Our View in August

August 10, 2021

Recovery ahead

Companies are reporting results above projections, but are trying to steer investors' expectations in a more realistic direction. Most markets have weathered this well so far, as well as uncertainty about regulatory intervention in China or higher inflation rates. This shows: The economic recovery is on track despite stumbling blocks.

One number, and everything is different. The monthly US nonfarm payrolls showed a rapid increase in jobs in July and pushed the unemployment rate down by half a percentage point to 5.4 %. Investors found this such good news that they suddenly forgot concerns about economic risks. At least that is what the immediate market reaction suggests.

In situations like these, it is worthwhile not to get caught by the hectic pace of the markets. For the risks have not simply disappeared. Nor have we thrown away our "green recovery" scenario because of this news. In our view, the recovery remains on track.

The equity markets may continue to rise in this environment, even if the air has become thinner in terms of valuations. We interpret the resilience of recent weeks as a good sign and remain invested according to the strategic allocation. On a regional level, we continue to prefer Europe.

In our view, the decline in bond yields is only temporary. The positive economic outlook and the signals of the US Federal Reserve to reduce securities purchases speak for rising yields in the coming months. Therefore, we remain underweight in government bonds.

However, after the recent price decline, we are increasing the gold allocation. We appreciate not only the diversification properties of gold, but also see the gold price well supported by negative real interest rates and a weak dollar in the longer term.

Dr. Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- **Economic recovery** on track
- **Europe** is favourite among equity markets
- **Chinese bonds** as a supplement
- **Gold** for diversification

- Risk of **interest rate rises**
- High **stock market valuations**
- Uncertainty around **China** following growth figures and regulatory intervention

● ● ● ● ●	strong overweight
● ● ● ○ ○	neutral
● ○ ○ ○ ○	strong underweight

Base: mandate CHF balanced

Money market	● ● ● ● ○
Bonds	● ○ ○ ○ ○
• Government Bonds	● ○ ○ ○ ○
• Corporate Bonds	● ● ● ○ ○
• USD bonds	● ● ● ○ ○
• Emerging Markets	● ● ● ○ ○
Equities	● ● ● ○ ○
• Switzerland	● ● ● ○ ○
• Europe	● ● ● ● ○
• USA	● ● ● ○ ○
• Japan	● ● ● ○ ○
• Emerging Markets	● ● ● ○ ○
• Themes	● ● ○ ○ ○
Alternative Assets	● ● ● ● ○
• Hedge funds	● ● ● ○ ○
• ILS	● ● ● ● ○
• Convertible Bonds	● ● ● ○ ○
• Gold	● ● ● ● ○

Our View on the **Economy**

- **Services sector** benefits from catch-up demand
- **Economic recovery** intact
- Central banks keep their **expansionary monetary policy** stance for now

- **Supply shortages** slow economic recovery
- Delta variant of the Coronavirus makes travel **restrictions** necessary again
- A return to normality will not stop the **industrial sector but it will slow it down**

The two main risks are back

Two possible bumps for the recovery are reappearing. One is the increasing number of Coronavirus cases. The rapid spread of the Delta variant calls once again for restrictions, especially in travel. On the other hand, the shortage of certain goods continues to weigh on the manufacturing sector. The lack of semiconductors in particular does not seem to be quickly resolved. It seems to be more a structural phenomenon than a temporary one. Against this backdrop, it is no wonder that early economic indicators are giving way – although at high levels. In the autumn and winter months we will see a return to a normal economic environment. Thus, the catch-up driven high growth rates of late will soon start to fade. However, the economic recovery is set to continue, as the risks of recession are currently low.

Our View on **Monetary Policy**

- **Fed prepares tapering**, but there will be no abrupt change of course
- **ECB has launched its new monetary policy strategy** and makes clear that there will be no rate hikes for the foreseeable future

- Difficult discussion about the right amount of **monetary policy measure** intensifies
- The monetary policy shift could lead to **rising nervousness** in financial markets

Fed starts to prepare tapering

The U.S. central bank, the Fed, has recently held back on monetary policy readjustments. However, policy makers announced that they had come closer to reaching the goals of price stability and maximum employment. At the same time, this means that tapering, i.e. a reduction in securities purchases, is getting a little closer. According to Fed Chairman Jerome Powell, the members of the Open Market Committee have been looking very specifically at exit options. It is thus clear that the course has been set for an end to the ultra-expansive monetary policy. But it will probably be several months before the Fed actually starts tapering. The end of the year could be a likely starting point for the reduction of securities purchases.

Our View on **Government Bonds**

●○○○○
strong underweight

- **ECB** makes clear that it does not move away from **ultra-expansive monetary policy**
- **In the eurozone,** ECB purchases **benefit** peripheral bonds

- Fed opens door to **tapering bond purchases** in the second half of 2021
- **Rising public debt will weigh** on government debt ratings
- Government bonds come with a **high interest rate risk**

Yields in retreat

Recently, the yields on government bonds on both sides of the Atlantic have been mostly declining. In the government bond markets, the economic recovery seems not to be trusted completely. At the same time, fears of a sustained rise in inflation appear to have subsided. The picture of a temporary rise in inflation drawn by central banks is now widely accepted. If the economic recovery continues over the next two years, there is little doubt in our view that yields will be on the way to higher levels. After the rapid rise on the long end of the interest rate curve earlier this year, the current consolidation has been strong, but not unusual. As we stick to our positive outlook for the economic recovery, we continue to expect higher yields going forward.

Our View on **Corporate Bonds**

neutral

- Monetary policy normalisation **cannot be easily implemented**
- The ECB clarifies that ultra-expansionary **monetary policy will stay even longer**

- Fed mentions November as a possible date for **first tapering**
- Returning to a normalised monetary policy **threatens losses from higher spreads and higher returns**
- Corporate bonds are exposed to **increased interest rate risk** (duration) due to low interest rate level

Topsy-turvy world: yields down, spreads up

The Fed is preparing markets for the eventual reduction of bond purchases (tapering). This would be a first step towards normalising monetary policy. Typically, credit spreads fall during an economic recovery while government bond yields rise. At the moment, however, it is exactly the opposite: If the Fed withdraws and allows markets to take over again, bond prices should move to the fundamental value. In the case of spreads, a compensation of 2 to 3 percentage points above the current level would be appropriate. For government bonds, too, higher yields would be justified given the inflation concerns. A withdrawal by the Fed would thus be a double whammy for corporate bonds. But whether the Fed can implement its plan will depend on how markets are responding. Market turmoil could quickly lead to a re-evaluation by the Fed.

Our View on **Equities**

neutral

- **Full order books** in manufacturing sector
- **Low interest rate environment** continues to support equity markets
- **Very good earnings** in the first half provide a solid basis for the rest of the year

- **Regulatory action** leads to **price corrections** in the Chinese stock market
- High **fundamental valuations**
- Expect **lower earnings growth** in the second half

Strong equity markets, but the air is getting thinner

Equity markets in the US and Europe have so far been relatively unphased by a more difficult business environment. Supply bottlenecks and cost pressure are the most important factors when assessing the outlook for corporate earnings in the second half of the year. Earnings growth rates are no longer supported by base effects when compared to the previous year. While the manufacturing sector enjoys full order books, specially hard-hit industries such as aviation, gastronomy, hotels and tourism remain under stress. However, the strong performance of equity markets have driven valuations higher. These are also challenged by the homemade correction of Chinese equities. Accordingly, we see elevated risks for higher short-term volatiliy in other markets as well.

Our View on **US Equities**

neutral

- **Strong economic growth** with an increasingly better looking labour market
- Senate has passed the **important stimulus package** by US President Joe Biden

- **High fundamental valuations** reduce risk premia for investors
- **Earnings growth** of technology sector slowing
- **Relative attractiveness** compared to other regions sinks

Looking for added value

The US equity market has been driven to new highs by strong earnings growth. The fundamental valuation stands at extreme levels, which, without an additional acceleration in corporate profits, increases short-term risks. The most important driver of the market, the technology-driven growth segment, is experiencing increasing resistance for various reasons (such as taxes and antitrust discussions). Cost pressures and increased investment expenditure suggest a slowing earnings growth in the second half of the year. This leads to a situation where risk premiums in other regions such as Europe appear more attractive for investors.

Our View on **Alternative Investments - Gold**

overweight

- Price weakness and expensive stock markets **justify higher weight**
- **Central bank purchases** support demand
- Low interest rates provide **opportunity dividend**
- **Protection** against higher inflation rates

- **Stronger USD** reduces purchasing power
- **Headwinds** if bond yields rise
- Prospects for **more restrictive monetary policy** have a negative effect

The dollar as a spoiler

Just like the half-year results currently determine what is happening in the stock markets, the latest World Gold Council report shows the trend in gold demand. It has remained stable year-on-year thanks to the recovery in the jewellery sector and higher central bank purchases. The price of gold itself recently benefited only to a limited extent from lower yields. For in periods of higher inflation and the prospect of a more restrictive monetary policy, the US dollar takes the lead. The stronger greenback reduces purchasing power and thus holds back gold. But the current level of yields argues for higher gold prices and so we see the latest sell-off as a buying opportunity to increase protection in the portfolio with a view to high valuations in the equity markets and risks of a setback.

Our View on **Currencies**

- **Defensive currencies** are currently in demand, including the **USD**, the **CHF** and the **EUR**
- The **EUR** has weakened against the **CHF** and **USD**, but is stronger against most other currencies

- **High-beta currencies like the SEK,** which sensitively react to risk-on and risk-off, currently lose
- **Emerging market currencies** are currently not able to strengthen against the leading currencies

No weakness of the greenback for the time being

When economic risks return to the fore, defensive currencies are in demand. These include in particular the US dollar and the Swiss franc, but also the euro. Within this triangle, preference is given to the US dollar and the franc. Risk-sensitive foreign currencies lose against these three currencies. So emerging market currencies, as well as the Swedish krona or the Australian dollar, are experiencing weakness. As long as the global recovery continues in the medium to long term, the current period is only an intermezzo in a broader trend that speaks for a weaker dollar.

Authors and Disclaimer

Authors:

Dr Felix Brill, Dr Thomas Gitzel, Bernhard Allgäuer, Harald Brandl, Jérôme Mäser