Our View on **2021**

10 December, 2020

VP BANK

With confidence into the new year

If one were to look at the current state of the equity markets, one might think that the Corona pandemic was just a bad dream. Even if some expectations of a normalisation seem exaggerated, there are good reasons to look to 2021 with optimism.

The progress in vaccine development and vaccination programmes gives confidence that the corona pandemic is under control in a sustainable way. It is true that life and economic development will be dominated by tightened lockdown measures in the short term. At the same time, however, there are signs that the economy will gain momentum in the course of 2021. The economic recovery will be supported by investments in the green economy. Governments are setting the pace in this respect. Climate protection is at the top of the agenda of government investment programmes, and at the same time, incentives are being provided for the private sector.

In the past year, it has been surprising how quickly the equity markets were able to make up for the sharp slump in spring. Some indices, such as the S&P 500 in the US, have even reached record highs recently. However, due to the corona-induced collapse in corporate earnings equity valuations look rich. At the same time, however, the low bond yields ensure that equities continue to be in demand. In addition, the return to earnings growth in tandem with the economic recovery will provide positive momentum.

As the equity markets in 2020 have largely been driven by technology stocks, it is now important from a return potential view that the recovery broadens. The combination of economic stimuli and voluminous investment programmes in green technologies can be the trigger for this broadening (see the latest issue of Telescope).

(continued next page)

Based on this, we believe that equities have a higher return potential than bonds in the medium term, despite the recent rally. Accordingly, we have decided to increase the equity allocation in the investment strategy at the expense of the bond allocation (see Infobox).

While we are confident about the medium-term prospects, there is still a heightened level of uncertainty in the short term and thus the risk of temporary setbacks. It is therefore important to make the portfolio as resilient as possible.

Among other things, we rely on a mix of promising equity theme investments and systematic low-risk equity strategies. In a persistently low interest rate environment, broad diversification across alternative asset classes is also important to make the portfolio robust. In our view, gold and insurance-linked securities are particularly suitable.

Dr Felix Brill, **Chief Investment Officer**

Info

Adapting VP Bank's investment strategy

VP Bank's investment process draws a distinction between investment strategy and investment tactics. The Sstrategy is decided by the Investment Strategy Committee (ISC), which meets twice a year. Tactics are set by the Investment Tactics Committee (ITC), which usually meets on the second Tuesday of every month and also at other times in reaction to exceptional market developments. The results are published in the monthly publication "Our View" (which you read now). After the latest strategic review, the ISC has decided to raise the equity allocation in response to the high probability of an economic expansion and to reduce the bond allocation to take account of the low level of interest rates. In the equity sector, emphasis is placed on investment themes that address long-term trends. In the bond sector, interest rate sensitivity has been further reduced. At the same time the ISC has reaffirmed a supplementary positioning in alternative asset classes in order to optimise diversification. This makes the portfolio robust and more effectively shielded against unpleasant surprises. We are also consistently applying sustainability criteria. The new investment strategy will be implemented in wealth management mandates as per 1 January 2021.

Our View on the **Portfolio**

- Shortening the duration of the portfolio by means of an **increased cash ratio**
- Neutral weighting in **equities** with a focus on long-term trends
- **Gold** as insurance for the portfolio

- High interest-rate risk continues to make **government bonds** unattractive
- Worsening solvency burdens **corporate bonds and US dollar bonds**

● ● ● ● ●	Strong overweight
● ● ● ○ ○	neutral
● ○ ○ ○ ○	Strong underweight

Base: Mandate CHF balanced

Money market	● ● ● ● ○
Bonds	● ● ○ ○ ○
• Government bonds	● ○ ○ ○ ○
• Corporate bonds	● ● ○ ○ ○
• USD bonds	● ● ○ ○ ○
• Emerging markets	● ● ● ○ ○
Equities	● ● ● ○ ○
• Switzerland	● ● ● ○ ○
• Europe	● ● ● ○ ○
• USA	● ● ● ○ ○
• Pacific	● ● ● ○ ○
• Emerging markets	● ● ● ○ ○
• Themes	● ● ● ○ ○
Alternative assets	● ● ● ● ○
• Hedge funds	● ● ● ○ ○
• ILS	● ● ● ○ ○
• ABS	● ● ● ○ ○
• Convertible bonds	● ● ● ○ ○
• Gold	● ● ● ● ○

Our View on the **Economy**

- The distribution of a vaccine promises a gradual **return to normality** this year
- Low interest rates **help the construction industry**
- The public sector continues to provide **generous support**

- Due to the specificity of the Corona recession, **catch-up effects** are weaker than in normal recessions
- The recovery is hampered by **rising insolvency numbers**
- Little fiscal leeway after widening of **budget deficits**

2021: A shot in the arm to get back to normal

The widespread distribution of a vaccine against Covid-19 promises a gradual return to normality in 2021. But the virus will still make its mark on the economic development. Due to the steep economic downturn in 2020 and the resulting low base, annual growth rates will still be considerable. Growth beyond the basic statistical effect will on average be modest in 2021. This is due to the specificity of the Corona recession. Demand for durable consumer goods, such as computers and furniture was relatively robust even during the second quarter's economic slump. The sale of these items even grew strongly in the third quarter. This, however, reduces the usual catch-up effect in such products in the aftermath of a recession.

Our View on **Monetary Policy**

- The end of **loose monetary policy** is not yet in sight
- The US Fed could soon follow the European Central Bank (ECB) and announce **new measures**

- Monetary policy resources will be **limited** in the future
- Risk of **valuation bubbles** rising as central banks continue their ultra-expansive policy

Monetary policy will continue to support in 2021

Central banks are monitoring the economic situation closely going into the year end. The European Central Bank (ECB) will head into the new year with expanded bond purchase programmes and continues to be ready for a further increase in 2021. Similarly the situation in the US: The Fed will remain expansionary in 2021. So interest-rate hikes are off the table for the time being. The ECB will also present a revised monetary policy strategy in 2021. Expectations are that the ECB will set a framework as flexible as that of the Fed. The US central Bank recently said it will tolerate inflation rates of above 2% in the future. This should also be the case at the ECB in the coming years. The European monetary authorities will also push forward with the "Digital Euro" project. Not only commercial banks, but also businesses and households would be able to hold central bank money in digitised form.

Our View on **Government Bonds**

Strong underweight

- The European Central Bank (ECB)'s net volume of purchases **covers the net new issuance** of government bonds in 2021
- **Peripheral bonds** may benefit
- Government bonds **diversify** a portfolio

- Government bonds carry a **high interest rate risk**
- The **supply** of government bonds has increased enormously
- Rising public debt is likely to **worsen sovereign credit quality**

Slightly higher yields in the new year

The European Central Bank (ECB) is facing down significant increase in returns in the euro area with its Pandemic Emergency Purchase Program (PEPP). Markets can therefore count on the ECB to provide the necessary volumes of bond purchase so that average yield will not increase significantly. However, an increase in yields in 2021 should not be completely excluded. If herd immunity occurs in the second half of 2021, the economic recovery could take hold. In the US, inflation expectations are already at their long-term average. If the economic recovery strengthens in the second half of the year, the safe haven demand for government bonds will be less pronounced. Instead, market participants are likely to demand a higher inflation premium in line with inflation expectations.

Our View on **Corporate bonds**

underweight

- Central banks have unlimited means **to buy corporate bonds**
- The **low-interest-rate environment** is likely to continue for a long time to come
- Further **state aid** will be provided as necessary

- Fundamental data have **deteriorated** markedly due to the pandemic
- Credit rating downgrades have doubled in 2020 compared to the previous year and is expected to further increase in 2021
- Central bank support is possibly called into question as **inflation risks** rise.

2021: The awakening of the zombies

The deterioration in balance sheets has started a decade before the Corona pandemic. The latter has only accelerated the problem. Credit rating downgrades have reached a new record level, and more and more companies are unable to pay the interest with their cash flows. These so-called zombie companies are running out of time. Central banks are aware of the dangers posed by such firms. We expect central banks to allow only a controlled increase in the spread. High Yield would have a performance of -2.75% on a 75 base points increase per quarter. For investment grade bonds, 25 basis points per quarter would leave us with a performance of -1.88%. But, in the event of unexpectedly strong inflation readings, the central banks' room for manoeuvre might get tight.

Our View on **Emerging Market Bonds**

neutral

- The **interest-rate spread** over advanced economies makes emerging-market bonds attractive
- Emerging economies are attractive in **tandem** with good-quality government bonds and equities

- The **lack of tourism** in many emerging economies is reducing foreign-exchange earnings
- **Currency depreciations** increase debt burden in foreign currency
- The **risk of default** has increased due to the Corona crisis

Interest spread and risks in 2021 are balanced

The courageous intervention of the International Monetary Fund (IMF) with numerous aid programmes has prevented conflagration in emerging economies. The good performance of emerging market bonds is therefore largely down to the IMF's assistance. Because the Corona pandemic has caused massive economic damage in emerging economies and financial resources are scarce, a sustained recovery remains difficult for some time to come. Emerging market bonds denominated in US dollars now offer a yield of around 4% measured by a broad index. By historical standards, this seems small, given the current risk situation, but it is relatively large number relative to the yield of 0.94% on a 10-year US Treasury bond. In our view, the interest-rate spread and the risks are currently balanced, which is why we are neutral on emerging market bonds.

Our View on **Equities**

neutral

- **Vaccines** against Covid-19 will support economic recovery
- The **digital transformation** increases profit margins
- **Fiscal measures** continue to provide economic impetus in 2021

- Big **euphoria** in stock markets increases the risk of short-term price swings
- The world economy remains **dependent** on **state support** for the time being
- Rising public debt increases **credit risk**

2021 will be characterised by normalisation

Next year will be marked by economic normalisation. This should stabilise particularly affected regions and sectors. That is the reason why cyclical Europe and emerging economies are benefiting. This rotation into cyclical sectors is already underway, especially in the automotive, aviation and traditional retail sectors, where the strongest recovery impulses are expected. The much-discussed green recovery also advances digitisation, but infrastructure projects are mostly focused on climate change. Industrialised nations such as Europe, Japan, and the US have such knowledge. Economic pressures on emerging economies remain high. Asia is proving to be the strongest economic region, with China at its core.

Our View on **Equities Developed Markets**

neutral

- The global **focus on environmental sustainability** ensures high activity in developed countries
- Europe, Japan, and the US have high expertise in **infrastructure development**

- Economic recovery generates increasing **state dependence**
- Efficiency or **supply problems** in the distribution of the corona vaccine could make recovery more difficult

2021: The recovery is digital and green

Developed countries, but also China, are pushing toward environmental sustainability. In parallel, urbanisation worldwide is accelerating. This development is mainly focused on modernising the infrastructure. Europe, Japan, but also the US, have great expertise in this field. Europe alone is planning to mobilise EUR 430 bn annually in the next decade. During the same period, the United Nations shall pursue the implementation of its sustainable development goals, taking into account a financing requirement of USD 6.3 trillion. Industrialised countries are becoming more sustainable in the fast pace of digital development. An economic trend that not only has stabilising effects, but opens new and additional growth potential.

Our View on **Equities Emerging Markets**

neutral

- **China's new Five-Year-Plan** promotes quality growth and higher incomes. This is good for consumption and the transformation of the economy
- A **weaker US dollar** tends to favour emerging economies

- A strong focus on environmental sustainability accelerates the **decline in demand for oil**
- High indebtedness and too much focus on raw materials increase risks for **Latin America** and **EMEA regions**

2021: China passes the threshold

The focus on environmental sustainability requires a renewal of infrastructure. This leads to the expansion of digital infrastructure, building refurbishment or even the intensive development of renewable energies such as wind and solar parks. All this leads to a demand for the corresponding raw materials (including iron ore, sand, rare earths, copper, aluminium, etc.), with a recovery in the global economy also helping to stabilise oil prices. Nonetheless, blanket investment in emerging economies should be avoided. We expect China and the emerging Asian economies to continue to benefit more because of industrial balance, strong consumption trends, and the importance of digitisation. Despite a tactical recovery potential, we remain cautious on the regions that are heavily focused on oil production and export.

Our View on **Gold**

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overweight

- **Economic uncertainty** often translates into higher gold demand
- Low interest rates provide an **opportunity dividend**
- **Asset with diversification** properties in the portfolio

- The **flow** toward ETFs has slowed lately
- **Potential headwinds** if bond yields rise, the US dollar gains strength**,** or markets suffer liquidity shortages

Growing appetite for risk slows gold in new year

Lower net inflows into publicly traded gold funds and the rotation of equity markets into cyclical sectors have contributed to the last correction of gold prices. Despite this, jewellery demand in the main markets India and China recovered significantly. Under the assumption that, despite the recovery, geopolitical and economic uncertainties will also be a features of the new year, we hold on to our positive outlook for gold. The continuing low-interest-rate environment and longer-term inflation risks are helping. Gold is particularly suited to protect against currency devaluation and thus benefits from a weak US dollar and low interest rates.

Our View on **Convertible Bonds**

neutral

- Convertible bonds benefit from rising stock markets, but with **controlled risk**
- This **avoids** psychological errors such as panic sales
- Less pressure and stress on investing

- Performance since the spring has been the strongest in the history of convertible bonds. They are **no longer cheap.**
- The **credit risk** is also increased for convertible bonds due to Covid-19

Safe choice for uncertain times

Convertible bonds are the hidden winners of the Covid crisis. Even if to a lesser extent than equities, they also suffered devastating losses at the start of the crisis. Unlike normal bonds, they did not benefit directly from central bank bond purchases. And so at times their yield exceeded that of non-convertible bonds. In other words, the option to convert into equities was for free. But convertible bonds are no longer cheap. However, in uncertain times, they are a useful portfolio component. Because their losses are usually only about one-third of those of equities but they usually deliver two-thirds of the equity upside in recovery phases. That helps in two ways: First, thanks to the lower volatility, investors are less tempted to lose their nerves at a low point. Second, with smaller losses, investors are back in black more quickly.

Our View on **Hedge Funds**

neutral

- With hedge funds, or even regulated absolute return products, portfolios may be **more robust**
- Performance expectations are achievable when they are adjusted for each product.

- The **manager selection** is demanding
- **Costs** are often still (too) high
- **Measuring performance** is difficult

Uncorrelated into the New Year

Hedge funds have performed well over the past 12 months with a return of 6% (measured by the HFRX Global index). But this figure is not really meaningful for more than 15,000 managers and as many strategies. The risks involved and thus the performance dispersion is huge. A major driver of the performance was the trend in technology stocks strengthening with the Covid-19 pandemic. We generally advise against hedge fund strategies that are too market-dependent. We recommend strategies which have added value over the years and have proven to be uncorrelated (i.e. independent of the market). A performance of 6% is realistic in the next year, no matter what the technology driven Nasdaq index does.

Our View on **Insurance Linked Securities (ILS)**

neutral

- **Uncorrelated** to financial markets and economic situation
- **Higher premiums** after damage in the past
- Excellent **diversification**

- Exceptionally **severe natural disasters** can lead to large losses
- Do not benefit from post-**pandemic** recovery
- The greatest risk is a **hurricane** over Florida metropolis, e.g. Miami

Highest premiums in years

By the end of November, the 2020 hurricane season ended with a new record of 30 tropical storms and hurricanes. This is twice the long-term average, influenced by the La Niña phenomenon. Since 1851, however, there has been no upward trend in hurricanes that made landfall. Rather, the increase in the number has to do with better tracking methods of storms via satellites. And a storms often collapse within two days. After severe damage in previous years, 2020 was a favourable year in terms of underwriting. Nevertheless, premiums are at their highest level since 2012. In the past, years with increased premiums were followed by years of above-average strength in this asset class. The outlook for 2021 is therefore extremely positive. ILS is a perfect complement for almost any portfolio.

Our View on **Currencies**

- **EUR:** Benefits from the current market environment
- **GBP:** If a Brexit deal occurs, the pound will continue to rise
- **AUD:** Benefits from a better economic situation in China

- **USD:** A steeper US interest-rate curve speaks for continued Greenback depreciations
- The **Turkish lira** remains badly hit
- **CHF:** We expect a weaker franc against the euro

The Dollar Weakening in 2021

With the leap over the psychologically important level of 1.20, further potential for the world's most important currency pair EUR/USD is opening up from a market point of view. Also, from a purchasing-power-parity perspective, another weakness in the US dollar is justified. In addition: phases of economic recovery are accompanied by a weakness of the greenback. Low US interest rates, coupled with a long-standing good economic performance, always led the exchange-rate pair EUR/USD to airy heights in the past. EUR/USD quotes of 1.40 are highly likely in such phases. If such quotations are not on the agenda yet, then this consideration of the exchange rate should be kept in the mind.

Authors and Disclaimer

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