Our View in January

11 January 2022

VP BANK

Disquiet in the bond market

2021 was a fantastic year for equities. In the first few trading days of the new year, however, rising yields on US government bonds have weighed on stock markets. The question is how high yields will climb.

Yields on government bonds have risen worldwide since the beginning of the year. Those of the 10-year US treasuries climbed towards 1.80 %, after 1.51 % on the last day of December. The yield on Swiss government bonds managed to return to positive territory, showing the flip side of the price movement. Thanks to our strong underweight in government bonds, we were able to limit the negative impact of this movement on the portfolio.

Investments with a high duration, i.e. with a high interest rate sensitivity, are under pressure due to this rise in interest rates. In equities, this affected growth stocks in general and technology stocks in particular. Value stocks and minimum variance strategies, on the other hand, did well in the first few days of trading.

The rise in interest rates shows that the issue of inflation is far from off the table. Inflation rose again in many European countries in December and, according to the latest labour market data in the US, wages are now also climbing. This raises concerns that, at least in the US, the wage-price spiral has been set in motion.

This concern also resonates in the latest statements by representatives of the US Federal Reserve. That is why bond purchases have been cut back even faster since January and the first interest rate hike is expected as early as March. The Fed is therefore sending an unmistakable signal: they are ready.

With the Fed's clear message, the chances are good that inflation expectations will not get out of hand and that the situation on the stock markets will calm down. Against this background, we confirm our tactical positioning.

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

Our View on the **Portfolio**

- Companies' **order books** are well filled
- Market expectations reflect **high confidence in monetary policy**
- Important **inflation-driving factors lose** force in the coming months

- **Risk of a wage-price spiral** in the US has increased
- **Supply bottlenecks and the Omicron** wave slow down economic recovery
- Increased risk of **abrupt market reactions** due to adjustments in expectations

● ● ● ● ●	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	● ● ● ○ ○
• World and Themes	● ● ● ○ ○
Alternative Assets	● ● ● ● ○
• Hedge funds	● ● ● ○ ○
• ILS	● ● ● ● ○
• Convertible Bonds	● ● ● ○ ○
• Gold	● ● ● ○ ○

Our View on the **Economy**

- **Recovery scenario** remains intact
- If **material shortages** improve, we expect a **boom in the manufacturing sector**
- The creation of a climate-neutral economy speaks **for long-term growth**

- Material shortages **hold back economic growth** in the short term
- **Omicron variant slows** the economy
- **Central banks** may be overreacting because of increased inflationary risks

Two-pronged economic trend - once again

Things can happen more than once. And so the year begins with it a new wave of the coronavirus pandemic. The global number of new corona infections has reached levels not seen before because of the highly infectious Omicron variant. This will hurt the services sector, even without a government-imposed lockdown. Cautious consumers are putting a strain on the service industry. The winter months will be like a bumpy road economically at least. Declines in gross domestic product especially in emerging economies, but also in parts of the eurozone should be taken into account. However, the manufacturing industry should see a strong catch-up effect later this year. The year as a whole is expected to be positive from an economic point of view, despite the difficult start.

Our View on **Monetary policy**

- **Fed** reduces bond purchases earlier, without financial-market disruptions
- **ECB** signals that it **will not raise interest rates** for the time being
- **SNB** delays tighter monetary policy

- **High inflation rates** limit central banks' room for maneuver
- Unexpected policy moves by central banks could lead to **nervousness in financial markets**

Central banks press the button

The big central banks have made their moves before the end of the year. In the US, the Fed doubles the reduction in monthly asset purchases (tapering) from $15 billion to $30 billion as of January. The buying of securities will end in March, three months earlier than originally announced. While the accelerated tapering came only after strong hints from Fed Chairman Jerome Powell, the Fed's projected three interest-rate hikes in 2022 was a surprise.

The European Central Bank (ECB) is also reducing liquidity. The pandemic PEPP emergency purchase programme will be terminated in March. The remaining APP purchase programme will be increased from EUR 20 bn to EUR 40 bn for a short period, but the ECB is planning to end this programme as well. So monetary policy is becoming more restrictive on both sides of the Atlantic.

Our View on **Government bonds**

strong underweight

- Market expectations don't point to a **long cycle of** rising **policy interest rates**
- Government bonds diversify a portfolio

- The **Fed** reduces government bond purchases faster than originally announced
- The **ECB** will also reduce **asset purchases** in the face of increased inflation rates
- Government bonds come with a **high interest rate risk**

Yields characterised by market expectations

The Fed is expected to raise the federal funds rate three times by 25 basis points this year. Some members of the Federal Open Market Committee even consider a reduction of the balance sheet, according to the minutes of the December meeting. But even the prospect of a more restrictive monetary policy did not help US yields to far higher levels. Market participants are currently reluctant to send 10-year US government bonds to a 2 % yield. In interest rate markets, it is expected that rate hikes will end when the funds rate hits about 1.5 %. Unless market participants expect a longer-term policy rate hike cycle, the potential for significantly higher returns remains limited.

Our View on **Emerging market bonds**

neutral

- **Yield advantage** vis-à-vis developed countries supports asset class
- Higher commodity prices are helping **commodity exporters**
- **Chinese bonds** diversify emerging market holdings

- **Rising US bond yields** may hurt emerging-market bonds short-term
- High **political risks** in a number of emerging markets
- Long maturity of emerging market bonds mean **high interest-rate risks**

Turkey leaves its mark

The risk premia on hard-currency emerging market bonds against US or German government bonds have recently risen again. This is mainly due to the situation in Turkey. Despite an inflation rate of 36%, Turkey's central bank has recently lowered its policy rate. This leads to a massive loss of investor confidence and a marked weakening of the Turkish lira. This also increases the risks of default. Turkish government bonds denominated in US dollar or euro would fall. Because of the individual risks involved, investors are cautious about bond investments in all of the emerging markets space. We rely on the admixture of Chinese bonds in our emerging market holdings. Bonds issued by China show a much lower volatility and offer additional diversification.

Our View on **Equities**

overweight

- Companies have so far **successfully handled challenges** like supply bottlenecks and price increases so far
- Thanks to a **solid economic environment**, the market digested the end of the ultra-expansive monetary policy well

- **Declining liquidity** likely to be accompanied by **higher volatility**
- Optimistic market expectations, as seen in high valuations, leave **little room for disappointments**

Important weeks ahead

Investors are currently waiting for important signals on the price front, especially whether a trend reversal in inflation can be expected. The upcoming annual corporate earnings season is expected to provide further insight into how companies have managed to cope with the sharp rise in producer prices. So far, larger companies have mostly been successful in overcoming the numerous challenges. Shareholders can expect higher dividends and more share buybacks.

Major central banks are signalling to normalise their monetary policy. Given a positive economic outlook, expansionary fiscal policy and loose financing conditions, a normalisation is bearable by equity markets. Nevertheless, a less liquidity-driven market is likely to lead to higher price fluctuations.

Our View on **Emerging market equities**

neutral

- Strong recovery in corporate earnings and stagnating share prices lead to **more attractive valuations**
- **Rise in commodity prices** represents tail wind for raw material exporting nations

- **China's policy adjustment** unsettles investors
- **Inflation** is an even bigger issue for emerging markets than for industrialised countries and therefore **requires greater action**

China looms large

While equities from industrialised countries were able to make substantial gains in 2021, emerging markets treaded sideways. The index heavyweight China, which was the first country overcoming the pandemic economically, turned out to be a burdening factor.

The share price weakness primarily reflects the uncertainty of investors with regard to political and, in some cases, economic developments in China. Operationally, companies in emerging markets recorded even stronger growth than their peers in industrialised countries. From a valuation perspective, their attractiveness has thus increased.

Our View on **Alternative investments - Hedge funds**

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neutral

- Hedge funds **are gaining importance in the portfolio context**, also because bonds have become more risky
- The **selection** of managers and hedge fund segments should be based on **market correlation**

- The large mass of hedge funds is market dependent and **will lose if a stock market correction occurs**
- Especially for relative value strategies such as fixed income Arbitrage **event risk is elevated**
- Risky events could be **unexpected central bank decisions** which may cause massive losses

Good year for hedge funds

When the media is reporting on hedge funds, it is usually about a multi-billion-dollar collapse, as was the case with Archegos last spring. But 2021 was a successful year for the hedge fund universe as a whole. Thanks to 24 bn net new money, the total sum invested in hedge funds has risen to around 4,000 bn USD. The performance was respectable at 8.9%. But compared to 27% by the US stock market, the question remains how much of it was market-correlated (beta) and how much was market-independent (alpha). This will become clear only when equity markets record high losses. We therefore recommend strategies such as CTAs (managed futures) or Global Macro, which generally have a lower market dependency.

Our View on **Currencies**

- Defensive currencies such as **USD, CHF and EUR** are currently in demand
- **EUR** weaker against **CHF** and **USD**, but stronger against most other currencies

- **High-beta currencies** such as the SEK are losing in a risk-on and risk-off market
- **Emerging-market currencies** remain fragile

No great defense by the SNB

The Swiss franc has continued to gain strength against the euro. There was not a big fight from the Swiss National Bank (SNB). The SNB is currently tolerating further appreciation. If it did intervene, this would mean ultra-expansionary monetary policy. But the inflation rates Switzerland, too, speak against a too loose monetary policy. The Swiss franc is expected to remain well supported for the time being. A general change of direction of the euro is needed. In the medium term, we expect the euro to be strong against the US dollar. In this case, the EUR/CHF currency pair would also tend to rise.

Authors and Disclaimer

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