Our View in July

13 July 2021

Economic risks have not disappeared

The vaccination campaign is making progress world-wide, now also in emerging countries. This takes some fear out of the delta variant of the Coronavirus. Nevertheless, economic risks are being discussed more intensively again. We are familiar with this: Even in summer, it's worth keeping an eye on the weather radar.

The US Federal Reserve is changing its tune to cautiously prepare the markets for a post-Corona world with less monetary stimulus. But instead of going up, yields came down. What seems surprising at first glance can, however, be explained. When the world's most important central bank pulls the lever, investors have to question their assumptions and expectations. What, for example, do the supply bottlenecks in the industry, the higher inflation or the threat of new restrictions due to the delta variant mean?

At the same time, economic indicators such as the ISM-index, which shows the business climate in the USA, weakened. This shows that there are risks to the upswing. Of course, they have always been there. But market psychology is such that risks are often ignored. Or, conversely, the focus is solely on risks.

The biggest pessimists have identified as a risk that the Fed could stall the economic upswing. In our view, this is not a scenario at present. We assume that investors will perhaps lower their expectations somewhat. But they should clearly expect the upswing to continue without ignoring the risks. That would be like a refreshing summer rain for the financial markets.

Our tactical investment allocation is geared towards recovery and is weatherproof at the same time. We have a neutral weight in equities, a strong underweight in bonds and an overweight in money market and alternative investments.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- Focused on **upswing**
- Overweight **European equities**
- **Alternative investments** as a way to diversify the portfolio
- **Chinese bonds** as portfolio supplement

- Current market phase harbors **increased risk of sentiment shifts** and abrupt price movements
- Government bonds on strong underweight due **to high duration risks**

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

Based on 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 effects
- Central banks remain on their expansionary **monetary policy course**

- A return to normality will not stop **industrial activity**, but slow its momentum
- **Shortage of input materials** in the manufacturing industry is a temporary economic burden
- Narrowing scope for **fiscal policy**

Normality returns, albeit slowly

With the population in the developed world increasingly immunised, social life is returning to normal. This has an impact on economic development. During the pandemic, the demand for services was reduced, but was strong for goods, such as electronic products or furniture. The main beneficiary of this extraordinary demand was China. It should therefore come as no surprise that the Chinese economy is now also baking smaller rolls. As a result, the global industrial economy is likely to lose some of its momentum. Instead, the hospitality industry is now benefiting. So it was the change in consumer behaviour that helped the manufacturing sector. Now we are gradually returning to economic normality.

Our View on **Monetary Policy**

- The need for expansionary monetary policy is declining thanks to the **economic recovery**
- Interest **rate hikes are not expected** for the time being

- The Fed is preparing markets for a somewhat **more restrictive stance**
- Difficult **discussion about the right monetary policy stimulus** intensifies
- The monetary policy shift could lead to **rising nervousness** in financial markets

Fed is looking for ways to exit

The Fed is striking a different tone. Markets are being prepared for a tighter monetary policy. The quarterly forecasts by Fed officials recently showed that 13 of the 18 are in favour of at least one rate hike until the end of 2023. In March, it was only seven. That means, the Fed is looking for a ways to end the expansionary monetary policy. Inflation rates are higher than originally expected. It is true that base effects play a role in this, i.e. the low base of the previous year as a comparison. But at the same time, the US economy is growing strongly. An ultra-expansionary monetary policy is no longer needed regardless of inflation. The now performing US economy no longer needs the Fed's money injections. In the coming months, the US central bank will therefore present a roadmap on how to reduce the asset purchases.

Our View on **Government Bonds**

strong underweight

- Central banks will act very **cautiously** when tightening monetary policy
- In the eurozone, **peripheral bonds** benefit from ECB purchases

- Continued recovery suggests a further **increase in yields**
- Rising public debt will weigh on **credit ratings** of sovereigns
- Government bonds present an **elevated interest rate risk**

Yields will rise again soon

The sharp drop in the yield on US government debt was one of the biggest surprises in financial markets in the last month. This is mainly due to the timing: Demand for US government securities rose just as the Fed's language changed and so prepared market participants for a more restrictive monetary policy in the future. But how does that go together? Some investors fear that the US monetary authorities will stifle the upswing with a tighter monetary policy. At the same time, some are concerned about the Chinese economy. The Chinese central bank is putting the brakes on lending. If the central banks of the two largest economic areas now being more restrictive, some market participants think, this could stall the economy. But despite all the justified concerns, the upswing is continuing and with it the rise in yields.

Our View on **Emerging Markets**

neutral

- **Yield advantage** vis-à-vis developed countries supports the asset class
- The **vaccination campaign** is now under way in the major emerging economies
- Higher oil and commodity prices help **commodity exporters**

- Emerging market bonds may suffer from a short-term **rise in US bond yields**
- High **political risks** in a number of emerging markets
- Long maturity of emerging-market bonds carries **high interest-rate risk**

Higher yield levels unfavourable

The vaccination campaign is also advancing in the major emerging economies. This promises a positive economic development. Moreover, if the global recovery persists, this would fundamentally be a good environment for emerging markets. However, risk premiums have increased only to a limited extent during the Corona pandemic. Meanwhile, the interest rate advantage of emerging market bonds denominated in US dollars is below pre-crisis levels. Emerging market US dollar bonds should, in our view, be an integral part of a well-diversified portfolio. We recommend to spread an investment broadly. We advise against individual risk in the form of investments in individual countries.

Note: More on emerging market economies and our assessment may be found in the latest issue of the investment magazine Telescope.

Our View on **Equities**

neutral

- **Results for the second quarter** should be positive
- Full order books and falling unemployment are signs of a **revival of consumption**

- Increased inflation and supply shortages squeeze **profit margins**
- Increased regulation by China has a negative impact on **Chinese stocks**
- High fundamental valuation in the US lowers **risk premia** even further

Tidal change in stock markets

Since March 2020, stock markets worldwide have been driven by the intensity of the reopenings or new lockdown measures. The strong recovery is now moving into a consolidation phase, with concerns that rising interest rates and increased inflation might stop the positive trend.
Further development will increasingly depend on the trend impulses now crystallizing and whether the resulting growth will offsets the higher costs. The outlook is very good, with government infrastructure projects to combat climate change playing a central role. The summer months thus become a tactical test for stock markets. Increased vigilance is required.

Our View on **European Equities**

overweight

- Competitive **European position** in sustainability technology
- **EU fiscal stimulus** especially for structurally weak regions
- The automotive market, which is important for Europe, has embraced **electromobility**

- **Export dependency** on China and the US
- Weak competitive position in the field of the **digital economy** which is important for the future
- Tough double act in **rebalancing industry** with regard to climate neutrality and digitisation

Europe is still our favourite

The price trend has recently lost momentum, while relative profit prospects have improved further. This combination of improved earnings expectations and stable price developments slightly improved the valuation measured by the price-earnings-ratio. The upcoming results for the second quarter will thus not only be a test of high expectations, but also a seismograph for the coming months. This is because a fourth wave of the Corona pandemic, expected by some, is closely watched to see how prevention will be organised. A renewed hard lockdown would certainly make markets much more nervous. The strategic setup of Europe is excellent. The high level of public climate investment will support businesses, especially from next year on. Setbacks would be a good opportunity for medium- to longer-term investors.

Our View on **Alternative Investments - ILS**

overweight

- Insurance-linked securities benefit from **rising interest rates**
- Strong **outperformance** compared to traditional bonds year-to-date
- **Higher insurance premiums** expected

- **Extreme events** cannot be predicted
- Relatively **expensive asset class**, as only accessible via collective investments
- **Product range** very wide from very defensive to highly speculative

The Hurricane season has started

Officially, the Atlantic season for hurricanes and tropical storms begins on June 1 and ends on November 30. Before it starts, the names of the storms are determined from A to W, the first one this year was called Ana, then came Bill. With Elsa, we are already registering the fifth storm, but the first of category 1 - a hurricane. Due to sea surface temperatures, 15-19 tropical storms, 7-9 normal hurricanes and 2-4 severe ones are forecast for this season. These storms will only affect insurers if the storm hits land, the country is populated, and insurance claims exist. ILS will only be affected if insurance companies have reinsured part of the risk. In addition, events will only be negative for the asset class should the damage exceed the premiums.

Our View on **Currencies**

- **USD:** The Fed signalling an exit from the ultra-lose monetary policy supports the USD for the time being
- **AUD:** Benefits from a better economic situation in China

- The **Turkish lira** remains weak
- **CHF:** We expect a weaker franc against the euro

No new weakness of the Greenback

The Fed's change in the wording made the US dollar gain some ground. Washington's monetary authorities are preparing markets for a change in monetary policy. The Fed is the first major central bank to signal that change. As the European Central Bank (ECB) will not follow this path so quickly, the greenback against the euro is likely to remain well supported for the time being. A rapid return to a weakness of the dollar is unlikely. This would probably require a clear recognition that the observed higher inflation rates are temporary, and that the Fed does not need to rush monetary tightening. If markets get their head around that, the longer-term weakness of the US dollar that we expect should continue.

Authors and Disclaimer

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