Our View in June

9 June 2020

VP BANK

Trust is good, caution even better

In the current crisis not only the central banks have intervened quickly, but also the governments. The financial markets have gratefully accepted the flood of liquidity and the economic stimulus packages.

In May and the first few days of June, stock markets around the world reacted to the announced Covid-19 support measures with profits and continued their recovery. The S&P 500 index is now trading at the same level as at the beginning of the year. This shows how much confidence investors have in the central banks. They seem to think that central banks won't let anything bad happen.

This confidence is also nourished by the fact that there are more and more signs of recovery in the leading economic indicators. Also, our VP Bank Corona Crisis Barometer has moved away from its low point and is showing sustained positive momentum. Does that mean the worst is already over? There are many indications that it is. But the path back to normality is still a long and hard one. A foretaste of this is provided by developments in China. After an initial strong revival, retail sales have improved only slightly of late.

As welcome as the latest development is, we caution against relying too heavily on the fact that the recovery will be without setbacks thanks to support from monetary and fiscal policy. As in social life, we believe it is advisable to continue to take certain precautions with regard to the portfolio. Sensible diversification helps to cushion any setbacks on the equity markets. On the equity side, we confirm our cautious tactical positioning. We are also hedging the US dollar completely again.

Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- Holding more **cash** than normal is an expression of caution
- A broad diversification is achieved with alternative investments, especially **gold**

- We see increased setback potential for **equities** in the short term
- **USD bonds** and **government bonds** bear increased interest rate risks

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

Base: Mandate CHF balanced

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

Our View on the **Economy**

- **Economic stimulus** packages offer confidence
- Central banks increase their **support**
- Economy frees itself from the **lockdown**

- **Insolvencies** cannot be prevented
- The record high level of public debt will constrain **fiscal policy** in the future
- **Monetary policy** is now limited

Economy picks up speed again

The global economy is still influenced by the corona pandemic. Although economic data are expected to improve considerably in the coming months following the easing measures now underway, there will be no rapid return to initial levels in the near future.

What remains is a deep crisis of confidence. Uncertainty about the future course of the virus and concerns about one's own health will continue to dampen consumer confidence for some time to come. China is currently experiencing this. Despite having overcome the first severe wave of infection, consumers in the Middle Kingdom remain cautious. Companies for their part are postponing investments. Although the economic stimulus packages worth billions may have a confidence-building effect, there is still some uncertainty.

Our View on **Monetary policy**

- Central banks **expand their** bond purchase programs
- Liquidity situation in **money markets** has improved considerably
- Fed and ECB **support** corporate lending

- **Arsenal** of central banks is limited in the future
- Zero and **negative interest rates** distort the price of risk for a long time to come
- Risk of renewed **price bubbles** in certain financial assets is high

Central banks are amending their buying volume

The European Central Bank (ECB) does not hesitate to improve its emergency measures. The pandemic emergency purchase programme (PEPP) will be increased by EUR 600 billion to EUR 1.35 trillion. The bond purchases will now be extended until at least June 2021. Originally, the PEPP should have ended at the end of 2020. In addition, funds from maturing bonds already held by the ECB will be reinvested until at least the end of 2022. In view of a massive economic slump, rising unemployment rates and an inflation rate that was too low, the ECB felt compelled to make improvements. If necessary, the US Federal Reserve is also likely to increase the volume of its credit vehicles, which were set up in response to the Corona crisis.

Our View on **Government Bonds**

Strong underweight

- Elevated **uncertainty** among investors helps government bonds
- Rising supply meets **higher demand**
- Government bonds serve as a counterbalance for any setbacks in equities

- Rising public debt leads to **downgrades**
- Government bonds carry a **high interest rate risk**

No big swings expected

Government securities were in great demand at the beginning of the Corona crisis, but have recently lost some ground. In view of the massive increase in government debt and the low or even negative yield level, the risk/reward ratio is unfavourable from an investor's perspective.

On the positive side, however, it should be noted that government bonds play an important diversifying role in the portfolio. If equity markets were to suffer setbacks in the coming weeks, they would help to cushion the negative impact on the portfolio. Yet, in our view, this alone is not enough to compensate for the unfavourable risk/reward ratio. We are therefore maintaining our strong underweight of government bonds.

Our View on **Corporate bonds**

underweight

- Central banks perceived as **credible**
- Fiscal packages to support companies **will be increased** if necessary

- **Downgrades** and loan defaults are **numerous** and are only the beginning of a long series
- Only a V-shaped economic recovery will **prevent a solvency crisis**
- **Debt increases** in every scenario

Relaxed credit market

Never before have fundamental data and market prices been so far apart. In US investment-grade corporate bonds, only 12 companies were upgraded by Moody's and S&P in the second quarter, while 84 were downgraded. In the high-yield segment, the ratio was 30 to 773. It has never been worse.

Even defaults such as those of J.C. Penney (retail) or Hertz (car rental) do not seem to worry markets. That they are so relaxed is due to the credibility of the central bank. If one analyses the Fed's communication, its head Jerome Powell has gained credibility; it is higher than at any time since the era of Alan Greenspan. In view of the amount of money that central banks are using and the "whatever it takes" mentality, more and more are jumping on the bandwagon. In the short term, this strategy may work, but in the longer term this might go off the rails.

Our View on **Equities**

underweight

- Announced fiscal policy measures can **help** the real **economy to recover**
- The **telecommunications** sector shows high operational stability and continues to be **valued at a discount**

- **Not all government support** leads to better share prices in the long term
- **Restraint** towards companies that would be bankrupt without emergency loans

Quality comes first

The strong recovery of the stock markets signals that market participants are anticipating a strong economic upswing. The rescue packages launched by governments around the world, some of which have already been increased, have obviously nourished this expectation. The stock markets are also paying close attention to progress in the development of vaccines and medicines for severe Covid diseases.

However, as positive as the stock markets have been in recent weeks, it is also clear that hopes of a rapid economic recovery or the hope of finding a vaccine may be disappointed again. In our view, at any rate, the risk of short-term setbacks has increased after the strong price recovery. In this environment, we underweight equities on the one hand and focus on quality in our selection on the other.

Our view on **Emerging market equities**

neutral

- **China** is weathering the current economic crisis better than international competitors
- **South Korea**'s positioning with regard to future industrial and technological trends is very promising

- China's stronger influence on **Hong Kong** may have a negative impact on the structure of the capital market there. Attention should also be paid to **Taiwan**.
- The corona crisis is extremely damaging to **India**'s economy, and the downgrading of government bonds is a clear warning

China at an advantage

The recovery in commodity markets has brought some relief in many emerging markets, but the warning lights are still on. This is because developing countries other than China generate about 47% of their earnings abroad. Chinese companies, on the other hand, generate 87% of their profits on the domestic market. The reason for this is that a high proportion of exports is generated by foreign companies. In an economic environment that will initially be characterized by the strengthening of domestic markets through fiscal policy measures, this must be kept firmly in mind. This is because investment spending will only leave the domestic economic zones to a limited extent. The main victims will be emerging markets and transatlantic alliances. A look at analysts' estimates for 2021 shows that higher earnings growth is expected for the USA and Europe than for emerging market regions.

Our View on **Insurance-linked securities (ILS)**

neutral

- Returns **independent** of financial markets and the economy
- **Higher premiums** after claims in the past
- Excellent **diversification**

- Exceptionally **severe natural disasters** can lead to high losses
- **Do not benefit from recovery** once the coronavirus is overcome
- The greatest risk is a **hurricane** over the metropolitan areas of the US state of Florida, for example Miami

Completely different risks

Whether the recovery of the economy following the Covid 19 wave takes the form of the letter V, U or L is not relevant for insurance-linked securities "ILS" or catastrophe bonds "CAT bonds".

What counts for them is primarily whether natural catastrophes occur and how these risks are compensated. The flight to liquidity has also led to outflows in this asset class. As a consequence, the declining risk capital has led to higher insurance premiums. Premium increases were particularly strong for Japanese hurricane risks. An above-average number of these had to be absorbed in the last two years. Hurricanes Hagibis and Faxai caused losses which statistically occur only once every 100 years.

Our View on **Currencies**

- **USD** does not yet show sustained weakness
- **CHF** still in demand as a safe haven for the time being
- **AUD** benefits from better economic situation in China

- **EUR** remains weak against the USD for the time being
- USD debt makes **emerging market currencies** vulnerable
- **TRY** and **ZAR** are particularly exposed to the risk of non-payment

Safe harbours losing somewhat

The risk-on mood on the financial markets has recently reduced demand for safe havens. The US dollar and the Swiss franc lost some of their gains. At the same time, high-beta currencies such as the Swedish or Norwegian krona appreciated. Emerging market currencies also benefited. However, the good mood among stock market participants is deceptive.

The economic situation will remain difficult for some time to come. It is doubtful that the strength of the safe havens will soon come to an end. Although a general change in direction for the US dollar is likely in the medium term, the ingredients for this are currently still missing. By contrast, the Australian Dollar could continue to profit from the better economic situation in China in the coming weeks.

Authors and disclaimer

Authors:

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