Our View in June

8 June 2021

VP BANK

Let summer begin

With high vaccination rates and restaurants open, the next phase of the post-pandemic recovery has begun. As welcome as this development is, it is causing headaches for the central banks in the advanced economies. Can they manage an orderly exit of their extraordinary monetary policy?

The economic recovery is in full swing. While the industrial sector was the first to come back, service companies are now also reporting a strong revival. This has a lot to do with the vaccination programmes, where Europe has been able to catch up in recent weeks. Restaurants and hotels can open again, sports studios may receive guests. And especially with a view to the summer holidays, the travel industry can look forward to more bookings. The revival of the service sector comes just at the right time, as industry is experiencing supply bottlenecks despite full order books. The economic outlook for the next few months is therefore very good overall. The supply bottlenecks are temporary and will not endanger the recovery in our view.

This challenges the central banks in the US and Europe to think about their emergency bond purchases. If they too conclude that the recovery can stand on its own two feet, they will have to rein in their activities. But wait: we are not talking about interest rate hikes, this is only about lower amounts spent on bond purchases. We expect plans to this effect to be announced in the second half of the year. Even then, monetary policy would remain very generous overall.

Our mandates are positioned for the recovery. Because these have traditionally been good times for emerging markets, we have decided to take a position in Chinese bonds.

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

Our View on the **Portfolio**

- Overweight in **money market** versus government bonds lowers duration
- **European equities** with the best starting point for the next upswing phase
- **Chinese** bonds as a promising addition to emerging market bonds

- **Government** bonds continue to face headwinds
- **Volatility** may increase when central banks communicate a change of their monetary policy stance

●●●●● 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**

- **Advances** in vaccinations in developed countries and falling incidence rates
- **Hotels and restaurants** benefit from relaxation of protection measures
- The public sector ready to **support**

- **Emerging economies** still suffer the consequence of the pandemic
- The **shortage** of **materials** in manufacturing industries is a temporary economic burden

Virus loses its economic horrors

The traffic lights for the economies in Europe and the US are green. Vaccination campaigns are at an advanced stage. In China, too, the number of daily applied vaccinations is increasing rapidly. Thus, there is hardly any obstacle to a return to normality. Even the difficulties with the shortage of materials are becoming less of an issue, as the service sector and the leisure sector, especially the hotels and restaurants, are opening again. The virus, however, remains a burden for many emerging economies. In a number of them, the vaccination campaign is not progressing as desired. But the accelerating economic recovery in the advanced economies is a good sign for emerging economies.

Our View on **Monetary Policy**

- Loose monetary policy **less required** in the face of economic recovery
- Central banks will **stick to their policies** for the time being

- **Maximum of expansionary** monetary policy is behind us
- Discussions about the **right course of action for monetary policy**
- Elevated risk of an **abrupt yield increase** at the long end of the interest rate curve

Central banks think about phasing out

Central banks have also taken notice of the fact, that negative economic effects caused by the pandemic are diminishing or even turning into positive effects. This will put the central banks' emergency asset buying schemes to the test. It is quite clear that neither the Federal Reserve nor the European Central Bank (ECB) want to make an all-too-jerky monetary-policy shift - after all, they don't want to jeopardise the recovery. Nevertheless, it is likely that central bankers are brooding behind closed doors about how to make a reduction in monthly asset purchases palatable to markets. And yet, financial market participants anticipate that the flood of money cannot last forever. A reduction in asset purchases is therefore unlikely to trigger major market shocks.

Our View on **Government Bonds**

strong underweight

- The ECB's net buying volume covers the net offer of government bonds in 2021
- **Peripheral eurobonds** may benefit

- **Supply of government bonds** has increased enormously
- Rising public debt levels are likely to **weigh on sovereign ratings**
- Government bonds carry **high interest rate risk**

Yields on an upward journey in Europe

The most interesting development in the sovereign debt market has recently been observed in Europe. While long-running US government bonds traded sideways, German Bunds and Swiss Bonds lost. So European sovereign bonds startet a life on their own, without being too dependent on their US counterparts. The well-running vaccination campaign and low incidence levels allow for a wide-ranging opening in the services sector. Growth is thus gaining momentum. Financial markets are increasingly questioning whether the European Central Bank (ECB) pandemic emergency programme still fits this reality. The lower negative interest rates at the long end of the German Bund curve thus reflect a slightly more restrictive ECB in part. In our view, the way forward is mapped out. German Bunds, as well as 10year Swiss sovereigns, will be heading towards a yield of zero in the second half of the year.

Our View on **Chinese Bonds**

new in the portfolio

- Attractive (real) **returns**
- **Diversification benefits**
- **Capital inflows** due to index inclusion

- Still a relatively **young market**
- **Geopolitical risks with link to China** for example Taiwan, Hong Kong, Trade, Climate Change
- **Currency risks**

China's Bond Market has awakened

At $27.2 trillion, China's bond market is the second largest behind the US (33.3 trillion USD). After a further liberalisation of the financial system in 2017, foreigners are allowed to invest unhindered in the local bond market. As a result, the most widely used indices such as Bloomberg Barclays, J.P. Morgan and, from October, FTSE, have all included Chinese bonds. According to some estimates, the FTSE inclusion alone will generate inflows of USD 110-170 bn. Unlike Europe and the US, the market offers positive real returns (return after inflation is deducted). China's 10-year government bonds are now yielding 3.5%, and the current inflation rate is around 1% (2.3% in the last 10 years). Compared to other bond markets, the correlation is extremely low, which is helpful in a portfolio context. The currency risk is particularly important for European investors because the renminbi is managed against the USD.

Our View on **Equities**

neutral

- EU countries will receive EUR 750 bn of **fiscal support** until 2023 which provides strong economic stimulus
- The fundamentals in **Europe** and **emerging economies** remain very attractive
- Convincing profit growth in **Japan**

- The US stock market is held back by consolidation in the **technology segment**
- Central banks' **expansionary monetary policy is tested** in the face of strong economic recovery

Stock markets in a finding process

The catch-up effect of the revival of the economy is likely to be largely priced in stock markets. The key question now is which industries are generating new, long-term trend-growth, and whether inflationary effects and higher capital costs (for example, through a more restrictive monetary policy) are more than compensated.

The answer is found in the fiscal measures on climate neutrality. Unlike monetary policy, these provide not just cheap money, but also new orders for the global economy. From this perspective, the current consolidation in markets represents a shift from rapid recovery to sustained trend growth. At the moment, in our view, Europe has the best starting point.

Our View on **Themes - China Consumer Basket**

●●●○○
included in the portfolio

- China's economy is growing more slowly, but gaining quality and achieving **global market leadership** in some segments
- China is the **most advanced** among emerging markets (71% of MSCI China is linked to digital economy)

- The **trade dispute** with the US remains a challenge
- China's **shrinking population** is limiting growth

Rising Prosperity

China's economy has benefited in recent quarters from an early easing of the Covid-19 related quarantine. The current slowdown in economic dynamics represents a transitional period. The road to higher quality growth is paved. The focus is on promoting climate neutrality by 2060, building local technology skills and promoting urbanisation. This enhances the quality of the labour market and promotes qualitative consumption growth which is also experiencing a more stable development as a result of the aging population structure. Quality of life and consumption will be more important for China's economic future.

Our View on **Alternative Investments - Gold**

neutral

- **Positive price momentum**
- **Net inflows into listed gold funds** after seven months with net outflows
- Low interest rates provide an **opportunity dividend**

- **Headwinds** if bond yields rise
- Discussion about **reducing central banks'** **bond purchases**

Monetary policy as a check on balance

After the gold price last broke the 200-day moving average, the mood brightened somewhat. After seven months of outflows, listed gold funds (ETFs) drew net inflows again. Driven by a weakening US dollar, continued stable real interest rates, and the collapse in crypto-market conditions, investors were again looking for gold. China is also coming back, because its central bank has allocated higher import quotas to commercial banks, reflected in higher gold imports. However, the upward trend in recent weeks may come to a sharp end if bond yields increase more than expected. Moreover, the discussions surrounding the retrenchment of central banks' bond purchases could weigh on gold prices in the coming months.

Our View on **Currencies**

- **EUR:** Strong economic data support the single currency
- **AUD:** Benefits from better economic situation in China

- **Emerging market currencies** benefit only partially from the weakness of the US dollar due to their underlying situation
- The **Turkish lira** remains weak
- **CHF:** We expect a weaker franc against the euro

More selective perception

When we talk about sideways markets, this is particularly true of the world's most important currency pair, the euro against the US dollar. There is currently a lack of impulse. It is well known that the recovery is gathering speed, as is the fact that central banks will lower their bond buying. After a period when markets rushed to positive news, things that were less obvious could now become the main interest. In the US, for example, the vaccination campaign is stalling, given the large number of non-vaccinators. Moreover, US President Joe Biden cannot convince the Republicans of his trillion-dollar infrastructure program. So it is conceivable that the US dollar might face headwinds in the short term because of adverse news.

Authors and Disclaimer

Authors:

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

Important legal advice