Our View in March

9 March 2021

VP BANK

Why rising interest rates are a good sign

The rise in interest rates in recent weeks has raised questions. Was the increase driven by growth optimism or inflation concerns? Are higher interest rates putting the brakes on the equity bull market? These questions will shape the discussions among investors in the coming weeks. In our view, the positive interpretation will prevail.

It can happen that quickly. In the US, yields on the10-year government bonds have risen to around 1.6 %. In August they were still at 0.6 %, a whole percentage point lower. Investors holding such securities in their portfolios have suffered losses as a consequence. In other currencies, interest rates for long-term bonds have also moved upwards, but the increase was more restrained. Thus, the difference between yields in dollars and those in euros and francs has increased.

The higher yields reflect on the one hand the spreading optimism about growth, which is particularly the case in the US. On the other hand, concerns about inflation have been given new impetus. In our view, however, the rise in inflation will only be temporary, as it is mainly driven by base effects with the oil price playing an important role in this. After the collapse a year ago, it is now higher than it was 12 months ago. However, by summer at the latest, these effects should fade out and inflation rates should fall again.

We believe that the inflation and interest rate discussions will not throw the equity markets off track. We therefore confirm our neutral positioning on equities. In the bond part of the portfolio, we are shifting into USD bonds at the expense of government bonds in the respective reference currency. This allows us to benefit from the higher yield in USD. In the case of the Swiss franc, the difference in 10-year bonds stands currently at around 1.8 percentage points.

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

Our View on the **Portfolio**

- Continued **risk appetite** thanks to growth optimism
- Increased yield differential makes **USD bonds** more attractive than CHF bonds
- **Insurance-linked securities** remain attractive even at higher interest rate levels

- **High duration** for Swiss and European government bonds
- **Sentiment indicators** signal short-term caution

● ● ● ● ●	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**

- **Vaccination** progress promises a return to normal life over the course of 2021
- The public sector is still prepared to provide **generous support**
- The low interest rate environment continues to strengthen the **construction industry**

- Due to the **special anatomy** of the Corona recession, catch-up effects are weaker
- **Fiscal policy** will be restricted in the future

The Atlantic Growth Difference

The growth gap between the eurozone and the US in the first quarter is striking. While on the other side of the atlantic the gross domestic product (GDP) can be expected to grow by more than 2% compared to the previous quarter, the euro area economy will once again decline. The containment measures will entail a contraction of GDP.

In China, too, the start of the year has been bumpy. The economic data was often weaker than expected. Recent outbreaks of Covid-19 have made it necessary for regional rigorous lockdowns in the Far East. So the Coronavirus still determines economic activity in much of the world. The situation will only improve in the second half of the year. The widespread distribution of vaccines allows for a sustained economic recovery.

Our View on **Monetary Policy**

- Less need for expansionary monetary policy **due to economic recovery**
- **Central banks** are in favour of maintaining their existing course

- The peak of expansionary monetary policy **has been reached**
- In the coming months, the debate on the **right monetary policy** is expected to intensify
- Risk of an **abrupt yield increase** at the long end of the interest-rate curve rises

Biden and Powell no longer complement each other

Financial markets are concerned about inflation. In our view, however, this fear is excessive. To be sure, inflation rates will rise significantly over the spring due to a range of corona-related special effects. But the biggest move should already be over by the summer. Central banks on both sides of the Atlantic will thus be looking through this period of short-term inflation. But the US Federal Reserve's stock purchases are different. The greater US President Joe Biden's fiscal stimulus, the less needed is the Fed's generous support. Fed Chair Jerome Powell and Biden are becoming reciprocal substitutes through their actions. Fiscal and monetary policy should no longer be seen as complementary. So the discussion about the beginning of the end of asset purchases has only just begun.

Our View on **Government Bonds**

strong underweight

- ECB's net purchases of government bonds **cover the net offer** in 2021
- Bonds from the **eurozone** may benefit

- Government bonds carry a **high interest rate risk**
- **Supply** of government bonds has risen enormously
- **Deterioration in sovereign ratings** likely due rising public debt

Increase in yields confirm the picture

The rise in long-term US government bond yields is now being viewed with concern in financial markets. But what we are seeing now is quite common. If policy (interest) rates are low and the economic traffic lights are on green, the need for safe havens will decline, and government bonds will lose value. In other words, the financial markets are turning into a "recovery" mode, which is generally positive. The difference between the 10-year US Treasury bonds and policy rates set by the Fed in 2009-2010 was for a long time more than three percentage points. At the time, the traffic lights turned green for the recovery. Looking at similar historic periods, the long-term interest-rates have always been sharply up after recessions. The movements may well be jumpy. This is precisely why we recommend a lower weight in sovereign bonds, with a preference for short duration at the same time.

Our View on **Emerging Market Bonds**

neutral

- **Yield advantage** over advanced countries supports asset class
- **International Monetary Fund** helps countries with various aid programs
- **Higher prices for commodities** such as oil help emerging commodity exporters

- Emerging market bonds may suffer for a short time from **the rise in US yields**
- Elevated **political risks** in a range of emerging markets
- Long duration of emerging market bonds carries **high interest-rate risk**

Higher yield levels unfavorable

Emerging market bonds have benefited since March 2020 compared to the sovereign debt of the major industrial nations. This was mainly due to the risk-on market environment. But the rise in US Treasury yields could become a stumbling block in the short term. While there is no statistically relevant effect in the long run between higher US yields and the risk premium of emerging-market bonds, there are short-term exceptions to this rule. The economic situation in many emerging economies remains critical due to the Corona pandemic. Higher yields do not fit such an environment. As a result, with rising levels at the long end of the interest-rate curve, emerging market bonds are unlikely to be able to continue their outperformance against US government debt.

Our View on **Equities**

neutral

- Strong and broadly based **economic growth** worldwide
- Attractive **financial market conditions**
- Lots of government support for regional economies

- **High valuations** of technology and trend stocks, especially **in the US and China**
- Short-term **negative sentiment indicators**

Tidal change

Fears of interest rates and of renewed economic restrictions due to coronavirus mutations have led to profit-taking. The focus is on growth and trend shares which have been up the most, as well as China, whose international benchmark index has already declined by 13% since 18 February. Increasing warning signals are coming from sentiment indicators. Fears of faster than expected rising interest rates, though, seem exaggerated. Because with every economic recovery, the cost of capital is normalised. Usually, the negative effects are compensated by higher earnings growth. But the transition to a stable period of growth is often rough. However, short-term setbacks would open up a good buying opportunities for medium- to long-term investors.

Our View on **Japanese Equities**

neutral

- Japan's economy recovers from the economic crisis with **great will for reforms**
- Very good market positioning worldwide in the field of **automation and electrical mobility**

- High proportion **of traditional industrial sector** focused on production
- **The age structure of society** hinders growth

Slow recovery

Japan's growth strategy, as in Europe, the US, or China, is strongly based on a green recovery. The focus is on digital transformation and reform for small and medium-sized enterprises. The reform package includes JPY 2 billion for decarbonisation, JPY 10 billion for digital transformation and a maximum JPY 100 million per medium-size enterprise for reform change. In doing so, the government in Japan aims to achieve future economic growth through industrial change. Japanese companies showed a strong recovery in profitability in the last quarter and this momentum is likely to continue. However, the obstacles to above-average growth are high. The pre-crisis surplus-production was too obvious. Investments will be less likely in the medium term, and there is (still) no clear commitment to the possibilities of digitisation.

Our View on **Alternative Investments - Convertible Bonds**

neutral

- Convertible bonds **benefit from rising stock markets,** but with controlled risk
- This helps **avoiding psychological pitfalls** like rushed selling

- The performance of the last 12 months has been the strongest in the history of convertible bonds, so they **are no longer cheap**
- Covid-19 **increases credit risk** for convertible bonds

Investing with Airbag

Corona vaccination will reach far more than the people in the risk segment in most countries during the summer. The question is now, whether monetary and fiscal stimulus is not too much of a good thing. The positive economic indicators, the strenghtening labor market and booming commodity markets are leading to discussions about inflation for the first time in a long time. A year ago, the yield on the US 10-year Treasury bonds was 0.5%, now is has reached 1.6%. During this time, convertible bonds increased by 68% despite the move in interest rates. However, we expect things on the rate front to calm down in the short run. The stock market should be able to live with slightly higher levels of interest rates, thanks to rising corporate profits. Convertible bonds are a good alternative, if things change. Investors participate in a positive market environment significantly more than in falling markets (see also investment ideas on convertible bonds - investing with airbag).

Our View on **Currencies**

- **USD:** The Greenback's depreciation speaks for a snapback in the short term
- **AUD:** Benefits from a better economic situation in China

- **Emerging-market currencies** benefit to a limited extent from the weakness of the US dollar due to challenging fundamentals
- The **Turkish lira** remains beaten down
- **CHF:** We expect a weaker franc against the euro

Swiss franc gives in

The Swiss franc has recently made a significant decline relative to the euro. This confirms our long-standing expectation of higher exchange rate for EUR/CHF. Demand for safe havens is falling. This is reflected not only at the long end of the yield curve with losses in long-term government bonds, but also in a weaker franc against the euro.

The Swiss franc is expected to become cheaper in the coming weeks. We expect prices of around 1.12 EUR/CHF. At the same time, the Swiss currency also gave in against the dollar. The Greenback went back above the 90 Rappen mark. The US currency is expected to be able to soar again after the sharp drop against the CHF over the past few months.

Authors and Disclaimer

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