Our View in November

9 November 2021

The Fed has learnt from the past

The Fed will start reducing its bond purchases in November. Anyone who was surprised by this must have been living in a filter bubble over the past few months. The markets were well prepared, and there were no major price movements.

Fed officials have been signalling the change in monetary policy for months in advance. Obviously, the people at the top have learned the right lessons from 2013. The then Fed Chairman Ben Bernanke had caught the markets on the wrong foot with his announcement that he wanted to reduce bond purchases. This ended up in an episode later named "taper tantrum".

Financial market participants also reacted calmly to the prospect of key interest rate hikes in the coming year, as expected by the Fed's governing body. Yields for shorter maturities of sovereign bonds rose sharply, but yields at the longer end of the yield curve fell slightly. This has flattened the curve, which in the past was often a signal of emerging concerns about a recession. This reflects the supply shortages in international trade, which have still not been resolved and thus increase short-term economic risks. But there are no widespread recession fears. Companies' order books are full and consumers are still confident and spend money. Therefore, we consider the flattening of the yield curve to be only a temporary phenomenon.

On the stock markets, too, the mood is anything but glum at the moment. The markets have recovered from their interim setback and a whole series of sentiment indicators show a renewed increase in risk appetite. This positive mood is fuelled by good to excellent company figures for the third quarter.

Against this backdrop, the Investment Committee has decided to stick to the current tactical positioning. In equities, we have a preference for the European market and for Chinese consumer stocks.

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

Our View on the **Portfolio**

- Companies' **financial results for the third** quarter support the stock market
- **Central bank communication** works
- **Chinese bonds** prove their worth in the portfolio

- **Flattening of the yield curve** as a risk signal
- **Emerging market currencies** still under pressure
- Recovery of the **Chinese stock market** is a long time coming

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

Base: mandate CHF balanced

Asset class	View
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**

- **Household consumption** supports growth
- Medium-term **recovery scenario** intact
- **Supply shortages** improves the economic outlook for 2022

- Supply **shortages to slow short-term growth** outlook
- **The next Corona infections wave**
- **Catch-up effects** in service sector are slowing

Difficult quarters ahead

The catch-up effects in the service sector are mostly over, so that the shortage of materials is now becoming more pronounced in the figures. This is aggravated by increased energy prices, especially for gas and electricity. For the Eurozone economy, fourth quarter growth is likely to be zero. A similar picture is emerging for the US economy. There, economic growth already weakened noticeably in the third quarter. The catch-up effects in the hotel and restaurant industry were already slowing, so that the shortage of materials became more apparent in late summer. The gross domestic product of the US grew by only 0.5 % compared to the previous quarter. However, if materials and intermediate products flow again in sufficient quantities, a strong upturn in industrial activity can be expected.

Our View on **Monetary Policy**

- **Fed** reduces bond purchases without triggering market disruptions
- **ECB** is signalling that **no rate hikes** occur in the foreseeable future

- Intensified discussions on **the right monetary policy**
- Unexpected harsh maneuvers by central banks could lead to **nervousness in financial markets**

Fed heralds the sea change in monetary policy

The Fed announced that it will reduce the pace of its bond purchases in November. They will be reduced by USD 15 bn a month. USD 10 bn less will be spent on government securities and USD 5 bn less on mortgage-backed securities. However, the Fed reserves the right to adjust the tapering depending on economic developments. The plan as it stands is to end the bond purchases by mid-2022. That would be faster than last time. The projections of the members of the Open Market Committee, last published in September, foresee a first interest rate hike as early as 2022. This would mean that the first rate hike would take place only a short time after the securities purchases will have stopped. Financial markets reacted calmly as these steps had been well communicated. If the Fed sticks to its timetable, monetary policy should not be a source of worry for markets for the time being.

Our View on **Government Bonds**

strong underweight

- **Supply shortages** are slowing economic growth in the short term, speaking **against an abrupt increase in yields**
- Government bonds **diversify** a portfolio

- **Fed** starts tapering monthly government bond purchases
- The **ECB will also have to reduce asset purchases** due to significant increase of the inflation rate
- Government bonds present a **high interest rate risk**

Inflation and economic risks in sync

Hardly any financial market segment currently shows the dichotomy between inflation and economic risks as well as government bonds. Due to a noticeable increase in inflation risks, long-dated government bonds should fall significantly. But the yield on 10-year US Treasuries recently fell below 1.60 %. The 2-year US government bonds, on the other hand, behaved quite differently: yields rose by a peak of 30 basis points in the period from September to October. This flattened the US yield curve. In the longer term, market participants seem to see economic risks. In fact, supply shortages create inflationary and economic risks in equal measure. If, on the other hand, the knot is untied in the flow of materials and goods, the situation will move in the opposite direction. The economy will pick up, which should push yields at the long end of the yield curve up again.

Our View on **Corporate Bonds**

- **Low interest rates will persist** even after the bond purchases by the Fed end next year
- In the foreseeable future, there is no increase in **credit losses** expected

- **Inflation risks,** especially when central banks misjudge the situation
- **Exogenous shocks** are not priced in at current risk premiums
- A **spillover of the turmoil in China** is not currently expected, but cannot be ruled out

Party continues despite slowing bond purchases

The US Federal Reserve reduces bond purchases (see Our View on Monetary Policy). Despite the tapering, a further USD 420 bn will be purchased until the end of the purchase programme by mid-2022, before the first interest rate cut is readied. The markets have been prepared for this scenario early enough and the news was warmly received.

The low interest rates are still favourable for companies next year. Looking ahead, credit defaults are expected to decrease and ratings to improve further. However, this also seems to be reflected in prices with extremely low credit spreads of below 3% for high yield. Price jumps upwards are therefore not to be expected, but losses due to exogenous shocks, for example due to the pandemic, an intensifying energy crisis or supply bottlenecks, are possible at any time.

Our View on **Equities**

- **Solid financial results** in the third quarter of 2021
- **High order intake and robust retail sector** support medium-term growth

- **Potential squeeze on profit margins** in the next quarters due to rising producer prices, energy costs and expected tax increases in the US
- **Speculative excesses in much sought after themes** such as electromobility and alternative fuels

Positive towards the end of the year

The solid financial results by companies in the third quarter gives the stock markets some breathing space at a high level. Many companies point to a more difficult environment in the coming months due to supply shortages, rising energy and production costs and higher wage costs. Nevertheless, the outlook remains at expected levels and is even being raised in some cases. However, market participants react sensitively to disappointments. This has led to a marked increase in the number of equities that suffered significant losses after their earnings statement. The air to the upside seems to be getting thinner overall. While the US market shows clear distortions, Europe and Japan offer more reasonable valuations. In both regions, the economic stimulus programmes for the coming years are having a supportive effect. This visibility is rewarded in uncertain times.

Our View on **European Equities**

- Climate action acts as a **stimulus**
- **Attractive valuations** when comparing countries and sectors
- **Italy and England** offer opportunities for investors focused on dividend returns

- **High export sensitivity** to emerging economies which face major **economic challenges**
- **Rising producer prices** and **supply shortages** have a dampening effect on sales and margins

Sustainably good

The high fundamental valuations of global equities partly mask the potential of European equities. With regard to the structural change of the industrial sector caused by climate policies, Europe offers the best public support package so far. This has already been adopted and is in the process of implementation. Especially for peripheral countries, this will lead to high economic impulses in the coming years. The fundamental valuation of European countries and the financial, automotive, industrial and energy sectors are moderate to attractive when compared globally. Despite supply bottlenecks and rising energy and labour costs, the low expectations of market participants for 2022 may well lead to positive surprises. The lights therefore remain green for Europe.

Our View on **Convertible Bonds**

- Convertible bonds benefit when **stock markets rise,** but with controlled risk
- **This avoids psychological errors** such as panic sales

- Convertible bonds are **no longer cheap** after an enormous performance since the outbreak of the pandemic
- Convertible bonds are often issued for **recapitalisation purposes**; a boom in large cap companies, for example, is missed

No longer cheap, but other advantages

Convertible bonds are the secret winners of the pandemic. Although to a lesser extent than equities, they also suffered significant losses at the beginning of the crisis (-1 6%). Equities lost more than twice as much. Since convertible bonds, unlike normal bonds, did not benefit directly from central bank purchase pro-grammes, their yield to maturity exceeded that of bonds without conversion rights. The option to convert them into shares was virtually free. So far, such a situation has only occurred once - at the height of the financial crisis in 2009. Now as then, this extreme situation proved to be a buying opportunity (performance since 45%).

And so convertible bonds are no longer cheap. Nevertheless, they are a sensible investment in uncertain times, as - according to the rule of thumb - they only participate to one-third in share prices in correction phases and to two-thirds in recovery phases.

Our View on **Currencies**

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

- **High-beta currencies like SEK** lose
- **Emerging market currencies** remain fragile, especially the **Turkish lira**

Dollar remains firm, emerging markets under pressure

In view of global uncertainties, supply bottlenecks and increased inflation risks, defensive currencies are in demand. The dollar is benefiting also because of the prospect of the Fed withdrawing from its expansionary monetary policy. If the global recovery continues, as we expect, we still expect a weaker US dollar in the medium to long term.

The Turkish lira once again received special attention. The currency is suffering from the interest rate cuts by the Turkish central bank. Instead of countering the increased inflationary pressure and the currency's weakness with interest rate hikes, the government is putting pressure on the central bank. President Recep Tayyip Erdogan is pushing for interest rate cuts to stimulate the economy. The loss of confidence will weigh heavily on the lira in the coming weeks.

Authors and Disclaimer

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