Our View in September

9. September 2020

VP BANK

A season with politics

The Corona pandemic is still preoccupying the world. Still, other topics are making it onto the front pages more often: Demonstrations in Belarus, the Brexit negotiations and of course the US presidential election. This autumn promises to be politically charged. Almost like in normal times.

Covid-19 infection rates continue to rise in Europe, especially in Spain. There, the second wave is now a reality, not just a fear. This is hitting the tourism industry hard, because it is destroying hopes of a sustainable recovery. Things are looking much better in other sectors. But the second wave means that many companies are entering the 2021 budgeting phase with a fair amount of uncertainty. Specifically, the owners and managers will ask themselves whether they can still exist after the state support will end and they will have to make staffing and investment decisions accordingly.

This is exacerbated by setbacks in the development of a vaccine. We therefore expect the corona pandemic to occupy us for a long time to come. Nevertheless, other issues have increasingly attracted the attention of the public and the financial markets. For example, the signals from the latest round of Brexit negotiations are worrying and the US presidential election campaign is coming to a head. The autumn could therefore become politically hot and difficult for investors to navigate.

This is exemplified by the recent development of the US Nasdaq index, which tracks technology stocks. After a long period of no holding back, it fell by 11% in just three days. Through our portfolio construction, we have ensured that such price movements have less impact. Overall, we remain cautiously positioned.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- The **economic recovery** is progressing despite all the uncertainty surrounding Covid-19
- Remain invested, but only with **certain precautions**
- Gold and insurance-linked securities increase portfolio stability

- The recent strong swings in **technology stocks** show that financial markets are not a one-way street
- European equities underperform relative to other regions
- Watch out for duration risks

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

Base: Mandate CHF balanced

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

Our View on the **Economy**

- **Strong growth rates** expected in the third quarter
- **Furlough money** in Europe and special government payments in the USA support private consumption

- **Rising number of insolvencies** could hamper recovery
- Fear of a **second wave of infections** could lead to new lockdown measures
- Budget deficits will **constrain fiscal policy** in the future

Fiscal measures remain an important support

In both the US and the eurozone, retail sales are back to their pre-Covid-19 levels in absolute terms. Government support measures, i.e. furlough money in Europe and special government payments in the USA, have prevented a long-lasting collapse in private consumption.

The economic damage caused by the Covid-19 pandemic is now most obvious in the industrial sector. Exports have hardly recovered so far and industrial production is also far below the levels recorded at the beginning of the year. This applies to almost all economies globally. The crisis is therefore far from over. The fiscal support measures merely mask the actual, difficult economic situation.

Our View on **Monetary Policy**

- Fed und ECB demonstrate **willingness to do more** if necessary
- The **«confidence» channel works**, central banks are still trusted

- Central banks must **think beyond** conventional tools
- Current **monetary policy** distorts the price of risk

Fed adopts new monetary policy strategy

In the future, the US Federal Reserve will no longer aim for an inflation rate of 2% at all times. Instead, it wants to achieve an average of 2% "over time". This means that inflation rates can remain above the 2% mark for a prolonged period without the Fed feeling compelled to act. It is thus possible that the currently very low inflation will be compensated over time with inflation running above 2%. This change in monetary policy strategy has no immediate consequences though. The US economy, severely battered by the corona pandemic, will continue to feel the pain from high unemployment for some time to come. And as long as wages do not rise, inflation rates will not go up significantly. In the longer term, therefore, US monetary policy should remain in a supportive mode even if the economy continues to recover.

Our View on **Government Bonds**

Strong underweight

- The economic consequences of the Covid-19 pandemic are not yet over which is **driving demand** for government bonds
- Government bonds contribute to portfolio **diversification**

- The **supply** of government bonds is increasing enormously
- Higher government debt will likely **trigger credit rating downgrades**
- Government bonds carry a **high interest rate risk**

New Fed strategy does not bode well for Treasuries

Government bond prices have hardly changed in recent months. On the one hand, the asset class remains in demand as a safe haven in view of the Covid-19-pandemic that has not yet been overcome. On the other hand, the record high volume issued prevents a further rise in prices. This bipolar situation is likely to continue for the time being. We continue to recommend to be cautious when buying government bonds. The US Federal Reserve has announced that it will tolerate inflation rates of over 2% in the future. If inflation rates were to be higher in the future and key interest rates to remain relatively low, government bonds would suffer as a result. This increases our concerns, especially since the risk-/reward ratio is already extremely unfavourable in the face of negative interest rates.

Our View on **Corporate Bonds**

underweight

- Central banks have unlimited ammunition and **can control markets at will**
- If necessary, **further support measures** can also be expected from fiscal policy

- The ratio of downgrades to upgrades of ratings is **extreme** and is not likely not change in the foreseeable future
- Covid-19 has led to **higher debt** while companies typically strengthen their balance sheets during recessions
- Fundamentally, the valuation of corporate bonds is **wrong**

The fed is the bull in a china shop

In June, Fed Chairman Jerome Powell said the Fed did not want to run around the bond market like a bull in a china shop, distorting market signals. But that is exactly what happened. Since March, the Fed has bought bonds for USD 2,900 bn. On the market for inflation-linked Treasuries (TIPS), break-even inflation rates have risen as a result of these purchases, although proven models do not indicate this development. The same applies to corporate bonds. Credit spreads are falling, although risk has increased. At 12.5%, S&P Global Ratings expects more credit defaults in the speculative area than during the financial crisis. Without the market distortion by the central bank, credit spreads would be two to three times higher. From a fundamental point, corporate bonds' valuation has probably never been so wrong as today. But because central banks have potentially unlimited funds, this is unlikely to change in the short term.

Our View on **Equities**

underweight

- Economic recovery **continues**
- Robust development of orders for **durable goods**

- **Euphoric sentiment** and significant increase in speculative market behaviour
- **Excessively high valuations** in the online retail and technology segment

A sector rotation likely

The US stock market has again outperformed the European one in recent weeks. However, the price rises in the USA are being driven by only a few stocks in the technology sector and online retail. Just how extreme the price rises were in some cases can be seen from the fact that this year's top performers would show an earnings yield of close to zero at current price levels in the year 2023. The strong recovery since March has thus already priced in much of the future potential. Against this backdrop, a sector rotation away from the hottest stocks into fundamentally strong stocks from more traditional sectors seems a likely scenario for the coming weeks. The slump in individual tech stocks over the past two weeks may have been a foretaste of this.

Our View on **Digital Transformation (equity theme)**

Included in the portfolio

- Significant **increase in online retail**, especially in food
- **5G equipment** will enhance demand for online services

- Heavy **price distortions** for companies in the electric mobility sector
- Shares of companies with medium growth record **disproportionately high price gains** (e.g. Apple)

Euphoria sets in

The Covid-19 crisis has proven to be a catalyst for digital transformation. We are focusing on online commerce, new forms of digital learning and the digital transformation in the health sector.

Internet security companies have also been in high demand in recent months, even if they have not been at the forefront of developments. Meanwhile, we are seeing the first price distortions in e-commerce. In our view, the potential in digital security, online education and the digital transformation of the healthcare industry is far from exhausted. Future price performance is likely to be somewhat lower due to the current euphoria, but the long-term trend remains unaffected.

Our View on **Insurance-Linked Securities**

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overweight

- **Independent** of financial markets and the economy
- **Higher premiums** following past claims
- Excellent **diversification**

- Exceptionally severe natural disasters can lead to **major losses**
- **Do not benefit** from recovery once the coronavirus has been overcome
- The **greatest risk is a hurricane** over Florida's major cities, e.g. Miami

The hurricane season has begun

The price of Insurance-linked securities' moves mostly independent of the real economy. The decisive factor is whether natural disasters occur and how these risks are compensated. Due to positive characteristics and the reach for yield by many investors, (too) much money flowed into this asset class in the past, which caused premiums to melt. This was partly compensated with higher risks. In the last two to three years, however, there has been an accumulation of severe natural disasters, which has spoiled investors' appetite. As a result, premiums have risen sharply this year and the asset class has performed very well so far. The decisive factor now will be whether there will be more cases of storms making landfall in the current hurricane season which lasts about until the end of November. Due to warm water temperatures and a La Niña warning, Colorado State University expects 12 Atlantic hurricanes. Four have already occurred so far.

Our View on **Currencies**

- **EUR:** EU reconstruction fund provides tailwind
- **CAD:** Benefiting from a weaker US dollar
- **AUD:** driven by improved economic situation in China

- The **US dollar** now also looks weak in the short term
- The **Turkish lira** remains under devaluation pressure.
- **Brexit** is coming to the fore again: the British pound is threatened by short-term setbacks

The Swiss franc is a welcome alternative

Although the euro has gained strength across the board since the beginning of the year, this is not true against the Swiss franc. The Swiss currency is still in demand as a safe haven. In a way, the franc is the "gold" of the currency markets. The sharp rise in the number of Covid-19 infections in Spain and France could make some investors doubt the future economic development in the common currency area. The Swiss franc is a welcome alternative in such an uncertain environment. However, the discrepancy between the broad euro development and the Swiss franc is now so large that somewhat higher levels of the EUR/CHF currency pair would actually be overdue in the short term.

Authors and Disclaimer

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Important legal advice