Our View in September

14 September 2021

Focus on China

The economic recovery globally is progressing despite persistent supply bottlenecks. At the same time, leading central banks are keeping a steady hand for now. However, equity investors are looking to China.

While the stock markets in the US, Europe and, above all, Japan continued to rise over the summer months, the Chinese market has been shaken up considerably. The political leadership in Beijing has caught many companies and investors on the wrong foot with drastic regulatory interventions. Technology companies such as Alibaba have lost ground, and only very few shares were able to withstand the downward pull. Measured by the index, the entire Chinese stock market has lagged the global market by around 40% this year.

We believe that now is a good time to add Chinese equities to the portfolio with moderation. However, we are not blindly betting on the entire market, but are concentrating on companies which are most likely to benefit from the new political goal of a fairer income distribution. These are especially companies in the consumer goods sector. On the other hand, those with monopolistic market positions, particularly in the technology sector, or companies in the real estate or oil sector are likely to remain under pressure. That is due to the threat of additional regulatory intervention or higher taxes.

On the other hand, we are halving our overweight in European equities. The European market has risen strongly since the beginning of the year. Although we still see potential for Europe, the outlook is not quite as good as it was a few months ago. This is because valuations have risen in line with the price development. Also, new travel restrictions due to the Corona pandemic threaten to slow down the economic momentum.

We are leaving the rest of the portfolio unchanged. We consider government bonds unattractive. Alternative investments such as gold and ILS remain interesting.

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

Our View on the **Portfolio**

- **Liquidity** helps reduce duration in the portfolio and creates flexibility
- **Chinese bonds** have proven their worth in recent weeks
- Positive outlook for **Chinese consumer stocks**

- **Government bonds** still carry a very high interest rate risk
- **Additional government intervention in China** cannot be ruled out

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	

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

Base: mandate CHF balanced

Our View on the **Economy**

- **US fiscal stimulus** supports the economy
- The **recovery scenario** remains intact
- Central banks remain on their **expansionary course** for the time being

- The **shortage of materials and pre-products** continues to slow economic recovery
- **Delta variant** of the Corona virus restricts travel again
- The catch-up in the **service sector is slowly running out**

Shortages hurt

Economic growth rates will be markedly lower in the fourth quarter. The catch-up effects in the service sector are now coming to an end, while the shortage of materials and goods as well as the logistical difficulties are a burden on the manufacturing industry. In the euro area, therefore, growth is expected to remain sluggish in the final quarter. In the third quarter, by contrast, catch-up effects generate sizeable growth rates. The situation in the US is different: There, a cooling is to be expected already in the current quarter. The rate of growth in the near future depends not least on the supply of materials and pre-products.

Our View on **Monetary Policy**

- **Fed is preparing to exit,** but there is no abrupt change in policy
- **ECB** makes clear that there will be **no rate hikes in the foreseeable future**

- Difficult discussion about **the right monetary policy measures** intensifies
- A change of direction in monetary policy could lead to **nervousness in financial markets**

ECB reduces bond purchases but does not taper

The European Central Bank (ECB) is currently on a tricky mission. On the one hand, economic catch-up dynamics are weakening somewhat, and on the other, inflationary risks are increasing. Taking both of these into account at the same time is a balancing act. It is difficult, but manageable, given the broad ECB toolkit. The ECB first picks the low-hanging fruits by slightly reducing the monthly volume of securities purchases. In the second quarter, it had increased its monthly sales volume, in order to counter a supply-implied increase in yields. In the third quarter, the maturities of European government bonds are lower, making the central bank feel secure and gradually reduce the purchases to the average monthly volume recorded in the first quarter. But this move is not the equivalent of tapering, as the US Federal Reserve intends.

Our View on **Government Bonds**

strong underweight

- Lack of goods and materials **hold back the economic development** and thus speaks against an abrupt increase in yields
- Government bonds **diversify the portfolio**

- **Fed** opens door for a gradual reduction in government bond purchases in the second half of the year
- The **ECB** will also reduce its asset purchases somewhat due to significantly higher inflation rates
- Government bonds carry a **high interest rate risk**

Yields to go higher again

In the eurozone, yields have recently increased markedly. The rise in inflation rates, although temporary in our view, and the prospect of the ECB's pandemic-emergency purchase programme (PEPP) expiring next year are reasons behind that. So financial markets are preparing for an adjustment of the monetary policy stance by the European Central Bank. Reducing the ultra-expansive monetary-policy, whether from the Fed, or from the ECB, brings with it the prospect of higher returns on both sides of the Atlantic. But, as business-cycle risks increase in the face of product shortages, markets will be cautious about selling government bonds early. The increase in yields is therefore unlikely to be as rapid as it was in the first half of 2021.

Our View on **Chinese Bonds**

Included in EM bonds

- Chinese government bonds **benefit from the uncertainty** in corporate bonds
- Government debt based on IMF data is below 50% of GDP and yet bonds are **yielding about the same as high yield**

- **Geopolitical tensions:** The Afghan failure has revived the Taiwan question
- Although the **renminbi** is relatively closely tied to the **US dollar**, there are currency risks, especially from a European perspective

China's Bubble deflated

China recognized years ago that part of its growth is based on debt that is unsustainable. Companies close to the state in particular, which had relied on an implicit government guarantee, piled up mountains of debt. Since 2018, China has been acting against the shadow banking system - which is still more than one trillion USD in volume. After the first default in 2014, credit defaults have stabilised at more than 100 in recent years. In recent months, several local government companies have come under pressure. The state refused to rescue them, sending a clear signal. One exception is China Huarong, which was rescued due to its size in August. The situation of China Evergrande, on the other hand, with more than USD 300 billion in debt, is unsolved. Chinese government bonds, which we consider attractive, stand to benefit from this uncertainty.

Our View on **Equities**

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neutral

- **Robust earnings growth** and continued support from monetary and fiscal policies
- Political change in **Japan** is accompanied by a relatively attractive fundamental assessment

- **Regulation in China burdens** local stock markets
- **Rising consumer prices** fuel fears of inflation

Change of favourites ahead?

Global equities continue to be driven by low yields. Inflation, which is still rising, is also causing stock markets' earnings yield to go into negative territory in line with bond markets. US equities are particularly expensive, where tech stocks again performed strongly in August and September. For eight out of ten sectors, the fundamental valuation is higher in the US than in Europe or Japan. Both of these markets are still attractive and have a very good starting position with regard to the transition to a climate-neutral industry. The high valuations in the US also make emerging market equities look attractive. The coming months are likely to remain interesting, but favourites will likely change.

Our View on **Chinese Equities**

Included in themes

- **The correction** has led to a significant cooling of fundamental valuations
- **New regulations** have the potential to improve the quality of the stock market and make future profits more stable

- **Regulatory measures** lead to lower productivity and **slow down the growth momentum** especially with regard to digitisation

A transition worth looking into

The Chinese stock market suffers from regulatory measures affecting almost all industrial and service sectors. Many of the measures concerning the influence of technology companies on young people and the use of private data address important issues that are also being discussed in Europe and the USA. Most affected are shareholders and entrepreneuers. The new order will lead to more diversified structures and forces companies to distribute profits more widely. While this lowers productivity, it increases added value. The resulting redistribution has a very high potential to favour consumer sectors for some time. While the consolidation seems to have not yet been completed, it is worth looking at consumer sectors.

Our View on **Alternative Investments - ILS**

- Big events like Ida often lead to **increased insurance demand**
- **ILS/Cat bonds** develop independently of the economy and provide **diversification**
- Asset class benefits from **rising money market rates**

- **Hurricanes** like Ida can sweep over metropolised areas and therefore lead to large losses **(Event Risk)**
- Because most cat bonds are placed in USD, **currency-hedged products** incur related cost

Hurricane Ida digested well

The Atlantic hurricane season lasts from June to the end of November, so we are already in the second half. At this point the models are much more reliable than at the beginning of the season. With 18 designated storms and 7 to 8 hurricanes, the current season is expected to be only marginally worse than the average of the last 25 years (16 storms/8 hurricanes). Most recently, hurricane Ida hit land at wind speeds of 243 km/h. It was Louisiana's strongest hurricane in 165 years. After a stretch of more than 1'000 Kilometers, Ida caused flooding even in New York. The initial estimates of USD 12-25 billion of damages can be well covered by ILS and do not yet lead to significant performance losses. But the true strength of the asset class will only become apparent as interest rates rise.

Our View on **Currencies**

- Defensive currencies **USD, CHF and EUR** in demand
- **EUR** is weaker than CHF and USD, but it is still stonger than most other currencies

- **High-beta currencies** like the SEK currently lose
- **Emerging-market currencies** can't stand up to major currencies

Pound: Welcome to Post-Brexit Reality

Britain is struggling with the consequences of Brexit. In supermarkets, shelves are partially empty and there is also a shortage of staff due to the decline of immigrated labour. Forex markets are now looking more closely at the post-corona reality. With economic pain, the prospect of further pound gains is dwindling. In our view, the 1.40 in the GBP/USD exchange rate is currently a cap. We do not think that a sustained appreciation of the British currency of more than 1.40 is likely at this time. On the other hand, statements by the Bank of England support the currency. A slight tightening of monetary policy over the next three years may be necessary. But an interest rate hike is not expected before 2023. In sum, we expect a sideways movement of the pound against the US dollar.

Authors and Disclaimer

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