Our View on 2022

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VP BANK

With optimism into the new year

The Omicron variant of the coronavirus has caused interim commotion on stock markets. An important reminder to pay attention to diversification in the portfolio even in good times. Despite short-term economic risks, we are generally optimistic for the new year.

So it does still exist: volatility in the stock markets. In recent months, one could get the impression that new risks and bad news were simply rolling off the prices. Inflation? A temporary problem. Supply bottlenecks? Passing. Change of course in monetary policy? Has been signalled well by the US Federal Reserve.

At any rate, it did nothing to dampen risk appetite. The price development speaks volumes. The US benchmark index S&P 500, for example, gained 25% between January and mid-November, i.e. before the slight setback, and the European Euro Stoxx 50 was not much behind with 23%. With the new Corona variant Omicron, this changed, at least in the short term. There were several daily losses, some of which exceeded 2%; volatility increased and several sentiment indicators reversed towards risk-off.

From our point of view, this is a good opportunity to increase the equity quota in the portfolio. Our economic outlook for 2022 is positive, despite short-term risks arising from corona-related constraints and the ongoing supply bottlenecks.

Against this backdrop, the earnings outlook for companies remains encouraging, which should provide the necessary underpinning for equity markets. In a regional comparison, we consider Europe to be the most attractive market.

On the other hand, we are closing the overweight position in gold. Gold remains an important strategic element to diversify the portfolio. However, there are currently no arguments for maintaining the tactical overweight.

Dr Felix Brill, **Chief Investment Officer**

Our View on the **Portfolio**

- Encouraging **economic outlook** for 2022
- **Central bank communication** works
- **European equities**
- **Insurance-linked securities**

- **Short-term cyclical risks** from new Coronavirus variant
- **Inflation** could prove more stubborn
- **Government bonds**

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

Base: mandate CHF balanced

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 2022: **Economy**

- Medium-term **recovery scenario** remains intact
- If the **shortage** of **materials** is resolved, we expect a boom in the manufacturing sector
- **Progression to a climate-neutral economy** speaks for long-term recovery

- **Material shortage** holds back economic recovery in the short term
- **Another wave of Covid infections** dampens economic development
- **Central banks** may be overreacting because of increased inflationary risks

Fairly good starting position

The economic outlook for 2022 is mostly favourable. The manufacturing industry on both sides of the Atlantic is sitting on a high mountain of orders and at the same time, inventories are empty. The reason for both is a shortage of materials. If raw materials and intermediate products flow again in sufficient quantities, a boom in the manufacturing sector is inevitable. At the same time, investment growth will be additionally fuelled by the transformation to a climate-neutral economy. The latter even speaks for a long-term upswing. But despite all the optimism, the short-term risks should not be neglected. Material shortages have not yet been eliminated and the coronavirus pandemic is raging with renewed strength. So while even a decline in economic output is possible in the short term, growth rates should soar when the flow of materials resumes.

Our View on 2022: **Monetary Policy**

- **Fed** reduces bond purchases without financial-market disruptions
- **ECB signals no rate hikes** in the foreseeable future
- **SNB** waits to tighten monetary policy

- Difficult discussion about **the right monetary policy measures** intensifies
- Unexpected sharp moves in policy could lead to **nervousness in financial markets**

Fed raises interest rates, ECB and SNB take their time

The monetary policy turnaround has already been initiated by a large number of central banks. In Europe, the central banks of Iceland, Poland, Russia, the Czech Republic, Romania and Hungary have raised their key interest rates. Meanwhile, the Federal Reserve may end its securities purchases more quickly than originally thought. Concerns are growing in the US about whether inflation rates might be more stubborn. To end the securities purchases earlier would enable the Fed to launch two more rate hikes next year. Meanwhile, the European Central Bank (ECB) and the Swiss National Bank (SNB) will take their time with the turnaround in key interest rates. As a first step, the ECB would have to discontinue its remaining securities purchases after the pandemic emergency purchase programme expires. It will take some time before the interest rate can be tightened.

Our View on 2022: **Government Bonds**

strong underweight

- **Material shortage** slows economic development and speaks against an abrupt increase in yields
- Government bonds **diversify** a portfolio

- **Fed** reduces government bond purchases progressively
- **ECB** likely to reduce asset purchases due to significantly higher inflation rates
- Government bonds are exposed to a **high interest rate risk**

Inflation and economic risks in sync

The Fed seems to have switched to alarm mode. The persistently high inflation rates are to be dealt with. To this end, the Fed will in all likelihood step up the pace of tapering its securities purchases. The aim is to be able to raise interest rates twice in the coming year. Interest rate hikes will only happen once the securities purchases have been discontinued completely. As a result, however, yields along the US yield curve and with them their European counterparts are likely to rise. The US yield curve will flatten, i.e. yields in the shorter maturity range will increase more strongly than for longer maturities. As the European Central Bank (ECB) and also the Swiss National Bank (SNB) show no willingness to raise interest rates in 2022, the shorter-dated government bond segment in Europe should prove relatively stable.

Our View on 2022: **Corporate Bonds**

neutral

- **Corporate balance sheets** improved during the pandemic
- **Low interest rate environment** preveails at least in the first half of 2022
- Constructive longer-term **economic outlook**

- **Credit default premia** price in only positive outcomes, no room for negative surprises
- If **central banks' inflation expectations** are not correct, significant losses must be expected
- **Yield pick-up** of corporate bonds can become a burden as interest rates rise

Stronger balance sheets thanks to Covid

Long before the Covid pandemic, the balance sheet quality of companies was deteriorating. This was part of the reason for the massive stimulus and central bank programmes. Combined with favourable financing conditions and pent-up economic demand, companies were able to gain financial health during the pandemic. The trend of credit rating upgrades outnumbering downgrades is likely to continue next year. However, this trend is already reflected in credit default premia. Especially in the second half of the year, when bond-buying programmes expire and maybe interest rate hikes are on the agenda, things are likely to become more unsettled. Risks from supply chains, an energy crisis or a persistently high inflation rate are not currently compensated for. The latter would narrow the central banks' room for maneuver.

Our View on 2022: **Equities**

overweight

- In some regions, **climate action investment programmes** are launched which benefit order books in **manufacturing sectors**
- **Robust earnings growth** supports dividends and share buybacks

- Global **minimum 15% tax** reduces profit prospects for US equities
- **Above-average price increases and rising wage costs** are squeezing margins

Déjà vu

The new Covid variant Omicron has again triggered a setback in the capital markets. The new variant has the potential to challenge the mostly linear approaches to fight Covid that have existed up to now and to provoke more progressive solutions. The re-orientation will be accompanied by uncertainties, although the robust economic environment continues to suggest a favourable environment for equities. Alongside accelerated digitisation, the ecological transformation of manufacturing industries is coming to the fore. Regions with fixed investment budgets such as Europe, Japan but also China are better off than regions where government support still seems vague. In order to be better prepared for higher price fluctuations, focus should be on fundamental quality.

Our View on 2022: **Equities Europe**

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overweight

- An **economic stimulus** of EUR 750 bn will mainly support smaller countries in the European Union
- **Low relative fundamental valuations** make the stock market attractive
- Above-average **dividend** which tend to continue to rise

- **Profitability** of European companies lags behind international competitors

Resilience pays off

Equities in Europe have been able to keep up well with the global equity markets in a more difficult market environment. This should also be the case in 2022. The robust economic development is more than supported by a historically large stimulus programme.

At the same time, the ecological transformation is renewing aging infrastructure. This not only enhances long-term value, but also increases profitability. The attractive fundamental valuations of equities in Europe do not reflect this potential. This is particularly true of countries such as Spain, Italy and Poland. European equities offer investors not only very good growth prospects but also above-average dividend yields.

Our View on 2022: **Equities USA**

neutral

- Leading position of the US in **digital transformation**
- Dynamic economic environment combined with **high profitability** underpins fundamental valuations

- **Very high valuations in key sectors** such as automotive, social media, industry and technology
- Introduction of the **global minimum tax** of 15% burdens profit prospects
- **Speculative activities** by US retail investors

Maturity test

US equities have delivered three times the total return of global equity markets since the technology trend began in 2012. Technological advantage and expansionary monetary and fiscal policies fuelled this development. China is emerging as a serious competitor to the US in this area, and both monetary policy and the tax regime in the US are likely to become more restrictive next year. Structurally rising wages are also putting pressure on margins. Although the growth outlook for US companies remains good, we expect 2022 to be more challenging for the equity market compared to other regions. While we have confirmed our neutral position, we are closely monitoring developments.

Our View on 2022: **Alternative Investments - ILS**

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overweight

- **Increased premia** expected after damages as in the past
- ILS move **independent** of financial markets and the economy
- Excellent **diversification qualities**

- **Exceptionally severe natural disasters** can lead to large losses
- Do not benefit from **post-pandemic recovery**
- The greatest risk is a **hurricane** over the Florida metropolitan areas, e.g. Miami

Climate-related inflation not forgotten

The Intergovernmental Panel on Climate Change (IPCC) is considered the gold standard in climate research. Its latest report states that the number of hurricanes will not increase in the coming decade, but their intensity will. A category 5 hurricane is 12 times more destructive compared to category 1, so insurance premia would have to increase by 1.35% to 2.5% p.a. to compensate for this effect.

Due to population growth, new construction development (especially in coastal regions), and inflation (wages and building materials), non-climate related demand for insurance is expected to increase by another 3.4% to 3.9% p.a.. This surge in demand coincides with a less extreme low-yield environment due to tapering. Reinsurance business in the form of insurance-linked securities is therefore likely to remain attractive.

Our View on 2022: **Alternative Inv. - Convertible Bonds**

neutral

- Convertible bonds benefit from **rising stock markets,** but with controlled risk
- Their **characteristics help avoid** psychological pitfalls like panic sales

- **Rising returns** lead to a higher bond floor
- Convertible bonds are often **issued by balance sheet restructuring** companies. An economic cooling may pull the **credit quality** down.

A favourable profile

Equity markets are at all-time highs, valuations are demanding. Money market yields are zero, even though the inflation rate in the US is over 6%. Investors who have invested over USD 4,500 bn in money market funds in the US alone are therefore losing purchasing power on a daily basis. Depending on whether higher prices lead to an economic slowdown or a wage price spiral, future price movements could be violent.

Convertible bonds are a sensible investment in these times. As a rule of thumb, they lose only one-third compared to stock prices during corrections and they win two-thirds during recoveries. This results in two advantages: First, thanks to the lower fluctuations, one is not tempted to lose one's nerve at the low point. Secondly, thanks to lower losses, they are recovered more quickly.

Our View on 2022: **Alternative Investments - Gold**

neutral

- **Protection** against higher inflation
- **Consumers and central banks** support demand
- Low interest rates provide an **opportunity dividend**

- **Stronger USD** reduces purchasing power
- Headwinds, **if bond yields rise**
- Prospects for **more restrictive monetary policy** have a damaging effect

Back to neutral

In contrast to industrial metals, gold fell short of expectations in the past year, which was characterized by an economic recovery and a general shortage of raw materials. Due to record low real interest rates and a strong US dollar, the gold price did not find a clear direction. Recently, outflows from listed gold funds have been limited. So far, inflation risks have not supported the price.

Despite a strong recovery, jewellery demand remains below pre-pandemic levels and thus has catch-up potential. Central banks are also likely to contribute to demand with additional purchases due to the strong rise in commodity prices. All in all, this argues for a neutral weighting of gold in the portfolio.

Our View on 2022: **Currencies**

- Defensive currencies such as **USD, CHF, EUR** are currently in demand
- **EUR** loses against CHF and USD but strengthens against most other currencies

- **High-beta currencies** such as the SEK lose in a of risk-on / risk-off environment
- **Emerging-market currencies** remain fragile

Dollar strong, EM currencies under pressure

The strength of the US dollar fits the current environment. Economic risks have increased in the near term due to material shortages. The renewed increase in Covid infections is also contributing to economic uncertainties. In addition, inflation rates continue to rise at a high level. This is a near-perfect environment for the dollar. However, when materials become available again in sufficient quantities, the whole situation will reverse, which should then lead to a devaluation. Meanwhile, the Swiss National Bank (SNB) is granting the franc further appreciation. Exchange rates below 1.05 against the euro are tolerated. A short-term appreciation should therefore be taken into account. However, if the global recovery continues, we expect a depreciation in the coming year.

Authors and Disclaimer

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