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Investment Policy

Q2 2021 | March 2021

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Key points

Implications of rising interest rates

Since Joe Biden's US election win last November, 10-year **sovereign yields** have risen 0.7 percentage points to 1.53% in USD. This uptick can be explained not only by hardening **inflation** expectations, up around half a point to 2.3%, but also by a 0.2 percentage point increase in **real** interest rates, still in negative territory at -0.7% (**Chart 1**). The trigger was confirmation of the $1.9trn US stimulus package, which comes on top of $2trn in March 2020 and $900bn in December, giving an unprecedented total equivalent to just over 20% of GDP.

The bond market is thus beginning to price in a very strong economic recovery, with price inflation also set to quicken. This is a fairly healthy development consistent with the expected improvement in economic fundamentals, affording the **Federal Reserve** some renewed flexibility. The Fed's role will be to cap this rise at what it judges to be the optimum level and, above all, to ensure that financial conditions remain accommodative. Its current silence appears to confirm that, for the time being, this level is not yet worrysome and its impact on the economy will be moderate.

While it is indeed too early to project an immediate impact on economic activity, the growth outlook continues to follow an upgrading trend, with the effects already visible in financial markets.

In bonds, the riskiest segment, **high-yield credit**, has been outperforming **investment-grade credit**, which in turn has been faring better than sovereign bonds: while the latter constitute the safest segment, they are currently struggling the most.

In **equities**, growth sectors, which benefited handsomely from the multi-year downtrend in interest rates, and defensive sectors, boosted by recent pandemic-related uncertainty, have been hit hardest. Conversely, cyclical stocks are riding the wave of the cyclical upturn and value stocks are being pushed higher by rising interest rates.

These trends look set to continue, albeit at a more modest pace. They penalise excessive caution; let's just hope they also reward risk-taking!

Scenario and conclusions

- Rate of **vaccination** is dictating pace of economic recovery
- Growth set to **quicken** sharply in H2
- **China** ahead of the pack, US following behind
- Record US **stimulus** package

→ **Equities**: neutral; continue rotating into more cyclical and value stocks

→ **Bonds**: reduce investment-grade credit; preference for carry (high-yield segment and USD emerging sovereign debt)

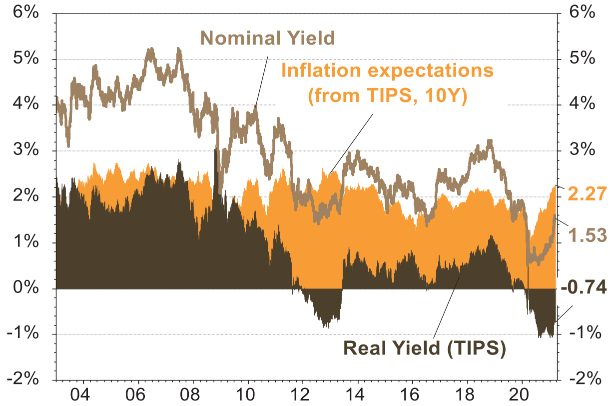
→ **Currencies**: adjustments (USD and GBP ↑; EUR and CHF ↓)

→ **Cash**: increase after selling investment-grade bonds

	UW (-)		N (=)		OW (+)
Asset allocation					
Equities			■		
Sovereign bonds	■				
Credit			■		
Alternative investments			■		
Cash				■	
Equities					
US			■		
Europe			■		
Switzerland				■	
Japan		■			
Emerging markets				■	
Bonds					
Sovereign	■				
Corporate investment grade		■			
High-yield corporate					■
Emerging market sovereign (USD)				■	
Emerging market sovereign (local)				■	

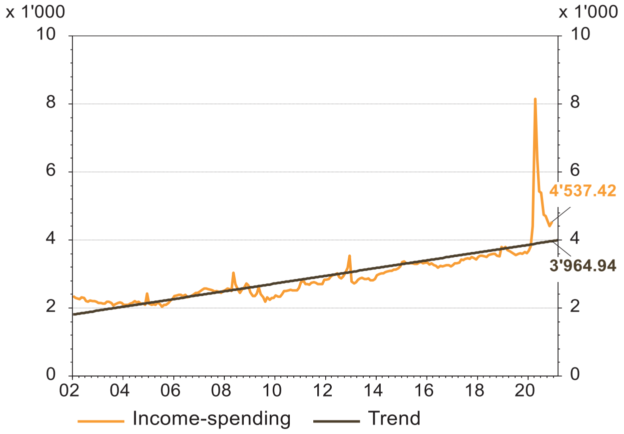
Economy: *risk of overheating at the end of the year?!*

Chart 1 | USD interest rates: the uptick in nominal interest rates is a result of hardening inflation expectations and rising real interest rates



Source: Refinitiv Datastream, 12.03.2021

Chart 2 | US: surplus household savings point towards high spending this year



Source: Refinitiv Datastream, 12.03.2021

Wondering whether the US economy might overheat at a time when part of the global economy is still shut down might seem like an academic exercise for economists. However, while such questions may appear misplaced, in reality they are not as far-fetched as all that.

This debate is prompted by the scale of the Biden administration's **stimulus package** and the way it is being allocated. Of the $1.9trn of new budget expenditure, nearly $1trn will go straight into consumers' pockets ($500bn in cheques sent out to households, $350bn to fund an increase in jobless benefits and $120bn in family tax credits). Thanks to support payments already received in 2020, US households saw their income go up last year – something that had never happened in any previous recession. And, since consumer spending was lower than usual, households built up around $600bn in surplus savings (**Chart 2**). This means the potential **surplus** available to be spent is $1.6trn, which equates to around 8% of GDP. This direct payment of grants to households – initiated, it must be said, under the Trump presidency – corresponds to nothing less than the implementation of the much maligned modern monetary theory (**MMT**). It is, in fact, a response to legitimate criticism of the misallocation of bailout funds during the 2009 financial crisis, when not enough money was channelled towards the economy. The upshot was that **inflation** became concentrated in asset prices, with liquidity mainly flowing into financial markets. This policy shift means this time around we should see a more lasting rise in the price of goods and services, and not just asset prices – something the market is already beginning to anticipate. Since total funding in stimulus packages appears to exceed the aggregate amount required (though this does not necessarily hold true at individual family level), there is reason to suppose not only that the economy might grow very quickly, but also that inflationary pressures might heat up.

In the shorter term, the pace of **vaccination** will dictate the rate at which economic activity resumes. After China, which is much further ahead in this cycle, US economic growth should be solid in Q1 before quickening sharply from Q2. Next will come the UK, whose vaccination programme is gathering pace. Lastly, continental Europe,

Financial markets

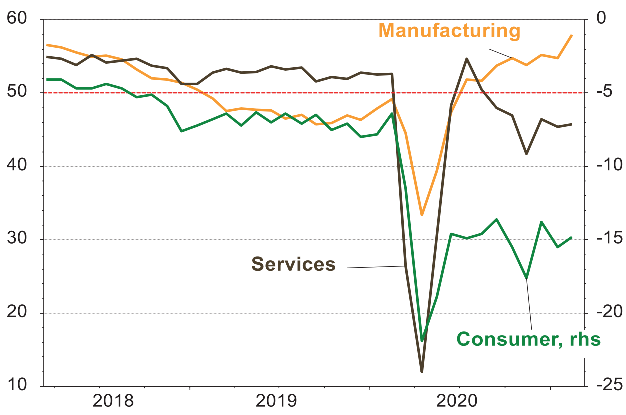
***) To 12.03.2021**	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q1*)	Since 31 Dec 2020	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2021 EPS	2022 EPS	2023 EPS
United States	3'834.84	4.55%	4.55%	21.86	2.0%	4.3	20%	24%	14%	11%
Europe	423.08	6.03%	6.03%	16.97	2.7%	1.9	29%	36%	16%	10%
Japan	1'951.06	8.10%	8.10%	16.78	1.9%	1.4	42%	-5%	44%	15%
Switzerland	10'839.93	1.30%	1.30%	17.42	2.9%	3.0	9%	9%	10%	8%
United Kingdom	3'851.15	4.80%	4.80%	14.07	3.2%	1.7	38%	51%	14%	9%
Emerging Markets (USD)	1'348.20	4.41%	4.41%	15.34	2.3%	2.1	28%	35%	16%	13%
World (USD)	2'807.21	4.36%	4.36%	19.80	2.2%	2.9	23%	28%	14%	11%

Source: Datastream, IBES consensus

including Switzerland, will catch up with the front-runners as strong, synchronised global growth emerges in the second half of the year. During its quarterly review in March, the OECD upgraded its growth outlook to 6.5% for the US, 3.9% for the eurozone and 7.8% (stable) for China.

While statistics, which are improving in Europe, are mostly consistent with confidence indicators (especially for the manufacturing sector and, to a lesser extent, for the services sector and consumers), the brightening US economic climate is already reflected in economic activity, with retail sales, for example, up 5.3% MoM in January (**Chart 3**).

Chart 3 | Eurozone (confidence indicators): only in the manufacturing sector has confidence recovered to pre-COVID levels



Source: Refinitiv Datastream, 12.03.2021

In a break with tradition, at its annual National People's Congress the Chinese Communist Party did not unveil any specific growth targets for either the current year or the period 2021-2025. It confined itself to forecasting growth of over 6% this year and reasserting its economic goals of ramping up added value in industrial production, pressing ahead with its urbanisation plans and quickening the transition to a low-carbon economy. Since China has already emerged from the crisis, its GDP in 2020 was already 2.3% higher than in 2019. The withdrawal of support – particularly in the credit sphere – will be gradual, limiting the risk of economic excess.

In the **eurozone**, Mario Draghi is heading up a new technocratic government in Italy. His mission is clear: to reassure Europe over the management of funding allocated to Rome (nearly €200bn) under the EU Recovery Fund.

Furthermore, the **monetary policy divergence** for which we are headed, with the ECB set to remain more accommodative than the Fed, should put a temporary stop to EUR appreciation, thus helping boost eurozone exports against a backdrop of quickening inflation.

The cost of the pandemic to **Switzerland's public finances**, although set to rise, appears to be under control. Thanks to sound management of the public purse over the past few years, Switzerland entered the crisis with very little debt compared with other countries (only 26.7% of GDP at end 2019). That being the case, the increase of just over 4% of GDP (compared with +16% of GDP in the eurozone and +20% in the US) took total debt to the equivalent of 31.3% of GDP in 2020. For reference, debt equated to 46.3% of GDP in 2003. Moreover, the **SNB** booked an accounting profit of CHF 20.9bn last year. While this is by nature a highly variable item and cannot therefore be distributed without careful consideration, 2021 has got off to a good start for Thomas Jordan: the Swiss franc – a victim both of the risk appetite that is dominating the world and of Mario Draghi's reassuring presence on the eurozone stage – has been depreciating against both the euro and the US dollar. With its public finances still among the very sturdiest, Switzerland remains well placed to bounce back.

10-year sovereign bonds	Level at 12.03.2021	Change Q1*) (bps)	Change since 31 Dec 2020 (bps)
USD yields – United States	1.64%	72	72
EUR yields – Germany	-0.33%	25	25
JPY yields – Japan	0.12%	9	9
CHF yields – Switzerland	-0.32%	23	23
GBP yields – United Kingdom	0.86%	62	62
Emerging markets (USD)	3.95%	38	38
Emerging markets (local currency)	6.52%	48	48
Commodities	Price	Quarter Q1*)	Since 31 Dec 2020
Gold (USD/oz)	1'710.69	-9.9%	-9.9%
Brent (USD/bl)	68.73	32.0%	32.0%

FX	Level at 12.03.2021	Change Q1*)	Change since 31 Dec 2020
EUR vs. CHF	1.1092	2.55%	2.55%
EUR vs. USD	1.1959	-2.58%	-2.58%
EUR vs. JPY	130.1063	2.99%	2.99%
EUR vs. NOK	10.0870	-3.71%	-3.71%
GBP vs. EUR	1.1681	5.59%	5.59%
GBP vs. USD	1.3895	1.65%	1.65%
USD vs. CHF	0.9291	5.11%	5.11%
USD vs. CAD	1.2495	-1.92%	-1.92%
AUD vs. USD	0.7750	0.43%	0.43%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
USD	GBP | JPY | GOLD | NOK	CHF | EUR
▪ **USD** ↑: benefits from monetary policy divergence	▪ **GBP** ↑: attractive valuation and expected economic recovery (vaccination) ▪ **JPY**: attractively valued and a safe haven currency ▪ **GOLD**: a currency hedge and a diversifying asset ▪ **NOK**: stabilised now that oil prices have picked up	▪ **CHF** ↓: high valuation; penalised by risk appetite ▪ **EUR** ↓: penalised by a late restart and a more accommodative ECB

Investment conclusions

The main **changes** to our investment allocations during the quarter were in keeping with those initiated in Q4 2020: decreasing our exposure to **investment-grade** bonds and, in equities, continuing the rotation into more **value**-oriented and **cyclical** stocks.

Indeed, with spreads on the highest-quality credit very low and no longer sufficient to cushion the rise in sovereign yields, negative returns are starting to appear. Meanwhile, high-yield – the riskiest category of credit – still offers enough of a surplus to act as a buffer against rising sovereign yields. Furthermore, the duration of these papers is shorter, so prices are less sensitive to rising interest rates. We have also added a new position in local currency **Chinese sovereign bonds**: the surplus yield is attractive and the currency's fundamentals are robust.

These interest rate movements are hurting valuations of long-duration assets, namely companies with highly visible growth. The steepening yield curve is of more benefit to financials. Lastly, the expected economic upswing is making cyclical companies – most exposed to economic conditions – more attractive at the expense of more defensive sectors.

On the currency front, the **dollar** has been perking up, with the interest rate differential once again tilting in its favour. Sterling has been benefiting from the consequences of Brexit, but above all from the success of the UK's vaccination campaign. The euro has been suffering as a result of economic restrictions and the ECB's stance, which is more accommodative than the Fed's. Lastly, waning interest in the Swiss franc is a result of prevailing optimism. Given that these trends could continue, we are adjusting our currency exposures accordingly.

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