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Investment Policy

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Key points

A structurally more accommodative Fed

At the end of August, Federal Reserve Chair Jay Powell unveiled the **new operating framework** within which the US central bank will be working.

The main **change** involves redefinition of the inflation target, with the previous **2% threshold** replaced by a **flexible average inflation** target (still at 2%). This means that, when coming out of a period of sub-2% inflation, as is currently the case, the Fed will be more **tolerant** of inflation slightly over 2%.

The other change is that monetary policy will be adjusted based on the shortfall between the prevailing level of **unemployment** and the theoretical full-employment level (the non-accelerating inflation rate of unemployment or **NAIRU**). This will no longer be explicitly quantified, thereby rendering it of less significance. This adjustment makes allowance for the fact that the link specifically between the unemployment rate and inflation has been much looser over the past few years (as evidenced by the pronounced flattening of the Phillips curve). This corroborates the idea that the economy can experience full employment without inflation **and thus without monetary policy needing to be tightened**.

This new operating framework confirms, then, that the Fed will be **structurally more accommodative** in its mission, with the **following implications**: the US yield curve will be steeper (short rates will stay lower for longer, while long yields are likely to incorporate a higher risk premium over inflation); overall, real interest rates will stay lower for longer, supporting the price of **gold** (and commodities) and exerting downward pressure on the **US dollar**; guaranteed low interest rates will favour the continued structural **compression** of the risk premium on other assets (i.e. expansion of equity valuations/narrowing of credit spreads) – a bubble in the making.

Scenario and conclusions

- Fresh pandemic-related **restrictions**
- A more tentative and uncertain **recovery**
- Wholesale **intervention** by authorities (governments and central banks)
- It will take **two years** to return to 2019 levels

→ **Equities**: downgrade to underweight

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

→ **Currencies**: reduce USD

→ **Cash**: overweight after selling shares

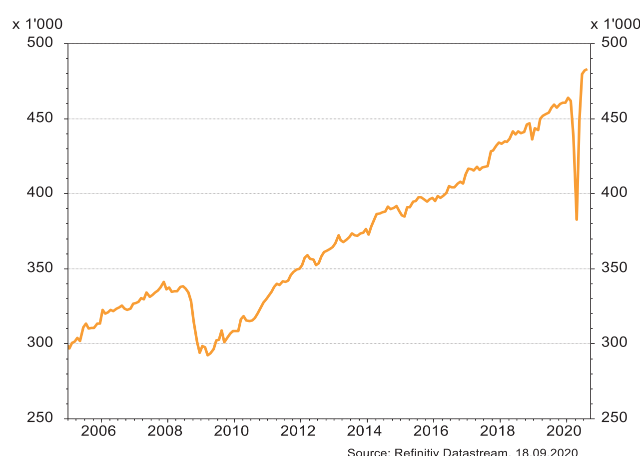
	UW (-)		N (=)		OW (+)
Asset allocation					
Equities		■			
Sovereign bonds	■				
Credit					■
Alternative investments			■		
Cash				■	
Equities					
US		■			
Europe				■	
Switzerland				■	
Japan		■			
Emerging markets				■	
Bonds					
Sovereign	■				
Corporate investment grade					■
High-yield corporate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

Economy: *is the acceleration phase already over?*

The **buoyancy** of the post-lockdown recovery came as a pleasant surprise. Furthermore, the US Federal Reserve has upgraded its 2020 growth expectations from -6.5% in June to -3.7% in September. It now expects the economy to return to 2019 levels as early as the end of next year; back in June, it was not expecting this to happen until the following year.

At the beginning of summer, a whole array of economic indicators – including for activity and not just confidence – picked up quickly, suggesting a V-shaped recovery after the first-half slump. It took less than three months for retail sales (c. 40% of US consumer spending, equating to 30% of GDP) to exceed their February level. By contrast, losses sustained in the great financial crisis of 2008 took more than two and a half years to recoup! (**Chart 1**).

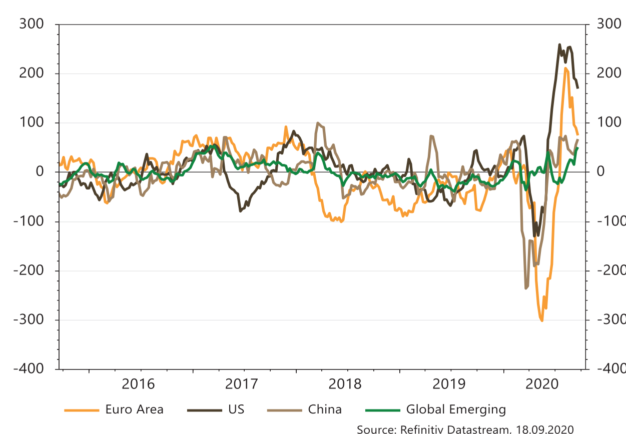
Chart 1 | United States: retail sales quickly bounced back



The same trend could be seen in most eurozone countries, albeit less strongly than in the US. Another indication of the effectiveness of stimulus measures put in place by various governments has been the upturn in the US housing market. Housing starts came in at 1.416m in August, above their 2019 level. The trend should remain positive, with similar numbers of building permits issued (1.495m) and confidence among homebuilders (as measured by the NAHB index) higher than at any time in its 35-year history!

However, signs of a **downturn** are beginning to surface. After bouncing back very strongly, some economic confidence barometers have little or no room to rise any further. Moreover, the momentum of positive economic surprises has already begun to wane (**Chart 2**).

Chart 2 | World: momentum of positive economic surprises set to slow



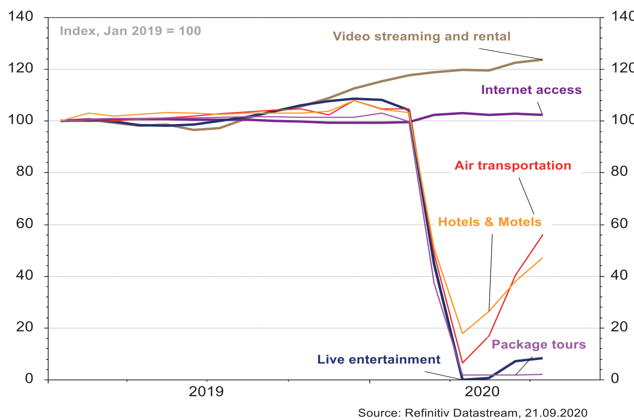
The imposition of fresh restrictions (travel, public gatherings, mask-wearing, quarantine, etc.) in many European countries will tend to slow the recovery. Those sectors already hit hardest (transport, hotels and catering, tourism, events) are not going to be able to recover quickly (**Chart 3**). It looks as if a vaccine is the only way all economic sectors are going to be able to recover their true potential. While some services sectors appear to have been the major front-line casualties, **manufacturing output** has also been struggling: excluding China (up 0.9% YoY), it has contracted 7% YoY globally. For the time

Financial markets

***) To 21.09.2020**	Performance			Valuation			Earnings growth			
Equity markets	Price (local currency)	Quarter Q3*)	Since 31 Dec 2019	12-month P/EPS	Dividend yield	Price/ net assets	12-month EPS	2020 EPS	2021 EPS	2022 EPS
United States	3'208.56	7.64%	4.29%	22.51	2.1%	3.8	13%	-16%	24%	17%
Europe	368.78	2.34%	-11.30%	17.22	3.0%	1.7	16%	-34%	41%	17%
Japan	1'646.42	5.60%	-4.40%	17.47	2.4%	1.2	19%	-11%	47%	15%
Switzerland	10'539.17	4.90%	-0.73%	17.77	3.0%	2.8	10%	-7%	16%	11%
United Kingdom	3'356.02	-1.60%	-20.00%	14.72	4.4%	1.4	11%	-42%	42%	20%
Emerging Markets (USD)	1'108.53	11.40%	-0.55%	14.56	2.8%	1.7	20%	-9%	32%	16%
World (USD)	2'367.99	7.55%	0.40%	20.40	2.5%	2.6	14%	-21%	29%	16%

Source: Datastream, IBES consensus

Chart 3 | United States: consumption of some services remains depressed…



Source: Refinitiv Datastream, 21.09.2020

being, it is generally estimated that 90% of the economy is capable of harnessing 100% of its potential. Measures in support of the worst-hit companies and sectors need to be extended to limit the number of business failures and job losses. Successful implementation of large-scale national and regional stimulus plans (rather than support packages, as previously) equating to several GDP percentage points (e.g. 4.1% of GDP in France), with a focus on future-oriented activities, will play a decisive role in maintaining positive momentum over the long haul. In the shorter term, as Jay Powell said at his September press conference, the economic **acceleration** phase is partially over and much **uncertainty** remains.

The **US elections** on Tuesday, 3 November are the major political event of the year. In seeking to ascertain what policy direction the new administration will take, it is not enough to know who out of Donald Trump (Republican) and Joe Biden (Democrat) will be elected president: at this point in time, the distribution of seats in Congress, split between a Democrat House of Representatives (233 seats vs. 197, where 218 constitutes a majority) and a Republican Senate (53 vs. 47), will be just as critical, particularly when it comes to tax policy. While the entire House of Representatives is up for re-election, the Republicans are unlikely to be able to overturn the existing majority. Meanwhile, only a portion of Senate seats are up for grabs: 23 currently held by Republicans and 12 by Democrats. These figures show that, by taking just four seats from its opponents (of the 23 on offer), the Democrat camp could win control of both houses of Congress.

For **financial markets**, the most favourable outcome would be a Democrat president and a Republican Senate. If that happens, a thawing of the current protectionist stance on international trade – trade policy being the prerogative of the president – looks likely. Furthermore, tax hikes (on both profits and capital gains) – pledges in the Democrats' programme and dreaded by Wall Street – would not be able to happen thanks to Congress's control over such matters. All in all, the outcome remains very uncertain. It is not beyond the bounds of possibility that, if the result is close on election night, with mail-in ballots still to be counted, the winner might not be declared until a later stage. This would mean a re-run of 2000 (Gore vs. Bush), but with much more acute social unrest and much more radical positions this time around.

Lastly, with the clock ticking, **Brexit** talks between the European Union and the United Kingdom are once again strained. Although this is much more of a local issue than the US elections, with more limited global effects, the impact on some sectors (e.g. the European automotive industry) – and on the United Kingdom as a whole – should not be underestimated.

10-year sovereign bonds	Level at 21.09.2020	Change Q3*) (bps)	Change since 31 Dec 2019 (bps)
USD yields – United States	0.69%	1	-30
EUR yields – Germany	-0.48%	-10	-36
JPY yields – Japan	0.02%	-5	3
CHF yields – Switzerland	-0.48%	2	-68
GBP yields – United Kingdom	0.14%	37	-49
Emerging markets (USD)	3.63%	12	-49
Emerging markets (local currency)	7.16%	-102	-16
Commodities	Price	Quarter Q3*)	Since 31 Dec 2019
Gold (USD/oz)	1'954.65	9.6%	29.0%
Brent (USD/bl)	43.72	5.6%	-33.0%

FX	Level at 21.09.2020	Change Q3*)	Change since 31 Dec 2019
EUR vs. CHF	1.0789	1.37%	-0.75%
EUR vs. USD	1.1825	5.26%	5.31%
EUR vs. JPY	123.7294	2.11%	1.43%
EUR vs. NOK	10.7567	-0.72%	9.05%
GBP vs. EUR	1.0954	-0.44%	-6.89%
GBP vs. USD	1.2961	4.89%	-2.17%
USD vs. CHF	0.9097	-3.99%	-6.06%
USD vs. CAD	1.3182	-3.22%	1.65%
AUD vs. USD	0.7307	6.12%	3.94%

Source: Datastream

Monetary preferences

Rank 1	Rank 2	Rank 3
Appreciation expected	Stabilisation	Depreciation expected
EUR	**JPY | CHF | Gold | NOK**	**GBP | USD**
▪ **EUR**: new political commitment will reveal its robust fundamentals	▪ **JPY**: attractively valued and a safe haven currency ▪ **CHF**: high valuation but safe haven currency ▪ **Gold**: a currency hedge and a diversifying asset ▪ **NOK**: stabilised now that oil prices have picked up	▪ **GBP**: Brexit negotiations will dictate direction; attractive valuation justified by weak economic climate ▪ **USD**: weak fundamentals only partly offset by benefits of being a reserve currency

Investment conclusions

The continuing **improvement** in the growth outlook, confirmed by the reopening of various economies and the end of lockdown, enabled **risk assets** to continue to rally over the summer. This rise was also stimulated by continuing low **interest rates**, which favour higher valuations, particularly for tech stocks and growth stocks more generally.

Since we expect these conditions to **deteriorate**, we have **lowered** our exposure to **equities** (currently underweight in our allocations) and increased our holding of cash, which we hope to be able to redeploy before the end of the year.

Assuming there is no fresh lockdown (something nobody wants), new **restrictions** imposed in some countries to limit the effects of a second wave of the pandemic will result in growth expectations – which had in the meantime become overly ambitious – being downgraded. The risk of disappointment has clearly increased. Moreover, the approaching **US elections** will fuel a degree of ongoing uncertainty over the coming weeks. While the Brexit issue is more local, renewed tensions between the parties involved are unlikely to be conducive to additional risk-taking. Lastly, now that the European Recovery Fund has been agreed, we have increased our exposure to **EUR** at the expense of the US dollar.

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