Vontobel

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Vontobel Swiss Wealth Advisors

Investment Outlook – October 2020

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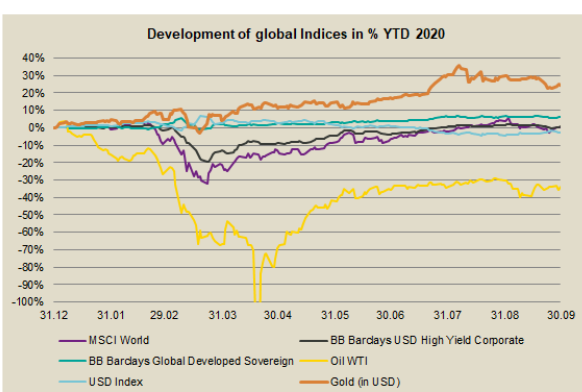
Investment Review

New COVID19 cases have increased sharply in recent weeks, with daily infections surpassing their peak levels reached in April in several countries. However, fatality rates have remained much lower than in the second quarter so far, likely reflecting more testing, a lower average age of the infected as well as better treatments. Governments have paused the reopening of their economies and locally adopted renewed containment measures. Uncertainties regarding the timely passage of a new stimulus package and increasing U.S. election noise added to virus related fears and triggered a significant correction across major equity markets during September. As a result, most equity indices are now back in negative territory since the beginning of the current year. In 2020, the Swiss SMI index is up by 3.8%, the S&P 500 gained 1.9%, the Euro Stoxx 50 index is down by 10.2% and the MSCI Emerging Markets index lost 3.2%, all on a total return basis in USD terms. Having reached a new all-time high of close to 2070 $/oz in August, gold started to consolidate in light of a stronger USD and slightly rising real rates, bringing the year-to-date performance to 22.3%. Government bond yields moved sideways in September and credit spreads slightly widened.



[Source: Bloomberg, Vontobel Swiss Wealth Advisors (VSWA)]

As of end of August we took partly profit in several stocks, which performed strongly in 2020 and exceeded our target allocation by far. Thus, we reduced the equity allocation in all multi-asset mandates from moderately overweight back to neutral. As already announced in the previous VSWA Investment Outlook we also reduced the gold quota in all multi-asset mandates from 8% to 6%. At the most recent meeting of our Investment Committee, we decided to stay course. After a very strong rally from March lows and increasingly extended valuation levels, the current market correction seems to be a healthy consolidation in an uptrend and not the beginning of a renewed bear market. The world economy has rapidly recovered from the corona-crisis and odds are high for a further normalization in the coming months as the world adapts to the virus, a vaccine seems due and fiscal as well as monetary policy remain supportive. In a world of record low yields, equities remain one of the very few viable alternatives for wealth creation. However, we see the risk of elevated volatility during the next weeks, driven by high virus related risks and potential tariff rhetoric as we are approaching U.S. elections.

Global Economy

The recovery of the global economy in the third quarter of the current year from the coronavirus induced drop seen in the first two quarters was much faster than anticipated by most market participants. Given the strength of the rebound witnessed in Q3, economic momentum will likely moderate in the final quarter of 2020. However, we are expecting global growth to remain clearly positive in Q4 and into next year. Global real GDP will most likely contract by 3.9% this year, followed by an increase of around 4.8% in 2021.

The vast majority of U.S. macroeconomic releases was above expectations in July, August and September, which indicates that the U.S. economy is in a better shape than previously feared. This is certainly a result of record high fiscal stimulus, which obviously can't continue for a very long time as the budget deficit as a percentage of GDP is expected to reach an absurdly high level of almost 17% in 2020. The ISM manufacturing index increased by 1.8pt to 56.0 in August, which was above economist's expectations. The underlying composition was strong, as the production, new orders, and employment components all increased. The ISM non-manufacturing index decreased by 1.2pt to 56.9 in August, slightly more than expected. The underlying composition was mixed-to-firm, as the business activity and new orders components declined, but the employment component increased. However, both leading indicators are comfortably in expansion territory, pointing to a likely continuation of the recovery. The jobless rate fell to 8.4% in August, and the six million workers still on “temporary layoff” suggest scope for a further decline in the unemployment rate over the remainder of 2020. Given the strong economic momentum we increase our U.S. GDP growth forecast for 2020 from -5.1% to -4.4%.

The composite purchasing manager’s index for the Euro area declined to 50.1 in September. Across sectors, the overall decline was focused on the service sector, with the pace of recovery in manufacturing reaccelerating from August. Across countries, the overall decline was heavily skewed towards France, Spain and Italy, with German manufacturing showing relative resilience. Eurozone retail sales declined by 1.3% in July, after having increased by 5.7% in June and 20.3% in May compared to the previous month. The German business climate increased in September, reflecting a more positive assessment of current business conditions and of business expectations six month ahead. While the improvement in business expectations slowed compared to previous months, it stands at the highest level since November 2018. At a sectoral level manufacturing, construction and trade all recorded modest improvements in business climate whereas sentiment in the services sector softened.

Switzerland took a smaller economic hit than many of its neighbors thanks to a less severe lockdown and its growing pharmaceutical industry. GDP fell by 8.2% in the second quarter, less than the 9.7% realized in Germany and the double-digit slumps in France, Italy and Spain. Switzerland’s relatively better performance implies that demand for government support for companies and workers has likely been lower than anticipated. While many countries have to deal with huge budget blowouts, Switzerland’s budget deficit for 2020 will be much smaller than originally projected and hardly surpass 5% of GDP.

Industrial production in China increased by 5.6% in August year-over-year, which was modestly above market expectations. Retail sales rose for the first time this year in August, up 0.5% from a year earlier. Fiscal stimulus and surprisingly strong exports boosted industrial output in recent months. Now, the return to growth in retail spending shows private demand starting to recover.

After a very strong rebound in Q3, macroeconomic momentum will likely slow but remain positive in Q4. We are still expecting global growth to normalize in 2021 as the world adapts to the virus, a vaccine may be due and fiscal and monetary policy remains supportive.

GDP growth (in %)

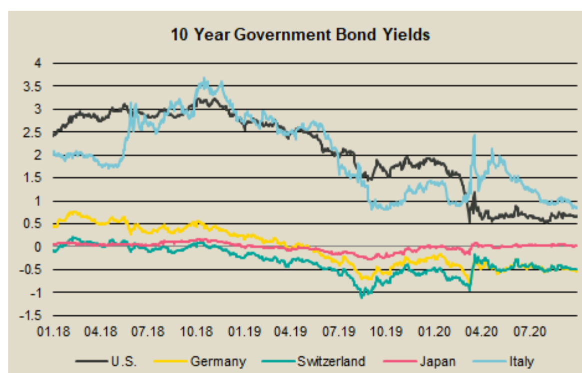
	2018	2019e	Current	Forecast 2020	Forecast 2021
Eurozone	1.8	1.2	-14.7	-7.1	5.6
USA	2.9	2.3	-9.1	-4.4(-5.1)	4.0
Japan	0.7	1.0	-9.9	-5.3	2.3
UK	1.4	1.2	-21.7	-8.4(-7.9)	6.3(5.9)
Switzerland	2.7	0.9	-8.2	-4.7(-5.4)	4.3(5.8)

VSWA Forecast; () old forecast

Bonds

The Federal Reserve (FED) concluded its September policy meeting by voting to keep short-term interest rates anchored near zero. The Federal Open Market Committee (FOMC) kept its pledge to aim for an inflation moderately above 2% for some time so that inflation averages 2% over time and longer-term inflation expectations remain well anchored at 2%. The FOMC expects to maintain an accommodative monetary stance until these outcomes are achieved, which most likely implies near zero rates through 2023. In addition to the rates decision the FOMC altered its medium-term outlook for GDP growth and inflation. The committee increased its forecast for the current year to -3.7% and lowered its outlook for 2021 and 2022 to 4% and 3%, respectively. For 2023 the committee expects 2.5% real GDP growth and 1.9% in the longer run. The FOMC increased its inflation projection for 2020 to 1.2%, though it still does not expect its 2% goal to be reached until 2023. The FOMC’s estimate for the longer-run FED Funds Rate remains at 2.5%. Given 10 year Treasury yields at around 0.7% the bond market clearly seems to underestimate the risk of rate hikes after 2023. The committee stressed that the FED would continue to purchase bonds “at the current pace to sustain smooth market functioning and help foster accommodative financial conditions, thereby supporting the flow of credit to households and businesses.”

With new COVID19 cases on the rise across Europe, social distancing rules and consumer caution may act as a ceiling on economic activity. However, the European fiscal and monetary response looks adequate so far. The European Central Bank (ECB) has recently stepped up its Pandemic Asset Purchase Program (PEPP). The 750bn Recovery Fund, which will provide fiscal support to countries most affected by the virus, will likely be ratified by the European Parliament and the 27 national parliaments by year-end and operational next year. Headline inflation for the Euro area decelerated to -0.2% year-over-year in August from 0.4% in July. Part of the decline can be explained by transitory factors, such as the reduction in German value-added tax, but relatively weak demand is likely to weigh on price pressures for the foreseeable future.



[Source: Bloomberg, VSWA]

Despite recent market jitters, credit markets have remained remarkably resilient with spread widening in the investment grade space limited to less than 10bp. This resilience will likely continue, driven by direct policy support from major central banks and a continuation of the global growth rebound, which started in the third quarter. The ability of central banks to strongly respond to any potential temporary constraints in risk appetite should not be underestimated and keeps spread expansion risk in check. Due to the aggressive interventions, corporations have been able to materially strengthen their liquidity positions. Aggressive cost-cutting measures and conservative capital management have helped to mitigate the damage from the contraction in global growth during the first two quarters of 2020.

Assuming that the economic recovery remains on track in 2021, investment grade credit will likely outperform governments bonds due to an ongoing strong search for yield, the prospect for further spread compression across the credit curve. The medium-term return potential for government bonds seems quite low as the global growth and inflation backdrop improves and yields at the longer end of the government curves may tend to rise.

Key interest rates (in %)

	2018	2019	Current	Forecast 3 months	Forecast 12 months
EUR	-0.40	-0.50	-0.50	-0.50	-0.50
USD	2.50	1.75	0.25	0.25	0.25
JPY	-0.10	-0.10	-0.10	-0.10	-0.10
GBP	0.75	0.75	0.10	0.10	0.10
CHF	-0.75	-0.75	-0.75	-0.75	-0.75

VSWA Forecast; () old forecast

10-year government bond yields (in %)

	2018	2019	Current	Forecast 3 months	Forecast 12 months
EUR (Germany)	0.2	-0.2	-0.5	-0.4	-0.3
USD	2.7	1.9	0.7	0.7	1.0
JPY	0.0	0.0	0.0	0.0	0.0
GBP	1.3	0.8	0.2	0.3	0.5
CHF	-0.2	-0.5	-0.5	-0.5	-0.3

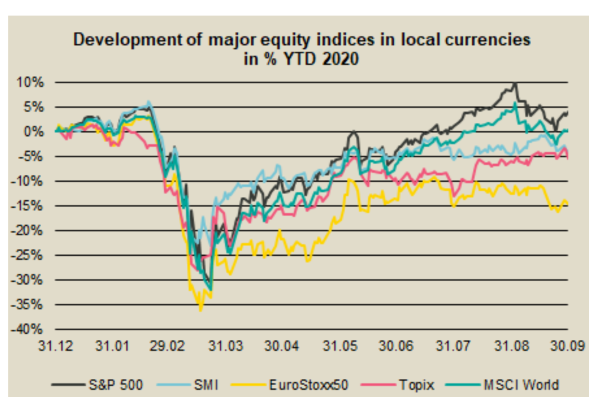
VSWA Forecast; () old forecast

Equities

The equity market correction, which started in the first week of September, was mainly driven by four factors: some profit taking after the strong run form March lows, a smaller U.S. fiscal package than previously expected, rising U.S. election uncertainties as well as increasing concerns about a second wave of COVID19 infections in Europe, given that new cases have already surpassed previous peaks in some countries and renewed containment measures have been implemented in some areas. As a result, the S&P 500 index fell from close to 3600 to around 3200 and the Euro STOXX 50 index lost 6% within two weeks, whereas the more defensive Swiss SMI index moved sideways.

Falling equity markets and slightly rising consensus earnings estimates resulted in a valuation multiple compression in most markets. With a price-to-earnings (PE) ratio of 20.0 based on estimates for 2021, the valuation of the S&P 500 index is now close to its 10-year average. The valuation of the Swiss and the Eurozone equity market is now clearly below historic averages. While the PE ratio of the Swiss SMI index stands at 16.9 based on estimates for 2021, the EuroSTOXX 50 index trades at 15.7. With a dividend yield close to 3% and an earnings yield of approximately 5% based on estimates for the current year, both markets offer a considerably higher income compared to the respective bond markets. Thus, equity risk premiums ranging from close to 4% for the U.S. to around 6% for Switzerland and the Eurozone are attractive and confirm our positive longer-term view on equities. Moreover, the current valuation of the S&P 500 index seems currently distorted by the high concentration a few strongly performing stocks. The biggest five stocks by market capitalization - Alphabet, Amazon, Apple, Facebook and Microsoft - currently represent more than 20% of the S&P 500 index. Their average PE ratio stands at 31 versus 17 for the other 495 companies of the S&P 500 index. Thus, the broader U.S. equity market is rather reasonably valued, whereas the valuation of the top five names seems justified given their superior growth prospects.

With the attention of many investors turning to the upcoming U.S. election as a potential source of risk it is in our view important to assess the impact of a potential democratic sweep on the earnings trajectory of the S&P 500 index. Vice President Biden's lead in national polls has narrowed from 10% to 6% in recent months. The probability of the Democrats winning the Senate has decreased from above 60% in July to currently 54%. Biden has proposed to lift the statutory tax rate to 28%, reversing only half of Trump's tax cuts. According to Goldman Sachs, such a step would reduce S&P 500 earnings by around 9% in 2021. The Biden plan includes around $7 trillion in fiscal spending on infrastructure, education, clean energy and healthcare over 10 years, partly financed via a tax reform and savings through prescription drug prices. Regarding the trade dispute with China the consensus view among investors is that even a democratic sweep would most likely not result in a major change in the relationship between the two countries. However, the overall tone, the openness for compromises and the way to manage trade tariffs may be different, especially towards Europe. From an earnings perspective, a Democratic sweep may only have a minor impact on the medium-term earnings prospects for the S&P 500, which is in stark contrast to the consensus belief of strongly negative implications for company earnings. According to Goldman Sachs, the combined effects of higher corporate tax rates, more fiscal spending, and potentially lower tariffs would likely result in a similar level of medium-term S&P 500 profits as their baseline forecast that assumes no major policy changes. Regardless of the outcome, the resolution of a highly uncertain election should help reduce the equity risk premium and support equity valuations.



[Source: Bloomberg, VSWA]

Equity market valuations

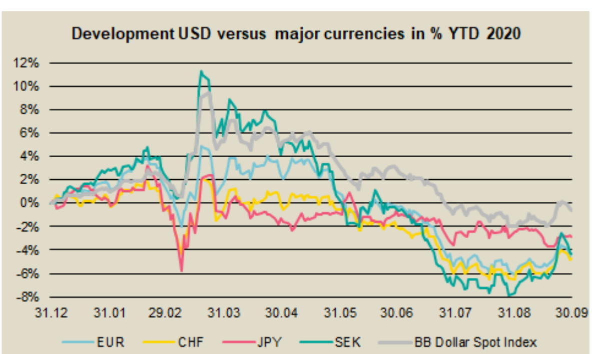
	Price to earnings ratios			Price to Book	Dividend yield %
	Expected 2020	Expected 2021	10 year average	2020E	2020E
USA	25.3	20.0	19.0	3.5	1.8
Eurozone	21.2	15.7	18.5	1.7	2.9
Switzerland	20.0	16.9	18.3	2.6	2.8
UK	19.4	13.1	22.9	1.4	3.8
Japan	21.2	15.0	17.9	1.2	2.2

VSWA Forecast; () old forecast

In the short-term, risk sentiment has the potential to shift pre- and post-election, eventually leading to fluctuating equity prices over the next weeks. Over a medium-term investment horizon, the expectation of an economic recovery and the FED policy will be more important in determining equity valuations than the outcome of the election. Whoever wins the election has the mandate to foster economic stability, increase prosperity, create chances across major parts of the society and reduce the unemployment rate.

Currencies

The Dollar rallied sharply against most G10 currencies as the equity market sell-off broadened beyond the U.S. technology sector in September. The USD appreciated most against NOK, SEK, GBP and AUD, whereas gains against the CHF and EUR were relatively muted. Dollar strength is very typical in a risk-off environment, reflecting the currency's international role and the importance of the U.S. capital market for global investor risk appetite. For the USD to resume its devaluation trend against EUR and CHF investors likely need to turn more optimistic about European growth prospects, which currently seem at risk given rising virus cases and more restrictive control measures in some areas of Southern Europe. Thus, in the very short term, we do not see much potential for an appreciation of EUR and CHF versus the USD. However, on a 12 months horizon we expect the USD to further devalue against EUR and CHF, as the outlook for vaccine approval and distribution may steadily improve and the global growth backdrop likely normalize heading into 2021.



[Source: Bloomberg, VSWA]

During the past 50 years the USD lost almost 80% of its value against the CHF, representing a devaluation of 3% per year. This depreciation is structural, as it is driven by the low Swiss inflation regime and an absurdly high U.S. budget deficit, which is projected to reach almost 17% of GDP this year and will likely remain at 10% in 2021. Given an already high public debt level, such a massive budget deficit seems unsustainable and may lead to persistent currency devaluation. Given the fiscal spending plans of the Democrats, the budget deficit could even get worse under a Biden-led government. As the devaluation path of the USD against the CHF seems obvious, U.S. investors should seriously consider a higher share of Swiss assets as a viable alternative to diversify their wealth.

Currencies

	2018	2019	Current	Forecast 3 months	Forecast 12 months
CHF per EUR	1.13	1.08	1.08	1.08	1.07
CHF per USD	0.99	0.96	0.93	0.93(0.91)	0.89
USD per EUR	1.14	1.12	1.17	1.16(1.19)	1.20
JPY per USD	110	108	105	107	105
USD per GBP	1.28	1.32	1.29	1.27(1.32)	1.30

VSWA Forecast; () old forecast

Commodities

Driven by a general risk-off environment, the price of West Texas intermediate (WTI) fell from 42.6 $/bbl to 36.7 $/bbl during the first two weeks of September. Oil demand is still clearly below the levels reached in previous years. However, given our expectation of an improving global macroeconomic backdrop, oil consumption will likely rise in the coming months. Global demand for jet fuel considerably increased from April lows, as global air traffic is stronger than expected and almost back to levels seen in previous years. Oil supply is well below 2019 levels as a consequence of OPEC+ cuts and production discipline. Worldwide rig counts are now at a 17 year low. These developments are already reflected in global oil inventories, which are still at relatively elevated levels but declined by more than 30% in recent months.

Gold's decline from the all-time high of 2070 $/oz, reached in the first week of August was mainly driven by a strengthening of the Dollar and slightly rising U.S. real yields. However, in our view the longer-term case for gold is still intact. Gold is the currency of last resort, especially in a world, where central banks and governments are debasing fiat currencies and pushing real interest rates to record lows. High and rising public debt levels in many countries across the world are raising the specter of financial repression. Investments in real assets, such as gold and equities, should clearly outperform nominal assets in such an environment.

Commodities

	2018	2019	Current	Forecast 3 months	Forecast 12 months
Crude oil (WTI, USD/barrel	45	61	40	45	50
Gold (USD/ troy ounce)	1281	1517	1'870	1950	2000
Copper (USD/ lb.)	3.30	2.80	2.98	3.05	3.15

VSWA Forecast; () old forecast

A rebound in oil demand, resulting from an improved global economic backdrop, combined with limited production growth, will likely speed up a rebalancing of the oil market in 2021. The long-term case for gold is still

intact, as rising public debt and negative real yields drive hedging demand. Thus, we continue to overweight gold relative to our respective benchmarks.

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