

## Outlook for 2021: In step with central banks

### **Scenario: A return to some degree of normality**

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Another skittish year for investors is drawing to a close. Following an auspicious start, the CoViD-19 pandemic which broke out in spring put an abrupt end to the economic and stock market recovery – at least initially. The pandemic called for a hitherto unimaginable readiness to make sacrifices amongst large parts of the populations in the various countries and regions affected. The rapid and even more expansive action taken by the major central banks, coupled with the substantial fiscal measures adopted by almost all industrialised countries, helped to avert the negative economic effects of the first wave. The election of a new President in the USA, which many had suggested would represent a risk for stock markets, has also not had any negative impact. Based on experience, as far as the stock market is concerned it is irrelevant which party's candidate is elected as US President.

But what is the position at present with regards to the pandemic, and how are things set to develop in future? When it first broke out, nobody knew anything at all about the virus. In the meantime, we have found out a lot more about it, although by no means everything. It has still not yet been “defeated” – the world will have to live with it for a long time to come. Under our base scenario, we are assuming that there will be a gradual return to some form of normality within six to twelve months. Vaccine availability, the further expansion of testing capacity and the maintenance of some protective measures will be essential for a rapid and tangible economic recovery. However, there is no guarantee that this will occur, or that protection will be absolute. There will still be risks. Moreover, the potential for disappointment is high.

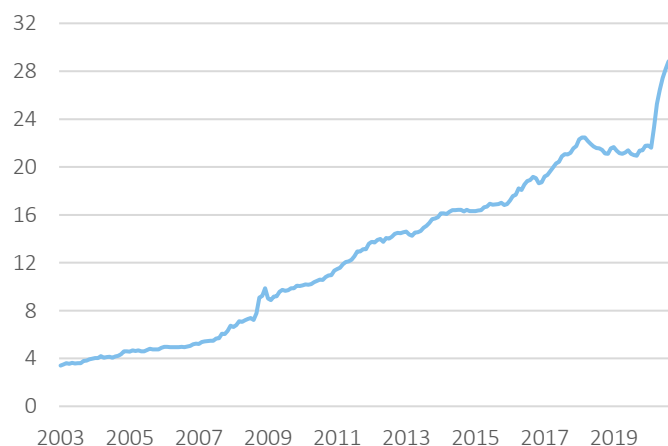
Vaccines are nearly ready to be rolled out. Work has been carried out on the development of a number of vaccines under unprecedented pressure. Initial results have been encouraging. However, only limited numbers of people have been tested in clinical studies, and questions remain concerning both the efficacy of vaccines in everyday life, as well as their safety. In addition, the mRNA technology on which the vaccines are based is a new technology, and no vaccine using it had previously been licensed before CoViD-19. Questions still remain regarding potential side

effects as well as the duration of immunity. Despite the “emergency approval” procedures, licensing as well as subsequent roll out – manufacturing, distribution, and administration – will not be complete until far into 2021. This timetable does not take into account any potential delays.

Even under this optimistic scenario, it cannot be assumed that the world economy will already return to pre-crisis levels in 2021. Perhaps it will in 2022. Also, thanks to government support packages for the economy, which are in turn being financed indirectly by low central bank interest rates, corporate profits look set to recover. Some of this has been factored in to share prices. We shall find out over the coming year whether the stock markets are making forward projections according to a time frame of only half a year or – perhaps lulled into a sense of false security by the abundant liquidity – of two to three years.

### Monetary policy drives up asset prices

*Graph 1: Cumulated total assets of six central banks (USD bn) as an indication of expansion of the money supply*



*Source: Bloomberg, Belvalor; central banks: Swiss National Bank (SNB), European Central Bank (ECB), Bank of England (BOE), Federal Reserve System (FED, the US central bank), Bank of Japan (BOJ), Bank of China (BOC)*

The key role played by central banks since the financial crisis, and also during the pandemic, has not changed at

all – on the contrary. Central banks have started to wear political hats so to speak and have been able to act as well as react more quickly. They are now responsible for the stability of the financial system (and hence de facto for share prices), providing support to the economy and ensuring the sustainability of government debt. They will be forced to keep interest rates low for the foreseeable future in order to avoid jeopardising the economic recovery and driving states into bankruptcy. In short: there is still much to be said for making core investments in real assets – i.e. equities, real estate and gold.

Other global risks and challenges, which have been kicked into the long grass by CoViD-19, will return to the fore after the crisis, and may potentially demand more attention. Tensions are being driven both by geopolitical and by social factors – “unequal distribution of income and assets” is only one example. The mountains to be climbed and the chasms to be bridged have not got any smaller as a result of the crisis, and there has been some degree of decoupling between the appreciation of financial assets (thanks to the equity markets) and economic reality.

Nevertheless, there is no way around equities, and thus the need to tailor portfolios to long-term investment trends. A combination of first-class equities of quality companies and leading companies dealing in key technologies is advisable. The issue of sustainability (ESG) is now an integral part of our quality criteria in the selection process of investments.

## ***Economic environment***

The economy (gross domestic product, GDP) and hence corporate profits will gradually recover to pre-pandemic levels – or, if the path of recovery is extremely positive, may even exceed them. However, the time frame is difficult to predict. We are already able to speak in terms of a potential return to pre-crisis levels in the near future thanks to the increasingly generous fiscal and monetary policy stimuli, which averted a general economic collapse.

From an economic perspective, 2020 will go down in the history books as a recession year. Apart from China, all leading industrial countries suffered a hitherto unprecedented collapse in economic activity as a result of the restrictions imposed on economic, public and social life in relation to CoViD-19. Based on experiences from comparable events in the past (e.g. SARS), China and most other Asian countries have been able to weather the crisis better, having taken more rigorous action. In Europe the pandemic resulted in a substantial drop of economic activity. While the USA also posted a fall in GDP, it was however lower than in most European countries.

Based on currently available information, we are expecting the world economy to recover reasonably quickly. Asian countries including China will lead the recovery, thanks to their structural growth. We are also forecasting a normalisation of economic activity in Europe. However, pre-crisis levels are unlikely to be reached in most countries until 2022. Government interventions in relation to the CoViD-19 crisis have been unprecedented in many European countries. Returning to a lower level of state intervention will be a Herculean task. Calls for state support are likely to become increasingly strident in the event of any setbacks.

Switzerland has weathered the crisis year 2020 well in economic terms. The knock to GDP has been less severe than had been feared. It should return to the pre-crisis level with the recovery in 2021 – not least thanks to the resilient pharmaceutical industry. The decline of business volume has been significantly greater in exporting sectors such as the engineering industry and tourism; the recovery in these sectors will take a lot longer.

Growth prospects in western countries remain modest. Structural problems, such as rising debt levels and the increasing burden of social spending, also because of demographic changes, have not gone away – and remain significant now more than ever. Lower interest rates might patch over the problem, although at a price of declining growth prospects. The situation is comparable with that experienced by Japan over the last 30 years: low interest rates, no growth, no inflation. As usual, the USA is set to find a faster return to post-crisis growth than Europe, where the diverging interests of individual countries represent more than simply a high barrier.

Nobody is expecting resurgent inflation. We accept the consensus position in relation to the labour markets that there will not be any surprises on the inflation front; considered globally, supply appears to be sufficient. On the other hand, rising commodity prices may pose a risk of triggering higher inflation, which is not unusual within the context of cyclical recoveries. Protectionist tendencies constitute a further risk for inflation. Last but not least, it is conceivable that the expansive monetary and fiscal policies will at some point – 2021? 2022? 2023? ...? – all of a sudden feed through into higher inflation rates.

## ***Currencies***

We are not expecting any major movements on the currency markets. The key factor is that interest rates are essentially zero in all western currency areas.

The consensus position is that the USD will continue to weaken, which is reflected in market positions. We think that the EUR has a little scope to increase in value against the CHF. Minimising and in part hedging against foreign currency risks is advisable, as well as being cheap thanks to low interest rate differentials.

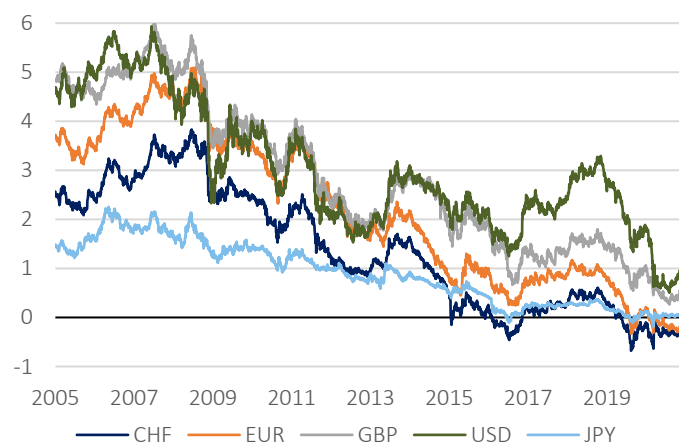
## Minimise currency risks

Rising commodity prices offer opportunities for the Norwegian krone (NOK), the British pound (GBP) and the Canadian dollar (CAD).

## Interest rates / bonds

Central banks' expansive monetary policies have been further expanded in 2020. Initial efforts to rein in bond purchases, creating scope for increasing base rates in the near future, were nipped in the bud by the pandemic. The European Central Bank (ECB) as well as the Swiss National Bank (SNB) have therefore been forced to stick to their negative interest rate policy. Since the US Federal Reserve (FED) was also forced to cut interest rates to zero in March 2020, where for instance the Bank of Japan (BOJ) and the Bank of England (BOE) had been for some time, USD bonds offer only marginal returns from now on.

Graph 2: 10-year government bond yields (%)



Source: Bloomberg, Belvalor

When it changed its inflation target, the FED rejected any quick return to higher interest rates: rather than being a fixed inflation target, the 2% figure is now applicable as an average. The USD inflation rate will have to exceed 2% for longer for the FED to consider raising interest rates. Similarly, growing levels of government debt also make interest rate rises impossible because it would be difficult for many countries to bear higher interest payments. Central banks will exercise caution when deciding whether to fuel this burden by implementing premature interest rate

hikes. We think that a return to a more normal monetary policy will be virtually impossible until 2022.

## From the “risk-free rate” of the past to the “return-free risk” of today

Interest rates are set to remain low for the foreseeable future. Bonds have a “return-free risk” rather than a “risk-free rate”. Investors are no longer being sufficiently compensated for the risk taken on. On the other hand, due to expectations of rising inflation and/or increased default risks, a steeper interest rate curve cannot be excluded. This would result directly in a fall in bond prices.

Good quality CHF and EUR bonds are associated with negative returns, even over longer maturities, whilst those in USD and GBP yield practically nothing. Investing in classical bonds is becoming increasingly less convenient – aside from exceptions and specific individual cases. Positive returns can only be found for bonds specialising in specific fields, in which we invest through selected collective investments. These include segments and strategies such as convertible bonds, emerging markets investment grade, high yield, senior loans, cat bonds, “CoCos” (contingent convertible bonds, hybrid capital of banks) or US “municipal infrastructure”. However, the better return is also associated with a higher risk.

## Equities

In our view, equity markets have started early to look forward to a post CoViD-19 time. As usual, it is difficult to say whether this time will come only six to nine months into the future, or rather after two to three years. The same issue arises when attempting to reliably estimate how much the bull market for equities is being fuelled by the immense quantities of money being pumped in by central banks.

Attention is now focusing on the profits and cash flows of companies. These are the key drivers of the longer-term trends of share prices. The positive profit revisions expected point towards an outperformance of Small & Mid Caps. Stock picking is thus still appropriate. It should focus on quality companies that benefit from macro-trends and that are well positioned in growth markets such as Asia.

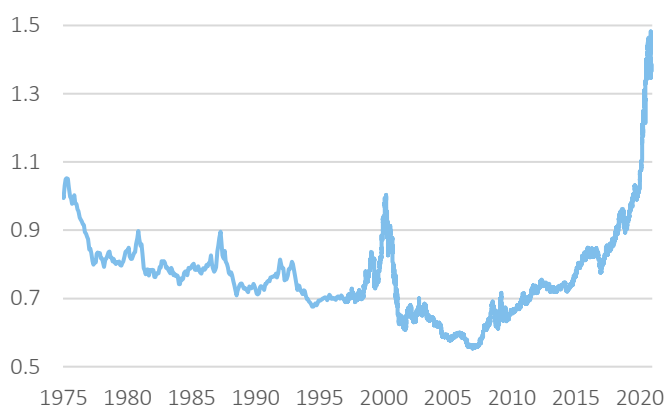
Investors should not disregard the fact that a large proportion of positive share price performance in recent years has come from an increase of valuation multiples. Equities are currently trading in the “most expensive” band under the long-term models referred to by us.

However, it is conceivable that prices increase further due to low interest rates and expansive monetary policy. The risk premium that remunerates shareholders over the long term for the risk taken on compared to government bonds suggests that equities are still attractive.

In actual fact, despite everything equities have got a green light, with “green” being the operative word. Sustainability has become a buzzword, leading to discrepancies and excesses in terms of valuation. “Environment, Social and Governance (ESG)” considerations have become an established benchmark for investments. However, it must be borne in mind that stock prices of companies with this seal of approval have already been boosted, which calls for a cautious approach.

Following the outperformance by “growth” equities, based on the consideration that growth capable of justifying high prices is more difficult to achieve, we may be temporarily entering a period focusing on “value” equities, which are mainly to be found in Europe. It remains to be seen whether this will mark a trend reversal. For this reason, we are attempting to strike an optimum balance between the two approaches. Over the longer term, it makes sense to focus on quality companies. Our key quality criteria include structural market growth, a leading market position, management with a track record, a solid balance sheet, good and stable margins and attractive returns on capital, along with a reasonable balance between using cash flows for investing in growth and for pay-outs.

*Graph 3: Relative development of “growth” vs. “value”*



Source: Bloomberg, Belvalor; Growth = MSCI World Growth Index (start: 100, 31/12/1974), Value = MSCI World Value Index (start: 100, 31/12/1974)

All of this seems a little disconcerting. Markets are more fragile and have become more prone to setbacks. But, “external shocks” like pandemics cannot unfortunately be forecast. If you try to think about everything that could possibly happen, it often gets in the way of a good

performance, which in turn creates a cushion for setbacks. Equities remain our preferred investment class – although always with a watchful eye and exercising the necessary foresightedness and caution.

## **Commodities and alternative investments**

An economic upswing is driving demand for commodities, which is inevitably leading to rising commodity prices. We are optimistic, especially about the much-maligned oil market. Prices could climb above USD 60 a barrel. We are investing in low-priced equities of companies from the oil and commodities sector, preferring those that take ESG seriously. Gold has not lost its lustre and is rather going through a consolidation phase now. As an alternative, we are favouring platinum, the price of which has bottomed in the face of its reduced industrial relevance. It is advisable to include gold in a balanced portfolio – for the purpose of both hedging and diversification.

### **Gold has not lost its glitter**

Diversification is also an issue in relation to cryptocurrencies. They are becoming more widely accepted and more attractive. It is important to keep track of developments.

The search for returns coupled with higher prices during times of low or negative interest rates is stoking demand for alternative investments. Private equity is still attractive. We invest in themes like private equity, private debt, real estate, and infrastructure and prefer equities of leading private equity managers.

Infrastructure is also still a hot topic. The most suitable approach is either direct investment in the corresponding equities, or attractive, bond-like niche strategies.

### **Swiss real estate**

The direct impact of the pandemic on rental income from Swiss real estate has been low and has not caused any problems for real estate funds and equities. Compared to bonds, real estate equities and funds have an attractive distribution yield. On the other hand, caution is necessary in relation to investments with high premiums above the intrinsic value. This also applies in relation to commercial properties and those with high vacancy rates. Overall, there is still excess demand on the real estate market due first of all to the investment requirements of institutional investors, and secondly also of private investors. This will continue to put upward pressure on prices.