Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

No time for complacency

Q1 2020

Table of contents

Editorial

Dear Reader,

By all measures, 2019 was an exceptional investment year. Despite lingering concerns about a US recession and other investor worries, most – if not all – asset classes delivered solid positive performances. The policy reversal of the US Federal Reserve, which translated into three rate cuts over the course of the year, was at the heart of this flattering result.

We are fairly certain that this outcome will not be repeated in 2020. For one thing, the Fed has signaled that it sees no need for additional stimulus. Furthermore, most asset classes appear fairly valued, suggesting their upside is limited. We continue to hold fast to the principle that diversification is the key to robust portfolio management. Observing this core principle and holding low-volatility, low-correlation assets should help investors to contain any potential drawdowns.

The US presidential elections will loom large in 2020 – we therefore take a preliminary look at this event in our Special Topic on page 10.

We wish you a very successful investment year and look forward to your feedback and comments.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Still in growth mode

The global economic context has changed little in recent months: Manufacturing has failed to regain its footing while the services sector has enjoyed ongoing healthy business conditions. Easy monetary (and possibly also easier fiscal) policy are set to continue supporting growth – during the first half of 2020, at least.

Table 1: Real GDP growth (y/y in %)

	2019E	2020F	2021F	Short-term trend
United States	2.3	1.8	1.9	↘
Eurozone	1.2	1.0	1.3	↘
Germany	0.5	0.7	1.2	↘
United Kingdom	1.3	1.1	1.5	↘
Japan	1.0	0.5	0.8	↘
China	6.1	5.9	5.8	→
India	5.6	5.1	6.2	↗
Russia	1.2	1.7	1.8	↗
Brazil	1.1	2.2	2.5	↗

Table 2: Consumer price inflation (y/y in %)

	2019E	2020F	2021F	Short-term trend
United States	1.8	2.1	2.1	↗
Eurozone	1.2	1.2	1.4	↗
Germany	1.4	1.4	1.5	↗
United Kingdom	1.8	1.7	1.9	↗
Japan	0.5	0.7	0.7	↗
China	2.9	3.1	2.1	→
India	3.7	4.0	4.1	↘
Russia	4.5	3.3	4.0	↘
Brazil	3.7	3.7	3.8	↘

Source: Bloomberg, IMF, HBZ

Key points

- Longest-ever US expansion to continue well into 2020
- Europe positioned for another growth 'up-leg'
- China remains biggest single contributor to global growth despite lower rate of expansion

The never-ending cycle

The current US expansion has entered its 32nd quarter and is undoubtedly the longest on record. The rate of expansion may be lower than during previous cycles but even at 2.0% real annual growth, jobs will continue to be created and income will rise. This unprecedented cycle has been achieved in the face of serious fundamental challenges of which the US-China trade dispute is just the latest manifestation. And as we embark on 2020, there are few signs of an imminent end to this cycle: Monetary conditions are easy, especially given that US nominal GDP growth is in the vicinity of 4%; US fiscal policy is relatively loose; and the external environment is likely to improve with the signing of 'Phase 1' of the US-China trade deal. Finally, this being a presidential election year, incumbent President Trump has little interest in rocking the economic boat any further. Companies may take this as a cue to notch up their lagging investments. We therefore expect US growth to stay around potential for at least the first half of the year.

Somewhat better growth in Europe

Judging by the latest economic data, the growth slowdown in Europe appears to be coming to an end, boding well for somewhat stronger economic performance in the months ahead. The end of the acute phase of Brexit uncertainty should lead to improved business confidence in the short term, however finalizing a new trade relationship with the EU will be a daunting task requiring major compromises on both sides of the Channel. As in the US, central bank policy will keep financial conditions accommodative while fiscal policy is likely to ease considerably in the UK – and possibly also in Germany.

Counting on China

The global economy has become increasingly reliant on China as the largest contributor to growth. While Chinese growth will continue to slow in 2020, probably falling below 6% for the first time in recent memory, even at this reduced rate the annual nominal increment will be equivalent in size to the Spanish economy. The US-China trade deal will provide additional impetus for growth, as will the revised NAFTA agreement ('USMCA'), once it has been signed by the US Senate. Emerging economies will be the first to benefit from improved trading conditions in the context of a stable US dollar and low US interest rates.

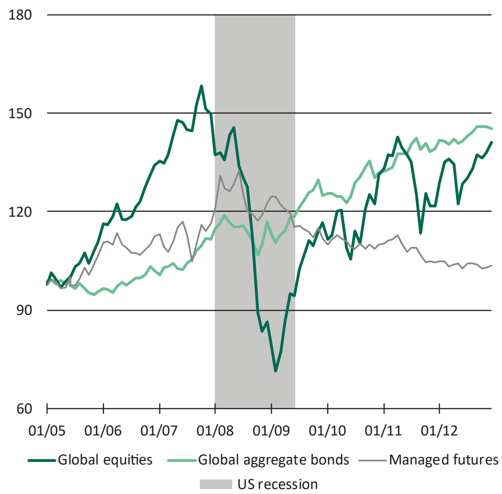
Investment strategy: No time for complacency

2019 was a stellar year for most asset classes and the backdrop remains favorable for risk-taking. However, investors should not become complacent. The world remains a precarious place and portfolios need to be well diversified to absorb more or less persistent bouts of volatility.

In the beginning was ... diversification

Diversification is the backbone of modern portfolio management. Under conditions of uncertainty – a somewhat academic description of the inherently messy and unpredictable world we inhabit – investments are best distributed across a range of assets with different sources of return. Ideally, such an allocation will allow for relatively steady returns, as the poor performance of some instruments will be more than offset by those that outperform. With expansion being the natural state of economies, and by extension financial markets, expected and realized returns should be positive. However occasional drawdowns, which may be brutal but are often short-lived, are unavoidable. Again, diversification is the best way to limit the impact of such periods of turbulence. With another strong year under our belts, we expect to reduce our risk exposure over the coming months as the current cycle continues to mature. There is no need to list all the possible risk scenarios for 2020; suffice it to say that history suggests the current high valuations for both bonds and equities will cap future returns. We will particularly be focused on assets offering superior risk-adjusted returns, such as investment-grade credit, EM sovereign debt and defensive equities, or strategies with low or negative correlation to equity markets such as managed futures and micro-finance.

Chart 1: Diversification at work − 2004 to 2012
(Total return index 100 = 10/2014)



Source: Bloomberg, HBZ

Our positioning

With the exception of our reduced investment in energy stocks and a modest increase in European equities, we have not materially changed our exposure at the turn of the year. Going forward, we will add to our Treasury holdings and increase our allocation to alternatives, including hedge fund strategies. High valuations across all asset classes will make us more cautious in the investment of new money.

What to watch

While the US presidential elections will doubtless dominate the headlines for much of the year, we will be monitoring a range of other developments that have significant disruptive potential at this stage in the cycle, specifically USD liquidity against a backdrop of lingering tension in the US repo market, US trade policy towards nominally allied nations, as well as corporate leverage and earnings. It goes without saying that geopolitics requires our ongoing attention even if the market impact of such events is often fleeting.

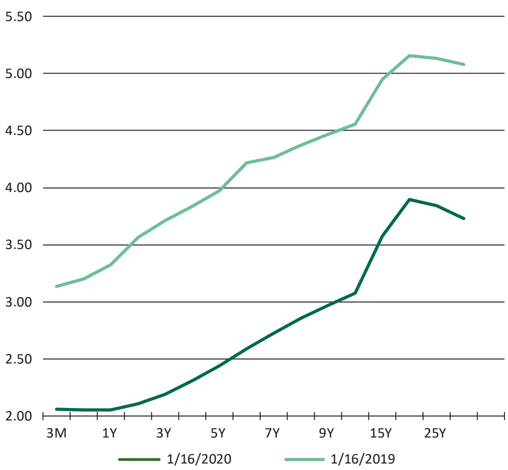
Key points

- Diversification remains core principle of portfolio management
- Lower expected returns requires greater focus on risks
- US politics set to dominate headlines in 2020

Fixed income: Coupon, what else?

2019 has been an outstanding year for global credit markets thanks to the simultaneous drop in credit spreads and yields. Most fixed-income assets are now expensive and we expect to earn the coupon return, at best. Our favorites remain subordinated bonds of quality issuers and selected EM bonds.

Chart 2: Yields on BBB US corporate bonds (in %)



Source: Bloomberg, HBZ

Favor subordinated bonds

The economic backdrop of low growth and inflation and ultra-loose monetary policy continues to provide a good environment for credit. The spreads of investment-grade bonds tightened significantly last year and are currently close to their post-crisis lows. As we do not expect spreads to tighten further, this year the bulk of returns will come from coupon income. In fact, we expect moderately higher spreads and more volatility, however this should still translate into positive returns. Quality bonds are a key holding within a well-diversified portfolio, and despite an uninspiring return outlook, investors would do well to hold on to these lower-risk assets in anticipation of potentially more turbulent times. Within investment-grade, we favor corporate hybrids and subordinated financial bonds which should benefit from investors searching for additional yield. Hybrids are long-dated, callable subordinated bonds, normally issued by investment-grade companies and offering yields well above those of senior bonds from the same issuer. Most hybrid bonds tend to be repaid at the first call date, limiting the duration risk. We also remain positive on the subordinated financials of national champions where investors continue to be well compensated for the additional risk they assume.

Emerging markets: Not cheap but attractive

A de-escalation in the US-China trade conflict and signs that leading indicators are turning the corner should raise confidence and improve the outlook for emerging markets where fundamentals are solid on balance. Valuations are no longer cheap but by historical standards, and compared to other fixed-income segments, EM assets remain attractive. We continue to prefer EM sovereigns in hard currencies. While we are not counting on returns like those generated in 2019, we nonetheless expect a performance here that is likely to be better than for most other bond-market segments. Selectivity remains the name of the game in order to avoid unpleasant surprises. Finally, given policy support and favorable technicals, we think Asian hign-yield bonds, including Chinese real-estate bonds, represent an attractive satellite investment. However, this is a risky space largely made up of lower-quality issuers. Only investors with the appropriate risk profile should consider an investment and they should allocate only a moderate share of their portfolio, ideally via a well-diversified fund.

Key points

- Coupon return, not much else
- Subordinated bonds continue to offer yield pick-up
- EM bonds still relatively attractive

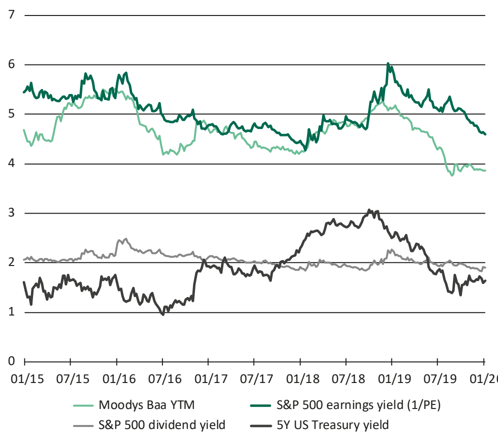
Equities: More modest returns in 2020

Global equities hit new all-time highs amid a gradual fading of macroeconomic concerns, central bank easing and a healthy US labor market. Following an exceptional year, we expect more modest returns in 2020. But how much of this next cycle extension has already been priced in?

Still some upside

Global equities recorded their best annual returns of the decade in 2019. Equity performance was fueled by multiple expansion (an increase in stocks' price-to-earnings ratio), while earnings growth remained subdued in most regions. Multiple expansion reflects an anticipated improvement in the economic environment for corporations; this must now translate into renewed earnings growth. While certain markets such as the US look expensive when measured on a price-to-earnings basis, we believe global equities will continue to be supported and have the potential to outperform other asset classes.

Chart 3: S&P 500 yields higher than bond yields (y/y %)



Source: Bloomberg, HBZ

The case for equities

(a) The high proportion of European – and to a lesser extent US – companies offering a dividend yield above their bond yield speaks in favor of an allocation to equities. (b) In 2019, fixed-income products largely dominated investment flows, implying uneven investor participation in the equity market rally. Consequently, investors' positioning does not currently look stretched. (c) The additional compensation investors demand for investing in equity instead of government securities – a metric known as the equity risk premium – remains elevated by historical standards and has room to fall. (d) Volatility will undoubtedly increase going into the US election. While Democratic candidates and the incumbent President disagree on many issues, both camps agree on the need for infrastructure spending, a topic likely to once again take center stage. (e) The signing of 'Phase 1' of the trade deal between the US and China should improve global business confidence and support emerging markets. (f) China will be celebrating the centenary of the founding of the Chinese Communist Party in 2021 and the country therefore cannot allow its economy to weaken.

A diversified allocation

With no recession in sight, we recommend a geographically diversified, 'style-neutral' equity allocation. Calling for an underperformance of the US equity market has traditionally proved to be a perilous exercise. However, it certainly makes sense to hold some European, Japanese and emerging market assets as they have underperformed, are underowned and are relatively cheap. In the noisy US political context, non-US markets could shelter investors from campaign-related market volatility.

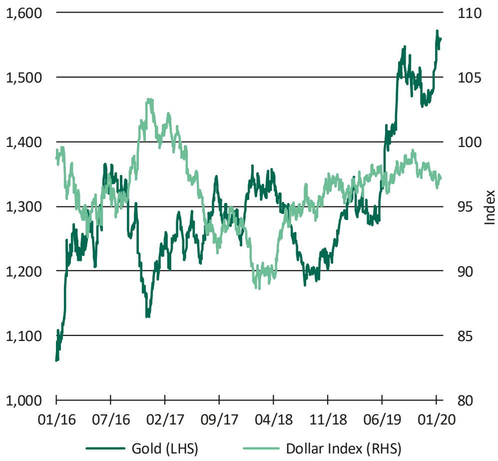
Key points

- Markets still offer some upside
- Economic and technical environment still relatively supportive
- Diversify across geographies and styles

Commodities and FX: Some USD weakness possible

Despite being an eventful year, currency volatility was generally low in 2019. Barring geopolitical shocks, we expect the first half of 2020 to resemble the end of 2019, with the US dollar weakening modestly in a more favorable global macroeconomic context.

Chart 4: Gold and the Dollar Index: US dollar steady as gold picks up (USD/oz)



Source: Bloomberg, HBZ

Fed course reversal in 2019, USD steady

2019 saw the Fed cut interest rates three times and expand its balance sheet to avert a liquidity crisis in the repo market. In 2018, by contrast, the Fed hiked interest rates four times and initiated a balance sheet reduction program. Given the fundamental policy reversal we might have expected a highly volatile year for the USD, however the greenback, as measured by the Dollar Index, moved within a 4% range and closed the year flat. After a period of relative strength, the USD weakened in the fourth quarter in response to a stabilizing macroeconomic backdrop and positive developments on trade and Brexit. Better growth in 2020 could accentuate this move, but with most major central banks on hold and a well-advanced economic cycle, any further USD depreciation should remain contained. As ever, emerging-market currencies should be the prime beneficiaries of a weaker dollar, but a modest recovery in global growth could also push the euro higher. While the destiny of sterling still lies in the hands of Brexit negotiators on both sides of the Channel, we expect the parties ultimately to find mutually acceptable terms to define their new relationship. In the meantime, the Bank of England has reiterated that it has room for additional monetary stimulus. Sterling should therefore stay volatile but appreciate over time.

Gold, oil and geopolitics

Following a strong rebound in the first four months of 2019, weaker growth and trade greatly affected commodity prices mid-year. Once trade concerns had begun to abate, commodities rallied and closed the year with strong gains. In early 2020, the US-Iran stand-off was a timely reminder of how commodities behave in response to geopolitical stress, with gold reaffirming itself as the risk diversifier of choice for investors. We concur and maintain our favorable outlook for the yellow metal. Oil jumped on the news of the increased tensions but rapidly retreated once the worst of the crisis had passed. Finding a balance in the oil market will still be a significant challenge for OPEC, with non-OPEC production forecast to grow in 2020. We expect oil prices to remain range-bound, pressured by excessive supply but supported by a healthier economic environment. Attractive investment opportunities will once again abound for trading-oriented investors.

Key points

- US dollar to weaken modestly in favorable global growth context but downside limited
- Gold is ultimate diversifier in face of geopolitical risk
- Oil attractive as trading asset

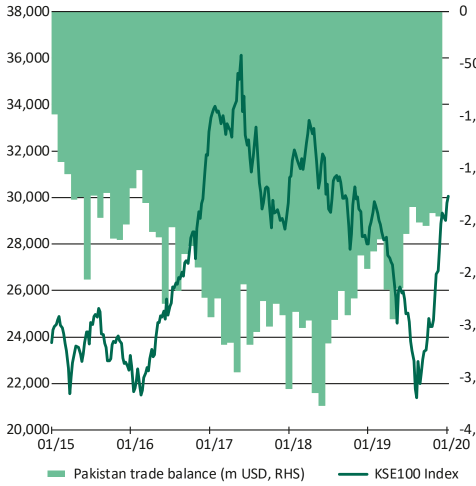
Key markets: A year of transition

Having digested some major and painful macroeconomic adjustments, the Pakistan economy seems to be on the mend but it is not yet out of the woods. Expo 2020 should boost UAE growth, at least temporarily, as should the new Tory majority in the UK parliament.

Pakistan: From pain to gain?

2020 will be a year of transition for the Pakistan economy as the government will have to stay the course to meet tough IMF conditions and pursue important structural reforms including for its highly strained public finances. As a result, growth will remain subdued although some policy measures should improve the trade competitiveness of key sectors. Inflation is expected to stay elevated before rolling over in Q2. This will open a window for the State Bank to start gradually easing its very tight monetary policy, improving local credit conditions in the process. Having depreciated by some 40% over the past two years, further downside for the PKR is limited at this point. Following the sharp contraction of imports, the country's external accounts have improved dramatically but additional efforts will be needed to put them back on a sustainable footing. The stabilization of the current account and currency have already contributed to a rebound in the local stock market and expectations of lower rates mean that the rally is unlikely to end any time soon. The question is whether foreigners will finally join in.

Chart 5: Pakistan − Stock market finally reacts to improving external accounts (USD bn)



Source: Bloomberg, HBZ

UAE growth boost thanks to Expo 2020

The much-anticipated Expo 2020 will provide an important boost to the UAE economy, which has already been supported by the three-year fiscal stimulus plan adopted in 2018. In turn, growth is expected to reach the highest level since 2016. However, the outsized real-estate sector has still not bottomed out; together with fickle oil prices and lingering regional tensions, it remains the key downside risk for the economy.

Brexit *ante portas*

The comprehensive victory of the Conservative Party in the national elections in December 2019 means that the UK will leave the EU on January 31, 2020. With some Brexit uncertainty removed, growth should recover, at least temporarily, supported also by the end of fiscal austerity. Concerns about a hard Brexit could, however, resurface later in the year if negotiations with the EU on a trade agreement were to stall. Bank of England policy will remain reactive, with a bias towards easing if needed. UK asset prices should benefit from improved visibility but they remain at risk in the event of a disorderly exit in 2021.

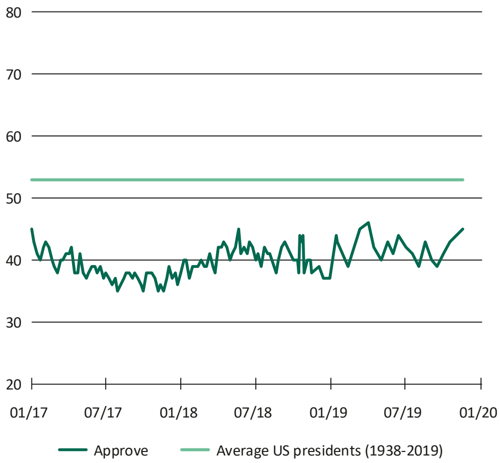
Key points

- Pakistan economy stabilizing – stock market stands to benefit
- Expo 2020 to lift UAE growth
- Some – but not all – Brexit uncertainty removed

Special topic: A first glance at the US presidential election

The impeachment process is about to move from the House to the Senate, yet President Trump is still expected to win a second term in November. What could change this, and what would the consequences of such a turn of events be?

Chart 6: President Trump's approval rating: low but steady (Index 0 - 100)



Source: Gallup, HBZ

Key points

- Trump remains favorite to win second term
- Financial markets would welcome continuity
- Equity markets would react negatively to signs of Democrat victory

Why Trump remains the favorite

Historically, incumbents have been favored in US presidential elections, and despite his low approval ratings and divisive personality, Donald Trump remains the candidate to beat. The impeachment process has so far done nothing to change the Republican Party's support for the President which remains as strong as it was at the beginning of his term of office. To date, polls in key swing states have not shown a clear break towards the Democrats. As long as he can hold on to some of them, Donald Trump is likely to win the majority of the electoral college even if, as is expected, he once again loses the popular vote.

Could the Democrats win?

While it is still early days in the US election campaign, it is safe to say that the Democrats are likely to face an uphill struggle in their quest to regain the White House. The choice of challenger will certainly make a difference but the outcome of the election will probably largely depend on the performance of the US economy over the remainder of the year. A recession, or even just a further contraction in manufacturing, could end Trump's hopes of retaining some of the swing states in the US industrial heartland and thus his presidency. His willingness to sign what amounts to a ceasefire with China over trade indicates that he and his team are keen to avoid such an outcome at all costs. At this point, with a 'cessation of hostilities' on the China front and based on the latest economic data and forecasts, a recession by mid-2020 is a low-probability event.

Investment implications

Financial markets would most likely welcome a second term for President Trump even if his tax and spending policies will in due course threaten the very fabric of the US economy, leading to higher income inequality and ballooning Federal debt. A win by the Democrats would be viewed more negatively and any indication to this effect would feed through to equity markets well before November. The main concern among investors is that a Democrat administration would roll back some of the Trump-era tax cuts and launch a new wave of regulation for multiple industries, notably health care, financials and energy. Moreover, Democrats have been highly critical of the power of the large internet companies, which could also face regulatory actions. All of this would be negative for the US financial markets.

Market data summary

As of 20 January 2020

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	7,080.0	10.4	2.5	43.5
S&P 500	3,329.6	11.5	3.1	46.6
EuroStoxx 50	3,808.3	6.4	1.7	15.4
FTSE 100	7,674.6	7.3	1.8	6.6
SMI	10,841.8	8.8	2.1	31.0
Nikkei	24,083.5	7.1	1.8	25.8
MSCI EM USD	542.9	12.4	2.9	38.0
Sensex 30	41,659.3	6.0	1.0	54.1
KSE 100	42,834.0	26.5	5.2	-13.2
Hang Seng	28,859.7	8.0	2.4	26.1
Russia RTS	1,645.5	21.4	6.2	44.5
Brazil Bovespa	118,478.3	13.1	2.4	83.6

Bond indices	Last	-3M %	YTD %	-3Y %
Citi US gov	1,595.66	0.0	0.5	10.6
CIti US Corp	2,457.45	2.1	0.9	19.4
CIti US HY	1,117.01	3.3	0.7	19.3
Citi Euro gov	248.29	-1.4	0.3	9.2
CIti Euro Corp	251.11	0.3	0.3	8.1
CIti EM Sov	920.69	3.0	0.9	20.5
DB EM Local USD	178.98	3.1	0.4	20.2

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	97.61	0.3	1.3	-3.1
EUR	1.11	-0.5	-1.2	3.7
CHF	0.97	1.9	-0.2	3.5
GBP	1.30	0.0	-2.1	4.9
JPY	110.14	-1.4	-1.4	4.1
AUD	0.69	0.2	-2.1	-8.9
CAD	1.31	0.2	-0.6	2.0
ZAR	14.47	2.0	-3.4	-6.0
INR	71.09	0.1	0.4	-4.1
PKR	154.62	1.1	0.2	-32.2
Gold oz	1,557.24	4.8	2.6	29.1

Interest rates	3M interbank %	10YR government %
USD	1.82	1.82
EUR	-0.39	-0.21
GBP	0.70	0.63
CHF	-0.68	-0.55
JPY	-0.05	0.01
AUD	2.96	1.17
CAD	1.17	1.56
ZAR	6.59	9.02

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For your notes

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