HBZ Investment Quarterly

Recovery in sight!

Q1 2021

Table of contents

Editorial	3
The macro backdrop: Recovery in sight	4
Investment strategy: How long can this last?	5
Fixed income: Decent returns only in niche markets	6
Equities: Momentum, momentum!	7
Commodities and FX: Demand and price recovery	8
Key markets: Recovery – slow or fast?	9
Special topic: Sustainability goes mainstream	10
Market data summary	11
Disclaimer	16

Editorial

Dear Reader,

The arrival of several vaccines to fight the deadliest pandemic in over a century has fundamentally changed the outlook for the world economy, and the conditions for a solid recovery in 2021 now appear to be in place. However, the path ahead will be fraught with dangers and the risk of (at least temporary) setbacks is real.

Many investors are troubled by elevated valuations in most asset classes. While we have some sympathy for these concerns, we believe a major reversal would only occur if some of the key drivers currently sustaining market momentum were to disappear (e.g. if the major vaccines were to fail and/or there were to be a sharp and continued rise in interest rates). Neither of these scenarios seems likely in the coming quarters. We therefore recommend staying invested in a well-diversified, global portfolio.

In recent years, investors have become increasingly interested in using their portfolios to achieve goals that go beyond pure economic returns, a development captured by the concepts of sustainability and ESG investment. We discuss this change against the backdrop of current market developments on page 10 of this issue.

As we embark on a new year that will present plenty of challenges, we wish you success – and above all, good health. As ever, we look forward to a robust exchange of views on our analysis and recommendations.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

Habib Bank AG Zurich

The macro backdrop: Recovery in sight

The pandemic is forcing many economies to maintain harsh containment regimes. However, the rollout of multiple vaccines against COVID-19 and sustained fiscal and monetary stimulus have set the stage for a broad-based recovery in 2021.

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

	2020E	2021F	2022F	Short-term trend
United States	-3.5	4.0	3.1	↗
Eurozone	-7.4	4.7	3.7	↗
Germany	-5.6	4.0	3.4	↗
United Kingdom	-11.2	5.1	4.8	↗
Japan	-5.3	2.7	2.0	→
China	2.0	8.2	5.5	↗
India	-8.4	9.0	5.7	↗
Russia	-3.8	3.0	2.5	↗
Brazil	-4.6	3.5	2.5	↗

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

	2020E	2021F	2022F	Short-term trend
United States	1.2	2.0	2.1	↗
Eurozone	0.3	0.9	1.2	↗
Germany	0.4	1.3	1.4	↗
United Kingdom	0.9	1.5	1.9	→
Japan	0.0	0.1	0.5	→
China	2.6	1.6	2.3	→
India	6.4	4.5	4.6	↘
Russia	3.4	3.8	3.8	→
Brazil	3.2	3.5	3.5	↗

Source: Bloomberg, IMF, HBZ

Key points

- Biden administration to increase government spending to shore up recovery
- With Brexit behind them, EU to focus on growth
- China and India to drive EM/global economic expansion

Change coming to the US?

Following its most tumultuous presidential election in recent history, the US will now have to confront its many demons. Notwithstanding unproven claims to the contrary, Joe Biden won a clear mandate to become the country's 46th president and his Democratic party was also rewarded with the slimmest of majorities in the Senate, handing it control of Congress – at least until November 2022. President Biden's top priorities will be to fight the still-raging COVID-19 pandemic and support the economy with a huge stimulus and infrastructure investment plan. With the vaccination campaign gaining momentum, these measures should reinforce the recovery that started during early summer 2020. Data may be volatile, with soft patches here and there, but the reopening of the economy paired with significant pent-up demand should translate into real growth of 4-6% for the year as a whole. The Federal Reserve is committed to keeping monetary conditions as accommodative as possible; this may even mean taking further action to ensure that the yield curve does not steepen too much, too quickly. Once the recovery is on course, the new administration will likely begin addressing the justified grievances of those portions of the population that powered Trump's rise.

EU: Beyond Brexit

The signing of the Trade and Cooperation Agreement with the UK at the very end of 2020 will finally allow the EU to refocus on the task of reviving economic activity in its member states. With a substantial pandemic recovery plan in place, EU growth is set for a strong – but possibly delayed – rebound. The ECB is keen to see higher, not lower, inflation and will thus keep its monetary toolkit fully deployed and aligned with eurozone and EU economic priorities.

China and India leading EM growth

While it is clear that the pandemic has had a profound effect on the emerging world, the precise extent of the damage is not yet known. However, its two largest economies are set to enjoy a strong recovery. Having avoided a full-scale recession, China has had a comparatively 'good' pandemic, and India too has got off relatively lightly, all things considered. Both countries are likely to see a year of strong growth.

Investment strategy: How long can this last?

With global equity indices at record highs and both bond yields and credit spreads near record lows, investors are right to ask whether last year's remarkable market performance can continue. We believe it can, provided certain conditions hold.

Momentum and fundamentals

After a year of surprisingly strong returns considering the most extraordinary market context in recent history (even the 2008–2009 period pales in comparison), many are wondering whether this momentum can be sustained. Worries center on high valuations discounting strong earnings as well as on extremely low interest rates, which in many cases were responsible for lifting valuations to current levels in the first place. If either of these variables gives, there is little doubt that equity and credit markets will be in trouble. But is such a scenario likely? For the earnings recovery to falter, mutant strains of the COVID-19 virus would, for example, have to overwhelm the new vaccines, forcing governments to keep containment regimes in place for longer. However, there is no evidence yet that any of the approved vaccines would fail to protect against such new strains. For interest rates to rise to levels that would threaten the recovery, bond markets would have to run riot and central bankers sit on their hands. Neither of these outcomes is likely in a world of zero yield for cash and activist monetary authorities. Could a surge in inflation sap economic activity? Yes, it could, but a sustained rise in inflation seems unlikely given high unemployment and spare capacity. An abrupt withdrawal of fiscal and/or monetary support is equally improbable. However, a policy error of this kind or a geopolitical incident present residual risks, so investors are best off maintaining well-diversified portfolios.

Chart 1: Low yields equal high valuations

Source: Bloomberg, HBZ

Our positioning

At the end the 2020, we switched our equity allocation to neutral – a move which we funded by selling our position in convertible bonds. We maintain our underweight in fixed income, where we continue to focus on the themes of credit and subordination, and we are investing the balance in alternatives, namely hedge funds and gold.

What to watch

The pace and shape of the economic recovery will be the key drivers of financial markets in the months ahead. Central bank communication should be closely scrutinised, too. As the 'taper tantrum' in 2013 showed, investors react to even the minutest shifts in language if they perceive these as undermining the dominant investment thesis. Last but certainly not least, the policies of the new US administration could impact markets in unexpected ways.

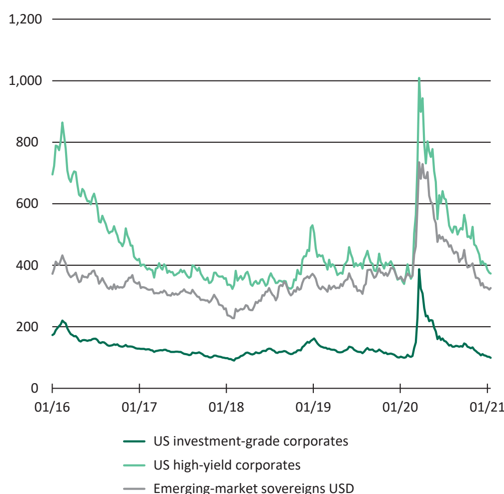
Key points

- Economic recovery to support markets
- Central banks unlikely to let yields surge unchecked
- Diversification remains key to successful investment strategy

Fixed income: Decent returns only in niche markets

In recent months, credit spreads have tightened further and US Treasury yields have remained low by any standards. As a result, most fixed-income assets will deliver only low returns. Value can still be found in subordinated bonds (including 'CoCos') and in emerging market corporates.

Chart 2: Not much 'juice' left in credit (option-adjusted spreads in basis points)



Source: ICE BofA, HBZ

Moving down the capital structure

Spreads on USD investment-grade bonds have narrowed further thanks to less political uncertainty and positive news on the vaccine front. Further material tightening is unlikely and returns are set to be low for this asset class for the foreseeable future. One option for enhancing yields is to add corporate hybrids or subordinated financials. While these bonds have also rallied substantially, they still offer higher returns and a more attractive overall risk/return profile, especially if the focus is on quality issuers. Contingent convertibles, or CoCos, are one segment that stands out, as these bonds offer the most substantial yield pick-up. While investors should be aware that CoCos can be converted into equity or partly written off if certain trigger levels are breached, increased capital requirements have bolstered the capital adequacy of most issuers, meaning that such outcomes are fairly unlikely for genuinely sound names.

Why not EM corporate bonds?

While broad EM sovereign and corporate spreads have also tightened, many hard-currency EM sovereign and corporate bonds still offer value, both in relative and absolute terms. In the sovereign space, EM high-yield bonds offer the most potential due to their higher spread levels – and thus greater potential for further compression as the global recovery continues. But investors must be selective and should avoid the weakest candidates, such as Sri Lanka. The hard-currency EM corporate space also looks attractive, as we see potential for further spread tightening. An often-overlooked feature of EM corporates is their relatively short duration compared to their sovereign peers. However, this market segment is relatively volatile and is only appropriate for investors with a correspondingly high risk appetite. Given the under-researched nature of this market, we recommend investing only through a well-diversified collective investment vehicle.

Key points

- Value still to be found in subordinated bonds
- CoCos an attractive alternative
- EM corporates offer upside potential

... or non-directional strategies?

Many investors have begun to question the value of investing in bonds at historically low yields. Indeed, the current environment certainly strengthens the case for non-directional strategies, such as absolute or total return, which seek positive performance independently of the cycle.

Equities: Momentum, momentum!

Equity markets started the year on a solid footing, sustaining the rally of the past few months. The latest political developments on both sides of the Atlantic bode well for the asset class, even if renewed disruptions over the winter months are set to delay the economic recovery.

A catch-up game

Democrats will control the US policy agenda for the next two years, though holding the Senate by the thinnest margin will constrain the implementation of President Biden’s agenda. We expect additional fiscal spending without corresponding tax hikes given the fragility of the economy. Coupled with the COVID-19 vaccine rollout, this should result in faster economic growth. We believe the improving macro backdrop will support the US stock market, and by extension, global equities. Companies and sectors most sensitive to the cycle should continue to catch up with 'COVID-19 winners'; at the same time, we do not believe that a pause in the outperformance of technology stocks would signal the end of this secular trend. We advise clients to balance their exposure to growth stocks and structural trends with selected cyclicals such as mid-caps, consumer cyclicals, emerging markets, and European equities. Companies that have suffered most from the pandemic will power the next leg of the rally. The market should also continue to reward regions and countries (e.g. China) that are able to limit the damage of the pandemic. But those with the most effective vaccine rollouts will ultimately take the lead.

Chart 3: US equity style and size performance
Index (100 = 20/1/2020)

Source: Bloomberg, HBZ

Valuations and interest rates

In many cases, valuations are close to – or at – historical highs. Such elevated valuations are sustainable as long as interest rates do not rise abruptly. A steeper yield curve would compress valuations and bring the rally to a halt. Beyond the virus, this is probably the principal risk facing equity markets, as a sharp increase in bond yields would also impact longer-duration assets, such as growth stocks with their higher expected future cash flows.

Looking for diversification in Europe

A Brexit deal was reached at the very end of the 'transition period'. While the deal addresses trade in goods, it is very minimalist when it comes to services. International investors have until now rightly shunned UK equities. As valuations look attractive and investors’ positioning remains light, we believe UK equities have the potential to rebound. On the other side of the Channel, eurozone equities are generally geared to global growth and should likewise benefit from any improvement in global trade.

Key points

- Favorable political backdrop
- Cyclicals to continue to catch up
- Interest rates main threat to risk assets

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Commodities and FX: Demand and price recovery

The current reflationary environment is supportive for commodities. While copper prices have already reached multi-year highs, the demand recovery on the oil market has not yet reached this stage. A weaker US dollar would support commodity prices further, but we do not see this as a requirement.

Chart 4: A different demand/supply dynamic

Source: Bloomberg, HBZ

Balancing the oil market

Winter lockdowns should prove to be only a temporary setback for oil. Anticipating the reduced demand, Saudi Arabia recently announced an additional 1 million bbl/d output cut for February and March. Saudi Arabia and OPEC's main priority is to draw down high inventories in order to bring the oil market back into balance. Active short-term supply management, demand recovery, and constraints to non-OPEC supply due to the relatively low price of oil should all facilitate this rebalancing. We expect the oil price to grind higher over the course of the year.

Preference for base metals over gold

The macro backdrop is constructive for base metals, with robust demand in China and a vaccine-driven global recovery in activity on the horizon. Metal prices have been rising strongly for some time now, while supply remains constrained due to underinvestment in recent years and COVID-19 disruptions. We expect prices to stay elevated, albeit accompanied by bouts of volatility. Beyond traditional infrastructure and equipment, investment in lower-carbon technologies, such as electric vehicles, will be a growing source of demand for mined commodities such as copper and lithium. Investors' views on gold are now mostly dependent on inflation expectations. Gold fully assumed its role as a safe-haven asset during the crisis. With a global vaccination campaign under way, investors may decide to reduce their holdings and reallocate to more cyclical assets. While we expect inflation to accelerate, the numbers will – initially at least – mostly reflect a base effect. Over the coming months, we forecast gold will remain in the current USD 1,800–1,900 range.

Moderate US dollar weakness

In a world without interest rate differentials, the US dollar could – in the early phase at least – further weaken as the global recovery intensifies. As safe-haven demand for Treasuries wanes and abundant supply further deters investors, prospects for the euro and some pro-cyclical emerging-market currencies should be favorable. An expansive fiscal policy and successful vaccine rollout could raise the specter of Fed tapering later in the year, despite recent comments by its chairman to the contrary. We expect the US dollar to continue to trade on the weaker side, however with limited downside overall.

Key points

- Oil to edge higher
- Base metals to outshine gold
- US dollar to weaken only moderately

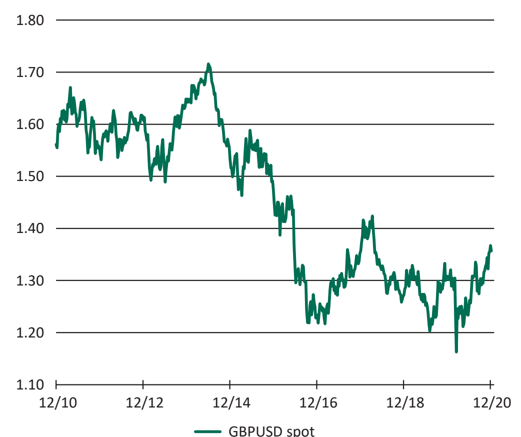
Key markets: Recovery – slow or fast?

Our key markets have all had an exceptionally challenging year but, to differing degrees, they are starting to see the light at the end of the tunnel. Important pending policy decisions will determine their fortunes in 2021.

Pakistan: A sustained but modest recovery

Pakistan suffered its first recession in decades as a result of the pandemic. But overall the country has managed the crisis remarkably well and the ongoing recovery is expected to gain strength in the months ahead. Re-engagement with the IMF will secure the necessary funding to stabilize the country's vulnerable external accounts. The IMF will also require many politically sensitive reforms but the program offers a chance to relaunch long-delayed structural changes, ranging from privatization to utility/energy prices and tax collection. Such reforms should help prepare the ground for more foreign investment. The State Bank, on the other hand, may have to dial back its monetary policy easing – some 100bps of rate increases are likely by mid-year. While this should further stabilize the currency, the impact on the stock market should be modest and more upside is likely.

Chart 5: Will the GBP thrive in post-Brexit Britain?



Source: Bloomberg, HBZ

UAE: More tailwinds than headwinds

The UAE economy suffered a double blow in 2020, hit as it was by the impact of the pandemic on non-oil sectors and the collapse of the oil price itself. Growth will resume in 2021, though, and higher oil prices and the postponed Expo 2020 will give a boost, as will the end of the Gulf Cooperation Council's dispute with Qatar. At the same time, Saudi Arabia's ambitions to turn its country into a business hub for the Middle East is an unwelcome challenge to the position that the UAE has hitherto enjoyed. Local asset prices should benefit from the improved outlook, although the weighty real-estate sector will remain a drag.

UK: Finding a new place in the world

The COVID-19 pandemic has hit the UK particularly hard; the outlook for 2021 will be clouded by this fact and the additional challenge of redefining the country's place in the world now that it has left the EU for good. While the Trade and Cooperation Agreement does enable tariff-free goods trade, as merchants have already discovered, transacting with continental European markets is anything but frictionless. Amid its worst crisis since World War II, the UK government will need to build a new web of global commercial treaties; this may not be easy given that the UK's relative loss of power. The Bank of England will maintain its highly accommodative policy and could still opt for negative rates. The GBP's fortunes could depend on them.

Key points

- Pakistan to stabilize amid gradual recovery
- More tailwinds than headwinds for UAE
- UK faces uncertain future in aftermath of Brexit

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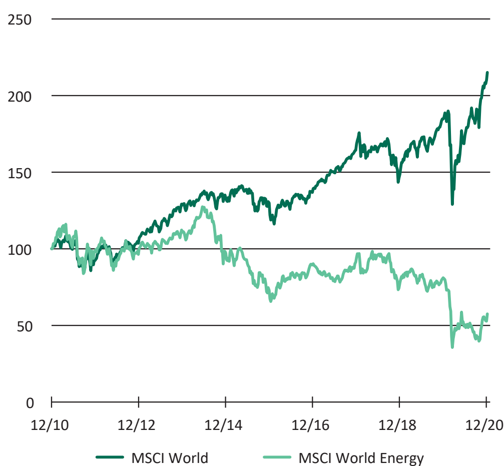
Special topic: Sustainability goes mainstream

Increasingly, investors expect more from their assets than mere financial returns. They want their portfolios to align with a broader set of environmental, social or other goals. The new US administration with its far-reaching agenda of change is set to accelerate this trend.

Chart 6: Sustainable investment – fossil fuel stocks underperform (index 100 = 12/2010)



Source: Bloomberg, HBZ

Environmental, social and governance (ESG) is shorthand for the assessment of these dimensions within an investment process in addition to traditional financial metrics. It is often synonymous with 'sustainable investment'.

Key points

- Sustainable investment has gone mainstream
- Biden agenda as potential game changer
- Investors should consider ESG for their portfolios

And then there was ESG

The world has come a long way since Milton Friedman famously declared that the sole 'social responsibility of business is to increase its profits'. Indeed, people have long recognized that money is not an end in itself but a valuable resource with which to pursue other, non-monetary goals. Over the years, more and more market participants have begun subscribing to an agenda that fosters socially responsible investing (SRI) and assesses investments on the basis of environmental, social and governance (ESG) criteria. The investment industry has duly supplied this demand with an ever-expanding range of products and solutions. According to one source, in 2020 (and despite the global pandemic), assets under management in passive instruments (ETFs) based on ESG principles grew by more than 200%, albeit from a low base.

Navigating the sustainability space

Sustainable investments come in all shapes and sizes and the industry has yet to define common standards. However, the mainstreaming is well underway and the next iteration of the European MiFID regulation will require ESG considerations to be factored into the investment and advisory process. Indeed, many asset managers have already broadened their selection criteria to include ESG dimensions. Only time will tell who is seriously committed and who is just riding the wave. There is, however, a growing body of evidence that the application of ESG or similar criteria is value-creating. For example, take the performance of the MSCI World Energy Index, which is mainly composed of fossil fuel and related companies. At close to 14% per year, the underperformance of this sector over the past ten years relative to the MSCI World as a whole has been staggering.

The Biden agenda

The election of Joe Biden as US president may turn out to be a major catalyst for sustainable investing. Although the ambitious USD 2 trillion climate change plan may not be implemented in full, regulatory and fiscal support for 'green tech' will certainly favor companies active in this area. Changes to labor laws will reward employers who already pay attention to the wellbeing of their staff and working conditions within their supply chains. For investors, the bottom line is simple: ignore ESG at your peril!

Market data summary

As of 18 January 2021

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	8,085.2	11.6	1.0	30.5
S&P 500	3,768.3	8.2	0.3	34.7
EuroStoxx 50	3,597.6	10.9	1.3	-0.6
FTSE 100	6,724.8	13.6	4.1	-12.7
SMI	10,872.0	6.5	1.6	15.0
Nikkei	28,242.2	20.6	2.9	18.8
MSCI EM USD	656.5	21.1	5.2	18.8
Sensex 30	48,564.3	21.5	1.7	37.7
KSE 100	45,726.7	13.8	4.5	4.9
Hang Seng	28,862.8	18.4	6.0	-10.1
Russia RTS	1,472.9	30.0	6.2	15.1
Brazil Bovespa	121,609.8	23.7	2.2	50.2

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,695.68	-1.4	-1.0	16.0
FTSE US Corp	2,657.54	1.4	-1.0	22.6
FTSE US HY	1,183.22	5.4	0.4	18.2
FTSE Euro gov	258.48	-0.1	-0.2	12.1
FTSE Euro Corp	257.68	1.2	0.1	8.4
FTSE EM Sov	944.02	2.3	-1.8	13.8
DB EM Local USD	180.65	6.2	-0.6	5.2

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	90.77	-3.0	1.0	0.4
EUR	1.21	2.4	-1.3	-1.3
CHF	0.89	2.0	-0.7	7.7
GBP	1.36	4.4	-0.7	-2.3
JPY	103.85	1.6	-0.5	7.0
AUD	0.77	8.4	-0.1	-3.9
CAD	1.27	3.0	0.0	-2.6
ZAR	15.23	7.8	-4.1	-20.7
INR	73.07	0.1	-0.3	-12.9
PKR	160.56	1.1	-0.3	-31.0
Gold oz	1,828.45	-3.3	-3.0	38.2

Interest rates	3M interbank %	10YR government %
USD	0.22	1.08
EUR	-0.55	-0.52
GBP	0.03	0.30
CHF	-0.77	-0.46
JPY	-0.08	0.06
AUD	0.01	1.07
CAD	0.45	0.82
ZAR	3.64	8.85

For your notes

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