Habib Bank AG Zurich

HBZ Investment Quarterly

Stabilization (for now)

Q2 2019

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Editorial

Dear Reader,

The performance of financial markets in the first quarter of the year was in line with our expectations — indeed, it exceeded them. In most cases, the losses suffered in 2018 have been fully reversed across asset classes. This is certainly good news.

Notwithstanding this gratifying start to the year, things are unlikely to get easier going forward. In a sense, we are back where we were in the late summer of 2018 before global equity markets went into a tailspin, and only time and economic developments will tell whether investors are right in their assessment that there is no imminent risk of recession. Some data does however suggest that the worst of the downturn is over and that we can expect better momentum into the second half of the year.

But risks still abound: growth could yet disappoint; Brexit may turn out to be softer than many had feared, but political uncertainty remains high; and, if the US refuses to renew expiring permits for importing Iranian oil, we may be in for an unexpected shock in the form of a further spike in oil prices. For all these reasons, we are keeping our equity exposure below benchmark and have increased our exposure to investment-grade bonds, including US Treasuries.

In this edition's Special Topic we revisit hedge funds, often maligned as expensive and ineffective investments, but which may return to the fore as markets once again become harder to navigate.

As ever, we appreciate your feedback and look forward to continuing our lively exchanges on investment-related topics.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Stabilization

Following a sharp deceleration from the second half of 2018 onwards, global economic activity appears to have begun to stabilize late in Q1. Once again, central banks contributed to calming nerves but the outlook remains one of low growth and material downside risks.

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

	2018E	2019F	2020F	Short-term trend
United States	2.9	2.4	1.9	↗
Eurozone	1.8	1.2	1.4	↗
Germany	1.5	0.9	1.4	→
United Kingdom	1.4	1.2	1.5	↘
Japan	0.7	0.7	0.5	↘
China	6.6	6.2	6.0	↗
India	7.4	7.0	7.3	→
Russia	1.8	1.5	1.7	→
Brazil	1.2	2.0	2.5	↗

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

	2018E	2019F	2020F	Short-term trend
United States	2.4	1.9	2.1	→
Eurozone	1.7	1.3	1.5	↘
Germany	1.9	1.5	1.7	→
United Kingdom	2.5	1.9	2.0	↗
Japan	1.0	0.8	1.2	→
China	2.1	2.0	2.2	→
India	4.1	3.4	4.0	↗
Russia	2.9	5.0	4.0	→
Brazil	3.7	3.8	4.0	↘

Source: Bloomberg, IMF, HBZ

Key points

- Fed and ECB calm nerves on both sides of Atlantic
- Downside risks remain material over medium term
- China past worst of downturn

US: Lower for longer?

As US GDP growth continued to decelerate into the first quarter, many analysts warned about an impending recession. The latest economic data does not corroborate these concerns but rather signals some upside from current low levels. To a large extent, the future trajectory of the economy hinges on the employment market, which returned to decent growth in March after hitting an air pocket in February. Provided the US economy continues to add jobs and deliver some – albeit modest – wage growth, consumption will remain resilient. The Fed's new-found pragmatism will take care of the rest: unchanged short rates will anchor floating-rate debt and the imminent end of the balance-sheet reduction program will keep longer-term yields down, sustaining affordability for corporate and government debt and, importantly, mortgages. Downside risks persist over the medium term though, not least due to the unpredictability of the administration's policy agenda on foreign trade, government debt and fiscal spending. Confidence in the country's institutions could also take a hit if the president were to succeed in packing the Fed with political appointees.

Europe back in the doldrums?

Europe's economies have suffered multiple shocks – some endogenous, some exogenous – since growth peaked in mid-2018. Fortunately, however, recession does not appear imminent. Domestic demand seems to be sufficiently robust to offset the drag of a struggling manufacturing sector. That said, by February downside risks were substantial enough for ECB policymakers to halt the next step in the rate normalization process. With inflation below target and political risks proliferating (Brexit, populism, etc.), monetary conditions are set to remain accommodative well into 2020.

Emerging markets to the rescue?

Emerging markets have finally started to produce some positive news flow again: Brazil's economic performance is on the mend and, more importantly, the Chinese economy has passed the worst of its most recent downturn. At least cyclically, its growth rate should begin to pick up. While we should not downplay the fact that considerable risks continue to hang over certain economies, overall we expect better EM growth, which in turn will help stabilize the global outlook.

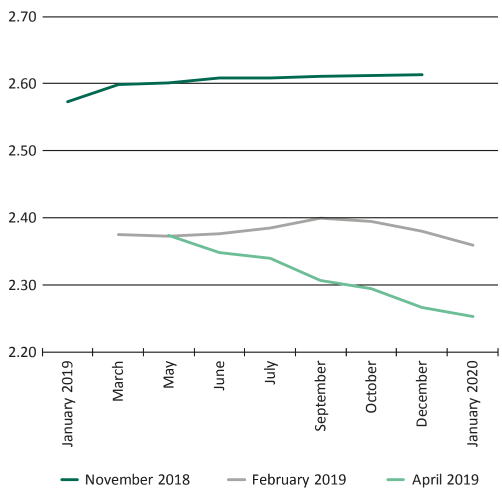
Investment strategy: The music is still playing

The first-quarter rebound confirms our view that the sell-off in 2018 was fundamentally unwarranted. A more protracted downturn will inevitably come at some stage, but for the time being a dovish Fed (and ECB) and a modest rebound in growth should ensure for some limited upside to asset prices.

Back from the brink

Things looked dire at the end of last year. Then the world's two key central banks – first the US Fed and then the ECB – threw a life line to financial markets when they pivoted to a more dovish policy stance. In this context the signal from a flat, and at times inverted, USD yield curve has become muddled and is of limited value to investors. The key question now is: will growth rebound from its currently paltry levels, as we expect? If it does, credit in particular should perform well, as servicing and rolling maturing debt will continue to be manageable at reasonable rates for all but the weakest borrowers. Compensation is no longer attractive for US high-yield, so we favor going for a credit barbell between investment-grade in developed markets and non-investment-grade in emerging markets. Capital-structure arbitrage also continues to make sense. In equity we will also maintain a barbell between the traditionally more defensive US market and emerging Asia, which should rally further if and when China and the US end their trade dispute. Sector-wise, financials have lost some of their appeal due to the flatter yield curve, and overall a more defensive stance is warranted here. Finally, any weakening of the US dollar would be a bullish development in the current context, however downside would be limited due to the currency's yield advantage.

Chart 1: Fed funds futures continously repriced down (% p.a.)



Source: Bloomberg, HBZ

Our positioning

As we kept our positioning unchanged going into the year, we were able to ride the risk rally and more than recover the losses we sustained in 2018. Against a backdrop of anchored long-term yields, we have increased our portfolio duration and added more US Treasuries as a hedge. Otherwise we maintain our broad diversification across asset classes and strategies.

What to watch

With monetary policy set for the foreseeable future, we will turn our attention to corporate results, especially the current US earnings season. Markets anticipate negative earnings growth year-on-year but only the final response by investors will show whether this has already been fully discounted; guidance for future quarters will become particularly important. We will continue to pay attention to the US policy cycle – including the management of the debt ceiling.

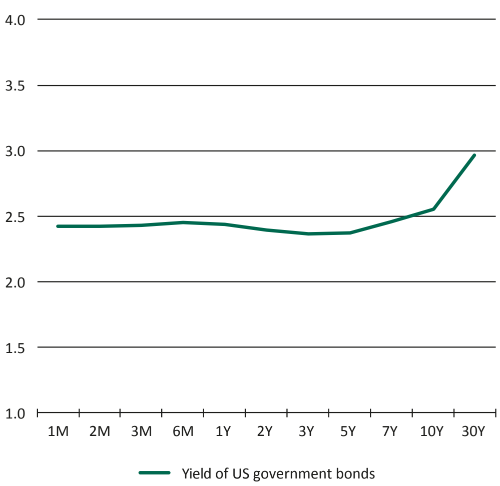
Key points

- Central banks throw financial markets lifeline
- Credit to continue to outperform
- US earnings season and US debt ceiling top of our watch list

Fixed income: Search for yield favors emerging markets

Most fixed-income segments delivered solid returns in the first quarter and we still see value among EM sovereign bonds and subordinated financials. However, investors would do well to hold investment-grade bonds as well for rainier days to come.

Chart 2: Very flat yield curve in USD (% p.a.)



Source: Bloomberg, HBZ

Key points

- Add investment-grade bonds for rainy days
- EM sovereign bond yields still attractive
- Stick with subordinated financial bonds

High-grade bonds – all-weather investments

Spreads tightened significantly in the first quarter of this year and, in our view, have now returned to fair levels. Total returns of bonds in the coming months will be driven by the carry, as we expect US treasury yields and spreads to remain stable. While we do not expect the cycle to end imminently, we are reckoning with greater volatility in the near future. During such times, it is useful to have portfolio stabilizers like investment-grade bonds in the mix; these securities generated positive returns in December 2018, as lower US Treasury yields offset spread widening.

EM sovereigns with attractive yields

EM credit has benefited from a more dovish Fed this year and progress on the US-China trade front served as an additional tailwind. We believe that EM sovereign bonds in hard currency will continue to be supported by stable US treasury yields and a stable USD. This sector still offers a relatively high yield compared with other fixed-income assets and will continue to attract investors hunting for yield. The main risks to this outlook are a re-escalation of the US-China trade tensions and a resurgence of US growth relative to the rest of the world, which in turn would cause the USD to strengthen and force the Fed to reverse its current stance. Other risks are a commodity (oil) price correction and a deeper-than-expected, synchronized global slowdown. Independently of whether any of these risks materialize, we expect an increase of volatility in this market after the huge rally in Q1. We continue to recommend short-dated Turkish sovereign or quasi-sovereign paper although careful selection is advised. Finally, rates for many EM currencies are much higher than in USD, some cuts are possible, and many currencies remain attractively valued. Local EM assets could therefore perform well in the months ahead but due to their volatility they are only suitable for investors with an 'equity-like' risk tolerance.

Value in subordinated financials

Many financials have deleveraged their balance sheets and are much better capitalized today than they were prior to the financial crisis. We favor issues by national champions and bonds which are lower down the capital structure (e.g. subordinated bonds) since they still compensate investors for the additional risk taken.

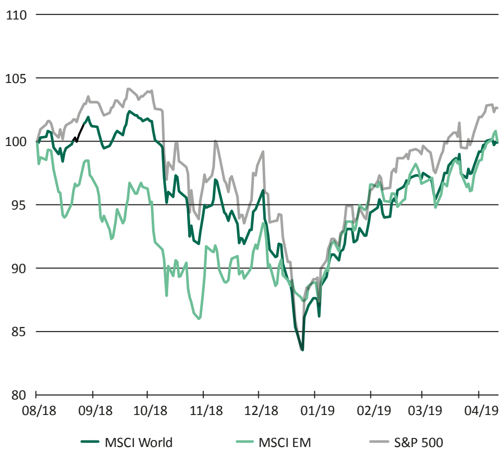
Equities: The long goodbye

Over the past six months equity prices have performed an almost perfect 'V' — a precipitous sell-off triggered by recession fears followed by a no less dizzying rebound once the Fed flinched. Equities now need to prove their fundamental mettle in order to remain attractive to investors.

Rates matter

If we have learned anything from the roller-coaster ride of the past six months, it is that rates matter. This may sound trivial but investors never tire of debating at what level of Fed funds or Treasury rates equity markets will cave in. In Q4 2018, the mere whiff of higher rates and possible recession sent equity markets into a tailspin. So, with rates anchored again, is everything back to normal and the future rosy? Not really. Few things remain the same for long in modern economies – hence either growth will pick up and the Fed will resume tightening or the incipient growth momentum will peter out and the Fed will have to go into reverse. Neither scenario is good for equities. At the beginning of the year, we made the case for equities in these pages and we remain convinced that equities are in many ways the most attractive asset class in relative terms. But since then a quarter has passed and the economic context remains fraught with risks. The current earnings season is a first opportunity for companies to prove that they can still deliver solid results in this advanced stage of the cycle. If they do not, investors could well lose hope and cash out.

Chart 3: The perfect V: Equity markets reverse Q4 sell-off (indexed at 100 (01/08/2018)



Source: Bloomberg, HBZ

Where to put your money

Until this time comes, we maintain our preference for US stocks based on the market's generally more defensive nature, although we recognize that the dominance of the IT and communications sectors may have altered this characteristic. At the same time, we fear that Europe, including the UK, will struggle to outperform due to the large proportion of financials as well as utilities in the main indices and as long as the continental car industry fails to solve its structural problems. However, for investors looking for current yield, European – and in particular UK – stocks offer attractive opportunities, with dividend yields north of 4% available from blue-chip companies. We continue to favor emerging-market equities and in particular emerging Asian markets with their leverage on China (whose economy, incidentally, we expect to rebound, and which on average can rely on strong domestic growth drivers). As regards our sector allocations, we are overweighting health care and IT, although we recommend rebalancing this exposure in favor of the former due to various regulatory and political risks facing the US technology industry in particular.

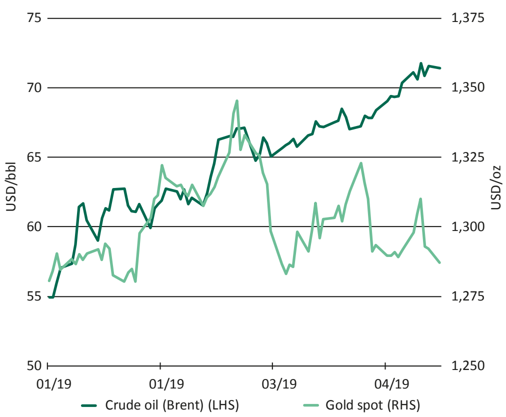
Key points

- Steady interest rates support equities
- Sustained earnings power essential to maintain investor confidence
- We see growth potential in health care and IT but recommend reducing exposure to the latter

Commodities and FX: Still a USD world

The pre-eminence of the USD is hard to challenge, especially as its yield advantage remains firmly in place. Commodities finally achieved a comeback in Q1 despite relative dollar strength but further upside will depend on firmer global growth.

Chart 4: Commodities: Cyclicals outperform defensives



Source: Bloomberg, HBZ

Key points

- Relative yields continue to favor USD
- GBP harbors substantial upside once orderly Brexit set in motion
- US policy towards Iranian exports to drive oil price

Dollar dominance

When the US Fed turned dovish at the end of 2018, USD weakness seemed inevitable and indeed, on a trade-weighted basis, the US currency swiftly lost some ground. However, when other central banks, especially the ECB, joined the Fed and toned down their rhetoric, the USD duly recovered. The lesson here is that as long as the US yield advantage remains in place and major political risks persist in the UK and the eurozone, the USD will continue to reign supreme notwithstanding the damage the Trump administration has inflicted on the US's reputation around the world. That said, we believe the GBP has the most upside among the majors: the currency is cheap, a lot of bad news is already priced in and, once an orderly Brexit has been set in motion, the Bank of England will probably raise rates. Apart from the large short positions in the markets, not much speaks for the euro. Further afield among EM currencies, carry still looks attractive, as we expect global growth to experience a mid or late-cycle uptick into H2. The likes of the Brazilian real, the South African rand or even the Turkish lira may enjoy another (brief) moment in the sun.

A rally of sorts at last

After a long period of underperformance the commodity complex finally came back to life during the past quarter and delivered a solid positive return overall. As is typical in this sector, dispersion was wide, with the cyclicals such as crude oil (WTI and Brent), iron ore and nickel standing out. More defensive commodities in precious metals and softs tended to lag. The sustained recovery of the crude oil price is attributable to greater production discipline on the part of OPEC members and Russia. In the face of growing US production they swallowed their pride and kept a firm lid on their output growth; a sharp rise of the crude price duly followed. Going forward, the performance of commodities will depend on the extent and duration of the anticipated recovery of global growth and, for crude oil, on how the US manages the expiry of the waivers granted to importers of otherwise sanctioned Iranian oil. The Chinese cycle will determine the trajectory of industrial metals; inventories have generally declined, but any surge in demand could quickly lead to further gains.

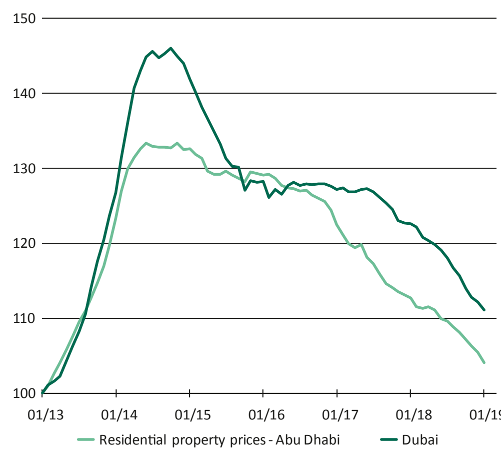
Key markets: The price of procrastination

Regrettably, our three core markets illustrate perfectly the results of a policy of kicking the can down the road: protracted uncertainty, loss of confidence and subpar growth. The time of reckoning will come sooner for Pakistan and the UK, but the UAE too will have to re-assess its priorities and policies.

Pakistan: Waiting for what?

When the new government assumed power last summer, hopes were high for a new set of policies to address the country's most pressing economic challenges. However, instead of swift, determined action, a period of hesitation and contradiction followed. While the government was able to mobilize substantial funds to reduce the pressure on foreign reserves, it could not restore confidence and growth has duly fallen to levels that are recessionary in the context of Pakistan. As elsewhere in the world, the country's central bank has done much heavy lifting while the rest of the adjustment has been absorbed by the currency. Looking ahead, investors are impatiently awaiting an agreement with the IMF, even if such a deal could entail further downside for the Pakistani rupee. Despite large official inflows, external and domestic finances remain stressed and require some tough policy decisions. Relations with India may thaw once the Indian elections are behind us however the material risk of being blacklisted by the Financial Action Task Force could provide yet another excuse for equity investors to stay on the sidelines. The truth is that attractive valuations are worth little when there is no light at the end of the tunnel.

Chart 5: UAE real estate prices falling fast
(index = 100 January 2013)



Source: Bloomberg, HBZ

UAE: Moving beyond real estate

In 2018 the UAE recorded disappointing annual real growth of 1.7%. 2019 should be better, as the rebound in the oil price has bought precious time for the economy. Activities in the context of Expo 2020 should provide some additional uplift. But there are mounting concerns beyond that point unless the dependency on oil – and especially real estate – can be broken.

UK: Brexit goes into overtime

Having failed to convince Parliament to adopt the painfully negotiated EU withdrawal agreement on three occasions, Prime Minister May has changed tack at the eleventh hour, seeking a deal with the opposition. The final outcome is still far from certain but a softer Brexit, including a customs union that will keep the UK firmly tied to the EU, appears increasingly likely. Still, even once Brexit has been 'settled', the UK faces real political uncertainty as the proponents of a hard Brexit are intent on further polarizing public opinion. After an initial relief rally for UK assets and a rebound in growth, the economy could be held hostage by a political elite hell-bent on settling scores.

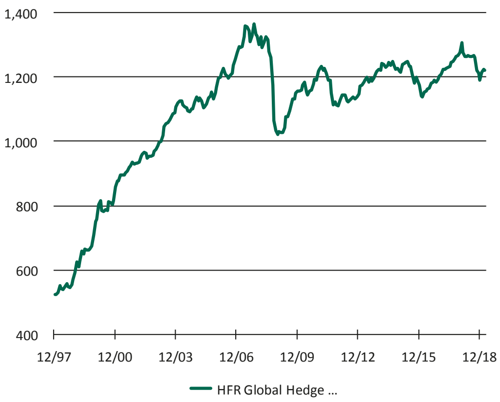
Key points

- Pakistan's economy pays price for delayed policy action
- Oil and real estate to support UAE growth in 2019 but probably not beyond
- Even Brexit will not solve UK's political crisis

Special topic: The case for hedge funds

Overall, hedge funds have had a disappointing few years. However, dismissing them casually as expensive and ineffective investments is too simplistic. As we will surely be facing tougher times on financial markets in the future, it is worth taking a moment to revisit this interesting investment space.

Chart 6: Hedge funds: Past performance is not a reliable indicator of future results



Source: Bloomberg, HBZ

Key points

- Hedge fund strategies no longer exclusive domain of ultra-rich
- Many strategies on offer to diversify and stabilize portfolios
- Net returns are what count, not fees

Hedge funds and related strategies

Hedge funds were initially designed as vehicles for wealthy individuals and institutions to hedge the risks in otherwise long-only equity portfolios. Over time, they evolved into the speculative entities made famous by George Soros who more than anyone has shaped hedge funds' aura of exclusivity coupled with financial brinksmanship. The underlying strategies deployed by hedge funds also changed over time, eventually embracing just about all investment approaches and asset classes. However, the reputation of hedge funds was shattered in the aftermath of the 2008 financial crisis, which left investors disillusioned by their underperformance, illiquidity and high fees.

Mainstreaming hedge funds

To focus solely on the disappointments associated with hedge funds since 2008 would be to miss the bigger picture. For one thing, many single hedge funds have done extremely well in the intervening period. For another, the widely used hedge fund indices are a flawed reflection of a diverse field of strategies with highly dispersed performance records. More importantly, there has been a mainstreaming of many hedge fund strategies, which are now even available in the 'retail compatible' UCITS format. Today, there is a wide range of successful funds on offer, especially for liquid strategies in equities, credit and futures, which do not require long lock-ups. As with conventional mutual funds, the challenge lies in selecting the right manager, because investing in a hedge fund strategy is typically less straightforward than buying stocks or bonds and frequently involves complex derivative transactions and overlays. Moreover, there are often no representative benchmarks available to evaluate a single hedge fund's performance. Despite these potential downsides, investors should not be discouraged from accessing hedge funds, as they can perform a valuable function in diversifying and stabilizing portfolios.

Focus on net returns, not fees

Much of the criticism leveled at hedge funds centers on their fee structures. But should it matter if a fund costs 2% plus a performance fee if a manager systematically generates superior net returns? We would argue that just as one is willing to pay more for a better-performing car, one should be willing to pay a premium for a manager who delivers above-average results.

Market data summary

As of 12 April 2019

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	6'207.3	10.4	14.7	38.5
S&P 500	2'902.2	11.8	15.8	40.8
EuroStoxx 50	3'448.1	12.3	14.9	17.2
FTSE 100	7'427.6	7.4	10.4	19.0
SMI	9'469.4	7.3	12.3	21.6
Nikkei	21'870.6	7.4	9.3	37.3
MSCI EM USD	503.5	9.0	13.0	40.3
Sensex 30	38'767.1	7.7	7.5	54.2
KSE 100	37'337.9	-4.4	0.7	11.1
Hang Seng	29'909.8	12.2	15.7	45.9
Russia RTS	1'250.9	8.9	17.0	37.3
Brazil Bovespa	94'420.9	0.8	7.4	81.6

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US gov	1'511.50	1.6	1.6	2.7
FTSE US Corp	2'239.15	4.7	5.0	10.9
FTSE US HY	1'052.63	4.8	8.3	27.9
FTSE Euro gov	238.67	2.6	2.5	3.8
FTSE Euro Corp	243.25	3.4	3.1	5.8
FTSE EM Sov	844.09	4.9	6.3	15.8
DB EM Local USD	165.72	2.0	5.2	9.3

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	97.18	1.2	0.7	3.1
EUR	1.13	-1.4	-1.2	-0.5
CHF	1.00	-2.1	-1.8	-4.5
GBP	1.31	1.7	2.8	-8.0
JPY	111.57	-3.4	-2.1	-2.9
AUD	0.71	-0.3	1.9	-6.3
CAD	1.34	-0.5	2.2	-4.0
ZAR	14.01	-1.3	3.1	5.7
INR	68.93	2.5	0.9	-4.0
PKR	141.49	-1.3	-1.3	-26.1
Gold oz	1'292.92	0.2	0.8	3.0

Interest rates	3M interbank %	10YR government %
USD	2.60	2.55
EUR	-0.31	0.06
GBP	0.83	1.22
CHF	-0.72	-0.27
JPY	-0.06	-0.06
AUD	2.96	1.88
CAD	1.17	1.78
ZAR	7.16	9.05

For your notes

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