Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

Lockdown and beyond

Q2 2020

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Editorial

Dear Reader,

When we entitled our previous edition of this publication 'No time for complacency', we had little inkling of what was going to hit us during Q1 2020. The spread and impact of the latest Corona-virus outbreak, now commonly referred to as COVID-19, has been as fast, severe and unexpected as any shock the world economy has experienced since World War II. And it is not over yet.

Nevertheless, there are already some lessons we can take away from these dramatic events, not least the crucial importance of portfolio diversification, which was key to limiting the drawdown during the darkest days in March. In addition – and we have devoted our Special Topic to this issue – it is clear that the pandemic will have fundamental, long-term consequences that will dominate financial markets for years to come. One of them is the latest surge in sovereign debt in the developed economies.

Eventually, though, the world will recover from this latest crisis, and in due course the outlook for financial markets will brighten up again. Until then we need to remain nimble and modest: nimble in order to take advantage of the opportunities the market sell-off has created, and modest to the extent that we must recognize our limited foresight in a fast-moving and ever more complex world.

We hope our commentary can offer some perspective in these exceptional times and look forward to our continued engagement.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

Habib Bank AG Zurich

The macro backdrop: Lockdown

Just when global growth was set to regain some vigor, the virus struck. The COVID-19 pandemic will lead to the largest drop in economic activity since World War II. With luck, the swift response of central banks and governments will have prevented the worst, however the recovery is bound to be fraught with uncertainty.

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

	2019	2020F	2021F	Short-term trend
United States	2.3	-3.3	3.5	↘
Eurozone	1.2	-5.0	3.5	↘
Germany	0.6	-4.5	3.4	↘
United Kingdom	1.3	-4.6	3.4	↘
Japan	1.0	-2.5	1.4	↘
China	6.1	3.0	6.5	↘
India	5.0	4.8	4.2	↘
Russia	1.3	-1.5	2.0	↘
Brazil	1.1	-1.6	2.6	↘

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

	2019	2020F	2021F	Short-term trend
United States	1.8	1.1	1.9	→
Eurozone	1.2	0.5	1.3	→
Germany	1.4	0.8	1.5	→
United Kingdom	1.8	1.1	1.6	→
Japan	0.5	0.1	0.4	→
China	2.9	3.3	2.1	↘
India	4.2	4.8	4.0	↘
Russia	4.5	3.4	4.0	↗
Brazil	3.7	3.3	3.7	→

Source: Bloomberg, IMF, HBZ

Key points

- Slow but forceful US response saves financial system
- Europe to suffer for longer; eurozone cohesion at risk
- Vulnerabilities exposed in many emerging economies

US Fed saves financial system – again

Like the rest of the developed world, the US was slow to respond to the COVID-19 outbreak. Once the gravity of the threat had been understood, however, the US Federal Reserve responded forcefully with a succession of rate cuts and, more importantly, vast new liquidity measures. Similarly, the Trump administration, initially in outright denial, eventually orchestrated a massive fiscal package worth over USD 2 trillion with Congress. While these actions will not prevent GDP from contracting more than it did during the Great Financial Crisis, they should mitigate damage to the economic fabric. A recovery from late Q2 2020 onwards is likely, although the surge in unemployment – well above 10% by most estimates – will hold back consumption, the core driver of US growth, for some time. The pandemic will not only have long-lasting effects on the US economy (most obviously, lower interest rates and higher debt levels) but it may also have changed the odds for the November election, which pre-February was President Trump's to lose. Due to his erratic behavior during the crisis and with Joe Biden as his most likely challenger, the outcome is now wide open.

Europe's worst nightmare

Europe has been particularly hard hit by the pandemic and the economic consequences of the lockdown will be even more devastating here than in the US. Although the ECB and other central banks and governments have done what they can to limit the fallout, for the EU the rift between the supposedly frugal northern European countries around Germany and the fiscally challenged southern member states has now become an existential threat to the bloc's survival; the recovery will be all the more tenuous as a result, and the eurozone will most certainly have to seek closer integration if it is to last.

Another test for emerging markets

The pandemic has gripped the world with incredible speed, exposing the structural weaknesses of many emerging economies in the process. Their dependence on foreign capital and markets has made them particularly vulnerable. Moreover, the ill-timed oil price war has weakened many economies where oil is an essential source of revenue. Finally, measures to contain the pandemic have sapped domestic demand. Even China, where activity has started to rebound, will not escape a major slowdown which will feel like a recession.

Investment strategy: Where do we go from here?

Financial markets have just suffered the worst shock since the Great Financial Crisis. Once again, central banks have prevented a total meltdown, however the landscape investors must now navigate has become yet more treacherous. Diversification is thus more important than ever.

Perilous quest for value

The precipitous sell-off in March cheapened assets across most markets. Corrections often overshoot fair value, thereby creating attractive entry levels, but can current market conditions hold durably given that central banks are once again the players that have saved the day? Ultimately, valuations should simply reflect underlying fundamentals such as corporate earnings and cash flows. If fundamentals do not improve within a reasonable time frame, asset prices could fall yet further. Investors therefore need to be mindful of the pitfalls lurking in today's uncertain world. We currently see credit as the most attractive asset class given that a credit crunch has been avoided and authorities have taken steps to ensure both the liquidity and solvency of the financial system. Real assets – especially equities – will start to look more appealing once the recovery is underway. As central banks will need to keep interest rates low to avoid choking an incipient recovery, yields will remain depressed (possibly negative) in real terms for all but the lowest quality fixed-income assets. Moreover, the expansion of central bank balance sheets and government debt will undermine trust in both fiat currencies and sovereign credit. Real estate may no longer be such a safe bet as an alternative, either, given that technology is increasingly rendering bricks-and-mortar obsolete in both retail and work contexts. As ever, as a store of value and hedge against inflation, gold remains an effective preserver of purchasing power.

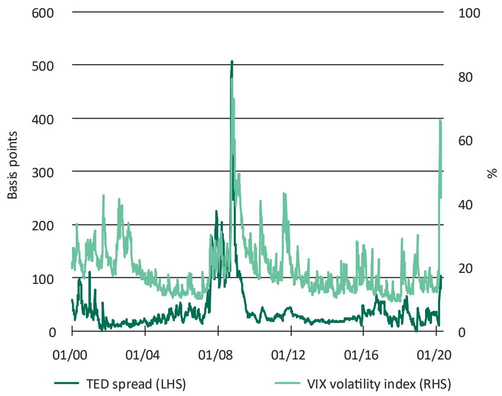
Our positioning

We, like many other investors, were overtaken by the speed and breadth of the sell-off in March and held on to most of our positions. More recently, we exchanged Japanese for Swiss equities as a defensive move. We also increased our exposure to investment-grade credit and replaced part of our convertible exposure with US high yield to take advantage of the Fed bid.

What to watch

The fluidity of the pandemic and the fact that many governments and central banks entered unchartered territory with their latest policy measures requires us to recognize that some of the tried-and-tested market metrics may no longer be as reliable. We believe that, despite their shortcomings, earnings remain the single most relevant gauge of economic fundamentals and financial markets.

Chart 1: COVID-19 – market stress but no generalized funding crisis



Source: Bloomberg, HBZ

Glossary

TED spread: difference between the risk-free rate (US T-bills) and the interest rate paid on Eurodollar deposits; as a proxy for risk in the interbank market, it serves as an indicator of systemic stress.

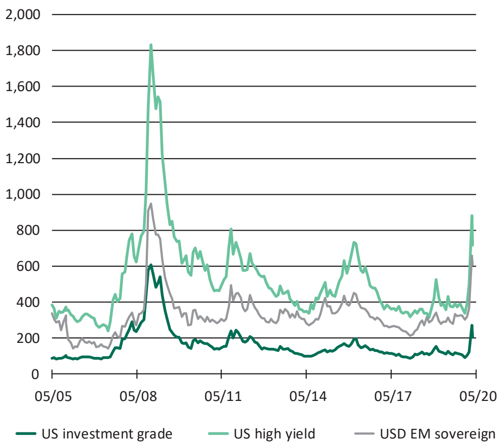
Key points

- Value may not be what it seems
- Credit in short term, equities in long term
- Corporate earnings best source of market guidance

Fixed income: Opportunities following the sell-off

Credit spreads widened dramatically during March as credit markets all but seized up. At current levels, they suggest improbably high default rates, creating opportunities in many market segments. We favor investment grade, selected EM USD sovereigns and, tactically, US high yield.

Chart 2: Not 2008, but significant widening of spreads (credit spread in basis points)



Source: Bloomberg, HBZ

Key points

- Investment-grade bonds attractive again
- Good entry levels for US high yield for tactical trading
- Prefer EM sovereign bonds over EM corporates

Investment grade and – tactically – US high yield

The indiscriminate sell-off in March and early April, driven by concerns over the economic impact of COVID-19 and exacerbated by the collapse in oil prices, created attractive valuations in most bond markets – especially in the investment-grade space. In addition, corporate behavior turned more bondholder-friendly as companies shifted their focus away from returning cash to shareholders towards shoring up balance sheets and liquidity. For US high-yield bonds, spreads widened to levels not seen in years. Since then, thanks to central bank actions, market liquidity has improved, outflows are slowing and bid/offer spreads are narrowing. The US Fed has also expanded its corporate asset purchase program to include so-called 'fallen angels', thereby boosting prospects for weaker credits. Under this program, the Fed will buy bonds issued by companies rated 'investment-grade' as of March 22, and subsequently downgraded to no lower than BB-, which should help US high yield to normalize. Other central banks and most governments have also launched programs to mitigate the effects of the crisis. All of these measures will provide a powerful lift to the asset class.

Emerging markets – cheap once more

Regardless of maturity and quality, most EM bonds have repriced significantly, driven by forced selling from ETFs and mutual funds. As a result, market liquidity for many bonds has dried up and spreads have widened to levels not seen since the Great Financial Crisis in 2008. The severe disruption will inevitably result in some of the weaker credits being restructured, especially among corporates – and possibly a handful of sovereigns as well. However, we assume that most of this risk has already been priced in. In emerging markets, we consider sovereigns or quasi-sovereigns in hard currency most attractive. Given low visibility, it is more important than ever to stay well diversified, preferably via an actively managed collective investment vehicle. In single names, we advise focusing on more liquid and higher quality issuers (e.g. Indonesia) and staying away from low-rated issuers (e.g. Sri Lanka). We recommend holding off on new investments in the EM corporate bonds segment despite very attractive valuations at present; the risk of disappointment remains too high.

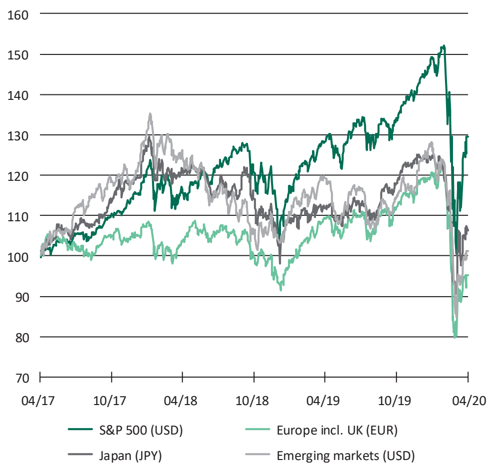
Equities: A forward-looking asset class?

US equities suffered their fastest bear market since 1987 when investors realized quite how dire the consequences of the pandemic could be. But fiscal stimulus and colossal asset purchases by the US Fed have beaten back the systemic threat, allowing equities to rapidly recoup some of these losses.

Winners and losers

What started as an indiscriminate sell-off has morphed into a more nuanced appreciation of the potential winners and losers in a post-COVID-19 world. The already leading position of the technology sector has been reinforced and health care innovation is being rewarded (although investors are ignoring the unavoidable debate about drug prices). The lockdown has also turned the spotlight on the valuable defensive characteristics of many consumer staples companies. However, with the extent of the slowdown still uncertain, the market is lowering its expectations for cyclical sectors. At the other end of the spectrum, energy companies are facing both a steep drop in demand and the impact of the collapse of the oil price. The US equity market appears to be looking past inevitably abysmal Q1 and Q2 earnings and has its sights set on the second half of 2020 and beyond. Analysts are, after all, supposed to value companies based on at least two years of earnings, not just two quarters, aren't they? This is certainly true, but it is also true that the effects of the COVID-19 crisis will be felt for far longer than just two quarters and the impact on economic activity and consumer behavior may well be more severe than current valuations suggest.

Chart 3: Performance over past 3 years
Index (100 = 04/2017)



Source: Bloomberg, HBZ

Favor the US and EM Asia

Within developed markets we favor the US over Europe and Japan. While the US market has rallied substantially from recent lows, holding quality companies and world-leading franchises is a sound approach in an uncertain economic environment. Equally, while the unprecedented US fiscal and monetary policy response has provided a backstop to the market, we expect volatility to remain elevated as earnings, consumption and unemployment figures serve as a reality check. Stock selection and patience are paramount in this context. Europe entered this crisis in an already weak state and the duration of the lockdown will certainly have profound economic and social ramifications. Within emerging markets, Asia (particularly China) should respond well to a re-opening – albeit at a slow pace – of the global economy. While Asian economies are highly dependent on global trade, they are ahead in terms of their COVID-19 recovery, and further policy support could yet be deployed to help restart the region's economy. We favor Asia over other emerging markets, where high sensitivity to the oil price will present an additional challenge.

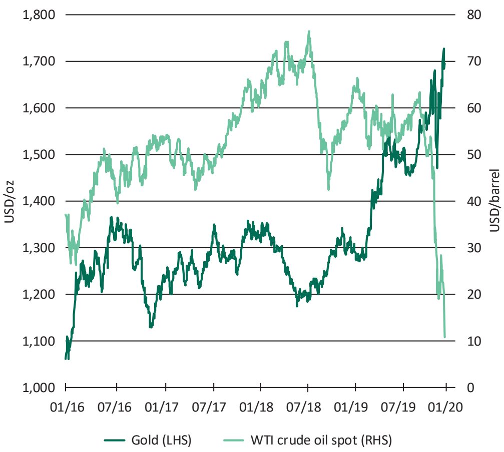
Key points

- Technology sector as long-term winner
- Diversification and careful security selection key
- US and emerging Asia current favorites

Commodities and FX: A wild ride!

There has been no shortage of drama on FX and commodity markets since the pandemic hit; wild swings have become almost commonplace. And many currencies continue to trade at depressed levels against the USD, despite monetary interventions.

Chart 4: Gold and oil on opposite trajectories



Source: Bloomberg, HBZ

A USD liquidity shock

As the economic and human fallout of the COVID-19 crisis became clear, the US dollar appreciated sharply against most currencies. Its status as the international funding currency of choice led to a liquidity shock – that is to say, there was a shortage of USD. Coordinated and massive interventions by the Fed and other central banks were required to restore momentum. Now that the liquidity squeeze has eased, we expect the dollar to stabilize. The Fed's rate cuts down to the zero lower bound have also eliminated most of the USD's interest-rate advantage. Moreover, fiscal measures to support the economy will see the US budget deficit balloon. While going forward the USD is unlikely to be as well supported as it was before the pandemic, the flexibility and resilience of the US economy will give the greenback a decisive advantage against other core developed-market currencies. Selling pressure will occur only once we return to some degree of normality. Against this backdrop, gold could be an attractive hedge against USD weakness given that central banks are expected to tolerate – even welcome – some inflation. The low interest rate environment is also reducing the opportunity cost of holding gold. Sterling will remain volatile against the dollar as, despite the severity of the health crisis, the UK remains unwilling to extend the Brexit transition period. The euro meanwhile lacks general support as the region entered the pandemic in an already weakened state. The Swiss franc should remain range-bound as the solid footing of the country's economy will be challenged by the fragility of the EU, its largest trading partner. And finally, weak fundamentals, capital outflows and falling commodity prices inform our cautious view on emerging-market crosses.

Twin shock for crude oil

Finding a balance in the oil market was proving to be a major challenge for OPEC even before the COVID-19 pandemic struck. As many economies were shutting down and crude oil demand was starting to collapse, a dispute between Saudi Arabia and Russia exacerbated the oil glut and led to a dramatic plunge in crude prices. The recently brokered deal between OPEC and non-OPEC producers falls well short of covering current demand destruction but should moderate the pace of inventory build; this is a positive for crude oil prices – but only for the medium term.

Key points

- USD to steady at current levels
- Gold as hedge against potential USD weakness
- Oil lacks fundamental support in short term

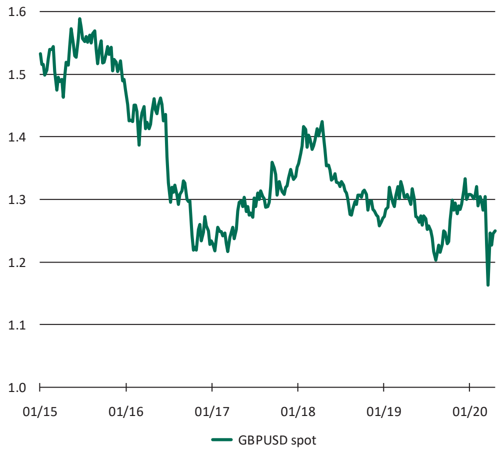
Key markets: Reversal of fortunes

Activity in our key markets is expected to contract severely during the current calendar year in the wake of the global pandemic shock. The collapse of the oil price is an additional blow to the UAE, and Brexit could yet trigger more downside for UK assets.

Pakistan: Recession instead of recovery

Before the pandemic, the outlook for Pakistan had been improving materially as the economy had started to emerge from last year's sharp slowdown. Now the country's economy is expected to contract in 2020 for the first time since 1952, albeit by less than many other emerging (and, for that matter, developed) economies. The central bank has already responded with a series of rate cuts, which offer welcome relief. The oil price collapse will further remove pressure from Pakistan's external accounts and provide additional support to local consumers, especially once the lockdown measures have been eased. Furthermore, although the government remains fiscally constrained, it has announced a sizeable stimulus package (some 3% of GDP) aimed at the industrial and export sectors as well as low-income labor. The IMF has not objected, conceding that exceptional times require exceptional measures – indeed, it has agreed to grant additional financing through one of its emergency facilities. Even with such assistance, the recovery will be tough and will potentially hamper any rebound of the local stock market, which is already down almost 25% in USD terms this year.

Chart 5: Despite sustained depreciation GBP remains at risk



Source: Bloomberg, HBZ

UAE: Triple whammy

COVID-19, an oil price collapse and a near-certain one-year postponement of the much-vaunted Expo 2020: these are the shocks the UAE's economy will have to absorb this year. Although GDP is expected to contract substantially as a result, the country will most likely weather the storm thanks to relatively sound public finances and ample reserves. Longer term, however, the outlook has once again taken a turn for the worse.

UK committed to Brexit despite pandemic

While COVID-19 is ravaging the UK, the government has reaffirmed its determination to see Brexit through by year-end. Given the current context, only the most rudimentary of trade agreements appears feasible, exposing the UK economy and UK assets to the risk of an additional shock in 2021. Currently, however, all hands are on deck to fight the virus and its economic consequences. GDP will probably fall by more than it did during the Great Financial Crisis, but the measures adopted by the Treasury and the Bank of England should limit the collateral damage and provide a better starting point for a recovery.

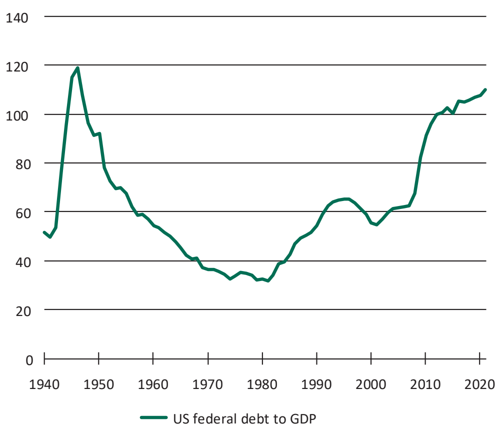
Key points

- Recession on cards for Pakistan
- Oil price collapse complicates matters for UAE
- UK risks additional economic shock in 2021 due to Brexit

Special topic: How the world will change after COVID-19

The COVID-19 pandemic is far from over, but it is already clear that it will have far-reaching consequences for the world economy and global financial markets. Below, we review some of the more fundamental changes we expect to emerge from the crisis.

Chart 6: US Federal debt back to pre-World War II levels (%)



Source: Bloomberg, HBZ

Key points

- Globalization challenged
- New manufacturing approaches/ working methods to emerge
- Staggering debt levels; some form of financial repression inevitable

Globalization revisited

When China belatedly responded to the initial outbreak, the ensuing lockdown quickly strained the supply chains of many global manufacturers. This worrying dependence can only be addressed by reconfiguring and diversifying such supply chains; a certain amount of redundancy may be inevitable in order to ensure this greater flexibility. For critical products such as active pharmaceutical ingredients, reshoring may be the only acceptable solution to regulators and consumers. While globalized production makes eminent economic sense, it cannot guarantee security of supply. Almost overnight, this has once again become a crucial concern for many nations. As a result, price levels will probably rise and the pace of growth fall.

Another boost for information technology

While more than 90% of global GDP was at some stage affected by lockdown measures, many industries were able to continue functioning once their business continuity plans had been set in motion. In future, many CEOs and business owners will therefore be focusing even more on processes that are technologically enabled and location-independent. This will create new opportunities for many types of service provider as well as for new business models. Established IT companies have a clear edge here and the experience of the crisis may make governments more reluctant to impose new regulations on these incumbents.

Soaring debt levels

The one key difference between the COVID-19 pandemic and the 2008 financial crisis was the swift and comprehensive response of central banks and governments once the potential economic damage had become palpable. Central banks across the world rapidly released a flood of liquidity to prevent the financial system from seizing up. Wide-ranging new central bank asset purchases as well as impressive government credit programs then addressed the real risk of a worldwide credit crunch. At the time of writing, these measures to counter liquidity and solvency risks have already greatly stabilized financial markets – albeit at substantial cost in terms of a further massive expansion of sovereign but also corporate indebtedness. Historically, inflation, default and financial repression have all played a role in eliminating such excessive stocks of debt. It will be no different this time round.

Market data summary

As of 20 April 2020

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	5,943.2	-16.0	-14.0	15.7
S&P 500	2,874.6	-13.7	-11.0	22.0
EuroStoxx 50	2,886.4	-24.0	-22.9	-16.1
FTSE 100	5,793.1	-24.3	-23.2	-18.6
SMI	9,658.8	-10.9	-9.0	12.9
Nikkei	19,669.1	-18.3	-16.9	6.7
MSCI EM USD	428.5	-21.0	-18.8	1.1
Sensex 30	31,665.4	-23.8	-23.2	7.6
KSE 100	33,549.9	-21.5	-17.6	-31.2
Hang Seng	24,330.0	-15.5	-13.7	1.1
Russia RTS	1,072.6	-34.9	-30.8	-1.0
Brazil Bovespa	78,990.3	-33.5	-31.7	23.9

Bond indices	Last	-3M %	YTD %	-3Y %
Citi US gov	1,722.64	7.9	8.5	17.6
CIti US Corp	2,473.55	0.7	1.6	17.6
CIti US HY	1,013.70	-9.3	-8.6	6.3
Citi Euro gov	247.47	-0.3	0.0	8.3
CIti Euro Corp	240.40	-4.3	-4.0	2.3
CIti EM Sov	809.67	-12.1	-11.2	1.9
DB EM Local USD	157.45	-12.0	-11.7	-0.1

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	99.78	2.3	3.6	0.1
EUR	1.09	-1.9	-3.1	1.2
CHF	0.97	0.2	-0.1	3.1
GBP	1.25	-4.2	-6.1	-2.8
JPY	107.54	2.3	0.8	1.5
AUD	0.64	-7.2	-9.2	-15.3
CAD	1.40	-7.2	-7.7	-4.1
ZAR	18.81	-23.3	-26.0	-30.4
INR	76.40	-7.1	-6.7	-15.6
PKR	163.79	-5.4	-5.3	-35.9
Gold oz	1,682.82	7.6	10.3	31.1

Interest rates	3M interbank %	10YR government %
USD	1.11	0.62
EUR	-0.24	-0.49
GBP	0.66	0.30
CHF	-0.59	-0.48
JPY	0.00	0.02
AUD	2.96	0.84
CAD	1.17	0.65
ZAR	4.60	10.33

Habib Bank AG Zurich

For your notes

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Authors

- Dr. David Wartenweiler, Chief Investment Officer (d.wartenweiler@habibbank.com)
- Stefan Wüthrich, Senior Portfolio Manager, Fixed Income (s.wuethrich@habibbank.com)
- Thomas Lanfranconi, Investment Advisor, Equities (t.lanfranconi@habibbank.com)

Contact for Switzerland

- Leonardo Castillo, Head of Wealth Management Switzerland (l.castillo@habibbank.com)

Contact for UK

- Usman Ahmad, Treasury UK (u.ahmad@habibbank.com)

Contact for UAE

- Mohammed Sibtain, Wealth Management (m.sibtain@habibbank.com)

Layout

- Pascale Manga, Communication Support (p.manga@habibbank.com)

Printing

- Theiler Werbefabrik GmbH, Rütenenstrasse 6, CH-8102 Oberengstringen (werbefabrik@bluewin.ch, www.werbefabrik.ch)

Editing

- MOTIF Executive Communications, Rebbergstrasse 39, P.O. Box, CH-8024 Zurich (www.motif.ch)

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Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

Habib Bank AG Zurich

Private Banking
Weinbergstrasse 59
P.O. Box 225
CH-8042 Zurich
Tel: +41 44 269 45 00
Fax: +41 44 269 45 18