HBZ Investment Quarterly

A boom unfolding

Q2 2021

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Editorial

Dear Reader,

There is something unsettling about the current rebound in the global economy, which is being powered by fiscal and monetary largesse in response to the greatest public health crisis in recent memory. And, sure enough, the anticipatory mechanism of the market has been at work for some time already. Are we to brace ourselves for disappointment just as fundamentals are about to prove that the natural state of an economy is to expand and for markets to move up?

We think not — or at least, not yet. We agree with the Fed and see higher yields as a fundamentally healthy and positive sign of economic normalization. At the same time, we cannot ignore indications of excess, although we fail to see an imminent trigger that could reverse the positive market sentiment in the near term. Our response? Shorter duration to limit the impact of higher yields and a broadly diversified equity allocation so we are better positioned to capture at least some of the increasingly frequent market rotations.

As the surge in yields has been a determining factor during Q1 2021, we have chosen this as our Special Topic in this edition. While the impact of this development has been considerable to date, we do not think the current process of rate normalization will derail the positive near-term outlook for the global economy and financial markets.

We hope you enjoy reading our latest insights and look forward to a lively exchange by whatever means the still-lingering pandemic permits!

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Rebound, what a rebound!

The accelerating roll-out of COVID-19 vaccines and the gradual lifting of pandemic-related restrictions is likely to catalyse a huge rebound in global activity during 2021. However, a major resurgence of the virus could still threaten this blue-sky scenario.

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

	2020E	2021F	2022F	Short-term trend
United States	-3.5	6.2	4.0	↗
Eurozone	-6.8	4.2	4.2	↗
Germany	-5.3	3.3	4.1	↗
United Kingdom	-10.1	5.0	5.6	↗
Japan	-5.1	2.9	2.1	↗
China	2.3	8.5	5.5	↗
India	-7.4	11.0	6.2	↗
Russia	-3.5	3.1	2.5	↗
Brazil	-4.5	3.4	2.4	↗

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

	2020E	2021F	2022F	Short-term trend
United States	1.3	2.5	2.1	↗
Eurozone	0.3	1.5	1.2	↗
Germany	0.4	2.0	1.4	↗
United Kingdom	0.9	1.6	1.9	↗
Japan	0.0	0.1	0.5	↗
China	2.5	1.6	2.3	↗
India	6.2	4.7	4.6	→
Russia	3.4	4.6	3.8	↗
Brazil	3.2	4.9	3.6	↗

Source: Bloomberg, IMF, HBZ

Key points

- Highest US real GDP growth in over thirty years
- EU to lag, China to lead Asia
- New COVID-19 outbreaks as major downside risk

US growth to top 6%

Unless just about all analysts have got their forecasts hopelessly wrong, the US economy will grow this year at its fastest pace since 1984. Fueled by pent-up demand, fiscal stimulus, and easy monetary conditions, US GDP is thus likely to close the gaping hole opened up by the pandemic as early as the end of Q2. This powerful momentum will carry over not only into H2 2021 but also into 2022. The Federal Reserve has already made it clear that it will not stand in the way of the unfolding boom and that it will tolerate higher inflation, provided it does not become entrenched. While a discussion about recalibrating the Fed's asset purchases may emerge later in the year, no concrete steps are likely before H1 2022. Additional spending plans, totaling trillions of US dollars, have already been announced, although the bar for them passing through Congress, whether in whole or in part, will be much higher than for previous plans. Even without them, the US will exert considerable pull on global growth – in particular on economies that are tightly integrated into its supply and production chains.

EU lagging again

The pandemic has once again laid bare some of the structural flaws at the heart of the EU, which this time have led to unnecessary delays in the bloc's vaccination program. As a result, EU growth will lag the US but also the UK and many Asian economies. However, there is still a good chance that restrictions will be lifted in time for the summer holiday season, so important for the Mediterranean economies. The ECB is expected to remain on hold for the time being and keep a watchful eye on the euro to ensure that currency strength does not sap the recovery.

Divergence within emerging markets

China started the year in a strong position, having avoided a recession in 2020. However, the defensive stance of the country's leadership, including the quest for self-sufficiency and more central control over technology-driven business models, presents risks for the longer term. Notwithstanding this, China is set to deliver strong growth in the near term, pulling along much of Asia. India, expected to grow at an even faster pace, will first have to face down a new surge in COVID-19 cases. Much of Latin America, Africa and the Middle East will expand at lower rates, held back by the pandemic but also structural weaknesses.

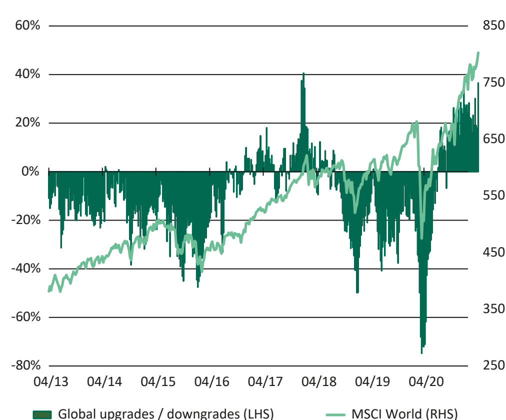
Investment strategy: Valuations vs. fundamentals

The sharp rise in bond yields since the beginning of the year has challenged, but not derailed, the equity bull market. Despite lofty valuations across most asset classes, the rebound in earnings and the prospect of ongoing supportive financial conditions continue to favor risk assets.

Strong cross-asset tailwinds from earnings

The sharp rise in yields across the curve since the beginning of the year has challenged some of the more optimistic investment theses, with highly valued, long-duration assets (both bonds and equities) suffering a setback — at least temporarily. However, the unfolding global growth recovery is putting a floor under the current risk-on investment environment. Strongly rebounding corporate earnings are supportive for both equity and corporate bond markets. Low interest rates are also allowing companies — and countries — to refinance themselves at attractive conditions. After all, credit spreads have not moved in line with government bond yields, on the contrary. Such conditions suggest that substantial, well-diversified equity exposure remains warranted and lower-rated credit should be favored over government bonds on account of its significantly shorter duration. The dearth of even moderately attractive risk-free assets presents some problems when it comes to constructing robust, multi-asset portfolios, however we believe only an overtly negative outlook would justify allocating anything other than the bare minimum to such assets. As long as financial conditions remain supportive, we see asset-backed securities and some non-traditional strategies as acceptable alternatives. The strong US dollar also makes a case for gold, which is at its most attractive when out of favor.

Chart 1: Earnings are pulling equities along



Source: Citi Research, HBZ

Our positioning

Late in 2020 we neutralized our equity allocation and, more recently, we shortened the duration to reduce interest rate risk in our multi-asset strategies. However, we have maintained our credit overweight. We have also accentuated our cyclical bias. Going forward, we will increase our exposure to alternatives with an allocation to direct-lending strategies.

What to watch

Beyond the current earnings season, we will focus on pandemic-related trends which may entail both up and downside risks for financial markets. We will also be tracking developments in Eastern Ukraine and — in particular — Taiwan closely. We take China's claim to the island seriously and worry about the intentions of the country's increasingly inward-looking leadership. Any escalation would have momentous consequences for the world.

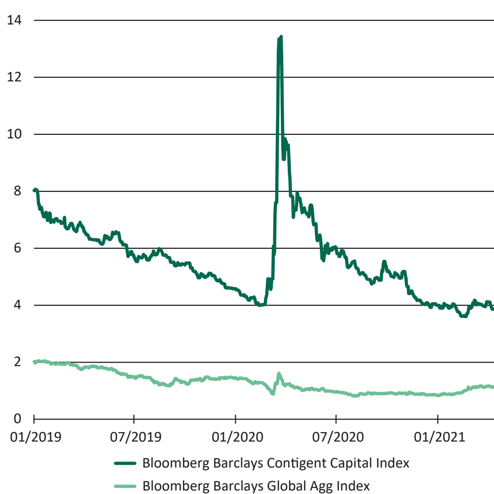
Key points

- Growth and earnings rebound to support risk assets
- Portfolio risk tilted towards equities and lower-rated credit
- Geopolitical risks on rise again

Fixed income: Shorter duration

In recent months, US yields have risen significantly, causing returns on many longer-duration, fixed-income assets to fall into negative territory. Subordinated bonds, asset-backed securities, and high-yield bonds – including emerging-market corporates — count among the few remaining pockets of value.

Chart 2: Subordination still pays (yield to maturity in %)



Source: Bloomberg, HBZ

Subordinated financials still worthwhile

Investment-grade bonds have returned negatively year-to-date and, with a narrow cushion of spreads to absorb higher yields, this segment is most exposed to the risk of a further rise in government bond yields. Hence, with the exception of subordinated issues of highly-rated corporates and financials, most high-grade bonds are no longer attractive. Banks' and corporates' credit metrics continue to be solid, and investors will receive a respectable pickup for only a moderate increase in risk. This even applies to non-investment-grade bonds from these types of issuers.

ABS as alternative to longer-duration credit

At this stage in the cycle, asset-backed securities (ABS) have a distinct appeal, making them a viable alternative to senior but unsecured investment-grade bonds. Due to their collateralized nature, most ABS bonds have better credit ratings (single A or higher) than the average investment-grade corporate. While their duration is significantly lower on average, the yields on offer are on a par with those of investment-grade credit. We favor European ABS bonds due to the more creditor-friendly legal environment. Given their attractive risk/return profile, we recommend switching at least part of the investment-grade credit allocation into European ABS (currency hedged) — preferably through a well-diversified, actively managed collective investment vehicle, as the rate normalization process still has further to go.

Corporates top among emerging-market bonds

Many emerging-market credits should benefit from the recovery in global activity and higher commodity prices as well as the still very accommodative global monetary conditions. However, long duration is a risk for EM sovereigns in general while challenging credit fundamentals limit the prospects for EM sovereign high-yielders, some of which face a near-term risk of restructuring. Due to their lower duration EM corporate bonds are less interest-rate sensitive and, in the context of the global economic recovery, the ongoing search for yield should lead to a further tightening of their still wide spreads. Finally, and often overlooked, the fundamentals of many EM corporate issuers are actually sounder than that of their respective sovereigns but the intricacies of the credit rating process do not allow this to show in their ratings.

Key points

- Subordination remains attractive
- ABS — valid alternative to investment-grade corporates
- EM corporates offer better risk-adjusted returns than sovereigns

Equities: Stay long for now

Equity markets have almost fully priced in the recovery from COVID-19. Fundamentals remain supportive, the reflation trade is still on, and we expect continued earnings growth to support equities. However, investors should brace for higher volatility.

Economic growth and anticipation

The most important driver of stock performance is the economy. Consumption is booming in the US, with strong household balance sheets thanks to stimulus checks and low refinancing rates. Monetary authorities have also been a major factor in the global recovery. By the end of 2021, nearly a third of all broad money in circulation in the US will have been created since the onset of the pandemic. Markets are working on the assumption that the pandemic is about to be overcome. While it would be premature to declare victory in Europe and many emerging economies, equity markets are all about anticipation.

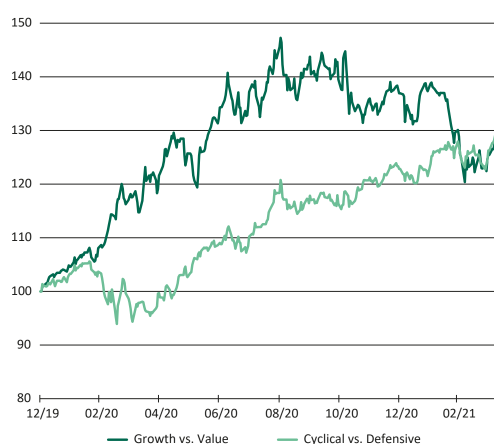
Valuations in context

US equities appear expensive in absolute terms as well as relative to the rest of the world. Yet, while valuations are indeed historically high, they should be seen against the backdrop of low interest rates and low inflation. The US is home to many quality companies and its economy is enjoying by far the greatest degree of fiscal and monetary support. With its size and depth, the US equity market offers active investors plenty of opportunities. In Europe, the recovery should materialize in the second part of the year. European — and for that matter EM — equities are geared to the incipient cyclical upswing and we would advocate an allocation to both regions. However, the outlook for EM is less certain at present as higher yields, a strong US dollar, and questions about China's economic policy represent potential headwinds.

Diversification to manage rotations

Equity investing is becoming more complex as markets are subject to 'inflation scare' and rising yields, and investors are having to assess the prospect of higher corporate taxes as well as — ultimately — a shrinking Fed balance sheet. Rising bond yields will be a drag on the performance of defensive sectors and investors should therefore generally favor cyclicals. Well-diversified equity portfolios should be exposed to multiple return drivers and include a mix of growth and value stocks. The IT sector is supported by structural trends but suffered a setback as rising yields hit the valuations of the most expensive companies. However, rising yields will not lead to a perpetual rerating of growth stocks. Investors should follow a barbell approach, owning well-established technology companies with solid earnings visibility together with higher-growth stocks.

Chart 3: US equity performance (100 = 31/12/2019)



Source: Bloomberg, Russell, MSCI, HBZ

Key points

- Brace for higher volatility
- Earnings growth to support equities
- Rotations call for diversification

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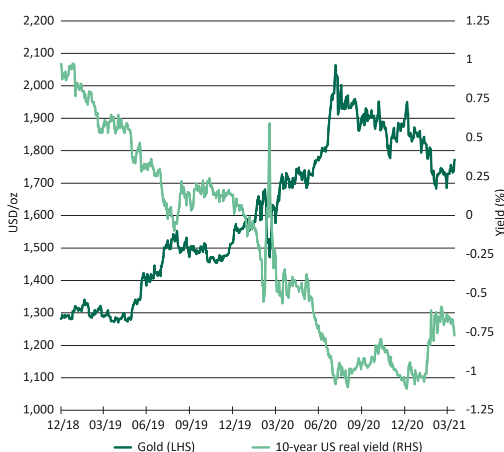
Commodities and FX: Reflation to lift oil and support USD

The gradual unlocking of economies and effective supply management by OPEC+ have propelled the oil price back to early-2020 levels. While medium-term dynamics are moving against oil, demand is still expected to grow. The US dollar should remain firm, and gold has only limited upside at this stage.

Chart 4: Gold — an inverse relationship with US real yields



Source: Bloomberg, HBZ

Peak shale

Oil demand is picking up, especially in the US where the vaccination campaign is well underway and economic activity is accelerating. The forthcoming summer driving season and a material increase in air traffic should support the price of oil. On the supply side, US shale producers remain cautious, with rig count still about fifty percent below the pre-pandemic level and production unlikely to return to the past peak. Last year's oil price collapse has reinforced capital discipline, and the medium-term outlook for fossil fuel demand is tilted to the downside. Peak oil will occur not because of a lack of reserves but because of societal and technological progress. OPEC+ has so far managed the oil supply effectively, with Saudi Arabia assuming the brunt of the cuts. Continuing its delicate balancing act, the organization recently decided to marginally loosen it quotas.

US dollar well supported

The impressive economic outperformance of the US continues to favor the dollar — it is, after all, rare that US growth approaches that of emerging Asian economies. Purely based on growth expectations, the EUR, GBP, and CHF should all decline against the USD. While fundamentals such as current account and fiscal deficits imply a weaker US dollar in the longer term, ultimately monetary policy will be the deciding factor. If the Fed is among the first to normalize, the USD will receive further support.

Gold under pressure

Gold slid below the USD 1,700/oz mark during March but could well rebound in the coming months on higher inflation. However, this acceleration in inflation will be temporary and we believe that the factors driving higher prices, such as supply disruptions and pent-up demand, will eventually subside. We continue to recommend gold as a portfolio diversifier and as a hedge against unexpected US dollar weakness or persistently elevated inflation. Investors with large gold positions should, however, consider reducing their exposure on a rebound in price. We expect real yields to rise and the US dollar to remain firm on the back of strong economic growth. Even if the current monetary policy context is conducive to higher inflation, we believe that long-term deflationary forces linked to technological progress and changes in consumer behavior will prevail.

Key points

- Oil demand to keep on rising
- US dollar to remain firm
- Limited upside for gold

Key markets: Moving at different speeds

While global in nature, COVID-19 has played out very differently in different regions. Of our key markets, the UK and the UAE have been among the first to emerge from the pandemic. Ultimately, local conditions will shape the trajectory of any recovery.

Pakistan: Many pain points

A new wave of COVID-19 infections spreading across the subcontinent has created new risks for Pakistan's economic recovery. Given the country's extended fiscal position, the government has limited room to offer additional economic support, which leaves monetary policy as the main provider of stimulus. Consequently, and despite higher headline inflation readings, the State Bank of Pakistan is likely to keep rates on hold for most of the first half of the year. When it comes, monetary tightening is expected to be measured and gradual, but it will still impact economic conditions. Sustained by remittance inflows as well as bilateral and multilateral funding, the country's external accounts have remained manageable. The latest review of the current IMF program, which was recalibrated to take into account the impact of the pandemic, has paved the way for the disbursement of another tranche. Pakistan has also successfully mobilized nationals' offshore assets and tapped international markets with a multi-tranche USD bond offering. Relative macro stability should allow the PKR to remain well supported, however the equity market is still at the mercy of the uncertain medium-term growth outlook.

Chart 5: Growth recovering at different speeds

Country	**% change of real GDP**		
	2020E	2021F	2022F
Pakistan	-0.4	2.8	4.0
UAE	-3.5	2.5	4.0
UK	-10.1	5.0	5.6

Source: Bloomberg, HBZ

UAE: Seeking a more resilient economy

The UAE's economic recovery has remained uneven to date as the pandemic has continued to limit activity in many sectors despite the high vaccination rates already achieved. Relative to other economies, the improvements in growth in 2021 will be fairly moderate, not least due to a sharp drop in the expatriate population. However, the pandemic has encouraged the UAE government to push for further structural reforms and revive plans to establish a proper AED bond market.

UK: The end of the tunnel?

The impressive vaccine roll-out has allowed the UK government to lift some restrictions already, with further easing likely into the summer. The recovery of economic activity should consequently be robust. The negative impact of Brexit and lingering tensions with the EU create only moderate downside risks. The better economic prospects essentially rule out further monetary easing but the bar appears even higher for any tightening. The GBP — and with it many UK assets — have already anticipated much of the good news and are now vulnerable to negative data surprises.

Key points

- Pakistan's recovery underway but hampered by weak public finances
- Moderate rebound of activity in UAE
- Early exit from COVID-19 restrictions bodes well for UK activity in 2021

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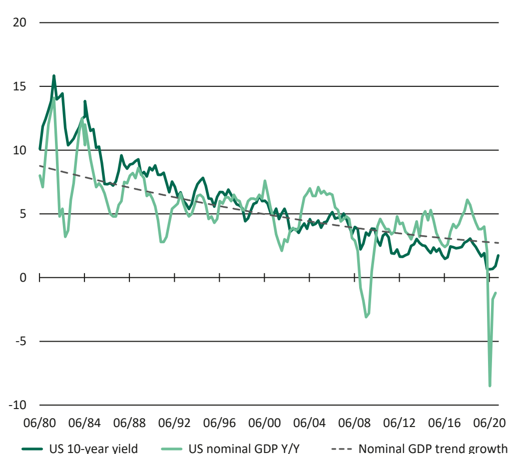
Special topic: Should we be afraid of higher yields?

Among the many dramatic developments in financial markets over the past year, the gyrations of interest rates stand out. As the world emerges from the worst of the pandemic, rates have started to normalize, forcing investors to assess the implications.

Chart 6: Nominal GDP trend suggest a higher but not sky-high 10-year yield



Source: Bloomberg, HBZ

Where will yields settle?

At the height of the first wave of the pandemic, the yield on the 10-year US Treasury note fell to as little as 0.5%, suggesting doom and gloom for years to come. Since then much has changed and yields have moved up — although, at 1.6–1.7% for the 10-year note, they remain very low. How much further can yields rise? According to an old rule of thumb, the 10-year yield should roughly match nominal GDP growth. Given that US growth is expected to top 6% this year and inflation to breach 2%, the level of yields implied by this rule would be devastating. Fortunately, the 10-year yield should be seen as an approximation of nominal growth over the next ten years. Since US growth and inflation will moderate again in the years ahead, a level of 2.5% for the 10-year note is probably the most we can expect in the medium term.

Consequences and implications

While such a move would still generate mark-to-market losses for many longer-dated fixed-income assets, the market impact of this development would be far from dramatic. Moreover, higher yield levels would offer better reinvestment rates, which would be positive for overall returns. Although the Fed is highly unlikely to lift its policy rate for several years to come, longer-term inflation expectations should remain well anchored. However, the ultimate test will come when the Fed tapers its bond purchases. Higher yields have also led to higher levels of asset price volatility, although equity volatility has declined again recently. The fact is that higher interest rates tend to go hand-in-hand with greater market uncertainty, which in turn requires investors to review their risk appetite and exposure.

Where do all those bonds go?

Duration risk is currently poorly compensated and will remain so as long as the economic context is geared towards higher rates. If yields were to become unhinged, investors would face dire consequences. But the likelihood of this happening is low, unless markets balk at the wave of new issuance from developed-market sovereigns. In all of this, it is important to remember that there are large pools of captive duration buyers, mainly institutional investors, which need long-term assets to match their liabilities. They may have started to allocate to other long-duration assets, however they still maintain very large bond books. Let yields rise further and at some stage they will hit the bid!

Key points

- Bond yields are unlikely to go through the roof anytime soon
- Rising yields lift asset price volatility — investors need to review their exposure and risk appetite
- No buyer's strike in offing

Market data summary

As of 19 April 2021

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	8,831.2	8.5	10.3	47.2
S&P 500	4,185.5	10.2	11.4	55.4
EuroStoxx 50	4,035.8	12.2	13.6	15.8
FTSE 100	7,023.0	4.6	8.7	-4.2
SMI	11,247.5	3.4	5.1	27.3
Nikkei	29,685.4	3.7	8.2	33.8
MSCI EM USD	654.5	-2.0	4.9	22.3
Sensex 30	47,670.1	-3.5	-0.2	38.5
KSE 100	45,250.5	-1.4	3.4	-0.3
Hang Seng	29,116.8	-1.8	6.9	-5.2
Russia RTS	1,483.7	0.9	6.9	28.6
Brazil Bovespa	121,113.9	0.4	1.8	41.1

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,657.89	-2.3	-3.2	14.6
FTSE US Corp	2,596.72	-2.5	-3.3	22.4
FTSE US HY	1,200.86	1.4	1.9	20.4
FTSE Euro gov	252.23	-2.4	-2.6	8.5
FTSE Euro Corp	256.09	-0.6	-0.5	8.2
FTSE EM Sov	927.92	-1.7	-3.5	14.7
DB EM Local USD	172.88	-4.5	-4.9	0.6

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	91.56	1.1	1.7	1.7
EUR	1.20	-1.1	-2.0	-2.9
CHF	0.92	-3.3	-3.8	5.6
GBP	1.38	1.7	1.5	-2.4
JPY	108.80	-4.2	-4.8	-1.1
AUD	0.77	0.6	0.7	0.1
CAD	1.25	1.9	2.2	1.2
ZAR	14.31	5.2	3.0	-16.0
INR	74.36	-2.3	-2.4	-12.2
PKR	153.25	4.8	4.6	-24.4
Gold oz	1,776.51	-3.4	-6.0	32.2

Interest rates	3M interbank %	10Y government %
USD	0.19	1.56
EUR	-0.54	-0.27
GBP	0.08	0.76
CHF	-0.75	-0.23
JPY	-0.07	0.09
AUD	0.04	1.72
CAD	0.44	1.54
ZAR	3.68	9.07

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)

Group Wealth Management

- Salman Haider, Chief Executive Officer (salman.haider@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

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