Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

Into an uncertain recovery

Q3 2020

Table of contents

Editorial

Dear Reader,

When financial market historians come to revisit the current period, they will likely speak of a pre- and a post-pandemic era. Although the COVID-19 outbreak is far from over, the impact across most markets and asset classes has already been colossal – first and foremost due to the economic shock, but also due to the acceleration of social and technological change and the escalation of tensions between the US, the incumbent superpower, and a rising China. The collapse of interest rates is another outcome that will have lasting effects.

For us as investors, ultra-low interest rates present particular challenges when it comes to constructing and managing portfolios. We will therefore have to assess our strategic allocations to fixed income and review the role of government bonds in portfolios. This is an issue of utmost importance which we explore in this edition's 'Special topic'.

We continue to recommend seeking safety in diversity and favor a sizeable allocation to risk assets for as long as the initial economic recovery continues. Given the high level of uncertainty, it goes without saying that we will be reviewing our investment policy at very frequent intervals.

Despite all the challenges, we wish you a successful summer quarter. As always, my team and I look forward to your feedback.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: An asymptomatic recovery?

When lockdown measures were eased in late Q2, activity initially rebounded in most major economies. However, the further path of recovery is likely to be uneven as renewed regional COVID-19 outbreaks are posing major challenges.

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

	2019	2020F	2021F	Short-term trend
United States	2.3	-5.6	4.0	↗
Eurozone	1.2	-8.1	5.5	↗
Germany	0.6	-6.2	5.0	↗
United Kingdom	1.3	-8.8	6.0	↗
Japan	1.0	-4.9	2.5	↗
China	6.1	1.8	8.0	↗
India	5.0	4.2	-4.7	↗
Russia	1.3	-5.0	3.4	↗
Brazil	1.1	-6.5	3.5	↗

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

	2019	2020F	2021F	Short-term trend
United States	1.8	0.9	1.7	↗
Eurozone	1.2	0.4	1.1	→
Germany	1.4	0.6	1.5	↘
United Kingdom	1.8	0.8	1.4	→
Japan	0.5	-0.1	0.2	↘
China	2.9	2.8	2.2	↘
India	4.2	4.8	3.9	↘
Russia	4.5	3.2	3.5	↗
Brazil	3.7	2.5	3.0	↗

Source: Bloomberg, IMF, HBZ

Key points

- Political interference harming US response to COVID-19
- Coordinated fiscal response could revive EU
- Uneven prospects for EM regions

The price of denial

In the early stages, the US policy response to COVID-19 was fast, forceful and comprehensive. But much of the positive momentum has since been squandered by an erratic administration more concerned about the November presidential elections than coordinating a national effort to combat the pandemic. Moreover, the social unrest triggered by the George Floyd incident has highlighted the deep divisions running through American society and created new risks which could further undermine the country's dynamism and international standing. While lockdowns could only ever be temporary, the politically motivated and often poorly managed reopening of the US economy has undoubtedly contributed to a surge of new cases which will hamper the ongoing recovery. Additional fiscal measures may be forthcoming but political calculations by the opposing parties could reduce their effectiveness – the Democrats are keen to deprive President Trump of positive headlines and the Republicans are focusing on their narrow political base. The US Federal Reserve has stayed above the political fray but has limited latitude for providing additional monetary stimulus. However, its increased emphasis on full employment rather than inflation suggests that the current policy stance will remain in place for years to come. The outcome of the presidential elections (a victory for the Democrats seems ever more likely) will have no bearing on this.

Europe rising to the challenge?

An early hotspot of the COVID-19 pandemic, the EU has paid a heavy economic price. However, the ensuing quasi-existential crisis has revived the bloc's vital spirits. Under renewed Franco-German leadership, a far-reaching recovery package has been adopted. Even some structural reforms in the EU's weakest economies, such as Italy, may now be achievable. The ECB meanwhile will continue to ensure that the eurozone's financial system remains functional and well-oiled.

EM: The weakest link?

Exposure to global trade is a key weakness of many EM economies. Hence, any recovery in the developed world will be a crucial lifeline to them, as indeed the early rebound in Chinese activity already is providing. Weak governance and a slow resumption of global capital flows will hold back growth, especially in Latin America and much of the Middle East and Africa.

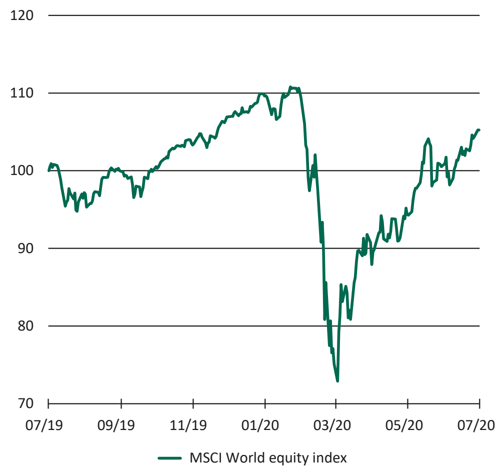
Investment strategy: In uncharted territory

The world economy is currently suffering its worst contraction since World War II and yet, after a violent sell-off, risk assets are back on a tear. Since neither fundamentals nor momentum should be ignored, we are maintaining a diversified, but defensive positioning in these unusual circumstances.

Beyond liquidity

US corporate earnings are expected to contract by some 20% in this calendar year and yet the leading S&P 500 index is up for the year. How can this be? Part of the answer lies in the aggressive monetary and fiscal measures adopted in response to COVID-19. These actions created expectations of a medium-term recovery, which market participants assume will reverse much of the damage done by the pandemic. They are thus expecting asset prices to normalize as well. In the context of rock-bottom interest rates, which central bankers indicate are here to stay, this actually implies higher valuations and possibly even tighter spreads than before the crisis. But we should not fool ourselves: the world economy is much weaker today, uncertainty is higher, and the political fallout of the pandemic has created additional obstacles over which markets might still stumble. The core dilemma for most investors is the fact that there are no longer any risk-free or low-risk assets offering a reasonable return. A well-diversified portfolio consisting of high-quality credit, real assets (including equities, gold and inflation-linked bonds) as well as alternative investments, offers the best prospect of meeting a reasonable return target in the current environment. However, we would strongly advise against any approach that simply increases the allocation to risk assets in the hope of meeting return expectations.

Chart 1: Global equities have almost fully recovered (100 = 07/2019)



Source: Bloomberg, HBZ

Our positioning

The abrupt sell-off in March was followed by a staggering rebound in April and since then markets have trended up stongly. Our decision to hold on to our positions has thus been rewarded and drawdown has been limited significantly. In the meantime, we have made some adjustments to our regional equity exposure, in particular lifting our EM allocation to 'neutral' at the expense of Europe.

What to watch

Near-term, corporate earnings will determine market performance. However, the tone of comments and guidance – not simply the already well-anticipated poor overall results – will also play a major role. As we move through the summer, the US presidential elections will come into focus. A change in the White House can no longer be excluded and this could lead to many of Trump’s reforms being reversed. Higher US corporate taxes are one possible outcome.

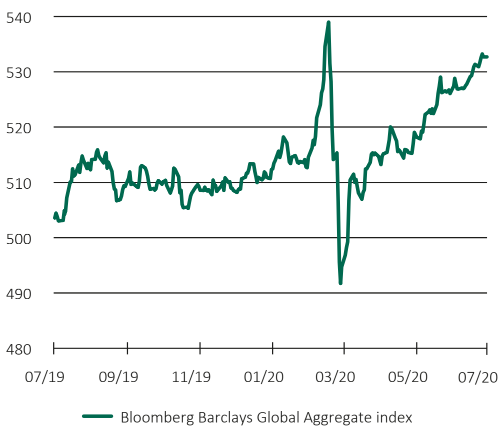
Key points

- Liquidity and low rates continue to drive performance
- Weak fundamentals call for cautious, well-diversified positioning
- Markets to focus increasingly on US presidential elections

Fixed income: Rally set to continue but at a slower pace

Credit spreads have tightened significantly since their highs in late March. In the current environment most fixed-income segments should continue to perform well, albeit at a slower pace. We see most potential in subordinated insurance bonds, US high yield and selective emerging market sovereigns.

Chart 2: Investment-grade bonds have recovered from losses (100 = 01/1990)



Source: Bloomberg, HBZ

Investment-grade and high-yield bonds still attractive

The recovery in credit spreads which started late in March made further progress though Q2. The drivers of the recovery – the unprecedented actions by central banks and governments – continued to support investment-grade credit. We believe this segment will continue to perform well in an environment of sustained monetary support and global demand for yield. Quality remains important given elevated uncertainty, and security selection will continue to be vital to generate value. We particularly recommend holding some subordinated bonds (bonds ranking lower in the capital structure) from solid investment-grade issuers: investors receive materially higher returns which compensate them well for taking on the additional risk. We especially favor subordinated insurance paper issued by national champions, as these issuers tend to be well-capitalized and have historically experienced very low default rates. Spreads in US high yield have also continued to tighten from their very wide levels in March. In our view, these spreads remain attractive, but we will be focusing on higher-rated names which should continue to have access to liquidity and can survive even periods of more elevated volatility in the near term. We recommend taking exposure only through well-diversified investment funds given the higher inherent default probability, and hence selection risk, in this market.

Selectivity key in emerging markets

EM bonds have rallied exceptionally strongly in recent weeks. The environment nonetheless remains constructive as economic news flow, including leading indicators, has improved in most regions. Commodity prices have also started to trend higher. Moreover, policy makers are likely to react swiftly to any signs of a stalling recovery. Notwithstanding this, we are aware that this asset class displays higher fundamental risk and price volatility. Investors should thus only invest a share of their portfolio in EM bonds in line with their risk profile. We prefer EM sovereign or quasi-sovereign bonds in hard currencies and especially favor supranational bonds which have a record of very low default rates and offer an attractive risk/return profile. On the other hand, EM corporate bonds have rallied to a point where we no longer find the valuations as compelling given the segment's risks; we therefore recommend reducing exposure here.

Key points

- Subordinated insurance paper attractive
- US high yield valuations still appealing
- Prefer EM sovereign bonds over EM corporates

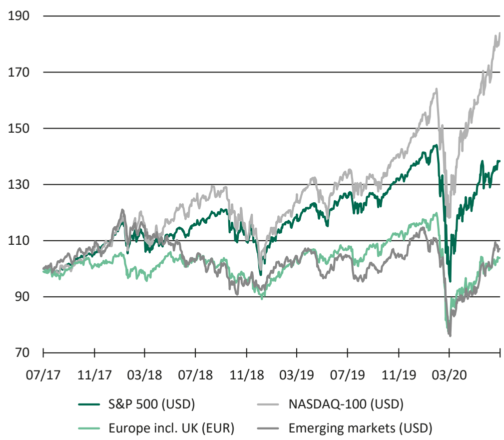
Equities: Where do we go from here?

The fastest bear market since 1987 has been followed by one of the fastest stock market recoveries on record. An unprecedented monetary and fiscal response, the containment of the pandemic in many countries, a steep return to activity, and hope for a vaccine all explain this roller-coaster ride.

US market leadership

To the public and many investors, the recovery of the US equity market seems to have been uncannily swift and totally disconnected from economic realities. In all this, it is important to remember that the performance of the S&P 500 index or the Nasdaq 100 is not truly representative of the development of America's economic fabric. Under a broad definition the technology and health care sectors, which have been the main beneficiaries of many structural trends accelerated by COVID-19, make up over 40% and 15% of the S&P 500, respectively. This is a significantly larger share than the corresponding weight of these industries in overall GDP. The appeal of technology stocks is obvious given their generally low leverage, high margins, solid earnings growth, and a perception that the sector has defensive characteristics. Technology stocks are probably fully valued but this does not in itself warrant a steep correction. Market leadership evolves with economic circumstances, and businesses that are more sensitive to the cycle will have their time again once the pandemic has been brought under control. Long-term sectoral trends will eventually prevail. The quality, industry leadership and innovation of many American companies will ensure the continued attractiveness of the US equity market. However, economic recovery will take time; the market is not only at the mercy of a potentially large second wave of COVID-19 but also of policy mistakes, such as the early withdrawal of monetary – and especially fiscal – support.

Chart 3: Nasdaq outperformance over the past 3 years
Index (100 = 07/2017)



Source: Bloomberg, HBZ

Be mindful of risks in the short term

We are constructive on equities over a two-to-three-year horizon, assuming a vaccine eventually becomes available and quality companies, even if they are severely impacted by the pandemic, ultimately regain their footing. But USD-based investors should consider Europe and EM for their cyclical exposure, especially as there is also some potential for currency appreciation in these regions. The economic recovery, company earnings, and the US election will dominate the second half of the year. We do not see the US election as a long-term threat to the market, though. The attractiveness of equities relative to bonds should ensure sustained interest in the asset class. Investors must, however, remain mindful of the potential volatility associated with the evolution of the COVID-19 virus near-term.

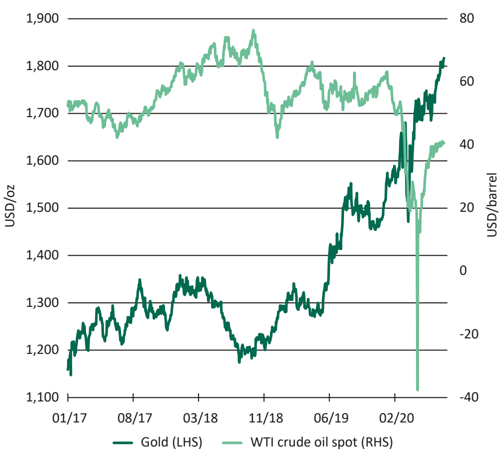
Key points

- Crisis accelerating structural trends
- Beware of policy mistakes
- Positive regarding long term, mindful of risks in short term

Commodities and FX: Gold – the real alternative to the USD

Under the current circumstances, gold is an asset of choice. The yellow metal's characteristics are appealing under various macroeconomic and market scenarios, including one in which the US dollar weakens.

Chart 4: Gold's upside trajectory and oil's recovery



Source: Bloomberg, HBZ

A golden opportunity

The opportunity cost of holding gold – a negative-yielding asset after cost – is no longer being debated in a lower-for-longer interest rate environment. The Federal Reserve sees near-zero interest rates through 2022 and has pledged accommodative policy until the economy reaches full employment again and inflation returns to its 2% target. Currency debasement due to quantitative easing and loose monetary policy speaks in favor of gold as a store of value and a hedge against the adverse consequences of monetary and fiscal stimulus. Real yields in the US are currently negative and approaching record lows. Although the likelihood of a surge in inflation remains low in the near term, a progressive repricing of inflation expectations should benefit gold. Another factor supporting the gold price is the weakening of the US dollar. While we do not expect a meaningful drop, the absence of an interest rate differential between the major currencies implies that the growth differential should play a major role in determining valuation trends. The evolution of the pandemic and its consequences for economic activity should lead investors to redirect flows, at least temporarily, towards regions with low infection rates, such as Europe. Against this backdrop, some EM currencies could also re-rate further. A weaker US dollar should benefit gold simply by virtue of the fact that it is priced in USD. The US dollar could, however, appreciate against most currencies again if the pandemic accelerates. In such a scenario, gold would attract additional interest thanks to its defensive properties. Gold will only lose its appeal once a vaccine becomes available, or if we return to the low-growth, low-inflation environment that characterized the economic cycle before the pandemic struck.

Key points

- Gold has its place in a diversified portfolio
- USD could weaken but not significantly
- Limited upside potential for oil price

A delicate balance for oil

Having reached sub-zero levels in April, the oil price has recovered strongly and stabilized around USD40/bbl for both WTI and Brent. OPEC+'s intention to taper production cuts may still put the hard-fought battle for price stability at risk. The decrease in demand for oil – a structural trend that pre-dated COVID-19 – has been accentuated by reduced air and ground mobility. Even if part of the world returns to normality, upside potential for the oil price appears limited in the near term.

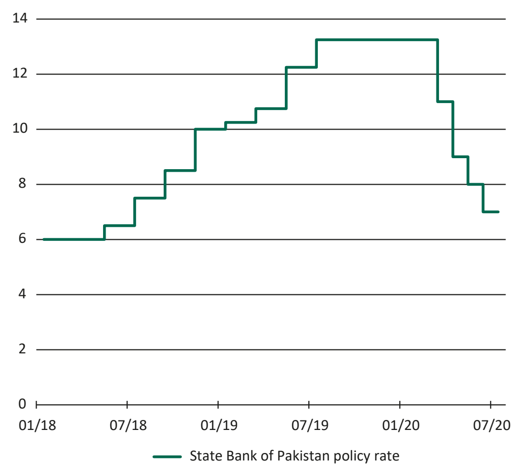
Key markets: A shock too many?

Since February, the COVID-19 pandemic has wreaked havoc with the global economy and all of our key markets have suffered a serious hit. It will take some time to assess the full impact of this shock on their long-term prospects, however it is already clear that the damage will be substantial.

Pakistan's weaknesses laid bare

Although the decline in GDP growth in Pakistan may well be modest in 2020, the fallout from COVID-19 will make it feel like a full-blown recession. Indeed, the sharp deceleration of activity coupled with depressed oil prices prompted the State Bank of Pakistan to lower its policy rate further at an emergency meeting in June. The Bank's swift response to incoming data highlighted just how serious the economic situation is. At least the external accounts appear to have stabilized for now thanks to a combination of factors, including lower demand, surprisingly robust foreign remittances and a more flexible exchange rate regime. The government has also been able to mobilize substantial additional multilateral support. This latest crisis has, however, once again laid bare the country's many structural weaknesses, especially with respect to its fiscal and external accounts. Reforming and rebuilding will require huge efforts by all stakeholders and will likely come at considerable cost, not least to investors. With soaring domestic and foreign debt, some form of restructuring may become inevitable.

Chart 5: Reversal of Pakistan's monetary policy (% p.a.)



Source: Bloomberg, HBZ

Mission to Mars to save the UAE?

The launch of a mission to Mars is emblematic of the UAE's desperate quest for a new business model. Multiple crises and rapid technological change have undermined oil and real estate as long-term growth drivers and, in the wake of COVID-19, even tourism now offers only mixed prospects. 2020 is set to be one of the toughest years on record for the UAE economy and local assets, with little short-term relief in sight. The currency peg, at least, does not seem to be in question.

COVID-19 ravages UK economy

The UK economy has suffered an unprecedented collapse in 2020, with GDP declining by some 25% during the first four months of the year compared to Q4 2019 according to the Bank of England (BoE). Small wonder then that the BoE increased its asset purchases in June and has vowed to keep its policy rate close to zero for the foreseeable future. Fiscal policy has also been relaxed significantly. However, the government's shambolic handling of the pandemic and the increased probability of a 'skinny' Brexit deal (at best), leave UK assets vulnerable and the GBP exposed.

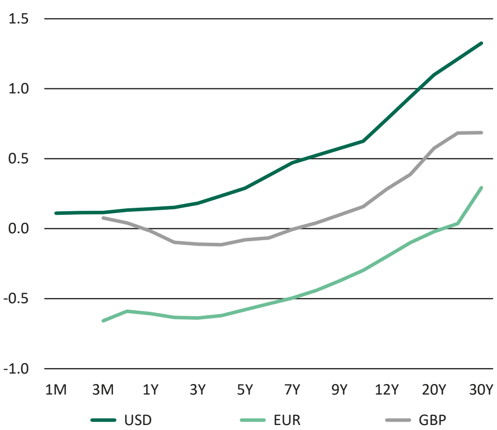
Key points

- Huge effort required to relaunch Pakistan's economy
- UAE desperately needs new growth drivers
- Seriously weakened UK economy poses risks to GBP assets

Special topic: Low rates forever?

When the scale of the COVID-19 pandemic's potential impact on economies became apparent, central banks had little choice but to slash rates to rock-bottom levels. And they do not intend to raise them again anytime soon. What does this mean for investors and how should they respond?

Chart 6: Few risk-free options remaining (% p.a.)



Source: Bloomberg, HBZ

Risk-free no more

The dearth, or even absence, of risk-free assets with a reasonable return is one of the most problematic side-effects of the policy responses to COVID-19. Moreover, the fast-rising levels of both sovereign and corporate debt in the context of stifled growth create a material – and in some cases imminent – risk of defaults, haircuts and restructurings. This leaves many investors who have traditionally parked their savings in safe US Treasury bills, notes and bonds (or their equivalent in other currencies) with tough choices. In the case of short-dated US government paper, for instance, current yields do not even cover transaction/custody costs. And asset allocators who have typically used government debt to manage risk in their portfolios can no longer blindly rely on these instruments.

(Still) no alternative

Having said this, it is probably too early to shift to an entirely new paradigm (even if one were to exist). After all, US Treasuries performed by the book during the onset of the COVID-19 market crash, outperforming just about every other asset class. And this characteristic has not disappeared as a result of current low yields. Indeed, their convexity actually amplifies the price movement of bonds at lower rates and hence their potential returns. However, the impact of inflation is a valid concern. Currently at some 0.6%, nominal yields on 10-year US Treasuries already don't compensate for even moderate future inflation, let alone a more significant increase. But in order to protect real value, investors can turn to another government asset, so-called inflation-linked bonds (or TIPS in the US). TIPS may underperform nominals during a deflationary crisis, but over the cycle they tend to outperform them by about 1% p.a.

A pragmatic approach

So, what should investors do? For all but the most risk-seeking investors some allocation to fixed-income assets, including Treasuries, remains unavoidable even if that allocation is lower than in the past. Pure Treasury investments should be tilted towards inflation-protected instruments since central banks seem willing to tolerate more rather than less inflation. The remaining allocation to nominal Treasuries should favor longer-dated bonds since they offer the best diversification effect.

Glossary

TIPS – Treasury Inflation Protected Securities where the principal is adjusted periodically for inflation

Key points

- Low risk-free rates force investors to revisit bond allocations
- Treasuries still have a role to play
- TIPS an efficient way to hedge against future inflation

Market data summary

As of 20 July 2020

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	6,787.8	15.6	**-1.8**	23.6
S&P 500	3,224.7	14.2	**-0.2**	30.4
EuroStoxx 50	3,375.8	16.0	**-9.9**	**-3.5**
FTSE 100	6,272.4	7.9	**-16.8**	**-16.2**
SMI	10,438.4	6.7	**-1.7**	15.6
Nikkei	22,717.5	15.5	**-4.0**	12.8
MSCI EM USD	506.7	18.5	**-4.0**	7.0
Sensex 30	37,344.3	18.0	**-9.5**	17.1
KSE 100	37,638.1	12.4	**-7.6**	**-16.5**
Hang Seng	25,058.0	3.0	**-11.1**	**-6.3**
Russia RTS	1,219.8	14.2	**-21.2**	17.5
Brazil Bovespa	102,888.3	30.3	**-11.0**	58.4

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US gov	1,729.90	0.2	8.9	17.5
FTSE US Corp	2,617.05	5.7	7.4	21.6
FTSE US HY	1,081.68	7.2	**-2.5**	10.5
FTSE Euro gov	252.98	2.7	2.2	10.6
FTSE Euro Corp	249.21	3.8	**-0.5**	5.7
FTSE EM Sov	904.01	12.1	**-0.9**	11.8
DB EM Local USD	170.11	7.7	**-4.6**	3.4

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	95.94	**-4.1**	**-0.6**	1.6
EUR	1.14	5.4	2.0	**-1.5**
CHF	0.94	3.0	2.9	1.2
GBP	1.26	1.0	**-5.1**	**-3.0**
JPY	107.02	0.4	1.3	4.2
AUD	0.70	9.8	**-0.4**	**-12.2**
CAD	1.36	3.9	**-4.3**	**-7.3**
ZAR	16.69	12.9	**-16.2**	**-22.3**
INR	75.02	2.2	**-4.7**	**-14.0**
PKR	167.29	**-2.4**	**-7.7**	**-37.2**
Gold oz	1,810.42	6.8	18.9	45.3

Interest rates	3M interbank %	10YR government %
USD	0.27	0.62
EUR	-0.44	-0.44
GBP	0.08	0.16
CHF	-0.69	-0.43
JPY	-0.05	0.03
AUD	0.10	0.89
CAD	0.55	0.53
ZAR	4.60	9.45

Habib Bank AG Zurich

For your notes

For your notes

Habib Bank AG Zurich

For your notes

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)

Price data as of 20 July 2020

Disclaimer

This report is for distribution only under such circumstances as may be permitted by applicable law. It is expressly not intended for persons who, due to their nationality or place of residence, are not permitted access to such information under local law. Neither this report nor any copy thereof may be sent, taken into or distributed in the United States or to any U.S. person. The information contained herein has been prepared from sources believed reliable but is not guaranteed by Habib Bank AG Zurich (HBZ) and is not a complete summary of statements of all available data. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial and/or tax situation or specific needs of investors. Employees of HBZ or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed within this report. HBZ and/or its employees involved in the preparation or the issuance of this report may have positions in the securities or options of the issuer/s discussed or recommended herein. Securities identified herein are subject to availability and changes in price. They may not be eligible for sale in all jurisdictions or to certain categories of investors. For additional information on investment risks (including, but not limited to, market risks, credit ratings and specific securities provisions), contact your HBZ financial advisor. The information and material presented in this research note are provided for information only and are not to be used or considered as an offer or solicitation to buy, sell or subscribe to any securities or other financial instruments. This note does not take into consideration the specific investment objectives, financial situation or particular needs of any person who may receive this note and invest in any financial instrument. HBZ has not taken any steps to ensure that the securities referred to in this document are suitable for any particular investor. This brochure is not to be relied upon in substitution for the exercise of independent judgment. HBZ strongly recommends to interested investors to independently assess, with a professional advisor, the specific financial, legal, regulatory, credit, tax and accounting consequences prior to any investment decision. The value and income of any of the securities or financial instruments mentioned in this document can go up as well as down. The market value may be affected by changes in economic, financial or political factors, time to maturity, market conditions and volatility, or the credit quality of any issuer or reference issuer. Many factors may affect the value of a financial instrument, and accordingly, investors effectively assume all risk and may receive back less than they had originally invested. Any investors interested in buying a financial instrument should conduct their own investigation and analysis of the instrument as to the risks involved with transactions on such instruments. Past performance should not be taken as an indication or guarantee for future performance. IIn Switzerland, this report is distributed by Habib Bank AG Zurich, authorized and regulated by the Swiss Financial Market Supervisory Authority (FINMA). In the United Arab Emirates, this report is distributed by Habib Bank AG Zurich, UAE Branches, authorized and regulated by the Central Bank of the United Arab Emirates. In the United Kingdom, this report is distributed by Habib Bank Zurich Plc, authorized by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

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