Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

Calculated risks

Q4 2019

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Editorial

Dear Reader,

Global activity slowed further over the summer quarter, largely due to heightened uncertainty stemming from erratic and confrontational US policies. Central banks have once again reacted in a timely manner to the lack of growth momentum, however only more clear-eyed policies will be able to rekindle the animal spirits of the corporate sector.

So far this year, investors have been rewarded for taking risks. While the global context does not yet warrant all-out retrenchment, we nevertheless recommend positioning portfolios in such a way that they can absorb unforeseen market volatility. Specifically, this means focusing on quality for both bonds and equities as well as on assets and strategies that can withstand a more pronounced downturn.

As we head into the final quarter of the year, we have begun reflecting on the outlook for 2020. Our key thoughts are summarized in this issue's Special Topic.

We hope you enjoy reading our publication and, as always, look forward to receiving your feedback.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: A recession looming?

Global activity continued to weaken during the summer quarter. In response, central banks — led by the US Federal Reserve — once again eased monetary policy. The impact of these measures on the real economy may be limited, however, and recession risks have materially increased.

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

	2018E	2019F	2020F	Short-term trend
United States	2.9	2.3	1.7	↘
Eurozone	1.8	1.1	1.0	→
Germany	1.5	0.5	0.7	→
United Kingdom	1.4	1.2	1.0	→
Japan	0.7	0.9	0.3	↘
China	6.6	6.2	5.9	→
India	7.4	6.2	6.2	↗
Russia	1.8	1.1	1.6	→
Brazil	1.2	0.9	2.0	↗

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

	2018E	2019F	2020F	Short-term trend
United States	2.4	1.8	2.0	→
Eurozone	1.7	1.2	1.2	↘
Germany	1.9	1.4	1.4	→
United Kingdom	2.5	1.9	2.0	→
Japan	1.0	0.7	1.0	↗
China	2.1	2.5	2.3	→
India	4.1	3.4	3.5	↗
Russia	2.9	4.6	3.8	↘
Brazil	3.7	3.7	3.7	↗

Source: Bloomberg, IMF, HBZ

Key points

- US growth expected to remain close to potential
- Europe needs right kind of stimulus
- Trade and geopolitics weigh on EM economic performance

Trump slump or full-blown recession?

President Trump's aggressive trade stance has played a major role in dragging US manufacturing activity down to near-recessionary levels. With the 2020 presidential election on the horizon, though, a recession would be a distinctly unwelcome development for the incumbent. Hence Trump's attacks on the Fed, which, given the challenging economic realities it faces — growth has slowed considerably since the beginning of the year and inflation is stuck well below target — had little choice but to ease. And further easing is likely, especially if no trade deal can be struck with China. While household consumption continues to hold up reasonably well, mainly thanks to a still robust labor market, the economic fabric is brittle and could begin to tear if business and consumer sentiment softens further. Nonetheless, for now we expect US growth to stay close to potential in the quarters ahead.

Europe in the doldrums

The slowdown in global trade and slump in manufacturing has hit the eurozone particularly hard and growth in Germany, the bloc's leading economy and one of the world's export champions, has virtually come to a standstill. The ECB has responded by cutting interest rates and renewing asset purchases but the impact of these measures may be modest. What Europe really needs are additional structural reforms and some fiscal easing; this is especially true for Germany, which is running both a current account and a fiscal surplus. Neither appear to be in the pipeline, however, so growth is set to remain sluggish at best.

Lower EM growth ahead

The weakness in the advanced economies has already spread to emerging markets, and in many countries this spillover has been compounded by home-grown challenges: China, which continues to transition to a more consumption-led growth model, is having to deal with numerous domestic imbalances; India is grappling with a fragile banking system; and Russia has failed to diversify its economy. While the relatively stable oil price and lower USD interest rates have cushioned some of the impact of lower global demand, sustained external relief will only come from a reduction of trade tensions and geopolitical risks.

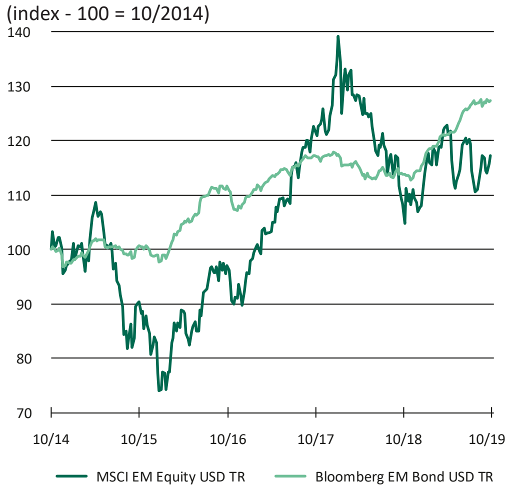
Investment strategy: Calculated risks

The past quarter delivered decent returns for fixed income but left equity investors flat at best. Is this a sign of things to come? Faced with binary risks, we recommend a prudent, well-diversified positioning which takes assets' downside properties into account.

Binary choices and risks

The global economy once again stands at a crossroads and investors face stark choices. If you believe a recession is the most likely scenario, then now is probably a good time to start dialing back portfolio risk and increasing exposure to safer assets such as government bonds and defensive equities; if, on the other hand, you believe that the world can muddle through — that solutions to pressing issues like the US-China trade dispute and Brexit can be found and risk assets will continue to outperform — then significant risk exposure should be maintained. We are partial to the latter assessment but are also conscious that the global expansion is now well into its tenth year. To take account of this fact, we believe portfolios should be broadly diversified and include assets and strategies that would help to mitigate potential drawdowns in the event of a sudden market correction. For example, we recommend keeping sizable exposure to emerging markets but with a clear emphasis on fixed-income assets, which at this point in the cycle offer better risk-adjusted returns than EM equities and hence our current underweight in this segment.

Chart 1: Risk-adjusted returns speak for EM bonds (index - 100 = 10/2014)



Source: Bloomberg, HBZ

Our positioning

Over the past quarter, we gave our portfolios a more defensive tilt by adding to our existing US Treasury positions. Within the credit allocation, we traded out of US senior loans and switched into EM corporates, which offer substantially higher yields than loans but also compared to US and European high-yield bonds with similar risk properties. We left the equity allocation largely unchanged, maintaining a distinct equity underweight and clearly favoring the US, a typically more defensive market.

What to watch

Although US President Trump appears to have morphed into the single biggest risk factor for global investors, we believe old-school fundamentals deserve as much attention as the stream of tweets emanating from the Oval Office. We will therefore be monitoring the current earnings season closely as the trajectory here will have a major impact on the outlook for equities going into 2020. We will also be tracking US employment data for any indications that recent signs of softening might cloud prospects for US growth in the year ahead.

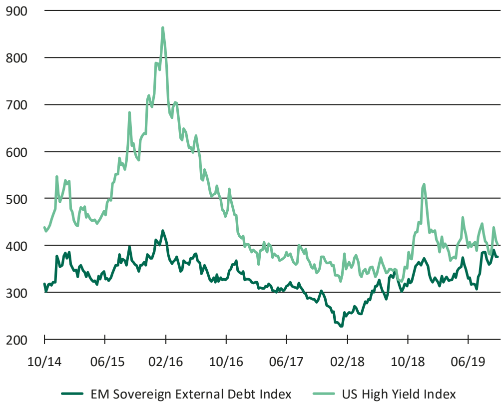
Key points

- Don't exclude a market 'melt-up'
- Pay attention to assets' risk properties
- Watch US employment data and corporate earnings

Fixed income: Selected EM bonds still offer value

Most segments of the fixed-income market have performed very strongly year-to-date; however, we expect only moderate performance going forward and favor EM bonds and EUR investment-grade corporates hedged back into USD.

Chart 2: EM sovereign debt more attractive than US high yield (credit spread in basis points)



Source: BoAML, HBZ

Attractive EUR investment-grade bonds

Investment-grade bonds in USD have generated double-digit returns this year. While credit spreads have tightened only slightly, the main return driver has been the collapse in US Treasury yields. The yield on US investment-grade bonds is currently around 3%, leaving only a thin risk buffer. Both a worse-than-expected economic outcome (which would cause spreads to widen) and a better-than-expected scenario (which would push Treasury yields up) could lead to a period of negative returns. We expect the US economy to grow close to trend and central bank easing could provide some tailwind. In this scenario, we expect low but still positive returns on quality US bonds. We currently see EUR investment-grade bonds as an attractive alternative, however. Naturally, the yield on EUR bonds is substantially lower, but when investors hedge their exposure back into USD, they stand to earn around 2.3% of additional return, matching the returns on US peers. EUR bonds offer some key advantages though: the economic cycle is less advanced in this part of the world and the average duration of European investment-grade bonds is currently more than two years shorter. Moreover, the ECB will resume its bond purchases in November, which will support this asset class. Last but not least, investors can benefit from better geographical diversification.

Emerging-market bonds: Well supported but not without risks

USD-denominated EM bonds have also produced double-digit returns this year, with price gains from lower US Treasury yields and tighter credit spreads both contributing to performance. The external backdrop for EM credit has improved overall, supported by additional easing measures by the Fed and the ECB. EM economies may slow but any slowdown is unlikely to be dramatic, as central banks in several countries stand ready to support growth by cutting rates. We therefore expect yields and spreads to remain range-bound in the current quarter and see EM credit as an important driver of portfolio performance. Nevertheless, the global outlook is uncertain due to the US-China trade spat, lower global growth, and the geopolitical tensions in the Middle East and other regions. These factors underscore the importance of credit selection. We recommend exposure via well-diversified EM funds and would advise against compromising on quality in the hunt for higher yields.

Key points

- Investment-grade corporates in EUR offer advantages over US issuers
- Investors can earn additional return by hedging back into USD
- EM bonds supported by hunt for yield

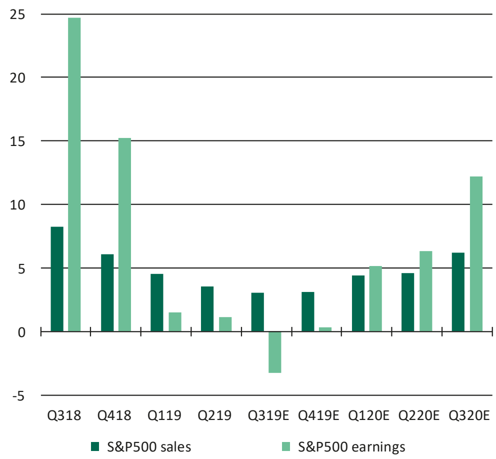
Equities: Can earnings growth pick up?

Despite adverse macroeconomic and geopolitical conditions, equities have generally fared well so far this year as many central banks have taken steps to protect the cycle. However, if the uptrend is to continue, companies will have to deliver on earnings. But will they?

Earnings, trade, and fiscal stimulus

Year-to-date, equity performance has been fueled by multiple expansion (i.e. an increase in a stock's price-to-earnings ratio), while earnings growth has remained subdued in most regions. Against this backdrop, US stocks have outperformed global equity markets but nevertheless remain reasonably valued. Further gains will be limited,though, unless earnings growth picks up significantly. European equities have also done well but weakness in the global manufacturing sector is a serious drag, especially on the export-driven German economy. Will Europe wait until it is too late to deploy fiscal stimulus? The Q3 earnings season started on a relatively positive note, despite widespread expectations of negative earnings growth in the US and elsewhere. Uncertainty is generally weighing on corporate confidence and restraining spending, while consumption and central bank measures have been the principal sources of support for corporations. Some sort of resolution on the US-China trade front would be an obvious catalyst for earnings and the stock market. But if there is to be another decent leg to this cycle, as opposed to a short-lived rebound, governments will have to take more decisive (fiscal) action.

Chart 3: S&P500 sales and earnings growth - recent past and forward-looking consensus estimates (y/y %)



Source: Bloomberg, HBZ

Investing with care

We recommend a below-benchmark allocation to equities. While equities generally offer more upside than bonds, they also harbor greater downside potential. Our central scenario assumes a continuation of the cycle on the back of supportive central banks and consumer resilience. We therefore believe a sizable exposure to equities is still warranted. We favor the US stock market due to the solidity of many of its constituents and the fact that the economy remains firm. US equities are also less exposed to global trade. At the sector level, US tech is still comparatively attractive given its superior earnings. But investors are advised to diversify their exposure across sectors and styles, by allocating capital to health care and financials for example. A robust portfolio should also feature stable, higher-dividend stocks. European, Japanese, and emerging-market equities offer serious optionality, but their dependence on the economic cycle and trade makes them riskier investments. Japan and emerging markets are trading at a discount versus historical valuations. We recommend maintaining only limited exposure to these regions.

Key points

- Equities offer more upside than bonds
- Earnings growth needed instead of multiple expansion
- Diversify across sectors and styles

Commodities and FX: Still a USD world

The past quarter has proved once again that, with the possible exception of gold, there is currently no alternative to the US dollar; favorable valuations alone will not suffice to trigger a dollar reversal. In aggregate, against a backdrop of lower global growth, commodity prices will also offer only limited upside.

Chart 4: GBP surging … for now (GBPUSD)

Source: Bloomberg, HBZ

Key points

- Gold as only alternative to dominant USD
- GBP offers most upside within G10
- Oil attractive as trading asset

Attractive valuations are not enough

All major currencies lost ground against the USD during Q3 as growth concerns dominated the headlines. Two Fed rate cuts convinced investors that the downside risks were real, and they duly flocked back to the US dollar as the world's preferred safe-haven currency. The USD has now been on an appreciating trajectory for almost two years, which we believe restricts scope for further upside. But favorable valuations alone will not trigger a sustained rally in any of the other G10 currencies; fundamentals will have to change for this to happen. At the time of writing, the GBP has come closest to such a tipping point, having suffered a 25% decline since the post-2008-crisis high in mid-2014 and a further fall of almost 10% since the fateful Brexit vote in 2016. If the fog surrounding Brexit lifts, there is real appreciation potential for sterling. The outlook is less clear for the EUR and JPY, mainly because their respective central bank policies diminish the relative attractiveness of these currencies. Historically, lower global growth has also been negative for most EM currencies, and we think the situation is unlikely to be any different this time. Moreover, many EM central banks have themselves adopted a more accommodative monetary policy stance which over time will reduce the carry.

Commodities as trading assets

Lower global growth will also affect demand for commodities. Hence any further upside for energy and metals, the two major commodity groups which have made respectable price gains so far this year, appears limited at best. Precious metals remain the major exception here — first and foremost gold, which will continue to benefit from risk aversion and is a strong diversifier of US dollar risk independently of the green back's performance against other currencies. Otherwise, we believe the value of commodities lies chiefly in their role as trading assets. In particular crude oil with its large price swings offers attractive opportunities for trading-oriented investors. We expect the crude price to remain within a wide but well-defined range, with the upside capped at around USD75/bbl by expectations of lower global growth as well as sufficient supply and a floor of around USD40/bbl defined by the economics of the US shale oil industry, the new swing producer of the global oil market.

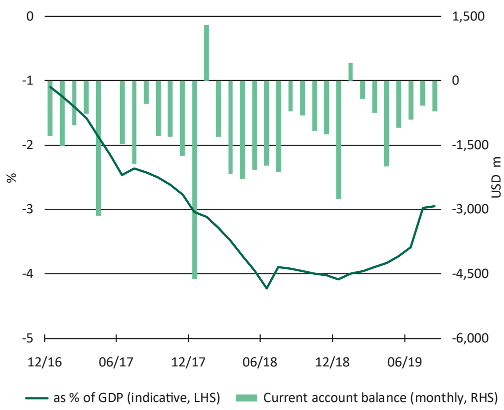
Key markets: No easy way out

Pakistan's economic deceleration is about to bottom out but the country still faces a long and difficult path to recovery. Meanwhile the UAE remains at the mercy of an uncertain regional outlook, and the ongoing deadlock surrounding Brexit continues to hold the UK hostage.

Pakistan: The uphill struggle continues

Economic growth in Pakistan will remain muted this year due to the many macro imbalances and the frequently painful structural adjustments required to correct them. The rigorous IMF program adopted in July has helped to stabilize sentiment, given the country access to additional multilateral funding, and contributed towards halting the slide of the rupee. The large current account deficit, the country's main vulnerability, has also reversed, albeit largely as a result of a sharp drop in imports. Inflation also appears to have peaked. This should allow the State Bank of Pakistan to start unwinding its extremely tight monetary policy in due course. The above developments have been well received by the local stock market, which managed to recoup some of the losses it has incurred year-to-date. However, the market remains engaged in a tough uphill struggle given the poor earnings outlook of many listed companies. Until macro stability has been achieved, foreign portfolio investors will stay on the sidelines despite highly attractive valuations.

Chart 5: Pakistan - current account deficit on the mend



Source: Bloomberg, HBZ

UAE: Only a slow recovery

Activity in the Emirates' non-oil sector remains under pressure, and this year's growth may exceed last year's modest performance only thanks to a pick-up in oil-related industries. Uncertainty in the region — in particular regarding the still struggling real-estate sector — continues to represent a key headwind for the local economy.

UK: Falling into a void?

The Brexit drama risks becoming a never-ending story. With the October 31 deadline looming, the country and its political elite are more divided than ever. Prime Minister Johnson has managed to negotiate an amended withdrawal agreement and a no-deal Brexit scenario is now less likely. However, Johnson still appears to be more concerned with outmaneuvering the Brexit Party than ensuring the wellbeing of the country as a whole. Even if a hard Brexit can be avoided, the UK will face serious problems in the years ahead and, in the worst case, could be seriously diminished in size and stature. An early general election is now inevitable, but, far from bringing closure, the outcome of this poll could throw up yet more challenges. As a result, UK assets will continue to trade at a discount.

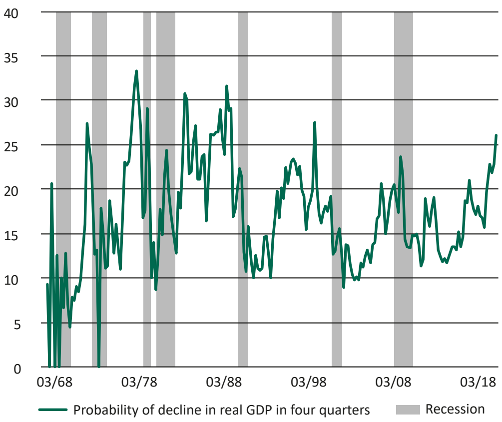
Key points

- Pakistan still has plenty of heavy lifting to do
- UAE at mercy of regional developments
- Brexit will continue to dominate UK assets

Special topic: A first look at 2020

As we have now entered the final quarter of the year, we need to start thinking about 2020 and the key issues facing investors. While we certainly do not claim to have a crystal ball, we believe we can derive valuable insights from the current state of affairs as well as historical experience.

Chart 6: Anxiousness rising: Current probability of a recession (%)



Source: Philadelphia Fed, HBZ

Key points

- Rates will stay low under almost any circumstances
- US recession is no certainty despite material risks
- US election outcome could significant impact markets and portfolios

More of the same for interest rates?

We expect some of the major trends to continue into 2020. The most important of these concerns interest rates, which are set to stay low unless policy makers initiate a radical change of course. Structural forces, such as changing demographics and technological innovation, are likely to continue contributing towards this low-rate environment. With rates anchored, return expectations for fixed-income assets will remain low. In the event of a global recession — a development we still consider unlikely — interest rates would probably decline further as central banks would cut their key rates and implement or enhance additional measures in response.

How material is the recession risk?

Mercifully, global recessions are rare. But a US recession would suffice to send markets into a tailspin. How likely is such a scenario? The Bloomberg consensus currently puts it at 35% over the next twelve months whereas the Survey of Professional Forecasters conducted by the Philadelphia Fed puts it at 26% for the same time frame. Both readings are high by historical standards and suggest an unusual concern among economists. One reason is the length of the current business cycle, which in itself increases the risk of a more or less pronounced slowdown. Another reason is the level of global uncertainty, which raises the risk of a policy error and a consequent sharp drop in activity and growth. These probabilities need to be taken seriously and should be reflected in the composition of any portfolio. On the other hand, we should not ignore the possibility of another year of modest growth which would reward continued risk-taking.

US elections as a game changer?

2020 will be a US presidential election year and election years have historically delivered modest positive equity returns. The real test usually comes in the first year of the new presidency: In the post-WWII period the stock market suffered whenever the incumbent was not re-elected. The 2020 elections may, however, be different for other reasons, which could impact the investment context. A win by a Democratic candidate would certainly lead to new regulation and could see efforts to limit the impact of climate change. Energy and health care are two sectors that would certainly come under significant pressure.

Market data summary

As of 21 October 2019

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	6,413.4	0.5	18.5	36.7
S&P 500	2,986.2	0.3	19.1	39.5
EuroStoxx 50	3,595.9	3.3	19.8	16.8
FTSE 100	7,158.6	-4.7	6.4	2.0
SMI	9,986.1	0.5	18.5	24.3
Nikkei	22,548.9	5.0	12.7	31.2
MSCI EM USD	483.0	-2.6	8.4	20.8
Sensex 30	39,298.4	2.5	9.0	40.0
KSE 100	33,117.4	2.0	-10.7	-19.8
Hang Seng	26,725.7	-7.1	3.4	14.3
Russia RTS	1,367.1	1.2	27.9	38.6
Brazil Bovespa	104,728.9	1.2	19.2	63.4

Bond indices	Last	-3M %	YTD %	-3Y %
Citi US gov	1,595.02	2.2	7.2	7.3
CIti US Corp	2,407.28	2.9	12.9	13.9
CIti US HY	1,080.97	1.3	11.2	17.3
Citi Euro gov	251.70	1.5	8.1	7.1
CIti Euro Corp	250.39	0.1	6.2	5.9
CIti EM Sov	894.07	0.2	12.6	13.6
DB EM Local USD	173.51	-0.4	10.1	11.8

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	97.28	0.1	1.1	-1.5
EUR	1.12	-0.5	-2.5	2.6
CHF	0.99	-0.5	-0.3	0.8
GBP	1.30	4.0	1.9	6.1
JPY	108.45	-0.6	1.0	-4.4
AUD	0.69	-2.3	-2.4	-9.6
CAD	1.31	0.0	4.0	1.7
ZAR	14.79	-6.2	-2.7	-5.4
INR	71.17	-3.1	-1.9	-6.2
PKR	156.44	2.6	-10.4	-32.8
Gold oz	1,492.01	4.6	16.4	17.8

Interest rates	3M interbank %	10YR government %
USD	1.95	1.78
EUR	-0.41	-0.34
GBP	0.79	0.76
CHF	-0.78	-0.56
JPY	-0.12	-0.13
AUD	2.96	1.15
CAD	1.17	1.55
ZAR	6.78	8.97

For your notes

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