Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

Short-term challenges, longer-term uncertainties

Q4 2020

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Editorial

Dear Reader,

The summer quarter witnessed the reopening of most economies and a sustained positive performance in most asset markets. Going forward, new gains will be harder to come by, however. The pandemic is still with us, and in the absence of a widely available vaccine, governments will have to keep some containment measures in place; this will inevitably affect overall economic activity.

Given the prevailing uncertainty, investors would do well to maintain a defensive positioning. However, as highlighted in the previous edition, the low interest rate environment, which is likely to be a fact of life for years to come, presents a particular challenge here and will require us to revisit well-established practices and assumptions.

In the short term though, the US presidential election remains the key concern for investors. While we may be spared a worst-case scenario in which the country descends into all-out chaos following a narrow and contested result, some caution is nevertheless in order. Only time will tell whether our apprehensions regarding this pivotal event, which we summarize in our Special Topic on page 10, were justified.

Until then we wish you continued success in all walks of life and look forward to our ongoing exchange.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Living with the pandemic

More than half a year after the outbreak, the global economy continues to struggle with the new realities unleashed by the virus. While activity is normalizing, the recovery will remain uneven and fiscal and monetary support will be necessary until a vaccine becomes widely available.

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

	2019	2020F	2021F	Short-term trend
United States	2.3	-4.4	3.8	↗
Eurozone	1.2	-8.1	5.5	→
Germany	0.6	-6.0	4.8	→
United Kingdom	1.3	-10.0	6.4	→
Japan	1.0	-5.7	2.5	→
China	6.1	2.1	8.0	↗
India	4.2	-5.8	7.2	↗
Russia	1.3	-4.4	3.3	→
Brazil	1.1	-5.3	3.5	↗

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	0.4	1.0	↘
Germany	1.4	0.5	1.4	↘
United Kingdom	1.8	0.9	1.5	→
Japan	0.5	0.0	0.2	↘
China	2.9	2.8	2.2	↘
India	4.2	4.8	5.1	↘
Russia	4.5	3.3	3.6	→
Brazil	3.7	2.6	3.1	↘

Source: Bloomberg, IMF, HBZ

US – low rates are here to stay

Whoever wins November's presidential election will have to grapple with the same harsh, COVID-19-induced economic realities that we are enduring now: unemployment hovering around 8%, a sky-high fiscal deficit and interest rates at historic lows. None of this is likely to change any time soon. Once opened, fiscal taps are hard to close under any circumstances. Election politics may prevent yet another round of fiscal stimulus, however some further fiscal action is likely when the new Congress convenes early next year. The Fed, for its part, has made it abundantly clear that rates are likely to stay at the lower bound for years to come. Indeed, under the new policy regime of flexible average inflation targeting, the Fed's target rate may not increase before 2024 – and possibly even later if measures aimed at lifting inflation expectations and realized inflation fail to have the desired effect. Activity slowed again during late summer following the sharp initial bounceback post-reopening, leaving little to no room for prices to rise in the current circumstances. And if a pre-COVID-19 unemployment rate of 3.5% did not fuel inflation, a jobless rate well above that certainly won't either. While a vaccine is unlikely to alter this backdrop significantly, it would definitely lift sentiment and business confidence.

Europe battling on many fronts

COVID-19 is not Europe's only problem, alas! The continent is battling on many fronts, from Brexit to tensions with Russia and Turkey. Though the contraction in Q2 turned out to be smaller than feared, the recovery has been patchy so far. The measures deployed by the EU Commission and the ECB have, however, put a floor under economic activity, buying national governments time to prepare more consequential recovery programs for 2021.

China on top – at a price

Among the world's largest economies, only China is forecast to deliver positive growth for 2020. This performance will cement its increasingly dominant role in the global economy. Irresistible though the country's rise may be, China will meet stiffer resistance going forward, and not just from the US. Europe – but also India and other emerging-market economies – are wary of becoming overly dependent on Chinese goods and capital and are looking to diversify on both of these fronts.

Key points

- US rates set to stay low, irrespective of election outcome
- It will take time for Europe's recovery to start in earnest
- China leads world in growth but faces increasing resistance

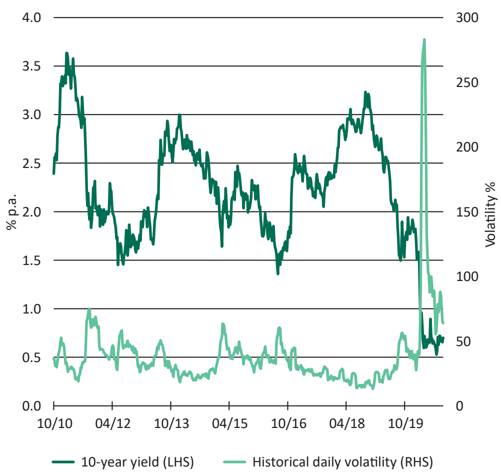
Investment strategy: The end of the balanced portfolio?

Despite the violent sell-off in March, multi-asset portfolios have managed to generate positive returns year-to-date. However, central bank actions have depressed bond yields to such an extent that some investors have started to question the traditional balanced approach. Are they right?

Moving towards balanced 2.0?

Time heals everything, they say. Looking at the astonishing rebound of global markets since the March lows, we are tempted to agree. Patience is indeed a virtue and recommending investors sell in the middle of the storm would have been poor advice. Notwithstanding this, portfolios should be reviewed regularly to assess risks and re-balance exposures. Such reviews are even more important today, when events have fundamentally altered the economic context. In particular, the prospect of a prolonged period of depressed interest rates begs the question: does the time-honored 'balanced allocation' approach still make sense? Although they performed this role to perfection when the pandemic struck, the concern is that – going forward – government bonds will no longer act as shock absorbers in volatile markets. Investors in some low-yield currencies, for example, are already allocating less to high-grade bonds in favor of real estate. We are not yet convinced that this is the way to go, not least because risks in real estate markets are considerable – after all, property prices would be just as exposed as bond prices in the event of a substantial interest rate rise. We are more sympathetic to worries about financial repression – policies that allow governments to inflate away their sovereign debt to more manageable levels. Possible alternatives here include inflation-linked bonds where the principal is protected, or private markets (e.g. direct lending) where yields are unlikely to fall as low as in public markets.

Chart 1: US Treasury yields: low but volatile



Source: Bloomberg, HBZ

Our positioning

We remain defensively positioned in our equity allocation but are maintaining our overweight in credit relative to government bonds as investors continue to search for yield. We are diversifying into alternatives to traditional fixed-income assets where returns will, at best, be capped at modest levels.

What to watch

In the short term, the US election will dominate investor attention. Volatility is expected to remain high given the risk of a close outcome. Beyond the election, corporate results will matter more than ever, since they will confirm whether earnings power has recovered in line with other economic variables. Finally, any news of an effective vaccine will boost investor confidence – in the short run, at least.

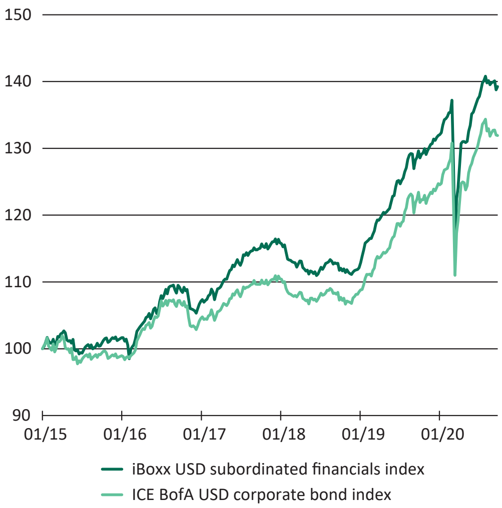
Key points

- Allocation to government bonds to be reassessed
- Private debt markets and inflation linkers as alternatives
- Elections, earnings and vaccine to dominate market developments

Fixed income: Coupon at best

Following a further significant tightening of credit spreads, most fixed-income sectors are likely to deliver only low returns going forward. Most value is still to be found in subordinated bonds from well-rated issuers, in selected emerging-market bonds, and in niche markets such as cat bonds.

Chart 2: Subordinated financials beat senior corporates (index, 100 = 01/2015)



Source: Bloomberg, HBZ

Subordination still pays

USD investment-grade spreads tightened further, reversing most of the widening that occurred between February and late March. As a result, expected returns have fallen. The key risk is potentially higher US rates and ensuing mark-to-market losses. One way to increase the return on an investment-grade bond portfolio is to include corporate hybrids and subordinated bonds from sound financial issuers. Corporate hybrids are long-dated, callable subordinated bonds, typically issued by investment-grade companies and offering yields significantly above senior bonds from the same issuer. Most hybrid bonds repay at the first call date, which limits duration risk. Subordinated financial bonds have similar features and pay a significant yield pick-up, compensating investors for nominally higher risk.

Stay with EM sovereign hard-currency bonds

Spreads for most EM bonds have also tightened considerably, but amid higher volatility given global uncertainties we expect only limited additional spread tightening. Within the EM universe, we continue to favor sovereign bonds in hard currencies from stable issuers. While we believe these bonds still offer an attractive risk/return profile, we also believe selectivity remains important. Our key concerns at the moment are the low oil price, the upcoming US election and a potential second wave of COVID-19. For EM corporate bonds, valuations are no longer as compelling given the risks associated with these investments. We are currently cautious with respect to this segment and recommend staying on the sidelines.

Look for alternatives

Given the bleak return expectations for core bond markets, we recommend diversifying fixed-income investments beyond mainstream strategies and markets. At this point, total return strategies could be an interesting addition to a portfolio. Such strategies tend to have a larger universe at their disposal and target a positive return under all market conditions. Cat bonds are another attractive alternative. These bonds allow insurers to raise money to cover the costs of natural disasters such as earthquakes; a payout is usually triggered when certain thresholds or parameters are exceeded. Collective investments are by far the best way to gain exposure.

Key points

- Low returns expected for investment-grade bonds
- Subordinated bonds continue to pay a pick-up
- EM sovereigns preferable to EM corporates

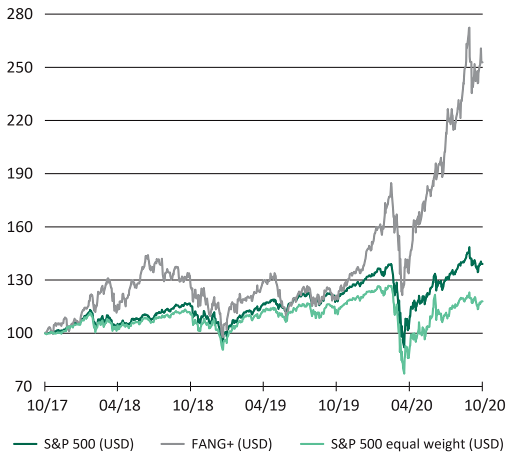
Equities: Temporary loss of momentum

Equities fared extremely well over the summer months thanks to much better than expected earnings and continued economic recovery. However, with four potential issues on the horizon, the end of the year may prove more challenging for equity markets.

Four wildcards

We are optimistic about the medium-term economic trajectory – and, by extension, about equity markets – even if the recovery has temporarily lost momentum. September was a volatile month for risk assets as a certain exuberance, notably in the valuation of technology stocks, was corrected. Investors also started to factor in four near-term risks, which could affect markets. The first two risks – a contested presidential election and uncertainty surrounding an additional round of fiscal stimulus – center on the US. The third – Brexit – is a material risk for Europe and the repercussions of a no-deal outcome could be felt globally. These three risks are temporary in nature, however: one of the two candidates will ultimately carry the election; equally, it is highly likely that additional fiscal measures will be forthcoming, although these may only be passed once Congress has convened in January; and Brexit certainty, deal or no deal, will allow Europe and the UK to move on. The risks related to a new wave of COVID-19, on the other hand, are potentially longer term in nature. But they are tempered by a much lower mortality rate than during the first wave, a better prepared health care system, and hope for a vaccine.

Chart 3: Outperformance of large-cap technology stocks (index, 100 = 10/2017)



Source: Bloomberg, HBZ

Diversification matters

Technology stocks, notably large caps, retreated from their early September highs but are still holding on to solid gains. Valuations for this sector appear rich, but earnings are real, and the pandemic has accelerated the adoption of IT solutions at both the corporate and household level. Moreover, major central banks have pledged to keep interest rates anchored close to zero for the coming years and a low interest rate environment tends to support growth companies and technology. A rise in long-term interest rates and antitrust investigations could temporarily derail the sector's performance though. Since the market lows in March, we have witnessed episodes of sector rotation. The technology sector has so far retained its leadership but the market is increasingly anticipating the announcement of a vaccine and a gradual return to normality. Against such a backdrop, investors should expect cyclical sectors such as consumer discretionary, industrials, materials and even financials to outperform. It is therefore important to build sector-diversified portfolios. The same applies to a portfolio's regional allocation where Europe and emerging markets offer more cyclical exposure.

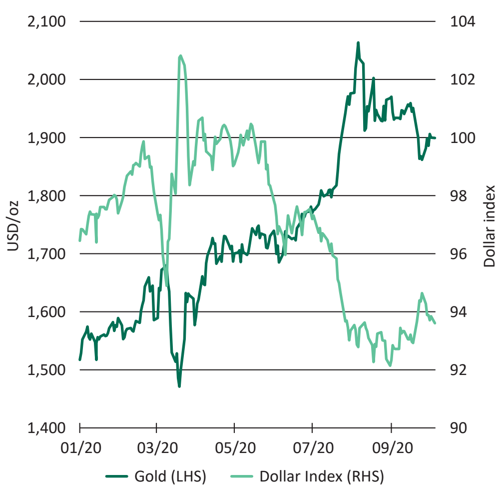
Key points

- Short-term risks but constructive for medium term
- Technology sector supported by low interest rates and high earnings
- Diversify regional and sector exposure

Commodities and FX: Gold forever?

Gold has been among the best-performing assets so far this year. Despite its strong performance, we believe the yellow metal will remain well supported going into 2021. Gold's unique characteristics make it a diversifier of choice within investment portfolios.

Chart 4: Gold's inverse relationship with the US dollar



Source: Bloomberg, HBZ

Gold, the US dollar and real yields

Many moving parts are influencing the price of gold, chief among them the direction of the US dollar and the level of real yields. We expect the US dollar to weaken further, albeit marginally, once the global economy regains momentum. The immediate trajectory of the US dollar is, however, uncertain and tilted to the upside, as COVID-19 has flared up again and a contested US election would – perhaps counter-intuitively – benefit the greenback. Real yields are important for gold as, by its nature, the precious metal is a non-yielding asset. The path of real yields – the nominal yield adjusted for inflation – is uncertain and should be assessed over both a medium and long-term horizon. While over the medium term nominal yields could rise in response to the economic recovery, there are currently no strong driving forces behind inflation. As a result, real yields, which are in record-low negative territory in the US, could rise and this could have a detrimental impact on the performance of gold. In the long term though, inflation could creep up over the coming years if deglobalization and a reorganization of supply chains materialize. With the Fed's 'low-for-longer' monetary policy, its large quantitative easing programs and its willingness to tolerate higher inflation, the monetary context would also be conducive to higher inflation.

Gold still on an upward trend

Investors' appetite for gold is intact even if the metal has not really played its traditional role as a hedge against market stress so far this year. In March, gold fell sharply as investors sold liquid assets and demand for the US dollar surged. In September, gold fell as risk aversion led to a strengthening of the dollar. The overall trend for gold nevertheless remains upward despite sideways markets and occasional corrections. The discovery and broad distribution of a vaccine could halt gold's rise, at least temporarily, though.

Oil range-bound but with upside potential

The oil price has been consolidating in a range following one of the most tumultuous price moves in recent history. The biggest challenge for oil is on the demand side due to reduced air and ground mobility, however we see limited further downside on the demand front from now on. If OPEC+ remain disciplined in their output management, oil could gain momentum in 2021.

Key points

- Gold as a source of diversification
- USD with only limited downside
- Oil to remain range-bound until next year

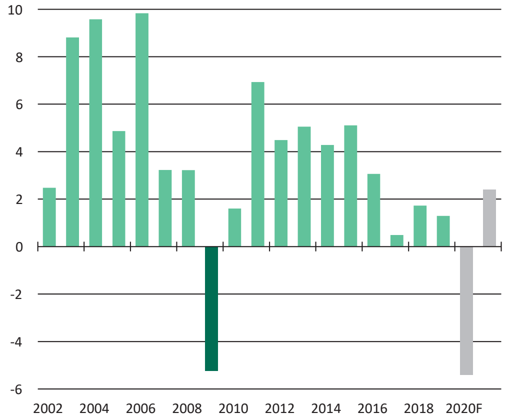
Key markets: In search of an exit

The recovery has also set in in our key markets but, as elsewhere, it has been uneven at best. While the UAE are desperately seeking to reinvent themselves, the UK is about to set sail into uncharted waters and Pakistan continues to battle on many fronts – and with uncertain prospects of success.

Pakistan caught between pandemic and politics

During the summer quarter activity rebounded noticeably in Pakistan as the spread of the virus slowed. Fiscal and monetary policy provided important support and both are expected to remain accommodative for the time being. The external position also materially improved thanks to a sharp decline of the trade deficit and record-high remittances. Despite these improvements, Pakistan will remain engaged with the IMF and is expected to resume the current program shortly. The stronger current account position has propped up the currency which will help to contain inflation and allow the State Bank to remain on the sidelines. The stock market has recovered most of the losses suffered in March. However, the overall state of the economy remains precarious and renewed political tensions, which could once again spill over onto the streets, risk capping any upside. Foreign investors in particular remain unconvinced about the medium-term investment case.

Chart 5: UAE growth downturn to be worse than in 2009 (real GDP y/y %)



Source: Bloomberg, HBZ

UAE – reinventing itself?

The Emirates are likely to suffer a deeper recession than initially expected following the collapse in tourism and widespread disruption to manufacturing supply chains. Swift and comprehensive action from the central bank and the government – fiscal spending is expected to increase by close to 30% in 2020 – has limited the downside. The surprise peace accord with Israel could create new opportunities as the traditional drivers of growth, including real estate, have stalled.

UK – stumbling towards the exit?

By any standards, the UK has had a bad pandemic so far, with the economy expected to contract by 10% in 2020 despite a revival of activity from June onwards. The latest surge in COVID-19 cases is a further embarrassment for a generally hapless government. To make matters worse, the government recently introduced legislation which directly contradicts the EU Withdrawal Agreement. While possibly a ploy to shift the blame for a breakdown of negotiations onto the EU, this questionable step has materially increased the risk of a no-deal Brexit and hence of more significant downside for the GBP. The Bank of England already increased its asset purchase program in June as an additional response to COVID-19 and it stands ready to take more action in the event of a hard Brexit.

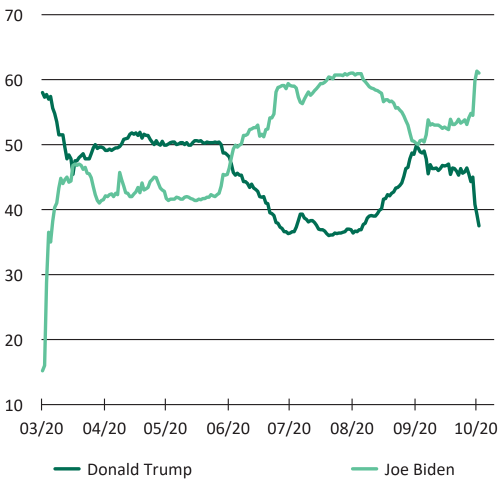
Key points

- Uneven recovery underway in Pakistan
- Peace deal with Israel to create new opportunities for UAE
- Risk of no-deal Brexit has increased again

US elections and what they mean for markets

For decades, US presidential elections have provided the world with a mighty spectacle but rarely have they been as momentous as this year. Investors need not take sides, but they should certainly consider the potential fallout of the election result for their portfolios.

Chart 6: Betting odds favor Biden (%)



Source: Bloomberg, HBZ

It could be ugly for some time

The choice that US voters make at this election – between incumbent Donald Trump and Democratic challenger Joe Biden – could be extremely consequential. The very reputation of the United States and people's trust in its institutions – which to this day underpin the country's global status – are at stake. Polls indicate that the race could be very close, although it is important to note that the inherent margins of error in such surveys also allow for an unequivocal outcome. What worries many investors is that President Trump has made it clear that he expects widespread fraud and that he would not hesitate to challenge the legitimacy of a vote, were he to lose by a relatively small margin in key swing states. In a tight race, both sides – but certainly the Trump camp – are likely to pull out all stops in contesting the result. Legal action could delay a final verdict into January 2021. Under such circumstances market volatility would undoubtedly spike. Violent clashes between hardened supporters could erupt, further fueling risk aversion. However, our key assumption remains that the US will not descend into civil war and that a US president will eventually emerge.

What should investors do – and expect?

US assets have enjoyed a stellar run since the dark days of the Great Financial Crisis. The pandemic, when put into a larger context, has done surprisingly little to dent this record. Investors who have benefited from this ride should therefore consider taking some profit and sit out the expected period of uncertainty with higher cash balances. Alternatively, they could reduce their US equity exposure and buy non-US assets, which are currently often more attractively valued anyway. Once the president and composition of Congress are known, investors can position themselves in line with the expected priorities of the incoming administration (Trump II or Biden). In the former case, lower taxes and further deregulation should favor banks, defense stocks and energy in particular. Under Biden, especially if the Democrats were also to regain control of the Senate, more fiscal stimulus and spending on green infrastructure would be generally supportive for growth and hence stocks, although favoring different sectors. We expect fixed income to fare relatively poorly whatever the outcome: low rates and an even higher budget deficit are toxic for bond returns.

Key points

- Close election result could lead to period of uncertainty
- Worst-case scenario – civil strife and no president by inauguration day – unlikely
- Underweight US into election

Market data summary

As of 5 October 2020

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	7,013.8	6.5	1.5	23.8
S&P 500	3,348.4	7.0	3.6	31.2
EuroStoxx 50	3,206.7	-2.7	-14.4	-11.3
FTSE 100	5,944.4	-3.5	-21.2	-20.8
SMI	10,283.4	1.6	-3.1	11.0
Nikkei	23,312.1	4.5	-1.5	13.0
MSCI EM USD	521.5	5.4	-1.2	5.4
Sensex 30	38,973.7	8.7	-5.5	24.6
KSE 100	39,286.4	12.1	-3.6	-2.9
Hang Seng	23,767.8	-2.7	-15.7	-13.7
Russia RTS	1,145.5	-7.3	-26.0	0.1
Brazil Bovespa	94,015.7	-2.8	-18.7	22.7

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,724.35	0.1	8.6	17.1
FTSE US Corp	2,607.91	1.1	7.1	20.7
FTSE US HY	1,108.24	4.1	-0.1	12.0
FTSE Euro gov	256.59	1.7	3.7	11.8
FTSE Euro Corp	252.81	2.1	1.0	6.7
FTSE EM Sov	909.04	1.4	-0.3	10.2
DB EM Local USD	168.84	-0.4	-5.3	2.5

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	93.84	-3.7	-2.9	-0.4
EUR	1.17	3.9	4.6	0.3
CHF	0.92	2.7	5.4	6.7
GBP	1.29	3.6	-2.4	-1.5
JPY	105.29	1.7	2.8	6.8
AUD	0.72	2.9	2.2	-8.0
CAD	1.33	2.0	-2.3	-5.4
ZAR	16.53	3.7	-14.7	-16.7
INR	73.14	1.9	-2.6	-11.1
PKR	164.47	1.5	-5.7	-35.8
Gold oz	1,899.84	7.0	24.7	49.3

Interest rates	3M interbank %	10YR government %
USD	0.23	0.71
EUR	-0.51	-0.54
GBP	0.06	0.25
CHF	-0.77	-0.50
JPY	-0.10	0.03
AUD	0.09	0.83
CAD	0.51	0.57
ZAR	3.36	9.42

For your notes

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