Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

The return of inflation?

Q4 2021

Habib Bank AG Zurich

Table of contents

Editorial

Dear Reader,

The COVID-19 pandemic is still with us, and some of its more persistent consequences have now become visible. Beyond the human toll and the financial turmoil, the damage done to supply chains in particular has become evident over the past quarter, as has the impact on global prices. The return of inflation has dominated headlines and spooked financial markets – many investors believe that we are about to enter a prolonged period of high inflation. Unsurprisingly, then, the issue of inflation looms large in this edition of our Investment Quarterly.

For various reasons, we are still siding with those who believe that current inflationary pressures will be transitory, however we are far from complacent. As we witnessed in late September and early October, rising market interest rates tend to go hand-in-hand with higher market volatility. When it comes to taking countermeasures, we recommend reviewing portfolio components for their risk contributions and scaling back if these turn out to be too large. Nevertheless, we remain constructive on the fundamental outlook into year-end and the beginning of 2022 and are maintaining our exposure to equities and credit.

In our 'Special topic', we once again focus on inflation, this time from the perspective of fixed-income investors. In the current environment of negative real rates, it is not a pretty sight…

We are delighted to present the latest issue of our Investment Quarterly and look forward to a robust discussion of our views and conclusions.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Lower growth but no stagflation

While the headlines suggest that the pandemic still has an iron grip on the global economy, the facts suggest otherwise: The US economy is back above its pre-COVID level and inflation, while stubbornly high, will subside in due course. An uneven normalization is set to continue.

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

	2020E	2021F	2022F	Short-term trend
United States	-3.4	5.9	4.1	→
Eurozone	-6.3	5.0	4.3	↘
Germany	-4.6	3.0	4.5	↘
United Kingdom	-9.7	7.0	5.3	↘
Japan	-4.7	2.4	2.5	→
China	2.3	8.3	5.5	→
India	-7.5	9.3	7.0	↘
Russia	-3.0	4.1	2.5	↘
Brazil	-4.1	5.1	1.9	→

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

	2020E	2021F	2022F	Short-term trend
United States	1.2	4.3	3.0	→
Eurozone	0.3	2.2	1.7	↗
Germany	0.4	2.9	1.9	↗
United Kingdom	0.9	2.2	2.7	↗
Japan	0.0	-0.2	0.5	↗
China	2.5	1.2	2.3	→
India	6.2	5.4	4.8	→
Russia	3.4	6.1	4.4	↘
Brazil	3.2	7.8	4.5	↘

Source: Bloomberg, IMF, HBZ

Key points

- Fed to end asset purchases as expansion continues
- ECB to maintain accommodative policy for eurozone
- China may ease policy to address growth slowdown

Fed at the ready

The most recent US economic data fell short of expectations as head-winds created by the latest COVID-19 wave this summer, as well as supply-chain disruptions, left their mark. Job creation in particular failed to meet (arguably bullish) analyst forecasts. However, medium-term growth prospects remain solid, with annual real growth still set to reach almost 6.0% this year and more than 4.0% in 2022. In our view, the economy has made sufficient progress towards meeting the Fed's conditions for formally announcing the start of asset purchase reductions. We expect such an announcement at the November FOMC meeting. While the Fed continues to consider the current surge in prices as transitory — and we share this opinion — tapering will create additional headroom for policy in case inflation turns out to be more persistent. Meanwhile, the Biden administration will continue to seek higher spending on infrastructure; although the debt ceiling may once again be used to extract some last-minute concessions, Congress is likely to compromise at some stage.

Europe lumbering along

Eurozone GDP has yet to reach its pre-pandemic level but a broad-based recovery continued during the past quarter in most member states despite supply-chain disruptions and other issues. While the ECB confirmed the scheduled end to its pandemic purchase program, the Governing Council made it clear that policy would remain highly accommodative for a considerable time. The result of the German elections also reduced the risk of premature fiscal tightening by the eurozone's largest economy.

Politics to dominate economics in China

Under the slogan 'common prosperity', the Chinese government launched a regulatory crackdown to bring some of the more enterprising sectors of its economy to heel. At the same time, the authorities continued to address excessive leverage in the real-estate sector, epitomized by the rise and fall of Evergrande, the country's second largest property developer by sales. Such shocks will invariably slow economic activity but the government has both the means and the will to keep growth close to its target of 6.0%. If necessary, fiscal and monetary policy will be eased, which will help not only China but the global economy as a whole.

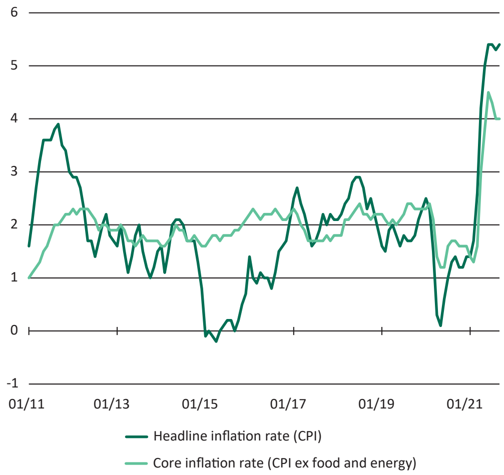
Investment strategy: Regime change?

After a volatile end to the last quarter and an equally bumpy start to the new one, investors are understandably anxious. Will inflation and higher rates put an end to the equity bull market? We do not think so, but we nevertheless recommend monitoring risk exposure carefully.

Is the rate regime about to change?

Higher inflation in virtually all economies has caused many investors to wonder whether the end of a multi-decade era of global disinflation has arrived. What tends to get forgotten here is that central banks have worked tirelessly to achieve precisely this outcome in order to defeat the threat of outright deflation. The latest bout of inflation actually has little to do with monetary policy but is the result of a very real supply shock, mainly as a consequence of the COVID-19 pandemic. While some of the effects may be longer lasting, in principle supply constraints can and will be solved and most central banks will not reverse tack in response. We therefore advise against a fundamental change in investment stance; rates will adjust to some extent but not to the point of creating a totally new investment regime. A range of structural forces (demographics, technology, etc.) are clearly working against run-away inflation. Nevertheless, given current conditions, it makes sense to deploy some risk-management measures (e.g. shorter duration for fixed-income assets and only moderate overweight for equities). The rationale for embracing a more risk-aware stance is that higher rates tend to lead to higher volatility. In order to keep portfolio risks aligned with long-term targets, positions may need to be adjusted. Alternative investments, such as hedge funds and private market strategies, likewise support this goal since they tend to exhibit lower volatility and are less correlated with public markets.

Chart 1: US inflation: what goes up must eventually come down (% y/y)



Source: Bloomberg, HBZ

Our positioning

We are maintaining our underweight and lower-duration stance in fixed income as market yields have further upside. In equities, we have moved closer to the benchmark in order to deal more effectively with ongoing market rotations. Finally, we are keeping a sizeable allocation in alternatives to manage the overall volatility of portfolios.

What to watch

While earnings have held up well so far, they will continue to provide the ultimate test for the durability of the equity market bull run. We expect inflation to subside in due course but any evidence to the contrary would require a rethink. Finally, Chinese policy moves could continue to unsettle markets, as would more drama regarding the US debt ceiling, which Congress is due to revisit in early December.

Key points

- No regime change but higher rates and volatility
- Review positions for their risk contributions
- Earnings, inflation, and China as key risks

Fixed income: Spreads to cushion rising yields

Yields should continue to move higher in the coming months, strengthening the case for maintaining shorter-than-usual duration. With the prospect of higher yields, and given compressed spreads, pockets of value remain limited largely to lower-rated credit, including emerging corporates and senior loans, as well as alternative fixed income.

Chart 2: Still room for US yields to rise (% p.a.)

Source: Bloomberg, HBZ

Key points

- Switch from high-yield bonds into senior loans
- EM corporates offer high yields and moderate duration
- Absolute-return strategies and direct lending as alternatives

Little value left in investment-grade bonds

Investment-grade bonds currently present unattractive risk/return characteristics given tight spreads and the real risk of higher US yields, which would entail mark-to-market losses. Only corporate hybrid bonds or subordinated issues of investment-grade financial companies offer reasonable value. Their higher spreads allow them to absorb rising rates more effectively.

Switch into senior loans

US high-yield bonds have performed reasonably well so far this year as fundamentals have remained supportive. We do not expect spreads to widen in the near future but the price upside is now clearly limited due to rising rates. Senior loans — typically arranged by banks for non-investment-grade issuers — are an interesting alternative. Investors receive an attractive spread, even relative to high-yield bonds, but enjoy minimal interest-rate sensitivity due to the loans' floating rate structure. Bank loans are non-listed assets; investment funds are therefore the only way for private investors to access this market.

Emerging corporates still top of the list

Spreads on EM bonds are also attractive. However, structurally, the hard-currency EM sovereign asset class has a fairly long duration which creates downside risk in a scenario of higher yields. We prefer their corporate peers: spread levels are high, duration is lower and the unbroken search for yield should lead to further tightening. However, investors should be aware that this asset class has performed well over the past twelve months and more volatility is likely in the near future.

What are the alternatives?

In the current environment, total- or absolute-return strategies are an all-weather alternative to traditional fixed-income investments. Such strategies pursue opportunistic investments across the entire fixed-income spectrum with the goal of delivering absolute positive returns independently of the cycle. Another option is inflation-linked bonds which protect investors from the impact of inflation on the purchasing power of their investment. Finally, professional investors can access the growing range of direct-lending products available in private markets where yields have not yet compressed to the same extent as for publicly traded instruments.

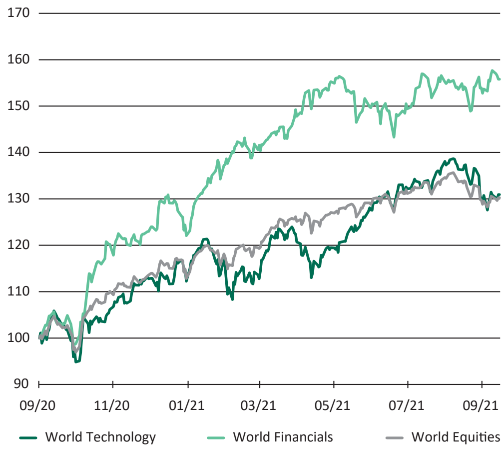
Equities: In transition

The S&P 500's winning streak temporarily ended in the early days of October after almost a year without a 5% pullback. Against the current complex economic and policy backdrop, equity investors should take the long view and focus on progress towards economic normalization.

A wall of worries to climb

Multiple worries — including about growth, despite the fact that forward-looking activity indicators continue to paint a solid picture — have led to a repricing of equity markets. China has been in the headlines since earlier in the year as the Communist Party's 'common prosperity' objective unsettled local markets and started to weigh on the confidence of international investors. Moreover, the Evergrande debacle has brought excessive leverage in the real-estate sector into focus. However, higher inflation seems a more legitimate cause for concern. Inflation caused by higher commodity prices, wages, and supply-chain disruptions has the potential to reduce corporate margins, lift bond yields, accelerate central bank policy normalization, and ultimately, affect global growth. While this is not our central scenario — we believe inflation is mostly the result of supply disruptions in the post-pandemic recovery and will recede over the course of 2022 — investors should monitor inflation-related developments closely.

Chart 3: Performance of the technology and financial sectors (100 = 30/09/2020, in USD)



Source: Bloomberg, HBZ

Solid earnings growth

Initial Q3 earnings results support our constructive view. While many companies acknowledge the impact of rising raw material prices and wages, order books are full and CFOs point to robust demand. Capital expenditure is also on the rise and continued business investment is an important positive sign for longer-term growth. At a time when monetary and fiscal stimulus has peaked, sustained investment is critical to maintaining overall global growth.

Market rotations and diversification

Until very recently, US equity indices have proved resilient but a lot of action has been taking place below the surface. 2021 has been marked by rapid sector rotations. Year-to-date, more than 90% of US stocks have experienced a correction of at least 10% from their 2021 highs and, for NASDAQ index members, the average decline has even exceeded this level. Investors should follow a barbell approach, holding technology shares for their long-term above-average growth potential and offsetting the risk of rising yields with exposure to the financial sector. Investments in quality companies should also be a key pillar of every equity portfolio. Allocations outside of the US will further diversify portfolios and add cyclicality.

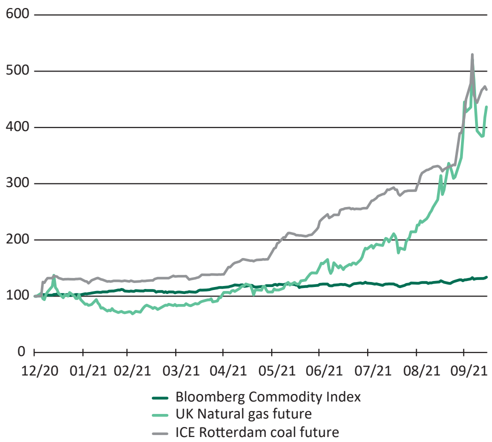
Key points

- Inflation a real concern for markets
- Resilient earnings point to sustained growth
- Balance sector and regional exposure

Commodities and FX: Scarcity is back

Supply constraints in the energy space have led to extraordinary price rallies in natural gas and coal. We expect the energy complex to remain well supported thanks to a combination of under-investment, supply disruptions, and strong demand.

Chart 4: Surging natural gas and coal prices in Europe (100 = 31/12/2020)



Source: Bloomberg, HBZ

Key points

- Temporary supply constraints for energy commodities
- Energy transition to sustain price volatility
- Gold remains range-bound

Gas prices and energy transition

Gas prices are soaring in Europe at a time when stocks are low and China is purchasing large quantities of liquefied natural gas (LNG) in global markets to compensate for local energy supply disruptions. Electricity prices have spiked in countries such as the UK and Spain. While oil is a truly global commodity with a geographically diversified production base and relatively large inventories, natural gas is traded more regionally. Nevertheless, energy markets are tightly interconnected and disruptions in one region typically have an impact elsewhere. The situation is compounded by the fact that the energy transition agenda may also be ahead of the currently available supply of greener energy. As investment in fossil energy sources decreases and climate change intensifies severe weather events, the overall supply of energy may occasionally struggle to meet demand. It is therefore likely that spikes in energy prices will occur more frequently until production from renewable sources has caught up.

Oil price well supported

Oil demand should continue to recover next year as mobility increases and economic activity normalizes. At the same time, supply could fall short of demand due to a lack of investment. Despite OPEC+ ramping up production, the oil demand-supply deficit should persist, pushing inventories to lower levels and supporting prices. A cold winter would provide further support, especially for Brent crude, as the European gas shortage should lead to a switch from gas to oil. Non-OPEC production is likely to decline longer term as expectations of a more climate-conscious world further reduce investment and supply.

Gold lacking clear catalyst

We are neutral on the yellow metal in the current context of above-trend global growth. While holding some gold as a portfolio diversifier will always make sense, rising nominal rates could keep the gold price under pressure. US dollar strength has been another challenge for gold, but going forward we see only limited further upside for the USD; this should at least should help stabilize the gold price. Gold would only become attractive to investors again if the USD were to weaken materially.

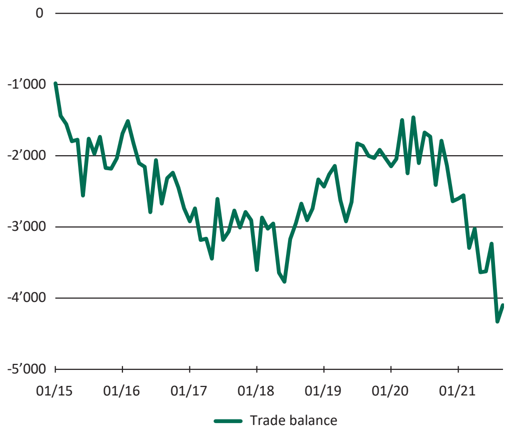
Key markets: Managing the recovery

While Pakistan has removed some monetary accommodation in response to weaker external accounts, UK policy makers are publicly mulling a similar move due to rising price pressures. The UAE meanwhile continues to pursue its transformational agenda as Dubai Expo 2020 opens.

Pakistan: Opting for prudence

The continuous deterioration of the current account as a result of surging imports and the ongoing depreciation of the currency forced the State Bank to make an initial rate hike at its September MPC meeting. While the strength of the recovery gave rate-setters confidence that the economy could absorb a less accommodative stance, the need to safeguard a still precarious external position required action. Moreover, the program review with the IMF is still pending and the government will want to ensure that it keeps all funding sources open. The hasty withdrawal of US troops from Afghanistan may eventually turn out to be a boon for Pakistan's economy, but in the short term the new security situation spooked international investors, who continued to sell local shares. Rising oil prices represent the latest challenge to the economy, but with solid underlying demand and still negative real interest rates, overall, conditions for robust growth in 2022 remain in place.

Chart 5: Pakistan: Trade gap widening again (USD m)



Source: Bloomberg, HBZ

UAE: Expo 2020 opens at last

Delayed by a full year due to the pandemic, Expo 2020 finally opened its doors. The six-month fair is expected to reinforce Dubai's — and with it the Emirates' — role as a regional hub. Meanwhile, the UAE continues to pursue its transformational agenda with the recent announcement of a net-zero emissions target by 2050. To achieve this, the UAE has earmarked close to USD 165 billion for investment in clean energy over that time horizon. This initiative should help to further diversify the economy and open up new opportunities outside the currently dominant real estate and oil/gas sectors.

UK: Delayed action

Brexit was supposed to allow the UK to break free from the suffocating embrace of the EU. Currently, however, the economy is straining to digest the delayed impact of Brexit in addition to pandemic-induced disruptions, and the government currently seems to have no convincing plan to remedy the situation. Prime Minister Boris Johnson's call for higher wages to address a serious labor shortage risks leading the country into stagflation territory. If, on top of this, the Bank of England loses its nerve and tightens rates prematurely, as many expect, the recovery could falter. This would weaken the GBP and other UK assets.

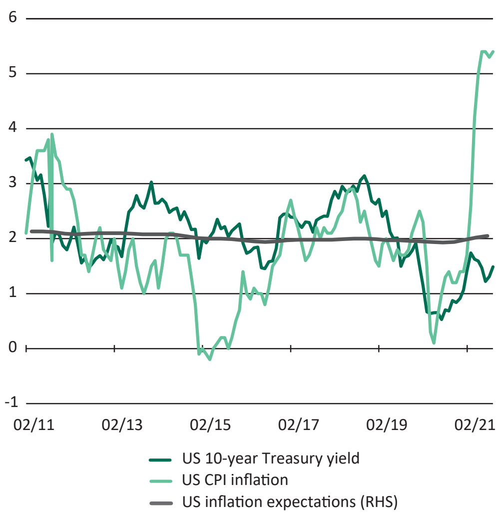
Key points

- Pakistan opts for prudence and tightens monetary policy
- UAE embrace net-zero to transform the economy
- Real stagflation risk as BoE policy error looms

Special topic: Inflation and fixed-income markets

Absent for many years, the bogeyman of financial markets — inflation — is back. Whether this turns out to be a temporary episode or a longer term trend remains to be seen. Whatever the case may be, it is important to understand why this development is of such concern for fixed-income markets in particular.

Chart 6: US real yields deeply negative (% p.a.)



Source: Bloomberg, HBZ

Inflation destroys value

Inflation represents one of the greatest threats to investors as it erodes the real value and purchasing power of assets. In principle, interest paid should compensate for this risk but this does not hold when inflation increases after the nominal rate has been set. The situation becomes even more serious when real rates are negative, as is the case in all major currencies today. With most leading central banks actively seeking reflation, the moderate increases in policy and market rates expected over the coming quarters will not change this state of affairs.

Nominal assets most exposed

The face value of nominal assets such as cash and bonds does not adjust to changes in the price level nor, generally, do the corresponding cash flows (interest payments or coupons). Hence, fixed-income investors stand to lose most in an inflationary environment. Other so-called 'real' asset classes respond differently and can provide some protection. Equities offer a partial hedge as, all else being equal, rising prices lead to higher revenues and higher profits. The value of real estate also tends to rise with inflation; real estate is thus another popular hedge against inflation, as are commodities, whose prices are themselves often at the root of higher inflation. These hedging relationships generally work well in an environment of moderate inflation but cease to do so when inflation rises into the high single digits or beyond. Not only does economic activity usually suffer in such a context but assets are also typically repriced more aggressively to reflect higher inflation and expected higher discount rates.

How to protect

For fixed-income investors, adjusting the duration of their portfolio is the obvious response to changes in interest rates. Unfortunately, there is no comparably simple course of action for addressing higher prices — and even less so, negative real rates. At least inflation-linked bonds, which are generally government-issued, offer a readily available alternative to traditional nominal bonds. The value of their principal, as well as that of interest payments, is adjusted periodically in line with changes in consumer price inflation. Other solutions commonly used by institutional investors, such as inflation swaps, are usually beyond the reach of private individuals.

Key points

- Inflation as threat to portfolios
- Nominal assets most affected
- Inflation-linked bonds one form of protection

Market data summary

As of 18 October 2021

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	9'366.1	3.2	17.0	58.4
S&P 500	4'477.0	3.5	19.2	61.7
EuroStoxx 50	4'154.0	2.9	16.9	29.3
FTSE 100	7'202.9	2.8	11.5	2.5
SMI	11'977.5	-0.4	11.9	36.4
Nikkei	29'025.5	5.0	5.8	28.8
MSCI EM USD	631.6	-3.6	1.2	41.5
Sensex 30	61'765.6	17.5	29.3	80.0
KSE 100	44'629.5	-6.7	2.0	17.5
Hang Seng	25'409.8	-7.6	-6.7	-0.6
Russia RTS	1'875.4	17.0	35.2	64.5
Brazil Bovespa	113'331.9	-10.0	-4.8	35.2

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1'668.74	-1.0	-2.6	15.6
FTSE US Corp	2'654.68	-0.9	-1.2	25.7
FTSE US HY	1'231.63	0.6	4.5	21.8
FTSE Euro gov	251.59	-1.0	-2.9	10.3
FTSE Euro Corp	256.02	-0.8	-0.5	8.0
FTSE EM Sov	936.59	-1.5	-2.6	19.0
DB EM Local USD	169.16	-2.1	-6.9	7.9

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	93.94	1.4	4.5	-2.0
EUR	1.16	-1.7	-5.1	1.2
CHF	0.92	-0.6	-4.2	7.7
GBP	1.38	0.3	0.5	5.1
JPY	114.22	-4.2	-9.6	-1.8
AUD	0.74	1.1	-3.7	4.2
CAD	1.24	3.2	3.2	5.6
ZAR	14.60	-0.8	-0.1	-2.0
INR	75.26	-0.6	-3.0	N.A.
PKR	171.29	-6.8	-7.1	-23.3
Gold oz	1'767.62	-2.4	-6.6	44.1

Interest rates	3M interbank %	10Y government %
USD	0.13	1.59
EUR	-0.55	-0.15
GBP	0.21	1.13
CHF	-0.77	-0.09
JPY	-0.09	0.10
AUD	0.04	1.74
CAD	0.46	1.61
ZAR	3.68	9.82

For your notes

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Price data as of 18 October 2021

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