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Investors' Outlook

A new era of co-operation?

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A new era of co-operation?

Dear readers,

This title seems counterintuitive given that Donald Trump and Xi Jinping seem ready to jump at each other's throats. But in light of the possibility of a Joe Biden win in November, tensions between America and China may ease a few months from now. In any case, the US presidential elections will be as exciting to follow as in 2016 (see the article on page 8).

In an attempt to boost the US economy back to its pre-Covid-19 levels, the US Federal Reserve reaffirmed that interest rates will remain at the current low level for years to come. The European Central Bank pushes a similar line, as do most other central banks, thus lending support to asset prices. Whether they will manage to successfully stoke inflation and solve mounting debt problems with the monetary policies in place remains an open question. The markets are skeptical.

Meanwhile, a solid V-shaped economic recovery is underway in China. Recent data shows that output and new orders are picking up. The world's second-largest economy is on track to reach its 2019 fitness level by the end of the year. At the other side of the world, the US economy is also showing signs of a V-shaped recovery, with key figures ticking up. In Europe, the situation remains more fragile. The euro zone's growth is set to plunge 8% this year, compared to a 4% dip in the US and a 2% increase in China, according to the Organisation for Economic Co-operation and Development.

Bolder approach to emerging markets
Despite the strong growth prospects offered by emerging economies such as China, most investors only hold around 5% of their wealth in emerging-market assets. Their natural home bias and concerns over high risks associated with emerging markets prevent them from adopting a bolder approach. Consequently, many an investor willingly misses out on bargains within reach, and is left sitting with prospects of substandard growth rates as well as decades of zero interest rates in developed

—
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economies. Meanwhile, a keen eye for emerging economies seems to make sense (see the article on page 10). Not only are their fundamentals better than those in industrialized countries, but emerging-market equities and certain types of bonds also offer far better valuations. We therefore recommend raising the exposure to emerging-market assets to more than double the current average.

Markets for Trump?
Across the Atlantic, the US presidential and congressional elections are quickly approaching. Financial markets, which tend to prefer Republican Party presidents, have already priced in higher volatility before and immediately after these events. At the time of writing, a Democratic sweep across the US seems likely on November 3. Polls see Joe Biden in the lead, even though Donald Trump has been closing the gap during the past few months. Historically, status-quo-loving financial markets sold off each time a challenger ended up winning the ultimate US race. Under Biden, who represents Main Street, not Wall Street, American companies and the richest individuals would face higher taxes. A more constructive geopolitical dialogue, on the other hand, could free us from trade war fears. Should the Democrats also manage to obtain a majority in both chambers of Congress – as the polls currently suggest – we would probably need to adjust our investment strategy. However, it would hardly shake our confident view that the global economy is gradually recovering.

⟶ Webcast
To view Dan Scott's webcast on recent market developments, click:
vonto.be/macro-en-oct20

Bumpy ride until year-end likely – more protection warranted

—
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—
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In the 75th year of the existence of the United Nations, the heavyweights among them seem to be as divided as ever. The US, China, Europe, the UK, Russia – most appear to be not only at loggerheads with each other, but also riven by internal conflicts. As truly global challenges like the pandemic and climate change show, this cannot be the way forward. Or can it? We may get more clarity as soon as November after the US presidential elections. Until then, and in fact until the end of the year, investors are in for a bumpy ride.

Equities retain their luster
We continue to favor equities over bonds. Within the former asset class, our preference lies with Swiss, US, Japanese and emerging-market securities. There are rising risks, which speak for higher volatility: general concerns about the outcome of the US elections, uncertainty regarding the continuation of government programs to restart economies, a worrying rise in Covid-19 infections and the danger of further lockdowns. These bode ill for a continued economic recovery, although this isn't our baseline scenario. While we acknowledge an increase in risks, we believe that over a nine-month horizon, the structural forces supporting equities outweigh them. Our confidence is rooted in the central banks' purchasing programs, still attractive equity valuations relative to bonds, and signals of economic robustness.

Fasten your Treasury seat belts
Given the higher uncertainty until at least the end of the year, investors should think about protecting their portfolios, in our opinion. We have therefore raised government bonds to neutral from underweight, while lowering high-yield paper to neutral from overweigh. If economic risks materialize, the high-yield sub-segment could see prices tumble and default rates rise. These changes at sub-sector level balance each other out, and our view of fixed income as a whole remains an unchanged negative.

An obvious way of increasing government bond positions is picking up US Treasury bonds with remaining maturities of 20 years or more, we believe. Our analysis shows that such assets serve as a good portfolio diversifier while providing protection.

Regarding other asset classes, we reiterate our positive view on alternatives as a whole, mainly due to our strong conviction in gold. You can find further asset allocation details in the table on page 5.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				Given the low level of interest rates, liquidity remains one of the least attractive asset classes overall. We maintain our underweight stance.
2 Bonds		→				We retain our overall negative view on fixed income. Within this asset class, we lower high yield (HY) to neutral from overweight and increase US Treasuries to neutral from underweight. Our analysis shows that longer duration is a good diversifier, adds portfolio protection, and helps address higher short-term risks. These include a possible failure in the US to extend fiscal programs, which would increase the likelihood of higher default rates. Moreover, central banks' purchasing programs support segments such as government and investment-grade bonds (IG), not HY.
3 Equities				→		We retain our overall positive stance on equities. We are comfortable with our overweight stance on all regions with the exception of Europe, rated neutral. Europe continues to suffer from specific risks and weaknesses linked to potential Covid-related lockdowns, Brexit uncertainty, and an underdeveloped technology equity sector. We believe that other markets such as the US, east Asia, Japan or Switzerland offer better opportunities in terms of valuation, technical trends, earnings momentum and quality.
4 Gold					→	Our strong overweight stance on gold remains in place. While inflation should remain contained in the medium term, it could become a worry if governments and central banks continue to resort to printing money. Moreover, the US dollar's weakness alongside limited gold supply should keep supporting prices.
5 Commodities			→			Commodity returns rarely move in line with those of stocks and bonds. They tend to rise in an environment of higher inflation, but hardly benefit from central banks' supportive measures. Our unchanged neutral stance reflects our conviction that an overweight position would be premature.
6 Alternative strategies		→				We retain our underweight on hedge funds and neutral on insurance-linked securities (ILS). They served as a cushion in times of high volatility. After the central banks managed to calm financial markets, the need for such a backstop decreased.

Changes month-on-month: same → higher ↗ lower ↘

Economic "rehabilitation" on track despite a second Covid-19 wave in Europe

While Covid-19 has made a comeback in Europe, and continues to haunt the US, the rate of infections isn't accelerating globally. Governments have learned to cope and will be cautious before imposing new strict lockdowns as they did in spring. As long as the number of fatalities remains low, the pressure on governments should stay low too. Despite recent headwinds, we remain confident that a global economic recovery is underway and stick with our "rehabilitation" base scenario.



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The third quarter fulfilled most of investor's hopes of a strong economic rebound. As expected, we received positive economic data at the beginning of the quarter, after which the inflow of upbeat surprises started to abate. Overall, the economic recovery is still on track, raising inflation expectations in financial markets. We expect prices to increase without rising above "normal" levels of inflation, and without central banks veering off their very expansionary course. That said, the second wave of Covid-19 infections in Europe and rising infection numbers in the US are a worry. Nevertheless, under our "rehabilitation" base scenario, we still forecast that economic performance will reach around 95% of the pre-pandemic level towards the end of the year.

Looking at local lockdowns

The worrying development of the pandemic in Europe and the US is being balanced out globally by a drop in new infections in several previous emerging-market hotspots. Importantly, the number of fatalities so far hasn't followed that of new infections higher – not even in hard-hit Spain or France (see chart 1). We doubt that governments (with the current exception of Israel) will be willing to re-impose the all-encompassing lockdowns that paralyzed the economy in the spring, for reasons such as the progress in the treatment of the disease, better healthcare infrastructure, improved public hygiene behavior, the tracking of spreaders, and the rising anti-lockdown sentiment in many countries. Instead, we are likely to see less strict regional lockdowns, similar to the ones already in place in Madrid, some French cities or several regions in the UK. This will to some degree dent economic growth, which is why we don't see a bounce-back to 100% of last year's economic output level in 2020, but rather to around 95%. Even so, central banks and governments will do all they can to support the economy. A fourth fiscal package currently held up in the US Congress poses an upside risk to our baseline scenario.

Euro zone: the second wave's muted impact

Surging numbers of new infections in Europe haven't resulted in a corresponding surge in fatalities, not even in the hotspots. National leaders have refrained from calling for hard new measures, with the exception of the UK, where ministers publicly threatened to impose new semi-strict national lockdowns if new cases rise further. We expect the resurgence of the pandemic across the European Union and the UK to push the leaders to forge a new transitory deal to mitigate the potential trade problems facing London and Brussels. On both sides of the English Channel, the second wave has already depressed business sentiment in the services sector, while manufacturing has so far proved resilient. Consumer confidence hasn't yet found its way back to pre-Covid levels but, apart from hard-hit Spain, shows further improvement, which is necessary to keep the economic recovery on track in the fourth quarter as well (see chart 2). Meanwhile, we expect the European Central Bank (ECB) to take an even more expansionary stance towards the end of the year in light of the second Covid-19 wave as well as ongoing economic and fiscal challenges. Moreover, two thirds of the ECB's emergency asset purchase program will probably be used up in December.

US: fiscal boost needed after monetary support

The US elections in November will be key for financial markets and will also have possible economic side effects in the medium-term (see article on page 8). America's economy recovered faster than expected in the third quarter. This surprised most observers including the US Federal Reserve, which upgraded its macro forecasts in September. Members of the US Fed's rate-setting committee now expect the jobless rate to fall to 7.6% at the end of 2020 versus a 9.3% forecast in June. That said, full employment will probably only be reached by 2023 as it will take years to absorb the slack in the labor market. Given the central bank's new willingness to let inflation overshoot its 2% symmetric target – a level it foresees in 2023 at the earliest – monetary support and "close to zero" policy rates will stay in place in the short and medium term. At the same time, the US Congress has so far failed to agree on a fourth fiscal package, or CARES 2.0, to boost the economy. The lack of fresh money poses a risk to the recovery and we expect the fourth-quarter growth rate to decelerate following the strong rebound in the third quarter.

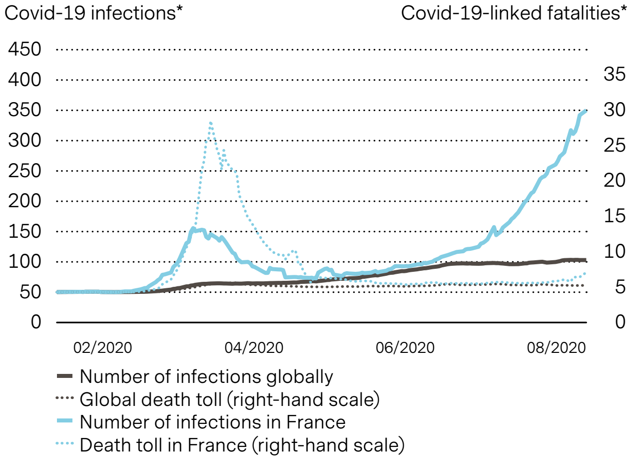
Japan: from Abenomics to Suganomics

Newly instated Japanese Prime Minister Yoshihide Suga is likely to follow his predecessor's "Abenomics" brand of economic policy based on supportive government spending and unprecedented asset purchases by the central bank. Strong combined fiscal and monetary support is still important in Japan to avoid protracted deflation, as core inflation turned negative again in August. In the medium term, Suga will focus on digitalization and deregulation and aim at boosting the country's low potential growth rate.

India suffering from Covid-19 lockdowns

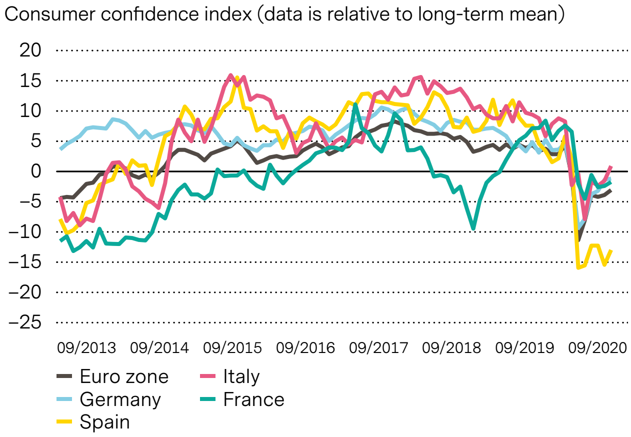
In emerging markets, the economic divergences can be partially explained by the extent of the pandemic shock and the size of stimulus packages. While we downgraded India, hit relatively hard in the second quarter (real GDP –24% year-on-year), we upgraded our forecast for Brazil. Here, the transmission mechanism between stimulus packages (approximately 10% of GDP) and the real economy seems to work better than originally thought. Mexico took an opposite route, preferring fiscal austerity to fiscal stimulus. This will make Mexico one of the laggards in the recovery but may please global rating agencies. China continues to lead the economic recovery, with capacity utilization rates in the industry close to pre-Covid levels. While growth in the Chinese services sector is slowly catching up to manufacturing growth, a persistent gap (due to social distancing rules) points to relatively low inflation pressure in the near term. This argues for little exported inflation to the world, as approximately 10% of the global industrial production base is still located in China.

Chart 1: Muted rise in virus-related death toll in previously hard-hit France



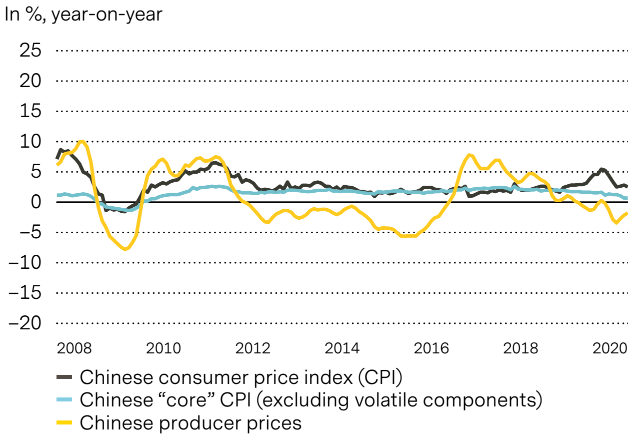
* Per 1 million inhabitants, five-day average
Source: World Health Organization, Refinitiv Datastream, Vontobel

Chart 2: Eurozone's consumer confidence is on its way back to pre-covid levels except in Spain



Source: Eurostat, Refinitiv Datastream, Vontobel

Chart 3: Inflation pressure from China remains low



Source: Refinitiv Datastream, Vontobel

Uncertainty ahead of US election day mounts after first Trump-Biden debate

The heated first debate between Donald Trump and Joe Biden gives us a taste of things to come until November 3 and beyond. Amid continued uncertainty about the outcome of the US presidential elections – and the likelihood of lengthy legal disputes about their legality – we expect financial markets to remain volatile in the next few weeks or even months. A Biden win and the Democrats' retaking of the US Congress would probably weigh on risky assets but benefit shares of utility as well as renewable-energy companies. A Trump win could trigger an equity rally and drive prices higher in the technology, healthcare, and communication services sectors.

—
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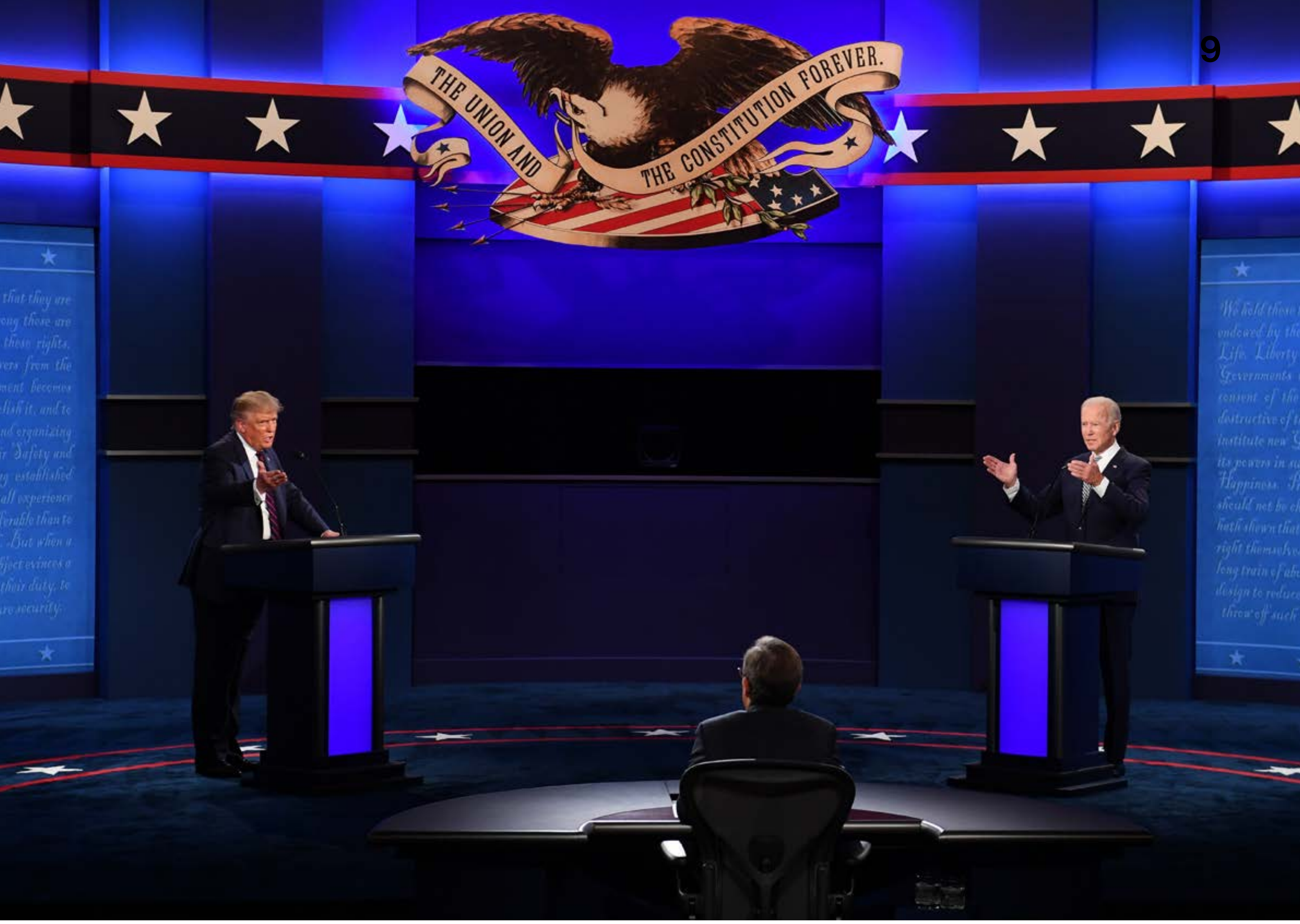
TV debates have been a vital part of US presidential campaigns since Richard Nixon's ill-fated appearance against John F. Kennedy in 1960. The first such encounter between Donald Trump and Joe Biden was rather a series of personal attacks than a debate. It is doubtful whether the next two debates on October 15 and 22 will bring much clarity or sway public opinion.

The latest national polls suggest that Donald Trump is heading for a defeat on November 3 with Joe Biden holding a lead of seven percentage points over the incumbent. Citizens polled in so-called swing states, which could tip the balance in one direction or another, also seem to favor the challenger (see chart 1).

Political stalemate poses a recovery risk
The US economy continues to recover from the Covid-19 shock, and its further development partly depends on the country's political landscape. Typically, the immediate impact of US elections on the economy is limited. We know that an incoming administration's policies rarely resemble the script at the time of the pre-election campaign. Moreover, they can be watered down in the legislative process. Currently, the demise of Supreme Court Justice Ruth Bader Ginsburg and the ensuing partisan battle over her replacement just before the election is a problem and a symbol of America's divisions. The political infighting is using up too much of the lawmakers' time and energy, who should instead focus on approving a much-needed new fiscal package designed to deliver unemployment benefits to millions of US citizens in precarious conditions. This would be a crucial precondition for keeping the US economy on an upward trajectory in the fourth quarter, in our view.

Three main scenarios and their market impact
Unlike the economy, markets reflect political developments almost in real time. The three most likely outcomes of the November 3 elections could have the following consequences:

1. The most likely scenario of Joe Biden winning the Oval Office and the Democrats securing both houses of Congress would probably have a short-term negative impact on equity markets. This "Democratic sweep" would give Mr. Biden the legislative power to raise corporate taxes and tighten regulation, which could weigh on sectors like technology, financials and healthcare. His plan to invest in green infrastructure and clean energy would probably benefit utility companies, while his aim to address climate change and strengthen environmental regulation would direct investment away from fossil fuel-oriented sectors to renewable-energy technologies. A mounting fiscal deficit under a Biden administration would push bond yields higher, although we think safe-haven flows from equities into bonds, among other things, would limit sharp moves in yields. In addition, the firepower of the US Federal Reserve dominates the yield trajectory.



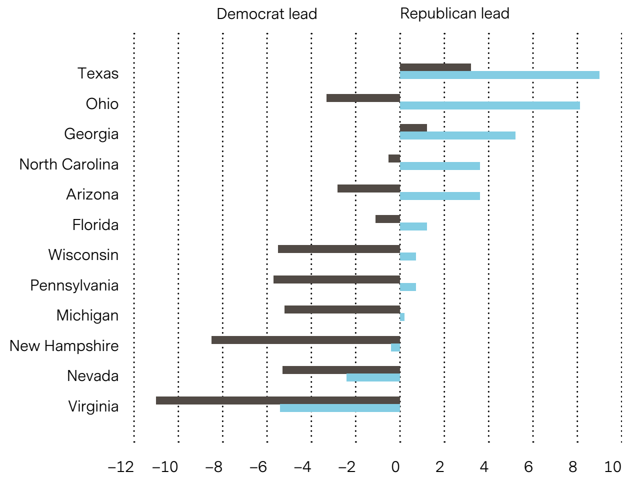
2. If Joe Biden wins the presidency but the US Congress remains divided along party lines, his legislative initiatives would be bogged down in partisan politics. The new administration's softer stance on foreign trade and international cooperation would be tempered by domestic political fights. Financial markets may see this as neutral or mildly positive.

3. If the status quo is preserved, i.e. Donald Trump wins and the political stalemate in the US Congress continues, this would probably benefit equities, possibly prompting a relief rally given the expected continuation of the current tax regime and a soft stance on regulation. Large tech companies, healthcare firms and communication services could be the winners – sectors that have already thrived under the Trump administration. On the negative side, the president's harsh foreign-policy rhetoric and anti-trade positions would remain a key market and global risk throughout his second term. In 2019, we have witnessed market sentiment turning sharply negative after the US started a trade conflict with China. The prospect of four more years of confrontation could sour the mood further.

Election day is approaching fast, but a lot can happen until then. This is especially true in the context of a global pandemic and the uncertainty to what extent a flood of mailed-in ballots would delay results. We believe volatility will remain elevated until the outcome is certain, which may take a while.

Chart 1: Democratic Party candidate Joe Biden leads in "swing states" such as Ohio, Florida, and Pennsylvania

Current opinion polls vs results of 2016 presidential race, in percentage points



■ Latest opinion polls
■ Hillary Clinton / Donald Trump 2016 victory margin (popular vote)

Source: Bloomberg, RealClearPolitics, Vontobel (data as of September 30)

How to harness the headwind: seeking profit from emerging-market assets

After a perfect pandemic storm, the US Federal Reserve and other supersized container ships are picking up unusual cargo. Corporate paper? Put them in the hold. Bond ETFs? Shovels full. Junk bonds? Use the crane. This may seem like the age of indiscriminate buying – hardly a strategy many investors find alluring. We hope to direct their gaze towards often shunned merchandise that nevertheless may hold great promise. In our opinion, equities and hard-currency bonds shine in the eye of the discerning active investor.

—
Sven Schubert, PhD
Head of Strategy Currencies,
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Emerging markets in particular have been buffeted by the crisis. The coronavirus has sparked a heavy sell-off – not as severe as the one during the global financial crisis in 2007/08, but nearly as bad as the worst three drawdowns in recent memory (see chart 1). Yet it is also true that since March until August, emerging-market equities and bonds have snapped back like a storm-bent palm tree. Investors, previously blown to the four corners of the earth, have noticed. According to a recent Vontobel survey[1], two-thirds of the respondents plan to increase their exposure to emerging-market equities, and 59% plan to raise their holdings in emerging-market bonds.

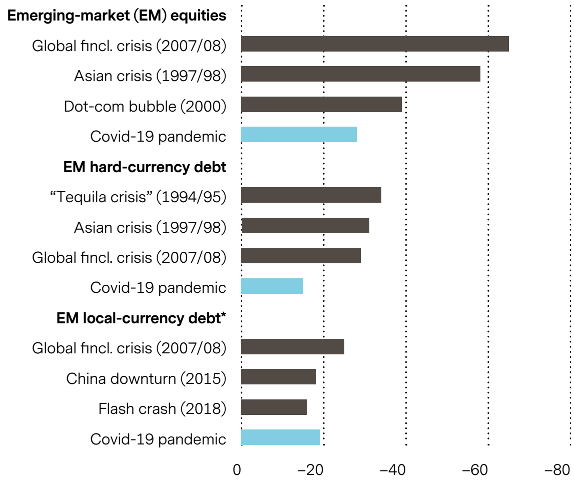
The fundamentals have improved

In theory, one could have expected emerging economies to perform better. By the end of 2019, many emerging economies exhibited much greater resilience (e.g. solid current accounts) than in 2007/08 and during the so-called taper tantrum phase in 2013 (see chart 2). While sovereign debt has risen, lower refinancing costs in many countries have partly compensated for the higher debt load. Moreover, since the end of 2019, the world economy and emerging markets entered a cyclical recovery with only moderate inflation pressure. Usually, this is an environment in which emerging-market assets, in particular growth-sensitive ones like local-currency debt and equities, outperform.

Solid fundamentals notwithstanding, emerging market prospects largely depend on "push factors" – developments beyond the countries' control. Among the negative effects of the pandemic were the breakdown of supply chains and a global demand shock that hit the industrial and services sectors in emerging markets particularly hard. Add to that collapsing commodity prices, rising corporate default risks, and a temporary drying up of US dollar liquidity – a particularly worrying event for emerging economies, which rely on US dollar-denominated bond issues next to local-currency debt. Fortunately, the coastguard sprang into action. Setting an example of American leadership, the US Fed threw emerging-market castaways a lifeline via a sizable US dollar swap facility to ease the dollar illiquidity. Additional government programs to support the economy helped as well.

Chart 1: The pandemic hit emerging markets hard, but there have been worse downturns

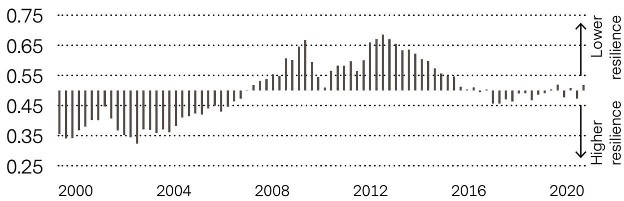
Largest downturns per asset class in %



*We used the MSCI, EMBI, and GBI-EM Global Diversified benchmarks for equities, hard-currency, and local-currency bonds, respectively. The local debt analysis only includes drawdowns since the inception of the GBI-EM benchmark in 2003.
Source: Refinitiv Datastream, Vontobel.

Chart 2: Emerging economies in better shape end of 2019 than during the financial crisis 2008 – 09

Emerging-market resilience index*



*Based on an early-warning indicator innovated by economists G. Kaminsky, S. Lizondo, and C. Reinhart ("KLR indicator"). Vontobel's "augmented" version of the KLR indicator is an index that can vary between zero and one, and includes 22 emerging economies.
Source: Refinitiv Datastream, Vontobel, as of July 2020.

[1] In April and May 2020, Vontobel and Longitude, a Financial Times company, surveyed 300 institutional investors and discretionary wealth managers across 18 countries. The details are available in the white paper Fortune favors the bold – active investors start to seize the opportunity in emerging markets. **https://am.vontobel.com/en/emerging-markets**

Not too late to hop on the long-term return train

With emerging markets already recovered from this spring's losses, some observers may wonder whether they have missed an opportunity. This brings us to our analysis of long-term return potential estimates based on seven-year cycles, which should reduce timing risks. Our long-term return estimates (see chart 3) reveal that emerging-market equities and hard-currency bonds look very attractive in a portfolio context.

A favorable view on emerging hard-currency debt rests on the assumption that the significant decline of yields in the corporate investment-grade and government bond sectors leaves global investors with few alternatives beyond high-yield paper and emerging-market hard currency bonds. After a spike to 8% in late March 2020, the yield on hard-currency debt (known as EMBI) came back to 5% during the summer months, which is still superior to yield levels seen in most other bond segments. Generally, the trend towards higher inflation in emerging markets – which reduces purchasing power over time and depresses the long-term return potential – is incorporated in our estimates.

Local-currency bonds attractive if well-timed

While the potential of local-currency emerging-market debt seems limited with estimated long-term returns broadly matching those of investment-grade corporate bonds (depending on the investor's currency), the merits of engaging in this sub-segment can be considerable. Here, investors should take a tactical, i.e. opportunistic, approach given this asset class's dependence on external factors like moves in commodity prices and the US dollar. This could mean holding local-currency paper with the view of rapidly increasing or decreasing it depending on external market developments. Should the dollar weaken – as we expect over the next 12 months – emerging-market currencies have moderate recovery potential. Naturally, the outcome of the US presidential elections or new twists in the US-Chinese trade saga could change currency forecasts overnight.

Asia favored in equity portfolios

Navigating the bond subsectors and a multitude of above or below-zero yields can be a challenge. By contrast, it seems much harder to spot any negatives in equity markets given the return potential highlighted in chart 3. Here, emerging-market stocks outshine developed-market ones by a wide margin, according to our return potential estimates. The valuation approach focuses on the equity risk premium, price-to-book and price-to-earnings ratios, with especially the latter two signaling an attractive return potential over time. Not surprisingly, investors looking to invest in emerging-market equities look set to continue to favor Asia – a region that appears most resilient in our analysis – and particularly China due to the technology-heavy corporate landscape there. Digital companies' strong business during the pandemic is a case in point.

Risks seem overstated – look at the differences

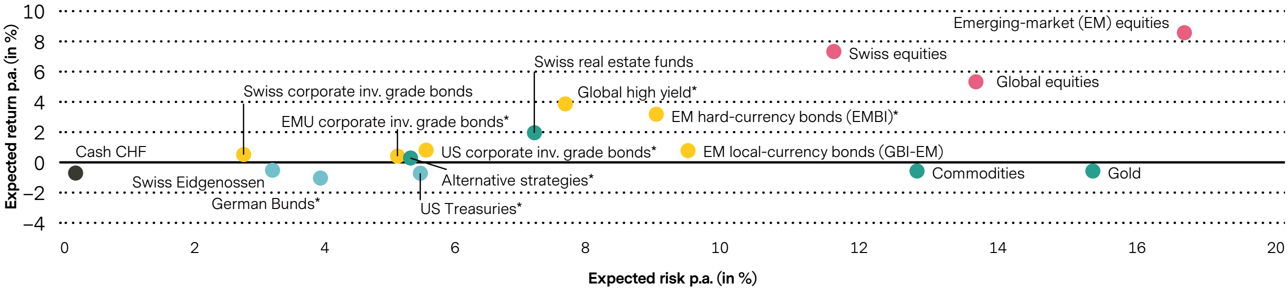
Some investors, haunted by the specter of country defaults, shy away from emerging-market equities or bonds. We agree that defaults are probably on the rise. Unfortunately, they are likely to affect the poorest developing countries that derive 70% or more of their revenues from tourism. Therefore, countries in the Caribbean may be hit hard. However, for the majority of countries within the benchmarks we analyzed in chart 1, default risks are overstated, in our opinion. Already in 2009, Carmen Reinhart and Kenneth Rogoff[2] not only highlighted the decline in the number of defaults (see chart 4), but also concluded that the link between the level of debt and sovereign debt defaults is weaker than many observers believed. Debt servicing indicators – which have improved due to the global low-yield environment – matter more than the level of debt. The two US economists also showed that countries with a track record of defaulting are more likely to default in the future. However, they coined the expression "graduation" as well, which means that countries can overcome their track record by proving they can repay their debt over a long period of time.

Help from Jackson Hole

The paucity of defaults in recent years raises hopes that the "graduation trend" will continue. Generally, we believe Asian economies are among the best-placed in the emerging-market space to manage external shocks. It is also worth noting that, in our view, some countries like Mexico and Russia, both of which possess sound fundamentals, were overly penalized during this year's market downturn.

Chart 3: Equities and hard-currency debt with promising return potential within the emerging-market space

In %, CHF (forecasts1 based on seven-year cycles)



[1] Our analysis is based on valuation metrics. *Hedged in CHF. The figures are forecasts, and as such are not a reliable indicator of future performance.
Source: Refinitiv Datastream, Vontobel, as of June 2020.

Moreover, as long as major central banks keep interest rates low – and the recent smoke signals from the central bankers' powwow in Jackson Hole indicate this will remain the case – debt sustainability risks are rather moderate. A conclusion we drew as well in our recent white paper "***modern monetary theory***".[3]

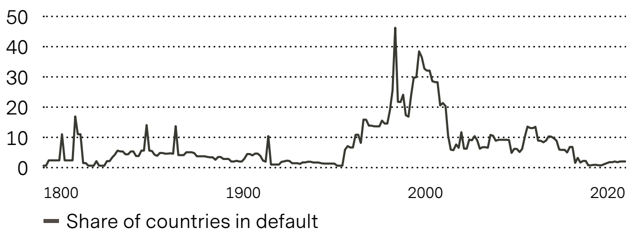
Don't sail with the crowd

Being an investor hasn't become easier. While this spring's panic selling is almost forgotten, the coronavirus continues to haunt us. The challenge is to look past the headlines towards attractive market sectors, a task that can be best accomplished through active portfolio management, we believe. Keeping track of the different fundamentals of emerging economies, and specific developments such as a growing popularity of "quantitative easing" as well as new Covid-19 infections remains the starting point for spotting risks and opportunities.

With emerging-market seas calming, investors should behave like master navigators and use all available navigational instruments to plot their course. Avoid the easy approach of running downwind with all sails set, as an unseen reef could sink the boat. Instead, sail on a broad reach and take the occasional beat to windward in order to reach your destination.

Chart 4: Number of emerging economies' defaults has been falling steadily

As percentage of world income



Source: C. Reinhart and K. Rogoff (2009) Database, Bank of Canada's Credit Rating Assessment Group Database, Vontobel.

[2] Carmen Reinhart and Kenneth Rogoff "This Time Is Different – Eight Centuries of Financial Folly", (2009), analyzing 66 countries, 250 sovereign external debt default episodes between 1800–2009 and 68 cases of default on domestic public debt.

[3] "Modern monetary theory – how do we get down from the debt mountain?" Vontobel, October 2019 **https://am.vontobel.com/en/insights/modern-monetary-theory-how-do-we-get-down-from-the-debt-mountain**

Fixed income adds a defensive tilt during an eventful autumn

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel

The coming weeks will be eventful. Consider the US elections in November, the second wave of Covid-19 infections, and worries about slowing economic growth in the fourth quarter. We take note of these economic and political risks and turn a bit more defensive within fixed income.

As we enter autumn, government bonds look back on a strong year with US Treasuries boasting a return of nearly 10% (see chart 1). This doesn't change our conviction that fixed income will underperform equities in the long term, due to the low-yield environment and our expectations that inflation will gradually rebound in the coming years from the current subdued level.

In the short-term, however, perceived risks of an economic slowdown, higher political risks as we approach the crucial US election deadline (see the article on page 8) and squabbles over additional fiscal measures to support the US recovery are all factors that could benefit government bonds given their safe-haven status. We therefore increase our government bond allocation to neutral to take a slightly more defensive stance within fixed income.

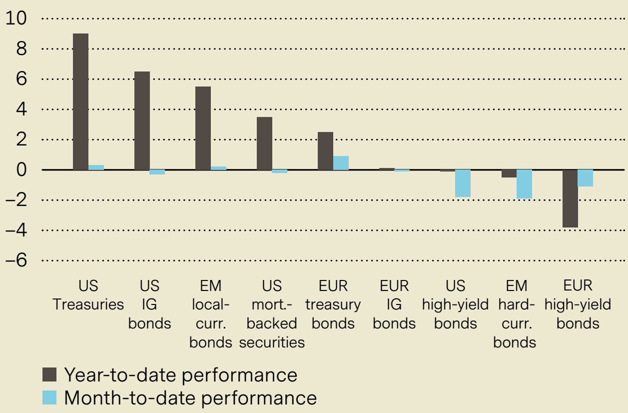
Yields to stay compressed
While there probably won't be new severe and broad-based lockdowns due to the pandemic, which seized up the economy around the globe earlier this year, risks surrounding recent Covid-19 outbreaks remain. This is especially true in Europe, where authorities are currently imposing new mobility restrictions on a local level.

On the other side of the Atlantic, attention has turned to the upcoming US elections and expected higher market volatility during the last weeks of the campaign. Should Joe Biden take the White House, and his Democratic Party both houses of Congress, very large fiscal programs may follow and prompt immediate safe-haven flows out of equities into government debt – even if the larger US fiscal deficit leads to higher bond yields in the medium term. However, any upward move in bond yields should be limited given central banks' commitment to inject liquidity and react if financial conditions deteriorate significantly in the event of rising risk aversion.

Risk of higher volatility in corporate bonds
The forthcoming events could dampen sentiment in the most vulnerable part of the corporate bond sector. We have thus reduced our exposure to the high-yield segment, where spreads to government bonds have narrowed from nearly 11% at the peak in March to below 5% in August (see chart 2). While spreads remain higher than before the pandemic crisis, the recent volatility has led to a renewed widening. In the junk bond sub-sector, there are concerns that a rising number of companies may default on their debt, especially if the economic recovery stalls due to the lack of additional fiscal stimulus. In these uncertain times, the junk bond segment's higher expected returns don't compensate enough for the short-term risks.

Chart 1: US bonds are leading within fixed income year-to-date

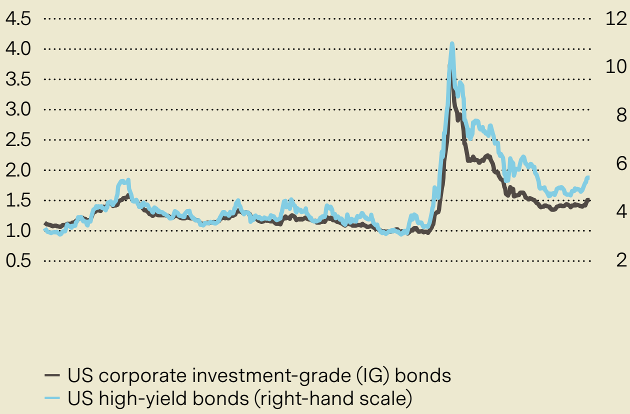
Total returns in %, in local currency



Source: Refinitiv Datastream, Vontobel (data as of September 28, 2020)

Chart 2: Spreads of high-yield corporate paper at risk of re-widening

Spreads in % Spreads in %



Source: Refinitiv Datastream, Bloomberg Barclays Indices, Vontobel

Green pastures for tech's Fabulous Big Five

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

The US equity market is home to a group of stocks you might call the Fabulous Big Five that send brokers' pulse racing. Predictions that these magnificent creatures would fall prey to profit taking have been proven wrong. While we admit their market capitalization cannot increase indefinitely, we believe that tech's Big Five can continue to inspire Wall Street's hunters and gatherers.

In September, equity investors suffered setbacks for the first time in six months. In retrospect, the strong rally in August was too good to be true considering economic and political uncertainties that lay ahead. As it is often the case, the rapid and steep recovery also attracted speculators who catapulted the markets to overbought levels.

Markets spooked by possible Trump exit

We see the recent setback in equity markets as a rather short-term phenomenon, probably triggered by a rising number of new Covid-19 infections in Europe and by investors realizing that the market-friendly Donald Trump may be on his way out. The upcoming US elections also throw into doubt a new US package to stimulate economic growth, currently under discussion in a deeply divided US Congress.

Our unchanged equities overweight reflects our conviction that this spring's massive lockdowns are behind us, and that central banks will carry on with liquidity injections for months to come. Moreover, equity analysts continue to revise corporate earnings estimates upwards.

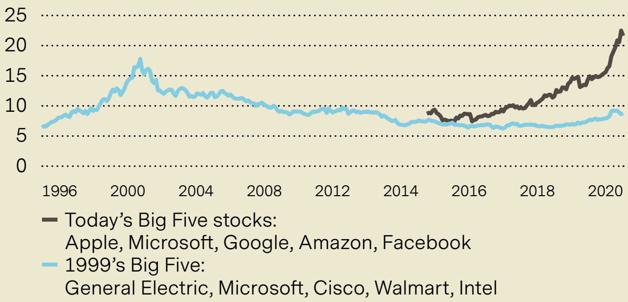
We specifically maintain our positive view on technology stocks, the most important equity sector. The Big Five in this category – Apple, Microsoft, Amazon, Google and Facebook – today account for over 20% of the US equity market. This is above the concentration level seen in 1999 when many investors and regulators were uncomfortable with a different group of five leading stocks (see chart 1). Should the Democratic Party win the US presidency and the US Congress, the pressure on tech's Big Five is likely to increase somewhat, albeit without major consequences, in our opinion. Ideas of splitting them up have been debated from time to time, but it is unclear this would even add value for shareholders.

Valuation still attractive

It is important to note that a commanding position of some companies doesn't mean their shares are overly expensive. The current group's expected price/earnings ratio is lower than that of the Big Five in 1999 and has fallen slightly in recent years thanks to strong earnings growth. Moreover, higher valuations are more justified in the current low-rate environment. Also, the argument that too much profit growth is discounted in tech stocks' share prices doesn't hold water. Expectations for the next two years are on a multi-year average and are nothing more than the result of strong structural trends, which could well be reinforced by the current pandemic crisis. The Fabulous Big Five may yet roam free.

Chart 1: The tech stocks' commanding position is unparalleled in recent memory

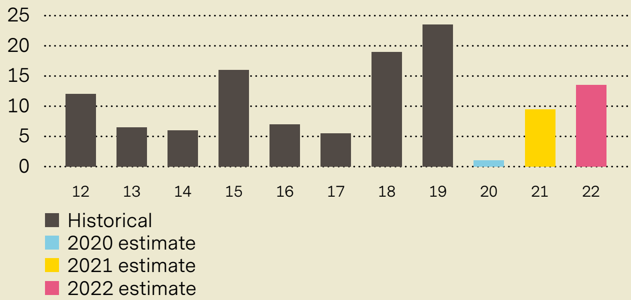
Market capitalizations in % of the S&P 500 index



Source: Refinitiv Datastream, Vontobel

Chart 2: Earnings expectations for the technology sector is withinhistorical range

Earnings-per-share growth in %



Source: IBES, Refinitiv Datastream, Vontobel

Oil: black gold's arduous road to recovery

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

Unlike solid-state gold, which has shone brightly in the past few months, black gold has remained stuck in a dark place. However, we are seeing some supportive supply and demand signals that could drive prices higher over 12 months, provided there won't be massive new shutdowns of the economy due to the pandemic.

Oil markets have been quiet this summer. The price of a barrel of Brent crude oil fluctuated between 40 and 50 US dollars in a relatively narrow range. This was to be expected as record high inventories limit further upward potential. On the other hand, oil prices are close to the production costs of US shale oil producers, a situation usually indicating they shouldn't fall below this floor.

Is all the excitement gone?
Will we be bored again next year, secretly hoping for the excitement that this year's temporarily negative oil price gave us? This is a possibility. Although oil may well continue to recover in 2021, we expect prices to remain below pre-crisis levels due to supply and demand factors.

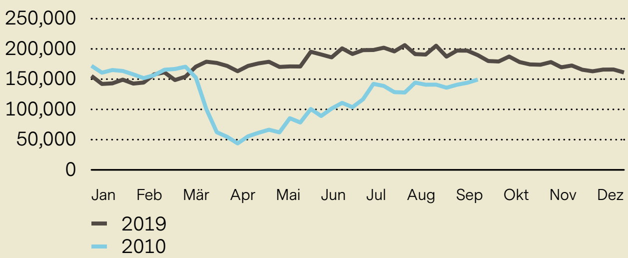
China fires on all cylinders
Let's start with the demand situation. The freeze on global economic activity during the first wave of the corona pandemic has created a once-in-a-lifetime collapse in global demand. It recovered somewhat with the (partial) lifting of lockdown measures, but oil consumption remains significantly below previous years' levels, especially in developed countries. Emerging economies, which account for the main share of global oil demand growth, have also been hit hard. In India, for example, demand for petroleum slumped by an incredible 45% in April. At the same time, the Chinese economy appears to have largely recovered.

It is also interesting to look at one of the hardest-hit sectors, the aviation industry. Surprisingly, at least from a European perspective, air travel has already increased significantly again (see chart 1). There are probably fewer long-haul flights transporting fewer passengers, but overall, these are encouraging signals for oil prices.

The pick-up in demand, though slow, is one of the main reasons for the decline in global inventories. Floating stocks, for example, have already fallen by a third from the high oil mark reached during the Covid-19 crisis. Another contributing factor is the current below-capacity output of the Organization of the Petroleum Exporting Countries (OPEC). Moreover, another oil-producing cluster, the US shale oil industry, needs time to get back on its feet after suffering a severe blow from low oil prices.

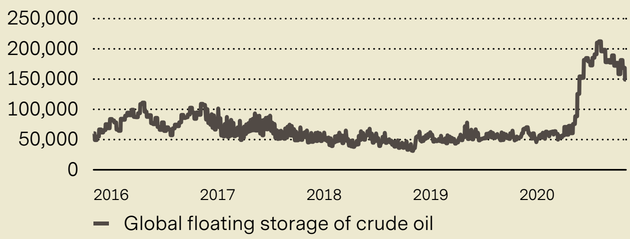
Taking aim at 60 USD
We expect these positive developments to continue in the coming months. This should result in significantly lower inventories and push oil prices higher towards USD 60 next year – if governments around the world don't shut down their economies again.

Chart 1: Air traffic is surprisingly strong from a European perspective
Number of global flights



Source: Bloomberg, Vontobel

Chart 2: Global inventories are coming down, but low levels are still out of reach
In thousands of barrels



Source: Bloomberg, Vontobel

US dollar bounces while European currencies take a breather

—
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Head of Strategy Currencies,
Vontobel

The US dollar may gain some ground while European currencies take a temporary breather. Some short-term support for the greenback should come from the US presidential elections in the next few weeks. However, we stick with our prediction of USD weakness in the medium to long term.

Cyclical currencies like the euro, the Swedish krona, and the Australian dollar may pause on their way up, allowing the US dollar to recoup some losses in the short term. This comes against the backdrop of the approaching US elections (which may lead to market volatility), the rising number of Covid-19 cases in industrialized countries (which could trigger limited shutdowns – see the Macro highlights section page 6), and high positions in cyclical currencies (which could translate into downward pressure should investors unwind them).

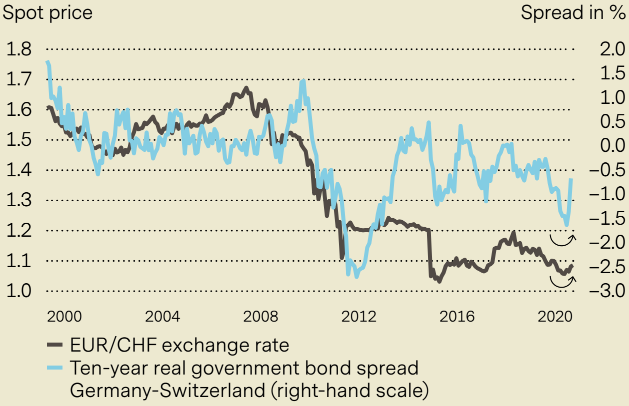
Lately, arguments for a longer-term dollar weakness have been building up. For instance, the US Federal Reserve's softer line on inflation could weigh on US competitiveness at some stage, and, therefore, the dollar.

Swiss franc pulled in different directions
Like we expected, the Swiss franc capitalized on the dollar's weakness, rising 10% between December 2019 and September 2020. Even though we stick to our view of structural Swiss franc appreciation over the next few years – in particular against the US dollar – we expect the franc to take a breather. Our view is predicated on an extreme buildup in speculative CHF long positions and a bounce-back in German real yields relative to Swiss ones (see chart 1). Since the global financial crisis, higher Swiss real yields versus Germany (i.e. the blue line in chart 1 in negative territory) have supported the franc. The recent rise in German real yields, albeit probably only temporary, may lead to a fleeting test of the 1.10 level in EUR/CHF, as was the case in the past.

However, the Swiss franc may take a leap higher on the forthcoming US Treasury report on Swiss-US trade relations. The authority may label Switzerland a "currency manipulator" if it meets all respective criteria, possibly triggering penalties by the US and intensifying speculative pressure on the franc. However, we believe such a verdict is unlikely this year because the cut-off date of the US Treasury's review is 2019, a time when Switzerland overstepped just two of the three currency-manipulator thresholds as defined by the US (see chart 2).

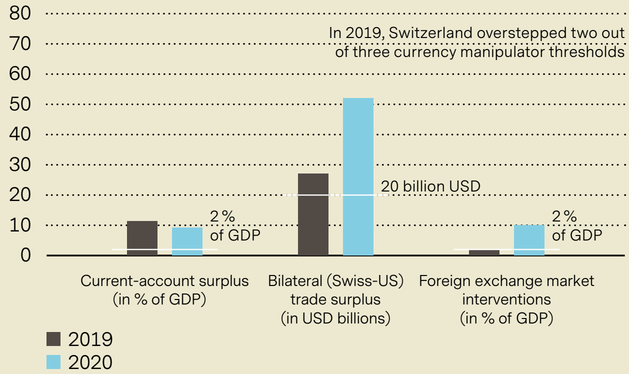
Hopes for "no-deal Brexit" solution
The risk of a no-deal Brexit has increased as the UK's proposed internal market bill would violate parts of the withdrawal treaty between Brussels and London. Such a possibility has raised eyebrows across the Atlantic, particularly in Democratic Party circles, and could endanger any US-UK free trade deal. Therefore, we still expect an amicable resolution with a watered-down bill and a temporary Brexit deal, which could give pound sterling a boost.

Chart 1: Narrower Swiss-German bond spread: a harbinger of a euro surge?



Source: Refinitiv Datastream, Vontobel

Chart 2: Switzerland has appeared on the US "currency manipulator" radar



Source: US Treasury, Vontobel

Economy and financial markets 2018 – 2021

The following list shows the actual values, exchange rates and prices from 2018 to 2019 and our forecasts for 2019 and 2020 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates and commodities.

GDP (IN %)	2018	2019	CURRENT	FORECAST 2020	FORECAST 2021
Euro zone	1.9	1.2	–14.7	–7.1	5.6
US	3.0	2.3	-9.1	–5.1	3.5
Japan	0.3	0.8	–10.1	–5.3	2.3
United Kingdom	1.3	1.4	–21.7	–8.4	6.3
Switzerland	2.7	0.9	–9.4	–4.7	4.3
China	6.6	6.1	3.2	2.1	8.3
INFLATION (IN %)					
Euro zone	1.8	1.2	–0.2	0.4	1.1
US	2.4	1.8	1.3	1.1	1.8
Japan	1.0	0.5	0.1	0.0	0.1
United Kingdom	2.5	1.8	0.2	0.8	1.5
Switzerland	0.9	0.4	–0.9	–0.6	0.5
China	2.1	2.9	4.5	2.5	2.0

KEY INTEREST RATES (IN %)	2018	2019	CURRENT	FORECAST 3 MONTHS	FORECAST 12 MONTHS
EUR	–0.40	–0.50	–0.50	–0.50	–0.50
USD	2.50	1.75	0.25	0.25	0.25
JPY	–0.10	–0.10	–0.10	–0.10	–0.10
GBP	0.75	0.75	0.10	0.10	0.10
CHF	–0.71	–0.69	–0.75	–0.75	–0.75
AUD	1.50	0.75	0.25	0.25	0.25
CNY	4.35	4.35	4.35	4.35	4.35
10-YEAR GOVERNMENT-BOND YIELD (IN %)					
EUR (Germany)	0.2	–0.2	–0.5	–0.5	–0.3
USD	2.7	1.9	0.7	0.7	1.0
JPY	0.0	0.0	0.0	0.0	0.0
GBP	1.3	0.8	0.1	0.3	0.7
CHF	–0.2	–0.5	–0.5	–0.5	–0.5
AUD	2.3	1.4	0.9	0.8	1.0
EXCHANGE RATES					
CHF per EUR	1.13	1.09	1.08	1.10	1.07
CHF per USD	0.99	0.97	0.91	0.94	0.88
CHF per 100 JPY	0.90	0.89	0.87	0.88	0.84
CHF per GBP	1.26	1.28	1.18	1.24	1.24
CHF per AUD	0.69	0.68	0.66	0.67	0.63
USD per EUR	1.14	1.12	1.19	1.17	1.22
JPY per USD	110	109	104	107	105
USD per AUD	0.70	0.70	0.73	0.71	0.72
CNY per USD	6.95	6.51	6.86	6.85	6.95
COMMODITIES					
Crude oil (Brent, USD/barrel)	53	66	43	45	55
Gold (USD/troy ounce)	1281	1521	1955	2000	2000
Copper (USD/metric ton)	5949	6149	6853	6750	7000

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 18.09.2020

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