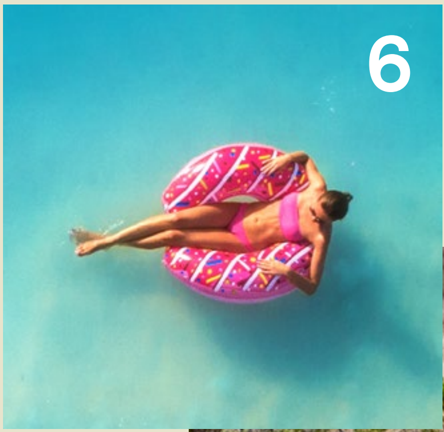
Vontobel

Investors' Outlook

Economy leaves ICU but remains a patient

June 2020

Content



i Dear readers, the Investors' Outlook is going digital. As of the July/August edition due next month, we look forward to providing you with all the benefits of a digital-only publication. You'll continue to find Vontobel's house view on asset allocation, our macroeconomic assessment as well as insights from across all of our boutiques. We hope you enjoy the reading.

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Economy leaves ICU but remains a patient

Dear readers,

Are your spirits lifted by the lifting of lockdown measures? As we return to work slowly but surely, experts disagree over the strength and duration of the second wave of infections ahead of us. Some fear a fierce and long-lasting second wave by fall, worse than the original one, as was the case during the Spanish flu pandemics in 1918. The most optimistic epidemiologists foresee recurring mini-waves of much smaller outbreaks every few months. What's already clear is that no economy will escape unscathed. We've witnessed a record drop in global growth rates over the past months and expect an uneven global recovery during the coming months.

Our reflection as investors is focused on lockdowns and whether a second wave of lockdowns is a possibility. Here we have a high degree of certainty that this won't be the case. National governments simply cannot afford the cost of further lockdowns. The experiences of two countries in particular are of special interest in seeing how life "as normal" with Covid-19 can look, Japan and Sweden. Over the past three months, Sweden has taken a laissez-faire approach to tackling the pandemic, leaving a large part of society open, while appealing to its population's common sense – stay at home if possible and if you feel the slightest flu symptoms, self-isolate. Japan also never initiated a full lockdown of its economy and the approach has worked so far. Its relatively low number of fatalities is especially impressive given the country's demographic composition. Only time will tell whether these approaches were the correct ones but it may be an example of how we can keep all of our economies open and running as we face the danger of a second wave.

Bolstered by unimaginable amounts of money from central banks and governments, financial markets have witnessed the fastest bull market bounce back from the March lows. While we share hopes that this crisis will be short-lived – with some observers expecting economic activity to reach pre-crisis levels before the end of 2021 – we are increasingly concerned about US-China trade tensions. China earlier this year pledged to increase US imports by at least 200 billion US dollars by the end of 2021 but is keen to renegotiate the existing phase 1 trade deal with the US as it sees the terms as difficult to meet. Meanwhile, the Trump administration announced new rules barring Chinese telecoms equipment giant Huawei and its suppliers from using American technology and software. The US Senate has proposed a bill to block Chinese companies from listing on US exchanges. Donald Trump has suggested that the ongoing Covid-19 outbreak is manmade, coming from a scientific lab rather than an animal market in the city of Wuhan. All these developments continue to weigh on sentiment. Rising social unrest in Hong Kong and China's new stern approach to protests there could destabilize the fragile US-Chinese relations further.

We nevertheless stick to our positive outlook for the global economy, despite the numerous uncertainties linked to the pandemic lying ahead. The massive monetary and fiscal packages provide us with a bridge across what is likely to be a severe but short recession. We already see first green shoots of an economic recovery in China, where industrial production has begun to recover. Similar patterns could emerge across the globe as other economies start to open up. The recovery won't be even, however. Our behavior as consumers and the way we go about our business has changed permanently. So while our spirits may have been lifted, the economy remains a patient.

—
Dan Scott
Chief Investment Officer
Wealth Management,
Head of WM Investments & Thematics

→ Webcast
To view Dan Scott's webcast on recent market developments, click:
https://vonto.be/macro-en-jun20

A strange world of stock market gains and economic downturn

—

Mario Montagnani
Senior Investment Strategist,
WM Investments & Thematics

Our scenario of a global, deep, but temporary shock caused by the pandemic has not changed. We still believe in a U-shaped economic recovery, despite it will probably take more time than initially thought to come back to levels pre Covid-19. Unprecedentedly weak economic data and significant downward earnings revisions have been integrated in economist and analyst forecasts in the past months. These now foresee a record weak second quarter 2020, a rebound in Q3 and, finally, a modest recovery in Q4. This should result in a contraction of the global economy by around 4%. Meanwhile, governments and central banks are pushing fiscal and monetary stimulus further, from rate cuts and sizable liquidity injections to asset buying programs or massive support packages. However, on a short-term perspective, volatility remains high considering the low visibility on how the pandemic will evolve or when a vaccine will be found and commercialized, especially given the possibility of a second wave in countries that are currently lifting lockdowns. Moreover, tensions between the US and China are resurfacing, adding to uncertainties.

In this context and after a strong and prolonged market rebound from the March lows, the Vontobel Investment Committee (IC) has decided to make adjustments to its sub asset class views.

In fixed income, the IC has decided to realize profits in investment grade (IG) bonds and reduce its view to neutral. As the coronavirus has upended global credit markets, however, we have now decided to neutralize this segment in favor of high yield (HY) bonds. On the one hand, one could observe a significant tightening of IG credit spreads to a point where the risk reward is no longer appealing. Meanwhile, HY spreads have failed to recover at the same pace of the rest of the market, opening up opportunities in the segment. We maintain our positive view on emerging-market bonds, as we believe that the asset class is appealing from a risk reward perspective. As both investment grade and high yield are neutralized, this leaves us with an overall neutral stance on the fixed income segment.

In equities, after having upgraded our view on Swiss equities to positive by the end of March on the back of the quality and defensive characteristics, the IC believes that now is a good time to lock in some profits and reduce them to neutral. In retrospect, this decision has worked in our favor, with Swiss equities outperforming most global indices over that period, particularly the European ones. At the same time, we raised our view on Japanese stocks from negative to neutral. Japan's export-driven economy is highly exposed to the economic recovery of its neighbors, China in particular. Since China was the first to emerge out of lockdowns and is already witnessing a recovery in economic activity, we see Japan as well positioned to benefit. After neutralizing both positions, this results in an overall neutral view on equities. From a long-term perspective, equity markets are still offering value and represent upside potential in our view. However, on the back of the uncertainties of above combined with the sharp rebound occurred since March, valuations are close or above historical levels. This would require additional signs of recovery to support both performance and valuation from here, hence our neutral.

The IC maintains its view for all other segments, namely its negative stance on government bonds, its positive stance on emerging-market bonds and the neutral take on all other regions within the equity space. We also remain positive for alternative investments (AI) overall, with a neutral view on both commodities and hedge funds and a preference for gold and other types of AI, such as insurance-linked securities.

	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. With their recent interest-rate cuts, the central banks of America and Europe have once again shown their determination to stimulate economic growth. The Swiss National Bank looks set to follow suit.
2 Bonds			→			After a good run, the IC has decided to realize profits in IG bonds and to neutralize this segment in favor of HY bonds. First, the significant narrowing of IG's credit spreads has reduced the attractiveness of this segment. Second, HY bond spreads have failed to recover at the same pace of the rest of the market, opening up opportunities in the segment. This leaves us with an overall neutral stance on the fixed income segment. We maintain our positive view on emerging-market bonds and reiterate our negative stance on government bonds.
3 Equities			→			The IC reduced Swiss equities to neutral, after having upgraded them to positive by the end of March. In retrospect, this decision has worked in our favor resulting in outperformance to major European indices. At the same time, we raised our view on Japanese stocks from negative to neutral. We believe the country's export-driven economy will benefit from the economic recovery of its neighbors, in particular to China. After neutralizing both positions, this results in an overall neutral view on equities.
4 Gold				→		We remain overweight in gold, as the precious metal benefits from central banks' policy of low-interest rates and investors' flight into safe havens., in a period where the investment world faces negative yields on over a quarter of outstanding IG bonds and on additional monetary easing, It is also suitable as a hedge against negative political and economic surprises.
5 Commodities			→			Commodities returns are largely independent of stock and bond returns. They benefit when inflation is accelerating but enjoy very little from the support measures provided by central banks. As long as there is no marked pick-up in economic recovery and no significant weakening of the US dollar, we are refraining from an overweight position. In the short term, commodities are also suffering from concerns about the Covid-19 virus.
6 Alternative strategies			→			During phases of increased volatility, as we are currently experiencing, we prefer asset classes that perform independently of bond and equity markets, such as alternative strategies. Within this asset class, we favor hedge funds.

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

Can this year's summer be the season of vacations and growth?

—
Reto Cueni, PhD
Senior Economist,
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—
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—
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There are tentative signs that life is slowly returning to normal. For example, students are back to school – but not for long, because summer is around the corner, a season of vacations (definitely) and growth (hopefully). But even if there is a rebound mid-year, the global economy will probably contract by some 4% for the whole of 2020.

Most countries that have relaxed lockdown restrictions seem to have managed to bring the economy slowly back to life at least partially (see chart 1, broken lines). But the rebound starts from a very low level, particularly in countries where the lockdown has been severe such as India or in the southern countries of the euro zone (see chart 1, bold lines). Likewise, other indicators such as energy consumption, air pollution or bookings at restaurants point to a staged and gradual economic recovery (see chart 2, table bookings).

The faster a return to normalcy, the more substantial the economic recovery. In Germany, for instance, people have started going out again (see chart 2), but bars and restaurants are not yet buzzing with activity as some restrictions remain and consumers first have to adapt to the new "freedom". Generally, the number of new infections and fatalities is decreasing, and we expect a further relaxation of lockdown measures accordingly. Meanwhile, government and central bank support for the economy has reached a record level (see chart 3).

We continue to expect a global economic recovery towards the summer and a substantial economic rebound in the second half of the year, provided there won't be a second Covid-19 wave with new strong lockdown measures. Some US states, for example, are loosening the screws already without much evidence that infections are coming down, which increases the danger of a new outbreak. And even if there were a substantial economic rebound, we forecast almost a 4% contraction globally this year.

Euro zone – infighting may water down rescue deal
Virus worries and poor economic readings aside, the European Union's political problems seem to be growing. There is a German constitutional court ruling that threatens to ban the German Bundesbank from participating in certain asset purchases by the European Central Bank (ECB). Although the short-term impact will probably be limited – we believe the ECB will even increase its emergency liquidity programs further – prospects of a shackled central bank could raise doubts about the euro's solidity.

There is also the wrangling about the size and the nature of the EU's financial support for hard-hit peripheral countries. Even so, we expect the heads of state to agree on a recovery fund worth approximately 750 billion euros in the form of direct grants, but also very generous loans that need to be repaid. Nevertheless, there is the risk that financially conservative countries such as the Netherlands, Austria or Sweden may block a generous deal. A veto to use direct grants or sell debt issued by the European Commission would be a strong message that any further integration of the EU and the euro zone is temporarily off the table. It would increase the chance of a further decoupling of the economically weaker south from the stronger north.

Gradual US reopening – Trump under pressure
Economic indicators continue to point at a record-low second quarter for activity, but high-frequency indices such as open table booking for seated restaurants show a slow pick-up in May (see chart 2). The US Congress has started to discuss more fiscal support for the economy amid rising fears of a protracted slowdown. The Democratic Party is pushing for as much as 3 trillion USD in additional financial support, an amount that Republicans have not yet backed. With the presidential elections in November drawing closer, the public has focused on President Donald Trump's handling of the Covid-19 crisis, and his approval rating has suffered. Currently, the incumbent trails Democratic Party nominee Joe Biden by around 5 percentage points, and is behind in key "battleground" states. The president's difficult situation might increase his appetite for a further confrontation with China.

America and China in social distancing mode
Recent Chinese economic hard data is in line with our expectation of a 2020 growth rate of at least 1.5%. While the domestic economy has picked up speed, the country's exporters still reel from the disastrous drop in demand from industrialized countries. Any worsening of trade relations with the US would be another blow.

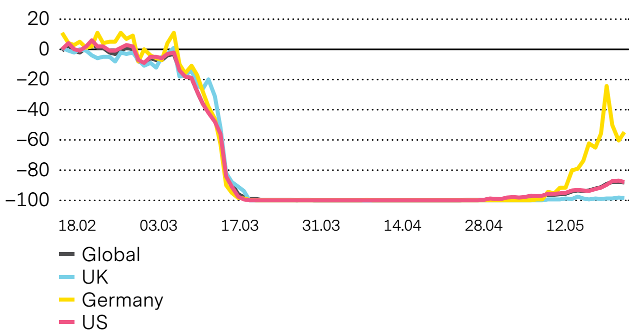
The Trump administration may tighten the screws further, burdening US technology companies with new restrictions on doing business with Chinese suppliers. Beijing would then probably retaliate, opening the door to an escalation.

Japan was already in recession before Covid-19 struck with the GDP falling in the fourth quarter of 2019 and the first quarter of this year. However, the country may benefit from China's economic recovery. Prime Minister Shinzo Abe announced that the country's state of emergency has been lifted in Tokyo at the end of May, one of the last regions in lockdown.

Elsewhere, Latin America is still suffering from stringent measures. Moreover, many countries such as Brazil have to shoulder an enormous debt burden, preventing them from supporting their economies further. Other emerging markets such as South Africa, Turkey, and India, face problems of their own in dealing with the economic shock the pandemic has caused (see India in Chart 1, for example).

Chart 2: People go out again in Germany, a country that has managed the crisis relatively well

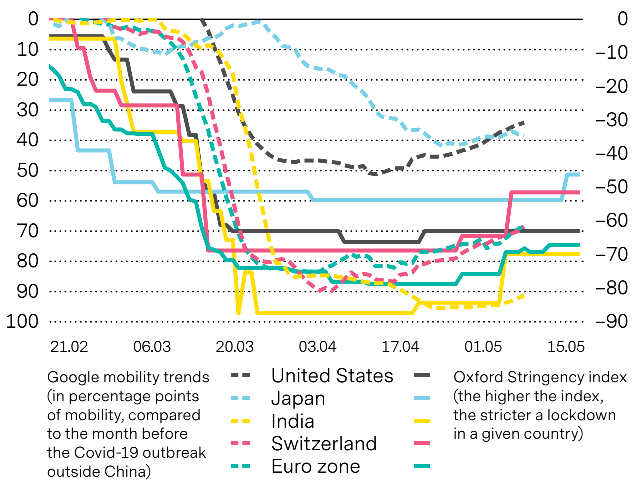
Open table bookings index



Source: OpenTable.com, Vontobel

Chart 1: Once lockdown measures are relaxed, economic indicators pick up

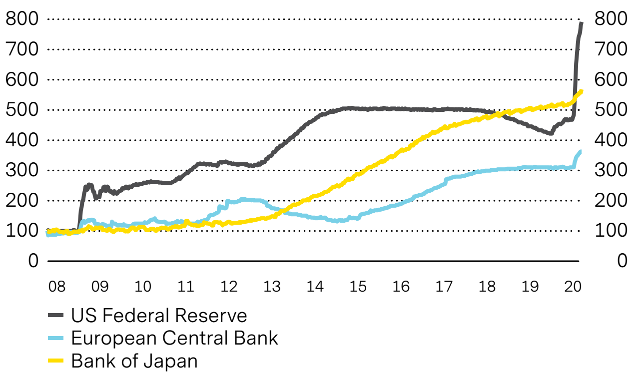
Stringency Index, inverted | Mobility index



Source: Oxford University Blavatnik School of Government, Google, Vontobel

Chart 3: Central bank balance sheets skyrocket as support packages multiply

Index (rebased to 100 January 2008)



Source: US Fed, ECB, BoJ, Refinitiv Datastream, Vontobel

Faced with continued income scarcity, investors may turn to bonds

—
Mark Holman
Chief Executive Officer, Portfolio Manager, TwentyFour Asset Management*

Panic selling and a liquidity squeeze in bond markets – the coronavirus pandemic has wreaked havoc in fixed income portfolios as investors rushed to build up cash. However, the first-quarter sell-off has also created opportunities for investors seeking to avoid income scarcity.

While March was one of the most uncomfortable months on record, we believe the brutal sell-off has created some of the best value opportunities bond investors are likely to see for several years.

The shock

The new coronavirus brought the global economy to a standstill and many companies saw revenues evaporating virtually overnight. We have entered a deep recession, and it could be a long time before we return to the productivity levels of 2019. On the positive side, in contrast to the previous recession triggered by the global financial crisis in 2007, governments and central banks have acted swiftly and with conviction, with trillions of dollars' worth of support for markets, firms and individuals.

The opportunity

One important effect of Covid-19 is that interest rates look set to remain near zero for "an extended period of time," to borrow a phrase from the central bankers' handbook. In fact, we may not see a meaningful rise in interest rates for much of the next decade. It is worth remembering that it took the US Federal Reserve until late 2018, a full 10 years after it cut rates to zero following the collapse of Lehman Brothers, to reach a high point of 2.25 – 2.50% for its main interest rate. Policymakers around the world swiftly cut base rates back to their lower bounds at the onset of this crisis, and it is hard to see them reversing course quickly while economies are shepherded through recession and recovery.

For investors, we think this means cash will not be a viable asset class going forward and income will once again be a scarce commodity. The good news is, there is now plenty more income to be captured in the bond markets.

We entered 2020 with bond markets looking fully priced pretty much across the board, and with a meaningful exposure to risk-free rates products such as US Treasuries looking a sensible and necessary hedge against likely spread widening in riskier assets. The March sell-off rapidly turned this situation on its head, with many sectors going from looking quite expensive to looking very reasonable in record time amid some of the most extreme trading conditions we can recall.

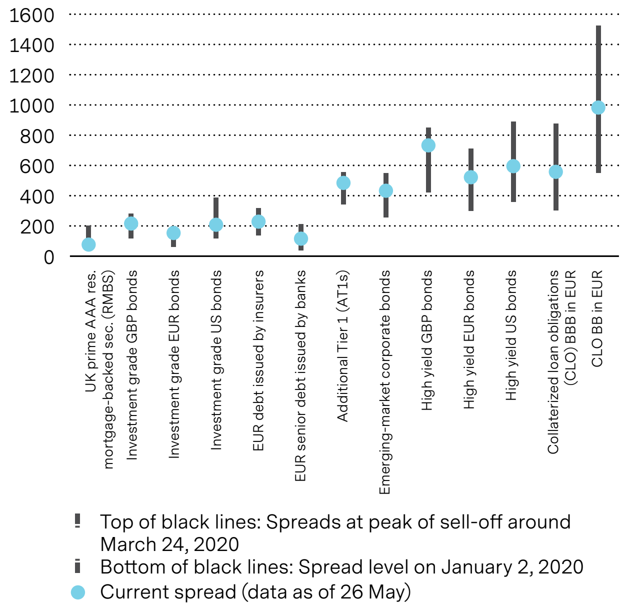
Chart 1 shows by how much several bond markets overshot at the height of the sell-off (top of black lines). In the meantime, spreads have started moving lower, but are still elevated. Their position relative to lows seen in January indicates the potential value for fixed-income buyers in these segments, in our opinion (see blue circles in chart 1).

* TwentyFour Asset Management, a London-based fixed income manager, is majority-owned by Vontobel

Investors should rely on animal spirits to hunt for attractive yields.

Chart 1: Higher spreads mean better value for bond investors

Spreads in basis points
(unadjusted for maturity and currency differences)



Source: Bloomberg, TwentyFour Asset Management

The strategy

What can investors do to try to benefit from this opportunity? First, we believe active managers will have a distinct advantage over passives in navigating this period. For bond investors, recession typically means a sharp pick-up in bond issuers' defaults and the danger of downgrades by rating agencies. We would not be surprised to see a default rate of 10% in 2020, and would expect at least ten downgrades for each upgrade. It should be impossible for passive funds to avoid every one of these. This won't be easy for active managers either, but relative value research has often been proven to be better rewarded at the beginning of a cycle than at its end. With flexibility and diligent research, I think there is a good chance of helping to identify the likely winners and losers as the global shutdown plays out. Here are three themes to consider for bond investors:

– **Lock in yields with longer-dated bonds.**
  We expect bond markets to lead the recovery, as investors will have a greater degree of comfort in solvency and coupon payments than they will in earnings expectations and dividend payments from equity. One way to improve income in the current environment is by locking in yields for longer with longer-dated bonds. The income from these bonds can generate attractive returns even in the absence of a recovery. One example could be BBB rated assets that have fallen just as much as the BBs and single-Bs because of the indiscriminate selling. While earlier on in the cycle investors tend to prefer gaining yield by taking more credit risk (i.e. higher-yielding bonds), at this point we would prefer to gain yield by taking more maturity risk (i.e. longer-dated securities).

– **Avoid the default zone by focusing on higher quality.**
  Locking in higher yields is no good if it comes with a higher probability of defaults and downgrades. CCC-rated bonds typically account for around 95% of defaults, with single-B names taking nearly all of the remainder, but given the nature and cause of this recession, we should also be mindful of some higher-rated companies jumping to default before their downgrades happen. In addition, we expect to see very strong sectoral biases. In our view, investors should be looking to sectors with greater earnings transparency and the most robust balance sheets, while trying to avoid sectors that are highly cyclical and look to be most at risk, such as retail, transport, leisure, auto manufacturers, commodities and real estate companies, to name a few. There will be a time for buying lower-rated companies or into the sectors mentioned above, but we don't think that has arrived yet.

– **Decrease reliance on government bonds for protection.**
  Government bonds (principally US Treasuries) proved their worth as a negatively correlated risk-off play at the start of this crisis, but they may no longer offer the same protection. After central banks' rescue measures, risk-free yields are so low that they cannot travel much further. With huge supply ahead to fund enormous fiscal expansion, and given the prospect of rising inflation, central banks will now probably set their sights on so-called yield curve targeting. They could end up "owning" the long end of the government bond curve, leaving merely the front end to investors. This means that risk-free bonds could become return-free too.

The way ahead

Market and economic conditions have shifted at incredible speed. We will remember the first quarter as a once-in-a-decade repricing of risk, but we may also look back at March and April 2020 as the best entry point of this decade for fixed income markets.

Active managers have to adapt their thinking and implement changes to portfolios as they seek to capture the opportunities created. Once we work our way through this most challenging period for the global economy, investors will face many of the same challenges of the past few years. Interest rates will remain low, income will remain scarce, and fixed income will remain as one of the better solutions, in our opinion.

"Core" bonds unattractive – further peripheral spreads tightening seen

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel Asset Management

While "core" sovereign yields are expected to trade sideways in the coming weeks, the spreads of bonds issued by southern European countries are likely to narrow. One of the reasons why the price rally in this segment may continue is a European recovery fund worth 750 billion euros proposed by France and Germany.

The coronavirus pandemic, and the subsequent rescue packages from governments and central banks, have sent yields on sovereign bonds to record low levels. In the US, they are down by 125 basis points for ten-year Treasuries so far this year. The yield hasn't moved much since the sharp fall in early-March.

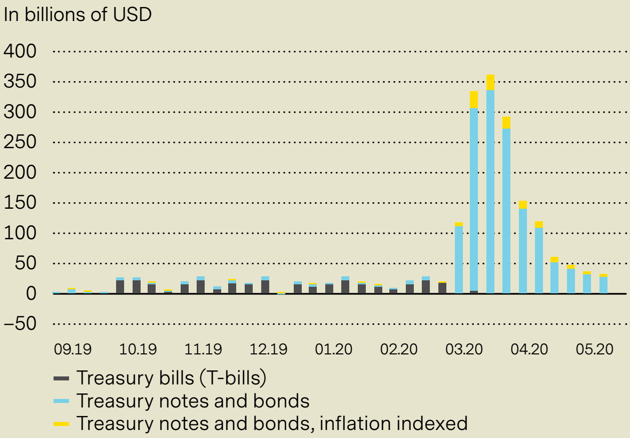
Yields to remain low forever?
We have had a negative view on government bonds for some time now. The current environment begs the question whether their yields will remain low forever. In the short-term, US bond yields are likely to continue moving sideways, as prospect of more fiscal easing by the US Congress are currently offset by the US Federal Reserve's very visible actions. Although purchases of Treasuries are down to approximately 40 billion US dollars per week versus up to 300 billion USD in March (see chart 1), the Fed keeps the lid on yields. In addition, US government bonds are still a good hedge against a deterioration of US-China trade relations.

The expected gradual economic recovery will then probably move long-term yields higher. US Federal Reserve Chairman Jerome Powell has made it clear there is no plan yet for below-zero key rates. Moreover, the Fed could, in our view, adopt a "Japanese-style" soft yield curve control. This would open the door to a gradual re-steepening of the long end of the curve (see chart 2).

Merkel-Macron proposal as a fresh start?
Like in the US, bond yields of core European countries such as Germany and France have stayed low since March. The spreads of peripheral countries to "Bunds" narrowed and widened intermittently on the back of the virus-related economic shock and stringent lockdown measures in southern Europe. Another reason for the volatility was the failure of European leaders to address the financial fallout of the health crisis.

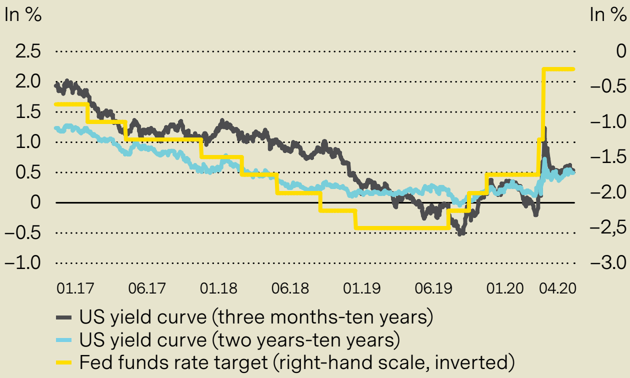
In this regard, the recent Franco-German proposal for a joint European recovery fund that could include temporary fiscal transfers to hard-hit countries could be an answer. It would help make peripheral bonds attractive and act as a second support on top of ongoing asset purchases by the European Central Bank. The deal is still sketchy and fiscal hawks will probably oppose any initiative smacking of permanent fiscal transfers. Even so, hopes for an agreement at the European level and fiscal relief for the peripheral countries will help to reduce the risk of further European fragmentation. Therefore, we will keep an eye on peripheral spreads, particularly on the yield difference between Italy and Germany.

Chart 1: US Federal Reserve's buying spree keeps bond yields down



Source: US Federal Reserve, Refinitiv Datastream, Vontobel

Chart 2: US yield curve and fed fund target move lower, but curve may steepen again



Source: Refinitiv Datastream, Vontobel

Why share prices and economic data are out of step

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel Asset Management

Backward-looking economic data and forward-looking financial markets often produce two radically different versions of reality. Such differences become particularly obvious during crises such as this one. At some point, the rosy picture painted by rising stock prices will need to be corroborated by higher corporate profits.

Some observers draw a straight line between the health of the global economy and financial markets. This can be misleading. Presently, the US tech stock market index Nasdaq is trading at absurdly high levels, while the US unemployment rate has shot up at record speed to hit more than 14% in April (see chart 1).

To understand this massive discrepancy, it is useful to take a closer look at economic indicators. There are three categories: leading indicators, concurrent ones and lagging ones. The unemployment rate is a lagging indicator, meaning that economic changes need time to filter through into the figures. The reason for this is that companies typically watch the situation for several months before deciding on whether or not to hire employees. This is one part of the equation. On the other hand, they usually waste no time to lay off staff – at least in the US.

Leading indicators offer little help at present

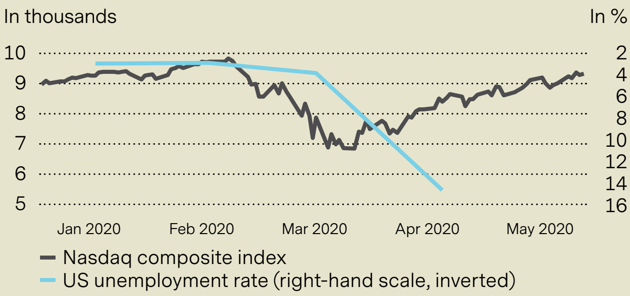
By contrast, financial markets are an echo chamber for leading indicators. They price in new economic and political developments within seconds. For example, investors follow forward-looking economic indicators such as companies' new orders or building permits. A changing world also leads to new areas to be covered. Nowadays, economists also track data of people's mobility behavior available from Google and Apple websites.

Does this mean that keeping an eye on leading indicators will help guide investors' steps? This is easier said than done. Currently, leading economic seem far from reliable. Stock markets have risen almost 30% since their lows in mid-March, despite new orders and building permits at rock-bottom levels, and below-average mobility data of the population.

This is due to the reaction of central banks to the coronavirus crisis. On the one hand, the enormous volume of new liquidity is flowing into the financial markets, and thus also into the stock markets. On the other hand, investors expect the global economy to stabilize thanks to the support of the central banks. Lower interest rates and more liquidity should reduce companies' financing costs. Stock prices are rising accordingly.

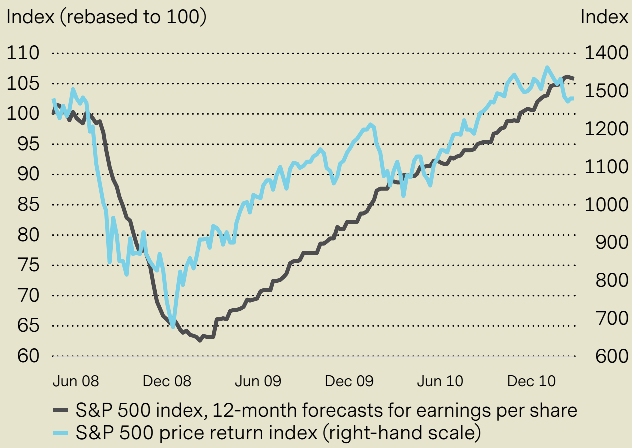
At some point, companies must start doing seriously good business to justify the high expectations and the rise in stock prices. If past crises are any guide, this will take some time (see chart 2). At the same time, any turn for the worse such as a second wave of Covid-19 would be priced in by the financial markets just as quickly as the current favorable news.

Chart 1: More people are unemployed, but stocks markets move up



Source: Refinitiv Datastream, Vontobel

Chart 2: Earnings estimates typically trail stock prices by some months during crises



Source: US Federal Reserve, Refinitiv Datastream, Vontobel

Rising oil prices could give gold another boost

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel Asset Management

A few months or quarters from now, investors may remember the coronavirus pandemic as the time when gold prices took off. The current low-growth and low-yield environment benefits the precious metal. Higher inflation on the back of rising oil demand would be another argument for gold.

Explaining gold's recent upward trend seems easy enough. If real interest rates fall, the opportunity costs of holding gold decrease, and this is what happened during 2019 and much of 2020 (see chart 1). What we don't know is where real interest rates will go next, and whether the moves will have the same predictable effect on the gold price as in the past few quarters.

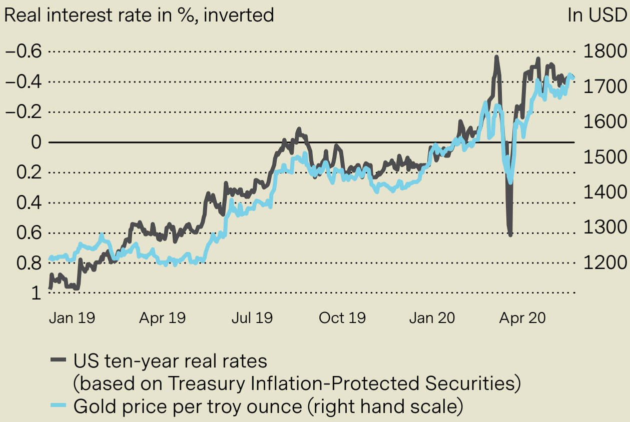
Let's assume that gold will continue to react to changes in real interest rates. For further simplification, let's break down this measure into an interest rate component and an inflation component. The former is central bank territory. Given that the coronavirus crisis is too drastic to allow for a tightening of monetary policy anytime soon, long-term interest rates should remain low. In addition, some monetary authorities like the Bank of Japan have started actively managing the yield curve, i.e. preventing long-term rates from rising.

This leaves us with inflation, and inflation expectations, as drivers of the price of gold, an asset investors always turn to in times of rising consumer prices. There is a close correlation between inflation and oil because energy prices are an important component of the basket of goods at the core of inflation measurement.

At the height of the Covid-19 crisis, oil prices hit rock bottom, even "negative bottom". Global demand in April fell to levels last seen in the year of 2000. Inventories across the globe filled immediately, resulting in the absurd situation of oil costing "less than nothing" in some markets. We believe prices will recover slightly over the coming weeks, as supply is only now beginning to decrease. This should then lead to higher inflation expectations, which will, in turn, also indirectly benefit gold via lower real interest rates. We are sticking to our target of USD 1,800 per barrel over 12 months.

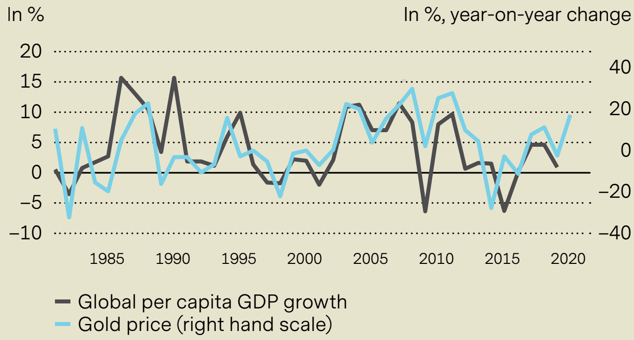
Gold can thrive in times of growth and inflation
Some special rules apply for gold, but the market does reflect big economic cycles (see chart 2). Like other asset classes, the precious metal needs a healthy economy to attract fresh interest from investors. What sets gold apart is that it can thrive in times of economic growth as well as during periods of high inflation.

Chart 1: When real interest rates fall, gold typically gains ground



Source: Refinitiv Datastream, Vontobel

Chart 2: Renewed economic growth may give gold another leg up



Source: Refinitiv Datastream, Vontobel

European currencies on the up as dollar sags

—
Sven Schubert, PhD
Head of Strategy Currencies,
Vontobel Asset Management

We expect European currencies to gain ground against the US dollar until year-end. Emerging-market currencies have further recovery potential after one of the sharpest corrections in the past few decades.

The Covid-19 crisis laid bare the lack of political soli darity within the euro zone, and has put the euro under pressure. Moreover, the currency took a hit from a ruling by the German constitutional court forcing the European Central Bank to prove the proportionality of financial rescue programs for the euro area. There have been some positive developments, though. The recent Franco-German initiative (also see the bonds column on page 10) represents an important step towards the elimination of economic imbalances within the European Union, in our opinion. Whether or not any temporary financial aid will from Europe's north to the south, we welcome the apparent change in the two core countries' attitude. The proposal has boosted the euro versus the dollar, and we believe this trend will continue, however, at a slow pace.

The European currency is also benefiting from prospects of a dollar weakness. On the one hand, this is due to the significantly more aggressive monetary policy in the US, and on the other hand, the likelihood of a relatively slow economic recovery there.

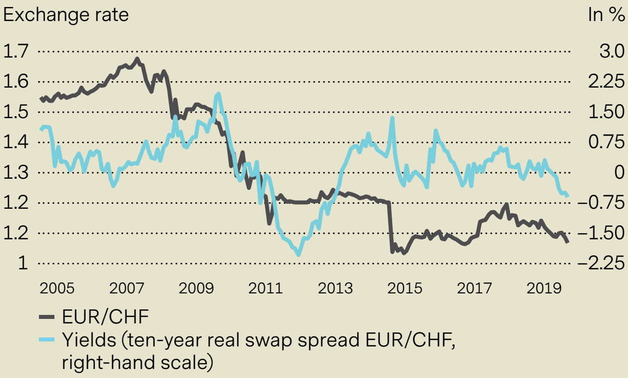
The pound is likely to lag behind other European currencies in the coming months, as the UK's trade negotiations with the European Union have stalled. The yen will remain a mere instrument for portfolio hedging. We doubt the currency has much upside potential, despite Japan's current-account surplus and the yen's undervaluation. It may, however recover slightly against the US dollar.

The euro's expected rise provides some welcome respite for the appreciating Swiss franc. However, this won't be a turning point for the Swiss currency. In the past, the franc has mostly gained ground when yields were low, and we expect this situation to persist (see chart 1). We continue to see EUR/CHF in a range of 1.05-1.10, but the franc will probably rise to around 0.94 against the dollar.

Mexican and Russian currencies unduly penalized

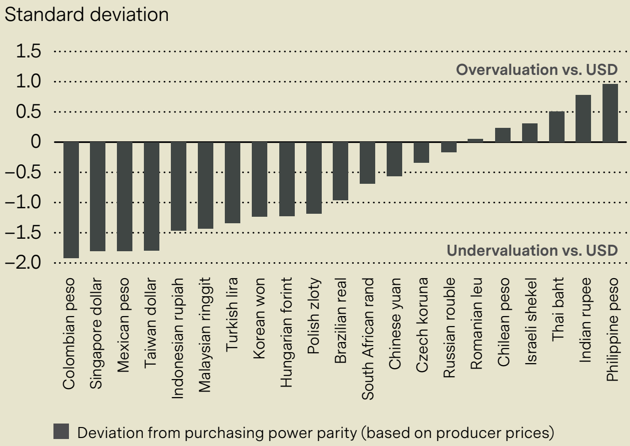
The recent downturn in emerging-market assets has weighed on currencies as well, some of which are at historically low levels (see chart 2). We believe that dismal prospects are now mostly priced in. In our view, the Mexican peso or the Russian rouble, to name just two, have been unduly penalized. The latter should benefit from an expected rise in oil prices, and of Russia's extremely low national debt amounting to 18% of GDP.

Chart 1: Swiss franc to take a breather from upward trend, but remains underpinned by low yields



Source: Refinitiv Datastream, Vontobel

Chart 2: Many emerging-market currencies are at historic lows versus the US dollar



Source: Refinitiv Datastream, 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	–3.2	–6.3	5.3
U.S.	2.9	2.3	0.3	–5.9	4.1
Japan	0.3	0.8	–2.2	–5.3	2.4
United Kingdom	1.3	1.4	–1.6	–6.2	4.8
Switzerland	2.7	0.9	1.5	–6.1	6.6
China	6.6	6.1	–6.8	1.5	8.1
INFLATION (IN %)					
Euro zone	1.8	1.2	0.4	0.7	1.6
U.S.	2.4	1.8	0.4	0.8	1.8
Japan	1.0	0.5	0.4	0.0	0.1
United Kingdom	2.5	1.8	1.5	1.0	1.7
Switzerland	0.9	0.4	–1.1	–0.5	0.9
China	2.1	2.9	4.5	2.6	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	–0.20
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	4.00	4.00
10–YEAR GOVERNMENT–BOND YIELD (IN %)					
EUR (Germany)	0.2	–0.2	–0.5	–0.5	–0.3
EUR (GIPSI)	2.2	0.9	0.7	0.7	0.9
USD	2.7	1.9	0.0	–0.2	0.0
JPY	0.0	0.0	0.2	0.4	0.7
GBP	1.3	0.8	–0.5	–0.7	–0.5
CHF	–0.2	–0.5	0.9	0.7	0.8
AUD	2.3	1.4	0.8	0.9	1.0
EXCHANGE RATES					
CHF per EUR	1.13	1.09	1.05	1.05	1.05
CHF per USD	0.99	0.97	0.97	0.95	0.92
CHF per 100 JPY	0.90	0.89	0.90	0.89	0.88
CHF per GBP	1.26	1.28	1.18	1.18	1.22
CHF per AUD	0.69	0.68	0.63	0.62	0.61
USD per EUR	1.14	1.12	1.09	1.10	1.14
JPY per USD	110	109	107	107	105
USD per AUD	0.70	0.70	0.65	0.65	0.66
CNY per USD	6.95	6.51	6.86	7.05	7.00
COMMODITIES					
Crude oil (Brent, USD/barrel)	53	66	35	40	45
Gold (USD/troy ounce)	1281	1521	1737	1700	1800
Copper (USD/metric ton)	5949	6149	5292	5750	6250

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 18.05.2020

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