Vontobel

Investors' Outlook

A bull run in the Year of the Ox?

March 2021

Content

3
Editorial

4
Investment strategy

We upgrade commodities on a solid outlook and a return of normality

6
Macro highlights

We may also remember the pandemic for "great reflation" expectations

8
Viewpoint

Dispelling three sustainability myths for bond investors

12
Asset classes in focus

16
Forecasts

Imprint

Publishing by
Bank Vontobel AG
Gotthardstrasse 43
8022 Zurich

Editor
Martin Gelnar

Authors*
Reto Cueni, PhD
Chief Economist,
Vontobel
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel
Darya Granata
Client Portfolio Manager
Fixed Income Boutique,
Vontobel
Frank Häusler
Chief Investment Strategist,
Vontobel
Anna Holzgang
Head of Sustainable Bonds,
Vontobel
Michaela Huber
Junior Economist,
Vontobel
Simon Lue-Fong
Head of Fixed Income Boutique,
Vontobel
Mario Montagnani
Senior Investment Strategist,
Vontobel
Sandrine Perret
Senior Economist and
Fixed Income Strategist,
Vontobel
Sven Schubert, PhD
Head of Strategy Currencies,
Vontobel
Dan Scott
Chief Investment Officer,
Head of Impact & Thematics,
Vontobel

Frequency
Ten times per year
(next issue April 2021)

Concept
MetaDesign AG

Creation & Realization
Vontobel

Images
Gettyimages,
Vontobel

Input deadline for this edition
March 1, 2021

Remarks
* see page 17 "Legal information": analyst confirmation

A bull run in the Year of the Ox?

Dear readers,

In 2020, the Chinese Year of the Rat brought twists and turns worthy of that shrewd animal. Will the Year of the Ox that started mid-February bring a bull run to equity markets?

Spring is clearly on its way, in atmospheric as well as psychological terms. Warmer temperatures, vaccination campaigns, and governments' support measures have brightened the outlook for the months ahead. People are only waiting to splash their cash on dining, concerts, shopping, or travel, as soon as the ongoing restrictions are lifted.

This will give the battered global economy a welcome boost. Inflation may therefore temporarily overshoot the 2% target in both the United States and Europe. Their respective central banks are likely to look through this development. They have pledged to stick to their policies of low interest rates, helping not only consumers but also financial markets. US Federal Reserve Chairman Jerome Powell recently warned that the US economy is "far from" being where it needs to be. Meanwhile, minutes from the most recent European Central Bank (ECB) meeting show it will maintain "favorable financing conditions for as long as possible."

The stimulus package worth 1.9 trillion US dollars unveiled by President Joe Biden prior to his inauguration is on track to be passed by Congress before mid-March. Even though it could turn out to be smaller than the proposed amount, the plan will still ensure that permanent job losses resulting from the second and third waves of the pandemic are kept in check. European governments have arranged similar rescue deals.

—
Dan Scott
Chief Investment Officer,
Head of Impact & Thematics,
Vontobel

Yet we shouldn't be blinded by the first few rays of spring sunshine. Uncertainties linked to the different vaccines' efficacy as virus variants emerge and the general public's degree of acceptance of the vaccines do linger. Sweeping lockdowns across Europe and restrictions in the Americas are still in place. Asia continues to fare better with far fewer reported cases.

Stick to equities, upgrade commodities

In view of all this, we continue to favor equities over cash and bonds. We stick to our overall positive view on equities, with a strong preference for emerging market stocks. Companies in these economies are not only relatively cheap, but also benefit from a weaker US dollar and Chinese stimulus measures. For similar reasons, we have upgraded commodities to overweight, also due to the expected release of pent-up demand.

Beware of the stampede

There are signs that the surge in money supply not only has encouraged institutional investors to take bigger risks, but also individual investors. The recent Bitcoin frenzy and surging interest for the trading app Robinhood, whose users have managed to move share prices, point in this direction. It also makes financial markets a fascinating, constantly evolving place prone to occasional stampedes of professional or retail investors. In the Year of the Ox, let's therefore be reasonably bullish without losing sight of the risks.

⟶ Webcast
To view our webcast on recent market developments, click:
vonto.be/macro-en-mar21

—
Frank Häusler
Chief Investment Strategist,
Vontobel

—
Mario Montagnani
Senior Investment Strategist,
Vontobel

We upgrade commodities on a solid outlook and a return of normality

With the Biden administration hitting its stride, some welcome normality has returned to the world stage. Washington is again sitting down at negotiating tables and sending reassuring messages to allies. In Europe, meanwhile, the man credited with saving the euro has been appointed Italian prime minister. Former European Central Bank head Mario Draghi is the third ex-EU official to take up residence in Rome's Chigi Palace (pictured) after Mario Monti and Romano Prodi.

While economists, politicians, and diplomats are heaving sighs of relief, there is no shortage of old and new worries that affect our lives including new strains of the Coronavirus and the crippling effect of lockdowns on the economy. According to US Federal Reserve Chairman Jerome Powell, the US labor market is worse off than what the official unemployment figure of 6.3% suggests.

Still fond of equities and now also commodities
That said, the solid and partly improving economic outlook has prompted us to upgrade commodities, a slight downward revision of our European growth outlook notwithstanding. The staggering amount of state funds propping up the economy – and financial markets – has given rise to discussions regarding the sustainability of the boom. After all, when the economy overheats, inflation is never far behind. Even so, central banks, burnt by previous experiences of changing track too soon, will probably keep injecting liquidity into the system in the next few months, keeping interest rates low. This is one of the reasons why we continue to favor equities over cash and bonds, although the latter category displays pockets of solid returns in sub-segments such as emerging markets. Details on our asset allocation are on page 5, and still more detailed views on pages 12 to 15.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				We maintain our underweight stance. Holding cash seems to make little sense when interest rates hover around zero and prospects of rate hikes are constantly pushed further back.
2 Bonds		→				While retaining an overall negative stance on fixed income, we have reduced investment grade (IG) corporate paper to a clear underweight, due to this segment's narrowing spreads to sovereigns (i.e. demand for IG has seen yields hitting new depths not far from those of government bonds), and low interest rates. At the same time, we upgraded government bonds by one notch to neutral. While their yields should grind higher at a slow pace, markets have already started to anticipate this move. We believe that selected government debt can now be similarly rewarding as good-quality IG. We maintain our neutral view on high yield, and continue to prefer emerging market bonds in hard currency.
3 Equities				→		Our positive view on equities remains intact and the same applies to all sub-segments. They beat bonds in terms of excess returns, for example, and favorable earnings reports suggests that most companies have so far weathered the pandemic quite well. This should continue to support their shares in the medium term. We stick to our preferences by regions, i.e. a neutral stance on European and an overweight on US, Swiss and Japanese equities. Emerging market stocks remain a strong overweight due to, among other things, a friendlier approach by the Biden administration.
4 Gold				→		Gold remains dear to us and an overweight, although we have taken some profits to finance our positive view on commodities. We continue to like the precious metal as a portfolio diversifier that protects against unforeseen risks. A continued US dollar weakness would also provide support for gold.
5 Commodities				↗		We have upgraded commodities from neutral to positive as we think they are now likely to benefit from the cyclical recovery of the global economy. Like gold, commodities will gain if the US dollar weakens. The release of pent-up demand should also support prices. Another reason is that commodities represent a natural hedge against inflation.
6 Alternative strategies			→			We reiterate our negative view on hedge funds and our neutral take on other types of alternative investments, such as insurance-linked securities. This leaves us with an overall neutral – and therefore unchanged – view on alternative investments.

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

We may also remember the pandemic for “great reflation” expectations

While the US death toll from the pandemic has passed half a million, the global number of new Covid-19 infections and fatalities is in a downward trend. This will allow governments to gradually relax social distancing rules, which bodes well for economic growth, but also suggests temporary price pressure. Economists and market participants increasingly engage in “great reflation” debates, a scenario that prices of stocks and bonds are beginning to reflect. Central banks look set to look through an inflation rebound this year and focus on the medium-term, as we are unlikely to move to a new post-crisis inflation regime.

Reto Cueni, PhD
Chief Economist,
Vontobel

Michaela Huber
Junior Economist,
Vontobel

Sandrine Perret
Senior Economist and
Fixed Income Strategist,
Vontobel

Sven Schubert, PhD
Head of Strategy Currencies,
Vontobel

The pandemic continues to produce good and bad news. On the one hand, there is early evidence that vaccinations significantly reduce the number of new Covid-19 cases and admissions to hospital. On the other hand, virus mutations remain a concern. Vaccination campaigns have accelerated after a slow start, but at the same time, there are large discrepancies between countries. While in the UK and the US, for instance, 60% of the population are expected to receive a first jab by April or May, there are worries it could take a year longer for the European Union (EU) to reach this stage (see chart 1).

We hold on to a favorable economic scenario

Nevertheless, in light of the expected success of vaccination campaigns and the latest favorable economic data, we stick to our cautiously optimistic baseline scenario “Boarding”. Governments’ financial aid should be sufficient to keep second-round effects (i.e. bankruptcies, layoffs) manageable. The re-opening of the economy and the impact of several base effects[1] will push inflation temporarily above the central banks’ targets in many developed economies before abating to more normal levels around the turn of the year. The monetary authorities will hardly change course as they, too, seem to consider transitory the forthcoming jump in inflation rates. Markets, however, might take a different view. The recovering global economy may bring temporary shortages in transport capacities or other supply side factors, making inflation estimates more prone to revisions.

Europe: Locked down for longer

Despite declining Covid-19 numbers in most countries, the relatively strict lockdowns in many European regions are likely to remain in place even longer, dampening economic activity in the first quarter. We have, therefore, reduced our growth forecast for 2021 again, but still expect a strong economic rebound in the second and the third quarter amid a relaxation of lockdown restrictions. Regarding inflation, the economic recovery, different base effects, and factors such as consumption-driven changes in inflation calculations, already pushed inflation into positive territory in January. We expect the price measure to overshoot the European Central Bank’s 2% target this year before a probable quick drop below that level at the end of the year. The transitory nature of these effects should prevent the ECB from prematurely abandoning its

[1] In 2020, a base effect stemmed from energy prices falling massively in March and staying low throughout the year, pushing inflation down. In March 2021, the year-on-year price comparison starts from a very low base (from March 2020), which increases inflation mechanically throughout the year.

ultra-expansionary policy while keeping markets' inflation expectations volatile. Finally, fiscal stimulus and other supportive measures should limit the number of bankruptcies and layoffs. The huge debt pile should remain bearable thanks to the help from central banks, but discussions about reinstating European debt-limiting rules may worry some observers.

US: Looking through the inflation rebound

The number of Covid-19 cases in the US has fallen from a peak in January to a level last seen in October 2020. Alongside a fast start of a vaccination campaign (see chart 1), this will put the US economy on a solid growth path in the second and third quarter. Our GDP growth forecast of 5.0% for 2021 could even be exceeded, in our view. Core retail sales in January were up 6% month-on-month, a sign that consumers have started to spend again, also thanks to incoming government money aimed at propping up the poorest households. A Democrat-supported plan for additional fiscal stimulus worth 1.9 trillion US dollars is set to fire up growth even more later this year. As always, there is a risk that an "overheating" economy will come at the price of higher inflation, and financial markets have to a degree priced in this possibility. So far, inflation is a small concern to the US Federal Reserve. Chairman Jerome Powell sees the upcoming inflation pick-up as transitory and is putting more emphasis on supporting the labor market recovery. According to the Fed, labor market "slack" makes the current 6.3% headline unemployment figure appear too small (see chart 2).

Japan: State of emergency sours sentiment

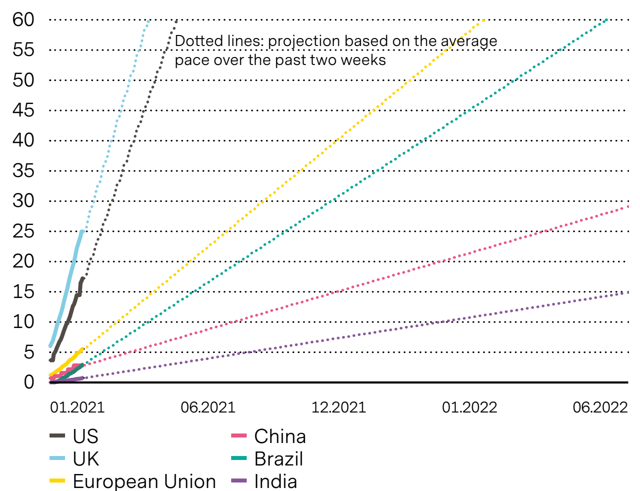
The pandemic-linked state of emergency in some of Japan's prefectures has dampened domestic demand and weighed on wages. While we expect activity to pick up again in the second and third quarter, we have slightly trimmed our 2021 GDP forecast to 2.5%. Deflation, rather than inflation, has dogged Japan for years, and concerns regarding a broad downward trend in prices won't disappear overnight. However, we expect price pressure to stabilize in the months ahead.

China: Getting off the monetary gas pedal?

The impressive recovery in emerging markets (we peg GDP growth at 6.2% in 2021 versus an estimated contraction of –2.4% last year) is mainly due to Asia's dynamic development. Here, most hard-hit economies have staged a spectacular comeback while others such as China, Taiwan and Vietnam haven't stopped growing, not even last year. It is worth noting that the recently announced Indian state budget for 2021 is likely to push growth close to 10%. The broad recovery should help countries like India or Brazil to stabilize their debt-to-GDP ratios, which should lead to falling risk premia. Inflation in emerging markets will rise this year, but the core rate – excluding volatile components such as energy prices – probably won't overshoot central banks' targets. As far as monetary policy is concerned, China may be the first country to gradually embrace normalization, i.e. abandon some measures to support economic growth. In any case, we stand by our forecast for Chinese growth of 8.5% in 2021.

Chart 1: Two thirds of the population in the UK and the US seen getting first Covid jab by April or May

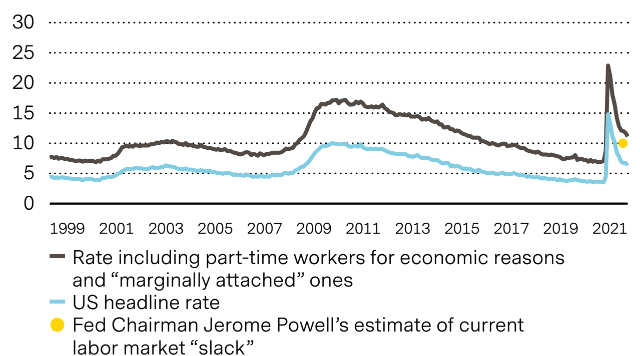
% of population treated *



* With first of two doses
Source: Our World in Data, Vontobel

Chart 2: Fed says US unemployment rate may actually be higher than 6.3% due to labor market "slack"

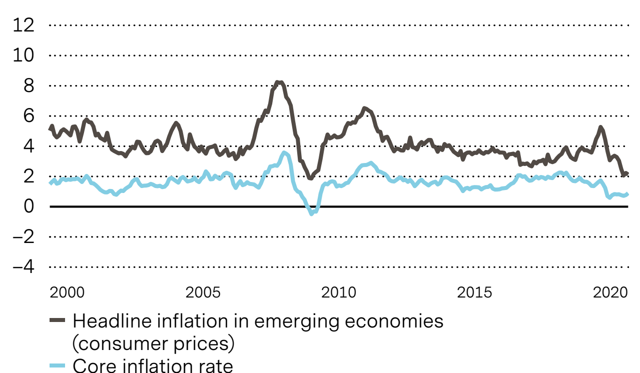
US unemployment rate



Source: US Bureau of Labor Statistics (BLS), US Federal Reserve, Vontobel

Chart 3: Moderate inflation pressure in emerging markets

Year-on-year change in %



Source: Refinitiv Datastream, Vontobel

Dispelling three sustainability myths for bond investors

If you're not plugged into ESG, you're chasing a Tesla with a Trabant. Today's reality is that more and more people want to do good. Moreover, regulators are pushing investors towards sustainability. With fast change (and progress) comes a need to adapt, which then requires a period of learning and adjustment. In this article, aimed at investors possibly considering products in line with environmental, social, and governance (ESG) standards, our fixed income specialists challenge three common myths related to ESG and bond investing.

—
Simon Lue-Fong
Head of Fixed Income Boutique,
Vontobel

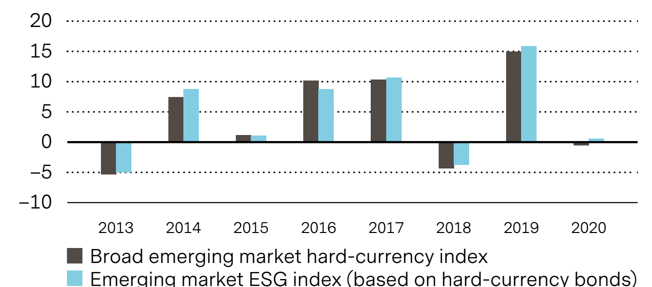
—
Darya Granata
Client Portfolio Manager
Fixed Income Boutique,
Vontobel

—
Anna Holzgang
Head of Sustainable Bonds,
Vontobel

Let's first look at what one might call the bonus myth: that ESG is a detractor to performance. This need not be the case. To give just one example, using emerging market hard-currency sovereign indices, during the past seven years (according to JPMorgan research), the emerging market ESG index has delivered higher returns and lower risks than the broader index (see chart below).

Sustainable emerging market hard-currency bonds exhibit superior returns

Performance in %



Past performance is not a guide to current or future performance.
Source: JPMorgan (data as of September 2020)

Simon Lue-Fong busts myth 1. "Fixed income investors cannot drive change in corporate management"

Fixed income markets are often underestimated as a powerful place for pushing sovereign and corporate issuers to implement ESG change. Some people perceive this as being a privilege of equity investors. However, there are powerful pricing mechanisms at play in primary and secondary bond markets that investors can use to have a tangible ESG impact.

The common perception is that fixed income investors are merely capital lenders with little leverage on management decisions. While accurate, this view ignores that bond investors are capital providers, whose convictions are reflected in market prices and bond valuations, which determine a company's cost of capital. Nowadays, bad "sustainability headlines" are likely to drive some potential investors away, pushing down the bond price and driving up the yield.

Critics might say the real action takes place in primary markets, where capital is allocated, and not in secondary markets, where it only changes hands. However, this is only partly true. With very few exceptions, companies and governments are serial issuers that tap the market repeatedly in order to refinance themselves, and provide a benchmark for secondary market trading. So, if a company has a questionable ESG track record, investors are likely to be wary. As a result, they will demand a higher yield on the issuer's bonds in the secondary market, which has a direct effect on the pricing mechanism of new issuances in the primary market. Higher yields translate to higher interest expenses, which hit the company where it hurts: the bottom line.

Engagement has risen to fame through belligerent equity investors forcing companies into action to address obvious weaknesses and thus maximize shareholder value. In fixed income investing, engagement is a less glorious affair. Without the option of proxy voting, bond investors' power to engage with issuers is more implicit than explicit and must develop further. As capital providers, bond investors have direct access to company management as well as government officials and are able to raise contentious issues. However, to avoid being palmed off with a polished PR answer, more collective action is required from bond investors who tend to only come together in the case of defaults and debt restructurings. The good news is that, in light of ESG's fast advance, it will only be a matter of time until bond investors find a common forum to press issuers on sustainability concerns – not least because, ultimately, ESG improvement can have a direct bearing on credit quality.

Darya Granata busts myth 2. "Relying on ESG-agency scores is sufficient to implement ESG"

Bond investors constantly track the credit ratings of the three big agencies, S&P, Moody's, and Fitch. These are established players, their approaches are similar and the results rarely differ in a fundamental manner. We as active, high-conviction asset managers look beyond the "usual" ratings, also regarding ESG. That industry is much younger and the variety of approaches often leads to different ESG scores.

Our analyst Lara Kesterton has quantified these differences in a recent article. There, she explained that there is a strong level of agreement among rating agencies when comparing credit ratings, which have a correlation coefficient of 0.964, close to the maximum of 1. This means that rating agencies are in almost perfect agreement when it comes to assessing the probability of a bond issuer defaulting. However, in the area of ESG ratings, the correlation is 0.493, more than halfway to zero, which indicates ratings are halfway between perfect agreement and complete randomness.

Beside subjectivity, data quality is another problem for ESG ratings. Not all companies are ready to deliver all the information ESG rating agencies require for their scores. For example, smaller companies (e.g. issuers of high yield debt or from emerging economies) are often not as advanced when it comes to reporting and disclosure. They often get a weaker score due to the lack of information, or sometimes receive a gap-filler score such as a sector average. Therefore, investors should rely on a broad range of information to identify "ESG leaders". This is also what we do in our team of credit analysts and portfolio managers – but not only that.

We believe it is important to understand ESG risks on the level of the individual issuer, and appreciating their impact on performance.

While history helps us understand the future, another reason not to rely on a single rating is its backward-looking nature. This is something ESG ratings have in common with credit ratings. "We are not a news agency", I once heard at an ESG-rating seminar, which is true. This infor-

mation lag also creates opportunities. In the corporate bond world, you often hear about "rising stars," companies, whose ratings change from high yield to investment grade, creating a pay-off for early investors. A company may not currently have a high ESG rating, but our fixed income portfolio managers such as Anna Holzgang (who will be dispelling myth number three below), focus on the transition of a company to an improved level of ESG. On the one hand, you can find and invest in an ESG rising star, an ESG leader. On the other, you are supporting companies with a credible transition plan.

Let's take an example, the utility sector. Here, we focus on utilities that are contributing to the transition to clean energy. So, we also accept utilities that don't have the highest ESG rating yet, but where we see an investment opportunity where we find a tangible improvement in the business model towards energy efficiency and renewables.

Anna Holzgang busts myth 3. "Companies with high ESG risks have no place in a sustainable approach"

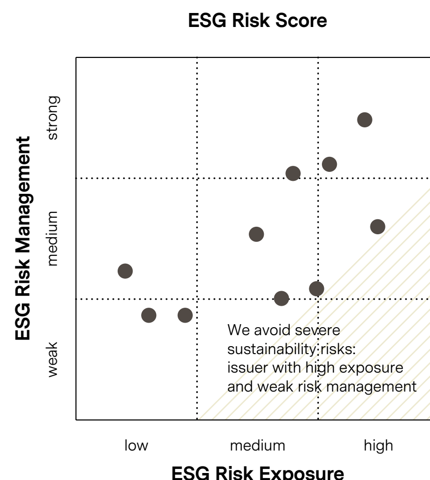
We don't automatically exclude companies with high ESG risks provided the company manages these well and has a clear transition plan to reduce them (see table below). Focusing on the ability of companies to manage ESG risks has an additional benefit as our experience suggests that issuers who actively engage on sustainability issues tend to have better overall risk management.

Throughout my investing career, I have noticed that excluding a significant part of the investment universe, the so-called "best-in-class" approach, is not the optimal way to go. For example, we may exclude electricity-generating companies that derive over 10% of their revenues from coal-fired power, but where companies have a clear exit strategy, we might raise the revenue threshold to 25%. We have clear limits, though, such as avoiding the most risky segments and risks stemming from bad governance and large exposure to environmental and social incidents.

We don't impose moral or ethical values, but focus on material ESG risks. Therefore, an investor should keep exclusions to a minimum. This helps achieve sufficient diversification. A key question is: what material impact will such a risk have on a company's cash flows? Unmanaged sustainability issues can significantly affect a company's financial flexibility. If governments decide to increase CO_2 taxes, for example, this could hit a company's results if it doesn't prepare properly.

We believe that ESG considerations are an integral part of every fixed income strategy, not just sustainable strategies: all bond investors should integrate sustainability into their analyses of both sovereign and corporate issuers.

ESG Risk Score



Source: Vontobel

Italian bonds set to benefit from Mario Draghi’s move into politics

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel

Bonds have suffered this year due to “reflation trade” concerns. We don’t expect central banks to react to rising inflation fears, least of all in the euro zone, where we add exposure to Italian debt. We stay underweight in high-rated corporate credit where both higher duration and very tight spreads offer limited risk-reward prospects.

The “reflation trade”, i.e. expectations of rising inflation rates, blindsided government bonds early this year. A steady increase in market-based inflation expectations pushed up US nominal yields higher, which started to send real yields higher as well. The magnitude of the increase was larger and came earlier than previously anticipated, exceeding our expectations of a gradual return of yields to more normal levels this year from a very low (pandemic) level. Even so, we stand by our view that central banks will look through higher inflation in staying highly accommodative this year. We therefore turn neutral from negative on government bonds after the underperformance observed since the beginning of the year, mainly by adding exposure to bonds issued by “peripheral” European governments.

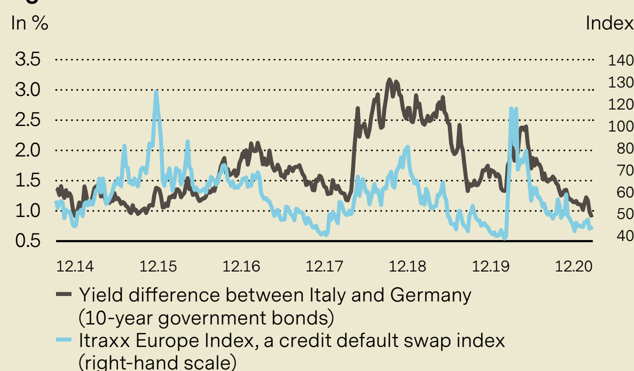
“Super Mario” effect calms Italian bond market

Political uncertainty in Italy increased in early January after Prime Minister Giuseppe Conte’s majority in parliament fell apart. The instability ended with Mario Draghi’s appointment as his successor. The move of the former European Central Bank president into domestic politics instilled fresh confidence into Italian markets. Commentators highlighted Draghi’s experience and authorship of the decisive “whatever it takes” line that prevented a break-up of the euro area in 2012. The spreads of Italian bonds to German benchmark ones have narrowed, and we expect this to continue. While solving long-term challenges in Italy will probably take longer than what “Super Mario” can achieve while in office, growth-friendly reforms can help investors feel confident of the country’s medium-term outlook.

Negative on investment-grade corporates

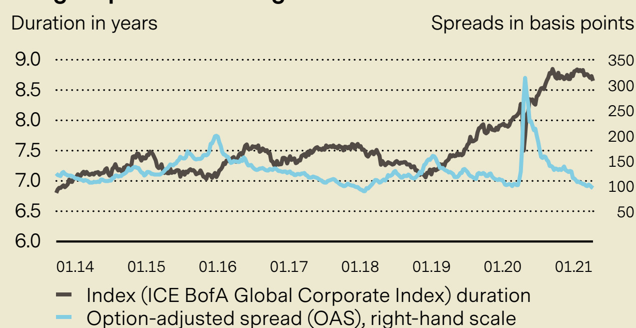
Another asset class that underperformed this year is investment-grade corporate bonds. This comes after the segment finished 2020 ahead of most other fixed income assets following a full recovery from previous lows. Its return potential now appears limited owing to, among others, the still very narrow yield gap to comparable benchmark issues, and higher duration. Therefore, we have cut investment-grade corporate bonds to a double underweight. This segment, while likely to benefit from an expected economic recovery that would also limit the probability of a rise in issuers’ default rates, is unlikely to repeat last year’s performance in 2021, in our opinion. We believe that other fixed income assets such as emerging market debt offer better perspectives.

Chart 1: Italian spreads to Germany are expected to tighten further



Source: Refinitiv Datastream, Vontobel

Chart 2: Investment-grade bonds less attractive due to tight spreads and long duration



Source: Refinitiv Datastream, ICE BofA Merrill Lynch, Vontobel

Will higher yields spoil the equity party?

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

It has been said there is no alternative to equity investing, but some investors feel a bit dizzy after the recent bull run. One small cloud on the horizon may be the recent rise in yields. These have been uninvited guests before, but we don't expect them to again crash the equity party in the short term. After all, real interest rates are still low, and central banks aren't likely to deviate from their generous monetary policy.

Equities started the year with the burden of relatively high valuations – not only owing to central banks' generous liquidity injections, but also high market expectations. This year, analysts expect earnings to grow by about 30% for companies in the global equity index.

We remain confident that the companies will be able to meet or even surpass these expectations. The current reporting season suggests as much. Although analysts have been revising their earnings estimates upwards for months, three out of four companies surprised on the upside (see chart 1). Although a slight majority of companies usually beats expectations, their performance is impressive nonetheless. No wonder market participants were pleased.

Economic rebound isn't only good news

While companies and their shares benefit from the global economic recovery, this isn't only good news for equities. The current confidence has also lifted long-term bond yields across all regions since February, posing several risks for equity investors because the value of future profits decreases with higher rates due to a higher discount factor. Simultaneously, the attractiveness of bond investments increases with rising yields. Some of last year's flows from fixed income into equity markets could be reversed.

Look at the real thing

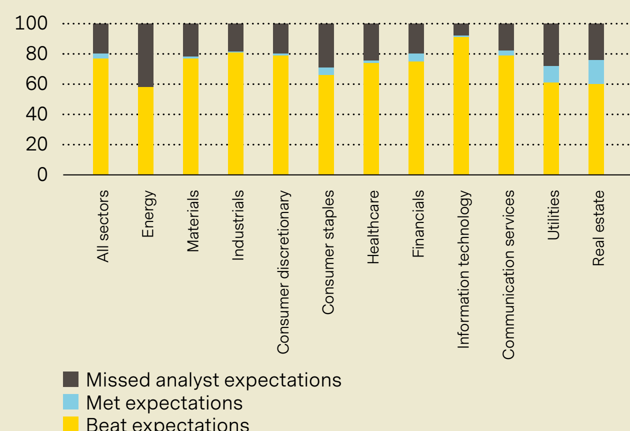
However, it is important to distinguish between nominal and real interest rates. The valuation of shares, which reflects expectations of future profits, correlates most strongly with real, less with nominal yields. When real interest rates fall, as they did last year, the shares' price/earnings ratios go up (see chart 2).

At present, real interest rates are not yet rising noticeably, so the valuation ratios have not moved either. The economic recovery is not only driving up nominal yields, but also inflation expectations. As such, the difference between nominal yields and inflation, i.e. real yields, is broadly unchanged. As long as this remains the case, and this is what we expect, equity prices seem to have little to fear from rising interest rates.

The situation would change if central banks abandoned their market-friendly stance. In 2013, for example, the US Federal Reserve wreaked havoc on financial markets after it hinted at ending bond purchases – a scenario that Fed chairman Jerome Powell recently ruled out. Therefore, we retain our equities overweight, presently shrugging off the rise in long-dated yields.

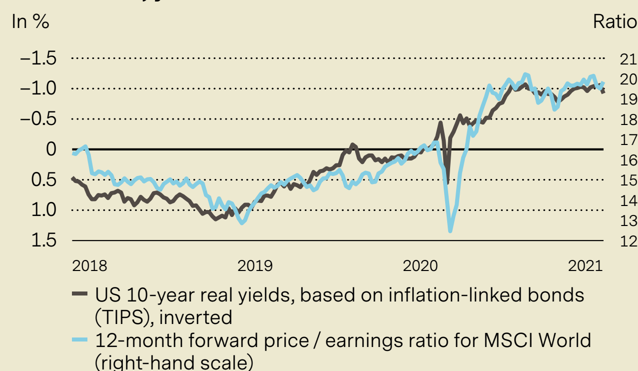
Chart 1: Fourth-quarter earnings of most companies above expectations

After reports by 56 % of the companies in the MSCI World



Source: Eikon, Refinitiv Datastream, Vontobel (data as of February 22, 2021)

Chart 2: Valuation multiples typically move with real, not nominal, yields



Source: IBES, Refinitiv Datastream, Vontobel

Commodity bears are on their way out

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

Hopes are high that a recent commodity rally foreshadows a new bull market. Bears indeed seem to be on their way out. Moreover, investors can expect attractive roll yields from transactions in futures contract. We move to commodity overweight.

Commodity prices move in long cycles. A surge in demand usually pushes prices higher at first. Higher returns attract new investors, which leads to investments in production facilities, and eventually, overproduction. The price then falls and the whole cycle starts again.

Starting in 2000, China's insatiable appetite for commodities triggered a price rally and a search for new mines or oil fields, before the global financial crisis put an end to the boom. Later, new input from the burgeoning shale oil industry sent prices even lower. It took years – until 2020 – before prices of the black gold bottomed out.

Bulls waiting to range free

There is talk of a new commodity super-cycle and we, too, have heard the bulls stomping their hooves impatiently. One of the catalysts could be strong demand for energy from renewable sources tied to international initiatives to make the economy more sustainable. Industrial metals, for example, should benefit greatly from the popularity of solar and wind power plants as well as electric vehicles. This comes against the backdrop of declining investments in new mining projects. Another limiting factor is the Covid-19-related closure of production facilities.

Oil, on the other hand, may be a bystander in the possible super-cycle. Even so, the world's most-traded commodity will hardly revisit last year's lows, but keep above a level of 60 US dollars per barrel, in our opinion. Supply issues may play a role because the oil industry is attracting less investment, with the exception of the shale oil segment.

Futures contracts reflect expected shortfall

So-called technical analysis – research focusing on a commodity's overcoming or undershooting important price points – also suggests an upward move (see chart 1). Further, the commodity futures market now reflects a shortage somewhere down the line. Short-term traded futures contracts currently trade higher than longer-term ones, which usually suggests low inventories (see chart 2, example oil). Investors in commodities also benefit from this situation via positive roll yields. In times of negative interest rates, investors earn a solid running yield if commodity prices remain flat. If they rise, as we see this happening, the asset class becomes all the more attractive. Accordingly, we have increased the commodity weighting in our portfolio and are now overweight.

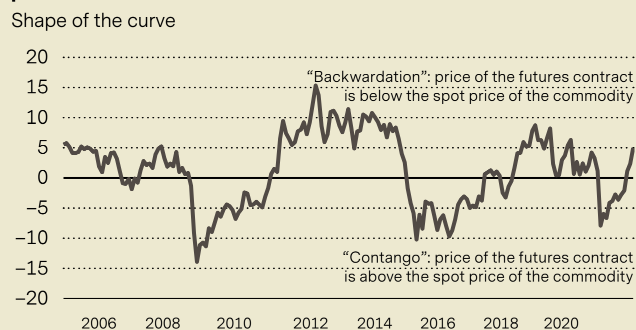
Chart 1: Commodities bounce off an important price level on technical support

Index

Source: Refinitiv Datastream, Vontobel

Chart 2: Commodity price curve currently points to positive roll returns

Shape of the curve



If short-term contracts trade higher than long-term ones, as is currently the case, investors can make a profit from selling the former and buying the latter (roll yield)

— Price curve of Brent crude oil (10-month versus 34-month contract)

Source: Goldman Sachs Research, Vontobel, data as of October 2020

Growth prospects put spotlight on export-linked currencies

—
Sven Schubert, PhD
Head of Strategy Currencies, Vontobel

Our outlook for a global synchronized recovery shines a light on cyclical currencies, which look set to gain strength versus the US dollar, the Swiss franc and the Japanese yen. Within emerging markets, those with weaker fundamentals could outperform temporarily.

The beneficiaries of a global synchronized recovery are cyclical currencies from the Asia-Pacific region (Australia and New Zealand), Europe (Sweden, Norway, the European Union, the UK) and emerging markets. All these currencies pertain to export or commodity-dependent economies. In the case of the UK, pound sterling is exposed to the financial industry and globally active companies.

The euro is still going strong

Economic green shoots traditionally benefit export-oriented economies such as Germany. This present a supportive argument for the euro. Another reason why the currency could gain strength is the likely easing of lockdown measures – particularly important for Europe because the region's economic might is rooted in the so-called "old economy" – traditional production – and less on high-tech companies, which have thrived during the pandemic anyway. Therefore, we believe the euro will continue its rally versus the dollar in the next few months.

But we also see increasing signs that the upward move in the EUR / USD pair is in a late cycle. The US Federal Reserve's monetary policy ceased being more aggressive than that of the European Central bank. Consequently, interest rate differentials have stopped moving in favor of the euro (see chart 1). Lately, ten-year government bond yields have risen faster in the US than in Europe, not the least because market participants expect the US Fed to be an earlier mover in terms of rate hikes relative to the euro area. We don't expect the Fed to move on the rate front before 2023, which means that the EUR / USD recovery should come to an end around 1.25 in the second half of 2021, in our opinion.

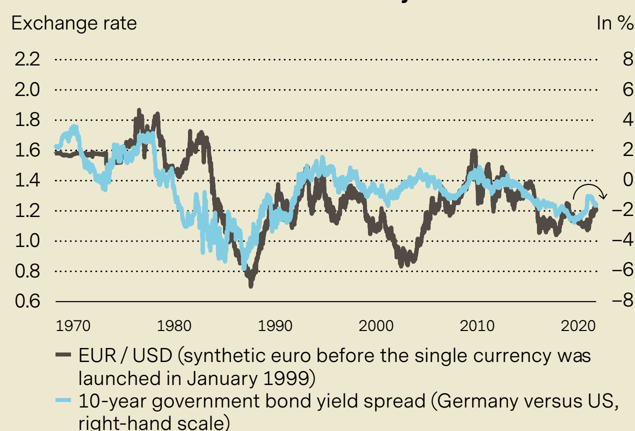
Franc and yen seen lagging, but solid

When cyclicals take center stage, safe haven currencies like the Swiss Franc or Japanese yen are left behind as a rule. While they will probably lag behind the euro, they are underpinned by factors like undervaluation (see chart 2) and sizable current account surpluses. At the same time, we doubt the Swiss franc could sustainably break above 1.10 (EUR / CHF) and 0.90 (USD / CHF).

Emerging market currencies with upside

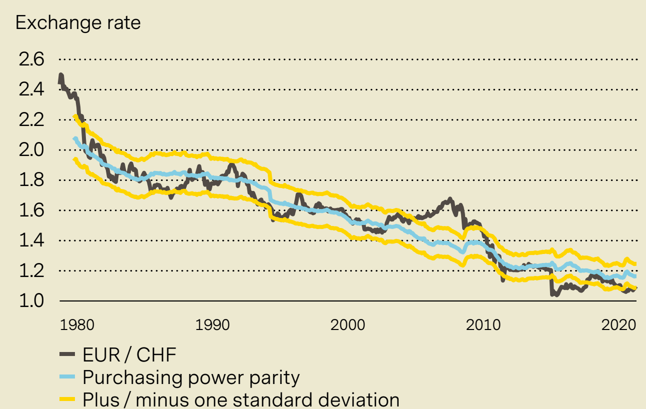
A global recovery, higher commodity prices and loose monetary policies are likely to support emerging market currencies. Some vulnerable ones like the Brazilian real or the Indian rupee may outperform as markets currently appear to be shrugging off high government debt (Brazil) or rising non-performing loans (India). Medium to longer-term, we see more potential for Asian currencies. China's economic opening is attracting direct investments, equity and debt flows, which should prop up regional currencies. We forecast USD / CNY to fall to 6.30 over the next few months.

Chart 1: Spreads between government bonds have moved in favor of the US dollar lately



Source: Refinitiv Datastream, Vontobel

Chart 2: Euro's fair value relative to the Swiss franc continues to decline



Source: Refinitiv Datastream, Vontobel

Economy and financial markets 2019 – 2022

The following list shows the actual values, exchange rates and prices from 2019 to 2020 and our forecasts for 2021 and 2022 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates and commodities.

GDP (IN %)	2019	2020	CURRENT	FORECAST 2021	FORECAST 2022
Euro zone	1.3	–6.8	–5.0	4.3	3.3
US	2.2	–3.5	–2.5	5.0	3.5
Japan	0.7	–4.9	–1.1	2.5	1.8
United Kingdom	1.3	–9.9	–7.8	5.0	4.8
Switzerland	1.1	na	–1.7	3.5	2.8
China	6.1	1.9	6.5	8.5	5.8
INFLATION (IN %)					
Euro zone	1.2	0.3	0.9	1.7	1.4
US	1.8	1.2	1.4	2.1	2.0
Japan	0.5	0.0	–1.1	0.2	0.3
United Kingdom	1.8	0.9	0.7	1.8	1.5
Switzerland	0.4	–0.7	–0.5	0.5	0.9
China	2.9	2.5	–0.3	1.7	2.3

KEY INTEREST RATES (IN %)	2019	2020	CURRENT	FORECAST 3 MONTHS	FORECAST 12 MONTHS
EUR	–0.50	–0.50	–0.50	–0.50	–0.50
USD	1.75	0.25	0.25	0.25	0.25
JPY	–0.10	–0.10	–0.10	–0.10	–0.10
GBP	0.75	0.10	0.10	0.10	0.10
CHF	–0.69	–0.76	–0.75	–0.75	–0.75
AUD	0.75	0.10	0.10	0.10	0.10
CNY	4.35	4.35	4.35	4.35	4.35
10-YEAR GOVERNMENT-BOND YIELD (IN %)					
EUR (Germany)	–0.2	–0.6	–0.4	–0.4	–0.3
USD	1.9	0.9	1.3	1.1	1.4
JPY	0.0	0.0	0.1	0.0	0.1
GBP	0.8	0.2	0.6	0.4	0.7
CHF	–0.5	–0.5	–0.3	–0.5	–0.3
EXCHANGE RATES					
CHF per EUR	1.09	1.08	1.08	1.10	1.10
CHF per USD	0.97	0.88	0.89	0.88	0.89
CHF per 100 JPY	0.89	0.86	0.84	0.85	0.88
CHF per GBP	1.28	1.21	1.24	1.29	1.25
CHF per AUD	0.68	0.68	0.69	0.70	0.66
USD per EUR	1.12	1.22	1.21	1.25	1.24
JPY per USD	109	103	106	103	101
USD per AUD	0.70	0.77	0.78	0.80	0.78
CNY per USD	6.51	6.51	6.86	6.30	6.30
COMMODITIES					
Crude oil (Brent, USD/barrel)	66	52	63	65	70
Gold (USD/troy ounce)	1521	1898	1810	1900	1900
Copper (USD/metric ton)	6149	7749	8424	8500	10000

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 18.02.2021, forecasts as of 16.02.2021

Disclosure notice and disclaimer

1. Analyst confirmation
The financial analysis contained in this Vontobel Report was prepared by the organisational unit responsible for financial analysis (Group Investment Strategy, Global Equity Research and Global Trend Research, Buy-Side Analysis divisions) of Bank Vontobel AG, Gotthardstrasse 43, CH-8022 Zurich, Tel +41 (0)58 283 71 11 (www.vontobel.com). Bank Vontobel AG is subject to supervision by the Swiss Financial Market Supervisory Authority FINMA, Einsteinstrasse 2, 3003 Bern (www.finma.ch/e/). The authors listed on page 1 of the study confirm that this study gives a complete and accurate reflection of their opinion of the financial instruments and issuers analysed, and that they have neither directly nor indirectly received any compensation for the specific assessments or opinions held by them in this financial analysis. The compensation of the authors of this financial analysis is not directly related to the investment-banking business-volume generated between Vontobel and the issuers analysed. The authors of this financial analysis do not own any equity securities in the companies analysed. The financial analysis was not made available to the analysed issuers prior to distribution or publication. Individual separate contributions contain no direct or indirect reference to specific financial instruments or issuers, and do not represent a financial analysis. Such contributions may therefore also have been compiled by authors outside the areas responsible for financial analysis. The latter are not subject to the restrictions applicable to financial analysis and are thus not covered by the above confirmation either, and are accordingly not mentioned in the list of financial analysts on page 2 of this document.

Investors' Outlook also regularly contains information on in-house Vontobel fund products. The Bank takes into account any risk of conflict of interest arising due to existing economic interests by having the AM/GIS MACI/Funds Research and Investments unit make the selections of the respective in-house products based on the best-in-class principle. This unit is organisationally and informationally independent of the Bank's sales units and is monitored by the Bank's Compliance department.

The prices used in this financial analysis are the last available closing prices on the indicated cut-off date. Any deviations from this rule will be disclosed. The underlying figures and calculations of any company valuation are based on the latest financial information, in particular the profit and loss statement, cash-flow statement and balance sheet, published by the analysed issuers. As the information comes from external sources, reliance on the information is subject to risks for which Bank Vontobel AG accepts no liability. The calculations and assessments made for the analysis may change at any time and without notice when other valuation methods are used and/or they are based on other differing models, assumptions, interpretations and/or estimates. The use of valuation methods does not rule out the risk of fair values not being achieved within the anticipated forecast period. A vast number of factors influence price performance. Unforeseen changes may arise, for example, due to the emergence of competitive pressure, a change in demand for the products of an issuer, technological developments, macroeconomic activity, exchange rate fluctuations or even a shift in the moral concepts of society. Changes in regulatory or tax laws may likewise have unforeseen and serious consequences. This discussion of valuation methods and risk factors does not claim to be complete. For more remarks/information on the methodological approaches used in our financial analysis and the rating system, see www.vontobel.com/CH/EN/Companies-institutions-research-equity-research.

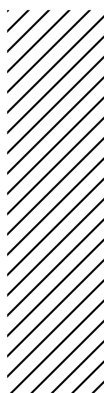
Basis of valuation and valuation methods
The Vontobel financial analysts use a variety of valuation methods (e.g. the DCF and EVA model, sum of the parts valuation, breakup and event-related analysis, key figure comparisons of peer groups and market) to prepare their own financial forecasts for the companies covered by them.

2. Disclaimer and sources
Although the producer believes that the information in this document is based on reliable sources, it cannot accept any responsibility for the quality, accuracy, timeliness or completeness of any of the information contained in this document. This research report is for information purposes only and does not constitute either an offer or a solicitation to buy, sell or subscribe, nor does it constitute investment advice or any advice with respect to tax consequences. The research report was written without regard to the financial circumstances of individual recipients. The producer reserves the right to change and/or retract any opinion expressed in this research report at any time. The producer further points out that the statements contained in this research report are under no circumstances to be construed as advice on tax, accounting, legal or investment matters. The producer neither guarantees that the financial instruments discussed in this research report are accessible to the recipients nor that they are suitable for the recipients. It is recommended that recipients of this report seek advice from an asset manager, investment advisor or other relevant advisor with respect to compatibility with the recipient's own circumstances and with respect to the legal, regulatory, tax and other consequences prior to making any investment decision. The producer does not regard any recipients of this report as clients if there are no other business or contractual relations. Any use of this report, in particular its reproduction in whole or in part, or its distribution to third parties, is only permitted with prior written consent from Bank Vontobel AG and full acknowledgement of sources. Bank Vontobel AG has taken internal organisational measures to prevent any potential conflicts of interest and, if there are any such potential conflicts of interest and they are unavoidable, to disclose them. For more details on handling conflicts of interest and maintaining the independence of the financial analysis department as well as disclosures relative to the financial recommendations of Bank Vontobel AG, see www.vontobel.com/CH/EN/MiFID-Switzerland. Details on how we handle your data can be found in our current data protection policy (www.vontobel.com/privacy-policy) and on our data protection website (www.vontobel.com/gdpr). This publication is deemed to be marketing material within the meaning of Article 68 of the Swiss Financial Services Act and is provided for informational purposes only. If you do not wish to receive any further Investors' Outlook from us, please contact us at wealthmanagement@vontobel.com.

3. Country-specific guidelines and information
The distribution and publication of this document and the investments described in it may be subject to restrictions in some jurisdictions due to local laws and regulations. This document and the information contained in it may only be distributed in countries in which the producer or the distributor holds the applicable licences. If there is no mention to the contrary in this document, it may not be assumed that the producer or distributor holds the applicable licences in any specific country. Please note the following country-specific information must be strictly observed. With the exception of the following distribution-channels, this research report shall be deemed to be distributed by the company indicated on its cover page.

Additional information for US institutional clients
In the United States of America, this publication is being distributed solely to persons that qualify as major US institutional investors under SEC Rule 15a-6. Vontobel Securities, Inc. accepts responsibility for the content of reports prepared by its non-US affiliate when distributed to US institutional investors. US investors who wish to effect any transaction in securities mentioned in this report should do so with Vontobel Securities, Inc. at the address hereafter and not with Bank Vontobel AG: Vontobel Securities, Inc., 1540 Broadway, 38th Floor, New York, NY 10036, Tel 1 212 792 5820, Fax 1 212 792 5832, e-mail: vonsec@vusa.com. Vontobel Securities Inc. New York, with headquarters at Vontobel Securities AG, Gotthardstrasse 43, CH-8022 Zurich, Tel +41 58 283 76 17, Fax +41 58 283 76 49, is a broker-dealer registered with the Securities and Exchange Commission and a member of the National Association of Securities Dealers. Bank Vontobel Zurich is a foreign broker dealer which is not delivering services into the USA except for those allowed under the exemption of SEC Rule 15a-6.

Additional information for UK clients
Bank Vontobel AG is a company limited by shares with a Swiss Banking license which has no permanent place of business in the UK and which is not regulated under the Financial Services and Markets Act 2000. The protections provided by the UK regulatory system will not be applicable to the recipients of any information or documentation provided by Bank Vontobel AG and compensation under the Financial Services Compensation Scheme will not be available. Past performance is not indicative of future performance. The price of securities may go down as well as up and as a result investors may not get back the amount originally invested. Changes in the exchange rates may cause the value of investments to go down or up. Any literature, documentation or information provided is directed solely at persons we reasonably believe to be investment professionals. All such communications and the activity to which they relate are available only to such investment professionals; any activity arising from such communications will only be engaged in with investment professionals. Persons who do not have professional experience in matters relating to investments should not rely upon such communications. Any contact with analysts, brokers or other employees of Bank Vontobel AG must be conducted with Bank Vontobel AG directly and not through offices or employees of Vontobel affiliates in London / UK.



Bank Vontobel AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com