Vontobel

Investors' Outlook

The global economy heats up and stokes inflation fears

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Content

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The global economy heats up and stokes inflation fears

Dear readers,

Just when we thought we could stop hunkering down in our interconnected yet improvised offices (sometimes carved out from a children's bedroom), a third pandemic wave has come upon us. Moreover, inflation worries have suddenly emerged.

March has brought another volcanic eruption in Europe (Iceland this time, after Italy in February), wild swings in weather patterns as well as gusts of change for investors. While the third wave of the Covid-19 pandemic now sweeps across the globe, governments' reactions range from an easing of restrictions amid a successful vaccine roll-out in the US to more lockdowns due to a failed mass vaccination strategy in Europe. Meanwhile, inflation is making a comeback, troubling the sleep of some market participants. Dream or not, this has real-world implication.

Across the Atlantic, consumer sentiment is boosted by the go-ahead for a stimulus package worth 1.9 trillion US dollars, and prospects of an even larger infrastructure package to come. The massive amount of federal and central bank money that's being pumped into the economy has revived fears of a broad upward trend in prices, pushing US Treasury yields higher. This development has made equity investors uneasy, as higher yields can make stocks look less attractive to hold.

When will central bankers blink?
But is inflation something to worry about? The Federal Reserve doesn't think so, reiterating it would keep key rates unchanged through 2023. Rightly so, we believe, as US inflation may spike over 3% – we see this as temporary – while unemployment remains high. Meanwhile, the European Central Bank has gone further. Apart from maintaining its low-rate bias, the Frankfurt authority is ramping up its bond purchases. Elsewhere, central bankers lack such nerves of steel. Brazil and Russia, for example, have hiked rates to curb inflation on the back of rising prices for oil, iron ore and agricultural goods.

—
Dan Scott
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While financial markets and central banks grapple with inflation fears and rising bond yields, equity investors seem to have fallen out of love with tech stocks.
We nevertheless continue to favor equities over cash and bonds. Right now, monetary and fiscal policies drive global growth, which in turn supports cyclical and industrial stocks. We haven't given up on tech just yet.
It is true that equity valuations aren't exactly cheap compared to bonds. Interest rates are and will, however, remain extremely low in historical terms, which puts a spotlight on growth themes. The upcoming earnings season thus looks solid, with analysts currently upgrading their estimates. Continued confidence on their part will help alleviate concerns over lofty valuations in the tech sector, in our opinion.

As for alternative investments, we remain neutral overall, retaining a clear preference for commodities. This subsegment, typically less vulnerable to higher yields than equities, should benefit from the ongoing cyclical recovery of the global economy. What's more, investors are taking a fresh look at commodities after haughtily disregarding them for years. We also stick to our slight overweight in gold, even though prices have recently come under pressure. The precious metal remains an excellent hedge against unforeseen risks.

→ Webcast
To view our webcast on recent market developments, click:
vonto.be/macro-en-apr21

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Central banks keep economy humming – focus on equities

Raising interest rates can put central bankers out of work. This is at least what happened in Turkey following a tightening move in late March. The sacking of the central bank chief reminds us of the huge implications of monetary policy. The country on the Bosporus (pictured) wasn't the only large economy to hike rates in March. Russia and Brazil went down that road too. Will the tightening be replicated in the US or Europe given recent inflation worries? We don't think so. Central banks on both sides of the Atlantic have made it clear they would keep interest rates low to support the economy.

March, said to come in like a lion and go out like a lamb (in weather terms), was a mixed bag. On the one hand, the pandemic continued to trouble investors, and glitches in the roll-out of vaccines contributed to the somber mood in Europe. On the other hand, the massive US relief package worth 1.9 trillion US dollars brightened up the horizon, despite emerging worries that the economy may overheat at some stage.

Gold and commodities also in favor

Like the US and European central banks, we keep a steady course. Our positive view on equities and our negative view on fixed income remain unchanged. While it is true that equities are no longer cheap, we still prefer them to developed-market government paper or investment-grade corporate bonds, for example. Apart from that, shares continue to benefit from ample monetary and fiscal support. We are also confident that equities will be able to stomach the current yield and inflation levels, and take comfort in the good earnings season that lies behind us. Earnings momentum has been positive, and analysts continue to upgrade their estimates.

Within alternatives, rated neutral overall, we have a clear preference for commodities. Gold remains a longstanding favorite of ours. More details on our asset allocation can be found on the overview page 5 and the asset class focus items on pages 12 to 15.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				Holding cash seems to make little sense when interest rates hover around zero (despite the recent uptick) and prospects of rate hikes are pushed further back. Our underweight remains unchanged.
2 Bonds		→				We reaffirm a negative view on fixed income as a whole, but note that investors need to be selective. We remain negative for investment-grade (IG) bonds, which have a long duration paired with unattractive yield prospects. Moreover, their recent weakness makes them a major underperformer within the fixed income segment since the beginning of the year. We maintain our neutral view on high yield after this sub-segment has closed the gap to IG. We also remain neutral with regard to government bonds and continue to favor emerging market debt.
3 Equities				→		Our positive view on equities remains intact and the same applies to all sub-segments. While it is true that equities are no longer cheap, they aren't more expensive than developed-market government paper or investment-grade corporate bonds, for example. Despite the sharp increase of bond yields, equities beat bonds in terms of total excess returns. Apart from that, shares continue to benefit from ample monetary and fiscal support. Our regional preferences remain unchanged: 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, their exposure to structurally growing sectors such as information technology.
4 Gold				→		Despite a recent fall in prices, gold remains an overweight. The precious metal continues to provide shelter during times of market upheaval and thus serves as a hedge against unforeseen risks. We also expect real yields, i.e. nominal yields adjusted for inflation, to remain stable, which reduces an important headwind for gold.
5 Commodities				→		Following our recent upgrade of commodities, we retain our bias. The asset class is drawing strength from the cyclical recovery of the global economy. In addition, investors have started returning to the market after years of abstention. Investors that worry about rising yields and inflation may consider commodities a natural hedge against such developments. Last but not least, commodities will gain if the US dollar weakens.
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 ↘

A tale of two paces: the US and Europe move wider apart in economic terms

The US and Europe are on course for a political rapprochement following a Trump-era estrangement. But in economic terms, the giant markets are drifting wider apart, hopes for a synchronized global recovery notwithstanding.

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The US is, for example, miles ahead in terms of administered vaccine shots (apart from the UK, see chart 1), which puts it in a position to overcome the pandemic stupor much earlier than Europe. US consumers can expect a rather fast relaxation of the restrictions, while their European peers see the restrictions prolonged or even tightened. Another fault line appears when looking at the amount and pace of fiscal stimulus measures. While many US households are already receiving new government-funded checks, European Union member states are still discussing about how to implement the EU recovery fund they agreed on last summer. This will further increase the dichotomy in the mood of the respective service sectors. Meanwhile, sentiment in the industrial sector is solid in the US as well as in Europe, supported by external demand and generally much less affected by restrictions. To cast our gaze beyond the transatlantic allies: Asia continues to manage the containment of the virus well. A slightly weakening business sentiment in emerging economies shouldn't mar their growth prospects.

In terms of monetary policy, the US Federal Reserve is unimpressed by rising yields, while the European Central Bank (ECB) is increasing the speed of its asset purchases to keep borrowing costs low. At the other end of the spectrum, some central banks in emerging economies have started a new rate-hiking cycle. Such differences in monetary and fiscal policies across regions are a harbinger of a multiform normality following a uniform global reaction to the virus in 2020.

"Boarding" scenario confirmed

Before taking a closer look at the big economic regions, we reaffirm our quite favorable economic baseline scenario "boarding". Delays in the euro area's economic lift-off are offset by US departures ahead of schedule.

Europe: close to a relapse

The latest resurgence of Covid-19 infections in major European countries bodes ill for a swift reopening of the economy. The domestic-oriented sectors will continue to suffer from prolonged or even tightened restrictions in important countries like Germany, France or Italy. The slow start of vaccination campaigns weighs on the business outlook, although the success of the UK and particularly the Israeli campaigns is a hopeful sign for the European economy (see chart 1). Meanwhile, government support schemes have been extended or strengthened, which should be enough to keep second-round effects such as corporate bankruptcies or lay-offs manageable. The ECB's latest actions designed to keep financing conditions for companies favorable are welcome, laying the groundwork for a fast recovery once virus containment measures are relaxed. However, the ECB will have a hard time keeping European borrowing costs low if these rise further in the US due to increasing growth and inflation expectations. The Frankfurt authority has so far kept its promise to control the rise in yields.

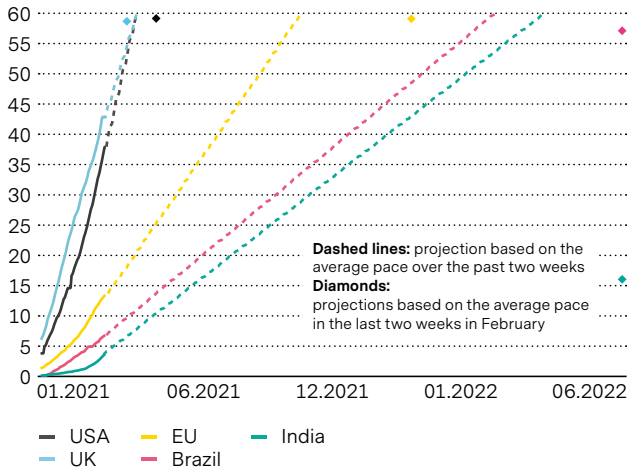
US: stronger than thought
The US economy is cruising ahead of other developed regions, not only in terms of vaccines but also in economic recovery expectations. President Joe Biden's goal to vaccinate 100 million Americans during his first 100 days in office was achieved in approximately half the time, putting the US in the group of the most successful global vaccine champions (see chart 1). With the March signing into law of the American Rescue Plan Act worth 1.9 trillion US dollars, the country is on track to post the steepest rise in the growth rate in decades. But once concerns about an overheating economy emerge, inflation fears follow (see chart 2). In March, the US Federal Reserve dismissed such worries, making it clear that it would keep policy rates unchanged through 2023 (see chart 3) and maintain the pace of its massive monthly asset purchases until further economic progress is made. Chairman Jerome Powell currently isn't concerned about rising long-term yields as long as financial conditions stay easy. We believe measures such as "Operation Twist" to cap a worrying rise in bond yields will be possible at a later stage should rising bond yields threaten the recovery.

Japan: central bank supports the recovery
An improved pandemic situation has allowed the last locked-down prefectures to come out of the state of emergency. The economic recovery will now speed up again, in our opinion. Some growth supportive news come out of the Bank of Japan. The first major policy review since 2016 has resulted in more monetary flexibility for the authority without compromising its accommodative stance.

Emerging markets: hiking cycle has started
Apart from undermining asset prices in late February and early March, the sharp rise in US yields has raised questions regarding the sustainability of the recovery in emerging economies. After all, higher US yield levels make emerging markets less attractive in investing terms, which at some stage prompts rate hikes on their part. The recent start of a fresh tightening cycle by Brazil, Russia, and Turkey, has to be seen from this perspective. Their rate hikes in Mach were not only meant to pre-empt a rise in inflation, but also to re-establish a "decent" interest rate differential to the US. So far, our growth outlook for emerging markets (6.4 % in 2021) and China (8.8 %) remains in place, but we will probably revise our forecasts if we see a continued rise in the US ten-year government bond yield to 2 % and beyond.

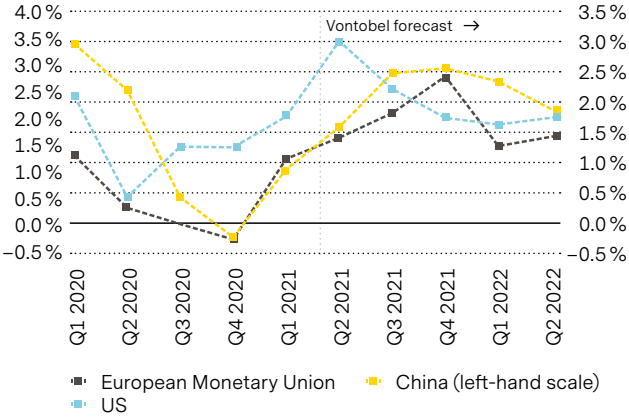
Monetary policy may seem like an academic affair, but even highly regarded central bankers are accident-prone. In Turkey, the massive rate hike of 200 basis points not only undermined the country's growth outlook, but also incurred the wrath of Turkish President Recep Tayyip Erdoğan. His dismissal of the bank governor took only hours, reminding investors of the political pitfalls in this emerging economy. We cannot rule out the possibility of poor governance in countries such as Turkey and Brazil going hand in hand with the seemingly uncontrolled rise in Covid-19 infections there.

Chart 1: US and UK will have given 60 % of their populations at least one vaccine shot by May
% of population treated*



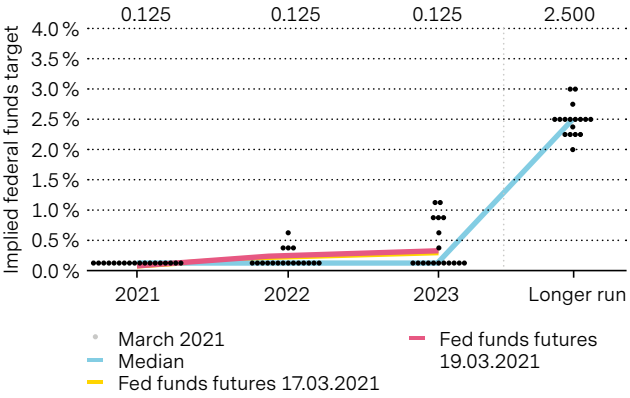
* Counted as any person that received a shot (not differentiating between first or second shot for two-dose vaccines)
Source: Our World in Data, Vontobel

Chart 2: Inflation in the US and Europe seen above central bank targets in 2021, then below in 2022
In %



Source: National statistical offices, Vontobel estimates

Chart 3: Fed "dots" point to first hike after 2023
Projections of the Fed's rate-setting comittee



Source: Federal Reserve, Refinitiv Datastream, Vontobel

How connectivity benefits corporate bond investors

The onset of the coronavirus pandemic was a brutal stress test for society, financial markets, and employment. Throughout last year and to the current day, all attention has been on the pandemic, as it both overshadowed and accelerated a structural change. For several years now, we have highlighted that the fifth-generation telecommunications standard (5G) and connectivity would change the world, bringing with it a prolonged period of lower interest rates. The pandemic gave a turbo boost to this connectivity trend.

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At the beginning of last year, we believed 5G would change the industrial world, because there would be more connectivity between devices and machines. But what we saw in 2020 was a different kind of connectivity, not device-to-machine, but device-to-device. Indeed, it was a brutal stress test as, from one day to the next, we were cut off from friends, loved ones, and our colleagues – we were told to stay home and work from home.

As humans, we are quite resilient and we bounce back – and we did bounce back by overcoming these new challenges. Our unusual isolation pushed us to find new ways to communicate. We did this via connecting apps and platforms such as Zoom, Teams, WebEx, or Skype.

Ten million jobs lost
This connectivity surge was beneficial in that it enabled many of us to keep working from home. Sadly, many employees in sectors such as the hospitality industry were left sitting at home without a job. This brings us back to the apps that have become part of our daily working lives. Far from being just convenient toys, they will actually help transform the employment landscape, we believe.

Employment numbers in the US, for example, paint a grim picture. America currently has a deficit of 10 million, a gap that won't be closed easily. A look at the US employment figures from the 1980s to 2020 (see chart 1) reveals the magnitude of the pandemic-induced job losses. But the chart also shows that in some sectors, hiring restarted soon after a recession. We can glean an important lesson from this.

After the 2008 financial crisis, we see that service-sector jobs declined, but then, they never really recovered. Now, with the Covid-19 crisis and our transition to using apps rather than face-to-face services, we do not expect there will be a significant recovery in the service sector. Why go to the shop to buy new headphones, when you can just press the smartphone screen a few times to find expert advice, search for the best price and then have the product delivered to your door? Each step in this now-typical sales process is deflationary. As technology continues to advance and replace routine processes, it would be no surprise if such jobs, which often require manual labor, ceased to exist after pandemic. And unfortunately, although the coder behind the shopping app and the blogger behind the expert headphone review site may be highly paid, ever fewer of them are necessary.

Low rates forever?
This trend of job polarization puts consumer-spending power under pressure as slack labor markets plus reduced consumption mean that inflation drivers remain scarce, requiring continued low rates (potentially even forever) to keep economies working. In other words, central banks will need to continue their bond buying programs for a very long time

Acutely aware of this 10-million-job deficit in the US, the Fed is committed to keeping rates low until at least the end of 2023 or the beginning of 2024. However, this is not a one-to-two year thing. The digital revolution is structural and, therefore, the employment-deficit problem is going to take a very long time to solve.

The Fed is not alone. Central banks across the world face the same challenges. They have a big task on their hands and they will try to keep yields low to keep the economy ticking. Inflation will be kept in check due to the disinflationary nature of digitalization and 5G connectivity.

Keep calm and get corporate bond "carry"
So, how can bond investors profit from this, if yields remain so low? We think it's not all bad news as this environment provides an opportunity to earn "carry" – i.e. reinvesting proceeds from a low-yielding security in a higher-yielding one, for instance – making corporate bonds a viable choice for investors. In fact, multiple factors support corporate bond prices, reducing their yield difference to comparable benchmark bonds.

Vaccines: A continuous vaccine roll-out probably leading to herd immunity by summer 2021 will help sustain the recovery. Corporate bonds tend to perform well in recovery times as companies act to the benefit of bondholders (e.g. paying down debt, issuing bonds).

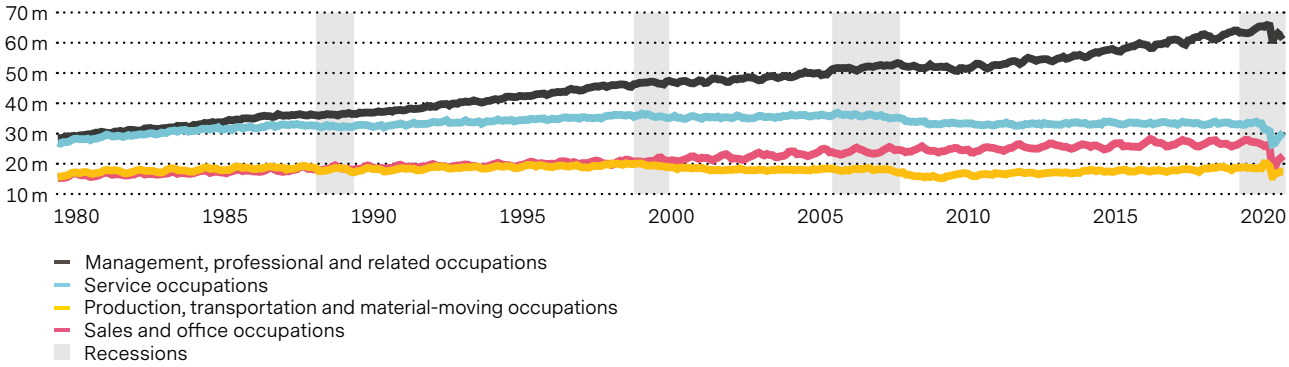
Bond scarcity: Central banks are buying new bonds and replacing maturing ones to keep their extraordinary liquidity programs running. It's premature to even think about a timeline to taper asset purchases. This comes on top of less primary issuance, as many companies prefinanced their needs, taking advantage of rock-bottom rates in 2020. In total, Citigroup Credit Research forecasts a reduction of euro-denominated bonds by 750 billion euros in 2021 – one of the highest amounts we have ever seen (see chart 2).

An uneven recovery: A third supporting factor that helps active investors extract value from corporate bonds lies in the uneven recovery that we are seeing. Some segments appear to offer substantial upside in 2021. We proactively seek opportunities in segments such as cyclicals, transportation and real estate. In addition, we continue to like subordinated banking and insurance.

The fourth industrial revolution
The changes we have discussed here are structural and they will keep rates low for a very long time. We have to think in eras, and an era is 25-to-30 years because digitalization is the fourth stage of the industrial revolution. Investors require returns and they are in need of steady coupon income. We are comfortable with the risk and the attractiveness of corporate bonds, and believe that active investors are in a good position to benefit from selected investments, perhaps for many years to come.

Chart 1: Some US job sectors rebound after recessions, others never recover

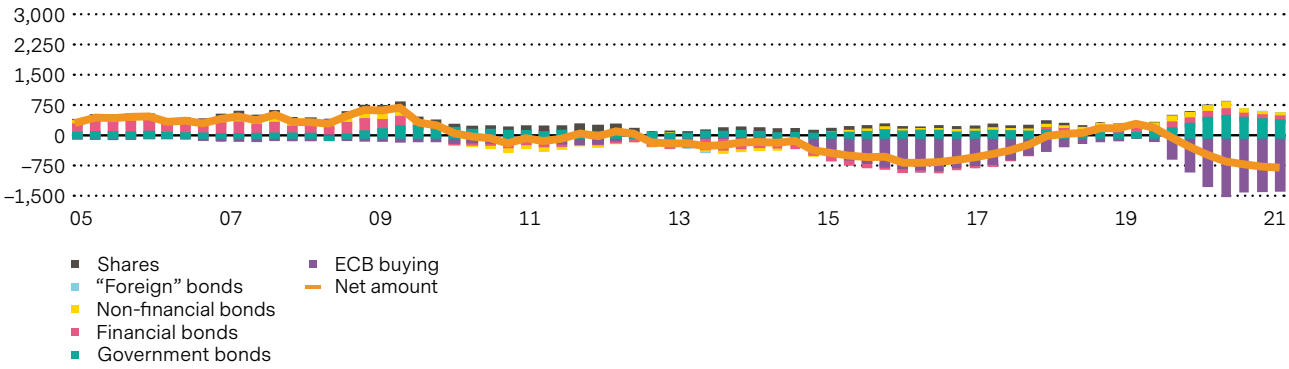
Employees in millions



Source: US Federal Reserve, Federal Reserve Bank of Saint Louis, Vontobel

Chart 2: European Central Bank's massive asset buys drain, and support, the bond market

In EUR billions (2021 figures are estimates)



Source: Citigroup Credit Research

After surprise spike in US yields, any further rise seen more gradual

—
Sandrine Perret
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"Lower for longer" is a term often heard in connection with interest rates. As regards US bond yields, the current motto could be "higher but slower". The ten-year government bond has hit the highest level in almost a year, topping at 1.75% before falling back again. The fast upward move surprised most market participants who had only been looking for such levels to be reached at the end of the year.

The reason for the upward move in US yields is mostly due to favorable US vaccine news, the approval of a massive fiscal relief package by the Congress, growth optimism, and last but not least, rising inflation expectations (also see our macro highlight article on page 6). This has affected long-term yields but also to some extend the shorter maturities such as five-year bonds (see chart 1).

Slower path to higher levels

The question on top of most investors' minds is where yields in the US will go next. We expect them to continue to rise in lockstep with the reopening of the US economy, whose outlook for 2021 is much better than only three months ago. The world's largest economy should be back to trend growth by the end of 2022, ahead of most other developed economies. This will probably push US yields up some more later this year, albeit not at the pace we have witnessed in the first quarter of 2021. A more gradual rise in US yields will be easier to digest for financial markets. That said, given the high degree of uncertainty surrounding the recovery, we cannot rule out sudden moves creating more market jitters.

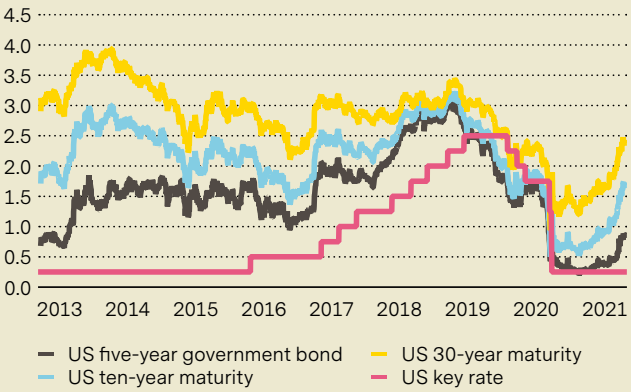
The Fed maintains a hands-off approach

The US Federal Reserve has explained rising long-term yields with better economic and inflation forecasts in the US. In contrast to the European Central Bank, which will pull forward some buys under its so-called Pandemic Emergency Bonds Purchasing (PEPP) scheme to cap rising bond yields, the Fed hasn't announced any such plans so far.

There are several reasons for the US central bank's relaxed approach. Despite rising quickly, US yields are still low in historical terms. Moreover, higher long-term yields so far haven't resulted in any tightening of the currently favorable financial conditions. The Chicago Federal Reserve's measure of financial conditions remain "highly accommodative" as stated recently by US Fed Chairman Jerome Powell (see chart 2). Should the rise in yields start to affect financial conditions or destabilize financial and housing markets, we believe the Fed would move to cap long-term yields by buying more bonds with longer maturities in an "Operation Twist" maneuver, as the authority has done before. For the time being, the Fed is likely to let yields find their own equilibrium as long as this doesn't prompt disorderly markets moves or a tightening of financial conditions. Such a development could endanger the Fed's dual goal of maximum employment and price stability.

Chart 1: Long-term US bond yields rise on growth and inflation optimism

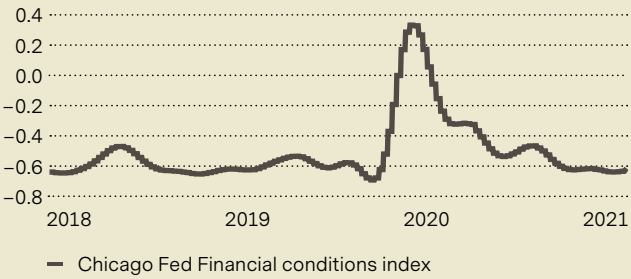
In %



Source: Refinitiv Datastream, Vontobel

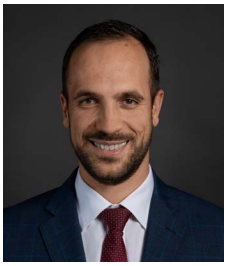
Chart 2: Financial conditions in the US remain easy despite higher yields

Index



Source: Chicago Federal Reserve, Refinitiv Datastream, Vontobel

Higher earnings prospects shield stocks from stiff rate winds



—
Stefan Eppenberger
Equity & Commodity Strategist,
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After weathering the Covid storm, equities face the next challenge in the form of rising interest rates. Can the improving earnings outlook for companies harden them against such headwinds in the coming months? We think so and retain our equities overweight in our portfolios.

Global equity markets continue to perform well with the rally that started a year ago showing no sign of abating. A recent highlight is the turning positive of cyclical stocks after a dismal 2020. Benefiting from strong economic prospects in most regions, this sub-sector is currently outperforming defensive shares. Energy stocks are top of the list this year on the back of rising oil prices.

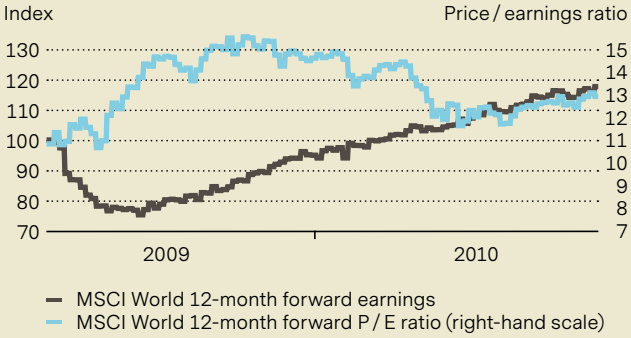
Financials lifted by prospects of higher rates
Meanwhile, weather radars have detected a new worry: higher interest rates. While equity investors usually batten down the hatches in such a situation, some market segments actually thrive in high-interest seas. Financial stocks, for instance, are lifted by prospects of rising income, apart from benefiting from recent strong corporate earnings. These factors have pushed the sub-sector to second place behind energy this year. Technology stocks, whose high valuations are more vulnerable to rising interest rates, are currently buffeted by headwinds leading to temporary losses of more than 10% in the technology-heavy US Nasdaq index, for example. The MSCI global index currently encounters the same difficulty due to its technology bias.

In the past, the expectation of a tighter monetary policy often caused price/earnings ratios to fall. The key question for the coming months is whether the improving earnings outlook for companies can shield them from the rainy spells of rising rates.

Cyclones come and go
Periods of chaotic weather combining low-pressure and high-pressure areas typically occur in the second year after a recession. In the first half of 2010, for example, the high valuations that had piled up in 2009 collapsed. Despite temporary volatility, financial markets then managed to close 2010 in positive territory after a steady recovery in corporate earnings estimates (see chart 1).

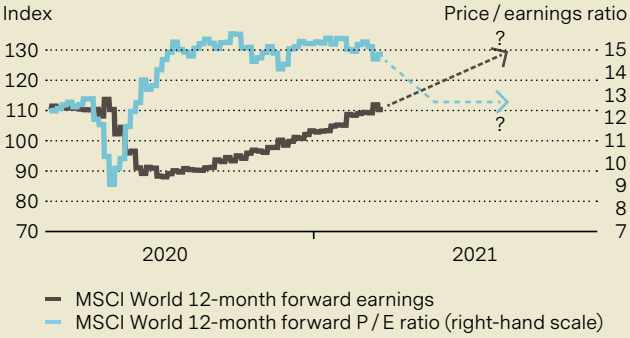
We face a similar situation today. Rising interest rates pull equity valuations down, but earnings expectations are being constantly revised upwards on improving economic prospects. Our confidence regarding equity markets remains unshaken. This could only change if an unchecked rise in yields were to leave investors running for storm shelters despite rising earnings expectations. At the same time, this scenario could well present a buying opportunity.

Chart 1: Earnings growth pushed equities higher in 2010, two years after the financial crisis



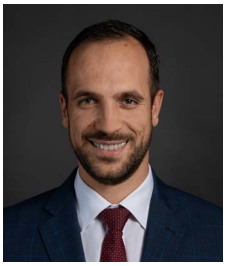
Source: IBES, Refinitiv Datastream, Vontobel

Chart 2: In 2021, earnings growth has sent equities higher so far



Source: IBES, Refinitiv Datastream, Vontobel

Gold loses luster as interest spike proves too strong an attraction



—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

The return of optimism in financial markets has dealt a blow to safe investments including precious metals. Gold currently appears to have lost much of its luster with investors switching to riskier securities. Bullion bulls may yet regain their footing because "peak optimism" will soon be reached, in our opinion.

For many investors, gold is an investment for uncertain times. As if to prove the point, the shiny metal climbed by more than 500 US dollars to over 2,000 USD per troy ounce last year. The surge protected many portfolios from heavy losses in times of economic hardship.

No need for an umbrella when there's no rain
The situation is fundamentally different this year, at least in the mind of most investors focusing on the current vaccination campaigns as well as generous monetary and fiscal policy support. The global economy is humming again, and there is even a sense of euphoria in certain markets. Moreover, previous uncertainty surrounding Donald Trump's policies or the Brexit negotiations are off the table. Consequently, investors as well as speculators are currently withdrawing from "safe havens" – not only precious metals, but also assets such as US government bonds, the Swiss franc or the Japanese yen (see chart 1).

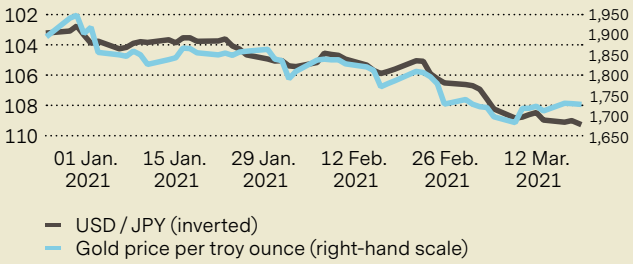
Of course, the next crisis may be around the corner. But most investors appear to think that holding gold is the equivalent of buying bunkers in New Zealand.

With governments increasingly likely to ease some Covid-19 restrictions in the coming weeks and the US Congress recently passing another massive stimulus package, the economic outlook should remain friendly. One pointer of improved economic sentiment is the recent rise in interest rates, even real interest rates that discount any inflation effect. And the more they rise, the smaller the allure of non-interest-bearing gold (see chart 2).

However, we believe this will be short-lived. The US central bank has clearly indicated that it wouldn't counter rising inflation expectations with interest rate hikes. Therefore, interest rates are unlikely to rise faster than inflation, which will keep real interest rates low.

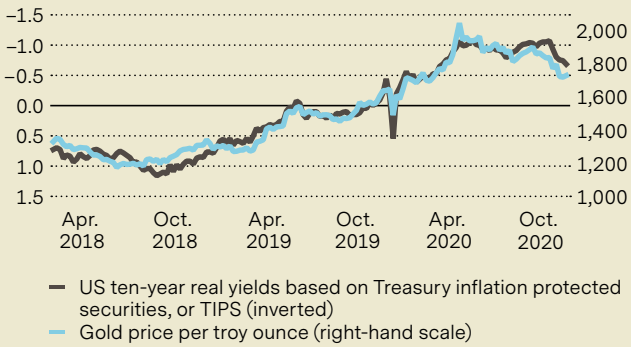
Support seen for gold price
In addition, many leading economic indicators are at such high levels that the next move will more probably be down than up. Other surveys show the potential of economic data to surprise positively has decreased sharply, which lowers the probability of economic signals improving market sentiment further in the next few weeks. Thus, gold prices should remain supported at current levels. We remain slightly overweight.

Chart 1: Gold selling off alongside other safe havens like the Japanese yen



Source: Refinitiv Datastream, Vontobel

Chart 2: Higher US real yields weigh on non-interest-bearing gold



Source: Refinitiv Datastream, Vontobel

Euro could hit a ceiling at around 1.25 versus the US dollar

—
Sven Schubert, PhD
Head of Strategy Currencies,
Vontobel

Our favorable view of cyclical, export-linked currencies like the euro remains in place. However, rising Covid cases in Europe and a surge in US yields are a significant near-term risk. A possible rebound in the greenback could limit the euro's upward potential at around 1.25.

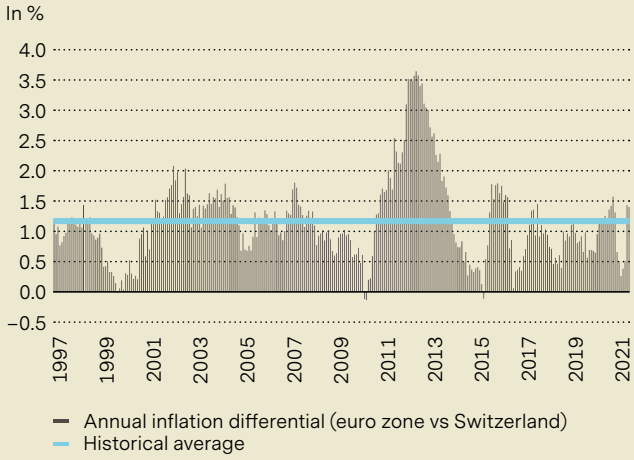
A slow rise in US yields remains key for our base scenario of a recovery of cyclical currencies. In particular, emerging market as well as European currencies should recover from current levels over the next few months. However, we see increasing signs of a USD rebound around the end of year.

Swiss franc weakness only temporary
The euro tried to break above a EUR / CHF resistance level of 1.10 earlier in March on the back of an improving growth outlook. This is, in theory, in line with the upward potential we see for the euro. However, several factors suggest that any weakness of the Swiss franc will be temporary. Firstly, changes in Swiss institutional investors' hedging practices – from around the time of the global financial crisis in 2007 / 08 onwards, they increasingly hedged foreign investments in Swiss francs – limited any downside pressure on the Swiss currency. Secondly, the Swiss National Bank's more stringent inflation targeting (the SNB aims for 0 % – 2 %) versus the European Central Bank's regime (target of 2 % or slightly lower) has contributed to lower Swiss inflation compared to that of the euro zone (see chart 1). This discrepancy causes the Swiss franc's fair value to rise over time.

Prospects of easier lockdown measures, particularly in Europe, are a significant bullish element in our constructive outlook for cyclical currencies like the euro. That said, the recent rise in Covid cases in Europe and renewed lockdowns in countries like Italy are a near-term worry for EUR / USD, with the pair nevertheless drawing support from vaccination campaigns and an improving outlook for a synchronized global recovery. We still see EUR / USD moving higher later this year, but note that spreads between US and European government bonds have already started moving against the euro (see chart 2). Therefore, we see the EUR / USD rise topping out at around 1.25 in the second half of 2021.

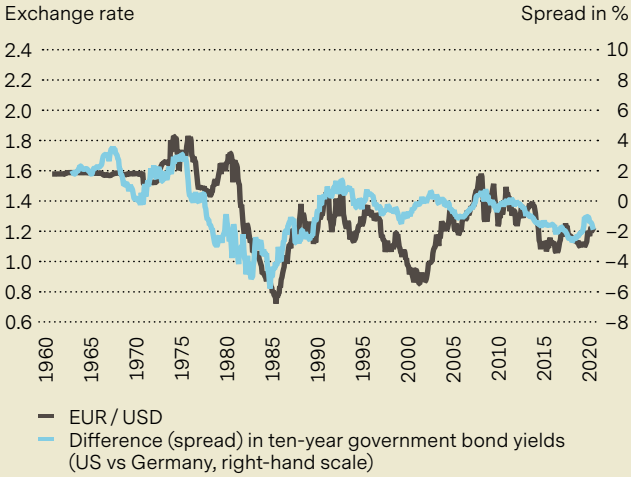
Watch your steps in emerging markets
Emerging markets should continue to benefit from a dovish US Federal Reserve and an improving global economic outlook. A slower rise in US yields from now on should reduce the risk of a premature policy tightening in emerging markets with negative repercussions for growth. Within this currency group, the economically more vulnerable currencies such as the Mexican peso and Brazilian real may have the highest short-term recovery potential. Investors need to be selective, though. Consider the recent plunge of the Turkish lira following the dismissal of the country's central bank governor by President Recep Tayyip Erdoğan. We expect the Turkish lira to remain on a longer-term downward path given the government's interventionism.

Chart 1: Higher average euro zone inflation versus Switzerland weakens the euro



Source: Refinitiv Datastream, Vontobel

Chart 2: The euro is seen running out of steam, in line with a move in bond spreads



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	–4.9	4.3	3.3
US	2.2	–3.5	–2.4	5.9	4.2
Japan	0.3	–4.9	–1.3	2.6	1.8
United Kingdom	1.4	–9.9	–7.8	5.2	5.0
Switzerland	1.1	–3.0	–1.7	3.5	2.8
China	6.1	1.9	6.5	8.8	5.8
INFLATION (IN %)					
Euro zone	1.2	0.3	0.9	1.7	1.4
US	1.8	1.2	1.7	2.2	2.1
Japan	0.5	0.0	–0.6	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	–0.2	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	–0.2
USD	1.9	0.9	1.6	1.6	1.9
JPY	0.0	0.0	0.1	0.1	0.1
GBP	0.8	0.2	0.8	0.7	1.0
CHF	–0.5	–0.5	–0.3	–0.4	–0.2
EXCHANGE RATES					
CHF per EUR	1.09	1.08	1.11	1.10	1.10
CHF per USD	0.97	0.88	0.93	0.88	0.89
CHF per 100 JPY	0.89	0.86	0.85	0.85	0.88
CHF per GBP	1.28	1.21	1.29	1.24	1.25
CHF per AUD	0.68	0.68	0.72	0.70	0.66
USD per EUR	1.12	1.22	1.19	1.25	1.24
JPY per USD	109	103	109	103	101
USD per AUD	0.70	0.77	0.77	0.80	0.78
CNY per USD	6.95	6.51	6.86	6.30	6.30
COMMODITIES					
Crude oil (Brent, USD/barrel)	66	52	69	65	70
Gold (USD/troy ounce)	1521	1898	1730	1900	1900
Copper (USD/metric ton)	6149	7749	9164	9000	10000

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 15.03.2021, forecasts as of 18.03.2021

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