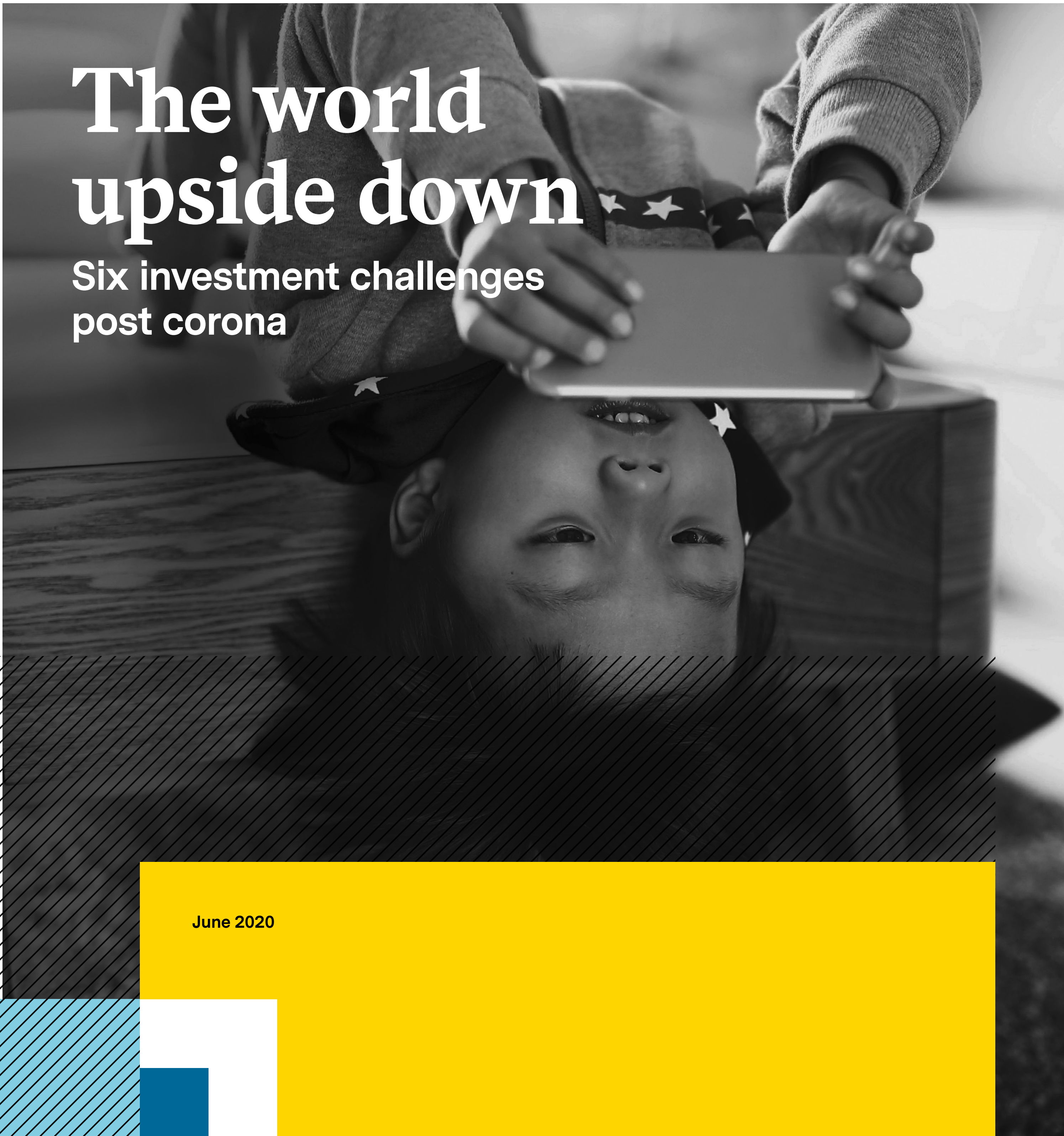
Vontobel

The world upside down

Six investment challenges post corona



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Asset Management

Sven Schubert joined Vontobel Asset Management in July 2011 as a currency specialist and economist for emerging markets. He holds a masters degree and a PhD in economics from the Free University of Berlin.

Frank Häusler joined Vontobel Asset Management's Multi Asset Boutique as Head of Macroeconomic and Cross-Asset Research, and took over the chief strategist role in 2019. He chairs the multi asset investment committee. Frank Häusler graduated from ETH Zurich with a masters degree in mathematics.

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

—
Frank Häusler
Chief Strategist
Vontobel Asset Management

Identify the winners, avoid the losers

Our lives have been transformed by the coronavirus. We used to come into the office, going about our business according to a predictable routine. Then, the coronavirus came along and turned everything upside down. Most obviously, it accelerated the shift toward digital: children taking classes by videoconference, middle-aged men and women cycling in the virtual world and pensioners finally beginning to shop online.

While much has been written about the shift to digital and its impact – e.g. increased broadband capacity or reduced urban pollution – relatively little has been written about the wider long-term changes for investors post coronavirus.

Here we aim to redress this imbalance and talk about some of the big-picture issues facing investors. Cutting through the noise of short-term volatility, our view is that many of these changes are highly predictable over the medium term. Therefore, investors able to take active management decisions should be able to identify the long-term winners and avoid the losers. Our conviction is that passive investors will be left holding some investments inappropriate for these times.

We have identified six themes that we expect will drive changes in the investment landscape. You may find them useful as food for thought – or investment ideas – before you, at some stage, settle into a new routine.

1. How to safely descend the debt mountain?

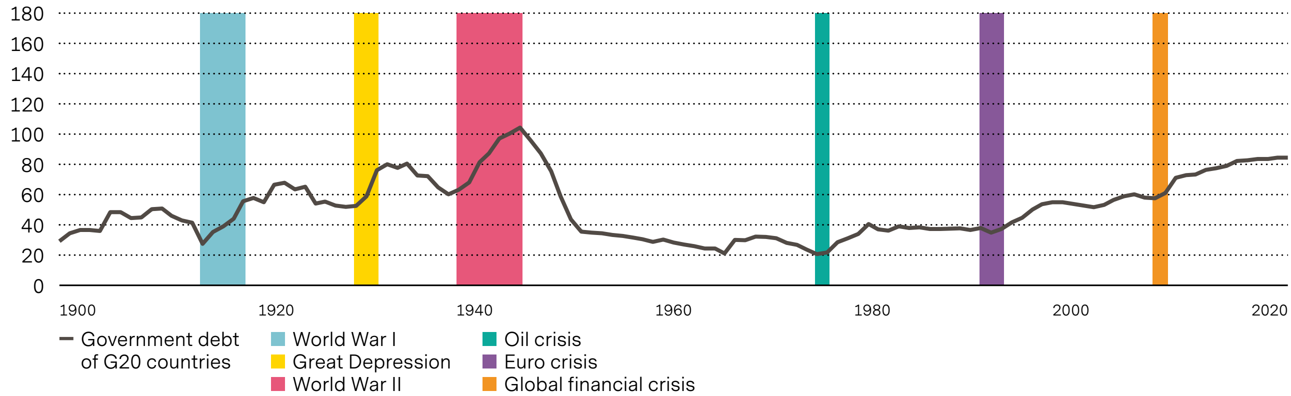
We have learned amazing things about our governments and ourselves during the Covid-19 crisis. One day, we fight over toilet paper, while the next we help elderly neighbors. Similarly, while most of our governments were ill prepared for a global pandemic, they took rapid action to stabilize their economies with massive financial support. Looking back, we see that most countries grew their debt[1] following every modern economic crisis (Figure 1). Therefore, investors need to consider their response to rising debt.

Will countries suffer a new debt crisis, or will they find an exit strategy? We see only four exit options: budget surpluses, inflation, debt relief, or adhering to the methods of the so-called Modern Monetary Theory (MMT). Followers of MMT argue that it is reasonable for a government to incur debt from the national central bank as long as the money is used purposefully. We agree with this view, provided governments find an exit strategy before out-of-control inflation awakens market participants' animal spirits (to learn more about the topic, read our white paper "***Modern monetary theory – how do we get down from the debt mountain?***").

Will we witness hyperinflation, or even deflation, if we consider Japan's decade-long inability to increase consumer prices despite massive stimulus packages? Or should investors mimic the central banks' bond-buying mania?

Figure 1: Government debt levels rose after every crisis since 1970

In % of GDP



Source: The International Monetary Fund, Vontobel

"Will countries suffer a new debt crisis, or will they find an exit strategy?"

Our view

None of these scenarios is attractive for investors. Therefore, think carefully about buying government debt. If you must buy some, look at countries where the central bank has unlimited buying power and is not politically constrained. This puts Europe at a disadvantage, as the European Central Bank has to satisfy many different countries with different wishes. True lenders of last resort on a national level, such as Japan, the UK, the US, or Switzerland, are better equipped to support their government-debt market in times of crisis.

[1] Norway is probably the only exception, as the country was able to sell sovereign wealth fund assets rather than increase debt.

2. Where to find returns?

As already touched upon in theme 1, government debt is less attractive and even risks becoming "non-investible" for everyone except the national central banks. It offers neither income, nor protection against inflation. Only corporate bonds and emerging-market bonds still offer a spread compensation for credit risk taken. In addition, both segments are now on central banks' buying lists. As we believe there is truth in the saying "don't fight the Fed" (see also an ***article*** of the same name by Daniel Seiler, Head of Multi Asset at Vontobel), we have a clear preference for investment-grade corporate bonds ("credit") versus government debt. Emerging-market debt offers even higher expected returns. Higher monetary easing capacity by emerging-market central banks, with real interest-rate spreads still at decent levels, argues for higher return potential for emerging-market hard-currency debt.

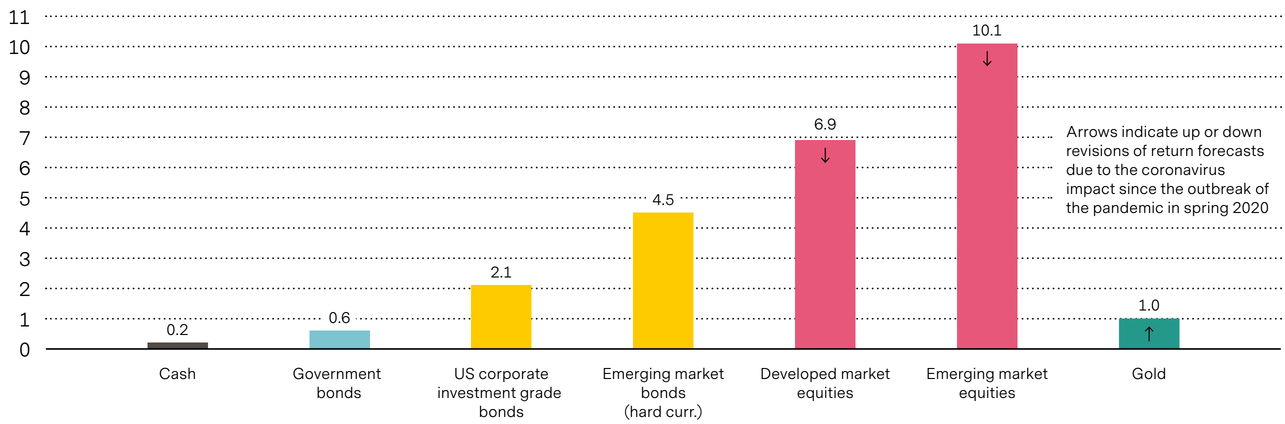
As for equities, it probably doesn't come as a surprise that our outlook is lower than before owing to higher debt and less globalization. However, this year's market distortions pushed prices for developed and emerging-market equities back into attractive territory. Within equities, we see technology stocks benefiting most from pandemic-related adjustments. Moreover, the technological sector seems more resilient than other industries due to the companies' high-margin business, low debt and high cash levels. A major risk is the struggle for digital supremacy between the US and China. This may hamper the companies' ability to do business with their counterparts. However, we believe that the digital revolution is difficult to stop in the medium to longer term, which makes the sector attractive from a strategic perspective.

Based on this thinking, we updated our long-term return assumptions (figure 2, also see our white paper "***Why Long-Term Investing Still Pays Off***" for the methodology we use).

Our view
Investors should pursue careful, active equity and bond selection, based on a deep understanding of business models necessary to avoid companies fundamentally damaged by the corona crisis fallout. Think about opportunities in developed and emerging-market equities in your strategic asset allocation and look for value in corporate bonds with sound balance sheets and business models. Particularly when investing in technology, we see no substitute for an active approach.

Figure 2: Equities and certain types of bonds with promising return potential

In %, USD (forecasts* based on seven year cycles)



* Based on the assumption that valuations are the best return indicators
Source: Vontobel (data as of May 31, 2020. The figures are forecasts, and as such are not a reliable indicator of future performance.)

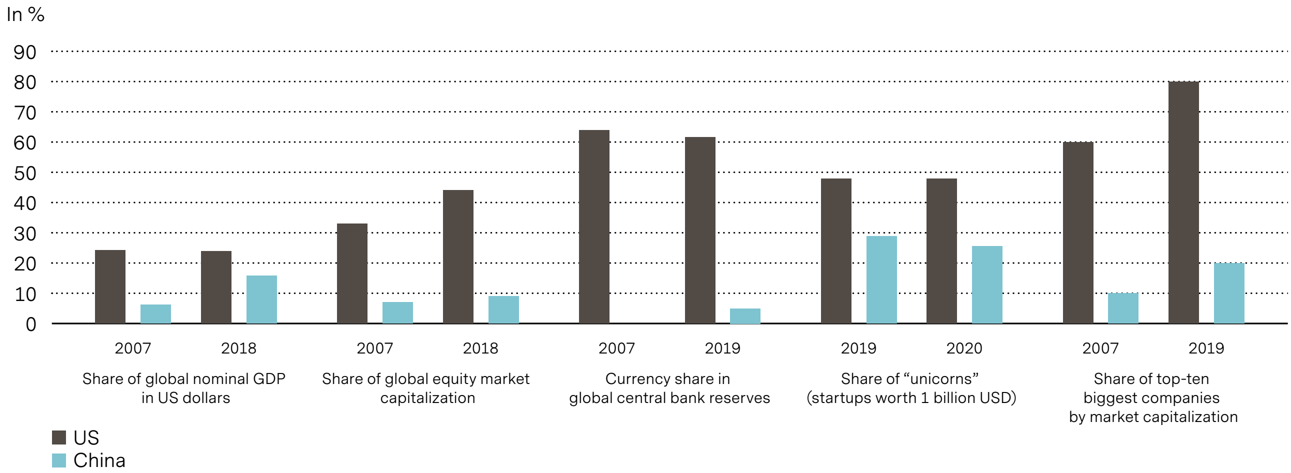
3. How to allocate between the US and China?

In the old days, it used to be the US versus the Soviet Union. Today, it's the US versus China (see also our white paper "***The next digital superpower***"). The pandemic has added another twist to the battle for global supremacy. The US government is using China to deflect from own shortcomings in handling the crisis, while China, having played a key role at the start of the pandemic, is now using the crisis to gain greater geopolitical influence by helping other countries in a well-publicized way. This reinforces a development seen already before the pandemic, where China developed into a major financier of Africa, meaning it can now steer these countries through a combination of inwards investment, debt restructuring and control of natural resources. In contrast, the US government adopted the opposite strategy and is now risking its global leadership role. For instance, stopping payments to the World Health Organization may be favorable with voters at home, but signals internationally that the US is not willing to be the world's problem solver. However, this doesn't mean that China is ready to take over the leadership of the US in the near term.

China trails the US on several important counts (figure 3), such as the significance of its own currency versus the US dollar in global central-bank reserves and the strength of its private enterprises, meaning it will probably take Beijing at least a decade to seriously trouble Washington in financial and economic terms. However, some believe that China is playing a longer game, and has thus focused on leadership in areas such as artificial intelligence and quantum computing. The US on the other hand feels threatened by China's rise, often citing national security concerns. For example, it tries to thwart the installation of Huawei 5G telecommunication infrastructure not only at home, but also abroad.

Our view
We believe that new technologies will shape the world economy in the longer run, so China, as well as the Asian region, are ready for a strategic upgrade to form a major part of our asset allocation. On a more detailed level, look for companies and countries best adapted to handle Chinese as well as US challenges. Or failing that, look for investments that will be highly successful in at least one environment.

Figure 3: Several metrics point to continued US leadership role



Source: Refinitiv Datastream, Vontobel

4. Which countries are most resilient?

Inequality is a hot topic nowadays, and countries are no exception. Depending how well they managed their wealth and their debt in the past, differences between them will increase in the pandemic's wake. We built a simple country ranking model around six indicators, such as government debt and growth metrics. Our model shows that some Asian countries are more resilient and in a better position to manage longer-term shutdowns given their ability to launch sizable fiscal packages (figure 4), bringing economic growth back on track faster than others.

Shown on the left in figure 4 are countries with strong finances such as Taiwan and South Korea, whose leaders adopted a fast and prudent approach to the corona crisis. Other countries particularly in Latin America, towards the right-hand side of figure 4, seem to be in a more difficult position.

When we look at Europe in aggregate, the positon is not very comfortable. One of the dangers unique to the euro zone is the political risk inherent in diverging economic development. Even before the pandemic, major countries like Germany and Italy weren't aligned. The gap between such countries now looks set to widen further because the laggards will perceive prosperous nations as leaving them in the lurch – vast rescue programs by pan-European institutions such as the European Central Bank notwithstanding.

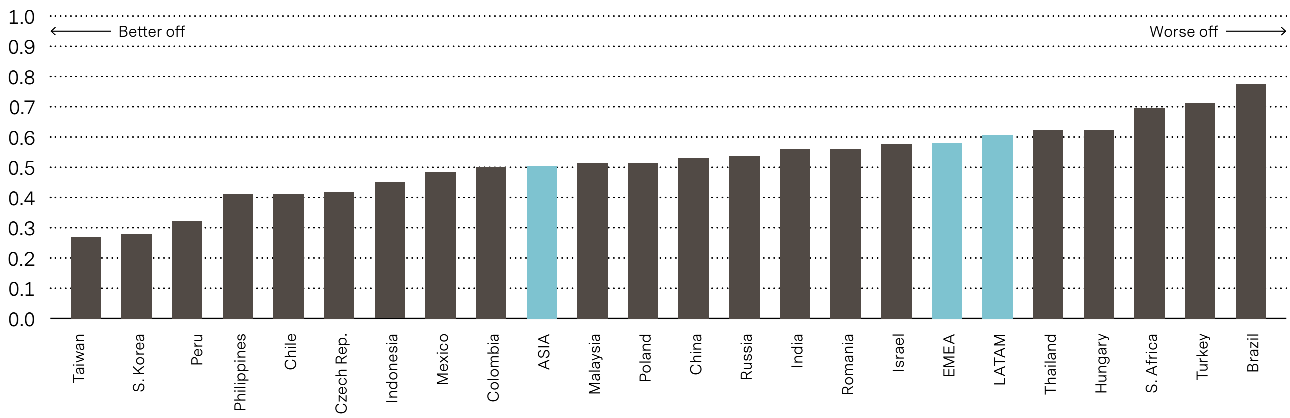
"The public is slowly warming to the concept of 'corona bonds'."

Here, another alternative may come into play. Europe's economically challenged nations have long championed the creation of debt-sharing mechanism via so-called "euro bonds", lately also known as "corona bonds". While we feel the time isn't yet ripe for such issuance, there are signs that the general public is slowly warming to this idea. A recent Franco-German proposal for massive recovery fund is a significant step towards debt unification, in idea always previously rejected by fiscally conservative countries within the European Union.

Our view
Think about incorporating country resiliency metrics into your investment decisions, so that you can increase allocations to the most resilient countries and reduce exposure to those with limited capacity.

Figure 4: Many Asian countries well positioned, with ability to launch significant fiscal packages

Country ranking * (0 – 1)



* Calculated as the unweighted average of the country rankings in six categories: 1) Government debt, 2) Primary fiscal balance, 3) average maturity of government debt, 4) refinancing costs, 5) S&P sovereign rating, and 6) expected 2020 real GDP growth
Source: Refinitiv Datastream, Vontobel

5. Who will benefit as globalization unwinds?

The media have often ridiculed the excesses of the division of labor, such as multiple European stops of a potato on its transformative journey towards the dinner table[2]. For all second thoughts regarding sustainability, supply chains of even the most mundane items are now global. While we have all benefited from cheap goods produced in Asia, the pandemic has laid bare the limits of globalization. To prepare for future crises, governments will try to become more self-sufficient in the supply of certain basic goods and medical supplies.

Taking a step back from globalization is hardly a new phenomenon – there have always been ups and downs in the international exchange of goods and services (figure 5). Over the last 10 years, globalization began to stall, owing to several trends:

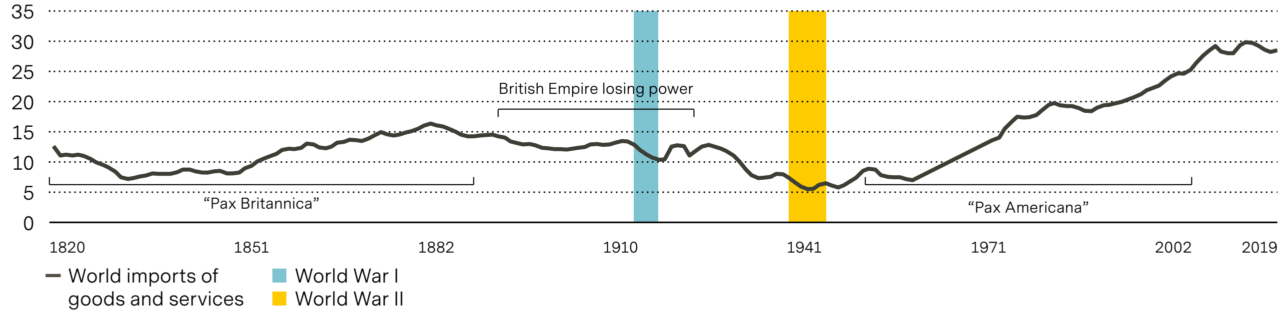
- Geography: Global demand is changing, with China and other developing countries increasingly consuming rather than exporting locally produced goods and services.
- Shorter supply chains: Speed to market as well as improving coordination and visibility across value chains is becoming more important.
- New technologies: Robotics, automation, and 3D printing, for example, reduce production costs and the need to outsource manufacturing.

In addition, rising populism in many countries added to the wish to bring back production home, or at least closer to home. Therefore, "nearshoring" could be the winner, although it would come with increased costs and slightly lower efficiency compared with today's fully offshored model.

Our view
We believe that emerging Asia (Bangladesh, Indonesia, Malaysia, Taiwan, Thailand, and Vietnam) and a few Latin American countries (e.g. Mexico) are likely to gain from global shifts in the supply chain. Mexico, for instance, will likely remain an important partner for the US, taking over much of the big neighbor's new manufacturing burden. Investors may therefore focus on selected equities or corporate bonds of the companies best equipped to benefit from this trend.

Figure 5: Globalization has stagnated since the global financial crisis

In % of world GDP



Source: Chase-Dunn, Kawano, Brewer "Trade Globalization since 1798" database, The World Bank, Vontobel

[2] "See for example «Verkehr: Rollende Landstraße», Der Spiegel, February 28, 1994
https://www.spiegel.de/spiegel/print/d-13688457.html

6. Will we have a green or brown recovery?

During the most acute period of the corona crisis, headlines focused on day-to-day problems rather than Greta Thunberg's environmental movement. However, after seeing previously unimaginable changes like city streets without cars, people are more aware of man's effect on the environment and now believe that change is possible.

While fundamental changes don't happen overnight, decisions to make them possible sometimes do, for instance Germany "Energiewende" to stop nuclear power after the Fukushima plant disaster in Japan. Regulation and government stimulus measures are key drivers of such transformations. Europe is ahead of other regions in this regard. Brussels lined up the European Green New Deal in 2019, an effort to make the European Union the first climate-neutral group of nations by 2050. This investment program worth 1 trillion euros will be partly funded by private investments. For all the complexity inherent in the EU's system, it has a strong record of pushing through eco-friendly initiatives such as tougher emission standards for cars.

This has significant implications for fossil fuel, in particular coal. While saving jobs is a short-term priority now, measures to restart the economy now often come with "green requirements" to cut at least the tail of the carbon emission distribution.

The other driver of change will be innovation, and this you can find on the corporate level with companies anticipating this change in regime. We believe there are significant investment opportunities in areas like digitalization, resource-efficient industries and "green" buildings that will not only serve long-term climate interests but also increase economic benefits.

Our view

Think carefully about investing in companies relying on carbon and other emissions, and particularly those whose models could be challenged by lower-emission technologies. Use the coming changes to your advantage by working with portfolio managers who have a deep understanding of the political and regulatory environment. Consider investing in clean technologies or employ an investment approach that uses ESG criteria to screen investments.

Conclusion

We presented you with some food for thought around six investment themes. Most already existed pre-corona, but have been accelerated and reinforced by it. While we are likely past the first wave of infections in the pandemic, it is still unclear how these trends will play out in short term. A lot will depend on whether we will get a second infection wave, but in the long term, it is clear that these themes will gain in importance and drive major changes in society and markets. In our opinion, this shift requires active investing, backed by solid research and conviction-based decisions. We believe that future investing success will be measured by the ability to anticipate these trends.

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Vontobel Asset Management AG
Gotthardstrasse 43
8022 Zurich
Switzerland

Editor
Martin Gelnar,
Vontobel Asset Management

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

Frank Häusler
Chief Strategist,
Vontobel Asset Management

Design
MetaDesign AG

Creation & Realization
Design Team, Vontobel

Images
Gettyimages
Vontobel

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Vontobel Asset Management AG
Gotthardstrasse 43
8022 Zurich
Switzerland

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