Vontobel

Investors' Outlook

Give us a good old villain to bring out the best in you

October 2021

Content

3
Editorial

4
Investment strategy

And the winner is… Wall Street

6
Macro highlights

Between peaks, when will central banks tighten the climbing ropes?

8
Viewpoint

Summiting "Peak Growth Mountain"—what you need for the descent

12
Asset classes in focus

16
Forecasts

Imprint

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Give us a good old villain to bring out the best in you

Dear readers,

Life as portrayed in James Bond movies is relatively simple. There's the good guy, struggling to overcome the obstacles thrown in his path by some Dr. No, Goldfinger, or Jaws. The hero ultimately triumphs, basking in glory and the admiring gaze of Miss Moneypenny. We will be reminded of this virtual reality shortly with Daniel Craig giving his farewell performance. He knows that we occasionally need an old-fashioned villain to bring out the best in us.

That said, things are looking rather grim on the world stage. Are we on the eve of entering a new Cold War era? The recent surprise announcement of the military pact between Australia, the UK and the US was a strong signal to Beijing that the "West" is keeping a watchful eye on the Pacific region. Washington and London will, as part of the trilateral deal, supply Canberra with at least eight nuclear-powered submarines.

Muscle-flexing abroad is sometimes accompanied by a tighter regime at home. The Chinese Communist Party, for one, has tightened its grip on the entertainment as well as the corporate sphere. Last month, the authorities announced the imminent ban of crypto transactions and the mining of digital assets. A massive clamp-down on entertainment has also followed. Some of the country's biggest celebrity fan clubs were wiped out from the country's internet in a matter of days. Cartoons and TV shows aimed at children are to be banned if the content is considered too graphic or violent.

Meanwhile, China's policy of "three red lines" that aims to crack down on excessively indebted companies has toppled one of its biggest property developers and sent shockwaves through the global economy. The troubles surrounding Chinese property giant Evergrande are likely to be well managed and remain contained as an isolated domestic event. They remind us, however, how close we are to the possibility of a Chinese "Lehman Brothers moment".

→ Webcast
To view our webcast on recent market developments, click:
vonto.be/macro-en-oct21

—
Dan Scott
Chief Investment Officer,
Head of Impact & Thematics,
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Markets fear inflation, I fear stagflation
Financial markets are increasingly worried about rising prices. The spike in inflation witnessed as economies reopened following months of pandemic-induced lockdowns has turned out to be a lot less temporary than initially thought. Inflation rates are expected to remain high in the months ahead given stifling global logistical bottlenecks. Container freight rates have increased more than fourfold compared to pre-pandemic levels. The outcome is higher shipping costs passed on to consumers. Bond (pardon the pun) yields have begun to drift higher as investors position themselves for rising interest rates. Given the pronounced slowdown in economic momentum, I fear we could have an altogether more difficult situation ahead of us—stagflation, a situation where the economy stagnates while inflation persists at high levels.

How does this impact our investment strategy? The current "post-peak" economic environment does not change our neutral equity positioning. Equities have historically not performed negatively over 12 months under such circumstances. We do, however, prefer US equities over European ones. The US stock markets hold more growth-oriented tech companies than their European counterparts, which are more geared toward financials and energy firms. Within fixed income, we continue to see opportunities in emerging markets.

Keeping the hero-villain relationship in mind, let's for a moment assume we're the good guys successfully dealing with Bond crooks like Alec Trevelyan, who tried to bring down the world economy in ***GoldenEye***. After this little morale-boosting exercise, we hope you will stay invested in the real world. After all, time in the market—staying invested for the long term—is more important than timing the market—trying to guess a share's next move.

—
Frank Häusler
Chief Investment Strategist,
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—
Mario Montagnani
Senior Investment Strategist,
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And the winner is… Wall Street

"Envelopes please… and the winner is… Wall Street." This is the result of our recent allocation review that saw us overweight US stocks at the expense of European ones. The slight change doesn't alter our overall neutral view on equities as a whole, in place since our last assessment a month ago. Back then, we argued that the so-called "peak growth, peak stimulus" environment, as well as equities' high valuations and the general uncertainty surrounding central banks' timing of any steps to tighten monetary policy, would make the path ahead more challenging.

For the time being, the stock exchange across the Atlantic seems little affected by the real-estate trouble brewing across the Pacific. The Chinese stock market is grappling with the difficulty of property developer Evergrande to pay its massive debt, the country's stronger-than-expected economic slowdown, and the side effects of Chinese regulators' crackdown on technology companies. Will China face its very own "Lehman Brothers moment"? So far, there is no spillover to other markets. More on this topic, and our view on the "post-peak" economy in general, in the "Summiting Peak Growth Mountain" article by Sven Schubert on the following pages.

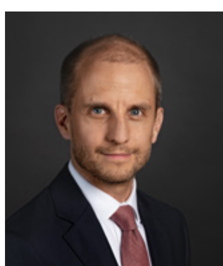
Our views on the other asset classes remain unchanged. We still underweight bonds as a whole but retain a favorable view on emerging market debt, regardless of the Evergrande worries. We continue to hold a slight overweight in cash and are ready to deploy it should buying opportunities arise. Gold remains among our favorites for its inflation-mitigating qualities, among others. For details, see the overview page 5 or read the asset class-focused items on pages 12 to 15.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity				→		Cash remains marginally overweight. We are keeping our powder dry at the moment but are ready to use it for new high-conviction holdings.
2 Bonds		→				Our slightly negative bond view remains unchanged. Given our expectation that ten-year US Treasuries yields will stand at 1.6 percent within three months, and at 1.9 percent within a year, investing in this asset class seems hardly attractive. We also retain all ratings on sub-segment level. We stay negative for investment-grade corporate paper, whose spreads to those of government bonds fail to draw much buying interest. We also stay neutral on government and high-yield bonds. Within the asset class, we continue to favor emerging market debt in hard currency, which hasn't suffered to the same extent as emerging market stocks.
3 Equities			→			We still feel comfortable with a neutral equity positioning. Markets could go either way but will mostly depend on whether or not corporate earnings will be able to drive investors' demand in the coming quarters. Among the risks are downward revisions of global GDP forecasts, a worsening pandemic situation, and central banks misjudging the timing of a possible tightening of monetary policy. The recent downward drag on emerging markets coming from China—weaker-than-expected economic growth, the tightening of regulatory screws, the debt burden of the property giant Evergrande—is a recent worry. On a sub-sector level, we reduced European equities from neutral to negative whilst upgrading US stocks to positive from neutral. The US market's attractions, in our opinion, include the earnings growth quality of US companies. Apart from that, all other sub-asset class views remain the same. This means that we remain neutral for Swiss, Japanese, and emerging market equities.
4 Gold				→		We reiterate our slightly positive view on gold. While we acknowledge that the yellow metal is facing some headwinds in the form of potentially higher interest rates, and especially higher real rates, we still believe that its qualities justify a slight overweight. For instance, the central banks' extensive money printing increases the appeal of non-dilutable assets like gold. The precious metal is also an effective hedge against heightened geopolitical risks and a possible spike in inflation.
5 Commodities			→			Commodities remain on neutral. The economic rebound after the pandemic has driven prices higher, but the "post-peak environment" could now weigh on prices. Weaker-than-expected growth in China, the world's most important consumer of commodities, could be another shot across the bow. Moreover, the commodity-supportive weakness in the US dollar will hardly continue, in our opinion. Longer-term, however, the case for commodities remains intact.
6 Alternative strategies			→			We are still underweight on hedge funds and maintain our neutral view on other types of alternative investments such as insurance-linked securities. This leaves us with an overall neutral—and unchanged—view on alternative investments.

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

Between peaks, when will central banks tighten the climbing ropes?

Peak growth, peak inflation, peak monetary policy, peak gas prices – economic publications today often read like a mountaineer's itinerary. It is hoped that the US Federal Reserve, as well as other major central banks, will correctly time the tightening of the climbing rope.



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The major central banks' climbing ropes have been remarkably slack to support economic growth. Now, the situation is changing. No schedule has been disclosed for "tapering", i.e. a scaling down of the massive bond purchases, let alone any rate hikes, but we expect the major central banks to start reducing their monetary stimulus around the turn of the year. As they stick to the view that inflation will become more moderate due to fading base effects and transitory production bottlenecks, we expect monetary "normalization" to happen rather slowly. This is likely to coincide with the normalization of growth (see chart 1), although we expect growth rates in most industrialized countries to remain elevated in the next quarters. By contrast, we see a declining growth rate in emerging markets on the back of some economic sluggishness in China and other Asian countries.

Accordingly, we have added the various imbalances in China's economic and financial system, as well as the Chinese regulators' heavy-handed approach, to our key risks for our economic outlook. Other risks include new lockdowns related to the Covid-19 virus, and possibly stronger second-round effects such as bankruptcies and layoffs, which may increase as the pandemic support measures are being phased out. We also keep in mind that an overheating economy could push inflation to a level forcing central banks to act faster than expected. The current rise in various energy prices has again brought this risk to the fore. Quick tapering steps would have a strong impact on the economic outlook and financial markets.

Europe: Economic cooling and monetary recalibrating
The European Central Bank (ECB) announced a first small reduction in bond purchases under its pandemic emergency program (PEPP). At the press conference, ECB President Christine Lagarde carefully avoided the term "reduction", speaking of "recalibration" instead, a wording indicating the sensitivity of the issue. Whilst the emergency program will probably run out in the first half of 2022, we expect the ECB to soften the effect by increasing the traditional bond purchasing scheme (APP) or to invent a new one. Set to remaining a bond buyer for a long time, the central bank will hardly increase interest rates hike before 2023, in our opinion.

Amid still strong economic growth, we expect inflation to grind higher, peaking around 3.5 percent at the end of the year before dropping back to below 2 percent towards summer. Due to further upward revisions of gross domestic product estimates and the latest positive figures from retail trade and industrial production amid ongoing support from fiscal and monetary policy, we are slightly raising our growth forecast for the euro zone to 5.1 percent for the current year and to 4.3 percent for next year. Nevertheless, we expect quarterly growth rates to cool down and "normalize" over the next quarters.

US: Economy on track, tapering fires up tightening debate

Consumer sentiment has suffered from a resurgence of Covid-19 infections. This held particularly true for private consumption, which led us to reduce our growth expectations for the second half, especially the third quarter. We now see a growth rate of 5.9 percent in 2021, revised down from 6.2 percent. Still, the post-pandemic progress in the labor market has continued. The number of job openings stood at an impressive 10.9 million in July, a record high, and qualified workers are still hard to find. The higher input costs companies face due to supply problems and raw materials shortages have translated into higher inflation in some sectors. Whilst this looks set to remain a transitory phenomenon, inflation will remain elevated well into next year. Partly as a consequence of this, we believe the Federal Reserve will in November officially announce a scaling back of its monthly bond purchases worth 120 billion US dollars, ending that program possibly mid-2022. The world's most powerful central bank has also signaled it could start raising key rates next year. Half of its rate-setting committee now expects a rate hike in 2022, and further such steps in the following years (see chart 2). Finally, budget discussions in the US Congress will be tense this fall, as the infrastructure spending bill is yet to be signed into law. Moreover, the debt ceiling would need to be raised in late October to allow the government to function and the US to honor debt repayments obligations. We expect Congress to agree on such a step but this will take a lot of political capital to both parties.

Japan: New leader has work cut out for him

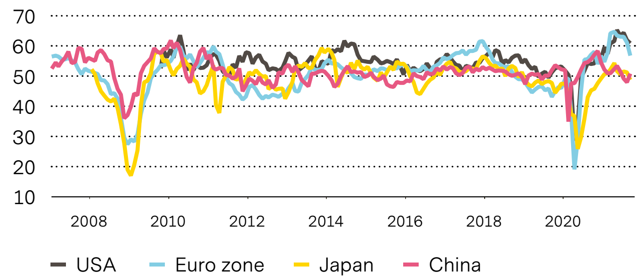
After Prime Minister Yoshihide Suga's surprise resignation, his successor Fumio Kishida will now need to bring the pandemic under control and put the economy back on track—no easy feat, considering slowing external demand and subdued domestic consumption. Against this backdrop, the Bank of Japan is left with little room to maneuver and looks set to remain accommodative for the foreseeable future.

Emerging markets: Clouds on economic horizon

Growth has peaked in emerging markets, mirroring an already more pronounced slowdown in Asia. Chinese authorities have flagged a switch to a more accommodative policy, which seems like a necessary measure to prevent economic ripple effects from slowing house prices in the wake of property developer Evergrande's woes (see chart 3). Currently, more than 20 percent of China's GDP, and nearly two thirds of Chinese households' wealth—and most of their debt via mortgages—are tied to the real-estate sector. Therefore, a sharp drop in house prices could throw China off its path towards a growth rate of approximately 7.9 percent this year and 5.9 percent next year. However, we have revised down our Chinese growth forecast only marginally to 7.9 percent. Authorities have recently announced additional measures to limit economic contagion risks and the central bank can still take bold monetary policy steps because of low inflation pressure. Elsewhere, Latin American and Eastern European central banks remain in tightening mode. With inflation apparently stabilizing, these tightening cycles may end in the medium term.

Chart 1: Manufacturing new orders purchasing managers' index

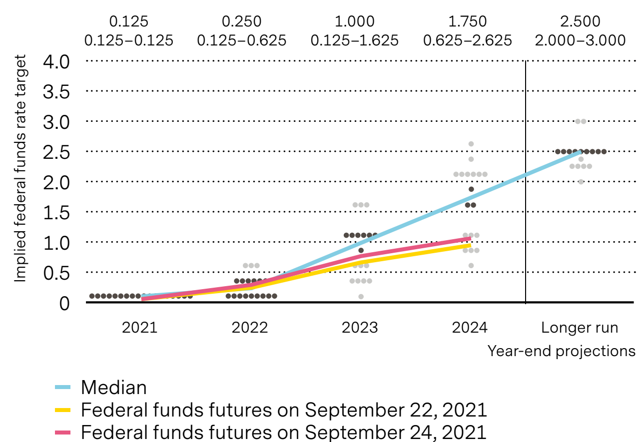
Manufacturing new orders purchasing managers' index



Source: IHS Markit, Refinitiv Datastream, Vontobel (data as of October 1, 2021)

Chart 2: "Dot plot"—the US Fed's rate projections—points to higher key rates

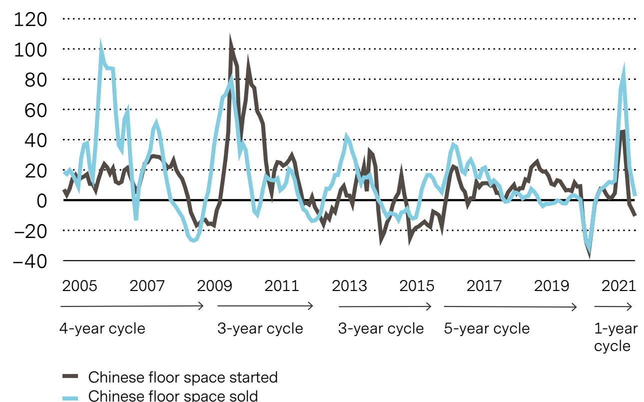
Projections as of September 2021



Source: Refinitiv Datastream, US Federal Reserve, Vontobel

Chart 3: Property sector woes are a burden for China

Index, year-on-year changes in %, three-month average



Source: Refinitiv Datastream, Vontobel

Summiting "Peak Growth Mountain"—what you need for the descent

—
Sven Schubert
Senior Investment Strategist,
Head of Strategy Currencies,
Vontobel

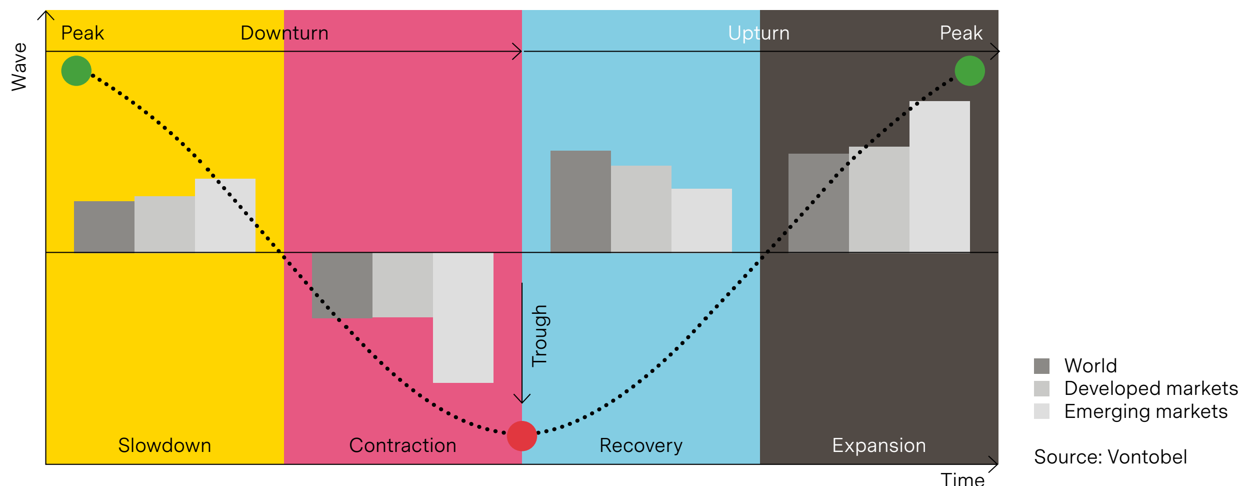
Experienced hikers know that descending can be more arduous than going up the hill. Fortunately, robust gear can help you overcome what obstacles there may be on your way. What equipment should you buy, and what should be left sitting on the shelf?

Before you consider the purchase of a special brand of trekking poles, hiking boots – or, for investors with a focus on emerging markets (EM), a specific security to make your journey more secure – let's first take a look at the GPS tracker. There's little doubt that we have indeed left "Peak Growth Mountain" behind, definitely in emerging economies but increasingly in developed markets as well. That's what our business cycle model "Wave" (see figure 1) suggests, and this is crucial information for investors taking a top-down macroeconomic view.[1] After finding your location on the map, you can start scanning the landscape for potential opportunities (or danger zones), using country, sector, and even theme-specific binoculars.

But first things first. Business cycles start with an economic recovery, typically followed by an increasingly unsustainable expansion triggering inflation and prompting central banks and governments to implement countercyclical "restrictive" policies, such as rate hikes. These policies stall the economic recovery, causing growth and inflation to peak. At that stage, the economy enters a slowdown followed by a contraction, which often coincides with a recession. This is usually the time when central banks and governments change tack, supporting the economy with "expansionary" policies such as tax cuts. What follows is another recovery, and the business cycle starts again.

Figure 1: The four economic states in the Wave model

The bars show positive / negative equity performance since the 1990s in the different states



So much for theory. In real life, things are more complicated, with business cycles often breaking this pattern, as they did during the pandemic crisis, for example. The stringent lockdown measures in early 2020 that threw the global economy headlong into the worst maelstrom since last century's Great Depression were followed by an economic recovery that was similarly spectacular.

Where is the business cycle taking us?

The mid-point of an economic slowdown tends to be a supportive environment for cyclical asset classes.[2] But could we already be getting close to the beginning of the next stage of the business cycle? To get a clearer view on this, and to identify the possible winners and losers, you as an investor will have to make assumptions about the future development. The key element here is to evaluate and anticipate the steps of governments and central banks that make or break an economy. Our business cycle model has worked well so far this year, pointing at an expansion-to-slowdown transition before it materialized. Currently, the Wave model shows a 67 percent probability that the global economy will continue to slow in the short term.

Eyes on EM hard-currency debt

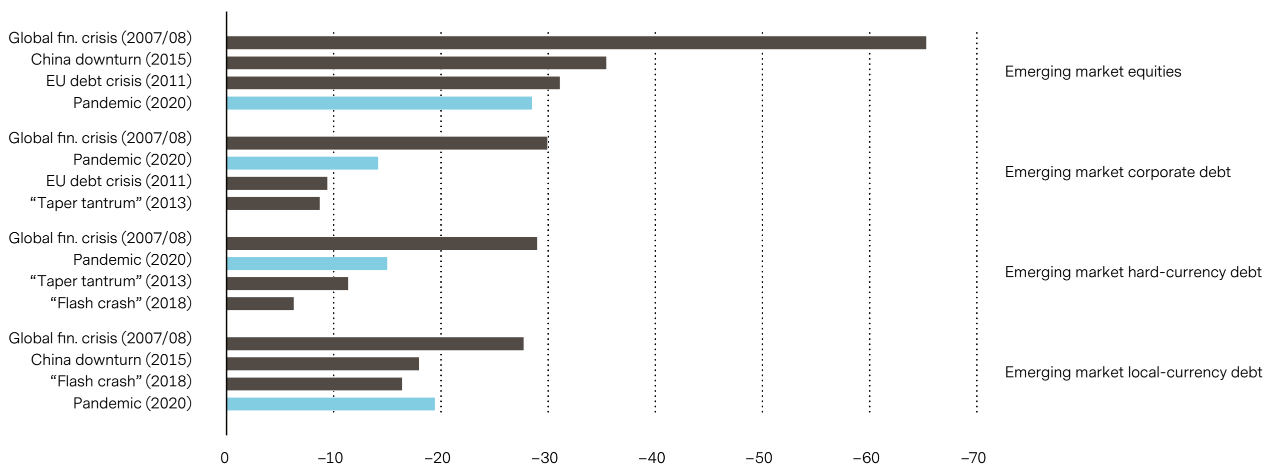
This suggests a cyclicals-focused but well calibrated equity strategy. Let's not forget that the longer we are in a slowdown, the bigger the risk of slipping into contraction territory, which is why defensive dividend-paying stocks, typically found in markets such as Switzerland, are becoming increasingly attractive. Due to their defensive nature, they are likely to outperform in a shift to a more adverse contraction scenario, but could participate in an equity market rally if the growth environment improves again. The continued edge of dividend yields (dividend payment relative to a company's share price) over bond yields is another argument for dividend strategies.

[1,2] Also see our recent article "How to check if peak talk has substance to it". https://am.vontobel.com/en/insights/how-to-check-if-peak-talk-has-substance-to-it

Generally, the attraction of defensive assets is particularly evident in emerging markets, where the risk of entering the contraction phase is significantly higher than in developed economies. This leaves us with a preference for hard-currency debt within the region. According to our analysis, emerging market hard-currency debt has generated slightly positive returns even during periods of economic contraction. Moreover, draw-downs—the biggest observed sell-offs—have been lower than in other asset classes (see figure 2).

Figure 2: Emerging market corporate debt and hard-currency debt among the most resilient categories

Biggest EM asset corrections since 2002 (return in % in respective period)

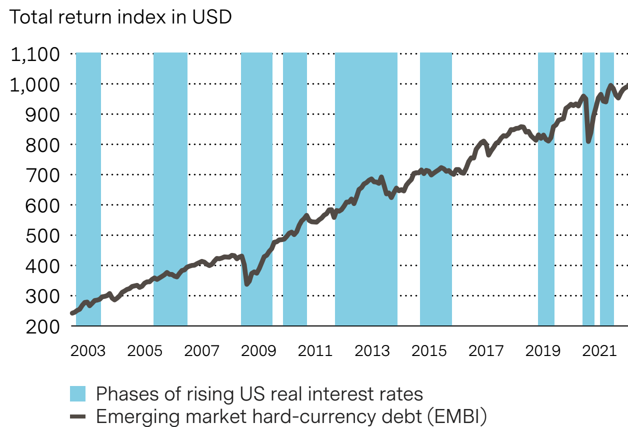


Source: Refinitiv Datastream, Vontobel

Our view on prices – we are probably past the "Peak Inflation Mountain" as well, also supports the rationale for engaging in this fixed income segment. With upward price pressure easing, central banks will be in no hurry to tighten monetary policy much more from here. In such a scenario, EM bonds denominated in hard currencies have room to gain in value, lowering the yield difference to US government bonds. The risks for emerging market bonds include a possible tightening of monetary policy in the West: Should the US Federal Reserve hike interest rates and the US dollar rise significantly as a consequence, dollar funding would become more expensive, leaving emerging markets in the lurch. However, we don't expect any such move by the world's most powerful central bank before the end of 2022. Therefore, any sustained USD strength may only materialize in the second half of 2022. Moreover, phases of moderate USD appreciation and a slow rise in US Treasury yields need not be negative for emerging market assets, which have proven their resilience in times of gradually increasing US rates (see figure 3).

Figure 3: Emerging market asset can withstand a gradual rise in US interest rates

Total return index in USD



Source: Refinitiv Datastream, Vontobel

Are emerging market equities a buy already?

Whilst emerging market assets tend to perform well in an economic slowdown, EM shares have underperformed so far this year. Between February and late August 2021, emerging market equities suffered two major downturns of more than 10 percent each, both times weighed down by index heavyweight China. At the same time, eastern European and Latin American shares performed well in the first half of 2021.

There are two main reasons for the overall sluggishness of EM equity markets. China's economy started slowing down in February, around the time its equity market began to underperform. On top of that came the regulatory crackdown against Chinese technology companies and real estate developers that triggered the second leg of the slump between June and August. After a decade of regulatory laissez-faire, the initiative by Chinese watchdogs can be interpreted as an understandable move to catch up with western regulatory standards. Even so, it was an eye-opener to many global investors who have never contemplated the possibility of such a massive regulatory push against China's national tech champions.

Therefore, the recent sell-off needs to be seen in the context of market participants trying to price in regulatory risks. Are we there yet? Concerns may linger, not the least because Chinese authorities may find it useful to tighten regulatory screws further, for example through the personal information protection law (PIPL), which takes effect in November 2021. What investors will want to see is more transparency in the regulatory process. Once this happens, the recent correction in emerging market equities will probably be seen as an attractive buying opportunity. Moreover, China will have to find ways of supporting the economy in light of recent underwhelming data. Chinese authorities have recently approved additional stimulus measures, a move that may usher in a stabilization of the local equity market.

Some hedging against inflation makes sense

Even though our business cycle model is not designed to predict cyclical inflation trends, it enables us to draw conclusions regarding price levels. The data series we use don't suggest permanent inflation pressure, even indicating somewhat lower inflation rates going forward. However, as labor markets continue to tighten, the risk of accelerating wage growth rises. Moreover, we see the emergence of a possible inflation driver tied to the corporate world's adaptation to sustainability requirements. To incentivize companies to go "green", governments tend to increase the costs of fossil energy sources, which is likely to increase prices for products and services. Therefore, adding commodities to a portfolio as an inflation buffer makes sense, in our opinion.

Be prepared as you're heading for the base camp

Things seemed easy enough on the way to "Peak Mountain", but now, we have a new situation. Many mountaineering expeditions fail on the way down from the summit because of poor preparation or bad judgment. Smart investors with the necessary risk-mitigating equipment should arrive safely at base camp, ready to take on the next challenge.

Global corporate bond markets unaffected by Evergrande turmoil

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel

With Chinese property developer Evergrande struggling to emerge from under a mountain of debt, investors are taking note. However, China's real-estate trouble has so far failed to spill over to most other markets. Whilst most Chinese issuers have faced significant losses, corporate paper outside of Asia remained unaffected.

Bond yields have recently drifted higher amid signs that the economic recovery is on track in most developed markets. With inflation appearing to be more persistent, central banks have started to hint at a withdrawal of extraordinary monetary support. The US Federal Reserve has been widely expected to announce a tapering of asset purchases in November. But the US central bank also pointed at a faster rate hiking cycle possibly starting as soon as 2022 (also see Macro highlight on page 6). As a consequence, bond yields rose across countries and maturities, with the benchmark US ten-year yield reaching 1.5 percent (see chart 1). We expect a continued rise in this measure towards our targets of 1.6 and 1.9 percent, in three and 12 months, respectively.

Real yields have more room to increase

Real yields—nominal yields minus inflation—have also left their troughs. With inflation expectations slowly edging lower from high levels, real yields are set to continue to recover from significant sub-zero territory. We believe that central banks will ensure the normalization process is gradual for fear that too fast a rise would hurt the recovery.

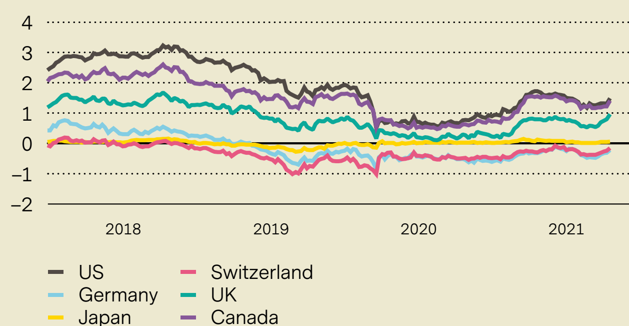
Resilient global credit markets

So far, corporate bond markets have been spared the trouble emanating from China's real-estate sector and Evergrande's default risk. Whilst equities suffered from this uncertainty, both global high-yield (HY) and investment grade (IG) securities face no contagion fears to speak of. By contrast, Asian junk bonds as well as the Chinese HY market have been losing ground since late summer (see chart 2). The main reason for the divergence between those market segments is the lack of direct exposure of US companies to Chinese real estate, a sector mostly funded by China's large domestic banks and owned onshore.

We believe the US corporate bond market would only be affected if Chinese default fears posed a greater systemic risk or if Beijing authorities failed to react to the crisis by monetary policy steps, for example. But this isn't our base case at this stage. Of greater importance to the global corporate bond market is the rise in yields, which, if continued, could dampen this bond segment's prospects given its long duration, i.e. the sensitivity to interest rate changes, and already low spreads. Therefore, we keep an underweight position in IG corporate bonds and a neutral view on HY bonds in our portfolios.

Chart 1: With central banks signaling a tighter policy, bond yields are rising across regions

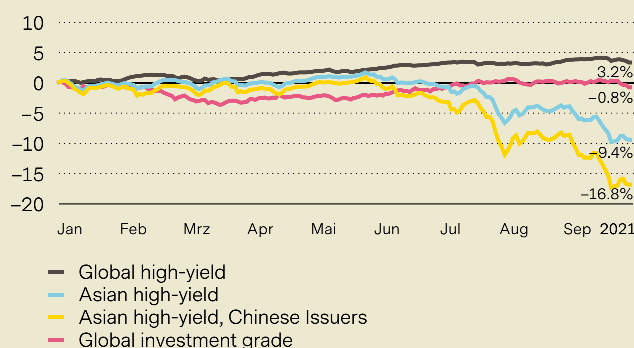
Ten-year government bond yields, in %



Source: Refinitiv Datastream, Vontobel

Chart 2: Evergrande's risks have mostly affected Asian high-yield bond markets

Bond indices (total return, rebased to 0 in December 2020)



Source: Refinitiv Datastream, ICE BofA indices, Vontobel

Why we prefer US shares to euro zone stocks

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

Investing mainly in US equities rather than euro zone stocks has paid off in recent years. We believe this will be the case for the next 12 months as well. Our current US-friendly view is also supported by the expected cooling of the global economy and American companies' solid earnings prospects.

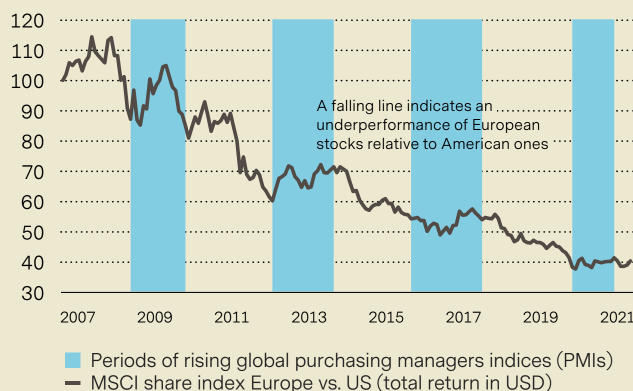
In August, we said goodbye to our overweight in equities. The sweet spot of economic recovery is behind us, and with it, arguably, the days of the spectacular returns that equity investments often generate in a high-growth environment. In a slowing economy, financial markets are more vulnerable to negative surprises. This was already evident in September with the temporary setback on the stock markets due to uncertainties in the Chinese real-estate sector.

European corporate profits underwhelm
The cooling of the global economy has a range of strong effects on regional stock markets. Over the past decade, US equities have been faring better in such periods than those from the euro zone (see chart 1). The main reason is the greater exposure of euro area stock indices to the global economic cycle, i.e. a larger dependence on industrial companies or car manufacturers. By contrast, the US leading index comprises significantly more pharmaceutical companies and technology stocks where demand is less dependent on cycles. Our current preference for Wall Street is also down to the development of profits. The string of record result in the US is in sharp contrast to profits in Europe, where corporate results are still below the level before the so-called euro crisis in 2011.

US expensive? Yes, for a reason
Many investors are cautious about investing in US stocks because valuations look much more expensive. They are pricey indeed, but rightly so, in our opinion. Stronger profit growth is a reason, but US companies also boast higher profit margins and generate significantly more profit per dollar of equity. Thus, when adjusted for higher quality, US shares aren't more expensive than euro zone ones (see chart 2).

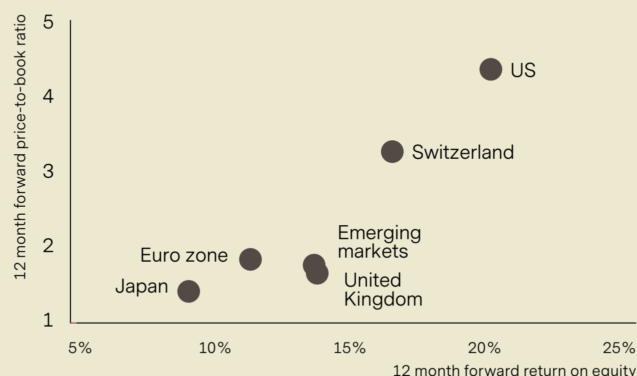
As was evident at the beginning of this year, European equities usually perform well when bond yields and inflation rise sharply. We don't rule out another rise in yields, but only to a limited extent. Inflation concerns should also ease next year as global supply chains start working more smoothly again. Finally, higher-than-expected US tax hikes could hurt US equities in the short term because this could dent corporate profits. However, such an effect should be temporary. What's more, US equities are generally less volatile than those in many other places. Therefore, the nights of US-focused investors could be quieter, especially if Chinese growth were to slow down at a faster-than-expected pace.

Chart 1: In an economic slowdown, US stock often outperform European peers
Index of relative performance of EU vs. US stocks, rebased



Source: Refinitiv Datastream, Vontobel

Chart 2: The higher price of US stocks is the consequence of better quality



Source: IBES, Refinitiv Datastream, Vontobel

We like gold as a buffer for a possible inflation spike

—
Stefan Eppenberger
Equity & Commodity Strategist, Vontobel

A stronger US dollar and investors' risk appetite have worried gold bugs this year. A more restrictive US monetary policy could put additional pressure on the precious metal. However, we retain our gold overweight for the moment to cushion portfolios against possible surprises on the inflation front.

An umbrella can be a nuisance in the absence of rain. But you suffer if you don't have one in a downpour. Likewise, assets such as gold, held as protection against market turbulence, haven't been particularly useful of late. But they may yet come in handy. We held on to gold but also had a relatively high exposure to risky assets until August. For diversification reasons alone, it is still worthwhile to hold some precious metals to shield the portfolio from setbacks.

Gold still below its August 2020 high

There are fundamental reasons why gold prices could go up from here. After all, US real interest rates are still around –1.0 percent. This is similar to the situation in August 2020, when we saw gold vault the 2,000 dollar mark. Today, prices are more than 10 percent below that level. The cause for the disappointing performance of the precious metal was the strength of the US dollar (see chart 1), which increased the cost for buyers who use other currencies than US dollar for gold investments. With the dollar potentially losing some drive amid an economic cooling, gold could benefit.

Higher rates would stun the precious metal

However, the prospects of the precious metal aren't clear. The US Federal Reserve has recently for the first time hinted at a rate hike in 2022. Higher interest rates increase the opportunity cost of holding gold. Moreover, interest rate hikes usually also dampen inflation expectations, lowering the attraction of gold's inflation-mitigating quality. But it's worth noting that the prospects of a rate hike within the next few quarters aren't clear either. Higher US key rates could darken the economic outlook, as would any move by the US Fed to scale back bond purchases. By contrast, if the central bank doesn't move, this could let gold shine more brightly.

Don't dismiss inflation

Finally, there are currently several reasons why inflation could remain high for longer. Global supply chains still aren't functioning smoothly. Inventory bottlenecks in various commodity markets have investors worried, and there is rising wage pressure in some sectors. Whilst we do expect inflation to fall next year, we think it's a good idea to guard against the possibility of this not happening. In such a case, gold is likely to be a better hedge than, for example, US government bonds (see chart 2). Therefore, we keep our small overweight in the precious metal.

Chart 1: When the US dollar appreciates, gold typically tumbles—and vice versa

Source: Refinitiv Datastream, Vontobel

Chart 2: Gold works best as a safeguard in times of rising inflation

Source: Refinitiv Datastream, Vontobel

Unimpressed with Chinese real-estate woes

—
Sven Schubert
Senior Investment Strategist,
Head of Strategy Currencies,
Vontobel

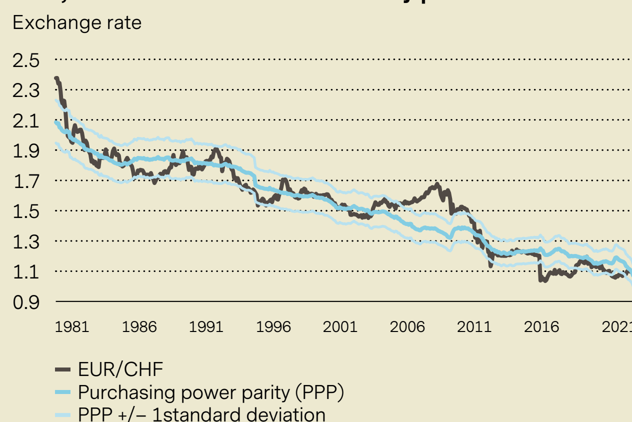
Developed market currencies have taken the Chinese property sector's woes in stride. Only the currencies of countries such as Australia with close economic ties to China have experienced a temporary weakness. The dollar may benefit from any normalization of US monetary policy, but we believe it is too early to bet on a strong dollar rally.

The trade-weighted US dollar most likely passed its cyclical trough last June. It rebounded on expectations of an approaching normalization of US monetary policy, which in a first step would see the US central bank limit its massive bond purchases. But such a step alone would hardly spark a US dollar rally. In 2014, the Greenback only took off when it became clear that the US central bank would soon hike key rates. We believe such a move could follow in second half of 2022 at the earliest, which could then send the dollar on a more sustainable upward path later in 2022. In the short term, the US Federal Reserve's hands will probably be tied due to economic headwinds, the US twin deficit, and the lagging vaccination rates in America, which also limits the dollar's potential. Therefore, we expect EUR/USD to break below 1.15 only in the second half of 2022.

Rangebound EUR/CHF expected
The Swiss franc is likely to remain on an appreciation trend in the medium to longer term. The "significant overvaluation" line the Swiss National Bank (SNB) has often used to talk down the franc seems no longer valid (see chart 1). Applying the purchasing power parity measure, we believe the fair value of the EUR/CHF exchange rate is around 1.10. Nevertheless, we think the SNB will hardly let the franc appreciate in the near term. An upward move in the currency would put downward pressure on prices—a counterproductive development in a period of (too) low inflation levels (see chart 2). Therefore, the SNB will most probably wait for euro zone rates to tick higher before raising key rates itself. We see EUR/CHF in a 1.12–1.06 range.

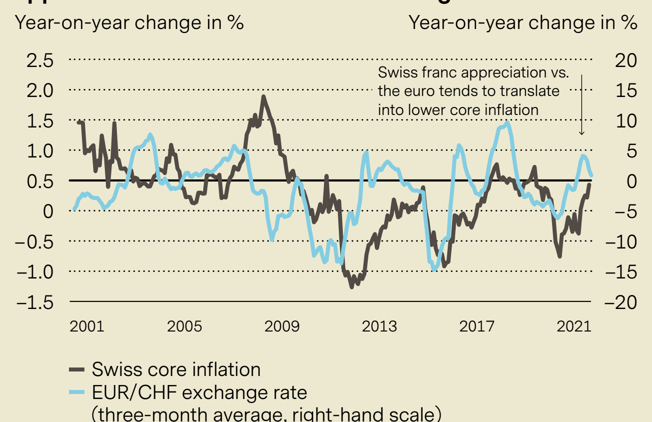
Emerging economies seem well prepared
An upward trend in the US dollar usually isn't good news for currencies of emerging economies. However, emerging market assets have proven their resilience before, often posting positive total returns even in an environment of a stronger dollar and rising US yields. If the rising tendency in both of these factors of the equation remains contained, which is what we expect, EM assets could continue to deliver. Moreover, central banks in emerging economies have re-established a decent rate buffer. Countries like Brazil have hiked key rates aggressively, stemming the outflow of capital by investors previously transferring their funds to higher-yielding markets such as the US.

Chart 1: Swiss franc no longer overvalued versus the euro, as the fair value of the currency pair has fallen



Source: Refinitiv Datastream, Vontobel

Chart 2: Swiss National Bank unlikely to let franc appreciate too much for fear of lowering inflation



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	1.5	–6.5	14.3	5.1	4.3
US	2.3	–3.4	12.2	5.9	4.1
Japan	0.0	–4.7	7.7	2.4	2.6
United Kingdom	1.4	–9.9	22.2	6.5	5.3
Switzerland	1.3	–2.5	7.7	3.5	2.8
China	5.8	2.3	7.9	7.9	5.9
INFLATION (IN %)					
Euro zone	1.2	0.3	3.0	2.3	1.7
US	1.8	1.2	5.2	4.1	2.9
Japan	0.5	0.0	–0.3	–0.1	0.2
United Kingdom	1.8	0.9	3.2	2.2	2.3
Switzerland	0.4	–0.7	0.9	0.6	0.7
China	2.9	2.5	0.8	1.1	2.0

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	0.25
CHF	–0.69	–0.76	–0.75	–0.75	–0.75
CNY	4.35	4.35	4.35	4.35	4.35
10-YEAR GOVERNMENT-BOND YIELD (IN %)					
EUR (Germany)	–0.2	–0.6	–0.3	–0.3	0.0
USD	1.9	0.9	1.4	1.6	1.9
JPY	0.0	0.0	0.0	0.1	0.1
GBP	0.8	0.2	0.8	0.8	1.1
CHF	–0.5	–0.5	–0.2	–0.2	0.0
EXCHANGE RATES					
CHF per EUR	1.09	1.08	1.09	1.09	1.07
CHF per USD	0.97	0.88	0.93	0.94	0.96
CHF per 100 JPY	0.89	0.86	0.85	0.87	0.91
CHF per GBP	1.28	1.21	1.28	1.27	1.23
CHF per AUD	0.68	0.68	0.68	0.69	0.66
USD per EUR	1.12	1.22	1.17	1.16	1.12
JPY per USD	109	103	110	108	105
USD per AUD	0.70	0.77	0.73	0.73	0.70
CNY per USD	6.95	6.51	6.86	6.60	6.50
COMMODITIES					
Crude oil (Brent, USD/barrel)	66	52	76	70	70
Gold (USD/troy ounce)	1,521	1,898	1,754	1,800	1,800
Copper (USD/metric ton)	6,149	7,749	9,307	9,000	12,000

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 17.09.2021, forecasts as of 23.09.2021

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