Vontobel

Investors' Outlook

A breath of fresh air

September 2020

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A breath of fresh air

Dear readers,

Coming back from summer vacation, we are reminded of spring and how a pandemic can change our lives. The coronavirus is currently rearing its head again with isolated hotspots suffering a second wave of infections. While this feels like a déjà vu, the horror of the first wave and the ensuing lockdowns has worn off. Financial markets have rebounded from the lows reached during March. Some markets like the technology heavy Nasdaq and the S&P 500 have been setting new all-time highs. Gold has also been glittering, for the first time breaking the threshold of 2,000 US dollars an ounce earlier this summer. Meanwhile, the airline industry, financials, commercial real estate and the energy sector continue to languish. This recovery is as unusual as the recession it followed.

Some things have changed incredibly fast amid the pandemic storm. Wearing masks in public places? No problem. Work, spend, play from home? Sure. Some old stock exchange rules have also been upended. Investors following the saying "sell in May and go away," have missed out on a number of opportunities in the past months. The good news is that it is not too late to enter the markets. Most remain attractively valued, supported by gradually improving economic data and unprecedented stimulus measures (in excess of 10 trillion US dollars) from governments and central banks across the world. We therefore remain positive on the outlook for equities, with a preference for those companies riding the structural growth trends that have received an additional boost from the Covid-19 lockdown – de-centralized supply chains, cyber-security, cloud computing, to name a few. Moreover, there is a wave of infrastructure spending coming our way, and we believe companies active in this area hold promise. Their defensive business models little affected by economic cycle make them more attractive than those of travel operators, for example.

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

Towards an "ESGellent" future?
Infrastructure also fits well into our sustainable investing strategy, as we now have a unique opportunity ahead of us to achieve a green global recovery from the pandemic. Some of the opportunities that come with recent "green" initiatives are highlighted in the "Investment in focus" article on page 8. So in a way, Covid-19 may have sped up the transition towards more sustainability and a replacement of coal burning plants by windmills.

Not all is well, of course. Many companies have laid off staff and more restructuring will follow. Some investor continue to worry about the second spike in infections as well as excessive inflation. For those who fear the devaluation of their assets resulting from rising inflation, we recommend holding real assets such as gold. Equities, of course, also offer such protection. Uncertainties linked to the outcome of the upcoming US presidential election in early November also continue to weigh on investor sentiment. President Donald Trump continues to trail his challenger Joe Biden in the polls, but the balance could at any time swing in the incumbent's favor. The Trump administration's anti-China rhetoric is likely to become more strident as the election approaches, which could unsettle financial markets and the economy.

We nevertheless remain confident regarding the global economy and financial markets, currently buoyed by central banks and generous recovery packages. While the pandemic continues to haunt us, it may have helped us put more focus on creating a more sustainable future.

→ **Webcast**
To view Dan Scott's webcast on recent market developments, click:
vonto.be/macro-en-sep20

Interest rates "lower forever"? We prefer equities to bonds

—
Frank Häusler
Chief Investment Strategist,
Vontobel

—
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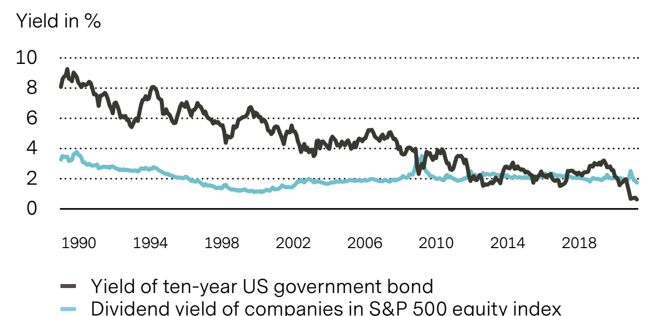
Senior Investment Strategist,
Vontobel

The key message from this year's virtual summit of central bankers in Jackson Hole, Wyoming, is clear: interest rate will remain near zero for years to come. This is yet another indication that central banks will do whatever it takes to keep pandemic-battered economies afloat. Interestingly, unorthodox monetary policy, long the preserve of "western" central banks, is gaining popularity in emerging markets as well. Supported by central banks' liquidity injections and government stimulus measures, the global economy seems on track for a recovery. However, the picture is less clear if we look at other yardsticks measuring second-round effects such as permanent job losses.

At the end of June, we upgraded equities to positive. Back then, a lot spoke for an overweight position: lockdown measures eased in many parts of the world, major central banks reacted with swift and decisive action, and governments bundled extensive support packages. This decision has worked in our favor, as equity markets rebounded significantly from the sell-off witnessed earlier in the year, with the most pronounced rally unfolding in the US, where especially tech stocks propelled indices towards new all-time highs. Despite equities' good run so far, we believe that a positive view on the asset class is still warranted.

This is due to several reasons. First and foremost, investors should bear in mind that the economy is still in the midst of recovering from the Covid-19 shock, and that we could so far observe more positive economic surprises than negative ones. While so-called "second-round effects" (e.g. due to the phasing-out of furlough schemes in some countries) will emerge at some point, be believe they will only become visible in a few months' time if at all material in magnitude. Second, central banks continue to provide markets with extensive support measures. Even some emerging markets central banks, which tend to have less room to maneuver than their developed markets peers, have recently signaled their willingness to consider unconventional measures. Yet central banks are not the only ones, which are determined to lay the foundation for the economic recovery – also, governments have committed themselves to extensive support measures. Another reason for the relatively higher attractiveness of equities versus bonds is evident in chart 1. For further asset allocation details, see the table on page 5.

Chart 1: Dividend yields holding up while bond yields slump – attractiveness of equities vs bonds has increased



Source: Refinitiv Datastream, Vontobel

	UNDERWEIGHT		NEUTRAL	OVERWEIGHT		
	significantly	slightly		slightly	significantly	
1 Liquidity		→				Given the low interest rates, liquidity remains one of the least attractive asset classes overall. We maintain our slight underweight.
2 Bonds		→				We stick with our underweight on fixed income overall. Within this asset class, both government and investment-grade bonds (IG) remain unattractive given their low yield versus equities. Despite risks modestly building up in high yield, we retain our relative preference and overweight on this sub-sector in light of still attractive spreads compared with those in IG, which we rate underweight, or emerging-market debt, where we have a neutral stance.
3 Equities				→		We retain our overall positive stance on equities. However, within this asset class, we upgraded emerging markets (EM) to overweight while downgrading Europe to neutral. This occurred due to EM assets' more attractive valuation, better earnings momentum, higher quality, and more appealing sector exposure. Moreover, emerging economies in east Asia – which make up about 60% of MSCI emerging market index – have handled the pandemic better than the Old Continent. Meanwhile, we continue to overweight Switzerland, the US, and Japan.
4 Gold					→	Our strong overweight stance on gold remains in place. While inflation should remain contained in the medium term, it could become a worry if government and central banks continue to resort to printing money. Moreover, the US dollar's weakness alongside limited gold supply should continue lending support to gold prices.
5 Commodities			→			Commodity returns rarely develop in line with those of stocks and bonds. They tend to rise in an environment of higher inflation, but hardly benefit from central banks' support measures. We are refraining from an overweight position at this time and retain our neutral stance.
6 Alternative strategies		→				We retain our underweight on hedge funds and neutral on insurance-linked securities (ILS). They served as a cushion in times of high volatility. After the central banks managed to calm financial markets, the need for such a backstop decreased.

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

Watch the Fed chief's smoke signals while the global economy recovers

This year's summit of the world's central bankers in Jackson Hole was a virtual affair owing to the pandemic. Still, the digital smoke signals that US Federal Reserve chief Jerome Powell sent across the Wyoming prairie were closely watched around the world. They speak in no hushed tones of the US central bank's resolve to spur growth, which will remain important even though the economy has hit its stride over the summer.

—
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—
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After darkening until May, the global economic picture brightened substantially during the summer months. Better data – in line with our expectations – started coming in as economies came out of strict lockdowns, governments launched record-high economic support measures, and central banks pumped liquidity into the financial system to stabilize markets. Not only the global demand – captured by retail sales data – but also supply – measured with industrial output numbers – rebounded quickly. Additionally, business sentiment surveys such as purchasing managers surveys (PMI) indicate a further improvement in global production (see chart 1).

Inflation rebounded from low levels with consumer prices likely to "normalize" further towards levels before the Covid-19 crisis. Keeping in mind the Jackson Hole smoke signals, we don't expect central banks to veer off their ultra-expansionary monetary policy course. We stick to our baseline scenario "Rehabilitation", in which global economic activity will reach a year-end level of around 95% of last year's. Our cautiously optimistic view could be compromised by a significant surge of Covid-19 infections (currently most acute in Europe), second-round effects of the economic downturn like more unemployment, or a worsening of the trade dispute between the US and its trading partners.

Europe on track, rising jobless rate looms

Post-lockdown economic data from the euro zone, Switzerland, and the UK, lifted spirits. However, economic growth in the euro area was record-weak for the second quarter (-12.1% vs the first quarter) and somewhat below our estimate, which urged us to downgrade the annual growth rate to -7.1 for 2020. Although we expect the growth recovery to continue in the second half, we forecast a further worsening on the jobs front in most countries due to structural changes, e.g. layoffs in the tourism sector. Unemployment will probably rise fastest in countries such as France, Italy, and the UK, which are beginning to make short-time labor schemes less generous (see chart 2). At the same time, this will reduce wage growth – one of the reasons why we expect inflation to normalize without surging above the inflation target. The European Central Bank (ECB) will probably follow through on its massive balance-sheet expansion plan via asset purchases, and engage in verbal intervention, i.e. distinctively "expansionary" communication, as it has to deal with a stronger euro and the Fed's policy overhaul (also see bonds article on page 8). Meanwhile, the Swiss National Bank (SNB) is likely to "only" keep intervening in currency markets to break any appreciation trend in the Swiss franc. Such ultra-expansionary policies, in combi-

nation with all the support measures from governments, should make potential second round effects manageable. These include job losses due to post-pandemic corporate bankruptcies or liquidity squeezes of households.

US economy surprises, consumers remain cautious
A spike in US Covid-19 infections notwithstanding, the economy has started to recover and data has generally surprised to the upside over the summer. Retail sales were up between May and July as relaxed lockdowns saw consumers opening their purse strings. Business sentiment has rebounded and the labor market is recovering from a low base. We have revised upward our forecast for 2020 annual GDP growth in the US to –5.1% from –5.9% to account for stronger growth in the third quarter – better, but still a dismal picture overall. We will continue to closely watch infection charts as well as labor market and consumer confidence indicators – the latter dropped again in August (see chart 3). Discussion in the US Congress regarding a fourth fiscal package worth 1trillion US dollars and additional unemployment benefits have been inconclusive so far. Failure to reach agreement could dent consumer sentiment further and leave millions of unemployed Americans in a precarious situation. Meanwhile, support from the US Fed is still massive. Its new flexible average inflation targeting will allow moderate overshoots of the “hard” 2% target. This implies that the federal funds rate will stay at zero for even longer (see also our bond section page 12).

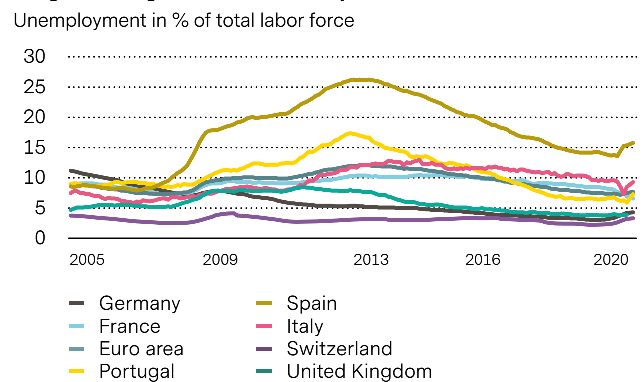
New Japanese leader will face old economic woes
Economic activity is also picking up in Japan, but the country trails other developed economies. We expect deflationary trends to persist this year and next. Prime Minister Shinzo Abe, who will step down before the end of his term in September 2021 for health reasons, will be remembered for “Abenomics”, a pro-growth policy his successor, likely to come from within the ruling Liberal Democratic Party (LDP), is expected to continue.

China powers ahead, Turkey in choppy seas
Emerging markets are generally recovering with Asia pulling the cart and Latin America lagging behind. This confirms our previous view that Asian economies – with the exception of India – have higher easing capacities than other emerging markets. Growth in China has recently surprised to the upside, prompting us to lift our 2020 growth forecast for the world’s second-biggest economy to 2.1% from 1.5%. The development in Turkey is cause for concern with depleted currency reserves – they only cover 45% of short-term debt – leaving the country increasingly exposed to foreign investors’ sentiment. Rising tensions between Turkey and Greece over gas resources near Cyprus aren’t helping. Capital flight and additional currency downside could undermine the economic recovery, possibly triggering aggressive rate hikes at some stage. Apart from Turkey, we see little risk of monetary policy swings, as inflation pressure across emerging markets remains moderate.

Chart 1: Manufacturers’ expectations of more orders point to a recovery in industrial production

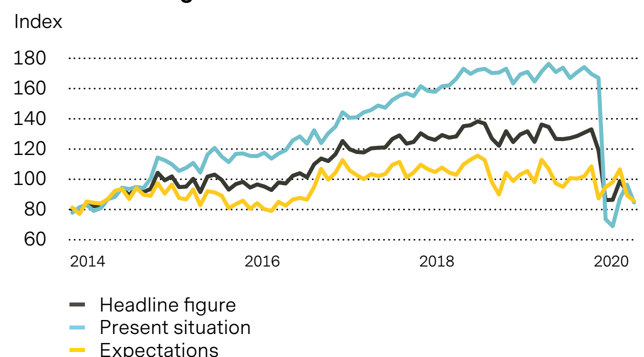
Source: IHS Markit, NPB, Refinitiv Datastream, Vontobel

Chart 2: The pandemic has reversed Europe’s longstanding decline in unemployment



Source: Eurostat, Seco, ONS, Refinitiv Datastream, Vontobel

Chart 3: After a brief rebound, US consumer confidence took a hit in August



Source: US Conference Board, Refinitiv Datastream, Vontobel

Will the pandemic blaze the "green recovery" trail?

Covid-19 still dominates the headlines, but worries about climate change haven't gone away. Could the "Great Going Green" be one of the pandemic-inspired tales our grand-children will remember? We have already marveled at clear blue skies without contrails, or cities cleared of the blur of toxic fumes. And we have been dreaming about a higher share of solar in the future energy mix in a world that may look a bit different from before the pandemic.

—
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—
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While we may be eager to tell a fantastic story, the reality is more prosaic. The Covid-19 outbreak brought carbon and nitrogen dioxide levels down globally, but these emissions are rising rapidly again. Pollution will also remain a problem for some time. Yet we are confident that things will change for the better – thanks to better technologies, better processes, better materials, but also a more conscious behavior.

Window of opportunity
The "decarbonization" of the economy was a hot topic in the period leading up to the pandemic, and it should gain traction again once the current health crisis is under control. Many observers say now is the time to ask fundamental question about our economy. While changes don't happen overnight, decisions to make them possible can be event-driven. Take Germany's "Energiewende", a post-Fukushima ruling to phase out nuclear power and invest into offshore wind farms instead.

We believe there will be a window of opportunity to attach green conditions to the largest state aid since the Great Depression. Car replacement incentives and support for shipping companies and airlines, for example, were implemented with requirements to reduce greenhouse gas emission. The French government, for instance, has demanded that Air France cut carbon emissions by half by 2030, in return for a 7 billion euro bailout.

Europe has a leg up
Regulation or government stimulus measures are among the factors driving such transformations. Europe seems to have a leg up on other regions in this regard. Brussels lined up the European Green Deal in 2019, an investment program worth 1 trillion euros to "decarbonize" the European economy. The aim is to make the European Union the first climate-neutral block by 2050, and the scheme will partly draw on funds from private investors. For all the complexity inherent in the EU's system, it has a record of pushing through eco-friendly initiatives such as tougher emission standards for cars.

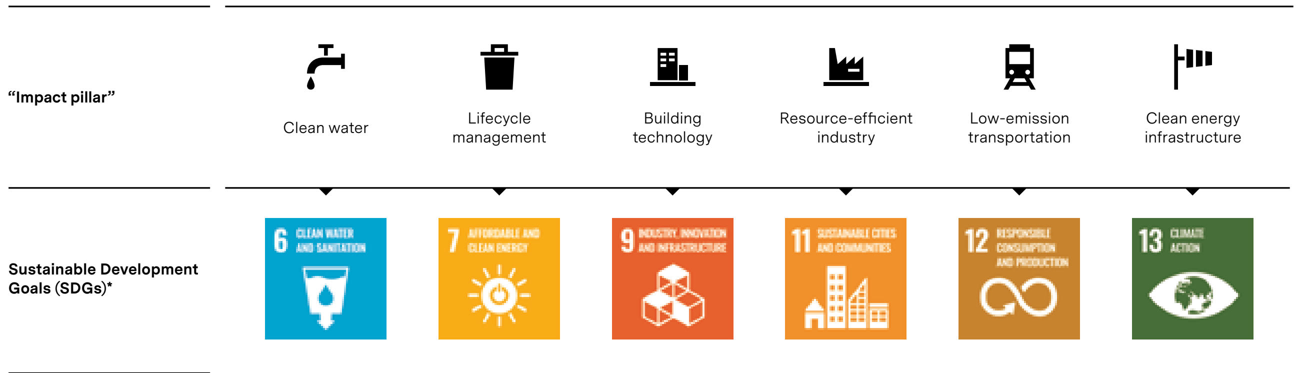
In the US, any faster move towards a "cleaner economy" will depend on the outcome of the presidential elections in November. The Democratic Party nominee Joe Biden wants to push the use of clean energy in the transportation, electricity and building sectors. Under the four-year plan worth 2 trillion US dollars, America would be on a path to reach the target of zero emissions by 2050.

China is transforming its energy sector
China – one of the world's biggest polluters but also the largest installer of solar and wind parks – is also in an energy transition. But its clean energy initiatives jar with the installation of at least 48 gigawatts of coal-fired power plants in first half of 2020. The longstanding plans to introduce a national emissions trading system would provide an important tool to cost-effectively decarbonize the energy sector.[1]

Companies rise to the challenge
The other driver of change will be innovation, a core competence of companies. We believe there are significant investment opportunities in areas like digitalization, resource efficient industries and "green" buildings that will not only benefit long-term climate ambitions but also increase economic benefits. We have been following several sectors for years (see figure 1), but the pandemic has thrust some of them into the limelight.

[1] See "Will China Choose a Green Recovery?", Center for Climate and Energy Solutions, August 6, 2020 https://www.c2es.org/2020/08/will-china-choose-a-green-recovery/

Figure 1: “Green recovery” elements found in six clean technology areas



* The Sustainable Development Goals (SDGs) are to be achieved globally and by all member states of the United Nations by 2030. The agenda featuring 17 goals was adopted by 193 countries in 2015.

Source: United Nations, Vontobel, for illustrative purposes only (as of July 31, 2020)

The work-from-home schedules most of us have embraced during lockdown remind us of the merits of connectivity. An interesting company active in this sector is Germany's TeamViewer, which offers software for remote control, maintenance and support for industrial applications as well as desktop sharing, online meetings and video conferencing.

Automation is another big topic. The mad scramble for medical equipment at the height of the health crisis has demonstrated the fragility of global supply chains. This phenomenon, and the US-Chinese trade conflict, will likely stimulate a build-up of stocks and some insourcing of production. Moreover, customers increasingly demand tighter environmental and corporate governance standards. The reshuffling of some manufacturing processes could generate good business for Daifuku or Kion, two companies active in factory automation, logistic systems or manufacturing equipment.

At the same time, the pandemic hasn't diminished the allure of most clean technology areas – we call them "impact pillars" to highlight the connection between investment and measureable impact on the environment. Take building technology. Cities are home to 55% of the world's population, and buildings absorb approximately one-third of all energy production, so lowering their consumption can make a world of a difference. One obvious way to do this is insulating buildings better, but installing energy efficient windows manufactured by France-based Saint-Gobain, for example, is equally important. Within the complex of heating, ventilation and air-conditioning systems, heat-pump producers like Sweden-based Nibe Industrier, or makers of energy efficient appliances and smart building controls like France's Schneider Electric or US-based Itron look set to benefit.

Another example is energy. The transition from fossil fuels to renewables requires top-notch power infrastructure. We expect to see significant investments to strengthen and expand the power grid over the next couple of years, and utility companies such as Orsted, and cable producers like Prysmian, play important roles in this market. Power from solar and wind has now reached volumes close to those from natural gas. A relatively new area of interest is hydrogen, but its contribution to the energy mix is small so far. Niche players benefited from numerous pilot projects, but now large industrial companies with hydrogen activities start scaling it up to commercial size. With their vast distribution and service networks, and deep pockets, they win customers' trust and will make this element a key part in the future energy market.

The green recovery

The world won't go back to pre-corona times, in our opinion. We may fill up our tanks with cheap petrol in the short-term, but fly less. Companies will want their employees back at their desks, but will also have discovered the benefits of video conferencing and lower travel expenses. Governments will have to shoulder mountains of debt, but may also line up legislation to promote better corporate governance and social standards. We believe that active investors like us, whose holdings reflect conviction and stock selection experience, will be able to take advantage of the opportunities the green revival offers.

US Fed's policy overhaul is likely to steepen the yield curve

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel

The US Federal Reserve has finally announced its new "average inflation" target, which implies that interest rates will remain "lower for even longer". Nevertheless, government bonds with long maturities will at some stage factor in an uptick in inflation, which is why we expect the yield curve to steepen slightly. Expectations regarding an imminent comeback of inflation pressure given the huge amount of liquidity that will be pumped into the economy have already lowered real yields significantly.

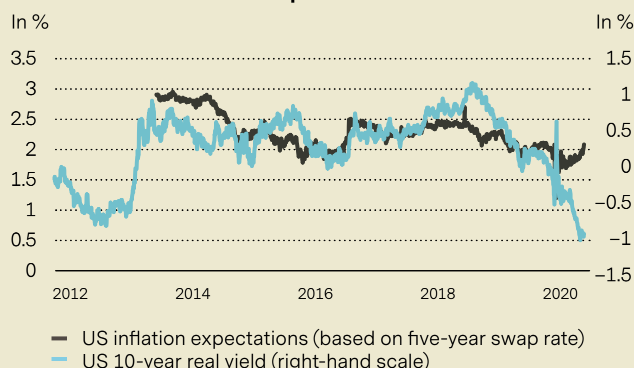
One notable move this summer has been the fall of real yields to a new record low. The US ten-year real yield, calculated as nominal yields minus inflation eexpectations, hit –1.08 in early August (see chart 1), and has since hovered around this very subdued level.

Higher prices due to economic recovery?
The factor behind the move has been the rebound of inflation expectations: with the economic recovery starting to take shape, investors are expecting more price pressure ahead. Real rates are likely to continue moving down over coming years, as nominal yields will stay low and inflation should gradually recover. However, we see little immediate risk of inflation overshooting massively, as economic activity and labor markets remain too weak to generate meaningful price pressure. Any further short-term downside for real yields should therefore be limited.

With new framework: rates lower for even longer
Under the US Federal Reserve's new flexible inflation policy announced at this year's virtual Jackson Hole summit of central bankers, the Fed will look to reach an average level of 2% over time, offsetting periods of weak inflation with readings "above 2% for some period of time". In addition, the central bank will prioritize employment over inflation in its monetary policy strategy, and will seek to ensure a maximum level of "broad and inclusive" employment. These dovish moves indicate the federal funds rates will probably stay at the zero lower bound for the foreseeable future. While the Fed's projections or "dots" currently point at no key rate hike until at least 2022, we believe the central bank could freeze key rates even beyond that date to allow higher inflation and boost employment.

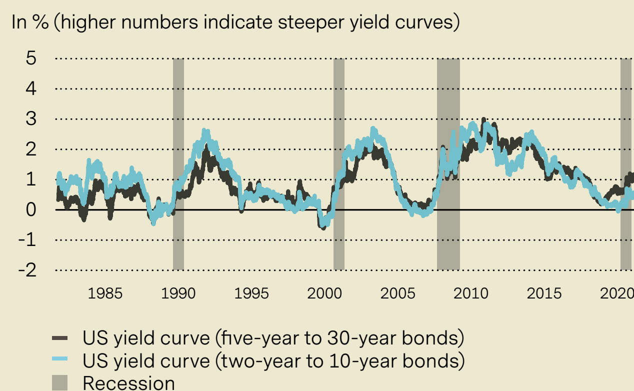
Expect a marginally steeper yield curve as a result
This strategy shift means that short-term bond yields, generally following key rates, will stay low for an even longer period than previously expected. Conversely, longer maturities could well price in slightly more inflation, ultimately leading to a steepening of the yield curve in the medium term, from the currently still rather flat level (see chart 2).

Chart 1: Ten-year US real yield at a low in August, medium-term inflation expectations rise



Source: Refinitiv Datastream, Vontobel

Chart 2: Yield curve seen steepening as markets price in a bit more inflation



Source: Refinitiv Datastream, Vontobel

Equities are still the place to be, regardless of the recent rally

—
Stefan Eppenberger
Equity & Commodity Strategist, Vontobel

A circumspect investor should do frequent reality checks. Since the end of June, we have been recommending an overweight in equities. At that time, we compiled a checklist of ten arguments that support our recommendation. The markets have moved more than 10% higher since then. Time to review our arguments.

The stock markets continued to move upwards over the summer without looking back. The MSCI World is already back in positive territory for the year, despite the global economic crisis. Particularly surprising for many investors was the quick rebound since the end of March. However, if we compare this with other periods, for example the stock market recovery after the global financial crisis, we are moving at a similar pace (see chart 1).

Arguments for stock investments still valid
We have been recommending an equities overweight since the end of June, based on ten points that investors need to keep in mind. The strong rally over the summer calls for a review. While most indicators continue to suggest an overweight position, a few advise a more cautious stance.

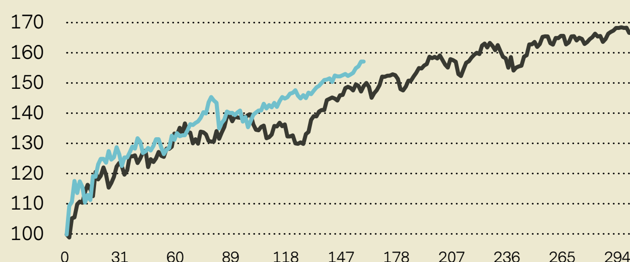
Most macroeconomic arguments support the investment case. First, any re-imposition of strict lockdowns seems out of the question. Governments and medical staff have learned how to handle the pandemic, and policymakers know drastic containment measures would nip the economic recovery in the bud. A strong argument is the central banks' generous injection of liquidity, much of which flows directly or indirectly into the financial markets. This should continue to support stock prices.

One indicator tracking the economic support from fiscal policy has slipped a bit from its June level as several aid initiatives are expiring or losing their effect. Likewise, the "economic surprises" measure, in an upward trend since June, will probably struggle to deliver better-than-expected results – for the simple reason that expectation may be too high now.

Investors worry? Little to worry about
However, the message from the remaining indicators is still clearly stock-positive. Valuations, especially when compared with government bond prices, look attractive, and may even continue to rise thanks to the expansive monetary policies. Corporate earnings for the second quarter have also surprised on the upside. As a result, analysts now need to revise their estimates upwards, which is usually a good omen for equities. Moreover, technology companies continue to exhibit strong earnings growth.

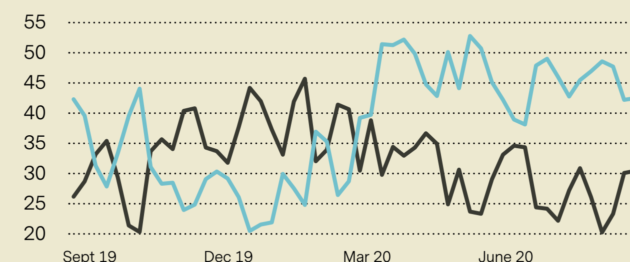
Surprisingly enough, the mood among investors remains subdued. According to representative surveys among US investors, a majority still expect falling rather than rising markets (see chart 2). But we believe there is little to worry about. A cautious sentiment among investors often indicates that markets can rise even further.

Chart 1: Equity market rebound after first Covid-19 wave surpasses recovery post financial crisis in 2009
Point gains in MSCI World Index



Source: Refinitiv Datastream, Vontobel

Chart 2: Investors remain cautious despite the stock market rally
In %



Source: American Association of Individual Investors, Refinitiv Datastream, Vontobel

Gold eases past ambitious price target amid “crazy” buying

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

Gold investors were able to enjoy a relaxed summer. Over the past few weeks, the precious metal gained more than 300 US dollars per ounce. While the potential for further rises is getting smaller, gold remains an attractive portfolio building block.

When we set a price target of 1,800 US dollars last March, some considered it ambitious. In the meantime, gold has reached, and eased past, this level with remarkable ease. Many analysts have now followed suit, raising their target to over USD 2,000, some even to USD 3,000. It seems that the whole world is crazy about gold. We also remain confident, but it is harder to find fundamental support for prices much above 2,000 USD – our new target.

The virtuous circle

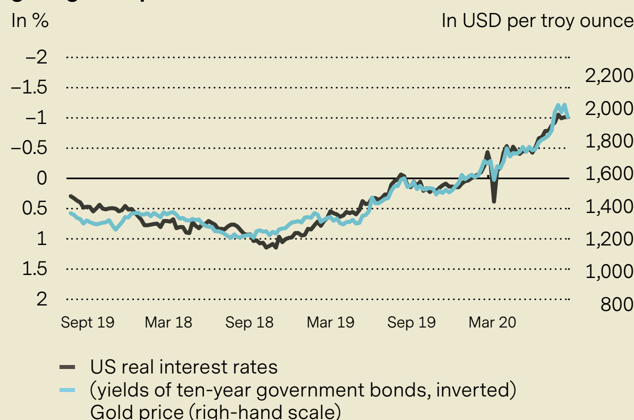
The key reason for the rally is the fall in US real interest rates. This heightens the attractiveness of non-interest-bearing gold. Rarely has this negative correlation been as obvious as at present (see chart 1). Moreover, the downward trend in US real interest rates (nominal interest rate minus inflation rate) puts the US dollar under pressure, which, in turn, drives US consumer prices higher. And in the current economic environment, the US Federal Reserve will hardly move to reverse this trend via higher key rates, for example. Quite the opposite: the US central bank has made it pretty clear it will tolerate more inflation. This means that interest rates will remain stable, inflation will rise and real interest rates will fall. The result is a threefold positive effect for gold: falling real interest rates, a weaker US dollar and rising inflation. However, any tightening of US monetary policy, or a leveling off of the rise in US consumer prices, would cut this cycle short.

We believe the gold rally will slow down in the coming months, as inflation is also likely to experience some headwind. The economy is growing well below potential, which rarely leads to inflationary pressure. In addition, real interest rates rarely fall below -1%, as we have seen during the last gold bull market (see chart 2). This means that the gold-friendly effect from rate moves will decrease.

Overweight confirmed

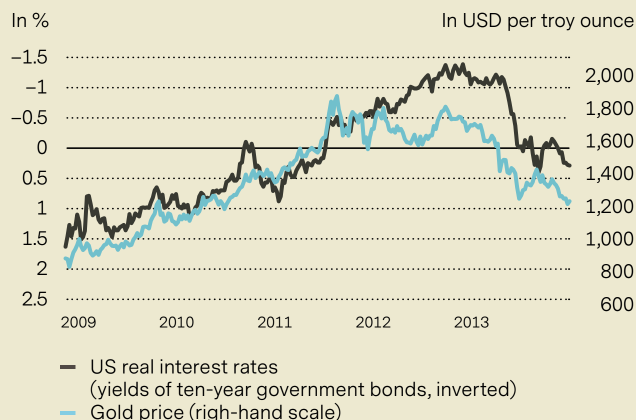
At the same time, a significantly weaker US dollar could spark another gold rally. It is also worth remembering that gold can have a stabilizing effect in a portfolio. Therefore, we remain overweight in gold.

Chart 1: When real interest rates go down, gold goes up



Source: Refinitiv Datastream, Vontobel

Chart 2: During a previous gold bull run in 2013, real interest rates bottomed out at –1%



Source: Refinitiv Datastream, Vontobel

Euro may pause on its upward path until US election dust settles

—
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After weakening over the summer months, the US dollar may move sideways ahead of US presidential elections. Even so, the European currency's medium-term appreciation trend versus the greenback will remain in place, we believe.

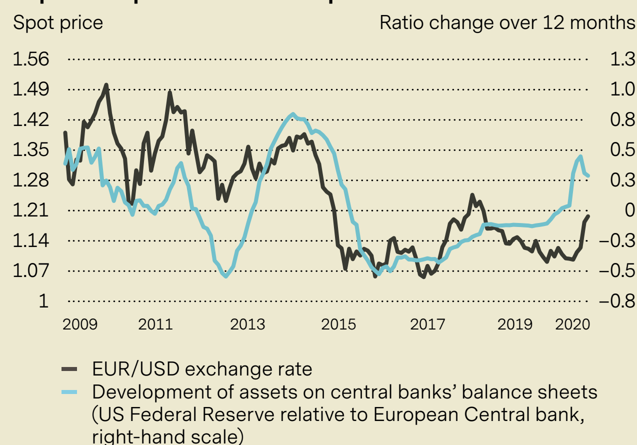
The key message from the first-ever virtual powwow of central bankers in Jackson Hole was clear: No US rate hikes as far the eye surveying the Wyoming prairie can see. This is bad news for the US dollar and good news for cyclical currencies in Europe and the Asia-Pacific region. Nevertheless, the risk of violent swings in currency markets remains. Much will depend on whether Donald Trump dials up his anti-China rhetoric to boost his approval ratings before November 3. So far, the Chinese reaction to the recent US ban on the TikTok and WeChat apps has been muted, but any nasty tit-for-tat could hit market sentiment. Therefore, we expect the euro and Scandinavian currencies to take a breather until the US election dust has settled. Naturally, there are many moving parts, including questions relating to the pandemic and the possible tightening of US fiscal policy under a Joe Biden administration.

Swiss franc riding on euro's coattails
Our bullish view on the euro and the Swiss franc remains in place. Our basic assumption is that the US will take longer to recover than the euro zone. Moreover, the liquidity injections in America surpass those in Europe (see chart 1), which is negative for the US dollar. The relative strength of the euro should drag along the Swiss franc given the close economic links between both regions. The euro's attempts to leave the Swiss franc behind typically end around a EUR/CHF level of 1.07, and we expect the pair to move in a 1.10–1.05 range over the next 12 months. This implies further moderate gains in the Swiss franc against the US dollar.

Consider the yen a US election hedge
The Japanese yen remains the most attractive currency hedge for the remainder of the year, in our opinion. Any escalation of the US-Chinese trade and technology spat should benefit the yen, even versus the US dollar. While a new Japanese prime minister will probably retain the pro-growth bias of outgoing Shinzo Abe, any sign of frugality would support the currency as well. Even in the absence of US election crossfire, the yen looks set to gain moderate ground against the US dollar, as it has for most of this year.

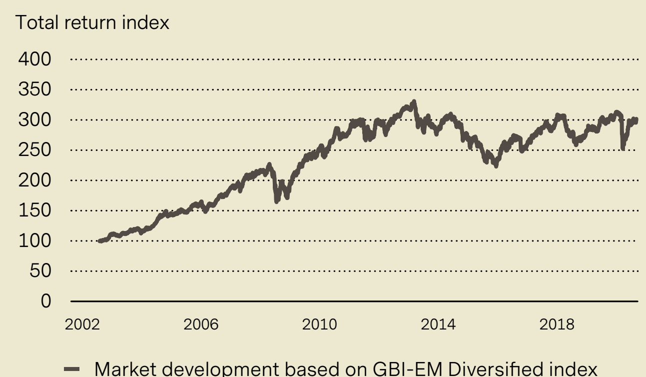
Emerging currencies unleashed post November 3?
Emerging-market currencies have hardly benefited from the dollar's recent weakness. Most of the solid performance within the local-currency debt segment came from the bond side (see chart 2). One important reason for the currencies' sluggishness is the uncertainty regarding the magnitude of the economic recovery in emerging economies. The situation won't change in the short term, but in our base scenario, we see moderate upward potential of emerging-market currencies versus the US dollar after the US elections.

Chart 1: US Federal Reserve's fast balance sheet expansion puts dollar under pressure



Source: Refinitiv Datastream, Vontobel

Chart 2: Emerging-market local-currency debt still trades below end of 2019 levels



Source: Refinitiv Datastream, Vontobel

Economy and financial markets 2018 – 2021

The following list shows the actual values, exchange rates and prices from 2018 to 2019 and our forecasts for 2019 and 2020 for gross domestic product (GDP), inflation / inflationary expectations, key central bank interest rates, ten-year government bonds, exchange rates and commodities.

GDP (IN %)	2018	2019	CURRENT	FORECAST 2020	FORECAST 2021
Euro zone	1.9	1.2	–15.0	–7.1	5.6
US	3.0	2.3	–9.5	–5.1	3.5
Japan	0.3	0.8	–10.0	–5.3	2.3
United Kingdom	1.3	1.4	–21.7	–7.9	5.9
Switzerland	2.7	0.9	–1.5	–5.4	5.8
China	6.6	6.1	3.2	2.1	8.3
INFLATION (IN %)					
Euro zone	1.8	1.2	0.4	0.6	1.3
US	2.4	1.8	1.0	1.1	1.8
Japan	1.0	0.5	0.4	0.0	0.1
United Kingdom	2.5	1.8	1.0	0.8	1.5
Switzerland	0.9	0.4	–0.9	–0.5	0.6
China	2.1	2.9	4.5	2.5	2.0

KEY INTEREST RATES (IN %)	2018	2019	CURRENT	FORECAST 3 MONTHS	FORECAST 12 MONTHS
EUR	–0.40	–0.50	–0.50	–0.50	–0.50
USD	2.50	1.75	0.25	0.25	0.25
JPY	–0.10	–0.10	–0.10	–0.10	–0.10
GBP	0.75	0.75	0.10	0.10	0.10
CHF	–0.71	–0.69	–0.75	–0.75	–0.75
AUD	1.50	0.75	0.25	0.25	0.25
CNY	4.35	4.35	4.35	4.00	4.00
10-YEAR GOVERNMENT-BOND YIELD (IN %)					
EUR (Germany)	0.2	–0.2	–0.5	–0.5	–0.3
USD	2.7	1.9	0.6	0.7	1.0
JPY	0.0	0.0	0.0	0.0	0.0
GBP	1.3	0.8	0.2	0.3	0.7
CHF	–0.2	–0.5	–0.5	–0.6	–0.5
AUD	2.3	1.4	0.9	0.9	1.0
EXCHANGE RATES					
CHF per EUR	1.13	1.09	1.07	1.07	1.07
CHF per USD	0.99	0.97	0.91	0.91	0.88
CHF per 100 JPY	0.90	0.89	0.86	0.85	0.84
CHF per GBP	1.26	1.28	1.19	1.20	1.24
CHF per AUD	0.69	0.68	0.65	0.65	0.63
USD per EUR	1.14	1.12	1.18	1.17	1.22
JPY per USD	110	109	106	107	105
USD per AUD	0.70	0.70	0.72	0.71	0.72
CNY per USD	6.95	6.51	6.86	7.05	7.10
COMMODITIES					
Crude oil (Brent, USD/barrel)	53	66	44	45	55
Gold (USD/troy ounce)	1281	1521	1940	2000	2000
Copper (USD/metric ton)	5949	6149	6512	6750	7000

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 21.08.2020

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