Vontobel

Investors' Outlook

"Stayin' Alive" as the global economy gets defibrillated

July / August 2020

Content

i Dear readers, as of the current July/August edition, the Investors' Outlook has gone digital, providing you with all the benefits of an exclusively internet-based publication. You'll continue to find Vontobel's house view on asset allocation, our macroeconomic assessment as well as insights from across all of our boutiques. We hope you enjoy the reading. Please also be aware that the next issue of the Investors' Outlook will follow in early September, after the holiday season.

Imprint

Publishing by
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Frequency
Ten times per year
(next issue September 2020)

Concept
MetaDesign AG

Creation & Realization
Vontobel

Images
Gettyimages,
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Input deadline for this edition
July 3, 2020

Remarks
* see page 17 "Legal information": analyst confirmation
** Duff & Phelps is a cooperation partner of Vontobel. Vontobel Asset Management is in the process of launching an infrastructure fund together with Duff & Phelps.

“Stayin’ Alive” as the global economy gets defibrillated

Dear readers,

Before using the defibrillator in a first-aid course, you learn to thump the patient’s chest to the rhythm of the Bee Gees hit “Stayin’ Alive”. Governments and central banks are applying some of the same Saturday Night Fever magic to the global economy.

Across the world, they have unleashed a historic flood of stimulus packages to combat the downturn in the aftermath of the Covid-19 pandemic. Japan has unveiled emergency economic packages equivalent to more than 40% of the country’s gross domestic product, including cash handouts to affected individuals and firms, and tax deferrals. In the European Union, the corresponding figure is 30% of GDP. Meanwhile, the US announced four emergency relief bills in March and April with a combined price tag exceeding 3 trillion US dollars. These included stimulus checks to qualifying American households, increases to unemployment insurance, the expansion of paid leave, forgivable loans to small businesses, and other major supports for business.

In addition, the Trump administration is reportedly set to announce a 1 trillion US dollar infrastructure bill as part of its next stimulus package. Most of the money would go to roads, bridges, and tunnels, with a quarter earmarked for the buildup of the latest generation of wireless communication infrastructure, and the upgrade of broadband lines in rural areas.

On the other side of the Atlantic Ocean, the German chancellor and the French president have called for a sustainable and climate-friendly recovery to revive the old continent’s virus-stricken economies while simultaneously combating climate change. Last month, the EU proposed a “green” recovery fund worth 750 billion euros that will boost infrastructure spending, while also contributing to the continent’s on-going green transition. Grants and loan guarantees will be earmarked for building renovations and environment-friendly heating, investments in clean cars, charging stations, zero-emissions trains and recycling infrastructure, as well as support of hydrogen as a fossil fuel surrogate.

Some European countries have already come quite far in the green energy transition because of major investments in wind turbines, solar farms and hydropower plants. Spain’s renewable infrastructure, for instance, generates more than half of the country’s total generation capacity. Last year, the UK reached a similar milestone when renewables for the first time generated more electricity than fossil fuels. Both countries annually produce more renewable energy than the energy generation capacity of the oil that Saudi Arabia pumps out.

As I write, the global economy is still in a recession, but there are already numerous encouraging growth signals as countries emerge from Covid-19 lockdowns. The record-breaking support measures to support the economy are reminiscent of the high-energy electric shocks that can bring around a victim of a heart attack.

The healing process won’t be without setbacks, however. We may see isolated and localized Covid-19 lockdowns or an escalation in trade tensions. The travel industry may never look the same again. Our embracing of “working from home” arrangements may have a lasting effect on commercial real estate prices. Nonetheless, asset prices are well supported by loose monetary policy and a flood of stimulus. As investors, we need to capture the current opportunities while dodging the potential risks.

The following pages will give you an understanding of our current allocations and our views across asset classes. We remain convinced that given the unprecedented level of fiscal stimulus and monetary policy support, global growth stands a good chance of reaching pre-crisis levels before the end of 2021. On that mildly positive note and to the tune of “Stayin’ Alive”, I wish you all the best for the summer.

—
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→ **Webcast**
To view Dan Scott’s webcast on recent market developments, click:
https://vonto.be/macro-en-jul20

Rehabilitation may come sooner than thought as economic fears recede

—
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—
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Our scenario of a global, deep, but temporary shock caused by the pandemic has not changed. We expect global GDP growth to contract by –4% in 2020 and rebound by 5% next year. We assume that potential future waves of infections will be manageable, and fiscal as well as monetary impulses from governments and central banks will remain in place. This would keep in check damaging second-round effects from containment measures.

The Vontobel Investment Committee (IC) therefore sees an increased likelihood of an "economic rehabilitation", while acknowledging risks tied to an unclear roadmap after Brexit, US-Chinese trade tensions and an uncertain outcome of US election. Overall, risky assets such as equities remain supported by prospects of positive economic surprises in the near term, a backdrop of easy money, loose monetary conditions as well as high investor cash balances. This brings us to the following recent changes to our asset class views:

In fixed income, we upgraded our view on high yield to positive while downgrading investment grade (IG) corporate bonds to slightly negative. High yield continues to offer an attractive spread, benefiting from the influx of so-called fallen angels, i.e. investment grade bonds recently relegated to the high yield category, thereby improving the overall quality of that segment. Moreover, investment grade corporate paper now again trades at levels seen before the crisis. We have also downgraded emerging market debt to neutral despite this segment's attractive yield. The pandemic is currently getting worse in emerging economies, a region where strained budgets often limit the possibility of fiscal policy offsetting economic woes. Given that we were already negative on government bonds, this leads us to a slightly negative view for the asset class as a whole.

We upgraded equities across developed markets, resulting in an overall positive view. It is encouraging to see that the market recovery has broadened to less expensive and more cyclical segments. This performance pattern is usually supportive for future returns, as it is more typical for an early stage of recovery in an economic cycle. Overall, equity market valuations do not appear expensive compared to fixed income, even when considering strong year-to-date gains by a few outliers. With yields on cash and bonds close to zero, equities retain their allure, which implies that investors are still prepared to pay higher prices. This is also why it is a mistake to compare today's equity valuation with peak levels observed during the dot.com period. We have added exposure to listed infrastructure companies, which directly benefit from government stimulus measures. In our stock selection, we focus on quality and structural growth aspects, rather than on regional performance.

Within alternative strategies, we are upgrading our view on gold to a strong positive, downgrading hedge funds to a negative and insurance linked securities (ILS) to neutral in order to balance the equity risk increase. In an environment of exceptionally low government bond yields, the strategic case for gold as an alternative shock absorber against unforeseen portfolio risk is strengthened.

Our downgrade in hedge funds and ILS stems from our view that in a market environment in which central banks suppress market volatility, the need for both asset classes on diversification grounds has lessened.

	UNDERWEIGHT significantly	UNDERWEIGHT slightly	NEUTRAL	OVERWEIGHT slightly	OVERWEIGHT significantly	
1 Liquidity		→				Given the low level of interest rates, liquidity remains one of the least attractive asset classes overall. In light of the recent monetary policy decisions, the central banks of America and Europe have once again shown their determination to keep interest rates "lower for longer". The Swiss National Bank looks set to follow suit.
2 Bonds		↘				We have moved to a slightly negative view overall. Within the asset class, the relative preference of high yield versus emerging market debt changes. We upgraded high yield paper to positive on its attractive spread at the expense of emerging market debt, which we took down to neutral. We have also downgraded Investment grade corporate bonds to slightly negative after prices bounced back to pre-crisis levels.
3 Equities				↗		We have upgraded equities to positive overall on the back of a more favorable view on developed-market stocks. Valuations remain attractive. With central bank's greasing economic wheels, and investors looking to deploy their cash, risky assets such as equities are likely to remain a buy. We are adding exposure to listed Infrastructure equities, which directly benefit from government stimulus measures.
4 Gold					↗	Gold moves to strong positive, presenting a counterweight to our increased equity risk. In an environment of exceptionally low government bond yields, the precious metal can act as a shock absorber, shielding portfolios against unforeseen risks.
5 Commodities			→			Commodity returns are largely independent of stock and bond returns. They tend to gain in an environment of rising inflation, but hardly benefit from support measures provided by central banks. As long as there is no marked pick-up in economic recovery and no significant weakening of the US dollar, we are refraining from a positive view.
6 Alternative strategies		↘				We downgrade hedge funds to negative and insurance linked securities to neutral. Being invested in these segments made sense in times of high volatility. However, the need to guard against wide swings has decreased after central banks' actions are targeted at calming financial markets.

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

Heading south, we see the economy turning the corner

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The more adventurous among us are about to head off to southern beaches, brushing aside worries about quarantine measures and cumbersome procedures at Europe's borders. We may also try to imagine what the world will look like after the summer lull. In our baseline scenario, the summer holidays should lift the mood among consumers and companies, and economic performance will rebound.

While all of us deserve a summer break from the daily drone of Coronavirus news, the issue won't go away. Our new economic scenarios reflect the likelihood that governments will keep the economy open despite a fresh outbreak of the disease later in the year, leading to our cautious optimism regarding this year's economic development (see scenarios table on page 8).

"Rehabilitation" is our base scenario (probability of occurrence 50%)

The economy is making a nice but gradual recovery with the help of crutches provided by central banks and governments. A second wave of infections, though severe, won't result in significant lockdowns because governments and people already know how to respond. The healthcare sector will have built up capacity, and the pressure to keep the economy running will be significantly higher than during the first wave.

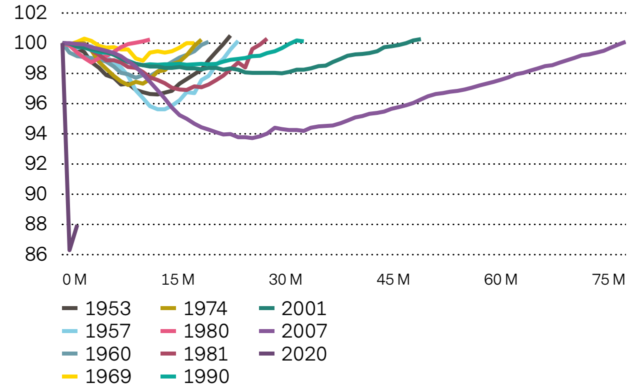
In this scenario, the economy will stage a second-half rebound from a deep but quick recession. The so-called second-round effects (e.g. insolvencies, bankruptcies of firms and households) should be manageable. Governments, consumers and states will return to previous spending patterns. Central banks will push the "whatever it takes" line to keep markets calm, indirectly financing governments' rescue programs. Debt will rise without presenting a massive problem (yet), but inflation will remain under control because the lockdown has done away with any upward pressure on salaries. This scenario rests on the assumption that trade relations between the US and China, or the UK and the European Union, won't deteriorate.

US struggles with pandemic:
Growth –5.9%, inflation 0.8%, key rate 0.25%
The financial markets will be in thrall to the presidential election in November. Donald Trump currently seems to be falling behind in opinion polls due to his handling of the health crisis and response to popular protests, but the race is still open. His rival Joe Biden has yet to prove his mettle. Their intensifying struggle and a rise in Covid-19 infections may lead to sharp mood swings at home and abroad. Though the US economy will start recovering in the third quarter, this year's annual growth rate will remain in deep negative territory and the US unemployment rate will stand at around 8%-10% by the end of the year (following an unprecedented collapse in the US labor market, see chart 1). It will be particularly interesting to follow the jobless situation in US "swing states" that could tip the balance of the presidential election. The US Federal Reserve's bond-buying program will continue at least until 2021, and the central bank's balance sheet could rise to USD 9 trillion by the end of 2021. No rate hike is expected before 2023. We expect the US Congress to pass a fourth – the last – fiscal support package this summer.

China holding up:
Growth 1.5%, inflation 2.6%, key rate 4.35%
Financial markets generally cherish predictability, and in this respect, China has lived up to expectations for 31 years. However, China's growing assertiveness – expanding its territory on the Indian-Chinese border, or in the East China and South Chinese Sea, or imposing a security law on Hong Kong – call into doubt its status as guarantor of stability. Geopolitics aside, its economy will be among a few to register growth this year (see chart 2), although a plus of 1.5% looks razor-thin compared with previous rates. In our base scenario, Chinese default rates and rising unemployment will be manageable.

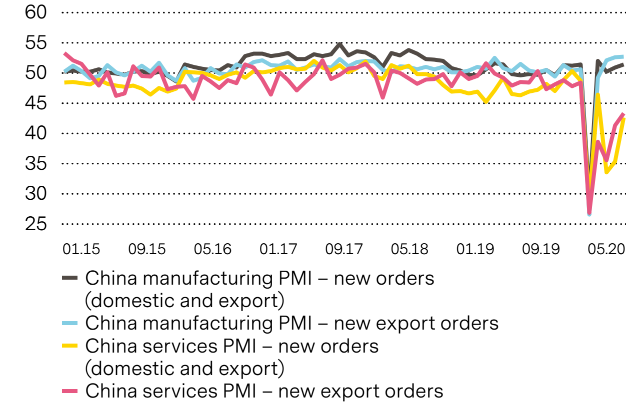
Euro zone fights its way back to growth:
Growth –6.3%, inflation 0.5%, key rate –0.50%
The coronavirus crisis has exacerbated the European Union's differences, but after botching the initial response to the crisis, there is also a growing sense of "we're all in this together". Apart from European governments launching national rescue plans and reopening borders, there are high-level actions and initiatives at the EU level to dampen the negative effects of the crisis. These include the first steps towards a common debt-financing mechanism (a Franco-German proposal for a recovery fund). The European Central Bank (ECB) keeps interest rates on the rising government debt low through its pandemic emergency purchase program, or PEPP (a new "quantitative easing" measure, see chart 3) and supports the banking system with liquidity provided even at a negative interest rate (via its long-term refinancing operations called PELTROs and TLTRO III, also see bonds column, page 12). The unemployment rate will be high at approximately 9% on average, but hard-hit southern Europe, at least, should be able to keep the rise in check as it returns to a more normal tourist season. Worries that the ECB's bond-purchasing program could be derailed by an adverse German Constitutional Court's ruling appear to have passed. In Switzerland, which isn't an EU member

Chart 1: Unprecedented collapse in US employment due to the pandemic
US employment index during past recessions
(100 = start of economic contraction)



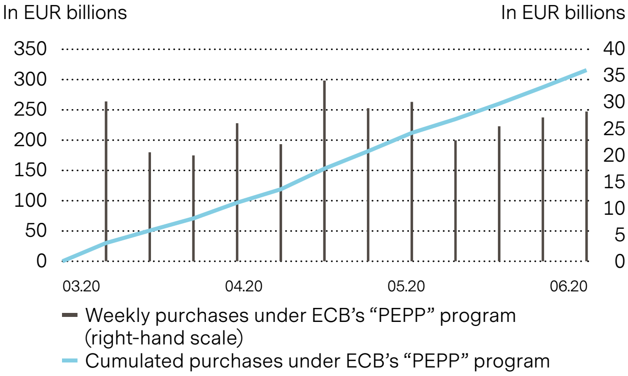
Source: US Bureau of Labor Statistics, Refinitiv Datastream, Vontobel

Chart 2: China's domestic economy springs back to life
Index (>50 means expansion)



Source: Statistical office of the Peoples Republic of China, Refinitiv Datastream, Vontobel

Chart 3: European Central Banks floods markets with liquidity



Source: ECB, Refinitiv Datastream, Vontobel

Our economic scenarios for the second half of 2020

Scenario	Developments
Rehabilitation (probability 50%)	– **Global:** No significant lockdowns despite second pandemic wave, deep recession but growth recovers – **US:** Harsher trade rhetoric because of elections but mild actions, gradual growth recovery – **Euro zone:** EU recovery fund, UK-EU negotiations according to plan, growth rebounds at a solid pace – **China:** Manages to stabilize economy despite global weakness, domestic demand recovers – **What central banks do:** Implement known measures, flag readiness to act ("whatever it takes" stance)
Intensive care (probability 25%)	**We will enter our negative scenario if we see more of the following developments:** – **Global:** Similar lockdowns as in the first half, three months of severe economic conditions – **US:** Trade dispute between the US, China, and the EU worsens, negative second-round effects – **Euro zone:** No recovery fund and breakdown of Brexit negotiations, US taxes car imports from EU – **China:** Massive trade and technology dispute with US, aggressive Chinese policy towards neighbors – **What central banks do:** Push the "whatever it takes" line harder, increase pace of asset purchases
Recovered (probability 25%)	**We will enter our positive scenario if we see more of the following developments:** – **Global:** Lockdown restrictions relaxed, negligible second wave of pandemic, "animal spirits" awaken – **US:** Trade tensions with China ease, negligible second-round effects, more fiscal spending – **Euro zone:** Recovery fund surprises, trade improves (no car tariffs on EU cars in US, smooth Brexit) – **China:** Relations with US improve, few non-performing loans, fiscal impulse surprisingly high – **What central banks do:** Remain supportive, ease out of "whatever it takes" mode in Q4

Source: Refinitiv Datastream, Vontobel

state, the economy will probably contract by close to 6%, but the country should be able to get its longstanding bilateral treaties with the European Union approved in a national referendum. Its sound fiscal standing will help Switzerland manage the crisis quite well.

"Intensive care" as risk scenario (probability 25%)

In this negative scenario, governments snap back into emergency mode amid a second onslaught of the pandemic, imposing lockdowns that send the economy into intensive care. The recent virus outbreak at a German abattoir shows that the recovery may come in fits and starts. Other risks emerge, nipping an economic recovery in the bud. The US-Chinese trade row gets worse and extends to Europe. Squabbles between European Union members raise fears that the euro area could break up. Negotiations between Brussels and London about a post-Brexit trade agreement collapse. The second-round effects from past lockdowns turn out to be substantially worse than in the baseline scenario.

US hit by new lockdowns and trade conflict:
Growth –10%, inflation: –1%, key rate –0.5%
In our negative scenario, a severe second wave of Covid-19 infections and its aftershock lead to a protracted economic downturn. The annual growth rate plunges by nearly 10%, while inflation turns negative. The lower growth rate fails to revive the labor market during the second half. Donald Trump seeks to blame China for any setback in his election campaign, and the deteriorating trade ties between the world's two largest economies stifle growth. In this environment, we would expect the US Federal Reserve to increase the volume of asset purchases and even use new tools such as negative interest rates to support the economy.

China slips on growth and geopolitics:
Growth –2%, inflation: 0.5%, key rate 3.00%
The outlook for China darkens on economic and geopolitical risks. Another global demand shock – for example due to strict lockdowns after a second wave of the pandemic – pulls Chinese growth rates into negative territory. In addition, China's growing aggressiveness – a more confrontational stance towards India as well as its neigh-

bors in the East and South China Seas, or the imposition of a security law on Hong Kong – drives investors away from China and other emerging economies. US sanctions against China due to its tightening grip on Hong Kong are a possibility but rather unlikely, in our view.

Euro zone facing double whammy:
Growth –9.5%, inflation 0%, key rate –0.6%
A failure to establish the EU recovery fund, a worsening trade dispute with the US resulting in import tariffs on European cars, or another series of nerve-wracking Brexit talks and votes depresses economic sentiment. We expect the ECB to react with a significant expansion of its monetary stimulus, e.g. doubling its assets purchases or even start buying equities, and probably cut key rates again.

"Recovered" as an optimistic scenario (probability 25%)

In this positive scenario, governments relax almost all the remaining lockdown measures, allowing the economy to throw away the crutches. The second wave of Covid-19 infections turns out to be a mere blip on virologists' screens, a situation possibly improved further thanks to a Covid-19 vaccine. Economies and financial markets roar back to life. The US spike in the unemployment rate is followed by a similar move in the opposite direction. Relations with China get better, sending an upbeat signal to financial markets. The EU sees its recovery fund take shape quickly over summer, and agrees with the UK on an "orderly Brexit" including an outline for a comprehensive trade deal. The flood of liquidity in the financial system, and a surge in consumer as well as business sentiment, trigger a wave of consumption and investments, pushing the global economic performance back towards levels seen at the end of 2019.

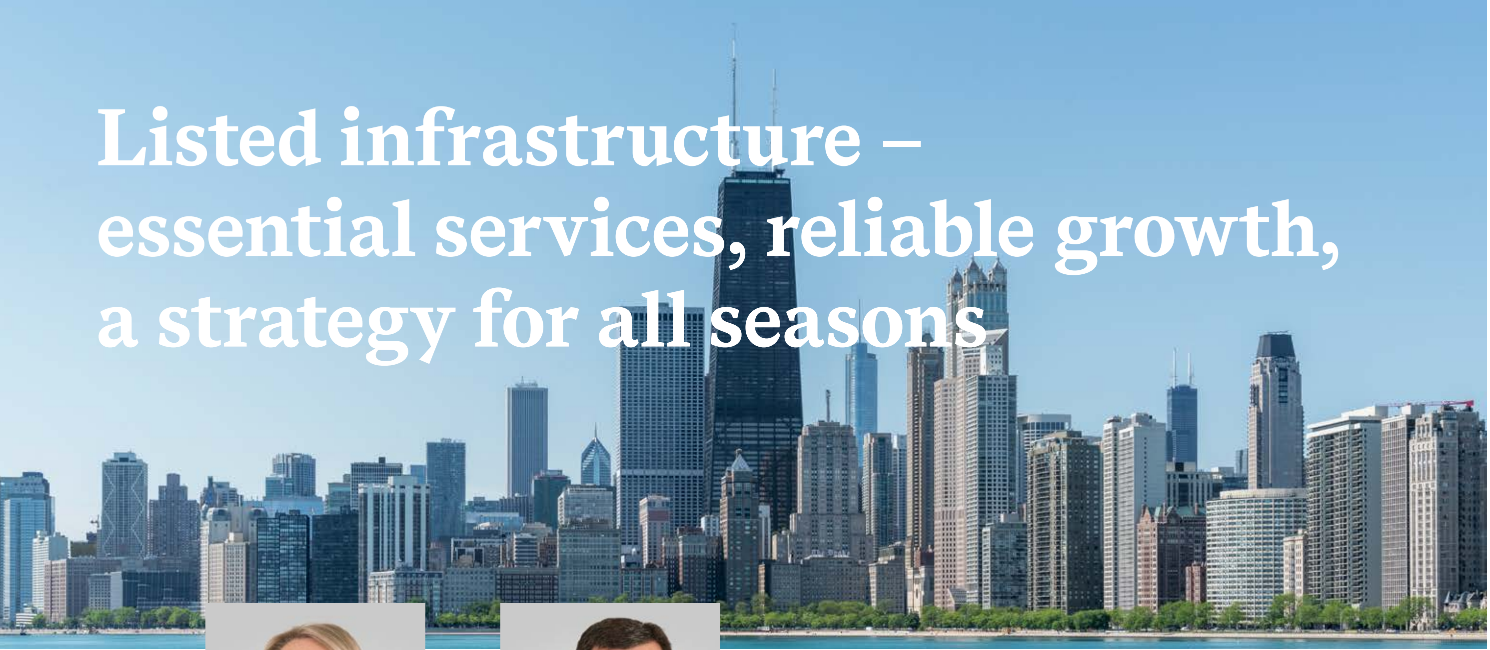
US stages fast rebound:
Growth –3.5%, inflation 1.5%, key rate 0.25%
A rebound in economic activity, evident in a summer-time bounce of private consumption to pre-Covid-19 levels, boosts business confidence and helps the labor market recover. Inflation normalizes gradually in the second half, showing a more rapid return towards the central bank's 2% target. In this scenario, the US Federal Reserve would remain very expansionary in the second half of the year, but refrain from additional supportive measures. Moreover, it would indicate cautiously that less accommodation is needed in 2021. The key rate would remain at bottom.

China returns to economic strength:
Growth 3.0%, inflation 3.0%, key rate 4.35%
Stronger-than-expected global demand results in a return to pre-Covid-19 growth rates. Non-performing loans rise only marginally in this scenario, and rating agencies start viewing issuers of sovereign debt more favorably after previously downgrading countries like South Africa and India. Moderate inflation pressure allows for a slow return from an accommodative towards a neutral policy stance. There is no escalation of geopolitical tensions or the trade conflict, although the US continues to limit China's access to US technology.

Europe with positive momentum:
Growth –5.0%, inflation 1.0%, key rate –0.5%
Europe manages to revive its economy quickly, not the least because of a successful tourist summer season. Economic sentiment surges on nearly absent second-round effects and a significantly more generous EU recovery plan including joint debt issuance. Fears of new potential US import taxes on cars and other European goods die down as the EU finds a temporary agreement with the Trump administration. An "orderly Brexit" laying the groundwork for reasonable EU-UK trade relations lift spirits in the region. The ECB would still implement its ultra-expansionary monetary policy but refrain from additional measures to support the economy, keeping key rates at the current levels throughout 2020.

Next year: German elections and Libor demise
We are confident that our scenarios will remain in place throughout 2020. Do we venture a peak beyond? Much will depend on whether governments will get a grip on corona, and on the outcome of the presidential elections in the US. Under Mr. Trump, we may witness increased unpredictability and a ratcheting up of the trade war, prospects not likely to cheer the market. Under Mr. Biden, we may see higher taxes and more regulation, likewise unpalatable to markets. Beyond these two big themes, some emerging economies may see their debt spiral out of control, but this risk is not in our baseline for 2021. Angela Merkel's stepping down as German chancellor will open a hard-to-fill vacancy at the heart of Europe's power structure. In the world of finance, the London Interbank Offered Rate will take its overdue retirement at the end of 2021. The process of introducing a replacement benchmark could be a cause for market volatility.

Listed infrastructure – essential services, reliable growth, a strategy for all seasons



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Building up and profiting from infrastructure lies at the heart of Swiss statehood. The hold on Alpine transport routes emboldened three Swiss mountainous regions to seek independence in 1291, forming a union that eventually developed into a modern state. Today, building roads and bridges, and more recently, telecommunication infrastructure, remains as fascinating a theme as ever – especially for equity investors.

Toll roads and toll bridges on the vital north-south European route across the Alps provided a handsome additional income for Swiss herders in the Middle Ages. In the 21st century, investors are naturally inclined to take a broader view. When we talk about listed infrastructure today, we mean shares of companies typically active in areas such as communications, utilities, transportation, and energy (see figure 1).

A CUTE proposition

Why do we believe these four sectors – let's call them "CUTE", by their initials – hold such promise? Companies active in these fields provide essential services, possess business models that are not easily copied by competitors, and operate under long-term contractual agreements. These qualities contribute to highly visible, less variable, and more stable revenue streams and earnings growth potential. We target investments in high-quality, owner/operator companies and strive to provide investors with stable growth, higher income, and downside protection, relative to traditional equities.

Sector views, trends and weights

Communications (sector weight currently 14.5%)

- Bullish long-term outlook for companies that build towers for mobile telecommunication
- Trends in wireless video and data usage as well as multi-year network investment plans by wireless carriers to deploy 4G/5G telecommunication technologies are positive drivers

Utilities (sector weight currently 47.0%)

- Steady earnings and dividend growth expectations, despite current environment where some companies within other industries are expected to put dividends on hold
- Valuations for US utilities relative to other infrastructure sectors may appear expensive, but are supported by solid fundamentals
- Maintain focus on constructive regulatory environments and utilities investing in renewables, which provides the opportunity for higher growth and returns

Transportation (sector weight currently 27.3%)

- Significant disruption from Covid-19 will have varied impacts
- Prefer North American railroads as potential margin expansion helps offset weak volumes
- High-quality diversified transportation companies with toll roads assets should recover sooner than airports, which were hit by passenger decline due to the pandemic

Energy (sector weight currently 11.2%)

- Sector stressed by economic shock, assets with utility-like characteristics drive our positioning
- Focused on large-cap, integrated "midstream" companies with earnings profiles supported by long-term contracts
- Investor sentiment remains poor, but the essential role of the assets underpins the long-term value of the sector despite low oil prices

* Duff & Phelps is a cooperation partner of Vontobel. Vontobel Asset Management is in the process of launching an infrastructure fund together with Duff & Phelps.

Why invest now?
Expectations are on the rise for spending on infrastructure projects worldwide. This holds true in emerging as well as developed economies, where the focus is more on repair and replacement of existing assets. Governments and central banks have acted quickly to help restart the economy. At the same time, many stocks are at attractive levels after this spring's market downturn. We also believe that investors will welcome new sources of return in a low-interest world. Another plus is the additional portfolio diversification infrastructure companies provide given their unique business models and specific performance patterns that differ from other equity sectors.

Infrastructure is sometimes associated with financial commitments that can test investors' stamina. This may be true for unlisted infrastructure, i.e. longstanding financial transactions mostly arranged by private equity names. By contrast, our market is liquid given that our holdings, typically around 40 stocks, are established names listed on stock exchanges in the US, Europe, and other regions.

What sets us apart?
As an active manager, we are expected to be able to trump passive investing through a combination of deep industry knowledge and stock-picking skills. But it is regulatory research where we really have an edge. We believe that having a firm grasp of changes in our market's regulatory environments can make all the difference to performance. A case in point is Asia where our underweight is mostly due to a lack of exposure to Japanese utilities. Market deregulation and the gradual restarting of Japan's nuclear power plants led to a price war between utility companies. Anticipating this, we stayed out of that sector, which turned out to be a wise decision.

What about sustainability?
The world is changing. Against the backdrop of a growing global population, government-mandated zero-emissions and renewable generation targets are driving a global movement from thermal power to renewables. In 2018, global wind turbine manufacturer Vesta estimated that clean energy represented less than 10% of all global electricity consumption, but is forecasted to grow to at least 33% by 2035, becoming the largest source of power by 2040. Multiple technologies and industries underlie the transition to clean energy. We focus on companies with strong sustainability credentials.

Are there any risks?
We have been investing in global listed infrastructure for decades and are convinced that active management works, and works well. The four sectors are highly specialized and areas in which trained and experienced research goes a long way. To give just one example: We sold Pacific Gas & Electric, the San Francisco-based utility, some time ago due to regulatory concerns – long before its role in the California wildfires, which eventually lead to the company declaring bankruptcy. That said, we cannot escape market downturns and once-in-a lifetime events like the pandemic-induced collapse in air travel, which currently bears heavily on our airport holdings.

Figure 1: What is "global listed infrastructure"?

Globally listed, robust companies …
- with "wide moats", i.e. business models that aren't easily replicated
- with predictable demand
- with long-term contracts and long-term growth
- that can thrive in an inflationary environment and withstand changes in regulation

… that can be attractive to investors seeking:
- "defensive" shares, i.e. stocks with relatively low volatility
- low drawdowns, i.e. prospects of limited losses even in the event of a badly timed investment
- consistent dividend payouts
- portfolio diversification

We believe such companies can be found in four sectors

Communications Telecommunication towers, satellite operators	**Utilities** Electricity, gas, renewable energy, water
Transportation Airports, seaports, railroads, toll roads, diversified transportation companies	**Energy** Oil and gas pipelines, storage, processing

Source: Duff & Phelps Investment Management, Vontobel

Headquarters in Chicago, America's crossroads
Duff & Phelps – not your average asset manager, not from New York or California – was founded in 1932 during the Great Depression. This was the time of government-sponsored programs to revive the economy through massive construction programs. Institutional investors participated in this effort, but they lacked industry knowledge. This prompted securities analysts William Duff and George Phelps to establish a company providing objective security research of the utilities industry, helping insurance and trust companies steer portfolios toward sources of reliable returns and away from outsized risks.
The company subsequently developed into an active asset manager specializing in infrastructure businesses listed on global stock markets. Its headquarters in Chicago (pictured) is well chosen. America's third-largest city is home to some of the tallest buildings in the US including such landmarks as the Willis Tower and the John Hancock building. Located at the tip of Lake Michigan, the city is a gateway to the plains of the US Midwest, sitting at the crossroads of water and land lines, and possessing one of the world's busiest airports, O'Hare. Capitalizing on its commanding position in transport, the city has always been a magnet for ambitious politicians, athletes, and artists. Chicago and the surrounding US state of Illinois is where Barack Obama and Michael Jordan rose to prominence.

ECB's largest-ever liquidity operation eases funding stress

—
Sandrine Perret
Senior Economist,
Fixed Income Strategist,
Vontobel

The European Central Bank's largest-ever refinancing operation will ensure that systemic risk in the financial system stays low during the economic recovery phase, easing funding stress in money markets. With that, it helps conditions in funding markets to continue normalizing.

As if to prove wrong critics decrying the ECB's initial failure to address the pandemic, the Frankfurt-based authority launched the Pandemic Emergency Purchase Program (PEPP) to facilitate a fast economic recovery. More recently, it also started lending money at even more attractive conditions to the banking sector.

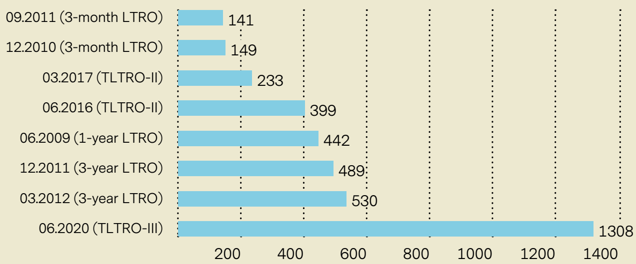
On June 18, the ECB provided 1.3 trillion euros' worth of liquidity to 742 banks through its targeted longer-term refinancing operations (TLTRO), long-term loans banks can access. The amount borrowed by financial institutions across the euro zone was the largest take-up on record, more than double the previous record allotted during the sovereign debt crisis in March 2012 (see chart 1). The large demand was due to liquidity needs in turbulent markets and the very generous conditions. Banks can secure three years of cheap funding, even at −1% (i.e. instead of paying interest, they end up receiving money beyond the amount borrowed from the ECB) during the first year if they meet the lending criteria. This is a bargain for the banks, outweighing the costs they incur when depositing surplus money with the central bank (i.e. the −0.5% deposit rate banks have to pay the ECB when depositing money there).

Some banks used the 1.3 trillion transaction to repay old loans, resulting in a net inflow of around 550 billion euros. With the new liquidity, banks were able to build a financial buffer to cope with potential losses and credit demand from the real economy. This will give banks confidence to keep lending to companies requiring loans and financing for the economic recovery that has started.

Moreover, turbulences in funding market have also eased. This was evident in the three-month Euro Interbank Offered Rate, the rate at which European banks lend to each other. It has come down significantly from the "funding-stress-induced" peak in March, the highest level since 2015. The additional liquidity injection by the ECB and the resulting rise in excess liquidity will ensure low funding cost with short-term interbank lending rates staying close to the ECB deposit rate. In this environment, credit standards and lending conditions are more likely to stay accommodative for the real economy.

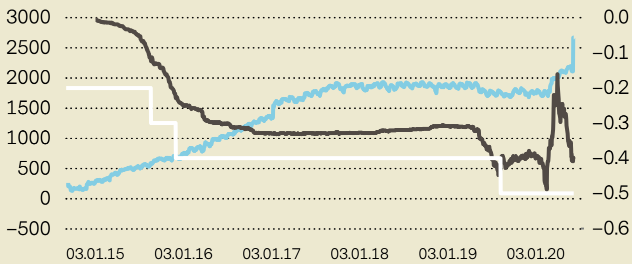
European periphery on a surer footing
Many banks from the European periphery, i.e. southern Europe, participated in the ECB's liquidity operation. They were the main beneficiaries of this endeavor to help reduce systemic risks within the euro zone during the recovery phase. This supports our view that sovereign bond spreads will tighten throughout the summer, unless political tensions in the euro zone flare up again.

Chart 1: Latest ECB's long-term loan program meets massive demand
In EUR billions



Source: European Central Bank, Bloomberg

Chart 2: Euribor rates ease as ECB excess liquidity increases
In EUR billions
In %



Euro Interbank Offered Rate, Euribor (three months, right-hand scale)
Excess liquidity
Deposit rate (right-hand scale)

Source: European Central Bank, Bloomberg

Are equities too expensive? We don't think so

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

In the eyes of some observers, the stock market rally that followed the lockdown-inspired downturn is too good to be true. They warn that prices are far too expensive to justify hopes for paltry future profits. In our opinion, this is not true. On the contrary, prices will probably become even more expensive. The central banks are making sure of that.

If you invested 10,000 Swiss francs, euros or dollars in global equities on March 23, the value of your initial investment would now be a third higher. At the same time, analyst estimates of 12-month company earnings are down by 25% since the beginning of the year. Many market participants are therefore wondering whether the relationship between price and value is still correct.

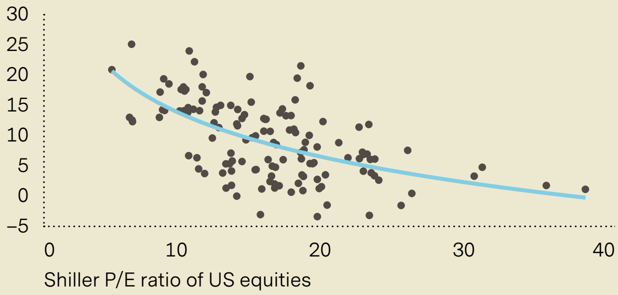
For us, the valuation level says something about the future return potential of an asset. The higher the valuation ratios, the lower the expected returns. This relationship, shown in chart 1, holds true for most valuation metrics including the one going back to Nobel Prize winner Robert Shiller.

Valuation appears to be just right
The Shiller P/E ratio, a long-term yardstick, currently trades below the long-term average. This means that global equities are currently rather cheap. However, by other measures such as companies' price / sales ratios, they seem expensive. Overall, our checklist of the ten most important valuation measures indicates that equities are currently neither particularly expensive nor particularly cheap. Therefore, the long-term return potential of equities is as attractive as in the past.

Central banks drive short-term outlook
However, the picture changes when looking at equities from a short-term perspective. Now the role of central banks becomes much more important. If they conduct an expansive monetary policy, for example with interest rate cuts, the price / earnings ratio increases – which in the eyes of a short-term investor bodes well for equities. Conversely, if central banks tighten the screws, the valuation ratio falls.

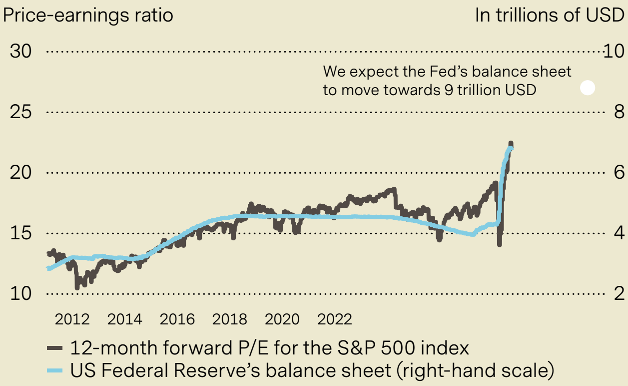
At present, everything points to a further increase in the price / earnings ratio. Central banks around the world are doing everything they can to revive the economy. The US Federal Reserve, for instance, is pumping liquidity into the banking system via massive asset purchases that inflate its balance sheet – a development that will continue over the next months, according to Fed chairman Jerome Powell. We believe the Fed's balance sheet could rise to 9 trillion US dollars. This means that investors with a rather short investment horizon have reasons to feel bullish (see chart 2).

Chart 1: The higher the valuation multiple, the lower the long-term equity return potential
Annual returns of US equities over seven-year cycles



Source: Global Financial Data, Refinitiv Datastream, Vontobel

Chart 2: Central banks drive price-earnings ratios higher, cheering short-term investors



Source: IBES, Refinitiv Datastream, Vontobel

Oil lacks vigor to rise much further after return from negative land

—
Stefan Eppenberger
Equity & Commodity Strategist,
Vontobel

Like some characters in the television series “Stranger Things”, oil has quickly managed to return from the Upside Down world of horror. Its fast rise from April’s negative prices to a level of over 40 USD may have surprised observers. From here, however, prices will have difficulty rising further. For this to happen, we would need to see a significant fall in the US dollar, which seems unlikely.

Normality is slowly returning to the world of finance. Look no further than the oil market for proof. The main reason for the commodity’s vault over USD 40 per barrel in June is the rise in oil demand following the slow but steady easing of lockdown measures. Another factor is a new spirit of co-operation between major oil producers, which has resulted in sharply reduced oil output.

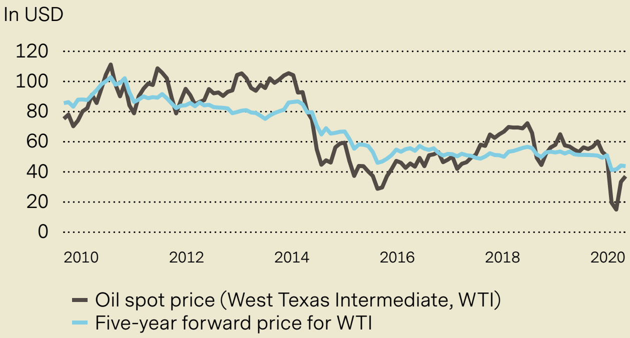
Nevertheless, the global inventory overhang is still significant. This is evident from the difference between spot prices and forward prices for oil (see chart 1). If forward contracts trade above spot prices, as is the case now, this signals that storage costs are high and inventories well stocked.

Historic precedence for capped spot prices
Today’s price charts resemble those from after the oil collapse in 2015/16, when inventories also hit new record highs. At that time, the commodity recovered relatively quickly and strongly. However, oil was stuck below pre-crisis levels with spot prices remaining below forward prices for over a year.

While spot prices can fluctuate widely, forward prices are less volatile. One way of predicting their direction is to follow the so-called breakeven cost of shale oil producers. In the past few years, forward contracts have closely tracked this profitability measure of the shale industry. There are reasons to believe that the going for “fracking” companies will get tougher, especially if a Joe Biden administration tightens the regulatory screws on the controversial industry. Prices for oil forward contracts would then be likely to rise in sympathy with higher breakeven costs.

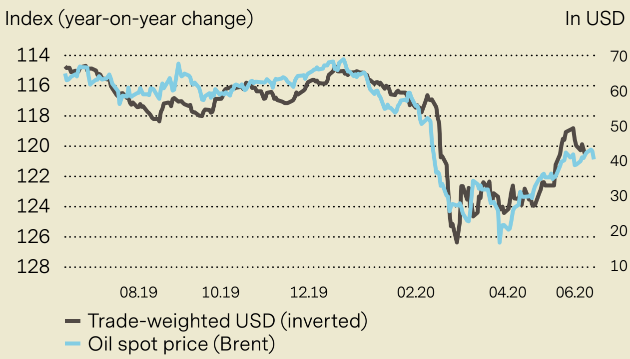
Oil seen in 40–50 US dollar range
We continue to predict a 40–50 USD range for the oil price, which is lower than what we saw before the pandemic stifled oil demand. The underlying assumption is that the US dollar will weaken only gradually. Any sharp move lower of the US currency would probably give oil a boost, an interdependence observed on various occasions (see chart 2).

Chart 1: Oil spot price seen below forward price for a while



Source: Refinitiv Datastream, Vontobel

Chart 2: When US dollar falls, oil prices benefit



Source: Refinitiv Datastream, Vontobel

Growth hopes see cyclical currencies and the euro surge

—
Sven Schubert, PhD
Head of Strategy Currencies,
Vontobel

Cyclical currencies and the euro continued to appreciate in June on the back of slowly recovering economic data. They also benefited from the US Federal Reserve's purchases of lower-quality corporate bonds, which underlined the central bank's resolve to support the recovery. The euro has also gained ground, without stopping the Swiss franc's strength.

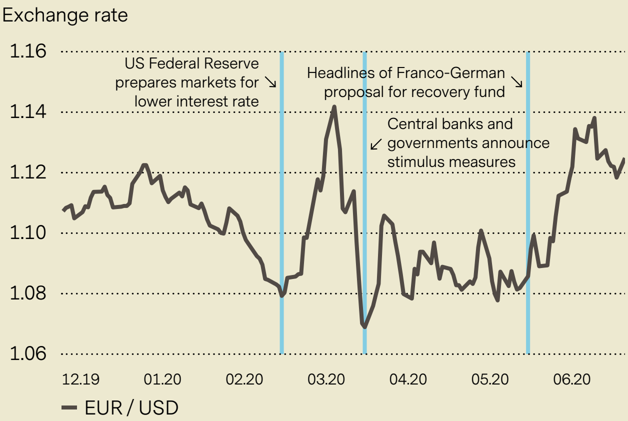
Currencies of countries such as Sweden, Australia, and New Zealand, strengthened on hopes that the global economy is recovering even faster than forecast by institutions like the International Monetary Fund. The euro also benefited – as it should, given Europe's better growth prospects relative to the US, where the pandemic is likely to take a still heavier economic toll. In addition, the euro was lifted by a Franco-German proposal for a recovery fund that would benefit financially challenged southern Europe (see chart 1). With separatist voices across Europe muted by the pandemic, more euro-supportive news may follow. In Poland, for instance, the pro-European mayor of Warsaw, Rafal Trzaskowski, has risen to prominence as a serious challenger of the country's president, Andrzej Duda.

When the euro is champing at the bit, the Swiss franc should in theory hold the horses. However, we doubt there is a sustained phase of franc weakness ahead of us. The ongoing low-yield environment (see chart 2) tends to support currencies like the Japanese yen or the Swiss franc. Therefore, we expect the EUR / CHF pair to remain in a 1.10 – 1.05 range for the time being. Due to our expectation of a weakening US dollar, however, we see USD / CHF grinding lower towards 0.88.

Pound sterling's political struggle
Political risks have put the pound under extraordinary pressure of late, although the currency's deep undervaluation and interest-rate advantage suggest it should strengthen. Now that the UK has exited the European Union, there is a danger that London and Brussels will botch trade talks. We believe a deal is still possible, and a surprise agreement would probably trigger a pound rally of 5 % or more against the US dollar.

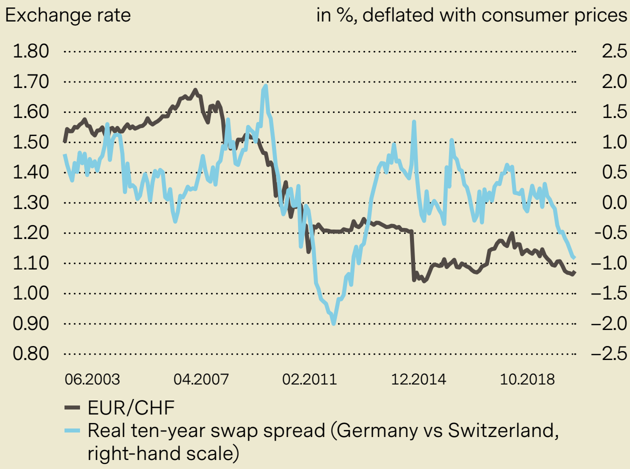
Friendlier factors for emerging markets
Emerging-market currencies remain transfixed by the Sino-US trade war. In the run-up to the US presidential election in November, Donald Trump may ratchet up his anti-Chinese rhetoric. But for the time being, Washington seems committed to the phase-1 deal agreement with Beijing. In combination with a global recovery in the second half and ample global central-bank liquidity, this has improved the outlook for emerging economies. That said, a massive second wave of Covid-19 infections could further undermine investors' confidence in countries with weak fiscal metrics such as Brazil and India. At the same time, we see upside potential for several currencies with solid fundamentals in Asia, as well as in Mexico and Russia, as many of them were unduly punished during the pandemic.

Chart1: Euro benefiting from Franco-German proposal for a recovery fund



Source: Refinitiv Datastream, Vontobel

Chart 2: The current low-yield environment tends to favor the Swiss franc



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	–3.2	–6.3	5.3
US	2.9	2.3	0.3	–5.9	4.1
Japan	0.3	0.8	–1.9	–5.3	2.4
United Kingdom	1.3	1.4	–1.6	–6.9	5.3
Switzerland	2.7	0.9	–1.5	–5.7	6.4
China	6.6	6.1	–6.8	1.5	8.1
INFLATION (IN %)					
Euro zone	1.8	1.2	0.1	0.5	1.4
US	2.4	1.8	0.2	0.8	1.8
Japan	1.0	0.5	0.0	–0.1	0.1
United Kingdom	2.5	1.8	0.5	1.0	1.5
Switzerland	0.9	0.4	–1.3	–0.4	0.8
China	2.1	2.9	4.5	2.2	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	–0.4	–0.5	–0.3
USD	2.7	1.9	0.7	0.7	0.9
JPY	0.0	0.0	0.0	–0.2	0.0
GBP	1.3	0.8	0.2	0.4	0.7
CHF	–0.2	–0.5	–0.4	–0.6	–0.5
AUD	2.3	1.4	0.9	0.8	1.0
EXCHANGE RATES					
CHF per EUR	1.13	1.09	1.06	1.07	1.07
CHF per USD	0.99	0.97	0.95	0.94	0.89
CHF per 100 JPY	0.90	0.89	0.89	0.88	0.85
CHF per GBP	1.26	1.28	1.18	1.20	1.24
CHF per AUD	0.69	0.68	0.65	0.65	0.62
USD per EUR	1.14	1.12	1.12	1.14	1.20
JPY per USD	110	109	107	107	105
USD per AUD	0.70	0.70	0.69	0.69	0.70
CNY per USD	6.95	6.51	6.86	7.05	7.10
COMMODITIES					
Crude oil (Brent, USD/barrel)	53	66	42	40	45
Gold (USD/troy ounce)	1281	1521	1741	1750	1800
Copper (USD/metric ton)	5949	6149	5829	6000	6250

Source: Thomson Reuters Datastream, Vontobel; closing prices for all data: 19.06.2020

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