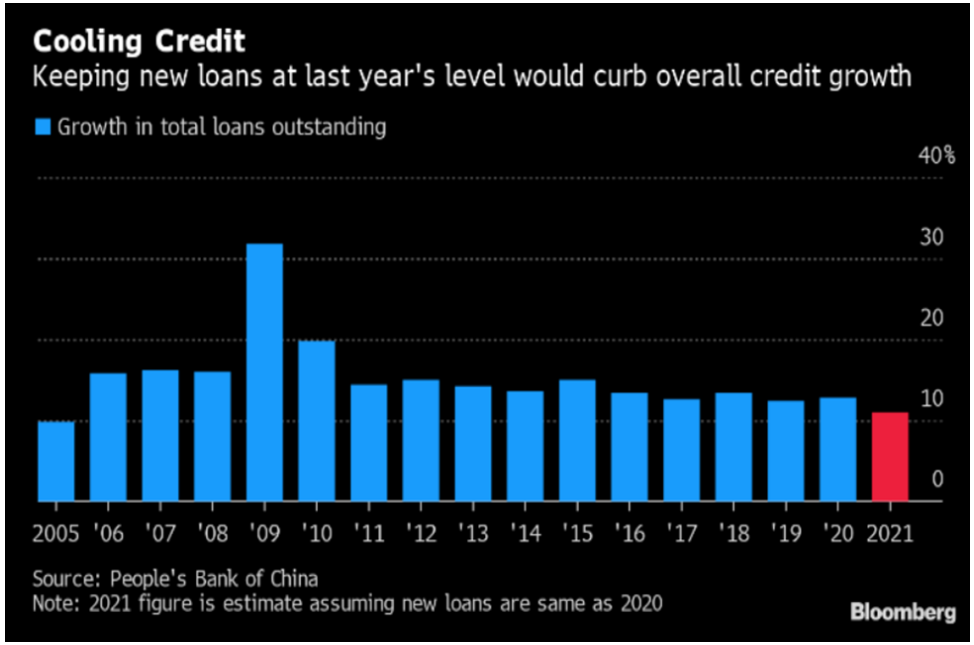
Quarterly Investment Strategy

April 2021

What does the uneven global economic recovery mean for markets?

The new year started with noticeable performance divergences in asset classes and regions. While some key equity markets reached new highs after a corrective phase, others – like China – declined sharply after a great start to the year. A surprising spike in yields hurt the fixed income market. While inflation was at the forefront of thinking – impacting the long end of the yield curve - investors now are increasingly worried about taper tantrum (Federal Reserve reducing purchases of bonds) and higher taxes. The uneven global economic recovery and its potential effects on central bank policies and markets will therefore be the main topic of our quarterly. Also on the inoculation front, the pace among countries differs strongly. Stock market investors, in particular, are willing to look through and take considerable risks. The level of speculative activity is very elevated. We currently see signs of exuberance. International tensions complicate the picture.

The economic recovery is most advanced in China. With the coronavirus largely contained, policy makers have shifted the attention to curb risks, especially in the financial and the real estate sectors. They already told banks in February to keep new lending in the first quarter at the same level as last year – a clear indication of a more restrictive policy, which prompted equities to decline. Loan growth finally ended the first quarter 8% above the previous year, when authorities flooded the market with cheap liquidity. On the fixed income side, also Asian bonds have been under pressure amid rising yields worldwide.

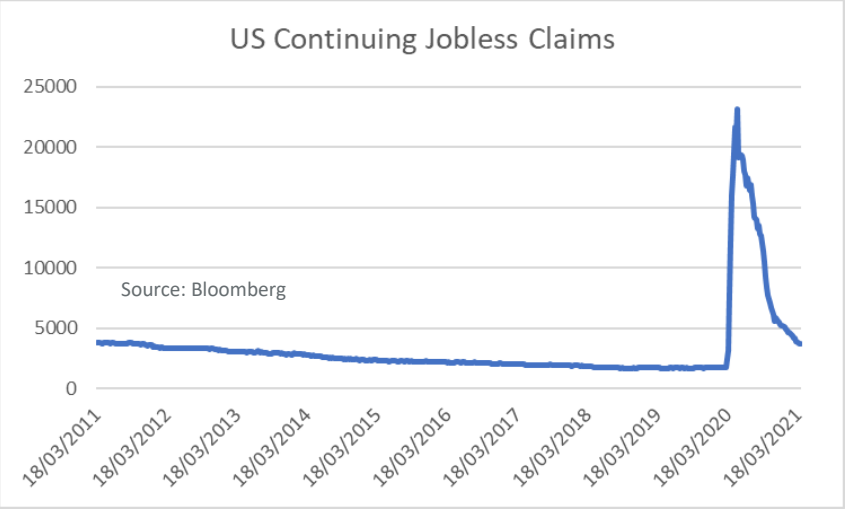


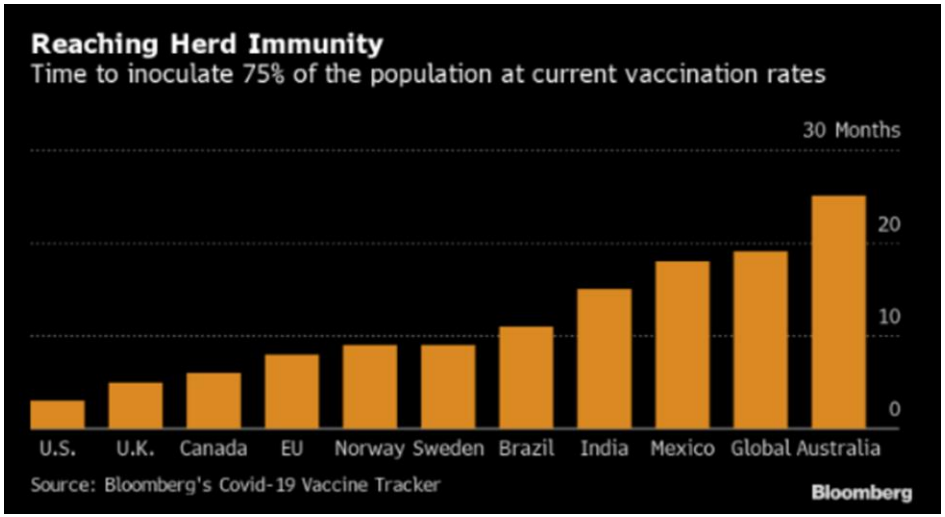
Most recently, however, investors are quite worried about the Chinese government response to potential financial health problems of one of the country's distressed debt managers, China Huarong Asset Management. The bond is one of many declared "government owned, no guarantee", Bond Rating AAA with the Agency China Chengxin and under the control of the finance ministry. As market turmoil intensifies the government remains silent. China's State Council reinforced the idea that struggling state-backed companies shouldn't rely on government support. China's finance ministry, meanwhile, is considering transferring its stake in Huarong to a unit of the nation's sovereign wealth fund that invests in financial companies. Many banks and brokers consider Chinese bonds as very attractive and have loaded their recommendation lists with names in the real estate sector. We are much more careful on this front.

Not just in China, but worldwide, many bonds are at the mercy of governments or central banks. Should liquidity be drained, which now starts in China, significant volatility has to be expected.

What does the uneven global economic recovery mean for markets?

The **US** economy is accelerating and considered second in the recovery. What China has too much, the US has too little. JP Morgan, which just reported first quarter results, showed loans falling 4% and the CEO described loan demand as remaining challenged. He is nevertheless optimistic the pandemic will end with a U.S. economic rebound that could last at least two years. He pointed to an "extraordinary" amount of spending power from both consumers and corporations as the country opens back up. The extraordinary initiatives comprising the Coronavirus Aid, Relief and Economic Security Act, The Additional Stimulus Package, the American Rescue Plan and the proposed Infrastructure Package represent a breathtaking 7 trillion support. The Federal Reserve and the Treasury remain very supportive. Weakness in the labor market are their main concern. One of the key leading indicators for labor are the jobless claims, which have improved considerably. The astounding addition of 916 thousand jobs in March was much stronger than anticipated with positive revisions in the previous two months. There was however a relaxation in labor costs.





When will the Federal Reserve start to withdraw policy accommodation? One of its members, James Bullard, introduced a new metric to closely watch: herd immunity. He stated that getting 75% of Americans vaccinated would be a signal that the Covid-19 crisis was ending, a necessary condition to consider tapering its bond-buying program. Whether 75% is really the right level is debatable. Swiss researchers see rather 90% as mutations have increased (meanings that also children need to be inoculated). As we can see on the above chart, the US is quite close to that target, followed by the UK with an estimated five months. Only focusing on this factor, central bank policies would diverge considerably.

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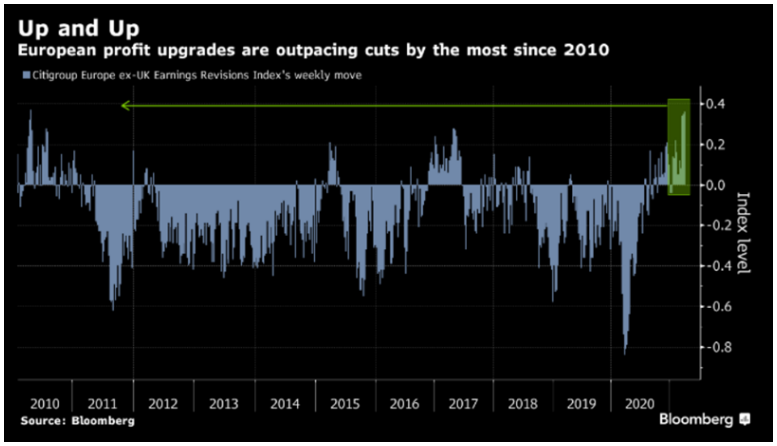
As the bond purchases will ultimately be curtailed, quality may become a more important factor. Year-to-date the only positive returns have been generated by high yield bonds and leveraged loans (see chart on page 6).

Equities will also be affected, should the flooding of liquidity ebb. Shorter term, we focus on first quarter reports and the management outlook. Expectations are elevated. Brokers revised S&P 500 forecasts upward by the most in any quarter this century. Usually, estimates come down during the quarter as companies try to set a bar for themselves they can beat. Energy stocks, banks and resources experienced the highest upgrades. Interestingly though, the travel and leisure sectors have seen outright downgrades. This can be interpreted that many analysts are still skeptical how quickly the economy will exit the pandemic slowdown. S&P500 companies are expected to post a 23.8% earnings growth for 1Q.

The very first company that reported has already pointed to a delicate weak spot: margin development. Fastenal (industrial and construction supplies) stated that pressures related to product cost inflation were rising, thereby affecting the margin. The company plans to take price action in 2Q. While inflation is seen as a temporary phenomenon by the Federal Reserve, the feedback from companies paints a different picture. Already last quarter, many companies mentioned inflation as a problem and not just shorter term. Price gains in transportation, gasoline and commodities are among the sharpest seen in recent years.

Another key topic relates to the financing of the jumbo-support programs. The Biden administration proposed an ambitious tax package. Goldman Sachs estimates that a full adoption would cut EPS growth to just 5% in 2022. As higher taxes face resistance in Congress, some compromising can be expected, though and earnings could grow close to 10%. Whatever the exact outcome, earnings deceleration will become an important theme over the next two years.

Europe is struggling with rising Covid-19 cases and troubled vaccination rollouts. Renewed lock-downs will impact the economic recovery. Market participants appear however united in looking through the pandemic, hoping for an economic acceleration in the second half of this year. Our previous "herd immunity" chart shows however, that a serious acceleration in inoculation efforts is needed to achieve this goal. Investors played European equities as part of the greater scheme of "reflation trade" due to their cyclical nature. Most recently, cyclicals have stopped outperforming as valuations have become quite lofty and briskly rising profit forecast have to be met by upcoming results or outlooks.



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Emerging Markets assets were expected to outshine the world at the start of this year. But – once again – they disappointed. The IMF just raised its 2021 economic growth forecast for Asia to 7.6% versus an earlier prediction of 6.9%. Asia is likely to experience favorable spillovers through trade channels as US fiscal expansion boosts growth and imports. China's growth forecast has been lifted to 8.4% due to stronger net exports and the US fiscal stimulus. Yet going back to our herd immunity chart, Asian countries lag - in some instances massively – other countries in inoculating the population. Vaccine scarcity has even hit India, which is considered the drug producer of the world. Covid showed, as probably all deep crisis in this world, protectionism and selfishness, ironically in a situation that is truly global.

Latin America was particularly hard hit by indifferent policies and nepotism, notably in Brazil. These attitudes are very difficult to change. The recession may therefore last longer than previously expected.

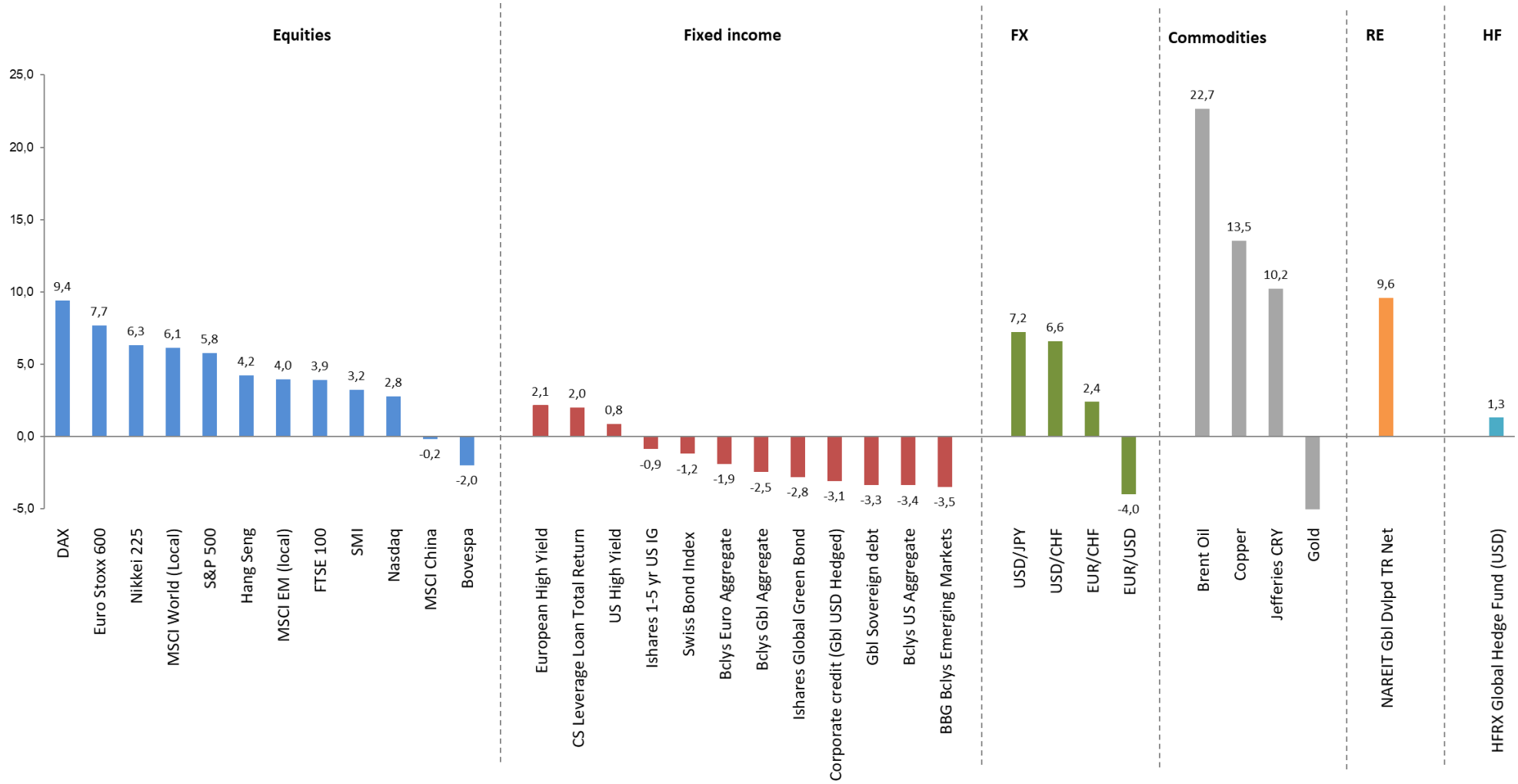
Russia is again targeted by the US with new sanctions. The US Treasury's Office of Foreign Asset Control is issuing a directive that generally prohibits US financial institutions from participating in the primary market for ruble or non-ruble denominated bonds issued after June 14, 2021 by the Central Bank of the Russian Federation, the National Wealth Fund of the Russian Federation or the Ministry of Finance of the Russian Federation, and further prohibits US financial institutions from lending ruble or non-ruble denominated funds to these three entities. Additionally, companies in the technology sector that support Russian Intelligence Services are designated. Some specific assets that are in the United States or in the possession or control of US persons will be blocked.

Another factor that impacted emerging markets was the USD. The widely anticipated weakening of the USD was probably the worst call so far this year.

Conclusions:

- **The better the coronavirus will be contained the more liquidity will be drained from markets.**
- **The economic recovery is led by China, which started already applying a less accommodative policy.**
- **Herd immunity has become an additional important factor in navigating central bank policy.**
- **The global recovery will be uneven.**
- **Equity markets already discount a brisk earnings recovery.**
- **Fixed Income markets will have to combat less support buying and a normalization in interest rates over coming years.**

Performance Major Asset Classes in 1Q 2021 in Local Currencies



Source: Bloomberg

Performance Major Asset Classes in 1Q 2021

- The 1Q performance showed noticeable performance divergences in asset classes and regions.
- Equities generally performed well with the MSCI World rising by 6.1%. Emerging markets lagged, rising 4.0%. China started explosively but finished with a tiny loss. Less abundant policies, but also new government directives for internet companies to rectify their anti-competitive practices weighed on stocks. Brazil was hurt by indifferent Corona policies and nepotism. Europe outperformed, which is particularly true for the export-oriented DAX. The «re-opening» scenario, which favors mainly economically sensitive companies, influenced cyclical-biased European stocks positively. The Nikkei, due to its sensitivity to the world economic growth, also slightly outperformed.
- In Fixed Income, only assets in the higher risk spectrum outperformed. Emerging market bonds were the laggard due to a very slow inoculation adoption and the stronger than expected USD advance. Due to the unexpectedly sharp rise in yields – the 10-year US Treasury yield jumped from 0.91% end of December to 1.74% end of March – instruments shorting the longer-end of the yield spectrum performed strongly. The shorter the duration, the lesser the negative return.
- Commodities outperformed all other asset classes with excellent performances in oil and copper. Gold was the distinct laggard.
- Global Real Estate increased close to 10%, despite the sharp increases in interest rates worldwide. As the sector has been hurt previously by lockdowns, it became also a «re-opening» play in some way.
- Hedge Funds showed a slight positive performance. The quarter was full of negative headlines and the leverage practice of some hedge funds even became an international scandal.

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