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PORTFOLIO UPDATE

JULY 2020

- EUROPEAN EQUITIES SWIFTLY CATCHING UP
- EQUITIES STILL THE PREFERRED CHOICE

REVIEW

Europe is catching up

The rebound on the financial markets continued at a vigorous pace at the beginning of the month. While certain indicators in June implied that the equity markets were becoming slightly overheated in the short term, private investors in particular showed very little concern for the time being. However, in line with the stock market adage of "the trend is your friend", even micro investors increasingly felt compelled to jump on the bandwagon, with online brokers posting record levels of new account openings.

Meanwhile, the forecasts coming from various financial institutions were less euphoric as the prevailing fragility of global economic activity remained a source of unease. Nonetheless, the measures to ease the lockdown implemented by governments around the world allowed numerous economic leading indicators to rise from their low levels. Ultimately, however, in reporting these trends, there was a general consensus that focusing on the rate of change rather than the absolute levels of the economic indicators would be more important for the markets. In other words, while unemployment rates remain high, new orders at companies are low and consumer buying appetite is still subdued, there are signs of improvement, which is the only thing that matters to the markets.

The rally eventually came to a halt around the middle of the month when the chairman of the US Federal Reserve warned of possible permanent job losses and continuously high jobless claims. At the same time, concerns about the risk of a second wave of infections rose amid reports of new cases linked to a wholesale food market in south Beijing. In any case, the time was ripe for the rally to take a breather, especially as the European Stoxx 50 – in tandem with other equity indices – had climbed by more than 17 percentage points over the preceding 11 trading days.

While the subsequent correction was limited, with share prices in the S&P 500 down by around 7%, the equity indices largely remained at this level in the second half of the month and have been trending sideways since then.

Meanwhile, the strength of the European equity indices relative to their US counterparts was a noticeable development (see table below). As US equities have been in greater demand over the last 20 years and delivered concomitantly higher returns on investment, the question is whether we are now seeing a trend reversal. The fact is that some US states are clearly finding it more difficult to keep the pandemic under control than European countries at present. Moreover, the Trump administration's ratings in the opinion polls ahead of the presidential elections in November have taken a nosedive in response to ailing economic output and the Black Lives Matter movement. All of these uncertainties do not currently bode well for investments in the US, while the overall situation in Europe seems to be largely unproblematic at the moment.

Financial markets 2020 total return

America	June	2020
S&P 500 (US)	2.0%	-3.1%
Dow Jones Industrial Average (US)	1.8%	-8.4%
EURO STOXX 600 (EU)	3.1%	-12.1%
DAX (DE)	6.2%	-7.1%
SMI (CH)	2.2%	-2.3%
MSCI Emerging Markets (EM) in USD	7.4%	-9.7%
Europe	**June**	**2020**
US Corporate Bonds Inv. Grade	2.0%	5.0%
US Corporate Bonds High Yield	1.0%	-3.8%
Pan-Europe Corporate Bonds Inv. Grade	1.2%	-1.6%
Pan-Europe Corporate Bonds High Yield	2.0%	-5.8%
Alternative Investments	**June**	**2020**
Gold	3.1%	17.1%
Oil (brent)	11.6%	-38.4%

Sources: swisspartners, Bloomberg

MANDATE RETURNS GROSS

	Euro			Swiss Franc			US Dollar			British Pound		
	Cons	Bal	Dyn	Cons	Bal	Dyn	Cons	Bal	Dyn	Cons	Bal	Dyn
2012	**6.6%**	**7.4%**	**10.5%**	**4.3%**	**6.5%**	**10.9%**	**5.9%**	**8.4%**	**11.8%**			
2013	**1.5%**	**6.5%**	**13.5%**	**1.9%**	**8.3%**	**16.7%**	**2.9%**	**9.4%**	**18.5%**			
2014	**6.1%**	**8.0%**	**10.2%**	**4.9%**	**6.5%**	**9.2%**	**1.6%**	**2.2%**	**3.1%**			
2015	**2.7%**	**6.3%**	**9.9%**	**-0.8%**	**0.0%**	**1.8%**	**-0.3%**	**0.0%**	**1.0%**			
2016	**2.3%**	**5.3%**	**7.1%**	**1.3%**	**3.9%**	**5.7%**	**2.8%**	**6.2%**	**7.2%**	**4.6%**	**9.5%**	**12.1%**
2017	**3.5%**	**7.3%**	**10.8%**	**4.3%**	**8.9%**	**15.0%**	**7.1%**	**12.7%**	**18.1%**	**4.7%**	**8.7%**	**14.2%**
2018	**-4.3%**	**-9.0%**	**-10.5%**	**-5.6%**	**-10.1%**	**-12.1%**	**-2.5%**	**-7.9%**	**-9.8%**	**-3.3%**	**-8.6%**	**-10.4%**
2019	**9.2%**	**15.7%**	**21.6%**	**8.3%**	**14.8%**	**19.6%**	**11.5%**	**17.5%**	**22.0%**	**9.4%**	**15.3%**	**19.8%**
Jan 20	0.4%	-0.3%	-0.1%	0.0%	-0.7%	-0.7%	0.3%	-0.5%	-0.5%	0.3%	-0.4%	-0.3%
Feb 20	-2.0%	-3.3%	-5.3%	-2.1%	-3.5%	-5.5%	-1.9%	-3.3%	-5.4%	-1.6%	-2.8%	-4.7%
Mar 20	-7.1%	-8.7%	-10.5%	-6.8%	-8.3%	-9.5%	-6.7%	-8.6%	-10.0%	-7.0%	-8.6%	-10.6%
Apr 20	4.1%	5.4%	7.4%	4.3%	5.2%	7.1%	4.2%	5.4%	7.2%	3.9%	4.9%	6.9%
May 20	1.4%	1.8%	2.3%	1.7%	2.0%	2.6%	1.8%	2.3%	2.9%	2.2%	2.7%	3.6%
June 20	1.4%	2.5%	2.9%	1.4%	2.2%	2.6%	1.7%	2.8%	3.2%	1.8%	2.8%	3.4%
2020	**-2.2%**	**-3.2%**	**-4.3%**	**-1.9%**	**-3.5%**	**-4.2%**	**-1.0%**	**-2.6%**	**-3.5%**	**-0.8%**	**-1.9%**	**-2.8%**

Actual portfolio returns may differ from the values shown above owing to costs and restrictions on implementation.

TRANSACTIONS IN JUNE

Hermes Multi-Strategy Credit Fund

High-yield bonds

EUR	IE00BKRCNG56
CHF	IE00BKRCNL00
USD	IE00BKRCNJ87
GBP	IE00BKRCNB02

Angel Oak Multi-Strategy Income Fund

Mortgage-backed exposure

EUR	IE00BZ099X74
CHF	IE00BZ099Z98
USD	IE00BZ09B087
GBP	IE00BZ099Y81

Redemption

11 June 2020

Conservative	-5.0 %
Balanced	-3.0 %
Dynamic	

Conservative	-3.0 %
Balanced	
Dynamic	

We have restructured the bond allocation in our mandates given the mounting debt levels of governments, central banks and companies. The overriding aim of these transactions was to continuously improve the credit rating on an aggregate basis. As a result, the Hermes Multi-Strategy Credit Fund has been disposed of in full. At the same time, we took the opportunity to scale back another lower-rated position in the form of the Angel Oak Multi-Strategy Income Fund.

Hermes primarily invests in the automotive, basic materials and energy sectors. We believe that these areas are at risk of staging a sluggish recovery from Covid-19. However, the fund has already recovered appreciably from its lows and we considered this a good time to sell.
We also see major risks relating to Angel Oak as it invests in mortgage-backed bonds in the US housing market. Due to the sharp surge in unemployment and the possible repercussions on the real estate sector, better opportunities in terms of risk/reward ratios are available elsewhere.

The proceeds have been invested in various instruments depending on the individual strategy. In the conservative mandates, we have reacquired a position in local government bonds and increased existing positions with good credit ratings. In the balanced mandates, we have taken an indirect position in government bonds via the Rubrics Global Fixed Income Fund.

CS China RMB Credit Bond

Asian bond fund

USD	LU1577536490

Subscription

18 June 2020

Conservative	+2.0 %
Balanced	+2.0 %
Dynamic	+2.0 %

The China RMB Credit Bond Fund from Credit Suisse invests in the renminbi (RMB) bond market, which is already the second-largest and fastest growing bond market in the world. There is a large supply of corporate bonds that are either backed by or have close ties to the state. The correlation between RMB bonds and European and US sovereign bonds is low, as is the level of correlation with a globally oriented bond portfolio. With attractive interest rates and a medium duration, the fund offers a welcome level of diversification. There is a focus on good-quality borrowers when selecting bonds, while broad-based sector allocation ensures diversification within the fund.

POSITIONING

Liquidity
(neutral)

Outside of the US dollar investment universe, there are few opportunities to avoid the negative interest rates applied by the central banks. If necessary, we are parking excess liquidity in cash and accepting a negative return, which is partially passed on to customers, especially as there are no other risk-free alternatives. Short-dated bond and trustee investments offer opportunities in US dollars.

Bonds
(underweight)

In an environment of mounting debt, we favour bond issuers with solid balance sheets, a healthy business model and correspondingly good credit ratings. At the same time, however, investors need to look beyond the top borrowers with AAA/AA ratings if they wish to achieve positive yields to maturity. Diversification is absolutely essential. In light of the limited scope for interest rates to be cut further, we are keeping duration – i.e. interest rate risk in the portfolio – low and are therefore better protected against sudden interest rate hikes.

Equities
(overweight)

Due to the COVID-19 pandemic, the improvement we are expecting to see in economic fundamentals will be delayed by several months. We are currently adhering to our generally positive outlook and consider the interim ceasefire in the Sino-US trade dispute to be favourable for the equity markets. Moreover, the central banks are ready to deploy all of the instruments at their disposal to stimulate global economic growth and support companies in overcoming financial shortfalls. While a temporary setback cannot be ruled out, we do not expect the March levels to be undershot.

Alternative investments (overweight)	A combination of insurance securitisations, market-neutral, arbitrage and option-based volatility strategies. In contrast to traditional asset classes, these instruments exhibit low levels of correlation and offer a degree of protection from geopolitical risks. In normal market conditions, the aim is to achieve a positive market yield while minimising volatility. A high level of liquidity is a fundamental requirement.
Foreign currencies (strategy-related)	Foreign currency allocations differ depending on the risk strategy. Hedging foreign currency positions for US dollar strategies is advisable in the current interest rate environment. These strategies benefit from a positive roll yield due to the interest rate differential versus the EU/Switzerland. Conversely, euro and Swiss franc strategies pay high premiums for hedging US dollar positions. At the same time, we expect demand for the Swiss franc to decline in the medium to longer term.

OUTLOOK

Equities still the preferred choice

What would you have answered if six months ago someone had asked where the equity markets would stand following the outbreak of a global pandemic and a worldwide lockdown, with the unemployment rate soaring to well in excess of 20% in some cases?

Would you have said 30% or perhaps 40% lower?

We have indeed seen losses on this scale at times, at least in the most widely watched stock market indices. But few of us would have also forecast the scale of the whirlwind rally that we have since witnessed. Looking at these data in isolation, the most obvious conclusion is that the financial markets are currently trading at levels that are hard to justify given the economic situation.

Markets continue to be driven by ultra-loose monetary policy and financial injections on a scale that is seeing some unemployed people receive more money from the state than they would normally earn from work. There is a strong general consensus that the central banks will only make an extremely gradual departure from their current business-friendly approach, even if research leads to the development of a vaccine. If this materialised, we would soon be free of the pandemic while key rates remained at record lows. This would be a nirvana for investors – a prospect that is fuelling hopes of further increases in equity prices.

Ultimately, it is an environment in which neither investing in bonds nor holding liquidity represent a genuine alternative. Those on the hunt for yield – and there are plenty of them – will discover that sooner or later all roads lead to equities. We already mentioned this in last month's report, and in this edition we have included the chart below to illustrate the pressure on investors to seek out yield. The average dividend yield of the stocks included in the MSCI World equates to 2.4 times the average yield (to maturity) of Bloomberg's global bond index. As the chart shows, the outbreak of Covid-19 has exacerbated this situation significantly.

Dividend yield versus government bond yields

Sources: swisspartners, Bloomberg

In response to this state of affairs, many investors are rushing into bonds of issuers with poor credit quality or much longer maturities in order to obtain what are supposedly acceptable returns on their capital. But in doing so, they certainly appear to be unconsciously accepting higher risks than those that investing in the shares of a solidly positioned company entail.

Nevertheless, central banks and the pressure on investors to seek out returns are not the only reasons underpinning our decision to stick with our overweight in equities at present. We certainly believe that the risk of a second wave of infections referred to above is real. But people have to accept rising infection rates as an inevitable consequence of lockdown measures continuing to be eased. The key issue in this regard is whether local lockdowns alone will be sufficient to ensure that healthcare services are not overwhelmed. If this strategy succeeds, the restrictions on businesses and the impact on economic activity will be manageable. This is the scenario that we are currently forecasting. As a result, while we still anticipate high equity market volatility, we are ruling out a sell-off such as that seen in March.

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