HYPOSWISS
ADVISORS

Review & Outlook
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Q1 2020 Review

COVID-19 changed everything

After rising for almost 11 years, the equity bull market which started in March 2009 came to an abrupt end by the spread of the coronavirus into Europe and the USA. The original outbreak of the virus in China led only to a temporary setback for markets as the S&P 500 soon recovered to reach new all-time highs again in mid-February 2020.

Markets were trading for many days in panic modus, dropping even 10% in one single day alone amid record high volatility, similar to the 2008/2009 financial crisis. Margin calls or deleveraging did contribute to the wild swings. Towards the end of March however markets started to stabilize but the underlying mood was still extremely nervous.

After Q1 2020 is over and finished, the end result is a decline of 20% to 30% in many markets, the MSCI World dropping 21.4%. The best performer surprisingly was China (SHANGHAI SSE Comp.) with only -10.1%, followed by Switzerland (SMI) with only -12.2% thanks to its defensive composition.

Interestingly, the NASDAQ with -14.1% was outperforming the rest of the USA, meaning it did both go up more than the S&P500 in the bull market and dropped less in the current bear market (no financial and oil stocks being one explanation). This is obviously a strong signal as one would have expected that value stocks would suffer less. If this "corona-crash" is already the end of the long-term bull market and the beginning of a longer bear market or only a strong correction is the key question all investors would like to know.

Fixed income markets were also hit in particular in the field of High Yield ("HY"), where missing liquidity was a big issue and bid/offer spreads were wide as some investors unloaded their bonds at almost any price and no new buyers emerged.

The coronavirus also took center stage on commodity markets and sent oil prices tumbling below USD 20, on the back of a sudden stop in global economic activity and the breakdown of the agreement between OPEC led by Saudi Arabia and Russia to restrain crude production, which could not have occurred at a worse time.

Gold did initially well but could not sustain its earlier gains.

S&P 500 Index – 01.01.2019 – 31.03.2020
Source: FIS Market Map

Fixed Income

Governments and central banks launch the big guns

Governmental authorities and central banks alike did launch massive stimulus programs in order to support growth and shield their economies from the contagion measures taken to combat the coronavirus pandemic. Actions were taken so far much faster than during the Global Financial Crisis of 2008/2009.

In the USA, the Republicans and Democrats agreed upon a USD 2 trillion rescue package. The Federal Reserve deployed an even bigger plan by announcing an 'open ended' (i.e. no limits) QE program, and the assets it can buy include treasuries, MBS and federal agency programs. All these mitigation measures revived recession concerns. The US 10yr yield has fallen below 1% and has since been at new all-time lows around 0.50%.

In the EU, the ECB announced QE packages totaling EUR 750 billion over the next 9 months, which translates to 80 billion per month, the highest pace of asset purchases on record.

Not surprisingly High Yield bonds suffered heavily similar to each crisis. To make matters worse, for many days, there was no liquid market at all and wide bid/offer spreads up to 10% made any trading basically impossible. Bonds of issuers in the oil and travel related industries (airlines, cruisers, hotels, etc.) declined the most.

We think that investors are perhaps understating the potential long-term inflationary consequences of all the stimulus that has been unleashed on the global economy. For the immediate future however, falling demand will result in downward pressure on prices – oil being the most obvious example – and these deflationary impulses will be exacerbated by rising unemployment. Interest rates will be kept low by central banks for a long-time to come.

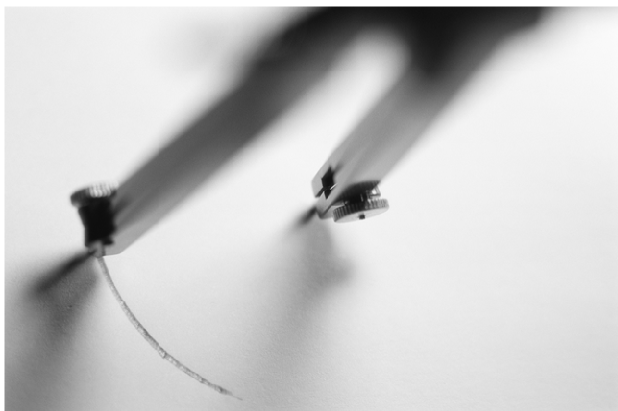
We were neutral in the Fixed Income asset class in USD bonds before the crisis and considering the unattractive yields now in place, will for a certain time not renew bonds which mature.

"Don't let your money work for you. Because it doesn't."

Expect the expected

This will automatically lower the Fixed Income allocation in our portfolios over time. Given the current interest rate situation, we consider TIP's (Treasury Inflation Protected bonds) and FRNs (Floating Rate Notes) as a possible shield against interest rises in the medium future.

In the HY sector, we assess risk under the new circumstances. In certain cases, we are of the opinion that the risk/reward is unfavorable (despite very cheap prices) and that positions should be exited, in particular for smaller oil companies who might not be able to withstand an oil price below $30 for too long or airlines who need government backing. Similar to the equity market, the HY sector has in the meantime recovered from its lows and offers selective opportunities with elevated returns if one is ready to take the risk.



Equity

The worst may already be over?

Equity markets initially underestimated the effects of the coronavirus and reached new all-time highs on February 19th when the Chinese province of Hubei was already in a complete shutdown. Thereafter, all markets globally (except China) suffered historic declines in the wake of the dawning realization about the extent of the virus' global spread, compounded by a surprise Saudi/Russian oil war. On several days, market trading was temporarily halted as a result of circuit-breakers that were triggered for the first time since the Asian financial crisis on October 27, 1997. These violent selloffs occurred in complete panic mode without the usual multi-day "counter trend bounce" that typically accompanies bear market selloffs. There was a 28-day period in which the S&P500 market could not even manage a two-day rebound.

This crash surely counts as one of the most extreme in memory, in particular how fast it all evolved. From its peak the S&P 500 lost **34%**. The 2008 financial crisis saw a maximum decline of **54%** - but within 310 days - and in the Tech Bubble crisis of 2000-2002 the index lost **47%** - but within 635 days.

At the present time the overall market sentiment does not value the current economic situation as severe going forward and concludes it will not end up in a multi-year long bear market similar to 2000 and 2008. The S&P 500 even managed a meaningful comeback by almost climbing 20% from its lows around March 20th, spurred by bargain hunters and amid an underlying nervous mood with high daily swings.

Looking ahead, the earnings season in the USA will start just after Easter. In the current situation, Q1 results will be rather a non-event from an economic point of view as markets will be likely driven by the rate of new infections and discussions about when the contamination peak is being reached, as well as by fiscal and monetary policy.

Consensus earnings expectations for Q1 have been revised down by 9% during the quarter and should show a decline of -7.2% (vs. +0.3% in FY 2019), making it the largest year-on-year

decline since Q3 2009. The downward revisions have been primarily driven by the oil & gas, industrials, consumer cyclicals and materials sectors. Looking forward, the key question is when profits will bottom. We expect this to happen for both US and European companies over the summer months. Historically, equity markets started to recover well ahead of earnings, and one could argue why this time should be any different. On the other hand, after the recent strong rebound of up to 20%, one wonders if maybe investors do not underestimate some of the negative consequences and yet unknown side effects of the different standstills.

We have entered this crash with a defensive equity allocation (42% for USD balanced portfolios). We decided not to sell positions during the panic selloff in March for our discretionary mandates. We will use the new constellation to re-allocate some securities and for the present time are of the opinion that the USA and Asia will come out stronger of this downturn then Europe.

Currencies

USD remains attractive for now

As a classical safe haven currency, the USD did profit from the outbreak of the coronavirus, despite the emergency rate cuts by the Federal Reserve to the zero lower bound, thereby eliminating part of the interest rate differentials with other currencies, which were an important factor for the strength of the USD in the past.

The negative economic effects feed through the US economy far less than in the Eurozone, which is more depending on exports to China and which is more industrialized than the services-oriented US economy. Another factor is the superior profitability and earnings of US companies relative to the rest of the world which is a magnet to foreign investors. Every time a Non-American buys Microsoft, Apple or Facebook stocks he is basically buying USD at the same time.

The EUR has a worsening outlook as containing the coronavirus drives the Eurozone into recession – similar to the rest of the world - but challenges its stability as the costs of supportive fiscal policy vary across member states, risking another Euro crisis.

Once the corona pandemic is over, unresolved European issues, geopolitical disputes and the legacy of the extremely lavish policies by other central banks will keep upward pressure on the CHF high. We are confident Switzerland will master the current situation positively.

Economics

Global economic activity is expected to recover during 2020

Harsh Covid-19 containment measures (lockdowns, travel bans, border restrictions) around the globe to stop the contagion and healthcare from collapsing abruptly hurt economies in all countries. The business cycle has been squeezed off and a deep recession is unfolding. Historically such an event of this magnitude has never occurred and there is no textbook solution how to solve it and how it might evolve.

The 'sudden stop' nature of the downturn stems from the fact that the global economy was simultaneously hit by both a massive demand and supply shock at the same time. When households are confined to their homes, they cannot spend as much as they usually would. On the supply side, production has been impaired because of worker's inability to get to their jobs. According to the US Bureau of Labor Statistics, less than 30% of employees can work from home. The global supply chain ceased to function normally.

Outside of China, the level of GDP is likely to be down 2-3% in Q1 of 2020 (Q4 on Q1) and then down another 5-10% in Q2, a negative print that has few parallels in economic history. Continued monetary support of all central banks and unprecedented fiscal stimulus should help drive the recovery once businesses reopen and workers return to their jobs.

Economists argue what shape the recovery will be: L, U or V.

An **L-shaped** profile would mean the level of output falls and remains permanently depressed relative to its long-term trend. A vicious circle could emerge where falling spending leads to higher unemployment, leading in turn to even less consumer spending.

We think however that all the measures taken will 'flatten the curve' of new infections and allow governments to relax on containment until either a vaccine will be found or new treatment options become available. With all the central bank money put into the system and all the fiscal stimulus programs, the danger of an L-curve should be relatively low.

A **V-shaped** recovery happens when output / demand quickly move back to their pre-crisis trend. As much as equity markets would like this scenario, it is probably wishful thinking. The virus will not disappear quickly and some measures to contain it will remain in place. Lots of people might simply be afraid to enter an airplane and some industries like cruise liners will suffer for a long time ahead.

A **U-shaped** recovery where output slowly rebounds and demand follows after inventories are reduced is the most likely scenario. What long-term implications lay ahead with all this printing of cheap money and record high new debt in most countries is another story, by economic theory, these steps should lead to higher inflation.

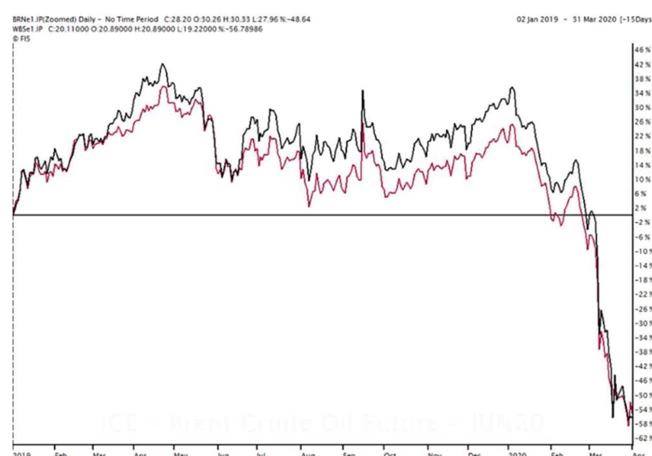
Commodities

Oil Shock

The double shock of pandemics and oil politics stirred up the oil market and the stage is set for a certain period of low prices similar to the one seen during 2014 – 2106. The so called OPEC+ deal which has partly shaped the oil market over the past few years, has now fallen apart. The collapse of consumption in March and going forward would require a swift adjustment of production, otherwise the market is running out of storage capacity soon. How the market is going to rebalance supply and demand seems open for now.

The short-term outlook is devastating for the oil business which by nature rests on comparable long-investment decisions and usually reacts to changes in demand (like now) only with a time lag. All actors across the entire cost curve will suffer, but on different time scales. Canadian heavy oil, for example, changes hand at below USD 10/barrel and can handle this storm but US shale business needs an oil price above USD 40-50/barrel.

The oil market has entered unchartered territory for now with many players being forced out of business. The current collapse in demand is deep but temporary and a recovery might begin already in Q3, or in Q4 at the latest. With production to decline relatively swiftly in the shale industry, and the USA putting pressure on Saudi Arabia to cut its output, oil prices might move again above the USD 30/barrel level towards 2021. They are however unlikely to move higher than the USD 40-50/barrel level because that would take them back above the current break-even cost for US shale producers, which is what Saudi Arabia and Russia will try to prevent from happening.



Oil prices (Brent and WTI futures) in USD – 01.01.2019 – 31.03.2020
Source: FIS Market Map

Just as during the Global Financial crisis 2008, gold failed to be an attractive hedge against financial risks during the stock market selloff in March. Bullion dropped to $1450 before rebounding back to $1577 end of March and at the time of writing is again well above $1600. The YTD comparison by March 31 showed that the gold ounce was trading in positive territory – few other assets were. It remains a good hedge against long-term inflation and is an insurance policy against geopolitical disasters. We keep our gold position of approx. 5% for these reasons.

Outlook

How long and deep will the upcoming corona-recession be?

Usually, this section is about the economy, the direction interest rates are moving and the translation into market trends. This time is different! It's the scientists advising governments on the containment measures to be taken who matter more than the economy. The key question will be for how long it will take to dismantle the steps taken like border controls or lockdowns. The pharmaceutical industry should rapidly emerge with a vaccine or another treatment option, otherwise the measures will need to be enforced for longer and could only be eased as more people acquire immunity.

As we are not medical experts we concentrate on the damage the economy will suffer in its entirety. We follow a base scenario A with a high probability and take into consideration an alternative path B. We position ourselves for strategy A which allows 2- 3 quarters of recession to be followed by a recovery, a so called U-shaped curve as described above. We are monitoring scenario B which would be a systemic crisis or a collapse of the financial system but consider this unlikely presently with all the government and fiscal programs which are put in place.

Equity markets will remain volatile as there might be more negative surprises ahead. On a longer-term view, equities offer a better risk/return reward to Fixed Income instruments. We prefer non-cyclical companies with solid balance sheets which can weather an economic downturn of 2-3 quarters. We keep bonds mainly for capital preservation and we like TIP's and FRN's and keep a certain amount of HY bonds to generate income.

We are confident that our portfolios are constructed and monitored in such a way to manage the upcoming economic downturn relatively safely but will still participate in any uptrend once it occurs.

Walter Küng – Senior Portfolio Manager

Asset Allocation

USD Reference – Balanced

	Bearish		Neutral		Bullish
Cash					■
Fixed Income			■		
FRN / Inflation			■		
Investment Grade			■		
Convertibles	■				
HY / Credit			■		
EM debt			■		
Equity			■		
North America			■		
Europe			■		
Switzerland			■		
Other Developed	■				
China				■	
EM				■	
Global Thematic			■		
Preferred			■		
Alternative Investments			■		
Real Estate				■	
Alternative Strategies	■				
Gold / Precious Metals			■		

Thematic investment idea

Cloud computing

Investing in a future megatrend

Cloud computing is among the most significant business transformations since the launch of the worldwide web and the adoption of email. It describes the availability of IT services from basic infrastructure, such as computing and storage, to application development platforms and specific software.

However its adoption is still in a relatively early stage. Surveys of IT decision makers indicate that nine of ten companies have at least some of their applications or infrastructure in the cloud in 2019, with those remaining expected to adopt cloud services by 2021. The average IT environment today, however, is still majority non-cloud.

Traditional IT is expected to continue shrinking in the years ahead. Just in the last two years, the average US company cloud spending budget, including both enterprises and small businesses, jumped 36% from $1.6 million in 2016 to $2.2 million in 2018. Given its central role in attempting to optimize the productivity and scalability of a firm's technology resources, cloud seems to ultimately be a foundational tool for enterprises of all sizes.

And what about the Covid-19 pandemic? The way the virus has impacted global markets and transformed day-to-day life in March of 2020 has been, in short, staggering. However, working-from-home isn't as disruptive as it might have been 20 or even 10 years ago. Technology companies, and particularly those that focus on cloud computing, provide services and capabilities that are usable from anywhere. It is a possibility that the virus could act as a catalyst for more activities to shift from the physical to the virtual realm as firms are forced to "get used to" operating in new ways quite quickly.

For investors, this is an opportunity to invest in a secular trend with a huge potential: Cloud computing. We prefer to invest in a diversified basket of securities and have selected proven active funds and ETF's. Should you want to know more, please feel free to contact your Relationship Manager.

"Luck shouldn't be part of your portfolio."

HYPOSWISS
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Expect the expected

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Mission Statement

- Hyposwiss Advisors' mission is to offer **personalized asset management services and financial advice** to high net worth individuals and families based in the **USA** and **Canada** with the overriding objective of **capital preservation** and **asset growth** performance oriented.

- Investments in compliant global assets are used to construct a **diversified balanced portfolio** tailored to the investor's requirements and deposited with **international banks** acting as qualified custodians.

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