Review & Outlook October 2020

Review and Outlook

Hyposwiss Advisors SA

www.HyposwissAdvisors.ch

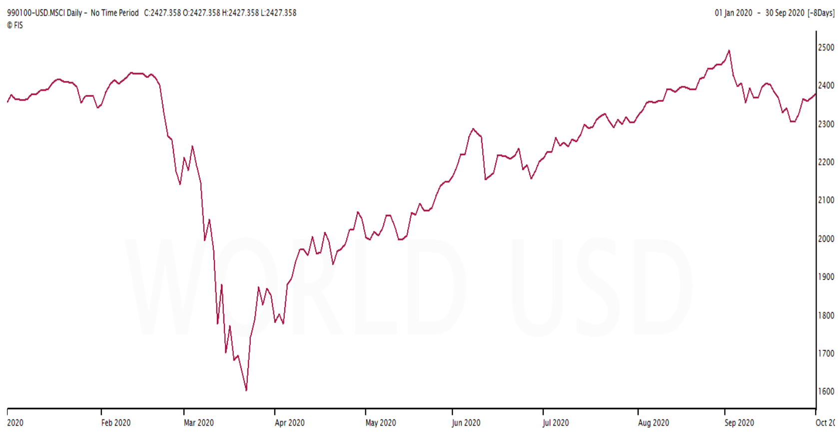
Q3 2020 Review

Covid-19 still ruling the markets

The **V-shaped recovery** of equity markets since their March-crash lows continued until the beginning of September, when we saw the first retraction, with the MSCI World loosing -3.90.% The MSCI World then finished the quarter flat for the year (YTD +0.05%). One could almost argue that global equity markets are not aware that in the real world a so called coronavirus crisis exists.

Contrary to the previous months, the **NASDAQ Composite** was underperforming all other indices by correcting -5.86% in September. After the astonishing rally of the FAANG stocks this year, a correction from overbought levels for some leading index members was overdue.

After the **first 9 months** of 2020, only the equity markets of the two largest economies of the world are showing positive figures year-to-date: the S&P 500 is up 3.24% and the Chinese Shanghai Composite is up 5.30%. This fact is directly related to Covid-19 and comes as no surprise as China was the first country to emerge out of the lockdown and the USA is home to many technology companies benefiting from the imposed lockdown measures including homework.



MSCI World Index in USD – 01.01.2020 – 30.09.2020
Source: FIS Market Map

Emerging markets were hit hard by the pandemic and unlike developed markets, fiscal accounts are more constrained, which puts limits on their growth recovery. **European markets** also strongly underperformed, in particular the UK market, which is struggling with the impending likelihood of a no deal or hard Brexit.

Fixed income markets are still dominated by central bank actions. The High Yield (HY) sector as a whole also recovered as yields, spreads and margins declined further, but certain sectors suffering from Covid-19 related measures are not out of the woods and we should see further defaults, especially in the areas of travel, leisure, airlines, oil, etc.

Contrary to equity markets, **oil** was not able to recover from its Covid-19 related lows as the imbalance between demand and supply is still putting pressure on prices. **Gold** on the other hand reached new all-time highs pushed up by the overall uncertainty. At the beginning of August, Gold climbed towards USD 2080, a level it could not sustain.

Fixed Income

Historically low interest rates finally reach the USD

For a few years, USD bonds were almost the last remaining instrument to earn a decent yield without too much risk. This opportunity is gone. The widely watched **US 30 years Treasury yield** stood at its peak in 1981 at 15.20%**.** 40 years later, during the Corona crisis, it dipped as low as 1.16%, which translates to a thirteen-time decline. Whether or not this 1.16% level was already the turning point, is too early to tell. It is surely one possibility to take into consideration, as at the time of writing the figure is up again at 1.57%. USD rates have nonetheless reached levels which one thought were only possible in the notoriously low yielding currencies such as Swiss Francs and Yen, next to the Euro. Still, USD bond yields are not yet below zero as it is the case in these other currencies and therefore, theoretically have room to decrease further.

US Treasury 30 year yield – 01.01.1981 – 08.10.2020
Source: FIS Market Map

The economic shock of the pandemic has effectively extended the **ultra-loose monetary policy** across the world for several years. Central banks are projected to pump a record USD 8.4 trillion of stimulus into the financial system in 2020, which translates to 14% of the world economic output. But despite this, policymakers are incentivized to loosen the monetary reins even further by keeping interest rates low or even below zero and might experiment with unorthodox policies such as yield capping, which would keep the yield curve flatter than it would normally be the case in a recession period. This could result in lower bond rates, even at the long end, such as with the above mentioned 30-year bonds.

If the Coronavirus crisis extends and the current economic recovery slows down, we might experience a situation with a repression last seen in the **1940's after WWII**, when central banks kept bond yields low to fund a post-war recovery. Such a scenario might have only a small likelihood as the coronavirus crisis has not the scale of WWII, but it is an indication of what could happen as well. In any case, the debt level of certain countries in Southern Europe and others is of historic high proportion and maybe unsustainable without the help of inflation.

The obvious risk of **inflation** seems to be low in the short term, but it seems inevitable in the medium to long-term. The unprecedented amounts of fiscal and monetary stimulus will stoke demand for goods and services at a time when supply is restricted because of the deceleration in global trade and post-pandemic strategic realignment of supply chains, from "just-in-time" to "just-in-case". The result will be that inflation could begin to rise potentially already in 2022.

We started the year with a neutral allocation in the Fixed Income asset class in USD bonds. Despite low yields, we keep our allocation mainly for **capital preservation**. Although we consider that yields will remain low for a few years, we believe no meaningful capital losses should occur. In view of the medium-term inflation risk, we have increased our positions in **TIPS** (Treasury Inflation Protected bonds).

In the **High Yield (HY)** space, investors' hunger for yield have pushed prices up. We keep most positions after having eliminated holdings in certain sectors such as airlines and certain oil companies. We watch our HY bonds closely, being aware that the coronavirus economic crisis will lead to further defaults, but hold on to those bonds which offer a favorable risk/reward ratio and increasingly cover this sector with carefully selected Funds and ETF's. Furthermore, we started with a small position in Convertible Bonds as they offer capital protection with a built-in upside potential.

Equity

What's next after the V-shaped recovery?

Covid-19 brought an economic devastation resulting in the almost **worst global downturn** in nearly a century. Equities during the same time were able to perform a V-shaped recovery and by doing so offered a certain degree of comfort to long-term equity holders.

Technology stocks outperformed so far in 2020, as their underlying business model profited from the new situation related to home-office and e-commerce. Amazon is an obvious example with a performance of over 70% this year. **Health care** is another promising sector. At the same time, high dividend stocks and value stocks were the clear losers during the Covid-19 crisis. The economic downturn has hit many of these companies hard, which in response had to cut or defer their dividends. Some were even forced to do so by their government requirements, in particular in Europe's financial sector.

Many **conservative investors** seeking high yields and/or value got disappointed, lost patience and sold stocks when their dividends were cut. Somehow it almost seems strange that during an economic crisis of such magnitude, well established stable stocks performed so poorly, whereas some high flying growth stocks - some companies founded less than 20 years ago – outperformed and now dominate the field. Ultimately, the coronavirus crisis will reshuffle the economic landscape completely. Certain trends that already exist on a low scale will come into force much quicker than without the crisis. We follow such events and therefore will continue to invest into future "Trend and Thematic Investments" to participate in such secular movements.

The upcoming **earnings season** will guide stock movements for the next three months. For Q3, the consensus expects S&P 500 earnings to decline by 21% against Q3 2019. This compares to an expected 31% decline in Q2 2020 versus Q2 2019.

Early reporters, EPS guidance of some companies and macroeconomic indicators like the Purchasing Managers Indices (PMI) and upside revisions to GDP-growth rate indicate that most companies will beat the down-revised earnings. If companies on a broad base are able to beat expectations, this would be supportive for the overall market.

The **direction of markets** will also depend on the macroeconomic developments amid the coronavirus measures. Furthermore, the worldwide fiscal stimulus during 2020 which accounts for roughly 5% of potential global GDP together with central banks remaining focused on keeping yields at rock-bottom levels will result in equity valuations coming under less pressure – there being no real alternatives to equities on a significant scale.

At the beginning of the coronavirus crisis we had a neutral to slightly overweight **equity allocation** depending on the risk category of each client. We did not sell any positions during the panic sell-off in March for our discretionary mandates and therefore fully participated in the V-shaped recovery.

We did some reallocations in Q3 by reducing positions in Europe and as mentioned above by buying Funds and ETFs invested in future **"Trend and Thematic Investments"**, some of which we have presented in our past quarterly letters. Going forward we intend to reallocate some positions into Asia / Emerging Markets and complete holdings into the above mentioned Trends & Thematics.

Currencies

The greenbacks fading allure

Whichever way you look, the dollar's prospects are getting gloomier. There were five main trends which supported the US currency in the nine years since it hit an all-time low in trade-weighted terms (2011), and most of them are slowly disappearing:

1) Superior economic growth: As lockdown measures are eased, the rebound of economic activity in the USA and in Europe appear to be in lockstep. Different economic indicators from both sides of the Atlantic confirm that growth seems to return at an equal rate following the relaxation of lockdown measures and is more in step than originally feared.

2) Higher interest rates: The US Federal Reserve holds rates close to zero, might do a restart of quantitative easing and has hinted as well to controlling the front end of the yield curve. The differential between USD rates and those of the rest of the developed world has shrunk from 200 basis points in the summer of 2019 to nearly zero. There is no longer a meaningful yield advantage for any investor by holding the greenback.

3) Valuation: The 9 year uptrend of the dollar has led to the fact that the USD is now fundamentally overvalued. Some economists set the overvaluation of the USD against a basket of currencies at as high as 15%.

4) World reserve currency: This status is a reflection of the dominance of the USA as a political, military and economic powerhouse and is still valid but is slowly starting to erode. Its share in global central bank reserves, for example, has fallen from 71% in 1999 at the start of the European Economic and Monetary Union to 62% in 2020. However, what remains valid is the USD status as a structural safe haven currency.

5) Magnet of capital: The superior profitability of US companies relative to the rest of the world serves as a magnet for capital. For international investors there is hardly any alternative to the US tech giants in order to achieve benchmark performance and by buying these stocks one automatically also must buy USD.

These factors point towards a downtrend for the dollar and among the currencies set to appreciate is the Euro, despite its complex make-up. Another candidate is the Chinese currency. Valuations are cheap, China's inflation is under control and the monetary expansion will slow over the coming years. Furthermore there is a chance that the Renminbi will rise significantly as an investment currency and eventually as a reserve currency.

Economics

The economic recovery is progressing amid heightened uncertainty

The new round of Purchasing Managers Indices **(PMI)** readings point to an improving economic backdrop, however there are high regional and sectoral divergences. In many countries and sectors, PMI readings are now above the 50 threshold, which points to growth in the next months and in some cases a progress towards the pre-crisis levels. The outlook for the services sector, in particular in Europe and certain emerging markets, is less upbeat as this segment was hit hard by the pandemic. For example, travel restrictions in Europe are being enforced as the number of new cases is increasing in many countries.

The latest **US labor market** data confirm the message of a progressing recovery. Payrolls increased, but missed the more upbeat expectations. This is despite revisions for the past two months being positive, which highlights the challenge of finding an accurate assessment of the current economic situation.

The **unemployment rate** in the US fell faster than expected to 7.9%, but is still uncomfortably high, most probably too high to be a helping argument for President Trump to win the election (As a reminder: before the coronavirus crisis, the rate was as low as 3.5%). The driver for the lower rate is mainly discouraged workers, as one can see in the lower participation rate. Finally, the increase in permanent and long-term unemployment is a clear indication that it will be a tough call to get all jobs back. This would need a continued (fiscal) policy support, which at the moment is a bone of contention between the Republicans and Democrats.

Commodities

Oil: Still suffering from the coronavirus crisis

The oil market was reeled from unprecedented turmoil earlier in the year, but unlike equity markets, oil prieces are still under pressure as there are doubts about the demand recovery and fears about oversupply by petro-nations.

Oil **demand** is back at around 95% of pre-crisis levels. Road fuel use recovered most swiftly in China and Europe, mirroring the V-shaped economic recovery. US consumption lags, not least because of depressed air traffic. Long-term Europe's different stimulus packages in favor of electric mobility will translate into less oil demand after 2030 at latest.

Oil **supply** is constraint because of the shale business hibernation and the petro-nations supply deal. While oil prices trade below the USD 50 level, US production trends sideways and when prices are around USD 40 the petro-nations should stand firm behind the supply deal. Also long-term, Venezuela and Iran could return to the market which would result in additional supply.

Despite the above mentioned uncertainties, we are of the opinion that oil will trend higher in the medium-term; whereas on a long-term view, electricity and other new technologies will prevail.

Gold: Reaching new all-time highs in Q3

Gold prices (XAU ounces) in USD – 01.01.2019 – 09.10.2020
Source: FIS Market Map

In our view, Gold is one of the big winners from the economic downturn caused by the Covid-19 pandemic, which in turn attracted trend-followers and technical traders pushing prices higher. At the beginning of August, gold was climbing towards **USD 2080**, reaching several new all-time highs. It could not sustain these levels but the gold rally is far from being finished for the following reasons:

Gold continues to offer investors some protection from increased turbulences in traditional asset classes. Negative interest rates, quantitative easing, a weakening USD and persistent geopolitical tensions will underpin demand for the metal. Long-term inflationary pressures could also boost the gold price. Global inflation might remain modest for the immediate future, however monetary and fiscal stimulus will at some point begin to push prices higher. In such circumstances, gold will come into play as a **store of value.**

We have increased during Q3 our allocation to the precious metal from **5% to 7%** in our discretionary accounts and intend to keep this allocation for the time being.

Outlook

US elections and coronavirus news will set the agenda

The upcoming US election on November 3rd will dominate the news-flow and markets alike, as they are typically the most-significant (geo-) political wildcard globally. It is not meaningful yet to speculate on the winner, but it is prudent to measure the different scenarios:

Biden Victory with Senate: Equities would suffer initially given a hit to 2021 earnings (increased corporate taxes), prospects of increased regulation (technology, banks) and minimum wages (lower margins). Depending on the size of the pullback, this might offer a good entry point, because history has shown that equities do not underperform during Democratic Presidents.

Biden Victory without Senate: This outcome would be only slightly negative to equities as this would probably lower the risk of higher corporate taxes and it could reduce foreign policy risks (China trade war).

Trump Victory with Senate: For financial markets, this is possibly the best outcome initially, and equity markets would surge on the day after the results on prospects of further tax cuts and less regulation. However the euphoria might be short lived should geopolitical tensions re-escalate.

Trump Victory without Senate: This is a potentially dangerous outcome as it would mean Trump wouldn't be able to accomplish anything domestically and might instead focus his attention on foreign policy which is often market-unfriendly (China trade relation among others).

Risks are mounting that a clear winner will not be pronounced on election night (November 3rd) due to the increased use of mail-in ballots requiring more time to be counted, or results being contested / re-counted in some key swing states.

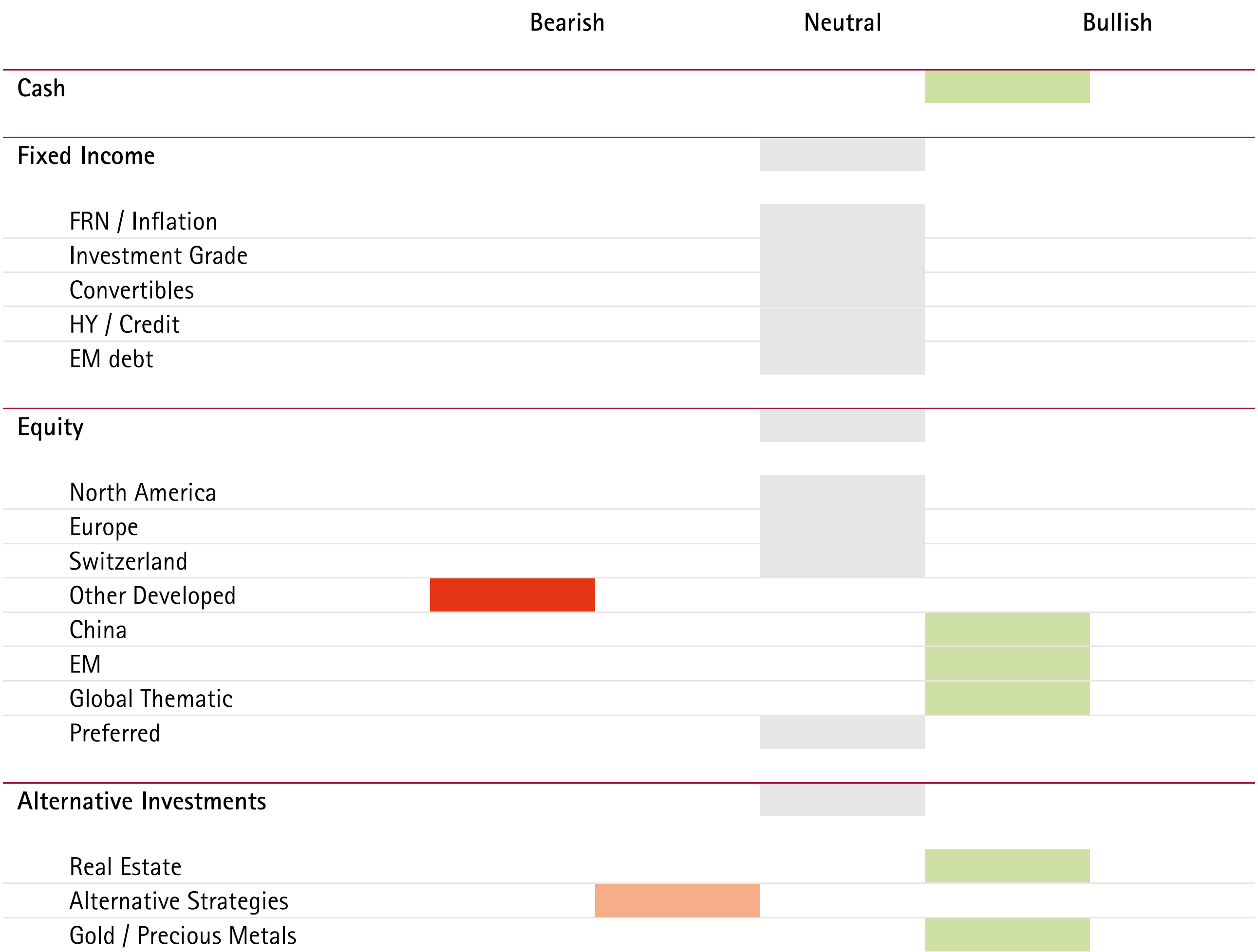
Otherwise, **Covid-19** related news and their impact on economies will continue to be key factors for markets.

With all these uncertainties we are not willing to take too much risk, **remain neutral** in our equity allocation and are confident that our portfolios are constructed to withstand each outcome of the US election and ongoing economic downturn but will still participate in the big global thematic trends of the 2020 decade.

Walter Küng
Senior Portfolio Manager

Asset Allocation

USD Reference – Balanced



Thematic investment idea

ESG investing

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

Expect the expected

Investing in a future megatrend

ESG (Environmental, Social and Governance) investing refers to a class of investing that is also known as "sustainable investing." This is an umbrella term for investments that seek positive returns and long-term positive impact on society, environment and corporate governance issues.

In the past, it was a widely held assumption that an investor had do decide between superior performance or ESG investing, as ESG friendly investments were considered to have an inferior return. However, during the Covid-19 economic crisis, many ESG unfriendly industries suffered heavily (oil, industrial metals), whereas ESG friendly technology stocks outperformed.

The investor community is increasingly leaning towards the consensus that ESG investing is not only better for the world, but also will deliver **superior investment results.** At Hyposwiss Advisors, we also came to share this opinion and intend to invest accordingly going forward.

A quick summary of the main points of ESG:

1) Environmental concerns: Climate change / Sustainability / Depletion of resources.
2) Social concerns: Diversity / Human rights / Consumer protection / Animal welfare.
3) Corporate Governance: Management structure / Employee relation /Executive compensation / Employee compensation.

Hyposwiss Advisors has the aim and ambition that the portfolios of our clients show a **footprint of ESG** investments. This footprint should over time include more ESG compatible investments; non-ESG compatible investments will slowly be reduced and ultimately are absent from the portfolios.

We have set up **general guidelines** how to accomplish our ESG goals by setting up a framework and internal procedures, for example how to proceed when selecting new securities or building new portfolios. When selecting securities we generally follow the ratings of widely respected public external providers, as assessing each company in detail would not be efficient.

Should you want to know more about our ESG investing guidelines or how your portfolio might be affected, please feel free to contact your Relationship Manager.

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.

Contact

Hyposwiss Advisors SA

www.HyposwissAdvisors.ch
info@advisors.hyposwiss.ch

Head Office
Rue de Hesse 7
1204 Geneva - Switzerland
Mr. Elio Barzilay

Tel.: +41 22 310 76 40
Fax: +41 22 310 76 39

Representative Office
Hufgasse 17
8008 Zurich - Switzerland
Mr. Michael Bösch

Tel.: +41 22 310 76 35
Fax: +41 22 310 76 39

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