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ADVISORS

Review & Outlook
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Review and Outlook

-Review
-Fixed Income
-Equity
-Currencies
-Economics
-Commodities
-Outlook
-Asset Allocation

-Thematic Investment idea

Mission Statement

Contact

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Q3 2021 Review

Equities dived in September – amid unbroken uptrend?

History does not repeat itself, but there are some seasonal patterns which stubbornly exist. One of them is that **September** is usually the worst month of the year for stocks, and that was true again in 2021, as the MSCI World dropped by -3.6%.

The **S&P500** as one of the more widely followed index lost the same amount (-3.6% MTD), a sign that this was a global, synchronous and in retrospect overdue drop. The **NASDAQ** index - after managing to reach a new all-time high at the beginning of September - even declined by -4.9%, indicating that technology stocks might be out of favor temporarily again as earlier in the year.

Interestingly, **China** on the contrary had a positive month (Shanghai Comp +0.5% MTD), despite being at the center stage of negative news, and proving yet again that the Chinese market is the only major exchange which has a life of its own, unrelated to US trends.

MSCI World Index in Local Currency – 01.01.2020 – 30.09.2021.2021
Source: FIS Market Map

The two main reasons for the September decline were higher interest rates, as the 10yr US Treasury yields went up by 20bp and the events around the Chinese real estate giant **Evergrande,** causing investor fears that this might end-up as the Lehmann Brothers collapse back in 2008. That event was not only the largest bankruptcy in US banking history, but it prompted one of the biggest financial panics of all times.

By September 30, 2021, the **MSCI World** was up by 12.6% YTD and the **S&P500** was the leading force as in the previous 10 years (+16.1% YTD). **Europe's** outperformance continues (EURO STOXX50 +14.9% YTD), as the September decline in Europe was smaller than in the USA, thanks to the more defensive character of its main index heavyweights. **Asia** was still negative for 2021 (MSCI Asia ex Japan -1.6% YTD), but did not register the same losses as the rest of the world in September.

Otherwise in Q3, **gold** continued its 2021 decline (-2.3% QTD), finishing at USD 1'729. The fact that gold could not profit from all the negative news around a potential Evergrande collapse was a big disappointment for all gold bulls. **Oil** had a huge rally in September (Crude oil WTI +9.4% MTD), continuing its 2021 run (+54.5% YTD), thereby pushing oil stocks up. Most but not all industrial metals continued their 2021-uptrend (Aluminum +15.2% MTD / +46.7% YTD).

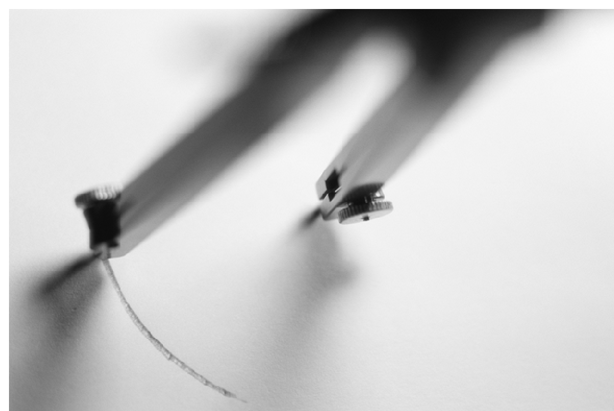
Equity

Was the September-dip a buying opportunity or the start of a correction?

In line with its **seasonal reputation** and as described above, the S&P500 posted its worst month since its March Covid-19 related decline, thereby enduring its first drop after a series of eight straight month of gains. The 'correction' however came on a relatively low 12.5% realized volatility, meaning there was no panic selling and it might ultimately be classified as one of those typical 'profit taking' events after a series of strong monthly gains.

Some **'buy the dips'** style of investors were frustrated during the first eight months of the year, as there were no opportunities to enter during a market pullback. As a result, that meant for some missing out on most of the upward move until these September days. Following the long-awaited dip, investors have used the occasion to deploy capital into equities. However it is still too early to exclude that this dip could turn into a **correction** (more than 10% down), a **cyclical bear market** (more than 20% down) or even a **secular bear market** altogether (multi-year period with unwinding of asset bubbles following years of excesses, often associated with a banking crisis).

Looking at long-term data series, the best strategy has been to be **invested all the way** (with temporary adjustments of under- or over-allocation). Whenever one sold everything or is otherwise heavily underinvested, it is extremely difficult to find the appropriate entry point back into the market.



In the short-term, the immediate trend will be set by the upcoming global **earnings season.** The expected numbers are still sizeable but not as demanding as for Q2 2021. Revenues are expected to grow at 13% year-on-year, and earnings by 27%, a high number compared to the pre-Covid19 situation. Analysts will closely monitor the evolution of **profit margins** given the impact of rising input costs and supply chain disruptions, as already many firms mentioned in Q2 difficulties in passing through cost inflation to the end-consumer. As such, those companies with a strong pricing power should be better positioned to maintain their profit margin despite slowing revenue growth and rising input costs.

The recent steep increase in bond yields triggered **a rotation** back into value/defensive and away from growth stocks, similar to the beginning of the year. This move might be even stronger should technology stocks not be able to deliver in their earnings reports those outstanding results which are expected from them. After most companies have beaten consensus strongly the last few quarters – resulting in huge gains in their stock values - expectations are lifted into skyrocket high numbers.

Client managed accounts:

We increased our **equity allocation** in the first 9 months of 2021 but only to a level which is sustainable in our view. Even after these increases, we are still slightly more conservative than some large asset allocators globally, and want to maintain this stance.

We did well with our US and European stocks but our positions in **Asia (and particularly China)** were underperforming in 2021 along with those markets. We decided to maintain allocations as we like the superior long-term growth story of the region, which we think will ultimately prevail and translate into higher equity valuations. We therefore do not want to reduce the exposure despite the currently lagging performance of Asia and China.

We have presented in our past (and current) quarterly letters ideas relating to investing in future **'Trend and Thematic Investments'**. We are of the opinion that the focus should be to be invested in **promising global future trends** rather than to choose the correct regional allocation. Therefore, going forward and as always depending on ongoing events, our intention is to continue to allocate investments in the above mentioned thematic investments.

Fixed Income

One problem solved (debt ceiling), one getting worse (inflation)

The **US Congress** is seemingly eager to enjoy the autumn recess and more quickly than anticipated agreed on an increase of the US statutory **debt ceiling** of USD 480bn, equivalent to two months of revenue shortfall. November will be again busy when Capitol Hill will have to agree on a final budget, including an infrastructure deal. In December, the current Continuation Resolution will elapse and most probably there will be another massive increase of the debt ceiling.

While the debt ceiling problem has been pushed back a few weeks, **inflation worries** are aggravating. The break-even inflation rates continue to edge higher by the day, an indication that bond markets fear inflation to stay elevated for good. The ten-year break-even inflation rate rose to 2.50%, the highest level since May. Back then it was President Biden's

fiscal initiatives coupled with the outlook for higher economic growth that fueled inflation expectation. This time it is rather the fear that the multiple temporary factors will translate into second-round effects, causing permanently higher prices and therefore the market focus will be on the next inflation indicators, such as the annual rate of increase of wages in the service sector, or the consumer price reports.

Despite all these inflation worries, the Treasury yields seems to be reluctant to move in line with the rising inflation expectations of the past few months. Peaking economic growth is one possible explanation for the **divergence between bond yields and inflation figures**, but growth rates were rather normalizing from unsustainably high levels than signaling a slowing of demand. At the same time, the FED has been buying Treasuries at a monthly rate of USD 80bn, while issuance declined below that level, a situation that will change in the coming months.

The FED has on numerous occasions given advance notice that it is intending to **taper** its Treasury purchases, maybe already in November. The higher supply of Treasuries should allow yields to reconnect with economic fundamentals, in particular with inflation expectations. At the same time, global reflationary forces have weakened lately not least because of a softer growth outlook for China. Furthermore a growing number of **supply-side issues** reduce the economic growth in the US and Europe for now. Other softer economic fundamentals also suggest that nominal yields will rise less than previously projected.

Client managed accounts:

Fixed Income remains an **unattractive asset class.** In order to generate some income, investors have to accept higher credit risk, meaning to hold either High Yield (HY) or Emerging Markets (EM) bonds.

We still have an underweight for Fixed Income in USD based accounts and even a higher underweight in our CHF/EUR based accounts. We did lower our allocation to bonds already three times this year and might reduce it further going forward. However, despite low returns, we keep a certain portion mainly for **capital preservation**, assuming that yields will not rise much higher than to their 2021 highs of Q1 earlier in the year. We are gradually restructuring portfolios to have a lower duration and occasionally sell long-dated issues. Capital losses should be limited, as we intend to hold securities until maturity.

With interest rates still at historically low levels, we continue to invest into higher yielding instruments in the **High Yield (HY)** space, which we cover when possible through funds with a

proven track record and active management ability.

Currencies

The outlook of the USD looks promising on a short-term view

The **USD** had a mini run lately and has broken the critical support level in the Euro/USD pair at 1.16 on expectations that the FED will shortly ease off its monetary measures as the speculation on timely tapering will persist for a while.

The current trend for the USD remains positive and could lead the EUR/USD to fall back even to 1.10. US Congress has also postponed the decision date for the debt ceiling to December and US employment is increasing considerably. However the long-term outlook for the USD is less constructive as the US twin deficits will ultimately put pressure on the greenback again.

The **Euro** lost 2.3% against the USD in Q3 and even 5.0% YTD as the solid growth outlook is constrained by the dovish policy of the European Central Bank (ECB). The ECB strategy explicitly tolerates an inflation overshoot and has set a high hurdle for an interest rate normalization which puts a limit to its cyclical-driven upside. However, the Euro's long-term outlook remains constructive as Europe's **purchasing power** remains strong and the main European countries offer a solid **balance of payments** situation, contrary to the USA.

The **CHF** will be supported by peaking growth momentum and global growth concerns, but the very loose monetary policy of the Swiss National Bank (SNB) will constrain its appreciation. Industry shut-downs in China and other diminishing risk appetite events offer support for the CHF, in its traditional key role as a **safe-haven currency.**

The **CAD,** as an **oil-related currency,** benefited from the recent surge in oil prices. Prime Minister Trudeau's bid to win an absolute majority with snap elections in September failed. The minority government is weakened, but fiscal support continues. The Bank of Canada's (BoC) hint at a lift-off of rates in H2 2022 due to inflation risks and soaring house prices has been surpassed by peer central banks and the BoC now only ranges in the midfield. More BoC tapering and prospects of rates hikes may support the Lonnie, but the direction of the oil price will ultimately be the key for the trend going forward.

The **CHN** remained resilient to increased headwinds from growth, policy risks and global negative news around a potential Evergrande bankruptcy, which ultimately had a bigger

negative impact on global stock markets than those in China itself. However, risks around spillover effects around the Evergrande case, as well as the handling of power shortages remain and enforcements of energy reduction targets are a medium-term risk. In the longer term, capital inflows and the internationalization of the Renminbi should be supportive.

Economics

Global economies still on their uptrend but pace is slowing down

The US economy added only 194'000 **jobs** in September, less than the 500'000 expected by the consensus, however the numbers for August and September had been revised up by a cumulative 169'000 jobs, bringing the **unemployment rate** to fall from 5.1% down to 4.8%. This mixed labor report still allows the FED to remain on track to formally announce the tapering of asset purchases at its next FOMC meeting in November.

On a global perspective, **economic growth** has also slowed down somewhat, but is still elevated. There are however some developments which could negatively impact western economies. Oil and other commodity prices continue to be stubbornly expensive which negatively affects consumer purchasing power. The US – and to some extent Europe as well - will **tighten fiscal policy** considerably from mid-2022 onwards which might affect economic growth depending on the level of borrowing and savings by that time. **The supply side** of the economy could be restricted by disrupted supply lines and huge labor shortages and such bottlenecks would impede economic growth. Last but not least, **China** is putting the brakes on different manners of development that it believes are not good for the Chinese population. It is a priority for President Biden to curb the influence of China, which increasingly restricts trade between the West and China.

These risks are offset by **positive forces**. The spread of the corona virus is increasingly being curbed, but after what happened the same period one year ago, the investment community wants to see more evidence that the virus is under control. Otherwise, consumers in the West still have considerable (unused) purchasing power, which is underscored by the fact that the massive price increases in property and stocks has made many people wealthier, giving them the choice to spend some of this new money easily earned.

The key will be how central banks will react, as we could have a recession if the monetary easing happens too soon. The US FED indicated it will terminate its policy of driving asset prices to higher levels once inflation shifts to excessive wages and CPI inflation, but is willing to

tolerate **inflation to exceed the 2% level** before any intervention.

Central banks will have to choose between **two evils**: risking another credit crunch or allowing inflation to rise too much. The likelihood is bigger that they will opt for higher inflation as this will alleviate the debt burden and will drive up nominal interest rates. This view represents the current market consensus.

Commodities

Oil and natural gas trading at multi-year highs

Bankers are wondering what is happening on the energy markets as natural gas and oil prices surged to **multi-year highs**. There is a straightforward denominator to the trend. The recent V-shaped recovery following the Covid-19 crash has overburdened the slower-moving and more complex energy supply chains.

While this is a known fact, many little hiccups finally led to a fierce upward spiral. These hiccups include coal supply disruptions in China, natural gas supply disruptions due to maintenance and outages both in Norway and Russia, soft wind conditions curbing wind production in Europe and a drought in China reducing hydropower. Furthermore, mechanisms such as Europe's market based emission trading scheme become unintentionally a booster for prices.

A chilly winter could make things even worse, but natural gas prices at current levels imply big bets on such a possible outcome. Ultimately however, oil politics are a function of prices, and with oil trading above USD 80 and at multi-year highs, the pressure from the consumer economies on petro-nations to remove restrictions is growing swiftly. China's power outages and high prices at the pump in the USA could visibly reduce oil demand.

On the long-term horizon, structural imbalances in the supply and demand relation, resulting from the ongoing trend towards electric cars, will put pressure on the oil price.

Gold: Higher prices would need higher inflation or a negative event

Gold prices did not follow contagion fears around the Evergrande events but continued to correlate with **real interest rates**. This is simply because real yields can be regarded as the 'opportunity cost' of holding a lower yielding asset such a gold.

It is still somewhat surprising that gold prices dipped more than one would expect from the evolution of real yields. The 10-year TIPS yield is

only slightly higher than where it was in early August 2020, when the price of gold reached a high of USD 2067 per ounce.

Gold investors are also taking it easy when it comes to the **inflation** debate, which has been fueled by rising energy prices. While we have reached the point where inflation starts to hurt the real economy, it seems we are not at a point (yet) like in the 1970s or 1980s, when surging inflation data triggered a gold rush pushing prices to new all-time highs.

Client managed accounts:

We hold gold as a long-term insurance against possible negative geopolitical events including a systemic financial crisis and an unexpected acceleration of inflation. We are not concerned too much about daily swings as we do hold gold for tactical reasons and only keep our long-term strategic position of 5%, which we intend to maintain for the above reasons.

Gold prices (XAU ounces) in USD – 01.01.2020 – 12.10.2021
Source: FIS Market Map

Outlook

Equities remain attractive and bonds unattractive

The current situation with global equities close to their all-time highs and interest rates still unattractive but slowly trending up from record lows is an **uneasy situation** for all investors alike. The ongoing debate about a possible path by which the global economy returns to 'normal' will contribute to volatility. Another open question is how central banks will ever solve their easy money dilemma. All hopes rest on the US FED, as it has committed itself in managing this process rather carefully and to timely pre-announce each step.

The **USD 10-year Treasury** yield has broken its key resistance levels at 1.55% and is now likely headed towards the highs of 2021 at 1.78%. We think however this rise is not sustainable and yields will not go much higher for now. The immediate trend though is set for rates to rise which is a negative for (long) bonds and will extend pressure on growth stocks.

Equity markets are enjoying a bull-run since early 2009, mainly spurred by declining interest rates reaching record lows and many wonder what would be happening now that rates seem to trend upwards again! History suggests that as long as yields do not increase enough to imperil the economy, stocks usually end up recovering after any rate increase and reach new highs.

History since 1985 also tells us that the first three weeks of **October** are periods of high risks and volatility for US stocks, which includes two crashes of 12% and 18%. Sharp rallies often followed those declines, but the good news is the market typically closed the month with positive performance.

After reaching new all-time highs at the beginning of September, equity valuations are no longer cheap even accounting for the current correction, but not at extremely expensive levels neither. The MSCI World Index trades at 18-times P/E earnings only. Relative to bonds, stocks still trade at a healthy discount. The **equity risk premium (ERP)**, measured by the gap between earnings yield and the real bond yield, stands at a high 580 bp, amazingly exactly where is stood in May 2008, which was shortly before the current bull market started.

As far as **economies** are concerned, the after-Covid-19 global recovery has peaked, with advanced economies leading the recovery, especially those with fast **vaccination** progress, whereas emerging economies with limited access to vaccines and less fiscal space are the laggards.

We **enter the last quarter of 2021** with the assumption that global stock markets will continue their recent recovery, but do not as yet predict a year-end rally, and we still follow the developments on the health situation and the vaccination campaigns. We keep some shorter dated bonds for capital preservation, HY/EM bonds to generate income, gold for unforeseen events and hold on to our current equity allocation with an increasing bias towards future 'Global Trends and Thematic' investments.

Walter Küng
Senior Portfolio Manager

Remark:

"Client managed accounts" refers to a generic description of general investments for managed accounts under discretionary mandates. Each account and portfolio could be materially different from this description and could invest or not in substantially different securities or products, based on individual risks and objectives. The descriptions above are not meant to reflect exact holdings by all accounts. Non-discretionary mandates could also be managed in a manner materially different than the description above.

For any question or doubt, please contact your Relationship Manager that will review your account and provide personalized comments and information.

Asset Allocation

USD Reference – Balanced

Thematic investment idea

Investing in a future megatrend

Artificial Intelligence

Artificial Intelligence (AI) involves **computers finding patterns**, identifying objects, making predictions or exercising judgement without being explicitly programmed with the rules governing these identifications or predictions. AI learns to do these things by crunching through vast quantities of data.

In certain task or applications, automatic action may follow from the AI's observation or prediction, often leading to the near-complete **elimination of human involvement** in the process.

AI is an exciting area of technology that has the potential to change how industries operate and consumers live their lives. Examples include self-driving cars, smart cities or security and fraud protection. AI ultimately provides limitless possibilities and, in the years ahead, there are likely to be ways to profit from the technology.

One of the most exciting aspects of AI is the fact that in the future, almost all businesses will be using it or touching it in some ways. From a 'total addressable market' perspective, this is a remarkable potential with no limits to the upside. However, from an **investor's point of view**, it is a huge challenge because if every company is touching AI, it is hard to structure an approach to select and find those companies with more sensitivity to the growth of the AI ecosystem as to include every company which is also tangentially touching the AI-space.

Typically, one differentiates between 3 kinds of business models in the world of AI:

Enhancers: These are companies that provide their own value-added services within the AI ecosystem, but were AI is not core in their products offering.

Enablers: These are companies that develop the buildings block components of AI such as advanced machinery, autonomous systems/self-driving vehicles, semiconductors, or databases used for machine learning. This is a recognition that AI, as an underlying concept, has been around for decades, but it is because the infrastructure in 2021 is so much stronger that AI is a megatrend at present, but was difficult to be put into action decades ago.

Engagers: These are companies that design, create or deliver AI in the form of products, software or complete systems building up businesses that depend on selling and spreading AI technology.

In short, the AI world offers a revolutionary, exponential technology with immense commercial potential. The key for investors is to find companies which derive a meaningful part of their revenues from AI, which represent the upstream and midstream part of the AI value chain, and which stand to gain the most from growth in demand for AI-powered products and services.

We believe there is a **long-term opportunity** for investors to participate in this still underestimated and fast growing thematic.

Should you want to know more about this trend and how to invest, 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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