CIO Update

Investment Committee Bank J. Safra Sarasin
14 April 2021

Green shoots everywhere

Strong economic data and interest rates in consolidation mode support financial markets.

Macro outlook – US economy sets the tone
The economic recovery continues, and so does the recovery on the US labor market. At 916,000, job growth last month was well above market expectations - the strongest increase in seven months. The bulk of the jobs were created in the service sector, against a backdrop of a gradual reopening of the economy and a successful vaccination strategy. This was also reflected in the high demand for consumer credit, which in February showed the strongest increase since the end of 2017. Meanwhile, leading indicators, such as the ISM Index, highlight the improved economic outlook for the coming months. The service component recently rose to 63.7 points, its highest level on record. The most dynamic increases were seen in new orders and business activity. Both subcomponents reached record levels.

This development is also reflected in the forecasts of the US Federal Reserve, which predicts an increase in US economic output of an impressive 6.5% this year. This is remarkable insofar as China, the second largest economy, has also just announced its growth target for this year, namely 6%. If these forecasts materialize, the US economy would expand more strongly than China's for the first time since the 1970s. What at first glance looks like a surprising shift is largely due to base effects. While the US economy with strong growth in 2021 would compensate for the more than 4% contraction of the previous year, in China it is merely a normalization to the growth rate observed in pre-COVID 19 times. Unlike in Europe and the US, output in China did not shrink last year, but rose by around 2%. Moreover, the Middle Kingdom has not intervened to any comparable extent in terms of fiscal or monetary policy. Europe, meanwhile, remains on the sidelines. With an estimated GDP growth of 3.7%, the old continent is lagging behind. This is all the more serious as the COVID 19 recession in 2020 brought a much more dramatic drop in GDP than was the case in China and the US, namely by around 7%. This is partly due to the slowness of the fiscal policy response, and partly due to Europe's suboptimal vaccination strategy. However, this has not weighed on leading indicators. European purchasing managers' indices have recently risen to an all-time high despite all the obstacles, far exceeding market participants' expectations. This is because the prospects for an improved growth environment in the second half of the year are good.

Despite the high growth forecasts of the U.S. Federal Reserve, the central bank expects realized inflation to exceed the central bank's target, but not substantially. The same applies to the economic development. Despite extensive fiscal programs and monetary policy support, the Fed is not worried about the economy overheating. If this proves to be true, it bodes well for the US economy in general and financial markets in particular, as it would allow a presumably smooth return to normal monetary policy with a decent rise in interest rates. Still, the uncertainty in this regard is high. However, the US Federal Reserve is still very comfortable with being "behind the curve". It considers the expected rise in inflation in the second quarter to be transitory and wants to take as much time as necessary for the labor market to recover strongly.

Editorial

Dear readers

The month of April is known in Switzerland for choppy weather. This year, too, summery days were followed shortly by wintry snow showers. In the end, however, spring will prevail with warmer weather. The global economy is also going up and down due to COVID-19 lockdowns. Hopes for widespread vaccination are being countered by rising infection rates in many regions. However, the green shoots seem to be gaining ground and macro data are signaling that we are in for a summer of very positive economic numbers. To a large extent, financial markets are already anticipating this. But as long as we take two steps forward and only one back, the potential does not seem to be exhausted yet.

Philipp E. Bärtschi, CFA, Chief Investment Officer

Bonds – Yields in consolidation mode

Since the Fed meeting in mid-March, financial markets have priced in a first interest rate hike even earlier against the backdrop of strong economic data. According to Fed fund futures, market participants expected a first rate hike as early as the end of 2022, which is more than a year earlier than the dot plot, a graphical representation of the interest rate expectations of individual FOMC members, indicates. A stark contrast. Whether this will be resolved by the bond market moving in the Fed's direction or the central bank adjusting its reaction function in the direction of market expectations remains to be seen. In any case, the dynamic rise in yields at the long end of the yield curve has recently paused. US government bonds with ten and thirty-year maturities are currently in a consolidation phase, after having reached their highest levels since the outbreak of the COVID 19 pandemic at 1.75% and 2.5%, respectively. The dynamic of interest rate increases at the long end of the yield curve is now expected to moderate, but risks appear to be tilted to the upside on the back of robust fundamentals. We expect higher interest rates by the end of the year, both in the US and in Europe.

While high-yield bonds are robust in this environment, it is a very challenging one for emerging markets bonds. The asset class was not able to absorb the rise in US yields. Emerging markets bonds denominated in local currencies were also heavily impacted by the appreciation of the US dollar in the first quarter. Rising inflationary pressures have also meant that local central banks, particularly in Brazil, Turkey and Russia, have had to counteract with monetary policy. The asset class appears attractive, but the idiosyncratic risks require good selection.

Equity market volatility back at pre-COVID 19 levels

Source: Refinitiv, Bank J. Safra Sarasin, daily data, 31.1.2019 to 14.4.2021

Equities – Continued upward trend

Equity markets, on the other hand, seem to have lost their fear of rising interest rates in recent weeks. Recently, it was primarily the better-than-expected macro data and significantly improved growth prospects that caused yields at the long end of the yield curve to rise. A good reason, then. The positive momentum in risk assets has continued accordingly, accelerating the rotation into cyclical stocks. Implied volatility in equity markets, which remained at elevated levels in the months following the outbreak of the COVID 19 pandemic, has also fallen significantly recently. The environment for equities therefore remains solid.

Asset Allocation – Overweight in equities

Cyclical rotation within and across asset classes has been the dominant theme in financial markets this year. Vaccination progress and extensive monetary and fiscal policy measures have increased the likelihood of a rapid economic recovery, not only in the US. Value stocks and small and medium-sized companies in particular are benefiting from this. Both equity market segments are still attractively valued and show positive momentum. We therefore remain overweight in these areas despite the already good performance in recent months. Temporary setbacks can be seen as buying opportunities. On a regional level, we are overweight in developed market equities, with a focus on cyclical regions outside the US. Here, in addition to the more attractive valuation compared to US equities, the strong US growth itself is a key reason for the preference of ex-US equities. A strong recovery of the US economy should lead to corresponding demand for imported goods and thus a widening of the trade deficit, which should increase liquidity and growth in other regions and weaken the dollar. Recently, inflows into the dollar have been strong due to high US interest rates. As US interest rate momentum declines, investors are likely to shift their focus to other regions. Valuations outside the US are more attractive, and the diversification potential increases due to ongoing deglobalization.

Within bonds, we remain underweight in duration, especially in government and investment grade bonds. On the other hand, the risk-return profile of high-yield bonds remains attractive, and the same applies selectively to emerging markets bonds. Despite a difficult start to the year, we consider the latter to be a good addition to the multi-asset portfolio - both from a growth and a diversification perspective. The negative impact of sharply rising US interest rates and a strong US dollar should ease in the medium term, releasing corresponding catch-up potential.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	+	Developed markets =	Emerging markets =	Large caps –	Small caps +
Bonds	–	Government bonds – – –	Corporate bonds – –	High-yield bonds ++	Emerging markets ++
Alternative assets	=	Money market =	Convertible bonds =	Other alternatives +	Real Estate =

Source: J. Safra Sarasin

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