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CIO Update

Investment Committee Bank J. Safra Sarasin
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Editorial

Dear reader

The flattening of the coronavirus curve in Europe indicates that the containment measures of the past weeks are showing positive results. This is encouraging for the health care systems of many countries, which hopefully will get off with a black eye, but also for the economy, which has been waiting for an early easing of the emergency measures. The damage already caused is enormous and must be set against the monetary and fiscal policy measures already adopted. A sharp economic slump should be followed by a strong recovery in the summer. The recent rally on the financial markets has already partially anticipated such a recovery. Nevertheless, there is still considerable return potential for long-term investors.

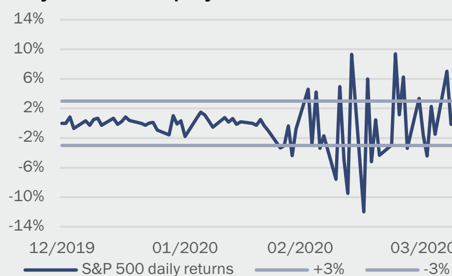
Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

Focus

First glimmers of hope

Review: Bear or bull market?
Against the backdrop of an exponential increase in coronavirus cases outside of China and the breakdown of OPEC talks, global equity markets have lost around a third of their market capitalization in record time. The daily moves in equity markets were massive and the uncertainty of investors as to the direction of the next move was enormous.

Daily moves in equity markets

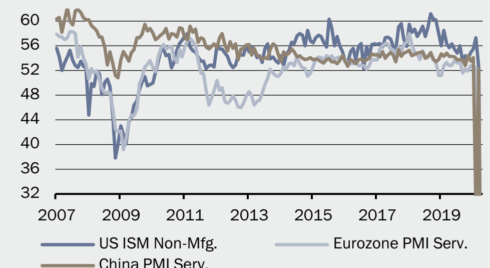


Source: Refinitiv, J. Safra Sarasin, 07.04.2020

With the recovery of over 20% in recent weeks, the shortest bear market in history came to an unexpectedly rapid end. The coming weeks will show whether the bears will come back again or whether the bulls will take the lead for a longer period of time.

Macro outlook: Recession or Recovery?
The drastic emergency measures introduced by many governments worldwide since March mean that we are already in the middle of a recession within a very short period of time. However, the depth and length of the recession is the major uncertainty factor. The forecasts of economists and analysts are correspondingly uncertain. However, the monetary policy measures of global central banks are correspondingly extensive and the fiscal policy measures of individual countries and regions correspondingly comprehensive in order to cushion the economic consequences of the pandemic.

Slump in purchasing managers' index



Source: Refinitiv, J. Safra Sarasin, 07.04.2020

In recent weeks, governments in Europe and the USA have approved loans and guarantees amounting to 10 to 15% of their gross domestic product. This will be necessary. The sharp drop in the services component of the purchasing managers' indices in March and the record number of initial claims for US unemployment benefit have already given a first taste of the economic consequences.

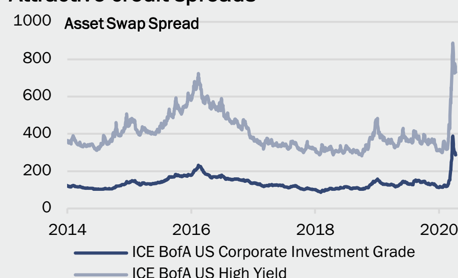
However, the example of China also shows that the economy recovers quickly once the emergency measures are eased. It is therefore likely that the trough will soon be passed and that investors will focus on the strength of the coming

economic recovery. At the same time, the economic slump is likely to be the most severe, but also the shortest in history.

Bonds: Low liquidity in bond markets

Global central banks have responded with monetary policy measures on an unprecedented scale. Only a few days after implementing two emergency interest rate cuts totaling 150 basis points, bringing key interest rates down to zero percent, the US Federal Reserve approved another comprehensive package of measures, which provides for unlimited purchases of securities and now also includes the purchase of corporate bonds. The latter was crucial as bond markets came under increasing pressure in recent weeks. Credit spreads on investment grade bonds have widened massively since the end of February and are currently at their highest level in ten years.

Attractive credit spreads



Source: Refinitiv, J. Safra Sarasin, 07.04.2020

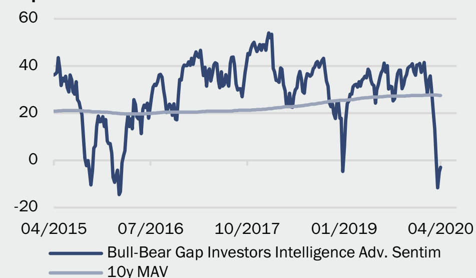
The current credit spreads are pricing in very negative scenarios. This is true for both investment-grade and, in particular, high-yield bonds. The risk premiums in both segments imply very high default rates that are significantly higher than the actual default rates realized in the past. Spread widening on emerging market bonds were similarly extreme. As investors were forced to reduce risks in their portfolios, outflows from the region were massive.

The biggest problem in the credit sector is therefore also the lack of liquidity in the market. Although the intervention of the central banks has led to a stabilization, volumes remain extremely low and bid-ask spreads extremely high. There is a huge excess of supply from investors who either want to sell their positions or have to sell them due to outflows. On the other hand, demand is low as long as the risk of default continues to rise. While fiscal measures are likely to prevent many defaults, there is a considerable implementation risk as to whether the money will actually get to the right place. In the short term, pricing is likely to remain difficult due to low liquidity. However, long-term we see great potential for a recovery in the credit sector and therefore remain overweight.

Equities: Is the worst over?

Although it is only possible to identify the trough with hindsight, the first signs of stabilization are encouraging. After all, European equity market indices have already suffered price losses of around 38% from peak to trough. The price declines in some emerging markets were even more devastating. As a result, investors were in panic mode in March.

Equities: Investor sentiment is at the bottom



Source: Refinitiv, J. Safra Sarasin, 07.04.2020

At the end of the quarter, equity market valuations became significantly cheaper compared to the beginning of the year. Not only on the basis of future profit expectations, but also compared to bonds due to falling interest rates. As certain sectors have been disproportionately affected by recent developments, sector and stock selection is of crucial importance. Given the ongoing high degree of uncertainty regarding the length and extent of the economic damage, we continue to take a defensive stance in risky assets. In March, we mainly built up positions in quality and growth companies within the healthcare and technology sectors.

Asset Allocation: Cautiously optimistic

Financial markets run ahead of the real economic cycle and will therefore reach their trough before the end of the pandemic. Even if there are likely to be setbacks, it is quite possible that we are already at the beginning of this recovery. Although volatility is likely to remain elevated in the coming weeks, we see initial opportunities to buy risky assets in this environment. We started the sharp correction with an underweight in equities and a largely defensive positioning within the asset class. End of March we have closed this underweight and are now neutrally positioned in equities. We are also gradually reducing the overweight in cash to take advantage of selective opportunities in emerging market bonds. We remain overweight in high-yield bonds, as the high credit spreads are offering an attractive compensation for the expected increase in default rates. Overall, we have slightly increased the risk in our portfolios and are cautiously optimistic that the worst is over for financial markets.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	=	Industrial countries =	Emerging markets =	Large caps =	Small caps =
Bonds	–	Government bonds – –	Corporate bonds =	High-yield bonds +	Emerging markets +
Alternative assets	+	Money market =	Convertible bonds =	Other alternatives +	Commodities/gold =/+

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