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PostFinance

Editorial

When will we see inflation? No idea!

It's well known that financial markets trade on the future – but what if we don't know what the future holds? Why a dependable approach is preferable to overconfidence.

Daniel Mewes
Chief Investment Officer

Everyone is talking about inflation. This comes as little surprise, as the central banks of the major currency areas have had little option but to finance their governments' spending since the start of the coronavirus crisis. Historically, such state funding has always led to currency devaluation.

This means that estimates and forecasts for future price trends are in great demand. Unfortunately, specific inflation forecasts are anything but straightforward. First and foremost, the central banks themselves have a strong interest in forecasting inflation – after all, they align their policy to it. Unfortunately, they often fail when it comes to inflation forecasts extending beyond the next few months, despite the fact that their forecasts are produced by a range of highly qualified experts. The reason for this is simple: the world is just too complex to predict what will happen next year.

Investment business based on a dependable approach

How should you approach this as an investor? It is well known that investors trade on the future. But what if you don't know the future? Especially when it comes to such an important factor as inflation?

At PostFinance, we also considered these questions when we launched e-asset management a year ago. How can we manage customer assets with a clear conscience, despite all the uncertainty?

An investment business primarily requires a dependable approach. Some key facts about inflation are evident, such as its short-term dependence on energy prices. We also use this knowledge when making tactical decisions in the investment committee. We believe it is important that the longer-term strategies for our portfolios are robust enough during protracted periods of inflation – which explains the comparatively high gold allocation, for example.

A dependable approach pays off

Overestimating our own knowledge would be dangerous – and would expose our customers' money to scenarios that are very difficult to predict. This solid approach means lagging behind occasionally in terms of returns. There will always be people who ride their luck and come out better off.

> «Successful investment means yielding solid returns at reasonable risk, even if the future is unknown.»

But our approach is about being in a good position when comparing the return with the risk assumed. And that's exactly what we do: we were delighted to feature in the top group in a recently published ranking for the "Sharpe ratio" criterion, which is the comparison of return and risk. Successful investment doesn't mean audaciously counting on particular scenarios. It means yielding solid returns at reasonable risk, even if the future is unknown.

Positioning

Not the time for gambles

The economy continues to return to normal. The UK and US equity markets in particular are showing potential. The downside of the recovery is falling bond prices.

The looming third wave of coronavirus and drastic measures to combat the further spread of the virus are still overshadowing life in Switzerland. But the financial markets have long shifted their focus to economic normalization. Justifiably so, in our view.

Two economies are set for a particularly strong recovery over the coming quarters – the USA and the UK. We are increasingly focusing on these two regions for equity investments. In contrast, we are reducing our positions in Japanese and European equities. Overall, we are maintaining the neutral equity allocation determined by the investment strategy.

Differentiating UK equity market

The US economy has come through the two waves of coronavirus in much better shape than its European counterpart. US consumers will also benefit from further generous state support over the coming weeks, and the rapid progress of the US vaccination programme points to rapid normalization of economic life by the middle of the year. In the UK, the signs are also good that it will largely be possible to relax restrictions by the middle of the year, given the rapid speed of vaccination. The catch-up effect is particularly significant in the UK. The UK economy has been one of the worst hit by coronavirus restrictions. By contrast, this catch-up effect is much smaller in Japan. The Japanese economy recovered almost completely in the fourth quarter of last year.

«The catch-up effect is particularly significant in the UK.»

The recovery of the global economy after coronavirus means that it is advisable to place greater emphasis in the portfolio on companies and sectors that have been particularly severely hit during the pandemic. In this respect, we also view UK equities as extremely attractive. The UK equity market has a high proportion of equities in the energy, commodities and financial sectors. The valuation of securities in these sectors seems comparatively low.

Performance of asset classes

Asset class		1M in CHF	YTD[1] in CHF	1M in LCY[2]	YTD[1] in LCY[2]
Currencies	EUR	2.6%	2.5%	2.6%	2.5%
	USD	3.8%	4.4%	3.8%	4.4%
	JPY	0.2%	–0.6%	0.2%	–0.6%
Equities	Switzerland	1.0%	2.7%	1.0%	2.7%
	World	4.0%	9.4%	0.2%	4.8%
	USA	3.7%	9.3%	–0.1%	4.7%
	Eurozone	6.3%	9.9%	3.6%	7.2%
	United Kingdom	9.5%	12.4%	4.2%	5.2%
	Japan	–0.6%	5.7%	–0.8%	6.4%
	Emerging markets	–1.2%	10.0%	–4.8%	5.4%
Fixed Income	Switzerland	–0.1%	–0.9%	–0.1%	–0.9%
	World	1.5%	1.0%	–2.2%	–3.3%
	Emerging markets	0.0%	–0.4%	–3.7%	–4.6%
Alternative Investments	Swiss real estate	0.2%	–0.7%	0.2%	–0.7%
	Gold	–2.7%	–4.6%	–6.3%	–8.7%

[1] Year-to-date: Since year start
[2] Local currency

Data as of 11.02.2021
Source: Web Financial Group, MSCI, SIX, Bloomberg Barclays, J.P.Morgan

The downside of the upturn

Interest rates on the capital markets usually rise during economic upturns. This is no different in the coronavirus recession. Interest on 10-year government bonds in the USA has risen by around 0.6 percentage points since the beginning of February and currently sits at 1.6 percent. The interest rate level also crept up in Switzerland.

Rising interest rates have a negative effect on bonds and result in falling prices. Equity and real estate markets, meanwhile, are impacted both positively and negatively by rising interest rates. The positive effect comes from the improved economic outlook, whereas the negative side is that higher interest rates lead to lower valuations. While the positive effect appears to have the upper hand at the moment, the markets have clearly become more anxious due to higher interest rates. The daily price fluctuations on the equity markets have increased recently. This is not unusual during a phase of economic recovery. However, the valuations of many financial investments are unusual. In contrast to previous periods of recovery, equities and real estate investments are currently standing at record highs in many places. This combination means that cautious positioning in the portfolios is advisable – despite economic optimism.

Positioning relative to long term strategy: Swiss focus

Asset class		TAA[1] old	TAA[1] new	underweighted[3] ––	–	neutral[3]	+	overweighted[3] ++
Liquidity	**Total**	**7.0%**	**7.0%**					
	CHF	6.0%	5.0%					
	JPY	1.0%	2.0%					
Equities	**Total**	**48.0%**	**48.0%**					
	Switzerland	26.0%	26.0%					
	USA	10.0%	10.0%					
	Eurozone	3.0%	3.0%					
	United Kingdom	2.0%	4.0%					
	Japan	2.0%	0.0%					
	Emerging markets	5.0%	5.0%					
Fixed Income	**Total**	**35.0%**	**35.0%**					
	Switzerland	19.0%	19.0%					
	World[2]	10.0%	10.0%					
	Emerging markets[2]	6.0%	6.0%					
Alternative Investments	**Total**	**10.0%**	**10.0%**					
	Swiss real estate	5.0%	5.0%					
	Gold[2]	5.0%	5.0%					

[1] Tactical Asset Allocation: short to mid-term orientation
[2] Currency hedge to CHF
[3] Positioning relative to our long-term asset allocation

☐ Adjustment compared to last month

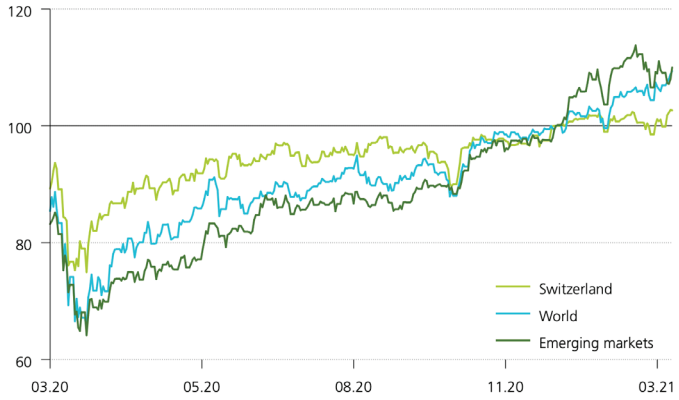
Market overview

Equities

The euphoria on the equity markets waned somewhat in March. Technology equities in particular suffered losses. By contrast, cyclical equities from the energy and finance sectors climbed in value. Both the improved economic outlook and rising interest rates may have contributed to this sector rotation.

Indexed stock market performance in Swiss francs

100 = 01.01.2021

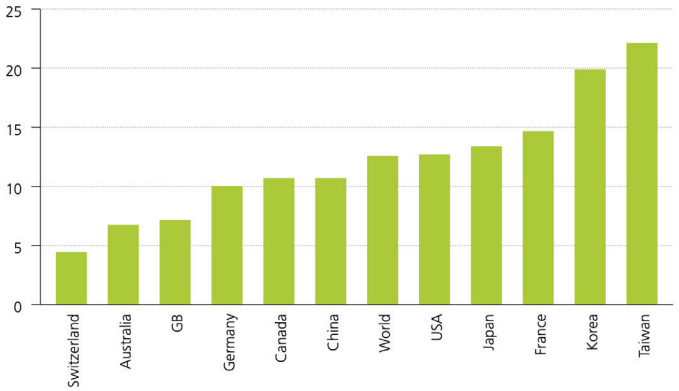


The euphoria on the equity markets waned somewhat despite the improved economic outlook. Technology equities – the strongest driving force behind the rally – suffered losses last month. Rising interest rates were a major factor in this trend. Technology securities justify their high value with large gains anticipated in future. If interest rates rise, these future gains will be more heavily discounted, resulting in losses in value. In contrast, sectors such as finance and energy – where rising interest rates and commodity prices can have a favourable impact – have benefited from this positive economic development.

Source: SIX, MSCI

Momentum of individual markets

In percent

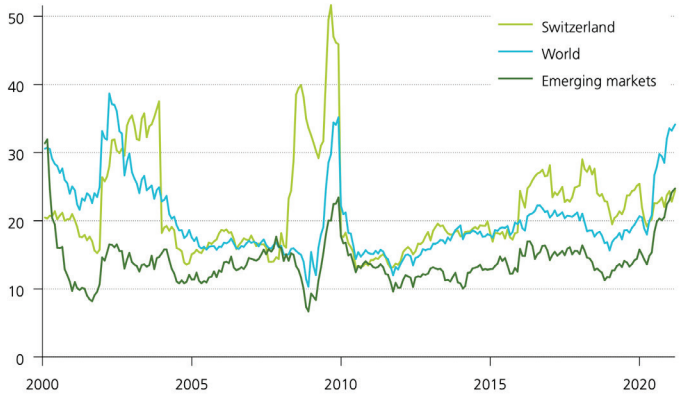


The waning euphoria has also subdued momentum in individual countries. While momentum in individual countries remains positive, its strength has faltered. The Swiss equity market, which is benefiting less from the economic upturn with its stable securities, is again lagging behind. The Chinese equity market also recorded heavy losses. After posting sharp gains, it seems to have run out of steam. No other equity market performed as poorly as China's last month. The strength of its momentum is now in the mid-range.

Source: MSCI

Price/earnings ratio

P/E ratio



The valuation level remains high. However, rising interest rates are jeopardizing these high valuations. This applies especially to high-growth stocks whose anticipated gains lie quite a long way into the future. If gains remain the same, valuations will tumble. Tech equities in particular were badly hit last month.

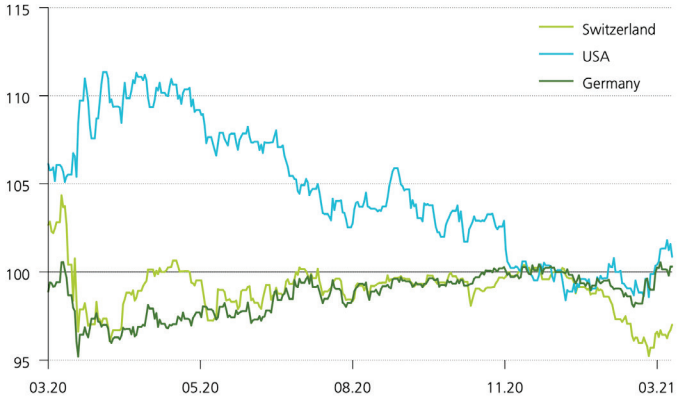
Source: SIX, MSCI

Market overview

Fixed income

Interest rates are continuing to rise worldwide. As well as higher inflation forecasts, the improved economic outlook has also been a factor recently.

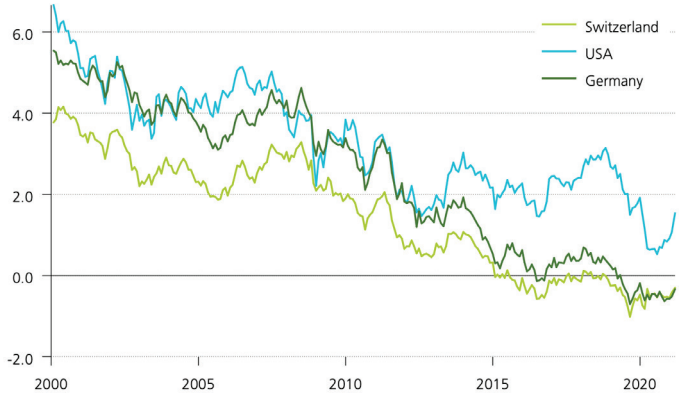
Indexed performance of government bonds in Swiss francs
100 = 01.01.2021



The US economy is experiencing an upswing and is even outperforming China as the engine of economic growth. In addition, a further stimulus package of 1.9 trillion US dollars was approved recently. The USA is also making great progress in combating the pandemic. The bond market, both in the USA and worldwide, has responded with a rise in yields. Central banks are permitting this increase in interest rates, despite continuing to promise to keep rates low. As a result, the value of nominal government bonds fell again recently. Swiss bonds recorded a loss of almost 6 percent last month.

Source: SIX, Bloomberg Barclays

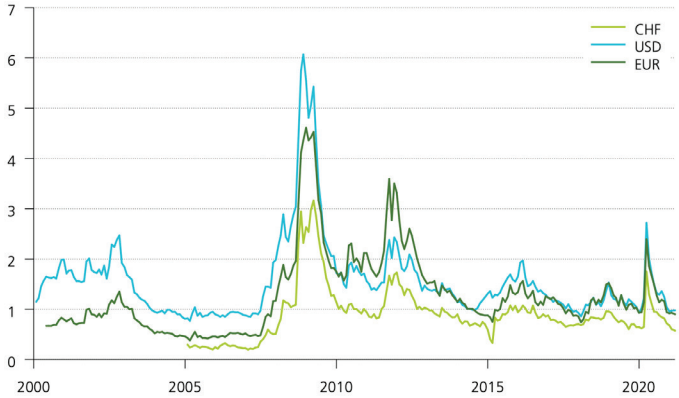
Trend in 10-year yields to maturity
In percent



The rise in real interest rates led to higher yields to maturity on government bonds, especially in the USA and Australia. The yield to maturity on 10-year US bonds is now close to 1.6 percent. Just two months ago, this figure stood at 1 percent. Long-term yields to maturity in particular have increased, while yields at the short end remained at the same level. This means the interest curves have become much steeper. Yields to maturity on 10-year bonds rose much less sharply in Europe than in the USA.

Source: SIX, Bloomberg Barclays

Credit spreads on corporate bonds
In percentage points



The positive mood on the market had already seen credit spreads on corporate bonds fall to their pre-coronavirus level across all ratings at the end of 2020. An exception was the credit spreads on Swiss corporate bonds of good credit standing. But these have also normalized recently. This situation is unlikely to change as long as the central banks continue their generous bond-buying programmes and the economic outlook remains good.

Source: Bloomberg Barclays

Market overview

Swiss real estate investments

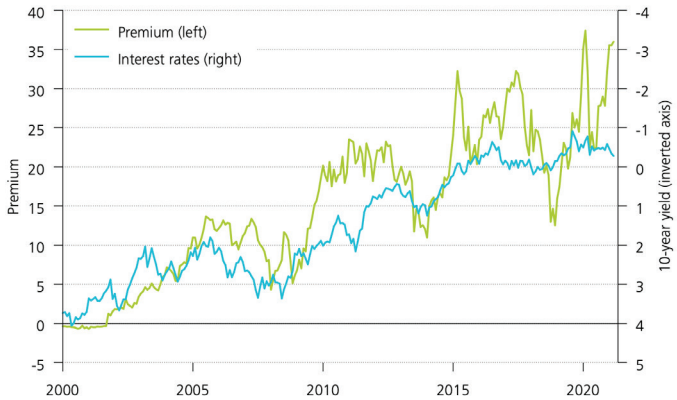
Swiss real estate funds have been trending sideways since the start of the year. The recent increase in interest rates did nothing to change that.

Indexed performance of Swiss real estate funds
100 = 01.01.2021

Indexed Swiss real estate funds have so far failed to build on their strong performance in 2020: they have trended sideways since January. After a slight price correction in February, their values have returned to the year-opening level. Prices also withstood the recent rise in interest rates. One reason for this may be demand from institutional investors who still have few alternatives in the predominantly negative interest-rate environment.

Source: SIX

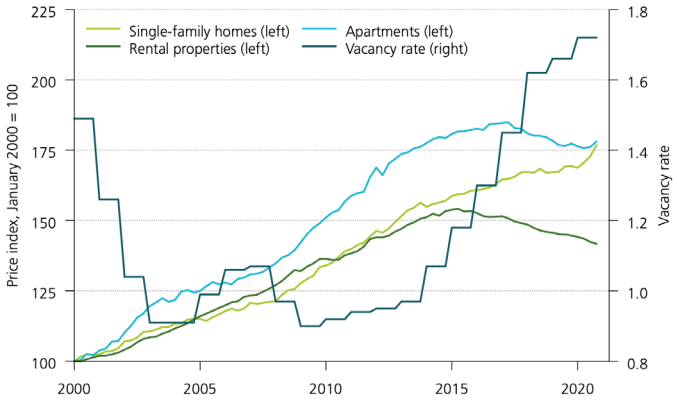
Premium on Swiss real estate funds and 10-year yields to maturity
In percent



The rise in interest rates over recent weeks has triggered little price reaction on the market. This means that average premiums achieved on the properties contained in the real estate funds have diverged further from their fair value. The valuation of the real estate, also known as the net asset value (NAV), is reacting sluggishly to interest rate changes. Unless there is a price correction, the premiums will remain at a high level. The average premium again stood at over 35 percent recently. This has only ever been higher in spring last year.

Source: SIX

Vacancy rate and real estate prices
100 = January 2000 (left) and in percent (right)



There is a new barometer for the real estate market in Switzerland. The Swiss Federal Statistical Office recently published the Swiss residential property price index (IMPI), which measures the nationwide price trends for residential property. This barometer indicates that a price rise of around 3.1 percent was recorded last year. As well as this sharp rise in residential property prices, mortgage interest rates also increased slightly in recent times. This makes the purchase of residential real estate more difficult.

Source: SNB, BfS

Market overview

Currencies

Demand for the Swiss franc, a crisis-proof currency, has fallen. By contrast, the US dollar's value recently rose sharply due to the improved economic outlook. Demand for pound sterling also remains strong.

The weakness of the Swiss franc over recent weeks means it is no longer the world's most expensive currency according to our estimates. It ceded this position to the US dollar, which recently recorded a strong increase in demand due to the brighter economic outlook for the USA. Even stronger than the US dollar was pound sterling, which gained by just under 2 percent against the dollar and by almost 4 percent against the Swiss franc. However, in terms of purchasing power parity, pound sterling is still undervalued against the dollar and Swiss franc and has upturn potential. The biggest loser is currently the Brazilian real, which has been severely hit by the coronavirus pandemic and record levels of national debt.

Currency pair	Price	PPP[1]	Neutral area[2]	Valuation
EUR/CHF	1.11	1.16	1.08–1.25	Euro neutral
USD/CHF	0.92	0.91	0.79–1.02	USD neutral
GBP/CHF	1.29	1.43	1.23–1.62	Pound neutral
JPY/CHF[3]	0.85	1.05	0.89–1.22	Yen undervalued
SEK/CHF[3]	10.94	12.20	11.00–13.39	Krona undervalued
NOK/CHF[3]	10.98	12.71	11.34–14.07	Krona undervalued
EUR/USD	1.20	1.28	1.12–1.45	Euro neutral
USD/JPY	108.52	86.21	70.84–101.57	Yen undervalued
USD/CNY	6.49	6.38	6.13–6.63	Renminbi neutral

[1] Purchasing power parity. This metric calculates an exchange rate using relative inflation rates.
[2] Range of historically normal fluctuations.
[3] Francs per 100 Yen or Krona.

Source: Web Financial Group

Gold

In light of the improved economic forecasts and rising interest rates, gold continued its downward trend. The precious metal currently stands at around 5 percent below the year-opening level.

Indexed performance of gold in Swiss francs
100 = 01.01.2021

The brighter economic outlook not only led to a recent increase in interest rates, but also continued to hit the price of gold. As a result, the precious metal continued its downward trend last month and has fallen by 15 percent in total since last summer's record level. The price per troy ounce of gold even briefly slipped below the mark of 1,700 US dollars.

Source: Web Financial Group

Economy

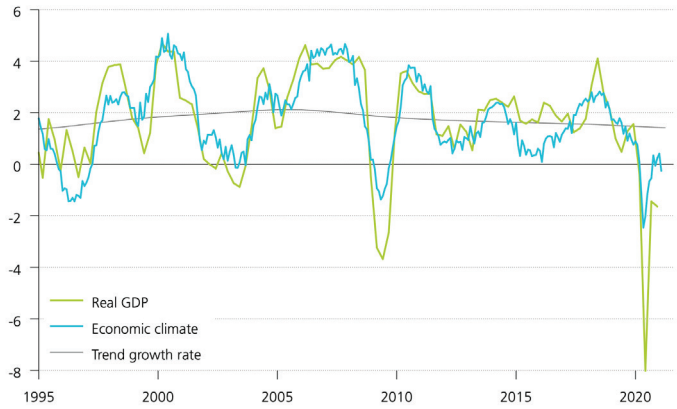
US economy hits the ground running

The outlook for the US economy is very bright. It is set to return to pre-crisis levels soon. The picture in Europe is much less certain.

Switzerland

Growth, sentiment and trend

In percent



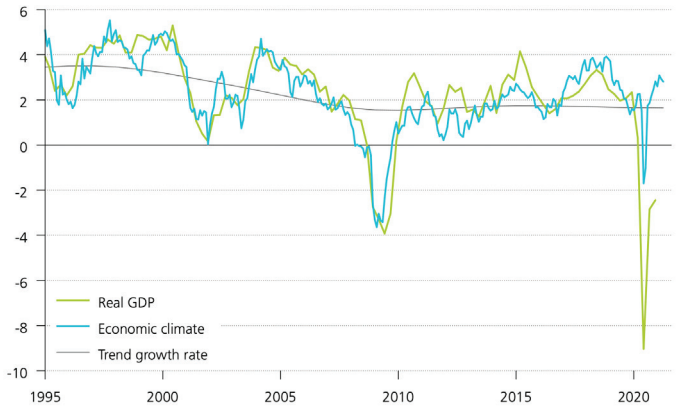
Source: Bloomberg

The Swiss economy grew by 0.3 percent in the fourth quarter of 2020 despite tightened coronavirus measures. Strong export dynamics – with exports climbing by around 6 percent compared to the previous quarter – was a factor, while the downturn in consumer spending was much less severe than during the first lockdown. It once again became apparent that, as the crisis wears on, people are increasingly less reluctant to consume and are spending money where they can. This trend also continued in the New Year: in January, the retail sector recorded a drop of just –0.5 percent in sales year-on-year, despite shop closures from 18 January. This means the economic downturn during the first quarter of 2021 is much less severe than in the first lockdown.

USA

Growth, sentiment and trend

In percemt



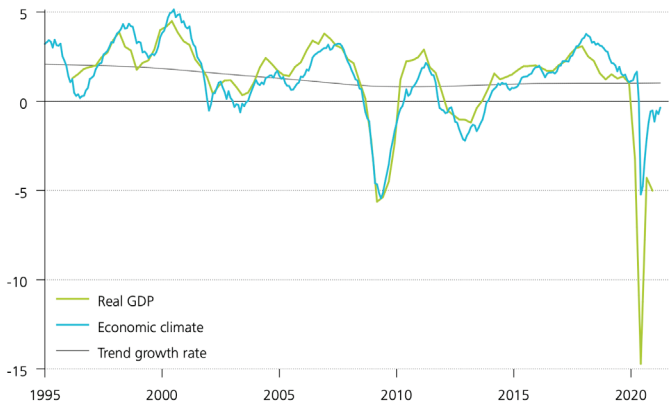
Source: Bloomberg

The US economy is currently gaining significant momentum. There are three reasons behind this. First of all, US government policy remains very expansive under the new President: a third huge economic stimulus package worth 1.9 trillion US dollars was adopted recently. This includes direct payments of 1,400 US dollars to a large section of the population. Secondly, on top of this amount, there is an estimated further 1.7 trillion US dollars that the population has saved during the crisis, due to limited consumption options. Thirdly, the vaccination programme in the USA is making very rapid progress, enabling the relaxation of coronavirus measures. This now creates the conditions for people to spend the money that has been saved and the government transfers. As a result, retail sector sales were up 7.4 percent year-on-year in January.

Eurozone

Growth, sentiment and trend

In percemt



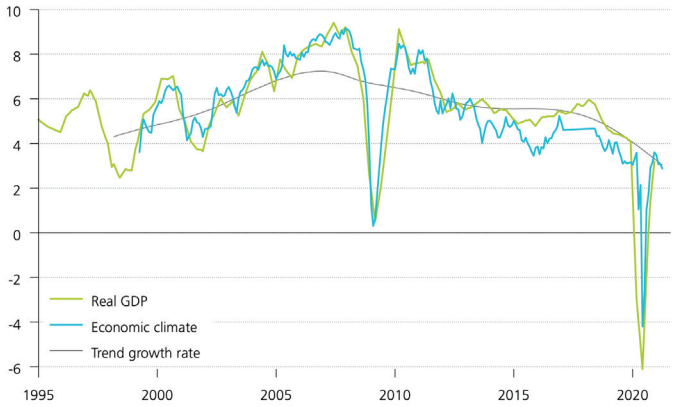
Source: Bloomberg

The eurozone is currently lagging well behind the USA in terms of economic momentum. Although strict coronavirus measures have been in place for months in various countries, the risk of a third wave rules out extensive relaxation and economic recovery. In contrast to the first wave, the central and eastern European countries are being hit just as severely this time as their ravaged southern European counterparts. In Germany, for example, the downturn in the retail sector of –8.7 percent year-on-year in January was steeper than during the first lockdown. In Austria, the slump of –16.8 percent in retail sales was extremely drastic. However, industry is currently providing some reason for hope: sentiment in this sector is at a record high, and industrial production posted growth (+0.1 percent) year-on-year for the first time since the start of the crisis.

Emerging markets

Growth, sentiment and trend

In percemt



Source: Bloomberg

The economic figures from China are currently painting a unclear picture: while the sentiment indicators from industry and the services sector point to an end of the euphoria of recent months, industrial production was up 35 percent year-on-year in January and February, and exports soared by as much as 60 percent. Even taking account of the fact that China was in lockdown last January and February, the figures for industry and exports are very strong.

Despite being severely hit by coronavirus, Brazilian economic output in the fourth quarter was just –1.1 percent below its pre-crisis level. However, the rapid recovery was achieved with unsustainable monetary and fiscal policy. Government debt is approaching the mark of 90 percent of GDP, which is extremely high for an emerging market. In February, inflation rose for the ninth consecutive time, reaching 5.2 percent and forcing the central bank to increase interest rates. This jeopawrdizes economic recovery.

Global economic data

Indicator	Switzerland	USA	Eurozone	UK	Japan	India	Brazil	China
GDP Y/Y[1] 2020Q3	–1.4%	–2.8%	–4.2%	–8.7%	–5.8%	–7.3%	–3.9%	4.9%
GDP Y/Y[1] 2020Q4	–1.6%	–2.4%	–4.9%	–7.8%	–1.4%	0.4%	–1.1%	6.5%
Economic climate[2]	→	↗	→	↗	→	↗	↗	↗
Trend growth[3]	1.4%	1.6%	0.9%	1.6%	1.0%	5.0%	1.0%	4.2%
Inflation	–0.5%	1.7%	0.9%	0.7%	–0.6%	5.0%	5.2%	–0.2%
Key rates	–0.75%	0.25%	0.00%	0.10%	–0.10%	4.00%	2.00%	3.85%

[1] Growth compared to year-ago quarter.
[2] Indicator, measuring the overall sentiment and typically leading 1 to 2 quarters in advance of GDP. A green arrow indicates accelerating economic growth, a red arrow indicates a slowing down.
[3] Potential growth. Long-term change in Gross domestic product with sustainable capacity utilization.

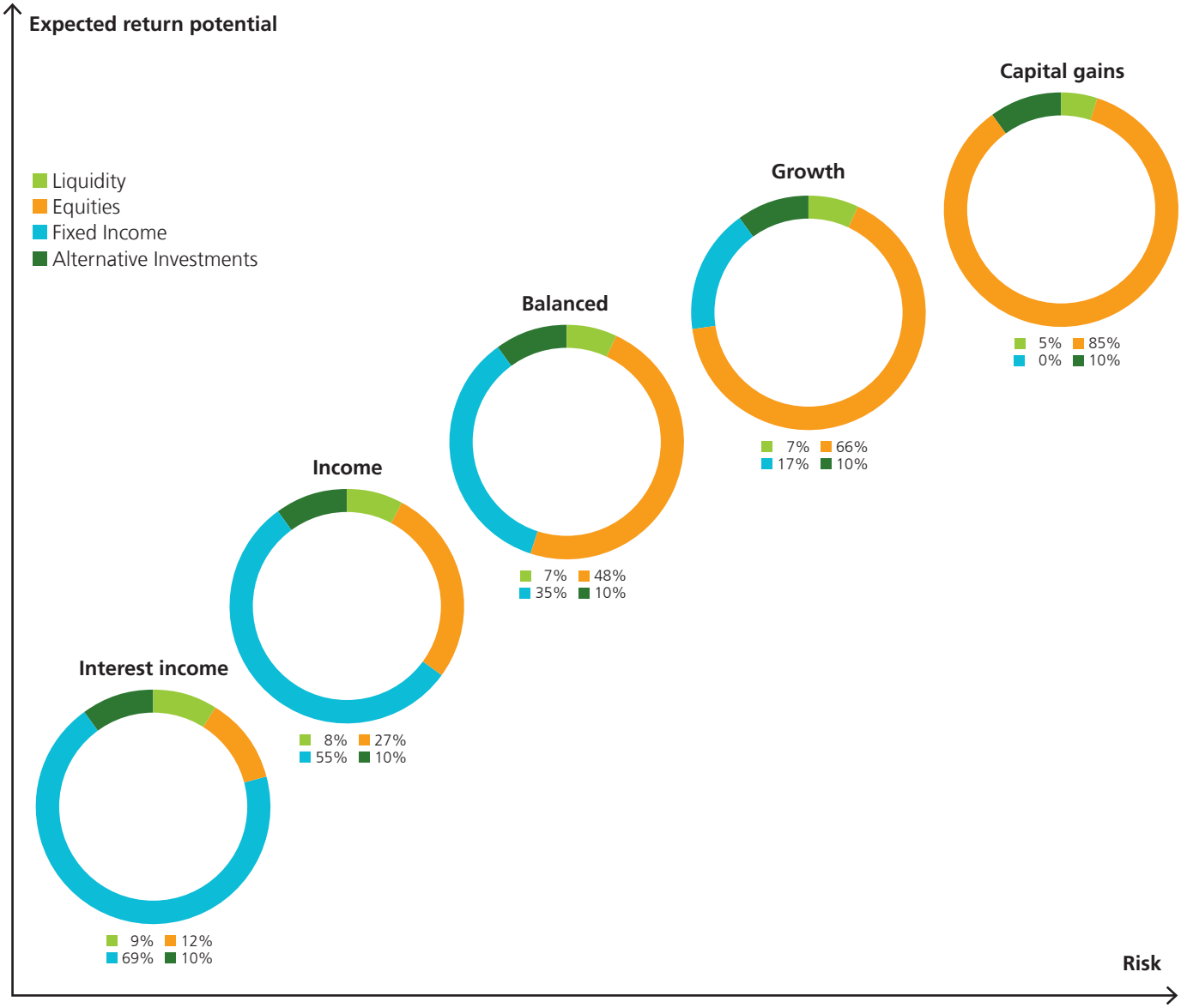
Source: Bloomberg

Model portfolios Swiss focus

UK equities with further recovery potential

Rising interest rates lead to higher volatility in markets as higher rates challenge record high valuation levels of equity and real estate assets. Despite recovery optimism, a cautious positioning is therefore appropriate.

We are maintaining our neutral equity quota, but are focusing on American and British stocks. Almost all signs point to green for the US economy in the coming months. But a catch-up sprint can also be expected in the UK. 2020 was a year to forget from an economic point of view, but now the rapid pace of vaccination gives hope that restrictions will soon be eased. In addition, the British stock market has a high proportion of shares from the energy, commodities and financial sectors. Currently, these not only have low valuations, but can also benefit particularly from the economic upswing.



Source: PostFinance Ltd

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