CBH | Asset Management

Quarterly Insight

Spring 2021

Creativity within Excellence

Composition abstraite - Félix AUBLET
1961 - Huile sur toile

Index

Asset Allocation

		Neutral	Underweight		Overweight	Change
CASH	**$**	**5%**		**12%**		
	€			**19%**		
Cash	$	5%			12%	1%
Cash	€				19%	1%
CORE BONDS	**$**	**50%**		**33%**		
	€			**26%**		
Government 1-5Y	$	15%	5%			5%
	€		0%			
Government 5-10Y	$	10%	5%			
	€		5%			5%
Investment Grade 1-5Y	$	15%			20%	
	€				18%	
Investment Grade 5-10Y	$	10%	3%			
	€		3%			
SATELLITE BONDS		**0%**		**8%**		
High Yield 1 - 5 years					2%	-2%
EM Hard currency					4%	
EM Local currency				0%		
Senior loans				0%		
Convertible					2%	
EQUITIES		**40%**		**37%**		
North America		17%	15%			-2%
Europe		8%	7%			
Asia Pacific & Japan		4%	3%			
China		2%			3%	-2%
Emerging Markets		3%		3%		
Global		6%		6%		
OTHERS		**5%**		**10%**		
Gold		2%			3%	
Other investments		3%			7%	

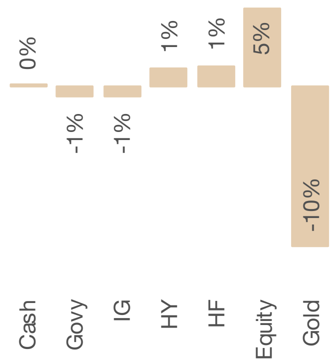
Asset Commentary

The Covid vaccine roll out is now well underway globally and large parts of the global economy are gradually moving towards easing restrictions. However, there are major regional differences with Europe significantly lagging behind. This will result in a highly differentiated economic recovery – at least in the initial phase. Against that backdrop, risk assets have been troubled by the rise in inflation expectations, a fast steepening in government bonds curves and a rotation from growth to value in equities. We pare down our positions in US and Chinese equities to capture the yields offered by steeper government bond curve, leaving some cash aside for further opportunities.

Economic background

The picture emerging from the last few months is one of a contrasted sanitary situation that will condition the steps in the 2021 economic recovery. The US has raised to the challenge and is moving hard and fast to loosen constraints in the early part of Spring. With China continuing to perform, Europe outside of the UK is very much left on the sidelines with an economic recovery likely delayed by at least one quarter.

Market performances (in %)



As stimulus programs keep rolling in, so do rising inflation expectations, but these should be transitory. There is no question that US and European authorities want to keep the taps running until the economy fully heals.

Cash

Central monetary authorities continue to implement ultra-loose policies. Recent statements from the Fed and the ECB have pushed any increase in policy rates beyond 2023. We raise slightly our cash balances to seize potential future opportunities.

Fixed Income

The fast steepening of the US yield curve looks somewhat premature and exaggerated given the proportion of the global economy that is still on state support. We take this opportunity to re-allocate into duration in both euro and dollar government bonds.
Equally, this has raised the attractiveness of investment grade bonds as well as emerging market debt, which now present a more attractive carry proposition than at the end of last year.
We pare down some of our exposure to High Yield bonds but remain overweight that credit segment.
Subordinated debt, for investors with the appropriate risk profile, still have a good potential.
We remain constructive on Emerging Market debt in hard currency but are selective on the jurisdiction, favouring Chinese and more generally Asian issuers.

Equities

Since January, the technology sector has underperformed despite delivering on the fundamentals front. Investor attention has also turned on value based equities in a move that has favored Europe to date. Indeed the old continent has had more to catch up on than the US. Government intervention in China on overall credit flows and more specifically on issuers linked to the personal finance sector has also had negative effects on valuations. We expect sentiment to improve as the country's export machine starts benefitting from the reopening of other large economies. At this juncture, we caution that there are limitations in the value reflation trade notably given the risks associated with a smooth de-locking of the European economies. In addition, the underperforming sectors of 2020 have for the most part closed a large proportion of the pre-Covid valuation gap. Even accounting for a better earnings profile, additional performance will require furthers catalysts in the form of an actual rise in demand.

Others

Opec has not reiterated its Spring 2020 mistake and has kept supply under control. Oil should thus remain in a 55-65 dollar per barrel range with shale producers preventing further price rises. Gold has underperformed notably, undermining theories around a large inflationary increase. We are content with our position on the yellow metal.

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

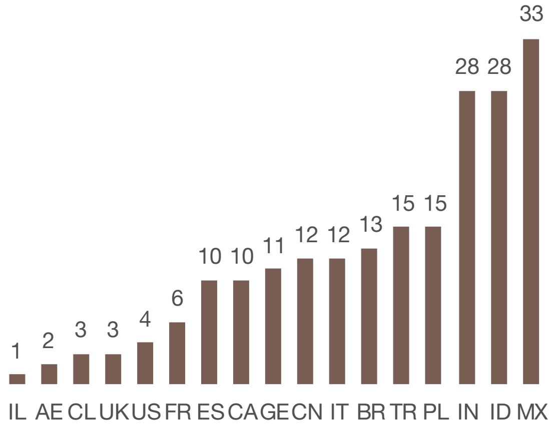
Macroeconomic Scenario

The largest vaccination effort in history is getting underway with more than 500m doses injected in the first quarter globally. Anticipations towards a strong economic recovery for 2021 have now significantly risen, fuelled further by the announcement of significant stimulus programs to be rolled out in the US and Europe. These expectations have led financial markets to start worrying somewhat prematurely about higher inflation levels. These considerations seem to leave aside the fact that the success of the vaccine roll out and thus the lifting of restrictions on populations' movement is hardly homogenous. This in effect will cause the 2021 economic recovery to be uneven over at least the next two quarters with China and the US powering ahead and Europe lagging behind.

An uneven global recovery beckons

Evidence from Israel, the UAE, the UK and now increasingly the US shows that the vaccination programme is working well, resulting in a sharp decline in Covid cases and more importantly in a fall in hospitalisations for the more vulnerable cross section of the population. The introduction of Covid variants has not changed the long term picture materially to date as all vaccines seem to have some degree of effectiveness against the worst forms of the disease for the time being. In the countries and regions that were quickly off the starting blocks in the vaccination race, restrictions are gradually lifted and life, with the economy alongside it, is returning to some semblance of normality.

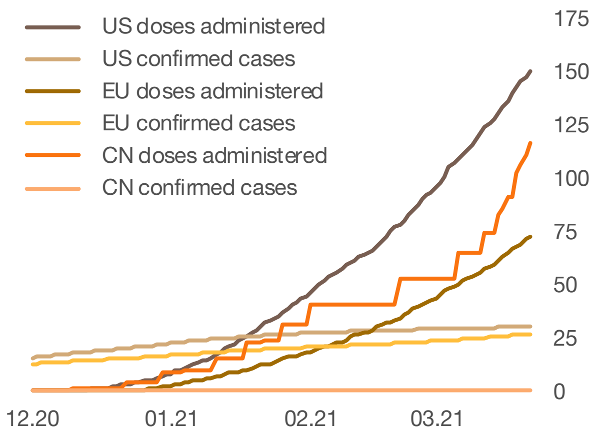
Months to having 75% of the population vaccinated



This in turn means that the formidable lead taken by the US in the vaccination roll out will likely hasten the country's economic recovery. With the Chinese economy strongly back online, the first part of the 2021 Covid recovery of this year is likely to leave Europe on the side of the road with the old continent poised to start catching up in the third and fourth quarter of the year. Despite the recent news around partial lockdowns in parts of France, Germany and Italy, the EU should get into full vaccination gear by May, leading to a gradual reopening in the summer. In addition there is evidence of a diminished lockdown impact on economic activity over time.

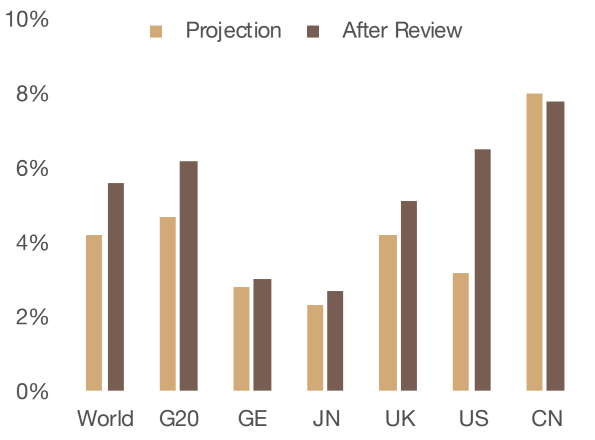
The strength of the recovery will still be accompanied in the US and Europe by the continuous support of governments and central monetary authorities. That support has been consistent and unfaltering since the early days of the Covid crisis even in the case of the Fed, which is now facing the double challenge of a steeper US yield curve and rising inflation anticipations.

Vaccine doses and new cases – US powers ahead

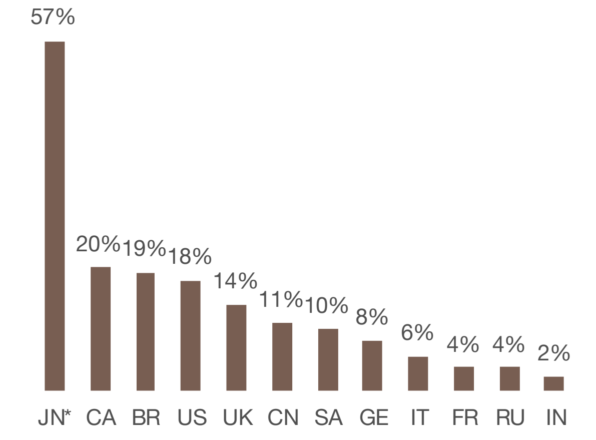


Testament to the recovery experienced by the Chinese economy are the efforts from the government and the Central Bank to contain any overheating by curtailing liquidity in the personal finance sector and ensuring enough state supervision in this area. This was brought to the fore in the recent deployment of antitrust measures against Ali Baba's unit Ant and now Tencent in the sector. This does not mean in our view that China is moving into economic growth and inflation control. Rather, it seems that the country is deploying preventive measures, presumably to avoid a repeat of the 2014-15 episode where the government was forced to curtail access to credit for local authorities and state sponsored sectors. These had enjoyed an infrastructure boon from the stimulus package deployed after the Great Financial Crisis of 2007-08. To illustrate the point further, China is expected by market participants to experience an 8.4% GDP growth rate this year, supported by the economic lift off in other geographies.

OECD growth targets for 2021 – then and now



Stimulus packages as a % of GDP



*Japan stimulus encompasses future investment commitments rather than actual cash payments – retreating for these would bring the number closer to 20%. The matter on EU countries is also made more complex depending on how they will use the EU support mechanism of EUR500bn.

Away from China, the picture in emerging market economies is as patchy as it was at the end of last year with strong economic growth expected for India and South East Asia countries. For Latam, the picture is more underwhelming with Brazil expected to show GDP growth of 3.5% as the health crisis reveals more structural issues.

Vaccination meets stimulus - jabs and jobs

Progress in the vaccination campaign is key for economies to reopen but the subsequent phase will still have to be accompanied by continuous state support measures.

Repeating the post GFC mistake of implementing austerity measures too quickly would clearly lead to similar results ie a rise in political populism. It seems that most of the large economies that have been deeply affected by the Covid lockdowns namely the US and the EU have learnt their lessons and made available large stimulus packages with a commitment not to phase them out until activity restarts in earnest and unemployment decreases close to its pre-pandemic levels.

Given the varied forms that government support has taken - from direct government payments to expansion of existing social net arrangements including tax payment delays as well as state loans to companies - it is difficult to maintain an exact tally of their scope and breadth.

None the less, we note that in aggregate, economies that account for the vast majority of the global output have produced fiscal packages above 10% of their own GDP. This is indeed larger than the activity trough they will have experienced in 2020-21, ensuring a strong base for economic rebuilding over the next two years.

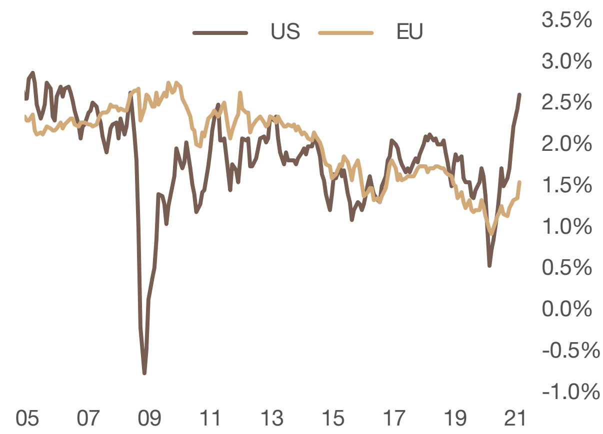
However the sheer size of the packages on offer have stoked fears of inflation. It also led market participants to assume that Central Banks could curtail liquidity and raise rates faster and harder than assumed only a month ago.

Inflation: bogeyman or real pain?

Fears over a return of inflation have thus taken center stage since the beginning of the year, in particular after the Biden administration's USD1.9trn stimulus package announcement. We note that this inflation fear is by and large a US phenomenon with little evidence of inflationary pressure in either China or Europe developing.

This ultimately took the shape of an increase in the 2 and 5 year inflation break even rates from 2% at the start to the year to 2.7% and 2.65% mid-March respectively - the highest in over 12 years. This in turn resulted in a sharp and fast increase in mid and long term US government bond yields – and the core Eurozone curves to a lesser degree.

US and Eurozone inflation break evens 2 and 5 years



Based on current evidence and recent historical trends, our thesis remains that consumer price indices –

particularly in the US - will increase in the coming quarters and ease off in the latter part of the year. The Fed seems to subscribe to that thesis and seems in no mood at all to even discuss the phasing out of its accommodative monetary policy. So to answer our initial question, we see inflation as a bogeyman rather than a source of real pain with a market that seems to be getting ahead of itself on the matter.

At its core the phenomenon of inflation is a **sharp and sustained increase in consumer prices caused by too much money chasing too few goods**. It tends to take shape when :

Money supply increases suddenly in a constrained economy eg Spain in the 1600s.

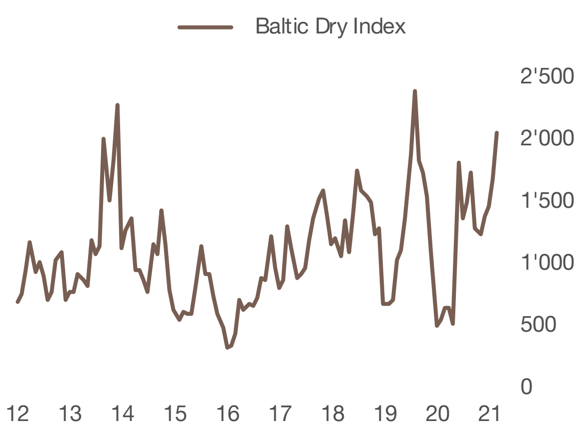
A country enters penury on the back of a credit and economic crisis of major proportions eg Zimbabwe or Venezuela.

A positive feedback loop starts between wages and consumer prices eg the 1970-80s. This happened at a time when unions had significant bargaining power and the supply of goods and services was limited.

The main parallels from these historical examples with the current situation are the vast monetary creation exercise of 2020-21 combined to the collapse of the global trade supply chains last Spring, which created a scarcity factor within a few industries.

Interestingly, the key hedge against inflation ie gold has not benefitted at all from the rise in these anticipations. Although bitcoin is often commented on as an alternative, gold remains for us the one and only true hedge against inflation. Therefore, the fall in the gold price year to date is evidence to us that the chatter around inflation is just that for the time being.

Tensions in bulk and container shipping



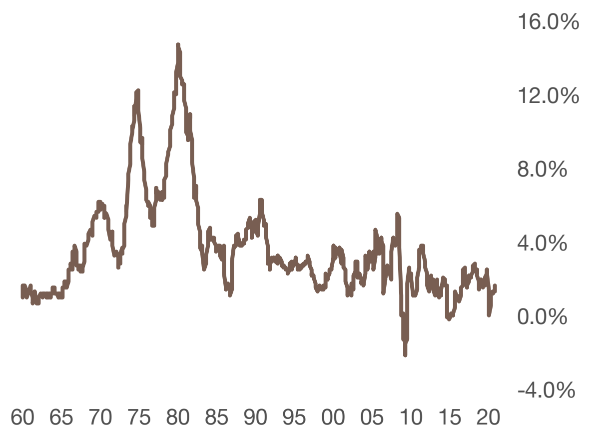
Nevertheless, the rearrangement of manufacturing and trade supply chains is turning into a convoluted and complex process. The first months of 2020 have been challenging for anyone working in the container shipping industry with a well-publicized shortage of containers in China and a sharp increase in the cost of container space on the most popular routes. Similarly, the rekindling of auto production has caused a steep shortage in microchips, resulting in production cuts for the major manufacturers.

None of this is cheap and will likely participate in a transitory rise in inflation, which we expect to ease once supply chains start flowing more seamlessly.

Another reason why we believe in a transitory inflation increase for the US and Europe is the fact that China did not experience meaningful inflationary pressures in its recovery.

Finally, even if the US CPI comes significantly above the 3% consensus in Q2, it will only produce a 1.65% average annual increase over the two years given how low the reading for Q2 2020 was. In any event, an inflationary catch up is overdue this year on the back of our expected economic recovery scenario.

US CPI – normalization under way



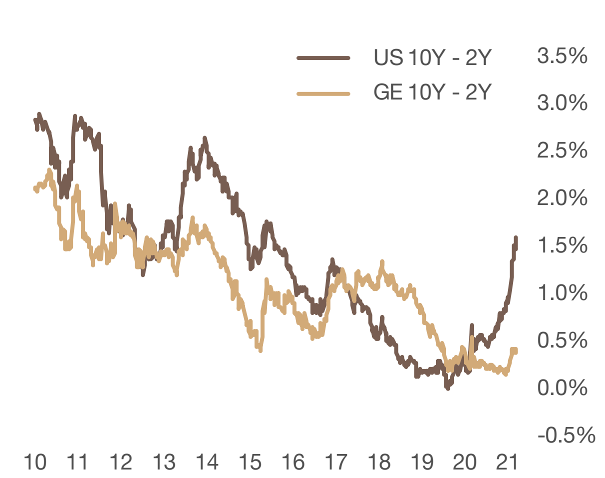
US long rates lift off – anything to fear?

Whilst higher long US treasury yields fits our year end scenario, we did not expect it to happen so early in the year. Given our view that inflationary pressures are likely to be transitory, we expect long dated government bond yield to remain at or move slightly below current levels in the months to come.

In addition, the recent partial lockdown announcements made by France, Germany and Italy coming on the back of rising contagion pressure have brought some calm in the bond market. These have shown that large parts of the global economy are still a few months away from reaching full reopening status.

The mini taper tantrum from end of February and mid-March is also typical of the market phase that we are in. Risk markets tend to call the change in the rate cycle too early after severe recessions and this time is no exception. We thus stick to our view that the Fed will start moving towards tapering in the early part of 2023, once the global and the US economy have been back into shape for long enough a time.

US and Bund treasury curves have steepened



Our last point about the yield curve is that some steepening is actually welcome after the economic winter of 2020. Steeper yield curves are a manifestation of an economic recovery and will significantly help the banking sector, which lends over the longer term and raises short dated funds.

At the moment, it appears that central monetary authorities are happy to let the long end drift. We believe that this will be the case for as long as higher yields do not threaten the economic recovery. Thus we would not be surprised to see the Fed intervene should the 10 year yield creep to above 2%. Finally, we do not care much for the argument that a 100bp increase in 10 year yields should have a materially negative effect on growth stocks valuations – these in fact tend to use limited amounts of debt and the larger tech groups are highly cash generative.

Geopolitics returns with an environmental twist

The Covid pandemic had placed geopolitical risk in the passenger seat for most of 2020 but recent events surrounding the new US administration show a return of old and familiar subjects.

US-China – new team, same playbook: the first summit between the US State Department's new top brass and China struck a frosty tone. The new US administration directly confronted China on politically sensitive topics namely Xinjiang, Taiwan as well as Hong Kong. Following the event, sanctions coordinated with US allies were pronounced against a few Chinese individuals. In this context and despite an agreement in principle on environmental matters, it seems unlikely that pressure will be significantly lifted in the sino-US trade.

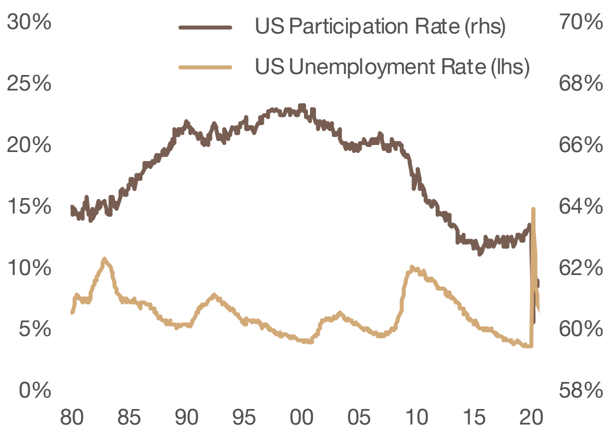
US and the Middle East : the new US administration's cold exchanges with Saudi Arabia and the open desire to revive the Iran nuclear deal – at a slow pace – are also potential risks on the region and naturally its main export. A return of Iran oil exports would likely weigh negatively on the oil price.

US and Russia : recent comments by the US president suggest that no cooling off is on the cards with the Kremlin. This in turn raises the prospect of fresh sanctions and creates some uncertainty and sentiment led downside risks for Russian assets.

Labour market recovery – why the last layer matters

Unemployment rates in the US and Europe have come down significantly from their Q2 2020 peak but this decrease seems to have plateaued as evidenced by the latest jobless claims in the US. The economic recovery strength in the US does not seem enough at this stage to bring the unemployment rate closer to its 3.5% pre-pandemic levels. The participation rate of the US population into the workforce remains close to historical lows – a metric that has structurally declined since the great financial crisis.

US Unemployment rate and labour participation rate



In Europe, the picture is broadly similar, bearing in mind that the unemployment rate was at 7.3% pre pandemic. The key difference is the much higher participation labor force at c80%.

There are obviously some structural and accounting differences in the treatment of the data but for the US, we expect the participation rate in the workforce to increase once the federal checks have been spent or saved. In Europe, this is more the case of speeding up the re-opening of the continent's economies after a failed start in the Covid vaccination campaign.

As we previously wrote, a return to pre-Covid lockdown unemployment rates will be crucial to avoid a repeat of the post GFC situation where the implementation of austerity measures led to a significant increase in political populism. As far as we can judge, most developed countries jurisdictions are keen to support the economic green shoots for as long as necessary. Interestingly, the UK is the first country to stick out from the crowd.

The tax question – UK pulls out the gun first

In our 2021 Outlook, we openly asked the 'who will pay' question. In its 2021 budget balancing act, the UK Chancellor gave a part of the answer through an increase in the corporate tax to 25% from 19% for 2023- the first since 1980. He also indicated that he would not change the income tax thresholds, which will result in households who see their income rise in the coming years being taxed more in an almost painless way.

As was the case post the GFC, we believe that a large number of jurisdictions will likely follow the UK example. This means in turn that stealth taxes on income and a rise in the state's take from corporations may well go towards bringing the increase in government debt levels under control.

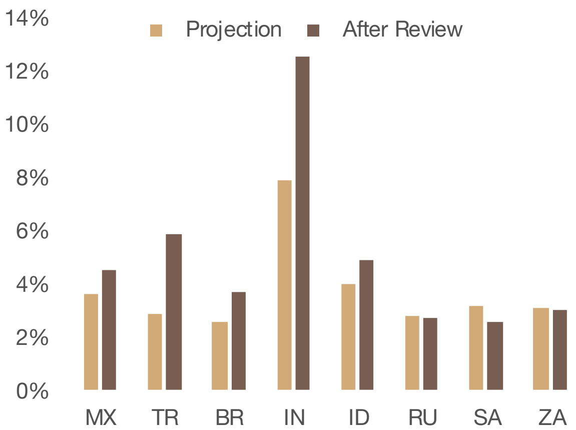
The logical conclusion is that the risk of negative corporate tax events will be lower on the jurisdictions coming out from this crisis with less debt in relative terms.

Emerging economies – an even more contrasted picture

The first discriminant in terms of economic performance remains the situation on Covid cases and vaccinations. Not many emerging markets have made progress on both fronts outside of China and the Middle East, which are both benefitting from a return to more normal economic conditions. We also see progress in India, where we expect a significant economic catch up this year.

Mexico also should benefit from the strong economic growth of its Northern neighbor, spurred by stimulus money. Aside from the risks linked to potential sanctions, Russia should perform reasonably well in 2021 with the rise in the oil price helping out.

Emerging Markets – revised OECD growth projections

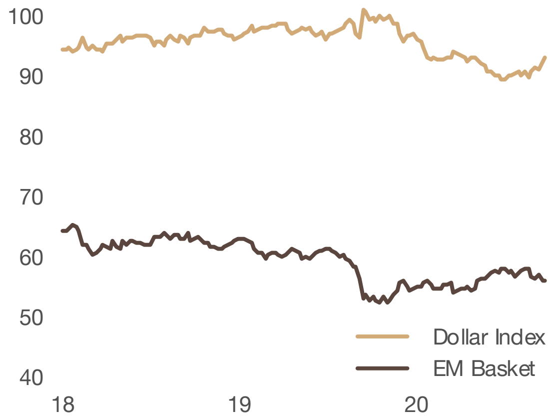


Conversely, the situation remains constrained in Brazil where the government is still dealing with the Covid outbreak and has to confront a depreciated currency and rising inflationary pressure. Turkey is also stuck in the travails of the economic crisis that started 3 years ago with no let up following the surprise removal of the Central Bank governor a few days ago.

King dollar has come back

After a dismal year end, the dollar has come back to life – earlier than we had initially predicted. The main cause was naturally the rising prospects of the US economy reopening following the success of the vaccination program. This was further fuelled in our view by the steepening of the yield curve, which is making US treasury and investment grade bonds more attractive for foreign investors on a relative value basis.

USD vs developed and EM currency baskets



We continue to believe that this trend will continue as the economic recovery that started in China at the end of last year will spill over to the US in the summer and finally reach Europe in the autumn. We are then likely to see a further steepening in the yield curve, increased growth anticipations and chatter around the Fed tapering – all factors that will ultimately strengthen the dollar going forward. After all there is still some room for the greenback to appreciate, considering that in 2019, the average dollars to euro exchange rate was close to 1.12.

Our 2021 economic scenario in brief

US GDP growth 5%

The breakneck pace of vaccinations and the historically large stimulus package will close the US output gap fast

US CPI 1.75%

Inflationary pressures will materialize as activity normalizes. We expect higher inflation readings in Q2 and Q3 but these should be transitory.

US Fed Funds rate 0.25%

The Fed continues to be very accommodative without committing to specific bond yield targeting. Any language variation if any would likely come towards the year end.

US 10-year yield 1.8%

The steepening pace has been strong year to date and we have reached our target for the full year early. Given the momentum and supply to come, we raise our target.

China GDP growth 8%

The only large economy that grew in 2020 will continue on its expansion path into 2021, possibly helped by a less contentious US trade relationship.

Eurozone growth 2%

In our view, consensus on growth is still overly optimistic on the Eurozone, even at the revised down 4.2% rate.

Eurozone CPI 0.75%

In the same vein, we see inflation struggling to rise significantly above three quarters of a percent in 2021.

EUR Refinancing Rate 0bp

The ECB has left the refinancing rate untouched at the worst of the crisis. The likely course of action is thus to continue using quantitative easing and other tools to support credit and the economic recovery.

German 10-year yield -0.25%

The Bund has followed US treasuries and the curve is now steeper. The ECB seems to want to contain a lift off in long yields with greater zeal than the Fed.

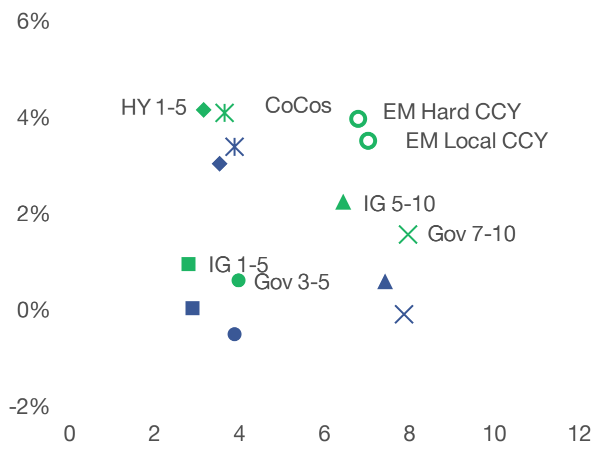
Fixed Income

The start of the year has been amongst the worst historically for the asset class with government bonds losing around 5% - depending on jurisdictions - on steepening curves. Investment grade and EM debt did not fare much better on account of the long duration profile in these sub asset classes. By contrast the High Yield segment has held relatively well. In the meantime, subordinated debt was the best performing sub asset class within Fixed Income. At this point, we believe that the climb in long term yields is due for a pause and recommend increasing exposure to duration. Maintaining an allocation in the High Yield and subordinated debt segment continues to make sense as the global recovery will likely translate into positive credit rating actions.

The Fixed Income value map

We plot below the different sub-indices of the Fixed Income market showing yield vs duration to maturity and for AT1s (contingent convertible bonds) yield and duration to call.

Fixed Income value map (EUR in blue, USD in green)



A barbell approach: credit with some duration risk

We called correctly the steepening of developed govies curves but were beaten in our expectations by the speed of it. Considering that the 10 year treasury yield averaged 2.1% in 2019, we have now made c60% of the journey back to normality. Given the European setbacks in the vaccination effort and the renewed attractiveness of the US 5-10 year treasury bonds, we believe that we are due for a pause in the rise in yields. In addition, we know that the Fed and the ECB are watching. Both institutions would likely intervene should a disorderly rise in yields happen in a way that could threaten the economic recovery.

High Yield and EM Hard Currency debt remain our favored sub asset classes within fixed income. Subordinated debt, including AT1 (Coco bonds) is also an interesting addition to our credit spread play for investors with the appropriate risk tolerance profile.

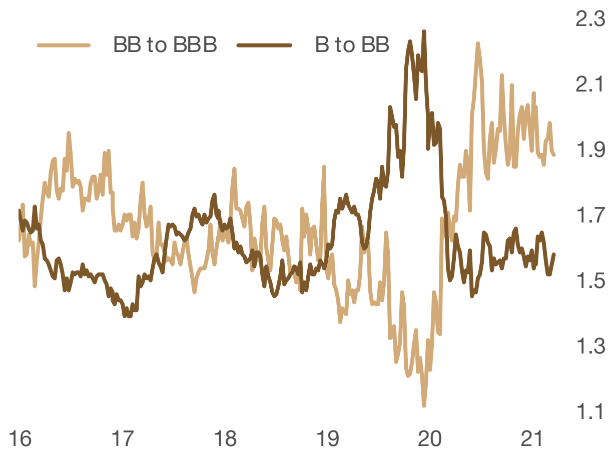
The recent rise in long bond yields means that duration has become more attractive for both government and investment grade bonds

As an illustration, the 5-10 year investment grade sub asset classes in dollar and euro now yield 2.2% and 0.6% respectively, offering better returns than has been the case over the last 6 months. Within the BBB rated sector, it is now possible again to find ten year paper yielding 2.5% or higher. Given our constructive view on credit spreads, adding long dated investment grade bonds at this juncture makes sense.

The BB segment still looks good in High Yield

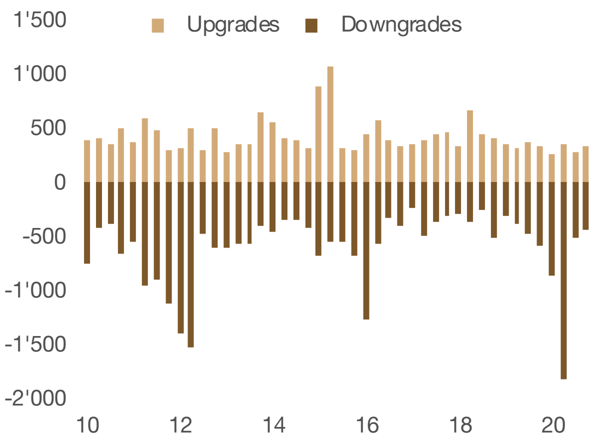
Within high yield, we continue to favor BB rated paper, which benefits from crowding out effects caused by the deployment of Central Banks' quantitative easing programs.

BBB to BB spread multiple and BB to B spread multiple



We also note that credit rating activity has become more balanced in recent months. Downgrades still outnumber upgrades but the ratio was 1.3 downgrade for one upgrade in Q4 2020 against 5.2 downgrades for one upgrade in Q2 2020. In our view, the number of upgrades should outpace downgrades in the next two quarters as credit quality recovers. We note none the less that rating agencies tend to exhibit inertia when upgrading.

Upgrades and downgrades

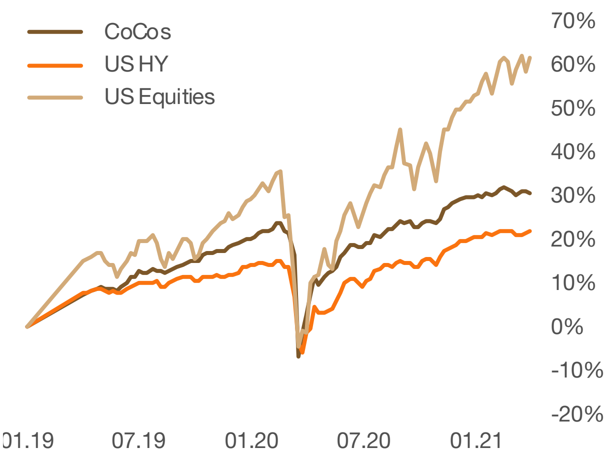


Lastly, the global default picture seems to be stabilizing with Europe catching up and the US plateauing. We are very much in agreement with Moody's, which in its latest default report indicated that global speculative grade defaults have likely peaked in December of 2020 at above 6%. This does not mean that the lower end of the high yield spectrum is yet entirely safe to look at but the sector seems to be finding a floor in terms of fundamentals. In that area of credit, selectivity is key and best left to debt restructuring and distressed specialists.

Subordinated debt will continue to steal the show

Subordinated debt of all shapes and in particular AT1s (Coco bonds) have been one of the best performing segments of fixed income year to date. This has been particularly true in euros where the asset class is exhibiting large yield to calls relative to other credit assets.

Performance of AT1s

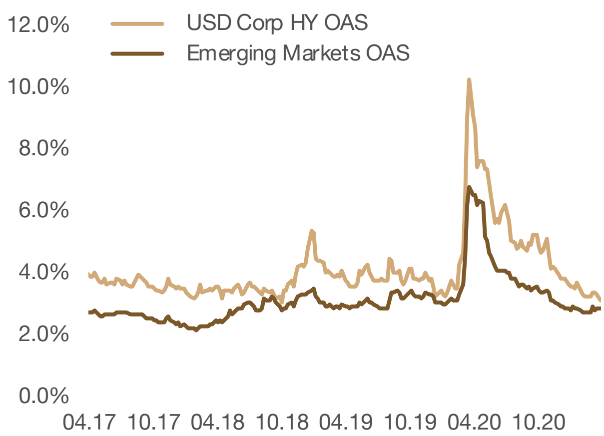


The investment backdrop on the asset class has been also supported by fundamentals. Indeed, the banking sector has maintained decent capital buffers despite the crisis. This is mostly due to the fact that governments rather than banks bore the cost of the lockdowns. However, measures taken by the regulators and individual institutions mainly on dividends have also helped.

Emerging Markets : this could have been better

The underperformance of hard currency emerging market debt year to date is largely explained by US treasury yield increase. There have been negative additional events, notably the rise in political risk for Brazilian and Turkish assets.

US High Yield and EM Hard Currency spreads



None the less, we continue to like EM debt in hard currency - more so than in local currency, accounting for the appreciation of the dollar, which we expect to continue. Our rationale is as follows :

Overall spread compensation is in line with the high yield and AT1 segments for a significantly higher credit rating mix.

The early return to growth conditions in China has caused credit spreads on Chinese issuers to tighten year to date. We expect this movement to continue as the year progresses

Higher commodity prices, in particular oil – will improve the overall fundamentals in a number of South East Asian sovereigns and corporates (eg Indonesia and Malaysia)

Mexico, which will benefit from higher oil prices and the rise in economic growth from the US is looking better despite the likely inflationary pressures that will result from the economic recovery

This does not mean that we consider all areas worth to invest in and we see a rise in potential risks in the following jurisdictions :

Brazil : the recent and unexpected removal of the Petrobras CEO by Jair Bolsonaro in Brazil has increased political risk in the jurisdiction. Bearing in mind that a general election will take place in the autumn of 2022, the political rhetoric is unlikely to abate any time soon – particularly considering the recent high court decision that enables Lula to enter the fray.

Turkey has also provided its fair share of political risk with the surprise removal of the Central Bank governor that led to a sharp downturn in the currency, Turkish bonds and equities. As the level of political uncertainty remains high amid a significant economic crisis, we would only look at Turkish assets – in particular bank and corporate bonds - with a high degree of selectivity.

Russia : the frosty start in the relationship between the incoming US administration and the Kremlin has increased the risk of additional sanctions. Regardless of potential implementation, this new state of affairs increases downside risks on Russian assets.

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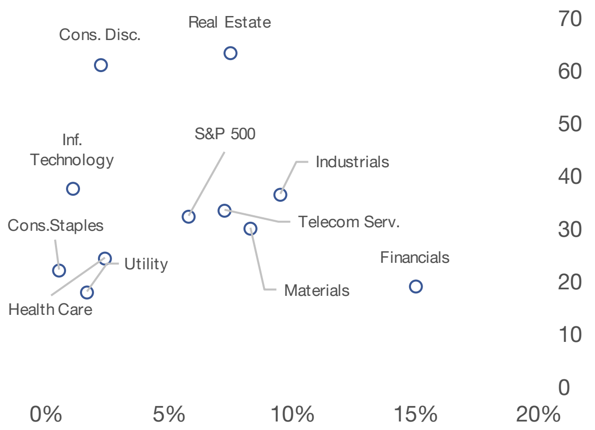
Equities

After a strong start, tech and Chinese stocks have had a tougher time in the wake of the US yield curve lift off. Chinese equities have been negatively affected by government action on tech groups as well as the control of credit expansion. This in our view should be temporary as the country's export machine will benefit from the reopening of the US and the European economies. The rotation from growth stocks into value has also generated disturbance under the surface in the US equity market but with only limited consequences for year to date performance. Europe has been the darling of the reflation trade, coming from much further afar than the US. Bad news on the Covid front has none the less dampened the catch up in valuations. We think there will be more performance to come from the asset class in the coming quarters.

The value map in equities

The stunning start of US tech has been hobbled by the rise in long treasury yields amid stretched valuations.

The US equities value map – ex energy



Long duration stock – a new concept?

The correlation between US tech shares and the 10y treasury yield has been almost perfect with the US tech stock index moving down and becoming more volatile as yields climbed. Of course, applying a higher discount rate to cash flows that will come in a distant future mathematically brings valuations down. Nevertheless, duration is a fixed income concept and by their nature, cash flows from fixed income assets do not grow – unlike equities. This is partly the reason why we are loathe to use the duration concept when discussing stocks.

Another reason is the fact that tech issuers do not have a lot of indebtedness. In fact the US large tech companies are amongst the US corporates with the strongest credit profile. With the smaller tech companies, the use of debt is not as widespread as is the case across corporate America. This means in turn that an increase in the cost of financing going forward is not the issue here.

Finally, we believe that the market will learn overtime to operate with an even steeper treasury curve for as long as the Fed remains accommodative.

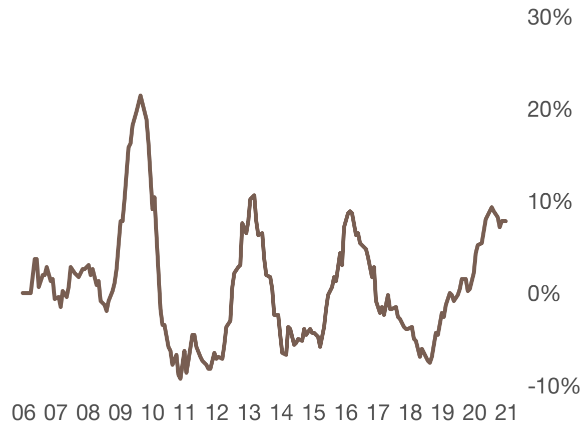
Chinese equities should find some reprieve

It seems that the Chinese government is keen to keep monetary expansion in check by tightening money supply. With this move, it also seems that the Chinese authorities want to avoid repeating the situation in which an overstimulated economy post the Great Financial Crisis led to the commodity crash of 2015-16. This does not mean that economic growth in China will not go beyond the government's self-stated 6% target once the US and European economies reopen in earnest.

In a similar vein, the Chinese government is training its sights on the expansion of personal finance in the country by tightening the supervision of large tech payments companies such as Ant or WeChat Pay. Comments from officials expressing their worries on stock market bubbles have also led to negative price action.

Looking at the amounts at play, the fiscal deficit reduction from 3.6% to 3.2% of GDP is hardly significant but shows that unlike what has been the case in the aftermath of the 2009 deep recession, China will not want to be the sole carrier of global growth in the years to come.

China credit Impulse



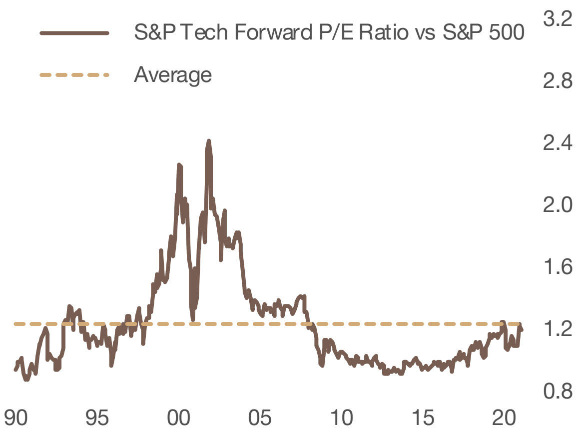
The impact of this heightened supervision and anticipations around fiscal moderation have weighed negatively on Chinese stocks since mid-February.

Whilst sentiment is unlikely to recover in the very short term, we believe that the strong growth that the country will enjoy this year will more than compensate for the political and regulatory headwinds over time.

US tech faces the reopening test

Recent non-conventional data such as trading app download and usage suggests that stimulus checks are not used as much for stock market speculation as the previous time around. Combined with stretched valuations and a more fragile technical backdrop, US tech stocks have come down by c11% from their mid-February peak. The move is somewhat reminiscent of the September 2020 decline against a similar backdrop.

US large tech forward P/E



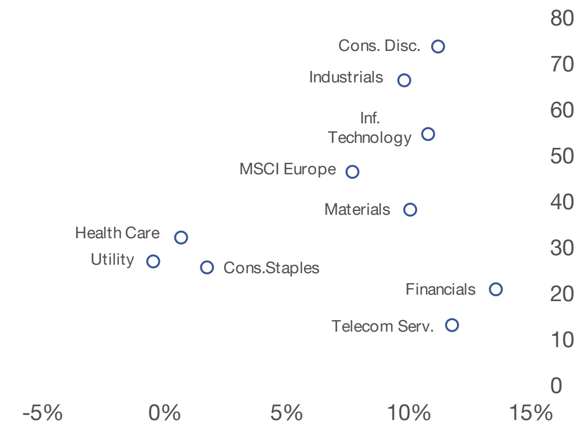
As economies re-open, the assertion is that a greater proportion of available revenue will be diverted from the digital into the real world. Whilst this may be the case in theory, an increasing proportion of real world activity relies on digital to function. In addition, usage of digital applications by people that have been working from home will likely diminish but will not vanish altogether given the convenience and cost savings that these tools have heralded.

More to come from broken Europe but later

Europe was the surprising outperformer in the first few months of the year as the so called rotation trade away from growth and into value took hold. The lack of tech stocks in European indices that heavily penalized performance throughout 2020 actually provided a boost as value stocks regained some poise globally.

In that movement, sectors that had been left aside such as energy, travel, banks and hospitality reflated strongly – particularly in the US.

The European equities value map

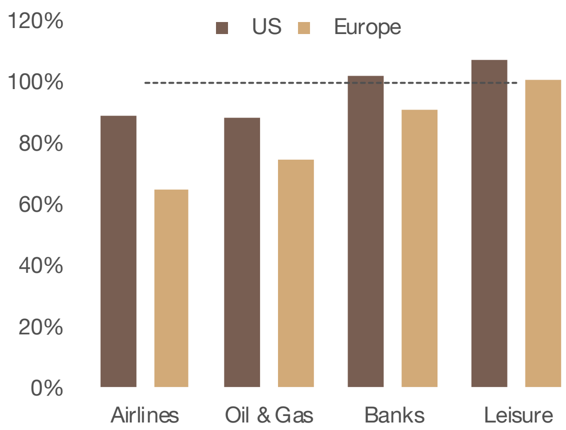


As the start of the vaccination in Europe hit significant roadblocks, enthusiasm for the reflation trade receded. There is still potential for European stocks to move closer to their pre-Covid levels but in our view it will take confirmation that restrictions will actually be lifted – in particular on travel. This will only happen if the old continent starts vaccinating its population with an American like alacrity.

The limitations of the reflation trade

We look at the underperforming sectors of 2020 and how far these trade from pre Covid levels so year end 2019. As one would expect following the progress on the vaccination front, the US are ahead in the reflation trade and some sectors are now trading at a premium relative to their pre-pandemic levels. That said, there is still room for issuers and sectors to catch up in particular for oil & gas and airlines groups.

Reflation in the 2020 sector laggards – US and Europe



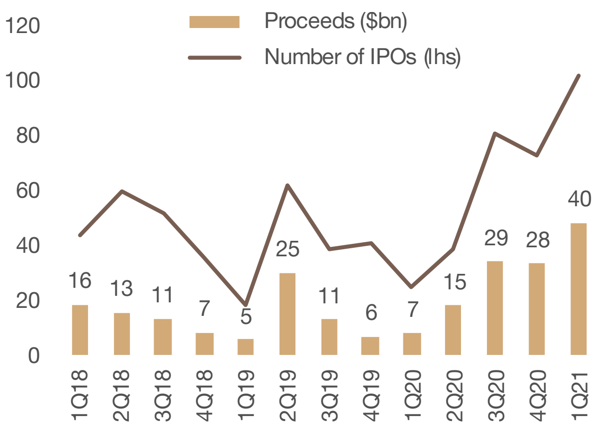
As much as a return to pre-pandemic valuations is to be expected, the issue that we have is that once value based stocks start trading at a premium to their late 2019 levels, the potential upside will be capped. Additional catalysts to the trade in the form of dividends returning and a lower cost base post crisis may further valuations but the potential upside on the recovery trade is in essence limited.

SPACs : the new Wall Street weapon of financial destruction?

The last year has seen the rise in SPACs or Special Purpose Acquisition Companies or so called ‘blank check companies’. These vehicle essentially raise funds through an initial public offering that are subsequently invested in shares in a company that used to be privately controlled. SPACs then can carry out an IPO of the underlying stocks that they own.

After a dormant existence for more than 10 years, SPACs took off in 2020 and became primary vehicles in the IPO process of a number of tech groups in particular. They now account for 70% of the IPO market.

SPAC volumes



Interestingly, they have also become a significant source of profit for investment banks. The recent decline in tech valuations and the rising interest from regulators – the SEC in particular -have somewhat dampened returns and activity to some degree. We are none the less watching this corner of the market with great interest as when Wall Street tends to do too much of a good thing, it typically leads to a sorry end. Perhaps this time, regulators will step in before the SPAC mania turns into a bigger issue.

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Commodities

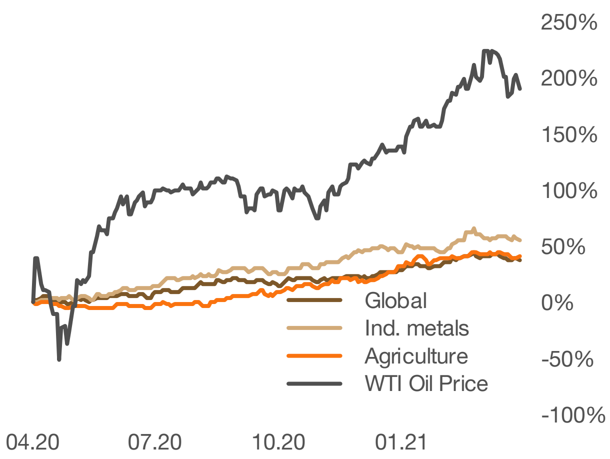
As control over supply seems well exerted and demand normalizes, so has the oil price set in a USD55-65p.b range. Base metal prices are following a similar trend on the back talk of a new commodity supercycle. Whether the latest historical highs can be maintained remains to be seen and will depend to a large degree on potential capacity additions. Precious metals have had a tougher time with gold retreating to levels last seen about a year ago.

Oil: price to stabilize at high level

The recent decision by Opec to keep supply arrangements in place has seen the barrel rise to above 65 dollar a barrel only to pull back on the return of partial lockdowns in Europe. To date the new US administration has not decisively acted against the US shale oil complex and supply in the sector remains abundant but seems to be meeting a rise in underlying demand. The recent Suez canal accidental blockage will likely also support prices further and until Opec starts meaningfully to open the taps again, we believe that the oil barrel will be evolving in a 55-65 dollar range.

This is also supported by the start of the US driving season, which we expect to be more significant this year than in a typical year should the US lift Covid linked restrictions of movement ahead of the summer months.

Commodity price panorama

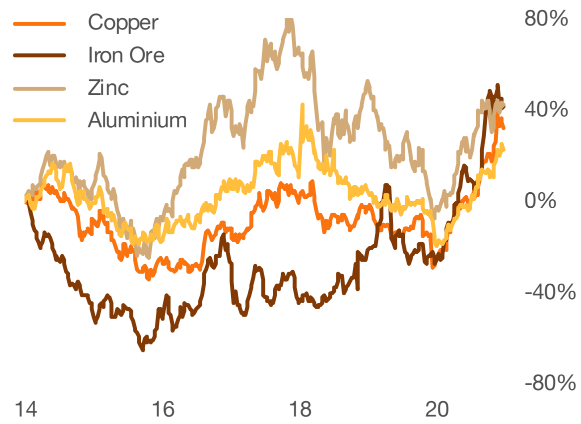


With last year's situation fresh in the Opec members' memory, we do not think that the cartel is likely to move aggressively on supply. Similarly, the return to profitability of the US shale complex limits naturally the potential rise in the oil price.

Base metals: testing new highs

Demand from China has been enhanced by the return to activity of parts of the US and Europe too. This has led copper, iron ore and zinc towards historically high levels. As swathes of the global economy will reopen in the coming months, we expect demand to continue to support base metal prices. This will likely be exacerbated by the lack of mothballed mining capacity given how ruthless mining groups have been on expansion capex following the 2015-16 commodity crisis.

Base Metals rebasing higher

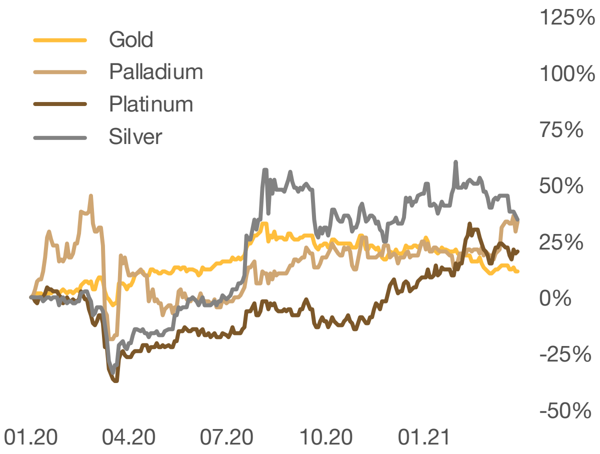


Key to maintaining current prices going forward will be investment discipline from mining groups. Management teams are still scarred by the latest crisis but new figures are being appointed at the helm of the mining majors. Talks of a new commodity supercycle should be spurring the industry towards expansionary capex and the next strategic moves in the sector will therefore be key. Any indication that significant capacity is being added in the sector will likely lead to an increase in downside risks over the medium term for base metals.

Gold: dude, where is that inflation?

It has been a poor start to the year for the yellow metal but gold prices seem to have found a bottom under current market conditions. This is indicative enough that market participants expect inflationary pressures to be moderate and transitory going forward. Since gold is the only real hedge against a permanent inflation rise, it should at least not depreciate in the current context.

Gold and silver – a divergence



Silver has been better behaved with part of the metal's supply used in industrial applications. The price of palladium and platinum also rose year to date as demand from the car industry has suddenly risen amid constrained supply. We believe there is more to come in terms of price appreciations as the various vehicle markets return to healthier demand conditions in the coming months.

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Currencies Market Expectations

Major Currencies

		Q2-21	Q3-21	Q4-21	Q1-22	Q4-22
EURUSD	1.18	1.20	1.22	1.23	1.22	1.23
EURCHF	1.11	1.10	1.11	1.12	1.12	1.14
EURGBP	0.85	0.86	0.86	0.85	0.85	0.85
EURJPY	130	128.0	129.0	129.0	129.0	131.0
EURNOK	10.02	10.11	10.03	9.95	9.85	9.50
USDCAD	1.26	1.26	1.25	1.25	1.25	1.25
USDCHF	0.94	0.92	0.92	0.92	0.92	0.93
USDJPY	111	107.0	106.0	106.0	107.0	109.0
USDCNY	6.55	6.45	6.40	6.40	6.40	6.40
GBPUSD	1.38	1.39	1.40	1.40	1.42	1.43
NZDUSD	0.70	0.72	0.73	0.73	0.74	0.74
AUDUSD	0.76	0.77	0.78	0.79	0.79	0.80

Other Currencies

		Q2-21	Q3-21	Q4-21	Q1-22	Q4-22
USDMXN	20.4	20.4	20.1	20.0	20.0	20.3
USDBRL	5.63	5.4	5.3	5.2	5.1	4.9
USDARS	92.0	102.4	111.4	126.2	135.0	166.1
USDTRY	8.25	7.7	7.9	8.1	8.4	8.4
USDILS	3.34	3.3	3.3	3.3	3.3	3.4
USDHKD	7.77	7.8	7.8	7.8	7.8	7.8
USDINR	73.1	72.8	72.6	72.3	72.5	73.1
USDRUB	75.5	72.8	71.5	70.1	69.0	70.0
USDPLN	3.94	3.8	3.7	3.7	3.7	3.6

The table above provides an overview of market forecasts for major currencies. It is composed of dozens of individual forecast providers and delivers a consensus forecast. These consensus forecasts represent a median number and all forecasts evaluated correspond to calendar quarter-end dates.

Future forecasts do not guarantee future performance and should only be used for indicative purposes.

Market Performances

	Name	QTD *	YTD**	2020	2019	2018	2017	2016
Cash	Dollar 3m Total Return	0.1%	0.1%	1.0%	2.5%	2.4%	1.1%	0.6%
	Euro 3m Total Return	-0.2%	-0.2%	-0.5%	-0.4%	-0.4%	-0.4%	-0.2%
Government bonds	US 3-5	-1.3%	-1.3%	6.2%	5.3%	1.5%	1.0%	1.3%
	Eurozone 3-5	-0.4%	-0.4%	1.3%	1.9%	0.1%	0.1%	1.5%
	US 7-10	-5.7%	-5.7%	10.0%	8.5%	0.9%	2.6%	0.8%
	Eurozone 7-10	-1.6%	-1.6%	4.5%	6.7%	1.4%	1.3%	3.5%
Corporate bonds IG	USD Corp 1-5	-0.6%	-0.6%	5.4%	7.0%	1.0%	2.6%	2.9%
	EUR Corp 1-5	0.0%	0.0%	1.1%	2.8%	-0.5%	1.2%	2.6%
	USD Corp 5-10	-3.9%	-3.9%	9.7%	14.3%	-1.7%	5.6%	5.6%
	EUR Corp 7-10	-1.4%	-1.4%	4.4%	10.9%	-2.4%	4.2%	7.0%
Corporate bonds HY	USD Corp 1-5	1.0%	1.0%	5.8%	13.9%	-1.8%	7.0%	16.5%
	EUR Corp 1-5	1.6%	1.6%	2.3%	11.3%	-3.8%	6.9%	9.1%
	USD Corp 5-10	1.0%	1.0%	-2.0%	9.1%	-1.9%	7.6%	7.3%
	EUR Corp 5-10	0.6%	0.6%	2.8%	13.2%	-4.4%	8.0%	10.8%
EM bonds (in $)	Hard currency	-3.5%	-3.5%	6.5%	13.1%	-2.5%	8.2%	9.9%
	Local currency	-3.7%	-3.7%	5.3%	9.5%	-3.4%	14.3%	5.9%
	Chinese Yuan	0.7%	0.7%	9.3%	2.8%	3.0%	5.0%	-4.7%
Others	S&P Leverage Loan Index	1.8%	1.8%	3.1%	8.6%	0.4%	4.1%	10.2%
	Global Convertible	3%	3%	26%	18.2%	-1.2%	7.2%	4.6%
Equities	North America	5%	5%	19%	29%	-6%	19%	9%
	Europe	8%	8%	-5%	22%	-13%	7%	0%
	Japan	8%	8%	7%	16%	-17%	18%	-3%
	Asia Pacific	2%	2%	17%	16%	-16%	29%	2%
	Developed Markets	5%	5%	14%	25%	-10%	20%	5%
	China	-2%	-2%	23%	38%	-21%	32%	-7%
	Latin America	-6%	-6%	-16%	14%	-9%	21%	28%
	Emerging Markets	2%	2%	16%	15%	-17%	34%	9%
Other investments	HFRX Alternative	1%	1%	7%	9%	-7%	6%	3%
	VIX	-15%	-15%	65%	-46%	130%	-21%	-23%
	G7 Currency Volatility	-6%	-6%	23%	-34%	21%	-36%	22%
	DJ Global Commodity	7%	7%	-4%	5%	-13%	1%	11%
	Gold	-10%	-10%	24%	19%	-2%	14%	8%
	Industrial metals	7%	7%	16%	5%	-21%	28%	20%
	Agriculture index	7%	7%	16%	0%	-13%	-12%	2%
	WTI Oil	22%	22%	-21%	34%	-25%	12%	45%
Currencies (vs. $)	Dollar Index	4%	4%	-7%	0%	4%	-10%	4%
	EM Currency Index	-3%	-3%	-6%	-1%	-11%	6%	0%
	Euro	-4%	-4%	9%	-2%	-5%	14%	-3%
	British Pounds	1%	1%	3%	4%	-6%	10%	-16%
	Swiss Francs	-6%	-6%	9%	2%	-1%	5%	-2%
	Japanese Yen	-7%	-7%	5%	1%	3%	4%	3%
	Chinese Yuan	0%	0%	7%	-1%	-5%	7%	-6%

* Quarter to date
** Year to date

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All data as of March 31, 2021
Published on April 1, 2021

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