LimmatWealth

Investment Strategy – August 2021

Data & Forecasts

Developed Markets	Growth (%)		Inflation (%)		Equities			Bonds (10 Years)			Currencies (vs CHF)		
	GDP 20	GDP 21	CPI 20	CPI 21	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Switzerland	-3.3	3.5	-0.7	0.4	15'666	↗	↗	-0.42	-0.20	-0.10	-	-	-
Germany	-5.3	3.4	0.4	2.7	15'711	↗	↗	-0.50	-0.25	-0.15	-	-	-
Eurozone	-6.8	4.6	0.3	1.9	4'160	↗	↗	-	-	-	1.07	1.11	1.13
United Kingdom	-10.1	6.8	0.9	1.8	7'119	↗	↗	0.52	0.85	1.00	1.26	1.30	1.31
United States	-3.5	6.5	1.3	3.8	4'403	↗	↗	1.19	1.60	2.00	0.91	0.93	0.94
Japan	-5.1	2.6	0.0	0.1	27'728	↗	↗	0.01	0.10	0.10	121	118	120

Emerging Markets	Growth (%)		Inflation (%)		Equities			Bonds (10 Years)			Currencies (vs USD)		
	GDP 20	GDP 21	CPI 20	CPI 21	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Asia ex Japan	7.8	7.8	1.9	1.9	839	↗	↑	-	-	-	-	-	-
China	2.3	8.5	2.5	1.5	3'467	↗	↑	2.82	3.20	3.10	6.46	6.40	6.40

Review – Relative weakness of cyclical sectors and regions continues

In July, cyclical sectors and regions continued their relative weakness as a whole, while defensive and technology equities showed relative and absolute strength for the second straight month. As a result, European and American technology equities dominate at the sector level, while the United States leads the field at the regional level. Matching the overall picture, the downward pressure on global long-term interest rates remains - real US rates (10-year) are even at an all-time low. Global long-term rates tend to explain the relative trend patterns of equity market segments very well. Against this background, the outlook for long-term interest rates is crucial for the relative sector behavior of equity markets. However, the current interest rate picture is quite complex and determined by opposing factors:

- On the one hand, there are good reasons for the long-term interest rate weakness that has now been going on for four months (e. g. 10-year US interest rates): The global economy has clearly passed the peak of the recovery momentum. All of the leading macroeconomic indicators are at a high level, but increasingly lacking in momentum. It is also foreseeable that the current high inflation dynamics (medium-term) will be largely temporary and will calm down in the next few months, because many important raw material prices show a declining year-on-year trend. For example, crude oil prices are likely to lose momentum as OPEC+ recently decided to gradually increase production over the next few months. After all, the delta variant is on the advance globally and is fueling fears of new anti-business lockdowns in autumn.

- On the other hand, there are good arguments for upward interest rate risks in the further course: The global recovery momentum has clearly decreased, but in many places is well above the respective potential growth and is therefore fundamentally inflationary. A similar message is conveyed by the continued rise in inflation expectations, which in the long term are incompatible with such low nominal and real interest rates. The new global Corona wave, based on more contagious virus variants, could also be noticeably milder than feared in view of the advanced vaccination coverage of the population.

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In summary, medium-term downward pressure on long-term interest rates is well founded. However, the longer-term prospects continue to speak clearly in favor of higher interest rates.

Equity markets around the world ended July with mixed returns. While the markets in the United States (+2.3%), Switzerland (+1.5%), and Europe (+0.6%) ended the month with positive returns, those in China (-7.8%), Asia (-5.4%), and Japan (-5.2%) printed significantly negative returns.

The interest rates on ten-year government bonds fell globally over the past month. They fell most in the United States (-0.25% to 1.22%), Switzerland (-0.25% to -0.37%), and China (-0.24% to 2.86%).

Currency markets moved within a normal range in July. The Swiss Franc strengthened against the US Dollar (+2.2% to CHF 0.91), the Euro (+2.1% to CHF 1.07), as well as the British Pound (+1.7% to CHF 1.26). The US Dollar remained unchanged against the Euro (USD 1.19).

Alternative investments have shown different returns over the past month. The gold price (+2.5% to USD 1,814 per troy ounce) and the oil price (WTI, +0.7% to USD 73.95 per barrel) rose, while hedge funds (-0.4%) had a slightly negative return in July.

Outlook – China's economy is weakening

The growth of the Chinese economy was quite robust in the second quarter with a plus of 1.3%, but is likely to weaken noticeably in the third quarter. After the economy had returned to the pre-Corona growth path at the end of 2020 and the economic consequences of the pandemic for China had thus been practically overcome, the Chinese leadership began to reduce the monetary and fiscal policy stimuli that they had previously used to overcome the crisis. Attention has shifted again to containing the enormous imbalances within the Chinese economy, and in particular the excessive debt. An outward sign of the changed priorities was the, by Chinese standards, extremely unambitious requirement to strive for growth of more than 6% in the current year, which in view of the low level of the previous year could hardly be missed from the outset.

The consequences of the more restrictive monetary policy are now clearly noticeable: The volume of loans granted in relation to gross domestic product (GDP) is as low as it was at the end of 2018, when a similar economic policy regime prevailed. The local governments have issued significantly fewer bonds than in the previous two years. The purchasing managers indices (PMIs) are still above the important expansion threshold of 50 points, but have been falling since the beginning of the year. Industrial production growth has declined by several percentage points, while retail sales growth has remained at a low level. The trend in imports remained positive until recently. In contrast, exports stagnated at a high level, which again led to a lower trade surplus towards the pre-Corona level. As a result, consumption, investment and foreign trade already contributed less to overall economic growth in the second quarter than in the previous quarter. There are many indications that this development will continue in the third quarter and that overall economic expansion will be slowed down as a result.

Positive impulses from China for the global economy are therefore not expected for the time being, which has an impact in particular on those countries that benefit to a considerable extent from exports to China, i.e. many emerging Asian countries and, in Europe, Germany in particular. However, strong negative effects also appear unlikely: China's leadership is well aware that their approach is a balancing act that harbors the risk of higher unemployment and social unrest. The stricter regulation of the private education system, for example, is also likely to be due to the need to limit the financial burden on households for tutoring.

Even more important recently was the lowering of the minimum reserve ratios that the banks have to keep at the National Bank: This clearly sends the signal that they do not want to push ahead with reducing lending at any cost. There is therefore much to suggest that lending will stabilize at the lower level it has now reached. In the medium term, China's economy would thus swivel on a course of moderate growth slightly below the 6% mark. The greatest risk remains that existing tensions with the United States will result in a kind of cold economic war. An increasing decoupling of the two economic blocs from one another would not only endanger globalization, but also put Europe in an extremely difficult position.

The longer-term fundamental outlook is generally friendly, but is increasingly showing symptoms of exhaustion typical of the mid-cycle and opposing effects. Markets have now fully processed and adequately priced in the recovery scenario for the next few years. The cyclical trade is therefore likely to remain under pressure and only be selectively/temporarily attractive. Vaccination campaigns continue to gain pace on a global level, but will not ensure herd immunity until autumn, especially in many emerging countries. The fundamental environment there will remain burdened by Corona. On the other hand, both monetary and fiscal policy in the industrialized countries will remain stimulating in the second half of 2021. However, financial markets are likely to increasingly look to the year 2022 and begin to price in a possible tightening of monetary policy, which can lead to temporary phases of fragility. The main medium-term risk is represented by the current tightening efforts in China (see above). However, the most recently published figures in China are friendlier again and could provide an indication of possible countermeasures at the end of the year.

We expect equity markets to continue to trend slightly upwards in the further course of the year, although temporary setbacks are possible. We continue to favor Switzerland, the United States and China over Europe and we continue to focus on good quality companies with strong balance sheets. After the setbacks in July, China offers an interesting entry or top-up opportunity.

Market participants do not expect any rate changes by the US central bank Fed and the European Central Bank ECB before the end of 2022. There are also no rate changes expected by the Swiss central bank SNB.

Trade disputes and geopolitical developments can lead to strong movements in currency markets. The Swiss franc serves as a safe haven in such cases.

Hedge funds continue to benefit from a normalization of correlations, volatilities, and dispersion. Hedge funds typically thrive when the dispersion is high and correlations are low because then they can take full advantage of their trading techniques and skillset.

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Limmat Wealth Ltd.