Habib Bank AG Zurich

(Incorporated in Switzerland 1967)

HBZ Investment Quarterly

What's next?

Q3 2021

Table of contents

Editorial

Dear Reader,

The world has taken great strides in its battle against the coronavirus pandemic but it is still too early to declare victory. Mass vaccine rollouts in many countries have nevertheless made it possible to lift the toughest public health restrictions, triggering an impressive rebound in activity. Financial markets — ever the great discounting mechanism — have anticipated many of these positive developments and now await confirmation of the future direction of travel: a more broad-based and sustained expansion or stop-and-go as the pandemic continues to linger on?

Given ample fiscal support and limited risk of premature monetary tightening by the US Federal Reserve or any other major central bank, we expect the world to transition into a new growth phase. The recent inflation surge should also prove to be largely transitory. The investment implications for us may be summarized as follows: limit duration risk as the rate normalization process is likely to resume, overweight credit and ensure well-diversified equity exposure as strong fundamentals continue to favor risk assets.

Over the past years, navigating financial markets has become increasingly complex, due not only to the plethora of new policy measures but also to the growing rivalry between the US and China. In our Special Topic on page 10, we highlight the associated challenges for investors in what we call the 'geopolitics of investing'.

As ever, we hope you find our commentary insightful and thought-provoking and look forward to our ongoing exchange.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

The macro backdrop: Recovery and beyond

As with the seasonal flu, the coronavirus will become endemic. But material progress in fighting the pandemic has put the world economy on a solid recovery path. 2021 is therefore expected to deliver solid growth against a backdrop of ongoing highly accommodative fiscal and monetary policy.

Table 1: Real GDP growth (y/y in %)

	2020E	2021F	2022F	Short-term trend
United States	-3.5	6.6	4.1	↘
Eurozone	-6.5	4.5	4.2	↗
Germany	-4.8	3.5	4.2	↗
United Kingdom	-10.1	6.7	5.4	↘
Japan	-4.7	2.5	2.5	↗
China	2.3	8.5	5.5	↘
India	-7.5	9.2	6.7	↗
Russia	-3.0	3.5	2.5	→
Brazil	-4.1	4.9	2.2	↗

Table 2: Consumer price inflation (y/y in %)

	2020E	2021F	2022F	Short-term trend
United States	1.2	3.5	2.5	↘
Eurozone	0.3	1.9	1.4	↗
Germany	0.4	2.5	1.6	↗
United Kingdom	0.9	1.6	2.0	↗
Japan	0.0	0.1	0.6	↗
China	2.5	1.5	2.3	→
India	6.2	5.3	4.8	→
Russia	3.4	5.6	4.0	→
Brazil	3.2	6.0	4.0	→

Source: Bloomberg, IMF, HBZ

US moving from recovery to expansion

US activity has continued to rebound strongly since the beginning of the year and has likely reached pre-pandemic levels during the past quarter. Meanwhile, the Biden administration has redoubled its efforts to boost spending on both material and social infrastructure. Given the current distribution of power in Congress, the more ambitious plans will probably die in its dark corridors but the Democrats will still want to push their political agenda in preparation for next year's mid-term elections. Some of the less controversial elements have already cleared important hurdles for ultimate enactment. The additional fiscal spending will support growth in the coming years when the post-pandemic rebound has run its course and Fed policy may — just may — become marginally less accommodative. Based on the somewhat more hawkish tone of the June FOMC statement, the tapering of asset purchases will be the first step in this direction, probably from early 2022 onwards. The Fed's policy rate, however, will most likely remain unchanged well into 2023, especially if, as we suspect, the recent inflation surge proves to be transitory.

Brighter prospects for Europe

After a slow start, EU member states significantly accelerated their vaccination rates during Q2. As a result, restrictions have been eased to the point where a relatively normal summer tourism season should be possible — for continental travelers, at least, and provided the arrival of the more contagious Delta variant does not trigger a wide-spread spike in new COVID-19 cases. With the ECB's monetary stance probably highly accommodative for longer following the policy review, and given the gradual deployment of pandemic-related EU spending, as well as the upturn elsewhere in the world, conditions for a robust recovery remain in place.

Stop-and-go in emerging markets

Many emerging economies continue to battle the pandemic, either because they have limited access to vaccines or, as in the case of many East Asian economies, because they have failed to prepare for large-scale vaccination. On balance, however, growth is set to return. As the only major economy which has already begun normalizing fiscal and monetary conditions and is now seeking to actively stabilize growth, China is an outlier.

Key points

- US Fed policy will not derail strong expansion
- Improving conditions for most European economies
- China to stabilize its growth trajectory

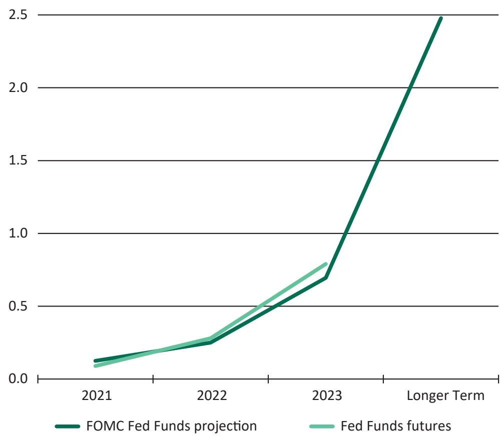
Investment strategy: Supportive fundamentals

High valuations, low yields and tight spreads make for a potentially toxic mix for markets and investors. While some short-term equity correction appears overdue, fundamentals are far from flashing red: growth is strong and so are earnings. Stay invested, stay diversified!

The Fed has not blinked

Initially, market reactions to the June FOMC meeting were unanimously negative. Eventually, though, investors realized that Fed members had not fundamentally altered their projected path of monetary policy, nor were they unduly concerned about temporarily higher inflation readings. They simply and gently reminded all economic agents that the current, highly accommodative environment will not last forever even though exiting it may be a drawn-out process. One of the key short-term threats to financial markets — a substantial tightening of monetary conditions — is thus nowhere in sight. This does not mean that there are no risks, however; equity markets, in particular, are overextended according to many metrics. Rapid sector and style rotations further complicate matters, but these should not distract from the fact that quality, our favorite equity style, outperforms over the cycle. At any rate, as long as fundamentals remain robust, we do not expect a more lasting downturn. Low yields and tight spreads have created more asymmetrical risks for fixed income, hence our more cautious stance in this asset class. Spread products, in particular high-yield and emerging-market corporates, should, however, continue to deliver reasonable returns. Finally, the US dollar stands to benefit from the FOMC's tweaked communication since it makes it amply clear that the Fed will be the first of the G3 central banks to take some chips off the table.

Chart 1: Fed still projects no rate hike before 2023 (% p.a.)



Source: Bloomberg, HBZ

Our positioning

We remain true to two of our core convictions: first, that diversification is the best way to achieve our investment goals; and second, that real assets are currently more attractive than nominal ones. We are thus maintaining our moderate overweight in equities, with a focus on quality, and our more pronounced underweight in bonds, with a preference for alternatives.

What to watch

The recovery is advancing at different speeds in different economies. Relative economic performance could therefore start to matter again, with important consequences for regional allocations. The current earnings season is also demanding much of our attention given that rich valuations create greater downside risks in the event of major misses.

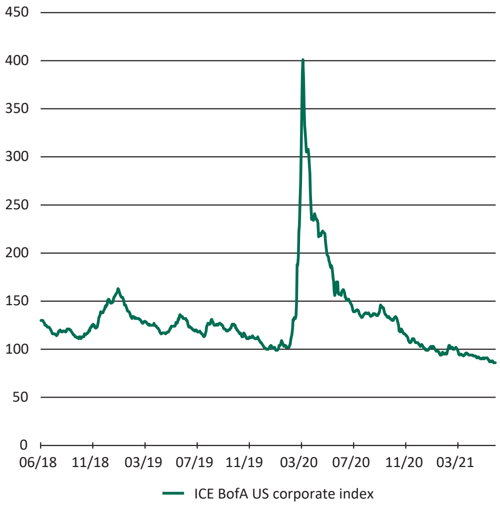
Key points

- June FOMC not a game changer for Fed policy
- Real assets to outperform nominal assets
- Relative economic performance likely to matter more going forward

Fixed income: Stay with shorter duration

The latest drop in bond yields does not make a great deal of economic sense and we expect yields to move higher in the coming months. We therefore favor shorter durations. As investment-grade bonds have lost their luster, we prefer high-yielding corporate and emerging-market bonds.

Chart 2: Very low spreads for investment-grade bonds (in basis points)



Source: Bloomberg, HBZ

Advantage high yield

Spreads for investment-grade bonds have fallen close to their all-time low and the cushion left for absorbing higher yields is alarmingly thin. Going forward, low — or even negative — total returns must be factored in for this sector. One of the few exceptions here is likely to be subordinated debt where investors continue to receive some compensation for the risks assumed. US high-yield bonds, on the other hand, still display compelling yields and improving fundamentals. Higher US rates would, of course, also represent a headwind for this asset class, but some additional spread tightening, as well as a decent coupon return, create room to offset the impact of higher rates. Their lower duration is another advantage in the current market environment. A further argument in favor of US high-yield bonds is that energy companies make up a substantial part of the market. They suffered high default rates last year and the survivors should now be able to reap the benefits from higher oil prices and stronger balance sheets.

Senior loans — a low duration alternative

Senior bank loans are another attractive fixed-income asset class in the current environment of low (but potentially rising) interest rates. Bank loans are typically arranged by banks for non-investment-grade companies. The loans have a floating rate, earning the reference rate (LIBOR or SOFR from mid-2023) plus a spread, and are consequently exposed to very minimal interest rate risk. Spreads have tightened meaningfully since their high last year. However, their continuing relatively high income profile keeps such loans attractive. Given the nature of bank loans (non-listed), a fund structure is the only way to gain diversified exposure to this sector.

Preference for corporates in emerging markets

Spreads for EM bonds remain generally attractive, particularly on a relative basis. The ongoing global economic normalization and higher commodity prices will also benefit many EM economies. In turn, spreads — especially in the high-yield space of EM bonds — should tighten further. Given the higher rate sensitivity of EM sovereign debt, we have a distinct preference for EM corporate bonds with their lower average duration. Moreover, their underlying quality is masked by rating conventions which make it difficult for corporates to be rated higher than their respective sovereign.

Key points

- US high yield remains attractive
- Senior loans as sound low-duration alternative
- Preference for corporate bonds in EM

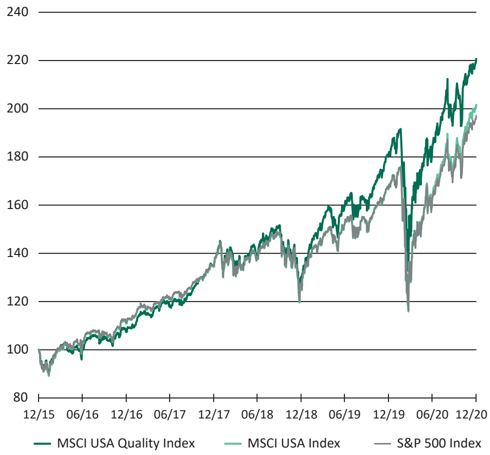
Equities: Peak growth, peak equities?

Falling economic growth momentum is not necessarily negative for the medium-term performance of equities, especially if the level of activity remains above trend. It can, however, be a source of volatility, as companies and markets adjust to a new phase in the cycle.

Economy, valuations and earnings

The global economy has likely reached its peak in terms of growth momentum as well as monetary and fiscal support. Importantly, though, the level of activity should remain well above trend for some time. Healthy household balance sheets and an improving labor market will support consumption. Corporate profitability is high — although wage inflation in the US must be followed closely, as it usually leads to lower profits — and capital spending is on the rise. Equity valuations, however, are stretched and the period of multiple expansion is most likely behind us. While metrics such as the price-earnings (P/E) ratio may decline from their current highs, this should not prevent price appreciation if earnings keep growing. Multiple expansion is usually behind the fastest and largest equity gains, as markets are all about anticipation. But earnings growth is the main long-term driver of market performance, and US companies have excelled in this domain. The coming earnings seasons, and particularly company guidance, will be important in sustaining this year's solid market returns.

Chart 3: Quality growth stocks outperform long term (index 100 = 12/2015)



Source: Bloomberg, HBZ

Balancing value and growth

Value stocks have outperformed growth year-to-date, but the so-called 'recovery trade' has been faltering since mid-May. The deceleration of economic momentum favors growth stocks and, more generally, companies that are able to sustainably increase their earnings. In this context, the technology sector has been performing well, also benefiting from lower bond yields. The trajectory of bond yields should keep the growth trade volatile, as we expect yields to grind higher in the second half of the year. With the 10-year US Treasury yield currently around 1.30%, the risk of a negative rate shock has definitely increased.

Portfolio implications

Expected market volatility would speak for a focus on quality companies. While quality can be found on all continents, it is most present in the US market. For cyclical exposure, investors should concentrate on continental Europe and consider allocating to the financial and energy sectors. The delayed COVID-19 recovery favors Europe, though a pick-up in Delta variant cases is cause for concern. Having lagged for some time, we expect the performance of emerging-market equities to improve, even if regulatory and growth uncertainty in China are blurring the outlook and curbing positive investor sentiment.

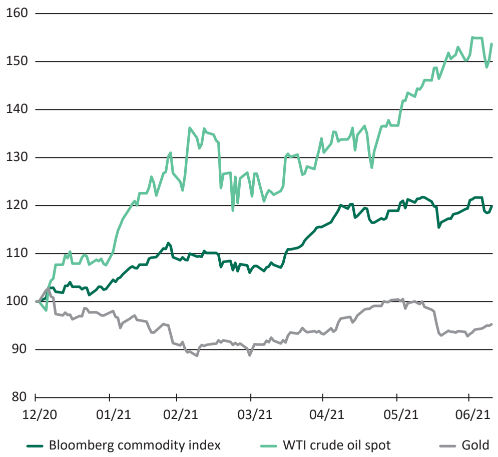
Key points

- Peak growth as source of market volatility
- Strong earnings to support equities
- Time to balance growth and value styles in portfolios

Commodities and FX: Firm USD despite reflation

Commodities have been the best-performing asset class year-to-date, led by the energy complex. Not all commodities are equal though — gold, for instance, has lagged. The economic recovery, inflation expectations, and the US dollar are all part of the explanation for these mixed fortunes.

Chart 4: Commodity performance
(index 100 = 12/2020)



Source: Bloomberg, HBZ

Tensions among OPEC+

Demand for oil continues to grow in lockstep with the global economic recovery. Until now, OPEC+ has responded effectively to the demand-led crisis by successfully managing oil supply. However, a crack in the coalition is now emerging as Saudi Arabia is opposing the UAE's request for an increase to its baseline production level. It is the timeframe for the end of OPEC+ production cuts that lies at the heart of this disagreement. Judging by international reactions to the associated price spike, further upside appears capped, unless Saudi Arabia is ready for a stand-off with its US and European allies. But a weaker OPEC+ alliance could lead to increased output and put downward pressure on prices. In summary, we expect OPEC+ to drive future price action, unless the demand recovery ends up being disrupted by the spread of the Delta variant.

US dollar driven by monetary policy

June saw the US dollar register its best monthly performance since November 2016, as the release of the Fed's latest interest rate projections brought the first hike forward into late 2023. While there was no announcement suggesting an imminent tapering, expectations for this also moved forward. The reaction function of the USD to the Fed confirms our view that monetary policy developments will be the deciding factor for relative currency performance. Until then, we expect major currencies to remain range-bound, driven by economic data releases and the evolution and geographic reach of COVID-19 variants.

Gold at a crossroads

Gold is generally driven by the broader macro outlook. While rising inflation expectations allowed gold to revisit the USD 1,900/oz. mark at the end of May, the metal fell sharply in June to record its worst month in more than five years. A marginally hawkish Fed, reduced concerns about inflation and a strong USD were the main drivers behind the sell-off. Currently, gold is hovering around USD 1,800/oz. Given the low level of real rates — gold is negatively correlated to them — and our constructive macroeconomic outlook, we see only limited upside for gold. Downside risks would materialize should the Fed signal a clearly hawkish policy shift. On the other hand, above-trend inflation in a weaker growth context could propel gold higher.

Key points

- OPEC+ playing with crude supply and price
- US dollar to remain firm
- Uncertain path ahead for gold

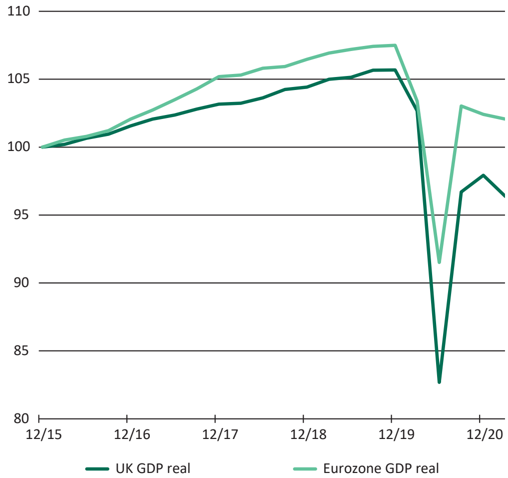
Key markets: And now for the hard part

The pandemic is still dominating the headlines, but our key markets have already moved into the recovery zone. In due course, however, underlying structural issues will reassert themselves and force governments and economic agents to embrace long-overdue changes.

Pakistan: Remarkable resilience

Preliminary growth estimates for the past fiscal year have confounded analysts and beat the expectations of both the government and the State Bank. A pragmatic handling of the third COVID-19 wave, albeit aided by a relatively low number of reported cases, has limited the economic damage and created some upside risk for the new fiscal year. However, structural issues remain ever-present and continue to mar the review process of the ongoing IMF program. The government now aims to conclude the program review by September, suggesting that some hard negotiations lie ahead. While the external position currently looks fairly robust, not least thanks to record remittances, IMF support remains essential for the country. The State Bank has already signaled its intention to gradually remove some of its monetary accommodation. Further policy action may also be needed to halt the surge in imports. The fact that the currency has resumed its depreciation trend is a sign that macro stability should not be taken for granted. In this context, equities could well remain stuck in a volatile sideways market.

Chart 5: UK economy underperforming since Brexit vote (index, 12/2015 = 100)



Source: Bloomberg, HBZ

UAE: Rebound of the non-oil sector

Thanks to the fast vaccine rollout, the UAE economy was able to stay largely open during the first half of the year. Hotel occupancy has started to recover, as have rents and residential real estate prices; trade volumes have already rebounded to above pre-pandemic levels. Logistics and transport, as well as tourism, stand to be early beneficiaries of the unfolding recovery. The latest spat with Saudi Arabia over crude oil output is, however, a timely reminder of the risk that the still-large oil sector poses to the overall economy.

UK: Underwhelming recovery?

Economic activity in the UK rebounded sharply following the early lifting of many of the pandemic-related restrictions. In light of the recent surge in cases of the Delta variant, the government's decision to remove the remaining restrictions appears somewhat premature. Moreover, trade frictions, and in particular a shortage of low-skilled workers (both results of Brexit), will create headwinds that may contribute to an underwhelming recovery. Since additional stimulus, either fiscal or monetary, will not be forthcoming, growth will settle at more modest levels once the recovery effects have dissipated.

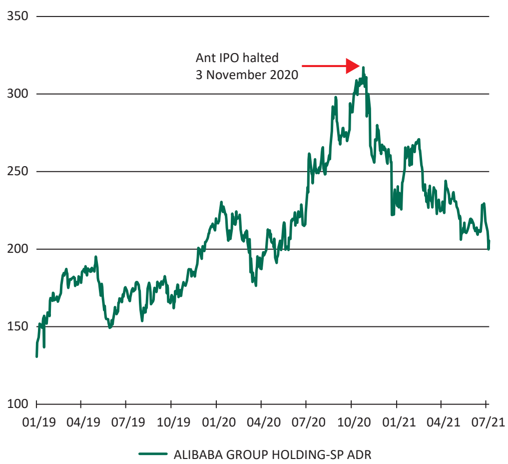
Key points

- Pakistan — resilient for now but structural weaknesses remain
- UAE — a tale of two economies
- UK rebound hamstrung by post-Brexit issues

Special topic: The geopolitics of investing

The rise of China, and the associated response by the US as the incumbent superpower, are defining much of the geopolitical context for financial markets. Investors must pay attention to the possible implications of this if they are to avoid getting caught between the frontlines.

Chart 6: Alibaba down 33% since run-in with regulators (ADR in USD)



Source: Bloomberg, HBZ

Key points

- Sanction regimes create pitfalls for investors
- Political priorities may trump commercial interests of companies and investors
- Chinese debt funding creates risk in event of sovereign debt restructuring

I sanction you

In the context of the current great-power rivalries, sanctions have become an instrument of choice for expressing displeasure at actions considered unfriendly by the opposing side. The US alone has some 36 sanction programs in place. Today's sanctions are increasingly targeting financial instruments and access to financial markets. Such measures can impact the ability of a sanctioned entity to raise capital or refinance maturing debt and thus challenge its commercial viability. Investors may be caught in the crossfire if they happen to hold an affected instrument which may fall in value or become illiquid. In some cases, investors may even have to part with assets if they do not want to fall foul of their own or foreign governments. Companies may also be declared a threat to national security, excluding them from lucrative investment or procurement contracts. This is precisely what has happened to the Chinese telecom equipment manufacturer Huawei in a number of Western countries.

Commercial goals come second

Similarly, Chinese authorities have tightened their grip on some of the country's most prominent technology companies, famously cracking down on the boss of Alibaba and canceling the country's largest-ever IPO. Chinese authorities were more concerned about cutting a mercurial CEO down to size than showing the world its formidable financial clout. The same appears to be happening with a number of Chinese IT companies which dared to list in New York. Clearly, there are other priorities at work here than maximizing market value and profit. Investors stand to lose big in such scenarios – the poor performance of Chinese shares year-to-date is testament to this.

Beware of zombie states

Historically, great powers have used their financial heft to influence other countries, and China is no exception. Through its Belt and Road Initiative, China has become the prime source of funding for many countries along its strategic development axes. It is clear that financial sustainability is not a criterion for receiving Chinese support, and China demands that the conditions of such loans are kept secret. Investors in the sovereign debt of such countries thus do not know how they will be treated in the event of a default. They may be in for a rude awakening.

Market data summary

As of 12 July 2021

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	9,163.8	5.4	14.4	50.8
S&P 500	4,369.6	5.9	16.3	56.2
EuroStoxx 50	4,046.1	2.1	13.9	17.4
FTSE 100	7,083.8	2.8	9.6	-7.4
SMI	11,960.5	7.0	11.7	35.6
Nikkei	28,569.0	-3.3	4.1	28.8
MSCI EM USD	644.2	0.4	3.2	31.8
Sensex 30	52,605.1	9.9	10.2	43.9
KSE 100	47,490.6	5.6	8.5	19.1
Hang Seng	27,515.9	-3.3	1.0	-3.4
Russia RTS	1,623.3	13.3	17.0	37.9
Brazil Bovespa	125,427.8	6.6	5.4	67.2

Bond indices	Last	-3M %	YTD %	-3Y %
FTSE US Gov	1,681.77	2.0	-1.8	15.1
FTSE US Corp	2,669.44	3.3	-0.6	25.3
FTSE US HY	1,226.36	2.4	4.0	22.6
FTSE Euro gov	252.94	0.1	-2.4	8.9
FTSE Euro Corp	257.37	0.4	0.0	8.4
FTSE EM Sov	947.30	3.5	-1.4	19.0
DB EM Local USD	172.10	0.6	-5.3	8.6

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	92.13	0.0	2.5	-2.8
EUR	1.19	-0.3	-2.8	1.7
CHF	0.91	1.0	-3.1	9.6
GBP	1.39	0.9	1.6	4.9
JPY	110.14	-0.6	-6.1	2.2
AUD	0.75	-2.1	-3.0	0.7
CAD	1.24	0.6	2.3	5.5
ZAR	14.22	1.5	2.2	-7.5
INR	74.64	0.7	-2.0	-8.0
PKR	159.54	-4.7	0.3	-23.7
Gold oz	1,808.32	4.2	-4.7	44.8

Interest rates	3M interbank %	10Y government %
USD	0.13	1.33
EUR	-0.54	-0.31
GBP	0.08	0.63
CHF	-0.76	-0.30
JPY	-0.08	0.03
AUD	0.03	1.32
CAD	0.44	1.33
ZAR	3.69	9.31

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For your notes

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