

OBSERVATION

3rd QUARTER 2021



02

KEYSTONES

Change is the
only constant

EQUITIES

The growth of value

04

FIXED INCOME

The bond market is
(too) relaxed

05

TRENDS

Careful what you wish for

06



HERITAGE.CH

CHANGE IS THE ONLY CONSTANT

Since November last year when the news hit of the first available vaccines markets have been living in a new normal environment. Markets have since ignored bad news and as long as interest rates remained low and liquidity abundant, higher highs were the norm.

Covid is just the latest example of the change we are witnessing. Politics is seeing change with Trump, Brexit and left/right wing polarization. Socially, inequality is increasing, and freedom of speech contracting. Economically we are taking on unprecedented levels of debt across government, consumer, and corporate balance sheets. Combine this with over a decade of central bank control of markets via monetary policy. Where does this experiment or pattern of change end? Add in what is happening at a fast pace in digitalisation, too (In the last section we look at central bank digital currencies), or in green energy and regulation. Change is the only constant.

Peak to trough the great financial crisis (GFC) took around 18 months for stock markets to turn. Last year the move took a month. The central bank medicine to large aggressive downward moves in stocks was brutal and historic. This is the central bank playbook since the GFC and they are now tied to this medicine. This central bank experiment will not end tomorrow and as investors we need to continue to accept it and go with the wave rather than swim against it.

Economies have experienced a classic V shaped recovery. Indeed, as many areas of the world remain under lockdown the impact and suffocation of economic activity continues. Analysing economies is made more difficult in a globalised world where

some nations are open, and others remain under tight lockdown.

Consumers and businesses have seen dramatic enforced shifts in their consumption, investment, and expectations for the future.

Consumer savings rates have jumped, businesses have shelved capex spending and across the board confidence shattered with the first lockdown.

These however are beginning to unravel, again with geographic variations. Europe continues to be under a reduced lockdown and should continue to see consumer spending and business investment power ahead. The US and parts of Asia are ahead

in this process whereby several emerging markets are lagging. The unevenness of vaccination supply is not helping either. Growth on a medium-term basis will therefore likely be geographically staggered and erratic in timing across nations but positive as consumers and businesses get back to normality via investment and spending. It will take time to witness the permanent scars, however. Job losses and fears should have an impact on future expectations for big ticket spending. Unemployment benefits mask this and indeed mask changes from real estate to credit card to auto spending. Retail, leisure, and other affected sectors will see change, we just do not know how permanent.

We expect some moderation in growth and inflation from lofty levels whilst remaining robust and within an

The V shape recovery via US services leading indicator



Source: Bloomberg



expansionary medium to long term up cycle. If this view is correct the impact on markets could be between negligible to some degree of moderation. As we write, the S&P is up 16% this year and around 95% since March 2020. Some moderation into yearend cannot be ruled out and would, arguably, be welcomed as a natural cycle of a market. The overall medium-term environment will remain very supportive for risk assets.

The topic of inflation is now in vogue. Global supply changes and the demand/supply of inputs remain constrained. Unprecedented amounts of liquidity have flooded the system seeing asset price inflation. Base affects statistically on the economic data show heightened inflation prints. The time lags and quality of the data remain uncertain. As has been described, we do not know the permanent impact on jobs and hence wages. However, inflation expectations are rising and commodities

including oil are soaring. Lumber is a classic example of mean reversion. It soared 150% as sawmills remained closed and has since May dropped 50%. These examples make economists jobs a nightmare given the time lags and variabilities already stated. Ultimately, we expect to see moderation in inflation as countries open. There remain risks for higher stickier inflation however which seem more likely than a return to 1–2% yoy CPI.

We are seeing more signs of speculative excesses, including in crypto currencies, SPACS and the greatly increased use of leverage. Ultimately this is to be expected in a world where central banks are protecting the downside to markets and new generations and assets are entering the fray.

The skill is positioning for the change, in a prudent way, and avoiding the noisy narratives of promise.

European politics is increasingly coming back to investors' attention. Germany goes to the polls in September and France in April next year. Both have the potential to continue the theme of change. Most electoral polls are not worth commenting on, we have learnt that from the US and UK. In Germany, the Greens have the potential to accelerate the clean/green narrative from within the heart of government. In France, the battle between Macron and Le Pen will be chaotic and potentially a rerun of 2017 especially as both suffered defeats in local elections. A market friendly candidate is most likely but the issues of the state of the economy, potential strikes, social unrest/terrorist attacks can play a decisive role in campaigns. Elsewhere geopolitics remains in the shadow of the mainstream media but truly alive. Geopolitics is difficult to hedge against but in an increasingly divided world are not going away. Taiwan and the Balkans remain sensitive areas as do the Middle East, Kashmir etc.

In conclusion asset prices will remain supported by central bank liquidity and increasingly fiscal policy. The process of tapering of asset purchases will begin but at a slow speed. Growth should remain very robust and inflation, overall, sticky. Shorter term a degree of mean reversion should be considered a possibility. Medium term we believe stocks can continue to outperform bonds and cash.

Lumber – up 165%, down 50%



Source: Bloomberg

THE GROWTH OF VALUE

Value and growth are terms often used in the context of stock picking and investment styles. Some of the differences are starting to show in the recovery phase.

Value stocks are equities that stand out for their low valuations relative to their fundamentals (e.g. price to book, PE, dividends, FCF, earnings). They often have high dividend yields and tend to be more sensitive to the business cycle. In short, value stocks tend to belong to companies that have a solid long-term business but are unloved by the market. Growth stocks on the other hand, are stocks of companies that offer substantial growth prospects. They are often disruptive and bring innovative products to the market. Their business is typically fast growing and reinvest their earnings rather than pay dividends.

Europe broadly possesses a higher proportion of value stocks than its global peers. The US is known for its

large proportion of growth companies, as illustrated by the weight of its IT sector (27%), more than twice the size of the next largest sector (Healthcare at 13%).

After a very strong start to the year, value has been among the weakest styles this summer, as interest rates worldwide fell, and flatter yield curves weighed on Financials. The growth style has therefore been outperforming, as lower interest rates strengthened the appeal of highly valued sectors such as Technology. This change in leadership allowed US markets to catch up with Europe after lagging in the recovery phase.

In Switzerland, the Federal Council recently terminated negotiations with

the EU. The aborted negotiations are expected to have little immediate impact on the Swiss economy which will be shaped by the rate and strength of the post-corona.

In Europe, the ECB balance sheet as a percentage of GDP is growing with the ongoing purchasing of bonds. This is likely to keep European equities attractive.

The bulk of the stimulus in the US is however behind us while in Europe it is ongoing. This could well support growth over the coming years and drive an outperformance of European equities.

MSCI World Value vs Growth (%)



MSCI World Value
MXWO000V Index
MSCI World Growth
MXWO000G Index

Central bank balance sheets as % of GDP



ECB Balance Sheet as % of GDP
BSPGCPEU Index

Federal Reserve Balance Sheet as % of GDP
BSPGCPUS Index

THE BOND MARKET IS (TOO) RELAXED

Government bonds, since we last wrote, have seen yields stabilise in April and since fallen into early July with the ten-year US Treasury yielding 1.35%. Looking forward the market continues to face several headwinds.

Inflation is above target with current yields offering very little protection. Additionally, the Fed and other central banks have begun to talk about tapering. Currently the Fed purchases \$120bn of bonds from the market each month. The tapering of this amount will be one less support to the market. Considering these the market is relaxed. It did not freak out when inflation in June hit 5% y-o-y in the US. Additionally, with growth remaining very robust too, yields have remained very subdued.

The Fed has begun to talk about tapering and highlighted to the market their expectation of raising interest rates into 2023. Clearly this is best described as an estimate as events can change quickly. It will likely prove very difficult for central banks to both taper and hike interest rates. The reliance from the market on various monetary policy schemes is significant. The amount of debt held across balance sheets means rates must stay lower to enable refinancing. Additionally, consumption is paramount to keep growth positive and central banks will have no choice but to expand their balance sheets and try to subdue yields.

Corporate bonds in an environment of effectively zero or negative interest rates offer value. However, overall, they remain well priced albeit pockets of value do still exist.

So, our outlook has not changed. We see continued underperformance of bonds to other assets. Some degree of moderation in growth and inflation can be expected on a 6-month view but this should not be cause for concern. It feels like bonds have

already priced this in. Therefore, although we do not see massively higher yields the current lack of yield offered by government bonds remains a concern looking forward. Medium term we believe equities will continue to outperform.

10 year US Treasury yield (%)



US CPI year-on-year (%)



CAREFUL WHAT YOU WISH FOR

The pace of change in digitalization is phenomenal. This writer got his first email address in 1996, had to wait minutes for a dialup internet connection and bought his first mobile phone, the size of a brick, in 1999.

Today we can access our bank accounts, download music, or translate foreign script within seconds on our smartphones. Amazon or Google have been perhaps one of the most visible and yet least understood ways of capturing such an investment trend. Instead of analysing Amazon as a network effect of internet usage, very sophisticated AI consumer awareness and cross selling it was seen for multiple years as an ordinary low margin online book shop. Amazon is since up 57,000%.

In just over ten years Bitcoin has come to the fore as a cryptocurrency. A currency it is not, but love it or hate it, it is

here to stay. The Bank for International Settlements (BIS) which is the central bank of central banks and the Basel Committee (on Banking Supervision) now recognise it as an asset. This asset class is still very much in its infancy and 90% will not survive past a couple of years, remember Netscape or Pets.com?

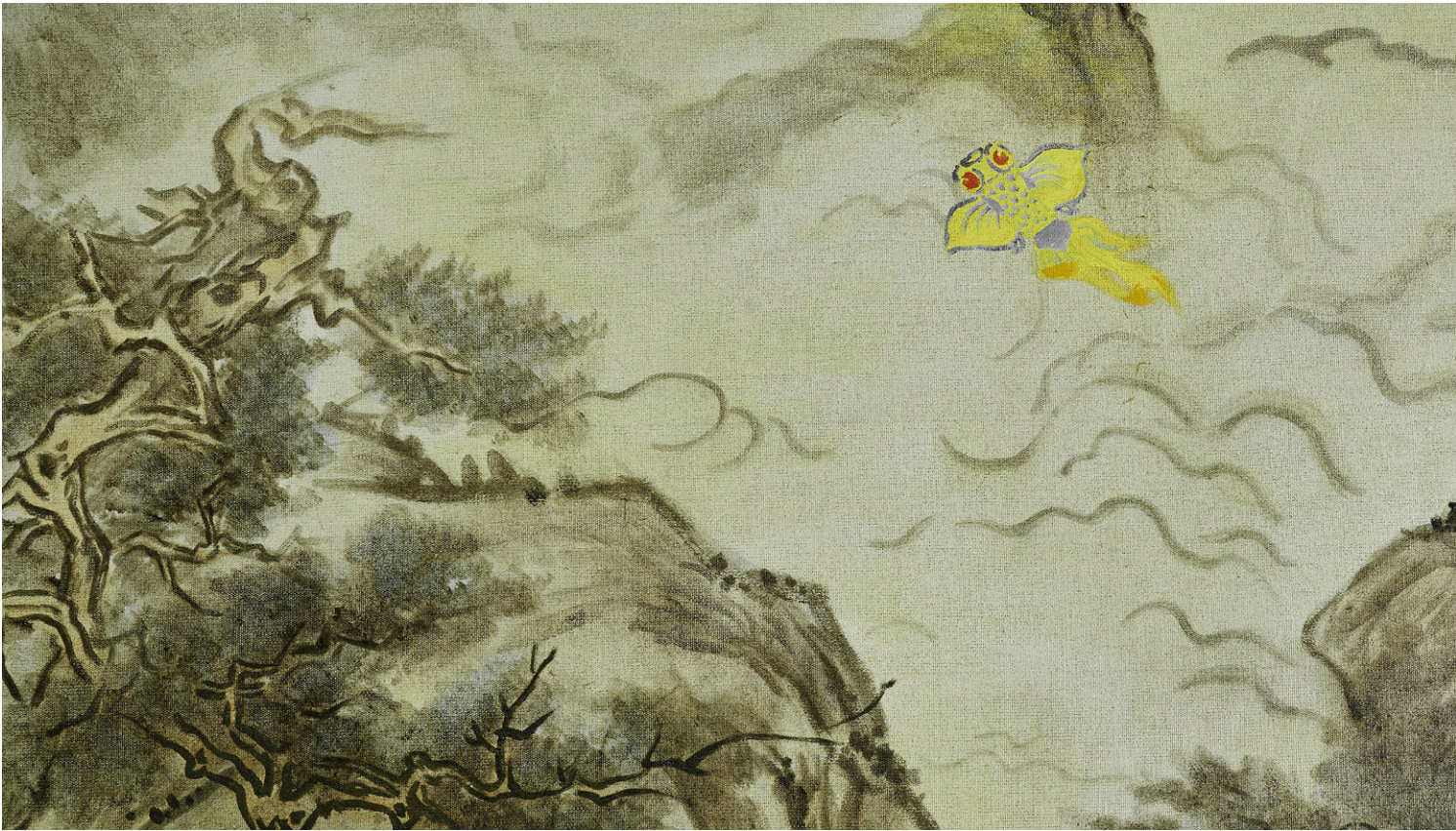
As is often the case, the private sector leads, and the public sector is forced to adapt. Regulation is essential based on the facts and not the narratives.

Bitcoin is not a home for the cash of drug dealers. The blockchain is transparent and has already enabled the FBI to prosecute. So too, the misinformation on energy usage. Bitcoin miners, out with China, use most of their electricity from clean sources. With a market cap of \$2.4trn decentralised, centralised, proof of work and proof of stake assets are tradable by everyone. However Central banks, led by China, are looking at getting in on the act with their own crypto assets – central bank digital currencies (CBDC).

The BIS just released a survey. More than 60 central banks responded

Not your average book shop - Amazon





representing 72% of the world's population and 91% of global output. No less than 86% responded stating they are currently exploring the pros and cons of CBDC's. At the forefront is China with the US trailing far behind. In Europe it's the same situation, lots of commentary but little action. Indeed, Sweden is the most advanced. Sweden is already largely cashless and plans to go fully digital in 2023. They are waiting on an ongoing parliamentary inquiry which will likely see a vote in late 2022. Cashless is different to having a CBDC. The Riksbank however have committed to converting to a CBDC after the eKrone is introduced.

The digital yuan (e-yuan) has been trialled extensively since 2014 and now a select number of e-commerce companies are paying their employees e-yuan. JD.com (+310k employees) have been additionally using the currency for business-to-business payments and accepting the e-yuan online since December. The Chinese plan to allow foreign visitors and athletes at the Beijing Winter Olympics in 2022 to use the e-yuan. Mastercard is currently waiting for approval to launch an onshore business credit

card using the e-yuan. Indeed, Mastercard are also cooperating with the Central Bank of the Bahamas, following the issuance of their sovereign digital currency, called 'sand money'. The Chinese have not stated whether they will go 100% digital, but the intention is clear.

The critics sight this as another step towards Big Brother type control. Clearly China is a lot further down that road arguably in part thanks to their culture. However, for everyone else there remain some significant questions with answers we can only guess at. Clearly the big advantage for central banks and hence governments is control of the financial system and their citizens. Freedoms will be quashed but then if you have not got anything to hide why should you worry? This is an answer we as individuals must answer given the form of democracy we live under.

This could do many things; it would cause the shadow economy to disappear and could see the end of the commercial banks. We could be heavily incentivized to buy or sell specific assets and in a downturn the government could directly pay

specific categories of citizens. On the flip side if we hold too much cash, they could tomorrow start charging us -10% on balances.

Ultimately CBDCs are coming, albeit it will probably take longer than first expected. It is unlikely the e-yuan becomes the new world reserve currency. It may have first mover advantage, but the rest of the world is unlikely to want an authoritarian regime in control of their data. The control available should not be underestimated. The final bill for COVID 19 will have to be paid and CBDCs allow for taxation to become very precise. However, the advantages for many will be just as clear as the disadvantages. In 1871 Western Union invented the wire transfer, it cost 3% and took 2–4 days often involving horseback. Today a wire transfer still costs 3% and takes 2 days. The giant market consisting of remittance users in emerging markets will be a huge winner, but in developed countries the loss of freedoms must be carefully analyzed.

EMOTION

CONTRIBUTORS

Jean-Christophe Rochat, CIIA
Jack Loudoun
Michel Mazenauer, CAIA
Mikaël Safrana, CIIA
Stéphane Trezzini

EDITORIAL

Nik von Guérard

DESIGN

Now Werbeagentur AG
Basel, Switzerland

PHOTOGRAPHS

Patric Pop

DISCLAIMER

This document is intended for informational purposes only and should not be construed as an offer or solicitation for the purchase or sale of any financial instrument mentioned herein or as contractual document. This document is not intended for distribution, publication or use in any jurisdiction where such distribution, publication or use would be unlawful nor it is directed to any person or entity to which it would be unlawful to direct such a document. The opinions herein do not take into consideration specific investment objectives, financial situation or particular needs of any person who may receive this document. Each person must make his own independent analysis, with professional advisors if necessary, before investing in any security, financial instrument or financial market mentioned herein. The information provided is based on sources believed to be reliable. However, Heritage Bank does not guarantee its completeness or accuracy nor does it accept any liability for any loss or damage resulting from its use. All information and opinions as well as prices, market valuations and calculations contained herein are subject to change without notice. Past performance is no guarantee of current or future returns.



HERITAGE.CH