

# OBSERVATION

2<sup>nd</sup> QUARTER 2020



02

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# THIS TIME IS DIFFERENT

2020 is already historically significant and will have a meaningful impact on future generations. The costs, both social and economic, may however never be accurately measured or appraised. We have witnessed similar situations before in 1987, the Asian debt crisis, 9/11 attacks and the Great Financial Crisis (GFC) but this time it is more a mixture of them all with a clear risk of an environment more akin to the years following 1929 developing.

Economies were already slowing as we came into the year, albeit the market was sanguine, US stocks enjoyed lofty valuations, stocks like Tesla soared and US interest rate markets priced one cut in rates towards the beginning of 2021.

Then along came a virus from Wuhan, China which spread across the globe as countries and regions were put under varying degrees of lockdown and social distancing. The public health shock hit a global economy awash with too much debt across the consumer, corporate and government balance sheets.

Additionally, the evolving demand and supply shocks have also encountered an oil price shock as Saudi and Russia battle to flood the market with ever-cheaper oil prices. Their target is the high cost North American shale oil producers, an intriguing move in an election year. Oil (WTI) has already fallen 60%, back to the levels of 2016 when US shales producers had their last crisis.

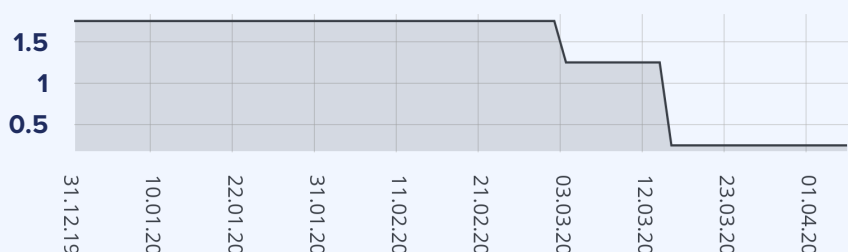
The virus also caused a financial shock, which erupted at unprecedented speed as investors rushed to sell risk assets and indeed, at times, all assets suffered as cash was sought. The response, however, from global authorities was swift and widespread. Interest rates were slashed in emergency meetings, Quantitative Easing and pledges of unlimited stimulus and support became a daily occurrence from policy makers. US election campaign pledges for

helicopter money and universal basic income, which two months ago were seen as fringe leftist policies, have been brought to the fore and are now considered mainstream.

Money is being printed at an alarming and unprecedented rate, which is more a consideration for tomorrow and the consequences of such we will discuss in the later section on Gold.

The portfolio exposure to risk assets was swiftly reduced as the team began to discount the likely outcomes. Equities and corporate bonds were reduced with an eye to ensuring as much liquidity as possible in the

**US Interest Rates**



Sources: Banque Heritage, Bloomberg

*The immediate outlook is predicated on a vaccine for the virus but also the testing and realization of where we are in the evolution of this pandemic.*

remaining fund holdings. With very healthy cash balances for the majority of March, we added a small amount of equity exposure back into portfolios. These were highly concentrated, high quality, handpicked and researched companies bought towards the end of the month. We remain defensive, cash rich looking for opportunities and the reality of the situation to be adequately priced into asset markets with an attractive enough margin. Options have also been used to cushion portfolios to downside moves.

The shocks to the global economic system are still being felt. Monetary and fiscal policy have been swiftly brought to bear with a clear message that there are few monetary limits. With the uncertainty, amount and widespread nature of the shocks to the system we do not believe a V shaped recovery is particularly likely. Our analysis is concentrating on whether a L, U or W shape growth pattern is seen. A recession will undoubtedly occur with a resultant bear market in assets, a wholly natural and important cycle of events. The question is how long this lasts, how deep economies go, and how much the cost to individuals, businesses and governments equates to. A vaccine will be found, and just like all the other tests of humankind, the challenge met and surpassed. Never underestimate the ability of humankind to adapt, overcome and come together as a race.

The aftermath in terms of timing remains uncertain. However, society, economics and politics will change and are unlikely to go back to the status quo pre virus. The total lockdown, combined with fear and panic, will change social habits, spending patterns, health awareness, sociality, mobility and much more. Economies, too, will have to de-lever, de-globalisation will increase and many firms simply will not exist or find that consumers have changed their habits to such an extent that they need to adapt fast. Financial repression, principally through inflation or tax hikes/spend-

ing cuts/increased regulations will become the norm. We have already seen the gentle persuasion of the ECB push dividend holidays across European banks. Bail-ins will be the tried and tested method, as was first used in Cyprus and now brought into law. Investors will have to be very aware of the cost to government support of an institution going forward; whether that is in holding equity or debt securities, governments will be paid back first.

Bear markets see brutal counter trend rallies which we are witnessing with elevated volatility across asset classes the new norm. Currency crises are starting to occur as we go to print particularly in Emerging Markets with the strength of the USD. The history books are full of the effects of such events in changing society and politics in Emerging Markets for generations.

Central bank stimulus once enacted has proven very difficult to retract. This will have to be dealt with too. In addition, politically the world has changed. The electorate, on the whole, were polarized and angry prior to the virus. This will take on an added dimension, especially if certain businesses are saved at the expense of others or some generations pay more than the rest. Additionally, it will be very difficult for politicians to take back the spending stimulus, which can more easily get them re-elected. However, although the present remains uncertain, the future is bright. Change is always a constant, and life will flourish. Markets and their participants will change and be forced to change. Digitalization will increasingly enter our lives, but so will the tried and tested methods of holding solid assets at a prudent level of risk for whatever the future throws at us.

EQUITIES	LAST PRICE	YTD %
S&P500	2749.98	-14.88
Eurotoxx 600	330.60	-20.50
Nikkei	19345.77	-18.22
China A shares	2961.54	-7.43
Brazil	79709.40	-31.07
India Nifty	9111.90	-25.12
Russia RTSI\$	1147.08	-25.94
MSCI World Local	1500.37	-16.64
MSCI EM Local	51090.2300	-16.88

COMMODITIES	LAST PRICE	YTD %
Crude Oil	26.21	-57.08
Natural Gas	1.78	-18.59
Gold	1711.40	12.36
Silver	15.72	-12.28
Copper	227.25	-18.75
RICI Global	1805.05	-2.80
RICI Agriculture	656.79	-13.43
RICI Energy	196.62	-48.85
RICI Basic Metals	971.30	-16.77
RICI Precious Metals	1839.33	-2.71

FIXED INCOME	LAST PRICE	YTD %
US Govt	417.51	7.43
EU Govt	252.03	7.63
US IG Corp	3241.31	14.57
US HY Corp	2154.67	12.85
EU IG Corp	151.37	8.09
EU HY Corp	410.62	11.67

CURRENCIES	LAST PRICE	YTD %
Dollar Index	99.6320	3.36
EUR	1.0929	-2.53
GBP	1.2463	-5.99
JPY	108.8000	-0.17
AUD	0.6291	-10.40
CHF	0.9676	-0.10
Brazil Real (BRL)	5.0872	-20.88
Turkish Lira (TRY)	6.6576	-10.61
India Rupee (INR)	76.2925	-6.44
China Yuan (CNY)	7.0461	-1.18
JPM EM FX	53.2250	-13.45

As of April 9, 2020



# CONSEQUENCES OF THE PANDEMIC FOR COMPANIES

The Coronavirus crisis will have a significant impact on future growth and earnings. It will also lead to a severe hit to dividends as companies move to preserve cash; pay-outs could therefore see their largest contraction since the great financial crisis.

Although dividends are traditionally much less volatile than earnings during recessions, investors should nevertheless prepare for some sizeable cuts in pay-outs going forward. A sharp earnings recession, companies struggling to hold AGMs due to Covid-19, and heightened regulatory pressure to restrict pay-outs mean that 2020 could see an unprecedented decline in dividends.

Governments in France, Germany and the US have announced limitations to dividends for companies receiving aid.

In Germany as in the US, all listed companies will be asked to suspend buybacks and dividend payments to qualify for government assistance. The sectors that are the most at risk are of course those where activity has almost stopped. In France, construction, industrials, transport, hotels, and non-food retail are the most exposed. Banks, Energy, Pharma and Insurance are the biggest dividend payers in Europe.

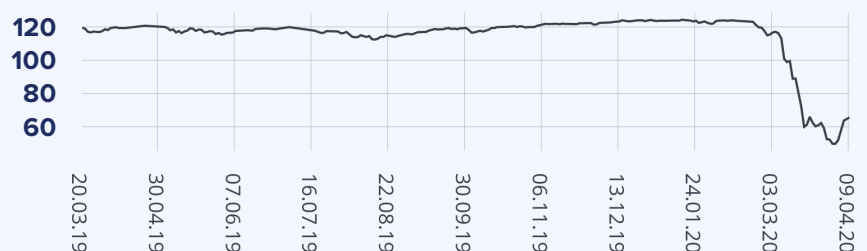
Banks account for 15% of MSCI Europe's dividend per share, followed by Energy (11%), Pharma (10%) and Insurance (8%). Given the regulatory pressure on Bank pay-outs and current oil prices affecting Energy,

a large portion of EU dividends seem likely to come under pressure from these two sectors alone.

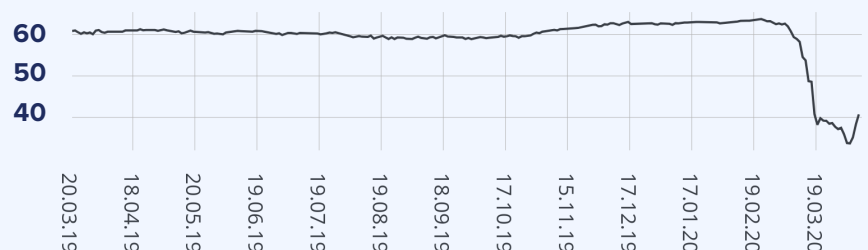
Retailing, Luxury and Autos have the highest proportion of dividends exposed to cuts or suspensions, 94% of Retailing dividends appear to be subject to suspension, while 70% of Luxury dividends and 68% of Auto dividends are exposed to either cuts or suspensions.

Dividend expectations have collapsed globally. The futures curves suggest that pay-outs will gradually recover in the US but remain depressed for the next decade in Europe! But in all challenges lie opportunities. Within this context, differentiation between troubled companies needing state support vs. solid, resilient businesses should come to the fore. This should make for a great stock-picking environment.

**Euro Stoxx 50 Dividend Futures**



**S&P 500 Dividend Futures**





# MARKET TREND

## GOVT. BONDS

As global central banks have rushed to slash interest rates to zero, government bonds have performed strongly, taking yields on ten-year maturities, close to or through the zero bound. Corporate credit, both investment grade and high yield, however have sold off in line with equities as investors rushed to reduce overweight positions and increase cash.

The two components of the yield of a corporate bond, the underlying government bond and the credit spread will be examined separately given their specific drivers going forward. Government bonds have been in a bull market for the last thirty years aided by a disinflationary trend, lowering of interest rates and the increasing demand for fixed income as an asset class.

With a yield that is positive in the US in nominal terms but negative in real terms where can the asset class go?

If we are in an unbreakable spiral of deflation, then the experiences of Japan are relevant. However, with the amount of stimulus from monetary and fiscal policies the risk is that stagflation rears its head. In that environment, there is no protection in government bonds to protect investors. Indeed, if inflation does eventually hit, the next experiment

the central banks will require will be to cap yields, something that occurred Stateside in the 1940s. The real return would however be deeply negative for investors. Corporate bonds have repriced lower on the back of the virus and very uncertain earning outlook. However, there are opportunities in high-grade issuers with little direct exposure to the virus e.g. Technology or Consumer Staples. The central banks are also supporting the IG market and although downgrades and defaults will be increas-

ingly witnessed, there are opportunities. The high yield market, which has also repriced remains frozen without central bank buying, and increasing downgrades are expanding the universe, most recently with Ford.

In short, duration high quality corporates there are definitely opportunities, and when the dust settles more, there will be gems too in high yield. However, the economic uncertainty remains heightened and very much still developing. Caveat emptor.

**European Corporate Bond Spread**



Sources: Banque Heritage, Bloomberg

# DEMAND AND SUPPLY

The weekly stimulus printed by the Fed is currently running at \$550bn. This is equivalent to 5 times the annual Gold production pre-shutdown. The attractiveness of the asset from a supply viewpoint is therefore high. On the demand front with the level of the monetary stimulus, the economic uncertainty and low level of real yields, Gold is potentially a very exciting asset class for the years ahead. It is certainly a cornerstone of Banque Heritage portfolios.

We have been in a disinflationary environment for decades and frankly have not had to worry about inflation for such a long and extended time. The risk is always that this changes and with the current prospects of a recession, potentially, a new economic regime. We are currently experiencing a deflationary spiral with the way markets and economies have effectively collapsed overnight. However, the stimulus is a cushion to this which has been swift, unlimited and its definitely not finished. But as investors we must look forward and the clear risk is rising inflation. However, we all thought the same in 2008/09 with this new idea called Quantitative Easing (QE) but it may well be different this time. The amount of QE1 in 2009 was equaled in little more

than a week in 2020. The amount of money is therefore present and along with the velocity of money is what will cause inflation to rise.

Japan has been the experiment that has not worked for decades and a clear warning for what not to do. Japan had its debt crisis back in the 1990s where its corporate debt to GDP peaked in 1993 and troughed in 2015. It has failed repeatedly to produce inflation.

Governments will one day need to be paid back for the cost(s) of this stimulus and the easiest way for that to happen is through inflation and financial repression.

Rising prices may come from reduced globalization after the earlier trade wars and the impact of the virus on manufacturing as companies seek to shorten supply lines. Political pressure may also rise to bring components within borders to support jobs and lessen strategic weaknesses.

Regulations also, to make the banks lend money, something which did not happen after the GFC would put the money to work in the system. Inflation expectations amongst consumers and the business community have also been pretty much nonexistent. When that changes then people's psyche will also change. The data over the next few quarters will be highly skewed and not representative of inflation across a group of items

**Gold Price from 2008 to 2010 in USD**



Sources: Banque Heritage, Bloomberg





where demand changes have been brutal. It is debatable however whether the official government statistics ever truly represented the cost of living.

The rise in inflation is not imminent, but we believe there is a clear risk and this is another driver behind having a core holding in Gold and precious metals. Indeed, Silver might be one of the first asset classes to react given its mixture of precious metal demand and industrial demand. The other precious metals are therefore also likely to do well with their own idiosyncracies in terms of demand and supply. One of those is Palladium, which is a byproduct of Platinum, and has been in deficit since 2012 and saw an amazing price spike earlier this year. Globally, precious metals and in particular Gold are an under-owned asset class with the most common excuse being its lack of yield. The underfunded pension funds of the world have zero exposure and with little yield left on government bonds their argument has vanished. If holdings were to change by 1%, the impact on price and physical supply would

be colossal. The big buyers to date have been central banks, particularly in Emerging Markets and the rise of ownership through ETFs.

It is also an asset that has a solid 3000-year history and ultimately, relative to monetary policy today, a finite and capped supply profile.

Looking back to the last crisis the asset performed well over a longer time horizon. Investors just need to be aware that in times of stress the only asset investors and traders want is cash. During March to October 2008 Gold fell over 25% due to the stresses in the market. For the calendar year, 2008 however it returned 5% and went on to outperform equities. With the current virus, we have seen large supply issues in the physical market as refiners in Switzerland and South Africa have closed. Mines, too, have been shut which will cause bottlenecks in supply chains for months.

For portfolios with so few safe haven assets available, we see Gold as an important tool. Indeed, with the nominal yield of US government bonds near zero the lack of yield argument for Gold falls flat.

Yes, there are storage and delivery costs, but these are small and fixed. It has been a long time since we experienced the threat of inflation and that is another defense to holding Gold. The unlimited effective printing of money and stimulus may be inflationary if the velocity of money rises. However, even from a basic Economics 101 viewpoint, owning an asset with a limited supply is a much more certain investment. Fundamentally therefore the rationale to own Gold is clear, however, using, weakness and forced selling in times of stress, as opportunities is the most optimum way to add exposure. Looking forward, if indeed we see a regime change and central banks do create the inflation they seek, then Gold will find another driver.



# TRADITION

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