Market Outlook 2nd Quarter 2021

Diverging Recoveries

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Economic outlook

- We expect an economic upswing towards mid-year, fuelled by catch-up effects. The strength of the recoveries, however, varies across regions.
- Inflation is likely to surge in the coming months. This increase will only be temporary, especially in Europe.

Financial market implications

- The low interest rate environment remains intact despite the recent rise yields. Equities, corporate bonds and real estate thus retain their relative attractiveness, but are in many cases richly valued.
- Cyclicals should continue to benefit most from the economic upswing.

Risks

- Vaccination rollouts are progressing very unevenly. This poses the risk of new mutations of the coronavirus forming, which would again jeopardise economic normalisation.
- Uncertainty about the long-term nature of global inflation fuels fears of quicker interest rate hikes, especially in the US.

Global economy: the great divergence

The global economy is recovering from the coronavirus crisis, but at different speeds depending on the region. In order to prevent the outbreak of coronavirus mutations, tighter containment measures came into force, especially in Europe at the beginning of the year. These weighed on global economic growth in the first quarter. The decline, however, was less pronounced than in spring 2020 due to three factors: First, this time the majority of global supply chains remained intact; second, stimulus measures were already in place; and third, governments on average chose more targeted and thus less drastic measures (with the exception of EU countries like Germany).

As the vaccination campaigns progress, we expect a gradual easing of the current restrictions. This leads us to expect stronger growth overall again in the middle of the year, albeit with regional differences. These are likely to persist throughout the next few years (see chart 1).

One reason for the regional differences is that vaccination rollouts are progressing at vastly different speeds. Vaccine shortages and supply bottlenecks remain significant hurdles. On average, therefore, wealthy countries vaccinate 25 times faster than countries with the lowest incomes. But even within the advanced economies there are stark differences. Pioneers such as Israel or the UK have already vaccinated a large part of their population at least once, and in the USA all adults are to be eligible to get vaccinated by the end of April. The EU, on the other hand, is clearly lagging behind these countries.

Chart 1

Uneven recoveries

Real GDP indexed, 100 = 2019 GDP

125
120
115
110
105
100
95
90
12.19 12.20 12.21 12.22 12.23
China
United States
Euro area
Italy
World
Switzerland
Germany

Sources: Baloise Asset Management, IWF World Economic Outlook April 2021

Other reasons for the diverging economic recoveries are: the strength of the economy before the crisis, the dependence on tourism, and the extent of the measures taken by governments in terms of restrictions but also aid packages.

Switzerland: **Positive outlook after dampener at the beginning of the year.** The Swiss economy is recovering from the deepest recession since the mid-1970s. However, the renewed lockdown led to a feeble start to the year. Weakness in the labour market thus remains as the number of job seekers has continued to rise in recent months. The unemployment rate was 3.4% in March. For the hard-hit hospitality industry, the rate is 10% and thus about twice as high as before the

crisis (4.9%). Only in recent weeks have the leading economic indicators improved. The KOF barometer, for example, climbed to 117.8 points at the end of March, thanks to strongly positive signals from manufacturing, and is thus as high as it was last in summer 2010. This points to a robust recovery in the second quarter. With this, the inflation is set to gradually return to positive territory and rise to 0.7% by year-end.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	-3,0%	3,2%
Inflation (year-end value)	-1,7%	0,7%

USA: Massive support for the economy. After Congress passed a USD 900 billion fiscal package in December, it was followed up with USD 1,900 billion in March, as the labour market remains soft. In March, the unemployment rate of 6.0% was still 2.5 percentage points above pre-crisis level. This aid package, together with an strong vaccination rollout, provides an exceptionally strong basis for a swift economic recovery in the coming months. The latest leading macro data, such as the US manufacturing purchasing managers' index, shot up to 64.7 points in March. The last time the index was this high was in the early 1980s. According to the surveys, it is becoming increasingly difficult for companies to meet rising demand as the effects of the coronavirus limit the availability of materials. As a result, inflation expectations also rose. Especially in the next six months, inflation, as measured by the personal consumption deflator, is likely to exceed the Fed's long-term target of 2%. Currently, however, a decline is to be expected thereafter.

Government is also expected to support the economy in the longer term. Biden's government recently presented the first part of an eight-year plan to fundamentally modernise US infrastructure. The approximately 2 trillion USD, which is planned for bridges, roads as well as the energy and water supply, among other things, is to be financed primarily through an increase in the tax rate for companies from 21% to 28%.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	-3,5%	6,4%
Inflation* (year-end value)	1,2%	2,3%

* measured at the consumption deflator

EU: A sluggish recovery. Ongoing containment measures and disappointing progress on vaccinations caused the Eurozone economy to contract further in recent months. Services in particular are suffering from the current circumstances, while manufacturing is quite robust. The Purchasing Managers' Indices (PMI) for these two sectors for March signal that this trend will continue in the coming quarter. The development of the member states is also heterogeneous. The data point to an economic expansion of the entire monetary union. However, the growth engine remains Germany, whose PMI reached a 3-year high of 57.3 points in March. The figures for France and Spain, on the other hand, are only just above the growth threshold of 50 points. This divergence in growth dynamics is also likely to persist over the next few months.

Inflation has already risen significantly, from -0.3% in December 2020 to 1.3% in March 2021, partly due to large changes in the weightings in the index. A further increase driven by base effects and stronger demand is expected in the coming months (see Focus: Inflation section).

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	-6,6%	4,4%
Inflation (year-end value)	1,2%	2,1%

China: On a strong path despite low vaccination rates. Unlike in Europe and North America, where vaccinations are seen as the path to normalising economic activity, China seems to have the pandemic under control with quick and sharp lockdowns. For with only 10 vaccine doses administered per 100 inhabitants, China, like many other emerging countries, is lagging behind the advanced economies. For comparison: in the UK or the USA, more than five times as many vaccinations have been administered to date. Nevertheless, a relatively strong recovery in the manufacturing was already apparent a few months ago. And now the weaker sectors are following suit. According to the purchasing managers' surveys, confidence among companies in the service sector rose to a 10-year high in March. This is supported by the still generous supply of credit and liquidity. If the economic data continue to show strength and private consumption in particular continues to rise, the government is likely to be the only major economy to gradually reduce economic policy measures in the second half of the year.

Overview of figures, in % compared to previous year

	2020	2021
GDP growth	2,3%	8,4%
Inflation (year-end value)	0,1%	2,5%

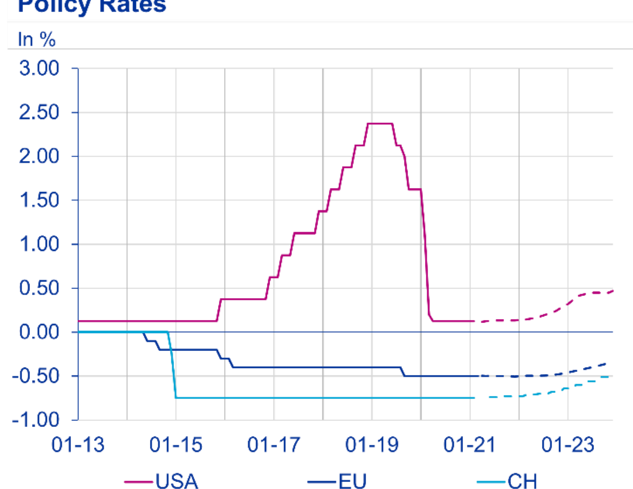
Monetary policy: Markets ahead of the Fed

The central banks' statements are clear, but the uncertainty surrounding the inflation trend is causing investors to doubt, which leads to volatility on the financial markets. The economy is being propped up with the help of low interest rates and government stimulus. This is pushing up prices and thereby fuelling inflation fears. To prevent the economy from overheating, central banks will have to raise interest rates sooner or later. This expectation is now reflected in the financial markets. Long-term interest rates have risen sharply, especially in the USA, where there has recently been strong fiscal stimulus. Since the beginning of the year, the yield on 10-year US government bonds has risen by around 80 basis points and is thus back at the level it was at the beginning of 2020.

The Fed's reaction was to emphasise that the rise in inflation is expected to be temporary and that this does not justify a change in monetary policy. It intends to leave its policy rate at the current level until the labour market has recovered from the crisis and inflation is at least 2% and trending higher. It also intends to continue to purchase bonds at the rate of $120 billion per month until substantial progress has been made on the employment mandate and the inflation target.

Unlike in the past, the Fed wants to base its monetary policy in this cycle on actual data and not on forecasts. Currently, it therefore does not foresee a rate hike until the end of 2023. Many investors see things differently. Prices on the futures markets indicate that investors expect the first interest rate hike at the end of 2022 and a further move in 2023 (see chart). Markets more strongly react to expectations than facts. We consider the current market expectations to be too optimistic and do not yet expect an interest rate hike next year.

Chart 2



Sources: Baloise Asset Management, Bloomberg Finance L.P. 10.04.2021

Long-term interest rates also rose in Europe, albeit less strongly than in the USA. The yield on 10-year Bunds is about 30 basis points above the year-end value, but at -0.28% it is still in negative territory. But even this increase was too much for the **European Central Bank** (ECB). It saw the danger that higher interest rates could slow down the economy. In March, it therefore announced that it would accelerate its bond purchases in the second quarter in order to keep the rise in interest rates in check.

Current prices on the futures market are signalling an interest rate hike in Switzerland. This is probably due to the global, or specifically the US interest rate increase and not the local economic environment. Indeed, the latest inflation forecasts of the **Swiss National Bank** (SNB) show that inflation will remain well below the 1% mark in 2023, even assuming that the key interest rate remains at -0.75%. There are therefore no signs of a more restrictive monetary policy in Switzerland in the coming years.

It remains to be noted that despite the recent interest rate rises, interest rates remain low by historical standards. However, the uncertainty surrounding the pace of interest rate adjustment in the US creates the risk of undesirable volatility in global financial markets.

Focus: Inflation

Inflation is likely to rise strongly in most regions in the coming months. Three driving forces are at play: base effects, supply-side bottlenecks and the massive fiscal stimulus measures. The first two forces are temporary effects for 2021. The third factor has long-term implications, but is primarily relevant for the US.

The **base effect** is a statistical phenomenon. Since inflation is calculated as a rate of change from the previous year, distortions occur if the base value, i.e. the value a year ago, was exceptionally high or low. Due to the drop in oil prices a year ago and the subsequent recovery, inflation rates will be higher in the coming months simply because of the oil price development.

With the economic reopening, a relatively rapid increase in consumption can be expected. However, the production capacities of many companies were severely restricted as a result of the pandemic and have not yet been fully ramped up again. This is likely to lead to **supply side bottlenecks** and thus temporarily to higher prices until supply can again meet the stronger demand. Companies are also increasingly reporting higher input costs in production because, among other things, raw material prices have risen sharply.

Chart 3

Inflation

yoy%

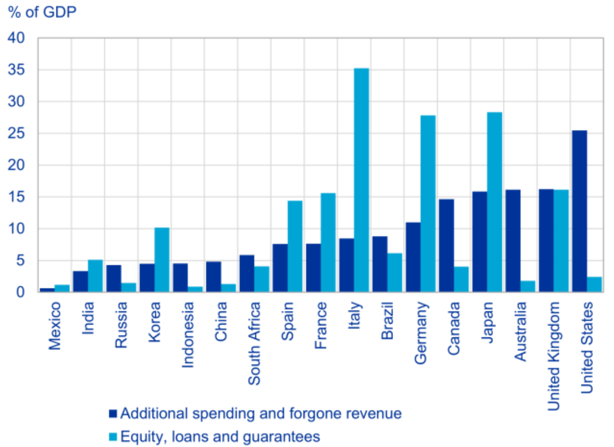
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0

12-15 12-16 12-17 12-18 12-19 12-20 12-21

Switzerland Eurozone USA

Note : For Switzerland and the Eurozone, inflation is measured by the national consumer price index (CPI). For the USA, the PCE deflator is shown, as the US Federal Reserve uses this measure as a guide. The forecast development corresponds to the current futures market prices.
Source: Baloise Asset Management, Bloomberg Finance L.P. 12.04.2021

Chart 4



Source: Baloise Asset Management, International Monetary Fund April 2021

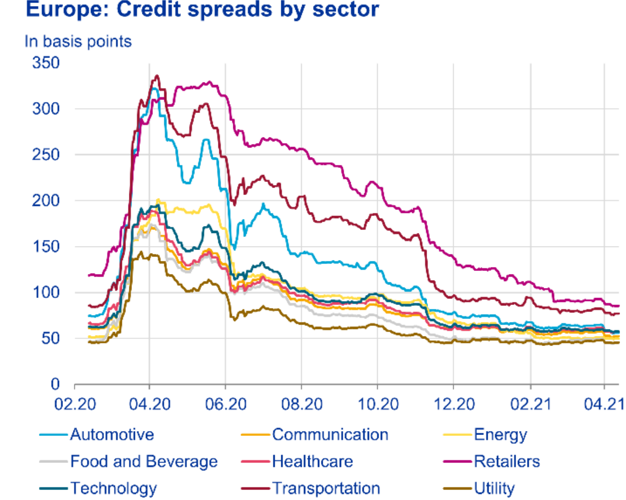
In response to the pandemic, governments implemented **massive aid packages.** How inflationary these measures are depends on how the stimulus enters the economy. In Europe, loans, guarantees and equity make up the bulk of the measures (see chart). These provide the necessary liquidity for companies, but do not cause consumer prices to rise much, i.e. they are not particularly inflationary. Additional spending on short-time work programmes should also be interpreted as shielding from deflation rather than a driver of inflation. The aim of such programmes is to reduce the loss of income of workers and thus prevent the collapse of inflation due to a slump in demand. In the US, on the other hand, the focus was more on additional spending, such as direct payments to households via stimulus checks, and on forgone revenues, such as tax breaks. Taken together, these boost consumption and thus inflation more than the aforementioned dominant measures in Europe. This means that the rise in inflation in the USA is more sustainable overall than in Europe.

Bonds: Low risk premia despite covid

Review: The US economy gained significant momentum in the first quarter as the US economy continued to expand. Higher government spending in combination with a restrained Fed decisively supported this development. Since the increased inflation expectations and the associated rise in interest rates for American government bonds are to be considered temporary according to the Fed's assessment, they do not pose a threat to economic growth. These brighter expectations were also reflected in the development of US corporate bonds. The average credit spread compared to government bonds with the same term tended to return to the pre-crisis level of around 95 basis points in the first quarter.

The ECB was keen to ensure favourable conditions on the capital market due to the fragile recovery of the European economy so far. Thus, the ECB emphasised that it would use its Pandemic Emergency Purchase Programme (PEPP) "decisively and efficiently" should interest rates rise to a level considered detrimental to economic recovery. The ECB's high level of activity in the bond market is also reflected in the very low level of credit spreads, which one year after the start of the pandemic are already at or even below pre-crisis levels across almost all sectors. Even sectors that were hit particularly hard, such as retail and transport (including airlines), no longer have an additional credit spread compared to pre-crisis levels, despite ongoing lockdowns and limited mobility (see chart).

Chart 5



Note: The basis for the presentation is the Bloomberg Barclays Euro-Aggregate Corporates Index.
Sources: Baloise Asset Management, Bloomberg Finance L.P, as at 12.04.2021

Outlook: In our view, fiscal and monetary policy support from national governments and central banks respectively in Europe and the US will remain. Both regions are still suffering from the aftermath of the economic turmoil triggered by the covid-19 pandemic. While the US economy is being hugely supported by further fiscal policy support, which brings additional inflationary pressures (see US section). However, we do not believe that the Fed will raise interest rates before 2023, on the one hand because it would actually welcome inflation rates above 2% for a while, and on the other hand because the US labour market remains fragile.

Against this background, central banks are likely to continue to play a stabilising role in the bond market in the coming months. We therefore expect credit spreads on European and American corporate bonds to remain stable at a low level.

Equities: Cyclicals catching up

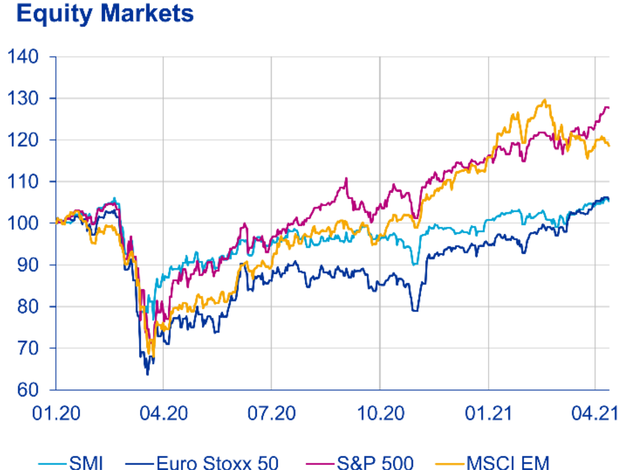
Review: Market expectations for the economic recovery are high. The year 2021 thus began positively for equities. The global equity market, measured by the MSCI All Country Index, rose by 4.2 % in the first quarter. As we expected in the last market outlook, cyclical sectors and markets in particular, such as the European stock market, were among the winners. The

performance of the Euro Stoxx 50, for example, was 10.3%. US stocks were also strong. These rose by 6%. Emerging market equities also had a strong start to the year. In mid-February, they were still almost 12% above their year-end value. However, fears of inflation and the resulting rise in US interest rates weighed heavily on this market in the second half of the first quarter. The high debt mountain denominated in US dollars in many emerging markets makes them particularly sensitive to US interest rate and currency fluctuations.

Outlook: Valuations in most markets remain well above average. Although high valuations primarily play a role in the expected return in the long term, they also make the markets more susceptible to price corrections in the short term. In addition, there is uncertainty regarding the development of inflation and interest rates. Since higher interest rates reduce the relative attractiveness of equities, further interest rate increases are also likely to cause price fluctuations in equities.

Chart 6

Equity Markets



Sources: Baloise Asset Management, Bloomberg Finance L. P., as at 12.04.2021

Despite gradual interest rate increases, the low interest rate environment remains intact. In addition, the stronger economic outlook makes us fundamentally constructive for equities. Specifically, we see further catch-up potential in the cyclical markets over the next three months. Ultimately, sectors such as industry and energy will benefit particularly from the economic reopening. Any corrections in the markets can therefore also be seen as an opportunity to make targeted reallocations to cyclical stocks and markets.

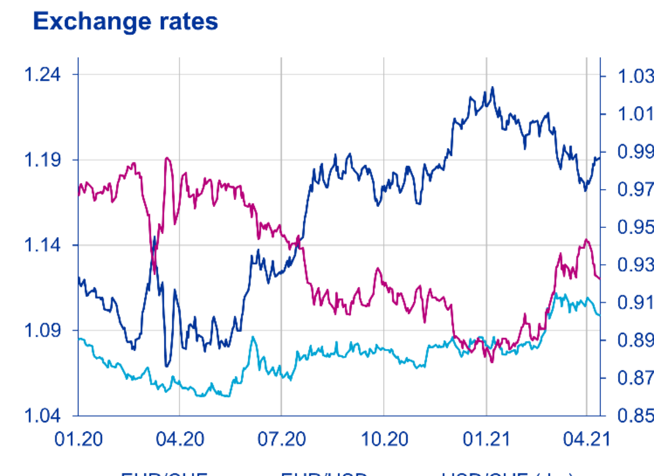
FX: Comeback of the US dollar

Review: At 1.11 CHF, the euro reached its highest level against the Swiss franc since summer 2019. As of 12 April, the euro had appreciated by 1.6% against the Swiss franc since the beginning of the year. The US dollar, which weakened sharply last year, also recovered significantly in the first months of the year. Stronger economic and interest rate prospects for the USA caused the US dollar to rise by 6.6% against the Swiss franc in the first quarter, before the strength subsided again in the first days of April.

Outlook: We expect an overall risk-friendly market environment to persist as the global vaccination campaigns progress. This somewhat weakens the appreciation pressure on the Swiss franc and thus the need for the Swiss National Bank to intervene in the foreign exchange market. However, the still sluggish economic recovery and the sluggish progress of imports in the euro area do not suggest a further strong appreciation of the euro against the Swiss franc in the coming months. The drivers of US dollar strength, however, i.e. the positive growth and interest rate differentials, remain intact and should continue to support the greenback in the coming months.

Chart 7

Exchange rates



Sources: Baloise Asset Management, Bloomberg Finance L. P., as at 12.04.2021

Real Estate Switzerland

Review: The ongoing hunt for yield and limited investment alternatives continue to fuel strong investor demand for real estate. The net initial yields on the transaction market, especially of very well-located multi-family houses, have continued to fall and are at 1.6%. In the first quarter of 2021, the yield differential between the purchase of a senior property and a ten-year government bond in the Swiss market remained unchanged at 2.2%, 50 basis points above the historical average.

Within the first quarter, the performance of real estate funds according to the SXI Swiss Real Estate Funds Total Return Index was +0.4%. At the end of February 2021, the average premium of the Swiss real estate fund market reached almost 34%. The difference in premiums between commercial real estate funds and residential real estate funds was around 14%. At the end of 2020, the premiums of residential real estate funds reached 43%, the highest level in the last twelve years - in the first quarter of 2021, this was still around 38%. Commercial funds are also relatively highly valued with around 24% premiums.

Chart 8

Real Estate Switzerland

2700
2500
2300
2100
1900
1700
1500
03.15 03.16 03.17 03.18 03.19 03.20 03.21

—SXI Swiss Real Estate Funds Total Return Index

Sources: Baloise Asset Management, Bloomberg Finance L. P. , as at 12.04.2021

Outlook: The outlook for real estate remains strongly dependent on the overall economic situation. If the vaccination campaign continues to gain momentum and the lockdown measures are gradually eased, we expect a recovery in Swiss economic activity from the second quarter of 2021. This, together with the persistent low interest rate environment, are positive supports for the real estate market. This means that the high valuations may persist in the coming months.

The risk is that although the overall economic outlook is brightening, tenant bankruptcies are likely to creep in, especially in structurally weak sectors such as hospitality, hotels and textiles. Thanks to generous government measures, a wave of bankruptcies as a result of the Corona crisis could be avoided until now, but in March 2021 the number of company bankruptcies now rose significantly in several regions. The bankruptcy rate for Switzerland as a whole is now significantly above the trend for the first time since the beginning of the crisis.

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Appearance
Four times a year, editorial deadline: 12.04.2021

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