CBH | Asset Management

Quarterly Insight

Summer 2020

Creativity within Excellence

Composition abstraite - Félix AUBLET
1961 - Huile sur toile

Index

Asset Allocation

		Neutral	Underweight		Overweight	Change
CASH	**$**	**5%**		**15%**		
	€			**20%**		
Cash	$	5%			15%	-2%
Cash	€				20%	-2%
CORE BONDS	**$**	**50%**		**28%**		
	€			**23%**		
Government 1-5Y	$	15%	0%			
	€		0%			
Government 5-10Y	$	10%	5%			
	€		0%			
Investment Grade 1-5Y	$	15%			20%	-5%
	€				20%	-5%
Investment Grade 5-10Y	$	10%	3%			
	€		3%			
SATELLITE BONDS		**0%**		**12%**		
High Yield 1 - 5 years					3%	1%
EM Hard currency					5%	1%
EM Local currency				0%		
Senior loans					2%	
Convertible					2%	2%
EQUITIES		**40%**		**36%**		
North America		17%	16%			1%
Europe		8%	6%			
Asia Pacific & Japan		4%	3%			
China		2%			4%	1%
Emerging Markets		3%	2%			
Global		6%	5%			-1%
OTHERS		**5%**		**9%**		
Gold		2%		2%		
Other investments		3%			7%	

Asset Commentary

We have entered a twilight zone where the government and Central Bank support mechanisms deployed in the lockdown have led to an uncomfortably yawning gap between valuations and fundamentals. For the time being, market sentiment has filled that gap, but as evidenced by the early June market jitters, this needs to be regularly sustained by government and Central Banks until economic conditions retrieve some semblance of normality. In the absence of a virus resurgence, we expect economic 'normality' to be reached in the third and fourth quarters of this year.

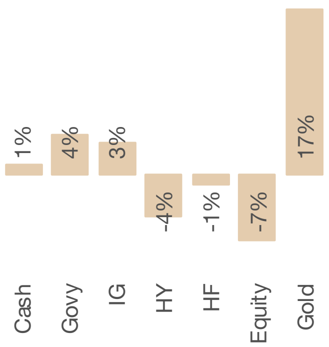
Economic background

Governments and central monetary authorities have thrown the kitchen sink at the economic depression caused by the decision to lock down economies. This in turn has resulted in a steep recovery in asset prices from the end of March nadir with credit assets driving the recovery, followed by a strong equity rally.

As far as we can analyze the current situation, the asset price reflation of the past two months is for a large part due to governments and central banks' heavy interventions. These have caused market participants to see beyond the expected trough in activity in the second quarter.

However, the sentiment wall is now facing a wave of economic bad news in what is typically a low liquidity point for markets. In our view the wall will hold if evidence of a pickup in economic activity comes quickly onto our screens. This in turn will largely depend on the shape and velocity of the recovery in economic activity.

Market performances (in %)



Cash

We have maintained high cash balances in EUR and CHF whilst being closer in USD to our benchmark. As the decrease in policy rates continues with the Fed toying with the idea of negative rate, we see a nil to negative carry situation for the foreseeable future in cash like investments. We are addressing this by reducing slightly our cash allocation to deploy in credit, emerging markets and equities with selectivity and measure.

Fixed Income

Our allocation away from government bonds into investment grade paid out and we look to paring it down slightly. Supply of US and European government debt will be sustained to pay for the Covid 19 lockdown bill, with a likely negative effect on prices. This makes us wary of duration risk. In credit, the opportunities offered in the mid-March sell off are now largely gone. The risk/return balance thus looks less compelling in investment grade even if the Fed and ECB support continue to keep a lid on yields. We are now more constructive on the higher quality part of the non-investment grade complex but stay away from the lower ratings where a wave of defaults will likely materialize.

Emerging markets in hard currency may offer an interesting case as the price action in the asset class is not adulterated by the ECB and the Fed actions. As yields compress in other markets, EM should too benefit from crowding out effects.

Equities

For US Equities, the catch up was strong from early April, halted only mid-June as doubts over valuations and upcoming catalysts got stronger. This turnaround was largely due to the rude health of tech issuers, which for some of them benefited from the shift in consumer activity during lockdowns. Then equities from more cyclical and depressed sectors caught up rapidly but still remain well below their pre Covid levels. European equities are still hamstrung by a smaller technology component and will as a result likely remain a disappointing equity trade over the longer term.

EM equities should be well supported with China leading the way whilst we expect US equities to continue to be supported by the resilience of technology companies. Similarly, we expect convertible bonds to pursue on their strong trend this year.

Others

The end of April dislocation that came on the back of a demand fall, a supply increase and a storage glut is now well passed us. At this juncture, we expect oil to stabilize around current levels as demand is gradually restored. Gold prices have been in a corridor since mid-April and only recently broke their range as risk markets became more unstable. At these levels we feel comfortable with our current neutral positioning.

Macroeconomic Scenario

Asset valuations have been reflated by the intervention of governments and Central Bank actions. The help packages have been large enough to wipe out the shorts and silence the doubters. Money did reach citizen's pockets in the lockdown months. In a historical move, governments and central banks have substituted money creation for economic activity with post war like debt to GDP ratios as a result. Only in a few months will we know whether the bet made by governments has worked by looking at the speed of the recovery. Markets in the meantime have assumed a fast fundamental recovery with little room for disappointment priced in. Experience teaches us that things are unlikely to be that simple.

A wave of bad news to digest

After months spent in an exceptional volatility regime, the market has found a state of stasis with not much apparent investor appetite to go significantly risk on. After the strong recovery experienced in April and May, questions have surfaced along the following lines :

Could a virus resurgence place parts of the global economy in lockdown again?
Our working assumption here is that there will be flare ups and clusters until the autumn and if the Covid 19 experiences a resurgence, governments will be better prepared, reducing the need for governments to go in full lock down.

How much permanent damage has been wrought on the largest economies?
The short answer is a lot in a short period of time with a significant increase in joblessness and bankruptcies expected in the autumn. We are fully expecting a wave of disastrous second quarter results accompanied by patchy management guidance in key sectors notably automotive, aerospace, tourism & hospitality, oil & gas, metals and mining as well as discretionary retail.

How fast is the economic recovery taking hold and with what level of quality?
The answer so far is patchy with the reflation in PMIs accompanied by a rise in early economic indicators, notably car sales. That said the May and June numbers will be influenced heavily by discounts and state incentives. The evolution of the economic situation in China helps to form a view as to the potential recovery with economic data coming to some form of normality three months after the end of the mass lockdowns.

In the meantime, we expect the data for the second quarter in Europe and the US to be abysmal at both the macro and the corporate levels. These will likely be worse for a lot of sectors than the already memorable Q3 data of 2008.

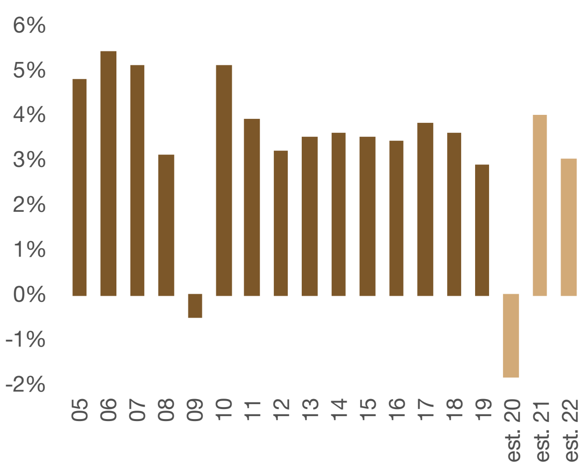
Adjusting our scenario: more of a square root than a V

In our last edition, we had factored in a contraction in global growth of less than one percent, an already steep fall from the three percent growth forecast that the OECD and IMF had in the cards for this year. As we stand, consensus is at -3.7% where the IMF has a 3% contraction and the OECD a severe and probably too pessimistic 6% decline. These are just numbers and provide an inherently crude representation of what may happen for the remainder of this year.

A lot will indeed depend on how fast the main economies will lift off, how much demand and jobs will have been destroyed and how fast unemployment will subside. Crucially, it also depends on a relatively quiet sanitary front in most jurisdictions with Covid 19 flare ups restricted to a few areas and being dealt with quickly. We would contend that the more the scientific world knows about this new disease, the less likely a second full lockdown is with partial measures likely to be implemented. In addition, we believe that a lot of countries have learnt their lessons, making sure that personal protective equipment is restocked in quantities and room is created in intensive care units before the autumn where fears of a virus resurgence may materialize.

The reopening of European countries and the US is taking somewhat longer than per our initial anticipation, leading in turn to a softer recovery in the third quarter of this year. Over the next few months the data will largely be about pent up demand being satisfied. The key question will then be about how much demand is around at that point. This will depend in turn on the state of consumer confidence – driven largely in our view by joblessness - in the third and fourth quarter of this year and into 2021.

Global growth – history and forecasts

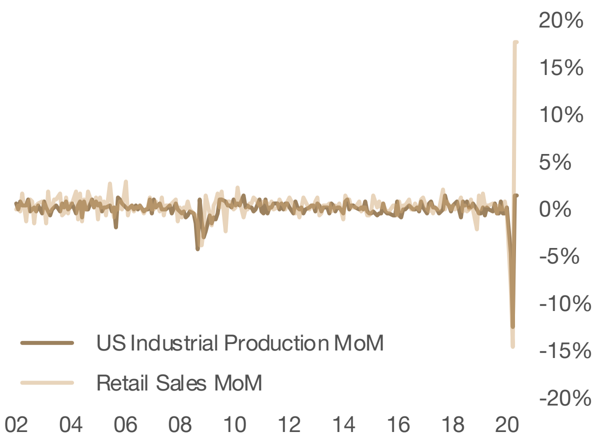


We believe that the contraction in economic activity is likely to be slightly more severe for the year than what we had in mind in April with Europe and also partially the US the main culprits. We now see a contraction in global economic activity of close to 2% against a previous 0 to 0.5% contraction for this year.
We expect the level of economic activity to recover at a slower pace given the longer than anticipated lockdown in Europe and the fact that large parts of the US are still grappling with the initial stages of the pandemic with certain states deciding to slow down their economic reopening.

A tale of two numbers

A striking example of what the main economies have become can be best illustrated by the juxtaposition of the US retail sales change and the US industrial production numbers for May. As shown in the chart below, it is clear that both quantum have recovered but the pace is much faster in retail sales than in industrial production.

Rebound in US retail sales outpaces industrial production



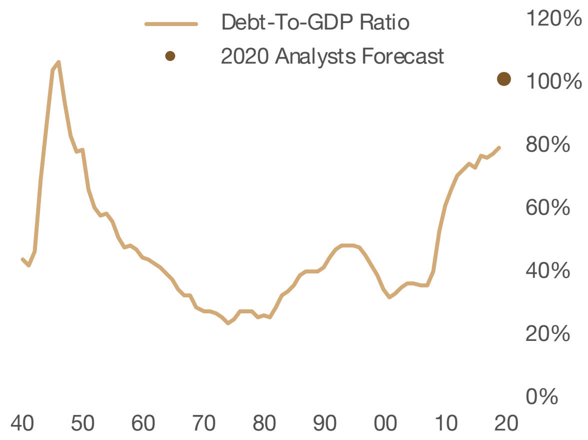
The fact that the two are recovering out of sync is testament to the efforts deployed by the US government in terms of aid packages – true helicopter money and the Fed's accommodative action.

Looking at the chart, it is clear that governments have replaced economic activity with money creation. That part of the bet coming from the implementation of the emergency measures taken in March and April has worked well so far.

Replacing economic activity with money creation

As we previously wrote, central banks have been backstopping governments, which in turn are backstopping their economies. The target is double for authorities: (i) make sure that households and companies have enough liquidity to go through a quarter of deeply depressed economic activity and (ii) reduce the risk to find their economies so damaged by the economic consequences of the lockdown that they are unable to re-start. The situation is reminiscent of the US after world war two without however the human damage but the debt to GDP ratio look familiar.

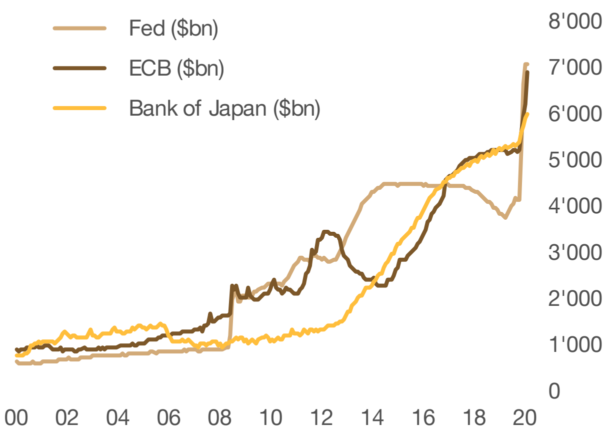
US debt to GDP: post war like metrics



The implication from this is that countries will experience a significant increase in debt balances this year, which will likely pull down the credit rating of the jurisdictions that had to contend with high indebtedness before the pandemic started. This has been reflected in a number of negative rating actions on sovereigns and affiliates. That said, rating agencies factor in their ratings Central Bank actions and financing solidarity undertakings between country groups.

That said, no one at this relatively early stage knows how these increased sovereign debt stacks will be dealt with in the future. However and unlike what happened after the Great Financial Crisis (GFC) of 2007-09, no government is moving towards austerity inspired policies and the intention is firmly to provide economic support in the reopening phase.

Central bank balance sheet on the rise



As evidenced in the chart above, the balance sheets of the main Central Banks have inflated beyond recognition. This is not an issue in our view as long as the Central Bank support is temporary and ebbs away towards the year end and beyond. There will be clear differences in the Central Bank support phasing out process over the next few years with Europe likely to emerge in the very last stages out of QE – if ever at all.

Quousque tandem?

There are several issues in our view to an indefinite extension of support measures. Central Banks remain one of the last bastions of credibility in the economic system and that credibility has proven critical in the response to the current crisis, particularly in the initial stages when they prevented a full credit market meltdown through the implementation of quantitative easing measures.

It is thus crucial that the world's largest economies start catching up in terms of economic activity to bridge the gap with the levels of spending fostered by governments and central banks help packages. The first indications that the bet has worked will be in the speed of recovery in the employment market. It is highly likely that the unemployment rate in the world's largest economies will shrink fast initially as economies reopen and activity restarts.

The danger lies in a more prolonged reduction in joblessness during what one could call the second phase of the economic recovery, ie when pent up demand has been met and not much is in sight in terms of economic growth. Avoiding a stagflation that could spawn economic problems, social discontent and political disruption in line with what large economies have experienced after the great financial crisis of 2007-09 should be at the forefront of policymakers' minds when they decide to pare down support mechanisms.

The world's largest economies have placed a large part of their working population under some kind of furlough arrangements. The continuation of these arrangements, whilst demand is gradually rebuilt and firms recover, will be key to maintaining social cohesion in a lot of developed economies. Furlough and state payments are only useful after all if people have a job to return to.

Once we have passed the current economic trough, governments and central banks will have burnt through a lot of support flexibility. The immediate implication is that the global economy can ill afford a crisis of a similar magnitude until at least some buffers are rebuilt to counter the next crisis. There is indeed a probability albeit minute at this stage that the confidence in the nature of money may be eroded through all the money printing and debt raising that has happened over the last 12 years.

Our 2020 economic scenario in brief

US GDP growth - 2% to -1.5%

We are assuming a second quarter deep trough followed by a relatively strong recovery at the back end of the year

US CPI 0.5%

The reduced activity level and the significantly lower oil price will dampen inflation further at least until the crisis ends

US Fed Funds rate 0%

Cuts have been broad and fast with the Fed acting also through unconventional measures. Rates will remain low for some time to come.

US 10-year yield 1% to 1.5%

Treasuries have hit an all-time low at the height of the crisis. Under our normalization at low level scenario, these should ease off

Eurozone growth -1.25% to -0.75%

Overall economic performance will be dampened by Italy and Spain and we expect a more timid recovery than in the US

Eurozone CPI 1%

We follow the consensus there, seeing risks tilted to the downside

EUR Refinancing Rate –25bp

QE has been the privileged route for economic support but we expect additional rate cuts to come in addition

German 10-year yield -0.25% to 0%

The broadening of QE has removed some underlying technical support for the Bund with EU periphery government bonds and IG credit benefitting

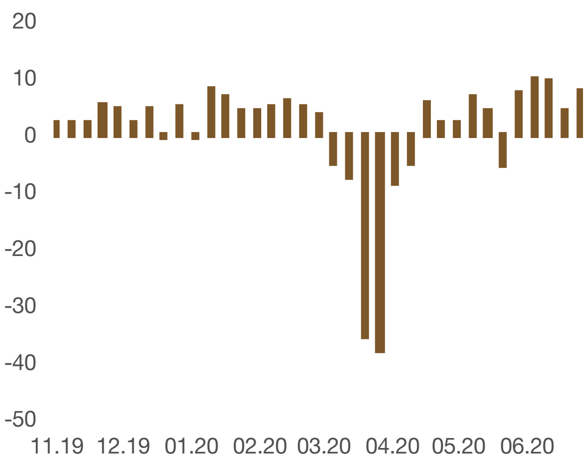
Fixed Income

A full meltdown of credit has been averted thanks to the intervention of central banks and governments. The record outflows in investment grade and high yield have been followed by inflows of a superior magnitude. Those were matched by historically high levels of issuance across the credit spectrum as companies scrambled to raise liquidity at increasingly favorable terms. The technical bid from Central Banks is keeping a lid on yields in developed government bonds and investment grade credit. This in turn creates crowding out effects for the high yield and emerging markets.

Central Banks check books are open

After a first botched attempt in March, the Fed and the ECB set out in April to pour enormous quantities of liquidity on the raging fire of market volatility. The worst was avoided with a normalization of spreads that brought back large inflows into credit markets.

US Investment grade weekly fund flows (USDbn)



After having tapped their liquidity lines to raise cash, corporates then issued bonds in size, making sure for the most part that they would have enough liquidity to face the second quarter activity trough and the subsequent uncertain recovery.

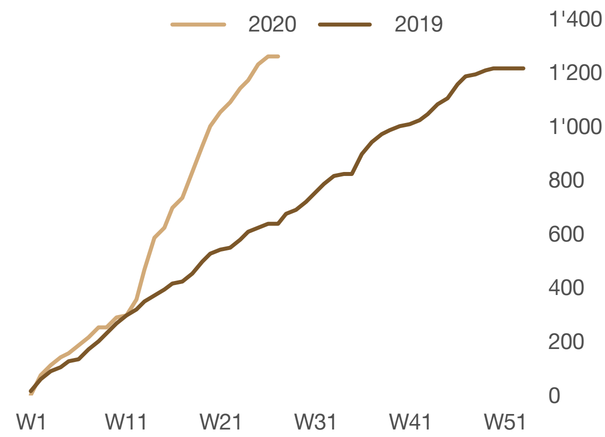
Central bank activity is now close to what has been dubbed yield curve control in both the US and the Eurozone. The main consequences of this heavy handed intervention are as follows :

The US government curve is unlikely to move significantly in the near term. The Fed may explore the possibility of negative policy rates but will likely hold out for as long as feasible.

Eurozone government bonds have experienced crowding out effects away from the core into the periphery. This makes BTPs attractive at nearly every spread widening opportunity. Should the Franco German attempt at a EUR750bn grant aid package be successful, it could mean a sea change in the structure of the Eurozone debt with funding coming through a solidarity mechanism managed by the EU Commission. These would be the first true Eurobonds and would be a major paradigm shift for the Eurozone.

US investment grade is technically supported both at the ETF level and by the Fed directly, which has now started purchasing bonds as part of its USD750bn secondary and primary market programs. So far the Fed has used up to 1% only of its purchasing power.

Weekly cumulative issuance: record amounts yoy (USDbn)



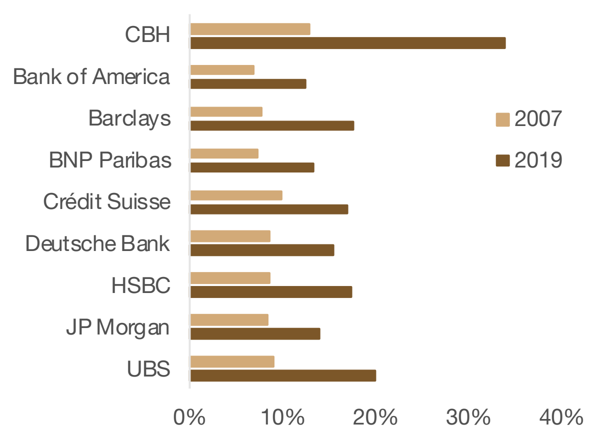
Euro investment grade is under the same technical underpinning with the ECB's EUR1.35trn program entailing the Pandemic Emergency Purchase Program (PEPP) and the well-known CSPP. The program was extended by EUR600m early June. The ECB has used up 17% of its buying program to date.

Banks are in a better place – insurance uncertain

Despite initial misgivings about banks in the early part of the pandemic, these have proven remarkably resilient to date. The buffers built up after the great financial crisis of 2007-09 have fully played out. Of course the road ahead could be rocky with rising personal and small and medium enterprises defaults but the much derided stress testing by banking authorities is now proving to have been a useful exercise. We also note that regulators have provided the sector with some relief on additional counter cyclical regulatory measures as well as accounting changes implementation.

In the second quarter, banks will provide additional and perhaps truer color on the provisioning for the pandemic. In the first quarter, the banking sector has taken precautionary provisioning but we highly doubt that it will be enough to cover for the second quarter damage. That said, we fully expect the larger and systemic institutions to withstand the shock induced by the first phase of the Covid 19 lockdowns.

Bank Tier 1 ratios then and now



We are slightly more cautious on the insurance sector, outside of insurers with very specific business models such as motor insurers, which have hardly experienced payouts during the lockdown period. In particular, re-insurance is giving us cause to be prudent as we do not know how the business interruption payments linked to the pandemic will be treated, particularly for the hospitality and tourism businesses. Again second quarter results will help provide context on what the state of claims is for each category of insurance companies.

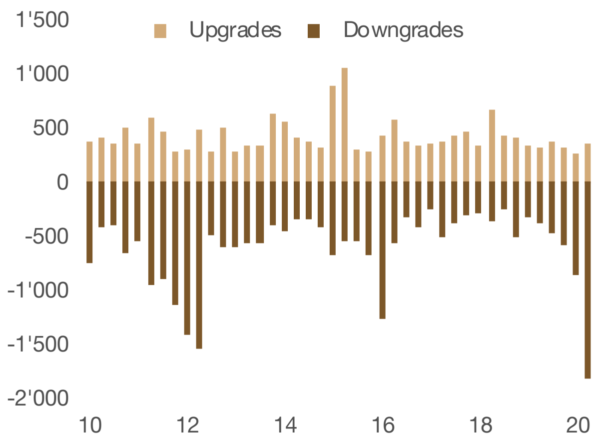
Rating agencies in the mood to downgrade

This has been one of the most brutal period in terms of rating agency actions, with the ratio of downgrade to upgrade reaching a ten year high at 5.3x globally. This is the highest number since the Eurozone crisis, which produced 4.6x more downgrades than upgrades in the first quarter of 2012. The number of downgrades relative to upgrades was particularly elevated in Latin America and in Asia with Europe and the US coming below the global average.

Rating agencies have clearly not given many issuers the benefit of the doubt and have acted in a fast and determined fashion, helped in that no doubt by the amounts of leverage built up over the recent years.

Looking ahead, we expect the ratio to normalize as we move into the third quarter. The number of daily downgrades has abated as we write but given the fair proportion of ratings under review for downgrade, we can expect another – smaller wave after the second results come out end of August.

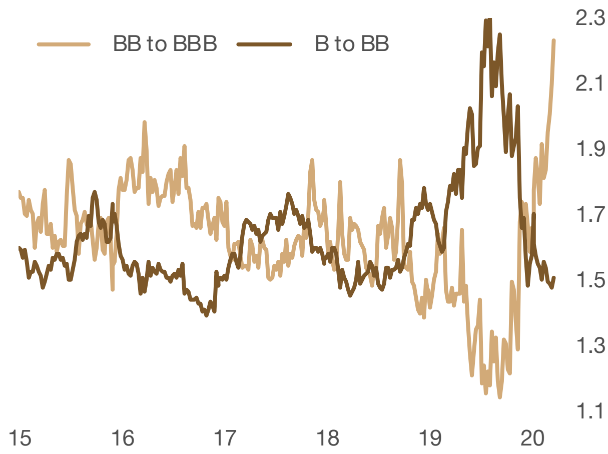
Moody's upgrades vs downgrades



High Yield: defaults vs fallen angels

This downgrade spree has resulted in a historically high number of fallen angel situations – companies downgraded from the investment grade into the non-investment grade category. At end of June, the number of fallen angels was indicated by S&P at a record 30 issuers including some very large borrowers such as Kraft Heinz (USD32bn debt), Occidental Petroleum (USD47bn) or Ford (USD105bn with Ford and Ford Motor Credit).

BBs look attractive again – spread multiples



The number of potential fallen angels – companies that are rated BBB- with their rating under CreditWatch Negative - as measured by Standard & Poor's is now at 126 companies, suggesting that the number for the full year is likely to be one of the highest ever attained.

This in fact has provided a wealth of opportunities as companies coming with large debt stacks in the high yield universe typically see their bonds decline in value ahead of the actual downgrade. Once this happens, management typically put in place some balance sheet protection measures such as dividend, costs and capex cuts. The spread premium offered by the BB credit rating category relative to the BBB stack is now at a 5 year high and we believe investors should capture this opportunity.

In addition, the Fed has indicated that it would be including fallen angels as part of its secondary market bond purchase program, provided that the company was rated investment grade as of March 22.

Early refinancing exercises to address short term maturities have been common to extend maturity points. We have seen a number of stressed exchanges at the deep end of the non-investment grade spectrum where companies have experienced catastrophic declines in cash flow generation.

Moving another rung down means addressing the rise in defaults that has caused companies such as Hertz or Chesapeake Energy, which presented a high level of fragility before the Covid lockdown struck. Defaults rates in high yield, typically a lagging indicator in any credit cycle have shot up to 4.6% as of end of May and on their way to reach 5% by end of June. By way of comparison, the default rate in 2009 rose to 12%. The rating agency expects the default rate for this year to come above 10%.

The implication from this is that as much as we view high yield as benefitting from the crowding out effects of the QE programs from central banks, there was never a better time to be selective on credits and focus on large BB rated issuers with the financial surface and asset base necessary to engineer a turnaround. The lower end of the ratings spectrum is soon to turn into a land of opportunities for the specialist distressed players with some high profile restructuring situations currently hitting screens.

Emerging markets: away from the Fed and the ECB

Outside of China and South Korea, EM economies largely came in late in adopting lockdowns and social distancing measures and were also negatively affected by the lack of export demand as well as by the fall in oil and gas prices. In addition, EM policymakers could not adopt to the same scale the fiscal and monetary response that helped softening the blow in developed economies.

Nonetheless, there are bright spots on the horizon with China's economy coming back, driven by domestic demand, liquidity injections and better than expected exports. That said, the recovery in economic conditions across the EM world is contrasted. The "good students", which adopted swift and drastic policy responses flattened the infection curve enough to favour a faster economic rebound. In this group, we can include China and North East Asia (especially South Korea) and Poland to name a few examples.

By contrast, "bad students" that were late in adopting solid policy responses are still suffering from accelerating infection cases and have still not flattened the infection curve. In this group, we can include the LatAm region, in particular Brazil and Mexico, India, Indonesia and Russia where the situation is improving.

EM sovereigns and Corporates spreads

This feeds in our preference for Asian markets, where risk-adjusted dynamics are more compelling. A quick rebound in EEMEA is constrained by uncertainty about infection rates and narrower policy space. Similarly, LatAm countries are likely to experience a slow rebound with major economies still fighting to contain the virus spread. Smaller economies like Peru and Colombia are likely to rebound faster than the largest LatAm economies as investment could resume rapidly.

With the output and revenue loss suffered by EM governments, pressures on expenditures related to Covid-19 and the need to support the recovery, fiscal deficits have risen everywhere. The financing of these deficits places many EM countries in front of difficult choices with stronger countries able to access primary markets.

For the weakest one, bond markets are still closed and the IMF has disbursed more than $25bn of emergency financing to EM countries so far. Given the magnitude of the shock and the already challenged financial position of some EM countries, the argument to provide more meaningful liquidity provisions, coupled with debt relief measures, gathered momentum among G20 countries. However, no consensus has been reached on implementation. Weaker countries are likely to ask for a higher participation from the private sector (i.e. Argentina, Lebanon, Ecuador, Zambia). Involuntary pre-emptive debt relief measures for a potentially large list of additional countries may further weigh on investor appetite for the frontier segment of the EM sovereign credit market. The same reasoning can be applied to the corporate sector, where the weaker credits are likely to struggle to refinance upcoming maturities.

As the rally goes on, carry trades between HY and IG credits that worked well in Q2 still have room to go. In the EM corporate sector, we anticipate some further spread compression in Asia albeit at a slower pace and against a pickup in supply. In EMEA and LatAm, we still see potential value in large, liquid quasi-sovereigns eg Petrobras, Ecopetrol, etc and in large corporations, which have enough financial resources to stay afloat eg. America Movil, Lukoil, Suzano to name a few). Opportunities still exist in riskier part of the EM credit universe, but we advise to approach this segment with selective caution.

A word on local currency debt

EM central banks have reacted to the crisis by reducing policy rates, sending short-term real rates sharply lower. We expect further policy rate cuts during the year. This should be positive for economic activity, but prospects of a more systematic monetization of government debts is likely to lead to increased risk premium in local-currency assets, including currency depreciation. This is likely to add to the existing pressures on EM currencies leading us to believe that this is too early in the day to consider this type of investment.

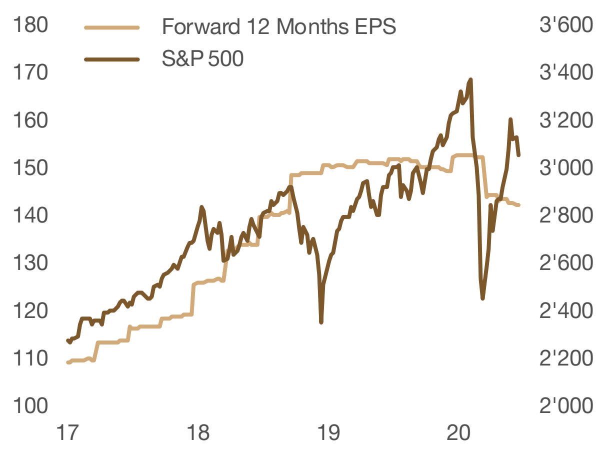
Equities

The V shaped recovery so far has been more of a reality for equity markets than for the real economy. The US markets and their high tech component were at the forefront of the rally with Europe catching up to some degree as investor sentiment improved. The market since mid-June has been in a wait and see mode with corporate results due end of July forming the next significant data point. Even if the re-opening of the main economies has gradually started, it is somewhat early for non tech sectors to reflect this with optimistic certainty. In that context, we continue to favor growth over defensive quality strategies and continue to see China and generally Asia as attractive.

V shaped for how long?

After going through Armageddon end of March, equity markets in developed countries have reflated strongly in the subsequent months until early June. US tech led the way with other sectors catching up subsequently until early June. Other markets followed with China remaining solid and Europe finally catching up.

S&P 500 comes back but EPS do not yet



At this juncture, the key question is how strong and lasting will the rally be? Our answer is that away from tech, healthcare and retail names, corporate fundamentals are for the most part badly damaged. The news flow momentum in terms of macro and individual issuer is unlikely to be positive in the short and that valuations are inflated by the various aid packages and central bank intervention.

This is the main reason as to why we are reluctant to increase significantly our allocation to equities at this current stage. We will be looking at the results season with great interest and once that data point is passed us – and the seasonal August liquidity trough too – we believe that we will be on stronger ground to make that call. For the time being, we are content with increasing slightly our exposure to US equities as well as to convertible bonds.

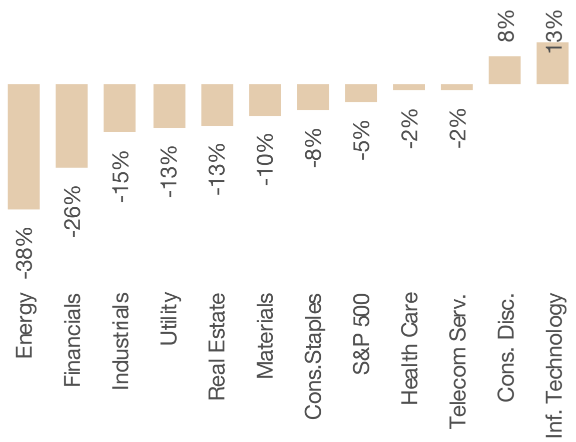
As a more general statement, we believe investors should focus on the long-term quality and viable companies with attractive dynamics almost regardless of the price or the valuation.

Another feature of this market is that investors need to be more dynamic than in the past in order to take advantage of corrections and rebounds, which tend to be stronger but also much shorter.

Our sector picture: tech is still privileged

In our previous edition, we did lay out, which sectors were likely to be the winners and losers of the Covid 19 lockdowns. Looking back, our view has evolved slightly even if we still favour the technology and healthcare sectors, which will continue to benefit from the Covid-19 uncertainty for several months. The two sectors are also part of a secular trend and are preferable to cyclicals, value issuers and non-US equity for the time being.

S&P 500 performance by sector



We also look increasingly at all the traditional sectors which are implementing restructuring plans under the cover of the virus. The nature of those plans typically implies large workforce cuts and production overcapacity reductions, measures that would have been unacceptable before the Covid pandemic.

One clear example is the automotive sector, which is currently experiencing an industrial paradigm shift with the electric car, autonomous driving and online sales. In addition, the low rates environment and various government incentives have improved customer access to new vehicles. The billions invested in electric car development will finally lead to the emergence of models able to compete with Tesla and create an area of growth and margins build up for the sector.

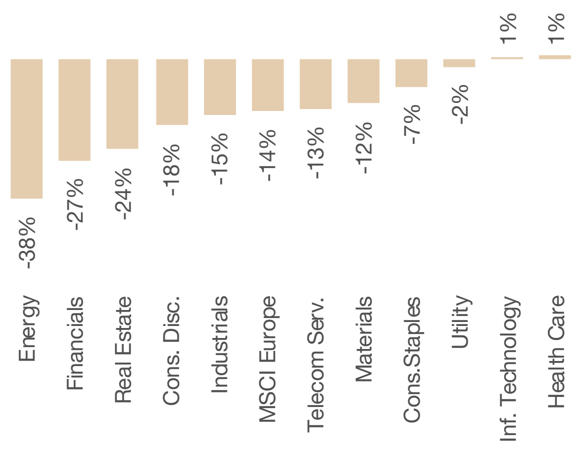
We stay away from banks and insurance, which will probably experience the negative consequences of low interest rates and strong competition. We would also exercise caution on commercial real estate in contrast with residential, which should continue to benefit from low base rates and demographics.

The energy sector has already bounced back strongly during the last quarter. Uncertainty about a lasting economic recovery and a fragile agreement between the producing countries could result in volatility for the sector in the short term. We still remain positive in the medium term, because the producing countries will experience rising pressure in order to balance their budgets, leading to firmer production compliance to support prices.

Finally, turning to the tourism sector, we think there are opportunities laying around but also too many unknowns at this current stage. Therefore, we see it as a sector fit for investors with more aggressive styles - either through long term positioning on high quality names or through strategies targeted at benefitting from high volatility.

To conclude, we do not actually believe in the "growth to value" rotation phenomenon that worked well in the last few weeks and that some market actors are suggesting to play in future quarters. With PMIs having normalized, more good news are needed in order to see a stronger rebound. Moreover, the absence of a rise in bond yields is another reason why we believe the tentative rotation into value is unlikely to last.

MSCI Europe performance by sector



Dividend yielders: interesting but too early

The start of the crisis was all about the rush to raise liquidity amid a disastrous sentiment landscape. Companies picked up state aid packages with the oft discussed constraint on dividend and share buyback restrictions. As the crisis ebbs off in financial markets largely thanks to central banks and governments' intervention, we start to see rising impetus from certain sectors to lobby governments or regulators to be able to pay dividends. European banks in particular have indicated that they would engage with the ECB and the EBA on the topic. We doubt none the less that regulators and governments will be sympathetic to such demands given the scale of the stimulus packages that have still to be rolled out.

The low interest rate environment and the normalization of credit spreads throughout the investment grade universe means that investors are likely to look at ways to get income beyond fixed income. Should the economic recovery take hold for the traditional dividend yielding sectors such as energy, retail and banks we would expect these to catch the eye of yield hungry investors.

Commodities

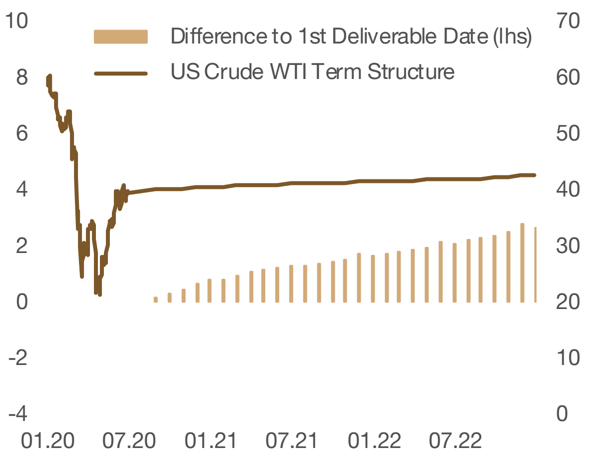
After plumbing new depths in April, oil prices firmed up and normalized as the glut in production and storage subsided and the tensions between the Opec+ countries eased. The re-opening of the larger economies will likely add fundamental support to the oil price in the short term. Away from energy, we find gold is in a ‘do nothing’ pricing zone with more upside potential for precious metals likely to benefit from a recovery in industrial activity, albeit gradual.

Oil: rebuilding the market

The Covid 19 lockdowns, added to the collapse of Opec+ negotiations in March, resulted in a historical production glut, a saturation of storage capacity and a fall in the contract for May delivery to a negative USD37.7 per barrel.

The situation improved markedly after the Opec+ countries agreed on production cuts in May, which were prolonged in June. The organization indicated also that nations that were non-compliant in June must enact additional production cuts for July, August and September. The move in May combined to the restoration of demand in China notably put oil on a stronger footing, with prices normalizing to the USD35-55p.b. range.

Oil term structure shows normalization signs



This has helped the US high yield market where the proportion of energy producer rose following the downgrade of Occidental Petroleum. EM oil and gas exporting countries also benefitted at a time when their economies are constrained by the cost associated with the Covid lockdowns.

At current levels, we do not see a lot of upside on oil prices and potentially some downside should the Opec+ production discipline break down further, leading to tensions in the cartel. In the meantime, the reprieve gained on prices is helping the better shale oil and gas producers, but was too late for some of the already troubled players such as Chesapeake Energy.

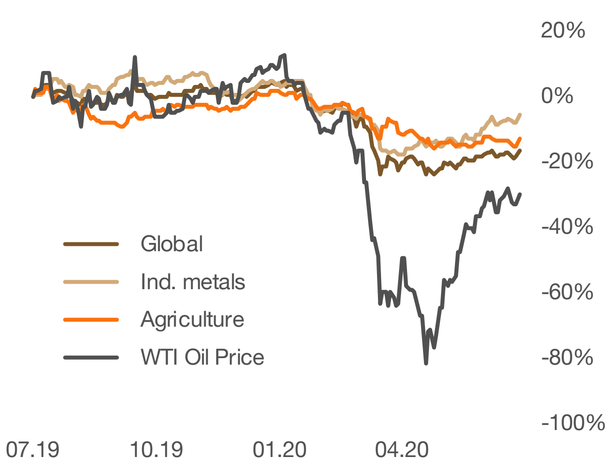
China oil consumption recovers

Commodities: base metals rise

Base metals have held up well – better than what the situation at end of March would have warranted. This is testament to the efforts put in place by mining companies in 2016 and after to reduce capacity around their more profitable assets and restrict capex expansion.

The temporary closing of mining capacity for health reasons helped also. Now that the Chinese economy has reopened, we feel that copper and certainly zinc are on a stronger footing. Iron ore is at elevated levels – this should not last long as mining sites reopen but steel producers will certainly feel the price increase of iron ore in their Q2 margins.

Commodity prices panorama



As we highlighted in our previous edition, the increase in agricultural goods prices was indeed temporary with levels declining in April and May in line with their previous trend. One driver was the normalization of wheat prices after the March spike.

Gold – price is getting stretched

After the selling pressure from end of March, linked in no small part to the need to satisfy margin calls, gold prices rose in April, exhibiting a positive correlation with risk assets.

This regime ended end of June with gold prices moving out of the USD1680 – 1750 an ounce range to edge closer to 1800 and the all-time high attained in September 2011 at USD1900 per ounce

Smiling gold, depressed platinum

Despite our view that risk assets could experience a potential draw down in the weeks to come, we are reluctant to buy into gold at such elevated prices.

At this current juncture and as economies gradually reopen, we believe that silver, platinum and palladium, which have all industrial applications and less wealth storage value could be interesting bets.

Currencies Market Expectations

Major Currencies

		Q3-20	Q4-20	Q1-21	Q2-21	Q4-21
EURUSD	1.12	1.12	1.14	1.14	1.15	1.17
EURCHF	1.06	1.07	1.08	1.09	1.10	1.12
EURGBP	0.90	0.90	0.90	0.89	0.89	0.88
EURJPY	120.9	120.5	121.0	122.0	123.0	125.0
EURNOK	10.72	10.80	10.70	10.50	10.48	10.20
USDCAD	1.36	1.36	1.35	1.34	1.33	1.31
USDCHF	0.95	0.96	0.96	0.96	0.96	0.96
USDJPY	107.6	107.0	107.0	107.0	107.0	107.0
USDCNY	7.07	7.07	7.05	7.03	7.00	6.90
GBPUSD	1.25	1.25	1.26	1.28	1.29	1.32
NZDUSD	0.65	0.63	0.64	0.65	0.65	0.67
AUDUSD	0.69	0.68	0.68	0.69	0.70	0.71

Other Currencies

		Q3-20	Q4-20	Q1-21	Q2-21	Q4-21
USDMXN	22.54	22.3	22.0	22.0	22.0	21.5
USDBRL	5.32	5.3	5.2	5.1	5.2	4.9
USDARS	70.58	78.0	82.3	89.5	94.5	104.0
USDTRY	6.85	7.0	7.0	7.0	7.1	7.0
USDILS	3.44	3.5	3.5	3.5	3.5	3.4
USDHKD	7.75	7.8	7.8	7.8	7.8	7.8
USDINR	75.01	75.3	75.0	74.4	74.0	73.5
USDRUB	70.53	70.0	70.0	69.5	68.0	69.1
USDPLN	3.97	4.0	3.9	3.9	3.9	3.8

The table above provides an overview of market forecasts for major currencies. It is composed of dozens of individual forecast providers and delivers a consensus forecast. These consensus forecasts represent a median number and all forecasts evaluated correspond to calendar quarter-end dates.

Market Performances

	Name	QTD *	YTD	2019	2018	2017	2016	2015
Cash	Dollar 3m Total Return	0.4%	0.9%	2.5%	2.4%	1.1%	0.6%	0.2%
	Euro 3m Total Return	-0.1%	-0.2%	-0.4%	-0.4%	-0.4%	-0.2%	-0.1%
Government bonds	US 3-5	0.6%	6.0%	5.3%	1.5%	1.0%	1.3%	1.6%
	Eurozone 3-5	0.7%	0.4%	1.9%	0.1%	0.1%	1.5%	1.8%
	US 7-10	0.9%	11.1%	8.5%	0.9%	2.6%	0.8%	1.7%
	Eurozone 7-10	1.7%	1.9%	6.7%	1.4%	1.3%	3.5%	2.1%
Corporate bonds IG	USD Corp 1-5	5.6%	3.3%	7.0%	1.0%	2.6%	2.9%	1.2%
	EUR Corp 1-5	3.2%	-1.1%	2.8%	-0.5%	1.2%	2.6%	0.6%
	USD Corp 5-10	10.0%	5.3%	14.3%	-1.7%	5.6%	5.6%	0.9%
	EUR Corp 7-10	7.8%	-1.3%	10.9%	-2.4%	4.2%	7.0%	-1.5%
Corporate bonds HY	USD Corp 1-5	9.4%	-4.4%	13.9%	-1.8%	7.0%	16.5%	-4.5%
	EUR Corp 1-5	11.2%	-5.2%	11.3%	-3.8%	6.9%	9.1%	1.0%
	USD Corp 5-10	5.8%	-9.5%	9.1%	-1.9%	7.6%	7.3%	1.8%
	EUR Corp 5-10	12.8%	-5.4%	13.2%	-4.4%	8.0%	10.8%	0.4%
EM bonds (in $)	Hard currency	10.0%	-0.4%	13.1%	-2.5%	8.2%	9.9%	1.3%
	Local currency	4.5%	-3.4%	9.5%	-3.4%	14.3%	5.9%	-10.4%
	Chinese Yuan	-1.0%	1.1%	2.8%	3.0%	5.0%	-4.7%	3.6%
Others	S&P Leverage Loan Index	9.7%	-4.6%	8.6%	0.4%	4.1%	10.2%	-0.7%
	Global Convertible	18.0%	4.3%	18.2%	-1.2%	7.2%	4.6%	-0.8%
Equities	North America	21%	-3%	29%	-6%	19%	9%	-1%
	Europe	12%	-14%	22%	-13%	7%	0%	5%
	Japan	11%	-9%	16%	-17%	18%	-3%	8%
	Asia Pacific	15%	-7%	16%	-16%	29%	2%	-4%
	Developed Markets	19%	-7%	25%	-10%	20%	5%	-3%
	China	11%	-3%	38%	-21%	32%	-7%	-7%
	Latin America	18%	-36%	14%	-9%	21%	28%	-33%
	Emerging Markets	17%	-11%	15%	-17%	34%	9%	-17%
Other investments	HFRX Alternative	6%	-1%	9%	-7%	6%	3%	-4%
	VIX	-43%	121%	-46%	130%	-21%	-23%	-5%
	G7 Currency Volatility	-29%	28%	-34%	21%	-36%	22%	-6%
	DJ Global Commodity	5%	-20%	5%	-13%	1%	11%	-25%
	Gold	12%	17%	19%	-2%	14%	8%	-11%
	Industrial metals	12%	-9%	5%	-21%	28%	20%	-27%
	Agriculture index	-5%	-15%	0%	-13%	-12%	2%	-16%
	WTI Oil	92%	-36%	34%	-25%	12%	45%	-30%
Currencies (vs. $)	Dollar Index	-2%	1%	0%	4%	-10%	4%	9%
	EM Currency Index	2%	-12%	-1%	-11%	6%	0%	-16%
	Euro	2%	0%	-2%	-5%	14%	-3%	-10%
	British Pounds	0%	-7%	4%	-6%	10%	-16%	-5%
	Swiss Francs	2%	2%	2%	-1%	5%	-2%	-1%
	Japanese Yen	0%	1%	1%	3%	4%	3%	0%
	Chinese Yuan	0%	-1%	-1%	-5%	7%	-6%	-4%

* Last quarter
** Year to date

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Geneva
Headquarter
CBH Bank
Bd Emile-Jaques-Dalcroze 7
P.O. Box 3754
1211 Geneva 3, CH
cbhbank.com
t +41 22 839 01 00

Zurich
Branch Office
CBH Bank
Bahnhofstrasse 82
P.O. Box 1213
8021 Zurich, CH
cbhbank.com
t +41 44 218 15 15

Luxembourg
SICAV
1618 Investment Funds
106, route d'Arlon
L-8210 Mamer
Grand Duché de Luxembourg
1618am.com

London
Subsidiary
CBH Europe Limited
18 Savile Row,
London W1S 3PW, UK
cbheurope.com
t +44 207 647 1300

Hong Kong
Subsidiary
CBH Asia Limited
Suite 2001, 20th Floor,
K11 ATELIER, 18-24
Salisbury Road, Tsim Sha Tsui, Kowloon, Hong Kong, HK
cbhasia.com
t +852 2869 0801

Nassau
Subsidiary
CBH Bahamas Limited
CBH House, East Bay Street
P.O. Box N-1724
Nassau, N.P., Bahamas
cbhbahamas.com
t +1 242 394 61 61

Rio de Janeiro
Asset management Co.
1618 Investimentos
Av. Ataulfo de Paiva,
204 Salas 305 a 308
Leblon, Rio de Janeiro/RJ
CEP: 22440-033, Brazil
1618investimentos.com
t +55 21 3993 6901

Sao Paulo
Asset management Co.
1618 Investimentos
RuaIguatemi, 192
Itaim Bibi, São Paulo -SP
CEP: 01451-010
Brazil
1618investimentos.com
t +55 11 4550 4401

Tel Aviv
Representative Office
CBH Bank
Electra Tower,
98 Yigal Alon Street Tel Aviv,
6789141 Israel
cbhbank.com
t +972 73 793 62 22

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CBH | Compagnie Bancaire Helvétique

Asset Management
Boulevard Emile-Jaques-Dalcroze 7
P.O.Box 3754
CH - 1211 Geneva 3

am@cbhbank.com
www.cbhbank.com