AquilaMonitor

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Independent, disciplined, transparent.
And a touch more personal.

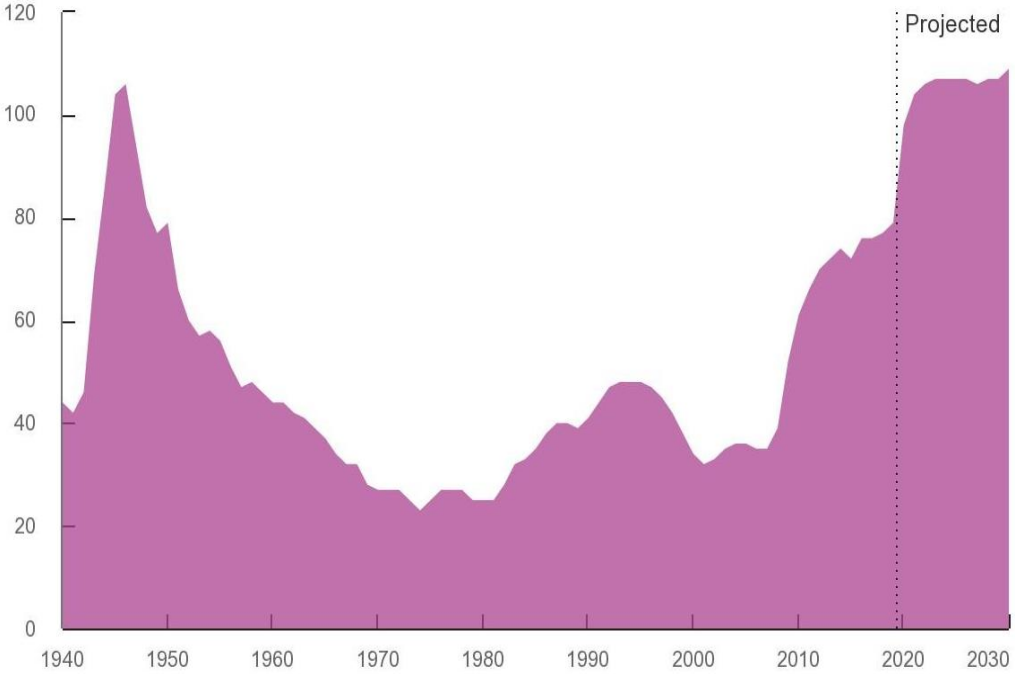
October 2020

Contents:

Executive Summary

- We expect the world economy to contract 4.5% in 2020 but forecast the recovery will produce 3.5% growth in 2021.
- The global economic recovery is losing some momentum because of rising Covid-19 infections.
- The economic effects of the Covid-19 pandemic have forced practically all central banks to push their policy interest rates close to zero. These central banks are now following the path already taken by the ECB and the Bank of Japan.
- US government indebtedness in relation to US GDP is now close to record levels. It will soon breach the previous record set immediately after World War II.
- Yields on government bonds continue their consolidation phase. The Fed is buying around $120bn worth of government and other bonds per month.
- Through its purchases of corporate bonds the Fed is pushing down yields in the secondary market.
- Equity markets have started to correct with technology shares leading the declines. Markets are closing in on technical support levels.
- The US dollar has started to firm once more.
- Despite gold's significant price drop we remain positive on the precious metal on a medium-term view.

US Federal debt held by the public, % of US GDP



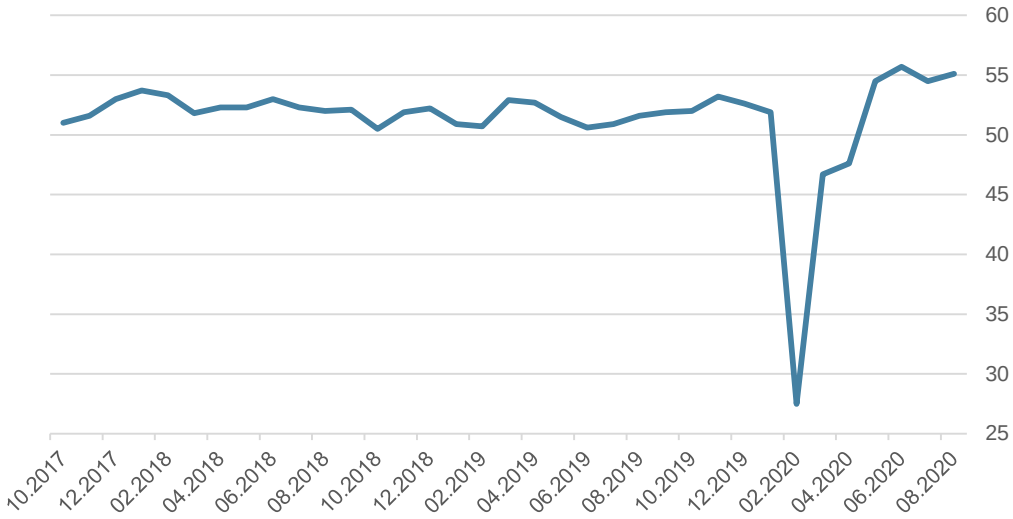
Source: Congressional Budget Office

US government indebtedness has risen to previous records…

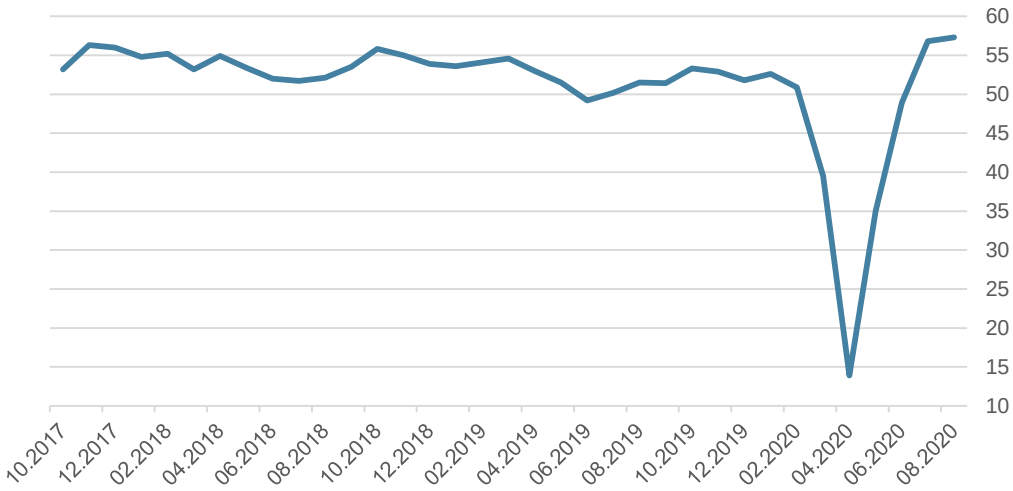
- … and in peace-time!
- US government indebtedness is increasingly worrisome. Annual Budget deficits above $1 trillion, or over 5% of Gross Domestic Product (GDP), are likely to be the norm rather than the exception over the next few years.
- The Congressional Budget Office (CBO) estimates the Federal deficit at around $3.3 trillion in Fiscal Year 2020, or around 16% of GDP. This would be the largest deficit as a percentage of GDP since 1945.
- In our view the CBO's projections are too optimistic.
- Due to the development of the debt situation, one can already predict that US nominal interest rates will have to be kept at very low levels for years to come. A two-percentage point rise in US interest rates would add about $500 billion to the US annual Budget.
- One way to combat spiraling US government indebtedness would be to implement significant tax increases, as Joe Biden has already proposed in his election campaign. Unfortunately, the Democrats also plan massive new spending on infrastructure investments, unemployment benefits, etc., which will offset the impact of any increase in tax revenues on the Federal borrowing requirement.

Business cycle

Purchasing managers index for China



Purchasing managers index for Russia



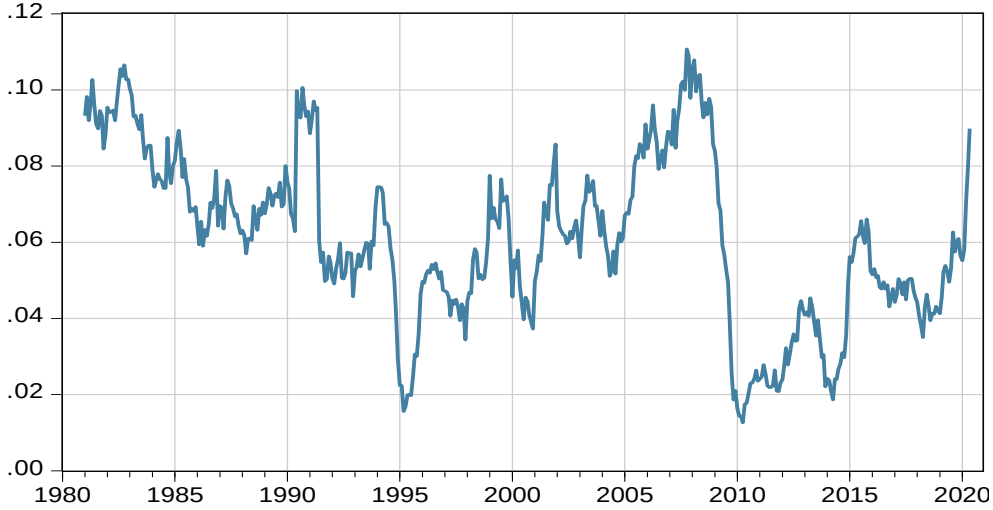
Source: Bloomberg Finance L.P.

The economic recovery is again losing momentum

- Our growth forecasts for 2020 (and 2021 in brackets) are as follows – World economy: -4.5% (+3.5%), US: -6.5% (+4%), EU: -7% (+5.5%), Japan: -5% (+2.5%), UK: -8% (+6%), Switzerland: -5% (+3%).
- The economic recovery is continuing at a slower pace due to an impending second wave of the Covid-19 virus and statistical “base effects”.
- The US economy urgently needs another rescue package. Since July 31, nearly 30 million unemployed Americans have no longer been receiving their additional weekly benefit of $600 a head. Democrats and Republicans are fighting over the necessary size of a further package as well as aiming for votes in the US elections on November 3rd.
- Given the political strife in Washington it is becoming ever more likely that a new rescue package will only be agreed after the upcoming Presidential election. Democrats are furious that President Trump is trying to fill the Supreme Court seat of the deceased liberal judge, Ruth Bader Ginsburg, as soon as possible, thus increasing the conservative majority in the court from five-to-four to six-to-three. This is highly sensitive. Supreme Court judges are appointed for life and could be a decisive factor in the upcoming Presidential election. Perhaps the only reason why Al Gore ultimately lost to George W. Bush in the 2000 Presidential election was because the then conservative-leaning Supreme Court stopped the Florida recounts. Given this history, some Democrats may oppose a fresh economic bailout before the election by way of retaliation. This would also mean that the Fed is set to become less stimulative. But we believe the next round of implementation of Modern Monetary Theory is only a matter of time and cannot be delayed much beyond the upcoming election. Markets could become nervous, the economy weaken, and corporate bankruptcies rise if a package cannot be implemented before January. In a Corona environment four months is a very long time.
- In addition to the economic issues, the debate over the trend growth rate of the industrialized world is set to become more urgent. Central banks have overridden the price discovery mechanism within markets, thereby allowing and encouraging uncompetitive firms to finance their continuation via cheap funding. Schumpeter-type competition and the creative destruction of unprofitable corporate business models (and the political decisions that should result), are therefore severely constrained. Capital and resources are being allocated to entities that should be allowed to fail, thus limiting the resources that might be used for more productive, more innovative businesses.

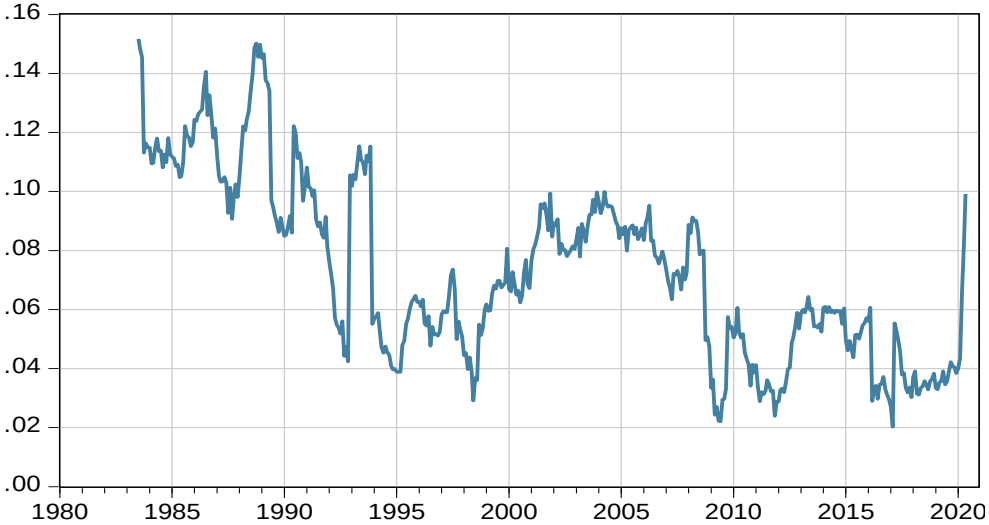
Monetary policy

Eurozone monetary aggregate M2, % growth year on year



Source: Thomson Reuters & Datastream and own estimates prior to 01.01.2002

UK monetary aggregate M2, % growth year on year



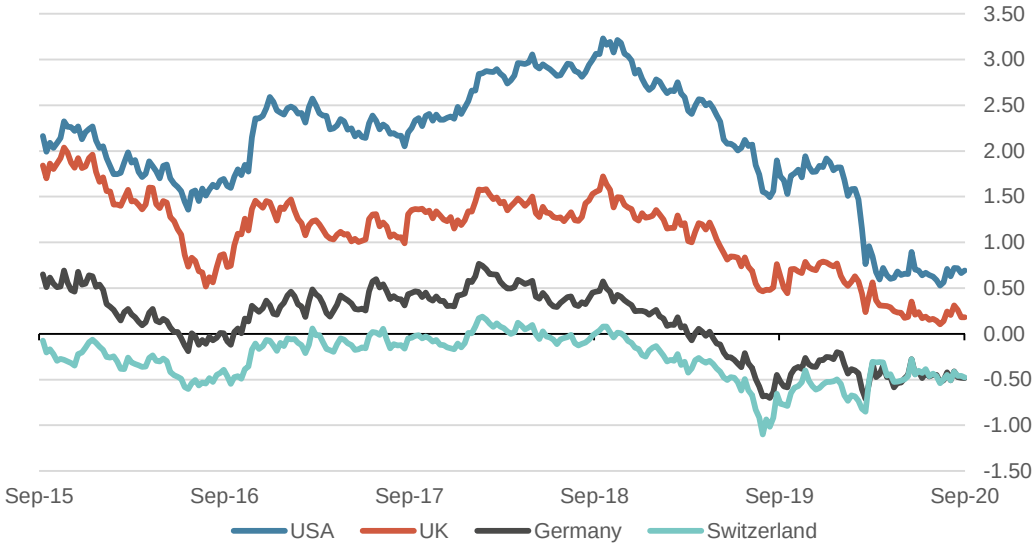
Source: Thomson Reuters & Datastream, own calculations

Central banks will continue their policies of monetary devaluation

- The Fed has clearly communicated to the market the conditions that must be met for an initial rate hike: full or overemployment, inflation of at least 2% and the prospect of a moderate overshoot of the inflation target for some time.
- Interestingly, the markets were largely left in the dark about the other main tool in the Fed's armory, the securities purchase and balance sheet expansion programs. However, it was communicated that securities purchases are going to be continued, at the current or a higher rate, for some time to come.
- The enormous expansion of central bank balance sheets has led to a sharp rise in the supply of money and a collapse of spreads on riskier bonds. This has “forced” investors to increase portfolio risk, including through investment in stocks. Low credit spreads and high stock prices have helped companies to access much-needed capital and liquidity during the lockdowns.
- The purchase programs of the Fed and the ECB mean that real interest rates out to 10 years are zero or even negative for corporates, even though companies and governments have been issuing new debt at a record pace. Thus, fundamentally poor credits are being kept on life-support at the expense of economic efficiency.
- To the extent that markets expect the Fed to stimulate more aggressively than other central banks the US dollar can be expected to weaken.
- It is only a matter of time before the next big US bailout package is passed in Congress, at the latest within a month of the forthcoming elections. After the package is passed, we assume the Fed will significantly increase its securities purchase programs. Also, if all vaccine candidates now in the later trial stages are found to be failures, we would expect the Fed to act immediately. Developments on the Covid-19 vaccination front are likely to have a significant impact on monetary policy.
- Food prices have an unjustifiably high impact on inflation expectations. Why? You buy food almost every day and can tell immediately when it becomes more expensive. This was temporarily the case at the start of the Covid-19 crisis. Now food prices are falling again. This means that inflation expectations are also falling. The risks of deflation are still higher than the risks of inflation. Therefore, central banks will continue their battle to cheapen their currencies and the money supply will continue to grow rapidly.

Asset classes – Equities and bonds

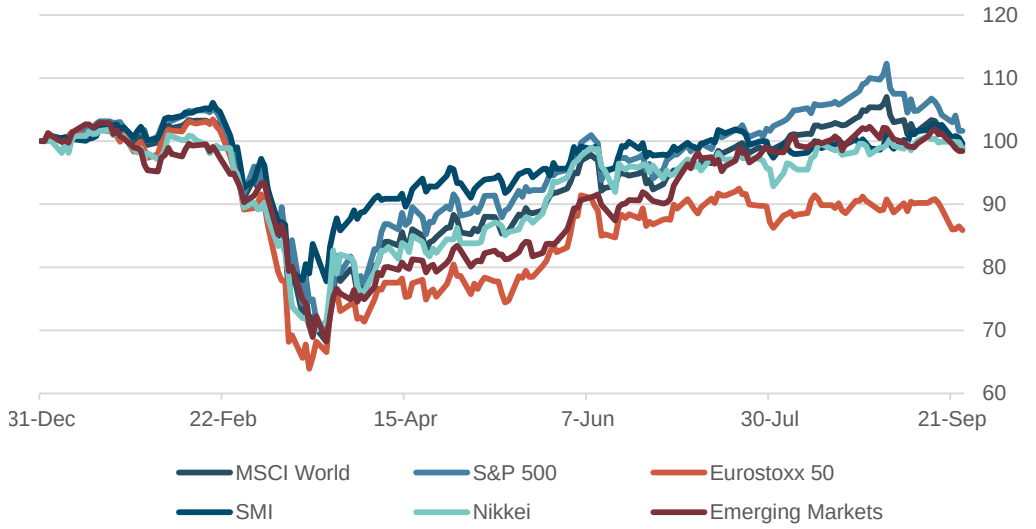
10 year government bond yields in %, last five years



Bond yields remain rather stable

- Central banks are still buying government bonds but demand for them is also coming from institutional investors again looking for “safe havens” as stock markets suffer another bout of profit-taking.
- But real yields in all currencies are now clearly in the negative range, making the entire asset class fundamentally unattractive.
- The supply side is set to increase massively in coming months as the various fiscal support packages need to be financed. Moreover, the most important central banks have recently signaled that they are currently not planning an immediate expansion of their security purchase programs.
- In corporate bonds, we expect the major refinancing wave of the first half of the year will not continue. But the Fed and other central banks are still active in the secondary market with their purchases of investment grade corporate bonds. This is depressing returns.

Equity markets, indexed performance, year to date



Source: Bloomberg Finance L.P.

Tech stocks correct

- After a massive rally in August and the first half of September, which was mainly driven by a few large technology stcoks and characterized by some unhealthy developments, disillusion has now set in. In recent weeks, various indicators had already pointed to the risk of a correction. The trigger was probably the rather cautious communication of the Fed regarding "support" for the economy from the monetary side.
- Fed Chairman Powell's demand that politicians must now take further fiscal measures collided with the fact that Republicans and Democrats have been unable to agree on the scope of the CARES 2.0 package.
- We are assuming markets will now have to go through a difficult phase. The longer the impasse, the less certainty as to whether and how there will be a result in the US Presidential election. Representatives of both parties have already announced "as a precautionary measure" that they will not automatically accept a victory by the opposing party. An already fragile political culture is being trampled upon and it is entirely possible that the courts will end up having to decide the election.

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Asset classes – Currencies and other assets

EUR/CHF, last 2 years

The US dollar rebounds

- Outstanding futures contracts betting on a falling US dollar reached record levels in September. So, with hindsight it is not surprising that a countermovement has now occurred, with the dollar rising in recent trading. One trigger for this could have been the communication from the ECB, which tried to weaken the euro after it rose above 1.20 on the EUR/USD. On the other hand, dollar purchases could be linked to the correction in stock markets. Both tendencies can be considered as part of a move to "risk-off". Stocks are clearly risk assets and the dollar is often perceived as a haven when investor uncertainty rises.
- All central banks face a dilemma when their currencies appreciate. Currency appreciation is not welcomed in an economic world that can only generate growth via competitive devaluation.
- The EUR/CHF currency pair is now just below 1.08. Europe is currently not in focus as a source of headlines, so demand for the Swiss franc is only moderate.

Gold price, US dollars per ounce, last 2 years

Source: Bloomberg Finance L.P.

Precious metals weaker.

- During the correction on the stock markets (“risk off”), gold has also been affected by profit-taking. Investors will have noticed the positive correlation between the two asset classes that developed in late summer.
- But the somewhat firmer US dollar and (reflecting the Fed's recent more cautious communication) somewhat “less negative” real interest rate environment also put precious metal prices under pressure. As is so often the case in a downturn the price of silver fell much more than that of gold. Thus, silver is now around 20% below its highs for this year. In gold, this gap is “only” around 8%.
- Since we anticipate that sooner or later all central banks will become much more active in seeking to depress real interest rates (quite probably by trying to raise inflation expectations), we remain positive on precious metals. There is a great danger is that the behavior of central banks will trigger a global currency crisis that in turn would put all nominal values under great pressure. Precious metals provide portfolio protection against this danger.

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Investment strategy for the 3rd Quarter 2020

Meeting of the Investment advisory commitee: 30.09.2020	Asset class	Investment Strategy: Income	+/-	Balanced	+/-	Grwoth	+/-
Defensive	Liquidity	20%	0%	12%	0%	10%	0%
	Bonds	50%	0%	30%	0%	15%	0%
	incl. Bond Funds						
Offensive	Stocks	20%	0%	50%	0%	65%	0%
	incl. Stock Funds + ETF						
	Others	10%	0%	8%	0%	10%	0%
	Real Estates, Commodities, Gold, Structured Products, Alternatives etc.						
		100%		100%		100%	

Additional Parameters

Reference currency: Swiss Francs (CHF)

Currency allocation:

CHF (Reference currency)	min. 50 %
EUR,USD	max. 20 % each
GBP	max. je 15 %
Other	max. 20 %
	(per currency max. 10 %)

Variations of +/- 5 % are possible for the various investment categories.

Covid-19 remained the dominant theme in the 3rd quarter of 2020. However, astonishingly, the economy has recovered better from the lockdown than what was generally assumed. Nevertheless, cutbacks were massive, and it would not be surprising if bankruptcies were to increase in specific sectors (gastronomy, event management, construction related to trade fairs, etc.) in the near future. Although it is SMEs that are affected, the job losses concern actual people. Furthermore, the public sector will have to deal with a sharp drop in tax revenues in the coming year. We expect corporate profits to fall, and private individuals to pay less income tax as a result of reduced working hours or, in some cases, job losses. Tax increases cannot be ruled out.

The Swiss stock market kept surprisingly quiet in the 3rd quarter. The SMI fluctuated within a range of about 500 points (low: 10,006/high: 10,552). In comparison with the beginning of the quarter, the index increased by 1.4%, and closed at 10,187 points. The gain of the SMI is thus somewhat smaller than that of the DAX +3.5%, the Nikkei +4.0% and the S&P500 +8.5%. Only the British FTS100 could not keep up (-4.9%). In the 4th quarter, the stock markets will be influenced by the elections in the US, the Brexit, and the policies implemented by the national banks. We do not anticipate a second lockdown and expect the underlying sentiment to remain positive.

On the currency front, the Swiss franc has lost some of its strength. This is due to the strong interventions carried out by the SNB. We do not expect any major fluctuations in the fourth quarter. Interest rates will not change much in the next months, either.

We wish you an enjoyable Indian summer and a peaceful Advent season.

Thank you for placing your trust in us.