dreyfus
BANQUIERS
1813

Compass

4th Quarter 2020

Debt-financed economic growth

The growth adjusted duration of equities

Real estate investments as a safe haven in stormy times

Growth outpaces value

The aggressive expansionary measures taken by governments and central banks provide an ideal macroeconomic environment for equities. Fiscal stimuli are having an impact on economies, but are financed mainly through debt. New debt issued, combined with weaker economies and hence lower tax income for governments, increases the degree of indebtedness significantly. Especially those economies, which were already highly indebted pre covid-19, should be monitored closely. Moreover, the US Dollar is also depreciating vis-à-vis other currencies. This is driven mainly by two factors. First, lower US interest rates have reduced the interest rate differential significantly. Second, foreign political challenges combined with continued bipartisan debate are accentuating the downward trend. Falling long and short term interest rates have fuelled equity prices over the past years, with growth significantly outpacing value. In this edition of the compass, we dive deep into why growth continues to outperform.
For the final part of the compass, we present the opportunity of investing in traded real estate funds.

Slightly more cyclical positioning within equities

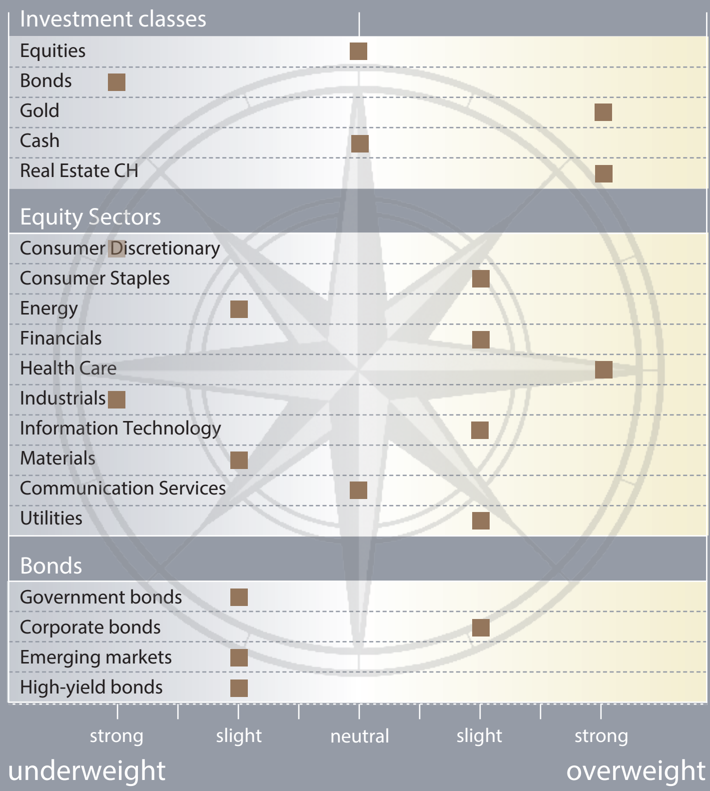
Currently, leading economic indicators suggest a global recovery of economic growth. However, uncertainties related to the recent unfolding of the corona pandemic and outcome of the US election, continue to affect financial markets. Therefore, we continue to stick to a slightly defensive allocation across equities, rotating towards more cyclical sectors.

Regarding the asset allocation we continue to be neutral on equities. Because of low real interest rates, we are underweight bonds. This is compensated by an overweight allocation to gold and real estate.

Within equities we reduce our allocation to consumer staples by increasing the allocation to IT. We continue to be overweight in the defensive sectors healthcare and utilities. Moreover, we also like financials, especially insurances and banks. For consumer discretionary and industrial we are still strongly underweight. While for energy and materials we are slightly underweight.

Within bonds we prefer corporate to government bonds. While we are still underweight emerging markets and high-yielding bonds.

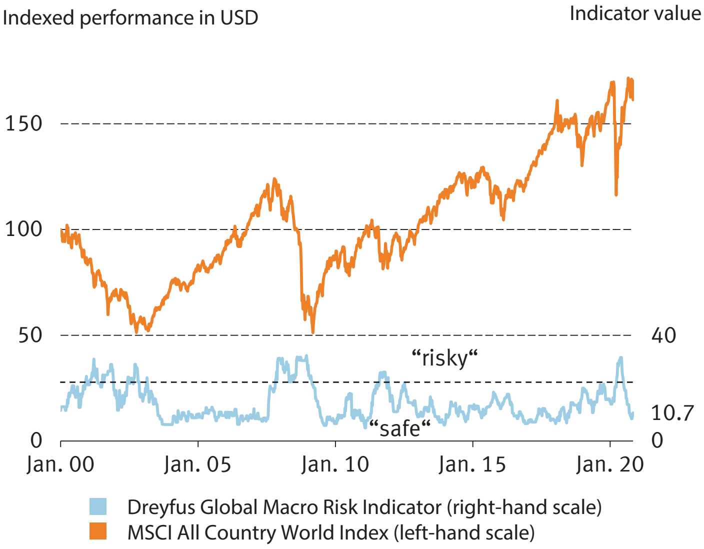
Asset allocation recommendation as of October 12th, 2020 for investors with CHF as their reference currency.



Basic Trend: Debt-financed economic growth

Basic Trend 1:

Indexed performance in USD

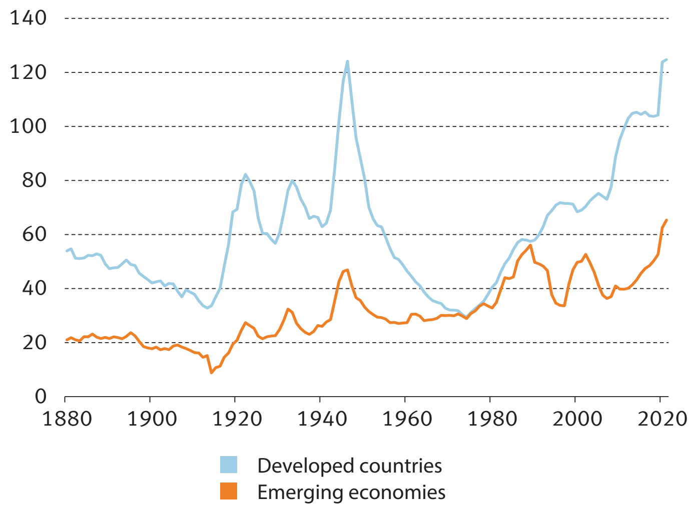


Improving economic indicators

To be able to identify early on long-lasting corrections in equity markets, Dreyfus Banquiers developed the Global Macro Risk Indicator "GMRI". It is based on 27 indicators which forecast economic activity globally across countries. The GMRI is expressed on a scale from 5 to 35, whereby values above 20 forecast a crisis. The economic impact of the pandemic quickly drove our indicator into the risk zone. Central banks' courageous intervention, coupled with substantial fiscal expansion, had a positive effect different leading economic indicators. As a result, our GMRI has quickly returned to safe territory, forecasting a promising environment for equities.

Basic Trend 2:

Government debt in % of the gross domestic product (GDP)

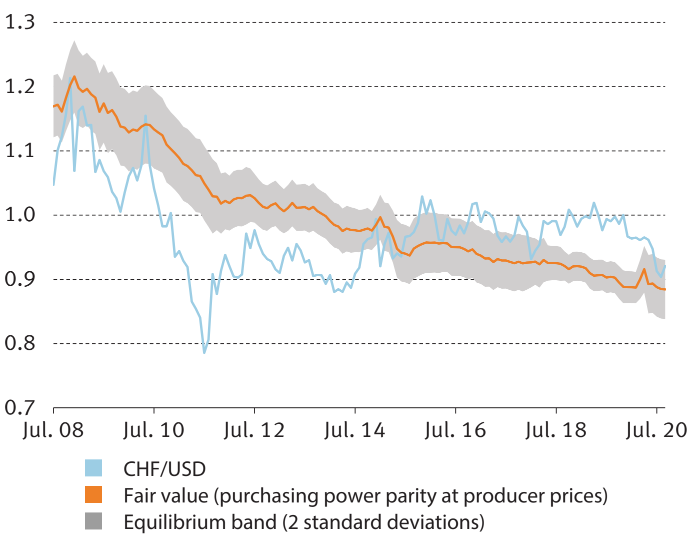


Exorbitant increase in government debt levels

To dampen the potentially lasting dramatic consequences of lockdowns on the economy, governments jumped to the rescue by raising historic amounts of debt. Recent IMF studies analyse the debt-to-GDP levels in emerging and developed economies. From this graph one can see how for developed nations, debt-to-GDP will reach levels above those witnessed during WWII. However since interest rates are currently very low, this does not represent a burden for those economies yet.

Basic Trend 3:

Exchange rate CHF/USD



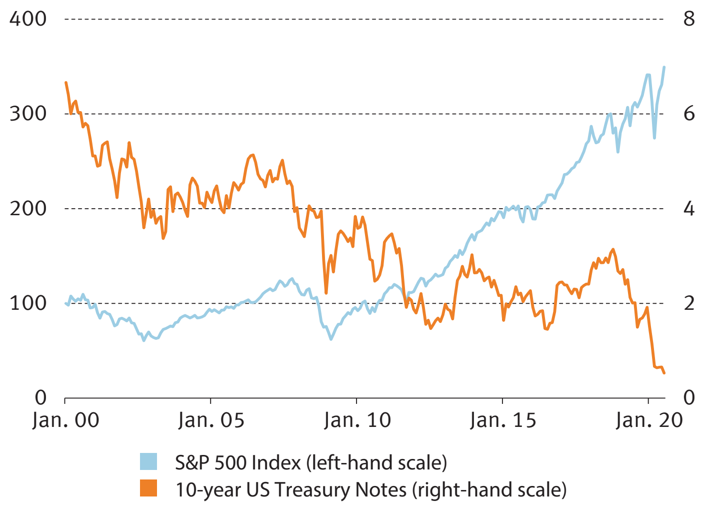
The USD, a crumbling ex-safe haven currency?

Following a lasting phase of relative stability, the USD started to depreciate significantly vis-à-vis the Swiss Franc. The main driver is the narrowing interest rate differential, caused by the interventions of the US Fed over the previous months. These interventions were far more aggressive than those taken by the SNB. Looking forward, we believe that the inflation differential could play a key role. If inflation in the US were to be higher than inflation in Switzerland, we expect the USD to weaken further. However, the exchange rate can also deviate away from the PPP derived "fair value", over a longer time horizon.

Current Topic:
The growth adjusted duration of equities

Current Topic 1:

Indexed performance (net total return) in USD   Yield in % p. a.

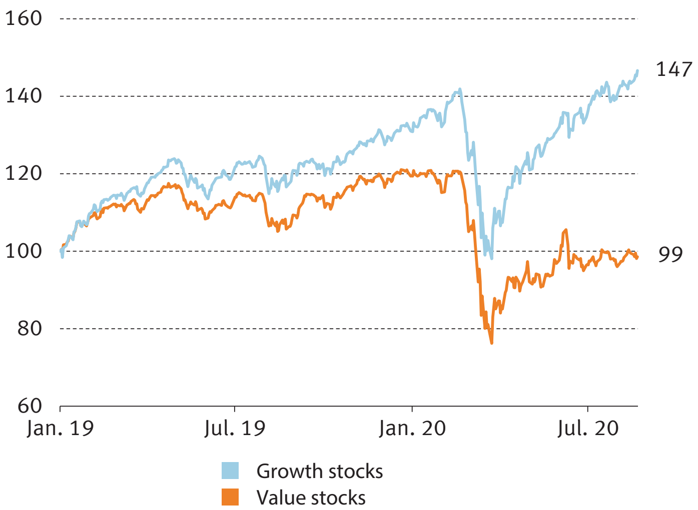


Rising equity prices driven by falling interest rates

Interest rates have been falling for decades. At the beginning of 2020, 10 year US government bonds yielded 6.7%, while today we are at 0.5%. Both the financial and corona crisis accentuated this trend further. The US federal reserve's aggressive intervention this year provided financial markets with abundant liquidity by purchasing bonds. This pushed yields further down. Seeking for yield pushed investors into equities, despite the higher risk of this asset class. Equities, compared to bond yields, are moving in the opposite direction going from one high to the next.

Current Topic 2:

Indexed performance (net total return) in CHF

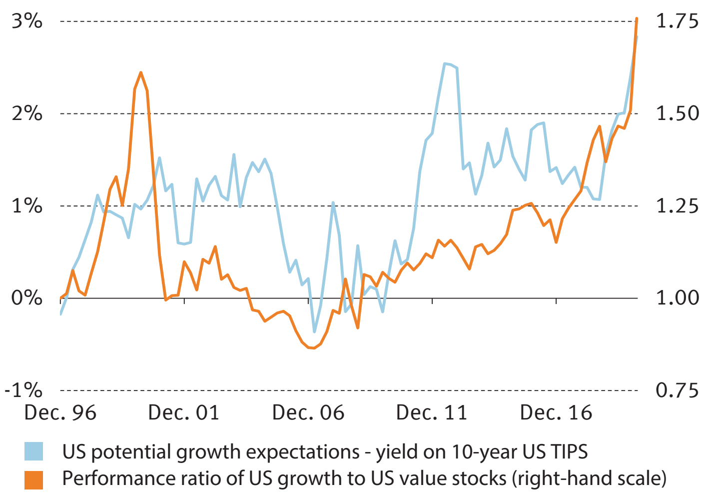


Growth vs. value

Investment styles are as old as the investment profession. The predominant investment styles are value and growth. First, value stocks have the following characteristics: substantial and positive cash flows, which are undervalued. Growth stocks, on the other hand, are companies which exhibit above average growth across multiple dimensions (e.g. revenue). Most recently growth stocks are in higher demand than value. This is clearly visible in the significant outperformance of growth versus value, mainly driven by high-flying tech stocks. These companies (e.g. Amazon) have greatly benefited from the pandemic, as remote working and ecommerce have driven the need for cloud based solutions. However, could there be other reasons why growth stocks are in such high demand?

Current Topic 3:

Difference between the annual growth and interest rate   Performance ratio



The growth adjusted duration of equities

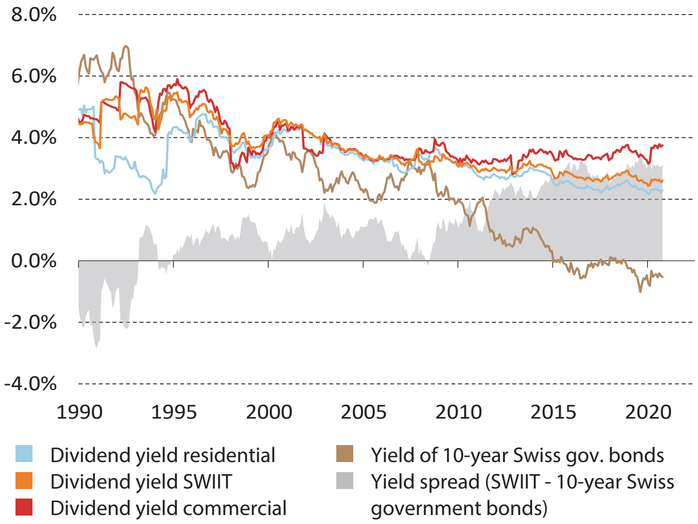
Discounted cash flow models are used to define the fair value by discounting to today all future cash flows to today using a discount rate. By definition growth stocks have a higher (revenue) growth rate than value stocks. As the difference between the expected growth rate and interest rates increases, so does the fair value of the underlying company. This is especially the case for companies with high expected future cash flows. This graph illustrates this. As the differential between economic growth and real interest rates rises, US growth companies outperform US value companies.

Knowledge & Experience:
Real estate investments as a safe haven in stormy times

Knowledge & Experience 1:

Source: SFP Group

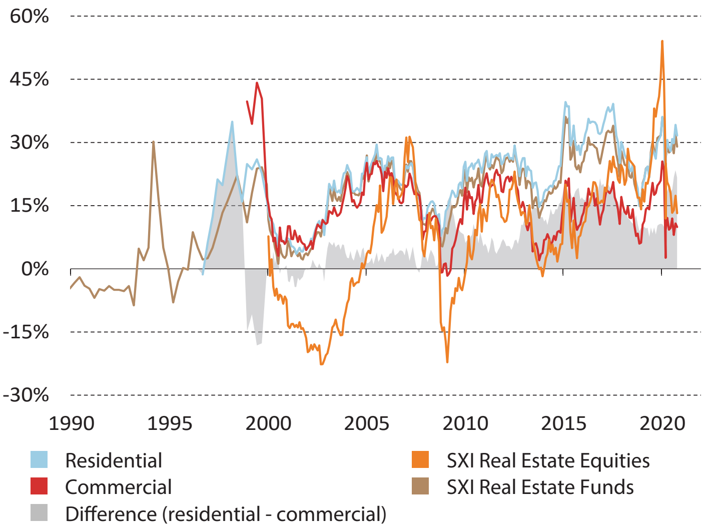
Annual return in CHF



Knowledge & Experience 2:

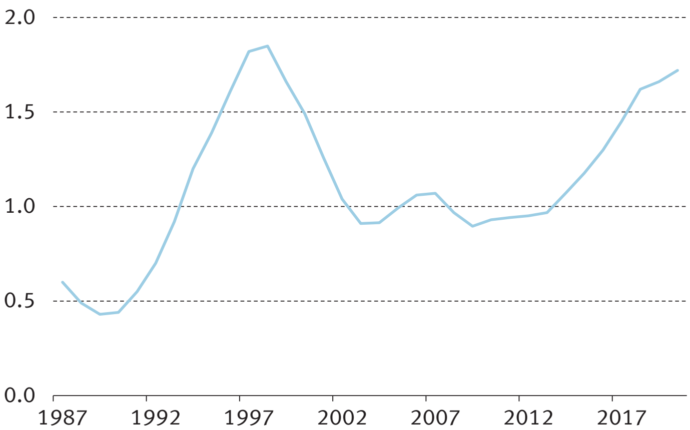
Source: SFP Group

Premiums of indirect real estate investments



Knowledge & Experience 3:

Swiss vacancy rate in %



Real estate protects against negative interest rates

Real assets are in high demand as central banks continue with their extremely expansive monetary policy. Aside from gold, real estate is also an investment in a real asset. Like gold, real estate investments protect from losses in portfolio values caused by negative interest rates. Moreover, they yield interesting nominal returns. For private clients, real estate investment funds and listed equity vehicles offer the benefits of diversification and liquidity. Moreover, post costs they offer unbeatable risk-return characteristics. The distribution yield of real estate investment funds compared to Swiss government bonds is currently at its highest ever. Just slightly below the one of equities. Finally, over the last two decades, real estate has proven to also be a crisis resistant asset class.

Commercial real estate and the corona crisis

As corona spread, Swiss commercial real estate suffered accordingly. The pandemic accelerated the structural shift from high-street to online shopping. The trend of remote working from home, also affected the value of office space. However, we do not expect Switzerland to experience a similar retail apocalypse as the US recently has. Mainly because the US, compared to Switzerland, has a far larger amount of available retail space per capita. Moreover, we do foresee demand for office space to drop over the coming years. Therefore, despite the challenging environment we believe that commercial real estate currently offers an attractive opportunity for investors. Many funds currently trade either with no agio, or sometimes even below net asset value, yielding returns not seen since the financial crisis.

Continued boom of residential real estate

Swiss residential real estate funds continue to be in high demand. Low interest rates outweigh the consequences of the corona crisis for rental properties. Fewer expats and lower immigration coupled with the economic uncertainties caused by the ongoing pandemic, are expected to accelerate the trend towards higher vacancy rates. However, we do not see people fleeing from cities as we have experienced in the US to date. Therefore, we believe Swiss residential real estate remains an attractive investment opportunity but deserves adequate caution. Certain real estate funds trade at a record high premium vis-à-vis their net asset value. Consequently we prefer funds which are not yet listed and therefore exhibit lower volatility, but have a clear path towards a listing at the Swiss stock exchange (SIX).

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

Dreyfus Sons & Co Ltd publishes Compass four times a year since June 2008. The publication is aimed at clients of the bank and interested parties. It describes some of the instruments and methods the bank uses to monitor everything to do with the financial markets. A description of the investment process can be obtained from your client advisers or our website. Compass provides guidance but cannot take the circumstances of an individual portfolio into account. It is for information and marketing purposes.

Contact: Dr. Daniel R. Witschi, CFA

Dreyfus Sons & Co Ltd, Banquiers
Aeschenvorstadt 16 | P.O. Box | 4002 Basel | Switzerland
Telephone +41 61 286 66 66 | Fax +41 61 272 24 38

contact@dreyfusbank.ch | www.dreyfusbank.ch