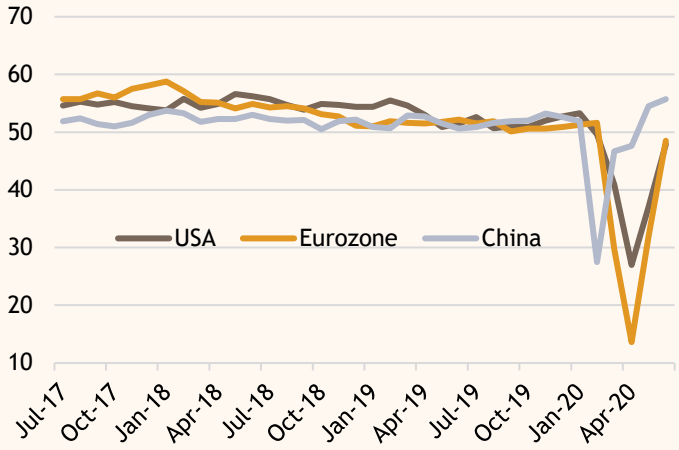
AXIOMA
Wealth Management AG

2020 Investment Strategy
2Q20 Update

Market Overview

Governments and central banks worldwide have responded swiftly with monetary and fiscal stimulus of unprecedented levels to support their economies, which were hit hard from self-imposed lockdowns due to the Covid-19 pandemic. This has led to a sharp recovery of bond markets, more so the US IG segment. As more stimulus was announced, riskier assets, such as emerging market bonds, have also rallied. In May, economies in both developed and developing world have started to re-open and this has led to a significant surge in consumer spending and industrial productions in May and June. PMIs indices worldwide have showed a V-shaped rebound.

Fig. 1 Purchasing Manager's Indices



Source: Bloomberg (30 June 2020)

However, the easing of restrictions has led to an increase in the number of infections, raising concerns about a potential reimposition of strict lockdown measures. We believe that fears of a March-like scenario are overblown, as there will be no political support for yet another total lockdown and potential restrictions on mobility will be localized. Nevertheless, considering the strong shock experienced by global economies and lingering worries about a significant rise in the number of infections, economic recovery will take a long time. We believe the central banks will keep monetary and fiscal stimulus elevated to support the recovery.

Oil prices have also recovered from April record lows. Continued rebound in the economic activity worldwide should further boost commodity prices including oil. This will in turn support oil companies in our portfolio, as well as oil-exporting countries. However, in our opinion, oil prices are unlikely to recover to the pre-crisis level any time soon.

Fig. 2 Benchmark Brent crude futures price (USD/barrel)

Source: Bloomberg (30 June 2020)

Corporate bond issuers have taken significant measures to strengthen their balance sheets and preserve their cash flow. We believe they will continue taking actions, like refraining from dividend payments and share buybacks, which would benefit bondholders. Nevertheless, the wave of downgrades which had started in April will continue, due to a significant drop in revenues and profitability.

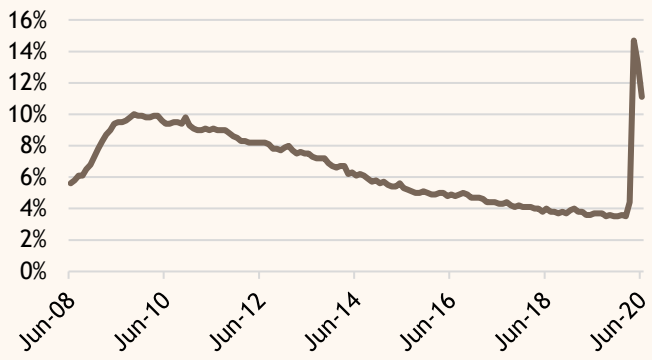
Geopolitical conflicts have resurfaced recently, after US president Trump blamed China for the current crisis, and China enacted a security law on Hong Kong which led to US Congress imposing sanctions. Market reactions to the geopolitical jitters have been rather muted, but we expect reciprocal accusations to intensify as we approach US presidential elections. In addition, the possibility of Democratic candidate Joe Biden winning US presidential elections is not currently priced in by the markets, and it may have an adverse effect on the market sentiment.

In our view, the main risks in the following 12 months consist of a significant rise in new infections and a prolonged economic recovery, amplification of geopolitical risks brought on by the US-China conflict and the US presidential elections. These risks may lead to persistent high volatility on financial markets. Still, central banks' injections of liquidity will remain the main driving force.

US Treasury Yield Curve

In March, US Central Bank intervened aggressively with a significant rate cut which brought the benchmark policy rate to the 0-0.25% range level. The policy rate decrease, coupled with the demand for 'safe-haven' assets, has pushed the US government yields to a very low level. For example, the benchmark 10-year UST yield fell from 1.5% as of 31.01.2020 to 0.66% on 30.06.2020. The US Central Bank has demonstrated an explicit resolve to keep the interest rate at this level until the economy recovers from the crisis. With the unemployment rate at a record 11.1% as of June end, it will take years to revert to the pre-crisis level of 4%.

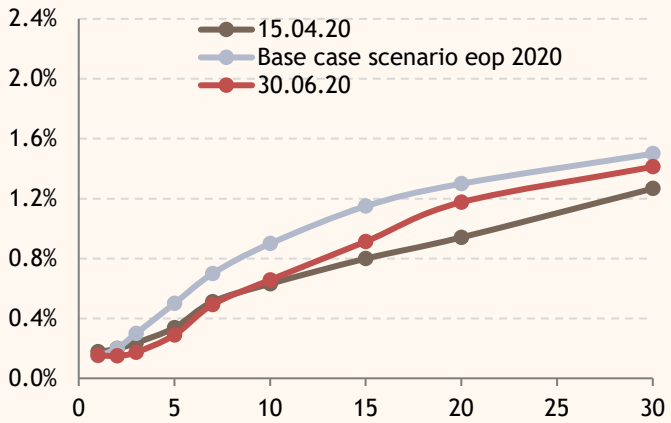
Fig. 3 Unemployment rate in the US



Source: Bloomberg (30 June 2020)

We believe that no inflationary pressure will show on the radar in the near-to-medium term, even with a recovery of commodity prices. Therefore, we do not see any chance of a rate increase until the end of the year.

Fig. 4 US Treasuries yield curve



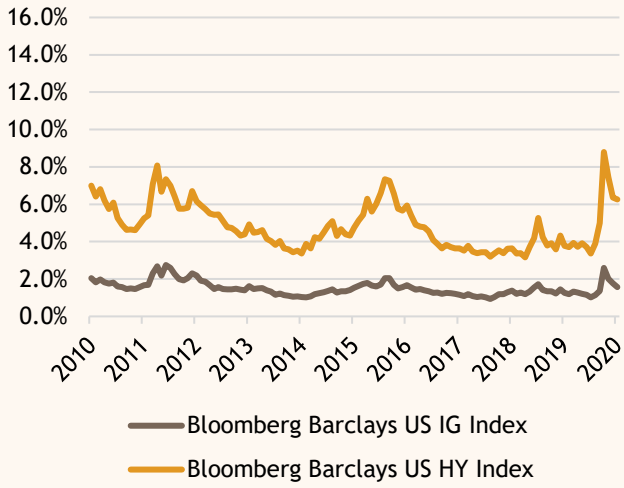
Source: Bloomberg, Axioma (30 June 2020)

Thus, we expect that the short end of the yield curve will stay anchored at current low levels. There may be an increase in longer-maturity UST yields due to additional supply, given the fact that the US government has had to issue new debt to sponsor fiscal programs. However, the curve steepening will be limited, as the Fed will most likely intervene with further purchases if deemed necessary to limit the upward pressure on the term premium.

Credit Spreads

Credit spreads have narrowed sharply over the past three months. This was mainly a consequence of the Fed's bond purchase buying program, which was extended to include not only IG bonds, but also high yield ETFs and fallen angels. The US central bank has further room for purchase, as only a small part of its bond purchasing facility has been used, and this will continue supporting bond markets.

Fig 5 US IG and HY Credit spreads

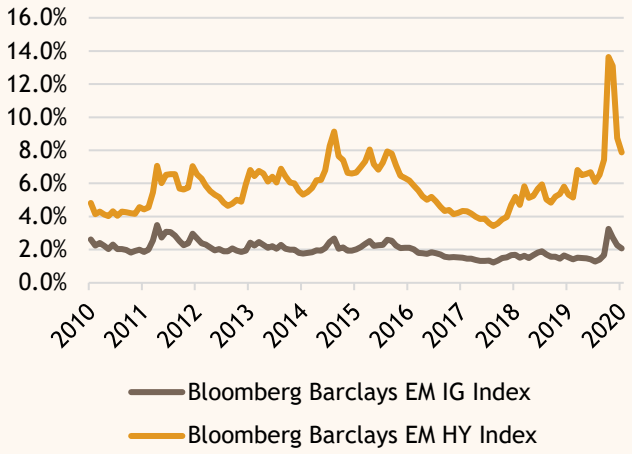


Source: Bloomberg (30 June 2020)

We believe there is little room for further tightening in US IG segment, as spreads are already very close to their pre-crisis level.

Central bank's aggressive quantitative easing will likely continue to encourage the search for yield and will therefore drive inflows into developed countries' high yield and emerging markets, which is consistent with our optimistic scenario. On the other hand, fundamentals of a large part of emerging market countries are worsening, putting pressure on both sovereign and corporate EM debt.

Fig. 6 EM IG and HY Credit spreads



Source: Bloomberg (30 June 2020)

Emerging market central banks have responded with considerable monetary support, not lagging behind their counterparts from developed countries. Lack of inflationary pressures have allowed them to cut rates considerably and some countries have also embarked on quantitative easing programs, their first experience of this kind. Some of the Latin American countries, like Brazil and Mexico, have not imposed severe lockdown measures and subsequently, have failed to contain the virus. This will add to the fiscal problems that these countries are already facing, posing significant challenges ahead.

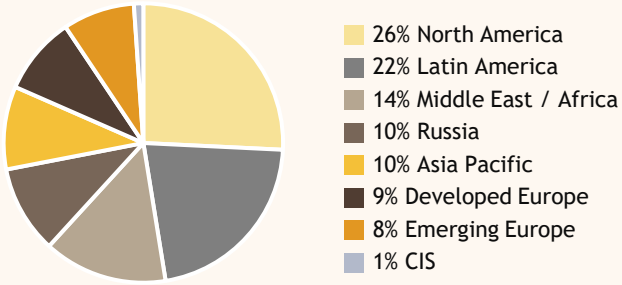
However, the evolution of emerging countries is highly divergent, depending on the magnitude of the Covid-19 spread and their pre-existing macro vulnerabilities. EM corporates have been affected by the worldwide slump in economic activity but the rebound in China and elsewhere is helping them restore production, while local currency depreciation is positive for exporters. However, a turn to risk-off due to uncertainty regarding the US elections or a much more difficult economic recovery in the US may induce a market sell-off, and in this case, emerging market assets, in particular those of Latin America, will suffer the most. This evolution is consistent with our negative case scenario.

Strategy

We have significantly increased the share of North America since March market correction, mostly on the back of IG issuers. The weight has decreased slightly from May, as we have taken profit on some issues which have rebounded to pre-crisis level in price terms. However, we are not yet ready to decrease it further, as the segment is likely to be most resilient should another market correction occur. In anticipation of high volatility ahead, we have sold a large part of long-duration bonds to decrease duration in our portfolios to 5 years.

Looking ahead, we favor primary markets for the issue premia. We do not limit ourselves to a certain geographical area and will select with a bottom-up approach in mind. Asia Pacific have shown lower price volatility in the recent crises as the result of more buy & hold investors. In contrast, Latin American bonds are often bought by US hedge funds which tend to trade actively and are thus prone to higher price volatility.

Fig. 7 AXIOMA Leveraged Bond Fund Geographical allocation



Source: AXIOMA, as of 30.06.2020

We have decreased leverage to about 40% as the result of profit-fixing. We do not plan to decrease leverage significantly as low interest rates will remain at least until the US elections. Rather, it will be the result of a search for interesting securities which comply with our current strategy: average duration of 5-8 years, credit rating – investment grade or higher range of high yield, price volatility – low.

Performance forecast

We have calculated subsequent 6 months performance according to 3 scenarios based on the Fund portfolio (av. coupon=4.37%, av. duration 5.05y, av. YTM=3.63%, leverage 42% as of 30/06/20): base, optimistic and negative.

- Base case – UST yields raise 25bps due to increased offer and credit spreads stay more or less at the 30.06.2020 level.
- Optimistic case – UST yields are at the 30.06.2020 levels and credit spreads recover another 60bps from base case scenario, but not completely to March pre-crisis levels.
- Negative case - UST yields are up 50bps from 30.06.2020 level and credit spreads widen back to the levels of 15 April 2020 (the level of the 1st rebound, as we don't expect the same deep correction as we saw in March 2020), with the default rate at 1%.

Refinancing rate we used in the calculations is 1.0% p.a.

Table 1. Strategy performance forecast, 6 months (01.07.2020-31.12.2020)

Strategy return	Optimistic scenario	Base case scenario	Negative scenario
Coupon component	2.2%	2.2%	2.2%
Price change due to change in UST yields	0.0%	-1.3%	-2.5%
Price change due to spread narrowing or widening	4.0%	1.1%	-4.9%
Default	0.0%	0.0%	-1.0%
Total:	**6.2%**	**2.0%**	**-6.2%**
Return subject to 50% leverage	**9.1%**	**2.8%**	**-9.6%**
Return subject to 75% leverage	**10.5%**	**3.2%**	**-11.3%**

Table 2. Strategy performance forecast, 2020

Strategy return	Optimistic scenario	Base case scenario	Negative scenario
01.01.2020-30.06.2020	8.1%	8.1%	8.1%
6 month return (no Lev)	6.2%	2.0%	-6.2%
6 month return (50% Lev)	9.1%	2.8%	-9.6%
6 month return (75% Lev)	10.5%	3.2%	-11.3%
FY2020 (no lev)	**14.8%**	**10.3%**	**1.4%**
FY2020 (50% lev)	**17.9%**	**11.1%**	**-2.3%**
FY2020 (75% lev)	**19.4%**	**11.5%**	**-4.1%**

AXIOMA Wealth Management AG
Bleicherweg 50, CH-8002 Zurich
Tel.: + 41 43 305 07 10
info@axiomag.ch
www.axiomag.ch

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We hope you find this information useful and will be glad to answer your questions

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