Your wealth is our priority.

FACTUM

Investment Report

December 2018

Strategy overview

Following the sharpest price setbacks in years in October, the situation showed signs of stabilising in November. American equity indices recovered around 2%, while the MSCI Emerging Countries Index gained an even more impressive 4%. Many factors continue to suggest, however, that risks remain high. In Europe, an orderly “Brexit” is still not home and dry. Now that the British cabinet and the EU have agreed on a common rulebook, the vote will take place in the British House of Commons. The outcome, and consequently the political future of Theresa May, is completely uncertain. The EU Commission has paved the way for a deficit procedure against Italy. In our view, however, it is unlikely that Italy will actually end up with a fine amounting to billions of euros. Global equity indices responded positively – at least in the short term – to the “truce” between the United States and China. The customs duty hikes of 10% and 25% threatened by the USA on 1 January 2019 have been suspended for the present, and the parties have returned to the negotiating table. For financial markets, this could represent a welcome breathing space.

“Politics has a decisive impact on the development of share prices.”

Economic data coming out of Europe, China and Japan has mostly come in at the lower end of expectations. It also seems likely that growth in the USA will slow slightly in 2019. What interests us, of course, is whether the weaker growth and resulting margin pressures have already been fully priced into earnings expectations. We believe that companies whose profitability is less affected by cyclical factors and whose balance sheets are sound currently represent better investments than highly cyclical, capital-intensive companies. We are sticking to our generally positive market view for the present, and have therefore moderately overweighted the equity ratio. The partial hedging of the equity ratio remains in place, though, to protect against further price setbacks.

“We are sticking to our moderate overweighting and partial hedging of the equity ratio.”

Politics

As we predicted, the Democrats secured a narrow majority in the House of Representatives in the US midterm elections in the USA, meaning that they have broken the Republican's grip on both Houses of Congress. The dreaded "blue wave" failed to materialise, however. The country has once again got a "divided government", as had been the case during President Obama's final six years in office. Here too, a look at the history books is extremely interesting. 18 "midterms" have been held in the United States since the Second World War. Following all midterms, markets rose significantly. On average, the S&P 500 gained around 17% during the twelve months following these elections. The big question now is whether the two Houses will block each other or whether they will endeavour to work together and find a common denominator. We see the potential to pursue reforms in the fields of infrastructure and health.

"Rally following the US midterms."

In the trade dispute between the USA and China, there has at least been some good news. A temporary "cease-fire" was agreed at the talks between President Trump and Xi Jinping at the G-20 summit in Buenos Aires at the beginning of December. The customs tariff hikes of 10% and 25% threatened by the USA on 1 January 2019 have been suspended for the present. In return for shelving the hikes, China will with immediate effect start buying American agricultural products as well as goods from the energy and industrial sectors. This is intended to reduce the US trade deficit with China.

"Truce between the USA and China."

No success was achieved in the key negotiations on forced technology transfer, the handling of intellectual property and the further opening of China's market to foreign companies. However, talks continue and will need to be brought to a successful conclusion within 90 days, otherwise the currently suspended tariff increases of 10% to 25% will come into force at the beginning of March. This means the deadline has effectively been shifted two months into the future. It is nevertheless a welcome breathing space for the financial markets. Hopes that the USA and China will still come to a comprehensive agreement is likely to create positive market sentiment, at least in the short term. In view of the complex material that is up for negotiation, the time limit of 90 days is tight. In our view, it is also conceivable that the deadline will be shifted even further into the future. With a view to the presidential elections in 2020, President Trump is likely to claim any success in the negotiations. It is still too soon to celebrate a happy outcome, but is enough for industry insiders to breathe a sigh of relief.

"In view of the complex material that is up for negotiation, the time limit of 90 days is tight."

FACTUM

Economy

The official China purchasing manager indices proved weaker than expected in November. The PMI Manufacturing continued to ease from 50.2 to 50.0 points, listing at exactly the level that marks the dividing line between expansion and contraction. This means the activity indicator fell to its lowest in two and a half years. The important sub-index for incoming orders fell for the sixth time in succession. However, the situation in the service sector, which in the interim accounts for more than half of the Chinese economy, has also deteriorated further. The PMI Services eased from 53.9 to 53.4 points, meaning this likewise came in below expectations. This means, though, that it remains comfortably above the growth-critical threshold of 50 points. The purchasing managers' index for the overall economy, the PMI Composite, sank from 53.1 to 52.8 points. It seems Chinese economic growth has continued to lose momentum in the 4th quarter. Chinese industry, above all, is increasingly feeling the effects of declining demand from abroad and the impact of US punitive tariffs. At the same time, the various stimulus measures put in place by the Chinese government have not yet had a sufficiently stabilising impact.

"Continuing slowdown in the Middle Kingdom."

The Brazilian economy is looking in better shape. GDP growth rose by a substantial 0.8% in the 3rd quarter relative to the previous quarter, the highest rate of growth since the start of 2017. This is likely exaggerating actual economic momentum, however, as a nationwide protest by truck drivers at the end of May hit growth hard and GDP rose by only 0.2% in the second quarter. Despite this, the economic recovery is a positive sign. Relative to the previous quarter, investment rose 6.6%, the strongest rise recorded in nine years. Consumer confidence has also improved markedly. The consumer sentiment index rose from 86.1 to 93.2 points in November to reach its highest level in four years. The sub-indicator for the current situation increased from 71.9 to 74.6 points, while that for expectations jumped sharply from 96.6 to reach 106.4 points. Much as in the USA following the presidential election of November 2016, a strong confidence effect is also palpable in Brazil following the election of President Bolsonaro. This means the previously anaemic upturn in Brazil could gain added momentum.

"Good data from Brazil."

FACTUM

Equity markets

"Jerome Powell boosts equity markets – at least temporarily."

On international equity markets, strong price gains materialised in the last week of November. US equity indices, in particular, recorded robust gains. The leading index S&P 500 improved by an impressive 5% over the week. Equity prices also moved substantially higher in Japan (+3.3%), in Europe (+1.2%), in Switzerland (+1.8%) and in emerging countries (+2.4%). The speech by US Federal Reserve Chairman Jerome Powell sparked enthusiasm on equity markets. Investors were, of course, delighted to hear from the world's most important central bank that there were fewer economic headwinds than feared.

It is important not to be overly confident, however. The Fed will only end the cycle of interest rate hikes earlier than previously communicated if the US economy actually shifts down a gear and inflation remains sedate. A slowdown in the US economy at a time when the global economy is generally weak may well lead to tangible growth worries on equity markets, especially if there are no signs of stabilisation in Europe and China. It has not yet come to this, however. We are optimistic that the US economy will continue to expand next year at an acceptable rate of 2.5% in real terms, and that the global economy will manage a soft landing. At the same time, however, we are also expecting heightened volatility.

Bond markets

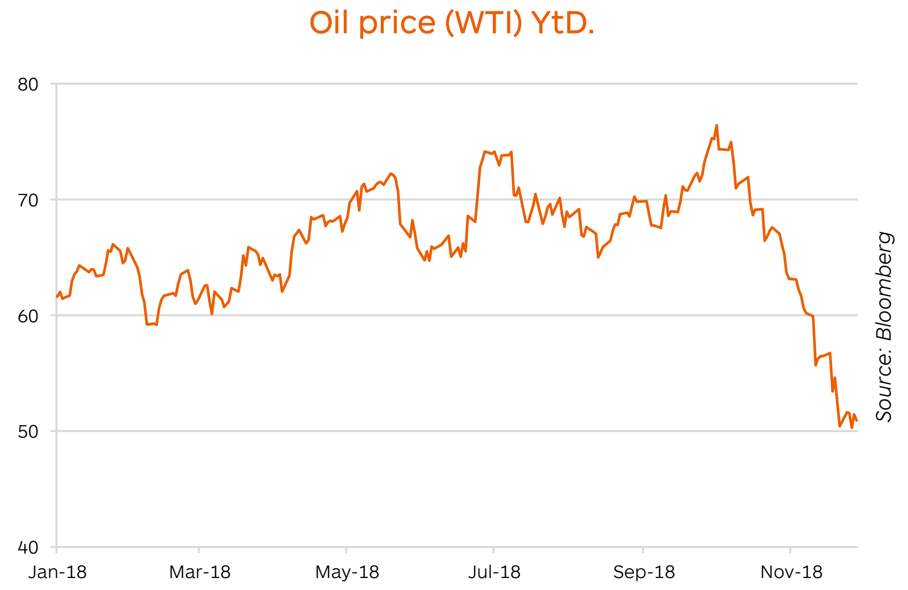
"Is the Fed really still independent?"

Only shortly after President Trump again let rip against Fed Chair Jerome Powell, Powell indicated that monetary policy would gradually be shifting to a more moderate course. This statement was noted favourably by financial markets. At the same time, the events will have boosted the debate about whether the Fed has yielded to pressure and is now kowtowing to the wishes of politicians. We do not, though, expect Powell to be overly influenced by the President's gut feelings. He has already made this clear on a number of occasions, at least indirectly. In actual fact, financial market volatility and the signs of weakness emerging in some areas of the US economy are likely to be what prompted the more moderate tones. In recent days, the sudden rise in risk premiums on the US bond market was noticeable. On account of the substantial increase in volumes in recent years and the higher indebtedness of the US corporate sector, this may be seen as the Achilles heel of the US economy. It is worth remembering in this conjunction that Powell remarked at the most recent Federal Reserve Meeting that excesses before the last two recessions materialised first and foremost on financial markets, and not in the form of inflation. Moreover, he confirmed that an excessively cautious monetary policy would entail higher costs than an excessively brisk approach. The challenge lies in the fact that central banks never really know whether their degree of restriction is appropriate. The Fed focuses on the so-called neutral interest rate, which in September was identified by Fed members at 3%. Powell's most recent statement suggests that the estimate for the neutral rate of interest is likely to be adjusted downwards, and that the appropriate degree of restriction will be achieved earlier. However, changes in real interest rates are also repeatedly cited as an important guideline. These rose by around two percentage points in the run-up to the past two recessions. Real interest rates have risen to the same extent since mid-2016, which would mean that monetary policy might already be having a more restrictive effect than is generally assumed.

Commodities

Just a few weeks ago, the price for the oil grade West Texas Intermediate was quoted at over USD 76 per barrel. An important argument for this was the sanctions imposed by the United States against Iran, which came into force at the beginning of November. Since October, oil prices have been moving only in one direction – namely downwards.

"Oil prices – extreme and unexpected price shocks have a long tradition."



US production has been higher than expected, which has boosted oil market supplies. Another factor has been Washington's softer approach to the Iran sanctions and the continuing shenanigans within the Organisation of Petroleum Exporting Countries (OPEC). This has put an end to prospects of a supply shortage. OPEC will be meeting in Vienna at the beginning of December.

Saudi Arabia, the largest and most important producer within the organisation, is already lobbying for a cut in production. What would normally have given the oil price a boost was this time unable to stop the downward drift on the oil market.

The oil market has long been accustomed to extreme and unexpected price volatility. Firstly, supply and demand are relatively rigid in the short term, which means that a change in these factors can lead to large price movements. In addition, the oil price is inherently vulnerable to fluctuations, because the relationship between the spot price and the price listed on futures exchanges is complex. In addition to supply and demand, oil inventories, the state of the global economy, exchange rates, interest rates, price hedging by companies and countries, and geopolitics are all factors that flow into the calculation.

"Various factors are responsible for the development of oil prices."

Currencies

It is not merely Europe's political turmoil, but also the terms and conditions of Britain's EU withdrawal and Italy's budget deficit that continue to weigh on the European single currency. European economic data has also been less than impressive of late. Following the weakness of German industrial production, Italian and French industrial production has also begun to show signs of weaker growth. It would come as no great surprise if the euro weakened against the US currency and the Swiss franc, at least in the short term – unless the US economy became significantly less expansionary, which would lower interest rate expectations in the US. This might indeed become a market topic towards the end of 2019.

"Not just political turmoil is undermining the European single currency."

FACTUM

Market Overview 30 November 2018

Stock indices (in local currency)	Current	1 Mt (%)	YtD (%)
SMI	9,037.76	0.17	-0.34
SPI	10,540.95	-0.89	-1.96
Euro Stoxx 50	3,173.13	-0.69	-6.45
Dow Jones	25,538.46	2.11	5.59
S&P 500	2,760.17	2.04	5.10
Nasdaq	7,330.54	0.50	7.26
Nikkei 225	22,351.06	1.96	-0.07
MSCI Emerging Markets	994,72	4.13	-12.02
Commodities			
Gold (USD/fine ounce)	1,220.52	0.47	-6.32
WTI oil (USD/barrel)	50.93	-22.02	-15.71
Bond markets			
US Treasury Bonds 10Y (USD)	2.99	-0.16	0.58
Swiss Government 10Y (CHF)	-0.10	-0.09	0.05
German Bund 10Y (EUR)	0.31	-0.07	-0.11
Currencies			
EUR/CHF	1.13	-0.88	-3.37
USD/CHF	1.00	-1.05	2.42
EUR/USD	1.13	0.04	-5.73
GBP/CHF	1.27	-1.13	-3.34
JPY/CHF	0.88	-1.43	1.79
JPY/USD	0.01	-0.46	-0.70

Author: Christof Wille, Dipl. Private Banking Expert NDS
Editorial deadline: 4 December 2018