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FACTUM

Investment Report

June 2018

Strategy overview

Recently published data shows that the global economic upturn has currently lost its positive momentum. While growth is continuing to accelerate in the United States, the latest set of data emanating from Europe points to an economic slowdown. In our view, however, this is more a growth hiccup than a new trend.

"Economic slowdown in Europe."

The past few months were challenging in many respects. Beginning with concerns about faster and more strongly rising US interest rates in February, an escalation of the trade dispute between the USA and China as well as possible negative consequences of pulling out of the nuclear treaty Iran occupied markets, and had a correspondingly negative impact on these. At the end of May, these factors were compounded by uncertainties associated with the efforts to form a new government in Italy, which led to heightened volatility on global equity and bond markets.

"Numerous trouble spots are currently weighing down on global equity and bond markets."

The Italian FTSE MIB Index lost around 12% of its value within a short timeframe. It is particularly worth noting, in this relation, that around 40% of the 40 stocks that make up the index are financial stocks – Intesa Sanpaolo and Unicredit each account for around 11%. The European banking sector slipped 2.6% to its lowest level since December 2016. Difficulties surrounding the formation of a new government in Italy appear to have put the risk of an EU/EURO crisis very much back on the agenda. In addition, having de-escalated the trade dispute with China, the US administration under President Trump has now shifted its focus back to Europe. Uncertainties in Italy pushed the value of the Swiss franc sharply upwards, and this posted gains against the euro. The CHF gained around 3.5% in value against the euro last month. We do not think a marked appreciation below 1.15 EUR/CHF will be taken lying down by the SNB.

"Attention is shifting back to Italy."

We remain firmly of the opinion that equities are likely to generate markedly higher returns (5-6%) than bonds during the course of the year. Despite this, we are sticking to the partial hedging of our equity ratio, on account of the above-described risks.

"We remain moderately upbeat."

Politics

It seems a new government – the 65th since the Second World War – is likely to be established in Italy (situation on 31 May 2018). The new coalition comprising the Five Star Movement and the Lega could be sworn into office before long. In Spain, Prime Minister Mariano Rajoy is facing a no-confidence vote. In our view, two scenarios are possible here: If the vote is successful, which seems to be the most likely outcome, Rajoy would either be forced to hand the reins of government power over to the social-democratic PSOE, or could step down before the vote and call a new election.

"Chaos has returned to southern Europe."

There appears to be a thaw in relations between Washington and Pyongyang. While it remains to be seen whether a summit will actually take place, negotiators say that preparatory talks have already made a certain amount of progress.

"Thaw in relations between Washington and Pyongyang."

It will be interesting to see how the trade dispute between the USA and China plays out. The positions of the two major powers are easy to understand. Ultimately, the key issue is global dominance in geopolitically important technologies. It appears inevitable that the United States, the world's biggest consumer – consumption accounts for around 70% of US gross domestic product, more than in any other country – will have a substantial trade deficit with the world's biggest producer nation.

"What links the foundation of NASA on 29 July 1958 to today's dominance of IT companies in the USA?"

Actually, however, there is another issue at stake here: The leading market position in new technologies. Whoever secures predominance here will also secure global dominance at the geopolitical and military levels, not just in global economic terms. We should not forget that the USA, thanks to its previous NASA space projects, was a leader in computer technology, which helped to prepare the ground for the US IT giants that dominate the world today.

"Trade dispute between the USA and Europe has escalated."

At the end of May the Trump administration announced that customs duties amounting to 25 percent on steel and 10 percent on aluminium would be imposed on deliveries from the EU, Canada and Mexico with effect from 1 June 2018. In our view, these customs duties do not represent a risk for the global economy. It would be more problematic if the trade conflict triggered a spiral of measures and countermeasures. As argued in this publication on several occasions in the past, a full-blown trade war would not produce any winners, neither in economic, nor politic terms.

Economy

"US economy in good shape."

The US economic slowdown that materialised in the first quarter of 2018 is already likely to have given way to a renewed economic upturn. This, at least, is what the economic data issued to date seems to suggest. First and foremost private consumption, which rose by only 1.1% in the first quarter, is likely to have gathered considerable momentum in the interim. In the case of the manufacturing sector, while the PMI improved only marginally from 56.5 to 56.6 points, this still meant the index hit a 44-month high.

"Clouds gathering in Europe."

Provisional purchasing managers' indices for the Eurozone and the two largest economies, Germany and France, slipped back in May. The purchasing managers' index for the overall Eurozone economy – PMI Composite – fell from 55.1 to 54.1 points to reach an 18-month low. In addition to lower growth, the Eurozone also saw a weaker rise in incoming orders, employment and order backlogs in May. At the same time, the business outlook for the coming year has become less optimistic.

"Consumer confidence remains high, despite slowdown."

In overall terms it is possible to say that survey results for the month of May proved disappointing. At the current level, the results point to growth marginally above 0.4% in the second quarter. The Eurozone's economy had already grown 0.4% in the 1st quarter of 2018. At the start of the year, purchasing managers' indices were signalling very high growth in the region of 1%. The growth acceleration to 0.6% in the second quarter that had been anticipated by the consensus is looking increasingly unrealistic. We are expecting

growth of around 2% for the Eurozone, which is still relatively upbeat. Our forecast is based on consistently high employment growth, which points to robust private consumption. On the positive side, consumer sentiment remains close to the high of January 2018.

Equity markets

May was a difficult month for global equity markets (see Market Overview). US indices, in particular the US technology index Nasdaq, bucked the trend. In March the technology sector, above all so-called "FANG stocks" – Facebook, Amazon, Netflix and Google – was responsible for the stockmarket correction. Excessive valuations, compounded by the risk of a downturn in earnings triggered by tougher regulation of data utilisation as well as reduced opportunities for tax optimisation led to sharp falls in prices. Many investors thought this signalled the end of the bull market, as it had specifically been these stocks that had been responsible for a large part of the extended stockmarket boom. Now, however, these fears seem to have dissipated into thin air. Many technology companies, and "FANG stocks" in particular, are either back near or even over their February highs.

"Nasdaq is recovering from its weak phase in March."

Corporate tax relief is certainly one reason for this performance. Rapid technological developments and the digitalisation of industry, inter alia the "internet of things" will keep demand for semiconductors, sensors, memory and computer capacities high in the coming years. The high valuations provide scope for corrections at any time, however.

Bond markets

Memories of the government debt crisis have rarely been so acute as at the end of May. Massive setbacks on Italy's capital market, triggered not least by government coalition negotiations, triggered price falls on equity and bond markets across Europe. The yield on 2-year Italian government bonds, for example, rose to 2.6%. The last time it was this high was in the summer of 2012, during the hottest phase of the financial crisis. Yield premiums, so-called spreads, on German government bonds, Bundesanleihen, also widened.

"Fears about a return of the crisis."

Of the approximately EUR 1.6 trillion outstanding government bonds, the European Central Bank holds around EUR 340 billion or some 20% of Italian government debt. The share has risen substantially in recent years, on account of the bond buying programme. At the start of 2016 the respective figure was less than 10%.

"ECB holds about 20% of Italian government debt."

40% of Italian government debt is held by domestic banks. It therefore comes as no great surprise that bank stocks, in particular, have been hit hard by bond market volatility. Shares in Unicredit, for example, which holds Italian government bonds worth some EUR 42 billion, were suspended from trading after the price dropped around 5%. The risks emanating from Italy's high government debt remain closely entwined with the Italian banking system.

"40% of Italian government debt is held by Italian banks."

About one third of Italian government debt is financed by foreign investors. In the wake of the 2008 financial crisis, the willingness of foreign investors to lend the Italian state capital has dropped significantly. Between 2005 and 2008, the share of foreign creditors was in the region of 50%. French banks are currently the most important foreign creditors, followed by their German counterparts.

"The French banking burden."

Unsurprisingly, financial market unrest quickly spreads to other weak candidates. In recent days, "contagion" of this nature has already been taking place. Bond yields in Portugal and Spain have soared. Greek government bonds suffered the sharpest losses, however. On Tuesday these literally plummeted, with yields rising by 30 basis points. It is worth pointing out, though, that the countries facing government debt crises are in a far better position today, in terms of growth and funding, than was the case five years ago. In our view, the greatest risk of contagion exists within European banks.

"We see a risk of contagion in particular within European banks."

Commodities

The United States starts the summer with its extended "Memorial Day Weekend" at the end of May. Around 36 million Americans hit the road in their cars on this particular weekend. Drivers are therefore likely to welcome the fact that oil prices fell by around 2% last month.

"Hit the road again."

There are rumours that Russia and the OPEC states are looking to raise their production quotas. The meeting of OPEC and non-OPEC states on 22 and 23 June is likely to throw light on this matter. It was around two years ago that oil prices slipped below the USD 30 per barrel mark. Since then, the price has risen almost three-fold. Despite the recent correction, US drivers will be paying around USD 0.65 more for fuel this summer than they did last year. At an average of USD 2.95 per gallon, however, fuel still costs only around USD 0.77 per litre.

"One litre of fuel in the USA costs around USD 0.77."

Currencies

While the Turkish lira has been anaemic for many years, it has recently been plummeting. At the end of May, the currency eased up to 5% against the Swiss franc. The Central Bank of Turkey (CB) then intervened and raised its base rates from 13.5% to 16.5%. At one point, up to 4,965 lira were required to acquire a single Swiss franc – an all-time record. Following the interest rate hike, the exchange rate fell 6%. Prior to this, the lira had slipped by some 20% since the start of the year, having lost around 75% of its value over the past decade.

"Facing currency crises."

The prevailing weakness of the Turkish currency derives essentially from the country's macroeconomic and political operating conditions, and is compounded by speculative activities. All eyes will be on Turkey to see whether the collapse in the value of the lira will cost Erdogan votes in the election on 24 June.

"Reasons for the weakness of the Turkish lira."

Market Overview 31 May 2018

Stock indices	Current	1 Mt (%)	YtD (%)
SMI	8,740.97	-4.37	-6.84
SPI	10,164.78	-3.42	-5.46
Euro Stoxx 50	3,406.65	-2.31	-0.31
Dow Jones	24,415.84	1.41	-0.24
S&P 500	2,705.27	2.41	2.02
Nasdaq	7,442.12	5.50	8.32
Nikkei 225	22,201.82	-1.18	-1.62
MSCI Emerging Markets	1,120.71	-3.52	-2.57
Commodities			
Gold (USD/fine ounce)	1,298.51	-1.28	-0.33
WTI oil (USD/barrel)	67.04	-2.23	10.96
Bond markets			
US Treasury Bonds 10Y (USD)	2.86	-0.09	0.45
Swiss Government 10Y (CHF)	-0.07	-0.15	0.08
German Bund 10Y (EUR)	0.34	-0.22	-0.09
Currencies			
EUR/CHF	1.15	-3.67	-1.49
USD/CHF	0.99	-0.51	1.18
EUR/USD	1.17	-3.19	-2.60
GBP/CHF	1.31	-3.89	-0.45
JPY/CHF	0.91	-0.02	4.78
JPY/USD	0.01	0.48	3.56

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