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Investment Report

March 2018

Strategy overview

"Keep calm in turbulent times".

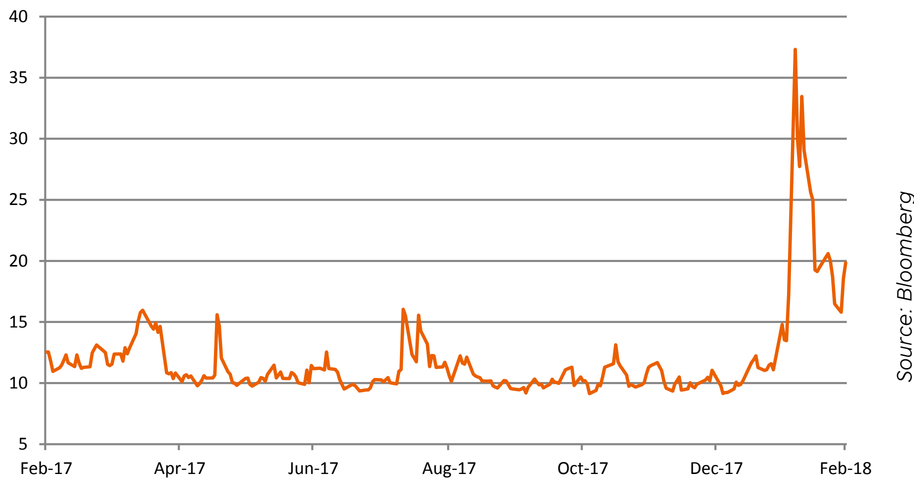
There was a barnstorming start to the year 2018. After gaining around 5% in January, however, global equity markets then underwent a correction. This needs to be seen within the context of a remarkably long period without a market consolidation, though. The correction started in the USA. This was at least partly due to the fact that the US equity market has not experienced a correction of more than 5% for over 400 days – that is to say for over a year. The Dow Jones Index, for instance, suffered the biggest absolute one-day loss in history, and the sharpest percentage one-day fall in six and a half years. In our view, this was triggered by a raft of factors. A rise in global bond yields, led by the USA, prompted by the rising US budget deficit as well as the surprising hike in wage growth. Volatility rose from an extremely low level, which surprised many investors, who had been expecting continued low equity fluctuations with investment products. Computer-driven sales – high-frequency trading – were suddenly triggered, and this is also likely to have compounded the developments.

"From a fundamental perspective, nothing has changed."

It is important to note that from a fundamental perspective, unlike in the case of the market corrections of 2000, 2008 or 2011, nothing has changed. Back then, many leading indicators were pointing to a marked downturn in the global economy, which is not the case this time round. In our view, we do not see a recession materialising any time soon.

"Panic sales that are driven by emotions are misguided."

The observed rise in volatility from the below-average level last year (see following chart) is a process that has not yet been wrapped up. Interest rates are beginning to rise, and this harbours uncertainties. In the short term, further market jitters are to be expected. For this reason, it is important for investors with medium to long-term horizons to keep their calm. In our view, panic sales that are driven by emotions are misguided.



What implications do the above-described market movements have for our managed portfolios? Following the first price slide, we decided to renew our hedge on the S&P 500 with maturity in March and June 2018 via put options, and engaged in profit-taking.

"What are the implications for our managed portfolios?"

As mentioned in previous reports, we reduced our equity ratio in January to neutral, and left the resulting liquidity on the current account. In retrospect, this was a smart move. After pondering the situation carefully, we then used the weak phase to raise the equity ratio once again. We did this by means of an exposure to the telecommunications sector in Europe. This had taken a beating, yet presents an attractive dividend yield. As a consequence, we are now once again moderately overweighted in equities.

"We used the weak phase to build up equities, and equities are now once again moderately over-weighted."

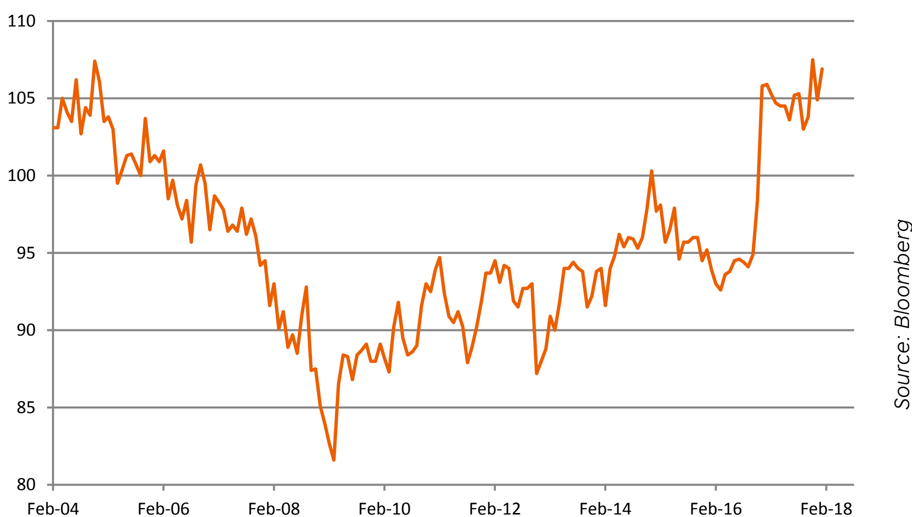
Economy

The small business sector in the USA is worthy of attention. As the latest survey conducted by the National Federation of Independent Business (NFIB) shows, this segment improved 2 points in January, and rose from 104.9 to reach 106.9 points. This means the sentiment barometer is again listing close to the long-term high it had in November when it reached 107.5 points. A record number of businesses (32%) stated that it was a good time to expand. The proportion of small enterprises that saw themselves obliged to pay higher wages was also significantly higher, however. This is being driven by the tight state of the labour market. The sub-index rose to 31 points, reaching the highest level since 2000. Many small enterprises are also planning to raise wages further. This sub-index reached 24 points, the highest it has

"Very positive sentiment amongst small US enterprises."

been since 1989. These statements dovetail perfectly with the picture of rising inflationary risks. The ability to attract qualified employees has now become the biggest worry for small enterprises, displacing concerns about too much red tape and excessive taxes.

NFIB Small Business Optimism Index



Equity markets

In what direction are equity markets moving? Are new records on the cards, or are we about to see a second wave of sell-offs? Since the “mini-crash”, which saw the S&P 500 Index lose a total of 12% – 4.6% on 5 February alone – indices around the globe have recovered markedly (see market overview chart). While American indices as well as emerging country equities have again been posting modest gains since the start of 2018, Europe remains moderately in negative territory, while Switzerland is even 5% lower. This is due to the fact that the index heavyweights Nestlé and Roche have lost around 10% of their value.

“In what direction are equity markets moving?”

From a historical perspective, such setbacks are nothing unusual. As the statistical analysis of historical price fluctuations in the Dow Jones Industrial shows, over the past 120 years a one-day drop of 4.6% has occurred about one hundred times during this period. If this event took place at regular intervals, it would happen about once per annum.

“How should the correction be judged from a historical perspective?”

If one examines S&P 500 corrections since the year 1970, there were a total of 14 correction phases, which on average led to a loss of 13%. From start to end, these lasted about three months, and the correction had been ironed out once again four months after bottoming out.

"Since 1970, an S&P 500 correction phase lasted three months, and it took four months for the correction to be made up once again."

In terms of extremely low volatility, the year 2017 was something of an exception. Over 50 days, the implicit volatility was less than 10% – this parameter was briefly below this level only during the years 1995/96 and 2006/07. The phenomenon of extremely low fluctuations is attributable to the improved global macro environment, high earnings growth and low interest rates. In our view, the current volatility is a more adequate reflection of the market risks. This means the correction can also be interpreted as a wake-up call, and one that creates new opportunities.

"The current volatility now properly reflects market risks."

We remain upbeat about the prospects for equity markets, and continue to see the highest potential in this asset class. At the same time, however, we should also expect greater market fluctuations. A suitable instrument can be used to hedge our managed portfolios against unforeseeable events at any time.

"In our view, the equities asset class continues to offer the greatest potential."

Bond markets

Publication of the Fed minutes on the interest rate decision of 31 January was eagerly anticipated at the end of February. The minutes show that the currency watchdogs took a brighter view of the economic situation and price momentum at the start of the year than had been the case at the December meeting. Against this backdrop, there is probably no longer an obstacle to an interest rate hike in March. In the interim, the market has comprehensively priced in this increase.

"Next US rate hike expected shortly."

Will there be three of four interest rate moves this year? The Fed is keeping its cards close to its chest. We are sticking, for the present, to our forecast of three interest rate moves. After years in which inflation lay below the 2% target, the Fed could now probably live with inflation slightly above the target for a certain period. This then suggests that the Fed, even if inflation were to rise slightly more sharply in the coming months, will refrain from overreacting, which is something that had been concerning some financial market watchers.

"We are expecting three interest rate rises from the Fed in 2018."

Bond markets saw some sharp movements. The yield on 10-year US Treasuries, for example, rose from 2.41% at the end of December 2017 to 2.86% at the end of February. With bonds, there is a clear link between interest rate levels and yields. If the general yield level rises, future coupons need to be discounted with a higher interest rate, leading to sinking market prices, depending on the maturity and level of the coupon.

"Sharp bond market movements."

Inflationary pressures materialising in the USA and in parts of Europe, compounded by the dispositions of central banks, will continue to be a focus for discussion in the coming months. We are continuing to expect a gradually rising inflationary and interest rate trend. So long as 10-year US Treasuries do not rise above 3.5%, equity markets and the economy should be able to absorb the higher level relatively well.

"We are continuing to expect a moderately rising inflationary and interest rate trend."

Commodities

Oil prices were weak in February. The price of the oil grade WTI slipped around 5% last month, listing only slightly above the 20-year average of USD 60. We are not expecting oil prices to plummet any time soon, however. The global economic upturn is too synchronous for this, and economic optimism is too strong.

"Falling oil prices last month."

Despite easing 2% in February, our view of gold remains essentially positive. We continue to see gold as an integral part of our portfolios. Gold acts as a portfolio stabiliser, particularly in the event of an unexpectedly swift rise in inflation or sudden geopolitical crisis.

"Gold also experienced a weak month."

Currencies

In recent months, many people had been expecting rising interest rates and yields to strengthen the US currency. This narrative, naively based on theoretical principles, frequently expounded. Those who speculated accordingly will now be licking their wounds. Since the start of last year, the American currency has not in fact gained at all. Instead, it has suffered losses across the board. This despite the fact that the American Federal Reserve began raising base rates in November 2015 in five 0.25% steps, latterly to 1.5%. And despite the fact that the yield on two-year government bonds has risen within one year from 1.2% to latterly 2.2%. Against the euro, the dollar lost up to 17%, against the Swiss franc some 10% and against the yen about 10%. The interest rate gap appears to have played a comparatively minor role in this, as the dollar price has become significantly decoupled from this.

"The US currency is showing signs of weakness."

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One reason for the weakness is likely to be the American twin deficit – that is to say the trade balance and the government budget. We see two reasons for this: Firstly, the fiscal-policy stimulus programme recently approved by the US Congress has come at completely the wrong time. This is not merely driving inflationary expectations higher; huge refinancing needs are also increasing the supply of bonds, which is having the effect of squeezing bond prices and boosting yields. Secondly, the trade balance needs to be refinanced as well, which will inevitably lead to higher imports, as capacities are already close to their limits. According to conservative estimates, the twin deficit is likely to rise to over 3% of gross domestic product in both of the next two years.

"Trump's policies are weighing down on the US dollar."

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Market overview 28.02.2018

Stock indices	Current	1 Mt (%)	YtD (%)
SMI	8'906.38	-4.60	-5.07
SPI	10'258.63	-4.46	-4.58
Euro Stoxx 50	3'438.96	-4.57	-1.60
Dow Jones	25'029.20	-3.96	1.69
S&P 500	2'713.83	-3.69	1.83
Nasdaq	7'273.01	-1.73	5.54
Nikkei 225	22'068.24	-4.41	-3.00
MSCI Emerging Markets	1'195.19	-4.63	3.31
Commodities			
Gold (USD/Fine ounce)	1'318.31	-1.99	1.19
WTI-Oil (USD/Barrel)	61.64	-4.77	2.02
Bond markets			
US Treasury Bonds 10Y (USD)	2.86	0.16	0.46
Swiss Government 10Y (CHF)	0.09	-0.02	0.24
German Bund 10Y (EUR)	0.66	-0.04	0.23
Currencies			
EUR/CHF	1.15	-0.37	-1.58
USD/CHF	0.94	1.43	-3.05
EUR/USD	1.22	-1.77	1.57
GBP/CHF	1.30	-1.66	-1.30
JPY/CHF	0.89	3.80	2.41
JPY/USD	0.01	2.35	5.63

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