FACTUM

Investment Report

September 2018

Strategy overview

Record – the S&P 500 Index in the USA, which encompasses the shares of the 500 biggest listed companies in America, hit a new all-time high of 2,914 points on 29 August. A correction of 20% or more has been avoided for around 3,460 calendar days, making it the longest bull market since the Second World War. Investors in America are not currently focusing on domestic policy shenanigans. Prices are being determined by good to excellent economic and corporate data. It is worth remembering that in the approximately 240-year history of the United States, a president has never actually been removed from office using the so-called impeachment process.

"The S&P 500 is enjoying the longest bull market since the Second World War."

In our view, attention should focus on the trade war conjured up by Donald J. Trump, the forthcoming budget debate in "Bel Paese", the persistently unresolved "Brexit question" and the recent withdrawal of capital from emerging markets. These factors have the potential to trigger a market correction. In our view, however, the risk of a strong global economic downturn is currently minimal.

"Risk factors, such as the forthcoming budget debate in Bel Paese, will need to be monitored closely."

At the present time, we are sticking to our neutral equity weighting as well as to partial hedging. In spite of (geo-) political tensions, the gold price performance has been disappointing in recent weeks and months – the stronger greenback was a contributory factor. The positive characteristic of portfolio stabilisation during times of heightened volatility has not manifested itself since mid-April 2018. In addition, key chart markers of USD 1,300 and USD 1,220 have been undercut and breached. Despite the fact that we are confident about the long-term diversifying qualities of gold, we have consequently sold a part of our gold exposure.

"Due to the disappointing performance of the gold price, we have reduced our exposure."

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Politics

Attention will turn to Italy in the coming weeks, where budget discussions remain the central issue. Although the two Deputy Prime Ministers Salvini of the Lega and Di Maio of the Five Star Movement disagree on various fundamental issues, they succeeded in integrating their election promises into a joint economic programme. Elements include the income tax cut associated with the introduction of a "flat tax", the hiring of 10,000 state employees and the reduction of the retirement age coupled with an increase in pensions.

"Over the coming weeks attention will turn to the budget discussion in Italy."

In around two months all seats in the House of Representatives and one third of seats in the Senate will be up for grabs. Up until now, Trump has enjoyed a Republican majority in the Senate and House of Representatives. A double majority of this nature has existed only four times since 1945. This was the case in 1953/54 under Dwight D. Eisenhower, in 2001/02 and 2003/04 under George W. Bush as well as now under Trump. During these periods the Dow Jones recorded gains of around 16% under Bush and 39% under Eisenhower. From this perspective it would be desirable for the "GOP" to defend its majority in both Chambers of Congress.

"US mid-term elections coming into focus."

Economy

The Indian economy saw growth accelerate further in the second quarter of 2018. Gross domestic product increased by a substantial 8.2% relative to the previous year. With the highest growth since the beginning of 2016, the market expectation of 7.6% was significantly outperformed. Analysis of the various GDP components shows that growth remains broad-based and that the sixth largest economy is in excellent shape.

"The Indian economy is in great shape."

The situation in Brazil is very different. The Brazilian economy again posted anaemic growth in the second quarter, and has been recovering extremely sluggishly from the most serious recession of the post-war period. In fact the modest growth of 0.2% was merely the result of inventory build-ups. Excluding inventory effects, GDP actually contracted 0.7%.

"Brazil is recovering only very slowly from its most serious post-war recession."

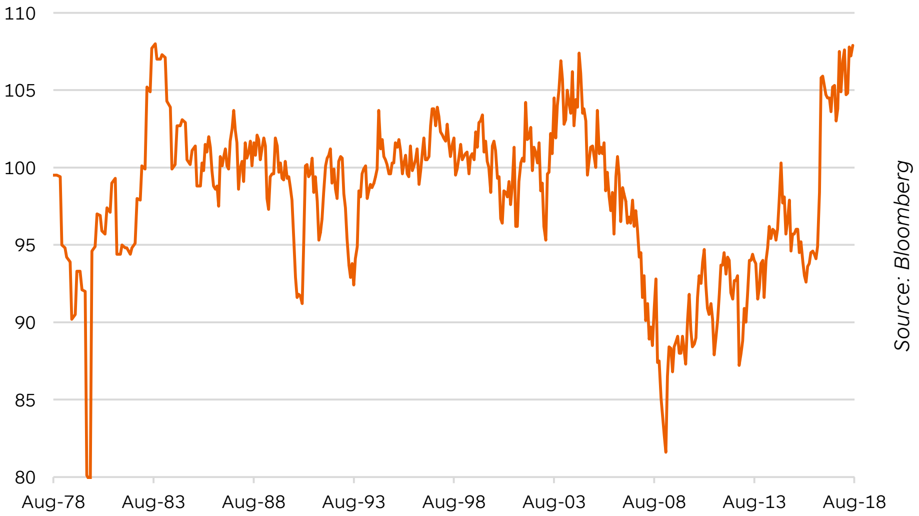
According to a revised estimate, the US economy grew even more strongly in the second quarter of 2018 than had initially been assumed. The annualised growth rate relative to the previous quarter was adjusted upwards from 4.1% to 4.2%. The GDP component of investment, which gained 8.5%, is particularly worthy of mention.

"US economy expanded even more strongly during the second quarter".

The NFIB Small Business Optimism Index, see following chart, which is compiled from business optimism surveys conducted amongst independent small enterprises, recently hit 107.9 points. This corresponds to the second-highest figure in this data series, and is just 0.1 points below the record high of 1983.

"Optimism amongst NFIB companies reaches the second-highest level since records began."

NFIB Small Business Optimism Index



Equity markets

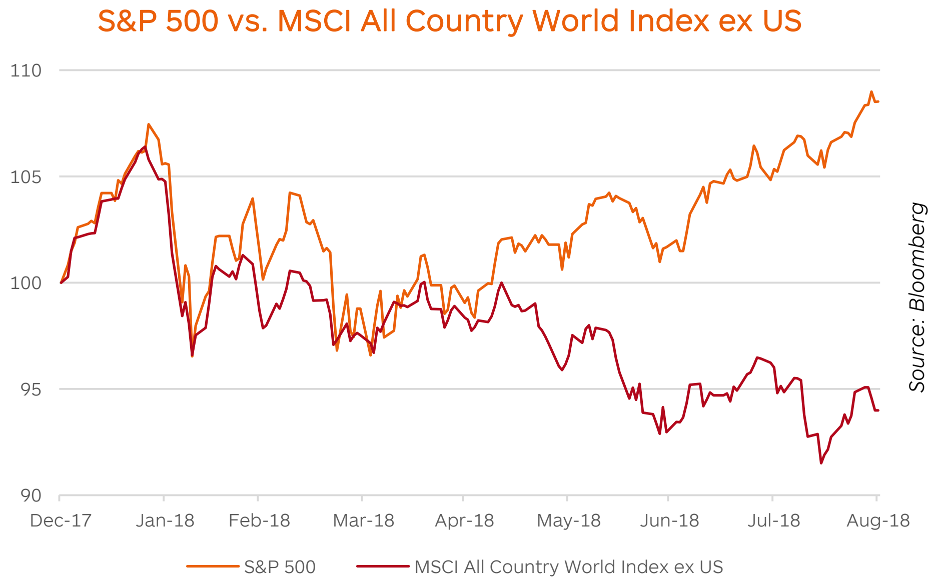
In August, global equity markets failed to maintain the recovery they enjoyed in July – with the exception of the United States and Japan. An important reason for the strong performance of the US stock market this year is the revision of corporate earnings. While 2018 earnings estimates for the USA have risen by over 10% since the start of the year, those in other equity regions have been revised downwards. Quarterly figures also show significant divergence between the USA and Europe. US companies have been able to lift their earnings by around 25% relative to the previous year – excluding the effect of tax cuts the growth rate would still have been marginally above 10%. European companies have seen their earnings rise by just 7%.

"Strong earnings performance by US companies."

The US equity market has also been greatly supported by share buybacks. The companies included in the S&P 500 Index announced buybacks amounting to around USD 430 billion in the second quarter, which is almost twice as high as in the previous quarter. Current estimates indicate that shares worth USD 800 billion will be bought back in the current year.

"Share buybacks as positive driver for the US equity market."

As the following chart shows, the US market (S&P 500) performed around 13% better this year than the MSCI All Country World Index ex US – that is to say, the rest of the world.



The question is how long this trend is likely to continue. The European interest rate landscape speaks for local markets. Average dividend yields in the USA are around one percentage point below the yield on 10-year government bonds, while in Europe and Switzerland the positive yield gaps are 3% and 3.5% respectively. Negative for Europe is undoubtedly the uncertainty when it comes to Italy and the potential risk of contagion for other peripheral countries. European companies would be more strongly impacted by a trade war or collapse in emerging economies than the USA. Listed European companies generate around 50% of their earnings abroad. We are firmly of the opinion that when it comes to unexpected events, the risks for European markets are bigger than for America. The main reasons why we are nevertheless maintaining overweighted equities in Europe are their lower valuations and the above-mentioned yield gap. In our view, there is no need to rush into a new exposure to emerging economy equities.

“Higher yields and risks in Europe.”

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Bond markets

We regard the optimistic economic assessment of US monetary authorities – the Fed called economic activity "strong" for the first time since May 2016 – as a clear signal of at least one more interest rate hike this year. We are expecting the next, eighth interest rate hike since the financial crisis to take place at the end of September. This is likely to see the target band raised by 0.25% to between 2% and 2.25%.

"The Fed calls the economy strong for the first time since 2016 – next interest rate move likely at the end of September."

The Bank of England lifted its base rate from 0.50% to 0.75% last month. Following the last hike in November 2017, this means the UK's monetary watchdogs have now lifted base rates twice since the financial crisis. One day after the interest rate decision, the Head of the Bank of England, Mark Carney, issued another sharp warning about an uncontrolled Brexit. There is an unpleasantly high risk that Great Britain could leave the EU in March 2019 without an agreement. A hard Brexit would disrupt trade, would slow the economy and drive prices higher. According to Carney, this is an outcome that needs to be avoided at all costs.

"Base rate hike by the Bank of England."

Turkey is facing serious problems because its strong growth has been financed with foreign capital and its currency reserves are insufficient to meet short-term liabilities. Turkey's external debt amounts to USD 450 billion, corresponding to 50% of GDP. Over the next twelve months, loans worth USD 120 billion are set to fall due. This sum substantially exceeds the currency reserves held by the Turkish central bank. The situation is compounded by a current account deficit amounting to 6% of GDP, which is causing a steady outflow of foreign exchange. Around half of the foreign currency debt – USD 220 billion – was issued by banks, mainly in the EU region, whereby most of the loans were granted through Turkish subsidiaries. For this reason we do not think contagion of the European banking sector is a realistic scenario. The Turkish currency crisis is unlikely to have a significant impact at the trade level, as only around 1.5% of Eurozone exports go to Turkey.

"Turkey is facing serious problems."

The fact that other emerging economies are also under pressure is of much greater significance. The reasons for this are the more restrictive US monetary policies, the trade conflict with the USA and the increase in foreign debt seen in recent years. When it comes to current account surpluses and foreign exchange reserves, Asian countries are in better shape than in the 1990s. That is why we do not believe that emerging markets will be affected across the board. Higher US interest rates triggering capital outflows from growth markets is a recurring scenario. In recent months, however, currencies of countries with high current account surpluses such as South Korea or

"Will the Turkey crisis drag other emerging economies down?"

Thailand have also come under pressure. This clearly indicates that worries about an escalating trade war are playing a role. Central banks in these countries are finding themselves obliged to raise interest rates simply in order to stabilise their currencies and inflation. This has made it necessary to trim growth expectations, which will further impair economic momentum at the global level.

Commodities

"Copper as leading indicator."

Many market watchers see the performance of the price of copper as a good leading indicator. After iron and aluminium, copper is the most commonly used metal. It is used in electronics, in the construction industry and in the transport sector. For this reason the copper price is thought to reflect the general strength of demand in the global economy, earning it the nickname "Dr Copper". The price of copper fell by around 22% between June and August, contributing to concerns about a weakening global economy.

Copper in USD

The fall in the copper price is difficult to explain, as looming labour conflicts in the key copper exporting country Chile would normally suggest that prices would rise. Demand also appears to be robust, because inventories that are monitored by external observers have been declining. This circumstance would point to a price increase.

This is making the slide in copper prices even more alarming. Events on the copper market may in fact be attributable to the escalating trade conflict between China and the United States. China accounts for around half of global demand for the industrial metal. This means weaker copper prices are therefore primarily a statement about expectations with regard to the Chinese economy. In addition, exchange rate movements have seen the dollar strengthen against the Chinese currency, dampening Chinese demand for the metal, which is denominated in dollars. While “Dr Copper” is therefore right to issue warnings, these are likely to be somewhat overblown.

“Dr Copper is issuing warning signals – although in our view these are overblown.”

Currencies

The US currency gained around 10% against the euro between mid-April and mid-August. Because of their substantial dollar debts and current account deficits, this has accentuated the difficulties faced by emerging economies such as Argentina or Turkey. At the Central Bank Conference in Jackson Hole in Grand Teton National Park in the federal state of Wyoming, US Federal Reserve Chairman Jerome Powell endeavoured to talk down the US dollar. He signalled further, gradual interest rate hikes, while simultaneously stressing that he would not under any circumstances be prepared to jeopardise the current favourable performance of the American economy. These “dove-like” statements caused the US dollar to depreciate, at least temporarily, and lifted the EUR/USD currency pair above the psychological and technical chart support level of 1.15.

“Jerome Powell is endeavouring to constrain the strength of the USD – which is also what Trump, who does not favour a strong US currency, wants to see.”

The question now is just how sustainable this movement will be. If the European economic environment does not improve significantly relative to the strong American economy, it cannot be ruled out that the euro might ease further against the US dollar as well as against the Swiss franc, after a period of consolidation. This could trigger renewed capital flows in the direction of the United States. Negotiations between the USA and China on customs tariffs and technology issues will be absolutely crucial for the Turkey crisis along with emerging economy currencies that have come under pressure due to the escalation of the trade dispute. The currency volatility index of the nine most important global currency pairs rose 20% in August, which is a huge figure for currencies.

“How sustainable is a price of over 1.15 for the currency pair EUR/USD?”

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Market Overview 31 August 2018

Stock indices	Current	1 Mt (%)	YtD (%)
SMI	8,973.56	-2.19	-1.15
SPI	10,740.34	-1.45	-0.10
Euro Stoxx 50	3,392.90	-3.70	-0.35
Dow Jones	25,964.82	2.56	6.73
S&P 500	2,901.52	3.26	9.94
Nasdaq	8,109.54	5.85	18.32
Nikkei 225	22,865.15	1.44	1.52
MSCI Emerging Markets	1,055.96	-2.68	-6.99
Commodities			
Gold (USD/fine ounce)	1,203.62	-1.68	-7.61
WTI oil (USD/barrel)	69.80	1.51	15.52
Bond markets			
US Treasury Bonds 10Y (USD)	2.86	-0.10	0.46
Swiss Government 10Y (CHF)	-0.10	-0.08	0.05
German Bund 10Y (EUR)	0.33	-0.12	-0.10
Currencies			
EUR/CHF	1.12	-2.91	-3.93
USD/CHF	0.97	-2.16	-0.55
EUR/USD	1.16	-0.76	-3.36
GBP/CHF	1.26	-3.40	-4.65
JPY/CHF	0.87	-1.48	0.89
JPY/USD	0.01	0.74	1.48

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