Investment Report

April 2018

Strategy overview

“Lighting the global trade fuse.”

The trade war that is being stoked by the United States has led to a further sharp rise in market volatility. There is broad agreement that a general rise in protectionism will push inflation higher and constrain growth. Even though it is difficult to judge whether the trade policy stand-off between the USA and China will indeed escalate and how strongly Europe will be affected, we are very much of the opinion that markets have tended to react overly sensitively. As a consequence we are sticking to the light overweighting of the equity ratio.

“Diverging central bank policies.”

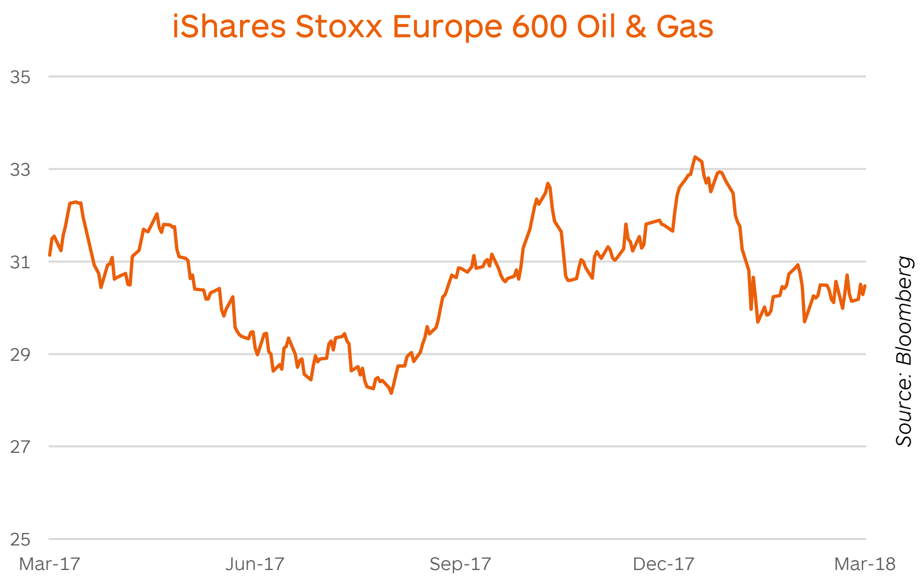
The US Federal Reserve raised its key lending rate 25 basis points, as anticipated, and appears determined to stick to its present policy. In Europe, the monetary-policy debate is revolving primarily around when to phase out the current QE programme. Deposit interest rates are likely to be raised at the earliest in mid-2019. The risk of an accentuating trade conflict, which could boost demand for Swiss francs, will probably persuade the SNB to hold off from raising interest rates before the ECB. Unlike equity markets, bond markets have barely responded to trade-policy imponderables. Higher inflationary expectations for the USA will become apparent above all at the longer end of the maturity spectrum. Net sales by the US Federal Reserve and the widening government deficit will push long yields higher.

“Gold remains an essential element of our managed portfolios.”

In view of the potential trade war escalation, market volatilities are likely to remain high. Sooner or later, the fact that US government debt is continuing to soar, and that some peripheral countries in Europe have levels of debt that are unsustainable in the long term, will raise questions about monetary stability. During times of rising risk aversion, gold offers good protection on account of its negative correlation characteristics, suggesting that demand for gold is likely to rise. We continue to view our gold exposure as an essential part of our managed portfolios, and are sticking to the position.

Following a strong rally during the second half of 2017, energy sector stocks (see following chart) have recently undergone a strong correction. They are currently listing at the support level of the previous year. As we are no longer expecting 2018 to produce the storming double-digit performance in traditional equity markets that was seen in the year 2017, in mid-March we used lower prices as well as heightened volatility to build up our exposure to the energy sector. The transaction had a neutral impact on the equity ratio. This means we simultaneously reduced our equity ratio that was covered passively by ETFs.

"Building up a position in the energy sector."



Politics

US President Trump carried out his threat to impose import duties on steel and aluminium. These measures and the responses to them pose risks for the international trading system. Free trade, or rather the international rule-based trading system, is an important pillar of the huge progress made in recent decades to boost prosperity and to combat poverty.

"Import duties on steel and aluminium come into force."

China, for example, has advanced from being an abjectly poor country to one with a per capita economic product of USD 8,800. Despite this, China continues to trail very substantially behind the USA. After all, per capita economic output in the Asian country is a mere quarter of American economic output. When one considers this starting situation, one can't help but feel that Xi Jinping might have sat down to the poker table many years too soon in his power struggle with Donald Trump.

"US per capita economic output is four times higher than in China."

Economic history teaches us that all sides lose when trade conflicts break out. In the 1930s the "Smoot-Hawley Tariff Act" triggered a trade war and a downwards spiral that accentuated the recession in the United States. A whole series of American presidents, including Ronald Reagan, George W. Bush and Barack Obama, discovered that trade conflicts are by no means easy to win.

"Trade conflicts produce only losers."

The big question now is how the trade dispute between the USA and China could pan out. For this reason, it is difficult to assess whether a reasonable negotiated solution will be agreed, or whether the conflict will develop into an all-out trade war. President Trump is already looking to the midterm elections in November, where the Republicans look set to lose their majority in both Houses of Congress. Until then, the US President will endeavour to notch up as many political successes as possible, because otherwise he risks becoming a so-called "lame duck". In our view, common sense and the knowledge that trade wars produce only losers mean that a negotiated solution is ultimately likely to be found.

"Will there be a trade war?"

It is difficult to judge Italy's political future. None of the parties were able to secure the necessary majority to form a government. Difficult coalition negotiations lie ahead. Neither the Five Star Movement nor the Northern League represent an attractive option for investors, however. In our view it is very likely that one of these anti-establishment parties will join the future government. This would undermine the determination to pursue further reforms and austerity, and would increase the risk of a continued status quo.

"Election in Italy brings uncertainty."

Economy

Nervousness on financial markets has not yet impacted US economic indicators or the real economy, at least not to date. While the ISM Manufacturing Index, which is generally considered to be the most meaningful leading indicator for the US economy, slipped back from 61.0 to 59.3 points, it is still listing near the highest it has been for fourteen years.

"US economic indicators holding up well."

GDP growth saw an unexpectedly strong upward revision in the final quarter of 2017. According to the latest data issued by the Bureau of Economic Analysis (BEA), the US economy grew by 2.9%, not by the 2.5% that had been reported in the previous estimate. The reason for the higher growth was an upward revision of private consumption from 3.8% to 4.0% as well as a less marked reduction in inventories.

"Upwards revision of US GDP."

Business sentiment within the Eurozone clouded slightly in March. The composite leading index for economic performance published by the European Commission fell for the third time in succession. Relative to the previous month, it slipped back from 114.1 to 112.6.

"Business sentiment within the Eurozone clouded slightly in March."

Despite this, there has also been positive news coming out of the Eurozone. For example, the Spanish government substantially raised its growth forecast for the current year. It is now expecting GDP to expand by 2.7%, having previously anticipated growth of 2.3%. In addition, the high level of unemployment is set to decline from 16.5% to 15% by the end of 2018.

"Spanish government raises growth forecasts."

Equity markets

The performance of stock prices in the first quarter can be summed up by one word – disappointing. Following a barnstorming start to the year, inflationary worries and a possible trade war weighted down heavily on global equity markets. While Switzerland lost around 5.5% in value at the end of March, the S&P 500 slipped 0.7%. MSCI Emerging Markets posted a positive +1.3% (see the market overview table).

"Disappointing performance of prices during the first quarter of 2018."

Continued share buybacks are providing support, particularly in the case of the US equity market. In 2017, buybacks totalled USD 530 billion, while a record figure of USD 800 billion is expected for the current year.

"Share buybacks supporting the market."

In regional terms, we are favouring Europe over the USA. The main argument for this is valuations, which are markedly more reasonable than in the United States. In a challenging environment, it is important not to lose sight of geographical diversification. As a consequence we are sticking to the neutral weighting of emerging markets and Japan.

"We favour Europe."

The big question now is what can reasonably be expected from equity markets in the coming weeks. The fact is that fundamental economic data remain advantageous. Provided the trade conflict does not worsen, it is our assumption that the global economy will continue to notch up robust growth. This is a soothing fact, and should provide equity markets with a degree of stability.

"We remain moderately optimistic for equity markets."

FACTUM

Bond markets

In March the US Federal Reserve raised its key lending rate by 25 basis points from 1.5% to 1.75%, which is what we had been expecting. The decision was unanimous. This was the sixth interest rate hike since the financial crisis of 2008. For this reason, attention focused on the forecasts of the members of the Federal Open Market Committee (FOMC). As in every quarter, the current fifteen members issued their opinion on the key interest rate. Financial market interest focused in particular on the so-called dot plot. This is a point cloud that shows which interest rate levels the individual FOMC members are expecting to see at the end of the respective year. It can provide an indication of the number of interest rate moves. The Fed's latest interest rate forecast shows that the Monetary Policy Committee continues to assume an average (median) total of three interest rate rises this year.

"US Federal Reserve raised key interest rates for the sixth time since the financial crisis of 2008."

At the press conference, Fed Chair Jerome Powell was asked about the repercussions of the US government's protectionist trade policy. According to Powell, customs duties were part of the discussion. The measures that have been imposed to date have not yet negatively impacted the US economy, however. At the same time, the trade war issue was admittedly a risk factor that has been growing.

"According to Fed Chair Jerome Powell, the risk of a trade war has increased."

Possible trade constraints could encourage stagflation, that is to say low growth and higher inflation. For the USA, the scenario of rising prices was realistic, and in Europe growth was likely to come under pressure due to the substantial surpluses. What would this mean for bonds? In the USA, the weak start to the year was likely to mean that interest rate hikes would be considered less likely. On the other hand, inflation is rising, making additional interest rate increases necessary. In overall terms, it is difficult to say which of these two factors is ultimately likely to prevail. Nevertheless, the risk premium for inflation, that is to say the incline of the interest rate curve, is likely to increase. If the risk scenario pans out, this will make products on US inflationary expectations interesting, and bonds with medium maturities may also be attractive, not least because the market remains focused on the Fed's anticipated interest rate hikes.

"While equity markets are already concerned about reduced growth expectations, the bond market continues to believe in higher yields."

FACTUM

Commodities

A fine ounce of gold has fluctuated within a bandwidth of USD 1,100 to USD 1,350 since 2014. On account of the uncertainties associated with the possible escalating trade war, market volatilities are likely to remain high. If the conflict does indeed hot up, then the fear of stagflation is likely to rear its ugly head once again. Sooner or later, the fact that US government debt is continuing to soar, and that some peripheral countries in Europe have levels of debt that are unsustainable in the long term, will raise questions about monetary stability. During times of rising risk aversion, gold offers good protection on account of its negative correlation characteristics, suggesting that demand for gold is likely to rise. On the supply side, gold production is likely to ease slightly on account of the fall in investment. This means there is a good chance that it will breach the USD 1,350 level. In the medium to longer term, the weakness of the greenback could help push the gold price higher. The recently approved tax reform and the increase in government spending mean that the trade deficit is likely to widen significantly. This will be a heavy burden for the greenback to bear. In addition, rising inflation is likely to cause real interest rates to sink.

"Gold – set to break through the USD 1,350 level?"

If one assumes that the price of gold is set to rise, then attention needs to be paid to gold stocks. As the following chart shows, the value of gold stocks (red line) has fallen 60% over the past ten years, while gold (orange line) has risen 45%. This therefore corresponds to a performance gap of 105%.

"We consider gold stocks to be an interesting admixture for a diversified portfolio."

Gold vs. Nyse Arca Gold Miners Index

In our view, gold companies are attractively valued in historical terms. In addition, these have done their homework. Costs have been cut, unprofitable projects have been sold off or shelved, and debt levels have been reduced.

FACTUM

At the current gold price, most companies are earning money and generating a positive cash flow. Discipline and generating added value for shareholders have top priority, which was not always the case in the past. Another positive factor is mine production – which accounts for some 70% of supply and peaked in 2016. We are firmly of the opinion that if the price of gold gathers momentum, gold stocks will profit disproportionately from this. Due to the high susceptibility to volatility, we are retaining a homoeopathic dose.

"With a rising gold price, gold stocks will benefit disproportionately – we are holding a homoeopathic dose."

Currencies

While interest rates have a role to play when it comes to forecasting currency prices, an examination of historical data shows that the correlation is not entirely clear. It has often been the case in the past that the euro-dollar exchange rate has risen, that is to say the dollar has weakened, despite the fact that the US Federal Reserve lifted interest rates, while the interest rate environment in other regions remained unchanged or less dynamic – and vice versa.

"Interest rates and their link to the performance of currency prices."

Within this context it comes as no great surprise that over the past 15 months the US dollar lost up to 16% of its value against the euro and up to 10% against the Swiss franc, even though the interest rate gap between the USA and Europe actually widened over this period. More recently, the US dollar has been posting marked gains ahead of the current interest rate increases, effectively pricing in the changes. A counter-movement was therefore to be expected. In addition, the huge US budget and trade deficits, the erratic nature of US policy and expectations that the European Central Bank and the Bank of Japan will also soon need to tighten their monetary policy belts, have led to substantial flows of financial resources from the USA to Europe and Japan. In view of structural factors, an unexpectedly rapid and strong interest rate hike in the United States or a global economic setback would need to be in the offing in order to strengthen the US dollar in the longer term.

"A crisis or an unexpected interest hike would help to strengthen the US dollar."

FACTUM

Market overview 30 March 2018

Stock indices	Current	1 Mt (%)	YtD (%)
SMI	8,740.97	-0.51	-5.55
SPI	10,189.89	-0.67	-5.22
Euro Stoxx 50	3,361.50	-2.15	-3.71
Dow Jones	24,103.11	-3.59	-1.96
S&P 500	2,640.87	-2.54	-0.76
Nasdaq	7,063.45	-2.79	2.59
Nikkei 225	21,159.08	-3.47	-6.36
MSCI Emerging Markets	1,169.27	-2.00	1.24
Commodities			
Gold (USD/fine ounce)	1,325.50	0.55	1.74
WTI oil (USD/barrel)	64.94	5.35	7.48
Bond markets			
US Treasury Bonds 10Y (USD)	2.74	-0.12	0.33
Swiss Government 10Y (CHF)	0.03	-0.07	0.18
German Bund 10Y (EUR)	0.50	-0.16	0.07
Currencies			
EUR/CHF	1.18	2.14	0.52
USD/CHF	0.96	1.25	-1.84
EUR/USD	1.23	0.87	2.46
GBP/CHF	1.34	3.16	1.82
JPY/CHF	0.90	1.50	3.94
JPY/USD	0.01	0.22	5.87

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