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FACTUM

Investment Report

January 2018

Strategy overview

Many forecasters had expected last year to be a “wild ride” characterised by heightened volatility, brought about inter alia by the erratic policies of Donald J. Trump. What actually happened couldn’t have been more different. Volatility sank to a record low level, and the Dow Jones in the United States posted 70 all-time highs within the course of just one year. This has never happened before. The Dow Jones also ended the month of December with gains, which was the ninth positive month in succession – the last time this happened was 1959.

“The Dow Jones posted 70 all-time highs last year – more than in any previous year.”

We too are extremely pleased with the past twelve months. This is also reflected by the positive performance of the asset management portfolios managed by Factum. Balanced portfolios achieved returns of between 7-12% after costs last year – depending on the reference currency.

“Portfolios managed by Factum with a balanced strategy generated a return of between 7-12% in 2017 (depending on the reference currency) after costs.”

It is not just investors who are likely to look back fondly at the year 2017. For the first time since the end of the financial crisis, the global economic upturn has been synchronous. In addition to booming equity markets, this also produced a rise in employment and a fall in unemployment in many countries around the world.

“Synchronous global economic growth around the globe.”

What implications does this have for the 2018 investment year? As bond yields have been rising only moderately and because the global economy is in robust shape, the stockmarket environment should remain essentially positive. The advanced cycle in the USA is likely to have been extended by the tax reform that was ratified in December. Inflationary pressures are set to increase, and the Fed could respond more strongly to this than the market is currently anticipating. The US Federal Reserve is however keeping all options open; it could suspend the programme to reduce the balance sheet, or might even intervene to support the economy once again if necessary.

“We are going into the 2018 investment year with equities overweighted in the Old World.”

Unemployment in Europe remains high, meaning that inflationary pressures are set to rise only moderately. We are not expecting interest rates in Europe to rise before 2019, and the ECB will proceed very cautiously with the announced tapering of bond purchases. In contrast to the USA, the upturn in Europe, as often mentioned in earlier Reports, is in a comparatively early stage with considerable untapped potential for higher earnings. For this reason, we are starting the year 2018 with equities overweighted in the "Old World". Companies have reduced their debts and dividend yields remain significantly higher than bond yields. This also applies to the Swiss stockmarket, which underscored its attractiveness with a dividend yield of around 3%.

Low real yields, moderately rising inflationary expectations and central banks that are reducing their bond purchases point to a rising yield trend in the bond field. These are reasons why we are significantly underweighted in bonds. Bonds nevertheless serve a purpose, not least because they can reduce portfolio risk in times of emerging stress. Gold also has a stabilising effect during times of crisis. For this reason, we view the precious metal as an integral part of a portfolio and are sticking to our investment.

"There is a broad spectrum of reasons why we are underweighting bonds – we are sticking to our positive view of gold."

From a historical perspective, global interest rates remain low. Within this context, we view the risk/return profile of alternative investments as being significantly more attractive than bonds. This prompted us to reduce our exposure to the fixed-interest segment and to raise the alternative investment ratio. In addition, against the backdrop of the very substantial price gains recorded over the past year, we partially hedged our portfolio using a suitable instrument. Low volatility made the hedging attractive.

"Raised exposure in the alternative category, in addition we have used a suitable instrument to hedge part of our portfolio against price falls."

It is worth mentioning in this conjunction that we remain constructively positive for markets, are not expecting any significant price falls in the near term and are therefore keeping equities moderately overweighted. In our view, there is an exceptionally low risk of a recession materialising over the next months, and for this reason it is too early to reduce the exposure to equity markets. So long as the economic environment remains advantageous, any possible corrections will only be short-lived.

"In our view, there is currently very little risk of recession, and for this reason we consider it too early to start reducing our equity investments."

Politics

The 35th President of the United States wrote history when he took his oath. On 20 January 1961 he was not just the youngest US head of state, and not merely the first Catholic in the Oval Office, John F. Kennedy also left one of the most famous quotes in world history: “My fellow Americans, ask not what your country can do for you, ask what you can do for your country.” Ten presidents later, the situation appears to have shifted diametrically. This has nothing to do with the fact that President Trump was the oldest-ever President of the United States at the time of his inauguration. With his open animosity towards the establishment in Washington, the current President promotes the mantra that the state had for many years left the population in the lurch, and that now was the time for everyone to help themselves as best they can.

“Donald Trump battling the establishment.”

At the domestic policy level Trump was able to record the biggest success of his incumbency, just in time for Christmas. The most far-reaching tax reform since Ronald Reagan has been realised. Largely unnoticed by the public, red tape has been reduced across the country and dozens of new judges have been appointed, thus helping to secure the conservative legacy of the Grand Old Party for many years to come.

“The Trump administration has been able to notch up its first domestic policy successes.”

On 6 November 2018 all seats in the House of Representatives and one third of the seats in the Senate will be up for election, along with numerous governor and parliamentary positions in the member states. Such midterm elections tend to be something of a litmus test for the administration. But the harbingers of the past few months do not bode well for the Republicans. In elections in New Jersey and Virginia, the Democrats surpassed all expectations, as in Alabama, by successfully mobilising women, African Americans and young voters. At the same time, the President is remarkably unpopular. His approval rating has remained stubbornly below 40 percent since May, and even slumped to a record personal low following the defeat in Alabama.

“Important elections in the House of Representatives and Senate are due in 2018.”

Until recently, it looked as if the Democrats only had the chance to win a majority in the House of Representatives – if at all. Thanks to the election result in Alabama, they can suddenly dream of the Senate, even if the starting situation there is more difficult.

“Democrats have good reason to think that they have a good chance of winning seats.”

All this would have serious consequences for the second half of Trump's term. If the Democrats actually manage to take the big congressional chamber in the autumn, they would soon slow their Republican rivals’ political momentum. But it is not just their reform agenda that the Republicans need to

“A Trump impeachment is not entirely off the cards.”

be worried about. A democratic majority could initiate an impeachment against President Trump – which could be fuelled by accusations of collusion with Russia. An impeachment would overshadow the 2020 presidential election, even if only the Senate actually has the authority to remove the President from office. What would happen if the Democrats were to beat them in the Senate is the stuff of nightmares for the Republicans and the President.

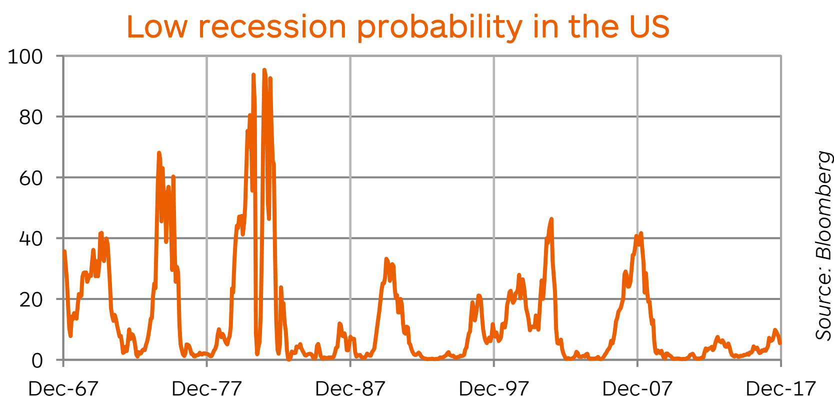
In Europe, while we see certain political risks with the election in Italy this spring and the faltering Brexit negotiations, these are unlikely to jeopardise the economic upturn. Germany is still engaged in exploratory talks to establish a new coalition government. In the Netherlands, Mark Rutte won the general election in March 2017, beating the right-wing populist Geert Wilders, while in France Emmanuel Macron successfully contested the run-off against Marine Le Pen in May.

"Political unknowns in Europe are known unknowns."

Economy

We are often asked what the outlook is for 2018, and when the next recession is likely to materialise. Admittedly, valuations are already challenging, particularly in the USA. This means that setbacks at the economic level, on the political stage and above all at the corporate level can easily trigger price slides. Our view of the economic environment is upbeat, however. Even in the USA, where the economic cycle is at its most advanced, few imbalances or symptoms of overheating are apparent. The Reserve Bank of New York calculates that there is a less than 10% probability of a recession in the US within the next twelve months.

"Low risk of recession in the United States."



The US economy is going into its ninth year of growth after the end of the financial crisis. The third quarter of 2017 saw GDP grow 3.2%, which was the strongest expansion in ten quarters. The final quarter of 2017 is also likely to have been promising. The ratified tax reform is set to boost this trend still further. Leading economic indicators are also pointing sharply upwards and show no signs of economic fatigue. The skid marks of more restrictive monetary policies are likely to become apparent in 2019, leading to a tangible slowdown in US economic growth.

"US economy at the late stage of the cycle."

The risk of economic contraction in Europe is likely to be even smaller. In the "Old World" the upturn is still relatively young, and began to gather proper momentum only during the course of last year. During the third quarter of 2017 the Eurozone economy grew more strongly than it had since the beginning of 2011, and the final quarter may have been even better. In addition, this growth is fortunately broadly based. Even Italy, which has long experienced anaemic growth, has been able to shift up a gear. The results of the latest purchasing managers survey illustrate the excellent state of the economy. The PMI Composite, which combines survey results from the industrial and service sectors, climbed to the highest level it has had in six years. At the same time, consumers are also decidedly confident, and are looking to the future more optimistically than they have for almost 17 years. In view of this promising starting situation, we are expecting the Eurozone economy to expand by more than 2%.

"Full speed ahead for the Eurozone."

Growth in the three major emerging countries China, India and Brazil is set to continue in 2018, although at different paces. Brazil, which pulled itself out of its most serious post-War recession in 2017, will see its economy revive moderately in 2018. Growth is likely to come in at around 2.5%, which is weak for Brazil. On the positive side, investments rose in the third quarter, following 15 quarters of negative growth. The massive fall in inflation, enabling base rates to be cut by 7.25% over the past 14 months to the current level of 7%, has also helped to support Brazilian economic growth. Inflation is likely to have bottomed out at 4.5%, and will remain at this level for some time. The political environment with the presidential election in October 2018 will be a considerable uncertainty factor. First and foremost is the question of the further development of reforms that are urgently needed to solve Brazil's structural problems, in particular the key pensions reform.

"Brazil has managed to pull itself out of the most serious recession in the post-War period."

China's economic performance was steady last year. Following the party conference, a number of new regulations were announced in mid-November, inter alia for the shadow banking system. The government appears to be serious in its determination to constrain financial risks as well as to combat environmental pollution. This more restrictive policy recently caused bond yields to rise. Economic momentum will continue to level off this year on account of the restrictive measures in the financial sector, environmental field and housing market. In overall terms we are expecting growth this year in the order of 6% to 6.5%.

"China's government has announced a raft of new regulations."

In India, economic growth was disappointing in the first half of 2017, due in particular to the cash reform and introduction of the standard national value added tax (GST). The economy picked up in the third quarter, however, and the latest economic indicators are signalising that the recovery is set to continue. We are expecting strong growth of 7.3% this year, which is more dynamic than the performance seen in 2017. In view of the fact that inflation has increased, the Bank of India has probably ended the interest cutting cycle. The base rate is likely to be left at 6.0% this year.

"Economic growth picked up in India in the third quarter of 2017."

Equity markets

Unlike in 2016, when equity markets plunged more than 10% during the first few weeks of the year – triggered by growth worries coming out of China – before bouncing back, the most important stockmarkets posted gains right from the outset last year. In addition, there were no serious corrections. In the USA, the S&P 500 Index lost more than one percent on just seven trading days, which is extremely unusual. Amongst others, the global stock index MSCI World (in USD) posted a particularly impressive performance, gaining around 23% (including dividends) – in an almost exactly straight line.

"2017 was a fantastic year for equities."

The fact that the ninth consecutive bull year, in a series that begun in the spring of 2009, was so positive and smooth (despite the occasional geopolitical crossfire) was very much a consequence of the ultra-loose monetary policies pursued by central banks.

"Positive equity market returns left, right and centre."

Markets rose impressively in the USA in 2017. The S&P 500 increased by around 22% and the value of the Nasdaq Composite even managed to rise by 30% (at the total return level and in local currency terms). In Europe, Switzerland and specifically the SMI gained 18%, while the EuroStoxx 50 trailed somewhat behind this at 10%. Emerging countries were also in bullish form, gaining 38% in terms of the MSCI Emerging Markets Index. The detailed market overview is set out on page 12.

This also prompts the question of what the prospects are for the current year. History speaks for the bulls. Since 1928, there have been 32 years in which the S&P 500 in the United States gained 20% or more. In the following year, the index – in median terms – then went on to rise +12.80%. There was only one year in which the index lost more than 10%. Admittedly, this cannot be the only argument for rising equity markets in 2018. In our view, high valuations, specifically in the USA, are limiting the upside potential for equity markets. In overall terms, we are expecting positive price gains in the current year. We can see potential trouble looming during the second half of the year, inter alia in the form of the elections to the House of Representatives and the Senate, in respect of the economic slowdown in the USA that we are anticipating in 2019, the uptick in inflation and the continued process of normalising US interest rates. While a degree of caution remains necessary, we continue to see equities as the most promising asset class.

"We continue to regard equities as the most promising investment class in 2018."

Bond markets

Yields on long-term government bonds remained stubbornly at low levels last year, and fluctuations were also comparatively moderate. This is what we had been anticipating for Switzerland, the Eurozone and Japan. In the USA, by contrast, we had been expecting interest rates to rise, as the first signs of labour market tightness had begun to become apparent in the US at the start of 2017. While 10-year treasury yields did indeed rise to over 2.6% in March 2017, they actually ended the year 2017 four basis points lower than they had been at the start of the year. This gives rise to the question of whether yields are set to remain this low, despite the worldwide economic recovery in 2018, or whether investors will need to prepare for rising interest rates. In our view, yields are likely to rise, although only to a very moderate extent. In the USA, 10-year US treasuries are likely to be about 20 to 30 basis points higher than at the end of 2017. US yields could edge towards 3%, if inflation rises and economic momentum remains unbroken.

"Moderate rise in yields expected in the USA."

In the US we are expecting the Federal Reserve, under its new Fed Chairman Jerome Powell, to increase base rates in two to three steps this year, by 0.5% to 0.75%. The market is currently expecting two interest rate moves. The reduction of the balance sheet will continue in 2018 according to schedule. In this conjunction, the total sum of the government and mortgage bonds that are no longer being reinvested will be increased every three months by USD 10 billion, until the upper limit of USD 50 billion per month has been reached at the end of 2018. The Federal Reserve's balance sheet will be USD 450 billion lower at the end of 2018 than it was at the end of 2017. In our view, it will take three to four years to restore the balance sheet.

"Jerome Powell will replace Janet Yellen at the top of the Fed in February."

The European Central Bank has decided to halve its bond buying from January 2018, from the previous EUR 60 billion per month to EUR 30 billion per month. At the same time, it extended the purchasing programme by nine months to September 2018, and also stuck to its forward guidance – no doubt in order to calm potential market jitters – that purchases could be expanded once again, if necessary. In addition, the ECB emphasised that it would be keeping its base rates at a very low level well beyond the life of the purchasing programme. For this reason, after the bond buying programme has come an end, a further year is likely to pass before the ECB considers an initial interest rate hike. We are expecting a step of this nature in mid-2019 at the earliest.

"We are not expecting an interest rate move from the ECB before mid-2019."

The Bank of Japan continued its struggle against deflation last year with as much determination as before. In doing so, it remained true to its monetary

"No news from the Bank of Japan."

policy concept of controlling the yield curve. Instead of a rigid purchase programme, the Bank of Japan keeps an eye on the entire yield curve by means of flexible bond buying. Given its huge portfolio of Japanese government bonds, it can so without ado. In this conjunction, the BoJ is targeting a yield of 0% on 10-year government bonds. This expansive monetary policy is likely to continue to be pursued until the inflation target of 2% is persistently exceeded. This will probably not be realised before mid-2019.

The Swiss National Bank has welcomed the fall in the value of the franc against the euro. It also amended its communication in September, and no longer considers the Swiss franc to be “substantially overvalued”, but instead merely stated that the value of the currency was “high”. Despite this, there is limited scope for independent monetary policies. SNB policymakers continue to pay close attention to the monetary policies pursued by the ECB. It is our assumption that the SNB will retain its negative interest rate of 0.75% throughout the whole of 2018.

“In our view, the SNB will retain its negative interest rate of 0.75% throughout the whole of 2018.”

Commodities

The price of a barrel of WTI grade oil moved sharply upwards once again in December (+5%) to reach the highest level seen since the summer of 2015. At the end of December, black gold was listing at around USD 60, corresponding to a gain of 12% for the year. Recent tensions in Iran, where the protests by certain sections of the population developed into demonstrations, have provided oil prices with additional support. Production cuts, which would have expired at the end of March 2018, are now being extended by a further nine months to the end of 2018. Also on board is the weighty non-OPEC member Russia. At the portfolio level, we are exposed to the energy topic by means of a lock-in certificate on three stocks selected by us.

“Oil prices remain at high levels, inter alia due to geopolitical tensions.”

At the end of December the price of gold was listing at USD 1,302, which is around 13.5% higher than at the start of the year. We remain comfortable with our gold holding, and are allocating up to 3%, depending on the particular strategy. In January of last year we bought a very small amount of exposure to gold mines. We are continuing to stick to this. The value of our gold mine holding rose by around 16% in December. As far as we are concerned, the story is still intact. Gold mines are supported by the fact that balance sheets have recovered – unprofitable projects were shelved in good time, or cancelled entirely – by the generation of free cash flow and the extremely attractive valuation.

“The value of our gold mine exposure rose 16% in December.”

Currencies

In addition to the Polish zloty and the Czech koruna, the euro was one of the strongest currencies in 2017. Against the Swiss franc, the euro climbed from 1.075 at the start of the year to 1.17, corresponding to an increase of around 9%.

“The euro was one of the world’s strongest currencies in 2017.”

Anyone who assumed that rising base rates in the USA, coupled with persistently loose monetary policies in Europe, would automatically strengthen the dollar found themselves being taught a lesson. Relative to the US currency, the value of the euro actually increased around 14% since January of last year. The strengthening of the euro can be explained mainly by the improving economic environment in Europe. In addition, the calm state of politics in the Old World is playing into the hand of the euro. The SNB as well as the tourism sector and exporters are likely to be delighted by this. In the short term, the EUR/CHF is likely to move sideways, and in our view the EUR/USD has moderate upside potential.

"The Swiss franc has been weakening, which will delight the Swiss industrial and tourist sectors in particular."

For good or evil, the year 2017 is likely to go down in history as the cryptocurrency year. In recent months, a steady succession of all-time highs has been reported for the cryptocurrency bitcoin on various online trading platforms. The digital currency was briefly trading at over USD 18,000 per unit, reaching a market capitalisation of over USD 300 billion – that is to say significantly higher than Nestle (around USD 260 billion). The fact is that the rising price of the token, which was launched in 2009 as an alternative transaction and value custodian system, has probably been the sole reason for its omnipresence in the media. Yet bitcoin transactions are too expensive and time-consuming, and massive value fluctuations moreover prevent the cryptocurrency from becoming a trustworthy alternative to old-established gold or

“2017 – the year of cryptocurrencies.”

cash. Despite this, massive capital inflows have been recorded. This is probably also due to its increasing accessibility. Various high-profile investment companies offer products that enable professional investors to participate indirectly in bitcoin, in the form of structured products, investment funds or futures contracts. These recent entries to the market are continuing to behave with extreme volatility, highlighting just how fragile the system is. It is just a question of time before regulators intervene or a single major investor (approximately 1,000 individuals hold 40% of the total market) liquidates his holdings, causing the price to nosedive. In our view, this gives rise to the question of when the end of the line will be reached.

Market overview 29.12.2017

Stock indices	Current	1 Mt (%)	YtD (%)
SMI	9'381.87	0.68	17.88
Euro Stoxx 50	3'503.96	-1.71	9.95
Dow Jones	24'719.22	1.92	28.11
S&P 500	2'673.61	1.10	21.82
Nasdaq	6'903.39	0.50	29.73
Nikkei 225	22'764.94	0.30	21.29
MSCI Emerging Markets	1'158.45	3.49	37.51
Commodities			
Gold (USD/Fine ounce)	1'302.80	2.18	13.53
WTI-Oil (USD/Barrel)	60.42	5.26	12.47
Bond markets			
US Treasury Bonds 10Y (USD)	2.41	0.00	-0.04
Swiss Government 10Y (CHF)	-0.15	-0.03	0.04
German Bund 10Y (EUR)	0.43	0.06	0.22
Currencies			
EUR/CHF	1.17	-0.05	9.16
USD/CHF	0.97	-0.95	-4.39
EUR/USD	1.20	0.85	14.15
GBP/CHF	1.32	-1.01	4.66
JPY/CHF	0.86	-1.08	-0.71
JPY/USD	0.01	-0.14	3.83

Author: Christof Wille, Dipl. Private Banking Expert NDS
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