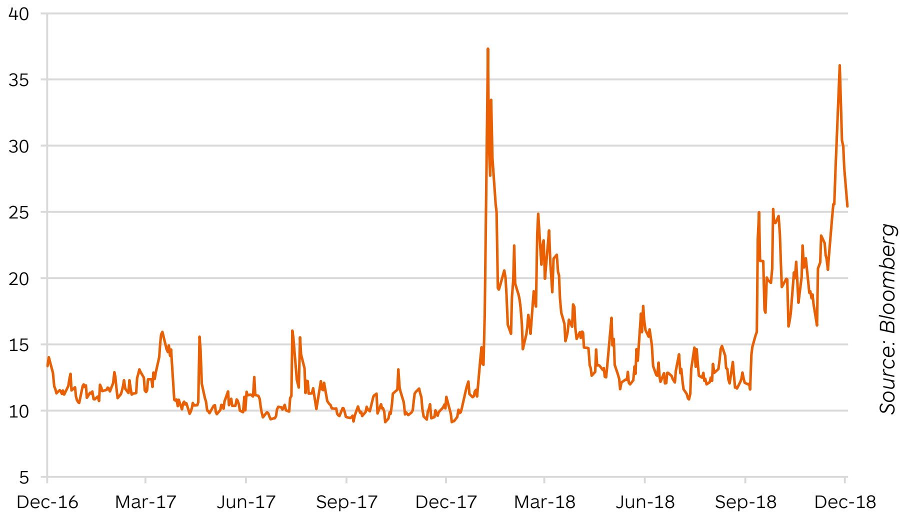
Strategy overview

While volatility, that is to say the breadth of fluctuations, was extremely low in the year 2017 from a historical perspective, the situation was diametrically different during the course of the past investment year. January may have got off to a tremendous start, with global equity markets gaining around 5%. But the first sell-off materialised in February and volatility soared, as the chart below shows. The situation then calmed once again, before moving sharply southwards once again in the fourth quarter. One of the triggers, in our view, was the fact that the International Monetary Fund trimmed its growth forecasts. The Dow Jones in the United States dropped 8.5% last December, making it the weakest December since 1931.

"The 2018 investment year – a year to forget – the Dow Jones recorded its weakest December since 1931."

VIX Volatility Index 2 years



FACTUM

The 2018 investment year was characterised by political developments that stoked a sense of uncertainty, such as inter alia the elections in Italy, the nuclear dispute with North Korea, the fiasco that is Great Britain's struggle to leave the EU or the trade conflict between the USA and China. Practically all important investment classes, specifically the key stockmarkets in Europe, Asia, the USA and emerging countries, as well as precious metals, real estate funds, hedge funds, corporate and emerging market bonds recorded a negative overall performance, also see Market Overview table. In our view, an escalation of the trade conflict, global economic concerns and a possible overshooting of the Federal Reserve are currently the greatest uncertainties for the financial markets.

From a technical perspective, stockmarkets are heavily oversold and sentiment indicators have fallen to very low levels, which essentially suggests a counter-movement. After the severe upheavals in December, price-earnings ratios of most markets fell to their ten-year averages, but are still not really bargains. Certain earnings estimates for 2019 may still be revised downwards, which would consequently push valuations upwards.

"From a technical perspective, markets are heavily oversold."

What does this mean for the portfolios we manage? We reduced our equity ratio in December, and consequently the proportion of "risky assets", too. We did this by divesting European stocks. From a relative perspective, Europe once again underperformed the USA and Switzerland. One of the reasons is the relatively high weighting of the financial sector, another is the political imponderables in Italy or Great Britain. While we also see rays of hope that could potentially lead to a stabilisation or counter-movement, we currently feel more comfortable with a defensive positioning. Consequently, we are starting the investment year 2019 with a neutral equity ratio. In the bond field, we have trimmed credit risks, improved credit quality and thus moved closer to the benchmark. We are sticking to the partial hedging of the equity ratio, to protect against further price setbacks.

"We have reduced the equity ratio in our portfolios, and consequently have a more defensive outlook."

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Politics

The past year was not exactly short of political events, as has been detailed on numerous occasions in previous reports. At present, the so-called "government shutdown" is dominating the headlines. The US government had not been able to agree with the opposition on the details of further funding for a number of federal authorities. Around 800,000 employees and contractual partners of public authorities are affected.

"The government shutdown is currently dominating headlines."

The test of strength during the longest administrative standstill to date more than twenty years ago was won by the then US President Bill Clinton. He faced off the newly-elected speaker of the House of Representatives, the Republican Newt Gingrich. Trump is facing a similar showdown with Nancy Pelosi, the Democratic spokeswoman-designate in the newly elected United States Congress. The conflict centres on the budget for the Department of Homeland Security, which the President wants to be given USD 5 billion for the construction of a wall along the border with Mexico. The Democrats are determined to prevent this at all costs. In 2016, the construction of the wall was one of the election promises that particularly attracted Trump's supporters in the presidential election campaign. If Pelosi concedes this issue to the President, it would increase reservations amongst the party's rank and file against the experienced Democratic veteran and would jeopardise her position as spokeswoman.

"The conflict centres on the construction of the wall along the border with Mexico."

All in all, following the mid-term elections, it is clear that power no longer lies in the hands of a single party. This will produce a great deal of political fireworks in the run-up to the presidential election in November 2020. It is highly doubtful, however, whether lasting solutions and progress will be achieved during this period.

"The political fireworks are likely to continue until the presidential election in November 2020."

Economy

With a growth rate in the region of 3% last year, the US economy is likely to have recorded its strongest growth during the current economic cycle. This was driven by substantial tax cuts as well as the flourishing labour market. It should not conceal the fact, though, that the US economy is coming to the end of the expansion cycle. Weaker growth does not mean weak growth. After all, the US economy is continuing to power ahead. The US consumer remains a dependable and indispensable pillar of growth. In addition to the slowing effect of the interest rate hike, fiscal policy will have less of a stimulating effect on growth this year and next. In overall terms we are expecting the economy to expand by around 2% in the current year. The unemployment rate will continue to decline, on account of the fact that the economy is

"The US economy is coming towards the end of its cycle."

continuing to grow faster than its potential. When it comes to prices, we are expecting inflation to remain moderate despite rising wage and cost pressures, as it is our assumption that most of the rising costs will be at the expense of profit margins. We are expecting an inflation rate of 2.25% for 2019.

"Persistent economic slowdown for the Eurozone."

The first two quarters recorded growth rates of 0.4% relative to the previous quarter. This was roughly in line with the Eurozone's potential rate of growth. In the third quarter, however, GDP growth declined to a pitiful 0.2%. The last time the Eurozone grew so weakly was more than four years ago. Italy and Germany even saw economic output contract. While one-off special factors can be cited as the cause in Germany (production shutdown in the automotive industry), the economic slowdown in Italy appears to be of a more permanent nature. Leading economic indicators in Italy, such as for example the Purchasing Managers' Index, have literally plunged and are pointing to heightened recessionary risks. However, leading economic indicators, such as the PMI Composite, also signal persistent weak growth for the Eurozone as a whole. We are currently expecting the Eurozone to achieve a growth rate of 1.50%. Forecast risks are, however, currently pointing downwards. For the current year, our inflationary expectations for the Eurozone amount to 1.75%.

"China's growth is likely to continue slowing."

2018 was a challenging year for the Chinese economy. Internally, debt reduction – above all the fight against shadow banking – led to a credit squeeze among private SMEs. At the external level, the burgeoning trade dispute with the USA has become increasingly burdensome. These two aspects will also have a negative impact on China's economic growth in 2019, with the effect of debt reduction diminishing and that of the trade conflict expected to increase. The Chinese government has already responded to this challenge with a series of monetary, fiscal and administrative stimulus measures. While looser monetary policy and the promotion of infrastructure investment remain on the agenda, the focus will clearly be on tax cuts. The principal objective is to reduce the fiscal burden on companies and households. In general terms, the tax cuts announced for 2019 are expected to amount to around 1.5% of GDP. Together with the weaker renminbi, this will partly offset the expected lower growth caused by the trade dispute and will keep GDP growth above 6%. On the inflation side, the trend is likely to be moderate, leaving the People's Bank of China room for a stimulating monetary policy. India is one of the few emerging markets where the economy grew faster in 2018 than in 2017. GDP growth in the first half of 2019 will be squeezed, however, by the falling away of positive underlying effects, political uncertainties ahead of the April/May elections and tighter financing conditions. Payment problems in the shadow banking sector are contributing to the latter. We are expecting the momentum of growth to pick up from the middle of the year, not least because investment activity is set to revive. This will result in GDP growth of 7.3% for the fiscal year 2019/2020 (as at 31 March 2020), which is roughly equivalent to the estimated rate of 7.2% for 2018/2019. India will consequently continue to be among the global leaders in terms of growth. With the appointment of the new Bank of India Governor Shaktikanta, who is said to have a somewhat growth-oriented attitude, and with inflation within the target range, it has become increasingly likely that the Bank of India will not raise key interest rates further.

Equity markets

Sentiment on stockmarkets again deteriorated significantly in December. Most stockmarket indices declined over the past few months and recorded sharp price losses in year-on-year terms. The MSCI World Index, of which the USA accounts for around 60%, lost 8.20% in value including dividends, see also the chart below:

"Disastrous December – some equity indices lost 10% of their value."

MSCI World Index 2018

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The Swiss Market Index (SMI) performed relatively well, with a decline of slightly more than 7%, including dividends. For investors who had invested in individual Swiss stocks, the figure is likely to look much worse, as the three heavyweights Nestlé (-1.78%), Novartis (+5.53%) and Roche (+2.45%) held up well. In relative terms, the USA also performed well, with the S&P 500 Index losing around 4% in value – until the autumn it had been on course to hit a new record. Japan lost about 10%, the Euro-Stoxx-50 index 11% and Germany and Austria even 18%.

What can we expect from stockmarkets this year? Or to put it another way, will they manage to get their act together or has the long bull market come to an end? The fact is that the broader economic climate has deteriorated in recent months. The global economy has lost momentum in industrialised countries as well as in most emerging markets. This can be seen clearly from the performance of the global Purchasing Managers' Index for the manufacturing sector, which is a good indicator of economic momentum due to its cyclical nature. Since the end of 2018, the PMI Manufacturing has successively lost ground and has eased a total of 2.5 points. It is worth remembering, though, that the activity indicator is still fairly comfortably above the critical level of 50 points at 52 points, and is also above its long-term average of 51.5 points.

“Has the long-standing bull market come to an end?”

For us, the question is whether the global economy is set to slow markedly, even to the point of a recession, or whether a so-called "soft landing" will materialise, as purchasing managers' indices suggest. Our scenario is a “soft landing”. As a result, we remain optimistic about the overall outlook for stockmarkets. In our view, the long-term bull market has not yet come to an end. 2019 is not likely to be an easy year for equities, however. In addition to economic challenges, the unresolved trade conflict between the USA and China is in particular stoking uncertainty. The odds on the 90-day ceasefire developing into a lasting peace remain very low. In our view, it is conceivable that the talks to settle the trade dispute will be extended beyond 1 March 2019. Financial markets should be able to live with this. In overall terms, we are expecting modest price gains this year. These are also likely to be accompanied by persistently high volatility.

“From a marked economic slowdown to a recession or soft landing.”

FACTUM

Bond markets

Monetary policies pursued by the major central banks continued to diverge over the past twelve months. While the US Federal Reserve significantly reduced its expansive monetary policy with a total of four interest rate steps, the European Central Bank (ECB) and the Bank of Japan (BoJ) continued their ultra-expansive course as before. The ECB at least phased out its policy of quantitative easing at the end of the year, and stopped buying bonds.

"Diverging policies of the most important central banks."

The market – that is to say, Fed fund rates – is not currently pricing in a single interest rate rise in the USA for the current year. We are expecting two further interest rate moves, after which the Fed is likely to leave rates unchanged for a while. However, the uncertainty of this forecast is much greater than in previous years. This has a great deal to do with the fact that the neutral key interest rate, that is to say the interest rate that has neither a braking nor a stimulating effect on the economy, is not far from the current key interest rate level, according to the Fed's own estimates. The Fed's monetary policy is consequently being determined almost exclusively by the performance of the economy, and is no longer – as had been the case in recent years – on a set path. If the economic slowdown turns out to be more pronounced than the Fed is expecting, it will raise key interest rates to a lesser extent or even waive further interest rate hikes altogether. Conversely, sustained strong growth or a higher inflation rate would result in a stronger increase in the key interest rate. Either way, the US Federal Reserve will be sticking to its gradual approach and will change monetary policy only gradually to take account of the delayed impact of monetary policy on the real economy. Put simply, one could also say that the monetary policy pursued by the US Federal Reserve has become "normal" once again. It stands and falls with the performance of the economy, and is therefore just as difficult to predict as the performance of the economy as a whole.

"We are expecting two interest rate moves from the Fed this year."

The European Central Bank is still struggling to normalise monetary policy. The asset purchase programme was discontinued at the end of the year. Since the spring of 2016, the base rate has been 0% and the deposit rate -0.4%. The ECB has already greatly restricted its ability to act here by promising to keep the base rate at its current level until at least the end of summer 2019. Due to the slowdown in growth, it has become more likely that the first base rate hike will materialise even later.

"The ECB is still struggling to normalise monetary policy."

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The Bank of Japan (BoJ) shows no sign of abandoning its ultra-loose monetary policy. In view of the fact that inflation is still clearly too low, the BoJ is not likely to change its monetary policy this year.

"No change of policy likely from the BoJ."

The Swiss National Bank (SNB) has maintained a negative deposit rate of -0.75% since January 2015. In the interim, there have been increasing calls for the negative interest rate policy to be reversed – against the backdrop of the favourable economic environment and the fact that inflation is back in positive territory. However, we think the SNB has very limited scope to take monetary policy measures, especially in view of the Swiss franc, which has recently being showing signs of strength. This is because a unilateral interest rate hike by the SNB – without waiting for the ECB – risks boosting the value of the Swiss franc still further, which would be unfavourable for the Swiss economy. In our view, a step of this nature is unlikely. Alternatively, the SNB would need to be willing to use its already bloated balance sheet for further currency purchases.

"In the current year, the SNB is unlikely to go ahead with an interest rate hike."

In most countries, yields on long-term government bonds remained at exceptionally low levels last year, or even fell further. The 10-year Swiss government bond (Eidgenossen) yield, for example, was -0.13% at the end of 2017 and -0.24% on the last trading day of 2018. In Germany, there was a marked decline in yields from the already low level of the previous year. The 10-year German government bond yield at the end of 2018 was 18 basis points lower than at the end of 2017. This had less to do with the performance of the German economy, however, than with the massive rise in long-term yields in Italy. Today they are more than 80 basis points higher than they were twelve months ago. This reflects investor scepticism about the widening budget deficit by the new Italian government. As a result, many investors sought refuge in German government bonds, which are considered to be safe, and pushed down yields there. Aside from Italy, the only industrialised country to see a tangible rise in yields was the USA. Over a twelve month period, the yield on 10-year US government bonds rose from 2.4% to 2.7%, temporarily peaking at 3.30%.

"Yields on long-term government bonds remain stubbornly low – apart from a few exceptions."

In view of the slowdown in the global economy and the ongoing geopolitical risks, yields are expected to remain low this year as well. In our view, though, the recent decline in yields has overshot the mark. This reflects excessive economic worries. In overall terms, we are expecting long-term government bond yields to rise in 2019 by between 20 and 40 basis points, depending on the country and region. In the USA, we are also assuming a flat to slightly inverted yield curve, whereby an inverted yield curve does not necessarily

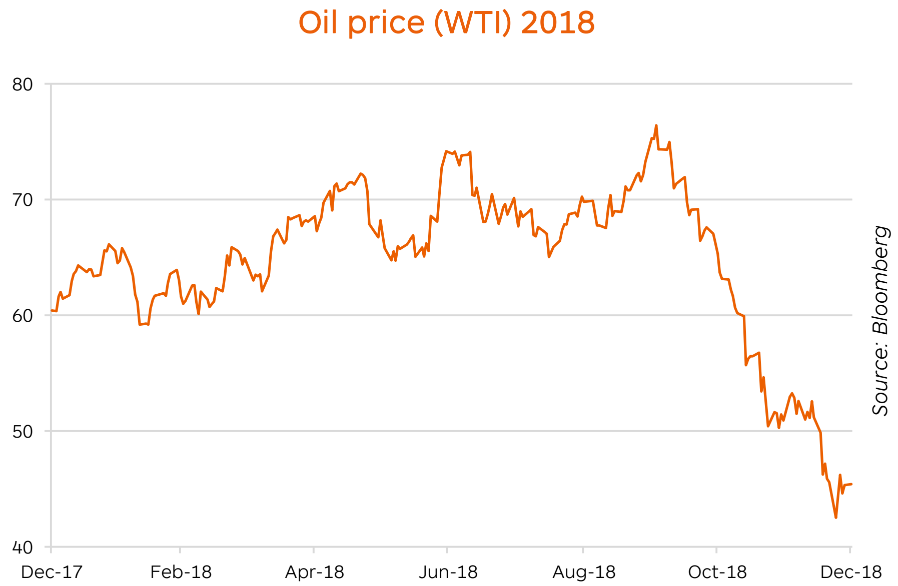
"In overall terms, we are expecting long-term yields on government bonds to rise in 2019."

have to go hand in hand with a recession. Inflation is also not likely to be a cause for concern this year: We expect inflation in important industrial nations to remain broadly unchanged in year-on-year terms.

Commodities

Disastrous – sums up the performance of oil prices since the end of September last year. The price of a barrel of West Texas Intermediate oil has fallen by around 40% since September, see the following chart:

"Disastrous – oil prices (WTI) fell by around 40% between September and December 2018."



Oil prices have long been accustomed to extreme and unexpected price volatility. However, prices are dependent not just on the development of supply. A potential easing of global oil demand during the course of 2019, brought about by a slowdown in global economic growth, also needs to be taken into account. This means the already historically high volatility of the commodities asset class in general, and of oil prices in particular, could continue over the coming weeks and months. The outcome of the last OPEC meeting (which takes place every six months) of reducing oil supply by more than 1% of global oil production is unlikely to be sufficient to achieve a sustained reduction in the notoriously high fluctuations in oil prices. This is because no specific production targets for individual countries were negotiated, and Libya, Venezuela and Iran were also exempted from the supply cuts.

The flight to the supposedly "safe haven" of gold did not help in the nasty investment environment. The yellow precious metal lost 1.5% of its value in 2018, although only thanks to the rally seen since mid-November. The price rose 7% between then and the end of December.

"Gold recently reacquired its shine."

Gold price 2018

In our view, an exposure to gold is an effective way to reduce the overall volatility of a mixed portfolio. Its performance will, however, continue to depend heavily on the movement of the US dollar and consequently on the policies pursued by the Fed. In the past, however, gold has often served well as a diversifier when geopolitical tensions have escalated significantly.

Currencies

The two most important currencies for the Swiss economy, the euro and the US dollar, moved in opposite directions relative to the Swiss franc in 2018. The euro, which started last year at 1.17, ended the year at 1.1269, corresponding to a decline of around 4%. The dollar was 0.9745 at the start of the year, and ended the period at 0.9858, meaning that it appreciated by around 1%. While the dollar benefited from a total of four interest rate hikes by the US Federal Reserve and the robust state of the US economy, increased political uncertainties in Europe – keywords being Italy and "Brexit" – and the recent pronounced downturn in the European economy had a negative impact on the euro exchange rate.

"Euro and US dollar moved in the opposite direction of the Swiss franc."

We are expecting comparatively moderate exchange rate movements in 2019. In our view, the US currency has only minimal appreciation potential, as the US Federal Reserve is approaching the end of its cycle of interest rate hikes and economic momentum in the US is declining. On the other hand, we see some appreciation potential in the euro. In view of the political risks, the safe haven of the Swiss franc is likely to remain in demand.

"We are not expecting any significant movements for the currently pairs EUR/CHF and USD/CHF in 2019."

FACTUM

Market Overview 31 December 2018

Stock indices (in local currency)	Current	1 Mt (%)	YtD (%)
SMI	8,429.30	-6.73	-7.05
SPI	9,830.06	-6.74	-8.57
Euro Stoxx 50	3,001.42	-5.23	-11.34
Dow Jones	23,327.46	-8.59	-3.48
S&P 500	2,506.85	-9.03	-4.39
Nasdaq	6,635.28	-9.38	-2.81
Nikkei 225	20,014.77	-10.33	-10.39
MSCI Emerging Markets	965.67	-2.81	-14.49
Commodities			
Gold (USD/fine ounce)	1'282.49	5.08	-1.46
WTI oil (USD/barrel)	45.41	-10.84	-24.84
Bond markets			
US Treasury Bonds 10Y (USD)	2.68	-0.30	0.28
Swiss Government 10Y (CHF)	-0.25	-0.15	-0.10
German Bund 10Y (EUR)	0.24	-0.07	-0.19
Currencies			
EUR/CHF	1.13	-0.47	-3.82
USD/CHF	0.98	-1.58	0.80
EUR/USD	1.15	1.33	-4.48
GBP/CHF	1.25	-1.61	-4.90
JPY/CHF	0.90	1.81	3.63
JPY/USD	0.01	3.53	2.81

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