Investment Report

October 2018

Strategy overview

A decade after Lehman Brothers went "belly up", Corporate America is now as pre-eminent as it last was under President Ronald Reagan in the 1980s. Even if Trump is not Reagan, his policies have supported the US market and the US economy, although not the economies of the rest of the world. In our view, certain approaches, such as the protection of intellectual property, are perfectly understandable. Trump's surprise announcement of a five-fold increase in the level of punitive tariffs imposed on China has weighed on emerging market and European equities, but has boosted US equities. In fundamental terms, the US economy has improved significantly since September 2008. For example, unemployment in the USA is the lowest it has been for 50 years, while in Europe, for example in Italy, where it is in the region of 11%, it is still higher than it was in the USA during the recession 10 years ago.

"The USA remains the dominant player."

International financial markets are likely to continue to be affected by the erratic actions of US President Trump over the coming weeks and months. In the United States, the economy appears extremely upbeat, while the upturn in Europe and China is losing momentum. The Fed is sticking to its rate hikes, while the first interest rate moves are not likely to materialise in Europe and Switzerland before the autumn of 2019. Due to the unattractive interest rate environment, especially in Europe and Switzerland, we favour underweighting the bond ratio. We are sticking to the neutral weighting of the equity ratio – the low interest rate environment and generally upbeat economic data are providing the necessary support. By contrast, we are continuing to rate political risks as significant, underscoring our view that a portion of the equity risk needs to be hedged against unforeseen events.

"International financial markets remain focused on the trade conflict, and for this reason we are hedging a part of our equity ratio."

FACTUM

Politics

In the US, mid-term elections are scheduled to take place on 6 November. This involves the election of legislative members. All 435 seats in the House of Representatives and 35 of the 100 seats in the Senate are up for election. In addition, governors will be elected in 36 federal states and 3 external territories. Participation in congressional elections is normally lower (at around 40%) than in the case of presidential elections (50-60%). On average, electors who vote in mid-term elections are slightly older and are very likely to be better educated than voters in presidential elections.

"US mid-term election – 435 seats in the House of Representatives and 35 of the 100 seats in the Senate are up for grabs."

So what are the prospects at the present time? In mid-term elections, it is generally the case that voters tend to vote against the party of government, causing the pendulum to swing in the opposite direction. In fact, ever since the American Civil War (1861 – 1865), the party of the ruling president has lost seats in Congress in 35 out of 38 mid-term elections. Trump's low approval ratings, which are in the region of 40%, suggest that his party is likely to suffer losses. The Democrats need to gain 25 seats in the House of Representatives in order to secure a majority. In our view, this scenario is indeed very likely to occur.

"In our view, the House of Representatives is likely to pass to the Democrats."

There won't be a so-called "blue wave", in our opinion, because the situation in the Senate is different. Of the 35 seats that are up for election this year, 26 are already held by the Democratic Party. The Democrats need to defend many more seats, and therefore have more to lose in the Senate than the Grand Old Party. Since 1938, no mid-term election has been so one-sided as this one. 10 of the seats that the Democrats need to hold are moreover located in federal states that voted for Donald Trump in the 2016 presidential election. In 5 of these states (North Dakota, Missouri, Indiana, Ohio and West Virginia), Trump even won with a substantial majority. By contrast, the Republicans are defending only one seat in a state (Nevada) that voted for Hillary Clinton.

"The Senate is likely to remain in the hands of the Republicans."

If our scenario materialises, the US President will have to reckon with significantly more headwind, fewer laws will make it to adoption and the Democrats will endeavour to block the Trump agenda. The next phase of the tax cutting programme is unlikely to be realised. The Democrats could even attempt to reverse a number of tax cuts, in order to fund an infrastructure programme. The Democrats are also likely to block the abolition of "Obamacare" and will be looking to expand Medicare, Medicaid and social security.

"If our scenario materialises, then domestic policy headwinds for President Trump are likely to increase substantially."

After weeks of trade negotiations between the United States and Canada, a result was announced. The North American Free Trade Agreement, NAFTA, between the USA, Canada and Mexico, which was cancelled by Donald Trump, has been revived under a new name and with a number of amended provisions as the US-Mexico-Canada Agreement, USMCA.

"USMCA – success before the mid-term elections."

Investors were taken aback by the adoption of the key provisions of the Italian budget at the end of September. The draft budget foresees a surprisingly high deficit of 2.4% of GDP for the coming year. The previous government in Italy had originally agreed to a deficit of 0.9% for 2019 with the European Commission, while the finance minister had promised a deficit of around 1.6%. Deficits of 2.2% and 2.4% are now being pencilled in for the years 2020 and 2021. Here, Italy had originally promised a balanced budget. The Italian government is thus ending its austerity drive of recent years and is risking a renewed rise in national debt. It means the Italian government is deliberately set on a confrontation course with Brussels. Italy needs to present detailed budgets by mid-October, and the European Commission will issue its verdict by the end of November at the latest.

"Italy on confrontation course with Brussels."

The response on financial markets at the end of September was unequivocal. The euro lost terrain against most currencies. Yields on Italian government bonds leapt upwards, and the interest rate gap relative to German government bonds also widened sharply. The Milan stock exchange fell over 4%, while Italian bank stocks lost even more. In our view, budget negotiations are likely to be difficult. Ultimately, a compromise will be reached between Italy and Brussels, but talks could drag on to the end of the year.

"Italy as a party-pooper."

Economy

Consumers in the USA are looking to the future with optimism. The sentiment indicator of the Conference Board rose from 134.7 to 138.4 points, marking a new 18-year high, meaning that the indicator is only slightly below the all-time high of 144.7 points recorded in May 2000. Definitive GDP figures for the second quarter confirm that the US economy grew robustly between April and June. Extrapolated over a twelve month period, GDP growth has been an impressive 4.2%, corresponding to the strongest quarterly expansion since the autumn of 2014. The US economy is also likely to have grown strongly in the third quarter. The annualised growth rate is likely to have been well in excess of 3%. In its estimate, the Federal Reserve Bank of Atlanta even assumes a GDP growth of 3.8% on the basis of all the economic data already available.

"US data remain upbeat."

Sentiment within the economies of the single currency deteriorated in September, for the ninth time in succession. It was announced at the end of September that the barometer dropped 0.7 points to reach 110.9 points. The separately collated indicator for the business climate within the industry sector remained unchanged at 1.21 points in September. Market expectations had been looking to 1.19 points. In December 2017 the indicator reached 1.60 points, which was the highest it had been in its 30-year history. Despite the steady declines, both indicators are still at a high level and remain above the long-term average.

"Sentiment within the Eurozone becoming gloomier."

As usual, the results of the purchasing manager survey in emerging markets show a mixed picture. It should be noted, however, that the picture has continued to deteriorate. The situation within the industrial sector, which accounts for a significantly higher proportion of GDP in emerging countries than in industrialised countries, has deteriorated further. At 50.8 points, the PMI Manufacturing lies only marginally above the critical threshold of 50 points. The New Export Orders Subindex has even sunk below the ominous threshold of 50 points (49.5 points). On the plus side, however, the situation within the service sector has improved somewhat, and the PMI Composite in emerging markets also saw a moderate rise in August. In the three major emerging markets China, India and Brazil, the PMI Composite has deteriorated across the board, in India and Brazil to a significant extent. At the same time, the activity indicator in China fell only slightly and is still listed above 50 points. In Brazil, by contrast, the PMI Composite has plunged sharply below the growth threshold of 50 points (47.8 points). Uncertainty about Brazil's future political course remains high, and this is likely to have contributed to the poor result. We are sticking to our cautious view of emerging markets and are therefore underweighted in equities in this region.

"Emerging country economies continuing to deteriorate – we have underweighted equities in this region."

Equity markets

We reported on the NFIB Small Business Optimism Index last month, which reached 107.9 points, the second highest level since data was recorded. In September, the index climbed to 108.8 points, the highest it has been since the data series was launched. The record level of business optimism is also reflected by the following chart, which represents the Russell 2000 Index. This index replicates the performance of 2,000 small caps in the United States.

"At 108.8 points, the NFIB Small Business Index is the highest it has been since records began."

Russell 2000 Index

While Europe and Switzerland, for example, have tended to move sideways this year, the broad S&P 500 in the USA has gained some 10%. One reason is likely to be the sizeable proportion of the market represented by the financial sector in Europe, over 20%. While the United States successfully recapitalised its banks and provided them with equity in the wake of the 2008 financial crisis, the situation is different in the Eurozone. It is also worth taking a look at profitability. Measured in terms of return on equity since the financial crisis, US banks have increased this to around 9%, while European banks have only reached about half of this figure.

"US banks have done their homework in the wake of the 2008 financial crisis."

As the following table shows, equity market returns diverged in the third quarter and significantly over the year 2018 as a whole.

Equity markets

Index	Q3	YtD.
SPI	4.65%	0.52%
EuroStoxx 50	0.42%	0.04%
S&P 500	7.71%	10.56%
Nasdaq Composite	7.42%	17.49%
Nikkei 225	8.81%	7.68%
MSCI Emerging Markets	-1%	-7.49%

Source: Bloomberg

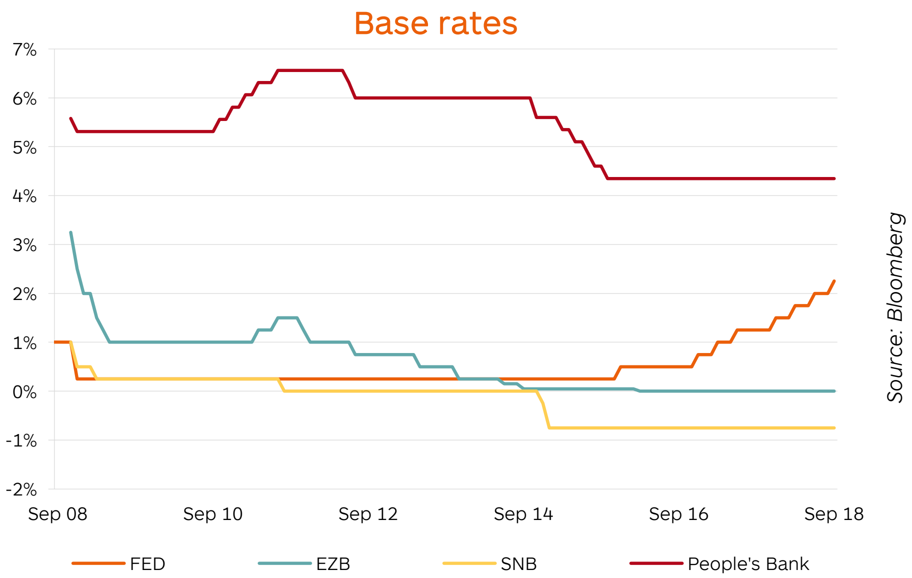
"Permanent decoupling of the American equity market?"

The US market has decoupled from the rest of the world. We see the reasons for this in US tax cuts, the sharp rise in share buybacks and the high growth in profits. Markets are almost completely ignoring the trade conflict and the associated risks to growth. If the impact becomes more visible in 2019 or the customs regime is tightened further, stockmarkets will focus more on growth and inflationary risks. The decisive factor for market divergences is widening profit expectations. During the first nine months, US earnings estimates were revised markedly upwards, while those for Europe were lowered slightly and those for emerging markets were cut sharply. These divergences are unlikely to continue to be so pronounced as they have been in recent months. On the one hand, the very substantial valuation differences between the American market and almost all other stockmarkets suggest that this will not be the case, while on the other hand, the high profitability of many US companies is likely to come under pressure as a result of increasing cost pressures and rising wages and financing costs.

Bond markets

"US Federal Reserve maintaining a steady course."

Unsurprisingly, the Fed raised key rates by 25 basis points to between 2.00 and 2.25% for the third time this year. In its comments on the decision, the Fed again spoke of strong economic activity and a reinvigorated labour market with upbeat employment growth. In addition, the unemployment rate remains low. Core inflation is in the region of 2%. The outlook and the question of to whether the Fed is likely to continue on the path of steady interest rate hikes over the coming years were particularly eagerly awaited. Here too, there were no surprises. The monetary watchdogs stick to the three interest rate moves scheduled for 2019. The Fed did not make a clear commitment to a further interest rate hike in December of this year. In the projections, however, a clear majority – 12 against 4 – stuck to four interest rate moves. They underscored their confidence with an upward revision of growth forecasts for 2018 from 2.8% to 3.1%. The US Federal Reserve is therefore continuing to pursue its gradual normalisation of monetary policy. Federal Reserve Chairman Jerome Powell has been very clear on this matter: So long as the economic signs do not change, the Fed will be sticking to its chosen path. While key interest rates are rising slowly but steadily in the USA, see below chart, the situation is markedly different in Europe and Switzerland.



Base rates in Europe remain at zero percent. The ECB will be reducing its monthly purchases of securities from EUR 30 billion to EUR 15 billion from October onwards, before discontinuing them entirely by the end of 2018. This is conditional, however, upon inflationary pressures and economic data not deteriorating significantly in the interim. We are not expecting the ECB to come up with an interest rate move before the autumn of 2019. After this, monetary policy is likely to be normalised very gradually, and any further interest rate moves will be administered only in homoeopathic doses.

"We are not expecting an interest rate move in Europe before the autumn of 2019."

Over the past month, the crisis in Turkey stoked a general increase in credit worries. In a classic reduction of risk appetite, "safe havens" such as Swiss and German government bonds were sought and corporate and emerging market bonds were sold by most market players. This caused their yields to rise relative to those of government bonds, resulting in a widening of the credit spread. Turkey could improve its situation through its own initiative.

"The Turkey crisis triggered a general rise in credit fears."

Specifically by pursuing more sensible economic policies together with interest rate hikes to combat inflation, which has reached a substantial 16%, by taking a more conciliatory political approach to the USA as well as by reducing the excessive debts of Turkish companies.

Our Investment Committee engaged in heated discussions of bond investments at its most recent investment meeting. A diversified strategy, including the overweighting of inflation-linked bonds, will be maintained, as the alternative of CHF and EUR bonds, nominally and even more when inflation-adjusted, is likely to generate negative returns in the medium term. In overall terms, we are sticking to our underweighting of the bond ratio.

“In overall terms, we are sticking to our underweighting of the bond ratio.”

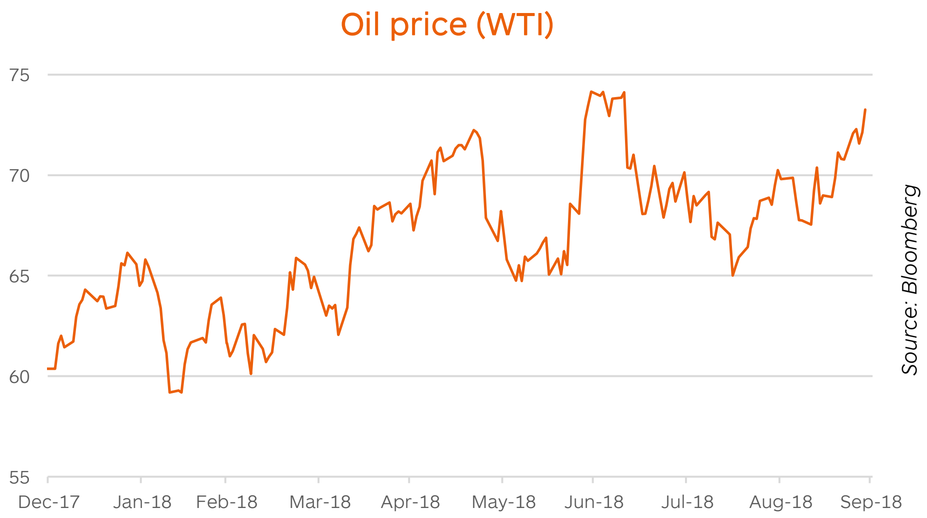
Commodities

The US government is also making headlines on international oil markets, and is consequently generating a clear price trend. US sanctions against Iran are set to come into force in November. After this, US threats against all countries that buy Iranian oil point to supply problems for oil. Pressure exerted by Trump on key members of the Organisation of Petroleum Exporting Nations (Opec) to boost their production does not seem to be having the desired result. At the informal Opec meeting, at any rate, any early increase in oil production was rejected on the grounds that the market was currently well supplied. At the same time, the heavyweight Saudi Arabia confirmed its determination to market more oil at short notice in the event of a global supply bottleneck.

“The US government is also making headlines on international oil markets.”

The price of WTI oil rose by around 5% last month. Over the year 2018 as a whole, it has gained an impressive 21%. In USD terms, it is priced at USD 73.25 per barrel, corresponding to 159 litres. The price of the oil products heating oil and petrol have also risen sharply. Futures on European heating oil have topped USD 700 per ton, which is the highest they have been for four years. Swiss consumers, in particular, will find themselves facing high prices. It is not just in sea ports that the price of oil has risen massively. Due to the low water levels of the River Rhine, freight costs have exploded and are thus providing an additional boost to prices.

“European heating oil is the most expensive it has been in four years.”



As we reported in the September issue, we reduced our exposure to gold in August. Despite (geo)political tensions, the price of gold has performed disappointingly in recent months. Here too, the resurgent US dollar is likely to have played a major role in this. During the current year, the price of gold has fallen by around 8%. Support might come from the Fed, if it stops its interest rate hikes next year. Until then, however, it will probably be difficult for the price of gold to move north.

"Gold has been a disappointment in the current investment year."

Currencies

The American writer Mark Twain is said to have once said that "forecasts are a difficult thing – especially when they concern the future".The same can be said of currency forecasts. The Swiss franc ended the 2017 at CHF 1.17 against the euro. The currency pair is currently at 1.14 (-2.5%). What are the reasons for the resurgence of the Swiss franc and for the weakness of the European single currency?

"Franc strength versus euro weakness."

In our view, there are a variety of reasons. First and foremost, the geopolitical situation, which has become less rosy in overall terms. Customs duties are having a negative impact on trade and global output chains. The recent crises in Turkey and Argentina as well as concerns about political developments in Italy and the Italian government's budget plans also led to a flight into the Swiss franc.

"What are the reasons for the performance of the EUR/CHF currency pair?"

Added to this is the outstanding state of the Swiss economy, which is why we believe it is unlikely that the Swiss National Bank will tighten its interest rate belt before the European Central Bank. On the other hand, Europe found itself struggling with an economic slowdown this year, which does not exactly speak in favour of the euro.

Market Overview 28 September 2018

Stock indices	Current	1 Mt (%)	YtD (%)
SMI	9,087.99	1.38	0.21
SPI	10,807.82	0.63	0.52
Euro Stoxx 50	3,399.20	0.31	0.04
Dow Jones	26,458.31	1.97	8.83
S&P 500	2,913.98	0.57	10.56
Nasdaq	8,046.35	-0.70	17.49
Nikkei 225	24,120.04	6.07	7.68
MSCI Emerging Markets	1,047.91	-0.54	-7.49
Commodities			
Gold (USD/fine ounce)	1,190.88	-0.86	-8.59
WTI oil (USD/barrel)	73.25	4.94	21.23
Bond markets			
US Treasury Bonds 10Y (USD)	3.06	0.20	0.66
Swiss Government 10Y (CHF)	0.04	0.13	0.19
German Bund 10Y (EUR)	0.47	0.14	0.04
Currencies			
EUR/CHF	1.14	1.38	-2.61
USD/CHF	0.98	1.32	0.76
EUR/USD	1.16	0.02	-3.34
GBP/CHF	1.28	1.89	-2.85
JPY/CHF	0.86	-1.02	-0.14
JPY/USD	0.01	-2.32	-0.88

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