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Investment Report

February 2019

Strategy overview

"As January goes, so goes the year" is a popular stockmarket saying. It is frequently cited at the end of January each year. If the rule proves correct for the year 2019, then investors can look forward to a positive equity year. American equity indices, in particular, have recorded a sparkling start to the investment year. The S&P 500 Index advanced 8%, the Dow Jones Index by 7.3%, the technology index NASDAQ by 9.8% and the Swiss SMI by a similarly impressive 6.4%. This means there has been a so-called "V-shaped recovery", with global equity indices recovering some of the losses suffered since October 2018.

> "The S&P 500 Index in United States recorded the best start to the year since 1987, gaining 8.01%."

It is worth taking a closer look at Dow Jones data since its foundation in the year 1896. In 75% of cases, a positive January was followed by a positive year as a whole. In years when the Dow Jones rose more than 7% in January, as is the case in the current year, then there has only been one occasion when there was a loss at the end of the year – namely in 1930. From this perspective, January provides grounds for optimism that the current investment year will produce positive equity returns.

> "Historically, when the Dow Jones advanced by more than 7% in January, there was only one occasion – 1930 – when the annual performance turned out to be negative."

This prompts the question of what has changed since December. It is worth noting that markets were heavily oversold in December and that the Fed contributed to a change in sentiment with its more moderate tones. The environment remains challenging, however. For example, the trade conflict, which in our view represents the greatest risk to the global economy and financial markets. Or the "Brexit question", the likely withdrawal of US troops from Syria, doubts about North Korea's nuclear disarmament and China's assertion of power in the South China Sea. It is our assumption that progress will begin to be made in the trade conflict between the USA and China in the coming weeks, whereby a comprehensive agreement is unlikely to be reached. The global economy is continuing to cool, which will encourage central banks to take a more moderate course.

> "The environment remains challenging, whereby we are expecting progress in negotiations on the trade conflict between the USA and China."

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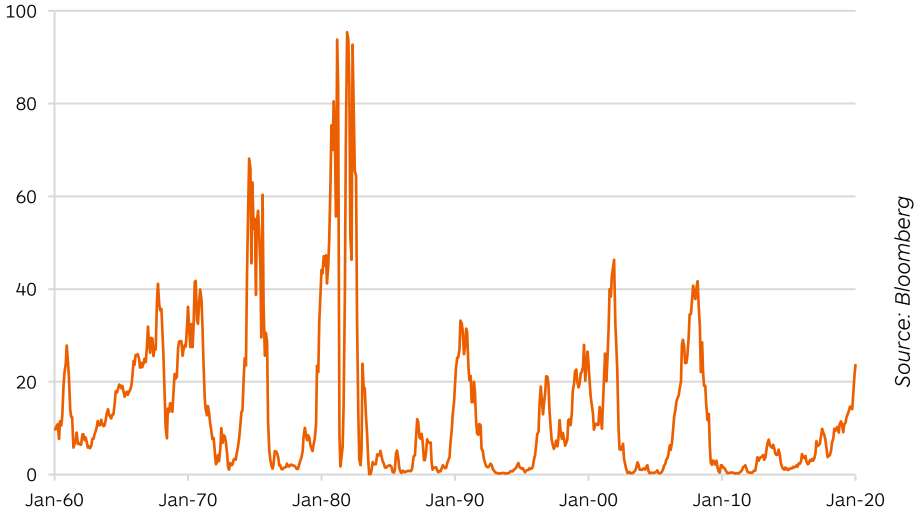
The fundamental facts of the past few weeks do not point to a recession, but instead to a marked global economic slowdown. This is also the reason why the Fed shifted its tone markedly. In December it was still talking about several interest rate hikes, with the economy on what might be called in autopilot mode. But it has recently been saying that interest rate hikes were not likely to materialise any time soon. This caused riskier assets, such as high-interest bonds or equities, to rebound.

"High-interest bonds and equities have recovered on the back of the moderate statements coming out of the Fed."

We share the view that there is a limited risk of recession in the near term. While the Recession Index calculated by the Federal Reserve Bank of New York has risen in recent months, in historical terms it remains at a low level in the region of 20% (see chart). In the post-War period, a recession has materialised on the back of such figures only on one occasion, namely in 1973 during the Oil Crisis.

"While the risk of a recession in the USA has risen, it remains low from a historical perspective."

Recession Index of the Federal Reserve Bank of New York



What implications does this have for our managed portfolios? As mentioned in the last Investment Report, we have positioned ourselves more defensively and have given equities a neutral weighting. The latest rise in equity prices contrasts with signs of an economic slowdown. On the other hand, share valuations have been declining for months. For this reason, earnings growth will remain decisive, along with political factors. In our view, a more defensive focus, in the sense of reduced economic sensitivity, relative earnings stability and, above all, less volatility appears to make sense in an economic downturn. We have continued to overweight gold, meaning that this remains an important portfolio component. It is currently listing at over USD 1,300 per ounce.

"We are currently sticking to our neutral equity ratio."

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Politics

On 30 and 31 January, Chinese and American delegations met in Washington to discuss improvements in trade relations. The responses of the US President, following two days of negotiations, were customarily upbeat. Donald Trump promised “the greatest deal ever”. By contrast, other voices, such as that of the US Trade Representative Robert Lighthizer, were markedly more restrained. Little was said about concrete results. The circumstance that negotiations are continuing is positive. Lighthizer will shortly be travelling to China together with Secretary of the Treasury Steven Mnuchin to continue the negotiations. A face-to-face meeting between Trump and the Chinese President Xi Jinping also appears to be on the cards.

“Decisive weeks in the trade conflict between the United States and China.”

The fact that the negotiations are progressing very slowly, or could even fail, is largely being ignored by the market at the present time. There remain only four weeks for an agreement to be reached between Washington and Beijing. The list of US demands is long, and some of these will be difficult for China to fulfil. 1 March is still the deadline for an agreement to be reached. Otherwise, the US tariffs imposed last autumn on Chinese products with a trade value of USD 200 billion are set to be increased from 10% to 25%. There therefore needs to be decisive progress in February, as in other respects the impact of the trade conflict on global growth and financial markets is likely to intensify.

“Are financial markets overly optimistic about the prospects for a solution to the trade conflict?”

By mid-February, the US Department of Commerce needs to submit a report on whether foreign car imports are jeopardising national security. On the basis of this report, the US government will then be able to decide whether to impose punitive customs duties on automotive imports. Parallel to this, domestic policy pressures remain high. By 15 February, the US Congress needs to reach agreement with Trump on a new federal budget and possible funding for the border wall with Mexico, otherwise another “government shutdown” looms. In his State of the Union address, President Trump announced that he would be meeting the North Korean Dictator Kim Jong Un on 27 and 28 February in Vietnam. In light of the fact that North Korea has still not taken any concrete steps towards nuclear disarmament, Trump conceded that much work still needs to be done.

“Further political decisions are set to be taken in the USA in February.”

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Economy

In view of the state of the wider global economy, there have been growing concerns about a hard landing in the "Middle Empire". Official purchasing manager indices in China show a very mixed picture for the industrial and services sectors. While the PMI Manufacturing gained only marginally from 49.4 to 49.5 points, the PMI Services improved for the second time in succession and rose 0.9 points to reach an impressive 54.7 points. This means activities within the service sector are as high as they were four months ago.

"Mixed picture for China's industrial and services sectors."

The situation within the industrial sector, by contrast, remains weak. In January, the PMI Manufacturing remained stubbornly below the critical threshold of 50 points, marking the critical divide between contraction and expansion. In particular, companies have been struggling to cope with a decline in incoming orders. The trade conflict with the USA is impacting the supply chains of Chinese companies and increasing pressure on companies that are already reeling from the effects of the weakening domestic economy. On account of the upbeat PMI Services, however, the PMI Composite, which combines the survey results from the industrial and services sector, actually improved and rose from 52.6 to reach 53.2 points.

"Chinese industry is being worn down by the crisis – an easing of the trade conflict would help."

Equity markets

For global equity markets, an easing of political imponderables, such as for example concessions in the trade conflict between the USA and China or in the budget dispute between the Democratic House of Representatives and the Republican President, would be desirable. On the positive side, the reduction in share values is worth mentioning. Measured against the MSCI World Index, the so-called price-earnings ratio has declined by around 20% over the past year. On the other, there are increasing signs of a sharp economic slowdown in many countries, particularly in Europe, and now also including China and the United States. For example, US consumer sentiment has fallen back to a level last seen in early 2016.

"An improvement in political imponderables could boost stock prices."

In particular in the event of a further economic slowdown, a number of considerations suggest a more defensive approach should be taken within the equity ratio, in the sense of reduced market sensitivity – market beta below 1 – as well as the relative stability of dividend and earnings growth. For equities as an investment class, the various factors are currently pointing to a neutral weighting. That is to say, positive and negative factors are broadly balanced. Political factors have the potential to move markets in both directions, however.

"Current factors make a neutral equity ratio the sensible option."

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Bond markets

The US Federal Reserve is paying tribute to the weaker global economy, political risks and less favourable financing conditions. In its monetary policy statement, the Fed expressed greater caution about the economic situation as well as the monetary policy outlook. The assessment of the overall economic outlook was downgraded from “strong” to “solid”. The Fed explicitly stated that it would take a patient approach to future monetary policy adjustments. According to the Fed Watch Tool of the US stock exchange CME, most investors are no longer expecting a further interest rate move from the US Federal Reserve this year. In our opinion, this seems rather optimistic, and would be conditional upon inflation not rising.

“Fed is exercising patience.”

In overall terms, while we take the view that the cycle of interest rate hikes has not yet run its course, it is our assumption that monetary watchdogs will be putting off the next interest rate move for some time to come. We are expecting the cycle of interest rate rises to resume in the third quarter of 2019. However, only if economic and inflation data allow this, which is our current assumption.

“We do not share the view that the cycle of US interest rate increases has come to an end.”

Commodities

Oil is likely to remain subject to very volatile movements. It is not clear what will happen to Iranian oil exports in the spring. Here too, everything depends on US President Trump. He granted exemptions in order to punish Saudi Arabia following the death of Kashoggi. Saudi Arabia and Russia then raised their oil production volumes massively, triggering the collapse in oil prices towards the end of the year. In addition, economic demand in the coming months is pointing less clearly upwards than was the case one year ago. Oil prices for the WTI grade rose 18.5% in January to reach USD 53.79 per barrel.

“Oil is likely to remain subject to volatile movements.”

Demand for gold rose in December, against the backdrop of political uncertainties and turbulence on international equity markets. In addition, declining interest rate speculation in the USA has put additional wind in the sails of the yellow precious metal. Gold gained around 3% in value in January to reach USD 1,321.25, and is currently in the technical resistance zone of USD 1,300 – 1,350 per ounce. We continue to see gold as a fixed portfolio component, and are consequently optimistic about prospects for the gold price going forward.

“We continue to see gold as a fixed portfolio component and are optimistic about prospects for the gold price going forward.”

Currencies

The deteriorating state of the European economy is not advantageous for the euro. Industrial production within the Eurozone declined in year-on-year terms to the level recorded in the summer of 2013. But because the US economy is also cooling, the euro managed to recover somewhat against the greenback and the Swiss franc. Its further development is likely be dependent mainly on statements issued by the US Federal Reserve and new economic data. This is because the current state of the European economy means the European Central Bank is highly unlikely to raise base rates. Discontinuation of the ECB's bond purchasing programme last December has already amply slowed the Eurozone economy; what it actually needs is stimulation. At present, we are expecting volatile sideways movements in the EUR/USD and EUR/CHF currency pairs over the next 3 to 6 months.

"We are expecting the EUR/USD and EUR/CHF currency pairs to be subject to volatile sideways movements."

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Market Overview 31 January 2019

Stock indices (in local currency)	Current	1 Mt (%)	YtD (%)
SMI	8,969.27	6.41	6.41
SPI	10,514.35	6.96	6.96
Euro Stoxx 50	3,159.43	5.58	5.58
Dow Jones	24,999.67	7.29	7.29
S&P 500	2,704.10	8.01	8.01
NASDAQ	7,281.74	9.79	9.79
Nikkei 225	20,773.49	3.80	3.80
MSCI Emerging Markets	1,049.93	8.76	8.76
Commodities			
Gold (USD/fine ounce)	1,321.25	3.02	3.02
WTI oil (USD/barrel)	53.79	18.45	18.45
Bond markets			
US Treasury Bonds 10Y (USD)	2.63	-0.05	-0.05
Swiss Government 10Y (CHF)	-0.24	0.01	0.01
German Bund 10Y (EUR)	0.15	-0.09	-0.09
Currencies			
EUR/CHF	1.14	1.12	1.12
USD/CHF	0.99	1.23	1.23
EUR/USD	1.14	-0.17	-0.17
GBP/CHF	1.30	4.07	4.07
JPY/CHF	0.91	1.95	1.95
JPY/USD	0.01	0.69	0.69

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