Investment policy 2018

Favourable conditions set to continue for now

- Global economy is going strong – inflation is becoming an issue in the US
- Cautious tightening of money tap
- Geopolitical risks should not be underestimated
- Equities remain the preferred asset class

Review of 2017 – strengthening economy, calming of political tensions

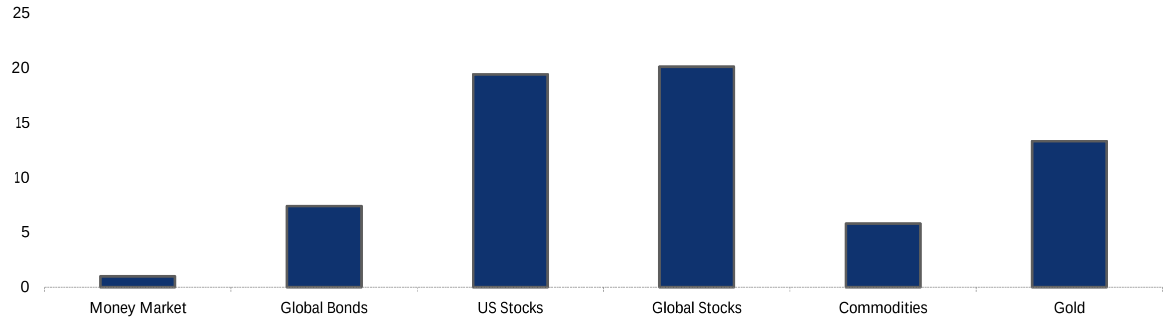
In 2017, hopes of a global upswing were confirmed. Global economic growth accelerated to 3.6% and approached the long-term average. The almost unique synchronicity in global economic performance – acceleration in the US, Europe and Japan and hardly any signs of a slowdown in China – provided a solid foundation for stock and commodity markets. An important contributing factor was that President Trump only selectively pursued the trade protectionist policies threatened during the election campaign (renegotiation of NAFTA agreement) and that the relationship with China, which is very important for geopolitical stability, became less tense. The spectre of right-wing extremism was banished in Europe, although it cannot be denied that right-wing populism has become a power in Eastern Europe in particular. The "fantastic" victory of the new En Marche party and the election of Macron as President of France were crucial for the stability of the European Community and the single currency. This cancelled the political risk premium, and the euro became one of the strongest currencies in 2017. The governing Tory party suffered an unnecessary and surprisingly clear election defeat in the UK, weakening the negotiating power of Teresa May in the Brexit negotiations with the EU to such an extent that a reversal of the Brexit decision is no longer unthinkable. In Germany too, the governing coalition suffered an election defect, which made the task of forming a government considerably more difficult.

As can be expected, the central banks' reactions differed. The US Fed increased key interest rates in three steps by a total of 0.75 percent. Because of the progress made by the labor market, the Fed wanted to counter the inflation trend triggered by wage costs. In Europe and Japan, however, monetary easing remained the order of the day. The noteworthy exception was the UK, where the key interest rate was increased to 0.5% in view of rising inflation. In China, monetary conditions were tightened as part of the government's growth policy.

The improved economy stimulated the commodity markets. Prices for non-ferrous metals increased sharply, and the oil price rose above USD 60 per barrel in the second half of the year. Fears that overproduction will continue were alleviated by a production agreement between

OPEC and Russia. Precious metal performance was varied, gold gained 13% while palladium strengthened by more than 50%.

Graph 1: Gross yield 2017 in USD for different asset classes



Yields on government bonds did not change, while risk premiums for private bonds and government institutions dropped further. In spite of very low interest rates, this made for a positive return on fixed-income investments. For equity investors, 2017 was an excellent year. Markets in the US strengthened by 20%, and the NASDAQ technology exchange improved by as much as almost 30%. At 10 to 20%, the European markets also reported very good growth. The UK market as well as the Euro Stoxx closed weaker. The emerging markets once again outstripped the old markets, with the Asian markets leading the pack. Generally speaking, equity markets were supported by good corporate profits and growing merger and acquisition activity.

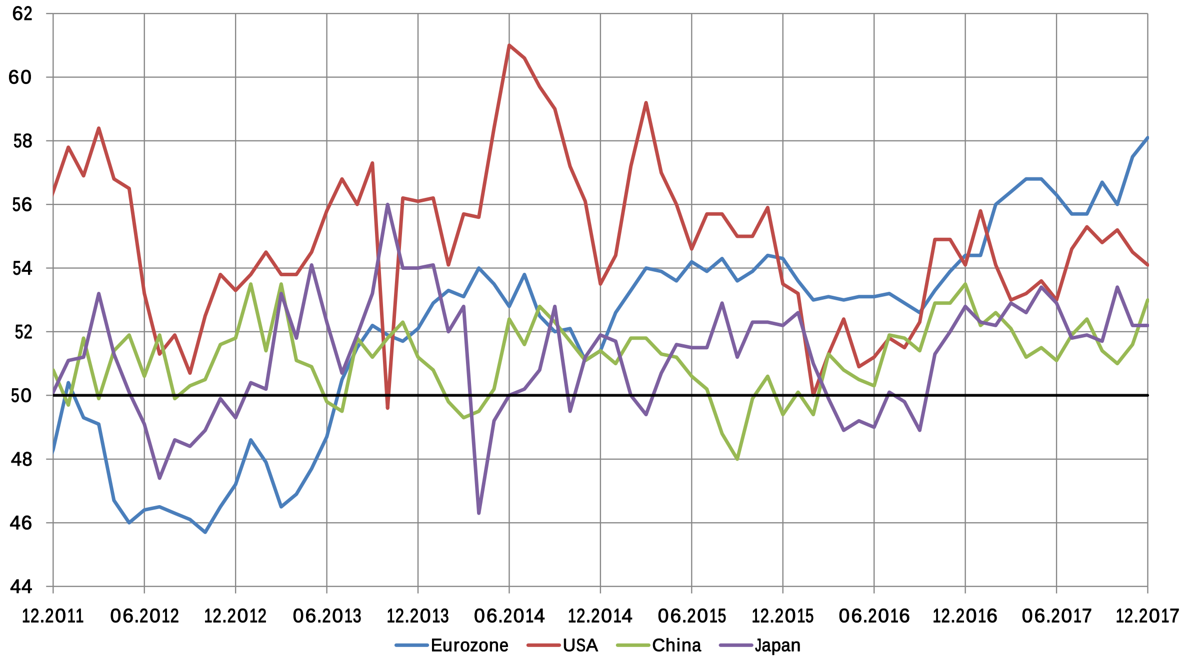
On the forex market, the euro attracted attention by improving 12% on the US dollar, primarily because of the abatement of political risks. The general weakness of the dollar (-10% in trade-weighted terms) was quite a surprise, especially as the US currency was supported by interest rate developments. Another surprise was the strengthening of the British pound by 10% against the US dollar, most likely as a counter-reaction to the Brexit shock. The Swiss franc lost around 9% against the euro and approached the level of 1.20, which should be advantageous for the export industry in the medium term.

Outlook for 2018

Economic trends

At the beginning of 2018, optimism is quite strong that the broad-based economic upswing will continue. The monthly survey of purchasing managers confirms an optimistic outlook for the four biggest economic powers on Earth (see graph below). The recovery of the economy from the biggest post-War crisis is continuing at a relatively modest pace. According to the OECD, global economic growth is likely to reach the historic average of 3.8% for the first time again in 2018 and will be slightly higher than in 2017. This is supported by a reversal in fiscal policy. In the years 2015 to 2016, the growth impulse was negative at an average of 0.5%, while a positive impulse of a similar magnitude is forecast for the period from 2017 to 2019. Growth in the US will strengthen, while the recovery in the Eurozone will continue. There is little sign of a collapse of the Chinese economy. The structurally compelling contraction in growth should therefore continue, but is likely to proceed with caution.

Graph 2: Purchasing Manager Survey



Continued growth combined with restrained investment activity in the past years will lead to capacity bottlenecks, and prices will rise sooner or later. The situation on the labor market will not only continue to improve in quantitative terms, but a shortage, in particular with regard to qualified workers, will increasingly occur. Experience to date has shown that an economy with a generous money supply (which is certainly the case at present) and falling unemployment will lead to an employment situation where prices generally start to rise. The US has already passed this point without boosting inflation. Although the pressure exerted by wage inflation can be cushioned by rationalization measures and the outsourcing of production to low-wage countries, it cannot be kept at bay permanently when demand is growing. Real wages in the US grew by around 2% per annum before the big crisis, and only by around half this figure in the last ten years. The OECD is now forecasting growth of around 30% for real wages to 1.3% p.a. The same wage development curve is expected in other countries, even though growth rates outside the US are forecast to be lower.

Monetary policy – cautious tightening

The prevailing opinion is that inflation in the US will rise at a leisurely pace until it reaches the target of 2% at the end of 2018. Market expectations about further interest rate hikes are therefore conservative: two increases of 0.25% each for the key interest rate are expected. The US Federal Reserve Board is slightly more restrictive and forecasts three interest rate hikes for 2018. In any case, a further tightening of monetary policy is granted, which is supposed to keep inflation in check. There is still a risk, however, that inflation can increase faster and more severely. If the tax reforms of the Trump government should have a bigger than expected impact on growth or the upcoming infrastructure projects should strain the capacity of the economy, inflation could suddenly become virulent and therefore a challenge for the Fed. Monetary policy will doubtless be much more restrictive than the consensus agreement, which could signal the beginning of the end of the long but slow upswing.

As economic trends and prices are stable in the Eurozone and in Japan, money market interest rates will remain at their lowest level. In the UK, the fact that Brexit is threatening an economic slump means that the interest rate hike introduced in 2017 may be cancelled when the focus should switch to growth. The Swiss National Bank will maintain its policy and keep interest rates low. The monetary authorities in China are juggling different balls: preventing the collapse of an enormous credit pyramid and a slowdown in growth with severe consequences for domestic policy, an exchange rate policy that does not provoke the US to apply protectionist measures, and the relative stability of domestic prices.

Capital market – central banks abandon market cultivation

The US Fed has already outlined its plans for reducing its securities portfolio, which has quadrupled to more than USD 4 billion in the past ten years. Generally speaking, the balance sheet should be reduced with caution in order to affect market prices as little as possible. It is clear that the Fed will become a net seller of government bonds, but it is difficult to predict the psychological effects of such a change on the market. The ECB will continue its buying program until autumn 2018, albeit while reducing its monthly purchases. The ECB's balance sheet is even more inflated than in the US, and the road to "normalization" could become a topic by the end of the year. Market intervention seems to be continuing in Japan in an attempt to keep the interest rate curve on the zero line. The relative expansion of the central bank's balance sheet was most pronounced in Switzerland, with the SNB's intervention focused on the forex market. The acquired foreign currency balances have been invested in a broadly diversified manner, including in the global equity market. If the strengthening of the euro should be confirmed, further intervention by the SNB will not be needed and this conjecture could trigger a normalization of the balance sheet.

Yields on government bonds are increasingly being determined by the upturn in long-term inflation expectations, but this effect is still very modest. Interest rates on government bonds are likely to rise, however, with the biggest upside potential in the US. Risk premiums for private borrowers have contracted further and are too small in some cases. This leaves a risk that yields on higher-yielding bonds can shoot up more than the average in the wake of rising (fear of) interest rates for government bonds.

Calm on the forex market?

Currency markets did not see much excitement in 2017, and many market analysts believe that this trend will continue in 2018. The consensus forecast (Bloomberg survey) for the EUR/USD exchange rate is 1.21, which equals the forward rate and means that the USD's interest advantage will be compensated by devaluation. The same is true for the relation between the British pound and the dollar. The Swiss franc on the other hand is likely to remain under pressure and to trend towards 1.20 to the euro. This expectation of marginal changes reflects the belief in the continued recovery of the global economy. Although there are many factors that support this favorable scenario, the risks should not be forgotten. Diverging economic developments, e.g. an overheating of the US economy or a collapse of the Chinese economy could trigger severe turbulence on the forex markets. Political events, which we will discuss later, also harbor disruptive potential.

Commodities – a heterogeneous asset class

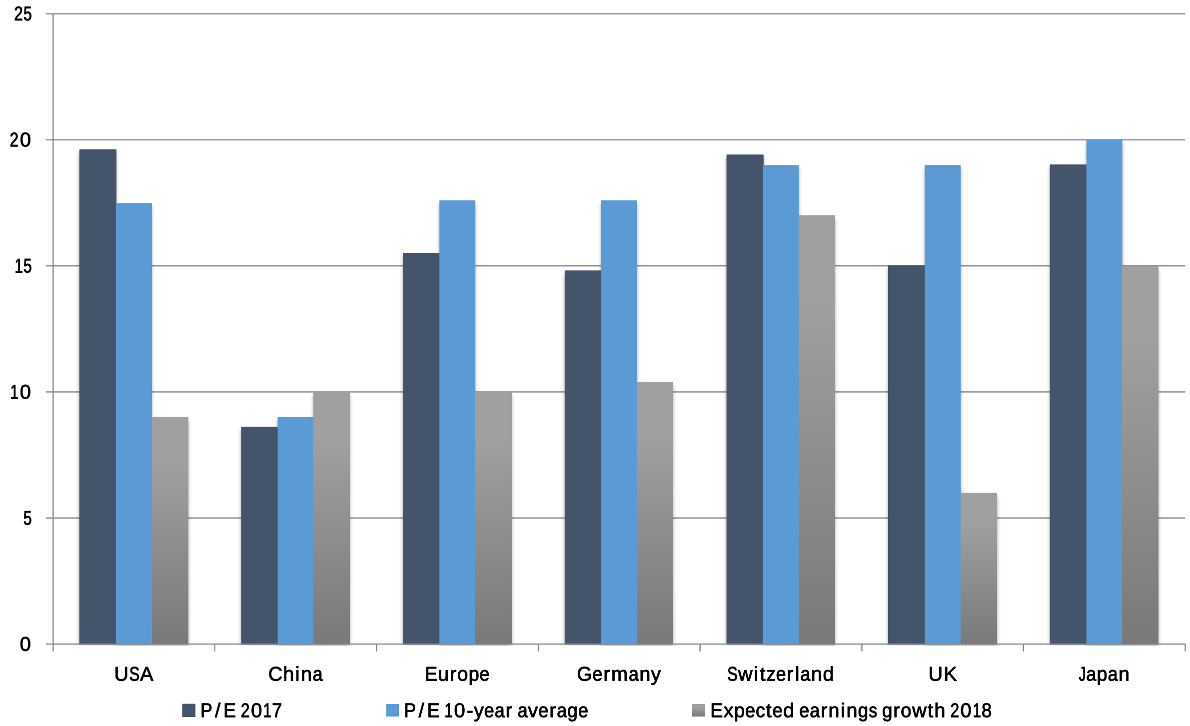
Commodities as an asset class hardly saw any growth in 2017, but this does not take account of the considerable differences in performance. Among the precious metals, palladium increased by more than 50%, while silver and platinum reported single-digit growth. Metals generally trended upwards, but with differences in scope. This price trend will continue because of an increase in demand stimulated by the economic upswing. Volatility can also be higher, e.g. for silicon, which has caught the attention of speculators because of the increase in demand driven by fast-growing e-mobility and the need to store solar energy.

The oil market is shaped by a slight rise in demand and a complex supply structure. To prevent a price collapse, OPEC and Russia have agreed to cut production. It is quite a surprise that this agreement has been observed to date, and there is no certainty that this will continue in future. Various war-torn oil-producing countries are entering the market. As the US fracking industry is profitable at the current price level of around USD 60 per barrel, it has successively increased its output over the past year. At best, the oil price will oscillate at the current level, and at worst, it will drop. Production shortfalls triggered by political events are always possible and could lead to temporary price spikes.

Equity markets have still some upside potential

Investors are intuitively cautious after a dazzling year. There is also a rational reason for such caution, as performance figures tend to follow an average that is considerably lower than the gains achieved in 2017. But an excellent year does not necessarily have to be followed by a bad one. Market valuations are a better indicator of what can be expected. The graph below shows the price/earnings ratio (P/E ratio) based on the profits for 2017, the ten-year average P/E ratio and the average expected earnings increase for 2018. Based on this approach, in particular the European markets remain interesting, as the P/E ratio of 15 is lower than the global average as well as their own ten-year average. The valuation of Chinese equities traded in Hong Kong is substantially lower, while the US, Japan and Switzerland are relatively expensive. An expectation of profit growth of 10% for the world index does not seem exaggerated, but within the context of expected nominal economic growth of around 5% and already high profit levels, market expectations seem rather ambitious. This means that the risk of disappointments and price corrections has become elevated.

Graph 3: Valuation of Equity Markets

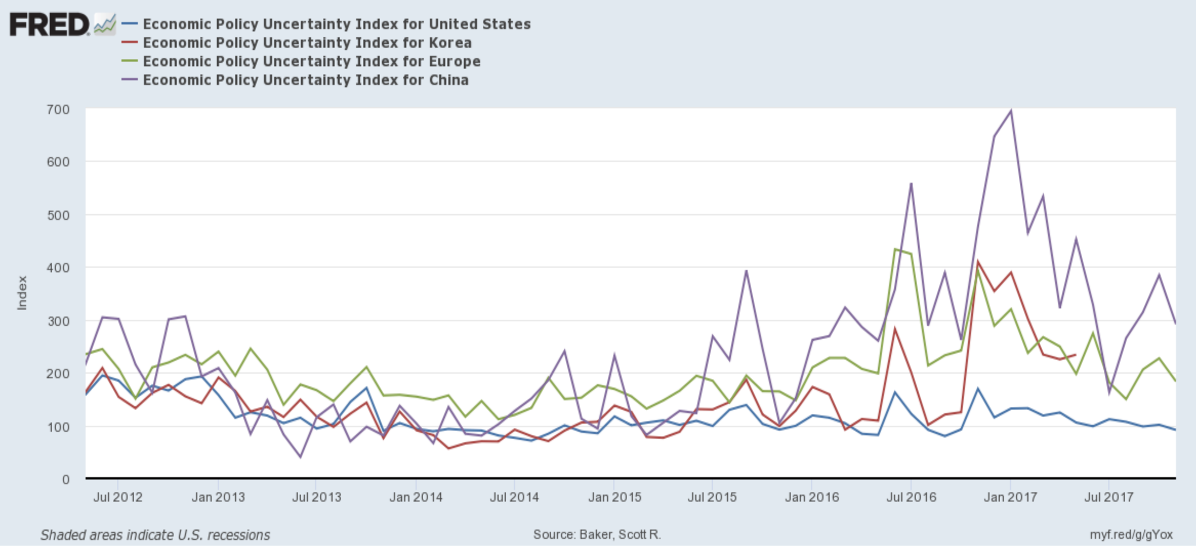


Given the different fields of activity in a national economy, attention should be paid to the fact that the digital revolution is advancing rapidly and offers investors many interesting investment opportunities. In spite of the relatively high valuation of the IT sector, it still offers much structural potential. Opinions about the health care sector are ambivalent: although extremely high investment risks and interventions in this sector by populist governments are common, demand for health care products and services are systematically rising in tandem with the growing affluence and life expectancy of the global population. This sector is valued attractively and offers potential for a diversified portfolio. Rising defence spending and investments as well as planned infrastructure projects in the US have boosted the valuation of the industrial sector, and some caution is needed here. The same applies to defensive consumer stocks such as Nestlé where there is no sensible relation between the valuation and the inner growth potential of the industry. You can find a more detailed assessment of the different sectors in the annual report of our Xantos equity fund.

Geopolitical risks not given enough attention?

As mentioned before, the geopolitical fever chart for Donald Trump's first year in office has cooled noticeably. Have investors become too nonchalant in a world where the US takes a martial approach to North Korea, the situation in the Middle East is anything but peaceful, and China is clearly asserting some territorial claims? Italy will elect a new parliament in the first half of 2018, deciding whether the country will turn its back on the EU. This is not quite as far-fetched as it seems in a country where the economic recovery is still hardly noticeable and the people are dissatisfied, which has manifested in a loss of confidence in the EU and the euro to an extent that was never seen before. An election outcome that favours the EU opponents could threaten the stability of the Community once again, but Italian securities are likely to bear the brunt of such a development.

Graph 4: Economic Policy Uncertainty



New elections for part of the US Congress will be held in November. If Trump loses the majority in parliament, his domestic agenda will become nothing but waste paper. As a "lame duck", foreign policy will be the only stage left to him, which could lead to growing tension with Iran and North Korea. The protectionist ideas promoted during the election campaign could also be revived. This is hardly an exhaustive list of the political risks that are relevant to the financial markets. In contrast to the end of 2016 political risks have predominantly negative consequences for markets.

Investment-relevant Conclusions

"It's not over till it's over"

Generally speaking, the investment recommendations of last year can be repeated:

- Fixed-income investments are rather unattractive and are burdened by rising US interest rates and small risk premiums.
- Although many commodities are in demand in the current economic environment, production output is also being adjusted and the price effects are limited. Under these conditions, precious metals are not in the focus of attention.
- Cryptocurrencies have been experiencing some hype, with Bitcoin in particular making headline news. We urgently advise investors not to include cryptocurrencies in a balanced portfolio. Transparency is insufficient, security is lacking and the value - although it cannot be calculated - is likely to fall outside the bounds of rationality.
- Equities remain the preferred asset class, even though the risk of setbacks has grown. In addition to the traditional markets, the spotlight also falls on the emerging markets thanks to commodity prices, a sideways trending US dollar and a strong Chinese economy. Asian countries benefiting from the digital revolution are particularly attractive. The IT sector is generally taking centre stage, while defensive sectors such as consumer staples or utilities are less interesting.

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