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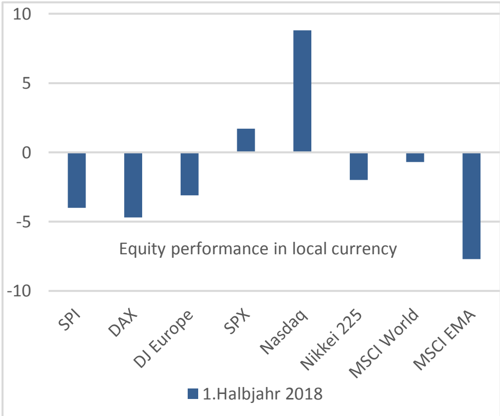
Half-yearly report June 2018

- The financial markets were heavily influenced by political developments (punitive tariffs and retaliatory measures, Russia and Iran sanctions, Trump-Kim talks, new governments in Italy and Spain, coalition crisis in Germany, G7 summit flop) and marked by extreme jitters. By contrast, the economic trend proved pleasingly favourable, keeping the corrections on the markets within reasonable limits, although there was increasing concern over growth in emerging markets.
- The trade dispute fuelled by President Trump under the "America First" banner is aimed squarely, but not exclusively, at China, meaning that it has already made its mark on many emerging markets. However, the danger of the situation escalating into a full-blown protectionist trade war also shook confidence in the global economy.
- Inflation reached its 2% target in the US and Europe. The Federal Reserve raised its key interest rate by a further 0.25%, while the ECB confirmed that its policy of bond-buying on the capital market would end this year but that it has no plans to increase its own base rates.
- The US exited the nuclear agreement with Iran and urged other countries to join it in reimposing sanctions. This had a knock-on effect on the price of crude oil, which jumped around 20%. OPEC voted to expand supply (under pressure from the US).
- Interest rates rose on the capital markets, generally hitting long-dated, poor-quality bonds the hardest. The spread on Italian government bonds climbed from 100 to 230 base points as the new government showed no regard for fiscal restraint.
- The US dollar rose across the board in the second quarter, due not least to the protectionist risks emanating from its administration. At 2.5%, however, the extent of this appreciation was modest over the first half of the year. The euro (and sterling) fell slightly against the Swiss franc as the gloss was taken off the EU's political stability. The Australian and New Zealand dollar, both commodity currencies, were amongst the losers.
- **Equity performance** in local currency for the first half of 2018:



- The equity markets lost around 1% compared with the World Index, while the Emerging Markets Index shed some 8%. The European markets, and with them the SMI, also disappointed. The NASDAQ put in a positive performance, however, adding 8.8%. Top performer was the IT sector with 9%, followed by energy and consumer stocks, with the telecoms sector bringing up the rear.

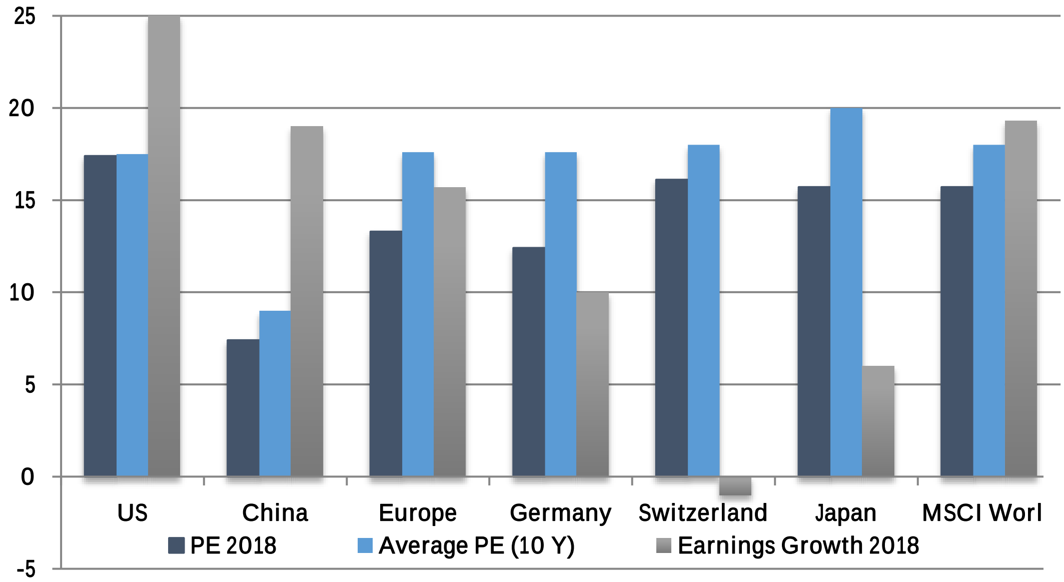
Outlook

Last year's geopolitical "nonchalance" has given way to unease, and the question arises as to whether the equity markets can free themselves from this political straitjacket. By its very nature, the political risk premium will be higher in a multipolar world than in a bipolar one. The real destructive power lies in Trump's trade policy, which he is using as a tool in his struggle for political and economic supremacy. Although the punitive tariffs imposed to date are insignificant from a statistical point of view, they may have alarming consequences. If the trade dispute continues to escalate, investment activity will be hit. Combined with the strong dollar and rising US interest rates, this will put countries that have a high dollar debt or whose currencies are pegged to the dollar in a challenging monetary situation. Any change of tack in the US government's protectionist trade policy will most likely be prompted by its own economy sensing that the strategy is proving counterproductive. With one eye on November's midterm elections to the US Congress, the opinion polls are not yet giving Trump any reason to modify his confrontational style.

All of this means that the financial markets will probably continue to be driven by this issue for some time yet. Based on the majority of indicators, the prospects for growth remain intact, while the US economy is increasingly at risk of overheating as a result of its government's loose fiscal policy. Monetary policy looks set to be tightened further, with global financial stability expected to play a key role in decisions over interest rates: if the dollar strengthens further on the back of protectionist fears, rate hikes could be abandoned or postponed.

Expectations of the earnings trend remain consistently high. As the chart below illustrates, the companies that make up the World Index are forecast to grow their earnings by nearly 20%. With a P/E ratio of 15.7x, the valuation lies below the long-term average, something that could essentially be said for most equity markets. As capital market interest rates will only rise slightly, equities remain attractively valued, a fact that will take on particular relevance if the combatants in the trade war bury the hatchet. Should the situation escalate further, however, these earnings forecasts can expect to be adjusted, setting the equity markets on a downward course. We are assuming that a development of this kind is in nobody's political interest. Nevertheless, an end to this nonsense is not yet in sight.

July 2018



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