MARCUARD FAMILY OFFICE

Investment Outlook
January 2017

1 False diagnosis, wrong medication

The Eurozone's economy has been growing above trend for a while now and the US economy has also recently attained a pace that is again consistent with growth at or even above trend. Meanwhile, global equity markets have rallied lately, more than making up for earlier setbacks, closing 2016 with a solid gain of 7.5 percent for the year.

While loose monetary policies were certainly helpful, economic prospects improved throughout the latter third of 2016. The initial market jitters following Brexit and the US presidential election proved to be short-lived. Nevertheless, while the Fed has cautiously started to tighten US monetary policy, the ECB has opted to continue its expansionary course, maintaining negative its interest rates and extending its asset purchasing program to the end of 2017. At the same time, calls for fiscal stimulus have grown louder. Donald Trump made it to the Oval Office at least in part by promising a big surge in infrastructure spending. Thus it appears that the diagnosis made by the patients – the economy and the markets – seems to differ from the judgement of the doctors – central banks and politicians. But who is right, the patients or the doctors?

There are several things to consider in assessing the current situation. First, the major economies are now growing in line with or even above their trend growth rates. In other words, these economies are near their full capacity, meaning that additional monetary or fiscal stimulus would likely be inflationary. Bond markets have clearly started to price in this eventuality as bond yields surged at an increasing pace since the US elections. But the fact remains that both trend growth and productivity growth have fallen to low levels. While this tendency was in place long before the global financial crisis and the extraordinary monetary policies that followed, it was reinforced in the aftermath of the global financial crisis.

There are several possible explanations for this development. For one, deep recessions can hurt productivity because workers lose skills as they drop out of the labour market. But quantitative easing and low interest rates can also distort asset prices. When this happens, capital is not necessarily allocated to an economy's most productive sectors, since a falling discount rate boosts values of all financial assets at the same time. This problem might also have been exacerbated by the trend of passive investment instruments and indexing — cost-saving alternatives to active strategies that gained even more appeal in a low-yield environment.

We think the end of easy monetary policy is now a fact in the US, and that it's only a matter of time until other major central banks follow the Fed's lead. We hold this view not only because the medicine of easy money comes with its own problems and unwelcome side-effects, but also because it cannot lift an economy's productive capacity – probably quite the contrary, as pointed out above. What's more, in the case of the Eurozone, we wonder whether it really makes sense for the ECB to staunchly defend an inflation target of 2 percent when the disinflationary tendencies in some member states may simply be due to the fact that competitiveness can only be restored through price changes, given that the common currency prevents currency adjustments. At some point, we think even politicans and central bankers will have to aknowledge that easy money will not cure all ills.

Accordingly, we still prefer to strictly limit interest-rate sensitivities within portfolios and we think it is more important than ever to carefully select the right investments and not merely ride with the tide of the overall market, which still ebbs and flows with interest rates. At the same time, potential policy-driven failures around the globe bear serious downside risks to markets and the economy. The still unclear but potentially destructive policy stance of the Trump administration toward global trade is just one such example. We argue that this again underscores the importance of true diversification, across asset classes, instruments and markets.

1.1 North America

- The US economy sputtered briefly in the first half of the year and its improving outlook now seems linked with the spending plans of President-elect Trump. But this ignores the solid improvements in business sentiment that were already recorded in September and October, well before the elections, when the perception prevailed that a Trump victory would hurt the economy and the financial markets. In November the ISM PMI confirmed the improving business climate, reaching a level that is above its long-term average. This was a marked improvement from a year earlier, paving the way for a recovery in business investments.

- This upbeat sentiment is mirrored in the labor market. The unemployment rate in November fell from 4.9 to 4.6 percent, which almost matches its pre-crisis low of March 2007. This is all the more remarkable because the economy has not been subject to the imbalances that artificially boosted economic activity back then.

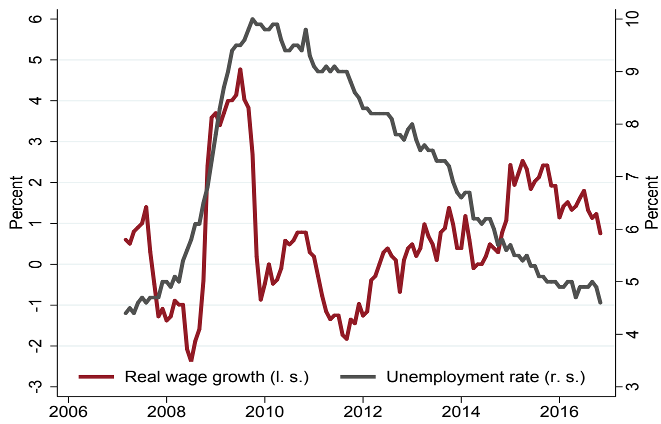
- Given that these developments already imply an expansion of economic activity that exceeds trend growth, Trump's fiscal plans, if implemented, are in all likelihood inflationary because they would stretch aggregate spending beyond sustainable levels. This has been reflected in inflation expectations that shot up sharply after the vote.

- The headline inflation rate has also accelerated visibly. Within just four months, it more than doubled from its 2016 low of 0.8 percent year-over-year, posted in July, to 1.7 percent in November, because, as expected, it was no longer pulled down by falling oil prices.

- With the exception of these rising price pressures, conditions for consumption remain favourable. Consumer sentiment is well above average, with employees benefitting from full employment and real wage growth.

- Against this backdrop, the Fed had no other choice but to resume monetary policy tightening. After an entire year with constant rates, in December it raised the target range of the fed funds rate by 0.25 percent, to a range of 0.5 to 0.75 percent. According the Fed's own projections, three more hikes of 0.25 percent can be expected in 2017. Given our view that inflation will rather surprise to the upside in 2017, we think the Fed at some point may feel compelled to accellerate tightening beyond what markets currently expect. Other risks associated with Trump's campaign rhetoric are decidedly to the downside, particularly policies that hurt trade and protect outdated economic structures, as the US fiscal situation embarks on a less sustainable path.

Healthy US labour market



The US unemployment rate has continued to fall, almost reaching pre-crisis levels. At the same time, real wage growth has been positive, but with inflation picking up, real wage growth has slowed further recently.

Source: Thomson Reuters Datastream, MFO

1.2 Europe

- Contrary to the situation in the US, the Eurozone economy held steady throughout 2016. US year-over-year growth temporarily fell below rates in Europe, but this situation is reversing as the US economy picks up the pace. However, economic sentiment in Europe, albeit cooling marginally during 2016, remained at above-average levels throughout the year, with a recent slight uptick, implying that the current trend of moderate growth will continue in the months to come and may even firm up slightly.

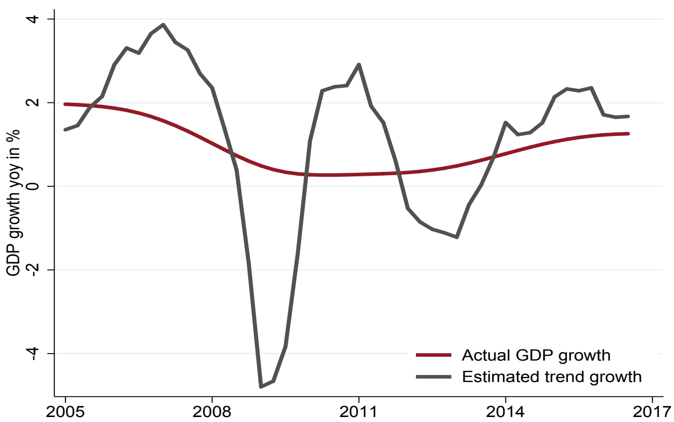
- While an annual growth rate of 1.7 percent may seem low, it is actually not low for Europe. This is because the trend growth rate is lower in Europe than in the US. According OECD estimates, trend growth in Europe should currently be around 1.3 percent and about 1.6 percent in the US. While these figures have to be taken with a grain of salt, since potential output is a theoretical concept that cannot be directly observed, they at least indicate that actual growth rates are not low from a business-cycle perspective.

- The unemployment rate remains on a steady downward trend in the Eurozone as a whole. In October it fell once more, from 9.9 to 9.8 percent. But, worringly, in some member countries like Italy and France, the unemployment rate remains stagnant at high levels, without convincing signs of an imminent recovery, underscoring the need for structural reforms that increase labor market flexibility and competitiveness.

- However, EU monetary policy continues to provide an incentive for politicians to kick the can down the road, with the European Central Bank maintaining its very loose monetary policy stance. In December the ECB extended its bond purchasing programme for a further nine months, until the end of 2017. From April, the ECB will buy bonds at a monthly volume of 60 billion Euro, less than the 80 billion Euro it is currently spending but since the programme has been extended, the final volume will be appreciably higher.

- The UK economy absorbed the Brexit shock remarkably well. Business sentiment has almost fully recovered from its post-referendum dip and is now higher than a year ago, pointing at a robust expansion, at least for the time being. Tailwinds are provided by the weakened pound and the Bank of England's ongoing loose monetary policy. The BoE lowered interest rates once after the referendum but given the British economy's recent strength, it abstained from further loosening measures, leaving the policy interest rate unchanged at 0.25 percent in December.

Above-trend growth in the Eurozone



The chart compares actual and trend growth in the Eurozone. Trend growth cannot be directly observed. It depends on an economy's productive capacities and its productivity growth. The trend line shown here is derived by smoothing historical data. Since about 2014, according to this proxy, the Eurozone economy has been expanding faster than implied by the underlying trend.

Source: Thomson Reuters Datastream, MFO

1.3 Asia and Emerging Economies

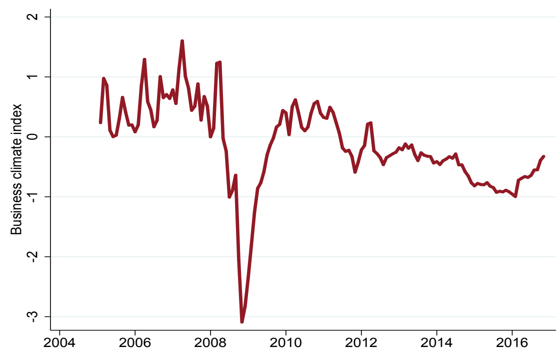
- Japan's economy expanded by 0.3 percent in the third quarter, which was slower than in the two previous quarters, although growth accelerated year-over-year from 0.9 to 1.1 percent. This might appear low, but it is in fact above the average of 1.0 percent posted over the past two decades. Compared to mid-year surveys, business sentiment improved slightly, suggesting the continuation of a moderate but likely somewhat faster expansion. Following a strong recovery rally, the renewed depreciation of the yen provides fresh support for Japan's exports. The headline inflation rate markedly gained momentum, jumping from -0.5 in September to 0.5 percent year-over-year in November. However, in contrast to other major economies, this was mainly due to significantly higher food prices.

- While the prospect of higher interest rates in the US might cloud the outlook for emerging market assets, aggregated business climate indicators suggest the continuation of the recovery in the emerging market economies generally. However, as we pointed out in November's *MFO Investment Outlook*, that does not alter the fact that fundamental problems persist in some large emerging economies – Russia and Brazil, for example – limiting their long-term economic prospects.

- Business sentiment data from China is also implying a stable expansion in the services and industrial sectors in the months ahead. In the third quarter of 2016, services grew by 7.6 percent year-over-year vs. 6.1 percent for industry. But concerns remain that the current level of expansion cannot be maintained because the recent surge in economic activity was mainly driven by public investments and a fizzing housing market; factors that should lose some steam since they currently seem to be at unsustainably high levels.

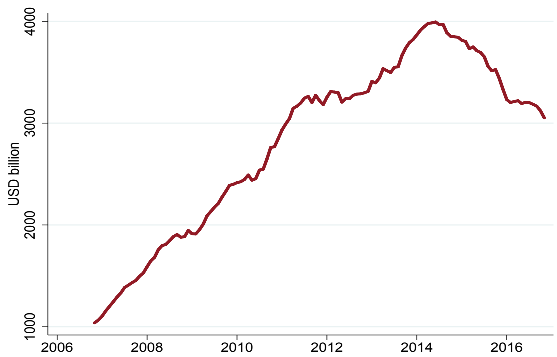
- Monetary policy and a depreciating yuan, on the other hand, act as supportive factors. In purchasing power parity terms, the yuan meanwhile seems marginally undervalued against the US dollar. This is readily exploited by US politicians, including President-elect Trump, who accuse China of manipulating its currency by artificially weakening its external value to help exports. A look at the facts, however, makes it clear that the reverse is true. The People's Bank of China has been consistently intervening in foreign exchange markets to prevent the yuan from falling further. This is reflected in its dwindling foreign exchange reserves, which have fallen by almost a quarter from their 2014 peak. Without these interventions, the yuan in all likelihood would be even weaker.

EM business climate recovers



Source: Thomson Reuters Datastream, MFO

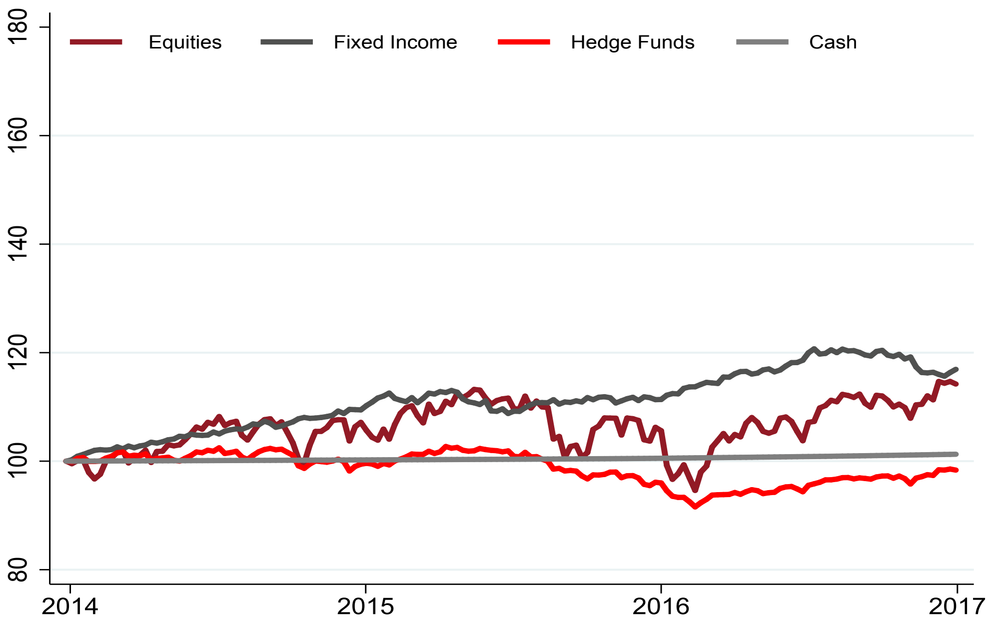
China's declining FX reserves



Source: Bloomberg, MFO

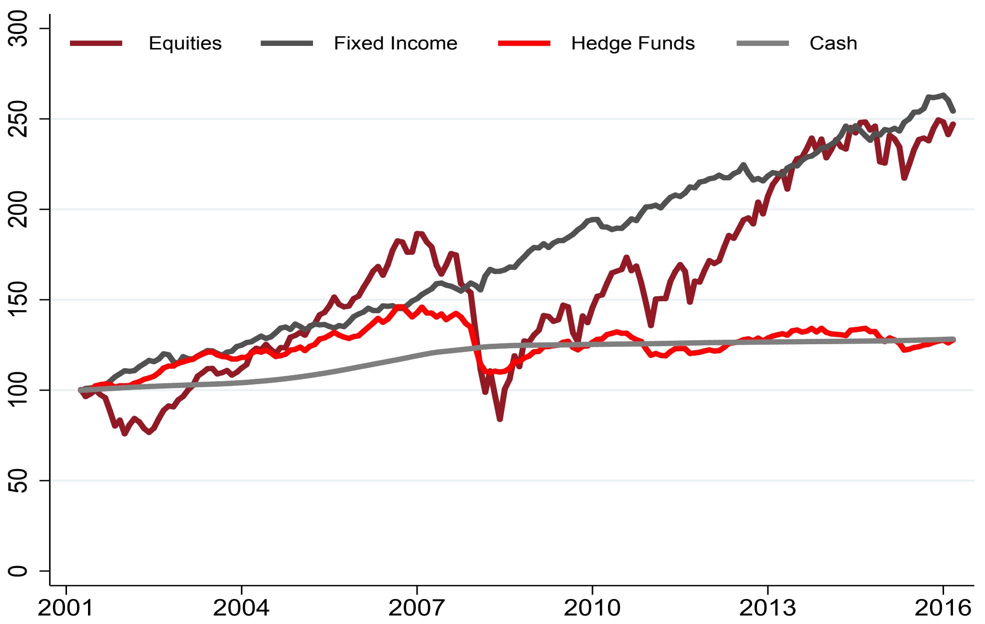
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- At the beginning of 2016, many observers thought that equity market performance would be influenced by major political events. A Yes to Brexit, the election of Donald Trump and a No to constitutional reform in Italy were all considered undesirable outcomes for financial markets in the runup to these events.

- Now that Brexit will in all likelihood take place, Trump was elected, an eventuality that became more likely as the election neared but still surprised markets, and Italy delivered its broadly anticipated No vote to reform, global equity markets nevertheless posted a strong performance in 2016, gaining 7.5 percent, in US dollar terms.

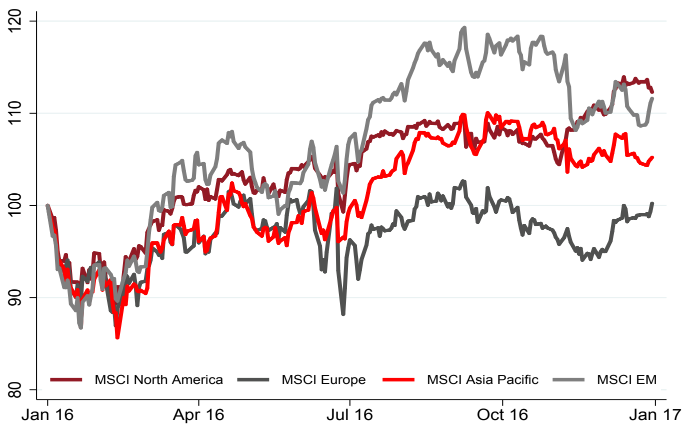
- Regionally, market performance varied sharply, with North American markets up 11.6 percent, European shares flat and Asian stocks up 4.9 percent, in US dollar terms. Emerging markets, which solidly led the pack until mid-year, were hammered by Trump's election but still managed to gain 11.3 percent for the year in 2016, in US dollar terms.

- In the long run, we think global equity markets are usually not driven by particular political events but rather by fundamental economic factors. Solid and, especially since September, improving global economic conditions lifted risk assets. Improving business and consumer sentiment suggest, on aggregate, the continuation of the global economic expansion.

- While equities might look expensively valued on a standalone basis, compared to fixed-income assets in particular, we think they still look reasonably priced, in relative terms.

- Technical indicators such as price trends measure the directional strength of equity markets, reflecting the prevailing buying and selling behavior of market participants. They continue to point to a neutral to slightly overweight position, especially given our assessment that market risk is currently at moderate levels.

US and EM equity markets lead



Source: Thomson Reuters Datastream, MFO

Despite political surprises like the Brexit vote, the European economy exhibited considerable resilience in 2016. But European equity markets clearly underperformed, while the US market weathered the slowdown in the US economy during the first half of 2016 quite well.

2.2 Fixed Income

- The first half of 2016 saw strong performance on fixed-income markets. Long-dated government bonds in particular posted very solid returns, outperforming almost every other major asset class. At the beginning of last year, fears about a possible hard landing in China and a slowing US economy clearly boosted fixed-income returns. The second half of the year told a very different story as bond markets retreated from their earlier highs, leading to a total gain for the year of 4.0 percent, in US dollar terms.

- That decline translated into deteriorating technical indicators during the last two months of the year. Trend indicators are currently no longer pointing to a continuation of the previous bond bull market, while at the same time market risk has markedly increased.

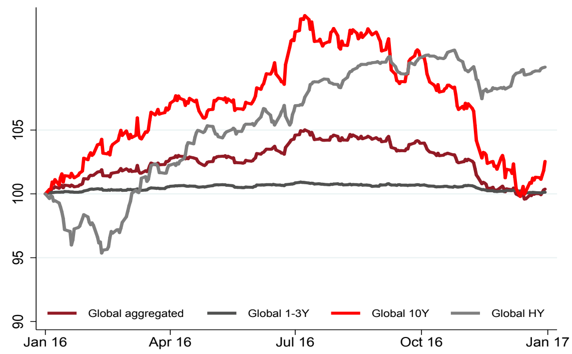
- While inflation expectations, as indicated by bond yields, already started to increase before the US presidential election, Donald Trump's victory triggered a repricing of bonds as well as a reevaluation of inflation expectations. Inflation expectations surged immediately after the election, as reflected in inflation swaps and bond yields.

- Although Trump's future policy moves are still unknown as we go to press, financial markets seem to anticipate that a combination of fiscal stimulus, tariffs and other measures aimed at repatriating industrial production will stoke inflation – as well as pushing America's debt-to-GDP ratio well above 100 percent.

- But despite the recent increase in yields, we still think that, on a longer-term basis, bonds are not, neither on a standalone basis nor in relative terms, an attractive investment yet. This is because the relatively positive economic outlook and the possibility of mounting inflationary pressures could further weigh on bonds' performance.

- We are therefore currently pursuing investments with fixed-income-like characteristics that are less interest-rate sensitive—that is, with a lower duration risk than traditional bond portfolios. Thus, we choose to increase exposure to floating-rate instruments and we are also ready to take on additional credit risk, which we mitigate by preferring investments in secured credits that are higher up in the capital structure.

Bond markets suffer from yield surge



Source: Thomson Reuters Datastream, MFO

US inflation expectations pick up

Source: Thomson Reuters Datastream, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- Hedge funds by and large had a difficult 2016 due to significant reversals among sectors and some difficult-to-assess events like Brexit. For the year as a whole, an allocation to hedge funds only made a limited positive contribution to performance, with the HFRX Global Hedge Fund Index returning 2.5 percent at the end of 2016. However, performance did improve since July. Among the explanations for this improvement are lower implied correlations among equities and the increase in US interest rates.

- Commodities on aggregate, as measured by diversified indices, had a strong run at the beginning of 2016 before entering a sideways performance pattern, resulting in a total return of 12.0 percent in US dollar terms for the year. Similarly, gold's strong performance in the first half of the year was followed by losses in the second half, trimming its year-over-year performance from its peak of almost 29 percent in July to only 9.1 percent at the end of year.

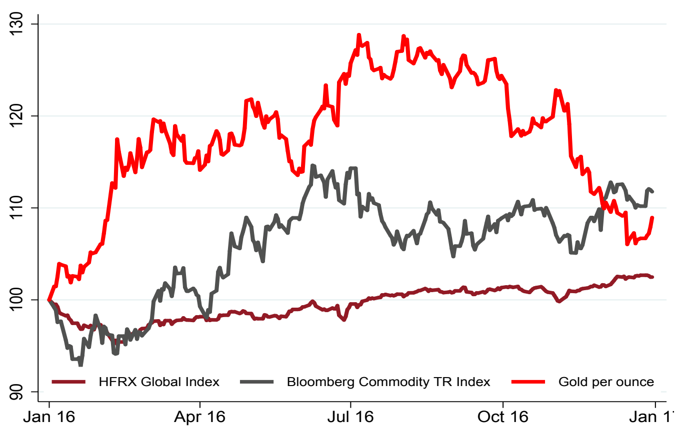
- Private equity fund raising remains strong, while exit activity in the first three quarters of 2016 slowed compared to the record levels of a year earlier. Unspent capital committed to private equity buyout funds hit an all-time high, contributing to heated competition for deals. The historically high deal pricing is spurring managers' creativity and specialization in an attempt to avoid contested auctions. Equity contributions in buyout transactions have increased, indicating a more careful course of action by debt providers.

Currencies

- Ironically, the result of the US election, which is regarded as inflationary, gave rise to the expectation that the Fed will have to tighten its monetary policy more vigourously. The expectation of higher interest rates in turn pushed the US dollar's value up. It has appreciated by 4.2 percent in trade-weighted terms since the election. However, we think the prospect of higher relative inflation should work against the dollar in the long term.

- The British pound, heavily undervalued after its steep depreciation during summer and autumn, started to recover late in the year. From the beginning of November to the end of the year, Sterling appreciated by 5 percent against a trade-weighted basket of currencies. Its recovery was particularly substantial against the euro but only marginal versus the US dollar.

Gold's renewed glow has faded



Source: Thomson Reuters Datastream, MFO

The price of gold soared during the first months of 2016. Thereafter it retreated from its peak year-over-year gain of almost 29 percent in July, closing the year with a total gain of only 9.1%. Commodities have started to recover from their lows, as did hedge funds, albeit only slowly.

3. Positioning

- Investment management firms often use their first or last publication of the year to present their predictions for the coming twelve months. That can make for entertaining reading but such posturing rarely has any lasting value, in our view. We analyse financial markets on an ongoing basis and position our clients' portfolios in ways that we deem most appropriate given the prevailing economic conditions, asset class valuations, market trends and risks. Looked at through this lens, we think the first of January is no more an occasion for playing the oracle than is any other date.

- We see broadly improving economic conditions, pointing to growth in the major economies that will at least be in line with trend levels. For some time now, we have been saying that inflation is being priced in at overly low levels in financial markets, and we remain convinced of that. The spike in inflation expectations after Trump's election was just the beginning, in our view, with more likely to follow.

- We still slightly overweight equities because the moderately positive economic outlook seems to favour growth assets and also because equity valuations seem less stretched than fixed-income valuations (although surging yields have improved bond valuations recently). We employ no specific country tilt and have only minimal exposure to emerging markets.

- Given our view that inflation may well surpise to the upside, plus the positive economic outlook as well as persistently unattractive yields, we continue to underweight fixed-income assets. Within the fixed-income allocation, we are positioned with an interest-rate sensitivity that is lower than indicated by the benchmark, and we still pursue more credit-risk exposure than implied by the benchmark.

- Within the universe of asset classes characterized by low volatility and low returns, we consider hedge funds more attractive than fixed-income securities and therefore keep an overweight in this asset class. We also maintain our diversified commodity exposure and a strategic allocation to gold as a diversifier and an ultimate form of insurance.

- Looking at our positioning in 2016, we overweighted risky assets (hedge funds and equities) and underweighted fixed income throughout the entire year. Eventually, the overweight in equities paid off and the fixed-income underweight emerged as the right allocation. Our preference for keeping durations short was an expensive position at the beginning of the year, but after Trump's election victory it started to pay off.

Positioning overview

	Equities				Fixed Income		Alternatives			Liquidity
	North-America	Europe	Asia-Pacific	Emerging Markets	Duration	Credit	Hedge Funds	Commodities	Precious Metals	
Macro	↗	↗	↗	↗	↘	↗	→	↗	→	↗
Market	↗	→	→	→	↘	↗	→		→	→
Valuation	↘	↘	↘	→	→	→				
Sentiment	→	→	→	↘	↘	→		→		
Aggregate	→	→	→	→	↘	↗	→	↗	→	→

Source: MFO

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Imprint

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