MARCUARD FAMILY OFFICE

Investment Outlook

March 2017

1 Facts, not tweets

A better start to the year at least for equities is hard to imagine. Global equity markets rallied briskly, despite significant political risks. In January and February, developed and emerging equity markets delivered impressive returns. Is this performance a short-lived mirage or is it sustainable?

The equities rally of early 2017 has left many observers deeply skeptical. They point out that equity valuations have generally become quite stretched and they charge that the rally is unjustified fundamentally, especially given the elevated political uncertainties in several major industrialized countries, including the US, core countries of the Eurozone and the UK, to say nothing of several dangerously heightened regional tensions around the world.

We do not ignore these justified concerns. But neither do we ignore the indications that the current economic recovery is indeed fundamental in nature and broad-based in its reach. First, we saw improving business prospects in most of the world's largest economies. Business sentiment indexes in the biggest developed economies are now well above average levels, while the struggling large emerging economies of Brazil and Russia have both improved lately, albeit from depressed levels. The improving outlook is also evident in much of the economic data that enters into business sentiment, including current output, future output, new orders, hiring, input prices and output prices.

Consumers are also optimistic in the US, the Eurozone and Japan. However, with energy prices finally rising, consumers actually saw price inflation jump in recent months. While we think the energy price-driven acceleration of consumer price inflation is likely to peak mid-year, we think we may also see underlying price pressures swell slightly, since the pick-up in economic activity comes with the economy already close to its full productive capacity. This at least is the case in the large, developed, industrial economies.

But despite improving sentiment and buoyant stock markets, the worry persists that this recovery could all end in an instant. Those who think the stock rally is a Trump bump fear that it could all be undone by a single presidential tweet. We do not share this view. We maintain that the economic environment is favorable for risk assets like equities and corporate debt, granting that elevated valuations do make them vulnerable to negative surprises.

That said, we still find governement bonds unattractive. At shorter maturities inflation isn't compensated and at longer maturities we think interest-rate risk is poorly rewarded. Thus, the problem of stretched bond valuations has certainly grown less severe after the latest yield increases. However, as we point out in the fixed-income section below, the future bandwidth of cyclical interest rate fluctuations is simply unknown, since interest rates will hardly reach levels seen a few decades ago. That makes it difficult to judge when the moment has arrived to increase the allocation to longer-dated bonds. However, and with more conviction, we can say that the case for our pronounced fixed-income underweight has weakened in recent months. Therefore, we would deploy the liquidity from an eventual rebalancing of our equity allocation into the core space of fixed income.

1.1 North America

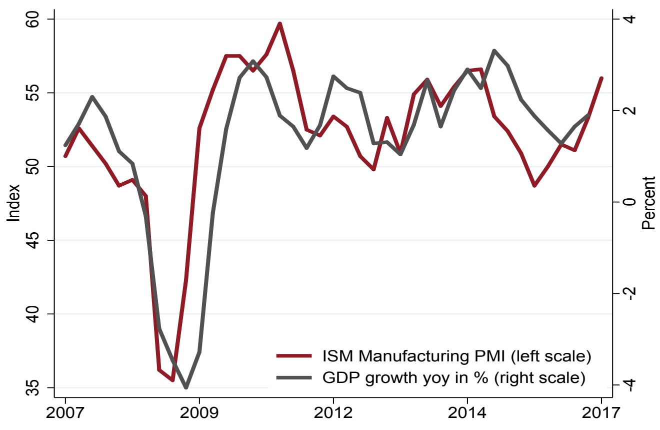
- Not because of but, in our view, despite the new administration and all the uncertainty that comes with it, US business prospects continued their upward trend in the first two months. This could augur that the long-awaited turnaround in investment spending might finally be at hand. In the absence of any negative surprises, this suggests that GDP growth could accelerate markedly from the 1.9 percent year-over-year level posted in the fourth quarter of 2016 and approach 3 percent. And this, in our view, is regardless of what the Trump administration does or doesn't do.

- At that pace, the US economy would grow notably faster than trend growth. At the same time, output gaps seem to have closed. Expanding activity in an economy close to full productive capacity paves the way for increasing underlying price pressures. This should motivate corporations to increase their investment activity. After years of underinvestment, this development would be growth-positive, in the short- and in the long term. Increased corporate investment spending lifts aggregate demand directly, while it also would have a positive effect on productivity growth.

- Consumers also appear to be quite optimistic and given the healthy state of the labor market, they have reason to be upbeat. However, inflation has increased quickly lately, weighing on real incomes. In December, inflation jumped above the 2-percent level for the first time in almost three years. In January, again lifted by higher commodity price inflation, the yearly inflation rate jumped from 2.1 to 2.5 percent, a five-year high. Core inflation also increased, from 2.1 to 2.2 year-over-year in January. While monthly variations should not be overinterpreted, this might be a first sign of increasing underlying price pressures. This view is supported by the uptrends observed in the inflation of services prices and hourly wages. Taken together, these developments support the case for the Fed to proceed with gradual interest rate hikes.

- In Canada, business prospects have been increasing steadily since summer 2016. The outlook in the manufacturing sector again showed a marked improvement in January, supporting a faster expansion of economic activity. This comes after the pick-up already seen in the third quarter of 2016. At the same time, consumption is getting support from improving labor market conditions. But, as elsewhere, the inflation rate has risen with the increase in energy price inflation. It jumped from 1.5 to 2.1 percent year-over-year in January.

Improving US business prospects



Source: Thomson Reuters Datastream, MFO

Prospects in the US manufacturing sector have improved steadily since last August. January saw another improvement in business conditions, suggesting that the US economy entered the year on a solid footing. GDP growth is likely to accelerate visibly from current levels, possibly approaching 3% in the months to come.

1.2 Europe

- Mirroring international developments, business sentiment in the Eurozone has improved further in recent months, signalling that economic growth slightly could accelerate from the steady pace seen over many previous quarters. Economic sentiment data compiled by the European Comission includes readings from several economic sectors and from consumers. It currently suggests that the economic expansion could approach the 2-percent level, up from 1.7 percent year-on-year in the fourth quarter of 2016.

- Against these positive fundamentals, and the support from loose monetary policies and a weak Euro, political risks loom large. Among them are another sequel of the Greek debt drama, uncertainty related to the kick-off of Brexit negotations and the possible victories of populist candidates in several national elections. But recalling last year's surprises, we think investors are well advised to avoid directional bets tied to expectations about political outcomes. After all, they can err twice: once on the specific political outcome and again on its consequences for financial markets.

- Also in Switzerland, businesses and consumers have grown increasingly optimistic in recent months, with another marked sentiment increase in January. Purchasing manager indices also imply that growth could accelerate a bit from the 1.4 percent level year-over-year posted in the third quarter of 2016.

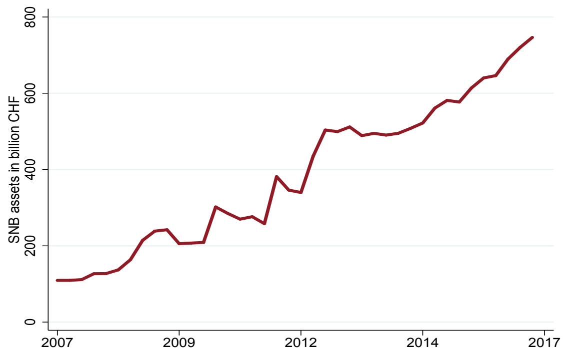
- At the same time, inflation has started to revive in Switzerland. After hitting a low of -1.4 percent in August 2015, the yearly headline rate increased throughout 2016. It reached 0.3 percent in January, thereby entering positive territory for the first time in two-and-a-half years.

- The Swiss National Bank is in a difficult position. The franc remains strong, challenging Swiss exporters, retailers and tourism. It has appreciated again versus the euro in the recent months, forcing the SNB to intervene steadily in foreign exchange markets to prevent even stronger franc appreciation. This has inflated the SNB's balance sheet further, to roughly 110 percent of GDP. But as long as the European Central Bank persists with its very accomodative monetary policy, the SNB has no choice but to maintain negative policy rates and intervene in foreign exchange markets. While rising inflation rates and an improving economic outlook in the Eurozone could back the case for an end to the ECB's monetary largesse sooner rather than later, political uncertainty should prevent this from happening for the time being.

Swiss growth possibly to accelerate

Source: Thomson Reuters Datastream, MFO

Inflated SNB balance sheet



Source: Thomson Reuters Datastream, MFO

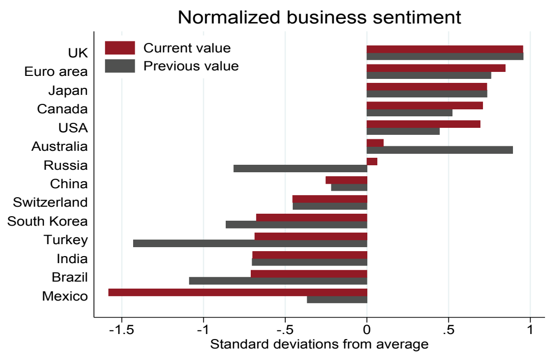
1.3 Asia and Emerging Economies

- China's economy expanded by 6.8 percent year-over-year in the fourth quarter of 2016, a slight uptick from the 6.7 percent rate recorded in the previous three quarters. The main driver was accelerating activity in the services sector, while growth in other sectors held steady. Looking ahead, official and private purchasing manager indices continue to suggest services expanding faster than manufacturing, which reflects the structural rebalancing underway in the Chinese economy towards a more consumption-based growth model. Somewhat in contrast to major developed economies, business sentiment indicators point at a continuing but modest expansion over the months to come.

- South Korea's economy has been rocked by the political scandal surrounding president Park Geun-hye, who was impeached at the end of last year. Growth slowed in the second half of 2016, and at the beginning of this year economic prospects remain subdued. The Manufacturing PMI continues to signal contraction in the sector, while declines in production and new orders accelerated in January. Comparing the business sentiment indices of the major economies, sentiment in South Korea remains below its long-term average, in fact posting the weakest performance among all the large, developed economies, weaker than all but a few large emerging economies. South Korean consumers are even more pessimistic, posting the lowest level of consumer confidence in our global ranking of major economies. Against that cheerless backdrop, the rising energy prices that pushed consumer and producer prices further up in January only add inflation to South Korea's economic challenges right now.

- Business conditions in Mexico have deteriorated after the election of Donald Trump in light of his campaign promises to restrict free trade and stop immigration. Economic activity slowed throughout the final quarter of 2016, a process that is likely to continue in the current quarter and beyond. Consumer confidence contracted sharply in January while inflation accelerated rapidly. And, unlike in most other countries, this is not limited to an increase in energy prices only. Also the general price level in Mexico increased at a faster pace, as indicated by the uptrending core inflation rate. Both these developments cloud the outlook for private consumption. Retail sales already contracted by 1.4 percent in December and we think a further contraction is likely.

Business sentiment in major economies



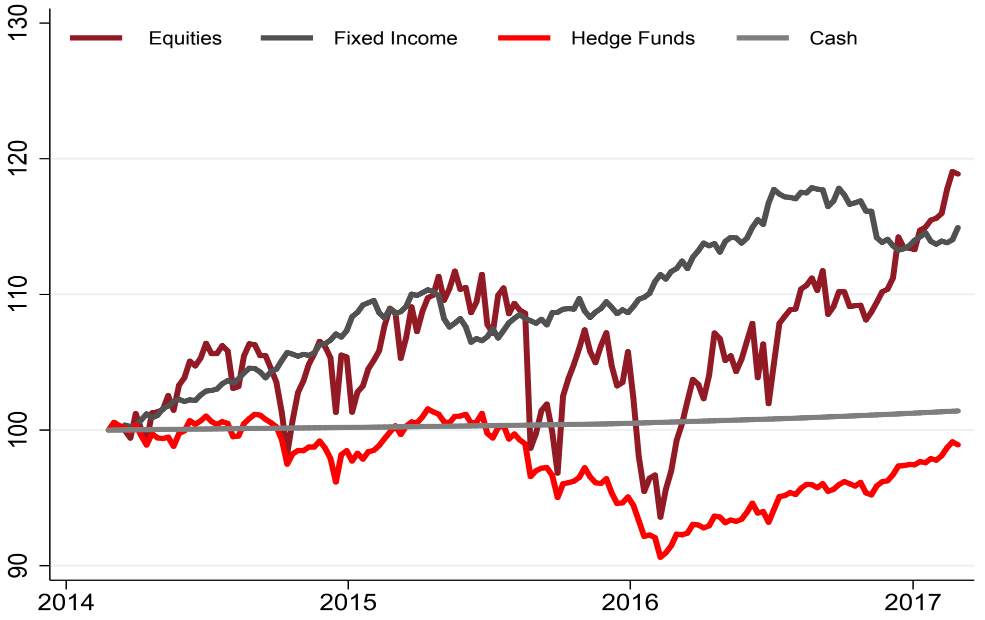
Source: Thomson Reuters Datastream, MFO

Clouded outlook for Mexico

Source: Thomson Reuters Datastream, MFO

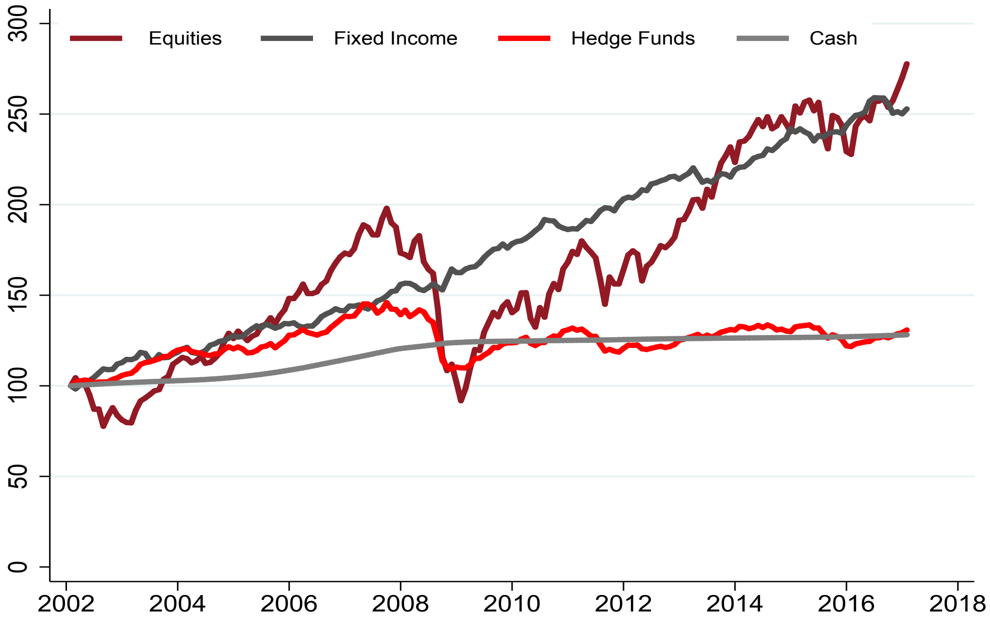
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- Equity markets have continued to rally despite a flurry of controversies surrounding the new US president. The significant political risks of the upcoming elections in Europe have also been brushed aside for the moment, as has the black hole of Brexit implementation.

- While equity market volatility, as measured by the VIX, has trended even lower than it was at the beginning of 2017, which could be a sign of complacency, we find it comforting to see that correlations have come down even further. In other words, we are not seeing a rising tide lifting all ships or a broad groundswell of investor euphoria driving markets higher. Rather, it seems that investors in aggregate remain skeptical, which can be seen as a sign of healthy markets.

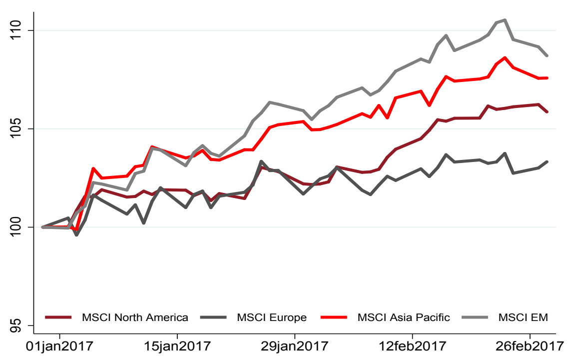
- However, sentiment has improved lately. Until recently investors “hid” in the most defensive equities, willing to pay a premium for stable earnings. Now they appear to prefer lower-valued companies that are also likely to suffer less from rising interest rates.

- From a valuation point of view, emerging markets are often said to be cheap. We do not fully share this view. The dispersion between valuations of different emerging markets is considerable. For example, Turkey and the Czech Republic can be regarded as very cheap, whereas Columbia and Peru, despite their underperformance, are still expensive. That said, we think investors should be selective within the emerging markets universe, which leaves room for active management.

- While equity markets in the emerging markets and Asia suffered in the aftermath of Donald Trump’s election, they still are ahead in 2017 with emerging equity markets up 8.7 percent and Asian equity markets posting a positive performance of 7.6 percent, in US dollar terms. European equity markets increased by 2.6 percent, in US dollar terms, still lagging behind the broad US equity market as measured by the S&P 500, which was up 5.9 percent. Medium-sized companies (S&P Midcap 400 Index) gained 4.3 percent but the small cap Russell 2000 Index that was initially buoyed most by Trump’s election took a breather, increasing by only 2.3 percent.

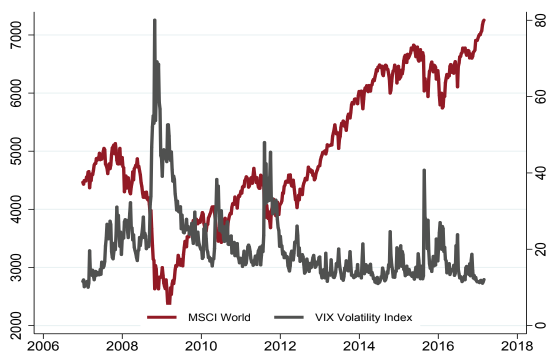
- The Swiss Market Index of large cap equities is dominated by Nestle, Novartis and Roche. It ended 2016 negatively and thereby clearly underperformed small- and medium-capitalised Swiss companies. So far this year, the SMI shows a positive performance of 4.0 percent in Swis franc terms but has again been clearly outpaced by small (+5.4%) and mid-sized companies (+7.2%).

Strong performance of Asia and EM



Source: Thomson Reuters Datastream, MFO

Volatility is at a low level



Source: Thomson Reuters Datastream, MFO

2.2 Fixed Income

- After retreating from the all-time highs seen in the final quarter of 2016, global bond indices have taken no clear direction since the start of the year. The Barclays Global Aggregate Bond Index, hedged in US dollars, trended sideways in the first two months of this year, posting a performance of 0.4 percent in USD terms by the end of February. This clearly lags behind equities. Long-dated bonds again underperformed the global benchmark, while indices representing shorter maturities held steady, posting a positive nominal return so far this year. High-yield bonds increased their lead, posting solid returns of about 3.0 percent (Barclays Global High Yield Index), in US dollars through February.

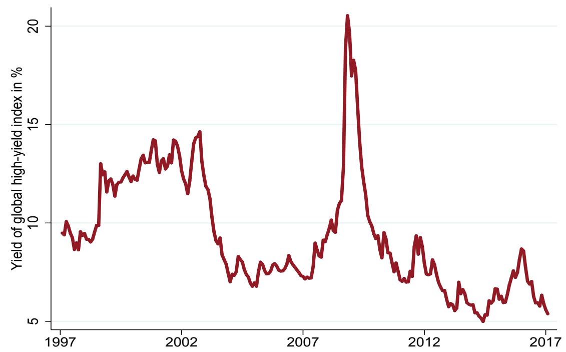
- In general, the past two months saw a further deterioration of technical indicators in the bond markets. Market trends worsened further and in all likelihood they will soon enter negative territory. At the same time, market risk indicators have risen to average or even slightly above-average levels.

- After the recent increase in yields, stretched bond valuations relaxed a bit. Nevertheless, we think that risks associated with fixed-income investments such as duration and inflation are still insufficiently compensated by markets. At shorter maturities, yields are mostly lower than inflation, meaning that bondholders lose money in real terms, while longer maturities do not sufficiently compensate the risk of rising yields, in our view.

- Unfortunately, it is difficult to assess the attractiveness of bond yields by making historical comparisons. If we take 10-year US Treasuries as an example, they yielded 15.8 percent at their 40-year peak in September 1980, while their yields fell to a historical low of 1.4 percent in August 2016. Currently, they yield 2.4 percent. But the historical peak hardly marks the upper end of interest rate fluctuations today. If we assume that yields peak at much lower levels, then an increase in the fixed-income allocation also becomes appropriate at much lower yield levels than in the past. In the 1970s and 80s, growth rates, inflation rates and productivity growth were all markedly higher than today, and so were interest rates and bond yields. Today's environment of low inflation and productivity growth justifies lower rates in general, in our view.

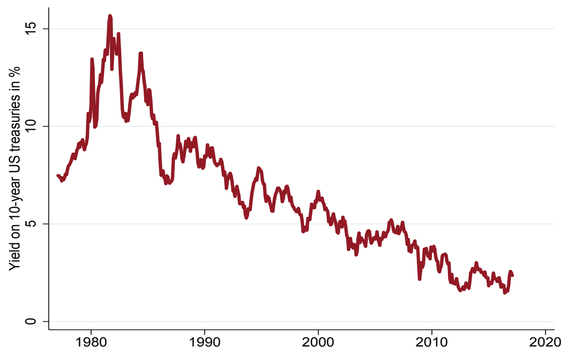
- While bonds associated with credit risk, especially high-yield corporate bonds, offer more yield and return potential than do sovereign bonds, yields of high-yield bonds are also low when seen in a long-term historical context. Therefore, we do not think that they are especially attractive at this point in time.

Is high yield attractive?



Source: Thomson Reuters Datastream, MFO

Yield on 10-year US treasuries



Source: Thomson Reuters Datastream, MFO

2.3 Alternatives

Hedge Funds

- Hedge funds have done well so far in 2017, with the HFRX Global Hedge Fund Index gaining 1.7 percent since the start of the year. Compared to the fourth quarter of 2016, correlations have further subsided and fundamental factors are again more at the center of investors' allocation decisions. As a maturing economic cycle generally increases price dispersions within equity and credit markets, we think hedge funds could profit from a widening opportunity set.

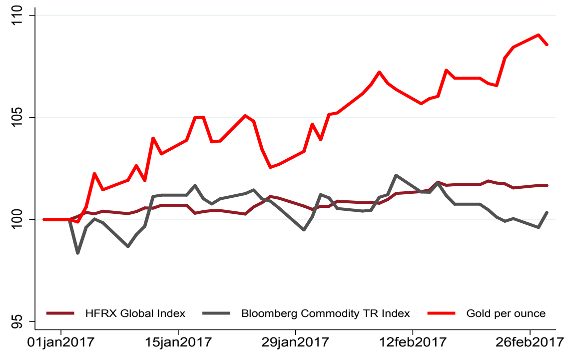
- In private equity the situation is basically unchanged since our previous *Investment Outlook*. Fund raising for private equity funds remains strong and the volume for 2016 is set to surpass 2015's level, reflecting strong investor demand for the asset class generally. Globally the announced buyout deal volume and exit volume declined from 2015's record levels. Available capital in private equity funds (dry powder) is at a record high today. The twin challenges for fund managers – to find attractive investment opportunities and to profitably sell companies from their portfolios – have become more difficult lately. Success requires a shrewd, differentiated value creation strategy.

Currencies

- The situation among the major currency pairs still follows the recent pattern: the US dollar and the Swiss franc are strong while the yen, the pound and the euro are weak. A major issue among economists currently relates to the tax reforms promised by the new US administration and their implications for the US dollar. One view has it that Trump's tax reforms could lift the dollar's value even further. Weighing up several arguments, we acknowledge that there may be only some limited lift for the dollar, if any. Given the dollar's current overvaluation, which is evident in a historical comparison, this might merely soften the downside rather than provide any true upside potential, in our view.

- In addition, increasing inflation rates and improving economic prospects could put the discussion of monetary policy normalisation back on the agenda, also outside of the US, increasing the likelihood that the valuation discrepancies between major currency pairs could start to normalize.

Hedge funds recover



Source: Thomson Reuters Datastream, MFO

US dollar expensive

Source: Thomson Reuters Datastream, MFO

3. Positioning

- The economic outlook has improved further in most major economies. Improving business sentiment, both in emerging and in developed economies, points to an acceleration of economic activity. We think this environment clearly favors risk assets.

- However, comparing the valuations of the different asset classes, we note that equity markets have now advanced into expensive territory, if not excessively so, while the valuation situation in the fixed-income universe has improved.

- Assessing technical factors, we see continuing strong trends in equity markets and deteriorating trends in bond markets – apart from high-yield. At the same time, we observe that equity market risk has been stable at average levels, while fixed-income risks have risen steadily, further favoring equities, in our view.

- Given our views on growth and inflation, and based on our technical assessment, we underweight fixed income and keep the portfolio's average duration shorter than indicated by the benchmark. We are willing to take on specific credit risk, preferably with variable interest rates – for example European bank loans – but we are not investing meaningfully right now in high yield.

- We implement our equity overweight avoiding specific country tilts, although we see slightly more attractive relative valuations in Europe and Asia than in the US. However, due to heightened political uncertainties we refrain from overweighting specific regions for the time being, adding that we may reassess this positioning in the near future. In our experience, basing investment decisions on political events does not often lead to success. With political developments, you have to be right twice; first with regard to the political outcome itself, and second with regard to the effects it will have on financial markets. Consequently, we prefer to refrain from taking active tactical positions in the run-up to a major political event.

- Should equity markets continue to rally, we will have to rebalance our portfolio to target positioning and potentially re-allocate part of the resulting liquidity to reduce our largest underweight, which we have so far maintained within the fixed-income allocation.

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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Published by:	Marcuard Family Office Ltd.
Editors:	Nadja Bleuler, n.bleuler@mfo.ch
	Frank Häusler, f.haeusler@mfo.ch
	Lukas Doerig, l.doerig@mfo.ch
	Thomas Gnaegi, t.gnaegi@mfo.ch
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Theaterstrasse 12
P.O. Box 328
8024 Zurich
Switzerland

Phone +41-(0)43-344 6000
Fax +41-(0)43-344 6001
info@marcuardfamilyoffice.com
www.marcuardfamilyoffice.com

your family values