MARCUARD FAMILY OFFICE

Investment Outlook
November 2016

1 The paradox that isn't

While the economic outlook brightened lately, global equity markets slumped. This apparent paradox is actually the logical consequence of the prevailing low yield-environment, or, as well, of its projected end.

After the negative economic surprises of August, when business sentiment turned particularly disappoiniting while equity markets rallied, the tables have turned over the past two months. The latest economic data have mostly strengtened the impression of an improving economic outlook. In some cases the August dips in business sentiment more than erased in September and October. Investment growth in the US returned to positive territory in the third quarter, while in Britain fears of Brexit-related damage seem to have receded somewhat. At the same time, the soaring rallies on global equity markets immediately after Brexit have since came to a halt. Markets started to post losses or experienced volatile sideways tendencies. Interestingly, losses were mainly driven by defensive market segments and dividend stocks, while the formerly penalized financial and technology shares rebounded.

Granted, the equity market slid despite improved economic data, which could suggest that the present situation actually is paradox, but we would argue this is not the case. The years-long global adoption of extremely loose monetary policies that came with record-low interest rates and massive quantitative easing programs has boosted asset values (and stretched valuations) across the board. We note that the more an asset's value depends directly on interest rates, the more severe this problem becomes. As depressed fixed-income yields pushed investors to look for safe alternatives, and these grew ever more scarce within the fixed-income space, investors increasingly turned towards dividend stocks as income-yielding alternatives, driving valuations for these stocks higher than for shares producing less income. In other words, as the improving economic news strengthens the case for the Fed to tighten monetary policy more swiftly, we think these same equities, with their significant interest-rate sensitivity, should be closely monitored. In this environment we advise investors to prefer low interest-rate sensitivities in their portfolios, not only within the bond allocation (by keeping durations short) but also within other asset classes, including the equity allocation.

But while stretched valuations in equities and most asset classes makes them vulnerable for interest rate hikes, tighter monetary policy is, at the same time, a reflection of an improving economic picture. Which also means that earnings prospects for companies are likely to improve. In our view this speaks against a reduction of a portfolio's existing allocation to risky assets. That said, for the moment, we would also not increase that exposure unless improved earning prospects or price corrections yielded more attractive valuations.

1.1 North America

- The early estimates for third-quarter US GDP growth exceeded expectations, helped by a surge in soybean exports to China – a one-time event that is unlikely to be repeated anytime soon. Nevertheless, the outlook for the US economy once again improved. Investment growth was positive for the first time in a year in the third quarter. In addition, on the heels of a rebound in orders and production, business sentiment brightened in September, implying that the dip posted in August might have been an anomaly. But long-term historical comparisons underline that US business conditions in fact remain below average.

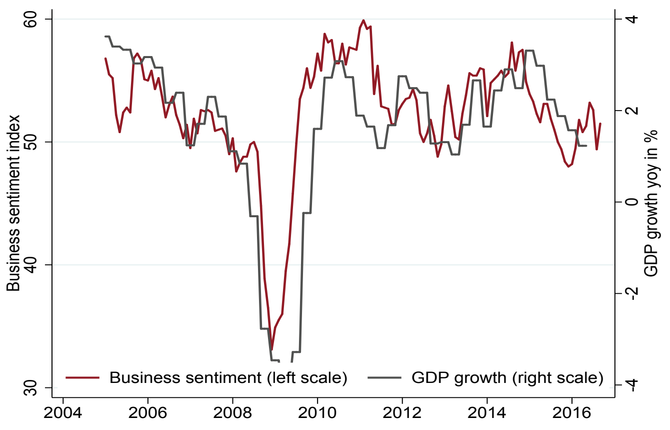
- While business sentiment has improved lately, US consumers didn't share the upbeat mood. Instead, they turned less optimistic in October although they continued to enjoy low oil prices, the enhanced purchasing power of the strong US dollar and a healthy labor market.

- The recent improvement in US business sentiment suggests that corporate investment there could start to revive, potentially lifting GDP growth towards its long-term potential. But despite encouraging developments, we find it difficult to muster much enthusiasm given that the sluggish economic expansion currently underway is still underpinned by the Fed's ongoing expansionary monetary policy, stubbornly negative real interest rates, and a government debt-to-GDP ratio that has not yet managed to reverse its upward trend.

- Headline inflation in the US increased from 1.1 percent in August to 1.5 percent in September year-over-year largely due to the decreasing dampening effect of commodity prices. Energy-related prices rose 2.9 percent from August to September, thereby contributing positively to overall inflation over the course of the month. Meanwhile, the core inflation rate, which excludes energy and food prices, fluctuated around its current, relatively stable level of 2.2 percent year-over-year.

- The recent uptick in US business sentiment, steady employment growth, as well as an inflation rate that has been trending upward since July are all paving the way for another interest rate hike from the Fed, a step that many observers expect in December and, hence, one that is currently priced in by futures markets. But, as we have previously pointed out, monetary policy tightening will likely be cautious and slow. This means that the negative real interest rates currently facing depositors and holders of high quality bonds – with yields unable to compensate for inflation rates – will not quickly reverse unless capital market interest rates themselves move quickly upwards.

Improving sentiment in the US



Source: Thomson Reuters Datastream, MFO

The chart shows business sentiment on one axis, and GDP growth on the other. The recent uptick in business sentiment is encouraging and should help US GDP growth to converge towards its long-term trend.

1.2 Europe

- Similar to developments in the US, business sentiment in the Eurozone as a whole also improved in September and October, brightening the region's economic outlook. This was evident in several sectors, with manufacturing posting the biggest increase, while the retail sector also saw a solid gain, followed by the ongoing sentiment recovery in the construction sector. Sentiment in the services sector remained basically flat while consumers have grown somewhat more optimistic. Taken all together, we think the improved economic sentiment hints at faster economic growth in the Eurozone over the coming months.

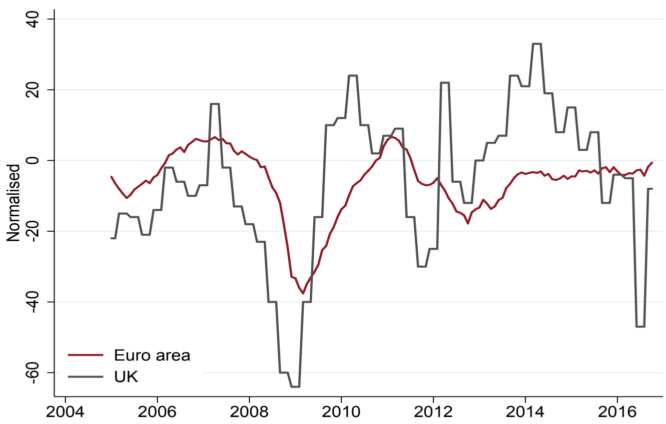
- Interestingly, the economic sentiment indicators for the UK compiled by the European Commission show that the decline in confidence in the wake of the Brexit shock was rather small and should rather be seen in the context of a longer downward trend. Looking at sectors, it is worth noting that only the services sector – which presumably will be hardest hit by Brexit – has fallen to below-average levels. This is not the case for manufacturing, consumers or even construction. A similar picture is painted by other indicators: According to the PMI indicators compiled by Markit, business sentiment in the manufacturing sector has more than recovered from its immediate and marked post-Brexit drop, while confidence in the services sector is back to levels seen at the end of June. In sum, we think this implies that the British economy's short-term outlook is now again similar as it was shortly before the referendum.

- While actual economic activity marginally slowed in the quarter after the referendum, the expansion of 0.5 percent in the third quarter exceded market expectations and was only slightly below the 0.7 percent seen in the previous quarter.

- Consumer sentiment has also recovered to levels comparable to pre-referendum levels. However, the weak pound is boosting consumer price inflation, which could produce for some headwinds for consumption.

- We think it's important to note that Brexit is not an event but rather a process whose long-term effects are difficult to comprehend for companies and investors. The long-term drag on UK growth, if there is any, is hard to assess today. Therefore the consequences of this divorce might not yet be fully reflected in the current expectations of market participants. However, for now, Britain's cyclical outlook for the coming months seems not to be particularly gloomy.

Business sentiment: UK vs Euro area



Source: Thomson Reuters Datastream, MFO

We update the chart we first presented in September's *MFO Investment Outlook* that shows UK business sentiment's sharp contraction in the second quarter while the Eurozone was largely unaffected. As the chart shows, third-quarter UK business sentiment has almost fully recovered from its post-referendum drop.

1.3 Asia and Emerging Economies

- China, always quick to release its GDP figures, posted year-over-year growth of 6.7 percent in the third quarter, the same rate recorded in the second quarter. But the stable growth figures might mask that economic activity actually has been increasing in recent months, as implied, for example, by some indicators such as producer prices.

- In any case, China's economic activity this year has mainly been driven by investments of state-owned enterprises and there are indications that they have crowded out private investments. This in turn could burden long-term growth prospects since state investments are usually less efficient than private investments. And as we have pointed out before, China's long-term growth prospects are anyway trending downward, due, among other factors, to demographic developments. However, on a positive note, the shrinking labor force has led to a rising wage share in the Chinese economy, which supports the country's shift towards a more sustainable consumption- rather than export-driven growth model.

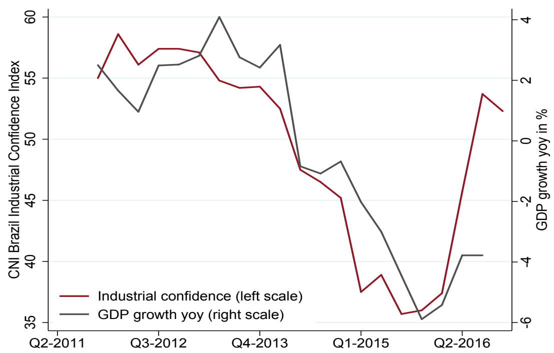
- That the worst of Russia's recent recession may be past is reflected in the second quarter GDP growth figures. The Russian economy contracted by just 0.6 percent year-over-year after shrinking by 1.3 percent year-over-year in the previous quarter. Meanwhile, business sentiment indicators are sending mixed signals, currently implying either a slight expansion or a contraction of activity. In any case, we think escaping economic stagnation is unlikely for Russia in the near term, as many familiar obstacles to growth remain in place. Russia is still suffering from Western economic sanctions, and any Russian concessions with respect to Ukraine seem further away than ever, while the country's own economic policies have grown increasingly protectionist and interventionist.

- Brazil also seems to have put the trough of its recent sharp recession behind it. In the first half of this year, economy activity contracted further but at a slower pace than previously. Current developments in business sentiment are also somewhat contradictory. While the purchasing manager indices compiled by Markit improved in September, they remained in contractionary territory for both the manufacturing and the services sectors. This contrasts with the CNI industrial confidence index, which has rebounded sharply since our previous Investment Outlook and, assuming that the correlation between this indicator and GDP growth observed in the past also holds in the future, this implies that a slow expansion of economic activity is soon in the realm of possibility.

Chinese producer price inflation picks up

Source: Bloomberg, MFO

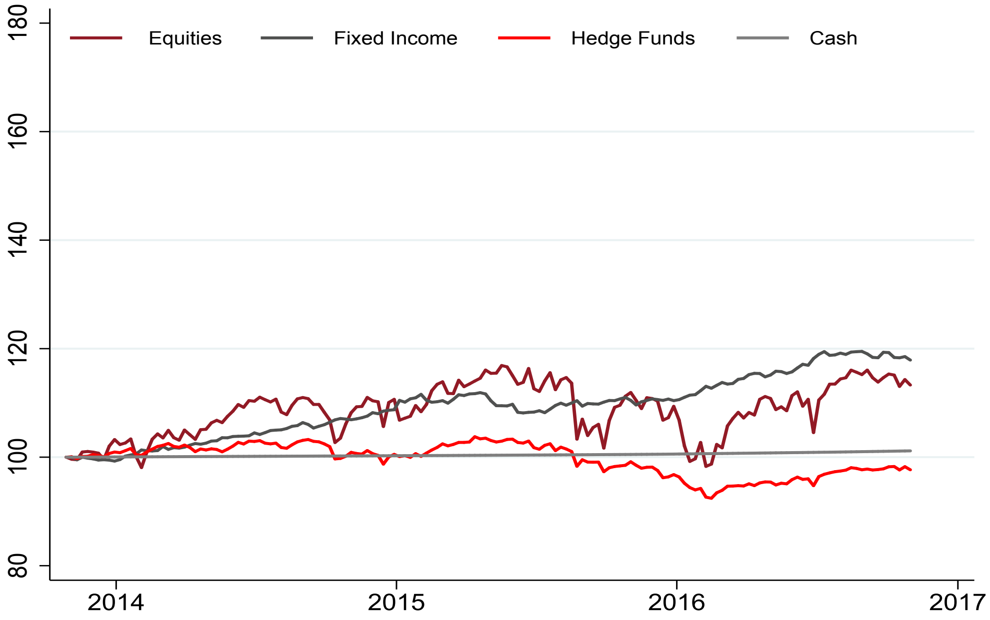
Confidence rebounds briskly in Brazil



Source: Bloomberg, MFO

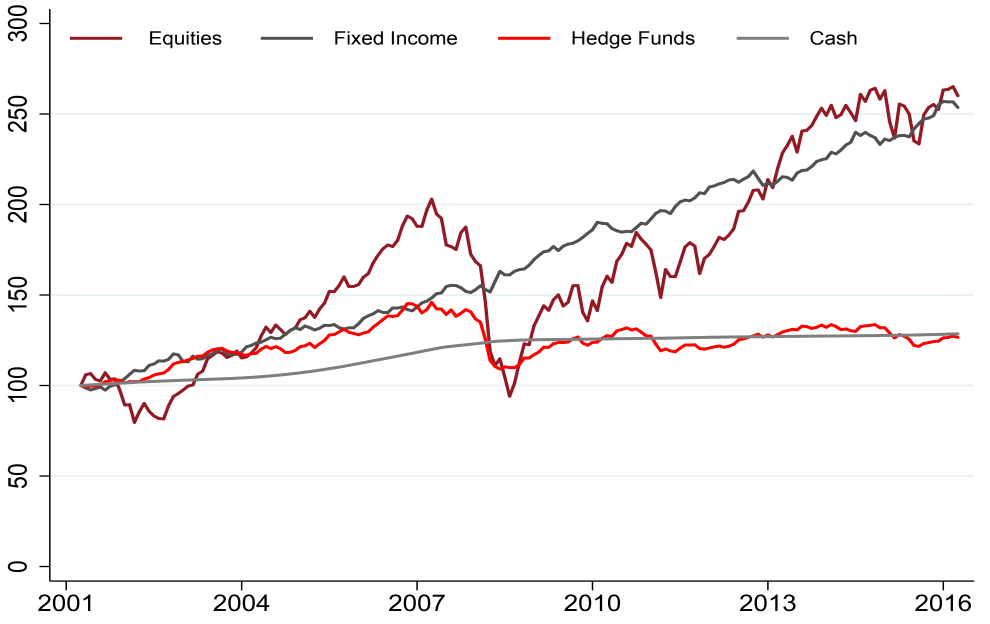
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

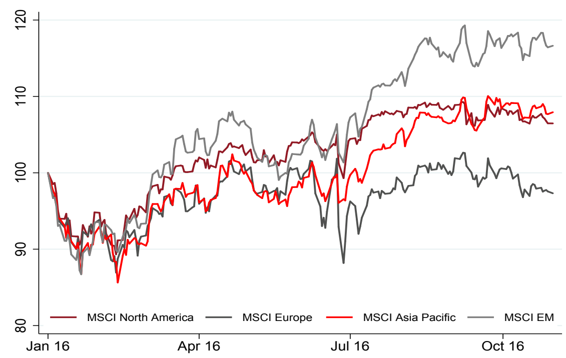
- Since the end of August, global equity markets as a whole have trended sideways to negative. Of the three main regions, North America, Europe and Asia, only Asia could further increase its positive performance, while the other two regions stagnated. Nor did the emerging markets, this year's star performer, add to their previous gains. However, looking at the first ten months of 2016, Emerging Markets clearly led with a total return of 16.6 percent, followed by Asia with 8.1 percent, by North America with 6.5 percent and finally by European equity markets with -3.6 percent in US dollars, a result impacted by the euro's renewed weakening.

- We would highlight the performance differences between the broad market and defensive equities. This was due to a significant rotation from defensive and expensive sectors such as Consumer Staples, Utilities and Telecommunications into the more cyclical and cheaper sectors such as Technology and Financials. Defensive equities clearly weathered the market volatility early in 2016 much better and consequently attracted many investors, while the broader market performed better in the second half of this year. In our equity selection, while we certainly consider active managers who take a "high quality, blue chip, low volatility" approach, this year's performance pattern underscores the merits of other approaches that focus on attractive valuations. But in addition to active management we also use index funds that typically have lower management costs.

- While some market participants are showing signs of growing caution on equities in the aftermath of Brexit, equity valuations still cannot be considered overly attractive as there were no major downward moves in the broadly followed indices. From a pure valuation perspective, we consider Japanese equities the least expensive. Comparing the performance of emerging markets with their respective aggregated business climate, these markets already seem to have more than fully factored in the economic improvements of recent months.

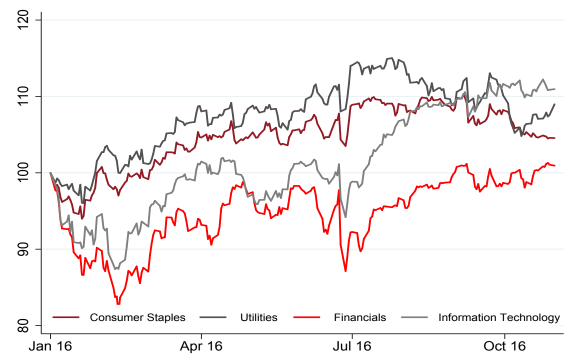
- From a technical point of view, broad equity markets are still in an upward trend though they are now losing a bit of steam. According our proprietary market risk assessment model, which is broader, for example, than the VIX volatility index, equity market risks now hover between average and above-average levels, but are certainly not low. However, in sum, given the still intact trends, our aggregate technical market assessment results in a slightly positive equity outlook.

Emerging markets outperformed



Source: Thomson Reuters Datastream, MFO

Defensive titles lose their appeal



Source: Thomson Reuters Datastream, MFO

2.2 Fixed Income

- After the remarkable fixed-income rally at the outset of the year, things changed in the middle of the year. Since then, broad global indices have been trending sideways. Nevertheless, with a year-to-date rise of 5.4 percent, the fixed-income asset class outperformed the global equity market.

- Consequently, the yield on the Barclays Global Aggregate Bond Index has bottomed out in a range of approximately 1.1 to 1.3 percent. The duration remained close below seven years. With that, the yield-to-duration ratio is still most unfavorable, and it only gets worse after hedging in EUR or CHF, which effectively consumes any remaining yield.

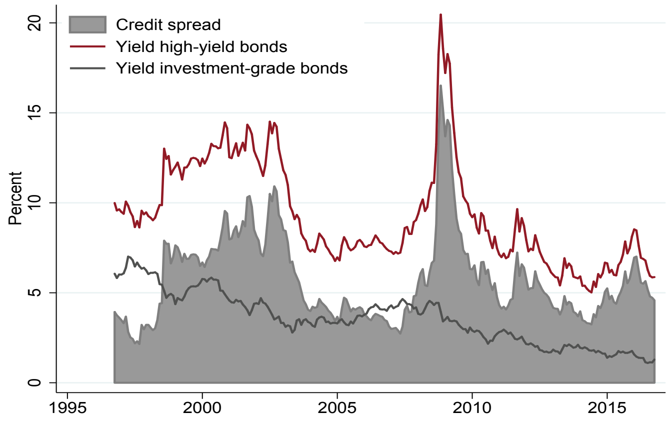
- Long-dated bonds associated with high duration risk performed exceptionally well at the beginning of the year, but they now seem in retreat from their all-time high levels. At the same time, the credit cycle has not yet ended, resulting in significant returns of high-yield bonds. Year-to-date, the market was up by almost 15 percent.

- Might this mark the end of the three-decades-long bond bull market? We don't know. But there are signs that markets are now finally reflecting what we have been reiterating for the past two years: bonds are not an attractive standalone investment. Their implied return expectations – especially when adjusted for potential inflation surprises – are very low or even negative, while risks are asymmetric. Nevertheless, in a portfolio context they still can add value if we assume that they will continue to balance the equity position during turbulent times and exhibit, when needed, a negative correlation to risky assets.

- Unsurprisingly, technical indicators such as price trends and risk measures are projecting a less positive outlook for bonds than they have in the past. Trends are receding and are now close to neutral territory, whereas market risks have started to increase from low to now average levels.

- Higher yielding bonds could be an alternative but their rally has compressed spreads since February's high to the point that we now think it inadvisable to add new high-yield or other riskier bond exposures. The compensation on offer for the associated risks no longer seems attractive. We are closely monitoring the situation for high yield, the credit markets in general and emerging market debt. Should there be a significant widening in credit spreads, we would be ready to deploy capital in those markets.

Credit spreads are low



Source: Bloomberg, MFO

While high-yield and other alternative yield-bearing credit investments, such as private debt and loans, yield more than conventional fixed-income securities, credit spreads do not seem attractive from a historical perspective.

2.3 Alternatives

Hedge funds, private markets and commodities

- After a difficult first seven months in 2016, hedge funds in aggregate, as measured by the HFRX Global Hedge Fund Index in US dollar terms, have begun not only to outperform equities but also fixed income. Fund of hedge fund managers that we follow reported better alpha creation by their underlying managers. Most managers are currently focusing on strict control of market sensitivities to equity and fixed income markets. They tend to see a limited potential for equity markets and are careful with regards to high-yield, whose spreads they regard as overly depressed.

- Since the end of August, commodities, as measured by the Bloomberg Commodity Total Return Index, have begun to perform positively again but remain below the highs of June. Since the start of 2016, commodities are up by 8.3 percent. And while a strengthening US dollar often acts as a brake on commodity prices, over the past two months commodities and the dollar have risen in tandem.

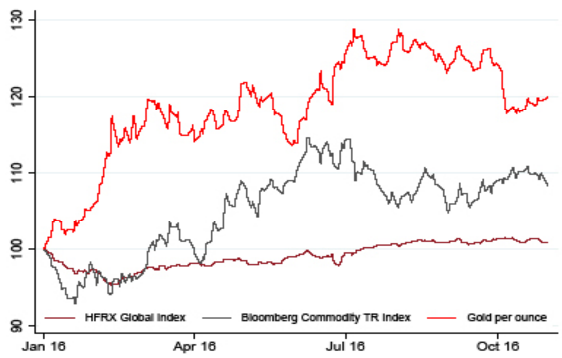
- Private equity investment and exit activity has stabilized at high levels. Fund managers confirm that, given the high prices, finding attractive new deals has become more difficult. But fundraising in private equity remains very strong and seems on the way to match 2015 in terms of aggregate capital raised. The current return environment and the consistent outperformance achieved by quality fund managers appear to be motivating investors to pour new capital into the asset class and to recycle the significant distributions received from PE funds recently.

Currencies

- In trade-weighted terms the US dollar has appreciated by 1.2 percent since the end of August, buoyed by growing expectations for the Fed to hike interest rates again soon. In real historical terms the greenback is relatively expensive, albeit below previous peaks. While a purchasing power parity comparison still shows the dollar overvalued versus the euro, the dollar's previous overvaluation versus the Japanese yen and Brazilian real, for example, has in the meantime been largely reversed.

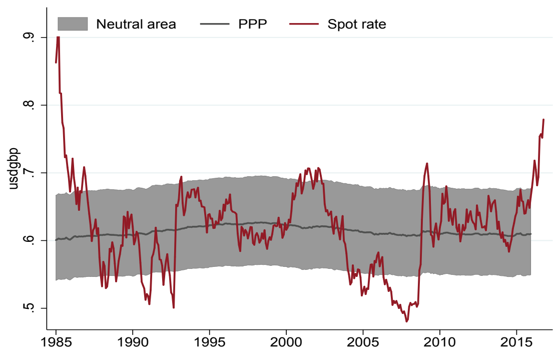
- The pound plummeted after the UK Brexited on June 23 and then leveled off to a sideways-tending phase but depreciation resumed in September. This has further sharpened Sterling's deviations from purchasing power parity estimates versus the US dollar, the euro and the Swiss franc. Acknowledging that further corrections are likely, especially in case of more bad news about „hard Brexit", we think the pound looks increasingly interesting.

Gold and commodities still lead



Source: Thomson Reuters Datastream, MFO

The pound is increasingly undervalued



Source: Thomson Reuters Datastream, MFO

3. Positioning

- Even though business confidence is rebounding and consumer confidence is mostly above average, the global economy is still stuck in its much-discussed low-growth environment and there is no indication as to when this fragile macroeconomic state will end. Also, equity and fixed-income markets are exhibiting weakening trends, with risks in both markets starting to increase. This is all unfolding against a backdrop of generally high but not excessively expensive valuations for most major asset classes.

- In such an environment we assume markets are vulnerable to political, financial or economic shocks that could escalate market volatility quickly. Therefore, we favor strongly diversified portfolios. While we have taken some active positions, as merited after careful scrutiny, we prefer to avoid exposure to single risks (or opportunities).

- Despite their current struggles, we think this is not the time to considerably reduce exposure to equities. Potential inflation surprises towards year's end along with stretched valuations – especially compared with equities – continue to speak for a fixed-income underweight. We also maintain our overweight on credit risk for now, further encouraged by the improved economic outlook, the absence of excessive leverage, and default rates that, while nominally on the rise, are still very low historically. However, given the historically narrow credit spreads in riskier segments of the credit market, we think it is premature to significantly increase exposure to high-yield or other more aggressive credit allocations.

- In capital terms, we maintain a slight equity overweight, invested with a sensitivity to market benchmark that is below one. Therefore, our beta-adjusted equity allocation is nearly neutral, as it has been for quite some time. Within equities, we maintain some emerging market positions but we otherwise do not tilt our portfolio towards any specific region.

- We also maintain a diversified overweight in commodities that we acquired cheaply, which should profit from a negative long-term outlook for the US dollar. Furthermore, should inflation tick higher, our commodity exposure should also serve us well. Finally, in most portfolios we continue to hold a small gold position as an ultimate diversifier.

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

Disclaimer

Imprint

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