MARCUARD FAMILY OFFICE

Investment Outlook

May 2017

1 The mild breeze after the storm

The dust has settled. When Donald Trump first took office, he generated veritable tweetstorms almost daily. In the meantime his tweets create a mild breeze at most. At least the winds they produce are not strong enough to disturb the dust that has settled during the new president's first 100 days in office.

Now that much of the turbulence that accompanied the start of the new US president's term has subsided, we observe that the gobal economic recovery remains on track. Not to our surprise, though, since, as we pointed out in our March Investment Outlook, the recovery is broad-based and global. Therefore, absent disruptive shocks, we think it should not be overly vulnerable to the political misadventures of any single country. The past two months saw further improvements in business sentiment across the globe. In all major developed economies, business confidence climbed above its long-term historical averages – especially in the US, the Eurozone, Japan and Canada. Similarly, most emerging markets have been profiting lately from brightening business prospects, albeit starting from low levels. Within the heterogeneous Eurozone the improvement in economic prospects seem to be broad-based across member states.

Meanwhile, the stellar equity market performance through the end of February was followed by sideways trading until equities resumed its uptrend after the first round of the French presidential election. Over the past 12 months, global developed equity markets delivered a total return of roughly 16 percent in US dollars, as measured by the MSCI World Index. While this approaches the upper band of rolling 12-month returns in normal times, historically it's not particularly outstanding. Nonetheless, we believe that valuations have become stretched in most equity markets. Investors have to dive deeper to more granular levels to find bargains. In our view, equity markets appear subsceptible to setbacks. However, given that economic prospects have continued broadly to improve, and in view of current market trends and the moderate levels of market risk, we maintain our favourable view on the asset class, viewing corrections as an opportunity to buy.

We all tend to grow comfortable with situations that have persisted for long time. That is certainly the case with special situations in financial markets and politics. Thus, it is unsurprising that some investors assume monetary policy normalisation will be limited to the US forever. In our view, though, the discussion regarding policy normalisation will soon heat up elsewhere, especially in the Eurozone, once the major political risks that shaped public perceptions at the start of this year are finally off the table. That moment could come after the final French presidential vote, on May 7. This assumes that Europe-friendly centrist Emannuel Macron defeats Marine Le Pen in the run-off, an outcome suggested by the most recent polls. If the discussion about policy normalisation were to gain momentum, we think it could loosen the grip of the now-so-familiar market narrative of the past few years: monetary policy divergence. This shift in expectations would have consequences for both the currency and bond markets. Yield spreads between US and EU bonds would likely shrink, while the US dollar would likely retreat from its high levels.

In additon, we not only expect to see more interest rate increases for shorter maturities in fixed-income and cash markets, in line with rising US policy rates. We also expect further yield increases for long-dated bonds, namely when it becomes clearer how and when the Fed – and later, the other large central banks still engaged in quantitative easing and asset purchases – finally start to unwind their inflated balance sheets and reduce their enlarged bond holdings.

1.1 North America

- Along with the improving business sentiment, which brightened further throughout the first quarter of this year, industrial production also increased. It was expanding by 1.5 percent year-over-year in March after stagnating in January and February. In parallel, capacity utilization edged up marginally. Purchasing manager indices have remained above average levels and continue to signal an expanding economy in both the service and the manufacturing sectors.

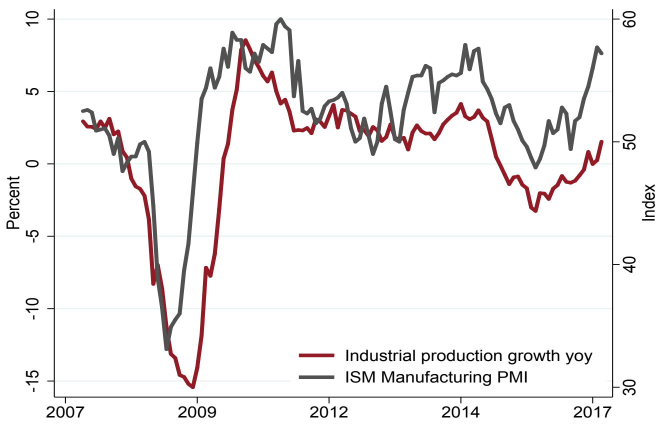
- Given the persistently positive business prospects, we continue to think that we will see some acceleration in investment spending in the near future. The outlook for the export sector remains favorable, too, given that the economic outlook has improved across the globe. Unhelpfully, however, the US dollar remains historically expensive, while uncertainties about the Trump administration's trade policies also cloud the waters.

- In parallel to the relatively steep acceleration of inflation rates in recent months, consumers have seen their recent real income gains eroded. After real wages grew by more than 2 percent year-over-year throughout most of 2015, real wage growth since slowed to a mere 0.3 percent currently. That drop has the potential to depress the climate for consumption. However, for the time being, US consumers continue to be remarkably optimistic, a mood that certainly has been helped by the improving economic prospects and the very favorable conditions on the labor market.

- Meanwhile, US inflation rates stopped accelerating lately. The headline inflation rate dropped from 2.7 percent year-over-year in February to 2.4 percent in March, while the annual core inflation rate decreased from 2.2 to 2.0 percent. Based on simulations assuming stable, moderately falling or moderately rising energy prices and a constant core inflation rate, we think the US headline inflation rate is likely to peak mid-year – at different levels, depending on scenario – and then decline toward the end of the year. However, in all of the three scenarios, the calculation implies that the headline inflation rate should remain above the Fed's medium-term target of 2 percent.

- In line with market expectations, the Fed increased the policy interest rate by 0.25 percentage points to a range of 0.75 to 1.0 percent in March. According to their own projections, the Federal Open Market Committee, which is responsible for setting monetary policy, expects to hike interest rates twice more by the end of this year, based on their latest assessment of the economy.

Industrial production accelerates



Source: Thomson Reuters Datastream, MFO

After the slowdown in 2015, industrial production growth revived throughout 2016 and into 2017. The latest data, from March, shows another marked acceleration in production growth, rising from 0.3 to 1.5 percent year-over-year.

1.2 Europe

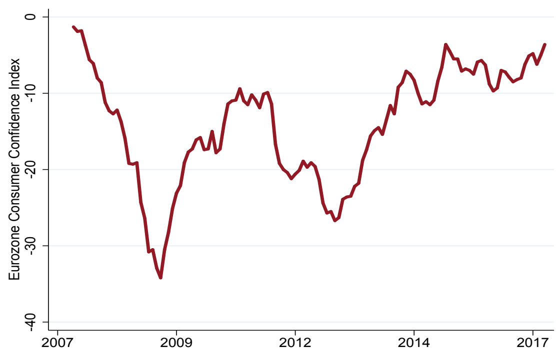
- The business climate in the Eurozone continued to improve in the past two months, as evident in Markit's preliminary flash estimate of its Eurozone Composite Purchasing Manager Index, which rose from 56.4 to 56.7 in April. Thus, this indicator, which reflects the prospects for the industrial and service sectors, reached a six-year high. The positive reading is broad-based. The sub-indices for incoming new business, price pressures and backlogs of uncompleted work are also almost at six-year highs, while job creation is approaching a ten-year high. The high readings are also broadly evident across member states. While France and Germany are seeing their fastest growth in business activity in almost six years, elswhere in the Eurozone, output growth has climbed near to a ten-year high.

- Eurozone consumers have also turned increasingly optimistic in each of the first four months of this year. Consumer confidence has meanwhile reached the highest level since March 2015, which was the highest reading since the global financial crisis. The optimism is confirmed by the ongoing improvements in the labor market. The unemployment rate has continued to fall slowly, while the vacancy rate has climbed to a post-crisis high, too. The recent rapid acceleration in the headline inflation rate came to a halt once it was no longer pushed by energy prices, remaining just below 2 percent year-over-year in April.

- While inflationary pressures remain limited, especially core inflation as a broad measure of price developments, the Eurozone's economic outlook implies an expansion of economic activity at a pace clearly faster than suggested by estimated trend growth rates. Against this backdrop, we think the ECB's monetary policies seem too loose. We expect that after the major political risks in Europe have subsided – assuming Le Pen's defeat – monetary policy normalisation in Europe will be discussed more prominently in public, slowly ushering normalisation into the realm of possibility.

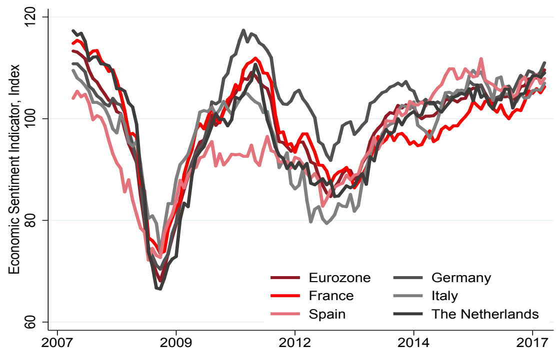
- The British economy has also proven to be quite resilient. It seems rather unconcerned, so far, about the uncertainties stirred up by the prospect of Brexit. Similar to the situations in the other large developed economies, UK business sentiment is also well above its long-term averages. While consumers turned less optimist after the Brexit vote last June, they remain relatively unimpressed by the increasing price pressures of the previous two quarters that were driven, amongst other reasons, by the pound's weakness.

Consumer confidence at a post-crisis high



Source: Thomson Reuters Datastream, MFO

Business prospects are synchronized



Source: Thomson Reuters Datastream, MFO

1.3 Asia and Emerging Economies

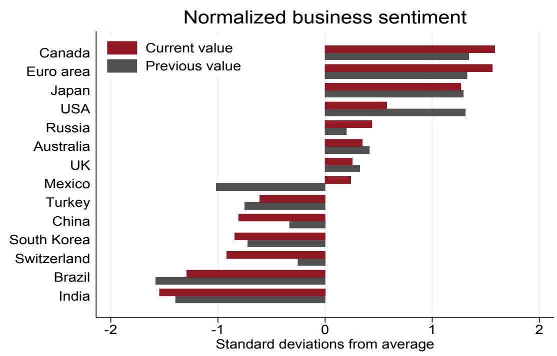
- While most emerging markets have also seen their economic prospects improve lately, the picture is somewhat less clearcut than in developed markets. Despite better dynamics, the major emerging economies do not yet seem to be out of the woods. Economic activity and business climate indicators, albeit improving, are still subpar in a historical comparison. In additon, many emerging economies struggle with specific domestic risks and structural problems.

- While Chinese business sentiment improved visibly throughout 2016, no further gains have been posted in the first months of 2017, at least according purchasing manager indices. Business sentiment has tended sideways, as opposed to the steady improvements seen in the major developed economies. In contrast, industrial production growth marginally accelerated throughout the first three months of 2017, rising from 6 percent year-over-year at the end of 2016 to 6.8 percent at the end of Q1. Going forward, we expect Chinese authorities to focus their attention on financial stability. China's financial risks have been piling up in the form of inflated property prices, soaring corporate debt and the emergence of an extensive shadow banking sector. Measures the authorities might undertake include tougher financial regulations and a tightening of monetary policy, which remains very loose, with policy rates at all-time lows. Whether that will be enough remains to be seen. Some comfort derives from the fact that China's capital markets are still largely isolated from the global financial system.

- Among the large economies, Brazil posted the second-strongest improvement in business sentiment, after Canada, over the past twelve months. However, in absolute terms, Brazil still resides near the bottom of the rankings. Depending on the specific indicator, surveys suggest either an ongoing – albeit slower – contraction or a return to slightly positive territory in the coming months. But despite this silver lining, Brazil's corruption scandal is also ongoing and genuine reforms are sorely needed to tackle this problem.

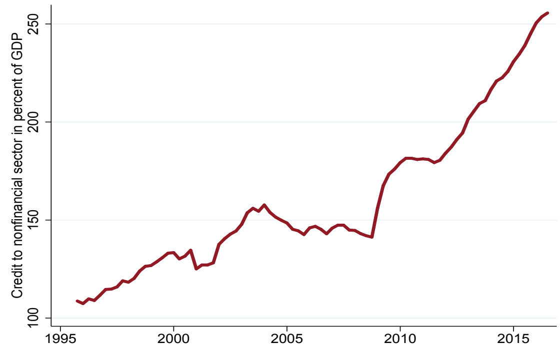
- On a positive note, the steep decline in Mexican business sentiment in response to the heightened rhetoric from the other side of the as-yet-to-be-built wall has recovered to a large degree. First impressions were deceiving: Mexico's short-term economic prospects in fact seem less gloomy than the initial assessments implied. However, the long-term consequences of changing trade relations between Mexico and its northern neighbour remain unclear.

Business sentiment in major economies



Source: Thomson Reuters Datastream, MFO

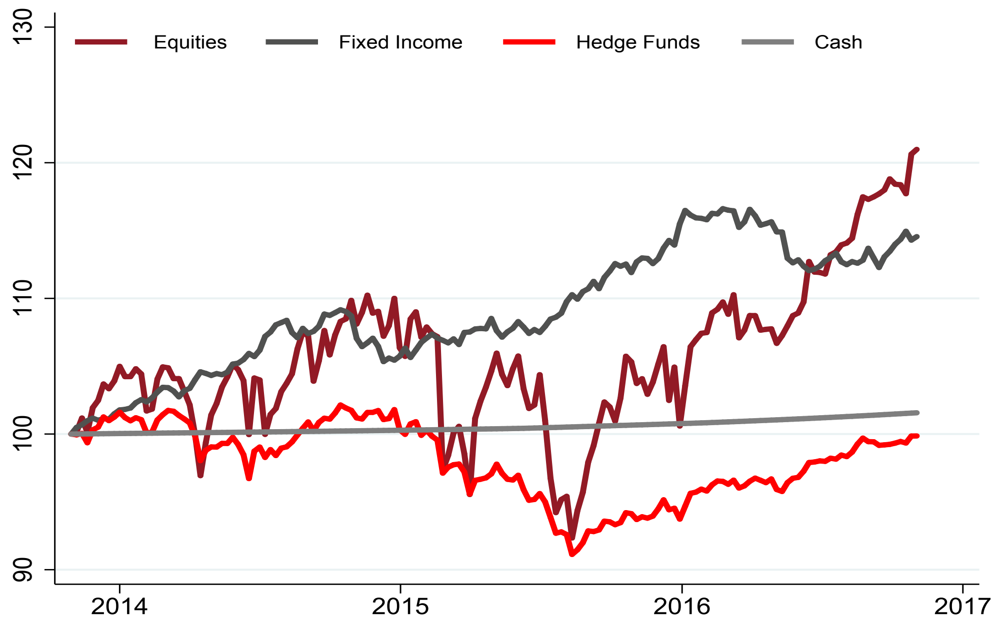
Debt of nonfinancial sector in China



Source: Thomson Reuters Datastream, MFO

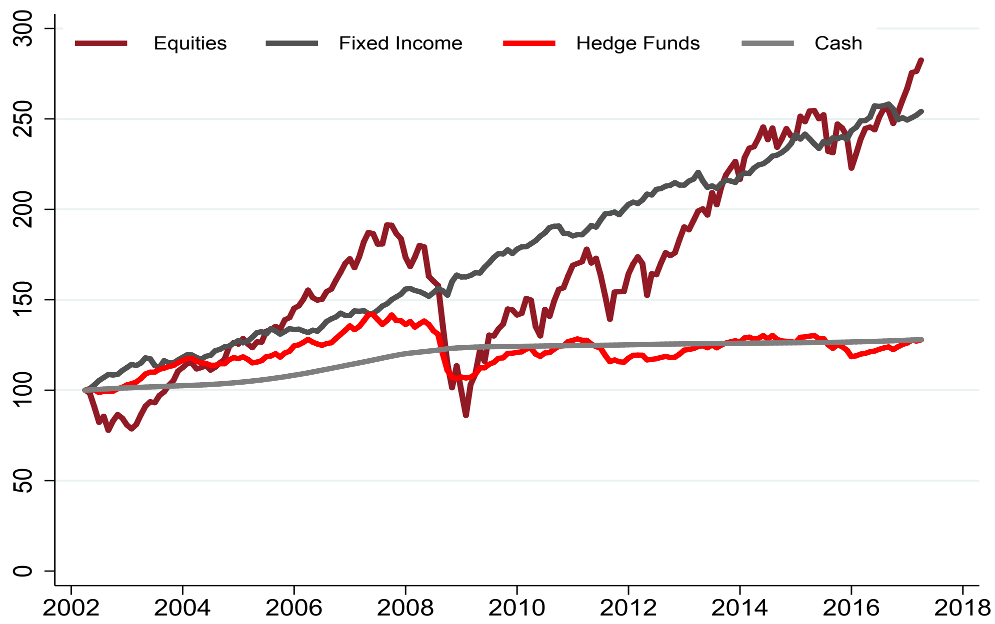
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- Year-to-date, European equity markets are the leading gainers globally, up 11.2 percent in US dollar terms through the end of April, followed by Asian markets, up 10.9 percent and North American markets, up 6.8 percent (MSCI indices). The MSCI World Total Return Index is up 8.0 percent. In the past two months, the pace of the advance temporarily faltered before resuming a strong up-trend.

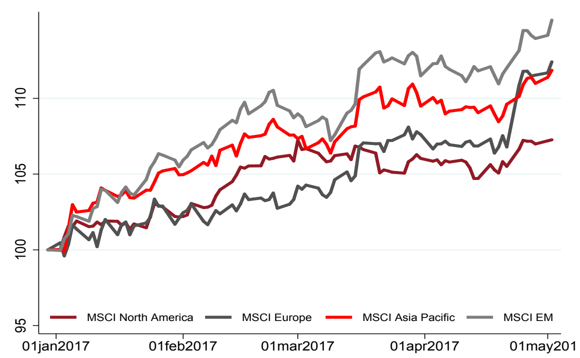
- Not only have equities performed solidly year-to-date, but global equities‘ returns over the past twelve months have also been remarkable. Even more surprising, there have hardly been any down periods. Broad global indices have not experienced a drop of 10 percent or more in that time period. Statistically speaking, this is unusual. A correction between 10 to 15 percent is always a possibility, even without changing economic conditions or valuations. It can be triggered simply by a short-term reinterpretation of a known situation, or by any type of surprises that are impossible to anticipate beforehand.

- The rally in stocks that were supposed to profit from Donald Trump's election campaign promises did, however, come to a halt. Consequently, US small and mid caps and US financials have underperformed the total market as opposed to the sharp repricing to the upside immediately following the election. In order for "Trump trades" – those relying on deregulation, onshoring of manufacturing, tax cuts, infastructure spending, etc. – to continue working, the president has to deliver specific outcomes in addition to strong rhetoric. In fact he would probably have to overdeliver since many of the promised measures are already priced in now.

- Following the recent rally, we find valuations elevated in all of the major equity regions. However, some relief to stretched valuations might come from improved earnings, which have been robust in the US and in Europe in recent months, eventually providing for some further support to equity markets. Unlike valuations on broad regional levels, valuations between different European countries and also within the emerging markets group as a whole are more scattered. In fact, this valuation dispersion is currently quite pronounced, giving active managers the chance to exploit long-term performance potentials.

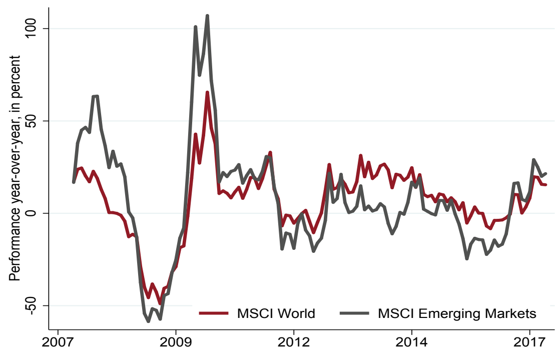
- In contrast to the headwinds provided by expensive valuations, technical indicators continue to support equity investments. Medium-term trends have remained positive, while market risk is currently moderate. Support for equities also comes from the positive economic prospects evident around the globe.

Regional equity markets, year-to-date



Source: Thomson Reuters Datastream, MFO

World equity markets, year-over-year



Source: Thomson Reuters Datastream, MFO

2.2 Fixed Income

- So far this year, global fixed-income markets posted slightly positive returns of 1.3 percent through the end of April, as measured by the Barclays Global Aggregate Bond Index and hedged in US dollars. After the sharp decline in October and November last year, the beginning of 2017 was marked by sideways-tending markets, with a slight rebound evident in March and April.

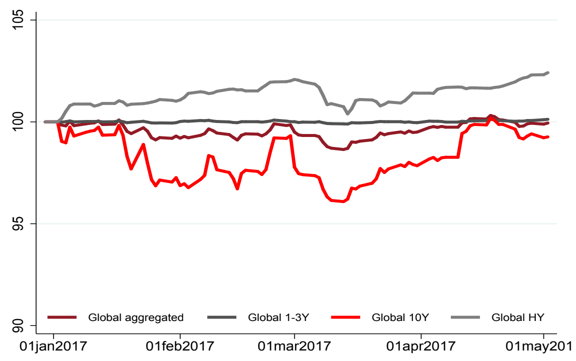
- While last year's repricing brought some relief, the characteristics of a broad global bond index do not yet exhibit attractive investment metrics. With a yield of 1.6 percent in US dollars, hedged in Swiss francs, the yield would even be negative – and at an average duration of approximately seven years, a US-dollar index offers neither fair compensation for interest-rate risk nor any compensation at all for inflation risk.

- By contrast, high-yield bonds continued their recent advance thanks to further credit-spread tightening. Credit spreads have begun to approach all-time lows, indicating that the credit risk inherent in high-yield bonds is not attractively compensated – at least when judged in a historical comparison. Looking ahead, we think further credit-spread tightening is possible, of course, but we note that the high-yield market has become much more a "coupon-clipping" exercise than a market profiting from rising asset values.

- But, as pointed out on previous occasions, while bond yields are clearly unattractive in a longer-term comparison, assessing the current situation is not so straightforward, given that potential economic growth rates and equilibrum interest rates have arrived at low levels. Therefore, from a valuation perspective, bonds should become attractive much earlier than in previous cycles in terms of yield levels, because average and peak yields will be much lower.

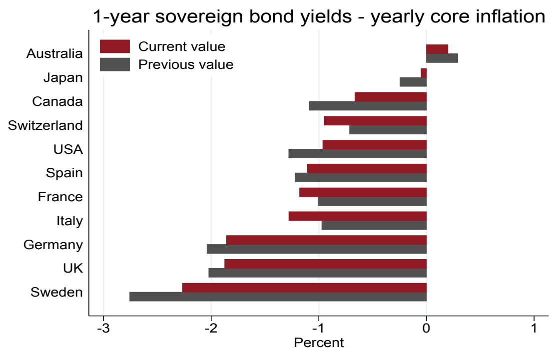
- Nevertheless, given the improved economic prospects and the associated pressure on the Fed to normalize monetary policy, we conclude that the risks associated with long-dated investment-grade bonds continue to be assymetric and that interest rates are more likely to increase than to decrease for both short and long maturities. While short-term rates should be lifted by rising policy rates, the eventual trimming of the Fed's balance sheet might further propel rising yields for bonds with long maturities. Therefore, we prefer credits with floating-rate characteristics to those with traditional durations. Additional headwinds are also evident in technical market indicators, with trends currently pointing to sideways markets and slightly elevated market risk, scoring lower than their equity counterparts.

High-yield markets outperform strongly



Source: Thomson Reuters Datastream, MFO

Real interest rates mostly negative



Source: Thomson Reuters Datastream, MFO

2.3 Alternatives

Hedge Funds

- Hedge funds, as measured by the HFRX Global Hedge Fund Index, got off to a good start in 2017, up approximately 2.1 percent in US dollar terms through the end of April, outperforming bond markets. Meanwhile, commodities showed mixed performance: While gold was up more than 10 percent by the end of April, thereby recouping the losses it posted at the end of last year, other commodities such as natural gas recorded losses of about 15 percent. In aggregate, commodities ended the period in negative territory, as measured by the Bloomberg Commodity Total Return Index in US dollars.

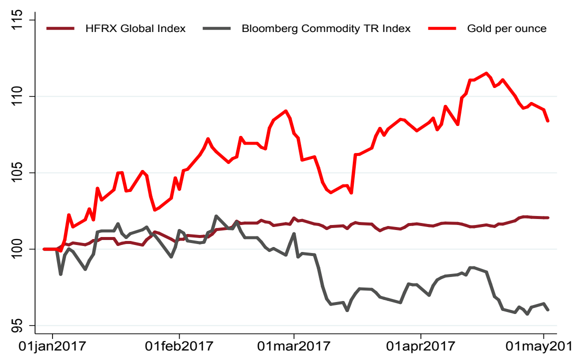
- For private equity the trends from 2016 have continued in 2017. Fundraising remains strong for private equity funds and the most established firms are dominating the space. The global announced buyout deal volume and exit volume declined further, to the lowest levels since Q1 2015 and Q1 2013, respectively. Only the exits via public market offerings were up. The available capital of private equity funds (dry powder) is still at a record high, and so are valuations in the M&A market. Therefore, a differentiated approach to deal-sourcing and value creation remains key for investors.

Currencies

- The Swiss National Bank has adjusted the calculation model of its trade-weighted and inflation-adjusted index for the Swiss franc. From now on, it will not only consider exports but also imports, as well as a broader set of countries. With that, the importance of the Eurozone in the index decreases from roughly 53 to 43 percent. According to the new index, the franc would be less expensive in a historical comparison than suggested by the old index. However, the SNB has not ceased to underline that it still considers the franc to be overvalued, especially against the euro – an assessment confirmed by our own PPP estimates.

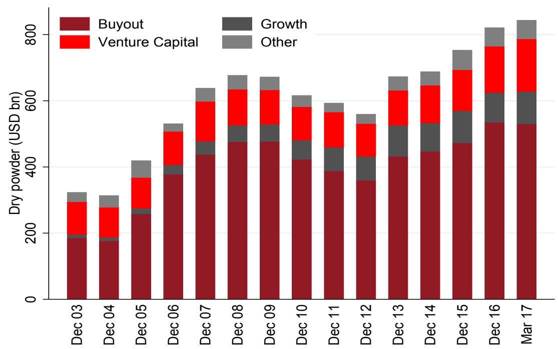
- While the euro is not weak on a trade-weighted basis, it remains frail against the US dollar and the Swiss franc. The rosy economic outlook for the Eurozone and the prospect that looming political risks – especially from the French presidential election – might soon fade are paving the way for monetary policy normalisation in the Eurozone. While we expect the ECB to proceed with excessive caution, the pressure to end their loose policies is clearly on the rise, in our view. At some point, we think that a growing debate on the issue should translate into changing market expectations, eventually lifting the euro against the US dollar and the Swiss franc.

Commodities drop again



Source: Thomson Reuters Datastream, MFO

Private equity dry powder at record highs



Source: Thomson Reuters Datastream, MFO

3. Positioning

- The economic outlook has continued to improve globally and it is demonstrably broad-based. Rising business sentiment and consumer confidence indices point to improving economic conditions ahead in both the emerging and developed markets. We note that the major developed economies have largely closed their output gaps and already appear to be growing faster than trend growth rates would suggest. Thus we think that additional monetary easing and fiscal stimulus in these economies would probably lead then to overheat and accelerating inflation rates.

- Against the backdrop of low interest rates, we find valuations of most asset classes are at expensive levels. Thus, for a value manager, it is difficult to find bargains on the level of broad asset classes. The same is true for the large aggregated equity regions. However, on a more granular level, within certain asset classes, valuations are widely dispersed – for example, within equity sectors, specific European and emerging market countries. Over the longer term, these dispersions offer opportunities for astute active managers. We therefore currently have a slightly more positive view on active managers compared to passive investments.

- 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 find equity market risk has been stable at average levels and fixed income risk has steadily risen, further favoring equities.

- Given our views regarding the likely path of economic developments, valuations and technical indicators, we continue to prefer risky assets, including equities and alternative investment strategies, to fixed-income assets. Given the combination of high valuations with the positive economic and market environment, we would use further equity market gains to take profits and would see setbacks as a buying opportunity.

- We think that the peristently low yields, the prospect of monetary policy normalisation, the improved inflation outlook, along with the absence of positive market trends and elevated market risk continue to speak for an underweight on the overall fixed-income allocation within a multi-asset portfolio, with a bias for credit risk versus duration risk.

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
	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