MARCUARD FAMILY OFFICE

Investment Outlook

July 2017

1 Prevention is better than a cure

Economic prospects in the major developed economies continue to look good, at least over the short and medium term, reviving investors' appetite for risk, supporting markets and asset prices. Are investors' animal spirits poised to replace low interest rates and loose monetary policies as the main driver of returns?

Developed equity markets globally delivered a stellar 17.7 percent return year-over-year at the end of June, at a moment in financial history when Argentina, a five-time defaulter of its debt over the past hundred years, just managed to place a 100-year bond that was oversubscribed several times at emission. At the same time, private equity is showing valuations that are almost at peak levels and very strong fundraising. And our own anecdotal experience suggests that nearly everyone with a smart phone is buying some hot new cryptocurrency that we have never heard of. Animal spirits have indeed revived and they are back on the prowl.

While our investment views have not fundamentally changed lately, we think some gradual adjustments are now warranted. The global economic recovery that we have been following since last summer is still on track. Business climate indicators in all major advanced economies are well above their long-term historical averages, pointing to robust, above-trend growth ahead. Emerging markets and commodity exporters in particular have at least climbed out of the recent trough. But while last summer's upswing had little visible impact on the performance of risk assets at the time, the current situation suggests that the opposite might be the case. As a consequence, we find asset prices particularly vulnerable to shocks right now.

Valuations across all asset classes have enjoyed a lengthy upward ride thanks to the extremely loose monetary policies and low interest rates of the post-crisis decade. Looking at asset values in terms of discounted cash flows, the current net value of most assets has been meaningfully inflated by low discount rates, that is, by low interest rates. This has affected all assets that yield cash flows and it has been stronger the more interest-rate-sensitive an asset is. As a consequence, long-dated governement bonds, the most interest-rate-sensitive of asset classes, have shown the highest valuations. However, the rising levels of risk appetite that also boost risky assets has changed this picture, especially within the fixed-income universe.

Until recently, corporate and high-yield bonds were more attractively valued, factoring in their risk, than long-dated sovereign bonds, but now these roles have reversed, in our view. Our models suggest that, on a five-year horizon, the valuations of longer-dated bonds have improved to neutral or even slightly positve levels, while the valuations of bonds subject to credit risk have clearly become unattractive. Now, it could be argued that a five-year time horizon is too short. But we think it almost passes for the "new normal" today, when the equilibrium interest rate hovers at very low levels. This means that a strong underweight of duration risk may no longer be justified in terms of valuation but also in terms of diversification benefits, because duration provides a degree of hedge against risk assets like equities or high yield in times of market stress. While the environment for risk assets continues to be favourable, at least for the time being, high valuations make markets prone to react strongly to shocks. By definition, we cannot foresee shocks. We can only endeavour to prepare for them as well as possible before they happen.

1.1 North America

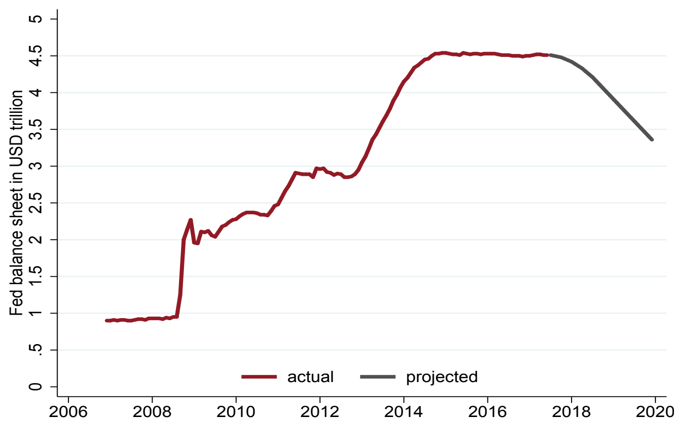
- Business prospects in the US remain favourable but sentiment in the manufacturing sector has retreated from the high levels seen at the start of the year. They still look robust when viewed historically, but they no longer point to growth rates of around 3 percent. In fact, business sentiment currently suggests growth of only around 2 percent, which is closer to, but still above, the centre of gravity—the realistic long-term trend growth rate over the entire business cycle.

- This follows disappointing first-quarter US growth. Consumption was especially weak, slowing visibly throughout the quarter. On a positive note, however, and in line with our expectations, private nonresidential investment picked up. But apparently, perceptions have aligned more closely with reality, as it becomes clear that the Trump administration, self-absorbed and hamstrung by scandal, will probably underdeliver on most of the initiatives that were expected to boost the economy.

- But it is important to note that despite the recent chill in business conditions, economic prospects still look good in the US. Both business sentiment and consumer confidence are above their long-term historical averages, markedly higher than they were a year ago. In addition, consumers benefit from a robust labour market that is at full employment, while inflation rates edged lower in May, the headline rate falling from 2.2 to 1.9 percent as the core rate dropped from 1.9 to 1.7 percent, year-over-year.

- Under these circumstances, the Fed introduced another 0.25 percent rate hike, to a target range of 1.0 to 1.25 percent, and finally outlined its strategy to reduce the vast bond holdings acquired through quantitative easing. The Fed, it turns out, will rely entirely on maturing securities and do without active sales, with the share of unreinvested securities rising in steps. Initially the Fed will continue to roll over maturing Treasury bonds above a cap of USD 6 billion every month. In the next step, this cap will be raised by USD 6 billion every three months until, after twelve months, it reaches a level of USD 30 billion. For agency debt it will apply a cap of USD 4 billion per month that gradually increases to 20 USD billion in twelve months. This is a gradual, predictable approach and, accordingly, early reactions from financial markets were muted. Long-dated interest rates even fell, leading to a slight flattening of the yield curve and a lower term spread. Given this initial reaction, we do not expect any marked boost to bond yields and term spreads.

Possible evolution of Fed balance sheet



The Fed's balance sheet has expanded to USD 4.5 trillion currently in the wake of its large quantitative easing programs. The chart depicts how the Fed's balance sheet would evolve if it were to start trimming its balance sheet in August, assuming the volume of maturing bonds always equals or exceeds the defined cap.

Source: Thomson Reuters Datastream, MFO

1.2 Europe

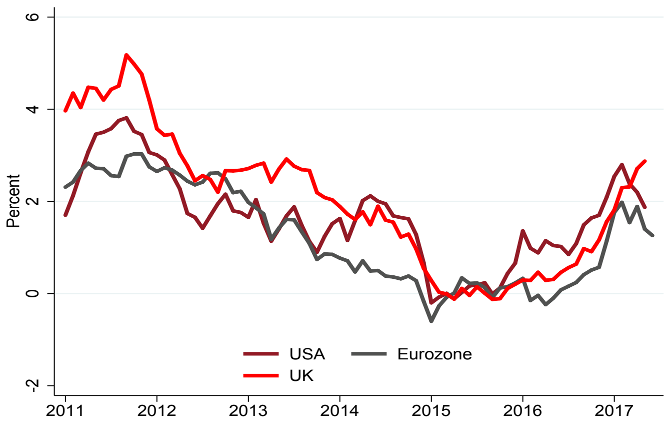
- The Eurozone's economy solidified further throughout the first two quarters of the year, confirmed by improving business and consumer sentiment. It posted a solid, above-trend growth rate of 1.9 percent year-over-year in the first quarter. Current economic sentiment, which includes data from various sectors and from consumers to depict the prospects for the entire economy, implies that growth has probably accelerated further throughout the second quarter, presumably to just above the 2-percent mark.

- Meanwhile consumer confidence in June climbed to its highest level since the global financial crisis and now has even surpassed its pre-crisis peak. Thus, the outlook for consumption remains favourable, further supported by an improving labor market and moderate inflation.

- At the same time, monetary policy remains extremely loose. Any actual policy tightening is unlikely to begin before the second half of next year. However, we expect markets to start pricing in this shift much earlier, as was the case in the US in 2014—which, by the way, would also take pressure off the SNB, which is still trapped in its highly expansionary policy stance. Mirroring the Fed's approach, the ECB's eventual policy change of direction will probably unfold as follows: First, the ECB would end its bond purchases, now thought to continue through the end of this year. Next, they would probably start with gradual interest rates hikes, before reducing their bond holdings. At their June meeting, the ECB took a first small step in that direction, abandoning their linguistic bias toward easing and noting that economic risks were now "broadly balanced" instead of the previous characterisation, "to the downside."

- This rosy picture for the EU is quite unlike what the Bank of England faces these days. UK inflation rates have markedly increased, without the recent pause in rising inflation rates in the US and the Eurozone. Core inflation is at 2.4 percent and headline is inflation 2.9 percent, year-over-year, driven by a weak pound and surging import prices. At the same time, the profound uncertainty surrounding Brexit is weighing on economic prospects. While, on aggregate, economic conditions remain favourable, the UK is clearly not enjoying the broad-based unambiguous uptrend that we are seeing in the Eurozone. While business confidence in the industrial sector is currently buoyed by the weak pound, sentiment in services is muted. Eventually, the BoE may be forced to tighten monetary policy in the midst of worsening economic conditions.

Divergent inflation rates



Source: Thomson Reuters Datastream, MFO

Accelerating inflation rates in the US and the Eurozone recently took a breather, while increases in consumer price inflation in the UK continued unabated, fueled by the pound's ongoing weakness.

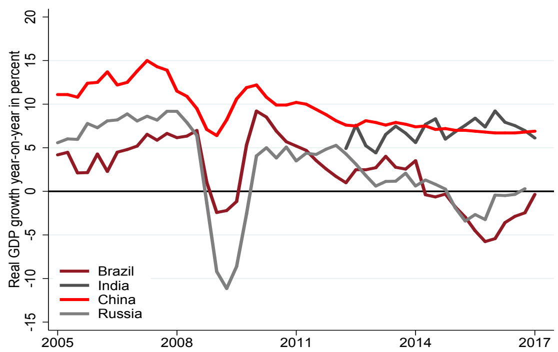
1.3 Asia and Emerging Economies

- Japan, the world's fourth largest economy, grew somewhat slower than in the previous quarter but it still managed to grow at an above-average 1.3 percent year-over-year, supported by robust consumption and export growth. Solid, above-average confidence levels among consumers and businesses suggest that a further slight acceleration in the current pace of economic expansion is possible in the coming months. Japan is also benefitting from tailwinds generated by the country's policy mix of loose monetary policy and fiscal stimulus, or "Abenomics," as its called, referencing current prime minister Shinzo Abe. Despite solid demand and the weak external value of the yen, inflation remains subdued, with the headline rate at 0.4 percent and the core rate at zero percent year-over-year. Clearly, the government's 2 percent inflation target is unrealistic. In addition, the weak yen currently has some upside potential, both from a valuation point of view and also given its safe-haven status. Especially in the event of a hard landing in China, where even the slowing pace of economic growth is only achieved with the help of increasing leverage and rising levels systemic financial risk.

- The Brazilian economy has stabilized further, albeit at low levels, as the first signs of recovery emerged in Q1 of this year. After the economy contracted by some 8.6 percent in real terms between March 2014 and December 2016, it posted its first positive quarter at the start of this year, with GDP growing at 1.1 percent quarter-over-quarter. However, economic activity remains anemic. Industrial production fell again in April, by 4.5 percent year-over-year, while on a positive note, retail sales growth continued its uptrend, having entered positive territory in April. The outlook for consumption has also improved, mainly thanks to the sharp slowdown in consumer price inflation, which fell further in May to 3.6 percent year-over-year, giving some relief to households that have been confronted simultaneously with an economic downturn, soaring inflation rates—which peaked at almost 11 percent at the start of 2016—and rapidly rising unemployment.

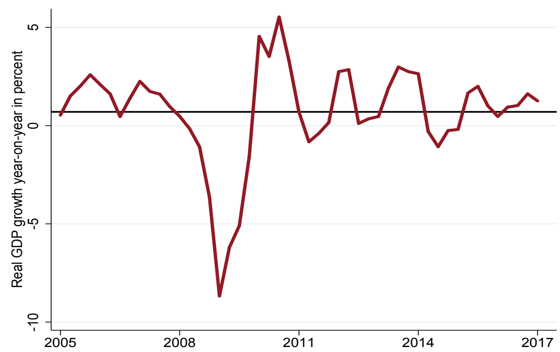
- As we pointed out in May's Investment Outlook, mirroring the improving economic prospects in advanced economies, there have also been signs of stabilisation in the emerging economies. However, critical vulnerabilites remain. One major threat to this weak recovery is the risk of a downturn in China and the associated feedback loop to other emerging economies, through commodity markets. On the other hand, support could come from a weakening US dollar, which currently offers little upside potential, in our view.

BRICovery



Source: Thomson Reuters Datastream, MFO

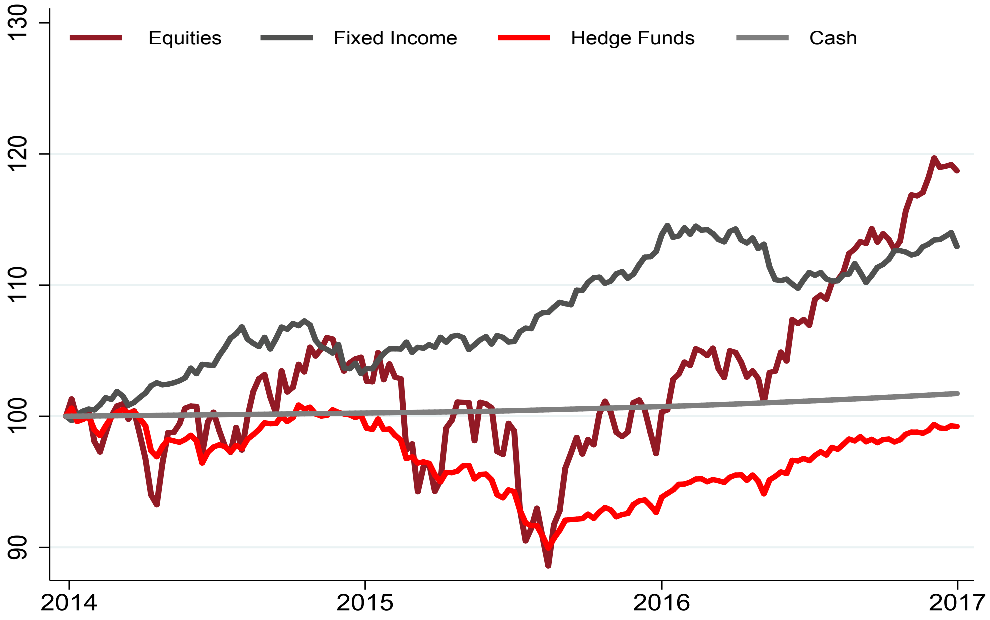
Japanese economy steadily expands



Source: Thomson Reuters Datastream, MFO

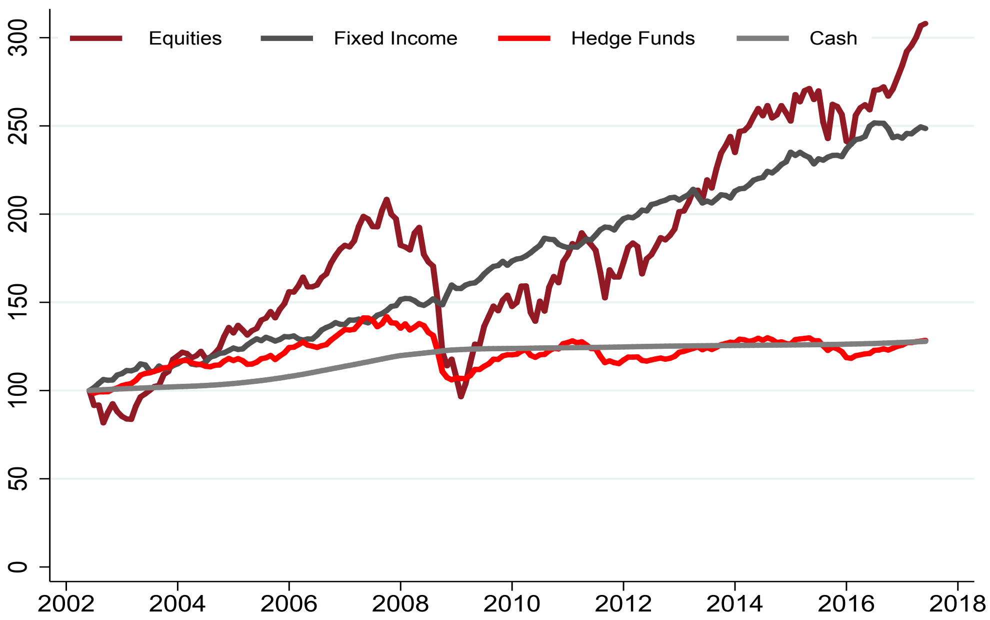
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- While most equity markets posted further gains in early May, they have since entered into a generally sideways pattern. However, the sizeable correction forecast by some pundits—and hoped for by many doomsayers and under-allocated investors—has not yet taken place. This means that most markets are still trading near their year-to-date highs. The MSCI World's gain of 10.7 percent through the end of June is clearly above the long-term annualized returns that can normally be expected from global equity markets.

- Valuations generally remain high and bargains are hard to find, making markets particularly vulnerable to negative surprises. However, we think the environment remains favourable for equities given positive price momentum, moderate levels of market risk and encouraging macroeconomic developments, especially in Europe.

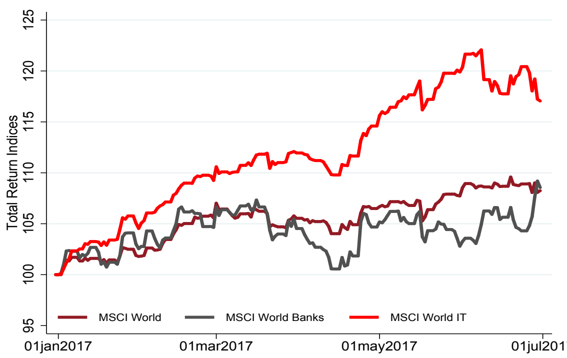
- Thanks to a stronger euro and lower political risk after the French elections, European markets are among the global leaders, as measured by MSCI, with a gain of 15.9 percent, in USD year-to-date. They just followed the Asian markets, which continued their upward trajectory, gaining almost 16 percent this year.

- S&P 500 US large caps are up 9.3 percent, not only more than S&P US mid caps, up 6.0 percent, but also more than US small caps, with the Russell 2000 up 5.0 percent. The much higher volatility of the latter two indices this year is noteworthy. Their continued underperformance could be a sign that market participants are losing confidence in Donald Trump's ability to push through his agenda, which was expected to benefit smaller US companies the most.

- On a sector level, US technology stocks are still clearly ahead of financial stocks in 2017, but investors seem to have just realized that while they offer mostly solid fundamentals, technology stocks have now reached valuation levels that are simply too high and were reached too quickly. Tech shares now trade around 19x future earnings, clearly above the long-term average of 14.5x. Meanwhile, financial stocks profit from expectations of a more lenient regulatory environment in the US.

- In the emerging economies, the sudden collapse of the Brazilian market was precipitated by a fresh escalation in long-simmering high-level bribery investigations. The ongoing slide of Russia's equity market again tracks with weaker oil prices. The other two BRICs, India and China, are each up by more than 20 percent year-to-date, according to the respective MSCI indices.

Bank vs technology stocks



Source: Bloomberg, MFO

Performance of BRIC markets

Source: Bloomberg, MFO

2.2 Fixed Income

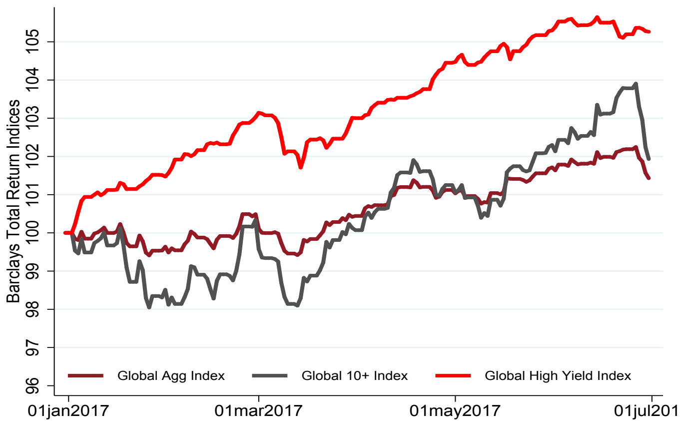
- After last year's repricing in the government bond space, following the US presidential election, broader global bond markets have resumed their upward tendencies. As tracked by the Bloomberg Barclays Global Aggregate Index, bonds hedged in US dollars were up approximately 1.4 percent year-to-date at the end of June. More unexpectedly, the longer-dated bonds in the Bloomberg Barclays Aggregate 10+ Year Index outperformed the broad index. Credit had a good first half of 2017, too. The Bloomberg Barclays High Yield Index was up more than 5 percent in US dollar terms, and the BBB index gained 2.5 percent. Major interest rates including US and German 10-year rates are showing no clear direction, both howering around 2016's year-end levels.

- Thus, yield and duration metrics for fixed income assets in general have not grown more attractive. According Bloomberg Barclays Global Aggregate Index, the average duration on global bond markets, approximately seven years, is again nearly at an all-time high, while the average yield is close to 1.6 percent. And high-yield exposure, with its flagging yields, once again only comes without fairly compensating investors for the risk it entails, and with durations close to what they were at the start of the year. After the lasting compression of credit spreads we even think that high yield, albeit offering higher absolute yields, is showing a more unattractive compensation for the risk taken than the aggregate market.

- The positive economic outlook and broadly improving growth dynamics, together with the fact that, at least in the US, monetary policy has finally begun to tighten all favour equities over fixed-income securities generally. However, despite the directional change in the US, in absolute terms the monetary environment remains supportive for fixed-income securities. We also learned in June that the Fed will unwind its stretched balance sheet only very gradually and predictably, relying exclusively on maturing securities and not pursuing any active sales. Therefore, we do not expect any sharp upticks in long yields or the term spread.

- Market indicators, including trend and risk data, produce a moderatly positive picture. Medium- and longer-term trends are still in neutral-to-positive territory and are very positive for high-yield, while market risk is only moderate.

Up, up, up it went



Source: Bloomberg, MFO

In the first half of 2017, both credit and duration risk exposure would have paid off: High-yield bonds and bonds with a duration of 10 years or more were the best-performing segments of the overall bond market, outperforming the global aggregate benchmark before the latter started to correct towards the end of June.

2.3 Alternatives

Hedge funds, private markets and commodities

- In aggregate, hedge funds had a good first half-year, with the broad HFRXGL index up 2.7 percent in US dollar terms by the end of June. However, the dispersion among the different hedge fund styles was considerable, with the performances ranging from around -10 to +8 percent, as indicated by the different HFRX sector indices.

- Commodity prices temporarily ended their mini recovery that started last year, losing 1.5 percent during the past two months, and about 7 percent since this year's peak in February, as measured by the Bloomberg Total Return Commodity index in US dollar terms. The dispersion has been even wider than in the hedge fund space: For example, palladium futures prices were up about 24 percent, while sugar futures prices fell by roughly 31 percent in US dollar terms by the end of June.

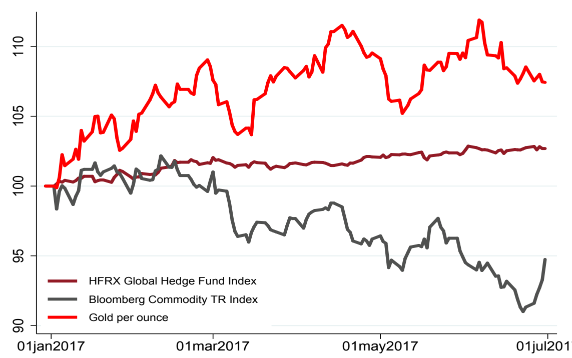
- For private equity the situation is largely unchanged from two months ago. Fundraising remains very strong while both deal volume and exit volume have slipped compared to a year ago. In the first quarter of 2017 we saw a slight decrease in average M&A valuation multiples in the US and in Europe. However, valuations remain at very high absolute levels and average debt financing has even increased.

Currencies

- Given the market's subdued initial reaction to the Fed's announcement of its cautious balance sheet unwinding strategy, we do not expect a marked increase in long yields and the term spread. Hence, despite a widening wedge between US and Eurozone policy rates, which would favor the US dollar, we continue to think that an intensifying debate on monetary policy tightening in Europe should support the euro, which, while not weak in general, does remain significantly undervalued versus the greenback. As we saw three years ago, when the dollar surged on the back of the Fed's pre-announced tapering – not even full-fledged tightening – of its bond purchases, actual policy tightening might not be required to move currency markets, in our view.

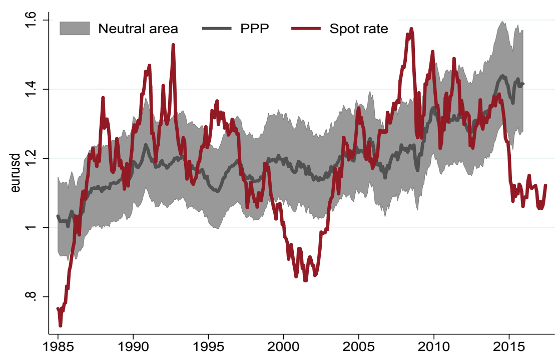
- GBP remains undervalued against most major currencies. However, while it is above its low for the year, it has hardly recovered from its downward turn. While the pound's undervaluation is large enough to justify a recovery over the long term, the mounting uncertainty about Brexit details do not speak for Sterling's recovery anytime soon.

Commodities continue to underperform



Source: Thomson Reuters Datastream, MFO

Euro still cheap vs. US dollar



Source: Thomson Reuters Datastream, MFO

3. Positioning

- After eight years of price inflation in almost all asset classes, valuations are generally at rich levels and it is difficult to find attractively priced assets. While most asset classes and markets are not excessively valued, all of them are expensive. That contrasts with the favorable economic outlook, buoyed by improving growth dynamics across the globe, healthy business and consumer sentiment, and muted but higher inflation than seen some months ago.

- While we have not materially changed our investment views and maintain our positive stance on risk assets, we would point out that there are various risks capable of triggering a correction in equity markets and other risk asset markets. China's mounting debt is one of the biggest risks to the global economy, but a range of potential policy blunders by the Trump administration or an escalation of the tensions with North Korea, among other political risks, also have the potential to unsettle financial markets. While we cannot know where the next shock will come from, market vulnerability is there in the form of almost universally stretched valuations.

- For the time being, we maintain our pro-growth stance and marginally overweight equities against fixed income assets. Equities are supported by the improving economic backdrop and strong technical factors such as intact trends and moderate to low levels of market risk, acknowledging that equity valuations are far from cheap. Within equities, we slightly overweight Europe and Asia at the expense of North America. From that perspective, and barring any marked deterioration in the overall environment, we continue to regard any eventual equity market dips as buying opportunities.

- Based on our assessment of the economic cycle, valuations and technical indicators, most fixed-income markets remain less attractive than equity markets. Therefore, we maintain our underweight, including our tilt towards floating-rate instruments and secured credit. However, we slightly reduce the deviations from the long-term strategic allocation, especially the underweight in duration, in order to improve the portfolio's resilience in the event of adverse market shocks, and also to acknowledge the fact that valuations of long-dated bonds have become less stretched lately.

- We also see a small gold allocation as a useful diversifier within a broadly diversified portfolio and as ultimate insurance in case of very adverse events.

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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