MARCUARD FAMILY OFFICE

Investment Outlook
November 2017

1. Can risk assets continue to soar?

Starting this, our final report for the year, with a quick backward glance, we can say that after a hard winter, equity markets enjoyed a bounteous spring and summer in 2017, followed by a magnificent autumn. Whether the coming winter will bring sun and powdery snow or slush and fog remains to be seen. But, for now, the most recent further improvements in business prospects globally clearly reaffirm support for risk asset markets.

That said, as we have noted several times in this space, and which by now is merely a matter of common sense, the stretched valuations prevalent in almost all major asset classes expose investors' portfolios to certain risks that cannot be ignored or avoided, but which can only be mitigated by sound diversification. At this point, we do not want to bore readers with the mantra of diversification – regular readers will know our take on this issue quite well by now. But, at a time when valuations are stretched so broadly, it does seem appropriate to consider whether the global status quo of recent years – very loose monetary policies and widespread negative real interest rates – have led to asset price bubbles, excessive leverage and increased systemic risks in financial markets.

In its latest Global Financial Stability Report, published in October, the IMF concludes that the global financial system has continued to strengthen due to the higher capital buffers of banks and enhanced regulation. However, the report also acknowledges that the quest for yield has caused vulnerabilities to shift to the nonbank sector, with "too much money chasing too few yielding assets" as investors have left their natural habitats and accepted higher credit and liquidity risks in order to improve their returns.

In addition, the IMF notes that leverage in the nonfinancial sector has been on the rise in the Group of 20 economies, which, despite the low interest rates, has led to higher debt service ratios, especially in the economies of Australia, Canada, China and Korea. Developments in these countries have to be monitored closely, in our view. In particular, we ask: will the authorities, mainly central banks, take advantage of the window of opportunity that is presented by improving economic conditions to contain financial excesses by implementing tighter monetary and macroprudential policies?

With regard to investors chasing yields, we would stress, again, that investors should firmly resist adjusting their risk profiles and take on higher levels of risk just because returns currently are low. But if the investment horizon is truly long-term, investors may benefit from diversifying the sources of risk they take on, for example, by substituting part of their established credit and duration risks with liquidity, operational and legal risks. But, we stress, this approach should only be considered if the investor is willing and able to bear potential mark-to-market losses.

In addition, some large institutional investors face regulatory constraints that permit them to access certain segments of the credit market with only limited investment volumes. As a consequence, to unconstrained investors these segments can be less crowded and can offer a better compensation per unit of risk, besides supporting risk diversification generally. Loans versus high-yield bonds are one example, as loans on average offer a somewhat better yield for comparable default risks or comparable yields at lower default risk. However, in any case, it is essential to assess risks and returns diligently. The headlong pursuit of returns might work right now, but this approach will certainly not succeed forever.

1.1 North America

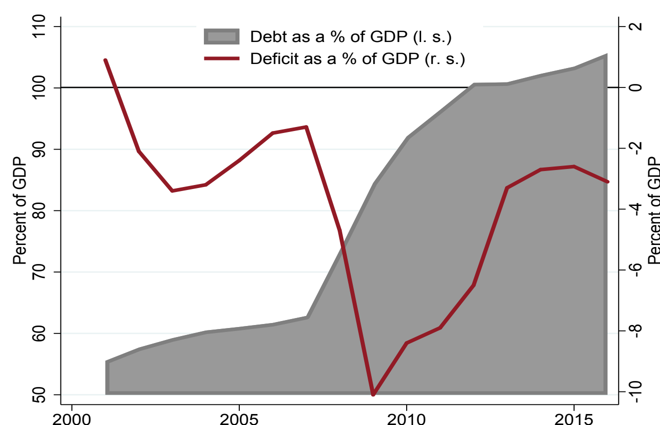
- Business sentiment in the US continued to edge upward in September and currently is only marginally below its multi-decade high of 2004. At the same time, industrial production is recovering, too. After declining throughout most of 2016, it grew again by 1.6 percent year-over-year in September. The bullish business sentiment should fuel a further pick-up in real activity and investment spending. The positive macro data is underpinned by anecdotal evidence, such as the Federal Reserve's so-called Beige Book, which reported modest to moderate growth in economic activity in all 12 Federal Reserve districts in October, despite major disruptions caused by hurricanes in three of those districts.

- Similarly, consumers have again grown more optimistic in recent months. In fact, consumer confidence is currently at its highest level in fifteen years. No wonder, since consumers continue to enjoy the robust conditions in the labor market. The unemployment rate fell to 4.2 percent in September, its lowest level since 2001. At the same time, the labor participation rate has maintained its uptrend. In addition, after weakening during the first half of the year, hourly wage growth has revived since the summer, up 2.9 percent year-over-year in September. With that, and with consumer price inflation at 2.2 percent year-over-year, real hourly wages recovered from their stagnating levels at the start of the year, up 0.7 percent year-over-year in September.

- In addition, the Trump administration seems to be making progress on tax reform. The consequences of its program on GDP growth and budget balances are not easy to predict. However, the reforms could marginally boost growth at the cost of enlarging deficits. Given that the federal budget balance has continued to worsen, such a pro-cyclical fiscal policy cannot be maintained over the longer term, in our view.

- As expected by most observers, in September the Fed announced that it would start reducing its bond holdings, beginning in October, according the plan it laid out in June. During this first month of balance sheet trimming, no meaningful impact on bond yields could be observed. According to its latest projections, from September, the FOMC expects to undertake three or four more interest rate hikes next year. In addition, president Trump named Jerome Powell and John Taylor along with incumbent Janet Yellen as his favorite candidates for the Fed chair. While some observers regard Taylor as potentially more hawkish than Yellen, we would expect the gradual tightening stance to continue in any

US federal debt still rising



Source: Thomson Reuters Datastream, MFO

In contrast to the Eurozone, US government debt has not yet stabilized. Despite favorable economic conditions, fresh deficit increases led the debt growing as a percent of GDP. Given that backdrop, tax reform that leads to even larger budget deficits does not seem sustainable over the long term.

1.2 Europe

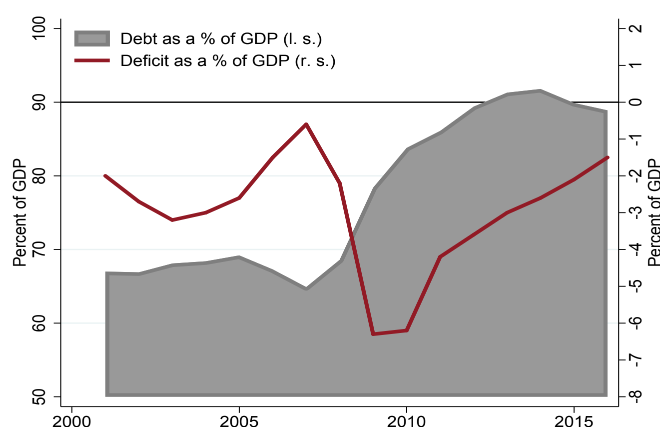
- Despite the fresh resurgence of political risk within the Eurozone, economic conditions improved again in September and October, implying that economic activity will likely also improve in the coming months. Economic sentiment in the Eurozone reached its highest level in 17 years in September.

- On balance, the Eurozone enjoys even more favorable conditions than does the US. Similarly, both business and consumer sentiment surveys are at very high levels, providing headwinds for investment spending and consumption. However, Europe's economies are generally more sensitive to the global business cycle, meaning that European economies should profit comparatively more than the US from the synchronized acceleration in global demand. In addition, European monetary policy remains very loose, whereas the US Fed has started to tighten monetary policy. As a result, real interest rates in Europe generally have remained deeply in negative territory, while they have trended upward in the US. What's more, budgets in the Eurozone, on aggregate, have consistently improved in recent years and are not far away from being balanced, implying that the fiscal drag of budget imbalances on aggregate demand has been steadily shrinking. This again contrasts with the fiscal situation in the US, where the persistent trend of increasing deficits has to be reversed at some point (although this moment is not yet in sight). However, the euro has been appreciating significantly in both real and trade-weighted terms, which, to a degree, could burden improving export demand.

- Switzerland, as a small, open and export-oriented economy, has long suffered from the very strong external value of its currency and from the economic weakness of its bigger neighbor and major trading partner, the Eurozone. However, the recent depreciation of the Swiss franc versus the euro and the steadily improving business prospects in the Eurozone and other major economies should translate into a visible acceleration in economic activity in Switzerland in the coming quarters, in our view.

- The British economy is still a picture of contrasts: Whereas the industrial sector profits from improving global demand and a weaker pound, which is reflected in industrial sentiment surveys that are close to all-time highs, sentiment in the services sector has deteriorated further. On aggregate, and against the backdrop of persistently high Brexit uncertainty, the UK economy should continue to expand at a similar pace, but without much of the positive impulses seen in other major industrial economies.

Government debt in the Eurozone has stabilized



Source: Thomson Reuters Datastream, MFO

Government debt as a percent of GDP in the Eurozone peaked in 2014 and fell slightly in 2015 and 2016. Meanwhile, in the Eurozone as a whole, government deficits decreased to 1.5% of GDP at the end of 2016. With that, the need to reduce budget deficits, and hence, their previous fiscal drag, has declined.

1.3 Asia and Emerging Economies

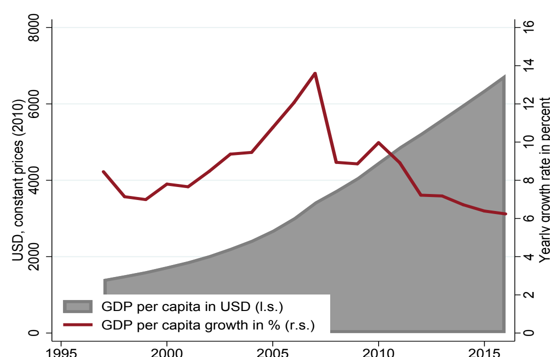
- Export-oriented Asian economies, similar to some European countries, have a relatively high sensitivity to global demand. Accordingly, they stand to profit from the synchronized acceleration of business prospects in the major industrial economies and from improving global trade generally. The recent marked improvement in Japanese business prospects in the manufacturing sector, as measured by the Bank of Japan's Tankan survey in Q3, can be interpreted against that backdrop. Thus, Japan continues its mild recovery, ongoing for almost six years now, supported by loose fiscal and monetary policies, making it one of Japan's longest recovery periods since the 1980s.

- China again posted a steady growth rate of 6.8 percent year-over-year in Q3. The artificially smoothed growth rate masks the volatility of China's underlying economic activity, we note. However, official purchasing managers indexes suggest a slightly accelerating expansion in both the manufacturing and non-manufacturing sectors in September.
- Due to demographic trends and the ongoing structural shift towards a more sustainable, less heavy-industry-dependent economic growth model, the need for supply-side structural reforms was reaffirmed by president Xi Jinping at the 19th Party Congress in October. Thus, we expect China's GDP growth to continue to moderate on average over the coming years. However, this moderation should not be interpreted as implying a decline in living standards, as the rebalancing of the Chinese economy towards consumption, services and more knowledge-intensive industries should also be accompanied by increasing per-capita GDP.
- But China's GDP growth has not been the main concern of most observers lately, nor of the Chinese authorities. Focus has shifted to the elevated risks to financial stability arising from China's high levels of corporate debt. Since the end of 2016, combatting these systemic risks has been a policy priority for the authorities, which have undertaken measures to deleverage state-owned enterprises and imposed more prudent monetary policies.

- Brazil is slowly crawling out of recession. After stronger exports lifted growth back into positive territory in Q1, Q2 brought the first quarter with positive consumption growth after nine consecutive quarters of contracting consumption.

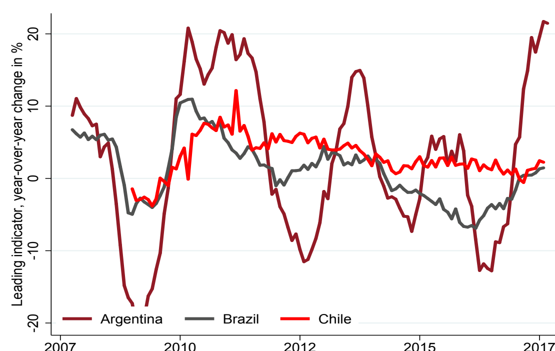
- Leaving aside notorious Venezuela, which would completely distort the picture, other Latin American economies such as Chile, Peru and Argentina, all show signs of firming confidence and improving business prospects.

Growing GDP per capita in China



Source: Thomson Reuters Datastream, MFO

Firming prospects in Latam economies



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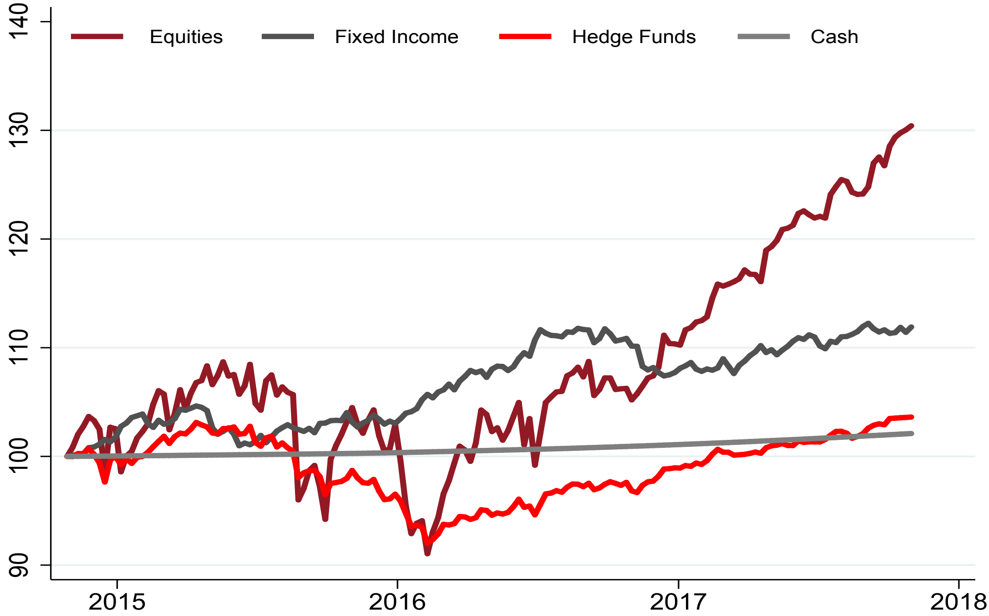
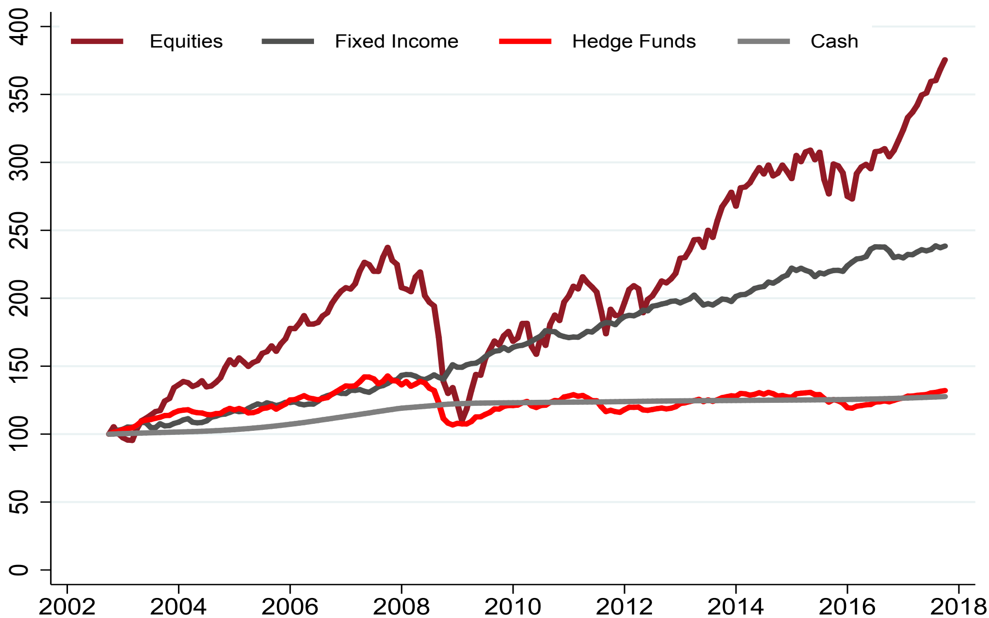
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- The MSCI World equity index was up 18.2 percent in US dollar terms at the end of October, posting very strong returns. European and Asian equity markets measured by MSCI are leading the advance, up 23.4 and 27.0 percent, respectively. The MSCI US index is clearly lagging, up only 16.2 percent. Emerging markets measured by MSCI are still going strong (+32.6 percent), and year-to-date they are outperforming the developed regions.

- Despite the political turmoil after the Catalan referendum, the MSCI Spain index outperformed MSCI Europe year-to-date by a significant margin. However, since the end of August, Spain has been lagging behind Europe, in euro terms. Volatility on European markets, as measured by the Euro Stoxx 50 Volatility index, increased only marginally, remaining at low levels, well below the levels in August, when volatility surged in the wake of increasing tensions between the US and North Korea.

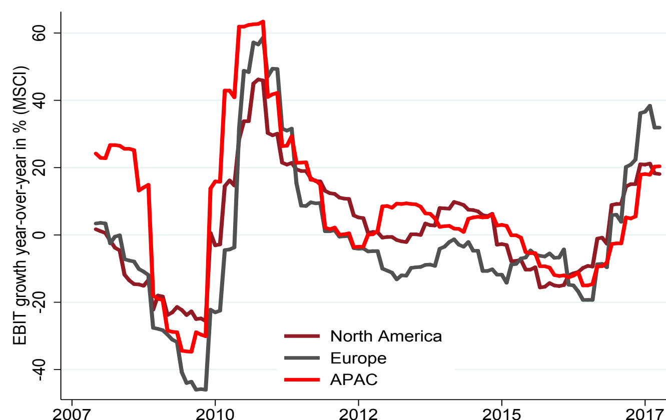
- Growth equities are still clearly leading value stocks, as a comparison between the MSCI World Growth and MSCI World Value indexes shows, with growth being 10.2 percent ahead of value. The race between large caps and small caps is much closer in a global comparison. However, in September and October, there seems to have been a reversal, as value is no longer underperforming growth, and small caps began to outperform large caps.

- The latest macroeconomic data reaffirms our view that the major advanced economies will continue to grow above-trend rates. Against that backdrop, equities remain our preferred asset class and we think they should profit the most in the months ahead.

- However, at the same time, the stretched equities valuations are making us cautious. As we have pointed out in previous issues of MFO Investment Outlook, valuations are rich across the board and apart from a few specific country or sector exposures, it is difficult to find major regions that offer good entry prices. Given the prevailing high valuations, there are many risks that markets regard as low-probability that, were they to materialize, would make equities especially vulnerable to steep setbacks.

- Market indicators such as price trends or market risk measures point to ongoing, strongly positive trends, with moderate to low levels of market risk. In sum, equity market tailwinds still outweigh concerns, making it premature to sound the alarm bell, in our view.

Strong earnings growth in Europe



Source: Bloomberg, MFO

Earnings dynamics of MSCI Europe companies have picked up strongly. Europe currently exhibits the fastest year-over-year EBIT growth rate of the three large global regions.

2.2 Fixed Income

- Global fixed-income markets, as measured by the Barclay's Global Aggregate Bond Index and hedged in USD, reached an all-time high in September, albeit with a year-to-date performance of +2.7 percent that clearly lagged behind equity markets.

- The rollout of the Fed's plan to trim its balance sheet, which began in October, has had no visible impact on bond markets so far. Yields on 10-year US Treasuries showed no clear trend. Looking ahead, we expect only a limited impact from the Fed's balance sheet actions.

- The main two levers steering a fixed-income portfolio are duration and credit. Duration is the weighted average of the times until the bond's cash flows are received. Credit refers to the credit quality of a fixed-income portfolio. This year, taking on additional credit risk compared to that of the benchmark – for example, BBB bonds or high-yield types of investments – paid off, both in absolute and risk-adjusted terms. In contrast, investors who had exposure to longer durations in their bond portfolios were able beat the benchmark as well, but with considerably more volatility.

- Credit spreads are at unattractive levels for investment-grade and high-yield bonds after recent further spread tightening. Assessing the attractiveness of duration risk is more difficult. It depends on the assumed future path of interest rates. If rates fluctuate within the range observed over the past five years, duration risks currently do not look unattractive. But, as we highlighted in the previous issue of *MFO Investment Outlook,* the level and range of long-term rates are unknown, challenging investment professionals, central banks and international financial institutions alike.

- Our fixed income portfolios generally comprise three buckets. Bucket number one is an index type of exposure, which is supposed to hedge equities in adverse market environments. It usually has a quality tilt, and mimics the duration and credit exposure of the market index. Bucket number two comprises active managers who actively adjust their credit and duration positioning, thereby adding additional revenue potential with the aim of beating the index over a complete market cycle. The third bucket comprises what we call "other fixed income." It can generate attractive returns while it usually has a more floating-rate character and, hence, limited duration risk. But it also tends to be less liquid than the other two buckets. It also exhibits the lowest correlation to the aggregate fixed-income market but potentially the highest correlation to equity returns.

Credit trumps duration in 2017

Source: Bloomberg, MFO

Credit has had a good absolute and risk-adjusted run in 2017, whereas longer duration bonds have shown higher market risk.

2.3 Alternatives

Hedge funds, private markets and commodities

- Hedge funds in aggregate delivered returns of almost 5 percent, in US dollar terms, as measured by the HFRX Global Index at the end of October. After a hesitant start to the year, the performance pick-up since mid-August has been remarkable. However, it is noteworthy that the differences in performance between the various hedge fund styles have been considerably larger this year. While strategies that have a short bias – that is, they take short positions to the market – are in deeply negative territory, strategies focusing on emerging markets are up by double digits.

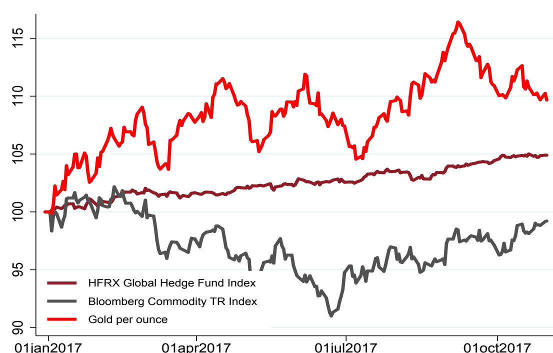
- Commodities, as measured by the Bloomberg Commodity Total Return Index, are flat in US dollar terms for the year. However, the dispersion among the various commodities has again been quite pronounced. While some industrial metals such as aluminum and copper posted very strong year-to-date returns, agricultural commodities have mostly ended up in negative territory. By the end of October they were trading well below their prices at the start of the year. On the back of a depreciating US dollar, gold has risen about 10 percent year-to-date at the end of October, exhibiting large price swings and elevated market risk.

Currencies

- While the British pound appreciated by about 3 percent in both real and trade-weighted terms during September and October, it is still almost 15 percent below its value two years ago. According to our purchasing power parity estimates, the pound remains significantly undervalued against the US dollar, the euro and the Swiss franc. But despite its strong PPP deviations, a speedy recovery for Sterling currently seems unlikely, as the uncertainty regarding the progress and the outcome of the Brexit negotiations continue to weigh heavily on Britain's currency.

- The unwinding of the large currency dislocations that followed the divergent monetary policies of the US and the other major currency areas that began earlier this year has come to a halt since the publication of our previous issue. After a marked depreciation between the start of the year and its low in September, the US dollar has regained some ground. The euro, which had appreciated by about 5 percent in real and trade-weigthed terms year-to-date, started to weaken again after the ECB announced in October that it will stick to its extremely expansionary stance and continue to buy bonds at least until September 2018, albeit at reduced volumes.

Gold recovers



Source: Thomson Reuters Datastream, MFO

Euro not the weakling anymore

Source: Thomson Reuters Datastream, MFO

3. Positioning

- The developments over the previous two months have confirmed our assessment of the investment landscape, which reflects the tension between a broadly favorable economic environment for risk assets and the generally stretched valuations in almost all asset classes. The backdrop for risk assets has even improved a bit lately – especially from a macroeconomic point of view. However, valuations have only become more stretched.

- Business sentiment and consumer confidence, especially in the advanced economies, have further improved from their already high levels, which speaks for an ongoing expansion and a slight increase in economic activity. At the same time, both the gradual monetary policy tightening in the US and the cautious tapering of asset purchases in Europe will in all likelihood persist. In light of the still low interest rates, refinancing conditions for companies remain at attractive levels, while earnings are flowing in strongly. From a macroeconomic perspective, and ignoring for the moment any looming risks, we are clearly living in a "risk assets world."

- Valuations are rich for most major asset classes, but especially in the equity and credit markets, both in the investment-grade and high-yield segments, leaving not much of a cushion in case of negative surprises. By definition, we cannot know from which front an eventual shock will come—from earnings disappointments, central bank actions, misguided policies, political conflicts, or one or several of the many more factors that are suitable candidates to trigger a stark change in sentiment, making risk asset markets vulnerable to setbacks.

- In the prevailing environment, we see equities as more attractive than most fixed-income investments, as they should profit more from the broad, positive global business prospects. Furthermore, equity markets are also presently exhibiting the more favorable market indicator readings.

- In view of all this, fixed-income remains an underweight and less attractive than equities. Classical credit investments in investment-grade and high-yield offer unattractive spreads. However, we still find some value in certain buckets of "alternative fixed income," for example, factoring or specific asset-backed strategies.

- We retain our small strategic gold position as a diversifier and alternative currency in case of substantial unexpected turbulence, which, we note, can occur at any time.

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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