MARCUARD FAMILY OFFICE

Investment Outlook

January 2018

1. Still a risk-assets world

In US dollar terms, the global equity market registered a stellar total return of roughly 22 percent in 2017. While no other asset class – apart from cryptocurrencies – rivaled equities, basically all asset classes have been boosted by two powerful factors: favorable monetary policies, still, and the increasingly synchronized global economic expansion.

Equity markets were not only characterized by remarkable returns in 2017. The sheer absence of market risk was also noteworthy last year. Throughout the year, global markets as a whole never once experienced a drop of 5 percent or more. At the same time, valuations grew ever more stretched in almost all regions and sectors. Indeed, investors would have to venture into some generally spurned market segments – such as the retail sector or some Latin American equity markets – to find reasonable valuations. Does this mean that a sharp correction is due and that we should radically reduce our equity exposure to prepare for a coming bear market? The answer, in our view, clearly is no. The globally synchronized economic expansion, the slow but steady monetary policy turnaround, and widespread double-digit corporate earnings growth continue to support risk-asset markets for the time being. Thus we think calling for an underweight in equities right now would be premature.

However, many of these positive factors are already baked in the cake, so to speak, meaning that the future distribution of equity returns will in all likelihood skew to the downside. In other words, viewed in a historical context, expected returns simply will be lower. We urge investors to be realistic about expected returns, and we also advise them to prepare for higher volatility ahead. We are not arguing for a drastic reduction of exposure based on vague fears. Rather, we advocate a measured equities overweight that is firmly in line with the investor's long-term investment strategy. And while we have always said that the stretched valuations render markets susceptible to sudden setbacks from negative surprises, we would also reiterate that the influence of political events on global asset markets is often overstated or misread and usually amounts to little more than short-term noise. Hence, assuming that the favourable global economic dynamics persist, we would currently regard such setbacks as a buying opportunity.

However, while we can endorse the view that there is nothing to fear but fear itself, ignoring the latent risks in the current environment would be equally foolish. The low-yield environment has pushed many investors to become "yield tourists," sending them far afield from their home turf to dabble in asset classes they would normally avoid – a phenomenon we currently observe in some segments of the credit market. As a consequence, they take on more risk than is compatible with their avowed preferences and liquidity needs. This is a dangerous game, with dire consequences for the yield tourists as soon as markets correct and liquidity dries up. Instead, we think investors simply have to accept the reality that, for a given risk level, expected returns are likely going to be lower than they used to be.

1.1 North America

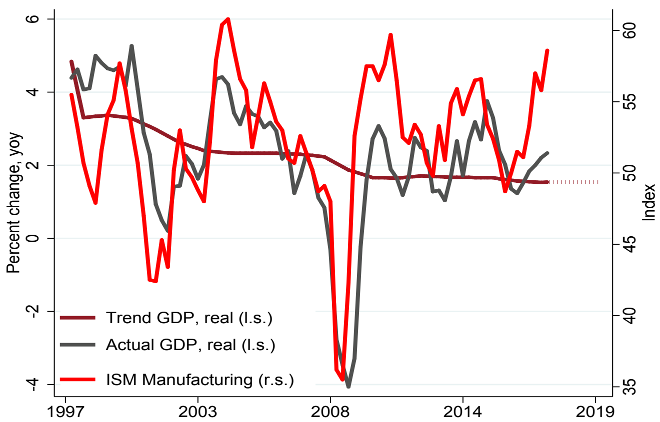
- The US economy expanded by 2.3 percent year-over-year in Q3 after growing 2.2 percent in the previous quarter. This steady pace of expansion masks the shifting impact of some specific growth drivers, however. Mirroring improved business prospects, investment spending increased, expanding by 1.8 percent over the quarter after growing by 1.0 percent in Q2, thereby nearly doubling its contribution to growth. Meanwhile consumption – albeit still the largest contributor to US growth – added a bit less to overall GDP growth in Q3 than it did in Q2.

- The latest data on business activity implies that the US economy entered the fourth quarter of 2017 on a solid footing. Industrial productivity growth further accelerated, up from 2.9 percent year-over-year in October to 3.4 percent in November. Business sentiment surveys suggest that prospects remain favourable in the near term. While the ISM Manufacturing Index retreated from its three-decade high of 60.8 in September, down to 59.7 points in December, it still indicates a solid expansion in the manufacturing sector.

- Given this positive cyclical backdrop, we would point out that the longer-term structural prospects of the US economy look rather less rosy. According to OECD estimates, potential US GDP growth is low, currently estimated at about 1.5 percent, limited by low productivity growth, only modest investment spending and adverse demographic trends.

- What's more, current US policy trends may only make matters worse. To cite one prominent example, the newly enacted Republican tax reforms are procyclical. While the reforms come into force during a cyclical upswing, over the next 10 years they stand to increase the federal deficit by more than a trillion US dollars. As this sum of money somehow has to be offset, it will be hard to mobilize funds for measures that would spur productivity and growth, such as spending on infrastructure or education. In addition, according to most non-partisan analyses, any stimulating effects from the tax reforms will likely be minimal, as they primarily benefit only the very top percentile of earners. In addition, it is doubtful whether the supply-side boost touted by proponents of the reforms – namely that it will encourage investment spending, which, via increased labor productivity, will lead to higher wage growth – will actually materialize. Historical evidence hardly supports this claim. A large cut in the statutory corporate tax rate in the 1980s, from 46 to 34 percent, triggered little if any surge in investment spending.

US economy booming for now



Source: Thomson Reuters Datastream, MFO

Elevated business sentiment supports a continuation of the cyclical recovery in the US for the time being. However, it is doubtful that this pace can be maintained over the longer term, as the current expansion is clearly at a faster rate than implied by the trend growth rate, which is around 1.5% year-over-year, according OECD estimates.

1.2 Europe

- As previously indicated by solid sentiment levels and other metrics, the economy in the Eurozone accelerated again in the third quarter of 2017. Real GDP expanded by 2.6 percent year-over-year after growing by 2.4 percent in the second quarter. Capital spending on machinery and equipment as well as exports also expanded faster over the quarter, whereas the pace of consumption growth and capital formation slowed.

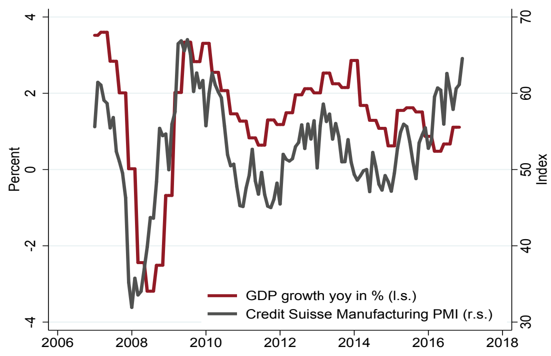
- Meanwhile, entering 2018, business prospects continue to point to high levels of economic activity. On the back of improved production and, in particular, larger export orders, business sentiment as surveyed by the European Commission rose close to its highest level in ten years in November. After marked upticks in November and December, the purchasing managers indexes in the manufacturing sector, as compiled by Markit, climbed to a record high at the end of the year, driven by sharp increases in output, new orders and employment. In December, production and orders rose at their fastest pace since 2000, while job creation was near or at record levels in several of the countries covered by the survey.

- Consumers were no less optimistic. The European Commission's Consumer Confidence Index climbed to a 17-year high in December. The climate for consumers has been brightened by steady improvements in the labor market, which, especially in Spain and Italy, can still be described as slack. Job creation is gaining pace while, at 1.5 percent, yearly consumer price inflation remains muted.

- After the significantly overvalued Swiss franc's marked depreciation against the euro in the second half of 2017, business conditions in Switzerland quickly recovered. The latest data suggests that the Swiss economy, which expanded by 1.1 percent year-over-year in Q3, should grow faster in the coming months, potentially climbing above 2 percent.

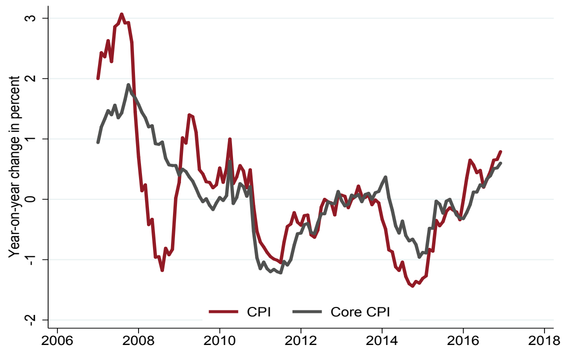
- The acceleration in inflation was no less impressive in Q3. Year-over-year, consumer price inflation in Switzerland rose to 0.8 percent in November. Remember, at its low point in 2015 it was at -1.4 percent and only at zero percent at the end of 2016. Against this backdrop we think the Swiss National Bank, which defines price stability as consumer price inflation of less than 2 percent per annum, could act earlier than most observers expect. It is often assumed that the SNB simply follows the ECB but, given this quick recovery in inflation rates, the SNB, although appearing to act defensively, may well be the cowboy that shoots first.

Swiss economy recovers…



Source: Thomson Reuters Datastream, MFO

...and so does Swiss inflation



Source: Thomson Reuters Datastream, MFO

1.3 Asia and Emerging Economies

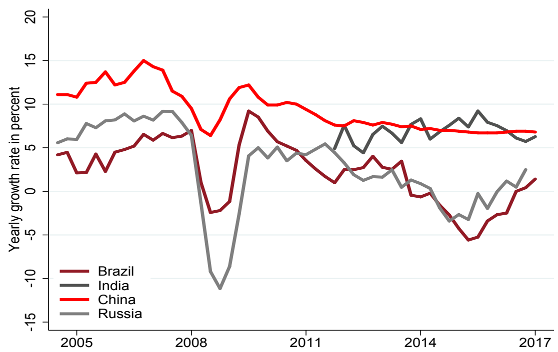
- On the back of the improving global economic prospects and increasing global trade, growth in the emerging markets visibly recovered in 2017. However, as a group, they remain a pretty mixed crowd. The Asian heavyweights, India and China, clearly led the pack of the large emerging economies, with GDP growth rates well above 6 percent year-over-year in Q3. Russia and Brazil, albeit recovering from their recent recessions, are still only growing at sluggish rates of between 1 and 2 percent, lagging behind most advanced economies.

- With the exception of China, purchasing manager indices in the BRIC economies suggest a slight acceleration in manufacturing activity in the near term, whereas the prospects for the more domestically driven services sector generally dimmed slightly in November. China tells a different tale, as November's PMIs indicate a stable and moderate expansion in manufacturing and a slight pickup in the services sector, too.

- Sentiment in global financial markets is clearly positive towards emerging markets currently, given the favourable cyclical backdrop. This was evident in the strong performance of emerging equity markets in 2017. But the economic realities are far from unequivocal. Most emerging economies, while progressing, are still held back by an array of homemade problems, including deficient governance, endemic corruption, weak institutions, a lack of economic diversification, an underdeveloped financial sector, a lack of infrastructure, etc. Russia, Brazil and South Africa all suffer from these problems, which are still rather the norm than the exception in the emerging world. Thus, investors must be selective and do their homework rigorously before wading into these waters. We think relying on specialists with in-depth knowledge of and experience in specific emerging markets remains advisable.

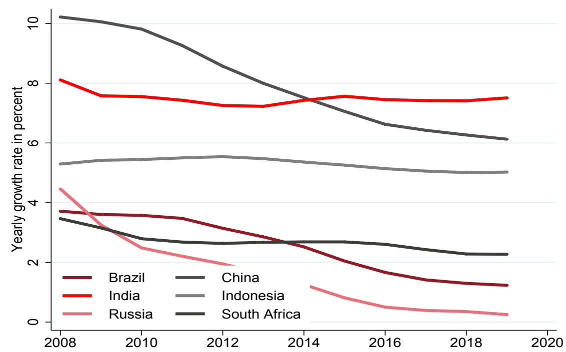
- We note that longer-term growth prospects as indicated by potential output, which measures an economy's productive potential, have declined in most emerging economies, as they have in most advanced economies, too, as shown in the chart below. Russia's potential growth rate is estimated to be even lower than that of most advanced economies, whereas Brazil's is comparable to the growth potential of the US and the Eurozone. It has only remained more or less stable in India and Indonesia. This decline is simply a side effect of economic progress, as the capital stock increases and marginal productivity falls. However, as in most advanced economies, demographic factors also play a role this development, especially in Russia and to a lesser extent in China.

EM economic activity recovers



Source: Thomson Reuters Datastream, MFO

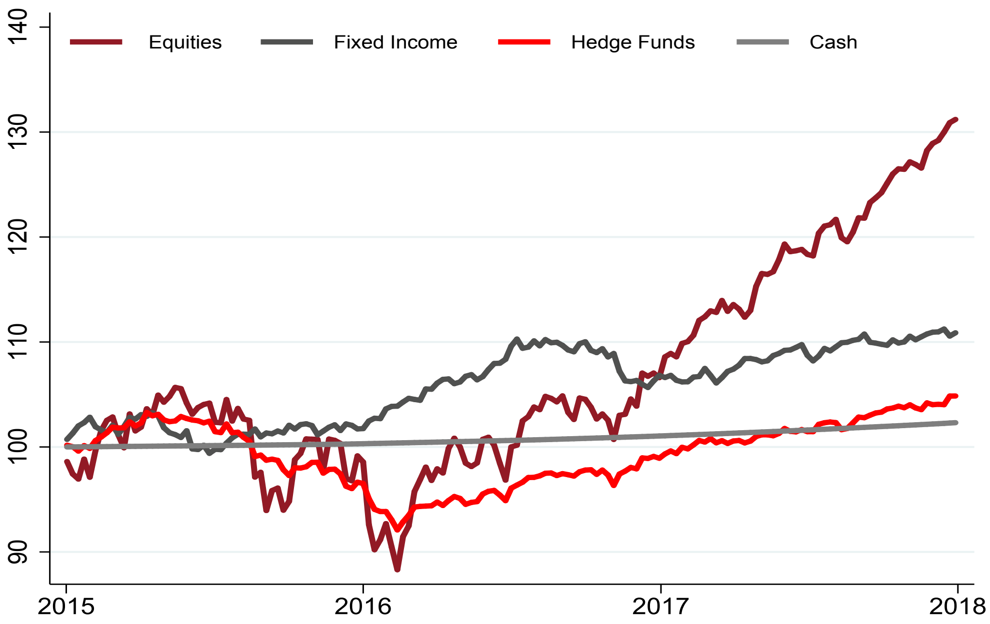
Growth potential declines in most EMs



Source: Thomson Reuters Datastream, MFO

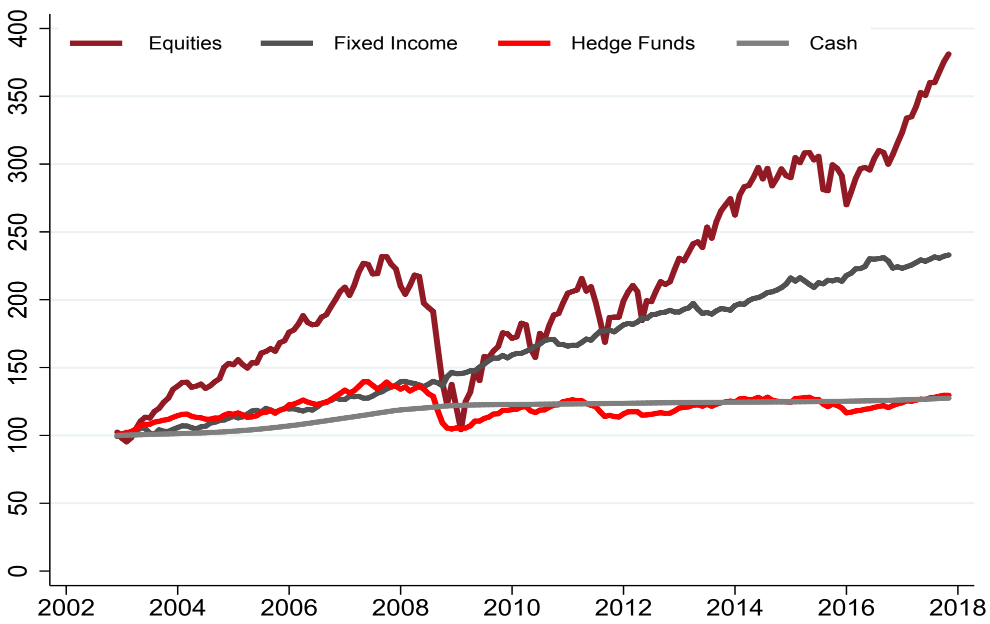
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

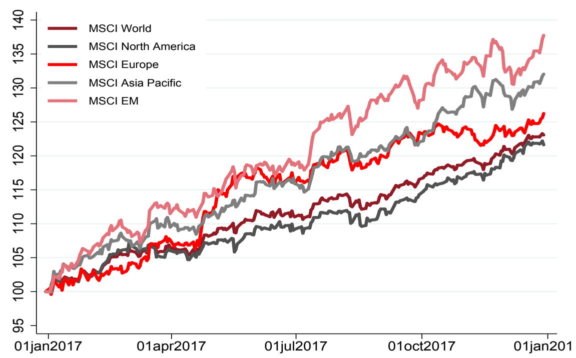
- In 2016, Britain's June decision to leave the EU and then Donald Trump's election victory in November led to increased political uncertainty. Today, political uncertainty remains high. Geopolitical risks such as North Korea's nuclear ambitions and China's aspirations for regional hegemony have added to the anxieties generated by an erratic US administration and the ongoing uncertainty surrounding Brexit. However, global equity markets have seemed largely unimpressed, proving once more that political events – while they surely can have an impact in the short term – are far less relevant for investing than the media might suggest. The MSCI World Index gained an astonishing 22.4 percent in US dollar terms in 2017. The regional leader was Asia Pacific, up 32.1 percent, followed by Europe, up 26.3 percent, and North America, up 21.6 percent in US dollar terms. Even more remarkable than this brisk performance was the utter absence of market risk. Global equity markets did not experience a single 5-percent drawdown during the entire year.

- Where do we go from here? We do not as a rule offer predictions for an entire year. As realists, we adjust our views on an ongoing basis as dynamics evolve over time. Currently the global economy clearly indicates a stance favouring risk assets. The global economic expansion is broad-based and is taking place at a rate that exceeds longer-term trend growth rates.

- In addition, equity market trends are still strong—in some cases even at extreme levels, which can hint at some near-term correction potential. At the same time, market risk across the board remains at very low levels. But as we have underlined several times in this report, valuations are rich and there is no single region or sector that offers truly attractive returns. From a valuation perspective there do remain some pockets of opportunity within a few emerging markets, for example, in Latin America or in unloved sectors such as retail, but they come with significant risks. Nonetheless, while the stretched valuations do not automatically imply a coming bear market or even a sharp market correction, they do clearly limit long-term return prospects. In other words, the high valuations tell us that for the next five to ten years expected equity market returns will by rather low by historical standards, though not necessarily negative.

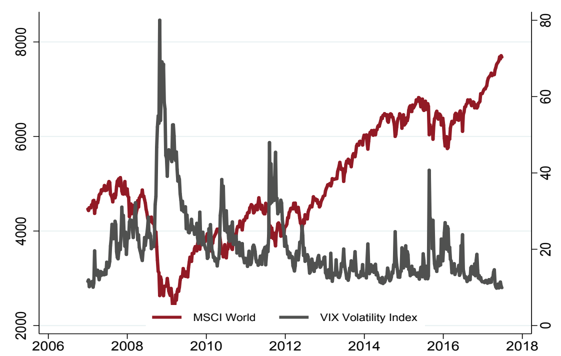
- Taken altogether, given the strong economic environment and stable market conditions, equities are still the preferred asset class, although valuations are at distinctly expensive levels.

Strong performance in all markets…



Source: Thomson Reuters Datastream, MFO

…while market risk is low



Source: Thomson Reuters Datastream, MFO

2.2 Fixed Income

- While "fixed income is dead" was often proclaimed in 2017, this was not the case on an index level. Hedged in US dollars, the Barclay's Global Aggregated Bond Index advanced a solid 3.0 percent in 2017. The Barclays Global High Yield Index gained more than 8 percent in US dollar terms. Credit in general had a very good year, too, with the result that spreads – the compensation for associated risks – have narrowed. And even long-dated bonds managed to deliver a sound return of 5.2 percent, as measured by the Barclay's Global 10+ Index.

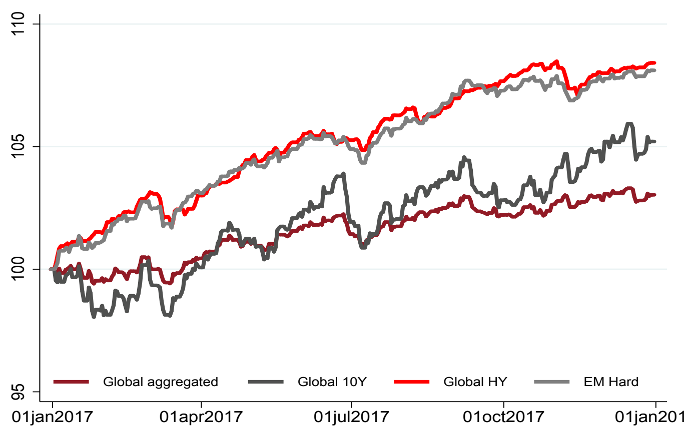
- Thus, the long-promised bloodbath in bond markets—precipitated rapidly rising capital market interest rates—has thus far not materialized. However, bonds that do not come with the respective credit and duration risks—that is, short-term bonds with an investment-grade rating—often do not compensate for inflation, resulting in a loss of purchasing power in real terms. In these less risky segments of the bond market, there was rather a slow, steady seepage than a sudden hemorrhage in the form of rapidly rising nominal yields.

- What's more, across all major fixed-income sub-asset classes, the spreads—the yields above those of government bonds—are unattractive by historical standards. In other words, valuations are expensive. Credit is now probably as expensive as equity investments. On top of that, the macroeconomic backdrop currently supports risk-asset classes more than fixed income.

- The longer these conditions prevail, the more we see so-called "yield tourists," investors who violate their risk budgets as they venture into ever more risky segments of fixed income, into areas where they had never been active before, purely in pursuit of yield. In trader slang, "BB is the new IG," meaning that bonds rated below investment grade (BB) are now considered investment grade (IG), which is certainly not the case from a risk-return perspective. Moreover, yield tourists further contribute to yield compression in the asset classes they "visit" by altering the supply and demand balance, pushing other investors into even riskier buckets of fixed-income products in an attempt to avoid the lower yields.

- We are convinced that it is dangerous for investors to acquire riskier assets just for the sake of additional yield. Low return expectations are a reality today; they are not a reason to alter one's risk profile. MFO is neither a yield tourist itself nor an organizer of yield-seeking expeditions.

Fixed-income: positive across the board



Source: Bloomberg, MFO

The higher the risk, the higher the return, be it high-yield, long-dated or hard-currency emerging market bonds. The riskier segments of the bond market clearly outperformed the aggregate market.

2.3 Alternatives

Hedge funds, private markets and commodities

- Compensating for a disappointing 2016, hedge funds posted decent returns of about 6 percent in US dollar terms in 2017, as measured by the HFRX GL Index. Given the remarkable absence of market risk in 2017, strategies with a high market-risk exposure such as emerging markets-focused hedge funds did very well while short-selling strategies posted losses.

- Apart from volatility, commodities, as measured by the Bloomberg Commodity Total Return Index in US dollars, delivered little in the way of returns. The Index ended the year with a total performance of 1.6 percent in 2017. The return dispersion between the different commodities was large.

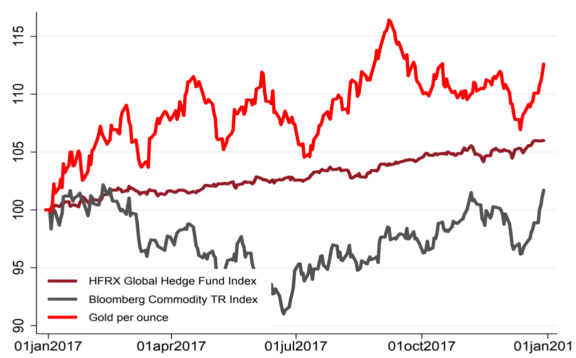
- According to Preqin, the third quarter of 2017 saw a slowdown in private equity fundraising. That said, fundraising remains at a very high level. Investors seem eager to re-deploy capital that has been returned by PE funds in recent quarters. The concentration trend continued, with the largest five funds securing almost half of the total capital raised. Deal activity slowed only moderately compared to a year earlier and remained at the level of the second quarter in value terms, roughly matching the level of fundraising and therefore not increasing the level of dry powder further. Buyout exit activity meanwhile fell for a fifth consecutive quarter. Sources of concern include the high valuations and in particular the increasing leverage levels. In the US middle market a record 52 percent of all buyout financing in 2017 was leveraged at six times cash flow or more, according to Thomson Reuters LPC.

Currencies

- In 2017, the large divergences between overvalued currencies like the US dollar and the Swiss franc and some undervalued counterparts like the euro and the yen finally started to unwind, at least partially. The euro clearly appreciated, rising by almost 7 percent in trade-weighted terms, while the US dollar depreciated by roughly 6 and the Swiss franc fell by around 4 percent.

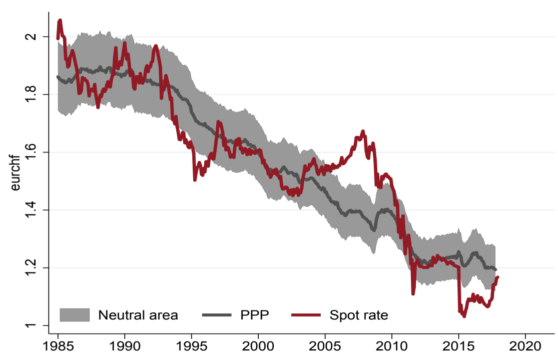
- With that shift, the strong overvaluation of the franc versus the euro in purchasing power parity terms has practically disappeared, whereas the overvaluation of the US dollar against the euro has become markedly less significant. At the same time, the British pound and the Japanese yen have remained cheap in a historical comparison, offering some recovery potential over the long haul.

Hedge funds with solid performance



Source: Thomson Reuters Datastream, MFO

Swiss franc no longer overvalued



Source: Thomson Reuters Datastream, MFO

3. Positioning

- Our earlier assessment that the current economic expansion is broadly based across regions and sectors has been confirmed over the course of the past two months. Recent data from both businesses and consumers further supports an economic expansion above trend growth rates.

- Hence, from an economic perspective, we are still clearly in a risk-assets world. Although stock market valuations remain quite rich, this does not necessarily mean that a sharp market correction is inevitable. But the high valuations do indicate that return expectations should be lower than in the recent past, speaking for some caution when allocating funds to equities. At the same time, shares still exhibit promising up-trends along with remarkably low market risk. As some trends are quite stretched now, shorter-term corrections seem likely and – assuming that the economic backdrop remains so favourable – these dips should not be be viewed as the start of a secular bear market. In sum, then, we still overweight equities, preferring Europe and Asia to North America.

- Fixed-income assets are not attractive given the current macroeconomic environment. Furthermore, spreads now offer inadequate compensation for the accompanying duration and credit risks, both in a historical comparison and in comparison with equities. Therefore, we still underweight fixed-income assets. Within fixed income, we maintain a duration exposure shorter than that of the index and we are more active on the credit side. However, we are in the process of shifting away from classical credit exposure, which is particularly unattractive from a valuation point of view, to asset classes with more floating-rate characteristics or to those which can explicitly hedge traditional credit.

- Looking at implied volatility and other measures of market risk, it would seem that markets have entered a risk-free zone. But history offers many examples of how market risk can quickly and unpredictably surge. We therefore maintain our gold position as the ultimate hedge against such sudden turbulence.

- In a market environment that seems almost too healthy, we advocate some simple guidelines: stick to your established strategy, resist the temptation to become a "yield tourist," do not alter your risk profile for yield's sake, and remain well diversified. Yield expectations need to be lowered to realistic levels. Chasing 2017's levels of return will, in all likelihood, lead to disappointments. Finally, while political events may roil the news media, they are ultimately of secondary importance for asset allocation.

Positioning overview

	Equities				Fixed Income		Alternatives			Liquidity
	North-America	Europe	Asia-Pacific	Emerging Markets	Duration	Credit	Hedge Funds	Commodities	Precious Metals	
Macro	↗	↗	↗	→	↘	↗	→	→	→	→
Market	↗	↗	↗	↗	→	↗	↗	→	→	→
Valuation	↓	↘	↘	↓	→	↘				
Sentiment	→	↗	→	→	↘	→	↘	↘	→	
Aggregate	→	↗	→	→	→	→	→	→	→	→

Source: MFO

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Published by:	Marcuard Family Office Ltd.
Editors:	Nadja Bleuler, n.bleuler@mfo.ch
	Frank Häusler, f.haeusler@mfo.ch
	Thomas Gnägi, t.gnaegi@mfo.ch
Editorial deadline:	3 January 2018

The *Marcuard Family Office Investment Outlook* is published every second month. The next *Investment Outlook* will be published in March.

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