MARCUARD FAMILY OFFICE

Investment Outlook

March 2018

1. Volatility redux

At the end of January and the beginning of February, after a year or more of remarkable placidity, volatility suddenly returned to equity markets. Does this mark the start of the next equity bear market? We think not.

The decline of roughly 10% in global equity markets was apparently triggered by US labor market data that came in better than expected. This drove inflation expectations upward, in turn pushing bond yields higher, to levels not seen since 2013. Since the inflated valuations in all asset classes are driven – not only, but certainly to a large extent – by the extremely low interest rates that have prevailed since the global financial crisis a decade ago, the reversal of that situation in the form of rising yields is taking some air out of inflated asset values generally, also those of equities.

But equity valuations are not only driven by developments of the discount rate. They also depend on future income streams and their outlook still remains positive as the global economy continues to show strength. Higher inflation expectations and thus higher yields should be seen in that context. Therefore, rising yields should not be interpreted merely as a negative for equity markets, since they accompany a broadly improved economic outlook.

Indeed, the today's low interest rates come with their own problems. While they can dampen the effects of a downturn and fuel demand via investment spending, interest rates that are too low for too long eventually lead to the misallocation of capital, which depresses productivity over the long term and fosters asset bubbles and, ultimately, painful and costly financial crises. This is a risk major advanced economies face as their central banks tenaciously cling to policies focused on consumer price inflation while largely ignoring asset price inflation. We think that against this backdrop normalizing interest rates in a strong cyclical environment can simply be seen as a healthy adjustment.

Thus, as long as the economic environment remains solid and market trends continue to be positive, we see no reason to call for a sharp underweight in equities, at least not yet. Instead, for the time being, we would use corrections to rebalance equity allocations cheaply, moving them back to their target levels. We emphasize, however, that investment discipline must also be maintained on the way up, as the stretched valuations inherently bear an elevated vulnerability to market setbacks.

Today's high valuations are depressing the potential future returns for equities and basically all other financial assets, despite the positive cyclical backdrop. Let's recall the beginning of 2017, when most pundits were focused on political risks such as the French elections or the potential policies blunders of the new US administration, instead of noting the improving global macroeconomic fundamentals. Hence, the potential for surprises back then was largely on the upside. Now, the situation is reversed. Even the darkest pessimists acknowledge that the major economies are enjoying a broad-based, synchronized expansion. Consequently, the potential for surprises now seems largely on the downside, paving the way for higher market volatility.

It is never advisable to prematurely adopt directional positions against the market. However, we can prepare for higher volatility by staying well diversified and maintaining strict investment discipline. And we would gradually adjust the exposure and eventually enter an underweight of risk assets should business prospects worsen or market trends turn. However, that moment has not yet come, in our view. In addition, investors should also track the development of bond yields and get used to the idea that at some point their bond underweight might no longer be warranted. While the future path and distribution of interest rates is highly uncertain, the more yields increase, the more attractive bonds become versus their more volatile counterparts, such as equities and high-yield bonds.

1.1 North America

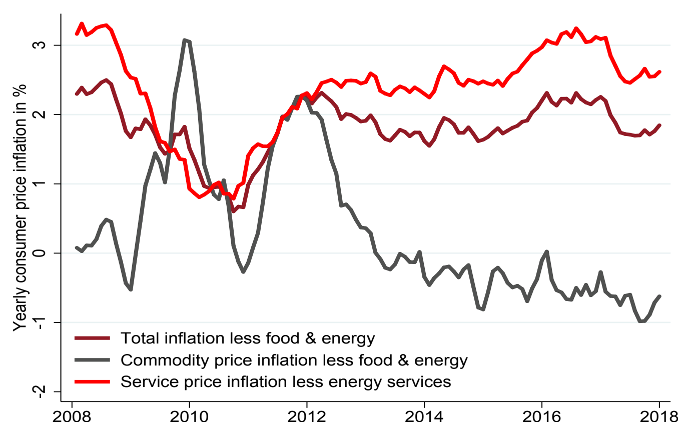
- Two months into the new year, US business sentiment remains at the solid levels seen at the end of 2017. The upbeat business outlook has also been increasingly evident in actual economic activity. Industrial production growth more than doubled throughout 2017, rising from 0.8% year-over-year at the end of 2016 to 3.4% at the end of 2017. And in January, it accelerated further, up to 3.8% year-over-year. Due to statistical issues, first-quarter economic growth in the US is usually disappointing but we think that the short-term outlook remains healthy, suggesting that the economic expansion is likely to maintain its current pace. Against this backdrop, we expect a further pick-up in business investments, supporting labor productivity and, eventually, wage growth, as well as overall GDP growth.

- The global upswing and the weaker US dollar were both evident in increased external trade, despite fears that exports might be undercut by threatened protectionist measures from the Trump administration. Indeed, while the yearly growth rates of both exports and imports have visibly increased in recent months, export growth, which rose from 0.6 to 4.9% year-over-year, exceeded that of import growth, which moved up from 2.7 to 4.6% year-over-year over the course of 2017.

- At the same time, the increased economic activity has not been reflected in higher consumer price inflation. Year-over-year in January, both the core rate, at 1.8%, and the headline rate, at 2.1%, have remained relatively constant in recent months. At the same time, benefitting from healthy labor market conditions, the growth of hourly wages picked up slightly in January, from 2.7 to 2.9% year-over-year, resulting in positive growth for real wages. In addition, according various metrics, consumer confidence improved further, surpassing pre-financial crisis levels. In sum, the environment in the US for consumption is also supportive.

- US economic activity should benefit from tailwinds coming from several sources over the course of the next few months. However, various longer-term risks are looming. First, the newly enacted procyclical tax cuts will probably increase deficits and debt levels at a time when the economy is booming, which will limit fiscal leeway in the event of a downturn. Second, despite the monetary policy turnaround, real interest rates are still very low, fuelling the risk of asset price bubbles and the misallocation of capital.

Uneven inflation developments in the US



Source: Thomson Reuters Datastream, MFO

Stable overall inflation rates mask the uneven developments in various sectors that lie behind these aggregate rates. While price inflation for consumer goods, contained by global competition, has clearly remained in negative territory, service price inflation that is mainly driven by domestic factors is clearly above the critical 2% level.

1.2 Europe

- After several business climate indicators set new highs in December, they retreated slightly or merely stabilized at high levels in January. This suggests that the current relatively rapid expansion of the Eurozone economy should continue at a similar pace in the coming months. With GDP growth of 2.7% year-over-year in the fourth quarter of 2017, the Eurozone grew faster than the US, Japan and the UK.

- Real economic activity is increasingly reflecting the elevated levels of business sentiment, suggesting an increase in business investments in the months ahead. Throughout 2017 and into 2018, capacity utilization across the Eurozone continued to rise. With a level of 84.4% so far in the first quarter of 2018, it is close to its high of 85.1%, recorded in 2007. Industrial production growth also accelerated visibly over the course of 2017, climbing to 5.2% year-over-year in December, up from 3.7% in November.

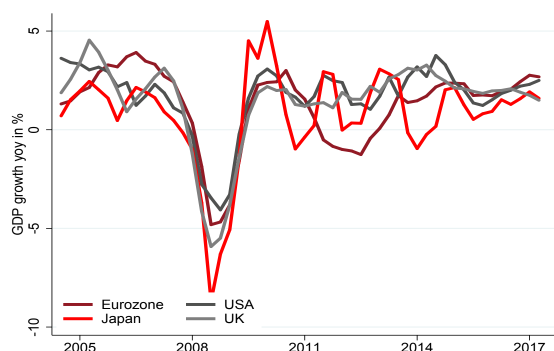
- Consumers have grown increasingly optimistic, too. Ongoing improvements in the labor market in the form of increasing vacancies and falling unemployment also contribute to an optimistic consumption outlook for Europe.

- In addition, external trade has benefitted from improved global demand. Exports from the Eurozone grew by roughly 8% year-over-year in December. It is often claimed that the currency's recent appreciation will tend to curb the Eurozone's growth prospects in the coming months. However, according our analysis, the sensitivity of the Eurozone's economic growth to exchange rate movements appears to be rather limited.

- Despite the recent economic acceleration, inflation in the Eurozone as a whole has remained muted, with core inflation reaching only 1.0% year-over-year in February. While this modest rate applies to most member states, core inflation in Germany, at 1.5% year-over-year, was notably higher. With this as a backdrop, the ECB is continuing its expansionary monetary policy, which is characterized by negative interest rates and ongoing – if smaller – asset purchases of EUR 30 billion per month.

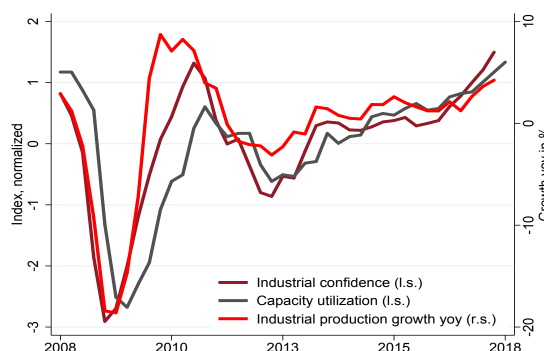
- In contrast, economic growth in the UK has continued to slow. GDP growth fell to 1.5% year-over-year in the fourth quarter of 2017 as Brexit continued to generate considerable economic uncertainty. However, given Britain's commitment to a default option in the absence of a deal while ruling out a hard border within Ireland, we think the UK will in all likelihood remain within the EU's Market and Customs Union.

The Eurozone beats its peers



Source: Thomson Reuters Datastream, MFO

Eurozone economic activity recovers



Source: Thomson Reuters Datastream, MFO

1.3 Asia and Emerging Economies

- While the cyclical prospects of the largest emerging economies seem more muted than those of the big advanced economies, they remained largely stable at the start of 2018, as measured by various business sentiment indicators. Compared to a year ago, business prospects in India and Brazil have improved markedly. Brazil has finally climbed out from its steep recession and Indian businesses are regaining the confidence that was shattered in the wake of an unsettling tax reform and a demonetization imitative. In Russia and China, economic prospects remained stable.

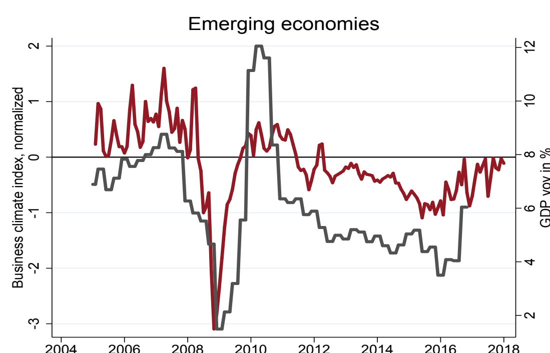
- From this perspective, and in view of the robust demand in advanced economies, downside risk in the BRIC economies currently seems limited over the short term. That said, signs pointing to strongly improving growth dynamics in the months ahead are also absent. Hence, the currently positive investor sentiment towards emerging markets seems more related to a weaker US dollar and the generally positive investor sentiment than to any strongly improving EM fundamentals.

- Japan's economic dynamics cooled slightly in the final quarter of 2017 but the economy still posted a solid 1.5% GDP growth rate year-over-year, well above the Bank of Japan's trend growth estimate of 0.5%. Various business surveys at the end of 2017 and the beginning of 2018 again offered encouraging signs, especially for the manufacturing sector, indicating a further increase in activity in the near term.

- At the same time, Japan's labor market has tightened. Vacancies have increased, the unemployment rate has held steady at a low 2.8%, and an increasing labor market participation rate helped real wages rise by 0.6% year-over-year in December. In this environment, it is not surprising that consumers grew more optimistic over the course of 2017 and into January of this year, implying a positive outlook for consumption.

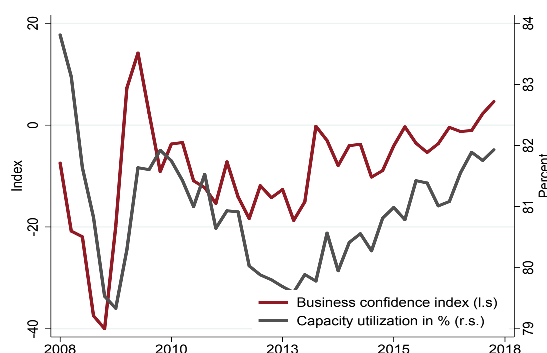
- Australia, the other large advanced Asian economy after Japan and South Korea, is also enjoying improving economic fundamentals. Business confidence resumed its uptrend towards the end of 2017 and has continued to improve in 2018. This has coincided with a rise in economic activity, as shown by the increasing capacity utilization in December and January. With that backdrop, the economic expansion, which accelerated markedly in Q3 of 2017, should see a further pickup in Q4, with more of the same expected in the current quarter.

EM business climate at average levels



Source: Thomson Reuters Datastream, MFO

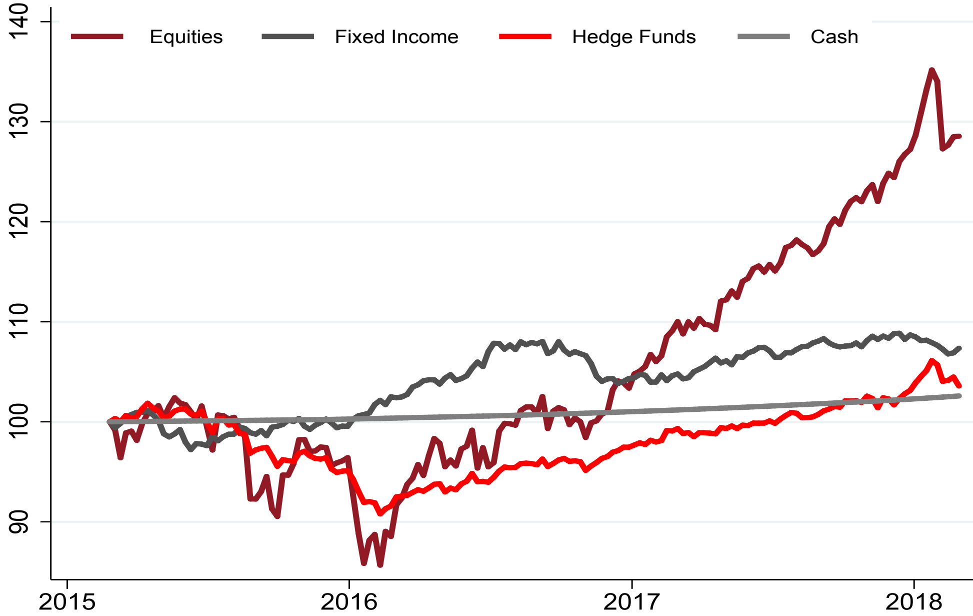
Improving prospects in Australia



Source: Thomson Reuters Datastream, MFO

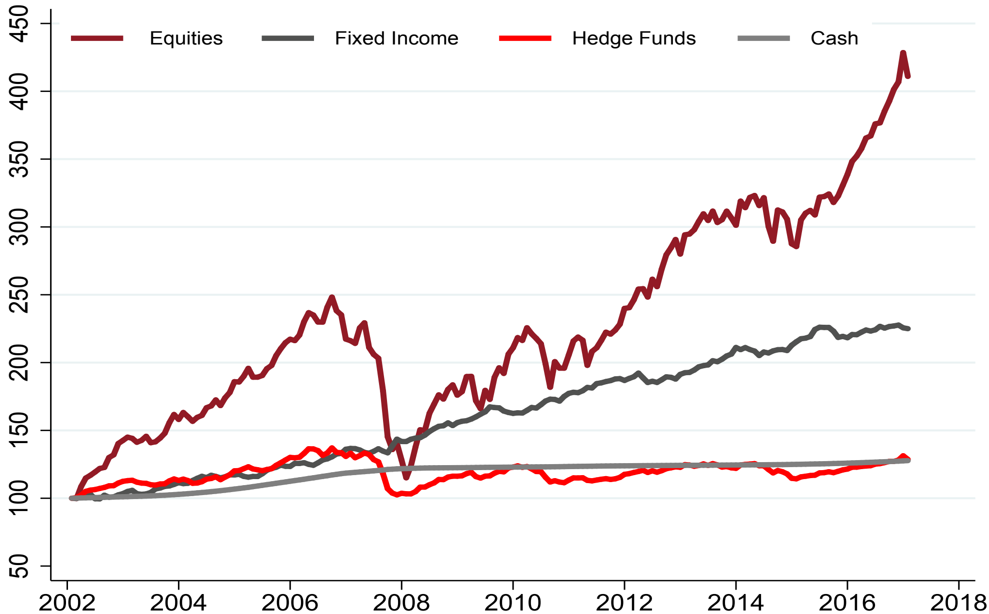
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- Beginning in February 2016, equity markets embarked on a steady upward trajectory without any notable corrections. This unusually calm period ended abruptly in January with the MSCI World Index declining by almost 10% in US dollar terms, yielding a year-to-date performance of 0.9% by the end of February. While this loss in value sparked some nervousness among market participants, corrections of this magnitude are quite normal. In fact, the extended period of calm before the correction was the true anomaly, in our view.

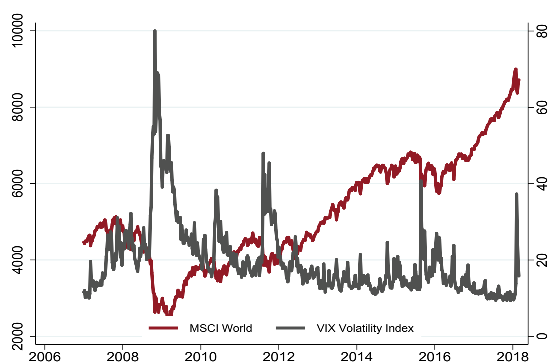
- In February, for the first time since 2015, the VIX, an index measuring expected equity market volatility, moved up significantly. It reached its second highest level in five years, although below the levels seen in 2008 and 2011. The VIX, we note, is now in the process of normalizing again.

- So, what was the likely cause for this market turbulence? We agree with the general interpretation that, after better than expected US labor market data, market participants started to factor in higher inflation, which in turn translated into higher yields that challenge the current high equity valuations. As discounted cash flow models show a lower net present value with higher rates than with lower rates, future cash flows are worth less when interest rates are higher. Furthermore, some investors might have taken profits after the heady performance of 2017 and the strong start to the new year, adding yet more selling pressure.

- However, bull markets do not simply die of old age, nor do they succumb to high valuations alone. Their demise usually requires a recession or some other shock to trigger a true bear market. We note that the current economic environment is still supportive for equity markets, given the broad global economic expansion. Thus, higher inflation expectations can simply be seen as a reflection of this healthy state of affairs. Yes, valuations were and are at high levels, dampening future return expectations and suggesting a degree of vulnerability, but they alone are not a sufficient trigger for a bear market, in our view.Furthermore, technical indicators such as medium-term trend signals still are in moderately positive territory, while risk indicators briefly moved higher but are once again retreating.

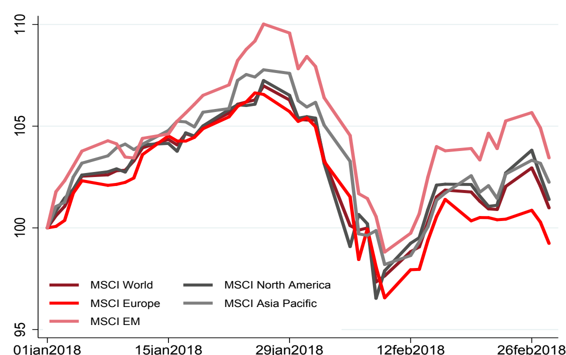
- To sum up, we still cautiously overweight equities against fixed-income assets, maintaining a broad diversification and rebalancing our equity position whenever the opportunity presents itself—both on the way up and on the way down.

VIX volatility index spikes



Source: Thomson Reuters Datastream, MFO

…and equities take a hit



Source: Thomson Reuters Datastream, MFO

2.2 Fixed Income

- Year-to-date, as measured by the Barclay's Global Aggregate Bond Index hedged in US dollars, fixed-income markets posted a loss of 0.9% by the end of February. Although rates are rising and the index is retreating from all-time highs, it is too early to speak about a bond bear market. Corrections of the current magnitude have been seen several times over the past decade.

- Comparing fixed-income segments that are duration-sensitive – for example, the Barclay's 10+ Years Bond Index hedged in US dollars – with indices whose performance are driven by credit risk – for example, the Credit Suisse Leveraged Loan Index – shows that the market operates under a regime of higher interest rates but not under one of higher credit risk, with its elevated default probabilities in the near to medium term. While the former has recorded a year-to-date loss of 1.7% in US dollar terms, the latter is up 1.3%.

- This observation is further underpinned by the yield of US 10-year Treasuries, which almost reached a five-year high in February, getting close to the 3% mark last seen in late 2013. At the same time, credit spreads of global high-yield and BBB indices remained at very low levels, showing no signs of a meaningful upward move, which is in sharp contrast to the spike in equity volatility recorded by the VIX Index.

- The currently positive economic backdrop still favors risk assets like equities over fixed-income assets, in our view. Furthermore, valuations for the most part still remain rich, especially in certain segments of the credit markets, making it difficult to find attractive long-term investments in the fixed-income space generally.

- Technical indicators are mostly in neutral territory for fixed-income. While trends are also mostly neutral, risk in the duration-sensitive sub-segments of the market has been rising.

- Given this backdrop, we maintain our general underweight in fixed-income versus equities as an asset class. Within the fixed-income bucket, we prefer the less interest-rate sensitive segments, where we accept slightly less liquidity and some structuring risk but where also can reduce classical duration risk. However, we stress that these are markets for specialists, and we therefore work with highly skilled external managers in the respective sectors.

High yield spreads did hardly move

Source: Bloomberg, MFO

The higher the spread, the higher the default probability. Currently, there are hardly any signs of stress in the high-yield markets.

2.3 Alternatives

Hedge funds, private markets and commodities

- Over the past two months hedge funds again showed that they tend to co-move – that is, have a positive beta – with equity markets, also during corrections, albeit with a smaller magnitude. Following the setback in global equity markets, the HFRX GL Index terms posted a year-to-date performance of approximately 0% in US dollars by the end of February. Again, the dispersion was very large after only two months. While event driven strategies are in negative territory emerging market related strateties are up for the year.

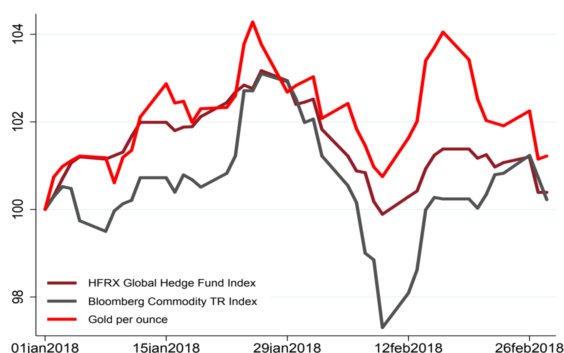
- 2017 turned out to be a year of records for private equity. According to Preqin data, deal activity in buyouts reached a new post-crisis record, with nearly 4200 private equity-backed buyouts announced or completed in 2017. And in terms of fundraising, 921 private equity funds reached a final close, securing just over USD 453bn, the largest amount of capital ever raised in a year. These record numbers, however, should not obscure the fact that the investment environment for private equity fund managers is ever more challenging. Purchase price multiples have continued to increase. In a recent Preqin survey of private equity fund managers, 30% reported that they are finding it more difficult to find attractive investment opportunities, and 36% reported that they are reducing target returns for their funds due to current valuations.

Currencies

- Starting 2018, most currencies continued to unwind their previous significant over- or undervaluations that stemmed from the "great monetary policy divergence" between the US and the rest of the world, a process that began in the second half of 2017. Hence, the USD resumed its downward trend, depreciating by 1.6% on a trade-weighted basis, while the EUR, which appreciated markedly in 2017, has merely broken even this year. The GBP, which still trades below its pre-Brexit value, also recovered somewhat, appreciating by 1.8% on a trade-weighted basis. However, the JPY accomplished the most remarkable move, appreciating by roughly 3.3% on a trade-weighted basis in two months.

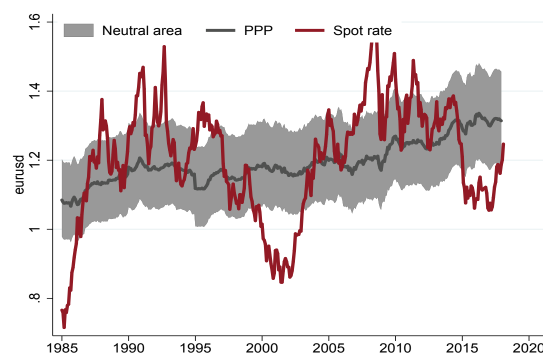
- After these shifts, our earlier conviction that the US dollar and the Swiss franc are overvalued against the euro has faded. Only the pound and the yen are still relatively cheap versus other major currencies from a purchasing power parity perspective.

Alternatives also suffer a setback



Source: Thomson Reuters Datastream, MFO

USD overvaluation no longer significant



Source: Thomson Reuters Datastream, MFO

3. Positioning

- Despite the recent equity market drawdown of almost 10% in US dollar terms, our positive assessment of the economic state of the world remains in place. Recent sentiment data from both businesses and consumers continues to support above-trend economic expansion in the major economies. The higher interest rates and associated higher inflation expectations are, in our view, just a natural reflection of that expansion.

- Thus, from a business cycle perspective, we are still in a risk assets world. Bull markets usually do not die of old age, nor simply because valuations are high. Despite the recent correction, valuations are still quite rich across the equity spectrum, apart from niche segments, depressing future returns. But this does not ordain an imminent bear market. At the same time, technical indicators, especially medium-term trend signals, still point to a further expansion of the equity bull market, albeit at a slower pace. In contrast, risk indicators appear to have spiked and are now retreating to lower levels. Hence, we are employing a slightly more cautious overweight in equity markets, with a slight tilt towards Europe and Asia and away from the US.

- At the same time, fixed-income assets remain unattractive. The economic developments reflected in the booming major economies are not supporting fixed-income assets, since higher inflation expectations put direct pressure on yields. However, as yields move higher, fixed-income assets will become increasingly attractive relative to equities. While we currently still see more upward than downward pressure on yields, and therefore maintain a shorter duration than that of the relevant index, we are monitoring the situation closely in order not to miss the point when it again becomes worthwile to take on duration risk. As we do not yet operate under a scenario of elevated default rates, we are still willing to be active in specific fixed-income segments associated with credit risk, especially in the extended credit space, such as loans, asset-backed securities or factoring, to name a few. These kinds of instruments better compensate credit risk than traditional corporate investment-grade or high-yield exposure, in our view.

- To sum up, with depressed return expectations and revived volatility, but without any fundamental changes in the healthy economic and the market environment, maintaining investment discipline is all the more vital. Methodical diversification and rigorous rebalancing, both on the way up and on the way down, remain vital to investment success, in our view.

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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