MARCUARD FAMILY OFFICE

Investment Outlook

May 2018

At a crossroads or just a speed bump?

2017 was a year with stellar equity performance and low market volatility. But this year there is evidence that the tide may have turned. The soaring valuations and optimistic expectations of recent years made risk assets vulnerable to negative surprises and rising interest rates, paving the way for the recent surge in volatility.

Volatility is not the only new factor newly evident in equity markets; the global economic picture has also changed. Last year saw steadily improving dynamics across the board. Business sentiment surveys and economic activity indicators routinely signaled accelerating economic expansion as the year progressed. But so far this year, that cheery outlook seems to have faded – at least for the time being. While the majority of indicators are still at high levels – signaling a robust economic expansion, faster than trend – business sentiment has notably cooled this year in most economies, implying that the pace of economic expansion will soon slacken. This growth slowdown, evident across most major economies, is most visible in the Eurozone and the UK and less so in the US and Japan. The slackening pace of growth is also visible across sectors. According to the IHS Markit Global Sector PMI, the readings for all eight broad sectors plainly cooled between February and March. All still signal expansion, but at a slower pace. Interestingly, the technology sector posted the second-weakest reading, with only consumer goods weaker. This contrasts sharply with the skyrocketing performance of tech stocks, which by far outpaced all other sectors over the past twelve months. For investors, we think this gap between the tech sector's outlook and its share prices merits some caution.

But does all this mean that we have reached the inflection point of the current cycle? We see no clearcut answer to that question at present. Vexingly, the current situation accommodates several causal notions. On the one hand, it could be interpreted as a consequence of weaker demand because cautious companies are postponing investments, purchases and new hires, responding to the elevated uncertainty produced by the Trump administration's disruptive views on global trade. Or it can be seen as the consequence of increasing supply-side pressures as companies, after an extended period of increasing production, now face rising input prices, longer delivery times and growing backlogs of work. The recent PMI subindicators that measure such factors have indeed provided evidence that supply-side pressures are on the rise. Assuming these pressures persist, we should see rising business investment, further adding to growth and long-term productive potential. Or, as Pimco bluntly phrased it in its cyclical outlook from March, "The global expansion is either nearing its demand-driven peak or in the early stages of a supply-driven renaissance."

Both notions may have merit; nor, we note, are they mutually exclusive. In our view, it seems premature to take sides. For one thing, we would need to see more data to confirm concerns about a real cyclical reversal. But whatever the verdict, the conflicting views themselves only underscore that uncertainty has increased, adding to the vulnerability of risk assets that already arises from their stretched valuations – especially as markets focus on dynamics and not merely on sentiment levels. However, in the light of the still positive, if weaker, market trends, the solid economic growth rates, and the slightly less expensive valuations lately, we remain cautiously optimistic on risk assets, although we admit that our conviction has waned recently as the economic data has cooled. This once again underlines our view that in the current environment investors should avoid large tactical deviations from their long-term investment strategy. That said, we think investors should frequently rebalance their portfolios, returning them to the target allocations, especially after strong market movements.

1.1 North America

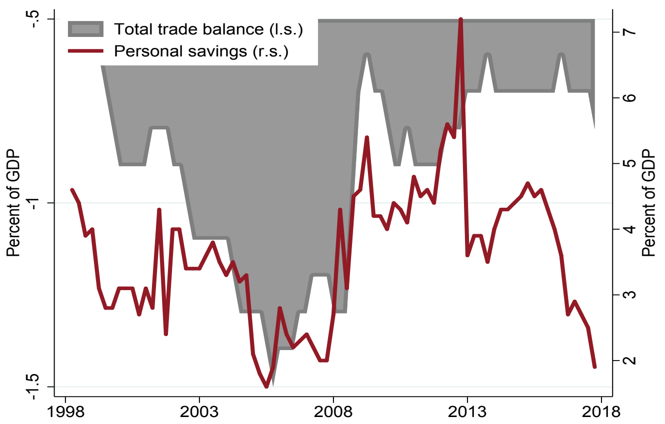
- The US economy closed the first quarter on remarkably solid footing. Sentiment in the manufacturing sector in the first quarter, as measured by the ISM Manufacturing PMI, held steady compared with year-end levels, while the ISM Non-Manufacturing PMI managed to improve. Tailwinds in Q1 came not least from the Trump administration's deep corporate tax cuts. With business sentiment remaining close to historical peaks, the current expansion should continue over the coming months, and, absent any negative surprises, we would expect again to see accelerating growth in business investments.

- Green lights are also flashing for consumption, with consumers again more optimistic over the course of the first quarter. Healthy labor markets, muted inflation and faster growth in real consumer income helped consumer spending increase at solid rates. However, household savings, which have been shrinking since 2016, continued to fall, down 14 percent year-over-year in February. This pattern exemplifies one of the core characteristics of the US economy: high consumption and low savings levels means that the US has to import capital from the rest of the world to finance its high consumption. This is why Trump's attacks on global trade, while professing to protect domestic US industries, in all likelihood will not reduce the US trade deficit.

- On the contrary, Trump's trade jousts, while having only a marginal direct impact on specific sectors, are sowing uncertainty globally, threatening business sentiment and eventually leading to postponed investments, purchases and new hires. And as Nobel laureate Paul Krugman argued in an April 4 New York Times column, trade barriers produce costs as they cause sectoral shifts within the economies as some goods and services that previously were imported have to be produced internally, less efficiently, while other goods can no longer be exported at previous levels.

- All year-over-year rates of US consumer price inflation increased in March. Core inflation rose from 1.8 percent in February to 2.1 percent in March. While personal consumer expenditures (PCE), the inflation metric monitored by the Fed, remained below 2 percent, it too is clearly on an upward trajectory. Given that backdrop, the possibility that the Fed might undertake four rate hikes this year, instead of the three implied by the Federal Open Market Committee and expected by financial markets, cannot be ruled out entirely.

US trade deficit swells while savings shrink



Source: Thomson Reuters Datastream, MFO

The chart compares personal savings with the trade balance in the US, both expressed as a percent of GDP. In recent quarters, savings fell, both compared to GDP and in absolute terms, which was most recently accompanied by a widening trade deficit. As the trade deficit equals the excess of national investments over national savings, all else equal, the trade deficit increases when savings fall.

1.2 Europe

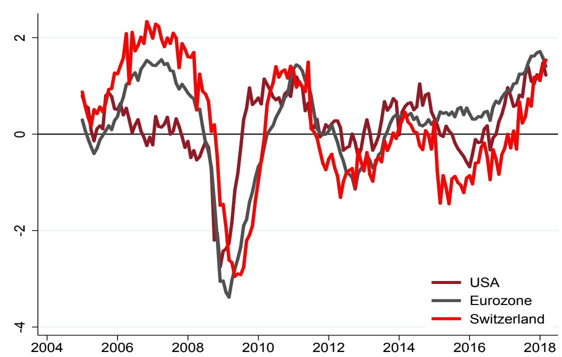
- After two years of steady improvement, the European Commission's euro area business climate indicator declined from its December peak, inviting speculation that the current economic cycle might be coming to an end. Lacking a crystal ball, we cannot say whether this interpretation is true. In order to rule out that this recent correction didn't simply arise because of short-term volatility – that it does indeed reflect a cyclical turning point – we simply need to see more data. However, the change in dynamics is itself noteworthy and undeniable. But despite this setback, business sentiment remains at very elevated levels, indicating continuation of the recent economic expansion at a pace clearly faster than trend growth in the coming months.

- As foreshadowed by a marked improvement in the industrial business climate, the Swiss economy accelerated visibly in Q4 of 2017, expanding by 1.9 percent year-over-year after growing 1.2 percent in the previous quarter. As measured by the Swiss PMI, industrial sentiment is clearly in expansionary territory, although it cooled significantly from its previous peak of 65.5 points in December, down to 60.3 points in March. This correction was stronger in Switzerland than in other advanced economies, which might partially be explained by seasonality, which frequently leads to weakness in this indicator in spring.

- Consumer prices increased by 0.6 percent and 0.8 percent year-over-year, as measured by the headline and the core inflation rates, respectively. Thus, both measures of consumer price inflation are well above their 20-year averages. Nevertheless, policy interest rates set by the Swiss National Bank as well as bond yields at the short end of the curve remained negative. While the situation is even more extreme in other European markets such as Germany and Sweden, it kept real interest rates – as measured by the difference between yields of 1-year sovereign bonds and the yearly core inflation rate – deeply in negative territory (see chart below). This steadily diminishes purchasing power if money is held in a bank account subject to negative interest rates or in short-dated bonds.

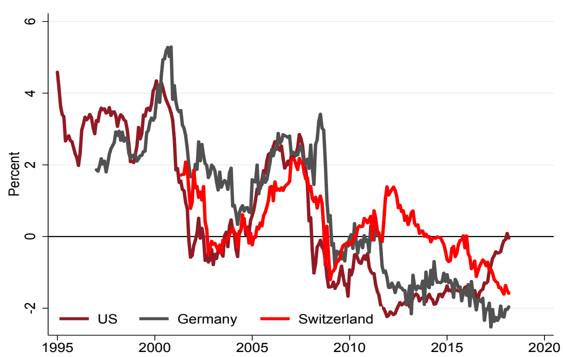
- With the revival of the Swiss economy and the weaker Swiss franc, the SNB has clearly gained leeway to finally start normalizing its very expansionary monetary policy, which is still characterized by negative policy rates; currently -0.75 percent. However, given the extreme cautiousness that has characterized the SNB's and other central banks' actions in recent years, we think the SNB is likely to postpone a first interest rate hike yet again.

Business sentiment remains expansionary



Source: Thomson Reuters Datastream, MFO

Negative real interest rates prevail



Source: Thomson Reuters Datastream, MFO

1.3 Asia and Emerging Economies

- According to the Bank of Japan's Tankan survey, both the current conditions and the prospects of all companies in Asia's second biggest economy held steady or even marginally improved in the first quarter, implying a continued expansion of the Japanese economy at a rate clearly faster than trend growth rate estimates, which hovers around 0.5 percent. In Q4 2017 Japan's GDP expanded by 2 percent year-over-year.

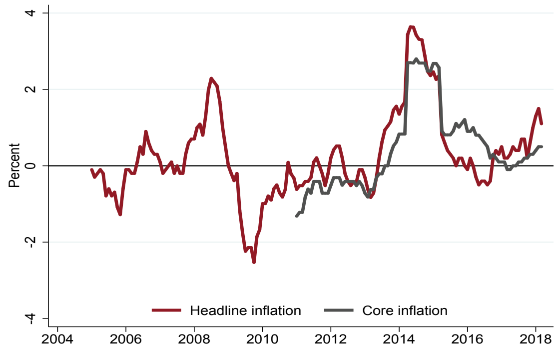
- Looking at individual GDP components, domestic demand appears increasingly robust, evident in accelerating growth in private demand and imports in Q4.

- Solid domestic demand is also reflected in consumer price inflation rates that are – granted – not high by international standards, but are high in terms of Japan's recent history. Japan's consumer price inflation, although it slowed in March from 1.5 to 1.1 percent year-over-year, is clearly above its 20-year average of 0.1 percent. Hence, Abenomics, the combination of expansionary fiscal and monetary policies and structural reforms, seems to have been successful in ending Japan's endemic low inflation regime. In this connection it's worth noting that the surge in inflation in 2014 was largely driven by the introduction of a consumption tax.

- In China, business sentiment indicators remain in expansionary territory for both the manufacturing and the services sectors, with prospects for the latter looking slightly the better. This is largely thanks to the long-term structural changes underway in China's economy as it shifts emphasis from industrial production to services. However, we find these indicators tend to behave overly consistently. Yearly producer price inflation, on the other hand, tends to fluctuate more strongly, and it has been cooling throughout the previous two quarters, slipping from 6.9 percent in September to 3.1 percent year-over-year in March. This at the least suggests that industrial activity has been slowing.

- In contrast, consumer confidence in January remained close to its record high from October. This was reflected in online retail sales that grew at a stunning rate of 35.4 percent year-over-year in March. This likely reflects a cyclical recovery of consumption after online sales growth fell to a low of about 26 percent in 2016 in the wake of an economic slowdown. But it is also clearly driven by a structural shift from bricks and mortar to online retail sales, with growth of the former slowing steadily over the past five years, although growing by 8.6 percent year-over-year in March, in-store retail sales in China remain impressive by Western standards.

Japan: Ending the era of low inflation?



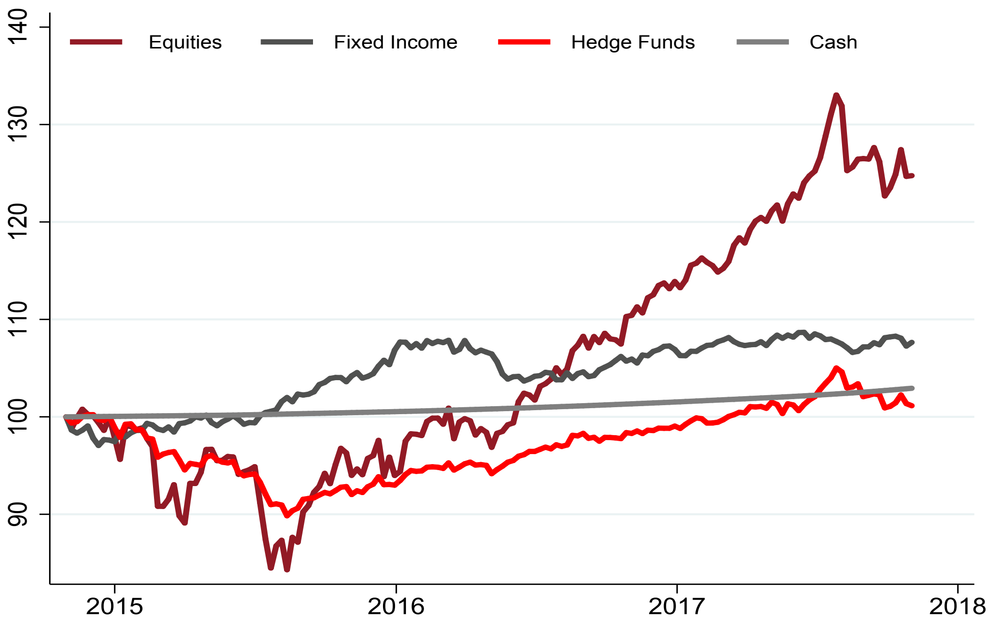
Source: Thomson Reuters Datastream, MFO

China: Shifting from retail to e-tail

Source: Bloomberg, MFO

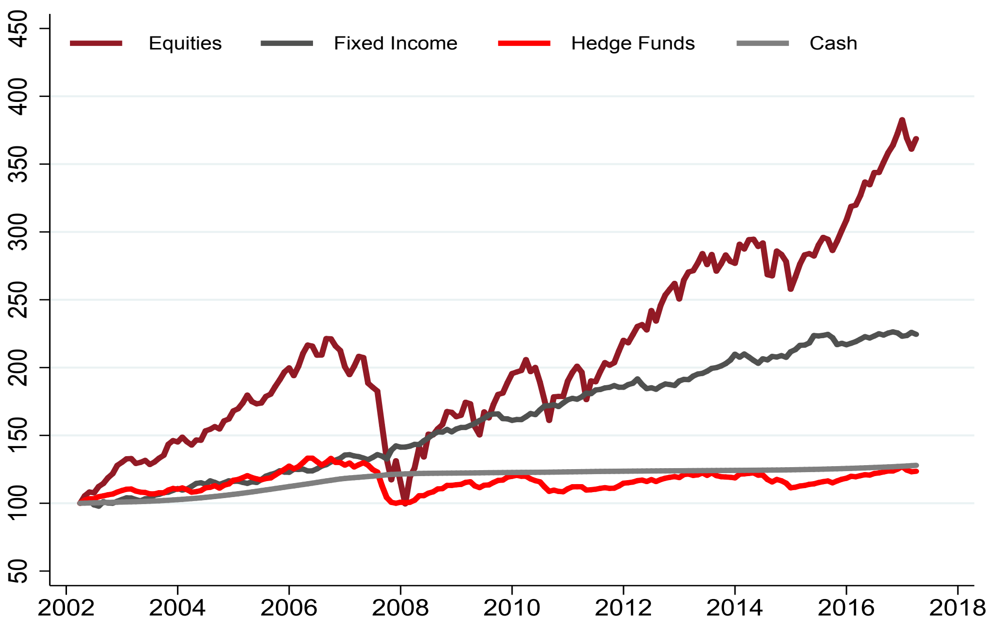
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

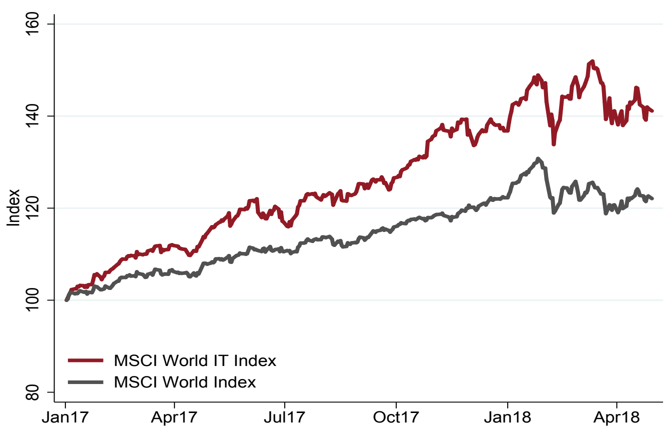
- The correction at the end of January/beginning February came as a shock to many investors who had grown used to the historically low volatility of 2017. But market participants now seem to have adjusted to the increased volatility. Most investors actually stayed put, meaning they neither added to nor reduced equity positions meaningfully. However, market sentiment generally seems to have become more cautious, with marginal additions to cash, according to fund manager surveys, and retreating enthusiasm for technology stocks.

- Broad equity markets have recently stabilized. The MSCI World has partially recovered, down 0.2 percent in US dollar terms for the year. In our view, the mostly encouraging corporate earnings reports have again outweighed lingering concerns over geopolitics and global trade. Most companies have solid balance sheets and are holding cash that, especially for US companies catalyzed by the recent tax reforms, will find its way to shareholders via continued buybacks and increased dividends.

- Within the various regions, European equities – whose performance in USD profited from a stronger EUR – led the way, up 1.1 percent, with Asian equities up 0.9 percent and North-American equities down 0.5 percent, in USD year-to-date, according to MSCI indices. In Asia, Japan's equity market performance stood out. Even though global funds still underweight the Japanese market, it is clearly in positive territory, with the broad MSCI Japan up 1.8 percent in USD, while small caps, as measured by the MSCI Japan Small Cap Index even gained 2.7 percent. As with European equities, the stronger JPY has influenced returns in USD positively. The fact that Japanese equities trail their earnings growth, thus making them attractively valued compared to global peers, might attract investors looking for value in generally expensive equity markets.

- Taken all together, we think the general conditions have become less supportive for equity markets at the margin. Not only has the macroeconomic backdrop weakened but market trends have also reverted to neutral levels over the previous months. Granted, after the latest market setbacks the heretofore overly stretched valuations have eased a bit, but weaker trends and higher economic uncertainy increase our sense of caution, resulting in a neutral to slightly positive equity market view.

Yesterday's high-flyer, tomorrow's loser?



Source: Bloomberg, MFO

The performance of the various equity sectors has diverged markedly since the beginning of 2016, with information technology, a sector classified as Growth, outperforming the other sectors by a large margin. However, we think it unlikely that tech will continue to live up to expectations as its excessive valuations and mediocre business results begin to put the brakes on its recent strong run, even making the risk of significant corrections possible.

2.2 Fixed Income

- Yields in global bond markets, as measured by the Barclays Global Aggregate Index, have continued to increase over the previous two months, approaching the 2-percent mark, their highest level in more than four years. As this development was driven by yield increases along the yield curve, the term spread – that is, the difference between yields of long-dated bonds minus short-dated bonds – remained relatively flat.

- As a consequence, the compensation investors receive for taking duration risk when buying bonds with a longer maturity versus a shorter maturity has remained unattractive. Thus, if investors want to profit from the better carry provided by the higher yields, we would advise increasing their exposure at the short end of the yield curve.

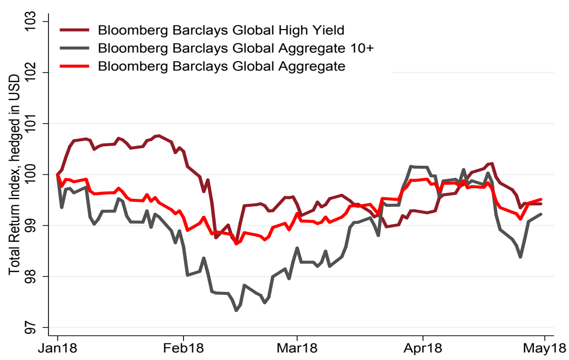
- However, while the overly depressed yields in the global bond market have revived in recent months, mainly reflecting higher USD rates, this is not yet true for European bond markets, where yields remain depressed and are sometimes still in negative territory. With recent increases in inflation, the rate at which purchasing power declines has accelerated. This is the case in Switzerland, for example, where inflation has accelerated relatively quickly in the wake of a weakening Swiss franc.

- As hedging costs quickly erode the additional yield, investors cannot get around this situation simply by investing in USD-denominated bonds. Therefore, investors with CHF or EUR as a reference currency continue to suffer from the limited investment opportunities in fixed-income markets.

- Given that backdrop, we have elected to maintain the general fixed-income underweight in our EUR and CHF portfolios. That said, we think the case for a strong underweight has continued to weaken for investors with USD as a reference currency.

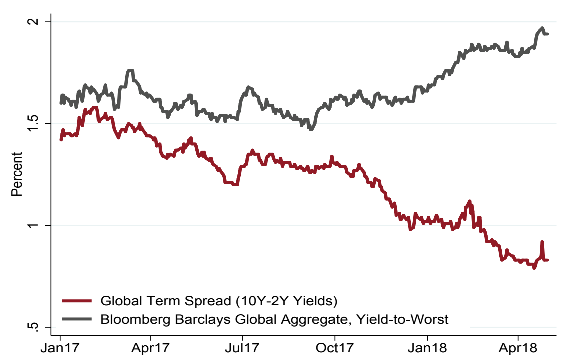
- Within the bond allocation, we continue to keep the duration shorter than the benchmark, while we overweight exposure to credit risk. Given the robust economic expansion, the absence of default increases, and the absence of signs of credit market stress, we think this stance is still reasonable. However, while we would not reduce our credit exposure for now, we clearly advise against a further build-up of credit risk. We would also counsel against venturing into exotic segments of the credit market, as credit spreads are narrow by historical comparisons and the risks therefore are very asymmetrical. That is, given the current low spreads, we think the likelihood of spread-widening is far greater than that of a further spread compression.

High-yield bonds held up well



Source: Bloomberg, MFO

Rising yields, falling term-spread



Source: Bloomberg, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- While their merits have been put in doubt and their high fees challenged, some hedge fund strategies have thrived in the more nuanced environment of the first few months in 2018. Equity Long-Short funds, in particular, were able to participate to some extent in the positive start into 2018 and were then able to cut losses during the correction.

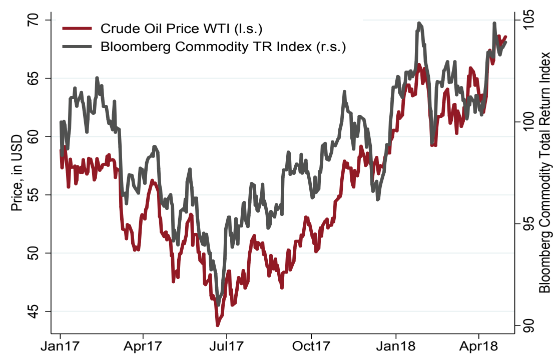
- Crude oil prices continued their recovery in recent weeks, climbing to three-year highs, helping diversified commodity indices to post a positive performance year-to-date. Supportive news came from the International Energy Agency, which reported that by the end of 2017 inventories had fallen markedly after global demand growth exceeded supply growth for the seventh quarter in a row. The long-term crude outlook is being shaped by somewhat contradictory factors: global demand is enjoying cyclical tailwinds from the current economic expansion, whereas structural forces might curb demand over the longer term, depending on how quickly a transition to more sustainable energy sources takes place.

Currencies

- After their steep depreciations against the euro, the US dollar and the Swiss franc are no longer overvalued and are now close to their estimated fair values based on purchasing power parity (PPP) estimates. Given this development, we no longer have a specific view on those currency pairs, after being negative on both the franc and the dollar for quite some time. We note that overshooting – that is, an excessive correction above the fair value implied by PPP – has been often observed in the past. Therefore, a further depreciation of the franc or the dollar versus the euro cannot be ruled out, but mispricings in the form of strong deviations from PPP should no longer act as a driving force of currency reversals. Hence, we currently see neither meaningful risks nor significant opportunities in the currency space. One notable exception might be the NOK, which seems exceptionally undervalued by historical standards, especially against the EUR.

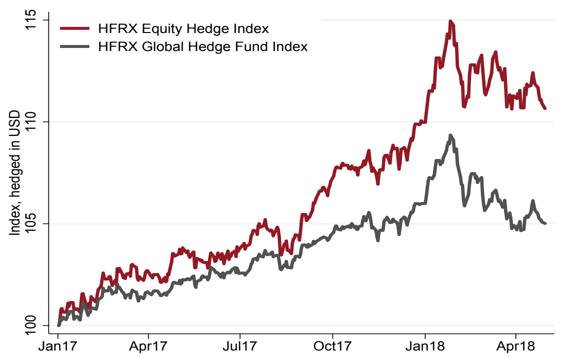
- The Swiss franc again made headlines in April, when it approached the threshhold of 1.20 against the euro, a level not seen since the Swiss National Bank abandoned it as its minimum exchange rate against the euro in January 2015. This provides a favourable environment for the Swiss National Bank, possibly allowing it to start selling of some of its vast FX holdings from its very bloated balance sheet.

Oil prices recover



Source: Bloomberg, MFO

Equity long-short strategies outperform



Source: Bloomberg, MFO

3. Positioning

- Our assessment of the broad economic environment, various specific market trends and risks, as well as valuations and sentiment surveys still leads us to a slightly positive view on equities and other risk assets. However, equity market trends generally have weakened after the surge in volatility earlier in the year, while the latest downtick in business sentiment indicators makes us more cautious about the overall economic outlook.

- While it could be argued that modest corrections in economic indicators are inevitable after the recent prolonged phase of steadily improving dynamics drove them to such elevated levels, the correction in business sentiment in the Eurozone should not be ignored, in our view as the latest three-month dip in Eurozone business sentiment clearly below the average three-month movement observed over the last five years. The reason we refrain from sounding the alarm bells right now is that the level of economic activity in the Eurozone and in other advanced economies is still quite high, well above long-term averages. This implies an expansion at a pace that still is clearly faster than trend growth rates indicate. However, the latest, moderating developments will lead us to closely analyze the next round economic data releases for signs of more clarity.

- Average yields on global bond markets continued their upward trajectory. However, especially on European bond markets, the situation remains problematic as yields at the short end are negative in real terms and the yield curves generally are very flat. Thus, taking on additional duration risk is undercompensated, in our view, especially in a rising yield environment. Therefore, we maintain our underweight for fixed income. In US dollar markets the situation looks slightly better. Returning the fixed-income allocation towards its strategic target will be advisable sooner in the US than in Europe, in our view.

- Within fixed income we still overweight credit risk, but with the observation that we find high-yield unattractive given their compressed spreads. We prefer loans since they tend to come with a shorter duration and often offer better compensation for a given risk level. In addition, we urge investors to carefully diversify their risk exposures. Finally, as we have emphasized in several previous issues of *MFO Investment Outlook*, embarking on a round of pure yield-seeking tourism, venturing into unfamiliar investment territory without a knowledgeable tour guide, is plainly inadvisable, 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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