MARCUARD FAMILY OFFICE

Investment Outlook

July 2018

1 Solid economic expansion increasingly at risk

Despite signs of stabilizing in May, global growth momentum has slowed lately and has also become less synchronized. The US economy has fared relatively well, supported by fiscal stimulus, while economic activity in Europe has slowed. In the first quarter of this year, for the first time in two years, the US economy expanded faster than the Eurozone's.

Economic activity in Japan slowed as well recently, while China has shown modest signs of improvement. Nevertheless, while the underlying trends remain robust and the major economies are still likely to expand faster than trend in the coming months, risks to the current economic expansion have increased recently. The latest escalations in a growing global trade dispute and the subsequent rise in economic uncertainty have the potential to undermine business confidence, potentially causing businesses to postpone investments, purchases and new hires, in turn weakening global demand.

Although a sharp slowdown, let alone a recession, is currently not (yet) in sight, such a setback would come at a bad time, as most economies still have meager war chests. Monetary policy has started to normalize in the US, leaving some room to maneuver in a downturn, but deficits are on the rise just as the boom peaks, further increasing the already high US sovereign debt levels. As a consequence, the US would have little leeway to apply any stabilizing fiscal stimulus if a recession were to occur. In Europe, the situation is reversed, but offers similarly limited options in the event of a downturn. While deficits have been narrowing in most Eurozone member states individually and in aggregate – granted, debt levels in some member states like Italy remain very high – the process of monetary policy normalization has barely begun and interest rates remain negative, limiting potential monetary policy responses to a slump.

In addition, inflationary pressures have recently been on the rise in the major advanced economies. While the increase in headline consumer price inflation was mostly driven by the temporary factor of higher oil prices, core inflation rates have also increased, implying that there might also be some underlying domestic price pressures building that could turn out to be more sustained than the temporary boost from oil prices. This strengthens the case for continuing the monetary policy normalization underway in the US, which has lately picked up the pace, and for the long-awaited – indeed overdue – monetary policy turnaround in Europe. That said, and assuming that fears centering around Italy do not materialize, the tailwinds from an easy monetary environment are going to fade.

But if the negative effect of higher interest rates is not more than outweighed by positive economic growth and hence upbeat earnings prospects, asset valuations will decline. The better the economic performance and the more sustained the current expansion, the more able financial markets will be to digest the monetary policy turnaround. However, given the increased economic uncertainty, we think downside risk for asset markets has marginally increased lately. Thus, in the current environment characterized by expensive valuations, slowing growth momentum, increased risks to further economic expansion, and tighter monetary conditions, we have grown more cautious about equity markets and other risk assets. We prefer to maintain an equity market positioning that is close to our long-term strategic allocation. And as all boats will no longer lifted simply by easy monetary policy, we expect volatility to remain elevated and its dispersion across regions and segments to increase. This leads us to think that active, selective asset managers might find some rewarding opportunities in the current rather fluid investment environment.

1.1 North America

- In Q1, the US economy expanded by 2.8 percent year-over-year, overtaking the Eurozone's rate of growth for the first time in two years.

- According business sentiment indicators, the US economy lost a bit of steam entering the second quarter, but still looks on track for above-trend expansion. Purchasing managers indexes in both the manufacturing and the services sectors dipped visibly in April but again partially recovered in May. Economic activity seemed to have increased further early in Q2, as capacity utilization and industrial production growth in the first two months of the quarter were higher on average than was seen in Q1, supporting investment spending.

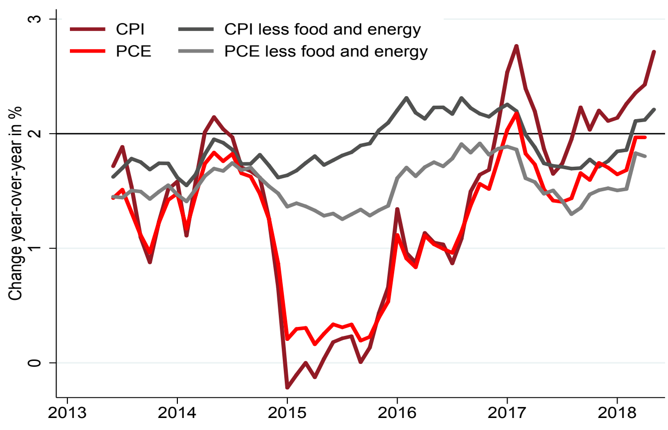
- The outlook for consumption also remains broadly positive. Consumer confidence has maintained its long upward trajectory, now clearly surpassing its pre-global-financial-crisis peak. That is unsurprising given that labor market conditions are still very favorable. The unemployment rate fell further, to 3.8 percent in May, the lowest level in 18 years. With that, it is now well below the NAIRU (non-accelerating inflation rate of unemployment) of 4.6 percent as currently estimated by the Federal Reserve. At the same time, vacancies increased further in May, again beating previous records.

- The only cloud on the horizon for consumption is coming from the rapid acceleration in consumer price inflation, which is partially eroding real wage growth. Real hourly wages stagnated in May as increased consumer price inflation cancelled out most of the nominal wage gains.

- Headline consumer price inflation rose with rising oil prices, which increased by about a 60 percent over the previous twelve months, pushing the yearly consumer price inflation rate from 2.5 percent in April to 2.8 percent in May. But core inflation, which excludes volatile food and energy prices, also accelerated from 2.1 to 2.2 percent year-over-year. This suggests that domestic price pressures are indeed on the rise, which is consistent with the rather heated state of the US economy. And the consumer price inflation measure tracked by the Fed, the PCE index of personal consumption expenditures, has now also reached the critical 2-percent mark.

- Given this backdrop, the Fed's second interest rate hike of the year, in June, was widely expected. However, the US central bank adopted a slightly more hawkish tone in its latest FOMC statement, which suggests four hikes are likely in 2018 instead of the previously expected three.

Consumer price inflation increases on all measures



Source: Thomson Reuters Datastream, MFO

The chart shows different metrics of consumer price inflation. All of them have accelerated visibly in recent months. While headline rates were driven by rising oil prices, core inflation, which excludes energy prices, has also seen increases, suggesting that the booming economy is subject to increasing and broad-based upward price pressures.

1.2 Europe

- Eurozone GDP growth slowed from 2.8 to 2.5 percent year-over-year in Q1 due to slower growth in investment spending while consumption growth accelerated, which was foreseeable in the cooling off of business sentiment that we observed in the first quarter of the year. After business climate indicators across the Eurozone slid in February, March and April, May saw stabilization, driven by improving order books, particularly for exports. That said, despite some bumps in the road, the data overall still suggests economic expansion continuing at a solid rate, clearly above trend.

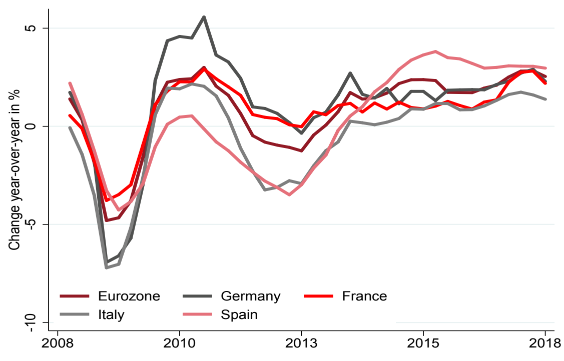
- Europe's consumers remain very optimistic, with confidence close to its peak reached in December 2017. The labor market continued to improve throughout the first half of 2018. The unemployment rate fell again in April, from 8.5 to 8.4 percent. Unemployment is still substantial and its recent dip masks the divergence in rates among the different member states. Substantial labor market slack remains in some peripheral Eurozone economies. In parallel, the vacancy rate continued its uptrend in Q1. However, as elsewhere, consumers confront rising inflation rates, which partially undo any gains in nominal wage growth.

- May saw visible increases in consumer price inflation. The headline rate rose from 1.3 to 1.9 percent year-over-year – thereby approaching the ECBs medium-term inflation target of "levels below, but close to 2 percent," while the core rate accelerated from 0.8 to 1.1 percent year-over-year.

- In its latest policy statement, in June, the ECB finally offered some clarity about ending its longstanding asset purchasing program. It announced its intention to halve net asset purchases from EUR 30bn per month to EUR 15bn after September, with the aim of ending the program completely after December. At the same time, the ECB underscored that it doesn't expect to start raising interest rates before autumn 2019, thus postponing interest-rate normalization yet again and widening the interest-rate differential between the US and the Eurozone still further.

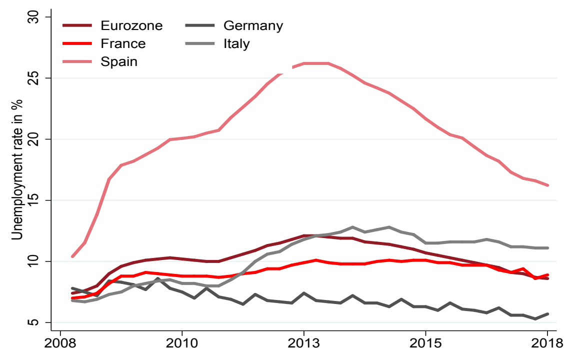
- The Swiss economy gathered pace again in Q1, expanding by 2.4 percent year-over-year after upwardly revised 2.0 percent in the previous quarter. The acceleration was driven by higher growth in exports and capital formation. At 62.4 points in May, the Swiss PMI remains solidly in expansionary territory, albeit somewhat below its previous peak of 65.6 points, in December. Hence, economic expansion at a pace similar to that of Q4 2017 again seems achievable, since global demand remains supportive.

GDP growth rates in the Eurozone



Source: Thomson Reuters Datastream, MFO

Unemployment rates in the Eurozone



Source: Thomson Reuters Datastream, MFO

1.3 Asia and Emerging Economies

- Just how vulnerable the heterogenous emerging market (EM) economies are to weaker external funding conditions and waning global demand became clear in recent months, as a broad array of EM currencies and asset markets suffered from a freshly appreciating US dollar and rising US interest rates.

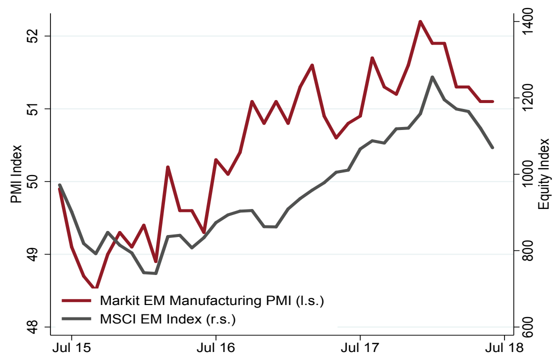
- The slightly weaker economic prospects in advanced economies also translated into weaker aggregate business conditions in EM economies. The Markit EM Manufacturing PMI worsened throughout the first months of 2018 from already not very strong levels, suggesting only sluggish expansion in the months ahead. Many emerging economies are indeed vulnerable to weaker external conditions, burdened as many of them are with homemade problems and structural weaknesses. In sum, the gap between EM and the advanced economies, whose recent economic performance has been relatively robust, remains in place.

- China posted better economic performance than its EM peers, in aggregate. Depending on the metric considered, conditions in China's manufacturing sector have remained stable or even firmed slightly since the start of the year. And in absolute terms, conditions in the services sector are generally better, which should be seen in the context of China's transition to a more consumption-based growth model. Indeed, the outlook for consumption looks very good. Consumer confidence in April stayed close to its record high of February.

- The pace of Japan's economic expansion slowed visibly in Q1, slipping from 1.9 to 1.1 percent year-over-year. This still clearly surpasses trend growth, however, which is estimated to be around 0.5 percent. The slowdown was mainly driven by fading growth in business investments and private consumption. The Markit Composite PMI for Japan, as well as data on real economic activity such as industrial production and machinery orders, suggests a stabilization of the economic expansion at the beginning of the second quarter rather than a continuation of the slowdown. However, the fresh drop in the Markit Manufacturing PMI in May – albeit remaining in expansionary territory – sounds a note of caution.

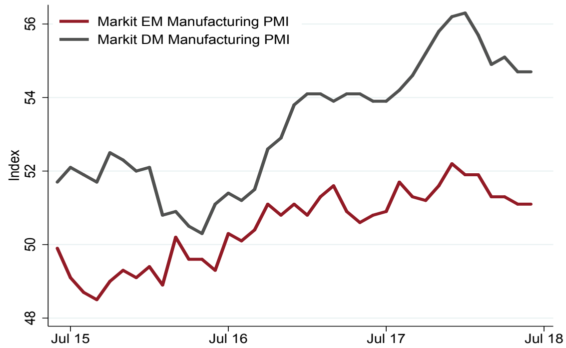
- Strikingly, on the back of lower food price inflation, consumer price inflation fell in recent months from 1.5 percent in February to 0.6 percent in April year-over-year despite higher oil and import prices, offering some relief to Japanese consumers. While nominal earnings growth also slowed in April, partially outweighing the benefits of slower inflation,

EM rally is already over



Source: Bloomberg, MFO

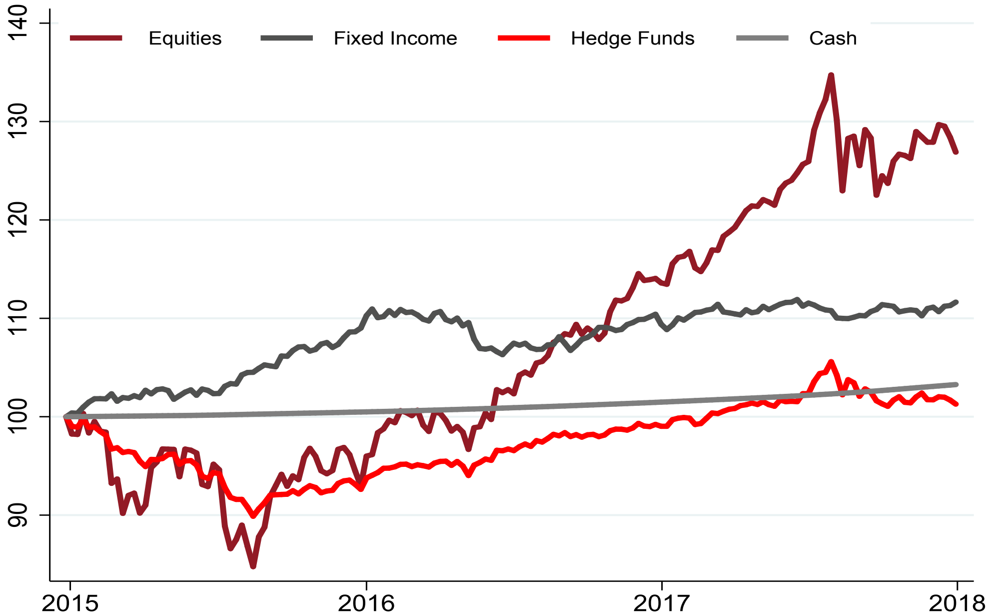
EM performance gap persists



Source: Bloomberg, MFO

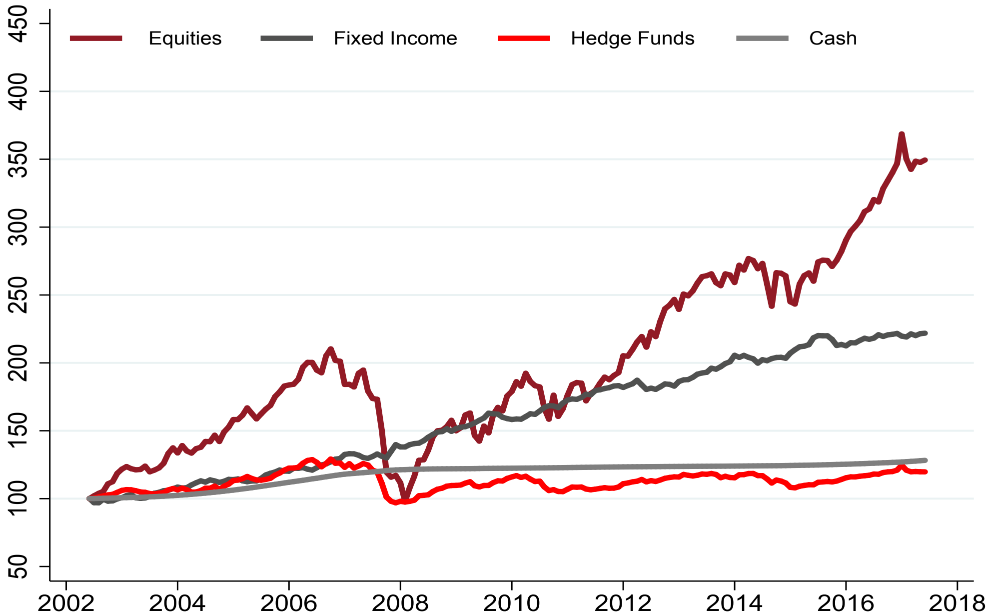
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- There seems to be a general consensus that equity markets are expensive. To argue that equities are still attractively valued one needs to take recourse to some improbable assumptions, for example, that the still rather low interest rates will never normalize again. Based on recent central bank actions, with the Fed hiking rates along the lines it previously communicated and even the ECB being forced to take rising inflation numbers into account, this particular assumption is losing credibility. The new Fed chair, Jerome Powell, seems intent on establishing his credentials as a believer in "sound money," a euphemism for tighter monetary policy.

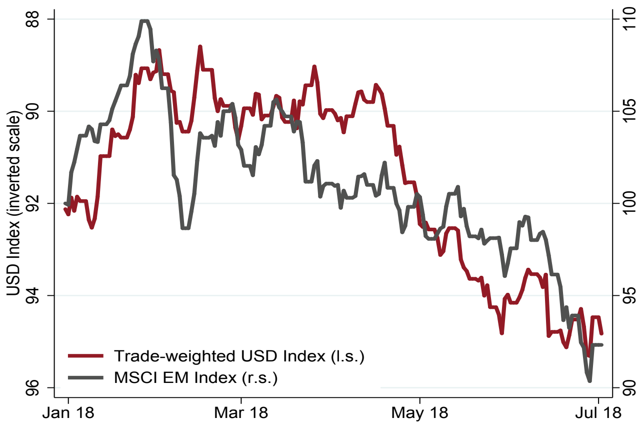
- Despite recent higher volatility, we have not yet seen a major market correction in the global developed equity market being flat as measured by the MSCI World Index. Looking at year-to-date performance, the broad US equity market measured by the S&P 500 is up 2.7 percent, while European and Asian markets, as measured by the respective MSCI indices, lost 2.9 and 3.2 percent, respectively.

- The Russell 2000, an index that covers US companies with lower market capitalization and fewer ties to the global economy, shows a clearly superior performance, up 7.7 percent year-to-date. Contrary to larger companies, potential global trade disruptions are seen to have less impact on Russell 2000 firms, while the booming US economy and the recent tax cuts should be supportive.

- After a populist government took office in Italy, renewed questions about the stability of the European Union led to a more critical assessment of European equity markets. This increased the relative appeal of the US stock market, whose recent performance has been largely driven by the heavy weighting of the technology sector. The slowdown in growth momentum outside the US has prompted many investors to prefer the structurally high-growth US tech companies, who seem to have escaped recent regulatory scrutiny unscathed, at least for the moment.

- Taken all together, we think the general conditions for equity markets have marginally deteriorated. Not only has the macroeconomic picture weakened, but market trends have also cooled to mostly neutral and even negative levels in some equity markets, including Europe's, over the previous months. Granted, after the latest setbacks, the recent stretched valuations have eased a bit but weaker trends and greater economic uncertainty increase our sense of caution, leading us to a neutral equity market view.

Emerging market equities: slaves of the USD



Source: Bloomberg, MFO

Emerging market equities, measured by the MSCI EM index, enjoyed a very good start in 2018 but then corrected sharply in February, in line with global equity markets. However, while the latter in general have since recovered, EM equity markets fell further into negative territory. Apparently, this slide has mainly been driven by fears that tighter external funding conditions thanks to a stronger USD and higher US interest rates would pose a challenge to emerging economies.

2.2 Fixed Income

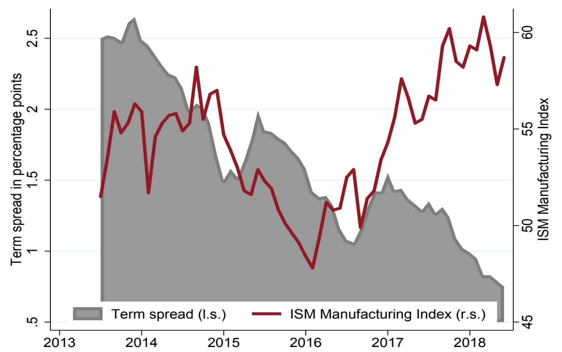
- Global bond markets recovered over the past two months, posting 0.07 percent year-to-date. So far this year, initial losses were largely driven by increases in yields, which are currently 0.33 percentage points higher than at the start of the year. Correspondingly, long-dated bonds as measured by the Bloomberg Barclays Global Aggregate 10+ Year Index underperformed, with a total return of -0.01 percent year-to-date.

- Previous losses within the fixed-income universe were largely driven by yield increases, but not by widening credit spreads. However, since mid-April, credit spreads resumed widening despite a trend of falling defaults. Option-adjusted spreads on global high-yield bonds increased by 0.77 percentage points year-to-date to about 4.2 percent at the end of June. That is below previous cyclical peaks such as the 8.8 percent in 2011 and 7.9 percent in 2016, or the skyrocketing 18 percent at the height of the global financial crisis in 2008. Interestingly, if we take the admittedly weak anecdotal evidence of the media as a guide, we note that references equating "high-yield" to "junk" again seem to be on the rise.

- The US Treasury yield curve continued to flatten as yields increased only at the short end of the curve, whereas yields for maturities of five years and more fell slightly. This is sometimes seen as a negative signal for the business cycle. However, the term spread – a simple measure of the steepness of the yield curve using, for example, the difference in yields between 10-year and 1-year US Treasury yields, has been on a downtrend since the start of 2014, with only short interruptions. In 2017, that is, during a time when the US economy undeniably gained steam, this downtrend continued unabated. Hence, at least in the US, the argument that a flattening yield curve is a signal of an imminent slowdown or even a recession seems not well grounded. The flattening of the yield curve may possibly be explained by a more reactive long end of the yield curve that responded earlier to changing expectations, pricing in eventual monetary policy tightening much sooner, while the short end now follows with a lag, driven by the actual increases in policy rates.

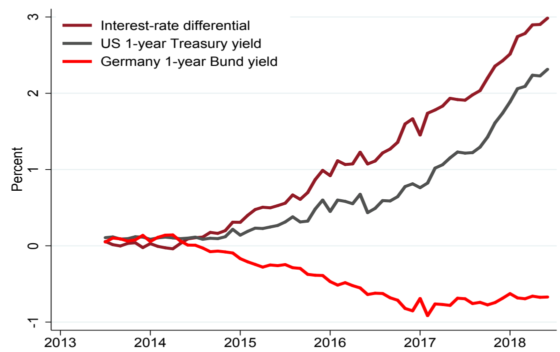
- While increasing yields have made USD bonds more attractive, investors with EUR and CHF as reference currencies continue to suffer from losses in their purchasing power when they want to avoid duration and elevated credit risks. They cannot evade this problem by simply investing in USD bonds, as hedging cost of about 3 percent largely consume any additional yield.

US term spread and the business cycle



Source: Bloomberg, MFO

Interest-rate differential widens



Source: Bloomberg, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- Within the hedge fund universe, as represented by the HFRX indices, equity long-short and equity market-neutral strategies again outperformed other hedge fund strategies year-to-date, with the (partial) equity hedge reaping benefits in the current, more volatile market environment. Given that markets and the recent economic expansion seem vulnerable, we think these kinds of strategies could also do well in the coming months.

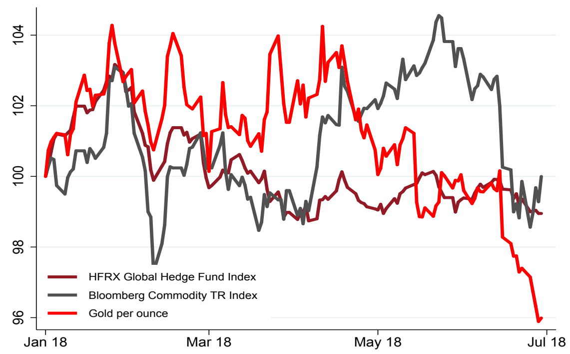
- After two record years in terms of PE fundraising, the slowdown in Q1 was unsurprising. The trend towards larger funds continued, with almost 60 percent of the USD 80bn raised by the largest ten funds. Dry powder, committed capital available to PE funds, has reached a new record level of USD 1.09tn. To put this sum into perspective, it represents about three years of deal activity, a number that has remained stable over time. Buyout deal activity continued to be very strong, driven by large transactions, with the number of deals decreasing by 10 percent and aggregate deal value increasing by 49 percent quarter-over-quarter. The slowdown in exits continued for the fourth quarter in a row, reflecting a shrinking number of portfolio companies, which peaked ten years ago. Valuations remain at record level but the difference between large deals, where valuations are the highest, and the middle market and small-cap deals is significant. Leverage ratios in buyout transactions further increased in 2017, only surpassed by the levels recorded in 2006 and 2007.

Currencies

- While 2017 and early 2018 saw corrections to the strongly over- and undervalued currencies, which translated into sharp depreciations of the overvalued USD and CHF against the EUR, these developments have partially reversed lately, as the USD recently rose against EM currencies and the CHF regained stength versus the EUR.

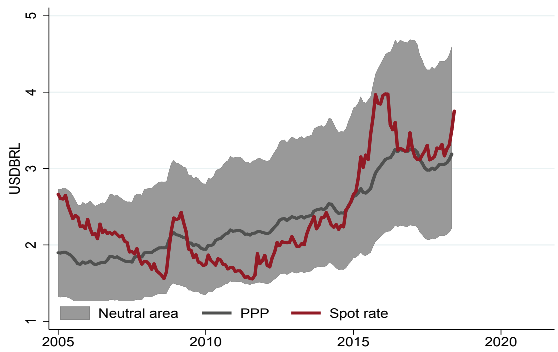
- The EM currency rout that started in spring continued over the past two months, with the Brazilian real, the Turkish lira and the Indian rupiah, to name just a few, losing about 19, 22, and 8 percent against the USD, respectively. However, in our view, the corrections in most cases still do not seem big enough to create attractive opportunities, even for more risk-tolerant investors.

The price of gold is falling



Source: Thomson Reuters Datastream, MFO

BRL not yet cheap enough



Source: Thomson Reuters Datastream, MFO

3. Positioning

- We note that the latest data implies that most large economies are still supposed to expand faster than trend in the coming months. However, we also note that risks to further economic expansion have continued to rise, especially stemming from the escalating trade dispute. Further disruptions to global trade could potentially undermine business confidence. Finally, we observe that the largest advanced economies are modestly equipped to fight any sharp downturn, given their fiscal and monetary policy constraints.

- At the same time, equity market trends have weakened, approaching levels pointing to a sideways pattern for global developed equity markets. For the US market, trends are still slightly positive, while they have turned slightly negative for the Eurozone, Switzerland and emerging markets in aggregate.

- The increased economic vulnerability and the less favorable equity market developments are matched by vulnerable asset markets. Valuations remain very elevated across all asset classes, as low interest rates and expansionary monetary policies have led to stretched asset prices. We therefore have become more cautious in our stance on risky assets, targeting a neutral positioning for equities.

- With regard to our fixed-income positioning, we maintain our view that for investors with USD as a reference currency, the fixed-income allocation can be kept close to the target allocation but with a duration shorter than the benchmark, and we continue to tilt toward credit risk. However, CHF and EUR investors remain caught between a rock and a hard place, as yields remain in negative territory not only at the very short end but along most of the yield curve, while the longest durations do not offer adequate compensation for the risk they entail, in our view. Therefore, we not only keep the duration short and overweight credit risk within the asset class, we also underweight the asset class as a whole for CHF and EUR investors.

- While the latest data on defaults still points to a downward trend in both the US and European high-yield markets, we think the asset class remains rather unattractive given the low credit spreads. From that perspective, the spread widening observed in recent weeks is hardly surprising. We therefore continue to prefer loans and specific credit risk. We prefer EUR credit exposure, as hedging costs for USD exposure are excessive for EUR and CHF investors. In contrast, USD investors can profit from substantial positive carry when hedging EUR or CHF credit exposure.

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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