MARCUARD FAMILY OFFICE

Investment Outlook
October 2018

Is money neutral?

Ten years after the financial crisis, the major advanced economies are humming – albeit while risks to the current economic expansion have risen. Nevertheless, most central bank still remain in crisis mode and as a consequence, after a decade of loose monetary policies, valuations for most assets are stretched.

Even though the major advanced economies have been growing above trend and some have already left their cyclical peaks behind, major central banks, with the exception of the Fed, so far have missed the opportunity to start tightening monetary policy. But policy rates also remain low in the US, despite several rate hikes. Consequently, monetary conditions in general still look very loose given current the levels of inflation, unemployment and economic activity. Apparently, central banks behave asymmetrically: they are less inclined to tighten monetary policy conditions in boom times than they are to loosen them in times of crisis. One explanation for this behavior might be their excessive focus on inflation. Central banks try hard to bring inflation into line with their targets. But as the link between domestic factors and inflation has become ever weaker, with global competition serving to moderate local inflation, central banks have instead ended up inflating asset values and fostering the accumulation of debt, thereby contributing to the build-up of systemic risk.

As the *Bank of International Settlements* (BIS) has recently pointed out, financial expansions can foster misallocations of capital, which in turn lower productivity growth since capital does not always end up in the most productive sectors and companies. This can have a lasting impact on GDP growth, not only before, but also especially after, a crisis. This is because the previously bloated sectors eventually face painful adjustments. Hence, the real economy is not independent from monetary policy, which used to be an axiom of classical economic theory. In other words, money is *not* neutral.

There is solid evidence that the current phase of loose monetary policy is again supporting the build-up of economic and financial imbalances. According to the BIS, "zombie firms" – companies that are more than ten years old, that lack growth potential and struggle to service their debt – are on the rise across the OECD. They are now surviving longer than at any time since the 1980s, a development that has coincided with the downtrend in policy rates. Meanwhile, the BIS estimates that, depending on the metric used, the share of such zombie companies has risen to 6 or 12 percent in the OECD economies.

Hence, thanks to overly loose monetary policy conditions, companies that otherwise would go out of business still have access to capital, which leads to a deterioration in overall credit quality on capital markets. This development is further fuelled by the behavior of investors, who take on higher risks to compensate for the generally low returns. As *Independent Credit View*, a Swiss research house, pointed out in a recent article, the average rating in the investment-grade bond universe sank from A- in 2007 to BBB- today, whereas the share of BBB-rated securities rose from about 25 to almost 50 percent over the past decade.

How can investors protect themselves against the potentially adverse consequences of these developments? First, we think that investors should be highly selective and emphasize credit quality to minimize their exposure to companies that will lose access to capital once the credit cycle tightens. Second, the greater the imbalances, the higher the turmoil will be once the credit cycle ends. As this will lead to sharp price corrections of all risk assets, it will certainly provide opportunities for those investors with steady nerves and enough liquidity to increase exposures in such phases. Third, we think it is crucial for investors to plan liquidity and their allocations to such illiquid assets as private equity, private debt and real estate in ways that enable them to hold these assets in all kinds of market environments in order to avoid forced sales at large discounts.

1.1 North America

- Despite the slight cooling in business sentiment, the US economy again gained steam in Q2, increasing the pace of expansion, from 2.6 to 2.9 percent year-over-year. However, we note, the acceleration was mainly fueled by increased private consumption, and it was also helped, ironically, by accelerating export growth. In the meantime, investment spending visibly slowed, a possible warning sign since the business cycle is usually driven by the investment cycle, which is the most volatile component of GDP.

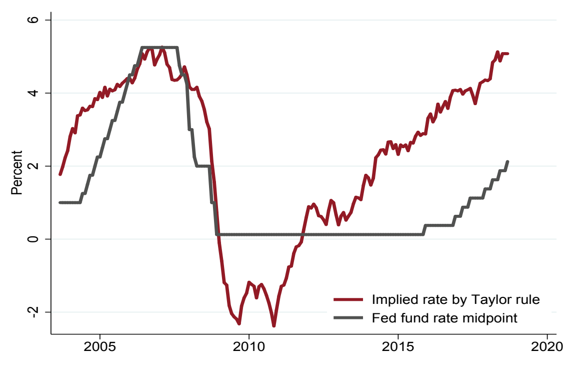
- However, entering Q3, capacity utilization and production growth have continued their uptrends and business sentiment in the manufacturing sector, as measured by August's ISM Manufacturing PMI, climbed to its highest level in more than three decades! In addition, labor is getting ever scarcer, signaling a green light for a fresh uptick in investment spending.

- Consumers remain optimistic, too, as evidenced by sentiment indices clearly above their long-term averages. Households are also enjoying a boost from the favorable labor market conditions, with unemployment low and job vacancies high and heading higher. Headwinds could come from higher inflation, however, temporarily driven up by higher oil prices as well as by solid domestic demand and the fact that the capacities of the US economy are increasingly being utilized. These factors are reflected in higher core inflation rates, which, according to both the consumer price inflation index and the personal consumption expenditures index, the Fed's preferred metric, are at or above the critical 2-percent mark.

- That said, the conditions enabling the Fed to continue its current stance of gradual monetary policy normalization should remain in place in the near term. In fact, current interest rates are still too low according to the widely cited Taylor rule, which calculates the appropriate interest rate as a function of the gap between the actual and the targeted inflation rates and the deviation of the unemployment rate from its long-term, non-inflationary level.

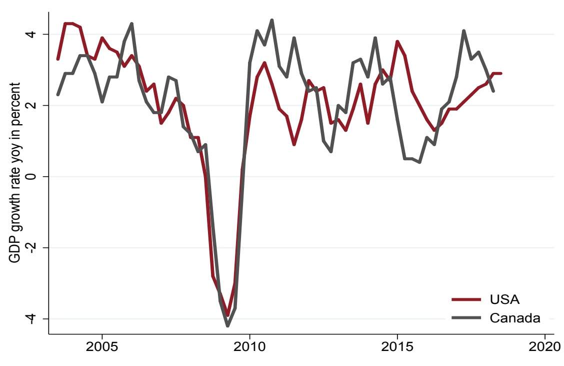
- The Canadian economy already peaked last year and growth has slowed continuously since the second quarter of 2017, down to 1.9 percent year-over-year in Q2 this year. Businesses and consumers are becoming increasingly cautious. The trade conflicts with its southern neighbor and main trading partner weigh on business prospects while consumers are confronted with rapidly accelerating inflation rates. In addition, monetary policy has grown tighter as the central bank has raised policy rates three times since July 2017. Rates now stand at 1.5 percent.

Monetary policy too expansionary?



Source: Bloomberg, MFO

Canadian economy slows



Source: Bloomberg, MFO

1.2 Europe

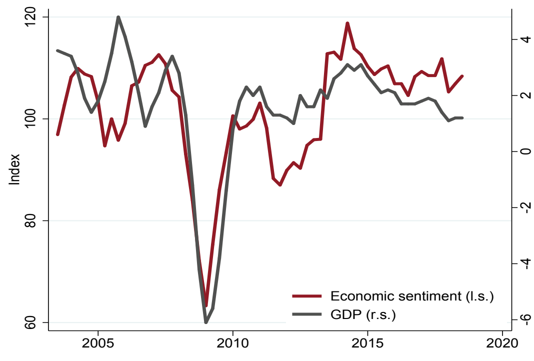
- Business climate indicators continue to signal a slowing Eurozone economy. Reflecting slower consumption growth, Europe's economy expanded by 2.1 percent year-over-year in Q2 after growing by 2.4 percent in Q1. For Q3, we expect the yearly pace of expansion might dip marginally below the 2-percent mark. This would still exceed the trend growth rate, which is the growth rate that can be sustained without creating inflationary pressure.

- This creates a challenging situation for the European Central Bank. According to Taylor rule estimates, the appropriate policy rate, currently negative at -0.4 percent, should be about three percentage points higher. For highflying economies like Germany's, interest rates are far too low, whereas for laggards like Italy today's interest rates might even be too high. Hence, in aggregate, the ECB's monetary policy environment remains too expansionary. But the bank may be reluctant to raise rates in a cooling economic environment. At the same time, it would not want to miss the opportunity to build up a buffer in advance of the next downturn.

- The UK economy has been slowing gradually since the start of 2015 but still showed resilience after the Brexit vote in June 2016. In Q2 of this year it seemed to stabilize, with year-over-year growth accelerating slightly, from 1.2 to 1.3 percent. The European Commission's Economic Sentiment Index, a broad-based metric that considers all sectors of the economy, also implies stabilizing economic conditions in the UK in Q3. However, in only six months, in March 2019, the UK will leave the single market and the specifics of the post Brexit-relationship between Britain and the EU remain undefined. As the clock ticks, this uncertainty has the potential to cloud business prospects and rattle markets.

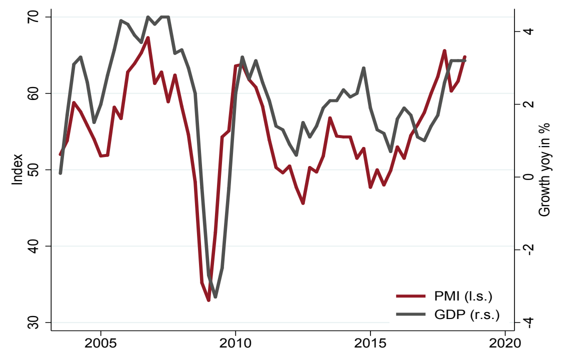
- The Swiss economy expanded by a solid 0.7 percent quarter-over-quarter in Q2. This is comparable to the pace of growth achieved in the final quarter of 2017, albeit slower than the 1 percent quarter-over-quarter growth rate in Q1 of this year. This performance was due to plainly slower capital spending growth and marginally slower consumption growth, partially compensated by a clear a pick-up in export growth. Year-over-year, the Swiss economy expanded at an unchanged and very robust pace of 3.2 percent, which is clearly above what the economy can sustain. Driven by rising oil prices, consumer price inflation continued its uptrend, rising by 1.2 percent year-over-year in August, challenging the SNB's monetary policy stance, which still stipulates a -0.75 percent policy rate.

UK economy stabilizes



Source: Bloomberg, MFO

Switzerland strong



Source: Bloomberg, MFO

1.3 Asia and Emerging Economies

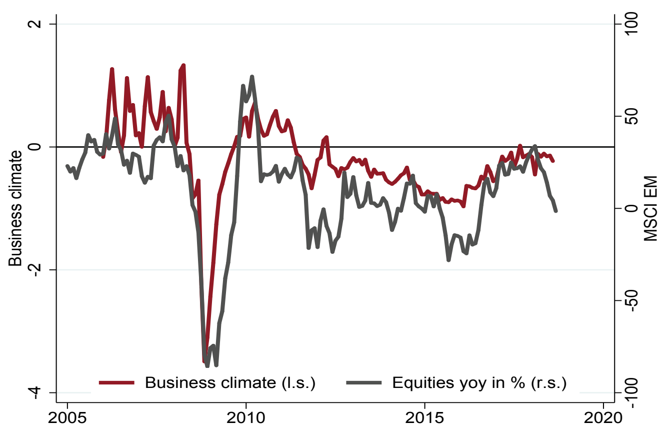
- The broad rout of EM currencies continued to dominate the headlines in recent weeks. This battering translated into the corresponding underperformance of assets denominated in local EM currencies. While economic prospects are not exactly rosy for emerging economies as a whole, nor do we find them entirely grim either. Business sentiment in EM economies seemed to stabilize recently, after it cooled in parallel with sentiment in the advanced economies. In view of recent business cycle developments, and absent a marked economic slowdown in the coming months, we think recent EM equity market performance seems overly negative (see chart below).

- While many EM countries have their specific weaknesses, financial markets currently either do not seem to differentiate among them sufficiently, or they tend to exaggerate the impact of the recent trade disputes. The problems faced by Turkey and Argentina are idiosyncratic, that is, country-specific. And, as we argue in the Currencies section, the strong USD is currently weighing on EM currencies, but the dollar's strength is not carved in stone.

- Looking at the composition of the MSCI EM Index, the benchmark index of the EM equity universe, reveals that China currently accounts for 28.7 percent of the index, followed by South Korea with 15.5 percent, Taiwan with 13.1 percent, India with 10 percent. Hence, the four largest index economies account for roughly two-thirds of the index's market capitalization. None of these four countries has external debt amounting to more than 35 percent of GDP, while the FX reserves of three of them suffice, or more than suffice, to cover their external debt, with the exception of India, whose external debt exceeds its FX reserves by about 32 percent.

- That stands in sharp contrast to the situation in Turkey and Argentina. Turkey's external debt amounts to 53 percent of it GDP and about 3.6 times the country's total FX reserves. Argentina's external debt is at 66 percent of GDP, fully 7 times its FX reserves. Hence, their vulnerability to capital flight and currency depreciation is far greater than it is for the heavyweights that dominate EM equity markets. What's more, in comparison, Turkey and Argentina are of only marginal importance in the global EM equity space. At present Argentina is not even part of the MSCI EM Index, although it will be included in March 2019. And Turkey has only a small presence. Together with ten other countries, it accounts for only about 5 percent of the index's total market capitalization.

Are the markets too pessimistic about EM?

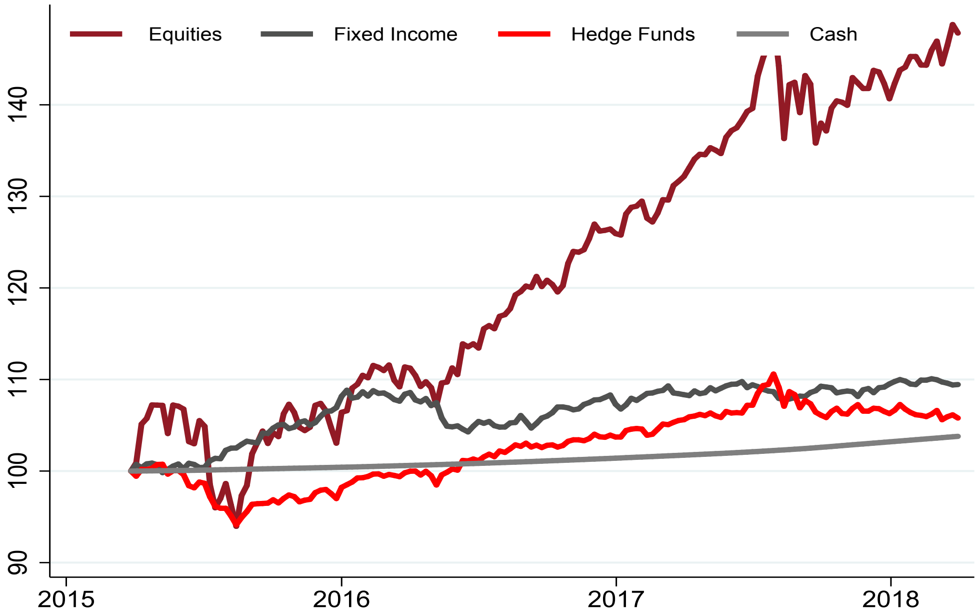


Aggregated business sentiment in emerging markets partially recovered and appears to have stabilized after its recent dip. However, we think equity markets are currently pricing in a much more adverse economic environment.

Source: Thomson Reuters Datastream, MFO

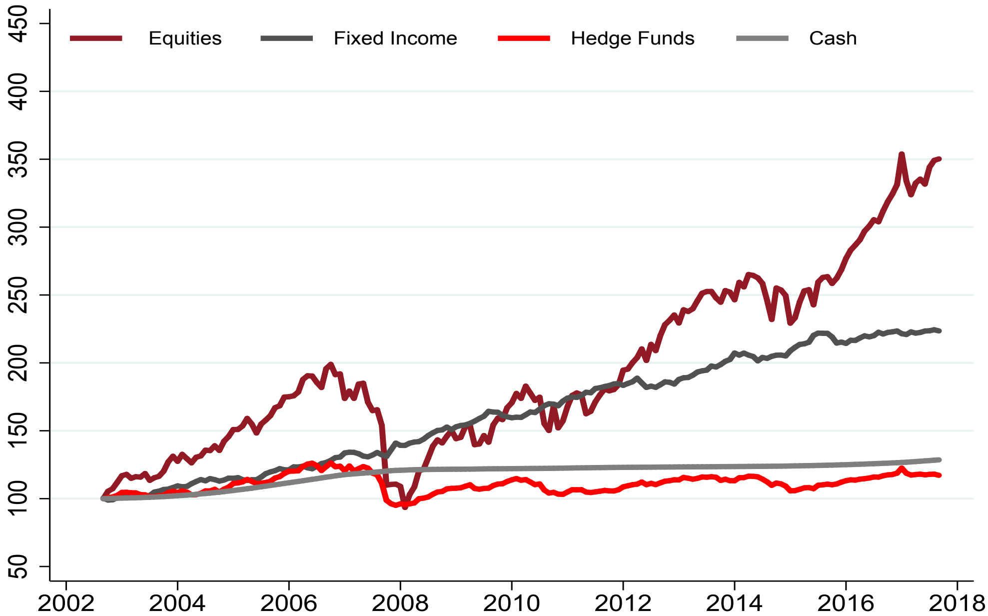
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

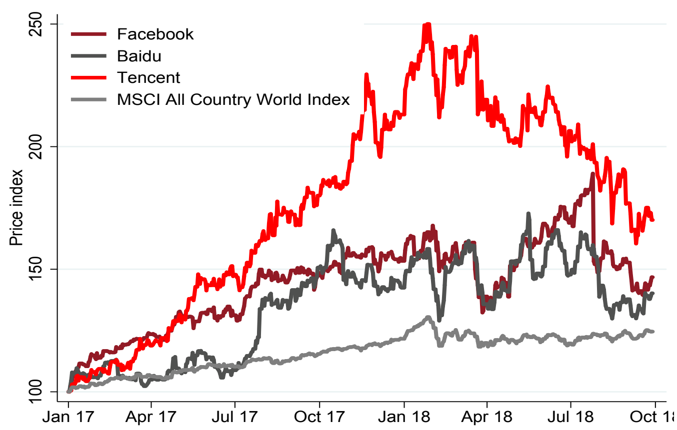
- Looking at the various regions, the US market again stood out, with the S&P Index up 10.6 percent year-to-date. This pattern clearly diverges from most other equity markets as the US stock market has steadily extended its outperformance against its global peers. It will be interesting to see whether the ongoing profit growth and stock buybacks, and possibly even a second round of tax cuts, will be able to prevail against an array of contrary forces including the Fed's interest rate hikes, the mid-term elections in November, trade disputes and worries about looming international economic weakness. Contrary to other markets, the US market has recently been trading with valuation multiples that were last seen before the massive drawdown in 2008. While we do not anticipate an imminent sharp correction, we do think the US market seems vulnerable to negative surprises, making us insist on a broad global diversification in line with the global equity index, marginally underweighting the expensive US market.

- Even previously unassailable tech darlings like Facebook have suffered some setbacks recently as many of the biggest internet-based businesses are having their power in the marketplace scrutinized by governments and anti-trust advocates. Speaking of technology stocks under pressure, China's tech sector can certainly be included here. With the MSCI AC Asia Pacific at -2.6 percent, Asian stock markets are now in negative territory for 2018.

- Emerging markets remain broadly under pressure, with the MSCI Emerging Markets at -7.5 percent year-to-date. The Turkish market is one of the more egregious examples, down -44.6 percent in USD. Although the fundamentals of individual countries vary widely, pessimistic investor sentiment seems to have fed a contagion. While valuations of EM equities look cheaper in absolute terms than those of their advanced market counterparts, they are only at average levels when viewed in a historical context. Hence, investors have to search for attractively valued sub-segments, offering selected opportunities for fund managers with open mandates.

- European equity markets have been basically flat in 2018. When the EUR's depreciation against the USD is taken into account, that is, when performance is measured in USD, MSCI Europe has posted a negative performance of -2.1 percent. Given the ECB's defensive stance, European companies will continue enjoying the benefits of loose monetary policies, which might provide the basis for positive surprises given the currently attractive valuations of EU equities.

Tech companies: High flyers lose some altitude



Source: Bloomberg, MFO

Due their rapid ascent, some tech companies such as the social network giant Facebook or Chinese multi-services platforms like Baidu and Tencent became important components and performance drivers of their respective stock market indices. However, while they have consistently outperformed the aggregate market over the past few years, they all suffered sharp corrections this year

2.2 Fixed Income

- Reflecting the Fed's gradual path of monetary policy tightening, USD money market rates have continued their uptrend over the past three months. As the yields for longer maturities did not fully mirror the increases seen at the short end of the yield curve, the already flat USD yield curve flattened further. As a consequence, the money market and short-dated bonds in USD have again become more attractive, both in absolute terms and relative to longer-dated bonds. This is also reflected in the strong fund inflows into money markets in previous months.

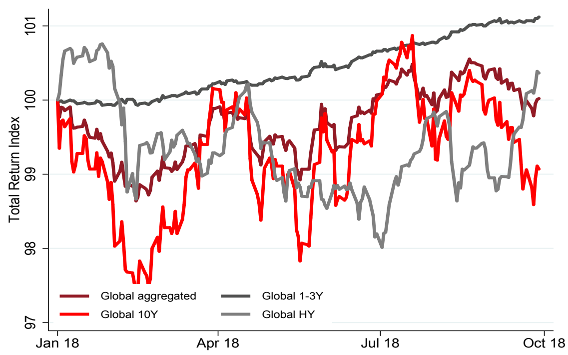
- After the recent yield increases, USD-denominated fixed-income seems attractive, assuming a scenario of interest rates broadly remaining lower for longer. The main risk would be a surge in risk premiums if bond markets reassess inflation risks and/or debt sustainability. Therefore, while we would keep the bond allocation in USD in line with our long-term strategic asset allocation, we prefer to maintain durations markedly shorter than that of the benchmark, given the flat yield curve, expectations for further interest-rate hikes and the possibility of higher risk premiums.

- In contrast, EUR and CHF markets have remained unattractive, characterized by yields that only turn positive for maturities of at least five or six years in EUR or ten years in CHF. In real terms the situation is even worse, as inflation has been increasing lately on the back of higher energy prices. As high hedging costs erode gains from shifting to the USD market, we maintain our marked fixed-income underweight in EUR and CHF portfolios.

- Some relief could come from the prospect of higher bond yields in the months ahead. The ECB will halve its monthly asset purchases in October, and likely end purchases completely after December. Hence, this particular headwind to higher yields is soon going to disappear. While policy rate hikes are not expected before autumn 2019 – and might be delayed further if negative economic surprises were to arise, markets should start to price in rising interest rates before late 2019, paving the way for yield increases in the EUR bond markets, which are unlikely to leave CHF bond markets unaffected.

- Credit spreads of high-yield bonds remain low in a long-term historical comparison. While they still profit from good economic conditions, including low and falling default rates, ample liquidity and favorable credit conditions, the low spreads do not leave much of a cushion for negative surprises or worsening conditions, making them susceptible to widening spreads.

Short-dated bonds outperform



Source: Bloomberg, MFO

High-yield spreads are narrow

Source: Bloomberg, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- Commodity markets were again characterized by large divergences between the different commodities. In general, crude oil posted substantial price gains, in contrast with the marked losses of precious metals, base metals and most soft commodities.

- At USD 85bn, PE fundraising saw a continued slowdown in Q2 2018, declining by 4 percent compared to Q1. However, this slowdown has to be viewed from the perspective of the record fundraising levels seen between Q4 2017 and Q4 2018, with more than USD 100bn raised in each quarter. New investment activity remained strong, and exit activity increased for the first time after a year of decline. The total exit value of USD 103bn was the largest since Q3 2015. The secondary market has been one segment of the PE market with particularly high growth in recent years. This market for the secondary purchase of fund interests and direct PE assets achieved its highest-ever total transaction value in the first half of 2018. In parallel with the heightened activity level, the average pricing has been on the rise, too. The pricing spread between top quality funds and second tier or EM funds remains very wide, however.

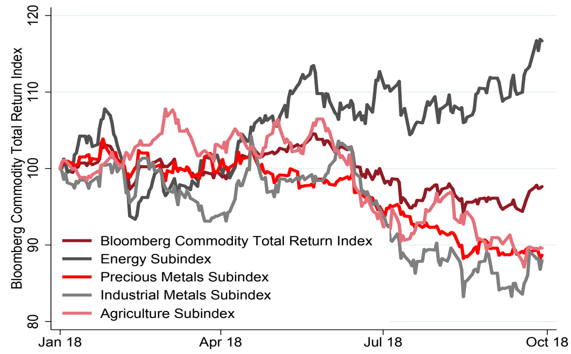
Currencies

- The EM currency rout continued in the third quarter. Following the additional losses, some currencies – for example, TRY, RUB, BRL, CNY and INR – increasingly look undervalued. Investors seem to lump all emerging countries together even though problems such as those faced in Argentina or Turkey are mainly country-specific. We think the breadth of the correction in EM currencies seems more than a little sentiment-driven.

- The main factor for this broad negative sentiment against the emerging economies is, in our view, the ongoing US dollar strength. However, from a purchasing power parity perspective, the USD again looks rather expensive, suggesting there is some room for a reversal. The argument that the widening interest-rate differential between the US and the rest of the world should lift the USD further might be short-sighted. Since the continuation of gradual monetary policy tightening in the US is widely expected, we think it is largely already priced in.

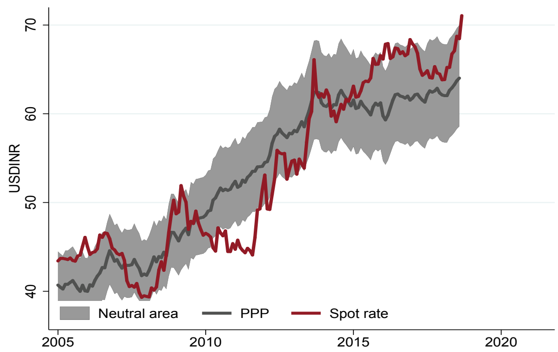
- That said, some EM currencies – for example, the ZAR – were simply overvalued previously. In these cases, the recent depreciation has lead to a healthy correction.

Divergent commodity performance



Source: Bloomberg, MFO

INR looks cheap



Source: Thomson Reuters Datastream, MFO

3. Positioning

- Given the recent slippage in economic momentum and the increased risks to the current economic expansion, in combination with the generally high valuations and weak market trends, we maintain our neutral stance on equities. We do this despite the fact that monetary conditions and the still robust, if slowing, economic expansion continue to provide some tailwinds.

- With the recent performance disparities between the US stock market on the one hand and its peers in Europe, Asia and the Emerging Markets on the other, we think that the US market has again become less attractive from a valuation point of view. We think it has grown a bit more vulnerable to negative surprises. We therefore prefer slight overweights in Asian and European stock market, which are justifiable, in our view, despite their underperformance year-to-date.

- After the recent yield increases, the USD money market again looks more attractive in absolute and also in relative terms compared to fixed-income assets with longer durations. We therefore would maintain the fixed-income allocation in USD close to neutral, that is, in line with the strategic allocation, but we would keep the average duration markedly shorter than that of the benchmark, as interest rates are on the rise and the possibility remains of a repricing of bond market risks, which would lead to rising risk premiums.

- For CHF and EUR fixed-income investments, the situation remains tense as interest rates have stayed in negative territory at the shorter end of the curve, up to relatively long maturities. We therefore not only keep the duration shorter than implied by the benchmark, but continue to underweight the asset class as a whole in these reference currencies.

- We maintain the credit tilt within the fixed-income allocation for all reference currencies. But we emphasize that as overall credit quality has been deteriorating due to the persistently loose funding conditions and the associated extension of the credit cycle, it is vital that investors focus on credit quality and exercise selectivity. We therefore continue to rely on active managers with a fundamental approach who can show that their portfolios have been comparatively more robust and subject to significantly lower default rates during times of market stress than was the case for the aggregate market.

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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Imprint

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