MARCUARD FAMILY OFFICE

Investment Outlook
January 2019

Time to be picky

The past year was a trying one for most assets, not only risk ones. Bond markets also finally felt the effects of the inflection in the monetary policy cycle and rising interest rates. Economic and policy uncertainties and flagging growth momentum currently cloud the outlook, leading us to remain cautious on risk assets. That said, we think misplaced or exaggerated pessimism may mask some attractive investment opportunities in some markets in 2019.

At year's end, investor sentiment soured thanks to a noxious combination of flagging economic momentum, elevated policy uncertainties, tighter financing conditions and increasing late-cycle fears. This shift in mood was accompanied by broad-based equity market losses and higher volatility, which in turn has led to clearly lower equity market valuations. Stock markets now generally look attractive in a historical comparison, or at least no longer quite so unattractive in the case of the US market. However, neither this nor the fact that the major economies held up well despite the generally challenging environment was able to revive investor sentiment, which increasingly seems to take for granted that the recent carefree business cycle and credit cycle have both come to an end.

Clearly, with interest rates on the rise in the US and rate tightening finally on the horizon in Europe, financing conditions are becoming less benign. Rising financing costs will particularly challenge highly leveraged companies. We note that within the investment-grade corporate bond space, on average, both the share of BBB-rated companies and their leverage have increased significantly since the 2008 financial crisis, and we see downside risk in that connection. Our concerns would grow more acute if the economic environment were to worsen and profitability were further squeezed while the cost of debt servicing increased. Such a scenario could trigger a surge in downgrades from investment-grade to junk, and associated losses as investors like pension funds and insurance companies, seeing their investment guidelines violated, would be forced to sell. Higher funding costs will also weigh on the stock prices of companies with high leverage and meager earnings.

However, we don't expect credit conditions to get much tighter simply because of higher policy rates. The Fed has already adopted a more cautious tone, and after four rate hikes in 2018 the current projections of the Federal Open Market Committee suggest only two hikes this year. And we think the ECB would not hesitate to delay its first rate hikes again if it thought the Eurozone's financial system or its economic expansion was at risk. Because inflation in the major advanced economies continues to be capped by the structural factor of global competition, central banks retain ample leeway on the easing side, implying that monetary policy should remain asymmetric with policy rates, most probably limited by lower upper bounds than in previous tightening cycles. Thus, tighter funding conditions would arise, especially in the US market, if investors were to ask for higher risk premia, that is, higher credit spreads.

To prepare for this risk, both equity and bond investors should be selective and focus on quality titles with solid, stable earnings and low leverage. As research by MSCI shows, such quality stocks tend to outperform in mild slowdowns and also in sharper downturns. We would also point out that not all BBB-rated corporate bonds that are priced similarly by markets come with the same risks. From a risk-versus-return perspective, selected high-yield bonds might be even more attractive than some of their investment-grade counterparts. Higher funding costs should also induce capital markets to differentiate more between sovereign debtors. Therefore, being picky in 2019 should help investors to manage risks while still being able to profit from risk assets if initial sentiment turns out to be overly negative and markets surprise on the upside.

1.1 North America

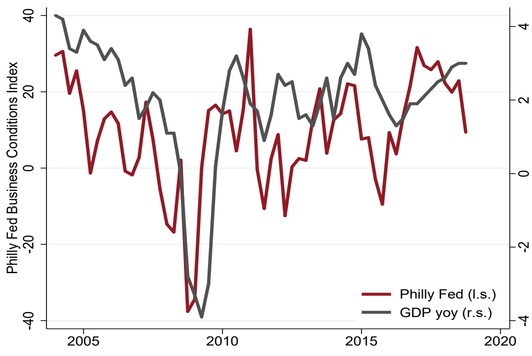
- The US economy expanded at a solid pace in Q3, as was implied earlier by increasing levels of economic activity such as capacity utilization and production growth. US GDP expanded by 3 percent year-over-year after growing 2.9 percent in Q2, and the US economy also benefitted from a fresh uptick in investment spending. For the near future, the green light remains broadly in place for the US economy. Business and consumer sentiment and economic activity levels all suggest that the US economy continued to expand at an elevated pace in the final quarter of 2018, similar to that of the previous two quarters.

- While the US economy enters the new year on a solid footing, there are signs that it is peaking and will likely slow from this point onward. Initial jobless claims saw a visible uptick from the end of September through November, before they resumed their downtrend in December. And cyclical indexes like the *Philadelphia Fed Business Outlook Survey* imply a slowdown in the coming quarters towards levels closer to the trend growth rate, which is estimated at slightly more than 2 percent.

- The sharp reversal of the oil price increase pushed the headline inflation rate from 2.5 percent down to the level of the core inflation rate, which rose from 2.1 to 2.2 percent year-over-year in November. At year-end, the price of a barrel of WTI crude was down by 21 percent, dampening upward price developments accordingly. Wage-price inflation remained on an uptrend in Q4, rising from 2.8 percent in September to 3.1 percent in November year-over-year. However, despite increasing domestic price pressures, overall inflation seems to be contained by the structural factor of global competition, evident in persistently stagnant goods prices.

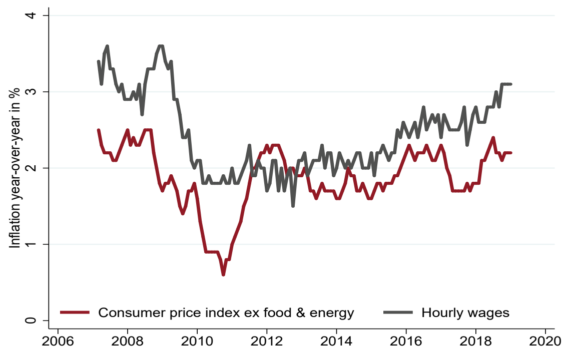
- Absent marked inflationary pressure, the Fed has the leeway to slow the pace of monetary policy normalisation if it thinks the US economy is facing stronger headwinds. Remarks by Fed chairman Jerome Powell about the policy rate approaching the "neutral" level were interpreted as the Fed becoming more dovish, which was confirmed at the Fed's December meeting. While it announced an expected fourth rate hike for 2018, to a target range of 2.25 to 2.5 percent, the Federal Open Market Committee now foresees only two hikes this year, after previously forecasting three. And Mr. Powell underlined that "there's a fairly high degree of uncertainty about the path and the ultimate destination of any future rate increases" as interest rates near this "neutral" level.

Philly Fed suggests slowing US growth



Source: Bloomberg, MFO

Limited inflationary pressure



Source: Bloomberg, MFO

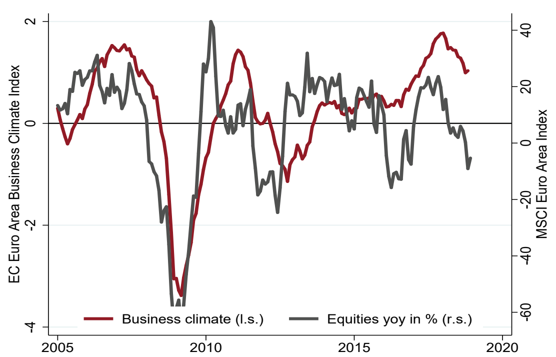
1.2 Europe

- Growth in the Eurozone slowed further in Q3, from 2.2 to 1.6 percent year-over-year. This was due to exports, which contracted slightly over the quarter while domestic demand, in aggregate, was unchanged. Consequently, the Eurozone economy, which is relatively sensitive to the global economy, could not escape the downturn in global trade, which, after growing by about 5 percent year-over-year at the start of 2018, expanded by just 2.3 percent in September. However, while the pace of economic expansion in the Eurozone clearly slowed, it is still in line with or even slightly above trend growth. Business sentiment, after declining throughout almost the entire 2018, stabilized in November at a level that is still high by historical standards. A similar picture – albeit without a recent stabilization - is drawn by consumer sentiment, which slid throughout 2018 but remains elevated in historical terms.

- We note that European equity markets currently price in a marked slowdown or even a recession, a view mirrored in the deteriorating investor sentiment in Europe. Against this backdrop, we think some upside surprises seem possible, especially if economic momentum stabilizes and the dust settles around the major political risks that are currently darkening investors' perceptions. We acknowledge that the current situation – flagging economic momentum, monetary policy tightening in view, and multiple elevated political risks – is more complicated than was the start of 2017. Then, too, there was broad-based policy uncertainty, but the Eurozone was buoyed by ongoing monetary expansion and strengthening economic momentum that ultimately surprised to the upside.

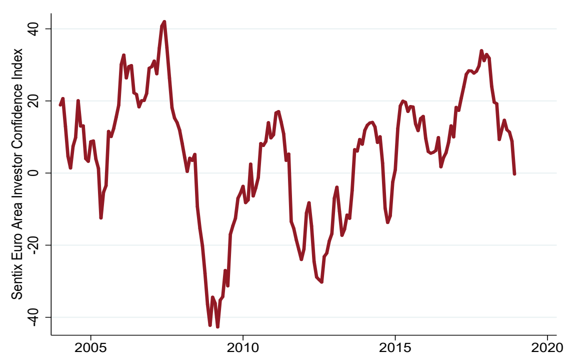
- At its December meeting, the ECB confirmed its intention to stop its asset purchase programme per year-end. It will reinvest proceeds from maturing bonds and abstain from rate hikes at least until the end of next summer. With that step, Eurozone monetary policy will become less expansionary, but still remain loose given the current level of economic activity. This comes roughly four years after the Fed ended quantitative easing and at a time when the European economy is already losing steam. With the policy rate still in negative territory, the ECB's range of policy options remains limited in response to a further marked economic slowdown or other negative surprises. In such circumstances, the ECB's first rate hike would likely be postponed. Other options include providing a third round of Targeted Longer-Term Operations (TLTRO) to credit institutions, or the active management of the maturities when the ECB reinvests the proceeds of maturing bonds.

Markets price in a marked slowdown



Source: Thomson Reuters Datastream, MFO

Investors are pessimistic



Source: Bloomberg, MFO

1.3 Asia and Emerging Economies

- The gap between emerging market (EM) and developed market (DM) economies in terms of business prospects persisted over the course of the fourth quarter of 2018, with the EM business climate still lagging. However, as we pointed out in the previous issue of *MFO Investment Outlook*, the dim view priced in by the markets seems overly negative, at least at present.

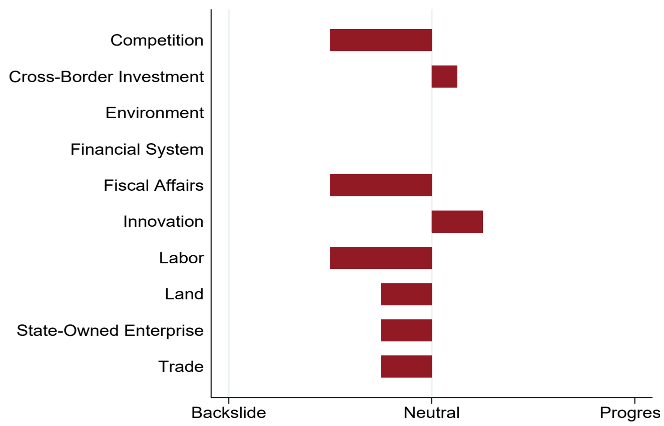
- While the economic environment for EM economies is challenging – weaker global business and trade prospects, higher uncertainty, tougher external funding conditions abetted by a strong USD and rising USD interest rates, as well as various country-specific risks – there are some bright spots. First, although external funding conditions are becoming less benign given the Fed's tightening stance, the USD is again expensively valued. Hence, the playing field is currently tilting toward US dollar depreciation rather than further appreciation. And a weakening US dollar would, in all likelihood, help EM currencies to recover, and, as a consequence, EM asset prices, too. Second, the sharp correction of the oil price since October offers some relief to the budgets of businesses and consumers and could help drive up demand, at least for net oil importers.

- China's economy continues to show signs of weakness. GDP growth, quite stable throughout 2017, slowed during the first three quarters of 2018. And given their usually very smooth behavior, falling PMIs indices in the final months of 2018 in the manufacturing and the services sectors also point to a continuation of the current slowdown in the Chinese economy. The confidence of Chinese consumers, which reached a record high in February 2018, has also markedly slipped – though still remaining at a high level in a historical context.

- The mix of structural and cyclical factors – declining trend growth, a national deleveraging campaign and the effects of the new US tariffs, whose impact on growth should be fully felt in the first semester – will continue to impede economic expansion this year, cushioned, we expect, by additional stimulus. But there may be some positive surprises, too, if the trade disputes with the US could be resolved faster than expected.

- While we believe that investors should focus on structural rather than cyclical themes in China, such as policy reforms and economic transitioning, it is important to note that the reform process for most policy goals has stalled in recent quarters. Moreover, the private sector is shrinking for the first time in two decades, as research of the Asia Society Policy Institute shows.

Reform process losing traction in China

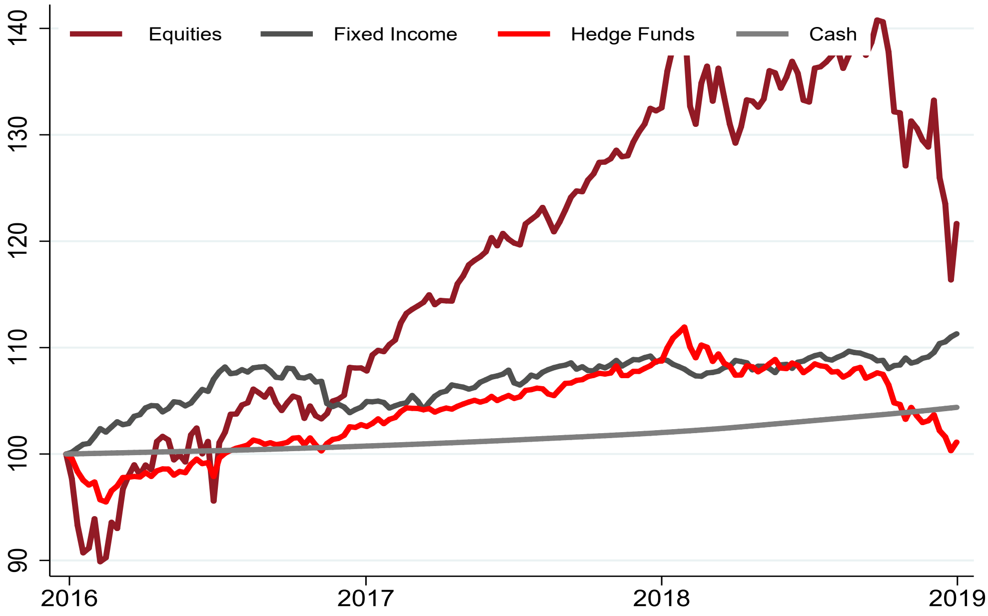


The chart shows the reform progress in the ten clusters monitored by the *China Dashboard* of the *Asian Policy Society Institute* and the *Rhodium Group*. As of fall 2018, progress could be observed only in two of the ten clusters, while six regressed.

Source: Asia Policy Society Institute, Rhodium Group

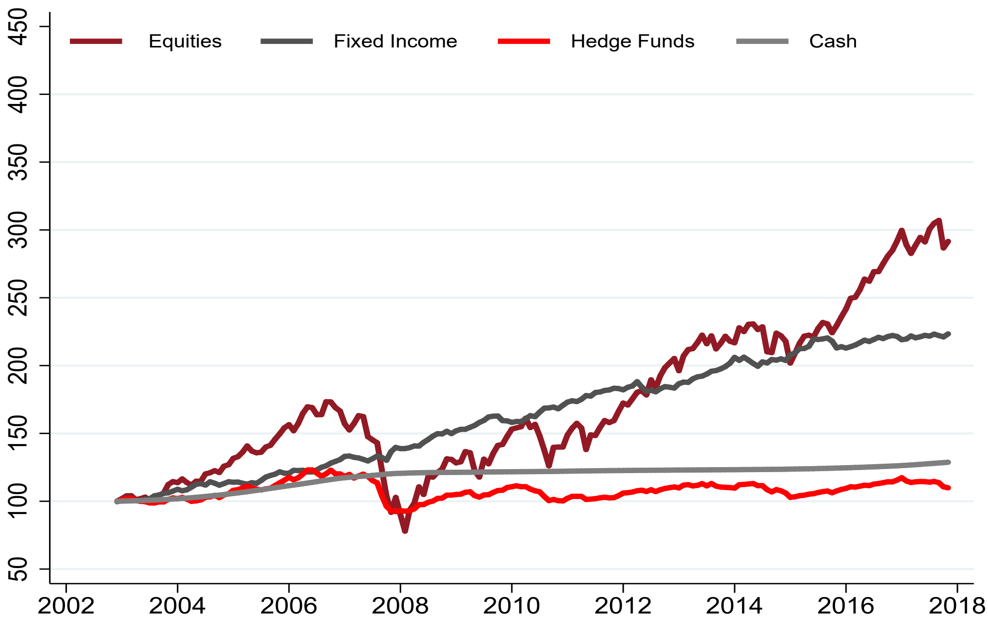
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- Those investors who adhered to the previously successful strategy of "buying the dip" had their nerves seriously tested in the fourth quarter of 2018. A combination of macro worries, including flagging economic momentum und uncertainty related to ongoing trade disputes, Brexit and Italy's budget struggles, and some bottom-up disappointments like the underwhelming numbers from previous market drivers like Apple, made most equity markets turn red for 2018. Global equity markets as measured by the MSCI World closed 2018 down by 8.7 percent in USD. The broad US equity market of the S&P 500 lost 4.4 percent in USD. European and Asian equity markets bottomed out in the fourth quarter of 2018 but still lagged over the entire year, with the MSCI Europe down 10.1 percent in EUR and Asia logging a loss of 13.3 percent in USD.

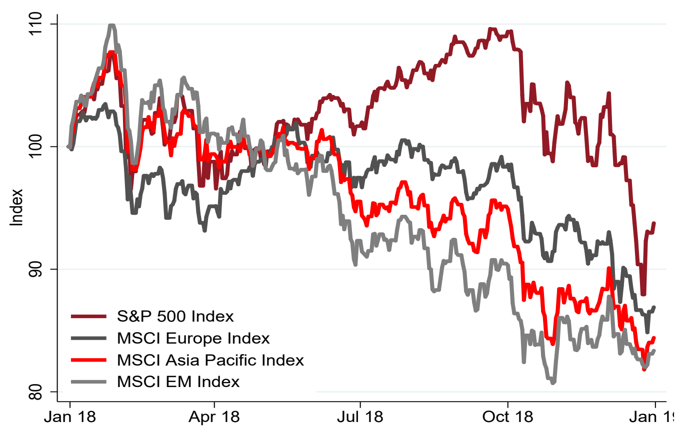
- Looking to 2019, it seems riskless to predict that volatility will remain high given the uncertainties plaguing the current global outlook. While the Fed gave markets some enthusiastically welcomed hints that it might tread more carefully when it comes to raising interest rates, the general direction will be less (and not more) monetary stimulus. And the effects of the very supportive US fiscal stimulus measures enacted in 2018 will fade in due course.

- Absent fresh economic tailwinds and given the negative market trends and elevated uncertainties, we are cautious with regard to equity market exposure generally. But while the dynamics of earnings growth have indeed cooled down, the recent price declines in equity markets have also lowered valuations. The valuations of some stocks already imply a full-fledged recession ahead, thereby offering attractive potential returns to selective long-term investors – especially those who apply a rigorous, fundamental, bottom-up assessment.

- According to various metrics, the valuations of most equity markets have returned to reasonable levels and are now either in line with historical averages, as in the case for the US market, or below those averages, for example, for several European and Asian markets.

- This ambiguous mix of elevated uncertainty, weakening economic dynamics, improved valuations, and sentiment that may be overly pessimistic speaks against marked tactical deviations from the long-term strategy. We therefore stick to our neutral equity market positioning and maintain investment discipline by rebalancing frequently back to the strategic allocation.

Europe, Asia and EM bottoming out?



Source: Bloomberg, MFO

Asian, European and emerging equity markets have stabilized. Given that these markets are currently pricing in relatively adverse scenarios, as opposed to the US market, we think that the latter is currently more vulnerable to negative surprises.

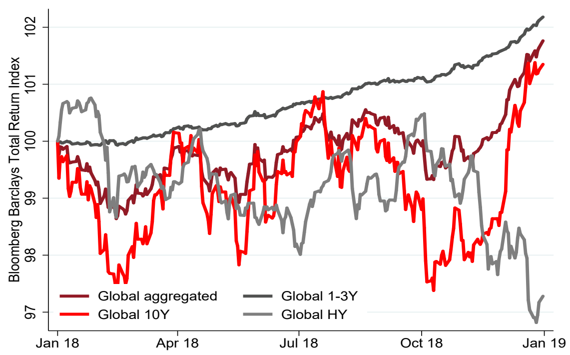
2.2 Fixed Income

- Fixed-income markets were mainly shaped by two developments in 2018. First, ongoing monetary policy tightening in the US led to rising interest rates, enhancing the attractiveness of money markets and short-dated USD-denominated bonds. At the same time, fixed-income securities with long maturities suffered losses, at least in the first three quarters of 2018, before rising risk aversion and late-cycle fears again led yields on longer-dated bonds to drop. Faster rising yields at the short end of the yield curve and, later, freshly falling yields at the long end of the curve caused both an upward shift in and especially a flattening of the yield curve. As a consequence, from a risk-return perspective, short-dated fixed income has again become more attractive than longer maturities. The second driver of fixed-income markets last year were rising policy rates in combination with fading economic momentum outside of the US. This fueled fears that the credit cycle might be coming to an end, as reflected in increasing credit spreads. For example, option-adjusted spreads on the Bloomberg Barclays Global High Yield Index rose from 3.4 to 5.5 percent at year-end, eroding the performance of the index, which stood at -2.7 percent at year-end.

- As we noted on the first page of this issue, rising interest rates lead to higher financing costs, which are problematic for highly leveraged companies. But this would not only be a problem for the high-yield space; it would also burden highly leveraged companies in the investment-grade space. Both the share of BBB-rated investment-grade issuers and the leverage of the median BBB-rated companies have risen since the 2008 financial crisis. However, credit quality varies within the BBB space, which might not always be reflected in the price. Companies with poor fundamentals risk being downgraded once the cycle turns. This is especially a concern for investors whose guidelines force them to sell downgraded titles, potentially causing significant price corrections.

- That said, downgrades and associated price corrections also offer an opportunity for less restricted investors to buy these issues cheaply. In any case, as of now, investors wanting to limit "fallen angel" risk and mark-to-market losses have to be selective and differentiate more thoroughly between issuers with varying credit quality in the BBB space. While spread-widening and mark-to-market losses are also a concern for high-yield investors, arguing against increasing high-yield exposure at present, selecting issuers that are less likely to a default should be the main concern. For both areas, managers that carefully select issuers should add value.

Short maturities outperformed



Source: Bloomberg, MFO

Rising spreads on high-yields

Source: Bloomberg, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- Similar to risk assets like equities, alternative asset classes also suffered under 2018's triple threat of tighter financial conditions, elevated uncertainty and a clouded economic outlook. As measured by broad indices, commodities, hedge funds, gold and global real estate investment trusts all lost between 2.5 and 10.5 percent over the course of 2018.

- Commodities across the spectrum stumbled last year, too, with only a few exceptions like palladium, corn and wheat ending the year in positive territory. Crude oil, depending on the fixed price cited, declined between 14 and 21 percent over the year.

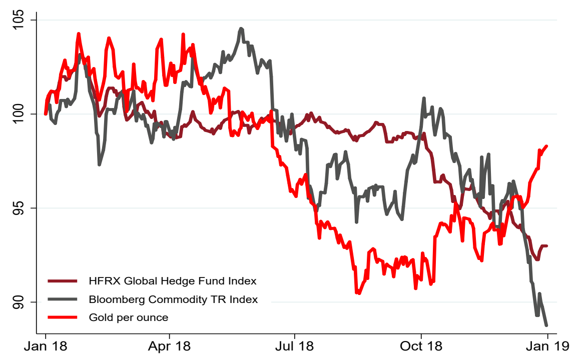
- Given our view that the USD is again overvalued and therefore now bears some depreciation risk, we see chances for some upside for gold and crude oil prices over the coming year. However, the fundamentals currently suggest only weak tailwinds for crude oil prices. The International Energy Agency expects supply growth to exceed demand growth again in 2019, as increased supplies from Saudi Arabia, Russia and the US more than offset declines from Iran and Venezuela.

Currencies

- Emerging market (EM) currencies, including the Turkish Lira, the Indian rupee and the Brazilian real recovered part of their earlier losses over the course of the fourth quarter. Others, such as the Argentine peso, the Russian ruble and the Chinese yuan, merely stabilized. As most EM currencies seem to price in rather adverse scenarios and much of the broad-based rout seemed driven by sentiment and USD-strength, we think EM currencies have largely bottomed out. Given their generally rather cheap valuations and the fact that the USD seems expensive again, with the field tilted towards depreciation rather than further appreciation, we see some upside potential for EM currencies.

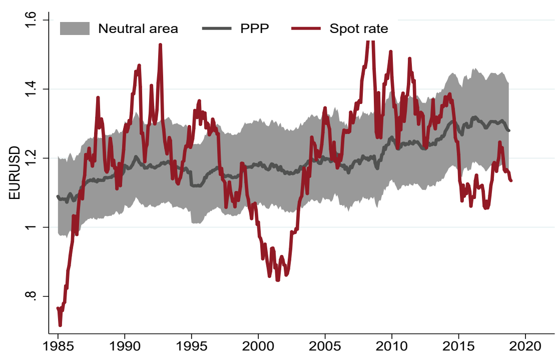
- The EUR again looks cheaply valued against the USD. With the monetary policy turnaround in the Eurozone finally in view, we think the thick interest-rate wedge between the two currency areas is likely to narrow again in favour of the EUR. Absent marked downside surprises that could induce the ECB to further postpone policy normalisation, we see some upside for the EUR going forward. In contrast, despite its recent additional appreciation, the Swiss franc currently appears to be fairly valued against the euro, in our view.

Alternative assets broadly suffered



Source: Thomson Reuters Datastream, MFO

EUR again undervalued against the USD



Source: Thomson Reuters Datastream, MFO

3. Positioning

- Against the complicated backdrop of slowing economic momentum, monetary policy tightening and broadly negative trends, we maintain our cautious stance on equities as an asset class and position ourselves in line with the strategic allocation. However, we think that investor sentiment might be overly pessimistic, pricing in quite adverse scenarios for most markets other than the US market. At the same time, valuations have broadly improved, most notably for non-US markets. While we cannot rule out further drawdowns before sentiment turns, we think upside surprises are within the realm of the possible. But given the contradictory signals we are currently seeing, we abstain from taking an active position in either direction in equities as at present.
- Following its clear outperformance throughout last year, the US equity market remains more expensive compared to equity markets of other regions. US equities are apparently pricing in a more optimistic economic scenario, with only a mild slowdown towards trend growth. Other markets seem to be pricing in a sharper contraction or even a recession. Therefore, we think the US market seems more vulnerable to negative economic surprises. Indeed, over the course of the final quarter of 2018, the US market finally faltered and started to underperform other regions. Against this backdrop, we feel reassured and maintain the overweight in European and Asian equity markets.
- While we haven't yet taken an active position, we expect EM equities and other EM assets to soon present attractive investment opportunities. For one thing, most EM assets price in much more adverse scenarios than implied by the actual economic data. For another, EM currencies are broadly undervalued against the USD. A reversal of this situation alone would lift EM assets.
- Given the signs that the credit cycle is reaching an inflection point and that average credit quality has worsened in the investment-grade corporate-bond space, and also in the sovereign debt space since the global financial crisis, we think selectivity remains key. We therefore continue to rely on active managers who pursue a thorough bottom-up approach and make hard-headed relative-value assessments. Within the equity space, we favour the shares of fundamentally sound, low-leveraged companies.
- Within fixed income, we maintain our underweights for EUR- and CHF-denominated portfolios, whereas for USD portfolios we are seeking a neutral position, since USD short-term yields have become attractive. In any case, however, we keep durations shorter than implied by the benchmark.

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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