MARCUARD FAMILY OFFICE

Investment Outlook

July 2019

Resilience instead of directionality

The latest escalation in the US-China trade dispute, started in May by a fearless and in equal measure reckless US administration, comes at a bad time for an already slowing global economy. Trade woes may stall an economic stabilisation whose first frail signs had only just emerged in spring.

The fact that the global manufacturing cycle cooled further, with the *JPMorgan Global Manufacturing PMI* slipping for the first time below the critical threshold of 50 at the end of May, actually masks an earlier, albeit frail, hint of stabilisation in the global trade and manufacturing cycle. The latest dip in the cycle was mainly driven by deteriorating confidence in the US, just as the negative dynamics in some parts of the world were showing some signs of slowing or even coming to a halt.

The hope that this seed of stabilisation in global business prospects might take root, or that the slowdown might even reverse, has receded lately given the latest escalations in the trade disputes. While we cannot yet know the detailed economic consequences of these conflicts, they are likely to include the reorganisation of global supply chains and some significant welfare losses for sellers and buyers, including US consumers. What is already clear, though, is that the uncertainty unleashed by the trade disputes is toxic for confidence – both for businesses and for investors.

Indeed, a recent poll by *Bank of America Merrill Lynch* suggests that money managers haven't been so bearish since the financial crisis of 2008, with equity allocations posting the second-largest drop on record and cash holdings the biggest jump since 2011. This renewed bearishness may not yet be reflected in markets for risk assets, as stock and credit markets resumed their uptrend in June after a short pause in May. But Treasury bond markets are currently sending worrying signals. Taken altogether, the "safe" segments of the fixed-income markets now tend to price in a rather gloomy outlook. The US yield curve is currently inverted, historically often a signal of a coming recession. Yields on 10-year US Treasuries fell from 2.7 percent at the start of the year to 2.0 percent by the end of June. Other government bond markets followed suit. Through the first six months of the year, yields on 10-year German Bunds and Swiss Eidgenossen were down by almost 0.3 and 0.6 percentage points, respectively. Swiss bond investors now have to invest in maturities of 39 years and longer in order to get a non-negative nominal yield. So, even within the context of the low-yield environment, bond yields are extremely low.

While events may prove us wrong, we currently think the pessimistic view priced in by bond markets seems overdone, as it diverges markedly from actual economic data. In particular, domestic demand has remained strong in the major economies and the chances for revived consumer price inflation, despite the latest drop, seem rather tipped to the upside. However, the slowdown in the manufacturing cycle, the uncertainty generated by the trade conflicts, and the diverging outlooks of bond markets and economic fundamentals certainly challenge investors tempted to try and time the market and make directional bets. Simply following the markets' frequent mood swings lately is likely to whipsaw procyclical investors. Therefore, we think it is more important to construct resilient, diversified portfolios than it is to attempt to take the right directional position. In other words, we think maintaining investment discipline is more crucial than ever. This is done by frequently rebalancing back to the strategic allocation and abstaining from large directional bets.

1.1 North America

- Despite several signs of slowing economic activity at the start of the year, US first-quarter GDP growth accelerated from 3.0 to 3.2 percent year-over-year, surprising to the upside. This acceleration was driven by faster growth in inventory investments, state and local government spending, and exports, compensating for slower growth in consumption expenditures, nonresidential fixed investments, and government spending at the federal level.

- However, sentiment and activity indicators are both suggesting that the pace of economic expansion in all likelihood slowed in the second quarter. The *ISM Manufacturing PMI* slid further, from 55.3 at the end of Q1 to 51.7 in June, while the *ISM Non-Manufacturing Index* has held up comparatively well, albeit also pointing to slower growth in the non-manufacturing sector. The slowdown in industrial production growth from 2.2 in March to 2.1 percent year-over-year in May further underlines the sense of slowing activity in the manufacturing sector.

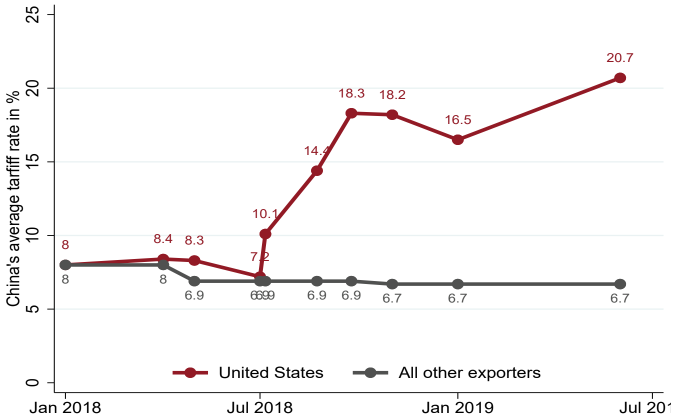
- In contrast, consumers are still enjoying some tailwinds. Unemployment remains close to a multi-decade low, below the level consistent with full employment. Vacancies are close to their historical high while real wages continue to grow. Reflecting these favourable conditions, consumer sentiment has remained above average.

- Consumers also benefited from slightly slowing consumer price inflation throughout the first half of the year, with the CPI core inflation rate standing at 2.0 percent year-over-year in May. *Personal Consumption Expenditures (PCE)*, the core measure for the Fed's monetary policy deliberations, stood at 1.6 percent year-over-year in May.

- On balance, however, while sentiment has deteriorated, uncertainty has increased, and the economy appears to be expanding at a visibly slower rate, the data is still far from implying a recession. Given that the slowdown is from boom levels, we now expect a pace of expansion nearer trend growth in the quarters to come.

- This contrasts with treasury markets, which currently price in three rate cuts until the end of the year. The Fed has been on hold since its rate hike in December and it intends to end its balance sheet reduction in September. And at its June meeting, the Fed expressed its readiness to ease monetary conditions if the economic situation worsened. Nevertheless, in our view, the market's expectations seem exaggerated and bear the potential for disappointment if the anticipated rate cuts fail to materialise.

US exports to China grow less competitive



Following the US-Chinese trade tit-for-tat, which has delivered higher tariffs on US imports from China and associated retaliatory tariff hikes by China on US exports, the US faces markedly higher average tariff rates on its exports to China. In contrast, the average tariff rate on exports to China from other countries has fallen slightly, thereby putting US exporters at a disadvantage in China.

Source: Peterson Institute of International Economics

1.2 Europe

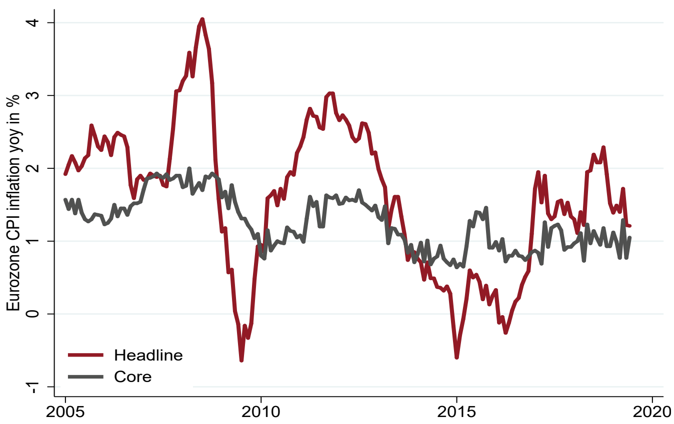
- Quarter-over-quarter, the Eurozone's economy again gained some steam. It expanded by 0.4 percent in Q2, after growing 0.2 percent in Q1, resulting in stable year-over-year growth of 1.2 percent. Household consumption, capital formation, external trade and government consumption all contributed positively, whereas changes in inventories subtracted from first-quarter growth. Looking at the different expenditure components that contribute to growth, we note that external trade recovered somewhat, expanding faster in Q1 19 after stagnating in Q4 18 and contracting in Q3 18.

- Eurozone business confidence indicators compiled by the European Commission also showed tentative signs of stabilisation in May, with industrial confidence firming up after deteriorating throughout the previous quarter. Meanwhile, confidence in services, which was already comparatively higher, remained stable.

- Consumer confidence, which had cooled in parallel with weakening business confidence throughout 2018, also stabilised, improving further since the start of this year. Overall, consumers continue to face a favourable backdrop. The labour market remains healthy, despite the economic slowdown of recent quarters. The unemployment rate continued its steady decline, reaching 7.6 percent in April, which is only marginally above the all-time low of October 2007. In addition, vacancies are at the highest level since this metric was introduced, in 2004. All of the above are reflected in the healthy growth of wages and salaries, up by 2.5 percent year-over-year in Q1 – well above the 1.4-percent annual consumer price inflation rate seen at the end of Q1. Hence, consumers were benefitting from solid increases in real wages, helped along, again, by falling CPI rates, with the core rate slowing to 1.2 percent year-over-year in June.

- Fixed income markets are currently pricing in a turnaround scenario: that the latest slowdown in CPI might mark the start of a turnaround beyond monthly volatility, which is reflected in the sharp flattening of the euro yield curve and the tumbling inflation swap rates. Accordingly, like its US counterpart, the ECB has adopted a more cautious tone of late, further postponing a first policy-rate hike at least until summer 2020. At its Forum in June the ECB signalled its readiness to adopt further stimulus measures, including rate cuts and fresh asset purchases, if needed.

CPI declines in the Eurozone



Source: Thomson Reuters Datastream, MFO

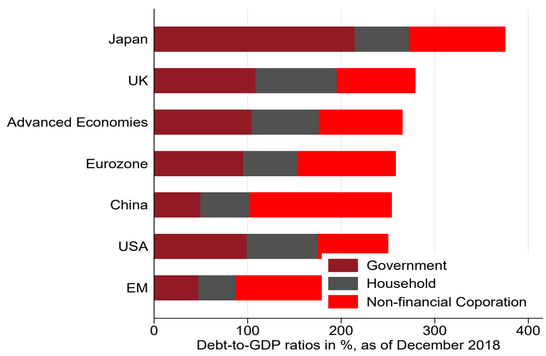
Core consumer price inflation slowed to 0.8% year-over-year in May before increasing again to 1.1% in June. If fixed-income markets are right, the dip in May was not temporary, but marks the turn toward flagging inflation momentum and an ongoing economic slowdown. However, we note, the core rate has mostly fluctuated around an average of 1.1% over the past ten years. In addition, seasonal factors explain part of the latest CPI dip. In that context, the latest drop in CPI core inflation hardly seems remarkable.

1.3 Asia and Emerging Economies

- After slowing through the first three quarters of 2018, economic activity in Japan regained pace, with GDP growing by 0.9 percent year-over-year in the Q1 of the current year. This is again in line with trend growth, after growing 0.3 percent year-over-year in the final quarter of 2018. However, the apparent stabilisation was mainly driven by faster growth in public investments while the contraction in exports was buffered by imports that fell more than exports did.
- Current levels of business sentiment as measured by the *IHS Markit PMIs* imply soft growth in the services sector and stagnation or even marginal contraction in manufacturing. Consumer confidence, in steady decline since June 2018, continued its downtrend in Q2 19, falling marginally below long-term historical averages.
- However, given the cooling economic conditions, inflation rates, which were notoriously low before the advent of "Abenomics" – a combination of expansionary fiscal and monetary policy and structural reforms – slowed a bit in May but remained remarkably stable, by Japanese standards, throughout 2018 and into the first months of 2019, especially in Tokyo.

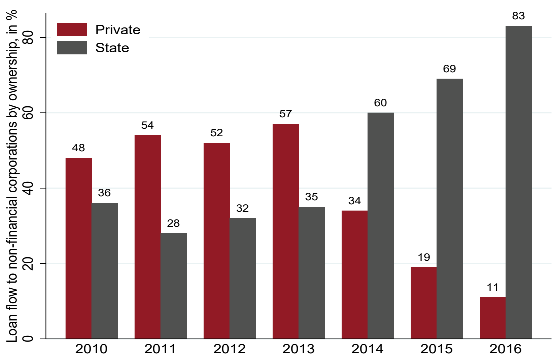
- The economic situation in China is also mixed. Unsurprisingly, the manufacturing sector is in stagnation territory. Meanwhile, business confidence in the services sector remains quite robust, implying an ongoing expansion.
- China's outlook remains clouded by the trade dispute with the US and by domestic problems, mainly related to debt. Total debt in China amounts to about 250 percent of GDP, which compares to debt levels in the US and Italy. However, the composition of the debt differs significantly, with most of it – about 150 percent – being corporate debt. And most of this corporate debt is actually what state-owned enterprises owe to state-owned banks. This situation has developed mainly as a result of China's large stimulus programs to build public infrastructure and create employment following the global financial crisis.
- Thus, the debt problem is mainly found on the balance sheets of state-owned corporations. The state, at its discretion, could engineer an eventual unwinding of excessive debt burdens. Thus, most observers assume that China's debt situation is under control.
- However, given that credit flows mainly via public channels, private firms in China must struggle with limited access to credit, especially after the authorities' recent crackdown on shadow lending, as the second chart below shows, with the loan flow ebbing markedly in recent years.

Comparing China's debt-to-GDP ratio



Source: BIS, MFO

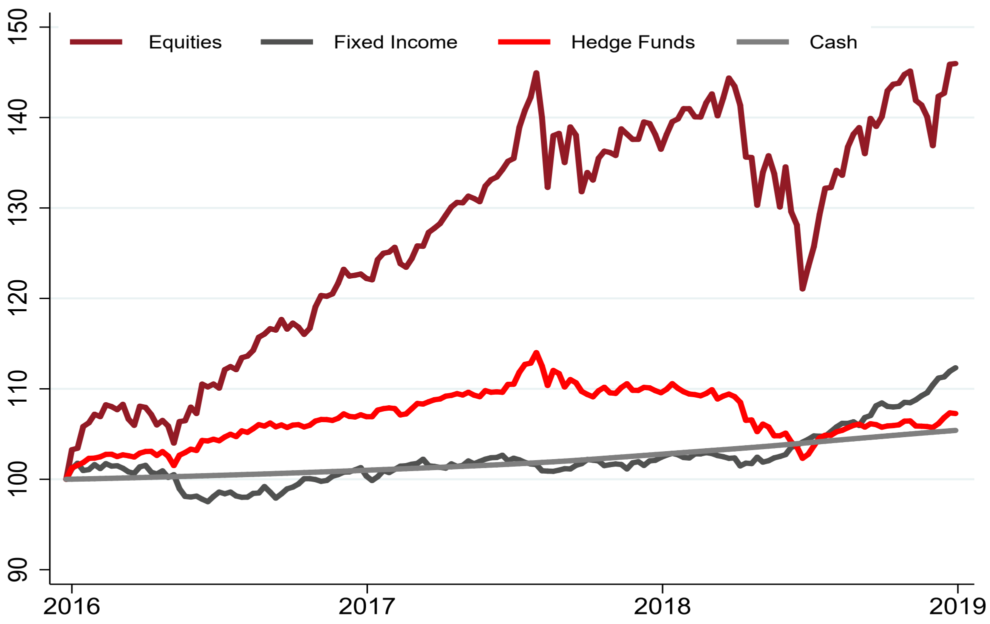
A tale of two credit cycles



Source: Peterson Institute of International Economics

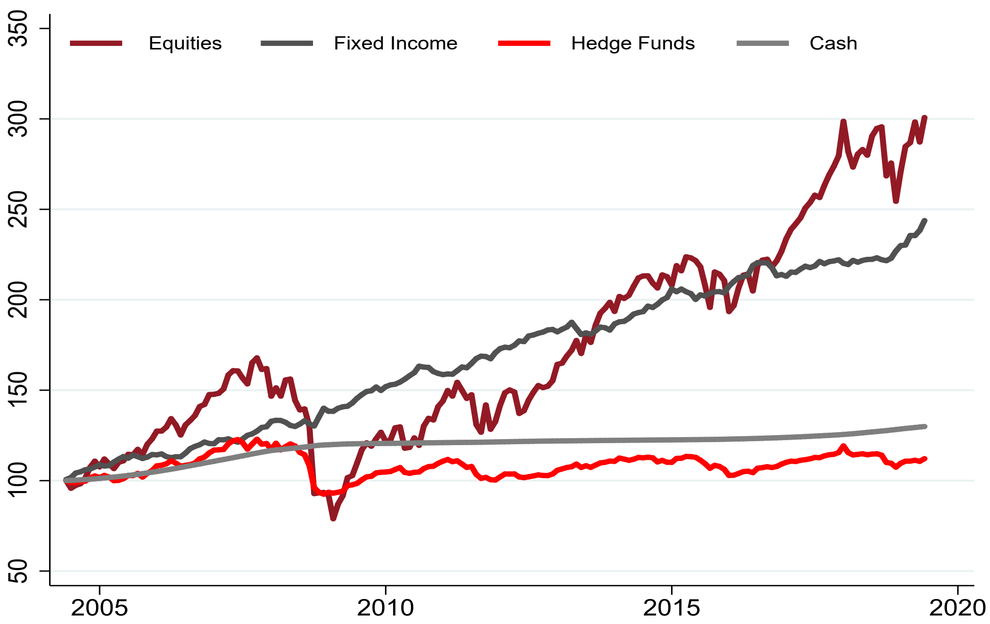
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- April saw most equity markets continue their ascent, only to be interrupted in May, when investors were spooked by the gruff trade war rhetoric and new US import tariffs on Chinese goods, followed by immediate Chinese countermeasures. The real risk is not the punitive tariffs but the fact that global corporations are being forced to make major changes to their supply chains and will probably be less open to making new investments.

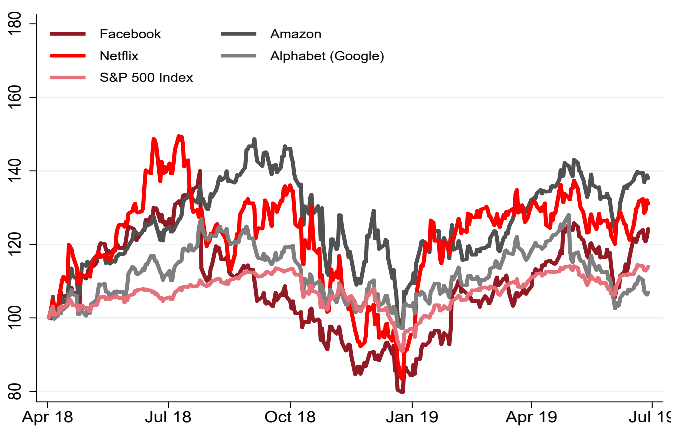
- In any case, even accounting for the correction in May, year-to-date equity market performance, as represented in the *MSCI World Total Return Index*, is still up 17.0 percent in US dollar, with the despair in May giving way to hope in June in anticipation of further stimulus from the central banks. With a positive performance of 18.5 percent of the *S&P 500*, the US market leads its European peers. The *MSCI Europe* was at 15.9 percent, and Asian equities in the *MSCI AC Asia Pacific* at 10.8 percent in late June in US dollar.

- As yield-starved bond investors now also venture into equities, the share prices of many companies, especially blue chips with historically stable dividend payouts, have reached all-time highs. However, the expectation is that as long as the Fed maintains an accommodative stance, equity markets will avoid a major downturn. On the other hand, absolute returns from this level onwards are generally expected to be lower than they have been in the past ten years.

- While Asian exporters generally suffered, some companies focussing on their domestic markets still enjoy good growth. The trade conflict between China and the US may have taken the spotlight but relations between China and Europe have also grown more confrontational. China is seeking to extend its influence in Europe, Asia and Africa through its Belt and Road Initiative, while the EU is increasingly blocking company takeovers by Chinese firms. China's response to the EU's tougher stance could hurt European companies, who generally are more dependent on external demand than are US peers.

- We find equity markets are generally priced for a reasonable amount of monetary easing ahead. And corporate earnings mostly still look likely to be solid. Thus, we consider a neutral stance on equities appropriate at this time. While Rule 1 is to invest according to one's risk tolerance, we expect further volatility and we will use these episodes to continuously rebalance our portfolios. In an unclear environment like today's, neither a too negative nor a too positive stance is appropriate, in our opinion.

FANGs defanged



Source: Bloomberg, MFO

Discussion of increased regulatory scrutiny led to a temporary setback for the high-flying FANG stocks. Various sources reported that the US Justice Department and the Federal Trade Commission were planning to launch investigations into these tech companies. In addition, they also attracted the direct scorn of the US president.

2.2 Fixed Income

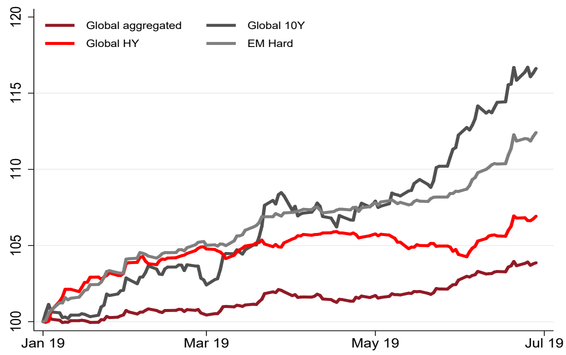
- The Q2 19 saw a temporary uptick in volatility in credit markets after a further escalation of the trade dispute between the US and China. However, towards the end of the quarter, investors refocused on fundamentals, causing credit spreads to narrow once more. As a consequence, high-yield credit spreads ended the quarter at levels similar and investment-grade credit spreads at tighter levels to those at the start of the quarter.

- Interest rate curves resumed their flattening trend in the US, Europe and Switzerland. US investor sentiment has particularly soured. The forward market currently expects three Fed rate cuts until the end of the year. However, the Fed itself has repeatedly stated that it would follow a data-dependent approach. While we think the economic data does not yet confirm the bearish market outlook, US business sentiment has visibly cooled and uncertainty has increased. However, as of now, US economic data implies only a normalization from high growth rates toward rates more in line with trend. Therefore, we think there might be room for positive surprises, with a subsequent recalibration of market sentiment. Consequently, we abstain from increasing the duration in our portfolios at this point. We remain neutral in USD portfolios and underweight in CHF and EUR portfolios, as in the latter two currencies it is impossible to earn a positive nominal yield, let alone real yield, even on maturities of 39 years and 20 years, respectively.

- Inflation expectations, as measured by five-year inflation swaps, fell visibly, to 1.2 percent in Europe and 2.0 percent in the US. Hence, while investors still seem to believe in the Fed's ability to reach its inflation target, the European Central Bank apparently is not expected to reach its just-under-2-percent inflation target, especially since the ECB's stimulus options are more limited than the Fed's.

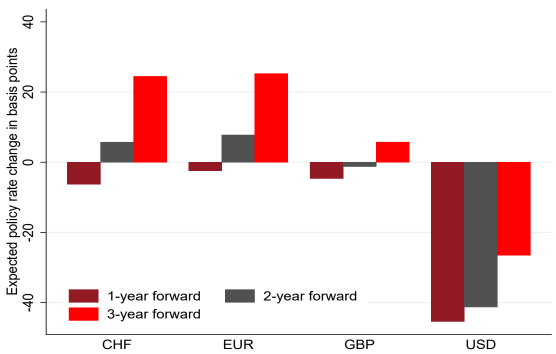
- Default rates, as measured by the S&P default rate for the twelve months ending in May, remained at the record-low level of 0.0 percent, where they have been since January. We expect the default rate to approach 1.5 to 2.0 percent in the medium term, in line with historical default rates. Given the low credit spreads and the again very low Treasury yields, financing conditions remain favourable. Unsurprisingly, against this backdrop, we continue to see eroding lending standards. Therefore, we refrain from entering into new credit engagements at this point and reiterate the need for selectivity.

EM bonds outperform



Source: Thomson Reuters Datastream, MFO

Market expects rate cuts



Source: Bloomberg, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- Commodities in aggregate, as measured by the *Bloomberg Commodity Total Return Index*, ended their uptrend and mostly declined throughout the Q2. They closed the second quarter up 5.1 percent year-to-date. But gold enjoyed a revival, gaining 9.9 percent year-to-date. Global real estate investment trusts, as measured by the *FTSE NAREIT All Equity REITS Total Return Index*, were lifted further by fresh declines in discount rates and an ongoing equity market rally, delivering a stellar 19.3 percent, year-to date. While hedge funds in aggregate delivered positive year-to-date performance of 4.1 percent, according the *HFRX Global Hedge Fund Index*, equity long-short strategies were apparently better suited to profit from market dislocations and elevated volatility and delivered 5.8 percent year-to-date, as measured by the *HFRX Equity Hedge Index*.

- The private equity industry continues to grow. Fundraising is flourishing, with dry powder at a cyclical high, according to *Preqin*. But competition for deals remains intense at elevated valuation levels of a median 11.5 times purchase-price-EBITDA multiple across developed markets. Following a strong exit year in 2018, Q1 19 exits experienced a slight historically common seasonal dip.

Currencies

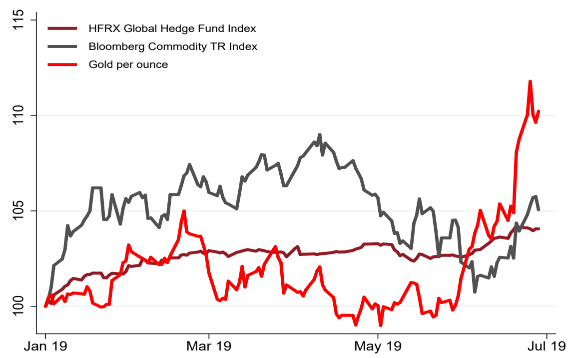
- For several quarters now, the USD has traded markedly above its fair value against many currencies, based on purchasing power parity (PPP). Emerging market economies would benefit especially from a weaker USD. As measured by the *MSCI Emerging Markets Currency Index*, which consists of currencies in the *MSCI EM Index*, the US dollar has already depreciated by 0.5 percent throughout Q2.

- Generally, from a PPP perspective, we continue to view the EUR, GBP, NOK, CAD and the JPY as cheaply valued against the USD. Even the notoriously expensive CHF has started to look rather cheap against the greenback.

- At its June meeting the Fed opened the door to potential interest rate cuts this year. The ECB has also expressed its readiness for further monetary easing. An eventual narrowing of the large interest-rate differential between the USD and other currencies could support a US dollar depreciation.

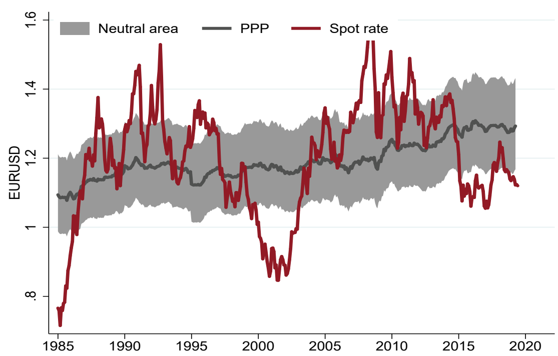
- We still consider the Swiss franc fairly valued against the euro, while the US dollar increasingly trades at the upper fair-value range against the franc.

Gold at a six-year high



Source: Thomson Reuters Datastream, MFO

US dollar still expensive



Source: Thomson Reuters Datastream, MFO

3. Positioning

- After the dip at year-end, the first-quarter "compensation rally" continued in Q2, eventually transforming itself into a rally responding to expectations of monetary policy easing. This boosted asset values, supporting stocks, private equity, real estate and debt markets alike.
- The current situation is challenging to articulate, as it seems inherently paradoxical. Risk asset markets rallied based on the expectation of easier monetary policies. But these will only materialize to the extent currently priced in if economic conditions markedly deteriorate. At the same time, safe-haven assets and gold are also rallying. To resolve this cognitive dissonance, it might be helpful to remember that we remain in a post-financial crisis world in which central banks are still predisposed to a significant easing bias. Thus, there is one common factor at work today – extremely low discount rates – that inflates the value of all kinds of assets.
- On balance, conditions for equity markets have stabilized somewhat. Our broad-based economic scoring model for the US, which considers the climate for businesses, consumers and export, as well as the credit cycle, has stabilised. After a sharp dip at the beginning of the year, it is again approaching neutral levels. The economic conditions in the Eurozone also imply a neutral view, on balance. Hence, in combination with flat market signals, we returned to a neutral stance on global equities, despite the swelling valuations.
- Given the persistently very low bond yields and extensive curve-flattening, bond valuations are unattractive, in our view, even in the current low-yield environment. Within EUR and CHF portfolios, therefore, we maintain our underweight on bonds in general and duration risk in specific. In these currencies, yields both in nominal and in real terms remain in negative territory until very long maturities. In USD portfolios we keep the bond allocation and the duration exposure in line with the benchmark.
- Within the bond allocation we also maintain our credit overweight. However, as we have pointed out before, aggregate risk, especially in the investment-grade segment of the corporate market, has been on the rise and could lead to distress if credit conditions sour and spreads widen. Therefore, investors have to focus on quality and fundamentals in order to avoid defaults that lead to permanent losses, whereas widening spreads can be borne by unconstrained investors.
- On the back of renewed lower real interest rates, revived positive price momentum and asymmetrical odds in favour of US dollar depreciation, we marginally increased our gold position within the bucket of alternative assets, at the expense of hedge fund strategies.

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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Editorial deadline:	1 July 2019

MFO Investment Outlook is published quarterly. The next issue will be published in October 2019.