MARCUARD FAMILY OFFICE

Investment Outlook
October 2019

The Lord of the Rates – The saga continues

In July, the Fed made an increasingly expected monetary policy reversal. After two and a half years and nine rate hikes, it cut interest rates by 0.25 percent, and did so again in September. Its Eurozone peer, the ECB, which never abandoned its emergency setting at the zero lower bound, announced a rate cut from -0.4 to -0.5 percent in mid-September and the resumption of its bond purchasing program, starting in November with a monthly volume of 20 billion euro.

The rate cuts came in response to weakening global economic prospects, flagging inflation and elevated political uncertainties. While the moves had already been partially discounted by financial markets, the Fed's cut at the end of July led to August's unprecedented compression of bond yields in all developed bond markets – which has since partially reversed. This leads us to look again at "the One Policy to rule them all," that is, monetary policy.

Remarkably, consumer price inflation has remained subdued across the advanced economies – stubbornly below the levels targeted by central banks despite robust consumption, healthy labor markets and the loose financing conditions that have prevailed since the 2008 global financial crisis. In other words, the policy regime of easy money seems less able to deliver its desired outcomes, while its negative side effects – asset price inflation and the quantitative build-up and qualitative deterioration of debt – have increased. As the Bank for International Settlements suggested in early September, structural factors including globalization, digitalization and some structural labor market trends like an aging workforce and the rising share of temporary employment might partially explain this weakened link between monetary policy and inflation.

As a consequence, in order to have any effect at all, central banks have had to use more firepower, in the process fostering the accumulation of debt and the buildup of systemic risk. As the chart in our fixed-income section shows, below, investment-grade debt was about 25 times GDP before the 2008 financial crisis and in the meantime has increased to about 45 times the collective GDP of the major bond issuers. In other words, driven by low interest rates on the one hand and anemic economic growth on the other, the stock of debt has grown much faster than GDP has since the financial crisis.

However, while the critics of unconventional monetary policies increase in number and calls for a more balanced policy mix grow louder – even from within the central banks themselves – we would point out that central banks will not change their methods from one day to the next. Therefore, we think "unconventional" monetary policy will remain conventional, at least for the time being, and that the current overreliance on monetary policy will end only gradually. The reign of the Lords of the Rates – the central banks – looks likely to continue for a while yet.

Thus, investors face an ever-sharper dilemma, caught between rising systemic risk and bubble-building on the one hand, and the pressure to participate in the ongoing reflation rally on the other. As a consequence, we emphasize that downside and tail risks have to be managed carefully—not simply by abstaining from market exposure ("beta") since the current rally might continue, but also by keeping idiosyncratic risks in check and avoiding potential defaults. The key is to be highly selective, especially in the lowest quality segments of the bond market, both in the investment-grade and in the high-yield space, as the former may face downgrades and the latter defaults once credit conditions tighten. In addition, managing liquidity remains vital, as an eventual downturn and the subsequent repricing of market risk will create attractive buying opportunities for those investors with sufficient liquidity.

1.1 North America

- Unsurprisingly, the US economy expanded at a slower pace in the second quarter than in the first. Year-over-year, US GDP growth slowed from 2.7 percent in Q1 to 2.3 percent in Q2. Faster growth in consumption and government expenditures partially offset the marked contraction in investment spending and exports over the quarter.

- While the statistics are not yet in, given the significant deterioration in manufacturing sentiment recently, we expect investment activity to have weakened again during the third quarter, further hobbling the pace of the economic expansion in the US.

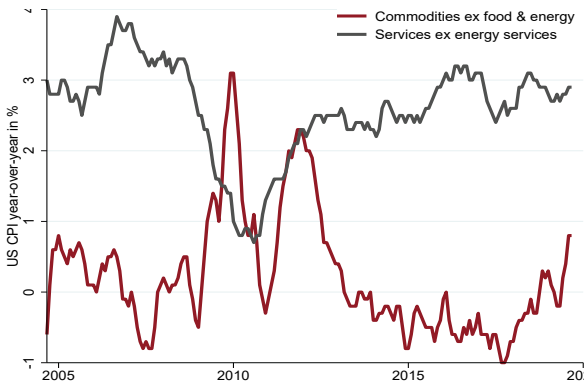
- Despite the marked cooling in business sentiment, consumer confidence remained near historical highs. Consumers still enjoy tailwinds such as a very low unemployment rate that is near a fifty-year low, high job vacancies and positive real wage growth. However, there are first signs that the positive dynamics in the labor markets have started to slow. Vacancies retreated slightly from their historical highs and job growth – while still positive – has begun to slow since the start of the year.

- If the slowdown persists or deepens, it would increasingly affect the labor market as companies stop hiring or even shed jobs, with obvious consequences for consumption. However, given the current healthy state of the labor market, there seems to be a certain buffer available.

- The PCE inflation rate, the consumer price inflation metric targeted by the Fed, has remained relatively stable throughout this year after cooling in the second half of 2018. At 1.4 percent year-over-year in August, it is still below the Fed's target rate of 2 percent. In contrast, the alternative measure of CPI core inflation firmed to 2.4 percent in August, thereby reaching its high of last year. In that connection, we find it remarkable that the previously stubborn gap between the core measures of price inflation for services and commodities is narrowing after the latter rate left negative territory in June and moved up sharply to 0.8 percent year-over-year in August.

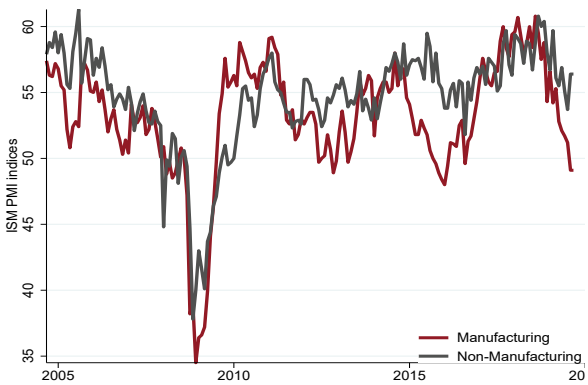
- If this uptick was driven by more expensive imports from China, the Fed might be confronted with a delicate situation, namely worsening economic prospects and higher consumer price inflation. Nevertheless, the Fed firmly reversed its tightening stance at the end of July, when it cut the target range of the fed funds rate by 0.25 percent, followed by another 0.25 percent cut in September, setting the range currently at 1.75 to 2.0 percent.

Core commodity price inflation edging up



Source: Bloomberg, MFO

ISM Manufacturing drops sharply



Bloomberg, MFO

1.2 Europe

- Economic dynamics in the Eurozone stabilized in the first half of this year after a visible slowdown during 2018. Expanding by 1.2 percent year-over-year in Q2, GDP growth was still close to estimated trend growth.

- Business conditions, as measured by the *Euro Area Business Climate Indicator*, slowed further in Q3. It remains to be seen whether the bottom has been reached in the manufacturing slowdown that is currently afflicting the Eurozone economy. The US-China trade dispute continues to sow uncertainty, which especially hurts cyclical economies like those in the Eurozone.

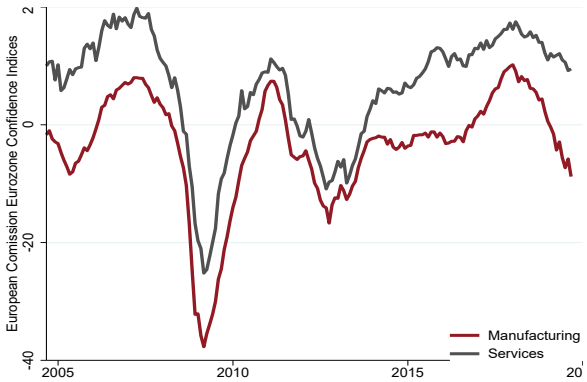
- In fact, over the longer term, European companies could profit from a reorganization of global supply chains stemming from the US-China trade spat. Before the trade dispute flared up, the average tariff rate for all economies on their exports to China was 8 percent. Now, every country except the US faces marginally lower tariffs on their exports to China, currently at 6.7 percent on average. Meanwhile, US exports to China are incurring tariffs north of 20 percent, according to the calculations of the *Peterson Institute for International Economics*.

- The services sector does comparatively better than the manufacturing sector. After slowing in 2018, services recovered, and with a level of 53.5, the *Markit Services PMI* was into expansionary territory in August.

- Consumption has held up well so far, as the labor market has hardly noticed the slowdown. Consumer confidence, after fading a bit in 2018, has been stable in 2019 at a level above the historical average. Households are still benefitting from the healthy labor market. At 7.4 percent, the August unemployment rate in the Eurozone remained close to its all-time low of 7.3 percent. Wage growth accelerated further in 2019; at 2.7 percent year-over-year, it is above average. Wages have also grown in real terms, since consumer price inflation fell to only 1.0 percent year-over-year in August. However, it is only a matter of time until the economic slowdown is felt in the labor market. The *Markit Composite PMI* for the Eurozone reported that job growth, while still positive, was only modest in August, its weakest month since March 2016.

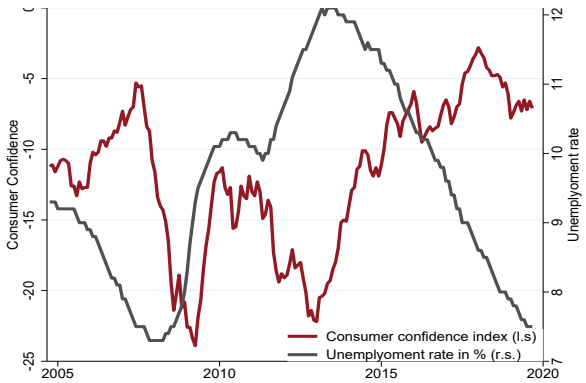
- On the back of deteriorating economic prospects, the ECB fulfilled market expectations and cut the deposit rate from -0.4 to -0.5 percent in mid-September, also announcing to restart asset purchases in November with a volume of 20 billion euro per month.

Eurozone services sector more robust



Source: Bloomberg, MFO

Eurozone consumers still face tailwinds



Source: Bloomberg, MFO

1.3 Asia and Emerging Economies

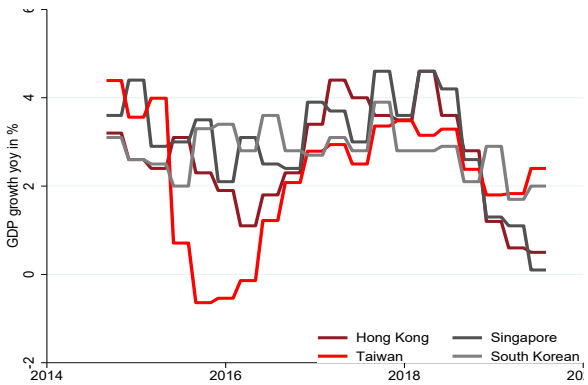
- While slowing over the second quarter, Japan's economy still grew by 1.0 percent year-over-year, which is in line or even slightly above trend growth. Faster growing private as well as public demand, and stabilizing export growth supported this performance.
- For Japan's near-term outlook, the stronger *Jibun Bank Japan Composite PMI* readings for August and September suggest a moderate but somewhat faster expansion of the economy than seen in Q2. This comes from a resilient and expanding services sector, and a stabilizing reading for manufacturing, albeit still indicating a moderate contraction.
- The labor market still seems to be in an excellent shape, with an unemployment rate of 2.2 percent, which is the lowest level in 27 years. However, consumer confidence started to sour visibly in the middle of last year, a tendency that has accelerated thus far in 2019.
- Taken together, thanks to robust domestic demand and supported by persistently accommodative fiscal and monetary policy, the Japanese economy should at least maintain its current pace of expansion in the coming months, despite headwinds from external trade.

- The Asian economies as a whole continue to suffer from the ongoing contraction in the global manufacturing cycle. As the *Markit Asian Sector PMI* shows, Forestry & Paper Products, Automobiles & Auto Parts, and Metals & Mining are the three sectors that have suffered most, with their production indices clearly in contractionary territory and the contraction gaining pace. At the same time, similar to the situation in Europe, Financials, Consumer Services and Consumer Goods are the sectors that are still doing comparatively well, posting positive growth.

- Looking at the latest GDP growth data, Taiwan and South Korea have held up surprisingly well given the slowing global trade. In contrast, Hong Kong and Singapore saw the biggest declines in activity, with the pace of expansion slowing to 0.5 and 0.1 percent year-over-year, respectively, in Q2. In Hong Kong's case, this is hardly surprising as political unrest has increasingly impacted business life in the territory.

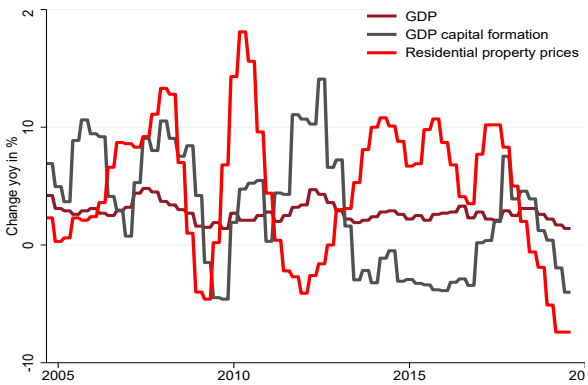
- Australia saw a marked slowdown in the pace of economic expansion, too. However, this was less driven by contagion from the global economic slowdown and more by local factors as investments in the construction sector collapsed following the slump in formerly inflated housing prices.

Diverging South-Asian economies



Source: Bloomberg, MFO

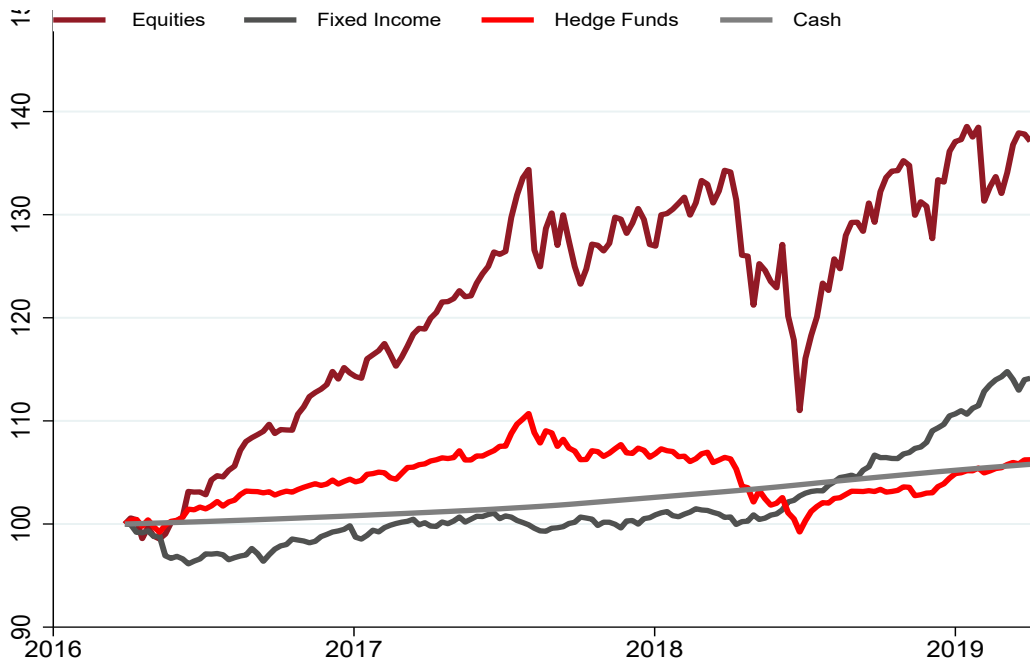
Australian housing bubble burst



Source: Bloomberg, MFO

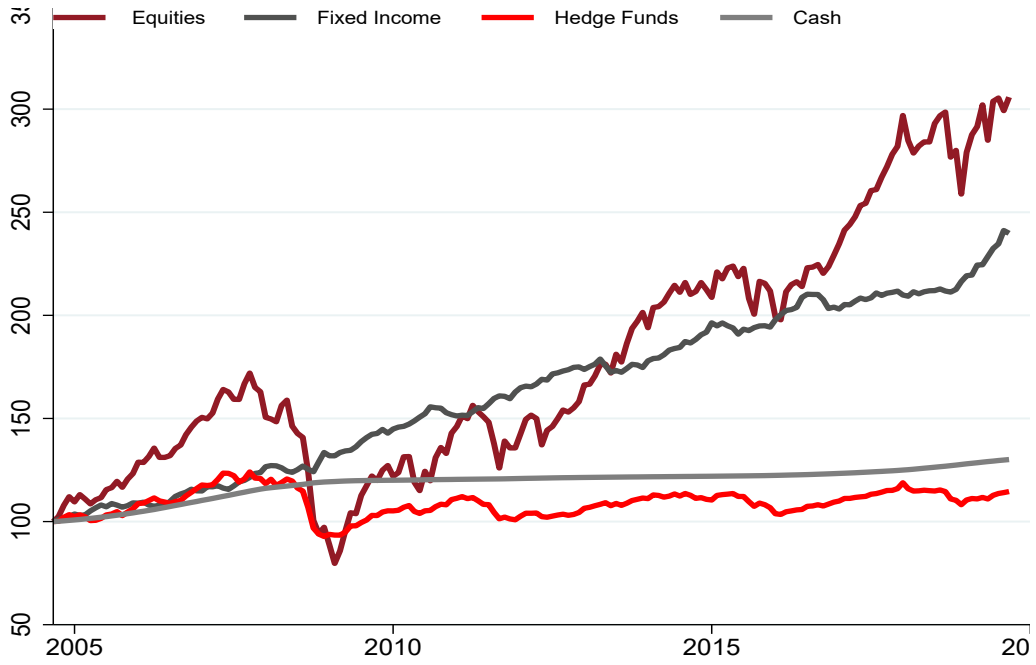
2. Financial Markets

Short-term market developments



Source: Refinitiv, MFO

Long-term market developments



Source: Refinitiv, MFO

2.1 Equities

- After a promising start to the third quarter, all major equity markets began a steep correction in the last week of July, when hopes were dashed for a quick resolution of the US-China trade dispute. After a phase of sharp fluctuations, markets regained positive ground in September, when the fears of an escalation in the trade dispute were superseded by hopes for additional monetary stimulus.

- Year-to-date, global equity markets tracked by the *MSCI World Index* are up 17.6 percent. Regionally, the *S&P 500*, covering the largest listed US companies, is up 20.6 percent for the year. The *MSCI Europe* has risen 19.9 percent, and Asian equities monitored by the *MSCI Pacific* closed the third quarter up 11.4 percent for the year.

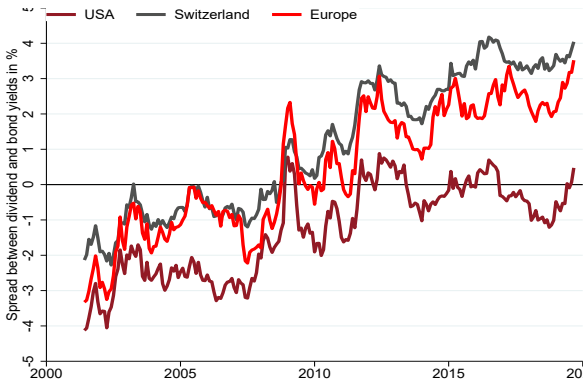
- Currently, the differences between equity markets is pronounced. Cyclical markets, such as those of Germany and some of the export-oriented Asian economies, are lagging behind the more defensive markets, like that of the US. One possible explanation is their higher exposure to the slowing global trade and manufacturing cycle. In addition, investors seem willing to pay for the perceived safety of stable earnings, bidding up the less cyclical stock markets. However, the aggregate earnings growth forecasts for US companies also imply a slowdown. As a result, higher stock prices mainly reflect an expansion of valuation multiples, likely driven by the very low interest rates of the current monetary environment.

- However, as bond prices have generally been even more inflated than stock prices by the low discount rates, the spread between dividend yields and bond yields in some markets has widened. As the chart below shows, this effect has been especially pronounced in Europe and even more so in Switzerland, where the respective central banks maintained a looser policy stance than the US Fed did.

- In contrast, the spread between dividend yields and bond yields is much narrower in the US, as interest rates are higher and dividend yields have been compressed by tech companies such as Facebook, Amazon, and Alphabet that do not pay out high dividends.

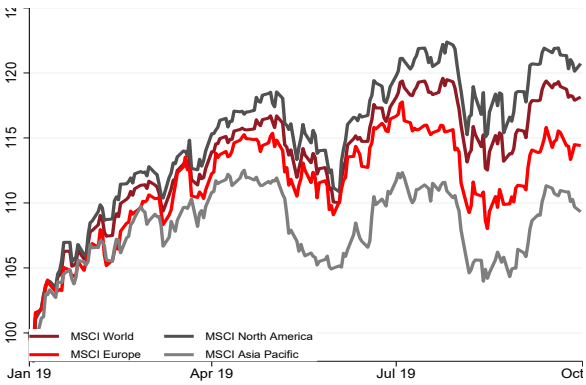
- While room for investor optimism is constrained by the slowing economic dynamics, a balanced assessment of the economic backdrop, market momentum, market risk, and valuations continues to suggests a neutral stance on equities. We see this view further supported by the relatively less stretched valuations for stock markets compared to bond markets, especially for regions other than the US.

Gap between dividends and yields widens



Source: Refinitiv, MFO

Volatile markets



Source: Refinitiv, MFO

2.2 Fixed Income

- The third quarter was characterized by unusually strong interest-rate movements, with yields dropping to record low levels throughout developed bond markets over large parts or the entirety of the different yield curves. The significant repricing in bond markets was in response to the monetary policy reversal in the US and in Europe, as inflation expectations decreased while economic risks increased.

- At the end of the third quarter, the bond markets of the US, Australia and the UK were among the last in the developed bond universe that still offered positive nominal yields along the entire yield curve. In contrast, most European government debt is now yielding negatively. This means that even highly indebted countries like Italy are now getting paid to borrow money, at least for shorter maturities. To put it another way, investors are being asked to accept losing money – not only in real terms but also in nominal terms – to lend money to Italy, a country which not too long ago was perceived as highly risky.

- The payoff profile of fixed-income instruments is asymmetrical, but the recent drop in interest rates has brought valuations to an extreme level—even in the context of our valuation models, which already take the prevailing low-yield environment into account. While we are well aware of the structural downtrend of interest rates that has been ongoing for almost four decades, the acceleration of this trend in the third quarter of this year has been extreme. From that perspective, the pullback in interest rates that has started in early September only seems logical.
- As a consequence, we continue to underweight fixed-income as an asset class in EUR and CHF portfolios, where, after accounting for currency hedging costs, benchmark yields have dropped close to zero or even into negative territory. For USD portfolios, we keep the bond allocation in line with the strategic allocation, as the compensation is still somewhat better, albeit not very attractive in historical terms.

- Given record-low yields and investors' continuous quest for yields, financing conditions remain attractive. Credit spreads have narrowed further and are now at the lowest level since the 2008 financial crisis, both for investment-grade and high-yield bonds when considering the standard *iTraxx* credit proxies. The *S&P Default Ratio* remains at a record low of 0.0 percent since the start of this year. Nevertheless, taking on liquidity and credit risk remains the only option for investors looking for positive yields. But in light of deteriorating credit quality, due diligence remains compulsory when selecting issuers, as does careful liquidity planning.

Yield curves under water

	1Y	2Y	3Y	5Y	7Y	10Y	15Y
Switzerland	-1.1%	-1.1%	-1.0%	-1.0%	-0.9%	-0.8%	-0.6%
Germany	-0.7%	-0.7%	-0.8%	-0.7%	-0.7%	-0.5%	-0.4%
France	-0.6%	-0.7%	-0.7%	-0.6%	-0.5%	-0.2%	0.1%
Spain	-0.4%	-0.5%	-0.4%	-0.2%	0.0%	0.2%	0.7%
Portugal	-0.5%	-0.5%	-0.4%	-0.2%	0.0%	0.2%	0.6%
Italy	-0.2%	-0.3%	0.0%	0.3%	0.5%	0.9%	1.4%
Belgium	-0.6%	-0.7%	-0.7%	-0.5%	-0.4%	-0.2%	0.1%
Netherlands		-0.7%	-0.8%	-0.7%	-0.6%	-0.4%	-0.3%
Greece	0.1%		0.3%	0.7%	1.1%	1.4%	1.8%
Austria	-0.6%	-0.7%	-0.7%	-0.6%	-0.4%	-0.3%	0.0%
Japan	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.2%	0.0%
United Kingdom	0.6%	0.5%	0.5%	0.5%	0.4%	0.6%	0.8%
United States	1.8%	1.7%	1.6%	1.6%	1.7%	1.8%	
Australia	0.9%	0.9%	0.8%	0.9%	1.0%	1.1%	1.3%

Bond yields: Negative | Positive | N/A

Source: Bloomberg, MFO

Debt-to-GDP ratio on the rise

Source: Refinitiv, MFO

2.3 Alternatives

Hedge funds, private markets and commodities

- Alternative asset classes all delivered positive performances over the third quarter, with REITs and gold leading the pack, not only over the quarter but also year-to-date. Profiting from a steep fall in real interest rates and spiking geopolitical uncertainty, the gold price increased by roughly 15 percent year-to-date, whereas rate-sensitive REITs were buoyed further by falling bond yields, delivering 28.5 percent in US dollars year-to-date, according the *FTSE NAREIT All Equity REITs Total Return Index*. Hedge funds, as measured by the *HFRX Global Hedge Fund Index*, were up 5.9 percent year-to-date. Meanwhile, commodities, which were tending sideways until the end of August, witnessed the largest ever one-day surge in the oil price after attacks on Saudi oil facilities in mid-September. This surge resulted in a 3.2 percent increase year-to-date for commodities, according to the *Bloomberg Commodity Total Return Index*.

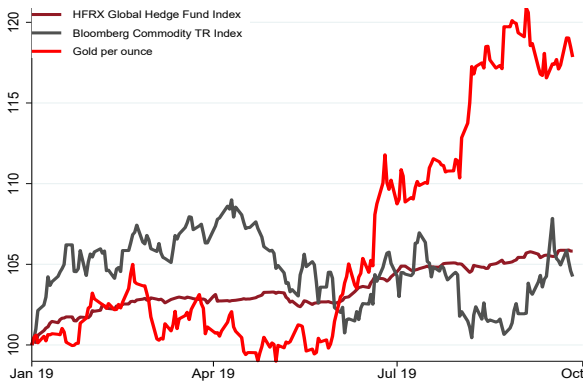
- Long-term private equity performance remains in double-digit territory, according to *Prequin*. Investor appetite remains high, reflected in the strong fund-raising numbers. However, for investors and fund managers alike, a granular and diligent analysis coupled with a sophisticated strategy is essential in order to succeed in an environment characterized by elevated valuation levels and intense competition. The increasing size and maturity of the PE market is mirrored in the secondary market, which reached a record volume of USD 42 billion in the first half of 2019, an increase of 56 percent over last year's previous half-year record, as reported by *Greenhill*.

Currencies

- Based on purchasing power parity (PPP), the Indian rupee and in particular the Chinese yuan currently look undervalued compared to the US dollar.
- The US dollar also continues to look expensive compared to the EUR, GBP, JPY, CAD and NOK, based on PPP. We think the interest rate differential between the US and Europe is likely to narrow because the European Central Bank's policy rates are at the zero lower bound, giving it less leeway than the Fed has to cut interest rates further. Therefore, the current environment is tilted towards US dollar depreciation, in our view.

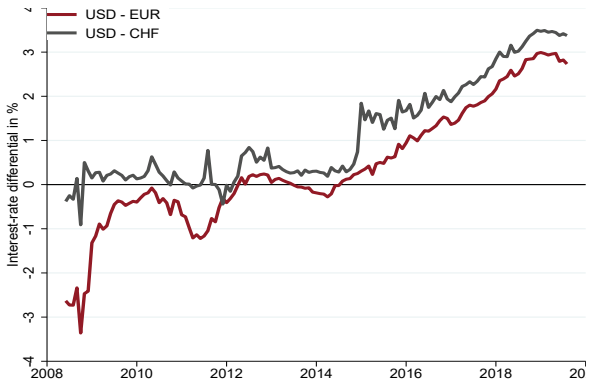
- While the Swiss franc appreciated further over the third quarter, on a PPP basis it remains within its fair value range against the EUR. Against the US dollar, however, the franc now even appears rather cheap.

Alternative asset rally continues



Source: Refinitiv, MFO

Wide rate differentials set to narrow?



Source: Refinitiv, MFO

3. Positioning

- We maintain our neutral stance on equities. Our models continue to signal average activity levels for the major economies, including the US and the Eurozone, despite weakening business prospects and elevated economic and political uncertainty. In addition, we find that technical market signals as well as valuation metrics are near average levels, too, reinforcing our neutral stance on equities. What's more, while fundamentals are deteriorating, the monetary policy reversal in the US and in Europe, and the resulting lower discount rates, continue to support stock prices. However, the third quarter also showed that the prevailing political uncertainty can foster frequent volatility spikes and directional changes.

- We think the directional change of the US Fed and the European Central Bank should support bond prices further. Nevertheless, simply speculating on bond prices rising further could backfire, since, from an absolute perspective, bond investors face very low or even negative nominal yields in most markets. And after accounting for inflation rates, bond investors lose purchasing power in virtually every currency area, while at the same time they have to accept comparatively high duration risks as maturities in the broad bond markets have steadily increased since the 2008 financial crisis. To illustrate this point, the *Bloomberg Barclays Global Aggregate Index* has meanwhile reached a maturity of nine years and only yields 1.3 percent on average, before hedging costs. After hedging, investors with EUR and CHF as reference currencies are still confronted with yields close to zero. That said, given its stabilizing function over financial and business cycles, fixed-income remains an important asset class for portfolio construction.
- Therefore, we continue to underweight bonds as an asset class. At this point, in order to earn positive yields, there is no way around taking on additional credit, liquidity or other forms of risk. However, as we have pointed out before, systemic risk is on the rise, as evidenced in the soaring levels of sovereign and corporate debt, as well as the qualitative deterioration of issuers' fundamentals. Therefore, these risks have to be actively and selectively managed in order to weather an eventual tightening of financing conditions, reduced liquidity and widening credit spreads. Simply put, increasing credit or private debt exposure is clearly not advisable right now, in our view.

- Finally, given the prevailing political uncertainties, the renewed lower real interest rates and the prospects favoring US dollar depreciation, we stick to our increased gold position in order to further diversify portfolio risks.

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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Published by: Marcuard Family Office Ltd.
Editors: Nadja Bleuler, n.bleuler@mfo.ch
Lukas Doerig, l.doerig@mfo.ch
Marie Pestalozzi, m.pestalozzi@mfo.ch
Philipp Stokinger, p.stokinger@mfo.ch
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