BELVALOR
Wealth Management

Outlook for 2018: hold shares – manage risks

Economic growth robust, valuations partly extended

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2017 fulfilled the largely optimistic forecasts as a positive year for equities. The global economy entered a phase of synchronised growth. The various events on the political stage passed without major upheavals on the equity markets. For the first time in years, corporate earnings were up across the board. The current upswing is expected to continue and gain in terms of quality and momentum going into 2018. It will improve in quality above all because the breadth of the recovery in Europe and Switzerland has increased. The European "problem countries" of France, Italy, Spain and Portugal have found their way back to attractive growth rates. In Switzerland, the stronger Euro (EUR) and a more stable US Dollar (USD) have bolstered the national economies. Leading sentiment indicators remain positive. Coupled with the continuing low interest rates, it is therefore also highly likely that capital investments will increase again, which will solidify the quality of the upswing.

Economic growth becomes more dynamic and of higher quality, ensuring rising corporate earnings

Following a decade marked by a very sluggish recovery in the world economy in the wake of the 2008/2009 financial crisis, we expect positive economic growth to continue into 2018. Thus, we forecast corporate earnings growth to continue. These are in fact ideal prerequisites for a continuation of the equity markets rally. However, the above described growth expectations are reflected in the optimistic assessments of analysts and have thus been priced into share prices. Even slight disappointments, in particular for highly valued shares, can lead to significant price corrections.

In our view, the consequences of strong growth are currently being underestimated by the markets. The inflationary potential is classified as low – despite the continuing very loose monetary policy. However, the very low market expectations of interest rates hikes do not sufficiently reflect the robust economic outlook. Nevertheless, since central banks' policies do not envisage any rapid tightening of policy, we consider more rapid and steeper interest rate rises to be unlikely also in 2018.

History teaches us that higher interest rates are also associated with greater volatility. This means that the risk of corrections in 2018 will be greater. A phase of over-valuation can last for an extended period. Market timing based on valuation models has been difficult in the past, as long as over- and under-valuation have not reached extreme levels. An indication of the tense situation is provided by the credit premiums implied in the valuation of high-yield bonds, which are close to historic lows.

Financial markets are currently suppressing a large number of risks from today's world. In principle, the economic framework conditions remain challenging over the long term. Globalisation has on average contributed to an increase in prosperity. However, a large number of economies in the western world are dealing with the consequences, such as high unemployment and debt levels. Additional challenges such as ageing populations, welfare deficits and the poor financial situation of western states remain unresolved.

For these reasons, there will be a need for conscious risk management over the course of the coming year. We propose a strategy for this, which we refer to on a portfolio level as the "barbell" strategy. When implementing this strategy within a portfolio, we recommend holding one weight invested in short-term bonds with high creditworthiness along with a second weight invested very selectively in shares. Investment classes that are labelled as a medium risk profile, but that are highly correlated with shares (e.g. high-yield bonds), will be reduced or avoided entirely. A relatively high level of liquidity (cash) in portfolios can complement the strategy and create freedom of action within situations in which investment opportunities arise as a result of market corrections.

Economic environment

Table 1: Economic growth and inflation in %

	Gross Domestic Product		Inflation	
	2017	2018E	2017	2018E
World	3.7	3.7	2.9	3.0
USA	2.3	2.5	2.2	2.0
Eurozone	2.3	2.0	1.5	1.3
Germany	1.9	1.8	1.7	1.8
Great Britain	1.5	1.1	2.7	2.3
Switzerland	0.8	1.7	0.5	1.0
Japan	1.5	1.3	0.4	0.3
China	6.8	6.3	1.6	2.1
Brazil	0.7	1.6	3.5	4.5

Source: Bank Julius Bär, OECD

At the end of 2017 we notice that economic growth has gained breadth and momentum worldwide. In 2018, the USA is expected once again to take back on its role as the global economic engine, and so not all market participants will be forced to look to China (which will nonetheless continue to make an important contribution). We consider it likely that, despite its failure to repeal "Obama Care", the Trump Administration will be able to push through its programme of tax cuts. This would have very positive effects for American companies, the attractiveness of the USA in general as a place for business and thus on the economy as a whole.

The Swiss economy is benefiting from an optimal environment. It had previously adjusted to a strong Swiss franc (CHF) and is now moving with the wind in its sails thanks to a stronger EUR and an apparently stable USD close to parity. The quality of the economic growth is apparent in the rise in exports and a broad-based recovery in the labour market. It is expected that the positive sentiment will be reflected by a greater willingness to invest, not only in Switzerland.

Since according to the SNB the rate of inflation - whilst being in positive territory - is not sufficiently dynamic and is too low, a clearly expansive monetary policy is still necessary. Conclusion: economic growth is proceeding at a near optimal level. However, over the long term the economic framework conditions remain challenging.

Developing countries are also fuelling the global upswing, in particular in Asia. Although some "emerging markets" are still problem countries, the international companies in which we invest on the whole still benefit from growth in emerging countries. Generally speaking, emerging markets are on a significantly stabler footing, also thanks to high energy prices. We continue to invest here predominantly indirectly through companies with global operations.

Currencies

The biggest surprise in 2017 on the currency front was the rapid strengthening of the EUR compared to the other major currencies. The rise against the USD from around 1.05 to 1.18 and against the CHF from a low point of slightly more than 1.05 to 1.16 was triggered by a perceived stabilisation of the Eurozone following President Macron's election win in France. For the time being, the failure of the "Jamaica coalition" in Germany has not undermined the EUR. However, a certain level of uncertainty will persist as long as the formation of a government is still not completed and there are prospects of a return to the polls.

The Swiss franc remains a hard currency
and a potential save haven
in the event of any future crisis

The high market consensus for the time being favours a continuing strong EUR. However, the favourable interest rates in the USD market compared to the EUR caution against over-confidence on the positive consensus for the EUR. As the exchange rates for the major currencies have become more aligned with their respective purchasing power parities, we expect that the exchange rate environment in 2018 will be reasonably stable. Over the long term, thanks to lower inflation rates compared to the EUR and the USD, the CHF will increase further in value in nominal terms – the CHF remains a hard currency and a safe haven as well in the event of any future crisis.

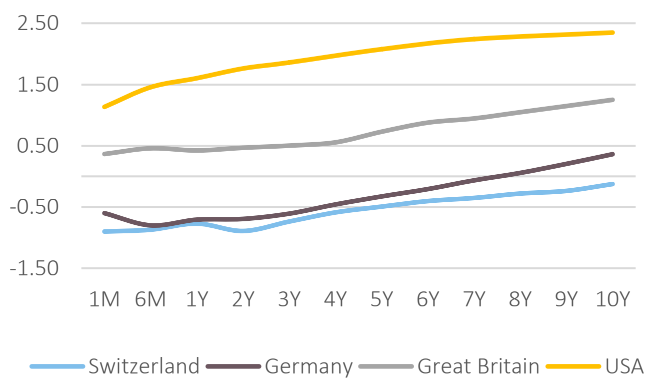
A note concerning cryptocurrencies: we do not intend to invest on behalf of our clients in Bitcoins or other cryptocurrencies. It is conceivable that central banks could take action to combat this "shadow market". These new currencies are driven by speculation and conceal massive risks. One must also remember that they do not have the status of legal tender.

Interest rates / bonds

Global interest rates remained at relatively low levels also in 2017. Long-term interest rates have consolidated, having risen around the end of 2016. The US central bank the FED has progressed towards the normalisation of short-term interest rates with additional rate rises. This has resulted overall in a flattening of the yield curve in

USD. The continuing low long-term interest rates indicate that the market is not expecting any substantial rise in inflation. The interest rate framework in Europe has only undergone minor changes over the last 12 months. Short-term interest rates in CHF and EUR remain in negative territory and the ECB has pursued its expansionary monetary policy. Because of the positive economic development, we expect the US central bank FED to raise interest rates further in 2018. In Europe, the ECB will gradually scale back bond purchases. Should the economy continue to perform positively, the SNB may consider removing negative interest rates towards the end of 2018 or at the start of 2019. The SNB will move cautiously and only take action after the ECB. In our view, this gradual normalisation of interest rates will not create any competition to equity markets. The following graph illustrates the yield curves of 10-year government bonds. The phase marked by falling interest rates, which lasted for 30 years, has been replaced by a phase with relatively low interest rates. In principle, we expect that low interest rates will remain with us for a long time to come.

Chart 2: Yield curves –
returns on 10-year government bonds



Source: SIX Swiss Exchange, Belvalor

This bond environment will continue to favour investments in corporate bonds (investment grade). High-yield bonds have become expensive and credit risks are no longer adequately compensated. We continue to prefer short maturities when investing in bonds. Private debt and senior secured loans represent an interesting complement to portfolios. These investments are influenced less by interest rate changes of central banks. From our perspective, bonds based on insurance risks (CAT bonds) represent an investment opportunity. This is in particular because, following several loss events in 2017, risk premiums have become more attractive again. "CoCos" (contingent convertible bonds issued by financial companies) remain attractive in certain selected cases. The balance sheet risks of financial institutions have been scaled back over the last few years. We are working through diversified investment vehicles in this area.

Equities

Global equity markets provided a decisive contribution to the positive performance of portfolios. Price trends could be attributed to two factors. First, companies were able to grow earnings. Second, share prices rose more than earnings and thus valuation of shares expanded. The valuation models referred to by us[1] point towards a slight over-valuation of equity markets. Although this calls for some degree of caution, the positive profit dynamic must not be underestimated. The past ten years since the financial crisis have been difficult, and the strong upswing might stay in place for some time.

Equities continue to be the most attractive investment class

Despite the fundamentally positive development, we are proceeding on the assumption that the equity rally is at an advanced stage. Initial signs of overheating are apparent – for example, companies that would have not received any funds from investors a couple of years ago are now being listed on the market through IPOs.

Nonetheless, risk premiums for equity markets as a whole are still at a reasonable level (cf. graph 3). Shares are attractive compared to other investment categories. In spite of the price increases over recent years, it is still possible to find attractively priced equities with decent dividend yields, predominantly in Switzerland and Europe. In the USA, we have placed a strategic focus on growth stock, in particular in the technology sector. The momentum within global equity markets remains positive. However, short-term corrections are possible at any time, and even likely on the back of the significant advances in 2017. We recommend exploiting short-term volatility in order to invest in quality companies.

The focus on quality companies will in our view become even more important. It is essential for us that the companies in which we invest take advantage of growth opportunities and have a leading position in their segment, which over the long term results in above-average margins.

[1] Source Swisscanto/ZKB: 1. Trend model: valuation based on long-term profit trends; 2. Model based on consensus earnings estimates by analysts.

Chart 3: Risk premium Swiss shares vs. bonds

Source: Bloomberg, Belvalor

In general, we are continuing to invest in equities since, under current circumstances, these offer the highest return potential. At the same time, depending upon market circumstances we are holding a higher proportion in cash within portfolios than in the past in order to reduce risk temporarily and to be able to take advantage of opportunities as they arise.

Real estate

Continuing low interest rates and positive economic growth actually represent ideal framework conditions for the real estate market. Directly owned real estate in good locations with stable rental income will offer an alternative to long-term bonds also in future, although at the same time this has become a rare - and thus expensive - commodity. In addition, real estate markets in Switzerland and Germany are starting to overheat. Example: Vacancy rates for residential properties in Switzerland are at their highest levels for ten years, against a backdrop of sustained intense construction activity. This means that the long period of upward revaluation and thus the "extra performance" of real estate investments shall end. Should the high vacancy rates fall together with rising interest rates, a correction of the real estate market might follow suit.

Commodities and precious metals

The recovery of commodity prices continued into 2017, with the development boosted by the globally synchronised economic upswing. Major commodities such as oil, industrial metals and iron ore were trading comfortably above the previous year's prices. Selected commodities, such as those used in batteries, put on even stronger gains. For instance, the prices of lithium, cobalt and copper increased dramatically. The drastic cutback in capital investments following the financial crisis resulted in a limited supply of certain commodities even though demand was increasing. This situation accounts for some of the price increases and we are proceeding on the assumption that the situation will remain interesting for numerous mining companies in the near future. We thus recommend further selective investments in mining companies. The fact that the consensus position is once again that commodity prices will fall again gives us confidence and offers scope for positive surprises over the coming year.

Commodity shares are attractive as moderate commodity price expectations have been factored in

The oil market is in equilibrium once again following the supply overhang that dominated previous years. The situation is no longer as attractive as in previous years, although exploration companies and specialized suppliers have been able to benefit from a revival of the business.

The price of gold increased slightly in 2017 and is at present close to production costs. A moderate upward movement in inflation, associated with our principal scenario of continuing low interest rates, would be positive for the precious metal. Due to the continuing problematic levels of government debt, political uncertainties and the creeping devaluation of standard currenies resulting from the policy of low interest rates, we shall continue to invest in gold. Gold shares are an interesting supplement to the portfolio for investors with a higher level of risk tolerance.

Alternative investments

In the US infrastructure sector, the high expectations of the previous year were only partially fulfilled. However, we are proceeding on the assumption that the more positive economic environment will lead to new investment plans. One type of investment that we recommend are collective bond investments in public infrastructure in the US. These offer an interesting risk-adjusted return. Shares in companies operating in the infrastructure sector are also of some interest. In the private equity sector, mature portfolios are highly attractive as there are opportunities to exit positions by selling to other investors or listing on public markets. New commitments in the area of private equity should only be made selectively as the cycle is already advanced. As in previous years, hedge fund performance in 2017 was below average. Most funds were unable to cover their relatively high costs and deliver an added value to investors. We only see opportunities and investment possibilities in niche strategies.