BELVALOR
Vermögensbetreuung

Outlook 2020: Equities remain the most attractive investment

Economic outlook improving

Thomas von Rohr and Peter Bänziger

In terms of investments, 2019 has been a good year despite the slowdown in global economic growth and the fact that in particular the manufacturing sector in some European countries was facing declining revenues. It was left mostly to the services sector to support growth. At an international level, the trade dispute between the US and China regularly hit the headlines. The conflict is essentially not only about tariffs but also about who is to secure global dominance in key technologies. Neither party conceded an inch, even though they are mutually dependent. The ultimate outcome of this situation is important for investors, hence we have outlined two possible scenarios below:

- Positive scenario: Mutually acceptable solutions are put forward in the trade dispute, which in turn alleviates uncertainty and companies begin to realize deferred investment decisions. There are signs of a cyclical recovery and the manufacturing industry experiences an upswing. Interest rates begin to rise.
- Negative scenario: The uncertainty continues and even increases, as an agreement has not been reached. Companies postpone projects, and the situation has a negative impact on consumer sentiment in many Western countries and in China. There is a slowdown in economic growth and corporate results are disappointing.

The two scenarios provide a simplified view and hardly represent the actual outcome. This said, we do expect the driving force of trade and business, combined with ceasing uncertainty, to pave the way for increased positivity in the markets. We expect the same for Brexit, where soon the situation should become clearer. We remain sceptical about the development of the European Union (EU). It is besieged by mounting regulations – an unfavourable development, stifling growth prospects. The economic conditions remain challenging. The political debate on sustainability and reducing carbon emissions is significant, and investors must factor this into their decision-making process.

As economic growth slows, monetary policies have become much more expansive. For example, the US Central Bank (Fed) cut interest rates several times. In October 2019, the Fed even initiated a change of course by announcing, it would expand its balance sheet again by resuming purchases of US Treasury bonds. The policies of other central banks have also become much more expansionary over the past year. Clear factors underly the significant increase in stock market indices. On the one hand, a part of the advances compensated for the losses of the previous year, and on the other hand, profits increased (mainly in the first half of the year).

Global monetary policies still expansive - increasing influence of politics

The European Central Bank (ECB) is under the new leadership of Christine Lagarde. It is no secret that she stands close to politics and argues for a looser fiscal policy. This development, as well as the attempts by the US President to influence the Fed, are proof that policymakers are increasingly influencing monetary policies. We are watching this development with concern. Sooner or later, confidence in currencies will suffer if this continues. Investors will feel compelled to move their capital into real assets.

Stock markets have already, in part, priced the positive scenario. If this scenario were to materialise, we expect an multiple expansion of equity valuations. From our point of view, equities remain by far the most attractive building block in an investment portfolio. Alternative investments (gold, private equity, infrastructure), corporate bonds, convertible bonds, cash and cash equivalents complement a balanced portfolio.

Economic environment

Table 1: Economic growth and inflation in %

	Gross Domestic Product		Inflation	
	2019	2020E	2019	2020E
World	3.0	2.6	3.8	4.1
USA	2.3	1.5	1.7	2.1
Eurozone	1.1	1.1	1.2	1.7
Germany	0.5	1.2	1.4	1.7
Great Britain	1.3	0.7	1.9	1.9
Switzerland	0.7	0.7	0.5	0.9
Japan	0.8	0.3	0.6	0.5
China	6.1	5.7	2.4	2.4
Brazil	0.8	1.7	3.8	3.5

Source: Bank Julius Bär, OECD

In economic terms, 2019 was rather disappointing. On the whole, economic growth fell short of expectations, with a few exceptions, such as the US, where economic performance remained steady. The labour market in particular remained very robust despite the lower rate of growth. Total debt continued to increase, particularly in the public sector.

Economic growth was very slow in Europe, at around 1%. Industry in Germany, especially the automotive sector, even experienced a "recession". The uncertainties surrounding Brexit and a perceived dysfunction in Brussels had a negative effect on the economic situation in Europe. Should the positive scenario described above materialise, there could be a temporary recovery in 2020. However, this would not eliminate the structural problems and we remain sceptical as to whether European policy could galvanise the action necessary for essential structural adjustments.

Parts of the Swiss export industry suffered as a result of the industrial slowdown in 2019. Major political decisions such as the reform of corporate taxes and the framework agreement with the EU have been further postponed in Switzerland. This has had a negative impact on the economy. We expect growth in 2020 and the subsequent years to remain at a relatively low level.

Political events have slowed down the economic development of many countries, such as Brazil, Turkey and India. The voice of the dissatisfied, sometimes very well-educated, younger generation is growing around the world and we believe this trend will not stop. It is increasingly posing a risk to the stability of many countries.

Inflationary pressures have actually decreased over the past 12 months. Energy prices are stagnating at a slightly higher level, but there is more than enough supply, so there is no pressure for higher prices. Labour cost pressures remain relatively low, despite historically low unemployment rates in most Western countries. Technological progress continued to dampen inflation by improving productivity. One risk driving higher inflation rates is the looming increase in regulation, especially in the context of the climate debate.

Annoying for investors is the fact that negative real interest rates will persist as long as the ECB leaves key interest rates in negative territory. Even though in our positive scenario it is conceivable that the negative interest rate period comes to an end, we believe that the low interest rate policy will not change for the foreseeable future, as higher interest rates are simply not sustainable for some European countries. If, contrary to general opinion, inflation was to pick up, there would be increased pressure on central banks to raise interest rates.

Currencies

In our positive scenario, the interest rate differential between the US, Europe and Switzerland is likely to decrease somewhat, which will tend to lead to a slightly weaker USD against the Euro (EUR) and the Swiss franc (CHF). We forecast temporary stability between the Euro and Swiss franc but believe the upside potential for the EUR to be limited.

> Temporary stabilisation
> of the Euro expected

In the long term, the CHF remains a hard currency for investors domiciled outside Switzerland. That is why we hold a strategic overweight in CHF, which is primarily covered by Swiss equities. Although the Swiss National Bank (SNB) has become somewhat more cautious about currency interventions, it is likely to intervene again if the EUR/CHF exchange rate falls significantly on the foreign exchange market in an attempt to limit the strength of the CHF. Against the backdrop of a positive scenario as described above, the SNB could temporarily exit negative rates in coordination with the ECB.

Interest rates / Bonds

After several rate cuts, the Fed has announced a "pause" in further interest rate steps. On the one hand, US President Donald Trump is constantly putting pressure on the Fed to push key interest rates into negative territory, as in the case of the ECB and SNB. On the other hand, US employment figures and inflation show that there is no need for further cuts in interest rates for the time being. The Fed will have to master this balancing act, and the (partial) solution of the trade war will also play a crucial role. This notwithstanding, the ECB and SNB are still in a "tight spot". In Switzerland, there will be growing political pressure on the SNB to end the period of negative interest rates.

Without significantly stronger growth, negative interest rates to continue

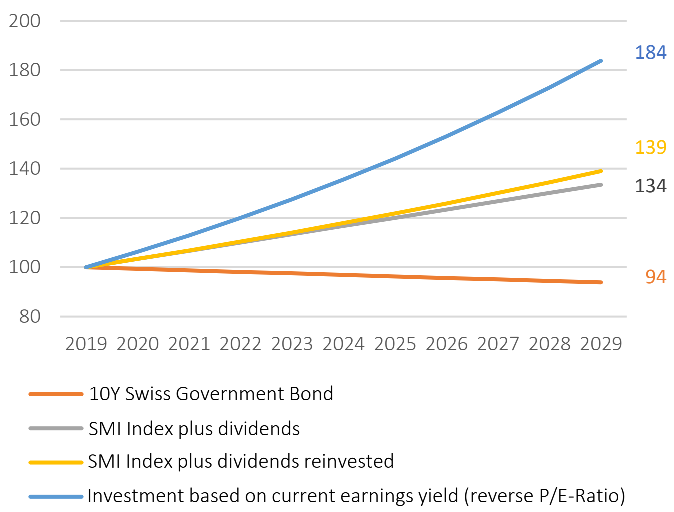
Interest rate "normalization"– i.e. an exit from the policy of negative interest rates – requires significantly higher growth in the Eurozone and also Switzerland. However, this is currently not in sight, unless the various political problems can be resolved more or less simultaneously. If this were to happen, there would most likely be a backlog demand for investments thanks to the previous time which was dominated by uncertainty. This would have a positive impact on growth rates. However, central banks will not be able to resolve Europe's structural problems on their own (e.g. an ageing population and rising public debt). Politicians must be prepared to drive forward appropriate measures. We strongly doubt that this will succeed, also given the unclear political majorities in Germany and Italy, for example.

Based on our positive scenario, we assume that interest rates in Europe and Switzerland will not continue to fall but remain at a low level or even rise slightly. As a result, bonds in EUR and CHF are likely to yield a negative return in 2020. This means that investment categories with (albeit partly low) expectations of positive returns are still in demand. These include emerging market bonds with investment-grade quality, as well as high-yield bonds. Contingent convertible bonds "CoCos" (hybrid capital for banks) have become clearly less attractive, especially in comparison with bank shares.

The dilemma will therefore continue for investors in the Eurozone and Switzerland. The risks outweigh the rewards in the bond sector in EUR and CHF. New investments in bonds are more likely to represent a return-free risk. Investors with a longer-term perspective and a risk-taking attitude will find a diversified investment strategy based on equities with high dividend yields to be an attractive alternative. The difference in yields between Swiss stocks and 10-year Swiss government bonds is so striking that shares would have to fall very sharply over the next 10 years in order to achieve the same (negative) return (see chart below).

We have made the following assumptions: The SMI index (price index) remains unchanged, the dividend yield remains at a constant level. The 0% bond issued by the Swiss Confederation maturing in 2029 serves as a basis of comparison. The picture for equities is even more positive if we apply the current earnings yield (reverse P/E ratio). Comparing German federal bonds with European equities would paint a similar picture.

Chart 1: Model calculation of CHF 100 in 10 years



Source: Bloomberg, Belvalor

Equities

As in the previous year, corporate profits continued to rise in all regions in 2019. Most of the growth in earnings was seen in the first half of the year, before it then weakened significantly in the second half. In the coming year, we expect earnings growth to normalise and believe, it will hold steady at the long-term average of 5 to 7% for the overall market.

The models we consulted indicate a risk-neutral valuation of equity markets, which is roughly the same as at the end of 2017. From a regional point of view, European equity markets continue to be undervalued.

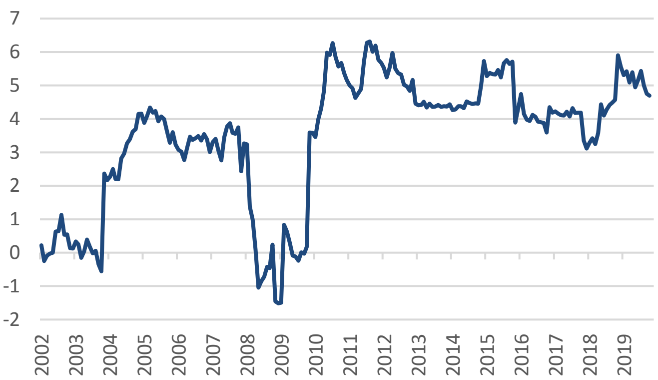
From a technical perspective, the picture changed in the second half of 2019. Major indices such as the Dow Jones, DAX, SMI and Eurostoxx reached new highs. Some of these indices have breached the trading margin that has held up for many years. This turn of events should not be underestimated and, from our point of view, points to a continuation of the positive bull market.

Equities - neutral valuation, positive trend

The positive development of the equity indices over the past twelve months has been largely driven by the index heavyweights. In recent months, we have seen an upward turn in cyclical stocks. This suggests that 2020 will mark the start of "normalization", or even a cyclical recovery. In such a scenario, we can envisage equities experiencing a valuation expansion as we do not expect significant changes on the interest rate front.

In the environment described above, we selectively rely on cyclical companies in addition to quality stocks. We select equities based on clearly defined criteria. For one, they must consistently generate a return on the invested capital that exceeds the cost of the capital. Another criterion is a leading market position in a sector, which is attractive in itself and is usually associated with above-average margins. We invest in shares of companies with a solid cash flow profile. We find growth-oriented companies primarily in North America and to some extent in China.

Chart 2: Risk premium Swiss stocks vs. bonds



Source: Bloomberg, Belvalor

Based on the interest rate situation and return profile, we believe that equities are currently the most attractive asset class. The possibility of a cyclical pickup in 2020 is an additional positive factor. However, investors should not underestimate the geopolitical risks. One such risk is the US presidential election in November 2020. If the Democrats were to win the election and implement some of their policies, this could instantly have a negative impact on equity markets. In order to take these risks into account, we take an opportunistic approach to hedging by buying put options.

Real estate

Investment pressure has again led to a strong demand for real estate also in 2019 and as a consequence, prices have also risen significantly. The yield spread between real estate (i.e. the corresponding fund or real estate shares) and bonds is still very high. We expect this trend to continue.

Factors contributing to an initial insecurity, e.g. rising vacancy rates combined with ongoing active construction work, are still being ignored, but they will lower future returns. Assuming there are no further declines in interest rates, the appreciations on the real estate portfolios will come to an end, so that "only" the significantly reduced cash flow returns can still be expected for new investments. Funds, as well as real estate stocks with high premiums (agios) compared to the intrinsic value, look the most vulnerable to a correction.

Commodities and alternative investments

A positive economic cycle will drive demand for commodities, which will also benefit lower valued commodity stocks.

When it comes to investing in commodities, we pick equities with low valuations and we invest in gold. We remain positive for the development of the gold price and recommend adding gold to any balanced portfolio.

The search for positive returns is fuelling demand for alternative investments. We still prefer private equity in the form of first-class investment funds that invest flexibly across the various asset classes (private equity, debt, real estate and infrastructure) or even directly in the shares of leading providers. We only recommend hedge funds specifically to blend and diversify (e.g. trend following strategies).

Infrastructure will remain a key topic. Either direct investments in the corresponding equities or attractive niche strategies comparable to bonds are suitable for a blended approach. However, they are not always easily accessible and furthermore their liquidity is severely restricted.