CIO Update

Investment Committee Bank J. Safra Sarasin

7 December 2018

Editorial

Dear reader

Recovering from the stock market setback in October will likely take longer than previously thought. Though the USA and China have agreed to a truce regarding their trade war, this fact does not provide greater certainty around the outcome of the negotiations. Moreover, further Twitter releases have the potential to whip up market volatility again. And while the US Federal Reserve (Fed) has recently tried to counter this with soothing statements, the Fed cannot halt the slowdown in economic growth in the short term. As a consequence, we expect risky assets will face a challenging environment in the months ahead. Nevertheless, given favorable valuations this also offers several opportunities.

Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

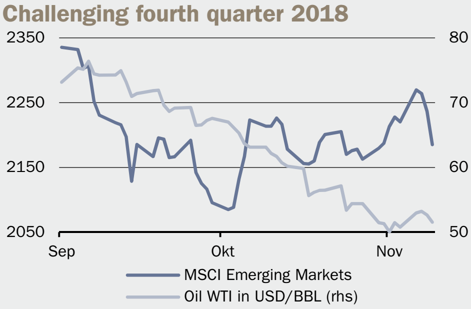
Focus

Investing in uncertain times

Review: Roller coaster ride

Recent weeks have been marked by sharp fluctuations in financial markets. At first, global stock markets appeared to recover from their October lows, only for prices to be dragged down by uncertainties around the future economic development, the Fed's monetary policy path and rising trade risks. In his latest speech Fed Chairman Jerome Powell sowed seeds of doubt about continuing the pace of the Fed's recent interest rate increases. Equity markets greeted this news enthusiastically.

Challenging fourth quarter 2018



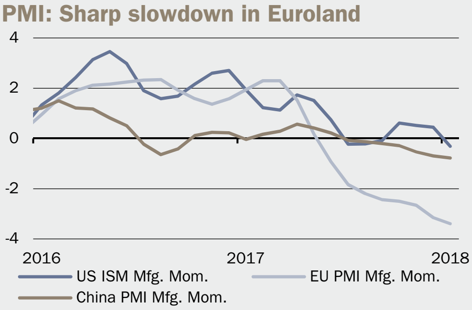
Source: Datastream, J. Safra Sarasin
daily data, 28 Sep to 7 Dec 2018

Emerging market equities, which this year have suffered the most under rising interest rates, subsequently staged the strongest recovery. Oil derived no benefit from the news, as slowing global growth and a build-up of excess supplies put oil under massive selling pressure once again, leading to a significant drop in oil prices.

Uncertain macro outlook

Uncertainty among investors about the global growth outlook remains high. Some glimmers of hope are emerging, especially in Europe, with the negotiated agreement on the UK's withdrawal from the European Union as well as the Italian government's apparent willingness to compromise, albeit to a very limited extent. Nonetheless, the political climate in Europe is likely to remain overcast in the first half of 2019, which is likely to have an adverse impact on financial markets. This will be compounded by the Old World's high dependence on exports and the strong pro-cyclical performance associated with this.

PMI: Sharp slowdown in Euroland



Source: Datastream, J. Safra Sarasin
monthly data, Nov 2016 to Dec 2018

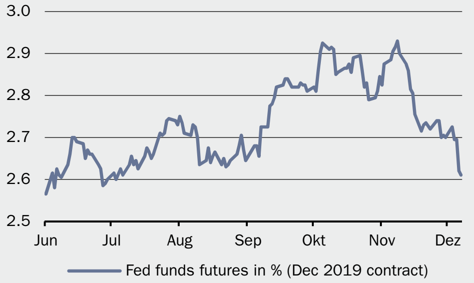
Against a backdrop of declining world trade volumes, this represents a rather challenging premise. Furthermore, as the Eurozone does not have a central fiscal capacity, no institution or mechanism exists that can provide fiscal stimulus for the whole of the euro area. We do not expect to see the introduction of reforms to tackle this problem in the coming months.

The US economy is showing the first signs of flagging momentum, albeit at a high level. Also it remains to be seen whether job losses at major US companies – as recently at General Motors – are merely exceptions or the first negative effects of an incoherent economic and industrial policy. In any event, the very supportive fiscal stimulus measures enacted in 2018 are expected to be discontinued without being replaced. On top of that, the interest-rate hikes made by the US Fed will start to have a restrictive impact in the coming year. A decline in economic momentum from an unsustainably high level is the only logical outcome.

Bonds benefit from Fed's stance

Investors have already started to question the Federal Reserve's projected path on interest rates in recent weeks. Chairman Powell's latest speech was interpreted to mean that the central bank may soon start to slow the rate of increases.

USA: Falling interest rate expectations



Source: Bloomberg, J. Safra Sarasin
daily data, 1 June to 7 Dec 2018

This interpretation was prompted by Powell's remark that key interest rates remain just below the range of estimates that would be neutral for the economy – that is, neither speeding up nor slowing down growth in the US economy. This change in the language describing the interest rate level and a weaker assessment of the economy led to a decline in interest rates across the globe. Yields on 10-year US Treasuries dropped back below 3%.

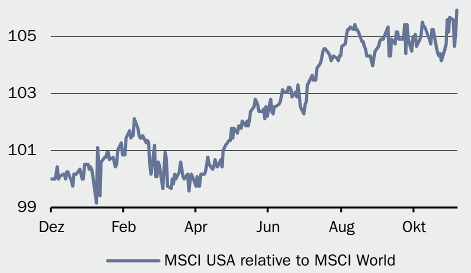
More attractive risk premiums for high-yield bonds

We expect weaker economic growth and the slight decline in inflation expectations to keep risk-free interest rates at a low level in the coming months. The longer interest rates stay at this level, the greater the incentive for investors to move back into higher yielding areas. High-yield bond spreads have greatly increased on the back of waning risk appetite in the fourth quarter. They offer an attractive yield at current levels based on our expectation that the default rate will not rise sharply in the coming year. We therefore used setbacks to build up new positions.

Positioned more defensively in equities

The recent jump in volatility has caused investors to constantly question whether the latest price movements are just a correction in an aging bull market, or whether it is a prelude to something far worse. In the short term, equity markets are supported by market sentiment and seasonality. Although earnings growth is likely to decline next year, the economic environment should remain strong enough to support positive equity returns. Nonetheless, taking a more defensive position at the start of the year is advised amid the continuing uncertainty. Dividend-bearing securities offer these defensive characteristics and in the past have shown their resilience during bouts of weakness. Nevertheless, stock picking is essential. At a regional level, we continue to favor the US equity market based on a solid economic environment and strong earnings growth, even though it is more expensive than other regions.

US stocks continue to outperform



Source: Datastream, J. Safra Sarasin
daily data, 29 Dec 2017 to 7 Dec 2018

Asset allocation: Seize opportunities

Many macroeconomic data points and leading indicators now bear testimony to the slowing pace of global growth. But the rate of growth is not slowing as much as markets are currently factoring in. Also, the Fed is seen taking a very cautious approach to further rate hikes. We therefore remain overweight equities, but will also actively manage our positions. It would be premature to throw in the towel now and await better times. In the later phase of a bull market, which we now find ourselves in, average returns on equities are historically very high but also very volatile. Hence, active portfolio management and risk control are essential in this environment in order to take advantage of opportunities as they arise.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	+	Industrial countries =	Emerging markets =	Large caps =	Small caps =
Bonds	– –	Government bonds – –	Corporate bonds –	High-yield bonds +	Emerging markets =
Alternative assets	+	Money market =	Convertible bonds =	Other alternatives +	Commodities +

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