J. SAFRA SARASIN

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CIO Update

Investment Committee Bank J. Safra Sarasin

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Editorial

Dear reader

2018 fell well short our expectations for the investment year. In an unusual turn of events, just about every asset class delivered negative returns and, as a result, investors searched in vain for safe havens. Hardest hit in the fourth quarter were equity markets, which suffered under rising US interest rates, the trade dispute between the USA and China, and an emerging slowdown in growth.

Global growth in 2019 is likely to continue to weaken for now. Nevertheless, the latest stock market correction does seem excessive. Since we do not expect a recession but a moderate upswing in the second half of the year, most risk assets should exhibit a positive performance this year. But political uncertainties remain elevated. This means that we will have to get used to seesawing financial markets, and forecast a tricky year ahead for investors in 2019.

Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

Focus

Tricky year ahead in 2019

Review: Record-breaking December

The stock markets' rollercoaster ride in October and November was followed by a record-breaking December. But instead of the hoped-for and typical year-end rally, Santa Claus delivered the worst December for the stock markets since 1931. On the eve of Christmas, the S&P 500 broke below 2,400 points to its lowest level since April 2017. 2018 not only broke the stock markets' multi-year uptrend, it also saw a sharp rise in fluctuations, as measured by the Volatility Index (VIX).

2018: Clear rise in volatility

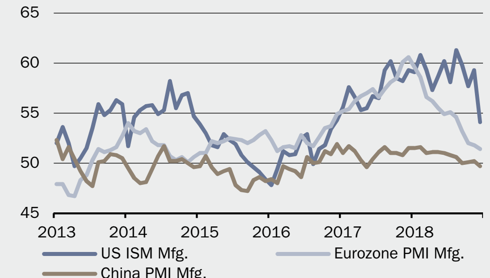
Source: Datastream, J. Safra Sarasin, 09.01.2019

Fluctuations like these are not uncommon. In fact, financial market volatility is in the process of returning to historically normal levels as central banks call an end to their ultra-expansionary monetary policies. So in addition to properly assessing growth prospects, active risk management is also a decisive factor in 2019.

Subdued global macro outlook

Global economic growth forecasts came under strong pressure at the beginning of the year following a sharp decline in the US ISM Manufacturing Purchasing Managers' Index in December. Manufacturing activities in several countries, such as China, are already trading below the contraction threshold of 50 points, indicating a contraction in the manufacturing sector, and more countries are likely to follow.

PMIs: In some cases near or below 50



Source: Datastream, 09.01.2019

Slowing global economic growth was caused by monetary policy tightening, which in turn triggered a sharp decline in US dollar liquidity and led to higher credit risk premia. This was exacerbated by the trade disputes the US administration picked with different nations, which continue to weigh on sentiment. We expect growth in the first half of the year to remain sluggish. This is likely to be followed by a modest upswing in the second half, fuelled among other things by

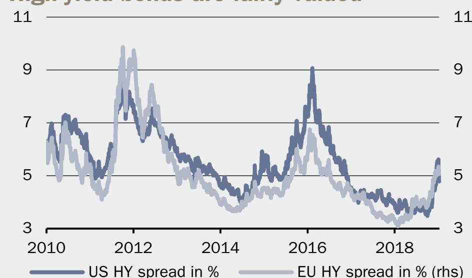
the Chinese government's stimulus measures.

The US Federal Reserve (Fed) has responded in recent weeks to the slowdown in growth and the more challenging financial conditions by taking an increasingly cautious approach in its communication. Financial markets subsequently lost no time in pricing out all further interest rate hikes. This seems overdone, given the robust labor market and gradual rise in inflation. We expect the Fed to pause in March, followed by two more rate hikes for the remainder of the year.

Bonds profit from Fed's stance

A pause in US rate hikes is likely to directly benefit investments that were hit hard by higher US dollar interest rates last year. At the top of this list are emerging market bonds. Credit risk premia have risen sharply and have now reached a fair level. Within emerging market debt, local currency bonds look particularly interesting based on our expectation that the US dollar will also depreciate further. Many currencies are undervalued and offer potential.

High-yield bonds are fairly valued



Source: Bloomberg, J. Safra Sarasin, 09.01.2019

Besides emerging market debt, high-yield bonds are also likely to profit from a lull in interest rate hikes. Credit risk premia in this segment have increased substantially, and compensate investors adequately again for assuming the default risk. Since a recession this year appears very unlikely and default rates may increase slightly at most, we expect this segment to generate a very positive yield.

Equities are more attractively valued

The combination of lower equity prices and falling risk-free interest rates means that equities are much less expensive. Whereas US equities are now fairly valued in long-term comparison, emerging market stocks as well as European equities are currently inexpensive. European equity risk premia, compared to the alternative that bonds provide, have risen to their highest level since 2012.

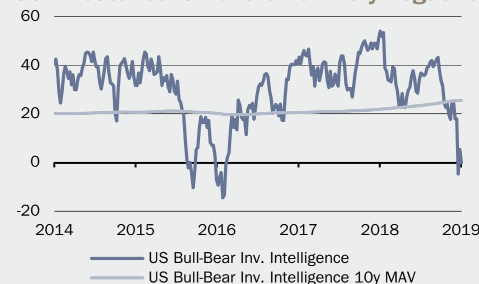
Attractive equity risk premia

Source: Datastream, J. Safra Sarasin, 09.01.2019

Equities have priced in a clear decline in corporate earnings, which would usually only happen in the event of recession. We therefore expect the stock market valuation to increase in the second half of the year, once it becomes clear that the current business cycle is not yet over.

We see the price tumbles in December as a classic example of investor overreaction. This is also evident in sentiment indicators, which have dropped to their lowest level since the end of 2015. These indicators often send good signals with a market selloff and point to a stock market recovery in the months ahead. However, we do not expect the recovery to take a straight line but a zigzag course. In the short term, negative reports from companies and reductions in analysts' earnings forecasts could weigh on equity prices. In our stock selection, we thus also focus on defensive sectors and quality stocks.

US investor sentiment is now very negative



Source: Datastream, J. Safra Sarasin, 09.01.2019

We have taken an increasingly positive view of emerging market equities. They are inexpensive and stand to benefit the most from a potential easing of the trade dispute and further stimulus measures enacted by China's government. Also, we see positive momentum for domestic demand in several countries, including Russia and Brazil, which should help to underpin equity prices as well.

Asset allocation: Probable recovery

We expect the stock markets to stage a recovery at the start of the year. But given the continuing slowdown in growth, short-term upside potential appears limited. As a consequence, we will actively manage our overweight position in equities. We remain clearly underweight bonds, but believe emerging markets as well as the high-yield segment offer selective potential. We maintain our allocation to alternative assets to spread the risk, ensuring adequate diversification in a balanced portfolio.

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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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