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CIO Update

Investment Committee Bank J. Safra Sarasin

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Editorial

Dear reader

After recent months saw an easing of the US-China trade war with both sides dialing down the rhetoric, negotiations have now reached a critical stage. December will reveal whether words are accompanied by actions, or whether the hatchet will be dug up again. Financial markets this year have been very concerned about the trade war, which has sent sentiment on a rollercoaster ride. Evidently, the final chapter has yet to be written, and investors should always be prepared for positive as well as negative surprises. Given the high level of uncertainty, we retain our balanced portfolio positioning despite increasing signs of economic stabilization.

Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

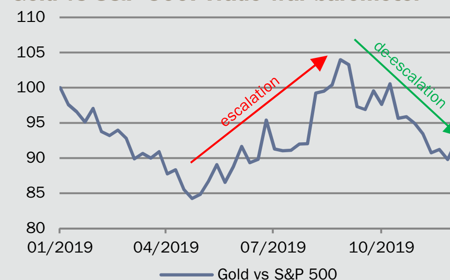
Focus

Trade war rollercoaster ride

Review: New record highs

Equity markets continued to perform well in November, scaling new record highs, thanks to easing fears of recession and supportive central banks. Gold, on the other hand, has recently lost its luster as a hedging instrument and lost altitude. This year, the ratio of gold price to US equities has proved a good barometer for the state of the trade war between the USA and China. The escalation of the conflict between May and August saw a sharp rise in the barometer, whereas it fell by a similar amount between September and November as the situation eased.

Gold vs S&P 500: Trade war barometer



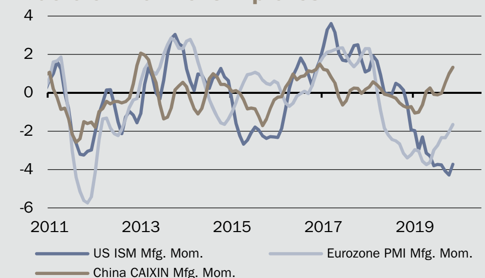
Source: Datastream, J. Safra Sarasin, 06.12.2019

December will reveal whether a «phase one» trade deal can be struck, or whether the trade war escalates anew.

Macro outlook: Signs of stabilization

Leading indicators and macro data have stabilized in recent weeks following a period of weakening global economic activity, which lasted almost 18 months. Most notably, manufacturing in some cases showed a marked improvement in November. This trend was particularly noticeable in Germany, although manufacturing here had experienced intense pressure in previous months. We expect the economic recovery to continue in the coming months and anticipate a moderate pickup in growth at the beginning of next year. However, it remains to be seen whether this recovery will carry through into the second half of 2020.

Macro environment improves



Source: Datastream, J. Safra Sarasin, 06.12.2019

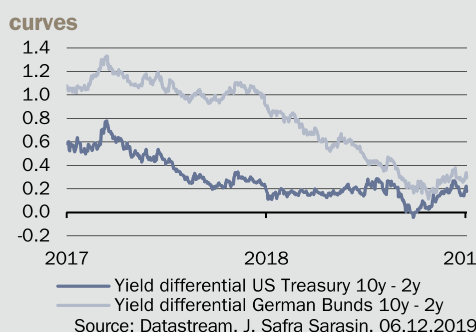
The economic outlook and expectations for the global financial markets still hinge on the political dynamic between the USA and China. The two countries' announcement of a possible «phase one» trade deal provides a strong hint that US President Donald Trump may have finally had enough of this trade war. Dogged by domestic political concerns in the form of impeachment proceedings and the impending 2020 presidential election, it is in President Trump's interest to declare a victory in the trade war and use this as politi-

cal capital. China, for its part, would also like nothing more than to end this trade war. Its economy is under pressure, not only due to the trade war but also due to policymakers' determination to bring China's debt down to a sustainable level. So the political calculus of both countries is moving toward closer alignment as each looks for a face-saving solution. It remains to be seen whether such a solution can be found.

Bonds: Hunt for yield

Although central banks currently remain on the sidelines in terms of monetary policy, they have clearly indicated in recent weeks that they will enact further monetary policy measures if they deem these necessary. Despite the signs of economic stabilization, we do not expect central banks will give up their accommodative stance so quickly. It is going to take a prolonged period of above-trend growth for inflation to become a theme again. This means that the potential for a sharp steepening of the yield curve is also rather limited.

Bonds: Recent slight steepening of yield curves

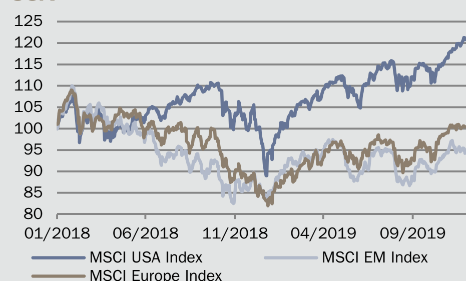


Source: Datastream, J. Safra Sarasin, 06.12.2019

Emerging market bonds remain an attractive asset class in an environment of low interest rates and meager return potential for conventional bonds. This asset class stands to benefit from the cyclical recovery, the continuing accommodative monetary policies of major central banks in developed countries and an inflation outlook that gives central banks in many emerging market regions additional monetary policy scope. Moreover, unlike other segments, this asset class offers investors adequate compensation for the risks and is well diversified thanks to the enlarged investment universe.

High-yield bonds are supported by the current economic environment as well. Furthermore, default rates are at historically low levels. But so are the credit risk premiums, which in certain rating segments of the asset class no longer offer adequate compensation for the risks taken. Although the carry is still attractive, active management is essential to achieving a balanced risk/reward profile. We believe there are more opportunities in Europe than there are in the US, and continue to focus on higher-quality bonds. Hybrid financial bonds are also an interesting segment that is well supported by fundamentals.

Equities: Catch-up potential outside the USA



Source: Datastream, J. Safra Sarasin, 06.12.2019

Equities: Liquidity boost in Q4

Clearly, there are latent uncertainties among investors about the potential for tensions in the US-China trade talks to re-escalate or that the global economy will not turn the corner as hoped. But even in these phases, share prices have maintained a robust performance in recent weeks, not least thanks to central banks' support. Valuations have continued to climb since the US Federal Reserve intervened in the repo market by introducing a wide range of liquidity measures and other major central banks pledged their unconditional support.

At current levels, US equity markets are significantly more expensive than those in other regions and have hardly any potential. Conversely, equity risk premiums in emerging markets and Europe are at their long-term average and have the potential to spring positive surprises in the months ahead. But a cyclical upswing has to assert itself before this can happen.

Asset allocation: Risk neutral

We are focusing on a risk-neutral allocation in our multi-asset portfolios. Given the uncertainty over the outcome of the ongoing trade war between the US and China, we continue to slightly underweight equities. In fixed income, we continue to strongly underweight government and investment grade bonds because they are particularly vulnerable to price falls during growth accelerations. We continue to favor high-yield and emerging market bonds based on the credit spread and coupon, which at least provides some buffering against risk. Alternative assets including gold ensure the portfolio remains well diversified and also offer the portfolio some protection should the trade war rollercoaster take another lap around the track.

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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/Gold =/+

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