J. SAFRA SARASIN

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CIO Update

Investment Committee Bank J. Safra Sarasin
4 October 2019

Editorial

Dear reader

Despite mounting growth concerns, we do not believe a global recession is the most likely scenario. Monetary and fiscal policy stimuli already implemented in many regions around the world should bring about a fresh upswing towards the end of this year. However, this forecast carries a high degree of uncertainty because the current growth trend is downward and political disruptions could further delay the recovery. As a result, we are retaining our cautious investment approach in all asset classes and are focusing on defensive strategies. As traditional bonds are very expensive, we focus, wherever possible and appropriate, on gold as a way to diversify the portfolio.

Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

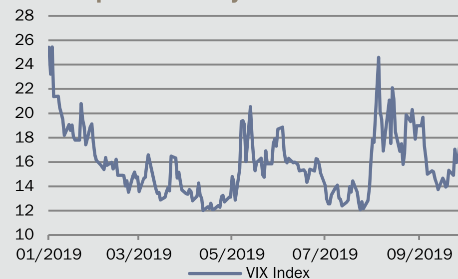
Focus

«In Gold We Trust»

Review: Mounting uncertainty

The back and forth in the US-China trade dispute was the main driver of financial markets in September. US President Donald Trump entertained hopes of renewing US negotiations with China while also saying that he did not necessary need to strike a meaningful agreement with China before the 2020 presidential election. Various business climate indices show that the trade dispute has likely affected the manufacturing industry more than previously thought.

USA: Implied volatility rises



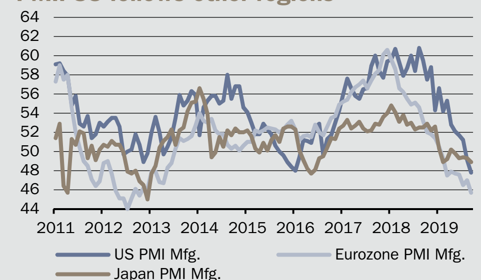
Source: Datastream, J. Safra Sarasin, 03.10.2019

Weak macroeconomic data have rekindled growth fears. Implied volatility has increased and risk aversion among investors rose sharply again at the beginning of the fourth quarter.

Macro outlook: Still weak

The economic environment remains negative. The Organization for Economic Co-operation and Development (OECD) has cut its global growth forecast for 2019 from 3.2% to 2.9%. The uncertainty faced by companies due to the trade war is weighing on investments and ultimately on consumer confidence. Nonetheless, there are significant disparities between regions. The US has an advantage because its dependence on international trade is lower than its trading partners'. Yet US economic data currently follows the other regions, rather than the other way round.

PMI: US follows other regions



Source: Datastream, J. Safra Sarasin, 03.10.2019

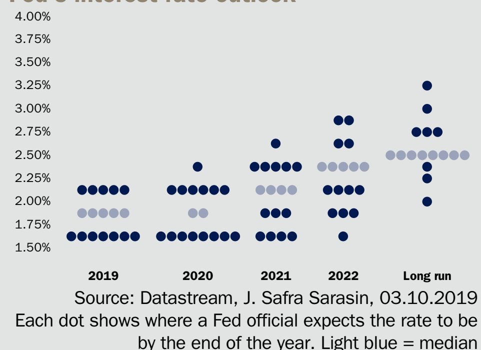
The economic slowdown in Europe is becoming increasingly entrenched. The European purchasing managers' indices (PMI) continued to drop in September. In particular, the German data gave investors cause for concern. The Manufacturing Purchasing Managers' Index dropped to 41.7 points in September, which is firmly in recession territory. Moreover, the sub-indices that act as forward-looking indicators (such as new orders) also give grounds for concern. The situation in China has stabilized somewhat. The upswing forecast at the start of the year

for the second half of 2019 has failed to materialize so far. However, the latest indicators do not show a further deterioration and are at least keeping hope alive that a weak recovery will unfold towards the end of the year.

Bonds: Central banks to the rescue

Responding to growing signs in recent months that Europe's slowing economy runs the risk of becoming permanent, the European Central Bank (ECB) cut its deposit rate. Nevertheless, ECB President Mario Draghi said that the time was ripe for governments to provide fiscal policy measures; monetary policy was at its limits and adverse side effects would become increasingly visible. Although the size of the German government's recent climate change package was a little disappointing, the governments of other countries could use the fiscal leeway provided by the ECB to pass policy packages.

Fed's interest rate outlook



Source: Datastream, J. Safra Sarasin, 03.10.2019
Each dot shows where a Fed official expects the rate to be by the end of the year. Light blue = median

The US Federal Reserve (Fed) also cut its key interest rate in September, as expected. Nonetheless, members of the Federal Open Market Committee (FOMC) were surprisingly divided when it came to the future course of monetary policy. Whereas the latest 'dot plot' of individual FOMC members' expectations for rates shows that at the most just one more rate cut is expected, market participants continue to expect several rate cuts over the next 12 months. Given the current level, these expectations are not without risks. The volatility of bonds has increased sharply in recent months, while the yield level has declined. In other words, the risk/reward ratio for bondholders has deteriorated sharply.

Focus on emerging market bonds

In total, 20 of the 33 major central banks have cut interest rates since the start of the year. And the pressure on yields is huge. Monetary policy measures and the fear of an impending recession mean that negative-yielding bonds reached about USD 17 trillion in September. In the search for positive real yields, emerging market bonds represent a sensible alterative in this environment, and provide a buffer thanks to the relatively high yield level. The strong US dollar has dampened demand somewhat in recent weeks and resulted in setbacks for several currencies. Nevertheless, local currency bond yields have very attractive prospects in the medium term, based on current valuations. Selection will play a key role for investment success, however.

Equities: Outlook still cloudy

Despite all the political concerns and economic risks, equity markets were trading close to their all-time highs at the beginning of the fourth quarter. We expect the coming weeks to bring some challenging conditions, however. Declining order intake in global manufacturing indicates weaker growth in the fourth quarter and therefore negative corporate earnings surprises. We expect companies will respond to the high level of uncertainty by releasing very cautious forecasts in the upcoming reporting season. This could lead to downward earnings revisions and cause investors to reassess equity valuations. Fortunately, equity valuations are not extremely high compared with recent years, but nearer the average. Valuations are also supported by extremely low bond yields, which offer some protection against major setbacks.

US equities are fairly valued

Source: Datastream, J. Safra Sarasin, 03.10.2019

Asset Allocation: Defensive stance

September has again demonstrated that erstwhile safe havens like government bonds no longer offer investors the same level of security they once did. Historically low bond yields and the structural rise in bond market volatility limit the portfolio's scope for diversification. We consider traditional bonds expensive and, as a consequence, continue to underweight this asset class. We have attempted to diversify the portfolio through alternative investments with an overweight allocation to gold. The precious metal is on a long-term uptrend and should perform favorably on the back of rising demand. We remain underweight equities. Growth momentum is weak and the economic environment is fragile. A lasting turnaround in the economic cycle is needed before equities can break out of their current trading range. We do not see this catalyst yet and have carefully selected our risks. This explains why we have not changed our defensive stance and why we focus on quality stocks and dividend strategies.

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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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