CIO Update

Investment Committee Bank J. Safra Sarasin

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Editorial

Dear reader

The big question preoccupying markets today is whether the negative interaction between the fear of recession and lower interest rates, which in turn signals a higher probability of recession, can be stopped. Although various possibilities capable of reversing this situation exist, they are unlikely prospects in the short term. The best hope is a cyclical upturn, which based on the length of the current downturn is due around the end of the year. Given the high degree of uncertainty attached to forecasts, which is also due to the unpredictable nature of the trade war between the USA and China, we are maintaining our cautious investment strategy with an underweight allocation to equities.

Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

Focus

Cautious positioning

Review: Interest rates in free-fall

The decline in global long-term interest rates at the beginning of August was triggered by a combination of mild disappointment that the US Federal Reserve lowered interest rates by just 0.25% at the end of July and weaker-than-expected economic data. A further escalation of the US-China trade war occurred shortly afterwards, causing interest rates to fall even further. At the long end of US yield curve, the 30-year bond yield sank to a new record low below 2%.

USA: Yields at record lows

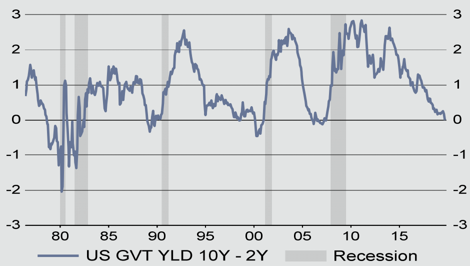
Source: Datastream, J. Safra Sarasin, 04.09.2019

For the first time in the current cycle, the yield on 10-year bonds dropped below the yield on 2-year notes, otherwise known as an inverted yield curve.

Macro outlook: Recession ahead?

The inversion of the US yield curve fuelled a big debate on the financial markets about the probability of a recession in the near future. An inverse yield curve is considered one of the most accurate signals of a looming recession and, as a consequence, is used in many predictive models. The last five inversions of the US yield curve were in each case followed by a recession.

USA: Inverse yield curve sends a signal



Source: Datastream, J. Safra Sarasin, 04.09.2019

But there are two problems associated with this signal. First, in earlier phases it took up to two years for a recession to emerge and, second, not every instance of inversion in previous decades was followed by recession. The risk of recession has certainly increased, but in the USA at least the economy has still some way to go before it reaches this point. US unemployment is at a record low and so far consumption has provided US growth with strong support.

The fundamentals in the other regions do not look very favourable. In China, the expected upswing has failed to get off the ground. Stimulus measures implemented to date are not producing positive results due to the escalation of the US-China trade war.

The Chinese government now also seems to be adopting a wait-and-see approach.

Europe is in a cyclical downturn. Germany posted negative growth in the second quarter, and in the third quarter sentiment indicators such as the ifo business climate Index deteriorated further. A mild recession can no longer be ruled out. Against this backdrop, we are not surprised that the German government is openly considering fiscal stimulus to bolster its economy.

Big differences in bonds

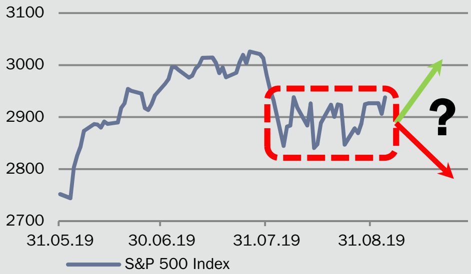
With the risks of recession on the rise, demand for bonds continues apace, and is unlikely to change anytime soon despite low interest rates. The number of investment grade bonds with a negative yield increased sharply again in August and is now at almost 30%. The search for yield continues, although investors are trying to differentiate between risks. Credit spreads on US high-yield bonds have widened, whereas risk premiums for euro-periphery countries have narrowed sharply. At the end of August, yields on 10-year Italian government bonds fell below 1% for the first time.

The big issue affecting emerging market bonds in August was the market crash in Argentina. The unexpected primary election result increased the default risk and triggered a mini earthquake, with the Argentine peso, equities and bonds suffering heavy losses. The negative effect of rising risk aversion spilled over into other emerging markets, resulting in price drops. This situation presents some unique investment opportunities, in our view. But at the same time, the renewed strength of the US dollar acts as a clear headwind for this asset class. Nevertheless, we continue to overweight emerging market bonds in the bond portfolio based on their valuation.

Equities see major fluctuations

Equity markets experienced some major fluctuations in August and risk aversion among investors increased sharply. The VIX Index, which measures the market's expectation of future volatility of the S&P 500 Index, fluctuated around the historically elevated level of 20, its highest reading since last December. The market suffered its biggest setback at the beginning of the month, after which prices stabilized. The stock market has a decision to make: whether to break above its resistance or below its support level. Based on the current economic backdrop, the risk of a downside breakout looks much more likely than the positive scenario.

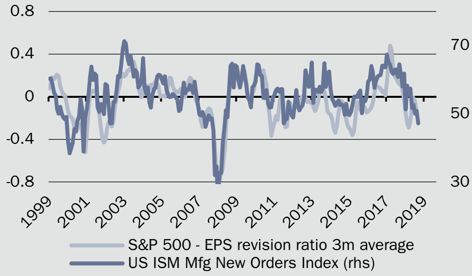
USA: Equity market faces a decision



Source: Datastream, J. Safra Sarasin, 04.09.2019

The equity market – like the bond market – is characterized by growing disparities due to investors' risk preferences. Defensive markets such as the USA and Switzerland are still close to their highest levels, whereas cyclical markets like Japan and the emerging markets have experienced a renewed setback. Banking stocks also remain under pressure and, in Europe, are trading at their lowest level since 2012. Their favourable valuations relative to bonds offer only a small crumb of comfort because they are based on (possibly) overoptimistic earnings estimates. The best indicator, in our view, of future earnings estimates, the ISM New Orders Index, is signalling negative earnings revisions at its current level. This picture is unlikely to change much in the coming months.

USA: Negative earnings revisions



Source: Datastream, J. Safra Sarasin, 31.08.2019

Asset allocation: Defensive stance

The spectre of recession hangs over the financial markets and is pushing interest rates ever lower and driving up risk premiums in all asset classes. We believe a number of factors have the potential to boost investor sentiment and pave the way for a reversal. One possibility is unexpectedly strong stimulus measures in the form of monetary or fiscal policy. Another is a subsidence or even a truce in the ongoing US-China trade war. These possibilities are unlikely to materialize in the short term, however. Signs of stabilization in several leading indicators, signalling a slight cyclical upturn towards the end of the year, give us the best grounds for hope. If the economic environment improves in the fourth quarter as expected, taking on a higher-risk investment strategy could prove worthwhile again. Till then, we maintain our cautious positioning with an underweight allocation to equities. Instead of bonds, which look expensive, gold is a good alternative to diversify holdings. Demand for this precious metal should continue to rise due to the high degree of uncertainty.

Contact
Philipp E. Bärtschi, CFA
Chief Investment Officer
+41 58 317 3572
Email: philipp.baertschi@jsafrasarasin.com

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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Bank J. Safra Sarasin Ltd
General Guisan-Quai 26
P.O. Box
CH-8022 Zürich
T: +41 (0)58 317 33 33
F: +41 (0)58 317 33 00
www.jsafrasarasin.com