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Sustainable Swiss Private Banking since 1841

# CIO Update

**Investment Committee Bank J. Safra Sarasin**

6 June 2019

30 YEARS of SUSTAINABLE INVESTMENTS

## Editorial

Dear reader

The renewed escalation of the trade war between the USA and China has caught investors off guard and triggered a sharp setback in financial markets in May. The expected economic recovery could be delayed given the heightened levels of uncertainty, and investors will need a great deal of patience to wait until the news flow improves. We do not think the US Federal Reserve (Fed) will be quick to provide support, which could lead to further disappointments. Hence, we are sticking to our underweight allocation to equities and remain cautiously positioned in our balanced portfolios. The total return generated in our portfolios since the start of the year is very satisfactory, and we expect the investment environment to improve again in the second half of the year.

Yours faithfully

Philipp E. Bärtschi, CFA

Chief Investment Officer

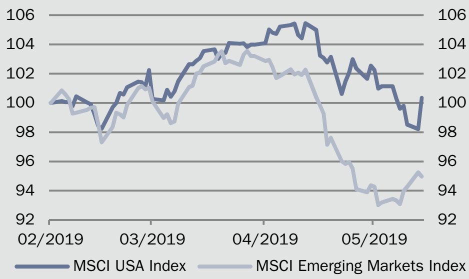
## Focus

# Need for patience

**Review: Setback in May**

The recent escalation of the trade war between the USA and China and attendant rise in investor uncertainty over further escalations and their negative effects on the global economic development have triggered sharp fluctuations in financial markets. Stock market sentiment oscillated between hope and despair in May. Emerging market (EM) equities, in particular, were hit hard by a hail of trade tariff announcements and unexpected political cluster bombs.

**EM equities hit by trade dispute**



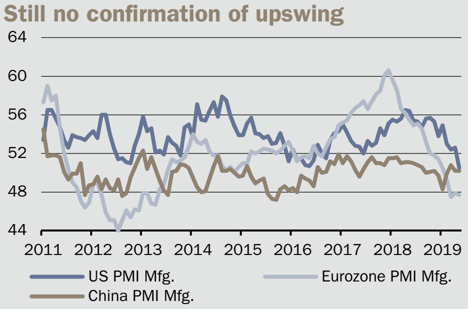

Source: Datastream, J. Safra Sarasin, 06.06.2019

Long-term government bonds, which have increasingly profited from speculation that the Federal Reserve (Fed) will cut its key policy rates rate, have emerged as a safe haven.

**Macro: Later-than-expected recovery**

With the expectation of a recovery in the second half of the year implemented in the base-case scenario of many analysts, uncertainty over trade policy conflicts – not just between the USA and China but also with Europe and Japan – as well as worse-than-expected US macroeconomic data led to a reduction in economic forecasts and weak market sentiment. The uncertainty associated with trade policy developments has the potential to become a catalyst for recession in the worst-case scenario. In a base-case scenario, it will likely cause a delay to the expected recovery in the second half of the year.

**Still no confirmation of upswing**



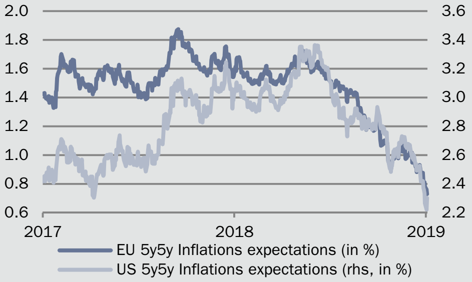

Source: Datastream, J. Safra Sarasin, 06.06.2019

The real risk lies not in the punitive tariffs but in the measures that go beyond punitive tariffs. Banning Huawei Technologies, China's flagship technology company, from the US market may well motivate China to launch more countermeasures. There is a risk that this situation will spur global corporations to make major changes to their supply chains, which will have a negative impact on earnings and investments. Since the costs to both parties in this trade war are very considerable and unpredictable, the most likely outcome is that the USA and China will strike a deal. A temporary respite from the ongoing trade conflict can be expected at the earliest at the G20 summit in Japan at the end of this month.

**Bonds: Will the Fed respond?**

The sharply elevated policy uncertainty now experienced by investors has greatly increased their appetite for purported safe havens such as US Treasury notes and German Bunds. In addition, there is the sharp drop in inflation expectations and an ultra-accommodative monetary policy environment, which keeps up the pressure on yields.

**Inflation expectations decline**



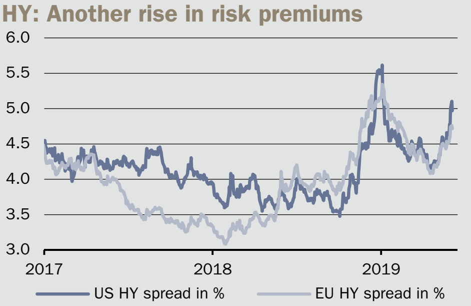

Source: Datastream, J. Safra Sarasin, 06.06.2019

Another reason for lower interest rates is investors' deep trust in Fed support. Members of the Federal Open Market Committee (FOMC) are doing all they can to keep this trust. Eric Rosengren, a voting member of the FOMC, has said that the risks to the US economy are now sufficient to justify a wait-and-see monetary policy approach. In fact, James Bullard, another voting member of the FOMC, is worried that the Fed may have overdone it with its rate hike last December. So it is not surprising that the market is now pricing in more than two benchmark rate cuts this year. This seems somewhat dramatic, given the very high hurdle to any rate reduction in an environment where the US economy is growing above its potential, unemployment is at its lowest level in 50 years and wages are rising.

**Resilient emerging market bonds**

Emerging market bonds have performed well in this environment, despite the slight rise in credit spreads of late. The economic environment remains solid, inflation pressures are muted and local central banks have ample monetary policy scope. Emerging market bonds in local currency were the only asset class to experience pressure in recent weeks due to the strong US dollar. Nevertheless, the significant undervaluation of emerging market currencies against the US dollar, the high real rate of return and a stable monetary policy environment with potential for rate cuts continue to speak in favor of this asset class.

**HY: Another rise in risk premiums**




Source: Datastream, J. Safra Sarasin, 06.06.2019

High-yield (HY) bonds have also retained their appeal thanks to high credit spreads, although they, like equities, were hit by the growing uncertainty that pervaded financial markets in May.

**Equities: Emerging markets have potential**

The escalation of the US-China trade war is the dominant theme on global equity markets. The daily volatility of the market has risen sharply since President Trump's «escalation-tweet». Each new piece of news triggers market volatility – in some cases very strong fluctuations. The rhetoric employed by both the USA and China has intensified in recent weeks, and emerging market equities and, in particular, Chinese stocks have come under strong selling pressure. Higher tariffs on Chinese imports to the USA and the US trade ban against Chinese technology company Huawei pose a heavy burden on China. Nonetheless, Beijing is very determined that its domestic financial market comes to reflect the economic prowess of the Middle Kingdom. The same can be said of its fiscal and monetary policy options. Since China‘s growth acceleration scenario remains intact, Chinese equities are also expected to recover. Lower US dollar rates and a weaker US dollar should also prove helpful for the other emerging markets.

**Asset allocation: Cautiously positioned**

The environment for equities remains difficult. Risks currently predominate, and the US administration's aggressive foreign policy stance toward China remains a factor of uncertainty that should not be underestimated. We continue to expect the USA and China to reach a trade deal. It is more a question of how much damage the dispute causes in the meantime and how long the delay to the expected economic recovery will be. This calls for a very patient investment approach to withstand the fluctuations in markets. As a result, we feel comfortable with our underweight allocation to equities and somewhat more defensive position in the portfolio.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**Attractiveness of individual investments**

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

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