

1<sup>st</sup> quarter 2019

# Investment Views



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# Current market assessment

The tables below summarise VP Bank's trend assessments for all asset classes in our investment universe. The arrows reflect the forecasts of our investment strategists for the coming three to six months.

|  | Q4<br>forecast | Current<br>forecast |
|--|----------------|---------------------|
| <b>Money market and currencies</b> (pages 6-9) |                |                     |
| <b>Currencies</b>                              |                |                     |
| EUR vs. USD                                    | →              | →                   |
| EUR vs. CHF                                    | →              | →                   |
| USD vs. CHF                                    | →              | →                   |
| GBP vs. USD                                    | ↗              | ↗                   |
| USD vs. JPY                                    | ↗              | ↗                   |
| AUD vs. USD                                    | ↗              | ↗                   |
| USD vs. SGD                                    | ↗              | ↗                   |
| USD vs. RUB                                    | →              | →                   |
| <b>Key interest rates</b>                      |                |                     |
| Switzerland                                    | →              | →                   |
| Europe (EMU)                                   | →              | →                   |
| USA  | ↗              | ↗                   |
| <b>Bond yields</b> (pages 10-13)               |                |                     |
| <b>Investment grade government bonds</b>       |                |                     |
| Switzerland                                    | →              | →                   |
| Europe   | →              | →                   |
| USA  | ↗              | → New               |
| <b>Investment grade corporate bonds</b>        |                |                     |
| Switzerland                                    | →              | →                   |
| Europe   | →              | →                   |
| USA  | ↗              | → New               |
| <b>Bonds: total return</b> (pages 10-13)       |                |                     |
| <b>High yield bonds</b>                        |                |                     |
| High yield                                     | ↘              | ↘                   |
| <b>Emerging market bonds</b>                   |                |                     |
| Hard currency bonds                            | →              | ↗ New               |
| Local currency bonds                           | →              | →                   |
| <b>Equities</b> (pages 14-17)                  |                |                     |
| Switzerland                                    | →              | →                   |
| Europe   | →              | →                   |
| North America                                  | →              | →                   |
| Pacific  | →              | →                   |
| Emerging markets                               | →              | →                   |
| <b>Alternative investments</b> (pages 18-21)   |                |                     |
| Commodities                                    | →              | →                   |
| Crude oil                                      | →              | ↗ New               |
| Gold   | ↗              | ↗                   |
| Real estate shares                             | →              | →                   |
| Private equity                                 | →              | →                   |
| Convertible bonds                              | →              | →                   |
| Hedge funds                                    | ↗              | ↗                   |

// Keeping  
a cool head in  
difficult times. //



Dr Felix Brill  
Chief Investment Officer





# Dear Reader

The start of a new year is a boom time for forecasters. But the same cannot be said of the world economy as we enter 2019. A year ago the economic environment was still positive, but in recent months the situation has become murkier. So will 2019 bring more trouble on the financial markets? 2018 was already challenging enough.

In this issue of Investment Views we focus on the dangers and opportunities of the coming year. Against a backdrop of major uncertainties on the financial markets, our analysis is essentially coolheaded. In the following pages you will not only read about political risks and economic challenges but also find many positive assessments. For us the glass is half full, not half empty.

If recent years have taught us anything, it is that the best basis for decision-making in times of political turbulence and economic uncertainty is a balanced analysis of the economy and the financial markets.

With this in mind, we wish you a calm but instructive read and a good start to 2019.

## 1. SPOTLIGHT



# 2019 outlook: navigating late-cycle turbulence

2018 WAS IN MANY RESPECTS A DIFFICULT AND CHALLENGING YEAR FOR INVESTORS. ONCE THE MARKETS HAVE ADJUSTED TO THE CHANGED INTEREST RATE ENVIRONMENT, GAINS SHOULD BE POSSIBLE AGAIN. BUT THE OUTLOOK IS NOT EQUALLY PROMISING IN ALL MARKETS.

After a very positive start, 2018 quickly turned out to be a difficult time for investors. For once, however, vicissitudes in economic growth were not to blame. The macro situation was better than it had been in many years. It was not until the closing months that a few countries start to weaken. Earnings of listed companies climbed globally by about 15% – likewise the best performance in years. Even so, the financial markets had a tough time. In contrast to previous experience, most markets failed to achieve a rapid rebound. Net performance for the year remained disappointing.

Losses were especially painful in cyclical markets and sectors. The local Chinese equity market (largely inaccessible to foreigners) was down by more than 20% at times – and the same goes for crude oil prices. By the usual definition, that constitutes a bear market. Bonds too were in the red, though losses here were less steep. How should we interpret these developments?

## Late-cycle syndrome

The economic expansion and the bull run on the financial markets have both lasted exceptionally long. The longer an upswing lasts, the more probable is its demise. Even so, upswings do not die of old age. Most indicators suggest that we are now in a late-cycle phase, but there are few signs of the cycle's imminent end.

It seems that the markets have been knocked out of kilter by changes in the capital market environment. For many years monetary policy had been a major driver of the bull market, but policy has changed and is no

longer supportive. Higher US interest rates provide an increasingly attractive risk-free alternative to equities, so investors are now less inclined to rush back into the market after a setback. Moreover, the increased political risks observable in recent years are no longer merely generating uncertainty and nervousness but are also for the first time having a negative impact on the real economy and corporate investment. These are unnerving developments for investors, but they also suggest that the current setback is merely a temporary correction and does not herald the end of the bull market.

However, it would be unrealistic to expect these negative factors to evaporate soon. They will probably be with us for some time to come. Markets are usually able to adjust to a changed environment, even if the adjustment takes time. Nevertheless, once the present challenges have been digested, the financial markets' stress level will probably remain higher than before. That is what happened in previous late-cycle phases.

As the market correction has taken place against the backdrop of solid business conditions, it has resulted in a fall in valuation ratios. The previous mild overvaluations in many asset classes declined during 2018 and in many cases were eliminated altogether. Although uncertainty may well continue in the short term, the fundamentals will come to the fore again in the medium term as investors grow accustomed to the new environment.

## Bonds: macro vs. micro

The long period of exceptionally low interest rates has left its mark on the fixed income markets. Debt has risen steeply, and borrower quality has gradually deteriorated. This has made corporate bonds more vulnerable to correction. As long as the economy continues to grow and credit conditions stay benign, this will not be a critical problem. Major pressures from the yield side are also unlikely. But the risks should not be underestimated, as recent cases have demonstrated. When debt exposure is high, company-specific problems (and these occur time and again) are more likely to plunge the company into life-threatening difficulties. A downgrading to junk status or a bankruptcy announcement could send shock waves through the markets and shatter investors' calm. Despite the solid business environment, we regard spreads on corporate bonds as too low. They have admittedly widened

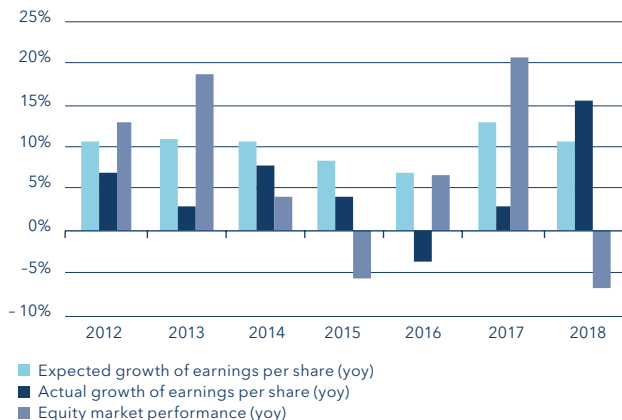
recently, but spreads reacted much more strongly to comparable equity market turbulence in 2011 and 2015/16. In the corporate bond sector investors should focus on solid quality and forgo specious extra returns.

### Equities' time will come

Seldom has it been clearer than now that the buying and selling of equities is primarily driven by expectations. At a time when international trade conflicts are threatening the global economic order, fundamentals play only a subordinate role.

Although recent trends in corporate profits have not had a major influence on share prices, their indirect impact should not be underestimated. Corporate earnings climbed globally by around 15% in 2018. That is well above the figure of just under 11% that was forecast at the start of the year.

Earnings expectations and performance (global equities)



Higher earnings coupled with lower share prices mean lower valuation ratios. Based on our economic growth forecast for this year (somewhat slower than in 2018 but still very solid), we expect corporate earnings growth of around 5% globally. Thus the fundamentals offer good upside potential. However, equities will face increased competition from bonds. After years in which equities were the uncontested favourites, higher US interest rates are now gradually threatening their primacy. But even if the gradual withdrawal of the central banks pushes interest rates into the limelight again, we expect no significant rise in bond yields for the time being. Interest rate movements are therefore unlikely to make trouble for the equity markets.

### Correct late-cycle positioning

The new year looks like starting in the same way as 2018 ended. The markets are still vulnerable to a correction, though in many cases lower share prices already reflect the heightened uncertainty. Despite the damage that has occurred (notably the rupture of some important trends), we expect the markets to enter calmer waters in the course of this year. Their fundamental upside potential should then make itself felt.

Trading-oriented investors can use periods of reduced market tension as an opportunity to adopt a more aggressive stance. If investors' fears lead to a heavy sell-off, counter-cyclical share buying should also prove rewarding.

Less active investors are well advised to stay in the market. At present we favour a mildly defensive positioning. When selecting shares, investors can already take advantage of cyclical opportunities. That applies, for example, to the energy sector, where oil shares have been hit by the collapse of the oil price. Chinese consumer stocks are not directly exposed to the trade dispute with the US, but they have been damaged by the exodus of many investors. This sector should now be supported not only by structural factors but also by the prospect of stimulatory action by the Chinese government. In general, equity positions should be broadly diversified with the focus on quality shares, which should fare better in the present environment.

In the bond markets, too, we recommend a cautious positioning. That applies especially to new purchases. BBB rated corporate bonds boast the highest yields in the investment grade sector, but downgradings could precipitate a sell-off due to the fact that many big investors are no longer permitted to hold lower-rated assets. Overall, borrower selection is becoming more important.

Another possible response is to take positions in alternative bond strategies, which can reduce the risks of default and interest rate changes and also open up new sources of return. Gold, too, is now an attractive portfolio component - and not only for reasons of diversification.



# A cold shower to ward off overheating

2019 PROMISES TO BE A CHALLENGING YEAR. THE ECONOMY AND THE FINANCIAL MARKETS WILL AGAIN BE DOMINATED BY POLITICS.

2018 was a remarkable year. A record-breaking heat wave was paralleled by hot weather on the political front. The US economy also heated up, fuelling rising inflation and higher wages. Experienced mechanics know that the temperature of a car's engine has to be kept under a control if it is not to seize up. Cooling is beneficial.

First let's look at the political scene. Donald Trump's aggressive posturing and punitive tariffs have shocked America's trading partners. The fog of uncertainty has been thickened by the Brexit negotiations and the brouhaha surrounding Italy's budget plans. At year-end these political tensions began to undermine global capital spending, with knock-on effects on world economic growth. Thus the tremors of 2018 will continue to reverberate in 2019. The start of the new year will be blighted by sagging growth. The good news is that there are still no signs of recession. Indeed, the slowdown could actually lengthen the life on the current expansion. A cold shower freshens you up, or – to stay with the automobile image – slower revs keep the gearbox cooler and make the engine last longer.

## Salutary slowdown

Trump's tax reform, coupled with an already healthy labour market, has given a major push to growth in various sectors of the US economy. This has obliged the Fed to keep its benchmark interest rate on a gentle but consistent upward trajectory. Higher US interest rates are already causing problems in other parts of the world. Countries that have borrowed heavily in US dollars now face higher refinancing costs, which can be a huge burden at a time of generally increased risk aversion among international investors. Turkey has

## Highlights

- The world economy has slipped into a lower gear. The political legacy of 2018 is casting a shadow over the start of 2019.
- The economic slowdown also has a positive side: it should lengthen the life of the current expansion.

been hit especially hard. Even the US itself is now witnessing a slowdown in house-building due to higher borrowing costs.

Faced with the global increase in macroeconomic risks and increased dangers for the US itself, the Fed is now trimming its sails. An overheating of the world's largest economy should therefore be averted, enabling the Fed to resume the process of moderate interest rate hikes after a probable pause in the first half of this year. Seen in this light, the slowdown of economic activity is a salutary development. A more moderate course of interest rate increases reduces the danger of choking off the economy. This should make the equity and credit markets less nervous, with a positive impact on business sentiment.

## Reality check

Provided the slowdown is temporary (though possibly of longer duration), expected lower global growth rates have a positive aspect. Overheating will be avoided. That might even lengthen the life of the current expansion, because central banks would not be forced to tighten excessively. On the other hand, the world still faces political pitfalls. Donald Trump's unpredictable actions will continue to keep the world on tenterhooks. The bottom line is that 2019 will see an economic cooldown, but its effect will be benign.

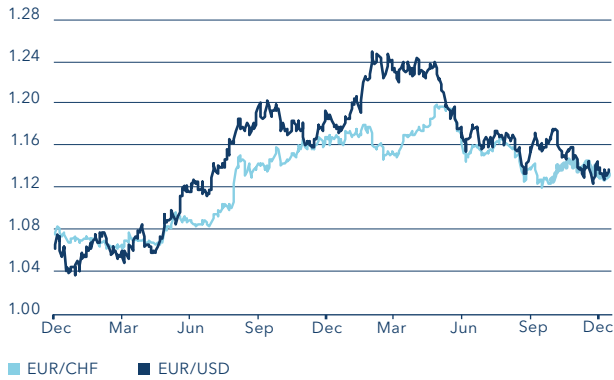
## 2. ASSET CLASSES

Money market and  
currencies

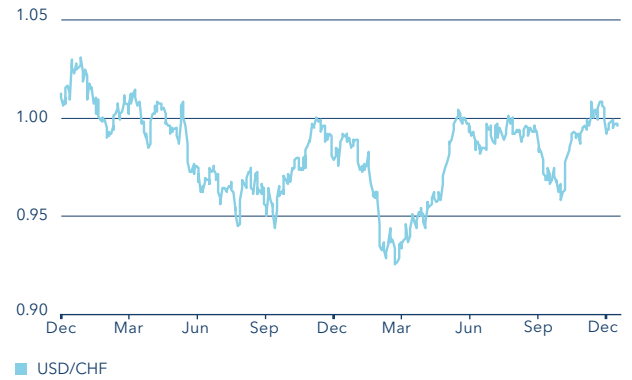


# Market overview

EUR/CHF and EUR/USD: exchange rates since December 2016



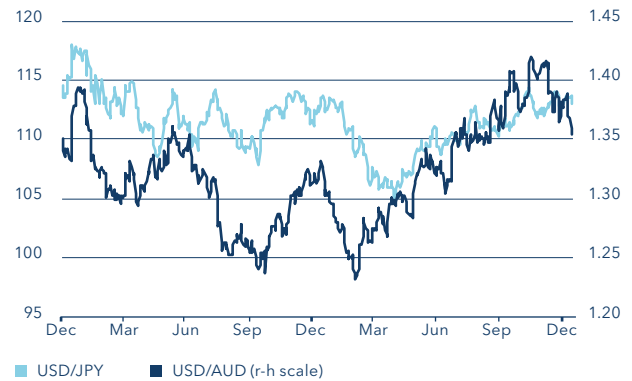
USD/CHF: exchange rate since December 2016



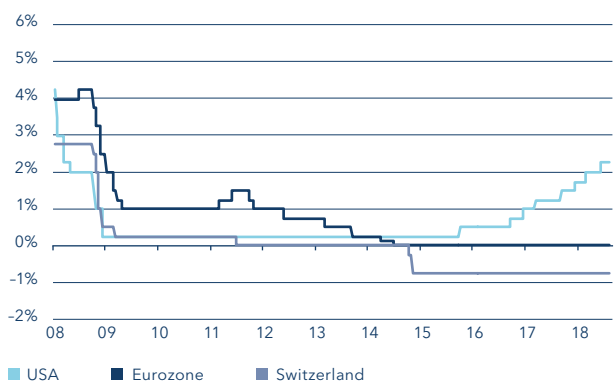
GBP/CHF and GBP/USD: exchange rates since December 2016



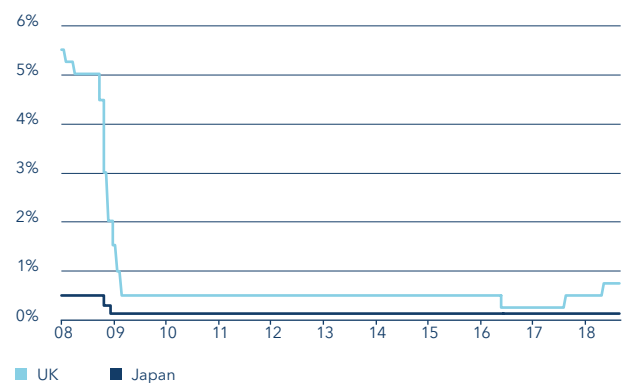
USD/JPY and USD/AUD: exchange rates since December 2016



Key interest rates in Switzerland, eurozone, USA: since January 2008



Key interest rates in UK and Japan: since January 2008



# Switching off the autopilot

THE CENTRAL BANKS ARE PROCEEDING WITH CARE. THE WORLD ECONOMY IS COOLING, AND INFLATION IS STILL SUBDUED. IT WILL BE INTERESTING TO SEE HOW THE EUROPEAN CENTRAL BANK BEHAVES.

It's like aviation. Soon after lift-off the captain switches to autopilot, and the mood in the cockpit relaxes. But if the plane runs into turbulence, the autopilot can be switched off and the crew takes control again. At the start of 2019 the Fed finds itself in a similar position. Over the last year it has been flying on autopilot, hiking interest rates almost automatically once a quarter. This was made possible by the inflation trend (see chart).

USA: fed funds rate and inflation



The Fed regards the current level of the fed funds rate as "neutral", i.e. having neither a stimulatory nor an inhibiting effect on the economy. However, a neutral level of interest rates is a theoretical construct that cannot be numerically defined. In other words, the level of interest rates that will put a brake on the economy cannot be accurately predicted. It can only be determined after the event. It is for this reason that the Fed has now switched off the autopilot and is keeping a close eye on the data. If it emerges, for example,

that the level of interest rates is causing companies to postpone capital spending or is pushing them into payment difficulties, the Fed will put further hikes on ice for a while.

## Fed sees risks

The Fed is currently facing two difficulties. The world economy is slowing, and so is the US real estate market. The cooling of the housing market, in particular, appears directly related to higher interest rates on building loans. As core inflation (i.e. excluding volatile energy and food prices) is now running at 2.2% and shows no sign of speeding up significantly, we expect the hiking of the fed funds rate to be paused during the first half of this year. This can be inferred from a change in the language being used by Fed members. Fed boss Jerome Powell and his deputy Richard Clarida have recently been placing greater emphasis on risks. The financial markets, meanwhile, are extremely sceptical about whether there will be any further substantial rate hikes. In other words, the market thinks the Fed has just about reached the end of its interest rate hiking cycle for the time being. We believe this view might be too negative. The current macroeconomic weakness does not appear likely to degenerate into recession. There is simply no sign of that happening at present. US companies are still taking on new labour, and that is reflected in an extremely upbeat mood among consumers. Indicators for US consumer sentiment are at a record high. At the same time, surveys of American businesses point to rising wages in the months ahead, and that should further underpin the already extremely robust level of personal consumption. In short: the overall economic environment provides scope for further interest rate hikes. Only a protracted period of economic weakness or a slide into recession would spell the end of US interest rate hikes.

## European Central Bank: little movement expected

2018 was an important year for the European Central Bank. Its monthly asset purchases were gradually wound down with the intention of terminating them completely at year-end (we went to press before this was due to happen). This marks the end of an epoch in the ECB's short history. The ECB says it wants to leave interest rates untouched until the end of summer 2019. If inflation accelerates and the economy permits, an

initial rate hike could come in the autumn. But exiting from monetary expansion will be much harder for the ECB than for the Fed. The Fed is an active participant in the market for overnight money and buys and sells short-term Treasury bills to keep the interest rate within the desired range. The ECB, for its part, lends liquidity to the commercial banks by means of a tender process. The problem is that its monthly asset purchases have pushed up excess liquidity in the eurozone to such an extent that the commercial banks have hardly any need for money from the central bank. Thus raising the refinancing rate (the rate that banks pay for borrowing from the ECB) has zero impact. The ECB will therefore probably start by raising the deposit rate, i.e. the rate at which banks make overnight deposits with the ECB. In an environment in which commercial banks need to park excess liquidity rather than borrow, this has become the ECB's de facto key interest rate. A hike in the refinancing rate will probably only be on the agenda in 2020 – provided the economic expansion continues until then.

### What will the SNB do?

Policy-makers at the Swiss National Bank are taking their cue from their eurozone colleagues. Inflation in Switzerland accelerated significantly in 2018 to over 1%, a high level for this country. But that was due mainly to the rise in oil prices. If volatile energy and food are bracketed out, Swiss inflation is running at a very low rate of 0.4%. Swiss GDP probably grew by almost 3% last year, an exuberant rate compared with other countries, but inflation stayed low. From this angle, the SNB is under no pressure to act. If it defied expectations and decided to tighten, the Swiss franc would probably appreciate steeply against the euro and US dollar. That could push inflation into negative territory and force the SNB to cut interest rates again. Thus monetary tightening would result in absurdity. Anyone who bets on higher Swiss interest rates in 2019 is liable to find themselves wrong-footed.

### Highlights

- The Fed is using its monetary tools cautiously. It will stick to its policy of gradual interest rate hikes.
- We expect little or no movement from the ECB or the SNB. Low inflation and modest growth do not call for tightening.

### Conclusion

The divergent courses that the Fed and ECB have been pursuing in recent years look set to continue. We expect further rate hikes in the US, while the ECB could take a small step in late 2019 by raising the deposit rate. In Switzerland, it will be steady as she goes.

| Key interest rates | Current forecast |
|--------------------|------------------|
| Switzerland        | →                |
| Europe (EMU)       | →                |
| USA                | ↗                |

Upside/downside ranges indicated by our 3–6 month interest rate forecasts:

|                      |                      |             |
|----------------------|----------------------|-------------|
| ↗ > +50 basis points | ↗ +25 basis points   |             |
| ↘ -25 basis points   | ↘ < -50 basis points | → No change |



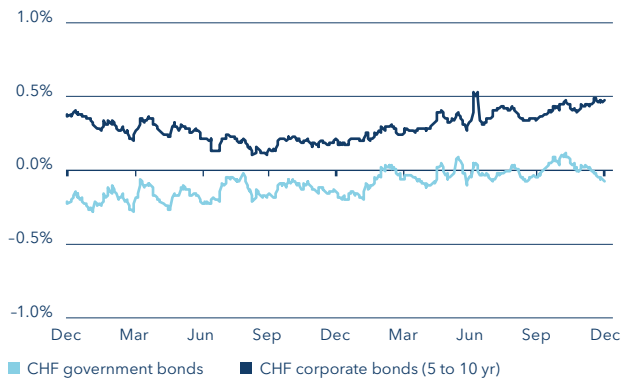
## 2. ASSET CLASSES

Bonds



# Bond yields – overview

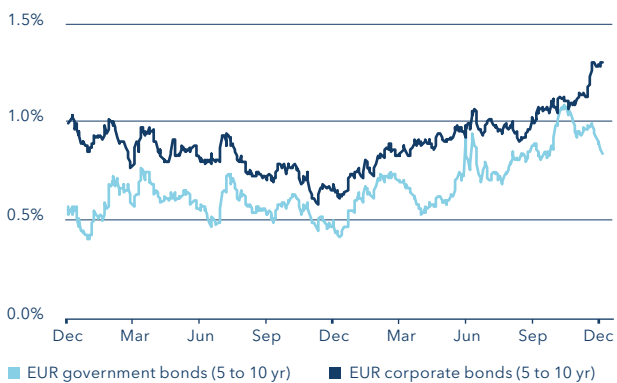
Switzerland: yields since December 2016



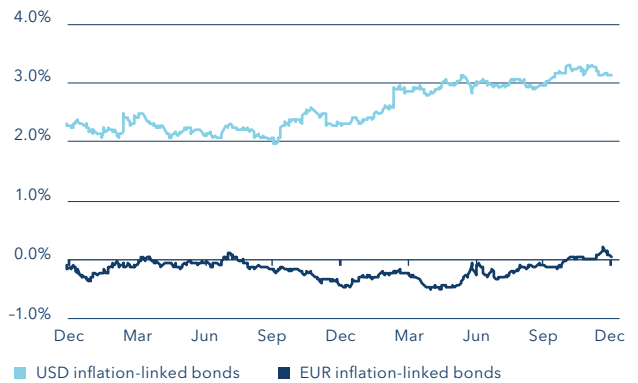
Emerging markets: yields since December 2016



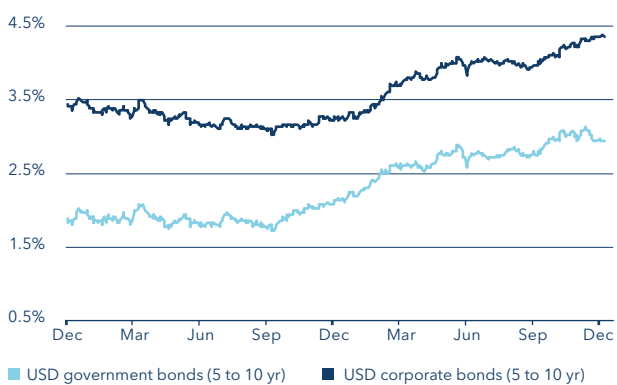
Europe: yields since December 2016



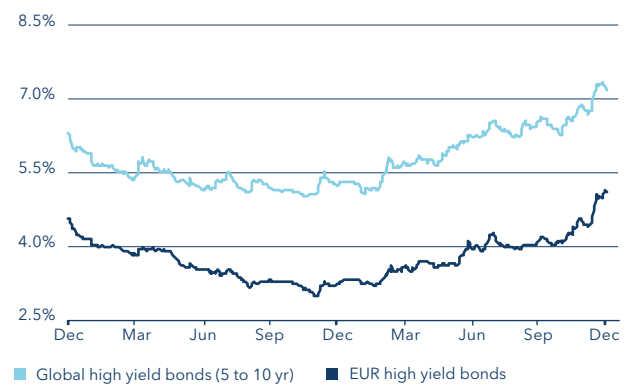
Inflation-linked bonds: yields since December 2016



USA: yields since December 2016



High yield bonds: yields since December 2016



# Bond yields: limited upside potential

THE LONG-AWAITED BACKUP OF BOND YIELDS HAS HAPPENED. ANALYSTS HAVE REASON TO CELEBRATE. BUT THE SCOPE FOR A SIGNIFICANT RISE IN 2019 IS LIMITED. THE WORLD ECONOMY IS COOLING AND CENTRAL BANKS MUST PROCEED WITH CAUTION.

It is rare for analysts to get their yield forecasts right. We made that point in these pages a year ago, but we noted that this time it might be different. And so it has proved. US bond yields have climbed, just as the consensus forecast said they would. Does this mean that yields are now off the leash and about to run amok? The short answer is: no.

## Central banks still on their guard

The world economy is currently in a cooldown phase (see page 5), while lower oil prices are pushing down inflation rates. Central banks will therefore act very cautiously. Statements by the Fed underline this. Representatives of the Federal Reserve have recently adopted a more circumspect tone. The message is clear: after a succession of rate hikes since December 2015, monetary policy will now be geared more closely to the data flow. We expect the rate hiking process to be paused in the first half of this year. The European Central Bank and the Swiss National Bank will leave interest rates largely untouched, though a cosmetic increase in the ECB's deposit rate is possible.

## Market scepticism

The financial markets are sceptical about whether the Fed has more big moves up its sleeve. Futures prices for short-term US overnight rates are signalling an imminent end of the rate hiking cycle. We regard this view as unduly pessimistic. Wage pressures in America are on the up, and that has always been a harbinger of central bank tightening in the past. We expect to see three interest rate hikes during the

coming year. If that happens, yields on long-term US Treasuries could potentially climb to 3.50%. But that scenario is for the second half of the year. We foresee little movement initially, with 3.20% likely to be the first step.

## ECB and SNB in lockstep

The European Central Bank faces a sharp slowdown of the eurozone economy. In this environment the monetary guardians in Frankfurt have little initial incentive to tighten the monetary screws. If the economy gets back on track, the ECB might decide to raise its deposit rate by 15 basis points, but that would not be enough to lift yields on 10-year Bunds to a significantly higher level. The markets would still be unconvinced that the ECB is committed to a full-blown rate raising cycle. The Fed's experience illustrates the problem. US bond yields did not start to move until it was clear that the Fed had genuinely embarked on a protracted period of rate hikes. Switzerland's position is similar. Our baseline scenario foresees no monetary tightening in Switzerland during 2019. The upside potential for yields on 10-year Swiss federal bonds is therefore tightly constrained.



# Inadequate compensation for credit risks

CLOUDS ARE STARTING TO APPEAR IN THE CREDIT MARKETS. AFTER YEARS OF ALMOST PERFECT CONDITIONS FOR BORROWERS, THE OUTLOOK IS NOW LESS ENCOURAGING.

## Massive expansion of supply

Yields on 10-year US Treasuries have been in constant decline since peaking at 16% in 1981. Corporate bonds have also profited, because investors seeking higher returns have been ready to accept a higher level of risk. The Bloomberg Global High Yield Index, which had a market volume of USD 613 billion at the end of 2008, has now swollen to USD 2,300 billion, while the volume of US investment grade corporate bonds has climbed from USD 2 trillion to USD 5 trillion. Despite this huge expansion of supply, however, credit spreads in the high yield sector have narrowed from 16.8% to 4.65%, while investment grade spreads are down from 5.1% to 1.4%.

## Potential ETF bottleneck

The growth of the high yield bond market has been assisted by its easy accessibility. The introduction of exchange traded funds (ETFs) investing in high yield bonds means that small investors can now invest simply and cheaply in this asset class. There are now 120 ETF products in this market, to which must be added many actively managed funds. USD 8 billion were withdrawn from these ETFs in 2018, but USD 109 billion of high yield investments are still under ETF management. The problem is that high yield bonds tend to become illiquid in periods of stress. This inevitably compromises the ETFs' liquidity. If too many investors want to sell at the same time, the exit may be too narrow.

## Declining quality

The low interest environment has led to a reduction of quality in corporate finances. As long as asset yields are higher than borrowing costs, high leverage means a higher return on equity. But the corollary is heightened

## Highlights

- The upside potential for yields on long-term US bonds is limited for the time being by the global economic slowdown.
- Low interest rates have led to a massive increase in the supply of corporate bonds.
- At the same time corporate balance sheets have deteriorated.
- Lower-quality issues in the investment grade sector should again be avoided this year.

risk, especially if funding costs move up, as they did in 2018. The Bank for International Settlements has carried out a study of 32,000 firms and discovered that around 12% of them cannot meet their interest commitments out of their pre-tax profits. The number of such "zombies" has risen relentlessly. In 1990 the corresponding figure was only 1%. Thus central bank policy is leading to a misallocation of capital.

## Conclusion

In view of the heightened risks, it does not take much to prompt a reappraisal of credit quality. Over 50% of investment grade borrowers are now rated as BBB. If some of these slip into the high yield category, both sectors will suffer. Given the many challenges that lie ahead, we expect lower-quality issues to perform negatively again this year.

| Benchmark   | Current forecast | % YTD <sup>1</sup> |
|---|------------------|--------------------|
| Gov. bonds Switzerland <sup>2</sup>                 | →                | -0.81%             |
| Gov. bonds Europe (EUR) <sup>2</sup>                | →                | 0.09%              |
| Gov. bonds USA <sup>2</sup>                         | →                | -1.13%             |
| Inv. grade corp. bonds Switzerland <sup>2</sup>     | →                | -0.98%             |
| Inv. grade corp. bonds Europe (EUR) <sup>2</sup>    | →                | -1.11%             |
| Inv. grade corp. bonds USA <sup>2</sup>             | →                | -3.55%             |
| High yield bonds <sup>3</sup>                       | ↘                | 1.16%              |
| Emerging market bonds (hard currency) <sup>3</sup>  | ↗                | -5.38%             |
| Emerging market bonds (local currency) <sup>3</sup> | →                | -6.57%             |

<sup>1</sup> As of 04.12.2018

<sup>2</sup> Yield

<sup>3</sup> Total return

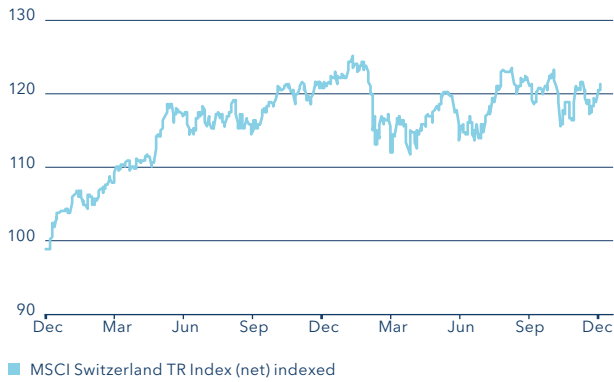
## 2. ASSET CLASSES

Equities



# Equity indices – overview

Switzerland: market movement since December 2016 (indexed)



Pacific: market movement since December 2016 (indexed)



Europe: market movement since December 2016 (indexed)



Emerging markets: market movement since December 2016 (indexed)



North America: market movement since December 2016 (indexed)



United Kingdom: market movement since December 2016 (indexed)





# Swings and roundabouts

2018 SHOWED THAT IT TAKES VERY LITTLE TO KNOCK THE WORLD ECONOMY OFF BALANCE. US-INSPIRED TRADE DISPUTES POSE A CHALLENGE TO INDUSTRIAL GLOBALISATION.

Synchronous economic growth in the G20 countries has been knocked out of kilter by the escalating tariff war. Measured by the growth of corporate profits, the US has got off lightly so far, but almost all other regions and countries have been hurt. Germany, as a major exporting country, has been hit especially hard. Corporate earnings growth slumped from an expected figure of over 10% to minus 3.3%. This was due mainly to German exporters' heavy dependence on Asia and a home-grown crisis in the automobile industry. It is still hard to say how the trade conflict will pan out, but the markets are upbeat about the outlook for 2019. The picture in America is rather different. Here earnings growth expectations for 2019 have slipped from 10.5% to 8.7% since October. After partying at others' expense, US companies are now suffering a hangover.

## Ebb and flow

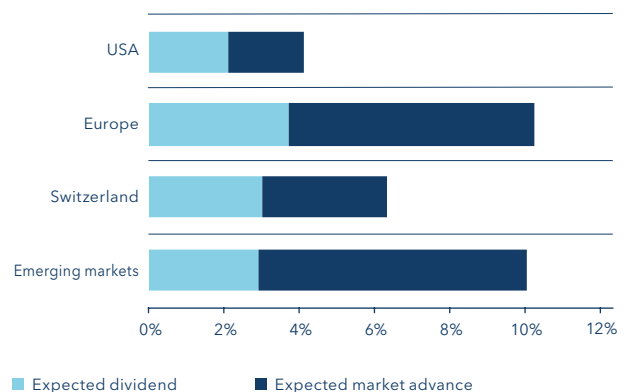
Although corporate earnings growth is now being revised downwards, what American investors fear most of all is an overheating of the domestic economy. With the Fed pursuing a course of monetary tightening, it will be hard to push equity valuations any higher. In fact, a cooling of the economic environment is just what US investors need at present, because it gives hope that the Fed will moderate its stance in the short to medium term. 10-year US Treasuries yielding 3% are very attractive compared with equities for conservative investors in North America, who have already trimmed their international exposures in response to the worsening economic outlook and unfavourable exchange rates created by the strong dollar.

But it looks as if this situation will be temporary. Major growth potential in the poorly performing regions has not evaporated but has merely been postponed to the

new year. As expectations for 2018 declined, those for 2019 grew more positive.

Corporate earnings growth forecasts for Europe have risen to 9.3%, while those for Germany have climbed steadily to 11.7%. Even on a conservative assessment, this suggests substantial recovery potential for equity valuations. The more conciliatory note struck by China and the US at the G20 summit in Argentina confirms that both countries recognise that the trade conflict has assumed unfavourable dimensions.

Equity price potential 2019



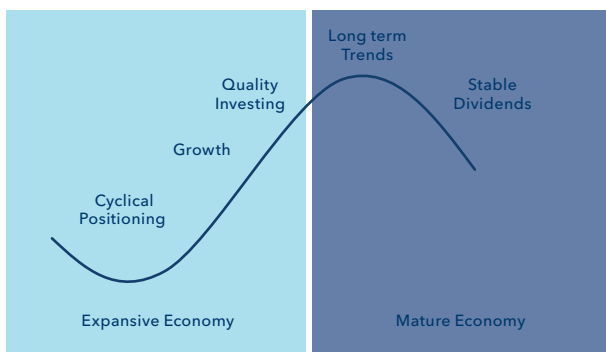
Expected returns for 2019 reflect these trends. Corporate earnings growth is expected to improve, and fundamental valuations in Europe and the emerging markets are set to normalise. P/E ratios in both regions are lower than their 15-year average and well below the overall level of the global equity market. Conversely, the US market is still trading at a premium. Moreover, US firms will not get the same support from the government this year as in 2018 (tax reform). Thus the pendulum is swinging to the other side, offering catch-up opportunities for regions that were under strain in 2018.

## Opportunities predominate in the long term.

The continuing robust performance of the world economy creates a solid basis for equity investments. But conditions have changed substantially. Borrowing costs in the US have already climbed steeply and are eroding corporate profitability and investment. A chiller

wind is blowing from the credit markets, with the trend towards rising risk premiums set to continue in 2019. Many of the current challenges have been known for some time, but the economic domino effects resulting from a further escalation of the trade conflict, Britain's departure from the EU and other contrary developments are hard to assess. Since the two last major equity market crises in 2000 and 2007, many international corporations have displayed great flexibility and impressive powers of survival. The current economic environment is certainly turbulent, but it also offers an abundance of possible solutions. Rarely have strong industrial trends been as numerous as they are now. Digitalisation and automation are playing a central role here, offering good potential for productivity improvement.

#### Investing along the capital market cycle



For years the markets have been focussing strongly on online business and consumer credit via the internet. Now, however, we believe that infrastructure is taking over as the predominant theme. Networked mobility, modern urbanisation, digital optimisation of healthcare and themes associated with sustainability are now firmly in the foreground.

#### Conclusion

Protectionism will again be a core feature of 2019, posing major economic and political challenges. When selecting equity investments, investors should pay close attention to heightened volatility and increased risk premiums. Sharp falls in fundamental valuation levels in Europe and the emerging markets are already

#### Highlights

- 2019 will be a tense but promising year for equity investors. While political and economic challenges will persist, the markets will benefit from attractive valuation levels and supportive industrial trends.
- We favour the following investment themes:
  - Automation through robotics
  - Investment in healthcare
  - High-class stocks: investing in quality
  - China: shift from exports to consumption

pricing in a more challenging investment environment. But strong industrial trends and continuing solid economic growth are plus factors for equities in the medium and long term. The biggest opportunities will initially be found in Europe, Switzerland and Asia. Investors should continue to focus on high fundamental quality, forward-looking business models (oriented towards key global industrial trends) and stable dividend payments.

| MSCI benchmark        | Current forecast | % YTD <sup>1</sup> |
|-----------------------|------------------|--------------------|
| Switzerland           | →                | -0.62%             |
| Europe                | →                | -9.61%             |
| North America         | →                | 4.78%              |
| Pacific (incl. Japan) | →                | -5.62%             |
| Emerging markets      | →                | -10.29%            |

Upside/downside ranges indicated by our 3-6 month absolute performance assessments:

↑ > +5%   ↗ +2% to +5%   → -2% to +2%   ↘ -5% to -2%   ↓ < -5%

<sup>1</sup> As of 04.12.2018; net return in local currency incl. dividends

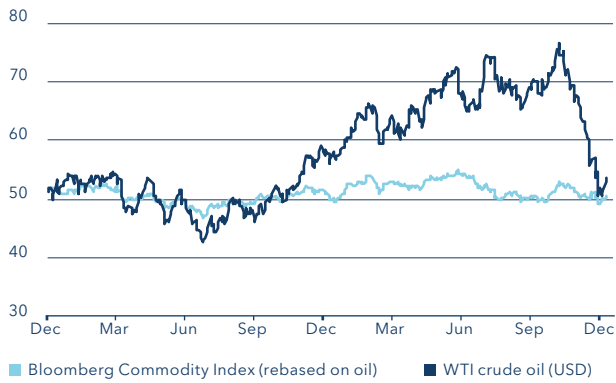
## 2. ASSET CLASSES

Alternative  
investments

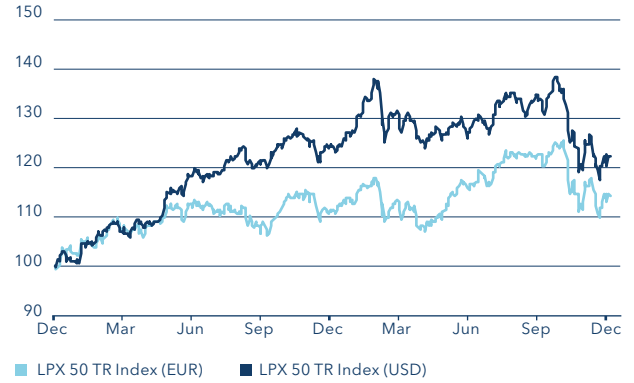


# Alternative investments – overview

Commodities: performance since December 2016



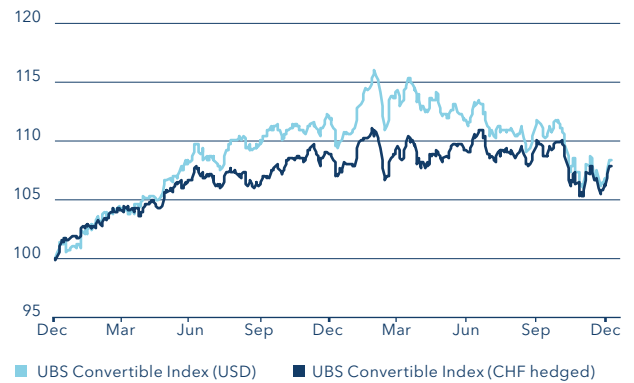
Private equity: performance since December 2016 (indexed)



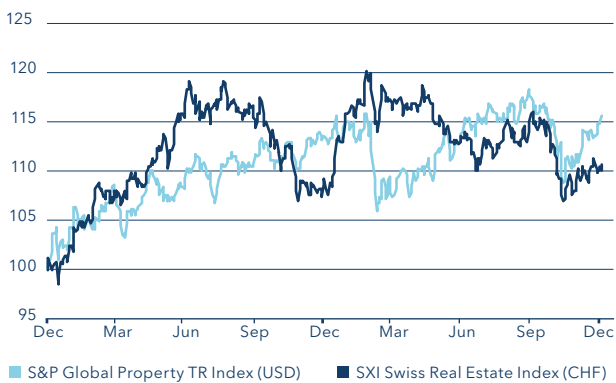
Precious metals: performance since December 2016



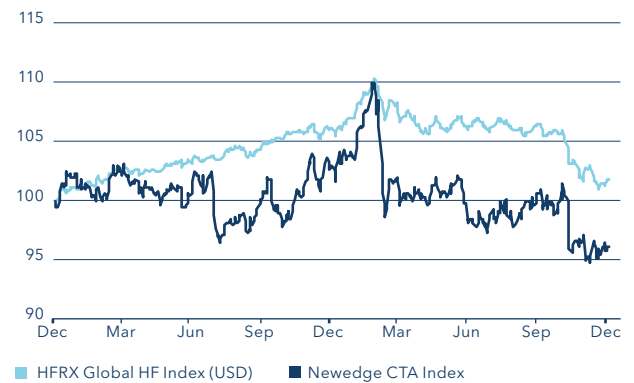
Convertible bonds: performance since December 2016 (indexed)



Real estate: performance since December 2016 (indexed)



Hedge funds: performance since December 2016 (indexed)



# Crude oil: trial of strength between OPEC and US

OIL PRICES HAVE BEEN ON A ROLLER COASTER, DRIVEN BY THE CONFLICTING INFLUENCES OF IRAN SANCTIONS AND SURPLUS SUPPLY. OPEC NEEDS TO STABILISE THE OIL PRICE AND STRENGTHEN COHESION AMONG ITS MEMBERS.

When Donald Trump announced sanctions on Iran and promised to squeeze Iran's exports of crude oil to zero, OPEC took him at his word. Fearing a shortage of supply, the Saudi-led cartel flooded the market with oil. The US responded gratefully by treating the Saudis with kid gloves. The murder of the opposition Saudi journalist Jamal Khashoggi seems to have been quickly forgotten. A little while later, Washington caused general amazement by issuing waivers to the principal importers of Iranian oil. Eight countries may now continue to buy crude oil from Iran, albeit in reduced quantities. The resulting surplus supply pushed the oil price down by over 30%.

## US shale vs. OPEC: the battle continues

OPEC's New Year resolution for 2019 could be as follows: push the oil price to a higher level and keep it there while strengthening cooperation among OPEC's members.

The OPEC meeting in December set the scene for rising oil prices by announcing production cuts of 1,200,000 barrels a day. Tighter supply means higher market prices. Donald Trump took exception to this. After all, it is in Americans' interest for the price to stay low. Although Trump and the oil industry see little need at present to pump more oil, a rising price could quickly cause a rethink. Given the falling production costs for US shale oil, more barrels could be brought to market relatively quickly.

In the longer term a low oil price would plunge many OPEC members into difficulties. They need a WTI price of more than USD 60 a barrel if they are to avoid a budget shortfall this year. Indeed, the biggest OPEC producer, Saudi Arabia, needs an average price of

USD 78. In its role as "swing producer", Saudi Arabia will be able to call the tune and initially pursue a "Saudi first, America second" strategy. It is also in OPEC's interest to avoid another oil price fiasco like the one we saw in 2016, when the market was flooded by untrammelled production.

We assume that such a debacle will not be repeated. Venezuelan output continues to shrink, and Iran will face a stricter application of US sanctions. The waivers are valid for only 180 days and will only be renewed on the basis of additional import reductions. The other countries that make up the "Fragile Five" petrostates might also encounter problems. Nigeria, Libya and Iraq are currently producing well above their average output for the last 10 years, but internal strife could quickly reduce supply from these countries.

## Patching up internal differences

OPEC can only achieve long-term price stability at a higher level by patching up its internal differences so that its members pull in the same direction. In the past OPEC members have stuck to their quotas only sporadically. The departure of Qatar, which wants to concentrate on natural gas in future, shows that OPEC's cohesion is gradually starting to crumble. The situation will not necessarily be helped by the installation of Venezuela's Manuel Quevedo as OPEC's new president this year.

Despite squabbles within OPEC and strong US production, we continue to view 2019 with confidence and expect to see a further recovery of the oil price. We are therefore sticking to our target price range of USD 65-70 per barrel.



# Precious metals: gold out of fashion?

GOLD HAS HAD A DIFFICULT YEAR. DESPITE A PLETHORA OF GLOBAL RISKS, THE GOLD PRICE NEVER ACHIEVED TAKE-OFF AND WAS HIT HARD BY THE HIGH-FLYING DOLLAR. BUT WHEN THE GOING GOT HARD AGAIN ON THE FINANCIAL MARKETS IN THE AUTUMN, GOLD PROVIDED PROTECTION.

2018 began on a promising note for gold. The previous year's final spurt initially continued, and speculators on the futures markets were extremely bullish. Gold seemed to be in fashion again. Looming geopolitical risks (Brexit and trade conflicts) seemed to make gold an attractive bet. So the price collapse of almost 13% between April and August came as a shock. But the causes were easy to find: the dollar was rising (propelled by the Fed's interest rate hikes), risk consciousness was on the wane, and inflation was too low to provide support. It is an established fact that the gold price is inversely correlated with the movement of the US dollar and real interest rates. For gold investors based in euros or Swiss francs, however, the strong greenback mitigated the impact of gold's decline.

## Financial markets still decisive

Chastened by last year's retreat, investors are no longer betting on a rising gold price. Short positions on the futures markets are now at record levels, despite festering geopolitical risks. Even so, gold should not be written off. In autumn 2018, when the equity markets lost their composure and started to correct, gold displayed its risk-reducing powers. This confirms the fact that geopolitical risks are not by themselves enough to make gold investments rewarding. Gold only benefits when risks turn to reality and have a direct impact on the financial markets.

We are confident about the outlook for physical gold demand in 2019. A major factor here will be purchases

## Highlights

- America is happy with the current low oil price. Falling production costs are helping to generate excess supply.
- But OPEC members need a higher oil price to avoid budget deficits. Production cuts and the difficulties of the "Fragile Five" petrostates could cause supply to contract.
- Investors on the futures markets are betting against a rising gold price.
- We recommend holding a supplementary position in gold as a portfolio diversifier.

by central banks, whose appetite for gold has increased. Further support could come from the futures markets if a rising price forces speculators to cover their short positions.

We therefore continue to recommend holding a position in gold, not because we expect the price to surge but as a means of protecting the portfolio from financial market risks.

| Benchmark              | Current forecast | % YTD <sup>1</sup> |
|------------------------|------------------|--------------------|
| Commodities            | →                | -3.78%             |
| Gold                   | ↗                | -7.27%             |
| Crude oil              | ↗                | -4.93%             |
| Commercial real estate | →                | 0.52%              |
| Private equity         | →                | 0.25%              |
| Convertible bonds      | →                | -2.38%             |
| Hedge funds            | ↗                | -4.89%             |

Upside/downside ranges indicated by our 3-6 month absolute performance assessments:

↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

<sup>1</sup> As of 04.12.2018



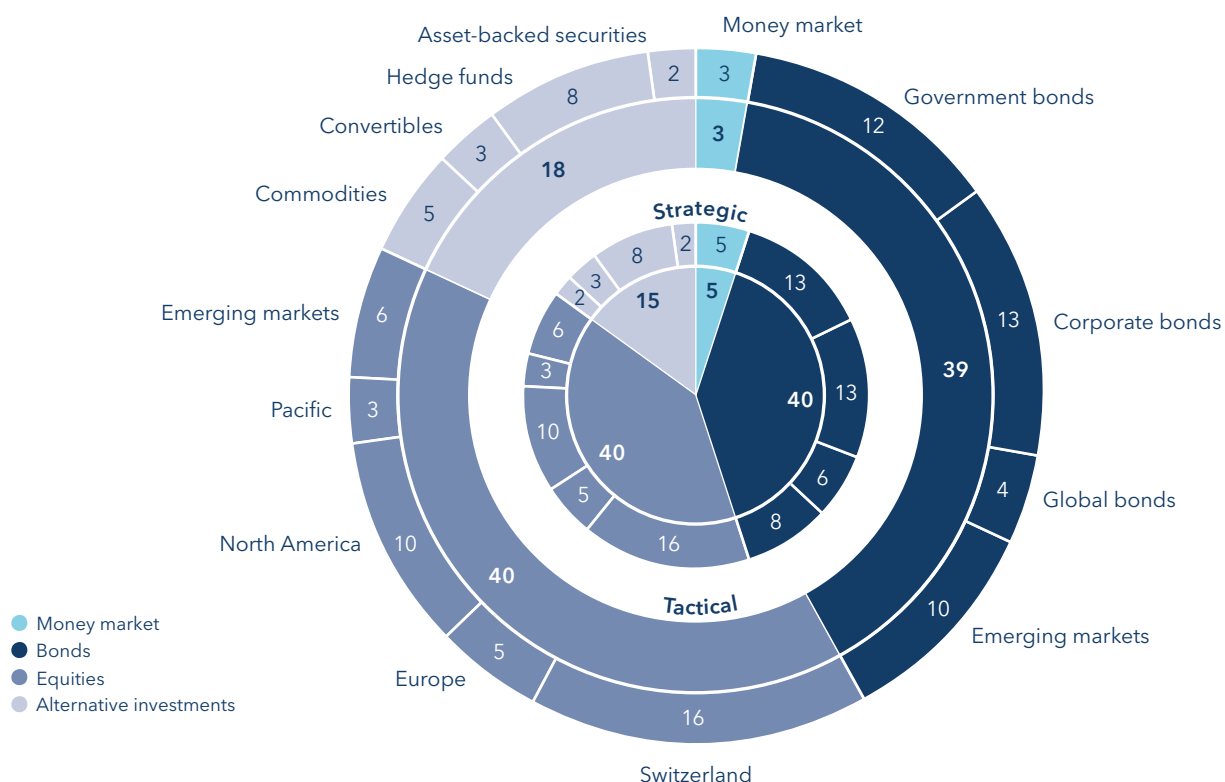


### 3. INVESTMENT MANAGEMENT



# Investment management portfolios

## Strategic and tactical allocation - balanced portfolio based in CHF (% weightings)



## VP Bank Strategy Funds

| Product name                             | Curr. | ISIN         | NAV date | NAV      | Payout | Currency hedged | YTD perf. % |
|--|-------|--------------|----------|----------|--------|-----------------|-------------|
| VP Bank Strategy Fund Conservative (CHF) | CHF   | LI0017957502 | 30.11.18 | 1,035.39 | no     | yes             | -4.57%      |
| VP Bank Strategy Fund Conservative (EUR) | EUR   | LI0017957528 | 30.11.18 | 1,377.81 | no     | yes             | -4.16%      |
| VP Bank Strategy Fund Conservative (USD) | USD   | LI0100145379 | 30.11.18 | 1,329.71 | no     | yes             | -4.55%      |
| VP Bank Strategy Fund Balanced (CHF)     | CHF   | LI0014803709 | 30.11.18 | 1,538.89 | no     | yes             | -5.45%      |
| VP Bank Strategy Fund Balanced (EUR)     | EUR   | LI0014803972 | 30.11.18 | 962.14   | no     | yes             | -5.16%      |
| VP Bank Strategy Fund Balanced (USD)     | USD   | LI0014804020 | 30.11.18 | 1,523.20 | no     | yes             | -4.21%      |

For detailed information on our investment management mandates, please contact your personal advisor.

# Current investment tactics

Let's start with a glance back at 2018. The year got off to a promising start, but the mood changed dramatically in February when interest rate worries swept the markets. Good US macro data indicated that the Fed would continue to hike interest rates over a protracted period. This put pressure not only on equities but also on government bonds, which suffered capital losses. The mood of uncertainty was further aggravated by other risk factors, notably escalating trade conflicts, the Brexit negotiations and problems surrounding Italy's public debt. Equities and bonds retreated in parallel, and the year closed with wide-spread net losses.

## Cracks in the global economy

The trade conflicts unleashed by the US are causing huge uncertainty in the corporate sector. Investments are being postponed, leading in turn to a contraction of exports. The upshot is weaker GDP growth worldwide. Despite the more conciliatory tone between the US and China at the recent G20 summit, we still do not know whether and how the tariff dispute is going to be resolved. In this environment the central banks are proceeding with caution. The Fed is signalling that economic risks have increased and that its future actions will be more closely geared to the data. The financial markets are already eyeing an imminent end of the interest rate hiking cycle. In our view, however, buoyant wage growth could oblige the Fed to implement further moderate rate hikes.

Provided the economic slowdown is only temporary (though possibly rather protracted), the expected decline in global growth rates could have a positive effect. Overheating will be avoided, which might well give the expansion a longer life expectancy, because central banks will not be forced to tighten excessively and the Fed will be able to continue with its policy of moderate interest rate increases.

## Bonds

We are keeping duration below benchmark in all reference currencies. Although we do not expect a serious economic slowdown or recession, we are cautious about corporate bonds. A close eye must be kept on company-specific risks. More and more companies have come under pressure recently as a result of failed investments and heavy borrowing. We expect credit spreads in the investment grade sector to move sideways at best, while lower quality issues face losses. We are tactically overweight in emerging market bonds denominated in hard currency. These carry an attractive risk premium. We are maintaining our position in inflation-linked securities.

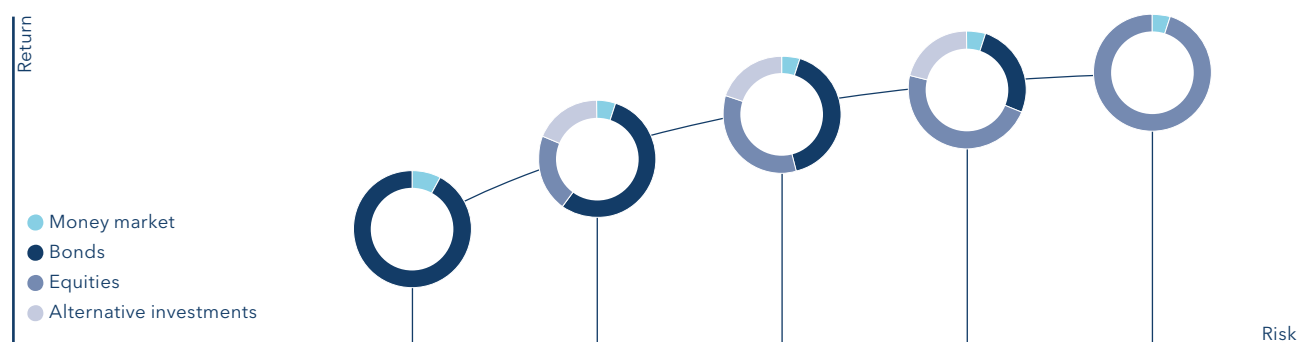
## Equities

Our equity positioning will initially remain cautious. The US equity market continued to benefit in 2018 from repatriations of capital, and this enabled it to outperform other markets. In the autumn, however, US stocks came under selling pressure. We therefore kept the US market slightly underweight before returning it to neutral at a lower level in mid-December. Although downside risks in global equity markets have not disappeared, the fundamentals for 2019 offer potential. If investor confidence returns, Europe and the emerging markets should be prime beneficiaries due to their reduced valuation levels.

## Alternative investments and currencies

In the alternative investment sector we hold a position in gold. Apart from that, this class of assets is weighted at neutral. We have an open USD position in our EUR- and CHF-based portfolios. Otherwise, currencies of the major developed countries remain hedged.

# Our solutions



| Features  | Fixed-income | Conservative | Balanced | Growth   | Equity   |
|---|--------------|--------------|----------|----------|----------|
| Equity allocation                                     | 0%           | 10-30%       | 20-50%   | 30-70%   | 80-100%  |
| Investment horizon                                    | 3 years      | 5 years      | 7 years  | 10 years | 15 years |
| Need for security                                     | ●●●●●        | ●●●●○        | ●●●○○    | ●●○○○    | ●○○○○    |
| Expected return                                       | ●○○○○        | ●●○○○        | ●●●○○    | ●●●●○    | ●●●●●    |
| Investment solutions                                  | Fixed-income | Conservative | Balanced | Growth   | Equity   |
| Strategy Fund from 1 unit                             |              | ●            | ●        |          |          |
| Fund Mandate from CHF 250,000                         | ●            | ●            | ●        | ●        | ●        |
| Classic Mandate from CHF 1 million                    | ●            | ●            | ●        | ●        | ●        |
| Special and Sustainability Mandate from CHF 2 million | ●●●●●        |              |          |          |          |
| Enhanced Mandate from CHF 5 million                   | ●●●●●        |              |          |          |          |

## 4. APPENDIX



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