2nd quarter 2019

Investment Views

VP BANK

Contents

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.

	Q1 forecast	Current forecast	
Money market and currencies (pages 6–9)			
Currencies			
EUR vs. USD	→	→	
EUR vs. CHF	→	→	
USD vs. CHF	→	→	
GBP vs. USD	↗	↗	
USD vs. JPY	↗	↗	
AUD vs. USD	↗	↗	
USD vs. SGD	↗	↗	
USD vs. RUB	→	→	
Key interest rates			
Switzerland	→	→	
Europe (EMU)	→	→	
USA	↗	→	New
Bond yields (pages 10–13)			
Investment grade government bonds			
Switzerland	→	→	
Europe	→	→	
USA	→	→	
Investment grade corporate bonds			
Switzerland	→	→	
Europe	→	→	
USA	→	→	
Bonds: total return (pages 10–13)			
High yield bonds			
High yield	↘	↘	
Emerging market bonds			
Hard currency bonds	↗	→	New
Local currency bonds	→	→	
Equities (pages 14–17)			
Switzerland	→	→	
Europe	→	→	
North America	↘	→	New
Pacific	→	→	
Emerging markets	→	↗	New
Alternative investments (pages 18–21)			
Commodities	→	→	
Crude oil	↗	↗	
Gold	↗	↗	
Real estate shares	→	→	
Private equity	→	→	
Convertible bonds	→	→	
Hedge funds	↗	↗	

// Exuberant start to the year //

Dr Felix Brill
Chief Investment Officer

Dear Reader

Global equity markets have bounced back energetically after their sharp retreat at the end of last year. Central banks have played their part. First the Fed hit the headlines by signalling a major change in its policy stance. Then in March the European Central Bank announced a further round of longer-term refinancing operations to provide liquidity for the eurozone's banking sector.

Political developments have also fuelled the market recovery. Here China has taken centre stage. At the latest meeting of the National People's Congress the Chinese government announced major tax cuts, and there are also signs that a resolution of the trade dispute between the US and China is within reach.

It is hard to imagine what sentiment on the financial markets would have been like without this support from the monetary authorities and political decision-makers. In recent weeks the world economy has not presented a pretty picture. Many countries are reporting a deterioration in macroeconomic data. The measures taken by the Chinese government must bear fruit quickly if discomfort on the financial markets is to be avoided. We believe that the chances of that happening are good.

1. SPOTLIGHT

Future-proofing revisited

RECENT MONTHS HAVE SHOWN ONCE AGAIN JUST HOW QUICKLY THE WINDS CAN SHIFT IN THE FINANCIAL MARKETS. IT IS NOW THEREFORE ALL THE MORE IMPORTANT TO REMAIN INVESTED BUT ALSO TO ENSURE THAT PORTFOLIOS ARE POSITIONED CORRECTLY.

In September 2018, against the background of a mature bull market involving growing risks and likely changes in the overall investment environment, we launched the initiative "Future-proofing portfolios: get your portfolio fit for the future". In anticipation of more turbulent times ahead, we recommended subjecting portfolios to a comprehensive review to ensure that they were properly positioned for the late cycle. Subsequent events moved quickly. October brought a rapid shift in equity market sentiment, which also affected the credit markets. The result was a correction of asset prices and valuation levels and a heightened awareness of risk. Has this made the concept of "future-proofing" obsolete?

Where do we stand today?

Even though the equity markets took a dive towards the end of last year and investors' nerves were strained, very little has actually changed in terms of the fundamentals. From a global perspective, the correction did not mark the end of the uptrend. The bull market remains intact. The future challenges outlined in our study still exist and have yet to be resolved, though investors have become more aware of them.

It lies in the nature of the equity markets that corrections normally occur very abruptly. A typical recovery, on the other hand, usually starts with big daily fluctuations before settling down and proceeding at a more leisurely pace. Thus the rapid, straight-line recovery that we have witnessed since the turn of the year came as a surprise.

The initial decisive factor was a normalisation of investor sentiment, as is quite usual after a phase of pronounced pessimism. The unexpected about-face in the Fed's monetary posture then kept the recovery going. Hopes of a resolution of the trade conflict between China and the US did the rest. The markets are now expecting a lot – but reality needs to catch up with expectations.

Too far, too fast?

As pleasing as the early months of the year have been, the recovery is on shaky ground. The fundamental data do not (at least not yet) justify the markets' optimism. Macroeconomic and corporate data are pointing downwards, and analysts and economists have tempered their forecasts. Even so, it might be a mistake to count on further stimulus from the central banks. The Fed's wait-and-see posture could soon come to an end. Average hourly wages in the US are now rising by more than 3% p.a. If this pushes up the broad inflation figures, the Fed will resume its interest rate hikes. Should the economy then fail to accelerate, the risk of disappointment looms. Investors could decide that the market has risen too far, too fast. The result would be profit taking and at least a temporary recalibration.

Investors wishing to protect their recent gains from such a setback should consider hedging. Several methods are available. Since there are also some good arguments for rising equity prices, we recommend hedging by means of put options. The big advantage of this approach is that investors can continue to participate in a rising market while protecting all or part of their capital on the downside. The disadvantage is the cost involved, but the recent market recovery has pushed hedging costs downwards.

Future-proofing 2.0

Already in our first study we recommended the use of hedging instruments. This should be done on a situational basis, since the cost of permanent hedging significantly reduces total return. But whether hedging is implemented or not, we advise investors to subject their portfolios to a comprehensive review. This should embrace the following aspects.

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Allocation: The allocation test starts by looking at the weightings of the various asset classes in the portfolio. Positions in risk-bearing assets should be brought back to the strategic levels. However, investors need to ensure that the strategic benchmarks are still consistent with their investment objectives. Investors who want to earn income despite today's low interest rates cannot do so without exposing themselves to risk. This makes it all the more important to consider forms of investment that act as a counterweight.

Portfolio construction: Diversification is important not just at the asset allocation level but also within individual asset classes. Splitting risks and investment opportunities is a crucial element of portfolio construction. Flexible bond funds, alternative bond strategies and unconventional risk premiums are useful portfolio ingredients in this context.

Implementation: There is little point in following this allocation and diversification advice but doing so with an inappropriate choice of individual securities. Here, too, it is necessary to focus on the risks involved. We have therefore formulated criteria for identifying equities and bonds that should be avoided due to inadequate quality.

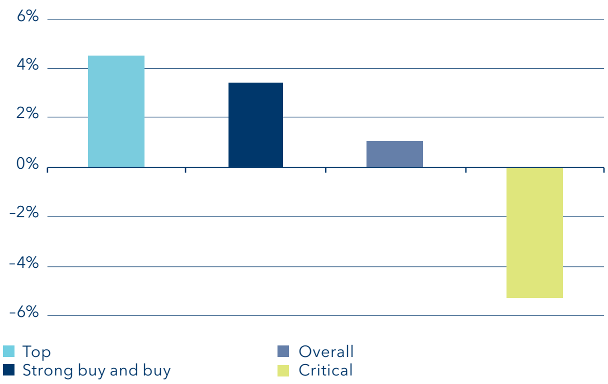
Does future-proofing work?

We have now tested our recommendations to see whether our future-proofing strategy really works. Although the benefits of appropriate portfolio allocation and construction are obvious and undisputed, the results for individual securities need to be tested. We have therefore looked at the performance of the equities and bonds that we assessed last September to see how correct our quality decisions were. The turbulence in 2018 Q4 provided a perfect acid test.

In our September analysis, we examined around 1,500 equities on the basis of various criteria, notably defensive price behaviour, leverage, profitability and capital efficiency. Companies that fared poorly by these criteria were classified as "critical" and earmarked for selling.

In the period we are examining, the "critical" shares recorded the worst performance. Shares rated as "top" and others in our recommended categories outperformed the market average. The test shows that high-quality equities, while not immune to a downward market phase, suffer less than the market as a whole.

Equities: assessment and performance



Average price movement (incl. dividends) 19.09.2018 – 20.02.2019

In reviewing our bond assessments, we examined how accurately we had identified those bonds that then came under particularly heavy pressure. Our assessments are arrived at by comparing agency ratings with forecast default rates derived from our research partner's credit models. If this comparison reveals potential for a downgrade, there is a risk of a capital loss – at least in the low quality categories. 97% of the bonds that have declined by more than 25% since the start of our future-proofing initiative fell into this category. For bonds that retreated by 10% or more the figure is 84%, and for bonds with a drop of 5% or more it is 74%. It is worth pointing out that almost two-thirds of the badly performing bonds that we failed to identify were very long-dated or perpetual bonds, which are naturally very sensitive to sea changes in the market.

Conclusion

Recent months have shown how important it is to identify and analyse portfolio risks in the current late-cyclical phase on the financial markets. Alongside asset allocation and portfolio construction, particular attention has to be paid to the selection of individual securities. We shall be pleased to assist you in this process to ensure that your portfolio is fit for the future.

Alarm bells

MAJOR INDICATORS SHOW A SIGNIFICANT DOWNTURN IN ECONOMIC ACTIVITY, AT LEAST IN THE EUROZONE AND CHINA.

Highlights

- Economic activity is flagging – especially in Europe. The eurozone's industrial sector is already in recession, but services are keeping their head above water.
- Much depends on the success of China's stimulus measures and a defusing of the trade conflict.

In our outlook for 2019 we forecast a cooling of the global economy. The question now is whether we were not being pessimistic enough. Major leading indicators are painting an alarming picture. Reports from Europe, in particular, tell a chilling story. Purchasing managers' indices for the European manufacturing sector have crumbled. Levels over 50 signal an economic expansion, while lower levels indicate a contraction. The most recent figure is 49.3 – which speaks for itself. In our view, however, it is too soon to leap to judgement. The situation in Europe's services sector is substantially better. Here the latest reading is 52.8, i.e. still in the expansion zone. Service providers cater mainly to domestic demand. In other words, the domestic economy is performing solidly, while exports (and therefore manufacturing) are finding the going hard. European industrial production is already in recession.

Worries about China

The situation is similar in the global economy. Production is limping, while services are robust. It is not hard to see where the problem lies. It looks as if the Chinese economy is in greater difficulties than the official data indicate. But assessing the real economic situation in the Far East requires some clever detective work. The export figures of China's neighbours are conspicuously weak – a sign that China's growth is sputtering. Another clue is provided by figures on Chinese enterprises' core earnings, which are down sharply from last year. But Beijing is alive to these problems and has already launched stimulatory measures in the form of tax cuts flanked by monetary easing. These are potent measures, but it will probably be some time before their effect is felt.

What about the US economy?

Meanwhile, the US economy is still on a steady growth track. The healthy US labour market unleashes self-reinforcing mechanisms. High employment encourages strong consumption, which in turn generates jobs in the manufacturing sector. But US growth cannot escape the laws of gravity. The world's largest economy will not be completely immune to the difficult international environment. Even so, the danger of recession in America is small compared with the outlook for the eurozone.

Conclusion

The world is in an uncomfortable economic situation. The eurozone's industrial sector is already in recession, but solid domestic demand in Europe has so far prevented a slide into overall contraction. Switzerland's economy, too, will feel the pain. The outlook now depends on China's stimulus measures and a defusing of the trade conflict. The traffic lights are at amber. We trust that within a few quarters they will go back to green.

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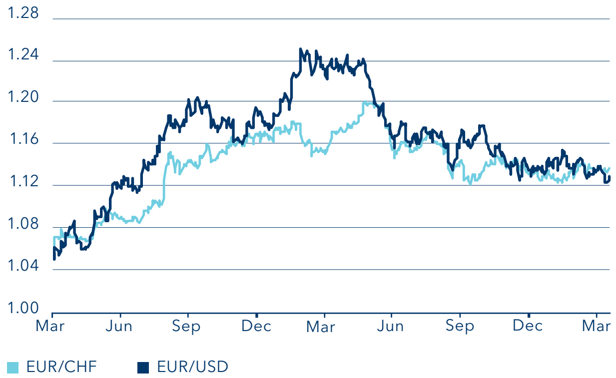
2. ASSET CLASSES

Money market and currencies

Market overview

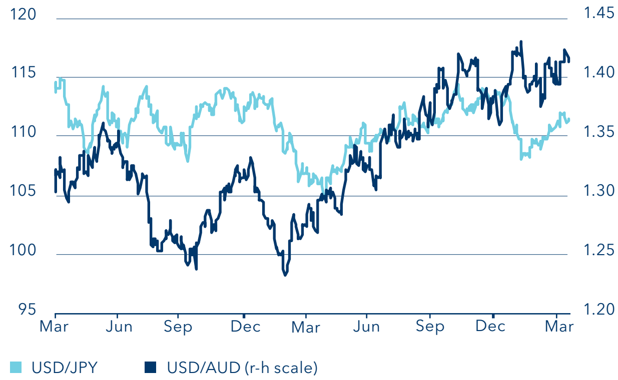
EUR/CHF and EUR/USD: exchange rates since March 2017



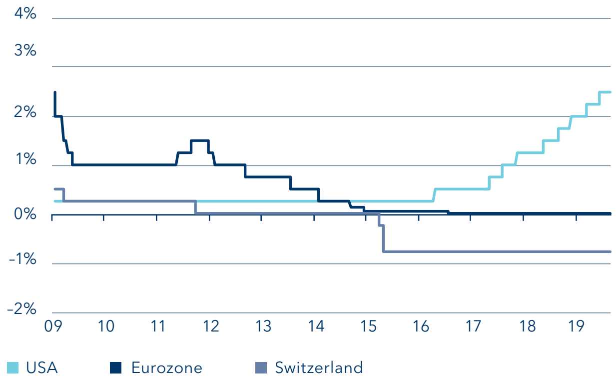
USD/CHF: exchange rate since March 2017

GBP/CHF and GBP/USD: exchange rates since March 2017

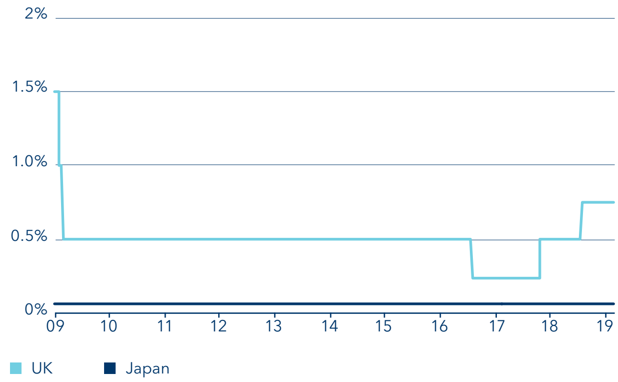
USD/JPY and USD/AUD: exchange rates since March 2017



Key interest rates in Switzerland, eurozone, USA: since January 2009



Key interest rates in UK and Japan: since January 2009



Central banks get cold feet

THE GLOBAL ECONOMIC SLOWDOWN IS MAKING CENTRAL BANKERS NERVOUS. THE FED HAS PUT INTEREST RATE HIKES ON PAUSE, WHILE THE EUROPEAN CENTRAL BANK HAS ALREADY ANNOUNCED NEW MEASURES.

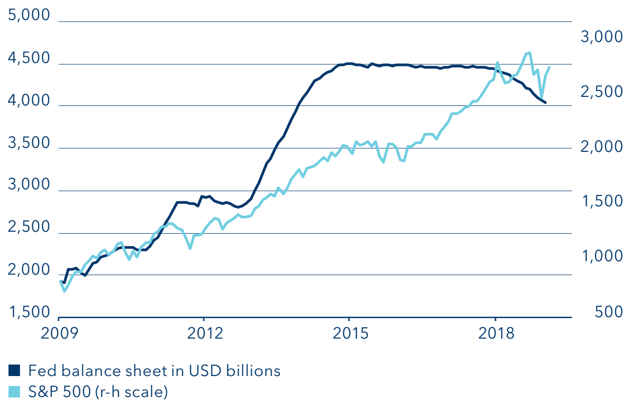
The Fed has surprised observers by pivoting to a sharply changed policy stance in its communications. Faced with retreating equity markets at the end of 2018, Fed Chair Jerome Powell got cold feet. The language used after the January meeting of the Fed's rate-setting committee (FOMC) was suddenly cautious – almost overcautious. Instead of a promise of further prudent interest rate hikes, the emphasis switched to flexibility – in all directions. The Washington based institution moved finally in March. It became very clear: Fed officials estimate no rate hikes any longer for the current year. But it is too soon for gloom-mongering. The state of the US economy is not really so bad, and a loosening of the monetary reins would be premature. The subsequently published minutes of the FOMC meeting gave a deeper insight into what Washington has in mind.

Interest rate policy is not the sole decider

Interest rate policy is only one part of the Fed's monetary arsenal. The management of the Fed's balance sheet is also a potent tool. During the crisis years, the Fed embarked on a policy of quantitative easing, which involved buying up an enormous volume of securities. This caused its balance sheet to swell by around USD 3.6 trillion. Since November 2017, however, the Fed has altered course and set about offloading this mountainous accumulation of assets. Its action deserves respect; no other central bank has changed course with such determination. Washington's example shows that exiting from an ultra-expansionary monetary policy is achievable.

But now it looks as if things have got too hot for Jerome Powell. Regarding to the FOMC meeting in March, the balance sheet reduction will stop by the end of September 2019. An enormous amount of liquidity has already been syphoned out of the markets. The Fed's security holdings are now more than USD 400 billion lower than at their peak. By taking this amount of money out of the markets, the Fed has imposed a drastic monetary squeeze, compared with which interest rate hikes look almost trifling. Since the Fed embarked on this process, the equity markets have become much more volatile. The chart below traces changes in the Fed's balance sheet against the performance of the S&P 500.

Fed balance sheet and the US equity market



Whether this is a causal relationship or a mere coincidence is something for academics to ponder over. But the fact that a causal connection between a smaller Fed balance sheet and a weaker equity market cannot at present be disproved is enough to make the Fed worry. Jerome Powell and his colleagues do not want to go down in history as the midwives of a major economic downturn.

There is also another aspect: a larger balance sheet gives the Fed more effective control over short-term money market interest rates. For this reason the Fed is likely to hold on to a substantial quantity of securities in the longer term. A return to pre-crisis balance sheet levels does not appear to be part of current central bank thinking. Washington is therefore more likely to push up interest rates than to continue the process of whittling down its balance sheet. Indeed, current economic data would argue for further interest rate hikes. Wages are still on the up, and core inflation (excluding volatile energy and food prices) is relatively high at over 2%. Labour market data also suggest no weakness in the US economy. Further rate hikes are at present therefore more likely than a cut.

What will the ECB and SNB do?

While America still has reason to be confident, the economic situation in the eurozone has deteriorated significantly. One can almost feel sorry for European Central Bank boss Mario Draghi. It was only last December that the ECB exited from its ultra-expansionary monetary policy by terminating its monthly asset purchases. But now Draghi is having to launch new support measures. The ECB's Governing Council has decided that key interest rates will stay at their present level "at least until the end of 2019". Previously it was "at least until the end of summer 2019". On top of that, every three months from September 2019 until March 2021 the ECB will offer eurozone banks two-year loans in the form of "targeted longer-term refinancing operations" (TLTRO III).

Thus eurozone interest rates will stay at zero or lower for at least the rest of this year. As the Swiss National Bank takes its lead from the ECB, the same will essentially be true of Switzerland. But the authorities are in a dilemma. Economic theory states that low interest rates should encourage people to cut their saving and consume now rather than later, thereby giving a boost to the economy. But if interest rates stay at rock bottom for many years, this effect may no longer operate. People cannot go on bringing spending forward indefinitely, because then they would have no savings for the future. This is especially true if a long period of low interest rates has eroded interest income to such an extent that people are in danger of not having enough for their old age and therefore have to save more and consume less today in order to have sufficient money for their twilight years. In extreme cases, therefore, negative interest rates can put a damper on economic activity.

Highlights

- The Fed has pivoted dramatically to a new stance. Now it's official: interest rates are on hold.
- The European Central Bank will stick to its low interest rate policy at least until the end of this year. This will make it difficult for the Swiss National Bank to put up interest rates in the foreseeable future.

Conclusion

The central banks have been spooked. A deteriorating economic environment has forced the Fed to change its tone and the ECB to launch new stimulatory measures. The Fed will not hike interest rates any further during the months ahead, and the timing of any hike by the ECB and SNB has been pushed farther into the future.

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

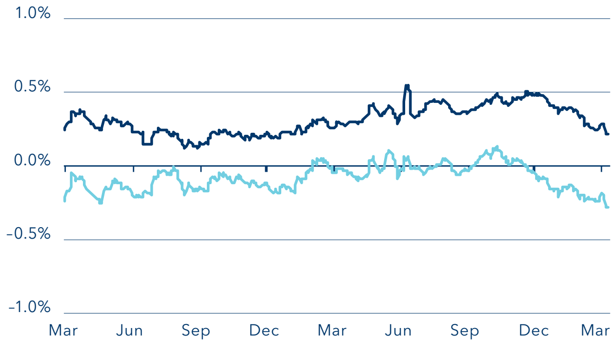
Upside/downside ranges indicated by our 3-6 month interest rate forecasts:
↑ > +50 basis points ↗ +25 basis points
↘ -25 basis points ↓ < -50 basis points → No change

2. ASSET CLASSES

Bonds

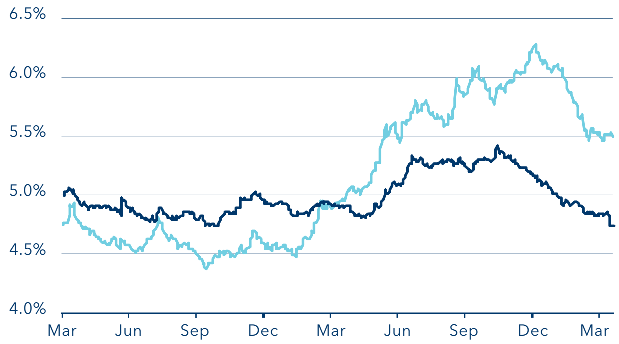
Bond yields – overview

Switzerland: yields since March 2017



CHF government bonds ■ CHF corporate bonds (5 to 10 yr)

Emerging markets: yields since March 2017

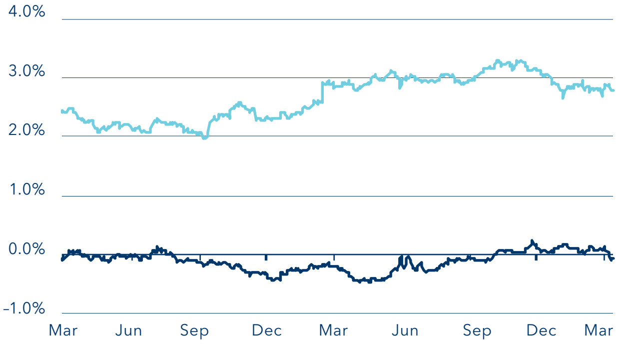


Hard currency ■ Local currency

Europe: yields since March 2017

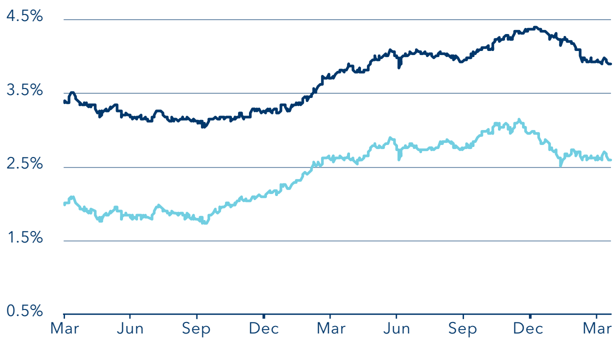
EUR government bonds (5 to 10 yr) ■ EUR corporate bonds (5 to 10 yr)

Inflation-linked bonds: yields since March 2017



USD inflation-linked bonds ■ EUR inflation-linked bonds

USA: yields since March 2017



USD government bonds (5 to 10 yr) ■ USD corporate bonds (5 to 10 yr)

High yield bonds: yields since March 2017

Global high yield bonds (5 to 10 yr) ■ EUR high yield bonds

Whatever happened to "bella Italia"?

ITALY HAS SLIPPED OUT OF THE HEADLINES RECENTLY, BUT INVESTORS SHOULD NOT BE COMPLACENT. ITALY IS STILL THE EUROZONE'S PROBLEM CHILD. UNFORTUNATELY, REFORMS WILL PROBABLY NOT HAPPEN UNTIL THE SITUATION BECOMES CRITICAL.

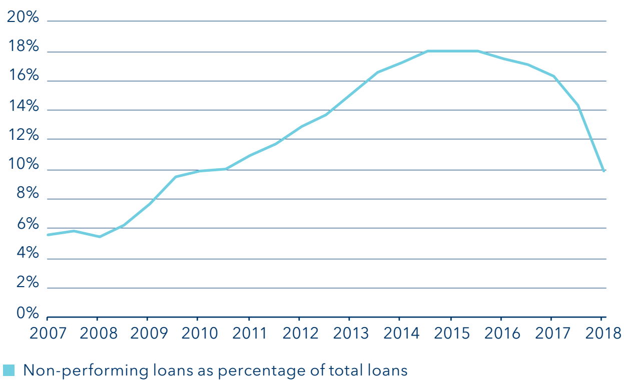
The holiday season will soon be under way. Once again tourists will be lured to Italy by its sunny beaches and mouth-watering cuisine. For investors, however, the Italian experience has been anything but pleasurable in recent years. Their dolce vita has turned sour as Italian bond prices have slumped.

The tug-of-war between Rome and Brussels regarding the Italian government's budget plans for 2019 is still a recent memory. The dispute has now been settled, but the economic situation remains fraught. In the third and fourth quarters of last year Italy's GDP contracted. That qualifies as a recession. Any degree of positive growth in the first quarter of 2019 would be regarded as a success.

Prospects for 2019 are hardly encouraging. GDP growth looks set to be in the region of 0.4%. With the economy expanding so slowly, debt as a proportion of GDP will edge even higher.

One bright spot is the news from Italy's beleaguered banking sector. The volume of non-performing loans has fallen sharply and is on course to return to pre-crisis levels (see chart). Helpfully, the Fitch rating agency has not downgraded Italy any further. The country's credit rating has been confirmed at BBB, though with a negative outlook.

Decline in troubled Italian bank loans



Let's be clear: Italy will remain the eurozone's problem child for the foreseeable future. Spain, Portugal and France have taken steps in recent years to make their labour markets more flexible. Spain and Portugal have already seen a big drop in the number of unemployed – and this trend is continuing. In France, too, legislative changes should bear fruit in the medium term – especially in combination with tax breaks for businesses and private households. In Italy, by contrast, the coalition government (an amalgam of the League and the Five Star Movement) is putting the labour market into an even tighter straitjacket. Reforms will probably only happen if events force the government's hand.

It might sound cynical, but perhaps the financial markets will have to get extremely tough with Italy in order to engineer an improvement. If the markets refuse to refinance Italian government borrowings, Rome would have to get help from the eurozone's rescue facilities under the aegis of the European Stability Mechanism (ESM). Such help would be conditional on effective reforms. In the longer term this is what is likely to happen. It's a bitter pill to swallow, but it's probably the only way that Italy can be kept comfortably within the eurozone.

Revamped indices demand caution

THE GLOBAL ECONOMIC SLOWDOWN IS ROOTED IN CHINA. BUT THE MAJOR INDEX PROVIDERS HAVE CHOSEN THIS MOMENT TO INCLUDE MAINLAND CHINESE EQUITIES AND BONDS IN THEIR INDICES.

Highlights

- The situation in Italy remains fragile, despite the current deceptive calm. The economy is in recession. Investors in Italian bonds need strong nerves.
- Interest rate cuts in China have unleashed a real estate boom and a borrowing spree.
- At this crucial moment mainland Chinese equities and bonds are being included in major indices.
- Anyone who invests in index tracking funds or ETFs will therefore now automatically have China in their portfolio.

China lowers its growth forecast

China has recently lowered its growth target to 6%–6.5%, a figure that would have been unthinkably low just a few years ago. The previous practice was to use monetary and fiscal stimulus to keep the growth rate above 7%. Since 2011, for example, banks' minimum reserve requirements have been cut from 21.5% to 13.5%. This has indirectly resulted in rising asset prices. Real estate prices are now climbing by over 10% a year, and this in turn has boosted building activity. The per capita area under construction is now 60% higher than the 2011 level. Compared with that, exports (and the oft-cited trade war) are insignificant for economic growth.

Exploding corporate debt

Low interest rates have also resulted in massively increased borrowing. Private household debt has soared from CNY 5 trillion to 40 trillion over the last ten years (+23% a year), while business debt has climbed from CNY 27.5 to 132.5 trillion (+17.5% p.a.). Total debt, at 260% of GDP, has reached dizzy heights, and this will be all the more worrying if growth continues to slow. But the government is alert to the danger and is taking action to curb the shadow banking system. In 2017 89% of all lending was through shadow bank vehicles. That figure has now been reduced to 74%. The authorities' declared aim is to shift these loans into the regular banking system or the bond market so that they can be subjected to greater control.

2019 index adjustments

The Chinese bond market, with a volume of over USD 3 trillion, is now the third largest in the world after the US and Japan. Hard-currency bonds in euros or dollars are already included in the emerging market indices. As from April this year, local currency Chinese government bonds and policy bank securities will be included in the Bloomberg Barclays Global Aggregate Bond Index with an eventual weighting of 6%. Inflows amounting to around USD 150 billion are expected.

Conclusion

Investors who hold a position in index tracking funds or passive ETFs should be aware that bond indices change their character over time. China will become increasingly important as its capital market opens up. But neither investors nor the rating agencies have much experience of Chinese borrowers. Highly indebted private companies should be treated with caution. The bankruptcy rate is likely to increase. In this environment selectivity is the watchword.

Benchmark	Current forecast	% YTD[1]
Gov. bonds Switzerland[2]	→	1.41%
Gov. bonds Europe (EUR)[2]	→	1.59%
Gov. bonds USA[2]	→	0.65%
Inv. grade corp. bonds Switzerland[2]	→	0.92%
Inv. grade corp. bonds Europe (EUR)[2]	→	1.99%
Inv. grade corp. bonds USA[2]	→	2.81%
High yield bonds[3]	↘	6.10%
Emerging market bonds (hard currency)[3]	→	4.95%
Emerging market bonds (local currency)[3]	→	3.11%

[1] As of 12.03.2019
[2] Yield
[3] Total return

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2. ASSET CLASSES

Equities

Equity indices – overview

Switzerland: market movement since March 2017 (indexed)

MSCI Switzerland TR Index (net) indexed

Pacific: market movement since March 2017 (indexed)

MSCI Pacific TR Index (net) indexed

Europe: market movement since March 2017 (indexed)

MSCI Europe TR Index (net) indexed

Emerging markets: market movement since March 2017 (indexed)

MSCI Emerging Markets TR Index (net) indexed

North America: market movement since March 2017 (indexed)

MSCI North America TR Index (net) indexed

United Kingdom: market movement since March 2017 (indexed)

MSCI UK TR Index (net) indexed

US equity market: operation hope

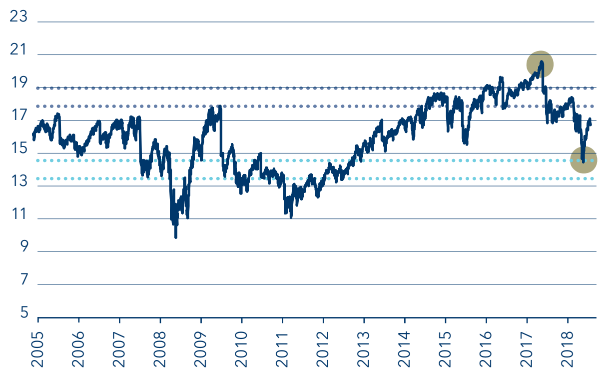
INVESTOR EXPECTATIONS HAVE ALWAYS BEEN A KEY DRIVER OF EVENTS ON THE FINANCIAL MARKETS. BUT AS SENTIMENT STRENGTHENS AND WEAKENS, FUNDAMENTAL FACTS SHOULD PROVIDE A COMPASS. RARELY HAS THE GULF BETWEEN EQUITY PRICE MOVEMENTS AND THE ECONOMIC INDICATORS BEEN GREATER THAN NOW.

Put simply, a company's market value is the present value of future payment flows plus the current market value of existing assets. Future payment flows can be calculated on the basis of expected dividends, operating cash flow or net profit. Important inputs are the forecast rate of growth and the discount rate used to ascertain present value. While growth represents future opportunities, the discount rate reflects expected risk.

The calculation is therefore essentially forward looking. In this context, expected earnings per share play an important part in investors' perceptions, because they show how well the company has mastered the economic conditions in which it operates. If market capitalisation is divided by expected earnings per share, we arrive at the company's price/earnings ratio (P/E). This metric provides a basis for judging whether the company (or the equity market as a whole) is valued at a level that can be regarded as fair, expensive or cheap. P/E also helps us assess the fair value of a share in comparison with competitors in the same industry group. But the absolute number tells us little. It needs to be set against historical levels and expected earnings growth.

Current market trends are strongly influenced by developments in North America, notably the normalisation of Fed policy and President Trump's tariff war with America's major international trading partners. Escalating threats and new import tariffs have ushered in a period of global economic weakness. The markets are exhibiting heightened volatility, with fluctuations assuming extreme proportions at times. In this environment P/E ratios provide a basis for an appropriate tactical analysis. Looking at trends since 2005, we find that the S&P 500 was tactically expensive at P/E levels above 18, while levels below 15 provided medium-turn buy opportunities.

US equities: price/earnings ratio

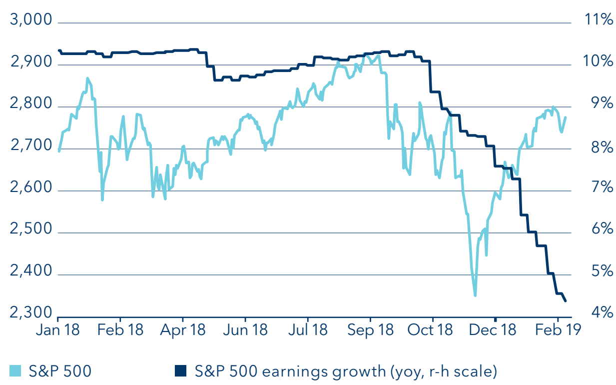


Corporate earnings capped by rising costs

After this year's recovery, how much more upside potential does the US market have? To answer this question we need to look at future earnings growth. The US economy is still robust. Strong technology-driven trends are creating a promising outlook. In the medium term, however, companies face an accelerating rise in major cost components.

US interest rates have been climbing steadily since 2016, as have wages and salaries. While yields on US Treasuries are currently consolidating, wage growth

US equity market performance versus earnings growth



is gathering momentum this year. Cuts in corporate taxation have provided a counterpoise to these negative effects, but that was a one-off factor. The situation is still disguised at present by record high profit margins, but higher labour and borrowing costs are likely to eat into corporate earnings as the year progresses. Meanwhile, ongoing trade conflicts generate increased costs for internationally active corporations, a fact that more and more market participants are taking on board. 2019 earnings growth forecasts have fallen from over 10% last October to 4.4% now.

This year's rally does not chime well with receding hopes of economic growth. The US equity market has manoeuvred itself into something of a dead end. Upside potential is reaching its limits unless further positive inputs come into play. On top of that, earnings expectations might still be overoptimistic in some cases. A stabilisation of earnings growth is already indicated by the market's present level. Current equity prices are above the average for 2018, when the situation was much more promising.

Earnings expectations, P/E and equity market potential (S&P 500)

		Earnings expectation per index point in USD				
		155	160	**169**	175	180
P/E	19	2,945	3,040	3,211	3,325	3,420
	18	2,790	2,880	3,042	3,150	3,240
	17	2,635	2,720	2,873	2,975	3,060
	16.5	2,558	2,640	**2,789**	2,888	2,970
	16	2,480	2,560	2,704	2,800	2,880
	15	2,325	2,400	2,535	2,625	2,700
	14	2,170	2,240	2,366	2,450	2,520

The above table provides a guide to possible upside potential by setting P/E ratios against corporate earnings. Expected market levels vary depending on changes in the fundamental fair value level and individual expectations regarding earnings growth. The figures in bold type reflect the present situation.

Highlights

- The medium- to long-term equity market outlook is very attractive, but short-term prospects are limited by the economic slowdown and rising costs.
- We recommend a cautious approach oriented towards long-term industrial trends:
  - Automation through robotics
  - Investment in healthcare
  - Quality stocks: upmarket investment
  - China, moving from exports to consumption.

Conclusion

This year's recovery on the world's equity markets is out of sync with major macroeconomic indicators and corporate earnings growth. The markets are hoping that current challenges will evaporate. Indeed there is a growing probability that the trade conflict will soon be settled. At the same time, central banks and governments are providing increased support. After the markets' strong rebound from previous lows, much of the upside is already priced in. Investments in the broad US market have only limited potential for the next two to three quarters.

MSCI benchmark	Current forecast	% YTD[1]
Switzerland	→	12.42%
Europe	→	8.98%
North America	→	11.83%
Pacific (incl. Japan)	→	6.53%
Emerging markets	↗	8.04%

Upside/downside ranges indicated by our 3-6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

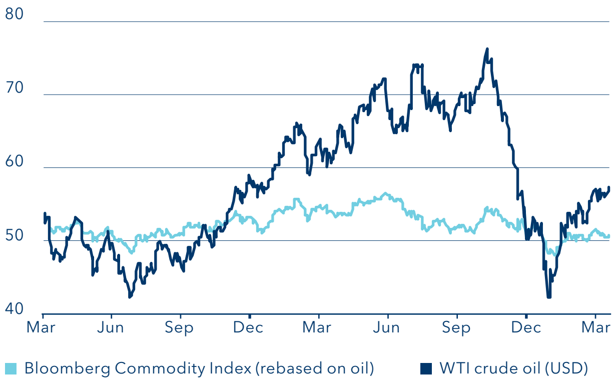
[1] As of 12.03.2019; net return in local currency incl. dividends

2. ASSET CLASSES

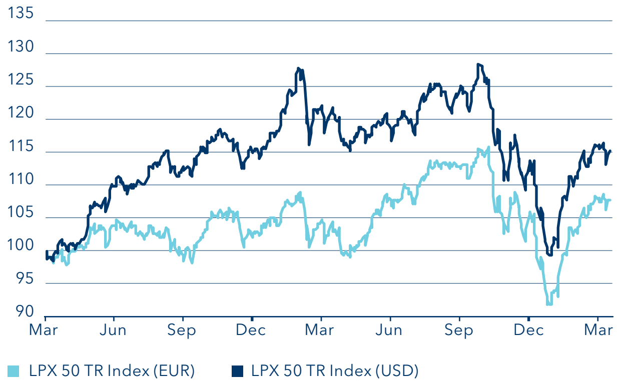
Alternative investments

Alternative investments – overview

Commodities: performance since March 2017

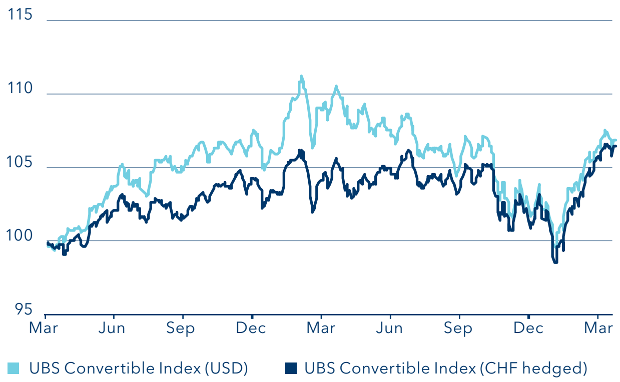


Private equity: performance since March 2017 (indexed)

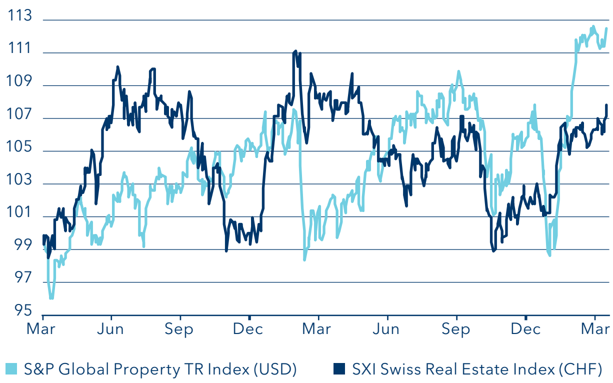


Precious metals: performance since March 2017

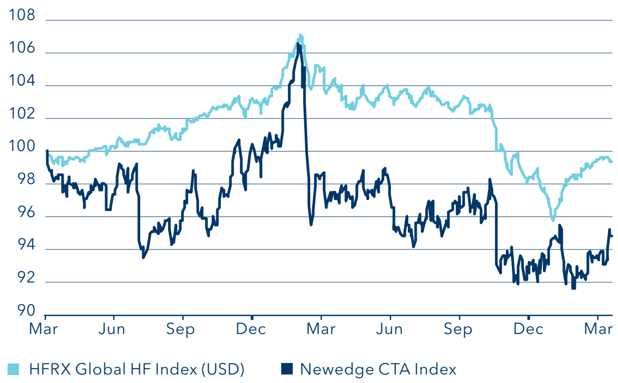
Convertible bonds: performance since March 2017 (indexed)



Real estate: performance since March 2017 (indexed)



Hedge funds: performance since March 2017 (indexed)



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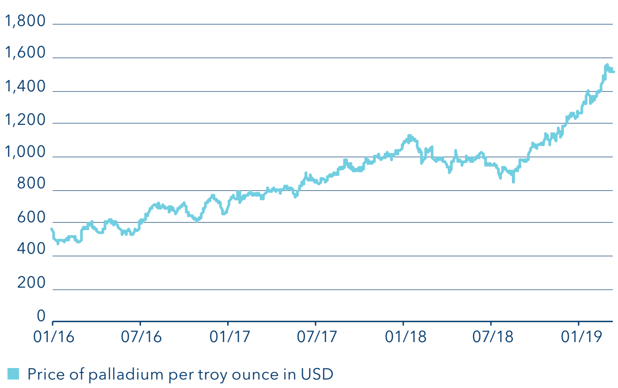
Can the palladium hype last?

PALLADIUM HAS BEEN ALL THE RAGE ON THE COMMODITY MARKETS IN RECENT WEEKS. THE METAL'S METEORIC ASCENT SHOWS NO SIGNS OF ABATING. WHAT IS BEHIND THE PALLADIUM HYPE?

It is no secret that precious metal prices tend to rise when conditions on the financial markets are unsettled. That is why investors take refuge in gold when other markets correct. But the star performer in recent months has been another precious metal. Since hitting a low last August, palladium has been climbing to new highs day after day, and in January it overtook the gold price. The market price of this shiny silvery-white metal has risen by almost 200% in the space of three years.

Palladium surge



The palladium market at a glance

Palladium, a chemical element with symbol Pd, is one of the "platinum group" metals. The other members of the group are platinum, iridium, osmium, rhodium and ruthenium. These rare metals are characterised by high density, strong electrical conductivity and a high melting point. Palladium is the least dense and has the lowest melting point in this group.

Palladium is mostly extracted as a by-product of nickel or copper mining. Pure palladium deposits were mostly exhausted decades ago. South Africa has the world's largest deposits of platinum group metals (over 90% of the total), but in recent years the Russian company Norilsk Nickel has become the biggest producer of palladium, making Russia the lead supplier in this market.

While the supply of palladium comes from just a few producers, demand for the metal is also highly concentrated. By far the most important buyer is the automobile industry. Thanks to palladium's excellent properties as a chemical catalyst (i.e. the propensity to speed up chemical reactions such as hydrogenation, dehydrogenation and petroleum cracking), this metal is used chiefly as a catalyst in automobile exhaust systems. Only 20% of global palladium demand comes from other sectors, notably electronics, technology, dentistry and jewellery-making.

What fired the rally?

Supply on the palladium market has lagged behind demand for a long time. Something had to give, and eventually the price exploded. The discrepancy between supply and demand is the result of various factors.

As the main buyers of palladium are companies in the automobile industry, whose business follows trends in the global economy, the economic expansion in recent years has caused a massive increase in palladium demand. But the leading producers of palladium did not have the resources to keep pace. At the same time, political and economic instability in South Africa, combined with the smouldering crisis in the Crimea and political tensions between Moscow and Washington, heightened the risk of supply outages. There were also reports that producer countries were starting to hoard palladium in the hope of even higher prices down the line.

At first sight increased environmental awareness among governments and the general public does not look helpful for palladium demand, but in recent years it has led to further bottlenecks. Several German cities are now mulling the possibility of banning diesel vehicles from their areas of jurisdiction. Unlike platinum, palladium is used mainly in catalytic converters for petrol-driven vehicles. The sea change in the automobile market has boosted demand for petrol-driven cars, giving a further lift to the price of palladium.

The global automobile market has seemed to be heading for a contraction in recent months, but speculators have continued to buy palladium and kept the bull market in motion. Palladium fever is no longer confined to the financial markets. The metal is also popular in the underworld. Switzerland and the US have experienced a wave of catalytic converter thefts. The Wall Street Journal reports that stolen car exhaust systems are now fetching between USD 150 and USD 450 on the black market depending on their palladium content.

Sustainable rally?

The question now is: where does the price go from here? We expect the discrepancy between supply and demand to continue in 2019. As long as the world economy does not slow down dramatically, demand for palladium will stay high. At the same time, given the limited location of global deposits, a compensating increase in mine output can be ruled out.

In the past the palladium deficit was partly offset by sales by investors. But previous large outflows out of physically backed palladium ETFs mean that the market can no longer rely on this source of supply. ETF holdings have fallen from 3 million ounces to around 720,000 ounces.

The strategic palladium reserves that Russia accumulated in the 1990s and early 2000s also appear to have been largely depleted. It is reported that an additional 11.5 million ounces have been pumped into the market over the last decade. That is more than last year's total global consumption (10.8 million ounces). What we do not know, however, is how much palladium the Russian central bank is holding and how ready it is to offload.

The latest data published by the US Commodity Futures Trading Commission (CFTC) show that palladium bulls have again taken a much stronger position in recent months. Despite the price rally, the number of long contracts has not yet approached its peak level. If speculators adopt an even stronger stance, the palladium price would have further upside potential.

Nevertheless, investors should be on their guard. A further rise in the price could bring a number of risks in its wake. Platinum and rhodium are good substitutes for palladium in catalytic converters, and automobile makers could therefore resort to these alternatives. That would involve a laborious and expensive switch, which producers are still reluctant to embark upon. Eventually, though, substitution could clip palladium's wings.

Conclusion

Undersupply on the palladium market will continue this year. The palladium rally can therefore be expected to continue in the coming months. But investors should act with caution. A higher palladium price will encourage automobile makers to give greater thought to the possibility of replacing palladium with platinum or rhodium. That would soon put a stop to palladium's gravity-defying antics.

Benchmark	Current forecast	% YTD[1]
Commodities	→	5.86%
Gold	↗	24.52%
Crude oil	↗	1.15%
Commercial real estate	→	11.50%
Private equity	→	15.15%
Convertible bonds	→	5.54%
Hedge funds	↗	2.61%

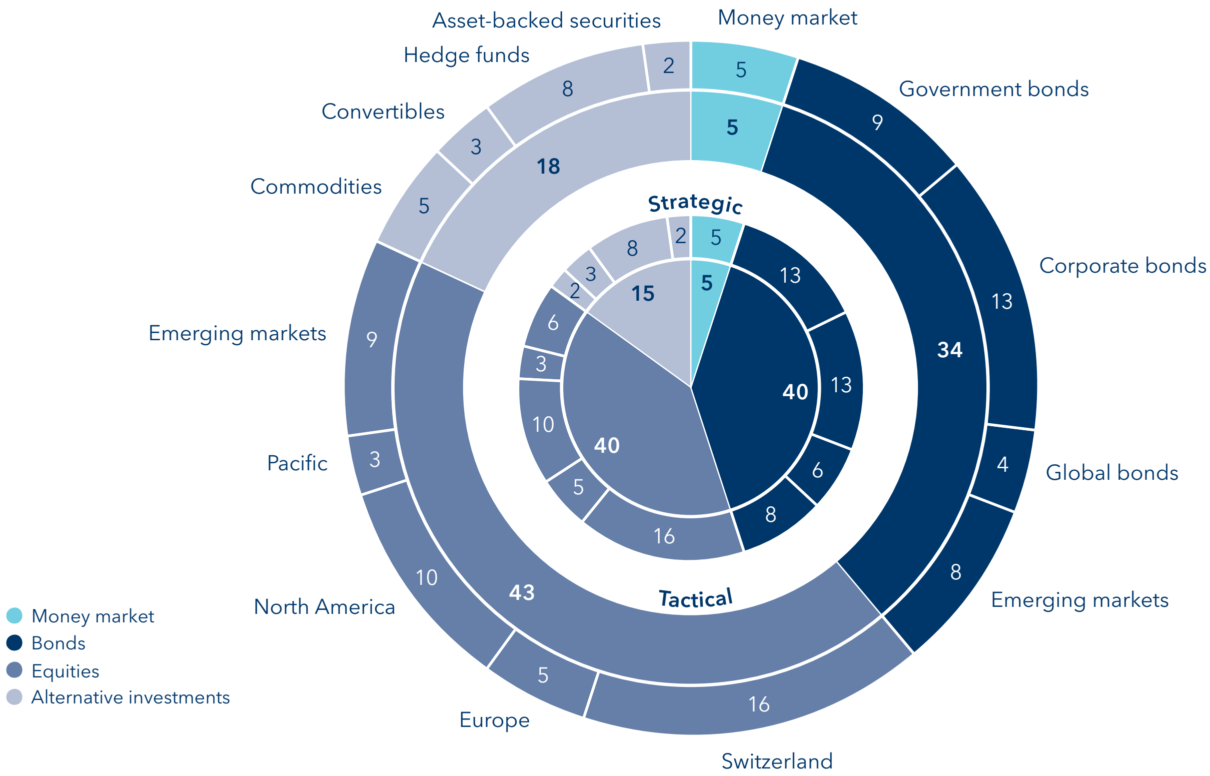
Upside/downside ranges indicated by our 3–6 month absolute performance assessments:
↑ > +5%   ↗ +2% to +5%   → -2% to +2%   ↘ -5% to -2%   ↓ < -5%

[1] As of 12.03.2019

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	08.03.19	1,052.78	no	yes	3.55%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	08.03.19	1,398.59	no	yes	3.24%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	08.03.19	1,352.86	no	yes	3.19%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	08.03.19	1,569.81	no	yes	5.03%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	08.03.19	979.31	no	yes	4.52%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	08.03.19	1,551.93	no	yes	4.63%

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

Current investment tactics

The financial markets have performed excellently so far this year in the face of multiple macroeconomic risks. We believe there is a good chance that the positive tone will continue during the weeks ahead. The new economic measures taken by the Chinese government are a pointer in this direction. Against this background we have decided to increase our allocation in emerging market equities.

Support for the financial markets

The equity markets paused for breath in early March, which is hardly surprising after their rapid ascent in the previous weeks. We believe that the markets now have the energy to climb further.

The central banks have done their bit to ensure that the equity markets do not run short of oxygen. To start with, the US Fed signalled that its interest rate hiking cycle would be put on hold. We do not expect any further rate hike in the current year. The ECB has now also given a helping hand. It has stated that it will leave its key interest rates untouched until the end of the year, and it has also announced a further round of longer-term refinancing operations due to start in September. The message is clear: the markets will be provided with the oxygen they need.

Finally, there have also been positive signals from China. Comprehensive tax cuts were announced at the latest meeting of the National People's Congress. Added to that, there are signs that a resolution of the trade conflict is now within reach. Taken together, these developments should be positive for equities, especially in the emerging markets.

Bonds

Changes of course in monetary policy have kept bond yields at a low level despite investors' increased appetite for risk. We are keeping duration below benchmark in all reference currencies. Overall, we remain underweighted in investment grade bonds. In February we terminated our overweighting in emerging market bonds after credit spreads narrowed again.

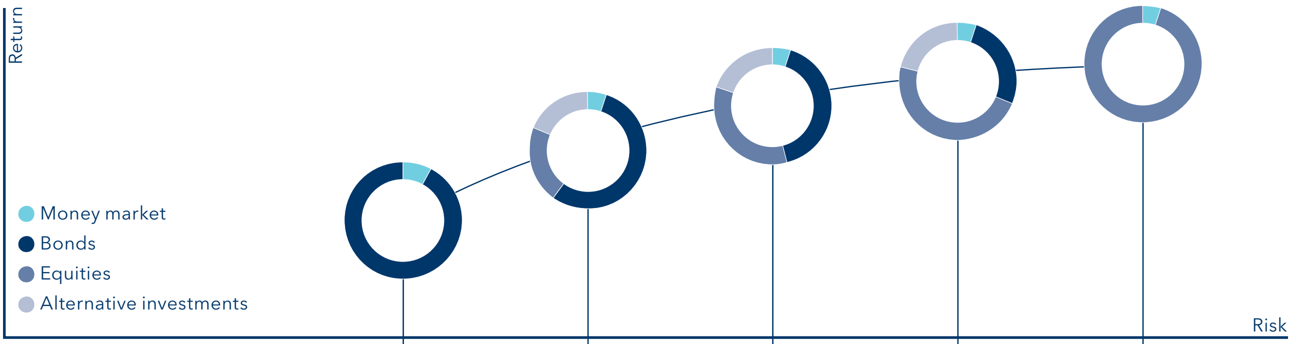
Equities

We have raised our emerging market equities position to overweight This move was motivated by various factors, notably valuation levels, tax breaks announced at China's National People's Congress and the improved prospect of a resolution of the trade conflict.

Alternative investments and currencies

In the current environment we still regard a supplementary position in gold as useful. We have neutral weightings in other classes of alternative investments, notably convertibles and hedge funds. To minimise risk, we are keeping developed country currencies strategically hedged. The USD is partly unhedged in our EUR- and CHF-based portfolios.

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		●	●	●	

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4. APPENDIX

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