

3rd quarter 2019

Investment Views

Contents

Current market assessment	Inside flap
Foreword	1
1. Spotlight	2
In focus	3
2. Asset classes	6
Money market and currencies	6
Bonds	10
Equities	14
Alternative investments	18
3. Investment management	22
4. Appendix	26
Contributors	27
VP Bank Group	28
Important legal information	29

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.

	Q2 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	↗	→	New
USD vs. SGD	↗	↗	
USD vs. RUB	→	→	
Key interest rates			
Switzerland	→	→	
Europe (EMU)	→	↘	New
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	→	→	
Local currency bonds	→	→	
Equities (pages 14-17)			
Switzerland	→	→	
Europe	→	→	
North America	↘	→	New
Pacific	→	→	
Emerging markets	↗	→	New
Alternative investments (pages 18-21)			
Commodities	→	→	
Crude oil	↗	→	New
Gold	↗	↗	
Real estate shares	→	→	
Private equity	→	→	
Convertible bonds	→	→	
Hedge funds	↗	↗	

// Equities are still an
important portfolio
component in the
late cycle. //



Dr Felix Brill
Chief Investment Officer



Dear Reader

Artificial intelligence and “big data” are constantly in the headlines. Whenever we use Google to look for a restaurant, we get an inkling of the power of massive data banks and their efficient exploitation. These days Google not only provides a restaurant’s address, contact details and customer ratings, but also gives us dynamic input such as customer numbers at different times of the day or week. This is a big help if we want to avoid the crowds.

Data are a useful forecasting tool, but predicting the course of the economy and the financial markets is still frustratingly difficult. Reliably forecasting the timing of the next recession or the scale of the accompanying equity market retreat is simply impossible. A study by the San Francisco Federal Reserve Bank in 2016 came to the conclusion that the probability of an end of an expansion phase is just about the same whether the expansion has been going on for 80 months or only 40 months.

This does not mean that we operate completely in the dark. We must use the available data to ensure that investment portfolios are prepared as well as possible for the future. The US economy is now experiencing its longest expansion on record. We cannot be sure how much longer the expansion will last, but we can say with confidence that even at a mature phase of the business cycle it pays to have equities in the portfolio. At the same time it is important to keep investment positions under constant review and to adjust them to changing conditions. In this issue of Investment Views we explain the points to watch in the various asset classes and set out our recommended portfolio allocations.



1. SPOTLIGHT

Navigating the late cycle

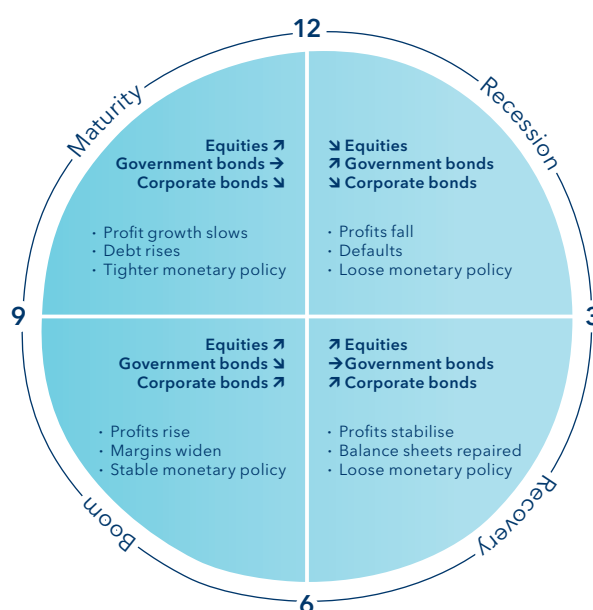
AT A MATURE PHASE OF THE MARKET CYCLE, INVESTORS ARE MORE THAN USUALLY IN NEED OF A COMPASS TO GUIDE THEIR DECISIONS. NAVIGATION IS ESPECIALLY TRICKY AT PRESENT, BUT CAREFUL ANALYSIS WILL HELP INVESTORS TO PLOT AN APPROPRIATE COURSE.

The current expansion of the US economy has become the longest on record, while the equity market is enjoying its second longest bull run ever. The business and investment cycles do not always run in tandem, but this time they have much in common. The longer the expansion continues, the greater becomes investors' need for navigational guidance.

Using the "investment clock"

A useful aid here is the "investment clock". This model splits the market cycle into four phases (see diagram). The process starts with a recession. A contraction of economic activity causes heightened uncertainty and losses on the financial markets. Central banks react by loosening monetary policy. As stimulus takes effect, the economy moves into a recovery phase. At first, central banks keep interest rates low to support the incipient upswing. On the financial markets, equity prices rise while credit spreads narrow and bond yields move up. As the expansion becomes broader and deeper, the cycle moves into the boom phase. As the cycle matures, equity markets continue to advance, but corporate bonds start to encounter headwinds. Monetary policy is tightened to avoid overheating.

The investment clock model is simple and clear, but it has a major disadvantage. It describes an idealised cycle and glosses over the uncertainties and complexities of the real world. The phases do indeed follow each other as described, but the dividing lines are fuzzy. At present, for example, monetary policy is still in expansionary mode, despite the fact that the equity market boom is now over ten years old. Notwithstanding these limitations, investors should keep the investment clock in mind when deciding how to position themselves.



Cycle approaching its end?

The investment clock helps investors ascertain where the markets are in the current cycle. But it is only a descriptive tool; it provides no direct guidance about when the next phase of the cycle will commence and when portfolio positions should be adapted. After a record 120 months of continuous growth in the US, there is little doubt that the expansion is at a mature stage, but that need not mean that a recession is on its way.

A recession can be triggered by various factors. There are three main types of trigger, though recessions are often the result of a combination of multiple causes:

- Excessive capital spending by companies, leading to misallocations of capital and falling returns
- An abrupt change in monetary and fiscal policy, e.g. in response to inflation
- Problems caused by overvaluation of financial assets or heavy borrowing in response to over-expansionary monetary policies.

Viewed through the prism of these criteria, there are few immediate causes for concern, which is surprising in view of the length of the current expansion. Capital spending is subdued, the absence of inflation pressure makes monetary policy fairly predictable (see pages 8-9), and equity valuations are not excessive. The only downside is the high level of debt in the public sector and increasingly in the corporate sector too. The lack of more serious signs of aging is presumably due to the fact that the US recovery is the gentlest in post-war history, with average GDP growth of only 2.3% per annum.

Cycles are vulnerable to external shocks, which can knock the markets out of kilter and/or trigger a recession. Such shocks are by definition impossible to predict. Geopolitical risks have undoubtedly increased, notably as a result of trade warfare, Brexit and the Iran issue. Investors seem to have become inured to these uncertainties. Their increasingly blasé attitude increases the potential negative impact of surprises and shocks.

Contradictory signals from the financial markets

The markets themselves provide little help in navigating the cycle. The signals they provide are contradictory or opaque. The blame for this lies primarily with monetary policy. Central banks use various tools to steer the business cycle. What distinguishes their present behaviour from previous cycles is the extremely prolonged application of monetary ease. The Fed is the only major central bank that has moved away from a super-easy policy to a more normal stance. The European Central Bank and the Bank of Japan are still in crisis mode, with Japan having been in an ultra-expansionary rut for many years now. Exceptionally, the Fed has now said it is ready to reverse its rate hiking course if necessary. This has helped convince the markets that rate cuts are in the offing. But that will only happen if the US economy weakens significantly. The fact that the equity market is celebrating a possible easing of monetary policy while taking the economic slowdown in its stride suggests a firm belief in a soft landing. In this scenario the global economic slowdown would merely be a blip in a continuing expansion.

The equity market's optimism is not shared by the bond market. On the contrary, yields on long-term US Treasuries have fallen below yields on short-term money market deposits. Many market participants are worried

about this, because every previous US recession has been preceded by an inversion of the yield curve. In fact, however, the current pattern of interest rates does not indicate that the end of the cycle is just round the corner. In the past it has taken about two years for a yield curve inversion to usher in a recession.

The discrepancy between the bond and equity markets is highlighted by their movements so far this year. Despite flagging corporate earnings growth (see page 16), the equity market has posted a double-digit advance. Yields on US Treasuries, by contrast, have hit historic lows. The close relationship between economic growth and bond yields suggests that this is a danger signal. Optimists attribute the discrepancy to the fact that different drivers are at work. While the equity market is driven by real-term global growth, the government bond market is guided by inflation expectations. But the corporate bond sector is also more sceptical than the equity market. Credit spreads have been widening gradually for over a year now. This points to an end of the expansion, whereas the US equity market is still flying close to its all-time high.

Difficult navigation

The business and financial cycles are both at an advanced stage. The fundamentals are not flashing red, but the signals from the markets are unclear and contradictory. Investors should not let themselves be lulled into a false sense of security. It is ten years since the last crisis, but the countermeasures taken at that time continue to reverberate or – as in the case of Europe – are still in operation. Established models like the investment clock are being distorted, and the same goes for many cyclical indicators. The situation is further complicated by overriding factors such as demographic change which affect prices, demand and productivity. Added to that is the threat of deglobalisation, which jeopardises the assumptions on which economic policy and corporate behaviour have been based for several decades.

Risks typically intensify in mature phases. But past experience shows that it pays to stay invested. In previous cycles the US equity market has advanced by 39% on average during the last 24 months before the end of a bull run, with a 27% gain in the bull's last 12 months. We therefore see no reason at present to bail out of the market. Nevertheless, investors should be careful about their positioning (see page 24):

- Surging debt and the rapidly growing number of lower-quality borrowers make the credit market vulnerable, even though low yields currently provide support. We recommend caution towards low quality corporate issues – either the risks are too high or the compensation too low.
- The outlook for equities at this late stage of the cycle is much better than for the credit market. However, given the handsome gains already achieved and the current weakness of the economy, a relaxed attitude would be unjustified. We recommend a cautious positioning.
- Government bonds have been a reliable portfolio stabiliser in the past. But in view of this year's fall in yields and their current absolute low level, we prefer diversification by means of other asset classes.
- At this advanced stage of the market cycle, investors should ensure that their portfolio is not over-exposed to risk. This applies especially to cyclical investments. Gold, market-independent hedge fund strategies and insurance-linked securities are useful for hedging purposes.
- Individual companies can be a high-risk investment in a mature market. Company-specific risks may be underestimated and growth potential overestimated, making such companies' securities especially liable to correction.

Data from America's National Bureau of Economic Research shows that the world's largest economy has been expanding uninterrupted since June 2009. The current "super cycle" has now outstripped the decade-long expansion of the US economy between 1991 and 2001.

The trade warfare unleashed by President Donald Trump is fuelling economic uncertainty. Punitive tariffs are being imposed in an attempt to cut America's huge trade deficit with China. Trade policy is being driven by Trump's "Make America Great Again" ideology.

Research by the International Monetary Fund (IMF) suggests that these actions are likely to be unsuccessful. Foreign trade deficits and surpluses are essentially driven by the basic shape of a country's economy. America consumes more than it produces – hence the deficit.

As long as this situation continues, the US is predestined to run a shortfall on its foreign trade account. Tariffs on imports from China will not change that. They can, however, put a brake on GDP growth, both in China and the US.

Globally, restrictions on trade lead to falling productivity and ultimately to losses of income, as the IMF study shows. The main loser at present is the eurozone, whose heavy reliance on exports makes it dependent on a smooth global exchange of goods.

Author: Dr Thomas Gitzel



2. ASSET CLASSES

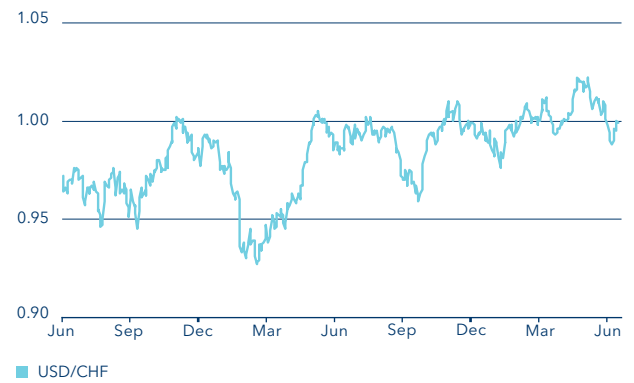
Money market and
currencies

Market overview

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



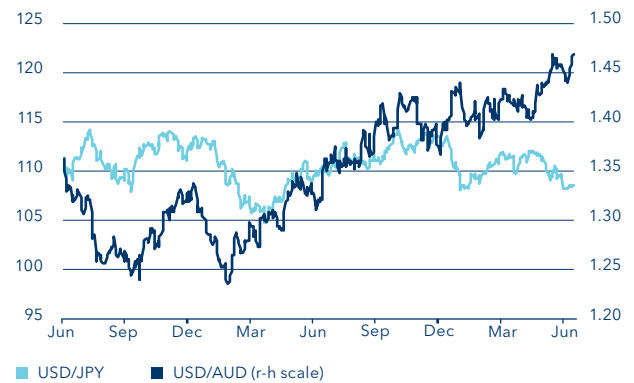
USD/CHF: exchange rate since June 2017



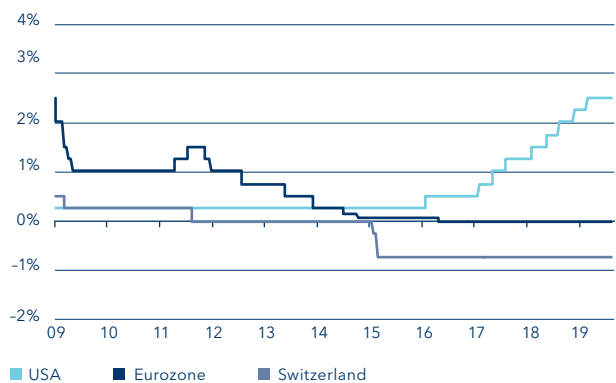
GBP/CHF and GBP/USD: exchange rates since June 2017



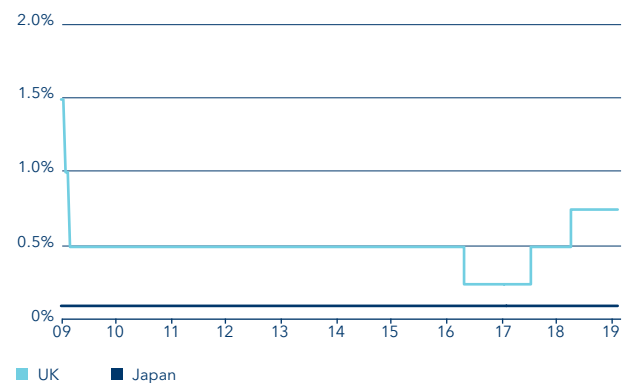
USD/JPY and USD/AUD: exchange rates since June 2017



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



Key interest rates in UK and Japan: since January 2009



Long live the expansion!

THE US ECONOMY IS EXPERIENCING ITS LONGEST EXPANSION SINCE RECORDS BEGAN. SIGNS OF OVERHEATING ARE VIRTUALLY ABSENT. THUS THE EXPANSION LOOKS SET TO CONTINUE, THOUGH THE INVERTED YIELD CURVE IS A WARNING SIGNAL.

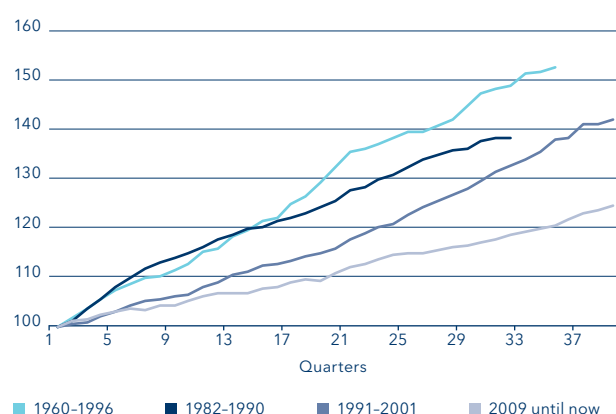
Who would have thought it? The expansion of the US economy that got going in 2009 after the financial crisis is still in progress. In June of this year it became the longest upward cycle in America's history, eclipsing the previous record established in 1991-2001. After the bursting of the credit bubble in the autumn of 2008, the almost universal mood was gloom and doom. What turned things round?

In fact, it was the depth and breadth of the financial crisis that laid the foundation for the current boom's longevity. The initial recovery was exceptionally slow, as a comparison with GDP growth in other recovery phases shows (see chart below). The duration and shape of the cycle do not enable us to place the present state of the economy at a precise point on the "investment clock". It is certain, however, that we are still in an expansion phase and not in recession (see page 3).

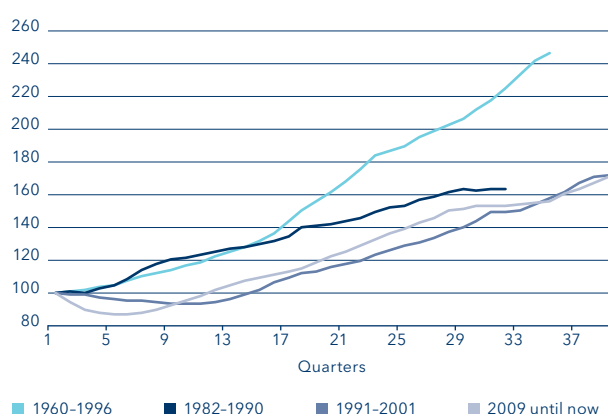
Overheating prevented by sluggish lending

The reason for the relatively sluggish pace of expansion lies in the financial sector. The bursting of the credit bubble in 2008 caused serious damage to banks' balance sheets. Healing these wounds took time, and in some European countries the scars are still raw. Paradoxically, it was these problems in the credit sector that set the world on the path of a protracted but slow recovery. It took some time before US banks were ready to lend more freely again (see second chart). Even when the recovery got underway, net lending at first continued to sink. Eventually, however, the enforced capitalisation of beleaguered US banks by means of the government's Troubled Asset Relief Programme (TARP) launched in 2008 had the desired effect. After a lag, lending got into its stride again in 2010.

Economic growth in major expansion phases
(indexed GDP: start of recovery = 100)



Outstanding bank loans in major expansion phases
(indexed: start of recovery = 100)



Subdued inflation and slow wage growth

The initially slow recovery of lending was mirrored by the sluggish progress of various economic metrics. Core inflation (excluding volatile energy and food prices), which is normally the trigger for monetary tightening in an expansion phase, was for long periods so slow that central bankers were left scratching their heads in bewilderment – not only in the US but worldwide. Experts are still not agreed why this was so. But an important role was undoubtedly played by the phenomena of “Amazonisation” and digitalisation. Many consumer goods and services have become steadily cheaper in recent years thanks to the rise of big online retailers and new electronic services. At the same time, new employment relationships have held down wages and thus reduced inflation pressure. Employment has tended to become more precarious with the widespread use of temporary work and platform-based working, in which small jobs are given to freelancers on a short-term basis. Such arrangements are often referred to collectively as the “gig economy”, the most famous example being the Uber transportation service.

An oft-cited study by the economists Lawrence Katz (Harvard University) and Alan Krueger (Princeton University) showed that 94% of all new jobs created in the US between 2005 and 2015 were in the form of alternative work arrangements. It is therefore no surprise that despite full employment in the US (joblessness at only 3.6%) wage growth has been modest at just over 3%, much slower than in previous recovery phases. The relatively slow rise of average hourly pay rates keeps inflation in check.

Fed stays dovish

A look at the history of the US economy shows that it has not been unusual for an economic expansion to be halted abruptly by high interest rates imposed by the Fed. This time, however, the sluggish trends of lending, wages and inflation have enabled the Fed to adopt an unusually dovish stance. Monetary tightening from 2015 onwards was only moderate and has now been put on hold, with a possibility of rate reductions to follow. This circumspect use of the monetary toolbox could pave the way for an even longer expansion. Such an outcome is not beyond the realm of possibility. Australia, it should be noted, has not experienced a recession since 1992. In the US, however, the inversion of the

Highlights

- The current economic expansion in the United States started after the financial crisis and is already ten years old.
- Typical signs of overheating are still virtually non-existent, but the inversion of the yield curve suggests caution.

yield curve (higher interest rates at the short end of the maturity spectrum than at the long end) suggests caution. In the past such a situation has been a reliable indicator that a recession was in the offing. Although there are no signs at present that the US economy faces an imminent crunch, developments should be followed with care. All in all, however, the expansion looks set to continue for the time being.

Conclusion

The economic collapse in 2008 and 2009 created the basis for the current record-long expansion. It is impossible to predict how long the macroeconomic cycle will stay in growth mode. At present there is no danger of overheating, but short-term interest rates are higher than rates at the long end, and that is usually a harbinger of recession. Whether that will be the case in the current cycle is moot. Central banks will act with care, and we expect the interest rate landscape either to remain unchanged or to shift very slowly.

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

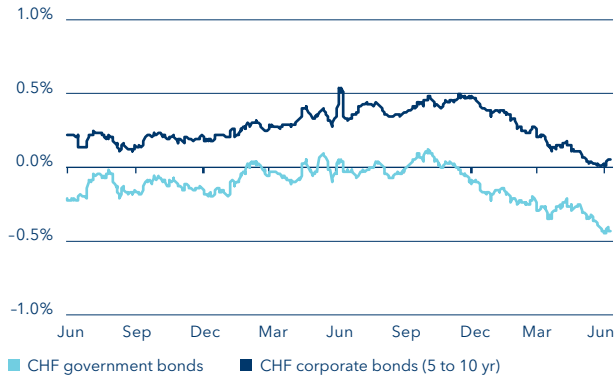


2. ASSET CLASSES

Bonds

Bond yields – overview

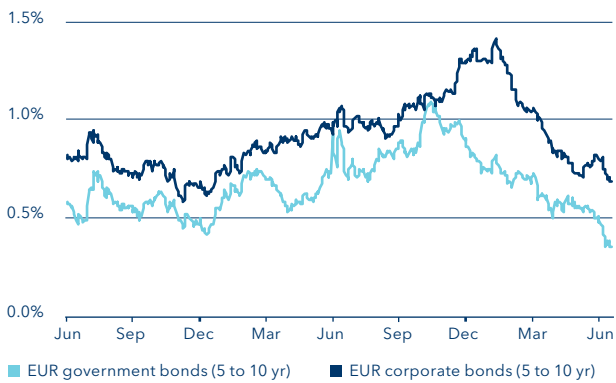
Switzerland: yields since June 2017



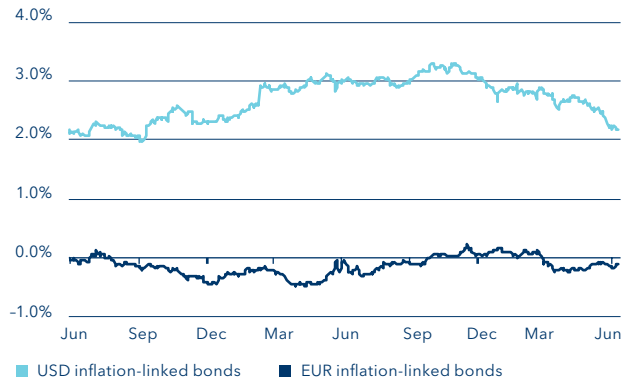
Emerging markets: yields since June 2017



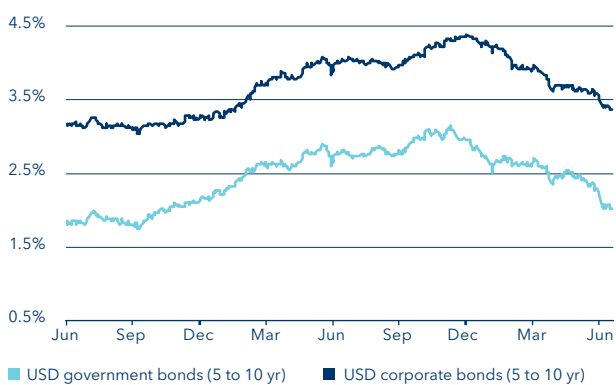
Europe: yields since June 2017



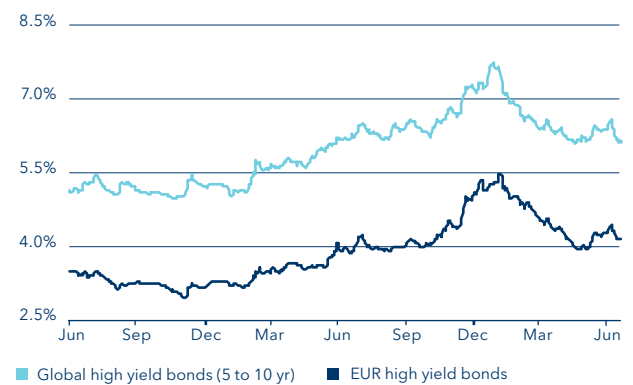
Inflation-linked bonds: yields since June 2017



USA: yields since June 2017



High yield bonds: yields since June 2017



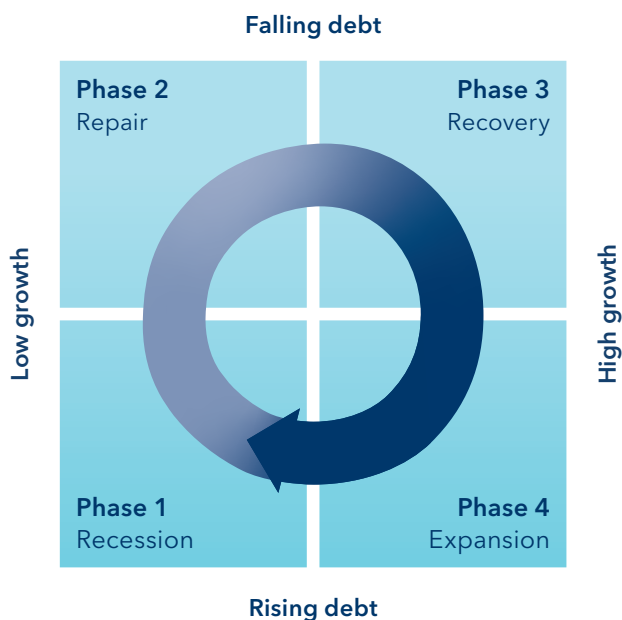
Corporate bonds – treat with care

CENTRAL BANK POLICY RECEIVES A LOT OF ATTENTION, BUT INVESTMENT DECISIONS IN THE CORPORATE BOND MARKETS ARE MUCH MORE DEPENDENT ON THE CREDIT CYCLE. THE ACCENT NOW SHOULD BE ON AVOIDING CREDIT RISKS.

Bonds are a standard part of a mixed investment portfolio. A distinction is drawn between bonds that are generally regarded as risk-free (securities issued by governments or quasi governmental bodies) and corporate bonds, which carry a credit risk. Both types of bond deserve a place in an investment portfolio, but they react differently to cyclical developments.

The key factor in the corporate bond sector is the credit spread (i.e. the yield premium over risk-free bonds). The credit spread widens and contracts in response to the credit cycle, which can be divided into four phases:

The four phases of the credit cycle



Phase 1. Recession

- Debt at peak level
- Deteriorating balance sheet quality
- Decline in corporate earnings
- Sharp rise in default rate

Phase 2. Repair

- Cleaning up corporate balance sheets
- Debt repayment and refinancing
- Capital increases
- Focus on cash flow

Phase 3. Recovery

- Profit margins enhanced by restructuring
- Increased free cash flow
- Falling debt
- Concentration on cost cutting

Phase 4. Expansion

- Deliberate increase in borrowing
- Increased mergers and acquisitions
- Leveraged buyouts
- Increased capital spending

Between expansion and recession

Indicators in the US and Europe have been at expansion levels for several years now, but recently there has been an increase in signals pointing to recession. This presents the corporate bond market with a tricky situation. Low interest rates and asset buying by central banks have encouraged excessive corporate borrowing. The volume of corporate bonds in Europe has climbed by 78% to EUR 2 trillion over the last ten years, while the corresponding increase in the US has been 135%. The worldwide volume of outstanding corporate bonds now stands at around USD 10 trillion. This expansion of the corporate bond market has outpaced economic growth.

Dividends and buybacks outstrip profits

Borrowing is not intrinsically a bad thing. On the contrary, it can enable companies to improve productivity by investing in automation or to extend their operations into new markets. But the situation becomes problematic when borrowed money is not used for productive investment but for shareholder-friendly actions, notably dividend payments and share buybacks. In 2018, for

example, over 80% of all companies in the S&P 500 mounted buyback operations. The total volume of these transactions was USD 806 billion, up 56% compared with the previous year. The idea is to spread the company's earnings over a smaller number of shares. If the number of outstanding shares is reduced, earnings per share increase. In other words, a company can raise its EPS metric even if earnings stay unchanged. This tactic is especially tempting at today's rock-bottom borrowing costs. Last year, buybacks and dividend payments by all S&P 500 companies exceeded their total net earnings (USD 1,116 billion). Indeed, over the last four years these companies have paid out USD 450 billion more to shareholders than they have earned. It is generally in the recession phase of the credit cycle that bondholders are treated disadvantageously compared with shareholders.

Deliberate impairment of balance sheet quality

Another motive for borrowing is to finance corporate acquisitions. The annual volume of global mergers and acquisitions over the last five years has been close to its post-crisis record of USD 4,500 billion. That compares with USD 2,000 billion in the preceding five years. This is another symptom of an advanced business cycle. Mergers and acquisitions mostly involve additional borrowing. Increasing a company's debt has a leverage effect that pushes up return on equity. This works especially well when central bank policy is keeping risk premiums at a low level. Over 50% of the US bond market now consists of securities with a BBB rating (the lowest investment grade category). BBB bonds are defined as being a generally good investment but

Highlights

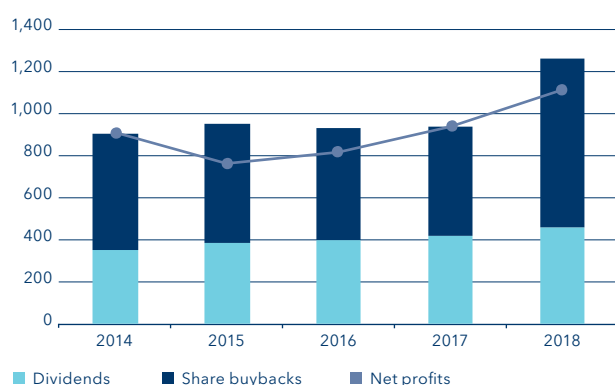
- The credit market is in an advanced expansion phase.
- There are clear signals that corporate balance sheet quality is deteriorating.
- Investments in corporate bonds should therefore be confined to top quality issues.

vulnerable to problems if the economy turns down. Downgrading to speculative status would force many institutional investors to sell, because the rules under which they operate debar them from investing in such companies. New borrowing would become more expensive, possibly plunging the company into a vicious downward spiral.

Conclusion

The credit cycle is already at an advanced stage. Proliferating share buybacks and generous dividend payments are weakening the balance sheets of US companies. Mergers and acquisitions are close to record levels. Balance sheet quality is being deliberately neglected in the hope of using cheap debt to improve return on equity. At the same time, macroeconomic risks are on the increase. These can have dire consequences for companies at the lower end of the rating spectrum. We therefore prefer government bonds. In the corporate bond sector only top quality issues are worth considering.

S&P 500: buybacks, dividends and profits (in USD billions)



Benchmark	Current forecast	% YTD ¹
Gov. bonds Switzerland ²	→	3.54%
Gov. bonds Europe (EUR) ²	→	4.93%
Gov. bonds USA ²	→	4.55%
Inv. grade corp. bonds Switzerland ²	→	1.97%
Inv. grade corp. bonds Europe (EUR) ²	→	4.35%
Inv. grade corp. bonds USA ²	→	7.82%
High yield bonds ³	↘	8.92%
Emerging market bonds (hard currency) ³	→	9.03%
Emerging market bonds (local currency) ³	→	6.02%

¹ As of 17.06.2019

² Yield

³ Total return

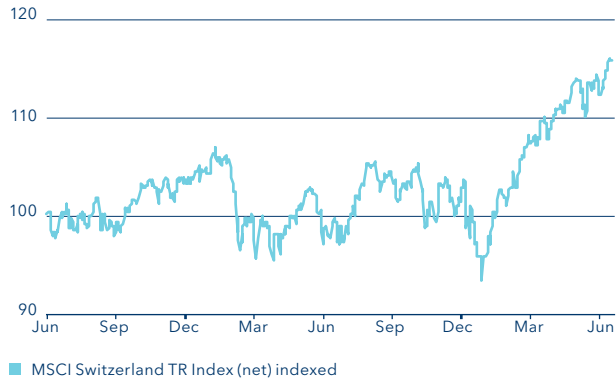
2. ASSET CLASSES

Equities



Equity indices – overview

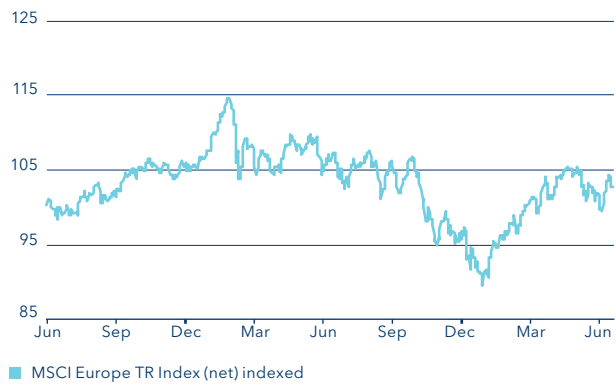
Switzerland: market movement since June 2017 (indexed)



Pacific: market movement since June 2017 (indexed)



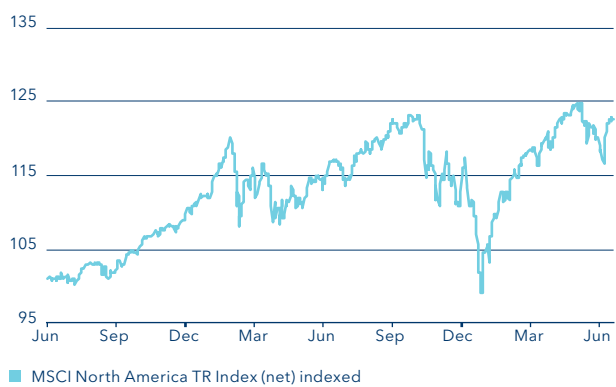
Europe: market movement since June 2017 (indexed)



Emerging markets: market movement since June 2017 (indexed)



North America: market movement since June 2017 (indexed)



United Kingdom: market movement since June 2017 (indexed)



Confusion of confusions

GROWING CHALLENGES ON THE FINANCIAL MARKETS HAVE LED TO A PARADOXICAL SITUATION IN WHICH SHARE PRICES RISE WHILE EARNINGS EXPECTATIONS FALL. HAVE INVESTORS LOST THEIR WAY IN AN INCREASINGLY CONFUSING ENVIRONMENT?

In 1688 Joseph de la Vega published the world's first book on stock exchange business and investor psychology. The title was "Confusion of Confusions". In four fictional dialogues between a merchant, a philosopher and a shareholder, de la Vega gives a vivid account of dealings on the Amsterdam stock exchange, where market manipulation, greed and recurrent panic were rife and where participants were already pondering the perennial question of how to assess an investment's "real value". His insights and observations are surprisingly relevant to today's financial markets. Investors' emotion-drive behaviour is still something of a mystery, but there has since been a clear evolution in basic knowledge and methodology. One useful tool is the "investment clock" (see page 3), which identifies successive phases of the market cycle. Our assessment suggests that markets have reached an advanced late phase of the business cycle.

Growing challenges

The current phase is characterised by flagging economic growth and a deteriorating business outlook. Capital spending and hand-outs to shareholders have caused corporate debt to rise faster than profits. Investors are well aware of this, and their concerns have led to increased market fluctuations and widening credit

spreads. To ward off overheating, the Fed gradually raised its fed funds target rate until December 2018.

Accelerating inflation is a usual feature of a mature expansion phase, but so far prices have remained subdued. Nor is the mood among investors really euphoric; valuations are not excessive. Many investment managers have reduced their equity exposures and downsized their positions in cyclical shares. In America, net inflows into exchange traded bond funds, at USD 66 billion, are twice as high as inflows into equity ETFs. P/E ratios in the US, emerging markets and Switzerland are at their five-year average, whereas the P/E in Europe is 1.2 of a standard deviation lower and can therefore be regarded as favourable.

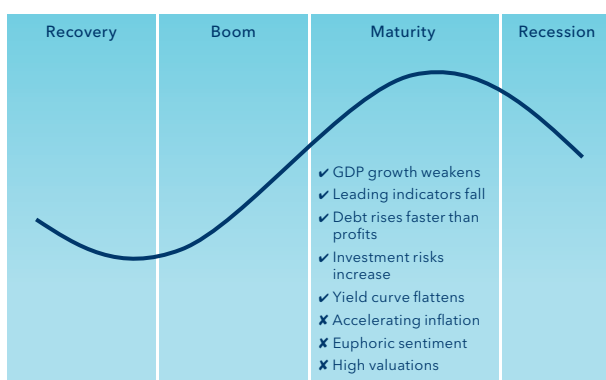
However, the wind is getting rougher for companies. In many cases, widening credit spreads have pushed up borrowing costs. At the same time, escalating barriers to trade are putting pressure on profit margins and operating costs. The upshot is that earnings growth has been flattening since 2018, margins are contracting and debt growth is accelerating. This puts a question mark over continuing high earnings expectations for the quarters ahead.

Five minutes to midnight: party time or tears?

Equity prices usually move in line with corporate earnings. Steadily rising earnings underpin strong gains on the share markets. Since the start of this year, however, we have seen a major divergence. While equity markets have been partying, expected earnings growth for the MSCI World has halved from over 8% to 3.8% during the last six months. In America the downward revision has been even steeper, from 10.5% to 3.3% and still falling.

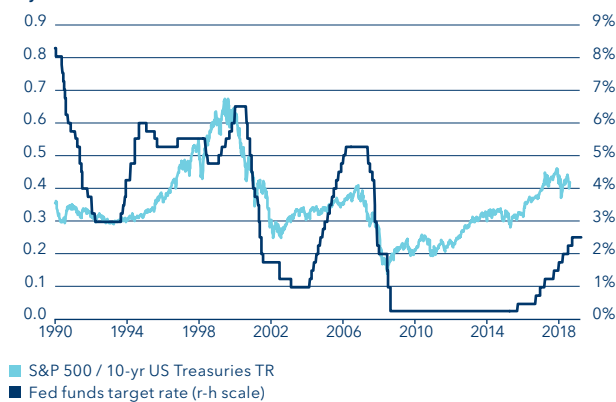
The Fed is alive to these facts. In January it performed a spectacular monetary U-turn, and in June it confirmed its new stance by emphasising the uncertainties facing the US economy. This sparked investor hopes of imminent rate cuts, and the markets are now pricing in three

Features of a mature equity market



cuts by the spring of next year. At first sight this reaction and the resultant positive impact on stock markets look reasonable. But as yet it is only wishful thinking. The Fed continues to downsize its balance sheet, which means that liquidity is being drained from the market. In any case, Fed actions would take time to bite.

Relative strength of equities and government bonds plotted against key interest rate movements



Meanwhile, companies and investors have to cope with harsher economic conditions. A key fact for investors is that government bonds have normally performed better than equities in an environment of falling key rates.

Investors have become increasingly cautious since the middle of last year. Equity portfolios are being rebalanced in favour of more defensive positions, and investments are also being shifted out of equities into bonds, gold and alternative asset classes.

Conclusion

The escalation of geopolitical tensions in almost all regions is having an increasingly negative impact on the global economy. This opens the door to uncertainties and emotional market movements. These unsettled times provide a good opportunity for reviewing investment objectives. Having a clear goal facilitates rational investment decisions. In his book, Joseph de la Vega warned against hoping that a positive trend will continue for ever; sometimes it is better to take profits.

While fundamental valuation levels are clearly not excessive, there is a strong probability of continuing heightened volatility in the months ahead. Thus our

Highlights

- The weakness of the global economy is depressing corporate earnings growth.
- We believe that investors are pinning too much hope on the impact of possible interest rate cuts.
- Investors should continue to focus on companies with solid balance sheets and stable earnings growth.

attitude towards equities remains positive but cautious. We are focussing primarily on companies with strong balance sheets and stable earnings growth in preference to firms with high debt and uncertain business models.

MSCI benchmark	Current forecast	% YTD ¹
Switzerland	→	20.60%
Europe	→	12.20%
North America	→	16.27%
Pacific (incl. Japan)	→	8.63%
Emerging markets	→	6.09%

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 17.06.2019; net return in local currency incl. dividends

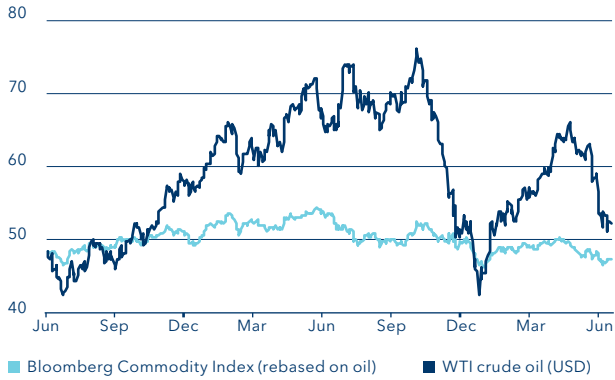
2. ASSET CLASSES

Alternative
investments



Alternative investments – overview

Commodities: performance since June 2017



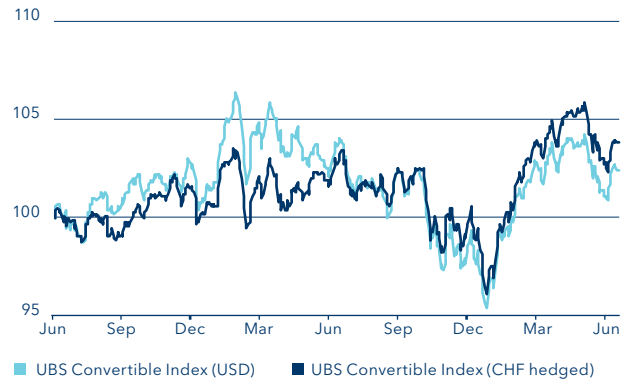
Private equity: performance since June 2017 (indexed)



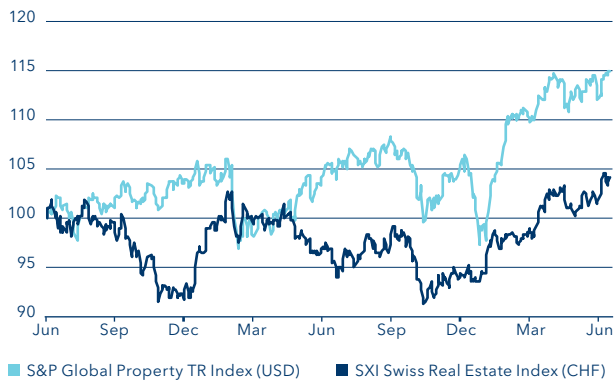
Precious metals: performance since June 2017



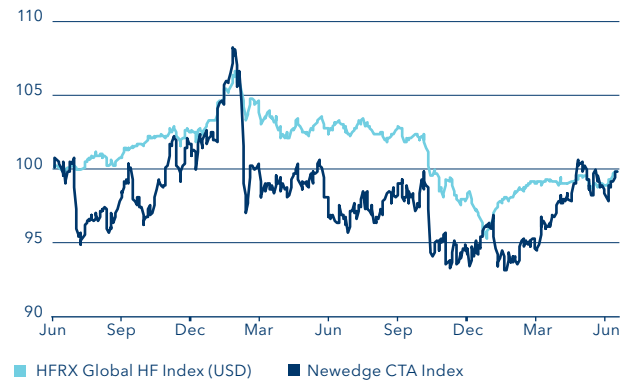
Convertible bonds: performance since June 2017 (indexed)



Real estate: performance since June 2017 (indexed)



Hedge funds: performance since June 2017 (indexed)



Late cycle necessitates careful selection

ALTERNATIVE ASSET CLASSES ACT AS PORTFOLIO DIVERSIFIERS BY PROVIDING ADDITIONAL SOURCES OF RETURN. IN LATE-CYCLE PHASES THESE ALTERNATIVES MUST BE USED WITH SPECIAL CARE. NOT ALL OF THEM ARE EQUALLY EFFECTIVE IN A FALLING MARKET.

Traditional portfolios consisting exclusively of equities and government bonds certainly have their attractions. In periods of economic expansion, rising corporate earnings drive equity prices upwards, while bonds stabilise the portfolio during periods of economic slow-down or recession.

In the present era, however, the situation is not so clear. The business cycle has become flatter and recessions rarer. Assessing exactly where we are in the cycle is far from easy (see page 3). Central banks intervene when a recession seems imminent and act to prevent “natural selection” in periods of overcapacity. Adherents of the Austrian School of economic thought talk approvingly of “creative destruction”. They see recessions as a process in which unproductive economic actors are weeded out and replaced by successful ones. The whole system thus becomes more robust. But this process has been inhibited in recent decades, with the result that systemic risks have grown. Interest rate cuts and central banks’ asset buying programmes have severely limited the upside potential of bond prices. These trends were led by Japan, where the average yield on 10-year government bonds has been below 1% since 1998. Given the bond market’s limited upside potential, the importance of alternative asset classes in the portfolio has risen significantly.

Which alternatives?

For the purpose of diversification, an investment portfolio should incorporate multiple sources of return. All possibilities need to be considered, and weightings will depend on the investment objective. It should be noted that some alternatives are sensitive to the business cycle and therefore suffer losses when equity markets fall. This applies especially to heavily leveraged investments such as real estate shares and exchange-traded private equity funds. In the commodities sector, industrial metals and energy are also cyclically sensitive. But other types of alternative investment can bring added value to the portfolio in the late phase of the business cycle and beyond. These include insurance-linked

securities, gold, convertible bonds and some types of hedge fund.

CAT bonds and other insurance-linked securities

Catastrophe (CAT) bonds and other insurance-linked securities (ILSs) are a type of investment that is largely uncorrelated with the business cycle and traditional financial assets. These instruments give the investor a participation in a reinsurance exposure against natural disasters and other underwriting risks. The commonest securitised risks covered by CAT bonds are US hurricane damage, European storm damage and earthquakes in Japan. There is a much larger market in direct reinsurance contracts, which also cover other risks, e.g. losses in aviation and shipping, energy infrastructure, crop failures and mortality. Importantly for investors, there is hardly any correlation between the risks involved throughout this sector. Flooding in Europe does not cause an earthquake in Japan.

Some ILS investment funds hold over 100 different positions. Although an incident can cause a particular position to become worthless, the effect on the overall portfolio is manageable. It also helps that these instruments carry no risk relating to changes in interest rates. Interest payments are based on a variable rate (margin over Libor).

A plethora of insurance claims over the last two years has pushed up premiums, i.e. investors receive higher coupons. The market for these instruments looks set to grow strongly in the coming years. Urbanisation and climate change will result in insurance contracts for ever greater amounts. In order to optimise their capital situation, insurance companies will seek to spread risks by securitising their exposures. This is not, of course, a risk free sector. The most reliable measure of the risk involved is the modelled “expected loss”, which amounts to 1-3% in defensive funds but can rise to as much as 8-15% in more aggressive funds. Thus investors have a wide range of possible returns at their disposal depending on their risk tolerance. But if a “once in a hundred years” catastrophe actually occurs, the loss

can be many times higher than the modelled figure. So far this sector has not been subject to a genuine stress test. Effective risk management by the fund manager is vital. But the performance of CAT bonds and other ILSs during the 2008 crisis showed that this sector is immune to equity market losses.

Gold

In contrast to insurance-linked securities, gold is one of the oldest asset classes in the market. It is worth looking at how gold has performed in the post-war period. In the ten years after the collapse of the gold standard in 1973 the price of an ounce of gold climbed from around USD 40 to USD 1,600. US inflation in that period was frequently in double digits. But in the 1980s and 1990s the central banks brought inflation under control and made massive sales out of their gold reserves, leading to a collapse of the gold price. The decline was halted by the Washington Agreement in 1999, and in the subsequent bull market the price climbed from USD 245 to USD 1,920 (in 2011). The 2008 crisis and worries about financial market risk were a major price driver for gold. When the central banks got the economy back on an even keel, the gold price fell again and has been in consolidation mode for several years now. But the central banks' successful action is not the end of the story – it has merely pushed the problems farther into the future. The scope for monetary measures in the next recession is limited, and fiscal action will be constrained by high public debt. Experience shows that gold performs extremely well not only in an inflationary environment but also in systemic crises. So it is not surprising that gold is now in demand again.

Convertible bonds

Convertible bonds are debt securities that can be converted into shares of the borrowing company. They provide investors with a way of participating in a rising equity market with a limited risk. If the share price falls and the investor waives his conversion right, the convertible bond is redeemed like a straight bond. As long as the company remains solvent, this "bond floor" puts a lower limit on the possible loss. As a rule of thumb, the holder of a convertible bond has a 2/3 participation in a rising equity market but only about a 1/3 participation in a falling market. Thus convertible bonds are a way of staying exposed to the equity market at a late stage of the cycle but with a limited risk.

Highlights

- Alternative asset classes help protect an investment portfolio, but selectivity is important.
- Insurance-linked securities successfully bucked the cycle in the last downturn.
- Gold has proved its worth as a portfolio hedge.

Hedge funds

The characteristics of hedge funds are as diverse as the 10,000+ managers who operate them. Private investors are often disappointed at the performance and diversification effects of these instruments. They frequently have exaggerated ideas about the potential rewards. High charges in this sector have come down a lot in recent years. The diversification effects vary greatly depending on the fund's investment style. Styles such as Global Macro, Equity Market Neutral and Managed Futures (CTAs) usually offer the best diversification.

Conclusion

Not all alternative asset classes are equally suitable for this late stage of the business cycle and beyond. In the current environment, investors should steer clear of real estate, private equity and cyclical commodities. Portfolios can be protected by means of ILSs/CAT bonds and gold and also to some extent by means of convertible bonds and appropriate hedge fund strategies. Choosing the right asset class and manager is becoming increasingly important.

Benchmark	Current forecast	% YTD ¹
Commodities	→	2.59%
Gold	→	10.25%
Crude oil	↗	4.36%
Commercial real estate	→	15.43%
Private equity	→	25.03%
Convertible bonds	→	5.63%
Hedge funds	↗	3.59%

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

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

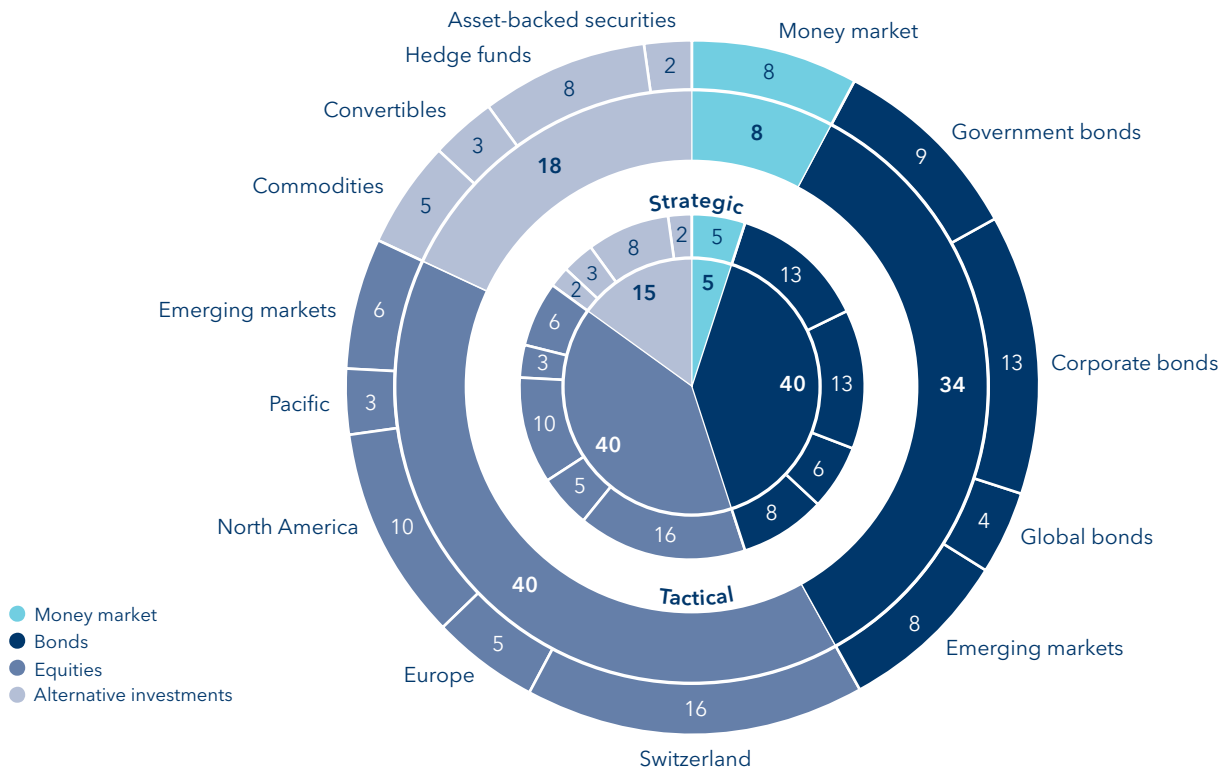
¹ As of 17.06.2019



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	14.06.19	1,070.64	no	yes	5.30%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	14.06.19	1,422.57	no	yes	5.01%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	14.06.19	1,393.56	no	yes	6.29%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	14.06.19	1,600.54	no	yes	7.09%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	14.06.19	997.48	no	yes	6.46%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	14.06.19	1,597.85	no	yes	7.73%

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

Tactical Allocation

Tactical allocation based on the “investment clock” aims to optimise the portfolio in line with the investment cycle (see page 3). This sounds simple enough, but using the clock as an aid to investment timing is far from easy and is perhaps even more difficult than usual at present. The US economy, for example, has grown uninterrupted since the financial crisis – the longest expansion in American history. But when will the clock start pointing to falling output and incipient recession? That is not an easy question to answer.

Experience shows that recessions are generally triggered by external shocks, banking crises or changes in fiscal or monetary policy. Current central bank policy is difficult to read. In the US and Europe a genuine monetary tightening has still not materialised. The Fed has gently raised interest rates and embarked on a downsizing of its balance sheet, but policy could switch to the opposite direction.

Keeping in line with the current cyclical phase

A broadly diversified portfolio should reflect this state of affairs. As the recovery matures, cyclical investments should be scaled down. But it would be a mistake to jettison riskier investments like equities and corporate bonds entirely. History shows that recessionary phases are rarer than growth phases. There is no denying, however, that the contraction of GDP can be dramatic, and the same goes for the reaction of the financial markets. So the aim must be to reduce risks in advance.

VP Bank has already adjusted its investment management portfolios accordingly (see page 23). At the start of the year the markets were in fine fettle, and the Fed’s surprise decision to halt the upward ratcheting of interest rates added fuel to investors’ confidence. Since then, however, clouds have been gathering in the economy and the financial markets. Leading indicators,

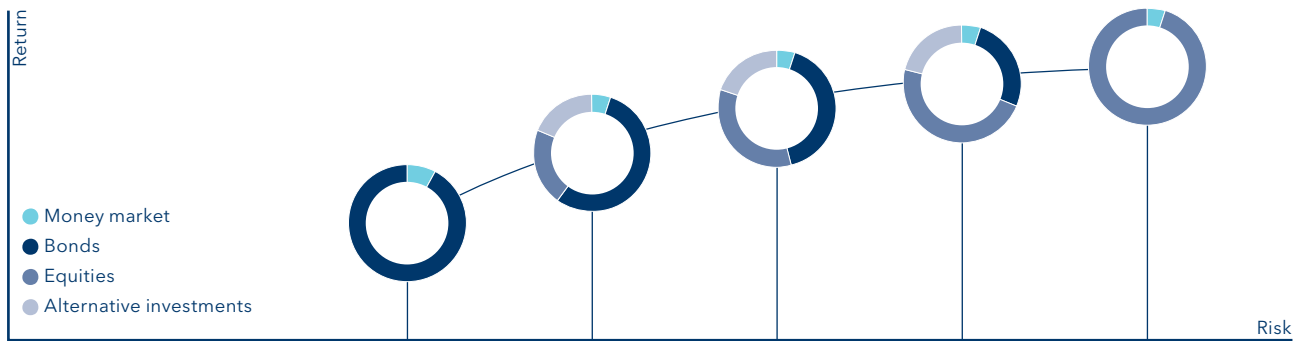
notably purchasing managers indices, point to a significant loss of economic momentum, and sentiment has also been hit by the trade conflict between the US and China. At the same time, market jitters have been aggravated by the inversion of the US yield curve. Investors now earn more by investing in three-month US deposits than on 10-year Treasuries. In the past an inverted yield curve was often a harbinger of recession. These uncertainties and the heightened risk of recession are reflected in our portfolio allocations.

Alternative asset classes overweighted

Our position in gold has been further augmented. Gold is a tried and tested hedge. It gives the portfolio a more defensive character and reduces fluctuations in portfolio value. We have also added a position in insurance-linked securities (ILSs), whose expected returns are independent of moves on the financial markets. These securities provide access to the premium income on reinsurance contracts, mostly relating to major natural disasters.

Overall, bonds are underweighted in our portfolios, while equities are now neutrally weighted after the reduction of the emerging market allocation. Our positions in gold and ILSs mean that we are overweight in low-volatility alternative asset classes.

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



Contributors



Bernhard Allgäuer
Senior Investment Strategist



Harald Brandl
Senior Equity Strategist



Dr Felix Brill
Chief Investment Officer



Dr Thomas Gitzel
Chief Economist



Bernd Hartmann
Head of CIO-Office

Your contact – wherever you may be

VP Bank Ltd is a bank domiciled in Liechtenstein and is subject to supervision by the Liechtenstein Financial Market Authority (FMA), Landstrasse 109, 9490 Vaduz, Liechtenstein, www.fma-li.li

VP Bank Ltd	Aeulestrasse 6 · 9490 Vaduz · Liechtenstein T +423 235 66 55 · F +423 235 65 00 info@vpbank.com · www.vpbank.com VAT No. 51.263 · Reg. No. FL-0001.007.080-0
VP Bank (Switzerland) Ltd	Talstrasse 59 · 8001 Zurich · Switzerland T +41 44 226 24 24 · F +41 44 226 25 24 · info.ch@vpbank.com
VP Bank (Luxembourg) SA	2, rue Edward Steichen · L-2540 Luxembourg T +352 404 770-1 · F +352 481 117 · info.lu@vpbank.com
VP Bank (BVI) Ltd	VP Bank House · 156 Main Street · PO Box 2341 Road Town · Tortola VG1110 · British Virgin Islands T +1 284 494 11 00 · F +1 284 494 11 44 · info.bvi@vpbank.com
VP Bank Ltd Singapore Branch	8 Marina View · #27-03 Asia Square Tower 1 Singapore 018960 · Singapore T +65 6305 0050 · F +65 6305 0051 · info.sg@vpbank.com
VP Wealth Management (Hong Kong) Ltd	33/F · Suite 3305 · Two Exchange Square 8 Connaught Place · Central · Hong Kong T +852 3628 99 00 · F +852 3628 99 11 · info.hkwm@vpbank.com
VP Bank Ltd Hong Kong Representative Office	33/F · Suite 3305 · Two Exchange Square 8 Connaught Place · Central · Hong Kong T +852 3628 99 99 · F +852 3628 99 11 · info.hk@vpbank.com
VP Fund Solutions (Luxembourg) SA	2, rue Edward Steichen · L-2540 Luxembourg T +352 404 770-297 · F +352 404 770-283 fundclients-lux@vpbank.com · www.vpfundsolutions.com
VP Fund Solutions (Liechtenstein) AG	Aeulestrasse 6 · 9490 Vaduz · Liechtenstein T +423 235 67 67 · F +423 235 67 77 vpfundsolutions@vpbank.com · www.vpfundsolutions.com

Published by

CIO-Office
VP Bank Ltd
Aeulestrasse 6
9490 Vaduz
T +423 235 61 73
F +423 235 76 21
investmentviews@vpbank.com

Editors and contributors

Bernhard Allgäuer, Senior Investment Strategist
Harald Brandl, Senior Equity Strategist
Dr Felix Brill, Chief Investment Officer
Dr Thomas Gitzel, Chief Economist
Bernd Hartmann, Head of CIO-Office
Clifford Padevit, Head of Group Investment Communications
Christina Strutz, Office & Publication Manager

Periodicity

Quarterly

Publication date

01 July 2019

This publication was finalised on

26 June 2019

Closing prices as at

16 June 2019, unless otherwise stated

Sources for charts and statistics

Bloomberg, Reuters, Thomson Financial Datastream,
unless otherwise stated

Photos

Roland Korner, Triesen
Rich Stapleton, London

Printed by

BVD Druck+Verlag AG, Schaan



MIX
Paper from
responsible sources
FSC® C013308



PRINTED MATTER
CO₂ NEUTRAL
by Swiss Climate
SC2018121202

Important legal information

This document was produced by VP Bank AG and distributed by the companies of VP Bank Group. This document does not constitute an offer or an invitation to buy or sell financial instruments. The recommendations, assessments and statements it contains represent the personal opinions of the VP Bank AG analyst concerned as at the publication date stated in the document and may be changed at any time without advance notice. This document is based on information derived from sources that are believed to be reliable. Although the utmost care has been taken in producing this document and the assessments it contains, no warranty or guarantee can be given that its contents are entirely accurate and complete. In particular, the information in this document may not include all relevant information regarding the financial instruments referred to herein or their issuers.

Additional important information on the risks associated with the financial instruments described in this document, on the characteristics of VP Bank Group, on the treatment of conflicts of interest in connection with these financial instruments and on the distribution of this document can be found at https://www.vpbank.com/en/legal_notice.

