2nd quarter 2018

Investment Views

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	→	↗	New
GBP vs. USD	→	↗	New
USD vs. JPY	↗	↗	
AUD vs. USD	→	↗	New
USD vs. SGD	↗	↗	
USD vs. RUB	→	→	
Key interest rates			
Switzerland	→	→	
Europe (EMU)	→	→	
USA	↗	↗	
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	↗	→	New
North America	→	→	
Pacific	→	→	
Emerging markets	↗	→	New
Alternative investments (pages 18–21)			
Commodities	→	→	
Crude oil	→	→	
Gold	↗	↗	
Real estate shares	→	→	
Private equity	→	→	
Convertible bonds	→	→	
Hedge funds	↗	↗	

// Back to normality //

Bernd Hartmann
Head of Group Investment Research

Dear Reader

Various market developments in recent months have heralded a return to normality. This applies especially to the restored connection between macroeconomic performance and bond yields. For years, ultra-loose monetary policies and minimal inflation had broken the link between macro data and the fixed-income markets. With good macro data failing to generate higher bond yields, the main beneficiaries were equities. Now, however, the previous interplay is apparently in action again. This could have far-reaching consequences for investors. In “Top issue of the month” we explain how investors can react to this changed environment.

A return to normality has also occurred on the equity markets. The period from November 2016 to January 2018 had seen the global equity index (MSCI World) rising uninterruptedly month after month. Such a long period of continuous advance without a single negative month is exceptional. Indeed, it is the first time it has happened since the index was launched in the 1970s. To this extent, the correction in February and the resurgence of volatility represent a normalisation. In the “Equities” section we explain where we expect the equity markets to go from here.

But the return to normality is not universal. Donald Trump’s plans to impose new import tariffs go in the opposite direction. World trade has benefited since the end of World War II from a successive dismantling of trade barriers. Deregulation has admittedly lost momentum in recent years, but a reintroduction of tariffs represents an ominous change of trend. There would be many losers and no clear winners. More on this subject in “Economic outlook”.

1. FOCUS

Insidious danger of rising yields

FOR YEARS THE CONNECTION BETWEEN ECONOMIC PERFORMANCE AND BOND YIELDS WAS A DEAD LETTER. THIS SITUATION HAS NOW CHANGED DRAMATICALLY.

Investors need to reduce their portfolios' sensitivity to interest rates. Ultra-expansionary monetary policies and virtually non-existent inflation over a number of years had broken the connection between macro-economic performance and bond yields. This is no longer the case. In our outlook for 2018 we emphasised that a yield backup driven by buoyant macro data could have a negative impact on equity markets. This now appears to be happening.

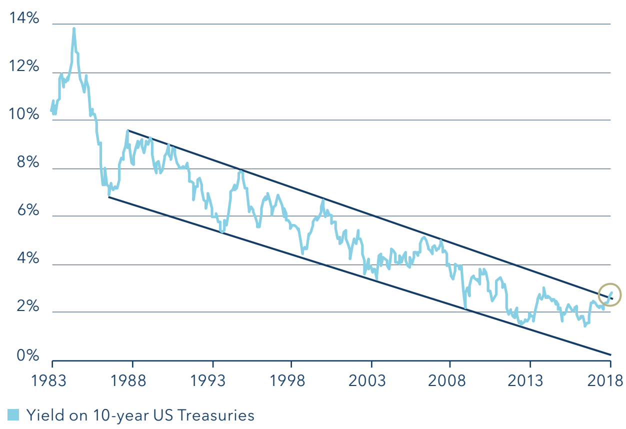
End of the bull market for bond investors?

Many investors had a rude awakening at the start of February. Back in December, the prospect of higher corporate earnings in the wake of US tax reform had accentuated the upwards trend of bond prices. But the upbeat mood was shattered in February, when interest rate expectations and bond yields climbed. The connection between macro data and interest rates appears to be gradually re-establishing itself and causing nervous reactions among investors.

The recent rise in yields has been driven primarily by a change in the real yield level, i.e. nominal yield minus inflation. Rising real yields indicate that the markets foresee an improvement in economic performance. The backup has pushed the yield on 10-year US Treasuries out of the downward corridor in which it has been confined during the last 30 years.

The result has been a resurgence of investor interest in bond investments. All eyes are on US inflation. The excellent employment situation in the US has not yet generated appreciable wage pressures, but wages are still rightly perceived as a price driver. This is confirmed by the latest data, though cyclical factors will weaken the effect. And it remains the case that structural factors such as globalisation, demographics and digitalisation reduce yields' upward potential.

30-year bull market in bonds



Following the recent backup, we now expect yields to pause. But investors should keep a careful eye open for any signs of movement, especially in view of the fact that the US inflation outlook is now muddied by the possibility of further fiscal stimulus. Input by the Fed is gradually waning as the monthly reinvestment of maturing Fed assets is wound down. At the same time the market is vulnerable to the record volume of futures positions betting on falling yields. If yields climb, many investors will be forced to close their positions. Such forced sales would accentuate the upward movement.

Ambivalent relation between bonds and equities

Yields play a key role in the financial markets as a measure of the relative attractiveness of different asset classes. Any change in bond yields affects not only the fixed-income market but all other asset classes as well. In general, rising bond yields are regarded as bad for equities. But empirical studies show that the relation between these two major asset classes is more complex than that suggests. Much depends, for example, on whether the yield backup is driven by inflation or constitutes a real-term increase. The starting level is also crucially important. Historical experience shows that a yield backup starting from a low level tends to result in higher valuations on the equity markets, which usually means capital gains for investors. But if bond yields are already elevated, the opposite occurs: a further rise in yields pushes equity valuations down. If this is not offset by strong earnings growth, the potential impact on share prices is negative. In other words, there is a critical point at which the impact on equities changes from good to bad. The turning point used to be around

5% for US Treasuries. In today's slower growth environment, however, the critical level is much lower, with negative effects for equities materialising at an earlier stage. We would now expect this to happen at a yield level between 3.5% and 4%.

The corporate bond sector, likewise, would not be immune to a steep rise in yields. Valuations could well be affected. Added to that, the risk profile of corporate bonds has been insidiously undermined in recent years by central banks' expansionary monetary policies and asset purchase programmes. Narrow credit spreads minimise the differences in financing costs between one rating category and another, with the result that borrowers have little incentive to keep their balance sheets in good shape. The temptation to increase corporate debt on cheap terms has been hard to resist. Companies have also taken advantage of the low yield environment to borrow at very long term. While this is sensible from borrowers' point of view and enhances their security, it exposes lenders to a heightened risk resulting from interest rate changes. Even slight shifts in interest rates can have major negative effects on the corporate bond market.

How to adapt portfolios

To minimise risk, investors should gradually start preparing their portfolios for an environment of rising yields. In the bond sector, this means steering clear of excessively long maturities. Borrowers with low ratings could also be problematic, and the same goes for shares of highly leveraged companies. Preference should be given to high quality assets.

In this context, investment portfolios can be enhanced by the inclusion of assets that have a low correlation with traditional investments. Insurance-linked securities (ILSs) are a possible candidate. Yields in this sector have admittedly been eroded by the general squeeze on investment returns, but the attraction of these securities is that their performance is largely independent of economic developments. The payout for investors is driven by insurance premiums and loss events. Premiums have been under pressure but can be expected to rise again now that the hurricane season is over. Another advantage is that ILSs pay interest at short-term rates and are therefore not exposed to the risk of capital losses due to interest rate increases.

In a more difficult and trendless market environment, vehicles based on hedge fund strategies can also offer good results. These vehicles are now tradeable on a liquid market and carry a lower market risk, which means they fluctuate less than the general market. They also benefit from the fact that they have a broader array of investment plays at their disposal. For example, they can exploit differences in the attractiveness of two similar investments by going long in one and short in the other. It should be noted, however, that success in this field depends much more heavily on the skill of the manager than in the case of a conventional bond or equity fund.

Private debt can be an interesting alternative to conventional corporate bonds. A private debt investment takes the form of a bilateral credit agreement that is not mediated by a bank or the bond market. In the absence of an organised market for these contracts, investors must be prepared to stay committed for a protracted period. By the same token, however, these investments are not subject to the central banks' asset purchase programmes. This means that their yields are not directly susceptible to officially induced distortions and investors are therefore better rewarded. A higher interest rate also compensates lenders for the lack of liquidity. Studies show that, in the event of default, private debt enjoys a higher recovery rate than conventional corporate bonds thanks to the collateral provided and the credit clauses applied. Another advantage is that, despite longer maturities, interest payments are based on a short-term rate (Euribor or Libor). Investors therefore benefit directly from any rise in interest rates. Nevertheless, adequate diversification is even more important in this sector than in the conventional corporate bond market. Except in the case of very large portfolios, this can only be achieved via an investment fund.

Conclusion

Macroeconomic data are now exerting a stronger influence again on interest rates and bond yields, with the US leading the way. Although a continuation of the yield backup is unlikely in the short term, investors should take a close look at their portfolios' sensitivity to interest rate movements. The solutions sketched above show how portfolios can be adapted to cope with this changing environment.

Trump plays with fire

DONALD TRUMP HAS RAISED THE SPECTRE OF TRADE WARS. BUT THE UNITED STATES, WITH ITS CORPORATE STRENGTH AND GLOBAL BRANDS, IS A MAJOR BENEFICIARY OF INTERNATIONAL FREE TRADE.

Highlights

- The US is a major beneficiary of the liberal international economic order.
- An escalating tariff war would hit America hard.
- We do not expect it will come to that, but peace on the financial markets has been subverted for the time being.

1817 was an important date in the history of free trade. That year saw the publication of a work entitled "On the Principles of Political Economy and Taxation" by the British political economist David Ricardo. In an analysis that is still relevant today, this self-taught economist, who had never been to university, analysed distributional conflicts in the industrial era and demonstrated that the wealth of nations is increased by free trade. Since then, economists have convincingly documented the benefits of low or no tariffs.

Fast-forward to 2018, and what do we see? The US is planning to slap punitive tariffs on steel and aluminium imports. President Donald Trump touts these measures as part of his America First policy. But the US economy is in fact a major beneficiary of a liberal international economic order. Apple, McDonalds, Starbucks and Google are just a few examples of the triumphant global spread of US corporations. When Donald Trump threatens to disrupt a major ingredient of America's economic success, he is playing with fire. Steel production represents the "old America" of the 19th and early 20th centuries, when the economy was powered by heavy industry. Today's crisis-riven steel industry is in secular decline. At the end of 2017 America's steel and iron producers employed 86,000 people, corresponding to only 0.7% of the manufacturing workforce. The steel sector is thus a very minor part of the US economy.

Negative indirect effects on the US

Companies that use steel and aluminium in their manufacturing activities are much more important in the US than steel producers. For these firms – automobile makers for example – punitive tariffs mean higher input costs. The resultant job losses could well outnumber the jobs protected by higher tariffs in the steel and aluminium industries. Past experience confirms this. In previous cases when punitive tariffs have been imposed on particular sectors, the negative indirect effects have outweighed any benefits. The planned actions are bad for consumers, raising the prospect of higher prices for automobiles and other products, e.g. canned drinks. Is that really what the administration wants?

Vicious spiral

The USA temporarily excludes the EU, now, but the issue is still not finally solved due to the preliminary character of the agreement. The risk behind this issue is: The European Union is already talking about tariffs on imports of American tyres and whisky. Given the marginal economic importance of these products, such action would be merely symbolic. But the danger of a vicious spiral of reactions and counter-reactions is very real. It all depends on whether Donald Trump is content to have made his point and leave it at that or whether further protectionist measures are in the pipeline. A key target is China, with which the US has a larger trade deficit than with any other nation – USD 375 billion at the latest reading. But a trade war between the world's two largest economies would be in nobody's interests.

No trade war, but increased market jitters

We do not think that it will come to a full-blown trade war. Too much is at stake. With its strong internationally active companies and global brands, the US benefits enormously from a liberal international trading system. Senior Republicans are already rebelling against the White House's plans. But the controversy highlights the fact that financial market tranquillity is over for the time being.

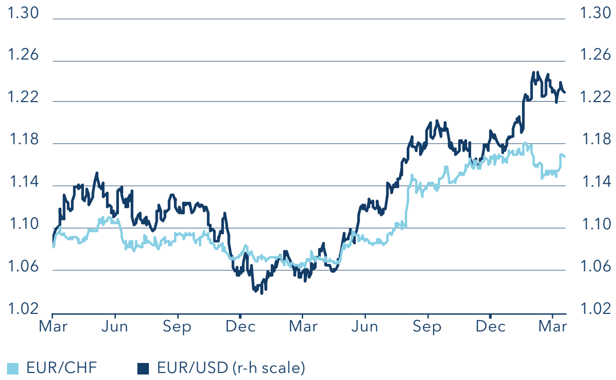
Legal note on page 29

2. ASSET CLASSES

Money market and currencies

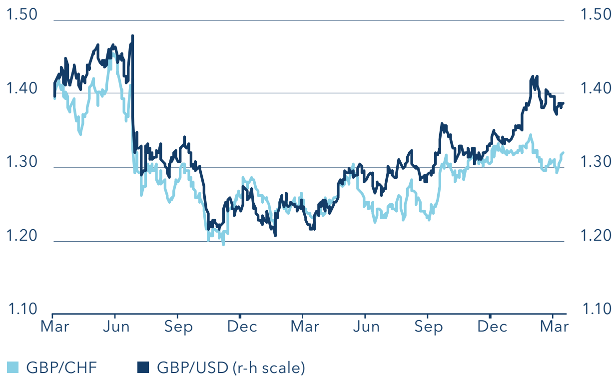
Market overview

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

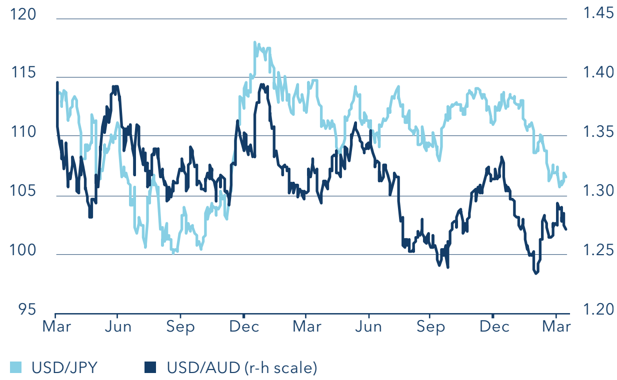


USD/CHF: exchange rate since March 2016

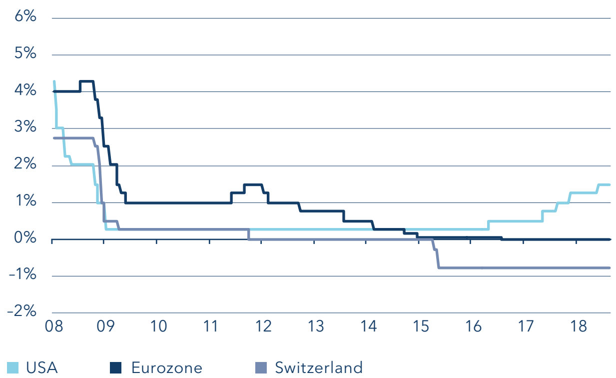
GBP/CHF and GBP/USD: exchange rates since March 2016



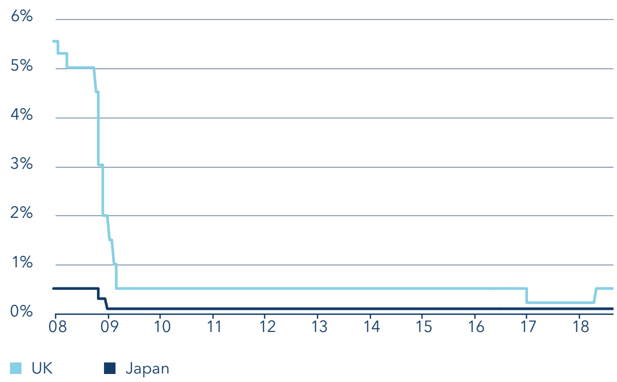
USD/JPY and USD/AUD: exchange rates since March 2016



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



Key interest rates in UK and Japan: since January 2008

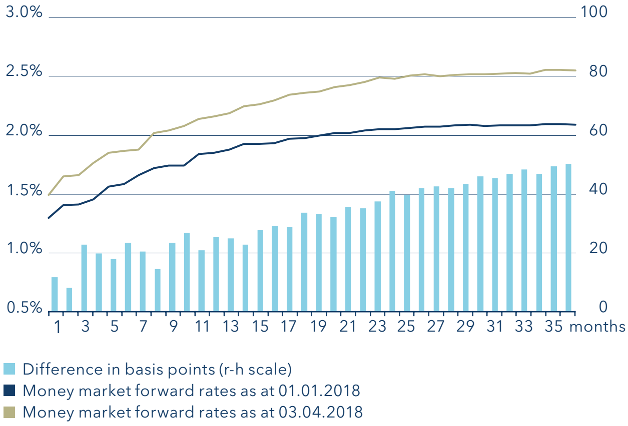


Markets eye higher interest rates

US ECONOMIC DATA ARE UPBEAT, AND THE FED FUNDS RATE IS ON A RISING TRAJECTORY – BUT THE US DOLLAR HAS FAILED TO RESPOND SIGNIFICANTLY. WE BELIEVE THAT THE GREENBACK WILL THROW OFF ITS LETHARGY IN THE COMING MONTHS AS THE MARKETS FOCUS MORE KEENLY ON INTEREST RATE DIFFERENTIALS.

The financial markets have had a turbulent time in recent weeks. Equity markets have been roiled, and government bond prices have sagged. The background to these events was a weather change on the short-term money markets. The connection might not appear obvious, but a closer inspection shows that it is real enough. One needs to start by looking at the market in US federal funds futures. The federal funds rate is the interest rate at which US banks borrow from one another on an overnight basis in order to meet their minimum reserve requirements at the Federal Reserve. In the federal funds futures market, participants buy and sell contracts on the basis of their expectations regarding future movements in the federal funds rate, and these expectations are therefore reflected in the contracts' prices. At the start of this year the price curve for 2019 and 2020 was largely flat. In other words, the market expected that the Fed would put rates up this year but remain generally passive thereafter. At the end of January, however, the wind changed abruptly. For the first time since the Fed's initial tentative rate hike in December 2015, the market started to price in a full-blown cycle of rising interest rates, with hikes continuing in 2019 and 2020. It was this change in expectations that triggered the recent market convulsions, because rising interest rates make fixed-income investments more attractive in relation to equities.

US money market forward rates



US tax reform fuels economic optimism

The markets' about-turn was sparked by economic hopes inspired by Donald Trump's tax reform. The Fed, too, is making optimistic noises about the economic outlook. Our upbeat start-of-year assessment of US economic prospects for 2018 is being vindicated, with GDP growth of 2.6% this year now looking possible. Surprisingly, though, the US dollar has not profited very much from these developments. The blame for the greenback's puzzling weakness is often laid at the door of America's "twin deficits", i.e. the deficits on the current account (essentially trade in goods and services) and the federal budget. The twin deficit malaise is likely to be aggravated by tax reform, which will eat into fiscal revenues, and the financial markets reckon that this is enough to justify a weaker dollar. In our view, however, this argument holds water only to a limited extent.

Parallels with "Reaganomics"

The present situation is reminiscent of the era of Ronald Reagan. So-called "Reaganomics" resulted in a blend of lower taxes and higher expenditure. Parallels with the policies of Donald Trump are obvious. Under Reagan the budget deficit climbed to over 5% of GDP, while the current account deficit amounted to 3% of GDP. Despite the deficits, however, there was huge upward pressure on the US dollar, because the Fed was ramping up interest rates while the central banks of Germany and France (the Bundesbank and the Banque de France) were pushing rates down. Thus the dollar's climb was driven by a widening interest rate gap in favour of the US. The dollar's ascent continued until the signing of the Plaza Accord in the autumn of 1985 (named after the Plaza Hotel in New York, where the signing took place) under which the countries of the G5 (France, Germany, Japan, UK and US) agreed to make concerted interventions to pull the dollar down. The interventions proved very successful, ushering in a period of protracted dollar weakness in the second half of the 1980s. So what light does this cast on the present situation? The simple fact is that the markets are currently focusing on the risks posed by US fiscal laxity while apparently ignoring the interest rate aspect – at least for now.

Interest rate divergence

The Fed's new boss, Jerome Powell, who has been in office since February, might be able to inject greater awareness of the widening transatlantic interest rate gap. In his testimony to the House of Representatives' Financial Services Committee in February he made a more hawkish impression than his predecessor Janet Yellen. This sparked renewed expectations of rising interest rates. There was even speculation that the Fed could implement four rate hikes this year. That is probably unrealistic. Official rate hikes presuppose rising inflation, but US inflation is still stuck below the Fed's 2% target, despite a moderate uptrend. In our view, conditions are not yet ripe for a sharp acceleration, because that would require more emphatic wage growth than we are seeing at present. Thus the Fed can be expected to stick to a course of modest interest rate rises this year.

Nevertheless, although we are more cautious than the markets about the interest rate outlook for 2018, the fact remains that the markets will focus more strongly on the already wide gap between US and eurozone borrowing costs. Central banks on the two sides of the Atlantic will continue to follow divergent courses in the coming months. While the Fed backpedals from the expansionary course it has pursued in recent years, the European Central Bank will be forced by sluggish inflation to remain in ultra-expansionary mode. The ECB's mandate is to maintain price stability, which is defined as an inflation rate of around 2%. As long as inflation fails to stabilise at around that level, the ECB has no choice but to implement a policy of easy money. If ECB President Mario Draghi were to tighten policy now, he would be failing in his duty.

Highlights

- The weather on the money markets is changing. For the first time the markets are pricing in a full-blown cycle of interest rate hikes by the Fed.
- So far the US dollar has profited only modestly from the increased prospect of higher interest rates.

Conclusion

We expect the US dollar to regain ground in the coming weeks – not only against the euro but also against the Swiss franc. The markets will focus more strongly on interest rate differentials. While the Fed will continue to tighten, the ECB will remain ultra-accommodative.

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

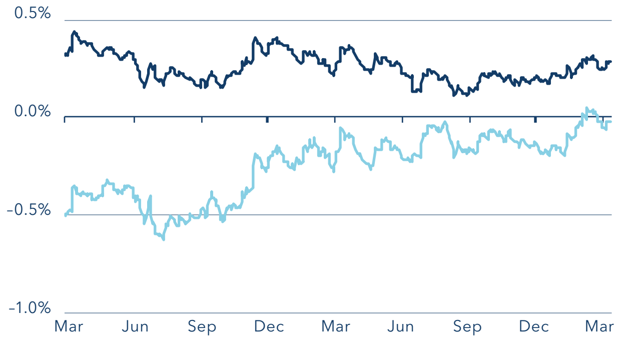
Upside/downside ranges indicated by our 3–6 month interest rate forecasts:
↑ > +50 basis points ↗ +25 basis points
↘ -25 basis points ↓ < -50 basis points → No change

2. ASSET CLASSES

Bonds

Bond yields – overview

Switzerland: yields since March 2016



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

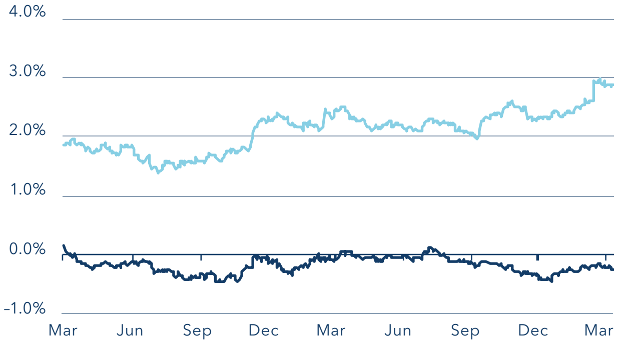
Emerging markets: yields since March 2016

Hard currency ■ Local currency

Europe: yields since March 2016

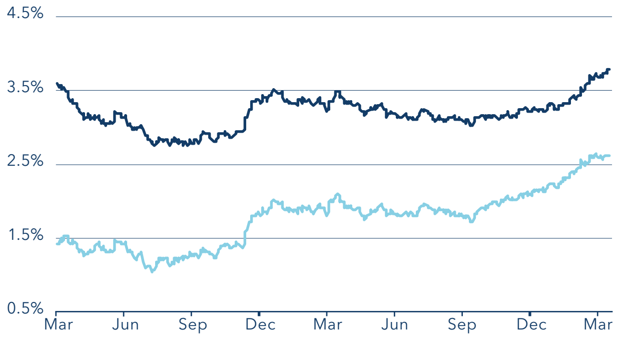
EUR government bonds (5 to 10 yr) ■ EUR corporate bonds (5 to 10 yr)

Inflation-linked bonds: yields since March 2016



USD inflation-linked ■ Euro inflation-linked

USA: yields since March 2016



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

High yield: yields since March 2016

Global high yield (5 to 10 yr) ■ Euro high yield

Where are bond yields heading?

WHAT IS THE MAXIMUM FEASIBLE LEVEL FOR BOND YIELDS? TO ANSWER THIS QUESTION, WE HAVE TO ASK WHAT LEVEL OF BORROWING COSTS WOULD UNDERMINE ECONOMIC PERFORMANCE. LET'S SEE WHAT POLICY MAKERS AND ECONOMISTS HAVE TO SAY ON THIS SUBJECT.

Long-term bond yields have recently backed up sharply. At the end of February the yield on 10-year US Treasuries was only just shy of 3%, compared with just over 2% last September. Quite a jump! For the first time, the money markets are now pricing in a protracted cycle of Fed interest rate hikes. This reassessment of the interest rate outlook has impacted on the Treasuries market. The question now is: How much further can bond yields rise? In previous rate-hiking cycles, 10-year Treasuries reacted only sluggishly to Fed actions. It should also be noted that at a certain point the yield curve becomes inverted, with short-term interest rates exceeding 10-year yields.

What is the neutral interest rate level?

The crucial factor for bond yields is the future course of official interest rates. As America is the pace-setter for global interest rate trends, we need to take a close look at the likely actions of the Fed. How many more fed funds hikes are in the pipeline? Economists talk of a "neutral" rate of interest, defined as the money market interest rate at which productive capacity is fully utilised and inflation is stable. Put simply, the neutral rate is the central bank interest rate at which monetary policy has neither a stimulatory nor a depressing effect on the economy. This neutral rate is not directly observable and therefore has to be estimated. Estimates, however, are based on assumptions, with the result that there are widely differing views about where the neutral rate of interest lies.

The members of the Fed's key monetary decision making body, the Federal Open Market Committee (FOMC), regularly give their own view by publishing an estimated level for the fed funds rate over the long term. This can be regarded as the neutral rate. The median FOMC estimate for the long-run rate is 2.875%. Fed economist Thomas Laubach and John Williams, who is President of the Federal Reserve Bank of San Francisco, have devised a theoretical model for estimating the "natural" real rate of interest (i.e. the neutral rate after adjustment for inflation). The Laubach-Williams model currently gives a neutral real interest rate of 0.45%. Assuming that core inflation (i.e. excluding volatile energy and food prices) will rise to about 2.0% in the second half of this year, the neutral real rate would come to about 2.5%, which is close to the FOMC's position.

Implications for bond yields

As we have explained, this neutral rate does not have any restrictive effect on economic activity. By raising interest rates, however, the Fed wants to head off an overheating of the economy. This means that the fed funds rate will have to go above the neutral rate. Historical comparisons suggest an addition of around 100 basis points. That would imply a peak fed funds rate of around 3.5% in the current cycle. The market in 10-year Treasuries would take that as a guideline. Even so, such a level should not be regarded as likely in the coming months. Inflation is simply too sluggish at present for that to happen. Despite financial market worries about resurgent inflation risks, we do not foresee a rapid acceleration of inflation in the months ahead. This will limit any further backup of bond yields for the time being. The same applies to European bonds, notably Swiss government bonds and Bunds.

Risks predominate

ENCOURAGED BY THE ROSY ECONOMIC OUTLOOK, CREDIT MARKETS HAVE SHRUGGED OFF THE EQUITY MARKET CORRECTION. NEVERTHELESS, RISKS STILL PREDOMINATE.

Highlights

- How far bond yields can rise depends crucially on the "neutral" level of interest rates.
- The neutral nominal interest rate for the United States is in the region of 2.5%.
- We expect bond prices in the investment grade sector to move sideways at best. We view lower qualities with caution.

Convincing economic outlook

The recent correction on the equity markets caused only a slight widening of credit spreads on corporate bonds. Spreads on high yield bonds widened by 30 basis points, while the increase for investment grade borrowers was only 10 to 15 basis points. An historical comparison based on the VIX volatility index suggests that a 200 to 300 point widening could have been on the cards. The rock that is supporting the market is globally synchronised economic growth. This is reflected in high profit margins and buoyant corporate earnings. Earnings expectations for US corporations have been boosted by tax reform and deregulation. Indeed, analysts reckon that the cost reductions resulting from deregulation will be even higher than the savings achieved through lower taxes.

Risks: "known unknowns"

Even so, corporate bonds are exposed to multiple risks. These can be listed as follows:

Yield curve: Negative yield curves have been harbingers of recession in the past. The flattening of the US dollar yield curve is already at an advanced stage. Many economists believe that the already long-lived economic upswing has only another two or three years to run.

Central banks: Over the last two years the balance sheets of the world's largest central banks have swollen by almost USD 2 trillion. This year an increase of "only" USD 121 billion is expected, and that will be followed by shrinkage from next year onwards. This will put the central banks in uncharted waters.

China: China is revamping its growth strategy in reaction to explosive debt growth in state-run enterprises. The focus is now on qualitative strategic growth. Regardless of the published growth rates, effective growth will therefore be lower. That points to increased credit defaults.

Liquidity mismatch: The ten largest ETFs now hold over USD 50 billion worth of high yield bonds. This means that liquid investment instruments are being offered on the basis of illiquid assets. A mass sell-off by investors would put a serious strain on these funds' ability to pay.

Leverage: Low interest rates and high profit margins have encouraged companies to increase their borrowing in relation to their equity base. This makes downgradings and defaults more likely.

Conclusion

Despite upbeat economic data, we view corporate bonds with caution. In addition to the risks enumerated above, company-specific risks also have to be taken into account. A growing number of companies have been plunged into problems as a result of failed investments. We expect spreads on bonds in the investment grade segment to move sideways at best. In the lower quality segment there is a danger of losses.

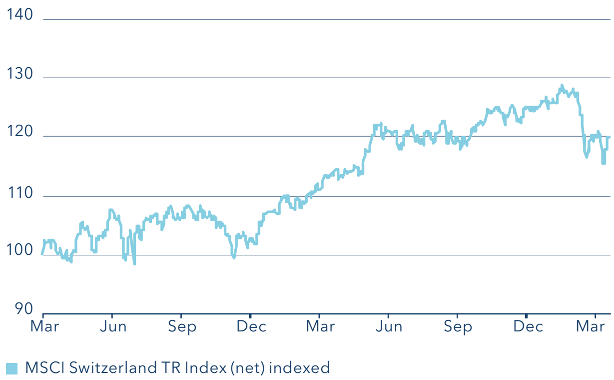
Benchmark	Current forecast	% YTD[1]
Gov. bonds Switzerland[2]	→	-2.25%
Gov. bonds Europe (EUR)[2]	→	0.19%
Gov. bonds USA[2]	↗	-1.98%
Inv. grade corp. bonds Switzerland[2]	→	-0.42%
Inv. grade corp. bonds Europe (EUR)[2]	→	-0.20%
Inv. grade corp. bonds USA[2]	↗	-2.85%
High yield bonds[3]	↘	-0.55%
Emerging market bonds (hard currency)[3]	→	-2.11%
Emerging market bonds (local currency)[3]	→	3.99%

[1] As of 12.03.2018
[2] Yield
[3] Total return

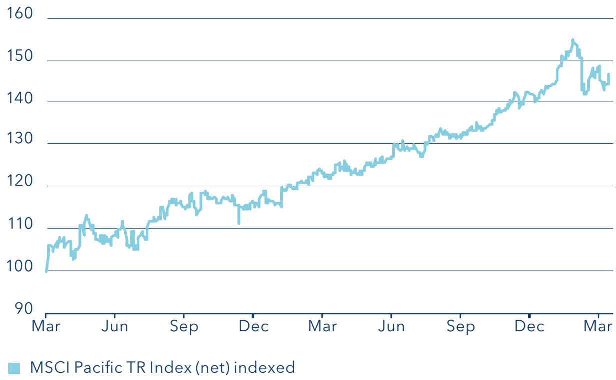

2. ASSET CLASSES
Equities

Equity indices – overview

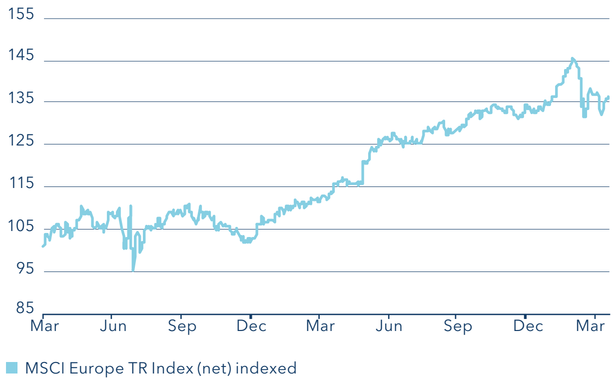
Switzerland: market movement since March 2016 (indexed)



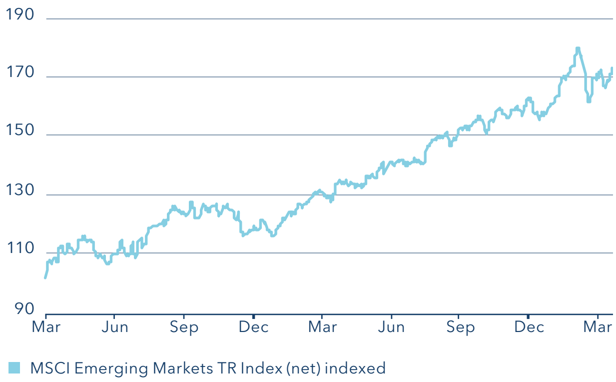
Pacific: market movement since March 2016 (indexed)



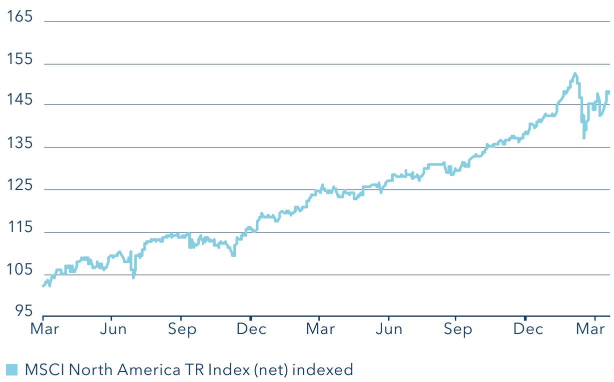
Europe: market movement since March 2016 (indexed)



Emerging markets: market movement since March 2016 (indexed)



North America: market movement since March 2016 (indexed)



United Kingdom: market movement since March 2016 (indexed)

Legal note on page 29

More challenging landscape

EQUITY MARKETS LOVE A BIT OF DRAMA. GYRATING SHARE PRICES, DENTS IN THE ECONOMIC INDICATORS, RISING BORROWING COSTS IN THE US AND EUROPE – AND YET MARKET SENTIMENT REMAINS BULLISH.

Solid global economic growth does not provide unalloyed support for this optimistic mood. In February the equity markets suffered their first significant correction since 2016. Strong US macro data took the markets by surprise and led to an abrupt reappraisal of the interest rate outlook for 2019 and 2020. The main trigger, alongside strong labour market numbers and resultant steeper-than-anticipated wage increases, was expected higher earnings growth in the wake of Donald Trump's tax reform. Buoyant corporate earnings were already pumping additional fuel into the bull market last autumn, resulting in clear evidence of market overheating. In January we therefore recommended taking advantage of low prices in the options market to build hedging positions until year-end.

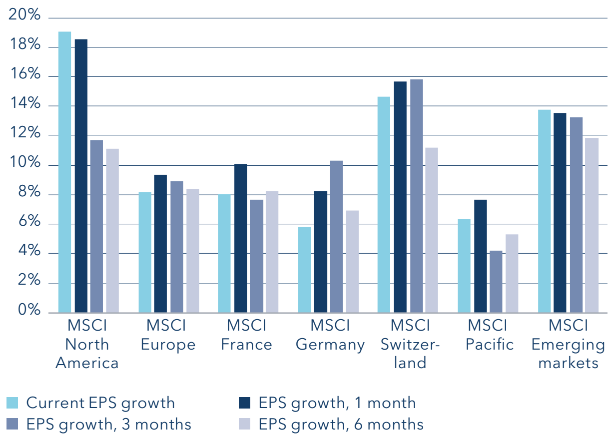
Earnings growth: strong but mixed

The announced US tax reform sparked a sharp rise in earnings expectations, pushing the US market's P/E ratio down from 18.7 to 17.4 at present. The market initially reacted by powering ahead to new all-time highs, and even in the present consolidation the US market has fared better than most other regions. During the last four weeks, positive corporate earnings momentum has been limited to the US and the emerging markets. Earnings forecasts in Europe have been revised downwards, in some cases drastically. All countries with weak earnings growth have underperformed the global average in recent weeks.

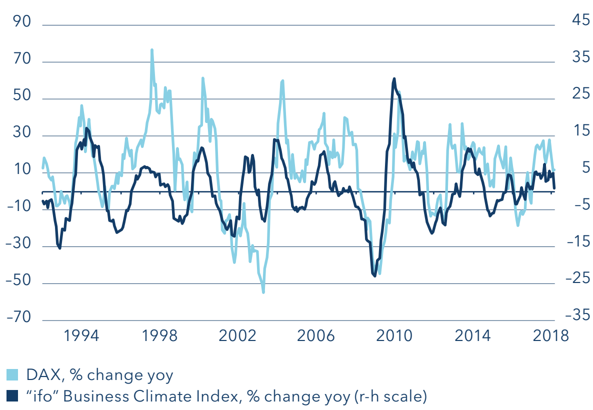
We expect equity markets to exhibit stronger divergences in the months ahead. Investors are focusing increasingly on earnings growth and stable dividends. Optically good valuation levels are no guarantee of a rewarding equity investment. Europe faces challenging times, especially now that the German powerhouse is starting to flag. German earnings expectations for this year have dropped dramatically, and Germany is also in the firing line of transatlantic trade tensions. These problems are reflected in the current retreat of the "ifo" Business Climate Index.

Germany's bellwether equity index, the DAX, is heavily dependent on business climate expectations. A falling "ifo" score generally precipitates a reduction of the rolling annual return on the DAX. In these circumstances it is hard to envisage the German equity market posting an above-average performance, at least in the short term. The "ifo" index also feeds through into various international economic indicators – not exactly good medicine for equity investors.

Earnings growth 2018



DAX and the business climate



Equities facing strategic headwind

The normalisation of US central bank policy is starting to bite. Yields on two-year US Treasuries have hit a 10-year high and are almost twice the level of two years ago. Forecasts for ten-year Treasury yields are also now nudging the 3% mark. Today's borrowing costs are not yet a problem for many companies, but the recent fall in automobile sales in the US is directly attributable to rising credit costs for car buyers. Increased share price fluctuations are also likely to push up credit risk premiums. This gradual accumulation of small effects means that companies are facing higher borrowing costs, which eat into profits.

New trade barriers are an additional burden. Donald Trump's decision to slap higher tariffs on US steel imports makes little sense economically. A recent OECD study underlines the fact that restrictions on international trade have a direct negative impact on global economic growth. The operational fall-out can be drastic, depending on the countries and industries concerned.

Higher import tariffs for steel will hit steel-using US manufacturers, who employ fifty times as many people as the steel industry itself. The American automobile and construction sectors take around two-thirds of US steel production. The main contributor to the US trade deficit, namely China (accounting for over 45% of the shortfall), will not be affected to anything like the same degree. Only 2% of Chinese steel exports go to the US. It is to be hoped that the affected countries will react calmly, so that the trade rift can be contained and defused. An escalation would spread the pain to other industries, such as electronics, clothing and food. America runs big trade surpluses in electronic consumer goods and food and would therefore feel the negative effects very strongly.

Conclusion

We are still positive about equities, but we believe that the current consolidation could have some way to go. Measured by the S&P 500, comparable corrections in the past (2010, 2011, 2015 to 2016) lasted three to six months and involved market losses of 15% to 21%. Barring an exacerbation of the trade conflict, the US market is therefore still carrying downside potential of between 8% and 10%.

Highlights

- The equity market environment is still positive but is becoming more challenging.
- Investors should focus on companies with strong balance sheets, good growth and stable dividends.
- We regard the following themes as promising:
  - VP Bank Swiss Dividend Basket
  - Telecoms shares – enhanced earnings momentum
  - Energy efficiency – a new doorway to environmental protection
  - Robotics-based automation.

This year investors should focus on the optimisation of overall returns, favouring companies with strong balance sheets and stable dividends. Swiss firms with tax-free dividend payments are attractive in this context. We would also highlight the European and US telecoms sectors, which have experienced a sharp rise in earnings momentum over the last three months. Lower capital spending is improving these companies' free cash flow, a development that is not yet reflected in their share prices. In the current environment, telecoms are therefore an exciting tactical play, not only for dynamic investors but also for those who adopt a defensive long-term approach.

MSCI benchmark	Current forecast	% YTD[1]
Switzerland	→	-4.20%
Europe	→	0.09%
North America	→	3.96%
Pacific (incl. Japan)	→	1.58%
Emerging markets	→	5.73%

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

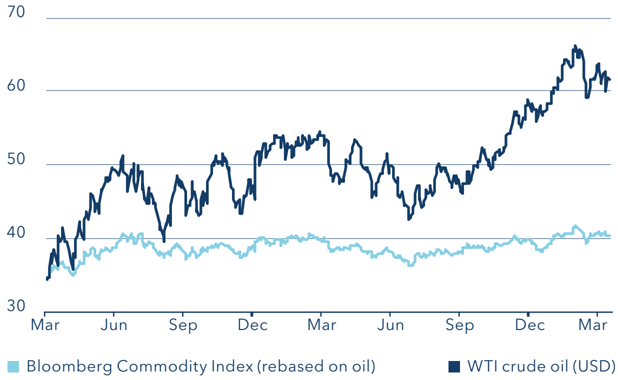
[1] As of 12.03.2018; net return in local currency incl. dividends

2. ASSET CLASSES

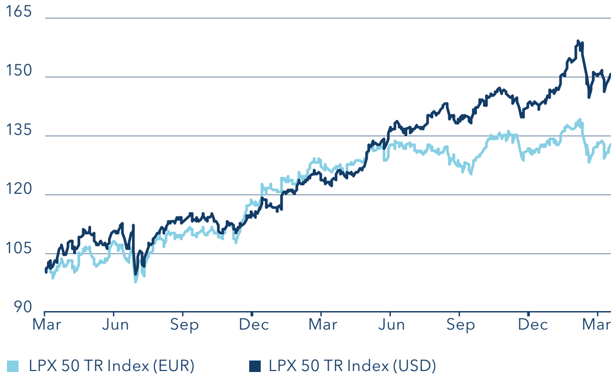
Alternative investments

Alternative investments – overview

Commodities: performance since March 2016

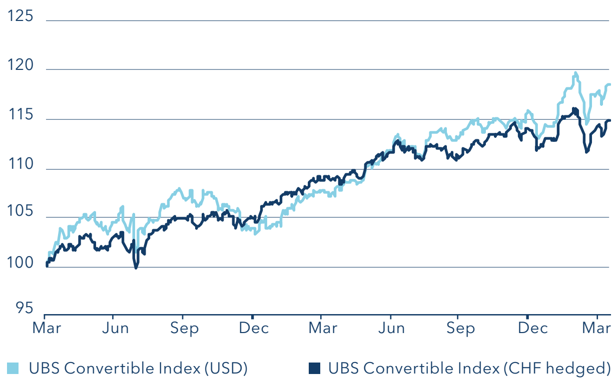


Private equity: performance since March 2016 (indexed)

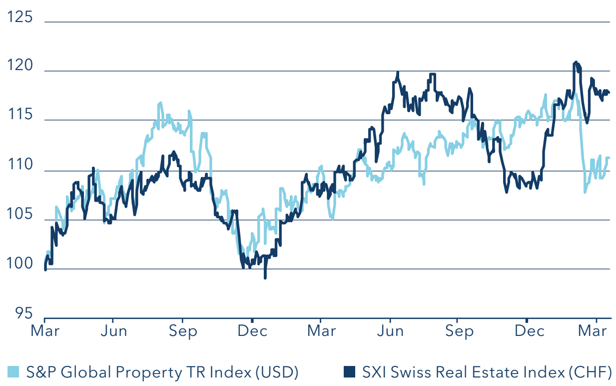


Precious metals: performance since March 2016

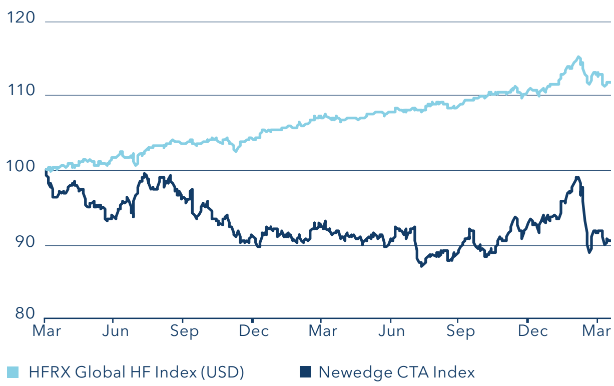
Convertible bonds: performance since March 2016 (indexed)



Real estate: performance since March 2016 (indexed)



Hedge funds: performance since March 2016 (indexed)



Investing when markets are high

THE BULL MARKET IN EQUITIES HAS CELEBRATED ITS NINTH BIRTHDAY. BUT THE RECENT CORRECTION REMINDS US THAT SECURITIES MARKETS ARE NOT A ONE-WAY STREET. ALTERNATIVE INVESTMENTS CAN HELP CUSHION SETBACKS.

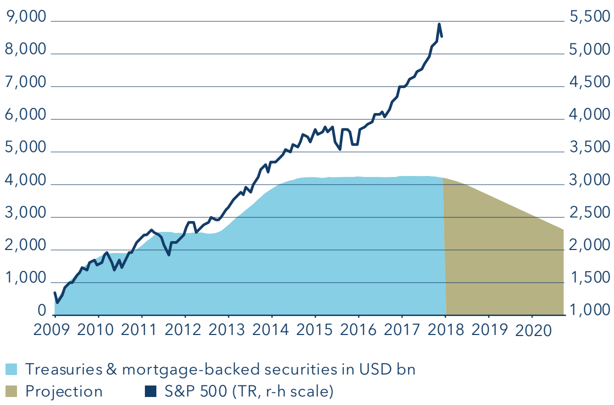
The main argument for including alternative asset classes in an investment portfolio is the diversification effect. Diversification is created by adding new sources of return. In the ideal case, the diversifying asset will rise in value when other portfolio components fall. This enhances the portfolio's stability and efficiency amid fluctuating asset prices.

Bonds losing their corrective role

Fixed-income investments used to perform the function of offsetting falls in equity prices. When equity markets corrected, the flight into "safe haven" government bonds pushed yields downwards, resulting in capital gains on bond holdings. It could also be realistically expected that central banks would react by easing policy. Mixed portfolios of equities and bonds therefore functioned well in the past, because at least one of the two asset classes would be performing positively.

This situation looks set to change in 2018. Resurgent US inflation could force the Fed to respond faster and more emphatically than previously assumed. That would result in capital losses in both the equity and the bond markets. The correction in February was a foretaste of what the future might have in store.

Fed balance sheet and equity prices



Possible alternatives

This explains the growing popularity of alternative investments. However, the diversification effect and the risks involved vary greatly depending on the instruments chosen and the method of implementation. Below we present a summary of possible alternative investments and explain the points to watch when investing.

Insurance-linked securities (ILSs) and CAT bonds

Catastrophe (CAT) bonds and other insurance-linked securities are securitised reinsurance instruments relating to natural disasters and other insurance risks. They have little or no correlation with traditional capital market investments. These instruments usually take the form of direct reinsurance contracts with maturities of one to two years. The investment amount is deposited by a special-purpose vehicle in a blocked account and invested in the money market. If no loss occurs, the principal is paid back to the investor together with interest and the insurance premium. Thus the investor enjoys the benefits of rising interest rates and excellent diversification vis-à-vis all other asset classes.

Private equity

Direct private equity investments tie up money for a very long period and are therefore mainly the preserve of institutional investors. Individual investors, however, can gain access to this market via listed private equity vehicles. As private equity usually involves the use of debt capital, risks are higher than in the equity market. Moreover, the diversification effects are modest. An important driver of returns in this sector is corporate transformation. Stock exchange flotations also generate major profit potential.

Private debt

Private debt investments (suitable only for professional investors) consist of portfolios of loans to small and medium-sized enterprises. Increasingly stringent capital adequacy rules have forced banks to scale down their lending, and the private debt sector has stepped into the breach. Private debt managers specialise in credit collateralisation and are able to shape loans with customised credit clauses. These highly secured loans therefore have a lower default rate than speculative bonds (high yield) and enjoy significantly higher recovery rates. At 5% to 7% over Libor, interest rates are also higher, while maturities are much longer.

Real estate

The range of available real estate investments is very large. A distinction has to be made between direct real estate investments and indirect exposures via investment funds, real estate investment trusts (REITs) or private equity funds. Besides equity exposures, investments can also take the form of debt or mezzanine (debt-equity hybrid) financing. The main possibilities for private investors are liquid real estate funds and REITs. The latter make extensive use of debt financing, resulting in leverage ratios of up to 80%, which makes them riskier than equities. Swiss real estate funds, by contrast, use little or no debt capital, a fact that has to be taken into account when comparing performance. The advantage of real estate investments is that rental income is much higher than government bond yields, which are subject to manipulation by central banks. The disadvantage is their high correlation with equities, which diminishes the diversification effect. Real estate, like equities, is affected by macroeconomic performance.

Convertible bonds

Convertible bonds are debt securities that can be converted into shares of the borrowing company. They offer a way of profiting from a rising equity market at limited risk. If the share price falls and no conversion occurs, repayment is made in the same way as for a straight bond. This "bond floor" places a firm limit on the risk of loss (provided the company remains solvent). As a rule of thumb, investors enjoy a two-thirds participation in a rising equity market but participate by only about a third if the market falls. Thus convertibles enable investors to gain an exposure to the equity market at this late stage of the cycle with a reduced risk of loss.

Commodities

Alongside indirect investments via shares in commodity companies, almost all classes of commodity are now accessible for private investors via ETFs and certificates. These instruments used to be confined almost exclusively to precious metals. An important feature of commodities, which are always traded on futures markets, is that contracts have to be rolled over as they expire, i.e. sold in exchange for a new contract for a more distant date. This can lead to "roll profits" or "roll losses" depending on the commodity involved and the supply and demand situation. Over the long term, price rises in all commodity groups are wiped out by roll losses, but there have also been numerous periods in which strong gains have been achievable. The diversification effect of commodities is above average but varies greatly depending on the portfolio structure and commodity concerned. Commodities in the energy sector, for example, are an excellent inflation hedge for a bond portfolio.

Hedge funds

Hedge funds come in a multitude of guises, with over 10,000 managers now operating in this field. Private investors are frequently disappointed by the diversification benefits and the returns achieved. Expectations regarding performance are often too high. Management costs are high but have come down considerably in recent years. The diversification effect varies greatly depending on the provider and the investment style employed. Styles like "global macro", "equity market neutral" and "managed futures" (CTAs) generally have the best diversification qualities.

Conclusion

Alternative asset classes can step into the breach left by the lost diversification effect of bond investments. Various possibilities are available, depending on the underlying portfolio and the investor's objectives. Your client adviser will be pleased to provide more information.

Benchmark	Current forecast	% YTD[1]
Commodities	→	–0.26%
Gold	→	1.76%
Crude oil	↗	1.53%
Commercial real estate	→	–4.45%
Private equity	→	0.52%
Convertible bonds	→	3.93%
Hedge funds	↗	0.62%

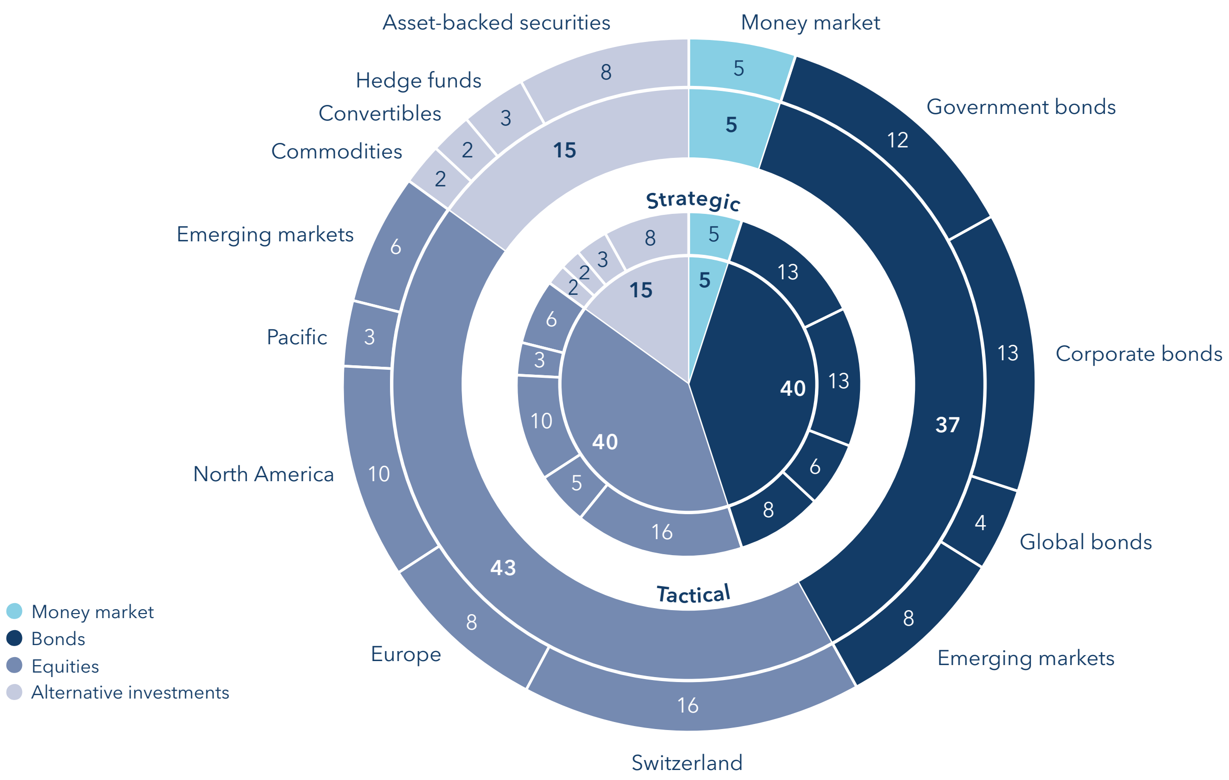
Upside/downside ranges indicated by our 3–6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

[1] As of 12.03.2018

3. INVESTMENT MANAGEMENT

Investment management portfolios

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



VP Bank Strategy Funds

Product name	Curr.	ISIN	NAV date	NAV	Payout	Currency hedged	YTD perf. %
VP Bank Strategy Fund Conservative (CHF)	CHF	LI0017957502	09.03.2018	1,062.85	no	yes	–2.04%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	09.03.2018	1,412.34	no	yes	–1.75%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	09.03.2018	1,375.36	no	yes	–1.27%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	09.03.2018	1,588.20	no	yes	–2.42%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	09.03.2018	994.76	no	yes	–1.94%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	09.03.2018	1,577.08	no	yes	–0.82%

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

Current investment tactics

Current investment tactics

US plans to slap tariffs on steel and aluminium imports have fuelled renewed uncertainty on the equity markets. The direct consequences are fairly clear, but there are growing worries that other countries might retaliate by imposing punitive tariffs of their own. That could prompt further actions by the US, plunging the world into a period of global trade conflict. At present, however, we do not expect such a scenario to materialise. We therefore reaffirm our current positioning and remain overweight in European equities and underweight in bonds.

Equity markets have been rocked by a spate of gloom-mongering since the start of this year. The first correction was triggered by jitters about interest rates and inflation. The second instalment came when markets were spooked by America's planned import tariffs and fears of retaliation by other countries. We do not see this as a long-term change of trend. Despite a slight dip in the leading indicators, the macroeconomic environment is robust. Global economic momentum is unabated. Conditions should therefore stay supportive for European equities. Moreover, the transatlantic interest rate gap should favour the US dollar versus the euro. We expect a moderate rise in bond yields, which justifies our underweight position.

Bonds

Recent yield trends have been synchronous: rising yields in the US – rising yields in Europe.

Increased inflation expectations in the US have led to a sharp backup of bond yields. The futures markets are now pricing in further key interest rate hikes in 2019 and 2020. While the US interest rate outlook is upwards, the scope for rises in the eurozone and Switzerland is limited by low inflation. Even so, we are keeping duration below benchmark in all reference currencies. Overall we remain underweight in investment grade bonds and neutrally weighted in emerging market bonds.

We are maintaining our position in inflation-linked bonds.

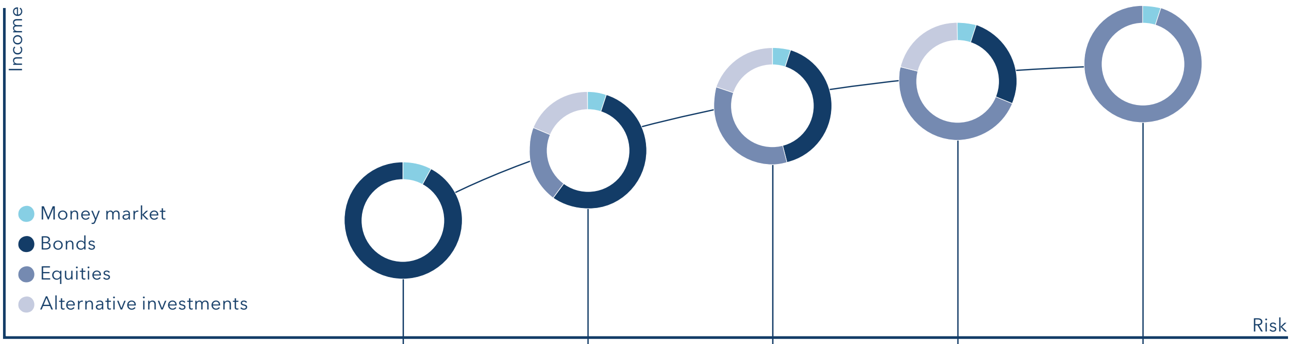
Equities

The upswing in economic activity has been reflected in a significant rise in US corporate earnings expectations. This is evidenced by corporate surveys and analysts' estimates. European equities should benefit from their lower valuations compared with the US. The eurozone still has catch-up potential vis-à-vis America, despite a recent slight fall in European earnings forecasts. Further support is provided by the relatively high dividend yield compared with bonds. Meanwhile, emerging markets are enjoying continuous earnings growth.

Alternative investments and currencies

We hold positions in alternative investments, notably commodities, convertible bonds and hedge funds, as a useful portfolio component providing risk diversification. These categories are weighted at neutral. We have an open USD position in our EUR- and CHF-based portfolios. Otherwise currencies of the major developed countries remain hedged.

Our solutions



Features	Fixed-income	Conservative	Balanced	Growth	Equity
Equity allocation	0%	10–30%	20–50%	30–70%	80–100%
Investment horizon	3 years	5 years	7 years	10 years	15 years
Need for security	●●●●●	●●●●○	●●●○○	●●○○○	●○○○○
Expected return	●○○○○	●●○○○	●●●○○	●●●●○	●●●●●

Investment solutions	Fixed-income	Conservative	Balanced	Growth	Equity
Strategy Fund from 1 unit		●	●		
Fund Mandate from CHF 250,000	●	●	●	●	●
Classic Mandate from CHF 1 million	●	●	●	●	●
Special and Sustainability Mandate from CHF 2 million	●	●	●	●	●
Enhanced Mandate from CHF 5 million		●	●	●	

Legal note on page 29

4. APPENDIX

Contributors


Bernhard Allgäuer
Senior Investment Strategist


Christoph Boner
Head of Investment Management


Harald Brandl
Senior Equity Strategist


Thomas Gitzel
Senior Economist


Bernd Hartmann
Head of Group Investment Research


Rolf Kuster
Senior Investment Strategist


Aurelia Schmitt-Marxer
Head of Investment Management
Liechtenstein

Legal note on page 29

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	26, Avenue de la Liberté · L-1930 Luxembourg · 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 (Singapore) Ltd	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 Bank (Switzerland) Ltd Moscow Representative Office	World Trade Center · Office building 2 · Entrance 7 · 5th Floor · Office 511 12 Krasnopresnenskaya Embankment · 123610 Moscow · Russian Federation T +7 495 967 00 95 · F +7 495 967 00 98 · info.ru@vpbank.com
VP Fund Solutions (Luxembourg) SA	26, Avenue de la Liberté · L-1930 Luxembourg · 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
Group Investment Research
VP Bank Ltd
Aeulestrasse 6
9490 Vaduz
T +423 235 61 73
F +423 235 76 21
investmentviews@vpbank.com

Editors and contributors
Stefan Schwitter, Head of Group Investment, Product & Market Management
Bernd Hartmann, Head of Group Investment Research
Dr Thomas Gitzel, Senior Economist
Rolf Kuster, Senior Investment Strategist
Marcello Musio, Senior Equity Analyst
Harald Brandl, Senior Equity Strategist
Bernhard Allgäuer, Senior Investment Strategist
Christoph Boner, Head of Investment Management
Aurelia Schmitt-Marxer, Head of Investment Management Liechtenstein
Christina Strutz, Office & Publication Manager

Periodicity
Quarterly

Publication date
26 March 2018

This publication was finalised on
23 March 2018

Closing prices as at
12 March 2018, 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

FSC www.fsc.org MIX Paper from responsible sources FSC® C013308

Swiss Climate climateneutral printing SC2017120603 • www.swissclimate.ch