4th quarter 2018

Investment Views

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Current market assessment

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

	Q3 forecast	Current forecast	
Money market and currencies (pages 6–9)			
Currencies			
EUR vs. USD	→	→	
EUR vs. CHF	→	→	
USD vs. CHF	→	→	
GBP vs. USD	↗	↗	
USD vs. JPY	↗	↗	
AUD vs. USD	↗	↗	
USD vs. SGD	↗	↗	
USD vs. RUB	→	→	
Key interest rates			
Switzerland	→	→	
Europe (EMU)	→	→	
USA	↗	↗	
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	↗	→	New
Europe	↗	→	New
North America	↗	→	New
Pacific	↗	→	New
Emerging markets	↗	→	New
Alternative investments (pages 18–21)			
Commodities	→	→	
Crude oil	→	→	
Gold	↗	↗	
Real estate shares	→	→	
Private equity	→	→	
Convertible bonds	→	→	
Hedge funds	↗	↗	

// Preparing your portfolio for future challenges //

Bernd Hartmann
Head of Group Investment Research

Dear Reader

2018 has seen a record breaking summer. But sustained sunshine has brought extreme heat and a lack of rain, leading to drought conditions in some parts of Europe. A similarly ambivalent picture can be seen in the financial markets, which face a more challenging future after the sparkling gains achieved in recent years.

Bull markets in almost all classes of asset have reached an advanced stage. This, combined with the phasing-out of monetary support for the markets, indicates a tougher investment environment ahead. At the same time, elevated valuation levels are impairing upside potential.

How should investors react? Disinvestment is a bad option. A better approach is to review the investment portfolio and ensure that it is optimally positioned to cope with a more difficult environment. In this issue of Investment Views we explain what that means in practice and where we discern the risks and opportunities. Our motto is: "Be prepared!"

1. SPOTLIGHT

Making your portfolio stormproof

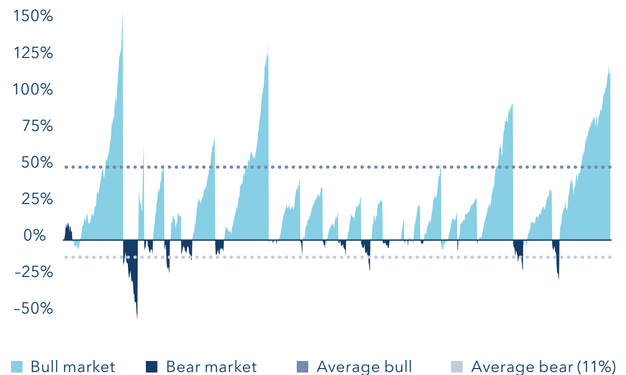
STRONG TRENDS IN RECENT YEARS HAVE PRODUCED ABOVE-AVERAGE GAINS ON THE FINANCIAL MARKETS. BUT CONDITIONS ARE NOW GETTING MORE CHALLENGING, AND RISK MANAGEMENT IS COMING TO THE FORE. INVESTORS SHOULD REVIEW THEIR PORTFOLIOS TO ENSURE THAT THEY ARE FIT FOR A TOUGHER FUTURE.

Since the end of the financial crisis the financial market environment has been close to ideal. Moderate economic growth and negligible inflationary pressures have legitimised the central banks' reflation policies. This has been good news for almost all asset classes, leading to a "bull market in everything", as the UK weekly The Economist has aptly put it. The fall in bond yields as a result of central bank asset purchase programmes has enabled bond investors to achieve enormous capital gains. At the same time the resultant yield famine has encouraged investors to move into corporate bonds and risk assets such as equities. Looked at historically, the current bull market in US equities is already exceptionally long-lived. The last 100 years have seen only one phase with stronger gains. The bull run in bonds is unprecedented. Yields in the US have been in decline since the early 1980s and in Europe since the mid-1990s.

Phases of above-average capital gains have occurred time and again in the history of the financial markets. What is special about developments in recent years is that both equities and bonds have posted exceptional advances over a protracted period while inflation – unlike in earlier booms – has been extremely moderate.

Sustained buoyant conditions have not been confined to the financial markets. Many countries have also experienced an unusually long economic upswing. This applies especially to the US, where the economy has been growing year on year since 2010.

Cumulative performance of a mixed US portfolio



Portfolio consisting of 50% equities and 50% corporate bonds; cumulative gains and losses

Markets in transition

The past years' gains have been a boon for investors, but now they are becoming a stumbling block. Climbing asset prices have pushed up valuation ratios in virtually all classes of investment, reducing their further upside potential.

The capital market environment is also changing, spearheaded by the US Fed. Seven interest rate hikes have brought US borrowing costs close to a neutral level. Since the autumn of 2017 the Fed has also been gradually scaling down the reinvestment of maturing securities. It has thus become the first major central bank to start reversing the prodigious expansion of its balance sheet that occurred as a result of its counter-crisis measures. Other central banks are still some way behind on the path towards normalisation, but the flow of liquidity from the major central banks is steadily being reduced and will shift into negative next year.

This gradual change of course not only affects the markets in which the central banks have intervened directly. Since the Fed started on the phased downsizing of its balance sheet, we have seen an increase in equity market volatility, albeit from an unusually low level.

Facing up to the risks

Given these changes in the capital market environment, investors need to focus more systematically on potential risks. The move away from expansionary monetary policies presents a major challenge. Monetary normali-

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sation in the US has so far proceeded without problems, but it is not clear that this will still be the case when other central banks follow suit and likewise adopt a more restrictive stance. That could have a substantial braking effect.

The fact is that we are in uncharted waters. A key factor is bond yields, which have been depressed by central bank purchases. Cheap money has pushed global debt to an even higher level than at the time of the financial crisis. This makes the economy and the public sector more vulnerable to an upturn in borrowing costs.

Although there are no immediate signs of recession, the longer the boom lasts the greater is the probability of an economic slowdown. The setback does not have to be as severe as after the financial crisis ten years ago, but the mountain of debt in many countries and/or the continuing expansionary slant of monetary policy reduces the fiscal and monetary scope for counter-measures. Added to this are smouldering structural problems. Imbalances in the eurozone, for example, could flare up again in the event of serious economic difficulties.

Income inequality is fuelling dissatisfaction in large parts of the population and poses a threat to social cohesion. Political extremists on the left and right thrive in this situation, and their unbridled ideas are often inimical to economic prosperity. Many countries are already showing trends towards protectionism and nationalism.

Disinvestment is a bad choice

Looming risks may prompt investors to get out of the market entirely. But it is still unclear whether, when and in what form the risks will materialise. Heightened risks and increased volatility do not lead directly to negative returns, especially in a solid environment of robust economic activity and strong earnings growth. Equity valuations are admittedly historically high, but they are not extreme. The same cannot be said with equal conviction of bond yields, but central banks will not quit the field precipitately.

Numerous studies show that in the long term it pays to be invested. Investors receive a return to compensate them for the risks they take. Premature exiting from the market can involve substantial opportunity costs in the form of lost returns. Rising optimism in a mature market leads to handsome capital gains, whereas holding cash for a long period results in a creeping erosion of wealth. Inflation (albeit low at present), combined with rock-bottom interest rates in many currencies, eats into the real purchasing power of cash assets.

What should investors do?

We basically advise investors to stay in the market but to carefully examine their portfolios with reference to risks, weightings and individual positions. Strong gains in recent years may have radically altered the portfolio's structure.

Investors should therefore now pay greater attention to risk management but should also be ready to seize opportunities as they arise. Tougher phases on the markets provide useful openings for vigilant players. Market retreats can be used to make tactical equity purchases, while heightened volatility might enhance the appeal of specific structured products. In phases of strong confidence and narrow fluctuations, we advise partial hedging. Systematic writing of equity options can also be a way of earning an additional return.

Conclusion

After a long period of strong advances, the air on the financial markets is getting thinner and expected gains are no longer as high as in recent years. Central banks' reflationary policies are being phased out. Risks are looming on the horizon, though the fundamentals remain positive.

Investors should stay in the market but should ensure that their portfolios are fit to deal with more difficult conditions ahead. Risks need to be identified and calibrated, and mature-cycle opportunities should be exploited. VP Bank will be pleased to help you analyse your portfolio and ensure that it is fit for the future.

Harsher weather ahead

THE SITUATION IS GETTING TOUGHER. TROUBLES AFFECTING THE FINANCIAL MARKETS ARE ON THE INCREASE. TURKEY IS ALREADY IN A FULL-BLOWN CRISIS.

As autumn winds start to blow, the weather on the financial markets is also getting harsher. The recent signs of crisis in Turkey highlight the possibility of storms ahead. Current problems are manifesting themselves in an incipient shortage of US dollars. This seems counter-intuitive. How can the dollar be in short supply if it can be bought anywhere in the world at the current exchange rate? The answer lies in actions being taken by the Fed, which is now engaged in downsizing its balance sheet. Quantitative easing has been replaced by quantitative tightening. The Fed is taking back the money it printed during the crisis years, and its balance sheet is contracting by USD 50 billion a month soon.

Shrinking Fed balance sheet

We have made a rough estimate of the change in global US dollar money supply. This aggregate comprises the monetary base directly controllable by the Fed plus the US dollar reserves held at the Fed by foreign central banks. By factoring in the US inflation rate, we can express the aggregate in real terms. This might all sound rather technical, but the result is simple: real US dollar money supply is shrinking. Thus the unwinding of America's expansionary monetary policy is in full swing. This makes life harder for countries that are running a deep deficit on their current account (chiefly reflected in the trade balance) and which therefore need a steady inflow of US dollars to cover it. Turkey and Argentina are cases in point. The problem is reflected in high levels of foreign debt. Low foreign exchange reserves in both countries make the situation even more fraught.

Highlights

- Storm warnings are sounding in the emerging markets. The main focus is on Turkey.
- But the situation in the emerging world is much more diverse than it was in the 1980s and 1990s.
- The good news is that the global economy as a whole is relatively robust.

Threat of a general emerging markets crisis?

The emerging markets should not all be tarred with the same brush. Economic conditions in the emerging world are much more heterogeneous than they were in the 1980s and 1990s. Asia is now the breeding ground of important future technologies. Many Asian countries are running handsome current account surpluses. In South America, even much-maligned Brazil can now boast a trade surplus and an historically low level of foreign debt. A full-blown emerging market tsunami is therefore unlikely. That said, the risk of a default in the Turkish banking sector remains high. Argentina agreed a standby arrangement with the IMF in June, providing the country with a financial lifebelt.

Storm-resistant global economy

The positive news is that the world economy as a whole is in good shape to cope with harsher conditions. Squalls in the emerging markets are rattling the windows of the developed world but will not cause the house to collapse. The US economy is gaining momentum, and the eurozone will also post solid GDP growth this year. Switzerland's growth rate will hit a four-year high. Thus the current picture is chequered. Seen as a whole, the global economy is doing relatively well, but major stresses are observable in some quarters. Investors are therefore advised to avoid concentrated risks and maintain a broad mix of asset classes.

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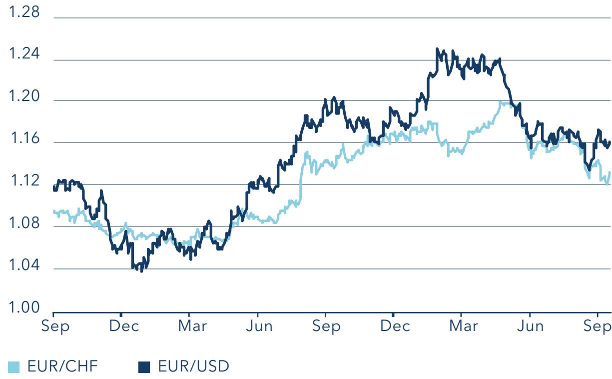
2. ASSET CLASSES

Money market and currencies

Market overview

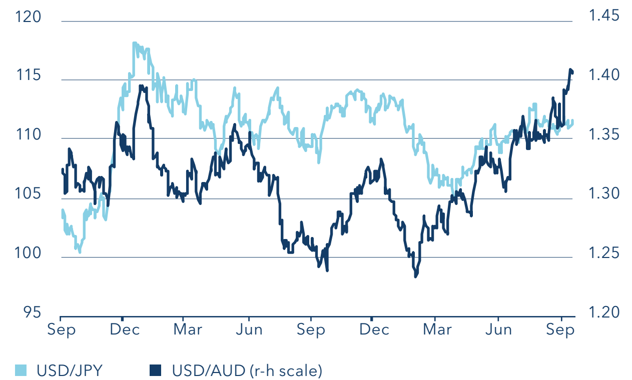
EUR/CHF and EUR/USD: exchange rates since September 2016



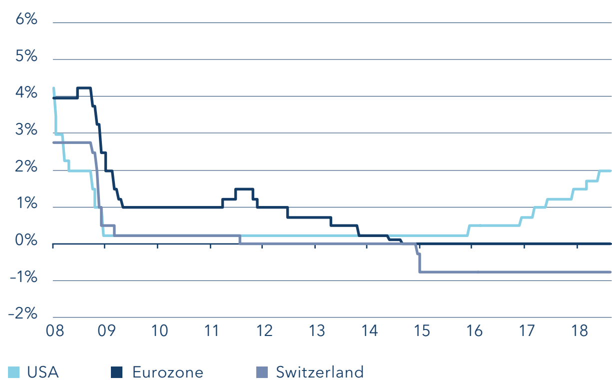
USD/CHF: exchange rate since September 2016

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

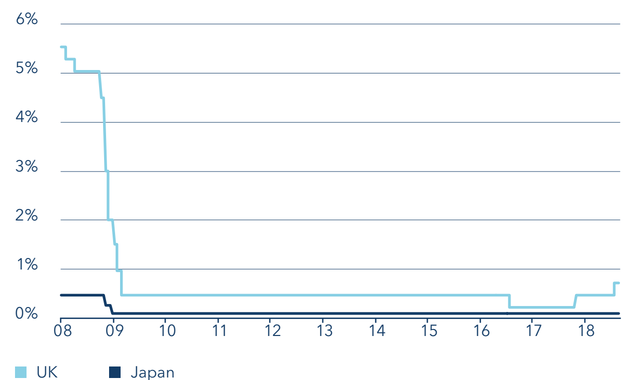
USD/JPY and USD/AUD: exchange rates since September 2016



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



Key interest rates in UK and Japan: since January 2008



US dollar: safe haven currency no. 1

THE ECONOMIC SITUATION IN TURKEY REMAINS CRITICAL. HIGH FOREIGN DEBT IS THE MAJOR OBSTACLE TO PROGRESS. TURKEY'S TRIBULATIONS HAVE HIGHLIGHTED THE VITAL ROLE OF THE US DOLLAR IN TIMES OF CRISIS.

Fears of a default by Turkey in August provided a vivid illustration of the US dollar's status as the world's top safe haven currency. As worries about Turkey grew, the greenback surged on the world's forex markets. This was not due to America's excellent macroeconomic numbers (the US also has a comparatively high level of public debt) but primarily to that fact that the dollar is a liquid currency universally acceptable as a medium of payment. Many sectors of the capital markets simply dry up in a crisis, with trading coming to a halt. But even in the most turbulent times on the financial markets the US dollar is available in sufficient quantities – in other words the currency is liquid. The US is not only the world's largest economy but also has the benefit of a truly convertible currency. The dollar's unique standing results in behaviour that at first sight looks paradoxical: the greenback appreciates in a crisis even if the cause of the crisis lies in the US itself. In September 2008 the US financial system was shaken to the core by the collapse of Lehman Brothers, but the dollar reacted by gaining almost 30% against the euro. The only thing that mattered at that point was liquidity.

Turkey: trouble on the Bosporus

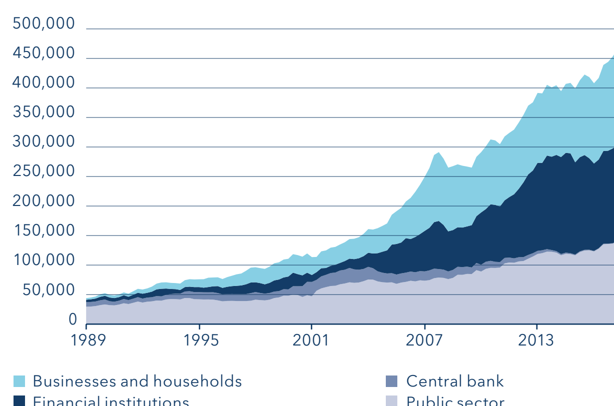
Let's look now at the situation on the Bosporus. The Turkish economy is sitting on a volcano. A crumbling currency and high foreign debt are an explosive mix. But it is worth considering the background. Just a few years ago many analysts saw Turkey as a new "tiger economy". The original tigers were the fast-growing economies of South Korea, Taiwan, Singapore and Hong Kong, but Turkey's growth rate of over 10% earned it membership of the tiger league.

This success was largely due to the efforts of Recep Tayyip Erdogan, Prime Minister until 2014 and since then President. It was Erdogan who initiated Turkey's application to join the EU. He liberalised the economy and committed the government to strict budget discipline. Thanks to these policies, Turkey became a prime favourite for international companies. Direct investment poured into the country. But now the situation has gone into reverse. Erdogan's increasingly autocratic style of government has alarmed not only the EU but also the financial markets. The result: Brussels is reviewing Turkey's membership application and the Turkish lira is plummeting. The lira's fall accelerated when Erdogan threatened to curtail the independence of Turkey's central bank, leading to a full-blown currency collapse in August when the European Central Bank expressed concern about possible contagious effects on Europe's financial system. The imposition of additional US tariffs on Turkish goods poured oil on the fire.

The millstone of foreign currency debt

The collapse of the lira makes it harder for Turkey to service its foreign currency liabilities. The focus of attention is less on public sector debt than on borrowings by the private sector. The public sector's foreign debt amounts to 14% of GDP, compared with 45% of GDP for the private sector. Figures published by Turkey's central bank show that most of these liabilities are denominated in US dollars. In absolute terms Turkey's total foreign debt amounts to almost USD 467 billion, of which USD 325 billion is owed by private borrowers and the remaining USD 142 billion by the public sector, i.e. the central government and local authorities. By comparison, the country's currency reserves are just under USD 80 billion.

Turkey's foreign debt (USD millions)



Highlights

- The US dollar is the world's number 1 safe refuge currency in times of crisis.
- The decisive factor in an uncertain environment is liquidity, i.e. a currency's tradability.
- The recent turbulence surrounding Turkey has highlighted the greenback's propensity to profit from crisis conditions.

The relation of public sector foreign debt to Turkey's currency reserves makes a government default unlikely, but the financial market crisis of 2008 has taught us how quickly private liabilities can be transmogrified into public debt. If a Turkish bank were in danger of collapse, a government bailout would be very likely. That means that debt would be transferred from the private to the public sector. Thus the distinction between public debt and the liabilities of the financial and corporate sector does not really hold water.

The situation could become even more precarious if the inflow of foreign exchange into Turkey's banking sector were to stall. Banks provide liquidity to each other in the form of short-term credit. If international banks started to cut their USD or EUR lending facilities to Turkish banks, the latter could have difficulty honouring maturing liabilities, ultimately leading to a default in the financial sector. The situation has been defused to some extent by measures taken by Turkey's central bank and financial assistance from Qatar. The central bank has tightened the rules on currency hedging, while the central banks of Qatar and Turkey have made an agreement that ensures Turkish access to urgently needed US dollar liquidity. But none of this removes the underlying problems. The situation therefore remains difficult.

Conclusion

The Turkish imbroglio has reconfirmed the US dollar's status as the world's top safe haven currency in times of crisis. The flight into dollars is due mainly to the greenback's liquidity, i.e. the fact that the dollar is available in large quantities and can therefore be traded easily even in difficult circumstances. The maturing of the business cycle and heightened stresses and strains in the financial markets make it increasingly advisable for investors to hold US dollar positions. Trouble on the Bosporus is by no means over. History shows that countries with high foreign currency debts not infrequently slip into default.

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

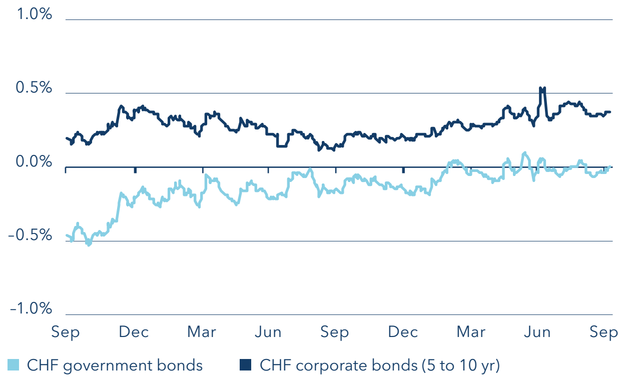
Upside/downside ranges indicated by our 3–6 month interest rate forecasts:
↑ > +50 basis points ↗ +25 basis points
↘ –25 basis points ↓ < –50 basis points → No change

2. ASSET CLASSES

Bonds

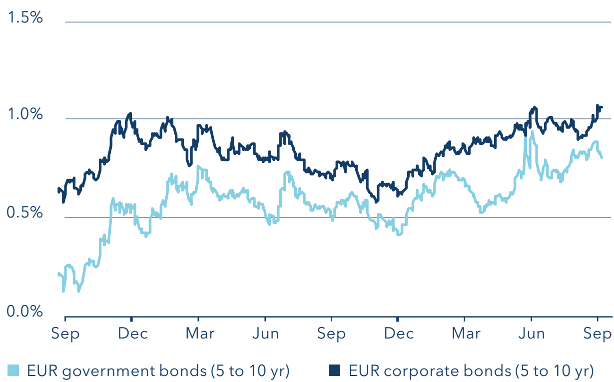
Bond yields – overview

Switzerland: yields since September 2016

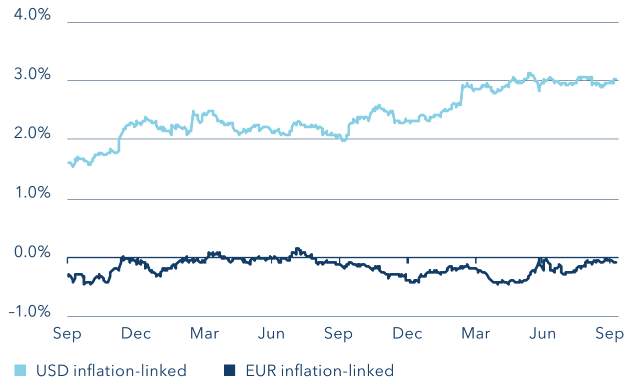


Emerging markets: yields since September 2016

Europe: yields since September 2016



Inflation-linked bonds: yields since September 2016



USA: yields since September 2016

High yield: yields since September 2016

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Dealing with the prospect of higher yields

THE AIR IS GETTING THIN ON THE FIXED-INCOME MARKETS. BOND INVESTORS FACE THE THREAT OF CAPITAL LOSSES THIS YEAR. HEIGHTENED RISKS ON THE FINANCIAL MARKETS USUALLY MEAN HIGHER YIELDS – BUT THE SITUATION ON THE BOND MARKETS HAS RECENTLY BEEN JUST THE OPPOSITE.

Investors are currently getting little or no compensation for lengthier maturities or higher credit risks. Revised valuations could lead to painful losses. We recommend taking a close look at the portfolio's risk profile and establishing supplementary positions in alternative bond strategies.

Duration and credit risk

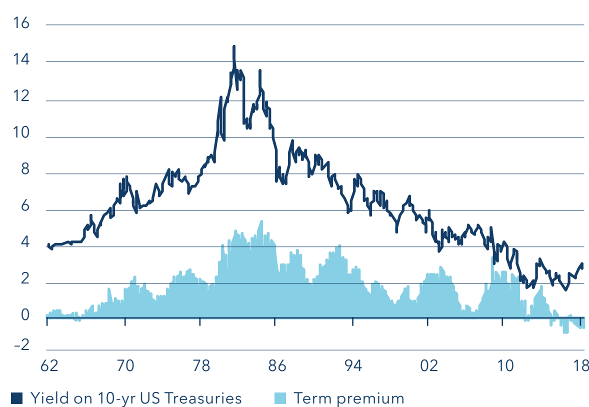
Traditionally, the two key metrics for bond strategies are duration (which measures the risk of a change in interest rates) and credit risk (the risk of borrowers' defaulting on their commitments). Although exposure to these risks produces slightly higher yields to maturity, we recommend against such a tactic at the present time. Rising risk-free yields and widening credit spreads can quickly wipe out several years' worth of coupons.

Duration – interest rate risk

Yields on government bonds can be divided into two components: a) expectations regarding the future course of short-term interest rates and b) the "term premium". If the future course of short-term interest rates were already known, the fair yield on a 10-year government bond would be easy to calculate. However, as interest rates can rise unexpectedly, in a normal environment long-dated bonds offer higher yields, i.e. they carry a term premium.

Parallel movements in this extra yield can be seen across the regions. "Risk-free" government bonds were in heavy demand after the financial crisis, supported by tighter rules on capital ratio requirements for banks and insurance companies and also by the unorthodox monetary policies being pursued by central banks. Historically, the term premium has accounted for up to two-thirds of the coupon, but currently it is negative. The US Fed started to raise the fed funds rate in 2015 and has implemented seven hikes so far. The market is pricing in three further rises by the end of next year. The European Central Bank (ECB) is expected to terminate its asset purchase programme in December. The phasing out of unconventional monetary policies has two key effects. As well as affecting expectations regarding future money market interest rates, the normalisation of monetary policy should lead to a recovery of term premiums worldwide. With term premiums currently negative and interest rates set to rise, an exposure to long maturities is therefore unattractive at present.

Term premiums: an historical overview



Source: VP Bank, Federal Reserve Bank of New York

Credit risk

The policy of cheap money was especially useful for companies with large debts. As risk-free interest rates fell, credit spreads also contracted. Lower interest rates encouraged companies to borrow more heavily – balance sheets became more highly leveraged. In other words, the corporate sector has become riskier. Corporate debt in the US has risen from USD 6 trillion in 2010 to USD 9 trillion at present, far outstripping economic growth. The current cyclical expansion has already lasted nine years, making it the second longest since World War II. Unemployment in the US has fallen from 10% to below 4%, provoking action by the central bank.

The resulting risk of a change in economic conditions is reflected in the yield curve. At the beginning of the upswing 10-year US Treasuries were paying 275 basis points more than 2-year paper; now the difference has shrunk to 20 basis points. It looks as if the yield curve will soon be inverted, which in the past was often viewed as a harbinger of recession.

Whether things will be different this time remains to be seen. Many analysts expect a recession in the next two to three years. That would be disastrous for heavily leveraged companies, which would face the threat of downward rating revisions, possibly leading to insolvency. This risk is not yet being priced in. Companies with a low credit rating are currently paying spreads of 4%, which is roughly in line with the long-term average default rate. But the environment is still positive at present, so investors have a good opportunity to review their portfolio's risk profile.

Alternative bond strategies

If investors find that individual bond positions exceed their risk tolerance and therefore decide to sell, the question is: What next?

- Park the proceeds in cash. The problem here is timing. Hoping to achieve optimal timing of exit and re-entry is unrealistic. Meanwhile, with real interest rates in negative territory, cash holdings will lose value in real terms.
- Shifting to shorter-dated bonds and/or bonds with a lower credit risk. After adjustment for transaction costs, the returns on defensive bond investments are low.
- Invest in alternative bond strategies.

Recent years have seen impressive growth in the number and diversity of alternative bond strategies. The distinguishing feature of these strategies is that they are not geared to traditional benchmarks. Benchmark-oriented portfolios have several disadvantages:

- Yields have fallen steeply in recent years, while maturities have lengthened (increased interest rate risk).
- Risk concentration in specific countries, borrowers and sectors results in sub-optimal diversification.
- High-debt companies have the highest index weightings.
- The rules governing the indices lead to unnecessary trades or opportunity costs. For example, bonds that have a maturity of less than a year or that lose their investment grade rating have to be sold.
- Tracking error considerations mean that insufficient attention is paid to the most lucrative risk-adjusted investments, which in any case might be outside the benchmark.
- The results are usually at variance with the investor's strategic goals.

Highlights

- The air is getting thinner on the fixed income markets. Bond investors face the threat of losses this year.
- We are cautious about duration (interest rate risk) and credit risk.
- Even a mild rise in yields can quickly wipe out several years' worth of coupons.
- We recommend taking a supplementary position in alternative bond strategies.

Conclusion

Long maturities and traditional credit risks are unattractive at present. Benchmark-oriented investments in the bond markets have many disadvantages. We recommend taking supplementary positions in alternative bond strategies. These can reduce or completely eliminate the interest rate risk or the credit risk and can also open up new sources of return. Adding such positions to the portfolio automatically enhances diversification, enabling risk to be minimalised.

Benchmark	Current forecast	% YTD[1]
Gov. bonds Switzerland[2]	→	-1.55%
Gov. bonds Europe (EUR)[2]	→	0.11%
Gov. bonds USA[2]	↗	-1.15%
Inv. grade corp. bonds Switzerland[2]	→	-0.66%
Inv. grade corp. bonds Europe (EUR)[2]	→	-0.51%
Inv. grade corp. bonds USA[2]	↗	-2.23%
High yield bonds[3]	↘	2.19%
Emerging market bonds (hard currency)[3]	→	-5.66%
Emerging market bonds (local currency)[3]	→	-11.95%

[1] As of 11.09.2018
[2] Yield
[3] Total return

2. ASSET CLASSES

Equities

Equity indices – overview

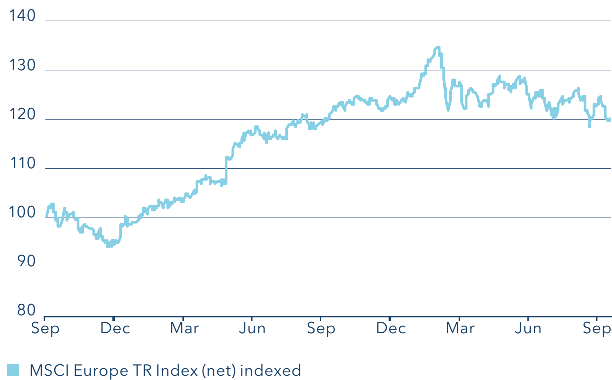
Switzerland: market movement since September 2016 (indexed)

MSCI Switzerland TR Index (net) indexed

Pacific: market movement since September 2016 (indexed)

MSCI Pacific TR Index (net) indexed

Europe: market movement since September 2016 (indexed)

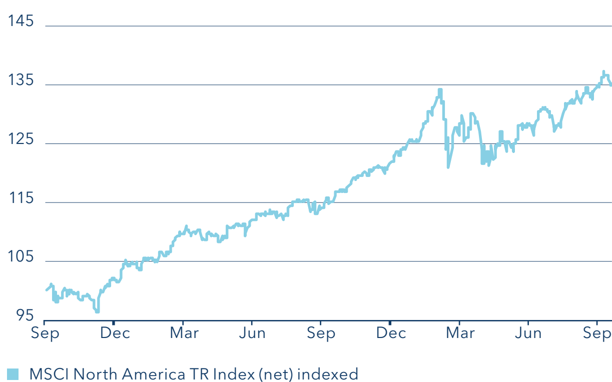


MSCI Europe TR Index (net) indexed

Emerging markets: market movement since September 2016 (indexed)

MSCI Emerging Markets TR Index (net) indexed

North America: market movement since September 2016 (indexed)



MSCI North America TR Index (net) indexed

United Kingdom: market movement since September 2016 (indexed)

MSCI UK TR Index (net) indexed

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A cycle without a circle

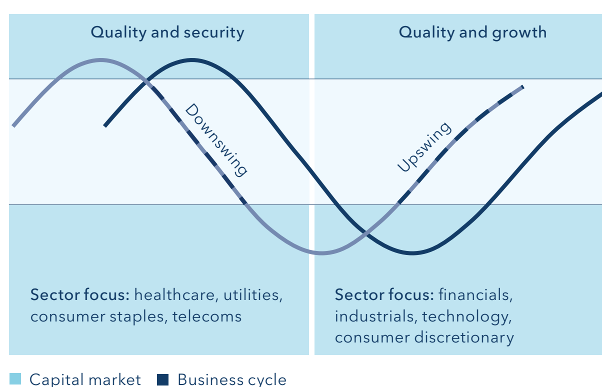
THE LONGER A BULL MARKET CONTINUES, THE GREATER IS THE TEMPTATION TO GET OUT WHILE THE GOING IS GOOD. IS SELLING EQUITIES THE RIGHT DECISION IN THE PRESENT ECONOMIC SITUATION? WE THINK NOT.

The longer an economic uptrend continues, the greater are the worries about possible setbacks on the equity markets. This is especially understandable in a year that has seen many controversial and sometimes painful events in the economy. To fear is human, and this includes the fear of not achieving financial goals or seeing one's wealth eroded. In reality, however, economic crises cause less serious investment losses than is widely assumed, even though investors' flight reflex magnifies the immediate market movements.

Market risks are not equal to economic risks

A distinction has to be drawn between market risks and economic risks. Uncertainty-induced stresses and strains on the markets are usually only temporary. Investors start to question the economic outlook on which current equity valuation levels are based. If earnings expectations are revised downwards, valuations fall. Overreactions frequently occur before the market finds its feet again. The consolidations in 2011 and 2016 are cases in point.

Generic business and capital market cycles



Economic risks, by contrast, are often rooted in over-exuberant business conditions, hyperinflation or recession. If the economy of a country or region starts to sputter, the consequences are much more widespread and protracted than in the case of mere market uncertainty. Unexpectedly fast interest rate rises or increased currency fluctuations ultimately impinge on companies' operations. The severity of the impact will depend on the business's fundamental health. Debt is a crucial factor here, whether we are talking about countries, companies or private individuals.

The business cycle is not a circle course

All this is expressed in the concept of the "business cycle", which is central to the process of investment forecasting. The chains of action in the economy are closely interlocked, and the phases of the cycle follow each other in a regular succession. But the character and duration of each phase depend on the intensity of cyclical events. That means, which economic metapher determines the current economic situation.

In general, cyclical sectors enjoy the strongest operational benefits of a cyclical upswing. Their earnings growth accelerates disproportionately, but this effect matures as the economy consolidates or weakens. Cyclically exposed companies generally display greater earnings volatility than defensive companies. The latter usually have a stable earnings performance but achieve much slower earnings growth over time. A cyclical positioning is therefore advisable during an economic upswing, whereas companies that boast earnings stability offer a comparatively safe haven in a difficult market environment and often also provide higher dividend payments as compensation for slower growth.

When we look at open economies and international patterns of interdependence, we find that the situation is complicated by the fact that cyclical phases are often not synchronised from country to country. Historically, the US has frequently sunk into recession before Europe. When America faces challenges, other countries might still be basking in economic sunshine. Equity markets also react in different ways. In five out of the last six recessions, the leading German index, "DAX", suffered its biggest losses in the year before a German recession struck. Paradoxically, only in two German recessions did the DAX lose ground while the recession was actually happening. Experience in

the US is mixed. Here the markets tend to react to recessions in real time. In most cases the twelve months following a recession see an exceptionally strong market performance. Investors understandably look for the right times to sell equities and then buy again. But research by the American investment management firm Morningstar shows that private investors lose a large part of their long-term earnings by trying to achieve optimal timing. The lesson is to stay in the market and calmly deal with the challenges that arise.

Switching is better than exiting

A better approach at times of increased uncertainty is to take a close look at one's portfolio and investment objectives. Are the equity positions qualitatively up to scratch? Can the company's business model provide solid underpinning for its shares in difficult times? What alternatives are available in the present market environment?

In periods of market turbulence defensive sectors such as healthcare and utilities often display greater stability. The American healthcare sector has performed much better during recessions than the US market as a whole. The same goes in all other regions as well.

This exemplifies the fact that useful alternatives are available in difficult markets. Good fundamental quality and forward-looking business models are crucial criteria for equity investments in any market phase. Within these parameters, the focus in difficult times should be more strongly on companies that perform basic economic supply and pay stable dividends, whereas in periods of economic expansion it is advisable to give the equity portfolio a clear cyclical slant.

Highlights

Tactical market risks are currently on the increase against a backdrop of continuing robust global economic activity and strong corporate earnings growth in all regions. Investors should focus on fundamental quality and forward-looking long-term investment themes. Our focus:

- Healthcare – "Invest in health"
- Energy efficiency – "Environmental protection"
- Industry – "Here come the robots"
- Infrastructure – "An investment in the future"
- Consumption – "Changing China"

Conclusion

Global economic and social challenges are on the increase. But world economic growth is still very robust, and we remain very constructive on equity markets. In the medium and long term the opportunities clearly outweigh the risks.

Automation, digitalisation and growing consumption in the emerging nations are major factors. In the present market phase global healthcare offers a unique combination of stable business models and attractive growth momentum. Companies that profit from demographic change, technological progress and digitalisation deserve special attention.

MSCI benchmark	Current forecast	% YTD[1]
Switzerland	→	–1.67 %
Europe	→	–4.72 %
North America	→	8.03 %
Pacific (incl. Japan)	→	–4.93 %
Emerging markets	→	–11.05 %

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 11.09.2018; net return in local currency incl. dividends

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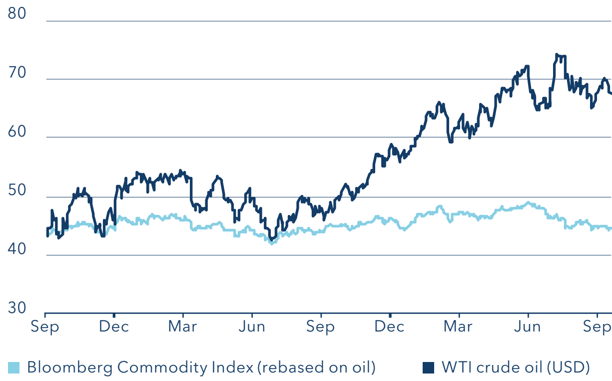
2. ASSET CLASSES

Alternative investments

Alternative investments – overview

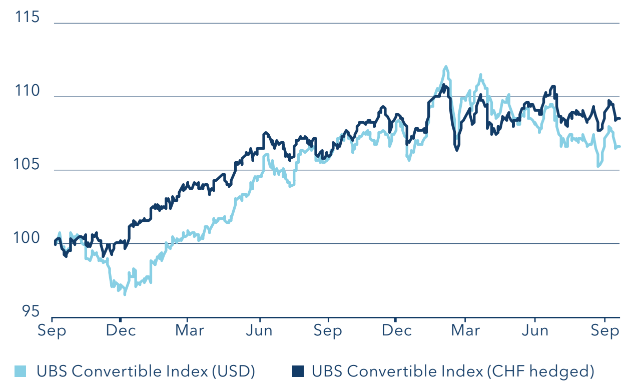
Commodities: performance since September 2016



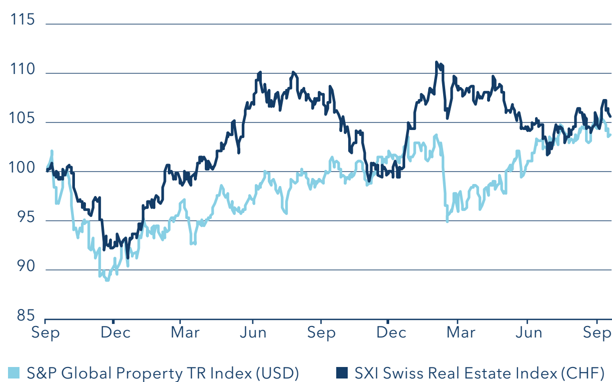
Private equity: performance since September 2016 (indexed)

Precious metals: performance since September 2016

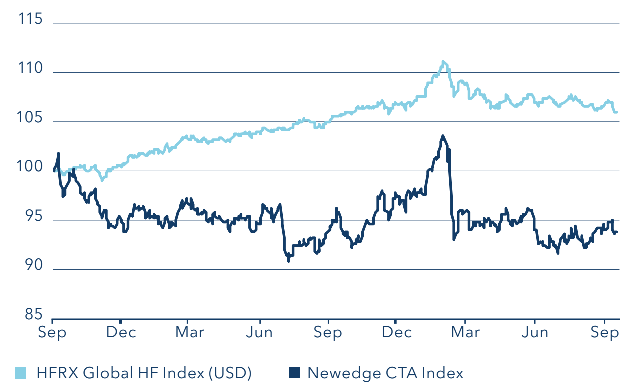
Convertible bonds: performance since September 2016 (indexed)



Real estate: performance since September 2016 (indexed)



Hedge funds: performance since September 2016 (indexed)



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Avoiding cyclical risks

IN TIMES OF NEGATIVE REAL INTEREST RATES, THERE IS ALMOST NO ALTERNATIVE TO EQUITIES. BUT WHAT HAPPENS IF EQUITY MARKETS OVERHEAT OR INTEREST RATES CLIMB? CATASTOPHE BONDS (CAT BONDS) AND OTHER INSURANCE LINKED SECURITIES ARE TAILOR MADE FOR SUCH A SCENARIO. THEIR BEHAVIOUR IS LARGELY INDEPENDENT OF THE BUSINESS CYCLE AND THE FINANCIAL MARKETS.

The payout on CAT bonds and other insurance linked securities (ILSs) is based on insurance premiums and whether or not a natural disaster occurs. These instruments therefore offer exceptional diversification characteristics and are an appropriate addition to any mixed portfolio.

Born in Switzerland

In May 1861 the city of Glarus in Switzerland was devastated by fire. Two-thirds of the city went up in flames within a few hours. 600 buildings were destroyed, and the loss of property amounted to CHF 10 million. Most owners were uninsured and lost everything. But insurance companies did not even have enough money to meet the claims of those that did have insurance cover. The disaster led to the creation of various fire and property insurance schemes throughout Switzerland. In 1863 the Swiss Reinsurance Company (generally known as Swiss Re) was set up as an insurance company for insurers. Urbanisation has magnified the losses that insurers and reinsurers have to cover. Hurricane Andrew in 1992, for example, caused insurance losses of USD 15.5 billion. The resulting shortage of reinsurance capital prompted reinsurers, banks and academics to look for new ways of transferring catastrophe risks.

Risk transfer

The first CAT bonds were issued in 1997. By securitising the risk of major catastrophes, insurance companies are able to transfer the risk to the capital market and thereby optimise their equity cover. The most frequently transferred risks are:

- US hurricane damage
- European storm damage
- Earthquakes in Japan

CAT bonds have lives of one to two years. During this period they are traded on a daily basis like normal bonds, with prices determined by supply and demand. Their minimum denomination is high, the standard being USD 250,000. The current outstanding volume of CAT bonds is relatively low at around USD 30 billion, but demand among investors is growing. Thus the yield famine has put downward pressure on CAT bonds' insurance premiums. However, premiums are determined not only by supply and demand but above all by the modelled risk, i.e. the probability of loss through catastrophe. If the probability of loss is small, premiums in the low single digit range are realistic, but if the probability is higher, double digit premiums are possible.

The investor's capital is invested through a special purpose vehicle (SPV) in a blocked account or in top quality money market securities. If the specified catastrophic event occurs, the entire principal goes to the insured party. Otherwise it is paid back to the investor together with the coupon (premium plus interest). Thus the investor benefits from rising short-term interest rates and enjoys an implicit protection against inflation. Unlike conventional bonds, there is de facto no interest rate risk.

CAT bonds vs. private transactions

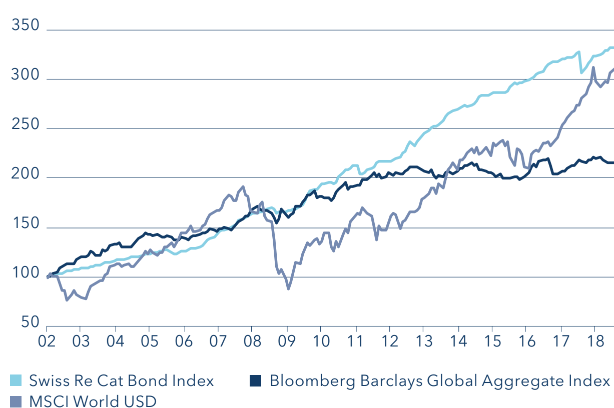
Insurance risks can be transferred not only by means of CAT bonds but also in unsecuritised form by means of direct reinsurance contracts. As well as natural disasters, the following risks are also tradable:

- Air, sea and space travel
- Oil platforms, energy infrastructure
- Crop failures
- Mortality

The market in unsecuritised private transactions is much larger than the CAT bond market, with a current volume of USD 400 billion. A further advantage from

the investor's point of view is improved diversification. There is no connection between floods in Europe and an accident in the US space programme. The disadvantage is illiquidity, because there is no secondary market in these transactions. On the other hand, maturities are shorter at three to twelve months.

CAT bonds: comparative performance



Points to watch: liquidity

With regard to investment funds in this sector, the risk/return profile and liquidity are the two key metrics. Insurance-related vehicles used to be the exclusive preserve of institutional investors. These were prepared to invest in illiquid products for the sake of the premium that illiquidity involved. In recent years, however, more and more private investors have shown an interest in this asset class. They invest in funds which concentrate on CAT bonds to ensure a higher level of liquidity. The downside is that fees tend to be higher and expected returns lower.

Investors who qualify as professionals under Mifid rules or are able to gain recognition as such can choose from a wide variety of funds. By accepting reduced liquidity (e.g. longer contracts) they can invest in products that offer higher risk premiums. This leads to substantially better risk/reward characteristics in the context of the prevailing dearth of rewarding fixed income investments.

Points to watch: risk

The most important decision for investors is identifying the level of risk that they are prepared to accept. Many funds base their "worst case" loss scenario on events that are modelled to occur once in 30 or 100 years. As most of these funds are relatively young, they have so far experienced only small losses, which have been quickly recouped. They have never had to deal, for example, with natural disasters occurring in the same year in Europe and the US or Japan. In other words, this asset class has never been subjected to a major stress test. Performance to date has been characterised by stable returns, with smaller setbacks and higher yields than in the government bond market. Risk assessment should therefore not be based on the fund's track record. Instead, investors should look at the risk indicated by the modelled worst case scenario. Some funds keep the modelled risk at a constant level, which means that yields are reduced if premiums fall. Others offset lower premiums by shouldering more risk in the hope of keeping the yield constant.

Conclusion

CAT bonds and other insurance linked securities reduce a portfolio's exposure to risks in the economy and the financial markets. In the past they have performed well in comparison with equities and bonds on a risk/reward basis, but they have not yet faced a major stress test. When assessing the risks involved, investors should look at the modelled worst case scenario rather than the fund's track record. In view of the interest rate risks and elevated valuations now prevailing in the capital markets, we recommend taking a position in CAT bonds or other ILSs. Ask your personal adviser about suitable products.

Benchmark	Current forecast	% YTD[1]
Commodities	→	-4.61%
Crude oil	→	15.17%
Gold	↗	-8.20%
Commercial real estate	→	0.68%
Private equity	→	7.11%
Convertible bonds	→	-0.55%
Hedge funds	↗	-1.48%

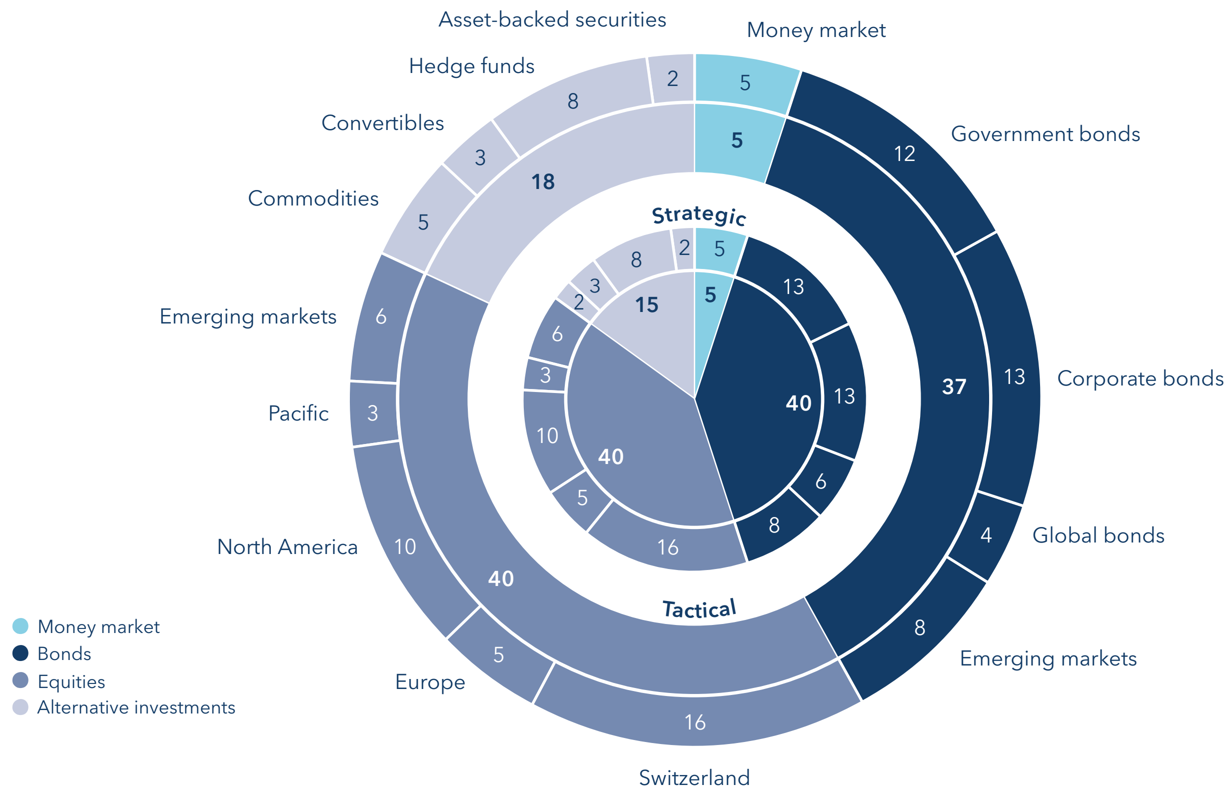
Upside/downside ranges indicated by our 3-6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

[1] As of 11.09.2018

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	07.09.2018	1,043.84	no	yes	–3.79%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	07.09.2018	1,395.92	no	yes	–2.90%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	07.09.2018	1,355.58	no	yes	–2.69%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	07.09.2018	1,554.03	no	yes	–4.51%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	07.09.2018	980.93	no	yes	–3.31%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	07.09.2018	1,559.40	no	yes	–1.93%

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

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Current investment tactics

The US economy continues to perform dynamically. The main drivers are exports, personal consumption and business investment. The signs are that GDP will continue to grow robustly in the second half of this year, though the Q2 result is unlikely to be bettered. The jump in net exports was an exceptional development attributable to new tariffs. Looking ahead, higher key interest rates, ongoing trade disputes and weaker fiscal stimulus are likely to result in a somewhat slower rate of expansion. This is reflected in the flat US yield curve. Eurozone growth in the first half year was disappointing, but the upturn in purchasing managers indices suggests a slight acceleration ahead. Eurozone GDP growth for 2018 as a whole will be positive, while Switzerland's growth rate will be at a four-year high. Performance in the emerging nations, by contrast, is weak. While the trade conflict between Europe and the US has been defused to some extent, the tensions between China and the US threaten to become more acute. Nevertheless, we regard it as unlikely that trouble in the emerging markets will degenerate into a global slowdown of growth.

The equity markets still present a split picture. The US market is riding high, having gained almost 8% since the start of this year, whereas the emerging markets have lost around 20% of their value. Turkey and Argentina are in investors' gunsights because of their high foreign debt, and we regard the situation in Turkey as especially critical.

The buoyant US economy has enabled the Fed to hike the fed funds rate substantially since the start of the year, whereas the European Central Bank has said it will keep its key rates unchanged at least until the end of summer 2019. While the interest rate outlook in the US is upwards, the scope for rate changes in the eurozone and Switzerland is therefore limited. Thus the yield gap between European and US bonds has widened further. However, recent wage agreements in the eurozone indicate that pay rates are on an uptrend, with resultant upward pressure on inflation.

Bonds

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. The latter carry an attractive risk premium. We are maintaining our position in inflation-linked securities.

Equities

The equity market environment remains challenging. While macroeconomic conditions are stable, geopolitical negatives are substantial. The eurozone is benefiting in relative terms from a lower valuation level than in the US and still has catch-up potential. Additional support is provided by relatively high dividend yields compared with bond yields. In the emerging markets we continue to favour Asia on account of its strong economic growth and fundamentally attractive valuation ratios.

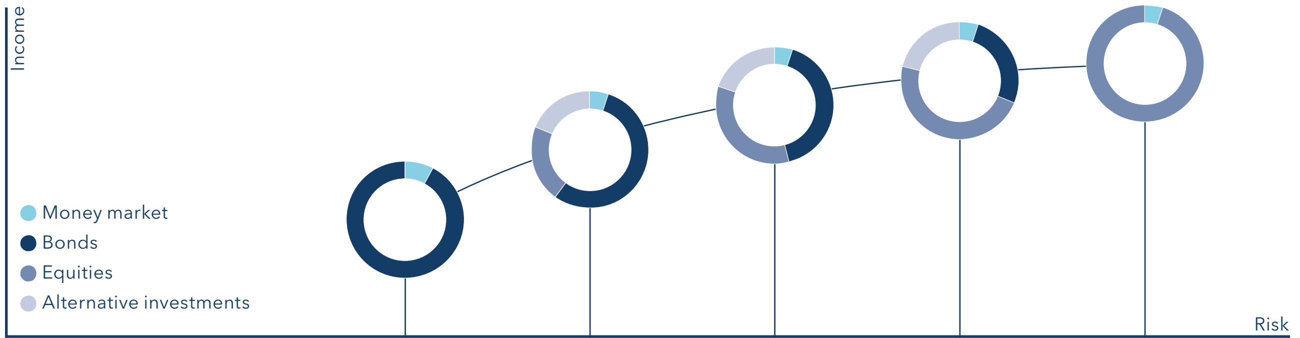
Alternative investments and currencies

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

Outlook

Various divergences, narrow market leadership and the very one-sided positioning of many investors are cause for some concern. Ongoing trade disputes and uncertainties in some developing economies have possibly not been fully discounted by the markets. Our current positioning therefore reflects a basically defensive approach. We are keeping a close eye on market developments and are ready to adopt greater exposures as soon as we see opportunities with attractive risk/reward characteristics.

Our solutions



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

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

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4. APPENDIX

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