LimmatWealth

Investment Strategy – August 2017

Data & Forecasts

	Growth (%)		Inflation (%)		Equities		
	GDP 17	GDP 18	CPI 17	CPI 18	Actual	3 Mths	12 Mths
Switzerland	1.4	1.7	0.5	0.6	10'311	↗	↗
Germany	1.9	1.7	1.7	1.6	12'118	↗	↗
Eurozone	2.0	1.7	1.5	1.4	3'449	↗	↗
UK	1.6	1.3	2.7	2.6	7'372	↗	↗
USA	2.2	2.3	2.1	2.2	2'470	↗	↗
Japan	1.3	1.0	0.5	0.8	19'925	↗	↗
Brazil	0.5	2.0	3.7	4.2	65'920	↘	↗
Russia	1.3	1.5	4.3	4.1	1'007	↗	↑
India	7.1	7.3	4.5	3.9	32'515	↗	↗
China	6.7	6.3	1.7	2.2	3'273	↘	↗

	Bonds (10 Years)			Currencies (vs USD)		
	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Switzerland	0.05	0.00	0.25	0.97	0.98	0.98
Germany	0.54	0.50	0.75	-	-	-
Eurozone	-	-	-	1.18	1.15	1.15
UK	1.23	1.25	1.50	1.32	1.28	1.30
USA	2.29	2.50	2.75	-	-	-
Japan	0.08	0.25	0.25	110	115	115
China	3.63	3.50	3.50	6.73	6.90	7.00

Review – Positive equity returns on a global basis in July

After posting partially negative returns in June, stock markets returned positive numbers on a global basis in July. Markets performed well in the US (+1.9%) as well as in Switzerland (+1.8%) and in Emerging Markets (+5.5%). In contrast, markets in Europe gave back a little bit in July (-0.4%) mostly driven by negative returns in Germany (-1.7%) and France (-0.5%).

World-wide, yields on ten-year government bonds fell slightly in July having a positive effect on prices of government and corporate bonds. In Switzerland, the ten-year government bond yield closed the month in positive territory for the first time since June 2015 (+0.05%).

We saw high volatility to some extent in currency markets last month. Especially the two currency pairs US Dollar/Euro and Swiss Franc/Euro were volatile as the Euro appreciated significantly against the USD and CHF. The US Dollar (-3.5%) weakened to the lowest level in 2.5 years while the Swiss Franc depreciated to the lowest level since the Swiss National Bank removed the peg to the Euro in January 2015 (-4.4%).

Alternative investments like hedge funds (+0.9%) and gold (+2.2%) also had a positive month.

Outlook – FED starts to unwind balance sheet

The four central banks of the United States, England, Japan, and Europe have provided an unprecedented amount of liquidity since the global financial crisis in 2008. Their aggregate balance sheet increased from USD 4 trillion in 2008 to USD 14 trillion today which amounts to about 40% of the aggregate gross domestic product (GDP) of these countries. This liquidity provision is likely to peak in the second half of 2017 and central banks will engage in a more contractionary monetary policy going forward. The central bank of the United States, the Federal Reserve (FED), already started cautiously raising interest rates at the end of 2016 and has just recently unveiled plans to start reducing its balance sheet towards the end of 2017. This marks the beginning of the end of quantitative easing (QE).

All main asset classes have strongly benefitted from QE-driven asset reflation. Global equities and high yield credit have each more than tripled since the lows at the beginning of 2009 (including dividends). Levels of bond yields and credit spreads are near their all-time lows and P/E multiples of equities are close to the levels of the technology crisis in the early 2000s. What does the end of QE mean for different asset prices?

The last three instances of bond selloffs (United States H2 2013, Eurozone April 2015, and Japan August 2016) led to weakness in the equity markets which proved to be short-lived. We mainly see two things which are different today than in the above-mentioned instances:

1. Equities are much higher valued today. Stocks in the S&P 500 Index were trading at a P/E-ratio of 13.5x in 2013 versus 17.8x currently. The Euro Stoxx 50 Index looks similar (11.2x vs 14.6x) and stocks in the MSCI World Index are about 30% more expensive than in May 2013. The announced withdrawal of liquidity via the reduction of the FED balance sheet could lead to a P/E compression this time, especially if earnings momentum were to also stall.

2. In 2013, the FED was the only central bank moving towards tightening which essentially drove the US Dollar higher. Today, the European Central Bank (ECB) is expected to perform a key turn in monetary policy soon. This could be further evidence that the USD is on a weakening trend and that the interest rate differential between the United States and the rest of the world will keep closing.

The expected changes in monetary policy at the FED and the ECB does not result in euphoria but we are cautiously optimistic with regards to the future returns of stock prices. In the current environment we prefer the equity markets of Switzerland and Emerging Markets, in particular China. Switzerland benefits from the weakening Swiss Franc versus the Euro and China published encouraging macro data recently. A continuing closing interest rate differential between the United States and the rest of the world would be a reason to increase investments in European banks but we think it is still too early.

The probability of a further interest rate hike by the FED in the coming six months is below 50 percent and therefore we do expect only gradually higher interest rates in the United States as well as in the rest of the world going forward. Accordingly we do not expect a shock at the bond markets for now.

We do not see a lot of volatility in the currency markets short- to mid-term. It is likely that the Euro will appreciate a bit further versus the US Dollar and the Swiss Franc in the short-term.

The current environment with high equity valuations and the looming balance sheet reduction by the FED is very interesting for hedge funds as they are not as exposed to the markets as traditional investments and the volatility and dispersion in all markets is likely to increase going forward. Higher volatility and lower correlations are ideal for hedge fund strategies. We think gold will remain more or less on the same level and therefore trend sideways in the coming months as we currently do not see any signs pointing to a financial crisis or recession in one of the important economic areas (United States, Europe, China).

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Jan Mueller, Chief Investment Officer