LimmatWealth

Investment Strategy – October 2017

Data & Forecasts

	Growth (%)		Inflation (%)		Equities		
	GDP 17	GDP 18	CPI 17	CPI 18	Actual	3 Mths	12 Mths
Switzerland	1.3	1.7	0.5	0.6	10'418	↗	↑
Germany	2.1	1.8	1.7	1.6	12'616	↗	↑
Eurozone	2.1	1.8	1.5	1.4	3'540	↗	↑
UK	1.5	1.3	2.6	2.5	7'289	↗	↗
USA	2.2	2.3	2.0	2.0	2'497	↗	↗
Japan	1.5	1.1	0.5	0.7	20'330	↗	↑
Brazil	0.6	2.3	3.5	4.0	74'443	↗	↗
Russia	1.6	1.7	4.2	4.1	1'142	↗	↗
India	7.1	7.3	4.5	3.5	31'611	↗	↗
China	6.7	6.4	1.7	2.2	3'344	↗	↗

	Bonds (10 Years)			Currencies (vs USD)		
	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Switzerland	-0.06	0.00	0.25	0.97	0.98	0.98
Germany	0.41	0.60	1.00	-	-	-
Eurozone	-	-	-	1.18	1.16	1.17
UK	1.33	1.25	1.50	1.35	1.30	1.30
USA	2.22	2.50	2.75	-	-	-
Japan	0.03	0.00	0.00	112	111	110
China	3.62	3.60	3.50	6.63	6.65	6.70

Review – Another positive month for equities

Equity markets in developed markets ended September largely positively, while indices in Emerging Markets showed a mixed picture. Equity markets in Germany (+6.4%), Japan (+3.6%), Switzerland (+2.7%), and the US (+1.9%) finished the month in positive territory, whereas the UK (-0.8%) gave back a little due to discussions around Brexit. Emerging markets as a whole had their first negative month of the year (-0.6%). Brazil (+4.9%) and Russia (+3.7%) advanced substantially as in August, whereas China (-0.4%) and India (-1.4%) finished the month slightly down.

Yields on ten-year government bonds increased world-wide in September, especially in the UK (+34 basis points to 1.37%). Swiss ten-year government bonds still yield negatively (-0.02%).

Volatility in currency markets was low in the past month. The Euro depreciated against the US Dollar (-0.8%) but appreciated marginally against the Swiss Franc (+0.2%). The US Dollar strengthened against the Swiss Franc (+1%) and now trades at 0.97 Francs.

Alternative investments such as hedge funds and gold showed a mixed picture last month. While hedge funds printed their eleventh consecutive positive month (+0.5%), gold fell below USD 1,300 per ounce (-3.1%).

Outlook – Higher interest rates positive for equities

Equity indices in Europe appreciated +5-6% since their recent summer through and the S&P 500 Index is up +4% to new highs. German and US yields are up 15-20 basis points and FED rate hike expectations have moved back to over 70% for December 2017. The reflation trade is back on as cyclical and bank stocks are rebounding. The US transport index, which was down -7% during summer and was highlighted by many as red flag, is now back to its highs. The question is once again, how far can this go?

We expect rising interest rates in the short-term, in Europe as well as in the US (see table on page 1). Bearish investors argue that rising interest rates have a negative impact on equity multiples and are therefore negative for stocks. We disagree mainly due to two reasons:

- We acknowledge that equity P/Es are at a premium to historical levels but we believe that bond yields can rise quite substantially without hurting stocks. In the past ten years, the S&P 500 Index was up 90% of the time during sharp spikes in bond yields. The relative value models between stocks and bonds suggest yields could move up significantly before stocks become expensive, to the tune of 100-150 basis points.

- In our view, the fact that bond yields are moving up for the right reasons is crucial. Eurozone manufacturing PMIs recently reached new cycle highs and global PMIs remain robust. Bond yields need to catch up in order to close the gap that has opened up. This bodes well for earnings. The oil price is up +15-20% over the past three months which is a good sign as the oil price typically was strongly correlated to S&P 500 top-line growth. Finally, any favorable delivery on the US political front should be seen as a positive from what were very subdued expectations.

After the small consolidation during the summer, equity markets now look interesting again and we are positive for the remainder of the year, especially for developed markets in Europe. Emerging Markets depend on a weaker US Dollar, which is problematic in our opinion (see below). If we believe in a stronger US Dollar going forward, it might be prudent to realize profits, especially after the phenomenal performance of Emerging Markets this year (+25.5%). We still like European banks due to increasing interest rates.

The probability of a further interest rate hike by the FED before year-end was 30 percent a month ago, today it is over 70 percent. We do not exclude the possibility of a further rate hike but this should be fully priced in the market and therefore not lead to any surprises. We do expect only gradually higher interest rates in developed markets in the mid-term, and accordingly, this should not lead to large price changes in bond markets.

We do not expect a lot of volatility in the currency markets short-term but we expect the US Dollar to strengthen against the Euro and Swiss Franc in the mid-term. Euro speculative positions are at three year highs and the US Dollar appears to have undershot the interest rate differential between the US and Europe. Expectations of US growth as well as FED rate hike projections are currently subdued; therefore, a positive surprise for the USD is possible.

The current environment with higher volatility and lower correlations is ideal for most hedge fund strategies. Gold rises and falls depending on uncertainty at the markets, especially uncertainty of geopolitical nature (North Korea and so on). We maintain our position for diversification reasons.

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Limmat Wealth Ltd.