LimmatWealth

Investment Strategy – February 2018

Data & Forecasts

	Growth (%)		Inflation (%)		Equities		
	GDP 18	GDP 19	CPI 18	CPI 19	Actual	3 Mths	12 Mths
Switzerland	1.9	1.7	0.7	0.9	10'737	↗	↗
Germany	2.3	1.9	1.7	1.7	13'189	↗	↗
Eurozone	2.2	1.8	1.5	1.5	3'609	↗	↗
UK	1.4	1.4	2.7	2.5	7'534	↗	↗
USA	2.6	2.2	2.1	2.2	2'824	↗	↗
Japan	1.3	1.0	0.5	0.9	23'486	↗	↗
Brazil	2.5	2.8	3.4	3.8	84'913	↗	↑
Russia	1.9	1.8	3.7	3.5	1'289	↗	↑
India	6.6	7.4	4.5	3.7	35'806	↗	↑
China	6.5	6.3	1.6	2.3	3'447	↗	↑

	Bonds (10 Years)			Currencies (vs USD)		
	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Switzerland	0.11	0.10	0.30	0.93	0.97	0.96
Germany	0.71	0.60	1.00	-	-	-
Eurozone	-	-	-	1.24	1.22	1.25
UK	1.51	1.40	1.80	1.42	1.36	1.40
USA	2.74	2.60	3.00	-	-	-
Japan	0.10	0.50	0.10	110	112	110
China	3.92	4.00	4.00	6.30	6.50	6.50

Review – More of the same, equities continue to rally in 2018

Equity markets around the world started the year with a bang, advancing 5.7% on average as measured by the MSCI AC World Index. Emerging Markets (+8.3%) outperformed their developed counterparts (+5.3) by quite a margin last month. Major global equity markets were led by Russia (+11.1%), Brazil (+11.1%), and the US (+5.6%) while markets in Japan (+1.5%), Switzerland (-0.1%), and the UK (-2.0%) lagged last month.

Yields on ten-year government bonds moved higher in developed markets at the beginning of this year. Ten-year yields increased in the US (+0.32% to 2.71%), Europe (+0.27% to 0.70%), and Switzerland (+0.26% to 0.11%) while they remained more or less flat in Japan (+0.04% to 0.09%). Yields in emerging markets showed similar volatility, especially in Brazil (-0.54% to 9.72%) and Russia (+0.27% to 4.14%).

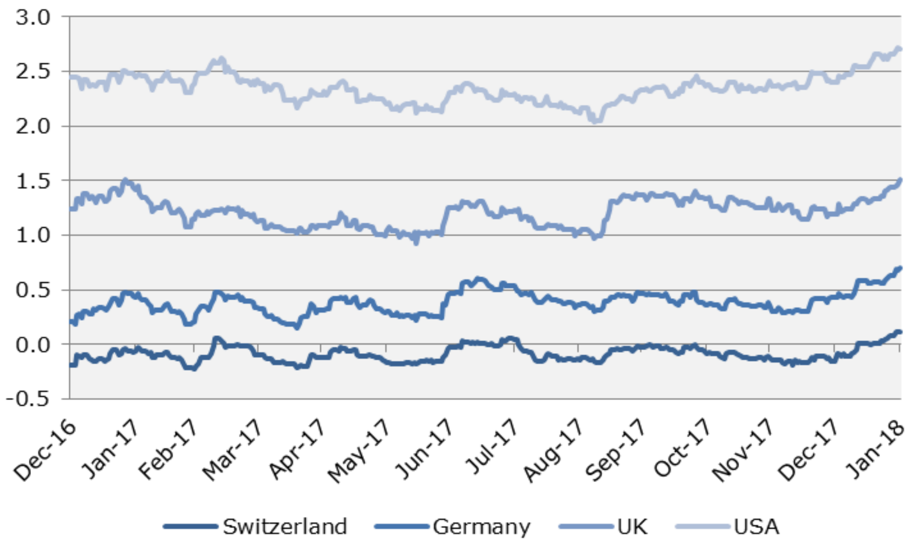
Currency markets were strongly impacted by the depreciating US Dollar in January. The US Dollar depreciated against all major currencies, most notably against the British Pound (-4.8% to USD 1.42), Swiss Franc (-4.4% to CHF 0.93), and the Euro (-3.3% to USD 1.24).

Alternative investments such as hedge funds and gold increased in value as well last month. Hedge funds had the best start to a year since 2012 (+2.4%) while gold closed the month at USD 1,345 per ounce (+3.2%). The oil price (WTI) increased to USD 64.73 per barrel (+7.1%).

Outlook – Rising bond yields are not expected to drive P/E multiples

The consensus among investors is that growth, earnings, and political backdrops will likely stay benign. The risk that a lot of investors currently cite most frequently is the potential for a further repricing of bond yields which in turn is perceived as a driver of P/E multiple compression.

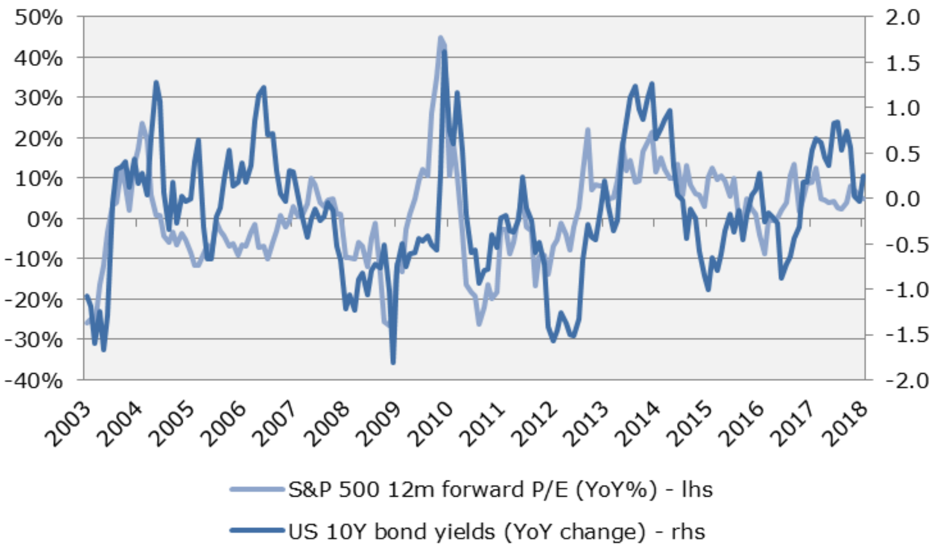
Bond yields started an upward move in early to mid-December which so far resulted in a 30-40 basis point increase of ten-year government bond yields in major developed economies. The Swiss ten-year government bond yield for example increased by 30 basis points since mid-December to 0.11% at the end of January while the ten-year US Treasury yield increased by 37 basis points since early December and even 67 basis points since early September to 2.71% at the end of January. This development looks similar in Germany and the UK (please see chart below).



10-Year Government Bond Yields, daily data from Jan 2017 to Jan 2018 (Source: Bloomberg, Limmat Wealth)

Will this upward trend – should it continue – negatively impact equity markets? We don't think so.

The move up in bond yields started from what are still depressed historical levels and it is actually happening for the right reasons (strong labor market, economic growth). Some analyst see it as a catch-up with activity numbers because yields appear to have significantly undershot PMIs last year. Equity valuations are not cheap in absolute terms but in the past 15 years, the correlation between P/E multiples and bond yields in the US was actually positive rather than negative (please see chart below). Moves in P/E multiples are strongly positively correlated with earnings revisions and as long as earnings momentum continues, P/E multiples should at least remain stable in the near future.



Correlation between S&P 500 P/Es and US bond yields, monthly data from Jan 2002 to Jan 2018
(Source: Bloomberg, Limmat Wealth)

The positive correlation should even work if the move in yields is inflation-driven. Equities should work as a natural inflation hedge as their earnings are strongly correlated to the Producer Price Index (PPI).

Regardless of the ultimate impact on the P/E multiples from any yield increases, the best way to hedge this risk is through a rotation out of growth and into value stocks. Growth stocks have driven the market performance in this cycle but could now be pressured by higher yields. The value part of the market has lagged during this period but could now bounce.

We believe equity markets will continue to move up albeit with a slower pace than in January. We do not see any fundamental data points that could negatively affect the markets and earnings growth globally is supporting this view. We are positive on all major markets over the next twelve months but we expect emerging markets to outperform their developed counterparts in the short- to mid-term as commodity prices continue to rise and the USD is likely to remain on a weakening trend.

The probability of a further interest rate hike by the US central bank FED in the first quarter this year is over 90 percent at the moment. This hike seems to be fully priced in and should therefore not lead to any surprises. We expect gradually higher interest rates in developed markets in the mid-term and therefore bond markets should only be marginally impacted.

We do expect volatility to remain relatively high in the currency markets short-term. The US Dollar remains in focus after a month of weakness at the beginning of the year given the US administration's unconventional openness to discussing the currency. Analysts would not be surprised if the volatility in the USD stays high especially as US president Trump's trade agenda gets more attention. Adding to the USD underperformance is the relative underperformance of the US versus rest-of-world activity data and ex-US central bank policy (Bank of Japan and European Central Bank).

As we mentioned all year long last year, more and more investors are starting to look at alternative assets and strategies as equity markets continue to edge higher. The current environment remains ideal for most hedge fund strategies and therefore hedge funds should continue to perform well. We maintain our gold position for diversification reasons.

February 2, 2018
Limmat Wealth Ltd.