LimmatWealth

Investment Strategy – March 2018

Data & Forecasts

	Growth (%)		Inflation (%)		Equities		
	GDP 18	GDP 19	CPI 18	CPI 19	Actual	3 Mths	12 Mths
Switzerland	1.9	1.8	0.7	0.9	10'041	↗	↗
Germany	2.4	1.9	1.7	1.8	11'995	↗	↗
Eurozone	2.3	1.9	1.5	1.5	3'332	↗	↗
UK	1.5	1.5	2.7	2.5	7'074	↗	↗
USA	2.7	2.4	2.1	2.3	2'681	↗	↗
Japan	1.3	1.0	0.5	1.0	21'042	↗	↗
Brazil	2.6	2.7	3.4	3.7	85'183	↗	↑
Russia	1.8	1.8	3.7	3.5	1'271	↗	↑
India	6.6	7.4	4.5	3.7	33'747	↗	↑
China	6.5	6.2	1.6	2.3	3'257	↗	↑

	Bonds (10 Years)			Currencies (vs USD)		
	Actual	3 Mths	12 Mths	Actual	3 Mths	12 Mths
Switzerland	0.07	0.15	0.40	0.94	0.97	0.92
Germany	0.63	0.75	1.00	-	-	-
Eurozone	-	-	-	1.23	1.22	1.30
UK	1.47	1.60	1.90	1.38	1.40	1.40
USA	2.84	2.80	3.00	-	-	-
Japan	0.04	0.10	0.10	106	110	110
China	3.86	4.00	4.00	6.35	6.40	6.40

Review – Volatility strikes back

February represented almost a complete reversal to what happened in equity markets in January. Volatility increased massively in late January and early February which led to the unwinding of the short volatility trade (short VIX) with losses in short volatility products mounting up to -95% from its peak. Global equity markets as measured by the MSCI AC World Index on average declined -4.2%. Major global equity markets were led by Brazil (+0.5%), Russia (+0.2%), and the US (-3.9%) while markets in Japan (-4.5%), Switzerland (-4.5%), Germany (-5.7%), and China (-6.4%, onshore) lagged last month.

Yields on ten-year government bonds increased in the US (+0.16% to 2.86%), Russia (+0.19% to 4.33%), and India (+0.30% to 7.73%) while the yields decreased in Germany (-0.04% to 0.66%), China (-0.08% to 3.85%), and Brazil (-0.11% to 9.61%). Yields in Switzerland remained unchanged (-0.02% to 0.09%).

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Currency markets remained somewhat volatile but the US Dollar appreciated for the first time in a few months. The US Dollar appreciated against the British Pound (+3.2% to USD 1.38), Japanese Yen (+2.4% to JPY 107), and the Euro (+1.8% to USD 1.22). The Swiss Franc appreciated slightly against the Euro and now trades at CHF 1.15 (+0.4%).

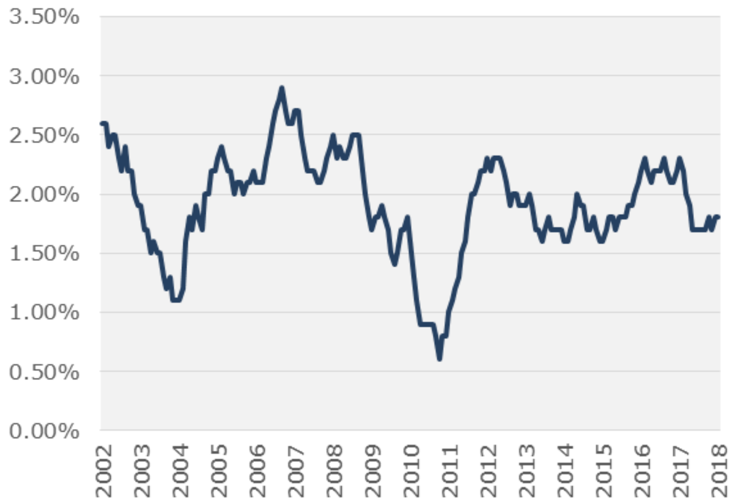
Alternative investments decreased in value as well last month. Hedge funds gave back their January gains and are now flat for the year (-2.4%) while gold closed the month at USD 1,318 per ounce (-2.0%). The oil price (WTI) decreased to USD 61.64 per barrel (-4.8%).

Outlook – Pickup in inflation and wage growth not a negative for equities

We do not believe that the current correction will become sustained nor should be seen as fundamental. In last month's investment strategy we argued that rising bond yields are not expected to drive P/E multiples and we still believe that the correlation between bond and equity prices remains inverse, i.e. equities will tolerate higher yields.

The focus last month was on a potential pickup in inflation and how market participants interpret this. Many experts and investors are concerned that rising wages could put pressure corporate profit margins and a move up in inflation would drive discount rates higher, therefore putting pressure on valuations, earnings, and the sustainability of the upcycle. We do not see it this way. We believe inflation and wages are increasing for the right reasons:

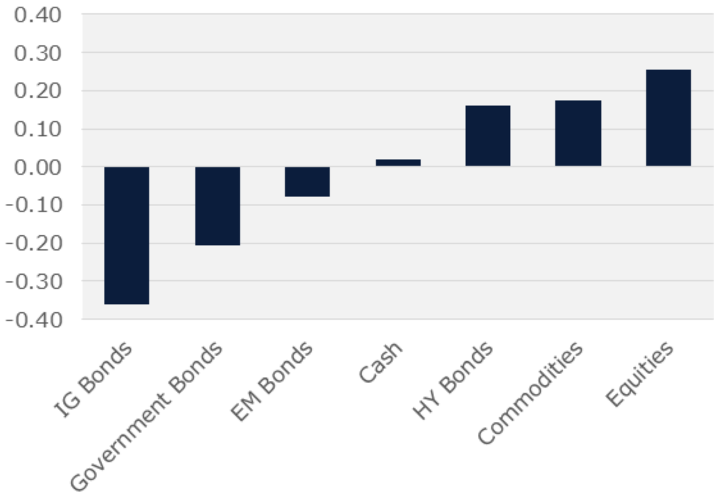
- Inflation is primarily a lagging indicator of growth and should not come as a surprise given that a lot of economies around the globe are supposed to grow above trend this year. Signs of higher inflation are building but the actual inflation rates are still relatively low in a historical context. The January 2018 US Core CPI print of 1.8% year-over-year for example is still below the last 20-year average and as much as 50 basis points below what we have already seen a few times in the current upcycle.



US Core CPI year-over-year, monthly data from Jan 2002 to Jan 2018 (Source: Bloomberg, Limmat Wealth)

- According to JP Morgan, corporate profit margins are most sensitive to the volume outlook through operating leverage and not to wages. The move up in wages is consistent with strong activity momentum and suggests the economic upturn is becoming more sustainable. Inflation typically is positively correlated to corporate top line growth and pricing power. Experts do not see a growth downturn anytime soon as real rates remain low and policy tightening is far from becoming restrictive.

- According to JP Morgan, equities are the most positively correlated asset class to inflation breakevens (market-based measure of expected inflation). Equities provide a natural hedge against inflation as they produce nominal earnings and sales growth. Historically, equities tended to deliver their best returns in 1-3% inflation range, the range most experts forecast now.



Correlation of global asset class performance to breakeven inflation, monthly data from Jan 2002 to Jan 2018 (Source: Bloomberg, Limmat Wealth)

We still believe that equity markets will continue to move up despite the increased volatility. Fundamental data look good and earnings growth globally is supporting this view with all the main regions delivering double-digit earnings-per-share growth (Japan +16%, Europe +16%, and US +14%). We remain positive on all major markets over the next twelve months and we expect emerging markets to outperform their developed counterparts in the short- to mid-term.

The probability of a further interest rate hike by the US central bank FED this month is 100 percent at the moment and this hike is fully priced in. 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 fairly high in the currency markets short-term. The US Dollar remains in focus after volatile two months at the beginning of the year.

Hedge Funds and other alternative assets and strategies welcome the increased volatility in all regions and asset classes although the moves in February were too harsh in a too short period of time for most hedge funds to be able to take advantage of it. We maintain our gold position for diversification reasons.

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Limmat Wealth Ltd.