

Investment Strategy February 2018

Long expected and yet surprising, global stock markets have begun to correct. Good fundamental data should help to prevent a slide into a sustained bear market.

Macroeconomic Environment

Global economy running smoothly

Currently, purchasing manager indices (PMI) are above the important level of 50 index-points in all regions of the world. Even the PMI of Brazil, that has experienced a stubborn recession, has achieved it again. Economic growth is stronger than it has been for a long time and gratifying indeed: USA 3%, Eurozone 2.5%, Japan 2% and significantly more momentum in emerging markets. In the USA, but also in Europe, the output gaps are virtually closed. Unemployment reached new lows in the USA. In Europe, on the contrary, unemployment is gradually declining but still relatively high. Consumer confidence and consumer sentiment are at very high levels as well. As a result, inflation respectively inflation expectation returns (as long awaited by central banks). The increasingly protectionist US economic policy is a certain risk factor for the positive economic picture.

What consequences could this development have on the financial and capital markets?

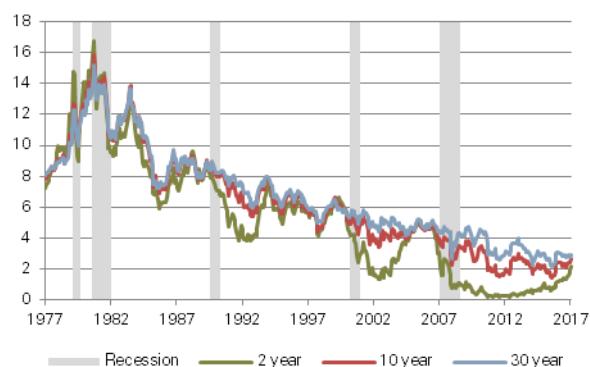
- Rising inflation expectations and rising wages due to lack of capacity ;
- Rising nominal interest rates due to higher inflation expectations ;
- Increasing likelihood of a reversal of monetary policy, meaning a restrictive monetary policy that removes liquidity from the economy and financial markets in order to avoid a sharp rise in inflation ;
- Fears that the positive momentum of the economy and corporate profits drop as a result ;
- Increasing risk of a correction of valuations of risk assets (adjustments to incorporate higher risk premiums) following one of the longest bull markets and currently challenging asset valuations ;
- Higher volatility on the financial and capital markets.

Our judgement

Inflation: Cyclical factors speak in favor of a rising inflation on the one hand. On the other hand structural factors such as technology, easy access to information (price comparisons), changing consumer behavior and an aging population should be strong enough to limit the inflation potential for the time being.

Interest rate development: The focus of market participants has shifted from the flattening of the yield curve to the absolute level of interest rates. Concerns are justified for two reasons: a) With declining economic growth, the level of interest rates that triggered recessions has fallen over the years.

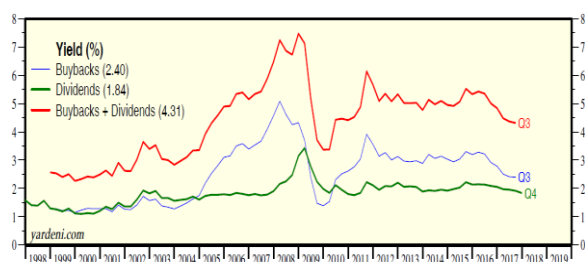
Development of US-interest rates and recessions



Source: Bloomberg

b) Yields on US-Treasuries exceeding the dividend yields of US-equity indices may lead to capital reallocations from equities to bonds. Currently, this yield difference is indeed in place as for example the dividend yield of the S&P 500 sits just under 2% while the yield of a 5-year Treasury bond is around 2.5%. However - and in particular valid for US stock markets -, share buybacks distort the picture and the total payout yield of US-equities is more in the range of 4%: a clear return premium over bonds. Although share buybacks have recently declined, a substantial reduction of them would require a recession which we currently do not anticipate. In Europe, dividend yields are still well above government bond yields. So do equities in Germany measured by the DAX-index return a dividend yield of 2.7%, still about 2% higher than the yield on a 10-year German government bond.

Total payout yield from share buybacks and dividend payments for the S&P 500 is around 4%



Source: Yardeni Research/Standard&Poors Corp.

Monetary policy: The new chairman of the US Federal Reserve, Powell, has taken over the chair from Yellen. In the past, the change at the top has often led to some uncertainty. The last statements of important central bank leaders left no doubt that the reversal of the ultra-expansive monetary policy will proceed only very carefully. Nevertheless, the regime change in monetary policy has been started, which will have a similar strong impact on markets over the next few years as in the years before.

Economy: As mentioned above, we are in a phase of a synchronous upswing. For us, the current economic cycle seems robust enough and the risk of slipping into a recession, even at slightly higher interest rates, is low for the moment. The reporting season has also been solid so far, with a large majority of companies exceeding earnings and sales expectations. However, the positive surprises in economic data are likely to decrease.

Valuations: Especially US stock markets were no longer cheap after last year's strong price gains. The impact of interest rates on valuations is quite significant due to the discounting of future cash flows. Rising inflation and interest rates make equity markets therefore prone to corrections. However, differences in valuations between regions and sectors are still quite large. While US-equities overall remain relatively expensive, cheap stocks can be found in Europe and emerging markets. Among sectors, financials stand out. The same is valid for well-known names from the international technology segment (keyword "digitalisation") that are usually not overly expensive compared to their growth prospects.

Volatility: For 2018, we anticipated a rise in volatility or, expressed more precisely, a normalisation after a year with exceptionally low volatility. So we are not completely surprised by the latest development. However, systemic risks are revealed: In Switzerland, the total loss of a speculative product, issued by a big bank, that was betting on ever lower volatility made headlines (and with reference to the banks communication that not the bank, but the investors

carry the loss...). We have mentioned the risk posed by these so-called "smart beta"- or "low volatility"-products in our Investment Strategy December 2017. It is quite possible from our point of view that there will be further damage especially in the hedge fund world. It should pay to closely follow the further development.

Conclusion: Correction - Yes, Bear Market - No

In the autumn of last year we had - too early - expected a correction in equity markets. Now, there it is. The speed of the correction is respectable with indications of so-called "flash crashes". Program trading ("Algos") and the unwinding of some of the above mentioned financial products should be responsible for this.

For investors, the question arises as to whether the correction we are just in, which we believe is not yet fully completed, may turn into a bear market that may affect the real economy.

Correction:
A temporary price movement that does not correspond to a longer-term trend.

Bear market:
A longer-lasting development characterised by sustained falling security prices.

Our base scenario currently anticipates no bear market for the following reasons:

The prerequisite for a bear market is an environment of a significantly more restrictive monetary policy with a subsequent recession. As described above, the central banks are expected to not abruptly change direction and proceed cautiously. In our opinion, the good fundamentals of the economy and the corporate sector look robust enough and will be able to weather a correction on the financial and capital markets.

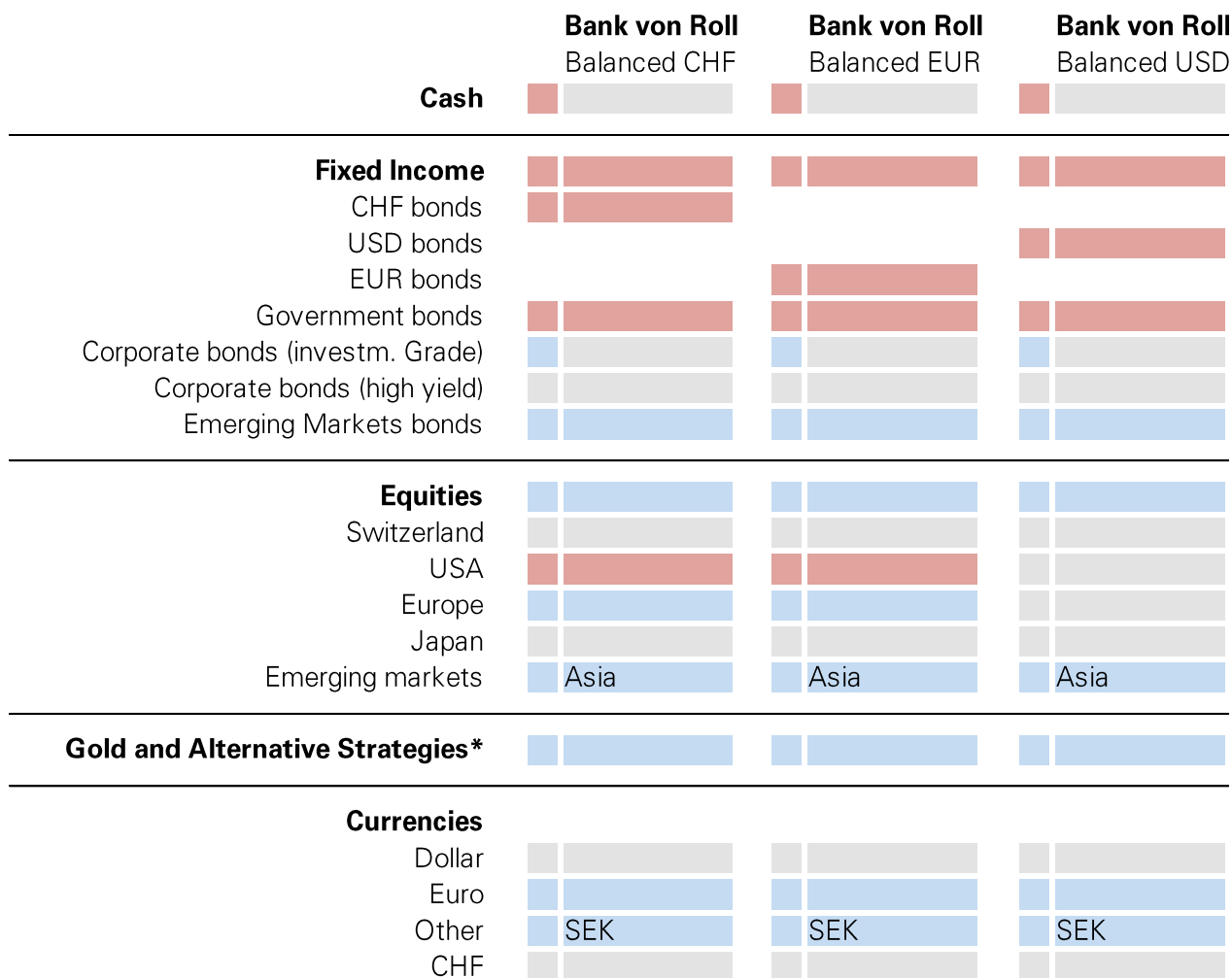
The heightened uncertainty and the associated required higher risk premiums lead to more volatility and interim corrections but make equities more attractive for new money. The future expected total return of stocks is currently slightly lower than in the past, but significantly better than the one of bonds. With stable or slightly rising interest rates, the anomaly of bonds providing equity-like returns should finally dissipate.

Investors should **keep a cool head** and take advantage of this phase to set new accents in their portfolios, to sell positions, that are no longer convincing, on stronger market days, and invest in quality names or long-term themes at lower prices on weaker market days.

Asset Allocation (with change vis-à-vis previous month)

Equity allocation = slightly overweight

Small square = previous month; large bar = target quota



Basis: Balanced portfolio for a CHF investor



no tactical or strategic allocation

*) contains Gold, commodities, real-estate, hedge funds, private equity etc.

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