Investment Strategy December 2017

Global economic growth should gain further momentum in 2018. Central banks will initiate a regime change on the financial and capital markets.

Macroeconomic Environment

Outlook 2018: Economic expansion gaining momentum

We assume that the global economy will expand at an even stronger pace in 2018 than in 2017. Various leading indicators, including purchasing manager indices (PMI), have risen again in November. Self-reinforcing effects (such as rising capital spending) should lead to more momentum and the economy now seems robust enough to handle minor accidents or shocks. Inflation is expected to pick up slightly in the USA, while prices in Europe or Switzerland are not deemed to rise noticeably. The countries of Asia, i.e. China and India, are probably at the beginning of a new economic cycle.

For the global economy, we expect a growth rate in the range of 4%, with emerging countries growing at around 5% and industrialised countries at around 2.4%. The Eurozone and the USA are expected to develop at a similar pace (around 2.3%), with Germany remaining the locomotive within the European Union (2.7%). In Switzerland, we also see stronger growth of around 2.2% after a rather mediocre development in 2017 with growth expected to be 0.8%. Despite the acceleration, global growth continues to lag behind the growth rates seen before the financial crisis.

Given low inflation expectations, interest rates are likely to rise to some extent only in the USA for the time being. We expect three additional rate hikes by the US-Fed in 2018, bringing the policy rate there to the range of 2% - 2.25%. For Europe, we currently do not expect significant interest rate increases. The economic cycle of the European economy traditionally lags the US economy. Furthermore, comparatively high unemployment and unexhausted capacity utilisation leave the European economy some room for further growth without cost pressure. Germany, too, will be able to live well with it, although its economic development justifies higher interest rates. The Swiss National Bank (SNB) will not react until signs of a change of course at the European Centralbank (ECB) become apparent. Whether the SNB gives up the negative interest rate completely or in stages will have to be seen when time has come. The introduction of negative interest rates took place in two stages in 2014/2015 (-0.25% and later -0.75%). Overall, investors can assume that the cycle of falling interest rates has largely been completed but interest rates will remain at very low levels for the time being.

The impact of the tax reform in the USA is still uncertain given the complexity of the bill. Overall, the effects are likely to be slightly positive, at least in the short term, though not as promising as marketed by President Trump. Goldman Sachs estimates the impact on growth for 2018 and 2019 at an additional 0.3%. The contributions are deemed only minimal thereafter, maybe even negative. Goldman Sachs also has doubts as to whether the bill will actually help the Republicans in the mid-term elections in 2018, as voters currently seem not to necessarily appreciate the tax reform at the moment.

Asset Classes

2018 should once again be a positive year for equities, with rising volatility however

Equities

The positive economic environment and low interest rates should support companies' earnings also in 2018. In the past, substantial price corrections on stock markets have been triggered by recessions. Given the solid growth expectations, this economic scenario looks to be out of sight with a decent margin. Therefore, our basic hypothesis is that equities will once again be the best asset class and should in particular better perform than bonds. We focus on quality stocks with strong balance sheets and from late cycle sectors such as industrials, financial services or consumption. Concerning the regional allocation, we are leaving the focus in Europe and will add stocks from Asia. A drawback continues to be the no longer favorable valuation of equities.

Bonds

As far as bonds are concerned, we do not expect any significant price change, which means that the expected performance will be in the area of the coupon payments, leaving only very limited yield potential in view of the prevailing low interest rates in Switzerland and Europe. We recommend that investors review their bond holdings for risk aspects such as quality and duration. High-yield investments (high-yielding bonds of non-investment grade credit quality) are only of limited attractiveness given the

very low risk premium. The risk of very long duration is not to be underestimated. Despite a sub-par performance in the current year, we continue to regard inflation-protected bonds with short maturities as a reasonable diversification factor.

Commodities

Last month, we pointed to record low commodity prices compared to equities. Seasonally, the first months of the new year should be a good entry point. We are slightly positive for this asset class, also from a portfolio diversification perspective. For the time being, the price of oil should hit a top unless there are upheavals in the Middle East. The price of oil also seems to be well supported downwards, which is why we expect a sideways movement.

Gold

We are optimistic about gold and expect a positive performance in the range of up to 5%. The outlook for rising interest rates appears to be contained in the gold price, and demand for gold from key emerging market central banks (such as Russia, China or India) should persist. In our opinion, the potential for surprise is on the positive side, as the number of risk factors did not decrease during the course of 2017. We will mention the most important risk factors further below.

Currencies

The continued positive economic development in Europe should benefit the EUR - the surprise currency in 2017. Another weakening of the Swiss Franc should be welcomed by the SNB and most of the Swiss companies. The outlook for the USD is not so clear as there are opposing factors. The interest rate differential, robust growth, positive short-term effects of the tax reform, such as the potential repatriation of USD, and the still existing function as "world currency", argue for a stronger USD, while the political will and rising debt, respectively the twin deficit (budget and current account), on the background of a record low savings rate speak for a weaker USD. A certain amount of surprise potential can be attributed to the Australian Dollar (AUD). Comparatively attractive interest rates, closeness to the Asian markets and catch-up potential after a mixed year could help the AUD to see positive performance in 2018. Occasionally, the NOK is also mentioned as undervalued. But we are bothered by the relatively low market liquidity of this currency.

Risk Factors

A colorful bouquet of complex factors that can significantly impact financial and capital markets

Monetary policy

The ultra-expansionary monetary policy, such as expressed by the growth of central banks' balance sheets, record-low interest rates or financial repression, was a major driver of the bull market in equities and many other markets. The economy now finally seems to have enough momentum of its own, so central banks can tackle a regime change. This change or normalisation of monetary policy carries risks. Waiting for too long will drive asset prices even higher ("asset inflation"), while intervening too early could strangle the economy. We assume that the central banks will tolerate the first for the time being because the latter is not wanted. In addition, governments cannot afford too high interest rates, as the debt burden has risen further since the financial crisis. The low interest rates and the positive economic development prevent the emergence of a credit crisis for the time being.

Geopolitics

Since Trump took office, geopolitical tensions have once again increased. A derailment of the situation in the Middle East would probably have the biggest impact on the global economy, as an oil price shock could shake it. As long as there is no armed conflict in North Korea, the impact should be limited. In Europe, government formation becomes more difficult, as the example of Germany shows. This can lead to the delay of urgently needed structural reforms at the European level.

Systemic Risks

Low interest rates and the hunt for yield have resulted in high valuations and record low volatility in virtually all asset classes, resulting in an ever greater number of indexed products and so-called "smart beta" strategies. Investors are not necessarily euphoric, but to a certain extent complacent. The market will adjust in the course of 2018 to the above-mentioned change in monetary policy, which will lead to greater volatility. More dangerous is that at the same time the correlation of the individual asset classes could increase. We also fear that bond market liquidity, which is already tight, will continue to deteriorate, especially if everyone like to move out the door at the same time.

Quintessence

We stick to our motto "forward, but with caution", which means: to favor quality-stocks, to diversify and to closely observe the market environment.

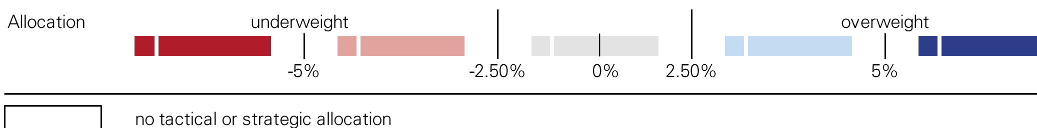
Asset Allocation (with change vis-à-vis previous month)

Equity allocation = slightly overweight

Small square = previous month; large bar = target quota

	Bank von Roll Balanced CHF	Bank von Roll Balanced EUR	Bank von Roll Balanced USD
Cash			
Fixed Income			
CHF bonds			
USD bonds			
EUR bonds			
Government bonds			
Corporate bonds (investm. Grade)			
Corporate bonds (high yield)			
Emerging Markets bonds			
Equities			
Switzerland			
USA			
Europe			
Japan			
Emerging markets	Asia	Asia	Asia
Gold and Alternative Strategies*			
Currencies			
Dollar			
Euro			
Other	SEK	SEK	SEK
CHF			

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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