Piguet Galland &
your investment
strategy
3rd quarter 2018.
In the run-up to the US mid-term elections, Donald Trump appears to have remembered that he was elected for his America First policy. He recently stepped up his efforts to keep that campaign promise – at the cost of alienating the entire international community. The US administration’s more aggressive stance appears to be dictated as much by short-term domestic politics – aimed at preserving the Republican majority in Congress – as by a desire to maintain the USA’s supremacy as other global superpowers emerge. Washington is particularly concerned about China as a rising force. Luckily enough, the trade and political tensions triggered by the USA have come at a time when the global economy is in good shape. While Europe – and to a lesser extent Japan – seem to be experiencing a more sluggish period after the sharp uptick in growth in 2017, the USA and major emerging markets remain buoyant. Unless trade tensions ratchet up significantly, growth shouldn’t be derailed, especially since monetary policies remain extremely loose around the globe, even if they are now being normalised. And inflation is rising only very gradually. Wages in particular have been slow to pick up even though countries like the USA and Germany have reached full employment.

These heightened global tensions have increased volatility, which tends to pick up anyway when the stock-market cycle is nearing an end. We therefore remain overweight equities rather than bonds. Yet as we enter a less favourable season, we recommend adopting a more defensive stance, particularly by increasing the quality of bond positions. We suggest buying long-term US Treasuries, as their yields have perhaps gained enough ground compared with the low yields offered by European sovereigns. To increase bond quality, we are selling US high yields – they offer profit-taking potential following their impressive performance over the course of this business cycle. It also makes sense to take a slightly more defensive position on equities. We recommend reducing exposure to markets that have recorded the best returns in recent months (i.e. the USA and Japan) and slightly increasing exposure to the very defensive Swiss market, which is still lagging behind. This adds up to a slight reduction in our equity allocation: by 1% in our conservative investment grids and 3% in our more dynamic portfolios. We will therefore see a temporary rise in cash and equivalents, which will be reinvested when new buy opportunities arise.

Higher yields in the USA could prolong the dollar’s appeal, until investors realize that Trump’s policy is likely to expand the country’s deficits. We expect investors to show renewed interest in commodity currencies and those emerging currencies offering the best fundamentals.
The US economy remains extremely buoyant. In Q2, GDP growth should accelerate for the eighth quarter in a row, with the consensus estimate putting it at 2.9%. In light of the latest indicators on manufacturing output, order books and retail sales, we wouldn’t be surprised if GDP growth beats the economists’ forecast and comes in at 3%. US output will most likely peak in Q2 2018 before flattening, and then slowing from mid-2019. However, there is no risk of a recession in the next 12 to 18 months. Confidence levels among both consumers and business leaders would suggest that a sharp deterioration in the USA’s economic fundamentals is highly unlikely. However, several risks will be lurking further down the line. In the medium term, investors will probably continue to fret over a potential surge in inflation and the risk of a trade war between the USA and its main economic partners. However, we think that corporate earnings could be the real source of disappointment. Companies will see a sharp rise in expenses as wages, commodity prices and financing costs all move upwards. These factors, coupled with a slowdown in activity in 2019, could weigh on the record earnings of «Corporate America».

We have therefore become more defensive, as cyclical sectors have broadly outperformed since the start of the year. We recommend a much more selective approach to tech stocks because their share prices leave very little room for further upside. We think it makes sense to move into market segments that have been overlooked, such as consumer staples and health care. This kind of defensive approach will help portfolios to weather the heightened volatility we expect to see going forward.

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Daniel Steck Analyst-Manager

Defensive stocks should catch up

US defensive sectors such as consumer staples show considerable catch-up potential, as they lag behind major indexes like the S&P 500 and Nasdaq.
Q2 was marked by renewed political uncertainty in Europe. Immigration remains a major concern, and the region’s failure to effectively manage the crisis has helped to spur a rise in populism. Markets are worried about Italy’s new eurosceptic government, and investors are paying close attention to Germany’s more hard-line stance on immigration and the resulting challenges for Chancellor Merkel. The migrant crisis has emerged as a key issue, one that highlights the fragility and lack of cohesion within the eurozone. And these uncertainties aren’t likely to be resolved anytime soon. But for the moment, the recent developments in Italy do not represent a systemic risk for the European Union. The real risk for Italy could stem from a lack of fiscal discipline, which would have repercussions on the country’s debt and leave Italy ill-prepared for the next recession. The USA’s more aggressive trade policy will serve as a test in this regard. While higher tariffs on steel and aluminium will have only a limited impact, the same cannot be said for the tariffs on cars, which would hurt Germany in particular.

“These political uncertainties have sparked a rise in the risk premium on European stock markets and a fall in bond yields, especially on German sovereigns. Value sectors, such as banks and telecoms, have taken a hit.”

Christina Carlsten Analyst-Manager

These political uncertainties have sparked a rise in the risk premium on European stock markets and a fall in bond yields, especially on German sovereigns. Value sectors, such as banks and telecoms, have taken a hit and will continue to struggle unless the current climate changes. On a more encouraging note, however, the economy remains on a firm footing and companies are in good health. Once the focus shifts back to these solid fundamentals, some attractive entry points will no doubt arise, particularly when it comes to value stocks.

We are now more cautious about the German market: it has sharply outperformed since 2004, investor optimism is still running high, and the risk of a trade war is looming. Within the eurozone, we are bullish on Spain, where growth should remain above average, and on France, which should be boosted by the reforms put in place by Macron’s government. We still recommend remaining neutral on the UK stock market, mainly because pessimism is at extreme levels and the market has a strong weighting in commodities – which we think are an appealing sector at present.

“Fault lines”

In the wake of the Italian crisis, there have been serious concerns about whether the eurozone will be able to keep it together. However, the risk is much smaller than it was back in 2012, at the height of the Greek crisis.

Source: BofAML European Equity and Quant Strategy, Bloomberg
Switzerland Performance doesn’t reflect fundamentals

Switzerland’s SMI lost ground in H1. Defensive sectors like healthcare and consumer staples struggled to find investors and weren’t able to help the index limit its losses.

Swiss equities have been the major disappointment of 2018 so far: the SMI’s major 2017 gains have largely been wiped out this year. It’s difficult to explain this lacklustre performance when Swiss GDP growth is comfortably on track to hit 2.5% this year – a level last seen in 2010. Investors appear to have been put off by the preponderance of defensive sectors like healthcare and consumer staples. And interest rates are still negative, which has weighed on Switzerland’s major banks.

If European and emerging-market fundamentals remain robust, investors may benefit from increasing their investments in Swiss equities, given that Switzerland is broadly exposed to these markets through its exports. In addition, although the Swiss franc has been volatile recently, it should continue to weaken, particularly against the euro. This is very good for the country’s exporters, which make up the majority of both the SMI and the SPI.

We therefore recommend a balanced exposure to large caps, together with a generous helping of smaller caps, particularly in industrials, which should continue to be buoyed by the robust global economy.

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Daniel Steck Analyst-Manager

A dynamic Swiss franc

Starting in early May, the rise in the Swiss franc – which hasn’t managed to break through the SNB’s longstanding target of CHF 1.20 against the euro – was coupled with a sharp decline in Swiss stocks, both on the SPI and the SMI.
Emerging markets
A widening gap between valuations

The outlook for emerging markets is still bright even though they have underperformed and volatility – which should be viewed as a long-term opportunity – has returned. These markets are being buoyed by robust global growth and low inflation.

Despite recent underperformance and a rise in volatility, the outlook for emerging markets is still bright in an environment of solid pace of economic growth and low inflation. As the valuation gap relative to the USA and Europe has widened further, we remain bullish on emerging markets and view the volatility as a long-term opportunity.

Several major geopolitical events took place in Asia during Q2; most notably the renewed North Korea-US dialogue and elections in Malaysia, which saw a former prime minister return to power. In normal times, such events could have brought some stability to the region. However, they were overshadowed this time by the war of words initiated by the US president and the prospect of escalating trade tensions in recent weeks.

China’s economic data released in May were weaker than expected. The Chinese economy is gradually decelerating with growth expected to be 6.5% in 2018 versus 6.7% in 2017. This is primarily due to a normalization of growth and measures of deleveraging implemented by the government last year. Under our base scenario, we expect a controlled deceleration of the economic activities. That said, if the protectionist policies put in place by the US administration start to undermine the current stability in China, we believe Beijing will promptly intervene to cushion the impact to its economy. After all, maintaining the country’s stability is President Xi Jinping’s top priority, even more so than the fight against shadow banking, which is actually not an imminent risk. In terms of the allocation to China, it is worth noting that although the Chinese stock market accounts for 16% of global market capitalisation, it only makes up 4% of the MSCI World index. Capital will therefore flow into China in the coming years as adjustments are made to reflect the country’s weighting in the global economy.

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Ed Yau
Analyst-Manager

Emerging markets are attractively valued relative to both their historical average and the European and US markets. This gap has widened further in recent months – with the MSCI EM currently trading at less than 12 times forward earnings and EPS expected to grow by 17% in 2018.

Attractive share prices

Emerging-market valuations remain appealing compared with their long-run average and multiples in the USA and Europe. The MSCI EM is trading at a P/E ratio of 12x, and growth is forecast to reach 17% in 2018.
Japan
A bump in the road

Despite the strong yen, trade tensions and the slight dip in GDP growth, Japan’s economic indicators are still solid. Share prices remain attractive, with earnings forecast to rise in the medium term.

Overall, the Japanese economy is still very healthy. There are, however, weak spots in some manufacturing segments: next year’s GDP growth forecasts have been revised downwards as a result. These revisions have been largely priced by the market in and shouldn’t affect Japanese share prices. On a more positive note, household income has seen its sharpest rise in a decade.

The trade tensions between the USA and the «rest» of the world, coupled with the rise in the yen, have rattled some investors. If Washington decides to attack the trade surplus run by Japan’s automobile industry, the worst-case scenario would be a 30% decline in car exports, which would shave up to 0.3 percentage points off GDP growth.

Corporate earnings growth seems somewhat lacklustre this year, even setting aside the trade tensions, the yen’s upside potential and the difficult comparison following the solid earnings recorded in 2017. We’ll most likely have to wait until 2019 before Japanese earnings growth surpasses that of its main trading partners. The Tokyo Stock Exchange is still attractive in valuation terms, with a 2019 forward P/E ratio of 15x.

Among investment themes, we still like robotics. First, the future of automation and robotics has garnered significant media attention and, second, the production of industrial robots is on the rise and has almost doubled since 2014, whereas the production of automobiles rose only slightly during this same period. After a sharp correction from some robotics stocks, we may reallocate to the automobile and automation sectors.

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Yas Higuchi Analyst-Manager

Robotization in full swing

Japan, the world leader in robotics, has seen growth in the production of industrial robots double since 2015, whereas the country’s automobile production rose only slightly during the same period.
Bonds

Have US yields hit a peak?

As we near the end of the macro cycle in the USA and long-term yields reach 3%, there are some strong arguments in favour of US Treasuries.

Wage growth could pick up in the USA: as the economy nears full employment, companies are finding it difficult to fill vacant positions, especially when they’re looking for highly skilled workers. Although this uptick in wages remains relatively modest for now, it should gradually spread to the rest of the economy – and could create inflationary pressure down the line. However, inflation should be kept in check by the increasing digitisation and robotisation of the US economy. And we don’t think the higher customs tariffs will trigger an inflationary spiral, unless trade relations deteriorate considerably worldwide. In fact, we think that inflationary fears may well have peaked. For one thing, commodity prices seem to be levelling off after surging over the past 12 months.

US long-term yields are currently close to 3%, making them attractive compared with the low yields offered by the strongest European sovereigns. Now is the time to start improving the quality of bond portfolios, since the business cycle is gradually nearing an end in the USA. We recommend taking profits on US high yields and investing in US Treasuries. Emerging-market bonds are certainly the most attractive segment of the global bond market, regardless of whether they are denominated in strong global currencies or local currencies. Diversifying into this segment makes even more sense given the losses recorded last quarter.

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Daniel Varela
Chief Investment Officer

Treasuries are back

US monetary-policy tightening could start to weigh on high-yield bonds – the risk premium on this bond category is at its lowest since the start of the cycle.

Source: Thomson Reuters Datastream
Market volatility has picked up since the start of the year, following a period of exceptional calm. For some, that lull was the result of the efforts made by central banks since 2013 to maintain abundant liquidity. In its determination to continue raising interest rates, the Fed has now broken this trend. Volatility should remain higher, which is normal at this stage in the economic cycle. Against this backdrop, we find the chart below particularly telling. It shows that alternative funds are still capable of protecting capital during stock-market downturns. This makes them especially appealing during periods of volatility.

In the first six months of the year, our bullish attitude towards long/short equity strategies paid off. The increased dispersion we have been commenting on for more than a year has provided a boost to active managers and significantly enhanced the returns delivered by stock-picking strategies. What’s more, managers have maintained their focus on stock-picking and are no longer looking to adjust portfolios’ directional exposure – an approach that has failed to consistently deliver added value. The result can be seen in the generation of alpha – i.e. the outperformance of long investments and the underperformance of short investments relative to the market – which is currently above the recent average. Although the sharp market movements recorded recently – particularly the rally in January and the downturn in late February – are not ideal conditions, we’ve seen that alpha comes back quickly once the situation settles.

Alternative managers were again able to preserve capital during the stock-market correction that followed the renewed volatility in February. Macro and systematic strategies have been weighed down by rotations and the downturn in emerging markets. In addition, dispersion between different markets remains limited, which means there are few opportunities to diversify into these strategies. We are therefore still bullish on bottom-up strategies, such as long/short equity, which are doing well in the current market environment, and we are maintaining only a limited exposure to top-down management, which includes systematic and macro strategies.

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Léonard Dorsaz Analyst-Manager
Currencies
The dollar is still popular

The dollar is still gaining strength, buoyed by the trade tensions triggered by Donald Trump and the USA’s solid economic indicators. The euro, which seems undervalued, nevertheless shows real upside potential.

The greenback is still popular even after reaching recent highs. According to sentiment indicators, investors are very bullish on the dollar. It has gained ground against the euro, partly thanks to the Fed’s statements about inflation and the possibility for further rate hikes, together with Mario Draghi’s comments about changes to the ECB’s monetary policy. It seems that the market has already factored in this good news and more to come. But this kind of consensus will make the dollar more vulnerable if it falls short of expectations, which are still running very high. We recommend erring on the side of caution when it comes to the dollar and still prefer the euro in the longer term. We think investors underestimate the single currency, which still has upside potential. All it would take is for Europe to stop releasing such disappointing data or – even better – record another uptick in economic activity.

The recent rise in inflation in Switzerland could have prompted calls for the SNB to begin normalising monetary policy. But in the coming months inflation is less likely to be lifted by oil prices, which could even drag it down. Recent events in southern Europe have shown, once again, that the franc is still safe heaven in times of uncertainty. The SNB’s task has therefore not been made easy: it has to defend the franc and maintain the country’s economic stability. For the moment, it would be better for the SNB to follow in the ECB’s footsteps rather than risk a further rise in the franc by normalising rates out of sync with the ECB.

After a number of false starts, begun again to weigh on commodity currencies. The Canadian dollar lost ground after Washington announced that it was raising its customs tariffs. And the Australian dollar fell on concerns that Chinese demand for commodities would decline owing to the US tariffs. The outlook is therefore relatively sombre for countries that rely on global demand, which is currently under pressure for political reasons. If these tensions ease, commodity currencies should gain strength after a very tough start to the year. We therefore intend to increase our positions in these currencies, especially if the USA dials down its trade policy a notch.

Recent events in southern Europe have shown once again that the franc is still the go-to currency in times of uncertainty. The SNB’s task has therefore not been made easy: it has to defend the franc and maintain the country’s economic stability.

Yas Higuchi Analyst-Manager

Dollar on the rise

In the short term, the dollar will be lifted by trade tensions, the Fed’s rate hikes and the repatriation of funds to the USA.

Struggling commo currencies

Commodity currencies like the Canadian dollar have been hit hard by the protectionist measures brought in by Donald Trump in order to put «America First». 
Opec and Russia agreed to raise output in order to stabilise the market, which has seen oil prices climb to their highest level in three years. But the decision will be tough to implement owing to logistical constraints.

And the target could prove hard to achieve for several technical reasons: some countries do not have any spare capacity, while others are facing bottlenecks or lack key infrastructure like pipelines.

“We expect oil to move within a range of USD 65–75 per barrel.”

Yas Higuchi Analyst-Manager

Despite the Opec agreements, oil output should eventually stabilise.
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