Vontobel

Asset Management

Investors' Outlook

Time to pause and reflect

March 2019

Time to pause and reflect

Dear readers,

Japanese gardens combine the basic elements of water, plants, and rocks with simple, clean lines to create a tranquil retreat. Adhering to Zen philosophy, these gardens were intended to be viewed during seated meditation – or zazen – and served as places to pause and reflect. Taking inspiration from their contemplative quality, we take time to step back and ponder the U.S. central bank's latest policy shift and what it means for financial markets and the most important asset classes.

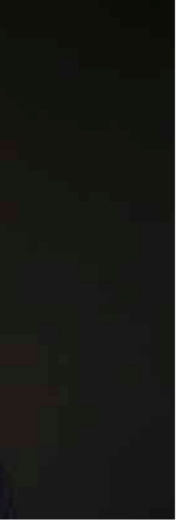
After the U.S. Federal Reserve (Fed) had shifted its policy guidance in a less hawkish direction, emphasizing the need to be "data dependent" and "patient", other central banks were quick to follow suit. The European Central Bank (ECB) downgraded its risk assessment for the Eurozone's growth outlook from "balanced" to "tilted to the downside", pushing back market expectations for a first rate hike well into 2020. Soon, other central banks from around the world joined in with calls for patience and flexibility in adjusting monetary policy. Notable examples include England, Australia, Canada, Japan and – in emerging markets – China and Brazil.

In other words, central banks shifted from "tightening mode" to "pausing and reflecting". We believe this policy reversal is justified given the meaningful risks financial markets are facing today. In essence, these include the global economic weakness morphing into a significant downturn (a very close possibility in Europe), falling inflation, Brexit and many more.

At least on the U.S.-China trade war front, we see first signs of a potential deal in the coming weeks. However, it is still unclear how the U.S. will act on car tariffs, especially European ones. The Department of Commerce submitted its research to President Trump but he has not had time to pause and reflect – nor tweet, which might change any time.

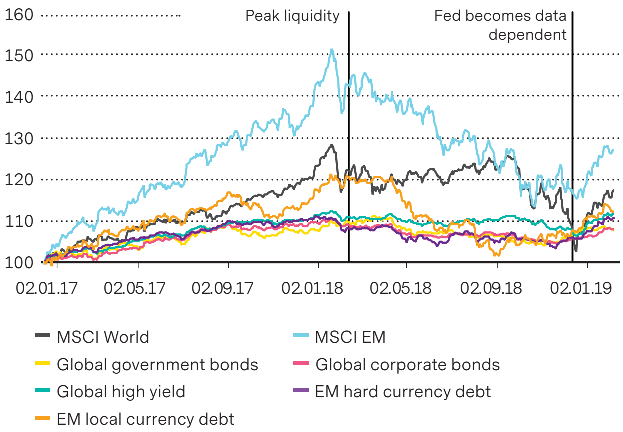
Amid these risks, markets cheered the dovish tilt from central banks and a weaker U.S. dollar in 2019; as a result, the most important asset classes have posted

→ Input deadline for this edition
Thursday, February 28, 2019



positive returns so far. As shown in the graph, increased central bank liquidity has been the main driver of positive asset returns across the investment spectrum. Cash, probably the most crowded asset going into 2019, has thus largely underperformed.

The pause that refreshes
Increased central bank liquidity has sparked a broader asset class rally in 2019
Total return index in USD



Source: Bloomberg, MSCI, BofAML, JPM, Vontobel

Below are the main expectations of our normalization scenario, the one we currently consider most likely:

- China's measures to support the economy, which start to be visible in early indicators (such as measures of money supply), will have a positive effect on Chinese GDP and support other regions like Europe and Japan.
- Therefore, Europe is likely to recover from an economic slowdown later in the year, dodging a significant downturn.
- The Fed will be able to conclude the rate-hiking cycle by increasing the base rate one or two more times, but without being perceived as too hawkish. Consequently, the U.S. dollar will likely be about to peak against most other currencies.

So, does this all mean then that investors are in for a nice ride? Well, not exactly. Our normalization scenario assumes no further escalation of the trade war, China stabilizing, a relief in emerging markets and no recession in Europe. Clearly, should one or more of these assumptions fail to materialize, this would pose a major risk for markets to keep climbing higher. Thus, apart from the macro data, it will be important to carefully watch corporate earnings; in a normalization scenario, strong earnings will be the key driver for asset prices.

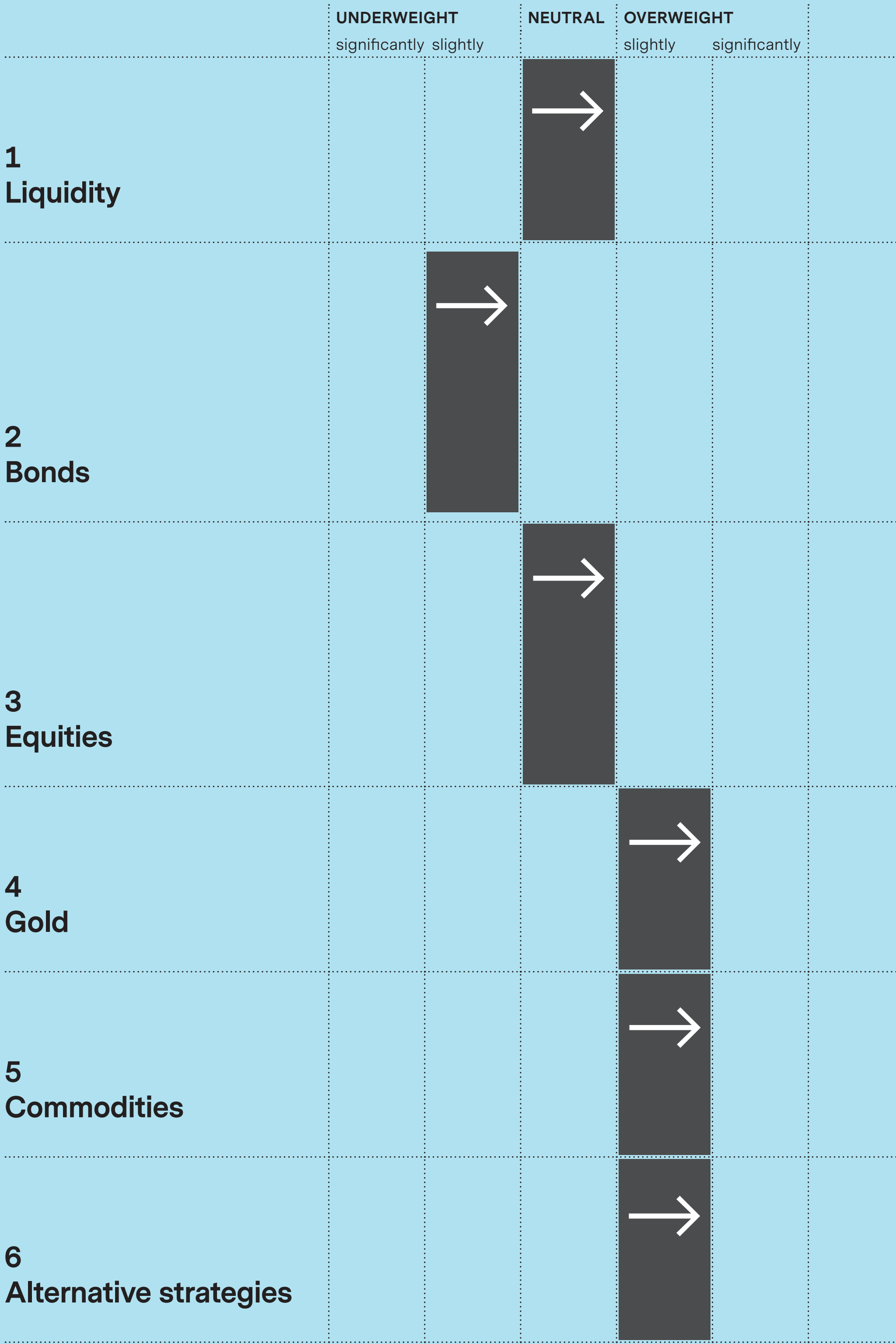
Overall, we maintain a positive outlook, which is above consensus views. However, given the risks mentioned – and the low level of visibility – we advocate prudent risk taking and believe a neutral stance on bonds and equities is warranted. Within bonds, we take the "short U.S. dollar view", i.e. we prefer emerging market local debt and corporate bonds to government bonds. Within the equity allocation, we prefer emerging markets over Europe where we see the former profiting more from Chinese stimulus and a weaker U.S. dollar while the latter is exposed to political risks and a looming car tariff threat. Further, commodities remain supported by three main factors: a recovery in China, a U.S. dollar that has likely reached its peak and solid demand typically seen during the late stage of the economic cycle. Regarding the greenback, we remain neutral for now but are looking for opportunities to go short.

Kind regards

Frank Häusler
Chief Strategist, Vontobel

New equity-mix: Overweight emerging market equities

After a painful fourth quarter last year, risky asset classes have started 2019 with strong gains. The main reason is the U.S. Federal Reserve, which looks set to pause its rate hike cycle. However, it also means that there is little scope for the trade-weighted U.S. dollar to move higher. At the same time, the Chinese central bank has delighted the world by stepping up monetary stimulus. This plays into our hands. We are maintaining our overweight for commodities, gold, and emerging market bonds in local currencies, and, within equities, now prefer emerging markets to Europe.



Changes month-on-month:
same, higher, lower

→ ↗ ↘

We are keeping a neutral liquidity position with no specific currency preference. We should have seen peak U.S. dollar strength and no longer hold U.S. dollar in other reference currencies. Should opportunities arise, we will have enough dry powder to deploy. Furthermore, especially in U.S. dollar, liquidity offers an attractive return.

We still conclude that government bonds in general hold little attraction. However, we are specifically not underweight Swiss government bonds anymore because, in hedged terms for CHF investors, they are actually more attractive than Bunds or U.S. Treasuries. At the current juncture, we prefer credit exposure, especially in investment grade. Although our high-yield outlook is generally still positive given strong underlying credit data, we took some profit after the very strong rally in the first weeks of the year, which was more a tactical move. Our largest overweight is in EM local currency debt which should profit from China stimulus measures and a softer U.S. dollar and also has a high carry.

We are retaining our neutral equity weight. It is neither time to take profits, as we believe it is too early, nor to increase exposure while uncertainty about the future economic growth path remains high. In terms of regions, we are underweight the U.S. (the most expensive market in our assessment) and overweight Japan and Europe where we see better valuations, and especially in Europe more catch-up potential. In Switzerland, UK and EM, we reiterate our neutral stance.

We are slightly overweight gold. We assume that we have seen U.S. dollar peak strength and, therefore, a headwind for the precious metal removed. Additionally, as long as real rates are no longer rising, gold should be relatively more attractive. Furthermore, it stills serves as a hedge or alternative currency in very adverse geopolitical and macroeconomic conditions.

History tells us that in a late cycle economy, commodities are relatively more attractive than equities and gold. On top of it, in our scenario where the dollar should not appreciate much further and China continues to stimulate its economy, commodities should outperform other major asset classes.

We continue to recommend an overweight in alternatives. We keep our focus on equity-market-neutral, CTA and global macro as well as relative-value strategies. In the current environment of higher volatility and uncertainty, these strategies should be able to play their role as a diversifier and return contributor.

—
Reto Cueni, PhD
Senior Economist

—
Ralf Wiedenmann, PhD
Head Economic Research

Our perspective on the world

We see the global economy continuing on a solid but weaker growth path over the coming twelve months, accompanied by moderate inflationary pressure. However, the risks for a meaningful downturn have further increased since the end of last year. In general, we still base our assumptions on a scenario in which central banks can continue their long slog towards a very leisurely normalization of monetary policy as the economies are already operating close to their long-term growth path.

However, growth in the USA, the eurozone, Switzerland, and China is likely to weaken in 2019 compared to last year. Japan is likely to preserve the growth rates it recorded in 2018 into the new year while in the U.S., the positive stimulus from tax cuts will decline sharply. In order to counteract the negative effects of U.S. import tariffs, China is about to ignite a greater stimulus. However, the slowdown in the Chinese economy so far has already negatively affected the economies in Europe and Japan.

In the United States, core inflation has already hit the 2% target. In contrast, core inflation is still a long way from reaching its target in the eurozone, Switzerland and particularly Japan. This situation will probably prompt the U.S. Fed to a maximum of two more rate increases this year, while we expect the European Central Bank to carry out its first interest rate hike in fall 2019. We do not forecast an interest rate hike in Japan, but rather a further reduction in bond purchases and a very moderate adjustment of yield curve control toward less expansionary monetary policy.

Risk outlook

After the escalation of the trade conflict between the U.S. and its trading partners last year, hopes of a benign outcome have surfaced. The USA and China have extended the ceasefire in the trade conflict, which expires at the beginning of March, and have promised a summit meeting of their presidents.

However, the trade conflict between the USA and the EU or Japan could be rekindled by the introduction of U.S. car import tariffs. Euroskeptic forces in Europe will be another risk in the European Parliament elections next May. If their vote share increases significantly, they could cause uncertainty to resurface regarding the European project – which in turn could throw the ECB off its normalization course. Similarly, the UK's impending exit from the EU is unsettling businesses, as the Brexit deal still does not have the approval of the House of Commons just four weeks ahead of the intended withdrawal date. There are also further geopolitical risks regarding the developments in Iran, Syria, Saudi Arabia, North Korea and Venezuela. An escalation of the situation could push energy prices, which have fallen recently, back up.

Chinese stimulus should spur global economic upturn again

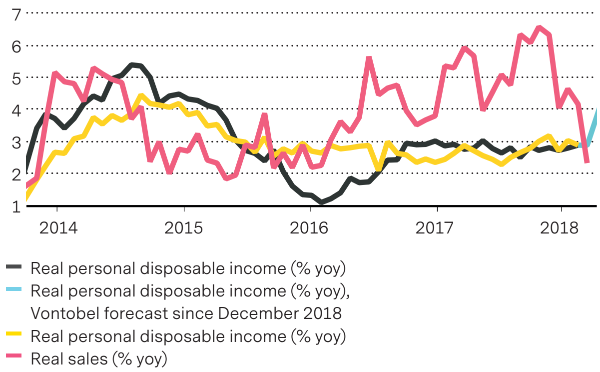
Ralf Wiedenmann, PhD
Head of Economic Research

Reto Cueni, PhD
Senior Economist

Weak U.S. retail figures have spooked markets but these are often a poor indicator for private consumption, which is so crucial for the U.S. economy. We anticipate robust growth in U.S. consumption and for the weakening global economy to resume its recovery in the lead-up to the summer, when international trade policy should be somewhat more harmonious.

U.S: Robust economy despite disappointing retail sector
Retail sales for December were not published until mid-February due to the government shutdown. The slump has spooked economic observers and investors in equal doses. Nonetheless, retail sales often paint a misleading picture of private consumption. Private consumption performs in line with disposable income, and this can be predicted fairly accurately by looking at employment, real wages, and weekly working hours. This data is provided by the Bureau of Labor Statistics, which was not affected by the shutdown and has thus already published the figures for January. These show that disposable income rose in real terms in December, with solid annual growth of 2.8% and an upturn in January (see chart 1). Despite the poor retail figures, we thus expect to see strong private consumption and, as this accounts for almost 70% of the entire economic output, robust economic growth.

Despite weak retail figures: Upturn in disposable income suggests robust consumption



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Bureau of Census, Thomson Reuters Datastream, Vontobel

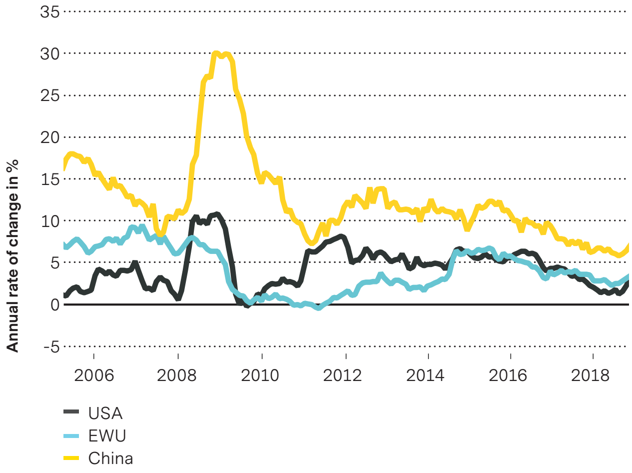
U.S. Federal Reserve likely to already adjust interest rates this year

While interest rate futures markets do not expect any further interest rate hikes by the U.S. Fed until the end of the year, we still anticipate rates to be raised once or twice. We regard the labor market as tight and so core inflation is unlikely to fall below 2%. In addition, we expect solid economic growth of 2.4% this year.

We still cannot rule out the European Central Bank (ECB) raising the interest rate

Industrial production is still declining and the industry business climate in the eurozone is poor, both of which currently imply that there will be no first interest rate move this year – the financial markets are priced accordingly. However, as we expect global production to stabilize in the second quarter and as money supply indicators are already reflecting renewed monetary stimulus in China (and in the U.S. and the EMU) (see chart 2), we also expect to see a slight upturn towards the middle of the year, even in the export-dependent eurozone (EMU). Price and wage pressure indicators in the eurozone also continue to show an upward trend. As a result, we still cannot rule out the ECB raising the interest rate for the first time at the end of the year.

Money supply indicators on the rise again in China, the U.S. and the eurozone



Source: US, European and Chinese central banks, Datastream, Vontobel

Trade policy still key

It remains unclear how global trade policy will develop. Nonetheless, distortion on the financial markets towards the end of last year and the global economic downturn should drive home to all political players that further escalation – for example imposing tough car import tariffs in the U.S. – would be poison for the global economy, and sooner or later for the U.S. economy too. This makes rapprochement between the U.S. and China, but also with Japan and the EU, more likely. The summer is also likely to bring some calm on the Brexit front. In general, a break and some time for reflection could help political leaders of the countries in the “zen garden” regain some harmony.

BONDS

—

Fabrizio Basile, CFA
Head of Fixed Income Strategy

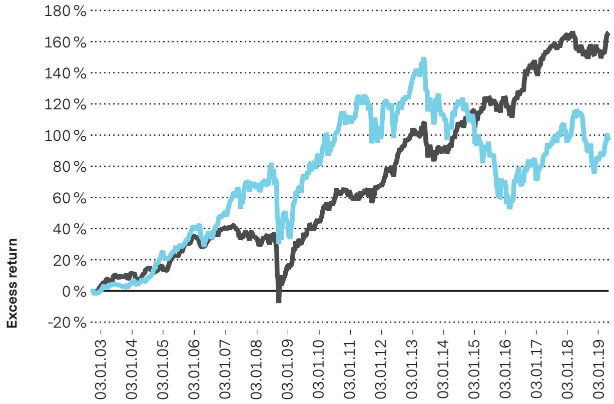
The time looks right for emerging market bonds, particularly local-currency paper

In the absence of recessions and U.S. dollar strength, EM bonds are one of the best performing fixed income segments over the medium term. In such a scenario, the strategy to invest in hard-currency paper can be "buy and hold". Local currency bonds, however, require a tactical approach, buying them when the time is right. We believe this is the case today.

Over the past 15 years, EM bonds in hard currency (EMBI) have returned almost twice as much as the Barclays global aggregate bond index (see chart 1). What is more, their outperformance has been accruing very steadily over the whole period.

The situation for EM bonds in local currency (GBI-EM) differs somewhat. Despite their longer-term outperformance, we note prolonged periods of underperformance either close to recessions or in times of U.S. dollar strength. Thus, the two segments require a different investment approach. Hard-currency bond investors may follow a well-diversified "buy and hold" strategy whereas investors in local-currency paper need to proceed more tactically to avoid possible prolonged periods of losses.

EM bonds outperform the broad market, but local-currency issues may have more potential today



Hard-currency EM bonds versus bond global aggregate (Barclays) — Local-currency EM bonds versus bond global aggregate (Barclays)

Source: J.P. Morgan Chase, Bloomberg, Vontobel

Overall, we expect local-currency EM bonds to perform well this year given 1) higher real interest rates in the respective countries compared to those in developed economies, 2) our expectations of stabilizing growth prospects in EM and 3) of a peaking U.S. dollar, the main currency against which returns are measured. The same applies to their hard-currency counterparts, according to our outlook. However, these will miss the contribution from EM currencies' possible appreciation versus the greenback.

EQUITIES

—

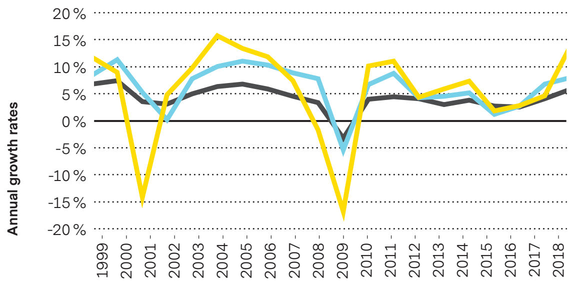
Ireneus Stanislawek, CFA, FRM
Equity Strategist

Without economic growth, outlook for corporate profits – and thus gains – remains modest

The Fed's recent announcement that it will proceed more cautiously when it comes to further interest rate hikes has supported equity markets. Investors are not anticipating any more interest rate hikes this year – but we are. If equities are to continue their upturn, corporate profits have to pick up too, and this requires economic growth.

We have taken a closer look at the link between economic growth and fundamental company data in the major industrialized countries (G7), comparing nominal economic growth with the change in corporate sales and profits. It showed that, in the long-term, economic growth, sales growth, and profit growth in the G7 countries all moved in tandem. The correlation between these was comparatively strong. The chart illustrates the situation in the U.S. On average, a 1% increase in economic growth led to a 1.6% rise in sales and – through the leverage effect – an upturn in profits of around 3%. The result in other G7 countries was similar. Japan and the UK were the exception. The U.S. saw a disproportionate rise in profits in 2018 following the U.S. tax reform and we therefore expect significantly lower growth for 2019.

If the U.S. economy grows, corporate revenues and profits tend to rise, too



Nominal GDP — Sales — Earnings

Source: Factset, MSCI, Vontobel Asset Management

Analysts expect corporate profits to continue to pick up globally, albeit only moderately as forecasts have already declined sharply in the last few months, and currently anticipate just a 5% year-on-year rise in 2019 worldwide. Respectable growth of +12% and +9% is expected for Switzerland and the Eurozone, respectively. This is partially explained by base effects, but the forecast for the Eurozone is still high given our economic growth forecast of +2.8% in nominal terms. Investors should thus expect these forecasts for Europe to be lowered. Accordingly, investors should assume that expectations for European equities will decline and not be supported by the macroeconomic environment this year.

CURRENCIES

—

Sven Schubert, PhD
Specialist Investment Strategy Currencies

Dollar has likely peaked

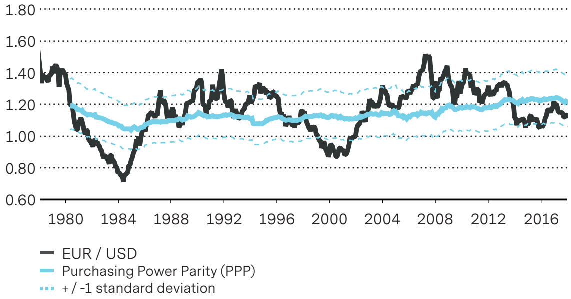
Signs are mounting that the dollar is about to weaken. European currencies in particular stand to benefit. We also see an upturn in emerging market currencies, although this potential is likely to remain negligible against a strong euro.

We are increasingly convinced that the dollar has passed its peak, with the upward pressure on the currency abating, particularly at a political level. The risks of a hard Brexit and escalation in the US-China trade dispute have been reduced.

Global economic risks have also subsided in the last few months, with central banks in China and the U.S. relenting and further loosening the monetary policy reins. This shift in direction has caused yields on global bond markets to fall considerably, resulting in lower refinancing costs at a global level.

European currencies in particular stand to benefit from this. Massive interest rate differentials established in the last few years are likely to decline gradually in 2019 and spur on the undervalued euro, franc, and Scandinavian currencies against the dollar (see chart). On the other hand, we see only low potential for the EUR / CHF exchange rate, with the high current account surplus, robust economy and our assessment of monetary policy at the SNB (SNB raises interest rates immediately after the ECB) all indicating that the EUR / CHF exchange rate will not increase much above 1.15 / 17.

Euro valued favorably according to purchasing power parity



Sources: Thomson Reuters Datastream, Vontobel Asset Management

COMMODITIES

—

Stefan Eppenberger
Investment & Commodity Strategist

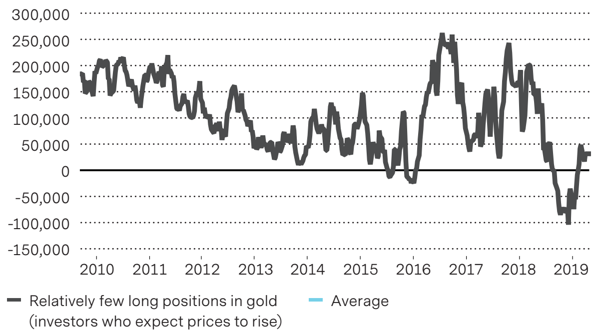
Oil and gold benefiting from Jerome Powell's New Year Gift

A weaker U.S. dollar and a return to more generous monetary policy in many places are buoying commodities, with the "black gold" also enjoying the effect of major oil producers cutting back production. Nonetheless, volatility in the Trump administration provides an element of uncertainty.

It was not only equities that suffered major losses in the final quarter of 2018. Oil prices also hit annual lows given subdued economic outlook. The turning point came in early 2019, when Fed Chairman Jerome Powell gave a speech indicating a far gentler pace of interest rate hikes. Equity markets soared, with commodities rallying too. Meanwhile, the Organization of the Petroleum Exporting Countries (OPEC) is cutting production. This should further support the price of oil – at least until Donald Trump resumes his frequent tweeting about (excessively) high prices. At the moment, Washington does not seem to be all too worried about oil prices, as shown by U.S. sanctions imposed on Venezuela, a key oil exporter. The situation would probably become critical only at the point when the price exceeds USD 80 a barrel.

Investor's interest in gold currently (still) limited

Net long positions in gold*



* Open long contracts minus open short contracts in USD

Sources: U.S. Commodity Futures Trading Commission, Thomson Reuters DataStream, Vontobel

Gold was the only commodity to shine in the fourth quarter of 2018, benefiting mainly from the considerable uncertainty in financial markets. The stock market rally at the beginning of 2019 did not halt its upwards trend and the price per fine ounce climbed over the USD 1,300 mark. Gold is currently benefiting from a slight weakening of the greenback, induced by the U.S. Fed's more cautious approach since the start of the year. Jerome Powell's change of tack is also likely to dissuade other central banks from adopting more restrictive monetary policy and, if this happens, it could bolster the price of gold even more. Gold therefore looks set to continue its upwards trend, especially as investors appear to have pent-up demand (see chart).

Key macroeconomic and financial market forecasts for 2019

USA		2019
Real GDP growth		2.40%
Inflation	↓	2.10%
Key interest rate[1]		3.00%
10-year government bond yield[1]		3.10%

EUROZONE		2019
Real GDP growth	↓	1.30%
Inflation		1.50%
Key interest rate[1]		–0.20%
10-year government bond yield Germany[1]	↓	0.60%

CHINA		2019
Real GDP growth		6.20%
Inflation		2.40%
Key interest rate[1]		4.35%

SWITZERLAND		2019
Real GDP growth		1.70%
Inflation	↓	0.80%
Key interest rate[1]		–0.50%
10-year government bond yield[1]	↓	0.20%

FOREIGN EXCHANGE RATES[1]	2019
USD per EUR	1.22
CHF per EUR	1.13
CHF per USD	0.93

COMMODITY PRICES[1]	2019
Crude oil (Brent, USD per barrel)	80
Gold (USD per ounce)	1,400

[1] Financial market forecast are for end of year

Arrow indicate change in forecast compared to last publication

Vontobel Asset Management AG
Gotthardstrasse 43
8022 Zurich
Switzerland

vontobel.com