NPB | Neue Privat Bank

Investment **News**

Investment strategy in a low interest rate environment

Negative interest rates – for all eternity?

In around 90% of all countries, economic activity is showing signs of a slowdown while inflation still does not seem to be an issue. Most central banks are feeling pressure to take monetary countermeasures. Bond yields have fallen significantly once again. In Switzerland and Germany, all government bonds with maturities up to 30 years have negative interest rates. This situation calls for an adjusted investment strategy.

Global slowdown in growth

The economic data published over the last few weeks makes it clear that economic growth is steadily slowing, even in the USA. The deteriorating economic environment does not come as a complete surprise, given that the US economy has already been expanding for almost a decade and was further invigorated by Trump's tax reforms in 2017/2018. The downturn is undoubtedly being further exacerbated by erratic developments in the USA's trade dispute with China. The global production of goods, with its complex supply chains, has been thrown into disarray by tariff increases. The trade war with China has blown hot and cold, causing a huge rise in uncertainty when it comes to selecting industrial locations and has a breaking effect on investments. In light of this, it is not altogether surprising that industry-heavy global export champion Germany already finds itself in a kind of technical recession.

Central banks run out of ammunition

The expansive monetary policy implemented over the last ten years originated during the financial crisis and was in fact designed as a temporary measure to mitigate the risk of a massive global recession. Just as central banks began to normalise their monetary policy (USA) or wanted to begin doing so (Europe), the economic situation deteriorated significantly once again. While US Federal Reserve chair Jerome Powell attempts to turn around interest rates, Draghi's latest efforts to loosen the ECB's monetary policy appear to be an act of desperation. There are increasing signs – and a growing number of critical voices – to suggest that simply opening the monetary floodgates is not enough to get European economies suffering from various structural problems back on track. In particular, the Bank of Japan and the ECB have manoeuvred themselves into a monetary policy trap from which they are finding it difficult to escape. As a result, rate hikes are off the agenda for some time and investors will probably have to continue living with low interest rates.

The bond investment dilemma

Weak global growth, combined with monetary easing, has once again delivered substantial price gains for bondholders. However, the downside to this is that there are hardly any bonds with an investment grade rating that yield positive returns, particularly in Switzerland and Europe. In fact, bondholders are faced with an investment dilemma: as well as no longer paying positive coupons, bonds actually hold an increased risk of setbacks after the most recent price gains. After all, how many investors are brave enough to buy a 100-year bond issued by the Republic of Austria that almost doubled in price in 2019 and is yielding less than 0.8% p.a. at a price of over 190?

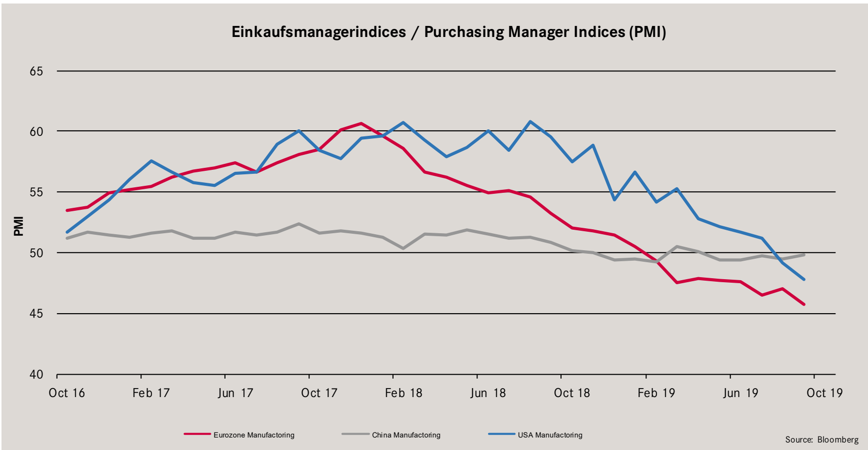
Investing in a low interest rate environment

Every asset class appears to be highly valued by historical standards. However, a flight solely to government bonds with negative yields is not a viable strategy for anyone but the most defensive investors.

Instead, a portfolio with the following asset allocation is recommended:

- a higher cash balance to enable investors to respond to declines in bonds and equities in particular;
- a focus on broadly diversified corporate and high-yield bonds (fund) including emerging market bonds;
- a diversified portfolio of convertible bonds that, in addition to offering a minimal return, also enable investors to participate in higher share prices;
- gold as a hedge against so-called 'event risks'; and,
- last but not least, it is hard to avoid equities and equity-based structured products despite their historically high valuations. The continuing low interest rate environment makes dividend-paying stocks relatively inexpensive. Stocks with high (secured) dividends such as infrastructure stocks with guaranteed cash flows for years to come benefit particularly strongly from this. Despite high valuations, funds continue to flow into what are known as SWAN ("**s**leep **w**ell **a**t **n**ight") stocks such as Swiss firms Nestlé and Givaudan that, despite being highly valued, also boast sustainable, less economically sensitive business models.

Prof. Markus Ruffner



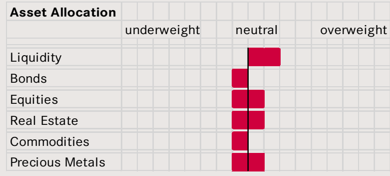
Is Trump creating his own recession?

In recent months, the economic situation has deteriorated further in almost every country. **Global trade** has weakened considerably, not least due to the international trade dispute and the risk of a disorderly Brexit. As a result, the World Trade Organisation expects global trade to grow by just 1.2% in 2019, the lowest rate since the financial crisis in 2009. Industrial production is being hit particularly hard. Leading indicators such as the industrial purchasing managers' index (PMI Industries) almost all suggest further weakening. Conversely, the purchasing managers' index for services (PMI Services) has remained remarkably stable ***so far***. Consumer spending has undoubtedly contributed to this performance, having proven to be an effective economic pillar in almost all countries. As a result, the economic slowdown is particularly pronounced in countries with a high **industrial share** (Japan: 21%; Germany: 21%; South Korea: 28%; China: 30%), while less industry-heavy economies present a lower risk of recession (UK: 9%; France 10%, USA: 11%).
After the economy in the **USA** long proved to be stable, the ISM's PMI Manufacturing Index declined from 49.1 to 47.8 points in September 2019, its lowest level in more than a decade. However, the ISM's PMI Services index calculated for the USA also dropped from 56.4 to 52.6 points. Meanwhile, the interest rate curve for the USD has inverted across all maturity bands, i.e. yields for short maturities are higher than those for longer-dated bonds. Although inverse yield curves have proven to be one of the most reliable indicators of recession in the past, exaggerated pessimism about the US economy does not appear to be appropriate. As the recently announced pseudo- or mini-agreement in the trade dispute with China shows, President Trump is not interested in digging his own grave and provoking a recession by escalating matters ahead of the election in November 2020.

Signs of a slowdown in Europe and Japan

The comparably high industrial share and a structural shift towards electric cars in the automotive sector make European growth engine **Germany** particularly vulnerable to increased trade risks and Brexit. As central banks have largely used up all of their ammunition, we are anticipating growth of well under 1% for Europe in 2020. One country that is expected to perform even more poorly is **Japan**, where negative growth can no longer be ruled out for 2020 due to significantly increased uncertainty surrounding trade relations.
The economic situation in **China** appears to be less dramatic. Given the size the economy has now reached, base effects mean that it is normal for annual growth rates to fall. Thanks to the largely intact scope for monetary and fiscal policy measures, we anticipate growth of around 6% in China in the coming year. A decline in export growth is likely to continue to be absorbed by increased domestic demand and a rise in infrastructure investments.

Strategy



Bonds should be underweighted in an environment of record low interest rates. Investors should continue to favour short and medium-term corporate bonds with an investment grade rating. Selective investments can also be made in higher-yield emerging market bonds.
Equities are no longer attractively valued after significant share price recoveries. Despite lower profit forecasts, we do not anticipate significant reversals, even though there is still the risk of a fresh escalation of the trade dispute. The prospect of persistently low interest rates may provide the equity markets with a valuable pillar of support.
Commercial **real estate** prices present a consolidation risk in many countries. There continues to be scope for higher real estate prices in a few European countries (e.g. Germany), in medium-sized residential construction.
Commodities: After considerable declines in crude oil prices, we believe these prices will stabilise due to the production cuts by OPEC countries and expect US shale oil producers to improve their investment discipline.
Precious metals: We regard gold and silver mainly as hedges against global political risks.

	Real GDP growth in %			Inflation in %			Output gap in %	Deficit in% GDP	Debt in% GDP	CDS spread in bp	Real interest rates in %
	2017	2018	2019E	2017	2018	2019E		2019	2019		
United States	2.2	2.8	2.2	2.1	2.5	2.0	-1.19	-4.4	82.3	14.53	-0.94
Eurozone	2.2	2.3	1.2	1.5	1.6	1.1	-0.07	-0.5	n/a	n/a	n/a
Germany	2.4	2.2	0.5	1.7	1.7	1.3	-0.17	1.7	64.1	11.47	-2.27
France	1.8	2	1.2	1.1	1.8	1.2	0.23	-2.5	97.0	21.32	-2.04
Italy	1.5	1.4	0.1	1.4	1.2	0.7	-4.10	-2.1	131.5	136.57	-0.34
United Kingdom	1.5	1.4	1.0	2.7	2.5	1.8	-3.43	-1.5	87.0	34.19	-2.05
Switzerland	0.9	2.2	0.8	0.5	0.8	0.5	-2.66	0,441	42.8	12.1	-1.58
Japan	1.5	1.3	1.0	0.5	1.1	1.0	-1.46	-2.04	236.4	24.75	-1.31
China	6.8	6.6	6.1	1.6	2.3	2.7	n/a	-4.17	47.8	49.1	0.81
India	6.5	7.3	5.2	3.4	4.7	3.6	n/a	-3.94	70.2	78.76	1.75
Russia	1.9	1.8	1.3	3.8	3	4	n/a	0.80	17.4	91.33	3.79
Brazil	0.7	2.2	0.8	3.4	3.4	3.8	n/a	-6.32	84.0	144.58	0.50

Sources: Bloomberg, Goldman Sachs, IMF, Economist, NPB Neue Privat Bank

Equity markets – fundamental valuations (performance in local currencies)

	Performance Equities (in %) YTD	Price/ book value	P/E ratio Current	P/E ratio 2020E	Dividend yield 2018E	Index
United States	15.41	3.31	19.02	15.80	2.17	S&P 500
Germany	14.80	1.59	19.71	12.47	3.52	DAX
France	16.22	1.62	18.86	13.26	3.68	CAC 40
Italy	17.59	1.13	12.98	10.35	4.77	FTSE MIB
United Kingdom	6.83	1.71	17.43	11.89	4.99	FTSE 100
Switzerland	16.85	2.70	21.64	15.17	3.51	SMI
Japan	7.20	1.64	15.36	15.21	2.25	NIKKEI
China	-0.63	1.14	10.00	9.68	4.23	Hang Seng
India	4.15	2.82	24.26	16.38	1.77	Nifty
Russia	23.52	0.88	5.67	5.84	n/a	RTS
Brazil	13.76	2.07	15.46	11.47	4.02	BOVESPA

Source: Bloomberg 09/10/2019

Trump as a "volatility generator"

After a spectacular start to 2019, most markets have not done much on balance since the end of April. Both the American S&P 500 and the German DAX index are around the same level as they were after the first four months of the year. The Swiss Market Index pushed slightly higher, while most Asian markets are well below the level they reached in April 2019, not least due to turbulences surrounding the trade dispute. The markets were kept on their toes by President Trump's erratic Twitter politics in the trade conflict between the USA and China. The oscillation between escalation and containment in disputes about the reorganisation of trade relations between the world's two largest economies has significantly increased volatility on the markets. It is still far too early to claim the "partial agreement" recently touted as a great success by Trump as an initial victory, especially as the details have not yet been set out in writing. Like it or not, investors must continue to gear up for surprising twists and turns in a tussle for global economic supremacy that will likely drag on for years. For the moment, Trump also seems to be timing the trade dispute primarily around his re-election – and endangering this with escalation and a self-inflicted recession would surely be the stupidest move of all.

Declining earnings for US companies

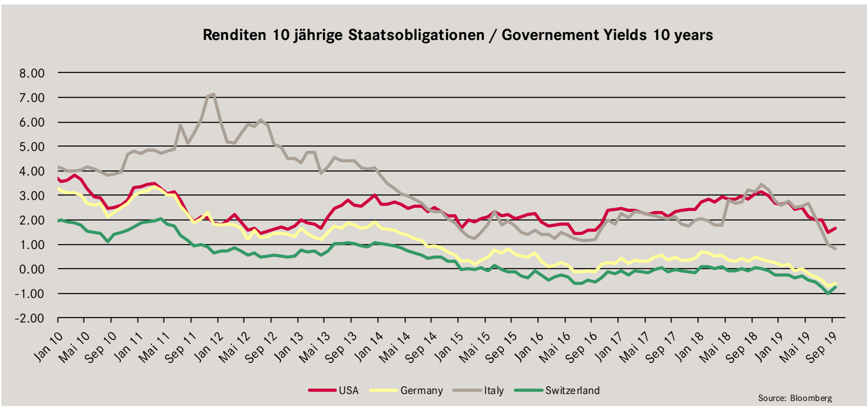
The fact that the equity markets have not suffered in most developed countries despite the rising risk of recession is largely due to developments of the interest rates. As the fundamental valuation of equities is primarily dependent upon the performance and the level of "risk-free" investments in interest-bearing securities, equities have become considerably cheaper compared to bonds. This is also evident from the still considerable dividend yields of equities, which contrast with the negative interest rates offered by bonds. The average earnings of US equities in particular are expected to decline by around 4% year-on-year in the third quarter of 2019, after having soared by approximately 25% on an annual basis in the previous year thanks to corporate tax reform. The outlook for European stocks is in general less dramatic, but companies in cyclical industries are likely to have to significantly downgrade their earnings expectations.

Low valuations for emerging market equities

At **country level**, the massive outperformance of the US equity market could slowly come to an end. Due to their significantly lower valuations (see table) and higher long-term potential to increase profits, we recommend overweighting equities from emerging markets relative to US stocks in the medium term. With regard to individual **sectors**, we are cautious about cyclical stocks. Dividend-bearing stocks (utilities, infrastructure, telecoms, energy) have become more attractive again in an extremely low interest rate environment. Stocks of companies offering less economically sensitive products and services and sustainable competitive advantages (so-called "long-term champions") are also still worth buying.

Panic buying on the bond markets

Growing economic and political uncertainty and rising recession fears coupled with interest rate cuts by central banks have prompted a spending spree for fixed income securities on the markets. This is particularly true for 10-year US government bonds, which now achieve yields of around 1.6% after 2.71% at the start of the year, despite the fact that the US government's refinancing volume has risen sharply as a result of rising national debt and the demand from countries like China has fallen considerably. Yields on 10-year German government bonds have dropped similarly sharply (-0.55%). It seems that the effectiveness of monetary policy has reached its limits when it comes to stimulating economic growth. This also tallies with the fact that the Swiss National Bank is no longer automatically willing to track the ECB's interest rate changes. It is a different story in the USA, where market players are anticipating another two to four (!) rate cuts in the current cycle. Emerging markets such as China and India have greater monetary scope to counteract an economic slowdown. We believe the risk of price setbacks rose after government bonds in Switzerland and Germany turned negative across the entire maturity spectrum. As a result, we recommend significantly increasing the share of cash and investing in bonds from emerging markets.



Trends & Forecasts

Short-term interest rates (money market 3-month Libor)

We anticipate three more rate cuts by the Federal Reserve until June 2020. The ECB will be forced to continue with its expansionary monetary policy for several more years so as not to impose additional burdens on individual southern member states.

	End of 2018	Latest	YTD %	12 months
CHF	-0.7134	-0.7866		-0.80
EUR	-0.3557	-0.4420		-0.50
USD	2.8076	2.0120		1.25
JPY	-0.0727	-0.1160		0.00

Long-term interest rates (10-year government bonds)

Amid declining economic activity, we expect bond yields to move sideways (1.8% for the USA). We anticipate a slightly steeper interest rate curve for the Swiss franc and the euro.

	End of 2018	Latest	YTD %	12 months
CHF	-0.28	-0.76		-0.70
EUR/GER	0.24	-0.55		-0.40
USD	2.69	1.58		1.80
JPY	-0.01	-0.21		-0.10

Equity markets

With markets remaining extremely volatile, we expect share prices to be slightly higher at the end of the year. Although dividend-paying European stocks are out of fashion among internationally oriented investors, we recommend an equal weighting of equities from American and European companies, particularly as the difference in valuations has reached a historic high. Individual equity markets in emerging countries (e.g. Vietnam, Russia) should be selectively overweighted.

	End of 2018	Latest	YTD %	12 months
United States	2,506.85	2,893.06	15.41%	3,100
Germany	10,558.96	12,121.25	14.80%	13,000
France	4,730.69	5,498.16	16.22%	5,700
Italy	18,324.03	21,546.71	17.59%	23,000
United Kingdom	6,728.13	7,187.81	6.83%	7,400
Switzerland	8,429.30	9,849.43	16.85%	10,300
Japan	20,014.77	21,456.38	7.20%	23,000
China/HK	25,845.70	25,682.81	-0.63%	27,000
India	10,862.55	11,313.30	4.15%	12,000
Russia	1,068.72	1,317.48	23.28%	1,500
Brazil	87,887.26	99,981.40	13.76%	110,000

Oil and gold

After a significant recovery in crude oil prices in the first few months of this year, prices have been under pressure due to growing fears about the economy. As a result of the OPEC production cuts implemented, we expect prices to stabilise at their current level. Gold remains a meaningful hedge against different types of global (political) risks.

	End of 2018	Latest	YTD %	12 months
Crude oil (WTI)	48.22	53.06	10.04%	55
Gold	1,281.58	1,503.82	17.34%	1,600

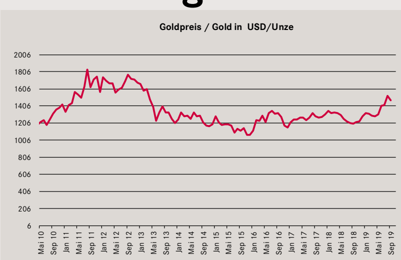
Exchange rates

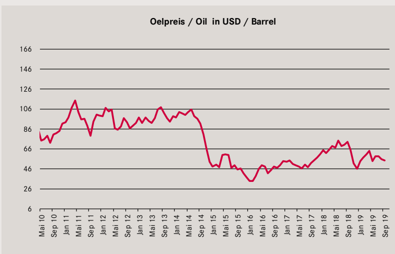
As the interest rate spread between USD and EUR is expected to narrow, we are anticipating the EUR exchange rate to appreciate slightly against the dollar.

	End of 2018	Latest	YTD %	12 months
EUR/CHF	1.1256	1.0926	-2.93%	1.11
USD/CHF	0.9828	0.9952	1.26%	0.98
EUR/USD	1.1452	1.0978	-4.14%	1.13
EUR/JPY	125.6200	117.9000	-6.15%	120

Source: **Bloomberg 09/10/2019**

Interesting Charts





Source: Bloomberg

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