NPB | Neue Privat Bank

Investment **News**

Moderate growth – no recession

Vertigo sets in after long upturn

Many an investor may want to consider feathering their own nests after the long-running upturn on the equity markets and considerable price gains in 2019. However, there do not appear to be any attractive alternatives to equities and gold, as government bonds have both negative yields and a significant price risk. Instead of the trade war with China, the dispute of the USA with Iran will cause increased volatility on the markets in 2020.

"Dance while the music is playing"?

2019 was almost too good to be true for investors, with universally high price gains for equities, bonds and gold. US President Trump and his tweets on the trade dispute were the only source of volatility on the equity markets, repeatedly straining investors' nerves. Amid all this splendour, many investors may well ask themselves whether it will soon be time to feather their own nests after price gains of 20% to 30% on most equity markets. Nevertheless, the bull market in US equities in now in its 12th year, while prices in the US bond market have been rising for an incredible 38 years. What is also astounding is that the markets have largely negated the incalculable risks in various crisis areas in 2019. The fact that growth in the global economy has dropped to 3% after a decade-long average of more than 4% is also having little impact on investor euphoria. With all this in mind, it is hardly surprising that prophecies of a crash abound, as proven by one bestseller among German investors with the cautionary title "The Biggest Crash of All Time".

High valuations across all asset classes

Investors' decision-making is being complicated by the fact that all asset classes, from equities and bonds to real estate, are highly valued. Meanwhile government bonds, as the "safest" of all investments, are now producing hardly any returns and present a considerable price risk after a decade-long rally. For those who do not want to invest their money in "real assets" like forests and whisky (!) as the aforementioned crash bestseller recommends, there seems to be no getting away from higher-risk investments in 2020.

Nevertheless, the economic environment has improved slightly in recent months, while even the European economy appears to have stabilised at a moderate level. In addition, the US Federal Reserve clearly signalled a supportive monetary policy with three rate cuts in 2019. With only a few exceptions, interest rate hikes are not anticipated across the world for some time, while additional monetary easing is expected in several emerging markets in 2020.

The glass is at least half full

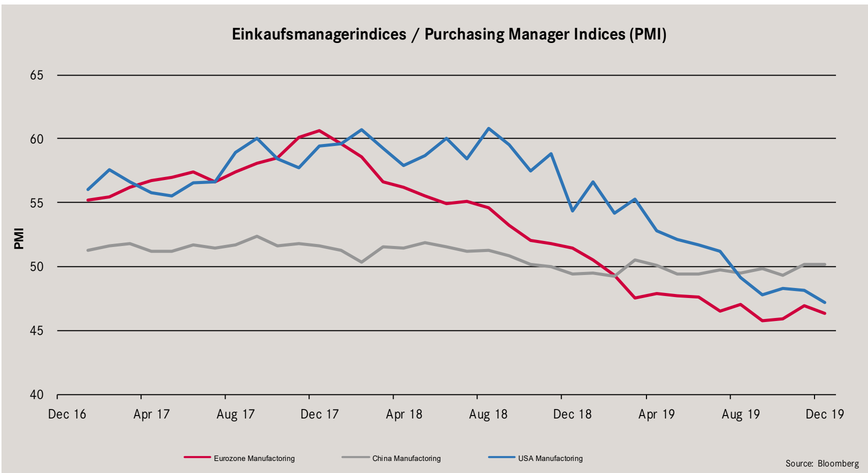
Even the biggest potential spoilsport, the trade war between the USA and China, appears to be off the table for the time being. President Trump has realised that by escalating the dispute and imposing erratic tariff increases, he runs the risk of stalling the US economy and jeopardising his re-election. Similarly, declaring a temporary truce also gives China time to stabilise the economy, divert its trade flows to Asia and Europe and reduce its reliance on USA's technology.

The equity markets are also being bolstered by expected earnings performance, including leading US stock indices. Total US corporate earnings barely rose in 2019 after their sharp rise in 2018 as a result of tax reforms. Earnings growth of 6% to 10% is once again anticipated for 2020, while companies in Europe, Japan and most emerging markets are also expected to record higher profits. It may also come as a surprise that the equity markets do not appear to be clearly fundamentally overvalued even after their spectacular price gains in 2019, particularly in the USA. As a result, the current *PE ratio* of S&P 500 companies is around 18, with an average of 16.25 in the last 25 years. If we take the *risk premium* for equities (expected earnings yield of equities minus risk-free interest rate) as a benchmark, which takes low interest rate levels into account, this is still around 4% even for "expensive" US equities, significantly higher than in the period from 1995 to 2007, for example.

Consequences for investment strategies

In light of this, we recommend significantly underweighting government bonds and not reducing the equity ratio, even though only single-digit price rises are expected in the coming year. US equities are slightly lower weighted in favour of equities from emerging market companies that benefit from a weaker dollar. Last but not least, gold continues to offer a sensible hedge against different types of economic and political risks in a low interest rate environment.

Prof. Markus Ruffner



Economic Situation & Strategy

Stabilising at a low level

Although it is difficult to precisely quantify the impacts of the trade dispute between the USA and China, it can be assumed that the breakdown of existing supply chains caused by erratic tariff decisions and their paralysing effect on investment decisions have noticeably slowed growth rates. For example, Euler Hermes, the world's leading credit insurer, estimates that global trade has shrunk by around 1.7% in 2019 when measured by the value of traded goods. At best, the superficial mini-deal between the USA and China will lead to a moderate recovery in global trade, with growth of 1% to 2% in 2020. Nevertheless, the economy appears to have bottomed out in most countries. This has undoubtedly been helped by the U-turn in monetary policy conducted by the US Federal Reserve, which has cut interest rates three times and sent the signal that it will react on a accomodative basis to the economic environment. Consumers have made an even greater contribution to stabilising the economy than central banks. In the USA, real wage increases in the region of 1.5% to 2% contributed to the upturn, while low levels of unemployment in Europe (currently 7.4% after more than 12.1% in 2013) are proving to be a constant pillar for consumption. Overall, it appears that global industrial production has stabilised at a moderate level.

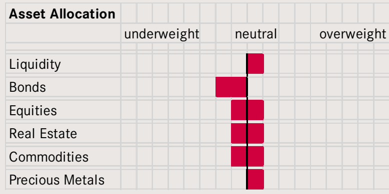
For the **USA**, however, a slowdown in growth from 2.2% in 2019 to 1.8% must be expected in this late stage of the economic cycle. Nevertheless, the US economy appears sufficiently robust to be able to create around 125,000 new jobs in 2020, which should ensure that the unemployment rate remains at record low levels.

In **Europe** it is apparent that there will be a semi-orderly yet still economically painful Brexit that will have drastic effects for the **United Kingdom**. A further slowdown in growth from 1.2% in 2019 to 1.0% is also anticipated for the eurozone in 2020. Overall, it appears that monetary easing has become significantly less effective in the eurozone. As a result, economically robust countries are generally recommended to take proactive fiscal measures to accelerate sluggish growth. Nevertheless, **Germany** is preparing a spending package to limit climate change, while **the Netherlands** is planning a tax reduction programme.

Recovery in emerging markets

Numerous countries categorised as emerging markets implemented monetary and fiscal measures in 2019 aimed at supporting the economy. Emerging markets are also among the main beneficiaries of a weaker dollar. As a result, **India**, **Brazil** and **Russia** in particular are expected to experience stronger growth in 2020 than in the previous year. Only China is likely to record a further slowdown in growth to around 5.7% in 2020 as a consequence of the trade dispute, although this still means that the country will contribute 1.5 times more to global economic growth than the USA.

Strategy



Bonds should be underweighted in an environment of record low interest rates. Corporate bonds, as well as high-yield and emerging market bonds, offer a supplementary option.

Equities have some potential for setbacks in the short term after considerable price gains. Expectations of rising earnings as well as the prospect of persistently low interest rates are helping to bolster share prices.

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), specifically in medium-sized residential construction. Real estate companies that have specialised on properties with cloud infrastructure are compelling in this regard.

Commodities: Rising crude oil prices have some potential for setbacks due to the threat of a supply overhang. Current price levels can only be maintained if OPEC countries manage to maintain their price-supporting measures.

Precious metals: We regard gold and silver mainly as hedges against global political risks. Persistently low interest rates are reducing the opportunity costs of holding gold.

	Real GDP growth in %			Inflation in %			Output gap in %	Deficit in% GDP	Debt in% GDP	CDS spread in bp	Real interest rates in %
	2018	2019	2020E	2018	2019	2020E		2019	2019		
United States	2.8	2.3	1.8	2.5	1.8	1.9	-1.12	-4.7	82.3	16.8	-0.01
Eurozone	2.3	1.2	1	1.6	1.2	1	0.03	-0.5	n.e.	n.e.	n.e.
Germany	2.2	0.6	0.5	1.7	1.3	1.2	0.00	1.9	64.1	9.91	-1.60
France	2	1.3	1.2	1.8	1.3	1.2	0.55	-2.5	97.0	20.06	-1.29
Italy	1.4	0.2	1.3	1.2	0.7	0.7	-4.10	-2.2	131.5	130.95	0.63
United Kingdom	1.4	1.3	1.4	2.5	1.8	2.1	-3.43	-2.3	87.0	21.88	-1.06
Switzerland	2.2	0.8	1.3	0.8	0.4	0.5	-2.66	0.441	42.8	10.77	-0.97
Japan	1.3	0.8	0.4	1.1	0.4	0.1	-1.37	-1.86	236.4	22.31	-0.43
China	6.6	6.1	5.7	2.3	2.9	2.2	n.e.	-4.17	47.8	33.96	0.23
India	7.3	4.9	6.3	4.7	3.4	3.4	n.e.	-3.61	70.2	71.08	3.16
Russia	1.8	1.1	1.7	3	4.5	3.4	n.e.	0.80	17.4	59.25	1.86
Brazil	2.2	0.9	2.6	3.4	3.6	3.5	n.e.	-6.36	84.0	102.53	0.07

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

Equity markets – fundamental valuations (performance in local currencies)

	Performance Equities (in %) 2019	Price/ book value	P/E ratio Current	P/E ratio 2020E	Dividend yield 2020E	Index
United States	29.59	3.63	21.63	16.76	2.03	S&P 500
Germany	25.48	1.63	24.53	12.67	3.36	DAX
France	27.86	1.77	21.65	13.83	3.55	CAC 40
Italy	28.28	1.22	14.27	10.82	4.52	FTSE MIB
United Kingdom	12.67	1.81	18.44	12.71	4.58	FTSE 100
Switzerland	25.95	2.79	25.17	15.48	3.36	SMI
Japan	18.20	1.77	18.46	16.47	2.09	NIKKEI
China	11.04	1.23	11.03	9.87	4.09	Hang Seng
India	12.85	2.89	26.17	17.16	1.71	Nifty
Russia	45.28	1.05	6.83	6.47	n/a	RTS
Brazil	31.58	2.37	18.64	12.29	3.76	BOVESPA

Source: Bloomberg 03/01/2020

Thank goodness for the Fed and the election

Having not moved significantly between May and October, the equity markets recorded an almost unprecedented rally in the last quarter of 2019. The Fed's three interest rate cuts reinforced the belief among investors that the US economy is robust enough to avoid a recession even in the later stages of the economic cycle. Repeated announcements from US negotiators as well as President Trump that the first phase of a trade agreement was close to being agreed also helped to ease the worries of equity investors. Although it is still unclear what exactly has been stipulated in this mini-agreement, some of the announced tariff increases appear to be off the table. Generally speaking, it is therefore assumed that there will be a period of calm on the trade front until the US election at least.

Unrealistic earnings expectations?

The fact that analysts significantly raised their earnings estimates for 2020 certainly did no harm to the price rally on the equity markets. After consensus earnings growth of around 1% was forecast for the global equity markets in 2019, these expectations were lifted considerably to around 10% earnings growth for 2020. Perhaps surprisingly, British companies are expected to record the strongest profit increases as they benefit from sharp devaluation of the pound. A rise in profits of around 15% is also anticipated for companies in developing countries that would also benefit from a further weakening of the dollar. However, American securities firms in particular consider the earnings forecasts for the USA to be overblown, as rising unit labour costs in the late stage of the economic cycle are reducing company profit margins.

New favourites

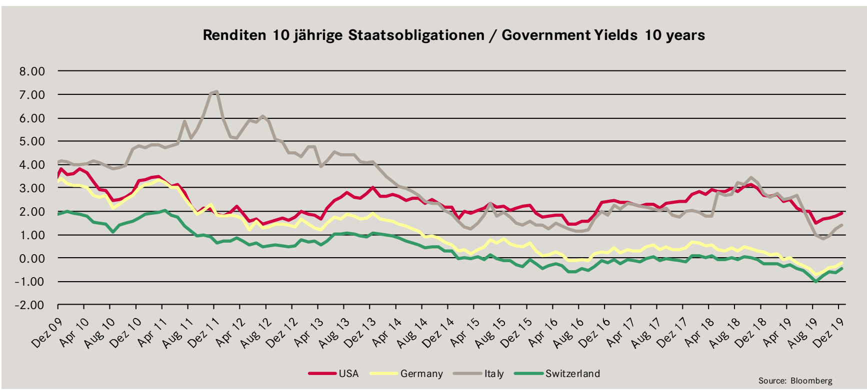
As a result of their fundamental valuations, relative underperformance in recent years and favourable earnings forecasts, we are slightly shifting our weighting from "expensive" markets such as the USA to "cheaper" equities in emerging markets. In doing so, tech stocks in China and extremely cheap Russian equities seem particularly interesting to us. One potential turnaround situation is that of "sold-out" British stocks offering catch-up potential in the event of a semi-orderly Brexit.

Generally speaking, increased volatility must be expected in a US election year. The prospect of victory for a "left-leaning" Democrat candidate will likely lead to massive taxes in exposed sectors. Whoever becomes US President, you can bet on a continuation of the trade dispute after the US election in November.

The challenging search for yield

Given the low interest rates, who would have thought that 2019 would turn out to be such a good year for bonds? Contrary to most forecasts, government bond yields declined substantially once again. A huge increase in the US deficit to more than USD 1 trillion in 2019 and the resulting need for refinancing did nothing to dampen the bond rally. Yields on 10-year US government bonds are now at around 1.8% after 2.71% at the beginning of the year. Yields on 10-year government bonds in Swiss francs and euros are also moving in line with each other, falling considerably once again to -0.56% and -0.275 (Germany) respectively. Fundamentally speaking, it can be assumed that central banks will make scarcely any interest rate increases in 2020. Nevertheless, in a period of economic stabilisation, it is entirely possible that yield curves will steepen again, which would be associated with price losses on bonds. As a result, we recommend shorter maturities.

While investors can continue to achieve positive yields on government bonds with the USD as reference currency, investors in CHF or EUR will have to venture even further into Greek or Italian government bonds or into corporate bonds to achieve positive yields as a result of the central banks' negative interest rates. Generally speaking, the premium that can be achieved for investment-grade corporate bonds has bounced back significantly. As a result, extremely selective investments should be made in corporate bonds. In doing so, it is important to realise that the currently low default rates on bonds are primarily dependent on company and sector-specific factors and are less dependent on economic factors. Significantly higher yields can be generated with well-diversified bonds issued by debtors from emerging markets and high-yield bonds that make a suitable addition to a bond portfolio.



Trends & Forecasts

January 2020

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

We do not anticipate further interest rate changes from the US Federal Reserve and the ECB in 2020. On the contrary, 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	End of 2019	12 months
CHF	-0.72	-0.69	-0.70
EUR	-0.36	-0.42	-0.40
USD	2.80	1.91	1.80
JPY	-0.08	-0.05	0.00

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

Due to the stabilising economy, we anticipate a slight rise in bond yields (e.g. to 2.3% for US government bonds). We also expect a slightly steeper yield curve for CHF and EUR.

	End of 2018	End of 2019	12 months
CHF	-0.28	-0.50	-0.30
EUR/GER	0.24	-0.19	0.20
USD	2.72	1.88	2.30
JPY	-0.01	-0.02	0.10

Equity markets

Amid volatile markets, we anticipate moderately higher equity prices by the end of 2020. Although European stocks are out of fashion among internationally oriented investors, we recommend an equal weighting of equities from American and European companies as a result of significant valuation differences. Individual equity markets (emerging markets and the United Kingdom) should be selectively overweighted.

	End of 2018	End of 2019	YTD %	12 months
United States	2486	3221	29.59%	3'400
Germany	10559	13249	25.48%	13'800
France	4679	5982	27.86%	6'200
Italy	18324	23506	28.28%	24'300
United Kingdom	6734	7587	12.67%	7'800
Switzerland	8429	10617	25.95%	11'000
Japan	20015	23657	18.20%	25'000
China/HK	25504	28319	11.04%	31'000
India	10860	12256	12.85%	13'500
Russia	1066	1549	45.28%	1'800
Brazil	87887	115645	31.58%	120'000

Oil and gold

Crude oil prices have recovered considerably over the past year. As demand is currently subdued, there is the risk of a supply overhang. As a result of increased production by US shale oil producers, OPC countries need to continue with production cuts to stabilise prices at their current level. Gold remains a sensible hedge against different types of global (political) risks.

	End of 2018	End of 2019	YTD %	12 months
Crude oil (WTI)	47.90	61.68	28.77%	58
Gold	1278.97	1515.20	18.47%	1650

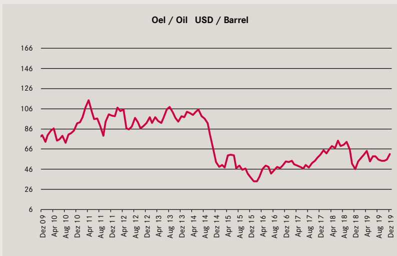
Exchange rates

We anticipate a further devaluation of the USD due to inflation differences with the EUR and CHF. The USD's role as a "safe haven" is also expected to become less significant.

	End of 2018	End of 2019	YTD %	12 months
EUR/CHF	1.1259	1.0854	-3.60%	1.08
USD/CHF	0.9846	0.9681	-1.68%	0.94
EUR/USD	1.1444	1.1211	-2.04%	1.15
EUR/JPY	126.2600	122.1100	-3.29%	123

Source: **Bloomberg 03/01/2020**

Interesting Charts



Source: Bloomberg

Imprint

NPB Neue Privat Bank AG
Limmatquai 1 | am Bellevue
PO Box
CH-8024 Zurich
Tel: +41 44 265 11 88
Fax: +41 44 265 11 89
info@npb-bank.ch
www.npb-bank.ch