MARCUARD FAMILY OFFICE

Investment Outlook
September 2017

1 Back from the presumed dead

That the current economic recovery is broad-based and global in reach, as we have been asserting here for some time, has been clearly confirmed by the revival of one economic driver that had been consigned to the morgue: global trade. Not long ago, sluggish global trade was often cited as signaling the end of globalisation, but the trade zombie has revived.

We are indeed dealing with the undead here. The expansion of global trade volumes has visibly accelerated since the end of 2016. In May, it grew at a rate of almost 6 percent, year-over-year, well above the 3.6 percent average of the past 17 years. And also clearly above the anemic rates posted between 2012 and 2016, when year-over-year trade volumes grew by only about 2 percent on average.

We see this trade surge as another sign that the current economic expansion is now truly synchronized globally, especially in the advanced economies, where a broad set of fresh data indicates that the economic expansion is underway at a steady, sustainable pace. At the same time, the big emerging economies are only slowly freeing themselves from domestic woes as they continue to struggle with such issues as high debt levels (China) or institutional weaknesses and corruption (Brazil).

Add low inflation and interest rates to the favourable economic environment for advanced economies and it could well be argued that financial markets currently face a Goldilocks moment, when everything looks just right. Risk assets such as public and private equity markets, real estate and high-yield debt are constantly benefitting from fresh tailwinds. But, as we all know, after years of uninterrupted price inflation, valuations have become stretched across most asset classes. The recent saber-rattling between the US and North Korea registered as a mere bump in equity market volatility, inducing no meaningful correction. Therefore, despite the positive economic backdrop, we think equity markets are vulnerable to setbacks. And spreads could widen markedly for high-yield bonds once economic conditions deteriorate and defaults start to rise.

Under these rather fraught circumstances, we continue to hold the current allocations in equities and credit where they are. We would not choose to increase exposure for now. Nor would we advise extremely underweighting duration risk within a balanced portfolio, because, as we wrote in the previous issue of *MFO Investment Outlook*, duration can be a helpful diversifier, often partially counterbalancing price corrections in risk assets in times of market stress. That said, we recognize that the reversal of expansionary monetary policy has already begun in the US, and it is within reach in other major advanced economies, too. Financial markets thus are facing presumably slowly rising interest rates.

Predicting just how fast and how far interest rates will rise is a difficult business, even for those with nothing else to do and with large teams of capable researchers. This was recently illustrated when the Bank for International Settlements and the US Federal Reserve published completely opposing views on the future path of interest rates. The BIS argues that rates will likely rise globally as more people enter retirement, increasing investment demand to compensate for the falling labour participation rate, while savings – that is, investment supply – should fall as retirees consume capital instead of working and saving. In contrast, Fed vice chair Stanley Fischer recently associated low interest rates, among other factors, mainly with the declining economic trend growth of an ageing society. The Fed and the BIS are serious institutions and both arguments have merit. We do not know which side will prevail, nor when, but we do feel able to conclude that these starkly opposing views illustrate the wisdom of avoiding large active positions that are based on a strong assumption, either way, on the future path of interest rates.

1.1 North America

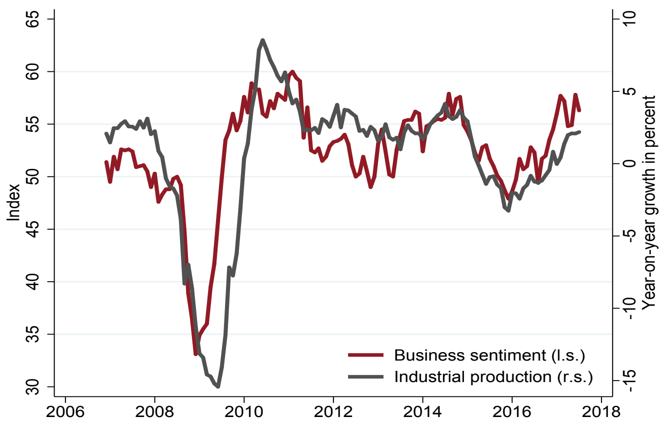
- The cascade of scandals emanating from the White House and the escalation of tensions between the US and North Korea stand in sharp contrast with the solid economic data. After a rather disappointing first quarter, economic activity again picked up the pace in Q2, more in line with earlier busines sentiment indicators. The rate of economic expansion more than doubled quarter-on-quarter, from 0.3 percent in Q1 to 0.8 percent in Q2, resulting in a year-on-year GDP growth rate of 2.2 percent. Consumption, private investment and government spending all grew somewhat faster again, too.

- The data from July suggest that the US economy also entered the current quarter on solid footing. Sentiment indicators point to an ongoing expansion at a similar pace ahead. In addition, the earlier gap between upbeat business sentiment surveys and muted economic activity—as measured, for example, by the growth of industrial production or durable goods orders—has narrowed, with the latter accelerating in recent months. That backdrop should support the admittedly mild ongoing recovery in investment spending.

- The outlook for consumers also appears favorable. Conditions in the labor market have continued to improve in recent months. The unempolyment rate fell further lately, to 4.3 percent. In parallel, vacancies rose to a new record level in June. They are currently almost 28 percent higher than they were at their pre-crisis peak, in 2007. What's more, headline consumer price inflation has fallen after the boost from the oil price recovery disappeared, taking some pressure off households, whose real incomes had been declining as inflation rates accelerated. Currently, at 1.7 percent year-on-year in July, the headline inflation and core inflation rates are aligned. One dissonant note, however, is the muted inflation of wages, with real hourly wages increasing by merely 0.7 percent year-on-year in July.

- According the minutes of the FOMC's July meeting, the Fed sees the prospects for the US economy as positive and it is likely to announce a starting date for the reduction of its bond holdings at its next meeting, in September. Another rate hike still seems to be on the table this year. However, the Fed is apparently worried about the destructive political forces circulating in Washington these days. Another source of instability is the crucial vote to increase in the US government's debt ceiling at the end of September, which Presdient Trump has threatened to block. The absence of political consensus on this issue could lead to a government shutdown, unleashing a raft

Economic activity catches up, again



The narrowing of the gap between elevated business sentiment levels and actual economic activity speaks for the robustness of the current economic recovery.

Source: Thomson Reuters Datastream, MFO

1.2 Europe

- The latest GDP data confirm the continuation of the economic recovery in the Eurozone. The pace of economic expansion accelerated from 1.9 to 2.2 percent year-on-year in the second quarter. Thus, the Eurozone even grew slightly faster than did the US. Accelerating economic expansion could be observed in various Eurozone states: France, Spain and even notorious underperformer Italy all experienced higher GDP growth rates in Q2.

- The European Commission's Economic Sentiment Indicator climbed to a post-crisis high in July, pointing to the continuation of the current expansion at an at least comparable pace. Sentiment indices for both the Eurozone and the European Union as a whole are above average in all sectors, including industry, services, construction, retail, and financial services. Consumer sentiment is up as well. In addition, the dispersion of the economic sentiment indicators among the member states is relatively narrow by historical standards – especially if compared to the euro crisis of 2010-2012. This implies that the different European economies are currently experiencing a synchronized recovery.

- However, structural weaknesses and the need for reform in many Eurozone member states, especially in core states like France and Italy, remain profound challenges. The current recovery offers a window of opportunity; if it is not exploited, the next downturn will be painful.

- The British economy is doing remarkably well, although it continues to face elevated uncertainty with regard to the specifics of its exit from the European Union. In the manufacturing sector, confidence is above average, profiting from the weak pound and improving export demand from developed markets. Confidence in the services sector is less elevated but it has remained in expansionary territory since the end of 2016.

- In Switzerland, improving export demand, especially from developed economies, and a weaker franc should generate some tailwinds for the Swiss export sector and provide some impetus to the overall Swiss economy, helping growth to revive in the coming months. Business sentiment, in contrast to the rather muted mood of consumers, improved further in recent months, implying a pick-up in economic activity, too. This should bolster employment and help to lower the unemployment rate, which increased after the surge in the franc's value in 2015 and has remained at a higher level, albeit low both in absolute terms and comparatively, on an international level.

Global trade back from the dead

Source: Thomson Reuters Datastream, MFO

Not very long ago, globalisation was pronounced dead. But today global trade volume is recovering, growing faster than its long-term average and clearly faster than it did during the slump of 2015 and 2016.

1.3 Asia and Emerging Economies

- While the latest data broadly confirms the continuation of the current economic expansion in the developed economies, the data for the large emerging economies, whose recovery has anyway been rather muted thus far, is less sanguine, signaling some fresh setbacks.

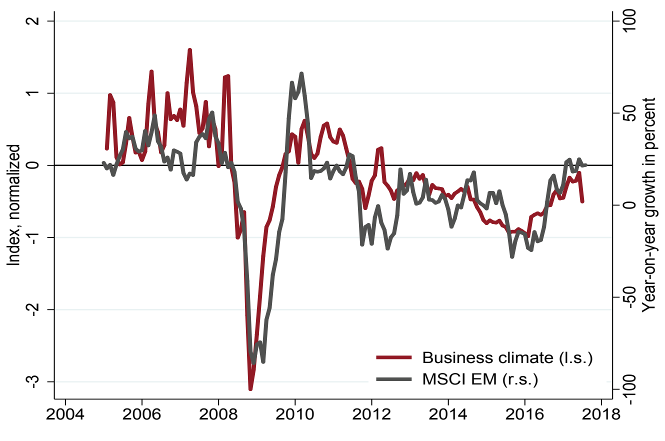
- In Brazil, business confidence indicators suggest the recovery there has stalled at least temporarily. In June and July, confidence in the industrial sector cooled from levels indicating a slow expansion to ones pointing at stagnation, while services confidence remains contractionary. This softening comes when the level of economic activity is still nearly 8 percent below the peak Brazil experienced in 2014, before it slid into a sharp recession that has lasted almost three years now.

- In Russia, the composite purchasing managers index, combining confidence levels in the services and manufacturing sectors, again started to cool in recent months after visibly improving throughout 2016. While the indicator still signals expansion, its latest level corresponds to the weakest reading in ten months. The slowdown is evident looking at the opposing patterns in the two sectors: while manufacturing activity has improved, services slowed to a 14-month low in July.

- The Indian economy, largely untouched by the global slowdown in 2014 and 2015, suffered a steep decline in economic conditions in July. The Markit composite PMI for July abruptly slipped from expansionary into contractionary territory after the introduction of a new tax on goods and services, implying a further slowing of the economic activity ahead. GDP growth had already slipped from 7.0 to 6.1 percent year-on-year in the first quarter, after economic activity was hit by the botched implementaion of a currency reform in November 2016. The latest contraction in business confidence is evident across sectors, but is especially pronounced in services.

- The new tax is consumption-based, replacing a multitude of direct and indirect taxes that had previously been levied by central and state governements. Different rates apply for different goods and services, and some basic necessities such as dairy products, education and health care are exempt. The new tax system has been critizied for raising prices, but it also brings more transparency, unifying a complex and fragmented tax code and bringing India one step closer to becoming a nationally integrated market. It is likely that short-term pain will be followed by long-term gain.

EM equities facing thinner air

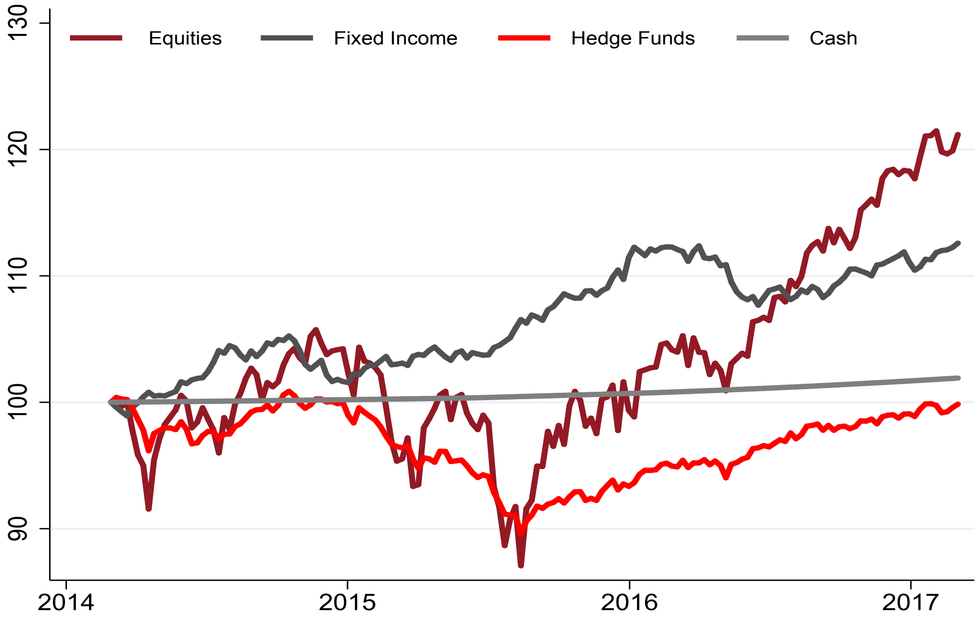


Source: Thomson Reuters Datastream, MFO

The aggregate business confidence measure for the largest emerging markets experienced a fresh setback recently. The air has again gotten thinner for a further equity rally, and upside for EM equity markets seems rather limited at the moment.

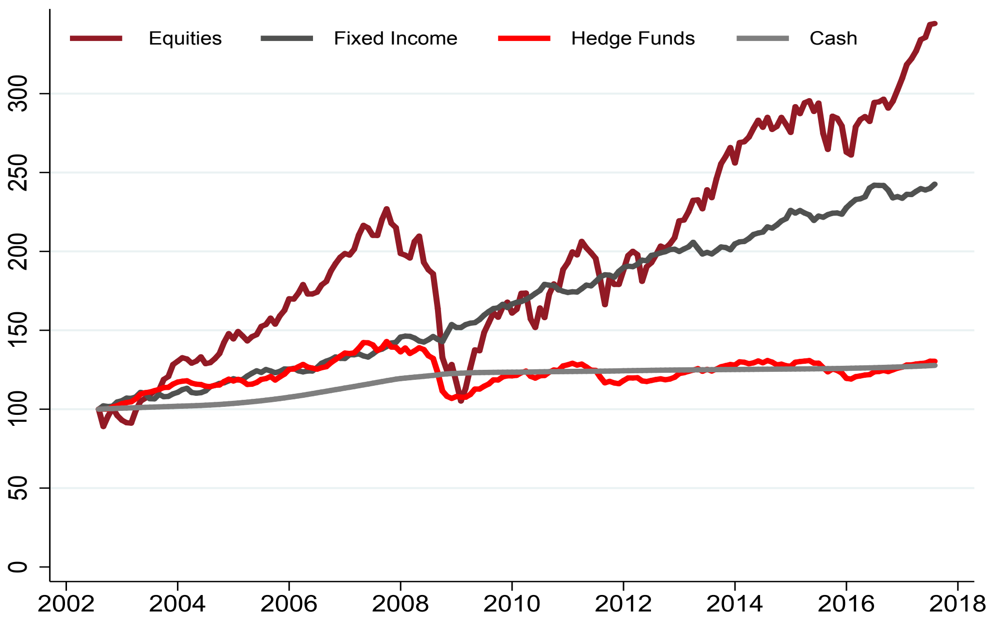
2. Financial Markets

Short-term market developments



Source: Thomson Reuters Datastream, MFO

Long-term market developments



Source: Thomson Reuters Datastream, MFO

2.1 Equities

- After a hesitant start, July proved to be another positive month for equity investors. Volatility remained low until the tensions between the US and North Korea in the first half of August shook everyone out of the summer lull. In the meantime, things seem to have settled down and equity markets have again resumed their upward trajectory. Global equity markets as measured by the MSCI World now show an increase of 13.5 percent so far this year.

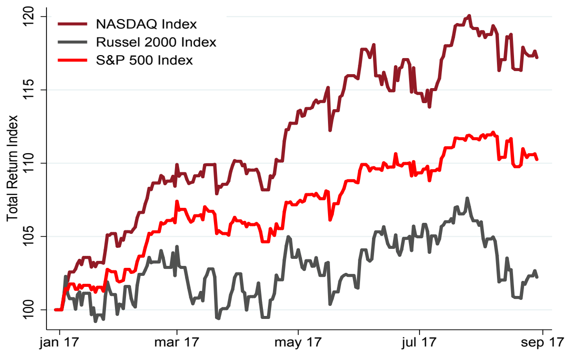
- While some share-price gains can be justified by good company results, valuations have further increased and most markets segments look expensive. This should remind investors to rebalance the weight of equities in their portfolios in a disciplined way, towards the level of their strategic long-term allocation.

- In US equity markets year-to-date, the NASDAQ Index, where the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) account for about a third of market capitalisation, is up 20.4 percent. This is ahead of the broad S&P 500 Large Cap Index, which increased by 11.3 percent. But the temporary dip in August revealed just how nervous investors are with the tech sector's high valuations. And, seemingly in line with President Trump's falling approval ratings, US mid caps (up 5.3 percent for the year) and small caps (Russell 2000, up 4.4 percent) are both lower than they were at the end of June.

- While European equity markets have edged lower so far in the second half of 2017, measured in euros, they still have gained when measured in US dollars. Global allocators consider European equity markets attractive because of its lower valuations than those in the US. The backdrop of continuously solid macro data is also a plus. Year-to-date, European equity markets measured by MSCI have risen by 19.3 percent in US dollar terms but only 5.9 percent in euro terms, showing the double-digit value increase of the euro. This is obviously a headwind to nominal returns of euro-denominated portfolios that are exposed to other currencies.

- Of the large economies, the equity market of China stands out. Undaunted by concerns about the stability of its financial system, the Chinese stock market measured by the MSCI China has added a further 15 percent in July and August, resulting in a 41.8 percent gain year-to-date. Chinese equity markets are driven by tech stocks like Tencent, Alibaba and Baidu, which all reported very strong earnings, collectively outpacing the impressive growth rates of their US counterparts.

NASDAQ lifted by FAANG stocks



Source: Bloomberg, MFO

China's brisk equities rally

Source: Bloomberg, MFO

2.2 Fixed Income

- After the correction in late 2016, broad global fixed-income markets recovered and have set new all-time highs. The Barclays Global Aggregate Bond Index posted a year-to-date performance in US dollars at the end of August of 2.7 percent, clearly lagging behind equity markets. Currently, the index has duration of seven years and a yield of roughly 1.5 percent. This duration is the longest seen in ten years, while the yield is on low, albeit not the very lowest, levels in that same ten-year window.

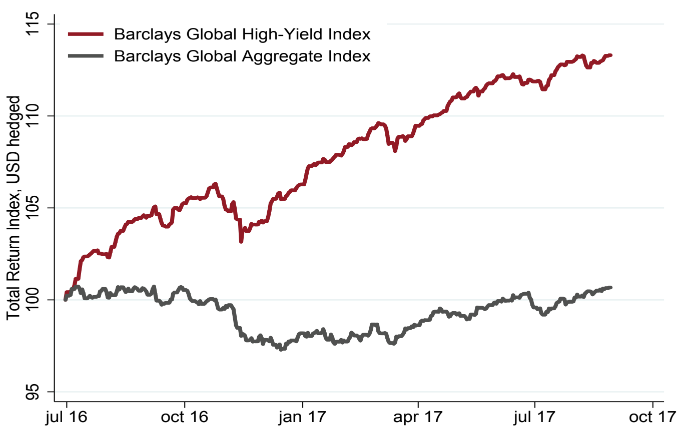
- On the back of an ongoing compression of credits spreads that were already narrow, lower investment-grade buckets such as the Barclays BBB Index and the Barclays High Yield Index have outperformed the global index year-to-date, stretching valuations in these market segments yet further.. At the same time, given our macro outlook, we do not assume defaults will soon increase meaningfully. From a valuation point of view, it is therefore currently not advisable to buy more credit exposure. However, given the favourable economic conditions, nor is it advisable to sell, and we therefore continue to be actively positioned on the credit side, with an average credit quality slightly worse than that of the benchmark.

- Despite the positive economic outlook, gradual monetary policy tightening and low yields, fixed income does not look unattractive as an asset class. The Fed's balance sheet reduction program will be gradual and largely predictable, without active sales of securities in the market. Global GDP growth numbers should remain muted due to long-term structural forces while inflation has so far remained anchored at rather low levels. With that backdrop, we do not expect dramatic spikes in interest rates over the intermediate term.

- This view seems to be confirmed by the market, which currently neither prices in a very positive nor a very negative scenario, as market price indicators remain at average levels. Given this mixed picture, our fixed-income portfolios are running at a slightly longer duration than at the start of the year, to hedge against setbacks in risk asset markets, but still shorter than the seven years of the market index.

- Over time, we have also added several "non-traditional" fixed-income managers to the portfolios – depending on how they fit into the portfolio's overall context. They are active in areas such as subordinated debt, senior secured loan markets, asset-backed securities and factoring, to name a few. These asset classes are traditionally less interest-rate sensitive and have a lower correlation to the broad global bond market.

High-yield unaffected by bond sell-off



Source: Bloomberg, MFO

In contrast to the broad market, high-yield was largely unaffected by last year's bond sell-off and has continued its rally into this year.

2.3 Alternatives

Hedge funds, private markets and commodities

- Hedge funds have posted steady performance this year, up by 3.5 percent in US dollar terms year-to-date at the end of August, with hardly any drawdowns, as measured by the HFRX Global Hedge Fund Index.

- Contrarily, the Bloomberg Commodity Index has been volatile, offering no clear direction. Year-to-date performance in US dollar terms reached -4.6 percent at the end of August.

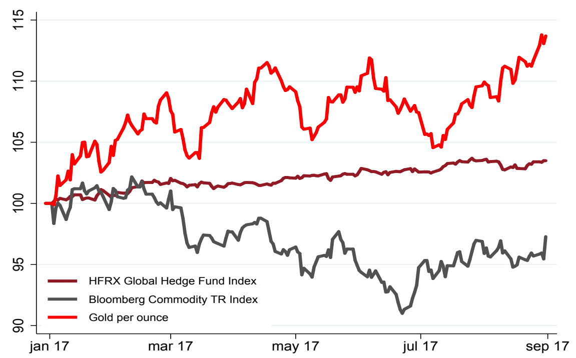
- Q2 proved to be another strong quarter for private equity fundraising, with USD 121 billion secured in the final closings of 206 funds, according to Preqin. It seems that fund concentration continues, with the ten largest funds accounting for two-thirds of the capital raised. While the value of deals in Q2 increased significantly compared to Q1, deal activity in the first half of this year was lower than in the same period a year ago, possibly due to high prices. Exit activity slowed further, posting the lowest number of exits since Q2 2010.

Currencies

- The sharp dislocations in major currency pairs that began in 2014, driven by the divergent monetary policies of the US and the Eurozone, have unwound further in recent months. Since the start of the year, the euro has appreciated by 6.6 percent on a trade-weighted basis while the US dollar has fallen by roughly as much. Given these large movements, the undervaluation of the euro versus the dollar was visibly reduced.

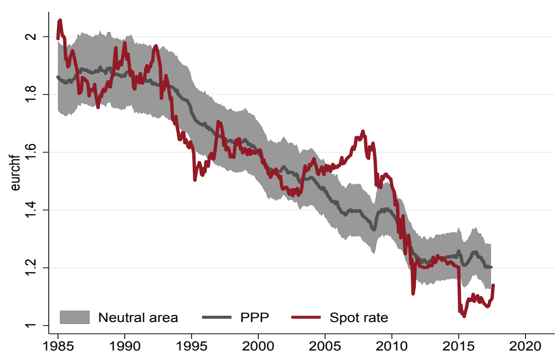
- An appreciating euro is also finally providing some relief to the perennially strong Swiss franc. The franc has shed 6.6 percent in value against the euro year-to-date, a tendency that gained serious momentum in August, when it lost more than 4 percent in value against the euro. According our purchasing power parity estimates, this sharp adjustment almost eliminates the franc's previous overvaluation versus the euro. However, we note, this shift was mainly driven by a strengtening euro, not by a weakening franc. On a trade-weighted basis, the franc's external value has only fallen by 1.7 percent year-to-date.

Commodities notoriously underperforming



Source: Thomson Reuters Datastream, MFO

Swiss franc no longer so overvalued



Source: Thomson Reuters Datastream, MFO

3. Positioning

- Since the slight upgrade to fixed-income in our previous MFO Investment Outlook, when we reduced our fixed-income underweight, our general view has not materially changed over the course of the past two months.

- Business and consumer sentiment are at levels that point to the continuation of the current above-trend growth path over the coming months, while inflation rates look to remain muted. On the corporate side, earnings are flowing strongly while debt costs remain low. Markets are currently in a Goldilocks scenario, where many key metrics look quite favourable. Still, political and other risks, as we discussed in the previous *MFO Investment Outlook*, are hardly priced in by financial markets currently. Consequently, any significant negative surprise could shake markets up significantly, in our view, especially given the current expensive valuations.

- Equities in general are still more attractive than most fixed-income investments, as they profit more from the positive growth outlook. Equity valuations are generally expensive but still not at outright exaggerated levels. At the same time, market indicators such as trend and market risk measures still point to a continuation of the bull run. We also retain a slight overweight in Asian and European equity markets at the expense of the North American market.

- We have reduced our fixed-income underweight in most portfolios over the course of the past several months but we still remain underweight in aggregate. Given our current assessment of the economic outlook, defaults should be few and far between, at least in the near future. Taken altogether, this leads us to maintain a slightly shorter duration on average than indicated by the benchmark, and to take a slightly more aggressive stance on credit. We still favour "non-traditional" forms of fixed-income such as loans, asset-backed securities, etc., where we see better value now than in traditional credit.

Positioning overview

	Equities				Fixed Income		Alternatives			Liquidity
	North-America	Europe	Asia-Pacific	Emerging Markets	Duration	Credit	Hedge Funds	Commodities	Precious Metals	
Macro	↗	↗	↗	→	↘	↗	→	→	→	↗
Market	→	↗	↗	→	→	↗	→	→	→	→
Valuation	↘	↘	↘	↘	→	↘				
Sentiment	→	→	→	→	↘	→	↘	↘	→	
Aggregate	→	→	→	→	→	→	→	→	→	→

Source: MFO

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Imprint

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Design:	Dyer-Smith Frey
Editorial deadline:	1 September 2017

The *Marcuard Family Office Investment Outlook* is published every second month. The next *Investment Outlook* will be published in November.

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