Valvest

Investment View – 4^{th} Quarter 2019

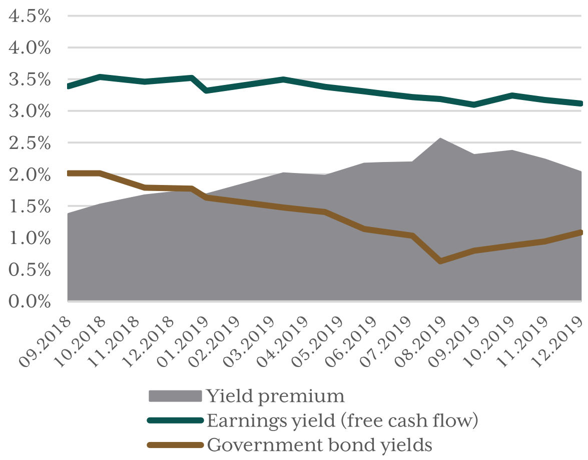
Review

A very good year for the financial markets has come to an end. To assess the markets valuation, however, the annual perspective is misleading. Part of this year's return was in fact a compensation for the weak year-end of 2018, when prices slumped despite good sales and earnings growth of the majority of companies. The correction was caused, among other things, by the escalating trade conflict between the USA and China and the interest rate hikes by the U.S. Federal Reserve. Financial markets discounted declining corporate profits and a weakening economic dynamic. Although the latter has materialized, most companies' sales and earnings development remained positive. Only a few sectors, such as automobiles and semiconductors, have seen significant drops in earnings. The service sector, on the other hand, continued to develop positively thanks to good consumer sentiment.

The trade conflict remains largely unresolved, even if the two sides have come closer in the past few weeks. The interests and concerns of both parties have become so public and anchored that a wide-ranging solution, without long-term consequences is difficult to implement. Companies have either already adjusted their supply chain or are preparing to do so if necessary. The United States may be politically divided at the moment, but there is a cross-party consensus on the position towards China.

The American central bank has moved from raising interest rates in 2018 to both lowering rates and buying bonds again. Interest rates worldwide fell again significantly last year. This stimulates both consumption and corporate investments and consequently has a positive effect on economic growth. Interest rates are also of central importance for stock valuations. That is because the valuation of the stock market is always relative to other asset classes. The following graphic compares companies' earnings yield with current interest rates. The difference between the two is the yield premium of stocks. Counterintuitively, the yield premium has risen and thus the valuation of stocks has become more attractive despite last years' extraordinary return.

Chart: Yield Premium of Stocks



The economy is additionally being supported by the expansionary fiscal policy of most governments. Ten years after the financial crisis and continued economic growth, nearly all countries still have a budget deficit. In the short term, this has a positive effect on economic development, but it further increases the already high public debt. Thanks to falling interest rates, this currently has no impact on the interest burden. However, it does not take a great deal of arithmetic talent to understand that the debt burden cannot absorb rising interest rates or declining tax revenues.

Outlook

In our view the scenario with the highest probability is continued expansionary monetary and fiscal policy in 2020, which would largely neutralize the negative effects of geopolitical tensions. The Brexit can finally be executed, which will lower uncertainties for consumers and companies. Donald Trump's re-election is currently expected, due to a lack of democratic competition. Consequently, there may be further advancements in the trade negotiations in the medium term. Economic growth should therefore continue to be positive albeit still relatively low.

Considering interest rates and the economic environment, valuations are reasonable. Cyclical sectors are even attractively valued if economic growth remains stable. We are keeping stocks slightly overweighted as we continue to focus on the best quality. We underweight fixed income investments in favor of gold and retain some cash for future opportunities.

Zurich, January 2020