Valvest

Investment View – 1. Quarter 2018

Geopolitics

After a quiet and successful 2017, market fluctuations have increased considerably this year. Much attention is being paid to the heightened geopolitical risks, threatened US import tariffs and the controversial presidency of Donald Trump. A trade war would be very negative for the globalized world economy. However, this is hardly in the interest of the participants. It is noticeable that politicians and media outlets in particular are struggling with the undiplomatic nature of the American president. We intend not to be guided by words, threats or promises of politicians, but by their actions and their impact on the economy.

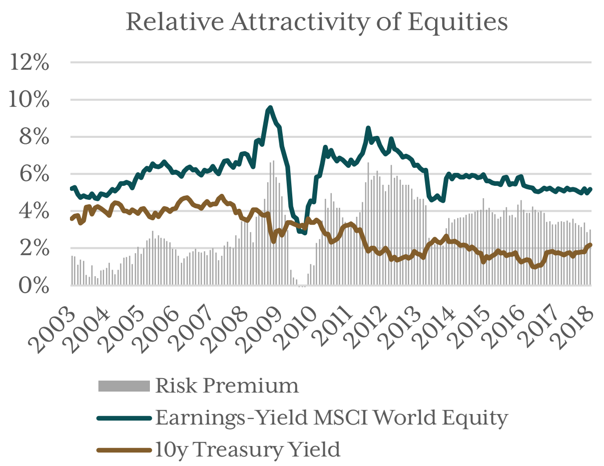
This approach also proves itself viable in the analysis of companies. The market reflects both opportunities and risks relatively efficiently. The announced tax cuts in the United States, deregulations, infrastructure programs and broad-based global economic growth helped drive share prices up to new highs at the beginning of the year 2018. The resulting company valuations embedded a very positive future and made it increasingly more difficult for us to find attractively valued companies. The market corrections in the beginning of February as well as towards the end of March have partially normalized the valuations.

Interest rates

A topic that attracted far less attention in the media are the rising interest rates. Their fundamental influence on the stock markets is however significantly more important. Interest is the price of money and therefore central to the valuation of all assets. As interest rates rise, equities become less attractive to bonds, providing the equity price remains unchanged. The reason for this lies with the reduction of the risk premium offered by equities over bond. The risk premium is the difference between the earnings yield of equities and the yield on government bonds.

Since the financial crisis in 2007/2008, interest rates have continuously been falling while corporate profits have strongly recovered. As a result, two relevant factors for the increasing equity valuations were positive. This situation has now changed in that the tailwind provided by falling interest rates has turned into a slight headwind as interest rates rise.

While the economy remains robust, rising corporate earnings must now offset rising interest rates.



Historically, rising interest rates are a sign of a strong economy and are statistically accompanied by rising equity prices. Only once interest rates reach a level so high that they become too great of a burden this correlation turns negative.

Considering that the real interest rates of the largest developed markets are still negative despite an eight-year economic recovery, we do not believe that we have reached that point yet. We do however anticipate slightly rising interest rates and expect persistent headwinds for equities. Thanks to tax reliefs in the United States, a globally robust economic situation and the positive consumer sentiment, these headwinds are currently still being compensated for with rising corporate profits.

Conclusion

Equities continue to offer attractive returns relative to other asset classes and therefore remain an important component of our asset allocation. In comparison to last year, we expect greater volatility in the equity markets, which would actually also be more normal. As an active investor, this environment provides us with the opportunity to differentiate between attractively valued vs. overvalued companies and to benefit from short-term market distortions.

Zurich, April 2018