Valvest

# Investment View - 4th Quarter 2018

**Review**

The stock market year 2018 has come to a rough end. Too many fundamental uncertainties currently have to be absorbed by the market at the same time. The markets signal that the risk of a negative development of the economy has increased. However, neither the exact state, the future path nor the reciprocal effects of the influencing factors on the economy can be precisely determined. Measurable parameters such as sales and earnings growth of companies or the mood of the purchasing managers, do in fact not paint a negative picture. That a cyclical high is followed by a certain weakening of the growth rates should not translate to pessimism.

The greatest uncertainty is currently caused by the almost tumultuous state of U.S. politics, both domestic and foreign. The trade conflict between China and the US is hampering economic growth, and punitive tariffs increase companies' input costs. In addition, despite economic recovery, Europe's fragile construct continues to show smouldering discontent at the ballot box.

After years of expansionary monetary policy by the central banks, the focus is now on the development of interest rates. Previously, every market correction had a direct impact on the US Federal Reserve's pace of rate hikes, but the current central bank chief Powell is taking a more determined path. This continues to suggest higher interest rates in the US, although the discrepancy with Europe is already substantial despite comparable inflation. Rising interest rates are in many ways not positive for stock markets. Not only does it dampen credit growth and thus economic growth, but also interest payments on debt weigh heavier on the income statements. Higher interests on credit causes also a headwind for real estate prices, which are directly felt by homeowners. In addition, the level of the interest rates is in direct competition with equity returns. In order for equities to remain equally as desirable as before, higher earning yields are required. With the current correction in the stock market that is precisely what has happened.

**Outlook**

Increasing corporate profits with stock prices going lower at the same time have made the valuation of the stock markets much more attractive. As a long-term investor, such price reductions represent interesting buying opportunities. However, these are rarely accompanied by euphoria, which is why investors have to act anti-cyclical.

We still do not expect an escalation of the trade conflict between the US and China. The two nations are confronted with enough existing problems that neither of the two parties is truly interested in an escalation. However, Europe’s problems will accompany us for years to come, as no structural changes took place. On both sides of the Atlantic, the economy is heavily dependent on artificially low interest rates. The interest rate dependency of the economy is too great to expect strongly rising interest rates without the occurrence of serious inflationary pressure. Real interest rates, i.e. interest rates minus inflation, are therefore still expected to be low for both the US and Europe.

With low real interest rates and neutral to positive macroeconomic factors, we do not expect the global economy to fall directly from strong expansion into a recession. Therefore, we consider equities to be attractive, even more after the latest market correction.

The investing environment has however become more demanding. We are in a phase in which the quality of a company becomes more important again. Well positioned companies can pass on increasing input costs, such as tariffs or rising labor costs to the consumer. This is a vital advantage compared to weaker companies, which are much more susceptible to increased input costs and as a result much rather feel the impact on their profitability. In such demanding market phases, these differences become very apparent. While some stocks have more than halved, others have lost little in value.

Market corrections of this scale are nothing out of the ordinary and do not play a major role in the portfolio given a long-term investment horizon and a high-quality level of the companies held. After an exceptionally quiet year for the stock market in 2017, we are once again confronted with increased volatility, which in turn demands investors to focus on quality and a long-term investment view.

Zurich, December 2018