Valvest

Investment View – 1st Quarter 2019

Review

Changes in the macroeconomic environment take time. The same issues that accompanied the market correction at the end of last year were also present and unresolved during the strongest start the stock markets have seen since 1998.

Most companies have now presented their figures for the year 2018. It is evident that the global economy is still in good shape and that the trade conflict between China and the USA as well as Brexit worries have so far only had limited negative influence. Nevertheless, economic growth has decelerated since the cyclical peak last year. This makes companies communicate more cautiously for the near-term future, but the mood remains optimistic.

Interest Rates and Inflation

In the last investment view we wrote about the commitment of the U.S. Federal Reserve Chairman Powell, to normalize interest rates in the near future. However, the sharp market decline at the end of last year was already enough to get the Fed off the path. The combination of interest rate hikes, contraction of the central bank balance sheet, and record-high issuance of new government bonds due to the budget deficit seem to have been too much to absorb. Not only are there no further interest rate hikes planned for the time being, but the reduction of the central bank balance sheet is also slowing down and will even be completely halted at the end of September 2019.

A key driver of the economy and the stock market are the low interest rates, which make the credit burden of companies and governments bearable and have a stimulating effect on the economy. Ten years into the recovery, the economy still does not seem strong enough to absorb higher interest rates. In Europe, interest rates are still widely negative. Central banks will not move forward with the normalization of interest rates unless increasing inflation rates force them to do so. In respect to inflation, almost all companies have reported increased cost pressure. Especially in the United States, personnel costs rose due to the low level of unemployment. Additionally, the high level of economic activity leads to rising transportation costs due to capacity restraints. Since no reduction in these costs is currently foreseeable, many companies are planning or already have implemented price increases.

Irrespective whether inflation rates rise or fall, interest rates adjusted for inflation are already largely low to negative.

Equities and Fixed Income

This low to negative real interest rate environment supports the attractiveness of assets that yield a return. In the case of equities, the yield has risen considerably at the end of 2018, thanks to rising corporate profits and falling market prices. The sharp recovery of market prices in the first quarter has again largely corrected this but given the continued relatively low interest levels and the overall healthy state of the economy, equities remain an attractive asset class.

Nevertheless, it is advisable to perceive the signals of the market. Defensive sectors, such as Healthcare, Consumer Staples and Utilities have outperformed since the correction at the end of last year. The same applies if the observation period is extended to the entire last year up until today. The only cyclical sector that has performed strongly over the entire period is Technology.

The economic slowdown is therefore to some extent already reflected in the prices. Considering the solid corporate results, full order books and the robust labor market situation, we see a cyclical weakening of the economy but not a recession.

Fixed-income investments remain less attractive, especially in Swiss francs and Euros. If the borrower selection does not involve significant risks, interest rates are usually lower than inflation. In view of the latest monetary policy decisions by the Fed and European central bank, this will probably remain so for years to come.

Conclusion

Real assets continue to be an attractive alternative to cash and fixed income in this environment. The latter remain underweight in our portfolios. In view of the somewhat elevated geopolitical risks and fair equity valuations, it remains important to focus on above-average quality investments and to adjust the sector allocation accordingly.

Zurich, March 2019