NOTZ STUCKI ASSET MANAGERS SINCE 1964

INVESTMENT OUTLOOK

Q4 2017

Written by James Macpherson

Contrary to predictions at the start of the year, when it was expected that they would have to contend with rising interest rates, markets have been strong this year. Moreover one of the main hopes on President Trump's election was that he would cut taxes and introduce a one billion dollar infrastructure plan. Not only has a clear tax policy not been set out by his Administration, but little else of any significance has been achieved so far, and the White House has suffered a dismaying series of shambolic incidents. Evidence mounts that Mr Trump lacks the skills to run the executive arm of government, which is all the more disturbing given the bellicose situation in North Korea. However markets have risen against a background of steady economic growth and continued low interest rates. What the rise in the indices masks though is what a narrow market it has been. It has been a market driven by passive flows, with more and more money being run by ETFs. Any change to either the low interest rate environment or the cult of ETFs would have profound implications for investors.

Further evidence of the desperate hunt for yield was revealed in the last quarter. Iraq raised a one billion dollar bond for less than 7% yield which was six times oversubscribed. Tajikistan raised its first international bond for $500m, for ten years at a little over 7%. Belarus raised $1.4bn also at a little over 7%. The European junk bond High Yield index yield fell below that of the US Government ten year yield. Investors will go to extraordinary lengths to find yield and when prices are this stretched they must be vulnerable to any bad news. The low yields on such poorly rated issuers is the more remarkable given that Central Banks have started to indicate that they are withdrawing their stimulus, and in the case of the Federal Reserve have already begun raising interest rates. Moreover bond yields can rise without strong growth. Employment is tight in most countries, and many governments are pushing through minimum wage increases. There is a shift of power from asset owners to employees. Second, the winding down of QE will remove an important buyer of bonds from the market. 2018 will be the first year since the crisis in which Central Banks will be net sellers of their bonds instead of net buyers. Third, Anglo-Saxon countries may be facing a structural shift. The huge trade surpluses generated in Asia and the Eurozone (principally Germany) over the last ten years have been recycled by being invested in Anglo-Saxon economies. The development of a consumer society in China and the cyclical recovery in Europe will lead to smaller surpluses, and correspondingly smaller capital outflows invested in the US, UK, Canada and Australia. This will mean these countries will have to save more and may need to raise rates to compete for capital. Fourth, there is a greater emphasis on fiscal expansion as voters tire of austerity. The US fiscal balance has increased, the UK is relaxing budget restraints, and now that Germany's election is out of the way there is a reasonable chance that European countries will be allowed to be less strict on their budgets. Finally there has been much more debate about the merits of extended QE and low interest rates with the suspicion that they may be creating a stagnant economy.

The problem with low interest rates is that it removes the incentive to save, and if you don't save you have no involvement in the future. The lack of a competitive cost of capital has allowed inefficient companies to survive, thereby denying new companies the ability to take their place. In the US the number of new firms setting up and the number of firms closing are at generational lows. The system is not being cleansed. On top of this is the mass of regulation that has been introduced. JP Morgan has 70,000 compliance officers. Citigroup's returns have fallen from 15% to 6%. Banks transmit credit round the economy so this hampers overall growth. Largescale regulation favours big companies as it acts as a barrier to entry for smaller competitors. Further low interest rates and the oligopolisation of the corporate sector has reduced the need to innovate and trapped capital in less efficient areas.

The increasing dominance of passive investment has led to a market dominated by momentum. There are increasing signs of investors chasing returns and buying stocks that have been strong and pushing them higher still. Originally the impetus for this was bond investors, who were desperate for yield, migrating into 'bond-proxy' stocks whose dividend yields were higher than sovereign yields. As yields remained low more and more money flowed into these products creating a self-sustaining momentum. But passive investment is the opposite of fundamental investment. There is no research, no analysis of criteria like cash flow, and no attention to valuation. The mechanics of index investing risk favouring overvalued stocks and buying yesterday's winners not tomorrow's. It has the advantage of being low cost, and when the market is being driven by momentum anyone who does not join in almost inevitably underperforms, but if and when the party stops it will be the worst place to be, because everyone is herded into a crowded space. A related problem in this market has been the influence of algorithmic trading where computers buy and sell stocks based on pre-programmed data which often has significant momentum characteristics.

Investors now need to make two judgements. First are the fundamentals good, and second how will the robots react?

The current equity bull market has had few setbacks. There have only been four of any size since 2009, and three of these were before 2012. The US market has become highly valued. On Warren Buffett's favourite yardstick of measuring total US stock market capitalisation against as a percentage of GDP it has reached a record high of 145%. This compares to an average of 60% in the period 1970 to 1995, and 100% from 1995 to 2017. The Shiller index which measures the market on average earnings for the past ten years is at 30x, a level only exceeded in 1929 and 2000, both of which preceded severe falls. Much of the US market looks stretched and vulnerable to a correction.

However Europe, Japan and Asia show much better value and their economies are improving. European growth is not exciting but a region with undoubted structural problems, inflexible labour markets and the straitjacket of a an ill-conceived currency is doing a little better than it was, and with the election of Macron there is some chance that some much needed reforms can take place. The Japanese market remains a strong long term story based on improving corporate governance and much more attention to shareholder returns. The Asian market has suffered in a similar way to the US with the index driven by just a few stocks. This has left considerable value in smaller companies.

It is clear that bonds are unattractive at current levels. In the US equities are expensive though, as always, there are opportunities for the stock picker. Elsewhere, however, equity markets offer plenty of value, with the financial and energy sectors clear examples. For other assets it is less clear. Gold is unlikely to perform until inflation is clearly rising. The last few months have seen dramatic rises in so-called crypto-currencies like Bitcoin. However it is worth considering that while there are only about 150 sovereign currencies in the world there are roughly 800 crypto-currencies, all of which have appeared in the last five years. The barriers to entry do not seem high. A carefully selected portfolio of equities, avoiding the obviously over extended areas, is the best strategy for the present.

NOTZ STUCKI ASSET MANAGERS SINCE 1964

www.notzstucki.com

www.nsfunds.com

NOTZ, STUCKI & CIE S.A.

Rue Saint Jean 98
1201 Geneva
Switzerland

+41 (0) 22 906 52 50
+41 (0) 22 738 72 87
geneva@notzstucki.com

NOTZ, STUCKI EUROPE S.A.

11, Boulevard de la Foire
1528 Luxembourg
Luxembourg

+352 (26) 27 11 1
+352 (26) 27 11 69
luxembourg@notzstucki.com

DISCLAIMER

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. THE VIEWS, STRATEGIES AND FINANCIAL INSTRUMENTS DESCRIBED IN THIS DOCUMENT MAY NOT BE SUITABLE FOR ALL INVESTORS. OPINIONS EXPRESSED ARE CURRENT OPINIONS AS OF THE DATE(S) APPEARING IN THIS MATERIAL ONLY. THIS DOCUMENT DOES NOT CONSTITUTE AN OFFER OR SOLICITATION TO ANY PERSON IN ANY JURISDICTION IN WHICH SUCH OFFER OR SOLICITATION IS NOT AUTHORIZED OR TO ANY PERSON TO WHOM IT WOULD BE UNLAWFUL TO MAKE SUCH OFFER OR SOLICITATION. ANY REFERENCE IN THIS DOCUMENT TO SPECIFIC SECURITIES AND ISSUERS ARE FOR ILLUSTRATIVE PURPOSES ONLY, AND SHOULD NOT BE INTERPRETED AS RECOMMENDATIONS TO PURCHASE OR SELL THOSE SECURITIES. REFERENCES IN THIS DOCUMENT TO INVESTMENT FUNDS ARE TO FUNDS THAT HAVE NOT BEEN AUTHORISED BY THE FINMA AND THEREFORE CANNOT BE DISTRIBUTED IN OR FROM SWITZERLAND EXCEPT TO CERTAIN CATEGORIES OF ELIGIBLE INVESTORS. SOME OF THE ENTITIES OF THE NOTZ STUCKI GROUP OR ITS CLIENTS MAY HOLD A POSITION IN THE FINANCIAL INSTRUMENTS OF ANY ISSUER DISCUSSED HEREIN, OR ACT AS ADVISOR TO ANY SUCH ISSUER.

REFERENCES TO MARKET OR COMPOSITE INDICES, BENCHMARKS OR OTHER MEASURES OF RELATIVE MARKET PERFORMANCE OVER A SPECIFIED PERIOD OF TIME ARE PROVIDED FOR YOUR INFORMATION ONLY.

ADDITIONAL INFORMATION IS AVAILABLE ON REQUEST.