Investment traffic lights

Our tactical and strategic view

General market overview

Looking around, you might well be asking yourself: Is it Christmas already? Rest assured that there are still seven weeks to go. However, this has neither discouraged shops from already selling their Christmas merchandise nor investors from starting the year-end rally. The markets continue to race from one peak to the next. October proved to be another benign month across most asset classes. Equity markets experienced strong performance across pretty much all regions. In local-currency terms, the Nikkei led with 8.1% total return, followed by the Dax with 3.1%. Among emerging markets, Latin America declined slightly, but Asian equity markets did very well. Emerging-market bonds saw declines across most regions, mainly, it appears, due to a stronger dollar. The greenback gained 1.6% against the trade-weighted currency basket[1]. Leaving emerging markets aside, fixed income had a pretty solid month, in particular as far as corporate bonds were concerned.

Once again, this was partly driven by strong economic growth in virtually all regions. So far, we have also had another strong earnings season. Technology firms were able to beat expectations particularly strongly.

Another important driver was once again monetary policy. Heading into October, that was hardly a given. Throughout the month, investors were left to wonder who would succeed Janet Yellen as the chair of the U.S. Federal Reserve (Fed). This occasionally led to market nervousness, based on fears President Trump might choose a more hawkish successor. Trump waited until November 3rd. With the benefit of hindsight, we – and along with most other market participants – were right to expect policy continuity. In the end, Trump decided to nominate Jerome Powell, who has already served alongside Yellen on the Fed and is likely to continue along the Fed's recent policy path. Talking about continuity, the term also describes well what to expect at the Bank of Japan (BOJ). Following the election victory of Prime Minister Shinzo Abe, BOJ president Haruhiko Kuroda is likely to see his tenure renewed for another term. Meanwhile, the European Central Bank (ECB) skillfully avoided rocking the boat at its long-awaited October meeting. Draghi confirmed that asset purchases would start to shrink in 2018. Beyond that, however, the ECB has kept all its options open. The only outlier was the Bank of England (BoE), who has had to raise interest rates for the first time in ten years. This has less to do with underlying economic momentum in the United Kingdom, than with a weaker pound driving up inflation. Whether this was the right move remains to be seen. Further delays in gaining clarity on the Brexit process could damage market confidence.

[1]The Trade Weighted U.S. Dollar Index depicts the value of the dollar against a currency basket using the trade-weighted average auf 26 currencies.

Delays can also be seen in the formation of the next German government. Another political issue investors are watching is the tense situation in Catalonia with parts of the population aspiring independency from Spain. In China, Xi Jinping has succeeded in increasing his power at the People's Congress considerably. This could temporarily speed up political decision-making. Nevertheless, we are slightly skeptical about how well such a concentration of power will serve markets in the long run. For one thing, it will not necessarily translate into a further opening and liberalization of the Chinese economy and capital markets.

Outlook and changes in positioning

Overall, we expect markets to continue trending upwards in the coming months. We have some concerns, however, regarding U.S. equities, which we have put on underweight. The tax reform continues to face numerous obstacles. Moreover, Washington is once more distracted by political turbulences, including the investigations by Special Counsel Robert Mueller and the recent charges he pressed against some former aids in the 2016 Trump campaign.

In terms of underlying fundamentals, however, we consider global equity markets to be well supported. Earnings and sentiment indicators remain solid across most major markets. Such strongly synchronized trends are unusual – and reassuring. In terms of regional preferences, the main change among equity allocations has been putting Japan on overweight. Political uncertainty here has faded, while earnings expectations continue to rise. In terms of sector preferences, we continue to stick to our preference for raw materials, finance and technology.

On the fixed-income side, our positions have not changed much either. At current yield levels, we are cautious on 10-year German Bunds, and neutral at both the very short and the very long end. With regard to sovereign bonds from the Eurozone's periphery, we may continue to see some trading opportunities, depending on how the situation in Catalonia continues to evolve, as well as on economic and political developments in Italy. For now, we prefer maturities in the 5- to 7-year range. We have also put euro high-yield bonds on overweight. For U.S. Treasuries, we remain neutral, but tend to view them with a little more skepticism.

As we expected, the euro has stopped its ascent against the dollar. While the interest-rate differential as measured by two-year bonds from Germany and the United States is very wide by historic standards and augurs well for the dollar, the political momentum is less supportive. For the rest of November, neither the ECB nor the Fed is scheduled to release market-moving information. Investors are more likely to focus on political developments. The issue of Catalonia is unlikely to go away. November could also pass without much tangible progress on the Brexit process. And far as U.S. tax reform is concerned, there remains scope for disappointment in terms of both the timing and the content of the final package.

Equities*

	1 to 3 months	until September 2018
Regions		
United States	🔴	→
Europe	🟢	↗
Eurozone	🟢	↗
Germany	🟢	→
Switzerland	🟡	→
United Kingdom (UK)	🟡	→
Emerging Markets	🟢	↗
Asia ex Japan	🟢	↗
Japan	🟢	→
Latin America	🔴	↗
Sectors		
Consumer staples	🟡	
Healthcare	🟡	
Telecommunications	🔴	
Utilities	🔴	
Consumer discretionary	🟡	
Energy	🟡	
Financials	🟢	
Industrials	🟡	
Information technology	🟢	
Materials	🟢	
Real Estate	🔴	
Style		
Small and mid cap	🟢	

Fixed Income*

	1 to 3 months	until September 2018
Rates		
U.S. Treasuries (2-year)	🟡	↗
U.S. Treasuries (10-year)	🟡	↗
U.S. Treasuries (30-year)	🟡	↗
UK Gilts (10-year)	🔴	↗
Italy (10-year)[1]	🟡	↗
Spain (10-year)[1]	🟢	↗
German Bunds (2-year)	🟡	↗
German Bunds (10-year)	🔴	↗
German Bunds (30-year)	🟡	↗
Japanese government bonds (2-year)	🟡	→
Japanese government bonds (10-year)	🟡	→
Corporates		
U.S. investment grade	🟢	→
U.S. high yield	🟢	↗
Euro investment grade[1]	🟢	↘
Euro high yield[1]	🟢	↗
Asia credit	🟢	↗
Emerging-market credit	🟢	→
Securitized / specialties		
Covered bonds[1]	🔴	↗
U.S. municipal bonds	🔴	→
U.S. mortgage-backed securities	🔴	↗

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Currencies		
EUR vs. USD	🟡	↘
USD vs. JPY	🟡	→
EUR vs. GBP	🟡	→
GBP vs. USD	🟡	↘
USD vs. CNY	🟡	↗
Emerging markets		
Emerging-market sovereigns	🟢	↘

Alternatives*

	1 to 3 months	until September 2018
Infrastructure	🟡	↗
Commodities	🟢	↗
Real estate (listed)	🟡	↗
Real estate (non-listed) APAC	🟢	↗
Real estate (non-listed) Europe	🟢	↗
Real estate (non-listed) United States	🟡	→
Hedge funds	🟢	↗
Private Equity[2]	🟡	→

Comments regarding our tactical and strategic view

Tactical view:

- The focus of our tactical view for fixed income is on trends in bond prices, not yields.

Strategic view:

- The focus of our strategic view for sovereign bonds is on yields, not trends in bond prices.
- For corporates and securitized/specialties bonds, the arrows depict the respective option-adjusted spread.
- For bonds not denominated in euros, the illustration depicts the spread in comparison with U.S. Treasuries. For bonds denominated in euros, the illustration depicts the spread in comparison with German Bunds.
- For emerging-market sovereign bonds, the illustration depicts the spread in comparison with U.S. Treasuries.
- Both spread and yield trends influence the bond value. Investors who aim to profit only from spread trends should hedge against changing interest rates.

Key

The tactical view (one to three months):

- 🟢
  Positiver view
- 🟡
  Neutral view
- 🔴

Negative view

The strategic view up to September 2018

Equity indices, exchange rates and alternative investments:

The arrows signal whether we expect to see an upward trend ↗ , a sideways trend → or a downward trend ↘ .

The **arrows' colors** illustrate the return opportunities for long-only investors.

- ↗ Positive return potential for long-only investors
- → Limited return opportunity as well as downside risk
- ↘ Negative return potential for long-only investors for long-only investors

Fixed Income:

For sovereign bonds, ↗ denotes rising yields, → unchanged yields and ↘ falling yields.For corporates, securitized/ specialties and emerging-market bonds, the arrows depict the option-adjusted spread over U.S. Treasuries: ↗ depicts a rising spread, → a sideways trend and ↘ a falling spread.

The **arrows' colors** illustrate the return opportunities for long-only investors.

- ↘ Positive return potential for long-only investors
- → Limited return opportunity as well as downside risk
- ↗ Negative return potential for long-only investors for long-only investors

Footnotes:

* as of 10/31/17

[1] Spread over German Bunds in basis points

[2] These traffic-light indicators are only meaningful for existing private-equity portfolios

Glossary

Bank of England (BoE)

The Bank of England (BoE) is the central bank of the United Kingdom.

Bank of Japan (BOJ)

The **Bank of Japan (BOJ)** is the central bank of Japan.

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the possible exit of the United Kingdom of the European Union.

Bunds

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years

Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Greenback

Greenback is a commonly used expression for the U.S. dollar.

High Yield (HY)

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Nikkei 225

The Nikkei 225 is a price-weighted index of Japan's 225 most important listed companies.

Periphery

Periphery countries are less developed than the core countries of a specific region. In the Eurozone, the euro periphery consists of

the economically weaker countries such as Greece, Portugal, Italy, Spain and Ireland.

Pound sterling (GBP)

The **pound sterling (GBP)**, or simply the pound, is the official currency of the United Kingdom and its territories.

Trade-Weighted U.S. Dollar Index

The Trade-Weighted U.S. Dollar Index tracks the performance of the U.S. dollar relative to other world currencies.

US Federal Reserve (the Fed)

The **US Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

Risk warning

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Foreign Exchange/Currency – Such transactions involve multiple risks, including currency risk and settlement risk. Economic or financial instability, lack of timely or reliable financial information or unfavorable political or legal developments may substantially and permanently alter the conditions, terms, marketability or price of a foreign currency. Profits and losses in transactions in foreign exchange will also be affected by fluctuations in currency where there is a need to convert the product's denomination(s) to another currency. Time zone differences may cause several hours to elapse between a payment being made in one currency and an offsetting payment in another currency. Relevant movements in currencies during the settlement period may seriously erode potential profits or significantly increase any losses.

High Yield Fixed Income Securities – Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

Hedge Funds – An investment in hedge funds is speculative and involves a high degree of risk, and is suitable only for "Qualified Purchasers" as defined by the US Investment Company Act of 1940 and "Accredited Investors" as defined in Regulation D of the 1933 Securities Act. No assurance can be given that a hedge fund's investment objective will be achieved, or that investors will receive a return of all or part of their investment.

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