Investment traffic lights

Our tactical and strategic view

General Market Overview

Children who still follow an old tradition and put their shoes out in the evening of December 5, do this in eager anticipation of St. Nicholas filling their shoes with little presents, sweets or coins. Most investors must have had a similar feeling in the past few weeks. Particularly holders of U.S. equities were blessed with loads of presents in November, even with a new record: the S&P 500 generated a positive return for 13 months in succession. (A relatively weak U.S. dollar performance in November certainly helped again.) The previous 12-month records were achieved in 1936 and 1950. The MSCI World mirrored the record due to its high weighting of U.S. equities (an impressive 59% at the moment.) In Europe and Latin America, however, St. Nicholas was not as generous and pushed these markets into negative territory in November. The Chinese stock market (Shanghai A-Share Index) also lost some ground. Above all, investors were surprised by the sudden daily loss of 2.3% on November 23. U.S. investors were not unscathed either as the Nasdaq Composite Index slumped abruptly by 1.3% a little less than a week later. However, having generated a year-to-date return of more than 30%, the shock should have been manageable. In general, most asset classes look good as of the end of November, negative returns are hard to find just before year-end, with some exceptions in the commodity space. Despite numerous political issues, the overall very positive economic data continues to boost markets.

Outlook and changes in positioning

As professional investors are slowly closing their books in December - a month with traditionally fewer trading days - trading volumes are below average. This could be enough to drive up volatility on individual days. This year, progress in the U.S. tax reform, above all, has the capacity to generate stimuli to markets in both directions. The Brexit negotiations have also repeatedly moved the British pound and UK Gilts and might again do so in December. As for the government formation process in Germany, however, we do not expect much impact on markets. From a tactical perspective, our positioning has changed little compared to the previous month. Within equities, we took Germany down to neutral at the beginning of November. Despite very strong ifo business sentiment data, earnings estimates were raised only hesitantly. Furthermore, the stronger euro is having a negative effect on German exporters. As for bonds, our most important change in November was downgrading 10- and 30-year U.S. Treasuries from neutral to negative. We do not expect yields to go up much, though. The market now appears quite certain that the tax reform will be adopted. However, we believe that the effects on the economy and corporate earnings will be less pronounced than many people originally expected. In the UK, we went from negative back to neutral in 10-year Gilts. Economic and Brexit headlines are rather balanced at present. Unless there are clear signals from the Brexit negotiations, we expect a tight trading range over the coming weeks. In Asian corporate bonds, we have reduced our tactical view to neutral (from positive), because we fear that the increased issuance activity might have a negative impact on prices.

Approaching the end of the year, we would like to look at our recently published strategic outlook for 2018. Central banks are likely to remain important market drivers in 2018 as well, only slowly scaling back their stimulus measures. The US Federal Reserve Board (the Fed) is likely to continue its cycle of rate hikes. Following one in December this year, we expect two more hikes in 2018. The European Central Bank (ECB) on the other hand is likely to end its bond purchases in 2018, so the first rate hike is not reckoned with before 2019.

We expect U.S. Treasuries and German Bunds to continue showing modestly rising yields. The moderate inflation environment as well as an overall expansionary monetary policy should limit the upward pressure on yields. Spreads for bonds from European peripheral countries are expected to widen to some extent. Spreads for corporates, however, are predicted to narrow slightly. This market segment is supported by a robust economy, low default rates, plenty of liquidity and – in the case of European bonds – ECB purchases. We are also positive for emerging-market bonds as they are driven by strong fundamentals and rising commodity prices. We consider inflation surprises to be the biggest risk for bond markets.

For the euro/dollar rate, we forecast a trading range of 1.05 to 1.25 dollars per euro in the course of the year. By the end of the year, we expect a slightly stronger dollar at 1.15.

Meanwhile, we consider global stock-market valuations as historically high. At present, however, growing corporate earnings are supporting the market. Earnings estimates for 2017 have been exceeded. We anticipate the earnings momentum for 2018 to be slightly weaker. Stock markets in developed countries should therefore have mid- to high-single-digit growth potential and emerging markets a little more. In terms of regions, we prefer emerging markets, Japan and Europe. Our tactical sector allocation remains cyclical, with financials and technology on overweight and bond-proxy sectors on underweight.

In light of the positive economic environment and rising yields, the price potential of gold seems to be limited. Trading in a range around $55 per barrel, we consider the oil price (WTI) to adequately reflect supply and demand dynamics.

Equities*

	1 to 3 months	until December 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 December 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	🟡	↗
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 December 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):

- 🟢
  Positive view
- 🟡
  Neutral view
- 🔴
  Negative view

The strategic view up to December 2018

Equity indices, exchange rates and alternative investments:

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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 11/30/17

1 Spread over German Bunds in basis points

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

Glossary

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.

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.

Gilts

Gilts are bonds that are issued by the British Government.

ifo Institute for Economic Research

The **ifo Institute for Economic Research**, based in Munich, is a leading European research institute, particulary known for its sentiment indicator "ifo Business Climate Index".

MSCI World Index

The **MSCI World Index** tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

Nasdaq Composite Index

The **Nasdaq Composite Index** is an equity index which contains all common stocks listed on the NASDAQ exchange.

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.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Shanghai Stock Exchange A-Share Index

The **Shanghai Stock Exchange A-Share Index** is a market-capitalization-weighted equity index comprising all A-shares listed on the Shanghai Stock Exchange.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

US Federal Reserve Board (the Fed)

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

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

West Texas Intermediate (WTI)

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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