Investment traffic lights

Our tactical and strategic view

General Market Overview

"Just keep on going" – this is what most investors may think when looking back at the year of 2017 and forward to 2018. As we forecasts rising markets for 2018, their wish might come true in terms of direction. But in terms of quantity, the current year might not pamper investors as 2017 did. First of all, 2017 was far too strong for that and, secondly, some drivers boosting the markets in 2017 are no longer intact. This was, in Europe, Macron's victory in the French presidential elections and the so called tax reform that was finally passed by the U.S. congress in late 2017. However, it remains to be seen whether and to what extent U.S companies and middle-and low income households should benefit from this rather hastily written law. In Asia, China and Japan both presented surprisingly good economic and corporate data. The even higher dynamics in the economic environment all over the world in the current year should, after all, pave the way for a good investment year 2018. However, not all assets might repeat their 2017 performance, particularly equities.

With total returns of 24.6%, the MSCI AC World (i.e. industrialized states and emerging markets) performed better in 2017 than in any other year since 2009. This is, however, only the case in U.S. dollar terms. In local currencies, global stock exchanges gained "only" 23.1%, thus falling short of the 28.1% achieved in 2013. This leads us to another major trend of last year: the weakness of the dollar. It lost almost 10% versus the trade-weighted currency basket and even 14% versus the euro. This puts the strong performance of the S&P 500 into perspective. It increased by 21.8%, whereas the Dax gained only 12.8%. However, in dollar terms, the Dax grew by 28.1%, thus reaching the 20 to 30% growth corridor alongside the Euro Stoxx 50, the Swiss SMI, the U.K. FTSE 100 and the MSCI Japan. Only Asia ex Japan (MSCI AC Asia ex Japan) performed even better, again in dollar terms, and gained 42.1%. Similar to the S&P 500, technology firms have been the main drivers of the index.

What other features of 2017 are outstanding? One of them certainly was low volatility which fell to historic lows in some markets. Others were an oil price that recovered strongly from mid-2017 on and gold prices rising from the start of 2017. The argument that precious metal always stands for some investor skepticism, despite good economic data, might be confirmed by the most surprising performance of a very young asset class: cryptocurrencies. The value of bitcoin has increased almost twentyfold in 2017, its rival ethereum almost even hundredfold. Our arguments against investing into these so-called currencies are to be found in our recent publication "Bitcoins all over the place." Finally, let's turn to the bond markets where returns (in local currency) mainly remained single-digit – however, only if you skipped Bunds. German government bonds of all maturities lost money in 2017, whereas emerging market bonds denominated in U.S. dollars boasted double-digit returns.

Outlook and changes in positioning

Although we do not think that low volatility heralds a stock market slump, it does carry an element of risk. Together with the high returns recently achieved, it has, on the one hand, increased market participants' self-reinforcing complacency. It has increased their risk appetite and lowered their risk awareness. On the other hand, it has prompted some institutional multi-asset funds, particularly those aiming to achieve a constant risk level, to drive up their equity share in this environment. After a strong 2017 and volatility at bottom levels, ever more investors are romping around riskier asset classes such as equities or corporate bonds. Although we do expect the economic environment to continue supporting the markets, riskier positioning by investors could trigger a minor market setback turning into a major slump, even if this is only short-dated. If this happens right at the beginning of 2018, this could strongly influence investor sentiment for the rest of the year.

But, as we already stated in our report last month, we assume returns to remain positive in the year of 2018 for almost all asset classes. We have only made minor tactical changes recently. Still in December, we had upgraded U.S. small- and mid-cap firms to neutral since they should benefit most from the U.S. tax reform. At the start of 2018, we downgraded 2-year U.S. government bonds as well as 10-year U.K. Gilts – the first, since good economic dynamics meet with high issuance in January and the latter, since we expect inflationary pressure to rise in the United Kingdom. Our short-term outlook for the Dax has turned more positive again after it had lost roughly 5% from its peak in only a couple of weeks.

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:

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

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.

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

Footnotes:

* as of 12/29/17

** as of 1/3/18

[1] Spread over German Bunds in basis points

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

Glossary

Cryptourrency

Cryptocurrencies are a new generation of digital currencies and payment systems that rely on cryptotechnology and distributed data management. They are privately organised and not bound to oversight by central banks or other official institutions. The pioneer and still most traded cryptocurrency is the bitcoin.

Dax

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

Euro Stoxx 50

The **Euro Stoxx 50** is an index that tracks the performance of blue-chip stocks in the Eurozone.

FTSE 100

The **FTSE 100** is an index that tracks the performance of the 100 major companies trading on the London Stock Exchange.

MSCI AC World Index

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

MSCI Asia ex Japan Index

The **MSCI AC Asia ex Japan Index** captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

MSCI Japan Index

The **MSCI Japan Index** is designed to measure the performance of the large- and mid-cap segments of the Japanese market.

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.

Swiss Market Index (SMI)

The **Swiss Market Index (SMI)** is Switzerland's most important equity index, consisting of the 20 largest and most liquid large- and mid-cap stocks.

Risk warning

Investments are subject to investment risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

Investments in Foreign Countries – Such investments may be in countries that prove to be politically or economically unstable. Furthermore, in the case of investments in foreign securities or other assets, any fluctuations in currency exchange rates will affect the value of the investments and any restrictions imposed to prevent capital flight may make it difficult or impossible to exchange or repatriate foreign currency.

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.

Commodities – The risk of loss in trading commodities can be substantial. The price of commodities (e.g., raw industrial materials such as gold, copper and aluminium) may be subject to substantial fluctuations over short periods of time and may be affected by unpredicted international monetary and political policies. Additionally, valuations of commodities may be susceptible to such adverse global economic, political or regulatory developments. Prospective investors must independently assess the appropriateness of an investment in commodities in light of their own financial condition and objectives. Not all affiliates

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Investment in private equity funds is speculative and involves significant risks including illiquidity, heightened potential for loss and lack of transparency. The environment for private equity investments is increasingly volatile and competitive, and an investor should only invest in the fund if the investor can withstand a total loss. In light of the fact that there are restrictions on withdrawals, transfers and redemptions, and the Funds are not registered under the securities laws of any jurisdictions, an investment in the funds will be illiquid. Investors should be prepared to bear the financial risks of their investments for an indefinite period of time.

Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Nonperforming real estate investment may require substantial workout negotiations and/ or restructuring.

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