1st quarter 2018

Investment Views

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Current market assessment

The tables below summarise VP Bank's trend assessments for all asset classes in our investment universe. The arrows reflect the forecasts of our investment strategists for the coming three to six months.

	Rate as of 05.12.2018	Nov. 2017	Jan. 2018	
Money market and currencies (pages 6–9)				
Currencies				
EUR vs.USD	1.183	↘	↘	
EUR vs.CHF	1.166	↘	↘	
USD vs.CHF	0.986	→	→	
GBP vs.USD	1.342	↘	→	New
USD vs.JPY	112.63	↗	↗	
AUD vs.USD	0.763	→	→	
USD vs.SGD	1.348	↗	↗	
USD vs.RUB	58.745	→	→	
Key interest rates				
Switzerland	-0.75%	→	→	
Europe (EMU)	0.00%	→	→	
USA	1.50%	↗	↗	
Bond yields (pages 10–13)				
Investment grade government bonds				
Switzerland		→	→	
Europe		→	→	
USA		↗	↗	
Investment grade corporate bonds				
Switzerland		→	→	
Europe		→	→	
USA		↗	↗	
Bonds: total return (pages 10–13)				
High yield bonds				
High yield		↘	↘	
Emerging market bonds				
Hard currency bonds		→	→	
Local currency bonds		→	→	
Equities (pages 14–17)				
Switzerland		→	→	
Europe		→	↗	New
North America		→	→	
Pacific		→	→	
Emerging markets		→	↗	New
Alternative investments (pages 18–21)				
Commodities		→	→	
Crude oil		→	→	
Gold		↗	↗	
Real estate shares		→	→	
Private equity		→	→	
Convertible bonds		→	→	
Hedge funds		→	↗	New

// There's still life in the bull market. //

Bernd Hartmann
Head of Group Investment Research

Dear Reader

As a new year gets underway, investors and investment houses traditionally take stock of the year just ended. Looking back, the markets' behaviour can be summed up in just one number: thirteen.

Thirteen successive months of positive equity returns! From November 2016 to November 2017 the MSCI World equity index (including net dividend income) delivered a positive return every month without exception. It is the first time this has happened since the index was launched in 1970.

Admittedly, the dollar's weakness has helped, and the number of positive monthly performances says nothing about the size of the gains achieved. But the message is clear: for the first time in years the markets were spared major unpleasant surprises. The few worries and uncertainties that existed a year ago have evaporated. Economic growth is picking up, established parties have seen off the populists in European elections, Donald Trump's most extreme plans have been thwarted, and central banks have gently prepared investors for upcoming policy adjustments.

The exceptional nature of the present run has implications for the immediate future. Investors should not let themselves by lulled into complacency by the markets' tranquil progress. These are unusual times. It should also be noted that investors are still virtually unanimous in regarding equities as the investment of choice.

What does that mean for the investment outlook? This issue of Investment Views is devoted entirely to prospects for 2018. We start with an overview in "Top issue of the month" and then take a detailed look at the various asset classes.

1. FOCUS

Outlook for 2018: getting the balance right

THERE CAN BE NO DOUBT ABOUT IT: THE BULL RUN ON THE FINANCIAL MARKETS IS AT AN ADVANCED STAGE, AND THE SAME GOES FOR THE MACROECONOMIC CYCLE. ALTHOUGH WE EXPECT THE MARKET ENVIRONMENT TO STAY BENIGN, 2018 LOOKS SET TO BE A MORE CHALLENGING YEAR, REQUIRING INVESTORS AND CENTRAL BANKS TO PERFORM A DELICATE BALANCING ACT.

Easy gains are over

Looking back, 2017 was a simple year. Market gains were driven by clearly identifiable factors. After the Brexit vote and the election of Donald Trump, there had been worries that Europe's "super election year" would see a populist victory in one or other of the countries that went to the polls. That did not happen. Nor did the election of Donald Trump herald a complete change of direction in the USA. The markets were therefore able to price out the political risk. Added to that, the performance of the world economy was surprisingly encouraging. For once, economists and equity analysts were not forced to revise their growth and earnings forecasts downwards, and that gave the markets positive momentum.

Central banks provided no new stimulus, but against the background of an improving economic environment the mere continuation of expansionary monetary policies had a stimulatory effect.

Environment largely unchanged

These ideal conditions for the financial markets will initially continue. Leading indicators suggest solid economic progress. Investment activity continues to expand, and the upswing is becoming stronger and broader. Accelerating economic activity had scarcely any impact on inflation last year. Structural forces have so far ensured that virtual full employment in the USA has generated hardly any wage pressures. In our baseline scenario we expect only a moderate acceleration of inflation rates. We believe, however, that there is some probability of a stronger rise in US inflation in the second half of the year, and we will keep a very close eye on this development.

In our baseline scenario, central banks will initially be able to stick to their present course. In concrete terms that means that the Fed will proceed with the gradual downsizing of its balance sheet, as already announced, and will probably implement two hikes in the fed funds rate. The European Central Bank will stay on a more expansionary tack but has announced a reduction in the volume of its asset purchases. The Bank of Japan will presumably remain accommodative. Globally this means that overall monetary policy will continue to be expansionary, though a normalisation has already started in some countries. The absence of inflation pressure enables monetary policy makers to take their time and keep the markets fully apprised of the policy outlook.

In the bond markets the largely unchanged environment indicates only a very moderate rise in yields. A genuine turnaround in interest rates will therefore be further deferred. Borrowing costs will stay low. But here too the risks are on the upside. If core inflation climbs, e.g. as a result of resurgent wage pressures in the USA, the Fed would be forced to intervene more vigorously than the markets currently expect. Inflation expectations, which are an important driver of bond yields, would rise, resulting in higher yields at the long end of the maturity spectrum. Even so, structural factors, notably high saving rates, would limit yields' upside potential.

Corporate bonds: creeping changes

As is well known, central banks' asset purchase programmes have led to distortions on the bond markets by increasing demand for corporate bonds both directly (official purchases) and indirectly (displacement effects due to official purchases of government bonds). We initially expect to see little change in credit spreads on investment grade corporate securities. Excess liquidity and earnings growth provide support, and borrowing conditions remain favourable. Spreads are historically narrow, and we do not expect them to be

reduced any further. Nevertheless, there have been creeping changes in the risk profile. Borrowers have very little incentive at present to try to reduce their borrowing costs by enhancing their credit quality. The result has been a steady decline in credit ratings and also an increase in corporate debt. Many companies have used low interest rates as an opportunity to borrow at very long term. While this makes sense for the company, it means that holders of investment fund units and benchmark-oriented investments are more exposed to the risk of changing interest rates. A change in the yield level would produce sizeable movements in the value of such assets.

We continue to regard high yield bonds as unattractive. Many investors are enticed by the higher coupons compared with investment grade corporate bonds, but in our view the limited potential return on a bond investment (compared with equities) does not justify the risks in this sector, notably the risk of an unexpected backup of interest rates or a sudden bout of selling. More attractive, in our opinion, is the outlook for emerging market bonds. Although significant capital gains are unlikely here, investors stand to profit from wider spreads.

Equities: earnings growth supports bull market

The equity market has been buoyed by resurgent corporate earnings growth. Although we regard bottom-up analysts' current forecasts as too high, we do expect earnings growth to be solid. This should provide a basis for further equity market gains. However, the speed and size of the advances will be smaller than of late. Recent equity market advances in many countries have outstripped corporate earnings growth, resulting in a further rise in already above-average valuation levels. Valuations are not yet so extreme as to dictate a market correction. But the higher the market goes, the thinner becomes the air. The US market, in particular, has been rising continuously without significant setbacks, and prices for equity options suggest that investors confidently expect plain sailing over the months ahead. Such situations in the past have often been the prelude to a correction.

Investors should therefore be careful not to draw the wrong conclusions from the current balmy situation. It remains true, however, that attractive alternative investment media are lacking. As long as the environment remains benign (which is what we expect), major corrections should be avoidable. We recommend a selective approach. Within the equity allocation we are focussing on regions that have lagged behind but promise attractive earnings growth, notably the emerging markets and Europe. We also see potential in tactical and strategic themes in the developed markets.

Alternative investments in favour again?

In the current phase of elevated valuations, alternative investments offer an interesting supplement to bond and equity portfolios. In contrast to conventional investments that directly track the value of the underlying asset, alternative solutions involve a broader set of instruments that enable investors to tap new sources of return, for instance by exploiting relative valuation differences. Typically the reward potential offered by these solutions is much lower than in a straightforward equity investment. But returns are steadier, and the investor does not carry the entire market risk. If the market corrects, the loss for the investor is typically smaller than for the market as a whole. In the bond sector, absolute return funds have a good chance of generating better returns in a difficult market environment thanks to their broad variety of exposures. Unlike classic offshore hedge funds, such alternative investment vehicles have the virtue of transparency and liquidity and are structured in accordance with UCITS norms.

Conclusion: a question of balance

The financial market environment looks set to remain upbeat, at least in the first half of the year. Performance should therefore remain positive. In our view, phases of heightened volatility are likely to interrupt the extremely calm conditions that we are experiencing at present. This makes it all the more important that investors stick to a firm course.

The present advanced stage of the market cycle is characterised by heightened valuation levels in all asset classes. This means that investors must strike the right balance. In the bond sector, especially, investors should carefully consider whether they are prepared to incur significantly higher risks in order to enjoy comparatively attractive coupons. The bull market in equities looks set to continue for the time being, but here too careful positioning is important. Alternative investment vehicles offer interesting possibilities for investors who do not wish to expose themselves to increased market risk at this advanced stage of the cycle.

World economy in wellness mode

AFTER THE DIFFICULT POST-CRISIS YEARS AND A SUCCESSFUL CONVALESCENCE, THE WORLD ECONOMY IS NOW IN WELLNESS MODE. PARADOXICALLY, THE MAIN RISK NOW IS AN EXCESSIVELY STRONG UPSWING.

Highlights

- The world economy is on a recovery track, accompanied by relatively subdued inflation.
- Growth will be driven notably by capital spending.
- In our baseline scenario we expect inflation to stay moderate.
- But there is no room for complacency. Stronger than expected inflation is a non-negligible risk.

After several difficult years of depressed growth, the global economy appears to have achieved a turnaround. Global growth of 3.2% in 2016 seems to have marked the bottom of the cycle. The outcome for 2017 is expected to show growth of at least 3.6%, followed by 3.7% in 2018. These figures are hardly exuberant, but progress is being achieved. Stronger investment activity in the developed nations is especially encouraging. Companies are coming out of their shells and putting more money into their operations. In macroeconomic terms this is very good news, because it generates self-reinforcing effects. Investment in plant and equipment involves buying goods from other companies, which boosts their order books and improves the employment situation. Higher employment also enables personal consumption to become a stable anchor of growth.

What will the central banks do?

Improved economic data would seem to argue for adjustments to current accommodative monetary policies in the developed countries. But inflation is still very subdued throughout the world. While resurgent oil prices have given a temporary lift to inflation rates, core inflation (i.e. without energy and food) has stayed low. Even the ebullient state of the US labour market (unemployment is now down to 4.1%) has failed to boost either wages or prices. Janet Yellen (still in office as Chair of the Federal Reserve) has called the situation mysterious. Central banks on both sides of the Atlantic will therefore remain cautious and act with moderation.

Everything coming up roses?

The equity markets find the present combination of solid growth and low inflation very much to their taste. Steadily rising share prices and relatively low volatility speak for themselves. But what if wages in the USA and Germany, for example, were to accelerate? Subdued inflation expectations on the fixed income markets would then have to be rethought. The Fed would presumably be obliged to hike interest rates more rapidly, and the European Central Bank might move more quickly towards exiting from its ultra-expansionary stance. Such a scenario would dispel the financial markets' tranquillity, at least in the short term. Looked at this way, faster than expected economic growth combined with rising inflation expectations represents something of a risk.

Conclusion

The economic omens for 2018 are basically good. But it would be wrong to be complacent. A close eye should be kept on inflation. If prices accelerate more than expected, there would have to be a rethink, with bond markets needing to price in significant hikes in US interest rates. That would sound alarm bells on the financial markets after the calm progress of recent years.

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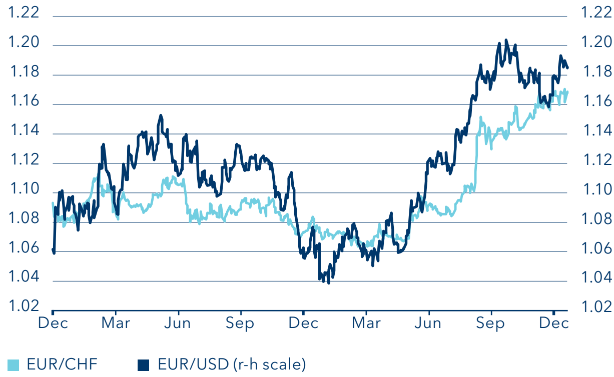
Money market and currencies

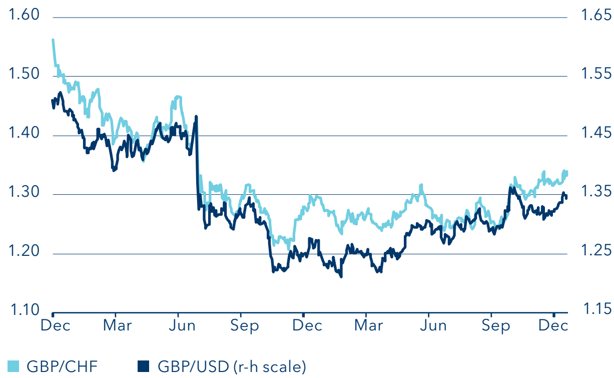
Market overview

EUR/CHF and EUR/USD: exchange rates since December 2015



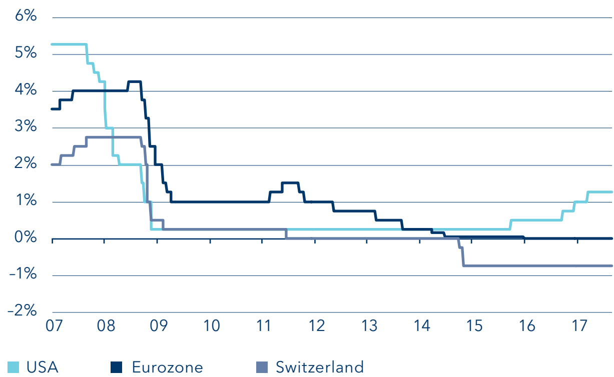
USD/CHF: exchange rate since December 2015

GBP/CHF and GBP/USD: exchange rates since December 2015

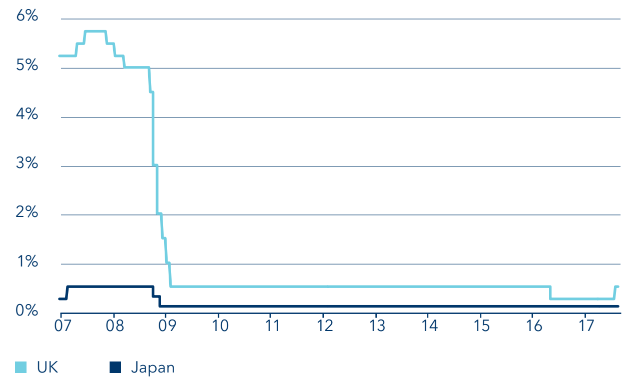


USD/JPY and USD/AUD: exchange rates since December 2015

Key interest rates in Switzerland, eurozone, USA: since January 2007



Key interest rates in UK and Japan: since January 2007



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Central banks still cautious

MAJOR CENTRAL BANKS ARE GENTLY APPLYING THE BRAKES TO THEIR EXPANSIONARY MONETARY POLICIES. THE INFLATION OUTLOOK MILITATES AGAINST A SHARP TIGHTENING. BUT WE SHOULD NOT BE LULLED INTO A FALSE SENSE OF SECURITY. SOME INDICATORS ARE SIGNALLING INCREASED INFLATION POTENTIAL.

The eurozone was last year's surprise performer in the global growth league. The consensus forecast for GDP growth across the eurozone had been muted at the start of the year, but it soon had to be revised upwards. It now looks as if growth for the year as a whole will come in at 2.2%. We expect a similar figure for the coming twelve months. In this respect we are more optimistic than the economists recently surveyed by Bloomberg, whose average eurozone growth forecast was 1.9%. We believe that self-reinforcing effects will make a difference. If firms buy more products from other firms, that pushes up employment and increases the incentive to invest in expansion. These effects reinforce each other, underpinning the economic recovery.

Higher capital spending ahead…

A similar trend is likely to be seen in the USA. Surveys suggest that many corporations are planning to expand their capacity. That means increased investment activity. Our analysis indicates that investment in plant and equipment could rise substantially. Overall, we expect the world's largest economy to post a growth rate of 2.6% in 2018. Similar forces will be at work in the Swiss economy, producing a more dynamic corporate investment climate than in 2017. Switzerland's GDP should therefore expand by 1.5%, well above of the disappointing 0.9% posted in 2017.

…but inflation remains subdued

Anyone who acts on the assumption that this optimistic growth outlook points to a significant acceleration of inflation is likely to be wrong-footed. Although the USA boasts full employment, US inflation still languishes below the Fed's target. The Fed itself is unsure why the good employment situation has generated so little upward pressure on prices. US wages have risen but not by nearly as much as the low unemployment rate would warrant. As long as wage growth fails to accelerate, inflation will remain relatively subdued. The Fed's projections envisage three interest rate hikes in 2018, but given the sluggish movement of consumer prices we expect to see only two. Even that forecast is bolder than the expectations being priced in on the money markets, which are anticipating only one hike in 2018. However, while opinions about the interest rate outlook are mixed, there is a large measure of unanimity about the downsizing of the Fed's balance sheet. The Fed will scale down its assets by increasing the non-reinvestment of maturing securities. The replacement of Fed Chair Janet Yellen with Jerome Powell will not affect this policy. Powell says he intends to continue with balance sheet reduction.

Meanwhile, the October meeting of the European Central Bank has largely set the ECB's monetary course for 2018. With core inflation running at only 0.9% at the latest reading, securities purchases will continue at a reduced volume of EUR 30 billion (until now EUR 60 billion) at least until September 2018. In these circumstances, an interest rate hike is out of the question at the moment and would not become an option until 2019 at the earliest. The situation in Switzerland is similar. A hike by the Swiss National Bank remains a distant prospect. Inflation is simply too low to justify monetary tightening. Moreover, the SNB will have to stay in line with the ECB so as not to provoke renewed upward pressure on the Swiss franc.

Caution required!

The baseline scenario outlined above makes comforting reading. Even so, one should not be too relaxed. Inflation dangers loom on the distant horizon, though they are too nebulous at present to be incorporated into our baseline scenario. The Federal Reserve Bank

of New York, for example, calculates an inflation gauge based on 346 individual indicators. The gauge now points to accelerated inflation. If that happens, incoming Fed Chair Jerome Powell would have to speed up the process of monetary tightening during his first year in office. But higher interest rates would be poison for the many US businesses that are now swimming in debt. Increased debt servicing costs would plunge highly leveraged firms into difficulties, probably resulting in a higher rate of bankruptcies. In this way central bank action could choke off the upturn.

The reason why we nevertheless hesitate to sound the alarm about resurgent inflation relates to the US housing market. The increased vacancy rate for rented properties means that the rise in the "housing" component of the consumer price index is likely to flatten out. This component includes not only actual rents but also notional rents for owner-occupied homes. Housing now makes up almost 34% of the entire index, so rents have a major influence on the headline inflation rate.

Conclusion

Our baseline scenario foresees moderately rising inflation, with central banks continuing to exercise caution. This implies two interest rate hikes by the Fed in 2018, while rate hikes in the eurozone and Switzerland are far off. In our secondary scenario, however, we attach importance to the possibility of a stronger acceleration of prices, as various indicators are already suggesting. This is no time for complacency. Investors should keep a particularly close eye on US core inflation.

Highlights

- Major central banks still find themselves confronted with disappointingly low inflation rates.
- The Fed will continue to exercise caution.
- Monetary tightening in the eurozone and Switzerland is still a distant prospect.

Key interest rates	January 2018
Switzerland	→
Europe (EMU)	→
USA	↗

Upside/downside ranges indicated by our 3-6 month interest rate forecasts:
↑ > +50 basis points ↗ +25 basis points
↘ -25 basis points ↓ < -50 basis points → No change

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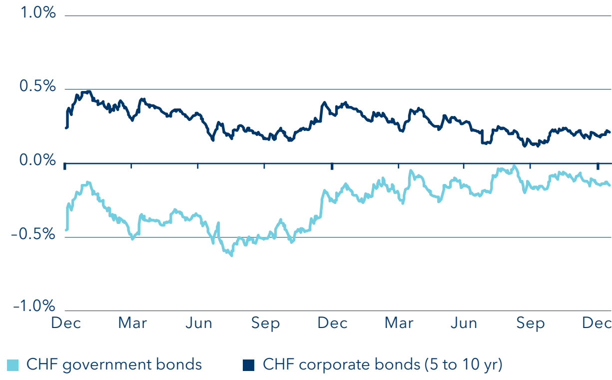
2. ASSET CLASSES

Bonds

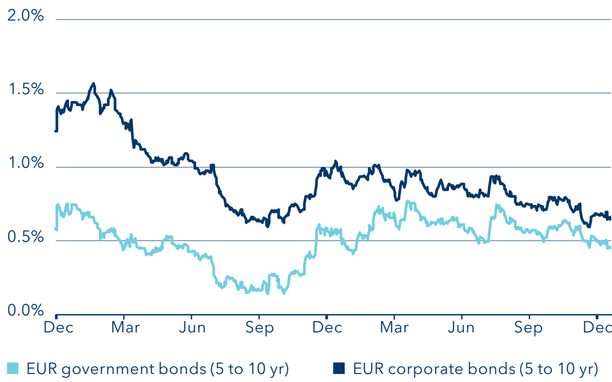
Bond yields – overview

Switzerland: yields since December 2015

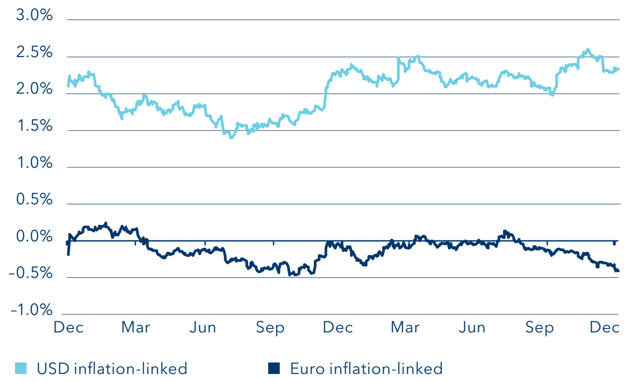


Emerging markets: yields since December 2015

Europe: yields since December 2015



Inflation-linked bonds: yields since December 2015



USA: yields since December 2015

High yield: yields since December 2015

Higher yields ahead?

ARE WE AT LAST ON THE THRESHOLD OF A SUSTAINED RISE IN BOND YIELDS? THERE IS HARDLY ANY OTHER AREA IN WHICH ANALYSTS' FORECASTS ARE SO FREQUENTLY WRONG AS IN THE GOVERNMENT BOND MARKET. BUT LET'S MAKE AN ATTEMPT.

By rights, current upbeat economic conditions should spell significant falls in government bond prices. But every year the bond markets remain amazingly robust. The real yield on 10-year Swiss government bonds (i.e. after adjustment for inflation) is in negative territory, and the same goes for German Bunds. It is hard to find an adequate explanation for this phenomenon. We have repeatedly explored the subject in the past without achieving a quantifiable solution. The fact is that yields have been falling continuously since the 1980s. Over the same period, global capital spending has also been falling as a percentage of GDP, while the global saving rate has risen. The resultant savings glut keeps demand for safe assets, i.e. government bonds, at a high level. The upshot, it is claimed, is a fall in real yields.

Economists argue, however, about whether this explanation holds water. Theoretically, saving and investment should be in balance, and any discrepancy between the two ought to be merely the result of measurement errors. It is therefore debatable whether the fall in government bond yields can really be explained in this way.

Focus on interest rate expectations

Instead of examining the trend over a number of decades, let us look at recent years. Our empirical analysis reveals an interesting connection between 10-year government bond yields and interest rate expectations on the money markets. This parallelism makes economic sense, because fixed long-term interest rates should reflect the inflation outlook and the future interest rate environment – hence the tight correlation between inflation and interest rate expectations on the one hand and long-term yields on the other. The tone on the fixed-income markets is set mainly by the Fed, which has reversed the direction of interest rates in recent years but done so only very cautiously. Given the disconcertingly low rate of inflation, the markets are sceptical about further interest rate hikes and are not even fully pricing in three hikes up to the end of 2019. In our view, it is this wary attitude that explains the low level of bond yields. We, by contrast, expect to see two Fed hikes in the coming year. If that happens, it should fuel at least a limited rise in bond yields, with the yield on 10-year US Treasuries rising from 2.39% to around 2.50%. We would then expect to see a yield of 0% on 10-year Swiss government bonds (currently 0.17%) and 0.50% on 10-year Bunds (currently 0.30%). Such levels were already seen in 2017 but were always followed by sharp falls. Our forecast implies that this time the higher levels will be sustained.

A risk scenario

Given our expectation of robust global growth, our bond yield forecast is subject to some risk on the upside. If faster US wage growth drives inflation to somewhat higher levels, that would have implications for market perceptions about the likely course of Fed interest rate hikes. Scepticism about probable Fed action would then give way to an expectation of more aggressive measures. In that event, long-term interest rates on both sides of the Atlantic would have to move to significantly higher levels. In continental Europe speculation would soon arise that the ECB might apply the monetary brakes faster than previously expected. This is still merely a risk scenario, but caution is the watchword.

Living with increased risk

Highlights

- With inflation expectations still moderate, bond yields are firmly anchored for the time being.
- There is a risk, however, that rising wages will push up US inflation.
- While equity markets foresee risks for highly leveraged companies, central bank actions have insulated the bond markets from these problems.
- We advise caution towards borrowers with low credit quality (e.g. high yield corporate bonds).

MARKET DISTORTIONS CAUSED BY CENTRAL BANK ACTIONS HAVE RESULTED IN MISALLOCATIONS OF CAPITAL. THE DETERIORATION IN THE QUALITY OF COMPANIES' BALANCE SHEETS PRESENTS RISKS.

Divergent market signals

The bond and equity markets are sending out conflicting signals. In the high-risk bond sector spreads against government bonds have hardly ever been narrower. Put another way, the market is assuming that future credit risks are low. The position of the equity markets is the exact opposite. The relative performance of low-debt companies versus the market as a whole has been positive for some years now – and this outperformance has become progressively more pronounced. Thus the equity markets are expecting trouble ahead for highly leveraged companies. Given that the bond markets are distorted by the central banks' asset purchase programmes, it must be assumed that the equity markets are judging the situation more accurately.

High yield bonds: the canary in the coal mine?

The macroeconomic situation confirms the equity markets' judgement. US unemployment has sunk to 4.1%, and the labour market could now overheat. Hourly wages are climbing at an annual rate of 2.4% and are likely to rise even more steeply if the supply of labour continues to tighten. This puts pressure on companies' margins and leaves them with less money to service their debt. To make matters worse, companies have been piling up debt in recent years. There is no denying the resultant increase in credit risk. The procession runs like this: equity markets follow bond markets, government bonds follow corporate bonds, and corporate bonds follow high yield bonds. High yield bonds are therefore the first harbinger of change.

Manipulation by central banks

Between mid-2014 and February 2016, credit spreads on high yield bonds widened by around 4.5 percentage points. This was in response to the collapse of the oil price. But under the impact of the ECB's asset purchase programme spreads have now dropped close to their all-time lows, despite the fact that the continuing high default rate would argue for a widening. In other words, the market is not adequately penalising debilitated corporate balance sheets. On the contrary, it is actually encouraging financial weakness. The ECB has announced an extension of its purchase programme until September 2018 but with a reduced volume. This suggests that an end of the distortions is in sight.

Conclusion

Future investment success in the bond and equity markets will require a stronger focus on the quality of corporate balance sheets. We are adopting a generally cautious approach to lower credit qualities in the corporate bond market.

Benchmark	January 2018	% YTD[1]
Gov. bonds Switzerland[2]	→	–0.39%
Gov. bonds Europe (EUR)[2]	→	1.30%
Gov. bonds USA[2]	↗	2.21%
Inv. grade corp. bonds Switzerland[2]	→	0.53%
Inv. grade corp. bonds Europe (EUR)[2]	→	2.29%
Inv. grade corp. bonds USA[2]	↗	5.86%
High yield bonds[3]	↘	6.25%
Emerging market bonds (hard currency)[3]	→	8.71%
Emerging market bonds (local currency)[3]	→	13.86%

[1] As of 05.12.2017
[2] Yield
[3] Total return

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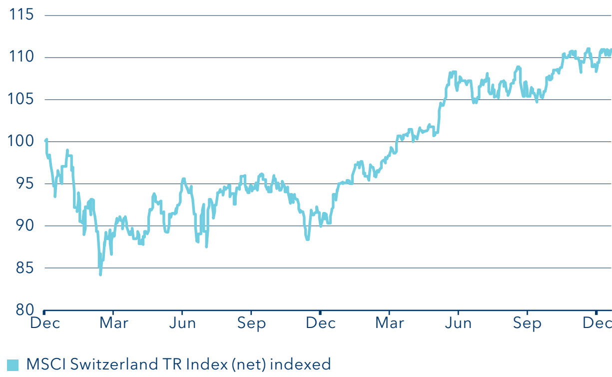
2. ASSET CLASSES

Equities

Equity indices – overview

Switzerland: market movement since December 2015 (indexed)



MSCI Switzerland TR Index (net) indexed

Pacific: market movement since December 2015 (indexed)

MSCI Pacific TR Index (net) indexed

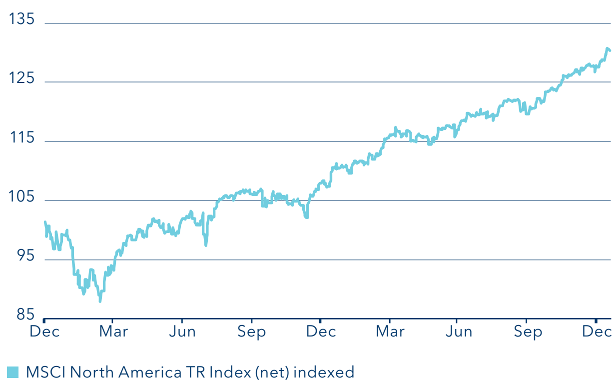
Europe: market movement since December 2015 (indexed)

MSCI Europe TR Index (net) indexed

Emerging markets: market movement since December 2015 (indexed)

MSCI Emerging Markets TR Index (net) indexed

North America: market movement since December 2015 (indexed)



MSCI North America TR Index (net) indexed

United Kingdom: market movement since December 2015 (indexed)

MSCI UK TR Index (net) indexed

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Strength through stability

2017 WAS AN EXCELLENT YEAR FOR EQUITY INVESTORS. ASIAN MARKETS AND TECHNOLOGY SHARES DID ESPECIALLY WELL. FAVOURABLE ECONOMIC CONDITIONS SHOULD CONTINUE TO DELIVER SOLID RETURNS ON EQUITY INVESTMENTS IN 2018, BUT IT WILL NOT BE PLAIN SAILING.

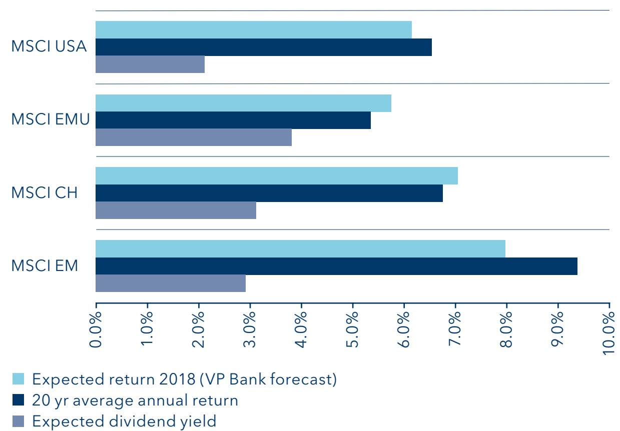
The bull run that started in 2009 has continued. A sustained uptrend of this duration strikes many investors as eerie, and warning bells were already being sounded in 2017. The US market in particular is at historically high valuation levels, and a correction can only be a matter of time. But last year showed how difficult it is to forecast the timing and extent of a market correction. As the new year gets underway, investors should keep a firm eye on the fundamentals and follow a systematic strategy.

Continuing solid returns

Global GDP growth in 2018 is expected to come in at 3.7%, with all G20 countries making a positive contribution. Worldwide economic activity has expanded and become more firmly based, generating continuing buoyant investment growth. Healthy new orders have boosted earnings expectations, and the gradual advance of domestic consumer spending in the emerging markets is having the same effect. 2018 will see a continuation of these trends, though with reduced momentum.

In our market forecasts for the new year we expect current high valuation levels to moderate. We also take account of the fact that initial earnings expectations are usually too high. In our baseline scenario we arrive at a total potential return of between 5.7% (Europe) and 7.9% (emerging markets). The figure for Switzerland is

Expected returns in 2018



7%, though this is the least confident of our predictions. Earnings expectations in Switzerland are exceptionally high, and such figures have never been achieved in the past. Dividends make up at least 3% of the expected return in the Swiss market. The capital gains component would therefore be much smaller than last year. At the same time the volatility risk is higher.

Risk perceptions

Underlying sentiment on the equity markets is positive but not euphoric. A degree of frustration exists regarding the already high level of valuations. This is focussing attention on possible negative scenarios, which are increasingly probable but whose consequences are still opaque. The dangers include more acute geopolitical risks and the reaction of the central banks to the strong performance of the global economy. The Fed is already aiming to normalise its monetary policy, but central banks in Japan and Europe continue to expand their balance sheets. In an environment of strong economic growth one needs to ask why this is so and how long it will last.

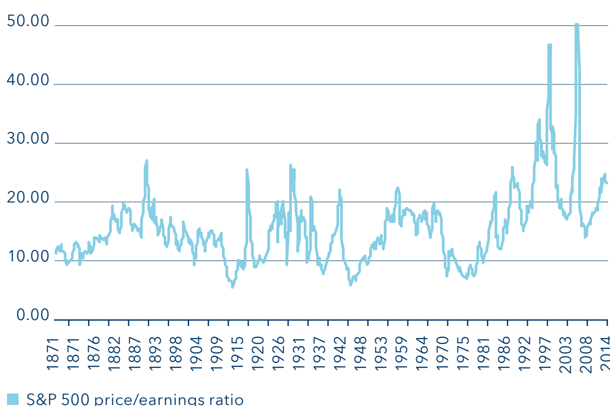
The markets know that today's highly experimental monetary policies not only keep interest rates artificially low but also drive share prices upwards. Low interest rates force investors and companies to adopt increasingly aggressive investment behaviour. The logical conclusion is that a revision of central bank policy could change the game decisively. Heightened volatility therefore needs to be factored into equity strategies.

Overall, however, we believe that the equity markets are well supported by robust and synchronous global economic growth. Positive returns should therefore be achievable in all regions.

Productivity is still the driving force

As the world moves towards increased automation and digitalisation, the economic landscape is characterised by wide-ranging infrastructure programmes at a national and supranational level. This puts the economic upswing on a broader basis and should have especially beneficial effects in countries that have so far made only slow progress in this respect. In Europe that applies especially to some countries on the southern periphery. We see the best conditions for high earnings growth and strong profit margins in Spain. Among the emerging markets we expect further economic stabilisation in East Europe and Latin America. In the industrialised world we see good prospects in Germany, Japan, South Korea and also the USA. These core countries are prime movers and accelerators of industrial trends. Countries that have structurally unbalanced economies or are in the throes of economic upheaval face major challenges. In the eurozone that applies to Portugal and Greece, but the UK and Australia are also battling with serious structural issues. China's economic growth should continue at a moderate pace, with slower expansion being offset by qualitative improvements and healthier margins.

S&P 500 long-term P/E



Highlights

- Synchronous global economic growth is still supporting the equity markets. Investors should focus on balance sheet quality and sustainability, with the emphasis on the following themes:
  - Environmental protection through energy efficiency
  - Automation through increased use of robotics
  - Infrastructure: an investment in the future
  - Change in China
- We see tactical opportunities in the US banking sector and the automobile industry.

Conclusion

Over the year ahead investors should not let market corrections deflect them from their basic investment strategy. Corrections are overdue for technology shares and Asian consumer shares especially. Earnings expectations are likely to be revised downwards in all regions. The revisions could start as soon as companies publish their earnings for the first quarter.

We would exploit any major setbacks as an opportunity to build up a position in long-term investment themes. Investment success in 2018 will be determined by a focus on balance sheet quality, solid business models and stable dividend payments.

MSCI benchmark	January 2018	% YTD[1]
Switzerland	→	16.86%
Europe	↗	23.13%
North America	→	19.12%
Pacific (incl. Japan)	→	21.87%
Emerging markets	↗	32.67%

Upside/downside ranges indicated by our 3-6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

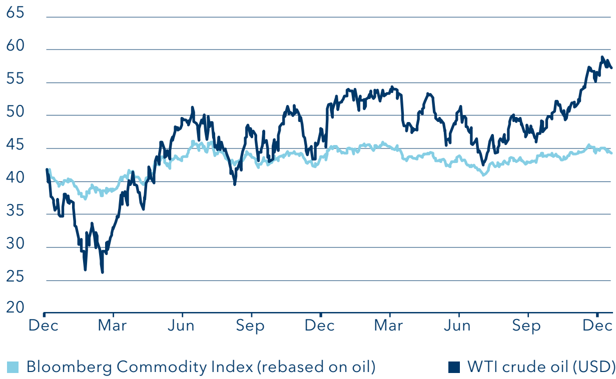
[1] As of 05.12.2017; net return in local currency incl. dividends

2. ASSET CLASSES

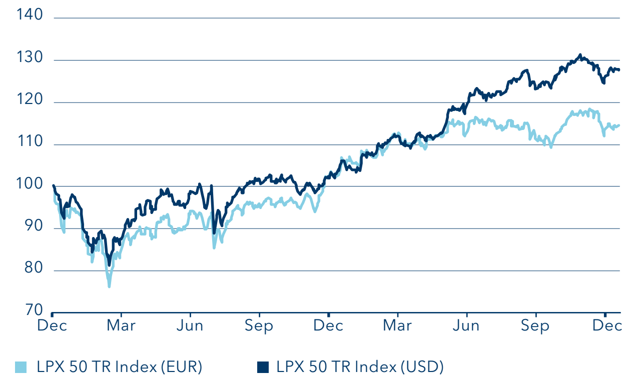
Alternative investments

Alternative investments – overview

Commodities: performance since December 2015

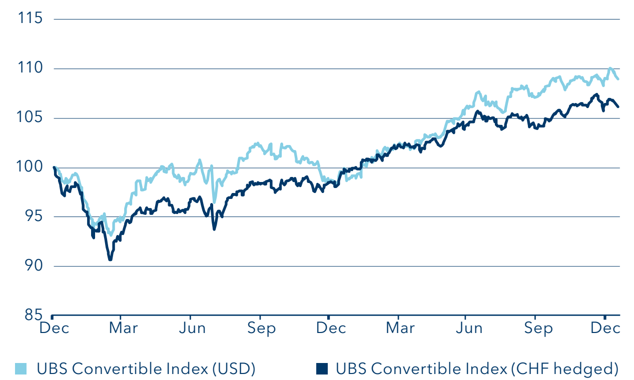


Private equity: performance since December 2015 (indexed)

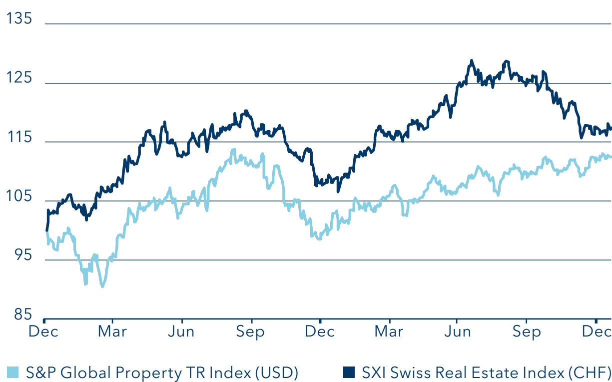


Precious metals: performance since December 2015

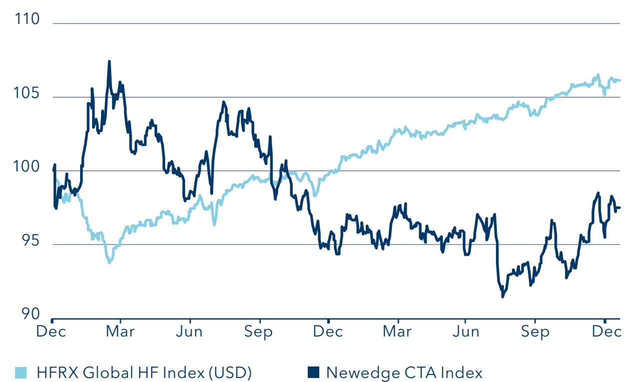
Convertible bonds: performance since December 2015 (indexed)



Real estate: performance since December 2015 (indexed)



Hedge funds: performance since December 2015 (indexed)



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Resurgent volatility in 2018?

2017 WAS A RECORD-BREAKING YEAR ON THE FINANCIAL MARKETS. EQUITY PRICES ROSE TO NEW HIGHS, VALUATION LEVELS CLIMBED AND VOLATILITY WAS UNPRECEDENTEDLY LOW. IT REMAINS TO BE SEEN WHETHER THIS TRANQUILLITY WILL CONTINUE AS THE CENTRAL BANKS CHANGE COURSE.

Consequences for investors

For investors who expect a market correction, the time has now come to consider what to do at this advanced stage of the financial market cycle. There are basically four options:
a) Sell
b) Hedge
c) Look for alternative sources of return (diversification)
d) Carry the risk and take no action.

This list makes it clear that the choice will depend on the investor's appetite for risk.

a) Sell or d) do nothing

Basically investors should stick to the long-term strategy that they have formulated in accordance with their individual attitude to risk. Barring a change of strategy, selling is therefore not a real option. If sales are mistimed and the markets continue to climb, the sold assets will have to be bought back at a higher price – perhaps just before the correction finally materialises. Investors who stay out of the market too long run the risk of not achieving their investment goal. Doing nothing while diverging from the long-term strategy cannot be regarded as a strategy at all. Investment success would then be left to chance.

b) Hedge

Like any sort of insurance, hedging involves costs. An important factor in the calculation of hedging costs is implied volatility (i.e. the expected degree of fluctuation in the market price), which is currently at a favourable level. For example, hedging the DAX by buying options would currently cost 3% up to March 2018. The interest rate risk on bond investments can be hedged on the futures market, but here the minimum contract size is generally CHF 100,000.

c) Look for alternative sources of return (diversification)

The primary aim of this strategy is to limit risk and thereby shorten the time it will take for the portfolio to recover after a loss. The supreme example of a portfolio diversifier is gold. In the past, the inclusion of gold in investment portfolios has proved to be an effective strategy, especially in periods of stress and in the event of an inflation shock. If a gold exposure reduces the loss on an equity portfolio from 50% to 25%, a complete recovery of the portfolio's value requires a market rise of 33% instead of 100%. That means a substantial reduction of the time it takes for the loss to be fully recouped.

A disadvantage of gold is that it yields no current income. Hence the growing popularity of other solutions. Beside hedge funds, there are also imaginative solutions for hedging equities, bonds and even alternative investments themselves. For example, instead of investing passively in commodities, there are instruments that enable the investor to skim off the roll yield on commodity futures. In this way a positive return can be achieved regardless of the price movement of the underlying asset. A relatively recent innovation are "absolute return bond funds" for private investors. These vehicles enjoy greater investment freedom than conventional bond funds. For example, they can operate with a negative duration, which means that in the event of a yield backup they not only avoid a capital loss but actually make a profit.

Conclusion

After the market rises of recent years, equities and bonds are no longer cheap and are therefore vulnerable to correction. The central banks are in uncharted territory, which magnifies the risks attendant on a change of monetary course. In our view this is therefore a good time for investors to reappraise their portfolios and consider replacing some of their conventional investments with alternatives. Your client advisor will be happy to help you find a suitable product.

Commodities outlook for 2018

2017 WAS A YEAR OF SPECTACULAR RETURNS ON THE EQUITY MARKETS. ON THE COMMODITY MARKETS, BY CONTRAST, EUPHORIA WAS DISTINCTLY LACKING.

Highlights

- The change of course by major central banks could provoke increased volatility in 2018.
- Absolute return products are a possible alternative to selling or hedging.
- There are hardly any identifiable upside price drivers for the commodity markets in 2018.
- Gold now seems the most attractive commodity in terms of its risk/reward profile.

Looking back and ahead

The performance of the commodity markets in 2017 was anything but convincing. With the exception of industrial metals, most commodities did little in the second half-year except try to recoup the losses of the first half. Investors were also hit by roll losses amounting to around 5% for the year as a whole. Positive price drivers for 2018 are hard to discern at present.

Gold needs more uncertainty

Gold provides investors with a traditional refuge in times of crisis or galloping inflation. Inflation rates are now gradually returning to "normal", but they are still too low to boost the gold price. Crises are notoriously hard to predict, but there is no sign of one on the horizon at present, at least for 2018.

Even in the absence of a crisis, however, it is obvious that current extremely low levels of volatility are an exceptional phenomenon and cannot be sustained. Like any form of insurance, gold should be bought before the loss occurs. The yellow metal is therefore attractive at present in terms of the risk/reward situation.

E-mobility and platinum-group metals

Not every precious metal is suitable as an insurance against crisis. Platinum and palladium, for example, are widely used in the traditional automobile industry. But the future of the automobile industry lies in electronic transport, and that requires other metals, notably copper and cobalt. Platinum and palladium will have to cede their place to these other metals, at least in the automobile sector. Moreover, run-of-the-mill platinum prices discourage buying by prestige-conscious jewellery consumers in China.

Between OPEC and shale

Crude oil's best years likewise seem to be over. "Black gold", as it used to be called, will of course be with us for a long time to come, but its importance will further decline.

Saudi Arabia is doing its utmost to keep the oil price high. Its production cuts are intended to restore equilibrium in a market flooded with shale oil. Other OPEC members have followed the Saudi lead unenthusiastically or not at all, leaving the Saudis to shoulder most of the burden. It is only a matter of time before individual OPEC countries or Russia find high crude oil prices impossible to resist and increase their output in contravention of the agreements made. Meanwhile, the new competitors in the USA will not miss this opportunity to push output to its maximum.

Benchmark	January 2018	% YTD[1]
Commodities	→	-1.52%
Gold	→	0.46%
Crude oil	↗	10.71%
Commercial real estate	→	8.69%
Private equity	→	10.50%
Convertible bonds	→	9.77%
Hedge funds	↗	5.15%

Upside/downside ranges indicated by our 3-6 month absolute performance assessments:
↑ > +5% ↗ +2% to +5% → -2% to +2% ↘ -5% to -2% ↓ < -5%

[1] As of 05.12.2017

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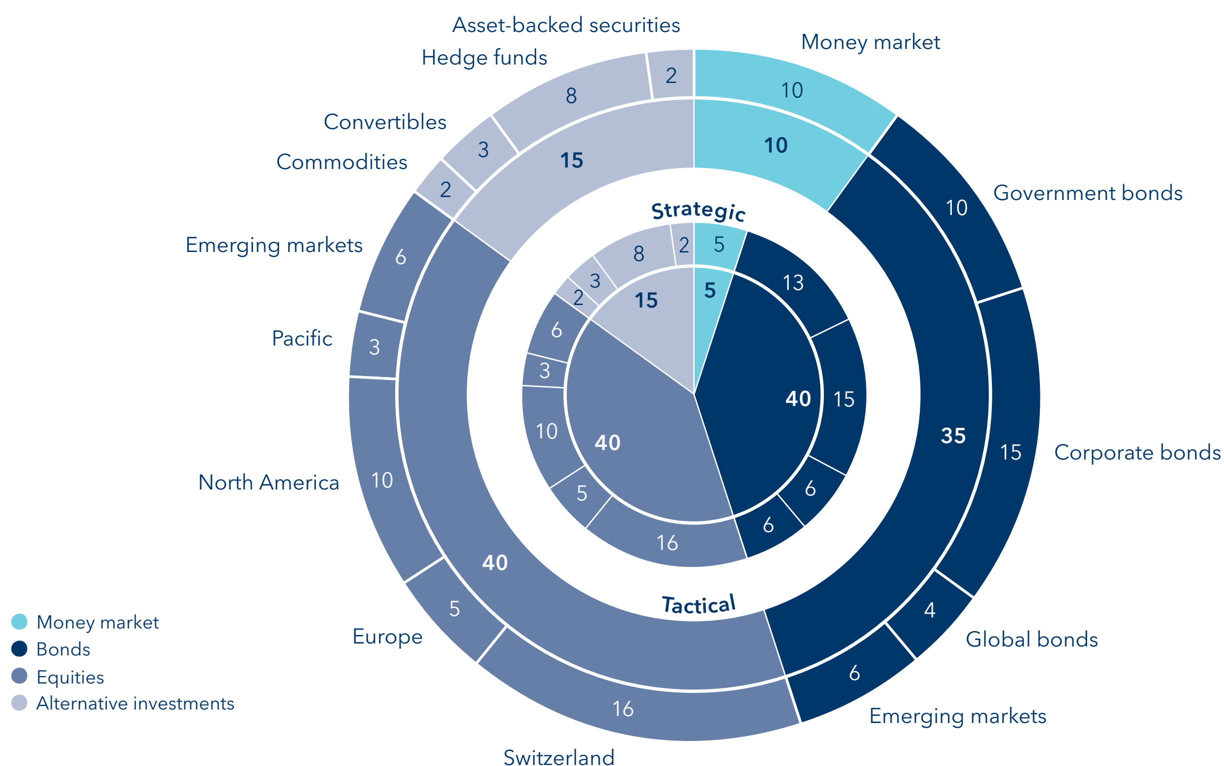
3. INVESTMENT MANAGEMENT

Investment management portfolios

Strategic and tactical allocation – balanced portfolio based in CHF (% weightings)



VP Bank Strategy Funds

Product name	Curr.	ISIN	NAV date	NAV	Payout	Currency hedged	YTD perf. %
VP Bank Strategy Fund Conservative (CHF)	CHF	LI0017957502	01.12.17	1,081.00	no	yes	4.09%
VP Bank Strategy Fund Conservative (EUR)	EUR	LI0017957528	01.12.17	1,433.74	no	yes	2.97%
VP Bank Strategy Fund Conservative (USD)	USD	LI0100145379	01.12.17	1,382.91	no	yes	5.43%
VP Bank Strategy Fund Balanced (CHF)	CHF	LI0014803709	01.12.17	1,617.60	no	yes	6.70%
VP Bank Strategy Fund Balanced (EUR)	EUR	LI0014803972	01.12.17	1,007.31	no	yes	4.67%
VP Bank Strategy Fund Balanced (USD)	USD	LI0014804020	01.12.17	1,569.55	no	yes	8.36%

For detailed information on our investment management mandates, please contact your personal advisor.

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Current investment tactics

Current investment tactics

The present economic outlook could hardly be better. Trends in the eurozone are particularly good. In contrast to previous years, the recovery is now embracing the whole of Europe. Many previously beleaguered countries have returned to growth in recent quarters and are now expanding strongly. The US economy, too, is performing well. America's labour market continues to recover. New job creation in October was better than expected, and the unemployment rate is now only 4.1%. Rising new orders and upbeat business sentiment justify hopes that the world's largest economy will continue to enjoy a following wind in the months and quarters ahead. Tax reform should provide further momentum and give a boost to investment and consumer spending.

Yields in the US bond market generally fell during 2017 in reaction to Donald Trump's failure to achieve his promised reforms. Thus the successful tax overhaul should now provide new impetus. Higher growth expectations imply increased inflation expectations. The Fed will therefore stick to its policy of gradual rate hikes, and that argues for slightly higher US bond yields.

Despite the positive macro environment we are keeping our equity allocation neutral. In our view, the economic positives are already largely priced into the market. The overall situation remains supportive for equities, but further gains will be limited by the gentle rise in yields on the bond markets.

Bonds

Recent yield trends have been mixed: falling yields in the USA, rising yields in Europe. We are keeping duration below benchmark in all reference currencies. We expect recent upbeat macro data to result in a mild increase in bond yields. We are therefore still underweight in investment grade bonds. Emerging market bonds are neutrally weighted. We retain a position in inflation-linked bonds.

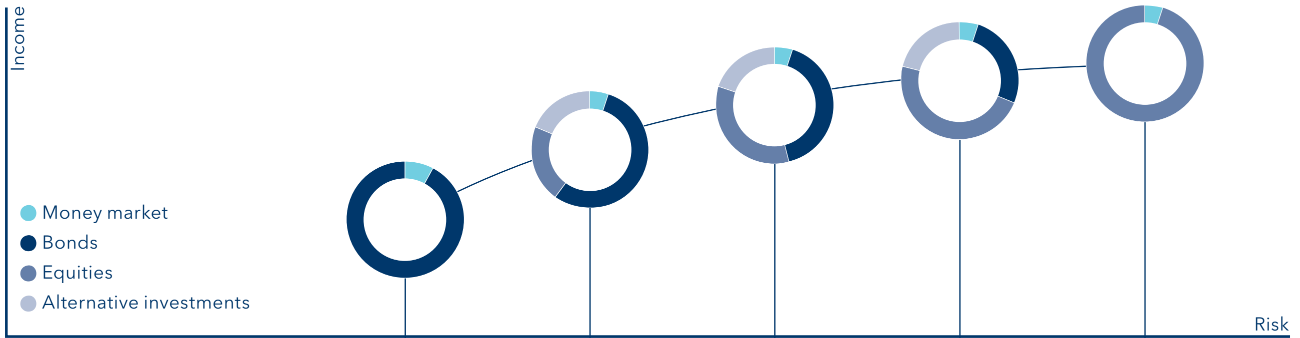
Equities

The upturn in economic activity has generated a substantial rise in earnings expectations, as reflected in company surveys and analysts' estimates. But historically high valuation levels, notably in the USA, and a slight retreat in European earnings forecasts have prompted us to adopt a more defensive position.

Alternative investments and currencies

We hold positions in alternative investments, notably commodities, convertible bonds and hedge funds, as a useful portfolio component providing risk diversification. These categories are weighted at neutral. We have an open USD position in our EUR-based portfolios. Otherwise currencies of the major developed countries remain hedged.

Our solutions



Features	Fixed-income	Conservative	Balanced	Growth	Equity
Equity allocation	0%	10–30%	20–50%	30–70%	80–100%
Investment horizon	3 years	5 years	7 years	10 years	15 years
Need for security	●●●●●	●●●●○	●●●○○	●●○○○	●○○○○
Expected return	●○○○○	●●○○○	●●●○○	●●●●○	●●●●●

Investment solutions	Fixed-income	Conservative	Balanced	Growth	Equity
Strategy Fund from 1 unit		●	●		
Fund Mandate from CHF 250,000	●	●	●	●	●
Classic Mandate from CHF 1 million	●	●	●	●	●
Special and Sustainability Mandate from CHF 2 million	●	●	●	●	●
Enhanced Mandate from CHF 5 million		●	●	●	

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4. APPENDIX

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