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Compass

3rd Quarter 2018

The global economy is slightly cooling off

Arising trade war

The 10 equity sectors (part 4 of 4)

Effects of a trade war

At the beginning of the year, global stock market prices fluctuated more than in the recent past. Volatility has returned. There are many explanations for this. One of the reasons for higher volatility is deteriorating economic data. Economic growth in Europe is slowing noticeably. Various leading indicators signal a slowdown in the economy, especially in Germany. In the US, on the other hand, the probability of a recession over the next 12 months is only 11%. The intensifying trade conflict between the USA and China, but also other nations, carries a considerable risk for the global economy. Overall, there is a threat of welfare losses. The origin of this conflict is the high trade deficit of the USA. This deficit has been rising almost continuously for years as compared to China. However, the US has a strategic advantage. Penal duties imposed by low-wage countries on imported intermediates make finished products intended for export less competitive. In the third part of this compass edition „Knowledge and Experience“ we conclude our series to introduce the 10 equity sectors. In it we present the telecommunications and utilities sectors. Finally, we introduce the new sector of communication services, which includes not only telecommunications companies but also media and internet companies such as Alphabet, Facebook and Netflix.

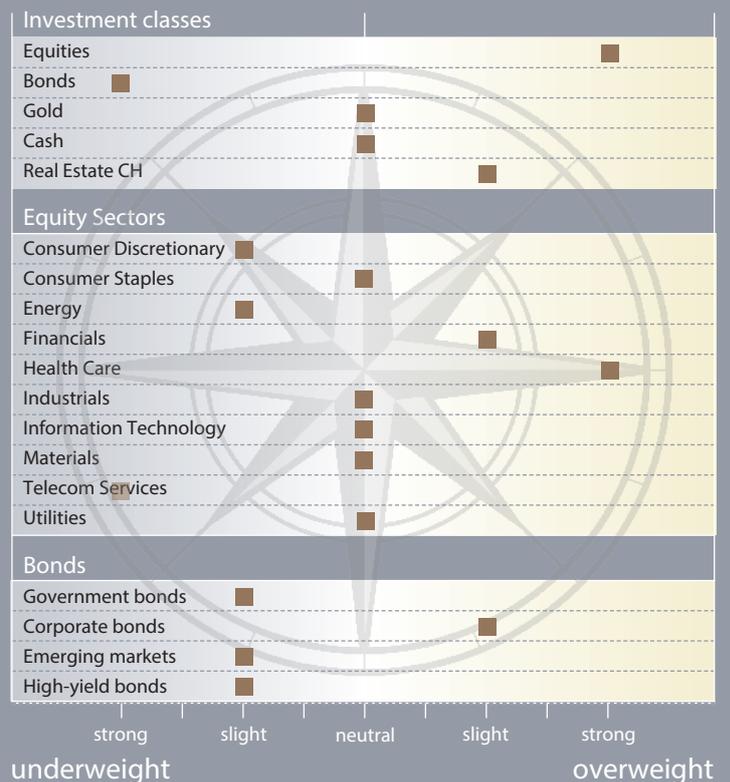
Defensive overweighting of stocks

Despite the higher expected price fluctuations (see Basic Trend 1) and a slightly cooling economy (see Basic Trend 2), a recession in the coming months seems unlikely. For this reason, we are sticking to the overweighting of equities for the time being, but are positioning ourselves somewhat more defensively within equities. In view of the still prevailing low interest rate environment, in addition to equities we slightly overweight Swiss real estate at the expense of bonds.

Within equities, we are rotating the sector allocation towards a somewhat more defensive orientation. Due to the significant price increases, we are taking profits in the cyclical sectors of industrials and information technology. In return, we are increasing the weight of defensive and currently low-valued consumer staples. We are also increasing the weighting of financial securities, as we expect higher interest rates in the long term.

In the area of bonds, we prefer corporate bonds to government bonds. We leave a slight underweighting in emerging market bonds and high-yield bonds.

Asset allocation recommendation as of June 25th, 2018 for investors with CHF as their reference currency.

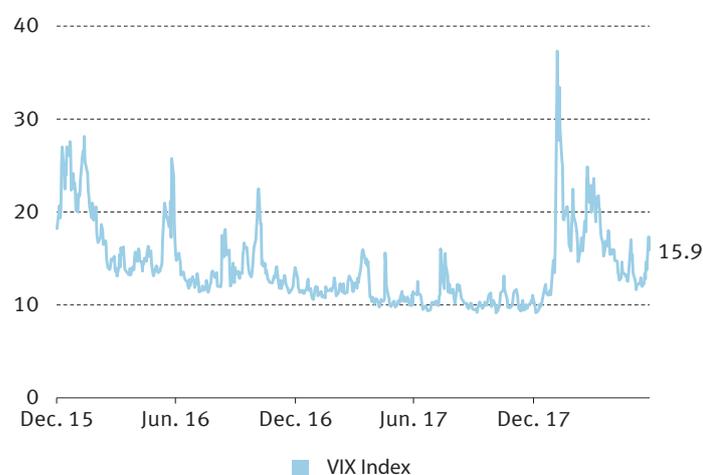


Basic Trend: The global economy is slightly cooling off

Basic Trend 1:

Implicit volatility of S&P 500 Index stock options

Source: Bloomberg



The return of volatility

Over the past nine years, prices on the global stock markets have risen steadily. In view of decreasing price fluctuations (volatility in technical terms), many investors felt safe. In the past year in particular, when global equities made particularly strong gains, volatility remained close to its historic lows. Stock market volatility returned at the beginning of this year. The US stock index S&P 500 temporarily lost more than 10%. At the same time, the volatility index VIX started to rise. Although the markets have recently calmed down again, many investors are deeply shocked. There are many indications for further moderate growth and rising share prices in the coming weeks and months, albeit with higher volatility.

Basic Trend 2:

Index value

Source: ZEW



Slowing economic growth

The recent past has been marked by exceptionally strong economic growth. Since the beginning of the year, various leading indicators have signalled that this will not last. Economic growth in Europe in particular is likely to slow down. The uncertain future of transatlantic relations, political uncertainty in Italy and, above all, increased inflation expectations have recently led to a deterioration in the outlook. The indicator for economic growth over the next six months, calculated by the Centre for European Economic Research (ZEW), has clearly returned. In addition, the emerging trade war between the USA and China (see Current Topic) and the rising price of crude oil are weighing on global economic growth.

Basic Trend 3:

Probability of a recession in %

Source: Federal Reserve Bank of New York



Will stock prices fall soon?

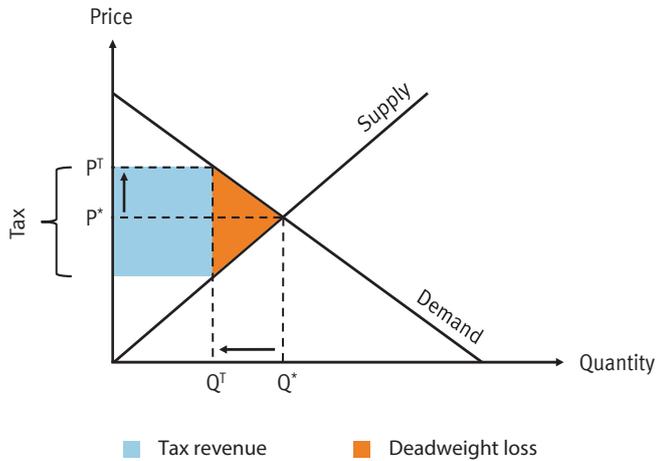
Every month, the Federal Reserve Bank of New York calculates the probability of an economic recession in the US over the next 12 months. The calculation is based on the slope of the yield curve, which has proven to be a reliable indicator of recessions in the past (see Compass March 2018 edition). Currently, the probability of a recession in the USA is only 11%. Although the probability has recently increased, it is still low by historical standards. In the past, stock prices on financial markets have usually already fallen six to nine months before a recession. Since the probability calculation is based on one year in the future, an acute financial crisis on the stock market seems unlikely.

Current Topic: Arising trade war

Current Topic 1:

Source: own presentation

Effects of a tax



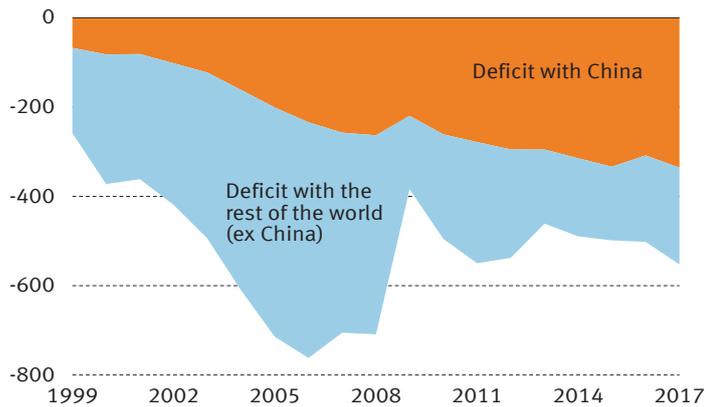
As prices rise, the supply of a product increases, while the quantity in demand decreases. The intersection of the supply and demand curve defines the optimum price (P^*) and the optimum quantity (Q^*). In this point, the full potential of the market is used and the so-called economic welfare is maximized. With the introduction of a tax, the product becomes more expensive. Due to the higher price (P^T), demand for products decreases and the resulting quantity (Q^T) is smaller than its optimum. The loss due to the introduction of a tax is referred to as welfare loss. This welfare loss contrasts with tax revenues and means that a tax leads to a suboptimal solution from the point of view of the economy as a whole.

Current Topic 2:

Source: Bloomberg

Trade deficit of the USA

US trade deficit in billion USD



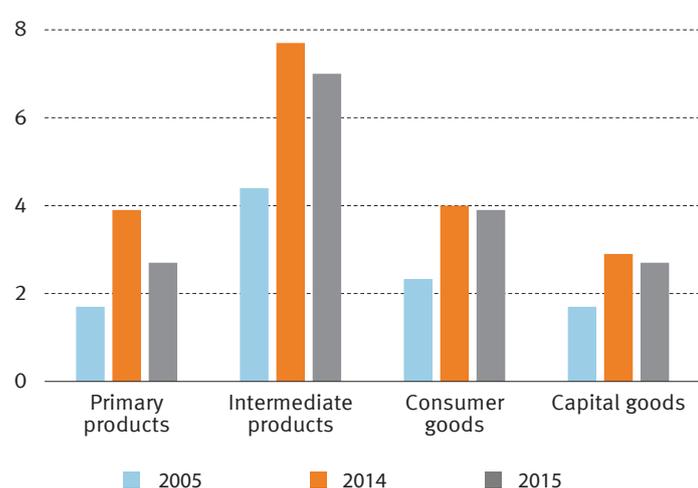
Donald Trump's statement that trade wars are good and easy to win is based on the steadily increasing trade deficit in the USA. The lion's share of this is accounted for by trade with China. Imports from China have always exceeded exports to China. This imbalance is the focus of current tensions between the US and China. US President Trump wants to reduce his country's trade deficit and has threatened China with various sanctions. The conflict intensified after the US imposed punitive tariffs on steel and aluminium from China and threatened further tariffs on goods worth several hundred billion USD. China, for its part, imposed tariffs and announced further retaliatory measures.

Current Topic 3:

Source: World Bank

The USA at an advantage

In billion USD



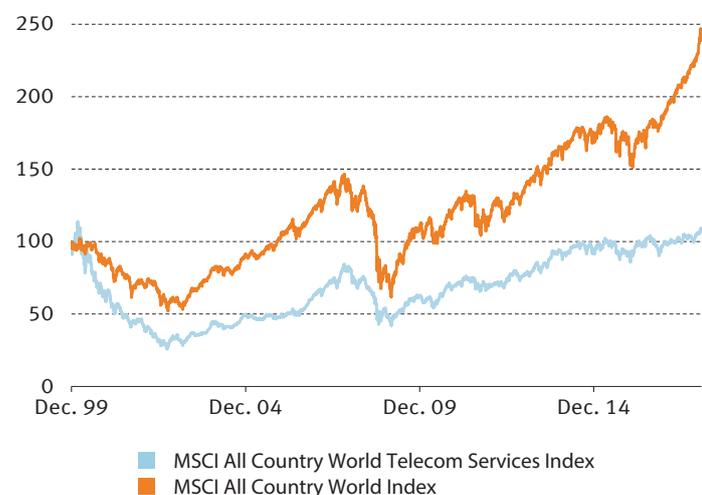
However, China's ability to respond to US punitive tariffs is limited. Intermediates are the most important component in international trade. Typically, these intermediates are imported from low-wage countries such as Mexico or China, assembled and re-exported as finished products. Penal duties on intermediate products would thus make exports of low-wage countries more expensive and thus less competitive. The tariffs threatened by China have so far been limited to basic goods such as food. However, broadly diversified punitive tariffs seem unlikely to us, as the welfare losses are also too high for the USA. However, the mere threat of tariffs should enable the US to force its trading partners to make concessions, such as importing more.

Knowledge & Experience: The 10 equity sectors (part 4 of 4)

Knowledge & Experience 1:

Source: Bloomberg

Indexed performance in USD



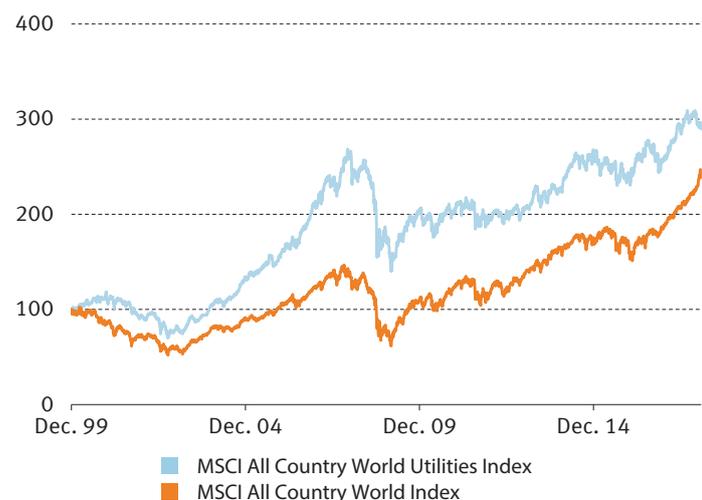
Telecom Services

Telecom services companies offer attractive dividend yields. Currently, these distributions are covered by sufficient free cash flow. However, there are doubts whether this will continue to be the case in the future, taking into account rising financing costs and investments in the expansion of 5G networks. Other factors are also weighing on this sector. In some countries, such as Italy, the competitive situation has intensified due to the entry of new suppliers. In addition, the telecom services industry is highly regulated. The internet giants that are pushing into the market with services such as WhatsApp are also causing problems. We therefore recommend underweighting telecom services stocks in a global equity portfolio.

Knowledge & Experience 2:

Source: Bloomberg

Indexed performance in USD



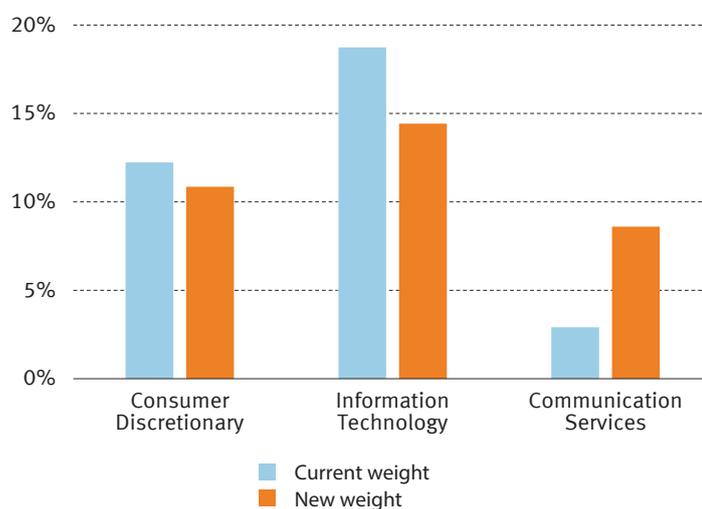
Utilities

Utilities' infrastructures form the backbone of our energy supply (electricity, gas, heat). Because electricity and gas pipelines are natural monopolies, companies in the utility sector are usually characterised by stable returns and high dividend payments. Sustainable energy supply has become an increasingly important issue in recent years. Accordingly, renewable energies have developed into an important growth area for utilities. The global trend towards electromobility and the recovering electricity prices in Europe also offer the utilities sector various growth opportunities and prospects of good returns in the coming years.

Knowledge & Experience 3:

Sources: Bloomberg, MSCI, own calculations

Weight within the MSCI World index



The new „Communication Services“ sector

In recent years, the way people communicate and access entertainment and other information has developed rapidly. This development is the result of the integration of telecommunications, media and internet companies. To account for this development, the telecom services sector will be expanded and renamed at the end of September. The new „communication services“ sector comprises the existing telecom services companies and, in addition, media and internet companies from the non-basic consumer goods sector as well as selected companies that are currently assigned to the information technology sector. Examples of affected companies are Alphabet, Facebook and Netflix.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

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