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BANQUIERS
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Compass

1st Quarter 2019

The late phase of the economic cycle

Stagnating economic growth in Italy

Swiss real estate:
An asset class for your portfolio

Your wealth, our responsibility.

Cooling economy and growing concerns about Italy

In recent weeks, various leading indicators have signalled a weakening of global economic momentum. We are currently in the late phase of the economic cycle. The US Federal Reserve began raising key rates some time ago and the yield curve is almost flat. In the past, their inversion was a reliable indicator of an imminent recession. Recently, the mood among purchasing managers also deteriorated, especially in Italy. However, Italy has been worrying for quite some time. The country's economic performance is still below the level before the financial crisis. And even a longer-term comparison shows that Italy has not grown since the introduction of the euro. We see the reasons for this in a lack of investment to modernize the country, an unfriendly business environment, but also in an education system in need of improvement and inefficiencies in public administration. In the third part of this compass edition „Knowledge & Experience“, we present the Swiss real estate market. We show which investment vehicles are suitable for a private investor and how this segment's offering has developed in an environment of low interest rates. Finally, we discuss whether the rise in the number of vacant rental apartments is an indication of a real estate bubble and what triggered the last real estate crisis in Switzerland.

More defensive allocation of equity sectors

For some weeks now, the macroeconomic environment has been clouding over (see Basic Trend 1). However, many of the negative leading indicators are coming from high levels and are still signaling moderate growth. For this reason, we are maintaining our overweighting of equities for the time being. In view of the persistently low interest rate environment, we are also overweighting Swiss real estate at the expense of bonds.

Within equities, we are taking a more defensive stance. We are reducing the weighting of the information technology, finance and consumer discretionary sectors. In return, we increase the allocation of utilities and the new sector of communication services due to the good momentum.

In the area of bonds, we continue to prefer corporate bonds to government bonds. For emerging market bonds and high-yield bonds, we leave a slight underweight.

Asset allocation recommendation as of December 18th, 2018 for investors with CHF as their reference currency.

	underweight: strong	underweight: slight	neutral	overweight: slight	overweight: strong
Investment classes					
Equities					■
Bonds	■				
Gold			■		
Cash			■		
Real Estate CH				■	
Equity Sectors					
Consumer Discretionary	■				
Consumer Staples					■
Energy			■		
Financials			■		
Health Care					■
Industrials	■				
Information Technology	■				
Materials			■		
Communication Services				■	
Utilities				■	
Bonds					
Government bonds		■			
Corporate bonds				■	
Emerging markets		■			
High-yield bonds		■			

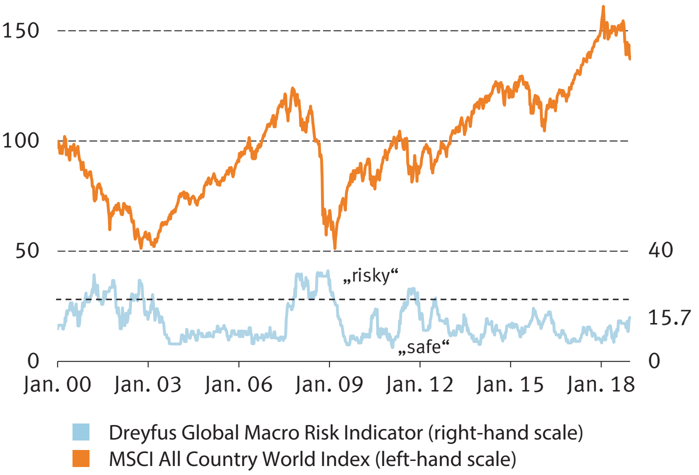
Basic Trend:
The late phase of the economic cycle

Basic Trend 1:

Indexed performance in USD

Source: Own calculations

Indicator value

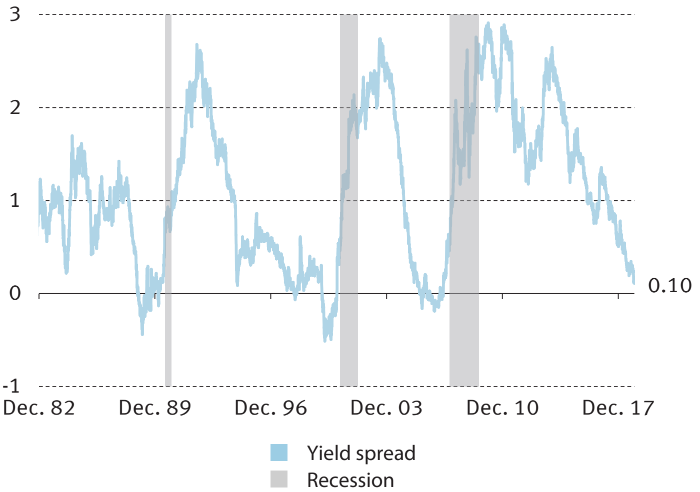


Increasing risks for equity investments

Dreyfus Banquiers has developed a risk indicator - the Global Macro Risk Indicator (GMRI) - in order to be able to identify long-lasting correction phases in the equity market at an early stage. The GMRI is based on 27 different leading indicators that forecast the development of the global economy, individual continents, regions and countries. Systematic decision rules assess each leading indicator and indicate whether it signals a positive or less promising environment for equities. The range of the GMRI is defined as the interval 5 to 35, with values above 20 forecasting a crisis. At the beginning of 2018, our indicator stood at 7.8. It is currently at 15.7 and thus signals a passable environment for equities, with increased risks.

Basic Trend 2:

Yield spread between 10- and 2-year US government bonds in % p. a.



The yield curve as an indicator of recession

The Dreyfus GMRI takes into account, among other things, the development of global financial market conditions. Since the USA are pioneers in the global economy, we consider the difference in yields between 10- and 2-year US government bonds. If the yield spread decreases, the yield curve becomes flatter. In the past, a flat yield curve (yield spread = 0) was followed by a recession. For some years now, yields on 10- and 2-year US government bonds have been converging again. In particular, rising key interest rates are accelerating this development. Currently, the yield spread is only 10 basis points. If the yield curve inverts, a recession would have to be expected in one to two years. The stock markets usually anticipate this development.

Basic Trend 3:

Sources: Markit, J. P. Morgan

Purchasing Managers' Indices

	Jun. 18	Jul. 18	Aug. 18	Sep. 18	Oct. 18	Nov. 18
World	53.0	52.8	52.6	52.2	52.0	52.0
Developed Markets	54.4	54.0	53.8	53.6	53.2	52.8
Emerging Markets	51.2	51.0	50.8	50.3	50.5	50.8
USA	55.4	55.3	54.7	55.6	55.7	55.4
Eurozone	54.9	55.1	54.6	53.2	52.0	51.8
Switzerland	61.6	61.9	64.8	59.7	57.4	57.7
Germany	55.9	56.9	55.9	53.7	52.2	51.8
France	52.5	53.3	53.5	52.5	51.2	50.8
Spain	53.4	52.9	53.0	51.4	51.8	52.6
Italy	53.3	51.5	50.1	50.0	49.2	48.6
China	51.5	51.2	51.3	50.8	50.2	50.0

Purchasing managers become more pessimistic

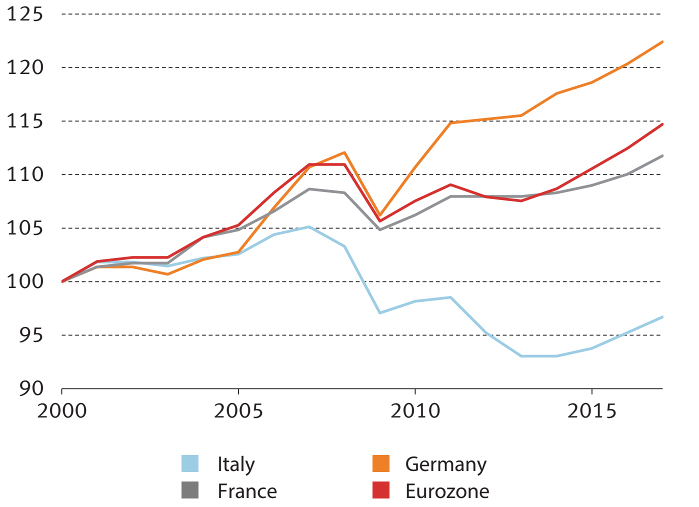
At regular intervals, usually monthly, purchasing managers in the manufacturing industry are asked about core figures. These core figures include the development of purchase prices, new orders and backlogs. From all these variables the „Purchasing Managers' Indices“ are calculated. They are regarded as leading indicators of economic development. If the index is above 50, this signals growth compared with the previous period. In addition to the level, the trend in the purchasing managers' indices is of particular importance. In recent times, some of them have fallen sharply. Particularly in Europe, the mood among purchasing managers is noticeably clouding over. Germany and France have seen particularly sharp declines. In Italy, the indicator even fell below the critical threshold of 50.

Current Topic: Stagnating economic growth in Italy

Current Topic 1:

Source: Eurostat

Indexed real gross domestic product per capita



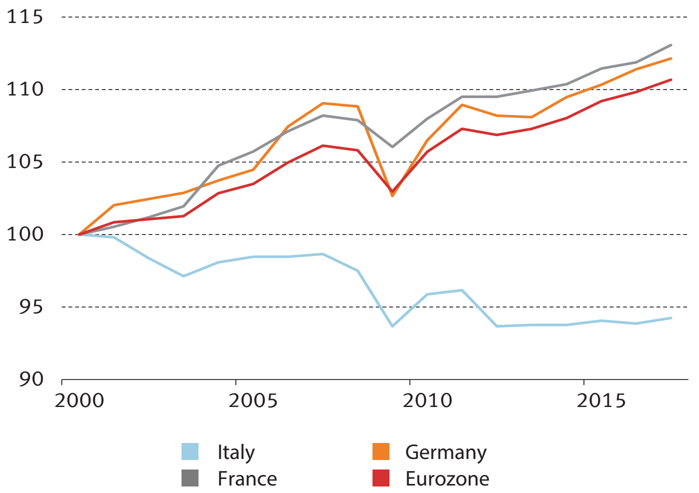
The depth of the Italian problem

The new Italian government is confronted with a sickly Italian economy. Growth has come to a standstill and economic output is still 5% below the level before the 2008 financial crisis. Together with Greece, Italy is the only country that has not recovered in the past 10 years. But the problems go even deeper: the gross domestic product per capita, adjusted for inflation, is even lower today than in 2000. There are various reasons why the Italian economy has developed only slowly. In addition to a lack of industrial modernization and an unfriendly business environment, the education system, which needs to be improved, is also making a significant contribution to this development.

Current Topic 2:

Source: Eurostat

Indexed real labour productivity per capita



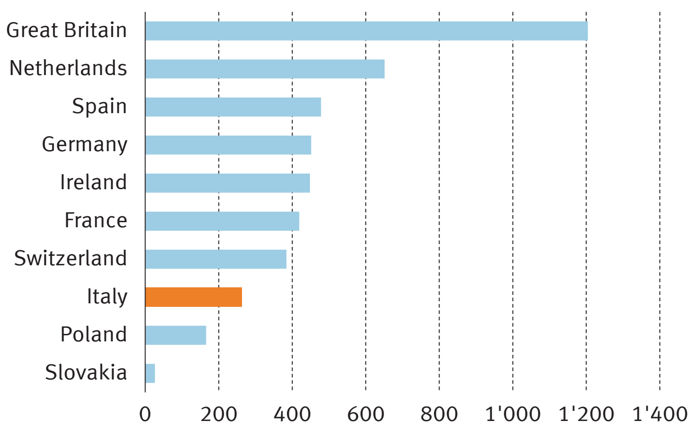
Lack of industrial modernisation

Italy's economy is heavily dependent on family businesses, which are typically smaller and less productive. Many of these companies do not invest in research and development and lack the necessary management skills and personnel to compete globally. The personnel problem is not least due to the highly centralised and unionised education system. According to the latest PISA study, the academic performance of Italian students is well below the OECD average. In addition, only 27% of all Italians between the ages of 25 and 34 have a tertiary degree, while the OECD average is around 45%. These structural problems have a negative impact on labour productivity.

Current Topic 3:

Source: OECD

Foreign direct investments in USD billions

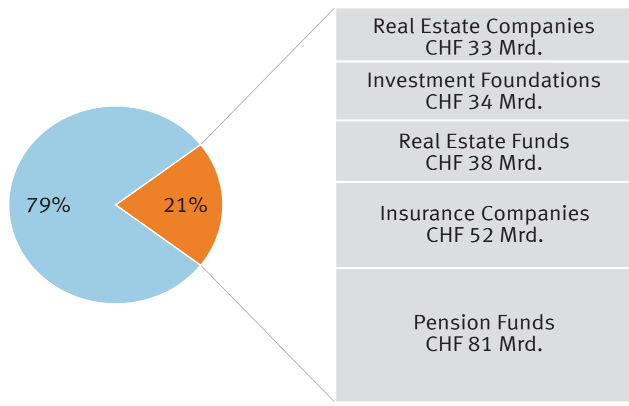


Unfriendly business environment

Italy scores poorly on most measures of government efficiency and satisfaction with public services. On the one hand, due to the poor level of civil justice in Italy, it takes much longer than in other developed countries to complete civil and criminal proceedings. On the other hand, there is a lack of efficiency in the bureaucratic handling of insolvencies, the payment of taxes and the granting of building permits. Inefficient public administration entails additional costs for businesses and hampers investment and growth. Due to this unfriendly business environment, Italy has received significantly less foreign direct investment than Spain since 2005, even though its economy is larger.

Knowledge & Experience:
Swiss real estate: An asset class for your portfolio

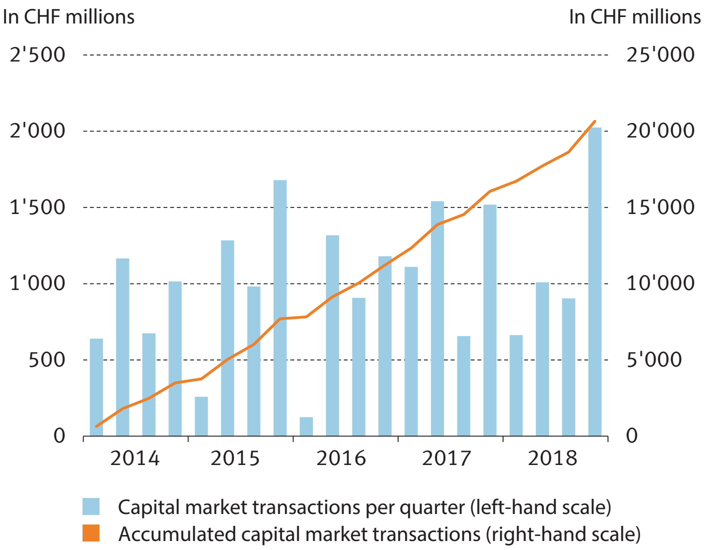
Knowledge & Experience 1: Source: Würst & Partner



The composition of the Swiss real estate market

The Swiss real estate market has a volume of CHF 1,141 billions. Of these, 79% are privately owned or held by private equity companies and cooperatives. The remaining 21% are owned by institutional investors. The lion's share of this 21% is held by pension funds and insurance companies. The investment universe available to private investors is limited to real estate funds and real estate companies. Of these, approximately CHF 60 billions are listed on a Swiss stock exchange. However, the liquidity of this asset class is comparatively low. The attractive risk-return ratio and tax-free distributions, if any, are arguments in favour of this, which is why real estate is considered a component of a well-diversified portfolio.

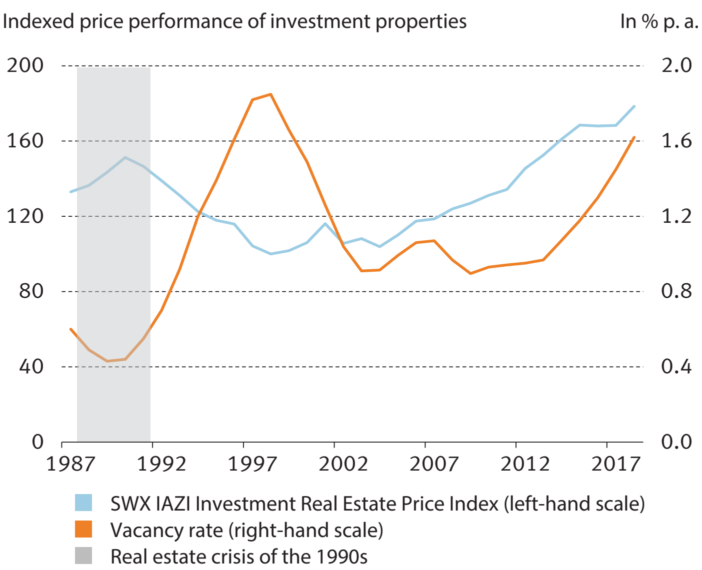
Knowledge & Experience 2: Source: BJSS-RE HUB



Increasing transactions in real estate funds

In the wake of the growing demand for real estate, an increase in capital borrowings and the establishment of indirect real estate investments has been observed in recent years in particular. In the real estate funds segment, insurance companies increasingly transferred their directly held real estate to funds. The high issue volume at the end of 2018 is one reason for the recently perceived subdued performance of this investment category. Despite stable demand, a marked increase in the supply of real estate funds leads to temporary price setbacks. In view of the relative size of this segment to the Swiss real estate market, however, the recent price trend should not be overestimated.

Knowledge & Experience 3: Sources: FSO, IAZI AG



Rising vacancy rates as indication of a real estate bubble?

The rapidly growing supply of real estate has led to an increase in vacant rental apartments since 2009. At the same time, interest rates fell, bringing prices for investment properties to a historically high level. However, both the vacancy rate of 1.6% and the price increase of 34% over the past 30 years do not seem worrying. With a share of just under 9%, construction investments relative to GDP are now in a much lower range than at the beginning of the real estate crisis in the 1990s (12%). At that time, it was not vacancy rates but rather an inflation rate of 5% that caused the real estate bubble to burst. To keep the inflation rate in check, the SNB had to raise interest rates from 3.5% to 7%, which led to a decline in real estate prices.

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.

Dreyfus Sons & Co Ltd publishes Compass four times a year since June 2008. The publication is aimed at clients of the bank and interested parties. It describes some of the instruments and methods the bank uses to monitor everything to do with the financial markets. A description of the investment process can be obtained from your client advisers or our website. Compass provides guidance but cannot take the circumstances of an individual portfolio into account.

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