Compass

1st Quarter 2020

Equity markets diverge compared to the real economy

Stick to your strategy

Gold shines also in the portfolio

Your wealth, our responsibility.

What to consider after a successful year for financial markets

Global equity markets have trended upwards for over 9 years. In 2019, equities were again among the best asset classes. This development occured against increasing macroeconomic and political uncertainties. First, the purchasing managers‘ indices of European manufacturing companies signalled stagnating economic growth. Second, the growth-inhibiting trend of deglobalization has increased since the last financial crisis. The most prominent example of deglobalization is the trade dispute between the US and China. This negative economic outlook was countered by major central banks through renewed expansionary monetary policy. The second part of this compass issue discusses how one should behave after a successful year for financial markets. Regular rebalancing can create excess long-term return for portfolios. Timing portfolio adjustments correctly is almost impossible. Fortunately, timing is not crucial for long-term returns. In the last part of this compass issue, we focus on gold as an asset class. Despite gold‘s historical correlation with inflation, real interest rates are the driving force behind its price development. Real interest rates have fallen globally as a result of demographic change, which positively affected the price of gold. Physically held gold not only offers better yield prospects than bonds for the portfolio but also shines due to a non-existent default risk.

More cyclical allocation within equities

Although the USA and China have reached a partial trade agreement, a concrete solution seems to be a long way off. Also, under the leadership of Prime Minister Boris Johnson, concerns related to a no-deal Brexit are back on the table. In consideration of these political uncertainties, we maintain our overall neutral equities' weighting.

Within equities, we recommend a more cyclical allocation. We increase the weighting of the financial sector to a slight overweight due to its attractive valuation and in view of a steepening yield curve. This increase is at the expense of the health care sector, where we reduce the weighting to neutral. In order to benefit from the good momentum in the information technology sector, we increase its weighting to a slight underweight. Finally, we reduce the weighting of the relatively expensive communication services sector to a slight overweight.

In the area of bonds, we continue to favour corporate bonds over government bonds. We maintain our slight underweight in emerging market bonds and high-yield bonds.

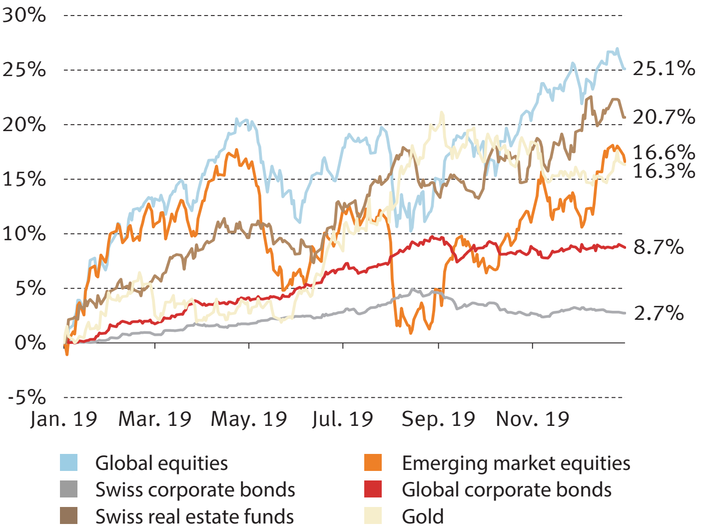
Asset allocation recommendation as of December 18th, 2019 for investors with CHF as their reference currency.

	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:
Equity markets diverge compared to the real economy

Basic Trend 1:

Total return (net) in CHF

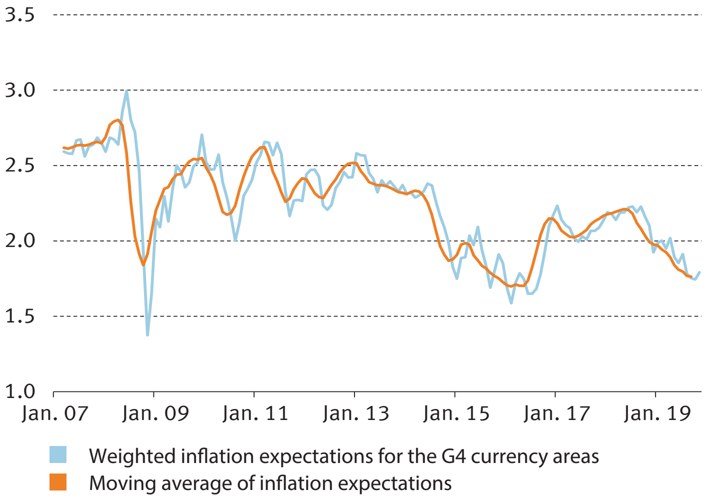


Development of financial markets in 2019

Hardly anyone expected that after the nine-year bull market, global equities would achieve their best result since the financial crisis. The divergence across individual equity markets during this bull run is also remarkable: US equities achieved an excess return of 179 percentage points over the equity markets of other developed countries. Fuelled by the interest rate policy of the US Federal Reserve (Fed), global corporate bonds also recorded their best year since 2009. The „normalization" of interest rates announced by the Fed has only materialized to a limited extent. Since December 2018 US key interest rates initially remained constant and then started falling again in June 2019. Even gold shone with a 16.3% increase in value.

Basic Trend 2:

Expected annual inflation in %



Hardly any inflation in developed countries

Why did financial markets perform so well in 2019? As already described, interest rates in the USA have only moderately rebounded. At the beginning of 2018, inflation was expected to accelerate in the developed world following years of expansionary monetary policy. To combat inflation, central banks would have to raise their key interest rates. However, as the chart shows, the market continued to revise inflation expectations downwards for the G4 currency areas (US, eurozone, UK, and Japan) over the course of 2019. Inflation in fact decelerated, allowing the monetary authorities to adopt a more expansionary monetary policy stance. This boosted global financial markets.

Basic Trend 3:

Source: World Bank

Exports in % of GDP

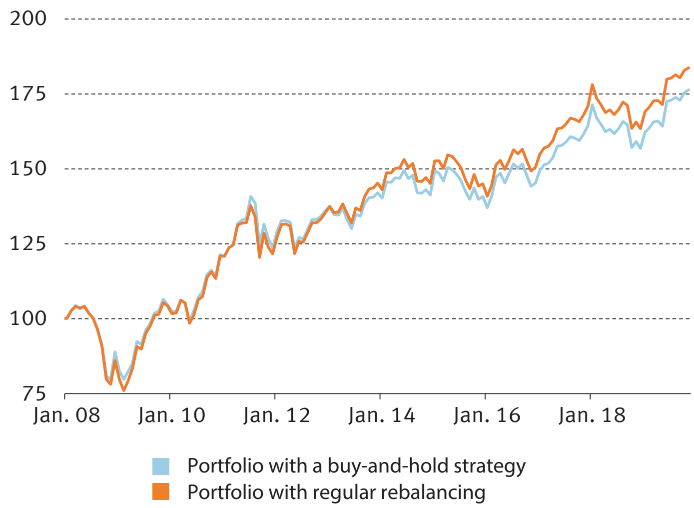
Has globalization already peaked?

The growth problems of global export champion Germany are symptomatic of a slowdown in globalization. This trend has been observed globally over the past years. In the two decades before the global financial crisis, the average annual growth rate of world trade volume was around 7%, but has since 2012 slowed to below 3%. The share of exports in global economic output peaked shortly before the financial crisis at 30.7% and since then never fully recovered. World Bank data is only available until 2018, so the US-China trade disputes have not yet been factored in. Yet, the purchasing managers' indices of the European manufacturing companies have been signalling stagnating economic activity since Q1 2019. This suggests that the share of world trade to global GDP is likely to have declined in 2019.

Current Topic:
Stick to your strategy

Current Topic 1:

Indexed performance in USD

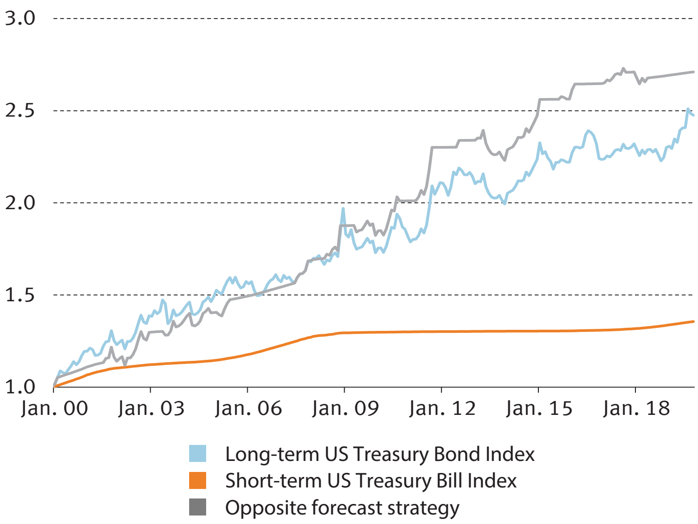


The benefits of rebalancing

Financial markets are characterised by cycles in which different asset classes exhibit different price fluctuations. The long-term goals of the investor define the individual investment strategy. This combined with diversification aspects, subsequently specifies the ideal weighting of each asset class. The resulting portfolio composition - and thus its risk/return characteristics - changes over time due to the different performance of the asset classes. Regularly rebalancing the portfolio weightings to the original investment strategy ensures that it always reflects the desired characteristics. The chart illustrates that in the long term, this approach creates an excess return compared to a buy-and-hold strategy.

Current Topic 2:

Indexed performance in USD

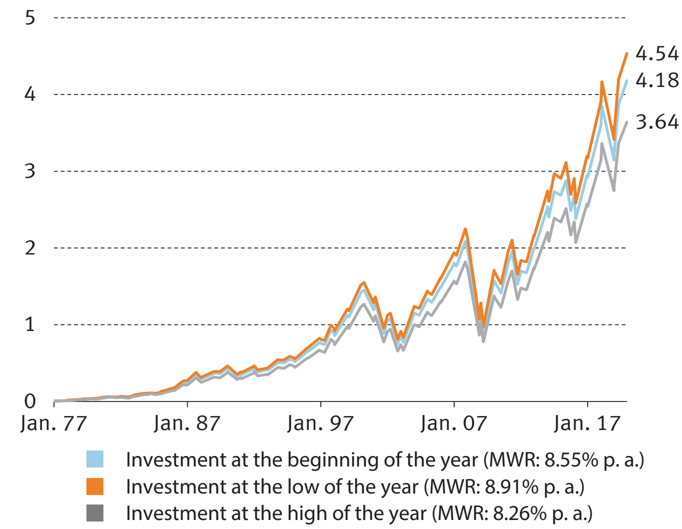


Forecasting errors

Predicting the performance of individual asset classes is almost impossible. To illustrate this, the chart shows the performance of an investment strategy which is created by contrasting the forecast of a renowned economic institute. This institute regularly forecasts the evolution of long-term interest rates on US government bonds. However, if one were to invest in long-term government bonds when interest rates are expected to rise, i. e. take an opposite view of the forecast, the portfolio value would be higher for the period under review. This is why Dreyfus Banquiers instead focuses more on risk statements to identify regimes with higher or lower risk, than on yield forecasts.

Current Topic 3:

Indexed performance in USD



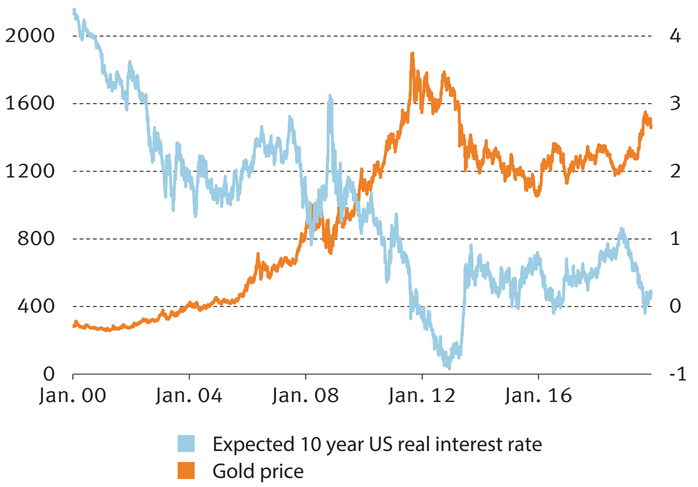
Market timing or time in the market?

Timing when to enter the market is an extremely difficult task. Therefore we generally recommend to at least partially always be invested. This can be shown by a simulation of three scenarios. Let's assume that an investor invested USD 10,000 annually in the MSCI World Index over the last 42 years at the following three different times. Scenario 1: at the beginning of each year. Scenario 2: at the best time of the year (annual low). Scenario 3: at the worst possible time (annual high). The differences in annual performance, as measured by the money-weighted return (MWR), are moderate. Instead of trying to ideally time the investments, it is worthwhile to focus instead on the risks taken and associated risk premiums earned by overweighting and underweighting the various asset classes, based on your own risk profile. Currently, we believe that equities continue to offer comparatively attractive risk premiums.

Knowledge & Experience: Gold shines also in the portfolio

Knowledge & Experience 1:

Gold price per troy ounce in USD | Real interest rate in % p. a.



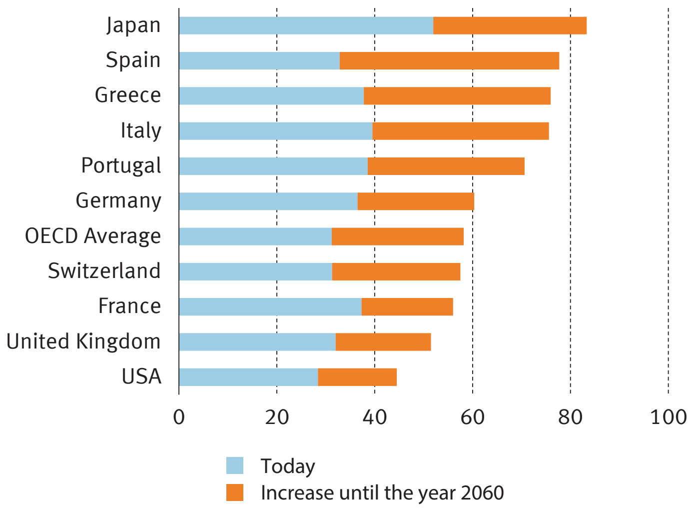
Real interest rates driving the gold price

After the gold price was unlocked in 1971, gold was long considered a hedge against inflation. Since the turn of the millennium, gold has however reached new highs despite the absence of inflation. Obviously, inflation is not sufficient to explain the development of the gold price. Therefore, one must consider the concept of opportunity costs. A gold investor forgoes interest payments that he could receive on bonds. The higher these payments are, the higher the opportunity cost of gold and the lower its price. As interest rates fall, the opportunity costs also fall and gold becomes more attractive. Real interest rates (nominal interest minus inflation) are considered the decisive factor, because an investment in bonds is only worthwhile if their yield exceeds the rate of inflation.

Knowledge & Experience 2:

Source: OECD

Number of persons over 65 years per 100 persons of working age

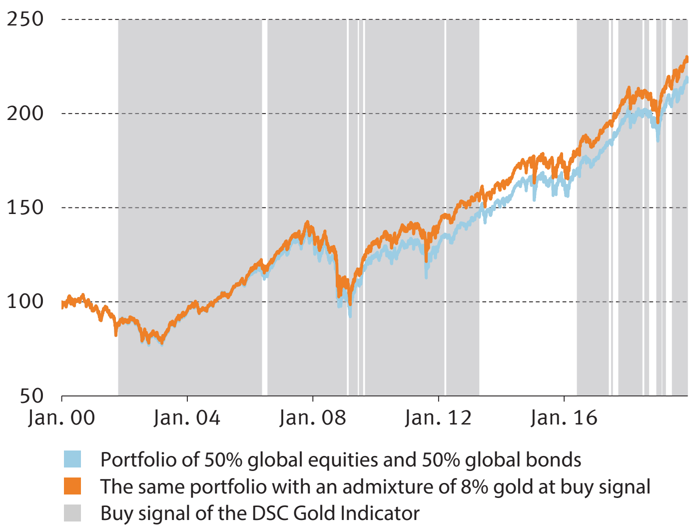


Demographics depress real interest rates

Since the turn of the millennium, real interest rates have fallen globally. The decline can be explained by the increased propensity of the population to save, which has led to a greater supply of capital and lower interest rates. The increased propensity to save is a direct consequence of increased life expectancy. Working age people need to save a larger proportion of their income and, potentially, work longer to finance a longer-lasting retirement. But the ageing of the population has an opposite effect on saving behaviour. Since employees can no longer save after retirement, the rising number of pensioners should stabilise the propensity to save at the current higher level.

Knowledge & Experience 3:

Indexed performance in CHF



Gold makes a portfolio brilliant

Low interest rates complicate the objective of capital preservation in asset management. In a balanced portfolio, not only is the yield of first-class debt securities lost, but also their function as a risk buffer in times of crisis is only guaranteed to a limited extent. Gold is key for risk diversification because of the constrained upside potential of safe fixed income havens in times of crisis. Furthermore, unlike bonds, physically held gold has no default risk. This is a feature that should not be neglected in view of the record level of public debt. Our gold indicator combines real interest rate expectations and risk indicators with gold price trend signals. It continues to signal a bright future for the precious metal.

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. It is for information and marketing purposes.

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