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Compass

4th Quarter 2018

The future of monetary policy

Construction shortcomings of the euro

Tasks and objectives of central banks

Your wealth, our responsibility.

Central banks' monetary policy

In the last years, prices on the financial markets have been predominantly driven by the expansionary monetary policy of the central banks. To support the economy after the 2008/09 financial crisis, many central banks lowered their key interest rates to historical levels. However, this measure was not sufficient to defuse the uncertainty on the markets. Futhermore, central banks began buying government and corporate bonds, which provided the markets with additional liquidity, but causing central banks' balance sheets to swell. By recently announcing the end to this policy, the US Federal Reserve has assumed a pioneering role globally. What the future of monetary policy could look like, and what problems and risks remain, are analyzed in the first part of this issue of Compass. The second part deals with the construction shortcomings of the euro. Greece has attracted attention in recent years due to structural problems. In 2010, the European partners, together with the International Monetary Fund (IMF), had to put together a rescue package to avert Greece's national bankruptcy. Although Greece is the eurozone's most prominent debtor, it is by no means an isolated case. In the last part of this issue of the Compass, we discuss the tasks and objectives of the central banks. We explain why their independence is not only a sufficient, but also a necessary condition for achieving monetary policy objectives.

A more defensive allocation within equities

Since January of this year, purchasing managers' indices have returned from their highs and reached a lower but still positive level. Other leading economic indicators also signal positive but slowing growth. Despite this slight slowdown in the economy, our Global Macro Risk Indicator (GMRI) continues to signal a promising macroeconomic environment for equities. Therefore, we continue to overweight equities. In view of the continuing low interest rate environment, we are also overweighting Swiss real estate at the expense of bonds.

Within equities, we are accentuating our defensive positioning. We are highlighting the rotation already mentioned in the third quarter issue of the Compass. Due to the relatively high valuation, we reduced the weighting of the cyclical industrial sector and, in return, increased the weighting of consumer staples.

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

Asset allocation recommendation as of September 17th, 2018 for investors with CHF as their reference currency.

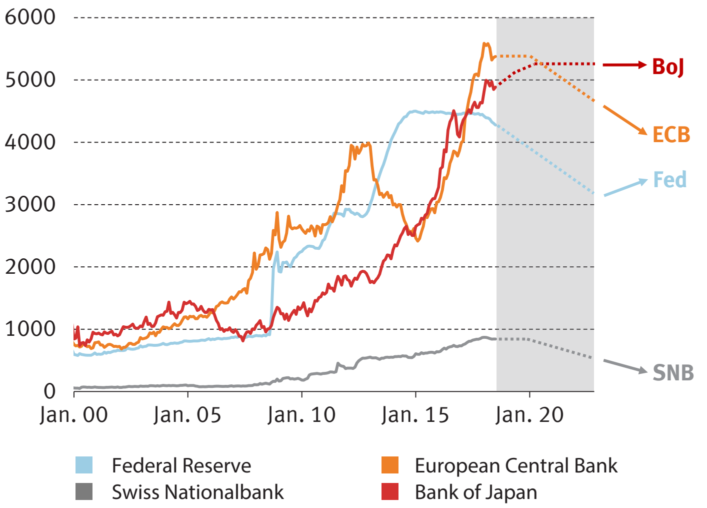
	underweight: strong	underweight: slight	neutral	overweight: slight	overweight: strong
Investment classes					
Equities					■
Bonds	■				
Gold			■		
Cash			■		
Real Estate CH				■	
Equity Sectors					
Consumer Discretionary		■			
Consumer Staples					■
Energy		■			
Financials				■	
Health Care					■
Industrials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

Basic Trend: The future of monetary policy

Basic Trend 1:

Balance sheet total in USD billions

Source: Bloomberg



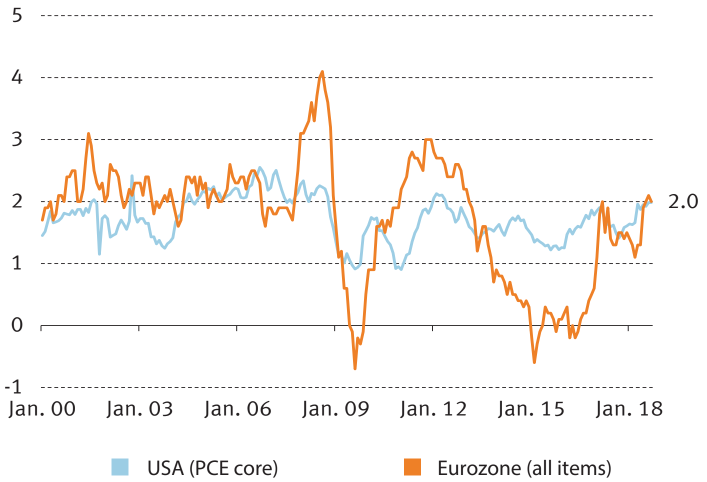
Aggregated balance sheet totals decline

The primary task of a central bank is to ensure the stability of the financial system. To this end, it uses two instruments: Money supply and key interest rate level. During the financial crisis of 2008/09, money supply once again increased significantly. This expansive monetary policy continues in many places until today. The US Federal Reserve recently began to withdraw money from the market. This is demonstrated by the reduction in its balance sheet total. The European Central Bank, on the other hand, will no longer draw any additional liquidity from January 2019. Its balance sheet total should remain constant for the time being. In aggregate, the balance sheet totals of the four adjacent central banks have been falling since March of this year.

Basic Trend 2:

Inflation rate in percent p. a.

Source: Bloomberg



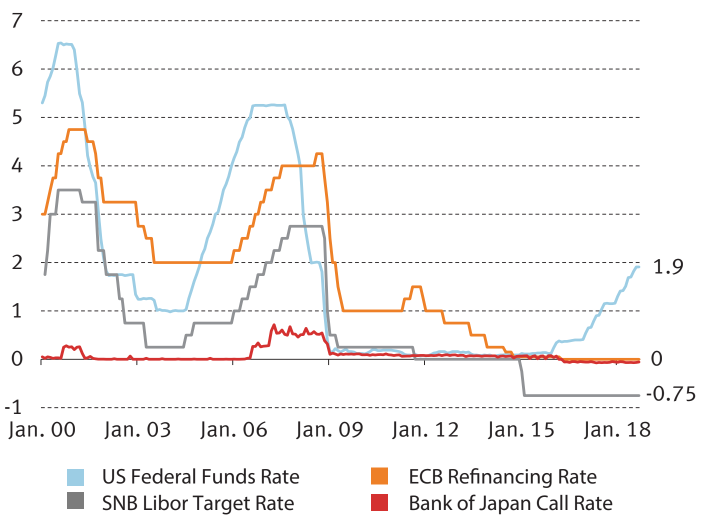
Economic upswing causes prices to rise

The increased central bank money supply carries the risk that prices will rise and inflation occurs. Since the financial crisis, the additional money supply has primarily been used by banks to buy government bonds. At the same time, the willingness of households and companies to hold more liquidity increased. This kept interest rates artificially low, especially for highly indebted countries in Southern Europe. Inflation rates also remained at a low to moderate level for a long time. Due to the strong economy, inflation in the USA and Europe rose again in recent months. The current inflation rate is around 2%, which is the inflation target of the central banks. If inflation continues to rise unabated, this development can be counteracted by raising key interest rates.

Basic Trend 3:

Target interest rate in percent p. a.

Source: Bloomberg



Farewell to a changing European interest rate policy?

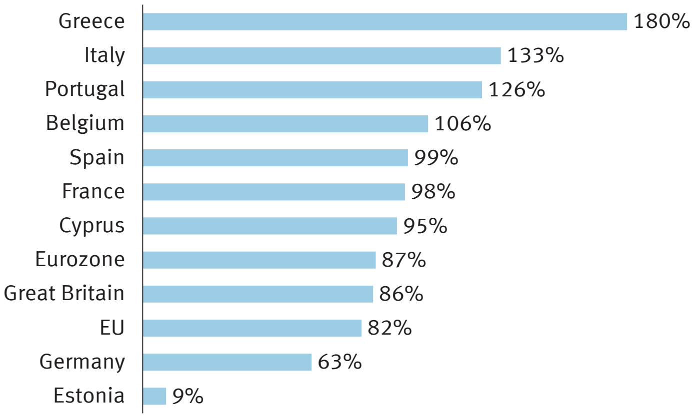
Rising key interest rates keep inflation at bay on the one hand, but also hamper economic growth on the other. If key interest rates rise, loans will become more expensive for companies and private households. In view of the good economic situation in the US, the Federal Reserve began raising key interest rates gradually. The US is thus playing a pioneering role here as well. Recently, the Federal Reserve even announced its intention to pursue an even steeper interest rate path. In Europe, on the other hand, interest rates have been close to zero for some time. According to ECB President Mario Draghi, interest rates will remain unchanged at least until summer 2019. The Swiss National Bank should adapt to this policy in order to strengthen the euro, as the weakness of the euro is based on many still unsolved problems.

Current Topic:
Construction shortcomings of the euro

Current Topic 1:

Source: Statista

Government debt in relation to gross domestic product (Q1 2018)



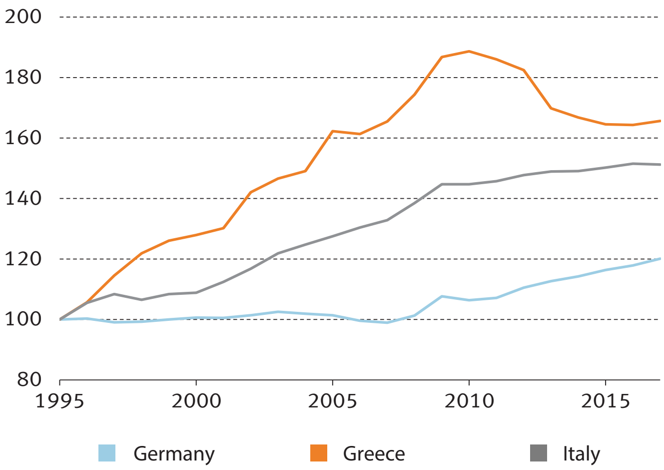
Greece leaves rescue program

Greece was the first country, for which the European partners put together a rescue package in 2010. Since then, Athens has received three aid packages totalling almost 290 billion euros. With the third package, Greece is now leaving the rescue program and will have to cover its refinancing needs via the markets going forward. Positive economic growth combined with budget surpluses form the basis for the renewed confidence of investors. But despite the progress made, the country's structural problems remain untouched. In order to pay off the debt of 180 percent of the annual gross domestic product, Athens must create a budget surplus of 3.5 percent before interest by 2022, and 2 percent before interest by 2060.

Current Topic 2:

Sources: Eurostat, own calculations

Development of nominal unit labor costs (indexed as of 1995)



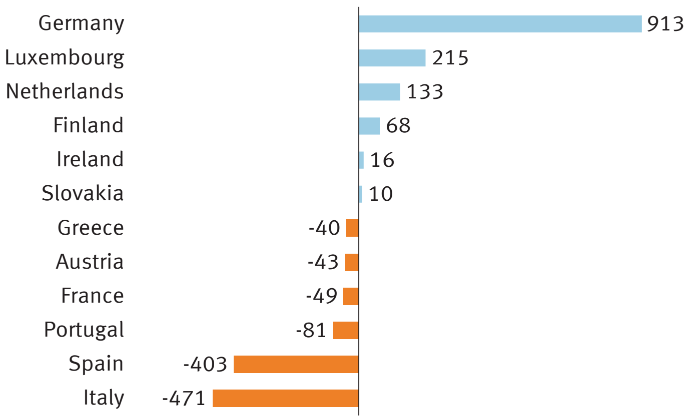
Problematic price development within the euro zone

In a monetary union, it is not possible to compensate for different price increases by adjusting the exchange rate. Therefore, one condition for the lasting existence of a monetary union is that the price trends of its member countries converge. In the euro zone, the Stability and Growth Pact should ensure that all member states aim for balanced national budgets and limited public debt. However, debt has increased in recent years. The main reason for this is that the nominal unit labour costs of the member states, which make a significant contribution to price development, have developed differently. In order to compensate for the loss of competitiveness, weaker nations had to incur debts.

Current Topic 3:

Source: Statista

TARGET2 balance in EUR billions as of July 2018



TARGET2 balances as a reflection of competitiveness

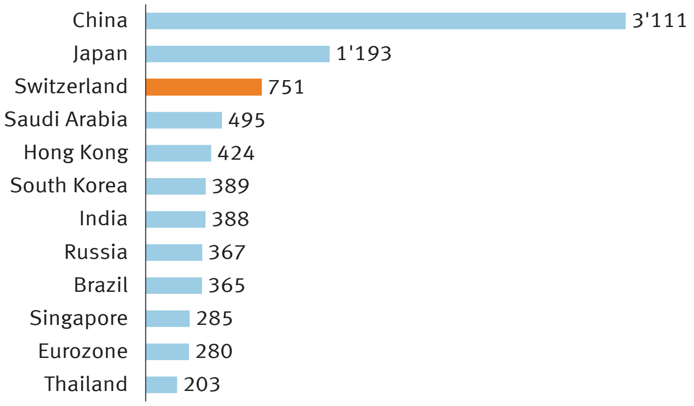
TARGET2 balances measure remittances between countries used to buy goods and assets abroad. The reduction in competitiveness triggered a decline in exports and an increase in imports in crisis countries. The deficits resulted in an increase in foreign debt and thus in the TARGET2 balances of these countries. According to the European Central Bank, a country must first settle its TARGET2 liabilities before leaving the monetary union, although a withdrawal from the union is not contractually provided for. Italy is currently regarded as one of the biggest critics of the euro. If it wants to leave the euro zone, Italy would first have to pay debts amounting to 471 billion euros. Germany, which currently owns the highest debt of 913 billion euros, would benefit most.

Knowledge & Experience:
Tasks and objectives of central banks

Knowledge & Experience 1:

Source: International Monetary Fund

Foreign currency reserves of central banks in USD billions



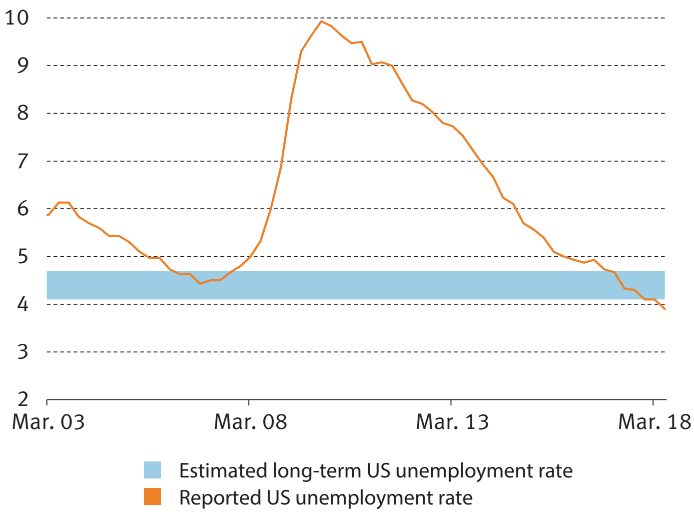
Tasks of central banks

The central bank is responsible for the monetary policy of a state or a monetary union. One of its best-known tasks is the supply of cash. The central bank has the monopoly to issue banknotes. It thus supplies the economy according to the needs of the payment traffic. Another important task is the management of currency reserves. Currency reserves ensure that the central bank has sufficient liquid assets to carry out foreign exchange transactions to control the exchange rate if necessary. Today, the Swiss National Bank (SNB) has the third-highest foreign currency reserves in the world. In order to prevent the franc from appreciating as a result of the euro crisis, the SNB massively bought up euros and the mountain of foreign exchange swelled.

Knowledge & Experience 2:

Source: Bloomberg

Unemployment rate in percent



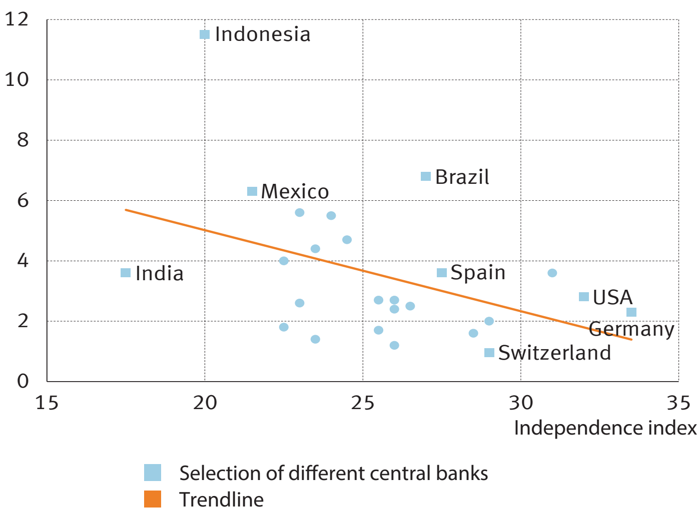
Objectives of central banks

The primary objective of central banks is price stability. Stable prices are an important prerequisite for growth and prosperity. The Federal Reserve defines two additional goals: First, long-term interest rates on the capital market are to be kept moderate. Secondly, it aims to achieve the maximum sustainable level of employment. This is the level of employment that can be maintained in the long run without destabilizing inflation. The US unemployment rate is currently at a record low of 3.9 percent. This is below the long-term unemployment rate, which is estimated by representatives of the Federal Reserve at 4.1 to 4.7 percent. If this trend continues, inflation is likely to accelerate.

Knowledge & Experience 3:

Source: J. T. Mathew (2006)

Annual inflation in percent p. a.



Independence of the central bank

The central banks' objective of price stability often conflicts with the government's objectives. Politicians are tempted to allow inflation for two reasons: On the one hand, a government can induce a dependent central bank to increase money issuance in order to finance government spending. On the other hand, the short-term positive effect of inflation can also be used to bring about a temporary economic upturn before re-election. The independence of a central bank is therefore seen as a necessary prerequisite for achieving monetary policy goals. In a study, J. T. Mathew calculated an independence index that divides central banks into a scale of 0 (dependent) to 36 (independent). A comparison of the index and inflation shows that more independent central banks are more likely to achieve the goal of price stability.

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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