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Compass

4th Quarter 2019

Effects of the trading dispute on interest rates and gold

The central bank policy of the future

Modern Monetary Theory

Your wealth, our responsibility.

Recession fears and trade dispute call for central banks

In the third quarter, signs of a slowdown in the global economy have increased. The trade dispute between the US and China is also threatening to escalate. Due to these uncertainties, low key interest rates are desirable in many places. If a central bank lowers key interest rates, yields on short-term bonds will fall. Yields on long-term government bonds, on the other hand, reflect market expectations regarding future interest rates. Recently, the yields of long-term Swiss and European government bonds have slipped into negative territory. One asset class in particular benefits from falling real interest rates. With a current price of 1500 USD per troy ounce, the gold price is at a 6-year high.
In the second part of this compass edition we present the current and future policies of the central banks. While key interest rates are falling in the US once again, new liquidity is being created in Europe. In both cases, this affects exchange rates and can lead to a currency war.
An extended period of weak economic growth, low real interest and inflation rates is referred as secular stagnation. This promotes the development of new economic policy ideas such as „Modern Monetary Theory" (MMT). We describe this theory and show how investors can protect themselves from the implications of this theory.

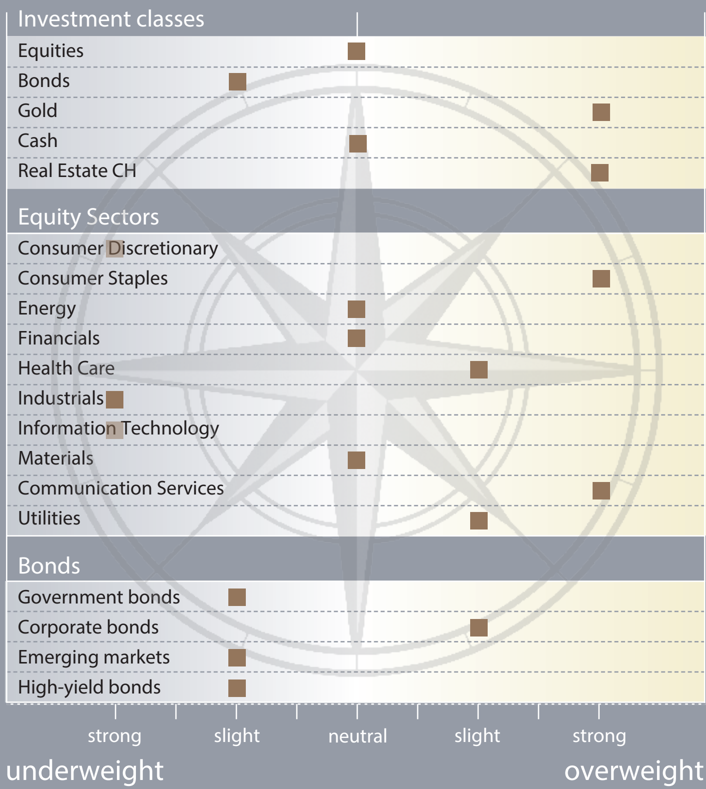
Status quo - neutral to defensive

In view of the current macroeconomic and economic policy risks, we are maintaining our neutral positioning of equities for the time being. Due to falling real interest rates in the US, the positive trend in the gold price should continue.

Within equities, we remain with our defensive allocation. We underweight cyclical sectors such as Consumer Discretionary, Industrials and Information Technology in favour of Consumer Staples, Health Care, Communication Services and Utilities.

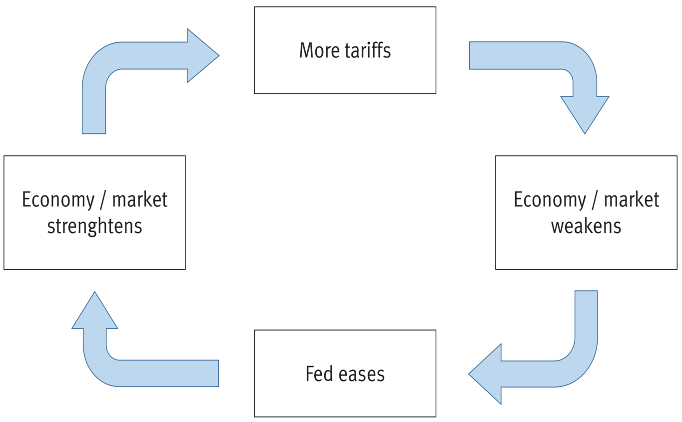
In bonds, we continue to prefer corporate bonds over government bonds. For emerging market bonds and high-yield bonds, we leave each with a slight underweight.

Asset allocation recommendation as of September 24th, 2019 for investors with CHF as their reference currency.



Basic Trend:
Effects of the trading dispute on interest rates and gold

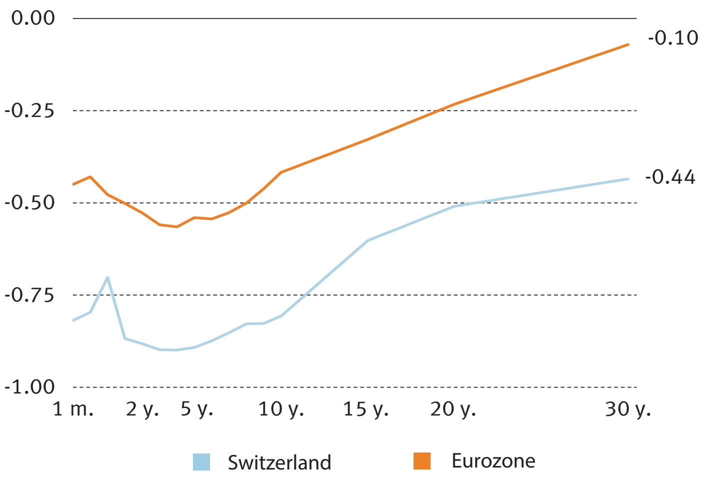
Basic Trend 1:



Adverse cycle between trade and interest rate policy

The trade dispute between the US and China threatens to escalate into a trade and currency war. Failed negotiations are always followed by new punitive tariffs. The tone becomes rougher. These kinds of competitive barriers lead to a slowdown in economic growth over time. If the economic outlook becomes gloomy, central banks will come into play. A turnaround in interest rates towards lower key rates, as recently seen in the US, makes loans more attractive and stimulates economic growth. The economy and the financial markets are gaining new strength. However, this opens up potential for the threat of new punitive tariffs, and the adverse cycle between trade and interest rate policy starts all over again. In this way, the desire for lower key interest rates is being met.

Basic Trend 2:
Yield in % p. a.



Negative interest rates also for long-term government bonds

If a central bank lowers its key interest rate, yields on short-term bonds fall. For bonds with longer maturities, yields usually return as well, but not to the same extent. This is because yields on long-term bonds reflect the market's expectations of interest rate levels in the future. Looking at the yields for all maturities, you can plot the so-called yield curve. Recently, long-term yields on both, Swiss and European government bonds (measured by German Bunds) have slipped into negative territory. This means that there are only negative yields for government bonds here, regardless of their maturity. Therefore, these government bonds are no longer an investable asset class for asset allocation.

Basic Trend 3:
Gold price in USD per troy ounce

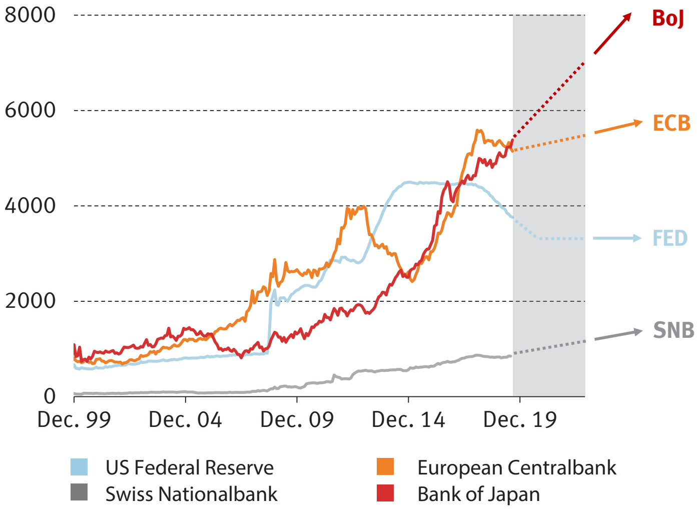
Gold price at 6-year high

The gold price is at a 6-year high of more than 1500 USD per troy ounce. Especially in the last weeks, the price of gold has risen significantly. The escalating trade dispute between the US and China, a slowdown in the global economy, but above all falling real interest rates - this is the difference between nominal interest rates and the inflation rate - should ensure that this trend will continue in the near future. However, unlike other asset classes, gold offers no generic return, i. e. there is no dividend (as with equities) or coupon (as with bonds). Only the price forecast is decisive for success. With our gold indicator (buy signal at USD 1212) and the overweighting of gold in our asset allocation (see page 2), we were absolutely right.

Current Topic:
The central bank policy of the future

Current Topic 1:

Central banks' total assets in bn. USD

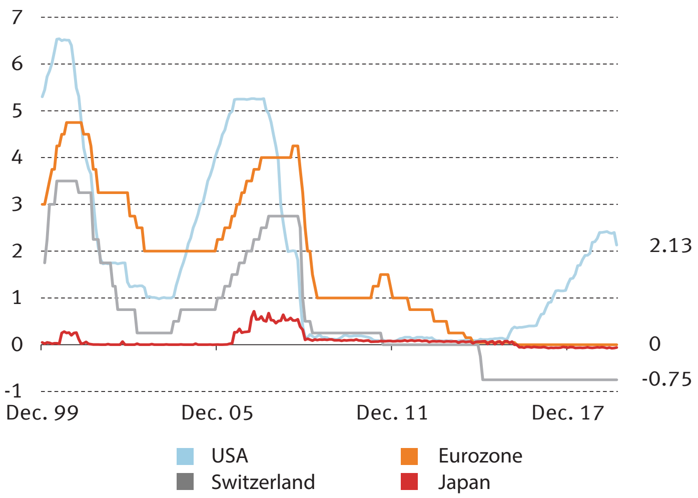


Are you ready for a new Quantitative Easing?

As a result of the 2007/08 financial crisis, several central banks began to provide the financial markets with additional liquidity. If a central bank creates additional liquidity, its balance sheet total rises. In particular, the total assets of the US Federal Reserve and the European Central Bank (ECB) have more than tripled in just a few years. The ECB's attempt to stop providing additional money seems to have failed. In view of the deteriorating macroeconomic environment, coupled with the threatened escalation of the trade dispute, the ECB announced in September that it would resume its „Quantitative Easing (QE)" programme and supply the financial markets beginning in November with EUR 20 billion a month for an indefinite period of time.

Current Topic 2:

Key interest rate in % p. a.

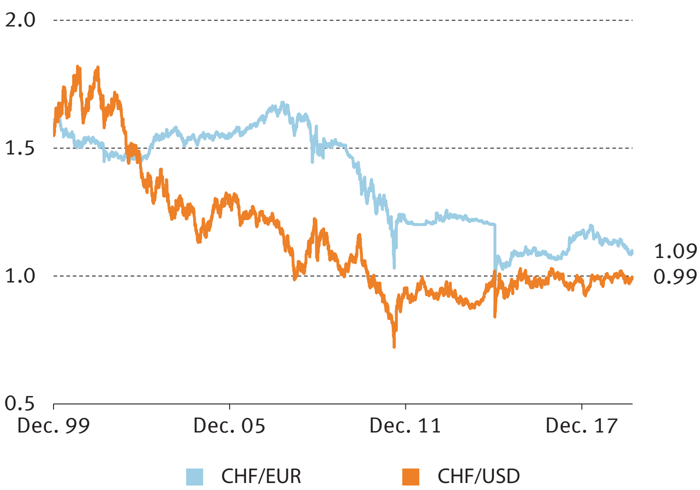


Keep your powder dry

Emerging fears of a recession have led various central banks to rethink their monetary policy and cut key interest rates again. The US central bank has kept its powder dry by successively raising key interest rates during a phase of economic recovery over the past few years. In the middle of this year, the Federal Reserve lowered its key interest rate by 25 basis points as a precaution. In September, it took a second step in the same direction and at the same level. A look at the forward prices shows that market participants expect at least 3 further interest rate cuts of -0.25% each by the end of 2020. In Europe and Switzerland, on the other hand, key interest rates remained low even in years of economic prosperity. This has been taking its toll recently.

Current Topic 3:

CHF/foreign currency



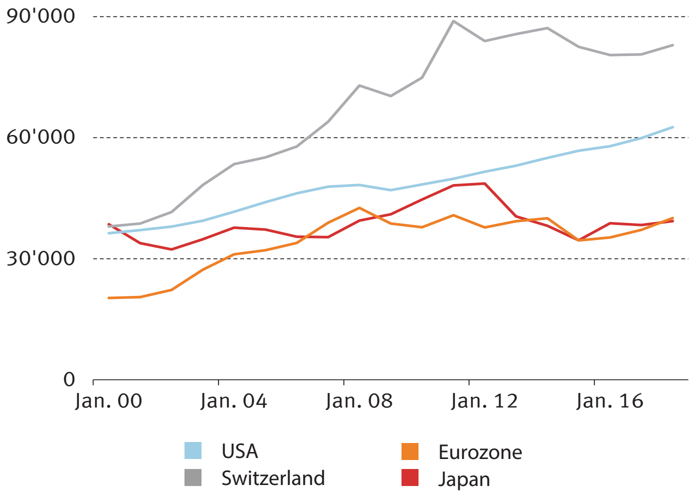
Global currency war - how far will the SNB go?

The global competition in „printing money" and undercutting each other with low interest rates also leads to exchange rate changes on the currency market. The more money a central bank creates and the lower its interest rate, the weaker its currency becomes. A weak currency is good for exports, as one's own goods become cheaper. Imported goods, on the other hand, become more expensive. For some years now, the Swiss National Bank has been trying to weaken the Swiss franc with negative interest rates and additional money supply. This is unlikely to change in the foreseeable future. Experts believe, however, that there are limits to this approach. If interest rates are too low, this will harm savers, banks and pension funds, among others. One day, the people will raise their voices against a balance sheet total that is too high.

Knowledge & Experience: The Modern Monetary Theory

Knowledge & Experience 1: Source: IMF

GDP per capita in USD

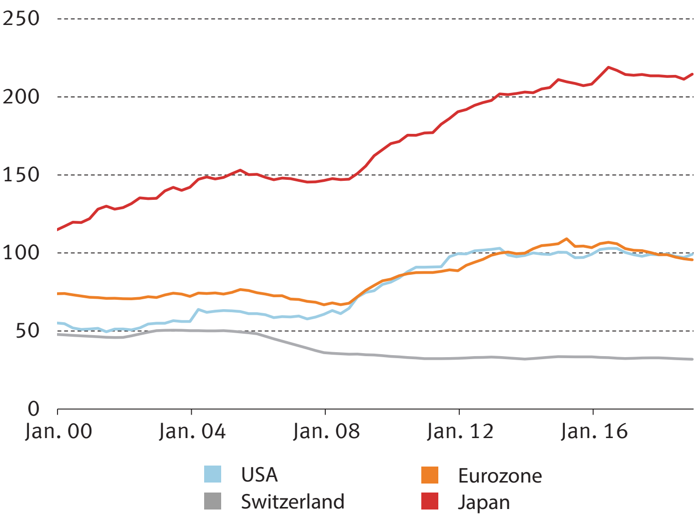


Secular stagnation

Even a decade after the 2007/08 financial crisis, economic growth in the developed nations is still sluggish. Inflation appears to be resistant to the expansionary monetary policy of recent years. The target inflation rate of 2.0% p. a. remains unattained. In fact, the market expects another 30 years of low inflation. Accordingly, interest rates are at or close to their all-time lows. The current situation is referred to as secular stagnation. This describes an extended period of weak economic growth, low real interest and inflation rates. In such an environment, central banks are almost powerless. They cannot stimulate the economy any further as nominal interest rates have already reached their natural floor.

Knowledge & Experience 2: Source: BIS

Government debt in % of GDP

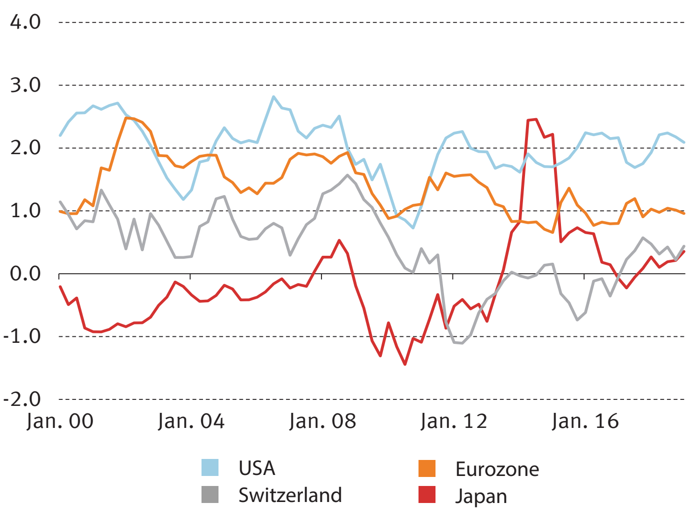


The Modern Monetary Theory

Secular stagnation promotes the development of new economic policy ideas. One of these ideas is the Modern Monetary Theory (MMT). It comprises various considerations that are both simplified and exaggerated. Specifically, the MMT states that a government should stimulate its economy through rising government spending. The level of the resulting debt is considered unproblematic if the state has its own central bank. In the case of an emergency, the central bank is always in a position to buy back the newly issued government bonds. Since the central bank has the right to print „fresh" money, it can never run out of it. Thus, even in the case of a crisis, there is never any default risk for its own government bonds.

Knowledge & Experience 3: Source: OECD

Core inflation rate in % p. a.



Implications of this theory for you as an investor

It is fundamentally a valid idea that in times of historically low interest rates, higher government debt should be sustainable and used to support the economy. Supporters of the MMT even formulate this idea to such an extreme that they speak of unlimited government spending. This should be financed by their own central bank. However, it should be borne in mind that too much new money inevitably leads to rising inflation rates. Investors can protect themselves from this inflation-related expropriation by investing in inflation-protected bonds. In the US such bonds are called „Treasury Inflation-Protected Securities" (TIPS). If a government's debt burden becomes too large and inflation rises, the value of these bonds will rise as well.

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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