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Compass

2nd Quarter 2019

Negative interest rates in Switzerland: temporary or permanent?

Structural problems in the euro zone

Precious metals as an alternative asset class

Your wealth, our responsibility.

When an exceptional situation becomes a permanent state

As a result of the financial crisis in 2007/08, various central banks lowered their key interest rates, some to historic lows. The Swiss National Bank (SNB) even introduced negative interest rates to weaken the Swiss franc and protect its domestic export industry. The situation that was initially described as a temporary exception has now become a permanent one. However, the low real interest rates are rather the result of a global oversupply of capital. If global capital and money market rates remain at this level, it seems highly unlikely that the SNB will turn away from negative interest rates. Moreover, Europe remains vulnerable due to structural problems. These include the divergence of national debt levels between the euro countries and the inadequate capitalisation of European banks. Furthermore, the global economy is in the late phase of the economic cycle. This also rules out a short- to medium-term increase in interest rates. In an environment of historically low interest rates and rising prices on global equity, bond and real estate markets, the question arises as to what alternative investments are available to an investor. In the third part of this compass edition „Knowledge & Experience" we present precious metals as an asset class. The focus is on gold, which enjoys certain advantages over other precious metals. We present the characteristics of a gold investment and what you as an investor should pay attention to.

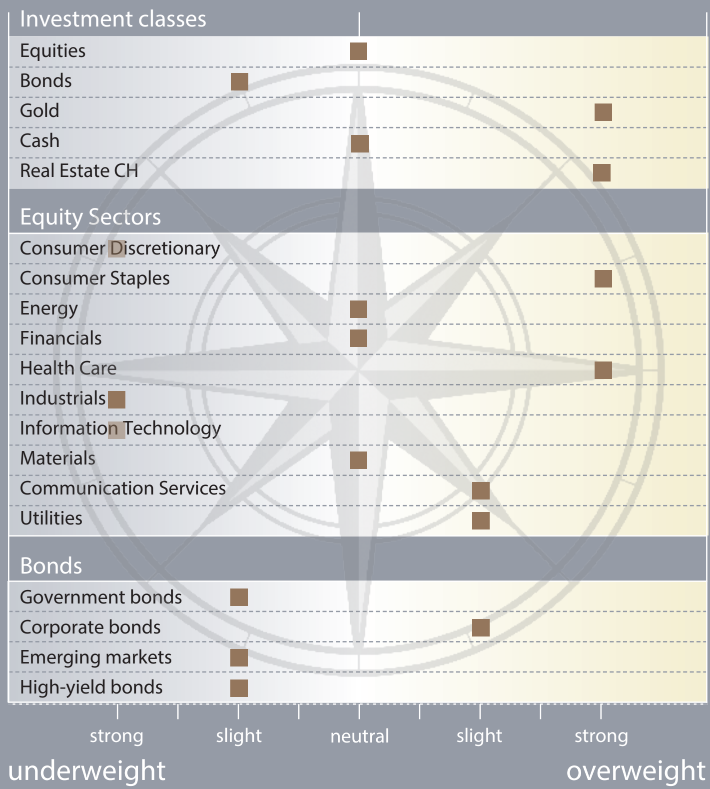
Neutral positioning at asset class level

More and more leading indicators are signaling the late phase of the global economic cycle. One leading indicator is the yield curve in the US, which is likely to invert in the near future (see Current Topic 3). For this reason, we are now taking a neutral position within the asset classes. We are reducing the equity allocation and, in return, increasing the allocation in favour of gold and Swiss real estate.

Within equities, we are sticking to our defensive positioning. We overweight the consumer staples, healthcare, communications and utilities sectors. On the other hand, we underweight the cyclical consumer discretionary, industrial and information technology sectors.

In the bonds asset class, we continue to prefer corporate bonds to government bonds. For emerging market and high-yield bonds, we keep a slight underweight.

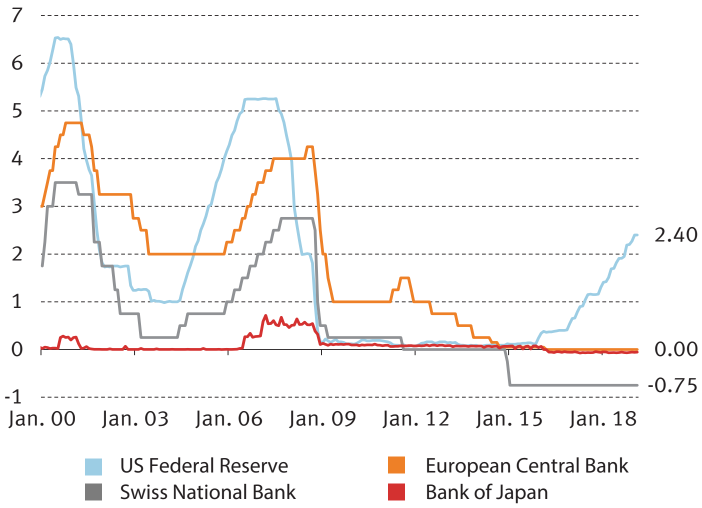
Asset allocation recommendation as of April 1st, 2019 for investors with CHF as their reference currency.



Basic Trend:
Negative interest rates in Switzerland: temporary or permanent?

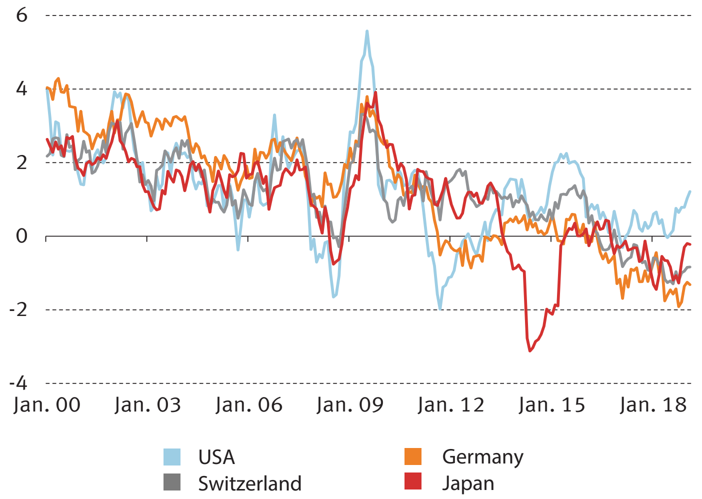
Basic Trend 1:

Key interest rate in %



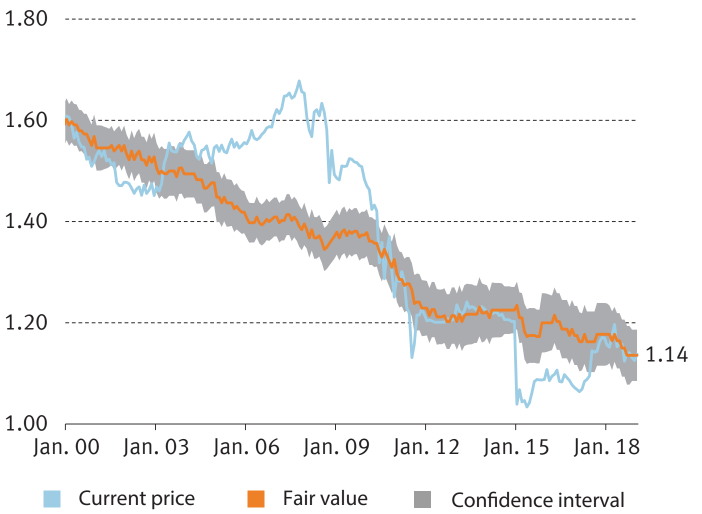
Basic Trend 2:

Real interest rate in %



Basic Trend 3:

CHF/EUR exchange rate



Negative interest rates to weaken the Swiss franc

Following the outbreak of the financial crisis in 2007/08, the leading central banks trod new, previously unknown paths. In addition to reducing the key interest rates, they provided the financial markets with additional liquidity through purchases of securities and currencies. The Swiss franc, considered a safe haven, experienced a massive appreciation. To support the Swiss economy, the SNB introduced a minimum exchange rate of CHF 1.20 per Euro in September 2011. In mid-January 2015, however, it surprisingly abandoned this exchange rate target. The resulting appreciation pressure of the Swiss franc was counteracted by the simultaneous introduction of negative interest rates. The SNB is still sticking to this interest rate level. The initial temporary situation has become a permanent one.

Oversupply of capital weighs on real interest rate level

Why did interest rates not normalise despite an economic recovery? The main reason are the low global capital and money market rates, which have fallen continuously over the past 20 years. However, it is not the nominal interest rates controlled by the central banks that are relevant for economic decision-making, but the global real interest rate level. In recent years, the supply of capital has, for demographic reasons, increased as a result of a large propensity of private households in industrialised countries to save. At the same time, the demand for capital by companies declined due to the change from an industrial to a service economy.

Is the Swiss franc still overvalued?

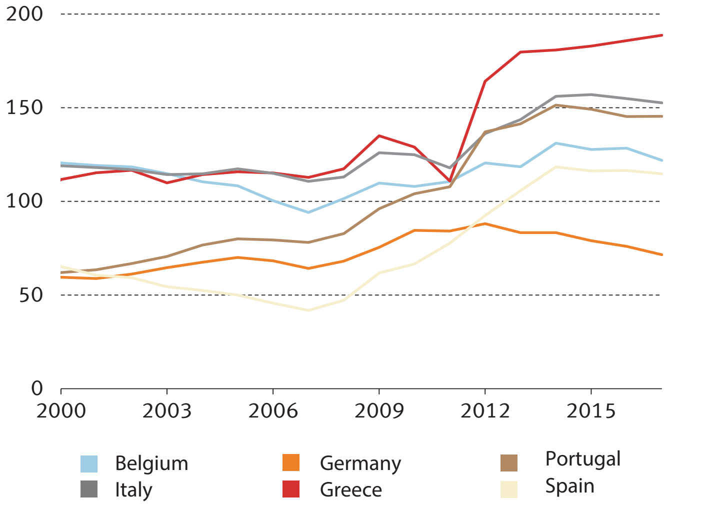
SNB representatives stress that the already expensive Swiss franc would continue to appreciate if negative interest rates were abandoned, triggering a rise in unemployment. Our calculation of purchasing power parity does not support the thesis that the CHF is substantially overvalued against the EUR. The SNB would certainly have to buy euros in the absence of negative interest rates if it were to prevent the Swiss franc from strengthening further. This would boost the SNB's balance sheet even more, which in turn would have to evaluate the disadvantages of ballooning total assets. Without a sustained rise in global capital and money market rates, an unilateral abandonment of negative interest rates by the SNB seems highly unlikely.

Current Topic:
Structural problems in the euro zone

Current Topic 1:

Government debt as a percentage of GDP

Source: OECD

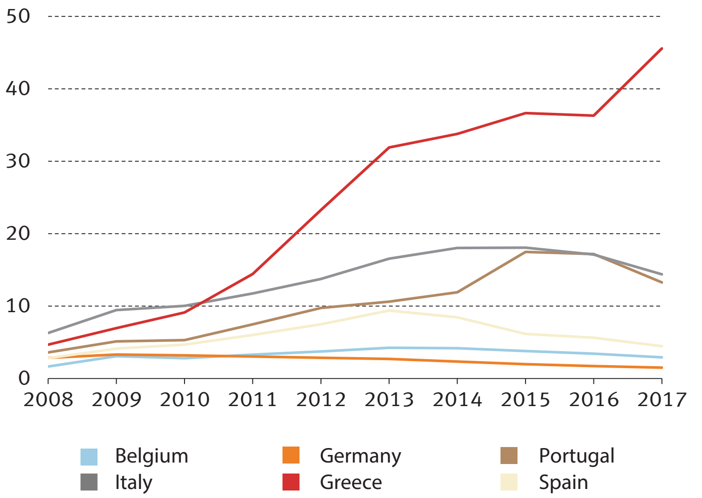


Diverging government debt levels in the euro zone

For Swiss money and capital markets, the development of the euro zone is particularly important. Within the euro zone, it is not possible to offset different price increases by adjusting the exchange rate. For a monetary union to survive in the long term, the economies of member countries must converge. To achieve this, all countries should aim for balanced national budgets and limited public debt. In fact, however, there are still major structural differences. By eliminating national fiscal policy as an instrument of economic policy, the divergence in competitiveness could only be compensated by an ever-increasing indebtedness of the weaker nations.

Current Topic 2:

Non-performing loans as a percentage of total gross loans

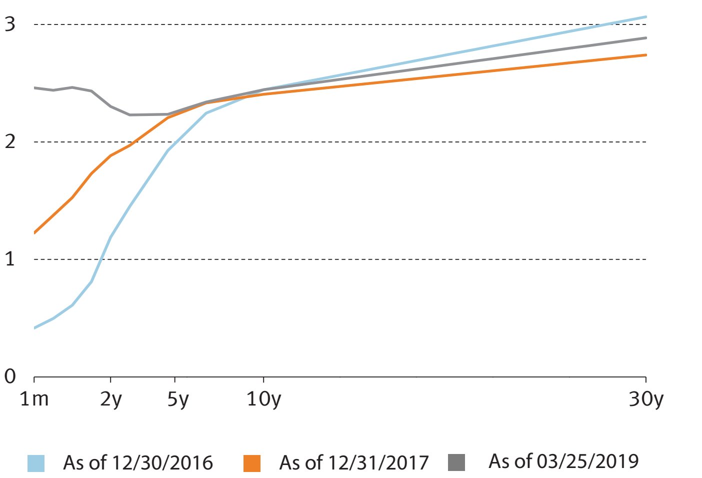


Inadequate capitalisation of European banks

This is compounded by the fact that a large proportion of the equity of European banks is invested in national government bonds. Even small price fluctuations in these bonds have a significant impact on the solvency and creditworthiness of European banks. Moreover, the high proportion of non-performing loans in banks‘ balance sheets, coupled with political uncertainties, means that the volume of credit is growing at a below-average rate. To counteract this, the European Central Bank must provide the capital markets with additional liquidity. This keeps money market rates artificially low. Only structural reforms that lead to stable, higher economic growth would allow real European interest rates to rise.

Current Topic 3:

Yield of US government bonds in per cent



In the late phase of the economic cycle

In order to judge the interest rate environment over the next 6 to 18 months, an assessment of the global business cycle must be made in addition to structural considerations mentioned above. In recent months, various leading indicators have signaled a slowdown in global growth momentum. We are currently in the late phase of the economic cycle. This is suggested by the US yield curve, for example, which is now almost flat. In the past, the inversion of the US yield curve was regarded as a reliable indicator of an impending recession. In our view, this means that the probability of an imminent rise in the pan-European interest rate level, including Switzerland, remains low.

Knowledge & Experience:
Precious metals as an alternative asset class

Knowledge & Experience 1:

Source: World Gold Council

Gold supply/demand in tonnes

Demand creates its supply

In an environment of historically low interest rates and rising prices of financial assets, alternatives to equities, bonds and real estate are in demand. One investment alternative are precious metals. Precious metals have always been in demand. The demand for gold, for example, has been unbroken for years. Since 2010, more than 4'000 tonnes of gold have been demanded every year. Gold is primarily used for jewelry, serves investors as a physical investment, for industrial production or as reserves for various central banks. The supply of gold covers this demand to almost the full extent. It is primarily composed of newly extracted and of recycled gold. If the demand for gold rises, its supply is increased with a time lag, but if it falls, the supply of gold is reduced.

Knowledge & Experience 2:

Gold price per troy ounce in USD

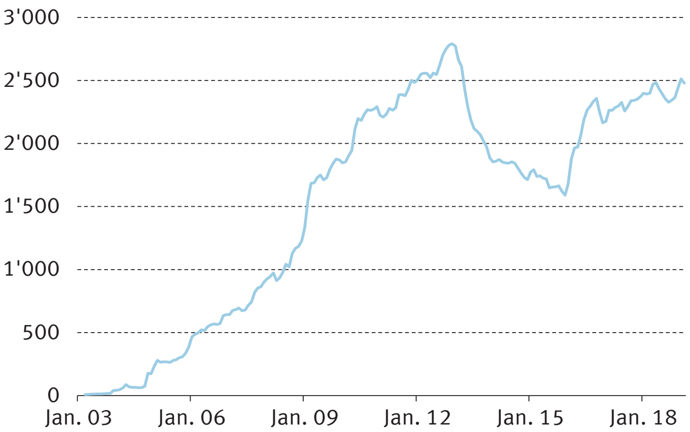
The brilliance of precious metals

Precious metals such as gold, silver and platinum can be traded on the stock exchange using derivatives. Trading takes place in USD. In addition to price risk, the CHF investor also bears an exchange rate risk. On the other hand, precious metals, especially gold, are regarded as a protection against inflation. What all precious metals have in common is that they do not generate any periodic income, i.e. they do not distribute dividends or coupons. Prices for precious metals have been volatile in recent years. Valued at USD 288 an ounce at the turn of the millennium, the gold price rose above USD 1'900 in 2012. Gold is currently trading at USD 1'300, with a rising trend. At this level, gold seems to be attractive to us as a diversifying portfolio asset.

Knowledge & Experience 3:

Source: World Gold Council

Gold physically deposited in ETFs in tonnes



Gold in the portfolio - physical or synthetic?

Gold has a special advantage over all other precious metals. Traded physically, it is exempt from Swiss VAT. Physical gold is available in the form of bars of various sizes or in the form of gold coins, such as the Vreneli. The larger the gold bar, the lower the transaction fees. Gold coins also have the advantage that they can have a certain collector's value. Exchange-traded funds (ETFs) are an alternative to physically hold gold. Their price moves with the price of physical gold in perfect synch, with very low fees at the same time. A majority of ETFs hold bullion physically. In recent years, the amount of physically held gold in ETFs has increased significantly.

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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Contact: Dr. Uwe Heller, CFA

Dreyfus Sons & Co Ltd, Banquiers
Aeschenvorstadt 16 | P.O. Box | 4002 Basel | Switzerland
Telephone +41 61 286 66 66 | Fax +41 61 272 24 38

contact@dreyfusbank.ch | www.dreyfusbank.ch