

Investment Strategy

The less hawkish stance on interest rates by the Federal Reserve Bank (Fed) and a comeback of the Oil price ignited a strong rebound of global stock markets, which erased the worst start to a year ever. Nonetheless, we still see several risks, leading us to position towards mainly capital protection strategies and neutral currency exposures.

A first risk is the **recent disappointing US economic data and inflation running at four year highs**. The Federal Reserve Bank has put itself in a difficult position, making it vulnerable to a policy mistake. If the FED raises interest rates too soon it risks a higher US dollar, pressure on emerging markets and deflating asset prices. If it keeps delaying higher rates it basically continues to inflate asset prices, provoke even higher debt levels and create serious credibility issues with global Central Banks.

A second risk is that the recent **Chinese stabilization could be more short-lived** than expected. Chinese policymakers have to maneuver through supporting growth while at the same time supporting reform and rebalancing the Chinese economy. The Chinese stimulus may also prove to be less effective in improving consumer demand.

One contributor to the stabilization in China and Emerging markets has been the **weaker US dollar and receding expectations of a US rate hike**. But these may well be temporary. Financial markets probably underprice the risk of Fed rate hikes over the next year or two.

Political risks in Europe are high and rising. The UK's upcoming EU referendum (June 23) remains a key uncertainty for the coming months and we believe a "Brexit", if it happens, would be a major negative in economic and political terms for the UK and EU as a whole. We still think the probability of the UK leaving the EU is low, but one cannot ignore it in risk management. There are other sources of political uncertainty in Europe, with new elections due in Spain, high support for non-mainstream parties in countries including Austria, France, Italy, the Netherlands, Sweden, Denmark, Hungary, Poland and Slovakia, and rising non-mainstream support even in Germany.

Another more immediate risk to equity markets are **high valuations** in the US and Europe in combination with the current low growth environment. These valuations cannot be maintained unless the global economy delivers higher growth and corporate profits start to rise again, which still has to be seen.

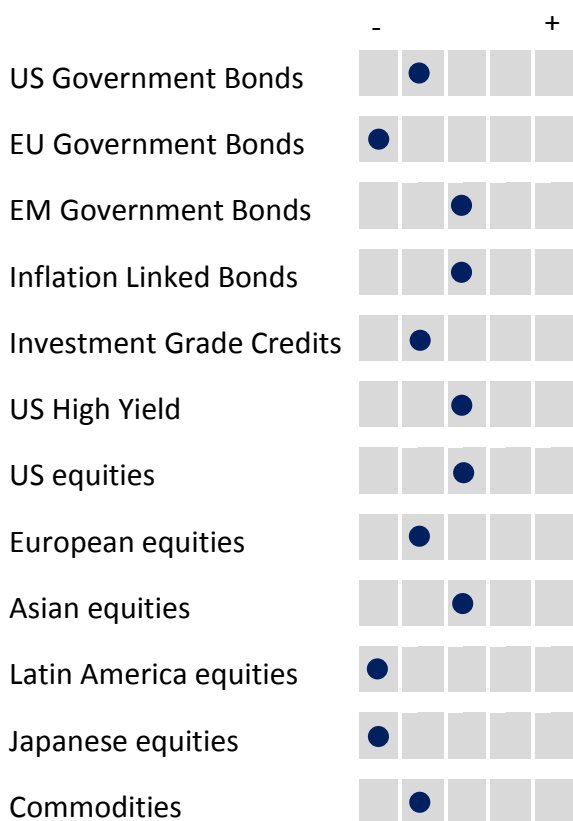
- The US stock market is currently priced at a P/E of 18.95, a 15% premium compared to its 10Y historic P/E;
- The DAX, the German stock market index is currently priced at a P/E of 20.36, a premium of 16.5% compared to its 10Y historic P/E;

We expect a **volatile summer** as the world cannot cope with a higher US dollar and rates yet. Easy monetary policies have been an important driver for asset prices for the longest period ever. Higher valuations, three years of unproductive corporate

behavior, limits to further easing and excessive borrowing from the future suggest that the market is ahead of itself.

We think the “commodity” risk factor is behind us.

Asset Allocation



Recommendations

1. Balanced portfolios should generally reduce high risk investments, such as equities, in the asset mix to below “Neutral”;
2. High quality stocks paying dividends are the preferred equity investments in the USA, Eurozone and Switzerland;
3. Investments in Japan are to be avoided;

4. Selected emerging economies such as India may be attractive for the higher risk investor;
5. US longer dated investment grade Credits should give capital protection, in case the Fed hikes interest rates to counter potential inflation;
6. With the exception of Inflation linked Treasury Bonds, US Treasuries are to be avoided in the shorter dated maturities;
7. European government bonds are to be avoided. Spreads between peripheral bonds and Bunds may move up if and when Greece returns to the agenda;
8. In a world of higher tax rates & \$9.9tn of negatively yielding debt tax-exempt assets such as US municipal bonds are attractive, along with EM debt;
9. The global high yield index approaches all-time highs, we take some profit as it will be vulnerable in periods of risk off;
10. Physical Gold should give capital protection against negative interest rates and currency devaluations.

Macro-economic environment

The International Monetary Fund (IMF) has recently adjusted **global 2016 growth** from 3.4% to 3.2%, caused by a 2% lower growth forecast for emerging economies. The IMF growth expectations much depend on a better performance in the second half of this year, which we doubt will happen. In the last three years growth for the second half of the year was disappointing. ←

The **US economy** signals a mixed performance. Housing prices have been rising, unemployment is low and the labor

market currently runs at full capacity. Yet Q1 GDP rose just 0.5%, its lowest pace in two years, thanks to lower corporate investments and lower exports. The deceleration comes amid sluggish growth around the world.

The **Fed did not hike rates** in February 2016 for fear of pushing the US dollar value up, while external economies like China and other developing economies went through a slow-down and a currency crisis.

With “full” employment, inflationary pressures from higher wages may return in the US later this year. As happened in the past (under Chairman *Alan Greenspan*), the Fed could end up being too late hiking rates, losing control over the inflation curve and risking higher uncertainty for markets.

Economic expansion in the **Eurozone** is holding up. Q1 GDP rose 0.6%, outpacing US growth. The PMI Manufacturing increased to 51.6 in March while the PMI Services grew to 54. Expanded monetary policy by the ECB has been well received, but there are signs that the trend in EUR depreciation is slowing and that bank earnings are being hurt by negative interest rates.

The European Central Bank's liquidity flush is slowly dripping through to the real economy, recent Eurozone bank lending data showed, adding to evidence that the region continues its gradual recovery.

Yet as neither ongoing growth, nor the announcement of more easing measures flanked by rising oil prices have managed to lift inflation expectations, concerns about the ECB's credibility have resurfaced.

Emerging economies are starting to stabilize. Their respective currencies have devalued enough (on average 45% versus

the US dollar since 2009). The recent lower value of the US dollar has made foreign debt more sustainable. Emerging market bond spreads have been coming down.

The Chinese economy is showing some green shoots; the economy is expanding lead by a better housing market and a surge in exports. Nonetheless, accelerating credit growth is a concern and the renminbi is still overvalued and needs an adjustment.

Commodity including Oil prices moved up remarkably in Q1, helped by a weaker US dollar, less supply and speculative buying. After reaching a price of \$27.81 per barrel on 20th of January, the price of Brent oil rebounded to about \$42 per barrel on the 18th of March, a **jump of more than 50%**.

The joint loss of Oil exporters caused by the low Oil price is estimated at \$450Bn. With the exception of Saudi Arabia, no Middle Eastern country can afford a low Oil price. There is now an abundant supply of Oil, with Iran and Libya increasing oil exports. This should cap the upside to its price.

The World Bank predicts a price of Oil/barrel at \$41 at the end of 2016.

According to the British bookmakers, the risk of a **Brexit** is not higher than 37%. The recent visit of President Obama had a positive influence (“*when we discuss trade we do it with a big economic block like Europe and not separately with Britain*”). An exit would be politically and economically catastrophic for the UK as well as for the Eurozone. Not only the Pound Sterling will be hurt; the EUR as well.

Greece will return on the Eurozone agenda with its financial problems. The outcome is unpredictable.

Generally, we remain skeptical on the latest monetary policy tool pushing interest rates

into **negative territory** with the aim to create inflation. This Central Bank tool, applied by countries like, Japan, Eurozone, Switzerland and Denmark is making markets very vulnerable and risky because of its unpredictability.

This policy may end up pushing “cheap” money into uneconomical investments, increase debt levels and overcapacity, the latter only emphasizing deflation. The longer this process takes the more painful it will prove to “normalize” things.

The Eurozone

The economic crisis that has ravaged the Eurozone reached a new stage at the end of April. Recent data confirmed that the overall economy of the 19 countries advanced 0.6% in Q1 this year. That gain, equivalent to an annual growth rate of 2.2%, brought the Eurozone’s GDP (total value of goods and services) to above the previous peak reached in the early months of 2008. It took Europe eight years to return to this peak; it took the US only four years.

The recovery in Europe has been uneven with Spain, Italy, Portugal and Greece still not back to their previous peak.

Europe’s jobless rate is still 10%, double the US. Disposable income in Italy shrank 4% from 2008 to 2014. Greek households lost 24%, while Germany at the same time gained more than 15%.

Helped by a lower EUR, surrendering 28% of its value against the US dollar since the summer 2008, exports have become the main engine for growth.

However exports face global challenges from competitive currency devaluations and lower demand (China) putting more pressure on France and Italy to sort out their mess.

In addition, a rapidly aging population is likely to constrain Europe’s fortunes.

The US Economy

Leading indicators in the US have been good, especially job creation (average of 225’000 workers per month since the start of 2015), jobless rate (5% at an eight-year low) and wage growth (2-2.5% since expansion began mid-2009).

Recent reports on **household confidence** have been mixed. The top concern is the slowdown in economic growth (Q1 GDP just rose 0.5%) and if it will result in a slower pace of income and job gains. Uncertainty regarding future economic policies is growing in view of the outcome of the presidential election.

US Core inflation is creeping up and stood at 2.19% at the end of March.

US CPI (ex food and energy) standing at 0.85% at the end of March has also been increasing. This could be a confirmation that economic growth is slowing down.

Average weekly earnings in the US moved from \$859.40 (April 2015) to \$874.79 (March 2016) up by some 1.8%.

Profit margins of US companies have come down from a high of 12.5% and are currently about 10.5%.

For the first 3 months of this year, 55% of the companies of the S&P 500 index that reported results, showed overall earnings declining by an average of 6.1%. Stripping out energy companies, earnings fell by about 0.5%.

Japan’s huge debt

Prime Minister Shinzo Abe’s Liberal Democratic Party has taken structural

economic reforms (*Abenomics*) to pull Japan from a 20-year economic slump.

Despite the creation of huge debts (debt/GDP at the end of 2015 stood at 229%) the Bank of Japan's (BoJ) drive for 2% inflation is losing credibility. Japanese companies are not supporting calls by the prime minister to increase wages (although the jobless rate is 3.3%).

The BoJ recently introduced negative interest rates. The surprise effect has been its impact on lowering long term yields, feeding through to lower mortgage rates. The strong Yen is most confounding. Negative rates should have stimulated buying more foreign assets weakening the currency over time.

Negative interest rates policy (NIRP)

NIRP is the most recently deployed weapon of Central Bankers in their long campaign of financial repression - a deliberate policy of depressing interest rates in order to transfer wealth from savers (private citizens) to debtors (largely governments). Financial repression is intended to improve near-term growth by encouraging consumption and discouraging savings.

Central Banks of Japan, Switzerland, Sweden, Denmark and the Eurozone have all introduced NIRP. Today, an estimated 25% of all outstanding government bonds in the Western World are now subject to NIRP. The USA and China have yet to employ it.

NIRP is controversial among economists. There is doubt whether this policy will encourage consumption. More importantly, NIRP complicates investment policies and returns of pension funds and insurance companies. It effectively has reduced the number of investable asset classes,

eliminating Bank deposits and short dated Government bonds or Investment grade Credits.

NIRP attacks the preservation of Private wealth, especially of the older generations.

The "safety trap"

Exxon Mobile just lost its triple-A ranking (falling oil prices and mounting energy sector debt). This leaves Microsoft and Johnson & Johnson as the only two American companies still in the triple-A club. The choice of ultra-safe bonds in today's corporate world has become very small, while investor demand for "safe" assets has exploded. Regulatory agencies demand that financial institutions load up on "safe" assets. Making this imbalance worse, central banks, like the ECB, are now gobbling up safe assets with the aim of loosening monetary policy. The net result is a tremendous squeeze in safe assets. Economics professors Caballero (MIT) and Farhi (Harvard) have labeled this severe imbalance the "safety trap".

Brexit

David Cameron has called for a referendum for June 23rd 2016 to ask UK voters if they want to stay in or leave the EU. According to the magazine *The Economist* the prime minister will have to rely on the opposition Labour Party to help persuade the public; MP's in David Cameron's own Tory party are split in the middle.

A vote to leave would damage the UK economy and it would imperil Britain's security. Britons would be giving up membership of a powerful club whose actions they can influence better from within. Britain has the largest population of Europe and is the fifth largest economy in the world.

A Brexit would uncouple Britain from Europe, its biggest market. The EU takes up almost 50% of Britain's exports, whereas Britain takes less than 10% of the EU's. As the fifth largest defense spender, a Brexit would loosen Britain's relations with its allies. Poorer, less secure and disunited, the EU would be weaker. Europe's power players would be reduced to Germany-France-Italy; The Atlantic balance between America and Europe would be enfeebled.

Bookmakers seem to have the upper hand in judging what will happen. After the visit of President Obama the probability of a Brexit fell to 37%.

Britain's farewell to Europe is unlikely – barring a surprise. However, if Britain does leave the EU, European stock markets would collapse along with the EUR.

The Investment Committee

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Market Returns

Equity	Q1 2015
MSCI AC World Daily TR Net	-1.5%
MSCI North America NR	1.3%
MSCI EUROPE NR	-7.1%
NIKKEI Net Return	-11.4%
MSCI EM NR	5.7%
SHANGHAI SE COMPOSITE	-15.1%

Bonds	
US Treasury	3.2%
Eurozone Sov	3.3%
Germany Sov	3.8%
USD EM Sov	5.8%
Loc EM Sov	4.6%
USD HY Corp	3.7%
EUR HY Corp	1.9%

Commodities	
ROGERS COMMODITY INDEX	-0.3%
GOLD SPOT \$/OZ	16.1%

Currencies	
USD - EUR X-RATE	-4.6%
CHF - EUR X-RATE	-0.5%
GBP - EUR X-RATE	-7.0%
JPY - EUR X-RATE	1.9%
NOK - EUR X-RATE	2.0%
AUD - EUR X-RATE	0.3%



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