HOVING
& PARTNERS
WEALTH MANAGEMENT

QUARTERLY INVESTMENT VIEW

Issue No. 4/4 4th Quarter 2016

Summary

It is very unusual that both stocks and bonds are expensive at the same time. US median stocks trade at their highest valuations ever, according to Goldman Sachs. Meanwhile, we have HSBC calling for an October 1987 type of crash, a sentiment echoed by numerous other investment banks.

However, there just isn't enough evidence that a major top is developing. Important technical indicators do not predict any major breakdown of the markets anytime soon. The US S&P 500 has been basically locked in a range between its mid-August high and its mid-September low.

On the fundamental side, world GDP is expected to grow by +2.7% in 2017 from +2.2% this year. On the earnings front, it appears that after four years of downgrades, earnings are getting better as reflected in the analysts' earnings revisions. Conditions should improve in 2017, with consensus expectations pointing to a +10% earnings increase in the US and Europe.

It will be interesting to see in the coming days if important technical support zones (2030 on the S&P 500) can hold. Patience has been the correct strategy. Trading the portfolios rarely makes anyone any money. We are close to our target prices on our Buy List.

Investors face a number of events in the coming months:

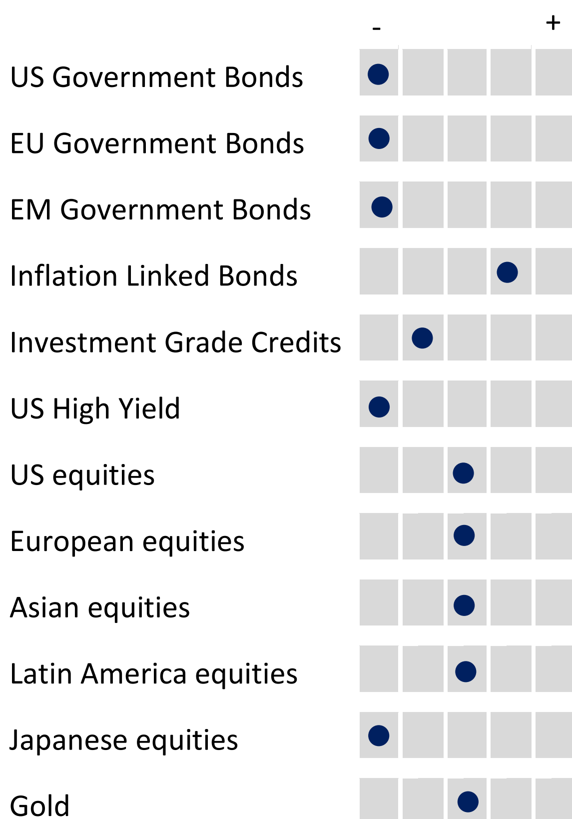
1) US presidential elections and its aftermath, as well as the elections for members of Congress and the Senate on November 8 this year. Markets are pricing in that Mrs. Clinton will win. A surprise win by Mr. Trump may cause markets to correct.

2) The next US Federal Open Market Committee on 13-14 December. We expect the Fed to raise the rate by 25 basis points. Investors can expect a bout of nervousness around mid-December.

3) Inflation. We see the first signs of rising inflation. What will be the impact of rising bond rates on the US Treasury market as well as the European bond market?

4) Elections in the Netherlands, Germany, France and Italy. 67% of the population of the union cast their votes. We expect these votes to have wide implications for local stock markets.

1. Asset Allocation



Our sense is that we are transitioning from an interest rate-driven secular bull market to an earnings-driven secular bull market. We have a slightly higher economic growth outlook with some inflation. Monetary policies by Central banks are becoming less effective and the pressures on governments to introduce more fiscal policy measures to counter low growth is increasing. After ten years of a deflationary environment we expect inflationary pressures to return impacting salaries and purchasing power of the consumer in the developed world.

We do not expect much upside for equity indices as a whole but there will be large divergences of performance on sector level.

Sector rotation will take place, or is already taking place, out of interest rate sensitive investments into more cyclicals.

We would recommend reducing equities trading like bonds – such as consumer staples - as they are as expensive as bonds. We would increase equity positions in European insurance and construction, energy, US infrastructure companies and emerging markets.

We would shorten the average duration of bond portfolios, sell government bonds and Credits, and keep or Buy inflation or index linked bonds. We would Hold Cash in American T Bills with various short term durations (1W, 2W, 3W. 4W).

Although we remain positive on the USD we hedge an overexposure against the EUR. We keep our hedge of goldminers and Cash against a disappointment in growth or monetary policy mistakes.

We remain positive on several secular growth themes; **1) Software** should receive a core exposure as companies are continuously cutting costs and manufacturing will become more software based. **2) Security** is a major issue and increasingly present to governments and large multinationals. **3) Payment systems** will undergo material changes moving from physical to digital. **4) Monitoring** and **connectivity** are getting increasingly more important as machine to machine communication takes off in sectors as healthcare and automotive.

2. The end of Globalization?

The Brexit vote, the rise of Donald Trump, the parliament of Wallonia voting against the EU-Canada Trade Agreement and the rising popularity of extreme right or left wing parties in the Netherlands, Austria, Germany, France and Spain are **"protest"** movements against the established political order. We believe globalization, one of the corner stones for global growth in the last 30 years, may have to cede place to more **protectionism** as a result of this political movement.

Globalization is in conflict with Nationalism, national self-determination and democracy. Harvard economist Dani Rodrik in his book the *"Globalization Paradox"* reminds us of the importance of the nation-state, arguing forcefully that when the social arrangements of democracies inevitably clash with the international demands of globalization, national priorities should take precedence.

Are we not hearing similar noise from within the euro area?

It is true that globalization has reduced the wealth gap between countries of which Asia benefitted the most. On the other hand, globalization has also increased the wealth gap within countries. Disposable income of the middle classes in the US or Europe have declined in the last ten years, while Wall Street and CEO's of large multinationals have made bundles of money even during periods of mediocre performances. The western worker sees more and more injustice in globalization and votes accordingly.

The anti-globalization campaigns should not be taken lightly by stock markets as this phenomenon may impact global trade policies hurting global growth. But we may also see more local capital investments by companies instead of going abroad. **Taxation** will definitely change and large US corporations will feel the pressure to repatriate money and to become more tax "patriotic". Too much cash should lead to increased **M&A activity**.

3. The United States

Donald Trump or Hillary Clinton?

The last minute Brexit vote took us all by surprise and we would be equally surprised if Donald Trump wins to become the next president of the USA (the US polls give him only 7% chances to win). We expect the race to be very close. Whoever wins, the election campaigns were a show of bad taste. Decision makers across the globe must wonder what to make of this once proud country.

The US security markets have priced in that Hilary Clinton is going to win. A win by Donald Trump is not priced in and we would expect Wall Street to bow to the unknown factor with a declining stock market.

The US economic cycle in overtime

The current American economic cycle has been going for about 87 months starting in June 2009 making it one of the longest on record. The longest cycle was 120 months (March 1991-March 2001). The current cycle might continue and beat the longest on record. In that case, we would have another 30 months or 2.5 years of economic expansion in the USA. The current cycle, at least in its early stages, was supported by a very long period of highly unusual and accommodating monetary policies. Full employment and long term employment on decline accompanied by well-timed and moderate Fed interest rate moves should support the continuation of an annual 2-3% expansion. In this scenario, the US$ should not get too strong.

This goes counter to the views that a US recession (two quarters of negative growth) is around the corner. In our positive view, economic support will also come from a re-born euro area, where growth has returned with a joint output now greater than when the financial crisis began in 2007.

4. Monetary policies

Euro area Government bonds have dominated financial markets with **nominal yields below Zero**, touching about 50% of the European government bond market. Mr. Draghi's monthly bond buying program has been successful in bringing down rates across the euro area, even in the periphery where economies face relatively more headwind. It is expected that Mr. Draghi will stop his bond buying program in March 2017, the first step to "Normalization".

The Fed is expected to raise rates in December 2016. US$ interest rates have bottomed and we expect that we are entering a period of rising interest rates across the yield curve. As always, such movements may be more abrupt than gentle. We expect euro area rates to bounce as well, although not induced by ECB policies. Interest rates in the EUR and the US$ have already started creeping up.

The **era of easy money** by Central banks in the western world is probably soon behind us. This is good news for private saving accounts, pension funds and insurance companies.

5. Investment results

In this unusual economic environment, investors were more preoccupied with preserving their capital than taking risks. This explains why they accepted negative yields in the first place!

Investors have been chasing yield or income producing assets, no matter the increased risks associated with these strategies and invested in Bond-like equities or high yield bonds and EM bonds. This crowded strategy has paid off because the joint effort by market participants forced prices higher in Q3 this year.

Despite the wall of worries, Q3 equity markets turned out to be better after all. The MSCI World index scored a return of +2.9% (EUR) led mostly by the soaring come-back of Emerging markets (+6.8% in EUR) and more specifically Asia (ex-Japan) (+7.8% in EUR).

In the meantime cheap money probably has led companies to borrow too much which might lead to **corporate defaults**. These have been rapidly increasing in the US (shale gas companies). The same is true for private debt in emerging markets which grew from 75% to 125% of GNP since 2009. In China, debt tripled among mostly state enterprises. The square meter price in Shanghai is now two times the one in Manhattan.

6. Risks

Our **positive** scenario is not without risks as it is based on positive global GDP growth coupled with a return of mild inflation and no overshoot of interest rates. Central banks would welcome inflation but not if it is coupled with little to no global growth.

The **stock market risk** is high. Valuations are dear and can only be justified if EPS growth picks up, especially in the US.

The risk of **US$ interest rates moving up** too fast is high. This would hurt stock valuations and may even cause a substantial stock market correction.

The other financial risk would be **inaction by the Fed**, confusing the markets. In the absence of a rate hike by December this year, investors would have to assume bad economic news.

Political risks are still plenty in number. The political situation in the Middle East remains dramatic. The failure of US policy in the area is the result of a long streak of errors allowing Russia's come-back on the political front.

Brexit will be an expensive exercise for the British (the British are now discussing the ownership of 50'000 bottles of wine in the cellars of the Brussels HQ of the union). The British economy is in fact doing quite well at the moment but probably the result of past policies and this situation should continue provided the exchange rate remains favorable.

Our **biggest economic risk** remains the huge amount of global sovereign debt (see our last quarterly review for more details).

Your Investment Committee

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