HOVING
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WEALTH MANAGEMENT

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Base Case Scenario

Our short term tactical indicators indicate a continuation of market corrections which started in June this year. Current markets are not supported by attractive valuations. Lack of liquidity and sudden panic can cause sentiment to change negatively further.

However, later in the year, we expect markets to calm down and our technical indicators predict a strong rebound of the main U.S. stock market (SPX rising to 2600).

Central bank tapering announced by the Fed for the end of the year going into 2018 will influence liquidity with consequences for asset prices in general. Investors may be too complacent at the moment underestimating the Fed's aim to normalize interest rates.

It appears President Trump's policy momentum has flagged. So far, no plans on fiscal measures or infrastructure projects have been announced, undermining U.S. growth expectations and the value of the U.S. Dollar. The very weak U.S. Dollar is perhaps the clearest reminder that a U.S. recession cannot be excluded in 2018 (we do not believe in this scenario).

A U.S. recession would undermine the announced plans of the Fed. A re-launch of QE accompanied by lower U.S. interest rates can be expected should a recession occur. This scenario is not widely expected.

The strong EUR/USD exchange rate is unexpected in the context of current Central bank policies (the Fed and the ECB). Since the beginning of the year, the EUR/USD exchange rate rose by 10 per cent, while two-year yield spreads between Bunds and Treasuries completely de-connected by rising by about 10 per cent in favor of Bunds.

The strong rise of the EUR may also be partly explained by the return of political stability and a healthier economic picture. The EUR was also under-owned.

The very weak USD is welcome news for American exporters and helps U.S. inflation (imported inflation), but undercuts the policies of the ECB, potentially impacting potential growth of the euro area.

The huge buying program of the ECB did manage to stabilize the volatility of the euro area bond markets. However, this has also liberated enormous money flows passing from one region to the other, increasing foreign exchange volatility as a result.

Central Bank Policies

Ten years after the beginning of the financial crisis (2007), one can say that the credit and bank crisis are behind us. Today, there should be less need for money accommodation and "normalization" of monetary policies is required to sustain long-term growth.

It is also important that insurance companies and pension funds can function again without manipulated interest rates.

And last but least, it is important that marginal companies can no longer depend on the "low interest" life line.

However, Central bankers seem to have ambushed themselves into a Catch 22 situation: they have very little room to maneuver to normalize monetary policies, as tightening rates at this stage of the economic cycle may still kill growth momentum.

Why tighten rates when inflationary forces are low and why is U.S. inflation so low despite full employment?

It is remarkable that wage inflation seems absent not only in the U.S. but also in the euro area. Asia and South America are practically the only regions with real wage growth.

Although somewhat puzzling, there clearly are factors making the outlook for jobs more uncertain, such as automatization, artificial intelligence and robotization.

Deflationary forces or lowflation are omnipresent in the system as a result of high debt, demographic factors, overcapacity and economic imbalances. Deflationary forces are usually more structural. To jack up interest rates in a deflationary environment may take much longer

Higher interest rates

Sooner or later the interest rate cycle will change leading to steeper yield curves globally. We predict this based on:

1. Global growth should improve. The global economy is now running on all cylinders growing synchronously in the U.S., euro area, Asia, China and Japan. Globally, profit growth should accelerate as a result.
2. USD interest rates are near a historic bottom and for the first time in years or even decades it seems possible that USD interest rates might rise and keep on rising based on advanced plans of the Fed to allow its balance sheet to run off at a gradual and predictable pace. "Do not fight the Fed" is our motto.
3. If USD interest rates rise, euro area interest rates can be expected to be dragged along to much higher than current levels. Euro area bonds are not yet priced in for this to happen and it would counter Mario Draghi's accommodating monetary policies, potentially disturbing the euro area recovery.

The U.S. Dollar

EUR / USD exchange rate should peak soon. The strong EUR is untenable and this year's 10 per cent rally should correct itself later this year. Today could be a good moment to buy USD against the EUR. However, going into next year, the EUR should get renewed support from a combination of narrowing interest rate spread; superior euro area economic growth, the euro area trade surplus and the beginning of ECB tightening.

Bond Markets

In its latest FOMC meeting the Fed hiked the Fed funds for the third time in the last six months by 25bp to 100-125bp. The Fed also announced it would start trimming the Fed's balance sheet ($4.5tn) from the end of the 3d Quarter 2017 up to the end of 2018. It is estimated that during that period the Fed's balance sheet will be reduced by $410bn or the equivalent of about 10 per cent (considered equal to a rate hike of 25bp). Both measures aim to tighten liquidity and are a dramatic 180 degree turn in U.S. monetary policies.

There is a lot of concern about the potential negative economic consequences in unwinding the Fed's huge balance sheet.

The impact of the Fed's rate hike was immediate with Treasury yields rising by more than 20bp with longer dated maturities. German Bund yields also went up immediately, maintaining the yield spread of about 175bp between the U.S. Treasury and German Bund curves. When the Fed Fund hike was announced by the Fed, the EUR/USD stood at 1.1150 (14 June 2017). At the end of June, the EUR/US$ had moved up to 1.1425. The adverse reaction by the currency markets seems more based on diminished growth expectations in the U.S. as a result of the rate hike. The impact on the U.S. stock markets was benign.

The ***debt ceiling stand-off*** is approaching in the middle of a Fed tightening cycle (October). The tightening adds an edge to the risk of the U.S. technically defaulting.

Bond volatility (U.S. Treasury and euro area bonds) is expected to increase considerably by Q4 2017 going into 2018.

Table 1: Bloomberg consensus 10Y Yields

	30/06/17	30/06/18
U.S. 10Y yield	2.47%	3.51%
Bund 10Y yield	0.32%	0.89%

The euro area government bond market is not expected to decouple from the U.S. Treasury bond market and should follow the same pattern of rising yields.

Note that the Bloomberg consensus expects Bund yields to rise faster (in %) than U.S. Treasury yields. In both cases, potential losses on bond positions could be significant, but – unexpectedly - losses on Bund positions could be much worse with a dramatic destabilizing impact on European financial markets, next year.

Mario Draghi, although sounding slightly more hawkish, has confirmed to maintain the ECB's buying program of €60bn per month at least until the end of this year. Trimming may begin at the end of Q1, 2018. The ECB may start hiking interest rates by Q1, 2019.

The mandate of Mario Draghi as ECB President ends on the 1st of November 2019. His replacement by a German banker is widely expected (Jens Weidman?). Under a German president the ECB can be expected to follow much more hawkish monetary policies. This does not bode well for Italian government bonds, but Spanish government bonds may manage to stay out of the picture.

We are not buyers of bonds in balanced portfolios, except for special situations such as bank lending or local currency EM government and corporate bonds. For example, the Mexican Pesos government bonds are attractive, yielding >8% with a relatively short duration.

Equity markets

With the exception of the London equity market in the 1st six months, Europe outperformed the U.S. equity markets, with the latter showing negative returns in EUR. In fact, without the "big five" technology stocks Wall Street's performance, this year would have been mediocre in USD and bad in EUR terms.

The MSCI World AC Index returned about 3 per cent in EUR. Frankfurt (+7.35%) showed the best return in Europe.

While the Fed's actions – if enacted - should potentially impact the U.S. bond markets directly (and indirectly euro area bonds), the good news is that profitability of companies is still reasonably solid in the U.S. and growing in Europe and Asia. This should enable equity markets at least to escape the negative impact of the first rounds of tightening by the Fed.

Wall Street analysts expect a year-over-year rise in S&P 500 earnings of 6.5 per cent for the Q2, 2017 earning season. Adding the uncanny ability of most companies to beat market forecasts by about 4 per cent, we may be seeing another quarter of about 10 per cent profit growth.

This should support the ageing U.S. bull run now in its ninth year, although the U.S. stock market remains very tricky. We have to see if the high performing technology stocks, which were responsible for much of Wall Street's performance this year, can sustain their impressive growth paths into next year.

A weak U.S. Dollar could be the savior for the S&P 500 in 2018. If the USD remains weak much longer, a switch from Eurozone to U.S. equities may be worthwhile to consider.

Table 2: Stock markets

	Q1, 2017	Q2, 2017
MSCI World (€)	+4.39%	- 3.05%
MSCI EM (€)	+9.91%	- 0.31%
S&P 500 (€)	+4.58%	- 3.38%
NASDAQ (€)	+8.59%	- 2.33%
London (€)	+3.85%	- 1.84%
Frankfurt	+7.25%	+ 0.10%
Amsterdam	+7.41%	- 0.23%
Paris	+5.58%	+ 2.23%
USD/EUR	- 1.27%	- 6.75%
Brent Oil (€)	- 8.33%	-14.98%

Oil is down 19 per cent this year, with a very negative sentiment. However with an improving global economy we may see a strong rebound in the price of oil. Supply/Demand remains uncertain and our view is not fundamental for higher oil prices, long term. But US$60/barrel is a possible target at the end of 2017 according to our technical analysis. We believe energy stocks could be a black swan (speculative Buy).

Commodity companies (Anglo American, BHP, Vale and Rio Tinto) should stage a come-back: Chinese iron ore imports are on track to break last year's annual record. If the buying level of the first six months is sustained, China will import 1.024bn tons of iron ore which will be a boon to big suppliers in Australia, Brazil and South Africa.

After paying nearly US$200bn in fines, ***U.S. banks and insurance companies*** now have stronger balance sheets than before the crisis. Financial health has yet to return to euro area banks, in particular in Germany, Italy and Spain.

U.S. banks beat forecasts of 2nd Quarter profits with JP Morgan Chase presenting the highest ever haul of quarterly profits (US$7bn). Citigroup hailed its best investment banking performance in seven years.

Financial markets, however, were unimpressed and the S&P 500 bank stocks index dipped as much as 2.4 per cent. This cautious reaction is a sign, in part, of how much expectation for the financial sector has risen since Donald Trump's election spurred hopes of a more bank-friendly environment.

Weakness in bond trading due to absence in volatility and tighter standards in car loans were a source of lower profits. Rising Treasury bond yields continue to be the prime source for U.S. banks to make money.

The current Fed monetary policies favor bank stocks although much has been priced in. Buy U.S. Financials on weakness.

The continuous presence of the ***Draghi Put*** should continue to be supportive to the European stock markets until the end of this year and probably further into 2018. Not only are European stocks generally cheaper than Wall Street's, supported by lower interest rates, the European economies are also going through a stronger revival across the euro area.

China should attract new money inflows having become a member of the MSCI club. Chinese High Tech companies remain attractive, such as: Alibaba Group Holding Ltd: E-commerce or Tencent Holding Ltd.: Media, entertainment, payment systems, internet and mobile services.

We remain positive on several ***secular growth themes***, previously mentioned in our quarterly reviews:

1) Software & Robotics should receive a core exposure as companies are continuously cutting costs and manufacturing will become essentially 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.

We expect the ***best performing equity sectors*** in the coming months to be: euro area Financials, small capitalized companies and cyclicals; industrials in Japan (Yen hedged); China High Tech; U.S. Energy; UK Commodity companies.

Asset Allocation

	-				+
US Government Bonds		●			
EU Government Bonds	●				
EM local currency Credits				●	
Inflation Linked Bonds		●			
Investment Grade Credits		●			
US High Yield			●		
US equities		●			
European equities				●	
Asian equities				●	
Latin America equities			●		
Japanese equities				●	
Gold		●			

Political & Economic risks

The rising populists in the Netherlands, Austria and in France have been pushed back by centrists, bringing a welcome stability to the euro area. After the election of ***Emmanuel Macron***, we can potentially see the introduction of reforms that step up activity to lift lackluster growth in France and the euro area.

The outcome of the ***Brexit*** negotiations is not expected before 2019. The last election did not give Theresa May majority; instead she had to make a deal with the DUP, the ultra-right Northern Irish party founded by reverend Ian Paisley. Brexit will cost the British taxpayers a fortune and it risks undermining the UK economy for many years to come. Inviting the British population to another Brexit election would be sensible, but this seems unlikely to happen.

Companies will continue to look for opportunities to minimize disruptions after Brexit. EasyJet is a good example; announcing that it will establish a Vienna-based airline (“EasyJet Europe”).

The biggest economic risks must be ***policy mistakes by Central banks*** and the ever increasing ***global debt*** situation. In addition, ***“over-regulation”*** has become an enormous burden to entrepreneurship and innovation.

Central bank low interest rate policies incentivized governments to maintain ***unsustainable debt levels***. But even worse despite the low rates, government debt still has increased in most countries in the last ten years (even Germany).

The biggest political risks are with ***North Korea*** with Supreme Leader Kim Jong-un following confrontational policies with the rest of the world and especially the U.S. government.

The conflict is extremely delicate with China not committing itself and also considering the ***inexperience of President Trump***. North Korea disposes of long-range ballistic missiles capable of delivering nuclear bombs.

It is very well possible that the U.S. attacks North Korea with a preemptive strike.

Student loan debt in the U.S. has been rapidly growing since 2006, rising to $1.4tn by late 2016, roughly 7.5 per cent of GDP (2016:$18.568tn). The amount of student loan debt today has probably surpassed the amount of credit card debt held by Americans. Forty three million have student loans with an average balance of $30'000. Nearly twenty million Americans attend college each year. 60 per cent borrow annually to meet expenses. This looks like a bubble in the making (similar event leading to credit crisis in 2007-2008). This Sword of Damocles could drag the U.S. into the next financial crisis.

The ***U.S. car loans debt cycle*** has also entered dangerous territory. The fear is that especially low credits are getting too easy finance and default rates are on the rise, in an environment where the value of the collateral is dropping.

Traditionally, official ***inflation numbers*** exclude housing prices or stock market movements.
But, these are important factors when measuring wealth or purchasing power. Nevertheless, official inflation numbers mostly deal with payroll numbers and house rent. In the last few years it is the rising housing and stock markets that made Americans wealthier (and elsewhere). Alan Greenspan, former Fed chairman, did consider these factors when he pulled the plug and hiked interest rates, calling his reason ***"irrational exuberance".*** The Fed is perhaps revisiting this view within the normalization process of U.S. monetary policies.

The Investment Committee

Michael Hoving
Jan-Paul Menke
Michiel van Wulfften Palthe

Hoving & Partners S.A.

30A, Route de Chêne

1208 Geneva

Switzerland

Authors

Michael Hoving

Jan-Paul Menke

Enquiries

Website
www.hovingpartners.ch

E-mail
jpm@hovingpartners.ch

Telephone
+41-22-544 12 90