HYPOSWISS
ADVISORS

Review & Outlook
Q3-2019

Review and Outlook

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Q3 2019 Review

US-China trade tensions still dominate the markets

Trade tensions have sent shock waves over the last few quarters, they did again in Q3 2019 - particularly in August - and they will produce further turmoil going forward. Another major event for markets was the missile attack on an important Saudi Arabian oil field on September 14th which temporarily raised the oil price by more than 15 % - however for one day only. The assault sent equity markets down for a few days, the USD appreciated in line with his role as a safe haven currency, and surprisingly, gold did not move much on the news.

In the end, equity markets were flat in Q3 2019, after dropping around 5% at the beginning of August on the above mentioned trade war news, but most major markets managed to close the quarter slightly positive, with the MSCI World gaining 0.23% and the leading S&P 500 moving up by 1.22%, thereby again outperforming the rest of the world.

S&P 500 Index – 01.01.2019 – 30.09.2019
Source: FIS Market Map

Another lasting new development during Q3 happened towards the end of September with the launch of an impeachment inquiry against President Donald Trump. As of now, it seems rather unlikely that Mr. Trump will be removed from his office as the Republicans dominate the Senate, but the process as such, will create uncertainty in the markets over the coming months and may overshadow into the election year.

Fixed Income

Central banks actions drive the market

The USD 10 year treasury yield dropped in Q3 from 1.96% to 1.68% at the end of the Q3, reaching is lowest level on September 4 at 1.43%, whereas the US Fed rate was reduced from 2.25% to 2.00%, in line with market expectations.

Central bank interactions will likely remain the main driver of the bond market. One third of all outstanding US Treasury debt (USD 5.1 trillion) sits with the FED, either owned by itself or held on behalf of foreign central banks. The Bank of Japan has even acquired more than 40% of the outstanding Japanese government debt since 2013 and the European Central Bank (ECB) will get there soon when it purchases European government debt ad infinitum, as it recently announced.

Since 2015, the ECB continues to deprive bond investors of income, with only a few months interruption in 2019. These purchases certainly helped to bring down bond yield levels substantially and did lower the cost of debt servicing for the member states. This trend is likely to continue going forward and allows treasurers to refinance their debt at 0% or even below.

One does not want to think about what will happen one day in the distant future, when interest rates will be back to their old historically 'normal' levels of 3% - 6% and the ability of certain debtors or governments to still cover their interest expenditures with actual future rates.

We are still overweight in the Fixed Income asset class in USD bonds and therefore did profit from rising bond prices. Next to the core holdings of government and high quality corporate bonds with investment grade ratings, we prefer high yield (HY) bonds to long-term duration bonds to generate higher returns with acceptable risk. In the current interest rate environment, we think duration risk is higher than default risk, if managed and surveyed properly.

> "Luck shouldn't be part of your portfolio."
>
> Expect the expected

Equity

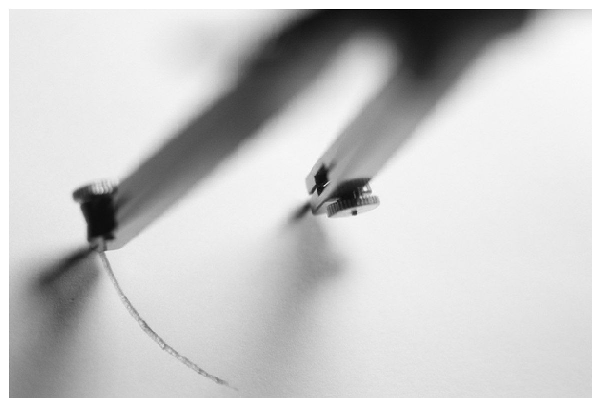
Equity markets still hovering around all-time highs

While equity markets are close to their all-time highs, many investors are still holding large cash positions and are thus missing out on one of the greatest bull markets in history, lasting more than 10 ½ years already. In the US, this is reflected in fund flows into equity mutual funds, which continue to be less than those into fixed income funds, and even faced a net redemption of 0.7% of assets under management. Fund flow data is of course only one measure of equity flows, but has been a useful contrarian indicator in the past.

Earning growth remains the long-term driver for equities next to the lack of compensation from depressed bond yields which make investors return to risky assets that offer a generous risk premium. For the first time since 2016, dividend yields on the S&P500 index are higher than the US 10-year Treasury yield, which has been a reliable buying indicator in the past.

Attention will soon turn to the 2019 Q3 earnings season and thereafter could shift to 2020 earnings expectations. Fortunately, investor sentiment remains cautious unlike in Q2 2019 ahead of the May declines. We see a certain trend towards value stocks which have been laggards the last few years. They were clearly dominated by the technology stars ('FANG' stocks) and we think the record high valuation discount of value stocks relative to growth stocks is unjustified.

The launch of the impeachment investigation against President Trump by Democrats is in our view a non-event for equities at this point, as the risk of an impeachment is limited and it is more a sign that the election campaign has now really started. Right now the strong economy in combination with the low unemployment rate both support a second term for Trump, however another uncertainty next to the trade war is now looming over the markets.



Currencies

The global cyclical slowdown is prolonging the USD rally

In times of slowing growth and below-trend inflation, all major currencies in Q3 did depreciate again against the USD. The support for the USD might dwindle in the next 12 months, as more rate cuts should lead to an expected pickup in economic activity. As the US FED has more room to bring down rates

compared to other central banks, the interest rate advantage of the US dollar will continue to decline. For the moment weak global growth momentum is bullish for the USD as the currency can rely on its status as a safe haven.

Looking more into the future, the structural outlook for the US dollar remains still bullish given the continued superiority of the profitability and earnings dynamics of US companies compared to their European counterparts.

This would of course all change should there be an economy-unfriendly surprise in the upcoming polls for the 2020 US election not to mention at the election itself. Elizabeth Warren for example has on her agenda more regulation especially in finance, tax increases for wealthy individuals and a lower dollar among others. Needless to say that the possibility of her being elected will be bearish for the USD, regardless of what will really happen afterwards.

Economics

Will the global economic backdrop bottom out in early 2020?

The manufacturing recession shows some signs of bottoming out, but too much optimism was clouded by the purchasing manager index for the USD, which dropped into contraction territory. Another key measure of the US economy was the payroll report on October 2nd which revealed that the pace of hiring is easing as the labor market continues to tighten. Companies hired an additional 135'000 workers in September, a slowing from the 157'000 hiring during the previous month and what more, the August numbers were revised sharply lower, as there were 195'000 more workers previously reported for the month.

Therefore, setbacks may still be possible, as the cyclical downturn stretches in the fourth quarter, but concerns that the manufacturing recession could spread into the wider economy have been delayed by indicators relating to other sectors, which show a strengthening, particularly in the US.

Most market hopes currently rely on policymakers supporting the delicate bottoming out of economic activity and bringing about a rebound. Central banks did deliver in September by further rate cuts from the FED, the ECB and various emerging market central banks leading to a climax in monetary easing for the time being. Fiscal stimulus as the other major political tool however will not be possible as President Trump would have a hard time convincing the Congress to implement some fiscal stimulus measures (like higher spending on infrastructure projects) after losing the House of Representatives in last year's midterm election.

China in the meantime was celebrating its 70th anniversary on October 1 with an impressive military parade and rises in the September PMI (Purchasing Manager Index) data. The non-manufacturing PMI also continues to show an expansion, albeit at a slightly slower pace. It is noticeable that new export orders continued to rise despite the trade war, in all likelihood because exports were routed to neighboring countries.

Commodities

The economy matters more for oil than the Saudi attacks

The sudden attacks on the main Saudi oil fields shocked the oil market, reminded investors of its fragility and raised geopolitical uncertainty – for a few days only. Ample inventories and spare capacities helped to weather their disruption and oil flows recovered swiftly. The attacks temporarily lifted prices – Brent Crude surged from around $ 60 to $ 71 – but two weeks later, prices were back to where they stood before the attacks. Oil producers did ramp up drilling - they always seem to do when prices are above $60 per barrel - and this oversupply is built in an environment characterized by a soft economy and decreasing demand for oil. Consensus estimates for the growth in world oil demand have incrementally come down to almost one million barrels per day for 2019. What this shows is that the economy matters more for the longer term trend in oil prices than such attacks as we have seen in Saudi Arabia.

ICE Brent Crude oil futures, USD – 01.01.2019 – 30.09.2019
Source: FIS Market Map

Gold had a big run in Q3 2019 by climbing from the 1400 level to as high as $1556 on September 4, 2019, but did retreat in the meantime to below $1500 again. Why gold dropped as much as it did from its highs is hard to tell. It looks like that trend followers and technical traders have lost patience with gold as well as silver, putting pressure on prices. Besides a somewhat stronger dollar, there are no fundamentals to justify such a heavy sell-off.

Surprisingly also, the gold price did not move on the Saudi attack news, which typically should be supportive for the so called safe-haven currency. However, the shaky economic outlook, trade tensions and further monetary easing of western-world central banks are all bullish for

gold and thus the long-term outlook remains positive.

> "Don't let your money work for you. Because it doesn't."
>
> Expect the expected

Outlook

The Q2 earnings season, the FED and the trade war will be key factors

Fixed Income investors should not extrapolate the returns of the past bull market – which lasted for decades - into the future. The 10-year US treasury yield dropped from 15.8% in 1980 to its low of 1.43% in September 2019, producing for bond holders high capital gains on their positions. They should not expect to replicate these returns the next few years. However, such a big secular trend will not change immediately and therefore we still hold significant holdings in bonds but do not expect them to give capital gains. We hold them as a vehicle for capital preservation. It is too early to sell bonds in our view.

Equity holders on the other hand have seen a 9.5% advance on a total return basis in the current decade, as measured by the MSCI World Index, while US equites have outperformed their global counterparts by 110% since 2008. While it is hard to see a prolongation of the bond bull market as seen above, the combination of monetary easing, improved economic growth and the steepening yield curve are all supportive for stocks and the equity rally might therefore continue well into the US election year. The risks remain the unsolved trade war (as before), the push for impeachment of President Trump (new item) and ongoing fears of a recession as the two economic warning signs for both manufacturing and hiring have shown at the beginning of October.

Commodities as well as oil are at this point of the economic cycle not attractive, but gold might profit from further trade tensions and more monetary easing.

On the currency front, the USD rally will most likely continue for the time being, due to its safe haven status and the still existing interest rate advantage.

Although it is not all blue skies in the months ahead for equity markets, we stay invested in stocks along the risk profile of each client with a shift towards value stocks and keep existing bonds for capital preservation. We also still like real estate as a valid income generating alternative and gold as a certain hedge against negative surprises.

Walter Küng

Senior Portfolio Manager

Thematic investment idea

Cyber Security

Investing in a future megatrend

Our world is becoming increasingly connected. Smartphones have long since become standard, smart homes are the next trend, and devices increasingly communicate via the internet. Digitalization, however, does not just connect and make processes easier. Data is also collected and this data is very valuable. If it falls into the wrong hands, it could do a lot of damage. For this reason, data protection and cyber security are becoming a structural megatrend.

Cyber security will become even more important with G5 technology and will present us with major challenges and significant security concerns. Quantum computing also opens up an entirely new spectrum for cyber security, for instance the encryption of bank data.

Companies will need to protect themselves from cyber-attacks which have the potential to do a lot of damage. For example, hackers could take control of medical devices connected to the internet, like pacemakers, insulin pumps or cardiopulmonary bypass pumps which could be manipulated by hackers as production is increasingly being automated. Another example in the field of individuals are hackers who could take control of our alarm systems at home or deactivate the brakes of our cars.

Cyber security is an aggressively growing industry, which has grown 35 times from 2003 to 2016 with 2017 -2021 spending expected to combine for US$ 1 trillion.

For investors, this is an opportunity to invest in a secular trend. We prefer to invest in a diversified basket of securities and have selected proven active funds and ETF's. Should you want to know more, please feel free to contact your Relationship Manager.

Mission Statement

- Hyposwiss Advisors' mission is to offer **personalized asset management services and financial advice** to high net worth individuals and families based in the **USA** and **Canada** with the overriding objective of **capital preservation** and **asset growth** performance oriented.
- Investments in compliant global assets are used to construct a **diversified balanced portfolio** tailored to the investor's requirements and deposited with **international banks** acting as qualified custodians.

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