DE PURY PICTET TURRETTINI & CO. LTD

Outlook

First half year 2020

- Continued global economic expansion, despite an already record-long economic and financial market cycle. Improving industrial momentum

- Equities remain our asset class of choice. Late-cycle risks and numerous uncertainties likely to cause greater than usual volatility

- Sustained low bond yield environment in Europe. Few exploitable trends in currency and commodity markets.

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January 2020

Global economic outlook

Extended slow-growth cycle

The U.S. economic expansion is now the longest since records began in 1854. In Germany, the current business cycle is also the most extended in decades (see Fig. 1 and 2).

Expansions do not die of old age

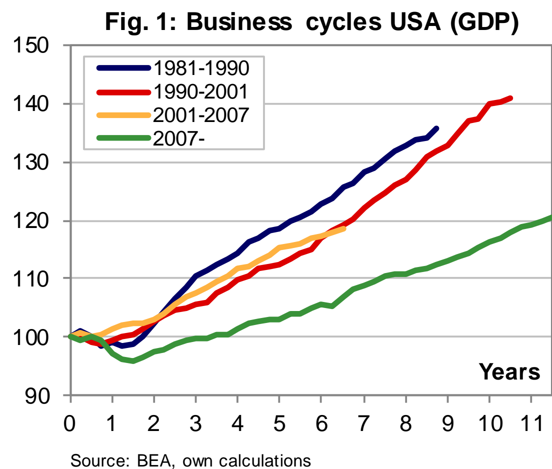
The peculiarity of this upswing is the comparatively low rate of economic growth, driven by weak demographics and muted productivity growth. Nevertheless, the drop in unemployment typically occurring during economic expansion has been clearly evident in both Europe and the USA (see Fig. 3). Accommodating economic policies (with low inflation allowing central banks to refrain from the usual late-cycle monetary tightening) and comparably few disequilibria make continued economic expansion likely in 2020, despite disturbances, notably those emanating from U.S. tariff policy.

Low inflation: Leeway for central banks

Besides slow growth, a general absence of goods price inflation is another key feature of the current business cycle (see Fig. 4).

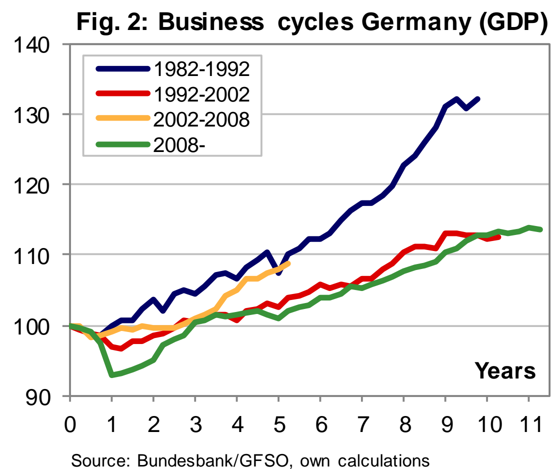
While European inflation might be explained by the weak economy, the same is clearly not an argument in the USA. The U.S. unemployment rate is near a historic low, with a number of additional indicators pointing to tight labour markets as well. It thus is

Fig. 1: Business cycles USA (GDP)



Source: BEA, own calculations

Fig. 2: Business cycles Germany (GDP)

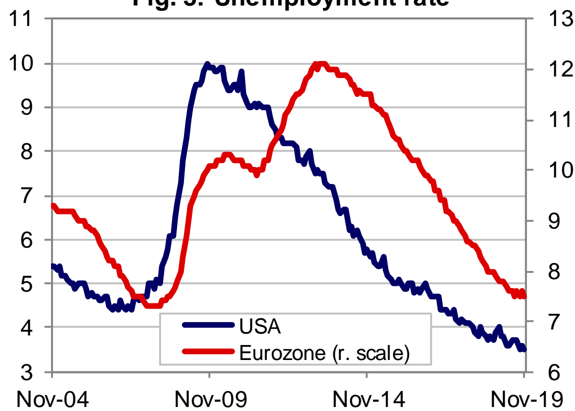


Source: Bundesbank/GFSO, own calculations

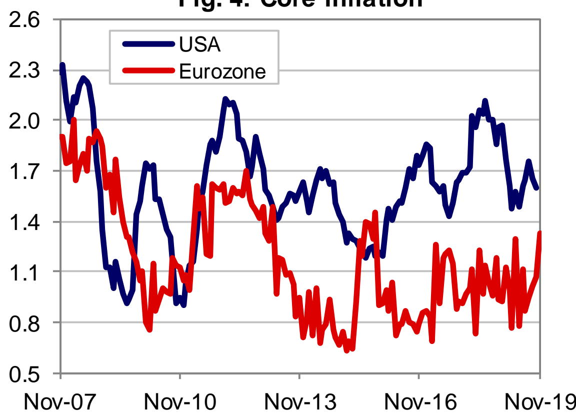
Table 1: Global economic forecast

	World share			GDP growth			Inflation			Current	Government*	
	Popul.	GDP	Growth	2018	2019	2020	2018	2019	2020	acc.*	Budget	Debt
Euro area	**5.7**	**17.0**	**6.9**	**1.8**	**1.1**	**1.2**	**1.7**	**1.1**	**1.2**	**2.8**	**-0.9**	**83.9**
Germany	1.1	4.9	0.9	1.5	0.5	0.9	1.9	1.4	1.4	7.0	1.1	58.6
France	0.9	3.5	1.7	1.5	1.3	1.3	2.1	1.3	1.3	-0.5	-3.3	99.3
Italy	0.8	2.6	0.1	0.8	0.1	0.5	1.2	0.8	0.9	2.9	-2.6	133.2
Britain	0.9	3.5	1.6	1.4	1.2	1.3	2.5	1.9	2.0	-3.5	-1.4	85.6
Switzerland	0.1	0.9	0.4	2.6	1.2	1.3	0.9	0.6	0.7	9.6	1.0	38.6
Emerging Europe	**6.4**	**6.3**	**3.1**	**2.8**	**1.3**	**2.1**	**5.8**	**6.7**	**5.7**	**1.6**	**-**	**31.3**
Russia	**1.9**	2.1	0.8	1.8	1.1	1.6	2.9	4.6	3.9	5.7	1.0	16.5
United States	4.4	**25.7**	**21.9**	**2.9**	**2.3**	**1.7**	**2.4**	**1.8**	**2.0**	**-2.5**	**-5.6**	**106.2**
Latin America	8.6	**6.5**	**1.9**	**1.5**	**0.8**	**1.7**	**6.2**	**7.2**	**6.7**	**-1.6**	**-4.8**	**69.6**
Brazil	**2.8**	2.3	0.9	1.2	1.0	2.0	3.7	3.7	3.7	-1.2	-7.5	91.6
Japan	**1.7**	**6.2**	**2.1**	**0.7**	**0.9**	**0.3**	**1.0**	**0.7**	**1.0**	**3.3**	**-3.0**	**237.7**
Asia (excl. Japan)	**52.6**	**28.0**	**57.0**	**6.0**	**5.5**	**5.4**	**2.3**	**2.4**	**2.3**	**0.9**	**-**	**-**
China	18.6	16.7	37.7	6.6	6.1	5.8	2.1	2.5	2.3	1.0	-6.1	55.6
India	17.4	3.4	8.2	7.4	6.5	6.3	4.1	3.4	3.5	-2.0	-7.5	69.0
Africa/Middle East	**19.8**	**5.8**	**5.0**	**2.5**	**2.3**	**1.7**	**8.1**	**9.4**	**8.3**	**0.9**	**-2.9**	**45.0**
World	**100.0**	**100.0**	**100.0**	**3.3**	**2.7**	**2.6**	**3.0**	**2.9**	**2.8**	**-**	**-**	**-**

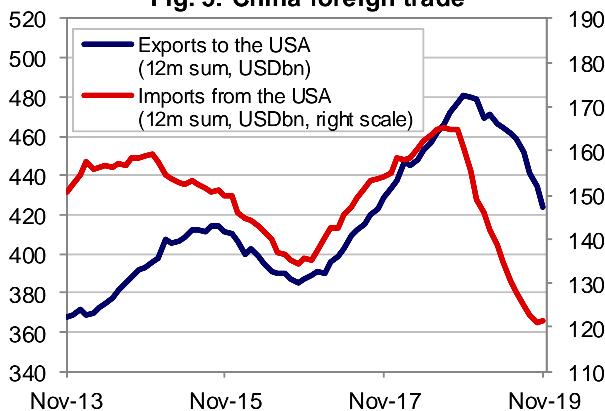
Note: *in % of GDP (current year, unless noted otherwise). Source: National statistics, IMF, OECD, Bloomberg-consensus, own forecasts and calculations



Source: BEA, Eurostat



Source: BLS, Eurostat



Source: Customs General Administration

exceptional that also U.S. inflation forecasts have been revised downwards over the past two years. This constellation provides the Fed with leeway to keep interest rates unchanged, or even lower them, without risking a marked increase in inflation.

Tariffs: Global impact lower than feared

Trade statistics point to a drop in China's trade with the USA, with imports falling disproportionately more than exports (see Fig. 5). In line with growing perceptions in the corporate world that punitive import tariffs (notably on imports from China) will remain part of President Trump's policy arsenal, an increasing number of companies is either relocating production out of China (revealed, for example, in an increase in China's direct investment flows into Vietnam) or making contingency plans to do so. At the same time, China is providing more incentives for companies to stay in the country.

Our baseline scenario for the U.S.-Chinese economic conflict is gradual de-escalation in 2020 (implying that punitive tariffs have peaked). A full resolution of the conflict in 2020 is highly unlikely, while escalation remains a distinct risk.

Industrial momentum: Inflection

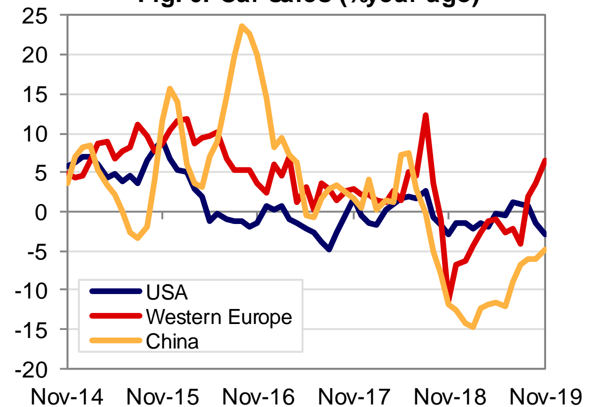
The industrial sector has been slowing since early 2018 (see Fig. 7). A key factor driving this downturn has been auto demand (see Fig. 6), with tariffs likely playing less of a role than often assumed. In China, auto demand has been declining sharply since 2018 as a result of expiring tax incentives. European sales were heavily distorted by the introduction of harmonized testing procedures (WLTP). This had a particularly strong effect on the German economy where auto production accounts for about 4% of GDP.

While the phase of high growth rates in the automotive industry is a thing of the past, moderate growth in demand can be expected medium term. Stabilization in global car sales should therefore contribute to a further improvement in global industrial momentum, a trend established in the second half of 2019.

Europe: Slow-growth expansion intact

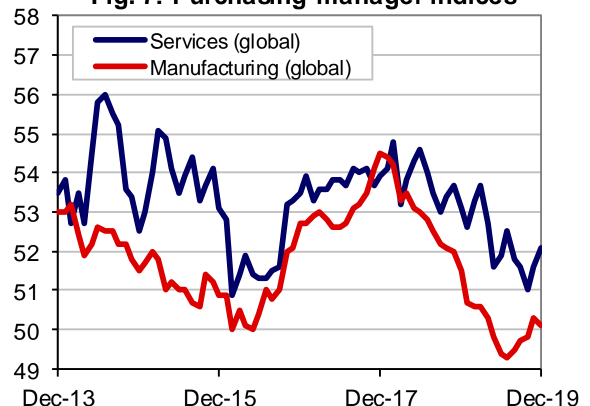
Underlying trends in Europe are pointing to economic expansion. The drop in the unemployment rate (see Fig. 3) in recent years implies that the euro area economy has been growing above its potential rate, which is low, given weak demographics and slow gains in labour productivity.

The U.K. December election result paves the way for Brexit by the end of January on the basis of Boris Johnson's plan negotiated with the EU. Reduced uncertainties should help to improve consumer and business confidence and add modestly to U.K. growth in 2020. After Brexit, the U.K. needs to negotiate a trade agreement with the EU. The sooner this happens, the earlier remaining uncertainties will be removed.



Switzerland: In line with global trends

In Switzerland, growth in consumption and corporate investment spending has been comparatively weak in recent quarters. In the third quarter 2019, the economy grew an annualized 1.6%, even though personal consumption outlays were up a mere 0.7%. In line with global trends, the purchasing manager index is pointing to a rebound in manufacturing (see Fig. 8).



U.S. expansion: The longest on record

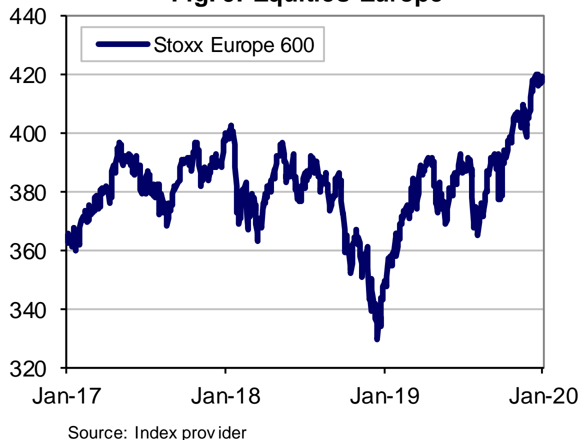
In the USA, economic data continue to show solid private consumer spending (up 2.5% in the past four quarters on average), driven by rising incomes and falling interest rates (which lower mortgage debt servicing costs). With this in mind and despite late-cycle risks, continued expansion of the U.S. economy is our base case for 2020.

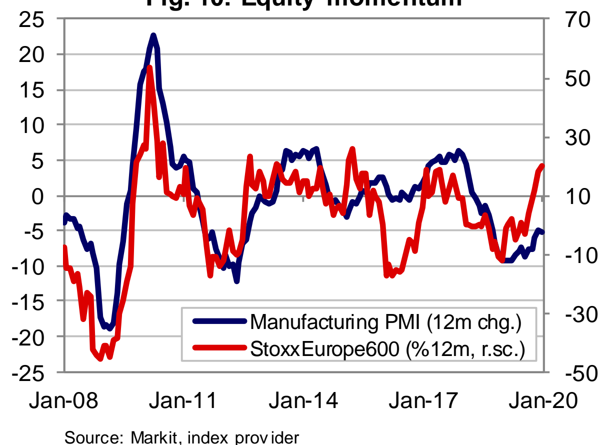
China: At the lower end of expectations

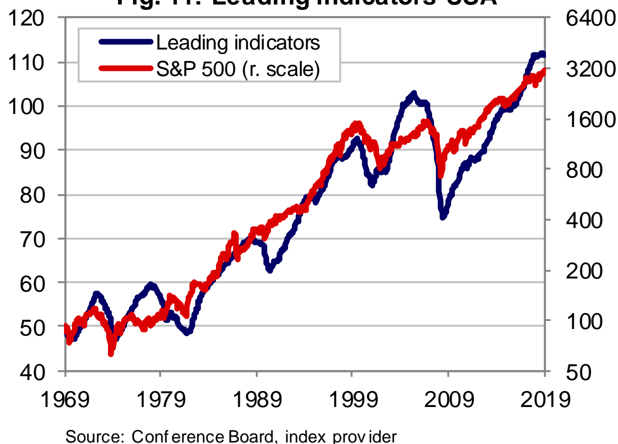
We continue to expect gradual slowing of economic expansion in China over the medium term, with U.S. tariff related relocation of the production of some export goods continuing to weigh. We thus see China's growth in 2020, similar to 2019, at the lower end of expectations, with risks to the downside. The government will counteract any pronounced weaknesses, however. While there is room to ease monetary policy, budget constraints are increasingly evident, which likely will prevent any large-scale fiscal stimulus. Nevertheless, China will remain a pillar of the world economy, accounting for 38% of global demand growth (see Table 1).

Equity markets

2020 scenarios: A Goldilocks baseline







Equity markets fell sharply around the globe in the final quarter of 2018, as if the world economy had already entered recession. With such fears unfounded, the basis was laid for a strong equity market recovery in 2019.

Economic momentum drives returns

After a solid rally in the first months of the year (see Fig. 9), warning signals emerged in the spring as the yield curve in the key U.S. market inverted and economic momentum continued to be negative. These risks faded during the summer months, as signs of stabilization in the industrial sector emerged. Industrial momentum (as measured by purchasing manager indices, see Fig. 10) is indeed a key driver of near-term equity market trends.

More generally, economic growth is associated with positive equity returns (see Fig. 11 which shows that the Conference Board's index of leading indicators correlates well with the S&P 500 in the past 50 years).

Our baseline is a Goldilocks scenario – economic growth and inflation neither too hot nor too cold – supportive of equities. This scenario assumes no further increases in U.S. tariffs on imports from China.

Alternative scenarios imply volatility

Any deviation from non-inflationary growth is a disturbance for equity markets. Notably, any marked rise in inflation or a drift into deflation would be negative, though neither is part of our view.

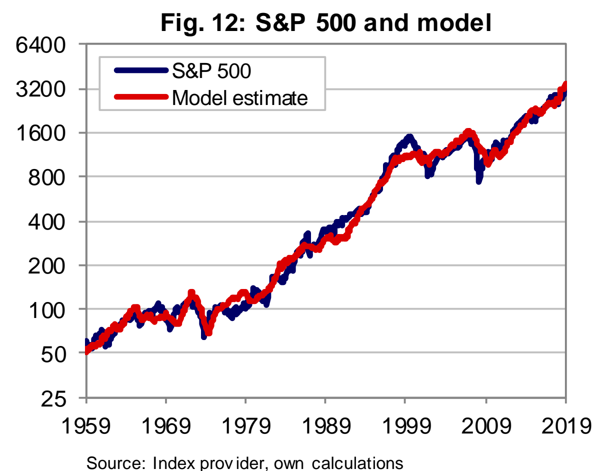
A more positive scenario, particularly for European markets, would require a solid rebound in industrial momentum, likely associated with a lasting truce in the U.S.-Chinese trade conflict. Negative scenarios to be watched are a further slowdown in Chinese growth and a U.S. recession (with a mild recession possible in the coming 2-3 years, though not necessarily in 2020, while a severe recession remains highly improbable, in our opinion). Moreover, U.S. inflation might pick up in a lagged response to tightening labour markets, which would be associated with higher interest rates.

Next to economic fundamentals, uncertainties – U.S. trade policy, political unrest, as in Hong Kong, and the upcoming U.S. elections – influence equity returns. Forecasting uncertainties (e.g. the announcement of fresh tariffs by the U.S. president) is naturally much more challenging than economic trends. We note that key uncertainties have been reduced in December after the U.K. general election, a first U.S.-Chinese

trade agreement and the successor of the NAFTA treaty passing U.S. Congress.

We believe that our broad range of scenarios will drive markets at different times in 2020 which implies that equity market volatility might be higher than usual.

Fig. 12: S&P 500 and model



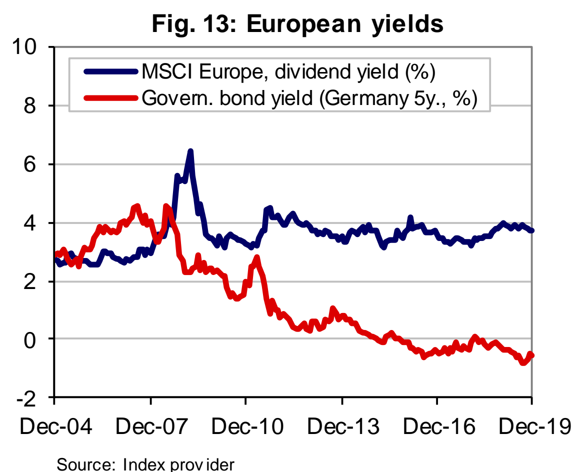
Source: Index provider, own calculations

Earnings recovery

In the third quarter, earnings for Stoxx 600 companies outside the energy sector fell slightly, while they increased modestly for S&P 500 companies. In both Europe and the USA, more companies have surprised positively than in a typical quarter.

In 2019, earnings are now expected to drop in emerging markets and Japan, while earnings in Europe and the USA are forecast to be roughly unchanged from 2018. While we believe that analysts' expectations for 2020 are somewhat high, we consider mid-single digit earnings growth in 2020 in both Europe and the USA to be realistic in the wake of an improving global industrial momentum.

Fig. 13: European yields



Source: Index provider

Fair value and attractive dividend yields

Currently, the valuation of the U.S. equity market is about in line (even a little below) the level justified by the fundamentals (see Fig. 12). While a similar long-term model for Europe is not available due to data constraints, company-based valuation measures suggest that European markets are roughly fairly valued as well. Particularly in Europe, the difference between dividend yields and the yields of comparatively safe bonds historically is very high (see Fig. 13) which is another argument supportive of equities.

Equity sectors

Our medium-term focus remains on consumer goods, both staples and cyclicals, healthcare, technology and selected industrial companies. Investors find attractive dividend yields in telecommunications and the energy and insurance sectors (the latter primarily in Europe). Conversely, we continue to see headwinds for European banks as long as interest rates do not rise in a meaningful way.

Heading into the U.S. elections 2020, any increases in the polling numbers of the Democratic Party would tend to be viewed negatively primarily for healthcare and defence companies.

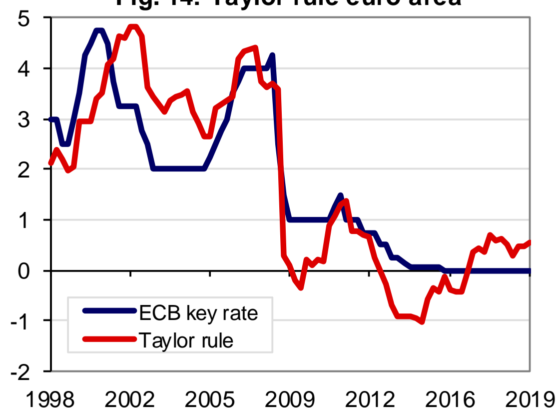
Table 2: Equity sectors

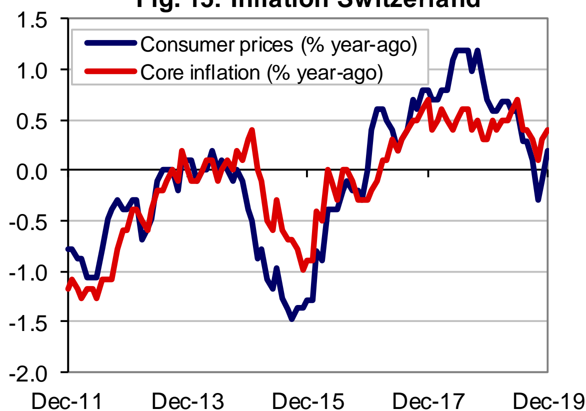
	Perform. 12 m.*	
	Europe	USA
Stable demand sectors	**22.1%**	**18.9%**
Consumer staples	26.6%	24.0%
Healthcare	28.4%	18.7%
Telecommunications	0.1%	20.5%
Energy	5.8%	7.6%
Utilities	24.6%	22.2%
Financials	**17.5%**	**28.4%**
Cyclical sectors	28.7%	35.1%
Durable consumer goods	21.8%	29.7%
Industrial companies	33.2%	26.8%
Technology	35.0%	48.0%
Basic industries	23.7%	21.9%
Market	**23.2%**	**28.9%**

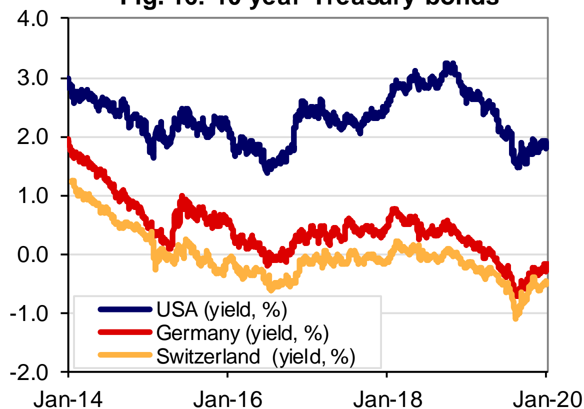
* As per 31-Dec-19. Source: Index provider

Central bank policy and bond markets

Supportive monetary policies







We believe that monetary policies are supportive for the world economy and financial markets, with key rates in 2020 either stable (in most industrialized countries) or falling (in key emerging economies). With most of the large economies in the world growing more than their potential growth rates, monetary stimulus is not widely needed, in our opinion.

Persistently low central bank rates

Options to loosen monetary policy in the eurozone and Switzerland are largely exhausted (though negative rates up to -1% are generally believed to be possible). In addition, the Taylor rule (see Fig. 14) suggests that interest rates in the eurozone are not too low in relation to fundamentals (notably, as inflation is below the central bank's target).

The Fed has further room to lower rates, although the Fed's own forecast does not envisage additional cuts beyond those enacted through October 2019. The Fed outlook ("dots"), however, suggests an ongoing low interest rates environment as the funds rate is projected to remain below the long-term neutral rate of 2.5% through the end of 2022 at least.

In Switzerland, core inflation has been falling recently (see Fig. 15). This implies that the Swiss National Bank is in no rush to end its negative-rates policy (and would have leeway to lower rates further should the franc strengthen more).

Government bond yields below fair value

Much argues that yields in continental Europe will remain at depressed levels for some time. Nevertheless, government bond yields are too low in relation to consensus estimates for growth and inflation in 2020. The current expansion will end eventually, however, and we believe that bond yields already price a global recession in the coming 2-3 years.

Given our outlook for ongoing economic expansion, we expect corporate bonds to outperform Treasuries in 2020. Despite the recent spread-narrowing, emerging market bonds in hard currencies remain strategically attractive, given their clearly positive yields.

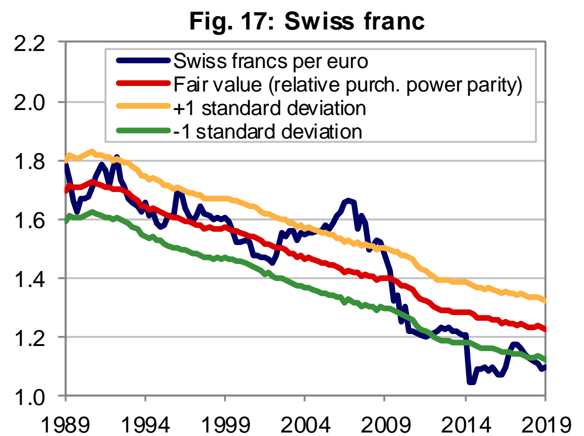
World currencies and commodities

Currencies: Low-volatility cycle

In line with trends in recent years, we continue to expect comparatively low currency volatility.

The U.S. dollar is somewhat expensively valued, while the euro is cheap. We see modest potential for the euro to recover as industrial momentum continues to improve. The euro will remain a weak currency, however, as long as ECB interest rates are not expected to be raised.

Brexit-uncertainties for the pound have been reduced after the December election. We estimate there is still some potential for further recovery.

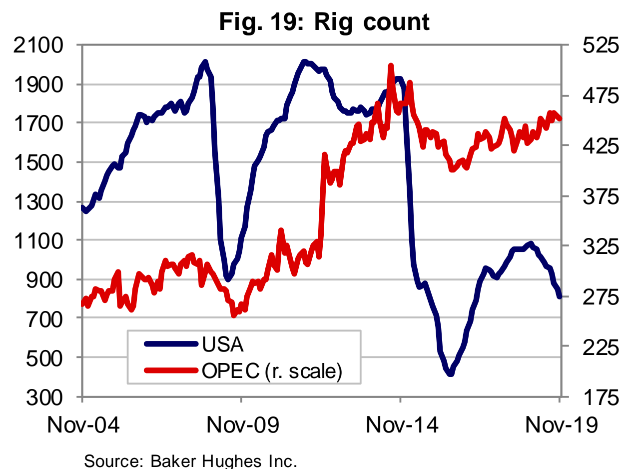


Swiss franc: Structurally strong

Even though we see the Swiss franc within its fair value range against the euro (1.20 to 1.25, see Fig. 17) in the medium term, the Swiss franc will likely remain overvalued as long as the euro area economy does not visibly pick up. As the interest rate difference vs. the euro is small, hedging costs are not expensive from a Swiss perspective. The trend in sight deposits reveals that the SNB intervened only briefly in the summer of 2019. SNB intervention is thus unlikely to weaken the Swiss franc. A cyclical pick-up in euro area growth in the first half of 2020 should nonetheless reduce upward pressure on the franc.

Gold: Diversification benefits and upside risks

Above-average geopolitical and economic uncertainties and record-low, often even negative, bond yields provide modest support for gold (see Fig. 18). Medium-term price risks appear to be on the upside, as gold mining companies have, on average, depleted reserves in recent years, which may cause a shortage in supply at some point (we consider this to be a risk rather than a foregone conclusion, however).



Oil and industrial metals

We expect the oil market to remain roughly balanced as weak demand is counteracted by production discipline (in particular Saudi Arabia and Russia) and signs of levelling off in the U.S. shale boom (witness the drop in the number of active rigs in the USA, Fig. 19). This scenario excludes the potential impact of geopolitical tensions, notably in the Middle East.

Prices of industrial metals remain supported as they are not much higher than production costs on average. Therefore, any improvement in industrial demand implies upside risks.

Asset allocation

Late-cycle strategy

Table 3: Asset allocation

Reference currency CHF	Conser-vative	Bal-anced	Growth
Liquidity	**5**	**2**	**2**
Bonds (incl. convertibles)	**58**	**25**	**15**
Equities	**19**	**47**	**68**
Switzerland	4	10	16
Europe	4	10	16
North America	3	9	14
Japan	0	2	3
China	0	3	4
Emerging markets	3	4	5
Thematic investing	5	9	10
Alternative investments	**13**	**20**	**10**
Metals & commodities	**5**	**6**	**5**
Total	**100**	**100**	**100**
Net exposure forex	20	25	25

Reference currency EUR	Conser-vative	Bal-anced	Growth
Liquidity	**5**	**2**	**2**
Bonds (incl. convertibles)	**58**	**25**	**15**
Equities	**19**	**47**	**68**
Europe	8	20	32
North America	3	9	14
Japan	0	2	3
China	0	3	4
Emerging markets	3	4	5
Thematic investing	5	9	10
Alternative investments	**13**	**20**	**10**
Metals & commodities	**5**	**6**	**5**
Total	**100**	**100**	**100**
Net exposure forex	20	25	25

Reference currency USD	Conser-vative	Bal-anced	Growth
Liquidity	**5**	**2**	**2**
Bonds (incl. convertibles)	**58**	**25**	**15**
Equities	**19**	**47**	**68**
Europe	4	11	18
North America	0	2	3
Japan	0	3	4
China	3	4	5
Emerging markets	3	4	5
Thematic investing	5	9	10
Alternative investments	**13**	**20**	**10**
Metals & commodities	**5**	**6**	**5**
Total	**100**	**100**	**100**
Net exposure forex	10	10	10

Our economic baseline does not suggest a defensive strategy

Our Goldilocks baseline economic scenario supports positive returns from equities and corporate bonds.

While there is a fairly broad scenario range, we consider the risks of a deep recession and a pronounced equity bear market to be low. Notably, there are no marked disequilibria in both financial markets (e.g. a nearly unparalleled overvaluation of equities at the beginning of the equity bear market in 2000) and the world economy (e.g. an over-leveraged banking system at the onset of the financial crisis of 2008).

Late in a business cycle, risks of an economic downturn are higher than earlier in the cycle, and downturns tend to materialize fairly quickly. Our investment strategy, therefore, remains more data dependent than usual.

Equites: Our asset class of choice

Absent empirically well-tested warning signals, equities remain our asset class of choice. Regionally, we currently favour European and emerging markets equities. We suggest a balanced (and thus not overly defensive) stock and sector selection, given the ongoing rebound in industrial momentum.

Among emerging markets, Asia, and in particular China, remain strategically favoured. Positive news on the U.S.-Chinese trade conflict would help the region outperform in 2020.

Bond investments: To remain challenging

While we see reasons to expect somewhat higher bond yields over the coming 6-12 months, those will remain structurally depressed in Europe. Among fixed income investments, we continue to favour corporate and emerging market bonds, with a preference for shorter durations. Convertibles bonds are worth holding as well.

As far as other asset classes are concerned, commodities, in particular gold, are included in the allocation primarily for diversification purposes.

Financial market review

A solid rebound in 2019

After a weak 2018, all asset classes, notably equities and bonds, have delivered positive returns in 2019 (Table 5).

U.S. equities have continued to outperform Europe and Japan, with the discrepancy even more striking when taking the performance of 2018 and 2019 together. The U.S.-Chinese trade conflict and the weak manufacturing cycle have weighed on emerging markets.

Currency movements have been comparatively small in 2019 (Table 4). Gold has benefited from global uncertainties and the current low or negative cost of carry.

Table 4: Trade weighted currencies

	Performance	
	2019*	2018/19*
Euro	-1.7%	-1.0%
U.S. dollar	-0.5%	4.4%
Swiss franc	3.1%	6.8%
Pound sterling	4.3%	3.8%
Japanese yen	1.4%	8.5%
Chinese renminbi	-1.3%	-3.2%
Indian rupee	-2.1%	-6.4%
Brazilian real	0.9%	-4.8%
Russian ruble	12.8%	-2.1%

*Data as per 31-Dec-19. Source: Index provider

Table 5: Global financial markets

	Latest	EUR-Performance		CHF-Performance		USD-Performance	
	price	2019*	2018/19*	2019*	2018/19*	2019*	2018/19*
Equity markets							
MSCI World	**2358**	**28.0%**	**20.1%**	**23.2%**	**11.2%**	**25.2%**	**12.1%**
MSCI Small Cap	444	26.9%	12.7%	22.2%	4.5%	24.1%	5.3%
StoxxEurope600	416	23.2%	6.9%	18.5%	-1.0%	20.4%	-0.2%
EuroStoxx50	3745	24.8%	6.9%	20.1%	-1.0%	22.0%	-0.2%
DAX (price return)	13249	21.5%	-3.5%	17.0%	-10.6%	18.8%	-9.8%
Swiss Market Index	10617	30.9%	22.1%	26.0%	13.2%	28.0%	14.1%
Sweden (OMX)	1772	21.6%	5.1%	17.0%	-2.6%	18.9%	-1.8%
USA S&P 500	3231	31.8%	29.4%	26.8%	19.9%	28.9%	20.8%
Japan (Topix)	1721	19.0%	5.2%	14.5%	-2.5%	16.4%	-1.7%
MSCI Em.Markets	**1115**	**18.0%**	**3.0%**	**13.6%**	**-4.5%**	**15.4%**	**-3.8%**
Emerging Asia	566	19.3%	3.3%	14.8%	-4.3%	16.6%	-3.5%
Emerging Europe	367	28.3%	13.6%	23.5%	5.2%	25.5%	6.1%
Latin America	2918	16.3%	10.5%	11.9%	2.4%	13.7%	3.2%
Bond markets							
Germany (5-7 y.)	457	1.1%	2.6%	-2.7%	-5.0%	-1.2%	-4.2%
Switzerland (5-7 y.)	247	4.1%	8.8%	0.2%	0.8%	1.8%	1.6%
Italy (5-7 y.)	810	9.5%	7.7%	5.4%	-0.2%	7.1%	0.6%
Euro corporates inv. grade	259	6.2%	4.9%	2.3%	-2.8%	3.9%	-2.0%
Eur. high yield	340	11.3%	7.1%	7.2%	-0.8%	8.9%	0.0%
USA corp. inv.grade	178	20.2%	21.2%	15.7%	12.3%	17.6%	13.2%
USA high yield	2183	16.9%	19.9%	12.5%	11.1%	14.3%	11.9%
Emerg. markets (hard curr.)	403	15.9%	16.3%	11.6%	7.7%	13.3%	8.6%
Commodities							
Crude oil (Brent)	66	27.7%	6.4%	22.9%	-1.4%	24.9%	-0.6%
Industrial metals	283	4.2%	-10.5%	0.3%	-17.1%	1.9%	-16.4%
Gold ($/ounce)	1517	21.0%	24.7%	16.4%	15.5%	18.3%	16.5%
Agric. commodities	348	1.9%	-1.9%	-1.9%	-9.1%	-0.3%	-8.4%
Hedge Funds							
Hedge fund of funds	6266	8.8%	9.4%	4.7%	1.3%	6.4%	2.1%

*Data as per 31-Dec-19. Hedge Funds as per latest available month-end. Source: Index provider

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