THE DRIVE YOU DEMAND

MONTHLY INVESTMENT OUTLOOK

May 2019 | Global Investment Committee

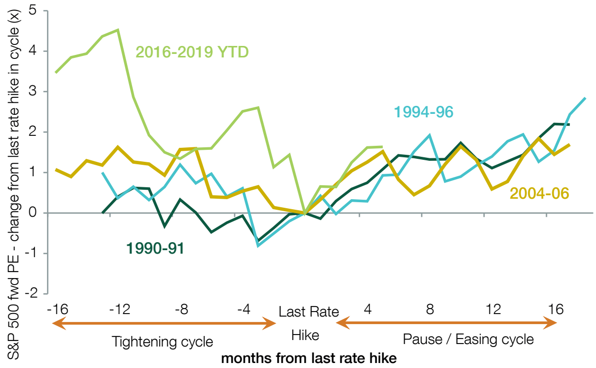
UNION BANCAIRE PRIVÉE

MONTHLY INVESTMENT OUTLOOK

A shifting risk-reward dynamic

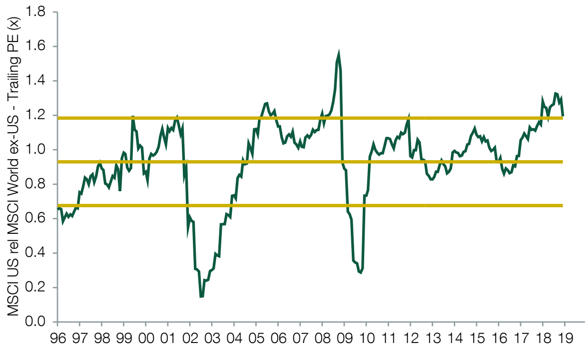
- Global equities continued their upward trek in April as further signs emerged to cool US recession talk that had built through the first quarter of the year. Earnings expectations remain under pressure although downward momentum is easing with upgrades in the US following a productive earnings season. Even the European earnings season has shown encouraging top line growth trends.
- Global equity valuations continued to expand with US valuations now nearing the PE expansion seen in previous Fed interest rate pauses. This leaves the gap between the US and the rest of the world near historical extremes.
- While this differential is encouraging for non-US markets, the renewed threat of trade conflict between the world's two largest economies may allow this imbalance to persist until resolved. In the meantime, a recovery in trade and global growth is a necessary catalyst for earnings upgrades in export-driven Europe and Japan.
- The more balanced language from the US central bank also introduces new concerns for investors. With a 'dovish' policy tilt since late-December, the shift places a greater burden on economic growth, earnings and valuations as drivers to a potential next leg in markets rather than the multiple expansion-driven year-to-date returns.
- With valuations elevated and downward earnings momentum easing, sluggish capital spending trends in the face of trade uncertainty pose the key risk to what has been resilient economic growth looking ahead.
- In light of the shifting risk-reward dynamic, we introduced capital protection strategies into our equity allocations in April. Combined with hedge funds, these 'asymmetric' strategies position portfolios to continue to participate in the ongoing upside of a durable US economy while cushioning the prospect of negative surprises, including a potential global geopolitical shock or a faltering rebound in economic growth. We have also closed long EUR and CHF exposure as the USD may assume a safe haven status in a more uncertain environment.
- Given the sharp fall in euro risk-free yields and the noticeable gains in euro investment grade credit, we no longer believe investor compensation is adequate for the interest rate and credit risk looking forward. As a result, we lock in YTD gains in euro IG in favour of capital preservation strategies in conservative portfolios and Danish mortgage bonds in more balanced strategies.

US PE expansion nearing an end



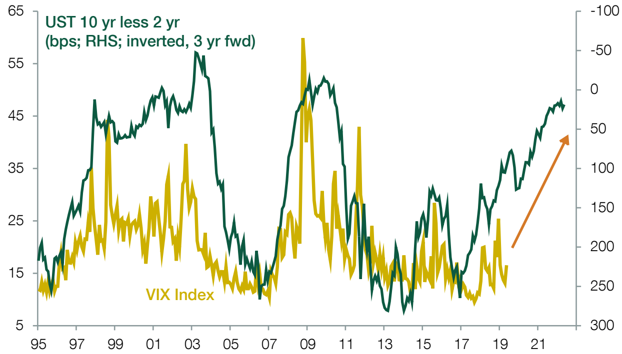
Source(s): MSCI, Bloomberg Finance L.P., UBP

US-RoW valuations near historical extremes



Source(s): MSCI, Bloomberg Finance L.P., UBP

Rising volatility favours asymmetric strategies



Source(s): Chicago Board Options Exchange, Bloomberg Finance L.P., Bank of America Merrill Lynch

GLOBAL TACTICAL ASSET ALLOCATION

Solutions with asymmetric risk-reward profile are valuable

Global economy / Asset allocation

- Global growth remains resilient thanks to services and the consumer, while manufacturing/export sectors remain weak.
- The accommodative global monetary regime and the current relatively easy fiscal policy should give support to a global economy facing renewed trade risks.
- Proactive risk management becomes a priority for investors, especially after the strong market rally we have seen since the start of the year. Looking ahead, the rekindling of trade uncertainty poses the key risk to what has been resilient economic growth.
- We continue to favour assets with "asymmetric" profiles – such as capital protected structured solutions, select long-short hedge funds as well as convertible bonds – which should help us navigate through the new and more challenging risk environment going forward.

Fixed income

- The latest economic indicators have improved which presents an asymmetric risk for investors at the long-end of the German and to a lesser extent, US yield curve. In turn, we maintain our bias to be underweight long-end rates.
- We were positive on European credit going into 2019. However, with investment-grade credit spreads having touched their tightest level since the political crisis in Italy plus strong YTD performance and growing geopolitical risks, the risk reward is now skewed against investors.

Equities

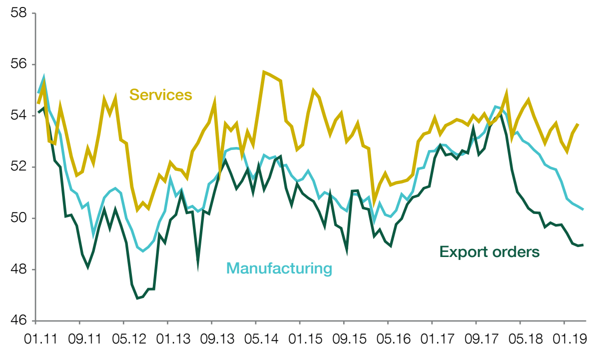
- Elevated US valuations limits the scope for continued PE-driven returns following the strong gains year-to-date. Should recent risks to global growth fail to materialise, we see modest upside potential to earnings expectations especially if the nascent rebound in economic activity continues.
- With trade concerns re-emerging, we have re-introduced 'asymmetric' exposure into our equities allocation in April to protect against the risk of a new and sustained trade war.

Alternatives

- Selected long-short hedge fund strategies present useful asymmetric exposure, protecting portfolios against any unexpected risks in equities and credit. As a safe haven, gold provides an increasingly attractive asset should volatility re-emerge.

Business confidence has stabilised in services while it remained fragile in manufacturing

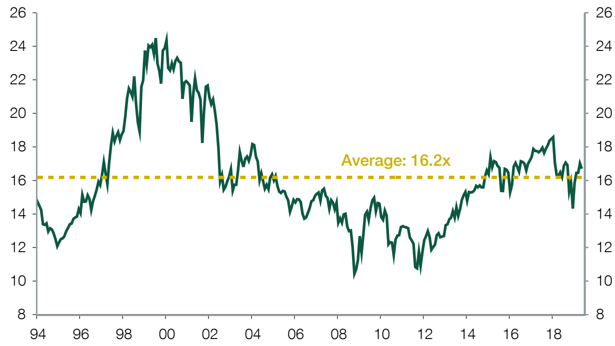
Global business sentiment (PMI Indices)



Source(s): Markit, JP Morgan

Limited scope for multiple expansion in the US

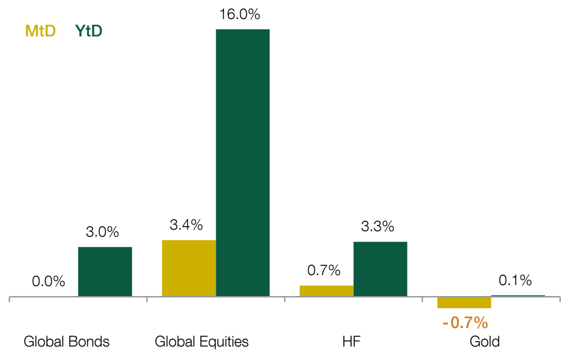
S&P 500: 12-month forward PER



Source(s): Thomson Financial

Global equities continued to grind higher in April

Major asset classes performance



Performance as at the end of April 2019
Source(s): Bloomberg Finance L.P., UBP

UBP ECONOMIC OUTLOOK

Sound domestic demand fundamentals and supportive economic policy

Key points

- Global growth should remain resilient thanks to domestic demand, while manufacturing and trade sectors remain fragile and have not yet bottomed out.
- After positive surprises on Q1 GDP growth, renewed risks weigh on Q2 growth related to trade tensions and elections in Europe.
- Domestic demand appears quite resilient in the major economies thanks to the sustained trend in consumption and services, and to the support available from relaxed fiscal regimes and accommodative monetary policy.

Domestic demand to remain on a sustained trend

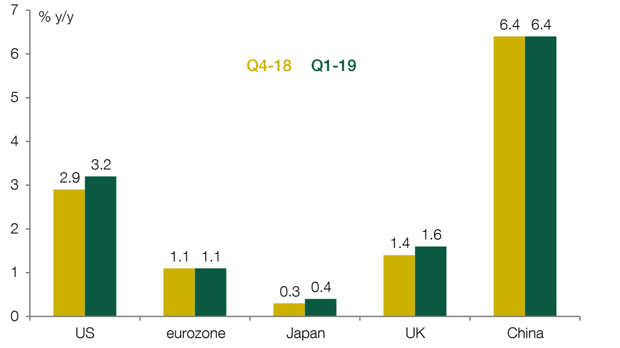
- US Q1 GDP growth (3.2% q/q) was supported by building inventories and improving net trade contributions, while domestic demand was temporarily moderate.
- Fundamentals for households remain positive, particularly employment trends , which should underpin firmer consumption in Q2 after a pause in Q1. Moreover, investment and residential housing should benefit from low interest rates and positive profit trends.
- In China, consumption and public infrastructure have rebounded, leading to 6.4% GDP growth in Q1. Fiscal policy should continue to favour consumption, local investment and also small firms.
- In the eurozone, the service sector was resilient in Q1 and the mix of higher public spending and the rising trend in construction fuelled the 0.4% q/q GDP rise in Q1. A positive trend in consumption is expected in the next quarters as employment improves steadily.

A more supportive economic policy

- All major central banks have now adopted a more accommodative stance, following the Fed's dovish strategy. There is room for central banks to ease in Asia-Pacific, while G7 central banks should seek to keep highly accommodative financial conditions in place.
- Fiscal policy has eased in Europe but the stimulus could increase if necessary after the EU elections. In China and some Asian countries, fiscal policy could help to offset weak export performance. In the US, the debate has begun around raising infrastructure spending, while a new increase in the debt ceiling looks likely.

Better than expected GDP growth in Q1-19

GDP growth in main countries



Source(s): National accounts, UBP

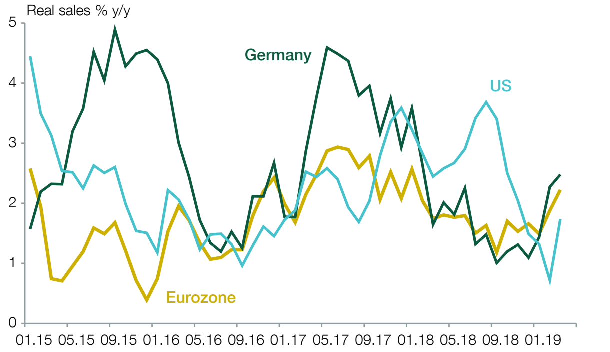
US, China and India offer the strongest growth outlook for 2019

GDP y/y %	2017	2018 UBP	2019 UBP
WORLD - *MER* *- on PPP basis**	3.1 *3.7*	*3.1* *3.8*	*2.8* *3.5*
USA	2.2	2.9	2.5
Japan	1.9	0.8	0.7
Eurozone	2.4	1.9	1.0
United Kingdom	1.8	1.4	1.3
Switzerland	1.6	2.6	1.3
Brazil	1.1	1.1	2.0
Russia	1.6	2.3	1.6
India	6.9	7.4	6.9
China	6.8	6.6	6.3
Developed countries	2.3	2.2	1.7
Emerging countries	5.0	5.0	4.9

Source(s): UBP, Bloomberg Finance L.P. consensus
* MER: market exchange rates; PPP: purchasing power parity

Lower trend in unemployment underpins consumption

Retail sales in the eurozone, Germany & the US



Source(s): Eurostat, DB, US Census Bureau

UBP ECONOMIC OUTLOOK

Trade war: this time is - always - different...

Renewed threats on world trade

- Ahead of an anticipated US-China trade agreement, the US instead increased tariffs on Chinese goods: from 10% to 25% on US$200bn of Chinese exports and threatened to extend the 25% tariffs to another US$325bn worth of exports.
- This renewed trade war comes at a time when the new NAFTA (USMCA) deal has not yet been approved and US trade negotiations continue with Japan and Europe. Separately, Brexit remains an issue for European trade.
- World trade has collapsed in the past year although the IMF expects a return to a sustained growth (4%) over the next two years. However, exports remained depressed globally, and the US trade deficit has expanded further despite the new trade policy.

Trade, business confidence and supply chain concerns

- The manufacturing sector has been hurt by threats and regular trade uncertainties. This has lead to a sharp fall in export orders and a related strong rise in company inventories, as precautionary measures kick in.
- If the US and China conspire to refuel trade tensions, a new fall in confidence could emerge, leading to further contraction in global trade and indirect shocks for all exporters, such as Japan, Korea, UK and Germany.
- Rising constraints on the global chain supply could have negative effects on employment in all countries, including the US, and not only a temporary disruption on exports, production and inventories. Latest US surveys reveal rising concerns in oil, primary goods, clothing and machinery, all related to trade uncertainty.

More policy support expected in the case of a trade shock

- A rise of US tariffs on all Chinese exports could remove close to 1 pp of China growth, but also 0.3/0.4 pp for other major economies.
- Economic policy in China, Europe and Japan will be used to protect employment and domestic demand; more aggressive tax cuts and rising public spending could then follow, while monetary policy could also become even more accommodative to mitigate the trade shock.

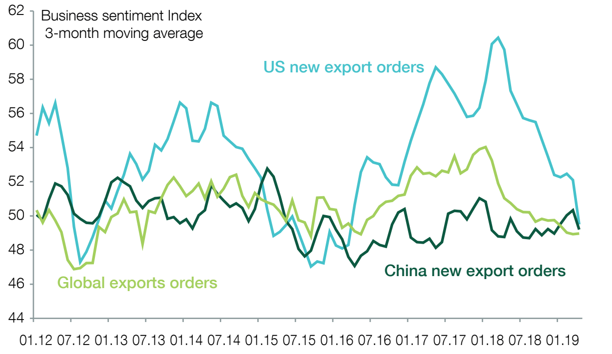
Global trade not yet in a healing process

World trade & industrial production

Source(s): CPB

Fragile and weakening sentiment on export orders in manufacturing in major economies

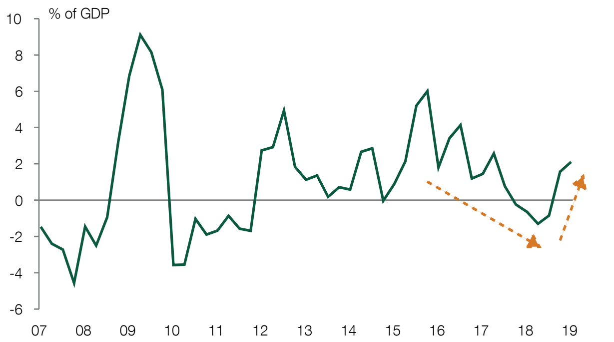
Business confidence on export orders



Source(s): NBSC, Institute of Management Supply, JP Morgan

Still room for further support to domestic demand in China

China fiscal inpulse*



* Central & local government only not including off-budget allocations such as special bonds, infrastructure and other funds
Source(s): Bloomberg Finance L.P., UBP

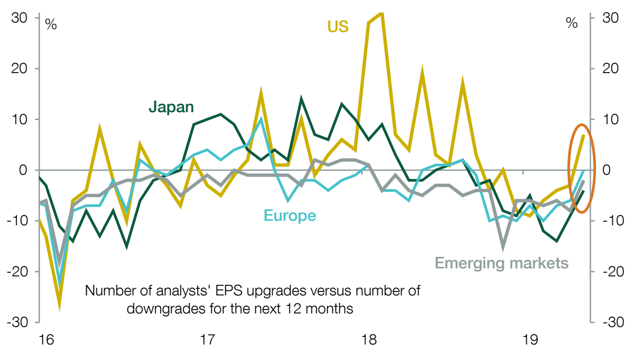
GLOBAL EQUITIES

Improving earnings momentum but less scope for multiple expansion

- Most equity markets posted solid gains in April supported by the dovish tone among central banks, combined with reassuring activity and corporate earnings figures.
- In the US, thanks to solid results, the estimated earnings growth rate for Q1 rose back to +1% (vs. -2% before the start of the earnings season).
- More importantly, guidance was globally reassuring with assessments of the macro backdrop being most frequently solid, including in the industrial sector.
- As a consequence, upward EPS revisions for S&P 500 companies have exceeded downgrades since mid-April, for the first time since August, 2018. Nonetheless the expected earnings growth rate for the full year is steady at 3%.
- We believe that upside revision potential exists and we expect 5-6% 2019 US EPS growth driven by a stabilising US economy, roughly unchanged operating margins (which remain below peaks) and ongoing share buybacks.
- However, this recent improvement in earnings momentum could be challenged in the short term by the recent USD rally, the latest fall in the ISM Manufacturing Index and potential tariff hikes on China. This, together with the slightly less dovish tone from the latest FOMC meeting, means that multiple expansion is probably close to its limit in the US where the 12-month forward PE has now reached 17x.
- Despite the threat of further escalation in the trade war, we keep our positive bias on Chinese equities once volatility surrounding the current trade rhetoric recedes. Recent US-China developments may actually increase the odds that Chinese stimulus will continue.
- As a consequence, we expect China's credit impulse - which has been a reasonably good leading indicator for the economic and earnings cycle as well as market performance - to improve further.
- Despite the strong year-to-date performance of the Chinese market, current valuations do not yet, in our view, constitute a constraint; this applies all the more given the long-term earnings growth potential of many listed companies.

US equities benefited from a majority of upgrades over the last two weeks

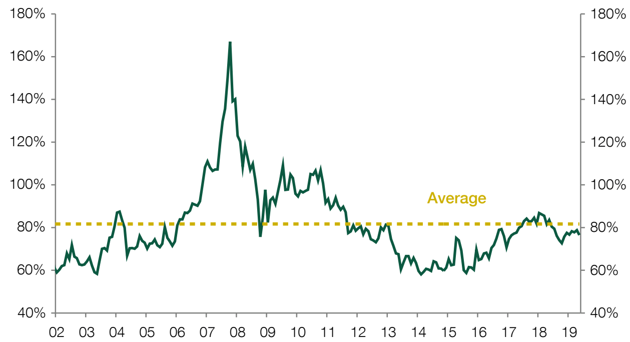
Earning revision ratio: US, Europe, Japan & EM



Source(s): Thomson Reuters

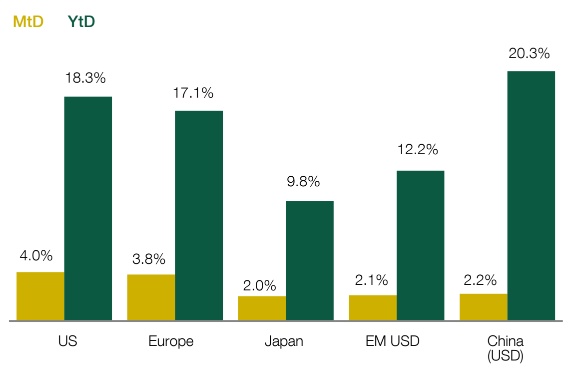
The Chinese market still trades at a significant discount to global equities

12-month forward PER: China relative to MSCI All Countries



Source(s): Thomson Reuters, UBP

Equitie performance



Performance as at the end of April 2019
Source(s): Bloomberg Finance L.P., UBP

GLOBAL BONDS

Risk reward appears less attractive in Euro Investment Grade

- A more hawkish tone from the US central bank drove a decline in US 10-year yields and a flattening of the US yield curve. Meanwhile, on the other side of the Atlantic, the ECB highlighted how risks to euro area growth are tilted to the downside pushing German 10-year yields back towards below zero.
- In spite of this, recent economic indicators showed incremental improvement in US and euro area economies which suggest rising risk at the long-end of the German and, to a lesser extent, the US yield curve. This leaves us with a preference for a short duration position for fixed income investors.
- The strong YTD rally in European credit and tightening spreads among high quality issuers combined with negative yields on German Bund has created an unattractive risk-reward backdrop for investors.
- As a result, we lock in YTD gains in favour of capital preservation strategies among conservatively positioned investors and Danish mortgage bonds in more balanced portfolios.
- In the US, we see opportunities in short-duration corporate debt but remain particularly attentive to any threats to the stability of corporate balance sheets given the high level of leverage in some sectors.
- Emerging market debt where yields are still relatively attractive – both on an absolute and relative basis over the longer term – should continue to benefit from the Fed's pause. However, a protracted trade conflict may present risks to this asset class.
- With yields having compressed significantly year-to-date, we believe risk-reward is also becoming increasingly asymmetric in the fixed income space. While short-duration strategies help mitigate interest rate risk in particular, we also see opportunities via low volatility alternative strategies including event driven hedge funds. These can act to help diversify return streams for low risk appetite bond investors.

Risk is asymmetrically skewed to the upside on the long-end of German yield curve

German 10-year government bond yield

Source(s): Bloomberg Finance L.P., UBP

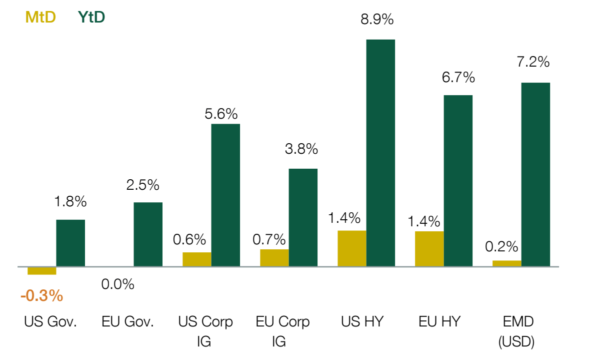
EUR investment-grade credit spreads have retraced a good part of their widening

EUR investment-grade OAS spreads

Source(s): BoA ML, UBP

Higher risk segments delivered better performance

Fixed Income performance



Performance is as and of April 2019
Source(s): Bloomberg Finance L.P., UBP

RECENT VIEW CHANGES

Rebuilding capital protection in equities; locking in gains in EUR fixed income

- Global equities have enjoyed strong performance YTD, rebounding from a particularly weak 4Q18. With valuations once again stretched and moderate (3-5%) earnings growth expected for 2019, upside potential requires more robust global economic growth to drive earnings. The renewed trade tension between the world's largest economies does, however, pose a credible threat to the nascent economic rebounds around the world.
- As a result, after having enjoyed the strong year-to-date performance, as in the summer of 2018, with volatility low in April, we began to re-introduce partially capital protected strategies into portfolios. These strategies should allow us to continue to participate in upside potential of markets should recent threats recede and pro-cyclical policy support emerge. Were recent rises in volatility to prove durable, these strategies should help shield portfolios as they did in 4Q18.
- In addition, we have also added US dollars in EUR and CHF strategies, closing our USD underweight. US dollars may assume a safe haven status in an uncertain environment, as we have observed in most previous equity downturns.
- Given the strong rally year-to-date, we lock in gains in Euro investment grade credit where investors are no longer adequately compensated with a paltry 0.7% yield for a seven year holding period. This has prompted us to reduce positions in favour of absolute return strategies in conservatively positioned portfolios and Danish mortgage bonds for the more balanced strategies.

World equities: Quick recovery from the turmoil of last year

MSCI ACWI rebased 100 at 01.01.2019

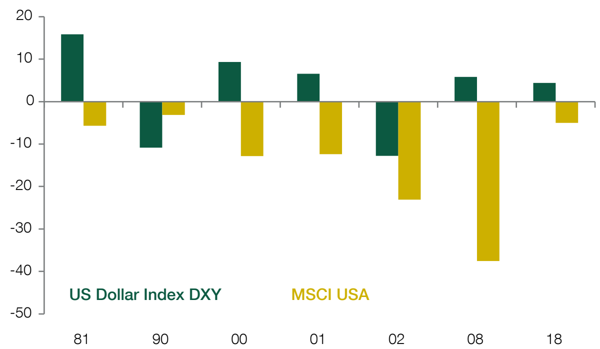
Source(s): MSCI, Datastream, UBP

Strong 2019 was driven mainly by valuation rebounding back from the fall of last year

MSCI ACWI 12-month forward PE

Source(s): MSCI, Datastream, UBP

Dollar assumed safe haven status in most market downturns (except 1990 and 2002)



Source(s): MSCI, Datastream, UBP

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