MAERKI BAUMANN & CO. AG

PRIVATE BANK

INVESTMENT COMMENT

February 2018

TURBULENT TIMES – KEEP CALM

Investing in times of falling volatility is always dangerous

The first few weeks of the new year began strongly for the markets – too strongly, as it turned out. After global equity markets performed unusually well from a historical perspective in January, recording a rise of around 5%, a clear consolidation (i.e. correction) has now taken place. However, this latter development should be viewed against a backdrop of long-term market gains in which no real market consolidation took place at all. The current correction began in the USA, which can partly be explained by the fact that no correction of more than 5% had been witnessed in the US stock market for more than 400 trading days, i.e. more than a year and a half. The trigger was actually a combination of factors. First came a rise in global bond yields, led by the USA against a backdrop of higher commodity prices. Then came a rise in US wage growth that surprised many investors. This was followed by a rise in volatility from extremely low levels, which likewise came as a surprise to many market participants who had purchased investment products in expectation of persistently low equity market volatility.

Another particularly important aspect was the fact that many market participants had assumed that both realised volatility and implied volatility (i.e. as reflected in option prices) would remain low in the equity markets. When volatility then surged in the wake of a higher-than-expected rise in US wage growth, both professional market participants betting on risk/volatility parity and many hedge funds found themselves having to adjust or liquidate their positions. From a fundamental perspective, however, nothing has actually changed this time – unlike in the market corrections of 2000, 2008 and 2011. In those years, many leading indicators were pointing to a clear deterioration in the global economy. By contrast, the leading economic indicators at the moment are not suggesting any likelihood of imminent recession. Overall, things also look good on the corporate earnings front, with many companies actually beating expectations. While it is true that the US equity market is rather higher valued than those of other regions – which is why we favoured emerging market equities in our last Investment Policy, given their historically low valuations – valuations on the basis of P/E ratios have now become much more attractive both globally and in the US.

Volatility may well remain high in the short term

The recent rise in volatility that we have seen – from the below-average levels recorded in December and January – may persist, and we are now witnessing a shift into above-average levels, a process that is not yet complete.

Thus the markets look set to remain very nervous in the short term. But this is precisely why investors who take a medium- or long-term view must keep calm. Panic selling triggered by the notorious emotion known as "fear" after valuations have already fallen to 2016 or (in some cases) even 2015 levels could well be regretted at a later stage. Obviously, the precise point of a short-term bottom is difficult to call: this ultimately comes down to when long-term-oriented institutional investors start buying once more and gain the upper hand over the traders who focus on the short-term picture. This in turn depends on when these short-term-oriented traders choose to take profits on their short positions on the one hand, and when long-term-oriented investors start to find valuations attractive again on the other.

At any rate, equity markets have now become more attractive, which is a clear argument in favour of medium- and longer-term exposure to equities. Even in the US, a price/earnings ratio of around 16x can no longer be described as expensive.

Fundamentals robust – global economy and corporate earnings are doing well

The fundamental situation of the global economy has not changed. Quite the opposite – the IMF recently increased its prediction for global economic growth in 2018 to 3.9%. The key economic indicators of the OECD, which can be found below, point to strong growth in the world's key economies, which is the most significant factor for corporate earnings. What's more, the indicators below show there is further upside potential to the previous hights.

The reporting season for US companies has turned out to be very solid. Earnings have risen more than expected, and even sales results have been surpassing expectations. On average, some 55% of companies have surpassed analysts' expectations – which tend not to be that pessimistic – over the last five years. The current figure is even around 75%.

Another important factor for the future will be the development of US interest rates. However, it would hardly be in the interests of the incoming Chairman of the Federal Reserve to mark the beginning of his tenure by putting the US economy or global financial markets under pressure.

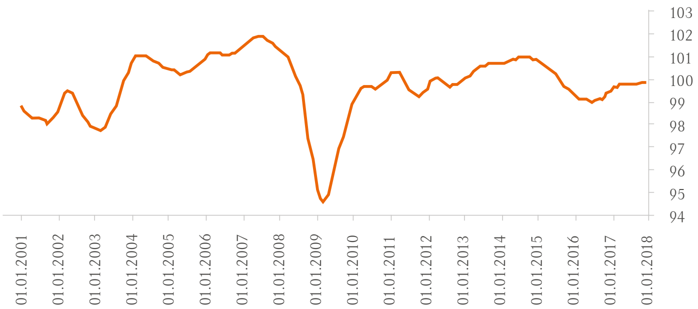
We are not expecting any explosive rise in inflation. A slight rise in US wages will be partly offset by a further improvement in productivity. Over in Europe, it should be noted that inflation is still significantly lower than the target of the European Central Bank. Nor is the European Central Bank in any hurry to call an end to its loose monetary policy: higher interest rates could have the effect of strengthening the euro even more, which would then pose a risk to European exporters just as these have started to exhibit strength once again.

European and above all emerging market equities have more attractive valuations than their US counterparts. Economic development is strong, corporate earnings are on the rise, and equities are now cheaper. Special focus has to be in the coming months on the US inflation and interest rate development.

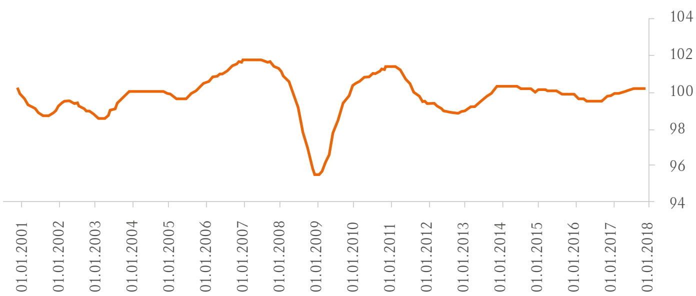
The most recent recommendations of our Investment Committee were as follows: Take advantage of the reduced valuations of equities to return to previous tactical equity weightings. Equities are preferred to fixed-income, particularly government bonds. And emerging market equities currently have interesting valuations, particularly when compared to the equities of other regions.

OECD leading indicators for the key economies are upward-pointing (source: Bloomberg LP)

USA: Economic leading indicator (seasonally adjusted index, source: OECD, Bloomberg)



Europe: Economic leading indicator (seasonally adjusted index, source: OECD, Bloomberg)



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(Editorial deadline: 12 February 2018)

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