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Portfolio Update

September 2019

- **Tariff hikes, a government collapse and the inverted yield curve**
- **Modest losses in the portfolios**
- **Professional investors offloading equities**

Review

Tariff hikes, a government collapse and the inverted yield curve

As in the rest of 2019 to date, there was no shortage of headlines news in August. However, in contrast to the preceding months we have seen a marked increase in equity market volatility over the past few trading weeks. While investors had previously been fairly sanguine about negative newsflow on the trade war, they have been reacting far more sensitively to the latest developments. Previously, there were hopes that Donald Trump would gradually strike a more conciliatory tone with a view to boosting his domestic electoral base. Further tariff hikes before the end of the year are increasingly calling this theory into question. However, it now appears to have dawned on the White House too that a falling equity market is unlikely to be much help in the election campaign. The financial markets barely had time to react to the two sides' entrenchment in the trade dispute before the president started trying to keep investors on side with implausible statements and tweets. One genuinely interesting aspect to emerge from this phase was the inability of automated trading systems – estimated to account for 70% of market trading volumes – to identify the inaccuracy of this information.

Alongside disappointing economic data, the collapse of the government in Italy, the prorogation, or temporary suspension, of the UK's parliament and the inversion of the US yield curve also stoked unease. For the first time since 2007, the yield on the 10-year US Treasury was trading below that of its 2-year counterpart. In historical terms, this is viewed as one of the most reliable indicators of a recession. However, the extent to which conclusions can be drawn about the current situation is hotly contested among experts. With interest rates at record lows and other large-scale interventions by the central banks, we are in uncharted territory. As a result, even indicators that have proved to be reliable in the past need to be treated with extreme caution.

In view of these developments, in the end it was thanks in no small part to the reasonably harmonious outcome of the G7 summit in Biarritz that there was not a more pronounced sell-off on the equity markets. Furthermore, German finance minister Olaf Scholz hinted at a possible economic stimulus package worth EUR 50 billion following the news that Germany had posted negative economic growth in the second quarter. China's decision not to respond to US tariff threats with renewed retaliatory measures gave investors another breather. As a result, losses in the portfolios were kept in check.

Equity indices 2019 total return

Americas	August	2019
Dow Jones Industrial Average (US)	-1.3%	15.1%
S&P 500 (US)	-1.6%	18.3%
NASDAQ Composite (US)	-2.5%	20.9%
Brazil Ibovespa (BR)	-0.7%	15.1%
Europe	**August**	**2019**
EURO STOXX 600 (EU)	-1.3%	15.5%
FTSE 100 (GB)	-4.1%	10.9%
CAC 40 (FR)	-0.7%	19.2%
DAX (DE)	-2.0%	13.1%
SMI (CH)	-0.2%	21.2%
Asia/ Pacific & Emerging Markets	**August**	**2019**
Nikkei 225 (JP)	-3.7%	4.7%
Hang Seng (HK)	-7.1%	2.4%
MSCI Emerging Markets (EM) in USD	-4.9%	4.2%

Sources: Bloomberg, swisspartners

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MANDATE RETURNS gross & POSITIONING

	Euro			Swiss Franc			US Dollar			British Pound		
	CONS	BAL	DYN	CONS	BAL	DYN	CONS	BAL	DYN	CONS	BAL	DYN
2012	**6.6%**	**7.4%**	**10.5%**	**4.3%**	**6.5%**	**10.9%**	**5.9%**	**8.4%**	**11.8%**			
2013	**1.5%**	**6.5%**	**13.5%**	**1.9%**	**8.3%**	**16.7%**	**2.8%**	**9.4%**	**18.5%**			
2014	**6.1%**	**8.0%**	**10.2%**	**4.9%**	**6.5%**	**9.2%**	**1.6%**	**2.2%**	**3.1%**			
2015	**2.7%**	**6.3%**	**9.9%**	**-0.8%**	**0.0%**	**1.8%**	**-0.3%**	**0.0%**	**1.0%**			
2016	**2.3%**	**5.3%**	**7.1%**	**1.3%**	**3.9%**	**5.7%**	**2.8%**	**6.2%**	**7.2%**	**4.6%**	**9.5%**	**12.1%**
2017	**3.5%**	**7.3%**	**10.8%**	**4.3%**	**8.9%**	**15.0%**	**7.1%**	**12.7%**	**18.1%**	**4.7%**	**8.7%**	**14.2%**
2018	**-4.3%**	**-9.0%**	**-10.5%**	**-5.6%**	**-10.1%**	**-12.1%**	**-2.5%**	**-7.9%**	**-9.8%**	**-3.3%**	**-8.6%**	**-10.4%**
Jan 19	2.4%	4.4%	6.0%	2.6%	4.7%	6.3%	2.6%	4.8%	6.1%	2.1%	4.0%	5.4%
Feb 19	1.4%	2.5%	3.3%	1.4%	2.4%	3.1%	1.4%	2.6%	3.0%	1.2%	2.3%	2.8%
Mar 19	0.7%	1.3%	1.9%	0.6%	1.1%	1.5%	0.8%	1.1%	1.5%	0.9%	1.3%	1.9%
Apr 19	1.1%	2.2%	3.2%	1.5%	2.6%	3.8%	1.2%	2.5%	3.3%	1.2%	2.3%	3.2%
May 19	-1.3%	-3.0%	-4.7%	-1.7%	-3.3%	-5.1%	-1.1%	-3.0%	-4.6%	-0.8%	-2.4%	-4.0%
Jun 19	1.4%	2.7%	4.0%	1.3%	2.5%	3.8%	1.9%	3.4%	4.7%	1.7%	3.3%	4.6%
Jul 19	0.8%	1.2%	1.3%	0.7%	0.8%	0.8%	0.7%	0.8%	0.7%	1.2%	1.6%	1.5%
Aug 19	0.0%	-0.2%	-0.9%	-0.2%	-0.4%	-1.3%	0.1%	-0.3%	-1.1%	0.0%	-0.3%	-1.1%
2019	**6.7%**	**11.6%**	**14.6%**	**6.1%**	**10.7%**	**13.0%**	**7.9%**	**12.2%**	**14.0%**	**7.6%**	**12.5%**	**14.8%**

Given the volatility on the financial markets and the marked rise in risk aversion among investors, in our view the results achieved – even those in negative territory – are quite satisfactory. With a substantially lower equity allocation, the most conservative alignment of the strategies also posted only a small loss. In the balanced and dynamic portfolios, returns were a little weaker in line with the risk appetite shown.

Individual equity positions had a supportive effect. These included the shares of animal drug producer Zoetis or memory product manufacturer Western Digital, which had a material effect on results thanks to impressive share price gains. Furthermore, all but one of the alternative investments achieved a positive monthly result in August. The results prove the capacity of these investments to realise a return that is unrelated to traditional asset classes when equity markets fall.

Bond investments also posted gains in an environment of declining yields, while equity positions from the US, Europe and, above all, Japan and the emerging markets generally delivered a negative performance. However, despite negative portfolio returns, we managed to generate a better monthly result on average than our peers across all strategies thanks to our earlier reduction in equity exposure.

Equities (neutral)	Given the deteriorating economic prospects and the Trump administration's unpredictable trade policy measures, the equity allocation has been reduced to a neutral level in recent months. While we still anticipate positive economic growth, we feel we have adopted the right positioning with a neutral allocation given the existing risks. The liquid funds available can be quickly deployed for new investment opportunities in the event of a market correction.
Bonds (underweight)	Focus on global flexible strategies in combination with high-yield bonds, senior loans and floating-rate investment products with low interest rate sensitivity, while underweighting direct investments in government and European corporate bonds that offer too little compensation for risk.
Alternative Investments (overweight)	Combination of insurance securitizations, market-neutral or option-based volatility strategies, which exhibit low correlations, unlike traditional asset classes.
Liquidity (overweight))	Outside of the US dollar investment universe, there are few opportunities to avoid the negative interest rates applied by the central banks. If necessary, we are parking excess liquidity in cash and accepting a negative return, which is partially passed on to customers, especially as there are no other risk-free alternatives. Trustee investments offer opportunities in US dollars.
Foreign currencies (underweight)	The foreign currency allocation is reduced in the portfolio by deploying foreign exchange futures transactions. A higher share in the reference currency is favoured at present on the basis of risk considerations.

TRANSACTIONS (most recent first)

DB Platinum Selwood Credit Fund Alternative investments Market-neutral credit	Submitted for subscription on 30 September 2019: (for all strategies) Selwood's market-neutral credit fund takes long and short positions on credit default swaps (CDS) of investment grade corporate bonds. The aim is to benefit from price anomalies via arbitrage transactions and to minimise market volatility. The DB Platinum Selwood Market Neutral Credit Fund replaces the Merian Global Equity Absolute Return Fund in our alternative investments.
Merian Global Equity AR Fund Alternative investments Market-neutral global equities	Submitted for redemption on 28 August 2019: (for all strategies) Market-neutral global equity funds evidently struggled to achieve positive returns in 2018 in tandem with the other alternative investments. This trend continued at Merian in 2019, while comparable funds recouped some of their losses. We have taken the opportunity to dispose of the position in our strategies and shift the proceeds into the DB Platinum Selwood Market Neutral Credit Fund.

OUTLOOK

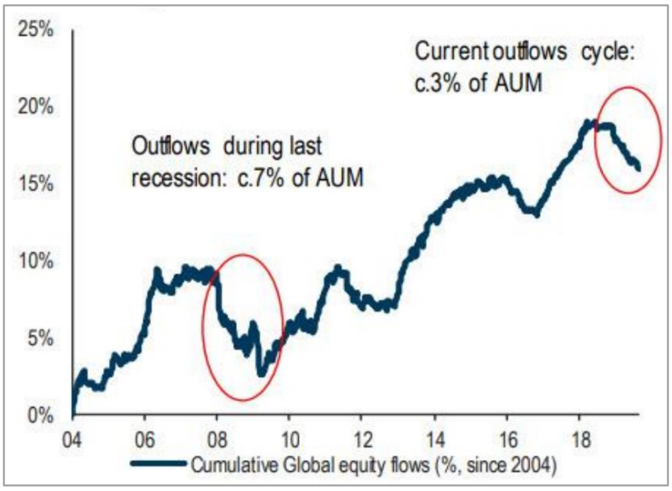
Professional investors are clearly minimising risk

Looking ahead, a number of interesting trading days are on the agenda. Pivotal central bank meetings are forthcoming, led by the ECB on 12 September, followed by the Bank of Japan, the Federal Reserve and the SNB on 19 September. Financial market expectations are fairly clear, but central bank representatives seem reluctant to respond to calls for key rate cuts and additional monetary policy measures. This is at least implied by comments and speeches from various voting central bank members. However, we will find out in the coming weeks whether their voices will indeed be heard. They have the backing of numerous studies indicating that financing conditions are certainly not the main reason for the investment restraint. Instead, obstacles such as a lack of specialist staff, uncertainty about the future or regulations are likely to be the primary drivers of this trend (EIB Investment Report 18/19). It is therefore questionable how influential any further liquidity injections would be in allaying companies' concerns.

Nonetheless, it is highly likely that the committees at the upcoming central bank meetings will advocate more key rate cuts and QE programmes, especially as they would otherwise run the risk of triggering another sell-off on the financial markets. In an environment of declining global economic growth, heightened uncertainty as a result of trade wars and unresolved political problems (such as Brexit), the latter would create additional burdens for companies and should be avoided at all costs.

It has been interesting to watch the trend in cash flows, with investors heading for safe havens such as government bonds, gold or money market funds in August due to fears of a recession. Professional investors have increasingly exited their riskier positions and structured their portfolios more defensively. An analysis by Barclays Investment Bank shows that the cumulative flows out of equity investments already amount to half of the volume seen in the last recession of 2008/2009.

Barclays Research: flows out of equities



Sources: EPFR; Barclays Research

The substantial outflows from US high-yield bonds and emerging market paper in August are another indication that investors are generally minimising risk. However, this does not necessarily have any negative implications as the majority of these shifts have already been completed. As a result, the risk of another sharp sell-off in equities should have decreased significantly. In any case, shocks rarely occur when underlying sentiment is cautious and largely tend to be the result of excessive euphoria.

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