Maerki Baumann & Co. AG

PRIVATE BANK

INVESTMENT COMMENT

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Glass half full

Political decisions can sometimes fail to match expectations – a lesson that was brought home to us in no uncertain terms last year. This year too, we can expect the odd "surprising political decision" that will cause a furore in the media. So we should prepare ourselves for frenzied commentaries in the press in which the focus is on the worst possible repercussions of some vote or other. Indeed, 2017 will serve up a whole host of elections, particularly in Europe: the Dutch will choose a new parliament in mid-March, the French a new president at the end of April/early May as well as a new parliament in mid-June, and the Germans a new Bundestag come the autumn. At the same time, the eight-year tenure of US President Obama has just come to an end. Venturing a look into the future, we suggest that the incipient Trump Administration will embark on a fundamental change of course in a large number of areas. That said, the extent to which Congress will go along with the wishes and declamations of the new President, which do not always appear realistic, is wholly unclear. So there should be plenty of "excitement" ahead.

At the same time, global equity markets have developed very positively over the last two months, which has caused surprise in some quarters. After all, stock markets are renowned for their dislike of uncertainty. Against a backdrop of "regime change" in the White House, the so-called Global Economic Policy Uncertainty Index has clambered to record highs since the start of November. Much could change under a Trump presidency, starting with trade policy (less global trade) and economic policy (an axe taken to the jungle of regulation), through to foreign policy (pressure on NATO partners to increase their share of defence spending), environmental policy (are the days of the Paris Agreement numbered?), social policy (a question mark over Obamacare) and finally tax policy (tax cuts for both individuals and companies).

As we see it, the investor appears to be looking at a glass half full right now: yes, global growth is rather weak compared to earlier economic cycles, and yes, the political risks are higher, but the prospects for the next few quarters still look rosy, at least if most things work out well. The fact that the risk of higher inflation has risen sharply on the back of an increasingly tight US labour market is not the main focus of the investment community right now. But in the medium term, i.e. beyond 2017, this is where we see the greatest risk to financial markets: rising rates of inflation will prompt central banks all around the world to increase key interest rates, at times aggressively, and given the high levels of indebtedness of both governments and consumers (in historical terms) this will then trigger the next recession. But none of this is likely to occur in 2017.

Indeed, many observers cite multiple reasons why there might not be a rise in inflation at all. These include greater integration of the emerging market nations into the global economy, continued weakness of consumer demand together with low levels of investment at companies, persistently low commodity prices (even if these have risen somewhat over the last few quarters), technological progress with its price-dampening repercussions, and capacity utilisation rates that are essentially still too low.

But we are very much of the other view. A number of indicators suggest that prices will rise over and above the year-on-year increase attributable to the surge in oil prices. For example, the Chinese Producer Price Index (PPI) has climbed from -6% to +5.5% since the start of 2016, its highest level for more than five years. In the US, the Producer Price Index has likewise risen from a level of -1.4% in October 2015 to (most recently) +1.6% in December, while the equivalent barometer in the eurozone has risen from -4.4% nine months ago to +0.1% as of November. In view of the anticipated increases in demand as a result of fiscal measures – with a slight economic boost from the public sector likely even in Europe – together with signs of increasing negotiating power on the part of employees (particularly in the US), we do not envisage the spectre of deflation rearing its ugly head again in the coming years.

So is it a case of a booming economy, rather like in the 1980s? From the current standpoint, such an expectation appears foolhardy. However, we can easily imagine such an assumption being widely adopted in the investment community if the initial measures taken by the new Trump administration in the fiscal area are received positively. The result would be an increase in equity valuations (higher price/earnings ratios [PER]), even though we already see evidence of overvaluations in the case of US stocks in particular: compared with their 50-year average, US equities are expensive to the tune of more than one standard deviation when measured against the median PER of the S&P 500. On the other hand, the equivalent valuation in 2000 – the peak of the dotcom bubble – was three standard deviations higher. In other words, there is still significant upside potential (of around 20–30%) even for expensive US equities if one anticipates a further phase of market euphoria. As stated above, we would not rule such a development out at the current time.

In Europe, equities have much lower valuations. For example, when viewed at the level of their relative Shiller PER (vs. world equities), German equities are very close to their 23-year low, while when viewed on the basis of median PER they are close to their historical average over the same period. We see attractive buy potential here.

Conclusion

There are plenty of question marks on the horizon, which is hardly surprising in view of the plethora of imponderables in connection with the new US President. Moreover, investor sentiment has now reached heady levels thanks to the significant rises in prices, which suggests a short-term correction to equity markets is a clear possibility. We would therefore continue to be buyers of equities in the event of a correction, particularly in Europe, despite the upcoming 2017 elections in key EU countries and the associated uncertainty. Over the next few years, a number of situations will probably unfold that could be critical for the EU (or the eurozone) – but we continue to anticipate repeated "muddling along" rather than any break-up.

We will be following interest rate developments in the capital markets closely over the next few months, as we currently see similarities with the scenario experienced in 1987. In the weeks ahead, the initial decisions of the new US President could dampen financial market sentiment, but in our view this would be only temporary. We remain very circumspect with regard to bonds, and recommend reducing interest rate risk (i.e. average time to maturity) further in the event of any counter-movement in yields.

Finally, we are doubtful about the US dollar showing its stronger side over the next few years, despite current market expectations to the contrary. Essentially the greenback is already considerably overvalued, the US current account balance remains in deficit, and we believe there is a very real question mark over the dollar maintaining its real interest rate advantage over other global currencies over the next few quarters. Given this background, we remain supporters of gold and commodities in general. To sum up, 2017 could actually go down in the annals of financial market history as a "good to very good" year.

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MAERKI BAUMANN & CO. AG
PRIVATE BANK

EDITORIAL
Daniel Egger, Chief Investment Officer

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ZURICH
Dreikönigstrasse 6
CH-8002 Zurich
Phone +41 44 286 25 25
info@maerki-baumann.ch
www.maerki-baumann.ch