

# OBSERVATION DECK #

2<sup>nd</sup> QUARTER 2019



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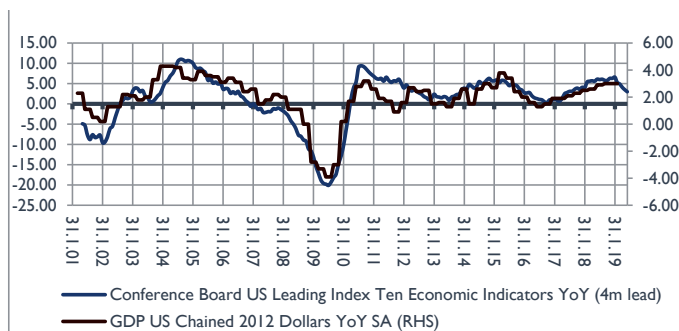
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# KEYSTONES

## CENTRAL BANKS TO THE RESCUE

After a fulminant start into the year followed by a first correction, the key question is what do markets have in store for us for the rest of the year? To answer that question, it helps to look back in order to understand where one is headed. Undoubtedly, we have entered the late stage of an economic expansion that has lasted for more than 9 years—the second longest on record in fact. While in itself late cycle dynamics historically bring about bouts of volatility as investors weigh the odds and magnitude of an inevitable slowdown, political risks such as trade tensions and BREXIT have added to uncertainty in the current cycle. The excessive December sell-off was clearly such a volatility event. Since then a technical rebound has set in that has been further fueled by increasingly easy central bankers. The tight financial conditions in December called the Fed to action, and with macro data slowing faster than expected and inflation sticky below the target, the ECB followed suit. Eventually, the Fed caved in for a second time for the same reasons in March by signaling a hiking pause and ending the balance sheet roll-off sooner than expected. Global monetary policy is firmly on hold for the rest of the year since then. Markets have even started to discount the first rate cuts in the US, Canada, and Australia—more on this topic in the fixed income section.

US GROWTH VS. LEADING INDICATOR



SOURCES: BLOOMBERG, BANQUE HERITAGE

What to look out for? We are most likely in the phase where leading economies such as the US are losing steam while economic growth rates continue to be above potential-- at least for another few months to come. A technical recession is still a distant event according to various indicators. Elsewhere growth rates are decelerating also, and survey data continues to fall. The loss of momentum in the Euro-Area economy, while expected, has been the most pronounced. The bulk of the European

slowdown is imported, however, with its relative large external sector. Trade tensions clearly weighed on the global export and manufacturing industry as China is suffering. To counter the slowdown, China has launched a fiscal and monetary stimulus package that is expected to bite in the second half of the year with ripple-on effects elsewhere. There are also some tentative signs that macroeconomic data in Europe will bottom out, but more patience is required. Our working hypothesis is that global growth will stabilize towards the end of the year.

The dovish pivot of global central banks has probably been fully priced, and it would seem that the current late cycle rally is trading on faith alone. We will ultimately need to see stabilization in macro data and growth to return in order to give equity and risk markets fresh impetus. A US-China trade deal and a BREXIT

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deal could also act as short-term catalysts in the meantime. While we expected equities to outperform bonds and cash this year we recommend to take only measured risks and not to bet the farm until we see better macro data.

## CURVE INVERSION - KEEP CALM

Dovish central bankers successfully talked down bond yields to stem a slowdown. These strong moves in yields were exacerbated by repositioning and hedging activities. As a result, the US yield curve--or more precisely a certain segment of the yield curve, notably the 10-years-3-month-spread, became inverted or negative. The yield curve usually inverts as a result of Fed hiking and declining long-term yields indicating a slowdown in growth. The yield curve, the difference between long-term and short-term rates, is one of the most reliable predictors of

US recessions. Over the past sixty years, there has been only one false positive. Given this high hit-ratio, it comes as no surprise that it got a lot of attention by augurs and the media alike.

The problem with this recession indicator is that it is a bad timing indicator as a recession can occur within a timeframe of three months to more than two years. On average, a recession has set in after 311 days once the curve has inverted. In a simple recession model, the current inversion of about 4bps indicates a 30% probability of a recession within 12 months. Other recession models, based on leading indicators or credit pricing do not flash any warning signs. While we pay close attention to these developments, we currently do not see a high risk of a US recession within a year and advise not to panic. It is also worth noting that historically equity markets tended to produce some of the strongest performances in the months following an inversion. In the past three instances of a curve inversion (1989, 1998, 2006) the S&P 500 has rallied on average 39%. On balance, it took 30 months for equity returns to drop below average again.

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USYIELD CURVE 10YR MINUS 3M



SOURCES: BLOOMBERG, BANQUE HERITAGE

Equities	Last Price	YTD %
S&P500	2892.74	15.34
Eurotox 600	386.68	14.64
Nikkei	21761.65	8.48
China A shares	3341.22	27.95
Brazil	97108.17	8.18
India Nifty	11596.70	6.76
Russia RTSI\$	1249.71	16.94
MSCI World Local	1644.75	14.11
MSCI EM Local	60253.7700	12.78
Currencies	Last Price	YTD %
Dollar Index	97.0250	0.89
Euro	1.1271	-1.71
GBP	1.3082	2.57
Yen	111.4600	1.61
AUD	0.7140	1.29
CHF	1.0025	2.08
Brazil Real (BRL)	3.8377	-1.12
Turkish Lira (TRY)	5.7476	8.66
India Rupee (INR)	68.9263	-1.21
China Yuan (CNY)	6.7194	-2.31
JPM EM FX	63.2870	1.70
Fixed Income	Last Price	YTD %
UST 10yr	130.99	2.22
EU 10-yr	141.76	1.82
US IG Corp	2043.71	5.23
US HY Corp	388.23	7.04
EU IG Corp	238.21	3.40
EU HY Corp	388.23	5.58
Commodities	Last Price	YTD %
Crude Oil	63.35	40.72
Natural Gas	2.69	-8.47
Gold	1293.80	0.98
Silver	15.04	-3.25
Copper	290.25	10.32
RICI Global	2452.15	11.75
RICI Agriculture	749.53	-1.08
RICI Energy	402.39	29.01
RICI Basic Metals	1217.20	6.49
RICI Precious Metals	1625.29	1.80

As of April 11th, 2019

# EQUITIES

## BEST QUARTER IN 10 YEARS

### EMERGING MARKETS

On both issues of the trade war and Fed policy the market has swung from extreme pessimism in the final months of 2018 to extreme optimism this year. This swing in sentiment has generated considerable changes in risk appetite and equity prices. Reports of Chinese stimulus are further lifting sentiment and this has benefited emerging market assets.

Challenges for emerging markets persist. Economic activity is still weak, if not contracting, in many countries according to the composite PMI reports. However, a more dovish Fed and the resulting prospects for a weaker dollar, combined with the Chinese stimulus measures, are increasing investor appetite for the asset class.

For this rally to continue we need to see a more complete resolution of the US trade disagreement with China and Europe and evidence that the Fed is willing to tolerate higher inflation and rising asset prices. These factors will in large part dictate the outlook for corporate earnings. We remain skeptical that America's trade agenda will move swiftly towards an amicable conclusion and so we remain cautious and do not chase this asset class.

### EUROPEAN MARKET

Global equities are enjoying their best start to the year since 1991 and are outperforming other key asset classes. The markets clearly look more vulnerable to bad news again as technicals have normalized following the December capitulation, RSI is outright overbought and valuations have re-rated. A lot of the market negativity in Q4 was caused by the worsening growth-policy trade-off in the US. Economic activity disappointed, the Fed tightened policy, and the yield curve flattened sharply as a result.

Despite the recent growth downgrade from the ECB, we think the macroeconomic news flow for Europe is about to get better. The

idiosyncratic drags on growth during the second half of 2018 are now fading, a rebound in China should also feed into Europe, wage growth is accelerating, and fiscal stimulus is picking up. In addition, if Brexit uncertainty abates, this could provide a further tailwind.

In Europe, flows have been negative year-to-date as investors have used the rally as an opportunity to de-risk, adding to bonds and cash. Positioning and sentiment are far from being exuberant. The bulk of the rebound is probably behind us, but we advise holding rather than selling, and would use the recent drop in volatility as an opportunity to add cheap hedges.

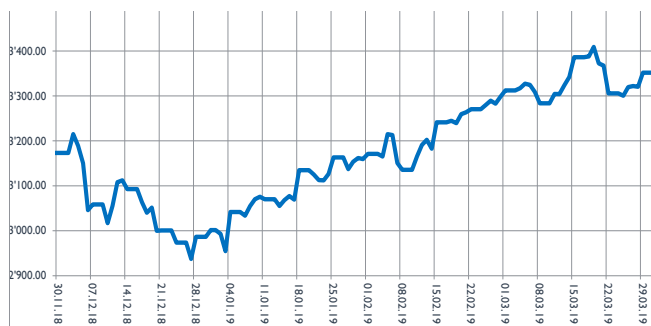
### US MARKET

US equities fully participated in the global rally since the start of 2019, erasing almost entirely the correction of last quarter, the extent of which was probably exaggerated. Positive sentiment of late was mainly driven by two factors. First, optimistic reports on progress with regards to the US-China trade talks, although not reaching a final stage, were clearly supportive of sentiment. Second, the change of stance by the Fed to a patient approach to rate hikes, implying a renewed accommodative monetary policy, relieved the market from fears of a policy error and exacerbated the move up.

Earnings season is now over. The results, although showing some deceleration, continued to point to a very healthy state for US companies. Guidance was however the weak spot as earnings expectations for 2019 have been revised meaningfully lower to low single digit level, down from 10% just a few months ago. The first quarter of this year is even expected to come in negative, raising the specter of an earnings recession as a realistic possibility.

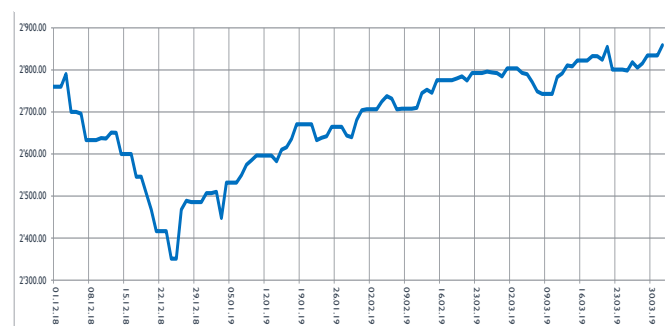
The overall environment remains supportive of US equities; nevertheless, we prefer a hedged approach given the valuation levels and the aforementioned deterioration in earnings trends.

EURO STOXX 50



SOURCE: BLOOMBERG

S&P 500



SOURCE: BLOOMBERG

# FIXED INCOME

## KEEP THE PARTY GOING

Global interest rates fell off a cliff after a weak set of macroeconomic data late in March. The yield of the German 10-year-Bund is back in negative territory - the last time it was negative was in 2016 - and in the US yields are back to 2017 levels. Slowing macro data and inflation that is going nowhere has put central banks on the spot, and they answered with dovish forward guidance. In the case of the Fed, this means no more rate hikes this year

and a sooner than expected end of the balance sheet reduction.

The ECB continued to push back the date of its first rate hike and announced a new round of TLTROs, which is nothing but a fancy word for funding Europe's

banks at a subsidized rate. De facto, global monetary policy is on hold for the remainder of the year. It would require a strong macro surprise to push the leading central banks back to their initial intentions of normalizing monetary policy. Markets in turn have begun to price in first rate cuts in the US (see chart), in Canada, and in Australia.

Admittedly, as far as the Fed is concerned, we did not expect such a dovish turn nor did we expect the ensuing market reaction. With hindsight, it becomes ever more clear as to what the current FOMC is really about: Keep the party going! Chairman Powell said it plainly in January at the FOMC press conference: "My colleagues and I have one overarching goal: to sustain the

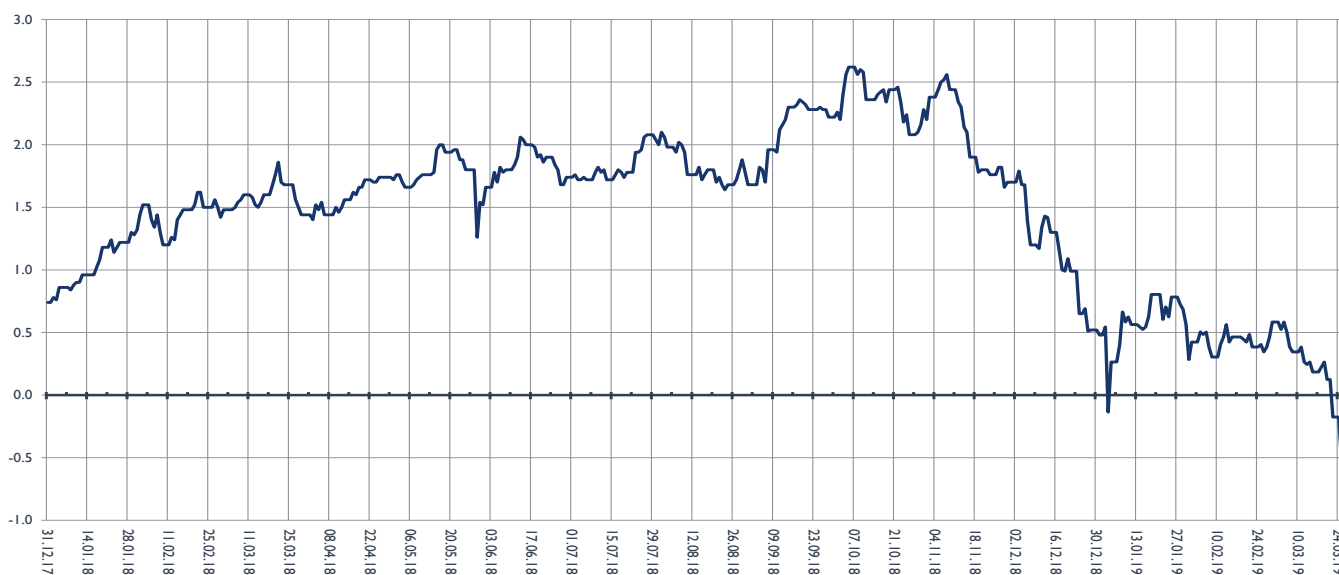
economic expansion...", or earlier in November: "So the best thing we can do is to try to sustain this expansion for as long as possible, and that's really what our policy is designed to do." Officially, the Fed has a neutral policy stance but markets have already discounted rate cuts within the next twelve months. So this begs the question whether the market is right. As of today, we do not think a rate cut will be necessary. We think the Fed

will remain on hold. Reliable indicators such as the ISM Manufacturing index have fallen from the peak but remain at levels that point to trend growth in 2019. The Conference Board's leading economic indicator is

suggesting some cooling with growth above potential (2%). Much of the current decline in yields is a result of the extended weakness in non-U.S. growth that has put pressure on all global bond yields. The current downturn in global yields is already looking stretched from a technical perspective and is reaching post-QE extremes. With tentative signs emerging that global growth is bottoming out, the next move in yields is probably up. It seems too late to chase the current rally. With supportive global central banks and low recession risks, the best place in fixed income will be high yield in the US and Europe in the short-run where at least some carry can be earned.

*"With supportive global central banks and low recession risks, the best place in fixed income will be high yield in the US and Europe in the short-run where at least some carry can be earned."*

NUMBER OF HIKES IN 2019 (VIA FED FUNDS FUTURES)



SOURCES: BANQUE HERITAGE, BLOOMBERG

# ALTERNATIVES CORNER

## THE CASE FOR HEDGE FUNDS

Despite an ever-growing number of funds (total HF AuM was valued at \$3.2trn by the 2018 Preqin Global HF Report), 2008-2018 felt like somewhat of a lost decade for the hedge fund industry. While double-digit returns were almost expected at the turn of the century, these past ten years were disappointing in terms of performance. Even worse, hedge funds did not deliver on their capital conservation promises either.

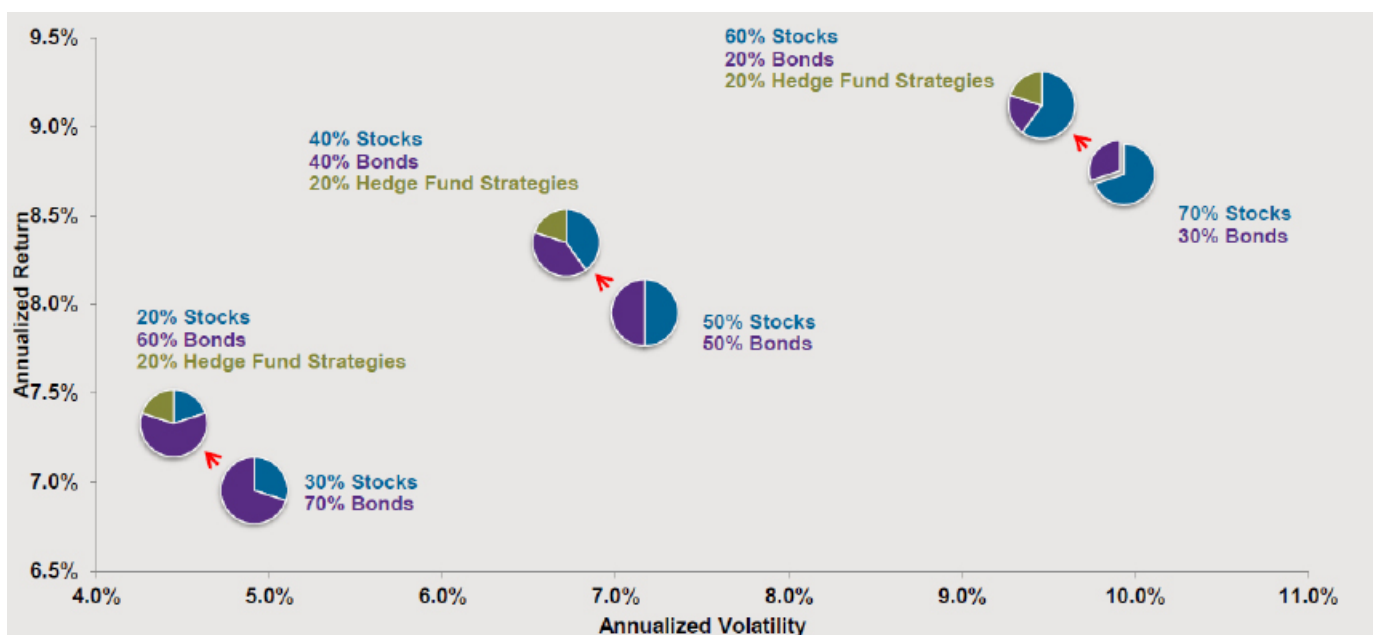
In order to unlock their potential, hedge fund managers need to find uncorrelated trades, arbitrage opportunities and overlooked pockets of alpha. While markets have indeed become more efficient, one may attribute this subdued regime to the unprecedented interventionism from central banks in the wake of the global financial crisis. These unconventional measures have increased correlations, stimulated bubbles (few were able to beat the S&P500) and left managers vulnerable to binary risks, many political.

We believe that this regime is about to change (see figure below). Less accommodative monetary policies, coupled with extended economic cycle fears should pave the way for more performance divergence and a generally more volatile environment. To that point, while markets suffered violent drawdowns at the beginning

and end of 2018, the likes unseen since 2011, our in-house fund of funds finished the year almost flat, at -0.37%, while the MSCI World lost -8.71% and the average balanced portfolio lost -6.45%. Today, hedge funds represent 15% of our asset allocation and we believe every portfolio should be exposed to alternative investments.

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## ENHANCING PORTFOLIOS THROUGH HEDGE FUNDS



SOURCE: JP MORGAN

## FOCUS ON MARKET NEUTRAL STRATEGIES

Market Neutral strategies lend themselves particularly well to the current environment. When uncertainty is most prevalent and market direction hard to predict, one would seek to avoid market risk entirely, which is what market neutral strategies try to achieve. They can be applied to equities, fixed income, convertible arbitrage, etc. Typically, this is accomplished through some type of hedging, either at the individual instrument level (i.e. taking a long position in a convertible bond while shorting the underlying stock to fully hedge its price fluctuations) or at the portfolio level (by achieving the lowest possible correlation between all the holdings).

This does not mean that Market Neutral strategies are risk-free. However, the associated risks are different from those found in long-only investing, hence their diversifying attributes. Furthermore, complete neutrality is seldom achievable as hedges are often imperfect. This is called basis risk and needs to be closely monitored.

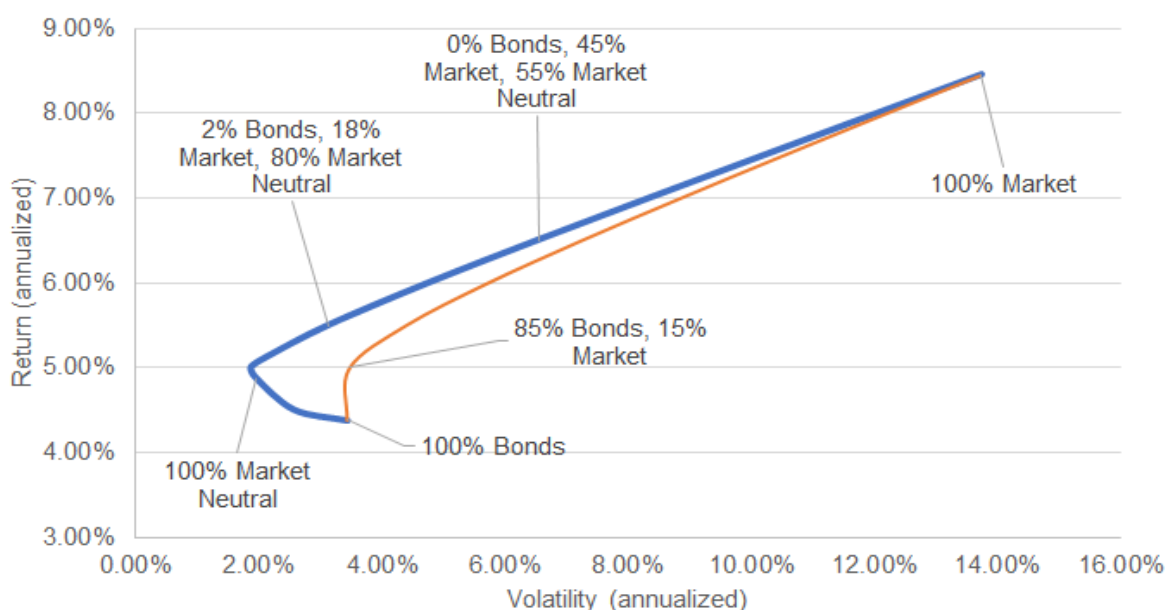
Ultimately, what makes a market neutral strategy successful is not only the manager's general financial and trading acumen but

also his ability to break down an instrument's risks into a number of clearly identified factors in order to selectively and precisely hedge out market beta.

Within our market neutral pocket, we currently hold an equity market-neutral strategy, a convertible arbitrage strategy and a merger arbitrage strategy. From September to December 2018, a theoretical equally weighted portfolio of those funds would have outperformed the MSCI World (-13.42%) by 11.78% and the average asset allocation fund (-6.41%) by 4.77%.

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EFFICIENT FRONTIER: 2 ASSET AND 3 ASSET PORTFOLIO



SOURCE: SEEKINGALPHA



# THE ARCHITECTS OF WEALTH



✚ BANQUE HERITAGE  
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