OBSERVATION DECK

3rd QUARTER 2019

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KEYSTONES

REAL RATES WERE REAPPEARING

It seems that the TIARA scenario ("There Is A Real Alternative") which started in 2018 is already out of date. After almost a decade of unconventional stimulus provided by Central Banks, leading to keeping bond yields below inflation rates and pushing flows of money into equities, 2018 was the first time where the main central banks have jointly begun to withdraw liquidity from the financial markets. Over the year, the US Federal Reserve has raised its benchmark interest rate by 25 basis points four times in a row, accelerating the pace since its first hike in 2015. At the same time, the European Central Bank decided at the end of December 2018 to formally end its 2.6 trillion euro ($2.95 trillion) asset purchase program which was part of a package of policy measures that was initiated in mid-2014, as inflation was finally getting closer to its target of 2.0%.

Following these tightening measures, investors massively sold off their bond portfolios, pushing the US 10Y yield up to 3%, a level last seen in 2011. Equity markets have also not been spared by this paradigm shift, as investors are having difficulties digesting the tightening measures and anticipating another round of aggressive FED interest rate hikes in 2019. Suddenly, over a couple of months, positive real rates have resurfaced which was the sign of a sound economy growing above its potential (in the US at least).

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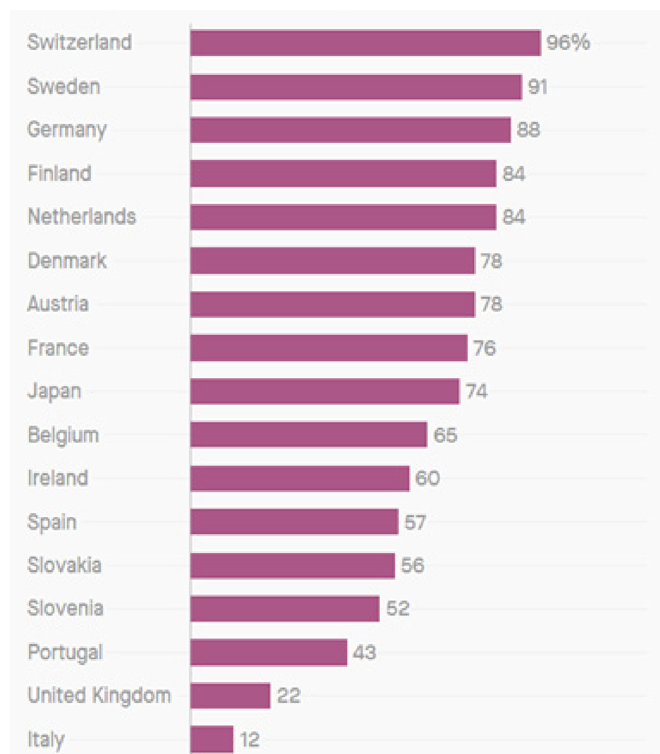
THE "TINA" SCENARIO IS BACK

Unfortunately, it did not last long! During the first quarter, the sky has darkened. The US economy has started to show signs of slowing down, inflation has remained subdued, and trade tensions between the US and China have increased a notch. In March, the FED surprisingly adopted a dovish stance, with a guidance of unchanged rates going forward and an earlier-than-expected ending of the balance sheet normalization process. The outcome was not long in coming! Financial conditions eased rapidly with the 10Y US Treasury yield plunging to 2.35% as of end of March, leading the US yield curve (3Y-10Y) to invert, the first time since the 2008 financial crisis. Does this predict that the next recession is coming soon? This is not sure as economic figures remain solid, especially employment and consumption data. However, the only certainty we have is that it seems we are now back in a "déjà vu" scenario. Indeed, the Fed's recent dovish move, combined with the even more worrying speech of Mario Draghi in March 7th, pushed the bond market's yields significantly down the road across the board. As of today, almost $12 trillion of investment grade corporate and government bonds have negative yields, predominately in Europe and Japan. This is the largest amount since the middle of 2016 when the UK voted to leave the European Union.

At the same time, equity markets did what they have been doing for the last 10 years. They rallied! While the global macroeconomic picture is deteriorating, the S&P500 is posting new highs with a performance above the 20% level on a year-to-date basis. It seems that we have once again entered a phase where the central banks will do everything possible to avoid any derailment of the economy. Rates could therefore remain very low for a fairly long period of time, something which could lead investors to park their money in risky assets. This is what we call the "There Is No Alternative Scenario" (TINA)!

SHARE OF GOVERNMENT DEBT WITH NEGATIVE YIELDS AS OF JUNE 18, 2019



SOURCES: TRADEWEB

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WHEN POLITICS TAKES CONTROL

The recent developments within the US and European central banks clearly indicate the end of the independence of these monetary policy bodies.

In Europe, the ECB, which is generally viewed as the institution most protected from politics, will be soon headed by Christine Lagarde – a politician and not an economist. Right after her appointment, the head of Germany's ruling Christian Democratic party said she should shift monetary policy to make it comply with the bank's inflation-targeting mandate.

In the US, Powell has endured increasingly harsh criticism from Donald Trump, the first American president in almost three decades to lash out publicly at the Fed. Many times over the last months, Trump has called on the central bank to slash interest rates and resume bond purchases to support the US economy.

Last but not least, Turkish President Recep Tayyip Erdogan has fired the governor of the central bank and replaced him with his deputy, as disagreements were rising over interest rates, which the government wants to lower in a bid to boost economic growth.

It is therefore obvisous that a new paradigm is emerging within central banks, and it is currently difficult to assess the impact of government intervention in state monetary policies.

Everything is currently being done to prevent the economy from running out of steam, but is it really healthy for the economy itself?

Equities	Last Price	YTD %
S&P500	3001.34	19.05
Eurotoxx 600	387.41	14.74
Nikkei	21685.90	5.15
China A shares	3038.62	16.36
Brazil	103906.00	18.17
India Nifty	11596.90	6.76
Russia RTSI$	1356.84	26.96
MSCI World Local	1683.82	16.82
MSCI EM Local	58099.1800	8.75
Currencies	**Last Price**	**YTD %**
Dollar Index	97.1900	1.06
Euro	1.1215	-2.20
GBP	1.2477	-2.17
Yen	107.9400	-1.60
AUD	0.7034	-0.21
CHF	0.9865	0.45
Brazil Real (BRL)	3.7598	-3.13
Turkish Lira (TRY)	5.6931	7.63
India Rupee (INR)	68.9613	-1.16
China Yuan (CNY)	6.8804	0.03
JPM EM FX	63.0490	1.32
Fixed Income	**Last Price**	**YTD %**
US Govt	394.02	1.38
EU Govt	239.48	2.27
US IG Corp	2974.29	5.13
US HY Corp	2069.82	8.40
EU IG Corp	145.70	4.05
EU HY Corp	392.69	6.80
Commodities	**Last Price**	**YTD %**
Crude Oil	57.99	25.63
Natural Gas	2.33	-20.75
Gold	1420.30	10.85
Silver	15.98	2.83
Copper	270.00	2.62
RICI Global	2351.27	7.16
RICI Agriculture	732.65	-3.31
RICI Energy	365.12	17.06
RICI Basic Metals	1180.66	3.30
RICI Precious Metals	1720.43	7.76

As of July 18, 2019

EQUITIES

AN UNBELIEVABLE FIRST HALF!

EUROPEAN MARKETS

For much of the year, equity markets have enjoyed a healthy climb, assisted by a dovish tilt from central banks, as well as the possibility of a trade deal between the US and China.

The calm market environment was disturbed in May. Investors' nerves were severely tested by the announcement that the U.S. would be moving ahead with tariff increases on US imports from China, and equity markets performed very poorly. In June, the central banks came to the rescue. Confronted with weaker economic data, risks to the trade outlook, and continued low inflation, the Federal Reserve and the European Central Bank indicated that the cavalry is coming in the form of further monetary stimulus. So bad economic news was good news for markets. The G20 meeting between Xi and Trump has shown good intentions with the US and China coming back to the table and avoiding escalation. However, we do not see any short-term resolution to the trade war.

Early this month, bond and equity markets rallied as investors cheered the unexpected nomination of Christine Lagarde's nomination to be the next President of the European Central Bank and the premise that this would extend an era of ultra-loose monetary policy in the Eurozone. European bond yields fell deeper into negative territory and investors are hungry for yield. Therefore, we continue to recommend buying stocks that pay attractive and growing dividends. Over the long-term, we know that the bulk of the cumulative total return from equities has come from dividends reinvested as opposed to capital gains.

US MARKET

US equities are hovering around all-time highs. Nevertheless, the path over the second quarter was far from a straight line. The positive tone around US-China trade talks exiting Q1 suddenly gave way to aggressive rhetoric and renewed tariff increase threats. Combined with mixed economic data over the period this was enough to send the market heavily down mid-quarter. The Federal Reserve was quick to react and, by sending dovish signals and openness to cut rates, triggered an impressive rally to wrap up the quarter.

The US is firmly in the late-cycle phase and the question now is whether the effect of Central Bank action will be sufficient to offset the slowing growth momentum. Opinions across the investment community vary greatly. The bullish camp sees a simultaneous trade truce and interest rate cut as an environment that should further buoy the equity market. On the other hand many observers point to the fact that if history is any guide, periods when the FED loosens policy because of a weak set-up, in the end the deteriorating economic conditions prevail and drive equities down no matter the policy action. The answer we think might be lying in the middle where the two market-driving forces prevail intermittently, leading to a range trading market and extended cycle. As we favor this scenario we recommend a somewhat more active trading stance, and a "buy the dip" approach should add value over the coming months.

EMERGING MARKETS

Manufacturing surveys have weakened around the world with a notable decline in the US business surveys and continued weakness in China and Japan.

"Excellent". That was the assessment of President Trump after his meeting with President Xi Jinping in Osaka. The trade war is a lose-lose situation overall, as supply chains undergo increasing disruption. China is on the losing side of the trade war, as companies increasingly shift capacity from the Chinese mainland to Southeast Asia. We remain slightly underweight emerging markets.

Japanese equities would also benefit from more positive news flow on trade as Japanese equities include a high proportion of international cyclical firms. We have a Neutral allocation to Japan.

STOXX 600 INDEX

SOURCE: BLOOMBERG

NASDAQ 100 INDEX

SOURCE: BLOOMBERG

FIXED INCOME

RACE TO THE BOTTOM

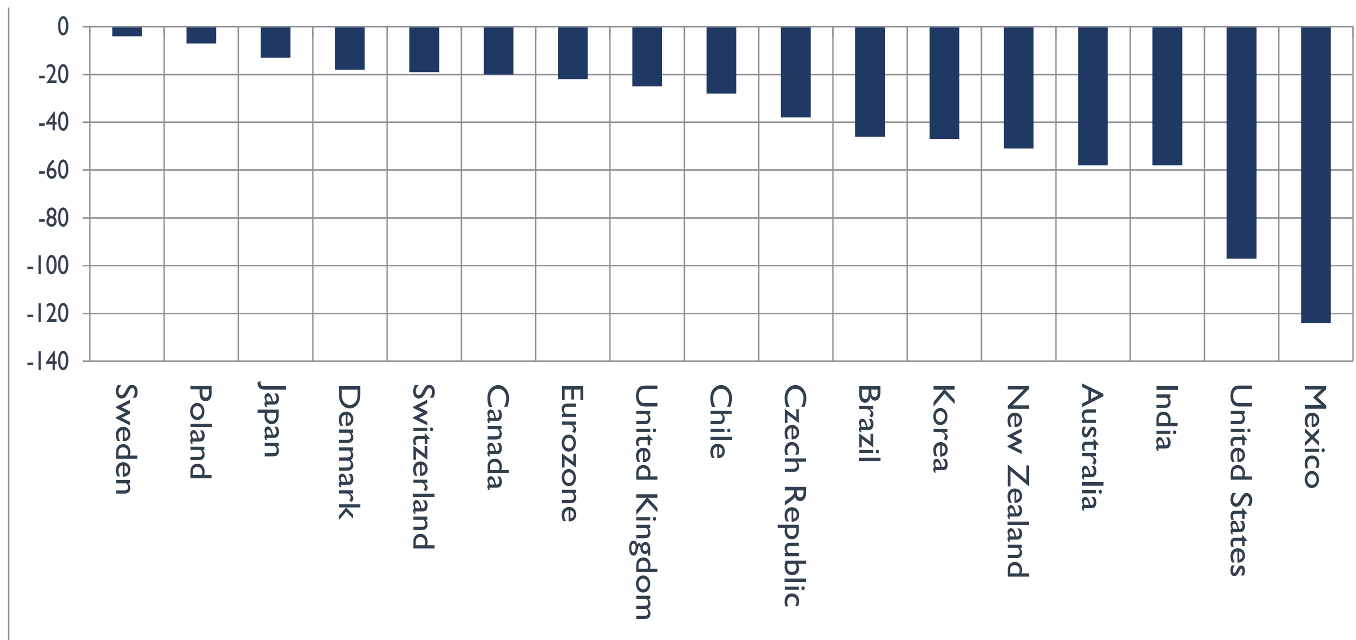
Against our expectations, global interest rates have continued their decline in the second quarter of the year. The move up in rates in April followed our Q2 playbook but turned out to be only short-lived. President Trump rekindled the trade war with China in May and sent yields into a tailspin. Global bond markets have begun to price substantial policy easing as the logical response by central bankers since (see chart), given the fragility of the global economy when an expansion reaches its final stages. Of course it is unfair to blame it all on the President of the United States; macroeconomic data itself has continued to be mixed and soft, some of which, however, may be due to a negative feedback loop from trade war fears. To make matters worse, US-Iran military tensions too have added to the demand for safe assets. The outlook for the global economy remains clouded and even if a trade truce is maybe reached, the negative effects of the dispute will take their time to work themselves out of the global economic clockwork. Tariffs themselves have a real economic impact by disrupting supply chains and halting business investments. So-called second round effects on financial market conditions are compounding the impact.

At the current juncture, it feels as if markets are blackmailing central bankers, and it sounds a lot like, "Give me what I want or I crash this rally and tighten financial conditions so drastically that you don't have a choice but to cut rates…" It is hard to argue against that logic at a time when the global economy continues to be fragile and fraught with uncertainty. We have changed our US interest rate outlook for the remainder of the year in April and moved back to neutral on duration. We, too, think now that the Fed will pre-emptively cut rates– most likely two times –to prevent that negative feedback loop from materializing. Again, we are reminded of Powell's words, "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."

" 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. " (Jerome Powell)

As for Europe, it is always very difficult to go long duration at negative yields in the hope that they will fall further. We doubt that further rate cuts in Europe will do much to alleviate Europe's structural issues. At the same time, the bar for further easing is low and thus it is an increasingly likely scenario. European credit is probably the better place here. As far as credit in general is concerned, the prospects of lower funding costs combined with a low recession probability is music to the ears of credit investors and should keep spreads tight.

MARKET IMPLIED CHANGE IN POLICY RATE IN 1 YEAR



SOURCES: BANQUE HERITAGE, BLOOMBERG

COMMODITIES

INVESTING IN GOLD

When the price of gold was fixed to the US Dollar in 1944 under the Bretton Woods Agreements, the going price was $35 per ounce. Adjusted for inflation, $200 of today's currency would get you the same amount of the precious metal.

Yet, the price of gold has been on a steady rise since the early 70s and the collapse of the gold standard, reaching more than $1400 today, a 600% increase adjusted for inflation.

The first mentions of gold date back to the Egyptians, around 3000 B.C. but the oldest flakes of gold were found in Paleolithic caves dating back as far as 40000 B.C.

Whether in ancient Greece, Mayan times, or during the 1870s gold rush, it has always been perceived as a valuable means of exchange. Nowadays, the largest holders of gold are central banks, looking to use their stock in order to protect their currencies against future emergencies such as uncontrollable inflation.

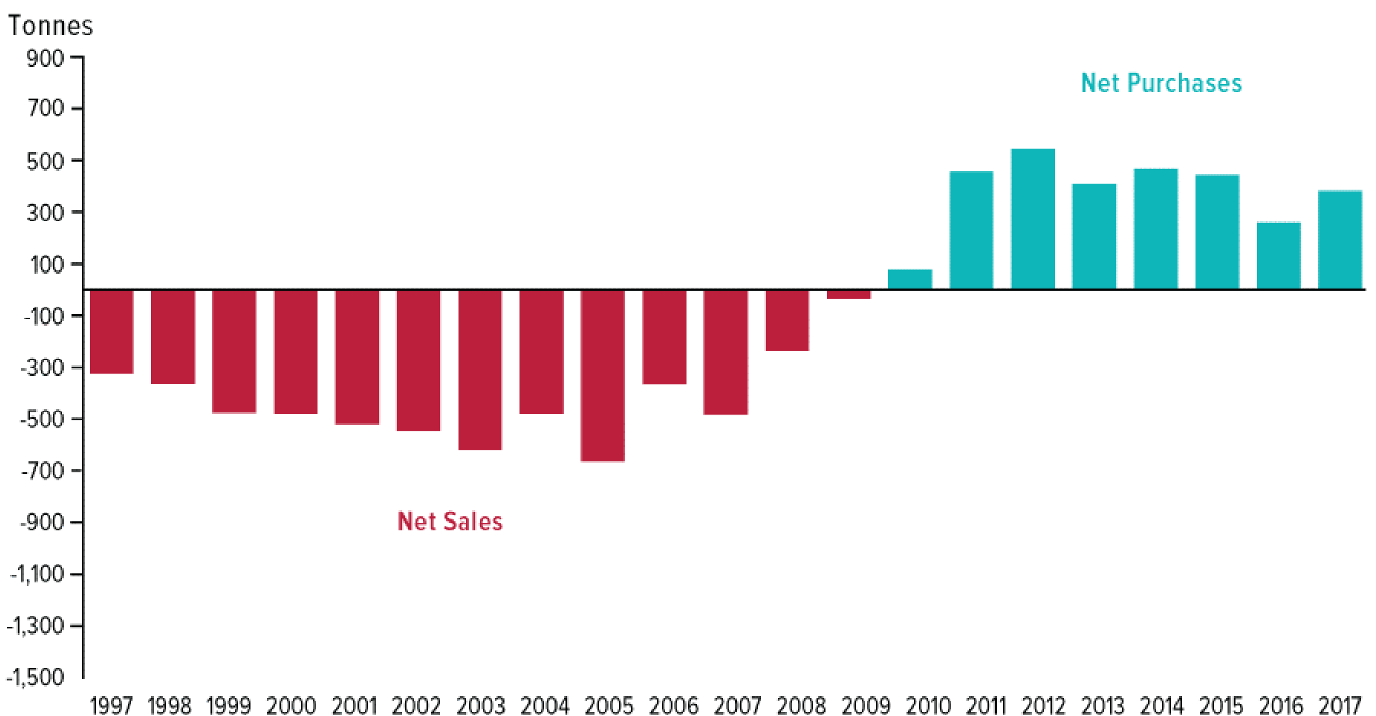
There is no one reason why gold is perceived as valuable. Besides its aesthetic characteristics and use in jewelry, it is a scarce resource. About 2000 tons of gold are produced per year vs. 10500 tons of steel in the US alone, every minute! It also has great physical characteristics, both as an electric conductor or as a malleable metal. Only one ounce of gold is needed to gold

" Nowadays, the largest holders of gold are central banks, looking to use their stock in order to protect their currencies against future emergencies such as uncontrollable inflation. "

plate a 1000-mile long thread of copper. Finally, it has historically been a "flight to safety" asset, seeing high price increases during periods of strong inflation or financial turmoil.

But what exactly drives the price of gold? Obviously, central bank reserves have a strong influence on the price of gold, affecting

CENTRAL BANKS CONTINUE GOBBLING UP GOLD



SOURCE: BIS, IMF, GFMS, THOMSON REUTERS

supply/demand in high magnitudes. Global industrial demand and luxury use is also a significant driver of the gold price, accounting for 66% of global demand. Being a scarce resource, supply and mine production are determinants to gold prices.

Supply has been decreasing since the 2000s, lending gold more of a "floor" value, while increased production costs also affect the final price of the commodity.

Last but not least, the value of the US dollar is strongly negatively correlated to gold. When the greenback is strong, gold is weak, and vice versa.

So why hold gold? Besides its history of holding value and its tangible nature, gold acts as both an inflation and deflation hedge. It tends to rise when the cost of living increases as it is priced in those currency units losing purchasing power and thus tends to rise along with everything else.

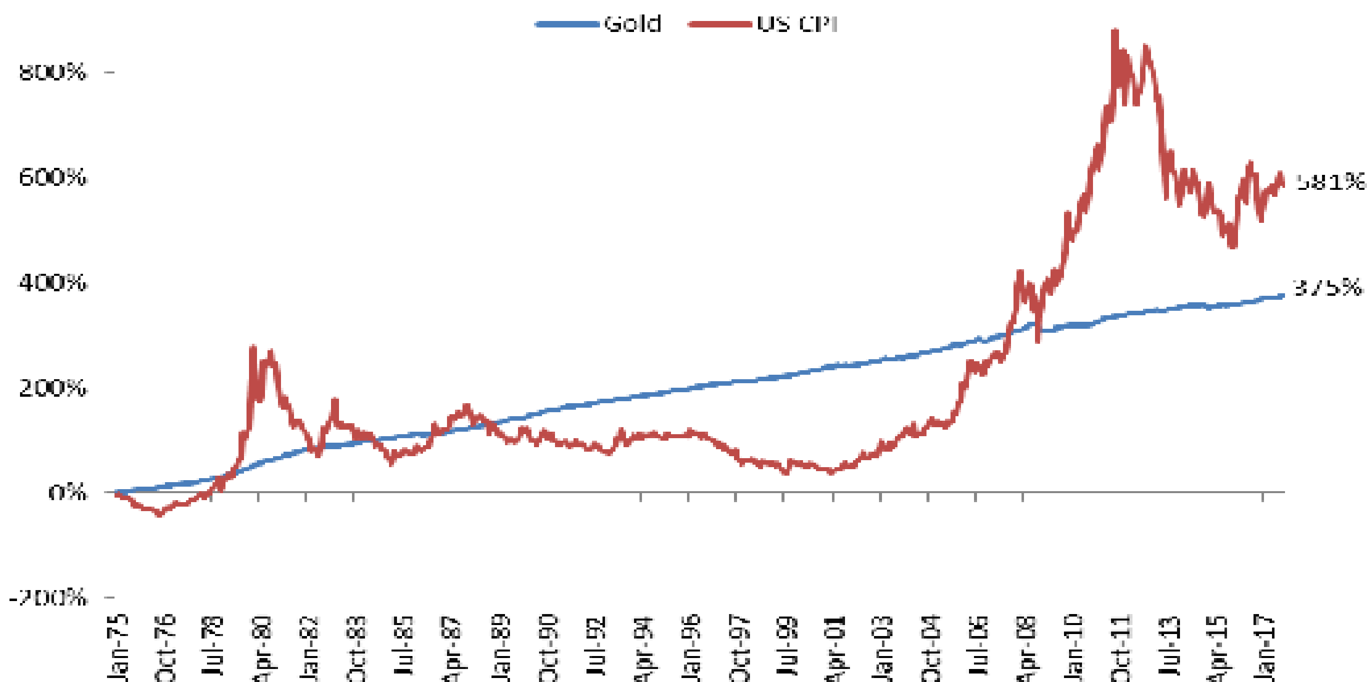
Contrarily, deflation is mostly associated with economic slowdown. When deflation arises, the best investment is to hold cash and the safest place to do so is often in gold.

" The value of the US dollar is strongly negatively correlated to gold. When the greenback is strong, gold is weak, and vice versa. "

One can easily figure out that gold is therefore a good portfolio diversifier and almost systematically enhances a portfolio's risk/reward.

Finally, its "crisis protection" attributes make gold a great tool to immunize portfolios against financial crises. To that effect, we have just increased our gold exposure to 6%, in anticipation of more volatile times ahead.

GOLD VS. INFLATION (JAN 1975 - OCT 2017)



SOURCE: PENSION PARTNERS

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CONTRIBUTORS	EDITORIAL	CONCEPT	PHOTOGRAPHS
JEAN-CHRISTOPHE ROCHAT, CIIA	BRECKINRIDGE KNAPP, CFA	VALÉRIAN FELDER	PATRIC POP
MARKUS KOCH , CFA	KATARINA ESTEVE	LUCIEN AUBERT	
MICHEL MAZENAUER, CAIA			
MIKAËL SAFRANA, CIIA			
STÉPHANE TREZZINI			

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