MIRABAUD 1819

INVESTMENT STRATEGY

JULY 2018

TRADE TENSIONS
BUILDING

IN A NUTSHELL

AS REGARDS EQUITY INVESTMENTS, WE HAVE DECIDED TO BUY THE "DISRUPTIVE TECHNOLOGY" THEMATIC, WHICH IS MADE UP OF THE E-COMMERCE, E-GAMING, CYBERSECURITY AND ROBOTICS SUB-THEMES.

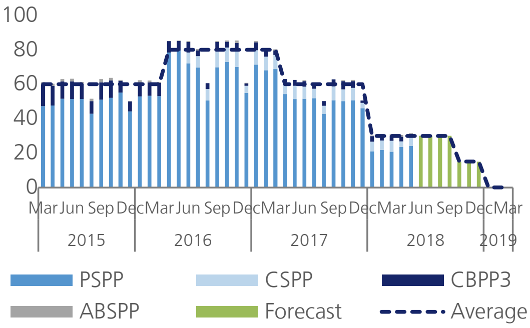
IN TERMS OF SECTOR ALLOCATION, WE ARE UNDERWEIGHTING EUROPEAN BANKS AND OVERWEIGHTING REGIONAL US BANKS.

IN THE BOND SEGMENT, WE RECOMMEND BUYING 3-MONTH US PAPER.

Markets have continued to fluctuate without showing any major trend since the start of the year. Political risk in Europe and global trade issues are weighing on risk assets despite solid economic data and company fundamentals. As a result, we are leaving our equity allocation unchanged but increasing our thematic exposure within it, via a certificate investing in companies operating in the fields of e-commerce, e-gaming, cybersecurity and robotics. In the bond market, we are still anticipating US monetary policy normalisation by focusing on short-duration, floating-rate and inflation-linked paper. Emerging markets have continued to underperform. Latin American currencies are under pressure, US interest rates and the dollar are still rising and the trade war is affecting Asian countries and Mexico.

GRAPH OF THE MONTH

ECB asset purchases (in billions of euros)

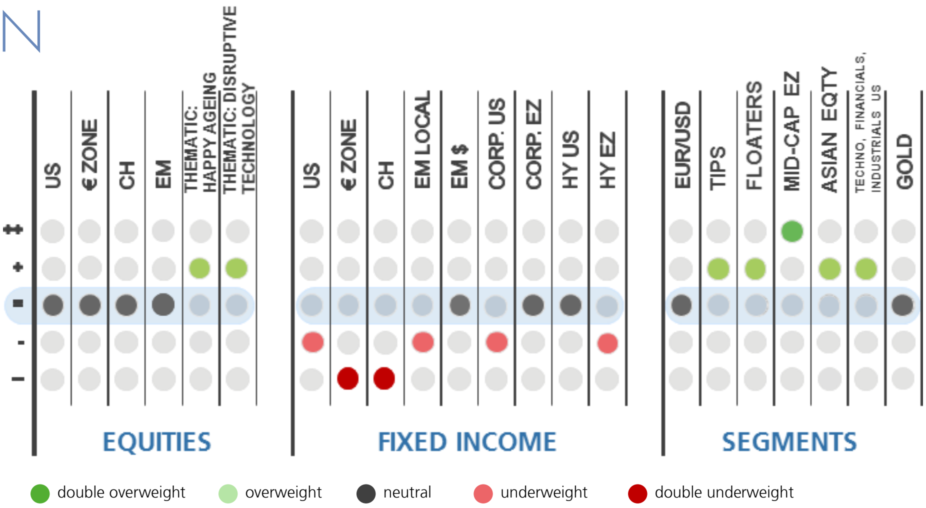


Sources: ECB, Mirabaud Asset Management

In June, central bank monetary policy announcements highlighted the divergence between economic cycles in the USA and other advanced countries. In the USA, the Federal Reserve expects its key interest rate to be between 3.00% and 3.25% by the end of 2019, a level that is likely to slow economic activity. The market, meanwhile, is more sceptical about the pace at which interest rates will return to normal and is pricing in a rate of 2.5%, although we do not share this pessimistic view. In Europe, the ECB has adopted a highly accommodative tone, despite planning to end its asset purchase programme at the end of the year, announcing that interest rates will remain at their current level until September 2019 at least. In Switzerland, the SNB is unlikely to raise rates before the ECB, while the Bank of Japan will maintain its current programme until mid-2019 at the earliest. This divergence between economic and monetary cycles will be the main factor influencing movements in global financial markets, particularly the bond and forex markets.

ASSET ALLOCATION

EQUITIES	
Europe	Neutral
United States	Neutral
FIXED INCOME	
US Treasuries	Underweight
EM USD	Neutral
SEGMENTS	
EUR/USD	Neutral
MID-CAP EZ	Double overweight



MACROECONOMICS

CURRENT CUSTOMS DUTIES ARE UNLIKELY TO HAVE A MAJOR DIRECT IMPACT ON THE GLOBAL ECONOMY.

The global trade war escalated in June and there are growing fears that new tariff barriers will prompt retaliation. Although the measures taken so far by the US administration are unlikely to have a significant direct impact on growth and inflation, the manufacturing sector is already less confident about future global production and confidence could fall further still if the uncertainty continues. The USA has mainly imposed customs duties on intermediate goods, with the aim of limiting price rises for end-consumers and negative effects on activity. However, the strategy could harm companies by pushing down their margins and making them less competitive.

Longer-term, if the trade war escalates further, it could affect almost $250 billion of US imports from China, expand to include the auto sector and prompt additional retaliatory measures. That scenario would cut US growth by at least 25 basis points and boost inflation by almost 30 basis points, at a time when it has already hit the central bank's 2% target.

In Europe, although the ECB has said that it will end its asset purchase programme in late 2018, its monetary policy remains loose because key interest rates are low and its balance sheet is large. The decision to end the asset purchase programme is based on progress made on the three criteria required for monetary policy normalisation: expectations that inflation will rise back towards its target level in the medium term, a high level of confidence that the convergence scenario will materialise and, to a lesser extent, the sustainability of that trend in the absence of extraordinary measures by the ECB.

EQUITIES

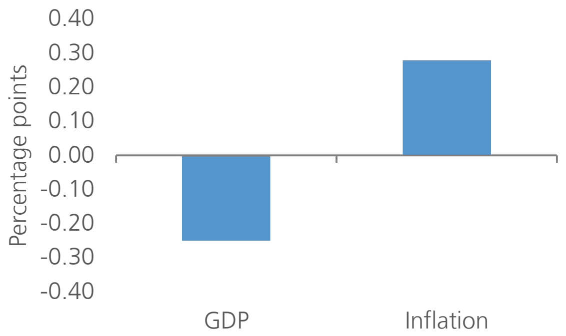
WE ADVISE BUYING THE THEMATIC FOCUSED ON E-COMMERCE, E-GAMING, CYBERSECURITY AND ROBOTICS.

There is still no real trend in equity markets. Although economic growth remains firm in general and earnings are being upgraded, the uncertainty created by the trade war is dragging down valuations. Germany's DAX index was particularly badly affected in June because of its exposure to the auto sector and to global trade.

Within our sector allocation, we have overweighted regional US banks. From the regulatory point of view, the situation is improving for medium-sized banks, with certain rules introduced after the financial crisis – such as the Volcker rule restricting proprietary trading and the "systemic" bank threshold – being loosened. From an economic point of view, firm US growth should support cyclical sectors. The earnings trend is improving, with growth of 28% expected in 2018 and 10% in 2019. At the other end of the spectrum, we have underweighted European banks. Despite stabilising recently, Europe's economic impetus has slowed in recent months, political risk has increased, earnings forecasts have been downgraded and the yield curve has flattened because of the ECB's accommodative tone.

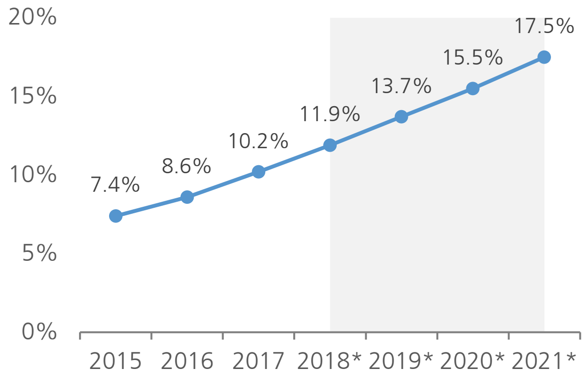
Within our thematic allocation, we recommend a new "disruptive technology" investment, which is made up of the e-commerce, e-gaming, cybersecurity and robotics sub-themes. This investment will provide diversified exposure to 1) revenue growth in online gaming – the largest segment of the entertainment-focused media sector – and particularly e-sports; 2) the expansion of e-commerce, particularly via smartphones; 3) increased expenditure on cybersecurity with the growth of the internet of things; and 4) growing use of robots and artificial intelligence.

Impact on the USA of applying customs duties to $200 billion of Chinese imports



Sources: Deutsche Bank, Mirabaud Asset Management

E-commerce as a proportion of retail sales



Source: Newzoo

FIXED INCOME

WE RECOMMEND BUYING 3-MONTH SOVEREIGN US BONDS.

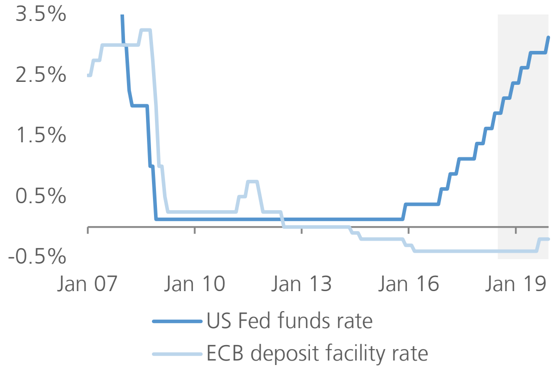
The sovereign yield curve is continuing to flatten in the USA. The 2/10-year government bond yield spread is now around 30 basis points, down 20 basis points since the start of the year and its lowest since 2007. The US Federal Reserve is expecting to raise interest rates more sharply than before, putting upward pressure on the short end of the yield curve because of higher expectations regarding key interest rates. In addition, long-term bonds remain in demand, keeping the term premium in negative territory. The prospect of reduced net Treasury issuance during the summer is also helping to flatten the curve.

During the second half of the year, diverging monetary policies in the USA, Europe and Japan also mean that expected yields, after euro and yen currency risk is hedged, will be negative. That is likely to reduce foreign demand for sovereign US bonds and prompt investors to favour short durations.

Within our portfolios, we continue to recommend inflation-linked and floating-rate US bonds. We also advise buying 3-month Treasuries, which are yielding almost 2%. In our view, longer-term bonds are not offering enough additional yield to compensate for their much higher duration risk.

In Europe, we are continuing to underweight eurozone sovereign bonds, and we have a negative view of peripheral countries. During June, the credit and high-yield segments of the bond market generated negative returns in Europe, because of the financial sector's large index weighting. Conversely, US high-yield bonds benefited from good performance in the oil and gas sector.

Greater divergence between the FED and the ECB



Sources: Bloomberg, Mirabaud Asset Management

CURRENCIES

THE FALLING YUAN IS HAVING A LIMITED IMPACT ON CHINESE GROWTH.

The dollar rose again in June. The latest monetary-policy meetings of the US and European central banks have increased the chances that interest-rate differentials between the two regions will widen further. By the end of 2019, the 3-month yield spread is likely to rise above 3 percentage points, its highest level since 2006. The economic situation has also moved back in the USA's favour.

The difference between current-account balances in Europe and the USA is an important driver of the euro/dollar exchange rate over the medium term, and its current level should cause the euro to rally against the dollar. However, in the current trade-war environment, investors seem to regard Europe's current-account surplus as a source of risk rather than a factor supporting the single currency.

The rising dollar means that emerging-market currencies are suffering. They were the worst performers in the first half of 2018. Looking more closely, however, the divergence between emerging-market countries is growing. The best-performing currencies were the rouble – especially after the WTI oil price rose 10% during – the South Korean won, the Indonesian rupiah and other Asian currencies. At the other end of the scale, the Argentine peso, the Brazilian real, the Turkish lira and the Mexican peso suffered from domestic political developments and trade risks.

In China, the yuan continued to depreciate. That resulted from a looser monetary policy adopted by China's central bank – with the 50-basis-point cut in the reserve requirement ratio set to inject CNY 700 billion into the economy – following disappointing activity figures at the end of the second quarter. In addition, the decline in the yuan represents the Chinese authorities' response to threats of increased US customs duties. However, compared with 2015-2016, when yuan depreciation prompted large-scale capital flight, China has tightened capital controls to limit outflows. The current trend is unlikely to continue if a solution to the trade problems can be found.

Further decline in the yuan

Sources: Bloomberg, Mirabaud Asset Management

WRITTEN ON 02.07.2018 BY THE MACRO-STRATEGY TEAM