HBZ Investment Quarterly

Lower growth but no recession

Q1 2019

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Editorial

Dear Reader,

This year has kicked off with renewed confidence on financial markets and correspondingly strong performance of financial assets. Are we witnessing a re-run of 2018 – a year that started well, only to deteriorate dramatically for most investors later on?

We will explore this possibility in this issue's 'Special topic', but admit that we do not have any conclusive answers. When it comes to monetary policy, however, we believe we can assert with some confidence that the central banks are not bent on normalizing at any cost. Our assessment is clearly borne out by the latest comments of various members of the US Federal Reserve.

So what should investors do at this juncture? Tactically, we recommend to maintain some sizeable risk positions in order to cash in on the current rebound across most markets. Having said this, it is important that positions reflect two key market conditions – higher overall volatility levels and the advanced stage of the cycle (along with lower marginal liquidity). We are thus underweight equities and will reduce our exposure further should fundamentals take a turn for the worse. Moreover, at some point this year conditions may warrant a shift towards longer durations and greater exposure to government bonds.

We hope our commentary will provide you with some useful insights and wish you a productive and successful 2019.

Yours sincerely,

Dr. David Wartenweiler, CFA
Chief Investment Officer

Habib Bank AG Zurich

The macro backdrop: Lower growth but no recession

Despite easing global growth momentum, the risk of recession remains low. Downside risks center on erratic US policy, structural weakness in Europe and the current soft patch in China. A more measured US monetary policy could go a long way towards containing these risks.

Table 1: Real GDP growth (y/y in %)

	2018E	2019F	2020F	Short-term trend
United States	2.9	2.5	1.9	→
Eurozone	1.9	1.5	1.5	↘
Germany	1.5	1.4	1.5	↘
United Kingdom	1.3	1.5	1.6	↘
Japan	0.8	0.9	0.5	↗
China	6.6	6.2	6.0	↘
India	7.2	7.3	7.3	→
Russia	1.7	1.5	1.7	→
Brazil	1.3	2.5	2.5	↗

Table 2: Consumer price inflation (y/y in %)

	2018E	2019F	2020F	Short-term trend
United States	2.4	2.0	2.2	→
Eurozone	1.7	1.5	1.6	→
Germany	1.9	1.7	1.7	→
United Kingdom	2.5	2.1	2.0	→
Japan	1.0	1.0	1.4	→
China	2.1	2.2	2.2	→
India	3.9	3.8	4.5	→
Russia	2.9	4.9	4.0	↗
Brazil	3.7	4.0	4.0	↗

Source: Bloomberg, IMF, HBZ

Impetuous president, patient Fed

With his unpredictable and headstrong leadership style, President Trump arguably represents the single biggest risk to the US economy. In this context, it is all the more crucial that the Federal Reserve stay level-headed. Responding to the market turmoil of December and a less certain economic outlook, Fed Chair Powell and his colleagues have adopted a more patient stance, signaling that any further rate hikes – should these prove necessary – could be more spread out. At the time of writing some additional tightening still appears warranted as US growth is on track to remain above potential for the foreseeable future. But the partial government shutdown, the slowing global manufacturing cycle and, most importantly, reduced fiscal stimulus justify a more cautious approach to interest rate policy, especially considering that the Fed's balance sheet reduction continues unabated. For the rest of the world this is good news: a softer US dollar will be reflationary and will compound the positive effect of sharply lower oil prices.

Don't expect much from Europe

Growth in the EU started to roll over in mid-2018 and there are currently no indications that this trend will reverse. Much-needed reforms have ground to a halt just about everywhere, most notably in France. Lower growth will also make it harder for the ECB to further normalize monetary policy – a move which would provide welcome relief to savers and financial institutions. Add to this the hopelessly muddled Brexit process and Europe is once again a cause for concern. Nevertheless, growth is set to stay above potential, leading to a further fall in unemployment (but not necessarily a rise in inflation). The European parliamentary elections in late May will be an important barometer of the prevailing mood.

China's soft patch

The trade dispute with the US could not have come at a worse time for China. While the country's transition to a more domestically driven growth model remains on track, the impact of this negative external shock will be substantial and risks delaying the government's plans to tackle imbalances in its financial system. At least the recently announced initiative to focus more to tax cuts in an effort to support the economy is an important step in the right direction.

Key points

- Fed ready to respond to easing growth, financial market turmoil
- Europe unlikely to re-accelerate in 2019
- Chinese growth to stabilize

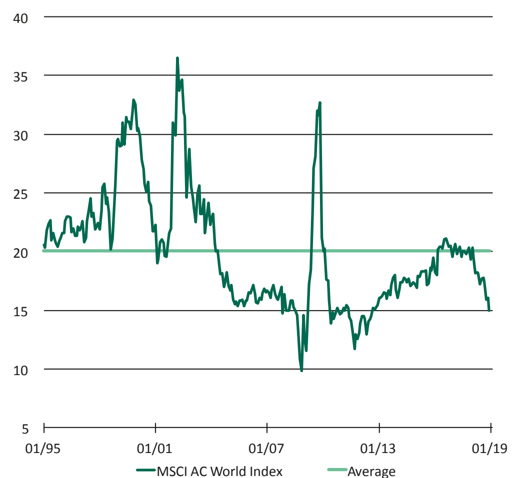
Investment strategy: Managing fear

2018 was a remarkable investment year: risk assets (particularly equities) came under intense pressure despite generally sound fundamentals. Fundamentals are bound to weaken in the future, but with no real risk of a US recession, financial markets are likely to recover – at least temporarily.

Sentiment vs. fundamentals

Investing on fundamentals was not a winning strategy in 2018 as fear dominated markets for most of the year. Whether justified or not, these fears drove returns for most risk assets into deeply negative territory, starting with the sell-off in emerging markets in May and ending with the collapse of US stocks in December. On the flip side, these sharp price corrections – the likes of which we would normally only see in the context of a recession scenario – took much of the froth off equity valuations. Credit spreads widened in lockstep. Combined with the generally higher level of yields, this development has created value in credit markets. For investors the bottom line is simple: assets that looked unappealing before the big sell-off have now become moderately attractive again. Among these, we count EM sovereign bonds and quality stocks in defensive growth sectors such as health care and the reconfigured communication sector. However, this cycle will not continue indefinitely and dollar liquidity will further decline. Positions should therefore be sized for a late-cycle environment defined by increased market volatility and higher levels of uncertainty. While we expect markets to trend up in the coming months, sharp reversals could occur at any time.

Chart 1: Global equities have substantially re-rated since early 2018 (P/E ratio (trailing))



Source: Bloomberg, HBZ

Our positioning

We have kept our positioning largely unchanged going into the new year. Firstly, we are already underweight equities and see no reason to decrease exposure any further at this point. Secondly, we will extend our duration slightly but intend to keep it well below benchmark. Thirdly, we will continue to add diversifying and low-correlation strategies and assets to prepare our portfolios for another tough year.

What to watch

In terms of fundamentals, we will continue to monitor Fed policy as well as corporate news flows (quarterly earnings, management guidance) closely. Although politics has undoubtedly become increasingly irrational and unpredictable in the US and the UK and will continue to cause volatility, in the absence of a major policy error this circumstance is unlikely to derail markets for a prolonged period of time. The principal (albeit still low) risk we are facing is that of a US recession, but we are not relying on the equity markets to predict this with any degree of accuracy.

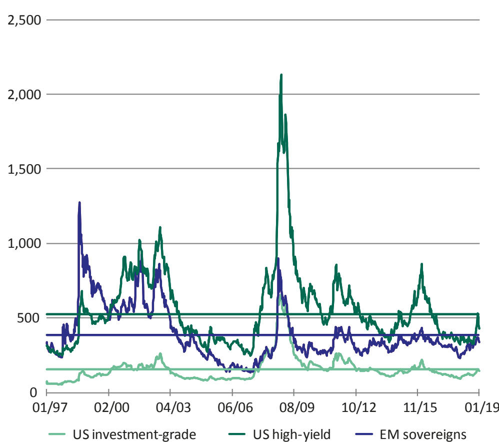
Key points

- Valuations have normalized in many asset classes following the dismal performance of 2018
- Barring a recession, markets will be risk-friendly for the time being
- Fed and corporate news flow will set the tone for markets

Fixed income: Stay long EM sovereign bonds

Credit spreads widened substantially in the last quarter of 2018 and, following the correction, valuations in most fixed-income segments now look reasonable. Coupons will be the main source of return, however, with the greatest potential to be found in EM hard-currency sovereign bonds.

Chart 2: Credit spreads fairly valued after widening (spread over treasury, in basis points)



Source: ICE BofAML, HBZ

Key points

- Further normalization of credit spreads likely
- Coupons will be main source of bond returns in 2019
- EM hard-currency sovereign bonds attractive

Valuations fair again

In the final quarter of 2018, credit spreads widened substantially across all fixed-income segments. Rather than interpreting this move as a sign of a deterioration in the fundamental outlook, we see it as part of a further normalization of the credit risk premium – the excess return that investors demand above the risk-free rate. While there are some concerns about elevated leverage among some issuers, the current aggregate leverage of the US corporate sector is not exceptional for this stage of the cycle. Spreads in the investment-grade space are likely to remain stable in the first half of this year and we expect relatively stable or slightly higher yields in the coming months; this should translate into positive total return for investment-grade bonds. An unexpected recessionary downturn of the US economy in 2019 would challenge this outlook though, as such a development would cause a number of BBB issuers to lose their investment-grade ratings. We are cautious with respect to corporate high-yield bonds. Although default rates will probably rise only slightly, we expect credit spreads to be flat at best or wider than they are at present, as financial conditions continue to tighten incrementally. Their total return will therefore be largely limited to carry.

EM sovereign bonds top the list

Last year was also a disappointing year for EM bonds, with all subsegments posting negative returns. The EM outlook will remain challenging but the risk/return profile has improved after the recent sell-off, particularly for EM sovereigns. Valuations, especially in the hard-currency segment, look attractive. Current account balances have improved in many economies and some of the issuers with the greatest external vulnerabilities (e.g. Argentina, Turkey) have started to address their imbalances. The imminent inclusion of five of the six members of the Gulf Cooperation Council in the leading Emerging Market Bond Index Global (EMBIG) will increase the latter's overall credit quality – as well as increasing its exposure to energy prices, of course. Although EM local currencies suffered badly last year, we expect EM local-currency bonds to stabilize in the coming months. There is some upside to be realized, but clients should be aware that this comes at the risk of substantial volatility, which can wipe out any gains in short order.

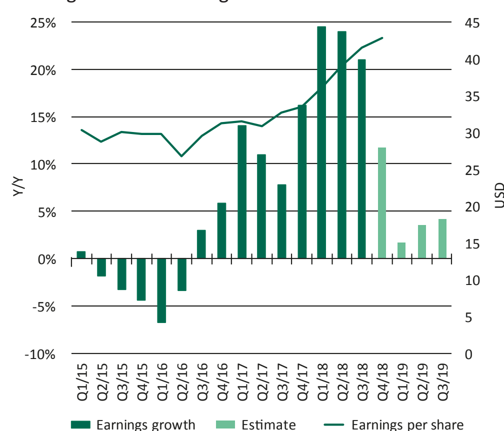
Equities: Indispensable for now

2018 was the worst year for global equities since the Great Financial Crisis. At the beginning of 2019 sentiment has improved but investors continue to fret about a multitude of risks hanging over markets. At the same time, the indiscriminate sell-off has greatly normalized valuations and the technical overshot should reverse.

The case for equities

As a cycle advances risks tend to increase and investors need to factor higher volatility into their equity allocations. Despite this volatility risk, we believe material exposure to this asset class remains warranted. As mentioned, the violent market corrections in the final quarter of last year normalized valuations to a considerable extent. At the same time, fundamentals have not changed dramatically and earnings have generally held up well. While US earnings growth in Q1 2019 will doubtless be significantly lower due to the challenging compareables created by the tax cuts implemented a year ago, the level of earnings is now substantially higher and this will allow companies to maintain or even increase their dividend payouts and share buybacks. Moreover, despite some exceptions in certain industries, corporate balance sheets are not excessively leveraged. Some adjustments, including a further reduction of the cyclical tilt, will be necessary once market technicals have stabilized. We would advise investors to increase exposure to defensive growth sectors such as health care and the reconstituted communication sector. Defensive sectors with more bond-like characteristics such as consumer staples will be unattractive as long as the risk of interest rate hikes remains.

Chart 3: S&P earnings growth to slow in 2019 but total earnings to remain at high levels



Source: Bloomberg, HBZ

A generally more defensive tilt

In our regional allocation we recommend a barbell between the more defensive US market (which has catch-up potential after the disproportionate sell-off in December) and higher beta exposure in emerging Asia and Japan. While the US tech sector clearly stands to lose if US-China trade relations deteriorate further, IT and health care are among the sectors with the best long-term growth prospects. Additionally, these sectors display low interest rate sensitivity and have some of the strongest balance sheets. We are less convinced that eurozone stocks will enjoy a revival, having disappointed for several consecutive years now. Structural headwinds are omnipresent and, short of a substantial easing of fiscal policy, we foresee limited cyclical support. Also, as many eurozone economies are highly export-dependent, a downturn in global growth is bound to impact export-sensitive stock markets such as Germany's. Finally, financials account for a large share of many continental stock markets and unless the ECB can start to normalize policy in earnest, the earning power of such companies will inevitably be challenged.

Key points

- Valuations have normalized following sell-off in Q4
- US earnings growth to slow in 2019, but in absolute terms, earnings remain close to record highs
- Favor defensive growth sectors and defensive markets such as US

Commodities and FX: Harbingers of a recession?

Commodities are typically considered an asset of choice during the later stages of an investment cycle, however the performance of this asset class in 2018 failed to corroborate this view; it was the US dollar's performance that was more in line with expectations. This may be about to change.

Chart 4: Weaker USD to boost gold price

Source: Bloomberg, HBZ

'Toppish' US dollar

The US dollar enjoyed another strong year in 2018, lifted by the return of market volatility and, of course, rising US interest rates. In December, however, the Fed signaled that the pace of quarterly rate hikes was not cast in stone, whereupon the dollar rally promptly stalled. In fact, already during the October market correction, the greenback failed to rise strongly. Arguably, these are indications that the currency's upside has become limited. This is partly the result of the sustained USD rally itself, which has cheapened many currencies to the point that they are now attractively valued. This is especially the case for many EM crosses, although at this stage of the cycle their valuations and high yields create a false sense of security. We would advise keeping exposure to a minimum. The situation is a little different for many of the majors. Having said this, the euro, the pound and the yen are all 'damaged goods' to some extent, and are all additionally challenged by low or even negative central bank rates – and, in the case of GBP, the politics of Brexit. In this context, gold, the ultimate alternative to fiat currencies, could once again enjoy a moment in the sun: its price is far from demanding and the cost of carry is unlikely to increase much further.

Commodity cycle out of kilter?

Not much has gone right for commodity investors of late. The dramatic collapse of the oil price in Q4 2018 was only the latest indication of a sentiment-driven market. Since then, some of the overshooting to the downside has reversed but the overall prospects for oil and the commodity complex in general have not improved significantly. The supply and demand picture is roughly balanced for most commodities and the undisputed softening of global growth is certainly going to keep demand growth in check. The poor showing of commodities is not necessarily a sign of an impending recession, though. Rather, the nature of global growth has changed; it has become less commodity-heavy. Over the long term, the transition to a less carbon-based energy mix will inevitably shift demand away from high-volume commodities such as oil and coal. This is also true for base metals for which much capacity has been added but where demand dynamics may change, e.g. due to new construction techniques. In the manufacturing of transport equipment such as cars and planes, for example, composite materials have already become valid substitute for aluminum.

Key points

- 'Toppish' USD creates downside risk
- Gold as valid non-currency alternative
- Structural challenges facing major segments of the commodity market

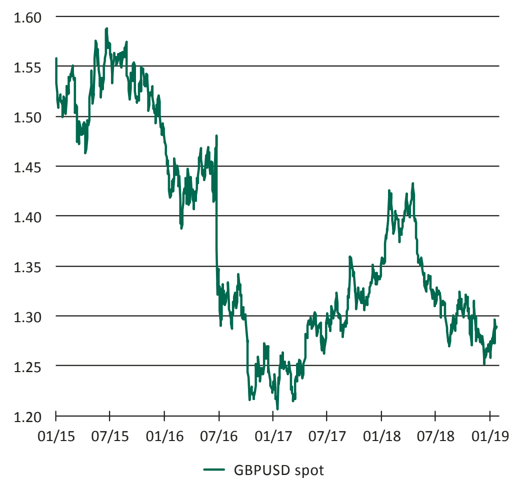
Key markets: More of the same

The new year has not changed conditions in our key markets: Pakistan has yet to convincingly address its macroeconomic imbalances, the UAE remains at the mercy of oil and its moribund real-estate sector, and the UK is careering towards the Brexit cliff.

Pakistan: Something has to give

Pakistan's economy continues to face big challenges, most notably domestic and external imbalances – and the government still has not presented a credible plan to tackle these issues. Although more funds have been pledged by Middle Eastern allies, the agreement with the IMF, which has yet to be finalized, will be crucial to bringing back some semblance of investor confidence. The IMF agreement will be especially important given the substantial amount of funding needed to cover the current account shortfall as well as some USD 6bn in debt repayments in 2019. Rating agencies have already turned more negative on the country's outlook which implies that funding costs could increase once again. Despite the negative impact of such measures for companies and consumers, further steps must be taken to stabilize the economy. These should include lower government spending in order to rein in the huge budget deficit and higher policy rates to contain inflation and an even lower PKR. The higher risk-free rate is thus just one of the factors confronting the stock market, which has now suffered two consecutive years of negative performance.

Chart 5: GBP trading on Brexit but cheaply valued



Source: Bloomberg, HBZ

UAE: Another uncertain year ahead

In line with other economies, activity in the UAE appears to be slowing although the latest PMI surveys still support a decent rate of expansion. Whether growth will accelerate in 2019 as currently expected by forecasters is a different question. While oil prices have rebounded, prices in the real-estate sector have yet to bottom out. This will continue to weigh on the economy in general and on local banks in particular; many of them may need to significantly increase their provisions for non-performing loans.

UK: The final curtain?

Right from the start, the British political class has cut a sorry figure in the Brexit drama that is now rapidly approaching its last act. Parliament voted in favor of an amendment that creates a major obstacle to a 'no-deal' scenario, but then overwhelmingly rejected the only deal on offer. Something will have to happen before 29 March 2019, when the UK is set to officially exit the EU. We still expect a last-minute agreement to emerge, and under this assumption GBP is a buy. But British politics has become unpredictable – even irrational – and the tail-risk of an accident remains real.

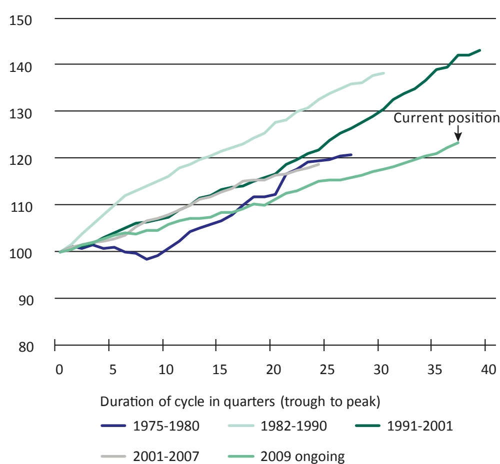
Key points

- Pakistan needs funding fast
- UAE at the mercy of oil and real estate
- GBP to rally if UK avoids 'hard Brexit'

Special topic: The investment year that was … and will be?

Characterized by big price swings and short-term trend reversals, 2018 was a tough year for investors. It is important to note, however, that it was not underlying fundamentals, but investors' perception of risks that had changed. Will markets follow a similar trajectory in 2019?

Chart 6: Maturing cycle to challenge markets
(Indexed to 100 at beginning of cycle)



Source: Bloomberg, NBER; HBZ

What worked and what didn't

Very few asset classes or sectors delivered positive returns last year. Among the few exceptions were US government bonds, which gained a meagre 0.9% across all maturities, and global health care stocks, which eked out a similarly anaemic return. Even those major equity markets which managed to deliver solid returns in local currency, such as India and especially Brazil, were in negative territory when translated into US dollars. Looking at our own portfolio, we concede that our investment strategies only bore fruit in a handful of asset classes, notably micro-finance, US mortgage-backed securities and short-duration EM bonds. Regrettably, though, our holdings in these segments were insufficient to offset the loss-making investments. In particular, our other EM exposure (both fixed-income and equities), developed market credit, Japanese equities and energy stocks proved costly. Our hedge funds and gold performed better in relative terms, but on average they still failed to generate positive returns.

2019 = 2018?

As noted elsewhere, the market context for 2019 is set to become even more demanding. While the relief rally since the beginning of the year may have some legs provided data and politics remain supportive, the economic cycle is well advanced and many assets remain expensive relative to their long-term averages. Many market commentators believe US equities are especially vulnerable given their valuations and certain disconcerting trends in leverage and long-term growth potential. Yet it is important to remember that valuations per se will not drive down asset prices – a trigger is needed. In 2018 that trigger was an overly negative interpretation of trends in USD yields. Something else could take its place in 2019. Recession fears, for instance – whether founded or not – could rapidly snowball. One area that should offer reassurance to investors in 2019 is relatively predictable monetary policy. This is important, as monetary conditions are a key determinant of the flows that underpin asset performance. Central banks may be itching to normalize rates but if the last few weeks have proved anything, it is that, unlike many political institutions, they still operate within a fact-based framework. In our opinion, neither the Fed nor any other major central bank will run the risk of over-tightening at this stage and the risk of a recession being triggered by a policy error therefore remains low.

Key points

- Few and minor gains in 2018
- Similar – but more numerous – risks in 2019
- Recession fears could return, but risk of recession due to policy error low

Market data summary

As of 21 January 2019

Equity indices	Last	-3M %	YTD %	-3Y %
MSCI World USD	5'751.3	-2.6	6.3	41.6
S&P 500	2'670.7	-3.5	6.5	42.9
EuroStoxx 50	3'124.9	-2.7	4.1	6.1
FTSE 100	6'977.1	-1.0	3.7	20.8
SMI	8'997.5	1.4	6.7	12.0
Nikkei	20'719.3	-8.0	3.5	29.4
MSCI EM USD	469.7	5.2	5.4	58.6
Sensex 30	36'592.5	6.6	1.5	52.7
KSE 100	39'657.9	3.2	7.0	29.0
Hang Seng	27'196.5	6.4	5.2	46.7
Russia RTS	1'172.9	4.1	9.8	85.6
Brazil Bovespa	96'096.8	14.1	9.3	154.8

Bond indices	Last	-3M %	YTD %	%
Citi US gov	1'481.67	2.8	-0.4	2.2
CIti US Corp	2'140.05	1.4	0.3	10.7
CIti US HY	1'011.12	0.1	4.0	33.7
Citi Euro gov	233.28	2.2	0.2	3.4
CIti Euro Corp	235.81	-0.5	0.0	5.6
CIti EM Sov	811.02	3.2	2.1	19.7
DB EM Local USD	157.42	3.3	-5.7	10.9

Currencies vs USD	Last	-3M %	YTD %	-3Y %
DXY	96.34	0.6	0.1	-2.8
EUR	1.14	-0.8	-0.7	4.9
CHF	1.00	0.2	-1.3	1.5
GBP	1.29	-0.9	0.8	-9.5
JPY	109.78	2.8	0.0	7.4
AUD	0.72	1.1	1.7	2.5
CAD	1.33	-1.2	2.6	7.6
ZAR	13.85	3.2	3.5	18.8
INR	71.19	3.2	-2.1	-4.5
PKR	139.88	-4.8	0.3	-24.7
Gold oz	1'282.68	4.4	-0.1	17.0

Interest rates	3M interbank %	10YR government %
USD	2.76	2.78
EUR	-0.31	0.26
GBP	0.93	1.32
CHF	-0.70	-0.13
JPY	-0.08	0.01
AUD	2.96	2.31
CAD	1.17	2.04
ZAR	7.15	9.42

For your notes

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Authors

- Dr. David Wartenweiler, Chief Investment Officer (d.wartenweiler@habibbank.com)
- Stefan Wüthrich, Senior Portfolio Manager, Fixed Income (s.wuethrich@habibbank.com)

Contact for Switzerland

- Leonardo Castillo, Head of Wealth Management Switzerland (l.castillo@habibbank.com)

Contact for UK

- Miguel Sanchez (m.sanchez@habibbank.com)

Contact for UAE

- Mohammed Sibtain, Wealth Management (m.sibtain@habibbank.com)

Layout

- Pascale Manga, Communication Support (p.manga@habibbank.com)

Printing

- Theiler Werbefabrik GmbH, Rütenenstrasse 6, CH-8102 Oberengstringen (werbefabrik@bluewin.ch, www.werbefabrik.ch)

Editing

- MOTIF Executive Communications, Rebbergstrasse 39, P.O. Box, CH-8024 Zurich (www.motif.ch)

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Habib Bank AG Zurich

Private Banking
Weinbergstrasse 59
P.O. Box 225
CH-8042 Zurich
Tel: +41 44 269 45 00
Fax: +41 44 269 45 18