PICARD ANGST

Our opinion

S2 2018

Stagflation on the horizon?

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Macro-economic trends

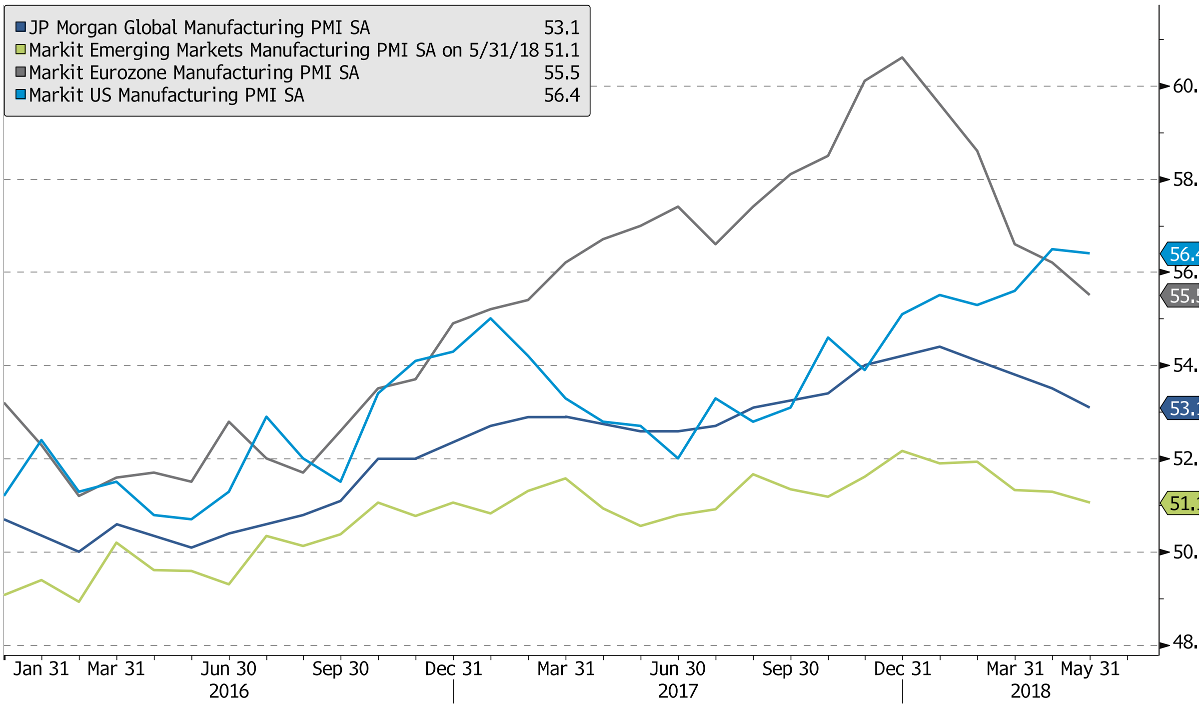
Quite a few of the prognoses concerning the course financial markets would take during the year which were broadly supported by the financial press and community of analysts at the beginning of the year now appear in need of a mid-year review. The façade of the globally synchronised growth acceleration now sports some significant scratches, emerging countries across all asset classes have lost ground and Europe's widely expected spurt to catch up with the United States once again appears to be nothing but hot air against the background of a rekindled political crisis affecting the European Union.

For us, that is more than reason enough to go back to the drawing board, critically appraise the predictions made at the beginning of the year and, where necessary, to reassess them. The impact will in particular affect two economic scenarios we put up for discussion in our annual prognosis for 2018.

Ailing preliminary indicators and economic data lagging behind expectations cast shadows on growth prospects

- The highly optimistic impression of a strengthening and globally synchronised economic upturn envisaged at the end of 2017 has since lost its dynamics over the course of this year.
- It appears as though the preliminary indicators such as the purchasing manager's index (PMI) for the production industry has passed its zenith (Fig. 1). Only the United States are withstanding this trend thanks to the upswing triggered by the tax reform that came into force at the end of last year.

Fig. 1: Preliminary indicators detect a deceleration of growth in the future



Source: Bloomberg LP, 2018

- This financial easement is, however, thwarted by the Federal Reserve's ever more restrictive monetary policy. Hardly anything is left of the much-anticipated positive effects of tax easement on the income situation of private budgets and the readiness of enterprises to invest. Accordingly, the USA's GDP growth of just 2.2% in the first quarter fell short of expectations. Nearly one half of the GDP growth achieved during the current economic recovery is due to the reduction in unemployment. The prospective growth potential has been further reduced due to the fact that in the meantime the full employment level has been achieved.
- But it is not only expectations for the future that are becoming more modest: current economic data reported since the beginning of the year cannot keep up with the analysts' estimations. This is clearly reflected by the course of the Citi Economic Surprise Indices for individual countries and world regions (see Fig. 2).

Fig. 2: Economic figures reported since the start of the year cannot keep up with analysts' prognoses

Source: Bloomberg LP, 2018

- It is a matter of some concern to see the Eurozone leading the negative ratings in both respects, especially as high hopes had been placed in the prospect of growth dynamics catching up with the United States in view of the advanced state of the economic cycle in Europe. The economic imbalances within the Eurozone highlighted once again by Italy are unlikely to be conducive to changing course at short notice.
- Nonetheless, growth expectations remain high. Even the International Monetary Fund (IMF) is sticking to its prognosis of a real global gross domestic product (GDP) of 4% for 2018 - at least for the time being. This would significantly exceed the long-term potential growth.
- The role of the pulling force for the global economy remains assigned to the economies of the emerging countries. But this is causing some concern. As anticipated in our annual outlook, the rise in interest rates around the world, whilst to date extremely moderate, in combination with the rebounding strength of the US dollar has caused the flow of capital to peter out or even lead to outflow of capital. Tighter financing conditions introduced by central banks to defend local currencies and capital markets are not conducive to strengthening expansion dynamics, and the increase in energy prices since the beginning of the year is adding extra pressure to emerging countries.

- China, however, appears as a light at the end of the tunnel in this context. Despite the increased political focus on fighting economic imbalances and speculation bubbles in the real estate sector that go hand in hand with a tighter monetary policy and a restriction of credit growth, the economy continues to grow at a sturdy 7% p.a.
- The mid- to long-term sustainability of the upswing is questionable despite the overall optimistic mood that continues to dominate the financial markets. After all, estimates concerning the potential growth of developed national economies have been retrogressive for years. A combination of demographic factors and a declining growth in productivity mean that real growth rates of little more than 1% p.a. can be expected for the USA. A similar trend is observable in Europe. Simultaneously, the indebtedness of private and public budgets in western economies has increased massively. The reason why this has not yet resulted in serious problems is exclusively due to the fact that interest rates have so far remained low and debt service costs have even dropped.

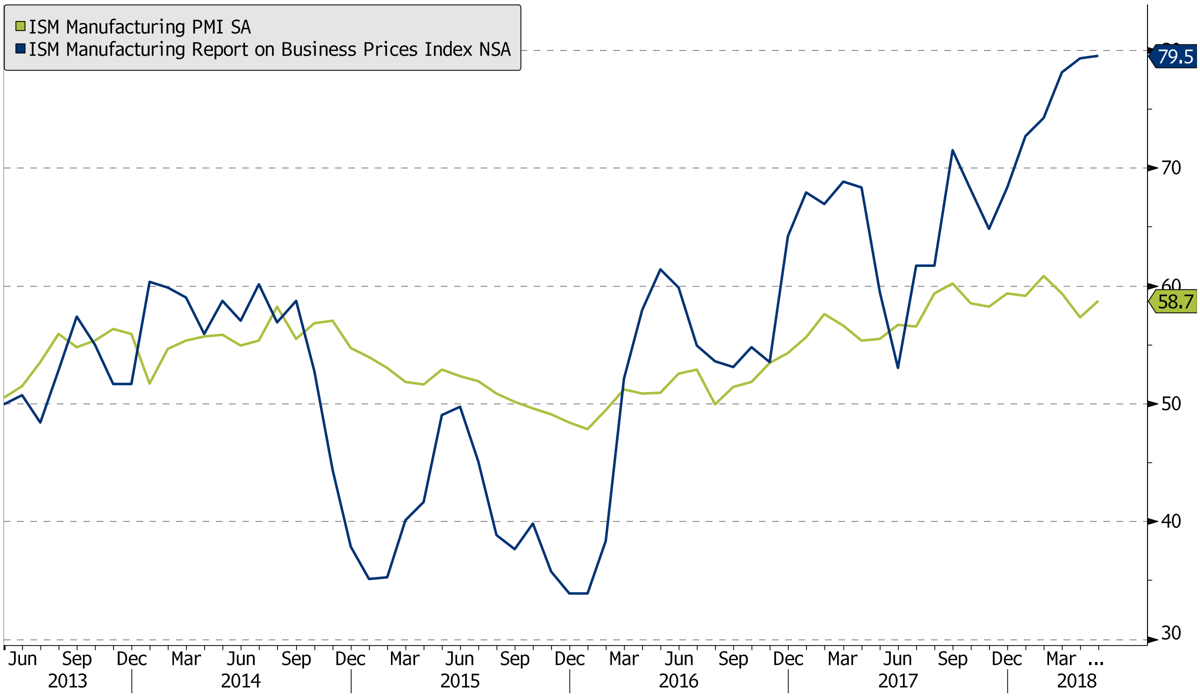
Protectionism and a looming global trade war raise latent risks for the global economy

- When US President Trump took up residency in the White House, many had high hopes that the protectionist items on the political agenda and the populist attitude would be largely held down by the reality of everyday politics; however, this wishful thinking is being challenged, at least with regard to the global trade. China is far from being the only centre of attention. The same strong wording is being directed at European allies, and even neighbours such as Canada and Mexico have not been spared from politically motivated tariffs on steel and aluminium designed to bring them down to their knees and coerce them into accepting concessions for a review of the NAFTA free trade agreement.
- Accordingly, retaliatory measures are meanwhile back on the political agenda and the world faces the threat of a spiralling escalation of ever stricter countermeasures. It goes without saying that a global trade war will poison the dynamics of the global economy.
- By the same token, the introduction of new tariffs and technical trade barriers will without a doubt increase the pressure of already existing inflationary tendencies (see below).

Inflation is on the horizon and will probably be largely tolerated by central banks for the time being

- During the course of the nearly ten-year economic recovery since the global financial crisis, structural factors such as increasing digitization (e-commerce) and automation (robotics) have continuously had a dampening impact on prices. Wages are rising, but to a significantly lesser extent than the low unemployment rates in countries such as the United States and Germany would suggest.
- The indicators of a foreseeable end to the long-lasting phase of dampened price pressure, however, are increasing. Whilst leading indicators such as purchase managers' indices (PMI) have weakened overall, a glance at the individual components of these diffusion indices reveals a more differentiated image. For instance, the producer price component of the American ISM Manufacturing PMI has risen successively since the start of the year and is now approaching historic highs (see Fig. 3).
- It can be assumed that this price pressure will be passed down the value chain and leave its mark on consumer prices in coming months. The US consumer price index has risen by 0.4% to 2.5%YoY since the beginning of the year and is now already significantly higher than the Fed's target rate.
- The United States face the threat of further price pressure in the form of wage developments in the dried-up labour market, where the unemployment rate most recently reached a new low of 3.8%.

Fig. 3: Declining economic momentum obscures escalating price pressure in the value chain



Source: Bloomberg, 2018

- It is unlikely that central banks will introduce sweeping measures in an attempt to counteract such a development. On the contrary, they tirelessly emphasise that the path to normalising monetary policy will be dependent on taking small and well-considered steps along the way. An overshooting rate of inflation is indeed most welcome and a consumer price inflation rate of 3% during the second half of the year, at least in the USA, would come as no surprise.
- Nonetheless, the normalisation of monetary policy will continue and make itself increasingly noticeable in the form of a headwind facing the economy and ambitious capital market valuations. Whilst the European Central Bank (ECB) utilised its purchasing programme during the first half of the year to counteract the shrinking process of the Fed's balance sheet, it is to be expected that these programmes will also be discontinued stepwise until the end of the year. Europe will then face the threat of key interest rate hikes in 2019
- Given the disappointing growth development in the USA, the fears that the actual growth effect triggered by the tax reform could turn out to be negligible and the fiscal easement could culminate in a purely inflationary impetus may indeed materialise. From an economic perspective it evokes the spectre of stagflation. Further interest hikes in quick succession stretching beyond the figure of three that was promised for this year would be just a first step in such a situation - to attempt avoiding a slide into scenarios last experienced in the 1970s.

Reassessment of our economic scenarios

During our outlook on the capital markets for 2018, we put two very different scenarios up for discussion that we have now subjected to a review in light of the developments of the first half of the year.

Scenario I: Inflationary late-cycle boom

- Since the global financial crisis, economic recovery has been characterised by huge over-capacities that have only slowly subsided. Firstly, many inefficient enterprises were kept alive as an unintended result of the central banks' low interest rate policy, leading to a lower elimination of production capacities than has been usual in history. Secondly, many private households have experienced a recession with the consequence that the reaction of consumers and businesses to fiscal and monetary policy impulses were far below average.

- Meanwhile, after eight years of economic recovery, a strong rise in employment figures and restrained capital investments, reserve capacities are now largely exhausted. Simultaneously, the strong increase in asset prices aimed at aiding the recovery of corporate balance sheets and consumers has contributed towards the significant increase in the inclination to consume and invest.
- It is therefore consequentially probable that economic growth will remain above its potential for the time being and that any remaining unutilised capacities will be exhausted. This scenario indicates a substantial acceleration of wage inflation. An increasing proportion of surplus liquidity in the banking system would find its way into the real economy in the form of higher consumer spending.
- Central banks can be expected to initially react with reservation to such a development. This is because the temporary tolerance of over-shooting inflation makes it possible to raise nominal interest rates slowly without simultaneously driving real interest rates to similar heights. Stock markets can be expected to initially react positively to such a scenario as long as profit expectations rise. Conversely, late-cycle asset categories such as commodities that are distinctively sensitive towards inflation pressure stand to benefit significantly.

Scenario II: Abrupt cyclical economic collapse

- The central element of the alternative scenario is an unexpected end to the global economic expansion which has been ongoing for over 8 years. When viewed from a statistical perspective, the current boom is one of the longest since the Second World War - indicating that the next recession is overdue. Additionally, and at closer inspection, significant economies such as China and the United States display various signs of a pending end to cyclical recovery.
- These are further impacted by factors of a structural nature that have had an effect as an economic headwind in recent years and have so far hardly been addressed by the introduction of effective measures. One of them is the demographic change leading to a declining number of employed people given the ageing population not only in OECD economies, but also increasingly in China. The potential growth of the global economy has declined significantly as a consequence of the decline in productivity growth that has been on the downturn for more than a decade. Moreover, the high level of indebtedness limits the extent to which above-potential growth can be maintained.
- The risk that growth cannot keep up with expectations during the coming year seems particularly eminent with regard to China. Now that Xi Jinping has cemented his grip on power for the next five years, China's government will likely turn its attention once again to problems where solutions would entail taking weaker economic growth into consideration. They include environmental pollution, over-capacities and credit creation that is out of control. Suitable measures such as stricter regulations, enforced closures of production sites and a tighter monetary policy and restrictions imposed on the shadow banking system will, however, go hand in hand with rising interest rates. The returns of long-term Chinese government bonds are already above the 4% mark, which in the past has led to significant corrections in the real estate market and a rise in payment defaults among businesses.
- Signs that the current economic boom is coming to an end are also visible in the United States. Credit growth in the banking system has declined significantly during the past year. A tighter monetary policy stands opposed by a low savings rate and an increasingly flatter yield curve, which in the past has been a reliable early warning indicator of an approaching recession (see the section on «Government bonds, money markets and credit markets»).
- If this scenario came to pass it would have substantial negative effects, especially for the equity and credit markets, whilst a flight into government bonds would probably move the proportion of negative yielding bonds back to the highs of 2016.

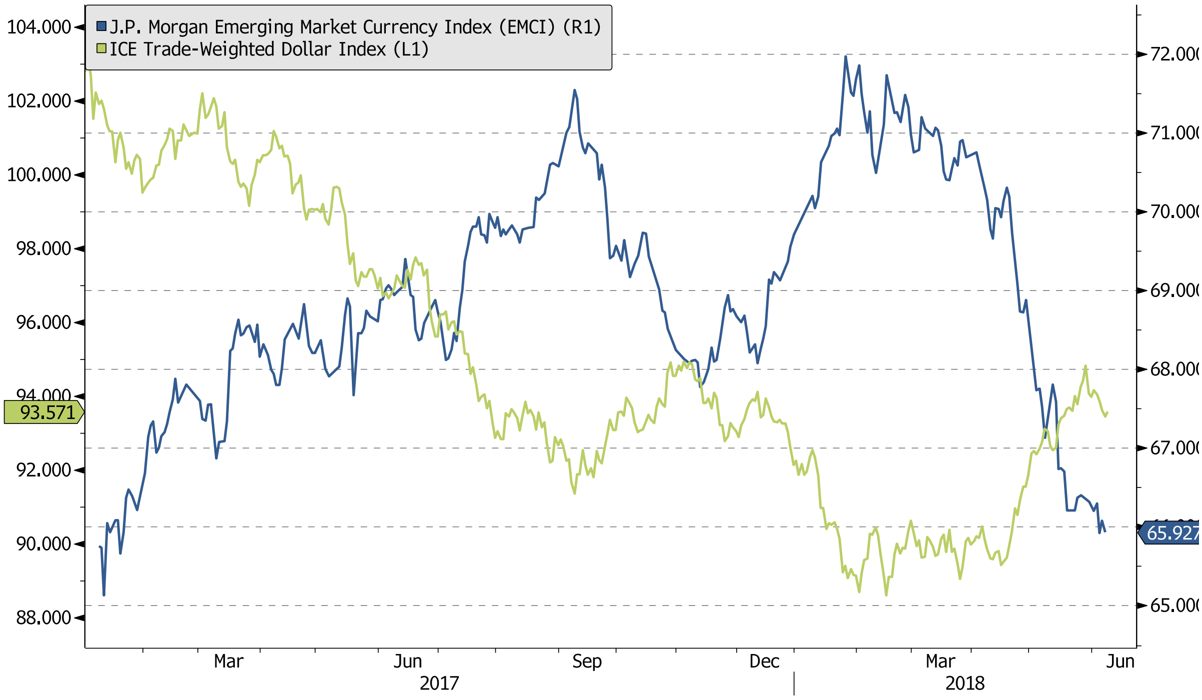
At the beginning of the year we placed greater emphasis on the first scenario of an inflationary boom, although we simultaneously questioned the robustness and permanence of such a development and therefore did not rule out that the cyclical and structural risk factors addressed in the second scenario could cause an abrupt end to such a boom by the end of the year. The risks of inflation have meanwhile become more concrete, albeit in conjunction with a reduction in growth dynamics. Instead of the second scenario replacing the first, it now suddenly seems that the inflationary aspects of the first scenario are merging with the cooling down of the economy described in the second scenario and represent an evolutionary path worthy of consideration. It seems that the risk of a stagflation scenario has indeed increased significantly.

Given this assumption it is likely that late-cycle asset classes such as commodities will benefit in particular during the remainder of the year due to their pronounced sensitivity to inflationary pressure. In contrast, equity markets could have already reached their zenith, while the flattening of bond market maturity structures is likely to continue in anticipation of an economic downturn.

FX markets: Following an unexpected weak phase at the start of the year, the returning focus on interest developments is driving a rebound of the US dollar, whilst the end of the carry trade is putting EM currencies under pressure

- Contrary to the expectations of many market participants who at the beginning of the year forecasted a recovery of the US dollar after its weak development during the previous year, the currency followed but one direction on a trade-weighted basis during the first quarter, namely southwards (see Fig. 4).
- The effects of the US tax reform on the international flow of capital are probably largely responsible for the development. The reform contributed towards a significant expansion of the budget deficit. In the past, phases in which high budget deficits occurred in combination with a pronounced trade deficit were often accompanied by a weakening of the US currency.
- During the second quarter, however, FX market participants directed their focus to the interest rate differential between the US dollar and the other OECD currencies, which has successively increased since the beginning of the year and caused a sharp rally of the USD. The economic decline in the Eurozone in comparison to the US economy probably played a role with regard to the exchange rate versus the Euro (see Fig. 1 and Fig. 2).
- The returned increase in the interest rate difference to the US dollar is especially problematic for investors whose home currency is either the Swiss franc or the Euro and who hedge their exposure to foreign currency in the form of US investments. In the case of the Swiss franc, these hedging costs have meanwhile exceeded the threshold of 3% p.a. with no visible prospect of relief for the current year.
- We expect to see the US dollar weaken slightly during the remainder of the year. No other currency has priced in the normalisation path of monetary policy to this extent. Given the anticipated tapering of the ECB's QE programme, the market will turn its attention increasingly to the catch-up potential of the single currency against the US dollar.
- A weakening US dollar cannot come fast enough for the currencies of most emerging countries. The popular carry trades that allow investors to benefit from higher interest rates in emerging countries have collapsed and become a nightmare for many of them. The J.P. Morgan Emerging Market Currency Index (EMCI) indicates that the majority of exchange rate profits from the previous year have meanwhile turned into losses (see Fig. 4).
- The reversal of capital flow it has triggered is even more hazardous and represents a risk to the global economy. The currencies of Argentina, Brazil and Turkey have suffered in particular, with Turkey's currency woes further afflicted by a politically motivated refusal to raise interest rates in defence.

Fig. 4: Sharp US dollar recovery triggers a flight out of EM currencies



Source: Bloomberg, 2018

Geopolitical risks are escalating, but the financial markets are (for now) still calm

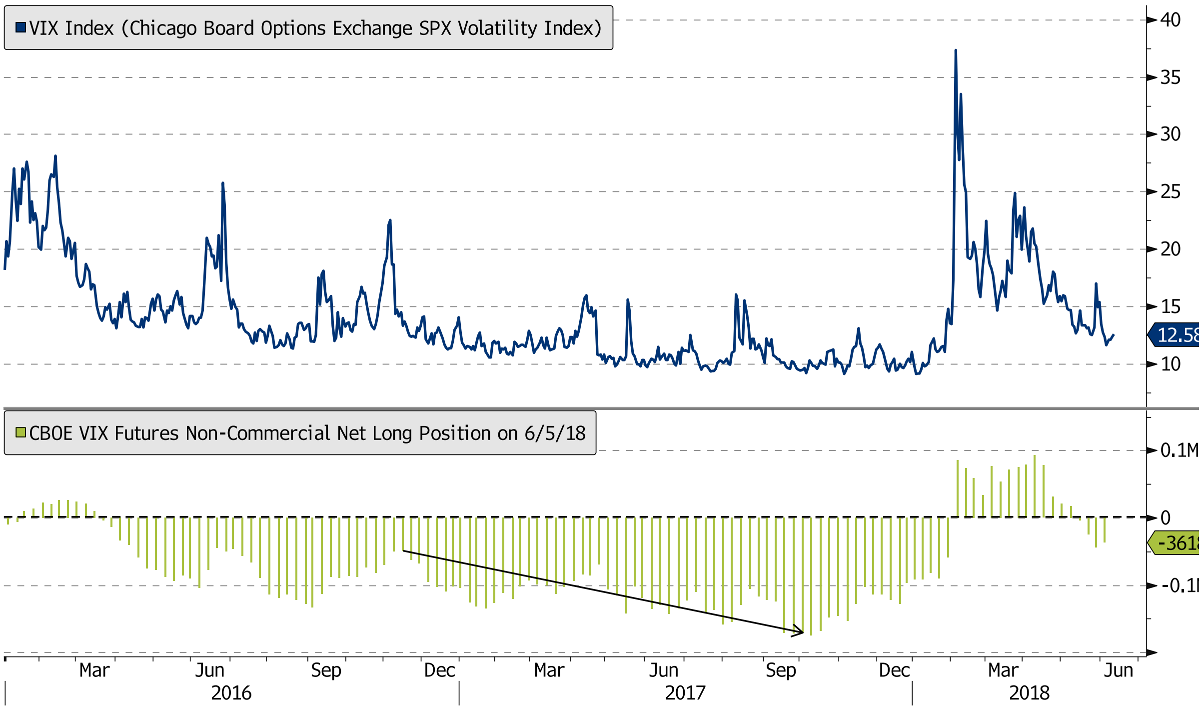
- While geopolitical risks were latently present during last year, they did not escalate, but that has changed this year. The nature of the threat has also changed. Whilst things in Syria are calming down and North Korea has - at least for now – taken on a friendlier tone, the new problem spots are Iran and Italy.
- Not only has the USA's unilateral withdrawal from the nuclear deal with Iran caused a great deal of turbulence on the oil markets (see section on «Commodities»), it has also destabilised the political situation in the Middle East. This is further impacted by the fact that the United States and its European allies have contradictory economic interests. The reintroduction of US sanctions against Iran has had a destructive effect on the established economic relations of many European enterprises operating in the country and is thus at a similar level to the various measures threatening to affect foreign trade.
- The looming conflict between Italy and the rest of the Eurozone, however, is of more immediate concern for financial markets. The financial markets did not react for quite some time despite the victory of the populist parties Lega Nord and the Five Star Movement during Italy's parliamentary elections. Investors were not startled until they perceived the threat of a potential coalition with an explicitly Eurosceptical governmental programme. Although the subsequent rapid increase in bond yields within just a few days and the political intervention of the state president caused particularly radical issues on the agenda to be alleviated or struck off, the situation itself has hardly changed, especially as the same people still have the reins of power in their hands. Once again, the rapid calming of markets seems to reflect first and foremost the inexhaustible confidence of market participants in the central banks and in politics and their readiness to neutralise all risks and hold investors unharmed if push comes to shove. Whether this will indeed be the case if the conflict in Italy escalates is questionable when considering the country's weight and absolute indebtedness.
- It appears once again that the investors' Pavlovian reflex so carefully trained by the caring hand of central banks is effectively counteracting a sustained increase in the risk aversion of financial markets regardless of the trigger. The progressive change in global monetary policy could, however, in future question this reaction and render financial markets once again more susceptible to political influence. Political developments that have so far been deliberately ignored will suddenly have a significant impact on the price formation on financial markets as soon as the risk awareness of investors becomes more acute in view of a less upbeat market environment and their aversion to risk rises as a result.

Stock markets

A volatility shock puts a preliminary end to the upward trend while investor optimism declines with regard to the future development of corporate profits

- The stock markets' relentless rise to ever greater heights initially continued during the first quarter. The near parabolic acceleration, laid down by the upward movement that seemed to be driven primarily by its inherent price momentum and has paid no attention to fundamental events and influences, was reminiscent of the end phases of previous stock market booms.
- However, the trend was not terminated by the exhaustion of speculative interests or fundamental factors, but rather by an external share volatility shock affecting the derivatives market. All in all, the volatility index for US shares (VIX) hovered around 10 points below its historic average during 2017. The number of bets banking on a continuing and even further declining volatility nonetheless grew to record-breaking proportions (see Fig. 5). The start of a correction to this excessive one-sided positioning triggered a feedback loop that pushed the VIX index to a peak exceeding 40 and exerted indirect selling pressure on the stock markets. The situation was further exacerbated by the fact that the intensity of market movements triggered the liquidation clauses of various funds and investment structures that trade with leverage on decreasing volatility.

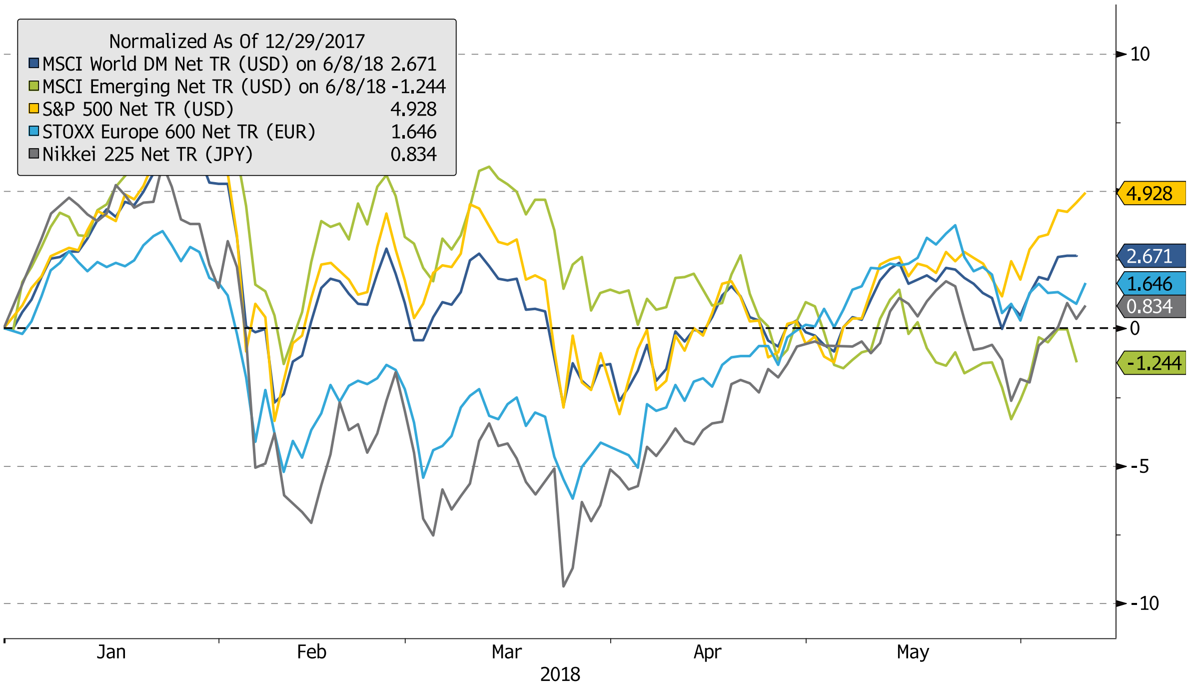
Fig. 5: Stock market volatility shock in February triggered by the liquidation of excessive bets on continuing low and decreasing volatility



Source: Bloomberg, 2018

- We stand by the assessment we made at the beginning of the year, namely that the phase of record low levels of stock market volatility is behind us and that a gradual increase in volatility is to be expected against the background of increasing correlations due to the stronger influence of macroeconomic developments (global normalisation of monetary policy, trade disputes, economic uncertainty).
- Profitability levels on global stock markets were mixed halfway through the year (see Fig. 6). That said, the majority of benchmarks found their way back into the profitable zone during the second quarter against the background of more stabilised macroeconomic prospects. The trend among last year's high flyers, the emerging economies, remains negative as the turbulence caused by a stronger US dollar and rising US interest rates places a burden on the markets.

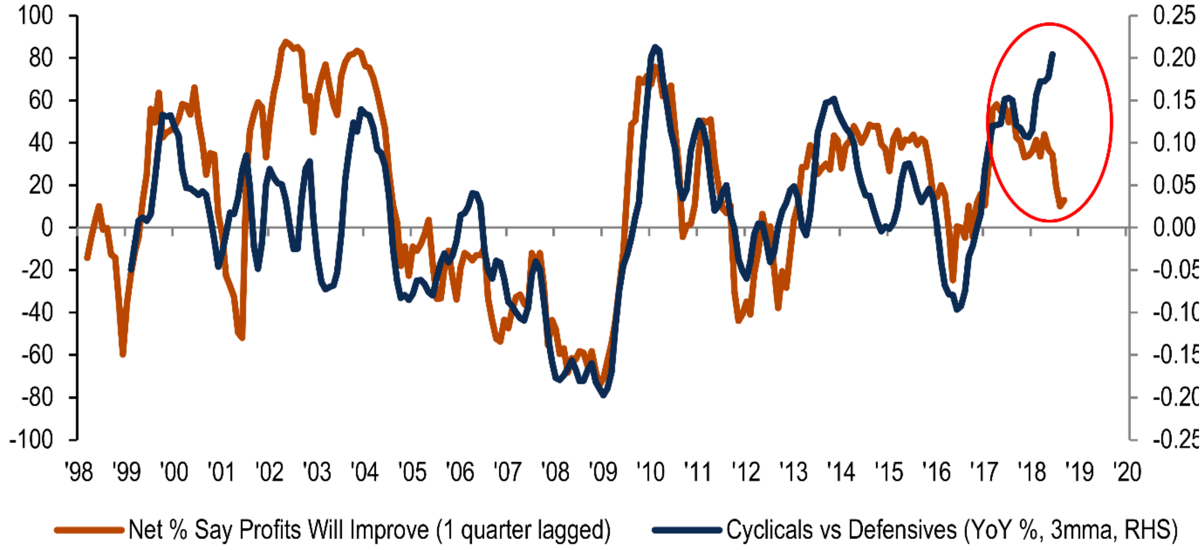
Fig. 6: Development of selected stock markets in 2018



Time series indexed at 0 per 31.12.2017. Source: Bloomberg, 2018

- The outperformance of cyclical sectors (technology, raw materials, industrials, cyclical consumer goods) in comparison with defensive sectors (telecommunications, pharmaceuticals, staples and suppliers) has continued as in the previous year. This further accentuates the average relative valuation mark-up for cyclical securities measured by their price-earnings ratio (PER), which is now at the same level as former cyclical highs.
- At the same time, investors have become more circumspect in their estimation of future corporate profits. The proportion of those expecting to see continued profit growth has declined to around one half. This has created a significant gap in the relationship between this statistic and the relative development of cyclical and defensive securities (see Fig. 7). The close historical relationship between the two suggests that the divergence will be resolved during a continuing phase of pronounced underperformance of cyclical equity sectors. In view of the dominance of cyclical assets in recent years and the significance they have achieved in benchmark indices, it can be assumed that a rotation of this nature will be accompanied by a general weak phase affecting global stock markets.

Fig. 7: Cyclical assets continue to outperform their defensive counterparts, but confirmation in the form of corporate profit expectations is falling



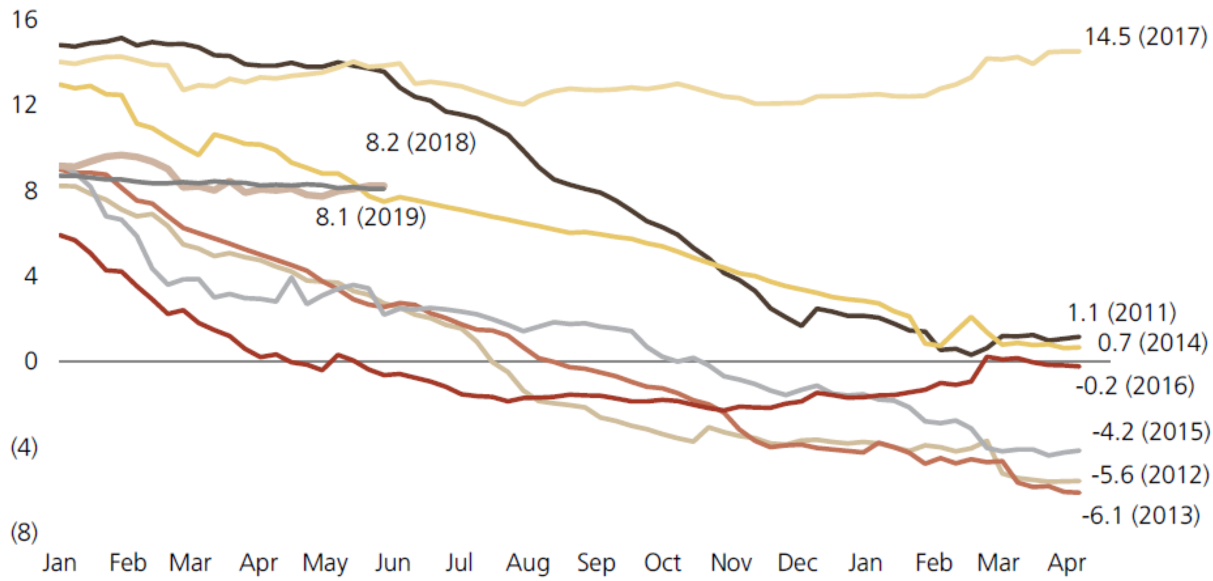
Cyclical sectors: Transports, Basic Materials, Technology, Consumer Cyclicals. Defensive sectors: Staples, Pharmaceuticals, Telecom, Utilities. Source: Bloomberg LP, BofA Merrill Lynch Global Fund Manager Survey, June 2018

- Producers of raw materials are the exception with regard to reservations towards cyclical sectors. Globally rising inflation rates combined with ongoing robust growth are a good reason to expect the markets for raw materials to carry on booming (see also the section on «Raw Materials»). Energy stocks remain attractive due the recovery of the oil price and in view of high dividend yields. Mining stocks are also a focal point, firstly because they are still trading at attractive valuations and secondly because of their leveraged exposure to base metals that historically have noted the highest price increases during the expansion phase of the economic cycle.

Opportunities for corporate profits to continue rising remain intact in Europe, but political and macro-economic risks have increased significantly

- The above-average collapse of its economic data in comparison to the rest of the world and the leading indicators for Europe have dampened the mood on European stock markets. When adjusted to reflect the USD basis, the pan-European benchmark EuroStoxx 600 has achieved no more than around one third of the of the profitability of the leading index S&P 500 for the US stock market since the beginning of the year.
- This begs the question as to whether 2017, which was the first full year of increasing corporate profits after six meagre years, could turn out to be just a flash in the pan. Foreign investors have already begun their retreat, leading to a net outflow from European stock markets during the last three months.
- Expectations for profit growth have been significantly trimmed for 2018 in comparison to the outstanding result of the previous year of 14.5%. Profit growth currently stands at 8.2% year on year and profit expectations have been decreased by approximately 1% since the beginning of the year (see Fig. 8).

Fig. 8: Consensus estimates for profit growth of European corporations



Details in per cent. Period under review: from January to the end of the following April Source: Datastream, UBS, 2018

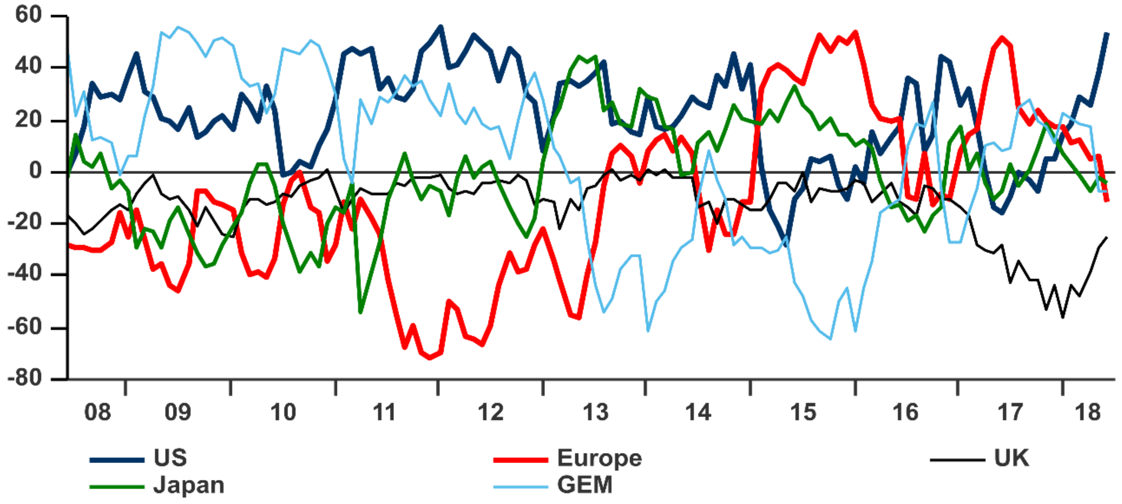
- Factors that could drive a continued cycle of expanding corporate profits, however, remain intact. Thus, growing sales and the enforceability of price increases will benefit from the slow but sure rise in inflation. Net profit margins have improved by 0.7% over the last twelve months and are set to increase further still as operating leverage takes hold. Furthermore, European enterprises still have the capacity to follow the US role model and increase the leverage on their capital structures, an effect last seen in 2010. There are also initial signs that capital investments are on the road to recovery.
- Additional upside potential could materialise if European stocks experience an expansion from the current PE ratio of around 15 to historic highs (+30% upside potential), foreign investors return to the European markets on a larger scale and M&A activity increases.
- There is, however, no doubt that the risks have increased this year. The turbulence on the financial markets triggered by the process of forming a new government in Italy has made it abundantly clear that the constructive weaknesses of the Eurozone persist and its inherent fragility can provoke the eruption of new crises at any time in spite of the regulatory reform efforts.
- Banks and insurance companies are naturally particularly exposed in this context, a reason for us to recommend a reserved approach to investments in these sectors. On the whole, the capitalisation of the European banking system is still significantly lagging behind that of the US. The fact that the Deutsche Bank share price reached new record lows in recent weeks is due not only to circumstances of systemic pan-European interdependence, but also and in particular due to scarce capital backing.
- A high foreign trade surplus has put the European Union in the sights of the US government, whose president is convinced that the rest of the world is fleecing the USA in regards to global trade, despite all the evidence to the contrary. Sectors with a high proportion of export trade therefore face significant uncertainty and risk. The automotive sector in particular could be the next to suffer after steel and aluminium. After all, if anecdotes are to be believed, the presence of German luxury cars on the streets of New York has been a thorn in the side of the American president for a long time already.
- The fact that Switzerland's stock market fared worse than the broad European stock market during the first half of the year despite the former's defensive qualities and positioning outside of the Eurozone may appear surprising at first glance. Reasons can be found in the extremely concentrated and top-heavy structure of Switzerland's stock landscape. If one analyses the primary drivers behind the negative development, one can see it is due first and foremost to the healthcare (Novartis, Roche), banking (UBS, CS, JB) and food (Nestlé) sectors. Two of these

are defensive sectors. The Swiss stock market is unlikely to continue under-performing, at least against the background of a cautious development of global stock markets, should it transpire.

US stocks: From a fundamental viewpoint still unattractive despite the outperformance during the first half of the year as a result of the corporate tax reform

- When measured against the S&P500 index, the American stock market made only very moderate gains during the first half of the year in comparison to the previous year, but is nonetheless far ahead of the other major stock markets (cf. Fig. 6). This relative strength is probably due to the fact that investors only recognize US stocks with profitability potential, according to the Global Fund Manager Survey by Bank of America Merrill Lynch. Hence the estimates of profit prospects are at their highest level in seventeen years (see Fig. 9).

Fig. 9: Estimates of profit prospects for US stocks highest in 17 years, while all other global regions are negatively assessed

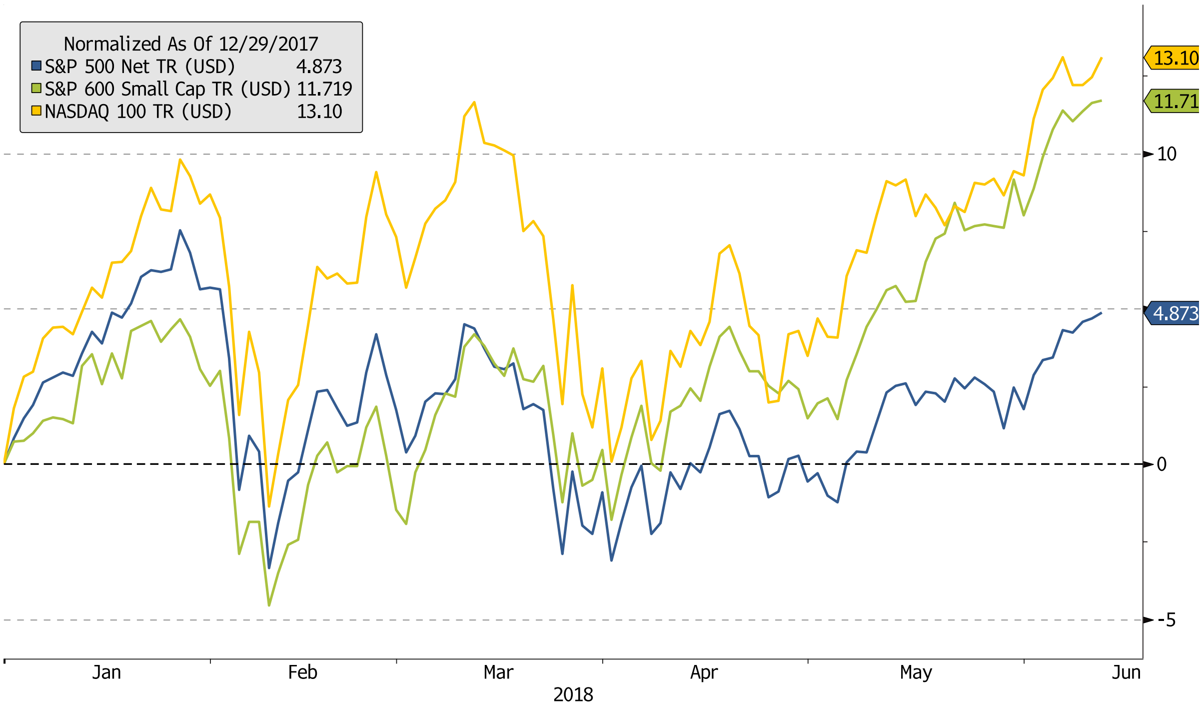


Source: BofA Merrill Lynch Global Fund Manager Survey, June 2018

- This optimism is due largely to the effects of the corporate tax reform that came into force at the turn of the year. Profit expectations for the first quarter rose accordingly and were still far exceeded by a profit growth of 24% achieved by S&P 500 corporations. Windfall gains and repatriated capital were largely converted into stock buy-backs and additional dividends to the benefit of shareholders.
- The comparatively modest price increase of the S&P500 in the moderate single-digit range comes as a surprise against this background. It should be considered, however, that the jump in profits is due to a significant extent to one-off effects. In view of effective taxation rates that were already around the 20% mark prior to the reform, the expected increase in corporate earnings after taxes will amount to a mere 10%. In turn, this justifies a price increase of the same extent only under the assumption that the corporate taxation rate will permanently stay at this low rate.
- Accordingly, various corporations have indicated in their quarterly reports that current results represent a "high-water mark". All in all, however, it has not deterred the community of analysts from extrapolating the one-off effects as a trend far into the future. The operating profit expectations for the S&P 500 for 2019 are currently more than 45% above the level of the past 12 months. When considered in conjunction with sales growth, this would imply operating profit margins that are 30% higher than the current record level and 50% higher than the average profit margin since the year 2000. Valuations have dropped considerably as a consequence of

the one-off effects, but the United States are still by far the most expensive stock market world-wide. The melange of extreme evaluations combined with excessive profit expectations has created a situation that is primed to disappoint.

Fig. 10: Striking outperformance of technology stocks and small capitalised companies characterise the US stock market during the first half of the year

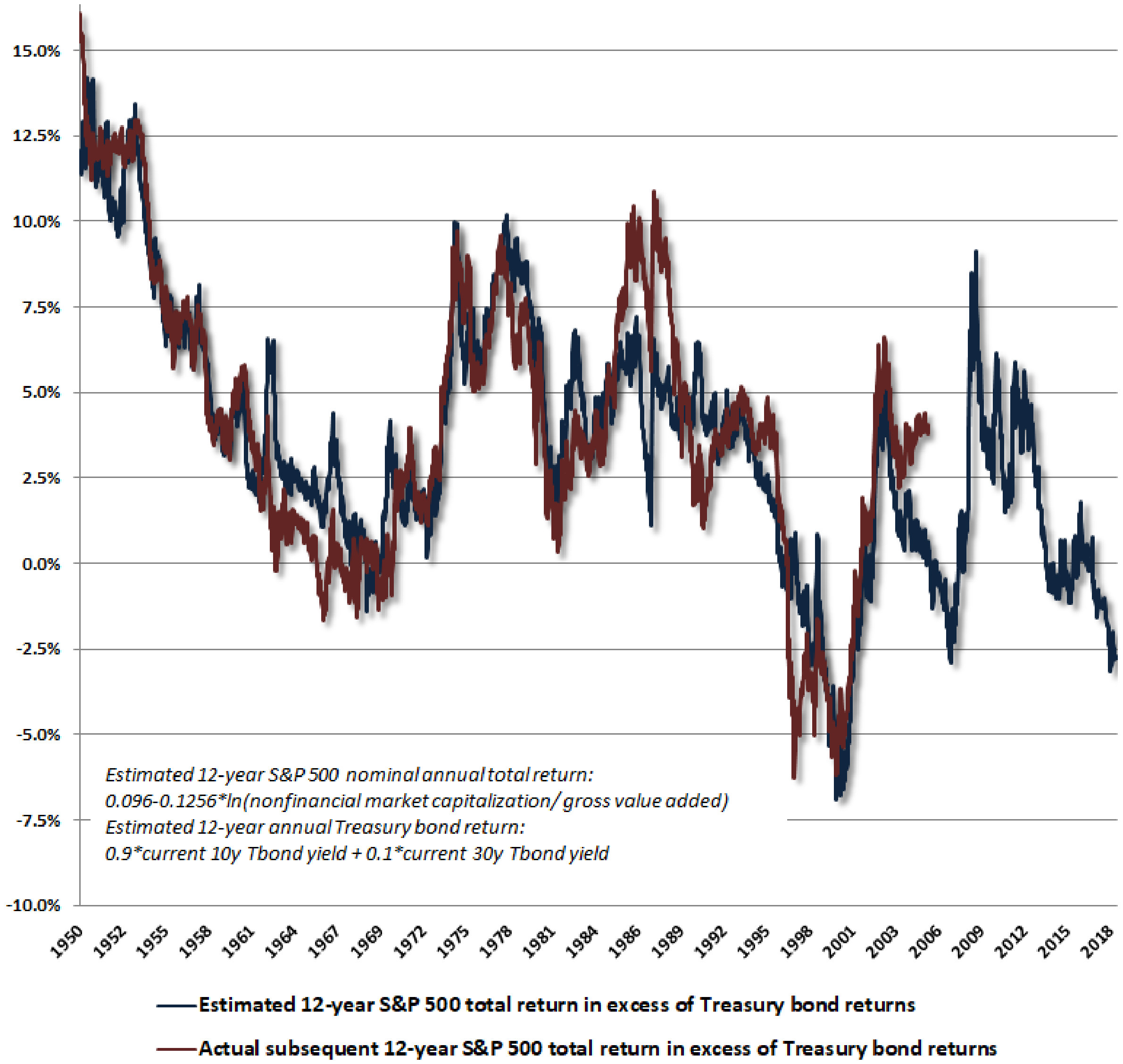


Source: Bloomberg LP, 2018

- A more detailed look at the structure of the US stock market reveals significant divergences between individual size segments and sectors. The technology sector has outperformed since the beginning of the year and, from the second quarter on, small capitalised companies have left the blue-chips of the S&P 500 behind them (see Fig. 10).
- With regard to the small caps, a considerable portion of their outperformance is probably due to the assessment of market participants that the lower international complexity and dependency on exports of small companies will to a large extent leave them unharmed from the consequences of a looming escalation of the trade dispute. In addition, small capitalised companies benefit to a special extent from the corporation tax reform as the effective tax rate for this market segment was previously comparatively high at an average of 32%. As previously postulated in our annual outlook, the recovery of the US dollar has also proved beneficial in comparison to the blue-chip segment.
- Nearly twenty years on from the internet bubble, technology stocks are once again the driving force of the US stock market. Their share in market capitalisation meanwhile stands at more than 25% - a level previously breached only once, namely for a short period in the year 2000 just before the speculative bubble burst. Thus, the dependency of the broad stock market on the fate of the technology sector has rarely been higher.
- This is further impacted by the fact that the technology sector has an extremely concentrated structure. The majority of market capitalisation is concentrated in five corporations that in the meantime are commonly known by the acronym FANG or FAANG (Facebook, Amazon.com, Apple, Netflix, and Google). Of some concern in this context is the fact that record-breaking cash inflows are coinciding with equally record-breaking share sales by insiders, which very likely reached a volume of USD 5bn during the first half-year alone.

- The risk that the technology sector poses to the broad stock market is by no means limited to just a potentially weakening course of business. The high sector concentration is in particular the result of the strong positive network effects that are characteristic of many business models. This is because the positive externalities promote a "Winner Takes All" dynamism whose natural end result is the establishment of monopolies. Although the interpretation of antitrust law in the United States has become much more reserved since the Reagan era, the fact that the reach of advertising platforms and social media has meanwhile entered the political sphere and even influences the outcomes of elections has provoked a potentially far-reaching political reaction. And even if measures stop short of destroying monopolist structures, the introduction and enforcement of stricter regulations on the protection of data ownership and personal privacy could have severe consequences for the business models of the tech giants.
- From a valuation point of view, the United States are and will remain by far the most expensive stock market not only in relation to other global regions, but also in a historical comparison to itself as extreme valuations are emerging from a variety benchmarks.
- However, history shows that valuations alone are of little use as a timing instrument for investment decisions. Their forecast value is negligible in the short term and it is much more the aggregated risk appetite of investors that determines the fate of the stock market. The significance of valuations suddenly increases only when the risk aversion of market participants rises sustainably.
- It is recommendable to fall back on valuation methods that grant adequate consideration to the cyclicality of profit margins to produce reliable forecasts with regards to long-term prospective returns. That is because they display especially high correlations with subsequently realised returns as long as an adequately long-term horizon of ten to twelve years is chosen. One of those valuation methods is the ratio of stock market capitalisation to nominal GDP or Gross Value Added, which also takes economic performance abroad into account. If one takes such values that have currently matched or exceeded the level last seen at the height of the internet bubble as a benchmark, one can conclude that, over the coming decade, investments in the American stock market can be expected to underperform US government bonds with an equivalent maturity by an annual average of 3% (see Fig. 11).

Fig. 11: The valuation of the US stock market gives reason to expect a significant under-performance in comparison to government bonds over the next decade



Source: Hussman Strategic Advisors, 2018

Stocks of emerging countries face growing risks, but certain regions and countries remain interesting nonetheless

- Many of the potential risks listed in our annual outlook for emerging countries have already manifested themselves during the first half of the year. They have proved to be particularly hard-hit by the cracks in the façade of the synchronous global upturn. Accordingly, when measured against the MSCI Emerging Markets Index, EM stock markets have noted the largest correction since achieving their apex in January.
- A significant proportion of emerging market economies is dependent on export. The trade war incited by the United States therefore represents a direct threat to growth. Moreover, the recovery of the US dollar in combination with rising interest rates has destroyed the basis for carry trades and caused capital flows to run dry, thereby exerting pressure on EM currencies and asset prices.
- The valuation discount against OECD stock markets, relatively high growth rates and the fact that profit expectations have so far been spared from significant pressure cannot compensate

for the icier wind sweeping across the global stage. Nonetheless, there are still individual regions and markets that continue to appear attractive to us.

- Eastern Europe and Russia are among them. We consider the market reaction to the recent additional sanctions imposed by the USA against Russia as a purchase opportunity. The country's economic condition has improved considerably since the last round of sanctions in 2014. The recovery of the price of oil played a major role in this scenario.
- The fact that the EMEA region has been lagging behind the MSCI benchmark by 16% since 2017, even though yield development is on a par with the EM average, speaks in favour of Eastern Europe as a whole (see Fig. 12). This is further impacted by a valuation discount of 20% affecting Eastern European enterprises.
- Emerging countries with a low dependency on exports and a growth story with a focus on the domestic economy are also of interest. India meets both of these criteria. Not only is India currently the fastest-growing economy, it also benefits from its relative isolation from external shocks in view of the high demands of a rapidly growing middle class. This explains why the Indian benchmark index BSE Sensex was able to add to the general trend during the second quarter and surpass the MSCI emerging markets index by nearly 7% on a USD basis.

Fig. 12: The valuations for Eastern Europe and Russia are significantly lower than the average for emerging countries and have catch-up potential

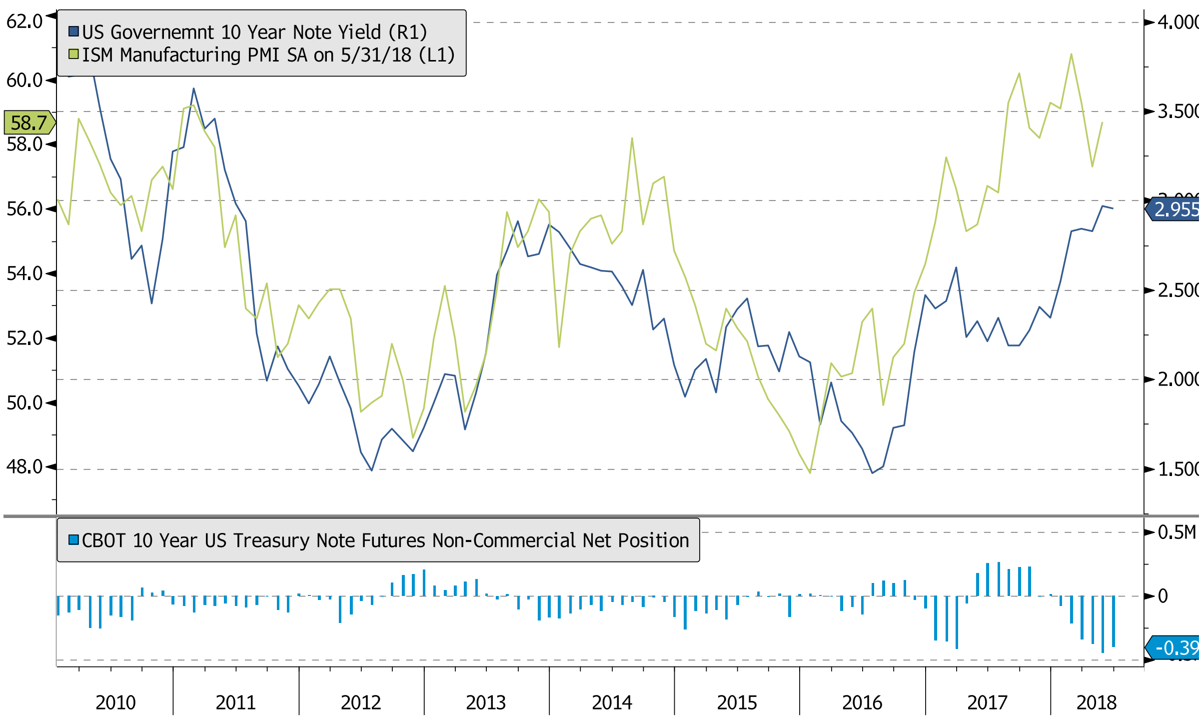
Source: MSCI, Datastream, UBS, 2018

Government bonds, money markets and credit markets

Accelerating inflation and a normalisation of monetary policy are driving the increase in interest rates, although structural factors are keeping up the pressure on the long end of the yield curve

- A continuing increase was observable from the start of the year after the YTM rates of long-term US government bonds in the previous year failed to sustainably move on from a sideward consolidation of between 2% and 2.5%. The yield on ten-year Treasury Notes even broke through the 3% mark on occasion.
- Thus, the gap that had appeared between the leading indicators of economic development and long-term interest rates began to narrow. That said, the correction of the ISM Manufacturing PMI that currently implies a ten-year yield of round 3.5% played a major role in the development (see Fig. 13).
- The interest-driving influence of the Fed's programme to gradually reduce its bloated budget will become more noticeable in view of its incremental expansion. The long end of the interest curve in Europe will also be increasingly exposed to market forces as the programme to purchase bonds is wound down during the second half of the year.

Fig. 13: The gap between the indicators of economic development and long-term bond yields begins to close



Source: Bloomberg, 2017

- Structural forces that have a dampening effect on the determining factors of the yield of long-term bonds, i.e. real interest rates, inflation expectations and term premiums will, however, continue to prevent any significant increase in interest rates.
- Long-term real interest rates are closely linked to the potential growth of an economy. It seems likely that the real interest equilibrium rates will stay put at their current low level in view of the declining potential growth for developed economies that has been consistent for the past decade. In addition to an accelerated demographic change, the contributing structural factors include the high indebtedness of public and private households and the resulting reluctance to consume and invest.
- From a cyclical viewpoint, the sluggish development of inflation turned out to be a millstone around the neck of bond yields. Driven by the acceleration of global growth dynamics, however, inflation expectations have experienced an upward trend since the middle of 2017 that has continued this year (see Fig. 15). That said, expectations remain fragile and susceptible to external shocks such as the Italy crisis in May.
- Even if traditionally dominant drivers of inflationary development such as energy prices will prospectively play a lesser role in the long term in view of structural changes in the energy sector (shale oil), we still anticipate a continuing and accelerating increase in inflation expectations as described in the section on «Macroeconomic Trends». It will go hand in hand with a further increase in the ten-year yield of US government bonds of significantly more than 3%.
- In addition to the declining inflation premium, the interest volatility that has fallen continuously over the past thirty years is exerting pressure on the term premium by lowering the risk of long-term bonds. It is very probable, however, that higher inflation rates would have an indirect invigorating effect on interest volatility.

Fig. 14: Interest structure curves continue to flatten, underscoring the scepticism regarding the sustainability of economic expansion

Source: Bloomberg LP, 2018

- In order to profit from such a development as an investor, one should firstly look at direct short positions on government bonds (e.g. on US Treasury Note Futures) or bet on a steepening of the interest curve (e.g. 2s10s Steepener Structures). It should be considered, however, that this is meanwhile a consensus bet, as a glance at the record highs of net short positions on the futures markets for US government bonds shows (see Fig. 13). This circumstance could explain the resistance ten-year bonds have so far experienced as they try to permanently establish a yield of over 3%.
- Further pressure is added by the scepticism towards the sustainability of economic stimulation. Consequentially, the flattening of the interest structure curves in the US Treasuries market has reached an extent last seen in 2007 shortly before the recession that was triggered by the global financial crisis. Interest structure curve inversions have in the past proved to be a reliable indicator for looming recessions (see Fig. 14).

Inflation-protected bonds preferred over nominal bonds

- The link to the real interest development of inflation-protected bonds weakens the headwind through rising nominal interest rates to the same extent as the increase represents an inflation premium. Inflation linked US government bonds (Treasury Inflation-Protected Securities, or TIPS for short) have fared better than their nominal counterparts during the first half-year due to the significant increase in the consumer price index.
- Under the assumption of a continuing recovery trend regarding inflation expectations, we continue to prefer inflation-protected bonds over nominal bonds and anticipate a relatively better development during the second half-year. American TIPS will probably continue to be the best performers.
- Investors who generally do not wish to forego long-term bonds are recommended to give preference to this market segment over long-term nominal bonds on account of its defensive character.

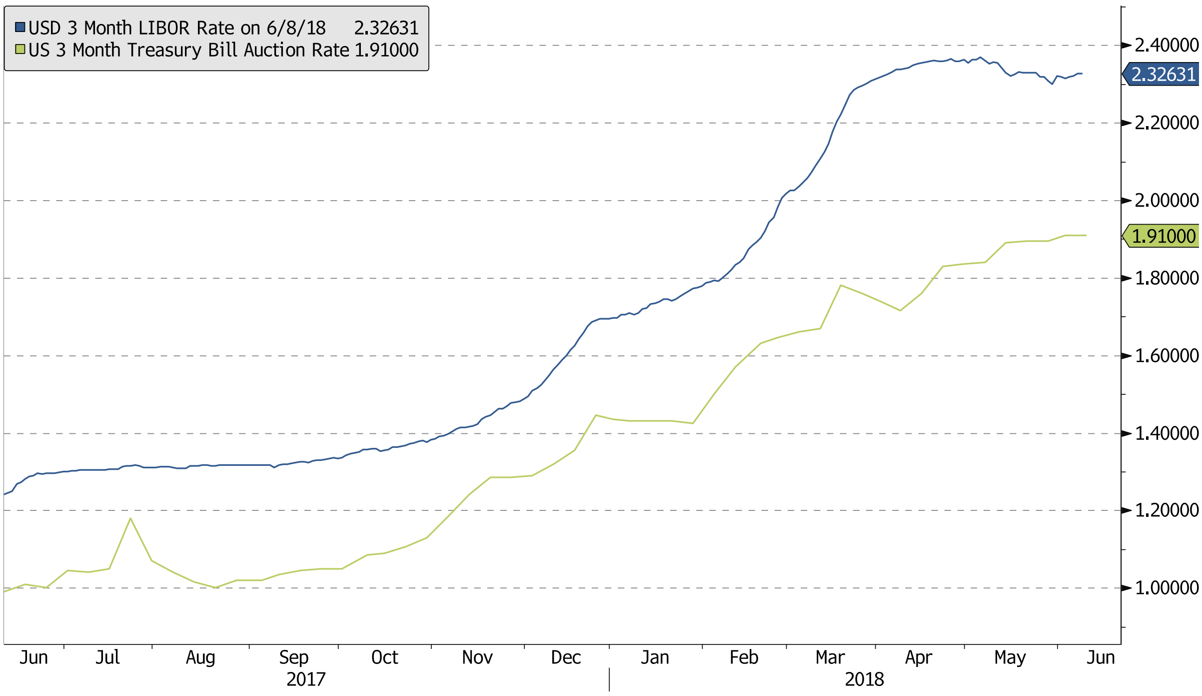
Fig. 15: The increase in inflation expectations persists in the USA and Europe but remains susceptible to external shocks

Source: Bloomberg, 2018

Short maturity profiles and variable interest investments in USD remain the preferred choice in view of inestimable duration risks

- Minimising duration risks remains a major interest of investors in view of a scenario that promises an accelerated rise in inflation despite declining growth dynamics. We are therefore upholding our recommendation to bring portfolios into alignment with a shorter duration and to bet on flexible strategies of low duration with regard to remaining bond allocations that are able to benefit from increasing interest rates at the short end of the maturity structure.
- As far as the dollar is concerned, the current key interest hikes are making money market investments with variable interest rates increasingly more attractive. During the first half-year, for instance, the USD 3M LIBOR rose by nearly 65 bp to 2.34%. The trend will probably continue as the Fed has meanwhile increased its forecast of the number of interest rate hikes from three to four, of which just two have been implemented. The trend affecting key interest rates could accelerate if the tax reform in the United States turns out to have an unexpectedly strong effect on growth or inflation.
- Floating rate notes based on the LIBOR are preferable over fixed-rate corporate bonds.

Fig. 16: US money market interest rates continue to rise strongly



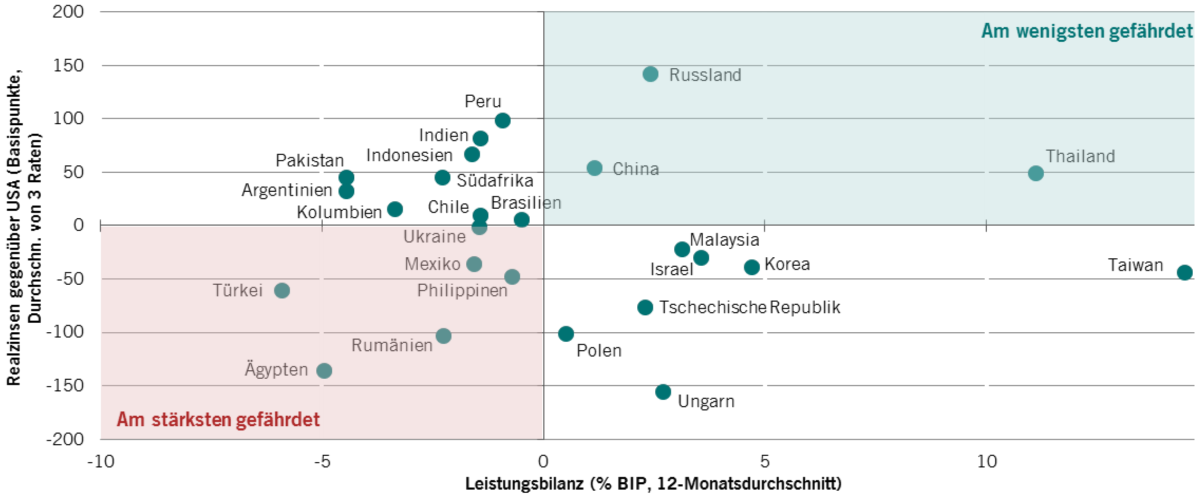
Source: Bloomberg, 2018

Emerging country bonds: the hangover kicks in

- Government bonds issued by emerging currencies in local and hard currency did little to please investors during the first half-year. Benchmarks for both market segments (local currency: JP Morgan GBI-EM Global Core, hard currency: JP Morgan EMBI Global) show losses of 6% on USD basis.
- The factors discussed in the sections on Macroeconomic Trends and Stock Markets have hit the bond markets especially hard as valuation haircuts against OECD bonds were eliminated during the course of the previous year's boom. Additionally, the inflation rates that last year fell to a twenty-year low of 3% on average had reached rock bottom and were on the rise once again.

- We therefore recommend caution in general, regardless of the currency class. Detailed differentiations, however, can be made with regard to the susceptibility of individual issuing countries to shock and can serve selective investors as a guideline.
- A simple method of identifying the countries particularly susceptible to shocks is to consider their external financing requirements via their current account position (risk proxy) and an average of real interest rates (return proxy). As Fig. 17 shows, emerging countries are extremely varied and therefore still offer plenty of investment opportunities.
- A glance at a broader palette of 10 risk factors (e.g. excessive indebtedness, hard currency debt and currency reserves) shows that Argentina, Turkey, Colombia and South Africa represent additional endangered markets. In fact, Argentina was recently forced to raise interest rates to 40% to protect the national currency. It is notable that the largest emerging countries (BRIIC) appear significantly less susceptible in comparison to 2013.

Fig. 17: Emerging country risk in consideration of current account and real interest rates



Source: Pictet Asset Management, CEIC, Datastream, Bloomberg LP, 2018

Central bank has the European market for corporate bonds in a pincer grip

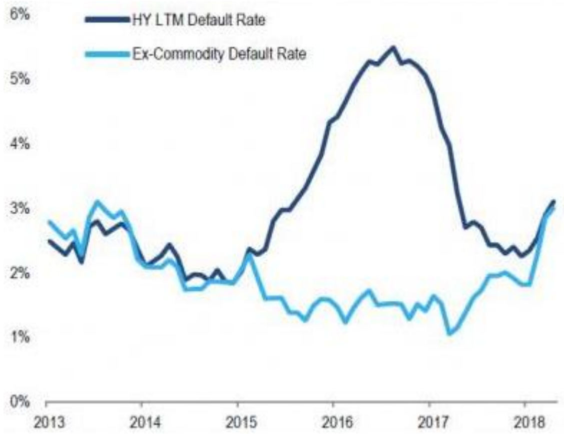
- The situation on the credit markets remains relaxed in view of a friendly economic environment. A surprising aspect of the year's course to date is the fact that the investment grade segment in the United States in view of rising credit spreads has distinctly underperformed in comparison to the high yield sector, which so far remains unfazed (see Fig. 18). And this despite the fact that issuance activity in the investment grade segment has decreased significantly as a consequence of the US tax reform.
- The qualitative structure of the corporate bond market is meanwhile deteriorating at an increasing rate. Rating agency Moody's, for instance, reported that the number of enterprises outside of the financial sector with a junk rating has increased since 2009 to 58% worldwide, the largest proportion ever recorded. Simultaneously, S&P reports that the median rating that was still an A back in the 1980s has fallen to BBB and thus just one level above junk.

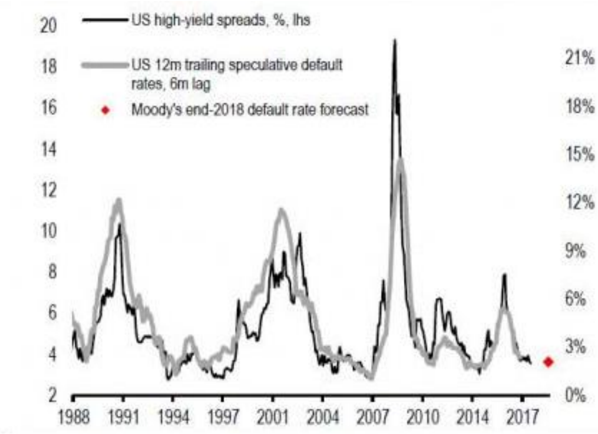
Fig. 18: Credit spreads in the investment grade segment have experienced a turnaround, while volatility rises in the high yield segment

Source: Bloomberg, 2018

- New bond issues contain ever fewer investor protection clauses and are becoming ever more speculative in nature. In the United States, the proportion of non-amortizing mortgages in the commercial sector is meanwhile at 75%, while the proportion of so-called "covenant lite" bonds for leveraged loans stands at 77%.
- The favourable market climate will not persist if basic economic conditions deteriorate. This is because the huge amount of debt and record leverage of corporate balance sheets has opened the prospect of an extensive wave of credit defaults when the next economic stress period arrives. When put into relation to the gross domestic product, the indebtedness of American companies is once again at a level that in the past invariably triggered financial crises.
- Although the current default rate is only 3%, it has risen rapidly in recent months (see Fig. 19 on the left). This speaks for increasing credit spreads as they are historically closely correlated with the default rate (see Fig. 19 on the right).
- In Europe, it is now clear that the ECB will successively wind down its corporate bond purchasing programme during the second half-year and bring it to an end at the end of the year. However, the ECB's purchases already seem to have lost their potency. In contrast to preceding years in which central bank purchases had a strong condensing effect on spreads, this year they have risen by nearly 70 bps since the beginning of the year despite additional purchases with a similar volume of EUR 70 bn.
- It is doubtable that the credit markets will be able to avoid a correction during the second half-year in an environment of tightening inflation, rising interest rates and the incremental winding down of quantitative easing programmes. This is because the development of bond purchases by central banks is characterised over time by a close and negatively correlated relationship with the height of the credit spreads.
- An additional and by no means negligible risk in the context of a potential credit market correction lies in the fact that ever more inflows have come from retail investors via inexpensive ETFs from which investors expect available liquidity at all times. Banks, however, have increasingly left their traditional role as market makers for regulatory reasons and positioned themselves in the per se illiquid market for corporate bonds. Unilateral sales pressure can very quickly give rise to unexpectedly high negative price fluctuations in such a market environment.

Fig. 19: Credit default rates rise in the high yield sector (left); credit spreads are historically closely correlated





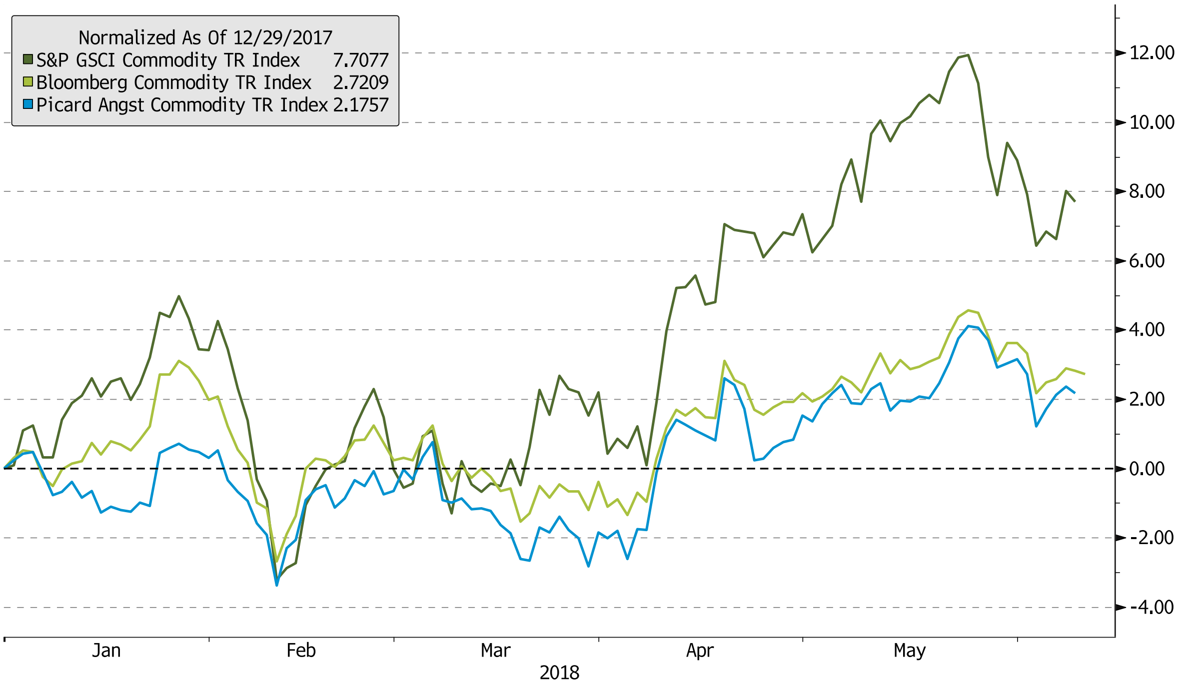
Source: Credit Suisse, 2018

Commodities

The cyclical upswing is strengthening

- The cyclical upswing on the commodities markets has continued during the first half of 2018. Participation has broadened across the sectors. Last year, nearly all the shots were called by cyclical commodities in the energy and industrial metals sector; however, signs of a structural change in the supply and demand dynamics of agricultural commodities - in particular grain and certain soft commodities - are meanwhile becoming apparent. Geopolitical factors have gained influence. The oil price increase of up to 15 USD per barrel since the start of the year, for instance, is not exclusively attributable to a reduction of the surplus supply, but also in part to the manifestation of geopolitical risks. Industrial metals, however, have taken a break following the very pronounced price increase of the previous year. Signs of weakening global growth dynamics have placed an additional burden on the latter.
- The fact that the commodities markets have shown resistance to the rapid recovery of the trade-weighted US dollar during the second quarter emphasises that the late cyclical dynamics of the global economy provide favourable fundamental conditions for ever more commodities. Precious metals were the only ones to struggle with currency developments but remained largely unfazed by increasing interest rates. Firstly, the interest hike at the long end of the market has so far proved to be comparatively moderate; secondly, inflation dynamics have accelerated noticeably. The increase in US consumer prices by 0.7% during the first half-year has kept pace with the Fed's interest hikes and has a moderating effect on real interest rates.

Fig. 20: Picard Angst Commodity TR vs. Benchmark Indices 2018



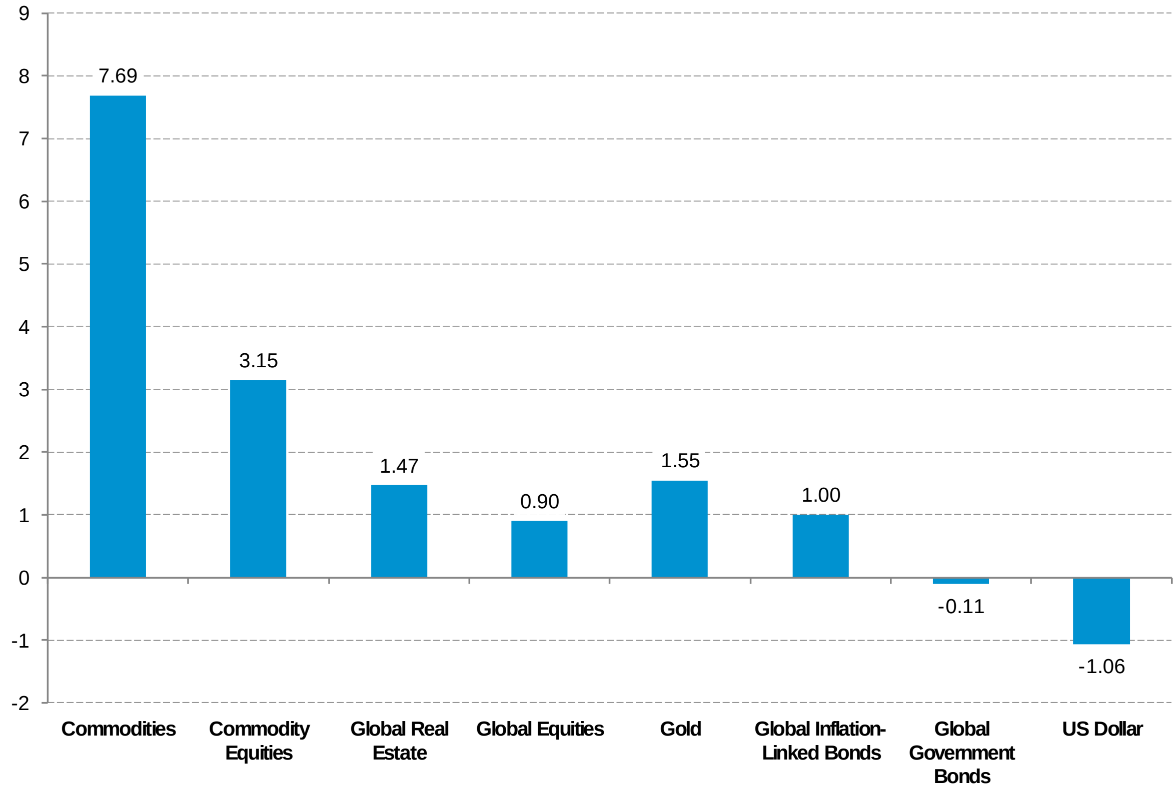
Source: Bloomberg, 2018

- Broad commodity benchmarks can look back on positive returns for the first half-year against this background. As is to be expected in the current phase of the economic cycle, investments in commodities have started to outperform not only bonds but also investments in stocks. Benchmarks with a high energy proportion and a pronounced cyclical exposure fared best of all. The energy-heavy S&P GSCI Commodity TR Index, for instance, gained more than 7%, while the more balanced Bloomberg Commodity TR Index improved by 2%. Unlike 2017, our own diversified Picard Angst Commodity TR Strategy did not manage to improve on its benchmark during the first half of the year (see Fig. 20).
- As in the previous year, the strategies that exclude agricultural commodities from their investment universe did significantly better, as they were able to benefit from their concentrated exposure to energy commodities. The Picard Angst Energy & Metals TR Strategy gained more than 5%, thereby further extending the previous year's outperformance of the Bloomberg Commodity ex-Ag ex-LS TR benchmark.

Tightening inflation pressure improves the prospects for commodity investments despite declining growth dynamics

- In the past, commodities have always experienced the greatest up-valuation and significantly outperformed other asset classes when the economic cycle had already passed its zenith, resource bottlenecks became noticeable and central banks began hitting the brakes. The pronounced outperformance during the late cycle expansion phase is due in particular to the fact that, in contrast to financial assets such as stocks, commodity prices are determined by the supply and demand situation on the spot market. Thus, prices rise when the current level of demand exceeds the available supply.
- Over the past year, the solid growth of the global economy paired with an increasing depletion of remaining reserve capacities has already expressed itself in a strong increase in demand for commodities across all sectors. The previously sluggish inflationary development has also gained momentum in recent months.
- Although declining growth dynamics may appear at first glance as a negative influence, this view ignores the fact that commodity prices are determined first and foremost by activity levels, not by growth alone. Positive yields can be expected as long as demand exceeds supply. The favourable initial situation for upbeat commodity markets will therefore continue during the second half of the year.
- We continue to expect an overall yield of up to 10% in 2018 for our proprietary commodity investment strategies. The lion's share, however, will stem from rolling contract yields, whilst the spot price development is likely to be comparatively moderate.
- The following factors will have a supporting effect:
  - Closing the output gaps combined with persisting employment growth will drive the wage spiral and accelerate the rise of inflation. Of all asset classes, commodities are the most sensitive towards changes in the rate of inflation and are therefore especially suitable for hedging against inflation (see Fig. 21).
  - Commodities benefit when the reins on monetary policy are tightened. This is because, just as when demand exceeds supply capacities and places upward pressure on commodities, it usually provokes a defensive reaction from central banks. On average, this is reflected especially positively by the cyclical sectors for industrial metals and energy.
  - The collapse of capital expenditure and investments in new production capacities since the global financial crisis is slowly taking effect as a limiting factor in satisfying increasing demands.

Fig. 21: Inflation protection effect of commodity investments – inflation sensitivity of asset classes toward the US consumer price index



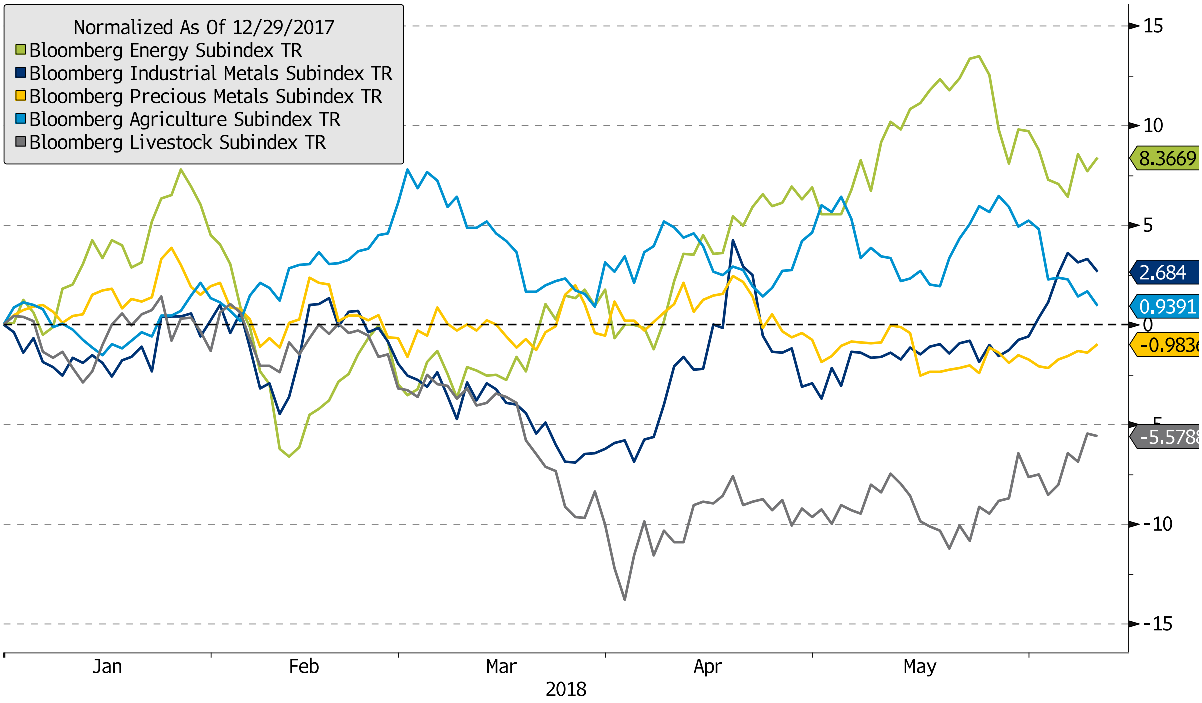
Source: Picard Angst AG, 2018

- 78 per cent of the 23 most-traded commodities are meanwhile displaying falling stock levels and therefore a supply deficiency. The reduced availability of commodities also effects the maturity structure. The turnaround of the forward curves in the energy sector from contango into backwardation has substantially improved the rolling yield profile for investors. Certain agricultural commodities and base metals are showing signs of a similar development that is likely to become more pronounced.
- The interest on the underlying capital of commodity investments (collateral yield) has recovered noticeably since the beginning of the year and is likely to reach a level of 2.5%to 3% in view of further foreseeable interest hikes.
- The diversification effect of adding commodities to a balanced portfolio is currently higher than it has been for years. Correlations are currently close to zero with regard to stocks and bonds and between the individual commodity sectors.

- The risks that could pose a threat to a continuing upswing on the commodities markets include:
  - The escalation of the latent trade dispute between the USA, China and the EU into a full-blown trade war could torpedo global economic growth with severe implications for the demand for commodities. On the other hand, if the effects of new tariffs remain limited then the resulting friction and rising production costs could potentially find reflection in increasing commodity prices.
  - China's growth fared well during the first half of the year but will eventually begin to slow down. Having consolidated political power structures, China's leaders will switch their focus to confining the growth of speculative bubbles on the real estate market, industrial over-capacities and environmental pollution, necessitating a restriction on the creation of credit. In view of China's role as the world's largest importer of commodities, an abrupt collapse in growth would question the continued recovery of the commodity markets.

– The trade-weighted US dollar has depreciated successively over the past year. However, the continued normalisation of US monetary policy and the prospect of fiscal policy easements give rise to expect an expanding interest differential in favour of the US currency in 2018. A resulting substantial dollar rise would become noticeable as a headwind against further commodity price increases.
– The US dollar has seen a rapid recovery in recent months once the market realigned its focus with the increasing interest rate differential between the USA and the rest of the world. If the US dollar on a trade-weighted basis should not weaken during the second half-year contrary to our expectations (see also the section on «Macro-economic Trends»), it would limit the extent of further price increases for commodities.

Fig. 22: Development of commodity sectors 2018



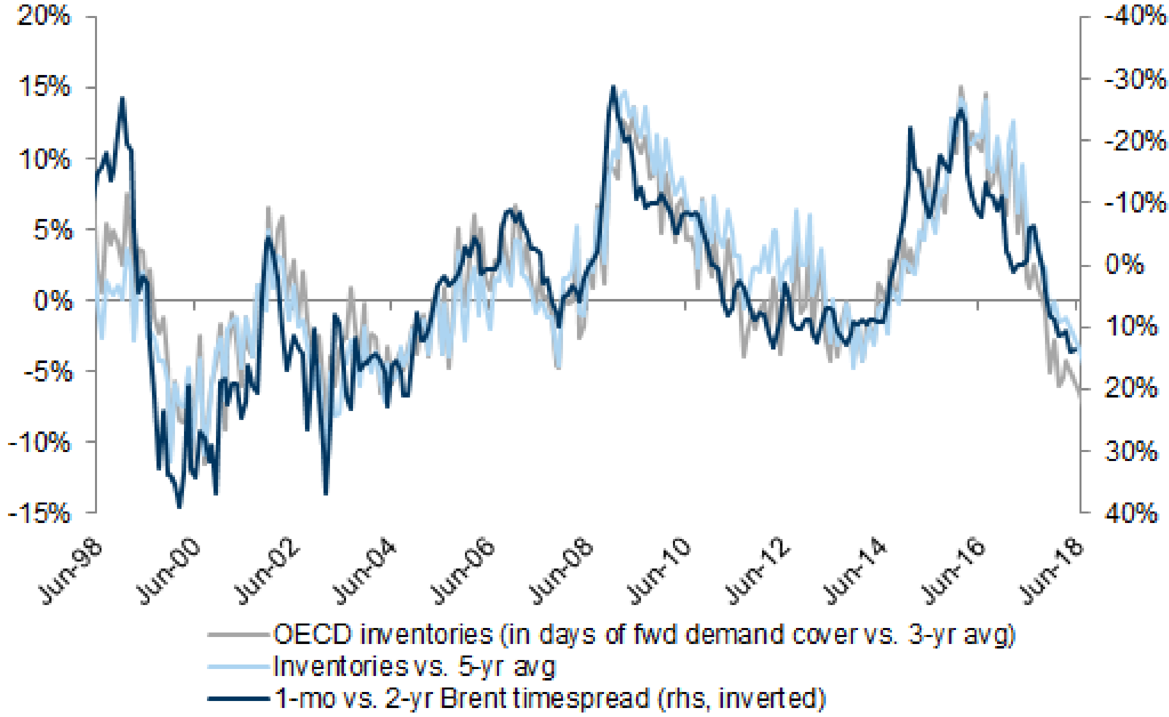
Source: Bloomberg, 2018

Energy

Energy prices continued to recover during the first half of the year. Disciplined compliance with the agreed production restrictions on the part of OPEC and Russia was the decisive factor. The goal of normalising global stockpiles was achieved earlier than anticipated in spring due to the very robust growth in demand driven by the emerging countries. They are significantly lower than both the three-year and the five-year average. The inversion of forward curves has intensified dramatically as a result. The contract roll yield on Brent Crude is reaching up to 15% p.a. (see Fig. 23)

The materialisation of geopolitical risks had a decisive impact on the robust rise in energy prices in addition to the dynamics of supply and demand. The price for Brent Crude at times exceeded USD 80 per barrel after the USA unilaterally withdrew from the nuclear agreement with Iran and reintroduced economic sanctions. However, its rise was curtailed for the time being by the announcement by Saudi-Arabia and Russia to increase the OPEC production quotas by up to a million barrels a day. All in all, it does not represent any easement of the supply situation in view of the originally agreed restrictions on production. This is because the additional supply merely compensates for the production outages in Venezuela and Iran due to renewed sanctions. Without this step the supply situation in the OECD would have reached precarious dimensions in view of the continued fall in inventories. Thus, energy prices may continue to rise, especially as OPEC production quotas, which have increased against the background of a robust economic environment, have in the past failed to develop a damping effect on prices until the start of the next recession.

Fig. 23: OPEC goal achieved: global oil stocks below long-term average



Source: IEA, ICE, GS Global Investment Research, 2018

The US shale oil sector was the only source of substantial production growth during the first half of the year. If the current trend continues, the United States could overtake Saudi-Arabia by the end of the year and become the largest producer of oil in the world. However, export capacities for US oil are subject to tight limits. Logistical bottlenecks caused by inadequate pipeline capacities restrict exports to less than 3 million barrels per day. This gave rise to a significant discount on the US oil type WTI in comparison to Brent that most recently expanded to more than USD 11 per barrel. Additional price discounts result between different delivery points for WTI oil in Texas and Oklahoma. This is increasingly reducing the effective incentive to further expand shale oil production, which could put an end to the sector's continued expansion against long-held hopes.

The energy sector remains of interest to investors at its current price level. Even if the spot price for oil should already have reached its zenith, that doesn't mean that its yield potential is exhausted. Even the scenario of a consolidated market promises an attractive return in view of extremely high rolling yields. The rolling yield on Brent Crude is likely to accumulate to 10% over the course of the entire year. At the same time, the potential for price setbacks has dropped in view of a substantial reduction in speculative positions on forward markets in recent weeks.

Industrial metals

Base metals have failed so far this year to come close to the previous year's outstanding return of 30%. All in all, the sector remains trapped in a consolidation movement. Although supply deficits are expected this year for important base metals (aluminium, copper, nickel, zinc) and expectations for global growth remain high, the previously very moderate inflation rate and, in particular, the stronger US dollar have developed into a headwind. Political risks that caused price turbulence on the markets for aluminium, nickel and palladium in April have turned out to be only temporary influencing factors.

It can also be assumed for the rest of the year that the prospects for individual metals will diverge significantly with regard to their supply dynamics. Decisive in this context is whether the supply cycle is dominated by long-term or short-term factors. Thus, the prospects for copper remain distinctly positive as the phase of supply growth is coming to an end in view of the drop in capital investment since 2013 and the development of new production capacities requires many years of lead time. In comparison, the aluminium market will have to reckon with headwind in 2018. This is because the availability of raw materials and energy as an input factor is not limited. Supply reforms and new environmental requirements in China will, however, strengthen higher cost structures and prevent prices from falling back to the levels of 2016.

Nickel managed to leave the rest of its competitors behind with a price increase of close to 20%, although a significant expansion of nickel ore supplies from Indonesia, the world's largest producer, now looms after the lifting of the export ban in this year. The halt of steel production capacities ordered by China during the winter months has led to an inventory reduction, which will now be reflected in the increased production of stainless steel. The metal is benefiting increasingly from the focus on its significance for the production of batteries for electric vehicles. According to estimates by analysts, the amount of nickel required for the production of batteries will increase tenfold over the next eight years.

The long-term prospects for base metals remain exceptionally positive. This is because the mining industry is only slowly recovering from a record low in profit margins that in 2016 reached their lowest level since 1998. They have in the past proved to be a reliable indicator for the development of the market balance with a delay time of around two years. This rises the expectations of a continuing recovery in the sector over the coming years in view of an increasing supply deficit.

Precious metals

While a surprisingly weak US dollar got precious metals prices and in particular the gold price off to a good start to the year, profits melted away in view of a challenging interest environment and a trend turnaround for the US currency.

However, the gold price proved to be astoundingly resilient even towards an increase in the YTM rates for ten-year US bonds in excess of 3%. Sensitivity towards interest rate developments has successively declined since autumn of last year. The correlation between gold and ten-year treasury notes, for instance, was recently even close to zero. The traditionally negative correlation towards the US dollar, on the other hand, remained comparatively constant at around -0.6.

The factors that could more sustainably raise or support the gold price during the second half of the year include in particular a weakening of the US currency, for which chances remain intact within the framework of Europe and other countries catching up with regard to growth dynamics and tackling the normalisation of monetary policy. An acceleration of the development of inflation beyond the rate of 3% would also be helpful as it would put pressure on real interest rates, especially as the central banks will adopt a reserved and cautious approach to the normalisation process.

Gold was unable to profit from its traditional role as a safe haven despite the turbulence affecting Europe's financial markets during the course of the conflicted formation of a new Italian government. Nonetheless, the return of a political risk premium is likely to be only a question of time. Implicit volatilities quoted significantly lower than the realised level of volatility on the options markets make it clear that gold's defensive character as a safe haven is currently lacking appreciation. During a longer phase of pronounced risk aversion, however, investors will view gold as an attractive escape option to alternatives such as government bonds that are not only characterised by high valuations but are also subject to the risk of inflation.

Agricultural commodities

After many years of tumbling prices, it seems that the agricultural markets are nearing a turnaround with some delay in comparison to the cyclical commodity sectors. While the situation for soft commodities is a mixed bag, the prices for most grain types have increased significantly since the beginning of the year.

Demand is exceeding supply for seven of the nine most important agricultural commodities. Despite very good harvests in recent years, corn and soya beans have noted falling stocks-to-use ratios for two consecutive years. The reason is that the low market price no longer gives producers the necessary incentives to expand cultivation areas and introduce other measures to increase yields. US corn producers cultivated 2.4% less corn this spring, which equates to a decline in stocks from 15.4% to 10% of the overall demand under otherwise constant conditions. With regard to soya, 2.1% less cultivation is likely to cause stocks to drop to 8% of demand by the end of the year. A stock level of below 10% for corn and soya has in the past proved critical and usually gives rise to an inversion of the forward curve and sharp price hikes.

Similar tendencies can be seen with regard to other agricultural commodities such as cotton. Alarming in this context is the fact that in many cases a moderate return drop is sufficient trigger serious supply shortages. Explosive price rallies cannot be ruled out if weather-related harvest failures such as those occurring this spring in South America continue, all the more so as global climate models are forecasting a potential return of the El Niño weather phenomenon for the second half of the year.

Picard Angst Investment Fund – Performance 2018

As per: 31 May 2018

Commodities – «Enhanced Beta» Strategies

All Commodity Tracker Plus		
Fondsvermögen	USD 160 Mio.	
Performance	Q2 2018	2018
Anteilsklasse P (USD)	+4.53%	+2.87%
Benchmark BCOM TR Index	+4.04%	+3.62%

Energy & Metals		
Fondsvermögen	USD 161 Mio.	
Performance	Q2 2018	2018
Anteilsklasse P (USD)	+5.99%	+5.42%
Benchmark BCOM ex-Ag ex-LS TR Index	+5.16%	+3.98%

All Commodity Fund (UCITS)		
Fondsvermögen	USD 6 Mio.	
Performance	Q2 2018	2018
Anteilsklasse Ca (USD)	+4.64%	+1.90%
Benchmark BCOM TR Index	+4.04%	+3.62%

Commodities – Systematic Risk Premium Strategies – Long-Short

Systematic Commodity Alpha		
Fondsvermögen	USD 29 Mio.	
Performance	Q2 2018	2018
Anteilsklasse P (USD)	+3.75%	+6.24%

Stocks

Picard Angst Systematic Equity Switzerland		
Fondsvermögen	CHF 23 Mio.	
Performance	Q2 2018	2018
Anteilsklasse 1 (CHF)	-0.75%	-7.77%

Picard Angst Padma India Fund (UCITS)		
Fondsvermögen	USD 34 Mio.	
Performance	Q2 2018	2018
Anteilsklasse I (USD)	-0.93%	-10.74%
Benchmark NSE Nifty 50 Index (USD)	+2.52%	-3.50%

Picard Angst Stabilized European Dividend Income (UCITS)		
Fondsvermögen	EUR 10 Mio.	
Performance	Q2 2018	2018
Anteilsklasse P (EUR)	+4.68%	-0.36%
Benchmark Euro STOXX 50 TR Index	+3.14%	-0.78%

Important Notice

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