Investment Strategy

October 2019

"THERE IS A BEAUTY THAT REMAINS WITH US AFTER WE'VE STOPPED LOOKING."

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Graph sources: Bloomberg/BearBull Global Investments

INTRODUCTION

Letter to Investors - Investment Climate

- No real signs of recession in the US
- Huge fall in long rates, and more flexible monetary policy
- The consensus is clearly too pessimistic
- Rate market forecasts will likely adjust
- Increased risk of a share correction

Unfortunately, a fall in uncertainty and volatility was not the defining feature of the third quarter. In fact, the quarter took its lead from the one before in terms of investment climate and overall investor sentiment. The main concern is still the lack of any real headway in the trade war between China and the United States. The news coming regularly from both Chinese and American diplomats has rarely given any real cause for hope; on the contrary, it has been a source of concern for financial markets on more than one occasion. In the end, this quarter proved rather similar to the previous quarter, and was shaped by a very clear rise in volatility in the middle of the period. For three quarters, the lack of visibility on this trade issue has been hitting purchase mangers' and the international industrial sector's confidence particularly hard. Leading manufacturing indicators, though, have stabilised and in some cases bounced back over the last few months, which may reassure investors. That said, sentiment has remained rather pessimistic in capital markets. They are maintaining a central scenario based on growing risks of recession, despite overall robust economic results that are frequently buoyed up by private consumption and public spending. The manufacturing sector is still being undermined by the lack of visibility, but unless consumption collapses in the near future, the current stabilisation of production should be followed by a more clear-cut recovery in the 4th quarter. In this still uncertain macroeconomic context, consensus forecasts for interest rates have remained very much on a downward slope, both in the United States and most other developed markets. Bond markets have posted another very good quarter, as ten-year rates fell 50 basis points in August before bouncing halfway back in September. Ten-year Swiss bond yields hit new record lows, after a spectacular fall from -0.53% in June to a historic low of -1.128% on 16th August. In terms of monetary policy, the expected trend change came with two rate drops: -0.25% in the United States, and a more timid -0.1% from the ECB. Central banks once again sought to reassure markets be reaffirming their intention to act to prevent any economic slowdown by rechannelling or announcing new liquidity injections. The SNB stood strong in the face of this trend and did not change its key rates. The quarter therefore draws to a close with similar stock market performances to the previous months, with results just tipping into the black for many asset classes.

After months of forecasts of recession and economic results in the end being more robust, particularly in the United States (+2%), the last quarter of 2019 could provide a reality check. The very significant drop in interest rates, sometimes to the tune of -50% in twelve months (from 3% in September 2018 to 1.5% in September 2019), will have a particularly positive impact on financing for companies, individuals, and more generally all economic agents. We already considered the risk of recession to be very much overstated, and this should also drop considerably thanks to the monetary policy measures taken by central banks, which look to be more expansionary in the long term. Real terms interest rates have also dropped considerably due to interest rates falling faster than price indices.

Long rates bounced back in the first two weeks of September; we believe that this heralds a change in forecasts, which should become even starker in the coming months. However, a rise in long rates should go hand in hand with much more positive economic statistics in order to truly make itself felt. The stabilisation of manufacturing sector prices will need to be backed up by more reassuring figures. We believe that the economic data published over the past few months has rather tended to be a little better than consensus forecasts. Bond markets should gradually adjust their forecasts as the economy proves itself resilient and risks of an economic slowdown wane, even if there is no trade agreement between China and the United States. We should not forget that trade between the two countries only represents a fraction of their respective GDP (2.4% for the United States and 0.4% for China) and that introducing new duties should only have a modest impact on their GDP. The adjustment of growth forecasts and interest rates should certainly also hang heavy over equity markets, the performance of which over the last nine months is largely due to the expansion of their value multipliers following a rate drop. Equity valuation levels leave very little opportunity for further upward movement. Prospects for real estate remain positive, relatively speaking, but we believe that increasing fees to 30% in Switzerland also seems to represent an excessive, though short-lived, show of enthusiasm. Commodities should be helped by the less pessimistic adjustment to economic growth forecasts, as should some emerging assets. There are still risks for most assets in the 4th quarter, whereas short-term opportunities remain limited. We therefore recommend a strategy focusing on diversifying positions and preserving capital.

Alain Freymond
Chairman
BearBull Global Investments Group

Graph sources: Bloomberg/BearBull Global Investments

BIG PICTURE

Key Convictions

- US growth will remain solid
- Central banks back in the limelight
- Low interest rates favourable to economic upturn
- Long-term interest rate markets have to adjust
- Valuation levels of risky assets once again generous

US growth will remain solid

Economic statistics published in the last few months have regularly surprised on the upside, presenting a fairly clear trend since July confirming that the actual state of the US economy currently is likely stronger than feared by a large number of economists and financial strategists. This can be explained on the one hand by the fact that the risks of recession have increasingly been taken into account and by the downward revision of economic expectations, and on the other by stronger actual results. In other words, statistics published over the past three months have contradicted investors' negative expectations. We believe the economy is healthier than generally assumed, in spite of the uncertainty tied to the trade war, due to very robust consumption. The US job market remains strong, as shown by job creation, which posted its largest increase in four months (195,000) in September. Wages continue to rise (sharp increase in average hourly wage) and are unlikely to decrease, driving up disposable income and US consumers' spending capacity. The outlook for consumption is solid for year-end. We expect that a favourable consumption climate will drive an upswing in investment and improve purchasing manager confidence. The generalised decline in interest rates (see below) will have an impact on growth which has not yet been factored into confidence indicators. We believe that the risks of recession are still very overblown, and we anticipate a shift in outlook towards a scenario involving an economic upswing.

Central banks back in the limelight

Central banks had a choice with regard to resisting pressure from financial markets to heed their alarmist predictions of a US recession loudly trumpeted since the end of Q3 2018. The banks will have resisted until the end of Q1 2019 before giving in to investor pressure and the panic steering capital markets, even though economic indicators remained positive overall, and economic results continued to bear witness to the persisting strength of the economy, in spite of the alarmist forecasts. Central banks thus chose to intervene, noting however that with regard to the Fed, while the latter's support for growth was unconditional, its assessment of economic conditions and the job market was positive. Since then, it appears that FOMC members have not been in full agreement regarding how to conduct monetary policy going forward. The normalisation process has thus been interrupted and will give way to a more flexible policy, which could lead to a third rate cut in the US in October. The expansion of central banks' balance sheets will thus likely resume and even accelerate in some cases.

We believe the risks of a slowdown are overblown and the US economy in particular will show itself to be resilient in the face of lingering uncertainty in the next few months. In this context, central banks could well limit their action to asset purchases and leave rates unchanged following the latest rate cuts. Central banks are back in the saddle, but they may struggle to resume their previous normalisation policies should the economy ultimately turn out to be, as we are expecting, much more resilient with regards to the risks of recession. Thus, while central banks are back in the limelight, they are unlikely to be strongly motivated to act over the next few months or to take any other measures than those already announced or implemented.

Low interest rates favourable to economic upturn

The overhyped risks of recession have pushed long-term interest rates down to levels prevailing before the subprime crisis and the 2008-2009 recession. In Switzerland, they even dropped 30 bps below these levels, regardless of the lack of genuine, tangible risks of imminent economic collapse. Thus, the decline in long-term yields pushed central banks back into the limelight in a hurry to reassure jittery markets. The actual outcome of the decrease in long-term rates and the shift in monetary policies, which are once again accommodative, will likely be to provide a strong economic boost. We expect declining yields across the yield curve to strongly benefit growth over the next quarters via consumption as well as investment. The declines in manufacturing leading indicators and in industrial output now seem more likely to be temporary, in particular thanks to the overall decrease in borrowing costs. The sharp drop in yields in an environment where inflation is lower but sustained over time by strong job markets everywhere should lead to lower real borrowing costs, also benefitting spending and investment. We expect this unique combination of low, real, long-term rates to contribute very positively over the next few months.

Long-term interest rate markets have to adjust

The collapse of yields seen in most capital markets was triggered by a wave of panic in August during which the risks of a sharp slowdown of the global economy were significantly overblown. In many cases the drop in yields exceeded 30 bps over just a few weeks, reducing 10-year Treasury yields, for instance, to 1.5%, while in Switzerland, the Confederation's 10-year yields fell below -1%. This wave of panic, resulting from the persistent feeling that the absence of a trade deal between China and the US would necessarily have a very negative impact on international trade and thus on the global economy, is unlikely to last. After fearing an economic slowdown for over twelve months and even gradually factoring in risks of recession, we believe that rate markets will shortly realise that these predictions are unlikely to materialise. Weakening manufacturing leading indicators have not really affected growth in the US and now seems to be stabilising. Over the next few quarters, consumption will remain the main driver of growth in various economies, which will likely continue to trend upward. The return of central banks to the limelight could slow the adjustment of long-term rates, but with or without a trade agreement, we believe long-term yields are abnormally low given the current economic context.

Graph sources: Bloomberg/BearBull Global Investments

Valuation levels of risky assets once again generous

After three months of volatility, many equity markets are trading at the same levels as at the end of June. The S&P 500 closed the previous quarter at 2941 points and the current quarter basically unchanged at 2975 points, for a modest +1% increase. In the Eurozone, the trend was slightly more positive, in spite of the persistence of real risks of recession in Germany, and the Eurostoxx50 closed at 3548 points, posting a +3.3% increase. Elsewhere, results were similar, with a +2% increase in Japan and +1.5% increase in Switzerland, while the UK and Germany stagnated at 0%, and China fell slightly by -0.5%.

The overall context last quarter was substantially impacted by the risks of a no-deal and its possible effects on global growth, before being somewhat bolstered by expectations of shifts in central banks'monetary policies. Expectations of rate cuts boosted equities, but what will happen over the next few months, as central banks deem their adjustments to be adequate?

Recall that, while last quarter was more volatile, with movements of +/- 5-7%, despite ending up almost unchanged, the previous quarter had been similar. Thus, it is key to note that volatility has established itself once again in the past two quarters, and current stock prices, although at the high end of the horizontal fluctuation band that has emerged over the past six months, are relatively unchanged since the end of April. After a very strong first quarter, equities have been stymied by rather generous valuation levels. Indeed, in the absence of genuine earnings growth prospects for 2020, market PEs seem high. In the US, the 2019 PE ratio is close to 20x, decreasing only to 18x in 2020. In the euro area, the current PE is lower (18x), and the risk premium remains positive for 2020 thanks to a PE ratio of barely 14.7x. In Switzerland, the SMI's valuation at 22x 2019 earnings is amongst the highest by international comparison. It declines to 17x for 2020, which remains high by Swiss historical comparison.

The rise in equity markets is currently impeded by these valuation levels, which will moreover be very sensitive to interest rate trends. Indeed, declining interest rates played a key role in stock market price increases to date by driving up multiples. This phase of expanding PE ratios could give way to a less favourable period should interest rates start to rise again. Rising rates would cause multiples to contract, which would not easily be offset by limited corporate earnings growth in 2020 and a return to levels prevailing in September 2018.

These risks are not negligible and could trigger a consolidation of equity markets in the near future and cause prices to return to the low end of the current consolidation band.

Current equity market valuations are once again generous and leave very little room for any sort of disappointment over the next few months.

Central Bank rate (EUR, CHF, GBP, USD, JPY)

UK Bank of England Official Bank rate
Switzerland National Bank Libor Target
Federal Reserve US Primary Credit Discount Rate
ECB Main Refinancing Operation Annoucement Rate
Bank of Japan Result Unsecured Overnight Call Rate

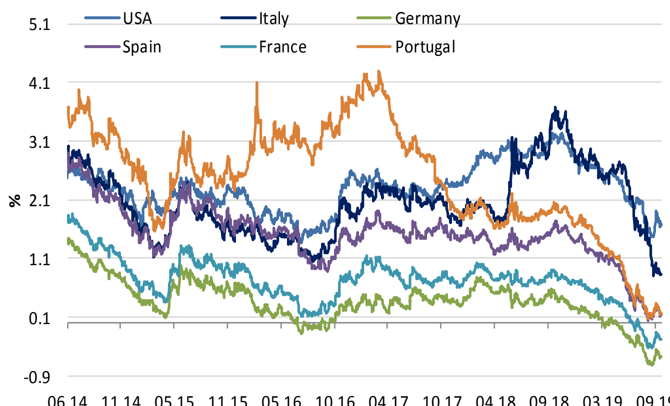
7 Major currencies against CHF (Normalized at 100)

USD-CHF X-RATE
EUR-CHF X-RATE
GBP-CHF X-RATE
CAD-CHF X-RATE
JPY-CHF X-RATE (x100)
CNY-CHF X-RATE
AUD-CHF X-RATE

Price/Earning Ratios in developed Markets

P/E Ratio S&P 500 INDEX
P/E Ratio FTSE 100 INDEX
P/E Ratio Euro Stoxx 50 Pr
P/E Ratio SPI SWISS PERFORMANCE IX
P/E Ratio S&P/TSX COMPOSITE INDEX
P/E Ratio DOW JONES INDUS. AVG

Government Bond yield (10 years)



Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

Global Outlook

- Excessive pessimism ultimately favourable to growth in the US
- Potential economic upturn in the euro area without Germany
- Technical recession could be avoided in the UK
- Private and public sectors shore up GDP in Japan
- Consumption will remain the primary driver of growth in Switzerland

Excessive pessimism ultimately favourable to growth in the US

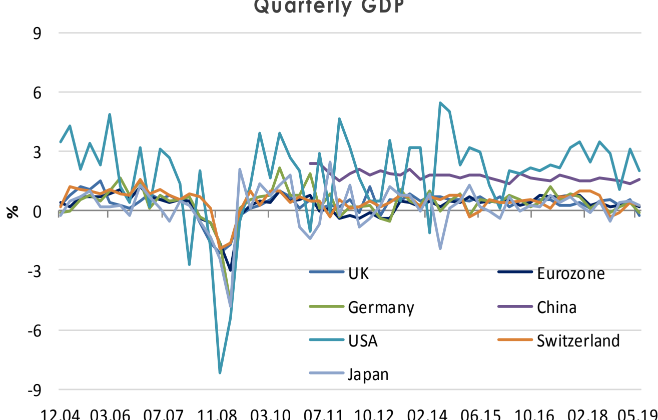
For the last 12 months, the main macroeconomic scenario in financial markets has been that emphasising risks of an economic slowdown and recession in the US. Since October, long-term rates have continuously declined due to massive purchases of investors fearing a recession. The drop in long-term rates in the US has been spectacular, as yields that were close to 3% in September 2018 have now fallen by 50% to only 1.5% at the end of August 2019. Fears of a recession have been fuelled by an ultimately rather limited number of factors, which obviously include the trade war between China and America first and foremost. The inversion of the yield curve has been another main factor supporting the argument of an upcoming recession. We will come back later to these two elements supporting the theory of a recession expected for 2019 or 2020, which we do not believe in for the moment. First, however, we would like to review a few key elements in terms of assessing the real risks of recession, which will have a significant impact in the next few months on the prevailing economic scenario as well as on the associated outlook for the main asset classes.

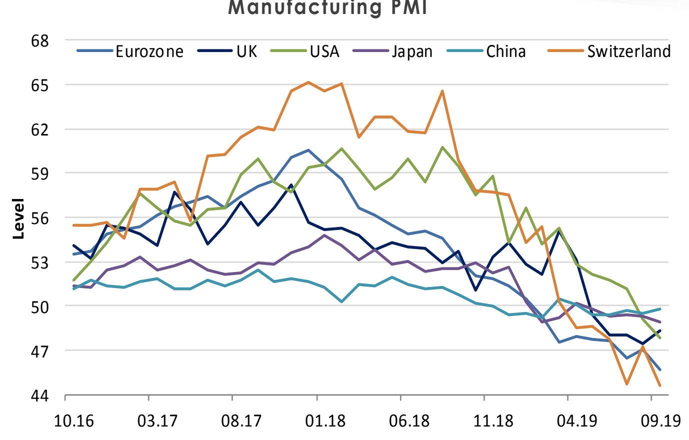
First of all, it should be noted that the Sino-American crisis did not have any major effect on financial markets initially in 2018, as it seemed obvious to all that both governments had a common interest in coming to mutually agreeable terms on the trade issue. The rising tensions between the negotiators then gradually exacerbated the fears of investors, who were more worried about the risks posed by trade war to the global economy. This factor became central in the perception of risks of a recession. It was partially accompanied by rising uncertainty and deeply affected the sentiment of decision-makers and purchasing managers, who showed caution by reducing capex as well as orders, among others. This phenomenon has affected the manufacturing sector much more than services or consumption. Hence, the declines in the manufacturing PMIs and in industrial output have been the most convincing elements in the shift of perception that supported the prediction of an upcoming recession. No agreement has been found to this day between the two protagonists, but after more than one year of failed negotiations, the US economy remains robust and has not shown any real signs of a recession, even though the latter has clearly been taken into account in capital markets, as shown by the 50% decline of long-term rates, without a reality check triggering any adjustment in these expectations, for the moment at least. We believe that this reality check is coming and that it will trigger a reversal in the downward trend of long-term rates. Excessive unfounded pessimism has thus led to adjustments in nominal and real interest rates which will be favourable to economic recovery in the next few quarters.

Potential economic upturn in the euro area without Germany

After a positive surprise in Q1, GDP growth in the euro area was severely impacted by Germany's negative growth (-0.1%) in Q2. Germany has thus undergone two non-consecutive quarters of moderate decline due to issues in its automotive sector and, more broadly, given the trade war and possible sanctions. these last few months with industrial production down -5.2% yoy (the sharpest fall in ten years) and a -8% decrease in exports (sharpest drop in three years). The German industrial complex has thus been hit very hard by the uncertainty regarding trade issues and the risks of recession, which are much more real and likely than in the US, especially in the absence of a clear turnaround in the Chinese-American conflict. The Eurozone's quarterly GDP growth rate thus weakened from +0.4% to +0.2% in Q2, mainly due to Germany's economic slump. Employment growth followed the same trend with job creation up + 0.2% over the period (+0.4% in Q1).

Within the EU, the Spanish and Dutch economies performed well, with GDP growth of +0.5%, significantly better than the results achieved in France (+0.3%) and Belgium (+0.2%), while Italy has been stagnant for several quarters. Germany has narrowly avoided a technical recession but has been hit hard by the general slowdown of the global manufacturing sector. The German economy has achieved unfortunate records.





Graph sources: Bloomberg/BearBull Global Investments

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Consumption (+0.2%), investment (+0.5%) and public spending (+0.3%) have been driving growth in Europe while the manufacturing sector and exports faced a drop in demand. Private consumption, government spending and investment each contributed +0.1% to GDP growth overall. These rather robust domestic fundamentals are in contrast with the manufacturing sector's difficulties. These positive factors seem more resilient and have somewhat boosted reasonable hopes regarding the capacity of Europe's economy to avoid a more pronounced slump in the next few months. The European economy is likely to grow significantly more slowly in 2019 (+1.1%) than in 2018 (+1.9%), even if Germany's growth is close to zero, while risks of a recession are estimated at less than 20% for 2020.

Technical recession could be avoided in the UK

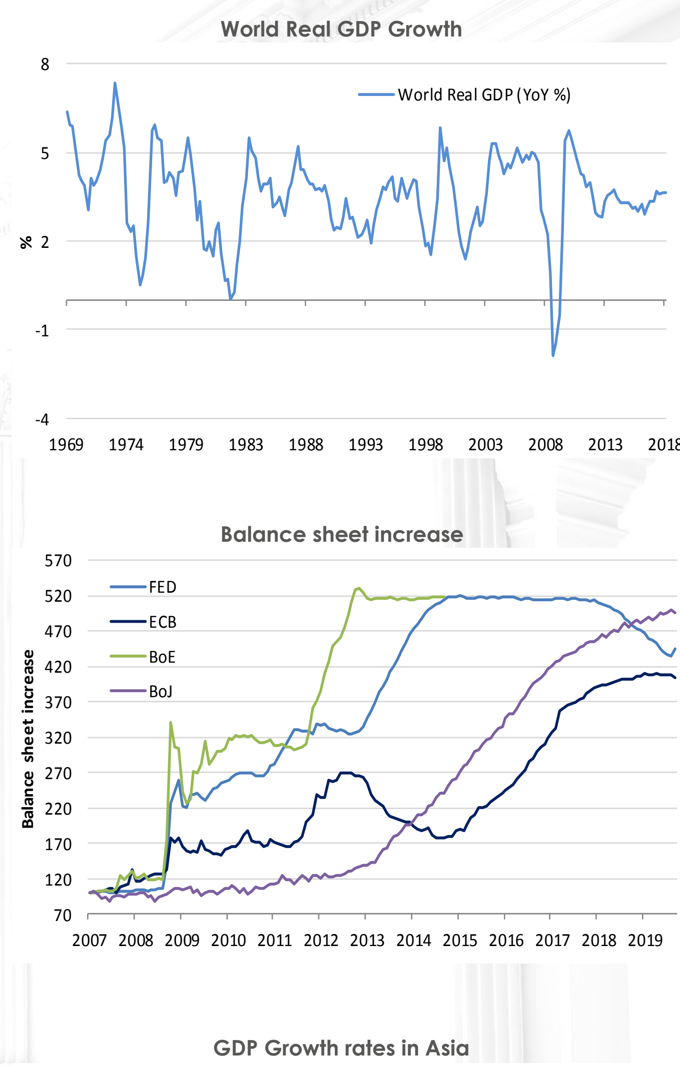
The British economy posted its first quarterly contraction since the end of 2012. Following seven years of growth, GDP finally felt the impact of the uncertainty tied to Brexit, dropping by -0.2%. On an annual basis, GDP still expanded by +1.2%, which is nevertheless significantly lower than its performance in March (+1.8%). Businesses that had built up inventory ahead of a withdrawal which they initially expected to happen at the end of March started to reduce inventory in Q2, which was detrimental to the GDP tally for the period. Consumption and government spending progressed by +0.5% and +0.7%, respectively, while investment (-1%) and exports (-3.3%) fell. However, a technical recession seems unlikely, even though uncertainty remains very high just days away from the current Brexit deadline.

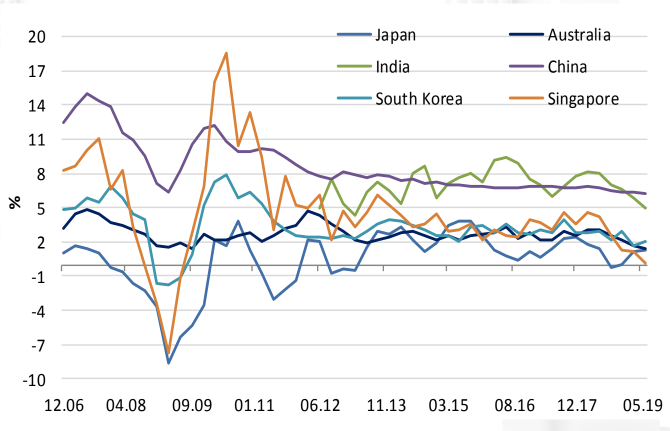
Indeed, the UK economy seems to have fared relatively well in July and August according to initial estimates.GDP was up +0.3% in July, raising the economic growth rate from -0.2% to zero over three months. These results are surprising, as GDP was forecast to grow by only a very slight +0.1% in July. The manufacturing sector as well as services and construction all participated in the upturn, posting stronger performances than expected, with a surge of momentum in manufacturing in particular and a strong showing by the service sector (+0.4%).

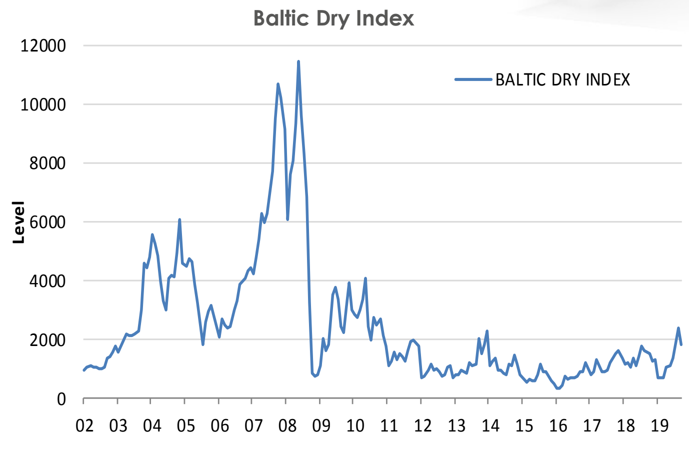
Indeed, momentum grew in the economy overall, dampening the immediate threat of recession thanks to upswings in industrial and manufacturing output of +0.1% and +0.3%, respectively. Construction also posted an increase of +0.5%. Results also seem to have improved in August, thus possibly pointing to growth of +0.2% to +0.3% in Q3. The political uncertainty surrounding Brexit is still hampering any decision and action by the BOE, which will proceed differently depending on the scenario that will ultimately materialise on 31 October or in the following months if talks are unexpectedly extended once again.

Should the UK withdraw with an agreement, the growth outlook will likely be revised upward, and given the current rate of inflation, interest rates could rise. However, we do not expect the BOE to act swiftly, as it will likely want to observe the impact of an agreement on confidence, growth, and inflation, before acting in a way that will likely be very deliberate either way. In the event of a no-deal exit on 31 October, the BOE will be compelled to act, cutting rates in an attempt to counter the negative impact of a brutal divorce on the UK economy. The costs associated with Brexit uncertainty have been estimated to amount to 2% of GDP growth since 2016.

The question of what sort of Brexit will be implemented is thus now more important than the direction of inflation, which has been steadily decreasing in spite of the pound's depreciation. Inflation dropped from 2.1% to 1.7% yoy in August, while core inflation fell to 1.5%. As for producer prices, they stabilised at 2%.







Graph sources: Bloomberg/BearBull Global Investments

BearBull Global Investments Group

Private and public sectors shore up GDP in Japan

Japanese GDP posted satisfactory growth of +0.3% at the end of June, just a little under the previous quarter's results (+0.5%). Although the yoy performance of the Japanese economy is by no means exceptional, it did turn in a respectable +1.3%. This confirms the trend reversal that occurred in Q4 (+0.5%) following a -0.6% contraction in the previous quarter, in spite of a very uncertain global context. Household consumption (+0.6%) contributed significantly due to a rather sharp increase in spending compared to the previous quarter. Investment overall was disappointing and had a negative impact on growth. While investment in equipment increased in some more domestically-oriented sectors, it decreased in the manufacturing sector, more sensitive to the escalation of trade tensions, in the wake of falling exports.

Japan thus remains very committed to coming to a trade agreement with the US to avoid further pressure on its export capacity, for instance via US import duties on Japanese goods, which would likely further weaken the already struggling Japanese auto industry. As for consumption, it will likely remain robust in Q3, before it starts feeling the effects of new taxes taking effect in October. Public spending, up +1.2%, was solid, as was public investment (+1.8%), such that government spending contributed +0.3% to GDP growth and was thus another essential factor in the resilience of Japan's GDP in Q2. The fragility of the Japanese economy, and its dependence on the export sector in particular, is clearly reflected in these results. Public spending for the most part offset the export sector's poor performance. The -12% drop in Japanese corporate earnings yoy – the steepest contraction since 2011 – is an indication of worsening economic conditions. While the overall performance of the Japanese economy thus seems satisfactory, in the absence of a trade agreement in the near future and given a very likely slowdown of consumption following the planned introduction of taxes in October, the fragility of the Japanese economy could become evident and disappoint at the end of the year.

For more positive signs, one has to look at the services sector, which paints a very different and significantly more positive picture. The services PMI, which came in at 53.3 in August, thus reached its highest level since October 2017, pushing the composite PMI (51.9) above its growth threshold (50). Japan's real GDP growth for 2019 is expected to reach + 0.7%.

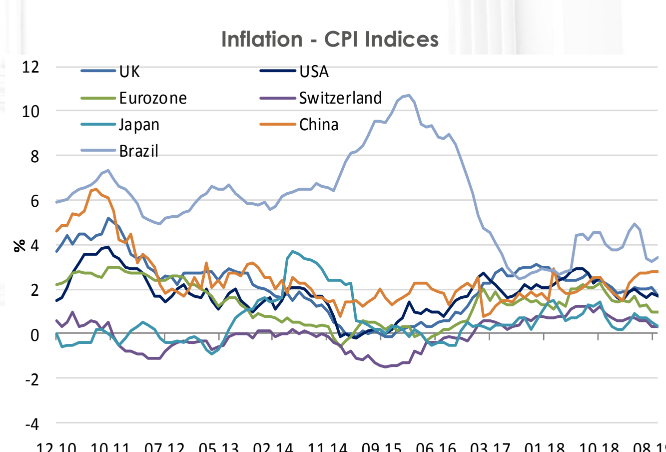
Consumption will remain the primary driver of growth in Switzerland

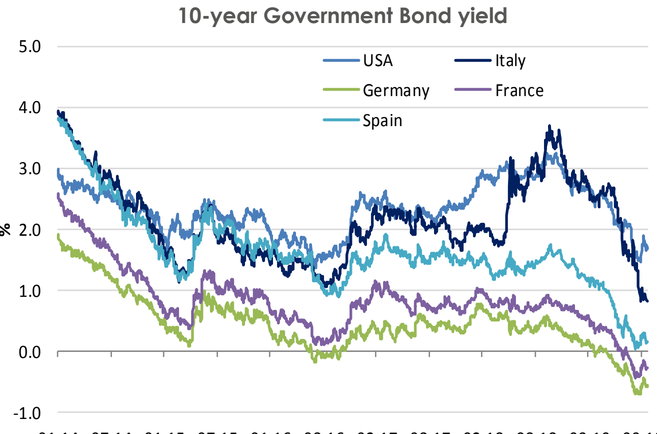
The economic forecasts of the Swiss government experts' committee had already been scaled down in the more uncertain context of the beginning of 2019. However, the recent situation will undoubtedly involve another downward revision of their growth estimates below their previous forecast, which had already been lowered from +1.5% to +1.1% due to fears relating to a slowdown in international economic activity and its effects on Swiss exports. The global economic downturn is now also affecting our economy, which has had to reckon with a slightly stronger Swiss franc for the past few months again.

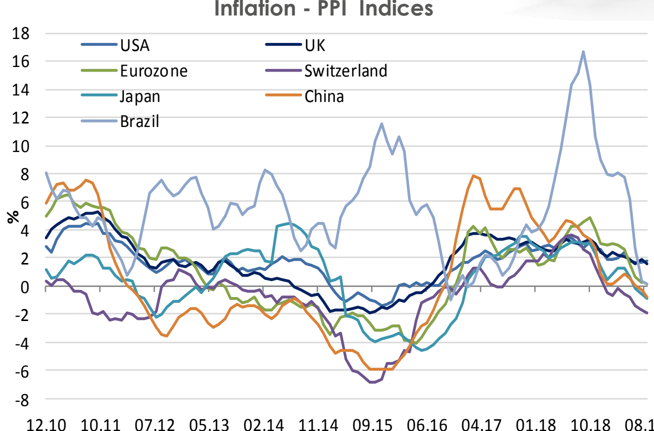
Our country's economic vitality in Q1 is thus threatened by factors that are essentially external. Switzerland is starting to feel the effects of the uncertainty surrounding Brexit and the conflictual situation between China and the US, which has impacted global demand. The situation in Germany has also somewhat affected our industrial sector of course, and Germany's slowdown is likely to have an impact on our exports. For the moment, the economy has withstood leading indicators' negative forecasts. The excellent performance of retail sales, still on the rise by +0.4% in July, has continued and is close to reaching its best results in the last five years, while the unemployment rate remains at its lowest level (2.1%).

2-year Government Bond yield

UK
USA
Eurozone
%
3.5 3.0 2.5 2.0 1.5 1.0 0.5 0.0 -0.5 -1.0
12.13 07.14 01.15 07.15 01.16 08.16 02.17 08.17 02.18 08.18 03.19 09.19







Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

United States

- Excessive pessimism unfounded but ultimately favourable to growth
- Nominal and real rates will support economic momentum
- Economic impact of trade war overestimated
- Why does the inversion of the yield curve not signal an upcoming recession?
- After two preventive cuts, monetary policy could mark a pause
- Economic conditions more robust than it seems

Excessive pessimism unfounded but ultimately favourable to economic growth

For the last 12 months, the main macroeconomic scenario in financial markets has been that emphasising risks of an economic slowdown and recession in the US. Since October, long-term rates have continuously declined due to massive purchases of investors fearing a recession. The drop in long-term rates in the US has been spectacular, as yields that were close to 3% in September 2018 have now fallen by 50% to only 1.5% at the end of August 2019. Fears of a recession have been fuelled by an ultimately rather limited number of factors, which obviously include the trade war between China and America first and foremost. The inversion of the yield curve has been another main factor supporting the argument of an upcoming recession. We will come back later to these two elements supporting the theory of a recession expected for 2019 or 2020, which we do not believe in for the moment. First, however, we would like to review a few key elements in terms of assessing the real risks of recession, which will have a significant impact in the next few months on the prevailing economic scenario as well as on the associated outlook for the main asset classes.

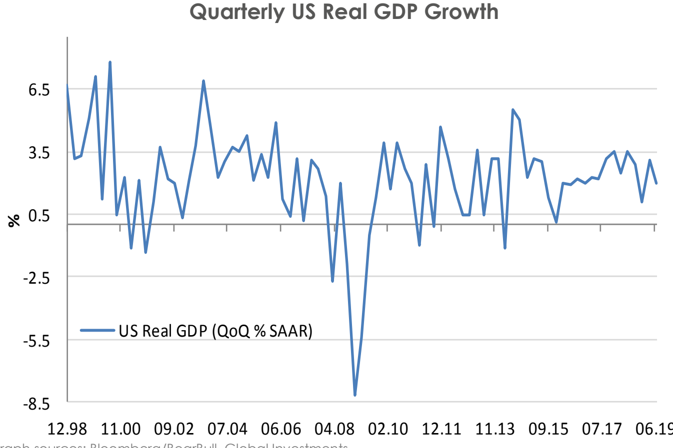
First of all, it should be noted that the Sino-American crisis did not have any major effect on financial markets initially in 2018, as it seemed obvious to all that both governments had a common interest in coming to mutually agreeable terms on the trade issue.

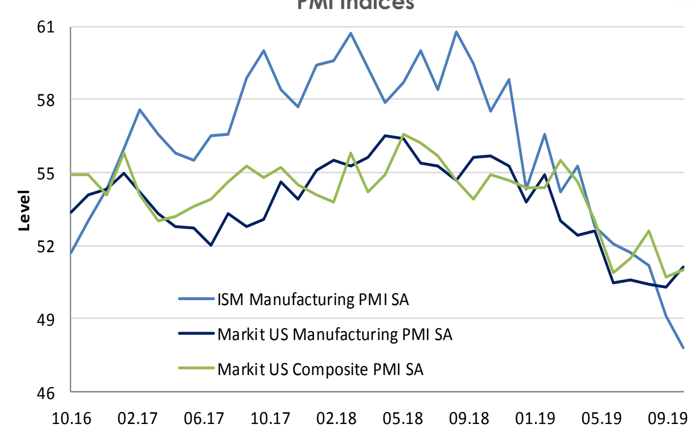
The rising tensions between the negotiators then gradually exacerbated the fears of investors, who were more worried about the risks posed by trade war to the global economy. This factor became central in the perception of risks of a recession. It was partially accompanied by rising uncertainty and deeply affected the sentiment ofdecision-makers and purchasing managers, who showed caution by reducing capex as well as orders, among others. This phenomenon has affected the manufacturing sector much more than services or consumption. Hence, the declines in the manufacturing PMIs and in industrial output have been the most convincing elements in the shift of perception that supported the prediction of an upcoming recession. No agreement has been found to this day between the two protagonists, but after more than one year of failed negotiations, the US economy remains robust and has not shown any real signs of a recession, even though the latter has clearly been taken into account in capital markets, as shown by the 50% decline of long-term rates, without a reality check triggering any adjustment in these expectations, for the moment at least.

We believe that this reality check is coming and that it will trigger a reversal in the downward trend of long-term rates.

Nominal and real rates will support economic momentum

Consequently, it should be noted that the decrease in interest rates is actually excellent news for growth since it lowers financing costs quickly for all economic agents – individuals, SMEs, multinationals, public entities and governments. Falling long-term rates will push back potential risks of a recession, and the change in monetary policy announced in July by the Fed will also have a similar impact. Beyond the decline in nominal rates, real rates will likely also provide some indirect support, helping strengthen economic momentum and the real estate market in particular in the next few months. Real interest rates, usually positive, are now negative in the US following the decline in (10-year) long-term rates from 3% to 1.5% and with inflation excluding food and energy at 2.4%.





Graph sources: Bloomberg/BearBull Global Investments

Citigroup economic surprise index USA

Citigroup Economic Surprise - United States

Level

70
30
-10
-50
-90

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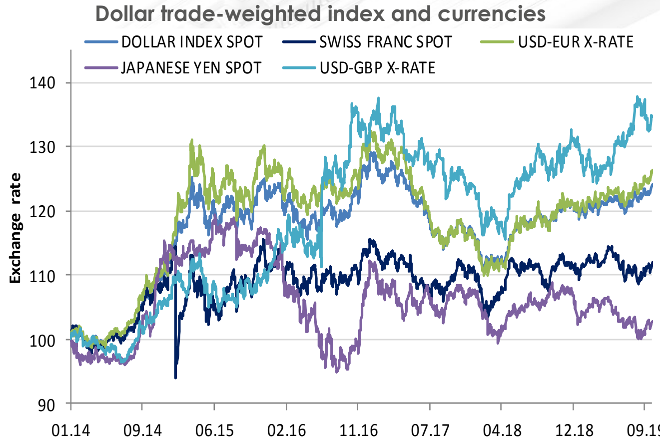


Excessive unfounded pessimism has thus led to adjustments in nominal and real interest rates which will be favourable to economic recovery in the next few quarters.

Economic impact of trade war overestimated

Fears of a recession motivated or triggered by a possible trade war between China and the US feel quite exaggerated if not unfounded to us. Indeed, for several quarters now, media attention has been entirely focused on the chances of success of the negotiations and the risks of them failing. However, a rational analysis of the real potential consequences leads us to put the risks for the economies concerned into perspective. Every year, the US and China generate about USD 20 trillion and USD 14 trillion in GDP, respectively. The economic relationship between the two countries amounts to about USD 550 billion, the main part of which (500 bn) is made up of US imports from China. The magnitude of trade between the two countries thus represents no more than 2.5% of US GDP and 0.3% of China's GDP. Since this trade dispute broke out, these data have been known by all. An increase in tariffs would thus only affect a very small proportion of both countries' GDPs. Nevertheless, the attention given to this issue is such that it has wrongly suggested that risks of a recession might be triggered by the introduction of customs fees that would penalise this trade.

The impact of an increase in tariffs on growth prospects has been grossly overstated for several quarters in our minds. The same goes for risks of a recession induced by this factor.

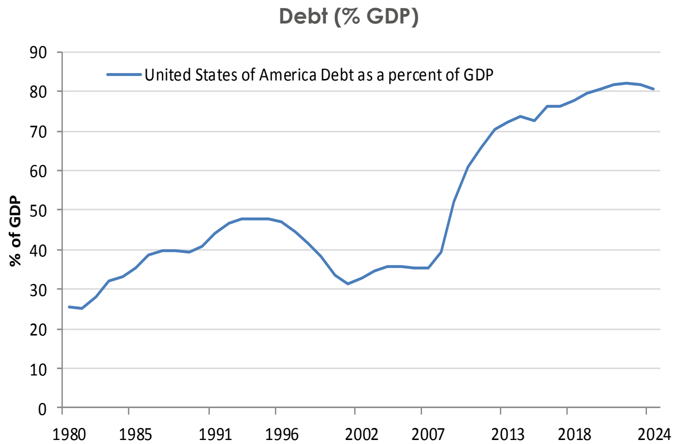
Why does the inversion of the yield curve not signal an upcoming ecession?

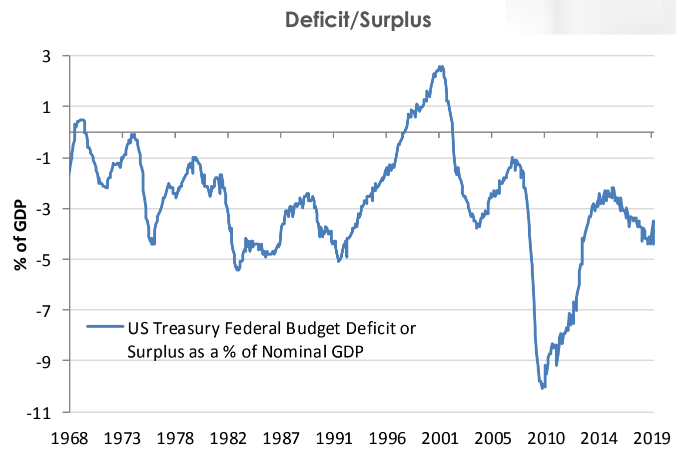
In previous decades, an inversion in the yield curve triggered by the excessive and inappropriate tightening of monetary policy has indeed often been followed by a recession. In these cases, the inversion in the yield curve was due to an increase in short-term rates (central bank key rates) corresponding to the implementation of restrictive monetary policies aimed at fighting excessive inflation and slowing down the business cycle. Volatility in short-term rates is usually more significant that in long-term rates, in particular because of central banks actively seeking to manage inflation. Monetary policy thus would lead to a rebound in short-term rates that eventually exceed the level of long-term rates to fight inflation.

A "classic" inversion of the yield curve thus follows this logic, often exceeding the economic slowdown objective by ultimately triggering a usually short-term recession. In such a case, it is indeed appropriate to fear a recession. However, in the present case, the inversion in the yield curve has not been triggered by an excessive increase in key rates beyond the equilibrium level of long-term rates. The opposite phenomenon has taken place. The Federal Reserve's normalisation policy was rather progressive and measured in an environment where an increase in price indices was completely expected and moderate. A sharp fall in long rates is actually at the root of this phenomenon in 2019.

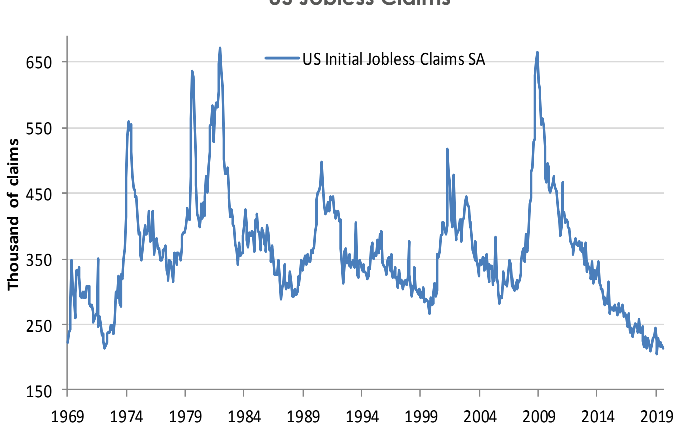
Hence, the inversion of the yield curve cannot be interpreted in the same way and have the same predictive power of a future recession as it may often have had in the past in different situations. Ultimately, it is the expectations of a recession relating to the US-China crisis that triggered an inflow of capital into bond markets, thus causing long-term yields to fall below short-term interest rates.

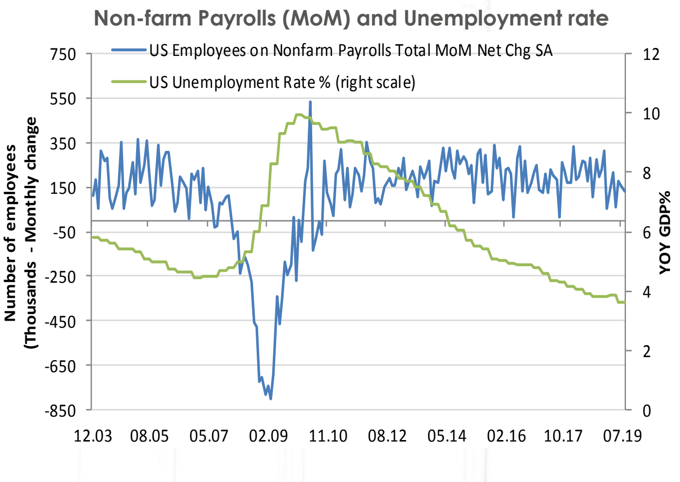
A return to a normal yield curve may already be happening following the Fed's rate cuts and the rebound observed in the first weeks of September.

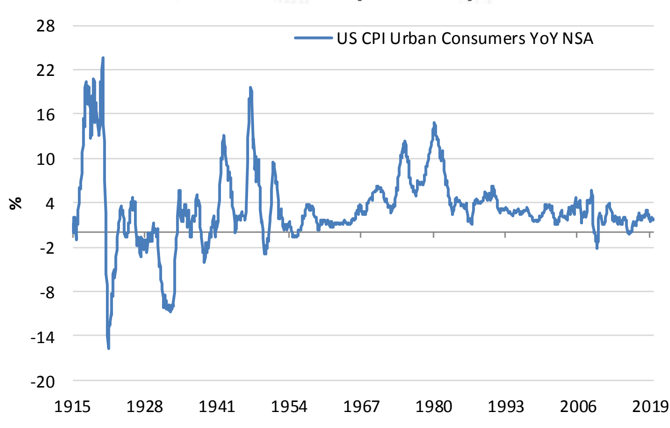


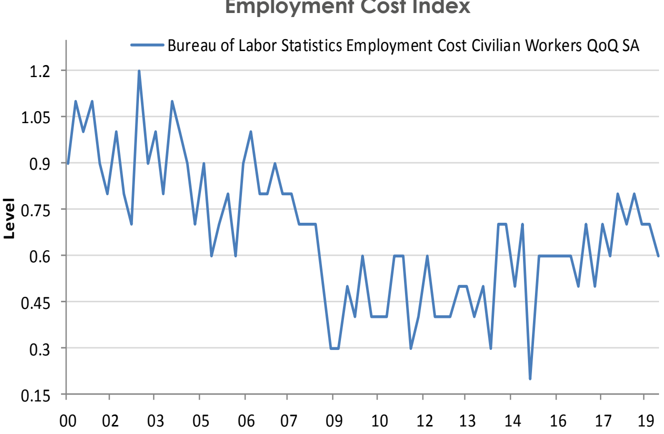


Graph sources: Bloomberg/BearBull Global Investments









Graph sources: Bloomberg/BearBull Global Investments

After two preventive cuts, monetary policy could mark a pause

The US Federal Reserve thus lowered its key rates twice in July and September in a monetary policy move that looks more like a forced preventive action than a real need to shore up the economy. Indeed, GDP in H2 is still increasing by +2%, driven by the strong contribution of consumption.

The Fed's forecasts for GDP growth in 2019 and 2020 are still at +2.2% and +2%, respectively. GDP will likely then grow by +1.9% in real terms in 2021. Nevertheless, the recession probability index with a 12-month time horizon calculated by the New York Fed has increased from about 15% in September 2018 to 37% currently. Risks of a recession indicated in this model have thus increased for the end of 2020.

The probability of a further cut in key rates in October has however fallen from 80% to 50% in one month. The Fed commented on its decision by explaining that it had considered the weakness of investment and exports while noting the robustness of the job market and of consumption.

The central bank ruled out the possibility of negative rates in case of a recession, but reaffirmed its commitment to implementing aggressive policies if required. However, FOMC members are divided on the measures to implement for the end of the year between those who favour the status quo and those who would prefer further cuts.

Economic indicators still wavering

The manufacturing PMI released for the month of September shows the first significant rebound since the beginning of the year, increasing from 50.3 to 51 after the small upswing observed in August. The stabilisation of this indicator, the main stress factor in terms of recessionary risks, is encouraging. It comes at a time when industrial output rebounded significantly by +0.6% in August, clearly above the consensus expectations of +0.2%.

However, the improvement of manufacturing PMIs in all the sub-groups (consumer goods, equipment, construction, materials, etc.) is unfortunately still very weakly corroborated by a rise in the services PMI from 50.7 to 50.9. Altogether, the composite index still increased from 50.7 to 51, moving away from the threshold of 50. The economic activity index calculated by the Chicago Fed has also risen above the growth threshold again, pointing to higher than average activity in August. However, consumer confidence indicators have unsurprisingly fallen in the context of the trade war and given the widespread reporting on the risks of recession.

Economic conditions more robust than it seems

Employment remains particularly satisfactory, as noted by the Fed Chairman in his press conference following his decision to lower key rates. Job creation posted its greatest increase in four months (195,000).

Wage pressures are increasing, and with rising disposable income, consumption will likely remain strong, driving price indices up. In the context of a relatively tight employment market, wage growth is naturally continuing in the US, reinforcing the outlook for private consumption, which remains the main driver of growth. In this context, the increase in average hourly earnings (+3.2%) in August is close to the decade's highest levels.

The economic surprise indicator sheds an interesting light on the current situation and confirms that the statistics published in September seem more robust than expected, in our minds. The chart below shows a clear trend since July. It can be explained on the one hand by the growing awareness of recessionary risks and the downward revisions of economic expectations, and on the other, by the better actual results. In other words, the statistics published in the last three months contradict investors' negative expectations.

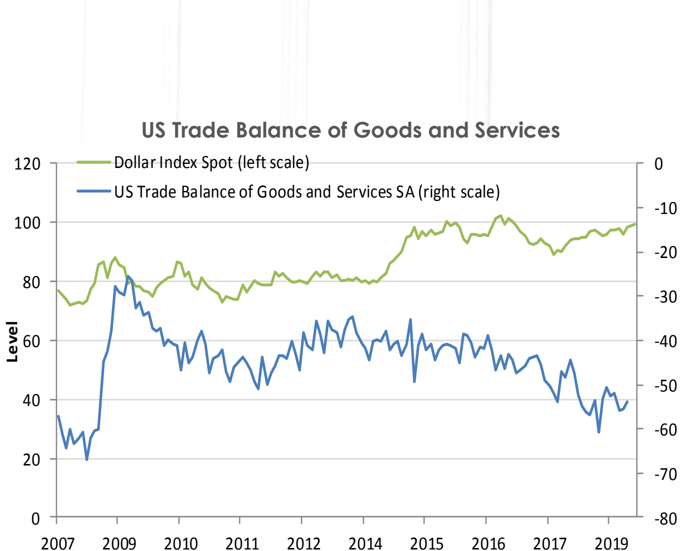
For the moment, the prevailing economic scenario in rate markets is still that of a slowdown in growth. We nevertheless believe it is likely that an increase in ten-year rates will be associated with better economic statistics in the next few months.

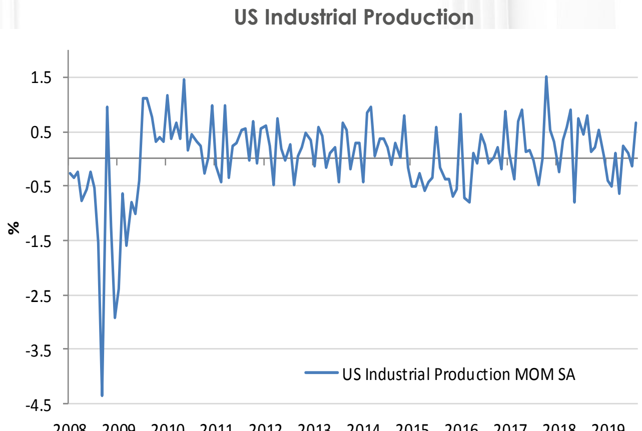
Rise in equities mainly due to PE expansion

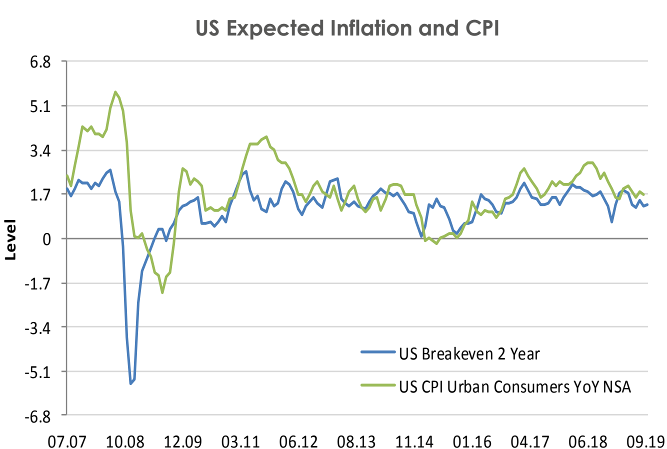
The return of equity indices to highs for the year places the asset class back into a high-risk zone and increases the probability of a price correction. If the slowdown turns out to be real, valuation levels for equities will not withstand the likelihood of profits collapsing. If conversely, the economy remains stable, the rebound in interest rates that will likely materialise will indeed have a negative effect on multipliers.

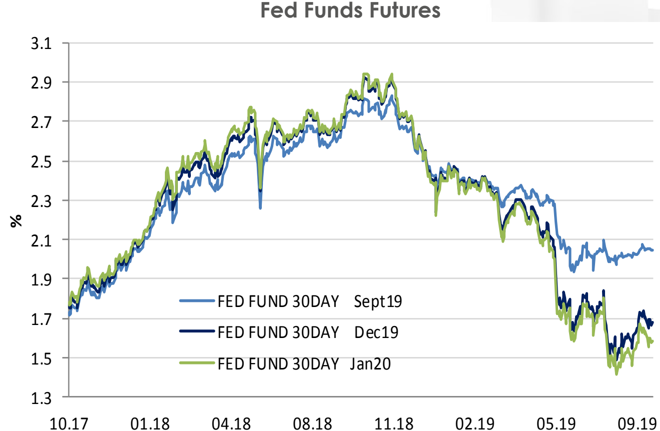
The rise in PEs associated with the drop in long rates in the last few months will be replaced by a unavoidable contraction that will accompany the rebound in rates. The impeachment proceedings against Trump that have finally been activated by the Democrats are very unlikely to succeed. It is unlikely to add much uncertainty and to be a major destabilising factor for financial markets.

Reduced exposure to equities seems appropriate in this context, which seems unlikely to trigger a new wave of appreciation of prices beyond 3,000 points on the S&P500 index.

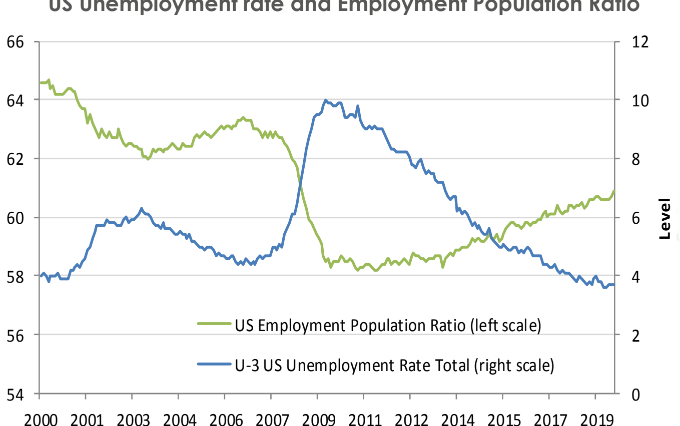


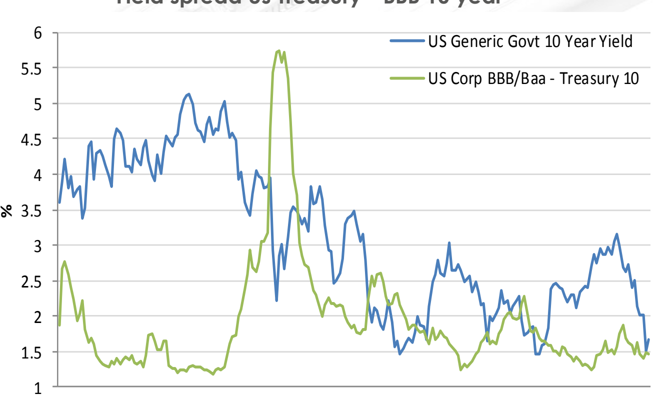


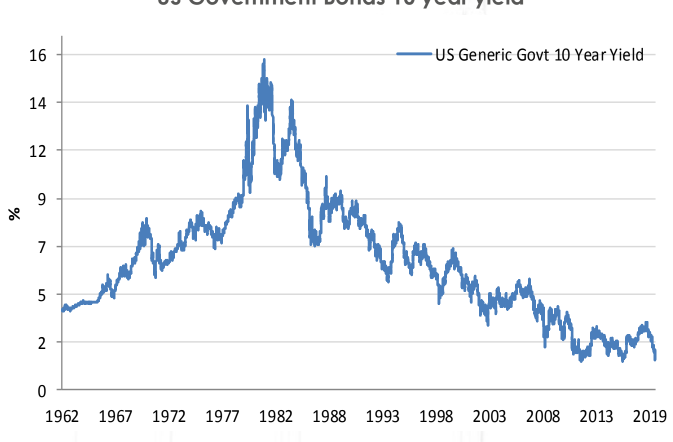


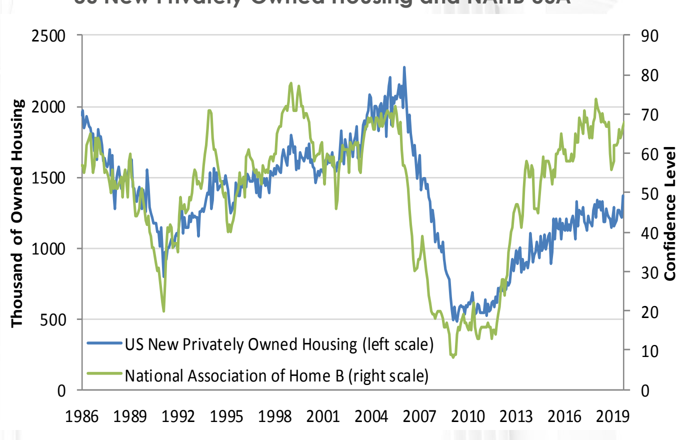


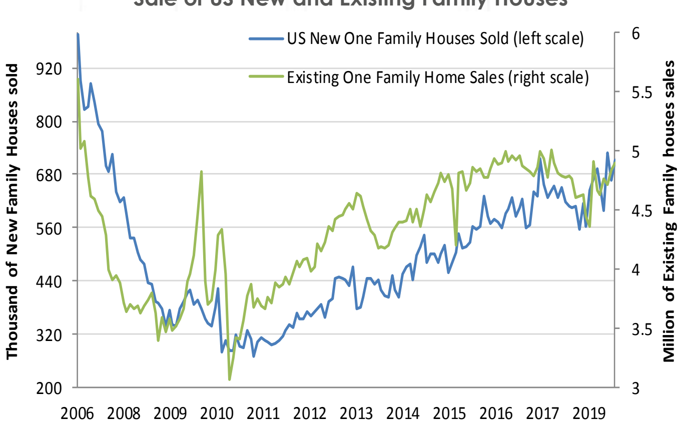
Graph sources: Bloomberg/BearBull Global Investments

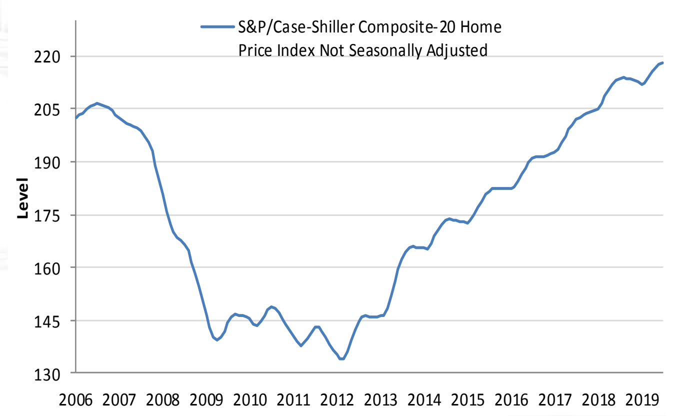


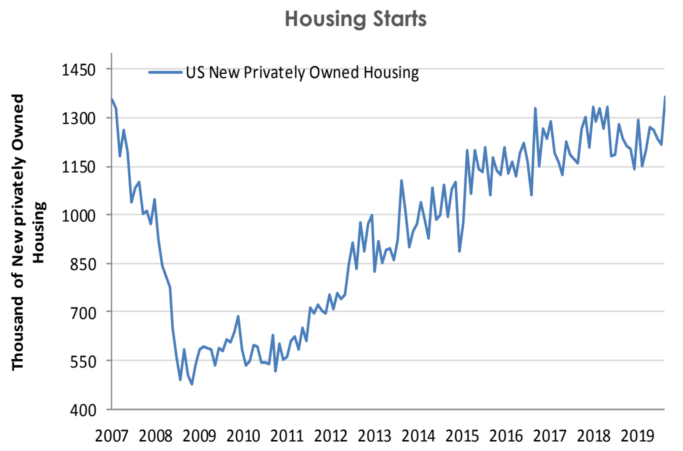


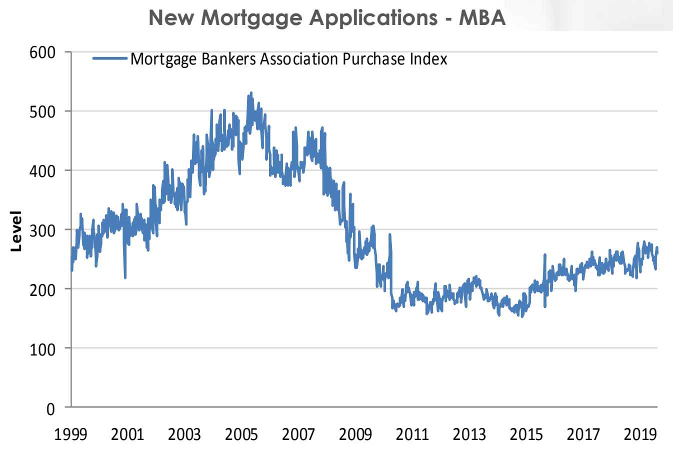












Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

Switzerland

- Logical slowdown in GDP growth in Q2
- Consumption is the main stability factor for GDP growth
- Things finally looking up for leading indicators
- Growth prospects scaled down for 2019
- Swiss franc relatively stable

Logical slowdown in GDP growth in Q2 in a very uncertain context

After a downward revision of Swiss growth in Q1 from +0.6% to a mere +0.4%, Q2 dampened the optimism of forecasters a little more. Indeed, the State Secretariat for Economic Affairs (SECO) published Swiss Q2 growth figures, which show a significant decline in demand. Switzerland's economy posted a +0.3% increase in GDP despite a difficult European context due to the -0.1% contraction of Germany's GDP. Nevertheless, our economy's performance is rather satisfactory in this context, even if risks of a more pronounced slowdown in the coming months persist.

The +0.3% increase of real GDP in Q2 is not worrisome, however, and is in line with the more uncertain economic trends observed in other countries. Domestic demand in Switzerland has thus logically weakened alongside international demand. Switzerland's nominal GDP in Q2 thus increased from CHF 173.8 billion to 174.5 billion. Year-on-year, Switzerland's GDP has thus reached approximately CHF 695 billion.

Switzerland's real GDP on a seasonally unadjusted annual basis grew by only +0.2% after increasing by +1.7% over twelve months in the previous quarter. Switzerland's economy cannot go it alone in the uncertain context of Q2 and is thus unsurprisingly running out of steam.

The economic forecasts of the Swiss government experts' committee had already been scaled down in the more uncertain context of the beginning of 2019.

However, the recent situation will undoubtedly involve another downward revision of their growth estimates below their previous forecast, which had already been lowered from +1.5% to +1.1% due to fears relating to a slowdown in international economic activity and its effects on Swiss exports. The global economic downturn is now also affecting our economy, which has had to reckon with a slightly stronger Swiss franc for the past few months again.

Our country's economic vitality in Q1 is thus threatened by factors that are essentially external. Switzerland is starting to feel the effects of the uncertainty surrounding Brexit and the conflictual situation between China and the US, which has impacted global demand. The situation in Germany has also somewhat affected our industrial sector of course, and Germany's slowdown is likely to have an impact on our exports.

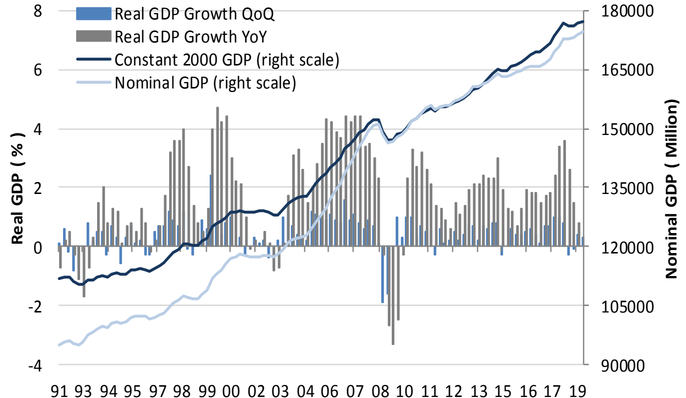
In this context, we have revised our own GDP growth estimates for 2019 from +1.5% to +1.3%.

Consumption is the main stability factor for GDP growth

Among the long-term causes for satisfaction in our economy, let us mention the resilience of private consumption, which once again this quarter has been one of our economy's main drivers. The latter's +0.3% increase still stands slightly above average quarterly growth thanks to the specific contributions of the health, housing and energy sectors. Compared with the previous quarter, government consumption is well below the +0.5% rise observed in Q1 with a small +0.1% increase. Investments in equipment and construction have slowed down markedly, falling by -1% and -0.1% respectively after a very good period in Q1. Value added in the construction sector adds stability (+0.1%) after a very positive result of +1.9% in the previous quarter. The same goes for equipment expenditures, which have fallen by -1% after rising by +1.5% in March.

Global uncertainty is hindering investment. Surprisingly, Switzerland's manufacturing sector has not suffered as much as one might have feared from the decrease in global demand and the rise of the Swiss franc. Our country's industry has performed well, unlike other European countries, by contributing positively to GDP growth. The manufacturing sector has increased by +1.3% in a very uncertain and difficult context for companies, even though business leaders have noted that margins are unfortunately under pressure.

Nominal GDP - Nominal and Real GDP Growth rate



Swiss Purchasing Manager Index (PMI)

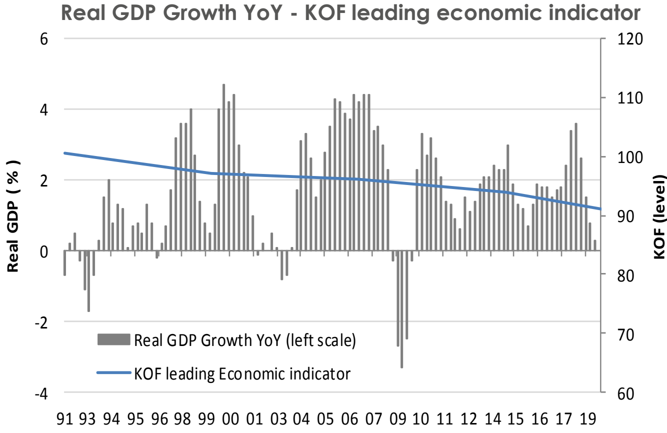
Switzerland procure.ch PMI

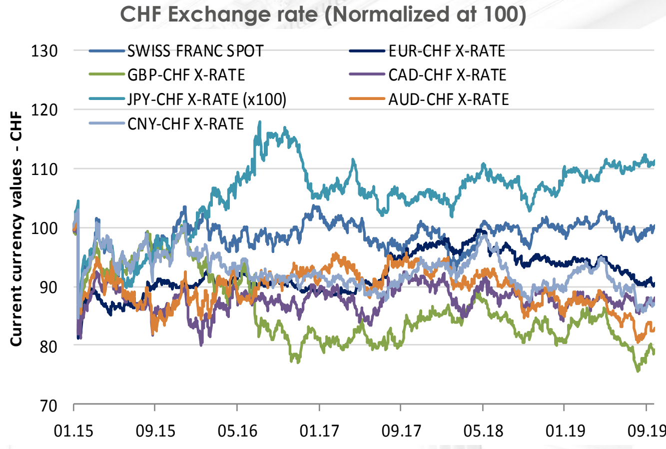
Level

70 66 62 58 54 50 46 42 38 34 30

12.03 07.05 02.07 09.08 04.10 11.11 05.13 12.14 07.16 02.18 09.19

Graph sources: Bloomberg/BearBull Global Investments





The pharmaceutical sector still supports this encouraging trend. Declining merchandise exports (-0.8%) adjusted faster than merchandise imports and services, which have fallen by -0.6%. The economy is thus following the trend set in the previous quarters with no genuine obstacles.

Things finally looking up for leading indicators

The manufacturing PMI index has continued the decline that began in 2018 to reach the level of 44.7 in July, i.e. the worst result in almost ten years. De facto, the rebound to 47.2 in August is good news and might herald a more positive change of trend for our industrial sector. The fall in the KOF leading indicators was marginally less worrisome until June (93.8), but the stabilisation and the slight recovery observed since (97) have once again renewed hopes of a global upturn in Q2. Let us mention however that the decline in leading indicators, which has lasted for more than twenty-one months now, was not followed by a marked weakening of Swiss GDP. For the moment, the economy has withstood leading indicators' negative forecasts. The excellent performance of retail sales, still on the rise by +0.4% in July, has continued and is close to reaching its best results in the last five years, while the unemployment rate remains at its lowest level (2.1%). Regarding exports, sales of Swiss watches clearly rebounded (+4.3%) in July after a -10.7% contraction in June. Industrial production also recovered and posted a +3.6% increase in June. Although they have not turned truly positive, leading indicators have stabilised and shown some more positive signs for a recovery in H2.

Growth prospects scaled down for 2019

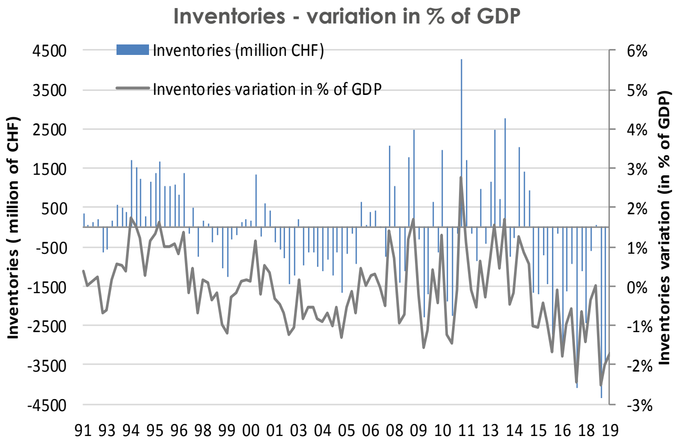
In light of the latest events, the uncertainty surrounding the China-US trade negotiations does not look like it will be resolved just yet. Weeks and months have passed without any noticeable progress. Although it appears obvious that both parties had better find some common ground, the objectives and political agenda of the two main protagonists are so different that it is increasingly difficult to assess the real chances of success of the negotiations, their content and the timing of a highly-anticipated agreement.

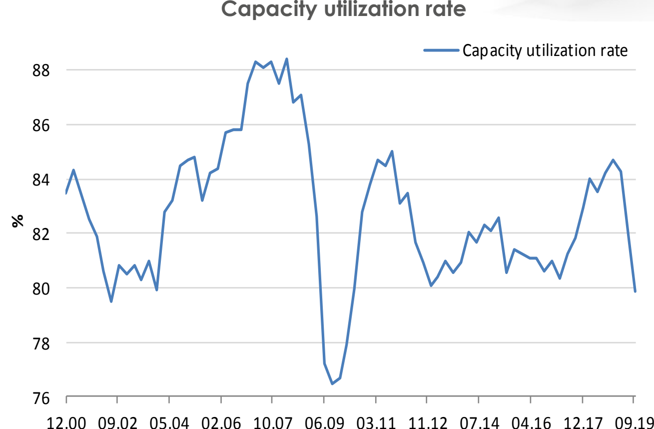
Our economy is not immune to the effects of the considerable uncertainty that is threatening investment, trade and growth because of the raging trade war. The fact that Germany is particularly affected by the uncertainty that has affected its automotive sector is not a reassuring factor for Switzerland either of course. However, the stabilisation of the leading indicators and the resilience of our economy as the Swiss franc has temporarily strengthened in the last few months are encouraging elements. They will likely strengthen domestic consumption momentum, which thankfully remained robust in Q2. Although the current context is not particularly favourable to the Swiss franc, which is not very likely to appreciate against the US dollar, the relative stability of exchange rates is unlikely to hamper Switzerland's foreign trade. Beyond exports, domestic demand is likely to remain positive, consumption is likely to strengthen somewhat in 2019, and growth is expected to be a little more dynamic.

We expect prospects for Q2 2019 to improve and drive the demand for Swiss products and services. In this context, we have reduced our GDP growth forecast to +1.3% for 2019.

Swiss franc relatively stable

Since the SNB's decision to introduce negative rates, the Swiss franc has remained relatively stable against the US dollar, despite the numerous economic and political upheavals that have happened in the last five years. The exchange rate has remained centred on a value close to parity, falling at times for a few weeks below 0.95 to the dollar or temporarily exceeding 1.03. Thus, interest rate and GDP growth differentials that strongly favour the dollar have not triggered any substantial appreciation of the US currency, which is likely to remain within the mentioned fluctuation range in the medium term. We believe that the next few months will likely be characterised by a new phase of widening yield spreads on long-term rates in particular, which will likely increase the attractiveness of the dollar and push the exchange rate above parity.





Graph sources: Bloomberg/BearBull Global Investments

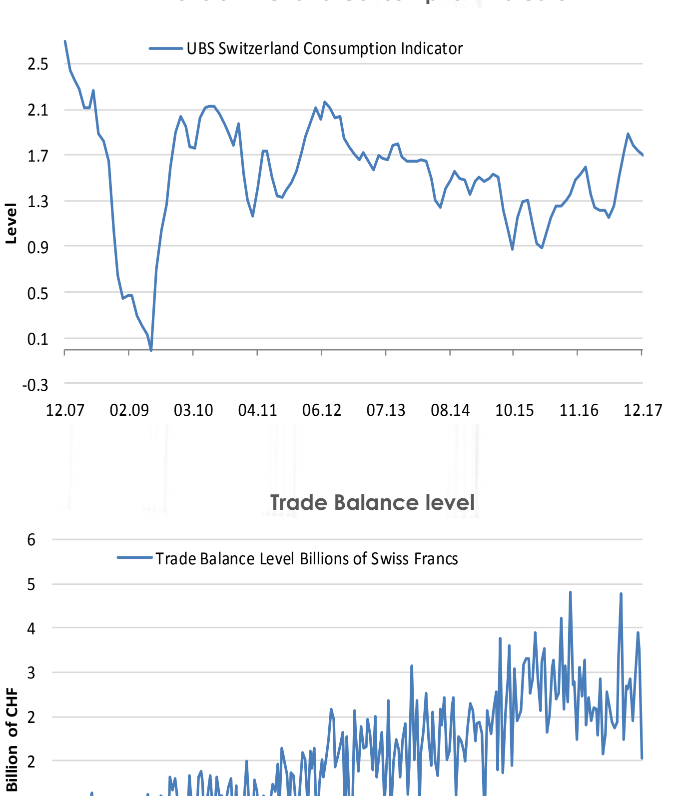
SNB Foreign Currency Reserves

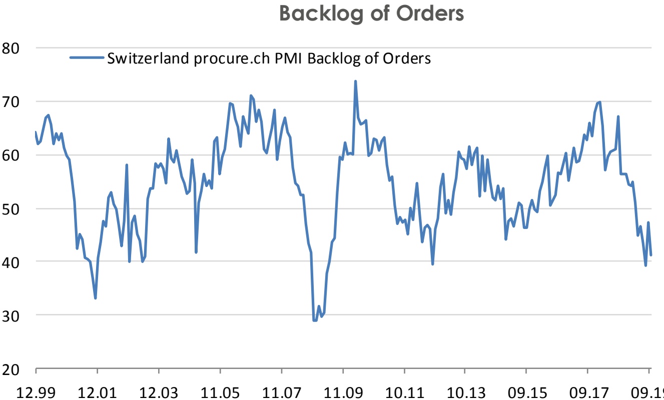
Switzerland Foreign Currency Reserves CHF

Million of CHF

900000 800000 700000 600000 500000 400000 300000 200000 100000 0

12.00 11.02 09.04 08.06 06.08 04.10 03.12 01.14 11.15 10.17 08.19





Graph sources: Bloomberg/BearBull Global Investments

With regards to the euro, the problem is different, especially since the yield gap between rates in euros and in Swiss francs is not that significant and the trend of the last few months does not point to the same type of trend we expect for the US dollar. The yield gap that the SNB had hoped to create and maintain to weaken the Swiss franc is increasingly under attack by the necessary and anticipated decline of the ECB's rates.

The gap had stabilised at about 60 basis points in early 2018 during the rise in the exchange rate to 1.20, but it then steadily dropped to fall beneath 22 basis points in the last few weeks. Due to the euro area's sluggish economy and accommodative monetary policies, it is difficult to imagine a rise of the euro against the Swiss franc in the short term. For such an appreciation to happen, a serious and lasting European economic recovery will have to occur or at the very least be anticipated with enough credibility.

It remains our view that a future phase of weakness of the Swiss franc will also depend on the relative economic performance and the interest rate differential between the Swiss franc and the euro. We still believe that the SNB will not raise its key rates as fast as the ECB, which today seems very unlikely in the near future. The surprise may however come from a decision to further reduce the SNB's discount rate by 25 basis points, which we do not believe is necessary in the current context of relative stability of foreign reserves in the last twenty-four months (767.1 billion). The euro/Swiss franc exchange rate is looking to stabilise after losing about -5% in the last four months, which were marked by somewhat irrational expectations in our mind of a recession in the US and of a marked global economic slump. A return to 'reason' is likely to have quick, positive effects on exchange rates and to take a little pressure off the Swiss franc.

Irrational situation with regard to long-term rates

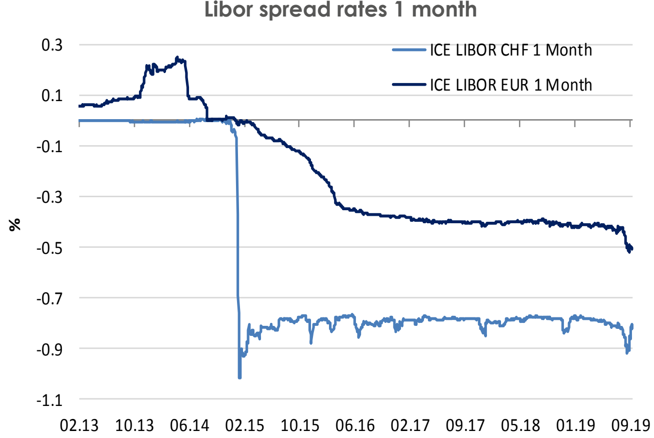
Interest rates markets are clearly not convinced that the global economy is not heading towards recession. The overall drop in yields, which accelerated in August, has also affected Swiss capital markets. The Confederation's ten-year rates have thus reached a new historical low at -1.12%, completely erasing the normalisation process of long-term rates that was initiated in the summer of 2016. This drop in yields is irrational and is likely to be followed by a very significant rebound as soon as risks of a recession are finally assessed rationally.

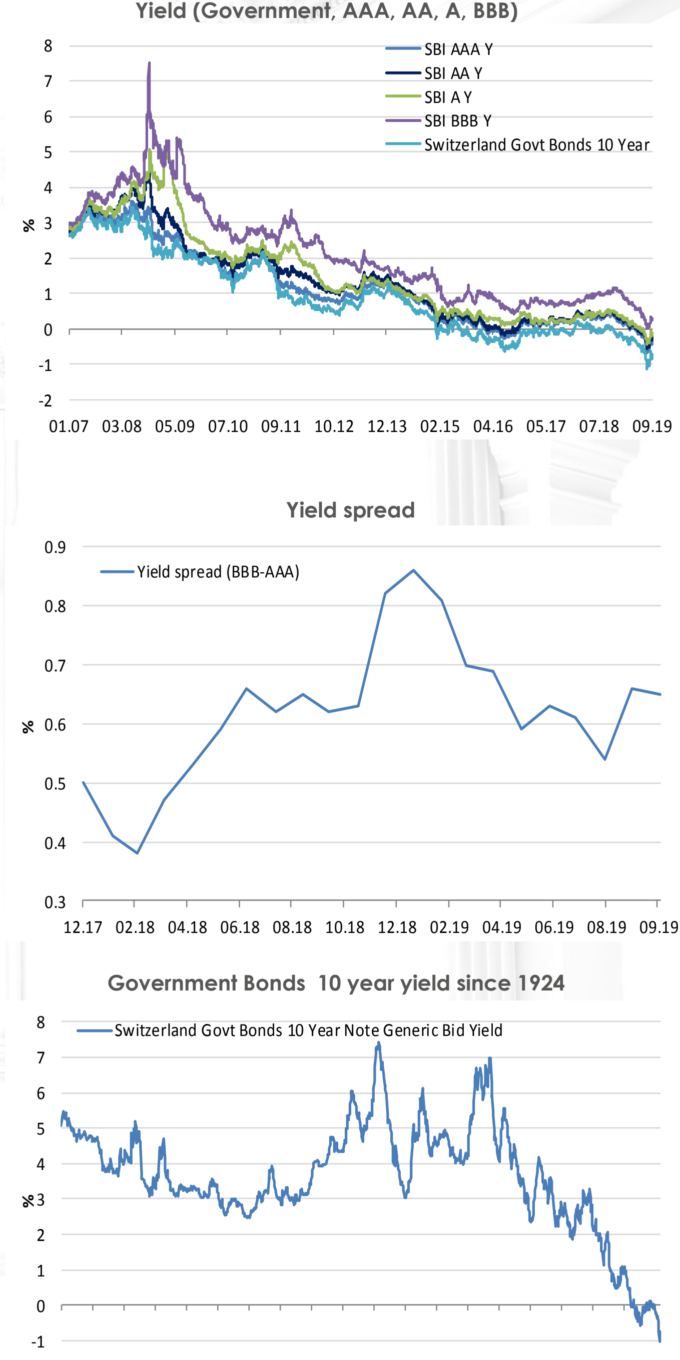
Rate cut boosts equity markets

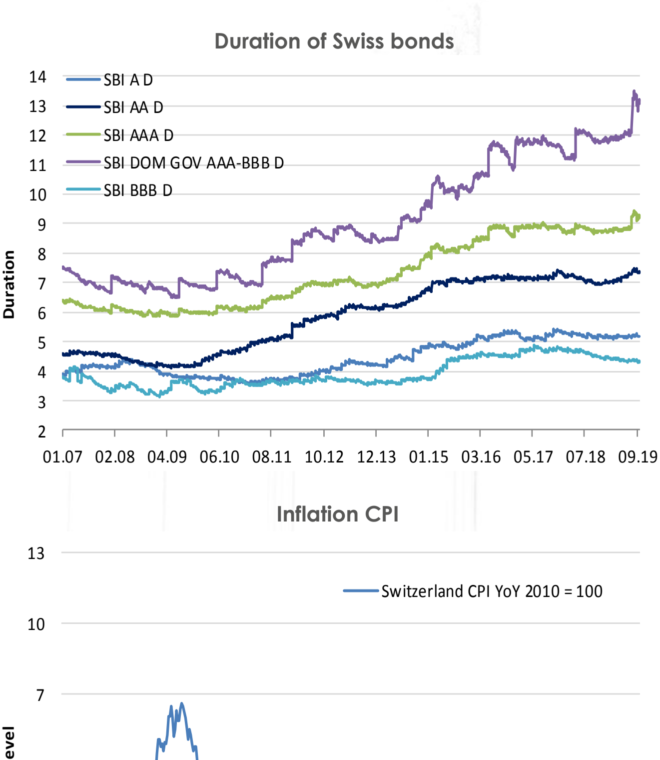
As expected, the marked adjustment of Swiss shares at the end of 2018 provided an investment opportunity for 2019. Nevertheless, after impressive rises in the first two quarters, the valuation of Swiss equities and especially blue chips has reached levels which we consider excessive already. Increasingly negative yields in Swiss franc interest rate markets have contributed in a substantial if not abrupt way to this enthusiasm for equities, pushing valuation ratios up excessively in the short term. We recommend a more defensive strategy given the current stabilisation of prices at high levels, which have been going on since June.

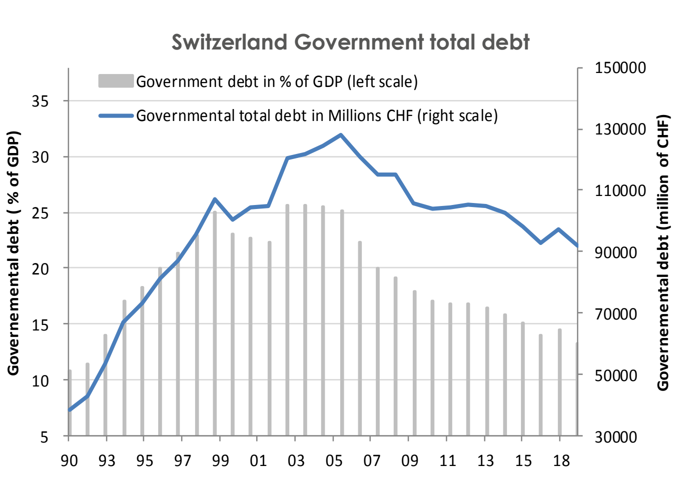
Beware high securitised real estate premiums

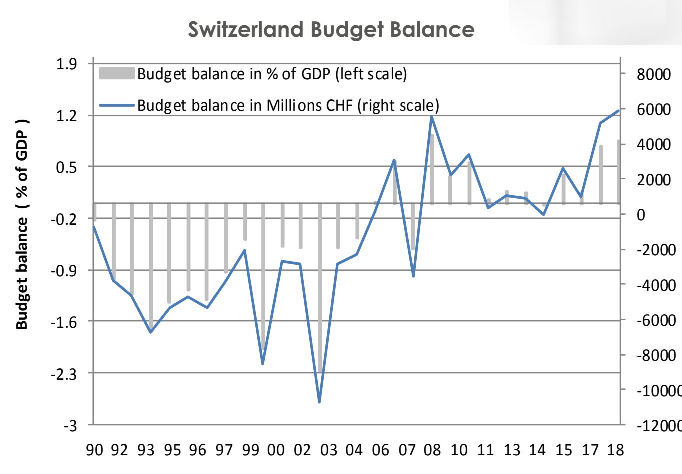
Securitised real estate remains a choice alternative to fixed-income investments in Swiss francs, but the recent momentum is nevertheless likely to run out of steam in the short term. Indeed, the increase in prices has triggered an expansion of premiums in both investment funds and real estate companies in excess of 30%. We believe such valuations are excessive and essentially linked to the irrational behaviour of interest rates. We recommend a temporary reduction of the Swiss securitised real estate allocation.











Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

Eurozone

- Contraction of Germany's GDP hampers growth in Europe
- Possible rebound of the European currency
- ECB firmly committed to supporting economic growth
- Real yields still attractive despite falling inflation
- Is the recession factored into long-term euro rates?

Contraction of Germany's GDP hampers growth in Europe

After a positive surprise in Q1, GDP growth in the euro area was severely impacted by Germany's negative growth (-0.1%) in Q2. Germany has thus undergone two non-consecutive quarters of moderate decline due to issues in its automotive sector and, more broadly, given the trade war and possible sanctions.

Germany has narrowly avoided a technical recession but has been hit hard by the general slowdown of the global manufacturing sector. The German economy has achieved unfortunate records these last few months with industrial production down -5.2% yoy (the sharpest fall in ten years) and a -8% decrease in exports (sharpest drop in three years). The German industrial complex has thus been hit very hard by the uncertainty regarding trade issues and the risks of recession, which are much more real and likely than in the US, especially in the absence of a clear turnaround in the Chinese-American conflict.

The Eurozone's quarterly GDP growth rate thus weakened from +0.4% to +0.2% in Q2, mainly due to Germany's economic slump. Employment growth followed the same trend with job creation up + 0.2% over the period (+0.4% in Q1). Within the EU, the Spanish and Dutch economies performed well, with GDP growth of +0.5%, significantly better than the results achieved in France (+0.3%) and Belgium (+0.2%), while Italy has been stagnant for several quarters.

Underlying trends in consumption and investment remain positive

Consumption (+0.2%), investment (+0.5%) and public spending (+0.3%) have been driving growth in Europe while the manufacturing sector and exports faced a drop in demand. Private consumption, government spending and investment each contributed +0.1% to GDP growth overall. These rather robust domestic fundamentals are in contrast with the manufacturing sector's difficulties.

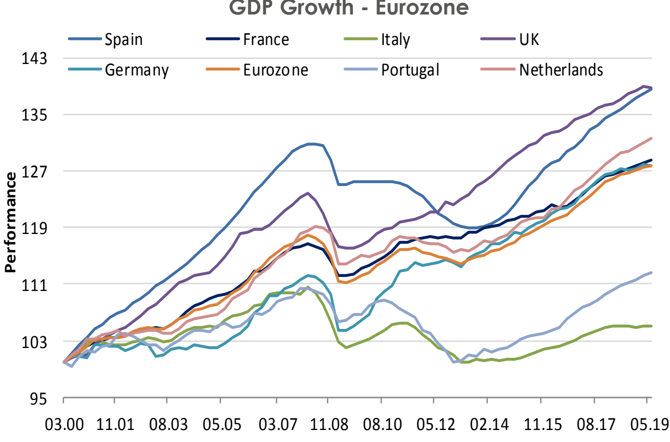
These positive factors seem more resilient and have somewhat boosted reasonable hopes regarding the capacity of Europe's economy to avoid a more pronounced slump in the next few months. The European economy is likely to grow significantly more slowly in 2019 (+1.1%) than in 2018 (+1.9%), while risks of a recession are estimated at less than 20% for 2020.

Leading indicators may have seen the worst and seem to be looking up

The large majority of national composite PMI leading indicators remain encouraging and quite clearly above the growth threshold of 50. Indeed, the Eurozone's composite PMI further increased slightly in August to 51.9, driven by the services PMI (53.5), on the rise since its low point in December 2018. The strong performance of the service sector thus offset the results, already known, of the struggling manufacturing PMI (47.0), which has thankfully been stabilising since March already. The composite PMI has consequently improved since the beginning of the year, confirming the positive trend it began eight months ago.

German manufacturing sector at its lowest

Hence, Germany is the main cloud on the European horizon, which is not as dark as it may seem. Manufacturing leading indicators have dropped continuously and now lie at their lowest level of the last ten years (43.5). They are pulling the composite index down, while services, at 54.8 and on the rise in August, are showing a totally different and more optimistic picture. Industrial production in the Eurozone slipped further by -0.4% in July, which is still better than in June (-1.6%), and year-on-year the -2% contraction is slightly better than performance at the end of 2018, which showed a drop of -4% over one year. Germany's industrial production is still driving overall performance down, although it should be noted that the latest figures published (-0.6%) are a little less worrisome.

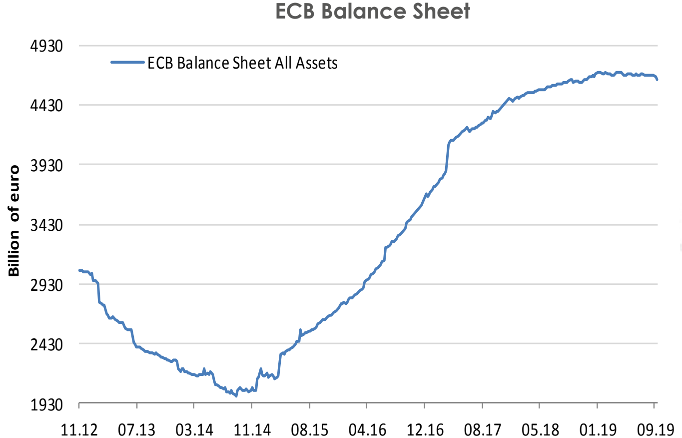


PMI (Manufacturing, Services and Retail) - Eurozone

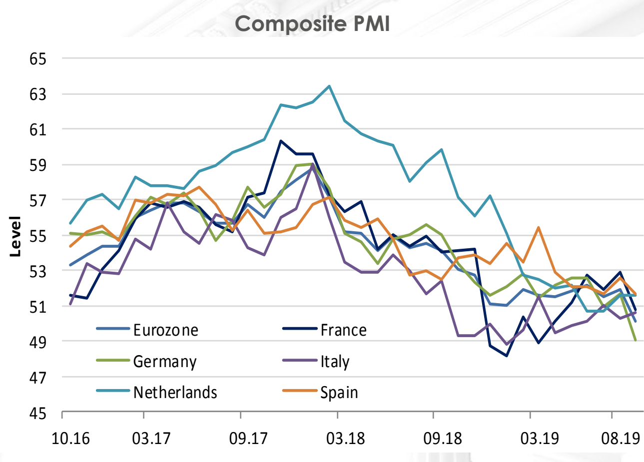
Markit Eurozone Services PMI SA
Markit Eurozone Retail PMI SA
Markit Eurozone Manufacturing PMI SA

Graph sources: Bloomberg/BearBull Global Investments

ECB Balance Sheet



Composite PMI



Gradual improvement in confidence

Positive trends in the employment market further strengthened in August thanks to new job creation (+0.2%). The unemployment rate for countries in the Eurozone (7.5%) has fallen back to the level that prevailed in late 2008, which corresponds to a drop in unemployment of 35% compared with the 12% peak reached in 2013. The European Commission's indicator reflecting economic sentiment has improved since the beginning of the year and has been stabilising for several months after falling steadily in 2018. It is obviously too early to talk about a return to optimism at this stage, but most of the other sentiment indicators also paint a more encouraging picture. Confidence indictors for Germany also point to a clear shift towards a more positive trend following the ECB's latest announcements, which reasserted the central bank's commitment to maintaining strong policies in support of European growth.

Possible rebound of the European currency

The worsening economic conditions in the Eurozone, essentially due to the German manufacturing sector's specific situation, ultimately had a relatively limited effect on the valuation of the European currency against the dollar in the last quarter. Indeed, the decline of German manufacturing PMIs weakened the euro, driving it down towards the lower end of its fluctuation band of between 1.12 and 1.16 against the dollar over the full period affected by worsening leading indicators between November 2018 and July 2019. The exchange rate only fell below 1.12 temporarily due to the return of uncertainty in financial markets in August. The EUR/CHF exchange rate also fell from 1.14 to 1.08, the Swiss franc benefitting from its safe-haven status until August. We believe the current level of the euro integrates most of the negative expectations regarding the risks to the German economy. The support measures announced by the ECB will likely breathe a little life back into the euro unless Donald Trump ends up targeting Germany more actively and severely regarding trade. A normalisation of growth prospects could nevertheless encourage investors to return to the European currency at its current levels, supporting an upturn in the EUR/USD and EUR/CHF exchange rates to 1.14.

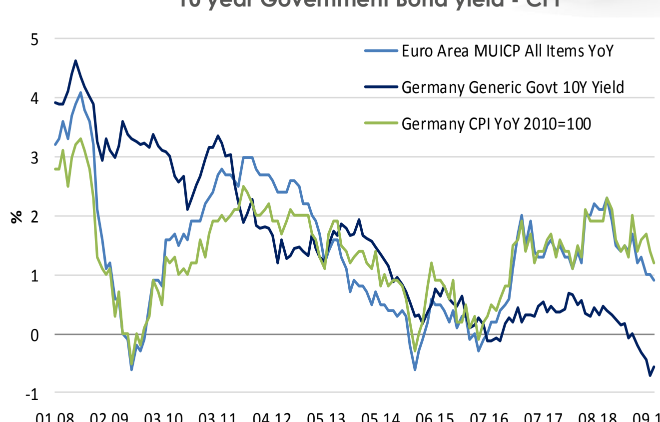
ECB firmly committed to supporting economic growth

The President of the ECB Mario Draghi is about to leave the bank, as he announces a new package of measures aimed at boosting growth in Europe. The Governing Council announced a 0.1% cut in the deposit rate at its last meeting, a gesture that was expected and ultimately had little effect. A further reduction could happen before the end of the year. However, if we are to believe the latest comments made by the Governing Council, the ECB will likely keep its rates unchanged until inflation moves closer to its 2% target, confirmed by continuing momentum. In the meantime, the ECB has relaunched a bond purchase programme in amounts of EUR 20bn per month for as long as necessary. This programme will likely be maintained for a while following the implementation of a rate normalisation policy in future. So far, we believe that this change in policy is unlikely to happen within the next 24 months. Consequently, the asset purchasing and quantitative easing programme could reach EUR 500bn. Inflation trends are also a major factor that may modify these forecasts if they remain anaemic.

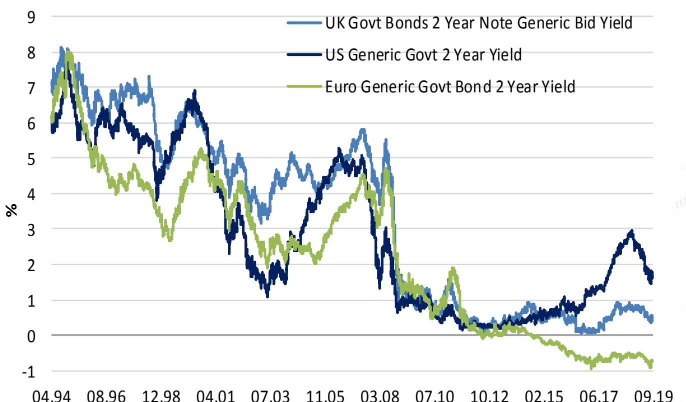
The ECB has also announced a new system that will prevent banks from being penalised for excess reserves by determining a multiple calculated based on the minimum required reserves. Set at six at the moment, this multiple will exempt close to EUR 800bn from being subject to a negative rate. The ECB has also reduced its outlook for inflation from 1.3% to 1.2% for 2019. Forecasts for 2019 GDP have also been reduced from 1.2% to 1.1%.

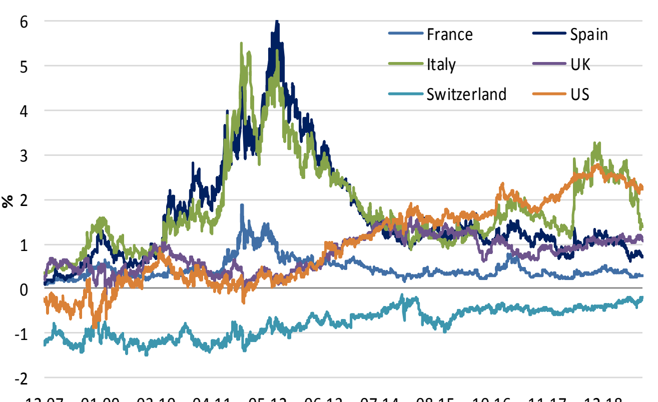
Citigroup Economic Surprise Index - Eurozone

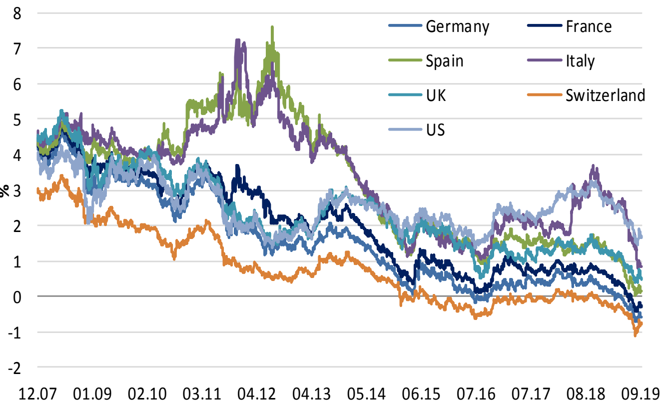
10 year Government Bond yield - CPI

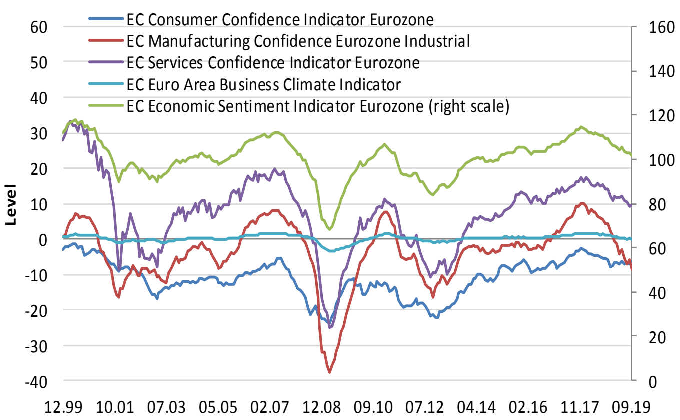


Graph sources: Bloomberg/BearBull Global Investments









Graph sources: Bloomberg/BearBull Global Investments

Real yields still attractive despite falling inflation

Inflation has recently strayed a little further from the European Central Bank's target according to all established measures. The CPI excluding food and energy for the Eurozone fell to 0.9%, i.e. a little below the average for the last three years, while the global index dropped from 2.3% in October 2018 to 1% in August, its lowest point since January 2017. As for producer prices, the PPI's drop to 0.2% is even more pronounced and is no great comfort to the ECB.

Recent development in capital markets have thus caused real yields on twelve-month maturities to drop slightly further, reaching -1.3% at the end of August, quite clearly below real yields of -0.1% in 2016. With the drop in ten-year rates to -0.7% at the end of August and inflation at 0.9%, real yields could fall even farther to close to -1.6%. Moreover, the fall in real yields in euros is a particularly positive factor for future European growth. The cost of financing investment, consumer credit and mortgage financing is thus very clearly negative and will likely boost demand in the next quarters.

Is the recession factored into long-term euro rates?

Anxiety increased in August in capital markets, which have all been rather significantly affected by the same probably unfounded expectations regarding the future of the global economy. Months have thus gone by since September 2018, and fears of a recession have not been quelled despite steadily improving economic statistics, in the US in particular, and preventive monetary policy actions meant to reassure markets. Firstly, long-term interest rates have dropped in the US, dragging in their wake most rate markets and especially Europe's ten-year rates. In this specific case, falling euro rates are clearly more justified due to the real risks of recession in Germany. In this environment, we have seen a truly exceptional flattening of the euro yield curve with negative absolute and real yields on all maturities of less than 25 years.

Next rotation of investment flows in favour of European equities

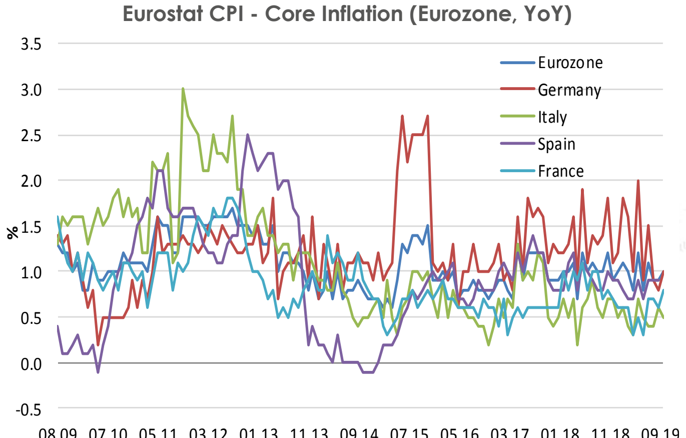
Domestic and foreign investors seem increasingly more inclined to focus on euro-denominated debt rather than European equities. This partly explains the continuing decline of rates in euros and the continuously attractive valuation level of European equities. Indeed, at the beginning of the present quarter, their relative valuation (PE 14.6x) remains eye-catching compared to US valuations (PE 18.2x) thanks to a "discount" of approximately 25%.

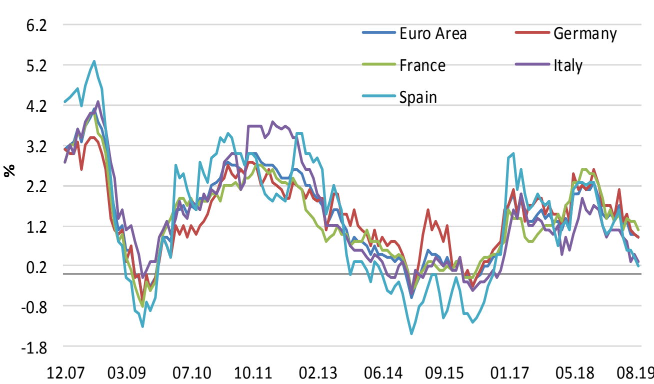
The expected revaluation phase has thus not happened yet, while the persistence of low rates, due to the ECB's announced policy, will likely now be perceived as an enduringly positive factor for European equities.

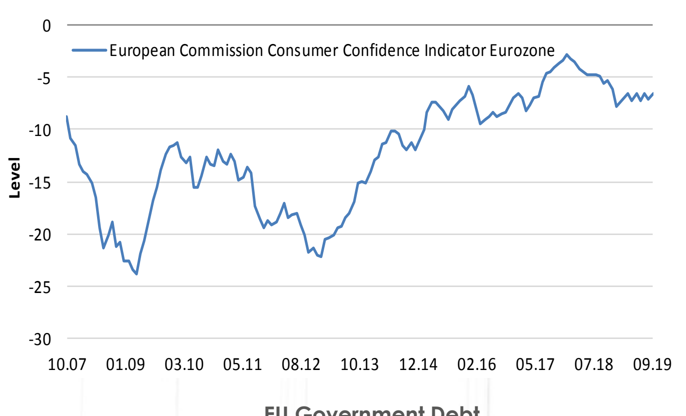
In terms of yield, European companies offer a dividend yield of 3.5%, clearly above the 1.9% yield offered by the S&P500. Nevertheless, the performance of the Euro Stoxx 50 since the beginning of the year (+18%) is still very similar to that of the US market (+19.9%) in local currencies.

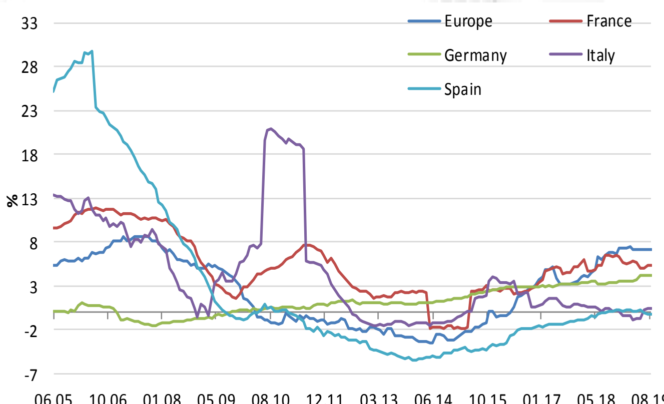
This valuation gap might be explained for the moment by the perception of a greater sensitivity of European stocks to external shocks such as the slowdown in China or in developing countries. Investors might thus be more convinced for the moment by the capacity of American companies to withstand such shocks rather than European stocks. Consequently, better economic conditions are likely to be the determining factor in terms of any outperformance of European equities.

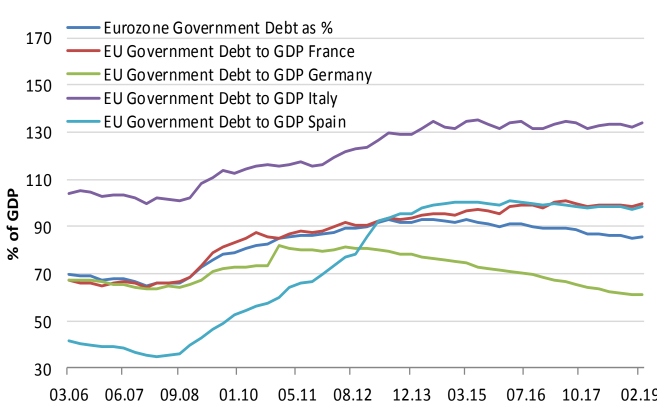
The strengthening of a long-term expansionist monetary policy is likely to help growth prospects improve sufficiently to trigger a long-awaited rotation of bonds to equities. Such a rotation will logically drive equities in the Eurozone to outperform.

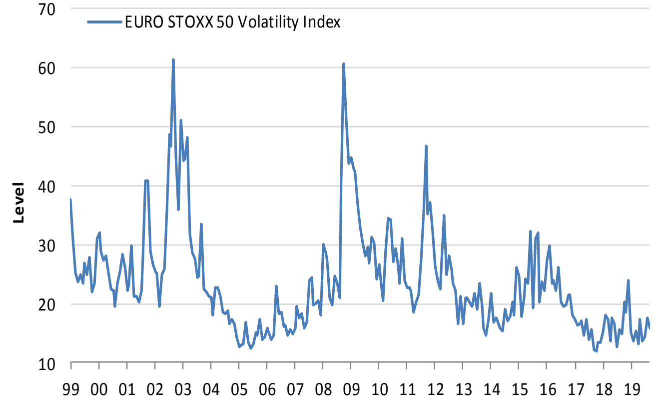












Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

United Kingdom

- Boris Johnson's strategy defeated by the Suprem Court
- A technical recession might be avoided following the decline in GDP in Q2
- Brexit outcome will determine the BOE's strategy
- Real estate market stabilisation
- Capital markets less attractive

Boris Johnson's strategy defeated by the Supreme Court

A few weeks after taking office, Prime Minister Boris Johnson seized power, suspending Parliament until 14 October or just two weeks before the Brexit deadline, in an attempt to postpone debate until after the Queen's speech presenting the government's agenda precisely on 14 October, namely just three or four days before the European Council meeting on 17 and 18 October. In theory, if Boris Johnson managed to thrash out an agreement before this date, Parliament would have time to ratify it.

While the UK Parliament is traditionally on break for several weeks in September due to the various political party conferences, the suspension decreed by Boris Johnson was going to prolong this break well beyond the last conference of the Conservative Party. The Supreme Court ruled this decision to be unlawful, thus dealing a severe blow to the PM. Parliament will thus reconvene on Wednesday, 25 September, and will be able to deliberate and organise urgent debates about Brexit.
The situation will thus not remain at a standstill, as Boris Johnson had hoped, and the PM is already bringing up the possibility of new elections. Given this context, the likelihood that the UK will withdraw without a deal on 31 October has diminished but nevertheless remains high. It is not certain that the reduced "political time" will enable the UK's political class to counter the Prime Minister's stated determination to leave the EU with or without an exit agreement.
The odds of such an agreement now seem increasingly low, following the Prime Minister's latest trip to Luxembourg, which turned into a diplomatic fiasco, as London rejected the EU's request that the UK government present a written proposal avoiding a no-deal withdrawal before the end of September.
The EU's ultimatum was obviously rebuffed. Thus, even though the President of the European Commission, Jean-Claude Juncker, had joined the UK Prime Minister in stating his determination to reach an agreement, an abrupt withdrawal seems to be the most likely scenario on 31 October, unless a further extension to Q1 2020 is ultimately granted by the EU at the last minute.

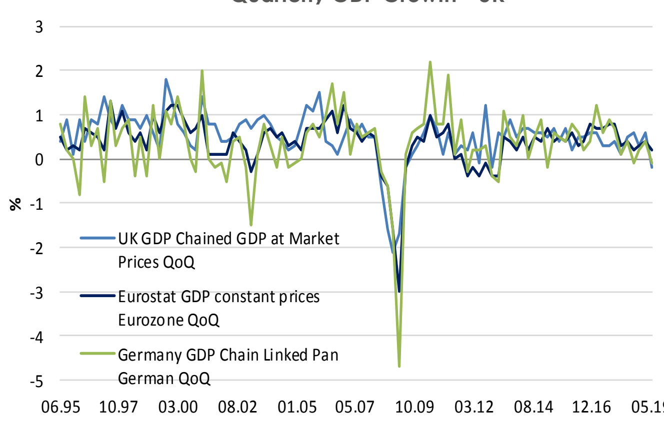
A technical recession might be avoided following the -0.2% decline in GDP in Q2

The British economy posted its first quarterly contraction since the end of 2012. Following seven years of growth, GDP finally felt the impact of the uncertainty tied to Brexit, dropping by -0.2%. On an annual basis, GDP still expanded by +1.2%, which is nevertheless significantly lower than its performance in March (+1.8%). Businesses that had built up inventory ahead of a withdrawal which they initially expected to happen at the end of March started to reduce inventory in Q2, which was detrimental to the GDP tally for the period.

Consumption and government spending progressed by +0.5% and +0.7%, respectively, while investment (-1%) and exports (-3.3%) fell. However, a technical recession seems unlikely, even though uncertainty remains very high just days away from the current Brexit deadline.

Indeed, the UK economy seems to have fared relatively well in July and August according to initial estimates.GDP was up +0.3% in July, raising the economic growth rate from -0.2% to zero over three months. These results are surprising, as GDP was forecast to grow by only a very slight +0.1% in July. The manufacturing sector as well as services and construction all participated in the upturn, posting stronger performances than expected, with a surge of momentum in manufacturing in particular and a strong showing by the service sector (+0.4%).

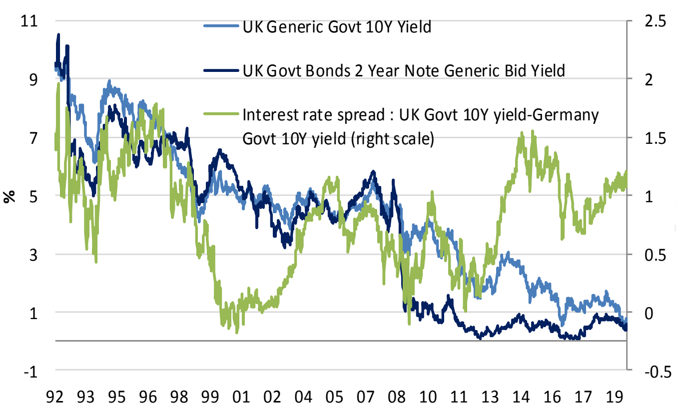
Indeed, momentum grew in the economy overall, dampening the immediate threat of recession thanks to upswings in industrial and manufacturing output of +0.1% and +0.3%, respectively. Construction also posted an increase of +0.5%. Results also seem to have improved in August, thus possibly pointing to growth of +0.2% to +0.3% in Q3.

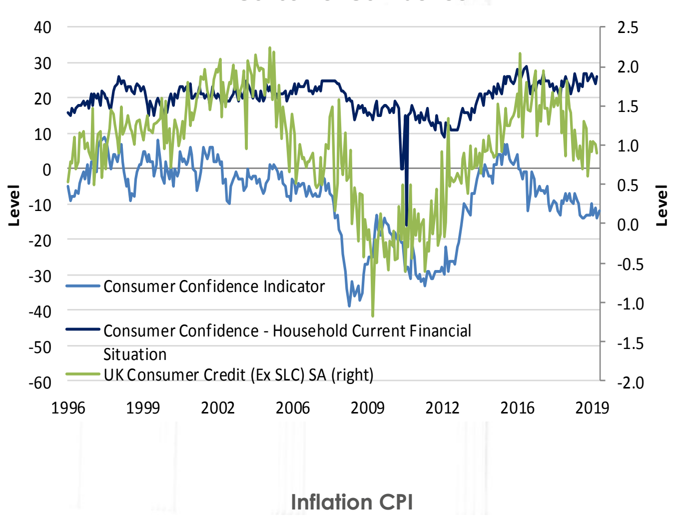


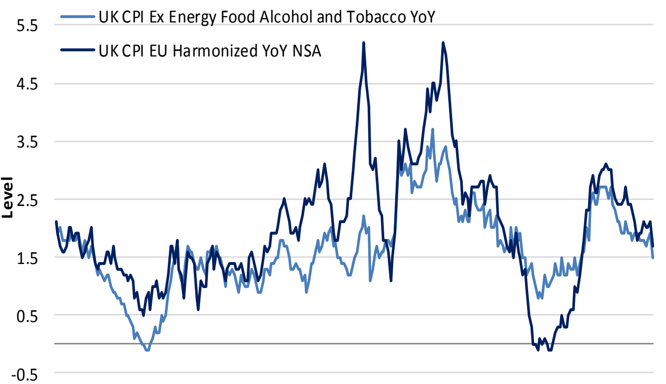
Manufacturing, Services and Construction PMI - UK

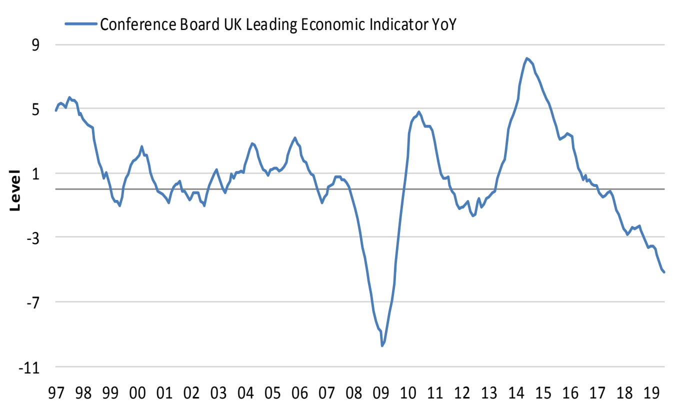
Markit/CIPS UK Manufacturing PMI SA
UK Services PMI Markit Survey
Markit/CIPS UK Construction PMI Total Activity SA

Graph sources: Bloomberg/BearBull Global Investments









Graph sources: Bloomberg/BearBull Global Investments

Still no sign of optimism from leading indicators in August

In spite of this stronger economic performance in July and August, the manufacturing PMI for August slid back yet again from 48 to 47.4 for the fourth consecutive quarter. The new orders index also reached its lowest level since July 2012. Brexit is not solely responsible for this decline, as the internationally-oriented segment of British manufacturing is also feeling the effects of the global slowdown tied to the uncertainty resulting from the trade dispute between China and the United States. Nevertheless, a growing number of businesses are modifying their production chain ahead of Brexit. In terms of the UK economy overall, months seem to be going by with no clear solution in sight to the political crisis, which is exacerbating the feeling of uncertainty among businesses and consumers. The service PMIs also fell significantly in August (50.6), leaving barely any margin above the 50-point mark separating growth from economic contraction.

Consumers also worried about uncertainty

British consumers remain relatively worried, and rightly so, following a summer rife with uncertainty and given the unending political crisis surrounding Brexit. Household confidence fell once again to a six-year low in August. While yoy wage growth was particularly satisfactory until July (+3.8%), jobless claims increased significantly, giving rise to some uncertainty. The unemployment rate continued to decrease, from 3.9% to 3.8%, but job creation declined from 115,000 to 31,000 in July, reinforcing a feeling already widely shared among the population that the situation is rather precarious. In September, yoy real estate price growth was once again close to zero, which is unlikely to help improve household confidence. Moreover, the upswing in inflation in August (+0.4% over a month) and the increase in retail prices (+0.8% over a month) will bite into consumers' purchasing power and depress confidence indices.

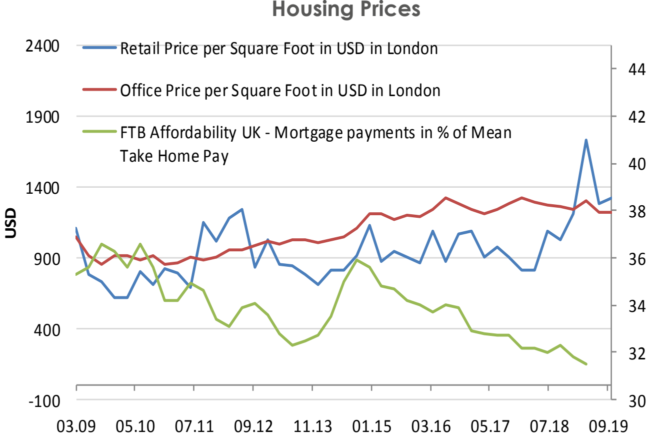
Brexit outcome will determine the BOE's strategy

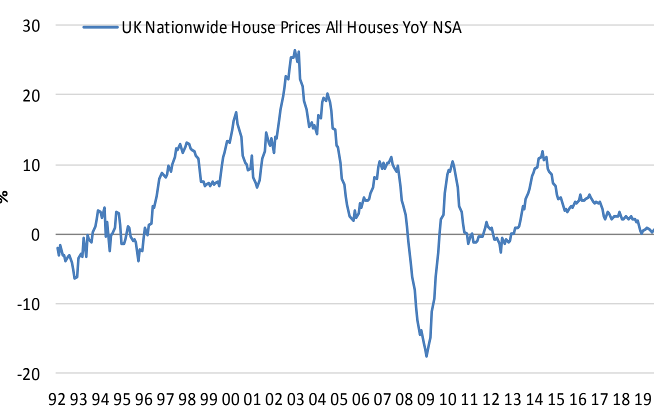
As expected, the Bank of England did not change its monetary policy at its more recent meeting in September. The nine members of the Monetary Policy Committee voted unanimously to keep rates steady at 0.75% and maintain its asset purchase objective of 435 billion pounds. The GDP growth forecast for Q3 was reduced from +0.3% to +0.2% and the inflation forecast was revised down to 1.6%.

The political uncertainty surrounding Brexit is still hampering any decision and action by the BOE, which will proceed differently depending on the scenario that will ultimately materialise on 31 October or in the following months if talks are unexpectedly extended once again.

Should the UK withdraw with an agreement, the growth outlook will likely be revised upward, and given the current rate of inflation, interest rates could rise. However, we do not expect the BOE to act swiftly, as it will likely want to observe the impact of an agreement on confidence, growth, and inflation, before acting in a way that will likely be very deliberate either way. In the event of a no-deal exit on 31 October, the BOE will be compelled to act, cutting rates in an attempt to counter the negative impact of a brutal divorce on the UK economy. The costs associated with Brexit uncertainty have been estimated to amount to 2% of GDP growth since 2016.

The question of what sort of Brexit will be implemented is thus now more important than the direction of inflation, which has been steadily decreasing in spite of the pound's depreciation. Inflation dropped from 2.1% to 1.7% yoy in August, while core inflation fell to 1.5%. As for producer prices, they stabilised at 2%.





Real estate market stabilisation

Real estate prices continue to trend up, increasing by +0.3% in August according to Markit/Halifax's updated calculation methodology. However, yoy price growth has slowed to a mere +1.8%. Another measure of price growth published by Nationwide Building Society already seems more pessimistic, showing yoy price growth of barely +0.6%. While monthly data has been somewhat volatile in 2019, the real estate market has stayed resilient until now despite the mounting uncertainty resulting from Brexit.

In the absence of any agreement with the EU, investors will likely remain worried, although the imbalance in the real estate market, with excess domestic demand, will remain favourable, especially if borrowing costs remain as low as they are today and if job market conditions remain robust. Wage growth has stabilised, and mortgage rates are still at historic lows. Mortgage approvals rebounded in July, reaching 67,300 mortgages approved, the highest level seen since Q3 2017. The situation in London is somewhat different, however, with more negative price trends and more significant price drops.

Capital markets less attractive

The drop in long-term interest rates in the UK has been particularly severe over the past several months. The fall from 1.6% in September 2018 to only 0.4% at the end of August 2019 took place in the context of generalised fear around the world regarding US and global growth. It was exacerbated by economic conditions within the UK and increasingly high risks of recession in the country. The uncertainty tied to the absence of a solution to the Brexit conundrum and the risk of a genuine collapse of economic activity in the event of a no-deal withdrawal thus pushed long-term rates below the lows reached just after the 2016 referendum. Pound-denominated capital markets are not attractive in the current context marked by political risks that are difficult to evaluate. A no-deal exit would plunge the UK into a unique situation with unpredictable consequences. The BOE would be forced to act to attempt to tamp down, if at all possible, the risks of a recession, whose magnitude and duration are obviously not easy to estimate. The likely outcome for the British currency would initially be negative.

Thus, the risk of holding pound-denominated bonds seems high given the significant FX losses that would ensue. If on the other hand an agreement became possible, the risks of recession would abate, and long-term rates would then likely gradually rise and the pound may stabilise. Given the uncertain context, we recommend that international investors avoid any exposure to pound-denominated capital markets and take positions in other bond segments.

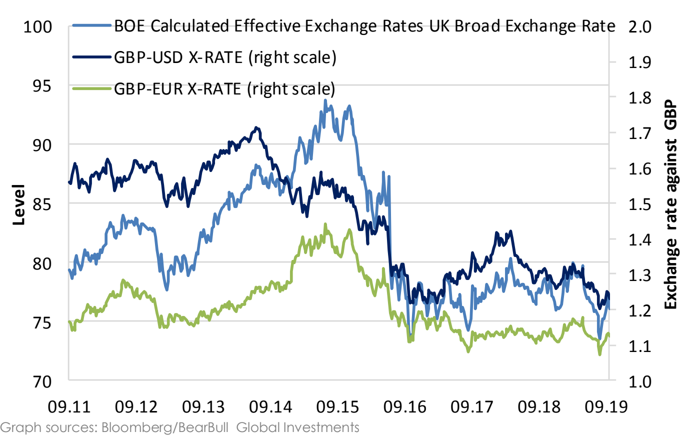
The key question for the pound's valuation is: What sort of Brexit?

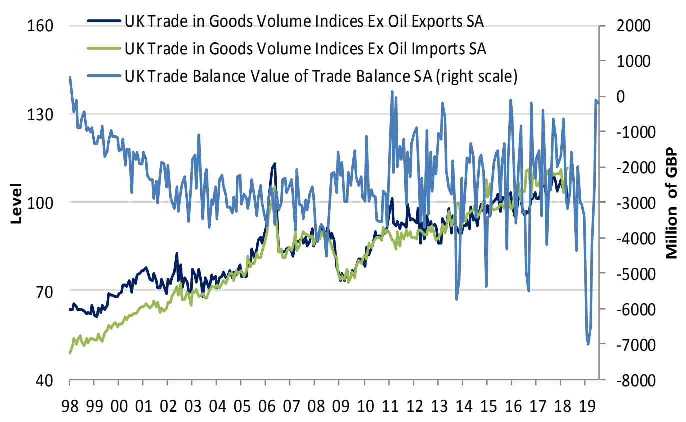
The pound remains impacted by the complex political situation that will determine whether Brexit will be brutal or whether a negotiated solution will help manage or limit the effects of a withdrawal from the EU. The latest development regarding this political impasse is the Supreme Court's decision to rule unlawful Prime Minister Boris Johnson's attempt to suspend Parliament. This decision could well push Boris Johnson to call for new elections. In this context, we maintain a cautious position with regard to the pound. We had predicted that the pound would likely drop below its December 2018 level of 1.25 against the dollar, and indeed the pound reached a short-term low of just under 1.20. However, we believe that there is a higher likelihood that the pound will stabilise above 1.24 if the likelihood of a no-deal scenario recedes once Parliament reconvenes on Wednesday, 25 September.

Uncertainty persists with regard to equities and real estate

In this persistently uncertain environment, the equity market's expected risk/return ratio does not seem attractive. While pressure on the pound could abate somewhat given the government's political setback, instability remains high.

We thus continue to recommend caution on UK equities, in spite of reasonable valuations and attractive dividend yields. With regard to securitised real estate, the risks of further deterioration of market conditions seem high enough to us that we recommend staying in wait-and-see mode. Recall that the BOE had mentioned that real estate prices might drop by 25% in the pessimistic scenario of a no-deal Brexit.





Graph sources: Bloomberg/BearBull Global Investments

BearBull Global Investments Group

MACROECONOMIC SCENARIO

Japan

- Japanese GDP maintains positive momentum in Q2
- Falling exports to Asia hurt Japanese economy
- Manufacturing still under pressure
- Lower unemployment rate, consumers increasingly worried
- BOJ likely to remain patient

Japanese GDP maintains positive momentum in Q2

Japanese GDP posted satisfactory growth of +0.3% at the end of June, just a little under the previous quarter's results (+0.5%). Although the yoy performance of the Japanese economy is by no means exceptional, it did turn in a respectable +1.3%.

This confirms the trend reversal that occurred in Q4 (+0.5%) following a -0.6% contraction in the previous quarter, in spite of a very uncertain global context. Household consumption (+0.6%) contributed significantly due to a rather sharp increase in spending compared to the previous quarter.

Investment overall was disappointing and had a negative impact on growth. While investment in equipment increased in some more domestically-oriented sectors, it decreased in the manufacturing sector, more sensitive to the escalation of trade tensions, in the wake of falling exports.

Japan thus remains very committed to coming to a trade agreement with the US to avoid further pressure on its export capacity, for instance via US import duties on Japanese goods, which would likely further weaken the already struggling Japanese auto industry. As for consumption, it will likely remain robust in Q3, before it starts feeling the effects of new taxes taking effect in October.

Public spending, up +1.2%, was solid, as was public investment (+1.8%), such that government spending contributed +0.3% to GDP growth and was thus another essential factor in the resilience of Japan's GDP in Q2.

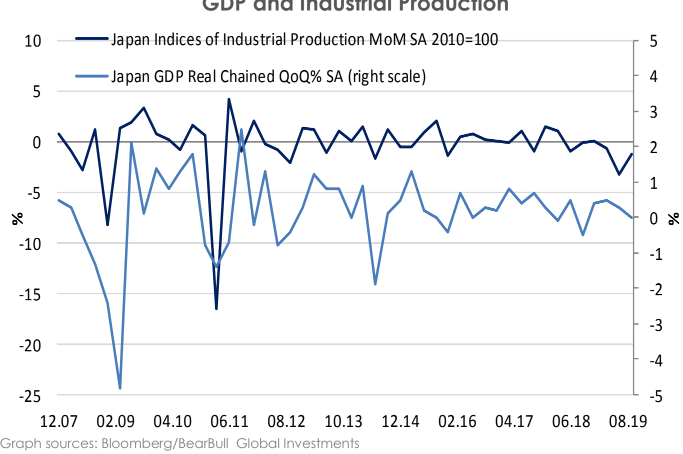
The fragility of the Japanese economy, and its dependence on the export sector in particular, is clearly reflected in these results. Public spending for the most part offset the export sector's poor performance. The -12% drop in Japanese corporate earnings yoy – the steepest contraction since 2011 – is an indication of worsening economic conditions.

While the overall performance of the Japanese economy thus seems satisfactory, in the absence of a trade agreement in the near future and given a very likely slowdown of consumption following the planned introduction of taxes in October, the fragility of the Japanese economy could become evident and disappoint at the end of the year.

Falling exports to Asia hurt Japanese economy

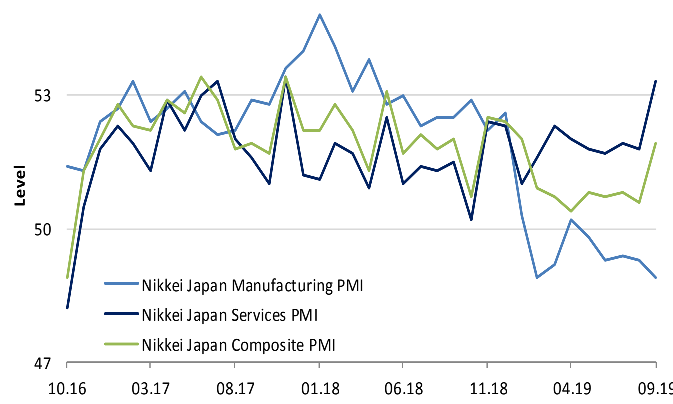
Historically, Japan ran a trade surplus over the past decade and a deficit between 2011 and 2015. The country's trade balance was once again negative in August (-136 billion) following a deficit in July (-249 billion) and a surplus in June (587 billion). The downturn in global demand continues to have a negative impact on Japanese exports. The further drop in exports in August (-8.2% yoy) was again more significant than the fall in June (-6.6%). In July, the decrease was concentrated in Asia, where demand plunged -8.3% yoy, while exports to Europe (+2.2%) and the US (+8.2%) were actually doing significantly better. The drop in imports in August was relatively more significant (-12%), contributing to the decrease in the trade deficit between July and August. The uncertainty, which persists to this day, regarding the issue of trade relations between the US and China continues to weigh on confidence and affect the Japanese economy, which is hardly on solid ground with regard to its own tariff issues with the US, in spite of seemingly constructive talks. The situation is unlikely to change in Q3; we expect the trade deficit to persist, still penalised by the same factors but likely to a lesser degree, before improving at the end of the year. On the currency front, in August the yen benefited from its safe-haven status in times of rising uncertainty in financial markets. However, along with an upturn in foreign demand, the currency factor remains a crucial element in any future improvement in GDP. The nominal interest rate spread, largely working against the yen, is in fact being offset by trends in real interest rates, which are currently preventing the yen from depreciating and thus boosting exports.

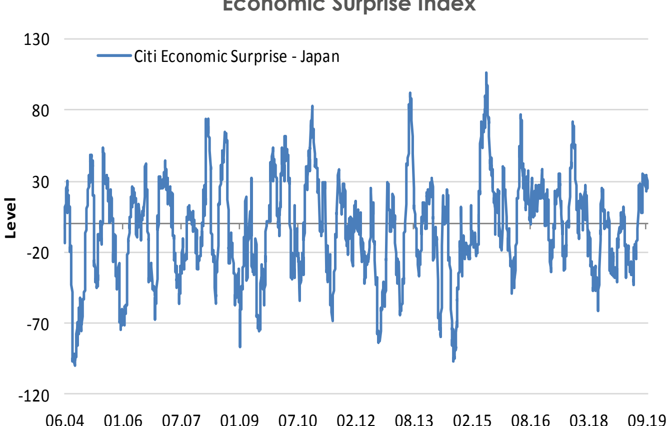
GDP and Industrial Production

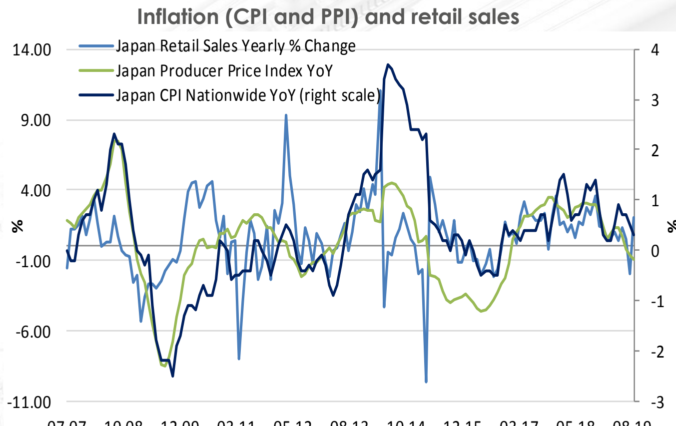


Graph sources: Bloomberg/BearBull Global Investments

Composite, manufacturing and Services PMI - Japan







Manufacturing still under pressure

Japan's manufacturing sector thus remains influenced primarily by the external factors mentioned above, and there are few signs offering any hope of a trend reversal in the near future. The small uptick in industrial output in July (+1.3%) was unexpected and stands in contrast with the decline posted in June (-3.3%), while inventory levels also decreased by -0.3%. Machine orders fell somewhat less than anticipated, while orders in the manufacturing sector in particular were surprisingly more robust (+5.4% in July) than those in other sectors, which posted steep declines (-15.6%). The volatility of monthly data unfortunately does not help to discern more reliable trends, such as that seen in the machine tools segment, where orders continued to fall, posting their steepest yoy contraction since 2009 in August (-37.1%). The manufacturing sector is thus still being battered, although manufacturing PMIs, which have been stabilising since March, may be signalling an improvement by the end of the year.

Leading indicators stabilising?

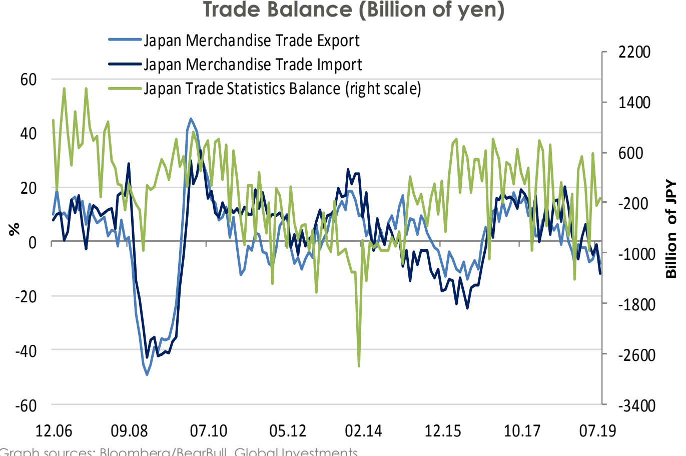
Uncertainty is still weighing on leading indicators, with the manufacturing PMI stabilising slightly under its growth threshold in August (49.3). During the past six months of relative stability, however, economic figures have been showing a deterioration of the situation in the manufacturing industry. For more positive signs, one has to look at the services sector, which paints a very different and significantly more positive picture. The services PMI, which came in at 53.3 in August, thus reached its highest level since October 2017, pushing the composite PMI (51.9) above its growth threshold (50). In spite of indications that the US and Japan have agreed on the terms of a preliminary agreement on trade and tariffs addressing the issue of Japan's trade surplus, uncertainty persists among industrial purchasing managers, who are concerned about the fall in exports to Asia. With regard to services, the latest surveys seem to indicate that business leaders are not worried about the increase in taxes from 8% to 10% that will take effect in October, thus significantly contributing to the improvement in overall sentiment. In August, the composite PMI finally showed more tangible signs of a forthcoming economic upturn.

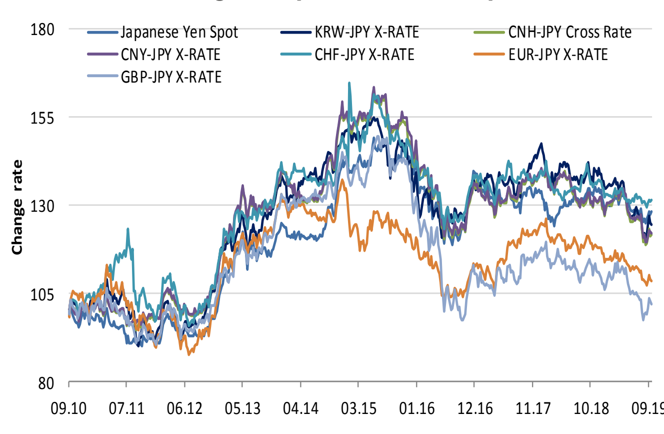
In spite of a lower unemployment rate, consumers increasingly worried

The job market remains very tight, in spite of the difficulties faced by the manufacturing sector over the past few quarters. The unemployment rate continued to fall over the quarter, reaching a record low of 2.2%. The small unexpected decrease in the jobs-to-applications ratio (from 1.61 to 1.59) in August likely reflects firms' adjustment process, whereby in the short term they are orienting somewhat more toward part-time jobs. Household expenditure increased slightly in July (+0.8% yoy), but real wages continued to decline over the same period (-0.3%). The central bank continues to hope that the job market's particular situation will boost wages, consumption, and inflation, but these effects are still struggling to materialise. It is thus not surprising given this context that Japanese consumers remain extremely cautious, as shown by the confidence index, which posted its worst result (37.1) in August since January 2015.

BOJ likely to remain patient

The Bank of Japan will likely keep its monetary policy unchanged during its next meeting in September. However, it will not be an easy decision to make given the current context in which two leading central banks (the Fed and the ECB) are once again cutting rates. During the BOJ's most recent meeting in July, Governor Kuroda also brought up the idea of a precautionary rate cut, clearly noting that he would not hesitate to lower rates once again if price indices stalled. The monetary policy committee takes deflationary risks seriously, but the proponents of patience still seem to be winning out. While the US Fed certainly yielded to the pressure of scaremongers who for 12 months had been harping on about an impending recession even in the absence of genuine warning signs, the BOJ is probably wondering if the appreciation of the yen and the struggling manufacturing sector are sufficient reasons to justify a rate cut in September or if sitting tight for a few weeks will leave enough time for a more positive outlook to take shape.





Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

China

- The worst may be over for the Chinese economy
- Leading indicators still wavering
- Trade surplus contracts
- Washington and Beijing could come to an agreement if they were more realistic

The worst may be over for the Chinese economy

While investors are worried about a recession, the Chinese economy seems on track to continue expanding with real GDP growth still exceeding +6% in 2019 and 2020. Various types of stimulus in China and other regions of the world will likely trigger a period of growth over the next six months.
On the domestic front, the PBOC already reduced the required reserve ratio, lowered borrowing costs for the private sector, and boosted infrastructure spending. Although these stimulus measures remain limited, they will have a positive impact eventually. xpectations of a recession are overblown and will be contradicted by an upswing in foreign demand for products manufactured in China. Indeed, even with the introduction of tariffs in the US, products imported from China remain competitive, especially following the depreciation of the yuan.

Moreover, we expect that the US president will likely follow the path of reason, heeding Republican lobbyists' calls not to jeopardise the bottom lines of US multinationals by further raising tariffs. An agreement thus still remains possible in the next few months, which would improve the global outlook. Note further that, while PMIs continue to waver, economic conditions seem to have improved already. Industrial output remains weak by Chinese standards but still grew by +5.6% since the beginning of the year. Retail sales also progressed by +8.2% year-to-date. Real estate investments rose sharply by +10.5%, but Chinese exports slowed somewhat, up a mere +2.6% yoy in yuan.

PBOC concerned about cryptocurrencies

The PBOC announced that it was entering the cryptocurrency space by launching its own digital currency. The director of the PBOC's research bureau said he had concerns regarding the rise of cryptocurrencies such as Facebook's Libra, which could impact central banks' monetary policy. Of particular concern to China is that the composition of the Libra would be dollar-based, potentially excluding the yuan. While the Chinese currency finally became a central bank reserve currency, included by the IMF in its special drawing rights (SDR) currency basket, it might lose this advantage with the emergence of the Libra and other similar types of cryptocurrency. The PBOC thus does not look favourably upon these developments and will seek to counter them by creating its own cryptocurrency.

Leading indicators still wavering

Leading indicators for the manufacturing sector continue to waver with no sign yet of any trend reversal. Indeed, the manufacturing PMI increased only slightly in September (49.8), driven by potential growth in domestic demand. The trade dispute has had a negative impact on exports, production costs, and sentiment, but the non-manufacturing PMI continued to trend upwards in September (53.7).

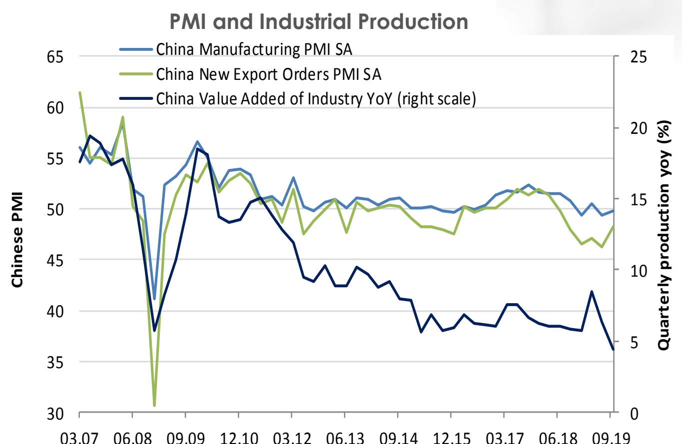
Trade surplus contracts

China's trade surplus shrank rather sharply in August from 310 billion to 239 billion yuan. Exports fell by -1% yoy in August after leaping up +3.3% in July. While exports to Europe and Asia grew, exports to the US continued to decline. Chinese exporters continue to diversify into markets outside the US. Exports to the US dropped by -16% yoy. Toy exports remained solid (+37%), indicating that US distributors stocked up in advance on merchandise that may later be subject to tariffs. As for imports, they continued to fall (-5.6%) in most countries. Only imports from ASEAN grew by +7.6%.

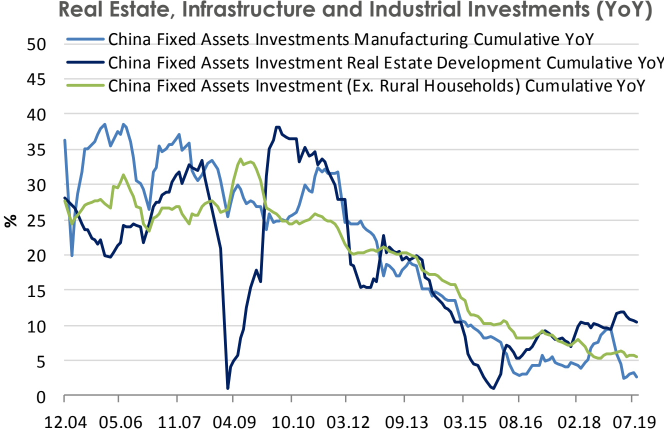
YoY GDP Growth

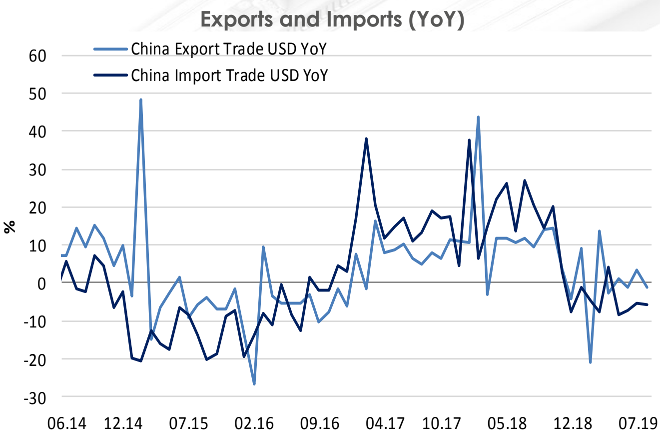
China GDP Constant Price YoY

%



Graph sources: Bloomberg/BearBull Global Investments





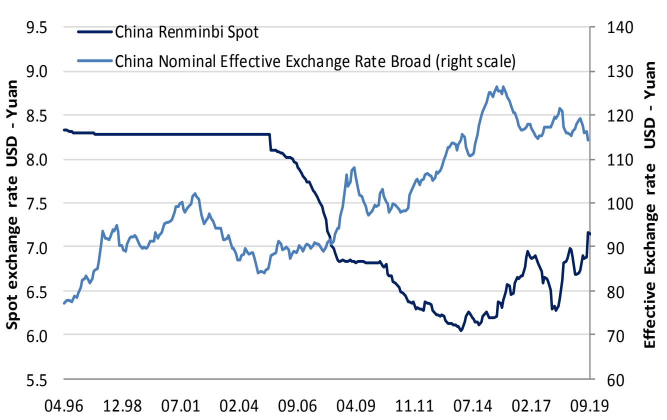
Washington and Beijing could come to an agreement if they were more realistic

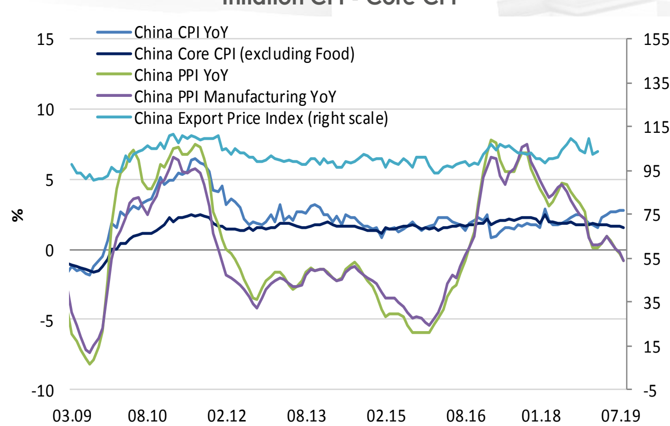
Talks between China and the US are set to restart on 10 October. After two years of stop-and-go scuffling in the negotiation process, both governments must come to realise that this dispute will not be resolved unless both parties make a more concerted effort and adopt a more realistic approach. While the overall conflict and the trade imbalances certainly will not be resolved with a simple trade deal, the uncertainty undermining financial markets and increasingly impacting both countries' economic momentum has to be lifted expeditiously.

Among other pragmatic and realistic efforts, Washington and Beijing should accept to limit the scope of negotiations to a certain number of points upon which they may actually come to terms instead of trying to reach a comprehensive agreement including particularly sensitive topics upon which the parties are unlikely to agree. For instance, Washington will probably have to accept that Beijing will initiate structural reforms outside of the negotiation process; and that human rights issues will have to be excluded from the discussions.

A trade deal would strengthen the yuan

Talks between Chinese and American negotiators are set to resume in October, but the likelihood that tangible progress will be made that would herald an agreement in the near future seems low. Nevertheless, curbing trends prevailing in the foreign exchange market over the past three months will require the presence of more positive factors. Indeed, last quarter was among the yuan's worst due to the difficulties faced by Chinese negotiators in trade and tariff talks with the US. For the first time since the financial crisis, the exchange rate fell below 7 yuan to the dollar, losing -3.6% of its value against the US currency. The yuan is also expected to experience a rough start to the fourth quarter following comments by the US president, who is contemplating restricting investments by US firms and investors in China.





Graph sources: Bloomberg/BearBull Global Investments

MACROECONOMIC SCENARIO

United Arab Emirates

- Dubai records 135% growth in FDI in H1 2019
- Dubai ranked third-most affordable city for prime real estate
- New real estate body to improve supply-demand balance
- Positive on Dubai Real Estate

Dubai records 135% growth in FDI in H1 2019

Dubai's Executive Council announced that the Emirate has attracted a record Foreign Direct Investment (FDI) of USD 12.68 billion in the first half of 2019 which represents a growth of 135% when compared to the same period last year. 61% of total projects were greenfield, followed by 27% new forms of investments (NFIs), 6% reinvestment, 5% mergers and acquisitions (M&As), and 1% for new joint ventures, with Strategic FDI projects accounting for 62% of total FDI capital flows to Dubai in the first half of 2019.

During the first half of 2019, Dubai has continued to progress in global rankings of the most attractive cities for FDI, ranking third in the world in attracting FDI, in terms of both capital flows and the number of greenfield projects. The FDI flows and rankings results were revealed by Dubai Investment Development Agency (DUBAI FDI), an agency of the Economy-Government of Dubai, based on the Financial Times' FDI Markets, which monitors data on capital flows and greenfield FDI projects around the world and the 'Dubai FDI Monitor' data.

This is yet another significant indicator that confirms the success of the recent economic policies and development plans initiated and implemented by the UAE government as highlighted in our previous publications. Dubai now ranks 3rd in the world in attracting FDI projects, most notably in the High and Medium Technology sector, solidifying the city's position in the eyes of the world as a city of the future. The FDI results of the first half of 2019 is a testament to the Dubai economy's competitiveness and resilience in the face of global shifts and challenges that have adversely affected the flows of FDI globally in recent years.

Dubai's Executive Council has also committed to continue to provide more incentives, guarantees and regulatory and legislative frameworks, to consolidate Dubai's position as a business confidence hub among the global investor community.

Dubai is ranked as the third-most affordable city for prime real estate

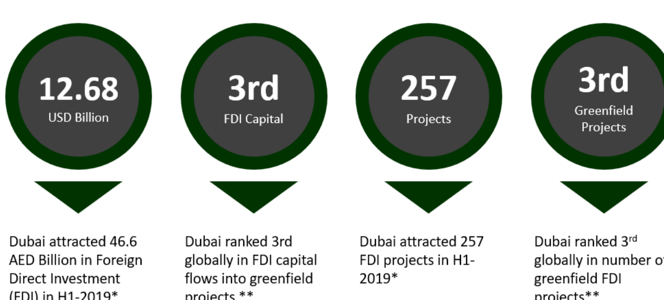
Dubai has been ranked as the third most affordable major city worldwide for purchasing prime residential property, according to Savills World Cities Prime Residential Index (H1 2019). The World Cities Prime Residential index ranked 25 major global cities based on capital values price per square foot and price movements in local currency in the half year of the year.

According to the figures, the average price per sq ft of a prime residential property in Dubai stands at USD 600. This compares to USD 330 per sq ft in Cape Town and USD 260 per sq ft in Kuala Lumpar. At the upper end of the scale, the most expensive property is Hong Kong (USD 4,730 per sq ft), which saw growth of 1.3% in H1; and New York (USD 2,520 per sq ft), despite witnessing a decline of 1.8 %.

According to Savills prevailing prime property prices represents a unique opportunity for domestic and foreign investors to consider investing in Dubai. Firstly, because the time is right as it is far more affordable to purchase prime residential property now due to lower transactional costs and overall lower prices when compared to other major global cities. Investors are paying less for top class specifications and now get the opportunity to secure super time locations at very competitive pricings—which would otherwise not be available in the market. Secondly, Dubai, with an average prime rental yield of 4.6%, benefits from very strong rental yields when compared to other global cities, which mean that long-term investors could generate robust annual returns when letting out property in the city not to mention strong potential the city offers for capital appreciation.

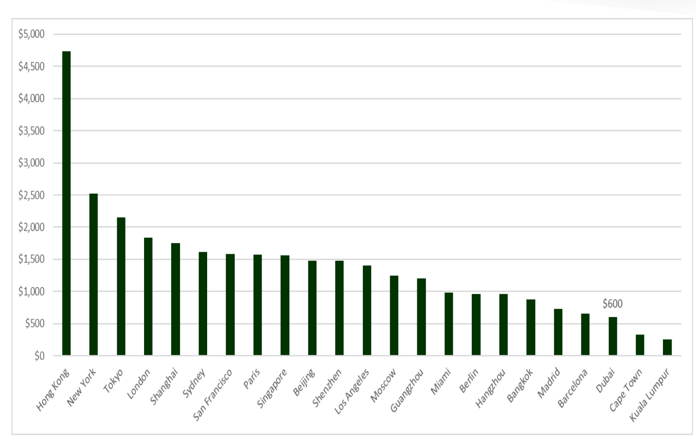
Demand for prime property in Dubai remains strong despite the prevailing mismatch of supply and demand which has let to compressed prices. As supply/demand balances out over time, prices will adjust accordingly, therefore, investment towards the bottom of the cycle could be a shrewd move.

FDI Flows into Dubai | H1 2019



Graph sources: Bloomberg/BearBull Global Investments / Dubai FDI Monitor

Prime Residential Values in June 2019 | Price per Square Foot (USD)



Source: Savills World Cities Prime Residential Index

Dubai prime residential rental yields 3rd highest among global cities

Latest data from the Savills World Cities Prime Residential Rental Index of 21 cities shows that after Los Angeles (5.2%) and Moscow (5.0%) Dubai prime residential offers the third most competitive prime rental yield (4.6%) when compared to other global cities. Dubai also benefits from lower transaction costs, overall lower prices and better property specifications according to the same report.

New real estate body to improve supply-demand balance

Dubai established earlier last month of a new Higher Committee of Real Estate, in a move to regulating the market and establishing a sustainable balance between supply and demand. The new Higher Committee of Real Estate - described as being like a planning authority will provide a better supervision to Dubai's real estate market in order to better balance supply and demand.

In line with other mature markets, Dubai's government has established the new authority - which includes senior representatives of major property developers among its members - to avoid duplication of projects and to act as a planning authority to supervise Dubai's real estate market. As part of this mandate, the committee will develop a comprehensive strategic vision for all major real estate projects for the next ten years.

Positive on Dubai Real Estate

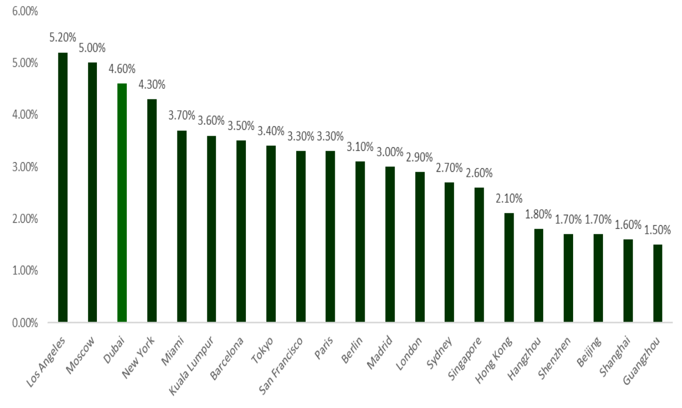
Based on the latest transactional data from Dubai Land Department, demand for prime property remains strong. In fact, after peaks in Dubai's housing market in 2008 and 2014, prices have fallen by more than 35%. As supply/demand balances out over time, we expect prime property prices to adjust accordingly, so investment towards the bottom of the cycle should be considered further. According to property finder, for those yearning for a market turnaround, there was some good news in H1 2019. The rate of decline slowed in most segments, leveled in some instances, and most encouraging were the modest increases seen in Abu Dhabi property market.

In Dubai, median advertised rent prices were essentially flat, dropping just 0.4% to AED 79,650 per annum. This is the smallest half-yearly drop in records since the prevailing property downward trend started. Slowing declines can be an indicator of a market approaching bottom but with 19,449 new residential properties completed in Dubai during H1 2019, including 13,677 apartments, at least as many expected in H2, and more next year, we suspect it will be some time before supply levels are absorbed in secondary locations. The headline, however, is that asking prices for apartments for rent in Abu Dhabi actually increased 1.9% to an advertised median of AED 72,167 per annum. This is the first uplift we have seen in a while and is good news for owners and investors.

The prime residential market in the UAE has been slipping fairly consistently for the last four years. Many analysts share our view and consider we must get close to or at the bottom of the market with most rightly arguing that there is little room for further significant reductions despite the upcoming supply.

The secondary market is also expected to benefit from lower levels of direct competition from real estate developers offering lower down payments and fairly long payment plans. Finally, the UAE government seems also more committed than ever to manage and stage future supply of property to pave the way for a healthy recovery. We are also witnessing a slow down of supply and the rise in end user and smart money demand. This is supported by significant price corrections, Developer incentive schemes and the establishment of the new department of Strategic Land Committee at the Dubai Land Department with the aim to avoid the duplication of projects in the sector and achieve a more sustainable balance between supply and demand. The Dubai Land Department (DLD) announced a 134% increase in real estate transactions following the creation of the emirate's new Higher Committee of Real Estate earlier this month on 2nd of September 2019. The above is very promising for the UAE Property Market where legitimate downside risks should be read in conjunction with upcoming data which justifies selective investments in prime property assets based on prevailing competitive yields and pricing.

Prime Residential Yields in to Global Cities | H1 2019



Top 10 World Cities Prime Residential Yields | H1 2019

	World City	Yield	Weekly Rent for 2,000 Sq ft Apt	$psf/Week
1	Los Angeles	5.20%	$2,840	$1.3
2	Moscow	5.00%	$2,270	$1.1
3	Dubai	4.60%	$1,110	$0.5
4	New York	4.30%	$4,260	$2.0
5	Miami	3.70%	$1,380	$0.6
6	Kuala Lumpur	3.60%	$450	$0.2
7	Barcelona	3.50%	$1,090	$0.4
8	Tokyo	3.40%	$2,650	$1.4
9	San Francisco	3.30%	$1,670	$0.8
10	Paris	3.30%	$1,860	$0.9

Graph sources: Bloomberg/BearBull Global Investments Savills

MACROECONOMIC SCENARIO

Emerging Markets

- Fears of a global recession persist
- Widespread drop in key rates for emerging economies
- Emerging equities corrected sharply over the third quarter (-4.16%)

Economic situation by country

Brazil—Since the last Monetary Policy Committee meeting, data on the Brazilian economy have been suggesting a gradual boost to the economic recovery. Globally, the implementation of further recovery measures in the big economies, alongside economic slowdown and under target inflation, has created a relatively favourable environment for emerging economies. Prospects remain uncertain, however, and there are still risks of a more pronounced slowdown in global growth.

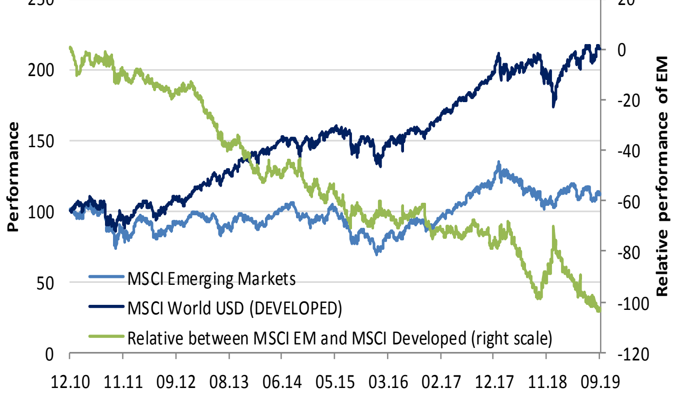
The Committee believes that the various components of underlying inflation are developing satisfactorily. This includes the most sensitive aspects of the economic cycle, as well as monetary policy. Inflation forecasts for 2019, 2020, 2021, and 2022 gathered by the Focus survey stand at around 3.5%, 3.8%, 3.75%, and 3.5% respectively.

Copom is seeing progress in the reform process and in the adjustments needed by the Brazilian economy, but it underscores the need to continue this effort in order to reduce its structural interest rate and ensure a lasting economic recovery. According to Copom's analysis, the way in which the benchmark scenario is developing, as well as the balance of risks, requires the degree of monetary stimulation to be adjusted, with a -0.50% drop in the Selic rate to 5.50%. The Committee believes that a consolidation of the scenario which favours any potential inflation would allow for extra adjustment to the degree of stimulation.

Russia—Annual growth rates for consumer prices dropped from 4.6% in July to 4.3% in August. According to Bank of Russia forecasts, most inflation indicators reflecting the longest term price movements are heading towards 4%. Temporary deflationary factors have also contributed to the slowdown in consumer price growth, in particular the seasonal change in the trend on fruit and vegetable prices due to the early harvests. The annual slowdown in inflation has also been influenced by the high base effect of the price trend for the main fuel types. Given the current inflation trend, the Bank of Russia has lowered its annual inflation forecast for the end of 2019 from 4.2%-4.7% to 4.0%-4.5%. According to Bank of Russia forecasts, and in light of the direction of monetary policy, annual inflation will stick close to 4% over the coming years.

The Russian economy's growth rate is still coming in under the Bank of Russia's expectations due to the contraction in demand for Russian exports because of the global economic slowdown, as well as weak investment activity, including in government investment spending. In July, industrial production continued its year-on-year growth, while leading indicators for July and August predict an economic slowdown for industry. Retail turnover growth is shrinking year-on-year due to the stagnation in real terms disposable household income. The labour market is unable to create any additional inflationary pressure. Indeed, the fact that unemployment has remained at its historically lowest ever level does not come from growing demand for jobs, but rather from a fall in the number of employees and the workforce. In the first half of the year, budgetary policy had a restrictive effect on economic activity, partially due to the slower than expected implementation of national projects planned by the government. More generous public spending, including on investment, in the second half of 2019 should boost the country's economic growth. In light of the weakness of economic activity since the start of the year, the Bank of Russia has dropped its GDP growth forecasts for 2019 from 1.0%-1.5% to 0.8%-1.3%. Russian economic growth rates for 2020-2021 have also been revised downwards given the expected slowdown in global growth. However, economic growth could head towards 2%-3% by 2022 if the measures taken by the government to overcome structural constraints are implemented.

On the 6th September 2019, the Board of Directors of the Bank of Russia decided to reduce its key rate by 25 basis points to 7.00% per year. If the situation develops in line with baseline forecasts, the Bank of Russia will analyse the need to drop key rates again at future meetings of the Board of Directors.



GDP Growth spread

GDP Growth spread (Emerging - Developed)

YoY %: 10, 8, 6, 4, 2, 0, -2

12.99 10.01 07.03 04.05 01.07 11.08 08.10 05.12 03.14 12.15 09.17 06.19

Graph sources: Bloomberg/BearBull Global Investments

India— Inflation's trajectory over the next four quarters is dependent on several factors. Firstly, the rise in inflation on food products could be propped up by the pressure on vegetable and pulse prices, as suggested by recent data. Unequal geographic and seasonal distribution of the monsoon could put upward pressure on the price of foodstuffs, although this risk should be mitigated by rainfall having recently caught up with forecasts. Secondly, despite surplus supply, crude oil prices may remain volatile due to geopolitical tensions, especially in the Middle East. Thirdly, inflation prospects measured by the CPI excluding food products and fuels remain low. Manufacturing businesses which took part in the survey on industrial prospects expect a drop in production prices in the second quarter. Fourthly, yearly inflation forecasts for households are modest. In light of all of these factors and the impact of recent reductions in key rates, inflation should settle at 3.1% for the second quarter 2019, 3.5%-3.7% for the end of the year, and 3.6% in the first quarter 2020.

Various economic indicators suggest a weakening of domestic and foreign demand conditions. The economic activity prospects index of the Reserve Bank of India is showing poor demand growth in the second quarter, although the fall in production prices bodes well for growth. The impact of easing monetary policy since February should also prop up economic activity over the coming months. Given these factors, real terms GDP growth should come in at 5.8%-6.6% in the first half of 2019, at 7.3%-7.5% at the end of the year, and 7.4% for the first quarter 2020.

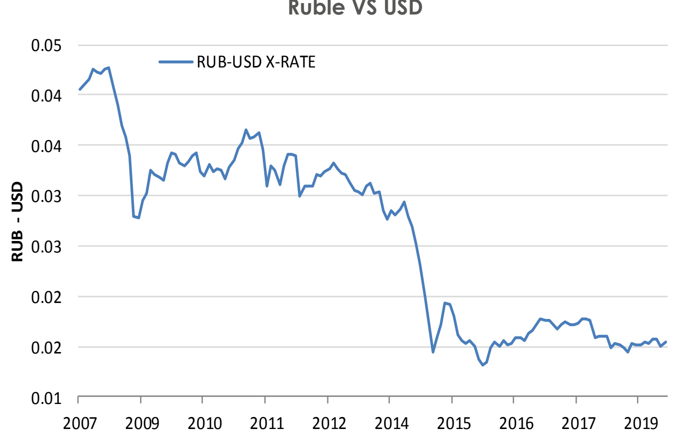
The Monetary Policy Committee believes that inflation should remain within the target bracket over the next twelve months. Since the last meeting, domestic economic activity has remained weak, given the global slowdown and the rise in trade tensions creating downward pressures. Private consumption, the backbone of global demand, and investment activity are still sluggish. Although effects of past rate drops are gradually being felt in the real economy, weak inflation prospects give a glimpse of additional measures from the Reserve Bank of India in order to reduce the negative trade balance. Responding to concerns regarding growth by stimulating overall demand, especially private investment, is the absolute priority at this stage, whilst remaining consistent with their mandate in terms of inflation.

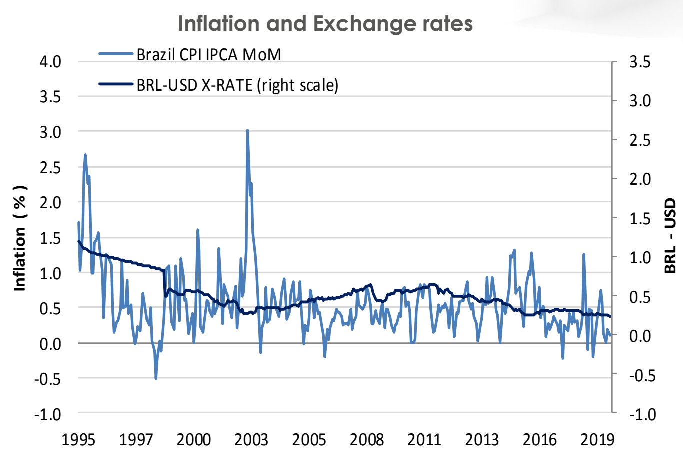
As such, all the members of the Monetary Policy Committee unanimously voted in favour of a reduction in policy REPO rates from 5.75% to 5.40%, and to maintain expansionary monetary policy. These decisions aim to achieve the medium term goal of 4% inflation, whilst supporting growth.

South Africa—Since the Monetary Policy Committee meting in July, economic indicators have confirmed that the global economic situation is weak and inflation low. The central banks of developed economies have proposed more monetary agreements, helping to ease global financial conditions. Developments in discussions on the trade war and geopolitical tensions remain negative risks. nflation prospects in the medium term are largely unchanged. The inflation forecast generated by the South African Reserve Bank's quarterly projection model predicts that global inflation should hit an average of 4.2% in 2019, instead of the previously forecast 4.4%. Whilst the 2020 forecast is unchanged at 5.1%, the forecast for 2021 has been increased slightly from 4.6% to 4.7%.

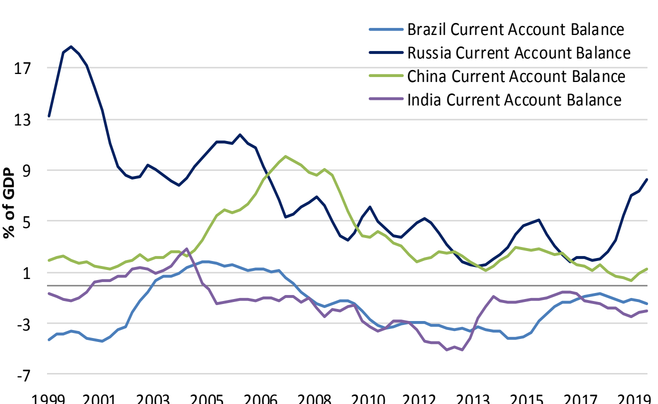
GDP leapt to 3.1% in the second quarter, after sliding -3.1% over the first quarter. This strong quarterly recovery was sparked by an improvement across nearly all sectors, including investment and government consumption spending. However, the long term weakness in most sectors is still of serious concern. Based on recent short term economic indicators for the mining and manufacturing sectors, GDP growth should stagnate in the third quarter. The GDP growth forecast for the end of 2019 is unchanged at 0.6%. Forecasts for 2020 and 2021 have been reduced to 1.5% (formerly 1.8%) and 1.8% (formerly 2.0%) respectively due to revisions to global growth and domestic growth potential.

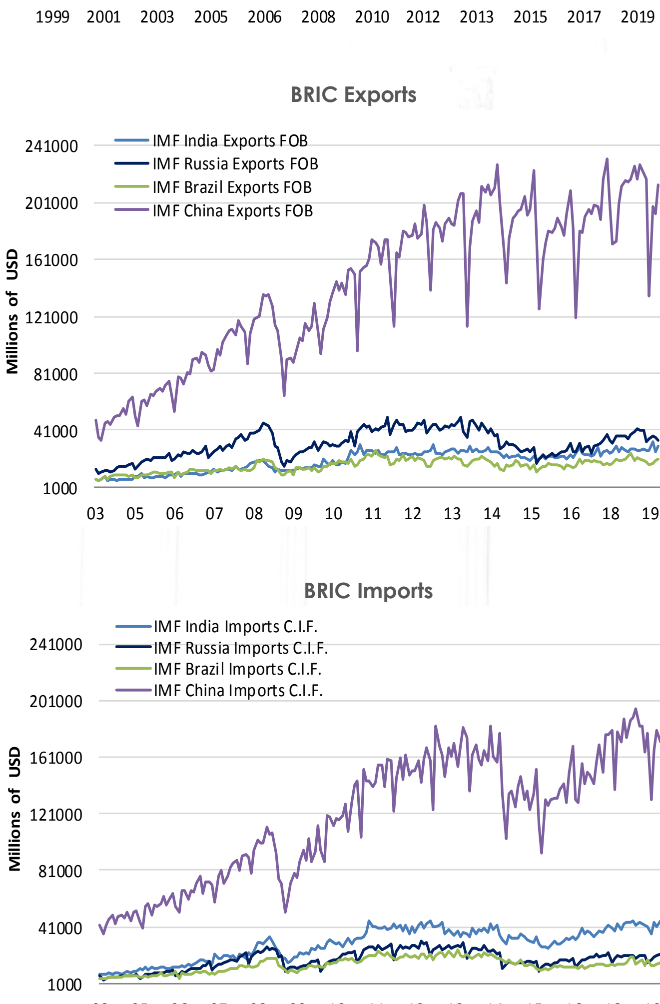
In this context, the Monetary Policy Committee unanimously decided to maintain its repo rate at 6.5% per annum. Monetary policy decisions still aim to pin inflation forecasts in the middle of the inflation target range, in order to ensure balanced, lasting growth.





Graph sources: Bloomberg/BearBull Global Investments





Colombia— As predicted, August inflation (3.75%) came in slightly under July's figures (3.79%). Shocks in terms of supply should start to fizzle out by the end of 2019, allowing inflation to carry on heading towards its target. New information on economic activity has led the technical experts at the Colombian Central Bank to revise its growth forecast for 2019 upward, moving from 3.0% to 3.2%. Unused economic capacity should gradually reduce. In this context, after having evaluated the economic situation and risk levels, the board of directors unanimously decided to leave the key interest rate at 4.25%.

Indonesia— In September, the Indonesian Central Bank set its benchmark rate back at 5.25%, the aim being to stimulate economic growth (+5.05%) in a context of forecasts of weak inflation of around 3%.

Mexico—The Mexican Central Bank once again dropped its key rate by 25 basis points to 7.75% at its September meeting. This is the second consecutive reduction this year, with inflation having slowed down over the past few months. It fell from 4.83% in December 2018 to 3.16% in August 2019, while economic growth slipped into negative ground (-0.8%) in the second quarter.

Taiwan—As expected, the Taiwanese Central Bank left its key rate at 1.375% in September. It dropped its 2019 inflation forecasts to 0.7%, due in particular to a slowdown in domestic inflation. Growth is now expected to come in at 2.40% at the end of the year, rather than 2.06% as previously forecast.

Turkey—The Turkish Central Bank dropped its one week REPO rate by 325 basis points to 16.50% at its September meeting, which was more than the market was expecting (250 basis points). This decision follows on from the previous 425 basis point drop in July, with inflation prospects continuing to improve in a context of moderate recovery of economic activity. As such, inflation dropped to 15% in August, and should head back to single figure growth in the coming months. The Turkish economy slid -1.5% year-on-year in the second quarter 2019, as compared to forecasts of -2%, and following on from a -2.4% contraction in the preceding quarter.

Romania, Czech Republic, Poland, Hungary—The National Bank of Romania kept its key rate at 2.5%, in line with market expectations. Inflation fell to its lowest point over the past four months at 3.8%, while the economy grew 4.4%.

The Czech National Bank left its key rate at 2% in September. Inflation stands at 2.9%, which is at the upper end of the 1%-3% target range, and economic growth (2.7%) has stayed at a similar level to the two preceding quarters.

The National Bank of Poland kept its benchmark rate at 1.5%. This follows a drop in inflation (2.8%), which is moving towards its 2.5% target. The Polish economy grew 4.5% in the second quarter 2019.

The Hungarian National Bank left its benchmark rate unchanged at 0.9% in September, while inflation slid from 3.3% to 3.1% and economic growth (4.9%) stuck close to 5%.

Graph sources: Bloomberg/BearBull Global Investments

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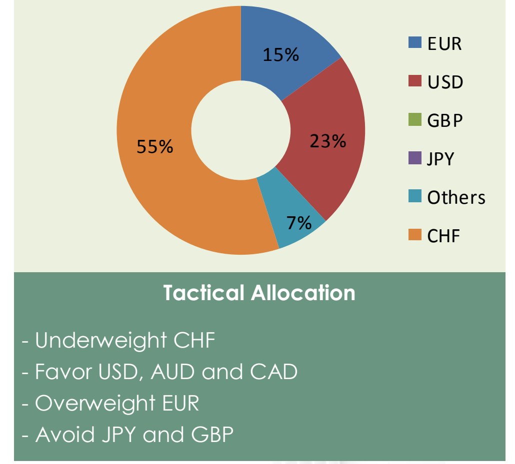
PROSPECTS AND STRATEGIES

Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

Currencies

- US fundamentals continue to favour an appreciation of the dollar
- The SNB does not seem concerned by the euro exchange rate
- The pound will not appreciate before a Brexit deal is on the table
- The BOJ unable to weaken the yen
- Yuan still under pressure in the absence of an agreement



LIQUIDITY/ CURRENCY	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
EUR vs CHF	↗	↗					■		
USD vs CHF	↗	↗					■		
GBP vs CHF	↘	↘			■				
JPY vs CHF	↘	↘			■				
EUR vs USD	↗	↗					■		
USD vs JPY	↗	↗					■		
GBP vs USD	↘	↘			■				

US fundamentals continue to favour an appreciation of the dollar

Since the SNB's decision to introduce negative interest rates, the Swiss franc has remained relatively stable against the US dollar, in spite of the numerous economic and political upheavals of the past five years. The exchange rate has stayed close to parity, occasionally slipping below 0.95 to the dollar for a few weeks or temporarily exceeding 1.03. We expect the recent +2% rise in Q3 to persist over the next few months due to fundamentals that seem to still be favouring the US currency, in spite of the frequently mentioned risks of recession in the US. Indeed, we do not share the view that the US economy is running out of steam and jeopardised by the Fed's short-sighted monetary policy and the detrimental impact on growth of a lack of trade deal. While it is certainly true that uncertainty has been lingering for months, affecting economic sentiment, we do not anticipate that this will have enough of an effect on US economic momentum to plunge the economy into a consequently unlikely recession.

This uncertainty is not confined to the US but is in fact affecting most economies. Fears regarding the risks of recession are widespread across markets, which have seen the same effects on interest rates. These risks already felt irrational and excessive initially, but after several quarters of generalised decline in long-term rates, negative real yields, and ultimately relatively significant action by the Fed, we consider the likelihood of an impending recession to be quite low. The US economy still seems to us the best equipped, at the start of Q4, to sustain a growth rate of close to +2% over the next quarters. Thus, interest rate and GDP growth differentials strongly favouring the dollar have not triggered any substantial appreciation of the US currency against the Swiss franc. In the medium term the CHF/USD exchange rate is likely to remain within the mentioned fluctuation range. We believe that the next few months will likely be characterised by a new phase of widening yield spreads on long-term rates in particular, which will likely increase the attractiveness of the dollar and push the exchange rate above parity towards the high end of its fluctuation band over the past five years, namely between 1.03 and 1.05 CHF to the dollar.

The SNB does not seem concerned by the euro exchange rate

With regard to the euro, the problem is different, in particular because the yield gap between rates in euros and in Swiss francs is not that significant and the trend over the last few months does not point to the same sort of trend we are expecting with respect to the US dollar. The yield gap that the SNB had hoped to create and maintain to weaken the Swiss franc is increasingly under attack due to the necessary decline of the ECB's rates. The gap had stabilised at about 60 basis points in early 2018 as the exchange rate was rising to 1.20, but it then dropped steadily, falling beneath 22 basis points in the last few weeks. Due to the euro area's sluggish economy and accommodative monetary policies, it is difficult to imagine a rise of the euro against the Swiss franc in the short term. For such an appreciation to happen, a significant and long-lasting European economic recovery will have to occur or at the very least be anticipated with enough credibility. We believe that any future weakening of the franc will depend on the relative economic performance and the interest rate differential between the Swiss franc and the euro. We still believe that the SNB will not raise its key rates as fast as the ECB, which today seems very unlikely to happen in the near future. The surprise may however come from a decision to further reduce the SNB's discount rate by 25 basis points, which we do not believe is necessary given the current relative stability of foreign reserves over the last 24 months (767.1 billion). The euro/Swiss franc exchange rate is likely to stabilise after losing about -5% in the last four months, which were marked by somewhat irrational expectations, in our mind, of a recession in the US and of a marked global economic slowdown. A return to 'reason' is likely to quickly have a positive impact on exchange rates and to take a little pressure off the Swiss franc.

Graph sources: Bloomberg/BearBull Global Investments

The pound will not appreciate before a Brexit deal is on the table

Following a negative second quarter, the pound closed out Q3 relatively unchanged against the Swiss franc. This apparent stability hides a more volatile reality, as the pound experienced two episodes of extreme volatility over the past months, first dropping by -6%, then completely making up lost ground at the end of the period. The pound remains strongly impacted by the complex political situation that will determine whether Brexit will be brutal or whether a negotiated solution will help manage or limit the effects of a withdrawal from the EU. The latest development regarding this political impasse is the Supreme Court's decision to rule unlawful Prime Minister Boris Johnson's attempt to suspend Parliament. This decision could well push Boris Johnson to call for new elections, generating further uncertainty. In this context, we maintain a cautious stance with regard to the pound. We had predicted that the pound would likely drop below its December 2018 level of 1.25 against the dollar, and indeed the pound reached a short-term low of just under 1.20. However, we believe that there is a higher probability that the pound will stabilise above 1.24 if the likelihood of a no-deal scenario recedes once Parliament reconvenes on Wednesday, 25 September.

The BOJ unable to weaken the yen

Negative nominal yen interest rates (-0.1%) remain unattractive overall by global comparison, and more specifically compared with US dollar rates still close to 2%. This nominal rate differential could seem favourable to the dollar, but due to lower inflation (0.5%) in Japan and steeper declines in rates in the US, real dollar yields have fallen faster than real yen yields, which have remained more stable. This real yield differential is thus likely one of the main factors explaining movements in the yen/US dollar exchange rate over the past few months, and this differential is thus currently not a negative factor for the yen. The BOJ would obviously prefer real yen yields to be lower, but in that regard the only factor likely to have an impact would be an upswing in price indices, as a large cut in policy rates does not seem to be a serious option. Thus the BOJ's only choice is to opt for patience, waiting for external factors such as an upturn in inflation or in long-term rates in the US to take shape, changing valuation parameters such that the yen may depreciate. We are not changing our outlook for the yen, which remains fundamentally bearish for 2019. A weak yen remains a necessary condition in terms of boosting economic activity and inflation in Japan. The stability of the yen against the US dollar (-1.3%) since the beginning of the year will likely be followed by a decline of the yen.

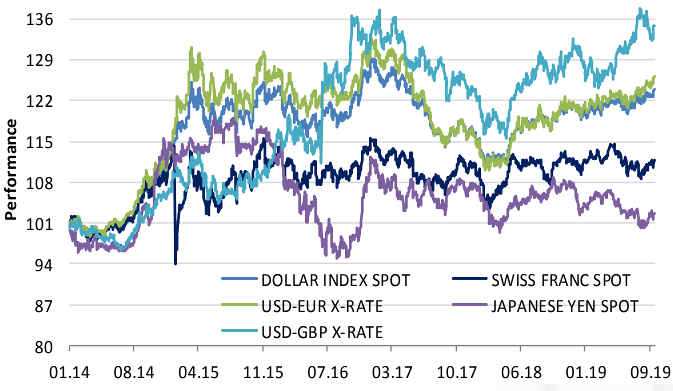
Yuan still under pressure in the absence of an agreement

Talks between Chinese and American negotiators are expected to resume in October, but the likelihood that tangible progress will be made that would herald an agreement in the near future seems low. Nevertheless, curbing trends prevailing in the foreign exchange market over the past three months will require the presence of more positive factors. Indeed, last quarter was among the yuan's worst due to the difficulties faced by Chinese negotiators in trade and tariff talks with the US. For the first time since the financial crisis, the exchange rate fell below 7 yuan to the dollar, losing -3.6% of its value against the US currency. The yuan is also expected to experience a rough start to the fourth quarter following comments by the US president, who is contemplating restricting investments by US firms and investors in China.

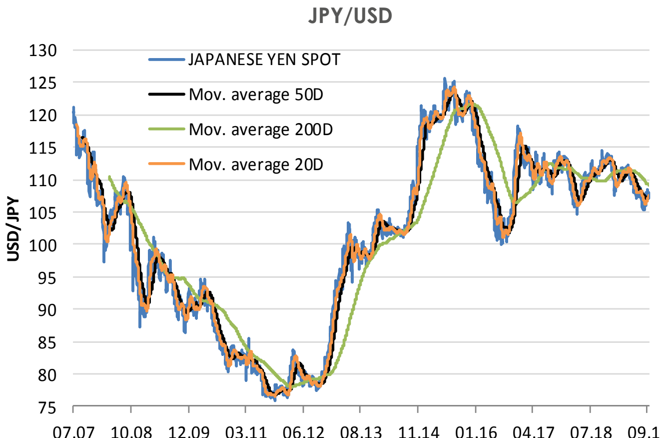
7 currencies against CHF (Normalized at 100)

USD-CHF X-RATE | EUR-CHF X-RATE | GBP-CHF X-RATE | CAD-CHF X-RATE | JPY-CHF X-RATE (x100) | AUD-CHF X-RATE | CNY-CHF X-RATE

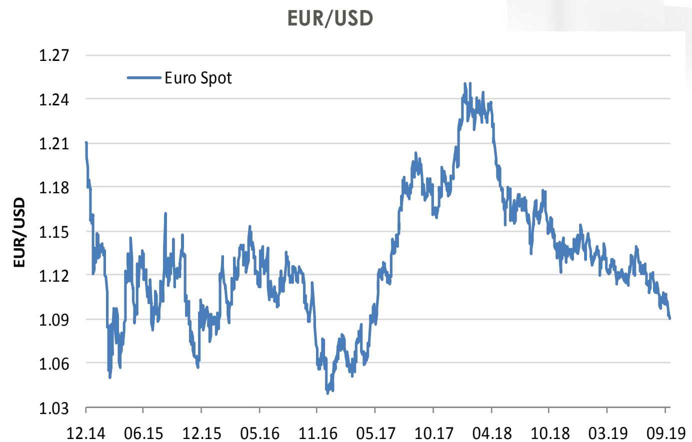
Dollar Trade-weighted index & cross rates (Normalized at 100)



JPY/USD



EUR/USD



Graph sources: Bloomberg/BearBull Global Investments

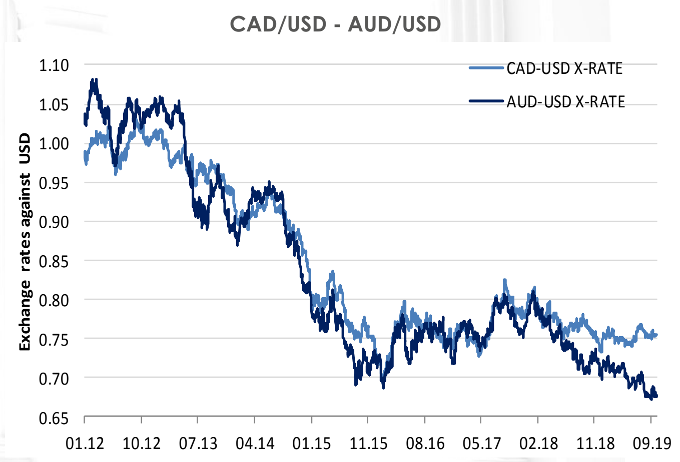
CURRENCIES

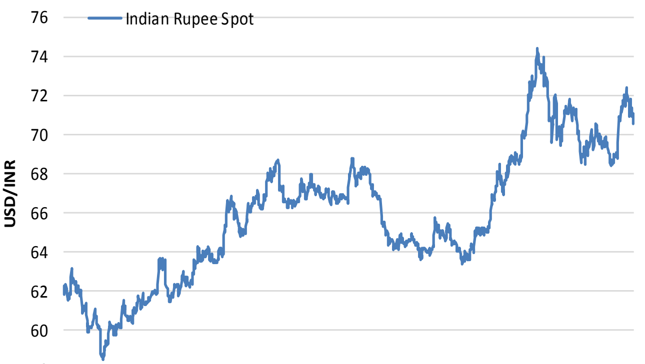
30.09.2019

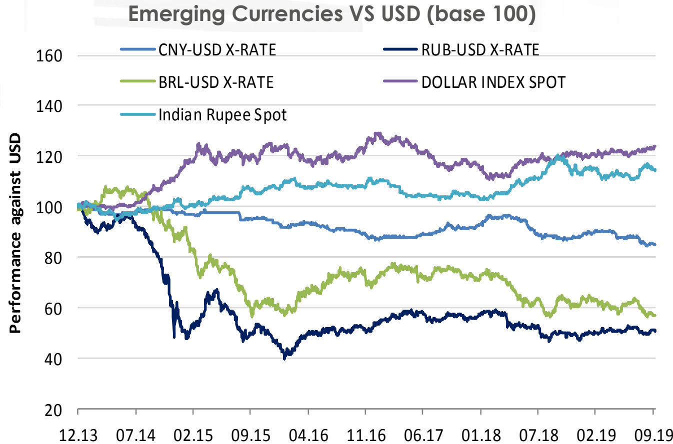
Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
AGAINST DOLLAR						
EUR-USD X-RATE	1.1	-0.9	-0.8	-3.4	-3.0	-5.0
CHF-USD X-RATE	1.0	-0.8	-0.8	-1.2	0.0	-1.6
GBP-USD X-RATE	1.2	-1.1	1.1	-2.4	-6.6	-3.6
JPY-USD X-RATE	0.0	-0.5	-1.7	-0.2	3.2	1.4
CAD-USD X-RATE	0.8	0.2	0.5	-1.0	0.8	3.0
AUD-USD X-RATE	0.7	-0.3	0.3	-3.5	-5.1	-4.2
RUB-USD X-RATE	0.0	-1.3	2.9	-2.4	0.6	6.7
CNY-USD X-RATE	0.1	-0.4	0.1	-3.9	-6.1	-3.8
INR-USD X-RATE	0.0	0.2	1.5	-2.6	-3.1	-1.5
BRL-USD X-RATE	0.2	0.2	-0.3	-7.5	-6.9	-6.6
AGAINST SWISS FRANC						
USD-CHF X-RATE	1.0	0.8	0.7	1.2	-0.1	1.6
EUR-CHF X-RATE	1.1	-0.1	-0.1	-2.3	-3.0	-3.4
GBP-CHF X-RATE	1.2	-0.3	1.9	-1.2	-6.6	-2.0
JPY-CHF X-RATE (x100)	0.9	0.3	-0.9	1.0	3.1	3.0
CAD-CHF X-RATE	0.8	1.0	1.3	0.1	0.7	4.6
AUD-CHF X-RATE	0.7	0.4	1.0	-2.4	-5.2	-3.0
RUB-CHF X-RATE	0.0	-0.5	3.7	-1.2	0.6	8.5
CNY-CHF X-RATE	0.1	0.4	0.9	-2.7	-6.1	-2.2
INR-CHF X-RATE	0.0	0.7	2.2	-1.4	-3.4	0.0
BRL-CHF X-RATE	0.2	0.8	0.4	-6.3	-7.0	-5.1

EUR/CHF - USD/CHF

EUR-CHF X-RATE (left scale)
USD-CHF X-RATE (right scale)





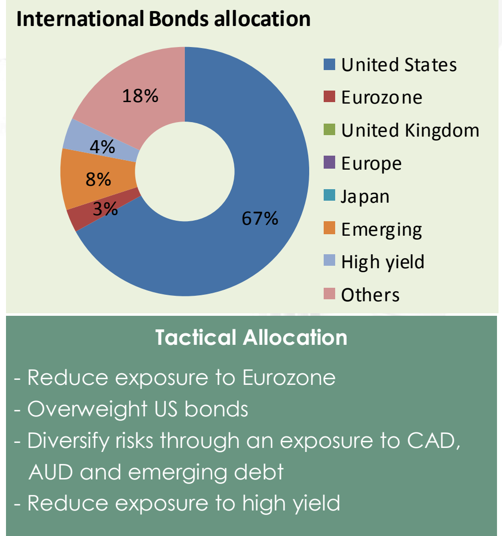


Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

International Bonds

- Yield curve returning to normal in the US
- US dollar long-term rates on the rise
- Risks of recession already factored into euro capital markets
- Regional and currency allocation shifting to US dollar markets



BONDS (Areas/currency)	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Switzerland	↘	↘↘	■						
United States	↘	↘					■		
Eurozone	↘	↘↘		■					
UK	↘	↘	■						
Europe	↘	↘↘		■					
Japan	↘	↘	■						
Emerging	↘	↘		■					
Other (AUD, CAD, NOK...)	→	→					■		

Yield curve returning to normal in the US

An inversion in the yield curve has been historically triggered by the excessive and inappropriate tightening of monetary policy and indeed often been followed by a recession. In these cases, the inversion in the yield curve was due to an increase in short-term rates (central bank key rates) corresponding to the implementation of restrictive monetary policies aimed at fighting excessive inflation and slowing down the business cycle. Volatility in short-term rates is usually more significant that in long-term rates, in particular because of central banks actively seeking to manage inflation. Monetary policy thus would lead to a rebound in short-term rates that eventually exceed the level of long-term rates to fight inflation. A "classic" inversion of the yield curve thus follows this logic, often exceeding the economic slowdown objective by ultimately triggering a usually short-term recession.

In such a case, it is indeed appropriate to fear a recession. However, the current situation in the US of the inversion of the yield curve has not been triggered by an excessive increase in key rates beyond the equilibrium level of long-term rates. The opposite phenomenon has taken place. The Federal Reserve's normalisation policy was rather progressive and measured in an environment where an increase in price indices was completely expected and moderate. A sharp fall in long rates is actually at the root of this phenomenon in 2019. Hence, the inversion of the yield curve cannot be interpreted in the same way and have the same predictive power of a future recession as it may often have had in the past in different situations. Ultimately, it is the expectations of a recession relating to the US-China crisis that triggered an inflow of capital into bond markets, thus causing long-term yields to fall below short-term interest rates.
The yield curve may already be returning to normal following the Fed's rate cut and the upswing in long-term rates in the first weeks of September. The risks of recession are still overblown currently and will likely be reconsidered over the next few weeks in light of the actual performance of the US economy. Indeed, US growth is neither weak nor concerning, quite the contrary, in view of the results published over the past several months, which have generally beat the consensus forecast.

US dollar long-term rates on the rise

With the last two rate cuts, the yield curve is normalising as short-term rates decrease. It is not clear that the curve will continue to adjust, however, as the likelihood of a third cut in October has decreased to only 50%. While the Fed may cut rates a third time preventively to reassure markets once and for all if needed, it would also likely do so this time to try to push inflation above its 2% target.

Real interest rates are already negative, increasing the odds of an economic upswing in the next few quarters. In this event, the flattening of the short end of the yield curve will be followed by a gradual upwards shock in the rest of the yield curve. Indeed, economic surprises have been positive on average in the US recently, shedding intriguing light on the current situation and confirming, in our view, that figures published in September were stronger than expected. However, this trend, in place since July, has not yet changed market expectations. Both the risks of recession, which have increasingly been taken into account, and the downward revisions of economic expectations have been overestimated, as shown by better-than-expected actual results. In other words, figures published over the past three months have contradicted investors' negative expectations, which will have to shift to factor this in. While the yield curve initially normalised via benchmark rate cuts, further normalisation will have to derive from a generalised decline in the remainder of the yield curve, namely at the long end.

BOND INDICES (local currency)

30.09.2019 — Total Return Performance

	Name	Last price	Curr.	7 d%	1 m %	3 m %	6 m %	YTD %
SWISS BONDS	SBI AAA-BBB	143.2	CHF	-0.3	-1.7	1.4	3.3	4.9
UE BONDS	Barclays EuroAgg	270.7	EUR	0.0	-0.5	2.4	6.1	8.4
UE BONDS - SHORT DURATION	ISHARES EURO GOV BND 1-3	144.9	EUR	0.0	-0.1	0.2	0.5	0.6
US BONDS	JPM U.S. Aggregate Bond Index	688.9	USD	0.2	-0.6	2.2	6.2	9.0
US BONDS - SHORT DURATION	BGF-USD ST DURATN BOND-USDA1	8.5	USD	0.3	-0.1	0.7	2.1	3.9
EMERGING BONDS	JPMorgan Emerging Markets Bond	595.0	USD	-0.7	-0.6	0.9	5.8	13.7
INTERNATIONAL BONDS (DIVERSIFIED) - USD	JPM Global Aggregate Bond Index	604.1	USD	-0.2	-1.0	1.2	5.1	7.1
INTERNATIONAL BONDS (DIVERSIFIED) - EUR	JPM Global Aggregate Bond Index	727.6	EUR	0.6	0.0	4.8	8.2	12.3
INTERNATIONAL BONDS (DIVERSIFIED) - CHF	Barclays Global Agg Corporate	156.6	CHF	0.6	0.0	2.2	5.5	10.8
CONVERTIBLE BONDS (UE)	Exane Europe Convertible Bond	8070.3	EUR	0.3	0.2	1.6	2.7	9.8
HIGH YIELD BONDS	Markit iBxx Gbl Dev Lq HY USD	150.6	USD	-0.7	-0.3	-0.4	1.7	8.2
HIGH YIELD BONDS - SHORT DURATION	AB SHORT DURATION HI YD-AT	14.8	USD	-0.5	0.0	0.5	2.5	8.0

1) Short & Medium-term (1-5 years)
2) Emerging Bonds (Corporate)
3) Emerging Bonds - Eastern Europe

Risks of recession already factored into euro capital markets

Inflation has recently strayed a little further from the European Central Bank's target according to all established measures. The CPI excluding food and energy for the Eurozone fell to 0.9%, i.e. a little below the average for the last three years, while the global index dropped from 2.3% in October 2018 to 1% in August, its lowest point since January 2017. As for producer prices, the PPI's drop to 0.2% is even more pronounced and is no great comfort to the ECB. Recent development in capital markets have thus caused real yields on twelve-month maturities to drop slightly further, reaching -1.3% at the end of August, quite clearly below real yields of -0.1% in 2016. With the drop in ten-year rates to -0.7% at the end of August and inflation at 0.9%, real yields could fall even farther to close to -1.6%. Moreover, the fall in real yields in euros is a particularly positive factor for future European growth. The cost of financing investment, consumer credit and mortgage financing is thus very clearly negative and will likely boost demand in the next quarters.

Anxiety increased in August in capital markets, which have all been rather significantly affected by the same probably unfounded expectations regarding the future of the global economy. Months have thus gone by since September 2018, and fears of a recession have not been quelled despite steadily improving economic statistics, in the US in particular, and preventive monetary policy actions meant to reassure markets. Firstly, long-term interest rates have dropped in the US, dragging in their wake most rate markets and especially Europe's ten-year rates. In this specific case, falling euro rates are clearly more justified due to the real risks of recession in Germany. In this environment, we have seen a truly exceptional flattening of the euro yield curve with negative absolute and real yields on all maturities of less than 25 years. Euro capital markets have thus already factored in the recession risks in Germany and positioned themselves to benefit from the ECB's future European debt purchases.

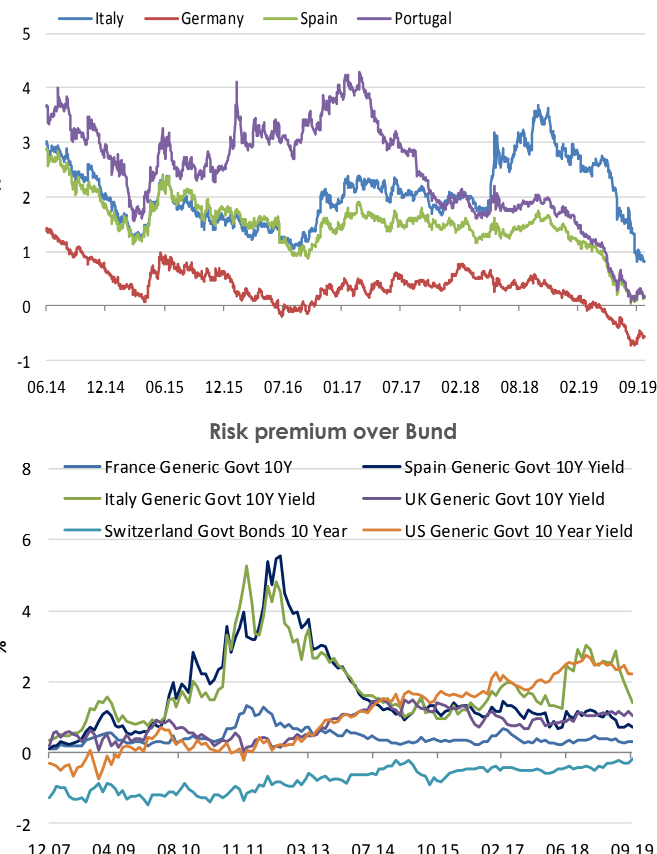
Decrease in the attractiveness of the UK bond market

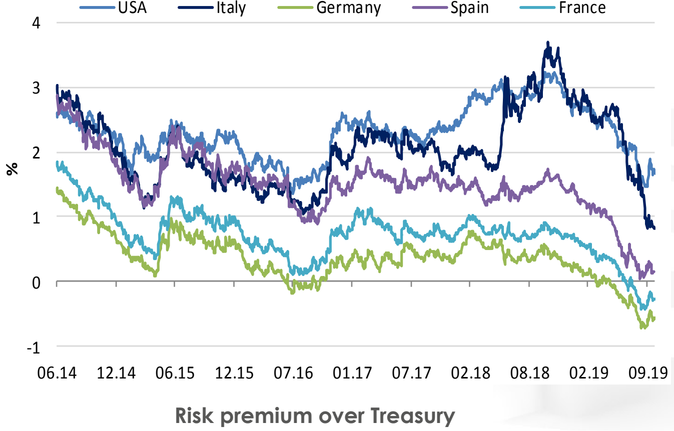
The drop in long-term interest rates in the UK has been particularly severe over the past several months. The fall from 1.6% in September 2018 to only 0.4% at the end of August 2019 took place in the context of generalised fear around the world regarding US and global growth. It was exacerbated by economic conditions within the UK and increasingly high risks of recession in the country. The uncertainty tied to the absence of a solution to the Brexit conundrum and the risk of a genuine collapse of economic activity in the event of a no-deal withdrawal thus pushed long-term rates below the lows reached just after the 2016 referendum. Pound-denominated capital markets are not attractive in the current context marked by political risks that are difficult to evaluate. A no-deal exit would plunge the UK into a unique situation with unpredictable consequences. The BOE would be forced to act to attempt to tamp down, if at all possible, the risks of a recession, whose magnitude and duration are obviously not easy to estimate. The likely outcome for the British currency would initially be negative.

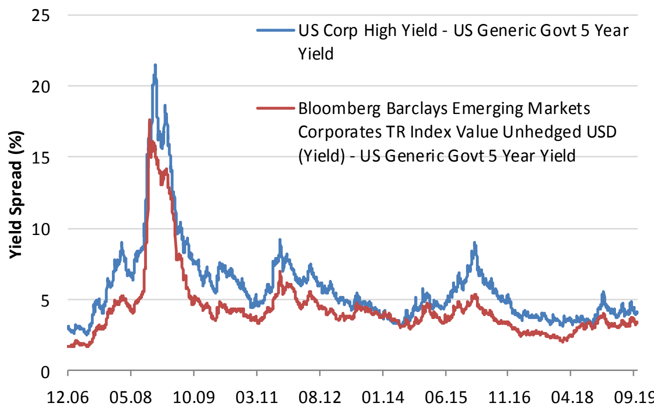
Thus, the risk of holding pound-denominated bonds seems high given the significant FX losses that would ensue. If on the other hand an agreement became possible, the risks of recession would abate, and long-term rates would then likely gradually rise and the pound may stabilise. Given the uncertain context, we recommend that international investors avoid any exposure to pound-denominated capital markets and take positions in other bond segments.

Avoid Japanese equities

Long-term rates in yen followed international trends, slipping from +0.15% in October 2018 to close to -0.3% in August. Prices indices are moving away from the BOJ's inflation target, with the CPI down to 0.5% and the PPI to -0.9%. The current context is not favourable to the bond market, which still fails to offer attractive prospects to foreign investors in terms of yields, while the risk of incurring capital and FX losses over the long run is significant.







Graph sources: Bloomberg/BearBull Global Investments

Beware of "high yield" bond valuations

Beware non-investment grade high-yield bonds, which benefited substantially from decreasing rates last quarter. Indices grew significantly once again, as investors seeking returns have been willing to take more risks to reach their objectives. While risk premiums on these investments have declined further, high yield still offers superior and attractive returns on a relative basis and will remain sought after by investors looking for yield pick-up in spite of compressed yield differentials.

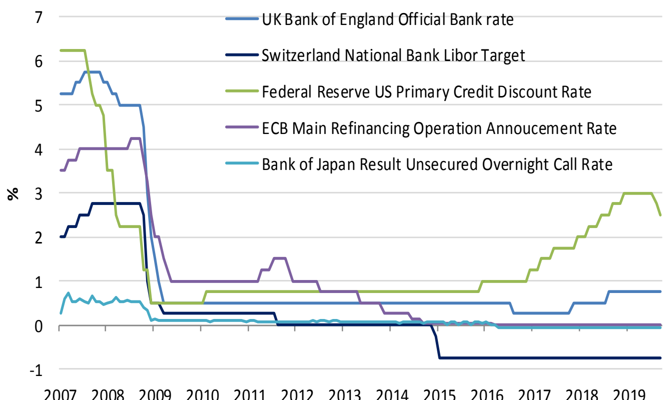
However, an improving economic outlook will have a significant impact on these assets, as they start to see competition from improving yields on investment grade issuance. Returns offered by non-investment grade debt will have to more clearly exceed those offered by investment grade bonds.

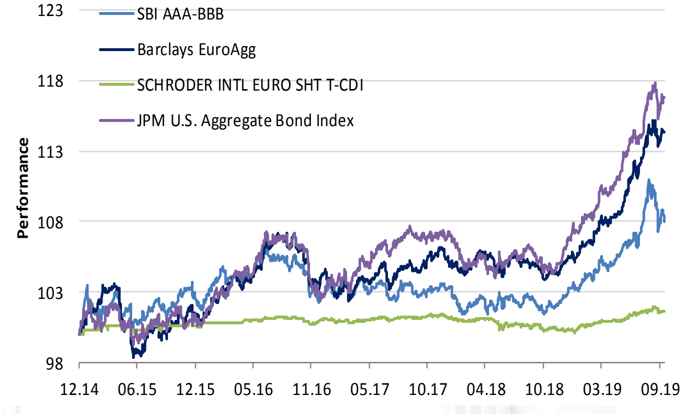
Regional and currency allocation shifting to US dollar markets

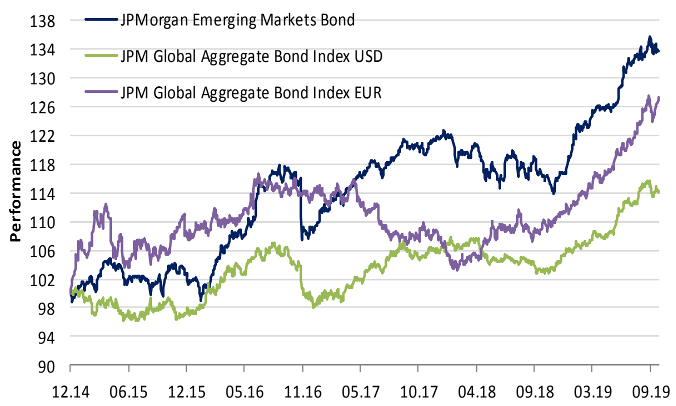
Bond yields have decreased across the board, but dollar yields currently offer among the rare opportunities to invest liquidity with a reasonably positive return at various maturities. Ten-year US government yields in particular are higher than those offered by other markets, such as the Canadian (1.38%) or Australian dollars (1%), which currently offer yields well below US Treasuries (1.7%).

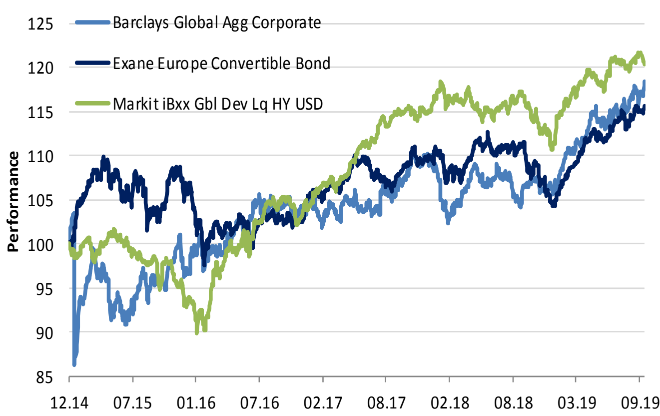
Euro government yields are negative or close to zero depending on the issuer, offering little of interest to investors, as is the case for Swiss or Japanese government debt.

In our tactical international bond allocation, we are overweight interest rate markets offering positive yields, with limited currency risk and interest rates that may offset the risk of a potential increase in market rates. At this stage in the business and financial cycles, we are overweight short maturities, as well as developed country investment grade issuers.







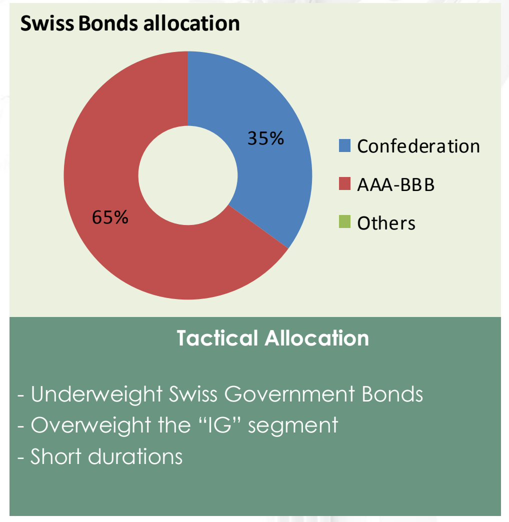


Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

Swiss Bonds

- Swiss long-term interest rates are sinking into unknown territory
- No benchmark rate cut following the ECB's decision
- Negative real yields favourable to growth in Switzerland



BONDS Type of Debtor	Expected Return 3months	1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Governement	↘	↘							
Corporate (IG)	↘	↘							
Others	↘	↘							

Swiss long-term interest rates are sinking into unknown territory

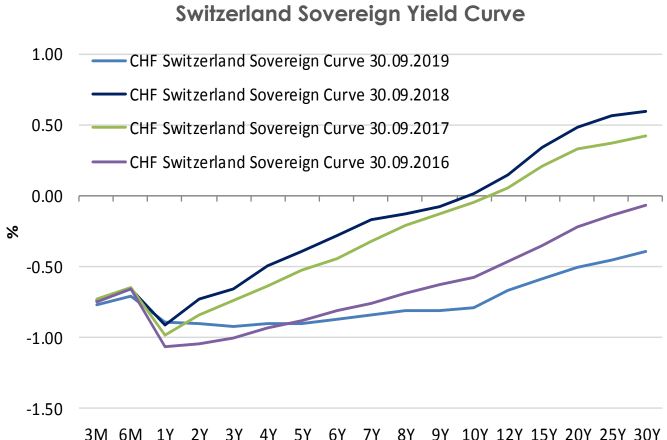
The generalised decrease in yields, which accelerated further in August, also impacted Swiss capital markets. Rate markets manifestly cannot be convinced that the global economy is not headed for recession. Switzerland followed the same path, in spite of positive economic conditions, with the decline in Swiss franc interest rates accelerating in August as well. Ten-year Swiss government yields thus reached a new historic low of -1.12%, completely offsetting the normalisation they had undergone since summer 2016. Yet this fall in yields is completely irrational given the state of the domestic economy. There are international risks, however, in particular close by, given the challenges faced by the German economy. Nevertheless, the risks of recession in Switzerland are not significant enough to warrant such a considerable decline in yields. This exaggerated drop in long-term rates will likely be followed by a significant rebound as soon as the risks of recession are viewed more rationally. Swiss long-term rates have thus fallen in concert with international yields driven by fears of a slowdown or even a recession. Swiss bonds progressed by +1.60% over the quarter, for a year-to-date increase of +4.87, below the performance of international bonds (+7.08%), but up significantly in spite of solid economic growth which does not warrant such behaviour. Swiss GDP should still expand by +1.3% in 2019, thanks to robust consumption. Domestic demand will likely continue to trend up, with consumption strengthening at the end of the year. Our outlook for the remainder of the year remains positive, even though leading indicators continue to waver. Recall, however, that the downward trend in leading indicators, which have been declining for over 21 months, has not been followed by a slowdown in Swiss growth. The recent stabilisation of leading indicators in a context of rising exports and industrial output is a positive sign.

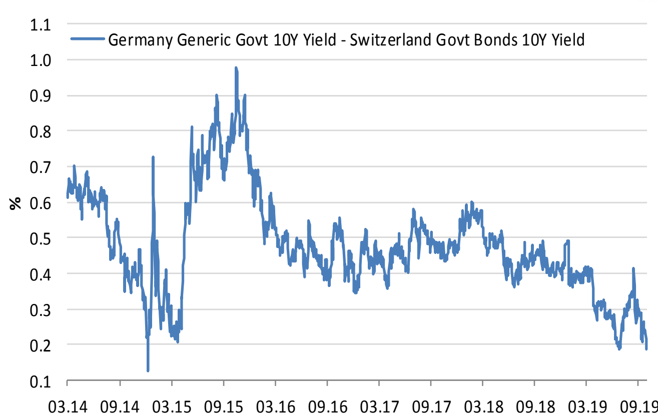
No benchmark rate cut following the ECB's decision

Prior to the ECB's shift in monetary policy whereby it cut benchmark rates by -0.1% in September, we estimated the risks of further rate cuts in Switzerland to be limited. Indeed, the SNB decided to keep its monetary policy unchanged, maintaining its benchmark rate at -0.75%. We still believe that the SNB will not raise its key rates as fast as the ECB, which today seems very unlikely in the near future. The surprise may however come from a decision to further reduce the SNB's discount rate by 25 basis points, which we do not believe is necessary in the current context of relative stability of foreign reserves in the last twenty-four months.

Negative real yields favourable to growth in Switzerland

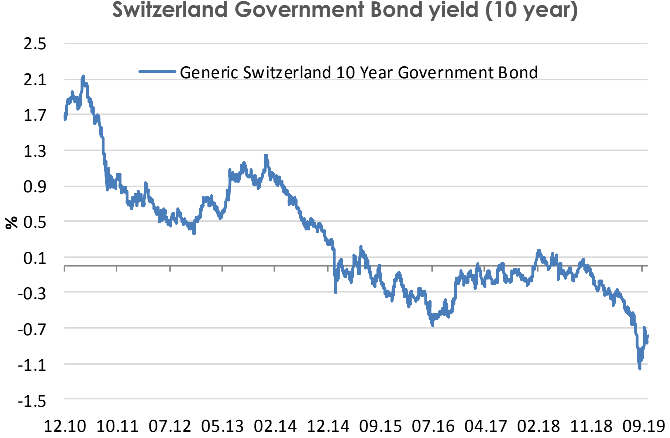
As previously noted, though even more obvious today following the decrease in nominal rates to -1.12%, real yields adjusted for an inflation rate of 0.5% (yoy, harmonised across the EU) seem to have fallen to -1.62%. In the short term, borrowing costs based on a 12-month LIBOR rate of -0.6% would thus be a significantly negative -1.1%. Negative real rates support economic growth, in particular by boosting consumption and investment. A prolonged period of negative real rates typically heralds an economic upswing.





Graph sources: Bloomberg/BearBull Global Investments

Switzerland Government Bond yield (10 year)



Switzerland Government Bond yield (10 year) since 1924

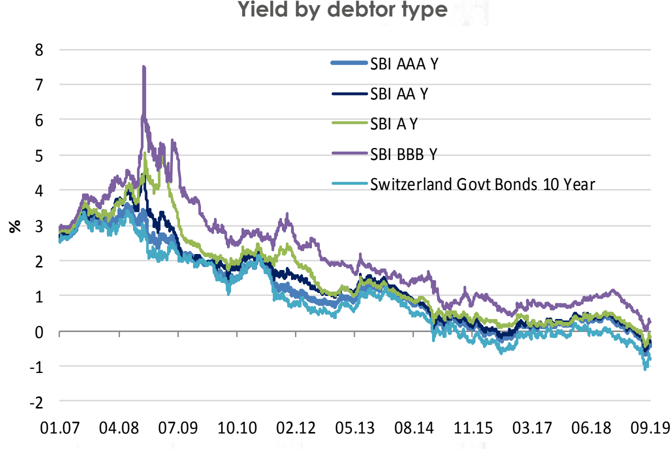
Switzerland Govt Bonds 10 Year Note Generic Bid Yield

%

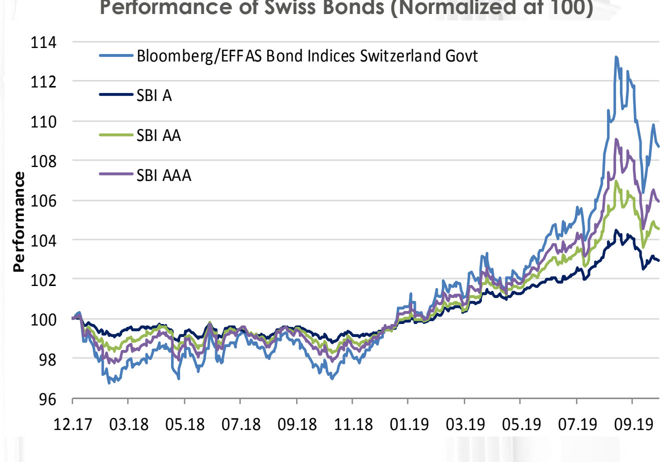
9 8 7 6 5 4 3 2 1 -1 -2

1924 1933 1943 1952 1962 1971 1981 1990 2000 2009 2019

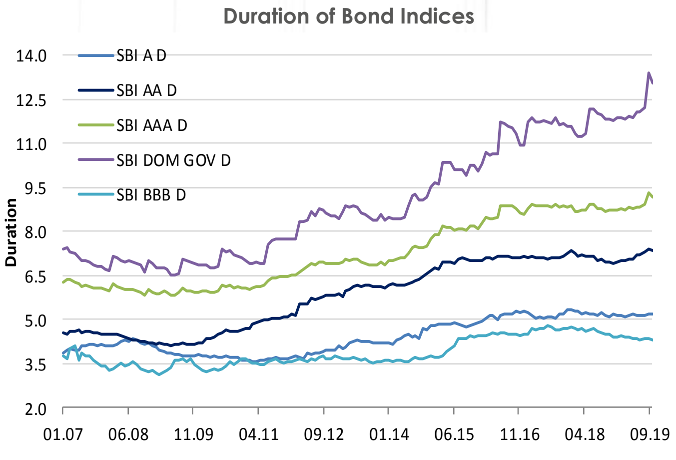
Yield by debtor type



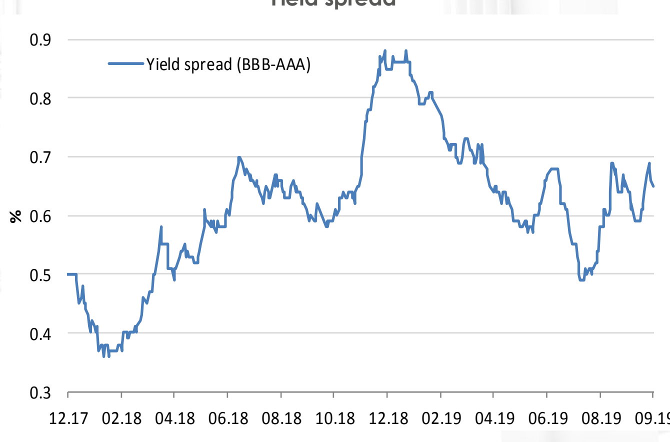
Performance of Swiss Bonds (Normalized at 100)



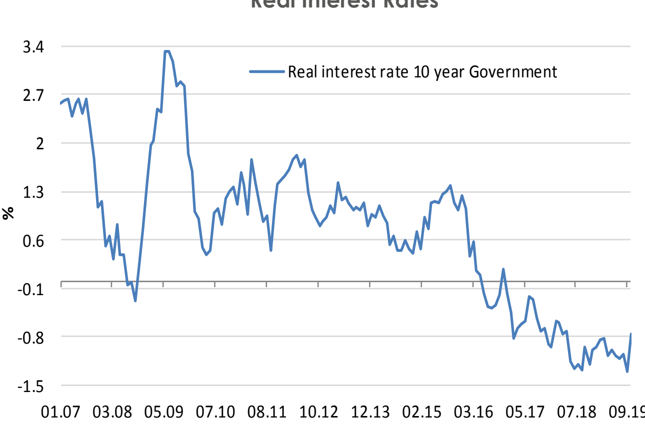
Duration of Bond Indices



Yield spread



Real Interest Rates



SWISS BOND INDICES (CHF)

30.09.2019 — Total Return Performance

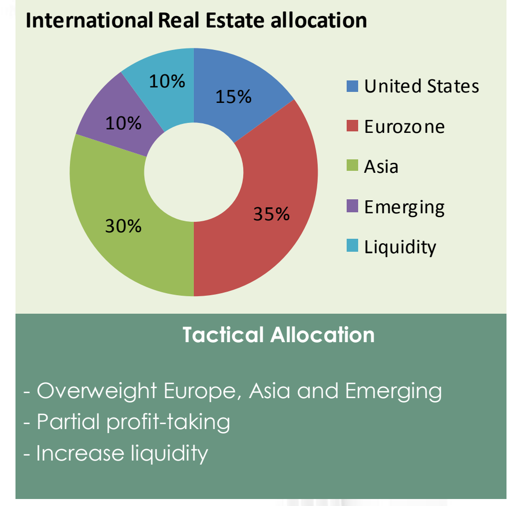
	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
Bloomberg Barclays Series-E Switzerland Govt All > 1 Yr Bond Index	284.1	CHF	-0.7	-3.0	3.4	6.6	8.7
SBI A-BBB	140.6	CHF	-0.1	-1.1	0.6	2.0	3.2
SBI AA-BBB	139.9	CHF	-0.2	-1.3	0.9	2.4	3.8
SBI AAA-AA	143.5	CHF	-0.4	-1.9	1.7	3.7	5.5
SBI BBB	153.0	CHF	-0.1	-0.9	0.7	2.2	3.6
SBI AAA-BBB	143.2	CHF	-0.3	-1.7	1.4	3.3	4.9
SBI DOM GOV AAA-BBB 1-3P	67.5	CHF	-0.1	-0.7	-0.8	-1.2	-4.7
SBI DOM GOV AAA-BBB 3-7P	87.4	CHF	-0.2	-1.3	-0.5	-0.2	-2.3
SBI DOM GOV AAA-BBB 7+ P	141.7	CHF	-1.0	-4.0	4.8	8.9	9.9

Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

International Real Estate

- Significant outperformance of developed markets
- Positive 'rate effect' running out of steam
- Monetary policy and long-term interest rates
- Conditions finally more favourable to emerging markets
- Direct real estate prices continue to rise



Tactical Allocation

- Overweight Europe, Asia and Emerging
- Partial profit-taking
- Increase liquidity

REAL ESTATE Areas	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Switzerland	→	↗							
United States	→	↗							
Eurozone	→	↗↗							
United Kingdom	↘	↘							
Asia	↗	↗↗							
Emergents	↗	↗↗							
Liquidity									

Significant outperformance of developed markets

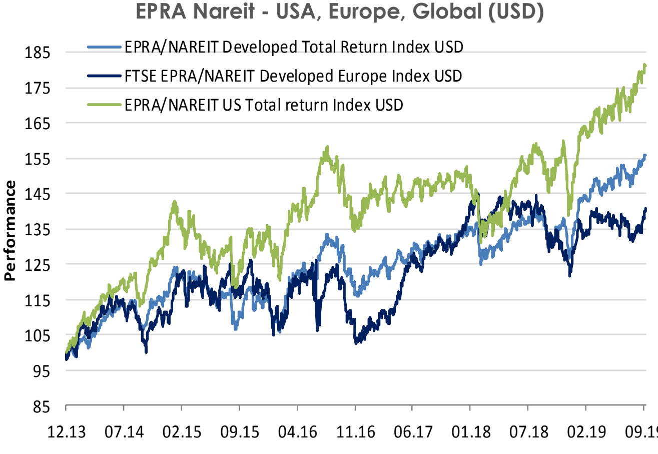
International securitised real estate investments continued to rise in Q3, posting an overall progression of +3.2%, or +18.6% year-to-date, favourably impacted in particular by the generalised decline in interest rates, which accelerated in August. Developed markets were the most significantly impacted by this decline, which provided a similar opportunity for price increases In the US, Europe, and the UK. Securitised real estate prices in these three regions thus grew by +7.58%, +7.49% and +6.43%, respectively, over three months, with half of the increases occurring mainly in September. Asia and emerging markets could also have benefited from the 'rate effect', as benchmark rates also decreased in most of these countries, but the risks of recession likely had a more significant impact there, ultimately driving valuations down. Over the quarter, listed real estate contracted slightly (-0.59%) in Asia and more significantly (-4.1%) in emerging markets. The underperformance of these two regions over the past three months relegated them to the bottom of the real estate performance ranking for the period.

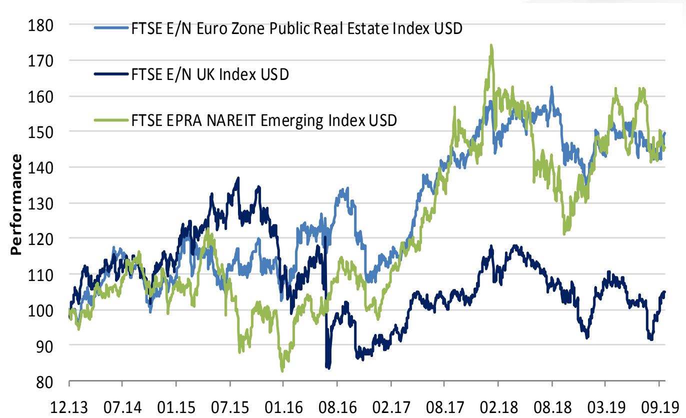
Positive 'rate effect' running out of steam

The positive performance of securitised real estate over the past few months has hinged primarily on the generalised decline in interest rates.

The almost perfect correlation amongst the performances of the various developed real estate markets seems a clear demonstration of the crucial role this factor played over the period. The decline in rates is synonymous with a decrease in the capitalisation rate of future rents. Consequently, all else being equal, the substantial decrease in long-term rates following the emergence of the recession scenario led to a significant increase of close to 20% in the value of real estate investments. The US market significantly outperformed all the other markets with an increase of +25% as 10-year yields fell from 3% to only 1.5% over the past twelve months. As is the case for other risky assets, the increase in prices derived more from a 'rate effect' than from improving fundamentals and expectations of rising rents and revenues. Looking at the increase in prices in light of these two factors is key, as future trends in securitised real estate could be strongly impacted by a change in the baseline scenario.

In the absence of an impending recession and after over a year of relatively attractive borrowing rates, stronger economic data would have an immediate impact on interest rates. Securitised real estate markets have benefited from declining rates and will thus obviously take a hit when the economic scenario shifts. This short cycle of declining interest rates linked with the risks of recession may in fact already be coming to an end. In our view, it is currently very likely that a recession will be avoided following twelve months of declining borrowing costs and much monetary easing.





Graph sources: Bloomberg/BearBull Global Investments

We believe that it is now more likely that the outlook will normalise, which will no doubt cause long-term rates and consequently capitalisation rates to rise, which would be unfavourable to securitised real estate.

Monetary policy and long-term interest rates

Monetary policy has once again been accommodative since July, following the Fed's initial move, as it gave in to financial market pressure by implementing a preventive policy aimed at countering the risks of recession associated with the persistence of the Sino-American conflict. The Fed chair already lowered benchmark rates by 50 bps and may be preparing to bolster his action with a third cut in Q4. In the Eurozone, the ECB also lowered rates slightly by -0.1% but is mainly using asset purchases to boost economic growth. The trends are similar elsewhere, with widespread benchmark rate cuts.

As the year comes to a close, a change of direction is very unlikely, Monetary policy is once again flexible and will boost economic momentum in the medium term. Thus, regardless of actual economic performance, we expect that short-term interest rates will remain a positive factor for securitised real estate markets.

On the other hand, if monetary policy measures manage to stem the risks of an economic slowdown, a more favourable economic outlook would inevitably lead to potentially significant upswings in long-term rates. The balance of these two factors will influence demand and the valuation of real estate investments.

Conditions finally more favourable to emerging markets

With regard to regional allocation, the US market is certainly the most richly valued in our view. The +25% increase in prices in 2019 is significantly larger than price increases in Asian markets, even though the latter have stronger momentum and higher rent increases. A modest correction in the 'rate effect' will have a significant impact on these markets.

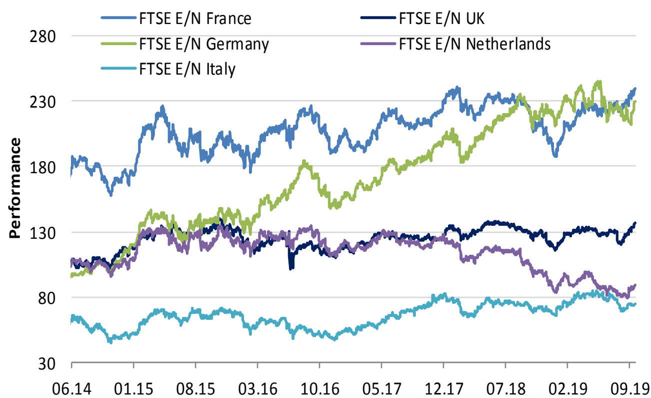
On the other hand, Asian and emerging markets were strongly impacted by the risks of recession and international investors' lack of interest and would likely see significant increases. They should benefit both from the shift in growth expectations and from declining interest rates, which also occurred across their respective markets.

We recommend overweighting the Eurozone and Asian markets as well as emerging markets, which are more likely to benefit from easing tensions and from an improvement in the global economic scenario.

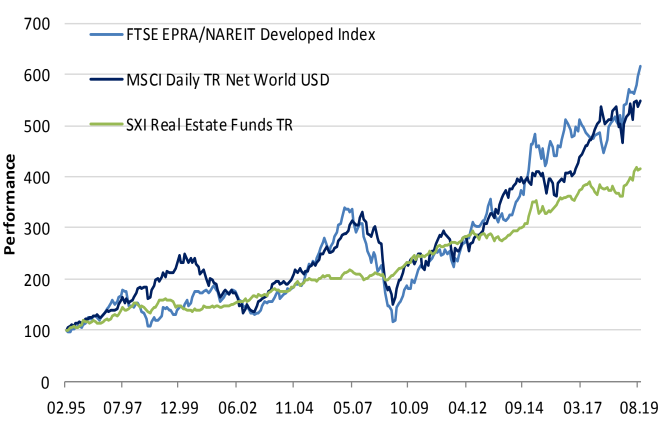
Real estate markets (local currency)

FTSE E/N Japan
FTSE E/N Dev Europe
FTSE E/N UK
FTSE E/N United States
Performance
150
140
130
120
110
100
90
80
12.14 08.15 03.16 10.16 05.17 12.17 07.18 02.19 09.19

European real estate markets (local currency)



Long-term Performance : international real estate, swiss real estate and international equities (local currency)



INTERNATIONAL REAL ESTATE INDICES (local currency)

30.09.2019 — Total Return Performance

	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
GLOBAL	FTSE EPRA/NAREIT Glb TR	3030.5	USD	0.8	2.4	2.2	3.1	19.4
DEVELOPED	EPRA/NAREIT Dev TR USD	5731.1	USD	0.9	2.5	3.6	4.5	20.7
DEVELOPED EUROPE	FTSE E/N Dev Europe	2288.9	EUR	2.8	4.6	7.2	2.9	18.8
EUROZONE	FTSE E/N Euro Zone	2616.6	EUR	3.0	3.7	5.9	1.2	15.8
USA	FTSE E/N United States	3300.2	USD	1.1	2.8	6.0	7.7	25.5
DEVELOPED ASIA	FTSE E/N Dev Asia	1776.8	EUR	0.8	2.0	2.1	3.3	20.4

Graph sources: Bloomberg/BearBull Global Investments

Direct real estate prices continue to rise

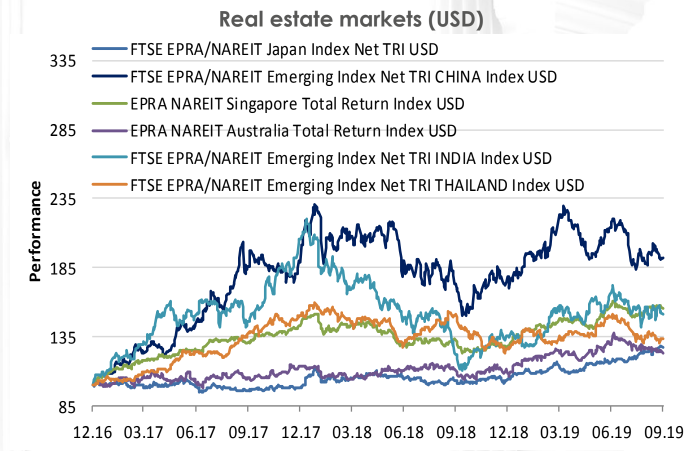
In the US, real estate price growth has been steadily declining, reaching a mere +3.18% yoy in July according to the global S&P Case-Shiller price index, while yoy growth in December 2018 still exceeded +4%. The index, which includes 20 metropolitan areas in the US, progressed by barely +2% yoy. Price growth has thus been steadily declining for several months. However, sentiment remains positive thanks to a particularly robust job market and exceptionally low interest rates, bolstering new home sales (713,000 new homes) in particular, up +7.1% in August, following a rather significant decrease in July. US real estate market data are already solid enough to be having a positive impact on Q3 GDP. We expect current trends to persist, favouring an upswing in prices in the next few quarters.

In mainland France, real estate prices were up +3.3% yoy in June. In Paris, the average price per square meter exceeded the critical threshold of 10,000 euros. Price increases in the capital could reach +7% yoy in October. Lower borrowing costs and declining unemployment are also factors supporting demand and price growth.

In the UK, housing prices grew by only +0.2% in September, its smallest increase since January. Brexit remains the primary factor hindering more dynamic price growth in the UK residential real estate market. On an annual basis, price stabilisation could shortly be followed by a real contraction. The economic slowdown in the UK and the uncertainty surrounding Brexit are the key factors underlying the current stabilisation in prices. Mortgage applications are down, indicating that demand is not accelerating. London once again posted one of the worst regional performances. The risk/return ratio does not seem favourable to the UK real estate market just a few weeks shy of the expected date of withdrawal from the EU.

In China, real estate investments progressed by +10.5% yoy in August, slightly below their performance in April 2019, but still high compared to the three previous years. Growth in the sector had reached a low in December 2015. The price of new homes progressed by +0.58% in August, or +9.1% yoy. The trend is stable, with the real estate market posting steady increases of around +0.5% since the beginning of the year.

In Japan, demand for commercial space remains very high, and vacancy rates for this type of real estate is now close to zero, similarly to the already very tight residential market. Continuously declining interest rates are boosting real estate investment. Rents continue to trend upwards given the tight market, in spite of high supply by historical comparison. Almost all market segments are seeing rent increases of over +7% yoy.

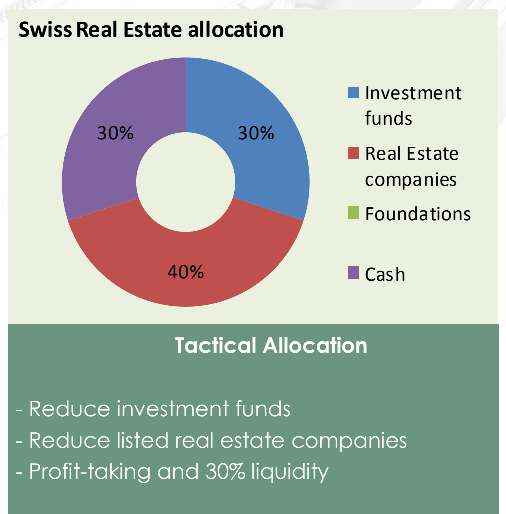


Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

Swiss Real Estate

- Warning signals for investment funds turn red
- The fall in interest rates is boosting Swiss securitised real estate
- The yield differential remains very attractive



REAL ESTATE Switzerland	Expected Return 3months	1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Investment funds	↘	↗							
Real Estate companies	↘	↗							
Foundations	→	→							
Cash									

Warning signals for investment funds turn red

A few weeks ago, we spoke of the rise in average fees for investment funds and real estate companies, pointing out that this rise was becoming a risk indicator which should be taken seriously given the already high valuations of listed real estate investments. Fund valuations were already very high in historical comparison, while those of real estate companies still had a little room left to rise. Real estate investment fund fees have now hit more than 30% on average, which is a warning threshold which has rarely been passed in previous decades.

The fall in interest rates is slightly boosting Swiss securitised real estate

In Switzerland, investment funds have very much benefited from interest rates starting to head down again in summer. Although likely overblown, this fall in bond yields very clearly propped up investor interest in securitised real estate generally. Thanks to this favourable situation, the global fund index grew +5.8% over the four weeks in which Swiss ten-year rates fell from -0.5% to -1.12%. The quick, widespread bounce back that followed in September largely corrected the exaggerated developments of the previous few weeks, and of course had a negative impact on Swiss securitised real estate. The fund index therefore lost most of the gains it had made, dropping -4% over the period, while the real estate company index took a lesser blow. Our tactical investment policy of partial profit taking after the initial wave of rises turned out to be particularly judicious. We are maintaining this policy in the short term, with the expectation that in the medium term we will be able to reposition at a lower price level, offering better prospects of capital gains in the coming months.

This type of movement on listed real estate companies was several weeks out of step, but it was much broader. The average growth of real estate companies between the end of June and the end of August hit +16%, before falling away in September. In this case, we are also still recommending profit taking, given fee rates, which, although not so close to the extreme levels seen in this segment, are still too high.

The yield differential remains very attractive

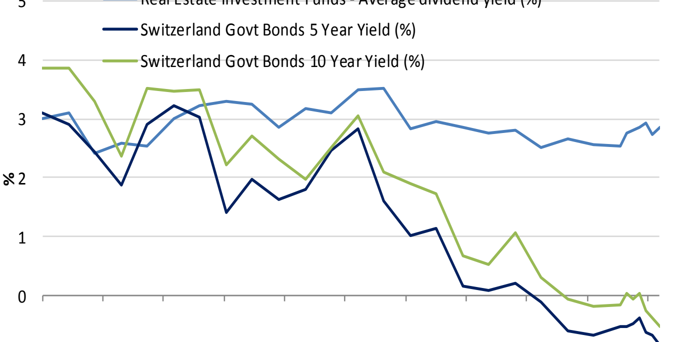
Despite the rise in prices, yield levels for funds (2.87%) and companies (3.3%) are, nonetheless, high. More specifically, they are high compared to Swiss ten-year interest rates (-0.5%). Attractive absolute yields, and risk premia which are still ample in terms of yield differential, therefore continue to prop up the influx of funds still flowing into this asset class.

SWISS REAL ESTATE

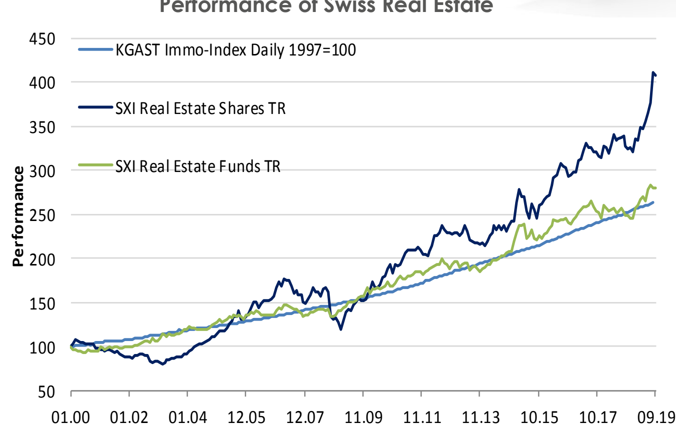
30.09.2019 — Total Return Performance

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
SXI Real Estate Funds TR	412.6	0.2	0.1	1.2	4.5	14.1
SXI Real Estate Idx TR	3035.2	0.5	-0.9	10.1	15.8	27.0
KGAST Immo-Index	293.9				1.8	2.8

Government and Real Estate Yield



Performance of Swiss Real Estate



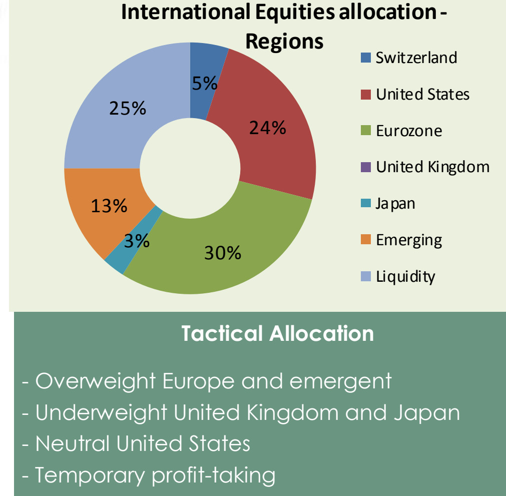
Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

International Equities - Regions

- Equity valuations once again high
- Investors to rotate into Europe
- Rise in S&P 500 essentially due to PE expansion
- Nikkei corporate earnings down -12%
- Wave of rate cuts in emerging markets

EQUITIES REGIONS	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Switzerland	↘	→			■				
United States	↘	→			■				
Eurozone	↘	→			■				
United Kingdom	↘	→	■						
Japan	↘	→			■				
Emerging	↘	→			■				
Liquidity								■	



Equity valuations once again high

After three months of volatility, many equity markets are trading at the same levels as at the end of June. The S&P 500 closed the previous quarter at 2941 points and the current quarter basically unchanged at 2975 points, for a modest +1% increase. In the Eurozone, the trend was slightly more positive, in spite of the persistence of real risks of recession in Germany, and the Eurostoxx50 closed at 3548 points, for a +3.3% increase. Elsewhere, results were similar, with a +2% increase in Japan and +1.5% increase in Switzerland, while the UK and Germany stagnated at 0%, and China fell slightly by -0.5%.

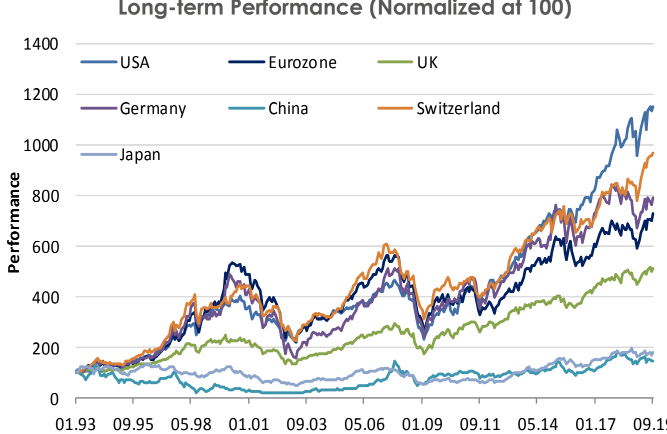
The overall context last quarter was substantially impacted by the risks of a no-deal and its possible effects on global growth, before being somewhat bolstered by expectations of shifts in centralbanks' monetary policies. Expectations of rate cuts boosted equities, but what will happen over the next few months, as central banks deem their adjustments to be adequate? Recall that, while last quarter was more volatile, with movements of +/- 5-7%, despite ending up almost unchanged, the previous quarter had been similar. Thus, it is key to note that volatility has established itself once again in the past two quarters, and current stock prices, although at the high end of the horizontal fluctuation band that has emerged over the past six months, are relatively unchanged since the end of April.

After a very strong first quarter, equities have been stymied by rather generous valuation levels. Indeed, in the absence of genuine earnings growth prospects for 2020, market PEs seem high.

In the US, the 2019 PE ratio is close to 20x, decreasing only to 18x in 2020. In the euro area, the current PE is lower (18x), and the risk premium remains positive for 2020 thanks to a PE ratio of barely 14.7x. In Switzerland, the SMI's valuation at 22x 2019 earnings is amongst the highest by international comparison. It declines to 17x for 2020, which remains high by Swiss historical comparison. The rise in equity markets is currently impeded by these valuation levels, which will moreover be very sensitive to interest rate trends. Indeed, declining interest rates played a key role in stock market price increases to date by driving up multiples.

This phase of expanding PE ratios could give way to a less favourable period should interest rates start to rise again. Rising rates would cause multiples to contract, which would not easily be offset by limited corporate earnings growth in 2020 and a return to levels prevailing in September 2018. These risks are not negligible and could trigger a consolidation of equity markets in the near future and cause prices to return to the low end of the current consolidation band. Current equity market valuations are once again generous and leave very little room for any sort of disappointment over the next few months.

Long-term Performance (Normalized at 100)



Chinese Equities - A and B (Normalized at 100)

Graph sources: Bloomberg/BearBull Global Investments

Investors to rotate into Europe

Domestic and foreign investors seem increasingly more inclined to focus on euro-denominated debt rather than European equities. This partly explains the continuing decline of rates in euros and the continuously attractive valuation level of European equities. Indeed, at the beginning of the present quarter, their relative valuation (PE 14.6x) remains eye-catching compared to US valuations (PE 18.2x) thanks to a "discount" of approximately 25%.

The expected revaluation phase has thus not happened yet, while the persistence of low rates, due to the ECB's announced policy, will likely now be perceived as an enduringly positive factor for European equities.

In terms of yield, European companies offer a dividend yield of 3.5%, clearly above the 1.9% yield offered by the S&P500. Nevertheless, the performance of the Euro Stoxx 50 since the beginning of the year (+18%) is still very similar to that of the US market (+19.9%) in local currencies.
This valuation gap might be explained for the moment by the perception of a greater sensitivity of European stocks to external shocks such as the slowdown in China or in developing countries. Investors might thus be more convinced for the moment by the capacity of American companies to withstand such shocks rather than European stocks. Consequently, better economic conditions are likely to be the determining factor in terms of any outperformance of European equities.

Rise in S&P 500 essentially due to PE expansion

The return of equity indices to highs for the year places the asset class back into a high-risk zone and increases the probability of a price correction. If the slowdown turns out to be real, valuation levels for equities will not withstand the likelihood of profits collapsing. If, conversely, the economy remains stable, the rebound in interest rates that will likely materialise will indeed have a negative effect on multipliers. The rise in PEs associated with the drop in long rates in the last few months will be replaced by an unavoidable contraction that will accompany the rebound in rates.

The 12-month forward estimate of the S&P 500's PE ratio was 14.5x at the beginning of 2019, progressing as the markets rose over the past nine months to reach 18.2x. Over the same period, the S&P 500 jumped up +19%, much less than the 25% increase of its PE ratio. The dividend yield of US stocks is below 2%, which means US equity market valuations are relatively high, while their dividend yields are rather low.

The impeachment proceedings against Trump that have finally been activated by the Democrats are very unlikely to succeed. It is unlikely to add much uncertainty and to be a major destabilising factor for financial markets.

The US equity market may benefit a little while longer from capital inflows motivated by the absence of alternatives in the fixed income and money markets as interest rates are too low and uncompetitive. In spite of the positive liquidity factor, we believe that some consolidation remains likely in the short term.

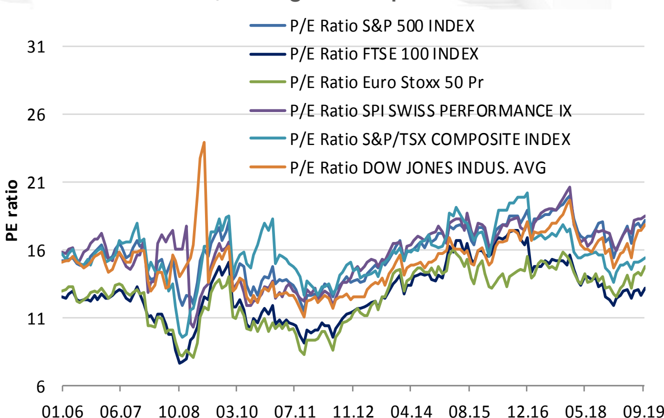
Reduced exposure to US equities seems appropriate in this context, which seems unlikely to trigger a new wave of appreciation of prices beyond 3,000 points on the S&P500 index.

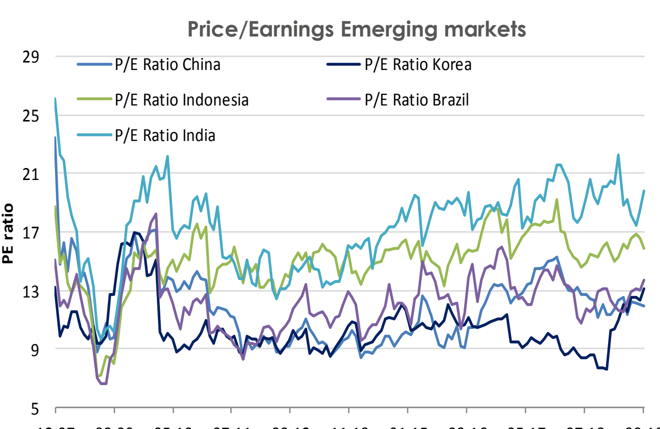
Nikkei corporate earnings down -12%

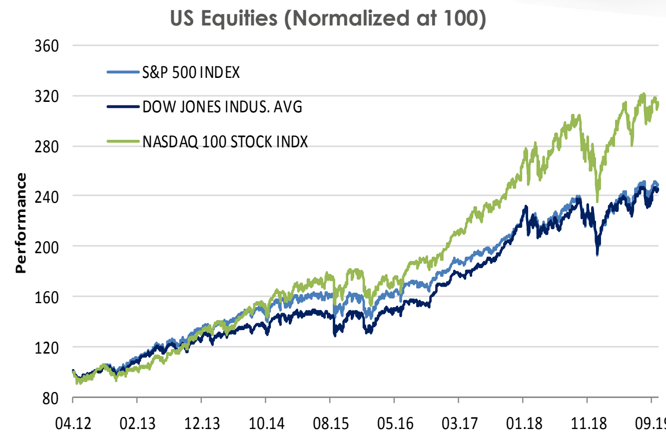
Economic activity and the results of Japanese firms have been strongly affected by the feud with South Korea and the trade tensions between China and the US. The fall in exports is obviously having an impact on the results of listed companies, whose earnings dropped by -12% yoy. Japanese companies exporting products assembled in China to the US have no other choice but to relocate and transfer production elsewhere, to Southeast Asia in particular. These changes in their production lines have consequences in 0the short term in terms of costs and earnings. . The Nikkei thus remains strongly impacted by Japan's specific economic situation within the overall context of the trade war between China and the US. The consequences of this uncertainty are genuine, but the worst may already be over for Japanese firms, which could once again benefit from a change in risk perceptions, as investors' 2019 earnings expectations are low and could thus be exceeded.

Volatility (USA, Europe, Switzerland)

CBOE VIX FUTURE (USA)
VSTOXX Index (Europe)
VSMI Vol Index for SMI (Suisse)







Graph sources: Bloomberg/BearBull Global Investments

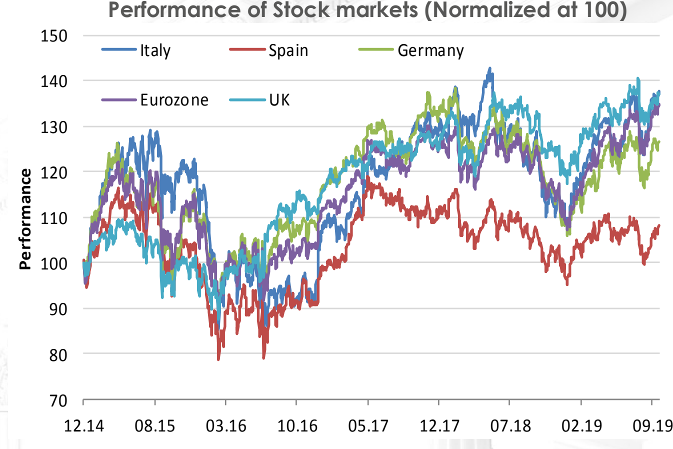
A weaker yen, lower trade tensions, and an improved economic outlook driven by the latest decreases in long and short rates in the US would be favourable to an upswing of the Nikkei. With this in mind, we maintain a rather neutral strategy on Japanese equities.

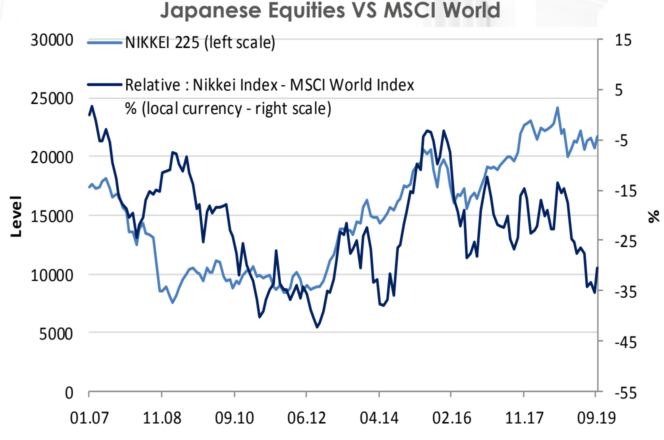
Avoid British Equities

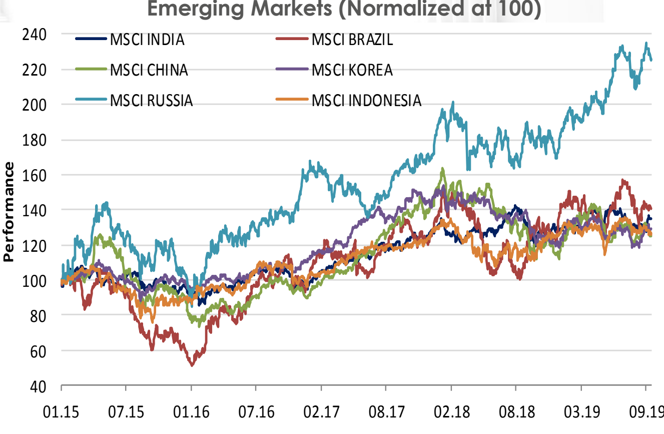
In this persistently uncertain environment, the equity market's expected risk/return ratio does not seem attractive. While pressure on the pound could abate somewhat given the government's political setback, instability remains high. We thus continue to recommend caution on UK equities, in spite of reasonable valuations and attractive dividend yields.

Wave of rate cuts in emerging markets

Emerging markets were impacted by risks of an economic slowdown and sluggish global trade resulting from the trade war between China and the US, declining by over -3% overall in Q3 following a slight decrease of -2% in Q2. However, the Fed's rate cuts enabled emerging market central banks to lower their rates as well in order to boost economic activity. Between July and September, sixteen emerging country central banks and eleven border countries announced rate cuts. The last quarter thus saw the largest wave of rate cuts in the emerging market universe in ten years. Emerging country equity markets were particularly hard hit by the shift in perceptions in August. The MSCI index plunged by around -8% before recovering somewhat, closing the quarter on a more limited decline of -3%. The uncertainty surrounding US foreign policy is the main cause of jitters in emerging markets, whose currencies are struggling to stabilise against the dollar. Net capital flows have been negative overall, although they have recently turned positive. A normalisation of the global economic scenario will likely be favourable to emerging markets, which will then benefit from better visibility.

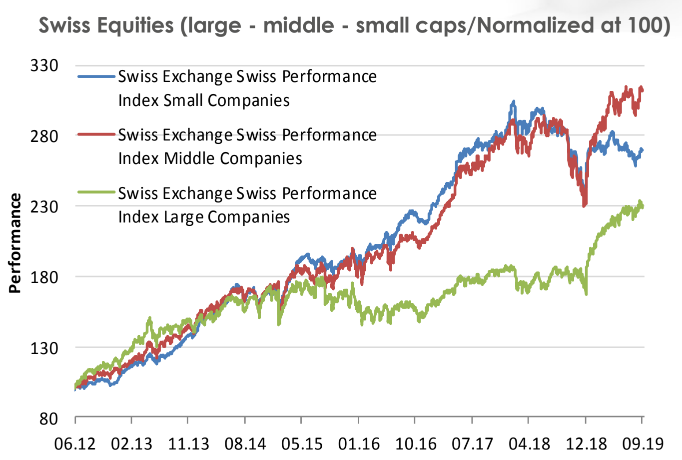






EQUITIES - BY REGION (local currency)

30.09.2019				Total Return Performance				
	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
SWITZERLAND	SPI Swiss Performance Index	12233.1	CHF	0.9	1.4	0.9	7.6	24.4
SWITZERLAND SMALL-MID CAPS	SPI Extra Total Return	4312.7	CHF	0.7	2.2	0.1	4.4	21.2
EUROPE	STXE 600 € Pr	393.2	EUR	0.9	3.7	1.5	3.5	20.3
EUROPE SMALL-MID CAPS	MSCI Europe Small Cap Net TR E	416.7	EUR	0.4	3.5	0.6	-0.3	17.6
UK	FTSE All-Share Index	4061.7	GBP	0.8	2.9	-0.4	2.5	14.3
USA	S&P 500 Index	2976.7	USD	-0.5	1.9	0.6	4.6	20.6
USA SMALL-MID CAPS	RUSSELL 2500	624.8	USD	-1.4	1.8	-1.4	0.0	17.7
JAPAN	NIKKEI 225	21755.8	JPY	-0.8	5.7	0.7	1.1	10.8
JAPAN SMALL-MID CAPS	Russell/Nomura Mid-Small Cap I	823.9	JPY	-0.7	6.3	0.5	-3.0	5.9
ASIA EX-JAPAN	MSCI AC Asia Pac Ex Japan	502.1	USD	-1.3	1.8	-4.9	-5.1	8.3
ASIA EX-JAPAN SMALL-MID CAPS	MSCI AC Asia Pacific Ex Japan Small Cap	884.4	USD	-1.8	1.6	-6.1	-8.5	1.4
EMERGING	MSCI EM	1001.0	USD	-1.4	1.9	-5.1	-5.4	6.1
INTERNATIONAL EQUITIES -DIVERSIFIED USD	MSCI Daily TR Net World	6364.9	USD	-0.5	2.1	-0.4	2.8	17.6

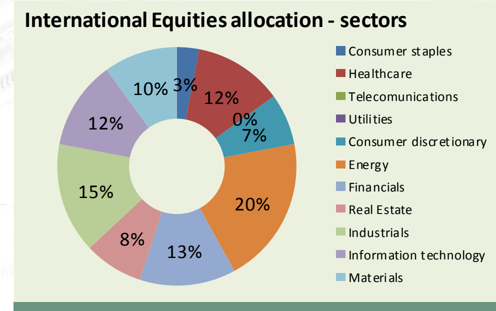


Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

International Equities - Sectors

- Increase exposure to defensive and industrial sectors
- Overweight healthcare, energy, industrials, and materials
- Economic outlook favourable to financials
- Remain underweight tech stocks



Tactical Allocation

- Underweight digital stocks and technology
- Overweight energy, materials, industrials and financials

EQUITIES Sectors	Expected Return 3months	Expected Return 1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Consumer staples	↘	↗			■				
Healthcare	→	↗					■		
Telecommunications	→	↗				■			
Utilities	↘	↗			■				
Consumer discretionary	↗	↗			■				
Energy	↗	↗					■		
Financials	→	↗				■			
Real Estate	→	↗				■			
Industrials	→	↗					■		
Information technology	↘	↗			■				
Materials	→	↗					■		

EQUITIES - BY SECTOR

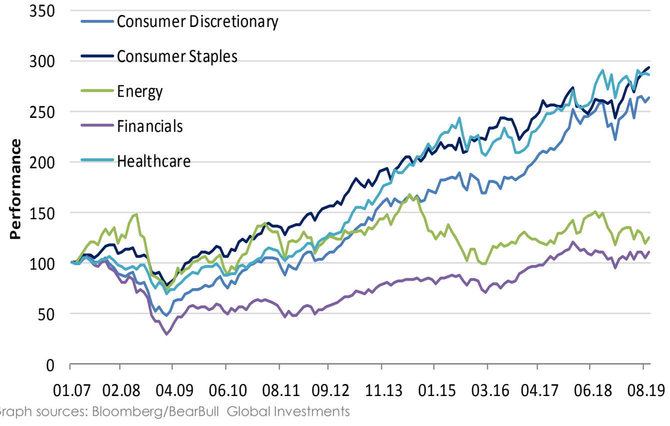
30.09.2019 — Total Return Performance

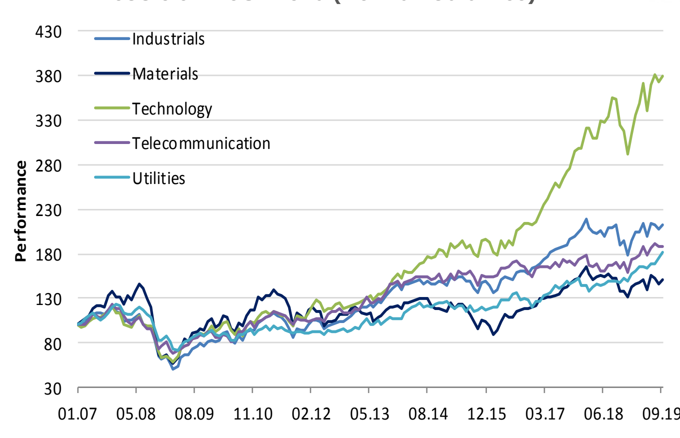
	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
CONSUMER DISCRETIONARY	MSCI WORLD/CONS DIS	261.1	USD	-0.5	1.5	-0.6	3.4	18.9
CONSUMER STAPLES	MSCI WORLD/CON STPL	245.9	USD	0.7	0.7	3.1	8.3	20.3
ENERGY	MSCI WORLD/ENERGY	189.0	USD	-2.3	4.7	-4.6	-7.2	7.0
FINANCIALS	MSCI WORLD/FINANCE	116.1	USD	-0.3	5.4	-0.3	3.6	16.1
HEALTHCARE	MSCI WORLD/HLTH CARE	246.1	USD	-1.2	-0.1	-2.1	0.5	8.9
INDUSTRIALS	MSCI WORLD/INDUSTRL	258.1	USD	-0.3	2.8	-1.0	2.1	19.6
MATERIALS	MSCI WORLD/MATERIAL	251.1	USD	-1.0	2.9	-3.4	-2.1	14.1
REAL ESTATE	MSCI WORLD/REAL ESTATE	230.1	USD	0.3	1.3	3.1	4.6	22.3
TECHNOLOGY	MSCI WORLD/INF TECH	273.4	USD	-0.1	1.6	0.5	5.7	29.9
TELECOMMUNICATION	MSCI WORLD/TEL SVC	72.0	USD	-1.7	0.2	0.0	4.0	18.4
UTILITIES	MSCI WORLD/UTILITY	147.9	USD	0.9	3.6	5.7	10.0	21.1

The performance gaps among sectors were relatively modest over the past quarter. Indeed, there was only a 10% gap between the best-performing sector (utilities +5.7%) and the worst. The energy sector was particularly strongly impacted by the fall in crude prices in the first half of the quarter, while utilities benefited from being defensive. Over the past month, the upswing in energy stocks (+4.7%) followed closely on the heels of the upswing in financials, which posted the strongest results (+5.4%). The healthcare sector continued to lag this past quarter (-2.1%), unable to improve its year-to-date performance.

Tech stocks also struggled in Q3 (+0.5%), as did more cyclical sectors (materials -3.4%, industrials -1%, consumer discretionary -0.6%, and financials -0.3%). In the short term, overweight defensive sectors in order to reduce overall risk in equity portfolios in the event of a potential consolidation resulting from an improving economic outlook, which could lay the foundation for a lasting stock market rally in 2020. With that in mind, we are adjusting our sector allocation, overweighting healthcare, energy, and materials, as well as financials and industrials. We remain underweight tech stocks.

The energy sector offers attractive valuations and earnings growth prospects and could thus potentially benefit from a less pessimistic global growth scenario and more positive trends in crude prices. This shift in outlook will also have a positive impact on demand for materials as well as on banking stocks, as rising interest rates are expected to favourably affect the latter's margins. Underweight tech stocks and growth stocks more generally in an environment that could become more favourable to value stocks.





Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

Swiss Equities

- Swiss equities are flirting with their previous highs
- Beware extreme valuations resulting from low interest rates
- Risk premiums not high enough to justify overweighting equities

Swiss Equities allocation - size

9% Small
30% Medium
61% Large

Tactical Allocation

- Overweight mid-sized capitalizations
- Decrease exposure to « ultra blue chips »

EQUITIES capitalization	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Small	→	↗↗							
Medium	→	↗↗							
Large	↘	↗							

Swiss equities are flirting with their previous highs

September ended on a somewhat positive note for equities with an increase of +1.4% as prices rebounded in the last three trading days. At the last minute, the SPI climbed back up over the 12,200 mark, testing once again what increasingly appears to be its medium-term resistance level. Since June, Swiss equities had stopped rising, fluctuating around 12,000 points for the SPI (9,800 points for the SMI) in a context of relatively moderate volatility (+/-3%). In fact, Swiss stocks have behaved no differently than most other markets given the still uncertain global economic context of the past weeks. However, the relatively modest performance in September masks the fact that the Swiss market has been trending upwards for two months now following its price correction at the beginning of August. After uncertainty rose sharply in August, causing a very abrupt fall in interest rates and equity markets, expectations of rate cuts once again boosted inflows into equity markets. Swiss equities benefited substantially from the impact on valuations of the decrease in Swiss franc yields from -0.5% in June to -1.12% in mid-August.

A relatively large proportion of stocks (67%) participated in this latest rise in the Swiss market. Indeed, 145 stocks posted positive performances, while 70 posted zero or negative performances. As for relative performance, 112 stocks outperformed the SPI (+1.45%), while 103 stocks underperformed the index.

With regard to the SMI, the proportion of stocks whose price increased was similar, as 13 of the 20 stocks comprising the index posted positive performances and 11 stocks outperformed the index (+1.96%). The financial sector took the top three spots in the ranking with increases of over +8% (Swiss Re, Zurich, and UBS Group).

Beware extreme valuations resulting from low interest rates

Initially, in Q1 2019, Swiss blue chips benefitted from being more defensive. Swiss stocks were subsequently less affected by upheavals in global financial markets in periods of rising uncertainty. However, in spite of the SNB's lack of concrete action on the monetary policy front, Swiss equity markets also benefited from the more positive stock market climate that arose based on expectations of rate cuts in the US. Since July, which is when the US Fed's attitude shifted, the Swiss market has also benefitted from a global environment marked by decreasing interest rates, which have played a key role in recent stock price movements, in particular by pushing investors to take more risks. Low long-term interest rates (10-year yields at -1.12% in mid-August) are obviously a problem for investors seeking returns. Negative rates push investment towards more profitable assets at the risk of causing dangerously high valuations. In our view, the Swiss market is already in the orange zone in terms of valuation, with a historically high PE ratio. However, a decrease in 10-year yields impacts the current value of future earnings via the discount rate. Decreasing interest rates thus drive up the value of future earnings as well as the current value of stocks.

While equity valuations have been driven to extreme highs both by the lack of attractive investment alternatives and by the discount rate on earnings driving up PE multiples, investors should remain cautious regarding future prospects in the event interest rates were to rise.

Indeed, the fall in yields, which drove up equity prices, which then stabilised at high valuation levels, could reverse rapidly if the US-China trade dispute were to be resolved or simply if expectations of a recession were to be substantially contradicted.

Thus, as long as uncertainty with regard to the two elements mentioned above persists, we believe that risk premiums are not at all high enough to justify a strategy of overweighting equities.

SWISS EQUITIES - Capitalization

30.09.2019 — Total Return Performance

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
SPI SWISS PERFORMANCE IX	12233.1	0.9	1.4	0.9	7.6	24.4
SPI SMALL COMPANIES INDX	24104.4	1.1	2.5	-0.8	-0.1	5.1
SPI MIDDLE COMPANIES IDX	17089.8	0.8	2.5	0.0	5.4	23.3
SPI LARGE COMPANIES INDX	11690.3	0.9	1.2	1.2	8.3	25.2

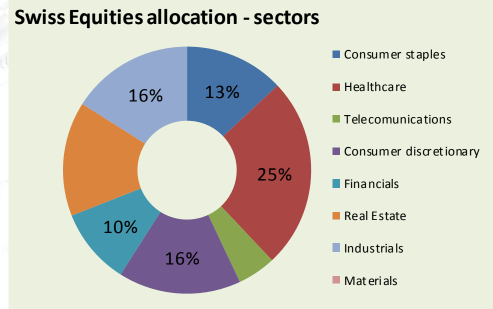
Swiss Equities Performance

Swiss Exchange Swiss Performance Index Small Companies
Swiss Exchange Swiss Performance Index Middle Companies
Swiss Exchange Swiss Performance Index Large Companies
Performance
120 115 110 105 100 95 90 85 80
12.17 03.18 06.18 09.18 12.18 03.19 06.19 09.19

Graph sources: Bloomberg/BearBull Global Investments

Swiss Equities - Sectors

SWISS EQUITIES Sectors	Expected Return 3months	1year	ALLOCATION (CHF Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Consumer staples	↘	↗			■				
Healthcare	↘	↗			■				
Telecommunications	→	↗				■			
Consumer discretionary	↗	↗					■		
Financials	→	↗			■				
Real Estate	→	↗					■		
Industrials	↗	↗						■	
Materials	→	↗				■			



Tactical Allocation

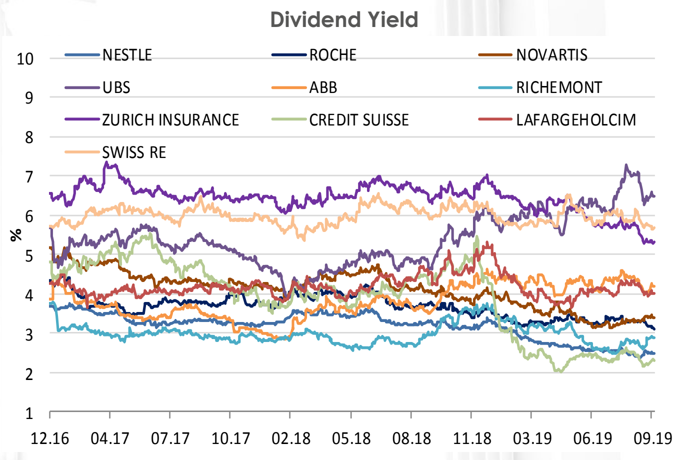
- Underweight consumer staples and Healthcare sectors in favour of cyclical stocks
- Overweight consumer discretionary sector

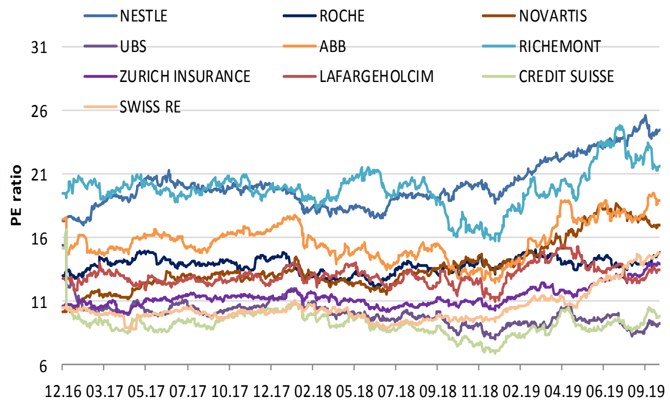
Not much room for growth for indices over the next 12 months

The increase in Swiss share prices in August was fairly close to analysts' average 12-month target price revisions. With respect to SMI stocks, the +1.96% increase in August slightly exceeded the average target price revision of +0.98%. Only four stocks saw their target price increase by over +2%. A bottom-up approach to the SMI indicates that the index's 20 component stocks have a remaining upside potential of only +6% through 2020. The banking sector still seems undervalued, with significant expected upside of +20%. However, these stocks remain very volatile and will likely have to wait for a reversal in interest rate trends to really see some margin growth. Following a period of consolidation, Novartis's share price is back at its March 2019 level and could thus appreciate based on a corrected valuation (PE 16.6x) and a target price almost 10% higher than its current level. Nestlé's share price had been accelerating upwards before also experiencing some profit-taking recently. Its valuation (PE 24x) still seems excessive and thus warrants underweighting the stock. Four stocks have caught our attention in the SMI, namely Swatch, Cie financière Richemont, Lafarge, and Sika. We believe these stocks still have some upside potential, as they are currently weighed down by the recessionary economic scenario.

Dividend yields remain a key selection factor

Certain stocks' high dividend yield turned out to be a key factor over the past several weeks for SMI blue chips. Investors favoured high dividend stocks in this low interest rate environment, and stocks with the highest dividend yields, namely exceeding 4%, were highly sought after. The five SMI stocks with the highest dividend yields, namely UBS (7.2%), Swiss Re (6%), Zürich (5.6%), Adecco (4.8%) and ABB (4.59%), are among the nine best performers of the past few weeks. This factor will remain important in the stock selection process.

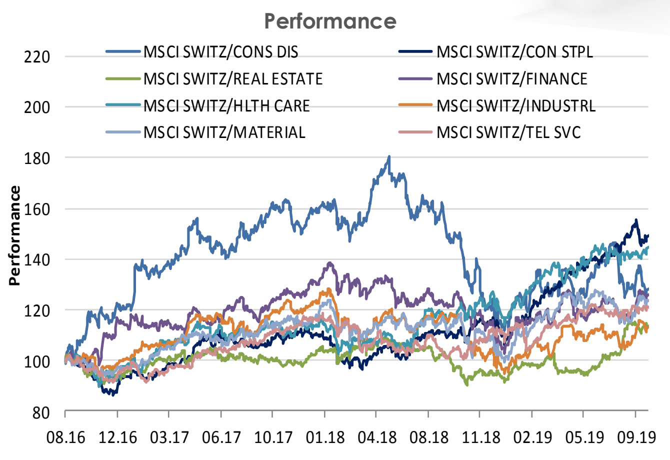




SWISS EQUITIES - BY SECTOR

30.09.2019 — Total Return Performance

Name	Last price	7 d %	1 m %	3 m %	6 m %	YTD %
MSCI SWITZ/CONS DIS	269.4	-0.1	-1.5	-7.9	-0.9	11.1
MSCI SWITZ/CON STPL	355.2	1.1	-2.2	5.9	15.9	38.0
MSCI SWITZ/FINANCE	57.0	0.3	6.8	2.5	5.7	18.5
MSCI SWITZ/HLTH CARE	174.0	1.5	1.6	-0.2	5.5	23.5
MSCI SWITZ/INDUSTRL	173.2	0.2	3.5	-0.5	5.9	16.6
MSCI SWITZ/MATERIAL	303.7	0.0	4.3	-2.0	3.6	22.1
MSCI SWITZ/REAL ESTATE	1136.6	-0.6	-0.9	13.7	15.5	22.8
MSCI SWITZ/TEL SVC	93.0	0.0	-0.4	0.4	5.1	9.8

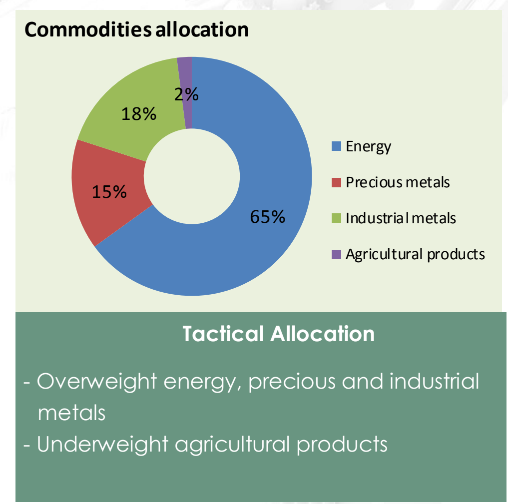


Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

Commodities

- Risks of recession are hobbling commodities, but propping up precious metals
- Short-term collapse in crude oil prices
- Increased demand for investment in physical gold



COMMODITIES	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Energy	↗	↗↗						X	
Precious metals	↗	↗↗					X		
Industrial metals	↗	↗↗						X	
Agricultural products	↗	↗			X				

Tactical Allocation

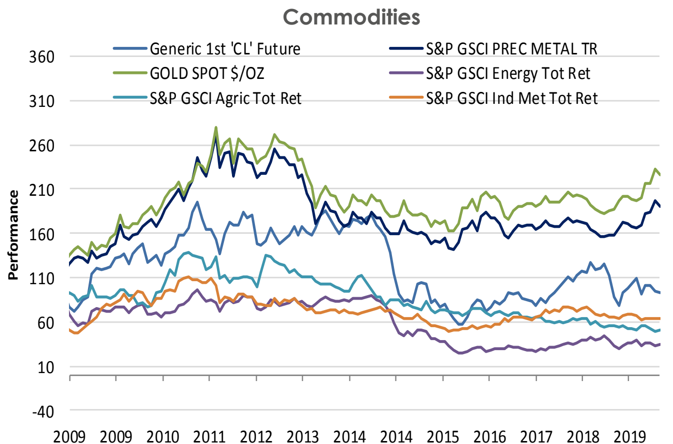
- Overweight energy, precious and industrial metals
- Underweight agricultural products

Risks of recession are hobbling commodities, but propping up precious metals

Rising uncertainty on trade and increased risk of recession in the third quarter pushed interest rates downward and forced central banks to change their monetary policies and adopt more expansive strategies. Growing fears of recession affected economic forecasts, as well as forecasts for future commodity demand. Forecasts for crude oil and certain industrial metals have regularly been revised downward. On the flipside, these same fears have propped up precious metal prices, largely due to the drop in interest rates. Commodity indices have therefore been buoyed up by the price rise on gold (+4.1%), silver (+11.44%), lead (+10.51%), and nickel (+34.36%), but were dragged down by the -7.5% drop in crude oil prices, as well as -4.36% on aluminium, -4.47% on copper and -5.36% on zinc. Overall, the -2.1% decrease on the Goldman Sachs index is not all that far off the Bloomberg index's neutral performance (+0.27%), despite it being much less exposed to the energy sector. The uncertainty regarding economic growth is legitimate, however we believe that the recession forecasts are overblown. The consensus economic scenario which has dominated financial markets until now has had a tangible influence on the overall level of interest rates around the world. The fall in long term yields in most countries, but particularly in the United States, was very broad in comparison to the real terms economic results posted by various economies. Changes in monetary policy, once again more expansionary after a period of normalisation, will work in tandem with reduced financing costs. We believe that a recession is now less likely than it was a year ago due to the positive effects of a fall in the money rate. As regards commodities, a gradual change in the global economic scenario, with a lower risk of recession, would be particularly positive for products that correlate with global demand. When that happens, a gradual improvement in prospects will have a positive impact on industrial metals and crude oil.

Short-term collapse in crude oil prices

Crude oil prices slid -7.5% due to the fall in growth forecasts for crude oil demand. The global slowdown scenario is not unrelated to this change in forecasts, but it may turn out that it really does not accurately reflect reality in 2020. Over the past few months, crude oil demand forecasts have regularly been lowered much faster than the decrease in supply. Today, the crude oil market is betting on the fact that reduced supply, especially the drop in Saudi production from 11 mbd to 10 mbd, will not be enough to balance the market for two key reasons. First of all, global supply cannot drop rapidly due to the still regular increase in US production. The US now produces more than 13 mbd thanks to the 9 mbd of shale oil now being produced. The increased supply from the US is mainly due to ever more intensive exploitation of shale oil in the Permian Basin, which this year rose from 8 mbd to 9 mbd. We believe that this production increase is already being hampered by the price drop from US $65 to US $50 per barrel in May, when the economic scenario rapidly deteriorated following trade negotiations being broken off. The regular decline in production indicators will have a visible impact on US supply over the coming months. Despite weaker forecasts leading to a price drop, demand seems to have been growing again since summer. The market should be in deficit over the next few months, which should push WTI oil prices back north of US $60.



Graph sources: Bloomberg/BearBull Global Investments

COMMODITIES (USD)

30.09.2019 — Total Return Performance

	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
	MSCI Daily TR Net World USD	6364.93	USD	-0.53	2.13	-0.39	2.83	17.61
GLOBAL	S&P GSCI Tot Return Indx	2393.1	USD	-4.0	1.7	-1.7	-7.6	8.6
WTI CRUDE	Generic 1st 'CL' Future	54.1	USD	-7.8	-1.9	-3.9	-13.4	19.1
BRENT OIL	Generic 1st 'CO' Future	60.8	USD	-6.2	0.6	-2.6	-12.3	13.0
NATURAL GAS	Generic 1st 'NG' Future	2.3	USD	-7.8	2.0	4.0	-13.0	-20.7
OR	GOLD SPOT $/OZ	1472.4	USD	-3.3	-3.2	3.8	14.1	14.8
ARGENT	Silver Spot $/Oz	17.0	USD	-8.8	-7.5	11.0	12.3	9.7
AGRICULTURE	S&P GSCI Agric Indx Spot	280.9	USD	2.6	6.0	-3.6	1.4	-1.0
INDUSTRIAL METALS	S&P GSCI Ind Metal Spot	319.7	USD	-1.4	0.7	1.5	-7.4	0.1

BearBull Global Investments Group

IEA, EIA and OPEC revisions to demand growth forecasts point to the same outcome, but they are entirely linked to the global slowdown scenario. As such, the real surprise could come in the form of a less pessimistic revision of this scenario. A watered-down trade deal could be struck between Chinese and American negotiators in the end. Any such deal would have a clear impact on economic prospects and financial markets. President Donald Trump may well be tempted to exploit this psychological factor during his re-election campaign. The dreary economic forecasts which led to long rates collapsing could well be proven wrong and spark a change in crude oil prospects.

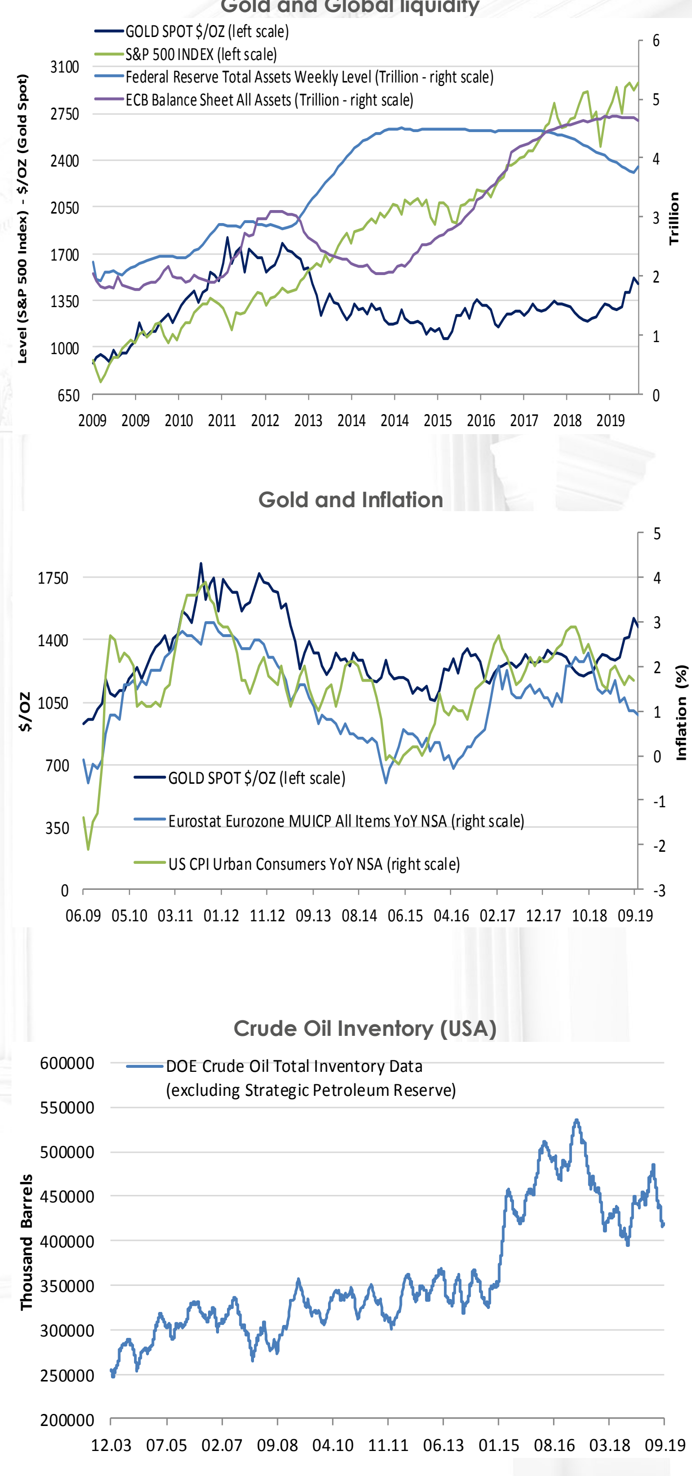
The general risk perception regarding the production and supply capacity of Saudi Arabia, and more broadly the whole of the Middle East, will be temporarily affected by the attack on one of its most important oil facilities on 14th September. Initial market reactions were strong, given the logical fear that half of Saudi Arabian oil capacity (5mbd) would be temporarily unavailable. The +10% rise in crude oil prices following this attack was only short-lived as it quickly became apparent that any damage was limited. The risk premium that had suddenly materialised evaporated following statements from Saudi, US, and Iranian leaders which clearly gave to understand that an escalation of tensions could be avoided. The main, indeed deciding, factor in future crude oil price developments will very likely continue to be the global macroeconomic scenario. Consequently, crude oil prices should fluctuate between US $50 and US $60 for as long as the recession scenario continues to dominate. An improvement in growth prospects will then spark a rise in crude oil prices back towards the US $75 level seen just a year ago. We should also remember that Saudi Arabia needs a higher crude oil price in order to balance its budget, and that on the other side of supply, US shale oil is not very profitable at current prices.

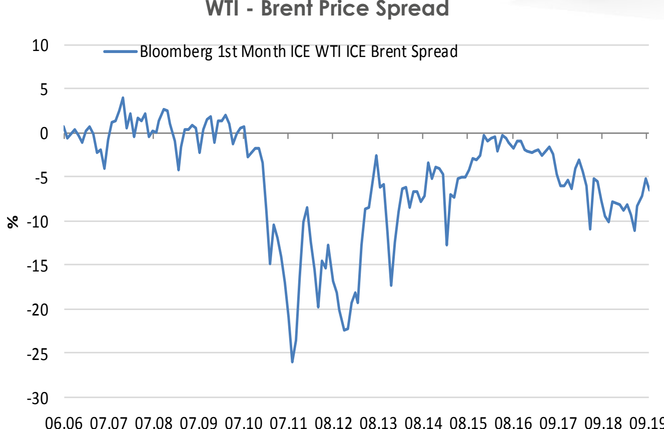
Increased demand for investment in physical gold

Precious metals have had an excellent quarter (+4.5%), thanks in particular to a drop in nominal interest rates, as well as in real terms rates, which are now in negative ground. Statistically speaking, the historical monthly performance of gold stands at +0.6% (from 1971 to 2019), but in periods of real terms negative rates this doubles (+1.2%). Long rates falling faster than inflation in various countries has led to negative real terms rates. On the other hand, the correlation between gold and inflation, which remains an important medium term indicator of gold fluctuations, could still work in gold's favour if current forecasts turn out to be accurate; forecasts for the next twelve months stand at +2.8% in the United States. The +7.5% rise in gold prices in August coincided with the drop in interest rates. It was followed by a -3.1% phase of consolidation as interest rates bounced back in September. Investment demand over the period was steadier. It posted growth each month, pushing the total number of ounces of physical gold held in ETFs from 74 up to 81 million in three months, giving gold more than +9.5% growth.

The increase in the price of an ounce of gold surpassed our short term objective of US $1,500. It consolidated after having hit this threshold. Other precious metals benefited from allocations being rebalanced across gold, silver, and platinum. The latter two benefited from this adjustment in July (+6.2%/+3.6%) and August (+13%/+8%).

There is a significant risk that financial markets will consolidate in October after prices bounced back and valuations increased. Renewed volatility will certainly prop up precious metal prices over the coming quarters. After a period of stabilisation at around US $1,500 per ounce, we now expect gold, silver, and platinum to head north of US $1,600, US $20, and US $1,000 respectively.





Graph sources: Bloomberg/BearBull Global Investments

PROSPECTS AND STRATEGIES

Hedge Funds

- A third consecutive favourable quarter for hedge funds

A third consecutive favourable quarter for hedge funds

Over the third quarter, the global hedge funds index has continued on the upward trajectory (+1.6%) it has been on since the start of the year. As such, over the first nine months of 2019 hedge funds grew +5.9%.

The quarterly results of the various non-traditional management styles came in in the black, without exception, and in a relatively tight pack. Indeed, the equity hedge, event driven, macro/CTA, and relative value arbitrage strategies moved up +1.8%, +1.7%, +2.4%, and +0.6% respectively.

Private Equity

- The best result of any asset class in 2019

The best result of any asset class in 2019

Private equity posted another stark quarterly rise between June and September (+7.7%) and closed on +36.2% since the start of the year. Private equity is therefore the segment with the highest performance across all asset classes after the third quarter. Notably, it surpassed the US real estate sector (+25.5%) and Australian equities (+23.9%).

From a geographical perspective, the United States kept up a fast growth pace over the third quarter (+11%). Europe and the UK posted quarterly results of +3.9% and +4.2% respectively.

HEDGE FUND INDICES (USD)

30.09.2019 — Total Return Performance

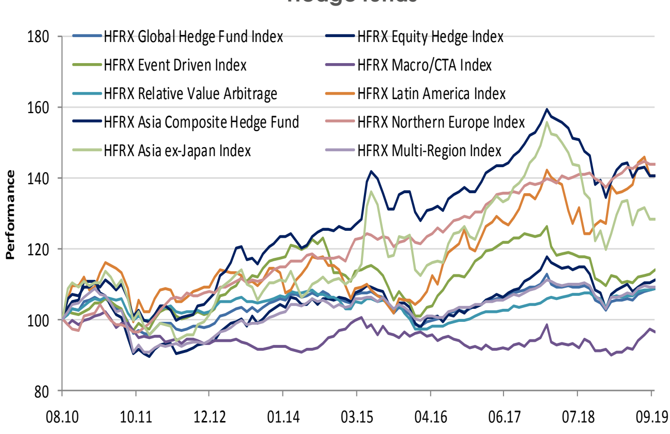
	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
GLOBAL	HFRX Global Hedge Fund Index	1260.1	USD	0.0	0.4	1.2	3.1	5.9
EQUITY HEDGE	HFRX Equity Hedge Index	1241.7	USD	-0.1	0.9	1.1	1.7	7.9
EVENT DRIVEN	HFRX Event Driven Index	1534.2	USD	0.1	1.1	1.5	3.4	4.3
MACRO/CTA	HFRX Macro/CTA Index	1183.0	USD	0.2	-1.1	1.5	5.9	5.1
RELATIVE VALUE ARBITRAGE	HFRX Relative Value Arbitrage	1227.7	USD	0.0	0.3	0.5	2.2	4.8
LATIN AMERICA*	HFRX Latin America Index	2249.3	USD	-	0.0	-4.4	1.5	8.5
ASIA COMPOSITE*	HFRX Asia Composite Hedge Fund Index	2269.5	USD	-	0.0	-1.3	-2.1	4.6
NORTHERN EUROPE*	HFRX Northern Europe Index	2069.5	USD	-	0.0	-0.4	1.4	4.4
ASIA EX-JAPAN*	HFRX Asia ex-Japan Index	2421.9	USD	-	0.0	-1.9	-3.7	7.3
MULTI-REGION	HFRX Multi-Region Index	1364.1	USD	-0.3	0.2	0.5	2.4	6.2

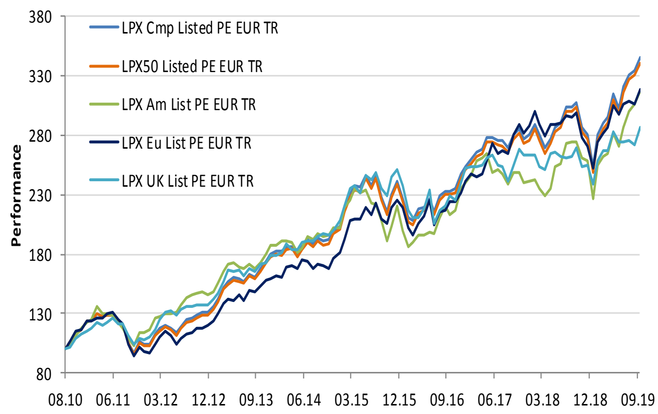
* Subject to one-month lag

PRIVATE EQUITY INDICES (EUR)

30.09.2019 — Total Return Performance

	Name	Last price	Curr.	7 d %	1 m %	3 m %	6 m %	YTD %
COMPOSITE	LPX Cmp Listed PE EUR TR	287.0	EUR	-1.4	3.1	5.3	14.6	36.2
MAJOR COMPANIES	LPX50 Listed PE EUR TR	2701.9	EUR	-1.4	3.2	5.4	15.0	36.9
USA	LPX Am List PE EUR TR	422.9	EUR	-2.2	3.7	7.8	19.1	39.9
EUROPE	LPX Eu List PE EUR TR	1019.1	EUR	1.5	4.0	3.3	7.5	26.3
UK	LPX UK List PE EUR TR	320.2	EUR	0.6	5.4	3.4	3.7	19.8





Graph sources: Bloomberg/BearBull Global Investments

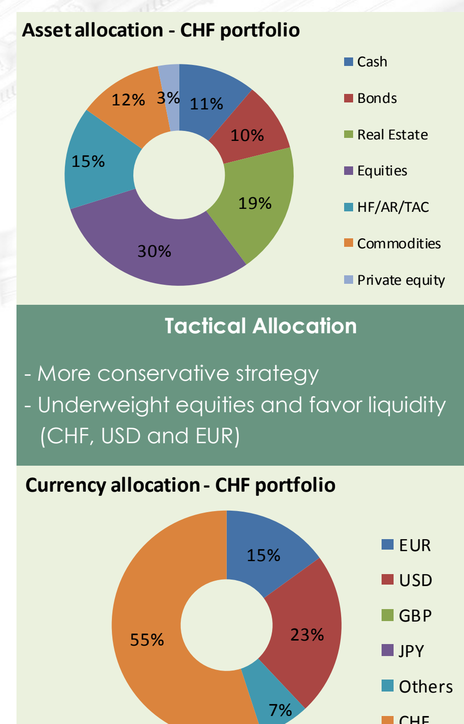
GLOBAL STRATEGY & ASSET ALLOCATION

Graph sources: Bloomberg/BearBull Global Investments

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - CHF

- Overweight USD bonds and short maturities
- Real estate yields remain attractive
- Reduce allocation to equities
- Overweight commodities



ASSETS	Expected Return		ALLOCATION (CHF Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Cash	↘	↘					■		
Bonds	↘	↘		■					
Real Estate	→	↗					■		
Equities	↘	→			■				
Hedge funds	↘	→			■				
Commodities	↗	↗						■	
Private equity	↘	↗			■				

Asset allocation

Our investment strategy focuses on traditional liquid assets (cash, bonds, equities, and real estate), complemented by other diversified and tradable assets (commodities, hedge funds, private equity).

Bonds

The decline in bond yields in August was excessive in the absence of genuine risks of recession. The significant decrease in long-term yields along with more accommodative monetary policies will have a positive impact on growth prospects. The US yield curve will likely continue to normalise. US dollar yields continue to offer attractive opportunities in relative terms in the fixed income segment compared to euro, yen, Swiss franc, and pound-denominated bond markets in particular. Long-term rates are likely to rebound in most markets. Dollar yields are now sufficiently attractive to move away from high yield bonds, whose risk premiums are now too low to warrant a significant allocation. We emphasise caution in our bond strategy and a reduced overall exposure to the segment, overweighting US dollar bonds and short maturities.

Equities

Current equity market valuations are unwarranted given the earnings growth outlook. The recent rise in equity markets appears to be primarily due to PE multiple expansion, which in turn is related to the significant decline in interest rates. Risk levels are now excessive and likely to give rise to negative surprises in terms of earnings and an upswing in interest rates. Equity markets are particularly vulnerable to these two factors, in our view. We recommend reducing exposure to the segment pending more attractive opportunities.

Commodities

Commodities will likely benefit from a gradual change towards a less pessimistic economic scenario. Progress in the trade negotiations between China and the US could lead to a broad-based revision in expectations, from which crude prices seem most likely to benefit. Chinese demand for oil products has remained particularly robust in spite of expectations of a global economic slowdown. Industrial metals will likely also fare well in this context.

Graph sources: Bloomberg/BearBull Global Investments

Real estate

Real estate remains the main alternative to interest rate markets. Yields are attractive, and risks of price corrections resulting from rising interest rates still seem modest in a context where real yields are often negative. We are overweight Swiss real estate, and on the international front, Europe and Asia. In the short term, however, rising premiums could restrict overall performance to direct returns.

Currencies

Changes in monetary policies are unlikely to radically alter interest rate spreads in the sense that interest rates will likely follow a similar path to that taken in the US. However, the US dollar remains the preferred currency because of both this spread against the Swiss franc and a stronger economic outlook. The Swiss franc will likely also start to weaken against the euro.

Market performances - Q3 2019

		Q3 2019		YTD	
		local	CHF	local	CHF
Exchange rates					
USD/CHF		2.2%		1.6%	
EUR/CHF		-2.1%		-3.4%	
GBP/CHF		-1.0%		-2.0%	
JPY/CHF		2.0%		3.0%	
Equity markets					
World	MSCI World USD	0.5%	2.7%	17.6%	19.5%
Europe	DJ Stoxx 600	2.6%	0.5%	19.5%	15.5%
Eurozone	DJ Eurostoxx 50	2.8%	0.6%	18.9%	14.9%
	MSCI Europe S.C.	1.2%	-0.8%	15.2%	11.3%
Germany	Dax 30	0.2%	-1.8%	17.7%	13.7%
France	Cac 40	2.5%	0.4%	20.0%	16.0%
United Kingdom	FTSE 100	-0.2%	-1.3%	10.1%	7.9%
Switzerland	SPI	2.1%	2.1%	24.4%	24.4%
	SMI	1.8%	1.8%	19.6%	19.6%
	MSCI Swiss S.C.	-1.5%	-1.5%	14.8%	14.8%
North America	SP500	1.2%	3.4%	18.7%	20.6%
	Nasdaq	-0.1%	2.1%	20.6%	22.5%
	Tse 300	1.7%	2.8%	16.3%	21.7%
	SP600 Small C.	-0.6%	1.6%	12.2%	13.9%
Japan	Nikkei 225	2.3%	4.3%	8.7%	12.0%
Emerging	MSCI EMF USD	-5.1%	-3.0%	3.6%	5.3%

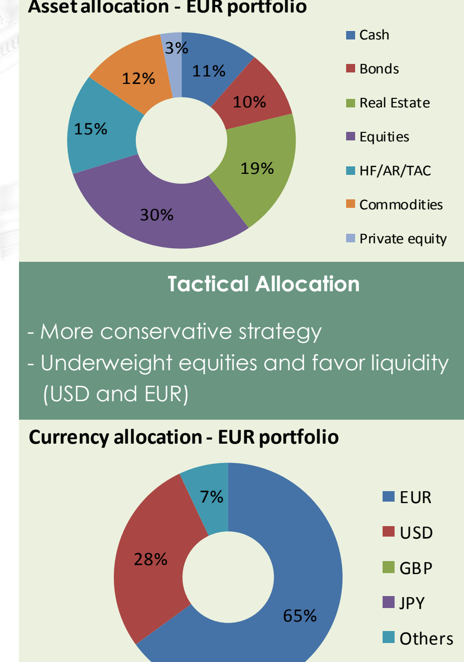
		Q3 2019		YTD	
		local	CHF	local	CHF
Interest rates (3 months)		*(level)*			
CHF		-0.76%			
EUR		-0.44%			
USD		2.09%			
JPY		-0.10%			
Bonds markets					
World	Citi Gr Global Govt.USD	0.8%	3.1%	6.3%	8.0%
Europe	Euro Ser-E Gov > 1	3.8%	1.7%	10.0%	6.3%
United Kingdom	UK Ser-E Gov > 1	6.5%	5.4%	11.8%	9.6%
Switzerland	SBI Général AAA-BBB	1.6%	1.6%	4.9%	4.9%
	SBI Govt.	3.8%	3.8%	8.1%	8.1%
USA	US Ser-E Gov > 1	2.4%	4.6%	7.7%	9.4%
Japan	Japan Ser-E Gov > 1	0.5%	2.6%	3.0%	6.1%
Emerging	J.P. Morgan EMBI Global	1.3%	3.6%	12.1%	13.9%
Miscellaneaous					
	LPP 25 Index	1.8%	1.8%	8.9%	8.9%
	LPP 40 Index	1.9%	1.9%	11.2%	11.2%
	LPP 60 Index	2.0%	2.0%	14.2%	14.2%
Real Estate CH	DB RB Swiss Real Est Fd	1.2%	1.2%	16.0%	16.0%
Hedge Funds	Hedge Fund Research USD	1.1%	3.4%	3.4%	5.0%
Commodities	GS Commodity USD	-4.2%	-2.1%	8.6%	10.3%

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - EUR

- Overweight USD bonds and short maturities
- Real estate yields remain attractive
- Reduce allocation to equities
- Overweight commodities

ASSETS	Expected Return 3months	Expected Return 1year	ALLOCATION (EUR Portfolio) underweight ---	--	-	neutral =	overweight +	++	+++
Cash	↘	↘							
Bonds	↘	↘							
Real Estate	→	↗							
Equities	↘	→							
Hedge funds	↘	→							
Commodities	↗	↗							
Private equity	↘	↗							



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The decline in bond yields in August was excessive in the absence of genuine risks of recession. The significant decrease in long-term yields along with more accommodative monetary policies will have a positive impact on growth prospects. The US yield curve will likely continue to normalise. US dollar yields continue to offer attractive opportunities in relative terms in the fixed income segment compared to euro, yen, Swiss franc, and pound-denominated bond markets in particular. Long-term rates are likely to rebound in most markets. Dollar yields are now sufficiently attractive to move away from high yield bonds, whose risk premiums are now too low to warrant a significant allocation. We emphasise caution in our bond strategy and a reduced overall exposure to the segment, overweighting US dollar bonds and short maturities.

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Current equity market valuations are unwarranted given the earnings growth outlook. The recent rise in equity markets appears to be primarily due to PE multiple expansion, which in turn is related to the significant decline in interest rates. Risk levels are now excessive and likely to give rise to negative surprises in terms of earnings and an upswing in interest rates. Equity markets are particularly vulnerable to these two factors, in our view. We recommend reducing exposure to the segment pending more attractive opportunities.

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Commodities will likely benefit from a gradual change towards a less pessimistic economic scenario. Progress in the trade negotiations between China and the US could lead to a broad-based revision in expectations, from which crude prices seem most likely to benefit. Chinese demand for oil products has remained particularly robust in spite of expectations of a global economic slowdown. Industrial metals will likely also fare well in this context.

Graph sources: Bloomberg/BearBull Global Investments

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Currencies

Changes in monetary policies are unlikely to radically alter interest rate spreads in the sense that interest rates will likely follow a similar path to that taken in the US. However, the US dollar remains the preferred currency because of both this spread against other currencies and a higher economic dynamic. Diversification outside the euro is justified by the lack of yield on the European currency.

Market performances - Q3 2019

		Q3 2019 local	Q3 2019 EUR	YTD local	YTD EUR
Exchange rates					
USD/EUR		4.4%		5.2%	
CHF/EUR		2.1%		3.6%	
GBP/EUR		1.0%		1.4%	
JPY/EUR		4.1%		6.8%	
Equity markets					
World	MSCI World USD	0.5%	4.9%	17.6%	23.7%
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		Q3 2019 local	Q3 2019 EUR	YTD local	YTD EUR
Interest rates (3 months)	*(level)*				
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EUR		-0.44%			
USD		2.09%			
JPY		-0.10%			
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Emerging	J.P. Morgan EMBI Global	1.3%	5.8%	12.1%	17.9%
Miscellaneaous					
	LPP 25 Index	1.8%	5.5%	8.9%	12.8%
	LPP 40 Index	1.9%	5.6%	11.2%	15.2%
	LPP 60 Index	2.0%	5.7%	14.2%	18.3%
Real Estate CH	DB RB Swiss Real Est Fd	1.2%	1.2%	16.0%	20.2%
Hedge Funds	Hedge Fund Research USD	1.1%	5.5%	3.4%	8.8%
Commodities	GS Commodity USD	-4.2%	0.0%	8.6%	14.3%

GLOBAL STRATEGY I ASSET ALLOCATION

Diversified portfolio: Medium Risk - USD

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- Real estate yields remain attractive
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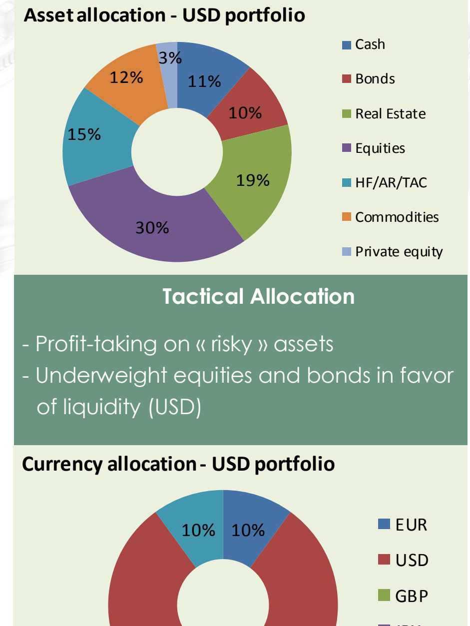

ASSETS	Expected Return		ALLOCATION (USD Portfolio)						
			underweight			neutral	overweight		
	3months	1year	---	--	-	=	+	++	+++
Cash	↘	↘					■		
Bonds	↘	↘		■					
Real Estate	→	↗					■		
Equities	↘	→			■				
Hedge funds	↘	→			■				
Commodities	↗	↗						■	
Private equity	↘	↗			■				

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The decline in bond yields in August was excessive in the absence of genuine risks of recession. The significant decrease in long-term yields along with more accommodative monetary policies will have a positive impact on growth prospects. The US yield curve will likely conti-nue to normalise. US dollar yields continue to offer attractive opportunities in relative terms in the fixed income segment compared to euro, yen, Swiss franc, and pound-denominated bond markets in particular. Long-term rates are likely to rebound in most markets. Dollar yields are now sufficiently attractive to move away from high yield bonds, whose risk premiums are now too low to warrant a significant allocation. We emphasise caution in our bond strategy and a reduced overall exposure to the segment, overweighting US dollar bonds and short maturities.

Equities

Current equity market valuations are unwarranted given the earnings growth outlook. The recent rise in equity markets appears to be primarily due to PE multiple expansion, which in turn is related to the significant decline in interest rates. Risk levels are now excessive and likely to give rise to negative surprises in terms of earnings and an upswing in interest rates. Equity markets are particularly vulnerable to these two factors, in our view. We recommend reducing exposure to the segment pending more attractive opportunities.

Commodities

Commodities will likely benefit from a gradual change towards a less pessimistic economic scenario. Progress in the trade negotiations between China and the US could lead to a broad-based revision in expectations, from which crude prices seem most likely to benefit. Chinese demand for oil products has remained particularly robust in spite of expectations of a global economic slowdown. Industrial metals will likely also fare well in this context.

Graph sources: Bloomberg/BearBull Global Investments

Real estate

Real estate remains the main alternative to interest rate markets. Yields are attractive, and risks of price corrections resulting from rising interest rates still seem modest in a context where real yields are often negative. We are overweight Swiss real estate, and on the international front, Europe and Asia. In the short term, however, rising premiums could restrict overall performance to direct returns.

Currencies

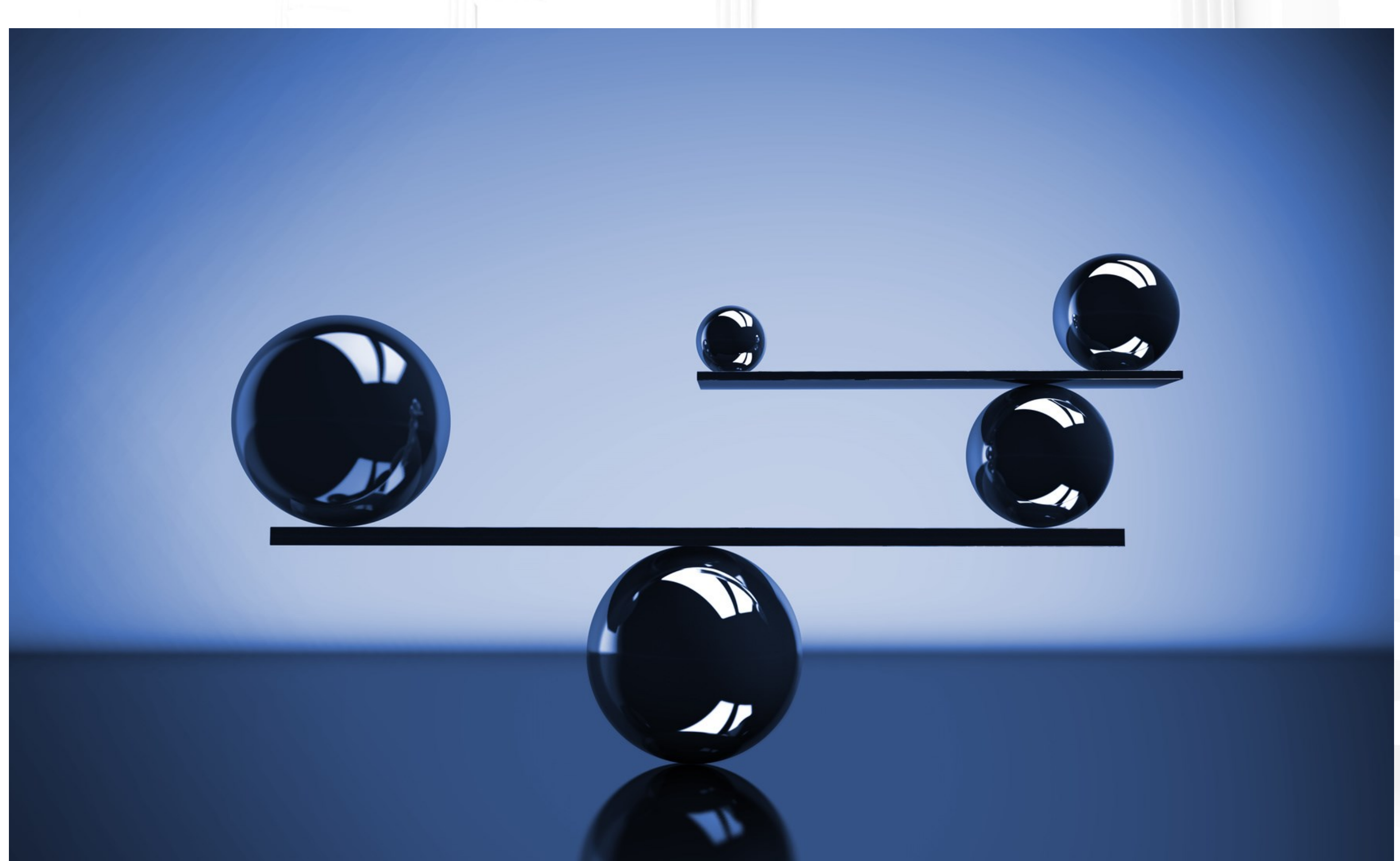
Changes in monetary policies are unlikely to radically alter interest rate spreads in the sense that interest rates will likely follow a similar path to that taken in the US. However, the US dollar remains the preferred currency because of both this spread against other currencies and a higher economic dynamic. Diversification outside the dollar offers few yield expectations and capital gains.

Market performances - Q3 2019

		Q3 2019 local	Q3 2019 USD	YTD local	YTD USD
Exchange rates					
CHF/USD		-2.2%		-1.6%	
EUR/USD		-4.2%		-5.0%	
GBP/USD		-3.2%		-3.6%	
JPY/USD		-0.2%		1.4%	
Equity markets					
World	MSCI World USD	0.5%	0.5%	17.6%	17.6%
Europe	DJ Stoxx 600	2.6%	-1.7%	19.5%	13.6%
Eurozone	DJ Eurostoxx 50	2.8%	-1.5%	18.9%	13.0%
	MSCI Europe S.C.	1.2%	-3.0%	15.2%	9.5%
Germany	Dax 30	0.2%	-3.9%	17.7%	11.9%
France	Cac 40	2.5%	-1.8%	20.0%	14.1%
United Kingdom	FTSE 100	-0.2%	-3.4%	10.1%	6.1%
Switzerland	SPI	2.1%	-0.1%	24.4%	22.4%
	SMI	1.8%	-0.4%	19.6%	17.6%
	MSCI Swiss S.C.	-1.5%	-1.5%	14.8%	14.8%
North America	SP500	1.2%	1.2%	18.7%	18.7%
	Nasdaq	-0.1%	-0.1%	20.6%	20.6%
	Tse 300	1.7%	0.6%	16.3%	19.8%
	SP600 Small C.	-0.6%	-0.6%	12.2%	12.2%
Japan	Nikkei 225	2.3%	2.1%	8.7%	10.2%
Emerging	MSCI EMF USD	-5.1%	-5.1%	3.6%	3.6%

		Q3 2019 local	Q3 2019 USD	YTD local	YTD USD
Interest rates (3 months)	*(level)*				
CHF		-0.76%			
EUR		-0.44%			
USD		2.09%			
JPY		-0.10%			
Bonds markets					
World	Citi Gr Global Govt.USD	0.8%	-1.3%	6.3%	4.5%
Europe	Euro Ser-E Gov > 1	3.8%	-0.5%	10.0%	4.6%
United Kingdom	UK Ser-E Gov > 1	6.5%	3.1%	11.8%	7.8%
Switzerland	SBI Général AAA-BBB	1.6%	-0.6%	4.9%	3.2%
	SBI Govt.	3.8%	1.5%	8.1%	6.3%
USA	US Ser-E Gov > 1	2.4%	2.4%	7.7%	7.7%
Japan	Japan Ser-E Gov > 1	0.5%	0.4%	3.0%	4.5%
Emerging	J.P. Morgan EMBI Global	1.3%	1.3%	12.1%	12.1%
Miscellaneaous					
	LPP 25 Index	1.8%	0.1%	8.9%	7.1%
	LPP 40 Index	1.9%	0.2%	11.2%	9.4%
	LPP 60 Index	2.0%	0.4%	14.2%	12.3%
Real Estate CH	DB RB Swiss Real Est Fd	1.2%	1.2%	16.0%	14.1%
Hedge Funds	Hedge Fund Research USI	1.1%	1.1%	3.4%	3.4%
Commodities	GS Commodity USD	-4.2%	-4.2%	8.6%	8.6%

INVESTMENT THEME FOCUS



Graph sources: Bloomberg/BearBull Global Investments

INVESTMENT THEME

Crude prices to stabilise above $60

- Economic slowdown scenario has significant impact
- Demand trending up
- Overly pessimistic revisions of expectations regarding demand for crude
- Supply will likely decrease more than expected
- Bullish outlook for 2020

Economic slowdown scenario has significant impact

Over the past twelve months, the economic slowdown scenario has steadily strengthened, significantly impacting a number of financial assets including crude prices among others. This scenario, which has had negative effects on oil prices, has been, and still is, based primarily upon one factor, namely the lack of tangible progress in the negotiations between China and the US on the issue of China's trade surplus.

As this scenario has strengthened, it has impacted capital markets and crude prices more than equity markets. US long-term interest rates (10-year) plummeted by over -50% from 3.1% to 1.5% in only 12 months, reflecting the pessimistic, recessionary scenario. Crude prices also fell from $76.9/barrel at their 12-month high in October 2018 to $42.36 at their low point in December. In dropping by -45% in a single quarter, crude prices actually adjusted more rapidly to this scenario than any other financial asset.

Leading indicators such as the manufacturing PMI reflected the uncertainties and fears of purchasing managers during this whole period. Industrial output and manufacturing data thus served as catalysts with regard to crude prices as well. The fall in the US PMI was more gradual and ultimately more similar to that of US interest rates than the fall in the Chinese PMI, which was almost as volatile as crude prices.

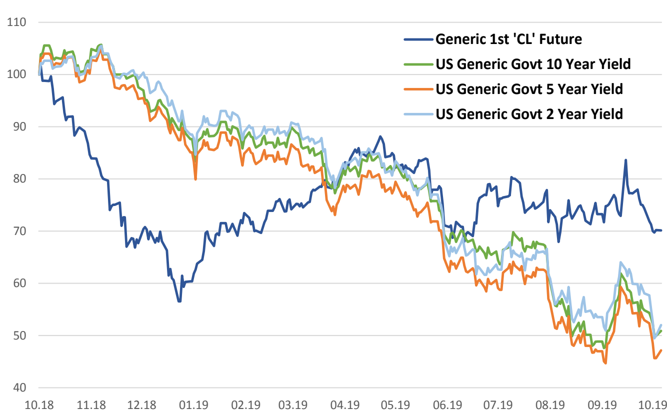
Indeed, the sharp initial drop in oil prices was strongly correlated with the decline in the Chinese manufacturing PMI between October 2018 and January 2019. The upswing in the Chinese PMI in the following months then supported an increase in crude prices from $42.36 to $65 (April).

Hopes of a trade agreement then faded, causing leading indicators to contract further both in China and the US, which this time was impacted more significantly than before. As the situation in the manufacturing sector has stabilised since June, crude prices have stabilised above $50 as well.

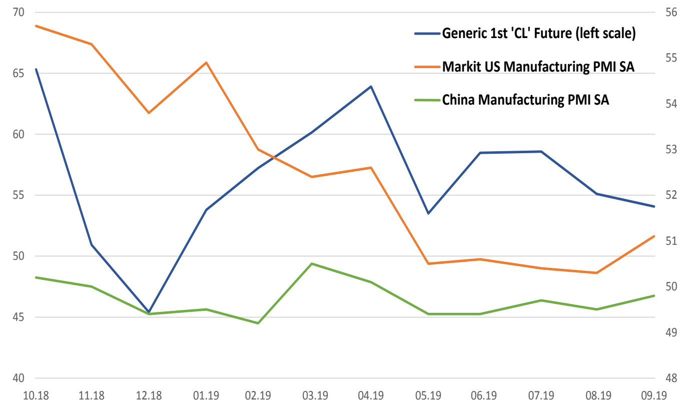
Upcoming movements in crude prices thus seem tied much more to the outcome of the Sino-American talks and the economic outlook globally, and in China in particular, than to other specific factors related to supply and demand for crude, which we will discuss below.

Regarding these two key points, we believe the recession scenario, whose likelihood of materialising was already very low, is less and less credible, due in particular to the positive impact of the generalised decrease in interest rates seen all over the world over the past twelve months. Borrowing costs have fallen by 50% in the US, and reductions elsewhere have also been significant at times. Moreover, changes in monetary policy, announced by a growing number of central banks over the past few months, will give a lasting boost to domestic economies with the help of falling real interest rates.

Oil and US interest rates (2,5,10 years)



Oil and PMI manufacturing US & China



Graph sources: Bloomberg/BearBull Global Investments

Furthermore, while China and the US may well struggle to reach acomprehensive agreement, we believe the two parties should at least negotiate a more limited agreement, which would lift the uncertainties detrimental to crude demand and prices.

Demand trending up

The situation in the global oil market clearly shows a sharp upward trend in demand, which has mostly outstripped supply since Q1 2017. In Q3 2019, global demand for crude exceeded 100 mbd for the first time. After a period of oversupply at the end of 2018, in the past two quarters global demand for crude oil has outstripped global supply, which is unlikely to exceed 100 mbd before Q4 2019. In 2017, inventories started to decline due to the strong increase in demand and to concerted reductions in supply by OPEC. Production cuts were sufficient to reduce supply below the level of demand and thus to cause prices to rise. This imbalance was enough to push oil prices (WTI) from $42 to $75 in twelve months, an 80% increase from June 2017 to June 2018.

In the shorter term, uncertainty regarding the direction of the global economy should theoretically reduce real demand. In our view, this expectation is already fairly broadly factored in by international agencies and investors. We will discuss below whether this expectation is realistic or perhaps somewhat overblown.

Overly pessimistic revisions of expectations regarding demand for crude

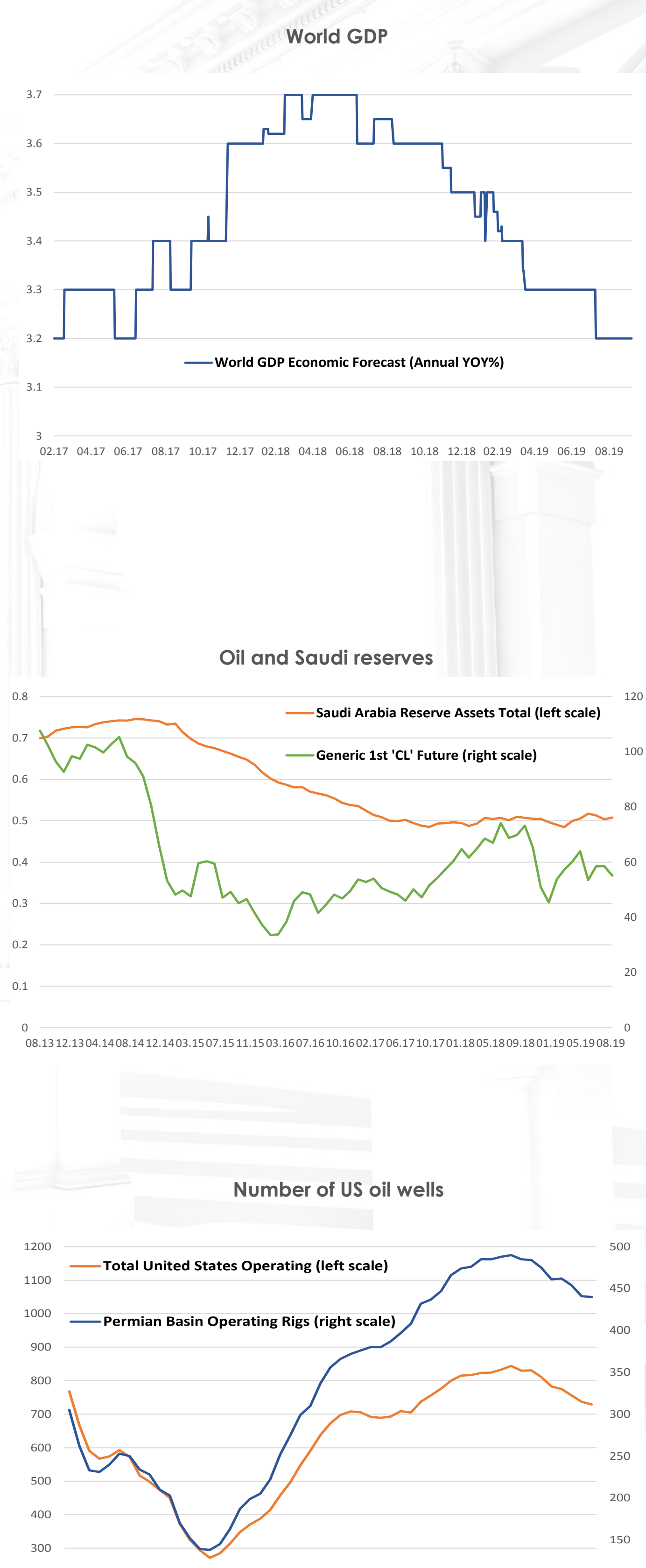
The various international agencies providing forecasts for crude oil demand have steadily decreased their outlook for the end of the year and for 2020 due to the uncertainties weighing on global growth. According to their latest estimates, the growth in current global demand for crude is estimated to be +1.1 mbd by the International Energy Agency (IEA) and +1 mbd by the Energy Information Administration (EIA) and OPEC (Organisation of Petroleum-Exporting Countries). In January, these estimates were higher by approximately 300,000 bd to 500,000 bd. The three agencies' revisions significantly affected the spot and forward markets. Nevertheless, China continues to import increasing quantities of crude. In August 2019, Chinese crude imports exceeded 42 million metric tonnes in one month, namely around 7.5% more than for the same period in 2018.

Supply will likely decrease more than expected

While international energy agencies' downward revisions impacted demand, they also affected the supply outlook, as they estimated the increase in supply from non-OPEC countries to be 2.2 mbd in 2020 for instance. Crude prices are still significantly influenced by politics and the Sino-American trade war. In a still uncertain political context, investors are hesitating to take risks in this market. However, oil production is declining and could potentially end up well below expectations for 2020.

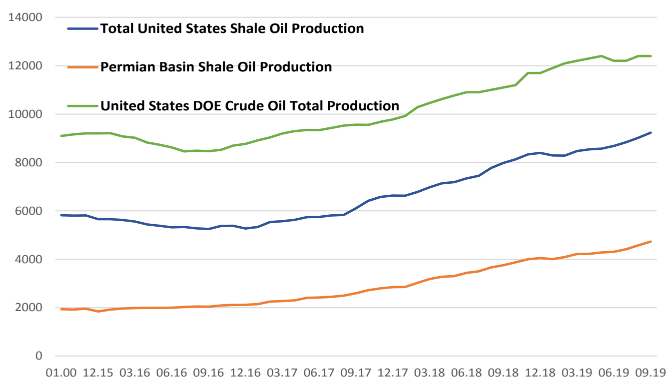
Leading indicators for oil production in the US point to a slowdown in production since the end of 2018, in particular in the Permian Basin. The latest official production figures were released in May 2019 and do not show any growth in production. In relative terms, production is down 500,000 bd compared to the same period last year. Drilling activity as measured by the Baker Hughes Rig Count indicator points to a sharp decline to only 700. These trends will likely persist as long as prices remain significantly below $75/barrel.

Thus, if these trends persist, the US and shale oil's share of global supply could be significantly below expectations, boosting prices.

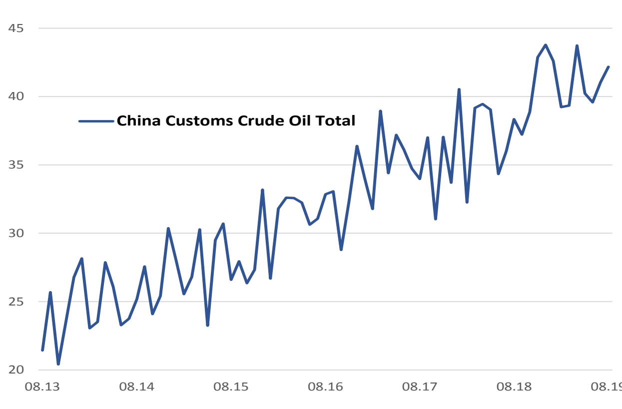


Graph sources: Bloomberg/BearBull Global Investments

US Oil Production



Chinese oil import



Decrease in supply from OPEC, Russia, and the US

OPEC

OPEC countries have remained disciplined over the past several quarters, abiding by their quotas. Saudi Arabia still needs oil prices to be between $75-80 to balance its budget and thus has an obvious interest in implementing measures to keep prices high. While the size of the country's foreign exchange reserves is determined by crude prices and its budget, in the current context, Saudi Arabia has to redistribute oil revenues to maintain much needed social peace and pursue its economic renewal projects. The last increase in crude prices from $42 to $75 just barely enabled the country to stabilise its reserves. Saudi Arabia is thus committed to continuing with these policies.

US

In the US, the shale oil sector has continued to consolidate, significantly altering supply parameters. The leading firms will be able to finance their shale oil production operations more efficiently and on a larger scale than independent producers. Thanks in particular to their financing capacity, Chevron and Exxon have announced investments of 20 to 35 billion dollars per year for the next few years. Production could thus become somewhat less sensitive to spot prices than before. However, larger firms' share of production will likely stay relatively small (20%) compared to that of independents, still well in the majority. Nevertheless, US production will likely slow or even contract, as already suggested by leading indicators for the unconventional oil sector.

Others

Non-OPEC countries do not seem ready to significantly increase production and exports. An agreement between Iran and the US is certainly not in the cards but would undoubtedly constitute the biggest negative surprise for crude prices.

Special situation following the attacks on the Abqaiq and Khurais oil sites in Saudi Arabia

The oil market was disrupted in September by surprise attacks on the Abqaiq oil refinery in Saudi Arabia. The drone attack, since then attributed to Iran, does not seem to have had a major impact on Saudi Arabia's production and export capacity. Initial worries had pushed crude prices up by +15% before official statements reassured the market and crude deliveries were carried out without delay.

This attack against a site that processes close to 50% of Saudi crude exports highlighted the vulnerability of the country's defence system, which was not up to the task of effectively protecting one of the country's main production facilities.

In spite if the shock, markets rapidly sought reassurance, dismissing any similar potential threat with possibly more devastating effects than those caused by the first blow. A few weeks later, momentary fears faded, and prices settled back down at the low end of the trading range in place since June. The main focus of attention in the medium term remains the fundamentals factor, which is still central.

Bullish outlook for 2020

Supply parameters will likely lead to a slight reduction in the global crude supply. Current expectations with regard to US production may be contradicted, as production is likely to be lower than anticipated.

On the demand front, expectations of an economic slowdown seem overblown, which will also likely lead to a gradual upward revision in the forecast.

Energy agencies' forecasts may thus be too cautious with their estimate of slightly over 1 mbd in excess demand in relation to supply.

In this context, crude prices will likely reach an initial equilibrium point at above $60/barrel in the medium term before continuing to climb towards $75.

Graph sources: Bloomberg/BearBull Global Investments

Graph sources: Bloomberg/BearBull Global Investments

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