PICARD ANGST

FY 2020

Outlook & Comment

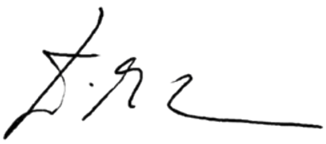
China could tip the scales

After the depressing results of the previous year, no investor would have expected that 2019 would bring a diametrically opposed development, which would even lead to one of the strongest years worldwide in the equity markets in historical comparison. This change is all the more astonishing when you consider that the global macroeconomic outlook has not experienced a comparable turnaround but, on the contrary, has weakened further.

The solution to the puzzle of this divergence lies in the renewed surge in liquidity provided by central banks. However, there is a great danger that the effect will be limited to a temporary stimulation of the financial markets. Especially as China's stimulus efforts are lagging behind the rest of the world, unlike in earlier phases of the global economic slowdown in 2015, 2011 and 2008. If this reflects the reaching of structural limits, China could turn out to be the proverbial tipping point for the outlook of the global economy in the coming year.

Against this backdrop, we remain cautious and defensive in our assessment of the outlook for the coming year, despite and precisely because of the euphoria currently being observed on the markets. This time there are no signs of a substantial recovery in growth expected from many quarters, similar to the 2016 rebound. The current high in equity markets is accompanied by a continued erosion of fundamentals, while central banks have already shot their powder before even being confronted with a recessionary economic environment.

Dr. David-Michael Lincke
Head of Portfolio Management



Overview

1. Macroeconomic Trends
Feelings of elation thanks to monetary policy's liquidity injections 4

2. Equity Markets
Focus on favourable valuations 19

3. Commodities
Supply bottlenecks ensure sustained potential 34

4. Swiss Property
Swiss property caught between negative interest rates and climate protection 44

5. India
2020 – a year of recovery? 55

Feelings of elation thanks to monetary policy’s liquidity injections

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

- Preliminary signs of stabilisation in some leading indicators have rekindled optimism with regard to the economy, but hard economic data and other indicators are yet to confirm this.
- In contrast to previous phases of economic weakness, China‘s stimulus efforts have had little effect so far and turned out to be much smaller in scale. If China has indeed reached the limits of its potential, the world economy is in danger of a continued and prolonged downturn.
- In the United States, the danger of a slide into recession has by no means been averted, even if the inversion of the yield curve has disappeared again.
- In contrast, with the exception of China, things are looking more positive for emerging markets, especially as many of these economies have considerable room for manoeuvre in their monetary and fiscal policies.
- Belief in the all-powerfulness of the central banks is is increasingly being shaken. In particular, ever more doubt is being cast over the usefulness of negative interest rates. That said, however, liquidity injections have not yet lost their impact on the financial markets. But it is doubtful whether the global turnaround in monetary policy to a course of renewed easing can actually avert the danger of a recession.
- The outlook for global bonds looks bleak. However, emerging market bonds offer a ray of hope, not only in view of the comparatively high yields to maturity, but also against a backdrop of significantly undervalued currencies.
- There is still no end in sight for the trade conflict between the United States and China. Hopes have become focused solely on concluding a minimal agreement, while the resulting uncertainty continues to increase world trade volumes.
- The sharp fall in inflation expectations contrasts with the robust development of spot inflation in the United States. This opens up opportunities in inflation-linked bonds.

· Despite falling key interest rates, the US dollar has remained strong so far; this is likely to change in the coming year, however.

Outlook

Despite preliminary signs of stabilisation in individual leading indicators, there are still few indications that the global economic downturn is at an end. The impression that China has reached the limits of its stimulus potential in light of the debt bubble is particularly worrying. Even though the central banks around the world have adopted an easing course, the historical example does not inspire much confidence that this alone can steer growth in a different direction. In addition, there is still no end in sight for the trade conflict between the United States and China.

1.1 Macroeconomic Trends

China reaches the limits of growth stimulation

The effects of the trade conflict between the United States and China are often used to explain the slowdown in the global economy that has been observed for some time. However, its origins lie in the slackening of stimulus efforts between 2015 and 2017, which China used to counter the recent slump in the domestic economy.

To boost credit creation, local government agencies were encouraged to issue large amounts of bonds and invest the proceeds into infrastructure projects. The shadow banking system was also mobilised; this tripled in size in 2016 alone. The consequence was a reactivation of the domestic property and infrastructure bubble, the effect of which was exported and saved the global economy from drifting into recession.

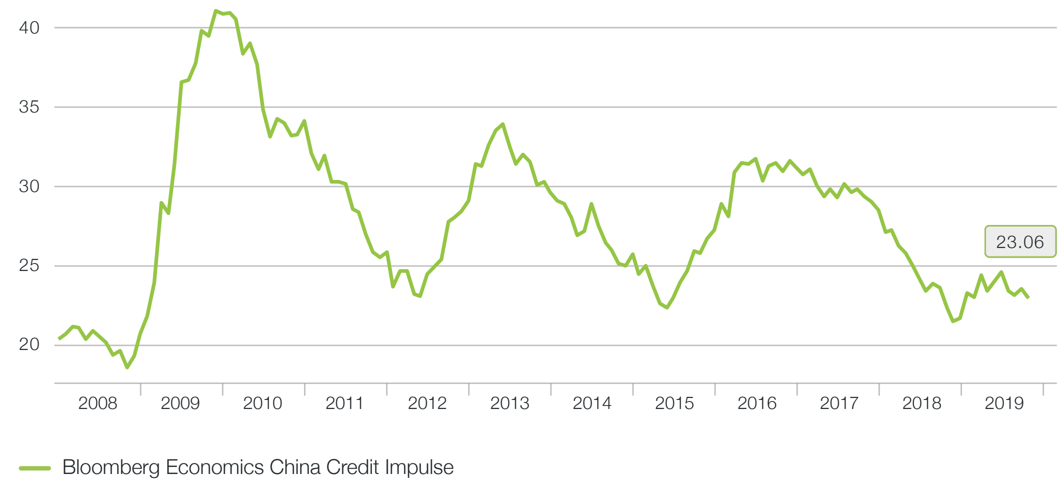
Since the global financial crisis, China, with its stimulus measures for the global economy, has repeatedly missed out on the energy boosts needed in critical situations to remain on a growth course. This can be clearly seen in what is known as the credit impulse, which relates the extent of credit creation in an economy to the growth rate of gross domestic product (GDP) (see Fig. 1). However, its development also shows that the intensity of economic stimulus measures has gradually decreased over the last decade.

The credit response to the current phase of weakness, which has pushed Chinese GDP growth below the 6% p.a. threshold, has so far been minimal. This is probably due to the massive debt bubble resulting from the massive financing of unproductive investments in the past, which has caused Chinese productivity growth to stagnate.

Nevertheless, the Chinese government has also tried to stimulate credit creation further this year; this has caused the country‘s debt quota, which was still declining in 2018, to rise to over 250% of GDP. While the economy quickly responded to such measures in 2015/16, the reaction in the current year has been extremely timid. Economic growth has fallen to its lowest level since 1992.

Fig. 1

Chinese credit impulse: The intensity of the economic stimulus measures has gradually weakened over the last decade



Source: Bloomberg LP, 29 November 2019

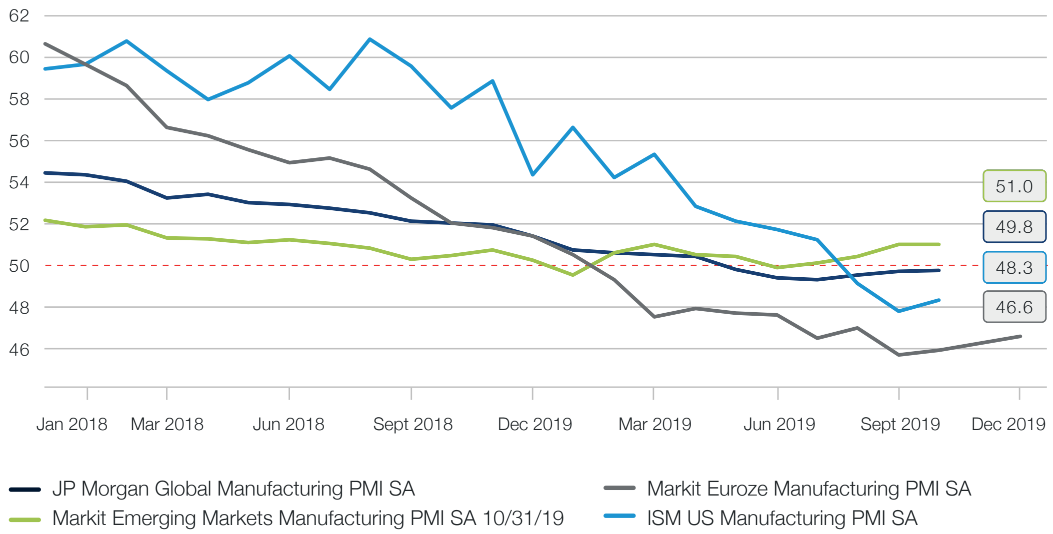
China seems to have reached the point where moderate stimulus measures are losing their effectiveness, and any further strengthening of the measures risks triggering a debt crisis. While central banks in the rest of the world have also returned to a course of easing, the central role played by China in maintaining expansion over the past decade suggests that the economic cycle is coming to an end. The financial markets, and especially the stock markets, have not yet received this message. Yet the divergence from the real economy will close in one direction or the other over the coming year.

Preliminary signs of stabilisation, but no resilient turnaround in global economic outlook

The economic weakness is concentrated in the manufacturing sector. Against the backdrop of ongoing trade disputes, economies that are very open and have a high export share are particularly affected. In Europe, this applies in particular to Germany and also Sweden.

Fig. 2

The weakening trend in leading economic indicators remains intact, but is only showing signs of stabilisation at a low level



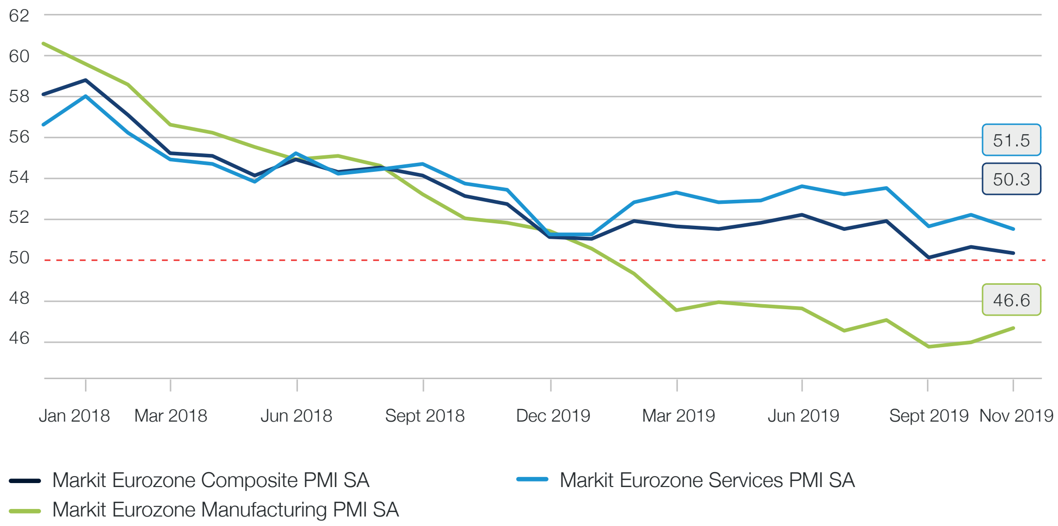
Source: Bloomberg LP, 29 November 2019

In contrast, demand for services, which are predominantly domestically focused by their very nature, is much more robust and remains on a global expansion course. This contrast is particularly marked in the eurozone (see Fig. 3).

In October and November, the purchasing managers' indices of many economies showed the first signs of stabilisation at a low level, which was met with relief by the financial markets. However, there are still no data points to confirm these survey values. Over the same period, only 16% of the leading OECD (LEI) indicators recorded an increase. Hard economic data continues to fall sharply, with the exception of labour market data, which has shown astonishing resilience in both Europe and the United States. However, the latter is a lagging indicator. There are also indications that the current stabilisation of leading indicators merely reflects the expectation of demand in China in anticipation of new tariffs coming into force in September and potentially in December.

Fig. 3

Weakness concentrated in manufacturing industry, while demand for services is surprisingly robust



Source: Bloomberg LP, 29 November 2019

Estimates for global economic growth were significantly revised downwards in the second half of the year. For example, the International Monetary Fund (IFW) expects growth of only 3.0% instead of 3.4% in 2019, the lowest rate of expansion of the global economy since 2009. While the IMF remains optimistic for 2020 and forecasts a growth recovery of 3.4%, the OECD expects growth to stagnate at the low level of 3.0%.

Europe will likely continue to suffer from political paralysis and confrontation in 2020. With marginal growth of 0.01% in Q3 2019, Germany has once again escaped a technical recession by the skin of its teeth. However, there is still no political will to make use of the fiscal leeway and support the economy with government investment programmes. Although the budget conflict between Italy and Brussels has defused as a result of the government reshuffle, the political process in the European Union remains marked by discord and disagreement. The fact that Britain's withdrawal from the European Union has been further delayed is of little help. This keeps the general uncertainty about the future path of the economic bloc high.

1.3 Macroeconomic Trends

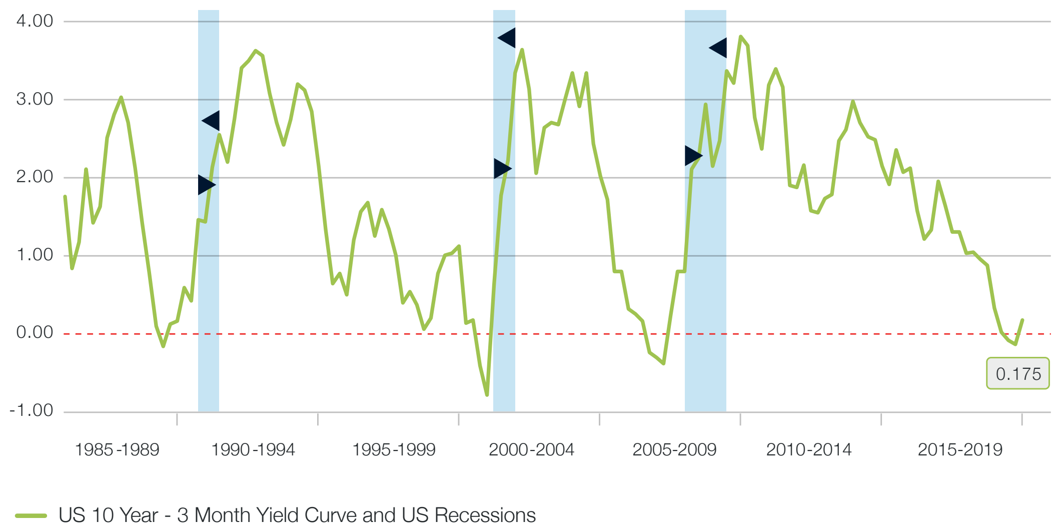
Danger of recession not averted in the United States

Over the summer, the inversion of large parts of the yield curve sparked fears of a recession in the United States. This is a development that has proven to be a reliable harbinger of any recession since the Second World War, albeit with considerable amount of variability with regard to lead times.

Since declining risk aversion and the resumption of bond purchases by the Federal Reserve have contributed to a reversal of this inversion, many of those issuing warnings have fallen silent. The historical track record shows that such a reversal of the inversion of the yield curve often occurs shortly before the onset of a recession and accentuates itself in the course of the recession. This development is driven on the one hand by measures taken by the central bank to lower key interest rates at the short end and, on the other, by the market's expectation, that growth will recover as the recession subsides, which is expressed in rising yields to maturity at the long end (see Fig. 4).

Fig. 4

Reversal of the US yield curve inversion before going into recession



Source: Bloomberg LP, 29 November 2019

The arguments against a recession occurring in the United States in the coming year or 2021 at the latest are sparse. For example, the fiscal stimulus from last year's tax reform has been exhausted. Hopes of a broad-based investment boost from companies have not materialised. Although full employment on the labour market is fundamentally positive, it also means that there is no reason to expect a continued spurt in exceptional employment growth. Due to the combination of demographic factors and sustained declining productivity growth, future real growth rates of barely more than 1% p.a. can be expected for the United States.

It should also be borne in mind that, in the case of the United States, this is now the longest economic expansion in the post-war period. From a mere statistical point of view, a recession is therefore becoming more and more likely. Various regional and sector-specific economic indicators as well as surveys among the executive management of large companies are providing increasingly clear early warning signals about an impending downturn.

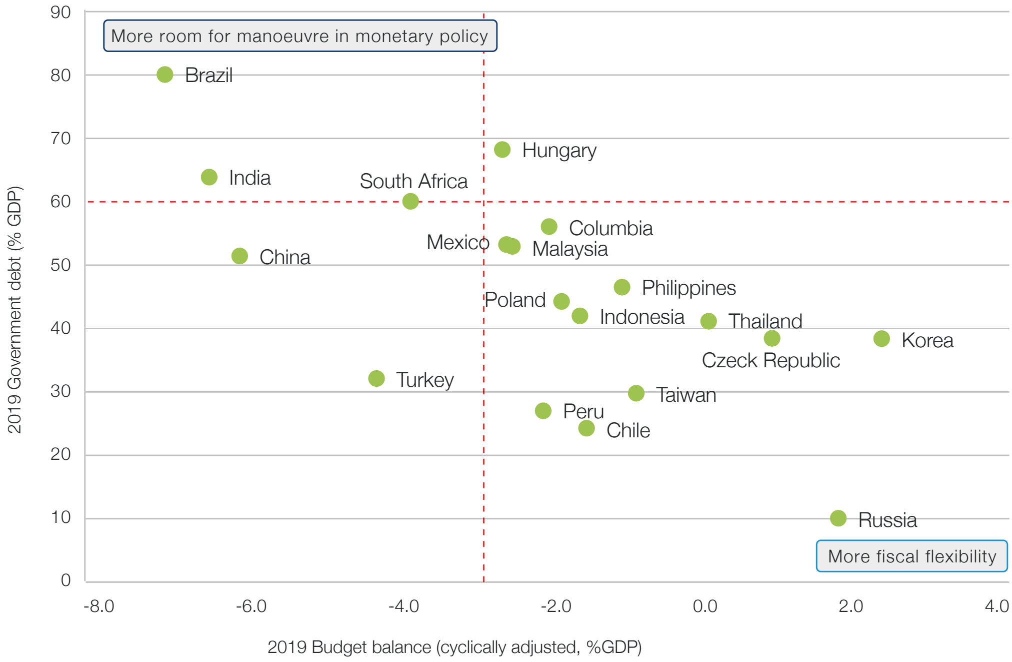
1.4 Macroeconomic Trends

Emerging markets show first signs of stabilisation

In recent years, it has become increasingly difficult for emerging market economies to fulfil their given role as the growth engine of the global economy. The fiscal and monetary stimulus measures introduced by China over the past year have had only a very limited impact (see above). It is questionable whether they will be sufficient to stabilise the growth path of the Chinese economy near the 6% mark, especially as the trade conflict with the United States increasingly produces headwinds. However, with the exception of China, many emerging markets offer a glimmer of hope for the global economy.

Fig.5

Many emerging markets posses monetary and fiscal room to manoeuvre to counter a further downturn



Source: Pictet Asset Management, Datastream, 29 November 2019

As expected, the emerging markets suffered from the slump in global trade. In particular, the commodity-exporting nations of South America are feeling the effects of the significant decline in prices and volumes in their export markets. Many South American countries have experienced the second recessive phase in three years, which puts their political systems under severe pressure. Now, however, it looks as if stabilisation could happen not only in this part of the world, but also in other emerging market regions.

This is mainly due to monetary policy's existing room to manoeuvre. While monetary policy is to a large extent exhausted in the developed countries, countries such as Turkey, Mexico, Brazil and South Africa have a great deal of monetary room for manoeuvre, which they are happy to use, as a series of interest rate cuts in recent weeks shows. The interest rate cuts issued by the US Federal Reserve in recent months have even increased this room for manoeuvre (see Fig. 4).

At the same time, there are many countries that have either deep deficits or even - in the case of countries such as South Korea or Russia - significant budget surpluses. This will enable them to increase their fiscal expenditure if necessary.

Belief in the all-powerfulness of the central banks is increasingly showing cracks

The central bankers are pulling out ever bigger guns in their fight against feared deflation. But far from using a sledgehammer to crack a nut, the effect has failed miserably for ten years. However, instead of taking this as an opportunity to go over the books and fundamentally rethink the strategy, they are now merrily making another attempt, in keeping with the motto “a lot helps a lot”.

Against this backdrop, even the most disposed sections of the analyst and media class now have serious doubts that the set objectives can ever be achieved this way. On the contrary, everywhere there is suspicion and fear that all the financial repression, with its increasingly negative interest rates, has become rather counter-productive and is cementing the economic growth malaise.

The idea that the average citizen could be urged to spend more money by paying a negative rate of interest on their savings, while consumer prices continue to rise slowly but surely, could only seem plausible to economists in the academic ivory towers of central banks. On the contrary, there is a growing impression that the prospects for pension fund assets and old-age provision are gloomy and that we will have to save even more for a rainy day.

Apart from a few exceptions such as the Swedish Riksbank, all this still hasn’t shaken the central banks from their belief that ever lower and more negative key interest rates are a proven remedy, if one would only steadily increase the dose. The question remains how much of this stagnation society is still willing to tolerate before established dogmas are exposed as magical thinking and vodoo in the eyes of the public.

The US Federal Reserve has now completed its move away from a hesitant normalisation path. Not only has there been no interest rate hikes over the past year, but key interest rates have now been lowered three times in a row. As the Federal Reserve regards the current economic slowdown as only a temporary phase of weakness, we do not expect further interest rate cuts in the coming year until there are acute signs of recession. However, given the level of only 1.5% of the Federal Funds Rate, the remaining dry powder to combat such a scenario is limited.

In addition, not only has the Fed ceased its efforts to normalise its balance sheet, it has also begun to inflate it again by introducing a new USD 60 bn per month purchasing programme (see Figure 6). The new purchases became necessary due to a surprising shortage of reserves in the US banking system as a result of the massive increase in the need to maintain liquidity since the global financial crisis due to stricter regulations. Even if this makes the intention behind the measure different from previous quantitative easing programmes, the effect on the central bank balance sheet is the same.

It is indeed correct to argue that restricting purchases to short-term money market instruments (US Treasury Bills) does not have the same transmission effect as absorbing long-dated government bonds. However, the markets for risky assets, in particular the equity market, have not yet followed this differentiation and have appreciated significantly since the introduction of the programme.

Despite all these measures, however, the question arises as to whether it is not already too late for the Fed to turn the tide and successfully avert a recession. The historical track record is not very encouraging. With the exception of 1967 and 1996, every interest rate cut that followed a cycle of rising interest rates inevitably led to a recession. With a remaining cushion of only 150 basis points, there is considerably less ammunition available this time than in previous economic downturns, when the central bank felt compelled to lower key interest rates by an average of 375 basis points.

Fig. 6

The US Federal Reserve Bank's balance sheet again experiences considerable growth

Source: Bloomberg LP, 29 November 2019

European Central Bank's (ECB) options are even more limited, as it did not care to normalise monetary policy in the first place. On the contrary, key interest rates were cut further into negative territory in September and additional interest rate cuts were not ruled out. However, in view of the precarious condition of the European banking system, which suffers severely from this, the remaining room for manoeuvre is severely limited. For this reason, banks have been granted allowances in line with the Swiss model, which in turn reduces the effectiveness of further interest rate steps. Against this backdrop, it is hardly surprising that the quantitative easing programme was again reactivated after it had only been discontinued at the beginning of the year. One gets the impression that the ECB is increasingly manoeuvring itself into a dead end. Accordingly, there is also a loud call coming from central bank circles for fiscal policy to play a stronger role in supporting the European economy. Nevertheless, even after Christine Lagarde took over from Mario Draghi, the ECB has not yet sent a signal that it would consider fundamentally questioning and rethinking its policies.

1.6 Macroeconomic Trends

Bleak outlook for bonds brightened by bright spots in emerging markets

The outlook for global bonds remains gloomy. Valuations are extremely high and inflation is weighing on yields. Real yields are at a record low of 1.4%. Although the share of negatively yielding bonds has declined somewhat over the past few months, at USD 12.4 bn it remains above the 2016 high (see Fig. 7). The weighted average yield to maturity on these commitments has recovered significantly since the summer, but is still quoted at -0.26% p.a. This means that half of all outstanding European government bonds and 20% of the universe of European corporate bonds with investment grade ratings are bearing negative interest rates.

Fig. 7

Global market value of negative interest-bearing bonds has risen to a new record high

Source: Bloomberg LP, 29 November 2019

Falling yields on government bonds have recovered from the summer lows, but remain caught in an overall downward trend (see chart 8). This reflects the weak economic outlook and the ever-present danger of many developed economies sliding into recession. Therefore, without corresponding resilient indications of a recovery in the economic outlook, we consider a further rise in yields to maturity to be an attractive opportunity for an increase in portfolio duration, particularly in the case of US government bonds.

There are also rays of hope, however; in the bond markets, these are emerging market bonds. Although the yield on emerging market bonds in local currency fell to an all-time low in October, the asset class continues to offer the best outlook of any major bond market. On the one hand, the yield of 5% p.a. is still considerably higher than that of other bonds. In addition, emerging market currencies appear very attractive. They are substantially undervalued against the US dollar and, given the relative growth trend, there are good prospects that this discount will decrease in the coming year. This will give an additional boost to emerging market bond yields. In addition to government bonds issued by emerging markets, corporate bonds issued by emerging markets are also of interest.

In contrast, corporate bonds are less attractive in industrialised countries. It is not only the high valuations that act as a deterrent, but also the historically low ratings of companies. The ratio of companies with a CCC rating to those with a B rating is currently even higher than during the 2016 energy crisis, a very difficult market phase for high-yield bonds.

European investment-grade bonds, for example, yield a meager 0.4% p.a. in a situation where Germany is threatening to slide into recession. This is all the more worrying given that global earnings growth is slowing sharply and has been declining over the last three quarters.

Fig. 8

Falling yields on government bonds have recovered from summer lows, but remain caught in a downward trend

Source: Bloomberg LP, 29 November 2019

1.7 Macroeconomic Trends

There is still no end in sight in the trade conflict between the United States and China

After a repeated back and forth with phases of escalation, which were in turn replaced by phases of de-escalation, the situation in the trade dispute between the United States and China at the end was almost back to where it was at the beginning of the year.

It is certainly true that it was primarily the trade deficit with China which the Trump administration initially took exception to. It should not be forgotten, however, that the conflict has a much wider dimension and meaning. Ultimately, the United States is concerned with keeping an emerging competitor for global economic and military supremacy in check. This explains its increasing focus on the technology transfer forced by China, the danger posed by China's monitoring of foreign companies and President Xi's ‚Made in China 2025' plan, which directly threatens the USA's technological dominance. The sanctions against the Huawei technology group should also be seen in this context.

Against this backdrop, it can be assumed that the core of the conflict will persist over the long term and that it will present a structural headwind with regard to the further expansion of world trade.

One could even argue that the globalisation of the world economy has not only stalled, but is already in reverse gear in many places. Globalised supply chains are being dismantled again. The focus of companies is becoming more regional. We are moving from the vision of an integrated unipolar economic system to a multipolar world. As a result, friction in commercial traffic is increasing again and efficiency is decreasing.

Hence ambitions to see at least a partial settlement of the conflict have been greatly reduced over the last few months. The focus now lies on negotiating of a "phase one deal", which deals only with those points that are of mutual interest, and thus open the door to a pragmatic agreement. On the American side, this includes the resumption of imports of US agricultural goods by China, while China is primarily interested in preventing a further increase and reducing existing tariff hurdles. However, as developments in recent weeks have shown, even an agreement on such a minimal deal seems by no means in the bag, and there are increasing rumours that a possible conclusion may not be reached until next year. This does not bode well for the chances of further agreements in subsequent phases, when far more controversial issues will be under discussion.

The global uncertainty triggered by the United States' new confrontational trade policy has already been reflected in the development of world trade. Trading volumes have been declining since the second half of the previous year, therefore (see Fig. 9). The IMF estimates that the tariff barriers introduced and uncertainty about future developments will reduce global economic growth by 0.8% by the end of 2020.

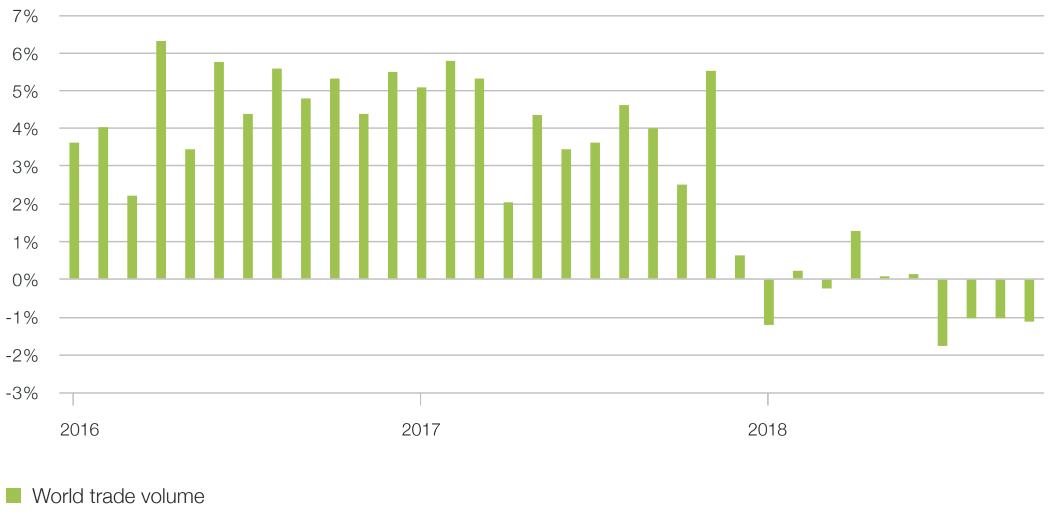
For the American economy alone, the consequences of continued escalation in the form of an extension of customs duties to all Chinese imports are much more dramatic. It is estimated that the US gross domestic product would be 0.75% to 1% lower and that credit spreads in the high-yield sector could widen from below 400 basis points to over 700 basis points.

In response to the tariffs levied against China, a reconfiguration of global value chains is already emerging. Vietnam in particular appears to be profiting from the withdrawal of production capacities from China. In addition, Taiwan, Chile, Malaysia and Argentina are enjoying an increase in direct foreign investment. India has also recently taken steps to increase its attractiveness as an alternative location for outsourcing value chains by reforming its corporate tax system.

There is also the danger that the next step in the escalation will be for the US administration to extend its confrontational trade policy to Europe, where the Americans cite the automobile sector as a particular thorn in their side.

Fig. 9

World trade volume continues to contract



Source: CPB Netherland Bureau for Policy Analysis, 29 November 2019

The potential for rising inflation despite economic weakness is underestimated

The development of inflation expectations is another reason for monetary policy to have thrown all normalisation efforts out of the window over the past year. After a temporary recovery over the first quarter, these collapsed dramatically over the summer and have since recovered only partially. For example, the break-even inflation rate for ten-year US Treasuries remains at only 1.65 (see Fig. 10).

One exception is the UK, where inflation expectations remain close to 3.5%; although this is likely to be largely due to persistent uncertainty about the UK's exit from the European Union and the associated inflationary consequences.

However, if one looks at the development of spot inflation in the United States measured by the Core CPI, it becomes clear that it is in a stable upward trend and is currently close to a ten-year high of 2.4% (see Fig. 10).

Fig. 10

US inflation expectations remain low despite rising spot inflation

Source: Bloomberg LP, 29 November 2019

It can be expected that longer-term inflation expectations will at least approach the effective inflation level, even if they don't manage to catch up. We therefore see potential for inflation-linked bonds in the United States.

The cover story of the American magazine Bloomberg Businessweek, which announced the death of inflation a few months ago, may turn out to be a classic contrary indicator over the longer term. The zeitgeist is changing and seems to be going in an inflationary direction. Warnings about over-indebtedness and budget deficits as well as warnings about more austerity have largely fallen silent. In return, radical theories such as „Modern Monetary Theory", which question the established separation of monetary and fiscal policy, have now become socially acceptable; they are not only finding a platform in leading press outlets, but have even become the subject of parliamentary debates. The days of disinflation and deflation that lasted since the early 1980s may therefore be numbered and may herald a regime that in some respects is more reminiscent of the inflation dynamics of the 1960s and 1970s.

1.9 Macroeconomic Trends

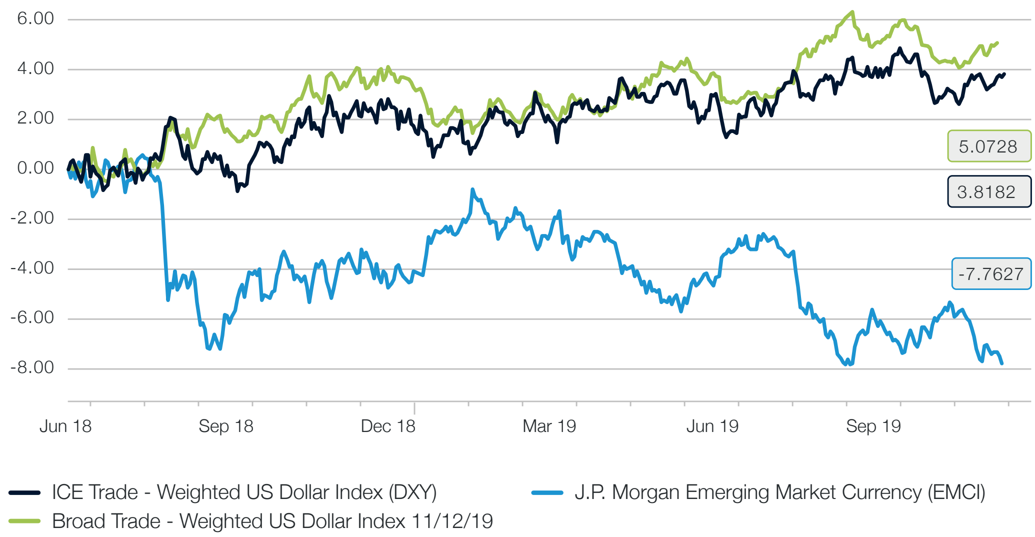
Recovery potential with EM currencies

At the beginning of last year, there were many indications that the continued strength of the US dollar against both most developed country currencies and, to a much greater extent, emerging market currencies would soon come to an end. However the US currency also continued to soar in 2019.

Even the reduction of the EURUSD interest rate differential in the wake of three key interest rate cuts by the US Federal Reserve has left little impression on the US currency so far. A significant factor in this regard has probably been the shortage of dollar funding, which has been reflected in a steady rise in hedging costs, among other things, which have in the meantime exceeded the 3% per annum threshold for the euro, the Japanese yen and the Swiss franc. However, the Federal Reserve's easing measures in the form of repo transactions in the money market and permanent liquidity measures in the form of purchasing Treasury Bills on a large scale will put a stop to this development.

Fig. 11

Distinct divergences on the FX markets as a result of US monetary policy: Broad and narrow trade-weighted US Dollar vs. emerging currencies



Source: Bloomberg LP, 29 November 2019

The ever-expanding US budget deficit should also put a stop to the dollar shortage. In view of the declining attractiveness of US investments, it is difficult to imagine that the annual issue of USD 1.3 to 1.5 trillion of additional government bonds at the current currency level will motivate a sufficient number of foreign buyers.

The fact that the US dollar is clearly overvalued on a broad basis when measured against its real effective exchange rate also suggests a gradual depreciation.

As an election year, 2020 also entails special political risks. In the field of challengers, Elizabeth Warren has good chances of being nominates as being nominated as the democratic to take on Donald Trump, which is assessed as particularly negative by the financial markets due to her political convictions. The very possibility of a Warren presidency could put the dollar under pressure.

The emerging markets currencies are likely to turn out to be special benefits of a weaker dollar. In view of an undervaluation of 20% to 25% against the US dollar according to relevant models, the resumption of considerable capital inflows into these economies can be expected in the wake of a depreciation of the dollar.

Your Contacts

Dr. David-Michael Lincke

Head of Portfolio Management
E-Mail: david-michael.lincke@picardangst.com
T +41 55 290 55 55

Focus on favourable valuations

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

· Over the past year, following the US Federal Reserve's change of course, the equity markets have focused solely on a global easing of monetary policy, whereby the signs of a progressive cooling of the global economy and declining corporate profits were deliberately ignored.

· In fact, the development of the global equity market over the course of the year can almost entirely be attributed to the development of the liquidity provided by the central banks.

· Cautious growth prospects for the global economy and the lack of a fundamental underpinning of the bull market are cautionary reminders for the coming year. Both the European and American equity markets slipped into a corporate earnings recession this year; the profit expectations for 2020 appear overambitious, especially for the American equity market.

· Distinct valuation divergences between regions, countries and sectors call for selectivity from investors but also open up opportunities. In addition to emerging markets, the medium- and long-term return prospects are attractive for parts of Europe. Energy and European banks stand out as attractive sectors, while technology stocks are likely to have exhausted their potential.

· The US equity market is threatening to become the victim of its own success: its high outperformance compared with the rest of the world comes with the downside of excessive valuations, which cause us to keep our distance.

Outlook

With astonishing carelessness and spurred on by the central bank's reopened money taps, global equity markets have climbed to new highs. Next year, however, the climate is likely to become tougher. Even optimistic scenarios for the global economic outlook postulate a modest recovery in growth at best. It is doubtful that this will enable the earnings growth hoped for next year and validate the runaway prices in view of the clear current recession in corporate profits. Investors are therefore advised to be selective and to focus on favourable valuations. At the country and regional level, this is particularly true of emerging markets, but Japan and individual markets on the European periphery are also luring customers with bargains. US equities, on the other hand, should be avoided. Not only are they extremely expensive to value, but the high weight of the technology sector also increases the risk.

2.1 Equity Markets

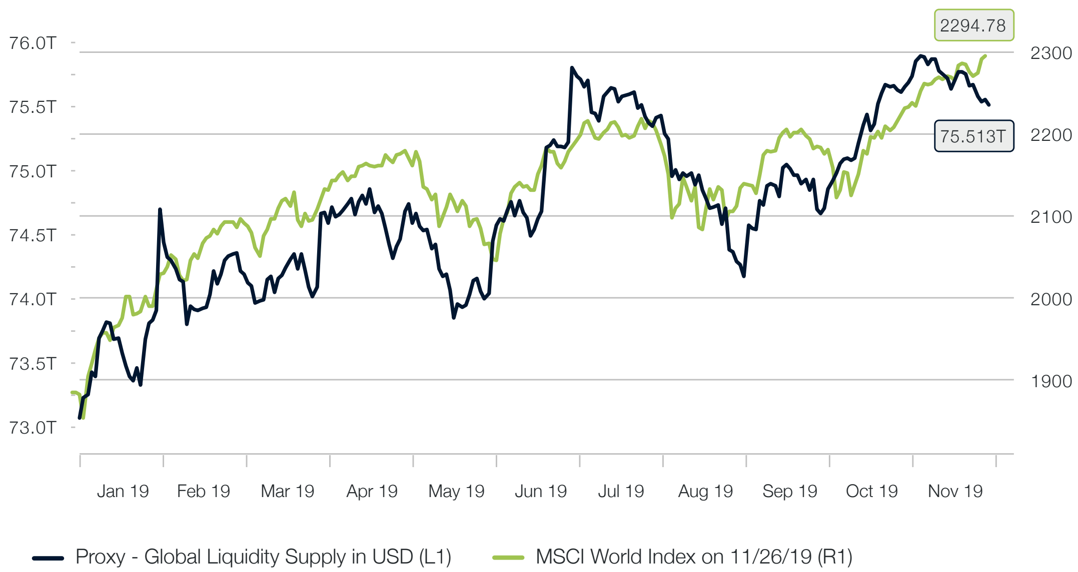
Equity markets in a liquidity frenzy

Over the past year, following the Federal Reserve's change of course, equity markets have focused solely on the prospect of a global easing of monetary policy. As a result, not only were the losses of the previous year made up again, but new highs were even reached in some cases. The signs of a progressive cooling of the global economy and declining corporate profits were deliberately ignored here. Only the headline-grabbing ups and downs of the trade dispute between the United States and China could temporarily dampen the risk appetite, but not for long. This is particularity astonishing when you consider that the economic impact of tariff-related distortions on world trade is fading in the face of the general slowdown in the global economy, which is being driven in particular by China.

In fact, in quantitative terms, the development of the global equity market measured by the MSCI World DM benchmark over the course of the year can also almost entirely be attributed to the development of the liquidity provided by the central banks (see Fig. 12).

Fig. 12

Global equity markets under the spell of central bank liquidity

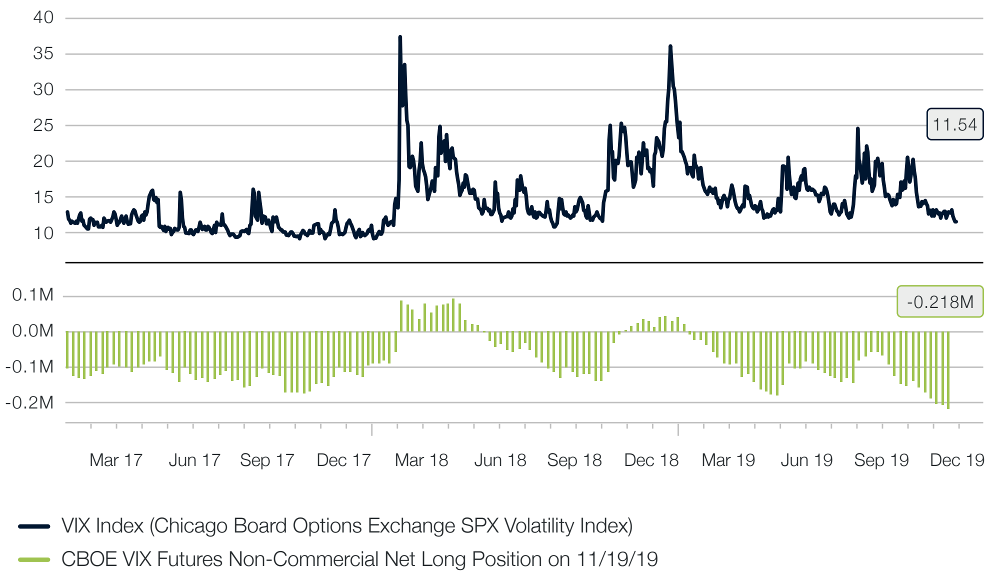


Source: Bloomberg LP, 29 November 2019

As in previous market phases, which were dominated by monetary policy activities, this is reflected in an increasing dampening of achieved and realised equity market volatility. Hence the VIX Index, a barometer of the short-term implied volatilities of options on the broad American S&P 500 benchmark, is again approaching the single-digit range, which has not been reached since 2017. This is accompanied by an increasingly one-sided positioning of speculative market participants in the corresponding futures. These investors' bets on further declining volatility (net short position) have already reached a new record level beyond the extreme values of 2017 (see 3). As a result, a crash on the volatility market occurred at the beginning of 2018, marking a medium-term top on the global equity markets. Once again, there is a high probability that the resolution of this imbalance will have a corrective effect on the equity markets.

Fig. 13

Implicit share volatility in free fall



Source: Bloomberg LP, 29 November 2019

However, it is not just internal equity market fundamental and technical factors that draw scepticism about the sustainability of the current bull market. The global macro environment and in particular the ongoing slowdown of the Chinese economy are also providing warning signals (see also the chapter “Macroeconomic Trends, Bonds and Currencies”). Over the past decade, the rest of the world's increasing dependence on the fate of China has resulted in a high correlation between the rolling returns of the global MSCI World DM benchmark and the intensity of credit expansion in China (see Fig. 14). The Chinese credit impulse has developed into a leading indicator for the equity market with a lead time of around five months.

The limited impact that the current Chinese stimulus measures have had thus far and the reluctance or lack of room for manoeuvre on the part of the People‘s Bank of China and the government to do substantially more suggest that the current divergence will close downwards.

Fig. 14

Close link between global equity market and Chinese credit expansion: Rolling twelve-month return of the MSCI World DM Index vs. Credit impulse of the Chinese economy with five months lead time

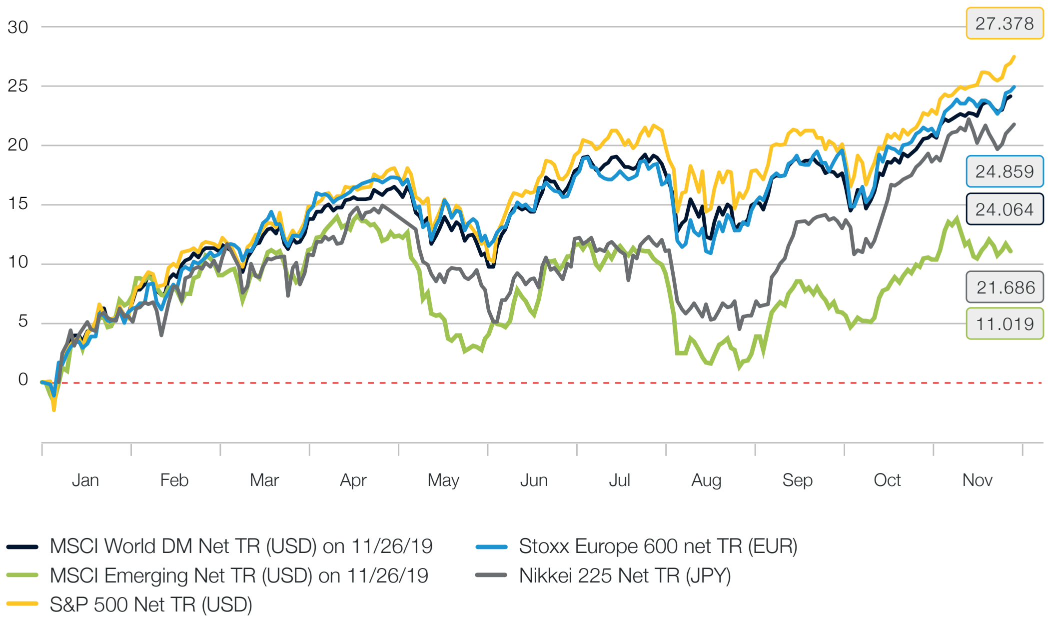
Source: Bloomberg LP, 29 November 2019

It is striking how clearly the equity markets of the emerging countries have been lagging behind most of the developed equity markets over the past year (see Fig. 15). The emerging economies are much more exposed to the dynamics of world trade. It is therefore not surprising that, against the backdrop of a reduction in expectations and repeated delays regarding the reaching an agreement between China and the United States, this underperformance has continued to accentuate in the second half of the year.

However, given the sustained higher growth rates in these parts of the world, it is surprising that the emerging markets have been experiencing a relative weakness in performance for almost ten years. Emerging market equities have now lost all the outperformance they gained against the developed equity markets since 2005. Conversely, this has also accentuated the valuation advantage for companies in these regions, which raises medium- and longer-term return expectations significantly above the OECD average.

Fig. 15

Development of selected equity markets in 2019 Time series indexed at 100 as at 31.12.2018



Source: Bloomberg LP, 29 November 2019

2.2 Equity Markets

Uncertain earnings prospects for companies and pronounced valuation divergences require selectivity on the part of investors

Both the European and American equity markets slipped into a corporate earnings recession over the past year. In the first three quarters, profits fell below the previous year‘s level, particularly in the third quarter with reductions of almost 5% in Europe and 3% in the United States. For the fourth quarter as well, consensus estimates assume that earnings will continue to fall.

However, a strong recovery is expected for the coming year. According to the consensus forecast, corporate profits in the United States, Europe, Switzerland and Japan are expected to rise by 8% to 9% in 2020. However, the modest economic outlook raises doubts about this optimism.

By contrast, the outlook for emerging market equities is improving again. The hoped-for trade ceasefire between the United States and China and the likelihood of further cuts in US interest rates should support growth in emerging markets. With an average of 4%, the emerging markets’ economies are likely to grow much more strongly in the coming period, with industrialised countries boosting their profits by 14%.

The emerging markets’ currencies have lost a lot of ground but are showing signs of bottoming out and are trading significantly below value. A substantial depreciation of the US dollar, which we expect for the coming year (see also the chapter “Macroeconomic trends, bonds and currencies”), will help not only EM currencies but also corporate earnings growth.

This is compounded by the growth-enhancing effect of an increase in capital inflows into emerging markets and the fact that many investors are still cautious about the outlook for emerging market economies. In our view, this should be seen as a counter-indicator that suggests upward potential.

Taking a valuation yardstick such as the cyclically-adjusted price-to-earnings ratio (commonly referred to as the Shiller P/E ratio) as a basis – which has proven its worth with regard to its forecasting power over longer time horizons – a picture emerges of an unusually high spread in valuations, not only between industrialised and emerging countries but also within the block of OECD countries.

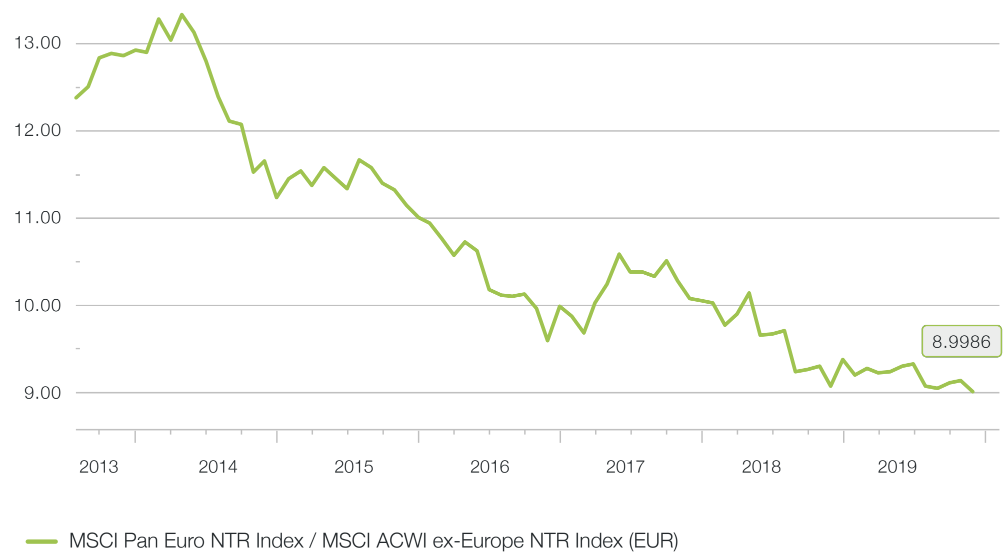
It is hardly surprising that the equity markets of many emerging countries appear attractive below this level. However, individual industrialised countries are also still clearly undervalued.

Japan remains our favourite industrialised country. Even though the economy is suffering from a slowdown of exports, equity valuations not only remain attractive on a relative basis, but also on an absolute basis. Of all the industrialised countries, Japanese equities are valued by most favourably by far. The low indebtedness of Japanese companies is another argument: On average, the ratio of net indebtedness to EBITDA is below 1.5%, which is lower than in the other industrialised countries. In addition, the Japanese central bank continues to pursue an extremely loose monetary policy.

Individual European markets also appear attractive from a valuation perspective. In view of the pessimism that Europe is showing on the financial markets, this is not surprising. However, reservations on the part of investors are understandable given European equities' years of sustained underperformance compared with the rest of the world (see Fig. 16), underpinned by largely stagnating corporate earnings.

Fig. 16

Long-term underperformance of European equities compared with the rest of the world



Source: Bloomberg LP, 29 November 2019

In view of its export orientation, a lack of momentum has increasingly turned the European equity market into a representative tool for the condition of the emerging economies. If demand accelerates in the emerging markets, companies will benefit, but this decline will be due to a lack of impetus in view of the structural growth weakness in the European domestic market.

Improved prospects for the emerging markets in the coming year could therefore also promise good things for Europe, even if the domestic economy is paralysed and the scope for monetary policy has been largely exhausted (despite assurances to the contrary by ECB representatives).

Particularly low valuations can be found in the countries on the periphery of Europe that have been shaken by the debt crisis, where, alongside Spain, Italy stands out above all. The Swiss equity market, on the other hand, is one of the most expensive in the world; however, in view of its defensive qualities, it should be able to hold its own in the coming year under the scenario of a weak economic environment and perform better than the European average.

2.3 Equity Markets

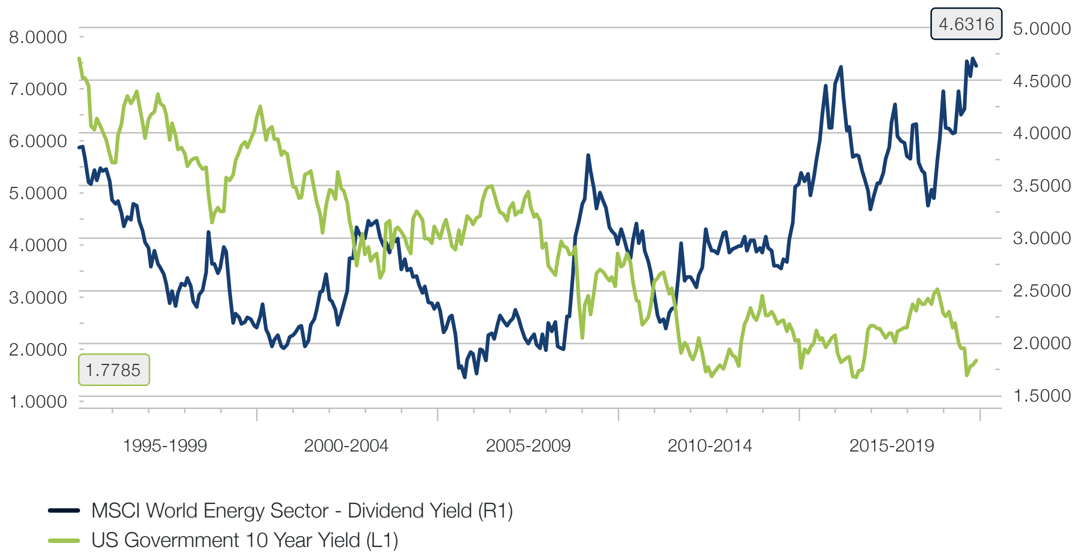
At sector level, prospects are opening up for energy stocks and European banks, while technology stocks appear overpriced

Commodity-related equities, including energy stocks in particular, turned out to be one of the sectors with the weakest development over the past year. Against this backdrop, the sector‘s dividend return has risen to nearly 5%, the highest in more than twenty years and well above the return on ten-year US Treasury bonds (see Figure 17).

From a valuation perspective, too, there are a number of arguments in favour of energy companies. Many stocks are quoted below the replacement value of their reserves, a situation last witnessed at the end of the previous decade in the wake of the global financial crisis.

Fig. 17

Attractive dividend return for energy stocks of almost 5% on average



Source: Bloomberg LP, 29 November 2019

Most European banks are valued even lower and only traded at a fraction of their book value (see Fig. 18). The recovery of the broad equity market over the past year has been largely overlooked. In contrast to the US banking system, regulators in Europe failed to implement rigorous recapitalisations in the aftermath of the financial crisis ten years ago, and to wind up institutions that were not viable in the long term or to merge then with stronger partners. The result is a structural weakness in earnings, which is reflected in an exorbitant valuation discount to American banks (see Fig. 18). This was put to bed for the time being in 2018; nevertheless, at the beginning of this year we warned against following the siren call of low valuations and to stay away.

In the meantime, however, the valuation of the banking sector relative to the overall market has reached extreme values, which has been followed in the past each time by a phase of significant outperformance. Thus, the book value discount is now more than two standard deviations below the book value of the overall market, while the dividend yield of the banks exceeds that of the overall market by two standard deviations.

The ECB is also making efforts to take account of the banks' lack of profitability through relaxations of and derogations to its negative interest rate regime. In addition, two of investors' biggest concerns have evaporated over the past year: the budget conflict with Brussels, which was a burden on the Italian bond market, has been resolved and the ECB has resumed its quantitative easing programme.

Fig. 18

Massive valuation discount of European versus American banks shows signs of stabilization

Source: Bloomberg LP, 29 November 2019

In contrast, the prices of defensive stocks such as utilities, pharmaceuticals and consumer staples, which are currently very attractive to investors in view of the shaky economic outlook, are already reflecting respectable premiums.

The prospects for technology stocks are also unattractive. In the past year, they again followed the pattern of previous years and clearly outperformed the broad equity market with their price gains. However, this outperformance has not been underpinned by correspondingly stronger profitability since 2018 (see Fig. 19).

But this is not the only reason why the technology sector is likely start running out or air next year. Twenty years after the internet bubble, the sector has once again become a driving force, especially in the US equity market. Their share of market capitalisation now stands at over 25%, a level that was only crossed once before for a short time at the turn of the century, before the speculative bubble burst. The broad equities market's dependence on the fate of the technology sector is therefore currently higher than ever before.

Until now, investors have ignored the potential risks that the trade war poses for technology stocks, which will likely come back to haunt them in the future. The fact that the US government has blacklisted Chinese companies such as Huawei is raising the spectre of a new technological Cold War and illustrates how susceptible companies in this sector are to sudden restrictions. Due to the close interdependence of the value chains, the consequences will be felt over time along the entire global value chain. The risk that the technology sector poses for the broad equities market is by no means limited to a potential clouding of the course of business. The high sector concentration is in particular the result of the strong positive network effects that characterise many of the business models; the positive externalities promote a winner-takes-all dynamic whose natural end result is the establishment of monopolies. Although the interpretation of antitrust law in the United States has become much more cautious since the Reagan era, the fact that the reach of advertising and social media platforms has now entered the political sphere and even influenced the outcome of elections has provoked a potentially far-reaching political reaction. Even if the destruction of monopolistic structures were to be halted, the mere introduction and enforcement of more stringent regulation to protect private data sovereignty and privacy could severely affect the business models of the technology giants. The US Department of Justice's recent announcement of an antitrust investigation into Google's parent company Alphabet underscores the seriousness of this risk.

Fig. 19

The outperformance of technology stocks lacks the support of a relatively higher growth in corporate earnings

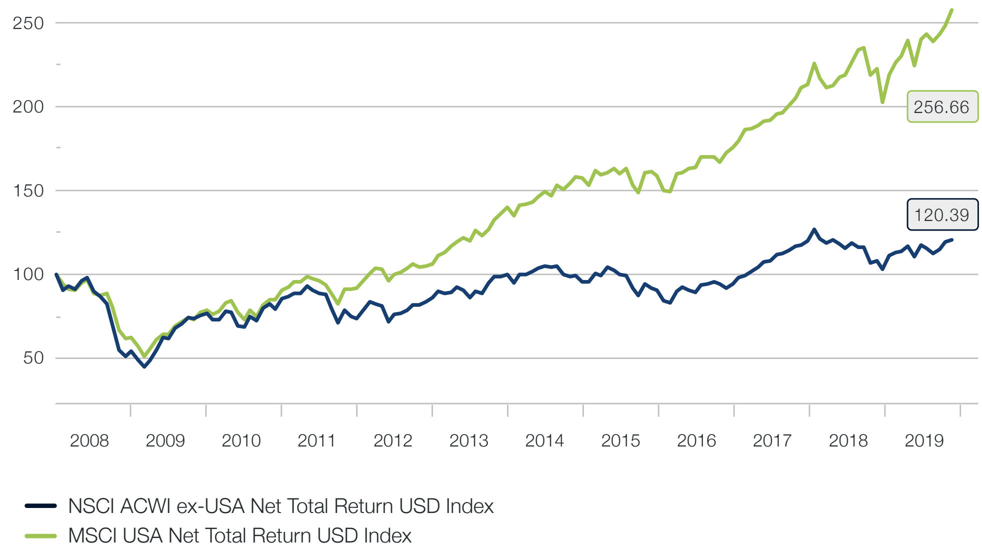
Source: Bloomberg LP, 29 November 2019

US stocks – high flyers with signs of fatigue

Nothing seems to stop the outperformance of the US equity market against the rest of the world. In the past year, it has once again outpaced the rest of the world, which, based on the MSCI ACWI ex-US Index, has been in a sideways consolidation for almost a decade (see Fig. 20).

Fig. 20

Practically no recovery for the rest of the world as US equities scale new heights



Source: Bloomberg LP, 29 November 2019

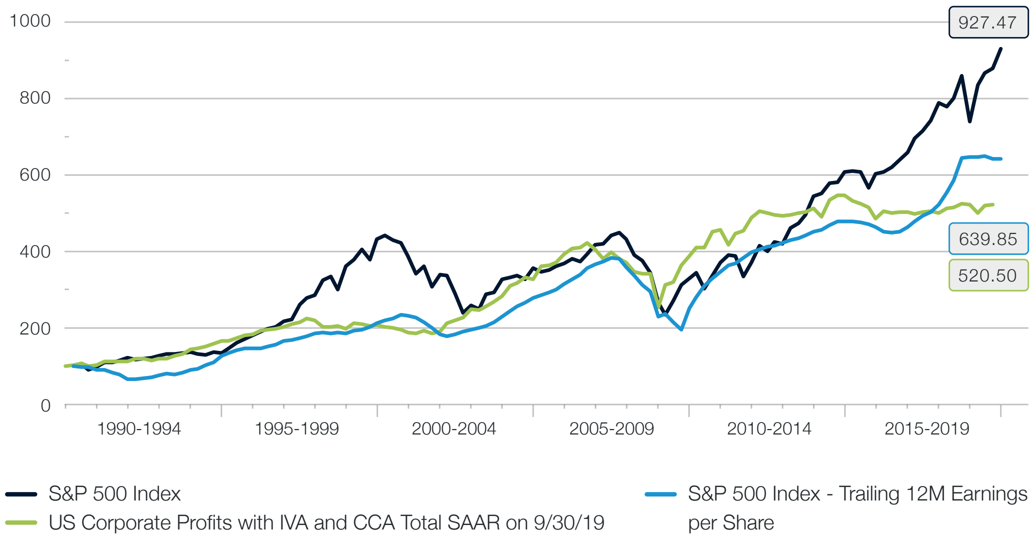
At the same time, however, the US market is becoming increasingly unattractive from a fundamental point of view. The development of fundamental data and corporate profits over the past few years has by no means kept pace with the share price. Around five years ago, there was already a decoupling of corporate profits from the National Income and Profit Accounts (NIPA profits) collected within the scope of national accounting for the entire national economy. Since then, they have exhibited no sustainable growth and have only developed sideways. However, the index also appears significantly overvalued compared to the accounting profits of the S&P 500 companies per share (see Fig. 21).

There are good reasons for temporary divergences between the two profit time series. Over the long term, however, both will find themselves again, with NIPA profit typically playing the role of a leading indicator with a lead time of around twelve months. The current divergence particularly reflects the fact that the source of much of the profit growth in recent years is due to financial engineering in the form of massive share buyback programs financed largely by the increasing leverage of corporate balance sheets. This significantly increased the reported earnings per outstanding share.

However, historical example shows that, sooner or later, phases of a strong drift between price and earnings performance of broad market indices will inevitably be followed by a renewed convergence between profits and prices. See, for example, the period from 1996 to 2003 marked by the internet bubble in Figure 21.

Fig. 21

US share prices outpace corporate profits



Source: Bloomberg LP, 29 November 2019

This also explains the persistently subdued-to-negative investor sentiment regarding equities, which is reflected in sustained outflows from equity funds despite new highs. In addition, the high level of equity sales by corporate insiders is anything but a sign of confidence in the attractiveness of the US equity market.

Companies themselves have jumped into the breach as buyers. Share buybacks fed by tax savings, repatriated capital and debt made favourable by continued eased financing conditions in the capital markets have set new volume records in the United States. A study by the Ned Davis Research postulates that without this support, the US equity market would be 20% lower than the S&P 500 index. A decomposition of the cumulative net purchases of American equities over the last decade even reaches the conclusion that, besides foreign investors to a small extent, the companies themselves were the only net buyers of American equities over the last decade.

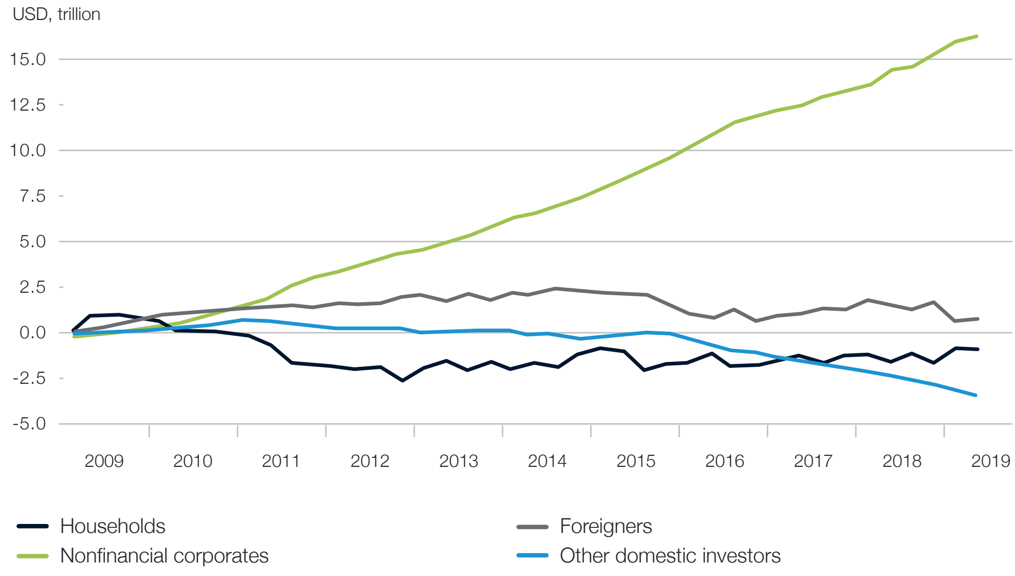
If one considers its high valuation and its disproportionately strong focus on cyclical industries, the US market appears all the less attractive. With the exception of Japan, this cyclical orientation is more pronounced in the US than in any other major market, and it is more exposed than emerging markets to cyclical sectors for the first time in its history.

For the coming year, influence of the upcoming election campaign for the US presidency should certainly not be underestimated. While it is in the interest of current incumbent Trump to bring about as robust an economic picture as possible against this backdrop, the ideological character and political goals of various opponents on the Democratic side pose risks for the equity market. In particular, Senator Elizabeth Warren, who is cited with good chances of receiving the democratic nomination, could become an Achilles‘ heel for the equity market. Her political programme includes stricter regulation of banks, a break-up of monopolies in the technology sector and a ban on fracking technology for oil production.

With regard to portfolio positioning, this indicates a significant underweighting, if not elimination, of the exposure to US equities. The extent of the valuation divergences also makes currency-neutral, market-neutral long-short combinations appear attractive, especially with regard to Japan, the emerging markets and Europe.

Fig. 22

Cumulative net purchases of US equities over the last decade



Source: Oxford Economics, Macrobond, 29 November 2019

Your Contacts

Christopher Kumpas

CEO Picard Angst MEA
E-Mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

Supply bottlenecks ensure sustained potential

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

- Despite the slowdown in the global economy, late-cyclical economic momentum meant the commodities markets enjoyed a positive year.
- Although economic risks have continued to rise, the opportunity for moderately positive commodity returns in the coming year remains intact, provided geopolitical challenges such as the ongoing trade conflict between China and the United States can be resolved.
- However, it is important to take a selective approach and advisable to favour commodities facing supply-side bottlenecks or production constraints, as demand-driven commodities and sectors are likely to struggle.

Outlook

Despite a challenging economic environment, the positive returns on commodity markets last year showed that the current upturn in the commodity cycle has not yet reached its end; although falling growth and inflation expectations raise questions about its longevity. But bottlenecks in supply and production point to continued potential in agricultural commodities, especially cereals and raw sugar, as well as in the energy sector. Without an early settlement of the smouldering trade conflict and a brightening of the global economic outlook, base metals may nevertheless continue to struggle. In view of the turnaround in monetary policy and rising risk aversion on the financial markets in the coming year, the greatest upside potential is to be found in precious metals.

Despite the slowdown in the global economy, the late-cyclical economic momentum meant the commodities markets enjoyed a positive year

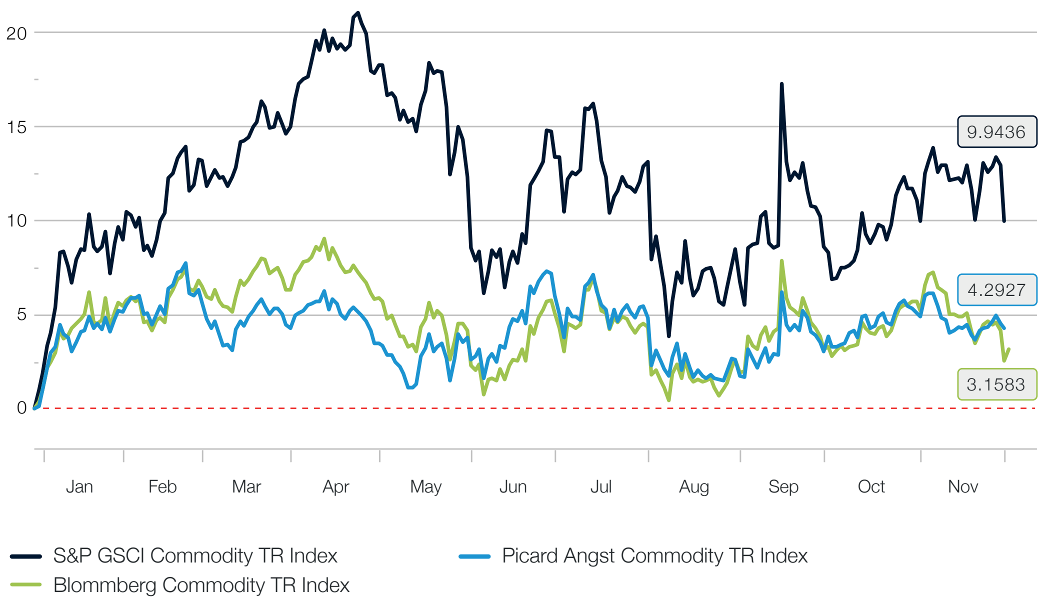
The commodity markets delivered a gratifying performance overall in 2019. The rise was led by the cyclical sectors of energy and industrial metals. This largely offset the sharp correction suffered by the commodity markets in the previous year.

Despite the continued slowdown in the global economy and disturbances caused by exogenous factors of a political nature, such as the trade conflict between the United States and China, commodity markets have once again demonstrated their late-cyclical nature. Historically, commodity returns have been particularly robust on average towards the end of an economic expansion cycle.

The strong recovery of the cyclical sectors in particular reinforces our view that we have not yet reached the end of the current commodity cycle.

Fig. 23

Picard Angst Commodity TR vs. Benchmark Indices 2019



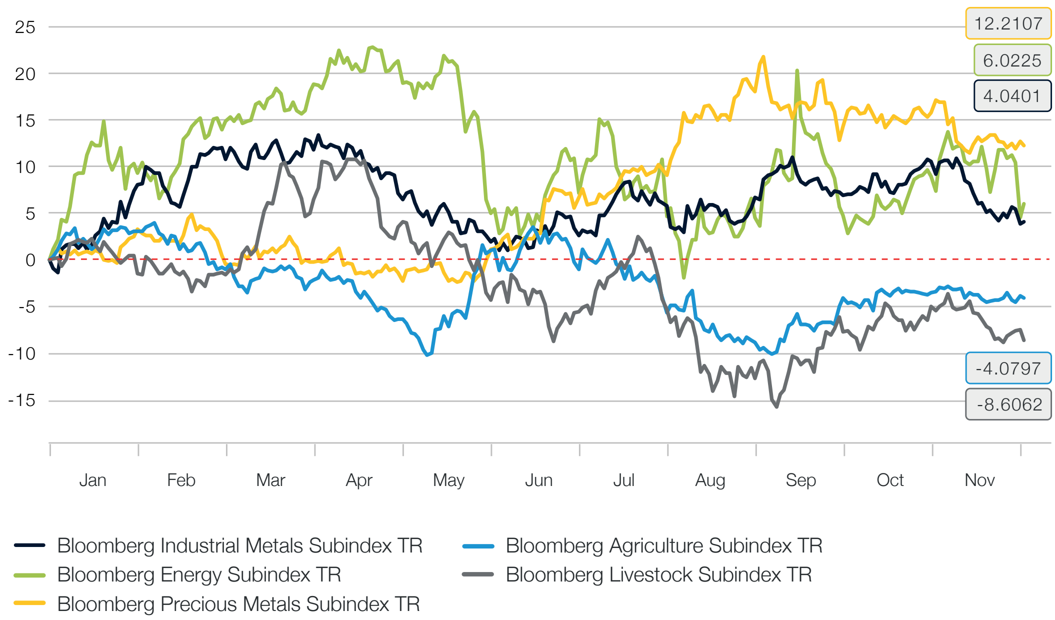
Source: Bloomberg LP, 02 December 2019

The leading role played by the energy sector in the recovery of commodity markets favoured strategies with a pronounced cyclical profile. Accordingly, among the broad commodity benchmarks, the extremely energy-heavy S&P GSCI Commodity TR recorded by far the highest gain, even though the correction of the oil price in the second half of the year significantly reduced the degree of outperformance. More balanced benchmarks such as the Bloomberg Commodity TR Index rose more moderately. Despite its comparatively less cyclical sector profile and the weaker development of the agricultural sector, our in-house PACI strategy (investable via our fund product Picard Angst All Commodity Tracker Plus) managed to keep up with the benchmark Bloomberg Commodity TR (see Fig. 23).

Thanks to their concentration on predominantly cyclical sectors, returns were especially high in those strategies that did not take agricultural commodities into account. In this category, our Picard Angst Energy & Metals strategy (which can be invested in via our fund product Picard Angst Energy & Metals) clearly outperformed the benchmark Bloomberg Commodity ex-Ag ex-LS TR.

Fig. 24

Development of commodity sectors in 2019



Source: Bloomberg LP, 02 December 2019

3.2 Commodities

Economic risks continue to grow, but the opportunity for moderately positive commodity returns in the coming year remains intact

In the past, commodity prices experienced the biggest appreciation and outperformed other asset classes when the economic cycle had already peaked, resource shortages were felt and central banks began to hit the brakes. In particular, the pronounced outperformance in the late cyclical expansion phase can be explained by the fact that commodity prices are determined by the supply and demand situation on the spot market – unlike financial equities such as shares, which discount future growth and cash flows. Prices thus rise when the current level of demand exceeds available supply.

Last year, the global economy gradually weakened further, and 2019 is expected to end with global GDP growth of 3% p.a. at best.

Broadly diversified commodity portfolios, for example benchmarks such as the Bloomberg Commodity Index, have required an average growth rate of over 3% in the past to generate positive returns.

For 2020, the International Monetary Fund (IFW) expects a moderate increase in economic momentum to a growth rate of 3.4%. This suggests that the prospect of a positive year 2020 on the commodity markets remains intact.

The gains are likely to be more modest than in the previous year, however, since uncertainty about the economic outlook has also significantly increased. This will be reflected in an increasing dispersion of yield development between sectors and individual commodities. In particular, preference should be given to commodities that are confronted with supply-side bottlenecks or production restrictions, while those driven by demand may struggle. This speaks in favour of positive return prospects, especially for agricultural commodities and also for the oil complex. Selectivity is required with base metals and natural gas, however. If real interest rates remain under pressure and risk aversion returns to the markets, there is a good chance that the upward trend in precious metals will continue.

In addition to economic factors, however, the importance of favourable political conditions must not be overlooked. Despite the reduction of ambitions for a first partial agreement, there is still no end in sight for the trade conflict between the United States and China and the political risks remain high.

In detail, a supporting effect on the raw material markets can be expected in particular from the following factors:

The sharp decline in capital expenditures and investments in new production capacities since the global financial crisis is increasingly becoming a limiting factor when it comes to meeting rising demand.

An increasing proportion of commodities now have declining inventory turnover rates and thus supply deficits. The reduced availability of commodities also has an impact on the maturity structure. For example, the forward curves in the energy sector have inverted significantly and flattened out for individual base metals and agricultural commodities. The rolling return profile for investors has improved as a result.

US monetary policy underwent a radical change of course last year. The factors that have caused the pronounced strength of the dollar in recent years are successively diminishing. A gradual weakening of the dollar is therefore to be expected in 2020, which will have a tailwind effect on the commodity markets.

Despite positive commodities returns, investor exposure to the commodity markets barely broke away from its low level over the past year and remains at the lower end of its historical range. In the past, such constellations have proven themselves to be counter-indicators for investor positioning and have resulted in significantly positive price trends.

Among the risks that could jeopardise a positive scenario for the commodity markets are the following:

Despite intensive negotiations and regular announcements that at least the conclusion of a partial agreement is imminent, the danger of a further escalation of the smouldering trade dispute between the United States and China, as well as the potential for its expansion to the EU, has been by no means put to rest. An unchecked trade war would torpedo any growth recovery of the already troubled global economy and in turn hit demand for raw materials hard. Economic momentum in China has been much more severely affected by the consequences of the trade conflict than the US economy. A significant further cooling of the Chinese economy would have far-reaching effects on the energy, metal and agricultural markets. China has indeed already introduced a diverse range of fiscal and monetary policy measures to stimulate the economy, but their impact has so far remained modest and there are increasing signs that further room for manoeuvre for economic stimulus programmes is limited in view of the high debt level.

Spot inflation in major economies such as the United States is extremely robust and is close to a ten-year high. Inflation expectations, on the other hand, have fallen significantly worldwide over the past year. Without a reflationary resolution of this divergence, there is little confidence in sustained increases in commodity prices.

In the second half of the year, the interest rate on the underlying capital for commodity investments (collateral yield) fell from over 2% to 1.55% p.a. in the wake of the US Federal Reserve‘s rate cuts. In the event of a continued economic slowdown, it cannot be ruled out that the collateral return on commodity investments will evaporate again, even on a dollar basis.

3.3 Commodities

Energy

The development of the oil complex in the past year was shaped by the conflict between the efforts of the OPEC cartel and Russia on the producer side to curb an oversupply by cutting production and market participants' concern about shrinking growth in demand in the wake of the the global economy's progressive cooling. Accordingly, following a strong recovery at the beginning of the year that lasted until spring, the development of the oil price in the second half of the year was volatile and lacked any sustained trend. Against this backdrop, even a large-scale attack on critical production infrastructure in Saudi Arabia in September, which temporarily switched off 5% of global production, only caused a brief rise in oil prices.

For the coming year, however, we see good prospects that the price of Brent crude oil will approach the USD 70 per barrel mark again. This is supported in particular by the following arguments:

A moderate recovery in global economic growth compared with 2019 should support demand growth for crude oil.

We expect OPEC and Russia to maintain, if not tighten, their production cuts at least until the end of 2020, not least to support the IPO of Saudi Aramco. Ongoing US sanctions against Iran and Venezuela will do the rest when it comes to keeping global supply growth under control.

In the United States, there are increasing signs of a slowdown in the shale oil boom. Exploration activity (measured by the 'rig count') fell by a quarter over the past year. This reflects the difficulties faced by the development companies in operating profitably at WTI prices below USD 60 per barrel. The credit and equity markets signal that investors in this sector are increasingly insisting on more discipline and for profitability to be given priority over growth.

The entry into force of the new regulations of the International Maritime Organization (IMO) for more environmentally friendly fuels should substantially increase the demand for oil from the shipping sector by up to one million barrels per day. A slight recovery in world trade should further strengthen demand for distillates. In combination, these factors should take the supply/demand balance back into deficit in the first half of 2020. In addition to a return of prices to the upper end of the trading range of recent years, investors can also expect to benefit from further increases in rolling yields in the course of such a development.

3.4 Commodities

Industrial metals

The prices of most base metals came under pressure last year. Weaker growth and, in particular, the deterioration in China's economic relations with the rest of the world as a result of the trade conflict have severely dampened investor sentiment and reduced demand.

Nevertheless, many base metals have seen a gradual reduction in inventories on the futures exchanges over the past year, which in other circumstances would not only have resulted in flatter forward curves but would also have had a substantial price-supporting effect. The only positive outlier over the past year is nickel, the price of which at times rose by up to 70%, after Indonesia surprisingly imposed an export ban on crude nickel ore at the beginning of 2020. Nickel also benefits from its potential in the manufacture of batteries for electric vehicles. According to analyst estimates, the amount of nickel required for battery production will increase tenfold over the next eight years.

Assuming an at least moderate recovery of the global economy and a gradual easing of the fronts in the trade war between China and the United States, the prospects for a more pleasing year 2020 in the industrial metals sector are good.

However, it must be taken into account that the prospects for the individual metals will diverge significantly in terms of their supply dynamics. The decisive factor here is whether the supply cycle is dominated by long-term or short-term factors. The medium- and long-term prospects for copper remain positive, as the slump in capital investments since 2013 has brought the supply growth phase to an end and the development of new production capacities is subject to long lead times. In contrast, the aluminium market is likely to face a headwind. The availability of raw materials and the input factor of energy is not limited. However, the supply-side reforms and new environmental requirements in China have cemented higher cost structures, which will prevent prices from falling back to 2016 levels.

The long-term prospects for base metals remain extremely positive. The mining industry is only slowly moving away from a record low in profit margins, which fell to their lowest level since 1998 in 2016. In the past, they proved to be a reliable indicator for the development of the market balance with a delay of about two years. This suggests that the sector will continue to recover in the coming years as supply deficits increase.

3.5 Commodities

Precious metals

In the precious metals sector, the past year was marked by a sustained eruption in the prices of gold, silver and platinum, some of which had been in consolidation for many years. In addition to fundamental factors, technical factors also contributed to this. Investor aversion to the sector had reached historical extremes in the previous year, which once again turned out to be the harbinger of a trend's turning point.

And so, together with prices, the mood of market participants in the precious metals sector has fundamentally changed over the past year. The central banks' worldwide turnaround away from normalisation of monetary policy towards renewed easing has made a major contribution to this. As a result, long-term real interest rates in the dollar zone, one of the primary determinants of the gold price, have begun a sustained downward trend (see fig. 25:) This helped the gold price to break above USD 1,400 per troy ounce.

There is a good chance that the upward trend will continue in the coming year. Factors that drove the last long-term rise in the gold price are once again coming to the fore. They include:

Robust physical demand: The demand for physical gold, traditionally dominated by China and India, is beginning to rise again. At present, however, it is primarily central banks that are once again acting as buyers on a large scale to diversify their reserves and have increased their purchases by up to a third in the past year.

Devaluation of the US dollar: Instead of further increases in key interest rates, the US Federal Reserve lowered interest rates three times over the course of the year. At the same time, the room for manoeuvre in the monetary policy of the central banks in Europe, Great Britain and Japan is limited. This should contribute to a gradual depreciation of the dollar in 2020.

Increasing economic and financial market risks: Rising concerns about the outlook for the global economy, geopolitical conflicts and stability risks in view of the historically high leverage of corporate balance sheets should sustainably increase the demand for gold to hedge portfolios.

Risks for a continued rise in precious metal prices emanate in particular from the bond markets. Yields to maturity at the long end have recently stabilised again, but remain caught in a downward trend. However, a sustained upward surge in long-term real interest rates – for instance in the wake of an unexpectedly strong economic recovery – combined with softening geopolitical tensions would call into question a continuation of the bullish gold price.

Fig. 25

The fate of the gold price remains closely linked to the development of real interest rates

Source: Bloomberg LP, 02 December 2019

3.6 Commodities

Agricultural commodities

In addition to base metals, agricultural commodities have felt the effects of the ongoing trade conflict between China and the United States most severely. The result was a noticeable decline in participation in the futures markets for agricultural goods. US soya beans were hit hardest in the price formation, with China reducing a previously used export share of more than 60% to zero. However, the prices of other major US futures contracts on cereals and soft commodities such as cotton also suffered significantly. This development is particularly lamentable for financial investors, who, due to liquidity and market access requirements, are dependent on the contracts of the major US futures exchanges and are generally unable to switch to local markets that are not affected or are benefiting from the situation, for example, for soy beans in South America.

The positive development of supply balances for most cereals, which is reflected in declining inventories, receded into the background in light of this development. This could change in the coming year with a provisional settlement in the trade dispute that substantially increases Chinese imports of US agricultural goods.

In 2019, soft commodity prices, which account for a large proportion of production in emerging markets, suffered primarily from the continued weakness of the EM currencies against the US dollar. This has pushed dollar-denominated prices to historic lows, especially for coffee. The outlook will brighten with the gradual weakening of the US dollar on a trade-weighted basis expected in 2020. Despite new export subsidies introduced by India, there is potential for recovery, especially for the sugar price. This is because the supply and demand balance for raw sugar is moving into an increasing deficit.

Your Contacts

Christopher Kumpas

CEO Picard Angst MEA
E-Mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

Swiss property caught between negative interest rates and climate protection

Klaus Kämpf, Managing Director, Sustainable Real Estate AG

In brief

- Investments in investment properties have always paid off in recent years. Overall, the Swiss property market is in good shape.
- Rising vacancy rates and falling rents for rental flats seem to point to a trend reversal. A closer look reveals that these issues mainly concern outlying regions. In the cities and urban areas, there is still a lack of living space.
- Property used for commercial purposes is benefiting from the economic situation, which is still quite good despite a slight slowdown, and the positive outlook. Offer rents for office and retail space moved sideways in 2019.
- Everyone is talking about climate protection. Buildings account for more than a quarter of Switzerland's greenhouse gas emissions. A significant reduction in greenhouse gas emissions from buildings has been achieved since 1990, despite an increase in building space. Nevertheless, climate protection targets were not met.
- Climate protection is not the only long-term megatrend with which the property industry should start getting to grips with today. Demographic developments are also challenging property owners.

Outlook

There is much promising another good year for property investments in Switzerland. Given the low level of interest rates for the foreseeable future, investment properties and indirect property investments remain attractive. Rising transaction prices with a simultaneous tendency towards stagnating or even declining rents cause an erosion of returns on newly acquired property. The old wisdom „location, location, location“ is gaining importance for new buildings.

So far, not even a third of the cantons have applied 2014's stricter energy regulations. At the same time, given the increasingly ambitious climate protection targets, the next round of tightening is already foreseeable. However, climate protection targets will not be met by simply increasing the requirements for new buildings; there is enormous potential in the energetic renovation of the old building stock. Due to numerous obstacles in the short term, it is not to be expected that the amount of renovations will increase significantly. In the medium term, however, the industry cannot avoid it. At the same time, answers must be found with regard to an increasingly ageing population.

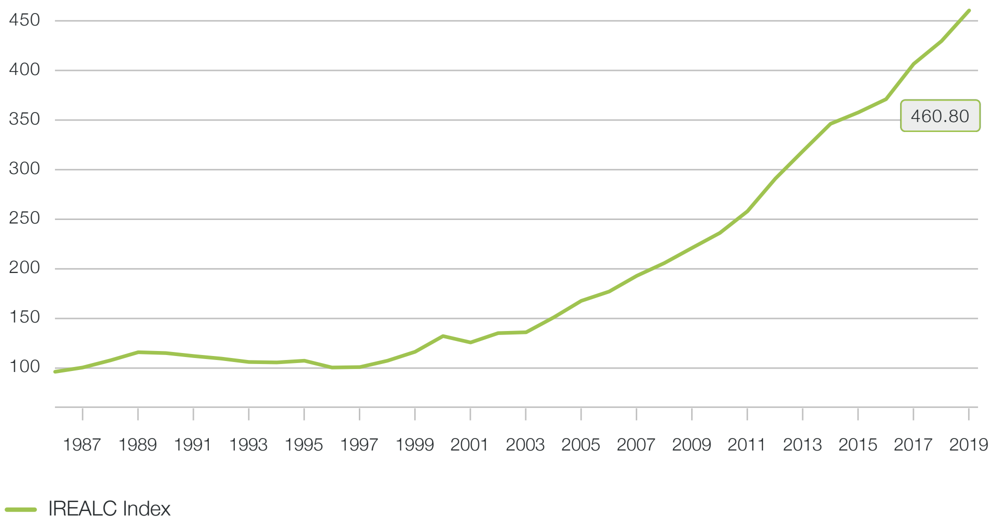
4.1 Swiss Property

The risks in the Swiss property market are gradually increasing, but there is no end sight for the boom (so far)

Swiss investment properties have been performing well for over 20 years (see Fig. 26). And all-important demand-relevant factors indicate that this will remain the case for some time to come.

Fig. 26

SWX IAZI Investment Real Estate Performance Index



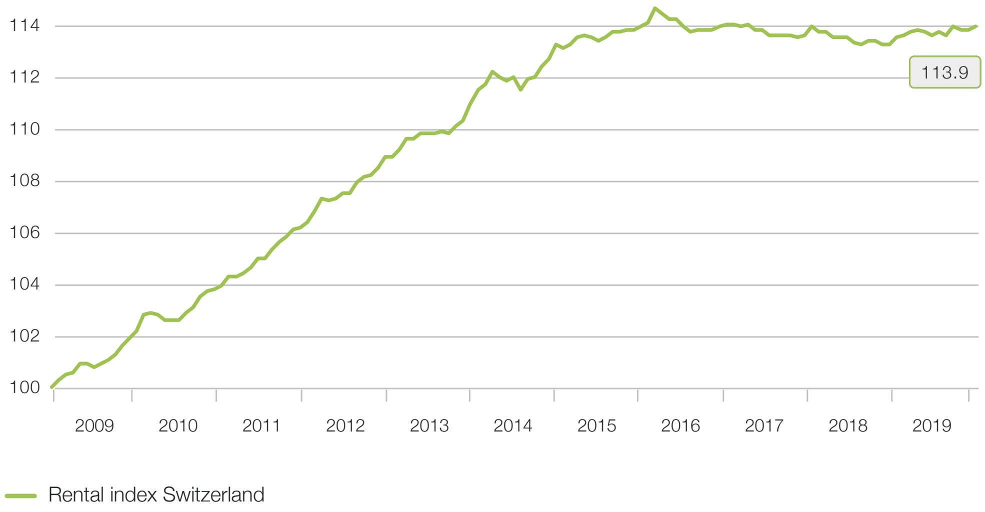
Source: Bloomberg LP, 11 December 2019

For the time being, a low interest rate environment can be assumed. The spread between the distribution yield of Swiss property funds and 10-year Swiss government bonds has reached an all-time high of approx. 3%. In this situation, further investor money is expected to flow into the Swiss property market. At the same time, the supply of existing properties and new construction projects remains limited. The market for multi-family homes nevertheless appears to be bottoming out in terms of initial returns on transactions. In 2019, following ten years of continuous decline, there was even a slight increase.

Population growth, the most important determinant of demand for rental housing, is likely to settle at today‘s level of 0.7 percent in the coming years. There is currently a decline in the number of building applications and building permits for rented flats, but this will only become apparent on the market after a time lag. For the time being, further rising vacancy rates and falling supply rents are to be expected – especially in outlying locations (see Fig. 27). In the big cities, on the other hand, living space remains scarce.

Fig. 27

Development of supply rents for flats



Source: Zurich Cantonal Bank, November 2019

Driven by the increase in jobs, office rents rose slightly last year despite a slightly weaker economy. An increase in employment and thus additional demand for office space is also expected for 2020. Since building applications and building permits for office buildings have been declining for some time, additional supply and demand for new office space will soon be in good proportion again. Outmoded office buildings are becoming more difficult to let.

Caution is advised for retail spaces. On the one hand, high-street trade continues to come under pressure from online retail. The mood of Swiss consumers also remains subdued. The consumer sentiment index is currently slightly below its long-term average. The declining demand for retail space is offset by brisk construction activity, which means that increasing vacancy rates and falling supply rents are to be expected.

In summary, one can say that investments in Swiss property will remain attractive for the foreseeable future. The Swiss property market remains fundamentally well positioned, but is only able to absorb new investments to a limited extent. More than ever, direct investments in property should be made with caution; one should especially carry out a precise analysis of tenant demand in new construction projects at outlying locations. Indirect investments in existing portfolios remain lucrative. Rising interest rates present the greatest risk for the property market.

Sustainability is the Swiss property sector's megatrend

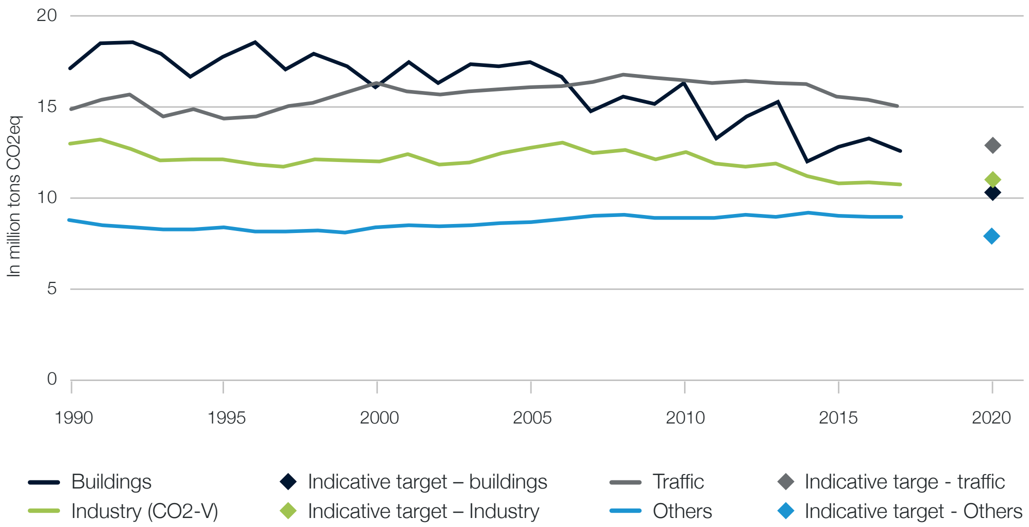
The story of climate protection is a consequence of increasingly ambitious goals. Under the Kyoto Protocol of 1997's United Nations Climate Convention, Switzerland committed itself to reducing its CO2 emissions to 10% below 1990 levels by 2010. The Swiss CO2 Act was passed to implement it. In the year the law came into force (2000), emissions were 2% lower than in 1990, but ten years later they were 1% higher than in 1990. In 2011, the CO2 Act was revised. The target for 2020 is a 20% reduction in emissions. By 2017, 12% had been achieved, and it is foreseeable that the 2020 target will not be met. With the Paris Climate Protection Agreement of 2015, Switzerland committed itself to halving its greenhouse gas emissions by 2030 compared with 1990 levels.

Based on new scientific findings on climate change, the Federal Council decided in August 2019 to tighten this target. The aim is for Switzerland to have balanced emissions levels (net zero emissions) by 2050.

Buildings account for 27% of greenhouse gas emissions in Switzerland. Between 1990 and 2017, emissions from buildings fell by more than a quarter – while the population increased by 26%. None of the other group of emitters can claim such a success. Nevertheless, the interim target of -40% for buildings in 2020 is unlikely to be reached.

Fig. 28

Greenhouse gas emissions by sector



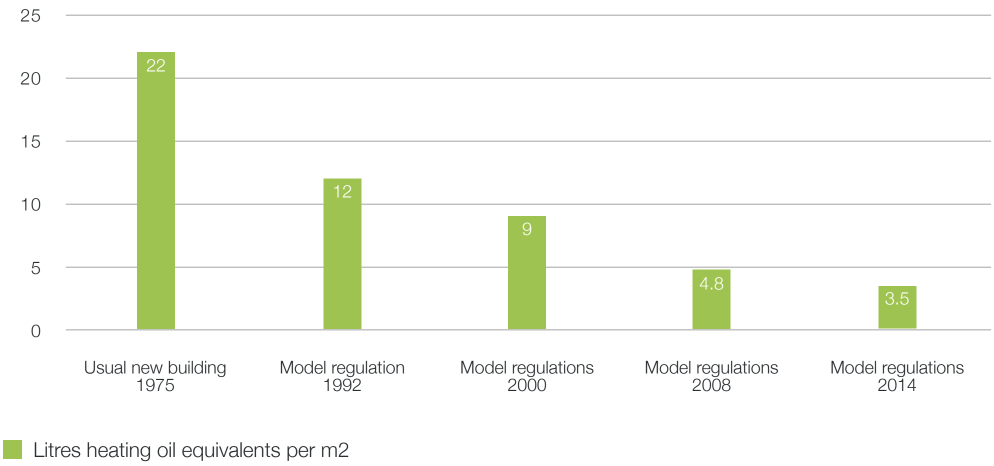
Source: Federal Office for the Environment FOEN, 11 December 2019

One important instrument of the CO2 Act is the CO2 tax on fuels. This is currently CHF 96 per ton of CO2. According to the proposal currently under discussion in the Swiss Parliament to revise the CO2 Act, the tax is to rise to a maximum of CHF 210. The rate actually collected depends on the degree to which the targets have been met. Two thirds of the CO2 tax flow back to households, which means that the annual additional costs at the CO2 tax's maximum rate of 210 CHF for the average tenant would in fact amount to about 100 to 150 CHF per year.

The successes to date in reducing climate-relevant emissions from buildings are primarily a reflection of the increasing tightening of regulations on energy consumption in new buildings. According to the latest model regulations, which are currently applied in seven cantons, the energy requirement for heat may not exceed the equivalent of 3.5 litres of heating oil. Compared to the previous regulations, this represents a reduction of 27%. In addition, there are further requirements, in particular for the use of solar energy. This has achieved a high standard for new buildings.

Fig. 29

Development of the limit values for the heating energy demand of residential buildings

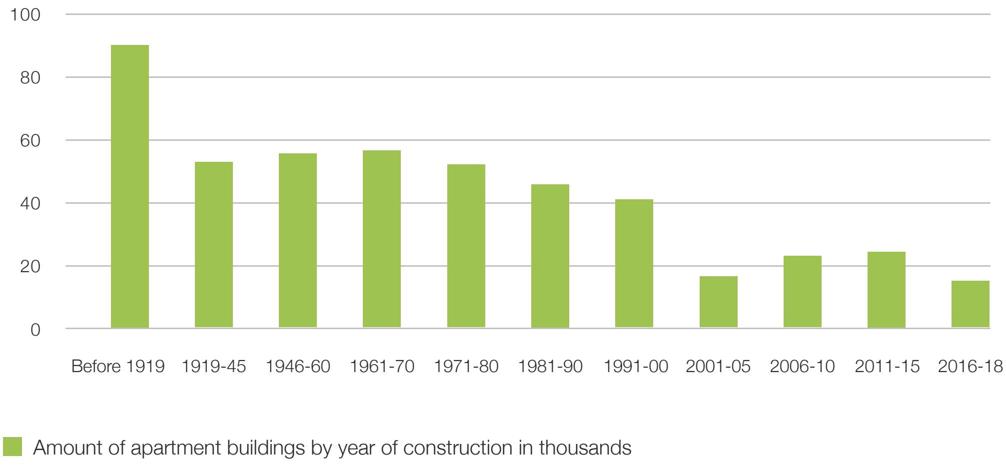


Source: Conference of Cantonal Energy Directors, 11 December 2019

However, three quarters of the buildings in Switzerland are more than 30 years old (see Fig. 30). Many of them have not yet been energetically renovated or have only been partially renovated. This is where the revised CO2 Act will step in. From 2026, a CO2 limit value of 20 kg per square metre will apply for heating system renewals. From 2028, the limit is will be reduced to 15 kg. Old oil or gas heating can then only be replaced with fossil heating if the house is very well insulated.

Fig. 30

Number of multi-family homes by year of construction

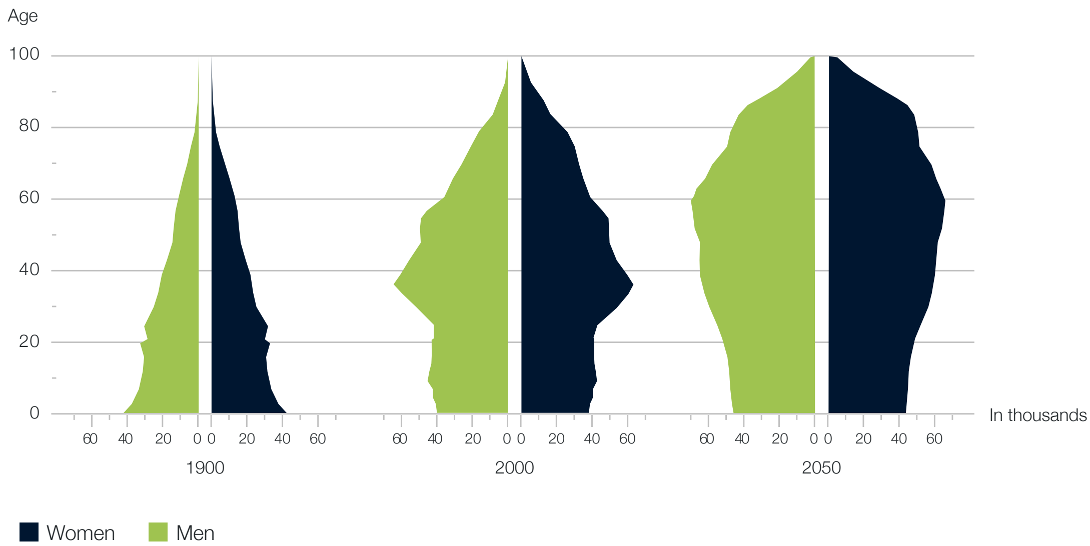


Source Federal Statistical Office, 11 December 2019

The current climate protection debate sometimes obscures the view of other social issues. The most obvious trend is the ageing population. In the course of the 20th century, the age distribution of the Swiss population changed from a pyramid (1900) to a fir tree (2000). An age structure dominated by baby boomers is typical in Switzerland today. A weaker young generation is facing a growing number of older people. By the year 2050, the fir tree will transform into a beehive (see Fig. 31).

Fig. 31

Development of the age distribution of the Swiss population



Source Federal Statistical Office, 11 December 2019

This development poses challenges not only to the health care system and old-age provision. The property sector would also do well to begin responding to the consequences of demographic developments today. The effects on housing demand are manifold. One can expect that the demand for smaller flats will increase. People want these to be as well connected as possible to the infrastructure of daily needs, especially shopping, medical care and public transport. In addition, more accessible housing is needed. And in view of further falling conversion rates in the second pillar, housing must remain affordable in old age. This is due to an ever-larger proportion of the population having to contend with stagnating or falling incomes.

What does all this mean for property investors and providers of collective property investment vehicles? To answer this question, it is first necessary to bear in mind that buildings live for a long time. The consequence of this is that around three quarters of 2050's buildings are already standing today. Accordingly, the property industry is well advised to anticipate foreseeable long-term trends today as far as possible. When it comes to climate protection, the focus for new buildings and the renovation of old buildings should exclusively lie on sustainable energy sources and the use of solar energy. In view of rising energy prices, this also helps to keep the 'second rent' in the form of ancillary costs low. In the case of new buildings, the mix of flats (number of rooms per flats) should also take account of expected demand in the longer term. And the rent for a given number of rooms should preferably not be in the upper segment of today's market. Due to the tendency towards rising construction costs (not least because of the stricter energy requirements), the latter can only be achieved through smaller living space. And finally, new buildings should provide reasonable access for the disabled. With good planning, this can be achieved in a largely cost-neutral manner. Building owners and property investment vehicles that act strategically in this sense over the long term are better equipped to meet the challenges of climate and demographic change.

Your Contacts

Christopher Kumpas

CEO Picard Angst MEA
E-Mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

2020 – a year of recovery?

Chrys Kamber, Fund Manager – Head of Indian Investments

In brief

- Developments in India in the second half of the year were mainly characterised by slower GDP growth and difficulties in the financial sector. In the second quarter of fiscal year 2020, GDP growth was 4.5%, the weakest figure since the first quarter of the 2013 fiscal year.
- The Central Bank of India lowered the key interest rate by 35 basis points to 5.4% and announced that growth now had top priority.
- The government has withdrawn the higher ‘super-rich tax’ for foreign and domestic investors and grants startups exemptions from capital injection taxes.
- The corporate income tax rate has been reduced from 30% to 22%, which will reduce the effective tax rate for Indian companies from 35% to 25.17%; new manufacturing companies established after 1 October will be subject to a tax rate of 15%.
- In order to plug the budget gap, the government intends to sell the state‘s stake in three public sector companies.
- A capital injection of USD 9.8 billion into public sector banks is intended to improve lending to companies, non-bank financial institutions, micro, small and medium-sized enterprises (MSMEs) and private customers.
- White goods recorded higher sales (supported by e-commerce), while gold jewellery and car sales declined.
- The stock markets continued to be polarised; the general market was unable to keep pace with key stocks. Thanks to a handful of highly-weighted stocks, the Nifty climbed to record highs; however, small cap stocks fell victim to the weak growth.
- Whereas foreign investors sold Indian shares – net of dividends – in the middle of the year, they increased their holdings again from October onwards.
- The Nifty’s average price/earnings ratio has risen to its highest level in the last two decades, raising doubts about the valuation level.

Outlook

- The government might review the tax on long-term capital appreciation that was introduced in April 2018 and lower personal income tax to stimulate the demand side.
- The Central Bank's accommodative monetary policy and a proactive, action-oriented government are key for a rapid recovery of the Indian economy.
- The recapitalisation of public sector banks will strengthen lending, lower the cost of credit and improve the classification of banks' distressed assets.
- Domestic capital inflows remained strong, reaching a seven-month high in November. Inflows into what are called systematic investment plans (SIPs) were constant at an average of around USD 1 billion per month.
- Given that inflation remains subdued at less than 4.5%, the Indian central bank has sufficient room for manoeuvre for the sixth consecutive rate cut this year and a further cut next year.
- A change in the strict labour laws and facilitation of land acquisition are currently under discussion. If parliament approves these laws in the winter, the mood should brighten massively.
- Together with the Indian central bank's accommodative monetary policy and the high savings capacity of households (as high as in 2012), a series of measures announced in recent months should stimulate demand in the next two quarters.
- In view of the fact that the valuation gap between the large caps on the one hand and the mid/small caps on the other is at a ten-year high, money should slowly flow out of the safe havens of the large caps towards the mid and small caps. For some stocks, whose valuation has increased far too strongly, there will be a consolidation.

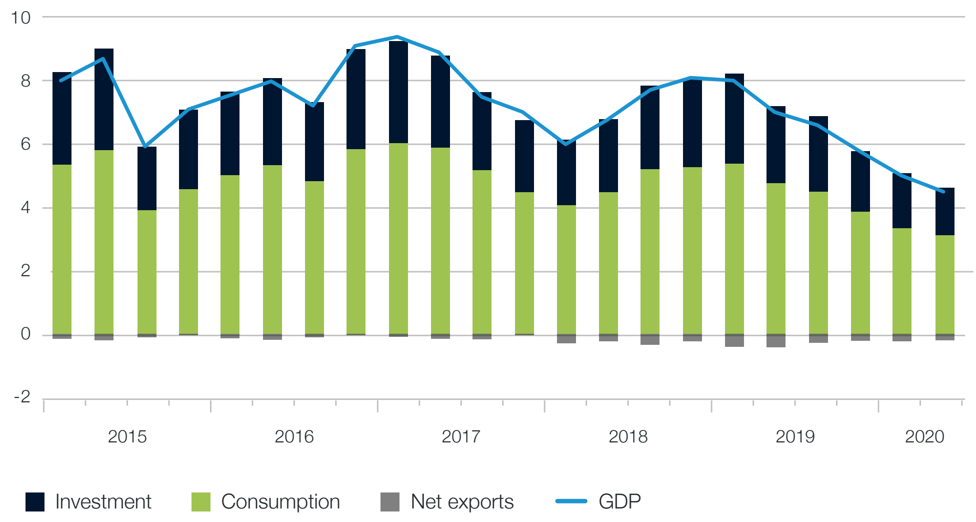
5.1 India

Weak growth – are we already in the recovery phase?

The slowdown in GDP growth was sudden, but not unexpected. While India still recorded impressive GDP growth of 9.4% in the first quarter of 2017, the country is now struggling to maintain growth above 5%. However, the market has already priced in the weak growth, with small and mid caps suffering the most. The overall market was affected by the abrupt decline in GDP growth, problems in lending, difficulties in the automotive sector and debt reduction in corporate balance sheets, as well as by asset declines due to increased tax liabilities and increased transparency in transactions.

Fig. 32

GDP growth



Source: Bloomberg LP, 06 December 2019

"In our opinion, this is now largely priced in. We expect the broader market to pick up in the first quarter of 2020 and growth from the second quarter of 2020."

The slowdown in GDP growth was sudden, but not unexpected. While India still recorded impressive GDP growth of 9.4% in the first quarter of 2017, the country is now struggling to maintain growth above 5%.

There are several reasons for the slowdown in GDP since the first quarter of fiscal year 2017:

The demonetisation that took place in November 2016 led to job losses and a slump in demand with correspondingly severe effects on consumption. However, this measure has accelerated financial inclusion and increased the use of digital payment facilities.

The demonstration was followed by a further disruptive measure in the form of a reform of the goods and services tax (GST) in July 2017. Small companies that had previously benefited from the tax differences had to adjust their transactions and prove tax transparency – or even give up.

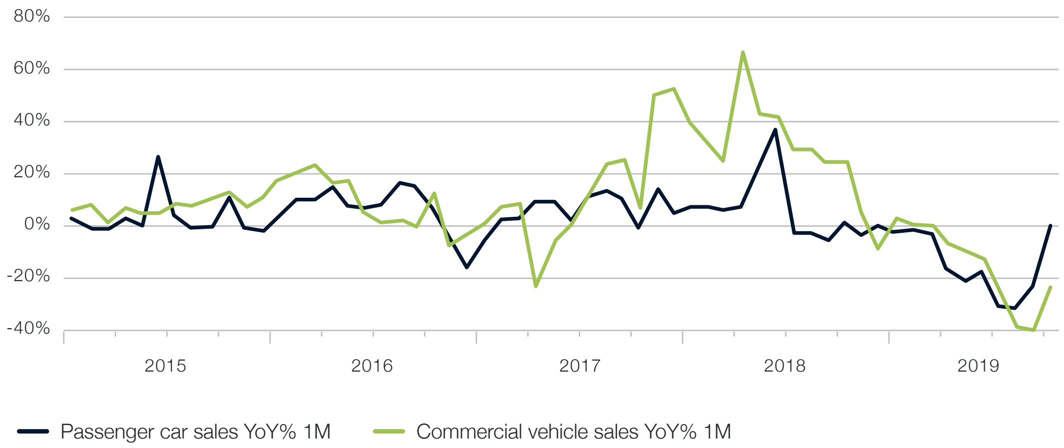
While the impact of these two disruptive events waned, the fact that IL & FS, one of the largest infrastructure financiers, stopped servicing its debt caused a liquidity crisis in September 2018. This default infected banks, property developers and companies with high debt ratios (e.g. Dewan Housing Finance Corporation (DHFL), Indiabulls Group and Anil Ambani Group).

Although liquidity returned in the first half of 2019 thanks to the measures taken by RBI, lending largely came to a standstill: Banks have almost stopped lending to non-bank financial companies. These are the most important lenders for MSMEs and consumers. When the banks reduced their loan commitments in these non-banking financial enterprises, financing for MSMEs became correspondingly more difficult. Lending to retailers and the property industry slowed and put an additional strain on property developers, who were already finding it difficult to refinance their debts. All these factors played an important role in weakening private investment and demand. On the other hand, government infrastructure spending came back on track in the run-up to the parliamentary elections. The weakness in industrial production is due to the slowdown in demand and the credit crisis. Although the credit business picked up in the second half of 2019, this development is limited to companies with good credit ratings and larger non-bank financial companies with healthy balance sheets.

The automotive industry, which contributes 40% to the GDP of India's manufacturing industry, suffered massively. In the first quarter of the financial year 2020, sales of passenger cars and commercial vehicles fell by 23% compared with the previous year; in the same period, sales of two-wheelers, which reflect the economic development in rural areas, fell by 16%. This illustrates the difficulties of the urban and rural economy on the one hand, also the changed consumer behaviour of millennials on the other.

Fig. 33

Automobile consumption will recover in the second quarter of 2020 after a slump



Source: Bloomberg LP, 06 December 2019

The US has once again threatened higher tariffs on Chinese imports, and trade talks between the US and China took place in the second half of the year. For emerging markets, this led to greater volatility in both their currencies and their equity markets. India's share of world trade is only 2%. The effects of the trade war are very manageable for India, if not a blessing for the country.

The government is rapidly taking the right steps to put India on the global stage and increase its share of world trade. The Government has reduced the corporate income tax rate from 30% to 22%, which will reduce the effective tax rate for Indian companies from 35% to 25.17%. In addition, new manufacturing companies established after 1 October are subject to a 15% tax rate if they start production by March 2023. This measure was taken not only to improve business investment, but also to improve India's global competitiveness. The country wants to attract companies that are looking for alternative manufacturing locations (outside China) or want to diversify into other regions in view of the trade war. In the short term, this measure will improve the business climate; in the long term, it will contribute to the expansion of production capacities. Although the tax cut was initiated primarily on the supply side, it will also support demand in the medium term. Increased corporate profitability as a result of tax cuts will benefit equity valuations, creating wealth and in turn boosting demand.

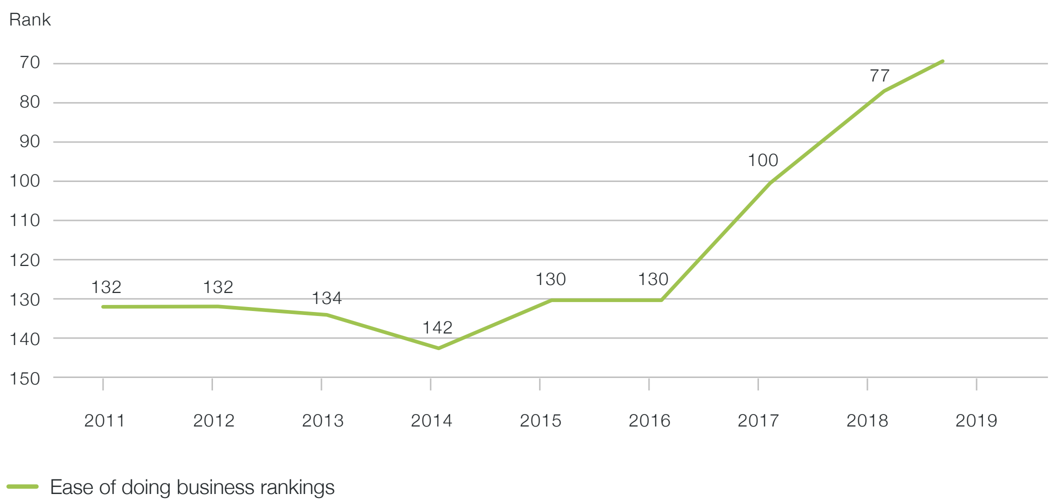
India has worked its way up to 63rd place in the Doing Business 2020 report, in which the World Bank analyses how easy or difficult it is to do business in the individual countries. Last year, India ranked 77th and the country has made considerable progress since then. Both the attractive tax environment and the improved business environment will attract foreign investment and encourage India to embrace global export business.

We will likely have to wait two more quarters before the government's measures to get India's economy back on track take full effect. The Central Bank of India cut interest rates by 135 basis points to 5.15%. However, only 29 basis points of the 75 basis points interest rate cut made in the second half of the year were passed on for new lending. Toll revenues rose by 6% from the end of October and then by 6% in November, offsetting the two-month decline in revenues from goods and services taxes. Investments from abroad have increased in the last two months. While these indicators cautiously suggest that the worst is behind us, further government structural reforms are needed to ensure that the burgeoning economic recovery is sustainable.

Small and mid caps will benefit from falling interest rates in the short term, as their interest costs will decrease. Market participants expect the next budget in February 2020 to include considered reforms. The reform of labour laws, the law on land acquisition and the reduction of personal income tax rates are also likely to be announced before then. The latter measure in particular should strengthen the demand side, as Indian consumers will have more money in their pockets. With the reform of the outdated labour laws and land purchase regulations, India's business environment will continue to improve and provide more flexibility for companies to manage their costs efficiently. The winter session of Parliament will have the privatisation of state-owned enterprises and major reforms in agriculture and mining on the agenda. Narendra Damodardas Modi has sufficient political capital to implement the reforms. We then expect a gradual, broad-based recovery in the second half of 2020. As equity markets tend to be ahead of developments, we could see an upward trend in the broader market at the beginning of next year. The risks for such a scenario are, for example, the default of a large company, a sudden jump in inflation, which calls into question the interest rate cut, a rise in oil prices or a rapid slowdown in the global economy.

Fig. 34

Both the reduction in the corporate tax rate and the significant improvement in the business environment will attract foreign investment to India

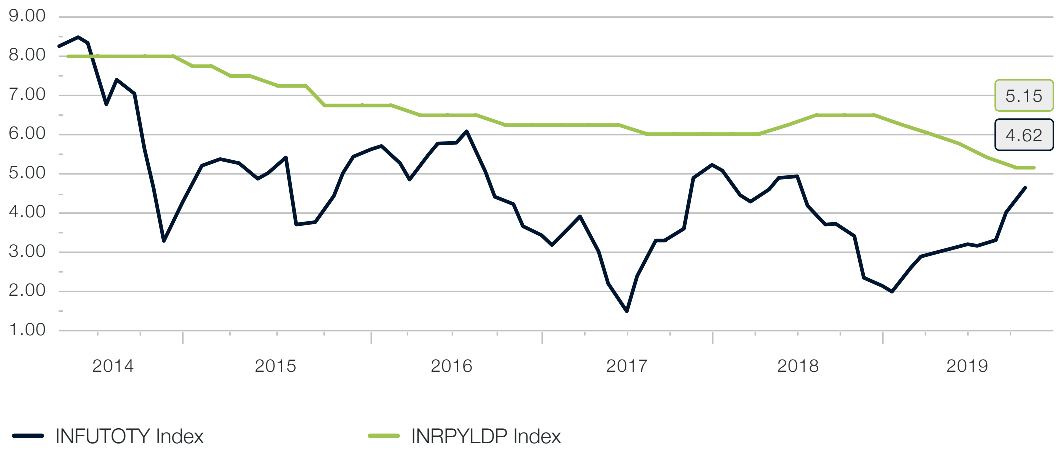


Source: World Bank's Ease of Doing Business 2019, 06 December 2019

While hampering growth in the short term, enforcing more transparency in the Indian economy provides a basis for such reforms to have a long-term impact. After certain upheavals, the economy and companies are adapting to the new environment. India needed to reach a nominal GDP of about one trillion US dollars from 1947 to 2002. And although the currency has depreciated by around 13% in the last five years, India has been able to increase its nominal GDP by a further trillion US dollars over this period. Despite the short-term weakness in growth, the Indian economy has structural advantages: on the one hand, the demographic dividend as the basis for solid domestic demand and, on the other, the government's willingness to invest in infrastructure. A GDP of five trillion US dollars may not be achievable for India in five years, but it can be achieved in eight to ten. India offers a wealth of investment opportunities.

Fig. 35

RBI lowered the interest rate by 135 basis points to 5.15% in 2019



Source: Bloomberg LP, 06 December 2019

5.2 India

The dynamics of the Indian consumer market are changing – another disruptive development is on the way

Around 65% of the Indian population is younger than 35 years old. The unprecedented penetration of internet and smartphone technologies, social media and e-commerce is influencing the dynamics of the Indian consumer market. Millennials are technically proficient and very culturally diverse. They are becoming more and more influential and will change demand structurally. The 400 million people of India's millennial generation make up 47% of the working age population and, accordingly, a large part of the Indian consumer base. They already account for 70% of household income and spend 330 billion US dollars a year (more than their parents). The consumer ecosystem is changing, and companies need to adapt their products and services. Millennials attach importance to quality, comfort, health/well-being and environmental/social aspects. Therefore, companies that are prepared for the rapid change of consumer needs and adapt their products and services accordingly will succeed. Other companies, on the other hand, will disappear from the market over time if they are unable to change their business model quickly. Millennials and Generation Z prefer companies whose products and services match their values. They will punish the others.

The first victims of this change are the gold jewellery and automobile sectors. Millennials prefer to buy electronic goods (comfort and well-being). This development can be clearly seen in the unprecedented sales figures for electronic household appliances during this year's festive season. Online retail is currently experiencing spending of 40 billion US dollars; by 2027, this volume is expected to reach 500 billion US dollars. The government has built infrastructure (roads, railways and airports) and has provided more and more citizens with affordable housing and electricity in the last five years.

5.3 India

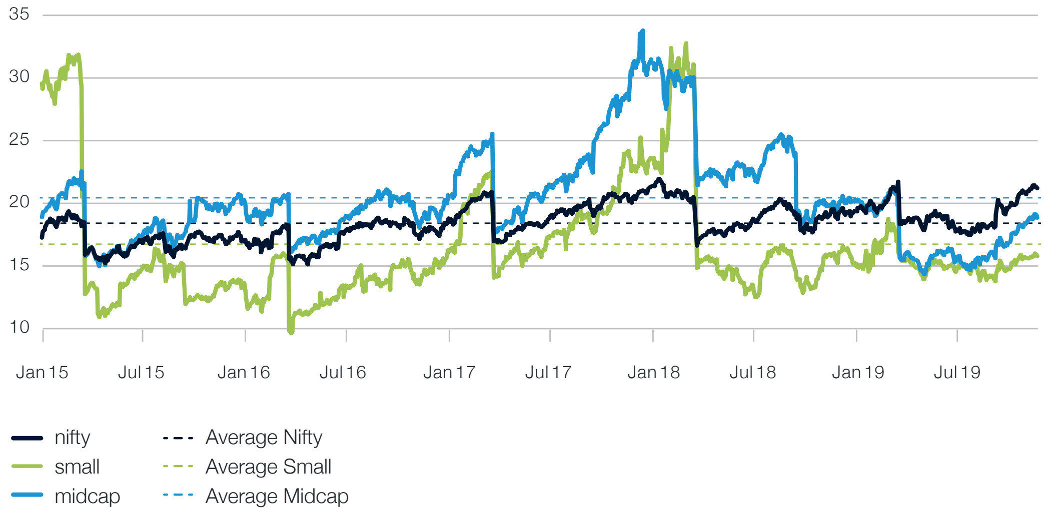
Are small and mid caps about to make a comeback in 2020?

The stock market can behave irrationally for a long time. While the economy appears to be weakening, the Nifty is reaching an all-time high despite extremely high valuations. If you take a closer look at the Nifty, you can see that only a handful of highly-weighted large caps contributed to its performance, while the rest of its components were in the red. The largest losses were recorded in small cap stocks, as market participants are still seeking safe havens. Data on domestic investment funds show that around 78% of the total investments of investment funds and insurance companies are concentrated in the country's fifty leading enterprises, ultimately those in the Nifty 50.

The euphoria triggered by the reduction in corporate income tax will soon subside; reason and thus the view of fundamental data shall prevail. The market will soon realise that the high valuation of the large caps does not justify the low valuation of the remaining securities. Since the underperformance is totally exaggerated, it can reach tipping point at any time. Small and mid caps have suffered the most since January 2018; their price-earnings ratio has fallen sharply since then.

Fig. 36

The gap between SMEs and the Nifty Index is set to narrow in the first quarter of 2020



Source: Bloomberg LP, 06 December 2019

The risk premiums of small and mid caps compared with large caps have risen significantly. This development is the result of a significant underperformance of small and mid caps compared with the main stocks since their peak in January 2018; in addition, short-term volatility clouds the outlook. When planning their investments in equity funds, investors can follow what is known as the 'core-satellite approach'.

Since mid-October, we have seen a moderate recovery in selected sub-securities and in securities that have come under pressure due to problems with corporate governance or payment defaults. It is only a matter of time before the prices of small and mid caps reflect the true intrinsic value of these companies.

Emerging markets will benefit from the globally accommodative central bank policy and negative interest rates, and India will be one of the beneficiaries of foreign capital inflows.

Your Contacts

Christopher Kumpas

CEO Picard Angst MEA
E-Mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

Legal disclaimer

Picard Angst MEA Limited

Emirates Financial Towers, South Tower, Office 2008,
DIFC, Dubai, U.A.E. PO Box 506935
Telephone: +971 (0) 43785111
info@picardangst.com, www.picardangst.ae