KEHRLI & ZEHNDER

INVESTMENT COMMENT

December 2018

- **Nowhere to hide**

  2018 marks the worst year for the financial markets since Watergate. None of the eight main asset classes was up this year. While absolute losses in a particular asset class were larger at times during the last 50 years, almost always there was at least one asset class that provided some shelter and compensated for losses elsewhere. All asset classes in negative territory without a recession is highly unusual.

  A tightening Fed is certainly the main trigger, as well as budget deficits in the US, slowdown in China, trade uncertainty and whipsawing oil prices. The US Fed not only raised rates eight times since 2015, it also stopped quantitative easing and stopped the purchase of Treasuries, which has left some USD 400 billion unfunded this year. Economists at Pictet calculated that USD 100 billion in liquidity reduction is the equivalent of a rate hike of 25bp.

- **Volatility is back**

  In 2018, there have been 20+ days with a 2%+ selloff in the markets - compared with none in 2017. Aside from the U.S. trade war with China, Brexit uncertainties, Italian budget issues, a revival of the Greek banking crisis, exacerbated by institutional systematic selling continue to drive up volatility. This has driven investors towards value-oriented, less cyclical and more conservative investments. We expect continued volatility until year-end due to window dressing activities. Many portfolio managers want to clear their portfolios of the losing positions, which will put additional selling pressure on this year's underperformers.

- **Emerging market - buy the dips?**

  Emerging market equities have suffered even more than their developed markets counterparts. Valuations have reached multi-year lows. They have been hurt by the relative strength of the US dollar (most of them are net oil importers), a slowing China and unresolved trade tensions that have caused havoc to the global supply chain. M1 money supply levels in China have hardly grown since the beginning of the year, partly due to capital flight. A turnaround in the emerging markets is unlikely in the coming months.

- **Flattening yield curve**

  Interest rates in the U.S. are expected to continue to rise on the short end with another expected increase later this week. The yield curve is the flattest since 2008 – with the spread between the 3-month and 10-year yield at less than 50bps. While an impending recession is often foretold by an inverted yield curve, in most cases a flat yield curve does not lead to an inverted one. There is little or no potential reward to take duration risk. What is the market waiting for? A clear signal that inflation is no longer a primary concern – as a stronger US dollar and lower oil prices would suggest.