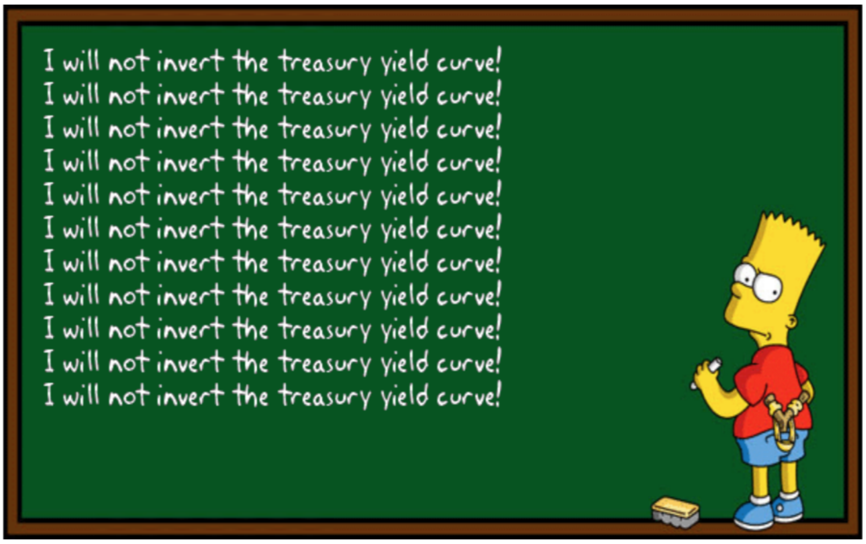
Market review March 2019



March bore witness to a rare stock-market phenomenon (inversion in the yield curve) which, whenever it takes place, leaves no investor indifferent as it is the precursor to a gloomy economic event: recession!

The fall in the stock markets of Q4 2018 occurred so suddenly and was so considerable that the worst case scenario is expected. Aware of the risks that a loss of confidence could have produced, central bankers have since redoubled their efforts to reassure the markets with less pessimistic rhetoric and actions which seek to maintain an accommodating monetary policy.

The present economic cycle is one of the longest in history. There is no doubt that we are closer to its end than we are to its beginning. It is characterised by ultra-accommodating monetary policies, a modest economic upswing in relation to past cases but extraordinary growth of financial assets. This major contrast explains part of the social tensions emerging in most developed counties.

While, at the end of summer 2018, markets forecast a rise in the interest rates by the ECB in the summer 2019 and three rises in interest rates for 2019 in the US, the threat of a trade war between the US and China has abruptly slackened the global economic climate. The global slowdown is palpable. In Europe, countries whose economic model is based on exports are decelerating (Italy is in recession and Germany could also follow suit).

Without further ado, central bankers have performed a U-turn between the end of 2018 and the beginning of 2019. In view of the threat of a steep downturn, the ECB has announced, with great fanfare, the renewal of its TLTRO programme which sets out to provide the banking sector with liquidity. It has put off any rise in interest rates indefinitely. The US Federal Reserve, which seemed to be on autopilot with a regular rise in interest rates (+0.25% per quarter) and a mechanical balance sheet reduction (- USD 50 billion per month), has suddenly regained control of the situation to announce a complete freeze on interest rate rises for 2019 and a much more gradual reduction of its balance sheet (with a final suspension in September).

In the light of such upheaval, the markets could not sit idly by. The long-term interest rates on both sides of the Atlantic have collapsed. The bund (the 10-year German Government bond) has re-entered negative territory (rock bottom yield of -0.08%). We now have more than USD 10 trillion in negative yield bonds in the world (as opposed to 6 trillion in mid 2018). The US long-term yield curve has also slumped and gone into reverse in relation to the part between 3 months and 10 years (3-month yield higher than 10-year yield).
As for the equity markets, they have been blessed by the largesse of central bankers and have continued to grow, in total disregard of the fears related to Brexit or the trade war.

Weisshorn Asset Management SA – 7, rue des Alpes, Case Postale 1800. CH – 1211 Geneva 1

+41 22 316 03 30 + 41 22 310 31 18 info@weisshorn-am.com www.weisshorn-am.com

Market trends at end of March 2019

End of March	MSCI World	S&P 500	Equities in Local Currencies EuroStoxx	CAC	Spain	Switzerland	UK	Hong Kong
Perf 1 Month	1.05%	1.79%	1.62%	2.10%	-0.40%	0.95%	2.89%	1.46%
Perf YTD	11.88%	13.07%	11.67%	13.10%	8.20%	12.44%	8.19%	12.40%

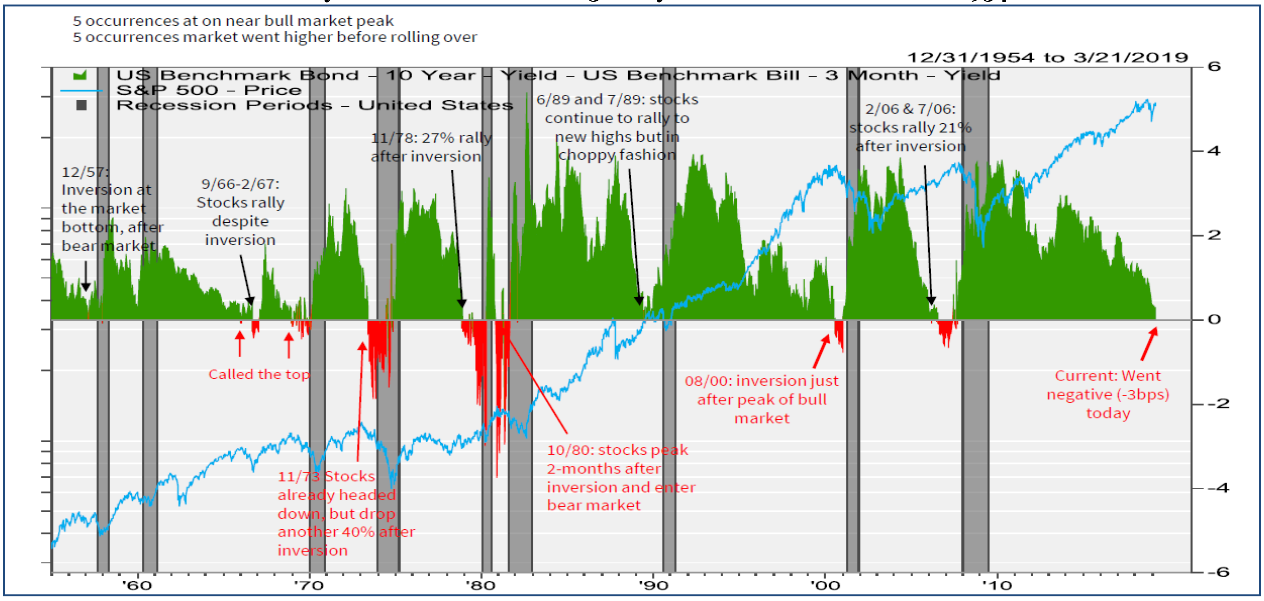
End of March	WTI Oil	Brent Oil	Commodities Gold	Copper	USD	Currencies vs EUR JPY	GBP	CHF
Perf 1 Month	5.10%	3.57%	-1.60%	-0.41%	1.46%	1.90%	-0.30%	1.70%
Perf YTD	32.44%	27.12%	0.77%	8.68%	2.05%	1.02%	4.39%	0.82%

End of March	Global Aggregate	US Aggregate	Bloomberg Indices Bonds Total returns Euro Aggregate	US 10 Year Treasury	German 10 Year Bund	Global Credit	Global High Yield	Emerging Sovereign $
Perf 1 Month	1.25%	1.92%	1.62%	2.53%	3.98%	1.52%	0.46%	1.37%
Perf YTD	2.20%	2.94%	2.51%	2.88%	5.42%	3.82%	6.33%	5.43%

Source Bloomberg 29/03/2019

As indicated by the data above, the performances of the equity and bond markets are exceptionally positive. Admittedly, they are offsetting the losses from the end of 2018, but we are experiencing a more reliable pace of economic growth.

History of the inversion in the 3m-10y rate curve in the US since 1954



Source: FactSet, Raymond James, Bloomberg.

The phenomenon of the inversion in the yield curve is rare enough to warrant careful examination.
In the last 60 years, except for 1967, an inversion in the curve has been the precursor to a recession. It generally takes place 18 months later.
Historically speaking, an inversion in the curve occurs when the central bank reports its key interest rates (short-term interest rates) to take the sting out of the overheating of the economy which would pose a threat to price stability. In the present case, the US Federal Reserve has admittedly raised short-term interest rates, but they remain at modest levels in relation to previous cycles. The current configuration is quite unique. Paradoxically, it is the long-term interest rates which have fallen. This phenomenon is symptomatic of the current context.

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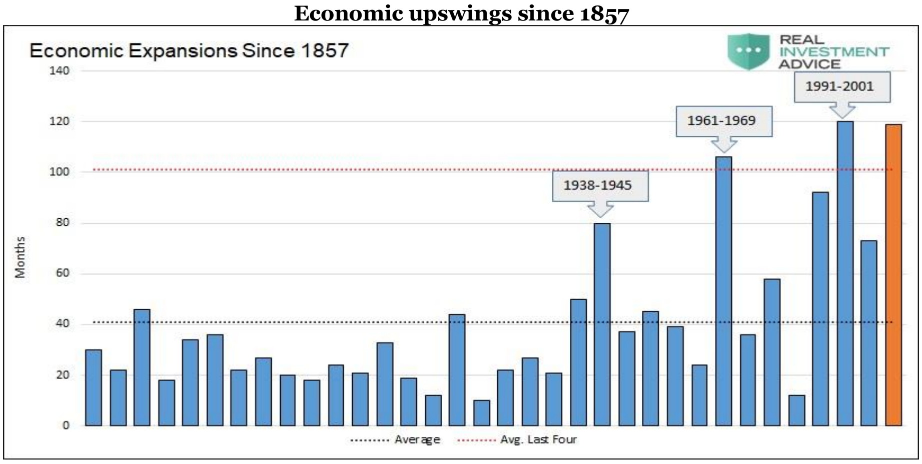
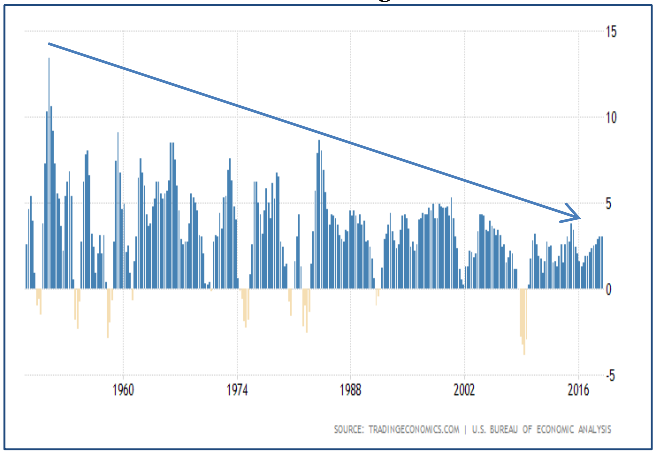
Economic upswings since 1857



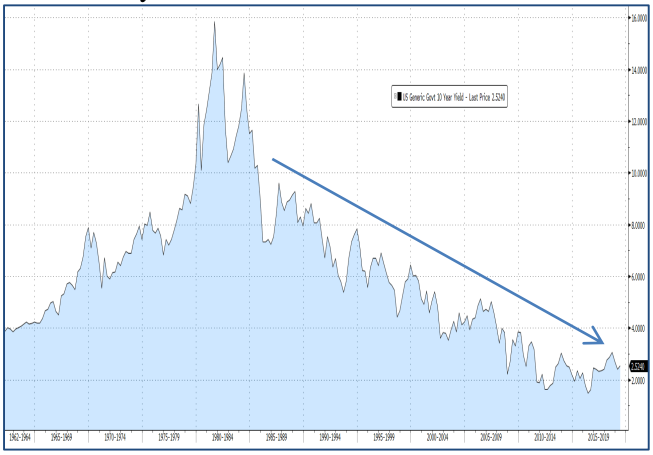
Source: Real Investment Advice

We are currently experiencing the second longest economic upswing in US history but the weakest in terms of growth rate.

Annualised GDP growth



10-year interest rates in the USA

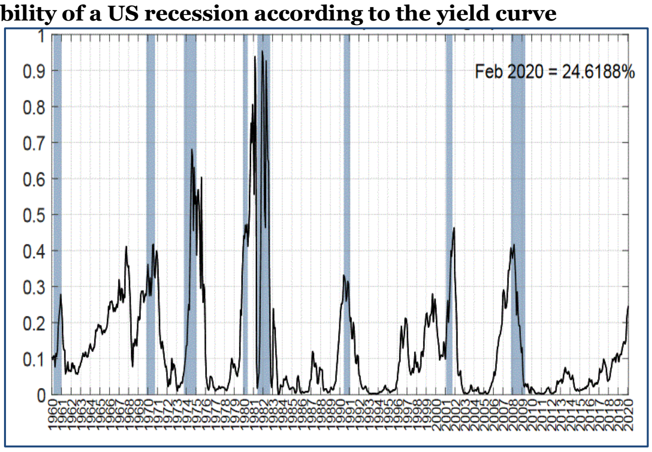


Source: Trading economics, Bloomberg

Long-term interest rates generally reflect the inflation-adjusted growth potential of an economy in the long term. An outlook of weak economic growth automatically presents itself as a slump in long-term rates. This is what is currently happening.

Slope of the US curve (3m-10y)

Probability of a US recession according to the yield curve



Source: Bloomberg, KBR

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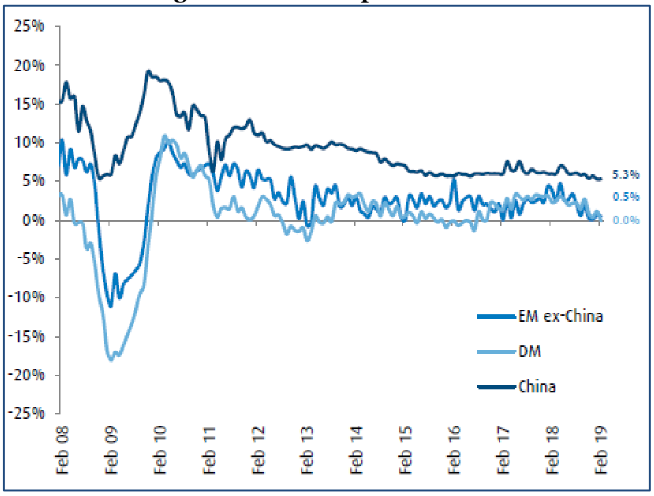
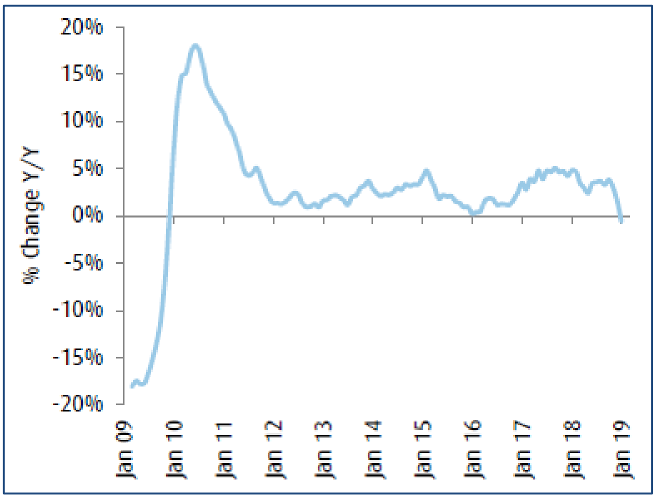
As indicated in the preamble, a yield curve inversion never augurs well and greatly increases the change of a recession (tightening of monetary conditions). But in this case, this indicator should be qualified. Monetary contraction is quite relative and, on the contrary, central banks maintain ample liquidity to add flexibility to the system.

The observed economic downturn appears to be somewhat connected with political phenomena. Brexit paralyses part of Europe as the economies of EU countries are intertwined. And most importantly, since the outbreak of this trade war between the US and China last summer, global trade has ground to a halt, as shown by the figures for global industrial production and trade (see graphs below).

Growth in global industrial production



Global trade

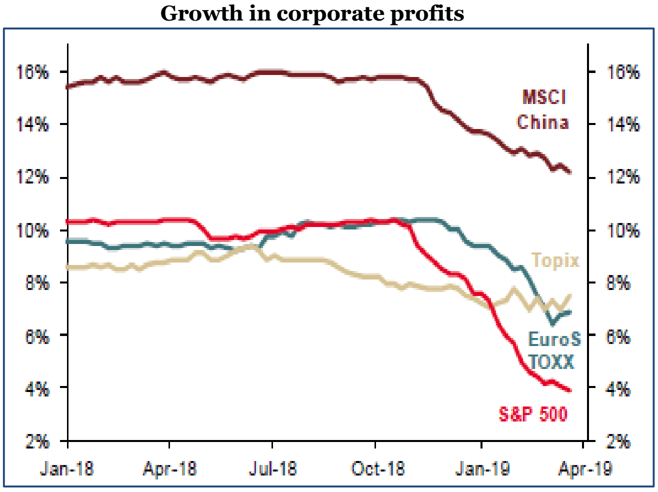


Source: BMO, CPB.

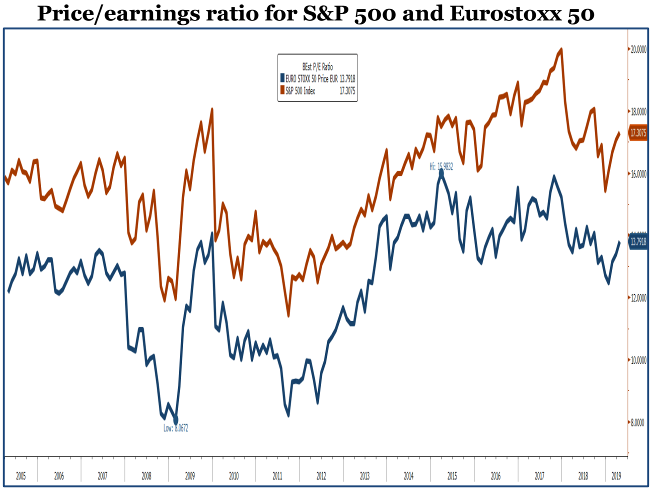
Equity markets seem to confirm this option. The decline of Q4 2018 pre-empted this slowdown while the current recovery endures despite political headwinds.
A more definite framework for Brexit and for these trade deals would greatly boost productive investments of companies around the world. It is difficult to establish a concrete timetable for these two events while negotiations drag on endlessly. However, it appears that political leaders have realised the economic calamity that these two problems would create if no agreement is reached.

We are now playing the old waiting game. The recovery at the start of the year enabled us to profit both from the equity market and the bond market.

Growth in corporate profits



Price/earnings ratio for S&P 500 and Eurostoxx 50



Source: MSCI, IBES, SG Cross Assets, Bloomberg.

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With slowing global growth, corporate profit estimates have also been revised downwards. The fiscal reform is a thing of the past in the US, so we do not expect any further stimulus. Valuations were highly attractive at the end of last year. This is not necessarily the case now.
Recession is not imminent (recession has already hit Italy!) and history tells us we still have 18 months ahead of us in the US. The current slowdown is more due to uncertainty caused by the political context than a major inflection point. But are remain on high alert.

It should be noted that the USD has remained surprisingly stable since last summer despite market turbulence.

Evolution of USD in relation to leading global currencies

Source: Bloomberg

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