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CIO Update

Investment Committee Bank J. Safra Sarasin
7 February 2020

Editorial

Dear reader

Financial markets have been subjected to two endurance tests so far this year. After the markets quickly absorbed the shock from the escalation of tensions between the USA and Iran at the beginning of January, it also appears that the fast-spreading coronavirus has not become a stumbling block. The generous and steady provision of liquidity by central banks has helped to greatly strengthen the resilience of financial markets. Investors have continued their search for yield and are using every minor setback to build up new risk positions. Provided the economic recovery remains intact, demand for equities, in particular, should continue to pick up. We have therefore used the current phase of uncertainty to gradually increase our equity allocation to a neutral level.

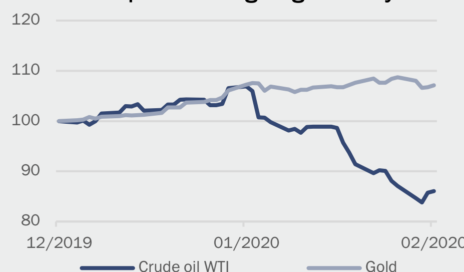
Yours faithfully
Philipp E. Bärtschi, CFA
Chief Investment Officer

Focus

Resilient financial markets

Review: Rising uncertainty
Market uncertainty about the effects of the coronavirus on the economy is depressing investor sentiment at the moment. This is supported not only by the sharp decline in yields and the US dollar's strong performance in recent weeks, the decline in the price of oil and slump in industrial metals also speak volumes. On the other hand, gold has proved to be a safe haven since the start of the year.

Gold and oil prices diverge significantly

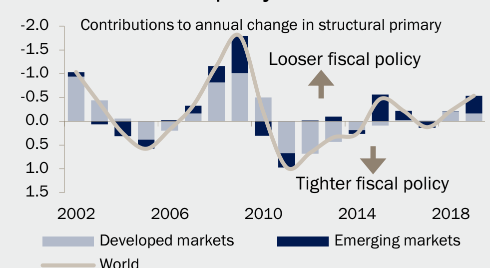


Source: Refinitiv, J. Safra Sarasin, 07.02.2020

It is difficult to estimate the extent of the damage on the global economy. But one thing is certain: economic growth is likely to be lower rather than higher in the short term, especially in China.

Macro outlook: Intact recovery
Nevertheless, the fundamentally positive macro trend should continue throughout 2020. Recent months have seen a progressive, broad-based improvement in the macroeconomic data and leading indicators. The manufacturing industry has stabilized at a low level and consumption remains strong. The export data for key emerging market regions have proved surprisingly positive in some cases and the market – especially in emerging markets and in Europe – is pinning its hopes on fiscal policy measures. Central banks have used monetary policy measures to give the governments here sufficient leeway to shape policies.

Considerable fiscal policy latitude



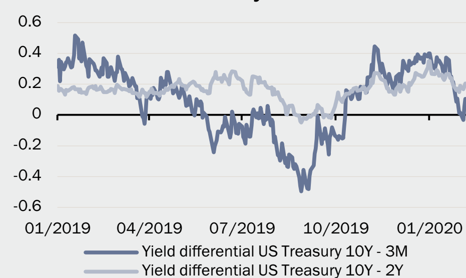
Source: J. Safra Sarasin, 07.02.2020

Initial measures taken by the Chinese government demonstrate its readiness to intervene via stimulus initiatives. Although growth in the first quarter is likely to be weak, deferred investment plans can be put into effect during the course of year, and enable a sharp increase in growth in the second half of 2020. Although the decline in the first quarter will have global repercussions, rather than stalling the economic recovery, it will simply delay it. This also has the advantage that interest rates will remain low and central banks will remain very accommodative for the time being. Inflation is not a theme, and this should remain the case for some time to come.

Bonds: Yield curve remains flat

More monetary policy measures that provide significant stimulus are no longer expected, however. A consensus in Europe is gradually emerging that further cuts to interest rates no longer have a positive effect, and might even hamper investment and consumer behavior. The Bank of England recently opted to wait for more data to come in before cutting interest rates. China still has a little leeway, which the government will use given the growth dip. The USA has the greatest potential to lower interest rates. After cutting rates three times last year, the US Federal Reserve (Fed) appears to be on hold for now. But in recent weeks, financial markets have priced in rate cuts again and the USD yield curve has inverted once more.

Partial inversion of USD yield curve



Source: Refinitiv, J. Safra Sarasin, 07.02.2020

We estimate that the hurdle for a rate reduction is high; however, we cannot rule out a reaction from the Fed in the event that the slump in Chinese growth has a stronger-than-expected effect on other regions. Inflation continues to fall short of expectations and the slide in oil prices should reinforce this trend. As such, investors will continue to take the view that there is a greater chance of a rate cut than a rate hike in the next 12 months. This asymmetry in expectations should also keep the yield curve flat and underpin demand for higher-yield bonds. As a result, we are sticking to our positive view of high-yield and emerging market bonds, despite the considerable drop in credit spreads.

Equities: Focus on quality and growth

In the second half of 2019, the cyclical recovery raised the question of whether the time had also come for cyclical value stocks. The relative strength of value stocks, which began in September, did not last long, however.

Equities: Focus on quality and growth

Source: Refinitiv, J. Safra Sarasin, 07.02.2020

Another change happened in November, when growth stocks took the lead again. Quality stocks also managed to retain their momentum throughout the entire period. It seems that investors harbor doubts about a significant economic recovery, which would lead to strong earnings growth and higher interest rates. They have more confidence in interest rates remaining low due to the generous provision of liquidity and, as a result, the continued rise of equity market valuations. Obviously, the latest development with the expected slowdown in China's economic growth will only reinforce this trend. Consequently, we think that investors should continue to focus on the theme of growth and quality. This means that preference should be given to sectors like technology, healthcare and consumption. At a regional level, this focus speaks in favor of US and Swiss equities. Clearly, emerging market equities have suffered the most in recent weeks due to concerns about the spread of coronavirus and its expected economic impact. We also see the greatest potential for recovery in the medium term here because emerging markets not only promise strong growth, they also come with an attractive valuation.

Asset allocation: Fairly neutral

We expect that the global economy will continue to recover moderately. China's economy will experience a sharp downturn in the first quarter, but should recover strongly during the remainder of the year on the back of additional stimulus measures. We have therefore used the current phase of heightened uncertainty to gradually increase our equity allocations to a neutral position. In the fixed income space, we continue to overweight high-yield and emerging market bonds. In alternative assets, we are rebalancing our portfolios with commodity investments. We are taking profits on gold positions and reinvesting the proceeds in commodities as a whole, which have lost a lot of ground since the start of the year. Commodity assets should recover sharply once coronavirus concerns subside, enabling the economic situation in China to stabilize.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	=	Industrial countries =	Emerging markets =	Large caps =	Small caps =
Bonds	–	Government bonds – –	Corporate bonds –	High-yield bonds +	Emerging markets +
Alternative assets	+	Money market =	Convertible bonds =	Other alternatives +	Commodities/gold =/+

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