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BFI INFINITY

An unsurprisingly turbulent year

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With 2018 almost behind us and 2019 already waiting in the wings, it is the perfect time to reflect on the developments of the year that is coming to an end and to look ahead at what awaits us in the coming twelve months.

In our last BFI Infinity InSights for the previous year, we already anticipated that 2018 would prove more challenging than the distinctly profitable 2017. Indeed, this year saw a return of volatility in financial markets that became very evident during the equity market sell-off in February and then again during the correction which started in October and is still ongoing at the time this report is being written.

While there is no shortage of risk factors and pressure points that are contributing to an unhealthy cocktail for global markets, there were two clearly identifiable main headwinds this year. First, with the hawkish stance that the Federal Reserve until recently maintained, rising interest rates have become a major stumbling block for US stock markets. The decrease of US Dollar liquidity in the global financial system has reinforced the impact and, even though the US currency seems to have peaked in December 2016, it has led to a bounce back after its slide in 2017. However, interest rates everywhere still remain low by historical standards.

The second and, in our view much more important, factor is the widespread concern surrounding the unabating trade disputes. In particular, the tensions between the US and China are casting a large shadow over the market outlook. The recent talks at the G20 Summit in Argentina have only offered a brief respite. The 90-day negotiation period that the two sides agreed to was initially welcomed by a market rebound, however, the hopes of a smooth resolution of the disputes were soon crushed by the surprise arrest of Meng Wanzhou, CFO of Huawei, one of the leading Chinese technology firms. The arrest, which took place in Canada at the request of US authorities, marked a new high in the escalation of the tensions between the two superpowers. The market reaction was strongly negative with equity markets around the globe falling by 5% or more within only a few days.

The entire incident also served to highlight what is arguably the real reason underlying the trade wars: the fight over future supremacy in the technology sector. As we outlined in depth in the last edition of our BFI Infinity InSights, the US has a long history of "elbowing" competitors in often indirect ways. In the context of the ongoing US-China trade conflict, the contested ground is the future of the artificial intelligence (AI) industry and its applications in healthcare, the automotive sector, the military, finance and economics, etc. One of the key battlefields of this technology war is the chip industry, which is the bedrock of all present and future AI applications. Having the right chips is the bare minimum in order to be able to compete in the AI frontlines.

The US is currently the global leader in the semi-conductor industry, with giants such as Qualcomm, Nvidia and Intel, however China is catching up fast. As the country is by far the world's largest buyer of semiconductors, Beijing has made it a top priority to reduce its reliance on US imports and to bolster local production instead. The threat to the US is therefore clear and, in this light, the targeting of Huawei is neither shocking, nor unprecedented. Back in April, the US Department of Commerce banned component sales to ZTE, the Chinese smartphone manufacturer, which caused the company to halt production and almost go out of business. Thus, when placed in its full context, the US-China trade conflict appears to run much deeper than most may realize. Although small conciliatory steps might be taken, such as the recent resumption of US soybean imports by China, unless the core strategic disputes are settled, the hopes of a full and sustainable resolution being reached within 90 days might prove overoptimistic.

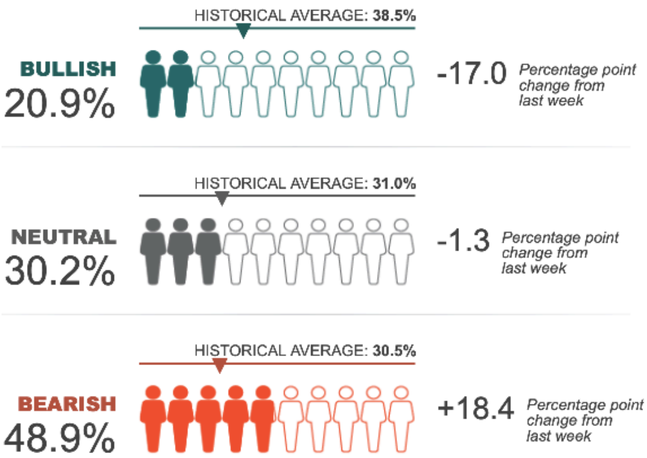
Overall, the wider trade issues have been with us for well over two years now, as it became clear after the election of Donald Trump that the US will seek to renegotiate trade treaties with many different countries. While the sharper, combative tone of the US on trade issues did not impress investors at first, the various tariff threats and their enforcement have started to gradually pile pressure on the markets. The longer the trade disputes go unresolved, the greater the adverse reaction of the markets will be. What is especially worrying, is that we are now starting to see an impact on future economic growth. This is evident in the sharp decline in US long-term interest rates, where the 10-year Treasury yield fell from 3.30% to 2.80% within only a few weeks. This is a clear signal that the growth outlook for the US, as well as for most other major economies, has been negatively impacted by the ongoing trade tensions.

An uphill battle ahead for the US?

The outlook for weaker growth in the US in 2019 and 2020, which is expected to slow gradually from its current pace of 3.5% to below 2% by the end of next year, according to both Goldman Sachs and JP Morgan forecasts, will remove a key driver that US markets so far relied upon. The outlook for the US Dollar is also rather bleak, as it is a distinct possibility that US interest rates might have already peaked, with the Federal Reserve having adopted a more dovish rhetoric for the coming year.

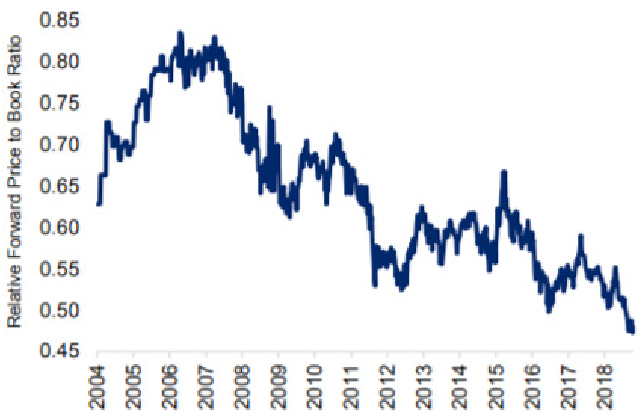
As can be seen below, when it comes to investor sentiment and expectations going into the next year, the complacency and overconfidence that we've been accustomed to over the last years seem to have severely dissipated. Pessimism has climbed to a 5.5 year high and a bearish outlook is pervasive, according to the latest Sentiment Survey by the American Association of Individual Investors (AAII). Thus, overall, the considerable valuation gap between equity markets around the world and the US, no longer seems to be justified.

Market outlook of individual investors for the next 6 months



Source: American Association of Individual Investors (AAII)

Eurozone relative to US Price-to-Book



Source: Citi Private Bank

From a Price-to-Earnings (P/E) point of view, but also from a Price-to-Book (P/Book) valuation perspective, US equity markets appear very expensive, compared to their much more attractive international counterparts. A prime case-in-point in this regard is the valuation difference between the US and Europe, which has never been greater in the last fifty years. In fact, through a P/Book lens, US markets are almost double (!) the price of European markets. It does not take much to figure out that these valuation differences are not sustainable. A lot of international markets are offering great long-term potential and a much more appealing value proposition than the US at the moment. Emerging markets also look extremely attractive, however, from a timing perspective, it would be advisable for investors to wait until the outlook for global trade starts to improve and market volatility dissipates and normalizes again.

The appeal of international investments from the point of view of a US investor is becoming increasingly apparent and hard to ignore. Declining, or at least laterally moving, US assets and a US Dollar that also might be moving lower in the coming years offer a rare entry opportunity to international investments. Valuations are attractive, most foreign currencies are relatively cheap and, overall, international markets offer more and greater opportunities to investors than can be found in today's overvalued and rather saturated US markets; that much is clear. Thus, the real question is: why did US assets, especially stocks, explode to such record-breaking price levels?

Of course, the fundamentals might go some way into justifying the historic rally. Growth in the US has been stronger than in most other countries, earnings of US companies have also outpaced their international peers, while unemployment figures are at historic lows. Nevertheless, economic and earnings data alone fail to explain away the vast valuation differential. More compelling answers are revealed when one takes a closer look at the balance sheets of US companies and the changes that took place therein over the past decade.

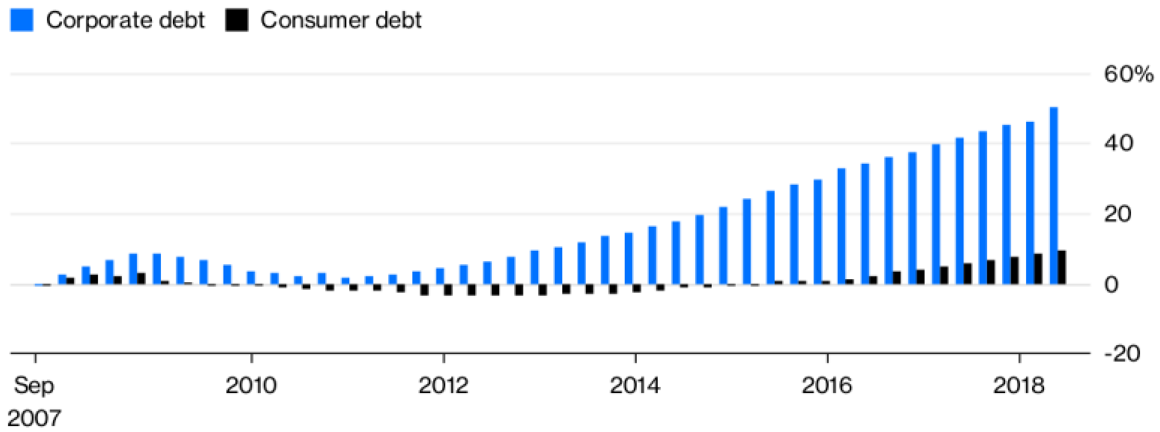
Unprecedented debt levels

US corporate debt has gone up significantly since the financial crisis of 2008. That's in sharp contrast with many of their international counterparts that have been paying back and shrinking their debt or have at least managed to keep it contained at the same levels.

Not so with US companies. As the extremely accommodative Federal Reserve policies made it historically inexpensive for them to borrow money, companies did exactly that. Using cheap credit, they funded buy-back programs that helped push up earnings per share growth to the extreme levels we have been seeing in the last few years. This financial engineering might have been an easy and at the time cheap way to prop up earnings growth until now, however, it has arguably achieved this at a very high future cost.

The total US corporate debt today stands at $9.1 trillion, a dramatic surge of 86% from 2007, according to the Securities Industry and Financial Markets Association. What is especially worrying, is that this increase was fueled to a large extent by bonds at the riskier end of the investment-grade spectrum. BBB-rated bonds have almost tripled since 2008 and now make up nearly 50% of all investment-grade credit. This shift is raising significant concerns over the impact of potential downgrades and subsequent sell-off scenarios similar to the one General Electric has struggled with in recent months. Overall, the anticipated growth slowdown and the need to service and repay this massive debt could adversely impact earnings growth, rendering the current earnings outlook for a lot of US companies overoptimistic going into the next year.

Business borrowing surge after the 2008 recession



Source: St.Louis Fed, Bloomberg

While the explosion of corporate debt might prove very problematic for many US companies over the coming years, it is not only Corporate America that has been spending beyond its means. US government debt is continuing to mushroom and to break record after record. Currently at $21.9 trillion, US debt is set to rise this year at the fastest pace since 2012. Also, during President Trump's first full fiscal year, the budget deficit increased by $779 billion, according to data released by the Treasury Department. In relation to the GDP, the deficit rose to 3.9%, its highest point in six years.

Dark clouds and silver linings

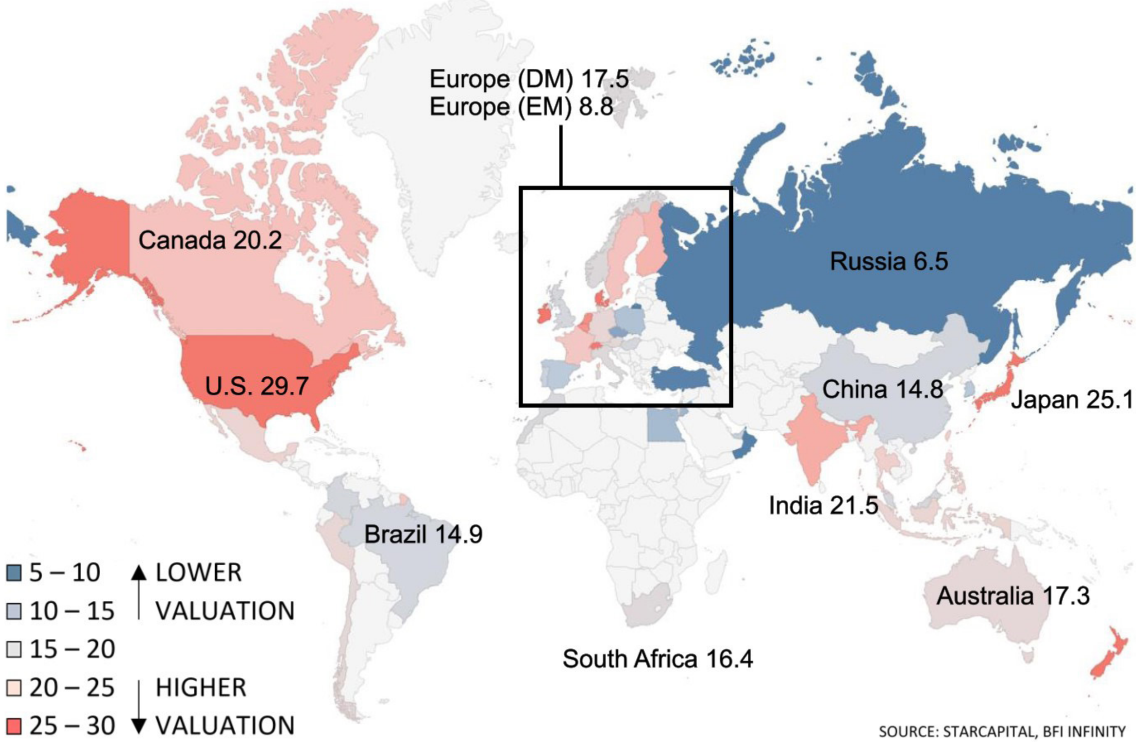
The combination of a heavy corporate and national debt burden, the continuing trade disputes and the prospect of slower economic growth along with a likely slowdown in earnings growth, set the stage for a challenging 2019 for US equity markets. Additionally, falling long-term interest rates and slower growth will also hurt the US Dollar going forward, since the yield advantage is shrinking and the large speculative US Dollar long positions in currency markets will likely get smaller as well.

All these factors should also be positive for precious metals. The recent increase in gold prices to around USD 1250/ounce might only be the start of a longer recovery in precious metals prices. Additionally, should market volatility persist or even spike further, safe haven assets are bound to become more appealing to investors, as is historically the case.

All in all, the different pressure points and risk factors we've outlined might create adverse conditions in US markets, but at the same time will very likely increase the appeal of international investments. In recent years, US stocks and the US Dollar have been the best performing investment areas, but this might soon change. Current trends and developments in the US economy and markets, as well as the anticipated changes going forward, could create the right conditions for a paradigm shift that sees the US sidelined by international markets that offer a better

GLOBAL PRICE OF EQUITY MARKETS

CAPE-RATIOS FOR MAJOR EQUITY MARKETS AS OF NOVEMBER 2018



SOURCE: STARCAPITAL, BFI INFINITY

value proposition. Thus, for the globally-minded investor, this shift can be translated into new, more competitive and profitable opportunities beyond the US. In other words, while the US door might slowly begin to close, a window is already opening in international investments.

Launching a US custody solution to invest internationally

Considering the risk factors that lie ahead for US equity markets and the currently still undervalued opportunities that international markets have to offer, we decided to create a turnkey solution that would allow our clients to benefit from precisely these conditions. Thus, as of January 1, 2019, we will be offering a US custody setup, specifically designed to provide clients with access to our international investment diversification strategies and still keep their money at home in the US. It is easy to set up and to maintain and all that is needed is to open an account with our US custody partner.

It is the first time we offer this US custody solution, but with international investments currently looking so attractively valued, the time is right to offer our clients a straightforward way to access these opportunities from the US, guided by Swiss expertise and our team's long and successful track record in international and European markets.

Please let us know if you wish to receive more information about our new US custody solution and we'll be happy to share further details with you.

As 2019 is just around the corner, all of us at BFI Infinity would like to express our gratitude for the trust you've placed in us and to reiterate our unwavering commitment to our mission, the long-term growth of our clients' investments.

We wholeheartedly wish you a very Merry Christmas and a happy, healthy and successful New Year.

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