4th May 2018

Volatility in financial markets offers new opportunities

Bullish recovery for US equities. Use the opportunity to reposition in emerging markets. Probable loss of « momentum » for European equities. Buy Switzerland.

Key Points

- The correction in equity markets offers new opportunities
- The recent phase of underperformance of the American market should not last
- Bullish recovery for US equities
- Positive outlook, but risks of loss of
- « momentum » after an exceptional April in European equities
- British stocks: remain cautious
- Yen correction in April fosters Nikkei perspectives
- A return to emerging markets is essential
- Chinese market to benefit from easing in political tensions
- Swiss equities benefit from a weaker Swiss franc

Equity markets correction offers new opportunities

Prior to February, it seemed that nothing could stop the march of American assets. But the rise in inflation and interest rates, as well as risks of monetary policy normalisation being bolstered, in the end won at the expense of the, until then unwavering, optimism of investors.

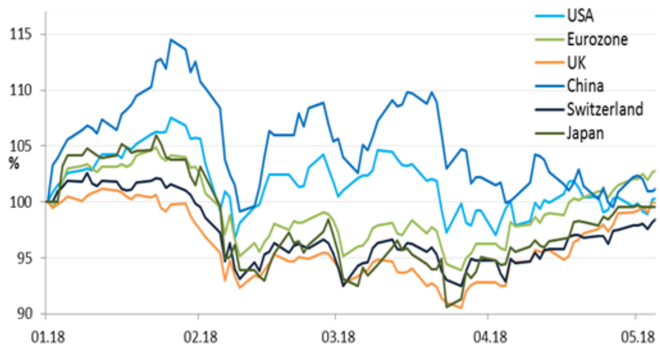
For a few weeks now, we have reacquainted ourselves with the risks that the situation on the jobs market represents for company margins, as well as the risk of profit growth being insufficient to justify the particularly high valuation levels before the correction to stock market prices.

The growth of multinationals' profits may be in fact lower than previously thought in the end, at close to the economy's growth rate.

The tax reform could be less important for multinationals on the S&P 500 than for medium-sized American companies. Beyond the fundamental issue of profit growth, we must not forget that the rise in US equities was sparked first and foremost by a strong rise in multipliers.

The February-March rebound, in the US market in particular, had temporarily re-inflated valuation levels before the second correction at the quarter-end. In the long term, the upward rate cycle could lead to a new phase of PE contractions. However company profits may develop, it is likely that interest rate rises will put an end to this ten-year expansion phase.

Evolution of the markets in 2018 (YTD)



Sources: Bloomberg, BBGI Group SA

Following on from US equities bouncing back in February-March, we predict renewed volatility, that would provide better investment opportunities and more reasonable valuation levels. The fall in share

prices at the end of the quarter following the emergence of new risks of a trade war between the US and China is perhaps, in our opinion, already likely to create these opportunities

Indeed, the valuation of the S&P500 index declined to 17x expected 2018 earnings, as prices dropped to 2,600 points. At this point, we do not consider the risk of a trade war as a key factor impacting corporate earnings growth. Consequently, observed volatility in this context has already improved valuation levels and provided further investment opportunities.

In the context of April, the underperformance of US stocks, especially against European stocks, should no longer persist.

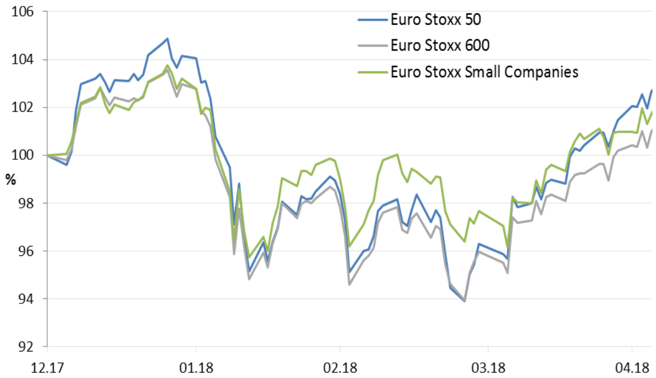
After having favored a certain prudence and a underexposure to US equities, it now seems to us that US equities should benefit from a recovery against the risk of a loss of « momentum » in European equities.

Positive outlook but risks of loss of « momentum » after an exceptional April for European equities

The correction to financial markets, starting in January 2018, was similar for Eurozone and US equities in the end. Fears linked mainly to the inflation recovery and faster rate rises in the United States had plunged all equity markets into a general price correction of around -10%. European indices had a year's worth of growth wiped out, and were at similar levels to the start of 2017. The price correction was not particularly intense, but it came at a point when the revaluation of European equities was far from over. As such, the valuation of European equities improved quite considerably, both in past and international comparison. It has become even significantly lower than the valuation of American equities. At just 13.2x 2018 profits, the valuation of European equities represented a 3.4 valuation point discount compared to US equities (PE 16.6x 2018).

We did not believe the approximately 25% valuation differential between US and European assets to be justified in the current context, which is also favourable for European assets.

European equities YTD



Sources: Bloomberg, BBGI Group SA

In terms of dividend yield, European assets also seemed much more attractive, offering 3.5% yield. This is nearly twice the yield of US assets (2%). The recovery in growth and company profitability are key elements, which are then bolstered by other favourable factors, such as, inter alia, the fall in great political and systemic uncertainty, and the improvement in banking sector conditions.

These factors made European equities more attractive that we expected to outperform in the medium term.

April was indeed particularly favorable for eurozone equities, which rose by + 7.3% while US equities lagged behind and rose by only +1.6%.

To date, valuation gaps are no longer as important and we believe that the outperformance of European equities should rather lose « momentum ».

UK equities: remain cautious

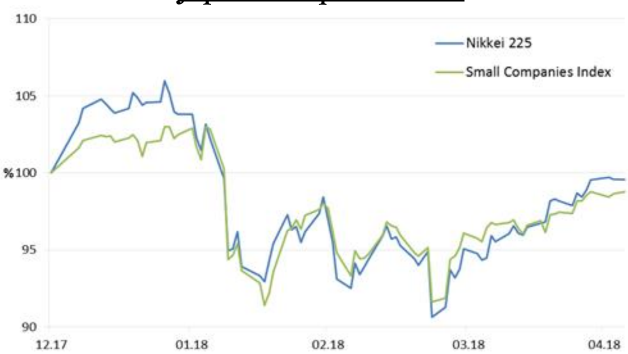
In the recent phase of correction, the UK market was once again trading at the same level as in October 2016, a few weeks after the vote (7,000 UKX). The drop in share has adjusted the valuation level. However, at around 13x earnings and an expected yield of 4.5%, the UK market did not present, in our opinion, the opportunity we expected given the still uncertain context of the Brexit negotiations. The sharp recovery of the market in the recent weeks is therefore a certain surprise, but we maintain our advice to remain cautious with regard to UK equities at this time.

Yen correction in April fosters perspectives with regard to Nikkei

In December 2017 we recommended that investors take profits in the Japanese market as it reached the 23,000 mark. Since then, a fall-off in international stock markets likely contributed to investors' awareness that Japanese equities remain very dependent on the exchange rate. The Nikkei's -13% drop to 21,000 points was among the steepest of the developed markets. Several weeks ago we cautioned that it seemed unlikely that Japanese equities would continue to rise in 2018 if the monetary context did not become more unfavourable to the yen. The yen's +6% increase against the dollar, along with renewed uncertain-ties among investors at the beginning of the year, was thus a key factor in the weakness of Japanese shares.

Today we believe that an uptick in the earnings growth of Japanese companies is still likely, due in particular to the upturn in the global business cycle; however such growth is ever more dependent on a depreciation of the yen. Results posted were indeed better than expected, leading to upward earnings revisions for 2018.

Japanese equities YTD



Sources: Bloomberg, BBGI Group SA

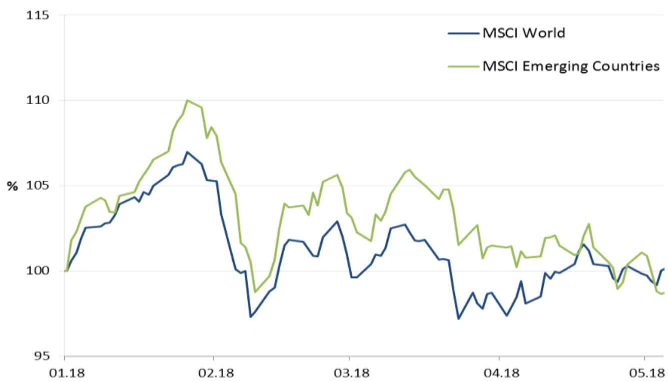
The most recent earnings season has thus led us to expect an increase in profits for the period ending on 31 March 2018, possibly higher than the 13-15% consensus forecast, in a possibly somewhat cautious forward guidance context. Listed companies' expected divided distributions could progress for the fifth consecutive year. In December, we recommended that investors take profits in the Japanese market as the Nikkei reached new highs. Japanese equities were then trading at 19x expected March 2018 earnings (17x 2019), which could still be considered reasonable, given the likelihood of positive surprises with regard to full year results. However, while their valuation was in fact similar to that of US shares, we cautioned that currency risk had to be taken into account. Even though the market was still offering opportunities for positive surprises and upward revisions over the next several quarters, the high valuations warranted profit-taking pending better opportunities. Valuations fell by 10% and are now less excessive.

We suggest to wait for a better visibility and an adjustment in the exchange rate to reconsider a reinvest in the Japanese market. The recent yen-to-dollar correction of around 5% points to a return of an exchange rate above 115 which should be favorable for Japanese companies and the Nikkei.

Heading towards emerging markets is essential

Several months ago we recommended taking profits on positions in emerging markets, and in China and India in particular; presently, however, we believe that price consolidation over the quarter offers new investment opportunities. In China, risks of a trade war already seem to be over-rated in the short term, as Chinese companies overall generate only 9% of their revenues abroad, which at the national level is ultimately not that significant. It seems that most Chinese companies will not be heavily impacted by a potential trade war given the relatively high share of domestic sales in their overall revenues.

Emerging equities YTD



Sources: Bloomberg, BBGI Group SA

Chinese equities were not spared by the wave of profit-taking triggered at the end of January 2018. Nevertheless, we believe that Chinese corporate earnings growth will stay robust in 2018. The valuation of Chinese shares at 13x expected 2018 earnings is not excessive, and the -15% correction constitutes a new opportunity to invest.

Swiss equities benefit from a weaker franc

In 2017, equity markets benefited from a favourable economic and financial context, but at the end of the year we were already concerned by an increased risk of a price correction in 2018. At the end of January, fresh fears of inflation increases in the United States surfaced, and key rates sparked an adjustment to long rates and to equity mar-ket valuations. This was obviously not limited to assets in US dollars. The correction to Swiss equities in February has already considerably reduced valuation levels, as seen in the price/profit ratio of Swiss indices, for example. We had stated that it was very likely we would see a short-term fall in prices at the start of the year; in the end, this drop hit -10%, and has therefore pulled valuations down from 17x to 15x. As such, the SPI is now trading at around 10,000 points, after having corrected 1,000 points from its peak in January (11,000) to bring it back down to levels seen at the end of April 2017.

This correction to Swiss equities offered a purchase opportunity for investors with an eye to the long-term. We recommended taking advantage of this opportunity, also because of more positive bottom-up forecasts.

The correction in the Swiss stock market has in fact slighltly improved analysts' consensus growth forecast somewhat. From now on this potential has been restored. The average growth target for share prices is approximately +13% over twelve months.

Remember that the dividend yield had improved and was up to 3.2%.

As we had mentioned in the previous quarter, a significant though temporary consolidation of share prices was to occur at the beginning of the year, driven by external rather than domestic factors.

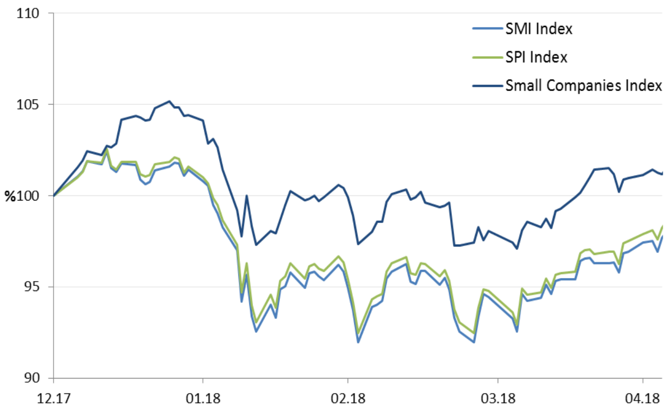
The rather generous valuation of the Swiss market offered little cushion in the event that international risks and uncertainty increased. This consolidation took place during Q1 based on external factors whose impact we expect to be only temporary.

The external factors that should have a greater impact over the next several months will likely be positive and linked to the resilience of global growth and to its positive effects on Swiss corporate earnings.

The persistent weakness of the franc will also contribute to higher profits.

Swiss equities have rapidly rebounded by almost +6% since our analysis and recommendation of repositioning. Like European stocks, the « momentum » of the Swiss market should be lower compared to US stocks. We still recommend maintaining the acquired positions, especially due to the volatility of the markets of the last weeks.

Swiss equities YTD



Sources: Bloomberg, BBGI Group SA

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