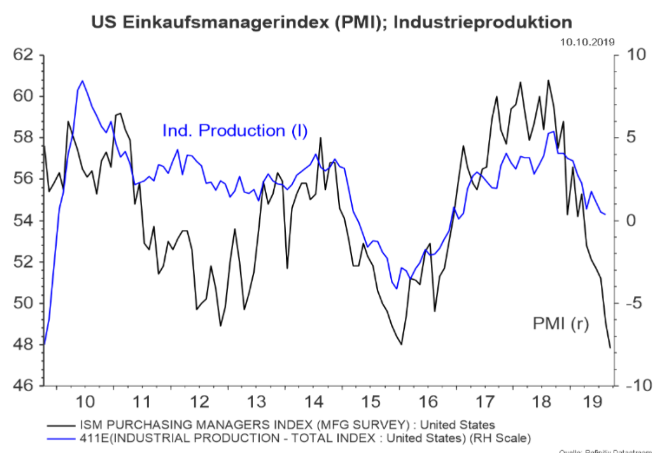
The real economy continues to weaken. Economic policy faces difficult questions

Prof. Dr. Josef Marbacher
Chief Economist

The real economy continued to weaken over the last quarter. Even in the USA, the leading economic indicator PMI (purchasing manager index) fell to a ten-year low (see graphic below). As a result, it can be expected that industrial production may mark negative growth over the next sixth to nine months. The barometer used by the Swiss Institute for Business Cycle Research of the ETH (KOF) also exhibited clear negative results, which predicts negative growth for industry. Germany is particularly affected with its above-average industrial sector. It is increasingly evident that the trade barriers imposed by the USA on the rest of the world have already caused significant losses of prosperity. If Trump were to target the European automobile industry, which is highly successful in the USA, Germany would be particularly affected, along with Switzerland as a supplier. The increasing probability of a hard Brexit, a likely chaotic scenario where Great Britain would leave the EU without an agreement, is also clouding the otherwise positive outlook of the global economy.



Time is slowly running out for Trump, the "great dealmaker". For more than two years he has been building up pressure on half the world, raising the expectation that he is close to a major breakthrough. If he is unable to show concrete results very soon, it could be difficult to get the stuttering economy back on a solid footing.

Financial investors have also grown sceptical. They have long since lost faith in the high economic growth rates promised by the US administration. They are lending their money for modest interest rates once again. The ten-year interest rate for US government bonds has truly plummeted. Within a few months, it diminished by half: from more than 3% to around 1.5%. The Federal Reserve is also alarmed. They have put interest rate normalisation on hold and lowered the short-term interest rate by a quarter percent for the second time. Over the next 9 months, we anticipate at least three more cuts. Most central banks in the world followed their example, even if their scope for interest rate cuts is significantly smaller than in the USA because they are close to zero levels or even falling into negative territory. This particularly applies for the European and Swiss central banks.

With regard to future economic development, however, we only partially share the current pessimism evident on the market. To begin with, the central banks have taken clear countermeasures, and furthermore it is our firm expectation that Trump will use all resources in his possession to try to win the election. His temperament leaves nothing to expect short of a pyrotechnical display of acts, deals and promises intended to show that America is on its way to becoming "great again". Therefore, we do not expect a global recession in the next 12 months. This does not rule out the possibility that the industrial sector, which dominates international trade, will fall into a technical recession (defined as two negative quarters).

In the view of investment policy, however, this weakening is less significant than the interest rate reversals. Although companies will experience a somewhat slower growth in profits, this is counteracted by the lower discount rates for future profits, and the latter are weighted more heavily on a percentage basis. This goes a long way toward explaining why stock prices have continued to increase since the start of the economic downturn.

This assessment of the economic and political situation also determines the decision process regarding investment policy. Although global stock prices have achieved lofty heights this year with increases of around 20%, the fundamentals and our estimates make it seem advisable to remain fully invested. We have not changed this position since February of this year when we set the overweighting of shares to neutral. However, we made a significant shift when it comes to bonds. They were increased once again from slightly overweighted to neutral. Therefore, we give more weight to the scientific findings of researchers who do not primarily attribute the extremely low interest rates to the loose monetary policy of the last decade, but instead to a series of real economic and structural factors. These include

- decreasing fertility in highly developed national economies,
- increased life expectancy,
- globalisation,
- the increasing shift from wage income to profit income
- increasing inequality in the distribution of wealth and
- growing insecurity regarding future developments.

The first empirical research has convincingly attributed the falling real interest rates over the past 40 years to these determining factors. Without a doubt, more studies are necessary to better explain this serious phenomenon.

But one thing is for certain: If the above hypotheses to explain falling real interest rates are even partially accurate, we will be facing low interest rates for a long time to come. We have also accounted for this situation appropriately in our latest asset allocation.

You can take the details of the asset allocation for the fourth quarter of the year from the following table.

Strategic and tactical Asset Allocation for the 4th Quarter 2019

	Reference Currency CHF			Reference Currency EUR		
	Investment strategy Balanced			Investment strategy Balanced		
	SA	IC	C	SA	IC	C
Investment categories						
Money market	**5**	**4**	**-1**	**5**	**6**	**-1**
Bonds	**40**	**41**	**+3**	**40**	**37**	**+3**
Home Country	24	24	+1	30	26	+1
Rest of Europe	8	8	+1	5	3	+1
USA	4	4	+1	5	7	+1
Rest of World	4	4		0	1	
Stocks and shares	**45**	**45**		**45**	**46**	
Home Country	9	8		15	14	
Rest of Europe	11	9		10	4	
USA	12	14		10	15	
Rest of World	13	14		10	13	
Alternative investments	**10**	**11**	**-2**	**10**	**11**	**-2**
Commodities	4	4	-1	5	4	-1
Various	6	7	-1	5	7	-1
Total	**100**	**100**		**100**	**100**	

SA = Strategic Asset Allocation IC= Investment Committee C = Change

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