

# Investment Outlook 2019



An extended cycle

# An extended cycle





“ The House View is an essential part of the trust we earn and the results we deliver.

# From my perspective

**Tidjane Thiam**  
CEO Credit Suisse Group AG

As I present our Investment Outlook 2019, a year that turned out to be much more eventful than we all expected is drawing to a close. Political events have had and continue to have a major impact on financial markets.

Global trade terms are being reshaped: tariffs, something we had grown accustomed to not thinking about, are back with some governments introducing tariffs and other protective measures for some of their trading partners. We have also seen new regional trade arrangements reached. In the past year, I have often discussed these important developments with clients and other stakeholders. In doing so, I have been able to rely not only on my own experience, but also on the Credit Suisse House View.

The House View plays a fundamental role in shaping the advice we give our clients and how we invest on their behalf. Our leading investment strategists analyze global political and economic trends, and distill a wide range of analysis and information from across the bank into one consistent view. In short, the House View is an essential part of the trust we earn and the results we deliver.

Innovation is another key value at Credit Suisse. Our House View also encompasses our five Supertrends: “Angry societies – Multipolar world,” “Infrastructure – Closing the gap,” “Technology at the service of humans,” “Silver economy,” and “Millennials’ values.” They provide compelling themes for long-term investors (see pages 34–37 for details). I would like to emphasize sustainable investments this year, included in one of our Supertrends, as this is an area of increasing interest for our clients today and of growing relevance for our world. We at Credit Suisse are committed to playing our part in making our collective investments sustainable, which we believe is also smart investing.

I wish you a prosperous 2019.

Tidjane Thiam

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Investment themes 2019



# An extended cycle

**Michael Strobaek** Global Chief Investment Officer  
**Nannette Hechler-Fayd'herbe** Global Head of Investment Strategy & Research

Most years have a dominant theme that shapes financial markets. In 2017 it was the Goldilocks economy – not too hot, not too cold – and the return of politics as a market driver. Trade conflicts and interest rate concerns dominated 2018. Going into 2019, we believe that a significant focus will be on the factors that can prolong the economic cycle.

Our Investment Outlook 2019 provides a roadmap to navigate the months ahead. For equities, we provide an overview of all sectors. We believe that technology will remain a strong driver. For fixed income, we examine the relatively rare phenomenon of a US yield curve inversion (when US short-term interest rates exceed long-term interest rates). And we discuss how to establish a successful currency strategy comprising carry, value and safe-haven currencies.

From the macroeconomic point of view, several factors may well prolong the economic cycle and speak against an imminent global slowdown. Productivity gains and benign inflation will be key for central banks' monetary responses and hence financial markets.

Last but not least, our special focus section is devoted to what has excited us most in the last two years: our long-term Supertrends, five investment themes that offer superior return prospects. Furthermore, we showcase education as part of our efforts in sustainable and impact investing, a market that has been seeing rapid growth as investors increasingly seek to combine financial returns with a social and environmental impact.

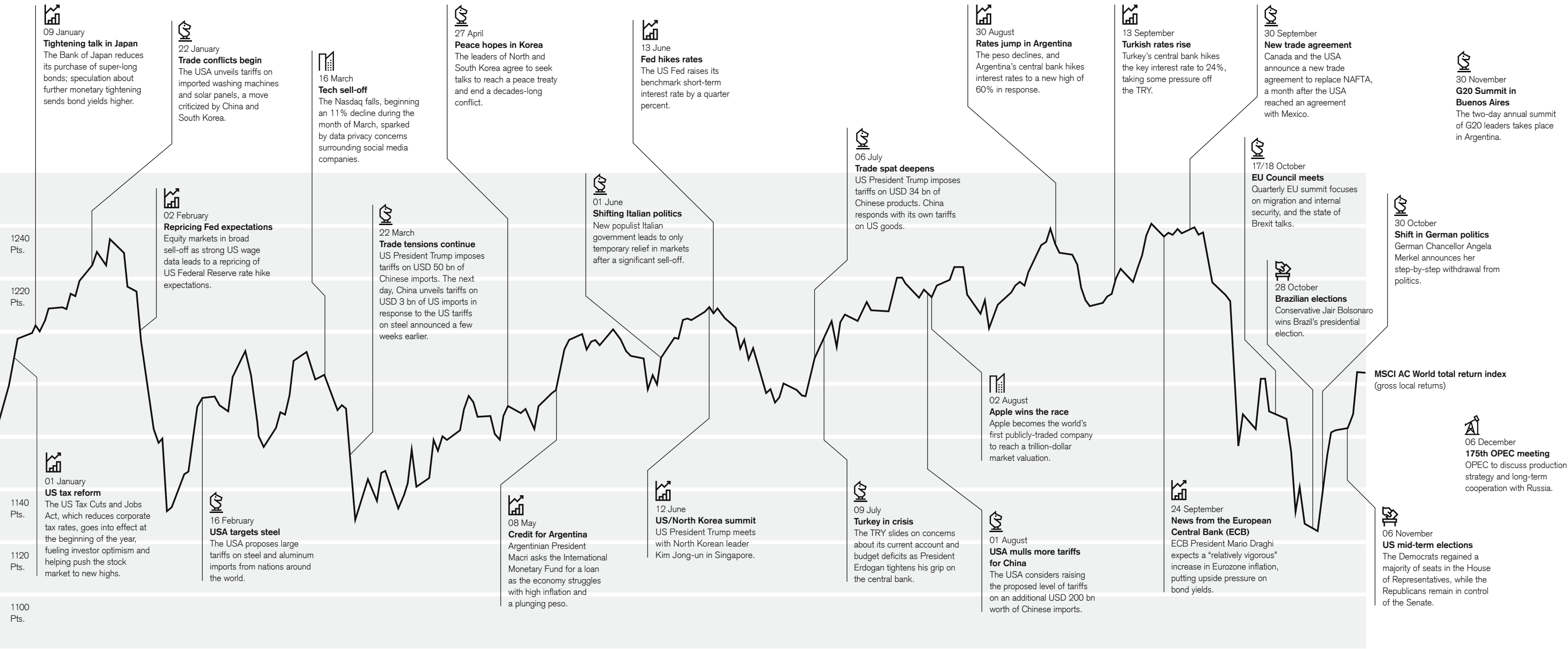
We wish you a successful year ahead.



“ A significant focus will be on the factors that can prolong the economic cycle.

# 2018: The year when trade shifted

-  political developments & global security
-  elections (presidential & parliamentary)
-  industry & corporations
-  monetary & banking system
-  energy (oil)



# Drivers likely to extend the cycle

From technology and USD stability to emerging markets rebalancing, we review six key market drivers and risks in 2019.

**Keeping inflation under control**

Growth momentum in advanced economies seems strong enough to extend the cycle into 2019 and beyond. The more important question for markets is whether inflation will remain as benign as it has been. If inflation rises significantly more than markets (and we) currently expect, the US Federal Reserve (Fed) will be seen as being behind the curve. Bond yields would further increase significantly, while equities and other risk assets would likely decline substantially. Barring an unlikely surge in productivity, wage growth will be the key driver of inflation.

**US dollar stability**

Gyrations of the USD tend to destabilize the world economy and financial markets. USD strength, as seen in H1 2018, can put severe strain on economies that require cheap dollar funding. Significant USD weakness puts pressure on export champions, such as Germany and Japan. It also raises the specter of inflation as commodity prices tend to rise sharply in response to a weak USD. The best of all worlds is a fairly stable USD. With Fed tightening well advanced, and the European Central Bank as well as the Bank of Japan gradually catching up, chances are good that the USD will indeed be stable.

**China’s resilience**

US trade policy is putting considerable strain on China. Moreover, after the USA recently renegotiated trade agreements with Mexico, Canada and South Korea, and amid de-escalating trade tensions with Europe, the US trade stance towards China could harden further. China’s patience is thus likely to be additionally tested. If its policymakers proceed cautiously, as in 2018, risks of instability should be limited and the expansion can be extended. Aggressive currency policy, credit easing or foreign policy, would be destabilizing, however.

“The best of all worlds is a fairly stable USD.”

**Calmer European politics**

Eurozone growth is expected to remain above potential in 2019, thanks in part to still loose monetary conditions. We expect political stresses to calm down to some extent. The exit of Britain from the European Union (EU), slated for 29 March 2019, should not do much harm to either side if handled wisely. In Germany, the ongoing political realignment is unlikely to cause instability, as the influence of the extreme parties remains limited. Meanwhile, we believe that Italy and the EU will ultimately find a compromise over the country’s budget deficit while reaffirming Italy’s euro membership.

**Emerging markets rebalancing**

Emerging markets (EM) entered the financial crisis with fairly healthy balance sheets. After 2008, cheap USD funds seduced EM, especially corporations, to substantially boost their foreign currency borrowing. Yet with the costs of USD liquidity rising in 2018 as a result of a more hawkish Fed, stresses emerged and some EM currencies suffered severe setbacks. At the end of 2018, there were indications that internal and external balance was being restored, in part with the support of the International Monetary Fund. If that process continues in 2019, EM can recover and global investors would benefit.

**Tech and healthcare innovations**

Technology stocks have been the dominant driver of global equity markets in the past decade. The MSCI World IT sector has outperformed the overall market by approximately 200% since March 2009. Social media, online shopping and ever more elaborate hand-held devices have taken the world by storm. An important question for investors is whether growth in this sector will remain this strong, with the emergence of new areas of focus such as virtual reality and artificial intelligence. A second key sector that is likely to influence the fate of equity markets is health-care, with investors keeping an eye on gene therapy and other innovative treatments.





# Global economy

## In short

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### **Different growth tracks**

The impact of US fiscal stimulus will likely peak in the course of 2019, but growth should remain above trend on the back of robust corporate capital expenditure, hiring and wage growth. In China, however, we are likely to see growth slow towards 6%. US tariffs, sluggish manufacturing investment and slowing consumption growth are likely to act as constraints. In Europe and Japan, still lax monetary conditions should help maintain moderate growth momentum. But in a number of emerging markets, growth looks set to remain subpar as policymakers focus on inflation and currency control.

### **Inflation on the move**

Notwithstanding higher capital spending, capacity constraints are likely to tighten further in most advanced economies. Given declining unemployment and intensifying labor shortages, wage growth should continue to pick up. Despite a moderate recovery of productivity growth, core inflation is thus likely to gradually move higher, with commodity prices an upside risk. Central banks will continue to respond in varying degrees, depending on domestic and external constraints.

### **Eye on emerging markets**

How high is the risk of renewed economic and financial instability? In many advanced economies, not least the USA, the unsustainable trajectory of government debt is the major longer-term risk. However, barring instability in Italy, a crisis seems unlikely because household and bank balance sheets have improved since 2008, while corporate balance sheets have only modestly deteriorated. In China, high debt levels should slow growth rather than spark a crisis. Stress is more likely to resurface in financially fragile emerging markets.



# Stimulus fades, but growth remains

The impact of US fiscal stimulus is likely to fade, but “easy money,” healthy capital expenditure as well as continued employment and wage growth should extend the cycle in advanced economies. Growth in China is set to slow further as policymakers opt for stability rather than strong stimulus.



“ A resolution of the trade conflicts would support business confidence, investment spending and growth.

The synchronized global expansion of 2017 gave way to a disparate growth picture in 2018. After weakness at the start of the year, US economic growth accelerated substantially on the back of cuts in corporate and personal taxes. In China, GDP growth held up better than expected despite government measures to rein in excess credit growth. As the US Federal Reserve (Fed) turned more hawkish in the spring of 2018, stresses began to appear in various emerging markets (EM), most prominently Argentina and Turkey. To protect their currencies from further depreciation, a number of EM central banks tightened policy, significantly weakening growth momentum. The weaker external demand from EM is likely one of the reasons why growth in the Eurozone moderated in the first few months of 2018.

## Fiscal stimulus reduced

Our base case for 2019 sees a moderate slowdown in global GDP growth relative to 2018, chiefly due to fading policy stimulus in the USA and policy tightening in EM ex-China (see forecast on page 31). While certain aspects of the US tax reform should continue to enhance household cash flows and remain supportive for companies, the impact of US fiscal stimulus is set to diminish. Across other advanced economies, we expect fiscal policy to be largely neutral apart from minor stimulus in Japan, and possibly the Eurozone. In contrast, many EM governments will likely be forced to tighten fiscal policy.

In most advanced economies, monetary policy remains fairly loose compared to both the pre-crisis years and much of the post-financial crisis years. It should remain accommodative in 2019 even with further normalization, despite a number of rate hikes. US monetary policy is still not particularly tight (see chart on page 18). Yet in 2019, it should gradually dampen US growth even if its impact may once again be greater in EM given the key role USD liquidity plays for many of these markets.

Companies keep investing

Barring a significant worsening of the global trade conflicts – or other triggers of greater uncertainty – we expect corporate capital expenditure (capex) to continue to expand in 2019. The need to adapt supply chains in response to tariffs may itself trigger some investment spending. Corporate investment is key to extending the cycle as government stimulus fades.

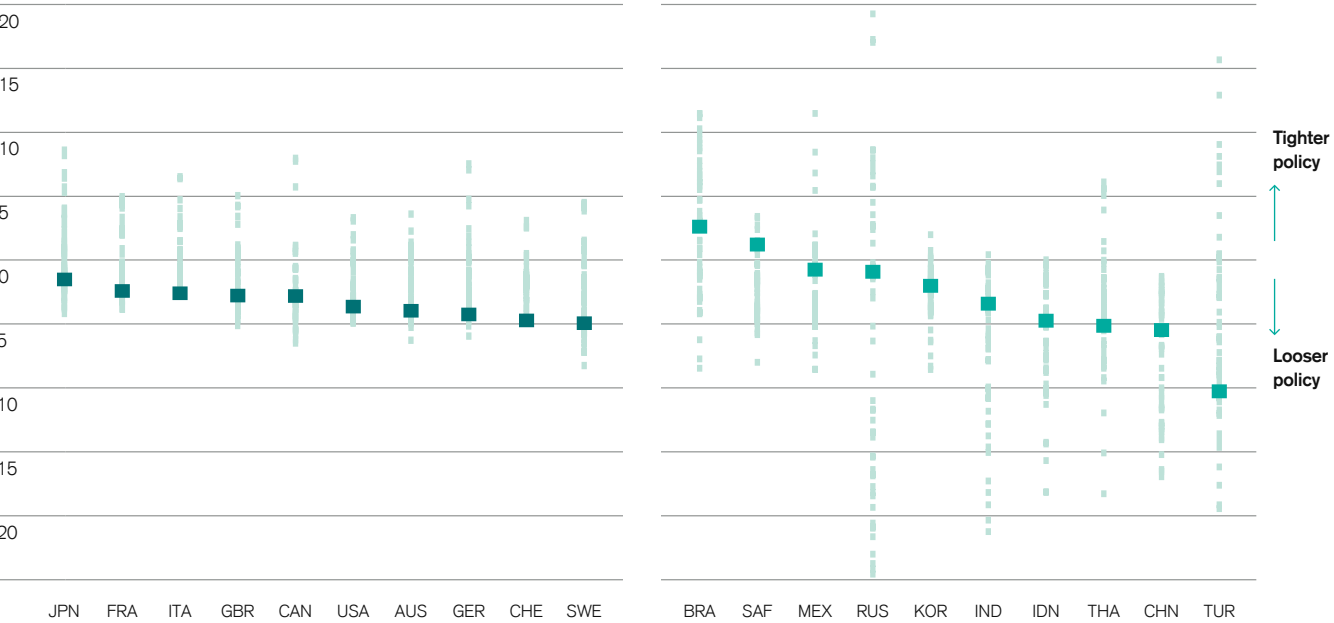
In late 2018, business optimism remained strong, especially in the USA, while capacity constraints were still tightening and funding conditions remained benign. Many companies are likely to further expand their market share in 2019, be it via capex or mergers and acquisitions. Growth companies generally have healthy balance sheets and strong cash positions. Moreover, high energy prices are likely to be supportive as well given the continued importance of energy-related capex.

“ Consumer spending should remain robust in most advanced economies.

Finally, claims that companies that buy back stocks have less funds for capex do not hold up to closer scrutiny – at least not in the USA. In fact, a bottom-up study of the S&P 500 universe by Credit Suisse analysts demonstrates that the two activities, which both reflect balance sheet strength, correlate positively. Given high and still rising employment rates and accelerating wage growth, consumer spending should also remain robust in most advanced economies.

Monetary policy still loose in advanced economies

Central bank rates minus nominal GDP growth (in % points\*)



\*Each point shows a quarterly value between Q1 2005 and Q2 2018  
Last data point Q2 2018  
Source Federal Reserve Bank of St. Louis, Thomson Reuters Datastream, Credit Suisse

China in a holding pattern

China's strong foreign asset position and low inflation give its policymakers more leeway in their actions than in many EM. At the same time, given the high debt levels of state-owned companies and local governments, Chinese policymakers are likely to refrain from returning to aggressive credit stimulus. Instead, they are likely to do just enough to prevent US tariffs from significantly depressing growth. They are also unlikely to opt for significant RMB depreciation. Meanwhile, the contribution of household spending to growth will be constrained because mortgage debt and debt service (almost 30% of household income, according to our estimates) have increased substantially on the back of rising real estate prices. Although China's growth rates remain far above the global average, its contribution to global growth will probably flatten or even decline after the 2017 recovery (see chart below).

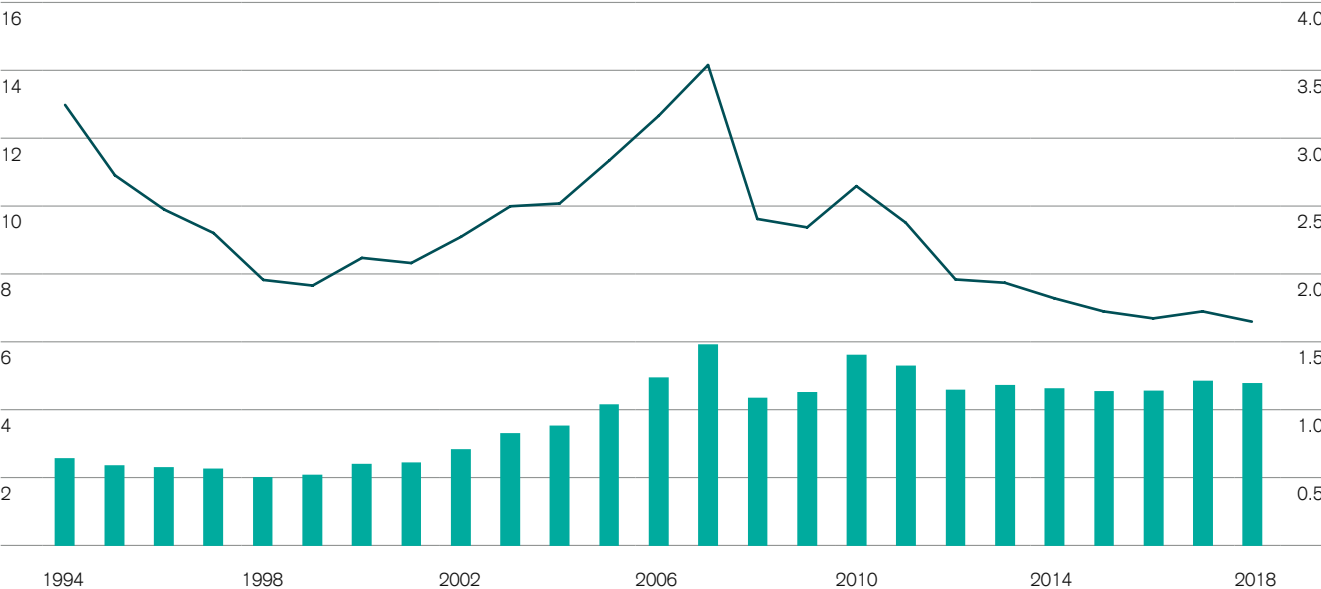
Our outlook for growth in other EM remains more cautious, though there are significant differences across countries. In countries with vulnerable external balances, the setbacks of 2018 are likely to extend into 2019 as policy continues to focus on currency stabilization. Political uncertainties will add to downside risks in a number of countries. Meanwhile, in countries such as Russia, higher commodity export revenues should offset pressure from tighter USD liquidity.

Upside and downside risks

Of course, there are both downside and upside risks to our base case. On the downside, country-specific issues such as Italy's fiscal situation might weaken Europe's growth outlook. A sharper-than-expected slowdown in China would most affect other Asian economies, but would also impact Europe. Significant setbacks in financial markets (e.g. triggered by an unexpected rise in inflation and subsequent fears of faster monetary policy tightening in the USA) could hurt confidence. However, a resolution of the trade conflicts would support business confidence, investment spending and growth. It would also provide new impulses for an extension of the expansion.

China's high growth contribution likely to diminish

Real GDP growth of China (in %) and contribution of China to global GDP growth (in % points, using purchasing power parity measures)



Last data point 2017  
2018 Credit Suisse estimate  
Source World Bank, Credit Suisse

— Real GDP growth of China  
China's contribution to world GDP growth (right-hand scale)

# Spotlight

## What makes the business cycle go round

Long-term growth trends and business cycle fluctuations have a significant impact on financial markets. This Investment Outlook focuses mostly on the latter.

### Shocks drive manufacturing cycles

Business cycles are driven by fluctuations (shocks) in aggregate demand or aggregate supply. The most common supply shocks result from sudden changes in the cost of widely used raw materials, especially oil. Aggregate demand shocks result from shifts in monetary or fiscal policy, which stimulate or restrain private spending. Excesses or shortages of manufacturing inventories also trigger business cycle fluctuations by affecting the momentum of industrial production (IP). Our economists note that global IP typically slumps every 3–4 years, a pattern visible in US and UK data since the 19th century. While such slumps corresponded with overall recessions up to the early 1980s, this is no longer the case, probably because the weight of manufacturing employment in the economy has declined and countercyclical monetary policy has become more effective. Given that 2015 was the most recent slump year, our risk scenario is for the next phase of global IP weakness to occur in late 2019 or 2020.

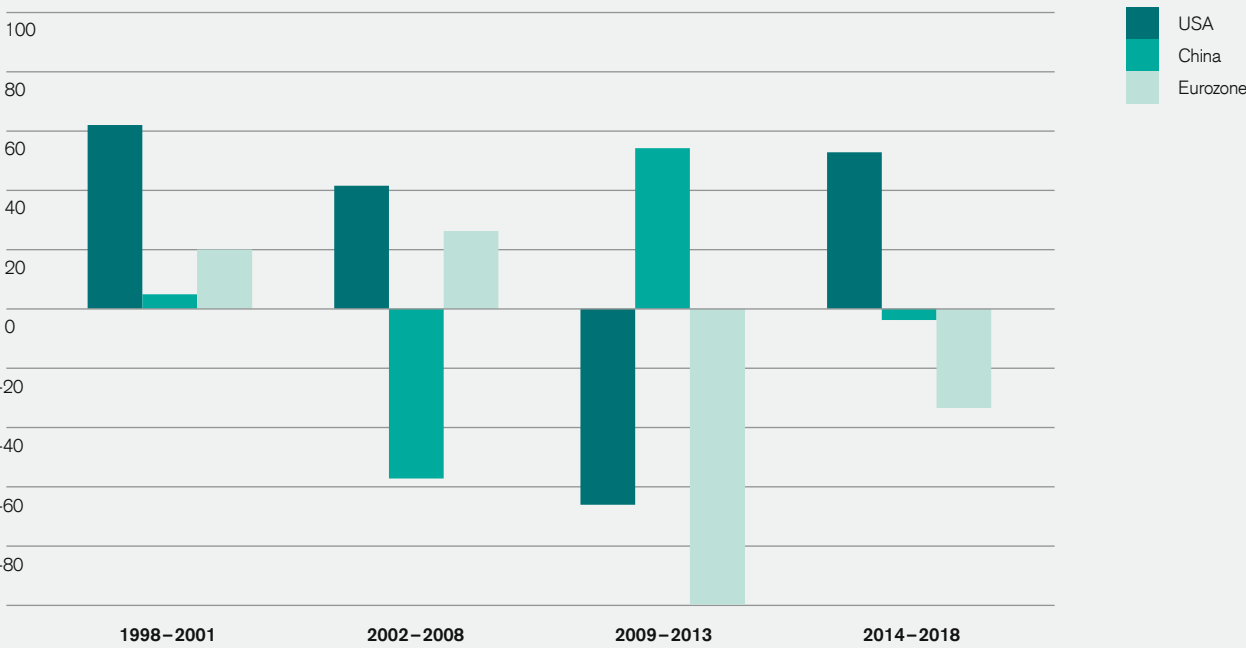
### USA in driver’s seat

Although the US economy is relatively closed in terms of international trade, it is a key driver of the global business cycle. This is likely because US policymakers are more focused on stabilizing employment and domestic consumption than other countries, and because their decisions have a stronger impact on the global economy via financial markets. In all but one period (the aftermath of the financial crisis), the USA has been a positive driver of the global business cycle (see chart on page 21). The Eurozone’s impact has been much weaker, except in the pre-2008 boom. Since then, the region has been a major drag on the global business cycle. China only provided a cyclical boost in the years after 2008. Looking ahead, a key risk is that the positive impact of US demand fades and there is nobody to take over the baton.

“ A key risk is that the positive impact of US demand fades and there is nobody to take over the baton.

### The USA has been the dominant stimulator of global aggregate demand

Changes in net spending in USD bn (annual averages for sub-periods)



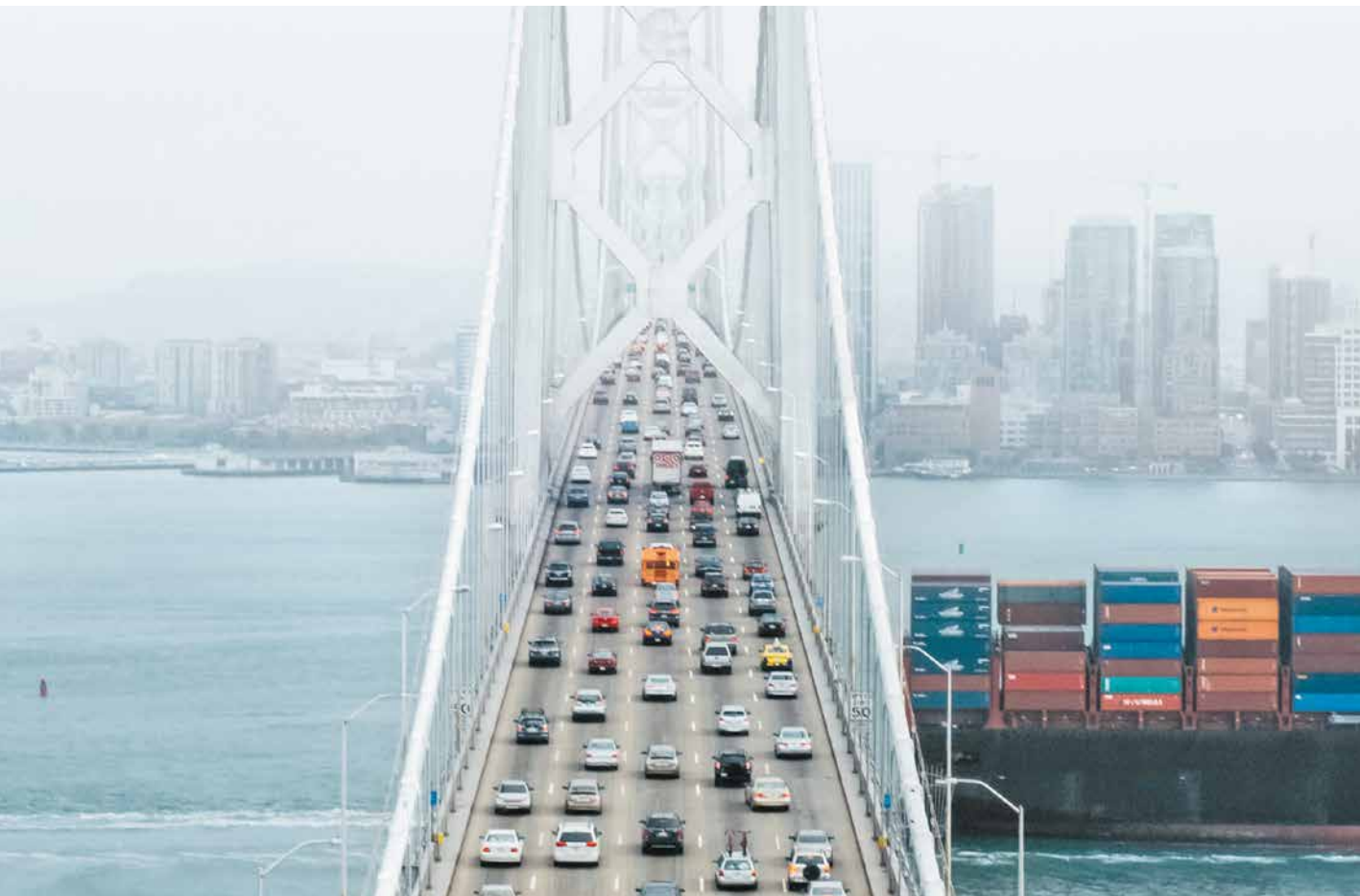
Last data point 2017  
2018 International Monetary Fund estimate  
Source International Monetary Fund,  
Credit Suisse

Note National income accounting shows that changes in the current account balance of a country correspond to the sum of changes in spending by households, companies and the government of that country. An increase in spending (reduced saving) increases the current account deficit, and vice versa. This chart shows the change in current accounts (with positive numbers indicating a worsening current account balance) and can thus be seen as an approximation of the demand impulse that a country provides to the rest of the world.



# World follows US Fed's tightening path

Our base case foresees a gradual rise of inflation in advanced economies and fairly stable inflation in emerging markets, albeit with significant dispersion. We expect monetary policy to continue to tighten globally, but at a moderate pace.



The evolution of inflation in the major economies, especially the USA and the Eurozone, will be a key driver of financial markets in 2019. Upside inflation surprises pose a greater risk to bond and equity markets than limited disappointments in economic growth. January 2018 was a case in point, as a minor upward surprise in US wage inflation triggered the year's largest correction in equities.

**More money in workers' pockets**

According to our base case, core inflation will rise modestly in the USA, Eurozone and several other developed economies in 2019 as capacity constraints tighten. By late 2019, unemployment rates in the USA and Europe will likely approach 20-year lows. Labor markets are tight in Germany, the UK, Switzerland, Canada and Australia. Even Japanese wages are now rising after declining for most of the past two decades. That said, the absolute rate of wage gains is still well below pre-crisis highs, including in the USA. Yet barring an unforeseen economic shock, we believe labor markets should continue to tighten, pushing wages up further. Academic literature has suggested that wage gains have been more subdued since the financial crisis due to the increased buying power of large corporations, especially

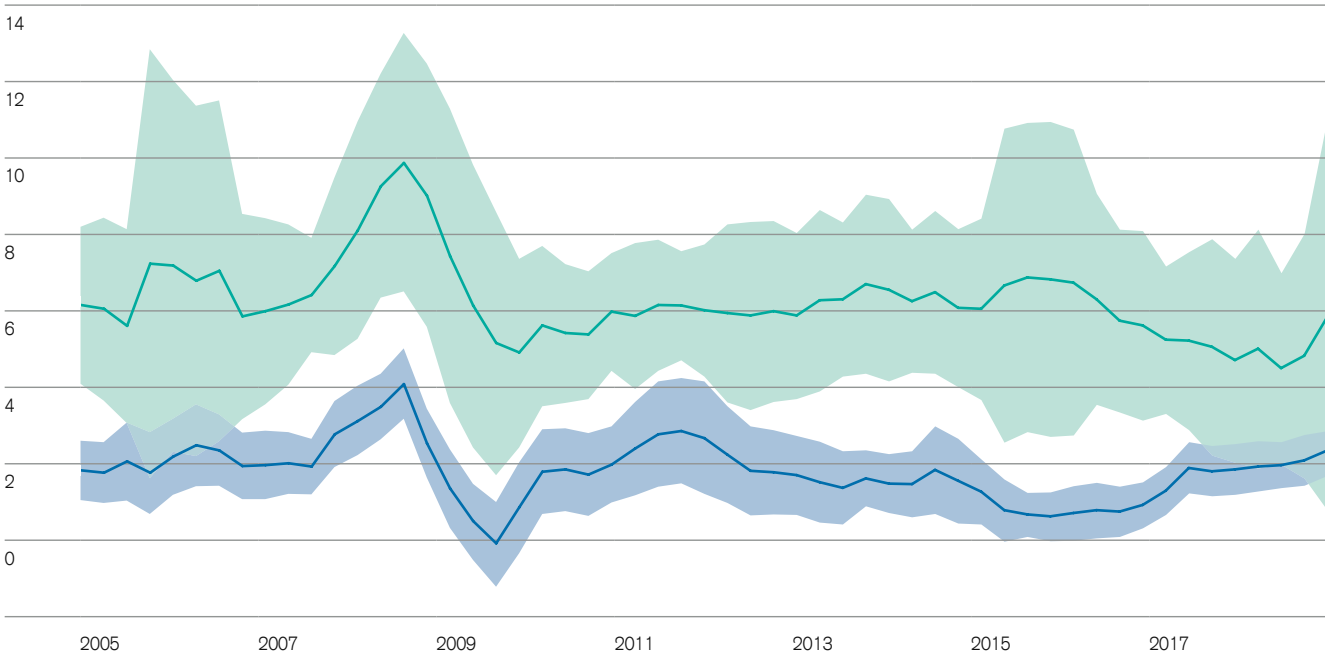
in the services sector. However, labor shortages in these areas seem to have increased quite significantly as well, and company-level evidence suggests that wage gains are accelerating.

**Beware the inflation jokers**

Wage inflation does not translate directly into price inflation. Other costs, including interest expenses and input costs (especially for raw materials such as oil) are key drivers of headline inflation. The significant increases in oil prices in 2007 and 2008 as well as in 2011 were the main reason why headline inflation rose at the time. If our global growth scenario holds, the price of oil and other cyclical commodities could rise further in 2019. Interest costs are also likely to creep up. Given strong final demand growth, the share of costs absorbed by corporate profits is unlikely to rise, as such increases typically occur when demand is weak. While we expect labor productivity measures in the USA and other developed markets to move higher, we do not believe this will markedly dampen inflation. In summary, with average inflation in advanced economies already close to the previous mid-cycle period (2004/05) levels, a further increase in inflation seems likely (see forecast on page 31).

**Inflation in developed markets is back at pre-crisis levels**

Consumer price inflation for ten major developed markets\* and eight major emerging markets\*\* (quarterly data %); line shows average, shadows show +/- one standard deviation.



**Last data point** Q3 2018  
**Source** Thomson Reuters Datastream, Credit Suisse

\* Developed markets:  
Australia, Canada, France, Germany, Italy, Japan, Sweden, Switzerland, UK, USA  
\*\* Emerging markets:  
Brazil, China, India, Indonesia, Mexico, Russia, South Africa, Turkey

— Developed markets  
— Emerging markets

Emerging markets take a different path

In emerging markets (EM) inflation may take a different path than in advanced economies. After 2011, inflation in EM diverged from the advanced economies as growth remained robust in the former and weakened in the latter following the Eurozone crisis. Inflation in EM then declined on the heels of lower oil prices and weakening growth in China. Looking ahead, headline inflation in EM may rise to some extent due to higher energy prices and the broad weakening of EM currencies in 2018. Yet we believe it is likely that monetary authorities in most EM countries will focus on steadying currencies, helping inflation stabilize in the course of 2019.

Interest rates to rise

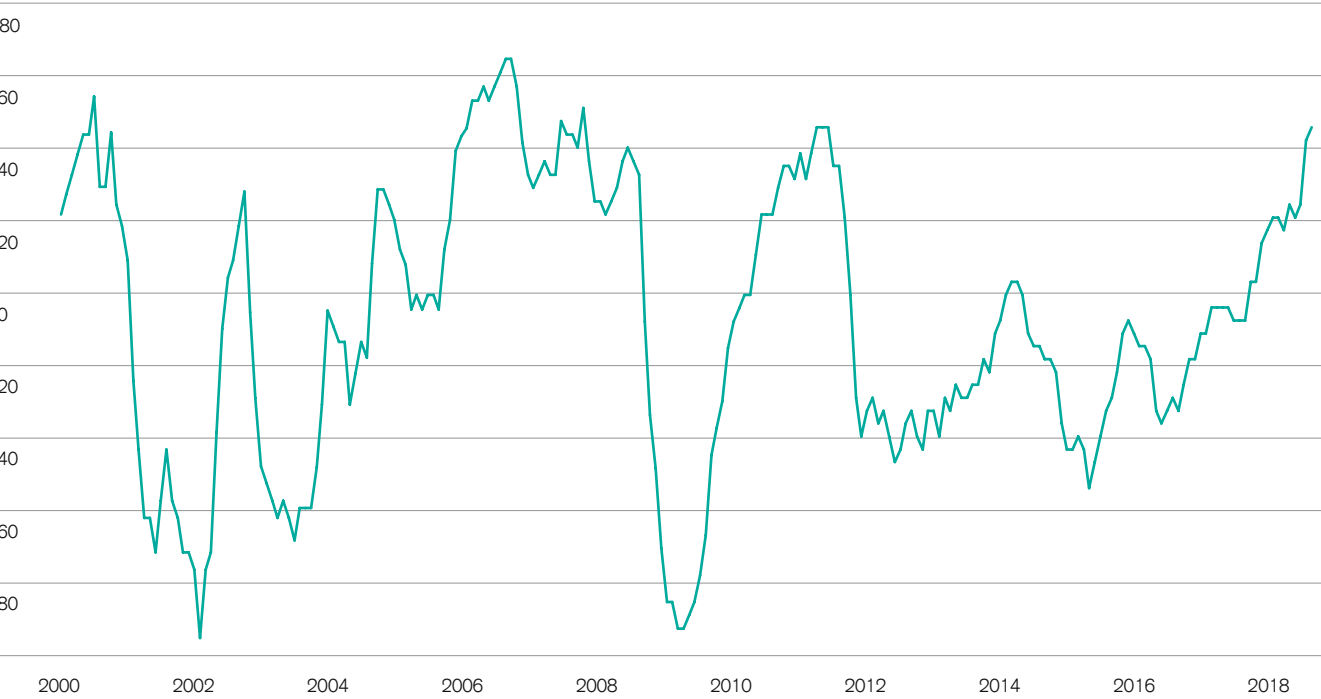
The base case of continued economic growth and moderately rising inflation suggests that monetary policy will tighten in most advanced and some emerging economies in 2019. At the time of writing, the futures market implied that the Fed funds rate would end up below 3% by the end of 2019. This would imply one to two further rate hikes in 2019, after a likely hike in December 2018, taking the real Fed funds rate to about 1%, broadly in line with our forecast.

At its September 2018 meeting, the Fed's Federal Open Market Committee removed the reference to its policy being "accommodative." While the Fed's new chairman, Jerome Powell, has eschewed precise estimates of "neutral" interest rates, consensus estimates of neutral are typically near 3%. Hence many market participants will probably consider US policy close to tight by the end of 2019. The European Central Bank (ECB), however, is set to end net asset purchases at the end of 2018 and unlikely to hike rates before H2 2019. Thus, its policy will remain accommodative.

In 2018, EM central banks have had to contend with tighter Fed policy and an appreciating USD. The risk case for them is that the USD experiences a further marked appreciation while global growth weakens. That would make things very difficult for policymakers. Even in the more benign case of solid global growth and no broad USD uptrend, EM central bank rates will tend to rise rather than fall given rising rates in advanced economies. However, we still expect most central bank rates globally to end 2019 well below the peaks of the previous cycle. This is consistent with the fact that this cycle is not driven by a significant credit boom, featuring extensive economic overheating.

Significant central bank tightening since early 2018

Number of central bank interest rate increases vs. cuts globally in prior six months (net percentage)



Last data point October 2018  
Source Thomson Reuters Datastream, Credit Suisse

# Spotlight

## Proclaiming the demise of globalization may be premature

The intensifying trade conflicts of 2018 have raised the specter of a reversal of the post-World War II globalization trend. We think this fear is exaggerated as most companies and countries continue to have a strong interest in maintaining (more or less) open markets. Moreover, we believe the US tariffs introduced in 2018 have so far been too limited to have a large effect.

That being said, our simple measure of globalization (global exports as a percentage of global GDP) has stalled since the 2008 financial crisis but for largely cyclical reasons: trade growth typically falls during

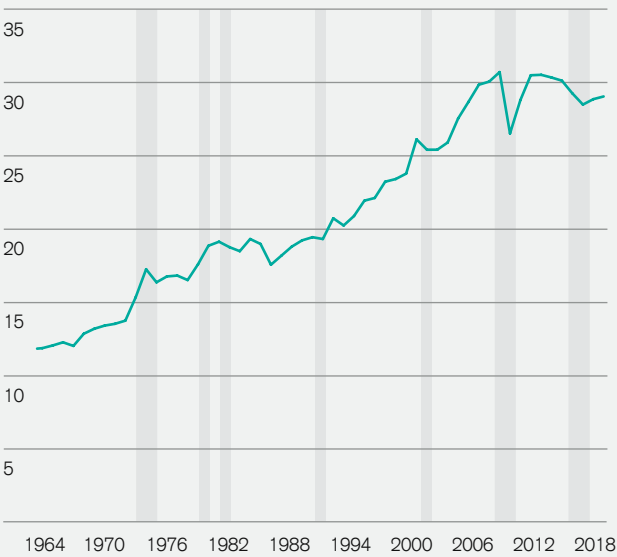
recessions, seemingly halting the globalization trend. Moreover, big declines in commodity demand and prices have the same impact. The effect is amplified as lower commodity prices reduce demand for mining-related capital goods. Finally, trade also tends to slow in periods of USD weakness, mainly because US import demand suffers; past instances of the USA imposing tariffs (President Nixon in 1971, President Bush in 2002) coincided with periods of weak growth or a weak USD.

Globalization unlikely to return to steep uptrend

In line with this analysis, our globalization measure has begun to recover with better post-2016 growth in China, as well as the 2018 recovery in oil prices and the USD. However, we believe it is unlikely that the measure will revert to its steep upward trend anytime soon. First, growth in China and other emerging markets that are strongly exposed to trade may be slower for longer. Moreover, the non-tariff barriers many countries introduced after the financial crisis may have lasting negative effects on trade. Third, the growing web of bilateral trade treaties may have simply diverted, rather than boosted, trade. Finally, the globalization of supply chains may have at least temporarily stalled as wage costs rose faster in some EM to which production had been outsourced. As trade barriers increase, the incentive to move production to the countries imposing barriers may further fuel that trend.

Slowing trade penetration largely cyclical

Total global exports in % of global GDP



Last data point 2017  
2018 Credit Suisse estimate, Netherlands Bureau for Economic Policy Analysis estimate  
Source World Bank, Credit Suisse

US recessions and China slowdown (2015/16)



# The global economy's stress test

Economic downturns or financial crises typically occur when an economy exhibits significant imbalances. Compared to 2007, household imbalances are markedly lower in the USA but fiscal imbalances are greater. In the Eurozone, both the external and fiscal balances have improved. In emerging markets (EM), the picture is mixed.



“Corporates have significantly lengthened the maturity of their borrowing so that the pass-through from rising interest rates to interest costs will be much slower than in past cycles.

Our base case for the global economy is moderately optimistic despite some risks, as we described earlier. Nevertheless, key countries do have potential vulnerabilities compared with previous pre-recession or pre-crisis years.

**US households in better shape**

The chart (see page 28) presents a spider web for a relatively broad range of US economic and financial indicators that allow for a differentiated risk assessment. Comparing the current period with past pre-recession situations yields the following results:

- The US labor market, as measured by the unemployment gap, looks slightly tighter than in 2007. Yet inflation pressures are lower, suggesting less need for outright tight monetary policy. This distinction is important because phases of overtightening have tended to act as catalysts for later recessions (e.g. in 1991).
- US households are in much better shape than in 2007. While higher interest rates will gradually boost debt service payments, the risk to the economy appears limited. This is also due to less stretched real estate valuations, which suggests that the housing market is far less likely to trigger a downturn.
- Corporate balance sheets are more exposed, however. So long as interest rates are fairly low and growth is robust, it should be unproblematic for corporates to find funding. A sharper hike in rates and/or an economic slowdown would be more worrisome, however. But bond spreads appear to already discount higher corporate risks. Moreover, corporates have significantly lengthened the maturity of their borrowing so that the pass-through from rising interest rates to interest costs will be much slower than in past cycles.



- The external imbalance (i.e. current account relative to GDP) is more benign than in past pre-recession periods. But it has been worsening since 2013 and is projected to further deteriorate.
- The fiscal imbalance is higher than in past pre-recession periods. Prior to the 2001 recession, the federal budget reached a surplus of more than 2.5% of GDP; in mid-2007 the deficit was just above 1% of GDP. Despite nearly 10 years of expansion, the deficit is currently at about 4% of GDP and likely to deteriorate further due to the 2018 tax cuts.
- Public sector debt has been rising and is above 100% of GDP (large unfunded public sector liabilities are not included here).

At current moderate interest rate levels, financing the debt is fairly unproblematic. A significant rise in rates would make matters worse, however, and could push interest costs as a share of GDP up sharply. An outright default of the US government is nevertheless very improbable given the Fed's potential role as lender of last resort. But in an economy operating at full capacity, easier Fed policy could increase inflation risks. Conversely, while tax increases or spending cuts might help fiscal dynamics, they would create headwinds to growth. Still, our view is that fiscal profligacy is unlikely to be a major issue for financial markets in 2019.

Eurozone juggles high debt, low growth

In the Eurozone, the key vulnerabilities – i.e. the fiscal balance and member countries' external balance – have improved substantially compared to 2007 (see chart below). The key issue for the Eurozone is high government debt, especially in Italy, coupled with low economic growth. Moreover, given that the ECB is winding down its asset purchases (i.e. quantitative easing), pressures on public sector debt may increase. Considering the huge size of Italian debt (approximately EUR 2.3 trillion, or 130% of GDP), any sign that the government is indeed moving away from fiscal discipline could have highly destabilizing effects beyond Italy, not least because the Italian banking sector remains quite exposed to government debt.

While the fundamental risk of instability has diminished in the Eurozone, the picture for the UK is less clear. Similar to the USA, the UK also continues to exhibit a twin deficit. In its case, the external balance is more prominent than the fiscal deficit. It seems unlikely that this situation will evolve into a financial crisis given the Bank of England's credibility, but in case of continued uncertainty over relations with the EU, questions regarding the funding of the external imbalance may arise.

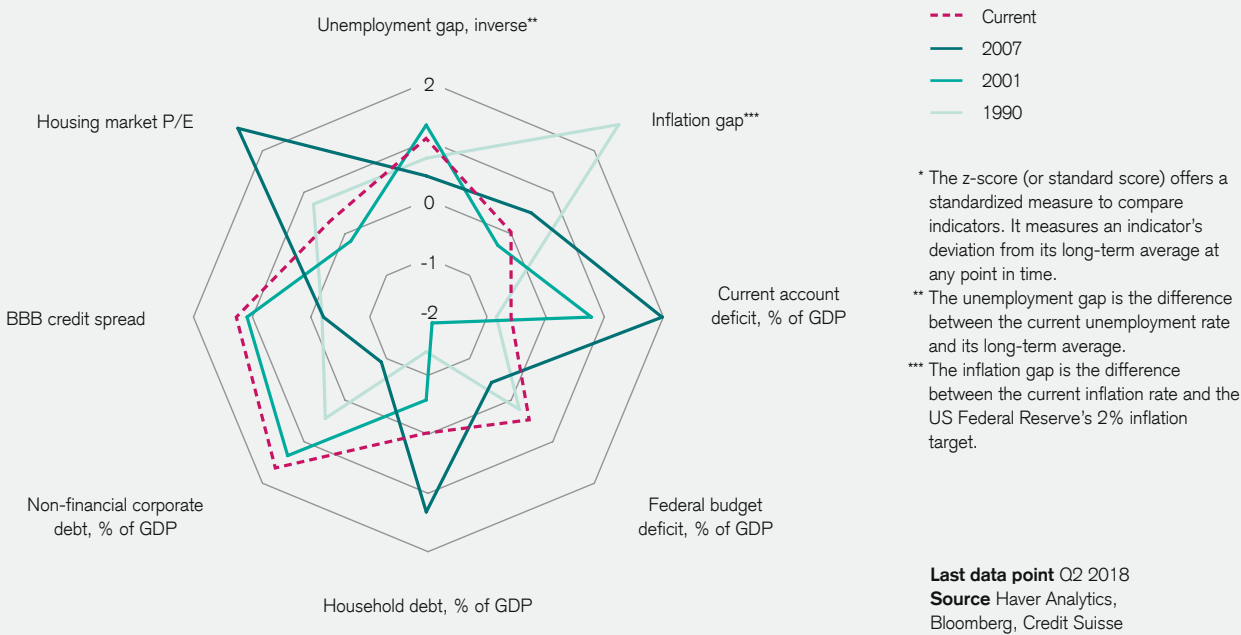
“ Similar to the USA, the UK also continues to exhibit a twin deficit.

Emerging markets: The strong outnumber the fragile

The fragilities in EM as a group are fairly limited, in our view. However, the reliance on foreign savings was significant in selected countries, notably Argentina, Turkey and South Africa, and should have been seen as a warning sign. Yet the external imbalances are less serious in other key countries such as Brazil, Mexico or Indonesia. Compared to the 1990s, the situation has in fact improved dramatically. Countries that witnessed a major crisis at that time, notably Thailand and Malaysia, have significantly improved their current accounts. But fiscal discipline has deteriorated to some extent in most countries.

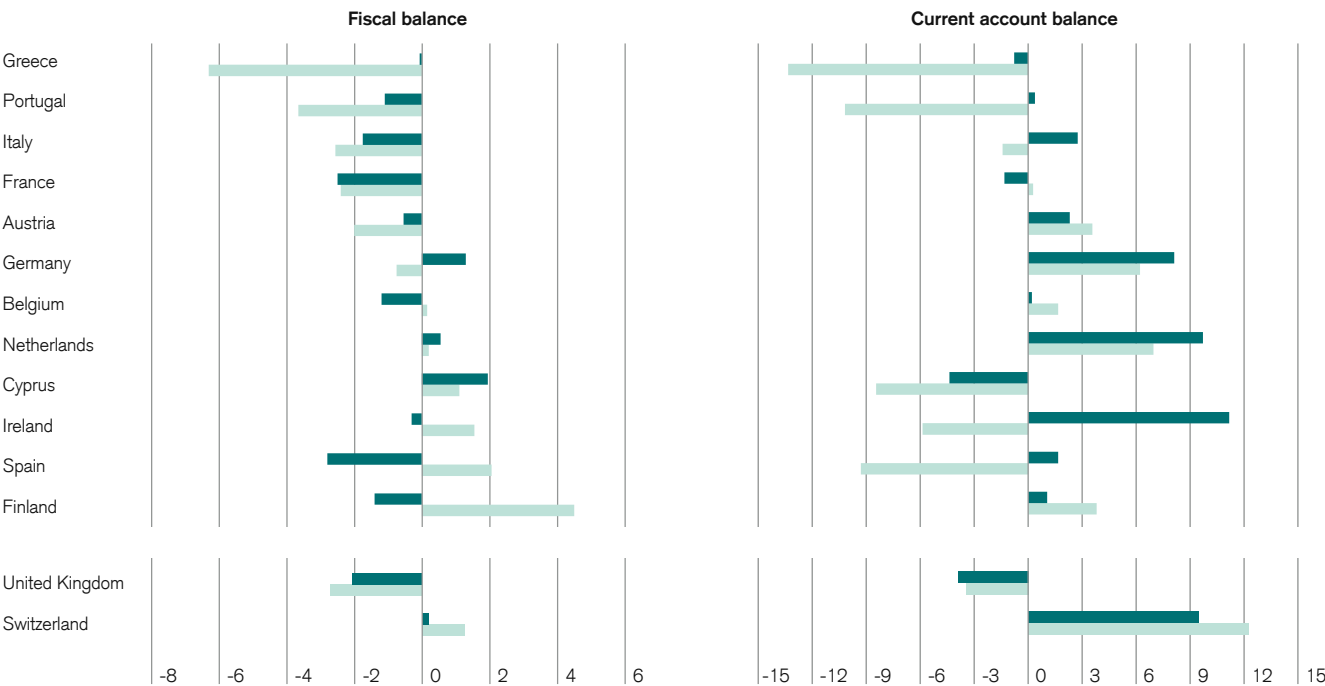
US vulnerabilities mostly lower than in 2007

Selected measures of economic and financial vulnerability prior to past recessions and today (z-scores\*)



Twin deficits have improved in almost all Eurozone countries

Fiscal and current account balances (in % of GDP)



Last data point 2017  
2018 International Monetary Fund estimate  
Source International Monetary Fund, Credit Suisse

China curbs appetite for debt

China is in a special fiscal situation: central government debt is not very high, but debt of state-owned enterprises and local governments has increased sharply since the financial crisis. Household sector debt is also elevated compared to household incomes. As most of China's debt is denominated in domestic currency and debts of strategic sectors are backed by the central government, we see the risk of a financial crisis as quite limited. Moreover, efforts to reduce that debt have been underway for some time. China is also attempting to curb lending outside of its banking system. In general, changing financial policy and concerns about over-indebtedness are acting as a brake on Chinese growth, a pattern that is set to continue. The trade dispute with the USA or other potential shocks pose a dilemma for China's policymakers, as they may need to provide renewed stimulus to prevent a sharper growth slowdown. But a crisis seems unlikely.

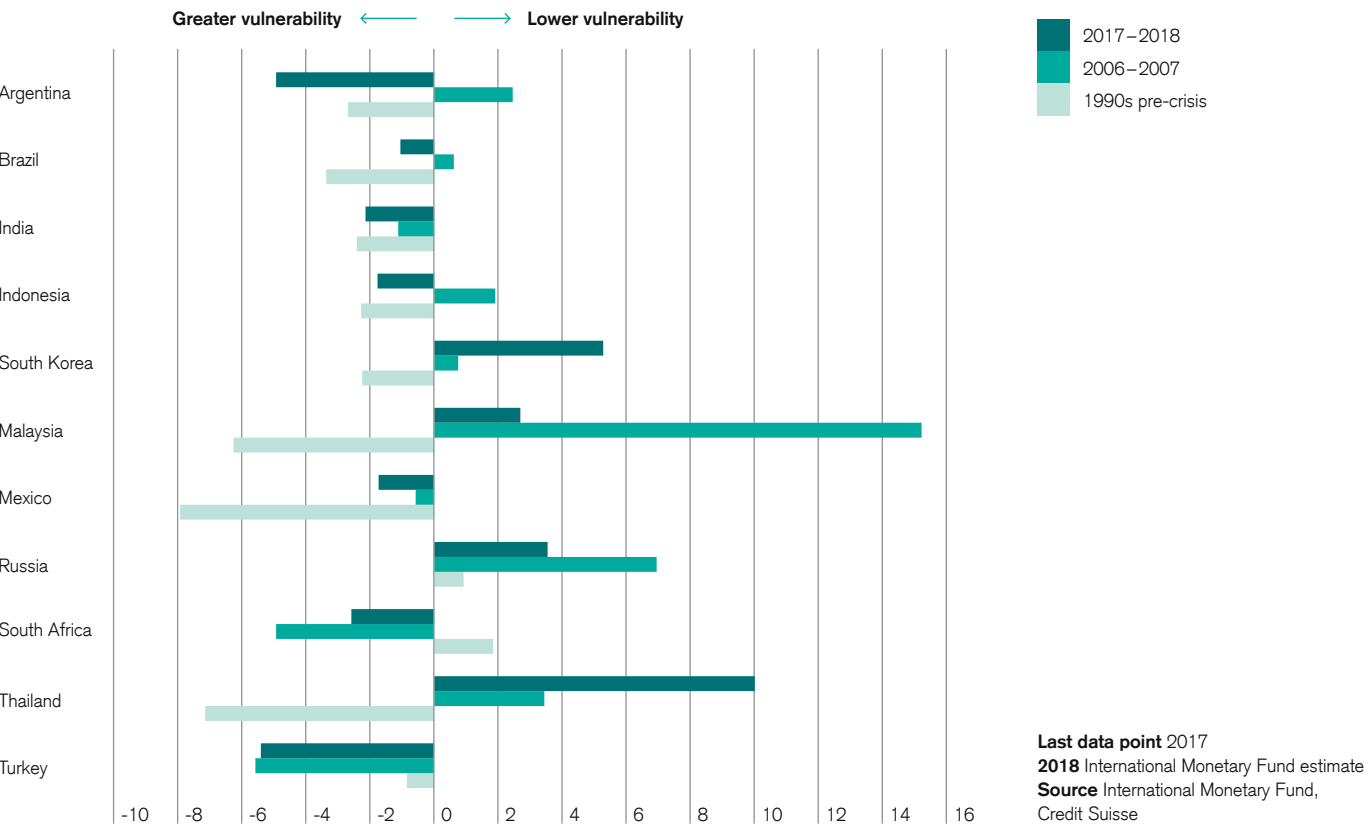
Crisis risks are still rare

In conclusion, we believe that the potential for financial instability is lower in most countries and sectors than before the 2008 financial crisis. The exceptions are select EM where the corporate sector is more vulnerable due to fairly high levels of foreign currency debt. In the case of China and the USA, where corporate debt is also high, the exposure is largely in domestic currency and thus less risky. In the Eurozone, we note a significant improvement in the financial stability metrics, but continued political risks. Similarly, the trade conflicts are essentially political, and our base case is that the key actors will not commit serious judgement errors that would trigger significant turbulence. Finally, we flag the rise of US public sector debt as a key long-term issue. The risk is not a debt default but a decline in growth once the fiscal stimulus runs out. This could exacerbate political tensions over how to rein in debt. One option, albeit not likely, would be more deliberate pressure on the Fed to inflate away the debt, with potentially serious consequences for the stability of the Treasury market and the USD.

“ The trade dispute with the USA or other potential shocks pose a dilemma for China’s policymakers, as they may need to provide renewed stimulus to prevent a sharper growth slowdown. But a crisis seems unlikely.

Lower financial vulnerability of emerging markets than in 1990s

Current account balance (as a % of GDP)



Forecasts for growth and inflation

Real GDP (y/y %)	Inflation (annual avg. y/y %)		
	2017	2018E*	2019F**
Global	3.3	3.3	3.0
USA	2.2	2.9	2.7
Canada	3.0	2.3	2.1
Eurozone	2.5	2.0	1.8
Germany	2.5	1.8	2.0
Italy	1.6	1.0	0.9
France	2.3	1.6	1.6
United Kingdom	1.7	1.2	1.5
Switzerland	1.6	2.7	1.7
Japan	1.7	1.3	1.0
Australia	2.2	3.2	2.8
China	6.9	6.6	6.2
India (fiscal year)	6.7	7.4	7.2
Brazil	1.0	1.8	2.3
Russia	1.5	1.6	1.4

Last data point 08 November 2018  
Source Thomson Reuters Datastream, Haver Analytics, Credit Suisse

Note: Historical and/or projected performance indications and financial market scenarios are not reliable indicators of current or future performance.

\* E: estimate  
\*\* F: forecast

# Regions in focus

The ties that bind: Regional performance in an interconnected world

## North America

One of the major risks to the region has subsided after the USA, Mexico and Canada agreed upon NAFTA treaty revisions. US growth should remain above trend in 2019 despite fading fiscal impulses and inflation should rise moderately. The US Federal Reserve is thus likely to continue to raise rates at a steady pace. Canada and Mexico should benefit from strong US growth. In the long term, the large US budget deficit could pose a risk if its trajectory becomes unsustainable.

## South America

The region's two largest economies – Brazil and Argentina – are likely to remain weak in 2019, but hopefully the latter should begin to tackle some of its deep-seated economic and fiscal weaknesses now that it is under an International Monetary Fund (IMF) program. With the pre-election deadlock over, chances are improving that Brazil may address some of its similar issues. In Colombia, Chile and Peru, the economic outlook continues to brighten, and they should benefit from higher commodity prices.

## Eurozone

With monetary policy still supportive and employment rising, domestic demand should continue to expand. Strong US growth and stabilization in China as well as emerging markets (EM) should support exports. With the European Central Bank only likely to begin raising rates in H2 2019, EUR appreciation should be moderate at best. Tail risks include a hard Brexit and a debt crisis in Italy.

## Africa

Growth in South Africa is likely to pick up slightly in 2019 on the back of higher commodity prices, but persistent failure to implement reforms may continue to hamper the country's performance. The same goes for the continent's largest economy – Nigeria. Meanwhile, reforms implemented under the 2016 IMF program continue to bear fruit in Egypt, with strong growth and declining inflation projected for 2019.

## United Kingdom

We foresee somewhat stronger but still subdued growth. Uncertainty over the outcome of the Brexit process is likely to limit investment spending so long as the outlook for supply chains, e.g. in auto production and the financial industry, are not clarified. A soft Brexit would support the GBP. The Bank of England is likely to remain on hold.

## Eastern Europe and Russia

Growth in Russia is likely to remain subdued even though higher energy prices support exports. Currency and bond risks are limited due to a strong external balance and credible economic policy. Meanwhile, growth in Central and Eastern Europe is likely to remain strong due to close economic ties with Western Europe.

## China

China's growth is likely to weaken somewhat in 2019. High real estate-related debt and debt service are likely to constrain consumer spending while the growth of investment spending is likely to remain subdued. The government will probably do just enough in terms of credit stimulus and RMB depreciation to protect the economy from the impact of US tariffs.

## Japan

Japan is likely to enjoy robust growth in 2019, as corporate investment continues to expand. Rising wages should support consumer spending, but the sales tax hike planned for late 2019 poses downside risks. Exports may be negatively affected by slower growth in China. The Bank of Japan may nudge its bond yield target up slightly, but is likely to continue to tread softly.

## Middle East

The currency crisis of 2018 sharply raised inflation and undermined business confidence in Turkey. However, a recovery should begin in the course of 2019 in response to stabilization measures. Higher prices support Middle Eastern oil exporters, but Iran is in economic crisis, in part because of renewed sanctions. Growth in Israel is likely to remain strong.

## Switzerland

The Swiss economy should benefit from continued healthy growth among its main trading partners. With the Swiss National Bank likely to remain on hold until the ECB starts to raise rates, CHF strength should abate. Meanwhile, domestic demand growth is likely to subside as immigration stabilizes at a lower level, while increasing overcapacity in rental units slows construction.

## India

While India is likely to remain the world's fastest growing large economy in 2019, the tightening of global financial conditions in 2018 does pose downside risks. With the current account deficit widening, in part due to higher oil prices, along with the INR's depreciation against the USD since January 2018, the central bank may need to tighten monetary policy more meaningfully.

## Australia

The economic outlook for Australia remains robust. Elevated prices for iron ore and energy should bolster exports, though China's expected growth slowdown poses a risk. Strong business confidence suggests that capex is likely to remain strong, however. Rising employment should support consumer spending, but higher interest rates suggest that the real estate sector may cool off.

## Emerging Asia (ex-China)

Growth in South Korea, Taiwan and Hong Kong is likely to slow slightly amid the growth slowdown in mainland China and, more specifically, in technology exports. In Southeast Asia, growth is likely to remain significantly higher on the back of solid investment and consumption. However, for economies with weaker external balances (Indonesia, Philippines), policy tightening to stabilize the currency poses downside risks.



# Supertrends: Investing in change

In May 2017, we took a fresh approach to equity investing, launching our five Supertrends. These long-term investment themes seem to have struck a chord with investors, adding positive value since inception.

Unsettled by financial market disruptions, investors today are looking for fresh approaches to investing. These include evolving areas such as impact investing, as well as new approaches to traditional asset classes. In May 2017, we launched our five Supertrends as an alternative way to invest in global equities. At the time, investors were already confronted with an increasingly complicated global equity investing environment with demanding valuations in certain markets and large differences in terms of performance across sectors and regions. Our view was that the successful passive equity investment trend of the quantitative easing era, such as exchange-traded funds (ETFs) on global equity indices, would no longer deliver the same performance going forward.

**Differentiated approach**

We developed the Supertrends with a view to investing globally in listed equities, but along very clear high conviction themes. These are based on multi-year societal trends that we believe will likely drive economic policy, company results and stock performances in a meaningful way for years to come. They cover themes ranging from population aging and the Millennials, to technological progress, the rise of a multipolar world and the upgrade of infrastructure worldwide.

Within the technology theme, our investments in areas like artificial intelligence, virtual reality and healthtech, all of which have recorded double-digit returns in the past one-and-a half years, have proven to be the strongest. Infrastructure was the slowest performer, however, but should benefit from renewed catalysts in 2019 as economic policy focuses on infrastructure expenditure again.

To date, Supertrends stocks or products are added to portfolios mainly to complement existing equity holdings. But as time passes and presuming the Supertrends continue to deliver the results we expect, we anticipate that investors may increasingly devote a larger share of their equity portfolios to these themes, turning them into mainstream holdings.

**Eye on sustainability and impact**

Similarly, we find that investors increasingly seek to construct portfolios that meet environmental, social and governance (ESG) criteria. An increasing number of investors go even further and invest with a view to making a specific social or environmental impact. One of our Supertrends – “Millennials’ values” – already reflects this increasingly important investment trend: it only retains stocks that fulfill minimum ESG criteria.

New impact investing solutions address two of the key issues of our time: healthcare and education. These solutions help provide a link between capital needs (for example students who seek a university education) and investor needs in these areas. The following pages provide more information about some of the exciting avenues Credit Suisse is pursuing as we bring impact investing into the mainstream.

# Why sustainable investing is smart

Sustainable and impact investments have seen remarkable growth. The urgent need to unlock the positive power of capital for change is best captured by the United Nations Sustainable Development Goals (SDGs). Making these objectives investable is a key trend in sustainable and impact investing.

Sustainable finance and impact investing have experienced remarkable growth in recent years. Institutional investors in particular have driven global demand for sustainable investments, a market that reached USD 23 trillion in 2016, according to the Global Sustainable Investment Alliance. There has also been a notable increase in interest and demand from other key client segments that we serve, including foundations and private wealth clients, with an exceptionally strong push from the mission-driven next generation, which we focus on as part of our Supertrends.

The top investment objectives identified by sustainable and impact investors are to achieve attractive returns complemented by risk mitigation and portfolio diversification, and of course to make a difference in the world.

**A careful approach to stock selection**

When it comes to sustainable investments based on environmental, social and governance (ESG) factors, companies are screened to exclude entities that are controversial or in breach of basic norms, and to promote sustainable investment by selecting entities with a best-in-class approach. Increasingly, quality data points are emerging to support these investment goals, including strong correlations between high ESG scores and financial performance, using ESG factors as a predictor of future earnings volatility, and as a defensive haven during market corrections.

**Impact finance and investments make the difference**

Measurable impact investment goes a step further and is key to addressing the large funding gap that is required to achieve the UN’s 17 SDGs. Among these goals, higher education stands out as an investment that has a deep impact because it creates a stable middle class that can support and develop the broader economy and society. In developing markets, enrolment in primary education has reached 91%, according to the UN. However, many young people are unable to continue their studies in secondary schools and even fewer at universities given the limited means of many families and financing challenges faced by governments.

The creation of innovative structures in impact finance makes it possible to invest in higher education projects that yield market returns for investors. Students have access to funding at moderate rates, allowing them to attend a quality university. The quality of such loans is high: these students typically have a repayment ratio that is well above average. And the investment in securitized bonds is diversified as there are hundreds of underlying quality loans to talented students with a low correlation to capital markets.

**Smart investing**

At Credit Suisse, we look back on 15 years of successful impact investing in the areas of education, financial inclusion, climate change, gender-lens investing and affordable housing. Based on this experience, we can say confidently that investing in companies and opportunities that are sustainable and impactful is simply smart investing.

# Pay it forward – Impact investing and education

Impact investing has experienced explosive growth as people seek investments which generate a financial return while creating a measurable positive social and environmental impact. This area is being aligned with the UN’s 17 SDGs, which include gender equality, clean water, zero hunger and quality primary, secondary and tertiary education.

For students in low-income countries, the hurdles to higher education can appear insurmountable. While 91% of children in developing countries are enrolled in primary school, just 1 in 12 young people will obtain secondary level skills in the least developed countries, according to UNESCO data.

Many young people are unable to continue their studies in secondary schools and higher education given the limited financial means of their parents and financing challenges faced by governments. In addition, donations devoted to higher education represent just a fraction of global donations. The average person in Sierra Leone would have to work more than 100 years to pay for one year at Harvard.

In an interview, Marisa Drew, Chief Executive Officer of Credit Suisse’s recently established Impact Advisory & Finance Department (IAF), discusses how investors can make a positive change in education.

**How great is the need for private initiatives in education?**  
It is absolutely critical that the private sector step in. In a 2015 report, UNESCO estimated that the annual funding gap for education would be at least USD 39 billion between 2015 and 2030. UNESCO is calling for more and better financing to achieve the ambitious SDG goal: a quality education, for all levels of education, in all countries, regardless of gender.

**How developed is the overall impact investing market for education?**  
Today the impact investing market for education is relatively nascent compared to other SDGs like clean energy. Historically, education funding has largely rested within philanthropic circles and the non-profit sector. The 2018 Global Impact Investing Network (GIIN) survey showed that only 4% of total impact investing assets under management (AuM) are dedicated to education. However, there is increasing awareness within the private sector that enormous funding gaps exist. According to GIIN, 20% of impact investors surveyed deployed capital in education in 2017 and 36% planned to increase their allocations to education in 2018.

“ At Credit Suisse, we believe in the multiplier effect of investing in education.

**What motivates someone to invest in education?**  
One of the biggest motivators I see for our private clients is that they benefitted from access to a quality education themselves. This is particularly true for clients who come from developing countries where universal education is a privilege, not a right. They often feel that education was their lottery ticket to a fortunate life and they want to pay it forward.

**What are the financial returns vs. risks in this space?**  
A key tenet of impact investing – and this is very important for investors – is that the investment must come with a commitment to measure the impact. There are two kinds of strategies: impact investors can seek to achieve returns consistent with traditional returns for a given asset class; or they can generate concessionary returns with a portion of the return coming in the form of the impact the investment is making. The risks are the same as for traditional asset classes, although most impact investments tend to be in private markets where duration is longer and liquidity is more limited.

**Why does Credit Suisse believe education is an attractive investment area?**  
At Credit Suisse, we believe in the multiplier effect of investing in education. The recent Goalkeepers Report\* from the Gates Foundation highlighted the importance of investing in young people and especially in their education and health in order to create opportunities. If an individual's investment in education can help reduce mortality, increase peace and security, stem the effects of climate change, lift people out of extreme poverty and foster economic prosperity – all while generating a financial return – we think the attractiveness of the investment case speaks for itself.

\* [gatesfoundation.org/goalkeepers/report](https://www.gatesfoundation.org/goalkeepers/report)





# Financial markets

## In short

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### **Anticipating asset trends**

US financial markets entered a late stage of the economic cycle in 2018, characterized by rising interest rates combined with a flattening yield curve. Our base case for 2019 foresees only a moderate further increase in US yields. This suggests that US fixed income investors should prepare to lengthen duration. In core bond markets outside the USA where yields are far lower, duration should remain short. In credit, the risk-return trade-off looks better for high yield than for investment grade bonds. Equities should continue to outperform on the back of robust earnings growth. Emerging market (EM) assets, which came under pressure due to tighter US monetary conditions, should regain ground as long as the risk of US rate hikes and USD strength abates.

### **Pockets of growth in certain sectors**

Despite some wobbles, technology stocks continued to outperform in 2018. We expect economic growth to normalize in 2019. But in line with late cycle patterns, growth stocks should generally continue to outperform. This should include the healthcare sector, especially if companies achieve breakthroughs in areas such as gene therapy. Some cyclical sectors like capex-oriented industrials should be buoyed as well. In Europe, depressed financial stocks should benefit from rising yields, while in the USA, the flattening yield curve will likely weigh on the sector. Real estate stocks may also remain under pressure due to rising interest rates.

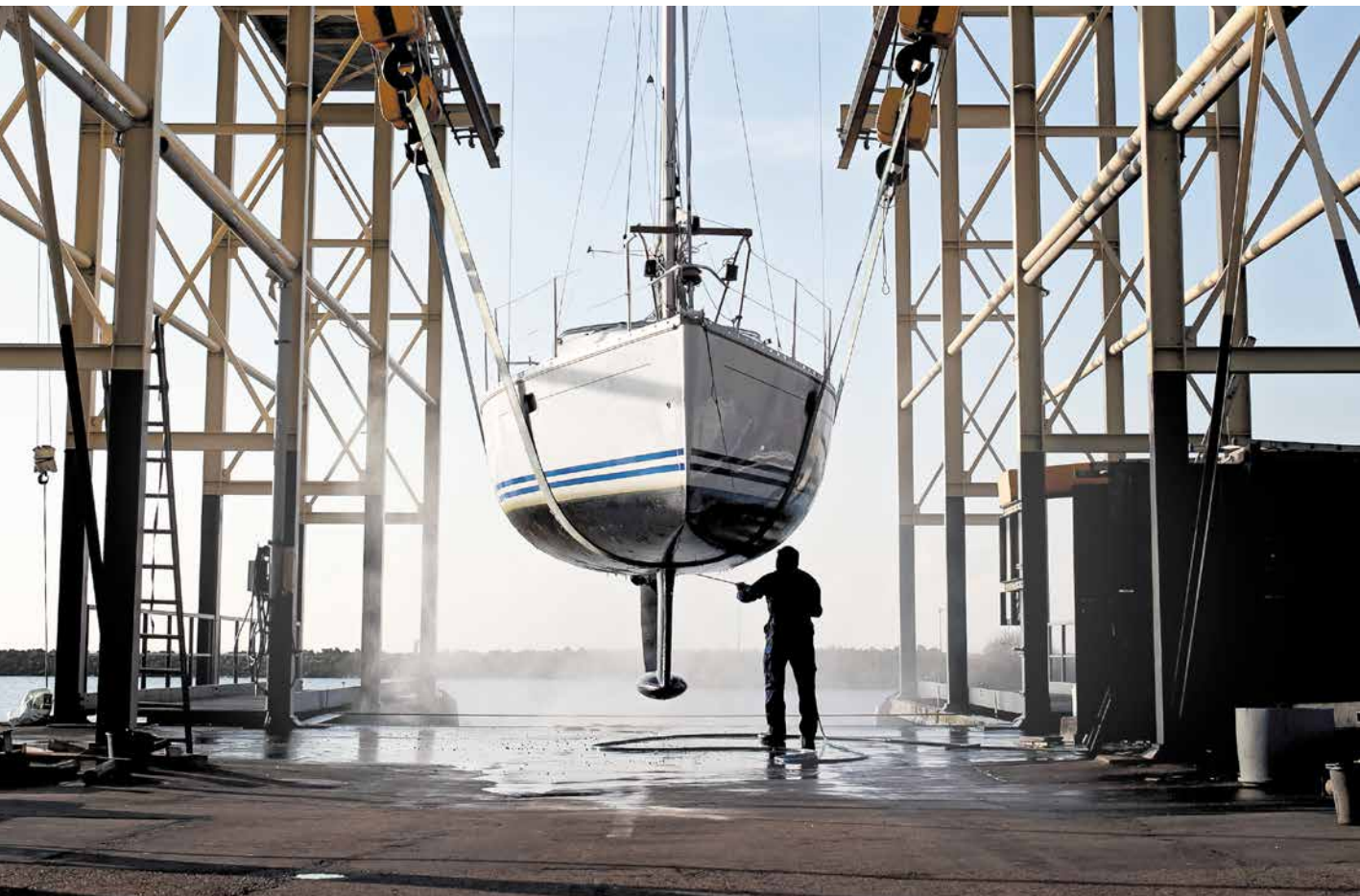
### **Where to for currencies?**

In 2018, the USD made moderate gains against the other major currencies, but appreciated significantly against a number of EM currencies. Going into 2019, we have a neutral view on EUR/USD. While the yield gap continues to support the USD, the start of monetary policy tightening outside the USA is likely to work against the currency. Valuation continues to speak in favor of the GBP as well as a number of EM currencies, some of which are also supported by a greater carry advantage. Among safe havens, we favor the undervalued JPY over the more expensive CHF.



# Positioning for late cycle growth

As the US transitions from economic recovery and expansion to overheating, the return profile for a number of asset markets is likely to change, with key implications for investment strategy. We continue to believe that equities should outperform.



“ The US economic cycle still matters most for global financial markets.

Unexpected political developments had a considerable impact on financial markets in 2018, and are bound to move them in 2019 as well. Nevertheless, the economic cycle will remain the key driver of markets. The behavior of the major asset classes tends to differ considerably depending on the stage of the economic cycle. We have taken these factors into consideration in developing our base and risk scenarios for the main asset classes in 2019 and determining our investment strategy.

Why the US cycle matters most

The US economic cycle still matters most for global financial markets. While the US economy now represents slightly more than 20% of the world economy (and less than 15% adjusted for differences in purchasing power), the US equity market still constitutes 54% of the global equity market (MSCI AC World). And while the US high grade bond market, at 41%, represents a smaller share of the global bond market, US bond yields are a key driver of global asset markets, as the USD remains the largely undisputed global reserve currency. Hence, although the decisions of the US Federal Reserve (Fed) are largely driven by domestic considerations, its policies determine the price for the bulk of global liquidity. In addition, most global fixed income assets are priced based on the US Treasury curve. Given the strong influence of the US economic and rate cycle on global markets, we therefore focus on the base and risk scenarios for US interest rates as we look ahead to 2019.

Financial market forecasts / performance 2019		
	2018 YTD performance on 07 November 2018	2019 expected total returns
Equities*		
US equities	6.78%	5.50%
EMU equities	-4.21%	4.00%
Swiss equities	0.14%	4.80%
UK equities	-4.04%	5.00%
Japanese equities	-6.31%	1.50%
Emerging market equities	-7.04%	8.30%
	Close on 07 November 2018	End-2019 forecast
Bond yields		
10-year US Treasury yield	3.24%	3.30%
10-year German Bund yield	0.45%	1.00%
10-year Swiss Eidgenossen yield	0.02%	0.50%
	2018 YTD performance on 07 November 2018	2019 expected total returns
Credit		
Global investment grade bonds**	-1.82%	-1.00%
Global high yield bonds**	1.09%	3.00%
Emerging market HC bonds***	-4.59%	5.00%
	Close on 07 November 2018	End-2019 forecast
Currencies & commodities		
EUR/USD	1.14	1.20
USD/CHF	1.00	1.00
EUR/CHF	1.15	1.20
USD/JPY	113.53	105.00
GBP/USD	1.31	1.40
USD/CNY	6.93	7.20
Gold (USD/oz)	1228.51	1250.00
WTI (USD/bbl)	61.89	67.00

\* Performance and expected returns are total return including dividends. Markets refer to MSCI country / regional indices in local currency. Performance of the periods 07/11/2013 – 07/11/2018 for those indices in chronological order are: MSCI USA: 18.5%, 5.4%, 3.5%, 24%, 10.6%. MSCI EMU: 3.8%, 19.7%, -7.1%, 26.5%, -6.8%. MSCI Switzerland: 10.3%, 5.2%, -8.9%, 23.4%, 1.6%. MSCI UK: 1.5%, -0.5%, 11.4%, 14.6%, -1.3%. MSCI Japan: 17.6%, 15.3%, -12.3%, 34.7%, -6.4%. MSCI EM: 5.9%, -0.8%, 6%, 29.2%, -6.7%

\*\* Barclays Global Investment Grade Corporate and Global High Yield index

\*\*\* JP Morgan EMBIG Div. (sovereign index)

Source Thomson Reuters Datastream, Credit Suisse  
Last data point 07 November 2018

Note: Historical and/or projected performance indications and financial market scenarios are not reliable indicators of current or future performance.

US economy remains on track

Our base case for the US economy in 2019 suggests that the combination of further Fed policy tightening and the fading fiscal impulse should dampen any economic overheating, and that some signs of a slowdown are likely to emerge. The main risk case would be continued strong growth and overheating. The risk of an outright contraction, in contrast, seems quite limited, at least in 2019.

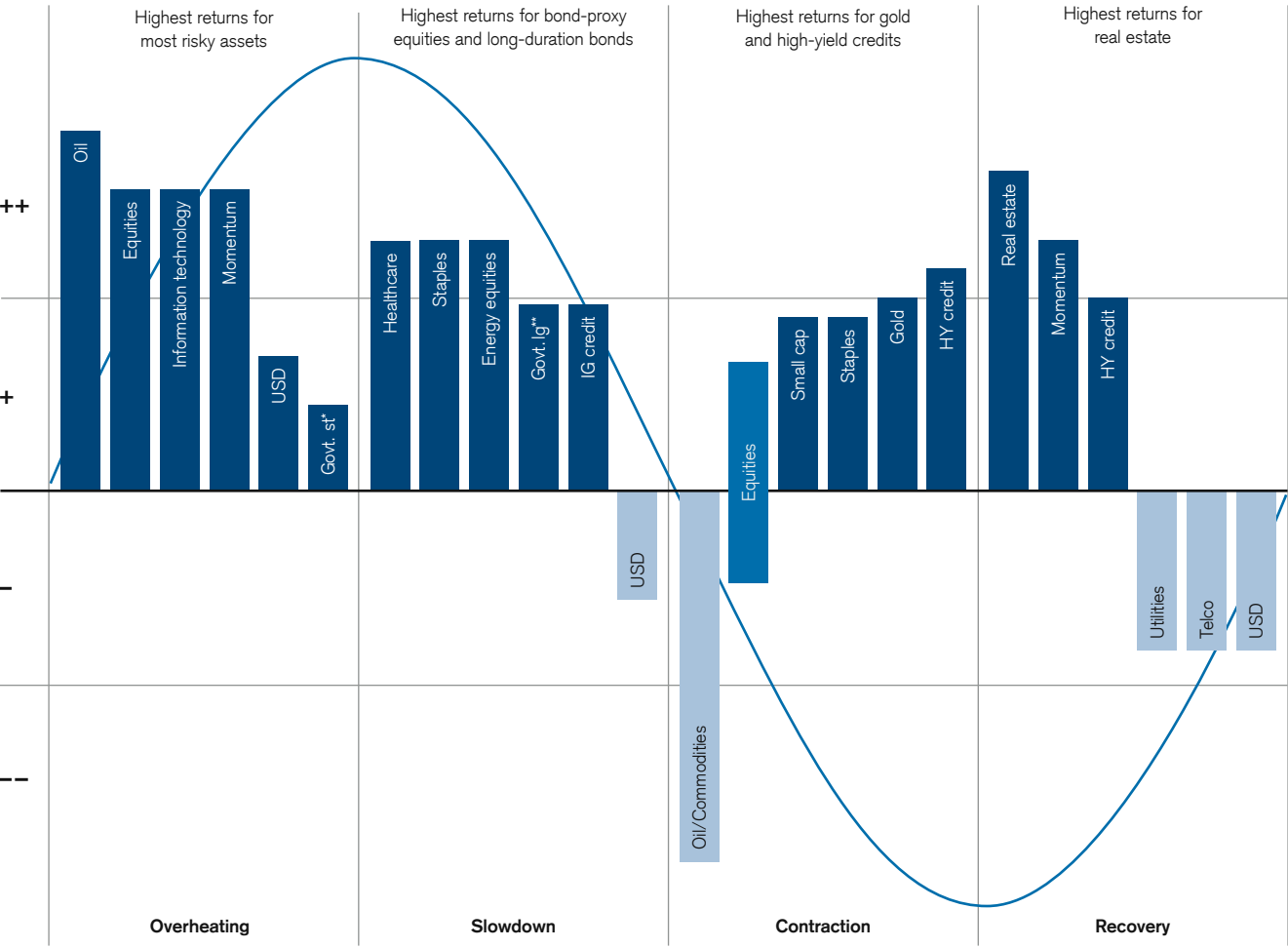
The main implication of our base case is a further flattening of the US yield curve. In the risk case of prolonged overheating, longer-dated yields would rise further and the

curve would shift upwards. Conversely, if the economy were to slow sooner, the yield curve would invert. The key implication of an expected flattening of the US yield curve is that USD-based investors should prepare to extend duration in 2019. Meanwhile, adding inflation-protected bonds to the portfolio would provide protection against a possible protracted phase of overheating.

As long as the global economy avoids a contraction in 2019, as we assume, our analysis suggests that credit should outperform Treasuries. The greater the confidence in the base case, or even an overheating scenario, the

“ As long as the risk of US rate hikes and USD strength abates, EM equities should benefit.

Asset class performance patterns across the business cycle



\* Short duration government bonds  
\*\* Long duration government bonds

**Note** The chart shows the typical asset class performance patterns across the following four US economic cycle phases, or regimes (sample: 1990–08/2018):  
1 “Overheating” phases are characterized by economic growth remaining above trend and inflation rising.  
2 “Slowdown” phases typically follow efforts of policymakers to halt overheating.  
3 If these policies have been too harsh or other negative shocks occur, an outright “contraction” or recession phase may ensue.  
4 “Recovery” phases are the periods following the low point of the cycle, i.e. the trough of recessions, and typically include a fairly prolonged economic expansion.

Source Credit Suisse, Bloomberg

larger the warranted allocation to higher-risk bonds. Yet it is important to assess whether valuations support such exposure. At the time of writing, US high yield spreads were above 350 basis points. This seemed to provide a reasonable buffer for a robust economic scenario, but little leeway for any significant negative surprises and higher default rates. US high yield also remains exposed to idiosyncratic risks, especially energy prices.

US investment grade bonds seem less attractive, however. Although cash positions of US corporations remain quite high, leverage has increased substantially since 2014 due to stock buybacks and higher investment spending. Moreover, spreads are tight by historical standards and the benchmark duration is long as corporations have until recently taken advantage of the low yield environment to issue longer-dated bonds. Hence this sub-asset class will tend to underperform Treasuries in both risk cases. A mix between Treasuries and high yield seems a better choice.

Brighter outlook for emerging market bonds

As for the non-USD bond segment, emerging markets (EM) are likely to be most affected by US interest rate developments. Indeed, 2018 provided a stark reminder that tighter USD liquidity can put severe strain on EM assets. Yet if our base case materializes and pressure on the Fed to tighten policy eases, EM hard currency bonds should outperform. Insofar as a less aggressive Fed reduces pressure on EM currencies, EM local currency bonds should also do well. One of the key risks for

EM local currency bonds is China: should the RMB depreciate further, other EM currencies might come under renewed pressure.

Finally, bonds in other hard currency regions such as Japan, the Eurozone and Switzerland are less affected by the US economic and interest rate cycle. Domestic economic developments and monetary policy are more important. In our base case, economic growth should remain robust in these regions and monetary policy should begin to normalize. As yields in most markets remain extremely low, returns are likely to be weak or even negative in 2019. A short duration stance therefore remains warranted in these markets. In credit, senior loans still seem attractive in Europe as bank asset quality should continue to improve. However, a specific tail risk for European credit is a loss of fiscal discipline in Italy and rising concerns regarding a possible Italian exit from the EUR.

Equities still offer potential

In a late cycle phase, equities typically continue to outperform most asset classes. Thus, equities should still be favored unless valuations become too stretched or a contraction takes shape. That being said, the performance of different sectors may diverge substantially depending on their sensitivity to interest rates. As for investment styles, momentum stocks tend to do well late in the cycle. This should benefit large leading sectors such as IT, one of our preferred sectors at the time of writing.

Similar to bonds, EM equities tend to be significantly affected by the US economic and interest rate cycle. As long as the risk of US rate hikes and USD strength abates, EM equities should benefit. That said, the influence of Asian growth is stronger for EM equities than for EM bonds due to the large weight of Chinese and other Asian equities in the MSCI EM index. Indeed, the Chinese domestic market is so large that its own business cycle has a major impact on EM equities. Our base scenario for China is a further moderate slowdown in growth, accompanied by somewhat easier monetary conditions, which would support equities. While continued robust US growth would also support Chinese and other EM equities, the risk of a further escalation of the trade conflict with the USA warrants some caution.

Most equity markets in advanced economies outside of the USA – with the exception of Canada – also depend less on the US rate cycle and economy. In 2018, most developed market equity indexes lagged their US counterparts due to the low weight of technology companies within their indices and as extremely low interest rates continued to hurt financial stocks. In Europe, political risks likely added to the underperformance. But the Eurozone market may well catch up, barring a renewed crisis triggered by Italy. In this context, steady economic growth and a meaningful increase in interest rates would support financials and other domestically focused Eurozone equities.

**Chinese demand should support commodities**

Most commodities, except for precious metals, tend to be highly cyclical assets. In most cases, they continue to do reasonably well in late cycle periods. But a significant rise in interest rates and a stronger USD tend to slow the ascent of commodity prices. Given our fairly moderate scenario for interest rates and the USD, this factor should not play a dominant role in 2019. As long as China’s all-important demand for commodities holds up, cyclical commodities should remain supported.

“ As we look to 2019, our base scenario suggests that equities should remain at overweight.

**USD under opposing influences**

It is challenging to predict the direction of the USD in 2019. In past late cycle phases, especially when the US yield curve inverted (i.e. markets considered monetary policy too tight), the USD would rally. Depreciation would then set in once the economy slowed and the Fed began to ease. We think it is unlikely that the Fed will tighten policy excessively in 2019. Conversely, any slightly hawkish surprise from the European Central Bank (ECB) or the Bank of Japan (BoJ) would tend to strengthen the EUR or JPY. At such a tipping point, the large US twin deficit might once again come into play and put downside pressure on the USD.

**Investment strategy for 2019**

As we look to 2019, our base scenario suggests that equities should remain at overweight. However, US investors should begin to lengthen bond duration. Valuations for EM bonds and currencies seem fairly attractive but China poses risks, and the same holds true for EM equities. In credit, high yield seems to offer a better risk-return trade-off than investment grade bonds. Demand for commodities should remain robust, while the factors supporting and weakening the USD are likely to be more or less in balance.

# Spotlight

## US yield curve inversion: Do we need to worry?

The US yield curve flattened significantly in the course of 2018, with shorter-term interest rates rising much more than longer-term yields. In the past, flat or inverted yield curves have coincided with recessions (see chart), which is why this development may raise doubts about the current, rather optimistic, outlook for US growth.

Here is why a flatter yield curve tends to foreshadow an economic slowdown: central banks typically raise short-term interest rates to reduce inflation pressures that emerge during a strong economic expansion. This lowers the inflation expectations component in bond yields. However, the central bank’s action also raises real yields. Higher borrowing costs subsequently slow the economy. A yield curve inversion means that the bond market has begun to discount a future easing of

monetary policy, which in turn implies that the central bank has tightened policy too much, increasing recession risk.

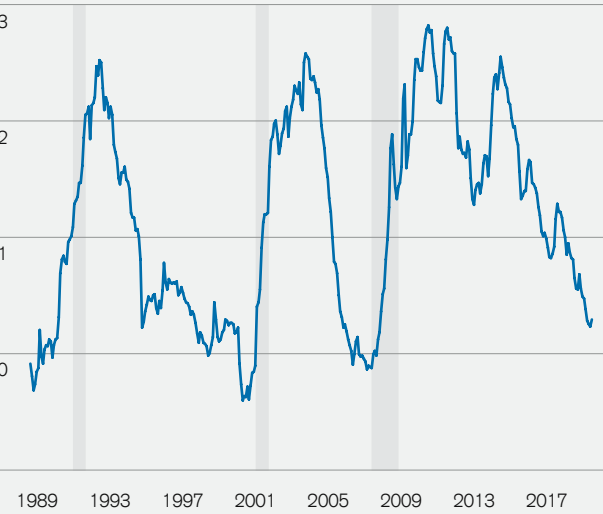
**“This time is different” – or maybe not**

Some argue that there are structural reasons for the yield curve to be flatter than in the past. For instance, they suggest that the term premium, i.e. the added interest investors receive for holding longer-maturity bonds, should be smaller than in the past because inflation risks are fundamentally lower because of central banks’ apparent success in containing inflation, which has helped to permanently lower inflation expectations. We have some doubts about this argument, not least because the curve has been just as steep in this cycle as in past cycles and because US inflation expectations are in fact back to average levels. Moreover, some factors, including much higher government debt, suggest the term premium should actually be higher than in the past. Hence, we believe it is premature to discard yield curve inversion as a warning sign of recession.

That said, we do not actually expect the curve to invert in 2019, not least because the Federal Reserve (Fed) is itself likely to regard a flatter curve as a warning sign. If the curve becomes too flat, the Fed will likely pause in its tightening path and thus allow the curve to steepen again in response to less restrictive policy.

**Yield curve flattens**

US Treasury yield spread: 10-year minus 2-year (in % points)



Last data point 30 October 2018  
Source Credit Suisse, Bloomberg

— US Treasury yield spread  
■ US recessions



# The sector standpoint

The outlook for most sectors around the world depends on global or regional business cycles. Where leverage is high, interest rate movements will have a significant impact. Moreover, rapid technological progress continues to boost innovators and disrupt many established companies.



Significant divergences characterized sector performance in 2018. The two leading growth sectors – IT and healthcare – delivered the strongest performance. No clear trend prevailed across cyclicals versus defensives. Energy was flat amid volatile oil prices, while tighter US monetary policy and the associated flattening of the US yield curve took a toll on financials.

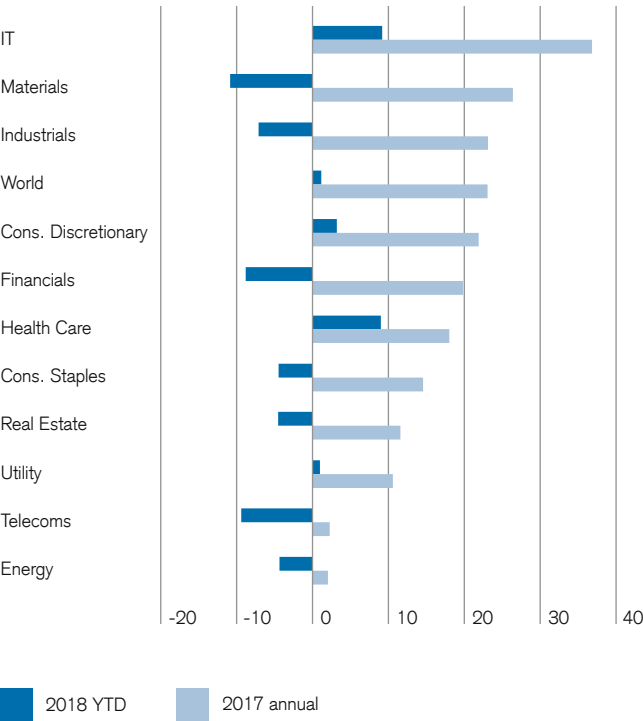
Looking to 2019, we believe that some of these trends should continue. For instance, we believe that capital expenditure during the late cycle may provide a boost for the industrials sector, while innovation and more attractive valuations could lift materials. The key question is whether IT and healthcare will again generate strong returns. While growth in most IT sectors should ease, we believe that innovations continue to make the sector attractive. In healthcare, we also see room for major advances, for example in the area of gene therapy.

**Consumer: E-commerce is the new normal**  
The consumer sector should benefit in our base scenario of continued robust growth and tight labor markets, though China and the trade dispute are key risks. In China, big

ticket items, such as autos are likely to remain under pressure, while structural growth trends, such as the expanding middle class, should support luxury goods including cosmetics and high-end alcoholic beverages. Higher tariffs on China would primarily hurt US consumers. Meanwhile, e-commerce is becoming the new normal and online sales are likely to continue to grow strongly. Some incumbent retailers are successfully adapting in this area.

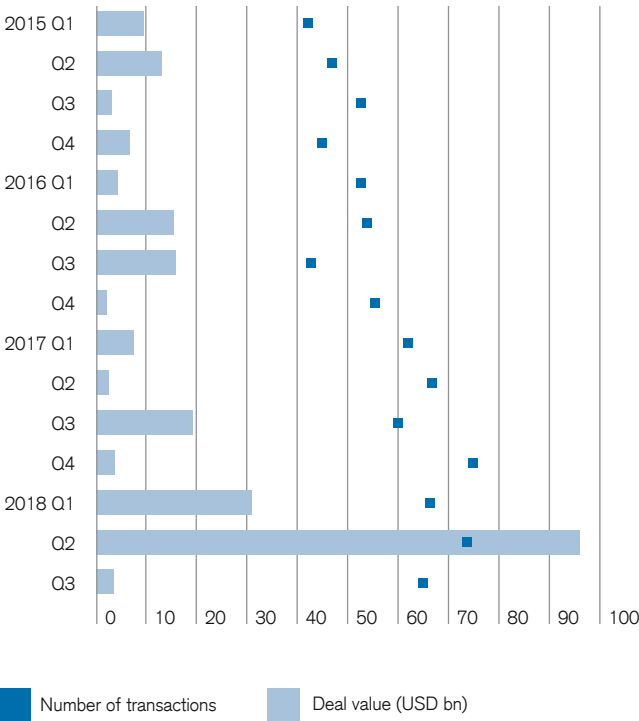
**Energy: Focus shifts to long-term growth**  
The outlook for the energy sector is positive as earnings are likely to be boosted by rising production volumes and higher prices. Valuations have returned to fair levels. As momentum in oil prices and earnings per share (EPS) growth eventually eases, investor focus is likely to shift to longer-term growth. Investors will closely watch for possible production constraints in the Permian Basin in the USA and the shale industry, as well as the impact of such constraints on exploration and oil services companies. Tightening regulation on shipping fuels for refineries is another area of concern. Finally, investors will look out for signs of recovery in offshore drilling after prolonged weakness in that area.

**IT still in the lead**  
MSCI World total gross sector returns (in %)



Last data point 08 November 2018  
Source Bloomberg, Credit Suisse

**Strong increase in biotech M&A activity**



Last data point 10 October 2018  
Source Bloomberg, Credit Suisse

Financials: Structural challenges remain

Growing demand for loans in most advanced economies should prove beneficial for financial stocks. In Europe, a further steepening of the yield curve in anticipation of the European Central Bank’s rate hikes should also be beneficial, while further curve flattening in the USA could act as a drag. However, national regulations, weak balance sheets and inadequate provisioning are slowing the much needed consolidation of the European banking sector. Cross-border mergers and acquisitions (M&A) are more likely in insurance, with non-life and health the preferred targets. In banks, the focus remains on cost containment rather than growth, though attractive potential dividend yields could provide a boost to the subsector.

Healthcare: Innovation and M&A driving growth

We expect to see a wave of adoption of biosimilar medicines over the coming years, supported by more aggressive leadership from the US Food and Drug Administration. This should enable large companies to invest in significant innovations, including gene therapy. Some of these therapies should become available in 2019 in the USA, including treatments that could be close to a cure for spinal muscular atrophy and hemophilia A. Fears of politically driven regulatory interventions are abating. We believe the companies that should outperform are those that lead innovation, whether developing new treatments inhouse or through tapping the small and mid-cap segment for M&A.

Industrials: Set for late cycle growth

Valuations of the industrials sector are at a cycle high, but growth in EPS and revenues should benefit if economic growth remains robust, as we expect. The capital goods subsector should be lifted by the recovery in the mining, oil and gas and industrial construction industries. The sector should also benefit from innovation in the automotive sector and further investment in robotics across industries.

IT: Growth cools off

Earnings momentum in the semiconductor industry is likely to ease after two-and-a-half years of strong growth. This is mainly due to expanding manufacturing capacity, which puts pressure on chip prices. That said, excess capacity is limited and the correction should be fairly mild given strong underlying demand for chips from data centers and sectors such as communication. The internet and software industries should benefit as companies shift to areas such as cloud infrastructure, business process digitalization and hyper-scale data centers. The IT hardware sector might see a slowdown in PC demand, with growth in the smartphone market expected to decline to a low single-digit rate despite innovations such as foldable screens, augmented reality services and 5G networks.

Materials: Shifting production and product trends

In steel, we expect production to keep improving on the back of strong demand. Environmental concerns in China should boost demand for higher-quality iron ore to reduce pollution. As China takes capacity out of the market and shifts to higher-quality iron ore, the global supply for steel should remain balanced in 2019. In the chemicals sector, China is shifting from coal to gas as a raw material input. Mining companies should continue to return capital to shareholders by paying attractive dividends and buying back shares. We see strong themes continuing in chemicals, including the evolution of battery technology for electric vehicles and the migration from plastics to biodegradable products. A potential slowdown in China is the key risk for the sector given that market’s dominance.

Telecom: Strength in mobile, weakness in fixed line

Differences between individual markets are likely to remain significant in the telecom sector. In the USA, we expect wireless market trends to improve thanks to new 5G offerings. In Europe, the regulatory environment is improving. With a separation of network and services now possible, shares of network companies may rerate. Attractive potential dividends and historically low relative valuations should attract investors, especially if growth optimism diminishes. In Japan, competition is set to intensify as a fourth operator has entered the market. In China, consolidation is on the horizon because the investments for 5G networks are too high for companies to finance on their own. Pressure from governments worldwide to roll out 5G networks and initiatives in areas such as the Internet of Things could decide the sector’s fate.

Utilities: The evolution towards greener and cleaner

Rising interest rates could put further pressure on the valuations of regulated utility companies, especially in Europe. Regulated utilities also have to digest new tariffs for regulated returns in Spain and the UK. In addition, investors will focus on the ongoing shift towards renewables in electricity generation portfolios as costs are falling to competitive levels. Thermal power producers are benefiting from nuclear power plant closures in Germany and Belgium as well as expected coal plant closures across several countries. Another area of focus is the recent spike in EU carbon prices. If this trend continues, it would support another increase in power prices and generate windfall profits for clean electricity generators.

Real estate: Looking for new opportunities amid headwinds

The real estate sector is influenced by two opposing factors. Economic growth and rising yields (associated with growth). In that sense, 2018 was a difficult year for listed real estate as US interest rates moved up significantly. Looking ahead, 2019 is likely to bring more volatility. Though economic growth remains supportive, a further normalization in global monetary policy is a headwind. In addition, pricing in commercial real estate markets looks increasingly stretched, especially in the USA. As the cycle becomes more mature, investors have to be more selective and look to opportunities beyond traditional core strategies. One example is logistics real estate, which benefits from the continued expansion of e-commerce; or assisted living and healthcare facilities to cater to the needs of an aging population.

Carbon-free electricity generation supported by surging CO<sub>2</sub> prices

CO<sub>2</sub> prices on the European Emissions Trading Scheme (EUR per ton)



Last data point 06 November 2018

Source Bloomberg, Credit Suisse

# The state of play for currencies

Investing in foreign currencies does not usually generate excess returns compared with holding domestic cash. When currencies are clearly undervalued, however, it can be worth taking such positions. Conversely, holding low yielding safe-haven currencies pays off when risks spike significantly.



Currency markets provided a number of surprises in 2018. Forecasts generally assumed that the major currencies would be able to build on their gains in 2017 against the USD. Yet the stronger-than-expected growth momentum in the USA prevented them from doing so. In response to strong growth, the US Federal Reserve (Fed) continued to raise rates while the central banks of other advanced economies retained a dovish stance. The interest rate or carry advantage (positive difference in interest rates between two currencies) for the USD thus increased. Furthermore, the worsening US twin deficit did not weaken the USD.

Looking ahead to 2019, we believe that a further surge of the USD is unlikely. While US growth is likely to remain higher than in other advanced economies, the gap should narrow. As for US central bank rates, they will remain significantly higher than in other advanced economies, with the gap likely to even widen until mid-2019. If growth and inflation continue to pick up outside the US, non-US central banks may, however, start tightening sooner. Finally, our valuation screen shows a moderate USD overvaluation

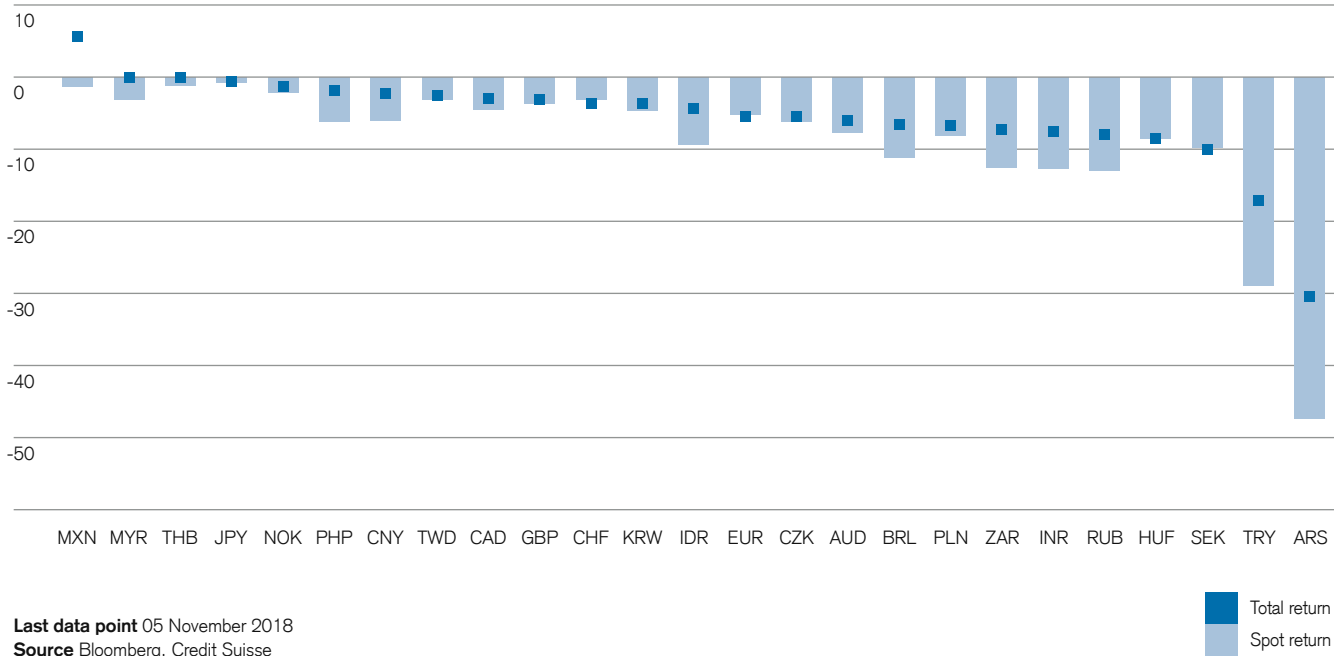
against the other major currencies. It is hard to tell whether the twin deficit might re-emerge as a risk factor for the USD. This would most likely happen if US economic growth slowed markedly, a development we consider unlikely in 2019.

As for emerging market (EM) currencies, we sense a bigger shift in fundamentals: policymakers in many EM were forced to raise interest rates as their currencies came under pressure in 2018. As a result, the carry between EM currencies and the USD has increased, in some cases substantially. At the same time, the valuations of a number of currencies have become more attractive. This suggests that both carry and valuation-based strategies may once more be effective assuming fundamentals stay constructive. Specifically, currencies will only appreciate if the external balance of the respective country stabilizes. Progress on rebalancing should therefore be watched carefully.

**Political twists in the road**  
In 2018, political events also impacted certain currencies. The escalating trade tensions between the USA and China depressed the RMB, while the close economic links of

## And the winner is... the USD

Spot and total returns of selected currencies vs. USD in 2018 (in %)





Japan and China may have prevented the attractively valued JPY from appreciating. In Europe, worries over Italian fiscal policy temporarily boosted the CHF, while the GBP swung back and forth with every twist in the road leading to Brexit. Looking to 2019, we do not think that the US-China trade conflict will be resolved quickly. As a result, the RMB may remain under pressure. Insofar as the Chinese authorities continue to ease monetary policy, this trend is set to persist. Yet we believe that China will proceed cautiously to avoid triggering investor uncertainty and capital outflows.

As regards the conflict over the budget deficit between Italy and the European Union, we believe it is quite unlikely that the European Central Bank will give in to Italian political pressure. Hence the EUR currency pairs should be little affected by these tensions. Meanwhile, valuation remains highly supportive of the GBP, implying that a soft Brexit may well help close the valuation discount. Conversely, a hard Brexit and its ensuing chaos would intensify pressure on the GBP.

EM currencies look more attractive

The developments of the past year appear to have produced a situation in which value and carry overlap for a number of currencies. Investors may thus be able to generate excess returns after a disappointing 2018. Among the advanced economy currencies, the GBP, NOK and

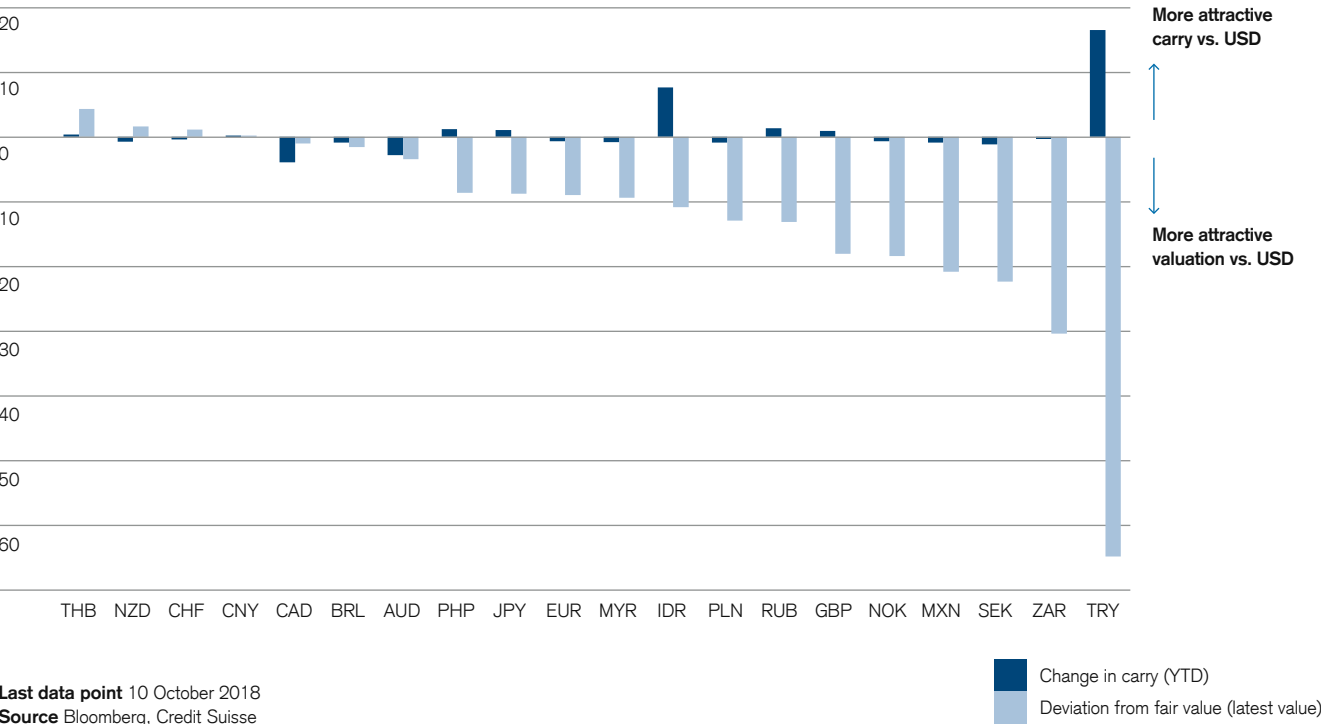
SEK looked clearly attractive based on our valuation screen as we went to press. Among EM currencies, the TRY and MXN seemed attractive. The NZD and CHF appeared expensive, while the only EM currency that looked expensive was the THB.

In terms of carry, two EM currencies, the BRL and TRY, looked attractive. Overall, our expectation of a fairly benign inflation picture in EM and a very wide real rate differential relative to developed markets, including the USD, suggests that other EM currencies may also outperform the USD. Meanwhile, some of the traditional advanced economy carry currencies, in particular the AUD, have lost appeal in the wake of Fed tightening. Among the safe haven currencies, the valuation divergence between the somewhat overvalued CHF and the undervalued JPY should close, especially if trade war concerns abate.

In conclusion, investors who hold large amounts of cash in low-yielding currencies (i.e. the CHF and EUR) that trade within their fair value band should be able to enhance returns by taking positions in some of the value or carry currencies described above. For USD-based investors, there is less incentive to take such positions as US cash returns are higher. That said, with the USD somewhat overvalued and the twin deficit making a possible comeback as a risk factor, limited diversification might improve portfolio performance as well.

Significant currency valuation adjustments in 2018

Deviation from fair value vs. USD (in %) and change in carry (interest differential in %) vs. USD



# Spotlight

## The twin deficit – boon or bane for the USD?

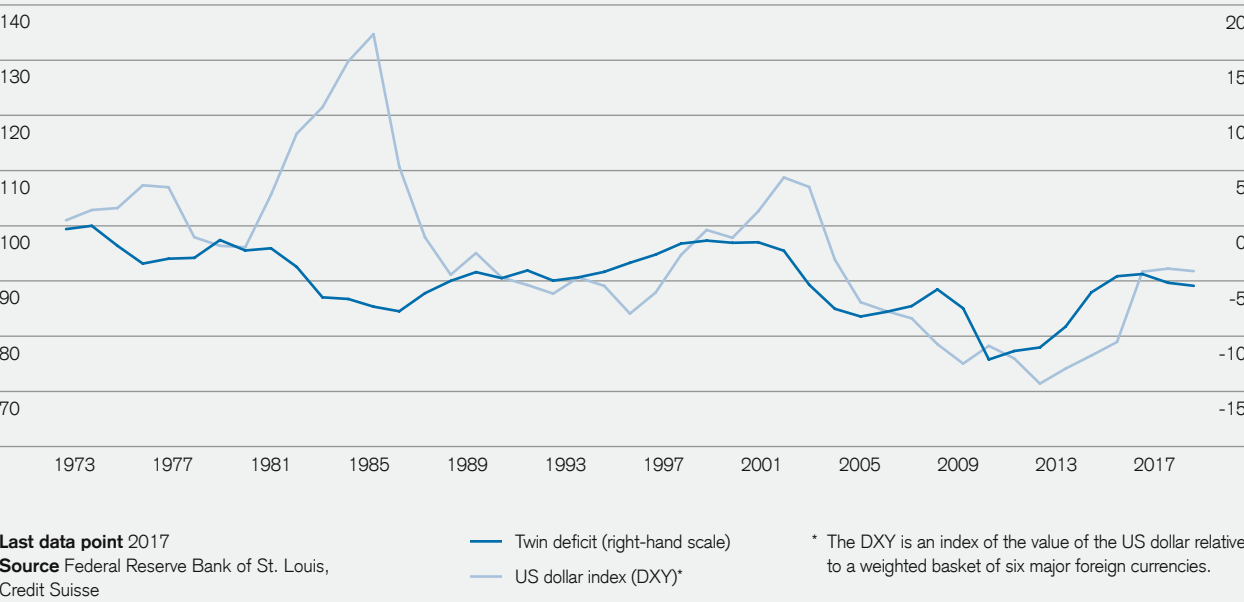
The so-called US twin deficit, i.e. the combination of a significant fiscal deficit and a current account deficit, is often seen as a risk factor for the USD. Yet the evidence is mixed. During the economic boom under US President Reagan that started in 1982, a worsening twin deficit coincided with a substantial strengthening of the USD. In all other instances, the USD weakened. This ambiguity results from the fact that rising fiscal deficits, often the main driver of a deteriorating external balance, boost growth and real interest rates. The latter are generally considered to bolster a currency. If a central bank raises interest rates to offset stronger growth and inflation risks, real interest rates are further boosted. This occurred in the early 1980s when the US Fed continued to pursue a tough anti-inflationary policy just as the Reagan tax cuts came into effect. The combination of expansionary fiscal policy and restrictive monetary policy boosted real interest rates and the USD.

Conversely, an increase in the current account deficit may weaken the currency in some situations. This is because an increase in the current account deficit requires global investors to increase investments in the respective currency. To entice them to do so, the compensating risk premium on the currency must rise. To achieve a higher risk premium, yield spreads have to increase or the currency has to get cheaper, or both.

It is hard to tell whether higher real interest rates or a higher risk premium will dominate in 2019. So long as optimism regarding US growth is robust and the Fed remains hawkish, the former is likely to dominate. Should US growth slow markedly, however, doubts about the sustainability of the twin deficit would increase, which could harm the USD.

Twin deficit does not always hurt the USD

Twin deficit (sum of fiscal and current account balance in % of GDP) and US dollar index (DXY)

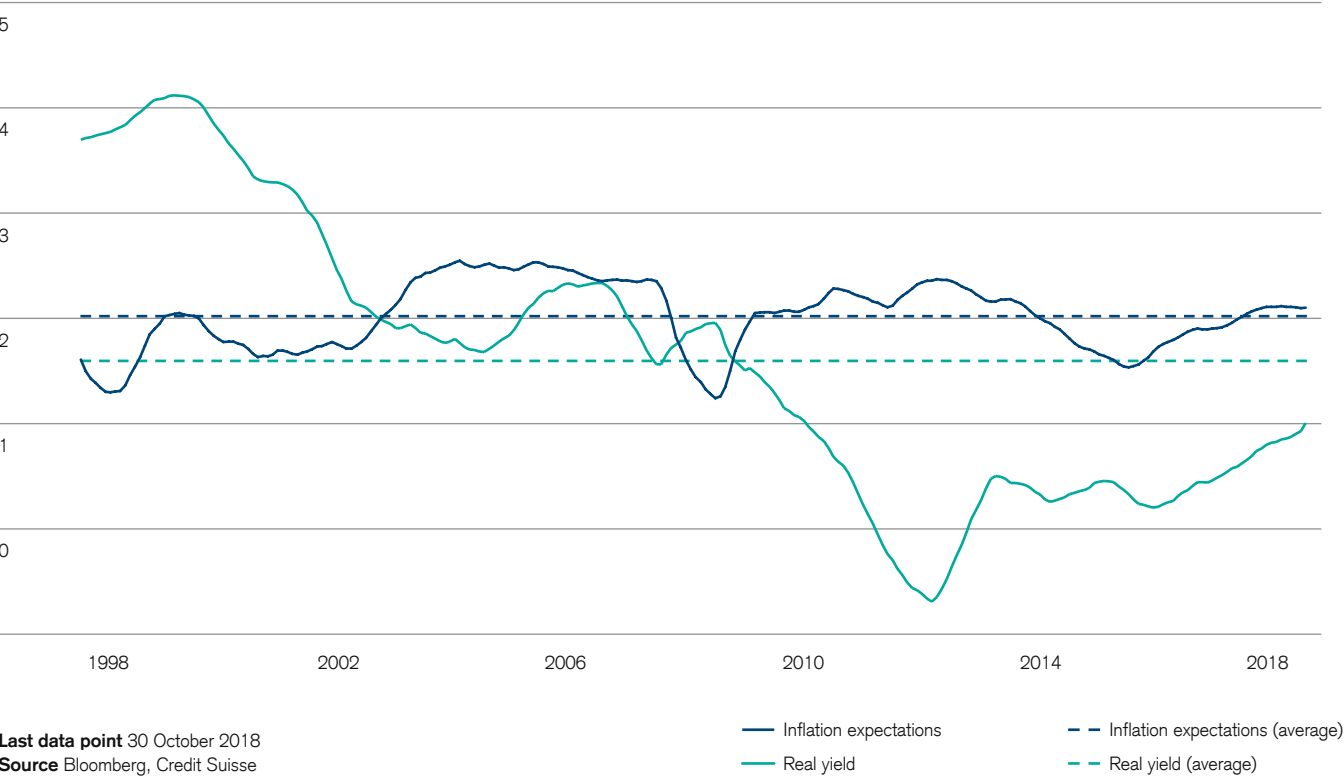


# Investment themes 2019

Every year we determine our top investment themes. This time we focus on: Interest rate normalization; Regional economic divergence; and New geopolitical regimes. We will continue to update these themes throughout the year to reflect changes in the Credit Suisse House View.

## How much further can real yields go?

Real yield and inflation expectations (derived from 10-year US Treasury Inflation-Protected Securities, 12-month moving averages, in %)



# Theme 1: Interest rate normalization

The cycle is at an advanced stage, but recession is still not imminent and central banks continue to normalize interest rates. Against this backdrop, investors inevitably wonder how to invest. We favor keeping a growth tilt in portfolios. This means focusing on assets that have consistently outperformed during the later phase of past expansions, while reducing market exposure by diversifying into more uncorrelated sources of return.

What can we observe from past cycles? On average, US bond yields have risen and the curve has flattened in the later stages of expansions. However, it is important to divide this into pre-Volcker shock (i.e. before the US Federal Reserve raised the federal funds rate to 20% in 1981) and post. Bond yields began trending higher along with inflation in the early 1950s, peaked in 1981, and then trended lower until 2012. This is important because any cycle analysis of bonds will mostly be driven by whether the longer-term trend in yields was up or down.

## Low yields make credit unattractive

Whether yields behave like the post-1981 era or the 1950s to 1980s period depends on the inflation outlook. For now, we do not believe inflation is likely to break out of its 25-year range, and thus the extent to which bonds can enter a bear market is limited. This does not mean yields cannot rise; it just means the terminal federal funds rate is likely to once again be lower than in the previous economic cycle. Additionally, today's low level of yields and very flat curve make it very difficult to obtain a positive return on bonds, especially outside the USA. Elsewhere in fixed income, one of the more consistent patterns we can observe from past cycles is that credit spreads tend to tighten early in the cycle, trough around three quarters of the way through the expansion, and then widen in the latter phase. Given the low level of yields this time around, credit seems quite an unattractive late cycle investment.

## Equities, commodities tend to outperform

As one would expect, equities tend to rally strongly in the later stage of the expansion. Within equities, small caps have underperformed large caps and cyclicals have quite consistently outperformed defensives.

The USD has on average depreciated in the latter third of past expansions but there is a lot of variation across cycles, so this is far from certain. In contrast, commodities and especially gold have tended to appreciate consistently.

## Opportunities for active managers

In summary, reducing market exposure should be intuitive given the exceptional bull market in this cycle. Additionally, tightening monetary policy and high valuations mean that forward-looking returns are likely lower than they have been. All these factors should benefit active managers. Alpha (uncorrelated returns) has been in short supply this cycle. High cross-market correlations and low macro volatility have made it very difficult to add value without beta (market) exposure. Going forward, volatility is likely to be higher, correlations are likely to be lower, and divergences between economies and assets more pronounced. Reducing beta can be achieved by adding exposure to absolute return strategies that aim to be uncorrelated across market environments. Actively managed hedging strategies can also help mitigate risk, while reducing the drag on returns compared to other hedges like buying put options.

# Theme 2: Regional economic divergence

Differences in the relative strength of labor markets and economic growth between countries have led to large divergences in global monetary policy, driving growing interest rate differentials and large currency moves. This has incentivized capital to flow into the USA, pushing the USD higher, but has also exposed weaknesses in emerging markets (EM) with large imbalances, like Argentina and Turkey. This helped drive further capital into US assets, creating a vicious cycle for EM. For investors, it is important to look for large divergences between fundamentals and prices in order to find attractive investment opportunities.

**Central bank policy in focus**

Monetary policy tightening cycles tend to flatten yield curves. Given that the Federal Reserve (Fed) continues to tighten monetary policy, the recent US curve flattening should continue. And as Eurozone growth starts to catch up and the European Central Bank becomes more hawkish, the Euro rate curve should also flatten. In contrast, the Bank of Japan has implemented a yield curve control policy that has capped the level of 10-year yields, hence any pullback in accommodation will likely have the opposite effect of steepening the curve.

**Wages on the rise**

In equity markets, there is a trade-off between higher wages and interest rates hurting margins and the higher growth that comes with it that could offset the negative impact of rising costs. Countries that provide more fiscal support and sectors that are less exposed to the impact of higher wages and rates because they are less capital and labor intensive or have lower leverage should also outperform.

**Current accounts make the difference**

There are also a number of divergences in EM that will likely persist over the coming year. Current account surplus economies should be less vulnerable, while current account deficit countries should be more vulnerable. If the capex cycle in developed markets (DM) continues to pick up steam, this contrast should become even larger, as surplus economies would benefit from a large rise in DM imports. If global growth slows down, most surplus countries should be able to pursue counter-cyclical measures, whereas deficit countries would likely face a worsening growth-inflation trade-off. Trade tensions are also important, and we think they are likely to remain elevated between the USA and China. Yet China will use a combination of stimulus and currency depreciation to offset any real impact on growth.

It is important to look for large divergences between fundamentals and prices in order to find attractive investment opportunities. This means that in some cases, where prices have moved very far from fundamentals, it may make sense to own current account deficit countries or to sell current account surplus countries. The election in Brazil has created volatility, which we think is unwarranted. Russia should benefit from the increase in oil prices and has some of the strongest fundamentals and most credible economic policymaking in EM. Israel has a strong balance of payments and a healthy economic outlook. However, South Korea is highly exposed to trade and globalization and is struggling to transition to a more domestically focused economy. South Africa has growing external debt and a widening deficit. It is also subject to a lack of structural reforms and ongoing political uncertainty. Combined, these factors make it one of the countries more exposed to external risks.

# Theme 3: New geopolitical regimes

The last 40 years have seen increasing globalization and free trade, deregulation and a focus on reducing the role of the state in society. These policies created three decades of strong global growth, which was accompanied by moderate inflation, low macroeconomic volatility and ever more integrated global markets.

**The rise of populism**

With the positives came unintended consequences: boom and bust cycles; a sharp fall in the bargaining power of labor; and rising inequality. This inequality was driven by a decline in real wages for mostly blue collar workers, who now had to compete with lower cost offshore centers. This meant communities that depended on those jobs saw declining standards of living and rising unemployment and crime, further compounding the sense of being left behind. The response of policymakers to recent crises helped support one of the largest bull markets on record, again helping the owners of capital and creating a recovery perceived to have benefited the few at the expense of the many. Immigration has given disillusioned voters an easy target for their anger and a focus for opportunistic politicians and ideologues. All of this has led to the rise of populism, which is likely to gather further momentum.

**Trade and inflation pose risks**

So what are the implications for markets? First we should assume that the current tensions between the USA and China will continue, but any economic impact would likely be offset by Chinese fiscal stimulus. Beyond trade, the main risk we see is around inflation. Investors have been conditioned to believe that inflation cannot rise meaningfully and thus neither can bond yields. But this has been a unique period in history and current populists, if left to their own devices, would clearly pursue policies that would reverse many of the disinflationary forces of the past 30 years. Combined with high debt levels and an unsustainable fiscal trajectory, this creates a key risk. To be clear, we are not forecasting such a scenario. We are simply pointing out an asymmetry of market pricing. A rise in global inflation expectations to levels that were normal before 2007 would likely result in a material repricing of asset markets.

Were such a risk to materialize, it is likely that the bond/equity correlation would reverse, which would reduce diversification in portfolios, and real assets like commodities and Treasury Inflation Protected Securities (TIPS) would benefit. To be clear, we are not likely close to a real inflation shock, and it would probably need a severe economic slowdown to happen. However, buying cheap inflation protection when it is available makes sense. As populists favor fiscal expansion, the equity markets of countries most able to provide this stimulus should outperform, which at present means the USA and China. China is clearly not populist, but the government has the ability and willingness to use fiscal stimulus, which is also its main defense against US trade tariffs. We favor being short duration government bonds in the Eurozone vs. the USA.

**Demographic shifts**

In addition, population aging is continuing, and the baby boomers will soon start focusing their spending mostly on healthcare. This will be a drag on growth and a strain on healthcare and social security programs, and will have to become a key focus of policymakers and a further challenge to the fiscal situation. We suggest owning select parts of the healthcare sector, which should benefit from increased demand as the baby boomers age, as well as parts of the tech sector that aim to automate and lower costs in healthcare as well as improve the patient experience in old age. Our Silver Economy Supertrend is a good way to position for this shift.

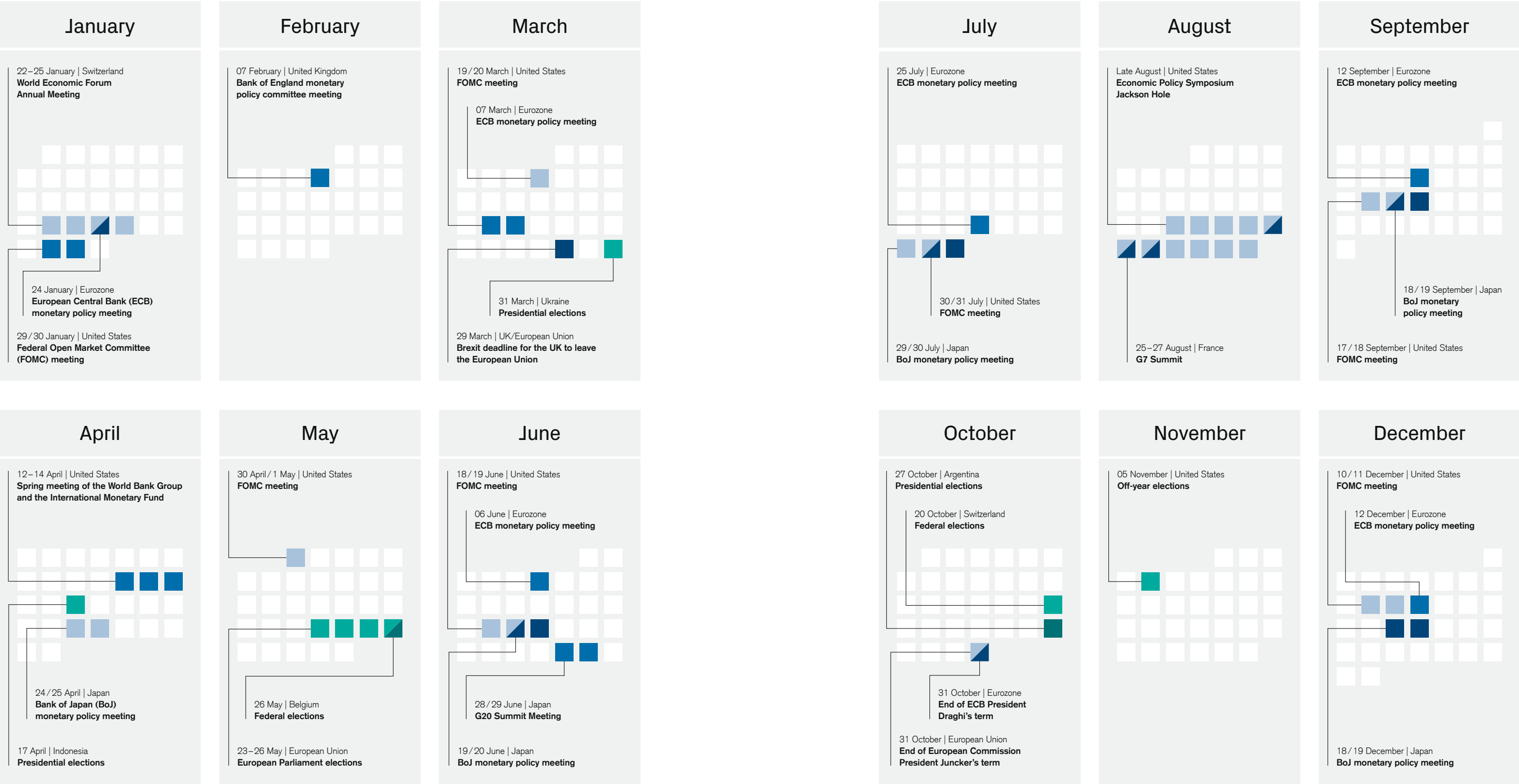


# Milestones 2019

summits & meetings

elections  
(presidential & parliamentary)

**Note** Not all central bank meetings are listed.



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## Risk Warning

**Every investment involves risk, especially with regard to fluctuations in value and return. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income.**

For a discussion of the risks of investing in the securities mentioned in this document, please refer to the following Internet link:  
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Commodity transactions carry a high degree of risk and may not be suitable for many private investors. The extent of loss due to market movements can be substantial or even result in a total loss.

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