

Editorial



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After a sustained and record-setting stock market rally in the US, signs of recovery in Europe and improved economic indicators accumulating globally, 2017 so far appears to be the year that could finally “break the curse” of the sluggish growth, not to mention the political

and economic instability, we’ve seen in recent years.

With Macron’s victory in France, and economic indicators out of Europe showing increasingly strong vital signs, fears of a Euro collapse or a break up of the EU slowly but surely have faded into the distance. The French election gave Europe some time to regroup from the Brexit fallout but also presented a rare opportunity to heed the public will throughout the continent and move forward with the necessary reforms. It remains to be seen if and how meaningful changes towards an open market will materialize and whether the EU leadership will practically acknowledge the need for deregulation on a member-state level. If they fail to

do so, and insist instead on further centralization, this period of renewed public support is unlikely to last very long.

For now, however, morale is high and expectations even higher, with improved growth forecasts for the Eurozone in the coming months. European markets are now catching up with their US counterparts, which they had underperformed for the last eight years. This shift presents both numerous investment opportunities as well as strategic dilemmas which we’ll cover in this InSights. We will also take a closer look at the European equity markets versus their US counterparts.

Our short- to mid-term outlook at BFI Infinity, has become more optimistic, as we believe that we are indeed entering a more stable period for the global financial system, and possibly a return to more solid economic growth. However, it is also our view that the recovery is still fragile and we remain vigilant of all relevant developments in the markets, as well as potential political and economic risks. Through a calm, detailed and balanced assessment of the facts, our focus always remains fixed on the timely adaptation and optimization of our positions and on offering meaningful advice to our clients, according to their individual portfolios and personal goals.

In the Limelight: French Election

We look into the political and economic implications of Macron’s victory in the French election, and examine its impact on the future of the country, as well as on the EU at large.

US vs. European stocks: A turning point?

Our analysis of the European market recovery, the expectations over the coming months and our assessment of the corresponding investment implications and opportunities.

Our Perspective

Daniel Zurbrugg, CEO BFI Infinity

Overview

After last year's Brexit upheaval and the surprising victory of Donald Trump in the U.S. election, it was clear that the presidential elections in France would be one of the key political events of 2017. Although earlier in the year, Francois Fillon and Marine Le Pen were expected to be the two top candidates, it was finally Emmanuel Macron who fought and won against Le Pen. At first glance, Macron's landslide victory might look like a surprise underdog win. Yet upon closer inspection, it becomes clear that it was almost inevitable. The 39-year old, charismatic and moderate "outsider", arguably won this election largely due to the lack of a better choice. Most French voters firmly rejected the traditional, established parties and eliminated them from the race in the first round already, then simply voted for Macron as the only way out of the "imponderable" scenario of a Le Pen Presidency.

A new president for France, a second chance for the EU

Although Macron's victory was welcomed with a sigh of relief, especially among the established parties in France and in Europe, the political and economic challenges that now await the young new President are quite formidable. It remains to be seen how successful his reform agenda will be, as well as his plans to improve economic growth and create jobs, while carefully rationalizing and deregulating the domestic economy and job market. What is, however, clear is that his victory was a blessing for the once uncertain future of the EU, as his vision of a stronger, united Europe was one of his key campaign points. As the German elections in autumn are also expected to confirm and solidify the support for the Union, it would seem that the tide for the recently embattled EU has turned.

Nevertheless, it is important to remember that public opinion is always in a state of flux, and it would be wise for the EU leadership in Brussels not to grow complacent over the recent votes of confidence. In order for the European Union to survive in the

long-run, it needs to reinvent itself, to learn the lessons from Brexit and take notice of the public will for change and meaningful reform that remains strong throughout the continent. Priorities and policies need to shift towards a competitive open market economy and this will require further steps to deregulate the national economies of individual member states.

The political turmoil in Greece and Italy are good examples of how pressing the need for a policy change is. After years of austerity and cost cutting, the people are simply not willing, and arguably not even able, to make more sacrifices. While fiscal discipline will remain an important priority on the EU's agenda, there needs to be a more balanced approach going forward. Otherwise, support will once again wane for the European Union.

Improved outlook for Europe

For the next six to twelve months, the outlook for Europe has significantly improved and it is therefore no surprise to see that European equity markets have outperformed U.S. markets by around four percent since the start of the year. Given the rather large valuation discount that European markets have compared to their U.S. counterparts, we expect continued outperformance of the former. This is especially true from the view point of U.S. Dollar-based investors, who can now use a still strong Dollar to purchase relatively cheap European equities in Euros. Thus, we feel that the investment case for European equities and other international markets is currently very strong and for U.S. Dollar-based investors, it might be a very attractive opportunity.

A silver lining for the global economy

Over the last months, we have seen significant signs of improvement in the global economy, a trend that has been gaining momentum in recent weeks. Apart from the recovery in Europe, we are also seeing an improving situation in most parts of the world. Such good news, of course, has not gone unnoticed by

Central Banks and it is already influencing interest rate policy decisions. As monetary stimulus has snowballed over recent years, it is difficult to precisely assess just how dependent the economy has become to these policies. With Central Banks now starting to move towards higher interest rates, it will be challenging to predict how high they can go before they threaten to once again stifle economic growth. In our view, today's economy and financial system are still fragile and thus a significant increase in interest rates could have a devastating effect on economic growth.

However, Central Banks are well aware of this challenge and will likely be very careful with rate hikes. Although we expect overall higher interest rates going forward, we believe that Central banks will generally stay "behind the curve" and increase rates at a slower pace than they did in previous economic cycles. What we also expect is that governments worldwide will opt for more fiscal stimulus programs to revive and support growth. The economic agenda announced by U.S. President Trump, clearly goes in that direction. As other countries are already starting to follow suit, a distinct shift begins to emerge, from monetary stimulus toward fiscal stimulus, despite already high levels of debt in many countries.

It is our position that although the outlook for the global economy has somewhat improved, a lot of uncertainty still remains, especially with regards to the longer-term view. With faster economic growth in the short-term, we also expect profit growth of companies to improve. This should continue to support equity markets in the coming months, even as rates might move higher. Given that a lot of

companies today are very lean and highly efficient, we think that corporate profit growth might even surprise to the upside. In our view, international markets and European markets in particular, now present much more interesting opportunities than in the U.S. and the timing is excellent to factor this shift into an investment strategy. Despite a slight appreciation in recent weeks, the Euro is still trading at very low levels and might now have some very solid recovery potential, which makes the investment case for European markets even more compelling.

Outlook and expectations

After the strong start that equity markets had so far this year, we would not be surprised to see a deceleration during the summer. In fact, it would not be unusual to see even a slight correction in coming months, as has often been the case in recent years. Overall, as long as markets remain well supported, we would see any consolidation or small correction in the coming months as a prime opportunity to build up positions. Of course, risks are always out there and some of them are harder to manage than others. That is why we continue to recommend a well-diversified global portfolio, with some allocation to precious metals and alternative investments, as an optimal way to ensure wealth preservation, stability and overall resilience.

In the Limelight

French Elections: Europe gets a second chance

On the 7th of May, the French voters handed a landslide victory of 66.1% to the centrist independent Emmanuel Macron, assuaging the widespread fears of a last-minute, Trump-like surprise win of the right-wing Marine Le Pen. Her Front National trailed behind with 33.9%, and yet, the real losers of this election were the established, traditional political parties, which were already banished by voters from the Élysée Palace in the first round.

Redrawing the French political map

As the populist tide still retains its momentum from last year, the widespread anti-establishment sentiment also made its mark on the French election, as evidenced by the first round. The two major political parties, the Republicans and the Socialist Party, that had monopolized French politics for nearly half a century, were overwhelmingly rejected by voters, in a table-turning moment in modern western politics. The public made it clear that they need new ideas, new faces, and a new vision for France. Hence, they opted for the 39-year old former investment banker who served as Minister of the Economy under President Hollande, a relative newcomer to party politics with his 13-month-old “En Marche!” movement.

Despite the sensational campaigning and the heated debates, Macron’s lead since the first round suggested that the public had been successfully “tempted away” from Le Pen’s nationalist agenda. His tempered policy platform, his profile and the support he has received from the media and from established mainstream politicians throughout Europe have positioned him as the “way out” from a Le Pen presidency. To many voters, this appears to have been reason enough to support Macron. The accusations of intolerance, racism and divisiveness that plagued the Front National throughout the campaign, might have ultimately cost them the presidency.

Markets rooting for Macron

The results of the first round were welcomed by the markets, pushing the Dow Jones and S&P indexes

upwards. But it was the French stock market that made a real comeback, with the CAC 40 up 4.5%, reaching its highest level since the 2008 crisis. The Euro also jumped to a 5.5 month high against the dollar, while French bonds rose as well. This “relief rally”, was interpreted as sign that investors trusted the moderate, former Rothschild banker to steer France during these turbulent times more than Le Pen and her controversial agenda.

However, the reaction to Macron’s actual final victory has been rather muted. Markets had already priced in the election outcome, as the polls following the first round consistently put Macron comfortably in the lead, thereby limiting the potential for a more significant relief rally.

A look behind the scenes

A central theme in these elections was the country’s relationship with the EU, putting scenarios of a potential French withdrawal from the Union on the table, as Le Pen promised a referendum on the country’s EU membership. Macron’s platform was instead built on his faith in a united Europe. However, only days before the final vote, Macron’s opinion on the EU “evolved”: He acknowledged the public’s anger towards the EU, stressing that a so-called “Frexit” is an option for him too, if the Union fails to reform. Whether this was merely an eleventh-hour political maneuver to attract voters from the Eurosceptic block, or an actual indication of his Presidential approach to the EU, remains to be seen.

Le Pen, in her last minute attempts to attract voters from the undecided pool and from defeated candidates, toned down her plans to drop the Euro, as she focused her rhetoric against Macron. She referred to him as “the candidate of finance” and as a banker working against the interests of the French people. On top of this offensive from the Front National, came the massive and coordinated hack of the Macron campaign just hours ahead of the final vote, leaking internal emails and other sensitive documents. And yet, neither Le Pen’s attacks, nor the leaks, were able to halt Macron’s momentum.

However, Macron is now inheriting a deeply divided country. Le Pen may have lost, but as the Economist pointed out, “she still set a Front National record, nearly doubling the score her father achieved. Her party, and populism, will continue to weigh on French politics.” And then there is also the sizable block of those who were dissatisfied with both options, as more than 25% of French voters abstained from the election altogether. This translates into 12.1 million registered voters who stayed away from the polling stations, or 15.5 million if we include those who voided their ballots, outnumbering the 10.6 million votes cast for Front National and arguably making “discontent” the second biggest party in France.

The day after

The markets’ initial interest in the French election was focused on the potential political implications and the risk that it could bear not only on the French economy, but on the stability of the EU itself, just when economic conditions appear to move towards normalization. However now, after the election, the focus will have to revert to the fundamentals: Macron inherited an economy with a public debt-to-GDP expected to reach 124% this year, an unemployment rate of 10% and a stagnant economy.

Thus, it could become a bumpy transitional ride for the new President. His promise to shrink the public sector and loosen union laws, already faces fierce opposition from the blue-collar voting block and

the strong French unions. He has also promised €50 billion in public investments and an increased defense budget, along with big cuts in corporate taxes, a policy mix that could lead to more debt piling up.

France is indeed making its own mark in the turbulent European political environment and this election has already made history with the absence of any traditional parties in the second round. And while a number of challenges might lie ahead for Macron, it is still important to remember that the political and economic ramifications for both France and Europe would surely have been strikingly different, had Le Pen won.

It is therefore no surprise that Macron’s victory was met with a sigh of relief around the world and widely seen as a sign that France and the EU are now finally out of the woods; at least for now. Even though it still remains to be seen how the much needed EU reforms will materialize, in an investment strategy context, it seems that Europe has turned a crucial corner. As we don’t expect any surprises in the German election in September either, the EU leadership has now at least gained some time to address the fundamental, institutional problems it faces. Thus, with de-escalating political risk and an increasing sense of normalization, both politically and economically, the Old World currently makes a compelling case for investors.

US vs. European stocks: A turning point?

The stock market carnage of the annus horribilis that was 2008, has earned its place in the history books and in our collective memory as the crisis that brought the global economy to its knees. The US subprime lending meltdown triggered a worldwide contagion that saw multiple bank failures and dramatic nosedives in the value of stocks and commodities around the world. In the US, 15 banks failed, while others were saved through government bail-outs or acquisitions by other lenders, while the major financial markets lost more than 30% of their value, leading Dominique Strauss-Kahn, the then-head of the IMF, to proclaim that the world financial system was “teetering on the brink of systemic meltdown”. By all accounts, it seemed to be the end of the world as we knew it and there was no stock level too low to be predicted and accepted by the media. A similar, albeit more contained, doomsday narrative emerged again in 2011, when the EU crisis reached its peak. Once again, stocks dove, panic set in, and gold reached its record high on September 5th, at USD 1'900 USD.

Where we stand today

Since the last market earthquake, little has been done to enforce any of the necessary structural reforms that would help prevent the next meltdown déjà vu. Instead, much was done to create huge liquidity and to keep interest rates down. “Kicking the can down the road” has been the underlying principle of the policy direction adopted by governments and Central Banks around the world. Short-term patchwork solutions have proven to be favored by politicians, who have little incentive to enforce the drastic changes needed in order to address the systemic problems.

This postponement of the inevitable does buy (or rather borrow) some time, but it also creates misallocations and triggers the formation of new bubbles. We see clear evidence of this today, in the dangerous market distortions created by the artificially low interest rates; In the US, as an example, stocks run wild while the fundamental problems of the economy and the US debt levels are much worse today than they were during the last

crises. The policy of low interest rates has forced return-starved investors into the stock markets, one of the few options left in such a hostile investment environment.

Strategic crossroads

After one of the most significant bull markets in the US market's history, the question on investors' minds is “Should I stay or should I go?”. Is now the time to sell before the next crash hits, or is this an opportunity to “double-down”, increase stock positions and take advantage of the positive momentum? This is a legitimate and quite pressing dilemma, in the midst of elevated stock valuations and ever-increasing economic and political risk.

In such a critical crossroads point, it is wise to stay calm, avoid any knee-jerk reactions and instead take a more holistic view. While it is easy to develop an investment “tunnel vision”, the more prudent approach would be to assess all the available options, always through the lens of one's own, personal goals, expectations and risk tolerance.

Case in point: with US stocks close to all time high, it is natural to look for better opportunities elsewhere. European stocks have underperformed the US market for the past eight years. Since the lows in March 2009, S&P 500 has risen by 246% compared to the Eurostoxx 50, which is up by only 135%. Also, European stocks are currently traded at around the forward price-to-earnings ratio of 15,00 compared to a P/E of 18,40 in the US. Even more favorable for European stocks is their price-to-book comparison to their US counterparts: The Eurostoxx 50 stands at a forward P/B of 1,78, whereas the S&P 500 P/B ratio hovers around 2,86.

The main reason for the strikingly different performances between the US and European markets is the political uncertainty which was and still is being perceived as higher in Europe than in the US. However, this monocausal risk assessment approach appears to ignore the vulnerabilities and fundamental problems that are present on both sides of the pond. Specifically in the US, unfunded

Figure 1: Comparative historical performances of Stoxx 600 and S&P 500



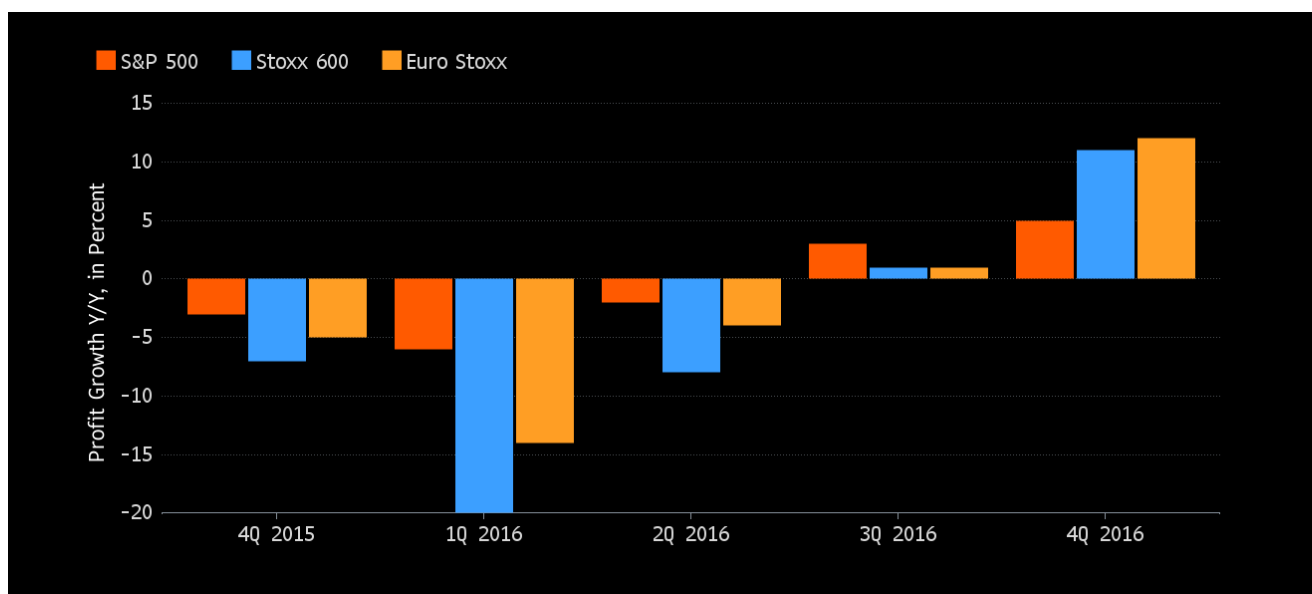
Source: Bloomberg

state pensions nationwide have risen since 2005 from \$339 billion to nearly \$1 trillion, while student loan debt is spiraling out of control at \$ 1.4 trillion with an increasing number of defaults. Household debt rose to \$12.6 trillion in 2016, up \$460 billion from 2015, the highest increase in a decade. Subprime car loans have long been touted as a prime candidate for the next crash, as auto loan debt exceeds \$1.16 trillion. In a disconcertingly similar trend to the housing bubble, subprime auto loans have been ballooning in recent years, while the

corresponding delinquency rate is now at its highest point since the aftermath of the 2008 crisis and car sales in the US have already started to decline.

Contrariwise in Europe, since bottoming out in 2016, the growth forecasts have improved for the continent's largest economies and the Eurozone as a whole. As seen in the chart below, the tide has also turned for corporate profit growth and the earnings growth expectations for European companies are now outpacing those for the US.

Figure 2: European companies profit growth overtakes their US counterparts



Source: Bloomberg, JP Morgan

As for the political uncertainty factor, it is important to remember that this is a risk that not only weighs on Europe but also on the US. In fact, after the election results in the Netherlands and most recently in France, the fears of political instability and Brexit-like surprises appear to be de-escalating. By contrast, in the US, the Trump factor is still a “known unknown”, as there is no way of telling which of his campaign promises will survive the fierce, uphill political battle and in which form they will materialize.

Investment implications

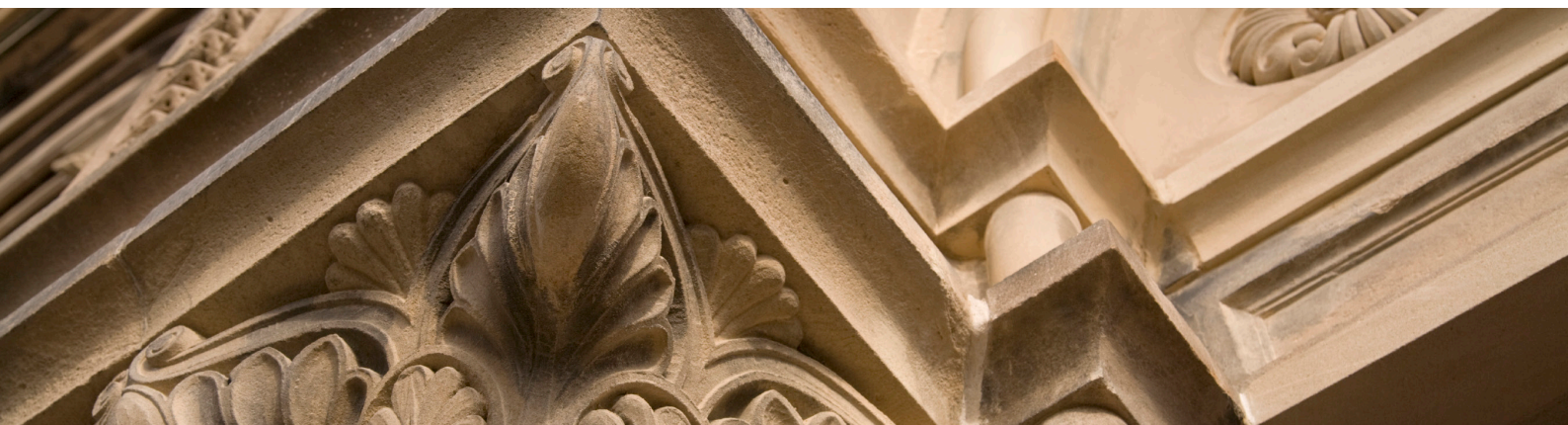
The appropriate assessment of all these factors depends strongly on each individual situation. For an investor who is looking for wealth preservation over the long-term, radical investment changes are in general not advisable and can often be counter-productive.

It is our view that equities should be still part of the overall asset allocation. However, because of the levels stock markets have reached in general, the percentages of equities in a given portfolio might need to be reviewed and fine-tuned accordingly. Moreover, at a time when bonds bear more risk than reward potential, an increase in proven alternative

strategies which have little or no correlation to the stock and bond markets could very well be the right move for some investors.

As for the US versus Europe dilemma, there are several factors to consider. For example, because of the huge risk premiums in Europe, the weighting between US and European stocks might have to be examined. Due to a strong US Dollar and an outperformance of the US stock markets, international diversification for a US investor has often been disappointing in the last years, as the international investments underperformed the US investments.

However, this is how diversification works. It is the underlying principle and the very mechanism that secures wealth preservation over time: While one side might now be outperforming the other, the tables can, and historically do, turn over a longer time horizon. In fact, we might just be entering such a table-turning period, where non-US investments outperform their US counterparts. The concept of jurisdictional diversification and global investment diversification worked for decades in the past and we are confident that it will continue to do so for the foreseeable future as well.



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