

## CEO Corner

### “Mid-Cycle Slowdown” after 10 years of growth?



Daniel Zurbrugg  
CEO BFI Infinity

Our readers will remember that in the [July edition of our BFI Infinity InSights](#) investment update, we talked about the sharp reversal of expectations for the global economy. We also anticipated the immediate reaction from central banks that have in the meantime started to lower interest rates again. At the same

time, the voices calling for yet another round of quantitative easing are becoming louder. In this issue of the InSights, we want to look at the economic cycle and where we currently stand. As the title above indicates, we'll also examine whether the language that the Federal Reserve recently used to describe the current economic slowdown accurately reflects the present situation. The central bank called it a “mid-cycle slowdown”, which indicates that they expect it to be temporary. However, there are clear signals that suggest we are in a late-cycle environment, as the economic expansion stage is very advanced and thus a slowdown is likely.

The US-China trade issues, as well as the Brexit saga, have long been hanging over our heads and still remain unresolved, while the increasing uncertainty of the recent past is clearly casting a shadow on the future. This is reflected in the broad-based evidence we are getting from economic indicators showing that the global economy is indeed slowing down. Although the World Bank recently revised down its global GDP forecast to 3 percent, even that number might still look a little high in our opinion. Global GDP growth of 3 percent simply means that, besides China and India and a few other emerging markets, there is just very little growth left in developed markets, including Europe and the U.S.

Central banks are trying very hard to stimulate the global economy by cutting rates again, but the question that remains is: is it really going to help? And should central banks really cut interest rates to zero or even into negative territory? Our answer here is a clear NO to both questions. The problems of the global economy are unlikely to be solved through interest rates, but through the structural reforms that are sorely needed.

In this regard, the trade tensions clearly represent a step back rather than forward and it remains to be seen whether a solution will be found for this problem. In recent weeks, there is increasing hope that the US and China will at least reach a partial agreement, yet it is still questionable if a firm deal is going to follow. A clear resolution to the US-China trade tensions would be a strong positive signal, and even though we believe that trade issues are going to be a permanent problem in the coming years, in the short-term, the global economy would still benefit from a deal and financial markets would be quick to show a positive reaction to the news.

We are somewhat surprised that despite the overall weakening outlook for the global economy, so far fears of a recession in 2020 are still quite subdued. Even the Federal Reserve, despite its sharp reversal in monetary policy, has gone to great lengths to reassure investors, with Chairman Powell describing the US economy as being in “a good place” and of course, calling the current phase a “mid-cycle slowdown”. In an economy that has seen the longest economic expansion in recent history, it is hard to believe that this broad-based slowdown we're seeing is only a “mid-cycle” and temporary phenomenon. Even if it is, the lower interest rates and the sentiment boost resulting from a potential resolution to the trade problems are unlikely to lead to any significant improvements until maybe mid-2020 and this means that there is still a probability of a recession in early 2020. Nevertheless, equity markets continue to hold up really well and volatility has retreated back

to very low levels in recent weeks. Overall, the market does not seem to be too bothered about slowing growth, declining earnings and downward revisions to earnings expectations.

This begs the question: What could cause equity markets to fall sharply in coming weeks and months, if anything at all? Or are equity markets so dependent on monetary policy support that investors will simply continue to ignore the risks and hope that central bankers will come to the rescue once again? These questions are keeping us busy and have certainly led to some very intense discussions at our investment committee meetings. For now, we have decided to stay more defensive and to continue to allocate our investments very carefully.

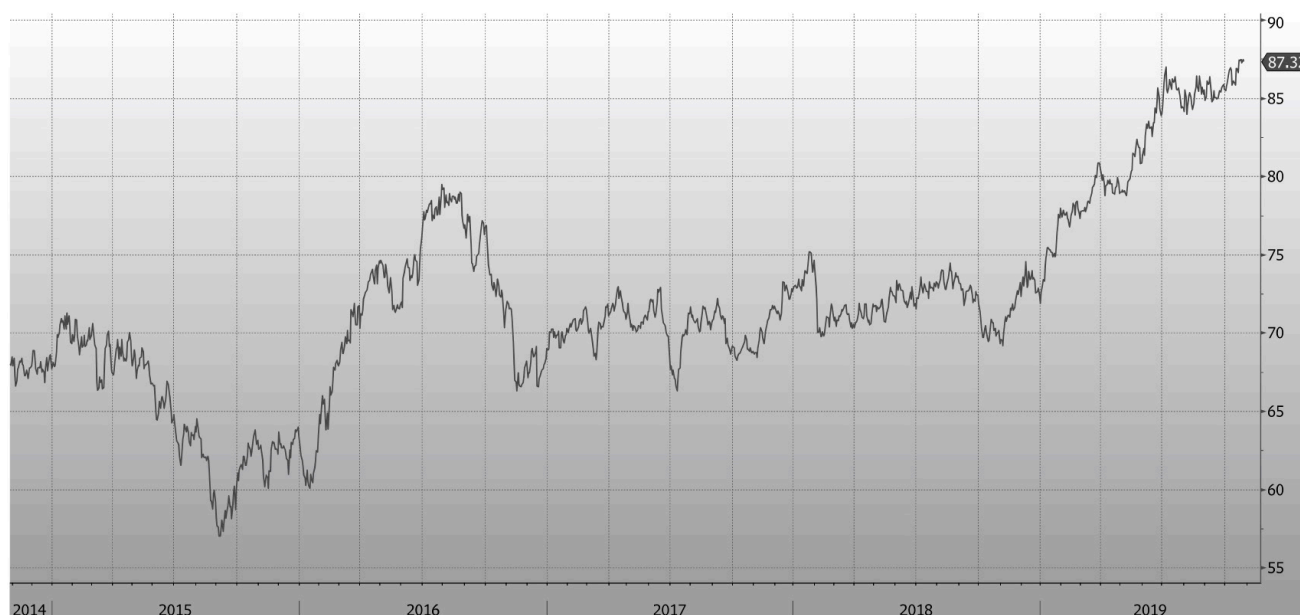
With regard to our equity investments, we have decided to remain invested in conservative sectors such as healthcare, consumer staples and utilities for the most part, sectors that tend to do well during times of economic weakness. We simply feel it is too early to become more aggressive and allocate to more cyclical sectors again. On top of the conservative allocation, we have also decided to keep our positions hedged for the time being. This simply means that even if there is an equity market correction in the coming months, our clients should not get affected, yet they'll still be able to

participate in the upside to some extent should there be a positive surprise in equity markets. We feel very comfortable with this position, because the risk-return trade-off seems to be heavily skewed to the downside in our opinion.

Our conservative approach is also reflected in our other asset classes. We continue to focus on USD denominated bonds of the highest credit quality and are also long precious metals, gold in particular. We continue to believe that gold has further upside potential in the coming months and the recent move to the USD 1500/oz price level and the subsequent support around this level is a very bullish signal in our view. We also remain positive for the other precious metals.

This current market environment is once again giving investors the chance to look for opportunities in alternative investments. For us, the main holdings remain hedge funds, especially in the L/S sector and Asian REITs, mainly specialty REITs with long-term stable cashflows and profit margins. It seems that investors have recently discovered this asset class and there were significant inflows of new capital into this area, which is not surprising, considering the current environment. Stable long-term cash-flows, strong profit margins and attractive dividend distributions are very appealing to investors given the uncertain outlook for 2020.

## Stoxx Asia Pacific REITs Index



Source: Bloomberg

Readers might notice that so far we haven't mentioned the never-ending Brexit saga. This is because we feel it has almost become a non-event for financial markets. It might eventually have some effect on the pound and maybe the Euro, but we doubt that it will have much of a meaningful influence at all. We also don't want to speculate about the eventual outcome, as anything seems to be possible at this point, even a new referendum. But again, we don't think it is all that important anymore.

While 2019 has been a very positive year for us in terms of investment performance, we will start the next year with a careful approach and will wait to see if the outlook improves. Of course, 2020 will be an important year, as we are already starting to look out for the presidential elections in the U.S. that will certainly have a strong influence on financial markets. It is too early to talk about these elections and speculate about the eventual outcome, but we are certainly going to cover that in one of our next BFI Infinity InSights as we get closer to the election date.

With that being said, we would like to wish all of our readers a good finish to 2019 and already convey our best wishes for a great and certainly very interesting 2020.

## Preparing for the next paradigm shift



Dirk Steinhoff  
Chief Investment Officer

Over the last few months, we have witnessed a few noteworthy changes in the markets, in most major economies and in the policy direction of key central banks. Economic data and indicators out of the U.S., the euro area and China have shown increasingly signs of

weakness, while the Federal Reserve has completed a 180 degree turn in its monetary policy stance and joined its peers in adopting a supportive policy direction. Equity and bond markets showed in Q3 increased short-term volatility, but ended the quarter mostly positive.

While it is true that current and leading economic indicators fueled fears of a recession in many investors' minds, a more nuanced and comprehensive approach is arguably best suited in order to fully understand where we stand today and to form our expectations of what lies ahead.

In a recent analysis, entitled "Paradigm Shifts", Ray Dalio outlined some of the key principles and factors

that investors should consider during periods of change and turning points in the economy and in financial markets. These paradigms, he observes, are always driven by large-scale and unsustainable forces, such as excessive debt-fueled growth, that go on for so long and so extensively that most investors become complacent and eventually overstretched. Thus, when the "tipping point" is reached and the paradigm shift occurs, many are caught unprepared.

### Signs of a "gear change"

It can be argued that we are now on the verge of such a shift. After a decade of extremely accommodative monetary policies, heavy corporate borrowing and a historic bull market in the U.S., we now begin to observe signs of investor anxiety and indications of economic weakness in the world's largest economies.

In the U.S., although consumer spending has remained at relatively high levels, recent manufacturing and services data point to a wider slowdown. At the same time, extraordinarily high corporate debt levels are raising widespread concerns. According to research by Blackrock, U.S. corporate debt as a percentage of GDP now stands near 47%, a spike that caused the International Monetary Fund (IMF) to issue a stern warning in mid-October arguing that

U.S. corporate debt to GDP at record highs



Source: Bureau of Economic Analysis, Federal Reserve, BofA Merrill Lynch

action is “urgently” needed to stave off the risk of a meltdown in the corporate sector that could spread to the banking sectors.

As for the Federal Reserve, it has completely reversed its stance since the beginning of the year and its attempts at quantitative tightening and a more hawkish interest rate policy are now distant memories. Instead, the U.S. central bank delivered yet another interest rate cut at the end of October, even though many economists and analysts argue that the need for one is highly debatable. As for its asset purchases, while Fed officials have been very careful not to use the term QE, the bank did unveil a plan to expand its balance sheet once again. The move, meant to stabilize the repo market that experienced wild spikes in September, will involve large Treasury Bill purchases, at an “initial” pace of \$60 billion a month.

Over in Europe, recent economic data out of Germany, the powerhouse of the euro area, have largely justified the widespread recession concerns. After nine successive years of growth, the economy is expected to contract again in the third quarter as it did in the April-June period, officially placing the country in recession territory. Additionally, although the IHS Markit measure of manufacturing and services rose slightly in October, it is still clear that the slowdown will persist into the fourth quarter. Employment in industry fell to a 10-year low, while consumer sentiment sank to its lowest level in three years. Naturally, the uncertainty surrounding Brexit and the US-China trade war have largely been blamed for the decline in the export-dependent German economy.

In the meantime, other key economies in the bloc also face significant headwinds. In September, Spain, the eurozone’s fourth largest economy, posted its weakest job creation numbers in six years, according to the nation’s labor ministry. In April, Italy’s economy narrowly exited its third recession in a decade, as it returned to growth in the first quarter of the year. However, it is doubtful whether this growth can be sustained, as most of the challenges and risk factors still persist, not least among them being the fact that the nation is burdened with the largest government debt in the European Union, at more than €2.3 trillion.

Finally, the risks caused by China’s slowdown are also important to consider. In the three months ending in September, the world’s second largest economy grew by 6%, the weakest pace since the country started reporting quarterly data in 1993. Slower growth is largely expected to persist, with the IMF projecting that the Chinese economy could grow by 5.8% in 2020. While it is reasonable to expect a “cooling” stage after a decade of rapid expansion, the impact on the global economy can be severe. The Chinese government has so far held back on aggressive stimulus measures that could exacerbate the country’s debt problem and instead tries to focus more on domestic consumption. This strategy is seen by many economists as prudent, as it sets the stage for the country to expand in a more sustainable way in the future. Nevertheless, the trade war highlighted just how much western economies rely on Chinese imports and it also made clear that a protracted period of lower demand by the Asian superpower could prove very challenging for its trading partners and for the global economy.

## Investment implications

Although the risk of a wider and sustained economic slowdown is considerable, we don’t expect a sudden or extreme implosion comparable to the 2008 crisis. We rather anticipate a more gradual decline, as current central bank policies, potential future interventions, as well as fiscal measures, are likely to dampen the impact of a recessionary period. For instance, it is useful to remember that interest rates are at historic lows and will in all likelihood remain at the same or even lower levels. This is a factor that is bound to soften the blow temporarily, even if global economic data further deteriorate or in the event of a significant stock market correction.

Nevertheless, as we already anticipated in our last issue of the InSights, the market euphoria and the investor complacency that we have gotten used to over the last few years are likely to be reversed, as we do believe that over the next one to two years, we will gradually enter a new phase in the global economy and in equity markets. Thus, we recommend caution and a shift toward a more defensive investment strategy, in order to be prepared for the



## Best-performing assets in different cycle stages

	Recovery	Expansion	Slowdown	Contraction
<b>Sectors</b>	<b>Materials</b> Real Estate Technology	Consumer Discretionary Industrials Technology	Utilities Real Estate	<b>Consumer Staples</b> <b>Healthcare</b> Utilities
<b>Smart Beta</b>	Small Cap Value Large Cap Value	Small Cap Small Cap Value	Low Volatility Quality Dividend	Low Volatility Quality Dividend
<b>Fixed Income</b>	High Yield Investment Grade	<b>High Yield</b> Investment Grade	<b>High Yield</b> <b>Long-Dated Bonds</b>	Treasuries



Source: State Street Global Advisors

potential weakness that could lie ahead. For instance, considering sectors and asset classes with a historically low correlation to equity markets would be an important element in this strategic shift.

A white paper recently released by State Street Global Advisors underlines the advantages of this approach. Having conducted a long-term analysis of U.S. business cycles, the analysts clearly identified the best performing sectors during each of the four stages of the business cycle (i.e. recovery, expansion, slowdown and contraction). During slowdowns and contractions, healthcare and utilities were among the most frequent outperformers, while consumer staples excelled too, as the sector “produced a consistently significant level of return throughout the entire recession phase”.

These results are very much in line with our own approach here at BFI Infinity. With, in our opinion, the major western economies being at the late stage of the expansion phase and China already at the beginning of the slowdown phase, we have already started

to prepare for a potential downturn by adjusting our stock exposure accordingly, while we additionally also hedge our stock exposure to the downside. We have focused on utilities, healthcare, and consumer staples, as we recognize the defensive potential of these sectors. However, a “blanket” approach is, of course, ill-advised. Instead, it is important to identify the most reliable companies within these sectors: those with a strong balance sheet, low debt levels, high operating margins and those with the lowest sensitivity to bear markets.

At the same time, it is also important to understand that adopting a more “defensive” approach doesn’t mean that investors have to compromise or to contend with lackluster performances. To the contrary, there are very attractive opportunities in these sectors, with solid operating margins and a promising outlook. One such company is the BKW Group, a Bern-based international energy and infrastructure company. The Swiss group employs around 8,000 people and it plans, builds and operates infrastructure to produce and supply energy to busi-

nesses, households and the public sector, and offers digital business models for renewable energies. Overall, it is very well positioned and provides a full range of solutions, from engineering consulting and planning for energy, infrastructure and environmental projects, to construction, servicing and maintenance of energy, telecommunications, transport and water networks.

Leroy Seafood Group is another bright example. The Norwegian corporation has a long and solid track record, with a history that stretches all the way back to 1899. With 4,500 employees, Leroy's core business is the production of salmon and trout, catches of whitefish, processing, product development, marketing, sale and distribution of seafood. Every day, the company delivers seafood corresponding to five million meals, in more than 80 different countries, while it has production and packaging plants in Norway, Sweden, Denmark, Finland, France, the Netherlands, Portugal, Spain and Turkey, as well as sales offices in the U.S., Japan and China.

Overall, while we remain cautious, we have also factored into our strategy the possibility that, especially in an election year, governments and central

banks could manage to give the stock markets an extra boost. Additionally, our outlook is also positive on precious metals, as we explained in a recent [article on the topic](#). Finally, on a more general note, while we do see U.S. equities as being relatively expensive at the moment, we don't see this as universal phenomenon. The valuations of the European and Asian markets are much more moderate and we believe they still present many opportunities at very attractive levels.



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