Prime Partners

SINCE 1998

MARKET INSIGHT

FEBRUARY 2018

Market Analysis

The year is off to a flying start

January 2018 is looking like a good month for risky assets, continuing the trend of the second half of 2017. Risk appetite has remained strong among investors. Indeed, economic data continues to point to a robust upturn. The World Bank has therefore upgraded its growth forecasts for 2018. Moreover, corporate earnings for the last quarter of 2017 were outstanding, as illustrated by the US, where 75% of companies beat the consensus for earnings growth. That being the case, the attraction of equities for investors is understandable, particularly as a gradual normalisation in monetary policies does not seem to pose any real danger. In fact, central banks' tapering of liquidity support for financial markets should remain limited in the coming quarters.

> "We have not succumbed to the wave of optimism seen in recent weeks."
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

At first sight, the overall climate looks favourable for risky assets and it can be seen as justification for recent stock market rises. Yet this needs qualification in the light of two major developments in January, namely the upward pressure on bond yields and the weakness in the US currency across the board. These two phenomena may serve as a wake-up call from the optimistic climate of recent weeks.

As far as the dollar is concerned, we have to say that its continued slide has taken us by surprise. Not that we are positive as regards the US currency, but we were counting on a less turbulent start to the year. The EUR/USD exchange rate testing 1.25 in January simply confirms investor mistrust of the dollar, which has been growing since 2016. One might even ask if the bearish consensus on the greenback has not gone too far!

We remain inclined to believe that the trend will remain bearish for the dollar in 2018, but that its downside potential is now more limited. However, should we face the currency war feared by some (see Mario Draghi's recent remarks) we will have to envisage the EUR/USD testing 1.30 in 2018.

We are not yet at that stage, but it is a risk that cannot be ignored. Excessive exchange rate fluctuations could disrupt the favourable economic and stock market cycles currently anticipated by the consensus.

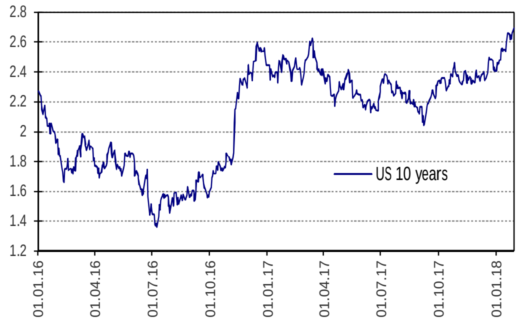
The rise in bond yields is another worrying sign, as 10-year dollar yields topped 2.70% at the end of January, which is practically double the level seen in July 2016. This pressure is far from trivial in an environment where there is no medium-term funding for Trump's tax cuts and the issue of the US debt ceiling remains unresolved. The rise in yields takes the wind out of the sails of global stock markets, as the US has pulled all government debt along in its wake.

While stock market investors have weathered this development, it is reasonable to assume that a continued rise in yields will have an impact on stock prices. We believe that the current move will push US 10-year yields above 2.8% in the coming months. This should induce a consolidation of equities after the rise chalked up by the major indices over the last 18 months!

Given what we have said so far, you will have gathered that we have not succumbed to the wave of optimism seen in recent weeks.

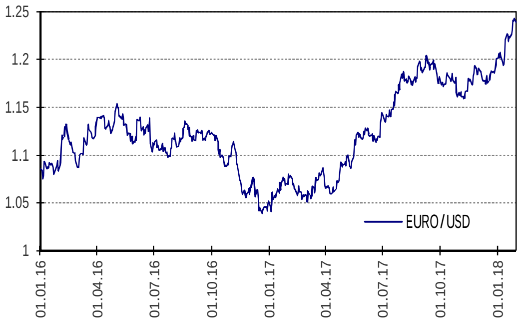
We remain cautious regarding the rise in risky assets. In this context, a look at stock price charts clearly shows that the main indices are at overbought levels, particularly in the US.

US 10 years: on path to 3%?



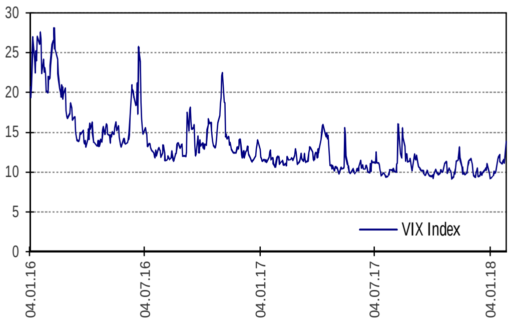
We have not reduced the defensive bias of our tactical allocation; on the contrary, we have taken advantage of the recent upward move to lighten our exposure to the equity risk in the portfolios. We thought this move justified due to a solid performance of our portfolios in 2018.

Dollar vs Euro: the recent fall seems excessive



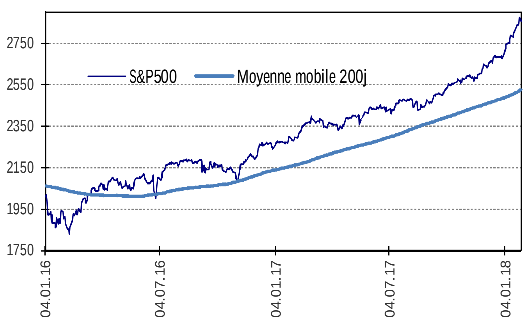
As far as our regional allocation is concerned, we have held the course, favouring Japan, Europe and emerging countries over the US and UK. In January, we decided to take on greater yen risk exposure in our investments in Japanese securities. The Japanese currency could benefit from better domestic fundamentals and reverse the bearish trend of recent years. In addition, against the backdrop of a potential rise in stock market volatility, the yen could serve as a safe haven, in line with its behaviour in the recent past.

Volatility: is an uptrend taking place?



Our bond strategy remains unchanged, with flexibility still the key characteristic. Our focus is on tactical strategies. We continue to overweight emerging debt and could increase this exposure further during the coming weeks. We remain more cautious on the corporate debts in developed countries.

US equities: obvious technical overbought conditions



Overall we maintained our holdings in alternative assets built up in the second half of 2017. Note that we took advantage of the positive performance of gold in January to lighten our allocation slightly. Our aim here was also to endorse our scenario of a consolidation period in the coming months following excessive losses in the US currency. We remain convinced that gold will test the level of USD 1,400 per ounce in the medium term (end-2018).

In conclusion, we are not sitting on our hands against the prevailing backdrop of positive sentiment in the financial markets. Our allocation adjustments in January illustrate that we remain sceptical as to whether risky assets can continue their recent trend in the coming weeks.

While we have doubts about the short-term potential for equities, we remain convinced of the fundamentals, which remain sound. Yet we believe that the current low level of volatility is unsustainable given the upward pressure on government debt yields. In addition, the uncertainty surrounding exchange rates justifies our slightly defensive bias.

We still consider it is necessary to manage overall risk in the portfolios, particularly as the strong performance in January should not mask one essential fact; the upside potential for equities by the end of 2018 has been reduced accordingly.

Against this background we have replenished our cash reserves to take advantage of the

increasing likelihood of a period of consolidation following recent stock market rises.

We were certainly guilty of a lack of optimism in recent months. Yet after this flying start to the year in stock markets, now is not the time to change course.

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