Prime Partners

SINCE 1998

MARKET INSIGHT

MARCH 2018

Market Analysis

The expected correction is materialising (at last!)

The correction started at the end of January but it really took hold of the financial markets in February, radically changing the general climate seen at the beginning of the year. The charts provided below highlight some salient facts that have accompanied the drop in share prices.

The sell-off was not particularly surprising; in our previous monthly insight we had already expressed reservations about the euphoria gripping investors, confirming our recommendation to underweight equities in a diversified portfolio.

There are two important points worth mentioning now that the correction is here. The speed of the decline may seem surprising if we compare February's events with previous episodes, which lasted much longer. This immediately raises a question: was the markets' rally over the second half of February temporary or part of a sustained trend?

There is something else we cannot ignore: bonds did not provide a safe haven when volatility returned to stock markets. It has been a long time since we last saw such a development. It reflects the start of a new stage in the financial and economic cycle. In other words, the positive downward correlation between equities and bonds proves that the risk of the global economy overheating is now embedded in the minds of some investors.

It seems premature to talk of overheating, but the first signs of inflation picking up should be confirmed over the months ahead. This keeps up the pressure on central bankers committed to normalising their monetary policies.

The inflation issue was crucial in changing investors' attitudes in February. The problem is not that they fear price rises, but that they feel less sure about the path to be taken.

The question of "suitable" macroeconomic policies then becomes a legitimate source of doubt, especially as the easing bias on the US fiscal policy is not without risk – to the Federal Reserve in particular. Investors are now contemplating the possibility of a quicker than expected rise in US key interest rates.

Although we do not believe the economy is overheating, we could yet be entering the last phase in the financial cycle; one that is less favourable over an 18-month horizon. This is another way of saying that the Goldilocks scenario of 2017 is unlikely to continue.

> "Flexibility is more appropriate than ever."
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

Therefore, risk management remains key to allocating portfolio assets. We still believe there is no reason to overweight equities in the current circumstances.

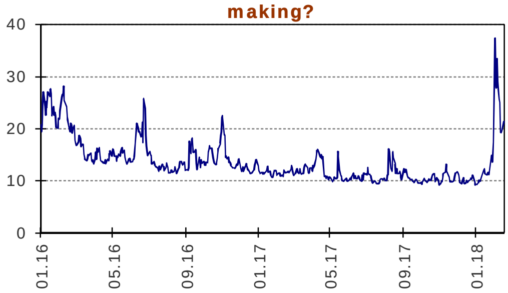
Does it mean that we were unresponsive to the risky asset correction? Far from it.

Firstly, we took the opportunity presented by the recent correction to increase our weighting of equities, changing our positioning from underweight to neutral. To do this, we unwound most of the index hedging that we had added over the previous months.

We also strengthened certain investments to reinforce our regional choices on markets: overweighting Japanese, emerging and European equities at the expense of the US and UK ones.

Our desire to manage the global risk to our allocations led us to build up our alternative investments, especially on long/short equity strategies.

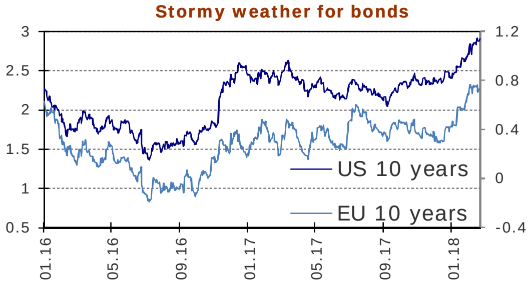
VIX: a lasting upward trend in the making?



This reflects the thought process we have been following for several months, namely that liquid alternative investments merit inclusion in any investment strategy in 2018. The addition of an M&A arbitrage strategy at the end of last year was most satisfying given the performance delivered in January.

To manage risks, strengthening equity positions has meant having to take profits on fixed income – credit in particular. With little upside potential remaining, we reduced exposure to investment grade corporate issuers. This was part of a credit risk reduction policy followed since mid-2017. In contrast, we increased exposure to emerging market debt, the carry on which looks attractive as the macroeconomic fundamentals are improving in the countries concerned. Moreover, this adjustment also allowed us to focus more on the ESG aspect of our investment policy.

Stormy weather for bonds



We continued to work on our thematic equity component. Our favourite themes (robotics, digitisation, US infrastructure, biotech) are unchanged. However, we took advantage of the price drop to diversify our biotechnology exposure, i.e. we added an active management product to the portfolios with a higher risk appetite.

In light of the above, the main bases for our tactical allocation are unchanged, despite some important adjustments.

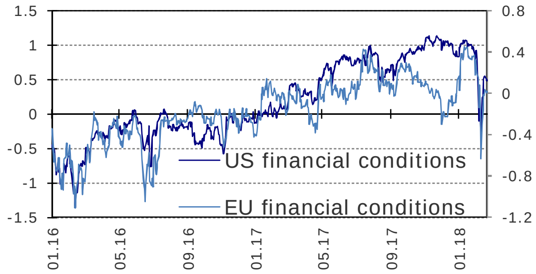
In a nutshell, February's correction came at the right time for us to seize some opportunities. We assessed these in the context of our medium-term fundamental views, which are broadly unchanged.

USD / EUR: stabilisation would be welcome

Financial and macroeconomic conditions justify our preference for equities over bonds. All the more so as we think that a milestone has been reached in getting to the final stage of the financial and economic cycle that began in 2009.

However, although stock indices could still rise towards the end of 2018, a new pattern of volatility, involving more erratic movements in these assets, is likely to take shape from now on. This is a good enough reason not to abandon risk management as a guiding principle of an investment policy.

US & EU: keep an eye on financial conditions!



By way of example, the last few weeks have allowed us to differentiate between the types of risk taken in our portfolios. Profiles with a greater willingness to bear risks have seen their weighting of equities increased relative to more defensive profiles.

To conclude, the renewed volatility and the events of February forced us to act, without undermining our belief in the analysis that we have been putting forward in recent months.

We will remain alert to fundamental developments and we would not hesitate to change course if new factors were to influence our global scenario. Flexibility is more appropriate than ever now that the consensus forecast is wavering.

. Geneva, 28 February 2018

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