Prime Partners

SINCE 1998

MARKET INSIGHT

MARCH 2019

Market Analysis

March 2019

Joy reigns supreme on financial markets

The risky asset rally that began in January continued into February, with the financial community much more upbeat.

Investors clearly got what they wanted, namely for central bankers to step back and consider the direction of their monetary policy. Normalisation seems to have been put back. This alone has reduced the risk of seeing the major central banks commit a fateful error that might have led to a rapid emergence of the global recession that had been so feared at the end of 2018.

Ongoing US-China trade negotiations, statistics pointing to a stabilisation of the international economy, and a better earnings season than anyone could have imagined, obviously helped to revive market optimism. However, the liquidity issue appears to have been crucial in the turnaround on financial markets over the last two months.

> "So, down with the pessimists, be carefree and let joy reign supreme? We are far from conveying such a message."
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> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

In his (excellent) 1975 film Let Joy Reign Supreme, Bertrand Tavernier describes the delights of French aristocratic society enjoying a carefree life in a brilliant 18^{th} century. Life's pleasures ignore the smouldering fire that will lead to the 1789 revolution just a few decades later.

So what does this have to do with the subject at hand, I hear you ask?

A carefree attitude is often taken by people who do not want to face a brewing storm. Market operators are no exception. Commentators talk about denial in describing the tendency of investors to reject the evidence that risky assets have entered a "bear market". Some are quick to state that this is the case now; in other words, the rally of the past two months is only a temporary recovery, in a deteriorating environment, characterised by the emergence of a bear market since the last quarter of 2018.

Although we are receptive to some arguments that the most pessimistic put forward to justify their wariness of the recent risky asset rally, we do not accept their conclusions.

There is a difference between identifying a risk and its materialisation. While it would be ridiculous to believe that a recession is impossible in the short run, we do not feel that it is appropriate to call into question our core scenario: global growth, which has been slowing for several quarters, should stabilise over the coming months. The recent decision of central banks to hold off raising interest rates in the next few months should help. Equally, initial signs that monetary stimulus - in the second half of 2018 - is having positive effects on Chinese lending are good news for the international economy. The prospect of a trade deal between Beijing and Washington, however partial, is something else that should not be ignored in our assessment of the global economy.

As regards the markets themselves, certain factors also suggest that we should not be over pessimistic. It will be quite a while before the recent market recovery reverses the contraction of price / earnings ratios since the start of 2018.

Also the level of cash in institutional portfolios remains high. A look at the performance of individual stock market sectors since the beginning of the year suggests a broad participation of the various segments in the rally, in contrast to the previous upswing when indices' performance was narrower.

There is also the fact that while market sentiment has improved, it is far from the kind of euphoria that warrants the utmost caution. This is especially true because the markets do not seem to be dangerously overbought from a technical viewpoint.

So, down with the pessimists, be carefree and let joy reign supreme? We are far from conveying such a message.

The course of action that we have followed since 1 January demonstrates this. After increasing our equity exposure over the first days of January, we have been taking profits in recent weeks. We have reduced the equity risk in our portfolios in stages. We also felt it appropriate to scale back our convertible bond positions, because the equity sensitivity was too high. As a result, we ended February being underweight on stock markets.

The fact that our allocations are performing well obviously motivates our decision to reduce the riskiest assets. One must never lose sight of the target return that any strategy can reasonably be expected to achieve. Accordingly, it seemed astute to take profits given the target returns that we have in mind for what remains the last phase of the current economic and financial cycle.

The adjustments made reflect our risk management policy, which has been central to our allocation for several months. We have added another element to it in recent weeks: a determination to be more tactical in our investment policy, taking into account the erratic behaviour of markets in recent quarters.

The sharp drop in equity volatility, as shown in the VIX index on the S&P 500, seems excessive and unconnected to the risks that the markets are currently facing. For example, we cannot rule out the emergence of a poisonous climate between Europe and the United States on the trade front over the coming weeks, while Europe remains prone to political uncertainty, for example in Italy, France and now Spain.

One could add that investors seem to be treating central bankers with condescension, as they are no longer factoring in any interest rate hikes this year. Such a prediction seems dangerous to us, especially with regard to the Federal Reserve.

On the earnings front, where analysts' sharp downward revisions had significantly contributed to the fall in equity prices in the last quarter of 2018, the future remains uncertain. Positive surprises on the Q4 2018 figures were fewer and further between, even though expectations were already much lower.

Put simply, our outlook is not carefree. Quite the opposite: we have adjusted our investment policy in full awareness of the risks. Any risk is also an opportunity, and when mindsets are too negative, it is time to grasp opportunities. This is what we did in January. It now seems more reasonable to "trim the sails", which does not mean that we will not be increasing our equity exposure at a later date. Combining risk management with a tactical approach to allocation is central to Prime Partners' strategy in 2019.

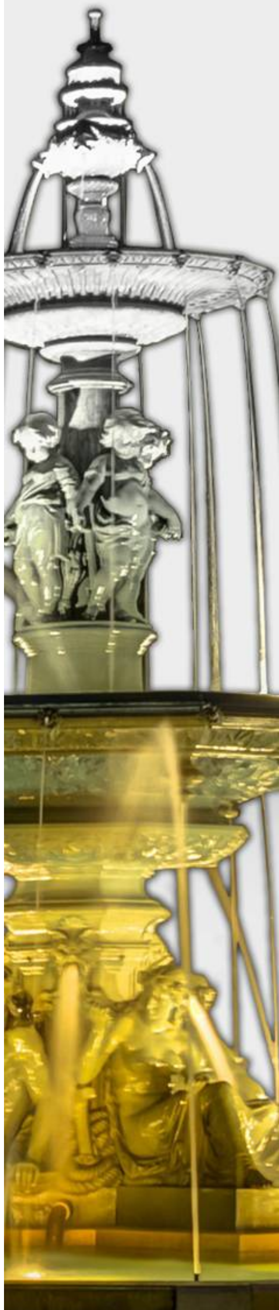
We have however maintained a strong focus in recent weeks on: 1) remaining underweight on bonds, 2) remaining overweight on alternative investments, particularly through an increase in gold and long / short bond strategies, and 3) our negative medium-term positioning on the dollar.

Our thematic allocations, which have performed well since the beginning of the year, also remain an important part of our equity investments. Furthermore, while we continue to overweight emerging market securities, we have reduced our Japanese positions in recent weeks.

Jules Renard once wrote: "listening only to his courage, which said nothing, he chose not to act". Our recent action shows that this is not the case for us.

But there will be no recklessness on our part! The performances of the past two months must not be extrapolated for the immediate future.

Geneva, 25 February 2019



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