Prime Partners

SINCE 1998

MARKET INSIGHT

MAY 2018

The dollar stages a comeback

Under pressure for the past few months, the dollar overcame all odds and bounced back in April, as we were expecting. Beyond this, the renewed strength of the dollar helps to explain – at least partially – a number of significant events that have affected the financial markets in recent weeks.

Firstly, it is worth noting that the US currency has benefited from very definite indications that European economic conditions are no longer pointing towards an acceleration in activity for the coming months. This trend is not unexpected given Europe's recent negative economic surprises. However, it has taken some time to convince investors of a fact that we had already highlighted in our most recent monthly commentaries. Having long been impressed by Europe's economic performance, key market players have realised too late that the continent cannot continue to grow beyond its potential.

Because the strength of the Euro over the past year is part and parcel of any such 'cooling down' of the European economy, the EUR/USD exchange rate adjustment makes sense; all the more so, if we take into account the recent statements made by the ECB affirming its desire to 'very' gradually end its unconventional policy.

Overall, it appears that recent economic developments confirm the economic scenario that we have been constructing for the past few months: although solid, global growth will not get stronger. In addition, as the impact of lower taxes materialises, the US economy looks set to regain its position as leader of the cycle.

In this context, the Fed is likely to carry on raising interest rates over the coming quarters, as the risk of inflation continues to grow. The upward trend on US bond yields will be sustained in the short term.

As a matter of fact, following a lull in March, the 10-year Treasury yield finally broke the 3% mark in April, increasing the dollar's earnings advantage against the major currencies. Combined with relatively more favourable US economic growth, the attractiveness of its interest premium has (finally) bolstered the dollar.

Another development brought on by the latter trend saw emerging assets, including equities, currencies and debt, come under pressure in April. This is not at all surprising given the historical relationship between the dollar and the emerging financial markets.

"It would appear that we do not need to change our main tactical choices."

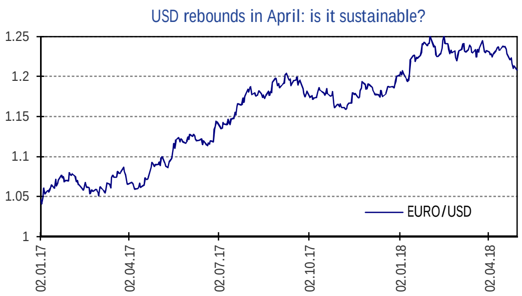
In contrast, European equities have benefited from the dollar's strength and outperformed their US counterparts, a phenomenon that has been sufficiently rare of late.

Beyond its impact on the markets, the appreciation of the dollar is even more significant given the reservations we have about the currency in our medium-term outlook.

Is it time to change tack? We don't think so.

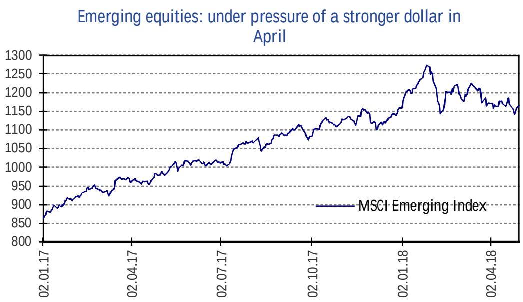
Firstly, because we are not surprised by the recent recovery of the dollar as its weakness appeared excessive to us. Secondly, because the deterioration in US public accounts and external balances over the medium term favours a dollar's weakness. In conclusion, we are maintaining our recommendation to take advantage of its recent strength to scale back positions.

Because of our concerns regarding the dollar's fate over the next 6–12 months, the disappointing performance of emerging assets in April has not prompted us to change our investment advice regarding these assets in the medium term.

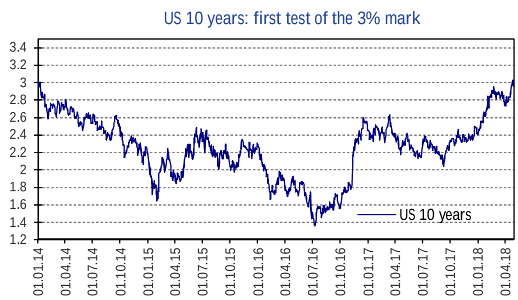


We have only slightly adjusted our asset allocation over the past month. Only the strengthening of tactical bond strategies at the expense of convertibles needs to be considered.

The main tactical choices (underweight bond exposure, neutral exposure to equities and the strengthening of alternative investments and / or cash) do not appear to need any adjusting in light of the dollar's 'temporary' strength.

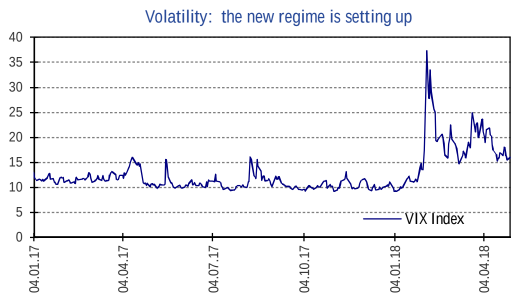


We would also like to highlight a development we were expecting: the stock market volatility index (VIX) seems to have settled into a new regime, characterised by more marked movements than we saw throughout 2017. This has prompted us to continue focusing on overall risk management in our tactical allocation.



The geopolitical environment is certainly still very unsettled. Although the Korean crisis looks set to be resolved peacefully, the same cannot be said for the Middle East, especially Iran. The coming weeks will give us a better idea of the US' approach, based on whether Trump decides to extend US support for the Iran nuclear deal or not. In this context, there is no room for complacency manifested by accumulating risk in a diversified portfolio.

Similarly, while the future of monetary policy is now quite clear, it should not be forgotten that a more restrictive stance, particularly in the US, will weigh on liquidity conditions and reduce central bankers' support for risky assets.



Finally, our vision of a gradually advancing economic and financial cycle but in its last phase should provide incentives for maintaining a reasonable exposure to equities – and indeed credit – in a portfolio.

To conclude, we began 2018 with a strategic option not to overexpose ourselves to risky assets this year. While the first-quarter market correction allowed us to eliminate our tactical underweight in equities, we still do not see any reason to consider equity overexposure over the next few months.

. Geneva, 1st May 2018

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