Prime Partners
SINCE 1998

MARKET INSIGHT

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Clouds on the horizon for summer 2018

It is sometimes said that meteorologists make better predictions than economists; if nothing else, this certainly puts the wisdom of listening to the latter into perspective. As summer dawns and storm clouds gather on the international horizon, we could be forgiven for wishing we had a weather forecast to shed light on the economic and financial outlook.

With hindsight, the start of 2018 seems to have been driven by wishful thinking rather than any tangible reality in relation to the buzz around risky assets early in the year. Unconvinced by January's upswing, we decided to retain our defensive positioning while waiting for a correction that did eventually occur.

Our focus on managing the overall risk of our portfolios has led us to adjust our allocations by strengthening alternative strategies, reducing our exposure to corporate debt and increasing our cash holdings over the past few months. The equity weighting remains close to what we would consider to be a neutral weighting in our investment strategy, despite having fallen over recent weeks. This adjustment reflects our uneasiness regarding certain developments, especially the trade issue.

> "Our equity exposure would be a lot lower if we anticipated a catastrophe on the markets."
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

Should we be talking about a trade war? We should not jump the gun, but it is clear that the escalation of retaliatory measures triggered by the US administration is far from reassuring. In fact, it goes some way to explaining the erratic behaviour of the markets over the past few weeks.

It is true that the economic outlook could suffer in an actual trade war, especially since investors have already had to get used to the idea that their global growth forecasts for 2018 were overblown. This has had knock-on effects for projected profit growth.

The storm clouds of a trade war could gather over the summer if stakeholders fail to work towards a compromise. Unfortunately, we are all now well-acquainted with President Trump's methods! As we try to predict how the President of the United States will proceed, it is vital to recognise that we cannot work from the assumption that he will not follow through on his words.

And since it never rains but it pours, we should not overlook the clouds on the European horizon either. As we expected, Emmanuel Macron's hopes of reshaping Europe are hitting a brick wall – in the form of a disruptive strain of populism – even in Germany. On its own, a Franco-German agreement on a European budget will not be enough to allay investors' legitimate concerns that Europe is once again facing destructive political pressures. How will the Old World get back on an even keel? This recurring question has come up time and again over recent years. The risk of untimely storms may be particularly high this summer as the Trump administration piles on the pressure and seeks a review of NATO funding. At the end of summer 2018, Europe may find that it has failed to overcome internal struggles and has also been dealt a blow in terms of the transatlantic alliance – none of which is very reassuring for investors.

There is one topic that should not be giving them sleepless nights, however, and that is monetary policy.

The Fed and ECB used June meetings as an opportunity to clarify the roadmap for the next 18 months. There were no surprise deviations from the monetary tightening process that we had been anticipating.

We should take this positive factor with a pinch of salt, though, because major central banks are primarily focused on tailoring their messaging so as to manage investors' expectations. It is also important to note the flexibility they are showing in response to changing economic and financial conditions. In this regard, the aforementioned uncertainties may impede central banks' ability to implement their own action plans. So even on this front, uncertainty reigns supreme!

As we can see, the start of summer may have brought the sunshine, but we cannot assume that the same is true on the financial markets. The advancing economic and financial cycle has already led investors to turn away from corporate debt, which has lost its appeal after a substantial rally in recent years. Emerging markets have seen major outflows in the past few months. Some investors are concerned over the narrow base of any of the recent equity markets' rallies which are mainly being fuelled by momentum stocks such as those from the technology sector. Lastly, a new volatility regime has taken hold on the stock markets in recent months. The first half of the year brought a marked shift in the overall economic environment that we cannot ignore.

All of these factors mean that we are entering the summer period with relatively defensive positioning.

We remain committed to our preference for risk management, especially in light of the conditions described above. That is why cash and alternative investments now account for a sizeable proportion of our positions and we have avoided an equity overweight. We remain considerably underweight on bonds and are retaining a strong tactical bias in the management of our fixed income investments.

Over the last 24 months, we have shifted our equity strategy to a theme-based approach. This has enabled us to reduce the importance of regional choices for our investment policy, although we still recommend favouring Japanese and emerging market stocks. In this context, we recently introduced the theme of education.

This investment theme naturally complements our existing investments in robotics, digitisation, US infrastructure and biotechnology.

The paragraphs above may seem somewhat pessimistic, but we see them as realist.

For instance, our equity exposure would be a lot lower if we anticipated a catastrophe on the markets in the coming weeks.

Since the end of last year we have been saying that we would not be overweight on equities in 2018 in light of our economic forecasts.

The adjustments we have made to our investment policy over the first half of the year reflect this thinking. We have no reason to question our legitimately cautious approach based on the uncertain international context. Moreover, risk management will remain a priority in the second half of 2018 and this may lead us to reduce our equity exposure over the coming quarters. This choice will be heavily dependent on economic developments, which may be negatively affected by the risk of a trade war. Thankfully, we are not there yet.

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Prime Partners SA
Rue des Alpes 15
P.O. Box 1987
1211 Geneva 1

www.prime-partners.com

CONTACTS

François Savary
Chief Investment Officer

Jérome Schupp
Equity Analyst
Julien Serbit
Portfolio Manager

T: 41 22 595 09 97
fsavary@prime-partners.com
jserbit@prime-partners.com