Prime Partners

SINCE 1998

MARKET INSIGHT

SEPTEMBER 2018

What if the dollar were the main problem?

Although the situation was not catastrophic, there was no real rest this summer for financial markets, and this applies to equities, foreign exchange and, to a lesser extent, bonds.

The addition of the Turkish crisis to recurring international trade disputes and the medium-term outlook for the global economy quite rightly led to a return of risk aversion in August. The recent spike in implied volatility for equities (VIX index) provides the best indication of this uptick in uncertainty.

Could the Turkish issue unleash a systemic crisis? This is a question many are now asking. We consider that fears that the woes of the Erdogan government could provoke a global economic and financial crisis via contagion in other emerging countries are unfounded. Market operators seem convinced otherwise, judging by the recent acceleration in the fall of emerging markets (down 20% since the beginning of the correction), which is comparable to a bear market. Bonds have not been spared in this environment of general mistrust towards emerging market assets, although the extent of their decline is more limited.

The situation is tense on the trade front, in particular as regards relations between China and the US. But there has been one positive development: the agreement between Europe and the US to hold off on any tariffs on cars. Given this latest development and a potential meeting between Trump and Xi in the autumn, we continue to believe that an international trade war can be avoided.

Both the Turkish crisis and the issue of a potential trade war should remain the focus of attention, as the situation is constantly changing.

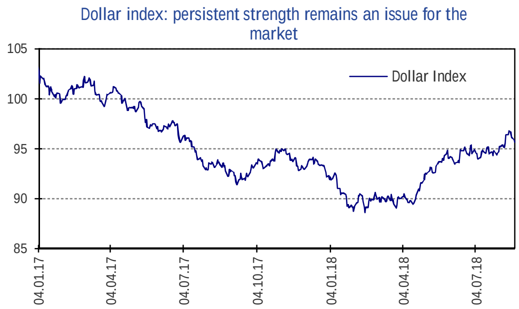
On the other hand, visibility regarding the future actions of the major central banks has improved over the summer. Despite some pressure from Trump, the US Federal Reserve has confirmed its intention to gradually raise the cost of money during the coming quarters. Meanwhile, the ECB remains on course for a probable end to its asset purchase programme by December 2018. The process of mopping up liquidity, which has greatly contributed to erratic conditions in financial markets and the reversal in the corporate debt market since February, should continue during upcoming quarters.

This latter point is the basis of our belief that we have entered the final phase of the economic and financial cycle. The speed with which we proceed depends on the aforementioned uncertainties (e.g. trade issues and Turkey). At the moment, based on leading economic indicators, the downturn remains muted. There should be decent economic growth on a 6–9 month horizon. In other words, the likelihood of recession is limited. In contrast, a more favourable scenario for economic growth than the one we consider is close to zero.

We have maintained our investment policy unchanged, with a focus on risk management. This approach is reinforced by the worry of the (persistent) strength of the US currency. This phenomenon affects not only emerging currencies, but also the currencies of developed countries, first and foremost the euro. While we had thought an upturn likely for the dollar, after a difficult 2017 and start to 2018, we have been surprised by its recent strength. As this development is synonymous with the reduction in global liquidity, it is detrimental to financial markets. In addition, it complicates the macroeconomic

> “For the most risky positions, it’s time to shift from buying on weakness to gradually scaling back holdings.”
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

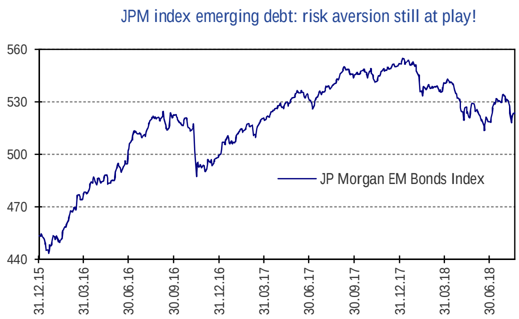
management, in particular monetary policy. Against this backdrop, emerging markets and China are particularly vulnerable.



We still believe that the deterioration in underlying fundamentals (rise in the US budget and trade deficits) speaks in favour of a medium-term depreciation in the US currency. While we have reduced our targets versus the euro for the end of 2018 (from USD 1.25–1.27 to USD 1.20–1.22), we remain cautious on the dollar in the medium term.

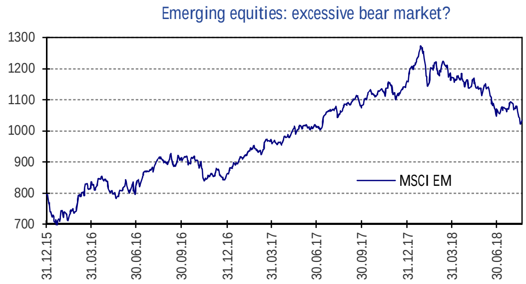
For the moment one thing is clear: a strong dollar and heightened foreign exchange volatility support the argument for an investment policy based on reasonable risk.

In light of this, we made few changes to our portfolios over the summer period. We continued to reposition our bond allocation, reducing our exposure to high yield debt, and introduced an education investment theme in our equities holdings. These adjustments have not had a significant impact on the total risk of our portfolios.



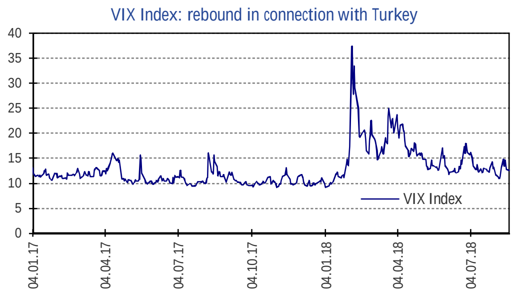
The absolute performance of our strategies after eight months was slightly negative, which could be considered disappointing, but their volatility was limited.

We suffered a setback as a result of our major bet on emerging markets in 2018. While we remain vigilant, we have decided to maintain our exposure unchanged. Economic conditions and an attractive valuation on an international basis justify holding on to our emerging equity investments. As far as bonds are concerned, the relatively attractive carry should not be overlooked, but some specific situations must be avoided (e.g. Turkey and Argentina).



Gold has not fulfilled our expectations during recent months either. Despite the fall in prices over the summer, we maintain our exposure in antici-pation of our US dollar scenario playing out. We believe that levels of USD 1,150–1,200 per ounce offer buying opportunities.

On a more positive note, the recommendation not to ignore the defensive sectors in equity markets proved sound, given their outperformance in recent months. Some will see additional proof of the nearing end of the economic and financial cycle in this outperformance of defensives and of the US stock market versus its international counterparts.



Once again, we are back to this fundamental question about the cycle!

In conclusion, the decision not to take action is still a decision. We firmly believe in our choice to stick to the strategic calls set up over the course of recent quarters.

This is not a lack of resolve on our part, but rather an expression of our conviction that overall conditions justify a focus on risk management as the key priority.

As such, we remain committed to our battle plan, namely a gradual reduction in risky assets in favour of investments in cash and alternative strategies. In other words, as the economic

cycle enters its final phase, buying risky assets on weakness is no longer appropriate.

For the most risky positions in a portfolio, it's time to shift from buying on weakness to gradually scaling back holdings. We now have to get the timing right – never an easy task!

. Geneva, 23 August 2018

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