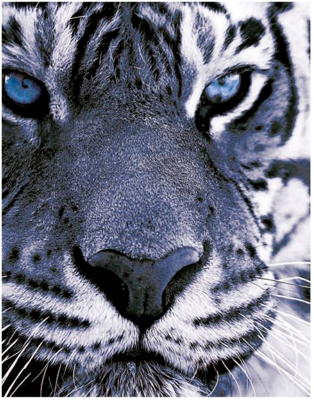
MARKET INSIGHT

SEPTEMBER 2019

INDEPENDENT ASSET MANAGER



Market Analysis

September 2019

Heatwave and summer storms spread to the financial markets

"While the sun shines and markets are back up, it may be wisest to ride the current, and yield to the siren song of exuberant optimists."

That was the irony-tinged message of watchfulness we left you with in our June commentary. The resurgence in volatility and a consolidation in the equity markets over the summer proved our approach to be the right one.

This was firstly the case because we faced the headwinds of August underweight in equities; secondly, because our policy of adding to our positions in gold on any weakness over the past few months paid off and, lastly, because our decision to recommend liquid, uncorrelated strategies broadly held its own, too.

The resurgence of volatility in risk assets – as reflected by the spike in the VIX – is something we expected, given the degree of euphoria that overcame investors in June. As we mentioned at the time, liquidity alone – through a further easing in monetary policy – is not enough to power a smooth and enduring advance in the equity markets.

Against this backdrop, a lacklustre earnings season and the introduction of fresh tariffs on Chinese goods by Donald Trump served as the catalyst for a correction in equities and a shift into safe havens such as gold and government bonds. Those investments were also buoyed by mounting fears of an imminent global recession.

That point has become a crucial factor shaping the financial outlook for the next 12 to 15 months. For our part, we are still inclined to believe that fears of a recession are overdone. Our economic outlook has not changed. Granted, certain sluggish figures and the threat to expansion posed by the trade war should not be overlooked.

"We are still inclined to believe that fears of a recession are overdone"

FRANÇOIS SAVARY, CHIEF INVESTMENT OFFICER, PRIME PARTNERS

It is always important to own up to your mistakes, and we look back with regret at our unduly negative stance on government debt, which has performed remarkably well over the summer – in stark contrast to our expectations.

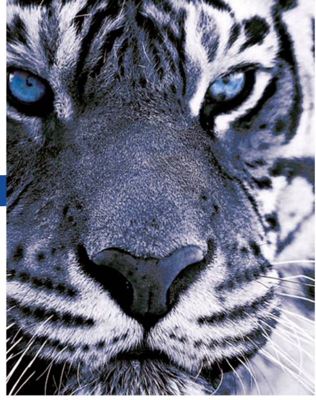
Ultimately, we are now emerging from this period of storms in the markets with healthy performances, because their volatility has remained in check. That point deserves to be highlighted because the aim of our investment strategy since the beginning of the year has been to manage the global risks we face. The fact that events have played out in keeping with one of the main strands of our investment strategy is reassuring.

However, the dichotomy evident in numerous economies between segments driven by brisk domestic trends and more outward-facing segments continues to suggest that growth may stabilise over the next few months.

Are we being wildly optimistic? Far from it. We see a limited, but nonetheless significant probability (25%) of a recession arising in 2020. When we talk about managing the risk factors in our investment policy, that's exactly what we mean! What could prompt us to revise up the risk of a recession?

A shift towards greater protectionism is clearly one factor. If the United States were to continue moving in its current direction of more trade tariffs, we would have to factor this into our global growth outlook.

Likewise, if the White House hawks were to force through use of currency depreciation, we would have to change our outlook accordingly.



And what about monetary policy? There’s no doubt that a shift towards monetary easing is underway at all the world’s leading central banks. And a U-turn appears unlikely after all the messages they have been sending out in recent months, as their credibility is at stake. Granted, a trade deal – even a partial one – between the Chinese and Washington authorities could affect the extent of the drive to inject more liquidity, but not the principle itself. In our view then, monetary policy is less of a concern than the others, at least for the next three months or so.

Last but not least, political and geostrategic events are an imponderable that we need to reckon with and will monitor very closely. We will tweak our expectations accordingly, where applicable.

As the world faces some complex challenges, one should refrain to jump to conclusions. On the contrary, our priority is to keep our options open, while staying on the course we have mapped out. That’s precisely what we have endeavoured to do since the beginning of the year.

As you will have gathered already, managing our asset allocation tactically will remain a guiding principle for us in the coming months.

We have not sat idly by during the market turbulence of recent weeks. We have seized opportunities on various fronts.

Generally speaking, we took advantage of the stock market correction by increasing our exposure to risk assets to a reasonable extent. To begin with, we scaled down the equity hedges that we had put in place. As things stand, that limited adjustment does not affect our recommendation of underweighting equities. Indeed, the still limited visibility over the economic cycle warrants precisely that kind of stance, at least over the short term.

Secondly, we have increased our exposure to convertible bonds. These offer what we regard as appealing features (convexity) for the current phase in the cycle. The equity component of these hybrid assets provides a prudent increase in equity risk.

Lastly, our unwavering commitment to managing risk has prompted us to build up our positions in low-volatility equity strategies.

We remain sceptical about the strong rally in government bonds amid fears of the “Japanification” of the global economy.

The release of the latest European PMI figures backed up our decision not to review our cautious stance on the safest form of debt.

We believe the pressure on credit spreads may spawn opportunities to top up certain investments in corporate debt, without losing sight of the fact that this type of asset displays a high level of correlation to equities.

Despite recent events in Argentina and the “unrest” in Hong Kong, we have not altered either our equity or debt exposure to emerging markets. The valuation of equities and debt carry trades remain attractive since emerging equity markets have lost considerable ground over the summer and questions about Argentina have given certain investors the jitters.

In the currency markets, the persistent strength of the US dollar has prompted us to review our year-end targets for the euro/dollar exchange rate. That said, we still expect the greenback to lose ground and so we recommend taking advantage of its current strength by reducing exposure.

As for the Swiss franc, we admit to being surprised at its gains of late. The upward trend has put the SNB in a bind and prompted it to intervene again. The Swiss central bank is more or less out of other options until fears among investors – who regard the Swiss franc as a safe haven – subside again.

While the Swiss economy has clearly lost some of its momentum, we believe it is still worth playing a downturn in our national currency against the euro. That said, the move will be limited, and it does not seem reasonable to think that the EUR/CHF will go beyond 1.12-1.13 in the short term.

Lastly, despite being somewhat overbought after a significant summer rally, we still like gold. Amid the current uncertainty and an opportunity cost that has melted away to nothing in the heat, the outlook for gold remains bright. As a result, a level of USD 1,550-1,600 does not look out of reach over the coming months. So we will be looking to add to our positions during any periods of consolidation.

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