Prime Partners

SINCE 1998

MARKET INSIGHT

DECEMBER 2018

Market Analysis

The end of the cycle is upon the financial community

One month seems indistinguishable from the next for investors, with November proving just as complicated as October on the financial markets.

While the disruption seen in October, on the stock markets in particular, can be attributed to a downward adjustment in 2019 economic and earnings forecasts, November's movement seems more profound, and more likely to have a lasting impact on financial markets. It seems investors have suddenly accepted a reality that they have ignored for far too long: we have entered the last phase of the economic and financial cycle.

The turbulence on the stock markets, the sharp decline in growth sectors (technology in particular), the poor performance of corporate debt and an easing of 10-year US bond yields at the end of the month are all signs that investors have realised that the financial and economic cycle is nearing its end.

In this context, some are even predicting a global economic recession in 2019. Is this a realistic possibility? We would prefer not to jump to any conclusions at this stage.

This is particularly easy for us to say, as we have defended the idea of a lasting economic slowdown for several months. Certain signs on leading economic indicators, and the doubts we have expressed concerning the medium term impact of Donald Trump's tax cuts, have led us to take this view. We see no reason to revise our opinion in light of more recent economic data.

However, the latter do not indicate an impending recession. A moderate slowdown in global growth over the next few quarters, mainly driven by the normalisation of activity in the United States, is therefore still the most likely scenario.

In other words, if the end of the cycle is upon us, a recession starting in 2019 should not be the core assumption of the economic scenario on which we base our investment strategy for the next six to twelve months. The rapid onset of a recession must only be considered a risk in relation to our reasoned forecast for the global economy. In this respect, we slightly increased our assessment of the probability of this risk materialising (from 20% to 25%), mainly in response to the decline in global PMI figures in October.

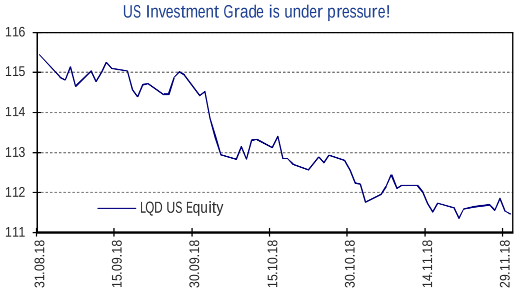
Managing the overall portfolio risk has been one of our priorities since the beginning of the year. The events of the last two months have confirmed this position.

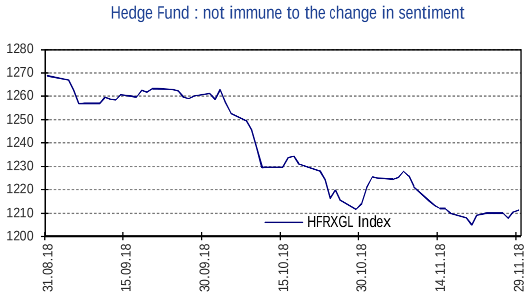
A reduction in our exposure in the credit segment and our refusal to buy on weakness on the stock markets were guiding principles for our asset allocation in 2018. The increase in cash positions and liquid alternative strategies were the by-products of these trends.

In light of the difficult conditions on financial markets since the end of summer, and the re-correlation of assets prices, it is unfortunate that we did not reduce risky positions further. We are aware of this fact.

Similarly, we must admit that the strength of the dollar since spring 2018 has taken us by surprise. Lastly, our decision to remain invested in emerging market assets, particularly in Asia, has not proven to be very effective over the last twelve months, despite an initial sta-bilisation in recent weeks.

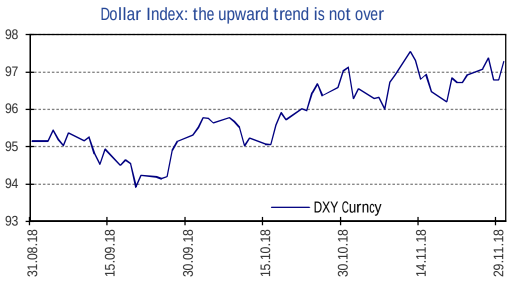
> "There is no reason to believe that erratic fluctuations in asset prices will subside over the coming quarters."
>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS





You have to acknowledge your mistakes to be able to move forward. But we also have to remain firm on the options we have chosen, so long as the scenario we have developed is relevant. The overall portfolio risk must be managed until the end of 2019 with all of this in mind.

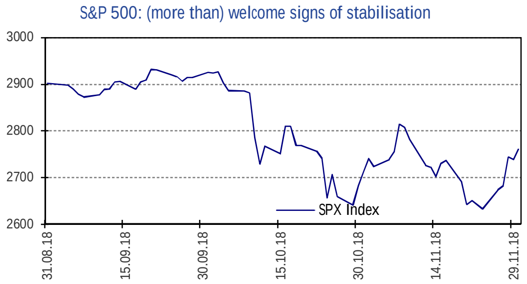
We suggest that investors remain vigilant on their equity exposure, which will have to be reduced over the coming quarters. In other words, we should avoid exaggerating the potential for stock market indices to rise by the end of 2019, even if we consider that they are likely to rally in the next few months. We'll say it again: it is no longer the time to buy on weakness on the equity markets.



US equities have limited upside potential compared to their European and above all Japanese and emerging market counterparts. This last point justifies prioritising Asian equities. In addition to valuation arguments, our scenario of a decline in the US dollar is expected to support the emerging market assets.

In this respect, the dollar is vulnerable because of the impending slowdown of the US economy, the current deterioration of US external accounts, and the Federal Reserve's gradual completion of its monetary policy normalisation process. In this regard, Jerome Powell's recent speech signalled a shift that justifies our decision to bet on a limited number of US rate hikes in 2019 – in this case, two.

The end of the cycle is always difficult for credit, particularly for the high yield segment. These assets are all the more risky now that we have entered a balance sheet downsizing phase by the main central banks. There is therefore no reason to doubt our policy of underweighting this asset class as part of a diversified allocation. As such, the pressure on credit spreads, which has intensified in recent weeks, must not lead us to believe that buying opportunities have emerged.



To sum up, the fact that market operators have accepted that we have entered the last phase of the financial and economic cycle has hurt markets in recent weeks. However, we should keep in mind that the end of the cycle usually takes place over several quarters and that it does not spell negative returns on financial assets, so long as a recession remains out of sight. For the time being, it seems too early to bet on a looming recession, likely to induce a lasting bear market for risky assets, and equities in particular.

Unlike some investors, it comes as no surprise to us that a new volatility regime has taken hold of the markets. There is no reason to believe that the erratic fluctuations in asset prices will subside over the coming quarters; this does not mean that equities will not be able to post positive returns, at least in the first half of 2019.

Despite a challenging environment over the last few weeks, we have kept our investments on track. We remain convinced that 2019 will offer opportunities to reduce risk, however it is not yet time to make such adjustments.

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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