TELOMERE | Capital

Outlook 2019 – Q1

Our investment views

Outlook 2019 – Q1

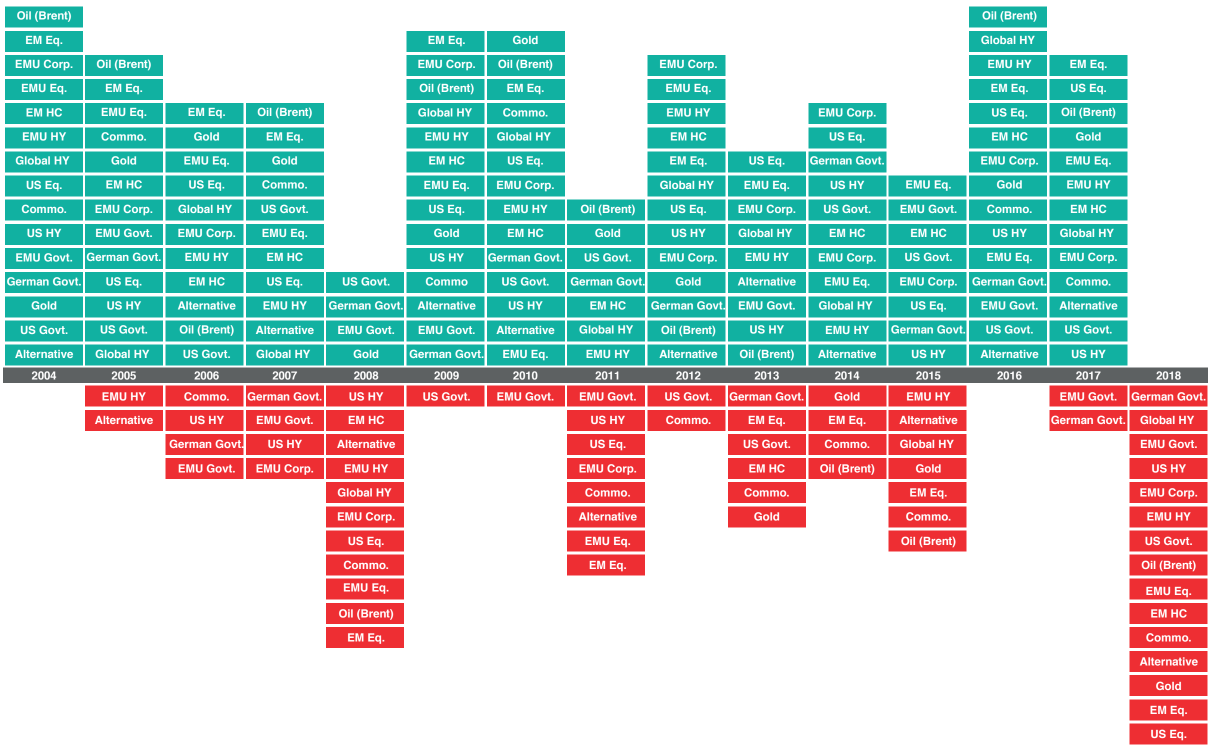
With this document, we are pleased to share with you our views and investment recommendations for the first quarter of 2019.

But to understand the future better, a journey back in history is required. By looking back at the annual performance of the different asset classes over the past 15 years, the facts are clear: 2018 was the worst year for the markets (see Chart 1). Indeed, all assets show a negative return.

Even 2008 had not experienced such a scenario. In this particular environment, combining this observation with the dynamics of risky asset markets during the last quarter of 2018, it is likely that 2019 will be a difficult year, **this will not be without opportunities. As for the risk factors and topics to monitor closely during the first quarter of the year, here are the ones that will have a major impact on the dynamics of asset prices and which will have to be taken into consideration to build our allocation:**

1. Global growth
2. The trade war between the United States and China
3. The monetary policy of central banks
4. The Brexit
5. The evolution of the price of oil
6. Corporate profit growth

ASSET CLASSES RETURN RANKING BY YEAR



GRAPHIC 1

Slowdown of global growth or recession ?

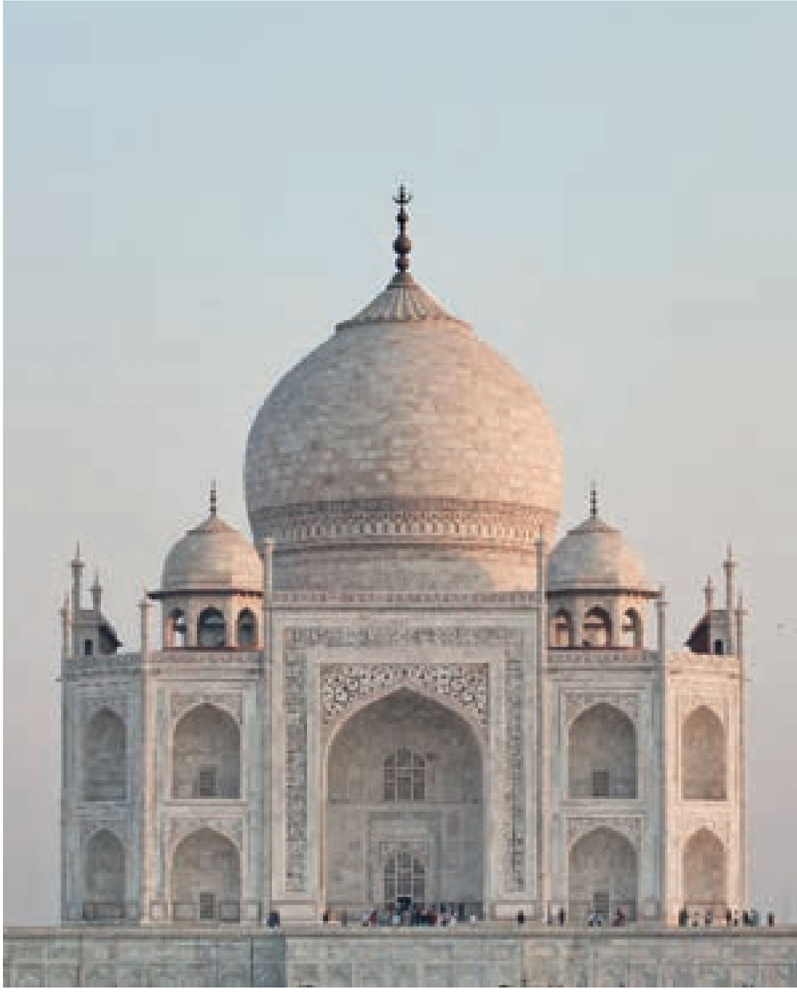
Perfectly irrelevant a year ago, this question is now at the forefront of the 2019 outlook for banks and asset managers. Market volatility, which has seen two major waves of fluctuation in 2018, is the main cause.

If the price dynamics had been different, the term «recession» would be absent today from the speeches and we would talk calmly about a «gentle slowdown». But this is not the case. However, it is important today to determine what is factual and what is merely felt.

In general, growth expectations were revised downward in the fourth quarter of 2018. Admittedly, these adjustments are not substantial (3.7% against 3.8% for 2018; 3.5% against 3.7% for 2019 and 2020), but they still announce a slowdown.

As for leading indicators, they confirm this trend. According to the IMF, the OECD and the World Bank, growth would have peaked in 2018 and is now expected to ebb again as a result of repeated bouts of more lenient monetary policies, geopolitical tensions, and tariff increases imposed on China by the United States.

In this context, we will focus below on the four largest contributors to global growth in 2019, namely China, the United States, India and the European Union.



China

The commercial power struggle with the United States and debt consolidation and reduction measures have led to slower than expected growth in China.

It will not be the facilitation of credit standards or global trade that will support it next year. In this context, we share the opinion of many economists who believe that the Chinese authorities should carry out tax cuts to create a positive dynamic for businesses and consumers, while accelerating the shift in the technological and environmental transition, one of the major objectives of the Made in China 2025 plan.

Should tensions with the United States intensify, growth should still be robust thanks to new support measures launched by the government.

United States

Like China, growth in the United States is expected to be lower. According to the OECD, it would reach 2.7% in 2019 against 2.9% in 2018. At stake: a weakening of the impact of the fiscal stimulus, higher interest rates and a decline in exports.

However, domestic consumption, which accounts for some 60% of US GDP, should remain strong. As for the possible ups and downs of the economy, the recent decline in oil combined with a slowdown in the pace of rate increases - or even its complete cessation - will help contain them.

An important element could, however, create a positive surprise; this being the potential investment plan of USD 1,000 billion in infrastructure, which is still on the agenda. Finally, if certain factors had a negative impact on the growth dynamic, their effects will certainly not be powerful enough to destabilise the US economy.

India

After a 6.7% growth in 2017 and 2018, India should maintain its momentum with an estimated GDP of 7.5% for 2019.

The reforms initiated recently seem to be bearing fruit, although they initially had a negative impact on the economy, because of the brutality of their implementation.

Today, even the IMF welcomes them. However, it should be remembered that India is particularly sensitive to the price of oil, which affects the 2018 figures and will inevitably have an impact on those of the first part of 2019.

The current price of the barrel, if maintained, should therefore positively support the next results. In addition, with a risk of recession being close to zero and a dollar that could weaken, Indian equities could therefore show interesting performances.

The European Union

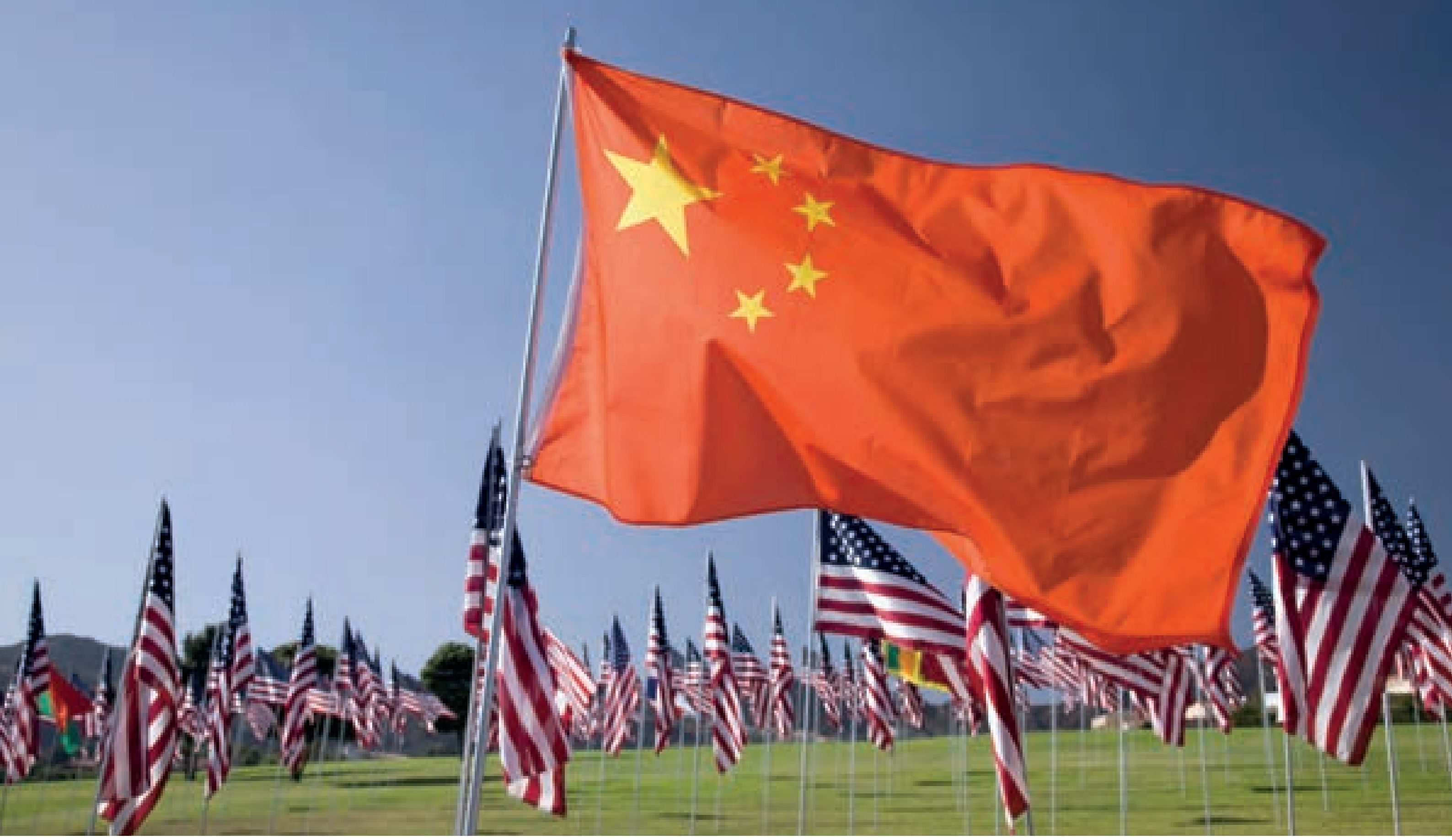
From a global point of view, the weakening of the trade rebound and geopolitical tensions are the two main factors that prompted the European Commission to revise its forecasts downwards, altering growth in the eurozone from 2% to 1.9% for 2019.

As for the internal issues within the Union, these have not changed. The United Kingdom and Italy still hold the pinnacle of risk. Whatever happens, there is absolutely no doubt that the European Union will be strongly impacted if Brexit results in a no-deal. Today, it is impossible to precisely visualise its consequences.

However, barring exceptional events, consumption and investment should continue to support growth. Nevertheless, the low interest rate environment and the accommodating fiscal policies will support the economy, which should not experience a recession if an agreement is reached between the UK government and Brussels.

It should also be noted that while the global economic slowdown is becoming more pronounced, the current indicators do not show signs of a recession in Europe for 2019.

Central banks and governments are now well equipped to react quickly in the event of a sharp decline, which is reasonably reassuring for investors.



Towards a change of tone in the trade war?

The speculative upward movement that followed the announcement of a truce between Xi Jinping and Donald Trump was short-lived. Probably because this truce was not really a truce.

This was highlighted, at the beginning of December, by the arrest in Canada of the financial director and daughter of Huawei founder, who finds herself under extradition to the United States. In any case, this event makes it possible to affirm one thing: the trade war has begun a transition towards a more technological conflict.

And all the more so because the conditions imposed by the US administration on the authorities in Beijing are aimed at slowing down the Made in China 2025 policy, which is to make the Middle Kingdom a super-nation in the technology sector.

In such a context, tensions between the world's two largest economies are expected to continue even though we believe that the tone will decrease between players, the goal being to gain influence without derailing international trade. With a deadline at the end of March - the deadline given to China to propose a new agreement - we can better understand the direction that the negotiations will take.

It should also be noted that a summit will be held in January between the two countries: the ideal opportunity to evaluate more precisely the content of the compromise discussed between the two camps. But let's not forget that Xi Jinping does not seem to want to give in to all Donald Trump's requirements.

On the other hand, if the US economy were to experience a slowdown in the coming months, China could find itself in a strong position. With fewer assets in hand, the American President would then be forced to relax his position on world trade so as not to offend his electorate. He could then focus on the infamous infrastructure investment plan to «bring another victory to his fellow citizens».

Hardening of monetary policy or return to accommodation ?

If volatility in risky asset markets continues to materialise and the slowdown becomes more important, there is a strong likelihood that central banks will take a break from the normalisation of their monetary policy.

Some of them could even backtrack. We do not see the direction of the Fed and the ECB engage in a hardening of financial conditions if the markets and the economy are lagging behind. Nevertheless, in the absence of a marked slowdown, central banks will continue their normalisation process.

As a reminder, the Fed will accelerate the reduction of its balance sheet by starting to sell some of the bonds in its possession. The result of this action would be, in this context, similar to the consequences of a rise in rates. In fact, a reduction in the balance sheet of 330 billion is equivalent to a rate increase of +0.30%.

Finally, central banks still have effective means to restore confidence and reassure investors.

Which scenario for Brexit ?

Originally scheduled for 11 December, the vote on the Brexit deal brokered by Theresa May with the European Union was postponed until January because of the many criticisms and deep divisions it created.

The subject should therefore again animate the debates of the Parliament from 7 January (after the holidays), until 21 January.

If the new text is adopted, the government will have to draft a law on the European Union Withdrawal Agreement.

This will include several major points such as civil rights, financial transactions or details of the transition period.

The European Parliament will then have until 28 March to approve and ratify this Withdrawal Agreement. In case of signature, it will enter into force on 29 March. Otherwise, the no-deal will impose itself, forcing the European Union and the United Kingdom to put in place a contingency plan to limit friction and avoid chaos at the borders to at least allow trade continuity.

Anyway, the schedule is tight. Not to mention the unpopularity of the agreement that Theresa May brings to Parliament. If the vote is negative, it seems unlikely that a new deal will be concluded in due time.

In this context, Theresa May could then face a vote of confidence, leading to the holding of new elections. As all scenarios are possible, it is very difficult to predict the future between the European Union and the United Kingdom.

We will therefore remain cautious on UK equities and GBP denominated assets. As for the result of the vote in January, it will of course hold our full attention.

In which direction is the price of the barrel going ?

The sanctions against Iran have not drastically changed the price of the barrel as anticipated by the majority of analysts. Indeed, the US administration having decided to grant exceptions to the largest importers of Iranian oil, the country was able to export more barrels than expected.

In addition, inspired by Donald Trump's encouragement launched before the mid-term elections, Saudi Arabia reached historical production levels of 11 million barrels per day during November.

If we combine these two elements with the explosion of production observed in the United States, the market could only register a sharp drop in the price, due to the sharp increase in supply. In fact, the crude price setting standard, West Texas Intermediate (WTI), was 41% cheaper at the end of the year than at the October high.

These fluctuations prompted OPEC+, which includes Russia, to meet in November at a well-publicised meeting which resulted in the announcement of a substantial drop in production of around 1.2 million barrels per day. Reflecting Russia's growing influence in the cartel, this agreement represents a paradigm shift.

We are no longer in the situation of 2015 when the organisation needed several meetings over several months to find common

ground. In this context, this decrease should make it possible to support prices during the first quarter of the year. OPEC+ will meet again in April with the objective of raising the price again.

By the time of this meeting, the price of crude oil should oscillate between USD 48 and 55, according to the WTI.

Have corporate results reached their highest ?

Since the fourth quarter of 2016, the profits of American companies have steadily increased. This is evidenced by the S&P 500 index, which saw a 37% increase over the same period.

The year 2018 has largely contributed to this growth with a second and third quarter more than remarkable. So much so that it is now legitimate to ask how to maintain or better these record levels.

Especially since negative factors start to weigh heavily in the balance; notably, the impact of tariffs that will materialise in the fourth quarter earnings as well as the compression of the fiscal stimulus. All of this has prompted analysts to revise downwards their forecasts for 2019.

However, we believe profits should remain at the same levels as seen so far. The analysts' revisions are in our view related to the decline in confidence currently felt in the market.

Corollary to this observation: expectations are lower than expected, the earnings could surprise upwardly, by becoming a positive catalyst for indices.

Economic Outlook

United States

Full employment, inflation under control and normalised monetary policy, all indicators are green, reflecting the excellent performance of the US economy.

Even if growth were to post a slight decline, like the profits of US companies, the new tariffs imposed by the US government and their impact on prices do not seem to affect the consumer at the moment.

In addition, some companies have decided to relocate their production in the United States, to the delight of the President who had made that a campaign promise. As for the Fed, it should normally slow down the pace of its rise in rates.

The nervousness of the markets like that of the President encourages the Fed to go in this direction. Note, in this context, that the long-term interest rate curve indicates a slowdown in inflation, which means that they should not rise indefinitely.

It remains to monitor domestic policy that may bring its share of uncertainties induced by the ongoing proceedings against the President and controversial laws he would like to pass in force.

US equities

Until October, the US equity market was the only one still generating profits before the second major correction of the year came on the scene. With its 2,511 pts recorded on 2 January 2019, the S&P 500 index however expects a rally to try to regain its level from the previous year for the same date, 2,690 pts.

The rebound is still possible because the economy is doing well. We still find a strong nervousness and a lack of conviction on equities in general. Not wanting to give in to this trend, we prefer to stick to the fundamentals of the US economy, which shows a certain solidity, which is why we are maintaining our positions for the first quarter of 2019 with a preference for technology and oil stocks, which have suffered a sharp decline since October.

For more speculative investors, China represents a long-term attractive value that could be invested either directly or through the US base materials sector. However, it is worth remembering that if the market suddenly comes to life, we will adapt our investment policy.

Europe

If the beginning of the year 2018 was marked in Europe by a good economic situation, it was gradually eroded, as a consequence of the trade war entered by the United States and the decrease of the demand of important commercial partners, from emerging markets in particular.

For the first quarter of 2019, Europe should logically continue to suffer from this situation. Moreover, the European Union does not currently seem to have the institutional capacity to deal with this kind of challenge.

In addition, the monetary policy of its Central Bank (ECB) should harden with the announced end of its asset purchase programme (Quantitative Easing), like the Fed and the Bank of England,

At the political level too, the uncertainty generated by the United Kingdom and Italy will continue and weigh on investors' morale. The low level of the euro is the only positive note we see at the moment. It should indeed stimulate certain sectors related to exports.

European equities

Down by nearly -15% this year, the Euro Stoxx 50 reflects the poor performance of the European stock market. A surprise for both analysts and investors.

Even if a rally were to take place at the turn of the year, the first quarter will remain complicated in all cases, the economic outlook mentioned above containing many risk factors. However, the latest talks between the United States and China seem to be moving towards a positive resolution of the trade dispute between them.

This would have an immediate impact on the first quarter and opportunities to seize. In this context of declining prices, we reiterate our preferences for the export-oriented consumer discretionary sector as well as for financial stocks with a high dividend.

Switzerland

With its +2.6%, the Swiss economy is doing better than the European economy, whose annual growth is estimated at +1.7%. Despite this good result, we expect a slowdown.

It will indeed be difficult to maintain this pace in the long run. Moreover, the European Union could tighten Switzerland's access to the common market, seeing it as a risk in the context of its Brexit negotiations.

If we expect a slowdown, inflation and interest rates should remain low in the context of a normalisation of economic growth, estimated at 1.5%.

Swiss equities

With a result of -10.40%, the Swiss market index (SMI) suffered particularly from the discount of financial (-35%) and luxury (-25%) stocks. But this decline seems to us exaggerated as evidenced by the figures released by these two sectors in the last quarter of 2018. We therefore rely on the current levels of players in this market by maintaining our confidence.

Bonds market

United States

With rising interest rates and an increase in the risk premium, 2018 will have been a difficult year for US bonds. This double punishment has led investors to a negative annual performance.

In addition, interest rates continued their quarterly increase of a quarter point, contrary to expectations. This should not be the case in 2019, however, given the markets' turbulent end of year.

A strong signal for Fed director, Jerome Powel, who should not try to tempt the devil (nor President Trump) by maintaining the steady pace of rate increases followed in 2018.

However, from an economic point of view, the situation remains optimal, with a record level of activity, historically low unemployment and contained inflation. This new year should therefore be more lenient, especially for good quality issuers (IG).

With a negative performance in 2018 for all types of risky assets, High Yield bonds are no exception, an have significantly underperformed good quality bonds (IG).

Given the strong price correction observed at the end of the year, we believe however that a pocket of value has been created in this bond segment. An opportunity to seize during the first quarter of 2019.

Europe

After a start of the year under the sign of economic growth, reality soon caught up with us. Several factors, including the trade war between China and the United States, the Italian budget and Brexit, weighed heavily on yields. The strong rise in risk premiums will have maintained the performance of European bonds in the red in 2018.

In 2019, interest rates may however increase, because long rates should rise following the announcement by the Director of the ECB, Mario Draghi, of the end of the asset purchase programme (Quantitative Easing) for the first quarter of 2019.

If the segment of high-yield bonds will suffer initially, it should then find its base level, but, this time, without the infusion of the ECB. Given the economic performance of the eurozone, which remains well below its potential, we are not afraid of rising rates.

Emerging countries

Like Argentina and Turkey, bond markets in emerging countries are characterised by high volatility. Even if it is time for appeasement, a crisis can always occur in the event of a defect of an issuer.

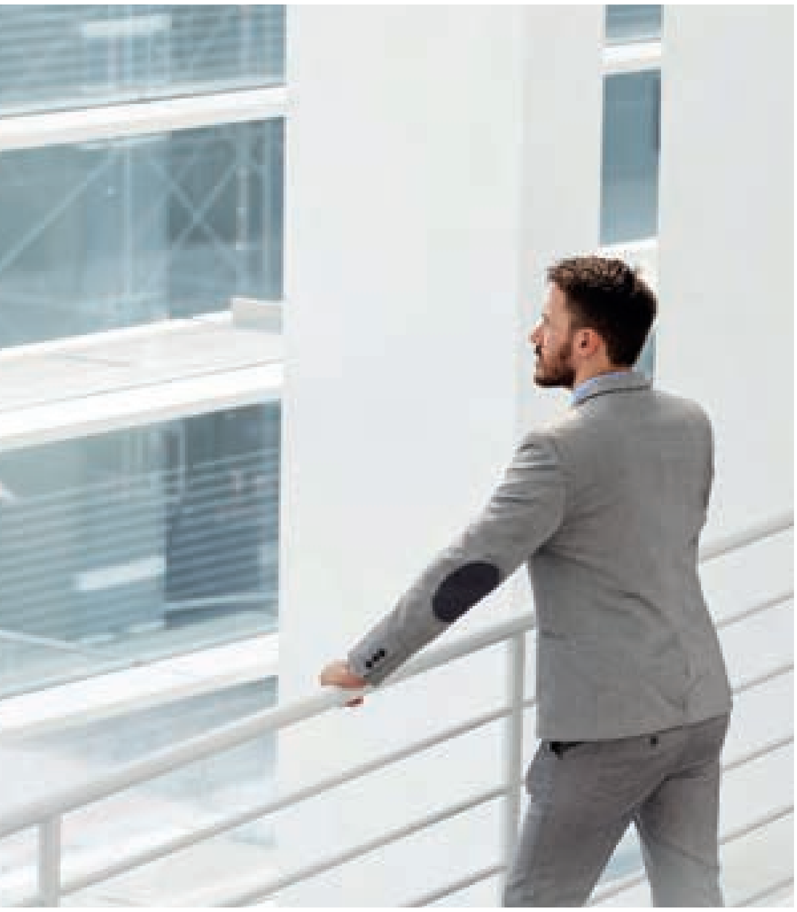
This is all it takes to consider that this asset class is reserved exclusively for investors who can afford large fluctuations in their portfolio. The year 2018 reminded us of this, even if the worst is behind us.

But that does not mean that volatility will come down even though the dollar and US key rates have reached a point of stability. With the increase in the risk premium, however, we have a safety cushion for new investments.

In this context, we favour hard currencies (USD, EUR or CHF) as well as issuers with a good credit history and a maturity of less than 5 years.

Conclusion

The year 2019 seems to be the year of all dangers. With a sharp rise in volatility, assets give the feeling of recorrelation and investor confidence seems low. However, by taking the necessary steps back and analysing the data, 2019 may well become a year full of opportunities.



With expertise, know-how and composure, we will make every effort to navigate well in markets whose fundamentals remain strong, in our view. Indeed, we believe that global economic growth will continue despite existing negative indicators.

In this context, we are positive on risky assets. However, we decided to position ourselves in neutral on global equities to keep all the necessary flexibility in case of a rise in volatility or if the visibility on major risk factors get better.

The fixed income compartiment follows the same philosophy as we positioned ourselves in neutral on High Yield and Investment Grade. We reduced our underweight position in Emerging Debt in comparison of our previous positioning during the Q4.

Hugo Derny
Investment Strategist

Tony Pangallo, CFA, CAIA
Member of the Investment Committee

Asset allocation

	Underweight		Neutral	Overweight	
EQUITY					
Global Equities	○	○	●	○	○
Swiss Equities	○	○	●	○	○
European Equities	○	○	●	○	○
US Equities	○	○	●	○	○
Emerging Markets Equities	○	○	●	○	○
FIXED INCOME					
Cash	○	○	○	●	○
Investment Grade	○	○	●	○	○
High Yield	○	○	●	○	○
Emerging Markets	○	→ ●	○	○	○
ALTERNATIVE INVESTMENTS					
Oil	○	○	○	●	○
Gold	○	○	●	○	○
Alternative Funds	○	● ←	○	○	○

Based on 12-month forecasts