TELOMERE | Capital

Outlook 2020 – Q1

Our investment views

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With this document, we are pleased to share with you our views and investment recommendations for the first quarter of 2020.

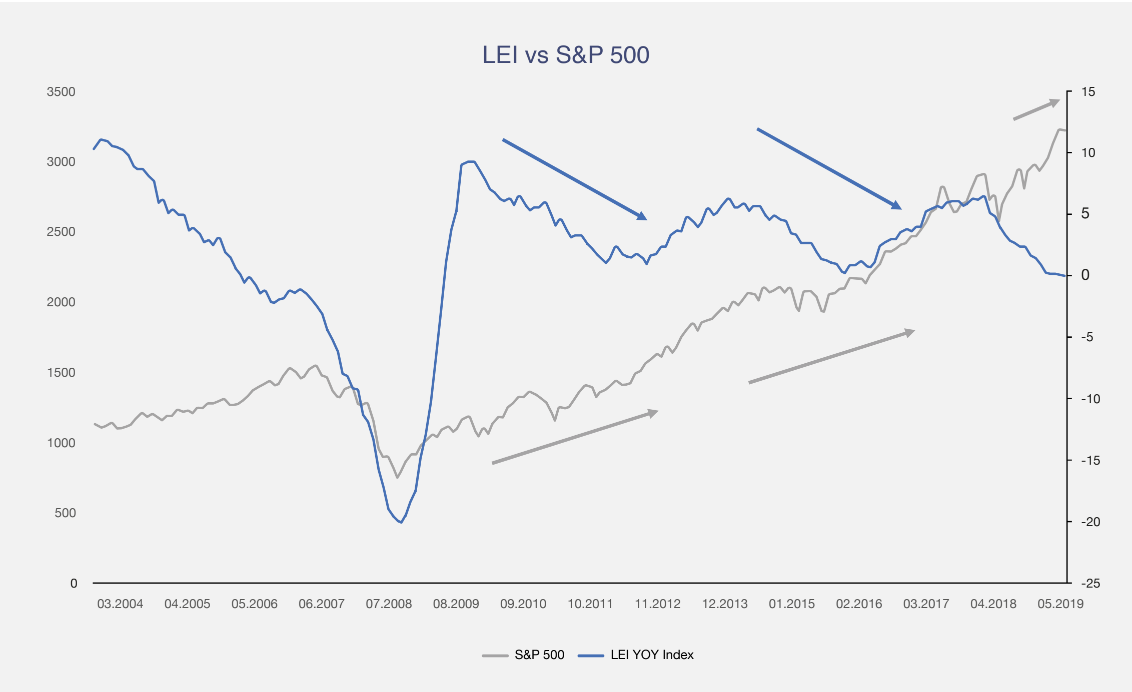
Following the violent correction that took place in the last quarter of 2018, it was decided to be particularly careful during 2019. The financial markets, supported by the central banks, posted record performances: total increase of 31.48%, 27.75% and 30.16% for the S&P, the Stoxx 600 and the SMI, respectively, as of 31 December.

At the same time, we saw an impressive appreciation in bonds resulting from lower rates as well as a compression of credit spreads. In the end, 2019 was an exceptional year during which most asset classes ended up in the black. However, this is not the result of an improvement in the fundamentals.

Having said that, the leading economic indicators have lost ground, global growth has slowed down to its lowest pace in 10 years (3.1% compared to 3.8% in 2018) and the earnings per share of the S&P 500 fell slightly due to the trade conflict between China and the United States as well as the economic slowdown within the People's Republic. This "war" has indeed caused a lot of uncertainty for all economic players. It must also be remembered that up to the last quarter of the year, the news fluctuated between boundless optimism on the signing of an agreement and last-minute problems.

Exporters and importers have therefore remained in total uncertainty since the start of the conflict and this has been strongly reflected in world trade figures. The sanctions have also disrupted supply chains in different sectors. The most prominent case is that of the giant Huawei, which found itself without an operating system after being placed on the black list prohibiting any American company from collaborating with the Chinese manufacturer. Google was therefore forced to revoke Huawei's Android license.

This kind of event can only have a short-term destructive effect on a global economy already plunged in political uncertainty and which must face a crucial period of transition between the faltering influence of the United States and the rise in power of China.



In the same way as this conflict has undermined potential growth, the slowdown of the Chinese economy is also weighing on global dynamism. The Middle Kingdom accounts for almost a third of global growth.

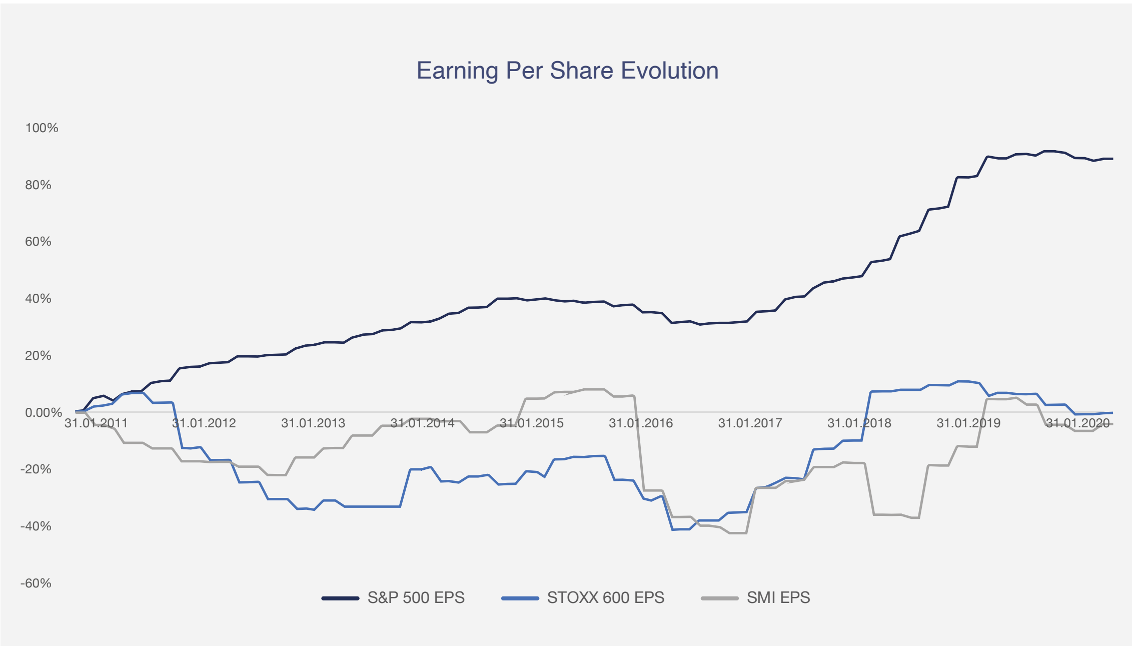
To quote the famous expression originally used to describe the global importance of the American economy: "When China sneezes, the world catches a cold". The figures released by Beijing highlight the slowdown in the economy, that is to say 6% year-on-year. It is at the same level as in the early 90s.

The reasons for this slowdown are certainly structural: there is a normalisation of growth partly caused by China's transition from an emerging country status to an economy more oriented towards domestic consumption. But the reasons are also cyclical.

On the one hand, Chinese consumers have been impacted, i.e., their morale was affected by the trade war as well as a significant inflation of pork prices linked to the swine flu epidemic (price increase of 70% in one year). It is important to emphasise that domestic consumption represents almost 40% of the GDP.

On the other hand, SMEs find it difficult to finance themselves. Local banks finance a majority of Chinese SMEs, but these are impacted by the policy to clean up the financial sector and fight against "Shadow Banking".

This is why the government is trying to counter this decline in momentum by using both fiscal and monetary reforms.



However, the recovery is slow to start and is impacting economies around the world. As a result, there has been a synchronised movement of monetary easing from the world's central banks.

Ultimately, it was this main factor that enabled the markets to post this exceptional performance. However, the economic impact seems to be weaker or take longer to materialise.

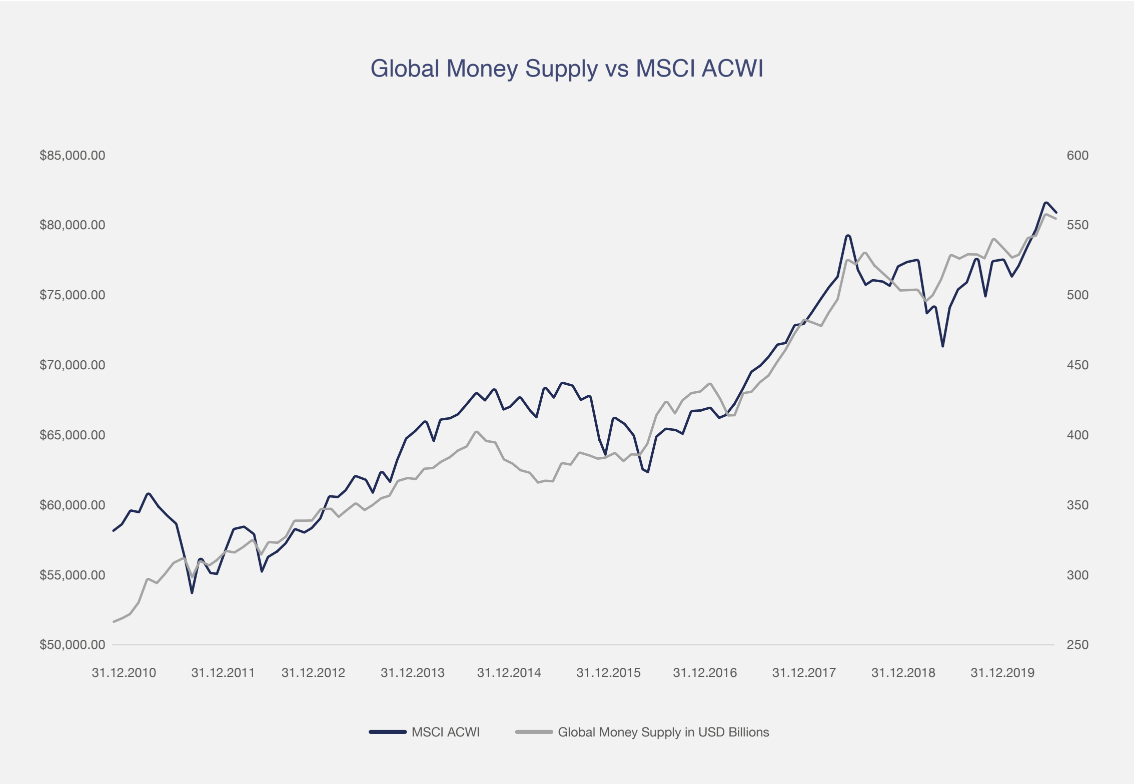
It now seems important that the various governments and economic centres modify their budget to continue to support this cycle.

Therefore, in addition to the risk factors that we will mention later in this review, it will be necessary to monitor carefully the political discourse, especially in Europe concerning a shift in budgetary policies.

At the same time, the central banks' comments and actions will continue to be carefully monitored. It will also be necessary to be vigilant about the evolution of earnings per share, which will have to return to the upward trend to regain a healthy performance potential and attractive valuations.

Here are the risk factors that we are carefully monitoring and that we believe could impact the markets or the economy:

1. The progression of the American economic cycle
2. The American elections
3. The Coronavirus and the Chinese economic slowdown
4. The valuation of the equity market



In which stage of the american economic cycle are we?

One of the fundamental points of the investment process is to identify which economic cycle we are in. This helps to best allocate capital and adapt risk management. Over the past ten years, this exercise has become more difficult due to the repeated central bank interventions and operations carried out to smooth economic cycles. However, some signs or indicators seem to have retained their relevance.

For example, let us consider the yield curve and the yield spread between the 30-year and 1-month rates. The evolution of this yield is closely monitored by the financial community because its predictive power has often proved to be correct. Indeed, before a recession, the differential will first become negative (meaning that the 3-month yield is higher than the 30-year yield) and then it will become positive again. This is when you have to be on your guard. If we take a look at the dynamics of this spread, we see that this spread has not yet reversed. However, it has dropped sharply since 2010 and we are getting closer to zero. In line with the relevant indicators, we also find surveys concerning job rotation and the creation of new jobs called Job Openings and Labour Turnover Survey. In these surveys, two indices are of particular interest to us: job creation and the resignation ratio. When an economy is growing, companies tend to create new jobs and employees leave their employment more easily because there is more work available. When the economic context becomes less buoyant, these two indices stagnate and eventually turn around.

Currently, job creations are declining and the resignation rate has stagnated since mid-2018. If we add the record level of corporate debt in the United States, we conclude that we are in the advanced phase of the economic cycle. However, that does not mean that the markets will collapse. The action of central banks and governments on monetary and fiscal levers can smooth or prolong the growth cycle. This is why we will be very attentive to the Fed's messages and to the various speeches of Donald Trump, during his campaign, who may well propose new fiscal stimulus measures.

US elections: which candidate is dangerous for the markets?

Donald Trump was elected President of the United States almost four years ago. Next November, the Americans will vote to decide whether or not to re-elect him. The popularity rating of the forty-fifth president of the United States was dented during his first year in office.

But it has recovered since then and has gone up to reach 44.7% of positive opinions today (average given by about fifteen polling firms and media outlets). If we add that to the fact that no Democratic candidate seems to be unanimous with the fact that the statistics are always in favour of the outgoing candidate, there seems to be a high probability that Donald Trump will be re-elected. It must be said that “The Donald” divides but he is nonetheless charismatic.

He represents the embodiment of forgotten American workers faced with a Democrat elite disconnected from reality. And this strategy has worked. However, the Democratic camp is struggling to find its candidate, the one who would convey charismatically a message strong enough to counter Donald Trump. Joe Biden, vice-president of Barack Obama, was to embody this candidate, but he is often criticised for his age and his sometimes incoherent words; described as senile by its greatest detractors.

Elizabeth Warren, who had her moment of glory by rising rapidly in the polls, saw her popularity collapse following her proposal for Medicare for All, which is estimated at around USD 20,000 billion. Bernie Sanders, a candidate who is still very divisive, has strong supporters but does not seem to have a sufficient ballot to win. However, November is still far away and anything can happen.

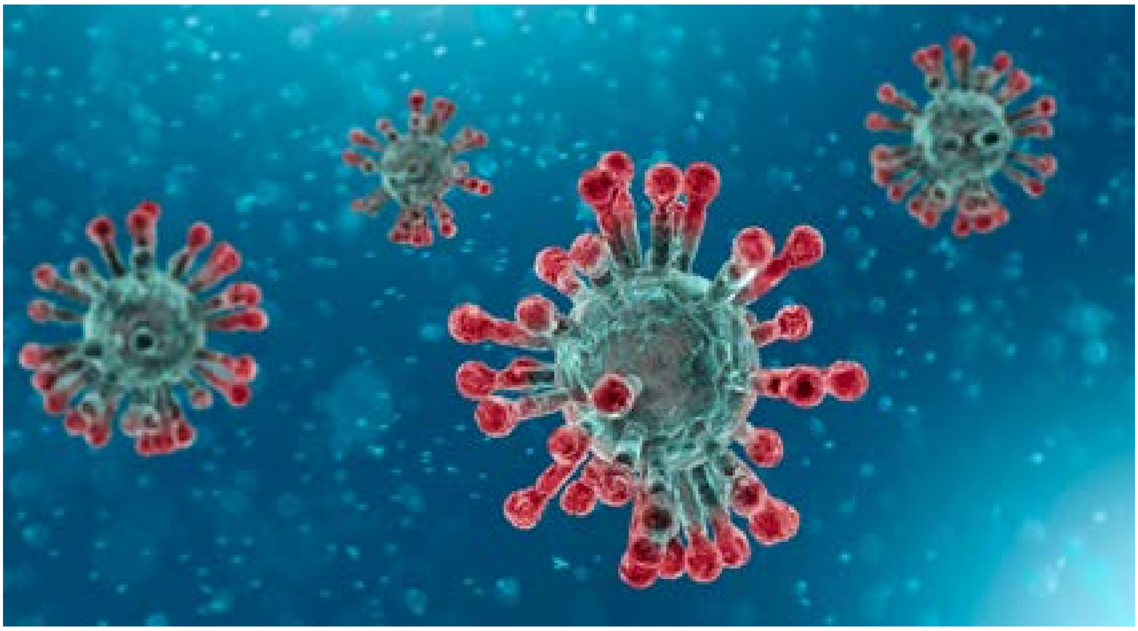
Bernie Sanders has an aggressive programme towards the private sector and American capitalism. Although the candidate does not have unanimous support, his popularity rating keeps climbing to 23%,

behind Joe Biden (27%). Elizabeth Warren went from 26% to 15%. The candidate who is currently in third position in the polls to become the Democratic candidate also has an aggressive programme: 2% wealth tax for all fortunes over USD 50 million, Medicare for All, dismantling of the GAFAs.

Given the radical shift to the left of the Democratic candidates, the markets may well experience episodes of volatility. If Joe Biden loses ground, Warren and Sanders could rise sharply and create a surprise. We will carefully monitor the progress of each candidate.

With the results of the Democratic Party’s presidential primaries in June, we believe that the first quarter of the year should be potentially spared from a surge in volatility caused by the US elections. All the more so that President Trump is likely to emerge stronger following the failure of the Impeachment procedure led by the American Democrats.

Coronavirus: how the global economy could be impacted?



In December, we did not visualise an epidemic would be classed as a risk factor to be monitored. The 2019-nCoV Coronavirus epidemic has spread very quickly in China, helped by a relatively late response time from the Chinese government. However, when the first official case of infection in Shanghai was announced on 20 January, the Chinese authorities quickly took drastic measures: quarantining tens of millions of people, extending the holidays of the Lunar New Year and cancelling the festivities, mandatory wearing of a mask or even immediate cremation of deceased persons.

WHO, for its part, declared a state of international emergency on 30 January. At the same time, several countries have closed their borders and repatriated their nationals while certain airlines have cancelled flights to and from China. The majority of reported cases are located in mainland China, but the spread has been rapid: at the time of writing, more than 20 countries have been affected, approximately 20,000 cases have been reported and more than 400 deaths have been confirmed. It is difficult to measure the extent of the indirect impact of the epidemic on the world economy, but the direct impact of the measures taken by the authorities and the private sector is likely to weigh on Chinese growth. Indeed, many companies have been forced to temporarily close their offices and many factories have stopped production. Leading indicators in China may suffer in the first quarter, but the Chinese central bank and the central government will do their utmost to limit the negative effects of the virus on business. The radical measures announced also show the determination of the People's Republic to contain the epidemic as soon as possible. However, the markets still showed their concern.

The equity markets lost part of their advance, commodities such as industrial metals and petroleum suffered strongly and interest rates fell in a movement to reduce risks. The financial markets' epidemic reaction shows that this is a risk to keep an eye on. To better anticipate the overall impact of 2019-nCoV on the economy, we will continue to closely monitor leading indicators such as purchasing managers' indexes, stock movements and investor sentiment. We will remain cautious until the situation is completely stabilised.

Are US stocks too expensive?

Valuations are rarely the triggers for bearish trend. However, they can amplify bearish trends or signal the approach of a burst of volatility.

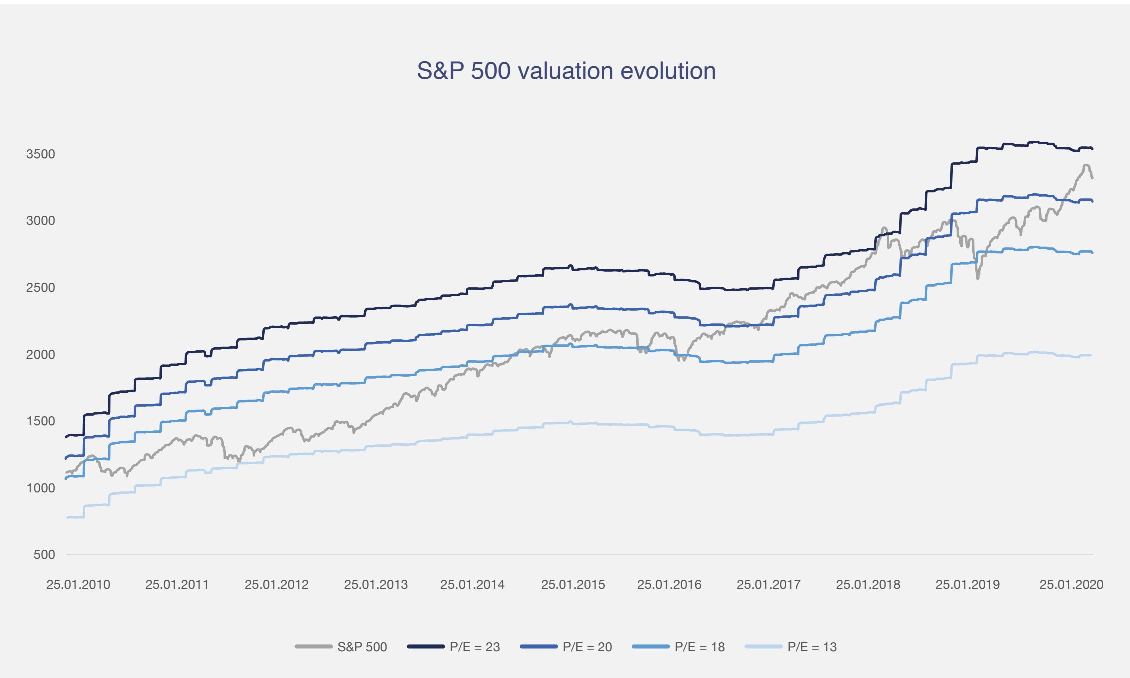
The fall in risky assets following the spread of the Chinese Coronavirus was undoubtedly exacerbated by the high level of valuations in the early days of the movement.

The following graph shows the level of the S&P 500 framed by its valuation limits expressed in Price to Earnings ratio. The graph traces the history over 10 years.

Before the Coronavirus correction, the S&P 500 was close to its highest recovery point, which has hardly happened in the last 10 years. We can conclude that valuations have been historically high.

On the one hand, an expansion of valuation multiples can be justified by a context of low rates. In fact, the more the rates fall, the more the future cash flows increase and conversely the cost of capital decreases.

However, this mechanism has a limit and the central banks must be more aggressive to justify a sustainable rise in valuations. Therefore, the companies' results will have to reverse the trend and start rising again to relax these levels of valuation and restore bullish potential.



Equity markets

Global Equities

A year of US recession was expected by some market stakeholders in their beginning-of-the-year forecast. In reality, the opposite occurred, 2019 was a strong year in every way. Corporate profits continued to expand and valuations went from 15x to 22x profits on the MSCI World, the global equity index. US-China trade deals, UK elections, and accommodating central banks have pushed stocks to record levels.

We believe that the world economy is at the end of a cycle. Indeed, the caution of central banks in their decisions to keep rates low and their messages confirms our view. Investors with few short-term investment solutions to invest their liquidity continued to channel it into equities in view of the potential resolution of the risks mentioned above.

This first quarter promises to be relatively buoyant for equities given the momentum in reducing short-term macroeconomic risks. We therefore take the decision to increase our overall exposure to equities in our portfolios from very underweight to neutral.

United States equities

The US equity market ended the year on a high note with a 2019 performance of +31%. The sector with the best performance is technology with +47% and the sector with the least progress being that of energy at 7.43%.

Like our overall allocation, we are increasing our exposure to US equities from slightly underweighted to slightly overweighted.

This allocation is explained by the good resilience of the American economy thanks to its sustained domestic consumption and its very dynamic labour market.

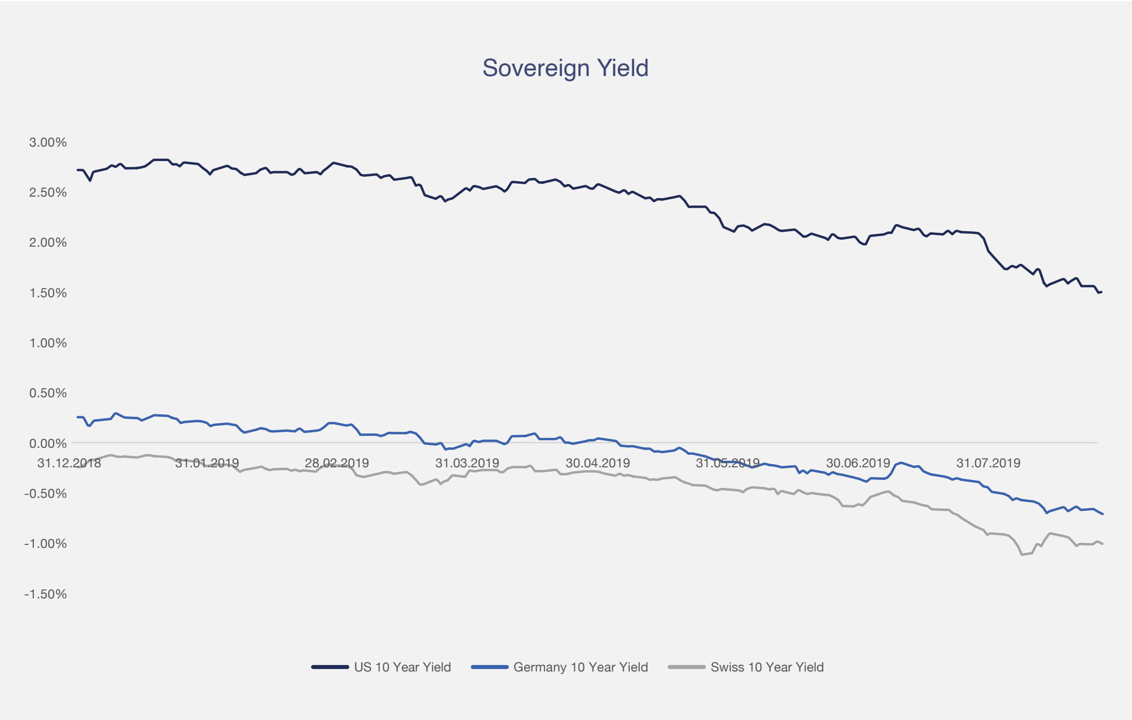
We are aware of the relatively high evaluation levels. However, we believe that the momentum should not stop and that the risks are limited for the moment.

Despite this overexposure to US equities, for this first quarter, we prefer to focus on defensive sectors such as telecoms. In our opinion, the technology sector has grown too quickly.

European equities

The European equity market also ended the year strongly with a 2019 performance of +24%. This delay vis-à-vis the American market is justified in our view given the structural weakness revealed by weak domestic demand, its economy being dependent on export in a context of ambient conservatism and its virtual absence in the league of large "Big Tech" companies. Mr Trump having signed his phase 1 trade agreement with China, he should logically turn to Europe to satisfy his electorate and therefore prepare for his re-election in 2020. We maintain our underweight position in this region and favour the sectors with a high dividend like European financials.

Fixed Income Markets



Global Bonds

The bond market has been very profitable this year. 2019 started with relatively high rates against rising end-of-cycle rates in large developed economies.

As inflation did not have an impact on risk indicators, central bankers preferred not to tempt the devil by keeping an accommodative policy and let the possible economic slowdown do the rest. 2019 was therefore a very good year for bond investors with rates in December 2019 significantly lower than in January, so rewarding bond investors with large capital gains.We are raising our overall allocation from neutral to slightly overweight as we believe the global economy should not overheat in the current environment and therefore should not see rate hikes affect prices in the short term.

United States Bonds

US bonds rewarded investors with an increase of around 9%, capital plus interest. This year is starting with significantly lower rates than last year, so reducing the potential performance. Like last year, we mainly allocate our portfolios to good quality investment grade bonds. The High Yield segment is therefore underweight because its risk/return profile is considered too low. Indeed, the risk premium asked for carrying this type of bond with a credit rating lower than BBB- turns out to be historically low. It went from +4.5% in January to +2.91% currently of risk premium to be added on a government bond of the same maturity.

European Bonds

The European bond market generated a profit of around 7% in 2019. Like its American counterpart, it will be difficult to equal this performance this year. Indeed, rates are already at floor levels and, unless there is a very marked slowdown, they should not drop much lower.

European banks have issued a lot of hybrid debts offering attractive yields taking advantage of ultra-low rates and therefore enabling eurozone investors not to get caught up in negative rates. Germany and its fiscal orthodoxy will keep interest rates low for the coming quarter.

Emerging market bond

We increased our allocation in emerging markets from slightly underweight to slightly overweight. Central banks are expected to remain calm at the start of the year.

The risk premiums for carrying this type of asset have been reduced somewhat, but the Q4 momentum should continue.

Argentina is still facing a default that could materialise later this year. This event, although already anticipated by traders, could shake the market.

Turkish bonds, for their part, have managed to recover all the ground lost since 2018. There are still pockets of value in this region.

Conclusion

Despite the risk factors detailed in this review, we have decided to increase our equity allocation from Underweight to Neutral. We believe that the possibility of seeing the equity market continue to rise is great. Indeed, central banks should continue to add liquidity to the market and we believe that companies should release improved results. However, we decided to protect the portfolios exposed to equities by buying put options. We made this choice of hedging so as not to penalise the portfolios in the event of a rapid rise in the markets and to allow smoothing potential increases in volatility at low cost.

At the same time, we are very slightly overweight in bonds. As the primary market was active at the start of the year, we took advantage of these opportunities. Within this pocket, we are neutral on Credit Investment Grade, slightly underweight on US High Yield, slightly overweight on emerging market bonds and underweight on sovereign bonds.

Concerning Alternative Investments, we are neutral on Hedge Funds and gold. As a reminder, we initiated our position on gold at USD 1468 per ounce in November.

Finally, we believe that risky assets should continue to provide performance in the portfolios. However, the risks are present, the signs of recovery are still timid and the risk factors mentioned will bring their share of volatility. We will have to adapt quickly because market regimes could change suddenly. Helped by our allocation matrix allowing flexible and diversified management, we will do our utmost to ensure the best possible risk/return ratio.

Hugo Derny
Investment Strategist

Tony Pangallo, CFA, CAIA
Member of the Investment Committee

Asset allocation

	UNDERWEIGHT	SLIGHTLY UNDERWEIGHT	NEUTRAL	SLIGHTLY OVERWEIGHT	OVERWEIGHT
EQUITY	○	→	●	○	○
US Equities	○	○	→	●	○
European Equities	○	●	○	○	○
Swiss Equities	○	○	○	●	← ○
Emerging Equities	○	○	○	○	●
Japanese Equities	○	●	○	○	○
FIXED INCOME	○	○	○ →	●	○
Investment Grade	○	○	●	○	○
High Yield	○	●	←	○	○
Emerging Markets	○	○	○	●	○
Government Bonds	●	←	←	○	○
ALTERNATIVE INVESTMENTS	○	○	●	○	○
Gold	○	→	●	○	○
Alternative Funds	○	○ →	●	○	○
CASH	○	●	←	←	○

Based on 12-month forecasts

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