Outlook 2019

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After a very uninspiring and disappointing 2018, which delivered losses to almost every asset class and style investing, something not seen since the Global Financial Crisis, we are staring at 2019, which is likely to be marked again by geopolitical and trade threats, and a more than uncertain economic environment. In 2018 the only two mainstream investments that delivered a positive result were a 24h USD deposit, 1.9%, and the 10 year German Bund, 3.1%. In fact the general landscape will continue to be treacherous in 2019, on all fronts. Financial markets will likely focus on:

- the Great China rebalancing
- Trade tensions and protectionism
- European politics
- Economic growth and inflation
- A monetary policy mistake by one of the main central banks
- High yield: a great opportunity or a source of troubles to come?
- Any geopolitical issue that might arise or reemerge, (Middle East, North Korea, etc)

China is rebalancing its economy towards domestic consumption, technological advance, and A.I. amongst other things, it's a fact and it will not stop, as it is a central piece to its 2035/2050 vision. It is certainly causing irritation to many, and is one of the reasons for the tensions between the US and China. Partial victories for both sides could be agreed relatively soon, as China is decelerating fast, and the US is starting to feel the impact economically. Trump also needs a victory for its domestic audience: so something will probably be agreed over the next several weeks. However globally the trade tensions will persist: the much touted replacement for NAFTA, the USMCA, still leaves in place tariffs for Canadian steel and aluminum production for example, while the dispute with Europe is likely to come back to the fore again, probably after the partial Sino-American agreement. Globally trade disputes are likely to stay with us for a while, as the forum used to settle them, the WTO, is now snubbed by the US and has lost credibility.

European politics will continue to be in the headlines, whether it is Brexit, France, Italy, or the upcoming European elections in May. Populism is growing everywhere, following the financial destruction of the middle class over the last two decades. The likely answer from governments, after either establishing a citizens' income or increasing subventions, will inevitably be an increase in taxes where the money is: the rich and the corporates. This is likely to reduce the profitability of the companies, as it will impact their margins.

Over in the US, the tax stimulus of 2018, which for the first time in history happened during economic expansion, is likely to create a huge hole in the US finances: while the US is currently experiencing its longest government shutdown in history, and probably a solution will be found for Trump's wall, (or fence), on March the 2nd the debt ceiling will be automatically reinstated, likely at around 22 trillion USD. We can expect again months' long negotiations after that date, and probably a reemergence of the risk that the US might not honor its debt some time in summer, although it's most likely that ultimately it will, and avoid default. Will Trump finish his term, or will he be reelected? We will not tag ourselves as specialists in US politics, however on the first question: we think that, as long as Republican senators feel that Trump is a tailwind for their own reelections, they will not stand in his way. On the second question: frankly at the moment we do not see any real

alternative within the GOP party, and on the democratic side a serious candidate with real winning chances has not emerged yet. So yes, Trump could be reelected with the status quo.

Global economic growth started to slow down at the end of the Summer, led lower by China and continental Europe, while the US, pretty much alone, has been holding up quite well. Leading indicators, like PMIs numbers, have on their side peaked in December 2017, particularly in Europe, and have continued declining since. While Italy's budget woes, the yellow jackets movement in France, or the new car pollution rules introduced in August could be considered as temporary factors, as several economists think, we tend to side with those that think that indeed we could be heading toward a synchronized global economic slowdown in 2019. While it was supposed to be only a temporary slowdown in Q3, all preliminary numbers from Q4 are weak, companies are signaling a slowdown, while inflation expectations have collapsed everywhere but in the UK, where salaries are on the increase because of Brexit, and the lack of workers. In Europe also it does appear like the unemployment rate has stopped falling, and thus remains at very elevated levels in various countries. In the US where the unemployment at 3.7% is at historic lows, salaries are actually increasing at the fastest rate since the GFC, but somehow companies are not, or cannot, increase prices of goods and services. This is something that has been going on since 2017, and a subject of a big debate amongst economists, as to why this is happening. From our point of view, almost every signal that we get from the data is flashing red, and we are therefore quite cautious for the year. Germany is no exception, and some politicians are already discussing about setting up a stimulus plan, just in case: no doubt they have the means for it, as the country has been running budget surpluses since 2014. Indeed it will be almost impossible that the US continues to grow at the current pace, absent any new fiscal stimulus, while the rest of the world slows down.

This leads us to one of the central question for 2019: what will central banks do? The path of policy normalization that they expected to carry out seems to be in danger:

- In the US the Federal Reserve did increase rates, to 2.5%, while it started to reduce its balance sheet. Last year it also mentioned that it expected it would increase rates 4 more times in 2019, and once in 2020, it has since changed its stance and said it would be more data dependent going forward. There is however a huge discrepancy : the financial markets are actually implying no rate hike for this year, and actually one rate cut for 2020, while inflation swaps are pricing in inflation at less than 1% for this year, and the short end of the curve has inverted. So either interest rates' markets are completely wrong, which is rarely the case, or the FED will stay put this year. They could also do a monetary policy mistake and misjudge the economy, by hiking too much, or maybe not enough.
- In Europe we have been writing for some time now, that the ECB should have acted earlier, in normalizing policies. Yes, the QE stopped in December, but corporate spreads are back to the same levels to where they were when the bank initiated the corporate buying program, and rates are still negative. Unless the economy rebounds, we think ECB's president Draghi will retire in November with rates still negative.

On the back of the above, it will be no surprise to our readers that we approached 2019 with a cautious footing in terms of investments. We did indeed in 2018 reduce gradually our risk allocation in both equities as well as high yield fixed income, and are now underweight both. Some equity sectors in Europe, like industrials, are indeed trading at recessionary valuations, while the high yield space, i.e. credit spreads, across the world has reached levels not seen since early 2016, which are levels of growing concern, again: either are the financial markets right, or for the optimist it is a great buying opportunity. We prefer to stay cautious, and wait for at least a stabilization of the macroeconomic figures, to proof us wrong, and miss a few percent of the upside, rather than dip our toe right now. At least for USD portfolios, there is a real alternative as 3 months rates are at 2.8%, while for EUR portfolios there is no alternative but cash at negative rates.

With so many uncertainties in so many asset classes, Gold is attracting capital flows again, making it an ideal diversifier in a global portfolio, and we keep it as part of our asset allocation.

In currencies, the numerous uncertainties that the major central banks, and investors, are facing, from politics to economy, makes it difficult to do any long term predictions on policy actions. This is why we think the EURUSD pair, is likely to stay trapped in the same broad range of 1.10-1.25 for the year, similarly to 2018. The British Pound on its side, will continue to be hostage to the Brexit process and its evolution.

Strategy

Overall Exposure

We are Underweight both Equities and Fixed Income, and Overweight Cash along with a Gold position.

Equity: Underweight

Slight Overweight Continental Europe, Underweight UK, Underweight US, Overweight Japan, neutral Asia ex Japan.

Fixed Income: Underweight

Underweight High Yield in EUR and USD. Neutral Investment Grade EUR along with an Overweight in Investment Grade USD Bonds, Underweight Sovereigns, Underweight EMs. Long Global Inflation Linked Securities, Long Cat Bonds.

Currencies: Neutral/Small long USD

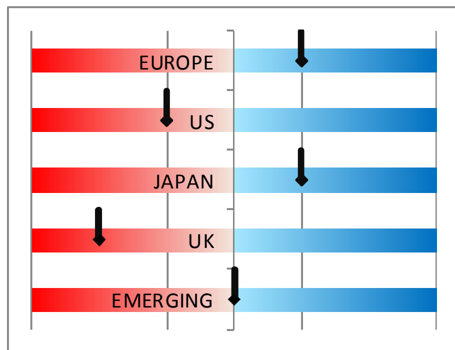
We still have a long but reduced USD position, portfolios are hedged against GBP.

Commodities: Neutral

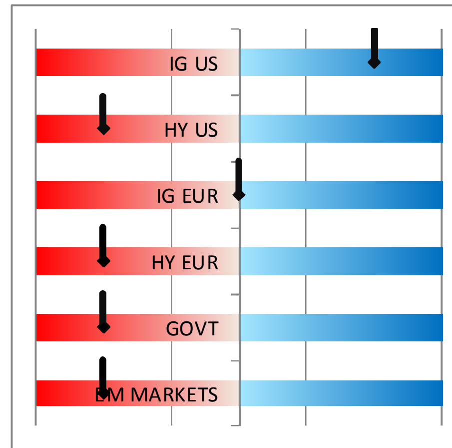
Long Gold, avoid Crude Oil.

Conviction Thermometers

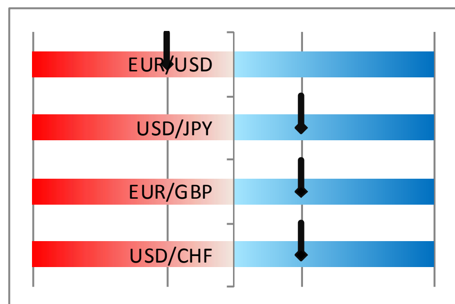
Equities



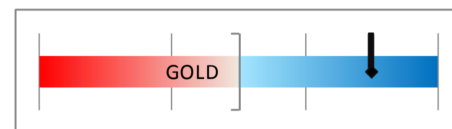
Bonds



Currencies



Commodities



*Negative view / Positive view

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