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# MONTHLY INVESTMENT OUTLOOK

January 2019

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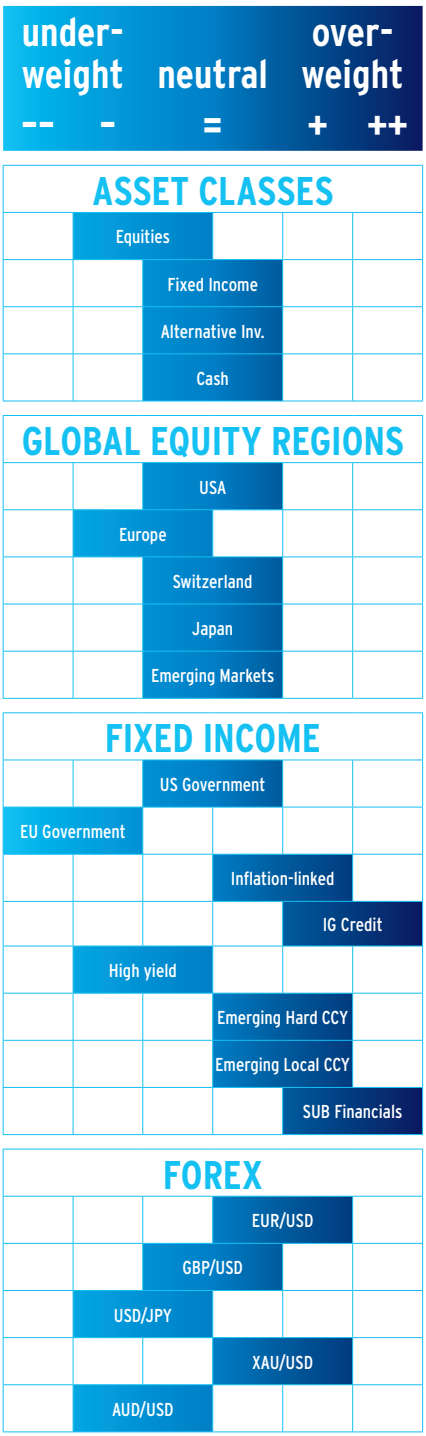
# AT A GLANCE

- The equity bull market is ageing, focus on risk management has become increasingly important.
- After disappointing performances in 2018, safe haven assets (treasuries, gold, yen etc) might finally stage a comeback in 2019.
- EM assets (equities and bonds) might benefit from a potentially weakening USD and attractive valuations.
- When pessimism is so widespread, a short-term contrarian rebound in risky assets is highly probable.



# INVESTMENT INSIGHTS

2018 was a horrific year for major equity indices. It was also a very challenging year for asset allocators. The old principles of portfolio diversification did not work to the same success as previous years, with almost all sub asset classes posting negative returns, except cash in USD.

Both the economic environment and investor sentiment changed swiftly during the year. Fears of an overheating US economy shifted toward the possibility of an imminent recession only a few weeks ago. Sentiment moved from euphoria, where investors did not pay attention to the risks (trade wars, Italian political situation etc), to extreme bearishness.

To better assess the 2019 outlook, we need to take into consideration one important development: main central banks are not expected to grow their balance sheets anymore after 10 years of liquidity injections. The end of the ECB quantitative programme has been well-communicated by officials, and the Fed remains in tightening mode. We would like to highlight two consequences of this new situation. First, Central Banks, through their easy monetary policies, have acted lenders of last resort, helping financial markets to stabilize when needed, and also offering a protective put on risky assets. In this regard, the drastic recent change of tone of US Fed Chairman Powell is striking: he has been forced to adapt his speech after the market turmoil, by mentioning that he "is listening sensitively to the message that markets are sending". Secondly, removal of liquidities tends to exacerbate market moves, hence feeding cross asset volatility.

In such a context, being overly exposed to equities seems unwarranted as managing risk is becoming increasingly important. Moreover, the current economic situation is clearly pointing to a global slowdown. Europe has been decelerating since Q1 2018 while China is adopting stimulative policies to restore growth. Even the US economy, which was shielded from global economic weaknesses, seems to be recoupling with the rest of the world. December ISM manufacturing's decline was one of the biggest by historical standards, clearly suggesting that the US economic momentum is losing steam.

Given the strength of the US labor market (with 312k jobs created in December), we have good reason to believe that the US economy will not face a sour scenario this year, i.e. a sudden recession. Nevertheless, we acknowledge that companies' earnings might be at risk of disappointment, and relying solely on attractive valuations is not enough to justify an overweight stance on equities, particularly at a time when the technical picture has turned negative.

In the short-term, given the widespread panic levels reached on different sentiment indicators, a contrarian rebound in risky assets might take place. And if the current bounce, initiated in late December, is extending, it will be a good opportunity to further reduce equity exposure, hence increasing the cash level, one of the best stabilizing assets in a portfolio.

Finally, we believe that traditional safe haven assets (gold, treasuries and JPY in particular), which posted disappointing performances in 2018, will be able to generate positive returns this year in a context of rising volatility. It might be a good time (after a seven-year bear market) to increase positions in the yellow metal as US real interest rates will likely fade going forward. Moreover, any weakening in the dollar will feed gold appreciation.

**THE QUOTE OF THE MONTH**

*"We are listening sensitively to the message that markets are sending"*

Jerome Powell
4th of January 2019

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# EQUITIES

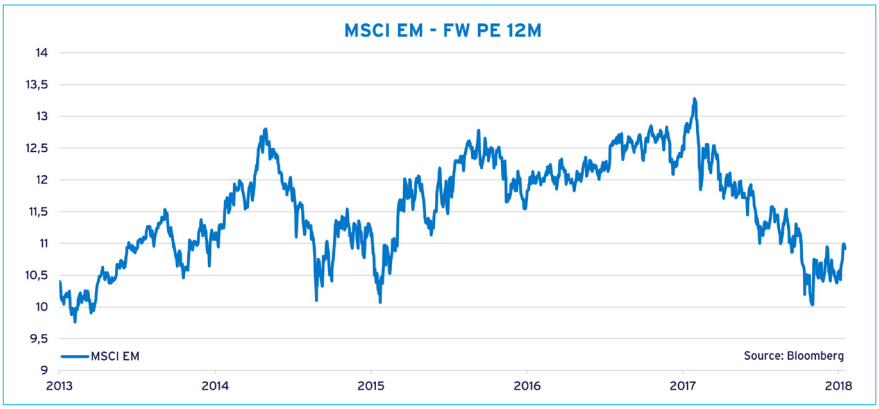
2018 was a roller-coaster year for equity markets with a nasty epilogue: it was the worst December performance for the S&P 500 since 1931. From euphoria in January to extreme bearishness in December, major indices endured four major drawdowns, ranging from -8% to -15%. We did not expect such a scenario in a context of strong EPS growth with US companies able to deliver a tremendous 22% profit growth over the year on the back of a supportive economic backdrop. In Q4 2018, fears of a global synchronized slowdown next year, coupled with tightening financial conditions are probably the main arguments justifying such a painful outcome for equity markets.

For 2019, we need to take into account that the volatility regime has changed and adapt our views accordingly. While we believe that current market pricing is disconnected from the fundamentals, we cannot discard further PE multiple contraction, particularly if companies cannot deliver on the earnings front. In this regard, the latest profit warning from Apple is adding to fears of potential negative surprises in the incoming earnings season. Therefore, allocation to equities should not be exaggerated despite attractive valuations and we would recommend reducing some exposure in case of a strong bounce. This is a drastic change of tone compared to 2017.

We find emerging markets equities attractive on relative and absolute valuations grounds. Moreover, EM equities should benefit from a potential weakening USD.

From a sector/style standpoint, cyclical names have been hammered lately, triggering a massive de-rating. Given the current oversold conditions, we believe a short-term rebound might take place. However, we are definitely more cautious for the medium-term and we would stick to more defensive segments, such as healthcare, staples or utilities. Additionally, favoring companies offering high-quality criteria is appropriate.

Finally, it is too early to downgrade the technology sector, even though we are less bullish than in the past. Selection is key and some US companies still offer a good way to invest in structural growth themes (software, internet etc).




| under-weight -- | - | neutral = | + | over-weight ++ |
|---|---|---|---|---|

## GLOBAL EQUITY REGIONS

| | | | | |
|---|---|---|---|---|
| | | USA | | |
| | Europe | | | |
| | | Switzerland | | |
| | | Japan | | |
| | | Emerging Markets | | |

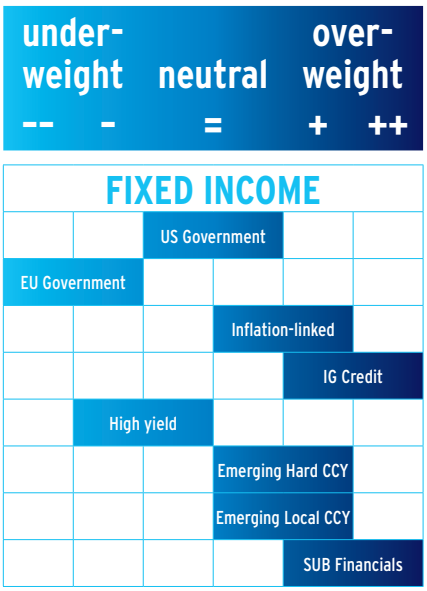
## U.S. EQUITY SECTORS

| | | | | |
|---|---|---|---|---|
| | | | Healthcare | |
| | | Industrials | | |
| | | Financials | | |
| | | | Energy | |
| | | Cons. Discret. | | |
| | Cons. Staples | | | |
| | | | Technology | |
| | | Utilities | | |
| | | Telecom | | |
| Materials | | | | |

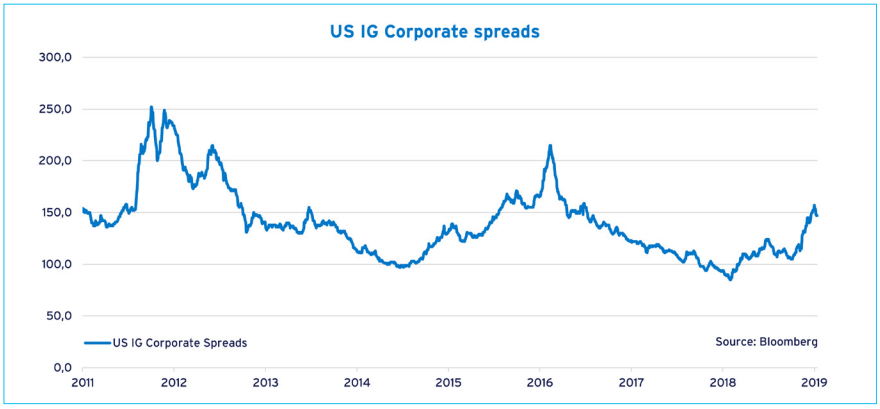
## EU EQUITY SECTORS

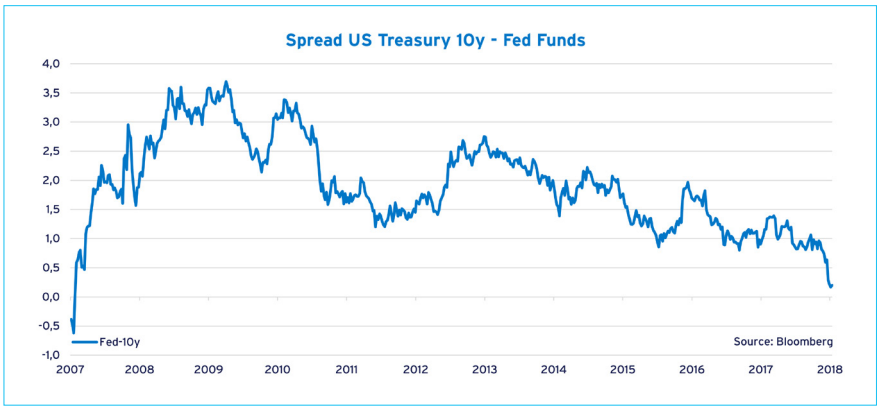
| | | | | |
|---|---|---|---|---|
| | | Healthcare | | |
| | Industrials | | | |
| Financials | | | | |
| | | | Energy | |
| | Cons. Discret. | | | |
| | | | | Cons. Staples |
| | | | | Technology |
| | | Utilities | | |
| | | Comm. Services | | |
| Materials | | | | |

# BONDS




2018 has been challenging for most asset classes, including fixed income, and 2019 looks to also be complicated in an environment characterized by tightening monetary conditions with a backdrop of slowing economic activity globally. These leading forces have been obsessing the market over the last quarter, leading to a sharp rise in volatility and risk premia, which translated into a marked increase of credit spreads. It also provoked a flight-to-quality into safe-haven government bonds. While this environment should persist in 2019, we judge the current pricing as excessively negative when confronted with the reality of the fundamentals. We therefore expect risky assets to rebound as well as core government bond yields to rise at first. We tactically favor credit (Investment Grade quality, FRN and intermediate maturities) against govies (short duration), and also like emerging market bonds (in both hard and local currency) as well as subordinated financials in Europe. Credit spreads are indeed fairly attractive at current levels. Also, the marked divergence of monetary policies across the main continent offer some attractive carry through in FX hedging strategies (notably EUR credit hedged into USD). Still, over the medium-term, as the cycle is rolling over, we will adopt a more defensive stance where we believe quality and liquidity will be key, and thus will move higher on the credit scale while lengthening portfolios' duration.



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# FOREX

| under-weight | | neutral | | over-weight |
|---|---|---|---|---|
| -- | - | = | + | ++ |

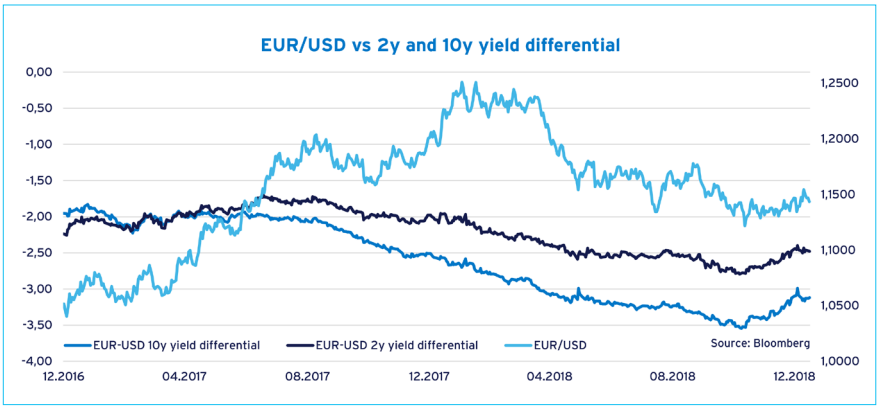
| FOREX | | | | |
|---|---|---|---|---|
| | | | EUR/USD | |
| | | GBP/USD | | |
| | USD/JPY | | | |
| | | | XAU/USD | |
| | AUD/USD | | | |

The main theme driving the medium-term USD outlook at the beginning of the year seems to be the expected US economic slowdown. This already led to a sharp correction in bonds yields since November 2018, to the market pricing out any Fed rate hike in 2019, and is pushing the dollar index down from its recent peak at 97.7. The US economy is indeed showing signs of slowing down after a tax-cut induced exceptionally strong 2018. The housing market is deteriorating and manufacturing activity is decelerating. Despite the latest strong employment report, disappointing leading cyclical indicators should carry more weight in influencing the US dollar trend for the months to come. Tariffs and rising labor/funding costs should also lead to slowing corporate earnings growth and to USD outflows (benefiting EUR in particular). Speculative positioning in USD longs remains high, suggesting significant potential for positioning adjustment.

In the Eurozone, political tensions somewhat eased off at the end of the year, with a compromise reached over the Italian budget. However, following the UK Parliament's rejection of Theresa May's Brexit deal, the situation remains highly uncertain. Political turmoil remains in the spotlight in France, and European Parliamentary elections in May will likely be a headwind for euro strength in H1 2019. The sour economic situation is not improving and sentiment remains depressed as indicated by the latest confidence indicators. Before seeing any inflection in the Eurozone's deteriorating economic backdrop, it is hard to get excited about the EUR vs the USD.

Despite US yields declining sharply since November 2018, EUR/USD has remained relatively stable in the 1.13-1.15 range, the favorable trend of the yield differential for EUR being counteracted by political woes, capital outflows and disappointing economic data. Our technical analysis point to a short-term bullish bias in EUR/USD, and a breakout above the 1.15 area is likely. In the medium-term, however, we do not foresee the pair exiting the wider range of 1.12-1.18 in Q1 2019.

We expect USD/JPY to weaken with the Japanese yen benefitting from two major supports: valuation and safe haven demand. Hence the combination of heightened global uncertainties and cheap valuation should help JPY be strong in the short to medium-term. Since Q4 2018 USD/JPY correlation with yield differential has increased, partly explaining JPY strengthening from 1.14 to 1.08. Japan economic surprises also improved in December, further supporting the Japanese currency. Longer-term it seems plausible to us that USD/JPY will decline below 2018 low (ca. 104.50).



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