

WHAT TO EXPECT IN 2019

Profits, FAANGs and rate rise cycles are set to define the US market in 2019. Top investors discuss the themes they believe will really shape the landscape this year

TRUMP, TECH, AND THE GREAT VIX REVIVAL



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Editor

Trump. Trump. Trump. There, I've said it. It is nearly impossible to talk about US market performance without mentioning the man at the helm of the country.

The US President has reassured investors that the fall-backs seen in December will be recovered once his trade deals take root, and he has also castigated the Fed for raising rates. With such a vociferous leader, how can investors operate without at least paying some attention to the macro-political noise?

So what are asset allocators actually doing when it comes to US markets? Francois Savary, CIO of Swiss group Prime Partners, says we are in a unique position which demands action.

'Going into 2019 and especially due to the very strange market conditions in December, we have decided to review our US equity exposure. We saw signs of market capitulation in December when the VIX reached the 35 level,' he adds.

The extent of this shift led the Geneva-based investor to switch US equity exposure to an underweight in his allocations over the course of 2018 and into 2019. However, he remains largely bullish on the prospects for the world's most-closely followed stock market.

'The significant setbacks in technology stocks were another factor that suggested we may have reached an entry point on some stocks. Therefore, we have adjusted our defensive sector allocation towards more growth following the terrible month of December.

'Does it mean that we change our medium-term view for US equities? No, but we do consider opportunistic buying could be possible if we continue to look for stocks on weakness. This is the thinking that will continue to drive our allocation decisions with regards to global equities in 2019,' he says.

His comments are echoed by Italian investor Davide Montaldo, who is also adopting an opportunist's stance when it comes to the US market. 'For me, 2019 is about growth, while yield has also returned in the US. Both points are opportunities for us to try to make money over the next 12 months and beyond.

'On the equity side it is about being active, trying to take advantage of the dispersions of returns,' he says. 'You need to build long-term positions on stocks with strong fundamentals and long-term themes. But you need take positions gradually if you are building new portfolios over the coming year.'

COPING WITH VOLATILITY

Many investors are concerned that 2019 will be a year of marked volatility for the US. According to Bloomberg, over the course of 2018 the S&P 500's 20-day realised volatility hit its highest level against its European counterpart since the financial crisis.

In this light, many investors are re-evaluating their US exposure. Pierre Molinero, who works within the fund of funds team at OFI Asset Management, is among those who have noted a sea-change in the role US equity exposure plays in portfolios.

'US equities have been the only game in town for several years. If you wonder why the US market has not played its defensive role recently and has dipped more than its European



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and emerging counterparts, overcrowding in the US equity sector is the usual suspect.

'The US economy is decelerating – after reaching an unsustainable growth rate of 4% – while the central bank is tightening monetary policy. This makes a toxic cocktail when valuations remain lofty. At first, market P/E seemed to have returned close to its historical average.

'But margins remain at a historical peak, at more than 10%, and US corporates have relied heavily on financial engineering to boost earnings per share, creating weaker balance sheets in the downturn. So we remain prudent on US equities in the medium term,' he says.

However, you would be

wrong to to assume that equities encapsulate the whole US story. The focus on Fed policy has not dimmed despite a move towards normalisation, which has brought several rate hikes over the past 12 months. Jerome Powell's actions have significant ramifications for the US bond market.

OUTLOOK FOR BONDS

According to 2018 data, US bonds, as measured by the Bloomberg Barclays US Aggregate Bond index, hit a cyclical peak over the course of the year, which can be attributed to tighter Fed policy and the effects of a strong dollar coming to the fore.

Invesco fund selector Pierre Bellot says there are many obstacles for the US bond market in the year ahead. While the performance in higher-yielding parts of the market is likely to improve – barring a major spate of defaults – Bellot is cautious on the country's sovereign debt situation.

'After their recent recovery, US treasuries look unattractive. Hedging costs mean that the German bund yield is higher than equivalent euro-hedged US treasuries. The outlook for the US dollar also appears bleak, given the US twin deficit is likely to grow and its economy looks set to slow while those in EM/Europe stabilise or pick up.'

Nevertheless, Bellot, like Savary and Montaldo, is cautiously optimistic when it comes to stock market opportunities. 'If the global economic expansion continues, US equities could offer the best opportunities in 2019, especially as valuations are back to moderate levels.

This is particularly the case with cyclical stocks, where relative valuations have fallen to their lowest levels in the past four decades.'

RIDING OUT UNCERTAINTY

Looking ahead, selectors are braced for uncertainty. Pierre Bonart, head of multi-management at Edmond de Rothschild, is cooling his stance following the tumultuous end to the previous year.

'The chaotic end of the year on markets, especially in the US, raises questions about what can be expected this year. The US market saw



launch a long/short equity fund of funds in August 2018, with adjusted market exposure through market-neutral funds, in order to protect on the downside,' he adds.

'Valuation differences between sectors have not all been corrected and we believe the value style still has catch-up potential. The volatile environment also favours a prudent focus on quality investments for the year ahead.'

Meanwhile, Molinero brings the question back to the age-old concern of whether it will still make sense to be active in the US market in

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a strong sector rotation during the last quarter, with sharp declines in the various sectors that were on the rise.'

Bonart says the US market decline was expected and his company tried to be proactive in the face of a changing outlook. 'Markets have been rising for more than nine years and the valuation spreads between sectors had reached levels not seen since the beginning of the millennium, with certain stocks capturing the bulk of investor attention and market capitalisation.

'This encouraged us to

the near term. 'The biggest challenge in the US has been alpha generation from active managers. US managers have struggled to outperform for several years, and 2018 has been no exception.

'Several explanations have been highlighted – ETFs, market performance driven by mega caps, QE, algorithmic trading strategies, and so on. We don't think these issues are permanent and we remain confident that some high-quality managers will be able to perform in a challenging environment,' he says.