Prime Partners

DEPUIS 1998

MARKET INSIGHT

SEPTEMBER 2020

CITYWIRE SWITZERLAND TOP 50 INDEPENDENT ASSET MANAGERS 2020

Market Analysis

September 2020

We've got through the easy part. Now what?

If we look back on the pessimism that prevailed in the spring, summer 2020 was full of surprises for both the economy and the financial markets. Many, often dismal, forecasts proved to be entirely misplaced.

In terms of the global economy, our instincts were on the money: we observed a V-shaped economic recovery, based on the numerous consumer spending and production statistics and leading indicators (PMI indices) published.

Although we welcome such a development, we must recognise that the positive momentum that started in late spring has recently weakened, prompted by the US partially getting to grips with the COVID-19 pandemic and an upsurge in the latter in Europe and Asia.

While mortality rates are significantly better than what we saw in the winter and spring, the growing number of new infections in several countries is weighing on ecnomic agents. In other words, COVID-19 is not going away without a fight and this could dampen the confidence of business owners and consumers in the coming months.

"Navigating through opportunities and risks remains a daily challenge."

FRANÇOIS SAVARY, CHIEF INVESTMENT OFFICER, PRIME PARTNERS

The difficulty in managing this crisis is that there is a simultaneous shock on the demand and the supply. An unusual phenomenon that could, if things take a turn for the worse, have a depressive impact on the global economy; this must not be underestimated.

September, which is fast approaching, will be crucial to see whether the stimulus measures adopted by governments and central banks will prevent unemployment rates from plummeting. Against this backdrop, it is hard to ignore the recent severance and redundancy package announcements, which could undermine improvements in demand if there is a sustained rise in unemployment.

Similarly, without greater visibility on the economy and the health situation, there is reason to wager that business investment will remain tight in the short term.

We are not questioning our global scenario of a medium-term upturn in activity, but we do think that the latter will be more erratic over the coming months unless a COVID-19 vaccine becomes available soon.

In a nutshell, it seems that the easy part is behind us with regard to the economy and that we must now get used to the idea that economic activity will not return to 2019 levels before the end of 2021, or even the first half of 2022.

Economic policies continued to build on the decisions made at the end of winter 2020: we are still seeing huge liquidity injections and it seems unlikely that this will change anytime soon, according to various statements from central banks and politicians.

The adoption of the European Economic Recovery Plan at the end of July was also indicative of policymakers' mindsets on all sides: exceptional measures for exceptional circumstances!

The agreement struck between European leaders constitutes a major event for Europe in its efforts to sustain the union, which has increasingly come under fire in recent years. Time will tell whether Europe has finally turned a new leaf and made a concerted, much-needed effort to come together.

Generally speaking, the developments in Europe fall under the broader discussions on the scope of the budgetary and

monetary resources granted worldwide to manage the current crisis.

Questions surrounding the dramatic increase in debt or the inflationary risk inherent in such profligacy are perfectly legitimate, but there are no easy answers.

The de facto adoption of "modern monetary theory", which submits central bank policy to budgetary needs, was the easiest part of this decision, given the current extraordinary economic conditions.

However, this leap into the unknown could prove less straightforward than it appears on paper, since the above theory is not without criticism. This will make the job of central bankers and their government counterparts more tricky in the coming quarters. The reality principle, which has governed decisions in recent months, must underlie any action they take. This will be no easy challenge given the lack of certainty.

Thus, the issue of inflation and the risk of it making a comeback will remain at the forefront of debate. In this respect, it is worth pointing out the surge in gold prices over the summer, which could suggest that market operators are now sceptical as to decision-makers' ability to keep inflationary pressures in check.

Once again, the easy part of the macroeconomic management of the crisis is behind us. The implementation of massive action plans we have witnessed is remarkable. It remains to be seen whether decision-makers have been playing the role of sorcerer's apprentice, justifying fears of them carrying on regardless of the adverse economic and financial fallout.

This brings us to the markets' behaviour over the summer.

As we said previously, the rise in the price of gold – despite its recent consolidation – is a significant phenomenon; similarly, the fall in the US dollar, which appears, at least in part, to be a result of gold's price increase, came as a surprise to many. These two developments were music to our ears, as we had constructed our asset allocation to factor in such changes.

However, gold's and the dollar's marked fluctuaitons over the summer, combined with some form of consensus regarding the persistence of recent trends, must lead us to examine the validity of our positioning. We will come back to this later.

In terms of bonds, political and monetary authorities certainly focused their efforts on promoting a return to liquidity and "normal" market conditions in the spring. It has to be said that by the end of the summer, this was a complete success.

In a zero- or even negative-rate environment for government debt, the tightening of credit spreads stood out in recent months. Who would have believed, just six months ago, that yields on high yield debt would be so low.

The fact of the matter is that although the authorities have done everything they can to prevent a wholescale collapse, we cannot rule out a form of "creative destruction" in the coming quarters. As it happens, we must hope that the latter does materialise; indeed, it would not be a positive thing for the economy in the medium term if the number of zombie companies were to increase.

All this brings us to the conclusion that credit now offers limited potential. Separating the wheat from the chaff will be no mean feat, but policymakers must not shy away from doing so. Broadly speaking, preventing a return of mass fears about corporate debt, while accepting the inevitable bankruptcies, is not as easy as one could believe.

This takes us to the equity markets. If we had to sum up recent events in one word, that word would be "incredible".

First of all, this is because the pessimism of March offered hardly any indication that the markets could return to February's highs, like the US indices.

Better still, seeing the Nasdaq break record after record is quite remarkable.

On a personal level, we must admit that the markets' strength caught us off guard.

We did not blindly follow the crowd in March; quite the contrary. However, we were too cautious in our assessment of risk assets' potential for recovery, especially at the start of the summer.

This is a lesser evil, since we profited handsomely from the indices' climb.

As a matter of fact, it quickly became apparent to us in March that the measures taken to boost the bond markets' return to normal prompted a significant upturn in stock prices.

We do not think it necessary to question whether or not we have entered a liquidity "super cycle", which would be beneficial to equities in the medium term, especially if the recovery continues in the coming quarters. However, the markets' capacity to plough on without any real consolidation is astonishing.

All the more so, as some sentiment indicators suggest investors view the markets with a degree of complacency.

Moreover, market valuations have become expensive, particularly in the United States. Admittedly, the Q2 earnings season surpassed expectations, but we should not forget that they had previously been significantly downgraded.

When we take the (at times) unfavourable political and geopolitical developments into account, it becomes clear why we are still sceptical about the markets' ability to maintain their upward trend without consolidating in the coming months.

This last point is particularly true as the US presidential campaign is reaching fever pitch, and we expect to see some intriguing plot twists, to put it mildly!

To sum up the global landscape of economic and financial changes in the summer of 2020, we cannot get away from the feeling that we must not project recent developments onto the immediate future. This is one way of applying the famous reality principle cited earlier.

Turning to recent changes in our asset allocation, let us begin by saying that, broadly speaking, it has not changed substantially: diversification; risk managed as a priority; reflection on options adopted in line with daily changes in the economy, politics and finance; finally, a fundamentally tactical stance, in the face of uncertainties that mean the short term is just as important as long-term trends.

Our investment policy has barely changed, primarily on account of the lack of real consolidation on the stock markets.

Although we had reduced our index hedges (particularly on more aggressive profiles) after stock prices declined in June, we did not alter the weighting of equities held in the portfolio in July or August.

However, as market momentum sends them soaring to dizzying heights, it becomes increasingly pressing to decide whether or not hedges should be strengthened. This is particularly true as market breadth is relatively narrow in terms of sectors contributing to the advance, and as the electoral campaign in the US raises many questions.

For the time being, we have decided not to adopt a more defensive stance on the equity markets. This does not mean that we have ruled this out for the future, however.

Nonetheless, any such decision would only be temporary and tactical; we maintain our view that equities must play an important role in a medium-term asset allocation. The continued zero-rate environment, combined with an ongoing economic recovery – a scenario with which we agree – supports this.

We have nevertheless slightly increased our exposure to long/short strategies on equities in our portfolios.

We have not made any great changes to our fixed income investments either; at most, we have increased exposure to inflation-linked bonds because we expect inflationary pressures to rise in the next 12 months and certainly two years.

We did not go back on our decision to invest in credit over government debt during the summer.

This bias remains in place, but we think we need to tread more carefully in how we apply this. As such, we prefer investment grade debt and recommend avoiding making high yield investments in the current conditions.

Gold investments, which we strengthened in the spring, accounted for a significant proportion of our allocation at the start of the summer.

Given the speed with which prices rose in July, we took some profits, while maintaining an overweight on this asset class.

We continue to have a positive attitude towards gold, and do not think we have seen the end of its rise in the medium term.

The consolidation in the past few weeks justified our decision to trim back our position, but we must not completely withdraw from investments in physical gold by any means.

The current downturn should not last! The USD 2,200 per ounce price target is realistic over a 12-month period.

The accelerated depreciation of the greenback was in line with our expectations, and took us a little closer to the 1.20 target that we had set for the euro/dollar exchange rate.

It is right to underweight the USD; we expect to see sideways trading between 1.15 and 1.20 in the coming weeks. A return to 1.17 may offer opportunities to short the dollar, targeting 1.20 initially before testing 1.25.

To conclude, 2020 is already a unique year and the next few months are unlikely to change that, especially given the US electoral campaign and the resurgence of COVID-19 in the past few weeks.

When you are gripped by a crisis that is unprecedented in many respects, asset management is no easy thing. Navigating through opportunities and risks remains a daily challenge, but one that we have taken on and will continue to shoulder.

Admittedly, we have not done everything right in the recent period. We have, however, tried to map out our course and to convince you that it was possible to make certain decisions rather than standing idly by or, worse yet, crumbling with despair.

Given the performances reported by our various investment profiles since mid-March, it is fair to say that the work we have done deserves to be recognised; indeed, we had our sights set on a return to positive territory or close to zero. We have achieved this, perhaps more quickly than hoped, and this is truly a source of satisfaction.

We do not intend to let down our guard or become complacent.

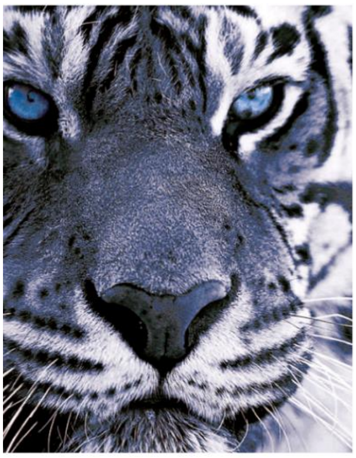
The main lines of our investment approach are in place and do not seem to require any significant alteration.

Like Monet, we will continue to make our refinements one stroke at a time, if necessary, based on any events and opportunities that may arise.

Managing risk must remain a priority over the coming months and getting overexcited is no more helpful than panicking. 2020 has served as a reminder of this, if we ever needed one.

Trying to adjust to the reality principle has enabled us to make good decisions in the last six months; we owe it to you to build on what we have achieved so far.

Geneva, 24 August 2020



Prime Partners SA
Rue des Alpes 15
P.O. Box 1987
1211 Geneva 1

www.prime-partners.com

CONTACTS

François Savary
Chief Investment Officer

Jérome Schupp
Equity Analyst

Julien Serbit
Portfolio Manager

Tel +41 22 595 09 97
fsavary@prime-partners.com
jserbit@prime-partners.com