Prime Partners

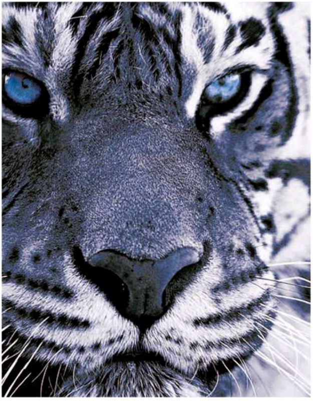
SINCE 1998

MARKET INSIGHT

DECEMBER 2019

CITYWIRE TOP 50

INDEPENDENT ASSET MANAGER



Market Analysis

Hope for the best and prepare for the worst

The 2019 equity rally has been described as one of the least popular in history. And this comes as no surprise when we consider how hard it was for investors to make gains. To see the truth in this, we need only cast our minds back to the pessimism about the future of the stock markets prevailing at the end of last year. Few investors at that point thought that US equities would have rallied by almost 25% by late November 2019.

Setting aside the difficulty of managing the stock market correction in the final quarter of 2018, we fared well and took advantage of dips to reposition ourselves on the markets at the start of the year. Our only regret is that we did not go even further.

After an excellent autumn for the stock market, global markets are now performing exceptionally well (although that's not to say that recent quarters haven't brought some ups and downs).

Central bankers returning to the spotlight by halting efforts to normalise monetary policy clearly contributed to this phenomenon. Reflation enabled investors to overcome the "fear barrier", although fears (of the trade war, Brexit, elections, etc.) have not disappeared – far from it.

And yet this does not alter the fact that, when we come to take stock, we can celebrate the strong performances achieved by the portfolios. However, we should have the humility to acknowledge the extent to which central bankers have helped us to compensate for the consequences of a major error on the part of a substantial proportion of the financial community in evaluating equities' growth potential when making predictions in late 2018.

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>
> **FRANÇOIS SAVARY,** CHIEF INVESTMENT OFFICER, PRIME PARTNERS

Overall, the performance of the accounts is satisfactory despite investors' supposed scepticism towards the stock markets throughout recent quarters. Does this trend not reveal something of a paradox?

Is it possible that investors have been playing their cards close to their chest? In other words, have cautious statements about risky assets actually been followed by changes to asset allocation? It is possible but unlikely in our view.

The financial community was saved by the fact that the vast majority of financial assets performed well in 2019.

Bonds had an exceptional year. Government debt, the credit segment and even emerging market bonds are seeing strong growth at a rate that exceeds the historic average by quite some distance.

We must not be blind to the fact that rallies of liquid assets can be dangerous, especially when they coincide with slowing profit growth, as was the case in recent quarters.

The increase in multiples we have witnessed in the wake of August's consolidation is a legitimate source of discomfort as we embark on constructing our portfolios for 2020.

Similarly, the idea that investors are drastically reducing their cash holdings in favour of equities, as shown by the recent monthly Bank of America Merrill Lynch survey, is not something we are enthusiastic about either.

Hasn't this equity craze come a little too late, given the phase in the cycle?

One possible answer to this question is that the equity risk premium is so high that it makes sense to rush headlong into the stock markets. We need to fully understand this argument in order to determine what our equity market stance should be as we look ahead to 2020.

Plus, on the economic front, recent signs seem to indicate that the global outlook is stabilising. This trend undoubtedly will have added impetus to the equity rise and weighed on bond yields over recent months.

As in the 2011-2012 and 2015-2016 periods, the global cycle could be on the cusp of another soft landing. However, this hypothesis, which we find persuasive, remains dependent on a China-US trade deal and is the best we can hope for. In other words, the chances that there will be a major acceleration in the global economy in 2020 are slim.

Expectations regarding profit growth in 2020 should therefore remain reasonable (at around 5%) and considerably below the level priced in by the consensus at present. And these expectations will only materialise if it turns out that global growth is strong enough to overcome the deceleration of recent quarters. Such an eventuality, which is credible in our view, will not be without consequences for bond yields, which are still at excessively low levels given the global context in which (overblown) deflationary fears abound.

Even if we set aside geopolitical risks, which are hard to predict, it is difficult to construct resilient portfolios based on an asset allocation with a horizon of 12 months.

Our options are cash, bonds and equities: cash has no appeal, bonds come with a major risk of "flying too close to the sun" and with equities we would appear to be closing the stable door after the horse has bolted.

The worst is still possible although not necessarily probable. With this in mind, we are of the view that 2020 will turn out to be a challenging year – not necessarily a bad thing in terms of market behaviour and performance!

We must be realistic, though, and note that the general environment favours a deterioration in the performance/volatility profile of financial assets. Plus, the total returns we should expect to be generated by a diversified portfolio have little chance of matching those of 2019.

Is this outlook enough to rattle us and prompt us to resist the sudden craze for risk among investors demonstrated by the survey mentioned above?

As with the erroneous forecasts in late 2018, it's important to (sometimes) break with popular opinion!

Hoping for the best and preparing for the worst is an excellent way to approach constructing a diversified portfolio in the current environment.

No one likes having to consider lower returns paired with greater volatility.

Facing these prospects will require plenty of courage, flexibility and above all an ability to separate temporary upticks in volatility from any fundamental changes in circumstances.

We know from experience that doing so is no mean feat! As the calendar year draws to a close, we sincerely believe that we should maintain the fact-based scepticism employed throughout recent months. Not all of our decisions have been crowning glories, but we can be satisfied with the performance achieved.

Hence, the main pillars of our investment policy have remained unchanged in recent weeks. We are holding fast to two principles: favouring equities over bonds and taking on a reasonable amount of stock market exposure.

We have added a thematic strategy on the circular economy to our allocations (as we noted last month). We still believe that a thematic approach to equity investments is a way to unlock value in the financial context in which we find ourselves.

Similarly, we have renewed our hedges on stock market indices as they reached maturity because we believe that short-term equities have achieved most of their full potential.

Lastly, although we have moved away from a long/short equity strategy that underperformed, we have not changed our view that alternative liquid investments are essential in a world of financial stagnation, near-zero interest rates and limited scope for stock market growth.

Risk management and tactics will continue to be our guiding lights in 2020.

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