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MARKET INSIGHT

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January's optimism crumbles in the face of reality

As we discussed last month, investors were perhaps a little too hasty in giving way to optimism and embracing the prospect of a sharp recovery in the financial markets.

Market behaviour over the last few weeks has borne out our decision not to accumulate risk at any price, as fixed income assets have shed most of their performance of the previous month while equities have seen real consolidation of their January gains. In addition, the dollar recovered, as we expected, while gold moved in the opposite direction, thus validating our decision to reduce our exposure in January.

Whatever one's view of the determinants of financial market behaviour, it will have escaped no one's attention that the fundamental situation – or investors' perception of it – has played a major role in the contradictory asset movements of the past two months.

The evolution of real rates or inflation figures, causing widespread disappointment among market traders, are the best evidence of a state of affairs which some had tended to conceal: the disinflation currently under way will not necessarily be an easy or linear process over the next 12 months.

Once again, the issue of inflation has come to the fore and with it all the fears about a possible blunder in monetary policy; this has increased misgivings about how high central bankers will have to raise interest rates in the coming months. This is another way of saying that we were right to be more than cautious regarding investors' expectations of possible declines in the cost of money in the US by the end of 2023. The consensus now is that the latter is not an option, and rightly so!

In our assessment of the overall situation, inflation and related uncertainties remain the most important issues in the short term; however, a central question posed by price movements in the medium term should not be ignored: what growth rate can be expected for 2023 and 2024?
This is an issue that will only gain in importance in the coming months.
In this context, even though we have lowered the probability of a recession (45%) in our assessment of the global economy, this option still dominates the various scenarios we envisage for the next few quarters.

The exceptional nature of the current economic cycle remains a powerful theme that we have expressed several times in this publication. We remain committed to this with an assumption that we do not wish to challenge: we have not entered a new cycle simply by moving from one calendar year to the next.

> While we have downgraded the probability of a recession, it is still the predominant option in our scenarios.

Therefore, the length of the monetary tightening cycle remains central and we do not believe it is over. On the contrary, we have factored in a further interest rate hike by the Federal Reserve in June 2023, primarily due to the strength of the labour market; similarly, we believe that the ECB will not be spared a 100 basis point increase in the cost of money by the summer.

It was because we wanted to manage as best we could the risks induced by the hypothesis of an end of the cycle, which investors no longer really seemed to consider credible in January, that we opted to maintain a defensive stance in our investment policy last month.

In other words, asset prices did not seem to us to justify chasing the rally in both bonds and equities.

It is fair to say that we were not overly upset to see US 10-year yields hovering near 4% and US equities testing the 4000 level on the S&P 500 index! Indeed, we were looking for opportunities to reposition our allocations more aggressively.

Has the time come to take more risk?

If you remember, we had set a range of 3800-4200 on the S&P 500 for the next few months in view of economic growth that is resisting better than expected and given the improving technical configurations on the main indices.

The return of the US index to the middle of this range has prompted us to strengthen the equities in our portfolios. In doing so, we have reduced our under-exposure to this asset class, while maintaining a slightly defensive bias, particularly for the more conservative profiles.

This overall stance seems justified by the limited visibility that continues to prevail fundamentally (firstly, the economic and monetary cycle, and secondly, future earnings growth); a context that should not encourage excessive risk-taking.

To put it another way, we saw the consolidation of January's gains as offering an opportunity to reduce our defensive stance on equities but not to reverse it completely!

The equity purchases we made did not call into question our choice to favour European and emerging market stocks over their US counterparts.

We have not been idle on the bond portion of our allocations either, especially for conservative profiles.

The sharp, rapid easing of interest rates in January had left us in an uncomfortable position; we had been unable to make additional purchases as part of our policy of adding to fixed income assets for several quarters.
The high price of these assets had thus led us to play a waiting game, in the hope of consolidation.

And we've been proved right, given the pressure on rates in recent weeks.

As a result, the sharp decline in prices on the bond market provided us with the opportunity we had been waiting for to increase our debt exposure in our less aggressive profiles.

The consolidation of January's gains has led us to reduce our defensive equity stance, but not to reverse it completely

Short to medium maturities remain our preference in both corporate debt and in US government debt, which we believe is more attractive than its European counterparts.

It should be noted that we also considered it advisable to lengthen duration as part of the reorientation of our bond portfolio.

The decision to hold on to emerging market bonds has not been called into question. However, by increasing the amount of government debt from the safest countries and US and European corporate debt in our portfolios, the relative weight of investments in emerging fixed income assets is now lower.

The desire to redeploy some of the cash in the portfolio should not allow risk management considerations to be neglected. This is as true for managing a bond allocation as it is for determining a general investment policy.

Last month we concluded our monthly commentary with these words: "*We remain committed to increasing our exposure to risk assets, but not at any cost. We have cash to redeploy, we just have to get the timing right. This remains our main challenge for the months to come.*"

At least we can say that we have put our money where our mouth is in recent weeks.

The challenges facing the markets remain significant in the short to medium term. In such a situation, cash and bond exposure remains preferred over equities, despite a reduction in our defensive bias in February.

FRANÇOIS SAVARY,
CHIEF INVESTMENT OFFICER,
PRIME PARTNERS

Prime Partners SA
Rue des Alpes 15
P.O. Box 1987
1211 Geneva 1
www.prime-partners.com

François Savary
Chief Investment Officer
Jérôme Schupp
Equity Analyst
Julien Serbit
Senior Investment Advisor

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

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