MIRABAUD

INVESTMENT STRATEGY

FEBRUARY 2019

THE FEDERAL RESERVE'S PAUSE

IS PROVIDING SHORT-TERM SUPPORT TO THE MARKETS

In a nutshell

EQUITIES:

OVERWEIGHT EMERGING MARKETS. UNDERWEIGHT EUROPE AND MOVE BACK TO NEUTRAL ON THE USA. OVERWEIGHT HIGH-DIVIDEND STOCKS IN EUROPE.

BONDS:

OVERWEIGHT EMERGING MARKETS. SELL INFLATION-LINKED BONDS AND FLOATING-RATE BONDS IN DOLLAR PORTFOLIOS.

Graph of the month

The markets have recouped more than half of their Q4-18 losses.

Source: Bloomberg

Returns in January 2019 were diametrically opposed to those of December. The main asset classes posted positive returns because of a "Goldilocks" environment, characterised by the much more accommodative tone adopted by the Federal Reserve – with investors now talking about a "Powell put" in reference to the Fed's tendency to loosen US monetary policy when financial conditions become tighter – along with a more reassuring trade situation and the limited impact that the US government shutdown has had on growth.

Discussions within the Fed about ending its balance-sheet reduction efforts in the near future also reassured investors about the risk of falling liquidity, which was one of the main drivers of the market correction and rising volatility last year.

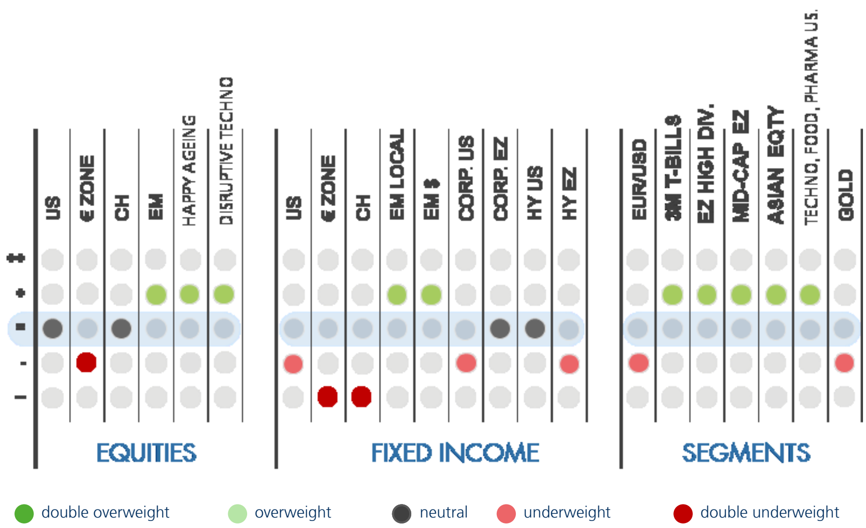
However, January's solid performance should not distract us from the negatives: the global economy is slowing, there is major political uncertainty and earnings forecasts for 2019 are being downgraded. January's good returns partly represented a technical rebound after the excessive correction seen in the fourth quarter of 2018. An increase in purchasing manager indexes in the manufacturing sector will be one of the conditions for a market rally in Europe.

In January, global equities gained 8% on average, with cyclical stocks, emerging markets and small and mid caps outperforming. The 18% jump in oil prices and the 8% rise in industrial metals prices supported the oil and gas and manufacturing sectors, which were the top two performers last month. The fall in bond yields and the US dollar pushed the gold price above $1,300 per ounce.

Bond markets also posted positive returns. High-yield paper outperformed investment-grade corporate bonds, while sovereign bonds rallied on reduced global inflation expectations.

Asset allocation

EQUITIES	
Europe	Underweight
United States	Neutral
FIXED INCOME	
US Treasuries	Underweight
EM USD	Overweight
SEGMENTS	
EUR/USD	Underweight
MID-CAP EZ	Overweight



Macroeconomics

THE US FEDERAL RESERVE IS PUTTING MONETARY-POLICY NORMALISATION ON HOLD

The US Federal Reserve slammed the brakes on monetary normalisation in January. Its policy of gradually raising interest rates has been replaced by a more patient, cautious approach, in response to various economic uncertainties and lower inflation expectations. The decision is understandable given the Fed's dual mandate.

Firstly, the US economy is running at full employment. The unemployment rate is 4%, close to its all-time lows, the labour force participation rate is at its highest level since 2013 and wages are rising at more than 3% per year. In addition, the Fed's monetary policy committee believes that the US economy is still in good shape. Inflation is also close to the Fed's target, with core "PCE" inflation of 1.9% in December. However, long-term inflation expectations have fallen and the decline in oil prices will remain a drag on inflation in the medium term. As a result, the risk of the economy overheating is relatively limited.

In the circumstances, and given the high level of uncertainty around the world, the optimal interest rate for the central bank is the natural interest rate, i.e. a theoretical rate that keeps inflation stable and output at its potential level. In its most recent meeting, the Federal Reserve took the view that the current range (2.25-2.50%) was in line with its estimate of this equilibrium rate. As a result, the Fed looks unlikely to continue raising interest rates unless we see signs of inflation overheating, which is unlikely in the first half of 2019.

Monetary tightening is likely to be put on hold around the world in 2019. After bringing its asset purchase programme to an end in 2018, the European Central Bank should keep its key interest rates unchanged this year and extend its programme of funding for the banking sector. The Swiss National Bank and Bank of Japan will not change course, while China's central bank will provide more support to its national economy.

Long-term inflation expectations remain low.

Sources: Bloomberg, University of Michigan

Equities

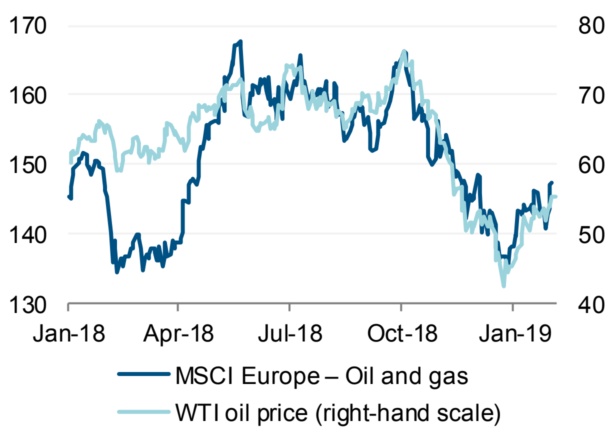
UNDERWEIGHT EUROPE AND OVERWEIGHT EMERGING MARKETS

Developed-country equity markets posted solid returns in January, with the MSCI World index gaining almost 8%, making up half of the losses sustained in the fourth quarter of 2018. However, this was more of a technical rebound after markets became oversold in late 2018 than the result of a significant improvement in the growth and earnings outlook. For 2019, investors are now anticipating earnings growth of only 6% in developed countries, significantly less than they were expecting at the start of the year. We took advantage of the January rally by taking profits on our overweight US equities position, and by adopting an underweight position on European equities because of the disappointing economic outlook. We remain neutral on Swiss equities because of the Swiss market's more defensive sector composition and the Swiss franc's safe-haven status. In the current environment of slowing growth and low interest rates, we also favour high-dividend stocks in Europe, which also offer lower risk exposure by comparison with the broad market.

Within our sector allocation, we used the oil-price rally and outperformance in the oil and gas sector as an opportunity to cut our weighting to neutral on this sector in Europe. In the USA, we are now overweighting the food staples sector, which is more defensive in nature.

Emerging markets outperformed global equities in January, with an overall return of almost 9%. The Brazilian stockmarket index fared particularly well with an 11% gain in local-currency terms. We overweighted emerging equities in January to take advantage of the potential for valuations to make up lost ground as trade risks fade. The more accommodative tone adopted by the US Federal Reserve, the stabilisation in emerging currencies against the dollar and the first signs of economic improvement in Asia are likely to support that uptrend in the first quarter. In China, monetary and fiscal stimulus will also provide major support.

The oil and gas sector outperformed in January.



Sources: Bloomberg, Mirabaud Asset Management

Fixed income

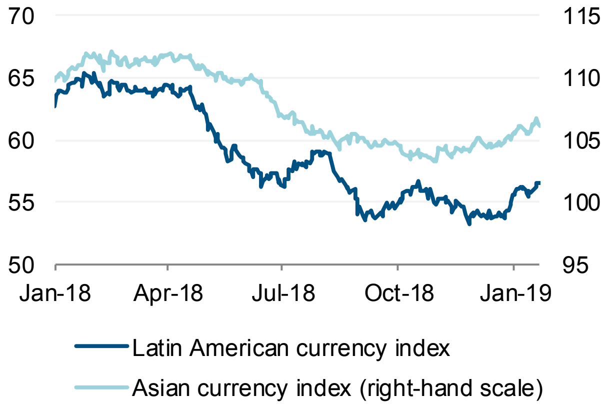
OVERWEIGHT EMERGING MARKETS

Because of the economic slowdown expected in 2019, coupled with lower inflation and inflation expectations, we have sold positions in inflation-linked bonds and floating-rate bonds in dollar portfolios. Lower oil prices will hold down inflation for much of 2019, while rising wages in the USA and Europe are still having a relatively limited impact on price indexes. In other words, the wage Phillips curve – the relationship between the unemployment rate and wage growth – is much steeper than the price Phillips curve. One of the reasons why the price Phillips curve has become flatter is the globalisation of value chains and increased competition in goods markets. We have reinvested the proceeds from these sales in government bonds with 3- to 5 -year maturities.

With emerging currencies stabilising, the US Federal Reserve adopting a more accommodative policy and emerging-market fundamentals improving, we are now overweighting emerging-market bonds. They are offering very attractive carry, with an average yield spread of 370 basis points with respect to US sovereign bonds, which provides protection against any credit or exchange-rate risk.

As regards monetary policy, we do not expect the European Central Bank or the Swiss National Bank to raise interest rates this year, because of the economic slowdown and low inflation. Accordingly, sovereign bond yields are likely to remain at today's low levels. Within our sterling portfolios, we recommend holding sovereign paper to protect against the risk of a hard Brexit.

Emerging-market currencies have stabilised.



Source: Bloomberg

Currencies

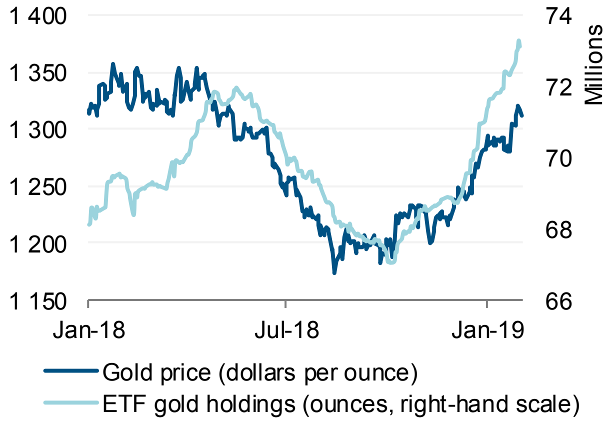
GOLD EMERGED AS THE WINNER FOLLOWING THE US FEDERAL RESERVE'S CHANGE OF TONE

Gold is now trading at more than $1,300 per ounce, having risen 3% in January. That rally was not just down to an increase in the risk of recession, but was driven mostly by the weak dollar and falling real interest rates. Demand for gold among emerging-market central banks has also increased sharply. Those central banks have taken advantage of more stable currencies and improved fundamentals to build up gold reserves again. Another factor driving demand could relate to gold purchases in China during the Chinese New Year period. In the current environment, an underweight position in gold is no longer appropriate. If the gold price falls to more attractive levels, we will look at taking our weighting back to neutral.

In the forex market, we expect the dollar to fall slightly over the medium term against the main emerging-market and developed-country currencies. Although interest-rate differentials remain wide between the USA and the other main developed countries, the scope for further widening is limited now that the Fed has paused monetary-policy normalisation. Reduced trade uncertainty should also play against the dollar, which is currently the highest-yielding safe-haven currency. In the near term, however, the challenging economic and political environment in Europe is likely to limit any rally in the euro. In the medium term, an improvement in economic surprise indicators could push the euro up to around $1.19-1.20.

Given the very high cost of hedging the dollar against the Swiss franc and euro – with the 1-year breakeven euro/dollar exchange rate being around $1.19 – we prefer to limit hedging on these currencies.

The gold price has rallied since the end of 2018.



Source: Bloomberg

WRITTEN ON 04.02.2019 BY THE MACRO-STRATEGY TEAM