GONET MARKET OUTLOOK
BANQUIERS 1845
QUARTERLY ▪ JANUARY 2020

NOTHING TO FEAR?

IN A NUTSHELL

The euphoria which is currently reigning over global markets faces three risks. First, the macro economy and earnings momentum are slowing down, despite the deal between China and the US. Furthermore, the exceptional liquidity supplied by the Fed since September is likely to be halted. Lastly, all categories of investors have adopted an increasingly aggressive positioning lately.

OUR STRATEGY

Between June and September of last year, our allocation was underweight in both equities and bonds. We increased our exposure to both of these asset classes on 16 and 17 October and therefore participated fully in the recent market rally.

Our preferences within each of these asset classes remain unchanged.

In fixed income, US Treasuries remain our only sovereign debt holding. We extended the duration of this position on 10 December. We also hold several actively managed vehicles in the investment grade and high yield segments and, in some risk and currency profiles, in European covered bonds as well.

Although the surge in optimism that we shall analyse opposite enabled European and Asian equities to narrow their performance gap, along with cyclical sectors, Wall Street and growth stocks in general remain well represented in our portfolios. We have also maintained an overlay in US tech stocks. Our portfolios are exposed to gold, while our Swiss franc denominated portfolios also hold property funds.

Overall exposure is therefore close to our long term allocation target. Although the markets may extend their gains further into the year, valuations among equities and corporate bonds leave only narrow leeway for error. We are therefore not planning to increase our risk exposure.

NOTHING TO FEAR, OTHER THAN AN ABSENCE OF FEAR

We all know F.D. Roosevelt's phrase "the only thing we have to fear is fear itself".[1] This noble statement needs to be inversed however in the current financial market context. The rally has been exceptional, as it has occurred across the entire board, including equities, bonds, precious metals and cryptocurrencies, and also due to its strength and the low level of volatility recorded. Today, euphoria reigns.

Most analysts are now converts, some very recently, to unbridled optimism, based on zero risk of a forthcoming recession, without inflation or deflation, coupled with unwavering support from the central banks, amid appeasement between China and the US and a painless Brexit and so on.

Each of these assertions is based on a sound rationale, but in part only. Although most of the macroeconomic and financial indicators we shall be reviewing remain positive, today's valuation multiples are particularly demanding. Potentially disappointing earnings growth, or potential defaults among distressed debtors and political uncertainty all appear to have slipped completely off the radar.

It is dangerous to ignore human nature however. Market psychology always swings between greed and fear. As of today, fear has disappeared.

Nevertheless, the current level of optimism could be undermined on many different fronts. We have grouped these threats into three themes: macroeconomic fundamentals; central bank intervention and internal market dynamics. Risks appear to be asymmetric under each of the three themes. Disappointment is more likely than any positive surprises among the major asset markets.

Geopolitics make a comeback

Although we shall discuss several sources of political uncertainty within these three themes further on, the first issue to highlight is the recent increase in tension in the Gulf following the attack on the US embassy in Bagdad by pro-Iranian groups on the 31 December and the retaliatory response from Washington, on 3 January.[2] At the time of drafting this review, the risk of regional escalation cannot be fully ruled out, although we believe it more likely that the efficiency of the US military action and the tragic downing of an Ukrainian airplane will calm the Teheran authorities for the time being. The Gulf is no longer as vital for global oil supplies as before, as we observed following the air strike on 14 September last year which paralysed half of Saudi exports. The initial surge in the oil price by around 10 dollars had been completely wiped out two weeks later. As for Iran, its weight in the market has diminished sharply since the US stepped-up its sanctions in November 2018.[3] Iranian production fell to 1.7% of the global total[4] and its exports to 0.5%, mainly towards China and India.[5]

Supply in the global crude oil market currently outweighs demand, which is likely to remain muted in 2020 chiefly on account of the macroeconomic context. Global growth has slowed down markedly and this trend is expected to steepen over the next few months. Although an uptick is likely to be discernible from the 2nd quarter onwards, growth is unlikely to match the rate recorded at the end of 2017. Let us examine the reasons for this assertion. ■

Oil prices and Iran exports

— Exports from Iran (barrels/day, left-hand scale)
— Brent crude price (USD/barrel, right-hand scale)
Sources: IMF, Federal Reserve of St Louis

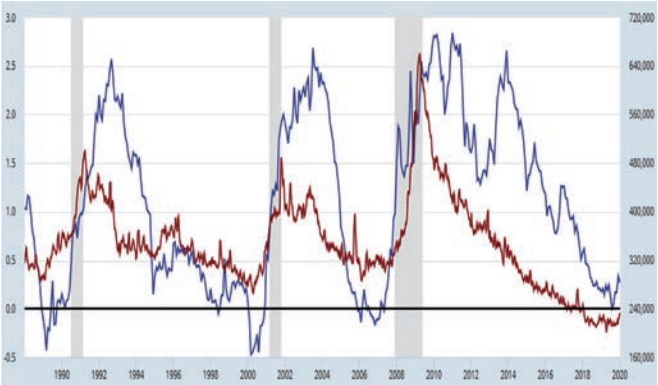
1 1933 first presidential inaugural address.
2 Missiles fired by a drone killed the head of foreign operations for the Iranian Revolutionary Guard Corps and the “Iraqi Hezbollah” chief as they met in Bagdad.
3 Following Donald Trump’s decision to withdraw from the Vienna Iranian nuclear program agreement.
4 1.7 million barrels per day in November 2019, vs 4.5m on average from 2016-2018. Global production reached 100.3 million barrels per day during the 3rd quarter of 2019, of which 19.5m in the US, 11.5m in Russia, 9.4m in Saudi Arabia and 4.7m in Iraq.
5 IMF and OECD International Energy Agency data.

I. DESPITE THE TRUCE BETWEEN THE US AND CHINA, GLOBAL GROWTH IS DECELERATING

A key point should be highlighted before starting the following discussion. Our analysis is based on the core scenario which assumes a low risk of the US economy tipping into a recession within the next 12 months. Although some analysts draw on a dozen different indicators, we have retained only two for our analysis.[6] The first of these is a leading indicator, namely the inversion of the yield curve between 2 and 10-year Treasury maturities, which was briefly the case at the end of last August. The second indicator is an increase in initial unemployment claims, which has so far not occurred.

Our second indicator has flatlined recently at close to its historic floor level. The general context remains encouraging, based on the latest business climate surveys, notably the PMI employment sub-indices in the manufacturing sector and particularly in services, which are no longer deteriorating.

US recession risk indicators



— Initial unemployment claims (4-week averages, right-hand scale)
— Treasury yields, 10 years minus 2 years (left-hand scale)
Shaded areas indicate recessions.
Source: Federal Reserve of St Louis

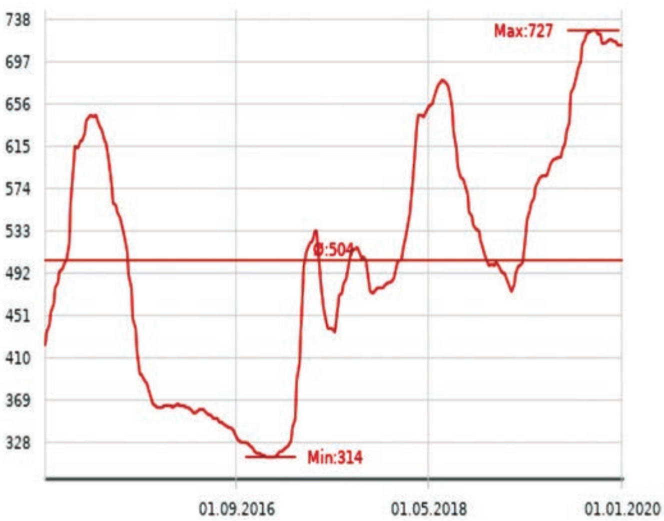
It is important to note that the initial jobless claims data is not a leading indicator. In the past, an increase in unemployment claims has occurred on average one month before the economy tips into recession. If this particular alert signal is activated over the next few weeks, we will have to radically review the following scenario and the ensuing investment strategy. Subject to this caveat, let us examine our core scenario, firstly in terms of growth. We believe that a slowdown in the global economy is inevitable. Although it would appear to be taking the form of a soft landing, it could nonetheless undermine the current market optimism, which is based mainly on the appeasement in the trade war between China and the US.

Appeasement between China and the US: a false hope?

Last year, the collapse in industrial production in Europe and Asia was particularly telling, even though the initial signs of a recovery have been observed over the past few months, particularly in China. Although tensions with the US weighed on trade and paralysed investment decisions, it would be too simplistic to attribute all of these factors to the trade war. Higher customs tariffs and other controls logically caused trade routes to be redrawn, with ASEAN countries substituting China as suppliers to the US, with Brazil and African nations exporting towards China, and so on. New freight contracts were booked and ports required equipment refurbishments, while inventories needed to be built up, which even added further growth.[7]

Container ships charter rates

Harpex Index



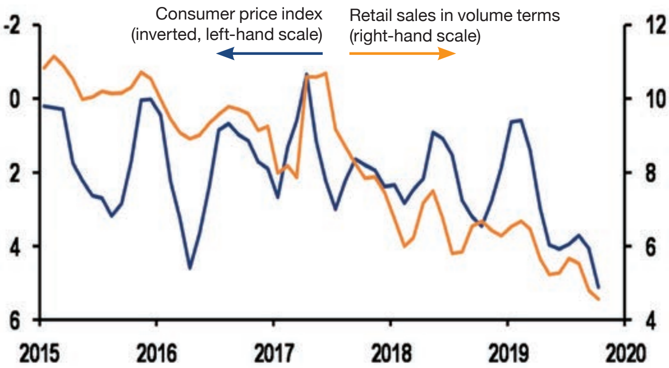
Source: Harper Petersen&Co

Furthermore, several sectors are experiencing difficulties which are not attributable to Donald Trump's policies, such as the automotive industry following the Dieselgate scandal, and more generally the industries impacted by energy transition.

Lastly and above all, the tertiary sector, which accounts for at least two thirds of global economic activity, is losing momentum. In the US, business activity has slowed down after the 2018 tax cut boost, due to the delayed impact of monetary tightening being halted 13 months ago. Conversely in China, despite signs of the industrial recovery referred to above, consumer spending and fixed investment are continuing to slow down gradually, excluding the public sector. Although this factor is an inevitable result of the transition towards a more diversified advancing economy, it is also attributable to demographic changes. As we have outlined on several previous occasions, Xi Jinping is actively piloting transition. As a consequence, the government, which has implemented a series of sector support measures, and the central bank, which is pursuing its light-touch policy, are not planning any real measures to boost credit.[8] A less selective policy would effectively risk favouring companies within declining sectors and the corresponding regional administrations. Both are heavily over-indebted and some of their lenders, including banks and financial companies, are also facing serious difficulties.

China: retail sales and prices

3 months over 3 months percent changes



Source : J.P: Morgan

Despite the repeated announcements, there is no sign of any shift in policy from Beijing. We are therefore maintaining our view that the Chinese economy will stabilise at a "new normal," characterised by a structurally lower growth rate than during previous cycles.

Trump, Xi and Johnson decide… the European Union endures

Flanked by the US and China, the European economic landscape remains ambivalent. Comfortably installed in 10 Downing Street, Boris Johnson will now be able to force Brexit through, although it is far from certain that the latest terms resulting from negotiations with the EU will be the final deal. A hard Brexit with no trade deal is still on the table. This remains a key unknown factor for the other EU members. A study published by Leuven University calculated growth loss for the remaining 28 EU members at 1.4 percentage points in the event of a hard Brexit.[9] A softer more orderly Brexit would nonetheless also lead to a loss of 0.5 GDP point. The hardest hit countries in either of these cases would be Ireland, the Netherlands and Denmark, while Germany and France would also be impacted to a slightly lesser extent.

The December trade deal between the US and China is another source of uncertainty. If the deal is finalised on 15 January, it will not only have a positive impact for Europe. China's commitment to import American products would trigger an inverse substitution effect compared to last year. US production, worth some 200 billion dollars over two years, would crowd out certain EU and Japanese exports, particularly in the electronics sector, the automotive industry and in aviation, according to a report published by the IMF.[10] Switzerland may also see a slight fall in its equipment and capital goods exports.[11]

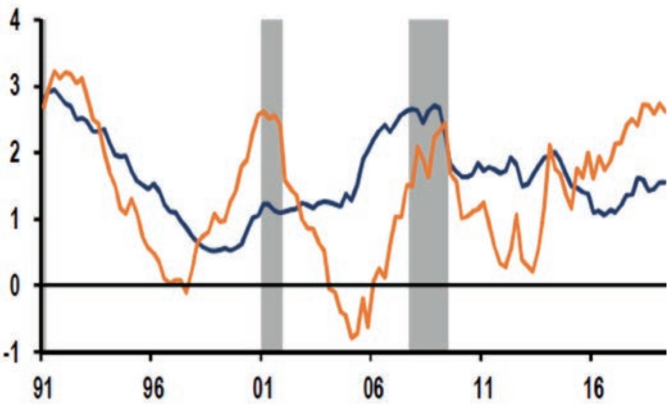
Watch capex, but consumer spending remains crucial

The reservations expressed above have hardly weighed on the euphoria which currently reigns in the markets. Today's prevailing optimism is based on the rationale that irrespective of the details, once phase one of the deal between China and the US and Brexit are done, companies will invest massively. We are sceptical of this argument. The trade war and Brexit have certainly weighed on productive investment globally, so we can now legitimately expect an uptick. However, a strong surge in capex is unlikely. The current economic cycle is characterised by weaker fixed capital investment growth than in the past, particularly in the US and in Europe. Although the growth rate in China remains higher than in western countries, it has slowed sharply over the past 10 years. This global structural trend, which began long before the 2008 recession although it has been partly obscured by constant IT innovation and modernisation in China, is likely to continue.

Furthermore, although financial conditions have been extremely favourable over the past 5 or 6 years in the US and for at least two years in Europe, companies prefer to buy back their own shares rather than invest in new equipment. Although infrastructure spending and energy transition will certainly provide a boost, these factors will have little immediate impact, as we highlighted last quarter.[12] Lastly, in purely cyclical terms, even if capital formation is designed to improve productivity and profitability, the inverse can often be observed. Companies step up their investments once their earnings have increased and not beforehand. Margins are under pressure in the US, as will soon also be the case increasingly in Europe, now that the employment rates and wages have risen sharply. Under these conditions, after hesitating for the past 10 or 20 years, why should companies now consider delving into their cash reserves?

US labor costs and output prices

Nonfinancial corporations, 3 months over 3 months percent changes



— Unit labor costs
— Output prices
Sources: US Bureau of Labor Statistics, J.P. Morgan

In other words, growth once again depends on consumers. This is clearly the case in the US and is becoming increasingly clear in Europe. Although European redistribution policies tend to mitigate cyclical effects, the level of employment and wage increases are determining factors. However, the employment rate is peaking in Germany and in neighbouring countries, while higher wages will ultimately put pressure on corporate margins. Although the long-awaited recovery in the manufacturing sector, which has still not materialised, will have a positive impact on confidence, it is unlikely to have much of a knock-on effect in the tertiary sector.

Although tax measures may enhance disposable consumer income, no major programmes are planned in Europe. In the US, the 2017-18 tax reform remains a powerful support factor, but the initial effects are now wearing off. Will Donald Trump attempt further stimulus measures ahead of the elections? Although there has been no fresh indication of any such strategy since our last quarterly review was published,[13] it nonetheless remains possible.

Finally, although the current macroeconomic situation is not excessively gloomy, it nonetheless appears more ambivalent than the glowing picture imagined by many investors. It is true to say that they have been dazzled by the fireworks set off almost by surprise by the Fed. ■

6 See our July 2019 *Market Outlook*, pp. 4-5.
7 As an indication, freight tariffs remain under pressure among commodities (Baltic Dry index) but not for containers which transport capital goods and consumer products (Harpex index).
8 The latest decisions, which included a further cut (the 7th in less than 2 years) in banking reserve requirement ratios on 1st January, remain below forecasted financing needs, particularly among large city authorities.
9 KU Leuven, Sector-Level Analysis of the Impact of Brexit on the EU-28, June 2019.
10 IMF Country Report N°19/266, People's Republic of China, August 2019, p. 21.
11 Exports towards China, according to the Comtrade database, totalled 6 billion dollars in 2018, i.e. 0.9% of GDP.
12 *Market Outlook*, October 2019, page 5.
13 *Market Outlook*, October 2019, page 6

II. FRESH MONETARY FLOODING

If we analyse central bank policy from the perspective adopted over the past few years, we could easily conclude that the situation has stabilised. Last year, forecasts were at odds with the implied levels priced-into the forward markets and were often in complete contradiction. The reality has proven both sides of the argument wrong.[14] Today the situation is completely different. Forward markets and most economists are banking on US base rates remaining practically unchanged. There was only muted reaction to the initial declarations from Christine Lagarde as ECB chairwoman, while the SNB and the Bank of Japan also appear to be anticipating stability.

However, a minor revolution is underway right before our eyes. Since 17 September last year, by responding urgently to a squeeze in the banking system, the Fed flooded the market with liquidities through repurchase agreements, otherwise known as repos. These operations, which are supposed to be temporary, were extended and intensified to such an extent that it is now only a matter of adays until the Fed's balance sheet will return to its all-time high, wiping out the quantitative tightening which had begun in 2018.[15]

Fed assets

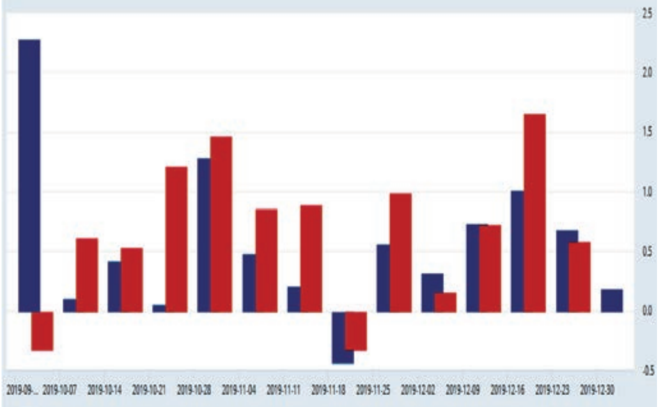
Total net assets of the Federal Reserve System (USD millions)

Shaded areas indicate recessions.
Source: Federal Reserve of St Louis

The current measures are not quantitative easing in the strictest sense, as there are no direct bond purchases. Instead, the Fed supplies short term financing to banks requiring funds. The size of the liquidity facilities is nonetheless enormous and unprecedented. Furthermore, the causes of the liquidity shortage remain unclear. Over the past several years, the gradual implementation of the Basel III banking supervision measures have incited the banks in the US and in other countries to manage their reserves very closely. Yet such a liquidity squeeze had never occurred. In a recent report,[16] the Bank for International Settlements suggests that the four Wall Street major banks had significantly stepped-up their funding for highly leveraged clients such as hedge funds,[17] which in turn increased the banks' own liquidity requirements. If this is the true reason for the squeeze, the intervention by the Fed is not attributable to an increase in the pace of the real economy, but to a speculative surge in financial markets. In the light of this explanation, it is troubling to observe that the rate of change in the S&P 500 index observed each week corresponds to the growth in total liquidity facilities provided by the Fed.[18]

Fed total assets and S&P 500 index

Weekly percent changes



— Total net assets of the Federal Reserve System
— S&P 500 index
Source: Our calculations, inspired by Torsten Slok's, Deutsche Bank

This therefore raises a key question among investors. Either this form of financing is in fact only temporary, as the Fed has repeatedly announced, and a downturn in risk appetite is to be expected as soon as the liquidity facilities are withdrawn, which should be in April based on the timetable announced in the past few days. Or on the other hand, the Fed has effectively implemented massive monetary stimulus, i.e. an unofficial QE4. The second of these two explanations in turn raises further questions as to why the Fed believes such intervention to be necessary, while the economy is in full employment and its inflation target has at last been reached. Two different conclusions can be drawn. Either the Fed fears a sharp slowdown in growth, reflecting the macroeconomic risks outlined previously, or it is concerned about financial imbalance, which brings us to the third theme in our discussion. ■

[14] 12 months ago, many reputed economists were expecting 3 hikes (of 0.25% each) in Fed Funds during 2019, which was coherent with the Fed's forward guidance. There were in fact 3 rate cuts.
[15] The Federal Reserve System balance sheet had shrunk by 620 billion between the end of 2017 and September 2019.
[16] *BIS Quarterly Review*, December 2019, pp. 12-14.
[17] Totalling 300 billion in June 2019, according to the same report.
[18] Calculated by Torsten Slok, Chief International Economist, Deutsche Bank Securities, for the period from 9 October to 24 December 2019.

III. STRAINED VALUATIONS, LOW VOLATILITY, UNEXPECTED POSITIONING

Near-term trends among all global financial markets appear to hinge on intervention by the Fed. Although this may come as no surprise, there is nonetheless a new factor involved. Over the past ten years, the Fed has justified its strategy, including three QE programmes, asset purchases tapering and finally the recently-abandoned quantitative tightening, through its interpretation of macroeconomic trends. When the Fed referred to external risks, such as the slowdown in China in September 2015, it has always been from the perspective of the impact on inflation and on jobs. Although its forward guidance never revealed its detailed intervention plans, it nonetheless gave the markets an insight into its decision-making process. It also enabled investors to set up positions based on their own forecasts. In contrast, the operation currently implemented by the Fed, which is the largest ever in terms of the amounts of available funds, is being presented as a response to temporary technical market factors. It is influencing risky asset markets across the board without providing the key to understanding its rationale. In one sense, this represents a return to the type of intervention by central banks which prevailed until 2009.[19]

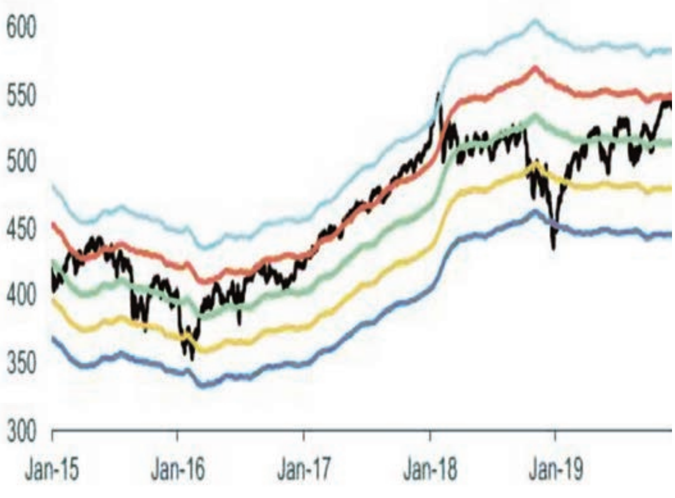
Over the past ten years, the rules in play in the markets have been simple. Following any event leading to a downward revision in inflationary outlook, investors would bet on the Fed adopting a more accommodating stance and would reallocate positions heavily towards risky assets.

Increasingly strained valuations

Valuations among most risky assets have widened further over the past few months, as market euphoria has fed on bullish forecasts, whereas economic activity and corporate earnings have not followed through. The S&P 500 index is trading on a multiple of 18 times and the MSCI All Countries index on more than 16, based on earnings forecasts which appear overoptimistic in our opinion, at least in terms of EBIT, as once again, share buybacks will compensate any relative weakness in organic growth, as we shall discuss below.

World equities index and valuation

Price/earnings ratio, 12 months forward, MSCI All Countries World Index

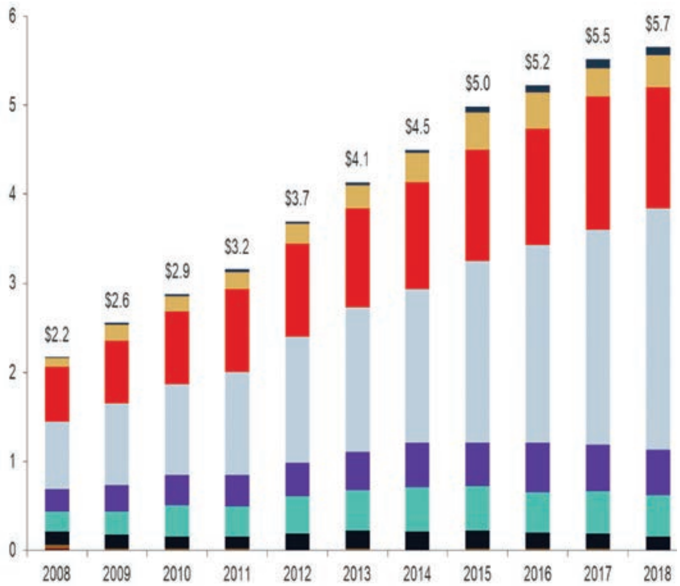


— MSCI ACWI — 14x — 16x — 13x — 15x — 17x
Source: Morgan Stanley Research

Valuations are also a concern for corporate bonds. Spreads remain close to all-time narrowest levels, reflecting optimism on the economic outlook and above all on the financial health of issuers. For example, dollar denominated high yield spreads are currently 420 basis points over US Treasuries, which implies an annual default rate of 6%, whereas 10-20% has been the standard in the US immediately before a recession. Furthermore, the composition of the indices has changed significantly over the past few years. In the investment grade universe, securities rated BBB, which is the lowest rating, now represent 47% of the total for nonfinancial corporates, compared to only 36% in 2008. In other words, the indices reflect a fundamentally weaker universe today than five or ten years ago.

US corporate bonds outstanding, by rating

Nonfinancials, end of year (USD trillions)



Investment grade
AAA AA A BBB
High yield
BB B CCC CC C D
Source: Federal Reserve of Dallas

There are many other similar examples to be found. Of course, risky asset valuations depend largely on the level of the risk-free rate and sovereign debt yields. A reminder of the extent to which most yields have tipped into negative territory is not necessary. This is the result of intervention by the central banks, which are showing no signs of inversing their strategies for the time being, even though the slowdown in economic growth, coupled with higher inflation, at least in the US and in China, would not imply unbridled optimism. Other financial imbalances also exist, including the US budgetary deficit and excess leverage in the Chinese private sector.

The simple fact that an asset is overpriced is not a reliable indicator of an imminent correction. Although mean-reversion is a powerful force over the long term, mispricing can be exacerbated before it is corrected. "The market can remain irrational a lot longer than you and I can remain solvent".[20]

Unexpected investor positioning

Of course, disappointing growth indicators, dashed hopes for an appeasement between China and the US or a series of debt defaults, could challenge market valuations and trigger a sell-off. The amplitude of any market correction also depends upon the positioning adopted by different categories of investors, i.e. whether they are overweight in the assets concerned and if they will be forced to sell due to excessive leverage and margin calls, or to offset losses in other markets. The myriad of potential configurations are impossible to identify before the event. However, several underlying allocation trends are clearly visible today, particularly the sharp contrast between retail investor positioning, institutions and hedge funds.

In a nutshell, retail investors have built up positions chiefly among risky bonds and have neglected equities, as reflected by trends in the ETF market. We know that the dollar and euro denominated high yield market has surged over the past few years mainly due to ETF intake. Most debt securities issues are immediately taken-up by inflow from funds, which raises questions over market liquidity in the event of a sharp correction.

Although institutional investments and long only funds are more diversified, they have also demonstrated unbridled enthusiasm recently. According to one of the most widely followed surveys published by Bank of America, although these categories of investor were still highly cautious just a few months ago, they have become more optimistic and are turning even more bullish.[21] Globally, asset managers are now fully invested, with cash weightings of only 4.2%,[22] and have sharply increased their risk exposure, switching from bonds to equities and from defensives to cyclicals and so on.

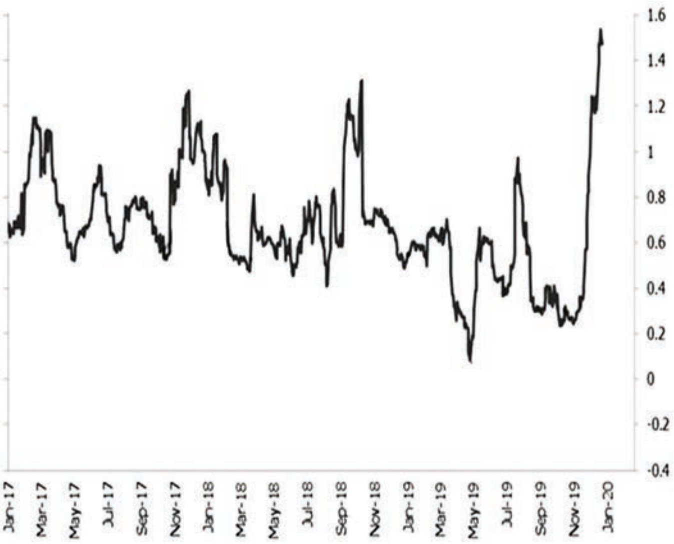
VIX index and open interest on VIX futures

— Fund managers — Small speculators — Intermediaries
Source: US Commodity Futures Trading Commission (CFTC)

The turnaround among hedge funds has been even more spectacular. Most had remained underweight equities over a long period, causing them to underperform significantly. During the second half of the year however, they stepped-up their financial leverage considerably, as we observed above in our discussion of the Fed, but did not reallocate funds to long positions in equities, judging by their beta coefficient which fell as low as 0.2x last November in many cases.[23] There has been an unprecedented turnaround however, with hedge fund equity risk exposure surging in a few weeks to 1.5x. Almost all strategies, including global macro, long/short equity, CTA, etc. appear to have participated in the rotation.

Hedge funds' sensitivity to US equities

HFRX beta relative to S&P 500 Index (30-day rolling)



Source: HFR, Nomura

To sum up, retail investors are continuing to accumulate holdings in the riskiest bonds, while institutional investors are fully invested and amplifying their pro-cyclical bias, whereas hedge funds have operated a U-turn and invested massively in US equities. In just a few weeks, risk appetite has surged and investor positioning has followed, making all markets vulnerable to disappointing macroeconomic indicators or an external shock.

The risks of low volatility

It may be considered reassuring that volatility among equities and currency markets remains extremely low and has recently fallen among bonds, after spiking over the past few months. It is therefore relatively inexpensive to hedge portfolios using derivatives. Some investors have done so, although not systematically, judging by the put/call ratio among the major US equity indices, which has increased but has not breached its historic average.[24]

Renewed short selling on the VIX index is another factor which should be highlighted. Short volatility strategies of this type were prevalent in 2016-2017 and drove implied volatility lower, which contributed towards investor euphoria. However, a technical squeeze in the market on 31 January 2018 brutally inversed the trend. During two consecutive trading sessions, the VIX index tripled triggering a correction of over 10% in the S&P 500 index and a similar downturn in the MSCI World index.[25] Today, less than two years after this fiasco, short VIX positions have reached the same level as in 2017 or even higher.[26]

Active managers' exposure to US equities

NAAIM Exposure Index (100 = fully invested, not levered)

Source: National Association of Active Investment Managers (NAAIM)

As long as these strategies can be maintained, they will continue to weigh on volatility among risky assets, but there could be a very sudden turnaround. If the VIX index rallies in response to a shock, short positions will have to be closed-out within the trading day in many cases, which will involving buying the index and will add further upside pressure. Risk parity strategies will then probably also be triggered. Thousands of major financial players have enormous amounts invested in these strategies, which chiefly involve selling equities when their volatility increases, which will drive prices lower. Although we have depicted these swings as a linear movement, the sensitivity of the options used may vary rapidly and also diverge. This is known as a gamma imbalance[27] which is difficult to identify before a squeeze occurs, triggering a potential chain reaction. ■

[19] Prior to the introduction of forward guidance by Ben Bernanke followed by Mario Draghi, central bankers were keen to conceal their intentions. In 1988, Alan Greenspan opened a conference with "I guess I should warn you: if I turn out to be particularly clear, you've probably misunderstood what I said".
[20] Often attributed to Keynes, this adage was probably coined by one of the most reputed Wall Street economists, A. Gary Shilling.
[21] 247 portfolio managers, representing 745 billion dollars under management, were surveyed from 6-12 December, BofA Securities, *Global Fund Manager Survey*, 17 December 2019.
[22] Another survey, limited to the US, corroborated the BofA results: the NAAIM Exposure Index stood at 97.44 on 24 December, vs 57.08 on 16 October (100 = fully invested, leverage over 100). https://www.naaim.org/programs/naaim-exposure-index/
[23] 30-day beta among HFR index components vs the S&P 500 index calculated by Nomura quantitative strategist Masanari Takada.
[24] The 200 day moving average on 27 December 2019 was 1.22, Chicago Board Options Exchange (CBOE), Market Statistics, https://markets.cboe.com/us/options/market_statistics/current/?mkt=cone
[25] See our April 2018 *Market Outlook*, p. 2 for our analysis at the time.
[26] –171,000 contracts at the time, –218,000 contracts on 18 November 2019 among institutional investors, hedge funds and other non-commercial players. US Commodity Futures Trading Commission, Commitments of Traders, https://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm
[27] The gamma coefficient is the 2nd derivative (variation in the rate of variation) in the value of an option compared to its underlying asset.

WHAT THE FED GAVE, IT MAY TAKE AWAY

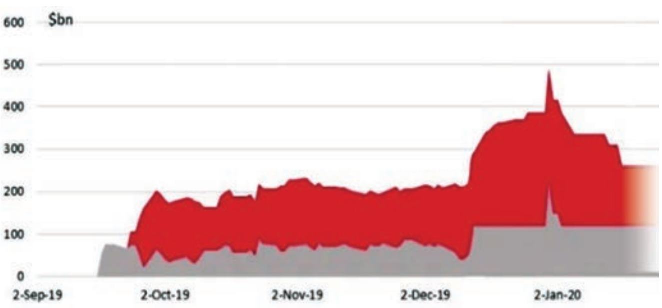
Let us recap before drawing our conclusion. The prevailing market optimism has disconnected practically all risky assets from their fundamentals. The current overpricing can only be justified by a sharp economic upswing which looks unlikely, given the longer term trends and the mixed impact of a deal between China and the US or from Brexit.

Although it was not presented as such, the unprecedented move by the Fed is further confirmation of the U-turn which it began a year ago. In the same way as halting rate hikes curbed the market correction at the end of 2018, the Fed's unusual intervention since September has triggered the recent bullish phase. Although current liquidity injection into the financial system covers unprecedented amounts of capital, it will not weigh on the entire yield curve in the same way as quantitative easing would and, above all, it is supposed to be temporary. The minutes of the FOMC meeting reveal plans to reduce the scale of operations from mid-January onwards, with a view to returning to normal by April.

What will happen once the Fed halts its liquidity injections? The global economy is unlikely to see any significant improvement by then and there is still considerable geopolitical uncertainty on the horizon. The conditions are also in place for volatility to possibly spike occasionally like in 2018. More sustainable selling pressure cannot be ruled out either, as institutional investors have no further cash reserves and leveraged strategies have switched from a cautious stance towards extremely aggressive positioning.

Fed open market operations (repos)

Daily amounts, accepted or scheduled (USD billions)



■ Overnight ■ Term
Source: Federal Reserve of New York, UBS

Although satisfactory fundamentals combined with unprecedented monetary stimulus measures may have engendered unequivocal optimism, as we stated above it is always dangerous to ignore human nature. Now that the dial has turned from fear to greed, we shall say that we have nothing to fear, except the absence of fear. ■

INVESTMENT CONCLUSIONS

In order to resume the current market situation, we would say that although the Fed's intervention has enabled investors to ignore the slowdown in growth and geopolitical instability, it has also incited them to take greater risks.

We are therefore currently recommending a neutral allocation compared to our long term strategy and we are ready to intervene if volatility resumes. Assuming a neutral overall positioning does not imply a lack of conviction on our part however, as we pick our positions within each asset class based on strong views.

In the case of equities, we are maintaining our preference for quality stocks, defined by a robust balance sheet and clear earnings visibility. Over the past few months, cyclicals and financial stocks have partially bridged the long-term gap compared to growth sectors. However, although several emerging and more precarious indices including Russia and Greece, have posted a long-awaited rally, as we discussed last quarter, we do not believe that the outperformance staged by the most cyclical stocks and markets is tenable due to the economic slowdown of course, and also because few companies in these sectors have sufficient cash reserves to buy back their own shares without raising debt. Share buybacks remain one of the key factors driving the market rally, as we have highlighted several times in the past, as they underpin earnings per share growth despite EBIT stagnating. Furthermore, defensive growth companies have not been hit particularly hard by the surge in cyclicals. The Momentum and above all the Quality factor, which is purely fundamental, have continued outperforming except during a few brief periods.[28] We are focusing our investments on those two factors, in our core portfolios and also through an overlay strategy among tech stocks.

We still prefer equities over credit. The investment grade segment is overpriced, along with high yield bonds which do not sufficiently compensate cyclical risks. We therefore use actively managed vehicles, enabling us to diverge from benchmarks which have seen a sharp fall in average credit ratings as we discussed above, and to diversify towards issuers other than industrial companies, namely covered bonds, securitised loans and debt-capital hybrids. Our portfolios denominated in Swiss francs also generally include Swiss property funds.

We have made an even clearer choice in our defensive bond selection. We hold exclusively US Treasuries hedged for currency risk. It is interesting to note that they are yielding higher rates than Greek sovereign debt. In short, our reasons for preferring T-Bonds are more fundamental, given that this is the only major market where real yields are not negative, despite the gradual rise in inflation. Although the main risk is of course the inexorable deepening of the federal budget deficit, demand from foreign institutional investors remains so strong that it should continue to soak up forthcoming bond issues. Over the past few months, volatility among bonds has been higher than in the equities markets and among major currencies. We seized the opportunity to increase the average duration of our portfolios, which are now close to the market level. We do not intend to adopt a more aggressive position however, unless of course recession risks surge.

Quality, Momentum and Value equity factors

MSCI World Factor Indices

— Value — Momentum — Quality

Although several emerging currencies have picked up against the dollar, while sterling has logically been driven by the ups and downs of the Brexit saga, volatility in the euro/dollar and dollar/yen rates was exceptionally low until the last few days of 2019. We still believe that global demand for US equities and bonds is offsetting the structurally negative trend in the dollar, although volatility will certainly increase. Although market consensus has turned more positive on the European economy and outlook for the euro is now bullish, we remain slightly more cautious as there is a risk of growth slowing down in Europe once the optimism triggered by the deal between China and the US wanes. Furthermore, political risks in the eurozone have far from disappeared, as will probably become more apparent during the spring. On the other hand, investor appetite may remain strong for the Swiss franc and the yen.

Gold price and dollar real yield

— Yield on Treasury inflation-indexed securities (5-year)
— Gold (London fixing price)
Shaded areas indicate recessions.
Source: IBA, Federal Reserve of St Louis

On the topic of gold the other safe haven, after gapping down, the price rallied dazzlingly even before the US embassy in Bagdad was invaded and the US reprisals against Iran. The strong intervention by the Fed has most likely stimulated demand for gold, which is the only asset providing protection against monetary adventurism.

We are maintaining our positions, although we shall be watching the Fed's operations very closely over the coming weeks. If the Fed reduces its level of intervention in keeping with the recently published timetable, gold could depreciate, although the flow-back of liquidity will have a further impact and could prompt a broader correction among the riskiest assets.

What if the Fed continues to expand its balance sheet under another pretext? This would be a further step towards inflating the "everything bubble". Macroeconomic risks as a potential trigger will have to be watched closely, along with investor positioning, which will provide the fuel for a correction.

In the last quarter of 2019, most financial assets were on a roll, thanks chiefly to the Fed. Let us not forget, however, that the central bank's role should be to "take away the punch bowl just as the party gets going."[29] Yet as of today, Jay Powell is filling up glasses as soon as they are empty. No party lasts forever, though. Let's enjoy this one while it lasts, but let's keep a check on our drinks intake. Also, it would be a good idea to locate the exit, just in case. ■

[28] The momentum factor in the MSCI indices is defined by excess profitability compared to risk-free yields, over the preceding 6 and 12 months; the quality factor is defined by the debt / shareholders' equity ratio, return on equity and volatility of earnings growth.
[29] As Bill Martin, Fed chairman until 1970, put it. Times have certainly changed.

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