

CIO Viewpoint

2019 investment themes

Investment Solutions

December 2018

Key Asset Allocation Views

As 2018 draws to a close, we have assembled **ten investment convictions** that we believe are set to play out over the coming year. While the US dollar looks as though it has peaked, equity valuations still look promising, despite the inevitable volatility ahead and the risk of a US recession is not on the horizon so far. We therefore remain convinced that there are opportunities for the prudent investor to take advantage of an environment that overall remains relatively supportive.

2018 saw its share of dramas. Turkey and Argentina suffered currency crises and oil markets were volatile. Politically, a new Italian government's electoral pledges put it at odds with the European Commission, the US mid-term elections and presidential votes in Mexico and Brazil changed the balance of power, Angela Merkel prepared her transition and 'yellow vests' took to French streets.

In addition, markets proved jittery as investors looked for signs that the bull market was ending, dipping sharply at the start of the year before reaching new highs, followed by further rapid corrections in October and November. In the process, technology stocks took a hit and skeptical investors tested company earnings. Much uncertainty is carrying into 2019, around US-China relations and its global implications, as well as the UK's self-inflicted Brexit chaos.

At the end of a testing year, we would like to take this opportunity to wish you a healthy, happy and prosperous 2019.



Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key dates in 2019

- | | |
|------------------------------|---|
| • 21 January | Deadline for UK to set out plans to manage a no-deal Brexit scenario |
| • 22-25 January | World Economic Forum annual meeting, Davos, Switzerland |
| • 29 March, 23:00 UTC | UK scheduled to leave the European Union |
| • April / May | India's general elections |
| • 23-26 May | European Parliamentary elections |
| • 28-29 June | G20 meeting in Japan |
| • 25-27 August | G7 meeting in France |
| • 27 October | Argentina's general election |
| • 31 October | Terms of ECB President Mario Draghi and European Commission President Claude Juncker end. |

Important information: Please read the important information at the end of the document.

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1

Volatility is here to stay

With risk assets now more sensitive to macroeconomic factors and political uncertainty playing an increasing role, volatility in market sentiment is here to stay. Nonetheless, there are reasons to remain cautiously optimistic: the New Year will begin with more favourable valuations and still-sound fundamentals.

2

Liquidity and cash

We have reduced the levels of risk in our portfolios since June, maintaining an overweight position in cash holdings. Asset liquidity helps us adjust risk exposure amid rising uncertainty while higher cash holdings allow us to seize selective tactical opportunities as they arise.

3

Equities versus fixed income

We continue to favour equities over high beta fixed income segments, which are more sensitive to the level of rates, as well as potentially suffering from illiquidity. Equity fundamentals are still solid and eurozone, Japanese and emerging markets still look cheap. We remain underweight credit and hold no high yield bonds. With no recession on the horizon, we believe that equities are less at risk, with valuations adapted to the current level of rates and corporate profitability unlikely to suffer as long as real rates remain below potential growth.

4

Technology and banks

Corporate profits in the US may have peaked but going forward, we expect earnings growth in line with their long-term average, based on stable sales growth, strong share buyback activity and limited impact from lower margins. In line with this thinking, the market consensus did not meaningfully change following the recent corrections.

US banks have performed better than their European peers, but selectivity, and pristine balance sheets are essential as we approach the end of the cycle. In the US, the sector has lagged; however, should the market strengthen investors may expect to see performance catch up. For European markets, there are signs of light for the Italian banks with the potential third round of Targeted Longer-Term Refinancing Operations, and valuations remain cheap.

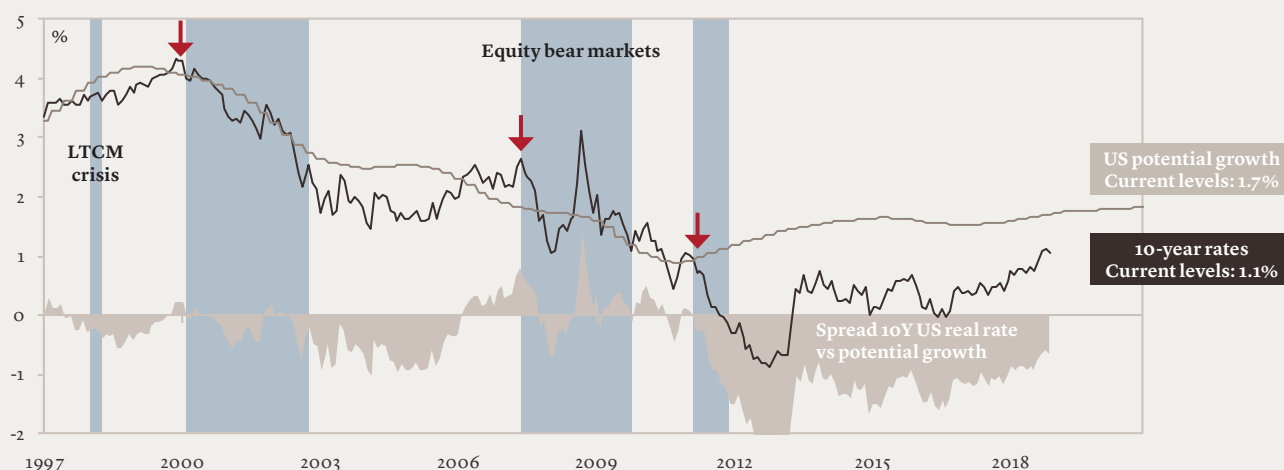
Despite strong earnings, technology valuations have fallen significantly and in semi-conductors, dramatically. We think recent profit warnings from Apple's supply chain provide interesting entry points in a now much less crowded trade and investors will return to a sector that offers both growth and defensive characteristics.

5

Emerging market assets

Emerging markets suffered in 2018 across all asset classes and are priced for very negative growth. Yet emerging markets enjoy broadly sound account balances, adequate foreign exchange reserves and still-young economic cycles. In addition, fiscal stimulus in China, a USD that has peaked and a temporary trade truce between the US and China should all support investor confidence going forward.

Chart 1: Higher rates derail bull markets when real rates exceed potential growth



Sources: Bloomberg, Barclays, Lombard Odier calculations

6

Real rates to peak in 2019

In this context of higher volatility, we will increasingly focus on portfolio protection as we enter 2019. As the Fed tightening cycle advances, we are getting closer to the peak in real rates. We still expect relatively low returns for bonds but begin opportunistically reducing our long-held underweight in sovereign bonds while maintaining a short duration, for now (see chart 1).

7

FX – USD weakness

We expect 2019 to bring a broad-based dollar depreciation due to the declining effect of 2018's expansionary US fiscal policy, followed by fading US economic growth. This will leave the US with a sizeable twin deficit problem (see chart 2). The US/Rest-of-the-World interest rate spread will also narrow from unprecedented and unsustainable levels as markets raise their rate expectations for other central banks.

8

Seeking FX havens

Given the lack of traditional haven provided by government bonds, we have looked for diversification and hedging strategies elsewhere, especially for European portfolios. In currencies, we have favoured hedging strategies, buying the Japanese yen first against the euro and then against the US dollar, to provide a cushion from volatility. As we move into next year, we expect emerging FX to stabilise after its steep sell-off in 2018 and prefer currencies with strong external balances, with reforms underway and low dependence on the USD.

9

Long sterling on second Brexit referendum

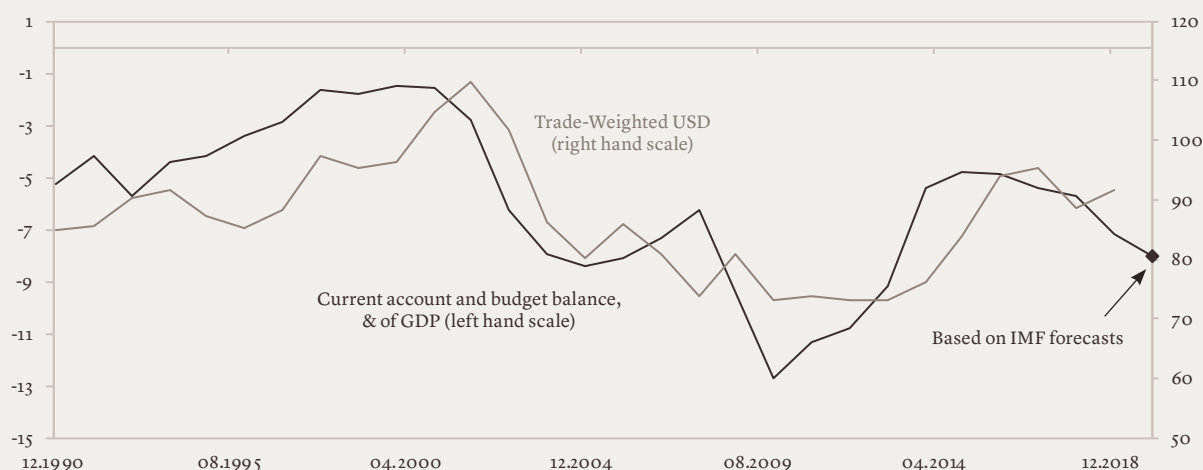
At the time of writing, GBP traded close to 20-month lows. We believe that UK will avoid a hard or 'no deal' Brexit, because either Prime Minister Theresa May will eventually get an EU withdrawal agreement through Parliament, or the UK will unilaterally halt Brexit, perhaps following a second referendum. Both scenarios would be GBP positive.

10

Commodities for diversification

A diversified exposure to commodities is appropriate in this environment. Current prices don't indicate tight supply-demand balances, with potential upside in oil and base metals. Any escalation in the US/China trade dispute or rising Middle East tension would provide upside in gold and/or oil, while a solution to the trade war would see base metals outperform.

Chart 2: US twin deficit bodes ill for the dollar



Sources: Bloomberg, Lombard Odier calculations

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