CIO Views

DECEMBER 2018

2019 : RETHINKING PORTFOLIO PROTECTION

While uncertainty is probably the single biggest issue we see as we look at the upcoming year, this was already the case in 2018, and asset managers have grown accustomed to taking it in stride. The real change ahead for 2019 lies less in the emergence of uncertainties than in the behavior of financial assets, which is set to move away from what we've seen in recent years.

The world's central banks are expected to disengage in 2019, from a balance sheet perspective. The aggregate balance sheet of the Fed, BCE, BoE and BoJ will decline for the first time ever. However, while the amount of shrinkage in liquidity is a known quantity, its consequences for the world's economies and for the financial markets remain unclear.

This development calls for asset managers to adjust to changing conditions, rethinking how they protect their portfolios and choosing the most suitable management styles.

Guillaume Lasserre
Chief Investment Officer,
Lyxor Asset Management

RENEWED CONFIDENCE IN THE US

In the context of a tighter monetary policy , we are not anticipating a recession in the US at least before 2021. With year-on-year growth of 3%, the country continues to reap the benefits of its recent tax reforms. Looking at the economy, there are plenty of positive signals to be found. While job creation has admittedly slowed, it remains high and well in line with the late-cycle trend we see emerging. Together with sustained wage growth, this job creation supports increased buying power, leading to greater consumer spending, which we expect to contribute over 2.5% to growth in 2019, in line with 2018.

In our view, weakness is more likely to be seen in corporate investment, which may be dragged down by uncertainties related to the trade war. These are also taking a toll on markets, as concerns rise that the recent truce, which has dialed down hostilities, has prevented the consequences of the crisis from being fully priced into the market.

The US economy is slowing, but we see this as a soft-landing, with no signs of strong inflationary pressures or major disturbances. That is why we believe that beyond raising interest rates in December 2018, the Fed will probably schedule only two additional rate hikes in 2019. This is one less than the FOMC's median projection. Scrutiny of the interest curve does not suggest a recession in the next two years and reveals no particular tension between short and long term borrowing costs.

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EUROPE'S WEAK POINTS

Although Europe is not on the front lines of the trade war underway between the United States and China, the EU is still at the receiving end of these tensions and may suffer consequences. The risks weighing on exports are not to be ignored, particularly for areas such as the German automobile industry, which is currently facing the threat of US tariffs. The situation is further destabilized by the risk of knock-on effects: a sudden decline in automobile exports would have repercussions throughout Germany's economy and soon spread to neighboring countries.

Financially speaking, Italy is the primary source of risk. While risk premiums indicate that there is more granular distinction among peripheral countries than there was in 2011-2012, Italy's predicament is nonetheless an additional stressor with implications for the whole of Europe. A relay effect would mean that the entire banking sector could be affected, followed shortly by sectors of the economy with significant financing needs.

Europe also faces singular political risks. While we believe a 'soft' Brexit solution will be found, the effects of a potential 'hard' Brexit cannot be ignored. After all, 45% of British exports go to the EU, while, in the other direction, 10% of Europe's head to the UK. If the British were to crash out with no agreement, the UK could sink into a recession that would inevitably hurt Europe.

Lastly, the EU's financial and economic integration has slowed to a halt. The banking union remains incomplete, while the capital markets union is stalled in the project phase. European companies continue to be considerably exposed to the global economic cycle, as the internal market is not sufficient to guarantee their margins.

We therefore see Europe's growth prospects as more fragile than the United States'. Nonetheless, the ECB has confirmed plans to discontinue QE in December 2018, with a rate increase scheduled for September 2019. We think it probable that the central bank will anticipate the maturing of long term refinancing operations by launching a new LTRO, on a smaller scale and under different conditions. This is a key issue, as it affects financing conditions for European banking institutions, especially in Italy, where there are direct implications for the country's economy.

A CAUTIOUSLY OPTIMISTIC GROWTH OUTLOOK

We've identified five key factors with the capability of shifting our scenario in a positive or negative direction, depending on how they play out:

- The trade war: between the backpedaling, muscle-flexing and truces, there is a constant variation in its intensity. We are expecting tensions to abate but are not holding out for a full resolution.

- The Federal Reserve: the Fed has shown it is watching the economy closely and prepared to intervene as needed without causing a market shake-up. In our scenario, we see the central bank as anxious not to prompt any further deterioration in the economy.

- Politics within the euro zone: in addition to Brexit and the Italian budget, France will have to demonstrate its ability to remain attractive by resolving its domestic problems. Our working hypothesis assumes a soft Brexit for the UK and a budget agreement between Italy and the EU.

- China's capacity to rev up its economy to compensate the effects of the trade war. In our view, China has the resources to jump-start growth and will see this as a needed measure.

- Oil prices: the cost of oil has a significant impact on the global economy and on financial markets. We expect to see a modest rebound.

At present, we are expecting positive outcomes for these five factors. If one or more of these hypotheses were to be disproven, we would revise our overall scenario and draw new conclusions as to asset allocation. From an investment perspective, the situation prompts a renewed appetite for riskier assets. In terms of investment, it translates into a preference for non-directional strategies and establishing protective measures that insulate portfolios against downside risk.

MANAGING A NON-DIRECTIONAL APPROACH

In terms of asset allocation, it is essential to take into account the lack of clarity regarding events to come, a situation that makes it difficult to rely on strong market direction.

We are currently neutral on equities. While the 12-month outlook remains positive, the market exhibits a certain lack of optimism. We are underweight Emerging equities and have a preference for defensive stocks.

We are maintaining our underweight position on bonds, given the rate hikes expected from the Fed, and focusing on short maturities.

As far as the credit markets more broadly are concerned, we are defensive on investment grade debt, and constructive on the riskier high-yield bond segment. The end of QE in the euro zone will abolish one supporting factor, and sovereign rates are trending upward. However, the 3% US nominal rate is looking attractive.

Without the advantage of a clear direction, maintaining long positions across a diversified portfolio carries greater risk. The bond market no longer seems to be fully playing its role as a natural hedge in case of shocks. Previously, portfolios were able to leverage the decorrelation between stocks and bonds, but this gap has been closing, as shown by the situation observed in October 2018. American equities lost close to 10%, yet the 10-year Treasury rate didn't budge.

For 2019, bonds will not provide sufficient protection for portfolios, given the five major types of events listed above that have the potential to derail the global economy and to weigh on risky assets.

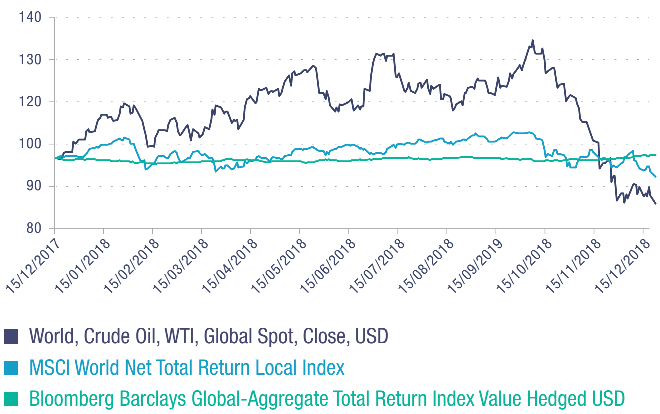
PORTFOLIO PROTECTION

We at Lyxor Asset Management have already begun setting up defensive mechanisms for protecting our portfolios before potentially destabilizing events take place. This is also something that is increasingly requested by our clients.

We have chosen to purchase protection for our portfolios, for instance, in the form of options. By stepping into the gap where non-correlated assets may no longer be as effective as previously, this additional protective measure makes it possible to continue investing in risky assets on both the equities and credit markets. This strategy is employed in addition to arbitrage, which cannot by itself provide adequate insulation from the various potentially threatening factors looming in 2019.

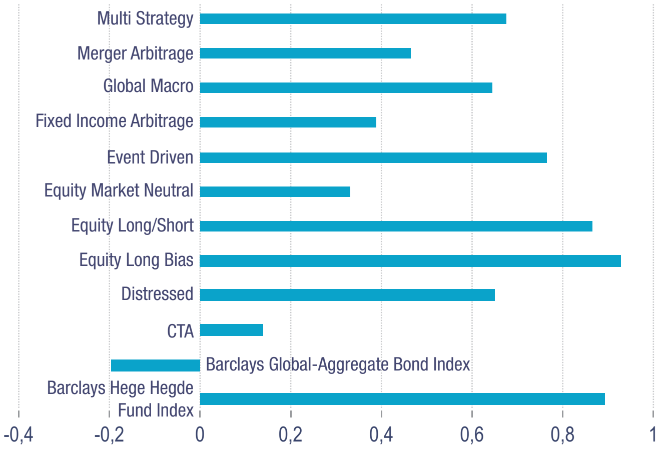
It is particularly advantageous to buy protection now, as it is priced quite low relative to observed levels of market anxiety. Implied volatility, as reflected in the VIX for the S&P 500, or the V2X for the Euro Stoxx index, has climbed less steeply than the actual volatility of the markets. Quite aside from price, the main issue is effectiveness, and we are currently choosing protective solutions that safeguard our portfolios, especially those which are diversified. We have also launched an equity fund for institutional investors with downside protection starting at -15%.

ABSENCE OF MARKET DIRECTIONNALITY



Source: Bloomberg, Macrobond, BarclaysHedge, Lyxor AM

BY BEING SELECTIVE, HEDGE FUNDS DIVERSIFY PORTFOLIOS.



Source: Bloomberg, Macrobond, BarclaysHedge, Lyxor AM

PICKING THE RIGHT INVESTMENT STRATEGY

While there are certainly choices to be made as regards protection, we are convinced that the circumstances also call for an emphasis on very specific types of management, in order to generate additional returns.

Alternative management is an attractive source of returns that is decoupled from the direction of the financial markets. Our belief is that non-directional hedge fund strategies should perform well in 2019. Among the available possibilities, we have identified the three most likely to benefit from the non-directional market. They are:

- Long/short credit strategy.
- Merger arbitrage strategy focused on M&A.
- Long/short equity variable bias strategy.

These allocation models offer the advantage of being less sensitive to the equity market, meaning their performance is independent of the market's orientation, in both directions. Such strategies allow us to round out our exposure to the main risk-bearing asset classes so as to best profit from our constructive macroeconomic scenario.

In short, we prefer to secure concrete protection for our portfolios today, via options, as we seek out diversification in the form of alternative risk premiums. These strategies add to traditional asset management techniques, such as our use of risk-adjusted weighting in diversified management.

Going forward, expertise in risk-management as well as in alternative risk premia will be key. In these two areas, Lyxor Asset Management has fully demonstrated its expertise and ability to choose the most relevant portfolio insurance and alternative management strategies.

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