

## THE SOFT-LANDING SCENARIO IS LOOKING MORE CREDIBLE

According to popular belief in China, the year that has just begun – the Year of the Pig – is likely to be a good one for the financial sector because the pig is a symbol of prosperity. However, pigs need to be watched because they are greedy, and greed can be damaging if it goes too far. We should be confident, then, but not overly so.

This, roughly speaking, describes the current attitude of the US Federal Reserve. Its tone has changed markedly now that patience has become the watchword of its chairman Jerome Powell. Whereas two or three further rate hikes were still in the pipeline a few weeks ago, the Fed is now indicating that it wants to pause its monetary tightening.

### **Trump's and the shutdown's influence**

This shift – from a very positive scenario to a more “wait-and-see” stance, in Jerome Powell's words – has caused conditions in the bond market to ease substantially, even as jobs are still being created at a record rate. US 10-year yields have fallen from 3.25% in November to 2.55% today. The Fed may well proclaim its independence loud and clear, but it is not unreasonable to suspect that Donald Trump's repeated harsh criticism of the central bank has helped cause its change of tone. The same could be said of the economic disruption caused by the shutdown, which paralysed a large portion of the US administration for a record 36 days.

Doubts about the prospects of major tech companies, which surfaced in the autumn, have been even more significant, since the business levels of these international groups can be regarded as a reliable indicator of the global growth trend. Apple recently warned about its profits, and such news inevitably raises questions about how long the growth phase will last.

After panicking in late 2018, investors are pinning fresh hopes on the Fed's sudden restraint and progress in talks between Washington and Beijing to resolve their trade dispute between now and 1 March. The violent market decline in December 2018 involved excessive selling that has now been partly corrected, and the S&P 500 has had its best start to a year for more than three decades. Overall, between the end of January 2018 and the end of January 2019, the Dow Jones was down only 4.4% and the Nasdaq down only 1.75%.

The relatively benign scenario of a soft landing in the US and China should ensure a degree of stability in the financial markets. This is especially true since valuations are now less excessive following the corrections seen across all asset classes in the second half of 2018.

On a historical comparison, the Nasdaq's price/earnings (P/E) ratio remains high, at 34 in early February. However, it remains well below its March 2018 peak of 52 and its 12-month average of 42. The Dow Jones P/E ratio, which was 21 a year ago, has also regained some breathing space, having fallen to 16.3.

## **Good news from China**

History has shown that steering an economic slowdown is a highly delicate operation. As a result, a cautious approach is required in the current transitional period, during which hopes of continued growth are coming up against concern that the current cycle is ending. Given the current uncertainty, major economic indicators will be crucial in tipping the scales one way or the other. Although oil prices have surged again in early 2019, they are less useful as an indicator because the increase is largely down to the crisis in Venezuela and OPEC policy.

However, investors will have to keep a close eye on US and Chinese statistics, as well as on corporate earnings announcements. Paradoxically, while Chinese exports could suffer badly from the trade dispute, China could also be the main source of good news. Chinese stocks, particularly in the tech sector, have rallied strongly and China's stockmarket has been one of the best performers since the start of the year.

## **Volatility back with a vengeance**

In any event, the current situation calls for an asymmetric approach to portfolio management. Equity exposure must be maintained, but accompanied by protection achieved through derivative and structured products in order to guard against possible market downturns. Investors will also have to deal with a phenomenon that they have become unaccustomed to seeing, i.e. volatility. This is because politics has regained the upper hand over the economic and financial sphere. For years, the influence of politics over the financial markets had seemed limited, but the arrival of Donald Trump has changed all that.

Volatility is back with a vengeance, which is one of the consequences of the US president's trade offensive. The president's determination to assert his authority is also shown by his move to call the Fed's independence into question. Volatility is also affecting Europe. A number of major deadlines are approaching (Brexit, European elections etc.) and many governments are under pressure, which means that we are likely to see decisions that are more clear-cut but, more importantly, less predictable.

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