February 2019 | Rothschild & Co Asset Management Europe

For professional investors only

Perspective

R-co Valor, Quarterly Strategy

In a certain way, financial markets reached a form of "levitation" in 2018, as they became convinced that US "tech" stocks would continue reaching peaks, bringing the entire market in its wake. That was a rude return to earth late in the year, with massive corrections for the sector as well as on almost all indices.

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2018, a melting pot of uncertainties

Let's talk about the Sino-American trade war, the US government shutdown, US indices' December underperformance, the endless "Brexit" talks, the "Yellow vest" movement in France, pressures on Italy despite headway in deficit negotiations with the European Commission, and, the feeling that the fed activated autopilot in the conduct of its monetary policy... The Chinese economy also appears to be slowing down, as well as the global economy, even if this slowdown is less significant in North American than in Asia or Europe. In light of the above, the feeling that investors showed in December that we are headed not just for an economic slowdown but for a recession after an almost-uninterrupted nine-year bull market seems somewhat justified. This is the clear signal sent by the market the 24th of December.

The Fed's about-face

The Fed's U-turn is clearly the main event on the markets so far this year. Back in late December, a likely shift began showing up in the words of Jerome Powell, the current Fed chairman, when he began adavancing the concept of "patience", wording that was then taken up in the Fed minutes. It now seems that this idea

is shared by most FOMC members. Such a shift in course in such a short time (just six weeks) is quite rare. This was a complete overhaul of the Federal Reserve's attitude and the almost-automatic execution of its normalisation process, particularly in running off its balance sheet. The Fed's main concern now appears to support the markets.

The markets remain concerned by the trade war

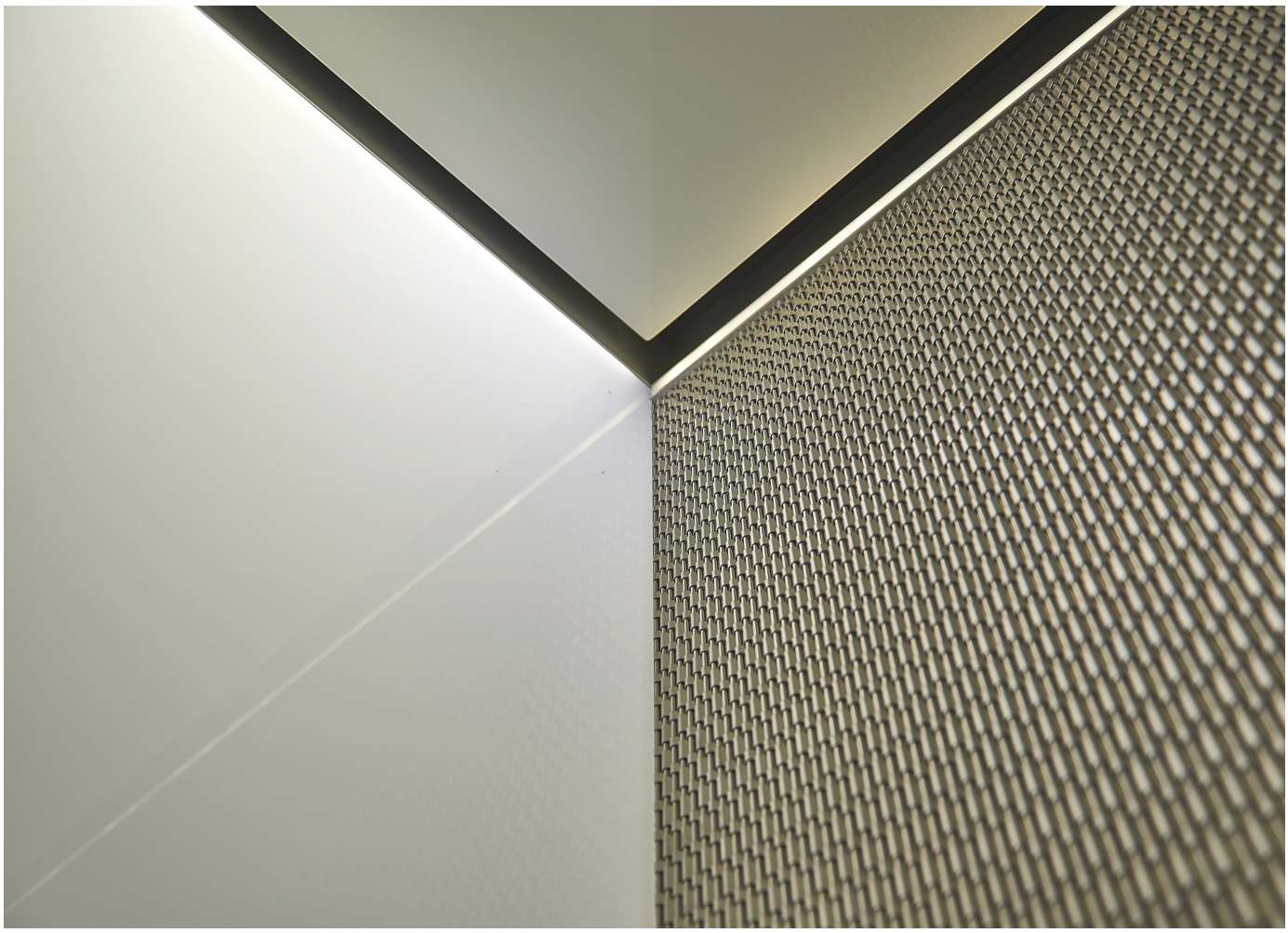
Negotiations are continuing between US and Chinese authorities to resolve the trade war, but the outcome is still uncertain. An agreement looks possible on trade in goods and trade deficit reduction, but intellectual property and trade in technology sector are issues that could be much harder to resolve. It is impossible to say whether the 1st March 2019, the official deadline for a new increase in customs tariffs will be kept, postponed, or whether a partial agreement will be reached with talks being put off on touchier issues... All options are still on the table.

Even partial headway could serve as a basis of negotiations with the Europeans and the Japanese and would send a positive signal that could restart global trade and, hence, economic growth. Investors would be relieved by such a signal and they are actually already pricing in such an outcome. An agreement would not have a very large mechanical impact on the markets, unless it cleared up all doubts and revolved all dissensions, a scenario that is highly unlikely.

On the wall

In the wake of the agreement between the Republicans and Democrats ending the 35-day government shutdown, which he deemed unsatisfactory, Trump made good on his threat of declaring a national emergency in order to obtain the funding needed to build his wall on the Mexican border. However, legal action by 16 US states is likely to slow the actual triggering of the process considerably, along with the release of the funds. This setback in Trump flagship measure and his need to show some meaningful victories to his voters, could cause him to seek a quick favourable resolution to the thorny issue of the trade war.

"The Fed's U-turn is clearly the main event on the markets so far this year..."



Shift in tone by the US administration

So far this year, despite this latest outburst, Trump and his administration appear to be more concerned about how the markets are doing. Whereas the American president had been flaunting when the US growth stood at 4% and the US financial markets were somewhat euphoric, the fourth-quarter correction, the steepest since 1931, seems to raise concerns within the White House about stock market trends and the deterioration in credit markets. This shift in tone, combined with the Fed's about-face, are essential to understand the steep rally so far this year. That being said, this rally shows the exact opposite of what we saw in the fourth quarter of 2018: cyclicals, with the exception of financials, are rising sharply at the expense of defensive sectors, such as telecoms, services, healthcare...

A gradual increase of our equity exposure in the fourth quarter

The portfolio's cash allocation, which amounted to about 20% at the end of the third quarter of 2018, was scaled back gradually in order to invest on the equity markets. We raised our exposure to China significantly in late October by reinforcing positions and introducing Momo Inc. and Tencent into the portfolio. These changes raised our equity exposure in both absolute and relative terms. In November, we continued to raise our allocation, with a clearly cyclical bias, particularly through industrial and commodity stocks. In December, our equity market exposure reached 93% after buying back all our S&P 500 futures hedges and, as we had in November, we continued to invest in companies such as Canadian Resources, Alibaba and certain financials.

"The shift in tone by the US administration combined with the Fed's about-face are essential to understand the steep rally so far this year..."

Changes in the portfolio on defensive themes

Pharmas and healthcare are among the few sectors that posted a positive performance during the quarter, in both absolute and relative terms. This is why we gradually took some profits on certain stocks, in order to invest the proceeds in other stocks offering attractive entry points. We therefore shifted our healthcare allocation, in particular in major US pharmas. We sold off Eli Lily & Co and bought Fresenius Medical Care, a company specialising in dialysis that we added to the portfolio in late November, and increased our exposure to the biotech Gilead Inc.

Gold mining sector also held up well during the review period. While this second "ballast", which we set up in 2016-2017, failed to play its role in the first nine months of 2018, the slight upturn in gold prices enables the sector to end the year in positive territory. Investors' moves in gold also allowed us to get a feeling for the market's highly defensive stance.

Lastly, two major deals have highlighted the current year, in a perfect illustration of sector consolidation, a theme that we had focused on via these sectors. Celgene came under a takeover bid by Bristol-Myers Squibb, which offered a premium of about 33% (however, the deal has not yet gone through). In goldmines, Goldcorp Inc. came under a bid by Newmont Mining, with a premium of 17%.

Tactical risk-management in 2019

The macroeconomic trend is unlikely to be very favourable in 2019. Even if it were, this would not be a desirable outcome. An overly steep upturn in the economy would exert new pressures on interest rates. The Fed's more accommodative policy is giving the markets some room to breathe probably for two quarters. We will therefore be keeping a close eye on US wage inflation, in order to measure its impact on US structural inflation, given the risk of interest rates rise in reaction to an inflationary environment.

"The Fed's more accommodative policy is giving the markets some room to breathe probably for two quarters..."

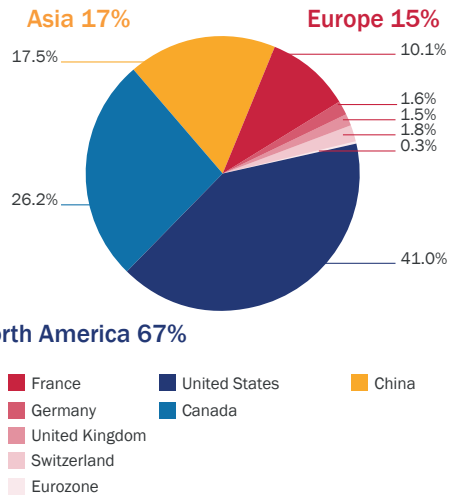
For the moment, US interest rates have fallen on the whole in both the short and long portions of the curve. This environment is supporting equity market valuations, as well as the entire economy. However, despite January's steep rally we are still not at levels comparable to late 2017. Moreover, earnings growth forecasts are quite reasonable, and there have been sharp earnings downgrades. As a result, equity markets are not looking at the world with rose-coloured glasses although risk premiums have receded slightly with shifts in the politico-economic environment.

Against this backdrop, and with our equity exposure currently at 92%, we will be keeping an especially close eye on these parameters. So far this year, we have taken some profits on the margins on Canadian transport companies, in energy on companies such as Concho Resources, and on LVMH, in luxury goods. We are therefore taking on a tactical approach to risk-management, based on shifts in the aforementioned factors and opportunities that may arise on the markets, particularly if interest rates turn back up.

Completed writing on 21 February 2019

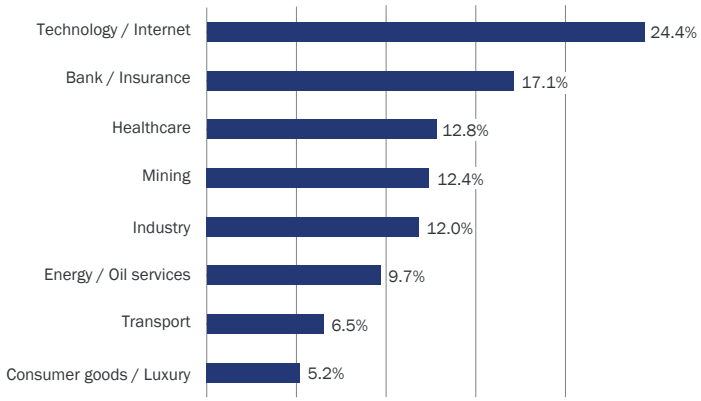
R-co Valor: Portfolio's geographical and thematic breakdown as of January 2019

Geographical breakdown (Equity Part)



Source: Rothschild & Co Asset Management Europe, 31/01/2019

Thematic breakdown (Equity Part)



Source: Rothschild & Co Asset Management Europe, 31/01/2019

R-co Valor: Portfolio's top 10 holdings as of January 2019

Stocks	Weight
Alphabet	3.4%
Ping An Insurance	3.4%
Alibaba Group Holding	3.4%
Teck Resources	3.4%
Facebook	3.4%
Morgan Stanley	3.1%
LVMH	3.1%
Manulife Financial Corp	3.0%
Tencent Holding Ltd	2.8%
Celgene Corp	2.8%

Nombre de lignes	43
Poids moyen	2.2%
Poids des 10 plus grosses lignes	32.0%
Poids des 5 plus grosses lignes	17.1%

Source: Rothschild & Co Asset Management Europe, 31/01/2019

	2019	2018	2017	2016	2015	2014	5 years	1 year volatility
R-co Valor C EUR	11.19%	-13.17%	9.54%	19.92%	4.55%	15.68%	54.70%	14.91%

Source: Rothschild & Co Asset Management Europe, 31/01/2019

Recommended investment period: 5 years

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