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OUTLOOK &CONVICTIONS

A very challenging 2019 ahead

EDMOND DE ROTHSCHILD, BOLD BUILDERS OF THE FUTURE.

ROUNDUP

MACRO OUTLOOK

- The structural impact of fiscal reform will cushion growth deceleration in the US
- China is expected to top up its stimulus plan
- Institutional changes and the trade war represent a double whammy for the eurozone

ASSET ALLOCATION

- The environment is looking rosier again
- Equities will gain the most from the cycle continuing
- To start looking more closely at portfolio liquidity risk

FIXED INCOME

- US inflation-indexed bonds have become very attractive in our view
- Expect German Bund yields to rise now that the ECB is providing less support
- In corporate debt, we prefer Europe, and particularly subordinated financial debt, as well as emerging country credit

EQUITIES

- Ongoing share price weakness suggests a sharp deterioration in corporate profits in 2019
- We see a decline in growth rates but not a decline in earnings
- Investor focus on the inverted yield curve may be missing the point

CURRENCIES

- Expensive US dollar hedging is proving problematic for many investors but exchange rate volatility still justifies adopting a high-conviction approach
- We are focusing on less cyclical currencies to help stablilise portfolios during market turbulence
- Gold could gain if the US dollar and interest rates stabilise against a persistently uncertain political and economic background

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GLOBAL GROWTH HANGS ON CHINA'S STIMULUS PLAN

The structural impact of fiscal reform will cushion growth deceleration in the US

China is expected to top up its stimulus plan

Institutional changes and the trade war represent a double whammy for the eurozone

THE US IS CENTRAL TO GLOBAL GROWTH

As we had correctly foreseen, the US is once again central to global growth. Our research led us to consider the structural impacts of fiscal reform in the US and not only its cyclical effects. Data for the first half of 2018 show that the Tax cuts and jobs Act has indeed boosted output capacity in the US. As a result, the US might only see a moderate slowdown in growth in 2019 thanks to the persistent benefits of fiscal reform on corporate competitiveness.

US domestic growth could underpin global growth because the US is still the world's largest importer. Moreover, Donald Trump wants to win market share, not reduce trade.

However, the Fed is expected to remain cautious. First, because budget talks between Republicans and the Democrat majority in the House of Representatives could increase the cost of US government refinancing. Second, our econometric models suggest the US dollar is 15% overvalued compared to its equilibrium level, a situation which acts as a constraint on any future rate hikes. And new home sales have fallen due to the higher cost of borrowing for companies and households. The Fed is also expected to be wary of anything that might risk provoking a eurozone slowdown.
Not only will the eurozone be facing institutional challenges in 2019 like European elections, the renewal of the European Commission and the appointment of a new ECB chairman, but the zone could also be the big loser from the US-China trade war. After raising customs tariffs, Washington has opened trade talks with the European Union. The aim is to get Europe to increase US agricultural imports by threatening to impose higher duties on their car exports to the US. At the same time, China is looking for new markets to offset the negative impact of customs duties on exported goods. GDP growth in the eurozone could slow to 1.5% in 2019 and 1.4% the year after. However, any depreciation in the euro could be limited by reduced financial outflows and improved ECB supervision of euro clearing houses. Budget policy could also be eased.

CHINA'S STIMULUS PLAN WILL PLAY A DECISIVE ROLE IN 2019

In an attempt to halt growth deceleration, Beijing has gone for monetary easing and announced tax cuts for households and companies. But looking beyond domestic growth targets, China's president cannot allow himself to fall behind the US in the leadership stakes. That is why the ongoing stimulus plan will need to be topped up, a move that, according to our estimates, should see GDP growth accelerate to 6.7% in the first half of 2019.

As a result, this Asian lift to global growth could reduce the negative impacts from persistent uncertainty over (i) the UK's actual exit conditions from the EU, (ii) the May 26 European elections which could see more seats going to anti-European parties, (iii) tensions between Italy, Germany and France and (iv) the beginning of fresh trade talks between the US and the European Union and the UK.

More details and an underlying analysis of our macro-economic scenario can be found in our "Macro Expectations 2019-20".

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THE CYCLE WILL TAKE BACK CONTROL OF MARKET TRENDS

The environment is looking rosier again

Equities will gain the most from the cycle continuing

To start looking more closely at portfolio liquidity risk

Returns on financial assets generally reflect the economic cycle but 2018 was a big exception.

We have to go back several decades to find so many assets with such negative performance. No bond or equity market survived intact in 2018. Even the gold ounce, in US dollars, failed to post positive returns. And Bitcoin lost almost 75%.

True, economies slowed more significantly than investors were expecting, for the most part in Europe and China. And political risk was particularly high due to mounting protectionism in the US, Brexit, Italy's budget saga, France's political woes and the Middle East. But all these factors taken together hardly justify these market returns.

Some observers have pointed to the threat of an imminent recession, seemingly flagged by an incipient inversion in the US yield curve. We simply do not share this view. The current configuration is primarily due to much less liquidity from central banks, a development that in hindsight investors had largely underestimated. Quantitative easing policies had to some extent inflated asset prices. Clearly, an about turn from major banks has weighed heavily. The Fed shrank its balance sheet and the ECB and Bank of Japan started to slow down expansion in theirs. At the same time, US 3-month Treasury bonds are now yielding an attractive 2.33%, a return to grace. This represents a change in the game and it means US investors are the only ones in the developed world earning a reasonable return from a risk-free asset. All this means that central bank action will play a decisive role in 2019.

FUNDAMENTALS WILL BE BACK IN 2019

Central bank liquidity should continue to contract but much less markedly as most of the ground was covered in 2018. Elsewhere, we expect the Fed to continue raising rates, but its new optionality now makes it less certain that returns on risk-free assets will increase further. Financial conditions are unlikely to ease but they should not significantly jeopardise performance as in 2018. As the economic outlook is still looking rather favourable and we are ruling out a recession, the environment is looking rosier again. That is why we remain invested, and notably in equities. It is difficult to say when the turmoil which erupted in the fourth quarter will end, but we have no doubt that periods when markets deviate from the fundamental picture can only be temporary. We simply have to be patient.

CLEAR-CUT ASSET ALLOCATION

For our selection of risk assets in portfolios, we prefer equities to corporate bonds:

› equities will gain the most from the cycle continuing.

› reductions in central bank liquidity will have less of an impact in 2019 but the chances are that corporate bonds and emerging country debt will be hit harder as these segments were the first to benefit from quantitative easing.

› should a recession occur earlier than expected because of external events, we need to start looking more closely at portfolio liquidity risk. Bond markets have never been through an economic crisis since the new banking regulations were introduced and so might react differently than in previous recessions. Before Lehman Brothers went bankrupt, investment banks were able to use their sizeable balance sheets to supply liquidity to markets in high-stress periods. Today, that is almost impossible and they have essentially been replaced by asset managers who behave in a much more cyclical way, in line with their clients' behaviour.

› historically, the risk-adjusted returns from corporate bonds most often underperform equities when a cycle is mature.

› US corporate leverage is historically high even if debt servicing is at manageable levels. But the situation could warrant tension on US corporate bond yields with the risk possibly spreading to other spread markets.

Nevertheless, it makes sense to hold bonds in a portfolio. First, unlike last year, their risk/reward profile is reasonable. Second, they should not be impacted by fundamentals. Third, bond exposure should provide better risk diversification than in 2018. The Fed's much more pragmatic stance over monetary tightening means duration once again has a countercyclical appeal. An economic or financial shock would cause markets to readjust their expectations for the Fed's benchmark rates, thereby triggering a drop in Treasury yields.

CONVEXITY AND CASH MANAGEMENT

We expected 2018 to be more volatile and we took a tactical investment approach throughout the year. We believe the background will be similar in 2019 and we intend to rely heavily on options to limit risk, both as protection against downside and to fund hedging costs. We will also actively manage cash positions so as to gain from any excessive volatility. Flexibility will be our investment watchword in 2019.

FLEXIBILITY WILL BE
OUR INVESTMENT WATCHWORD
IN 2019.

WHAT ARE THE BIGGEST RISKS TO OUR SCENARIO?

Political risk

The steep decline in the global political environment carries a serious risk of ungovernability, a negative factor for markets and a source of volatility. Markets have, of course, already discounted many such areas but the political sphere is full of surprises so we should remain cautious.

In Europe, mounting populism and serious social unrest have weakened governments in Germany, Spain and France and toppled the ruling coalition in Belgium. Italy's populist coalition government is as strong as its policies are ambiguous. The UK's failure to forge an agreement over Brexit, even with the exit date fast approaching, has totally removed any visibility on investing in the country. What is certain is that the expected reinforcement of European structures has, in the space of 6 months, been seriously compromised, undermining both France and Germany and leaving Europe's hybrid model with all its vulnerability exposed. The 2019 European elections will be closely watched to see what shape this new political environment takes. Meanwhile, the US political crisis is embodied by one man alone. Recurrent resignations by cabinet officials and White House staff, coupled with convictions of people in Donald Trump's close circle, give a strong impression of chaos and might even pass for distractions given the issues at hand. But there has been a major domestic development in the form of the government shutdown. And Bloomberg reports that Donald Trump is aiming to replace Jerome Powell at the Fed after much criticism of his policy as chairman. The crisis has also had an exceptional impact on global uncertainty with the trade dispute with China, threats to raise tariffs on European car imports, sanctions against Iran and the decision to withdraw US troops from Syria.

Oil as a political variable

Oil has increasingly turned into a political variable, especially since Donald Trump decided to try to influence its price in an attempt to

boost household spending power in the US. This new process relies heavily on relations with Saudi Arabia but also partly with Russia while fresh sanctions against Iran and the withdrawal of US troops from Syria has made the Middle East more complicated. The oil price should remain highly geared to this new paradigm and any shifts can be expected to have a knock-on effect on other markets.

What if inflation were to return?

We think there is only a small chance of this happening but it cannot entirely be ruled out as prices tend to start rising again when cycles mature. Any price tensions would be very damaging as they would lead investors to expect more monetary tightening, already a very sensitive issue in 2018.

WILL 2019 BE A YEAR OF TRANSITION?

2019 will kick off with many grey areas. But we believe there is rebound potential. Markets plunged in the fourth quarter of 2018, the Fed is now much more cautious over policy, we have the strong conviction that there will be no recession in coming months and there could be a reasonable conclusion to US-China trade talks, even if markets are sceptical of the outcome. As a result, we have maintained normal exposure to risk assets in our portfolios with a focus on equities rather than corporate debt.
But the time will come when we will have to prepare portfolios for the end of the cycle and that moment could come during 2019. We are not there yet. In the meantime, let's stay invested. Nothing is inevitable at this stage in the cycle.

Data sources: Edmond de Rothschild.

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SOME BOND MARKETS ARE LOOKING ATTRACTIVE AGAIN

US inflation-indexed bonds have become very attractive in our view

Expect German Bund yields to rise now that the ECB is providing less support

In corporate debt, we prefer Europe, and particularly subordinated financial debt, as well as emerging country credit

Corporate debt suffered negative returns across almost all segments in 2018. Credit spreads widened regardless of sector, rating or geographical zone. This was partly due to a number of political and geopolitical risks like US-China trade tensions, the approach of the Brexit deadline and Italy's populist party ruling coalition but it was primarily the result of fears of reduced central bank liquidity. And yet at the same time, government bond yields eased in core countries[1] and the only positive returns for the year came from markets where we were not expecting good news.

However, the fact that markets failed to anticipate trends has created opportunities. One year ago, we were confronted with excessive valuations on all global bond markets but we could now reasonably argue that some bond markets have become attractive again as we go into 2019.

THE YIELD CURVE IS NO LONGER DISCOUNTING ANY HIKE FROM THE FED

US TREASURIES

The Fed has now been tightening for 3 years and yields have risen significantly. To limit volatility and achieve orderly monetary normalisation, rates have been hiked gradually and accompanied by efficient communication. The Fed has at any rate avoiding making the same mistakes as in 2013 when its statements surprised markets and triggered a brutal correction on all bond markets. The US yield curve is now practically flat, its normal shape when investors expect a growth cycle to end in the near future. We have identified several opportunities on US bond markets:

› **higher short term rates**

The yield curve is no longer discounting any hike after the December 2018 move. We believe the market has overreacted to the notion of the Fed possibly marking a pause in its rate-hiking cycle. In fact, the bank wants some time to assess if past hikes have produced results. For our part, we see no worrying inflection to US growth momentum so it would be interesting to take a negative sensibility stance over short term rates in case the Fed increases rates again, even cautiously.

[1] Countries in the euro zone whose fiscal soundness is not a cause for concern either on the part of the markets or on the part of the authorities.

› US yield curve steepening

Donald Trump's fiscal stimulus has resulted in higher budget spending and thus an increase in government issuance. And as the Fed has shrunk its balance sheet, the longest-dated maturities are probably those which are most at risk in the US.

› US inflation-indexed bonds

US yields eased over the autumn as inflation expectations suddenly tanked. The drop was a reaction to the oil price plunge but it does not necessarily reflect US fundamentals, notably an acceleration in wage rises. But as inflation expectations have, curiously, fallen to way below their historic mean, this could be a good moment to invest in US inflation-indexed bonds. They are attractive essentially because of current real interest rate levels. They have risen further in recent weeks and are not only appealing because of their valuations but also the protection they offer when an economic slowdown starts to take shape.

EUROPEAN BONDS

The situation in Europe is different. Real rates have remained solidly stuck in negative territory due to extremely accommodating monetary policy. But improving fundamentals will now allow the ECB to reduce its stimulus and so we expect European bond valuations to normalise. That should mean higher German Bund yields but the trend will be gradual. The ECB is not going to raise its benchmark rates for several quarters and the scheduled December 2018 end to its quantitative easing programme does not mean it will stop buying bonds altogether. It will, in fact, continue its purchases because it will have to reinvest coupons and the proceeds from repayments of bonds already on its balance sheet. The amounts in question are estimated at between €10-20bn a month in 2019, a strong support factor. Moreover, German Bunds served as safe havens in 2018 and it is difficult to envisage a sharp increase in interest rates as long as visibility remains poor in areas which have fuelled volatility. Italy is a prime example.

PERIPHERAL EUROPEAN SOVEREIGNS

We are maintaining our exposure to Portuguese and Greek government debt. Both markets enjoy support factors which justify their inclusion in a bond allocation. The situation in both countries is returning to normal -European aid programmes have ended and economic fundamentals have improved sharply- and this has resulted in strong and sustainable easing in government bond yields. There is more uncertainty over Italy as the ruling coalition is fragile and markets will remain focused on the risks of fiscal slippage and even higher government debt levels. However, recent discussions between Rome and the European Commission have taken a more constructive turn and, over the short term, we are ruling out default risk and an exit from the eurozone. We have, as as result, remained upbeat on short term Italian government debt.

CORPORATE CREDIT

We do not have strong convictions across the entire corporate bond spectrum, preferring instead to distinguish between geographical zones. In Europe, we are steering clear of investment grade[2] because the segment has been one of the main beneficiaries of accommodating monetary policy; we have to be prepared for widening credit spreads now that the ECB has cut stimulus. We remain upbeat on high yield as it boasts solid fundamentals, low default rates and reduced leverage, plus factors which are only partially counterbalanced by worsening liquidity.
We are convinced European subordinated financial debt now represents a buy opportunity. After underperforming in 2018, valuations are looking attractive now that issuer profitability and solvency ratios have improved.
US company bonds, on the other hand, are not very interesting for currency-hedged European investors. Monetary policy divergence is such that hedging the US dollar in euro costs more than 3% a year, an historically high level. This rules out carry strategies[3] and so we prefer to avoid investment grade credit altogether. High yield[4] bonds are being hit by accelerating company indebtedness, a situation that is not totally factored into credit spreads.

EMERGING MARKETS

Credit spreads widened across all emerging country bonds in 2018. That represents an opportunity for company bonds as valuations are attractive and they offer diversification for investors looking for exposure to a global cycle that, in our view, still has potential. We do not expect any slowdown in emerging countries and believe that US prospects will remain good in 2019. As a result, we are focusing on emerging country companies with both domestic and global exposure.
We find emerging country sovereign debt attractive but issuer selectivity is essential. Emerging market bond returns will remain geared to investor flows and they appear to have stabilised. We prefer hard currency debt as local currency bonds will not be advantaged by expectations that the US dollar will remain strong against emerging currencies.

[2] Bonds rated as high quality by rating agencies.
[3] The carry strategy consists in holding the securities until maturity in order to benefit notably from coupons.
[4] Corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.

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EQUITY CORRECTION OR BEAR MARKET?

Ongoing share price weakness suggests a sharp deterioration in corporate profits in 2019

We see a decline in growth rates but not a decline in earnings

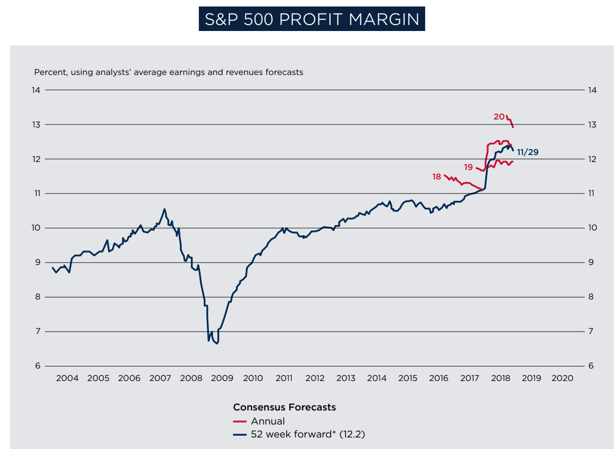
Investor focus on the inverted yield curve may be missing the point

Investors know that the trend in profit growth plays a key role in determining share prices. Companies have delivered strong profit growth in recent years, exemplified by the 23% Y/Y increase by US corporations in 2018. However, as we have flagged for some time, profitability measured by company margins is already at or near record territory in many countries and investors are now reacting to the reduction in analysts' forward looking expectations as margins look set to max out or decline.

In the US, for example, we expect earnings growth of around 4%-5% but analysts expect double this. Looking at the chart, we can see that US margins are higher than at any point in the past 14 years and 20% above the previous cycle peak in 2007. We sincerely doubt either wage, debt or raw material costs are heading down soon, and whilst productivity growth may accelerate, we doubt it can offset the aforementioned cost pressures. An adjustment period lies ahead and this is now troubling investors.

Aside from the worries about prospective earnings growth, there are no shortage of other possible causes of share price weakness. Brexit,

S&P 500 PROFIT MARGIN



*Time weighed average of the consensus estimates for the current year and next year. Monthly through December 2005, then weekly. Source: I/B/E/S data by Refinitiv

QuItaly, student debt levels, slowdown in China, trade wars, algorithmic trading, policy errors and inverted yield curves 'heralding' future recessions are just some. Few of these are new, but we take some more seriously than others. For example, we have some issues with those who insist that the inverted yield curve must be a forewarner of an impending recession (and an associated bear market). It is true that prior to the last six recessions the curve has inverted for 56 weeks, on average, before the downturns but

a closer look at the weekly spread between the 10-year US Treasury yield and the federal funds rate (the "official" version of the spread in the monthly Index of Leading Economic Indicators) shows that it has also inverted in the past prematurely, giving false alarms, for example during 1995 and 1998, well before the 2001 recession.

What is perhaps more interesting is why the yield curve has consistently inverted prior to recessions. Many believe that banks stop lending when the rates they pay on their deposits and borrowings exceed the rates they charge on the loans they make, so an inverted yield curve heralds a credit crunch, which inevitably causes a recession. This may have been the case in past periods, but as Eaton Vance's Andrew Szczurowski argues in a recent blog, what matters much more than the 2s-10s, or 2s-30s, or 2s-5s curve is what is happening to the curves at banks. In this cycle the rates US banks are charging for a mortgage are up 150 basis points from their lows and banks' margins are actually increasing as the Fed is hiking rates as they aren't paying their depositors much more today than they were over the past few years. Indeed, according to FDIC data available during the period during which the Fed has been normalising rates, net interest margins have increased from a recent low of 3.0% during Q1-2015 to 3.5% during Q3-2018. Moreover, the same FDIC data shows charge-offs having been relatively stable and provisions for loan losses matching those. So despite this year's flattening of the yield curve, there's little sign of a credit crunch at the US banks, which we view as reassuring.

EQUITY BULL MARKETS CAN BE PROLONGED IF INFLATION (AND INTEREST RATES) DON'T KILL THEM

While equities are in a down trend then history shows that country correlations tend to increase, meaning that trying to find a safe region to 'hide' tends not to be useful. Nor is it clear to us that a strategy of buying cheap stocks in companies just because the intrinsic value is high will work in anything other than the short term. 'Growth' stocks have certainly performed much better globally than 'value' stocks in recent years, not surprisingly since economic growth has been pedestrian in many regions. To argue that now is the time to buy into value names requires belief that accelerating economic growth and the accompanying pricing leverage is round the corner (value stocks in Japan have underperformed the market for the past nine years despite historically rock-bottom Price to NAV valuations). If our macro assumptions are too optimistic and growth slows (even if a recession is avoided) then it is unlikely that value stocks will perform well. Rather, we would prefer to invest in stable growth companies where debt levels are low and where business models remain valid in today's fast changing business environment. Finally, we think the current environment favours large cap stocks. Aside from being more expensive in many regions, small companies tend to have less access to cheap financing and are often more cyclically geared than their larger brethren, exhibiting higher volatility during periods of economic uncertainty.

Sector preferences globally have determined regional biases (if you have sought technology exposure then you've had to be in Asia or the US). They have also been a large driver of performance. For example, the best performing sector this year in the US (utilities) is up 6% whilst the worst (energy) is down 18%. Looking forward, despite investor anxiety around technology, we have little doubt that interest in tech companies and their products will persist. Advances in AI, blockchain and robotic are increasingly impacting the way firms in all sectors allocate capital, operate and innovate. Companies are adapting to all manner of opportunities to lower costs, shift production to lower cost regions (notable out of China and into Vietnam, India, Laos etc) and tap into either consumer of government demand driven industries such as driverless vehicles, renewable energy and media entertainment. Whilst the shares of such companies may have become hard to value and overpriced, these trends are not going to just fade away and investors may be able to buy into them at much more reasonable prices now. In short, we are not convinced that the reasons behind investor preference for growth stocks in recent years has disappeared. Once valuations are back in reasonable territory we think it will be a good strategy to own them.

Data sources: Edmond de Rothschild.

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TO BE HEDGED OR NOT, THAT IS THE QUESTION

Expensive US dollar hedging is proving problematic for many investors but exchange rate volatility still justifies adopting a high-conviction approach

We are focusing on less cyclical currencies to help stabilise portfolios during market turbulence

Gold could gain if the US dollar and interest rates stabilise against a persistently uncertain political and economic background

Investors with the euro or Swiss franc as their benchmark currency are facing a dilemma. Money and sovereign bond markets in these currencies offer negative yields over several years. Switzerland currently even has negative returns for maturities of over 10 years. In contrast, US interest rates have moved much higher following the Fed's decision almost two years ago to normalise policy.

The US yield curve may be flat, and even inverted, but short rates were above 2.5% at the time of writing. The six-month yield differential between the euro and the US dollar is around 3%, a significant carry cost which reflects the price of hedging for exchange rate fluctuations. For example, exposure to a US dollar-denominated asset yielding 2% translates into a loss of 1% after a year of hedging, all other things being equal. This is expensive and means hedged international investments are now looking less attractive. This is an important factor to take into consideration when building a strategic and tactical asset allocation.

Should we therefore no longer accept exchange rate risk in a portfolio? We are not that sure. With annual volatility running at around 8.5% for the EUR/USD, the estimated loss is much higher than the hedging cost. It has been estimated that with a 95% confidence indicator and a current exchange rate of 1.14, the euro could be trading between 0.95 and 1.33 against the US dollar at end 2019, a huge impact were such shifts to occur. On the other hand, reducing an allocation's exposure to foreign currencies and adopting a domestic bias instead also has its limits. Investors would in this case miss out on the benefits of international diversification, with expected yields not necessarily lower than on their domestic market. Accepting exposure to the US dollar thus amounts to a strong-conviction position given the risk factor. We must admit that our US dollar bias has been judicial as the currency gained close to 5% in 2018.

THE US DOLLAR IS KING

The main drivers for US dollar strength in 2018 were solid US growth compared to the rest of the world, higher benchmark rates, a rising yield gap, especially against Europe, and the currency's safe haven status. The King dollar moniker has never been more deserved. In 2019, assuming that the Fed presses on with its interest rate hikes and that today's uncertain environment persists, it is more than likely that the dollar will remain in demand. Europe's political situation, the potential for fresh trade tensions and the impact of tariffs on global trade are all factors that will tend to reinforce the dollar's safe haven appeal and its positive returns. The lack of any viable alternative is another point in its favour.
That said, we are struggling to defend the case for significant dollar appreciation. With the Fed turning more cautious and our belief that US

growth will taper, we find it harder to argue for interest rates to rise more than expected. As a result, a widening interest rate differential is less likely, even if we see no rate hike from the ECB in 2019. At the same time, the current US administration's spendthrift policy, and looming talks with a divided Congress on the debt ceiling, could encourage markets to focus more on the twin deficits, a development that would make the weak dollar scenario more credible. Note also that the market is geared towards more US dollar appreciation, so much so that any rapid reversal of these speculative positions could trigger violent shifts. This is arguably the foremost risk as a change in the Fed's tone might make speculators drastically review positions. It is even astonishing that the Fed's more accommodating stance in December, along with lower bond yields on markets, has not weakened the dollar. No doubt this is because of its safe haven status in volatile markets. Clearly, only a big event could topple King dollar.

THE EURO COULD REMAIN UNLOVED

We have some difficulty finding arguments in favour of the euro rebounding to the top of the bracket mentioned above. The European Union could be the big loser if the trade war worsens, France is beset with social unrest, and populism is on the rise so the euro could remain unloved at least until the May 2019 European elections. Recent economic trends and political uncertainty have maintained the risk premium and could limit any appreciation. That said, the Swiss franc is one European currency that could stand its ground in a diversified portfolio. Its safe haven status could well be in demand given prevailing risks. Financial markets are psychologically in a bear market, or at least highly sensitive to bad news, so the Swiss franc could still appeal to investors even if this would annoy the Swiss National Bank which is keen to get the franc lower to help exports.

Elsewhere in Europe, sterling will be worth watching in the first quarter of 2019. The exit from the EU will necessarily influence the pound whether it is a hard, consensual, negotiated or cancelled Brexit, or even a fresh referendum under the current government or a new administration. Every possible solution seems to have been explored but the Brexit denouement now looks more uncertain than ever. Suggesting a scenario looks more like a bet than a strategy to us as any impact on sterling has never seemed so black or white. As the doubling in the USD/GBP pair's implicit volatility in 2018 shows, this is a high-risk game. We prefer to avoid taking positions as that would be indulging in pure speculation and certainly not a case of strong-conviction choices.

RECENT ECONOMIC TRENDS AND POLITICAL UNCERTAINTY HAVE MAINTAINED THE EURO'S RISK PREMIUM AND COULD LIMIT ANY APPRECIATION

Eventually, gold as a currency and commodity proved resilient towards the end of 2018. Despite higher real rates and the strong dollar, the gold ounce rose from its August low of $1,180 to close to $1,250 near the end of December. Speculative positions on gold futures also moved into positive territory, a reflection of more upbeat market sentiment. And we can hope for more upside given the levels reached in 2017. With today's trade war, and mindful of the fact that currencies logically are the first to adjust to higher customs tariffs, it is possible that central banks like China's might wish to review their diversification policy and increase gold holdings. If the dollar and interest rates also stabilise, then a rise in gold is more probable.

To sum up, we believe that exposing a portfolio to foreign currencies has to be a strong-conviction decision, even if hedging is expensive. Although the dollar has risen significantly in 2018, we fail to see why it should make further strong gains. Nor do we expect it to weaken, at least not over the short term, due to its safe haven status and the lack of a viable alternative with adequate yields. Given today's economic and political uncertainty, we consider that it makes sense to be exposed to non-cyclical and safe haven currencies so as to manage risk and make portfolios more resilient to market stress.

Data sources: Edmond de Rothschild.

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