NATIXIS INVESTMENT MANAGERS

MANAGER POINT OF VIEW

# The View From Lugano in 2019

**Political risk came to dominate the headlines in 2018. It's a feature that seems unlikely to change in 2019. Whether you look at the ongoing trade war between the US and China, tensions in Europe around the automobile sector or the impact of Brexit, markets continue to spike and volatility is only likely to increase in the months ahead. Navigating this environment calls for the construction of flexible, diversified portfolios.**

**Matthieu Genessay**, Partner – Client Portfolio Manager at H2O Asset Management, gives his thoughts on what 2019 might have in store for investors and why several new strategies – and geographies – will make it an interesting year for H2O.

H2O Asset Management

**Matthieu Genessay**
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## With market sentiment continuing to be hit by growth, the actions of the US Federal Reserve, trade and political fears, what's your view of the global macro-economic picture in 2019?

The consensus view for 2019 is that the Fed will be very quiet and emerging markets will attract a lot of inflows. We tend to disagree with the consensus because, for example, even if the Fed doesn't hike as much as last year, the impact of one hike in 2019 will be very different to one hike in 2016.

You might see a more dovish Fed in 2019 – both in its tone and in its willingness to hike interest rates – but the market is going to struggle to digest the oversupply of treasuries. Foreign demand is already decreasing due to the cost of US dollar hedging, so there is a mismatch between supply and demand. Market liquidity disappeared last year because the Fed was cutting the balance sheet, but this year the net issuances of treasuries are skyrocketing to finance the deficit and Trump's programme.

It's a big difference too: in 2017, you had $700 billion of net issuances of treasuries; in 2019, it's going to be $1 trillion. And if you look at the global bond picture in the US, including credit from corporates, the net increase jumps from $1 trillion to $2 trillion. So, we feel that with even just one Fed hike this year, the impact on 10-year US yields can be much bigger than the reaction in 2018.

## How does your view translate across European and emerging markets?

The big macro surprise for 2019 will not be the Fed's policy but the collapse in global manufacturing and international trade, with more divergence between G3 and non-G3 countries.

Europe is following the US with a three-year lag and, unlike emerging markets, it is not desynchronised. Therefore, we expect European assets to outperform emerging markets. In fact, in this regard it could be similar to the scenario in 2017, where we saw a rebound in European assets.

Following a strong year of foreign outflows, European assets could outperform based simply on the lack of no new negative news. So, we remain positive on Europe. It's a market that is not as correlated as emerging markets to the Fed policy or other fixed income pockets.

Regarding emerging markets, we are maintaining a very limited exposure on credit, which is almost flat, and we're selling currencies, especially in Asia. In fact, we'd fear a Chinese recession in early 2019 rather than a US slowdown in late 2019. And whether the US and EMU [economic and monetary union] stay strong or China slows further, or both, the result is further divergence – which would make 2019 the continuation of 2018, rather than a return to 2017.

> *"After the volatility seen in 2018, particularly in Q4, many investors will be questioning their asset allocation and considering changing everything. But if you keep rebalancing your views every time you think the Fed is going to hike, you're likely to misjudge it and potentially miss out on the higher returns in the lead up to the market peak."*

### So, what's your key message for clients in terms of asset allocation?

In essence, you need to stick to your portfolio construction and avoid having macro calls that are too strong.

After the volatility seen in 2018, particularly in Q4, many investors will be questioning their asset allocation and considering changing everything. But if you keep rebalancing your views every time you think the Fed is going to hike, you're likely to misjudge it and potentially miss out on the higher returns in the lead up to the market peak.

We want to cover scenarios like 2017 and 2018, which are the complete opposite. In 2017, it was a very good environment for fixed income, so markets bought everything. In 2018, it was the opposite. We did perform on both occasions because we had very active currency management and maintained protection on the Fed.

And that's something we want to continue this year. So, the message is not to deviate too much from your long-term views, especially after a very volatile year where you feel that it's time to change everything. You need to avoid doing that.

### At the end of 2018, H2O announced the soft closing of its popular 'musicians range' of funds, including Adagio, Allegro and Moderato. This followed a similar move earlier in the year, following huge levels of inflows into your global macro range. What has been the overall reaction from clients?

It's always a really difficult decision. All asset managers have capacity limits, even though when you are getting closer to your capacity limits, you always feel there is a bit more capacity, so you never really react. We wanted to make sure our clients were aligned with our message from an early stage, so we wanted to do it as early as possible.

For some clients, I think it was possibly a bit too early in the cycle. But we really wanted to avoid having strong inflows at the start of the year, when you typically tend to have a lot of reallocation. The feedback we've had is that clients really appreciated this. They know that the way we manage portfolios today is exactly the way we were managing portfolios in 2010. And we've managed to do that with the same investment team, process, philosophy and risk target for each fund. So, our business model hasn't changed. We still have a low correlation to asset classes with very active management of the sizing of the positions across different asset classes.

Our philosophy regarding capacity is to slow inflows rather than stop them completely. Otherwise, just as if you were to stop cycling, you fall. Since the start of the year, we've implemented entry fees on institutional share classes and new retail share classes, and we've been actively promoting our new strategies.

### Likewise, how have clients and contacts taken to the announcement in December 2018 of H2O setting up a wholly-owned subsidiary in Singapore, with a view to position it as H2O's investment hub in Asia?

The feedback has been really positive. The Singapore-based entity is the firm's first office in Asia and the intention is to expand H2O services and capabilities to better service our clients, especially for those who are based in the Asia-Pacific region.

We've hired two senior portfolio managers and one client portfolio manager to get stronger insights on Asian investments and a better understanding of local intricacies, as well as to enlarge our expertise on global fixed income benchmarked and absolute return funds. The Singapore office provides H2O with the opportunity to enhance local investment capabilities in the region and to capture a rapidly expanding, and increasingly important, market.

### For you, why are liquid alternatives a particularly attractive option for investors in 2019?

Well, you have to be careful with this term 'liquid alternatives' because it can apply to a lot of strategies. The terminology has been used by many products in order to capture market shares on a trend that has been accelerating since 2016.

The way to monitor that is to differentiate the investment style with the investment strategy and universe. Liquid alternative strategies are active products relying on portfolio construction with both long and short strategies being embedded in the investment process. For instance, some alternative products are highly correlated to global bond benchmarks with a high duration risk, which started underperforming last year when credit spreads widened.

Our team has been managing liquid alternative investments since 1994 – even prior to the creation of H2O Asset Management. The short side of the portfolio has always been very active through bond futures and foreign exchange. So, it isn't anything new. And the best way to measure it is the correlation of our products with traditional fixed income benchmarks, which is slightly negative since inception.

Therefore, our message is that, if you want to move into liquid alternatives, be very careful on the quantitative side of it by analysing correlations and Sharpe ratios over a medium-term investment horizon.

Finally, it's not enough to only look at the good years and past track records. You need to look at specific events, like where credit spreads have widened. Ask whether these liquid alternative products do what they are supposed to do. Can they really be totally independent from the trajectory of yields?

### That sounds like a very positive message for investors?

Yes, and I think it should be. We are fully invested for 2019. There are lots of opportunities for alpha because you have dispersion within asset classes and different behaviours from central banks. So, it's an opportunity to look at the world on a related value basis.
Indeed, we believe that the market is starting the year overly pessimistic. Last year's volatility is simply preventing investors from investing. That's why we're poised to start buying back some risk.

For the first time in three years, we're seeing some beta opportunities. So, for our funds exposed to equities, one of the changes for the beginning of the year is to slightly increase the beta from zero or slightly negative to slightly positive.

*This interview took place in January 2019*

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