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Take Profits Or Run The Risk Of A Correction: The Active Manager's Dilemma

After a booming first half of the year, the second half is bound to become challenging for active managers. Stock markets have put in solid performances since January, fighting off successive calls for caution in the wake of the sharp downturn in the last quarter of 2018. While the turnaround in central banks' tone since the beginning of the year has proved to be the main factor in boosting equity prices and dampening volatility, it now looks highly unlikely that this will be enough to maintain equities' rebound in the longer term.

The impressive V-shaped movement that we have witnessed in recent months has singularly complicated strategists' and portfolio managers' work. With market developments punctuated by announcements, market timing in particular is proving to be quite tricky. This means that those professionals who opted to reduce their risk levels at a time when the markets crystallised all fears—without having later increased their exposure to equities—had, in the end, to resolve simply to take a place on the sidelines during the first half of the year. On top of this, inflows into equity funds have barely been in positive territory so far in 2019, meaning that strategists' traditional market timing techniques have failed.

At first sight, those who managed to exploit the strong rebound in the markets find themselves in a much more enviable position. Today, they are facing the thorny issue of whether or not to take profits. Too early and they will be criticised by their clients, who have already been frustrated by their portfolios' poor performances in 2018. The decision of whether or not to take profits is even tougher to take, as the markets' rebound happened very quickly in the first half of the year and we still have six months to go.

Equities' 20% rise since the beginning of the year cannot be looked at without taking into consideration the 15% correction that preceded it. Factoring in the V-shaped movement shows that performances are substantially more modest over one year, which is in line with the sluggishness of company earnings, and even with their contracting trend that began in the last few months. Now that the rebound has boosted equity prices, the markets seem to be quite close to their fair price, with valuations in line with their historic averages. The potential for any further improvement is therefore looking limited given the persistent threats that caused the fall of the major indices in the last quarter of 2018; for example, the desynchronization of global growth in the wake of the US–China trade war and the turmoil in various political spheres.

It is to these weaknesses that the markets owe the central banks' sudden and abrupt shift in policy, which occurred with next to no warning from their previously stated intent to normalise their policies and make them much more cautious, opening the way for interest rate cuts and a return to monetary activism. Central bankers seem to want to equip themselves with every possible means of stimulating their economies should the need arise. 2019 could start to resemble a transition period—a mini-cycle, during which activity will certainly contract but not quite tip over into recession. By acting in sync with each other, central banks are attempting to prepare their economies to weather this economic slowdown as best they can.

The real question here is to know if they will succeed in achieving this or, to put it another way, whether or not the redeployment of an unconventional arsenal will have as much of a positive impact as when quantitative easing was in full swing (i.e. in 2008 for the US and from 2015 for the eurozone).

This was the gamble that the markets took when they shot up in Q1. It was a bold bet: in recent years, firms have used weak interest rates to take on massive—indeed, historically high—amounts of debt, using this leverage on their balance sheets in an effort to improve their profitability.

With leverage already having been maxed out, the previous dynamic today looks almost impossible to recreate, and the most indebted economic sectors now have limited potential to contribute to any stimulus package.

The power and speed of the US Federal Reserve's shift in direction are in step with what is at stake: avoiding a recession at any cost. While its own room for manoeuvre (which has been built back up since 2015) is significant, firms find themselves in a much tighter corner.

For the recovery of the last six months to transform 2019 into an exceptional year, stock markets must—without fail—be given good news, otherwise, the risk of a potentially severe correction cannot be ruled out.

In the midst of such an uncertain market configuration, traditional allocation processes look as if they have been stretched to their limits. The best strategy probably consists of keeping one foot in risk assets in case the markets provide some nice surprises, while at the same time protecting portfolio performances. Sound asset management is the order of the day, which translates into more complex asset management strategies and models that make use of derivatives.

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