FUNDS NEWS DECEMBER 9, 2018 / 7:03 AM / 2 MONTHS AGO

RPT-Wall St Week Ahead-Licking their wounds, fund managers prep for rally in '19

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(Repeats item initially transmitted on Friday, Dec. 7)

By David Randall

NEW YORK, Dec 9 (Reuters) - With bond and equity markets from the United States to emerging markets all on pace to lose money this year, investors have not seen this much red on their screens since 1972, the last time no asset class returned at least 5 percent.

Yet fund managers are finding things to like despite the recent market volatility, which sent the Dow Jones Industrial Average down more than 2 percent this week.

As they start to position their portfolios for 2019, fund managers, from firms including ValueWorks, Sierra Investment Management and Federated Investors, say they are looking at sectors that could snap back next year thanks to a combination of more attractive valuations and a decline in the dollar.

Such a rally in both fixed income and equities markets would not be unprecedented. A 20 percent decline in the value of the dollar pushed the S&P 500 up nearly 38 percent in 1995, while the U.S. bond market returned nearly 17 percent the same year following one of the worst fixed-income bear markets in memory.

“If you look out at the broader picture, a lot of things are going right,” said Terri Spath, chief investment officer at Sierra Investment Management, citing strong consumer confidence and other economic indicators. “It’s easy to make a bull case because the economy is humming along just fine, but the market is nervous because the headlines are really loud and no one likes the unknown," she said.

Part of the yield curve inverted this week when yields on 5- year Treasuries dropped below those on both the 2- and 3-year securities, a signal that has preceded every U.S. recession in recent memory by between 15 months and 2 years. Yet the long delay between a yield curve inversion and a full recession can still be a profitable time to invest, said Charles Lemonides, founder of New York-based hedge fund ValueWorks.

"I don't buy the thesis that the economy is slowing, but I do believe we are late in the cycle. We're going into a period where investors are getting a little fooled by the headlines and avoiding names that have excitement," he said.

As a result, Lemonides has increased his long exposure to companies that have sold off, including battered semiconductor maker Micron Technology Inc, whose shares are down 37 percent over the last six months, and iPhone maker Apple Inc , whose shares are down nearly 23 percent over the last 3 months. At the same time, Lemonides has increased his short position on defensive stocks like consumer staples companies Clorox Co and Church & Dwight Co Inc, which have benefited from the market volatility.

Chad Oviatt, director of investment management at Huntington National Bank, said his firm has been increasing its allocation to U.S. large-cap stocks in anticipation that declining bond buying by the European Central Bank and a resolution of U.S.-China trade tensions will derail the rally in the dollar this year. That should improve margins for U.S. exporters.

A Reuters poll of 60 currency analysts that ended Dec. 5 forecast that the dollar will be weaker against major currencies next year, with most of the declines coming in the second half of 2019.

Battling Apple proves profitable for Spotify

Linda Bakhshian, a portfolio manager of several value-oriented funds at Federated, said the recent stock market volatility has made stocks, including Apple, JPMorgan Chase & Co , Walmart Inc and Microsoft Corp more attractive at a time when the U.S. economy continues to look stronger than either Europe's or China's. Low oil prices, continued job growth and strong consumer spending will likely prolong the U.S. economic expansion well past next year, she said.

"If the markets were to close for the year today, people would go into 2019 thinking that there are more opportunities given the valuations," she said. (Reporting by David Randall; editing by Jennifer Ablan and Dan Grebler)