ANALYSIS & STRATEGY

MONTHLY NEWSLETTER

No. 198
FEBRUARY 2019

Sent to press on 08/02/2019

ALL THANKS TO THE FED...

After one of the worst Decembers on the financial markets for more than 10 years, we had one of the best Januarys: +7.87% for the S&P 500, after -9.18% in December, and +15.04% for the barrel price of oil, after -8.36% in December, with similar performances for most risk assets.

The Fed's change in tone played a major role in this turnaround in market sentiment, as was also the case in September and December. With a bit of hindsight, some thought the Fed had extinguished the fire it lit in September when it said it wanted to go "further than getting rates to neutral".

All the same, the extremely accommodative message from Jerome Powell and every Fed representative, particularly with regard to balance sheet reduction, played a large part in reassuring the markets. As such, the markets can now go about their business in the knowledge that interest rates will not rise before the end of June, at the earliest.

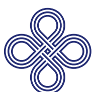
Another factor that probably contributed to the performance of the markets in January was their "overreaction" in the fourth quarter of 2018, and particularly at the year end, in markets that had become less liquid. Did the impact of systematic strategies amplify the market movements? Was it a capitulation on the part of institutional and private investors after a historically long bull market in US equities? Whatever the reason(s), the indicators that we follow show that all flows into non-risk assets ("core" government bonds, money market instruments) were at historically very high levels at the end of the year, which partly explains the rebound in January.

Moreover, other more fundamental factors have enabled this rebound to continue.

Corporate earnings releases, which are well on track in the United States, have been reassuring, at around 70% above analysts' forecasts, which is close to the historical average. This figure should be seen in context given the substantial downgrades that had been made to forecasts, but is nonetheless reassuring overall, assuaging the fears of a collapse in earnings expressed in certain quarters.

Similarly, the latest US activity indicators have helped to reassure investors of the low probability of a recession in the short term.

Now that the markets seem to have corrected their excesses, what attitude should we take? As things stand, it still looks like a good time to be investing in emerging markets. The risk premia remain high, investors have been keeping their distance, and the risk of a spike in the dollar seems fairly low in light of the Fed's recent statements. Elsewhere, we retain our positive view on Portugal and Spain, and on US inflation expectations.



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FIXED INCOME

THE FED PAUSES, THE ECB WAITS AND SEES

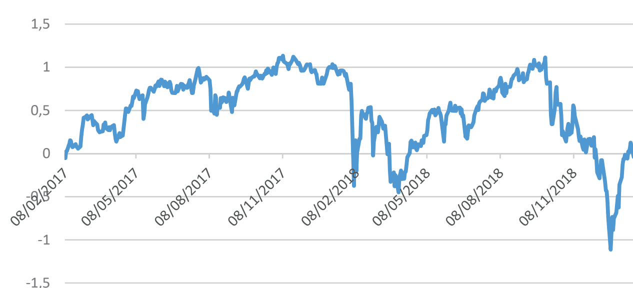
At the start of this year, the Fed gave significant support to risk assets, which, in most cases, clawed back the November and December losses. Moreover, in a speech in early January, and again at the latest FOMC meeting, Jerome Powell said that the Fed would be flexible on balance sheet reduction, which is currently taking place at a pace of USD 50 billion per month. The Fed has changed its tone from that employed in previous FOMC meetings due to uncertainty, and despite a slight tightening in financial conditions at the end of January. In its 30 January statement, the monetary policy committee described US economic activity as "solid" (and no longer as "strong"). It also said that it would be "patient" in determining its future monetary policy adjustments. An unexpected short-term pause in the inflation index monitored by the Fed (Core PCE) suggests there will be fresh monetary tightening later in the year.

The ECB Governing Council has decided to wait for the new economic forecasts in March before passing judgement on the persistence of the economic uncertainty weighing on eurozone activity, which now looks to be on a downward trend.

In this environment, which shows how difficult it is for the central banks to move on from their ultra-accommodative monetary policies, investors' search for yield is still a live issue. Emerging asset classes, high yield credit, subordinated bank debt and long-maturity peripheral debt are among the most popular sources.

However, the search for yield is hampered by a number of risks, chief among which are the economic slowdown and political risks in the eurozone, along with the publication on 17 February of the US government's recommendations for a wide-ranging trade agreement covering the automotive and agricultural sectors and a standardised treatment for incoming investment... Watch this space!

US Financial Conditions Index
(Source: Bloomberg)



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EQUITY MARKETS

ON THE RISE IN A HOSTILE ENVIRONMENT

Equities have rebounded strongly after a traumatic end to the year. From the 24 December 2018 low, the US market (S&P 500) jumped almost 17%, while the European (Stoxx 600 and Euro Stoxx 300) and emerging markets rose by around 9%. The S&P 500 was just 7% off its last September peak (2930.75).

And yet, the markets rose against an unfavourable, even hostile backdrop, lending weight to the theory that the 4Q 2018 correction was excessive. Moreover, and aside from Apple's profit warning (-9.7% on 3/1), conditions remain tough:

i) the global economy is slowing, not only in Europe, but in the United States as well (although the US government shutdown has limited the production of statistics, this trend is reflected in the most recently published leading indicators)

ii) corporate earnings forecasts have been revised down, with expectations roughly halved from +10% to +5% for 2019 for all developed markets

iii) political risks continue to threaten global economic activity and trade, with Brexit, political upheavals in the EU ahead of the May elections and US-China trade negotiations all in play

S&P at
7%
from its
2018 high

As with the acceleration of the downturn, the market rebound - at least from a technical standpoint - came about after the Fed softened its tone, with Chairman Jerome Powell giving a speech on 4 January in which he underlined that inflation was low and that the Fed was prepared to adjust its monetary policy "quickly and flexibly". It is also worth noting that the pressure from political tensions was largely reflected by the fall in market prices and that the Chinese and US governments have entered a more "constructive"phase of negotiations.

Taking a closer look at the changes in Europe at the start of this year, we see that: commodities and oil recovered after the sharp falls at end-2018; lower interest rates are helping sectors such as real estate (+10.7%); cyclical sectors, such as commodities (+12.4%), automotive (+11.6%) and industrials (+7.7%), have bounced back; and retail (+11.3%) is doing well after its December fall (-8%), with a reassuring level of post-Christmas sales. On the other hand, defensive stocks underperformed and telecoms were down 2.4% after outperforming strongly in the previous three months.

The extent of January's rebound, which took many investors by surprise, will not set a trend for the coming months. We see no particular trend emerging on the markets, which are likely to remain volatile all year. The 2018 annual results season has begun, and while performances have naturally been mixed, there has been less of a knee-jerk reaction than we saw at the end of last year, which shows that the markets were overly pessimistic then, and may even have panicked.

In these volatile markets and with economies slowing, we continue to favour growth stocks around the tech, digital and consumer goods sectors, and long-term trends related to the transformation of economies towards electrification, energy intensity reduction and carbon emission mitigation. At the same time, we are limiting exposure to equities following this upturn, as the markets may be unable to maintain this momentum and run out of steam.

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THE MONTHS PASS, BUT...

January 2019 ended with a major rebound for all risk assets, practically erasing December's correction: the main catalysts were the reopening of US-China negotiations, a temporary solution for the shutdown, the much softer tone from central bankers and 4Q 2018 corporate earnings. The S&P rose by 7.87%, the CAC 40 went up 5.54%, the Nikkei put on 6.2%, and one of the emerging indices jumped 8.8%.

In the UK, after an initial rejection by Parliament, Theresa May was given more time to renegotiate the Irish backstop.

In China, with the economy slowing, the authorities announced new measures to stimulate domestic consumption.

On the microeconomic side, Q4 2018 company results in the US and Europe have so far come out above consensus (60% and 63% of firms published above-forecast revenue respectively).

On the government bond markets, the 10-year Bund fell by 9 bp to 0.15%. Portuguese, Spanish and Italian 10-year yields fell, by 24 bp to 1.48%, 21 bp to 1.20% and 13 bp to 2.49% respectively. The ECB's Governing Council has not provided any further detail on how it will conduct monetary policy going forward. It has kept its benchmark rate at 0% and the deposit rate at -0.40%. The yield on the 10-year US Treasury also fell, to 2.63% (-5 bp). As expected, the Fed left its rates on hold, and has changed its message in light of the current uncertainty.

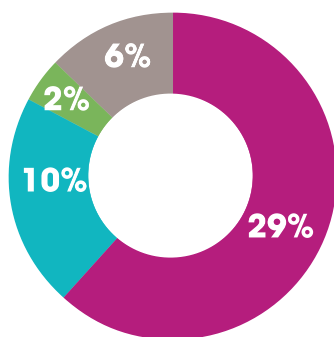
On the oil market, benchmark WTI and Brent barrel prices went up 18% and 15% respectively, to $53.81 and $60.98.

On the credit side, yield spreads between investment grade and high yield indices tightened during the period, by 9 bp and 57 bp respectively, to 1.14% and 4.16%. In the United States, high yield credit spreads tightened by 96 bp over the month, to 437 bp.

In forex, the dollar weakened against all developed and emerging country currencies. The euro-dollar cross closed at 1.1472 on 31 January. Meanwhile, the yuan rose 2.66% against the dollar over the month.

On the emerging markets, the JP Morgan Global Diversified Sovereign Index tightened by 57 bp over the month, to 358 bp.

As we move into February, we have mixed feelings, with the markets much calmer, but many background issues unresolved. We took advantage of the rebound to slightly reduce our equity exposure to 47%, while also making a minor addition to our position on Japan. In fixed income, after the rally continued, we are maintaining our low duration exposure. We remain diversified across emerging market debt, high yield bonds and subordinated financials. We have maintained our diversification in US inflation-linked bonds.



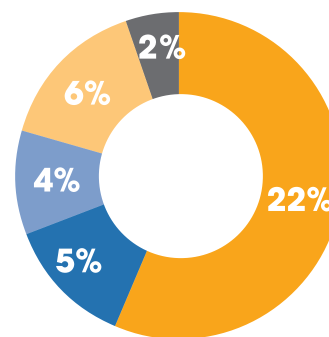
EQUITY EXPOSURE: 47%

UNITED STATES
We have taken some profits on US equities.

EUROPE
We are reducing European equities.

JAPAN
We returned to Japanese equities after their relative underperformance.

EMERGING MARKETS
We continued to gradually strengthen our positioning.



FIXED INCOME EXPOSURE: 39%

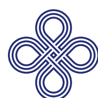
DEVELOPED GOVERNMENT BONDS
We slightly strengthened our position to balance global risk.

INFLATION-LINKED BONDS
We have reduced our bet on inflation-linked bonds, focusing on the US market.

FINANCIAL/SUBORDINATED DEBT
The position is unchanged.

EMERGING MARKET DEBT
We are maintaining our position.

HIGH YIELD CREDIT
We have added to our position / our overall reduction in equities.



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Published by La Française, a French limited company (société anonyme) with management and supervisory boards and share capital of €78,836,320 - Paris Trade and Companies Register No. 480 871 490
Editor in Chief:
Laurent Jacquier Laforge and Jean-Luc Hivert
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Caroline Babouillard
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Graphic design: Wanda Le Sauze

XX2105 - February 2019

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