ANALYSIS & STRATEGY

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AT LAST, SOME GOOD NEWS: 2018 IS BEHIND US...

A disastrous December brought to an end a year to forget for the financial markets: the S&P 500 was down 9.18%, its worst month since February 2009, oil lost 10%, the US 10-year bond yield narrowed by 30 basis points, and we could go on.

Last month, we said that the emerging markets could rally, and while they duly outperformed other regions (-2.9% for the MSCI EM, a positive performance for emerging bonds in strong currencies, a rise in EM currencies), they were nonetheless not immune.

The unpropitious climate prevailing over the previous few months is still in place, but have the underlying factors remained the same? We would say they have, for the most part, but whereas political tensions dominated a few weeks ago (US-China, Brexit, Italy, etc.), concerns have mainly shifted towards fundamentals.

The main question now seems to be: what will be the growth story in 2019? And in particular, how will US growth fare, after a record year in 2018?

Investors have three main concerns:

- *"The positive impact of President Trump's fiscal stimulus is coming to an end, and US growth is likely to stall without it"*. We only partially subscribe to this view, since by our estimates, the fiscal impact boosted growth by 0.7% in 2018 and should add 0.3% in 2019 (tax cuts until April 2019 and a $36 billion increase in federal spending over the year).
- *"The flattening of the US yield curve indicates a recession is on the way"*. We do not share the market's fears on this, as the yield curve can remain flat for an extended period without causing any problems. In our view, the difference between the return on capital and the cost of capital is more relevant, and this indicator is not highlighting any short-term risks.
- *"The Fed made a monetary policy misstep in raising interest rates when the financial conditions are tightening"*. Of course, the Fed could have paused its rate hike programme in light of the market correction, but it would have had to prepare the markets first. And it would have also needed Mr Trump to refrain from commenting on monetary policy. From our standpoint, the misstep came in Jerome Powell's statement in October, when he said that the Fed may go further than getting rates to neutral.

Overall, we are not particularly worried about the global or US economy in 2019. A slowdown is highly likely, but not a collapse. The oil price slide over the last three months should have a positive impact on consumption figures by mid-2019.

A number of political risks are continuing to affect the markets: firstly, Brexit, with the House of Commons' vote in the week beginning 14 January, and the US-China trade negotiations. However, we don't expect a "hard Brexit", and we note a more constructive tone in the US-China trade talks.

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FIXED INCOME

BOND MARKET PERFORMANCE IN 2018: AGAINST ALL CONSENSUS RULES (AND NOT FOR THE FIRST TIME)

90%
of asset classes
turned in negative performances
in USD

In the end, things could have been a lot worse for government bonds. Against a backdrop of improving growth at the start of 2018, many forecasters (including us) were expecting a bad year for this asset class. But this was not the case.

Overall, sovereign bonds posted positive performances in 2018. The US index returned +0.8% in USD (BoA ML); a paradox given the significant improvement in the economy and the Fed proceeding with four rate hikes as expected. In Europe, despite the deteriorating growth indicators after the fourth-quarter 2017 peak, the end of the ECB's quantitative easing programme would suggest that rate normalisation is coming. Nonetheless, the segment returned +1% in EUR (BoA ML index) over the year. So why was everyone caught on the hop?

The move into government bonds could simply be interpreted as a flight to safety in a climate of mistrust of risky assets, given the sources of tension accumulating (Trump, Brexit, US-China trade tensions, oil, etc.). However, a closer reading shows that the fall in monetary expectations was the main factor influencing yields over the period.

Hampered by a considerable increase in supply, oil prices plummeted. This movement had a major impact on the inflation numbers, sending inflation expectations tumbling.

Within the eurozone itself, the picture is pretty clear, with the significant underperformance of Italy over the period (-1.4%) the main factor; and it has to be said that the market rarely rewards the worst performers. The comparison with Spain (+2.6%) and Portugal (+3.1%) is stark. Also catching the eye was the performance of the eurozone's core countries, led by Germany (+2.3%), which benefited from their safe haven status: the yield on the 10Y Bund was 0.23% at the end of the year.

In short, the bond market swung like a pendulum in 2018, from one extreme to another. After a fleeting economic upturn, the market is now anticipating a sharp slowdown. We will probably see something in between. Our bet as we enter the new year is that the bond market will be relatively calm and asset valuations will reconnect with fundamentals.

EQUITY MARKETS

2019 IS PICKING UP WHERE 2018 LEFT OFF

While in 2018 the emerging markets were the precursors of the downturn, they were closely followed by the European indices, and then by a major correction on the US market (-24% between 3 October and 24 December). At the start of a new stock market year, the key issue is to work out if the bottom is close. The rebounds on 26 December (NASDAQ +6.16% and S&P +4.6%) and 4 January are indicative of both the excessive nature of the correction and the risk of adopting an excessively defensive stance.
Despite the impact of algorithms and equity market "momentum traders" amplifying movements beyond what the fundamentals would suggest, what pointers can help us evaluate the situation?

Global economic growth is forecast at around 3.5% and is slowing (unlike the start of 2018, when it was accelerating). While global growth has barely moved, in Europe it has declined significantly. The plunge in the manufacturing ISM in the first week of January (its biggest drop since October 2008) confirmed the slowdown in the US economy for 2019 and revived expectations of a global downturn at the end of a long cycle of growth projected for 2020. This slowdown should reduce US growth to around 2%, which is not a recession.

Stoxx600	-18.2%
S&P 500	-19.8%

High point, low point in 2018

Deteriorating prospects for growth and the markets brought down **long rates** (fall in the 10Y and 30Y). However, **the relationship between interest rates and equities has become stretched during this long period with rates at close to zero.** This decorrelation was accentuated in January 2018, when the US Treasury-financed corporate tax cut led to a fiscal premium being priced into long-dated government bonds. This did not prevent a fresh wave of market falls when the Fed hiked interest rates at its December meeting. The Fed has embarked on a phase of "quantitative tightening". It should remain pragmatic, but in this environment, we cannot expect to see growth in equity market multiples.

Corporate earnings have been revised down. While the consensus earnings forecasts that we use show growth of around 10% for 2019 in both the US and Europe, we project 2019 earnings growth at 4-5%, based on the assumption of a slowdown.

Lastly, **flows remain stubbornly negative** at the start of 2019, with the surge of outflows from equities continuing and no signs of a move into risky assets. The increase in the proportion of cash being held is a clear indication of risk aversion.

In these extremely volatile markets, many movements appear irrational, or at the very least, excessive. 2018 clearly showed us that geopolitical developments affect the economic outlook on which we base our decisions. Slowing, but positive, economic growth, along with the third consecutive year of corporate earnings growth, should support positive a market performance in 2019 following the excessive correction of 2018. Nonetheless, the combination of these positive fundamentals and the major unresolved political issues will keep **volatility high, with no particular trend emerging on the markets.** We are taking a cautious approach to exposure and risk management, while maintaining a selection of securities based on growth and quality, which should enable us to take advantage of the opportunities presented by the fourth-quarter falls. It is hard to see a trend reversal in the short term, although the general pessimism will undoubtedly provide some repositioning opportunities.

CONCERNS OVER 2019 GROWTH

The final month of 2018 saw concerns over growth impact risky asset classes: the MSCI World AC index fell by 7.2%, its worst December since 1988. Over the year, this index lost 11.2%, the worst performance since 2008. For once, US stocks took the biggest hit (especially energy and tech stocks), with the S&P 500 down 9.2%.

The fall in the oil price, the difficulty in getting the Brexit agreement across the line and the US government shutdown also had an impact

On the central bank front, the **ECB** kept its main interest rate at 0%, and its deposit rate at -0.40%. The **Fed** hiked rates for the fourth time in 2018, taking its key interest rate to a range of 2.25% to 2.50%. It now expects to raise rates twice, rather than three times, in 2019.

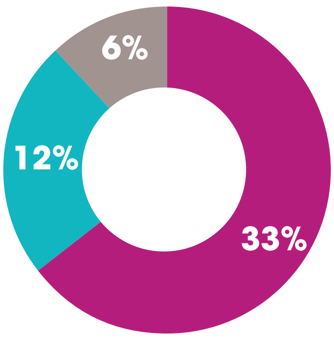
On the government bond market, US yields fell (10Y: 2.68%; -30 bp), dragging down their European counterparts (10Y Bund -7 bp to 0.24%), despite the improvement in the situation in Italy (agreement on the 2019 draft budget). Italy's 10-year bond yield ended the year at 2.74% (-47 bp over the month).

On the credit market, yields on investment grade and high yield bonds tightened to 1.28% and 4.24% respectively in Europe.

On the forex markets, the yen, a safe haven currency, rose against all other currencies. The EUR/USD cross increased by 1.3% to 1.1467.

On the emerging markets, the JP Morgan Global Diversified Sovereign Index widened by 20 bp over the month, to 415 bp.

In this early part of the year, we feel the market may be entering a lull. For this reason, we are maintaining our equity market exposure at 50%, with a majority position on the US market and some additions in emerging markets. In fixed income, after December's rally, we are maintaining our low duration exposure. We remain diversified across inflation-linked bonds, emerging market debt and subordinated financials.



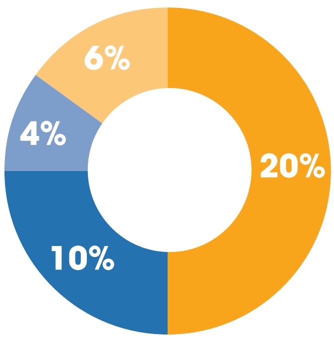
EQUITY EXPOSURE: 51%

UNITED STATES
We are maintaining a large position in US equities.

EUROPE
We are leaving our European equity positions broadly unchanged.

JAPAN
We are closing out our residual position.

EMERGING MARKETS
We are gradually adding to our position.



FIXED INCOME EXPOSURE: 40%

DEVELOPED GOVERNMENT BONDS
We are maintaining our position to balance global risk.

INFLATION-LINKED BONDS
We are sticking with inflation-linked bonds and refocusing on the US market.

FINANCIAL/SUBORDINATED DEBT
The position is unchanged.

EMERGING MARKET DEBT
We are increasing our investment in this asset class to 6%.

HIGH YIELD CREDIT
We are closing out our position in order to increase our EM position.

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