ANALYSIS & STRATEGY

MONTHLY NEWSLETTER

NO. 188

MARCH 2018

Sent to press on 08/03/2018

THE RETURN OF VOLATILITY

As we have said several times in the last few weeks, the key theme in February was the sudden return of volatility. Aside from the technical factors that caused this spike (see Flash), let's take a look at the fundamental factors that may explain the recent halt to the bull market in equities since summer 2017:

- **The rise in interest rates?** This is unlikely to be good news, but was to be expected in the current global growth and monetary normalisation environment...and a 50 bp increase in interest rates shouldn't have too much of an impact on earnings, assuming that rates don't go too much higher. We do not expect this level of increase to affect the buoyant real estate sector or impact significantly on the refinancing of US firms.
- **The rise in inflation?** The relationship between inflation and corporate earnings is not an easy one to analyse. As equities are real assets, they should benefit from inflation via an increase in their earnings. But this applies only up to a certain point, since if inflation is too high it increases uncertainty, and therefore, risk premiums. Historically, market valuations are at their highest when inflation is between 3% and 3.5%, but although rising at present, inflation is nowhere near this band and should not therefore be considered a threat.
- **A reduction in excess liquidity?** In general, central bank balance sheets are still expanding and should continue to do so until at least the end of the year. As such, we do not expect the excess liquidity to be cut off suddenly in the short or medium term.
- **The protectionist policies of Donald Trump?** We should keep some perspective on Trump's recent announcements: even if such policies were implemented, they would have only a modest impact on growth via global trade, and historically, have rarely triggered an escalation of protectionist measures. Nonetheless, it would be a concern if these measures were applied to key sectors.

For all these reasons, we retain a positive medium-term view on the equity markets and see the significant share price falls as an opportunity. We are also maintaining a slight upward bias on inflation breakevens, and rates in general.

LA FRANÇAISE
investing together

FIXED INCOME

Volatility on the equity markets was mainly fuelled by strong inflationary fears, but movements in inflation-linked bonds convey a more moderate message.

The latest upward move in core nominal yields, which began in early December, was more down to the rise in real rates than higher inflation expectations. Real rates have moved to reflect the upgrades to growth forecasts. Valuations therefore remain attractive on inflation breakevens, and they are likely to rebound in response to the inflation upside surprises we expect to see in the United States this year: in particular, underlying inflation, for which expectations remain modest, should be driven by the economic cycle. The inflation breakeven curve remains flat on these two areas, and the premium on the longest maturities still seems very low to us given the current stage of the economic cycle. We are therefore positive on inflation breakevens for the US and Europe, and favour long maturities.

2.1%
vs
1.9%
on overall US inflation

The new Fed chairman is now in place and has already expressed his confidence on inflation going forward. **Meanwhile, an increasing number of Fed board members are talking openly of the need for more monetary tightening.** And we think they have a point: the tax reform approved in December was accompanied by new budget spending measures from the start of the year, and these two factors should lead the Fed to upgrade its GDP growth forecast for 2018; inflation should pick up and wages are expected to rise given a tight labour market, which would provide sufficient grounds to quicken the pace of monetary normalisation. We should therefore see further rises in US short-term interest rates. Nonetheless, the Fed - along with the central banks of the major developed countries - will be careful not to hike rates too high, too soon, as this may weaken growth.

In the eurozone, real rates remain very low compared with the rest of the world and in light of the economic scenario: as in the United States, normalisation will likely take place when the ECB’s QE programme comes to an end. At such a low level, they are vulnerable to any comments in this area by the ECB and to events in North America.

The reconnection of core country rates with the economic fundamentals remains our central scenario, although we don’t see this being a linear process...

Rise in real rates (08/03/2018)

(Source: copyright 2018 Bloomberg Finance L.P.)

* US 10-year inflation swap rate
** US 10-year nominal rate
*** US 10-year real rate

EQUITY MARKETS

With all well at the start of the year, and 2018 carrying on where 2017 left off, we were expecting the equity markets to continue their progression accompanied by the synchronised global growth that was supporting activity and corporate earnings, with EPS up by some 10% more or less everywhere.

The equity markets continued to rise until 26 January, largely unscathed by the rises in interest rates and the EUR-USD exchange rate. **That date marked a significant change in mood, with an equity market correction of around 10%.** While European yields remained unchanged (1.01% for the 10Y OAT at end-February), comments by new Fed chair Jerome Powell prompted expectations of recurrent rate hikes in 2018 and a rise in US 10-year yields (10Y T-bond +0.15 bp in one month to 2.87%) focused the attention. The markets underlined this change in regime with a sudden spike in volatility, which was exacerbated by technical factors. The combination of the rise in interest rates and the return of volatility logically led to higher discount rates for future earnings, and therefore a correction.

$306 billion

Cost of damage caused by global warming in the United States in 2017*

The change in regime now seems to have been factored in by the markets, but despite a modest recovery since the end of the first week of February, investors continue to be wary. While we can say that the tensions on interest rates are still a factor, as well as concerns over a possible pick-up in inflation, it is also true that the leading economic growth indicators hit a ceiling a few days ago. However, these indicators have peaked at a high level, which is consistent with a global growth rate of more than 4% over the full year, and 2017 results releases are on a positive trend. When the markets closed on 1 March, 76% of Stoxx 600 firms and 97% of S&P 500 companies had announced their results. A majority of firms posted better-than-expected revenue and net income, on both sides of the Atlantic. In Europe, results improved after a lacklustre start to the season, with a level of positive surprises similar to that of Q4 2016. However, guidance from firms is below the targets indicated in previous quarters (30% below expectations vs 11% in Q2 2017 for example). In this climate of concern over inflationary tensions, and with results announcements coming thick and fast, rate-sensitive (long duration) sectors fell in February.

Investors are also considerably wary of rising political tensions, particularly with President Trump saying he will increase tariffs, which could weigh on global trade. We have previously raised this potential risk to trade agreements, and it has now become a reality. The measures announced should only concern steel and aluminium imports (with some exceptions), and could be in place from the end of March. On the other hand, President Trump's comments, combined with the recent resignation of White House chief economic advisor Gary Cohn, suggest a possible tightening of the conditions for trading with the United States and, reading between the lines, a hardening of its stance over its trade, financial and competitive relationship with China. This resignation will weigh on the risk generating pressure on the equity markets and the US dollar, and therefore on the yen, and ultimately, on Asian equities.

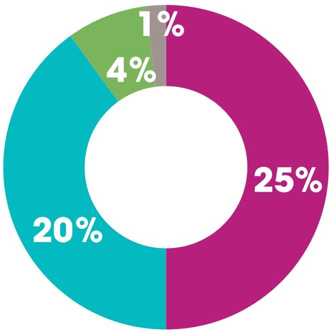
*Source: Climate Migration. In 2017, a string of climate disasters – six big hurricanes in the Atlantic, wildfires in the West, horrific mudslides, high-temperature records breaking all over the country – caused $306 billion in damage, killing more than 300 people. After Hurricane Maria, 300,000 Puerto Ricans fled to Florida, and disaster experts estimate that climate and weather events displaced more than 1 million Americans from their homes last year. This will only get worse – the migrations AND the weather.

THE POWELL EFFECT

There are very few hiding places on the financial markets.
Against a backdrop of changes in monetary policy, the improved US inflation figures were reflected in a major correction in US government debt and a chain reaction on risky asset classes and volatility. And with the risks associated with the Italian and German elections, plus the latest protectionist statements from Donald Trump, it's easy to see why the markets remain under pressure.
The S&P fell by 3.9%, the Euro Stoxx 50 dropped 4.72%, the Nikkei lost 4.46% and emerging markets were down by more than 6%.

The somewhat hawkish tone of new Fed chair Jerome Powell in his first speech maintained the already strong pressure on rates at the end of the month. The markets are now anticipating the possibility of four rate hikes in 2018.
In this unsettled climate, US government bonds and high quality corporate bonds posted a marked deterioration in performance. Europe was much more resilient, with the credit market close to breakeven. Emerging market US dollar-denominated debt was impacted by the US rate effect, falling by 2%.

Despite the more turbulent global environment and slightly disappointing US data for the month, we are sticking to our positive reading of the fundamentals. With the recent fall, equity valuation multiples have recovered, which combined with earnings forecasts, suggests upside for equities. We are maintaining exposure at close to 50%, reducing US equities in favour of their Japanese counterparts. As for fixed income, the US curve now offers attractive potential for balancing portfolio risk. We have reintroduced a substantial component of international inflation-linked bonds. Our stance on credit remains cautious, although we are continuing to maintain our bets on emerging and hybrid debt.



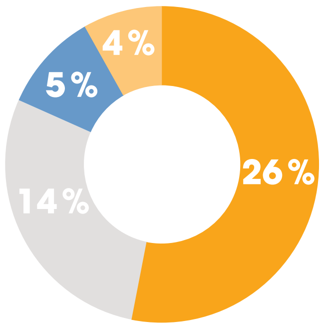
EQUITY EXPOSURE: 50%

UNITED STATES
We are reducing our exposure to US equities after the relative resilience shown in February.

EUROPE
We left our position unchanged.

JAPAN
We have made the tactical decision to strengthen our position in Japanese equities, after reducing it last month.

EMERGING MARKETS
We have reduced our emerging equity component.



FIXED INCOME EXPOSURE: 49%

DEVELOPED GOVERNMENT BONDS
We have reduced this component, which remains concentrated in exposure to US Treasuries.

INFLATION-LINKED BONDS
We have substantially increased our play on inflation-linked bonds, especially the US variety.

FINANCIAL/SUBORDINATED DEBT
We are focusing our credit risk on this theme.

EMERGING MARKET DEBT
We have reduced this component, but retain our preference for local currency assets.

HIGH YIELD CREDIT
We are continuing to avoid this asset class, for valuation reasons.

LA FRANÇAISE
investing together

128, bd Raspail 75006 Paris - France
Tel. +33(0)1 44 56 10 00
Fax +33 (0)1 44 56 11 00
480 871 490 RCS PARIS

www.la-francaise.com

Published by La Française, a French limited company with management and supervisory boards and share capital of €78,047,940 - Paris Trade and Companies Register No. 480,871,490
Editor in Chief:
Pascale Auclair
Content manager:
Caroline Babouillard
Editor: Marion Lévêque
Graphic design: Wanda Le Sauze

XX2105 - March 2018