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COULD THE OIL PRICE REACH $100/BARREL?

On 22 June, the main oil-producing countries outside the developed world met in Vienna to discuss a potential increase in production quotas. Much speculation and discussion followed the contradictory messages from Saudi Arabia, on the one hand, which favours a moderate increase, and Russia on the other, which wanted to expand quotas more significantly.

The agreement eventually reached was closer to the Saudi position, with the addition of 1 million barrels/day. However, this increase is only theoretical, as some countries may not use their quotas, thereby limiting the real boost to output to around 700,000 barrels.

This figure should also be seen in context, given the successive supply shocks that have been affecting the oil market for several months now. Venezuela and Libya are being impacted by specific issues limiting their oil supplies, and Iran is likely to be affected before long too. It is estimated that these three countries have contributed or will contribute to a reduction in oil output of around 1.3 million barrels in 2018. Moreover, there has also been a sharp increase in US shale oil production, although this has been offset by the rise in global consumption.

The oil market is ultimately still suffering as a result of a shortage of supply, and while the agreement reached on 22 June should reduce the shortage, it will not fill the gap completely. Unless there is a major slump in growth, which would reduce demand for oil, it is hard to see the barrel oil price falling significantly from its current levels. Nor do we think that Donald Trump's request to Saudi Arabia to increase production will be wholly successful: the Saudis have every interest in keeping the barrel price high ahead of the Aramco IPO planned for 2019.

The high barrel price is a good thing for one of our key themes, inflation breakevens – with the base effects continuing to be positive in the coming months. In the longer term, however, this is not good news for the growth of importing countries, such as the European nations or Japan.

Despite our strong conviction on inflation, our bets are currently fairly limited in view of the current uncertainty over global trade. We could be in for a somewhat volatile summer...

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FIXED INCOME

AN UNUSUAL SITUATION IN THE EUROZONE

1.6%

the ECB's 2019 forecast for underlying inflation

Unlike in the United States, eurozone growth is running out of steam (the consensus has already been revised down from 2.4% to 2.3% for 2018), while inflation is accelerating, albeit moderately, but with the trend taking it towards the ECB's target. The initial estimate for eurozone inflation was 2% y/y in June, mainly driven by positive base effects from energy prices. Underlying inflation is still low, however (1% y/y), despite the euro's recent weakness, and has so far been only minimally impacted by the second-round effects of the rise in energy prices: we should see it return towards its long-term average (1.5%) in 2019, as wage inflation picks up. The ECB has raised its forecast for underlying inflation to 1.6% in 2019 and 1.9% in 2020, thereby indicating its confidence that inflation will move towards its target in the coming months, despite the gradual reduction in its monthly purchases. Nonetheless, it does not appear to have convinced the markets as yet: inflation expectations are lagging in terms of assessing the path for inflation going forward, which we do not think is justified. With the exception of the Italian indices, it is interesting to note the relative resilience of the markets since the start of May, given all the stress around Italy and then the escalation of the trade war rhetoric favouring a flight to quality and benefiting core inflation.

French inflation it is also accelerating, and should benefit from the rise in regulated prices (+7.45% on gas from 1 July, the biggest rise for six years). Moreover, as part of the French government's planned €5 billion cut in spending on assistance to businesses, the benefit of reduced VAT rates for certain sectors will come to an end. We estimate the potential impact of these measures as 0.25% on French inflation. Furthermore, the changes in the rules for calculating the return on regulated savings in France over recent years have dampened demand from French banks for domestic inflation, which has significantly underperformed European inflation on the inflation swap market: the spread is at its lowest level for 10 years. That makes two good reasons to favour French inflation expectations.

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>
> **Maud Minuit**
> Head of Fixed Income

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EQUITY **MARKETS**

TRADE TENSIONS ARE IMPACTING RESULTS TRENDS

Two months ago, we adopted a cautious stance on the European equity markets, in order to reduce our exposure as the first signs of a trade war began to appear. In addition to this tactical decision, our overall opinion on the upside for eurozone equities remained positive.

The eurozone economic indicators are pointing to a slowdown, but nonetheless remain compatible with a growth rate of above 2%. We are maintaining our cautious stance accordingly. Beyond the dent in consumption related to the rise in the oil price, this caution is justified by two more fundamental factors:

- the stalling and effective slowdown of global trade
- the associated risk of a downturn in investment

This combination could lead to much lower-than-expected eurozone growth, and below-forecast corporate earnings growth.

$450 bn

Chinese imports that could be taxed by the Trump administration

The US president has made a number of protectionist statements in recent months. We have now entered the implementation phase: since 1 June, imports from the EU, Mexico and Canada of steel and aluminium have been taxed at 25% and 10% respectively, generating retaliatory measures. Taxes on Chinese products with a potential cost of $35 billion came into effect on 6 July, and the Chinese government has promised to retaliate immediately with similar measures. Donald Trump is unlikely to leave it there, as he is threatening to add tariffs totalling $450 billion to Chinese goods (i.e. the vast majority of imports from China and $200 billion more than expected).

The biggest risk is clearly of an escalation and the move towards a trade war that would have a negative impact on international trade and growth growth. The risk to the US economy is also high. The States that voted for Trump in 2016 are vulnerable to protectionist measures. As such, the intensity and duration of the trade tensions could be influenced by voters.

The markets are now factoring in the effects of US protectionism, and trade war risks are topping the list of investor concerns, after 20 years of "certainty" around global trade growth. There was a major correction on European markets last month, particularly those most exposed to global trade, such as Germany and Sweden. The same applies to the sectors most exposed to global trade, such as base materials, technology, manufacturing and automotive, which are posting falls. In the automotive sector – the latest target in Donald Trump's sights – uncertainties are likely to persist, despite the US ambassador to Germany saying that President Trump could suspend his threat to apply a 25% tariff on imports.

Our caution prior to the publication of 1H results this month (July) is more to do with the comments being made by business leaders on the effects of the rise in customs tariffs and their impact on investment, than the results themselves, which should generally be good. In June, Daimler lowered its guidance for 2018 to reflect the impact of trade tensions. ABB has also commented on the tensions, while Assa Abloy has accelerated its writedowns in China due to a slowdown in activity. Investors are already taking account of the trade war, and any developments will influence their positioning.

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TRUMP: MID-TERMS ARE COMING

The protectionist tensions have gone up another notch: ahead of the November mid-term elections, the US president could apply customs duties of 25% to vehicle imports from Europe and prohibit some investments by Chinese companies in US tech firms to prevent further technology transfers to China. In Europe, the stability of the German coalition has been a key concern.

On the macro side, global growth should remain at 3.8% in 2018, despite disappointing data in the eurozone and Japan (GDP revised to 2.20% and 1.10% respectively). In the United States, consumption and investment are on the rise (GDP revised to 2.9%). As for the emerging countries, China's growth should remain at around the 6.5% level despite the current risks.

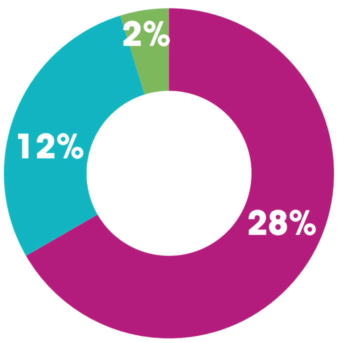
In line with expectations, the Federal Reserve has raised its key rate by one quarter of a percentage point, and expects to implement two further hikes in 2018. In the eurozone, the ECB announced a reduction in its monthly asset purchases from October 2018, from €30 billion to €15 billion, and plans to wind up the programme by the end of the year.

Overall, there was a mixed picture on the equity markets: S&P 500 +0.48%; Eurostoxx 50 -0.32%; Nikkei +0.46% and China's CSI 300 -7.66%.

On the fixed income markets, the yield on the US 2Y Treasury slipped by 12 bp to 2.53%, while the 10Y remained stable at 2.86%. In the eurozone, the 10Y Bund closed at 0.30%. Italian finance minister Giovanni Tria has adopted a pragmatic approach with regard to Brussels: yields fell to 0.68% (-37 bp) for the 2Y and 2.68% (-11 bp) for the 10Y.

On the corporate credit market, we observed the deterioration of subordinated insurance debt and corporate hybrids in the eurozone, with yields losing 20 bp. On the emerging markets, the JP Morgan Global Diversified Sovereign index remains under pressure, tightening by 25 bp over the month, to 369 bp. On the forex markets, the yuan posted its largest ever monthly fall: -3.5% versus the euro and the dollar. In commodities, Brent rose by 2.4% to $78.38, showing greater sensitivity to geopolitical tensions in the Middle East.

We are looking to the summer with mixed feelings, remaining cautious but looking for opportunities. We are reducing our exposure to the equity markets to 42%, retaining our focus on the United States and Europe. On European yields, we are maintaining our low duration exposure to core nominal yields, and increasing diversification in inflation-linked bonds. We will continue to have low exposure to credit and are maintaining a small component in emerging debt and subordinated financials.



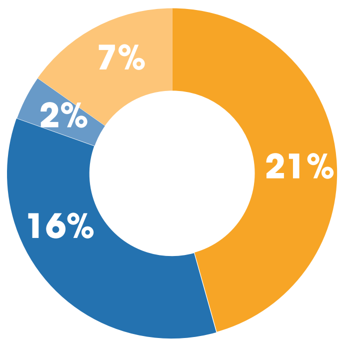
EQUITY EXPOSURE: **42%**

UNITED STATES
We are maintaining our position in European equities during the quarterly results season.

EUROPE
We have sold off some European equities to reduce our overall risk.

JAPAN
We are maintaining a 2% position in Japanese equities.

EMERGING MARKETS
We are steering clear of this asset class.



FIXED INCOME EXPOSURE: **46%**

DEVELOPED GOVERNMENT BONDS
Weightings are mostly unchanged.

INFLATION-LINKED BONDS
We are retaining our bet on inflation-linked bonds.

FINANCIAL/SUBORDINATED DEBT
We are maintaining an investment on this theme.

EMERGING MARKET DEBT
We will continue to increase our exposure gradually following the major correction in recent weeks.

HIGH YIELD CREDIT
We are still avoiding this asset class.

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