ANALYSIS & STRATEGY

MONTHLY NEWSLETTER

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ITALY, TURKEY, UNITED KINGDOM, UNITED STATES... POLITICS ARE FRONT AND CENTRE THIS AUTUMN

The trends in place before summer have outlasted the season. Once again, we note a clear outperformance by the US equity markets and political issues still very prominent in the emerging world and Europe. However, the macroeconomic backdrop remains promising in the majority of the world's regions, except for certain emerging countries, even though the trend is less pronounced than at the start of the year.

Italy will be under close surveillance this quarter in anticipation of proposals on its 2019 budget. A political cacophony between leaders Salvini and Di Maio on the one hand, and Tria and Conte on the other, major uncertainties on the budget, a downward revision of growth, and the eventual risk of new elections: even though the market seems to be factoring in a certain risk premium, we are staying clear of Italy.

On the protectionist front, Trump is still using an aggressive tone toward China. On 5 September the public consultation on the tariffs on $200bn in imported products wraps up, and there is little doubt remaining as to the result of that consultation. Since the Chinese will probably announce retaliatory measures, the situation is not expected to stabilise in the short term. There are also uncertainties about NAFTA, with heated discussions between the US and Canada; there are tensions between Washington and Brussels too, despite overtures that left room for a positive outcome a few short weeks ago.

Neither is there any clarity about Brexit, as the time left to reach an agreement dwindles by the day. However, Michel Barnier made some reassuring statements, such as that he was ready to propose an agreement with a degree of collaboration that no third country had known. Yet the two camps' positions still seem very divided on the most sensitive issues (Irish border, free movement of people, etc.), and Theresa May's position in her own party is still just as uncomfortable.

The emerging markets will be in the news too with an ever-worsening situation in Argentina and Turkey. While in Argentina's case the situation is expected to stabilise thanks to the IMF, the story in Turkey will depend in large part on the will of its institutions. With runaway inflation and a currency in free-fall, a very strong reaction from the central bank is required, which means that Erdogan must finally accept a little more monetary orthodoxy.

In this highly uncertain environment, we are now maintaining very moderate convictions: equity exposure at close to benchmark, low duration exposure to "core" yields, and very specific emerging-market bets. On the other hand, we are maintaining our positive view on breakeven inflation, which has not reacted to the higher inflation outlook since the start of the year.

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FIXED INCOME

50.1
Italian Manufacturing PMI
For August 2018

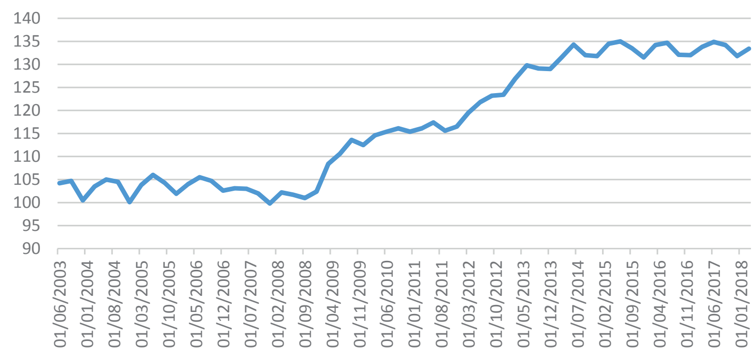
The emerging debt markets had a very volatile August. Risk premiums reached a high of 375 bp on 13 August (284 bp at 31/12/2017) in parallel with the latest stall of the Turkish lira, which also hit a low against the US dollar at 7.23 (the lira has depreciated 50% against USD). On top of the macroeconomic weaknesses, inflation above 16%, and a trade deficit of 5% of GDP, the government is losing credibility: Turkey has entered into a political conflict with the US that has brought with it trade sanctions on steel and aluminium. European countries' banking-sector exposures to Turkey as well as existing trade ties are not causing fear of contagion at this stage.

At 30 August 2018, the EM risk premium stood at 360 bp. The risks dragging down this asset class – trade and political tensions – persist, although there has been a slight détente since mid-August. For this to last, and support valuations, Turkey will have to address a resolution plan as quickly as possible, and Argentina will still have to show itself with the IMF at its sides to regain credibility on the markets.

Italy's autumn budget is highly anticipated. To what extent will the Italian government use its fiscal room for manoeuvre up to the 3% ceiling imposed under the Stability and Growth Pact? The debt/GDP forecast before the government was formed was 0.8% for 2019, 2.2% would be the most "reasonable" figure. Whatever the deficit's size, Italy's primary surplus will be impacted, which is bad news for its debt trajectory, especially as the growth forecast has been revised down. The change in volatility trend for yields will increase the debt burden. While it is true that market positioning and valuations are offering more protection than in the days preceding the crisis in May, the marginal buyer will be difficult to find, particularly as international investors have sold record amounts of BTPs since May, while the ECB will stop its purchases in December.

Our fundamental view is negative, and we do not expect any short-term respite on the political front: Matteo Salvini's party, the League, is topping all the polls. The draft budget will be submitted to the European Commission on 15 October after being presented to the Italian parliament. Recommendations from the EC will start to be issued in November. The risk of fresh elections cannot be ruled out.

Debt-to-GDP ratio



EQUITY **MARKETS**

As the first signs of summer arrived, we adopted a tacitly watchful – and fundamentally positive – attitude.Two months ave now gone by and we can see new clouds on the horizon.

The European Central Bank, in its monetary policy statement, has identified two major risks: "The threat of protectionism" and "financial market volatility"

On a macroeconomic level, indicators continued to decline in most of the world's regions. Particularly in Europe, France had to lower its GDP growth forecast by 0.3pt in 2018 and 0.2pt in 2019, and Germany saw a decline in its manufacturing orders.

"The threat of protectionism"

The first round of the trade war is now in the books, with the second portion impacting $50 billion in imports just now taking effect. This brings total taxed bilateral trade to $190 billion. The second round could be much bigger, with $260 billion in goods affected. Finally, even though the spectre of taxation on automotive goods seems to be receding, it could involve $360 billion in US imports.This tug-of-war between the US and its trade partners is impacting business confidence, and business investment has dropped off noticeably since the beginning of this trade war.

+13%

YTD performance gap between the US and Europe

The political risk or "financial market volatility"

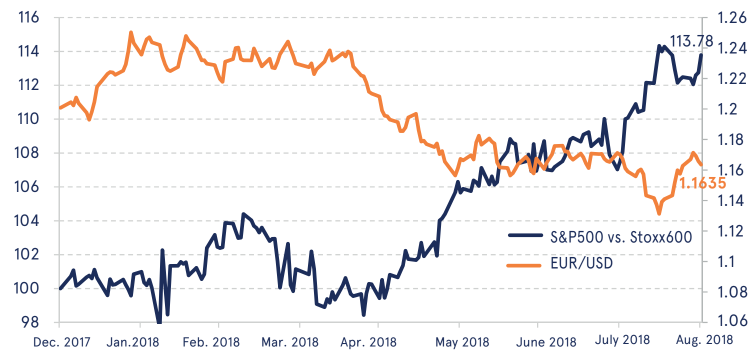
For the ECB, Italy still casts the biggest shadow. Aside from the structural problems of the Italian economy, the rise to power of a Eurosceptic coalition is helping to destabilise the eurozone. While the first version of the 2019 European budget is due by 27 September, Salvini is arguing for more fiscal largesse in hopes of increasing social spending, cutting taxes, and funding major infrastructure projects. These claims are putting pressure on Italian debt - not to mention that of the entire eurozone.

Performance gap between the US and European markets

Although the dollar has appreciated since the start of the year, the S&P500 outperformed the Stoxx Europe 600 by more than 13 points (expressed in EUR). The comparison is even more blatant against the emerging markets. Now more than ever, the US market seems to be a safe haven for investors.

Europe is still attractive, with a valuation at 13.7x 12-month forward earnings, compared to a five-year average of 14.5x. The United States is at 17x compared to a historical average of 16.4x.

S&P500 vs. Stoxx600 YTD (Base = 100, in EUR)



US EQUITIES, ALONE IN THE WORLD

Once again, the summer was marked by jittery investors. And for good reasons: Turkey's crisis is worsening and spreading to the most fragile emerging countries; there has been no progress on trade negotiation between Europe, China, and the US; political uncertainty reigns in Italy; growth could be slowing in China; and Brexit is still dragging its issues toward the exit.

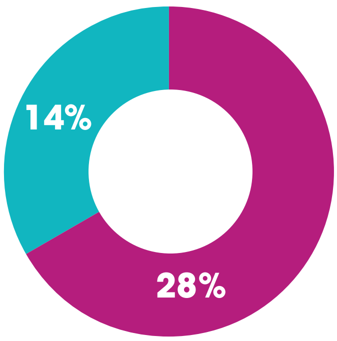
Investors are aware of these risks and abandoning the emerging currencies for "Made in the USA" assets, especially US equities. They are especially willing since economically the US is demonstrating its XXL strength. The effects of tax reform are reverberating through US corporate earnings, with the S&P 500 and NASDAQ back to their all-time highs.

This all seems very far away for the European indices that are being dragged down by political risk. For now, these uncertainties have not stemmed global growth, which is still stable at 3.7%, but the regional breakdown has changed. The United States is picking up steam, while Europe, Japan, and a few emerging countries are treading water.

The dollar is appreciating against all developing and emerging countries' currencies (excluding Japan). The Turkish lira has lost 20-25% of its value and, by contagion, the Argentine peso (-26%), South African rand (-8%) and Brazilian real (-6%) have also declined.

For the central banks, a 25-bp hike in the Fed funds rate is a certainty in September. On the government bond market, sovereign yields played their role as a safe haven. 10-year US and German bonds closed at 2.86% and 0.32%. This drop in nominal yields was caused by the decline in real yields. In the periphery, 2- and 10-year Italian yields closed at 1.47% and 3.24%, logically rising 73 bp and 52 bp, respectively. There were few remarkable events on the credit market. Subordinated insurance debt and corporate hybrids remained under pressure. On the emerging markets, the JP Morgan Global Diversified Sovereign Index widened 43 bp during the month to 370 bp at 31 August.

We are approaching autumn with the same mixed feelings, between caution and opportunity. We are keeping our exposure to the equity markets close to 40%, retaining our focus on the United States and Europe. On European yields, we are maintaining our low duration exposure to nominal Core yields. We will continue to have low exposure to credit and are maintaining a small component in emerging debt and subordinated financials.



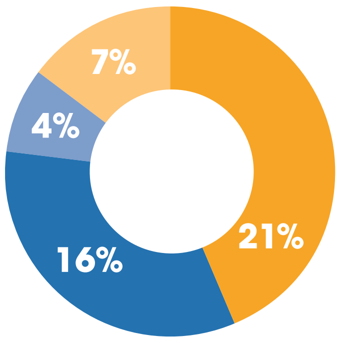
EQUITY EXPOSURE: 42%

UNITED STATES
We are maintaining our position in US equities despite significant outperformance.

EUROPE
We are building up European equities through arbitrage of Japanese equities.

JAPAN
We are taking our profits on Japanese equities and selling off the position.

EMERGING MARKETS
We are steering clear of this asset class.



FIXED INCOME EXPOSURE: 48%

DEVELOPED GOVERNMENT BONDS
Weighting unchanged.

INFLATION-LINKED BONDS
We are maintaining our bet on inflation-linked bonds after the summer's sub-par performance.

FINANCIAL/SUBORDINATED DEBT
We are slightly increasing our position.

EMERGING MARKET DEBT
We are maintaining our position after adding to it in early summer.

HIGH YIELD CREDIT
We are still avoiding this asset class.

LA FRANÇAISE
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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

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Content manager:
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Editor: Marion Lévêque
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