ANALYSIS & STRATEGY

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HAVE WE SEEN THE END OF THE BULL MARKET? PROBABLY NOT

The accumulation of a number of stress factors has finally caused the most significant market correction for some time. The US markets took the biggest hit in October, with the S&P 500 down 7% - its worst month since September 2011.

There are a number of issues causing concern (potential or real) at present: the US-China trade war, Brexit, Italy, the US mid-term elections, the results season, the slowdown in China and Europe...and as the catalyst, a message from the Fed that we thought was somewhat misjudged. As was the case in February, the rapid rise in US interest rates seems to have triggered this correction.

Some of these issues now look to be real risks: growth in Europe and China, and how the current political problems play out. Is the market right to be concerned? Yes, but only in part.

This is mainly because we think some of these concerns are overplayed.

Part of the slowdown seen in Europe relates to the German automotive sector, which should only be transitory. Eurozone growth will probably be 1.8% in 2018; this is lower than expected at the start of the year, but is still above potential (estimated at around 1.5-1.6%).

China's economy is slowing, but the Chinese authorities are fully aware of this and have been implementing some easing measures for some months in order to boost growth, along the lines of 2015-2016. A Chinese hard landing has been a recurrent market fear for around 10 years now, but has yet to materialise. Will we see a hard landing this time? We are not convinced.

This is partly because there was also some positive news in October:

- The rating agencies did not downgrade Italy to junk status, which should help Italian yields to stabilise.
- Although corporate earnings were somewhat disappointing in Europe, the US had another excellent results season, without any apparent fears over future earnings.
- Lastly, we have noted a slightly less vehement tone in political discussions of late (Brexit, Italy and even President Trump).

The sharp falls recorded in October were also due in part to major sector deleveraging, particularly by systematic funds. We previously wrote about this subject in February, and there are some similarities in what is happening now.

We do not see the significant falls on certain markets as fully explained by their fundamentals. This is the case for US equities, which have reasonably attractive valuations at present, and for inflation breakevens, which were impacted by the oil price slump during the month.

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FIXED INCOME

CAN FIXED INCOME STILL PLAY ITS ROLE AS A SAFE HAVEN?

For decades, investors have been used to managing their equity and bond allocations as two largely decorrelated asset types at times of market stress. Can this flight to quality approach still work in the current market environment, with central banks set to start shrinking their balance sheets in the coming months?

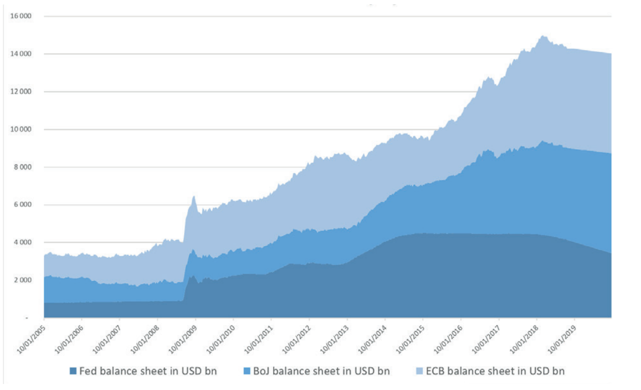
October was a particularly difficult month for the risk asset market, especially for equities. At the same time, bond yields, regarded as risk-free, have hardly moved, barely reacting to current risk aversion. For example, between 3 October and 31 October, the S&P 500 shed 7.31%, while the US 10-year yield went from 3.18% to 3.14%. A similar movement was seen in the eurozone between 2 October and 1 November, with the Eurostoxx 50 falling 5.45% and the yield on the 10Y Bund edging down from 0.42% to 0.40%.

This trend marks a departure from the correction phases of recent years, as was also the case earlier in 2018, in February. The beginning of 2016 saw yields ease significantly, as did August 2015, not to mention the 2011-2012 period. In our view, these movements are certain to continue as long as the macroeconomic environment shows no sign of a significant downturn, which is something we do not foresee at present. And this is why:

- After implementing unprecedented balance sheet expansion, the main central banks (Fed, ECB, BoJ and BoE) have embarked on a consolidation phase. The Fed has already started to shrink its balance sheet (by $50 billion per month), the ECB should bring QE to a close at the end of the year, and the BoJ has been reducing its asset purchases since the start of the year.
- Inflation numbers, after disappointing continually over a number of years, are showing signs of strengthening. Wage pressures in particular are clearly starting to appear in some countries (US, Germany, UK), which is not unexpected given current employment trends; this should continue in the next few months.
- The central banks' forward guidance has been increasingly precise in recent quarters in order to reduce uncertainty among the various financial players. On the other hand, it is difficult for the central banks to backtrack on their previous announcements. For instance, the ECB said it would phase out QE by the end of the year and implement a first rate hike in September/October 2019; it would take a significant change in the growth and inflation trajectories for this message to change. This short-term interest rate peg is naturally reflected in long rates, and prevents them from playing their role as a safe-haven security.

Core rates should therefore continue to rise, pursuing their normalisation course, even in an environment of turbulent equity markets. Unless the economy suffers a shock, that is, but we would reiterate that this is not our scenario.

Central bank balance sheets with projection to 2019



EQUITY MARKETS

BUY THE DIP

All the equity markets were hit by a wave of corrections in October, suffering falls ranging from -5% to -10%. This amplified the underperformance of the European markets, while the US market lost almost all its gains from the first nine months of the year as well as its previously strong resilience.

Biggest recent global corrections	Market peak	Max. decline (drawdown)	Market trough
September 2011	April-11	-22%	September-11
January 2012	April-11	-15%	January-12
June 2013	May-13	-7%	June-13
October 2014	July-14	-9%	October-14
September 2015	May-15	-13%	September-15
February 2016	May-15	-19%	February-16
February 2018	January-18	-9%	February-18
Current	September-18	-10%	?

At the end of October and in the run-up to the US mid-term elections, we think it's a good idea to maintain significant equity exposure. The main reasons for this are:

- with attractive valuation levels relative to all-time averages, the equity markets have entered oversold territory (RSI<30)
- US corporate earnings look set to show steady growth in 2018 (>+20%) and 2019 (>+10%), providing firms with a far higher return on capital than cost of capital, despite the Fed rate hikes
- emerging markets became oversold following the two shocks in April and May. This is particularly true for China, with the fall in the renminbi largely offsetting the higher import tariffs
- potentially positive capital flows to the extent that the level of cash in portfolios is high and where firms are able to redeploy their share purchase programmes after the earnings season

We also think that most of the political risks weighing on the markets since the summer (i.e. the China-US trade war, oil touching $80/barrel, the major risks in Europe over Brexit and the Italian deficit, etc.) have been identified and largely factored in through a record high 'equity' risk premium, while the government bond markets have remained relatively immune. Although the correction in February followed a a significant rise in US interest rates, this was not the case in October. Given the earnings growth reported, the most recent rate hike should not be a pretext for jumping the equity ship at current valuation levels.

More than a further positive macro sign, an easing of the political pressures could lead to a rebound on the equity markets, especially after the US mid-term elections. A weaker US dollar would be favourable to both a pick-up in the US markets and the performance of the emerging markets.

In a phase of market recovery, tech, industrial and consumer goods stocks should post better performances, along with commodities.

RED-BLOODED OCTOBER

October saw a strong peak in risk aversion: political and economic uncertainty crushed growth prospects, with the budget confrontation between Italy and the European commission and the stalemate in the Brexit negotiations weighing particularly heavily.

Italy's draft budget for 2019 was submitted with a deficit target of 2.4% for 2019 and 2.1% for 2020. Unsurprisingly, the European commission rejected it, giving the Italian government three weeks to revise its plan.

All risk asset classes suffered a major impact, mirroring the fall on the S&P 500 (-6.9%), which had its worst month since 2011: Nikkei -9.1%, Shenzhen 300 -8.3%, S&P -6.9%, DJ Stoxx 50 -5.9%.

However, the macroeconomic data revealed the ongoing resilience of the US economy: third-quarter GDP growth was 3.5% (annualised) beating the 3.3% forecast. In the eurozone, third-quarter growth was 0.2% qoq, undershooting the forecast (+0.4%).

On the microeconomic side, US corporate earnings were very good overall: 86% above expectations. In Europe, results were more mixed: so far only 45% of firms have exceeded earnings expectations.

Central banks: the ECB underlined the temporary nature of the slowdown, insisting on the strength of demand thanks to employment and wage trends.

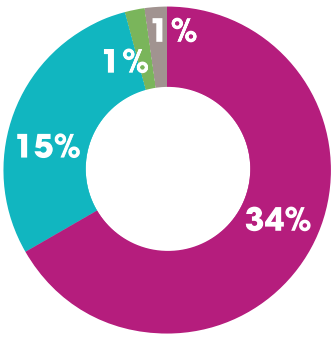
On the government bond market, the yield on the 10Y US Treasury closed at 3.14% [after fluctuating between 3.06% and 3.23% over the month], while the 10Y Bund settled at 0.38% [having moved between 0.35% and 0.57% during the month]. As expected, Italian yields remained under pressure: the 10Y yield tightened by 28 bp to 3.43%.

On the corporate credit market, the high yield market did poorly overall: the spread on B-rated issues widened in Europe (+88 bp) to 5.63%, and in the US (+63 bp) to 7.07%.

On the forex markets, the US dollar strengthened by 2.6% versus the euro, to 1.1312. Among the emerging countries, the best performers were the Argentine peso (+15% vs USD), Turkish lira (+8.4% vs USD) and Brazilian real (+8.8% vs USD).

In commodities, the Brent barrel price fell sharply (-8.8% to $72.67) despite concern over a shortage of supply from OPEC countries as the official date for the reinstatement of US sanctions on Iran (4 November) approached.

On the emerging markets, the JP Morgan Global Diversified Sovereign Index widened by 31 bp during the month to 366 bp at 31 October.



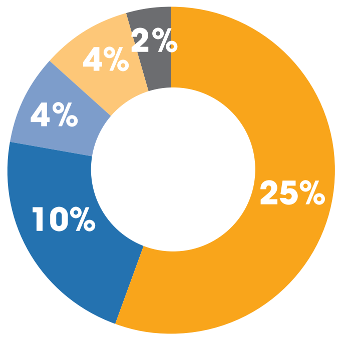
EQUITY EXPOSURE: 51%

UNITED STATES
We have substantially expanded our position in US equities.

EUROPE
We have slightly increased our exposure to European equities, with good diversification across styles.

JAPAN
We maintained the small position initiated last month.

EMERGING MARKETS
We have also initiated a small position on this theme.



FIXED INCOME EXPOSURE: 45%

DEVELOPED GOVERNMENT BONDS
We have increased the overall modified duration to balance the overall portfolio.

INFLATION-LINKED BONDS
We have reduced our bet on inflation-linked bonds on tactical grounds.

FINANCIAL/SUBORDINATED DEBT
The position is unchanged.

EMERGING MARKET DEBT
We have reduced our position for tactical reasons to concentrate risk in the equity component for the short term.

HIGH YIELD CREDIT
We have maintained our investment of 2% in European high yield.

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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Editor: Marion Lévêque
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