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POSITIVE MARKET OUTLOOK FOR 2018

The year 2017 ended with a higher growth rate than expected, due to an acceleration in the Eurozone, Japan and China, and the coming year should be equally buoyant:

- Leading indicators for the major regions are high and indicate global growth of 4% over the next few quarters, representing the highest growth rate since 2010.
- This growth appears much more synchronous than during previous years. Of the 25 main world economies, 24 are now showing growth.
- Perspectives in emerging markets are positive, regardless of the anticipated slow-down in the Chinese economy.

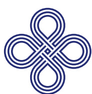
Inflationary pressures remain very low, whether in the Eurozone, the United States or in emerging countries. The circumstances supporting this trend will continue in 2018, but some aspects point to an acceleration:

- The rebound in commodity prices.
- The start of a wage inflation cycle, spurred by unemployment rates in the main industrialized countries that are close to their equilibrium levels.

The Fed and its new Chairman, Mr. Powell, should continue to normalize American monetary policy at a slightly faster pace than expected by the market. Inflation in the US will drive the FED's future monetary policy.

The ECB's asset purchases will decline quite sharply in 2018 and are expected to stop by the end of the year.

Furthermore, we will monitor any change in the BoJ's yield curve control policy.



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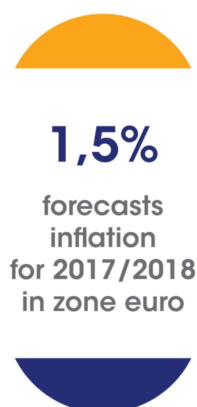
ABOUT FIXED INCOME

A reconnection between the interest rates of core countries and economic fundamentals will take time: the very clear dichotomy between the growth dynamic and the (currently disappointing) inflation dynamic will have a moderating effect on any upward trend in interest rates.

We must also remember that the combined balance sheets of the central banks will continue to grow in 2018 before reaching a balance by the end of the year, which limits the probability of a hike in interest rates, at least during the first half of the year.

If we continue to witness the normalization of bond yield curves, the accommodative monetary environment should support **peripheral debt** in the Eurozone and should be a counterforce in the event of a major shift in European interest rates. The increase in government rates that we expect should therefore be moderate which will be key for the other fixed income asset classes.



After a year of very positive performance in terms of European credit, margins have settled at historically low levels. We expect the proportion of **Investment Grade credit** purchased by the ECB to increase compared with other asset classes eligible for its buyback program, thereby limiting the impact on valuations.

We are positive on financial (bank) **subordinated debt** given the impact of expected reflation on bank results, the healthier state of balance sheets in the south of Europe, and easing regulatory pressure, following the signature of the Basel IV agreement.

In terms of **High Yield credit**, the fundamentals are good and default rates will remain very low, well below historical averages. Valuations are high and liquidity is an issue. We will therefore follow closely:

- Investor inflows which have dropped, given performance figures
- The financial leverage of US companies which remains high, making the most indebted companies sensitive to a more aggressive FED.
- The price of oil.

In terms of **emerging markets**, Investment flows will continue in 2018, since risk premiums remain very attractive relative to developed markets and to corporate debt.

Many emerging countries will hold elections in 2018, mainly in Latin America. Within this environment, local markets meeting specific domestic requirements should continue to perform well thanks to high real interest rates.

"In an environment where German and Japanese interest rates remain low, any significant rise in interest rates will be seen as an opportunity to invest cash in government bonds, especially US bonds,"

Jean-Luc Hivert,
CIO Fixed Income

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ABOUT EQUITIES

The macroeconomic environment expected for 2018 offers significant support for global equity markets and suggests another strong performance after an excellent 2017.

Synchronized global growth of 4% will back corporate activity and margins. As such, earnings per share are expected to be up by 10%, synchronized among the geographic regions.

Over and above the accelerated global activity, earnings per share should rise in the United States thanks to the increase in household disposable income and the finalization of the tax reform by the authorities. This profit growth should at least partially offset the American monetary policy normalization started by the Fed

The profits of European companies, and more particularly of those in the Eurozone, should increase by more than 10% thanks to the acceleration in activity and to the Eurozone's positive reaction to growth in emerging countries.

Nevertheless, we must pay special attention to:

- shifts induced by the digitalization of the economy, which, once detected, can affect an entire sector.
- the risk associated with a strong Euro for European export companies.

We still believe that the growth sectors should attract investors, although we could record 'technical' and occasional rebounds in sectors with low valuations.

The visible growth in industrial production will support investments that have not lived up to expectations in 2017, with the usual lag of 12 to 18 months. That is why the growth differentials between the sectors must be significant, with a preference for technological and industrial stocks.

We give priority to companies who have committed to a sustained investment policy with a profitability that far exceeds the cost of capital.

Beyond this scenario, what are the main risks?

In addition to geopolitical tensions (Korea, Iran, Donald Trump's foreign policy, etc.), special attention should be paid to the normalization of the main central banks' monetary policies, and in particular the drop in cash flow from 2018. The hike in interest rates will increase credit conditions and probably generate more volatility in the markets. These tensions will naturally highlight the historically high absolute valuation of risky assets classes. In the portfolios, we will also take care to monitor foreign exchange risks that materially affect the relative performance of the markets.

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2018, MOVING TOWARDS GREATER SELECTIVITY...

2017 has been a positive year for most risky asset classes.

With a structural negative return on money markets, investors had to be oriented equities, especially Asian equities (including Japan), US growth equities or European small caps.

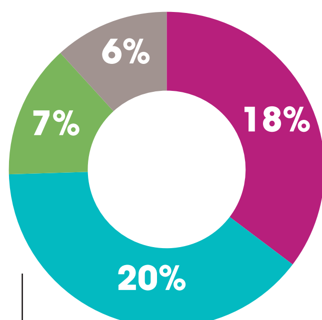
With respect to fixed income, there was no significant change. Emerging market local currency debt, and credit as a whole with a preference for subordinated or hybrid debt should have been favoured.

The blemish to this scenario was the strong decline in the dollar compared with most other currencies. European investors like us had to hedge that risk, even at a cost of nearly 2.5% over the year.

We are entering 2018 rather tentatively: quite neutral on equities (51%) as we maintain our main positions initiated last year, namely our overweighting of Europe and emerging countries to the detriment of the United States. The positive medium-term momentum has not been called into question, but it must be put into perspective after a strong year.

On the fixed income side, there is still very little credit in our allocations, due to valuations, as indicated previously. We are concentrating risk in emerging and hybrid debt. We continue to underweight core interest rates sensitivity and we are keeping some inflation-linked bonds.

It is clearly necessary to be more selective and flexible in 2018, in a very solid macro/micro environment that is however nuanced with stretched valuations in some markets. The political risk will remain ever-present.



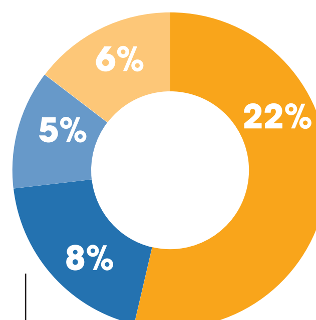
EQUITY **EXPOSURE: 51%**

UNITED STATES
We are tactically reducing our exposure to US equities following the positive strengthening seen over the last month.

EUROPE
We are adding to our position following material underperformance in November/December.

JAPAN
Very slight increase in exposure to Japanese stocks.

EMERGING COUNTRIES
Our allocation to emerging equities remains unchanged.



FIXED INCOME **EXPOSURE: 41%**

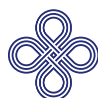
DEVELOPED GOVERNMENT BONDS
Stable weight, but increased geographic bets: even less in Europe and concentration on the US market.

INFLATION-LINKED BONDS
We are maintaining our diversified exposure to European inflation-linked bonds.

FINANCIAL/SUBORDINATED DEBT
We are concentrating our credit risk in this area.

EMERGING COUNTRIES DEBT
We are maintaining a positive bias on the asset class by mixing hard and local currency debt.

HIGH YIELD CREDIT
We are keeping our distance from the asset class for valuation reasons.



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