ANALYSIS & STRATEGY

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IS PROTECTION REQUIRED AGAINST "FRANCE RISK" ?

This month it's hard to look beyond the French elections, even though the markets seem less focused on the upcoming poll than they were a few weeks ago.

To go by the various research institute publications, market operators assess the probability of a Eurosceptic candidate winning the election at around 20%.
It is difficult to evaluate the impact of a victory by a candidate who wants France to leave the eurozone, but it seems highly likely that this would trigger a major period of stress across all European markets. Our projections have the spread between French and German government debt increasing from 65 to 200 basis points, the equity markets plummeting and the euro in free fall.

Given these assumptions – which are by no means certain – **how do we limit the negative impact on portfolios, while maintaining an allocation structure with an appropriate exposure profile in case these risks do not materialise?**

The answer to this question obviously depends on each portfolio under consideration, although in most cases, we recommend partial protection of risky assets. Moreover, considering that current market levels are rather high and that this political risk has not been factored in to any great extent by the markets (low volatility, low level of hedging, etc.), **we think the risk is currently asymmetric to the disadvantage of investors.** This does not mean that we think a Eurosceptic candidate will win, but simply that, at present, the markets are not paying us enough for us to shrug off this extreme risk without any precautions.

Putting this binary event to one side, **the strong macroeconomic data across the board in March was very welcome.** This seems to confirm an acceleration of global growth in the first quarter of the year, which helped short-term German yields to return to less extreme levels with regard to their fundamentals. March also saw disappointing inflation figures in the eurozone, which put a stop to rumours of early tapering by the ECB. With the quarter end and the end of the positive base effects on inflation, there may be **some profit-taking on any inflationary theme. This situation, coupled with the risk of disappointment over the implementation of Donald Trump's programme**, is part of the reason we are adopting a slightly more defensive stance prior to the French elections.

We currently favour European equities and emerging market assets (equities and fixed income instruments), and our bond components remain low in duration on government bonds, although this bias has been reduced since last month.

People are croaking about it

Take cover! — *Do you think there's a risk?* — *Well, not really... But I could be wrong*

ECONOMIC SCENARIO

Global growth is accelerating, with almost all regions benefiting. The equity markets had flagged this well in advance, with prices rising significantly since last autumn. On the other hand, commodity prices, especially in the case of oil, are marking time. Moreover, **the pick-up in US oil production suggests that global supply of this commodity could exceed demand for the foreseeable future.**

In emerging countries, activity is growing fairly steadily. For the biggest of these, China, growth appears to be at cruising speed. China's industrial output has been rising by just over 6% per year for the last two years, and the business climate indicators suggest this pace will be maintained, or may even increase. **The fall in value of the yuan was halted by the first hike in policy rates in some time by the People's Bank of China.** Brazil and Russia, meanwhile, have come out of recession. Taken together, emerging regions are growing by 4.5% per year on average.

The USA has emerged from a period of slower growth in 2015-2016, with a small increase in industrial output and a marked improvement in construction activity. The construction industry's overall view of the residential real estate market has even returned to a level last seen in the early 1990s. Investment is increasing very slowly. Unemployment is low and will continue to be low, without putting pressure on wages for now. **The eurozone is on a similar trajectory as the USA, with a significant, but recent, bounce in the business climate indicators,** which is visible across all sectors, particularly construction. The volume of private sector loans has returned to a positive, if pedestrian, trend. Borrowings are growing at the same level as nominal GDP.

Global inflation is stable at around 3%. Inflation began to pick up in developed countries in autumn 2016, and accelerated in early 2017. **Year-on-year figures are close to their peak, but should drop back towards 2% in the USA and 1.5% in the eurozone before long.** Short-term threats to growth appear to be fairly weak. The US and European Central bank committees met on the same day last month, 9 March. Their views on the current economic picture and outlook are rather similar. Growth is set to continue at a moderate pace, and the drift in inflation should be short-lived, with levels soon approaching the 2% target. However, the central banks had rather different things to say about their monetary policy: confirmation by the Fed of regular and gradual hikes in the Fed Funds rate to 3%; maintenance of current rates by the ECB for a long time, **with net asset purchases of EUR 60 billion per month until the end of 2017 (or more if necessary).**

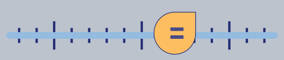
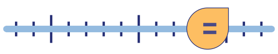
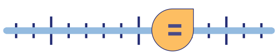
Unless a political incident threatens the euro, the short-term risks appear to be fairly minor, and risk premiums have fallen both on corporate bonds and emerging country debt. The equity markets should continue in good shape for now, although **a number of issues have yet to be resolved: the speed of US rate hikes, the terms and consequences of Brexit and economic differences within the eurozone.**

We are raising our 2017 eurozone growth forecasts very slightly. Uncertainty remains over the pace of Fed Funds hikes. A gradual rise towards 2.5% by end-2018 is most likely. Other risks exist that have not been taken into account in the baseline scenarios.

Baseline scenario		2017	2018
Growth rate*	United States	2.1	2.1
	Eurozone	1.5	1.3
Inflation rate*	United States	2.3	2.1
	Eurozone	1.4	1.5
Central bank interest rate**	Fed	1.5	2.25
	ECB	0.05	0.05

**Average annual growth rate*
*** Rate at the end of the year.*

AT A GLANCE
OUR MANAGEMENT CONVICTIONS
BY ASSET CLASS

EQUITY	Equities	UNDEREXPOSED  = OVEREXPOSED	The macroeconomic data remains solid but without a pick-up in pace. The Federal Reserve has begun to increase interest rates. The French elections represent a tricky transition for the eurozone.
EQUITY	Europe	UNDEREXPOSED  = OVEREXPOSED	Now that the political risk over the Netherlands has fallen away, positive economic indicators and comments by Mario Draghi have boosted performance, particularly of financials and cyclicals in southern European countries. The proximity of the French elections has prompted more caution on our part, without changing our positive opinion.
EQUITY	US	UNDEREXPOSED  = OVEREXPOSED	After four months of a sustained rally, the US market was flat in March. The Federal Reserve embarked on a rate hike cycle just as President Trump failed to get a Republican majority to repeal Obamacare, raising doubts over his ability to implement his stimulus programme.
EQUITY	Japan	UNDEREXPOSED  = OVEREXPOSED	In March, the Japanese market lost almost a third of its January/February gains (-1.1% in yen and -0.6% in euro), underlining its role as a safe haven. We remain positive, despite the possibility of a tense April in Europe.
EQUITY	Emerging markets	UNDEREXPOSED  = OVEREXPOSED	Performances were highly-divergent in emerging markets due to currency volatility: Brazil -2.5% and Mexico +3.8%, in Russia, the rouble was up and the market down -10% in euro, while the situation in Egypt was reversed. There was less volatility in Asia (MSCI Asia +2.5%). The fall in the dollar benefited exporting countries. In China, the PMI surveys are still reassuring.
	Convertibles	UNDEREXPOSED  + OVEREXPOSED	Despite the valuation shock in 1Q 2017, making the asset class more attractive, particularly in light of reflation in the European economy, we maintain our neutral bias in a context of political uncertainty related to the French elections.

FIXED INCOME

Rates	UNDEREXPOSED	=	OVEREXPOSED	The change in tone of the central banks signalled that their next moves will be towards tighter monetary policy. We should therefore continue to see an upward trend in bond yields.
Country allocation	CORE	-	PERIPHERALS	The French presidential election will be the decisive factor in the performance of eurozone government bonds over the coming weeks. Volatility should therefore continue until May.
Inflation	UNDEREXPOSED	=	OVEREXPOSED	Inflation break-evens fell in March. They now suggest that inflation will fall rapidly, to below 1%, which we think is too low.
Emerging markets	UNDEREXPOSED	-	OVEREXPOSED	The economic indicators point to global growth maintaining good momentum, which should improve the fundamentals of emerging countries. The average yield on external debt in USD of 5.47% (JPM) offers an attractive risk premium of 310 bp. We are more cautious on emerging Europe than last month in the run-up to the French elections. We nonetheless remain positive on the asset class, as market troughs continue to offer opportunities on emerging markets.
Credit	UNDEREXPOSED	=	OVEREXPOSED	The fundamentals remain favourable, but the political calendar and expensive valuations overall make the case for us to maintain a neutral stance on credit.
Investment grade	UNDEREXPOSED	=	OVEREXPOSED	Primary issuance remains abundant, although the ECB may reduce its bond purchases via the CSPP. Risk premiums remain tight, discouraging us from increasing our exposure.
Subordinates	UNDEREXPOSED	=	OVEREXPOSED	Despite valuations still being attractive in the current interest rate environment, good underlying sector fundamentals and a relatively calm primary market, the strong rally since the start of the year and the upcoming French elections mean that we have to remain neutral for the moment.
High yield	UNDEREXPOSED	=	OVEREXPOSED	The macro outlook continues to look bright, however, the upcoming French elections and debate over the US debt ceiling, the fall in commodities prices, especially oil, and the abundance of primary issuance on both sides of the Atlantic all point to the need for a cautious, and therefore, neutral stance.

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