ANALYSIS & STRATEGY

MONTHLY NEWSLETTER - LA FRANÇAISE

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CENTRAL BANKS? STILL THE FOCUS?

Over the last week I've been asked what the monthly newsletter will be about, replying "the central banks of course!", with inevitably, the same reaction each time: "again??". Well, yes - the central banks are still the focus.

We could talk about North Korea, the Catalan referendum or the elections in Germany, but in the end, **understanding what the central banks are up to is essential for an effective asset allocation.**

So, what did the central banks do in September? The Bank of England surprised the market by adopting a much less accommodative stance due to persistently high inflation, which naturally triggered a sharp rise in short rates. Meanwhile, the Bank of Canada hiked rates for a second time, in another move the market had not anticipated. The last of the surprises to mention is that the US Federal Reserve did not seem particularly concerned by the disappointing inflation figures, calling them "temporary" and reaffirming that a rate hike in December was likely. In the end, only the ECB delivered a more accommodative message, although this can probably be attributed in large part to the strength of the euro.

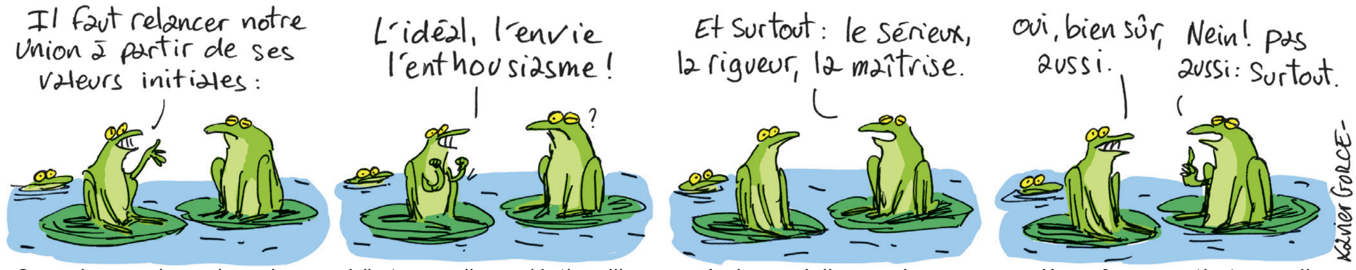
Moreover, with the announcement of an outline for US tax reform, Federal Reserve balance sheet reduction and rumours of the appointment of Kevin Warsh as Fed chairman, **it was not much of a surprise to see rates increasing by around 30bp in September.** Since the macroeconomic data remain pretty good in Europe and the US, **it is legitimate to ask if the stars are finally aligned for a more significant rate rise than we have become accustomed to. In answer to this question, we would tend to reply "not really"...**

This is because inflation is still below central bank targets and on course to be negative in year-on-year terms by March 2018. Central bankers are therefore unlikely to accelerate the pace of rate hikes in six months' time. In Europe, the output gap remains very wide, with unemployment still considerably far off 2007 levels, which gives the ECB some time to gradually rein in its extremely accommodative policy. Lastly, the size of central bank balance sheets continues to increase (€19 trillion and counting...) and this liquidity has to be invested somewhere.

In short, although we still have no appetite for expensive "core" sovereign bonds, we don't see that the conditions for a bond crash are in place at present. We are therefore adopting a less aggressive stance than last month, by reducing our underexposure.

As for equities, **we are maintaining our positive view of European and emerging market equities,** which remain attractive relative to other asset classes. We think this also applies to **emerging market bonds,** which we believe offer a more attractive risk-adjusted return than corporate bonds in general.

People are croaking about it



Our union needs a relaunch, starting from its original values. *What we really need is the will and plenty of enthusiasm.* *And especially, a serious, rigorous, expert approach.* *Yes, of course, that as well. No! Not as well, especially.*

ECONOMIC SCENARIO

The global economy grew at an annualised rate of 4% in the second quarter. The economic indicators for the summer months reflect slightly less dynamic activity after that. Growth in the emerging countries was flat. In the US, the business climate indices continue to be favourable for manufacturing, but considerably less so for services and construction. In the eurozone, meanwhile, the economy stalled. The confidence indices for activity and new orders remain high but are no longer rising.

Based on past experience, faster growth would normally begin to exert pressure on prices and wages. However, there is no sign of this so far, which is giving the monetary policymakers pause for thought. The inflation enigma particularly concerns the US economy. Year-on-year, global inflation is approaching 2% per year, but underlying inflation is falling despite record low unemployment. Various interpretations have been put forward to explain this apparent anomaly: the effects of globalisation on competition, the growing impact of digitisation, weak trade union bargaining power, etc. Janet Yellen appears to think a temporary lag of inflation on growth is the most likely explanation, and has confirmed the outlook for a gradual normalisation of monetary policy. On 20 September, the Fed announced that it would start to reduce the size of its balance sheet "gradually and predictably" from October. Reinvestments of proceeds from Treasury and agency securities will be capped at a monthly amount set in advance, and the cap will gradually rise over time. The size of the balance sheet will therefore decline on a gradual basis. This process will continue until the FOMC deems the balance sheet to have been "normalised". In other words, when the central money supply corresponds to the "normal" demand for money to meet the needs of the economy. The date has not been set in advance, but it seems unlikely that the process will be completed before 2021.

In the eurozone, underlying inflation was just over 1%, and is rising very slowly. In a recent speech at the Centre des Professions Financières, the Governor of the Bank of France clarified the ECB's strategy. He explained that while the relationship between inflation and economic activity has weakened, it nonetheless continues to exist ("We are both confident about the effectiveness of our monetary policy and willing to be patient regarding the time it will take"). Moreover, the working hypothesis is that the impact of QE is mainly due to the total stock of assets held rather than to the flow of recent transactions. At the current level of securities holdings,"the programme is impacting the yield on 10-year sovereign bonds in the eurozone, lowering it by around 100 basis points". However, despite the reduction in the monthly flow of net purchases, "we will continue to increase the size of our balance sheet".

In sum, our economic analysis is that **favourable factors (oil, interest rates) combined in 2016-2017 to boost growth some way beyond the natural pace of the recovery.** The temporary aspect will diminish in 2018. Our central scenario remains unchanged. We see global growth being likely to continue to rise at a modest pace in 2018, **with inflation remaining low and interest rates rising very little and very gradually.** This is a similar scenario to that drawn by the Fed for the US, and by the ECB for the eurozone.

We have left our 2018 growth forecasts unchanged. The most likely scenario for the fed funds rate is a very gradual rise towards 2-2.5% by end-2018. The ECB has confirmed that the first step towards normalisation will be to reduce purchases of long-term securities, probably in early 2018; however, the size of the balance sheet will continue to increase.

Baseline scenario		2017	2018
Growth rate*	United States	2.0	1.9
	Eurozone	2.1	1.7
Inflation rate*	United States	1.9	1.7
	Eurozone	1.5	1.4
Central bank interest rate**	Fed	1.5	2.0/2.25
	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

		UNDEREXPOSED		OVEREXPOSED	
EQUITY	Equities	UNDEREXPOSED	=	OVEREXPOSED	We remain positive in this phase of synchronised growth and investment recovery.
	Europe	UNDEREXPOSED	=	OVEREXPOSED	In September, the euro market grew by close to 5%. Nonetheless, we remain positive as the fundamentals are on a good trend but not fully priced in. The rise of the dollar against the euro has been a strong support factor.
	US	UNDEREXPOSED	+	OVEREXPOSED	The S&P 500 set new records in September in USD. The prospects for the implementation of tax reform led to a rise on the equity market, in interest rates and in the dollar. We have increased our exposure.
	Japan	UNDEREXPOSED	=	OVEREXPOSED	The USD and the announcement of parliamentary elections in Japan boosted market performance. We are factoring in these movements, but will be more cautious from 22 October, the day of the elections. The fundamentals have continued to improve.
	Emerging markets	UNDEREXPOSED	-	OVEREXPOSED	Tactical profit-taking, with the opening of China's 19th party congress this October and the recovery in the USD. We continue to take a positive view of the fundamentals for the medium term, boosted by growth in the region and the reforms under way.
	Convertibles	UNDEREXPOSED	=	OVEREXPOSED	The fundamentals are on a good trend despite the volatile EUR/USD rate in recent weeks, which could impact some Q3 results publications. Small and mid-cap convertibles are still our preferred route for increasing our exposure to European equities.

Fixed Income

Segment	Scale	Position	Comment
Rates	UNDEREXPOSED – OVEREXPOSED	=	Comments by Janet Yellen have pushed up market expectations for short-term interest rates. However, these expectations are some way off the Fed's forecasts, and we maintain a negative stance. In Europe, macroeconomic trends continue to improve, and although the ECB's exit from QE next year has been priced in by the markets, we think the end to QE could be slightly more aggressive than expected.
Country allocation	CORE – PERIPHERALS	-	On 15 September, S&P notched up Portugal's rating to investment grade. This news is set to enhance the country's already excellent performance in 2017 (+17% on Portugal 10-year). We remain positive, but are at the same time factoring in these valuation levels to reduce our directional exposure. We are also cautious on Spain, whose political difficulties (Catalan referendum) are weighing on its sovereign debt.
Inflation	UNDEREXPOSED – OVEREXPOSED	+	Both the recent fall in the euro, after a period of stability, and the rise in commodities prices are good news for European inflation, which could decline less sharply than expected in the coming months. Moreover, with the eurozone showing robust growth and unemployment continuing to fall, underlying inflation should remain on an upward trend.
Emerging markets	UNDEREXPOSED – OVEREXPOSED	=	In the emerging markets, we are still seeing an inflow of foreign capital and good economic data. We remain positive about the asset class.
Credit	UNDEREXPOSED – OVEREXPOSED	=	We are maintaining our neutral stance on credit for October, with the start of the results season, and more importantly, the ECB meeting.
Investment grade	UNDEREXPOSED – OVEREXPOSED	=	The month was a busy one for primary issues, with investor appetite varying among the different sub-segments of the credit market.
Subordinates	UNDEREXPOSED – OVEREXPOSED	=	Subordinated debt, particularly bank issuance, still offers value with valuations at attractive levels.
High yield	UNDEREXPOSED – OVEREXPOSED	=	The macro outlook continues to look bright, primary market volumes are being easily absorbed by the market and results are solid. Nonetheless, political risk persists (North Korea, Catalonia, Brexit negotiations...) and the banks could surprise the markets with a slightly more hawkish approach.

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