ANALYSIS & STRATEGY

MONTHLY NEWSLETTER - LA FRANÇAISE

No. 177 - March 2017 Sent to press on 08 | 03 | 2017

How low will German yields go?

The French elections have rarely been so closely followed by the financial markets as they were in February. On the fixed income markets, the OAT/Bund spread reached more than 80 basis points, before dropping back to around 64 basis points at the end of the month. These were the only markets to properly reflect this "risk", while there was barely a ripple on the equity and currency markets.

Against this backdrop, the most surprising movement was probably from German short-term yields, which headed downward all month long, to a record low of -0.95% for the 2Y, with the 5Y close to its record low at 0.60%.

These yields cannot be easily explained by the macroeconomic data, which show that European growth has been accelerating for several months, while activity indicators are at very high levels (eurozone PMI at its highest since 2011).

Nor can they be explained by the inflation data, as eurozone inflation has surprised to the upside over the last two months and currently stands at 2%, albeit with the "core" figure still below the ECB's target.

The stress caused by the French elections probably underpins part of the movement seen in German yields, although the ECB's sub-deposit rate asset purchases are the more likely source of the strength of these movements.

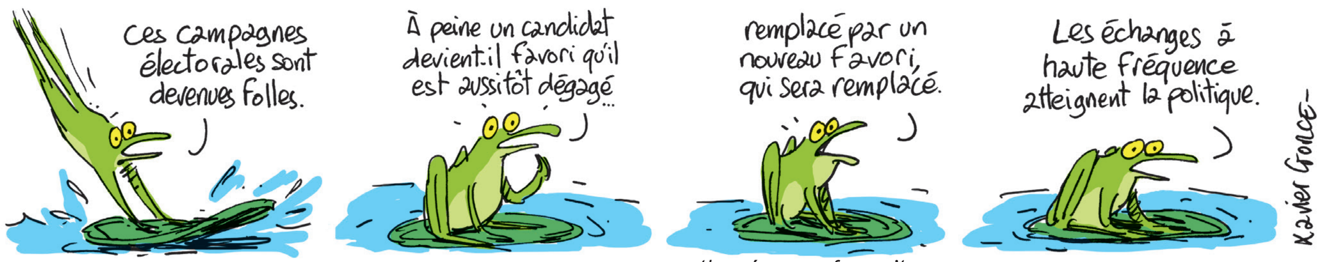
This disconnect between economic fundamentals, on the one hand, and yields on the other, is likely to persist until the ECB adopts a less accommodative stance. If the macroeconomic data continues on its virtuous path, this should happen at some point in 2017, which would lead to a gradual rise in German yields.

Meanwhile, the strong macroeconomic data is continuing to bolster equity assets across the board, helped by an excellent results season in the United States, Europe and Japan. If we do not see any political crises in Europe, this bull market should continue, especially for European equities, which are not currently much favoured by investors.

March should shed some light on a number of issues, both political and financial. We are expecting to discover more detail about President Trump's stimulus plan and the various measures expected by the market, which could well be disappointed. The four main central banks are also expected to be busy, with a rate hike now expected from the Fed, while the ECB is set to publish its new economic projections. Lastly, elections in the Netherlands could return European politics to centre stage.

We are staying away from the government bond markets, especially in Europe. Given the strength of the activity data, we are maintaining our positive bias on European equities, despite the political risks, and on emerging market equities and bonds.

People are croaking about it



This election campaign is really weird. *One minute there's a favourite, then the next minute...* *...there's a new favourite, who is then replaced by another favourite.* *High-frequency trading has reached politics.*

ECONOMIC SCENARIO

Fourth-quarter 2016 GDP estimates are now available for most countries. They confirm **a slight acceleration of global activity at the end of 2016,** with growth at 3.3% in the fourth quarter, up from 3.0% in the third quarter. Global inflation was stable at just below 3% in annual terms. Average annual inflation in developed countries, which had fallen to zero in 2015, rose to almost 2% in 2016. In emerging countries, however, average annual inflation fell sharply (from 6% to 4.5%). Overall, global inflation is stable, at historically low levels, and trending downward – helped by lower commodity and oil prices.

All the economic surveys in the eurozone suggest that the business climate will continue to improve. This is now looking relatively buoyant, at the highest level since the end-2010 bounce, although still below the 2005-2006 or 1997-2000 levels, which corresponded to peaks in the economic cycle. In the UK, growth was still strong in the fourth quarter, bolstered by a jump in exports. However, in the wake of the Brexit vote, we observed an acceleration in inflation (4% in annual terms over the last three months), a fall in retail sales, a rise in stock levels and a stagnation of investment.

In the United States, the activity indicators remain upbeat. In particular, the manufacturing PMI rose sharply, following a similarly rapid fall in 2015. Also notable was the rise in annual consumer price inflation, to almost 4% over three months. Purchasing power fell as a result, although the impact on consumption was buffered by a drop in the savings rate and an abundant supply of consumer credit. **Nonetheless, inflation should not continue to rise,** as it is not due to a wage/price spiral. For now, the Fed continues to predict a gradual rise in the Fed Funds rate, but the coming months' inflation figures will be crucial.

Apart from political risks, we do not see any major obstacles to global growth continuing at a moderate pace. For 2017, we are maintaining our forecast of slightly higher annual growth than in 2016 for the United States (and for Russia, among emerging markets) and slightly slower growth for the eurozone (and China). Globally, we expect growth to be stable or slightly higher in 2017. In addition, higher oil prices are likely to dampen growth in corporate earnings in the eurozone in 2017 and 2018, but drive faster growth in the United States.

The risk landscape has changed very little. **The threat of a slowdown is greatest in Europe** (Brexit, impact of higher oil prices, disagreement within the eurozone), while the United States could see turbulent money markets, and unpleasant surprises from inflation and interest rates. On the political front, the main risk lies in underestimating the possibility of a rise in protectionism and fresh discord in the eurozone.

US economic policy is gradually taking shape,
but it will take a while to boost growth. We are raising our eurozone growth forecasts very slightly. Uncertainty remains over the pace of Fed Funds hikes. The 2017 target could be increased.

Baseline scenario		2016	2017
Growth rate*	United States	1.6	2.1
	Eurozone	1.6	1.5
Inflation rate*	United States	1.1	2.4
	Eurozone	0.2	1.6
Central bank interest rate**	Fed	0.75	1.5
	ECB	0.00	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	July 2016 saw a transition from deflation to reflation, plus higher growth and yields. In November, the positive macro momentum was maintained while yields fell, particularly in Germany, on political concerns. We are now embarking on a phase of steady, rather than accelerated growth, while the Fed is predicting that it will hike interest rates.
	Europe	UNDEREXPOSED	=	OVEREXPOSED	Eurozone growth continues to accelerate, and the composite PMI is at its highest since April 2011. These figures are prompting upgrades in earnings forecasts, while higher interest rates will boost bank profits. Fourth-quarter 2016 results were some of the best in three years, particularly for manufacturing.
	US	UNDEREXPOSED	+	OVEREXPOSED	The US market rally is now four months old. The technical factors are strong, and the under-allocation to equities is generating regular flows (around USD 80 billion since the presidential election). These flows remain dependent on positive macro data, and we are currently in one of the longest periods without any negative news on the macro front. But watch out for those rate hikes on the horizon!
	Japan	UNDEREXPOSED	=	OVEREXPOSED	Japan's manufacturing PMI also rose in February (to 53.3, from 52.7 in January), its highest level for three years. Earnings are still growing and the market is stable (+1.85% YTD).
	Emerging markets	UNDEREXPOSED	+	OVEREXPOSED	The commodities markets are holding up well and the improved outlook provided particular impetus to Brazil (+11%) and the Chinese market (HSI +7%).

	Convertibles	UNDEREXPOSED	=	OVEREXPOSED	Although relative valuations for convertible bonds continue to show slight improvement, we are maintaining our neutral opinion in light of the latest results season and in the absence of any major catalysts.

Fixed Income

Rates	UNDEREXPOSED	=	OVEREXPOSED	All the economic data is pointing towards an acceleration of growth in the first quarter. Central bankers will have to reflect this improvement in their statements, thereby pushing up bond yields.
Country allocation	CORE	+	PERIPHERALS	German bond yields are not in step with the macroeconomic fundamentals. Instead, they signal an expectation of major short-term turbulence in the eurozone. With tensions rising ahead of the French presidential election, attractive opportunities are emerging in some peripheral countries.
Inflation	UNDEREXPOSED	+	OVEREXPOSED	Inflation breakevens have yet to reflect the rising inflation figures, thereby offering an attractive investment opportunity.
Emerging markets	UNDEREXPOSED	+	OVEREXPOSED	Emerging economies continue to improve, and with risk premiums still above 300 bp, this is a very attractive asset class. Market troughs represent opportunities on emerging markets.
Credit	UNDEREXPOSED	-	OVEREXPOSED	We are maintaining our neutral stance on credit. Our wait-and-see approach is based on strong primary issuance and the busy political calendar in Europe, particularly in France.
Investment grade	UNDEREXPOSED	=	OVEREXPOSED	The ECB's asset purchases are keeping credit spreads tight. However, fears over political risks in Europe could continue to be a source of spread widening. Moreover, the flurry of primary activity should continue as we reach the end of the results season, weighing on valuations.
Subordinates	UNDEREXPOSED	-	OVEREXPOSED	Fundamentals are stronger following the results season, but excellent recent performances have made valuations less attractive, leading us to adopt a more cautious stance.
High yield	UNDEREXPOSED	=	OVEREXPOSED	The macro picture continues to look rosy, and the political risks on both sides of the Atlantic appear to have slipped investors' minds. We are nonetheless remaining neutral, as political risks may once again take centre stage and abundant primary issuance could weigh on valuations.

La Française AM is a company of La Française Group – www.lafrancaise-group.com
La Française AM: SAS with share capital of €17,696,676 – registered with the Paris Trade and Companies Registry under number B 314 024 019 - 128, boulevard Raspail 75006 Paris - Portfolio Management Company - AMF authorisation No. GP 97-076 (www.amf-france.org)
Publications edited by La Française, a French limited company with management and supervisory boards and share capital of €78,047,940. Trade and Companies Registry number: 480 871 490. Editor in chief: Pascale Auclair. Content manager: Pascale Cheynet. Editor: Claudine Prêtre. Graphic design: Sylvia Chadi.
Printing: SB Grafic - 01 60 35 10 35.

LA FRANÇAISE

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

XX2105 – March 2017 – La Française Communications – Marketing Department Editors: Gilles Mainard and Michel Didier. Graphic design and printing: La Française.