ANALYSIS & STRATEGY

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THE CONSENSUS: A FALSE FRIEND

The market movements observed for the main financial assets since the start of the year belie both the trends in place at the end of 2016 and the generally optimistic forecasts around at that time. Can this consensus, which continues to hold firm, be shaken? Following the election of Donald Trump, the consensus had coalesced around the theme of reflation and its corollaries: higher US yields, overweighting of cyclical and bank stocks, dollar appreciation, underperformance of emerging markets, etc. A month later, most of these expectations were contradicted by the financial markets, with the dollar tumbling and emerging market equities rising at a time when their developed country counterparts were, at best, treading water.

No more than a pause after the sharp year-end swings or deeper doubts over the trend seen in recent months?

On the one hand, the macroeconomic data are still upbeat in the US, as well as in Europe and China, while thus far, corporate earnings remain on track – all of which is reassuring and limits the potential for a market reversal.

But two things about the short-term direction of the markets now seem very clear and less reassuring:

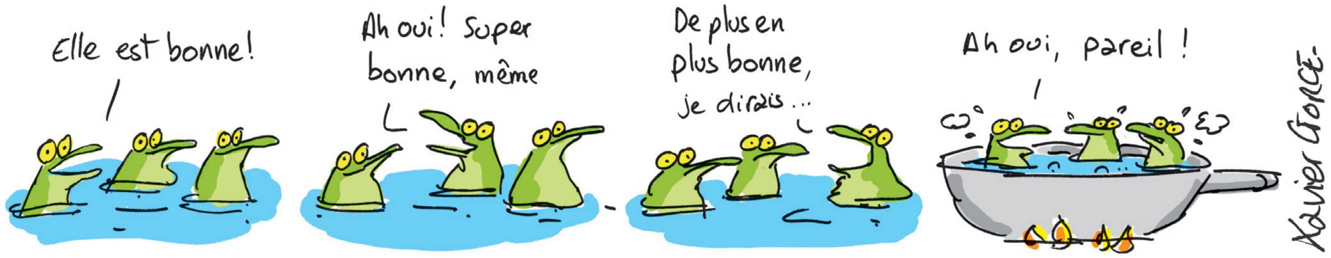
- The uncertainty over the policies that President Trump will implement is far from being alleviated. Until the end of the year, the financial markets focused on the positive aspect of the stimulus programme, drawing a veil over the more protectionist measures that could destabilise them. Trump's various statements and decisions on Germany, China and Japan have caused concern in recent weeks.

- The market consensus around certain key assets is holding firm: big short positions on volatility and US yields, and significant long positions in commodities, such as copper and oil, as well as on the dollar.

Nonetheless, there is rarely a need for an aggressive use of risk budgets when there is a strong market consensus; in the face of such collective enthusiasm, we prefer moderation and circumspection.

With these two observations in mind, we will choose the different themes in which we look to position our risk budgets carefully and selectively: we remain positive on the subordinated debt of European banks, negative on the government bond segment (especially in Europe), and for now, we will stay away from a dollar that has become very closely correlated with risky assets. Lastly we maintain our positive stance on European equities, particularly the value segment, but with an overall equity risk budget approaching that of the indices.

People are croaking about it



It's nice in here! *Yes, really nice!* *And it's getting nicer, I'd say...* *Yes, me too!*

ECONOMIC SCENARIO

The latest economic surveys confirm the impression that global activity is gathering pace. In the Eurozone, the January PMI surveys stood at 55.2 for manufacturing and 53.7 for services. To put this in context, in 2012-2013 (low-growth years in Europe) and 2010-2011 (slow recovery), these figures were around 45 and 58 respectively. We note a similar bounce in the United States, as well as a marked improvement in the household confidence surveys. It is almost as if the election of Donald Trump and his massive budget stimulus plan had triggered a wave of rosier economic forecasts, and since December, the markets have reinforced this. Nonetheless, the surveys reflect opinions and not actual results. At present, the real situation seems less clear cut. For example, initial estimates put fourth-quarter GDP (annualised) at 1.9% for the United States and 2% for the Eurozone, reflecting a slight acceleration.

The rise in the price of oil and certain other commodities is feeding through to consumer prices in all countries. In January 2017, annual inflation rose to 1.8% in Europe. With wage growth flat, purchasing power has barely increased in most countries. Inflation is at a crossroads. A gradual indexation of pay to prices and prices to costs could unleash a real inflationary spiral, driving up long-term yields in its wake. In our view, the rise in the price of basic commodities will moderate, and in the second half of 2017, we see consumer price inflation returning towards 2% in the United States and between 1% and 1.5% in the Eurozone. With monetary policy moving towards cautious normalisation, the trend in long-term yields is now upward. We will most likely see a series of mini-hikes punctuated by pauses or even periods of reversals.

On the face of it, the economic outlook is relatively favourable: modest growth and inflation returning towards central bank targets. **But major question marks remain,** particularly with regard to US policy. The motto currently doing the rounds of US corporate headquarters sums things up quite well: hoping for the best, expecting the worst. The US President has given the impression that he is determined to act on all his announcements.

The risk of protectionism should therefore be taken seriously. Everywhere, including in the United States, the economy is recovering twice as slowly as in previous recoveries on average. For ten years now, purchasing power gains have been weak, and for large portions of the population, non-existent. The latent discontent this has aroused may increase calls for protectionism from the public. **If these are heeded, we can expect a further deterioration in the growth outlook.** In Europe, meanwhile, aside from the forthcoming **impact of** Brexit, spread widening on government debt, particularly with regard to France, is a worrying sign for European cohesion.

The new US economic policy should boost activity but will be lengthy to implement. With global growth at a moderate pace and inflation returning to trend but still low, the US rate hike cycle is expected to be gradual, while the ECB is unlikely to raise interest rates before the end of 2018.

Baseline scenario		2016	2017
Growth rate*	United States	1.6	2.1
	Eurozone	1.6	1.4
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

		UNDEREXPOSED		OVEREXPOSED	
EQUITY	Equities	UNDEREXPOSED	=	OVEREXPOSED	2016 earnings growth was in line with expectations, strengthening the consensus for 2017, a key turning point after a period of gloom. Europe is still lagging behind, which we see as an investment opportunity in relative terms. Meanwhile, the M&A trend in Europe is accelerating.
EQUITY	Europe	UNDEREXPOSED	+	OVEREXPOSED	Our positive stance on the Eurozone is based on significant potential for operational leverage if growth accelerates. The global portfolios are underweight in this market due to the risk premium attached to the 2017 political calendar, which we think is too high and will eventually recede.
EQUITY	US	UNDEREXPOSED	=	OVEREXPOSED	The US market has risen by almost 8% in USD (+10% in EUR) since the presidential election We expect to see margin shrinkage under pressure from an increase in expenses, particularly in unit labour costs in 2017 and borrowing costs, without any productivity gains.
EQUITY	Japan	UNDEREXPOSED	=	OVEREXPOSED	Earnings are still on the rise and the market is positively correlated with dollar appreciation.
EQUITY	Emerging markets	UNDEREXPOSED	=	OVEREXPOSED	Resilient commodity prices and currency falls against the USD at the end of 2016 benefited emerging markets in January. The emerging market index rose by more than 6%, while Brazil advanced almost 12% in USD.

	Convertibles	UNDEREXPOSED	-	OVEREXPOSED	We have downgraded our opinion on convertibles to neutral in view of their relative valuation, which is less attractive in our view despite a positive trend in the quarterly results releases of European firms.

FIXED INCOME				
Rates	UNDEREXPOSED	=	OVEREXPOSED	Continued improvement in the global economic data and the pick-up in inflation should maintain the pressure on bond markets.
Country allocation	CORE	–	PERIPHERALS	Although peripheral country fundamentals are improving, uncertainties around the French elections are increasing short-term risk. We expect to see significant volatility until May.
Inflation	UNDEREXPOSED	–	OVEREXPOSED	Real rates should no longer be immune from the search for yield. Nonetheless, this asset class will receive a boost from the inflation figures, which should continue to show an increase.
Emerging markets	UNDEREXPOSED	=	OVEREXPOSED	Yields on emerging country bonds are still attractive and their fundamentals are strengthening. Uncertainties persist over US trade and monetary policy.
Credit	UNDEREXPOSED	=	OVEREXPOSED	Despite the positive global macroeconomic trend and decent corporate earnings, political risk on both sides of the Atlantic will somewhat limit visibility on the coming weeks for market participants.
Investment Grade	UNDEREXPOSED	=	OVEREXPOSED	Corporate earnings and credit ratios are improving, but credit spreads have tightened and offer little protection against a rise in yields. The USD market offers better potential.
Subordinates	UNDEREXPOSED	–	OVEREXPOSED	Subordinated bank debt still offers attractive yields and regulations have been relaxed, increasing the safety cushion on AT1 debt. In the corporate segment, we prefer short calls.
High Yield	UNDEREXPOSED	–	OVEREXPOSED	Political risk in Europe is cancelling out the positive macro effect and low volumes on the primary HY market in EUR. The uptick in USD primary issuance and uncertainty over Donald Trump's policies are having an impact, despite a favourable macro trend.

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