#04
DECEMBER 2019

LA FRANÇAISE insights

OUTLOOK 2020

From a fundamental standpoint, the global environment would benefit from interest rates remaining low on a more or less permanent basis. As such, the search for yield continues, including with respect to riskier assets.

- **Convergence towards potential growth is expected for a number of countries in 2020, with the balance of risks to the downside**
- **Hopes for a fiscal stimulus, prompted by the new leadership of the SPD in Germany and a big question mark over the USA's ability to deliver a new tax plan before the November elections will - if they are fulfilled - put pressure on interest rates**
- **The central banks, and in particular, the Fed, which relaunched refinancing operations in September - as did the ECB - look set to maintain an accommodative stance and flood the markets with liquidity**
- **The recent pause in the Fed's rate cutting programme is unlikely to be reversed, but should mean fewer rate cuts by the main emerging country central banks in 2020 (there were several in 2019)**
- **In the current environment, with the USD and oil price stable, inflation should remain low in 2020**

LA FRANÇAISE

In the developed countries, the slowdown/manufacturing recession is still in place, and labour market performance will be key to monitoring the risk of contagion to the services sector: convergence towards potential growth is expected for a number of countries in 2020, with the balance of risks to the downside. The rise in the household savings rate alongside a steady level of consumer spending is a warning to be taken seriously: if this turns out to relate to precautionary savings (negative interest rates, pension reform), these will not be used to fund future spending.

Protectionism will remain an important theme before the US elections, and even though tensions appear to have eased in recent weeks, it will continue to weigh on growth, the investment outlook and market volatility. The central banks will continue to factor this omnipresent threat into their balance of risks.

With monetary policy looking likely to remain accommodative for some time to come, there are two opposing camps in the market:

- Its virtuous effects have confused many market participants in terms of their ability to respond to the slowdown in global growth and lower inflation than deemed desirable.
- Conversely, some investors still believe that its benefits will eventually feed through to growth in 2020.

In our view, there are limits to what monetary policy can do, and ECB members have said as much. Fiscal policy needs to do more, especially as the message from Mario Draghi, when relaunching the asset purchase programme for an unlimited period, was to create long-term, low-cost refinancing conditions for governments. However, this will take time. Hopes for a fiscal stimulus, raised by the new leadership of the SPD in Germany and a big question mark over the USA's ability to deliver a new tax plan before the November elections will - if they are fulfilled - put pressure on interest rates. With Brexit continuing to fuel uncertainty in 2020, the focus will be on the fiscal stimulus, probably more so than in the eurozone. Japan has already announced a stimulus plan. The central banks, and in particular, the Fed, which relaunched refinancing operations in September - as did the ECB (which had in fact never stopped) - look set to maintain an accommodative stance and flood the markets with liquidity.

This was the case before and after the summer of 2019 for most insurance companies: the sharp fall in rates had a major impact on their solvency ratios that the regulators were keen to stabilise, if not increase. This led the insurers to increase the maturity of their IG* credit and peripheral debt purchases, and the banks to do the same to cover their asset/liability duration gap. These massive flows serve to limit any major tension on rates, particularly in Europe, as well as the compression of peripheral debt or IG credit risk premiums. And so, the search for yield continues, including with respect to riskier assets.

At the end of 2019, the indicators seemed to be showing that the economic growth of emerging countries had turned the corner. The economic forecasts suggest that 2020 growth will be close to 2019 levels; quarterly performance does not point to a significant recovery. Growth in China is likely to slow slightly between 2019 and 2020. This stabilisation of growth nonetheless remains subject to geopolitical tensions, progress being made in resolving the China-US tariff war, and the continuation of accommodative policies by the central banks. The recent pause in the Fed's rate cutting programme is unlikely to be reversed, but should mean fewer rate cuts by the main emerging country central banks in 2020 (there were several in 2019). These still have some room for manoeuvre given their current inflation levels, which are generally within central bank targets. In the current environment, with the USD and oil price stable, inflation should remain low in 2020. The results of legislative elections

LA FRANÇAISE

*IG: Investment Grade

(presidential and local) in Argentina, India, Ukraine, South Africa, Turkey and Romania, etc. have altered expectations for future economic policy, such as in Argentina, with the defeat of Mauricio Macri and the return of the Peronists to power, and in Ukraine, with the election of Volodymyr Zelensky and the arrival of a pro-reform government.

The major social tensions in recent months, in response to economic inequality, budget austerity, corruption and the deprivation of liberty have ramped up pressure on governments, and the repercussions for economic and fiscal policy will be seen in some countries in 2020.

Fiscal stimuli could also play a role in the economic recovery, but remain limited in countries with a solid financial base (low debt, deficit under control, major domestic refinancing). Lastly, we continue to be positive on emerging IG* debt in hard currency.

We remain positive on peripheral debt except in the case of Italy: the main risk factors to monitor in the coming months will be the resurgence of political risk, the fragility of the current coalition and the outlook for growth. Our internal valuation model suggests that Greece's PUR (premium per unit of risk) score is still attractive, chiefly due to reduced volatility. The very low core rate environment and the ECB's asset purchase programme continue to call for directional positions on peripheral debt and IG credit positions. However, it is clear that volatility is on the up, especially for German and US debt. These factors suggest fairly low risk budgets on 10Y directional yields, but the long end of the German curve seems rather expensive to us (risk of fiscal stimulus and PUR score signalling sell). We do not expect to see inflationary pressures, but our scenario has underlying inflation continuing on a moderately upward trajectory: the low valuations for the asset class should be a source of opportunities.

LA FRANÇAISE

*IG: Investment Grade

The cautious tactical approach in response to the economic slowdown and weak growth in earnings per share is no longer appropriate. With fundamentals looking set to stabilise in 2020, the elements for a risk rally were gathering at the end of the year and for 2020: optimism on the trade war, the decreasing likelihood of a no-deal Brexit, stabilisation of indicators (PMI) in Europe and continued growth in the USA.

As a result, our positioning has changed since mid-October, bolstered by the economic statistics and more encouraging corporate earnings, which could be signs that the pause in the trade war will halt the deterioration in the economic environment. Moreover, the third quarter 2019 results season showed a stabilisation of earnings growth forecasts for Stoxx Europe 600 companies.

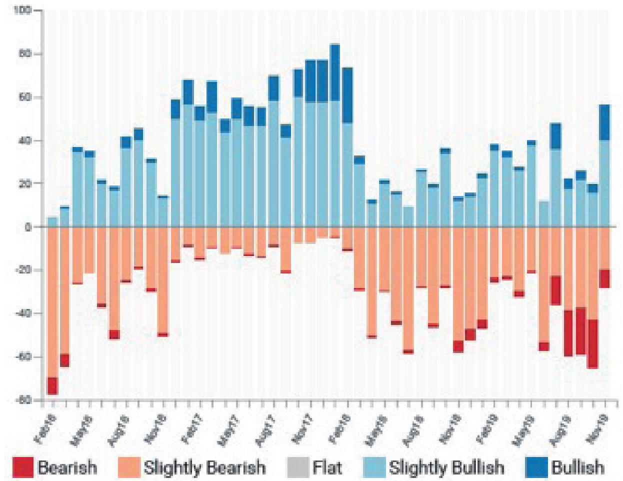
The 12-month forward P/E for the Stoxx Europe 600 has settled at around 14.5x (between the upper end of the 2003-2007 range and its 2015-2017 average), and a level that is not an impediment in itself, but is particularly dependent on changes in protectionism and geopolitical risk. If there is no further deterioration in these areas, risk assets should continue to do well, taking into account the improved outlook for the first half of 2020... In this environment, with European company FCF yields especially high compared to interest rates, equities could finally see a return to positive investment flows in some cases.

In terms of positioning, while European equity markets have been particularly neglected, investors seem to have regained their appetite for equities, judging by the success of certain IPOs. Allocation levels will also be influenced by "FOMO" – the fear of missing out on an equity market rally. This sentiment is backed up by more tangible data, such as the recent rebound in mutual fund inflows (see chart).

Lastly, the rise in long rates that followed the pause in the US rate cutting cycle was - based on the "insurance" cutting cycles (i.e. unrelated to a recession) of 1995-96, 2018 and 2019 - 100 basis points on average. This latest rise was also accompanied (three months after the last rate cut) by an average rise of between 5% and 15% on the S&P 500.

All these elements should be reflected in the continuation of the rotation towards more cyclical/value stocks, given that the current positioning is in growth/high quality stocks.

In sector terms, we now favour cyclicals (industrial, tech, consumer goods) and financials, which should benefit from a rise in long rates and an improved global economic environment.



Source: Goldman Sachs

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

Published by La Française, a French limited company (société anonyme) with management and supervisory boards and share capital of €78,836,320 - Paris Trade and Companies Register No. 480 871 490

XX3447 - DECEMBER 2019

Editor in Chief: Jean-Luc Hivert
Content manager: Caroline Babouillard
Editor: Marion Lévêque
Graphic design: Wanda Le Sauze