

ANALYSIS & STRATEGY

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THE ART OF DIVERSIFICATION

Almost half the companies listed on the major developed country indices have published their third-quarter 2017 results. The good growth figures of recent quarters are, logically, now bearing fruit, **with a marked rise in revenue** (+5% in Europe; +7% in Japan) and earnings up by between +7% in the USA and +16% in the eurozone. However, there were more positive surprises in the USA than in Europe. Meanwhile, **bond yields are still at record lows** (0.38% for the 10Y Bund) and the ECB announced on 26 October that it would reduce its monthly asset purchases, but extend the programme until September. **Investors will therefore be tempted to be strongly overweight in equities** – particularly Japanese and eurozone securities – **and underweight in the bond markets**. Each of these bets is highly logical in view of the fundamentals, although the construction of a portfolio that is well balanced portfolio in terms of risk cannot be seen as just a simple sum of fundamental convictions, since these may potentially be correlated.

Moreover, the strong dollar is boosting export earnings and Japanese and European equities in turn. A strong dollar is often linked to a more expansive fiscal programme or a more restrictive monetary policy, and therefore higher government bond yields. As such, holding Japanese and European equities and at the same time being low in duration does not provide sufficient diversification. This correlation was particularly apparent in early 2017, with the combination of a drop in bond yields, the underperformance of Japanese and European equities and the fall in the dollar.

Beyond our management convictions, a crucial part of our asset allocation work involves identifying the key exogenous factors that will influence the performance of the various asset classes, in order to construct a balanced risk allocation in relation to these factors, while it is difficult to anticipate the path such factors will follow.

For now, we remain positive on eurozone equities, which are benefiting from strong growth. We are maintaining diversification in Japanese equities, which have been boosted by the highly accommodative monetary policy of the Bank of Japan and a sharp rise in earnings. Diversification in emerging equities and emerging debt is still a relevant issue for us, given the ongoing rebound in activity, especially as these asset classes are benefiting from a weaker dollar, unlike our bets on eurozone and Japanese equities.

In the developed market bond component, we remain negative on German bonds, as their level does not reflect the marked improvement in the eurozone economic cycle. On the other hand, we see the very long end of the US curve as attractive, as it can be a shock absorber for any equity market bumps, and is also much cheaper than the German curve in view of its fundamentals.

People are croaking about it



I'm finding out about my new role...



...and the to-do list:



"make it great again"

KARIM GOUCE

ECONOMIC SCENARIO

The global economic situation continues to be favourable: sustained growth, low inflation, relatively stable long interest rates and stock market optimism. But there are some pressures, albeit still on the low side, to monitor: a small increase in US interest rates and the rise in the oil price from 50 to over 60 dollars.

The eurozone continued to grow at a strong pace in the third quarter (2.4% annualised after 2.6% in 2Q). The growth rate seems to be stabilising. In October, the outlook for activity - although still favourable - deteriorated slightly. There was also a slight fall in annual inflation, to 1.4% year-on-year. Underlying inflation was lower, at close to 1%. On the other side of the Channel, the consequences of Brexit are progressively impacting the UK. After several years of good growth, unemployment is still at its lowest level since the 1970s, but inflation is approaching 3%. Given the high trade deficit, there will have to be a move in monetary policy sooner or later.

In the USA, purchasing managers are very optimistic across all sectors. The preliminary GDP estimate for the third quarter supports this view (3.0% yoy, after 3.1% in 2Q). Global inflation is hovering around 2% per year. Underlying inflation (excluding energy and food) remains low. The GDP deflator, which is another measure of internal inflation, rose to 1.8% in the third quarter. Growth could be hampered by recruitment difficulties and very low household savings rates.

As for monetary policy, the ECB has confirmed that it will continue to support the market by reinvesting the proceeds from redeeming the securities it holds, as well as by continuing its net asset purchasing policy.

The change that it is to take place on 1 January 2018 will affect the amount of net purchases rather than the principle, with a reduction from €60 billion to €30 billion per month. **The size of the ECB's balance sheet will increase less quickly, but it will continue to increase.** The US president has appointed Jerome Powell to replace Janet Yellen at the Fed. Jerome Powell has been a Fed governor since May 2012 and has supported the normalisation of the Fed's balance sheet. His appointment represents continuity for US monetary policy. The market reaction was muted.

In China, the news agenda was dominated by the meeting of the 19th Communist Party Congress and Xi Jinping strengthening his grip on power. According to recent estimates, the Chinese economy is still growing at close to 7% per year. The biggest question mark is over real estate and construction. Volume sales of housing have fallen, although the rise in prices has barely slowed.

The recent IMF report on financial stability rules out short-term threats due to the exceptional monetary policies in place and the favourable global economic climate. However, it highlights **a number of underlying vulnerabilities.** The (possibly excessive) valuation of certain assets; the current (and rising) level of non-financial private sector debt; the external debt of emerging countries (which is supporting their short-term growth but makes the situation precarious); credit expansion in China; and the very low market volatility, which could eventually turn out to be sharply at odds with the real risks.




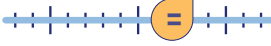


We are revising up our 2017 growth forecasts for the eurozone and the USA. Following the appointment of Jerome Powell to the Fed, the most likely scenario for the fed funds rate is a very gradual rise towards 2-2.5% by end-2018. The ECB has confirmed that the first step towards monetary policy normalisation in the eurozone will be to reduce net purchases of long-term securities, in early 2018. A rate hike will follow some time later.

Baseline scenario		2017	2018
Growth rate*	UNITED STATES	2.2	2.1
	EUROZONE	2.3	1.7
Inflation rate*	UNITED STATES	1.9	1.7
	EUROZONE	1.5	1.5
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

EQUITY	
Equities	<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;"> <p style="font-size: 0.8em; margin: 0;">UNDEREXPOSED</p>  </div> <div style="text-align: right;"> <p style="font-size: 0.8em; margin: 0;">OVEREXPOSED</p> </div> </div> <p style="font-size: 0.8em; margin-top: 5px;">Equities have put in a strong performance over the year since Donald Trump was elected. We continue to anticipate synchronised global growth and a pick-up in investment, and our current view on equities is positive. In this third-quarter results season, firms that fail to meet expectations are again encountering disproportionately negative reactions.</p>
Europe	<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;"> <p style="font-size: 0.8em; margin: 0;">UNDEREXPOSED</p>  </div> <div style="text-align: right;"> <p style="font-size: 0.8em; margin: 0;">OVEREXPOSED</p> </div> </div> <p style="font-size: 0.8em; margin-top: 5px;">The European markets showed strong growth for the second month in a row, particularly as regards eurozone equities. The ECB is set to remain fairly accommodative against a backdrop of dynamic European GDP growth until at least mid-2018. EPS growth should continue to rise in 2018.</p>
US	<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;"> <p style="font-size: 0.8em; margin: 0;">UNDEREXPOSED</p>  </div> <div style="text-align: right;"> <p style="font-size: 0.8em; margin: 0;">OVEREXPOSED</p> </div> </div> <p style="font-size: 0.8em; margin-top: 5px;">We increased our exposure last month for tactical reasons to benefit from expectations around the tax reform presented in the interim to the US Congress (the corporate income tax rate would drop from 35% to 20%). Jerome Powell has been appointed as the new chairman of the Fed's Board of Governors. These factors are likely to support the market, despite the high level of valuations.</p>
Japan	<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;"> <p style="font-size: 0.8em; margin: 0;">UNDEREXPOSED</p>  </div> <div style="text-align: right;"> <p style="font-size: 0.8em; margin: 0;">OVEREXPOSED</p> </div> </div> <p style="font-size: 0.8em; margin-top: 5px;">As expected, the parliamentary elections strengthened the Abe government, and the fundamentals continue to improve.</p>
Emerging markets	<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;"> <p style="font-size: 0.8em; margin: 0;">UNDEREXPOSED</p>  </div> <div style="text-align: right;"> <p style="font-size: 0.8em; margin: 0;">OVEREXPOSED</p> </div> </div> <p style="font-size: 0.8em; margin-top: 5px;">The 19th Congress of the Chinese Communist Party did not spring any major surprises, and served to strengthen the current regime. We continue to take a positive view of the fundamentals for the medium term, in light of the growth in the region and the reforms under way.</p>
Convertibles	<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;"> <p style="font-size: 0.8em; margin: 0;">UNDEREXPOSED</p>  </div> <div style="text-align: right;"> <p style="font-size: 0.8em; margin: 0;">OVEREXPOSED</p> </div> </div> <p style="font-size: 0.8em; margin-top: 5px;">The European macroeconomic environment and the recent decision by the ECB should provide significant support. Third-quarter results have been largely on track and convertibles are attracting inflows again. We have regained our positivity on this asset class.</p>

FIXED INCOME

Rates	UNDEREXPOSED		OVEREXPOSED	The reduction in purchases announced by the ECB has had no impact on monetary policy expectations; very few rate hikes are anticipated in the coming years and an initial quarter-point increase is unlikely before 2019. The extension of QE reduces the possibility of a significant rise in interest rates in the short term. Nonetheless, the parameters that the ECB chooses for its future purchases (e.g. average maturity, deviation from the capital key) could have an impact on movements in the yield curve.
Country allocation	CORE		PERIPHERALS	The progress towards a new electoral law in Italy that will reduce the chances of a populist movement achieving power is good news for Italian government debt. However, the political tensions in Catalonia have yet to be resolved, and we are maintaining our cautious stance on Spanish government debt. Lastly, Portugal remains one of our main convictions: its economy has been on the up for several months and its debt rating is improving.
Inflation	UNDEREXPOSED		OVEREXPOSED	Despite the recent disappointment over October inflation figures in the eurozone, we shouldn't forget that underlying inflation has been gradually rising since the start of 2017. Moreover, the significant rise in the oil price (+22% since September) and the recent fall in the euro are positive short-term factors for inflation, and could also be extended to all mid- and long-term projections.
Emerging markets	UNDEREXPOSED		OVEREXPOSED	Although rates have been more volatile over the last two months, emerging market bonds remain attractive.
Credit	UNDEREXPOSED		OVEREXPOSED	The ongoing support from the ECB against a favourable backdrop in terms of corporate earnings and the economic outlook in the eurozone validates the strengthening of our conviction.
Investment grade	UNDEREXPOSED		OVEREXPOSED	A positive trend in Europe, together with a period of on-track results releases from European firms, as well as the reassuring message from the ECB with the extension of its bond purchasing programme, are important support factors for the IG segment.
Subordinates	UNDEREXPOSED		OVEREXPOSED	The asset class continues to offer an attractive risk/reward profile. European bank results are more than reassuring, and the final stage of Basel III (otherwise known as Basel IV) will have a longer implementation period, which should enable the banks to address their capital shortfalls.
High yield	UNDEREXPOSED		OVEREXPOSED	The 'macro' and 'micro' results continue to be extremely positive, as are the actions of the central banks and the technical factors: 1) default rates have fallen; 2) net issuance continues to be negative (more rising stars than fallen angels, and a large volume of refinancing as loans). Another important factor contributing to this rosy picture is the marked rise in the oil price.

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