MARKET INSIGHT

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MARKETS: WHAT IS THE OUTLOOK FOR Q3 2018?

Global economy remains on track in 2018-2019

Despite the relentless media hype focused on a downtrend in economic indicators, global growth remains on track for now and the IMF expects it to reach 3.9% in 2018, representing a modest annual improvement of 0.1%. The impact of US protectionist measures and the decrease in the positive contribution from expansionary fiscal policies in 2019 should, however, cap global growth at 3.9%. Furthermore, the ongoing monetary tightening cycle in the United States and the end of quantitative easing in the eurozone are expected to have a number of consequences – some unintended – for all asset classes.

While global growth was revised upwards in 2017, it is clear that this will not be the case in 2018. The blissful optimism at the start of the year has given way to a harsh reality check for certain regions such as the eurozone, Japan and emerging countries (chart 1). Cyclical indicators in the euro-area have decelerated from their Q4 2017 peak and have fallen short of economists' expectations since the beginning of the year. We can nonetheless expect a marginal improvement, or at least a stabilisation, in the coming months. China's central government continues to manage the country's growth effectively, and is working hard to curb the overheating in certain sectors such as infrastructure and real estate. The growth target of 6.5% should therefore be reached in 2018, mainly due to domestic consumption and investment expenditure. However, this target represents a decline from the previous year, which saw 6.9% growth.

In the context of downward revisions of growth outlooks, only the United States has emerged unscathed. The tax cut likely explains economists' optimism about the land of Uncle Sam, while the numerous political crises in the eurozone are no doubt behind the general pessimism about the region. Odds are, however, that this apparent disconnect will not last. US consumption could be adversely affected by more severe inflation, in particular as the recent rise in oil prices could shrink US households' purchasing power, and partially wipe out the positive effects of the fiscal stimulus on growth.

In addition to growth outlooks, inflation expectations are now a crucial variable in investment strategy. Are we seeing the end of the "Goldilocks" environment, i.e. benign inflation and moderate interest rates despite robust economic growth and low unemployment? Since the summer of 2017, core inflation in the United States has gradually increased to the point that it is now above the Federal Reserve's 2% target. Furthermore, the strength of this increase in inflationary pressures has caught economists somewhat by surprise. Outside of the United States, however, inflationary pressures remain feeble and are below forecasters' expectations this year. The divergence from the eurozone, where core inflation has remained stubbornly close to 1% for several months, is illustrative of this. We therefore do not believe that the scenario of runaway and uncontrolled global inflation is plausible, given that structurally deflationary factors, such as the advent of new technologies, the decline in global productivity and the ageing population, remain firmly entrenched in the current economy.

A prudent and opportunistic approach to equities is appropriate in the short term

Analysts expect US companies' earnings to grow by 22% this year, well above the rate expected in the eurozone (10%) and in emerging countries (10%). The flipside of the coin is that there is not an insignificant risk that these high expectations will disappoint and this figure could be revised downwards, particularly if analysts have to review their target prices based on a EUR/USD of 1.15 rather than 1.25. We are also somewhat cautious about the 10% growth expected in the eurozone this year, given how difficult it might be for the banking sector to deliver robust results, in what remains a very low European interest rate environment. This is compounded by slowing economic momentum and mounting political tensions. We therefore have good reason to be sceptical about the consensus for these two regions. As for emerging countries, earnings growth expectations have recently been revised down and are now converging with those of developed countries despite stronger economic growth. This is not particularly surprising in the end, given the strength of the US dollar, the increase in interest rates, and geopolitical tensions against the backdrop of a trade war.

From an absolute valuation perspective, US equities remain the most expensive, while Japanese and emerging equities are the most attractive. Nevertheless, adjusted for the growth expected over the next three years, US equities remain

attractive and have the most upside potential, according to our estimates.

Despite a positive macroeconomic surge and reasonable US equity valuations, an analysis of price dynamics and market breadth compels us to temper our optimism somewhat in the short term. Since 2016, the increase has been fuelled mainly by cyclical sectors and growth stocks, headlined by the technology and consumer discretionary sectors which have risen by 96% and 68% respectively since the last trough in February 2016 (chart 2). The impact of this phenomenon is that the US index has become highly cyclical, and the prevailing bullish trend is now overly dependent on two sectors and a few large-caps (Apple, Amazon, Google, Microsoft, Facebook). A sharp reversal of this momentum would thus put the bullish US equity trend at risk. Remember that the outperformance by cyclicals relative to defensives (chart 3) was accompanied by an increase in bond yields by way of a gradual rise in inflation and an acceleration in economic momentum. Given the high level of the latter and the demanding expectations for US growth in Q3, the catalyst for a potential correction could well be both fundamental and technical. Although the beginning of a sector rotation in defensive sectors is good news for the extension of the bullish trend, we believe that such a rotation will not be sufficient to keep the market on its upward trajectory given that defensive sectors now represent only 26% of the S&P500 index compared with 38% at the start of the bull market in March 2009.

From a technical analysis standpoint (S&P500 index), the long-term bullish trend of 2009, as well as the one of 2016, remains intact with breadth still robust, despite the broad sideways consolidation pattern that has developed since February. In contrast, the MSCI All Country World ex-US shows a bearish trend that has already breached various supports and levels that define the positive trend. At this stage, a further decline of about 5% is expected before any substantial rebound is likely to materialise. Given the potential short-term risks, we prefer to take a prudent stance. Nevertheless, any excessive weakness would be an opportunity that should not be missed.

Investment-grade bonds in the United States and emerging debt present opportunities

The opportunities offered by bond markets vary by geographic region and credit segment. At a time when the economic and credit cycle is already at an advanced stage, and while signs of an economic slowdown are projected to increase, we believe the Fed's scenario of five key interest-rate hikes by the end of 2019 is overly ambitious. We therefore think that most of the upward adjustment to rates all along the curve is behind us on the US market. That is also the message we are getting from the yield curve, whose slope is currently virtually flat and could invert within a few months. Therefore, while it is still too soon to definitively extend the portfolios' duration, we are relatively positive in terms of allocation (mainly US Treasuries) and currently prefer short- and medium-term maturities that offer a very good risk/return ratio.

As for US credit, we prefer investment-grade corporate bonds, whose spreads have widened since January, over the high yield sector which is expected to suffer in a more challenging macroeconomic environment with more restrictive financial conditions.

The situation is different in Europe, where the central bank has maintained its decidedly cautious stance. The ECB's asset purchases have kept yields artificially low, prompting us to shun traditional bonds (sovereign and corporate debtors) which offer virtually no protection against the higher yields we anticipate – especially as this purchase programme will end by December. We are instead looking to alternatives such as the Swedish market and subordinated financial debt which, despite its recent underperformance, has offered attractive returns with solid fundamentals since the numerous recapitalisations post the 2008 global financial crisis.

Lastly, we still like emerging market bonds despite their sharp drop this year, reflecting a combination of the rising dollar, US rates, increased risk aversion and specific crisis situations such as those in Venezuela, Argentina and Turkey. This decline also led to a readjustment of risk premiums, and valuations are particularly attractive, whether in terms of interest rates or currencies, most of which are now undervalued. We expect to increase our exposure to these markets, in local debt or hard currencies, but are waiting for the situation to stabilise, which could happen if the dollar falls further. The fundamentals of these countries are, moreover, considerably stronger than they were a few years ago (external balances, foreign exchange reserves, inflation control, growth momentum, etc.).

In the short term, many factors support the US dollar

Last year the market focused primarily on the dynamics of the expected economic growth differential on both sides of the Atlantic, which had strongly supported the euro against the US dollar. Furthermore, with Emmanuel Macron's victory in the French presidential election in May, the political risk premium has evaporated and the significant capital flowing into European equities supported the single currency. However, the fundamental and technical factors that drove the EUR/USD from 1.03 to 1.2550 reversed in favour of the dollar in first-half 2018, with 2018 growth expectations for the United States showing improvement in Q1, while expectations for the eurozone deteriorating. This reversal largely explains the downward adjustment of the EUR/USD this year. Much has been written in recent weeks about the political troubles in Europe, in particular with the establishment of a Eurosceptic government in

Italy, the ousting of Mr. Rajoy's Spanish government over corruption accusations, and disagreements within the German coalition on immigration policy. The political risk premium, which had declined sharply in 2017, has returned with a vengeance in 2018 and should, in principle, continue to drive the flight of investment capital from the eurozone and the negative sentiment regarding the single currency.

As for the interest-rate differential, which was a secondary factor in 2017 and recently reached new peaks (more than 2.5% for the 10-year and 3.2% for the 2-year), investors once again prefer the more attractive return on the dollar. The core inflation differential between the US and the euro-area has more than doubled in the US's favour since the summer of 2017 and remains above 1%. Our findings indicate that the impact will be felt on the EUR/USD with an approximate six-month lag, which supports a continued decline in the pair.

The positioning of speculators on the euro has also changed significantly in recent months. The market, which had shifted from an extreme short to an extreme long position in the space of a few weeks in 2017, adjusted in Q2 2018 with the unwinding of more than two-thirds of the net long positions taken since May 2017. Technical analysis shows that the long-term structural trend on the EUR/USD – which starts from the peak of 1.60 reached in April 2008 – remains bearish with the failure to continue to move above 1.2550. At 1.16, the EUR/USD is currently trying to find support on the trend line coming from lows of 1.03 but has already largely fallen below the 200-day moving average. We therefore believe that a further decline to 1.1450, or even 1.1190, is likely before we see a more substantial rebound.

Although the slowdown in global economic momentum remains marginal and corporate profits are still robust, the risks and uncertainties are piling up at an alarming rate. Tensions in global trade could, in particular, take a toll on confidence and the real economy. Against this backdrop, the addition of diversifying assets and active risk management remain the cornerstone of portfolio management.

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"In addition to growth outlooks, inflation expectations are now a crucial variable in investment strategy."

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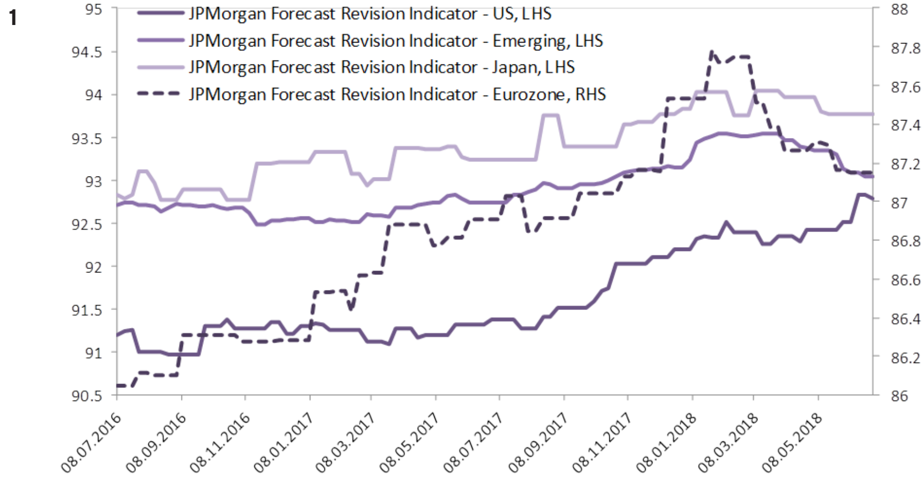

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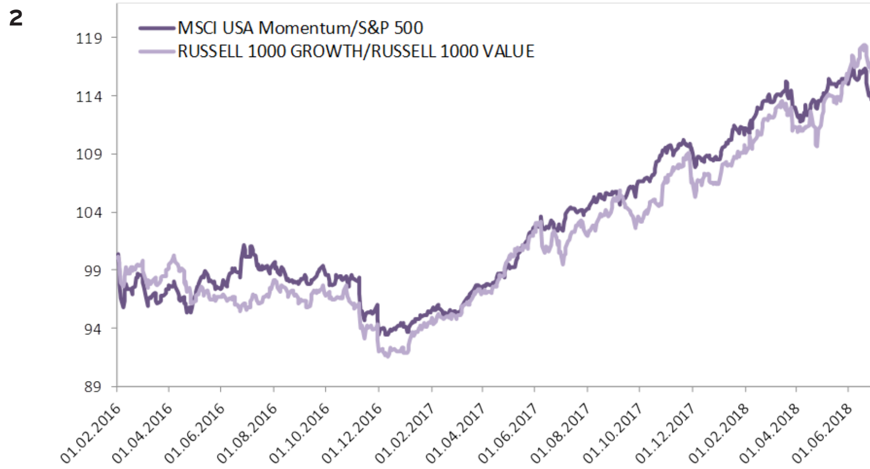

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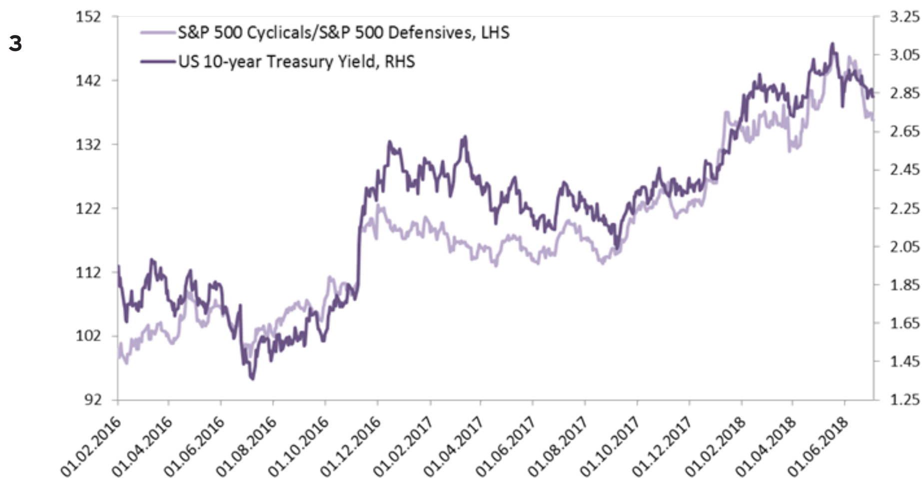

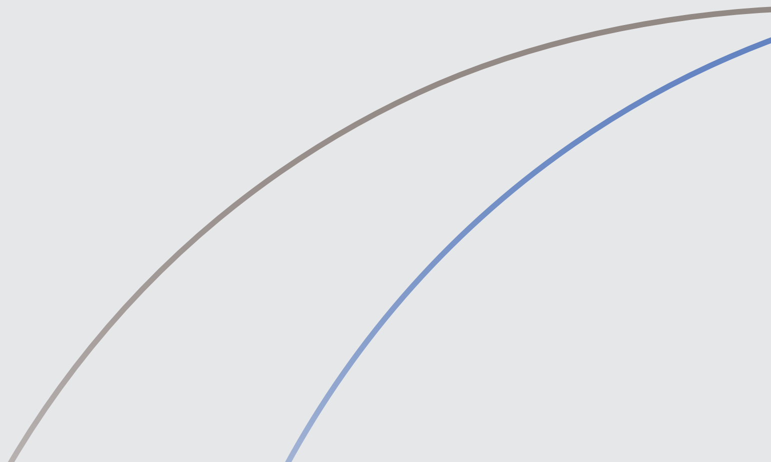

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