MONTHLY INVESTMENT OUTLOOK

March 2019

REYL
innovative banking

AT A GLANCE

- **Global macro-economic landscape keeps deteriorating.**
- **Cautiousness is warranted as equity markets are looking toppish.**
- **Both credit and interest rate risk look rich.**
- **EUR is held back by macro headwinds, but its resilience in this context is promising.**

	under-weight --	-	neutral =		+	over-weight ++
ASSET CLASSES						
		Equities				
			Fixed Income			
			Alternative Inv.			
				Cash		
GLOBAL EQUITY REGIONS						
			USA			
		Europe				
			Switzerland			
			Japan			
			Emerging Markets			
FIXED INCOME						
			US Government			
	EU Government					
				Inflation-linked		
				IG Credit		
		High yield				
			Emerging Hard CCY			
			Emerging Local CCY			
				SUB Financials		
FOREX						
				EUR/USD		
			GBP/USD			
		USD/JPY				
				XAU/USD		
		AUD/USD				

INVESTMENT INSIGHTS

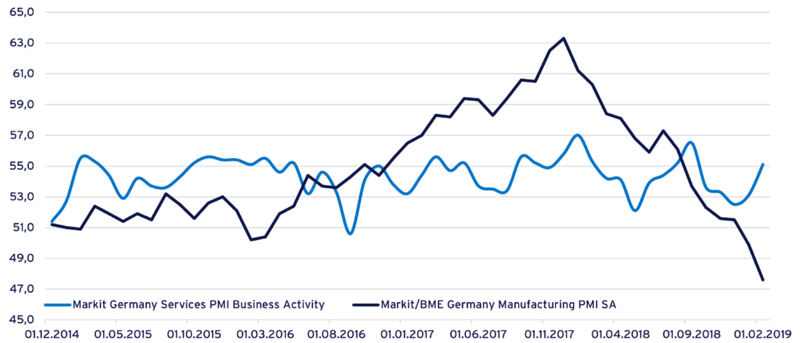
Are risky assets disconnected from fundamentals? At the end of February, global equities are up 11%, high-yield bonds surged by 6.26%, and the credit segment in its whole is enjoying solid gains on the back of spreads tightening. The U-turn in the Fed's monetary policy helped investors, lowering the probability of an imminent recession, restoring confidence, and sparking the current powerful rally in equities. Consequently, as earnings growth prospects have been revised down since the beginning of the year, the S&P 500 benefitted from a multiple expansion of 2.2 points, from 14x FW earnings at the Christmas Eve trough to 16.2x FW PE, back in-line with the 5-year average.

In the meantime, global economic indicators are still pointing to significant strains. China and Europe are facing a manufacturing recession, and are entering the contraction zone according to the latest PMI surveys which tumbled below the 50 mark. South Korea's economic activity or Baltic dry index prices, which are good proxies for tracking trade growth prospects, are also negatively oriented, emphasising that the global economic situation is still exhibiting numerous signs of slowdown. Why, then, aren't risky assets concerned by the deterioration of the manufacturing activity?

The resilience of the service component of the PMIs composite is one explanation. For example, German spreads between service and manufacturing figures reached 8 points (exhibit 1), highlighting an unusual divergence by historical standards. It means that despite some clear macroeconomic headwinds, the German consumer has not been impacted yet as it benefitted from the low unemployment rate, which translated into some wage increase. The second explanation justifying the current risk-on mood is based on the fact that financial markets are anticipating a better economic outlook for the second part of year. A potential trade deal between China and the US or a soft Brexit will obviously remove uncertainties and restore confidence among CEOs. Moreover, as European economic indicators are so depressed, economists' consensus reset their expectations to the downside, leaving some room for positive surprises.

However, in our opinion, this phenomenal comeback of risky assets is based on hope rather than facts. Therefore, we feel more comfortable maintaining a cautious stance in term of asset allocation with a mild underweight in equities as long as we do not foresee a clear improvement. The old financial adage "buy the rumour sell the fact" makes perfect sense after the current equity rally, and implementing cheap (low volatility) hedging strategies for portfolios seems appropriate right now.

EXHIBIT 1: GERMANY PMI MANUFACTURING VS SERVICES



THE QUOTE OF THE MONTH

"We are not predicting a recession, we are simply pointing out that we are conscious about the risks we bear."

Jamie Dimon
February 2019

EQUITIES

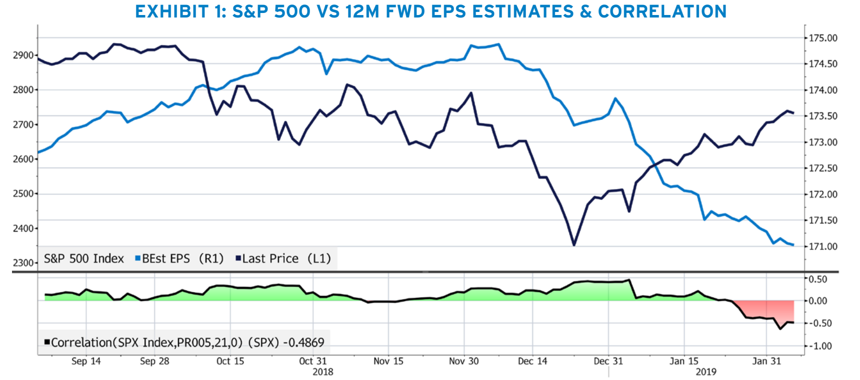
The start of the year in risky assets, and particularly in equities, is characterized by what we may call a “scissor pattern”. On one side we have global equity indices extending their strongest momentum rally in 40 years on the back of a more dovish stance from major central banks and hopes that President Trump and Xi Jinping will soon reach a trade deal. On the other side of the newsflow, we observe that the economic backdrop continues to deteriorate and the EPS revision trend accelerates on the downside in the US (exhibit 1). The S&P 500 was up 11.5% at the end of February, whereas 2019 EPS estimates fell from 7.4% to 4.1% during this period. Since we believe the downward EPS revision trend will carry on, we expect equity markets to catch-up on the downside and re-correlate with EPS forecasts.

In 2018 US earnings grew by 20% (15.7% sector median ex-energy) and revenue by 8.7% (8.3% sector median ex-energy). No sector posted negative earnings or sales growth, and net margins ended the year at 11.4%. Below the surface, however, data started to paint a less rosy picture. In Q4 2018, both the percentage of companies beating EPS estimates, and the magnitude of beat, were below the 5-year average. Looking forward, the Q1 2019 EPS estimates dropped sharply by 6.5% YTD and expected EPS growth is now negative at -3.2% y/y, the first negative growth estimate since 2016. What is astonishing is that after the Q1 setback, the consensus is again looking at slightly positive growth in Q2 (+0.3%) and Q3 (+1.9%) and growth surging by 8.5% in Q4.

We think the expected slowdown in real GDP growth in the US will have consequences for corporate topline growth and put pressure on margins (higher financing and labor costs), removing two key drivers of earnings growth. Slowing sales growth, higher costs, and tough y/y comparisons are making the 2019 earnings growth outlook uncertain. All in all, it seems to us that equity analysts are still too optimistic in expecting 4% EPS growth for this year. Given the large expected drop in earnings growth in Q1 2019, we believe subsequent quarters could also post negative growth, meaning that an earnings recession (two successive quarters of negative y/y EPS growth) is a possibility.

We remain underweight Europe ex-Switzerland since we find it difficult to be optimistic on European stocks before seeing the economy turning a corner and political risks abating. In the face of such strong headwinds, we feel like the attractive relative valuation is not enough to change our positioning. Global cyclicals are now overbought and we expect defensive stocks to start outperforming in the short-term.

EXHIBIT 1: S&P 500 VS 12M FWD EPS ESTIMATES & CORRELATION



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GLOBAL EQUITY REGIONS

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U.S. EQUITY SECTORS

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EU EQUITY SECTORS

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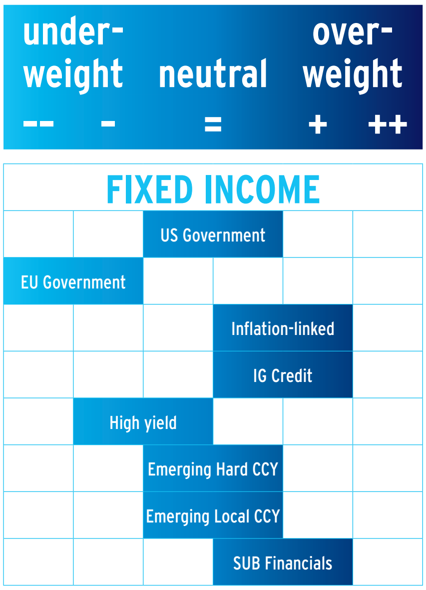
BONDS

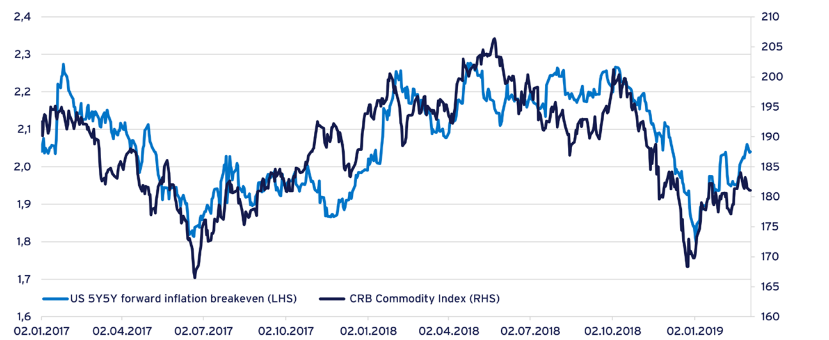


Risky assets have continued to post a remarkable rally in February, pushing YTD returns to levels which seem unrealistic when considered on an annualized basis (US High Yield +6.26% over 2 months for example). In the wake of strong equity markets, credit spreads have tightened further, a round trip back to levels not seen since the end of October last year, just before the sharp year-end correction. So was everything just a bad dream and is now forgotten? We believe there is still cause for concern, despite the fact that we don't advocate an expectation for a global recessionary scenario going forward. The current situation just seems too good to be true, and we can expect some clouds to come back to the minds of investors. Today's combination of very dovish Central Banks expectations, low volatility, low yields, easing financial conditions and strong risk appetite may be challenged sooner rather than later, as may a happy ending to the US-China negotiations, which largely seems to already be priced-in.

Admittedly, taking a microeconomic perspective, default rates projections remain low on a historical basis, and interest coverage ratios are comfortable. But corporate leverage remains elevated (particularly in the US Investment Grade sector) and earning are faltering. We must not forget that we are moving in a late-cycle environment, which is usually characterized not only by a growth slowdown but also by rising commodity prices. In that respect, the increase of oil and copper prices this year by almost +25% and +12% respectively is notable. This could be the source of the pain: rising inflationary pressures hurt corporates through higher input costs, which squeezes margins on top of already accelerating wages. Additionally, the renaissance of the inflation specter may awaken Central Bankers' willingness to tighten monetary policy further, especially if we witness some growth improvement in S2 this year after all the recent alarming signals.

This is clearly not what the market is pricing in right now. Higher yields and higher risk premia would be the price to pay, initially, in such a scenario. Who knows what the future may look like? Part of the answer is a thorough risk management of our portfolios, notably credit risk, and something tells us to start reducing it now. We sold our EM local currency bonds exposure this month – which appears to be a very consensual bullish call - and are preparing to take further steps in that direction.

EXHIBIT 1: US FORWARD INFLATION BREAKEVEN AND CRB COMMODITY INDEX



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FOREX

under-weight --	-		neutral =		+	over-weight ++

FOREX					
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Markets can't fight fundamentals for ever, but in the short-term they can focus elsewhere. In February, financial markets continued to price in a dovish Fed (with no hike expected in 2019 and an end to the Fed's balance sheet normalization in H2) and lower protectionist risks (US-China trade deal). This enabled the rally in risky assets to carry on despite the global macro backdrop continuing to point to a synchronized slowdown.

EUR/USD is slightly down YTD (-0.84%), with the price action stuck within the 1.1570-1.1234 range at the widest point. Despite narrower EZ-US yield spreads (exhibit 1) and tighter BTP/Bund spreads, the EUR has not succeeded in regaining ground against the greenback since November. Political uncertainties (Brexit, the yellow vest movement, EC elections) and equity outflows from European stocks are partially behind persistent EUR weakness, but we believe the main headwind to EUR strength remains the widening of the differential in consensus growth forecast between the Eurozone and the US (-0.13% YTD, table 1).

The Eurozone is feeling the pain of slowing global trade and falling exports to Asia, and is going through a large decline in manufacturing activity. This sharper and more protracted slowdown has alleviated the pressure on the ECB to normalize policy, leading to a more dovish monetary outlook. In the US, while the high inventory built-up should continue putting downward pressure on the economy in coming months, it is unclear whether the current US slowdown is only a soft patch or if it will be protracted and lead to the next recession. Given this macroeconomic environment we still believe the Fed will remain dovish, preventing US yields from substantially climbing and the greenback from strengthening further.

Despite strong macro and political headwinds, the resilience of the euro in the last three months shows that a lot of bad news is already priced in, and FX markets are starting to look through the short-term pain. Later this year, external headwinds from the China-US trade war are likely to abate, eventually boosting confidence and exports. Adding that political uncertainties should fade in H2, the wind could turn more supportive of EUR later in the year, hence our moderately positive outlook for EUR/USD. The bearish EUR positioning is a short-term supportive factor while the cheapness of the common currency remains a long-term support.

EXHIBIT 1: EUR/USD VS GR-US 10Y & 2Y YIELD SPREAD

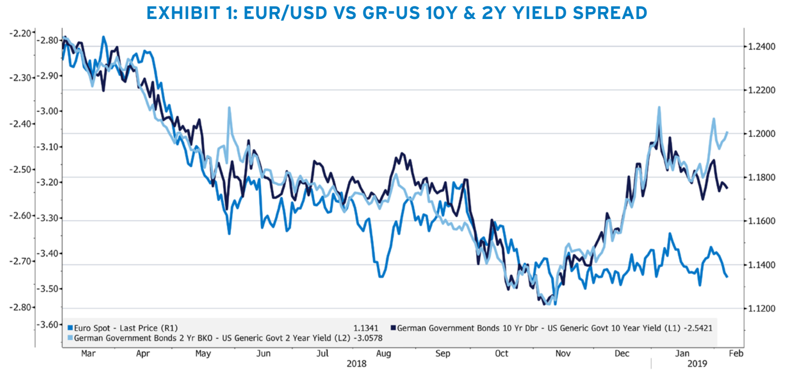

Table 1	31.12.2018	28.02.2019	Delta
EUR/USD	1.1467	1.1371	-0.84%
US 2y10y curve	0.20%	0.20%	0.00%
EZ 2y10y curve	0.85%	0.70%	-0.15%
10-year yield differential EZ-US	-2.48%	-2.53%	-0.06%
2-year yield differential EZ-US	-3.12%	-3.03%	0.09%
2019 GDP growth forecast EZ-US	-0.97%	-1.10%	-0.13%
Core inflation differential EZ-US	-1.28%	-1.05%	0.23%

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