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MONTHLY INVESTMENT OUTLOOK

October 2019

AT A GLANCE

- **Disappointing economic numbers keep rolling in.**
- **Negative earnings momentum continues.**
- **Reduce the credit risk duration.**
- **Increasing headwinds for the greenback.**

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

INVESTMENT INSIGHTS

The International Monetary Fund (IMF), under its new Chair Kristalina Georgieva, has slashed 2019 growth prospects to 3%, the slowest rate since the global financial crisis. Rising trade tensions and depressed manufacturing activity are the main culprits of the fifth straight 2019-growth downgrade by the institution. Given the state of the latest leading indicators (such as ISM surveys), which are still indicating an improvement, the downbeat revision did not come as a surprise. However, when digging into the details of the report, the interesting part comes from the positive effect of monetary stimulus. According to the IMF, global growth would be 0.5% lower in both 2019 and 2020 without such initiatives. Put it differently, this means major central banks have been successful in mitigating the negative side effects of tariffs hikes imposed by the US to China, hence acting as a counterbalancing force.

Will it be enough to avoid a global recession in the next six months? This is likely, but the probability of such a negative scenario has increased as the global outlook remains precarious given the high level of geopolitical uncertainties surrounding the world. In this regard, positive developments have emerged from the last meeting between China and US, with both parties agreeing to a (temporary) truce, which translates into a suspension of a subsequent tariff increase in October. Nevertheless, the deal is fragile and the reality is that the current situation has not changed from a couple of months ago because the only real positive news is the absence of further escalation. Ahead of the 2020 US election, President Trump might be forced to ease his rhetoric, as he cannot afford a US recession, which will ultimately lower his chance of a re-election. However, divergences between the two nations are still wide and filling the gap will not be an easy task.

Another source of uncertainty comes from the Brexit situation. The deadline is looming (31st of October) and based on the latest information, Boris Johnson has struck a deal with Europe. Final hurdle is a major one, as the UK Prime Minister needs to get the majority in the House of Commons. His Irish allies will likely not support the deal, hence reducing the chance to get a smooth Brexit.

A poor economic environment, coupled with negative world EPS growth and high geopolitical uncertainties did not prevent risky assets, namely equity indexes to climb the wall of worries, reaching 2019 highs. Even if positive outcomes such a Brexit deal or even a US China deal might materialize in the coming weeks, the risk/reward of chasing equities at current levels is not attractive, particularly given the high valuation level, entering the expensive zone, like in April and July 2019.

THE QUOTE OF THE MONTH

"In 2019, we expect slower growth in nearly 90 per cent of the world."

Kristalina Georgieva,
IMF Managing Director
October 2019

EQUITIES

We continue to see the balance of headwinds vs tailwinds as negative for equity markets as the global economic backdrop and earnings growth worsens and as the downward EPS revision trend continues. Profitability seems to have peaked and valuation is on the expensive side in the US. As for the central banks' part, we tend to believe that cheap money and lower for longer rates are already largely priced into current valuations.

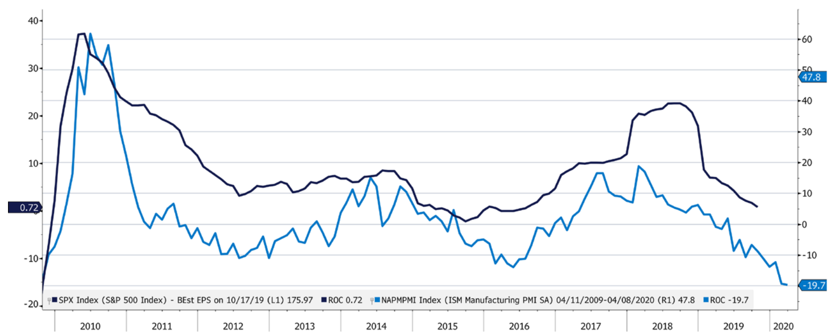
In light of the recent sharp deterioration in US manufacturing activity, and given the close relationship between rolling 12-month estimated EPS growth and ISM manufacturing momentum (c.f. exhibit 1), the negative earnings revision trend is expected to continue. Given these headwinds, however, the resilience of the S&P 500 has been remarkable. Some attribute this resilience to renewed global financial repression pushing investors into equities that, in most developed regions, offer a more attractive yield for a more reasonable valuation than bonds (based on risk premium models).

The dichotomy between the trend in macroeconomic momentum and the outlook for earnings growth remains wide as experts continue to expect EPS growth of 10% for 2020 and 2021 in the US. Certainly, this is not new as analysts are usually too optimistic at the start of the year, and spend the rest of the year revising down their growth assumptions. In our opinion, this optimism will weigh on sentiment and drag indices lower when analysts start to downgrade their 2020 EPS growth forecasts.

Consensus expectations for the upcoming earnings season is quite grim with a 4.1% y/y decline for Q3 2019. If these forecasts do materialize, it will mark the first time the index has reported three straight quarters of y/y earnings declines since the Q4 2015 - Q2 2016 period. For the whole year 2019, consensus remains positive, but barely, with 1.2% EPS growth. EPS for the Information Technology sector is expected to report the second highest y/y earnings decline of all eleven sectors at -10.2%. (source Factset). This is critical since Information Technology is the largest sector and has been the clear leader of the bull market for years now. However, there are two silver linings: 1) Softwares and Services are expected to grow EPS by 8% and 5% respectively in Q3, and together they account for 55% of the sector and 12.2% of the S&P 500; 2) for the whole year 2019, EPS growth for the IT sector should not decline and finish flat.

In the short term we believe the upcoming earnings season will be shaky, as we expect that negative surprises, or even just the hint of, will be sharply sanctioned (for example Fedex, Micron).

EXHIBIT 1: S&P 500 12M FWD EPS GROWTH VS ISM MANUFACTURING (6M LEAD)



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under-weight | neutral | over-weight

-- | - | = | + | ++

GLOBAL EQUITY REGIONS

		USA			
	Europe				
		Switzerland			
	Japan				
	Emerging Markets				

U.S. EQUITY SECTORS

				Healthcare	
		Industrials			
		Financials			
			Energy		
		Cons. Discret.			
	Cons. Staples				
			Technology		
		Utilities			
		Comm. Services			
Materials					

EU EQUITY SECTORS

		Healthcare			
		Industrials			
Financials					
			Energy		
	Cons. Discret.				
				Cons. Staples	
			Technology		
			Utilities		
		Comm. Services			
Materials					

BONDS

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

FIXED INCOME

		US Government			
	EU Government				
		Inflation-linked			
	IG Credit				
		High yield			
			Emerging Hard CCY		
	Emerging Local CCY				
			SUB Financials		

The credit cycle is aging. This may sound commonplace , after one of the longest periods of economic expansion on record (123 months in the US), underpinned by unconventional policies from Central Banks. Still, clouds have accumulated on the horizon to a degree we believe should warrant more caution looking forward and a rethink on the fixed income positioning. The "financial repression" engineered since the global financial crisis by monetary authorities including asset purchases has pushed investors down the credit curve, in order to try to get decent above-inflation remunerations on their fixed income investments. These forces have driven down both yields and spreads to stretched levels, and flattened the curves extensively. The resulting credit risk compensation looks poor now, especially at a stage where the weakening economic background, political uncertainties together with deteriorating corporate fundamentals may start to affect the sector more pronouncedly. Earnings have already been under pressure for several quarters now.

In fact, it is the Investment Grade (IG) segment which we find the most expensive, having posted a +13% performance YTD. The credit curve is now flat: the average yield of the 5-7 year US corporate index stands at 2.68%, against 2.20% for the 1-3 years segment. The tiny +0.48% difference looks tight on a historical basis, still close to the ten-year low of 0.37% last August. This is only the additional remuneration you get for almost tripling your duration risk. Not a great deal... More worryingly, looking at the US corporate market as a whole, the "breakeven spread" (spread / duration) is only 15bps, meaning that spreads widen by this amount you lose your additional carry above a risk-free credit exposure of the same duration. Definitely not a high security margin, for investing in a market where the corporate leverage has steadily increased and which is now composed of more than 50% of BBB rated bonds. Remember that spreads tend to widen during monetary policy easing cycles.

So how should investors position themselves now? At this stage of the cycle, we believe it is wise to reduce the credit beta and to favor carry strategies with shorter-term durations. We took profit on our relatively long US IG exposure to refocus on more high-yield tilted investments, and emerging markets names. Not that we particularly want to decrease the credit quality, but we think there are still more comfortable risk-adjusted remunerations in these sectors, if you avoid both the lower quality area and long maturities. We see stronger headwinds for 2020 but we believe the storm is not an immediate threat. And we see long duration in the risk-free space as the best diversifier against a spike in risk aversion!

EXHIBIT 1: US IG CORP INDEX YIELD DIFFERENTIAL 7-5Y VS 1-3Y

FOREX

	under-weight --	-	neutral =	+	over-weight ++
FOREX					
EUR/USD			EUR/USD		
GBP/USD			GBP/USD		
USD/JPY		USD/JPY			
XAU/USD				XAU/USD	
USD/CHF			USD/CHF		

Recent developments and macro data should have been negative for the US dollar. First, the global slowdown in manufacturing has caught up with the US economy, as recently evidenced by the sharp drop in the ISM manufacturing. More importantly, we also see early signs of a potential spill over in the services sector that will inevitably increase the odds of a US recession and thus put a brake on the greenback. So far, the impact of the trade war has not yet passed through to American consumers as sentiment remains elevated, but we remain alert to any sign of slowdown in US consumer spending. Nevertheless, the last two ISM readings mark, in our opinion, the end of the US macro exceptionalism that supported the dollar throughout 2018 and H1 2019. Second, domestic politics with the launch of an impeachment inquiry is expected to somewhat weigh on dollar strength, at least against other safe haven currencies. Third, the EZ-US interest rate differential, particularly in the 2-year bucket, narrowed substantially which theoretically bodes for a higher EUR/USD.

However, market participants did not really follow this playbook as the dollar index recently posted a new high. Despite all the headwinds accumulating, the dollar remains stubbornly resilient. Why? Our understanding is that the US dollar is being torn apart between the drag of domestic cyclical headwinds and the support of global macro uncertainties, both economic and geopolitical which sustain USD demand via the sentiment channel. As for the EUR part of the equation, it remains dragged down by the prolonged slowdown in manufacturing activity and anchored by negative interest rates. Even though pessimism is largely built into current prices, we do not see any reason to become more optimistic yet. Therefore we remain neutral EUR/USD even though a temporary undershoot below 1.09 remains a possibility in the short term.

The intensification of global cyclical drags keeps us defensive and we continue to favour defensive currencies, particularly the Japanese yen, and gold. Even more though in the context of a multi-asset class portfolio as we deem there are still benefits to holding onto JPY long exposure as a hedge against the risk of higher risk asset volatility. Based on the correlation between gold and JPY (c.f. exhibit 1), USD/JPY should trade lower and we keep our moderately bearish view for USD/JPY. Speculators have increased their positioning to net long, the most since Q4 2016 with plenty of room before the positioning becomes stretched. As the cycle matures, we expect US yields to remain under pressure and equities to struggle - both factors that are strong supports for the Japanese currency.

EXHIBIT 1: JPY/USD (LHS) VS GOLD (RHS) AND 6M CORRELATION

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