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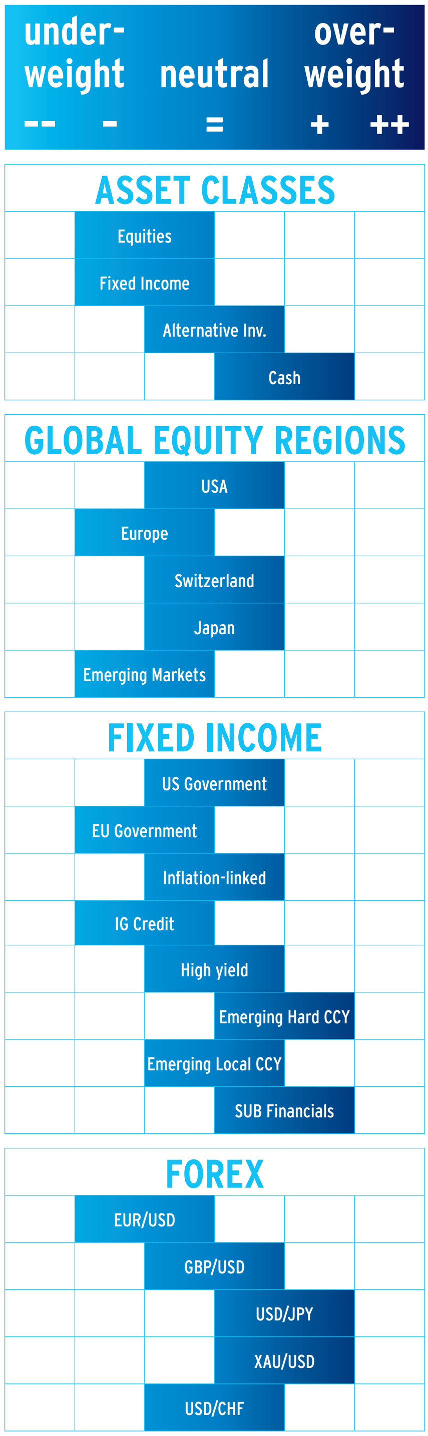
MONTHLY INVESTMENT OUTLOOK

February 2020

AT A GLANCE

- Too late to chase risky assets when euphoria is looming
- US equities reached 2000 valuations on some metrics
- Long rate duration continues to pay
- The US dollar surged in the wake of the COVID-19 outbreak



THE WRITING OF THIS ANALYSIS WAS COMPLETED ON 21 FEBRUARY 2020.

INVESTMENT INSIGHTS

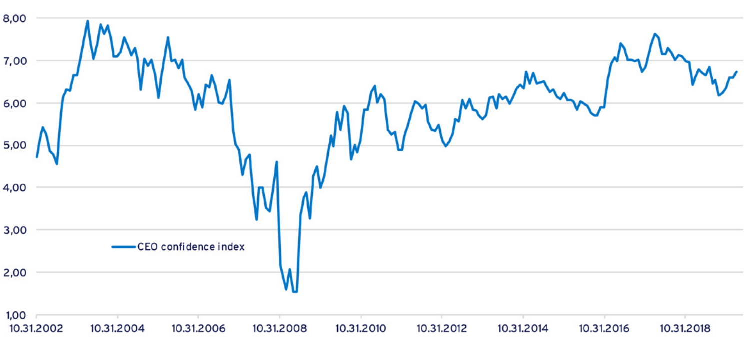
The coronavirus (COVID-19) outbreak was not strong enough to break the upward trend in risky assets. The S&P 500 is already up 4.5% in 2020, with the technology sector enjoying even stronger returns, crossing the 10% mark in only 45 days. Equity markets appear to be swiftly digesting any bad news, whilst focusing only on good news, thus getting ahead of themselves. According to our analysis, equity markets are too complacent, even euphoric we might argue, as investors are ignoring risks (put/call ratio reached very low level) and piling into equity funds, whereby the total amount collected reached USD 51 billion in 2020 (or topping USD 400 billion on an annualised basis). Whilst we acknowledge that markets are forward looking, they are betting on a sharp recovery in the global economy for the subsequent quarters (Q2 or Q3) after a potential disappointing Q1. The main issue is that the world economy has already been facing a sharp slowdown in key segments, such as manufacturing.

Therefore, the outbreak is adding to fears that the highly expected rebound in economic activity, called a "mini reflation cycle" by some market pundits, will not take place. This is likely to further undermine CEO's confidence, which was finally turning North after trending lower for 19 months (see exhibit 1).

As we are currently entering unchartered territory about the potential economic impact of the COVID-19 outbreak, it is wise to adopt a relatively defensive positioning in equities in the short term, combined with some safe haven assets such as gold and US Treasuries. Moreover, and while US assets (equities, credit and the US dollar) look expensive, they should keep outperforming as long as we do not see any evidence that the spread of COVID-19 outbreak is finally contained on the wake of strict quarantine measures. The US economy is relying on domestic consumption, the biggest GDP growth contributor, which is relatively immune to any slowdown in the Chinese economy. On the contrary, Germany will not be shielded in the same way from the Chinese economic woes, and should expect to endure more pain in the coming weeks.

Whilst we are not willing to chase equity markets at current levels given the uncertainties surrounding the COVID-19 outbreak, we believe that some opportunities might arise later as liquidity injections and government stimulus (notably in China and Japan) begin to offset the negative economic momentum that is taking place in the short term.

EXHIBIT 1: CEO CONFIDENCE



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THE QUOTE OF THE MONTH

"... the virus, they're working hard, looks like by april, you know in theory when it gets a little warmer it miraculously goes away."

Donald Trump

EQUITIES

Equity indices have resumed their upward path in February, ignoring the risks associated to the COVID-19 outbreak. Supply chain disruption is damaging production capacities, forcing companies such as Apple to issue a profit warning as Q1 2020 revenue targets will not be reached. In the short term, other companies will spread this kind of negative news, undoubtedly.

As long as uncertainties around the outbreak do not dissipate, it is almost impossible to make an accurate forecast about the earnings growth in 2020. Nevertheless, adopting a conservative approach when trying to assess the potential growth seems appropriate. At the time of writing, sell-side analysts' consensus is still expecting a decent 8% EPS growth for both European and US companies. We are not convinced and believe that even if the best-case scenario materialises (i.e a sharp rebound from Q2 onward), meeting these forecasts would be a challenge.

Along with the risk of disappointing earnings, P/E trailing valuations for the S&P 500 are becoming very expensive, above their long-term average (exhibit 1). However, some market pundits have argued that we are still far from the levels reached in 2000. Whilst we could not discard this statement, we have noted that different valuation metrics, such as the EV/EBITDA, are already close to the technology bubble level, and are therefore offering a different picture (exhibit 2). Why is there such a divergence? We found two explanations. First, under Trump's presidency, tax cuts have significantly boosted net income, increasing by 23% between 2017 and 2019. In the same period, aggregate EBITDA for US companies rose by 15%, a slower pace than the net profits. Secondly, US companies have been very active in purchasing their own shares (buybacks), artificially lifting earnings per share (key component of the P/E ratio) while issuing new cheap debt, in turn increasing the Enterprise Value (EV)*.

Beneath the surface of expensive, but not extreme, P/E valuations, lies a reality: US companies are capitalising on their astute financial skills to lift profits at the expense of new investments. Therefore, "real economic profits" are in reality much lower than they appear to be. Nevertheless, as long as central banks' liquidity injections are feeding the system, equity valuation can potentially expand further. In these market environments, we need to be agile by finding the perfect trade-off between riding the current equity bull wave without taking too much risk, as the elastic is getting stretched to breaking point.

**EV = market cap + total debt - cash*

EXHIBIT 1: SPX Index: EV/EBITDA (Trailing 12M)

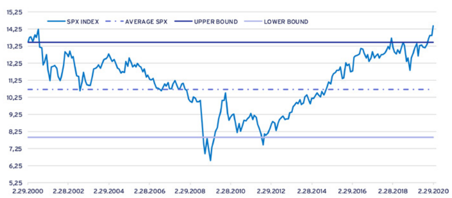
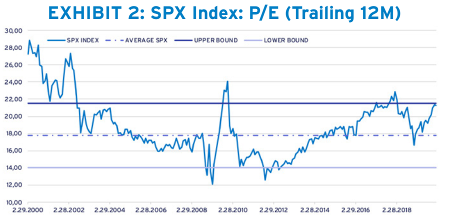


EXHIBIT 2: SPX Index: P/E (Trailing 12M)



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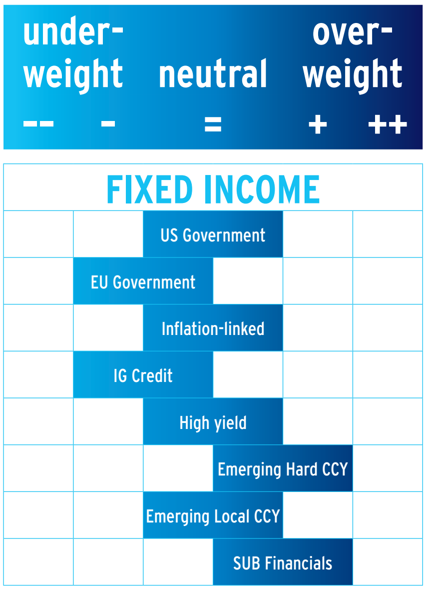
BONDS



The beginning of 2020 is bringing its fair share of surprises; the COVID-19 virus outbreak being a major one, and whilst forecasting its progression and final severity is a perilous exercise, it is obvious that its impact on global economic activity will be severe. It has come a bit as a grain of sand in the gears of the global economy, at a time when the massive liquidity injections by major central banks over the last twelve months had finally started to take effect. The main macro indicators have been bottoming out recently, notably in Europe. Global markets have been quick to embrace this promising scenario of recovering growth with no recession in sight, to a point where many signs of euphoria have appeared when looking at the ascension of risky assets.

The announcement of the coronavirus outbreak last month should have compromised this rosy scenario and tempered investors' exuberance. This was indeed the case, but the correction posted by markets was really short-lived: around ten days after the first market reactions, the major equity markets in the US and Europe have posted historically new highs, whilst credit spreads are nearing the pre-global financial crisis low points as the belief of containment and resolution remains strong. Paradoxically, core developed market's nominal yields have not climbed and remain at floor levels, anchored of course by extremely accommodative monetary policies of central banks across the globe. Alongside this, low inflation expectations and zero to negative real yields levels typically reflect gloomy economic prospects...

Between the two diverging messages of credit bonds and government bonds, which is the most credible? It is clear that both camps' valuations are distorted by central banks' policies and purchase programmes, which makes this interpretation more complicated. As a result, risk premia are depressed, and the security margin very thin, in our opinion. So, which assets should be privileged in such a context? We think that diversification here is paramount, and therefore keep our positioning combining short-term high-yielding credit bonds with a core long duration exposure (US Treasuries), as both positions' negative correlation improve the stability of a portfolio in uncertain times, while delivering a positive carry. Still, we acknowledge the asymmetric balance or risk at this stage of the cycle, and therefore contemplate reducing credit risk in the near future.

EXHIBIT 1: US 10y Treasury yield (inverted) vs spread diffrential B-BBB rating

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FOREX

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

FOREX				
--	-	=	+	++
	EUR/USD			
		GBP/USD		
			USD/JPY	
			XAU/USD	
		USD/CHF		

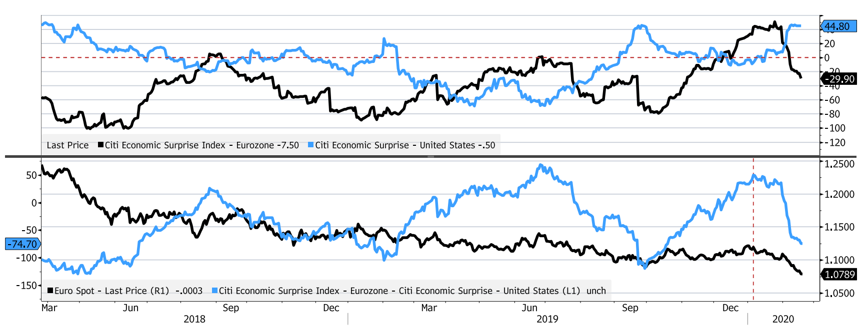
The dollar index already climbed more than 3% year-to-date, despite the consensus of FX pundits being bearish on USD for 2020. To be fair, the main driving force behind such a powerful move was unexpected as it lies with the outbreak of the COVID-19 virus. The expected economic fallout from the virus exacerbated relative economic performance expectations in favour of the US and the greenback. As Europe is more exposed to a Chinese downturn than the US, growth forecasts should be revised downward by a larger magnitude in Europe, thereby supporting the US dollar. In this growth-focused environment, as has been the case for some time now, interest rate differentials continue to take a backseat on main G10 pairs, as price action is uncoupled from the trend in relative carry.

This shift in relative sentiment regarding the Eurozone and US economies is clearly visible in the Citi economic surprise indices (c.f. exhibit 1). Since the end of January, US economic surprises have surged while Eurozone economic surprises have plunged, thereby narrowing the spread in favour of the US and dragging EUR/USD lower than the obvious support at 1.0880. Pessimism on EUR/USD can also be spotted in the option market as risk reversals are now negative on a one, three, and six-month horizon. The corollary of more upbeat sentiment for the greenback is that speculators (from IMM data) increased their long USD by USD 7.5 bn over the last month (from 6.66 bn in mid-January to 14.14 bn in mid-February). USD speculative positioning seems to have bottomed-out and there is still plenty of room to further increase longs, hence providing another potential support to the dollar. We downgrade EUR/USD one notch as we believe it will undershoot.

Despite the market already being (very) long GBP, pound crosses reacted positively to the resignation of Chancellor Sajid Javid, an event that prompted expectations of more fiscal accommodation in the UK Budget. For the BoE, the market is now pricing only 0.74 of a 25 bps cut for 2020 vs 1.35 at end January. However, for the time being, we remain neutral on the cable as we think that Boris Johnson is unlikely to seal a trade deal with the EU before the end of the year, given the complex nature of the task at hand and the fact that we do not expect him to adopt a more conciliatory stance.

USD/JPY has been surprisingly resilient as of late, de-correlating with risk aversion and yield differentials. It seems that portfolio outflows from Japan, particularly into foreign bonds, is a headwind to JPY appreciation. We downgrade JPY vs USD but maintain our neutral stance vs EUR, as JPY remains a good portfolio hedge.

EXHIBIT 1: EUR/USD vs Spread of Eco Surprises



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