BANQUE
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QUARTERLY OUTLOOK

4TH QUARTER 2020

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1. EDITORIAL

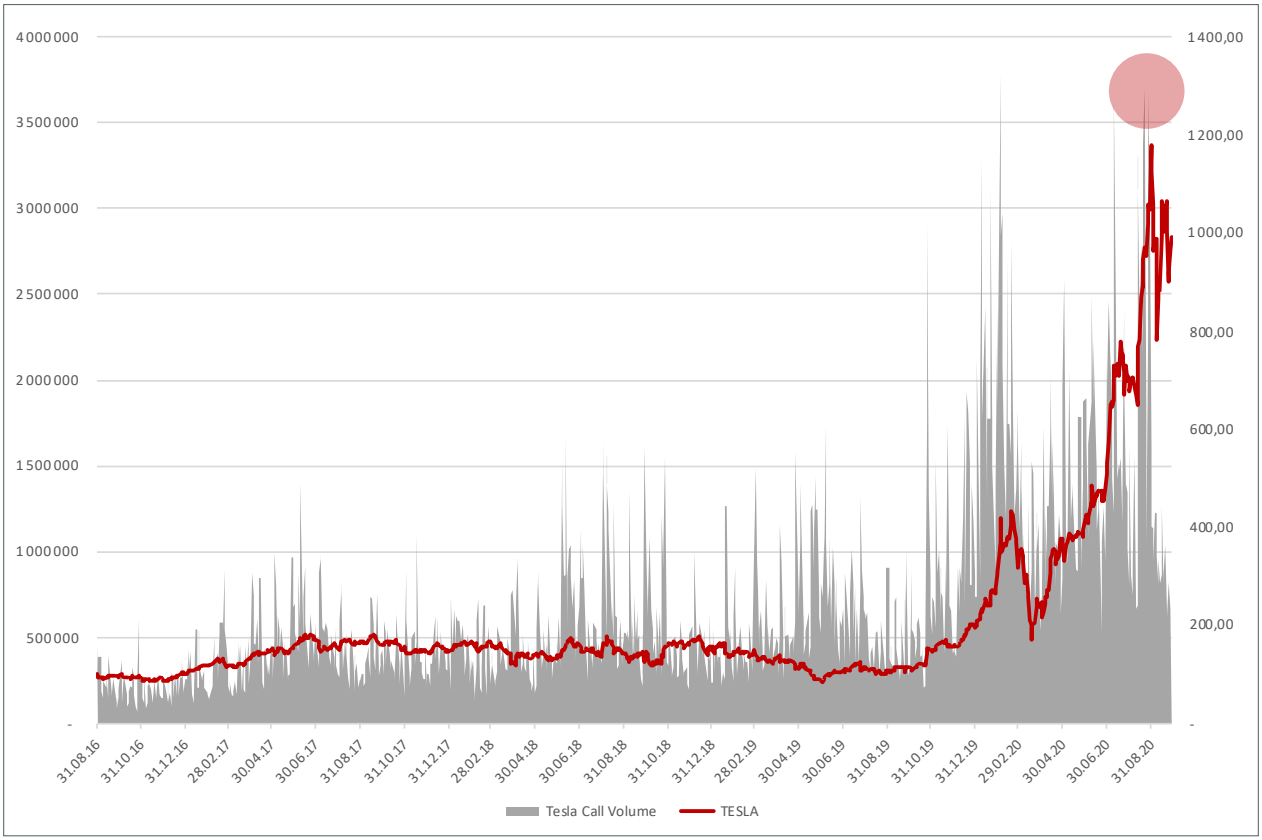
SUDDENLY, LAST SUMMER.

Stock market records in August, record temperatures in September, quite a summer in 2020!

And yet in financial markets the season had got off to a quiet start. The month of July was fairly calm for equities, digesting, as it were, the strong post-Covid rebound period. And then August arrived, and exacerbated enthusiasm for technology stocks caused markets to surge: the Standard and Poor's Index rose 7.2%, in its best monthly performance since the 1930s! The MSCI World Index gained 6.4%, posting its best month since 1986. And there are plenty more examples. Massive purchases of technology stocks went hand-in-hand with heavy buying of options. Call volumes were 40% higher than average, and the flows were powerful enough to worry and sometimes create problems for market makers. During one specific period, Tesla rose more than 10% day after day and market caps of significant size could gain 25% on the "mere" publication of far higher-than-expected earnings. (Salesforce gained 25% on Wednesday 26 August, admittedly on the back of a 22% year-on-year rise in expected calendar year earnings).

It is not so much the economic situation that changed during the summer, but rather the sentiment and positioning of market participants.

GRAPH 1 : TESLA SHARE PRICE REBASED & TOTAL CALL OPTIONS VOLUME



Source : Bloomberg, Banque Eric Sturdza, Tesla share price base 100 in August 2016, 28/09/2020

Everything that is excessive is insignificant, according to Talleyrand, but in the stock market this saying could be rather the opposite. What can explain such a summer market rally when the pace of macroeconomic improvement that began in early spring stayed on path without any particular acceleration? We had not anticipated this, and the ex-post explanation matters little, unless it gives us some keys to what follows.

Many commentators speaking of these stock market records mentioned the enthusiasm of US retail clients. These clients have acquired a taste for rapid stock market trades facilitated by the now famous Robinhood website, which permits and encourages low-cost speculation. With more than 12 million clients and an estimated worth of around $11 billion (the market capitalisation of Société Générale!), there is no doubt that the company has found its public! And this public played a role in the recent rise. But retail investors were not the only ones - far from it – to trigger this rally (we know, for example, that Softbank was also a massive buyer). Whereas the rise in the spring took place in a mood of great scepticism (bulls were in the minority compared with bears), the second part of summer saw a radical change in sentiment.

It is not so much the economic situation that changed during the summer, but rather the sentiment and positioning of market participants. These turnarounds are factors of market vulnerability: markets are now more sensitive because exposure is higher. Accordingly, in early September we rolled our equity hedges. Since then, the faster increase in Covid-19 cases and fears of a "complicated" US election which could result in a deadlock have validated this renewed caution. But we will still be only moderately cautious, because our core scenario is still one of macroeconomic improvement and a highly accommodative central bank that is swift to counter excessive pessimism.

2. FOCUS ON US ELECTIONS

WHAT IF?

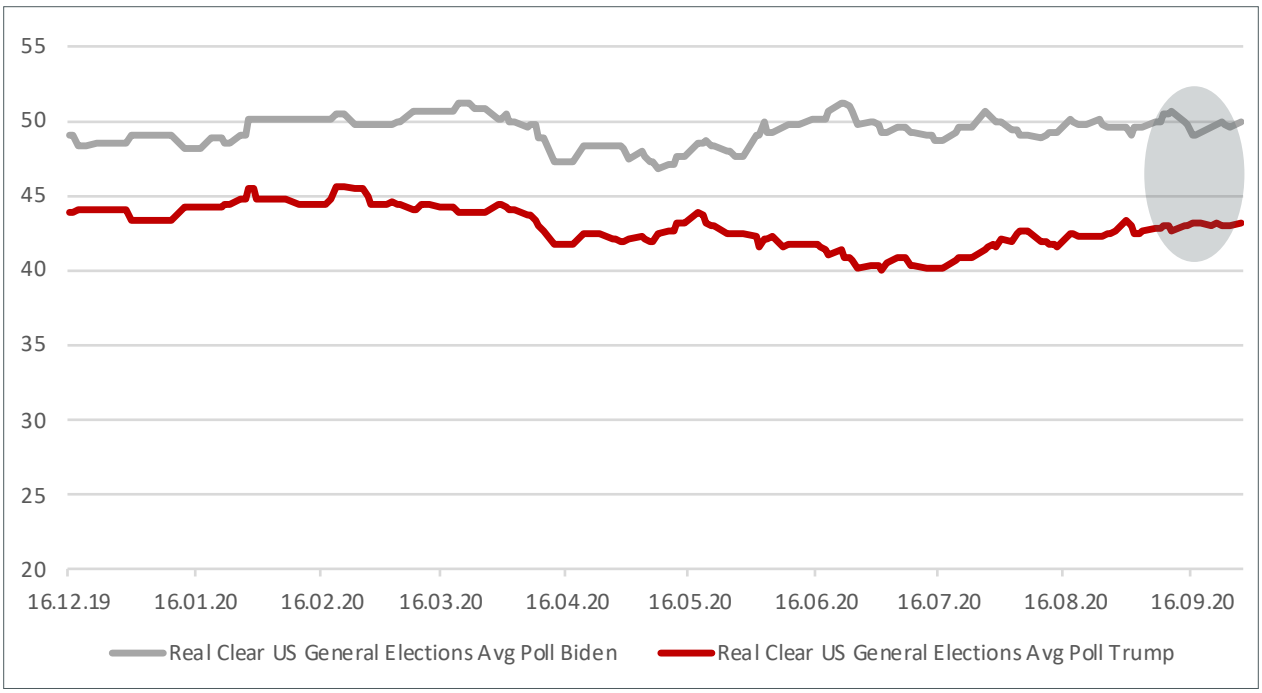
This is probably THE question on investors' minds, since 2020 proved to be a year rich in events that were considered unimaginable: a synchronised shutdown of the global economy in March, an economic recession matched only by that of 1929, unprecedented liquidity injection by central bankers, a negative WTI oil contract, Germany's conversion to fiscal stimulus and Donald Trump's one to a Universal Basic Income, and also the US stock markets making new highs just a few months after this crisis.

In these circumstances, and even when the Covid-19 epidemic has not yet been snuffed out and a second wave threatens Europe, it is in the end not so surprising to learn that the main concern of major institutional investors is the presidential election and its potential implications.

It is true that these elections which will take place on 3 November 2020 have significant implications for the world's largest economy: US citizens will be voting for their president but will also renew the House of Representatives, one-third of the Senate and eleven State Governors. The Republicans led by Donald Trump will be up against the Democrats led by the Joe Biden/Kalama Harris ticket.

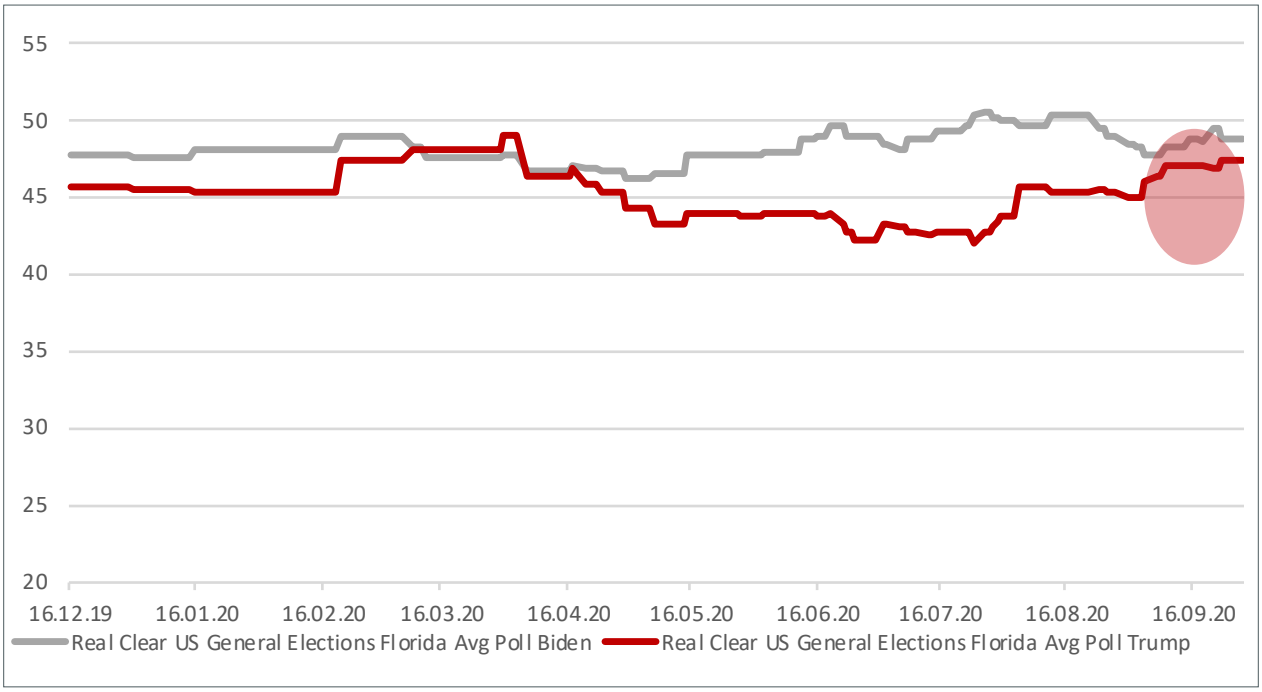
At the time of our writing this, Joe Biden has a comfortable lead over Donald Trump in the election polls, by 6% to 8% in the case of the popular vote (see Graph 2). These figures could suggest that, barring a last-minute surprise, the election is already settled, but the special features of the US ballot system make analysis of the data more tricky. The citizens elect members of an Electoral College who themselves choose one or the other candidate based on the result of the popular vote. In the great ma-

GRAPH 2: US PRESIDENTIAL ELECTION - NATIONAL AVERAGE POLLS



Source: Bloomberg, RealClear Politics, Banque Eric Sturdza, 28/09/20

GRAPH 3 : US PRESIDENTIAL ELECTION - FLORIDA AVERAGE POLLS



Source: Bloomberg, RealClear Politics, Banque Eric Sturdza, 28/09/20

jority of states, a "winner takes all" approach prevails, which explains how a presidential candidate can win the popular vote and lose the election, Al Gore and Hillary Clinton being the most flagrant examples of this.

Out of an Electoral College of 538 electors, then, 270 are needed to win the election. This electoral mechanism has the effect of attenuating any advantage that Joe Biden might have in the popular vote and heightening the importance of the "swing states" (ex. graph 3), which could potentially switch from one side to the other, where the gap is less than 3%, i.e. within the margin of error generally accepted by pollsters: Arizona (11 votes, advantage Biden), Iowa (6, advantage Trump) Florida (29, advantage Biden), Georgia (16, advantage Trump), Ohio (18, advantage Biden), Michigan (16, advantage Biden), North Carolina (15, advantage Biden), and Pennsylvania (20, advantage Biden). There are therefore around 131 electors that could swing to one side or the other.

In these circumstances, Joe Biden's advantage in the Electoral College seems more limited than in the popular vote, and the last days of the campaign could prove decisive, in particular the television debates scheduled for 29 September and 15 and 22 October. Given the apportionment of electoral districts and the record of the Trump administration especially with regard to management of the Covid-19 crisis, barring a last-minute surprise the House of Representatives should stay in the Democrats' hands.

On the other hand, the battle for a majority in the Senate could prove far more closely contested. Of the 35 seats renewed, 23 are held by Republican senators (the current majority), who therefore have most to lose in this election. Given the seats already acquired, the strong lead of certain candidates, and the latest election forecasts (source: 270toWin), the balance of power between Democrats and Republicans seems fairly evenly balanced at present (48 seats each). Four senatorial elections (Maine, Montana, North Carolina and Iowa) will probably be key and will be fiercely disputed. The Vice-President, due to his position as President of the Senate, has the deciding vote in the event of an evenly split Senate.

So there is therefore a significant probability that the future man in the White House will inherit a form of divided government, which is a classic feature of American political life. This has been the case for Trump in the second half of his term of office, and was also the case for Barack Obama during six of his eight years in power. The polarisation of American political life has tended to make these periods more sterile, but they are not a game changer for the country's political and economic life. The only scenario that could prove problematic for Donald Trump if re-elected would be one in which the Democrats gained complete control of Congress, leading to a revival of impeachment proceedings.

From this viewpoint, the presidential election has rarely been a decisive factor in the long-term economic cycle. The presidential cycle can amplify or slow down the economic cycle, but it does not drive the cycle. However, it could just be said that the election sequence can be a source of volatility that the discerning investor will try to profit from. **The real risk factor for US assets from this viewpoint would be disputed and uncertain election results,** which could affect consumer confidence, complicate bipartisan agreements, question the faith in US institutions and require an adjustment of the risk premium.

Admittedly the soil is fertile. Bear in mind that when questioned as to whether he could commit himself to a peaceful transition, Donald Trump was non-committal and on several occasions expressed his distrust of postal voting.

This, moreover, is one of the issues in this poll, because due to the Covid pandemic postal voting will probably play a greater role, and as a consequence in some states it will be difficult to determine the winner on the day after the election. Note that the election code and practices specific to each state govern any appeals and recounting of votes. **The spectre of 2000 looms, when the Supreme Court had to act as final arbitrator.**

Note that, having appointed two conservative judges and potentially a third one between now and the election, Donald Trump has an advantage here, at least from an ideological perspective, and this advantage is bolstered by the host of federal judges appointed during his first term (194, or around one-quarter of the total).

The real risk factor for US assets from this viewpoint would be disputed and uncertain election results.

Apart from judicial safeguards, remember too that the election process is regulated by a strict timeline. 8 December, or Safe Harbor Day, is the first deadline by which any appeals must have been expressed and regulated to allow the establishment of an ascertainment certificate. This certificate, issued by the State Governor, confirms the results of the popular vote in his (her) state and allows its big electors to take part in the Electoral College. On 14 December, the big electors proceed to elect the president and vice-president. These results are then validated by the new Congress in an extraordinary session on 6 January 2021 and the official inauguration on January 20th.

So there will be plenty on our plates until early November, or even potentially until mid-December. These elections could be a source of uncertainty and volatility that the discerning investor could be tempted to exploit. In the meantime, we have become more selective regarding US assets. Meanwhile, the world still goes round: Reinforced by record trade surplus, China has announced that it will aim for carbon neutrality by 2060, a topic on which the US are long awaited.

3. FIXED INCOME

AN ATTEMPT BY THE FED TO REVIVE INFLATION

Average inflation targeting

Against the backdrop of fears of another wave of the Covid pandemic, and with little hope of the acceptance of a further fiscal package a few weeks from the US presidential election, at its meeting on 16 September the Fed confirmed its change of target regarding inflation. From now on, it will no longer aim at a 2% inflation target but an average inflation target of 2%.

The Fed will thus be able to "let inflation run" above 2% and plans to leave its rates unchanged until 2023. The primary goal is a return to full employment and a convergence of medium-term inflation expectations around 2%. In the US market, the inflation breakeven measures the yield differential between a US Treasury bond (the nominal interest rate) and its inflation-indexed equivalent, Treasury Inflation-Protected Securities, or TIPS (the real interest rate). At present, the LT inflation breakeven has risen to a level close to 1.7%, supported by the economic rebound and the Fed's determination to revive inflationary pressure.

At this level, we prefer the status quo for our position in 30-year inflation-indexed bonds (TIPS). This is because we invest in this type of instrument either to protect ourselves against rising inflation or opportunistically when they offer attractive entry levels (i.e. <1.5%). This type of opportunity generally appears when there are fears of deflationary risk (for example, January-March 2016, August 2019 and March-April 2020).

At present, the yield on the 30-year US Treasury bond is 1.4%, that for the TIPS of equivalent maturity -0.3%, and the breakeven is 1.7%. In a scenario in which the breakeven rises to 2% (+0.3%), together with a rise in long-term interest rates to 1.8% (+0.4%), TIPS attenuate the impact of the rise in real interest rates (+0.1%). In an alternative scenario of convergence of long-term inflation expectations around 2% (+0.3%) without a rise in nominal long-term interest rates (1.4%), TIPS are a performance driver through the fall in real rates (-0.3%). Accordingly, investment in TIPS is justified in both absolute and relative terms and, together with US Treasuries, they are among the securities that are most diversifying and least correlated to global equities and credit risk.

The Fed will manage the slope of the yield curve, and credit

Far from conventional theory and against the backdrop of massive monetary and fiscal stimulus, inflation fears could continue to rise without causing any significant move in nominal long-term interest rates. Although the Fed refuses to lower its key policy rates into negative territory, it is prepared, without officially confirming this, to respond to any rise in nominal long-term interest rates. As we have already mentioned, after this exceptional Covid-19 crisis, neither the Fed, nor the ECB, nor any central bank in the world could afford to sabotage all the economic stimulus plans that have been adopted since early March in the event of excessive upward pressure on long-term interest rates or a further widening of credit spreads. The Fed and the ECB have no choice: they will adjust their respective quantitative easing programmes in order to buy long-term US Treasury bonds and euro-zone bonds respectively, as well as corporate bonds if necessary. We must therefore remain vigilant and selective, watching changes in long-term inflation expectations, credit spreads and the Fed's attitude regarding long-term rates.

4. EQUITIES

CONTINUING TO ENGAGE SELECTIVELY IN EQUITIES AMID THE FIRST POST-COVID CONSOLIDATION.

Equity markets worldwide consolidated in September, the first negative month since March 2020. All told, this consolidation comes after an unusual acceleration in equities over the summer, a two-month long, quasi-uninterrupted period of steadily increasing prices, especially rewarding to technology companies. The consolidation, initiated by the same large U.S. tech stocks on September 2nd, was initially attributed an exhaustion of the heavy speculative flows, some of which attributed to Masayoshi Son's Softbank's derivatives bet, which had until then reliably pushed the market upwards.

Following an initial purely "technical" interpretation of this early September market drawdown, other narratives and justifications have come to the fore to justify the ongoing consolidation. First, as the U.S. election approaches, fears of last minute posturing by the President, especially around China, is a source of concern for some. The prospect of a tight and contested election and the uncertainty it represents, also discourages risk-taking, especially as the passing of Justice Ginsburg could redefine the balance of power at the Supreme Court. Most important to economists, an apparent lack of consensus between Mr. Mnuchin and Mr. Powell on the type of stimulus required, reinforced by political posturing in Congress, introduce further economic uncertainty going forward. In Europe, disappointing economic numbers and localized resurgences in Covid cases, combined with a striking lack of progress on Brexit negotiations, all contribute to cooling the market's risk appetite ahead of the last quarter of 2020.

The more fundamental debate however centers on the balance between what current valuations imply with regards to future equity returns.

The more fundamental debate however centers on the balance between what current valuations imply with regards to future equity returns. In a simplistic but nonetheless informative way, the "Fed Model" proposed by Ed Yardeni in the 1990s compares the ratio between corporate profits and market capitalization (the "earnings yield", or inverse of the widely used "P/E Ratio") to the 10-year Treasury yield. By so doing, the model tracks how much of the aggregate corporate profits serve as additional returns for shareholders above and beyond what the 10y Treasury yield would offer. In a world of unprecedented monetary stimulus, the model helps to appreciate the market valuation when taking into account record low interest rates. In 1999-2001, a time now recognized as a major Bubble, market valuation were high to a level where 10y treasury bond yields were significantly higher than market's current earnings yield – because investors were persuaded of the immense future growth of these earnings.

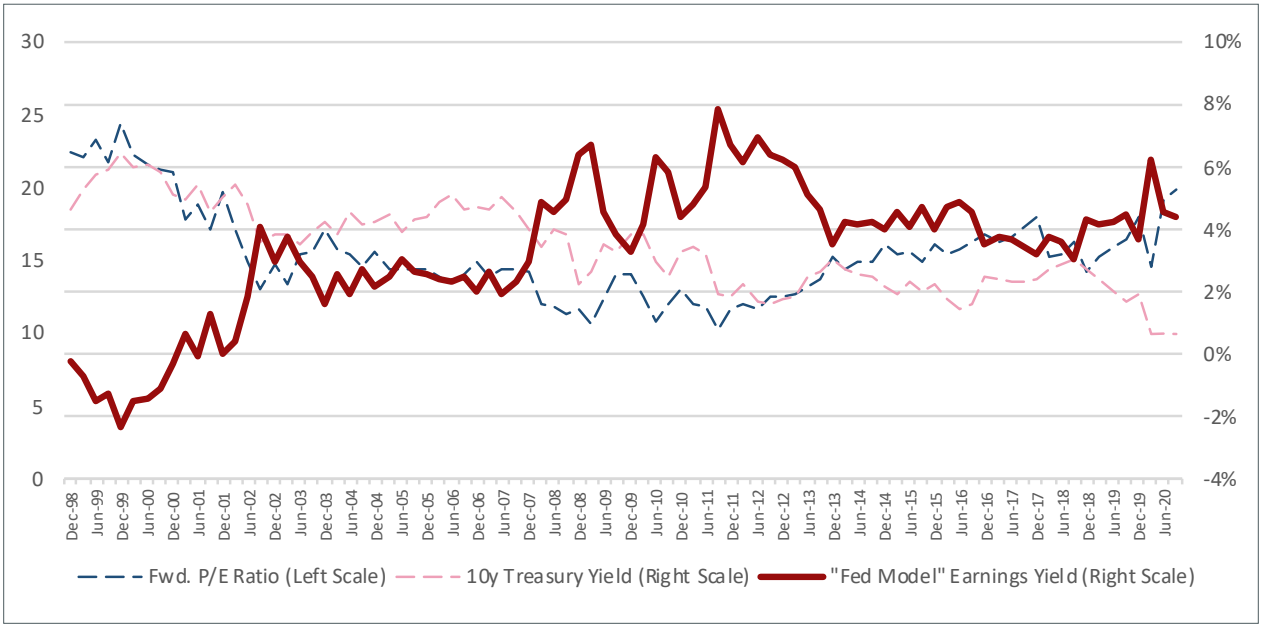
On the contrary, between 2009 and 2012, risk-aversion kept investors from bidding up equity markets, even though earnings were offering significantly more than treasury bonds. Today, based on con-

sensus earnings expectations for 2021, the 10y bond yield's record low rate does leave, all else equal, a similar type of premium as has been experienced since 2013.

So is the market valuation high? In absolute terms it is elevated, but most of it seems the consequence of record low interest rates and is not an equity-specific phenomenon. Indeed, on this metric, we are nowhere close to the excesses reached in 2001. Could equities disappoint ? Of course, especially if current expectations of corporate profits prove durably unattainable, or if interest rates rise precipitously. Are there pockets of "bubble" risks? Without a doubt, and the dearth of yield is likely fueling speculation in the "high growth" corners of the market.

In our opinion, the Equity asset class is still where investors can find long-term returns, although one should likely expect both a) corrections along the way and b) generally lower returns than what has materialized in the 2009-2020 bull market as one of the drivers, interest rates, has little left in the tank. Within equities, we remain convinced of the importance of sticking to reliable quality businesses and resist the temptations of speculative trendy companies with high multiples but no current profits.

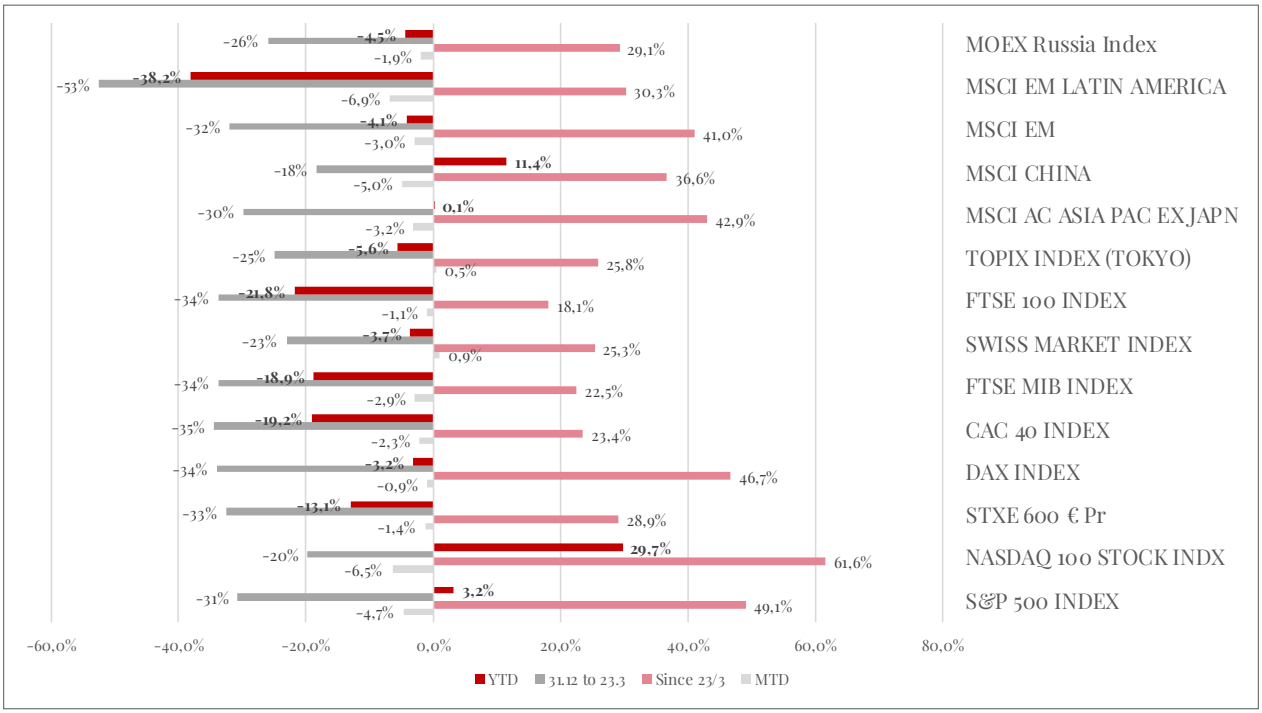
GRAPH 4 : «FED MODEL» MARKET VALUATION AND ITS COMPONENTS



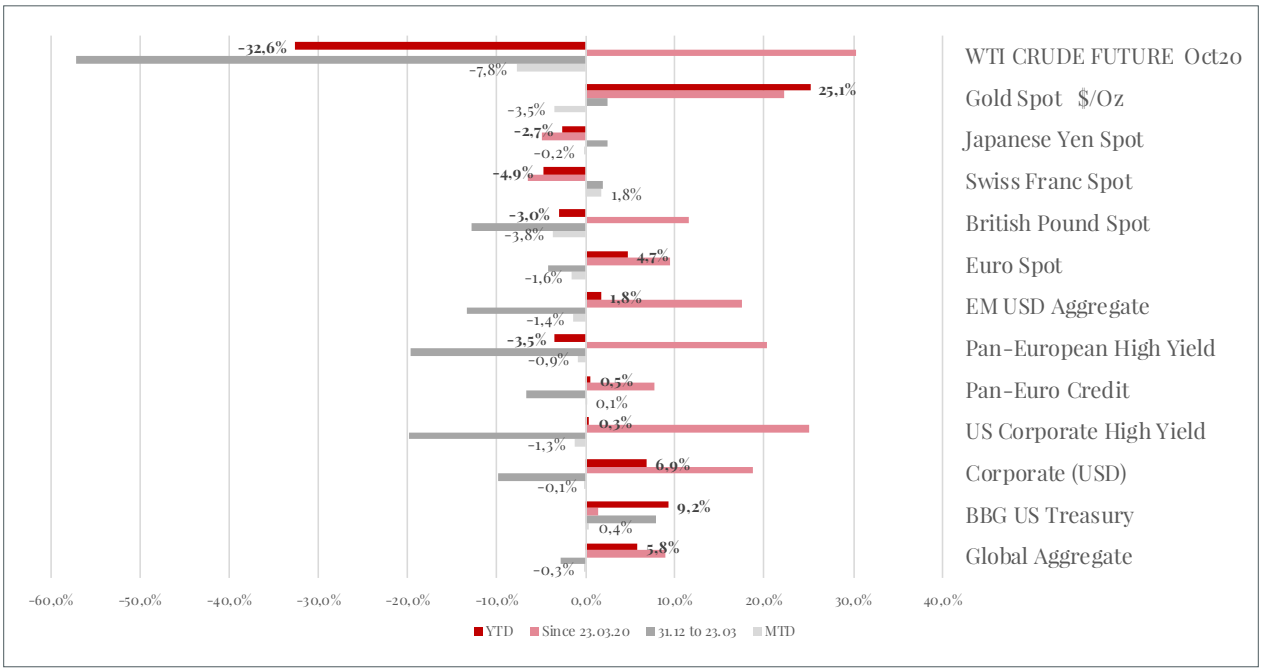
Source : Bloomberg, Banque Eric Sturdza

6. PERFORMANCES

EQUITIES IN LOCAL CURRENCIES



BONDS, CURRENCIES AND COMMODITIES



Source : Bloomberg, Banque Eric Sturdza, 29/09/20

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