BANQUE
ERIC STURDZA

MONTHLY NEWSLETTER
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1. EDITORIAL

SO FAR SO GOOD - UNTIL NOW ...

That is how investor sentiment could be summarised at the start of this year. Equity and credit markets are continuing in the same vein as in 2019, reaching new records and for the time being disregarding fears and geopolitical tensions. Only at month-end, the corona virus outbreak revives fears and bad memories from the SRAS.

And yet there was a real risk of seeing the euphoria of year-end 2019 disappear at the start of 2020, with the announcement of an American strike on an Iranian target, Major General Qassem Soleimani, on Iraqi territory. Oil and gold prices soared, equity markets started to dip… But this trend proved short-lived. Admittedly, markets were reassured by the Iranian response, which was considered moderate. Oil prices are falling sharply, since it must be said that the market is more worried about the Strait of Hormuz being blocked than the loss of the supply of Iranian oil (already significantly reduced). Neither party has a rational interest in a direct conflict with the other. Iran's economy is severely impacted by American sanctions: growth is flagging and inflation is galloping (+35%, Source: IMF). On the American side, Donald Trump surely remembers how George Bush Senior won the first Gulf War but was not re-elected as president.

The other main news this month was undoubtedly the official signature of "phase 1" of the Sino-American trade agreement. This agreement should be viewed as a first step in a long and difficult process. Moreover, Donald Trump has issued a warning along these lines: the next phases will be decisive but will only be negotiated after the presidential election (and Trump's possible re-election).

Although this deal seemed to be already factored in by the markets, it does contain some surprises. If carried out in full, it would result in a USD 200bn increase in US exports to China by 2021. Four main sectors are affected: manufactured goods, oil and gas, services and agricultural products.

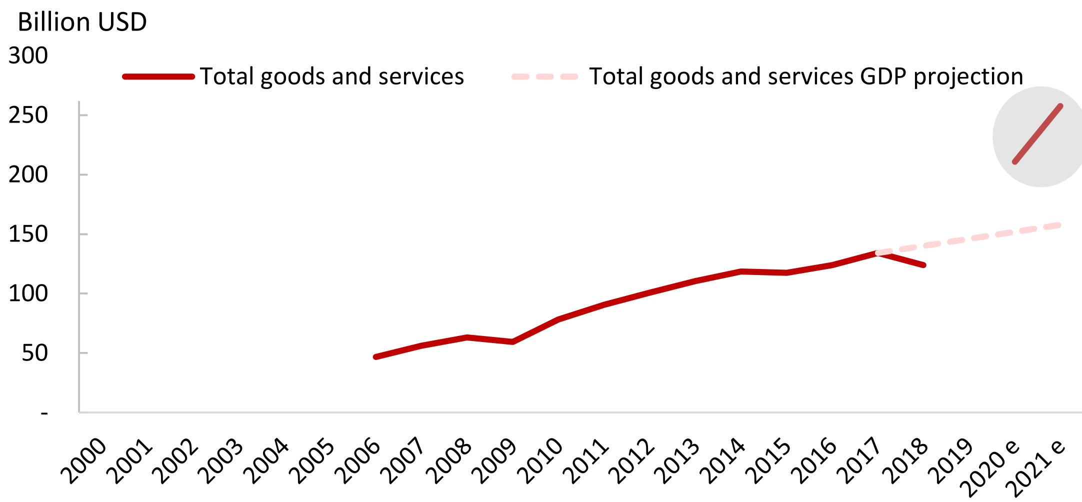
The "lower for longer" scenario seems to be still prevailing at the start of this year

Apart from the suspension of tariff measures planned for 15 December 2019, the document proposes no climbdown regarding other existing tariffs. On the other hand, the agreement provides for a bilateral dispute settlement mechanism, outside of the WTO and the multilateral system which had prevailed until then. The figures are mind-boggling, but at this stage it is hard to know whether they will be achieved., given the increase it implies for China (graph 1). There could be substantial substitution effects: imports of Brazilian soya beans replaced by US beans, and increased offshoring to Vietnam and Indonesia for Chinese exporters. As such, this deal looks like more of a truce than a permanent peace settlement.

Markets are preferring to focus on the glass half full rather than half empty. The "lower for longer" scenario seems to be still prevailing, judging only by the behaviour of long-term yields, which despite the easing of recent months rebounded at first only mildly before sharply dropping towards month-end. The price of gold remains firm. With regard to equities, the US market still has the edge on the rest of the world, the same holds for Technology and Quality Growth stocks relative to the rest of the market.

1. EDITORIAL
SO FAR SO GOOD – UNTIL NOW ...

Graph 1 : US Goods and services exported to China –Phase 1 impact (gray)



Source BEA, Peterson Institute, Banque Eric Sturdza

The kneejerk reaction to fears linked to the coronavirus reminds us, however, that the markets are today more vulnerable than in early 2019 with a more complacent sentiment, a more pronounced buyer positioning and higher valuation levels. The difficulty of the situation also comes from the fact that safe haven investments (long duration treasuries, gold) offer less diversification than in the past. This argues for a more cautious stance over the short term. In this environment, maintaining a high liquidity profile and greater diversification in portfolio choices seem to us two values to be nurtured for 2020.

2. FIXED INCOME
2019 n-COV, THE BLACK SWAN OF 2020?

Iran, Brexit, Trade Deal and a Chinese virus concern

At the start of this year, markets were no longer thinking about Brexit or the Sino-American trade war. They feared a violent escalation in the US-Iranian conflict. The death of a high-ranking Iranian military leader caused the stress to peak, but when Iran opted for a moderate response, markets heaved a sigh of relief and continued their onward march. The signing of phase 1 of the Sino-American trade agreement ultimately did not radically change the market trend: the news was probably already priced in, and Donald Trump revealed that the following phases would be signed after his re-election. At the end of the month, markets began to worry about a potential epidemic caused by the new coronavirus in China. Of all these events, it is definitely the latter that draws our attention. The SARS epidemic of 2003 is still fresh in the memory, and we are watching the development of this phenomenon very closely. It has led us to slightly raise the duration levels of our portfolios at the end of the month.

US macroeconomic data: robustness

In the United States, the only negative point was the extremely mediocre ISM figures published at the start of the month. The ISM Manufacturing Index came in at 47.2 (versus 49.0 expected), with a new orders component at 46.8 and an employment component at a very disappointing 45.1. On the other hand, the job figures for December were firm. With 145,000 jobs created, slightly lower than expected but following an excellent figure of 256,000 in November, the unemployment rate remained at 3.5% at the end of 2019. Wage growth ended the year at 2.9%, below market expectations. The US economic health is still showing signs of strength.

Fed status quo and slope of the yield curve

In this first month of the year, risk appetite, together with stabilising economy, a slight resurgence of inflation and a status quo in Fed policy of status quo will probably (according to consensus) result in a bearish steepening of the US Treasuries yield curve. We are still not convinced by this "Goldilocks forever" scenario. In the near term, the Fed will no doubt cite the strength of macroeconomic figures to justify its current inaction on interest rates. However, we feel bound to stress the size of the FED's balance sheet, because this is clearly a form of disguised interest-rate cuts, and this surreptitious QE, will undoubtedly be the number one factor explaining market behaviour in 2020. Experts who claim that recession risks have disappeared on the grounds that at the end of 2019 we switched from an inverted yield curve to curve steepening are in our opinion mistaken by not taking into account the effects of a virtual QE4 on the short end of the curve. The slope of the yield curve became normal again thanks to the fall in short-term yields following massive purchases by the Fed, and not a sell-off on long-term yields

Credit spreads defy gravity

At the start of this year, credit markets continued in the same vein as in 2019, driven by the stock market's exuberance. As a consequence, spreads have become very expensive: the CDX Investment Grade reached an all-time low at 44 bp this month. Twelve months earlier, it was 79 bp. In Europe, the iTraxx Index also reached the level of 44, moving closer to its record level of 43 in January 2018. The ECB continues and will continue with its asset purchasing programme, keeping European Investment Grade spreads in a positive dynamic.

3. EQUITIES

THE CURIOUS CASE OF EUROPEAN EQUITIES

For the past decade, European equities have suffered from chronic underperformance compared to their U.S. counterparts.

The post-Lehman bull market has certainly been sweet to virtually all equity markets given the level of extraordinary monetary stimulus worldwide.

However, the region hailed initially as the great competitor to the US given the power of its domestic market, per capital disposable income and cross-border synergy potential, has returned almost exactly half in total cumulative returns since 2007 - when comparing the net total returns of the S&P 500 Index and the Stoxx600 Index. For the most well-known European index, the Euro Stoxx 50, the result is even more disappointing: a mere 25% of the S&P 500's net cumulative returns.

Adding insult to injury, even with largely similar expected earnings per share growth rates over the coming year, the market is currently ascribing significantly different valuations to these two regions: around 19x estimated 2020 earnings for the S&P 500, but only 15x estimated 2020 earnings for the European index.

The epitome of the value vs growth debate

Once more, at first glance, there should be little hesitation to call for an outperformance of Europe versus the US: European companies, which have lagged the US, appear to be on similar earnings growth paths, but trade at a significant valuation discount.

Further, as one of the few regions in the world expecting acceleration of GDP growth, Europe should also benefit from momentum, a crucial ingredient to entice investors to risk additional capital. This debate mirrors the value vs growth debate taking place in the past year among practitioners: have we reached the point where valuation plays a large enough role to limit reasonable mid-term expectations of outperformance of growth stocks against their value peers, especially as near term growth differential seem to be eroding…

Looking under the hood at the composition of European equity indices sheds light on a significant reason for this apparent valuation discount. Indeed, the polarization of the index between the profitable, well-positioned leading companies (luxury, software) and large legacy corporations in sectors experiencing significant challenges is stark.

And contrary to the US index composition, the seeming valuation discount is concentrated in the challenged sectors which are not only heavier than their US counterparts in the index (autos) but also seem to be lagging in their restructuring (e.g. banks). In reality, European leaders are often as highly valued as their US competitors: be it L'Oreal versus Estee Lauder (both around 21x EV/EBITDA), or Worldline versus Global Payments (both around 20x), Europe has no reason to blush.

In short, it seems the main difference in Europe is not how much we appreciate greatness but how we treat our challenged companies, and how heavily they weigh in our indices.

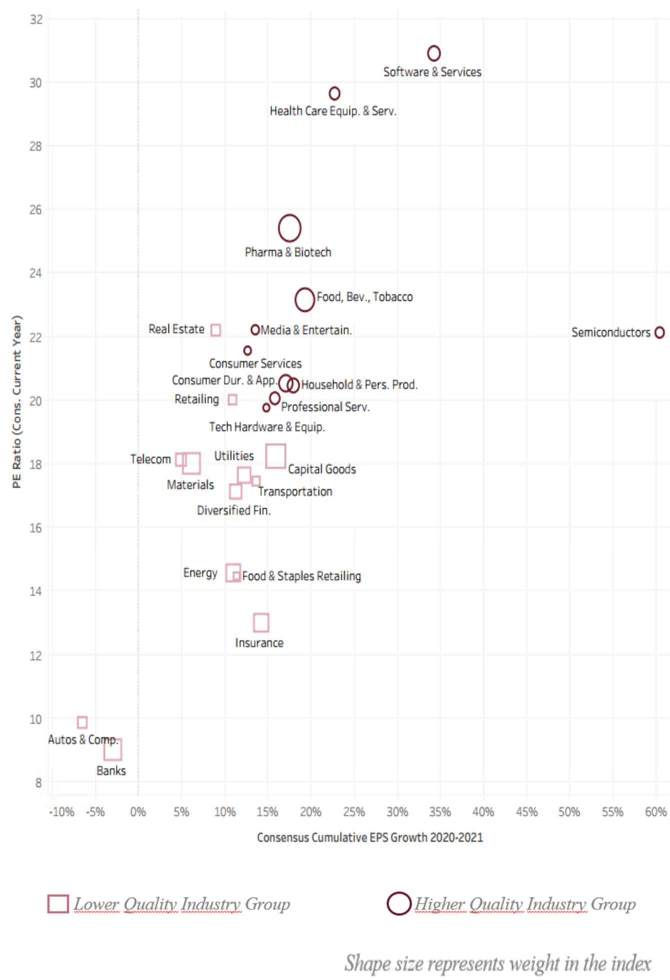
3. EQUITIES

THE CURIOUS CASE OF EUROPEAN EQUITIES

While the value case of Europe versus the US might not be as significant as it appears, it does to us carry important ramifications and opportunities for asset allocation given the current context. Indeed, the triple headwinds of idiosyncratic challenges, macroeconomic deceleration and investor outflows that have plagued European equities in the past 18 months have been an especially lethal cocktail and have without a doubt contributed to placing an ever-larger premium on quality and certainty. As the situation stabilizes and relative momentum, even modest, returns to Europe's economy, perceptive value managers, able to sort between the terminally ill and the temporarily unwell companies, should find exceptional opportunities in Europe compared to the rest of the world. This should thus be a time to harvest the alpha that has been, painfully, planted in the past year and a half.

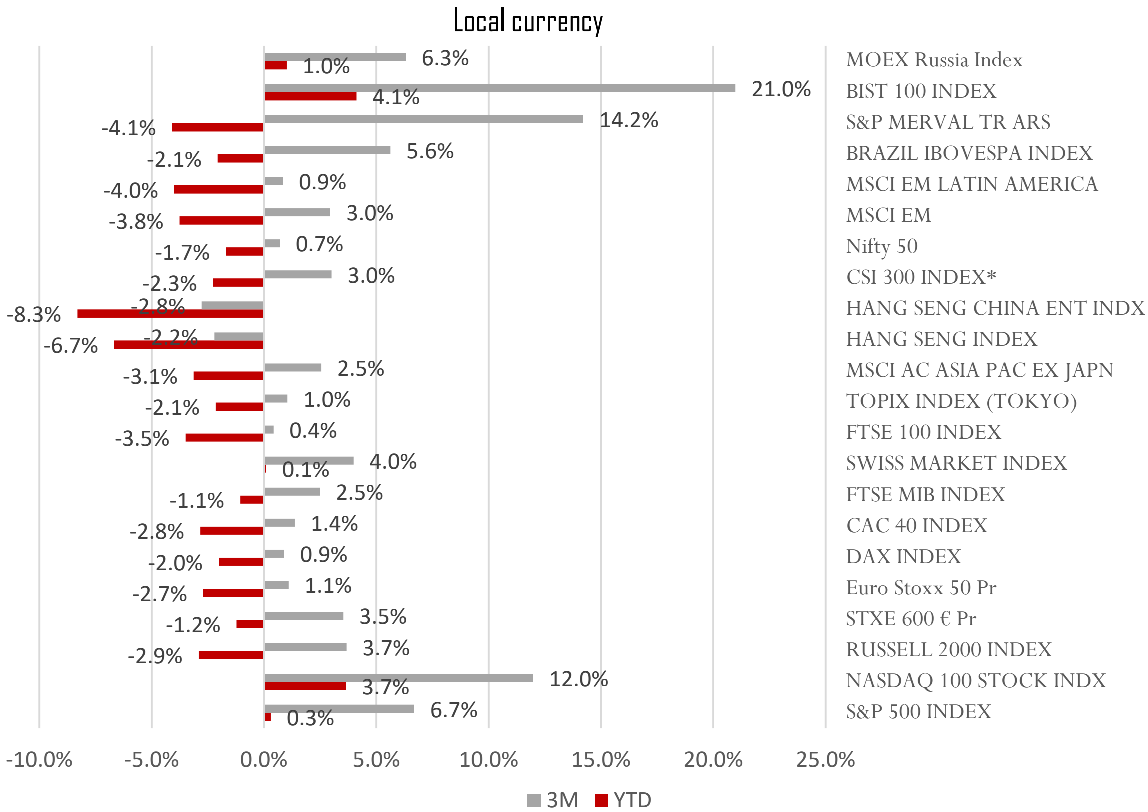
Consequently, while we agree with a pro-European view in equities for 2020, we also believe that the major catch-up opportunity resides in the value arena… as long as the economic picture and investment flows continue to improve.

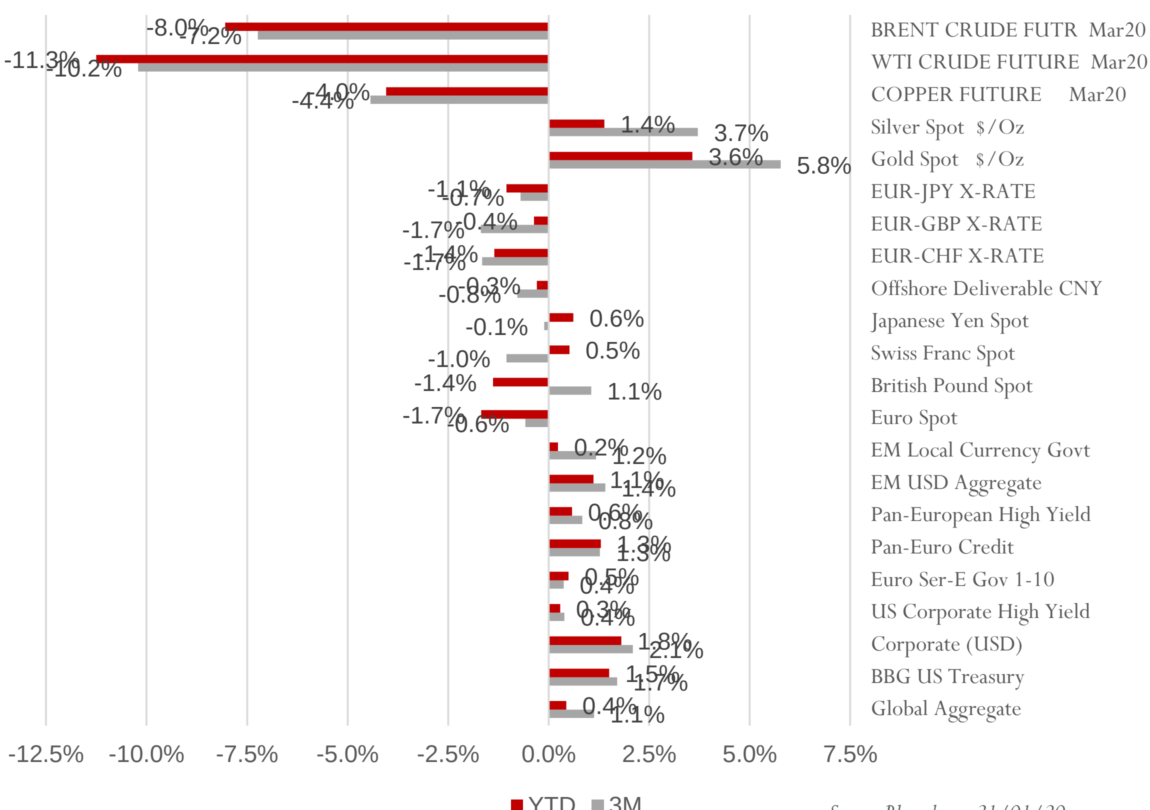
Valuation versus Expected Growth by Industry
Stoxx 600 Index



Source Bloomberg, Banque Eric Sturdza

5. PERFORMANCES





Source Bloomberg, 31/01/20
** 23/01/20*

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