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THE GLOBAL ECONOMY AND MARKETS OVER THE NEXT FEW MONTHS

"Pessimism never won any battle", Dwight Eisenhower

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Following a market low reached in March 2009 (an economic crisis which in the euro zone persisted until 2013) and a political crisis attested by the surge of populist parties, we are now in a more favourable period. Global growth of 3.7% is expected this year, benefiting most countries, there is practically full employment in many of the major countries such as the United States, Japan, Germany and the United Kingdom. Inflation is less than 2% almost everywhere despite persistent liquidity injections, and there is a recovery in global trade, with 3.6% growth in 2017. We should not ignore the grey areas and be blindly complacent given the sluggish growth in corporate credit, wage stagnation, the persistent spiralling growth in global debt and rising inequalities. However, we can hypothesize that despite more restrictive monetary policies, the economic environment will remain positive in 2018. International politics and more specifically the Korean crisis, is not so concerning either, because we tend to believe in a continued status quo.

United States: The growth cycle has reached 100 months, close to the record of 106 months recorded between 1961 and 1969. We can hardly detect any signs of an imminent recession. So we are holding onto our positions in this market and, in order to protect our performance between now and the end of the year, we are partially hedging our gains, because at 17x 2018 earnings, the market valuation is high, also because margins have declined since their peak at end-2014. Moreover, we cannot overlook the market rise of more than 20% since a Trump election which has had no tangible effect on growth. We cannot deny that the credit cycle peaked at end-2015 at the time of the first interest-rate hike, and we cannot disregard the fact that bank credit is growing half as fast as between 2014 and mid-2016, when it was increasing at a pace of 10% annually.

However it is still too soon to reduce holdings. The short-term macroeconomic indicators remain positive: for example the number of building permits remains stable at 1.2 million. GDP growth over the full year is expected to reach 2.1%. The ISM confidence index is at its highest level in the last thirteen years. Default rates are close to an all-time low. Job creation in the private sector remains high and the unemployment rate of 4.2% is close to full employment. Consumption is resilient, while household debt (at 70% of GDP) is well below the 98% level observed in 2007, and poverty, at 12.7%, has fallen back to its pre-2008 level. Furthermore, this does not factor in a reduction in corporate taxation that Donald Trump would like to implement, because we believe that it would be partially offset by a reduction in the deductibility of loan interest.

From a medium-term perspective, inevitably we will be more cautious, because structural issues pollute the statistics on employment, income, real estate and healthcare, and perhaps they may curb the momentum of the US cycle. Regarding employment, apart from some analyses which mention full employment, note that during the last decade population growth of 1% annually corresponded to an increase of only 0.5% per year in employment, which is reflected in the decline in the participation rate (people employed/people of working age) from more than 67% in 2000 to 62.8% in June of this year. We may add that the large technology firms create fewer jobs than large industrial firms. This is shown by the Krueger study at Princeton which emphasizes that the ten leading technology firms employ only 1.5 million workers whereas, in 1979, the ten leading industrial companies had 2.2 million workers. Finally, outsourcing by the large firms is constantly increasing, temporary work is becoming widespread, and more than 18% of the labour force works part-time. Regarding income, the Census Bureau shows that the median wage regained its 1999 level only in 2016. As regards real estate, two factors of vulnerability should be noted. Firstly, the mortgage market is increasingly eluding the banks to the benefit of unregulated players, whose market share has increased from 20% to 75% since 2007. Secondly, the real estate market has become unaffordable for many young people, because in the 18-34 age group half of men and more than one-third of women still live with their parents, a percentage not seen since the Second World War. A final word on healthcare. Healthcare expenditure at 18% of GDP, is higher than elsewhere, but life expectancy is declining.

What is worth noting in these different statistics? The inability of households to consume more. The growth rate is lower by half than in previous cycles and it is not going to improve.

Europe: ***"What is natural is diversified" Madame de Staël***

Today, three reasons lead us to remain overweight the euro zone: the economic indicators are expected to stay favourable, the valuation multiples are lower than those in the United States, and we remain confident in its capacity to promote reforms and to strengthen political and economic integration. Echoing the latter point, Madame de Staël's statement is accurate: the unity and diversity of Europe are not antagonistic. Greater integration is possible and necessary, and it will be essential to convince the hesitant and disarm opponents. Two figures, population and GDP, corroborate this assertion. In 1960, Europe was home to 13% of the world's population, while in 2050 this figure will be 5%. In 1980, Europe accounted for more than 30% of global GDP, and today just 18%. These figures should not be seen as a failure of Europe, because since the signature of the Treaty of Rome, per capita GDP has multiplied by four. They simply reflect the rapid development and catch-up of a few large emerging countries. Yesterday European integration was necessary for political reasons, while today it is necessary for economic reasons. Yesterday the threat was represented by the Soviet Union, while today unity is needed to counter Chinese conglomerates backed by public capital and to negotiate an agreement on taxation of the GAFA. Europe must go beyond its East/West conflicts on immigration and democracy, its North/South divergences on public finances, and it must strengthen banking, fiscal, monetary, economic and tax integration. Banking integration, because only 130 of the 6,000 European banks are covered by the banking union formed at end-2014. Non-performing loans still amount to €865 billion and the amounts earmarked for the resolution of a possible crisis are too small. Monetary integration, because the ESM (European Stability Mechanism) must, like the IMF, become a European Monetary Fund which can grant emergency loans. Economic integration, because more joint policies on issues of European interest, such as defence and energy, are possible and because measures are required

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to protect against social or environmental dumping. Tax integration, because although it is not realistic to plan for convergence of wages which, including social security contributions, are only €1.1 per hour in Bulgaria versus €42 in Denmark (source: Eurostat), the harmonization of tax rates could be a long-term objective. Fiscal integration, because a budget which represents only 1% of the European Union's GDP, 0.8% of which is used for redistribution to the States and only 0.2% of which is disposable, offers hardly any leeway for greater integration. The countries should be able to agree to an allocation of 2% of GDP for defence, 2% for energy and to combat global warming, and 2% for the digital economy, research and education, to nurture improved competitiveness. Given such a plethora of ideas, remember the saying of the philosopher ***Alain: "The secret of action is getting started",*** and we hope that this will be the case after the formation of the German government. The second reason for overweighting Europe is the macroeconomic data: growth of 2.2% this year for the second year in a row, equal to or even higher than that in the United States, industrial production growing 3.2% year-on-year, an unemployment rate which has fallen regularly to 9.1% after the creation of six million jobs since 2009, the ongoing recovery of the peripheral countries, Ireland with 5.2% growth last year, Portugal with 3% year-on-year growth, and Greece which now looks for 2.4% growth in 2018 and a further primary budget surplus. And finally, the market valuation is lower.

To those who might worry about the consequences of the German elections, it may be pointed out that a pro-European CDU-SPD coalition is still a possibility if Schulz, the main loser in the election, withdraws and the FDP, traditionally pro-European, excludes few of Macron's proposals. To those who might be alarmed by the uncertainty in Catalonia, we can point out that it has had major consequences for Spanish interest rates and bank share prices, a moderate impact on the euro, and an insignificant impact on the European stock market. Admittedly, Catalonia, in the heart of Spain, attracts foreign investment, and enjoys a per capita GDP (€29,700) higher than the Spanish average of €23,000. However, independence and thus an exclusion from the European Union would make this region less attractive to foreign investors, and one cannot overlook the debt burden (27% of Spain's debt versus 19% of GDP and 16% of the population).

- **United Kingdom**: To summarize the situation, we can repeat Churchill's saying about the members of the Baldwin government in 1936: "***Decided only to be undecided, resolved to be irresolute, adamant for drift … and all-powerful to be impotent***". Completely absorbed in designing a way out, Theresa May's government is spending all its energy on this issue and is absent from the major international debates. In the meantime, day after day, the published statistics converge in corroborating the economic mistake createded by the Brexit vote. The process has not begun, but growth is falling, the purchasing managers index for September points to a possible recession, construction started declining in September, the reduction in immigration is creating a shortage of labour in services. Investment by British companies is slowing, that by multinational firms is suspended, and consumption is stagnant even though the savings rate is at a low and the Bank of England is worried by spiralling growth in

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consumer credit (up 10% year-on-year). Purchasing power has declined in international markets by the percentage of depreciation of the pound sterling, and on the domestic level by the differential between 2.8% inflation and 2.5% wage growth. The country derives no benefit from the depreciation of the pound (by 15% against the euro since Brexit). A single example is sufficient to explain this: the automotive sector, which exports significantly, but which receives two-thirds of its components from abroad. Clearly, manufacturing production, a mediocre 10% of GDP, will be unable to take off, and the trade balance will remain deeply in the red.

- **Japan**: The stock market is still over-weighted in our portfolios, because the market & sentiment indicators converge to encourage optimism. Companies' cash holdings have never been as abundant (Gave suggests a figure of $4,000 billion). The valuation of 1.5x book value is one-third lower than in the other major markets. Share buybacks, which for a long time were non-existent, are expanding and the Bank of Japan continues to buy ETFs tracking the Japanese index, at a rate of 1% of the market capitalization each year. Yet many international investors still ignore Japan in their asset allocation. So much for the market indicators...We can add to these positive economic indicators, whether it be the figures for GDP, the figures for exports (10% growth in volume terms), construction boosted by the preparations for the 2020 Olympic Games, or consumer and business confidence. Longer-term, we are more cautious, because what can be the growth of a country reluctant to accept immigration and whose population is contracting? One statistic sheds light on the subject. In the year 2000, the 20-29 age group counted 18.3 million youths. The figure is currently less than 13 million, and by 2040 they will be hardly more than 10 million. The labour force, comprising 65 million people at present, will be reduced by 23 million people by 2050! One cannot even dream of a higher employment rate, because at 75% it exceeds that of the other major nations (as a reminder, the figure is barely 70% in the United States). And the unemployment rate, at 2.8%, is already lower than that of all the other major OECD countries.

- **China**: On the eve of the party congress which will begin on 18 October, it can be noted that China's weaknesses are temporarily strengths. Like the IMF and S&P, for example, we are concerned by the rapid accumulation of debt, and we suspect that state planning is not an ideal system in an economy increasingly focused on the service sector. The Chinese authorities are not worried by this and they are striving to conquer the world. Despite weak balance sheets, in many sectors very powerful groups are appearing, both public and private (the latter represent 50% of the capitalization versus 20% in 2010). These groups are capable of buying out their major international competitors, increasing their market share, and winning contracts by disregarding profitability and the observance of patent law. Last year, foreign direct investment was at record levels. At the same time, Chinese consumption is being boosted by the increase in wages by a factor of ten since the end of the 1990s and the expansion of the middle class and rapid dissemination of new technologies, especially mobile payments. The very good performance of the Chinese market (up 43%) has been boosted by the exceptional rise in the price of

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technology stocks (up 72%). Technology now accounts for 40% of the Chinese market capitalization, versus 2% ten years ago.

- **Emerging countries**: On the whole they are benefiting from the cyclical upturn in Europe and Japan, and also from domestic measures. Brazil, for example, is no longer in recession. Russia, which already came out of recession in 2016, is boosted by an upward revision of its outlook. India has been impacted by the withdrawal of 80% of bank notes in circulation, by a reduction in foreign investments, by weak private investment, weak exports, persisting infrastructure bottlenecks and a budget deficit of 3.2%, and so is suffering a growth slowdown to probably 5.7%.

- **Oil**: The statistics of the International Energy Agency (IEA) are revealing. High prices and then the effects of the recession caused a 10% contraction in demand for oil in OECD countries between 2005 and 2014. Similarly, the low level of prices in recent years has, since 2015, been conducive to an increase in consumption in OECD countries by around 1% per year, i.e. 400,000 bpd, on top of the annual increase of 1m bpd in emerging countries. Overall, in 2017 demand for crude oil increased by 1.6m bpd to 97.7m bpd, and overcapacity, which amounted to 4m bpd a few years ago, has collapsed, because oil companies have reduced their research spending, the production discipline of OPEC members and Russia has reduced volumes by 2%, and prices are therefore now at the high end of the $45-55 per barrel range that we defined last year. A windfall of more than $10 billion for the Russian budget in the run-up to the elections, an opportunity for Saudi Arabia which wants to maximize the value of Aramco before the forthcoming initial public offering, and an incentive for American producers who have lowered their production costs to $30 per barrel.

- **Interest rates**: The uncertainty is political rather than monetary. Political because four positions have to be filled at the Fed, including that of chairman. Will the majority be more inclined to trim the balance sheet (currently at $4,500 billion) and less inclined to raise interest rates? It is hard to give a clear answer at present. If Yellen's appointment is renewed, the Fed's balance sheet will probably be reduced by around $800 billion by the end of 2019 and the policy rate will probably be raised again in December and several times in 2018. At the ECB, an announcement at end-October could plan for a reduction in bond purchases from €60bn to €40bn per month in early 2018, then to €20bn in the second half and to zero by the end of the year. The real subject will be Mario Draghi's replacement in February 2019. Will it be the German Weidman, an advocate of austerity? Too soon to say. In the meantime, despite the consequences for market rationality, the liquidity provided by the major central banks will increase by a further $2,000 billion this year, or more than 10%. These injections will continue because, aware of the large debt burden of governments and many companies, central bankers want to prevent an upward spiral in long-term interest rates. Although the recent recovery in commodity prices will have a temporary impact in the coming months, inflation, which is currently 0.3% in Japan and 1.3% in the United States, will still not be a threat, because the winds are blowing in the opposite direction: creation

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of low-skilled jobs, retirement of well-paid baby-boomers, ongoing globalization, competition from robots, an increasing proportion of self-employed workers, reduced sensitivity of service economies to commodity prices, etc.

- **Currencies**: At the current level of the dollar, the larger the tax cuts (hence the potential for growth stimulation and a rise in interest rates) the stronger will be the dollar's rise. Conversely, improved Franco-German agreement to consolidate Europe will strengthen the euro. So two political factors, the attainment of a majority in Congress and the composition of the German government, give grounds for caution regarding currency exposure.

- **Conclusion on stock markets**: ***"It is great folly to seek to be wise on one's own"*** noted ***La Rochefoucauld***, but, keen to protect our portfolios' good performance, we have put in place hedges**.** However, while some fear the effects of monetary policy tightening on markets, and even fear an end to the growth cycle, or even a recession, this is not our position. The fact that valuations are considered high by the vast majority of investors is reassuring: we do not find in investors the feeling of exuberance that prevailed in 2000. Among the positive factors we may note the persistence, in the coming quarters, of moderate but sustainable economic growth worldwide, rising profits, the lack of alternatives (bonds or real estate) to equities, probably $1,000 billion worth of liquidity injected by central banks in 2018, central bankers' vigilance to prevent an upward spiral in long-term interest rates, greater fiscal laxity in many countries, and the predictable low level of inflation. For the time being what is essential is the positive outlook, while what is insignificant would be a Black Swan, an unforeseen event which ***René Char*** taught us to beware of when he wrote ***"What is essential is constantly threatened by what is insignificant".***

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