BANQUE
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MARKET STAGNATION IN H1: A PAUSE IN THE MARKETS' RISE OR A PRELUDE TO THEIR DECLINE?

"While believing that America is indispensable to the world, I do not want to see it offered as a universal judge and policeman."

***De Gaulle in Mémoires d'Espoir*.**

Bruno Desgardins ***July 2018***

- General de Gaulle's statement is still topical because, although there are four reasons accounting for the jitters on financial markets since the end of January, two of them, geopolitics and uncertainty regarding free trade, are due to statements by Trump. The third reason, a more restrictive monetary policy in the United States, is partly the consequence of the tax measures decided by Trump, and only the fourth reason concerns Europe and cannot be attributed to him.

- Fortunately, at the same time, global growth remains high (more than 3%) without any suggestion of imminent recession.

- In the United States, the GDP growth expected by the Fed in 2018 is 2.8%, and second-quarter earnings growth of 19% is projected. We might regret that, at the top of the cycle, the budget deficit will widen to 4.5% in 2019[e], as will the trade deficit, but this is the consequence of the tax cuts. Other indicators remain positive: in real estate, housing starts are up 20% year on year, and prices have risen 6.4% year on year. Regarding employment, job creations (1.5% at an annualized rate) are exceeding new entrants to the job market (1%), and the unemployment rate of 3.7% is lower even than its 1999 level. Lastly, investment is accelerating.

- In Japan, following eight quarters of growth, unprecedented since 2015, GDP has been adversely affected by a sharp slowdown in exports and declined by 0.6% at an annualized rate in the first quarter. Accordingly, growth will probably be limited to 1.2% in 2018 following a rise of 1.7% in 2017.

- In Europe, growth is admittedly slightly weaker, curbed as it is by political uncertainty in Germany and Italy, but is nevertheless expected to reach 2.1% in 2018. Credit flows have declined recently, but wage growth, at 1.9%, is higher than inflation.

- In China, economic growth is also expected to be weaker in 2018, at 6.3%, as priority is given to the need to control pollution, and hence shut down production capacity in coal, and the stated priority is higher-quality growth focused on innovation and consumption.

- In the emerging countries, growth is being undermined by the appreciation of the US dollar and the 70% year-on-year rise in the oil price, but remains high in India.

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I. The geopolitical and oil issue: *"Hasten slowly", Augustus*.

Geopolitics and oil are linked as Trump seeks to enforce an embargo on exports of Iranian crude oil without risking a surge in oil prices, and therefore wants to encourage Saudi Arabia and the other OPEC producers to compensate for a sharp decline in Iranian sales as of November. This policy is perilous, and we could only advise Trump to ruminate on the wise advice of Augustus.

For many months, we have repeated that the 50% reduction in exploration investment in recent years has reduced overcapacity to a minute portion. Year on year, prices have accordingly risen by more than 70% ($78 per barrel for Brent versus $44 per barrel in June 2017). The challenge is to offset a forced contraction in Iranian exports by a voluntary increase in Saudi, Russian and American production, against the backdrop of weak production in Venezuela and Libya.

- ***The unstable balance between oil supply and demand:***

- Growth in demand: over the past ten years, growth was only 1.1m bpd per year, but in 2017 we noted an acceleration to +1.7m bpd, unfortunately at a time when, as a consequence of a 50% fall in exploration spending after 2012, surpluses were disappearing. Accordingly, prices have increased by 70% year on year. This year, the International Energy Agency expects a further marked increase of 1.4m bpd to 99.2m bpd, but…
- … there has been a decline in production in Venezuela and Libya: from 3.2m bpd before the political crisis, then 1.9m bpd in 2017, Venezuela's production has fallen to 1.3m bpd and can be expected to decline further, because everything is going wrong in this formerly-rich country where GDP has declined by 50% in four years, inflation has reached 1300% and poverty affects more than 50% of the population. In Libya, production amounted to 1.6m bpd in 2012 and 0.8m bpd in May 2018 but is almost at a standstill temporarily due to unrest around the oil facilities. The output of Saudi Arabia, an ally of the United States, has apparently increased recently from 10m to 10.6m bpd and could be boosted to 12m bpd within a few months. Saudi Arabia has convinced Russia to discontinue the agreement to reduce production by 1.8m bpd. US production, which has already increased by 6m bpd in the past ten years to more than 10m bpd, reached 10.7m bpd in April, thus making it possible to increase exports to a record level of 1.6m bpd, and this figure can be expected to increase further. Shale oil production alone, which was 5m bpd in 2018, could reach 8m bpd in 2023 by some estimates.

- ***Iran: the dangers of an embargo.***

It is a long time since 1986, in the midst of the Iran/Iraq war and a few years after the Iranian revolution of 1979, under the presidency of Khomeini, when Israeli prime minister, Yitzhak Rabin, declared that "Iran is Israel's best ally" and Reagan had to explain to a Commission of Enquiry before Congress why he delivered arms to Iran, when he officially supported Iraq. Today, there is one winner, Israel, and one potential loser, Iran. To understand this, let us analyse the political situation, the economic situation and the prospect of an embargo.

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The political situation:

Israel enjoys the backing of the US, the indulgence of Putin, the stated support of countries such as India, Kenya and Rwanda which no longer fear to admit to their relationship with Israel, even the goodwill of the Saudis, who would even appear to have given up any demands regarding Palestine. Iran and its Shia movement represent a force only in the group of currently weakened Arab countries such as Iraq, Lebanon and Yemen. Iran cooperated with North Korea in the development of ballistic missiles, and must be jealous of how that country has become an established leader on the nuclear stage. While 35 inspection missions took place in Iran last year, nothing similar has yet been demanded by Trump of North Korea. While North Korea has dozens of nuclear warheads, Iran has none. While North Korea is surrounded by a benevolent China and a South Korea that is keen to promote exchanges, Iran is surrounded by hostile countries - Saudi Arabia and Israel.

The economic situation is risky:

There have been five years of drought, the currency has officially collapsed by 30%, and infinitely more on the black market, making imports more expensive; investment inflows, far from reaching the $50 billion figure dreamed of by Rohani two years ago, have barely exceeded $10 billion, and demonstrations are increasingly widespread, because young people are fed up with the wastage of currency on foreign adventures and the regime's inability to bring down mass unemployment.

What can be expected of the threatened embargo on Iran?

Politically, it is unlikely that Iran will pull out of the non-proliferation agreement (TNP), as the North Koreans decided to do in 2003, because neither the Russians nor the Chinese support this option, and it is conceivable that the Iranians could agree to include in the agreement, long-range missiles with a range of more than 2,000km which threaten Israeli and Western bases in the Middle East.

Economically, since most transactions are in US dollars, as the fear of sanctions kicks in, Iran has a lot to lose. Companies have until November before the sanctions are applied, but, behind all the gesticulations, it is hard to see the Europeans braving America's wrath, and Total, a major player in exploration, has already announced its withdrawal. European Union trade with Iran amounts to only $25 billion, which is small beans compared with $750 billion in trade with the United States, and it is hard to see companies taking the risk of being fined or shut out of the US market. One possible alternative, apart from using the Euro, would be to organize financing by the public banks of each European state or by the European Investment Bank, but nothing is certain. Iranian crude oil production, currently 3.8 million barrels per day, versus 2.8m bpd two years ago before the sanctions were removed, but especially exports, with 2.6 million bpd exported in May, down to 2.1m bpd in June, are threatened, because Donald Trump intends to punish anyone who buys Iranian oil. Apart from China, which buys 0.6m bpd from Iran and could increase its purchases, and possibly Russia which signed an agreement at end-2017 to stop trading in US dollars with Iran. Many buyers, notably India, the second-largest buyer, and Europe, which buys one-third of Iranian exports, seem prepared to give in, for fear of US sanctions. If crude

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prices were to go beyond $100 per barrel, global growth would be undermined and Trump would be to blame. So we hope that his staff will be able to bring him round to moderation.

- ***North Korea*: *the risk of disillusionment.***

It is astonishing that the president of the world's leading power should condescend to travel to meet the dictator of a poor country of 25 million inhabitants and, what's worse, for nothing in return. Astonishing, too, that he should stop US military manoeuvres in South Korea and consider repatriating the 30,000 US soldiers stationed there, at the risk of arousing concern among the United States' historical partners in the region, without even demanding inspections by the IAEA, inspections which, moreover, would not be easy in a country accustomed to secrecy.

Despite the satisfaction expressed by Donald Trump, it is worth noting that, on four occasions since 1985, negotiations have taken place between the United States and North Korea and that on each occasion, the agreement was broken shortly afterwards by North Korea.

In 1985, a few months after the launch of a first missile, North Korea agreed to sign the Non-Proliferation Treaty (NPT), but very soon after the country refused the IAEA's inspections.

In 1994, North Korea suffered an economic crisis. It accepted a visit by Jimmy Carter to Pyongyang and the signature in Geneva of an agreement providing for the discontinuation of North Korea's nuclear programme, dismantling of sites and submission to inspection by the IAEA, in return for the delivery of two civil nuclear reactors by the Americans. In 2002, however, the CIA discovered a secret uranium enrichment programme and North Korea withdrew from the NPT in 2003.

2005 brought another difficult period for the economy. The Koreans agreed to give up nuclear weapons in exchange for the authorization of a civil nuclear programme and economic aid. The Yongbyon facility was to be dismantled and IAEA inspectors were to be able to verify this, but relations with Bush turned ugly and the country resumed its nuclear activities in 2008.

The fourth occasion was in 2012 with further economic difficulties and further US food aid in exchange for a halt to nuclear tests and missile launches. But the nuclear tests began again in 2013.

In other words, dialogue between the United States and North Korea is not new, and the light of the past throws a shadow over Mr Trump's hopes. It is indisputable that the sanctions blocking exports of coal, steel and textile products, and the forced repatriation of North Korean workers posted abroad, have weakened the regime's chances of survival.

China, which accounts for 70% to 90% of the country's trade, undoubtedly restricted trade in the first quarter and, faced with economic problems, the wily North Korean president therefore agreed to negotiate, but shutting down a test centre or halting tests does not mean giving up know-how. It is inconceivable that the regime would

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abandon its nuclear industry, because it is the very assurance of its survival. At most, one could imagine a reduction in the defence budget, currently estimated at around 50% of GDP, to make up part of the lag in development behind South Korea, with a ratio of 1 to 30. The North Korean president's concern to reduce his reliance on China is also understandable.

II. The free trade issue: *"There is nothing to prevent waltzing around, and everything to prevent overturning alliances", Aron.*

The main factor of turmoil in financial markets, Donald Trump's turbulent protectionist measures, angers his traditional allies, with which he would be better advised to cooperate if the aim is to make China bend, and is disliked by Republican representatives who are passing on the complaints of farmers, manufacturers outside the steel industry, and consumer groups.

- ***The need to ward off the risk of protectionism***:

Openness to the world is associated with the idea of expansion. Without going back in time as far as Christopher Columbus who discovered the Caribbean, Vasco da Gama who opened up the Asian seas to Europe, and Jacques Cartier who explored North America, growth in international trade has been a driver of the global economy.

Conversely, protectionism is associated with reduced competition, a rise in consumer product prices, and thus higher inflation and loss of purchasing power. For a few protected jobs in sectors in distress, many jobs are destroyed in buoyant sectors which are the casualties of retaliatory measures. Harley Davidson's planned offshore relocation is just one example.

Among the many barriers to globalization, there are of course tariffs, possible regulation of corporate takeovers by the Chinese, and legal sanctions, which the Americans use excessively.

- ***Harmful tensions with Europe***:

Admittedly, the Eurozone has a trade surplus of $140 billion with the United States. Admittedly, the leading item in that surplus is none other than the motor vehicles and parts industry, representing around $30 billion, which explains the US threat to apply a 25% tax which would adversely affect German industry and possibly tomorrow Japan as well, because motor vehicles and equipment are the two leading items exported to the United States. However BMW is one of the biggest exporters out of the United States, Toyota produces 70% of the vehicles that it sells in the United States in the country and, in line with the above quote from Aron, if the United States want to be stronger in relation to China, it ought to promote agreement with its historical partners. Trump wants to overlook this obvious truth, but the Republicans know it and are hostile to these measures.

- ***Discussions with China***:

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China supplies 22% of US imports and receives only 8% of its exports. China is a challenge, because it imports only $130 billion worth of US goods and the trade balance between the two countries accounts for 50% of the US trade deficit, the equivalent of 1.7% of US GDP and around 3% of Chinese GDP. So it seems naive to believe in the Chinese intention of buying an additional $70 billion worth of goods. But the subject is tricky because, although China exports $500 billion worth of goods to the United States, 60% of that comes from multinational firms, often American, which have found in China a way of boosting their productivity. In other words, expressed in value added terms, the trade deficit would be reduced by one-third. After the tariffs, Trump is considering blocking FDI, China's direct investment on American territory in all sectors regarded as strategic. Such a measure is too radical, but makes more sense than tariffs knowing that, in 2017, the Chinese invested $170 billion beyond their borders.

The real challenge is the assertion of China's power which is still <u>inexistent</u> from a monetary viewpoint, because the Yuan is insignificant compared with the US Dollar, which still represents more than 60% of global liquidity. From a military viewpoint, that power remains <u>moderate</u>, because although it has staked out positions in the China Sea, the defence budget of $228 billion in 2017 is scarcely more than one-third of the $610 billion US budget. That power is now <u>strong</u> from the economic viewpoint, however, notably with the $1,000 billion promised for the Belt and Road Initiative, investments in Africa and the position of leading exporter in the world.

China has plenty of room for manoeuvre to retaliate against the Americans: <u>a political weapon</u>, with possible support to North Korea to ruin Trump's efforts. <u>A monetary weapon</u> of devaluation of the Yuan, turbulent in recent days with a 1.7% fall against the Dollar, although China would not want to cause capital flight as in 2016, when it devalued the Yuan by 7%. <u>A strategic weapon</u>, with ongoing offshoring of steel production units to Indonesia and Malaysia. <u>An agricultural weapon</u> via the substitution of Brazilian soya beans for US soya beans, produced in predominantly Republican states, because the Chinese know that agriculture, with a $21 billion surplus, is one of the leading US export items. <u>A financial weapon</u> by possibly reducing its stock of Treasuries, estimated at $1,180 billion, one-third of China's foreign exchange reserves, which would possibly oblige the Fed, which already holds $2,300 billion in Treasuries, to buy them back. <u>An economic weapon</u> via a possible boycott of the $220 billion worth of American products produced and sold in China, because we should not forget that GM sells more vehicles in China than in the United States and that Apple generates one-fifth of its sales there. And of course <u>the weapon of tariffs</u>.

- ***Trade with Mexico***:

Here again, we can measure the damage caused by Donald Trump if we consider that the likely election of Lopez de Obrador is a consequence of US policy. Considering just the figures, the Mexican trade surplus with the United States stood at $63 billion in 2016 and Mexican exports to the United States are equivalent to 80% of the total and 25% of GDP, but since the country mainly performs assembly, the value added of goods exported to the United States is limited to 13% of its GDP.

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To conclude on this subject of protectionism, it seems plausible that towards the end of the summer, ahead of the mid-term elections, Donald Trump will take minimal concessions by China or Europe as a pretext to claim victory and win votes in the November elections. In other words, we do not subscribe to the hypothesis of a trade war and that enables us to show some confidence in the markets' performance.

III. The European issue: *"The main danger threatening Europe is fatigue", Husserl*.

Apart from the potential for deeper European integration, we remain positive on Europe because the economic situation and outlook are favourable. In the past, political crises have made it possible to take steps forward and everyone knows that, without the Greek crisis, there would probably have been no quantitative easing or establishment of the European Stability Mechanism (ESM), but in the near term, political instability prevails and continues to affect markets adversely.

- ***Political environment***:

When the EU was enlarged into Eastern Europe back in 2005, optimism prevailed, europhile Tony Blair was British prime minister, and a draft European constitution was prepared and had not yet been downed by the French and Dutch referendums. Today, the picture is different and, paradoxically, European membership may have facilitated the election of non-liberal governments, as citizens see Europe as a sort of ultimate rampart. In Poland, 200,000 Ukrainians obtained a work permit in 2017, but populism has gained ground in eastern European countries due to fears of immigrants from the Middle East or Africa. These are countries with low birth rates (and this is possibly one reason), suffering from de-population and fearing cultural debasement as a result of immigration.

Donald Trump's threats against imports of German cars confirm the need for the French-German tandem to agree rapidly to jump-start European integration, before the European elections of 2019. There are no longer plans for a Eurozone finance minister, a Eurozone parliament or abandoning unanimous voting, but from defence to energy, and including digital technology, border security, the setting up of an emergency European Monetary Fund and the harmonization of corporation taxation, the field for potential consolidation remains vast. As in the past for Schengen and the Euro, Europe must aim at tangible breakthroughs to show electors another face than its technocratic image.

- **The Italian case: toward a split-up of the coalition.**

Politically, Italy is different from other European countries. Firstly, it has never had a strong Socialist party and for a long time the choice was between Communists and Christian Democrats. Secondly, Italy invented populism with Berlusconi. Lastly, until 2008, the Northern League was pro-European, in favour of a North which would be better integrated into Europe. Since 2008, following the crisis, and especially since 2013 due to growing immigration, with the entry of 700,000 illegal immigrants, attitudes have hardened. Today, the coalition seems

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fragile and temporary: on the right, populism is fighting for the national identity, and on the left for a universal income. The former mistrusts the State, while the latter counts on the State. Expelling 500,000 migrants, which is the League's goal, is impossible from an administrative viewpoint, and financing the economic programme of both movements is inconceivable.

Economically, Italy represents 15% of the Eurozone's GDP but almost one-quarter of its debt. These figures are deceptive: the reduction in the budget deficit can be explained by the decline in investment and not by savings on current expenses. The trade surplus can partly be explained by weak domestic demand. In 2017, the growth rate was the highest in recent years (1.7%), but the unemployment rate was still 11%, well above the 6% level of 2007. The populists' success reflects the malaise of a country whose GDP is still 6% below its 2008 level and whose per capita GDP is less than in 1999.

Public debt now stands at €2,300 billion, of which only 35% is held abroad, so a default would mainly hit Italian banks and investors. It is therefore reassuring to see Giovanni Tria put off costly measures such as lower tax rates and the introduction of a universal income. The yield spread with Germany on 10-year bonds rose from a low of 1.1 up to 2.8 percentage points before falling back to 2.3 percentage points. But we should not forget the country's credit rating, BBB, because a downgrade of this rating to high-yield bond status would shut off the country's access to normal ECB refinancing, undermining a banking system that is encumbered by a substantial proportion of the country's debt and insufficiently concentrated. The Italian stock market's outperformance this year has been wiped out, and the European banking sector, which outperformed between mid-2016 and end-January 2018, is now posting a significant underperformance.

Although a lowering of the retirement age, planned by both parties, seems unrealistic in a country which is losing 150,000 people a year, and although the tax measures are incompatible with compliance with European commitments, Italy's weaknesses nevertheless call for structural reforms: incentives for childbearing, currently very low at 1.37 children per woman, increased spending on education, the promotion of a meritocracy to discourage the numerous graduates leaving for overseas (120,000 in 2016, or 2% of the age group, and more than 1.5 million over ten years, which adversely affects the country which paid for their education). Italy has lost its most dynamic young people and many of those who remain vote for populists.

Finally, a financial crisis in Italy would not necessarily derail the other countries of southern Europe, Spain and Portugal, which are more robust than Italy both financially and economically. Their GDP has exceeded the levels of 2007, growth is higher, Spain's per capita GDP is 20% higher than in 1999, unemployment has fallen significantly, from 17% in 2013 in Portugal to 7.8%, competitiveness has been improved, and export market share has increased for both countries. Portugal exports 40% of its GDP versus 30% in 2007, as a result of a shift up the value chain and an increase in the number of exporting firms.

- **Greece: *"He who loses his debts is enriched", Balzac*.**

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After receiving €245 billion in aid from the European Union, Greece has freed itself from European custodianship. The country did not obtain even a partial write-off of its debt, but an extension of debt maturities by ten years until 2069, and an extension by ten years, until 2032, of the grace period for repayment of interest and capital on the €96 billion lent by the ESM. The measures demanded in return seem unrealistic and impossible to comply with in the long term, because the country is committed to achieving a primary budget surplus of 3.5% per year until 2022, and then 2.2% per year until 2069.

However, we believe it is still too soon to speak of a "Greek Renaissance": in 2017, GDP growth was only 1.3%, the unemployment rate still 20%, investment is too low, the banks are reducing their non-performing loans but are still incapable of financing SMEs, government is not yet a paragon of speed, and the emigration of young people is a structural handicap for the country's future.

IV. **Interest rates and financial markets**:

There are three question marks regarding the tightening of monetary policy, inflation risks and risks related to the foreign-currency debt of emerging countries.

- ***Are monetary policies likely to undermine growth***?

- We don't think so:
  Firstly, because long-term interest rates are still lower than economic growth almost everywhere, and the cost of debt in the United States is 1.6% in 2018 (source: CBO). The exceptions are a few large emerging countries which, for many months, we have excluded from our investment strategy: Turkey, South Africa, Brazil… and one OECD country, Italy.
  Secondly, because short-term interest rates are lower than inflation rates almost everywhere.
  Also, even in the United States, a country which is pursuing a policy of interest-rate hikes, the 10-year interest rate net of core inflation is only 0.7%, far lower than the 2.5% observed on a long-term basis.
  Lastly, the impact on the US economy of the Fed's downsizing of its balance sheet, by $30 billion per month at present, and by $50 billion per month next year, will be modest and, for the time being, is less than the amounts repatriated. From $4,300 billion, the balance sheet could reach $3,500 billion in early 2020, a figure still far larger than the $800 billion of 2007. However, the negative effects are more perceptible in emerging countries in a situation of current-account deficits or which have companies indebted in US dollars. Again, we are thinking of the countries mentioned above.

- In other words, for once it is not certain that an inversion of the US yield curve, possibly at the end of the year, would point to a recession. The manufacturing, housing market, job and sentiment indicators do not suggest this. Admittedly, the 2/10-year differential is low at 35 basis points, but the low level of long-term interest rates is, probably and partially, the consequence of Italian uncertainty, selling of

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euros and purchasing of dollar-denominated assets. Despite a more restrictive monetary policy in the United States, after seven interest-rate hikes and before two further hikes in 2018, the global economy is still being boosted by monthly liquidity injections at a rate of $100 billion, one-third coming from the ECB and two-thirds from the Bank of Japan. By buying €1,800 billion worth of bonds between March 2015 and mid-2018, including €345 billion of Italian debt, the ECB has facilitated recapitalization of the banks and, although it will reduce its purchases after September and stop them at the end of December, it will keep interest rates negative, at -0.4%, for most of 2019 and will reinvest the capital from expiring bonds. As regards the Bank of Japan, no monetary policy tightening has been announced as yet.

- ***Is there a risk of an upturn in inflation***?

The question is often asked, and our answer remains no. The situation of Japan is symptomatic: the core inflation rate is only 0.7% in May, despite virtually full employment (the unemployment rate does not exceed 2.5%) and despite the entreaties of the prime minister, who is constantly asking businesses to raise wages and offering tax incentives for this purpose. And yet, this spring, the big corporations offered wage increases of no more than 2.3% to 2.5%. In fact, if you deduct automatic increases related to promotion by seniority, the final increase is two percentage points lower. The situation of small businesses is more encouraging, since they are obliged to be more generous to attract workers.

Admittedly, inflation has not always been caused by wage growth. The rise in the oil price played a role in the 1970s, but nowadays OECD economies are less sensitive to this factor. The fall in the profit ratio was one cause of the price rises in the 1960s, but nowadays profit ratios are higher.

In the United States, core inflation was 2.2% in May, headline inflation was 2.8% and wage growth was similar, despite the low unemployment rate. In Europe, the core inflation rate in May was only 1.1%, far from the 2% target. In the United Kingdom, the inflation rate was 2.4% in May. In China, the inflation rate reached 2.1% in April. So, inflation remains low everywhere.

- ***Risks related to the foreign-currency debt of emerging countries***:

The liquidity glut which enabled emerging countries to raise $7,700 billion in debt in 2017, including $800 billion in foreign currencies, has been followed by the negative effects of a liquidity squeeze and an increase in energy prices combined with a strengthening of the dollar, thereby placing pressure on interest rates and purchasing power, because subsidies have often been reduced in recent years. Since mid-February, the stock market indices of Turkey, Brazil and Indonesia have fallen heavily. There have been major capital outflows from these countries, especially when, like Turkey (inflation rate exceeding 12%, decline in purchasing power, official interest rate of 17%), India and South Africa, they are suffering from structural current-account deficits (5.6% for Turkey), or substantial corporate debt denominated in foreign currencies (20% of GDP in Turkey).

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In Brazil, the trade deficit is admittedly very small at 0.4%, and foreign exchange reserves are large, at $380 billion, i.e. more than the $320 billion of debt in foreign currencies, but the country just came out of recession in 2017, the unemployment rate remains above 10%, the budget deficit amounts to 7.5% of GDP, the public debt ratio is deteriorating rapidly, at 75% of GDP, there are numerous labour disputes and the currency has fallen by 14% against the US dollar since the end of January, which explains the worsening inflation situation.

The vulnerability of countries in a situation of a current-account deficit, which we have often mentioned in our previous notes, was dramatically reflected by Argentina's appeal to the IMF after raising its official interest rate to 40%, but in vain.

Not surprisingly, we therefore remain reluctant to invest in these countries.

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***Conclusion**: "I am prepared for the worst but hope for the best", Disraeli.*

- The euro: despite political tribulations in Italy, difficulties in developing deeper integration of the Eurozone, and rather disappointing Q1 economic statistics in the Eurozone, the currency recently fell against the dollar but, year on year, it was up by 1.7% when the US tax reform had not yet been enacted.
- The US dollar: up by about 5% since mid-April, is being boosted by political tensions, the interest-rate and growth differential with Europe, the $300 billion of cash repatriated in the first quarter, and the rise in oil prices which has exacerbated the currency's scarcity.
- The Swiss franc: a trade surplus of CHF35 billion, equivalent to 5% of GDP, low inflation, an unemployment rate below 3%, regular GDP growth, a positive net external position of CHF870 billion, all these qualities justify the currency's structural strength, even though it has lost 1.8% against the US dollar this year.
- The yen: on the back of an expected current-account surplus of 3.8% of GDP, the yen has also apparently regained its safe haven status and appreciated by 1.7% against the US dollar this year.
- Note the divergence between the perceptions of public opinion and the reality: for example, the Chinese current-account surplus (10% of GDP in 2007 and less than 1.5% at present) has never been denounced as strongly as it has now. The same applies to Chinese investments in the United States, which are 90% lower this year but still one of Donald Trump's favourite themes. The same applies to the focus on steel, which employs only 140,000 out of 145 million workers in the United States and does not even represent 1% of market capitalization. The same also applies to immigration in Europe, with inflows now very small, around 10 times smaller than in 2015, but faced with a very hostile public opinion. The OECD calculates that the European labour force will increase only 0.3% by 2020 following the arrival of 4 million asylum seekers between 2014 and 2017. We therefore believe that these fevers will subside.
- In light of the risks of recession which are not yet perceptible, minimal inflation risks, moderate risks of a trade war, contained geopolitical risks and persistently strong earnings growth, we believe that the disappointing performances of stock markets are a passing phase. The two most sensitive points are the consequences of an embargo on Iran and the situation of some emerging countries. Erratic performance will probably persist until the presentation of the Italian budget, until we have a better idea of the consequences of the Iranian sanctions on oil prices, and until there has been a clarification of the trade war, all of which will probably take us through to autumn.

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