

MARKET REVIEW

Since the start of October, despite exceptional earnings growth in the United States (22%) and reasonable growth in Europe and Japan (around 10%), and although the economic outlook is still positive, the stock market indices of the major economies have fallen by about ten percentage points on average.

To understand these markets, let's analyse whether the four reasons for concern are justified, namely rising interest rates, the possibility of a recession, the costs of the trade war, and the slowdown of growth in China. We will disregard inflation, which is at 2% in the United States and 0.9% in Europe, as it will fall again. We will also ignore oil prices, which Saudi Arabia will be keen to contain in order to satisfy Trump. As for Emerging market risk, of the three weak links, the first, Argentina, is under IMF supervision with a loan of \$57 billion, the second, Turkey, has a "claim" on the United States and Saudi Arabia, while the third, Pakistan, is in discussions with the IMF.

- *Rising interest rates*: The Fed is reducing its balance sheet by \$50 billion per month, the ECB is poised to put an end to its injections of €15 billion a month at the end of December 2018, and the Bank of Japan is struggling to buy up as much as it would like to. So, after \$15,000 billion in liquidity injection since 2008, there is a fear that liquidity will dry up, causing a rise in long-term interest rates, a contraction in corporate margins, more fragility for indebted companies or countries, a slowdown in the real estate sector, thus the start of an "end of cycle". The sequence of events is well known, but the panic is premature: in the United States, real interest rates, which are what counts, are still low, and nominal rates, with 3.11% at 10 years, hardly exceed the expected GDP growth rate of 3% this year. In Europe, the upward spiral in rates only penalizes Italian economic policy, sparing the countries of southern Europe, while markets, with a spread relative to Germany that has fallen to less than 3 percentage points, are betting on a compromise with Italy. At the same time, in Germany and France long-term interest rates are at historically low levels, lower than at the beginning of the year. Even if they were to rise to 3.5%, US long-term interest rates, both in real terms and in relative terms compared with the debt level, would not endanger growth.

- *The possibility of a recession*: Growth is slowing in Europe, and will slow in the United States as of next quarter, as the impact of the tax stimulus (\$200 billion this year) and repatriation of offshore cash has been absorbed. Clearly, housing starts, at 1.1 million, are declining in the United States and prices are rising less strongly. But there is neither unsold stock nor a price bubble, because prices are only slightly above 2006 levels. US growth in the third quarter owes little or nothing to corporate or real estate investment and much to inventory rebuilding, which is inevitably temporary. However, consumption remains buoyant and should continue to be boosted by the low level of unemployment (3.7%) and a slight acceleration in wages (to 2.8%). So recession is not a threat in OECD countries.

- *The costs of the trade war:* The policy conducted by Donald Trump penalizes steel-consuming companies, as Caterpillar and Ford have reiterated; it discourages international investment, which accounts for the IMF's downward revision of its global growth expectations. We assume that Trump will be unable to ignore the complaints from business circles, which are one component of his electorate, and that the Democrats, if they regain control of the House of Representatives, will not ratify the agreements with Canada and others. So, let us keep this threat in perspective.

- *The growth slowdown in China:* Disturbing signals are converging, whether the GDP growth figure, at 6.5% in the third quarter (the lowest rate since 2008), automotive sales (which fell 5% in September), profits of industrial firms (which grew by only 4%), or the lack of credit elasticity in successive reductions to the reserve requirements rate. Then there is local and regional government debt, amounting to 40% of GDP, and corporate debt, at 140% of GDP, hindering the continuation of such policy. Lastly, overcapacity exists in numerous sectors, from real estate to infrastructure. Of the four factors examined, the latter is the most tangible cause for concern, because in recent years China has accounted for one-third of global growth.

Conclusion:

- For our portfolios, the short-term discomfort lies in the markets' vulnerability as attested by a chartist analysis of the indices, while the comfort, in the longer term, is based on valuations, and the undervaluation of the majority of the stocks contained in our funds.
- Fundamentally, in this turmoil, we are pleased with the composition of our portfolios. Specifically their liquidity, transparency, absence of leverage, and clear preference for investment funds over single lines. Thus avoiding the large declines in some high-quality stocks some by as much as 30% to 50% over this period.
- Finally, bear in mind the absence of alternatives to the equity markets, whether cash in euros at -0.40% or in CHF at -0.70%, bonds which are unattractive unless denominated in US dollars, or real estate which suffers from illiquidity, put together with ageing populations and heavier taxation in many countries. In a world in which debt is the equivalent to three times global GDP and in which the value of this debt has been biased by the aforementioned monetary injections, investment strategy must inevitably be focused on equities, because wealth creation is constructed by companies. Admittedly, earnings growth will be weaker than it was. Yes, companies use - sometimes excessively - artifices such as share buybacks, accounting for \$1,200 billion this year in the United States, and the distribution of super-dividends, possibly financed by debt, to boost their stock market performance. Yes, they sometimes exploit monopoly positions or take over competitors to find growth drivers. Yes, the demand for quarterly earnings reports impedes the execution of a long-term strategy. But come what may, in a capitalist economy, it is almost superfluous to reiterate the essential role of enterprise.

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