BANQUE
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QUARTERLY PERSPECTIVES

1st QUARTER 2020

CONTENTS

1. EDITORIAL
WHAT SHOULD BE REMEMBERED FROM 2019 AND WHAT OUTLOOK FOR 2020?

2019 ends on a positive performance for a large number of asset classes, in sharp contrast with 2018.

It would be tempting for some to describe this as an easy year, but bear in mind that in December 2018, recession fears caused the S&P 500 Index to fall 9.18% in that month alone, which was the steepest December fall since 1931. 2019, too, was not without its ups and downs: equity market corrections in May and August, escalation of the trade war between China and the United States, political and financial crisis in Argentina, break-up of the government coalition in Italy and a deal for the United Kingdom's withdrawal from the European Union negotiated at the eleventh hour.

In short, therefore, the global economy slowed sharply in 2019 but avoided recession. This modest but is reflected by a double-digit rise in the main stock markets worldwide! This is a simplistic view, but it reminds us that what counts most for markets is the difference between expectations and actual events, rather than an absolute figure.

It is true that (once again) the central banks were very helpful. All are now in accommodative mode: those that already were (the ECB) and those that no longer were (the Fed). The global money supply, which went into a slight contraction for some time, is expanding again: the strong performance of financial assets is also due to underlying monetary «doping». This paradigm change also accounts for the strong rebound in 2019 and allowed bond and credit markets to post fine performances this year again. In so doing, this also pushed the yield on a growing number of bonds into negative territory. From a market viewpoint, 2019 is the exact opposite of 2018: all asset classes have risen, whether they be «risk-on» like equities or «risk-off» like gold or government bonds. The «risk-on» attitude is also reflected by pronounced sector rotation: cyclicals and value stocks seem to be at last interesting investors again. This trend started in October and provides an initial key to 2020. Investors are implicitly buying an improvement in the cycle (admittedly encouraged by very attractive valuations of those sectors!).

At the risk of killing the suspense, we believe that two factors should be borne in mind for 2020. The good news is that the economy is improving slightly; the bad news is that investors have been very convinced of this since the autumn. The resolution of uncertainties surrounding Brexit and progress on the trade war have given further arguments to the most risk averse.

Key to the projections for 2020 is a correct interpretation of central bank policies: their role will remain as essential as it has been in recent years. From this viewpoint, the perspective is encouraging. The Jerome Powell of recent months is far from the Jerome Powell of mid-2018 (he who in «plain English» warned of a more restrictive policy). The Federal Reserve has just lowered its rates three times this year, and although no other move is expected in the immediate future, it seems clear that it remains in highly accommodative mode. As regards the European Central Bank, it too will remain a factor of support for the markets. There is no reason to expect a pullback

due to a change of central-bank policy. Long-term yields are expected to stay within the range observed in 2019, i.e. between 1.46% and 2.78% for 10-year US Treasuries. And if we were to fine-tune that projection, it would undoubtedly be by raising the lower bound, because while producer prices remain under pressure, consumer prices are gaining ground in China and in the United States in particular (rising by 3.6% and 2.95% respectively).

« Two factors should be borne in mind for 2020. The good news is that the economy is improving slightly; the bad news is that investors have been very convinced of this since the autumn. »

A second question to be asked is whether there are any valuation bubbles? This question cannot be casually swept aside, since corporate debt, for example, has increased in significant proportions (outstanding debt of US$14,230 billion versus $7,540 billion ten years ago)*. This liquidity is also overflowing into assets such as private equity and real estate, and could create an explosive mixture of excessive valuations and illiquidity, as we are reminded by the collapse of WeWork, a unicorn whose valuation has fallen precipitously from $45bn to less than $10bn.

These signals should be heeded, even though we do not think they herald an imminent disaster.

Probably, therefore, we should bet in the short term on a continuation of the long economic bull cycle which began in 2009. Much has already been said about its atypical nature and the fact that the US market has profited from it enormously by comparison with the rest of the world.

To take the projections further and consider on which assets to be invested, we believe that the catch-up movements triggered some time ago are set to continue. The European market and especially emerging markets are regaining ground and will probably continue to do so. Small and mid caps - on lower valuations in the past two years - offer great opportunities. Cyclical stocks have been hit hard by the trade war and deserve a larger weight in asset allocations. However, the entry points will have to be adjusted. As mentioned earlier, the positioning of market participants is far more aggressive than a year ago. Very low VIX, far more pronounced buying consensus… A less favourable technical situation.

2020 will probably be a better economic vintage than 2019, but not such a good stock market vintage.

**Source: Bloomberg BarCap Global Aggregate Credit, Nov 2009, October 2019*

2. MACRO PERSPECTIVE
A SLIGHT IMPROVEMENT IN THE ECONOMY IN 2020?

In its latest bulletin in October, the International Monetary Fund once again adjusted its growth forecasts downward for the global economy for 2019 (Table 1). Global growth is expected to mark a sharp slowdown relative to 2018, and in 2019 it is expected to have fallen to 3.0%, i.e. its lowest level since 2009.

Those countries which saw their growth accelerate in 2019 are exceptions: Japan accelerated slightly, but it benefited from a favourable base effect, and some sub-Saharan countries also, but they have an insignificant weight in the global economy. This growth slowdown is also reflected by subdued inflationary pressure, especially in mature countries, and the main central bankers are well aware of this, moreover

Table 1: IMF growth outlook

			Forecast			
	2017	2018	2019	19 vs. 18	2020	20 vs. 19
World	3,8%	3,6%	3,0%	↓	3,4%	↑
USA	2,2%	2,9%	2,4%	↓	2,1%	↓
Euro Zone	2,4%	1,9%	1,2%	↓	1,4%	↑
- Germany	2,2%	1,4%	0,5%	↓	1,2%	↑
- France	2,3%	1,7%	1,2%	↓	1,3%	↑
- Italy	1,7%	0,9%	0,0%	↓	0,5%	↑
- Spain	3,0%	2,6%	2,2%	↓	1,8%	↓
Switzerland	1,7%	2,5%	1,1%	↓	1,5%	↑
United Kingdom	1,8%	1,4%	1,2%	↓	1,4%	↑
Japan	1,9%	0,8%	0,9%	↑	0,5%	↓
High Growth markets	4,8%	4,5%	3,9%	↓	4,6%	↑
Asia ex Japan	6,6%	6,4%	5,9%	↓	6,0%	↑
- China	6,8%	6,6%	6,1%	↓	5,8%	↓
- India	7,2%	6,8%	6,1%	↑	7,0%	↑
Latin America	1,2%	1,0%	0,2%	↓	1,8%	↑
- Brazil	1,1%	1,1%	0,9%	↓	2,0%	↑
- Mexico	2,1%	2,0%	0,4%	↓	1,3%	↑
Russia	1,6%	2,3%	1,1%	↓	1,9%	↑

Source: IMF, October 2019

At present, the IMF is still counting on a renewed acceleration of global growth in 2020. While analysts expect that these estimates will probably have to be revised downward, we think that the scenario of a stabilisation of this growth is conceivable due to the reduction in risks surrounding the trade war and Brexit. Emerging regions will probably be the driver of this slight pickup in economic growth, which is a plausible scenario with less restrictive financial conditions and first signs of a respite in trade tensions, which, remember, had hurt these countries proportionally more severely.

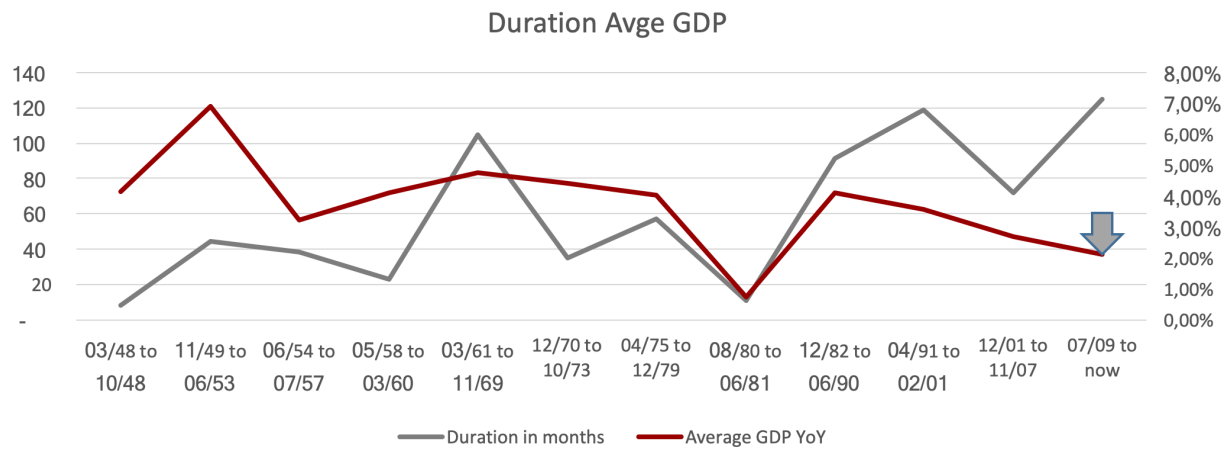
In a world of low growth and moderate inflation, and when central bankers seem to have spent their ammunition for the time being, pressure is rising on governments to do more in terms of fiscal stimulus, focusing particularly on the energy transition and decarbonisation. This focus could also prove to be a driver of global growth, but which is not without long-term risks given the high debt levels of public and private economic agents.

United States: an atypical cycle

Growth is slowing in the United States but remains robust, as underscored by the figures for the past three quarters, i.e. 3.1%, 2.0% and 2.1%. The economy continues to be sustained by consumer resilience, with an unemployment rate of 3.5%, the lowest in 40 years, monthly job creations average 180,000 at an annualised rate, and wage inflation is 3.1%.

Much has been said about the atypical nature of this economic cycle: it is not only the longest ever observed (126 months to date) but also the least vigorous (2.1% average annual growth in the US over the past 10 years). The US market has profited hugely from this, whereas the MSCI «World ex United States» Index is just fluctuating around its 2006 levels! *(Chart 2)*

Graph 2 : Economic cycle duration vs. US GDP annualized



Source: Bloomberg, NBEA

In the end, while everyone was expecting further monetary tightening, the Fed changed policy: it has cut its policy rate three times this year and surreptitiously revived QE. Jerome Powell's latest speech points to a pause in the coming months, but it seems clear that the Fed will probably remain accommodative.

This year, Christmas came 10 days early in the United States: after several months of escalation, China and the United States have apparently reached a so-called phase 1 agreement. Under this agreement, the United States would decide not to apply the planned 15% tariff on consumer goods originally scheduled for 15 December and would reduce from 15% to 7.5% the tariffs established in September. On the Chinese side, the main concessions will apparently be made in the form of purchases of agricultural products, oil and gas, and a commitment to open up their financial services to US firms. While this agreement represents a first step in the easing of Sino-American relations, caution is still the watchword until this agreement has been ratified and implemented, and given that numerous problems are far from being solved, notably regarding the existing tariffs, intellectual property, access to US technology for Chinese firms, and subsidies to certain sectors of the economy.

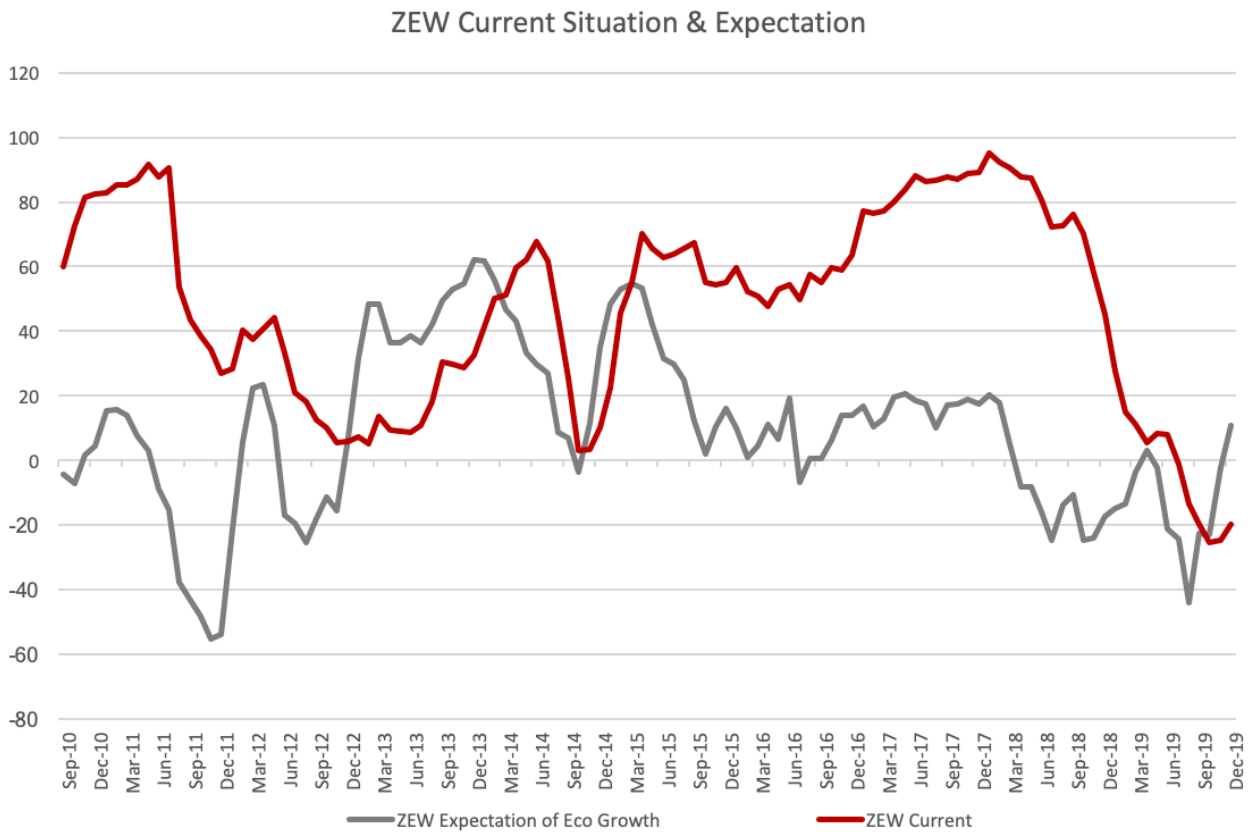
It was nevertheless essential to start this easing less than one year from a presidential election, or else the American job machine might seize up and jeopardise President Trump's record.

Eurozone: Germany bends but does not break

In November, Germany learned its growth figure for the third quarter with relief. Thanks to a very modest 0.1%, the country avoided being declared officially in recession: good news, no doubt, but perhaps not as good as that. By just avoiding recession, some of the pressure placed on the German government to start fiscal stimulus disappeared.

Admittedly, with an unemployment rate of 5.0%, the lowest in a generation, and manufacturing climate surveys (Chart 4) that are improving, there is less pressure on the domestic level and the soft patch in Q3 has almost been forgotten.

Graph 3: Germany ZEW



Source; Bloomberg

It must be said that the removal of uncertainties regarding the trade war and Brexit (see below) are all reasons for business circles to hope for a slight improvement in 2020.

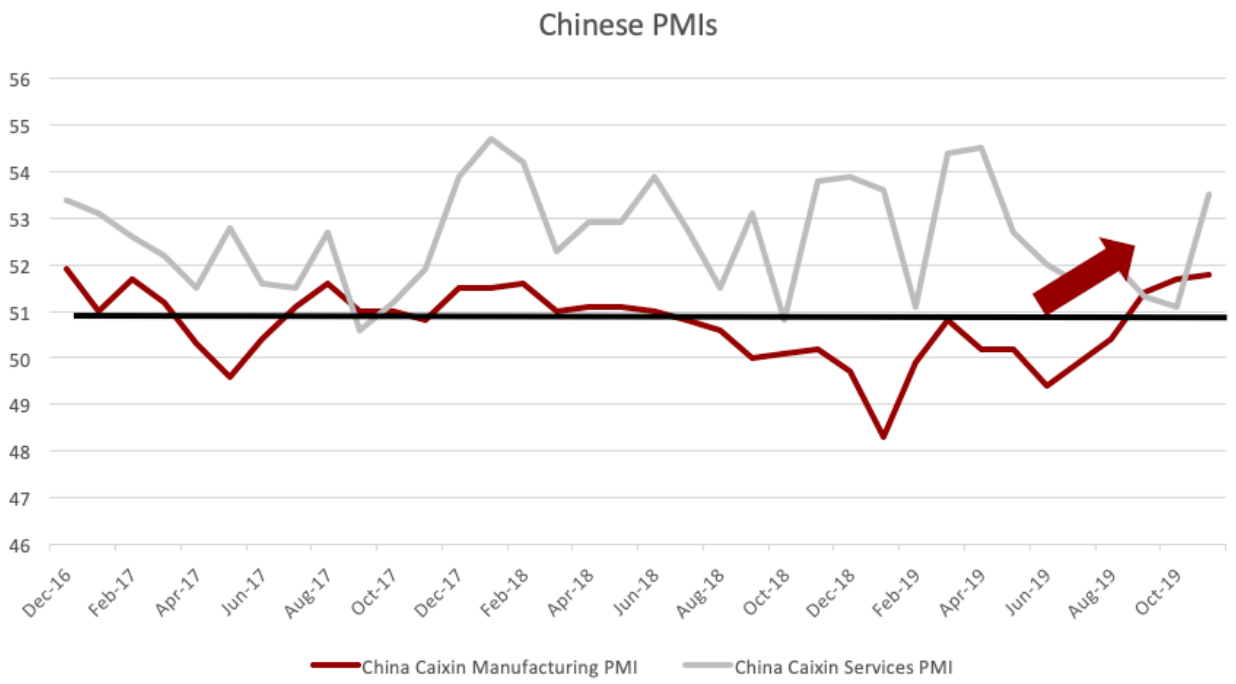
United Kingdom: Brexit on the rails

Following a lightning campaign, the British Conservatives led by Boris Johnson won a clear majority with 365 of 650 seats. But they will have to deal with increased regional demands and the weakening of the Irish Unionist Party. Thanks to his new majority, Boris Johnson should be able to have the Brexit Withdrawal Act passed by the end of January 2020. Once ratified, the United Kingdom and the European Union will have until the end of 2020 to define a framework for their future relationship and negotiate a free-trade agreement within less than one year. Although the risk of a no-deal exit has decreased, the Brexit issue is far from being settled. The British economy, which had slowed under the burden of uncertainty caused by Brexit, should benefit from the reduction in systemic risk and from potential stimulus measures, but it is hard to imagine a prolonged confidence shock given the uncertainty concerning future relations between the EU and the United Kingdom. It will also be interesting to see to what extent Prime Minister Boris Johnson will be able to keep the promises of the candidate and what concessions could be granted to Scotland and Northern Ireland to quell secessionist tendencies. The pound sterling has picked up again and appears as the main winner in the short term.

Asia: Europe dreams of it, Asia has done it

This could summarise the attitude of Asian governments with regard to fiscal stimulus measures. China had already shown the way by undertaking a programme of corporate tax cuts amounting to 2,000 billion yuan, and a reduction in VAT – from 16% to 13% for manufactured goods and from 10% to 9% in the construction and transport sectors. The killjoys will say that this stimulus is limited by the deleveraging policy of the Chinese authorities and by sustained 4.5% inflation. That is to forget rather too quickly that inflation has been boosted significantly by food price inflation following the swine fever epidemic in China. This unfortunate event should nevertheless enable China to more easily meet its quota of purchases of US agricultural products. Like in the rest of the world, the manufacturing sector is showing initial signs of stabilisation and improvement.

Graph 5: Chinese PMIs



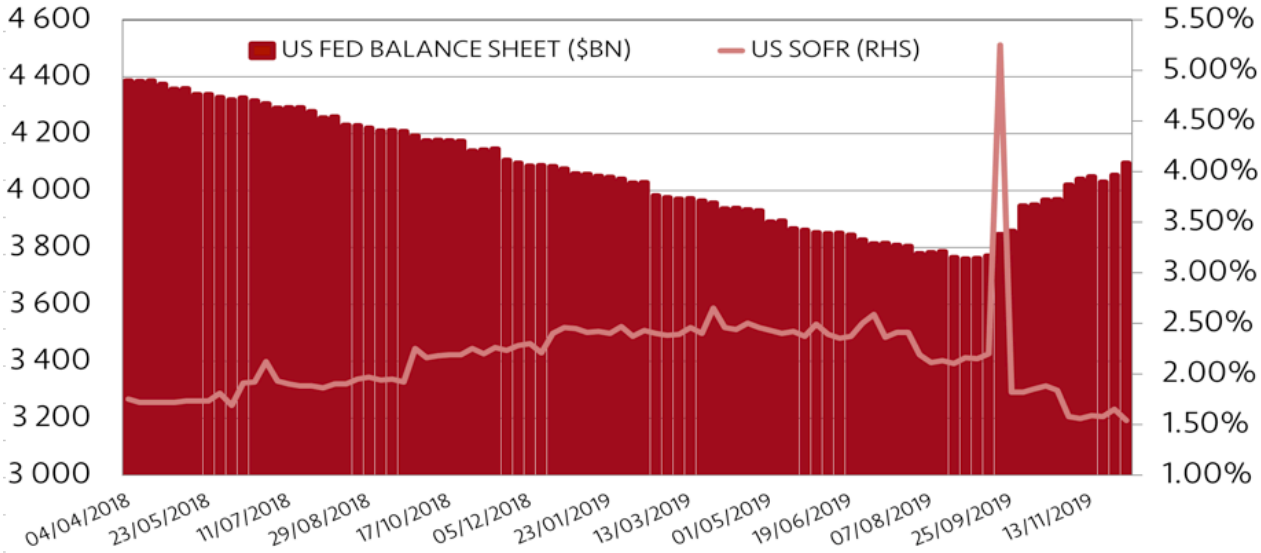
Source: Bloomberg

In Japan, the government has also decided to implement a stimulus plan worth JPY 5.7 trillion in 2020. This should be able to partially attenuate the growth slowdown which the country can be expected to face following the 2% sales tax hike in October.

3. FIXED INCOME
A HANGOVER IN 2020 AFTER THE FESTIVITIES OF 2019?

2019 can be summed up in a single point affecting fixed-income markets, but also the other markets. A year ago, the Fed announced to us that it was going to raise its interest rates three or four times and that it was going to drastically reduce the size of its balance sheet (quantitative tightening on automatic pilot, according to Jerome Powell). The ECB had just finished its programme of asset purchases and could not see why its deposit rate, which was already set in negative territory at -0.40%, should be changed. Twelve months later, the Fed had lowered its policy rate three times, it had to stop its balance sheet downsizing programme and, at the end of the year, it did a complete about-turn and increased its balance sheet again via a surreptitious QE4 plan to stop haemorrhaging on the money market (a problem that has still not been resolved as yet, incidentally: see Chart 6).

Graph 6: FED Balance sheet & Secured Overnight Financing Rate

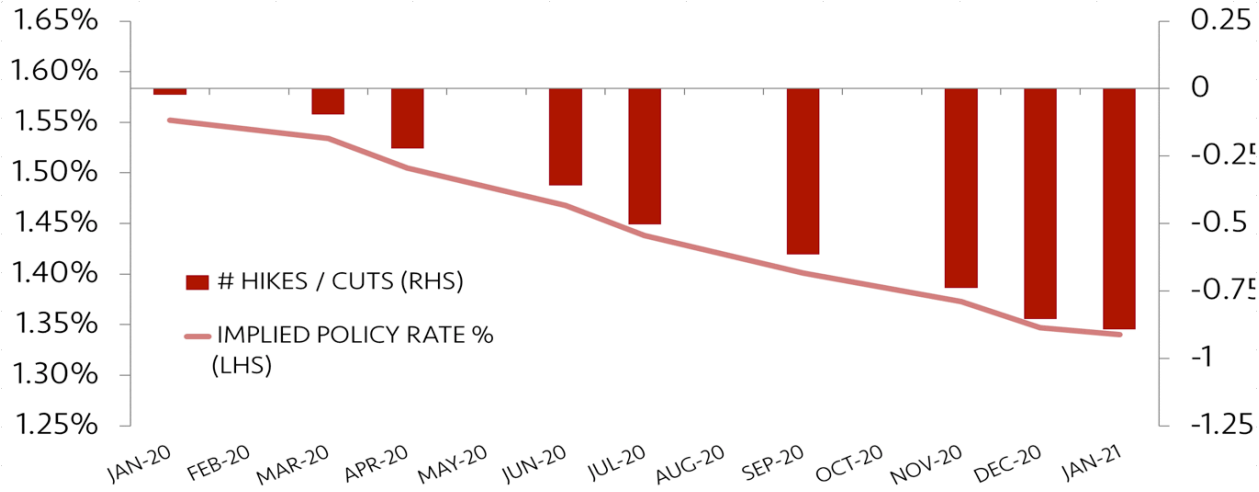


As regards the ECB, a QE2 was adopted in the autumn and the deposit rate was lowered to -0.50%. So, markets were expecting a year marked by more restrictive policies, but the tap has never been opened so wide, to the great joy of equity markets. Accordingly, after both ending 2018 in the red, bond and equity markets ended 2019 posting excellent performances. This gives great satisfaction, but also makes one wonder what 2020 will bring.

« The Fed considers that 2020 will be a year of status quo on its Fed funds rates, while markets believe that an interest-rate cut will take place around June. »

This year-end 2019 is marked by a sharp reduction in systemic risk. The two subjects of concern which dragged down sentiment throughout the year, the Sino-American trade war and Brexit, could see a favourable outcome. In any case that is what markets think. 2020 will be the year of the US presidential election. No doubt this subject will be one of the main themes of the coming year. On the macroeconomic front, the markets are also more optimistic. The risk of a recession in the United States seems to be diminishing significantly and initial signs of stabilisation in the Eurozone are starting to appear. The tone of the central banks is therefore less pessimistic. The Fed considers that 2020 will be a year of status quo on its Fed funds rates, while markets believe that an interest-rate cut will take place around June *(see Chart 7)*.

Graph 7: FED Fund rate probability in 2020



Meanwhile the ECB, according to its new president, remains open to all possible options but concedes that the outlook is brighter. Markets are taking these assertions at face value: have they already forgotten what the same people were telling us at the end of 2018?

To conclude, we maintain our convictions for next year. The Federal Reserve could be forced to go back on its word and lower its rates. Such a scenario would be more likely to materialise if the first quarter were to prove rather sluggish and if circumstances permitted. It could even be forced to increase the volume of its purchases to increase the size of its balance sheet. Sooner or later, 10-year US Treasuries could return to their lows of the summer of 2019, or even lower in the event of a shock. At the start of the year, we will probably hear renewed talk of the return of rising inflation expectations. That is why, on very long bonds, we will continue to give priority to exposure to real interest rates via 30-year TIPS (Treasury Inflation-Protected Securities). We are not expecting an exceptional vintage in 2020, after an already excellent year in 2019, but fixed-income markets still have a long life ahead of them!

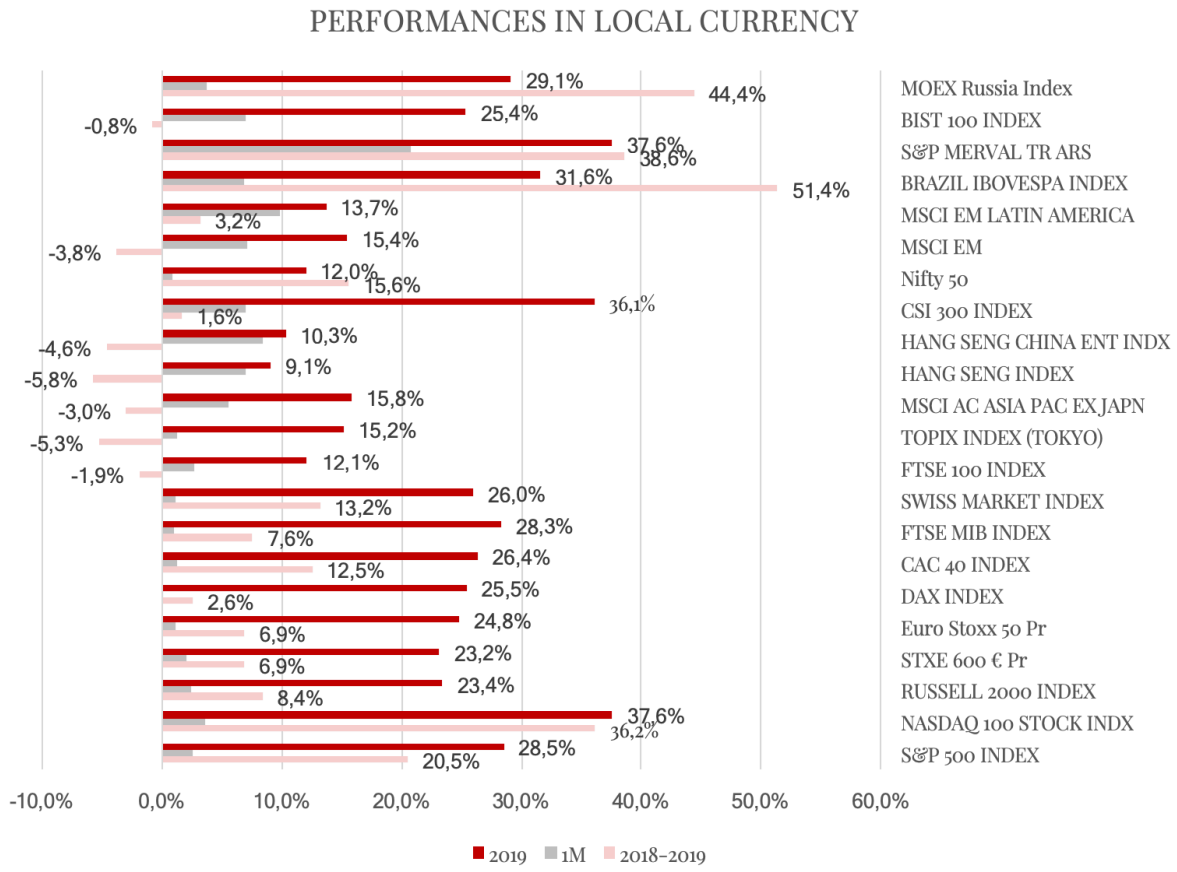
4. EQUITIES
FUNDAMENTALS VERSUS TECHNICAL FACTORS: WHO WINS?

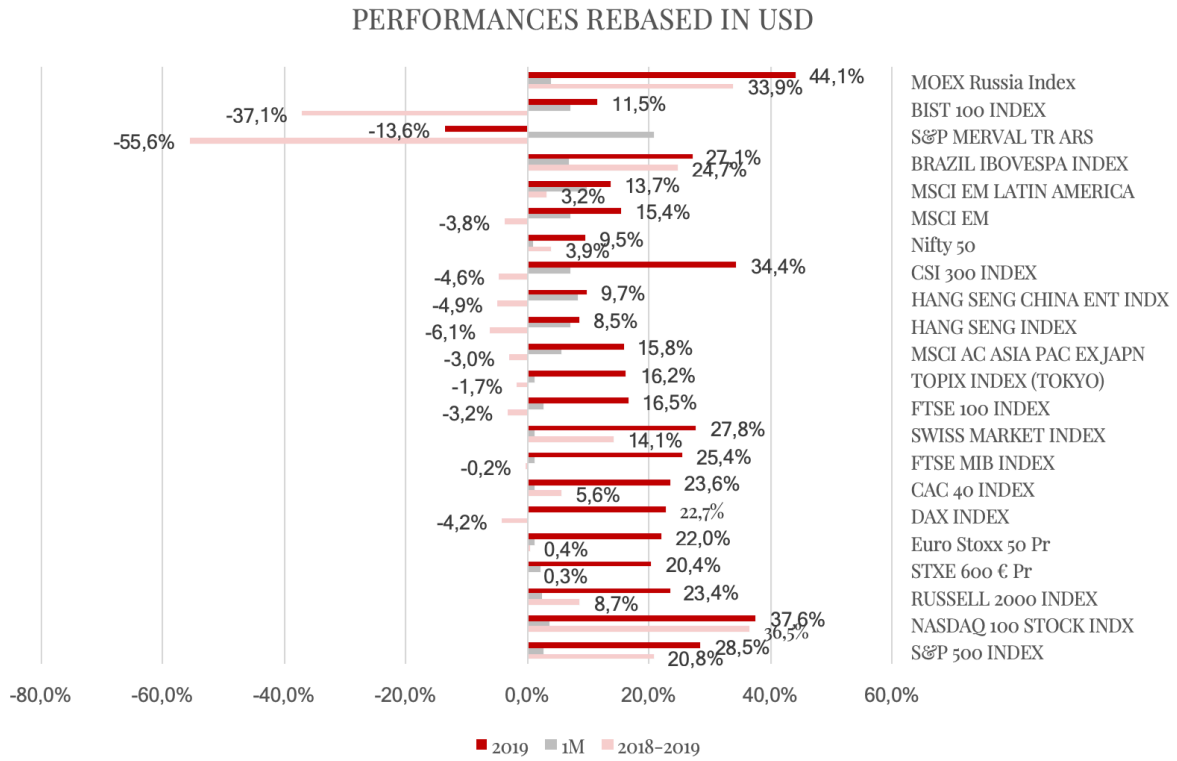
Global equities, as represented by the MSCI World Net Return Index, posted their best performance since 2013, the year when fears of a collapse of the European Union were calmed and when quantitative easing showed its full power in the EU and the United States, resulting in a significant expansion of valuations. The parallels are clear: in a tense geopolitical and macroeconomic environment in the form of the Sino-American trade war and the Brexit saga, the Federal Reserve's about-turn in 2019 was sufficiently substantial to add liquidity to the system, reduce the interest paid by businesses, and demonstrate its capacity for intervening and stabilising markets. As a consequence, investors were sufficiently confident to wait for the macroeconomic cycle and the corporate earnings cycle to stabilise and regain strength. Accordingly, the index's performance in 2019 is due almost exclusively to more optimistic expectations (valuations), and not an improvement in the existing fundamentals. The cycle strength has not yet formally materialised, even though premonitory signs have started to attract «value» investors towards the cyclical stocks that have fallen furthest.

While the fundamentals are still not very encouraging - slowing global growth, contraction in manufacturing activity, stagnation of corporate earnings - the technical situation is increasingly positive : a «phase one» Sino-American agreement and a clear mandate for Boris Johnson reduce uncertainty, capital outflows from equities have started to reverse, large corporate cash piles enable acquisitions and share buybacks, the central banks remain highly accommodative and the indices breaking through their highs are giving strong signals of momentum and arousing «fear of missing out». Notably for Europe and emerging markets, a sound technical situation and low valuations could offer upside potential for equities so long as signs of a mere stabilisation of the fundamentals continue to appear. Faced with few alternatives to generate returns in a world in which interest rates are largely negative, investors will probably jump on the opportunity to invest in equities, a proposition that is made rather more attractive by the reduction in macroeconomic and geopolitical risks.

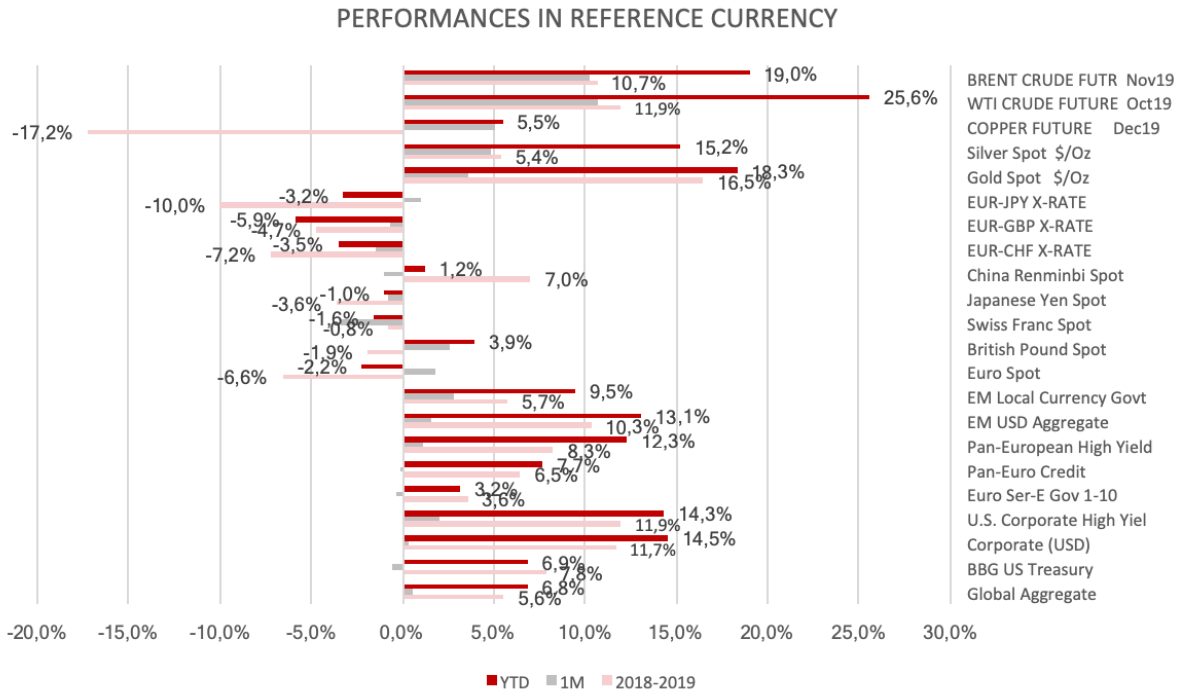
To conclude, while 2019 proved a great year for equities, this performance should be tempered by the base effect, i.e. the steep fall in the fourth quarter of 2018. On the 2020 horizon, the signs of stabilisation of macroeconomic activity and geopolitical risks enable investors to consider that a rebound is more likely. While the fundamentals will have to confirm these positive expectations, the technical situation for equities remains positive, i.e. widespread under-investment, liquidity, momentum and the lack of alternatives.

6. MARKETS AND INDICATORS





Source : Bloomberg, Banque Eric Sturdza, 31/12/19



Source : Bloomberg, Banque Eric Sturdza, 31/12/19

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