# Quarterly market review

July 2017

## Editorial

After a strong start of the year, the past few weeks marked a clear deceleration of the developed markets rally. In the United States, the stock exchange reached all-time highs right up to May, propelled by the renewal of the world economy, President Donald Trump's pro-business promises, and the FED's careful timing of restrictive monetary policy. June, however, left the stock exchange frozen at its 8% gain since the beginning of the year (and at 0% if we convert it to euros). As a result, investors await catalyzers that will rekindle the upward trend the stock market achieved in the first months of 2017. The US economy is steady with an anticipated slow growth of 2%, supported by a near fully employed labor market and an unemployment rate below 5% seen over the last 12 months. That being said, growth may not be as robust as leading indicators suggest. The FMI lowered growth expectations made in April after considering difficulties Mr. Trump faces in getting congress to accept fiscal and economic measures, and, as a consequence, growth in 2017 and 2018 may not be as steady as anticipated. With a P/E ratio of 18, US stocks are no longer as cheap as they used to be. An additional rise in the stock market will be linked to an increase in company earnings. As a result, investors are taking a wait-and-see attitude before Q2 earnings are reported. The FED is expected to continue normalizing its monetary policy after hiking US interest rates by 25 basis points in mid-June. The FED plans to further implement gradual rate rises before the end of the year, and revealed balance sheet reduction plans.


In Europe, stocks strongly progressed following the results of the first round of the French presidential elections where chances of appointing an anti-European populist candidate looked increasingly tenuous. This rise is also attributed to robust macro-economic data and strong company earnings reports in the first quarter. However, the month of June saw the European stock market fall by some 3%. The fact that we hit technical tops, political uncertainty in the UK and the rise of the euro drove investors to take profit. More recently, on the 27th of June, Mr. Draghi gave a speech that had an impressionable impact, even bringing a new fear among the investors who were used to the idea that there is not that much to worry about when investing in bonds in western countries, where, despite recent growth, inflation rates seemed incapable of normalization.


The ECB president highlighted that "signs now point to a strengthening and broadening recovery in the euro area," stating that "deflationary forces are being replaced by reflationary ones" and that "forces damping inflation are temporary." The power of these statements reinforced the idea that the ECB would soon announce a gradual end to its Quantitative Easing program, leaving investors both nervous and attentive on a short term basis, before the season of the Q2 earnings reports start. Still, we consider European stocks to have potential, even more so than US stocks. Analysts continue to anticipate a +/-17% EPS growth in 2017 among companies in the Eurozone, which still benefit from a solid macroeconomic environment with valuations reasonably standing at 15.5x earnings in 2017.

| | Q2 2017 | YTD | Close 30/06/17 |
|---|---|---|---|
| DOW JONES | 3.32% | 8.03% | 21 349.63 |
| S&P 500 | 2.57% | 8.24% | 2 423.41 |
| FTSE 100 | -0.14% | 2.38% | 7 312.72 |
| EUROST.50 | -1.69% | 4.60% | 3 441.88 |
| CAC 40 | -0.04% | 5.31% | 5 120.68 |
| FTSE MIB | 0.45% | 7.02% | 20 584.23 |
| MSCI EM | 5.47% | 17.23% | 1 010.80 |
| CRUDE OIL | -9.01% | -14.30% | 46.04 |
| GOLD | -0.62% | 7.75% | 1 241.55 |
| EUR/USD | | | 1.1426 |
| EUR/CHF | | | 1.0950 |
| EUR/GBP | | | 0.87710 |
| EURIBOR 1M | | | -0.373% |

Following Draghi's speech, Eurozone sovereign rates tightened: 10- year German bond yields grew from 0.25% the 26th of June to 0.55% the 6th of July. Long term US bond rates followed the same movement, and some investors are keen on the idea of a coordinated intervention among central banks, as we further discuss in our Special Topic section.

The euro reached the highest level against the dollar since 2015. Reasons for this include the victory of pro-European presidential elect Emanuel Macron, which distanced the possibility of the Eurozone weakening, and, in turn, encouraged the strengthening of the European single currency, which climbed from 1.07 to 1.12 against the dollar. On top of that, fundamentals of the Euro-area economy seem pretty strong, and growth of the European economy appears more favorable than that of the US. As a result, we see for the first time since many years that Europe and the US will execute a similar rate of growth. Sintra's speech was the icing on the cake which fired the Euro up yet again, pushing it to near resistance level of 1.14, penalizing portfolios largely exposed to the dollar.

Emerging markets outperformed developed markets during the first semester

with a growth of 18%, fueled by the relative stability of their currencies, the oncoming of a calmer period in the commodities sector, a positive outlook on the global economy, and a certain clarity on the Federal Reserve's actions and monetary policies. The Russian economy is revived and growing again, climbing 0.5% from the fourth quarter in 2016 to the first quarter in 2017. Household consumption is on an upward trend, a rise in revenues in the oil and gas sector is helping to reduce the budget deficit, and the banking sector is stabilizing. In Brazil, on the other hand, the political story continues as President Temer is caught in the Petrobas scandal. For the past month and a half, the president has been under investigation for charges of bribery and obstruction of justice. Unfortunately, this weakening of political power could delay some important reforms, such as pension reforms. The country should experience zero growth in 2017, though there were more and more signs that point to a near end of Brazil's recession. China, alternatively, is flirting with a growth target of 6.5% this year. Authorities are keeping an eye out in the face of rising credit risks. The central bank implemented more restrictive real estate policies in cities where the housing market is overheated and started to lightly tighten its monetary policies. Finally, in India, short term growth is slightly declining (a temporary decline in household consumption with demonetization and a reduction of private investments). However, the encouraging forecasts and leading indicators should accelerate growth and bounce back activity.

For the upcoming quarter, we intend to stay cautious towards bonds, avoiding "govies" as well as excessively expensive investment grade bonds. We will spotlight instead mid-maturity corporate high yield European bonds. We will maintain our diversified selection of flexible global bond funds as well as our emerging market bond funds, while it goes without saying that this allocation will not dominate portfolios of conservative clients. Equity markets, especially in Europe, seem to hold more potential than fixed income markets, and recent declines due to growing fears among investors could be buying opportunities. After a complicated year in 2016, absolute return funds this year regained vitality and an attractive capacity to perform independently of indices and with less volatility. We also will reserve an important allocation to our flexible multi-asset managers, striving to retain a balance between the most cautious (Ruffer, Nordea, BNY Mellon) and the most optimistic (M&G, Kestrel, CPR) managers. We will keep a small allocation for gold and commodities in general, especially as oil performances and a number of agricultural commodities have been disappointing, creating new intervention points in the CRB Index. The summer may be trickier than 2017's first two quarters, but our thorough commitment to diversification and use of uncorrelated instruments allows us to approach the next market phase with serenity.

## *Broad View*


Will the sun rise on Japan again?

After more than 25 years of deflation, budding signs of progress are restoring confidence in Japan. In the first quarter of 2017, Japan's GDP grew by 1.3% on an annualized basis, marking its 5th consecutive quarter of growth, primarily due to robust exports. Recently, the Japanese government rose its outlook of the global economy for the first time in six months, demonstrating confidence in the current pursuit of economic recovery supported by exports. It also rose its evaluation of the housing construction sector and public investments.

The bank of Japan sees higher household consumption in the context of improved employment rates and household incomes. The optimism of large Japanese industrials have reached a three year high, measured by the renown Tankan report, which surveys the sentiment of the business community. And for the first time since the 1980's, there is an undeniable labor shortage. As such, a widely followed index, which compares the number of job offers with the number of possible candidates, is increasing without interruptions. In May it hit about 1.50, a level that has not been seen since the late 1980's.To reestablish confidence, the Nikkei newspaper revealed that a group among the ruling coalition of the Diet proposed a tax incentive plan to the Japanese government. The plan aims to repeal the anticipated VAT hike for 2019. Consequently 2020's budget balance will be difficult to reach.

Despite double-digit earnings and outlook growth, the Japanese stock market reported a moderate performance (+ 4.80%) compared to that of other developed countries such as Europe (+ 6%), and the United States (+ 8.5%), and even more so when compared to emerging countries whose growth soared to more than 17%. Yet still there are many encouraging signs: the deleveraging of companies has come to an end and will allow share buyback. This market balance has already been made more favorable by the boost in demand for shares from the Bank of Japan and the Government Pension Fund (GPIF).

Still, we must remain relatively cautious, as it would not be the first time that high expectations for the Japanese economy would remain unfulfilled. As for the evolution of the Japanese stock exchange, do not forget the trick behind the Japanese yen, as there is a historically strong inverse correlation between the Yen and the Nikkei, and any excessive appreciation of the yen will be sanctioned on the Stock Exchange.

# Macroeconomics

United Kingdom:

- Activity is slowed by uncertainties caused by Brexit.
- The manufacturing indicator remains at a good level but fell 3 points from 57.3 to 54.3, while the service indicator fell from 55.8 to 53.4.
- Inflation surprisingly rose to + 2.9%. GDP growth of + 2%.
- Consumer confidence is eroding.

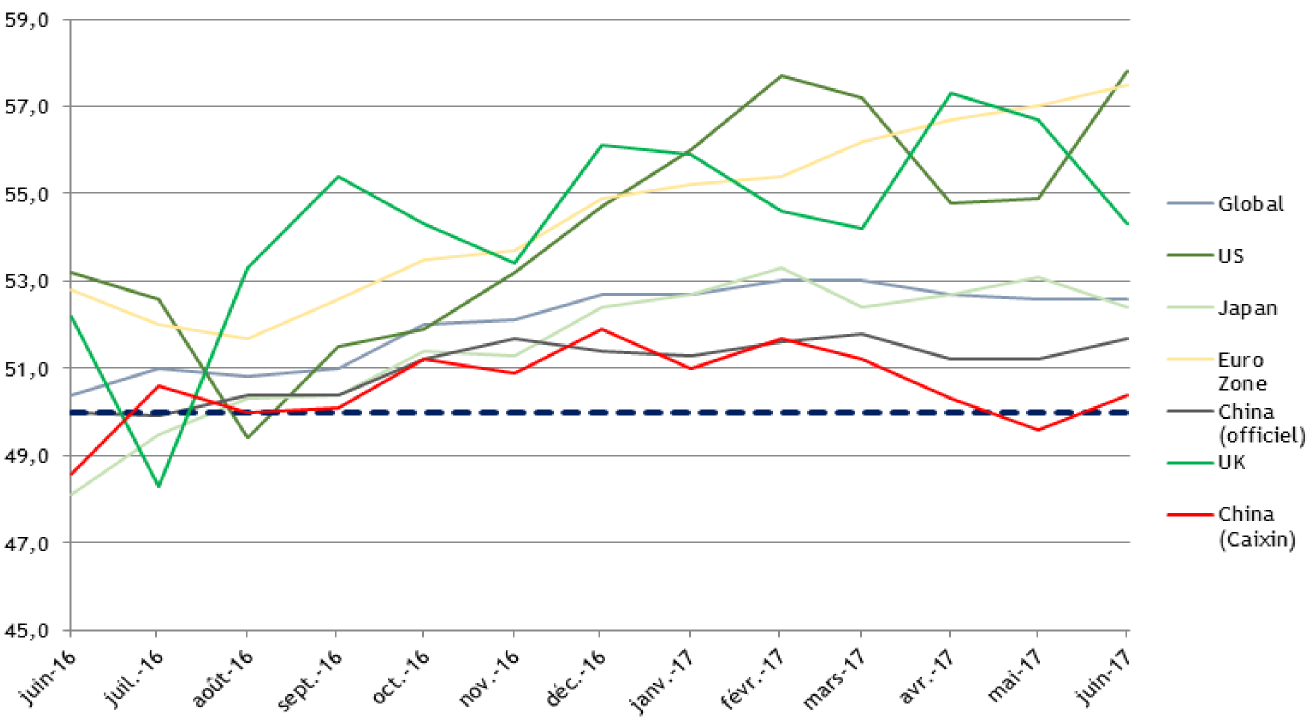
Europe:

- 2017's second quarter growth accelerated.
- The ISM manufacturing and services indexes reached record highs, see graph below.
- Improvement is global and includes France and Italy, who have been late in the cycle in recent years.
- Inflation declined over the last quarter but remains above + 1% (+ 1.3%).
- Consumer spending accelerated, demonstrating a newfound confidence.
- Eurozone growth of + 1.9% annualized in the first quarter, the second quarter is expected to be at least as good.

United States:

- In the first part of the year the U.S. economy was somewhat disappointing. Indicators give assurance of growth, though it is below expectations.
- With an increase of + 1.4% at the beginning of the year, growth in the U.S. economy is, for once, less than the euro area.
- However, June ISM manufacturing and services indexes predict a reacceleration of GDP in the second part of the year.
- The 222,000 jobs created in June assured investors of the state of the U.S. economy.

Evolution of ISM Manufacturers on a sliding year



PERSONALIZED PORTFOLIO MANAGEMENT

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## Special Topic

**The U.S. Federal Reserve: Is this the way out ? (continuation)**

Central banks acknowledge reflation…

In the last sessions of June, markets moved towards the end of the quarter on a gentle slope until they were shaken by the annual forum of the European Central Bank, where discussions took place between some of the world's most influential central bankers in Sintra. Like the US Federal Reserve, (cf. our April 2017 Special Topic) central bankers, almost in unison, started to think and openly communicate about ultra-accommodative exit policies used after the subprime crisis in 2008. Since then, it took the full 9 years up until now to support, reassure and revive the global economy and finally brush away deflation fears.

Over the past few months, there has been a widespread macroeconomic improvement thanks to favorable political outcomes, despite problems associated with Brexit. No longer is this improvement reserved for the good students (Germany, Northern countries), but also countries lagging in the cycle, such as France and Italy. All this, meanwhile, is accompanied by stabilization in the emerging countries, with China at the forefront. Mrs. Yellen's Fed has already begun the withdrawal process and started to hike Fed fund rates, which commonly accompany any improvement in economic activity. Other central bankers of developed countries (Bank of Japan, Bank of England; ECB) are reassured by the efficiency of the following exceptional measures: confidence has returned to the government debt, credit has been re-launched, and unemployment is declining. Taking advantage of these ideal circumstances is paramount as bankers face  the new hurdle of recovering ammunition of monetary policy in order to stay resilient in the next phase of economic contraction. In one, two, three years? It is impossible to know the future, but it is better to prevent. In supporting economic recovery, bankers should gradually withdraw the drip infusion of monetary stimuli. M Draghi started the withdrawal process in March this year, bringing the amount of purchases of monthly assets down from 80 to 60 billion euros. The market didn't seem to get the message with a 10-year German yield at + 0.22% at the beginning of the month. However, the point seems to have been heard loud and clear more recently, as this same yield two weeks later has more than doubled at +0.56%!

The Bank of England seems even more in a hurry as rate hikes are already a topic of internal debate. Within two years, Brexit should be validated with highly uncertain consequences in the long run and likely negative consequences in the short run. From there the bank will have to act promptly, but to do so it requires ammunition that it does not have. The noose is tightening as uncertainty already weakened consumer confidence and activity, despite the support of the heavily depreciated currency.

At the market level, this widespread monetary shift is good news (at least for the first part of the tightening), and should continue to support equity markets (however, beware of the sectorial rotations that will follow). Without a doubt, the shift will disrupt bond managers who have been spoiled, for many years, by global estimations of duration and credit risk. We bet that certain portfolios, those that aren't protected from this paradigm shift, run the risk of suffering. And as one of the most successful investors once said, "it's only when the tide goes out that you learn who has been swimming naked."

*The recent evolution of the 10-year yield rate on German debt*


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