2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly marketreview

January 2018

Editorial

In 2017, the combination of liquidity provided by central banks with the harmonized recovery of global growth created a favorable environment for risky assets and boosted the valuations of many asset classes. All the stock markets performed well. For example, the S&P 500 index rose by 19.42% and increased for 14 consecutive months, setting a record for the longest period of consecutive monthly increases. This kind of sequence hasn't been seen since the 50s. However, it is important to note that this increase, essentially driven by technology stocks (Google, Apple, Amazon, Facebook ...), has left aside many sectors that haven't really progressed this year and still have potential for improvement.

It is also worth noting that for a European investor calculating performance in euros, 2017's performance is less glorious due to the greenback's some 14% decline against the euro. Thus, expressed in euro, the US market's performance is only +4.77%, comparable to the performance of the European market (+ 5.56% for the Europe Stoxx50 index). This performance is far behind emerging markets, the big winners of 2017, with a performance of + 34.35% for the MSCI Emerging Markets expressed in USD (+ 17.87% in EUR).

At one point investors feared the manifestation of a political risk in Europe with the rise of populism in several countries. This did not develop and equity markets were greeted with relief with Emmanuel Macron's victory against Marine Le Pen who represented uncertainty for the financial community due to the vagueness surrounding her rhetoric on the euro's exit and the return of the franc. On the other side of the Atlantic, Donald Trump's difficulties in pushing his reforms through have not stopped the US stock market from rising. The large majority of US companies delivered positive results in 2017 on both turnover and profits.

Still supported by accommodative monetary policies (even though the US Federal Reserve has already begun to raise its key rates and the end of Quantitative Easing is close in Europe), the bond market had a positive year, though not as impressive in terms of performance as recent years. The Bloomberg Barclays Govt 1-10Y Bond Index, representing the European government bond market from 1 to 10 years, posted a modest 0.39% increase (vs + 1.86% in 2016), while the IBOXX Euro Liquid Corporate Index, reflecting market loans issued by European companies, rose by 1.53% (vs. 4.12% last year). Only the high-yield debt market and emerging bonds managed to deliver returns of 4% or more this year. As we can see, **it is becoming more and more difficult to generate performances with bonds**. Given the rebounding global economy, yield curves can't decline much more. In Europe, for example, negative short-term rates, the need to pay interest to the bank for holding cash in a bank account, has never been seen in the history of developed countries (apart from Japan and its very specific case of long-term deflation). On top of that, the 10-year German rates have wavered throughout the year on extremely low levels between 0.3 and 0.5% while growth accelerated across the Rhine; inflation, still zero in 2016, is today up to 1.7%. The narrowing of credit spreads, which is among the most important drivers of bond performance with falling interest rates, is reaching its limit, especially in Europe, where the yield spread between corporate bonds and government bonds has reached historical lows.

Should we fear a bond crash in 2018?

As things stand, we do not expect a 2018 bond crash. Inflation figures are not what they were 10 or 20 years ago. Even after years of unconventional monetary policies (which were necessary to save the international financial system and avoid deflation), the average inflation rate in the world economy is less than 3% and is even around 2% in OECD member states. All the while the pace of economic growth continues to accelerate and some countries

	Q4 2017	YTD	Close 31/12/17
DOW JONES	10.33%	25.08%	24 719.22
S&P 500	6.12%	19.42%	2 673.61
FTSE 100	4.27%	3.44%	7 687.77
EUROST.50	-2.53%	6.49%	3 503.96
CAC 40	-0.32%	9.26%	5 312.56
FTSE MIB	-3.71%	13.61%	21 853.34
MSCI EM	7.09%	34.35%	1 158.45
CRUDE OIL	12.23%	12.47%	60.42
GOLD	3.11%	13.09%	1 303.05
EUR/USD			1.2005
EUR/CHF			1.17029
EUR/GBP			0.88809
EURIBOR 1M			-0.368%

(such as the United States and Germany) are almost at full employment. Today, a growing number of investors and key market players have accepted the fact that there is probably a new paradigm of moderate inflation, which is based on the existence of large, global deflationary forces. These forces are notably long-term structural forces particularly linked to demographic factors and technical progress. A rapid and significant rise in global inflation seems unlikely considering the current situation. This viewpoint is based on the idea that the central bank's withdrawal of unconventional measures will be very gradual, similar to the reduction of their balance sheet. This should allow the bond market, admittedly expensive worldwide, to post at worst a slightly negative performance in 2018 and returns similar to 2017 at best.

Hence nothing outstanding is expected, which reinforces us to favor equities over bonds in 2018, as we did in 2017. We will continue to invest in bonds via the most flexible funds possible, which can be positioned very short term in duration if needed and which can seek additional returns on high yield or emerging segments.

Caution and selectivity will be key concerning equities, especially on the US stock market as the New York Stock Exchange is no longer particularly cheap after 9 years of a near uninterrupted rally. The S&P 500 is trading at nearly 20x earnings, a standard deviation above its long-term average. The growth of the global economy accelerated in 2017 and forecasts remain optimistic for 2018. Bear in mind, though growth is a necessary condition for the development of markets, it is not enough.

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In 2018, stock markets could continue to rise in either of two ways: by increasing profits, or by increasing multiples. This year the challenge for US equities will be to rise despite already high multiples and strong expected earnings growth at +12% verse +9% in Europe. Despite estimates of lower earnings growth in Europe, we will continue to favor this area because it is where the potential for margin improvement is most significant with considerably lower valuations (2018's P/E EuroStoxx50 index only amounting to 15.27.) Europe's monetary policy should be much more accommodating than that of the United States. For the moment, the ECB is keen to reduce the amount of monthly asset purchases, reserving the first rate hike for the end of 2018 or early 2019. The US Federal Reserve is expected to continue the rate hike cycle that began in 2017, with three or four probable hikes planned for 2018. We will maintain a special focus on emerging equities, even after their outperformance last year. In comparison to the performances registered in the United States since 2009, the accumulated underperformance is still significant. The potential for improved margins and therefore earnings growth is substantial, and valuations are still modest (the estimated P/E of the MSCI Emerging Market is barely at 14.18x). Finally, in 2018 where volatility could make a big comeback with the expected US rate hikes or the geopolitical agenda, we will continue to build our portfolios on two other pillars: absolute return funds (which can "short" the market) and flexible multi-asset class funds, diversifying and bringing together very cautious managers (BNY Mellon Real Return, Ruffer, Nordea Stable Return ...) and the more dynamic ones (M & G Dynamic Allocation, Kestrel ...).

Grand Angle

THE RETURN OF THE ASIAN DRAGONS

After several years of underperformance, we are witnessing the awakening of the Asian Dragons. The region's economic growth is the highest in the world and should even slightly accelerate in 2018. Forecasters expect the region's GDP to grow above 6%, substantially outpacing the global economy. Asian countries are fully benefiting from the recovery of the global economic cycle thanks to their exports of manufactured goods. Additionally, Asian countries are benefiting from the stabilization of the Chinese giant and also from the United States' prolonged growth cycle. Following in China's footsteps, consumer markets are increasing across Asia.

Structural reforms

The introduction of structural reforms is a new phenomenon that allows this region to generate internal growth and to be less dependent on the rest of the world. In addition, most countries in the region have taken measures that will allow them to maintain high growth rates over a long period of time.

These measures are gradually paying off. In India, Mr. Modi's government has initiated a number of changes that will significantly transform the country's economic environment. Monetary reform, with the demonetization of large denominations, has largely achieved its goal: to attack the underground economy without causing a major slowdown.

The demographic factor

Another key point is that changing demographics will continue to play an important role in the region: consider that the Indian population is the youngest of the emerging countries. There rests high potential for urbanization. Urbanization is at 35% in India and 50% in China, much less compared to Latin America where it reaches 70%.

A region at the heart of innovation

Asian economies have largely modernized in recent years. MSCI Asia ex Japan has a 27% exposure to IT stocks, while MSCI World only has a 17% exposure. Asian technology giants like Samsung, Baidu, Tencent and Taiwan Semiconductor are increasingly able to compete with major US technology companies. China alone publishes more academic research in the field of artificial intelligence than the United States. A company like Baidu, for example, devotes almost all of its research and development spending to the field of artificial intelligence.

The new business vision

Another change is on the horizon: a renewed focus on profitability and the shareholder. Asian companies have long prioritized growing turnover, even at the risk of making unprofitable investments. However, priorities have changed and business leaders in the region are instead turning their attention to shareholder profitability. Operating margins have recovered and return on equity has improved since the beginning of the year.

Relatively inexpensive markets

Stock markets in Asia have not yet recovered the accumulated underperformance since 2011, which would be some 20% on the basis of P/E multiples. A redeployment of foreign capital could help correct this gap and recover the Asian Dragons' outperformance.

Macroéconomie

United States

- The labor market remains strong as the US economy created 2.06 million jobs in 2017, though slightly less than in 2016, reaching close to full employment.
- In December, PMI indices gave mixed signals: the manufacturing PMI accelerated while the services index fell, with the number of new orders falling to their lowest of the year.
- Despite three rate increases in 2017 and those to come, levels of profitability and activity among companies should remain supported by the dollar's decline and the implementation of tax cuts voted at the end of the year.

Europe

- The last sequential quarters were similar to one another. The virtuous cycle of growth seems to be developing in all Eurozone countries. From a cyclical point of view, macroeconomic improvement could become sustainable.
- Manufacturing activity continues to rise at a steady pace; the index surpassed 60 for two months, hitting to a record!
- Once again, France's economy accelerated over the last six months, and should present a growth of 1.9% in 2017, a record since the crisis of 2008.
- The Purchasing Manager's Index and Consumer Confidence Index leaves us optimistic for the first months of 2018.

China

- Chinese growth remains under control despite persistent concerns among many investors. Central authorities seem fully aware of the risks of over-indebtedness and are determined to reduce production capacity in saturated sectors.
- Household consumption is well oriented. It plays an increasingly important role on the country's growth as living standards rise and the unemployment rate remains relatively low.
- With a reasonable growth target of 6%, a current budget deficit of 4%, and moderate inflation at 2.5%, the country seems well equipped to face challenges to come.
- In this environment, Chinese companies are expected to post strong earnings in 2018.

US unemployment rate since 2006

USURTOT Index | 95) Compare | 96) Actions | 97) Edit | Line Chart

01/31/2006 - 12/31/2017 | Last Price | Mov Avgs | Key Events

1D 3D 1M 6M YTD 1Y 5Y Max Monthly | Table | Chart Content

Last Price 4.1
High on 10/31/09 10.0
Average 6.6
Low on 10/31/17 4.1

Special Topic

What can we expect from central banks in 2018?

First, a general reflection: since 2013, when the US Federal Reserve announced it would begin phasing out of quantitative easing, there has been little disruption to the economic recovery in the United States.

The policy will continue to gradually normalize over the next five years, with Jerome Powell continuing the policy set by Janet Yellen for the Federal Reserve. We can expect three additional rate increases in 2018, which could carry the rate to + 2.25% within one year. Given this context, inflation and labor market indicators will be particularly monitored throughout the year. The second part of this policy concerns the Federal Reserve's balance sheet, which has been stable since 2015. The goal now is to start reducing it. The Federal Reserve has two concomitant paths to doing this - the non-reinvestment of maturing assets, or the sale of these assets before maturity.

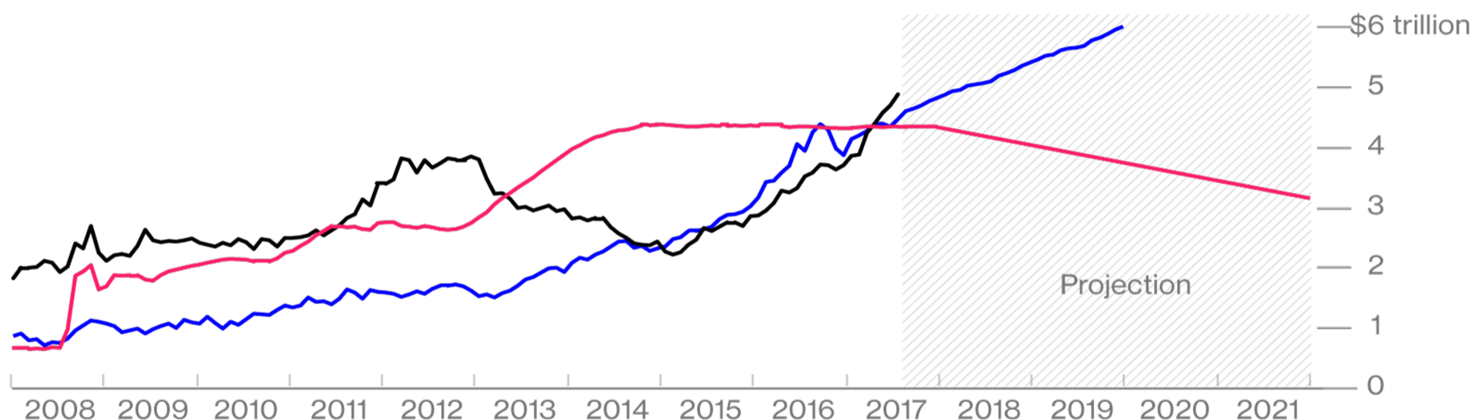
In Europe, the good news surrounding the virtuous cycle of growth validates the choice of the ultra-accommodating policy. This program, for lack of coordination, which at first forced the Euro Zone into recession, did not really start until 2012. That is why the ECB only started to take its first step backward in 2017 when it decreased the amount of asset purchases on the market from 80 billion per month in the first quarter of 2017 to 60 billion at the end of the year. With pressure from Germany and economic improvement, Mr. Draghi should give a deadline in 2018 for the end of asset purchases. In the meantime, asset purchases should be around 30 billion this month. As for rate hikes, short of any surprises, nothing is expected before 2019, especially as the euro's rise and contained inflation will encourage the ECB to be cautious.

The People's Bank of China, in close cooperation with central authorities, should anticipate a stable rate policy. However, it will continue to adjust the bank's reserve requirement to limit the amount of loans made to the economy according to needs. Overall, it will maintain more of a neutral / restrictive policy.

In 2018, the Bank of Japan will be the only central bank among the world's major countries to continue a highly expansionary monetary policy. Though progress of the Japanese economy is undeniable, the country is facing significant structural challenges, a decline in population, and a worsening labor shortage. Economic improvement alone is not enough to balance the negative impact of structural trends on consumption, investments, and price levels.

Central Banks Balance Sheets
Japan moving into uncharted waters

Bank of Japan ■ European Central Bank ■ Federal Reserve



Note: BOJ projection assumes the yen-dollar exchange rate remains at the current level and the BOJ's asset holdings continue to increase at the current level.
The Fed. forecast is the baseline scenario from the 2016 annual report, and assumes that balance sheet normalization begins in January 2018.

Source: BOJ, ECB, Fed data compiled by Bloomberg

Bloomberg

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