2pm PERSONALIZED PORTFOLIO MANAGEMENT

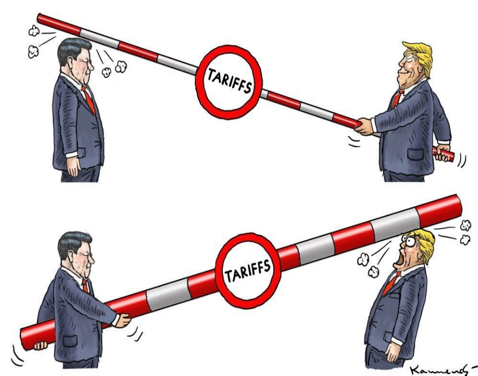
Quarterly market review

July 2018

Editorial

An episodic first semester ...

Last year, equity markets had benefited from a favorable momentum and this trend continued in January. However, the rise in yields of government bonds, a consequence of the good health of Western economies and the beginnings of inflationary fears in the minds of operators, led to a sharp decline in stock markets in February. Thus, the S&P500 index lost nearly 12% from January 26 to February 20. Same for the Eurostoxx50 index, falling more than 10% between January 23 and February 09. Moreover, this downturn occurred in a context of strong and rapid rise in volatility which has backfired on many operators who were playing the opposite strategy of lower volatility. The urgent unwinding of some of these positions could undoubtedly amplify this stock market consolidation. A technical rebound was then set up, quickly aborted with Donald Trump's offensive statements on the trade deficit issue. At the end of March, the Eurostoxx50 posted a fall of -4.07%, against -1.22% for the S & P (and -3.39% expressed in EUR) and +0.93% for the MSCI Emerging Markets (-1.28% in EUR).



Operators then integrated this "trade war" risk and focused on the good first quarter results for US companies and the large share buyback flows. It is this "focus" on fundamentals that fueled the rise in April and May in Europe and the United States, as emerging markets are marking a notch with rising fears over the consequences of tightening monetary policy in the United States on emerging economies and currencies, fears from our point of view which are some bit exaggerated, as individual situations are specific within these countries.

The major event of the second quarter will undoubtedly be the return of political risk in Europe, with the arrival in power in Italy of an unlikely coalition government combining the anti-system party, the 5 Stars Movement (M5S) with the League, the far-right party.

Unsurprisingly, this oil and vinegar marriage unsettled the bond market and the performance of the 10-year Italian BTP, which revolved around 1.8% in April, has suddenly stretched 120 basis points to go up to 3%. Faced with this violent bond shock, the Italian stock market fell sharply, dropping 13% between May 7th and May 29th. Another consequence of this transalpine upheaval, the "flight to quality" towards the German sovereign debt, with a 10Y Bund Yield, which went from 0.65 on May 15 to 0.20% in session on May 29. Note that in Spain, the Rajoy government was overthrown by a coalition led by the Socialist Party which also caused some tension on the Bonos, but not commensurate with those observed on the Italian debt.

At the global level, the softening of the thorny North Korean issue is somewhat in the background because of the US president's feud on the trade front with China. Fears over the exacerbation of these trade tensions, with all the risks that this may entail in terms of global growth, again shifted markets in June, with some sectors, such as the automobile industry, being particularly affected. On June 30, the Eurostoxx50 posted a disappointing -3.09%, better than the -7.68% achieved by the MSCI Emerging Markets (-4.95% in EUR). Only the S&P500 managed to stay in positive territory, with +1.67% YTD (and +4.68% in EUR). Prudence however, this relative good performance masks huge sectoral disparities and was made on a very limited number of companies. 75% of this return is explained by only 10 stocks, mostly in the technology sector, while many defensive/old economy stocks are currently on low points.

	Q2 2018	YTD	Close 29/06/18
DOW JONES	0.70%	-1.81%	24 271.41
S&P 500	2.93%	1.67%	2 718.37
FTSE 100	8.22%	-0.66%	7 636.93
EUROST.50	1.01%	-3.09%	3 395.60
CAC 40	3.02%	0.21%	5 323.53
FTSE MIB	-3.50%	-1.04%	21 626.27
MSCI EM	-8.66%	-7.68%	1 069.52
CRUDE OIL	14.18%	22.72%	74.15
GOLD	-5.42%	-3.83%	1 253.17
EUR/USD			1.1684
EUR/CHF			1.1570
EUR/GBP			0.8847
EURIBOR 1M			-0.370%

As for central banks, the FED has given its roadmap and will continue its policy of monetary tightening by making two additional increases this year in addition to the two already made. For the rest, economists are divided on the capacity of the US Federal Reserve to continue in the same direction in 2019. The flattening of the US yield curve, with a differential of just 40 basis points between the 2-year and 10-year rates raises fears that there will be less room for maneuver and that the rate hike cycle will be soon over. On the other hand, others are much more optimistic and see further rate increases next year to curb an economy that is currently running at full capacity. But we can see for now that 10Y US Yields are struggling to settle permanently beyond 3%. Direct consequence of the commercial war fears that would affect global growth? Persistence of deflationary forces in the economy? The next few months will tell. In Europe, the ECB will stop buying assets in December, but Mario Draghi has hinted that no rate hike is expected before the end of summer 2019.

In this context, and despite the instability created by the new tenant in the White House, we remain constructive on the asset class Equities, especially after the declines observed in June. Indeed, the global economic situation remains well oriented and the low interest rate environment, especially in Europe, is beneficial for companies. Activity indicators are at high points

in the United States and at elevated levels in Europe and Asia. The favorable dynamics of business investment could take over from private consumption to support growth and companies should show this year a good growth of their results (+ 10% in Europe, + 25% in the United States, greatly helped by tax reform). On the other hand, we remain more circumspect on the bond sphere, which we see clearly, as far as the euro zone is concerned, has been suffering since the beginning of the year (low interest rates and shifting credit spreads). The IBOXX Euro Liquid Corporates index fell by -0.67% at the end of June, a figure that conceals even greater declines in the High Yield sphere. We view favorably the components of our alternative allocation, which may once again be performing well with the return of volatility. And of course, we remain exposed to our mix of asset allocation funds, which overall are struggling in this first half, with performances ranging between -1.00% and -3.70% YTD.

The Big Picture

Never sell the skin of the Russian bear !

How does Russia overcome the impact of sanctions?

The 2014 US sanctions coincided with a simultaneous decline in oil prices and the ruble price. This time, oil prices are on the rise under strong global demand and good understanding between Russia and OPEC's leading country, Saudi Arabia. At the same time, the price of the ruble has declined and thus allowed to amortize the new sanctions.

Sound Economic Fundamentals

Russia has been able to reduce inflation at a rate of 2.4% per year, very close to that of major developed economies, and presents a well-functioning public finance structure. Debt accounts for only 12% of GDP. As a net creditor when compared to the rest of the world, the country also boasts a large current surplus account, sufficient to cushion the effect of sanctions. The leading indicators also point to strong GDP growth, led by the energy sector, but also a stronger job market and an increase in industrial production. By stimulating spending, the June World Cup should also help to offset sanctions. And a phenomenon already observed elsewhere, a good performance of the national team, regardless of the final outcome, should likely improve consumer morale. Firms in the country are showing great resistance, having succeeded significantly in reducing their dependence on Western capital.

The sharp recovery of the financial markets

The strength of the Russian economy is also reflected in corporate bonds. Russian bond spreads have only widened by 60 basis points since the announcement of sanctions. The ruble, after losing 15% between February and April, has stabilized and the stock market, to the surprise of many, has returned to its level of early 2017, before the fall of 25% recorded in the first half. However, the fundamental reason coincides with the sharp recovery in the price of oil that has risen in one year from USD 45 to USD 75.

***Conclusion:** the Russian stock market is one of the most reliable instruments for any investor who wants to take a position on oil, because in reality, cold war or detente, it is the black gold that determines the state of health of the Russian bear.*

RUSSIA CDS USD SR | 95) Compare | 96) Actions | 97) Edit | Bar Chart
07/11/2008 - 07/06/2018 | Last Price | CBIN | USD | Mov Avgs | Key Events
Last Price 135.723
High on 10/24/08 1243.337
Average 235.678
Low on 07/04/08 71.750

Macro-economy

Context: Generalized rebound of economic surprises ; the strategists who had become too pessimistic are astonished.

EUROPE

- There is a slowdown in activity in the Euro Zone in the first half, after a very good 2017 year.
- For once in a long time, 75% of GDP growth result from household consumption, which should support future investments.
- The labor market is doing well with an average of 220,000 jobs created monthly. At the same time, the unemployment rate dropped to 8.4%, a low for 5 years. It peaked at 12.1% in early 2013.
- The impact of political uncertainties in Italy and Germany, migration issues and tensions with President Trump, for the moment, are limited.
- The decline in the euro over the last quarter should help exporters but accentuate the inflationary effect of higher oil prices.

CHINA

- Like the euro, and in the same proportions (-6.5% in the last quarter), the Chinese currency depreciated against the US dollar. Despite this, inflation remains under control at + 1.8% for the month of May.
- Manufacturing activity stabilizes following the elimination of excess capacity and the fight against pollution.
- Domestic consumption is doing well, and services, according to the official index and Caixin, have been progressing since three months.

USA

- Since the low point in April, the US indicators are rising again, the manufacturing index is at its highest and that of services is approaching.
- New orders indicators suggest that this momentum could continue.
- Consumer confidence remains at high levels.
- Given these very good indicators, strategists seek to identify what could end the economic cycle and cause a significant slowdown (or recession); for the moment, clear horizon.

ISM Manufacturing since 2007

Special Topic

What lies behind Trump's attitude towards China ?

The year 2018 is marked by the belligerent attitude of President Trump against China. His short-term goals are certainly linked to the mid-term elections in November with a desire to be the champion to his constituents as the protector of middle-class jobs facing the "unfair competition" of foreign multinationals.

This short-term view, however, should not obscure the more fundamental concern of China's formidable expansion in two areas in particular: technology, formerly preserved territory of the big American groups of Silicon Valley, but also recently in the defense sector with a budget rising sharply and more inclination of taking over the area in Asia.

The president and a part of the American intelligentsia are thus faced with a problem that is much more important to them, a longer-term danger. Indeed, America, the world's leading economic power for decades, could lose its place in the not-too-distant future in the face of the rise of the Middle Kingdom. Already in 2018, 18% of global GDP growth comes from China, against 15% for the US.

Since the 2008 crisis, every year or so, we have been promised a fall, a break-up or a deep recession in China. It must be obvious, it is not for now. On the contrary, and despite the recent difficulties, the country is progressing in many areas: a much more balanced growth towards services, the fight against corruption, the reduction of excess capacity, all with a relative mastery of excess indebtedness in the productive sectors. Even endemic pollution has begun to decline, especially in the major cities.

Not everything is perfect yet, but the growth generated in recent years is undeniably much better; 68% of GDP growth now comes from consumption, compared to 42% in 2010. Proof of excellence, 38% of graduated engineers in the high-tech sectors are Chinese (5% are American), 43% of the world's patents are registered in China, which makes some say that the continuation of the technological revolution will be in China. Not to mention the stock market development (the second largest in terms of size with almost half of the world's start-ups and numerous IPOs), even though it is still underweight in indexes and with investors.

The awareness of the US authorities of the "Chinese danger" is still raised a notch during the speech of Xi Jinping, on the occasion of the renewal of his mandate in late 2017. He took the opportunity to indicate the objectives he had for China by 2025 at the economic level. Some expected a resizing of major state groups with many privatizations and openings for competition (as envisaged by WTO rules). This was not the case and the declared and assumed policy would be to strengthen, recapitalize and make subject groups serious competitors to leading American groups.

From now on, Trump's tough trade talks are just the beginning of a long-standing confrontation between a giant who wants to protect itself from a giant who is on the rise…

One-sided deal? U.S.-China trade in 2017

China runs up huge surpluses in tech, manufacturing

Source: U.S. Census

NOTICE TO READERS

Document completed on July 5, 2018. The information contained in this document is for informational purposes only and may contain errors. The information contained in the text and illustrations may not be copied or used without the prior agreement of 2PM. All rights reserved.