2pm PERSONALIZED PORTFOLIO MANAGEMENT

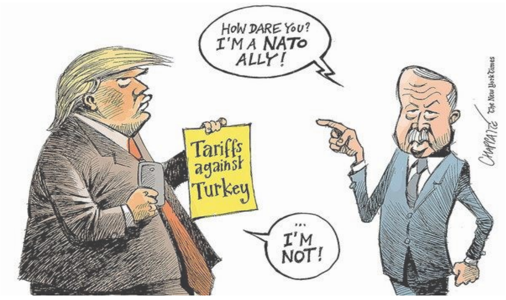
Quarterly market review

October 2018

Editorial

Over the last few months clouds gathered over financial markets. First, there was Donald Trump's strong-arm initiative aimed at correcting the US bilateral trade deficit at the risk of slipping into an all-out trade war. Outbidding on customs tariffs made operators anxious about potential consequences on trade and world growth. To compound matters, fears of a trade war reached their zenith before the summer at a time when activity on the other side of the Atlantic was showing signs of slowing down with a momentary fall in the ISM index. In addition, an improbable Italian coalition took office (with an explosion at a high of the spread between Italy and Germany) and that's all it took for the European markets to fall by 7% between 22 May and 27 June.

Thankfully, in July, results of US companies for the second quarter, confirmed the vitality of the US economy. It's true that some shares, such as Facebook, were a bit volatile, but globally investors were reassured that US growth finally seemed steady, helped by Trump's plans to boost the economy and cut taxes. The Chinese authorities took measures, notably monetary measures, so as to maintain their economy in good working order. Globally, at the beginning of the summer, world growth remained on an even keel and was welcomed in July by risky investments, equities and corporate bonds.



Alas, along came August, and remained faithful to a tradition of summer weakness due to reduced liquidity. Most risky investments, especially equities, slowed down, for example Eurostoxx 50 fell by -3.76% in August, recording a disappointing -3.17% for the first eight months of the year. Idem for MSCI Emerging Markets, falling by -2.90% the same month (and-8.85% YTD). Nevertheless, there was good news on the macroeconomic front: improving consumer confidence indices and European growth revised at an annualised 2.2% with core inflation struggling to overcome 1%. This explains the accommodating attitude of the European Central Bank regarding short term interest rates, at least until the end of next summer. Unfortunately, once again, political events overshadowed good macroeconomic results. The dramatic collapse of the viaduct in Genova and more waves of migrants in the Mediterranean led to renewed tensions between the fledgling Italian government and the European authorities. This caused an even greater spread between the Italian BTP and the German Bund. Meanwhile, Brexit negotiations continued between the UK and the EU causing uncertainty and downward pressure on the pound sterling. Emerging countries continued to suffer from tensions over trade and the rebound of the dollar. In addition, in August, dialogue between China and the United States deteriorated even further with President Trump threatening to apply 25% customs tariffs on 200 billion Chinese goods (as opposed to the previous figure of 10%). As for Turkey, which has already been in difficulty since the beginning of the year, the current deficit of 6% of its GDP sank even further; the American decision to raise import tariffs on Turkish aluminium and steel made an already fragile situation deteriorate even further. The Turkish Lira lost some 32% against the US$ in August alone, and -72% since the beginning of the year ! In this uncertain climate which also saw massive repatriation of American companies, emerging markets went down in August. Only the American stock market, which benefited from excellent macroeconomic results and the formidable momentum shown by tech stocks, managed to record a positive performance in August. Consumer spending figures were higher than expected as a result of tax reforms and a job market in good shape, with unemployment at 3.7%, a figure which would make any number of European countries green with envy.

The beginning of September also proved difficult, especially in European markets who, decidedly, this year are struggling to transfer the improvement in fundamentals in the Euro Zone into positive returns. The announcement of new customs tariffs against China and tense discussions with Canada over NAFTA made the American trade deficit sink even deeper, revealing the first impact of a trade war and reviving fears of protectionism. The increase in the trade deficit was the biggest since March 2015 and remained at a high level of approximately 70 billion dollars per month in 2018. In addition, imminent mid-term elections encouraged investor caution as they face the risk of new measures being announced by the White House. And so, Eurostoxx 50 sank further, some 5% between 28 August and 7 September. Luckily, renewed US-Chinese negotiations and continuing discussions between the UK and the EU, (and more encouraging communiqués stating the ability of both sides to find a solution to the most complex issues) gave an impulse to western markets which showed a clear recovery in the last two weeks of September.

	Q2 2018	YTD	Close 28/09/18
DOW JONES	9.01%	7.04%	26 458.31
S&P 500	7.20%	8.99%	2 913.98
FTSE 100	-1.66%	-2.31%	7 510.20
EUROST.50	0.11%	-2.99%	3 399.20
CAC 40	3.19%	3.41%	5 493.49
FTSE MIB	-4.23%	-5.22%	20 711.70
MSCI EM	3.67%	-9.54%	1 047.91
CRUDE OIL	-1.21%	21.23%	73.25
GOLD	-4.84%	-8.48%	1 192.50
EUR/USD			1.1604
EUR/CHF			1.1398
EUR/GBP			0.8904
EURIBOR 1M			-0.371%

Nevertheless, despite this rebound, year-to-date returns do not present a pretty picture. Apart from US markets and an S&P500 up at 8.99% (which, it should be remembered, was artificially boosted by a small number of tech companies), throughout the rest of the world, stock markets reported losses in the first nine months of the year: -2.99% for Eurostoxx 50, -5.19% for the German DAX, -6.52% for Spanish IBEX, -5.22% for the Italian MIB30, -3.13% for the Swiss SMI.. ..and a swingeing blow of -9.54% for the MSCI Emerging Markets!
Bond markets didn't help as shown by a fall of -0.69% on the IBOXX index, a drop which does not reveal the far greater losses on subordinated bank loans as well as on the emerging debt. Hence we see negative year-to-date performance on the multi-asset funds which we've been following.

Given this, what can one expect over the coming months ?

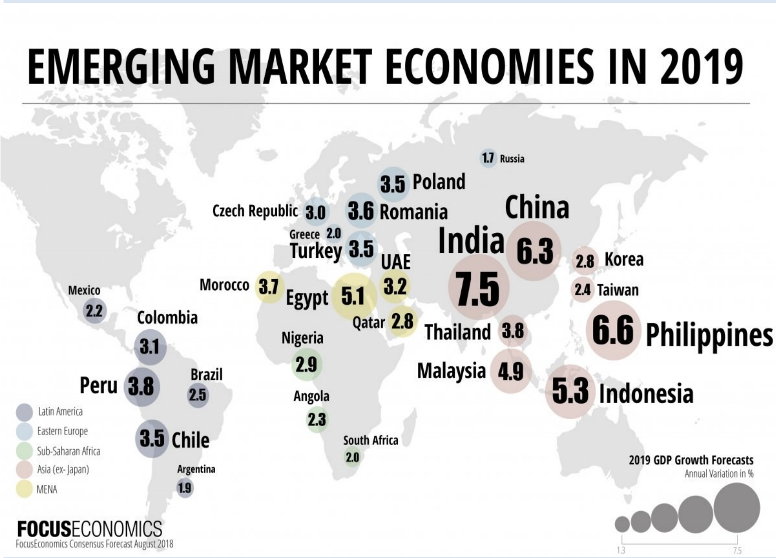
We believe that to a large extent the European stock markets have taken on board a great deal of bad news already reflected in the figures, especially the new deal imposed on world trade by Donald Trump. Thus Eurostoxx 50 has a price-earnings ratio of 14.10 for next year compared with 17.94 for the US stock market. We believe it is time for operators to reconsider the good fundamentals: Euro Zone growth of over 2%, an environment of low interest rates until at least August 2019, greater business profitability with expected EPS rising by +15% next year. Not to mention an American economy firing on all cylinders with exceptionally dynamic results for US companies, confident households and a President at times able to strike a new trade deal such as the one signed by the United States and Mexico. For Euro based investors we continue to favour a higher weighting for European equities compared with those of the US or Emerging Markets. As for bonds, we maintain our cautious position in terms of duration and favour recourse to flexible funds. For the most part, bonds are expensive and we recommend not to be overweighted on this asset class. Clearly, we will continue to favour a large allocation in a number of multi-asset funds allowing diversification and exposure to instruments generating revenue and others which we would not have access to directly, such as infrastructures. After years of relatively good economic visibility aided by monetary injections administered by central banks, risks have increased requiring investment in a wider sphere. To begin with, let's just mention the desynchronisation in the vitality of different economies. While the US economy is exceptionally vigorous, political threats in Italy and the spectre of a hard Brexit will tend, temporarily, to slow down the dynamic rythmn in Europe, while at the same time, fears of a trade war are disrupting the economies of the emerging countries. A decent agreement on 20 November between Xi Jinping and Donald Trump on the sidelines of the G20, would clear the horizon for the markets for the end of this year. But with the risk of American inflation, care must be taken to avoid hitting the rocks again. In fact the job market is once again becoming very tense in the United States, salaries increased by 2.9% by the end of August 2018 on an annual basis - and Amazon has just raised the minimum wage of its employees by 15%. All of this is compounded by the rise in the price of crude oil due to logistic difficulties in Texas and stable OPEP production. In the event of escalating tensions between the US and its major trading partners, production costs could rise and this inflationist trend would require a more vigorous reaction than anticipated from the Federal Reserve. In turn, difficulties in emerging countries whose balance of payments are in deficit would be aggravated. As a result growth may slow down in developed countries. Thankfully, many deflationist factors still exist in the world economy linked to demographics and technological developments.

We face multiple risks but remain persuaded that diversification and a long-term vision are the best way of generating a stable and positive performance. Not giving in to short term panic, avoiding knee-jerk reactions, keeping a steady course and remaining geographically diversified is the way to counter idiosynchratic risk. Over the past 5 years, it is noteworthy that a purely European portfolio would have shown a lower risk-corrected performance than a portfolio diversified worldwide. This reassures us that we, at 2PM, have the right approach; we have been in existance since 2006 proving that our position in difficult markets is robust.

The Big Picture

CAN WE STILL BELIEVE IN THE EMERGING MARKETS ?

At the end of the year, at the time when major investment companies present their investment strategy, emerging markets were some of the strongest recommendations. Nothing seemed to stop their revival which began in 2016 with tangible signs of economic improvement. But this did not take into account positions taken by President Trump. By starting a trade war, he ignited the dynamite. Within a few weeks, the emerging market share index fell by 10% making the drop in relation to the peak at the end of January over 20%. Bonds fell by nearly 14% mainly due to the collapse of local currencies especially the Argentine Peso (-50%) and the Turkish Lira (-40%). The bellicose rhethoric of the American administration aside, a few countries have been the main focus of attention due to specific structural problems: Argentina had to request urgent aid from the IMF and its Central Bank rose interest rates to 60% to counteract galloping inflation. To a lesser degree, in August, Turkey received the full blow of sanctions announced by the US following the dispute over liberating an American pastor being held in Istanbul. In South Africa, Cyril Ramaphosa's honeymoon period seems to have evaporated and some believe it's the next country to tumble.



In view of these elements, should we dispair of this zone presented not so long ago as the new Eldorado? The block judgement of the media and financial markets could lead one to believe this to be the case. In reality, it's not all black and there are contrasting situations. In fact, some countries are showing remarkable economic stability in this financial turmoil. Russia is pretty resiliant to sanctions, inflation is contained and debt is less than 20% of GDP. Russia has a budget deficit which a number of large European nations would envy. China is facing American pressure with great skill by taking measures to relaunch the economy while manipulating its currency. As for India, GDP is growing at an annual rate of 8% with inflation on a par with the Euro Zone, i.e. under 2%. This confirms the improvement in the economy since 2014 when Mr Modi became Prime Minister.

It would be unreasonable to disregard an investment zone which represents 85% of the world's population, 50% of global production and which is growing twice as fast as developing countries. Especially when those shares are bought at a concession price 25% lower than European equities and nearly 40% lower than quoted on the S&P 500. For those uneasy with the idea of investing in equities, there remains the possibility of investing in bond funds in euros or dollars where the yields are 4 points higher than on loans issued by the US Treasury.

Macro-economy

UNITED STATES

- New rise in the key rate (upper limit) of 0.25% to 2.25%. The next rise will be in December which will bring the rate up to 2.5% by the end of the year. These rate increases will help the economy to pick up both at consumer and industry level.
- There is a gulf between American manufacturing and the rest of the world ; massive tax cuts have led to vigorous investments.
- In this environment and thanks to renewed productivity, inflation remains contained at 2.2% for the core index (+2.7% including energy and food products).
- The job market is doing well, unemployment is at a historic low of 3.7%. However, many Americans still remain outside the job market.

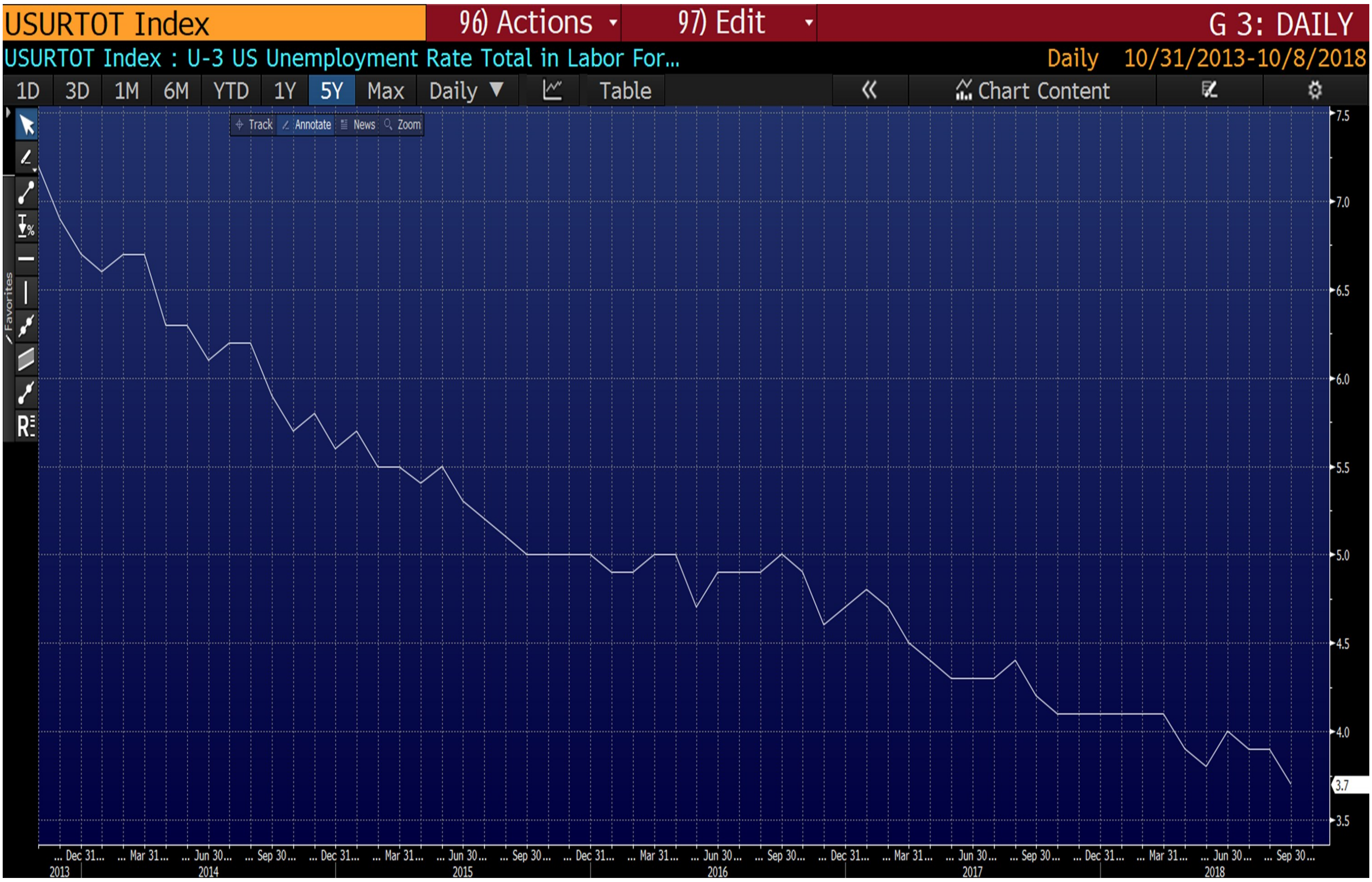
EUROPE

- Manufacturing continues to decelerate. It has fallen since the end of 2017 from 60 to 53.7, is still expanding but remains disappointing.
- The effects of the drop in the Euro since April could reverse this trend and there may be a rebound by the end of the year.
- Uncertainty in Italy, difficult Brexit negotiations and Sino-American tensions over customs tariffs are not encouraging investment despite continuing favourable financial conditions.
- Activity in the services sector remains solid, especially in France and Germany. The continuing fall in unemployment, which at 8.1% is the lowest for 10 years, to some extent explains the vitality of this sector.

CHINA

- Manufacturing is slowing down due to the trade war and measures taken by the authorities to reduce production capacity as well as their attempts to contain pollution.
- The services sector remains healthy and consumer spending is buoyant, up +9% in August despite the rise in the price of oil.
- The fourth quarter should see the results of monetary and budget policy incentives: lower taxes, a more flexible bank loan policy...
- Inflation remains contained at +2.3% making any measures to relaunch the economy that much easier to adopt.

UNEMPLOYMENT RATE (U-3) SINCE 2014



Special Topic

FED and ECB : The end of ultra-expansionist policies is taking shape...

Firstly, the normalisation of ultra-expansionist monetary policies is excellent news. This is undeniable proof that the economy has improved in the leading developed countries. In the US and even in Europe, unemployment has levelled with pre-2008 crisis figures, growth is close to, even higher, than the potential and globally countries have tried to reduce debt. However, if we see the glass as half empty, this normalisation draws liquidity out of the financial system, especially in dollars, and one may wonder about potential negative consequences.

During this phase of monetary tightening, the Federal Reserve has already increased its key rate eight times since December 2015 taking it to 2.25%. Mr Powell has indicated that this should continue in 2019 to reach 3/3.25 by the end of next year. According to the monetary authorities, this economic cycle should continue. Thus, over the last three years, the increase of 2% was both contained and very progressive, whilst during the last two cycles increases came thick and fast and the rates were much higher: 17 increases from 2004 to 2006 of between 1% and 5.25%, 6 increases between 1999 and 2000 of 4.75% to 6.5%. It was possible to manage this as inflation was controlled. At the same time, the FED worked on its balance sheet and started to reduce it by -340 billion dollars since mid-2017.

Clearly, each cycle is different. This one has been particularly long because the 2008/2009 crisis was exceptionally painful, the real estate crisis took the international financial system to the edge of an abyss and drew the world economy close to deflation. Nothing could be worse. To sum up, the American financial authorities now have enough monetary ammunition to face the next downward cycle (simple slowdown, recession, crisis…?)

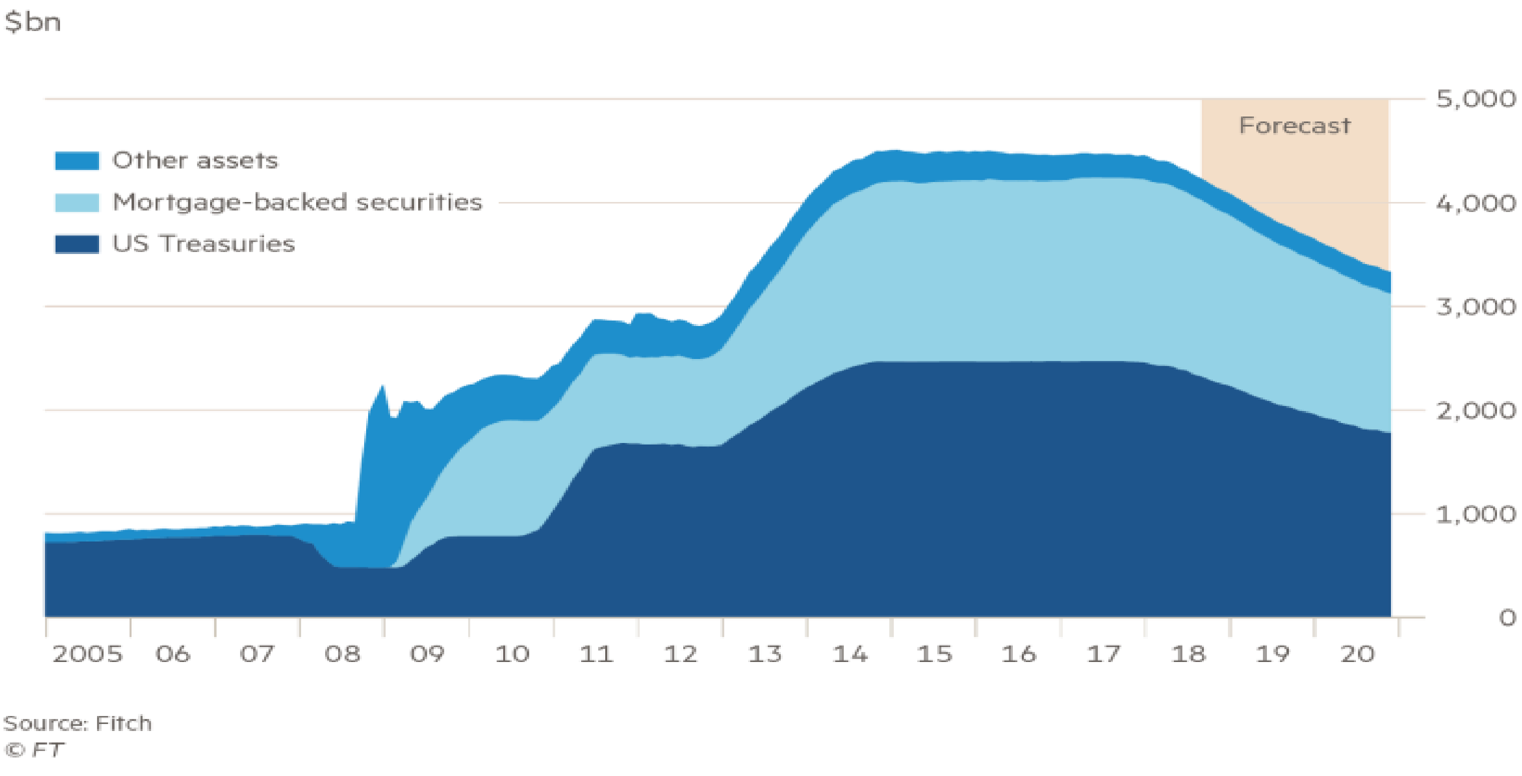
The ECB hardly has any such ammunition, and is four years behind its American counterpart due once more to the fall of the euro in 2011. Nevertheless, normalisation has already started with a reduction in securities buying which should stop by the end of this year. Since 2010, the ECB bought 2600 billion euros of debt, equivalent to 22% of the GDP in the Euro Zone (vs 25% of US GDP at the highest point for the FED); 84% of public debt, 8% of bank debt, 7% of corporate bonds and 1% of ABS ; that is the current situation at the ECB.

New purchases are going to stop but the reinvestment of assets maturing in 2019 will represent 15 to 20 billion euros a month.

As for the key rate, Mr Draghi has also signaled the way forward: Once the FED appears to have finished raising interest rates, the ECB will proceed. This is expected in the third quarter of next year. This is an unusual situation, bond yields between the two zones is already evident: there is a difference of 2.4% on short term interest rates and of 3.4% on two-year rates which explains the recent rise in the dollar, one of the rare currencies in the developed world to offer a decent return.

Once more the voices of the Prophets of Doom rose up against innovative but necessary policies, warning of catastrophic scenarios whereby the central banks would have to revert. They have been wrong-footed. To a large extent the FED has accomplished its mission. A perfect strategy so far? Only time will tell.

FED balance sheet evolution (in billion of dollars)



NOTICE TO READERS

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