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A NOTE OF WORRY FOR THE WORLD ECONOMY

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2018 ended on a more unsteady note in macroeconomic terms, with business leaders surveys reflecting a view of a slowing world economy that lacks the wherewithal to recover. Yet at the same time, plummeting oil prices are set to act as a severe drag on the pace of inflation.

Against a backdrop of slowing economic activity and inflation far short of central banks' targets, monetary policies are not about to shift towards normalization. Only the Fed – which must curb the effects of excessive fiscal policy in an economy running on full employment - will adopt a tighter strategy, as the US economy's long-term balance depends on it. An immediate effect of this is to keep the long end of the yield curve low, reflecting both economic conditions and investor behavior, as they do not want to take excessive risks at a time when the economic and financial context has become very volatile and is expected to stay that way.

> ***"The recovery in purchasing power following on from the drop in energy prices will offset political uncertainty that is dampening the Old Continent."***

World economy less lively

After an exceptional 2017, economic growth worldwide dipped in 2018, reflecting Europe's inability to maintain a strong pace of growth, as well as the impact of rising oil prices on household purchasing power. 2018 also saw the emergence of a less coordinated and less cooperative trend across the globe, creating uncertainty across the board, particularly for companies, as they tend to sit tight and wait when the future is less predictable.

The euro area cycle hit its peak in late-2017, and activity has tended to move towards its potential growth rate since then, further dented by weaker world trade and the failure to implement coordinated policies across the bloc. This broader trend will not reverse in 2019, and growth will set on its potential pace of around 1.6%. The recovery in purchasing power following on from the drop in energy prices will offset political uncertainty that is dampening the Old Continent.

Meanwhile in the US, growth stepped up a pace driven by very expansionary fiscal policy, yet in 2019 lower taxes will have a lesser impact, while tougher monetary policy will have a visible effect on economic activity, especially in real estate, which has already been flagging for several months.

Looking further afield, statistics in China are not disastrous, but they do not point to any potential sources of economic acceleration. The economy is in the throes of intensive transition away from an excessively hefty manufacturing sector towards services, and this requires a very active economic policy. Wariness on China is due to

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questions on the reliability of figures: official data are optimistic but some indicators point to doubt on their solidity due to this transition and also in light of trade tension with the US, which escalated right throughout 2018. There are concerns that a potential slowdown could well be underestimated, thereby undermining the world outlook, and we cannot rule out the potential role this factor may have played in the adjustment on risky asset markets.

Political uncertainty in Europe

Falling oil prices – driven down by the lasting influence of the US – are set to lead to lower inflation, close to core inflation in developed countries, but also in several emerging markets. This factor combined with the turnaround in activity will not push central banks into swift normalization of their monetary policy, with only the Fed set to make at least two moves to avoid the development of imbalances that would be more damaging for the US economy than an economic slowdown in 2020.

This situation will bolster purchasing power and reduce financial restrictions, propping up domestic demand in several countries and curbing the risks of a decline in activity, making for a welcome countercyclical effect.

Various areas of uncertainty fuelled concerns right throughout 2018, whether due to certain decisions (Brexit, Italy) or lesser cooperation worldwide, and as 2019 gets off to a start, these questions remain while others add to them. This year's European elections and political balance in Europe more broadly speaking raise a number of questions on the stability and strength of the largest market in the world. Tension on technological leadership between China and the US will keep on creating disruptions in the perception of world economic activity.

Yet even a partial reduction in these uncertainties would help bring some predictability back to the financial markets.

> ***Tension on technological leadership between China and the US will keep on creating disruptions in the perception of world economic activity.***

FIXED INCOME MARKETS FACE MULTI-DIMENSIONAL RISKS IN 2019

Fixed Income Management Team

The world fixed income market is set to provide the stage for some major drama as 2019 kicks off.

The Fed's quantitative policy is gradually winding down, and investor concern is focused on the recent flattening of the US yield curve, which was pushed down by risk aversion and fears on growth. An inversion of the yield curve has traditionally heralded a recession with a few quarters' lead, yet economic indicators still point to a robust economy. During his statements on December 4, President and CEO of the Federal Reserve Bank of New York, John Williams, reiterated that the Fed should expect to continue hiking key rates. Yet 10-year Treasury rates are back under the 3% mark, driven down by oil prices and their impact on inflation projections. Lastly, the Fed's latest statements managed to reverse investor sentiment as they now expect an end to key rate hikes in the near future, fitting with the end of the growth cycle.

«The road will be paved with a number of risks in 2019, and market and economic dangers will probably take on greater importance.»

Political concerns

The macro-financial environment is becoming more strained in the euro area, pending the ECB's tightening of monetary conditions at a time when economic activity is beginning to dip, particularly in Germany. Yields in the country are now falling again, with a low of 25bps on the 10-year, indicating that a substantial portion of yields are negative again.

These fears on the economic environment add to existing political concerns, after Theresa May reached a Brexit deal with the EU, but has not yet managed to convince Parliament of the terms, leaving doubts on the actual conditions for taking the UK out of the European bloc. Meanwhile, the Donald Trump/Xi Jinping trade war is still a worry, despite progress during the G20 summit and a ceasefire on retaliation measures to allow for negotiations to resume. Lastly, discussions between Rome and Brussels on Italian deficit projections are fuelling investor jitters at a time when growth projections for 2019 and 2020 look difficult to hit.

Against this backdrop and despite a stabilizing dollar, yields on emerging debt are rising again due to worsening risk premiums.

So the road will be paved with a number of risks in 2019, and market and economic dangers will probably take on greater importance.

In the euro area, Mario Draghi is poised to bring his term to an end with a token hike to deposit rates, and monetary policy is set to remain cautiously accommodative with a likely extension to the TLTRO program. It is worth noting that the ECB has massive amounts of coupons and maturing debt to reinvest, and is keeping considerable operational leeway. So against a backdrop of continued low inflation, bond yields will remain low with particularly strong downward pressure on the long end of the curve.

Increased volatility on US yields

Risks in Italy may dwindle temporarily, but the country's debt will be subject to various points of pressure sooner or later, leading to doubts on its sustainability. Pressure will be manifold – political with the European elections approaching, financial as the ECB will purchase less and banks have already invested heavily, and especially economic with possible moves from ratings agencies. The sovereign situation in Italy will remain a worry in 2019, even if investment from foreign investors has decreased considerably.

It is important to remember the strong connection with US rates, which are set to be more volatile. As the cycle comes to an end, statements from the Fed will reflect leading economic and housing figures. J. Powell will bravely endeavor to sustain financial stability that has been hit by the normalizing cost of risk and will also have to take on board heightened fiscal and external imbalances in the US, which could eventually hamper the dollar. The first part of 2019 could see a continued flattening of the US curve, before the short end becomes attractive again.

Lastly, the quarter ahead may also set the stage for some fresh opportunities, especially on emerging debt, some of which is recovering some value after a disastrous 2018.

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> ***«The sovereign situation in Italy will remain a worry in 2019, even if investment from foreign investors has decreased considerably.»***

2019 TO BE A PIVOTAL YEAR ON THE CREDIT MARKETS

Credit Management Team

2019 is set to be something of a similar year to 2018 from a macroeconomic standpoint, and this year's risks will remain Brexit and the spread of populism.

Positive aspects include ongoing solid fundamentals, particularly on growth prospects and corporate earnings, while default rates are historically low and are poised to remain so. Leverage is admittedly higher, but remains acceptable, and lastly, the risk of a poorer economic scenario would lend credence to a slowdown in the rate hike cycle in the US, as well as a potential extension in the ECB's exceptional policy measures to cut back financial fragmentation. These factors would all be good news for credit spreads.

> *The market's relative robustness during the years of quantitative easing is set to be hampered as technical factors that have propped up the market for the past three years dwindle.*

So 2019 looks set to be a particularly attractive year for credit investors and is poised to be a pivotal year on the credit markets.

The market's relative robustness during the years of quantitative easing is set to be hampered as technical factors that have propped up the market for the past three years dwindle, i.e. the end to CSPP. However, the markets have already priced in these negative aspects, which are offset by attractive valuations: credit spreads have returned to strong levels in both absolute and relative terms, and are historically wide if we strip out the crises in 2008 and 2011.

Attractive investment grade market

The combination of these two factors will lead to greater investor discernment between issuers on the market, while spreads that provide higher returns will also act as a greater safeguard. We are set to see greater dispersion within the market, providing a driving force for performance.

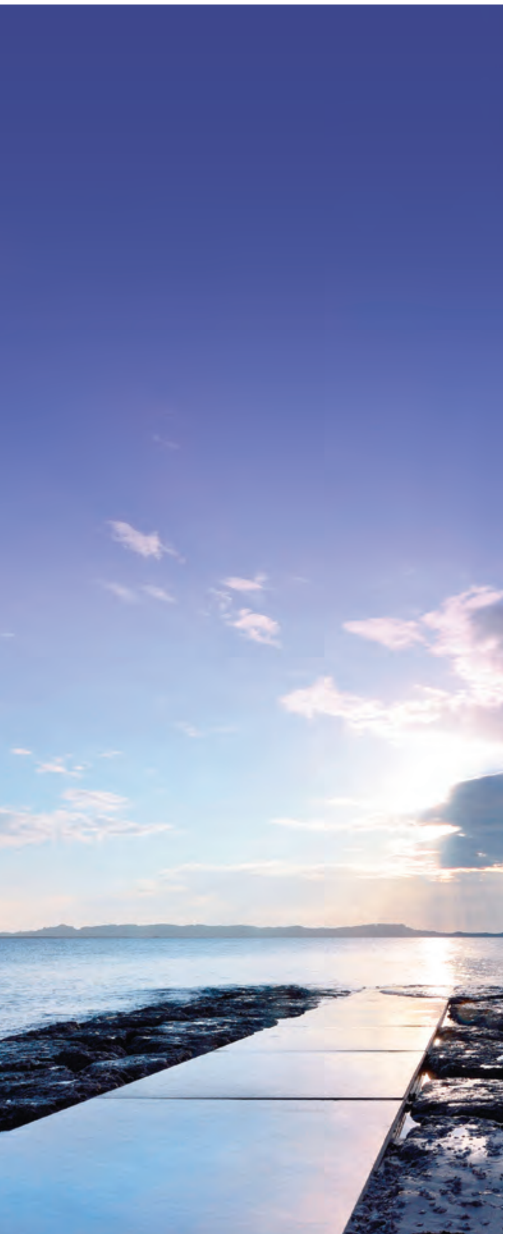
On the investment grade market, the weighting of BBB issues is often mentioned as a risk factor for 2019, after increasing from 20% to 50% in Europe and from 30% to 50% in the US in the past eight years, but in our view, several aspects alleviate this risk:

- The market's natural regulation mechanisms will reduce the issue potential for these issuers over time and require that they offer higher issue premiums.
- Stock- and issuer-picking will enable investors to safeguard against the risk of rating migration and the ensuing technical events i.e. forced sale.

> *The European high yield market will be able to rely on strong credit quality.*

The market has now fully understood and priced in this risk, as reflected by the BB/BBB spread multiple, which stands at 2.3 vs. the 2.8 historical average.

We feel that the decrease in technical support factors has now been well and truly priced in and think that the investment grade credit market's risk-return ratio is particularly attractive as compared to other asset classes on the bond market on current valuations.



In more specific terms, the European high yield market will be able to rely on strong credit quality. Debt and default levels (1.2%) are at an all-time low and will remain so in 2019. Issuers have been able to refinance their debt over recent years, cutting back their interest expense and extending their bond maturity dates. This will lead to lower activity on the primary market in 2019, thereby propping up the secondary market. The bank loans market remains fairly open, with CLO issues in Europe revealing strong demand that helps meet corporate funding requirements.

Positive outlook for leveraged loans

Despite hefty outflows on high yield funds in 2018 (AuM down 8.4% at end-November), the market is set to continue using corrections on spreads to reposition on this high yield debt class due to even more generous valuations, as shown by reallocations on the asset class in September 2018. The spread on our benchmark stands at +500bps, which is the figure witnessed before the announcement of the CSPP. Looking to the past, we have to go back as far as early 2004, just before a long period of market outperformance, to see such levels.

In view of risks such as the end to QE in Europe, political uncertainty and volatile interest rates, the European high yield market will testify to its relative resilience in 2019. As is the case for investment grade, with increased dispersion, credit-picking will be the main source of alpha.

Lastly, on the leveraged loan segment, we expect the market to remain robust, setting aside a few periods of volatility. Strong demand witnessed in 2018 should continue into 2019,

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with CLO requirements and increased interest from Asian investors in the asset class. We are likely to see lower supply than in 2018 with fewer jumbo deals and we also expect moderate M&A activity.

These technical factors will overshadow aggressive credit quality (high leverage and lax legal documentation), against a backdrop of low default rates. Expectations of the end of the cycle should not prove a serious threat in 2019.

OPPORTUNITIES ON EQUITY MARKETS IN 2019 DESPITE TOUGH CONTEXT

Equities Management Team

2018 ended with a fresh surge in volatility on the world equity markets. The markets seem to have been dented for the longer term by the lack of clear progress on Brexit, the budget situation in Italy and now in France, as well as US protectionism, and this overall configuration will keep volatility on the equity markets above 20% in 2019 in annualized terms.

> ***Defensive sectors' strong outperformance – on the back of their lesser exposure to the cycle and to market index fluctuations – should continue over the first quarter at least.***

Banks' weakness in Europe can be seen in their valuations, which fall well short of their net book value, while the question of a repeat performance of the bank TLTRO program leaves risks on a surge in the cost of capital for the most shaky financial institutions. Italian banks are also poised to be hit by potential renewed pressure on sovereign spreads in the country, with exposure of €400bn: this deterioration would directly hit their capital ratios and share prices. The economic slowdown has been visible in corporate earnings trends for more than a year. The expected decline in growth will bring EPS growth to below 5% in 2019. Analysts' EPS projections point to growth over the year of around 10%, however this looks ambitious at this stage, and a deterioration in market valuation multiples is possible from 12x 2019 earnings.

Steep discounts in the automotive and basic materials sectors

Defensive sectors' strong outperformance – on the back of their lesser exposure to the cycle and to market index fluctuations – should continue over the first quarter at least. The oil sector will probably post lower profits due to renewed and long-lasting excess crude oil supply in the US, while dividend payout is likely to decrease in the sector. Meanwhile looking to cyclical stocks, the automotive sector's additional discount (6.4x 2019 earnings) prices in its structural difficulties and probably the impact of several corporate governance problems regarding directors' compensation and the implementation of new sector standards. Yet vehicle demand has reached its cyclical peak. Weak valuations on basic materials (7.1x) look to be the result of protectionist measures, conversely, the food and personal care sectors are trading above their 10-year average.

> *A weak euro should admittedly act as a support ultimately and prompt renewed US inflows in 2019 after an extended period of investors avoiding European equities.*

A weak euro should admittedly act as a support ultimately and prompt renewed US inflows in 2019 after an extended period of investors avoiding European equities. Once the Brexit date and European elections are past, the second part of the year should see a recovery.

Likely rebound on emerging markets

Earnings growth remains on a robust trend in the US. The combined operating margin for S&P 500 companies stands above 19% and sales per share continue to display double-digit annual growth. However, the astounding increase in US non-financial companies' financial leverage since 2012 is a major source of weakness, particularly as additional debt was used to focus more on share buyback programs and financial transactions than spending on productive investment. Some sectors bought back as much as 4-5% of their market capitalizations over the past 12 months, and this tends to artificially inflate EPS figures. Tougher funding conditions would considerably hamper these flows. In other words, it looks like directional trends on the equity market in the US will remain extremely sensitive to the slightest comment from the Fed, as shown by 4Q 2018 index trends. Speculative positions dropped 50% during this period and this probably curbs the extent of any fresh period of decline. There was a rebalancing in flows on style-driven investments (growth vs. discounted stocks) to the detriment of listed tech star stocks, which had long underpinned US index performances. The positive slant for discounted stocks will continue at the start of 2019. Any break in the rate hike cycle will be good news for the most highly leveraged balance sheets.

> *The astounding increase in US non-financial companies' financial leverage since 2012 is a major source of weakness.*

Emerging markets plummeted in 2018, dragged down by protectionism and the dollar's concurrent rise, as well as sanctions and other specific events, with prices tumbling. The Chinese market is trading at less than 10x 2019 earnings and some markets, including Turkey and Russia are trading on around 5x. Sell flows decreased at the end of the year in Asia excluding Japan, while investors continue to steer clear of the Latin American market. A recovery on the emerging markets looks likely.

ADDITIONAL NOTES

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