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EURO AREA ON THE FRONT LINES IN THE WORLD TRADE SHOCK

Philippe Waechter
Chef economiste

Macroeconomic momentum has taken a severe downturn since the summer of 2018, as shown by the sharp and sudden slump in world trade since the start of the fall. Trade contracted slightly in January 2019 from a previous yoy growth figure of 4% at the time. This very drastic downtrend is primarily attributable to Asia, as the region's imports and exports have taken a clear plunge over the past several months. Meanwhile, other regions are seeing less dramatic trends and have not necessarily experienced this same deterioration in profile.

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The speed of this trend suggests that it is mainly due to US trade policy moves and the country's conflict with China. However, we do not think that the two countries will come to an agreement any time soon, as the real issue at stake here is technological leadership, and neither side wants to play second fiddle.

More volatile indicators in the US

This shift in trend is damaging for economic activity right across the globe as China is already seeing a slowdown in manufacturing activity, while other Asian countries are highly dependent on their neighbor, so they too also feel the effects. With the main growth region in the world affected, global momentum is clearly hampered.

However, from a short term standpoint, we note that indicators produced by March surveys (Markit) staged a recovery, albeit not reflecting a surge in activity across the board. Figures improved slightly in China – with surveys in the country giving an index above 50 – while they are no longer sliding as quickly as before in Taiwan, South Korea and Japan. However, it is still too early to declare that there has been a sustainable turnaround in trend.

The US continues to enjoy robust growth with its very vast and extremely powerful domestic market, although the pace has not been quite so brisk since the end of 2018. Indicators have become much more volatile and therefore provide a much more contrasting view on the outlook, as seen on the labor market as well as in real estate. This may point to a lackluster economy, supporting the possibility of a more marked downturn in activity over the months ahead. Against this backdrop, the Fed made an about-turn, voting not to commit to potential rate hikes and balance sheet pruning. The central bank does not want to tie itself in a straitjacket, as it aims to keep the leeway required to react swiftly and

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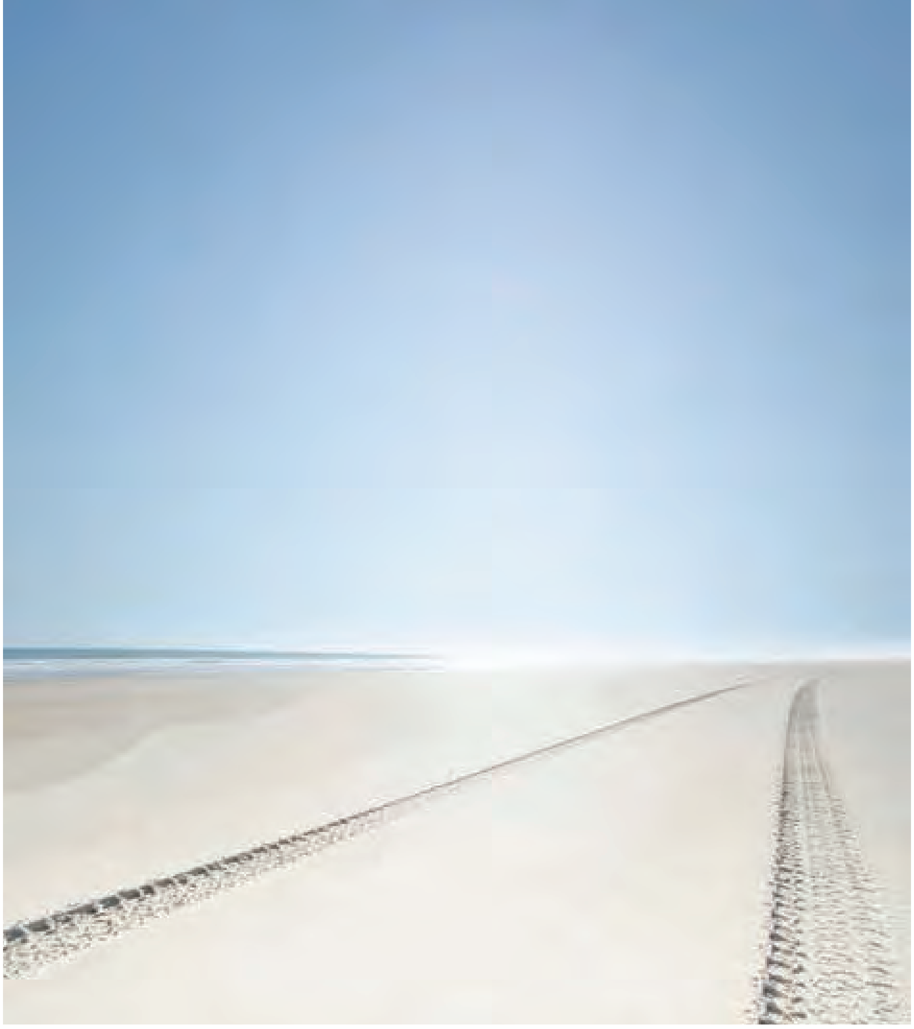
flexibly if it runs up against a tricky situation.

So when it comes down to it, the euro area is the most affected region. Its economy is more open than the US and so it is harder hit by any external trade shocks. The decline in trade in Asia hampers German trade to the region and makes for a sharp contraction in the manufacturing industry in Germany.

Yet economic policy will be unable to cushion this shock, and this can be seen by a primary budget surplus. So even if monetary policy remains accommodative, the policy mix is damaging for growth. The euro area internal market lacks the wherewithal to cushion this shock and current policies do little to reverse this trend.

No policy changes ahead

Our questions on the euro area are also a result of the region's weaker productivity gains. All developed countries face the same issue, but the euro area economy is more open to outside influences, so it feels the force of any shock all the more. Productivity reflects an economy's ability to stage self-sustaining growth, so strong gains reflect robust economic momentum and negative shocks can be absorbed quickly and subsequently disappear. However, when productivity gains are sluggish, economies have a much harder time dealing with shocks, and difficulties can last longer and have a sustainably damaging impact on the economy This is when an accommodative policy mix can come in useful.



However, this is not the case for the euro area as has been shown, and there is little chance that the situation will change. Recent discussions between Emmanuel Macron and Annegret Kramp-Karrenbauer (also referred to as AKK, replacing Angela Merkel as leader of the CDU party) on their views on the role of Europe suggest that the two points of view are incompatible, with one side seeking greater sharing and pooling than the other. But with Germany steering euro area fiscal policy since 2011, it is highly unlikely that this will change.

> *In the absence of inflation, the ECB will not take the risk of triggering a shock on the economy by suggesting a potential tightening in monetary policy, even for a later date.*

One immediate effect is that in the absence of inflation, the ECB will not take the risk of triggering a shock on the economy by suggesting a potential tightening in monetary policy, even for a later date. Mario Draghi made the ECB's long-term accommodation very clear during the press conference in March, so in other words, interest rates are unlikely to change over the next two years.

In the UK, the government has still failed to come up with an answer to the Brexit conundrum. So now we sit tight and wait, although every additional extension comes at a cost for growth in the UK – where the effect is strongest – but also in Europe.

Text completed on 04/03/2019

FIXED INCOME MARKETS ON A SOLID TREND DESPITE UNCERTAINTIES

Fixed Income Management Team

The first quarter of 2019 marked the end to the series of nasty surprises that stacked up at the end of 2018, and risk premiums fell back sharply at the start of this year for several reasons after a disastrous fourth quarter 2018 for financial assets overall.

These two forces – fundamental and monetary – that triggered an easing in risk and term premiums are potent enough to last into the second quarter.

On the macroeconomic arena, the end of the US cycle is postponed as shown by stabilizing leading indicators. However, the recovery in risky assets had little impact on US Treasury valuations with the 10-year fluctuating around 2.60% until February, when the Fed confirmed the accommodative take already on display in late 2018, leading to a fresh substantial easing.

Meanwhile in China, aggressive government fiscal and monetary policy provided stimulus in the country, as authorities announced fiscal measures for companies worth 2% of GDP at the National People's Congress. A cut in VAT rate also aims to revitalize economic activity and make China more competitive as compared to its other countries.

> *We expect the 10-year US Treasury note to remain close to current levels out to end-June 2019, and do not anticipate a rise in European long-term rates either.*

Support from central banks

Tension between the two sides in the US-China trade war seems to have eased, but severe discord remains on certain issues, and this question could raise its ugly head again during the second quarter. There is now a significant chance of a no-deal Brexit after Theresa May failed to garner support for her deal from either her government or Parliament as a whole. With the UK economy beginning to feel the effects of these uncertainties, the Gilt continued to gain sharply.

Looking to monetary policy, the Federal Reserve announced that balance sheet run-down will soon come to an end in the months ahead. The decision is in line with recent comments by Chair Jerome Powell suggesting a target size for the balance sheet in the ballpark of 16-17% of GDP. This acts as a strong support for US interest rates particularly as the interest rate hike cycle now seems to be almost finished.

Meanwhile, the ECB surprised the market by further postponing any normalization of monetary policy in light of economic weakness in the area, and even kicked off a fresh two-year bank funding program to maintain accommodative financial conditions. These moves pushed the German 10-year towards zero for the first time since 2016.

Interest rates low on a long-term basis

These two forces – fundamental and monetary – that triggered an easing in risk and term premiums are potent enough to last into the second quarter. World growth remains positive, albeit fragile, and neither China nor the US is sinking into a distinctive slowdown for now. Central banks are reassured as inflation remains in check and they continue to flood the financial system with liquidity, and this financial repression will continue to promote investors' blind quest for yield, particularly where money market rates are zero or negative. We expect the 10-year US Treasury note to remain close to current levels out to end-June 2019, and do not anticipate a rise in European long-term rates either. The ECB still needs to reinvest proceeds and this continues to underpin the market, while banks will continue to step up their sovereign debt purchases with the new TLTRO. Despite this, the Italian sovereign situation still remains a concern for 2019 although the proportion of debt held by foreign investors has fallen considerably. We remain negative on Italian debt and neutralize maturities up to two years. However, our stance on Spain and Portugal remains positive.

Sound outlook for emerging debt

Given the prospect of low interest rates over the long term, we think that emerging market bonds will continue to attract international investors, even on local debt, as arguments supporting this asset class are definitely making an appearance again this year: the dollar and oil are stabilizing while not hitting new highs and the trade war is less likely to hamper the growth trend. In our view, sovereign yields on some emerging countries adjusted for volatility still harbor a lot of value.

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Central banks are well aware of their weak economies and flagging world trade momentum, so they will be extremely watchful for any warning signs of a turnaround in the cycle. The financial system is still vulnerable to external shocks but is better able to cope with political uncertainties this year. Listless volumes are another expression of weakness, and the excesses of the first quarter will be tempered one way or another this quarter. We expect to see more volatility again and a weaker correlation between performances from the various asset classes from the second quarter onwards as investors seek to safeguard against certain risks and better single out sources of yield. Brexit will be a major source of concern and a worst case scenario cannot be ruled out.

Text completed on 04/01/2019

CREDIT VALUATIONS PROMPT CAUTION

Credit Management Team

The year is set to continue in the same vein as the first quarter of the year (which was characterized by remarkable performances from the credit market as a whole) with the impending threats from Brexit and the surge of populism in both international relations and the forthcoming European elections poised to raise major risks and harbor strong opportunities.

Macroeconomic fundamentals seem to point to a slowdown in the world economy, but the main central banks' monetary policies will remain very accommodative and shore up the credit market. From a microeconomic standpoint, default rates remain historically low, while leverage is kept in check. Meanwhile all participants right across the markets have clearly singled out the issues surrounding Brexit and the European elections but failed to price them in to any great extent.

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Selection remains crucial

Performances were outstanding on the Investment Grade market with yield of around +3.2% over the first quarter of 2019 for the euro IG market and 5.2% for the dollar IG credit side, hitting a 20-year high. The showing on the euro IG market was a result of considerably narrower spreads, reflecting the improvement in credit risk perception, while on the US credit market, we have been seeing a slowdown in performance as a result of lower USD rates over recent weeks. Technical factors increased at a faster pace in Europe than the US in the first quarter as credit funds enjoyed positive inflows once more, while the prospect of low interest rates drove investors' search for yield. Valuations have therefore become less attractive – both in terms of total yield and credit spread – and this warrants a certain degree of caution.

> ***«If we take 2018 as the benchmark, stock-picking and discernment on issuers will be some of the keys to outperformance for credit investors»***

Market confidence bellwether dispersion has also considerably decreased. If we take 2018 as the benchmark, stock-picking and discernment on issuers will be some of the keys to outperformance for credit investors, as confirmed by the range of credit stories that made for excellent investment opportunities in 2018.

The weighting of BBB issues is often mentioned as a market risk factor, 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, this should not act as a risk as shown by the first three months of the year:

- Market interest in corporate issues remains very high and the lack of liquidity on this segment in the interbank market is a source of performance. This segment has outperformed since the start of the year.
- Stock- and issuer-picking continues to offer a very effective safeguard against this risk.

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.

If we look at both technical and fundamental aspects, we feel that the market outlook warrants a degree of caution and that any widening in credit spreads, whether broad-based or specific, should be viewed as a potential investment opportunity on the Investment Grade market.

> ***«Despite the High Yield segment's additional spread (and risk), we think that some investors could be tempted to take profits in light of the current outlook.»***

Potential entry points for High Yield

The European High Yield market notched up an excellent performance over the first quarter, with total yield of +5.12%, buoyed by renewed risk appetite as a result of attractive valuations, as expected. Euro High Yield funds posted positive inflows of €2.7bn in the first quarter – equating to 4.1% of assets managed, and close to half of outflows in 2018 – while new issues were sluggish on the primary market, as refinancing requirements were low, so market balance was found by severely narrowing spreads by on average 100 bps.

Company quality admittedly remains robust in the medium term, with low default risk, reasonable debt and sound liquidity, while technical factors prop up the market – positive inflows and weak supply – but valuations have returned to their June 2018 mark, so we remain watchful and cautious.

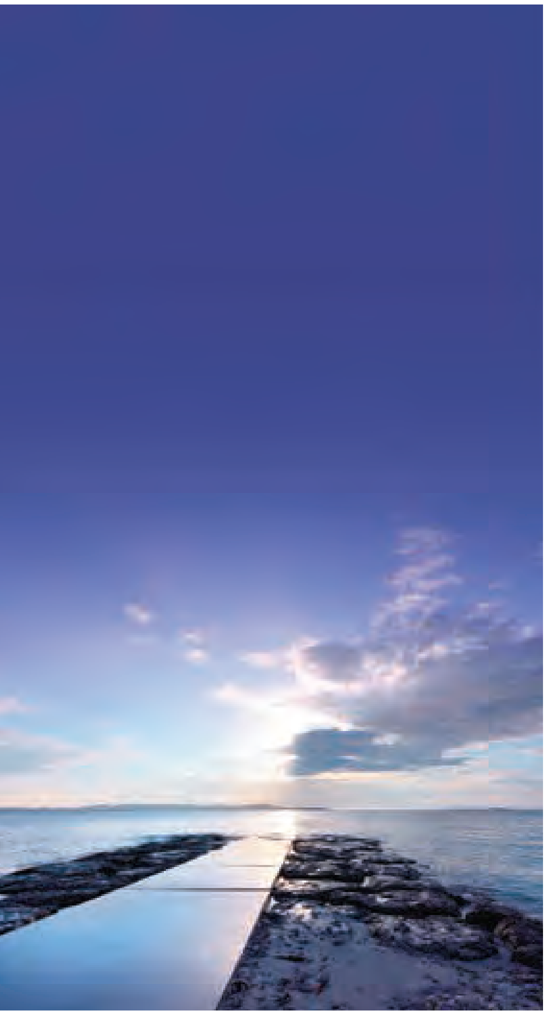
Despite the High Yield segment's additional spread (and risk), we think that some investors could be tempted to take profits in light of the current outlook. The market also remains exposed to today's major risks, which include Brexit, the US-China trade war, and the European elections. The central banks' accommodative policies should continue to act as a safety net and curb any dramatic widening in spreads. The asset class' scope for carry also plays a vital role in its ability to cushion this volatility. Against this backdrop, we think that renewed spread volatility will provide entry points on High Yield debt but also calls for relative caution in the medium term.

Text completed on 04/02/2019

FRAGILE RECOVERY ON THE EQUITY MARKETS

Equities Management Team

The world equity markets wiped out the losses suffered in the fourth quarter of 2018 much more quickly than expected, with the strong rebound driven primarily by the shift in policies from the main central banks i.e. Fed, ECB and PBoC. Perception of excessive liquidity thereby pushed up valuations, and in the US, the S&P is currently trading less than 5% from its all-time highs, while Europe has surged more than 10% in 2019 so far and China has soared 24%, although the extent of gains reflects a reweighting of this market in global indices. A number of questions remain on the sustainability of this stockmarket rally and we have already hit our end-of-year targets in March. Price-to-earnings multiples are rising, despite a drop in earnings growth projections. Meanwhile, volatility looks artificially low given the large number of political and economic risks – Brexit primarily – and out of kilter with current uncertainty on the economic costs of the UK's exit from the EU. Sluggish volumes also make it difficult to fully confirm this self-fulfilling and indiscriminate trend and the extent of the upswing is unusual.



> *Volatility looks artificially low given the large number of political and economic risks – Brexit primarily – and out of kilter with current uncertainty on the economic costs of the UK's exit from the EU.*

The worst is never sure

Low volumes over the past six months probably reflect certain active investor groups' (hedge funds, CTAs: systematic strategies) clear underexposure to the asset class. These market operators are not structural buyers, but they contribute to market liquidity and the formation of prices. However, apart from positioning requests, derivative exposure for traditional fund managers and hedge funds does not point to significant excesses. The equity markets have therefore probably been in something of a vacuum and available cash will be re-allotted as political and economic uncertainty eases. Rising commodities as well as increasing prices for sea freight over recent weeks remind us that that the worst is never completely sure. Looking to European institutional investors, weak bond yields dent returns for bond portfolios, while strong equity dividend yield (3.35% in Europe) is only on offer on the high yield segment at this stage. However, a catalyst is still required to consolidate share prices and reverse the allocation trend into bonds.

In Europe, defensive sectors began to outperform again after cyclicals' attempt to stage a rebound was hard hit by sluggish economic indicators. In our view, this looks more in line with the macroeconomic cycle situation. Expected 12-month EPS growth on European equities stands at around 7%. Low interest rates have major implications for different sectors, with banks' profitability dented again. The new TLTRO programs look less generous, and this situation is set to be a hindrance for banks' share prices in peripheral countries. Consolidation in the banking sector remains a priority. Meanwhile, the automotive sector also faces a threefold threat with major technological change, the consumption cycle running out of steam, and various governance problems. Weak valuations cannot prop up this sector forever.

7 %

Expected 12-month EPS growth on European equities

«So after a shift in tone from the central banks, stockmarket gains in 2019 can only continue if the economic cycle stabilizes.»

Political uncertainties still a drag

The 1Q 2019 earnings reporting season will kick off from mid-April onwards in the US, and analysts anticipate EPS consolidation, although aggregate operating margins for S&P 500 companies are expected to improve slightly. However, the accretive impact of share buybacks and M&A has been dwindling for the past several months, as these moves have decreased with pressure on credit spreads in 4Q 2018. Marginal share buyers (companies themselves) are now less present. Looking to individual sectors, banks are hampered by inversion of the yield curve, while the healthcare sector is also suffering a performance lag. The quest for growth is becoming a priority again for US shareholders, and this trend will continue to underpin tech stocks, especially equipment manufacturers.

On the emerging markets, China is fueled by investors' forced buying as they track indices. However, valuations are not excessive at close to 11x 2019 earnings. Meanwhile, a trade agreement with the US would drive prices up. The re-emergence of political risk in Brazil and even Turkey warrants a discount after a sound trend at the start of the year.

So after a shift in tone from the central banks, stockmarket gains in 2019 can only continue if the economic cycle stabilizes, which will require an end to uncertainty on trade conflicts and Brexit. However, valuations keep downside in check.

Text completed on 04/02/2019

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Global perspective and local presence

Part of the 2nd largest banking group in France[2]: Groupe BPCE.

ALONGSIDE OUR CLIENTS FOR MORE THAN 30 YEARS[3]

More than 1,000 institutional clients, private banks and IFA[2] trust us.

EXTENSIVE RANGE OF HIGH-QUALITY SOLUTIONS

13 fixed income strategies / 10 equity strategies
7 alternatives solutions / 1 global insurance platform[3].

RESPONSIBLE AND COMMITTED COMPANY

One of the 1st French asset manager signatories to the UN PRI in 2008[4].

Full carbon compensation of our direct greenhouse gas emissions since 2016[3].

1 – Source: IPE Top 400 Asset Managers 2018 ranked Ostrum Asset Management, previously Natixis Asset Management, as the 52nd largest asset manager, as at 12/31/2017. **2** – Market share: 21.5% in customer savings deposits and 21.1% in customer loans (source: Banque de France Q3-2017 – all categories of non-financial customers). **3** – Ostrum Asset Management, as of 10/01/2018. **4** – United Nations Principles for Responsible Investment. More details: unpri.org.

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