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DONALD TRUMP OR THE ECONOMICS OF MISTRUST

Philippe Waechter
Chief Economist

There is one thing that everyone agrees on when it comes to Donald Trump: his determination to dictate the state of the world economy via the decisions taken by the White House and the situation in the US economy.

The foundations for this position are laid by the belief that the economy is a zero-sum game i.e. whatever the US loses, other countries gain and vice versa. This translates into the conviction that when a country develops and

> *«Adam Smith, David Ricardo and many others have shown that trade is beneficial and can provide gains for all.»*

starts to trade with the US, the trade balance must be even, otherwise the situation is unjust. This logic is taken a step further as Trump believes that measures should be taken to bring production back into the country for any goods that are imported but that could actually be manufactured in the US – along with the related jobs of course. Yet the world did not grow by taking this kind of view, and Adam Smith, David Ricardo and many others have shown that trade is beneficial and can provide gains for all.

So if we take on board this zero-sum game approach, we realize that Trump's trade war – which had actually started during his election campaign – can be explained. His campaign trail quest was to bring all industrial jobs back to the US, but this approach was not fully successful, so when he became president he implemented more dissuasive border tariffs, for example with Europe, but more particularly with China. This approach also helped the White House restyle NAFTA, the free trade agreement between Mexico, Canada and the US, albeit in a slightly different context.

Doubts over the Fed's independence

However, the most spectacular issue still remains the battle of wills with China, triggered by the US' vast trade deficit with the country i.e. $419bn in 2018. By voting for Trump, Americans clearly marked their determination to bring manufacturing back to the US. Yet this perception of a trade imbalance was not always a problem for the US as China reinvested its surplus in US financial assets, helping make up for insufficient American savings. But the situation changed as China is no longer buying as many T-bonds, which knocks this balance out of kilter. The overall world balance has also shifted as China can now rival the US on cutting-edge technology on the back of its progress in this field.

This zero-sum game is costly first and foremost for Americans, as they continue to import Chinese goods that have now become more expensive. Meanwhile, this struggle has also triggered a great deal of uncertainty worldwide, changing be-

> *The US is no longer playing the role it took on in the past as both a source of economic impetus and the world's policeman.*

havior and denting growth as it is now difficult to hazard a guess as to how the future will play out, even for Americans.

There is another major fall-out from this zero-sum game: attempts to force the US Fed to take an overly accommodative approach to shore up the US economic cycle no matter what and even at the expense of others, including the belief that it should cut its key interest rate by 50bps in July. However, this would not be consistent with the US cycle – which remains buoyant – and it would also raise real questions as to the central bank's independence and doubts on the impact for the financial markets.

This approach is not just confined to within US borders. During a recent speech, European Central Bank President Mario Draghi raised the possibility of more accommodative monetary policy for the euro area with the aim of tackling risks on growth and pushing inflation back up again. Trump instantly retaliated with a critical tweet, as a more accommodative slant would supposedly lead to a weaker euro, which would apparently dent US interests.

A whole slew of economic and political examples of this zero-sum game approach can be found elsewhere e.g. Germany seen as benefiting from the "US umbrella" without directly paying the price, or questions on the need for the US to protect the Strait of Ormuz when oil that is transported there is on its way to other countries.

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Building a new world

All decisions are now dictated by their impact for Washington, while the White House has at best adopted a bilateral approach, and most definitely not a multilateral strategy. The US is no longer playing the role it took on in the past as both a source of economic impetus and the world's policeman.

We can see the beginnings of this new balance in the US' tricky relationship with China. Countries need to develop a new world order and Europe must also find its role in this set-up. The old continent has traditionally been very supportive of the US, and is now raising questions for very objective reasons. It must now take on the role as a full partner in this newly emerging world and it has its part to play. It is clear that the US' role has now changed and the country is no longer the absolute yardstick on technological choices, especially as compared to China.

Now if we go back to our zero-sum game, doubts will probably soon emerge on this idea. We are seeing an inverted yield curve in the US, reflecting the fact that investors are having trouble looking to the future and taking plays on how it will pan out. If the US economy slows severely in 2020 or slides into recession, it may be useful for all concerned to take a more multilateral approach again to address a very uncertain outlook that will be tough for all across the board.

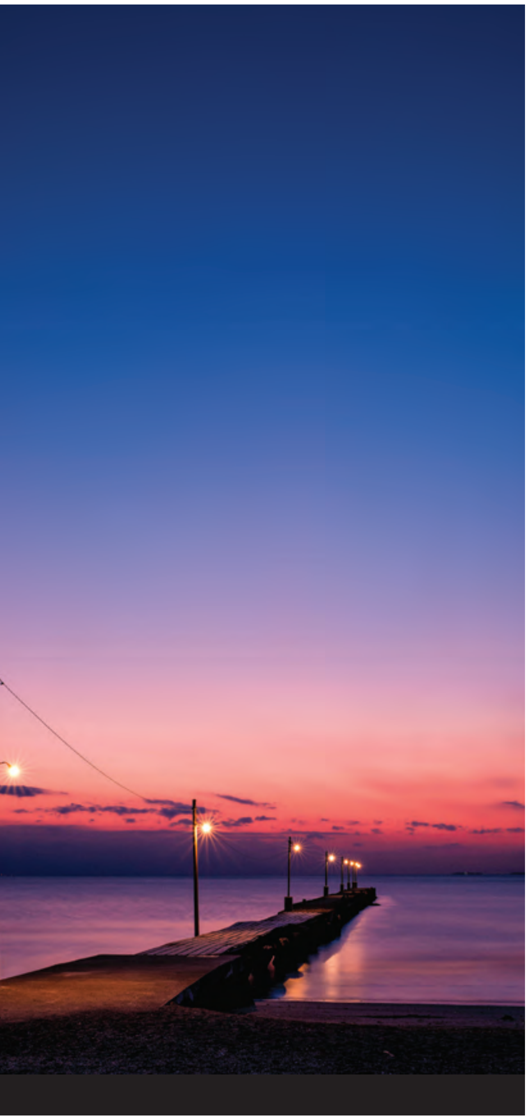
Text completed on 06/26/2019

FIXED INCOME MARKETS BUOYED BY DROP IN INFLATION FORECASTS

Fixed Income Management Team

Second quarter economic stats ended up confirming investors' fears from the end of last year of a slowdown in growth worldwide triggered by the US – where fiscal stimulus is waning – along with a trade war that eased for a time but still severely dented trade volumes. This environment is good news for the fixed-income markets overall, particularly as inflation forecasts are falling across the board. Sluggish core inflation is now encouraging the central banks to maintain or even heighten their financial repression by managing their yield curves, thus extending the growth cycle. The assurance of low interest rates over a prolonged period of time is driving investors to seek out yield without any real distinction between risks and with increasingly high duration: an analysis of investment flows most definitely reflects a clear failure to take a discriminating approach for the moment.

> ***«There is an increasingly stark resemblance with the Japanese scenario, and dwindling inflation forecasts from the OECD are increasing the similarities.»***



Peripheral debt outperforms

The swift deterioration in the growth outlook on the financial markets triggered a quest for safe havens, lifting sovereign debt and taking the US 10-year close to 2%. Renewed pressure on risk premiums in May was short-lived, and expectations of a rate cut from the Fed took over, inverting the curve as the US 2-year eased to 1.8%. Meanwhile on the European bond market, yield on the German 10-year also dipped to revisit its 2016 historical lows at -0.3%, while the French 10-year hit 0%. Minutes from the ECB meeting confirmed the TLTRO III program for September, and Draghi's comments at Sintra further heightened the current feeling that interest rates are set to stay low for a long time to come.

Despite macro-financial and political risks in Italy, peripheral and Italian debt in particular outperformed in the euro area, especially on the long end of the curve. The Spanish 30-year has posted absolute performances of almost +20% over the past quarter, far outstripping European stock-market showings. For once, yields on the Greek 5-year moved below the Italian performance this quarter.

The ECB is now determined to keep interest rates low and could even start to ease monetary policy again or crank up bond purchases if further risks emerge. Meanwhile the Fed has clearly embarked on a cycle of interest rate cuts while also easing off on its balance-sheet runoff until September, which means close to $16bn in sovereign debt for purchase on the market each month. There is an increasingly stark resemblance with the Japanese scenario, and dwindling inflation forecasts from the OECD are increasing the similarities. Central banks are increasingly moving away from their fundamental purpose – safeguarding the value of their currency – whereas financing the economy at a low cost and keeping strong liquidity in the system to maintain financial stability have become the main priorities. Investors have grasped this, and they are using this implicit guarantee to march on with purchases across all asset categories despite 'risk-free' remuneration becoming increasingly negative. Geopolitical and financial risks are having little impact on investors' herd behavior. We think that for now it is important to keep an eye on investment flows but be more discerning in selecting debt in the third quarter.

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Buoyant outlook for emerging debt

We maintain our broadly long duration stance on OECD sovereign debt, particularly the US and EU, and still underweight the very long end of the US curve, as well as Italy where growth and budget discipline are still disappointing. Positive sentiment on most emerging debt should increase as the US dollar weakens, thereby substantiating our positive outlook on this segment, particularly on Mexico, Brazil, Peru, Indonesia and Poland.

Lastly, the markets have already well and truly priced in concerns on the suspense surrounding trade negotiations between Washington and Beijing. However, the fall-out from a conflict in the Gulf or a disorderly Brexit in the fall are not entirely factored in. All these factors could revive risk aversion in the third quarter of the year, but still not reverse the main trend on interest rates, unless oil revisits its highs.

Text completed on 06/24/2019

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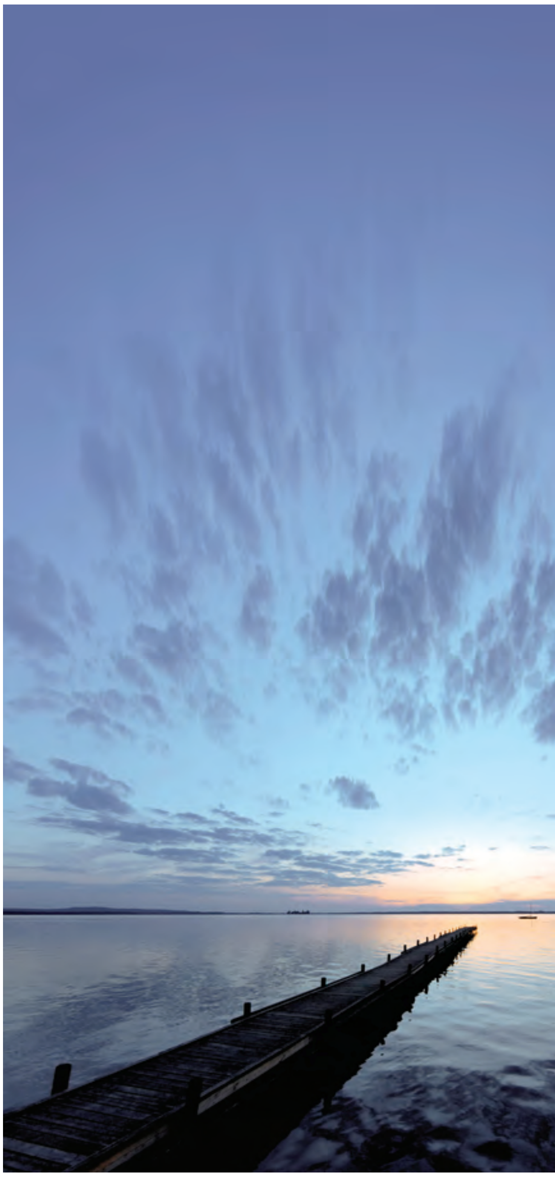


SOLID CREDIT OUTLOOK FOR THE THIRD QUARTER OF THE YEAR

Credit Management Team

The first quarter of this year turned out to be an exceptional time for the credit markets, but the second quarter is putting in much more standard performances: after a historical rally for credit spreads in 1Q, the second quarter was characterized by volatility during May, mostly as a result of renewed US-China tension. During the first quarter, credit market investors had bought the idea that the US and China would soon come to a trade agreement at some point during the second quarter, but the US unexpectedly took a harder line, undermining this scenario and hampering world macro-economic fundamentals. Central banks' monetary policies are set to remain accommodative and will shore up the credit market.

> *«In our opinion, investment grade valuations are now attractive again at Euribor +75bps vs. a 3-year average of Euribor +58bps.»*

Valuations are attractive again

Credit spreads widened 25bps in May, so in our opinion, investment grade valuations are now attractive again at Euribor +75bps vs. a 3-year average of Euribor +58bps. Technical factors were on a solid trend in 2Q and will now be bolstered by the prospects of sustainably low interest rates. Inflows on IG credit funds are sound and steady, at around €8bn YTD, while the primary market is still at the cruising speed seen over recent years with issues of close to €54bn in May. Despite widening credit spreads, the European investment grade market displayed gains of 0.65% in 2Q vs. a rise of 4% YTD.

The high yield market continued on with its performance in 2Q – much like investment grade – although showings were not as robust as in 1Q, mainly fueled by carry. Some investors opted to take profits, while overall market sentiment became more cautious following US-China tension. High yield spreads widened in May, but were still only 20bps wider than the average over the past three years. The segment provides stronger yield than sovereign bonds, and this could potentially attract investors.

Fundamentals for high yield compa-

> *«Fundamentals for high yield companies remain solid and default risk is limited.»*

nies remain solid and default risk is limited. Investment flows slowed during the second quarter of the year, although they remained positive and could surge again over the months ahead. The primary market was still active and moderate, faced with loan market competition on new issues. We remain confident on future performances for the high yield segment.
There are two main potential scenarios for the credit markets to at least remain resilient, if not positive, in 3Q:

- Heightened tensions between the US and its trade partners, which would dent the economic outlook. In this type of scenario, central banks would ramp up accommodation to offset the impact of this conflict, which could entrench risk-free rates at a lower point and trigger an outperformance from the credit markets due to investors' moves to seek out yield, and in light of negative risk-free rates.
- An improvement in the international geopolitical and trade outlook, which would include an outperformance for risky assets – particularly corporate debt – if it were to ward off the threat of an economic slowdown and prompt an interest rate hike.

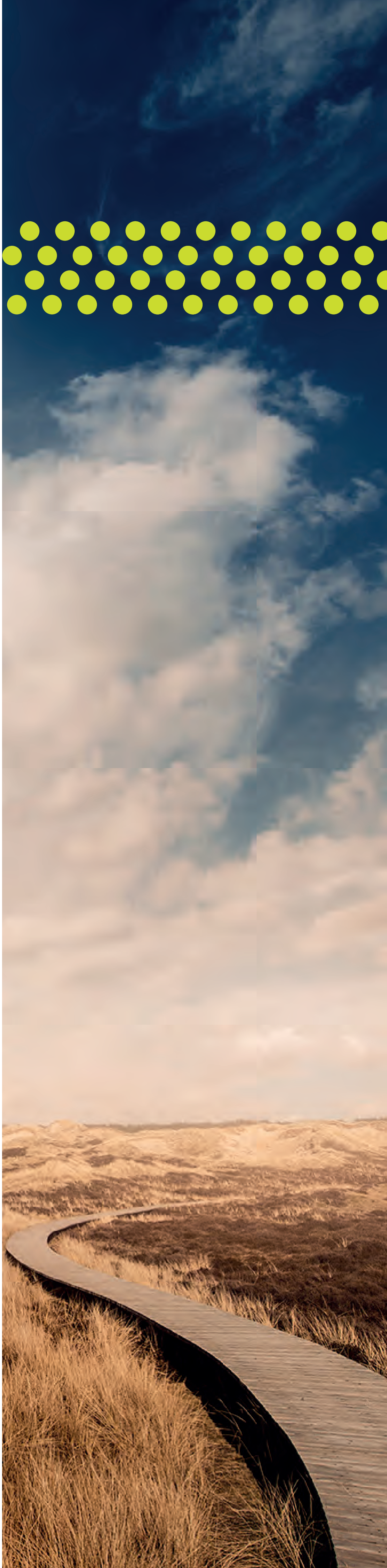
Deterioration in credit quality

The European leveraged loans market was buoyed by high demand for CLOs – with issues up 8% at mid-June on the back of Asian investors' interest – and private debt funds this quarter, as we expected at the start of the year. The primary leveraged loan market was unable to meet this demand, with a 44% decline at mid-June as compared to 2018, and this disproportion should last throughout the summer, as CLOs issued since the start of the year have to invest massively in the first six months after issue.

> ***Dispersion – often a reflection of the market's confidence – continued to increase as we expected.***

Default rates remain low, but leverage continued to rise and credit quality declined further with favorable legal documentation for borrowers. Widening spreads did not offset this deterioration and the situation is unlikely to change in the short term.
Lastly dispersion – often a reflection of the market's confidence – continued to increase as we expected. We are convinced that the keys for outperformance for credit investors will be stock-picking and a discriminatory approach between issuers, especially against a backdrop of low interest rates.

Text completed on 06/21/2019



EQUITY MARKETS BUOYED BY THE CENTRAL BANKS

Equities Management Team

The equity markets took an upturn again after a great deal of upheaval in May following escalating trade tension between China and the US, as China took retaliatory measures after the US authorities targeted Huawei. The main western stock-market indices turned in performances of between 10% and 20% in 2019. After the Fed took an accommodative slant six months ago, valuations surged on the key US market as well as on emerging markets that are exposed to dollar trends, while Europe followed suit, driven by an undervalued euro. However, double-digit showings in 2019 are not attracting flows from end investors, and the hefty outflows from equity funds that began in the last quarter of 2018 continued: bond funds benefited as they are in a better position to take advantage of uncertainties on the world economy.

The Fed extends euphoria

US companies' profitability has held up so far, but the downturn in business surveys is a harbinger for a slump in profits. EPS projections are for an 11.6% increase on a 12-month timeframe at this stage. These projections now seem to be jeopardized by the expected slowdown. However, share buyback programs' accretive effects are persisting, pushing EPS up at a much faster pace than revenues and aggregate profits. Under current financial conditions, there are around $200bn in share buybacks each quarter and this factor provides considerable support for stock-market valuations, although the price to pay is an increase in financial leverage. The Fed has merely extended the euphoria by changing its stance and the S&P 500 is now trading on ambitious multiples of over 17x 12-month forward EPS, leaving little room for disappointment. Looking to the various business sectors, semi-conductors underperformed after sales worldwide took a nosedive following on from trade restrictions. The energy sector also plummeted with oil tumbling and prices coming close to US producers' marginal cost of production (WTI at $52). The profit outlook in the sector is deteriorating severely, along with prospects in the basic materials sectors. However, on the flipside, US consumers' resilience will help stocks in that sector outperform.

> ***«The S&P 500 is now trading on ambitious multiples of over 17x 12-month forward EPS, leaving little room for disappointment.»***

Despite the rebound in the euro area in June, fueled by Mario Draghi's comments, the Euro Stoxx remains 30 points short of its January 2018 peak, while sluggish trading volumes also reflect the shortage of inflows on the asset class. Euro area equities are

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trading on around 13x 2020 EPS, so there is no clear discount. However, dividend yield remains attractive, with coupons paid out coming to 3.5%. At the same time, low volatility is promoting hedge purchases. We cannot rule out the possibility that institutional investors will cautiously revisit the asset class, especially with long-term bond yields at a low. Overall earnings momentum remains moderate and aggregate operating margins have narrowed more than a half-point over the past 18 months.

From a sector standpoint, European banks are continuing to suffer. The new TLTRO III is not as advantageous as the ECB's previous program and banks' undervaluation to their net assets is getting worse. Basic materials and transport & leisure are sliding, in line with revisions to expected earnings, while sectors like utilities that are exposed to interest rates are performing better. The pursuit of quality and visible growth also remains a major investment theme. The personal care sector should continue to outperform, and more broadly speaking, defensive growth sectors will probably continue to outperform. A premium on quality stocks still looks warranted. However, equity investors are steering clear of the most shaky business models, despite high yield spreads narrowing considerably over the past several months. European indices are now set to fluctuate around their recent highs.

Emerging markets shored up by a falling dollar

The Bank of Japan's continued asset purchases have not curbed the decline in P/E multiples in Asia. The TOPIX is now trading on 2020 P/E of less than 12x. Expected growth is admittedly weaker than in other countries (+5% on a 12-month timeframe) due to downward pressure on operating margins across most sectors. However, there is an improvement in the payout ratio, with dividend yield on the TOPIX coming out at 2.5%.

The Chinese stock-market has been dented by Trump's protectionist measures, but the currency adjustment and China's gradual reweighting in worldwide indices are helping stabilize share prices. Valuations of close to 11x show that a large number of risks are priced in. EPS growth is expected to come to around 12% over the months ahead. A positive outcome for the trade war will most likely trigger a recovery for Chinese equities. Broadly speaking, the dollar's current decline will be good news for the emerging markets.

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To sum up, strong support from central banks is keeping equity valuations high, but end investors are steering clear of the asset class. Earnings expectations look optimistic in light of economic risks, but dividend yield remains a key argument in Europe.

Text completed on 06/21/2019

07/03/2019

OSTRUM AM AGAIN VOTED ONE OF BEST ASSET MANAGERS ON PARIS FINANCIAL MARKET

The Extel survey among finance professionals (investment managers, listed companies, etc.) singles out the best companies in the sector across brokerage, asset management and financial communications each year, with the results published exclusively in French financial daily *les Échos.* Ostrum Asset Management ranked fourth this year in the French asset manager category, as a result of its research, which clients applauded for its high value added. Ostrum Asset Management's strong positioning is also reflected in the fresh award for Head of European Equities and ESG Equity Portfolio Management Ronan Poupon, who was ranked No.3 in the French fund managers and analysts category.

06/04/2019

AFG BOARD OF DIRECTORS APPOINTS MATTHIEU DUNCAN VICE-CHAIRMAN

Ostrum Asset Management's CEO Matthieu Duncan was appointed vice-chairman of the French asset management association AFG (Association Française de Gestion) at the Board of Directors' meeting on June 4. He joins Chairman Eric Pinon and vice-chairman Philippe Setbon, whose terms have been renewed. Matthieu Duncan will focus particularly on spearheading the AFG's actions in Europe and internationally.

06/04/2019

CSR – A FUNDAMENTAL COMPONENT OF OSTRUM'S IDENTITY

The fifth edition of Ostrum Asset Management's CSR report, covering 2017 and 2018, has just been published. Performances over the past two years were once again applauded by excellent UN PRI scores, as we bolstered our approach across the key CSR aspects and also extended our commitment into some new areas.

Our world is in the midst of massive change and it is up to us to collectively address these fundamental issues. Not only climate change, demographic growth and resource depletion, but also the digital revolution and questions of diversity are all factors we must take into account in order to accelerate the transition to a more sustainable world.

"Our approach may have changed and matured over the years, but our ambition remains the same. Yesterday, today and tomorrow, committed and responsible, Ostrum AM leads the way on ESG" states Matthieu Duncan, Ostrum AM's Chief Executive Officer.

Read Ostrum's CSR report on www.ostrum.com

Reference to a ranking or rating does not indicate the future performance of the fund manager.

ADDITIONAL NOTES

ABOUT OSTRUM ASSET MANAGEMENT

A TOP TIER ASSET MANAGER IN EUROPE[1]

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.

www.ostrum.com

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