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Central Banks – the ultimate upholders of the world economy

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Bond asset demand remains robust despite valuations

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Limited upside on the equity markets

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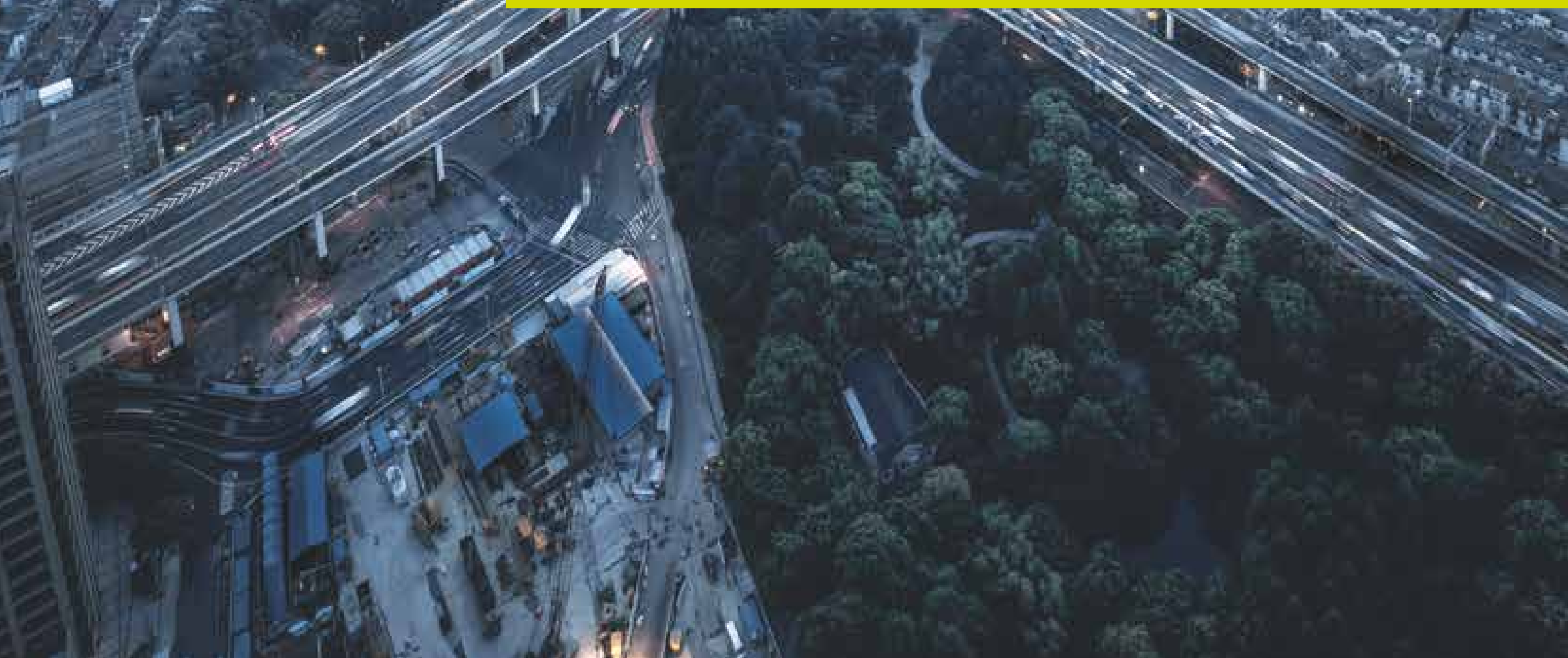

CENTRAL BANKS – THE ULTIMATE UPHOLDERS OF THE WORLD ECONOMY

Philippe Waechter
Chief Economist

The central banks are now willing to do anything it takes to prop up the economy and keep a lid on the risks of a disruption in growth. The boundaries shifted at both the ECB's and the Fed's meetings this September, and monetary policy is no longer dictated by the same criteria as in the past in either Europe or the US. The central banks are tightening their grip on the economy.

Looking to the old continent, the European Central Bank has radically changed its goals for the long term. The bank's interest rate targets for the euro area were both vague and fairly short-term so far, with no conditionality – apart from hinging on the overall state of the economy perhaps. However, the institution has now pledged to follow the rules set out at its September meeting until its sees the inflation outlook robustly converge to a level sufficiently close to, but below, 2% on a structural basis. Current low interest rates and the bank's Quantitative Easing program are most definitely here to stay: inflation has not converged towards 2% on a sustainable basis for the past 10 years. The ECB is now taking a very long-term view, and this is a massive shift. The bank is no longer sure that its initiatives will help it achieve its key goal in a set length of time.

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A fragmented world economy

On the other side of the pond, the Federal Reserve's more accommodative stance is now dictated by the global outlook to a greater extent than before. The US economy is not very open to outside influences and so the Fed's moves have traditionally been dictated by domestic economic conditions, bar 2008 and the collapse of Lehman Brothers. However, since the start of 2019, the factors driving the Fed's monetary policy have changed. In 2018, the bank's rising key rate was a response to its goal of rebalancing the policy mix after the White House's hefty tax cuts and with an economy running on full employment. The administration's policies failed to have

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the expected effect at a time when international risks were also rising, so in January 2019 the Fed altered its strategy: it changed its stance and cut back its Fed Funds rate for the first time in July this year, and again just recently in September. This new direction is now dependent on the world outlook, and this is the crucial point to bear in mind. The US economic situation does not need monetary accommodation at all, but this has not stopped the Fed going down this path. This change in direction could even be counterproductive if there is a swift downturn in the economy. The public deficit already stands at more than 5% of GDP and interest rates are already very low, so we would be justified in wondering what the Fed would do in the event of a downturn – can we expect negative interest rates?

The surprising aspect here is that the central banks' decisions were simultaneous and this may point to a very different situation to the framework of the past. If we look at the worldwide economy, the main noteworthy point is how fragmented it is. Several countries seem to have taken a Donald Trump-like approach, whereby the economy is seen as a zero-sum game, and this obviously leads to a lack of economic policy cooperation and coordination in a continued globalized world. There will not be an automatic change in the distribution of output witnessed over the past 20 years, and the industrial and manufacturing sector is set to remain a key source of growth for the emerging markets for a long time to come. Against this backdrop, it is difficult to see how a joint strategy could emerge and set the world economy on a solid growth track.

A very distinctive role

So in the current context, the central banks have a very distinctive role to play – they communicate extensively and are skilled in coordinating their actions and cooperating. They now no longer seek to drive growth via accommodative policies, but rather they are adopting a broad-based coordinated strategy aimed at curbing the risk of a breakdown in growth and the ensuing effects on the economy. We have seen that growth projections from both the US and the euro area remain lackluster and have failed to improve despite the various steps taken. The central banks want to buy time and restrict the risks for the economy, as they wait and hope for some impetus to emerge that could set the economy on a faster growth track. This impetus could come from fiscal or technological sources, or it could develop from the clear leadership for a specific area of the world, e.g. China. The central banks are primed ready to intervene in this way for a long time to come. However, for the short term, this approach may hamper their ability to steer the economy, and this unprecedented situation could in turn prompt governments to take matters into their own hands to ensure that the various economies can create enough jobs. This would make the world economy less global, with each individual government only addressing its own economic situation.

Text completed on 09/24/2019

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BONDS ASSET DEMAND REMAINS ROBUST DESPITE VALUATIONS

Fixed Income Management Team

In today's environment, we could say that bad news from the economy is good news for financial assets – be they risky or not – and the world fixed income markets are no exception to this rule. In a current seemingly inflation-free context, every time disappointing economic stats are unveiled, an ever more assertive monetary response is expected, as if there were no limit to the central banks' powers of accommodation. The equity markets may be hampered by the escalating trade war, the crisis in Argentina, the Brexit quagmire and a fresh round of Italian political drama, but yields worldwide continue their race into negative territory, which is symptomatic of both current gloom on the worldwide economy and investors' continued demand for bond assets. The US 10-year flirted with 2016 lows in early September, sliding below 1.50%, while the entire German yield curve has descended into negative territory.

Emergings buoyed by investors hunting down yield

If we look to asset allocation the world over, capital movements point to clear risk aversion in the third quarter of the year. End investors continue to trim their equity market exposure, while building up their bond fund positions since the ECB summit in Sintra in late June. Meanwhile, renewed interest in US index-linked debt in the bond space has gone alongside demand for gold. There are clear signals that investors' reallocation moves are designed to hedge against inflation or a decline in the dollar, yet the greenback remains solid – trading at around 1.10 to the euro – while inflation breakevens are still on a downtrend.

In the euro area, the recession in German industry and Mario Draghi's last dash are also shoring up the outlook for sovereign bonds. The seeming shortage of demand for the latest 30-year Bund issue was merely a by-product of the auction procedure that the German finance agency uses. Meanwhile, an election has been averted in Italy with the new government, and the BTP to Bund spread narrowed to 1.30%, although the Italian yield curve still remains fairly steep. However, Ireland was hit by the UK's toing and froing over Brexit, and the country's debt now carries yield close to Portuguese and Spanish figures on mid-length maturities, despite the fact that it boasts lower credit risk. Elsewhere, French debt was lifted by Japanese investment and continues to do well, despite

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its valuation, while on the other side of the Channel, trends on the UK bond market are as changeable as the whole Brexit debacle. The 10-year Gilt slid to 0.40% when Boris Johnson took over at the helm, before rising dramatically as soon as the idea of an extension to the Brexit date was floated. On the emerging markets, spreads were surprisingly steady, despite the crisis in Argentina and the decline on the yuan. This asset class continues to attract solid end investments, and yield well and truly stands out from the crowd. After widening in August, spreads soon entirely erased this showing.

Safeguards against excessive valuations

Mario Draghi gave the fixed income markets a generous leaving gift before he steps down as President of the ECB, cutting back the deposit rate to -0.5%, with all interest rates expected to remain at the current level – or lower – until such times as inflation converges towards the 2% mark. On long-term rates, the bank is resuming its Asset Purchase Program at a monthly pace of €20bn from November 1, with a large proportion of this to focus on sovereign debt. This announcement has already pushed the Italian 10-year down drastically, and this Quantitative Easing move (QE) is set to heighten financial repression. The aim here is to push the entire yield structure down into negative territory for all countries – even Italy.

Yet can we say that the future looks bright? Moves from the central banks and macroeconomic trends for the third quarter of the year point to continued low long-term rates across the board over the rest of the year. However, with valuations at excessive levels, it will be important to hedge portfolios against a sudden surge in long rates, especially in Germany due to valuations and potential moves into risky assets. We will probably see more traditional correlations as investors need to finance risk-taking when visibility clears. However, carry is becoming particularly negative on certain types of debt.

Volatility expected to swell

To add to all this, a dialing down of trade tension could push up US interest rates as the tariff tit-for-tat had escalated to such an extent that it heightened expectations of a recession. However, this should not overshadow fundamental trends on the fixed income market, where nominal levels tend to lower. So the hunt for yield still remains our key theme out to the end of the year, with a preference for some emerging debt in USD or local currencies. Now that the new Conte government has been formed in Italy, we have a resolutely constructive stance on the entire Italian yield curve, which still harbors value. We also overweight the US vs. Germany on short maturities, as we feel that the Fed's monetary easing will be a long-term policy, not just a stopgap move. Lastly, with the prospect of a no-deal Brexit on 31 October now dwindling, we wound down our positioning on the UK bond market. In Europe, we will look for value in Norway, where the risk-return ratio is still attractive.

With bond yields very low, duration high on the main bond indices and liquidity scarce, we are poised to deal with increased volatility. An active and diversified approach can help add value by looking for performance drivers across all fixed income sources, i.e. duration, currencies, yield curve, aggregate allocation and diversification. It will also be vital to closely monitor liquidity, as the least liquid investments could be more at risk if the central banks' policy moves disappoint. Ultimately, higher volatility will bring investors back down to earth and to the reality of fundamentals and imbalances sooner or later.

«It will also be vital to closely monitor liquidity, as the least liquid investments could be more at risk if the central banks' policy moves disappoint.»

Text completed on 09/20/2019

HEADING FOR A RECORD YEAR ON THE CREDIT MARKET

Credit Management Team

With year-to-date gains of 8%, 2019 is in the running to rival 2014 and its 9% surge as one of the best vintages on the investment grade credit market. The asset class' yield to maturity currently stands at 0.50%, which is still low in absolute terms. Meanwhile the high yield market is displaying similar trends, with 2019 poised to be an excellent year, notching up a YTD rise of almost 10% already. Spreads have narrowed massively by close to 150bps on BB-B ratings (BofAML Euro BB-B High Yield Index constrained HEC4) and valuations are tight in absolute terms, with 2.4% yield on duration of 3. Current yields raise doubts on the sustainability of the trend witnessed this year, particularly with the last quarter set to be dogged by various macroeconomic and external risks, i.e. Brexit, trade war, Middle East, etc.

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However, just this once we think that forces pulling bond yields down should keep on supporting investors on the credit market, as the central banks seem more determined than ever to keep their accommodative stance.

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Upbeat outlook for high yield market

The European Central Bank's recent decision to resume its Asset Purchase Program and an increase in the number of bond assets with negative yield are leading to a crowding out effect for the credit asset class, which is particularly beneficial for the investment grade corporate debt market, as it carries additional yield. This crowding out is reflected by uninterrupted and continuous inflows into the asset class in 2019, with a total of €18bn for the European credit market. Lastly and despite a slew of primary bond issues, we think that this balance of forces will trigger an outperformance for credit spreads, as the end of the year is not a particularly busy time on the primary market.

High yield should also be driven by some positive technical factors out to the end of the year, as the asset class now looks like a potential source of yield in today's persistently low interest rate environment, and has attracted massive inflows of more than €11bn so far this year – equating to 10% of total assets. This trend is set to continue over the quarter ahead. The primary market looks active, but this is actually largely a result of companies' debt management programs as they repurchase their bonds, and is acting as a support propping up current market levels. Corporate fundamentals remain solid and default rates should be kept in check over the months ahead. However we do draw particular attention to downgrades for some specific issuers, i.e. Lecta and Progest in the packaging sector, and Thomas Cook in the travel sector.

Leveraged loans market out of kilter

The investment grade credit risk premium – i.e. spread – has hit a relatively attractive point in absolute terms at 75bps, ahead of its 3-year 58bps average. However, this valuation unfortunately offers very little in the way of a Brexit-related premium, and we prefer to remain cautious in the short term. We cannot rule out a resurgence in Brexit-driven volatility out to October 31 and we think that this will provide a major buy opportunity on the credit market.

The supply-demand mismatch continued on the leveraged loans market, as we expected, and even gathered momentum over the summer. Supply dwindled further, with primary issues down vs. the two previous quarters as they declined 24% since the start of the year vs. 2018. Meanwhile on the demand side, 2019 looks set to be a record year for CLO issues, with €21bn YTD and around €4bn ahead for the near term. Early redemptions have also increased and spreads therefore narrowed over the quarter, particularly over recent weeks.

Default rates remain low, but credit quality has not picked up – with high leverage and favorable legal documentation for borrowers – and even difficult deals found buyers. The current context is likely to continue over the months ahead, so a stringent bond-picking approach will be more crucial than ever.

Text completed on 09/26/2019

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LIMITED UPSIDE ON THE EQUITY MARKETS

Equities Management Team

Summer on the stock-markets turned out to be volatile. Trade tension revived by Donald Trump at the start of August and political uncertainty in Europe from Brexit and Italy, as well as Asia from the situation in Hong Kong, gradually dwindled. The main central banks' fresh monetary easing moves helped drive up share indices at the end of the third quarter towards the highs of 2018-2019, although earnings growth slowed across most areas. Many investors still steer clear of the asset class despite 3.4% dividend yield in Europe well and truly outstripping fixed income coupons, even for high-quality companies.

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A paradoxical situation

GDP growth is flat in the US and funding conditions are very positive, while the drivers of market volatility are erratic, primarily fueled by political events. Yet the US market is still guided by a paradoxical trend: share buybacks are the main source of demand for US equities, while institutional investors and households are structural sellers. Companies continue to buy back shares worth somewhere in the region of $160-200bn per quarter, and we have witnessed a resurgence in M&A transactions over recent months. Conversely, 80% of IPOs are from companies that often display demanding valuations despite the fact that they suffer regular operating losses. From an economic standpoint, US companies' profitability is however curbed by rising unit labor costs, while operating margins are historically high and are hitting a plateau in most sectors. Earnings for S&P 500 companies therefore gained less than 2% in the second quarter of 2019 and the profit outlook remains lackluster for the short term, with financial leverage trending upwards. All these factors explain why institutional investors remain unenthusiastic.

> *«Share buybacks are the main source of demand for US equities, while institutional investors and households are structural sellers.»*

We are also seeing increased financial leverage from speculators, with margin debt on the NYSE above the $600bn mark. If tension on the repo market in mid-September were to spread to equity investment financing, the markets would clearly be hit by positions subsequently being wound down. Despite record highs on the main indices – with the S&P 500 trading above 3,000 points – the trade war is still having a hefty impact on certain individual sectors. Some exposed areas, such as tech hardware makers, are suffering a sharp fall-off in multiples, while we are seeing a sell-off on stocks that are dependent on transport and international trade. So overall, some factors are keeping US equities' upside in check, particularly when we bear in mind that significant monetary easing is already priced in.

Investors rearrange their positions

European equity markets suffered a correction on a par with May's showings in August (7%), and this acted as something of a warning bell, triggering portfolio rotation moves, as the defensive growth stock theme gradually gave way to a focus on discounted cyclical stocks. The slowdown portrayed by economic surveys has largely underpinned the growth factor over the past two years, but indicators are stabilizing – admittedly at a low point – and suggest that this trend is coming to an end. Cyclicals have been sensitive to the slightest signs (or false alerts?) of progress in the China-US trade feud, but whatever the outcome to negotiations, this trend seems to be indicative of investor efforts to move into stocks that also provide high dividend yield.

Banking stocks also played their part in this asset rotation. Net book value multiples admittedly still point to expected shareholder value destruction, the cost base is high and the interest rate outlook is squeezing brokerage margins. However, the ECB at last seems to have fully grasped the negative repercussions of its monetary policy, and part of banks' cash reserves will be exempt from the deposit rate (-0.50%): this interest amounted to €7.2bn on a yearly basis. European banks' 15% rebound from their low in August reflects a clear change in perception, and this turnaround runs alongside profit-taking on consumer stocks that are exposed to China in particular. The long-term outlook is probably still upbeat, but the slowdown in Chinese consumer spending is likely to dent high multiples, particularly for luxury goods. Meanwhile, mid-caps are suffering a significant performance lag this year, i.e. -4% vs. large caps.

Overall, upside on the equity markets now looks slender. Most western indices are trending close to their highs, but earnings growth seems to be stagnating. An earnings recession cannot be ruled out in the third quarter and monetary support from the central banks is priced in. The focus should be on the dividend theme and rotation into discounted cyclical stocks.

Text completed on 09/20/2019

«The defensive growth stock theme gradually gave way to a focus on discounted cyclical stocks.»

OSTRUM SUPPORTS CAISSES D'EPARGNE WIN IN *MIEUX VIVRE VOTRE ARGENT* AWARDS

Ostrum AM is proud to have contributed to the awards received by the Caisses d'Epargne banks during the *Mieux Vivre Votre Argent* ceremony on September 25:

- No.2 in the Corbeille d'Or award for retail banking networks over one year
- Certificate for the Best Equity Range over one year

These awards applaud Ostrum AM's range of actively managed equity and fixed-income fund products available for Caisse d'Epargne retail clients.

OSTRUM PULLS OFF PRI SUCCESS AGAIN

Ostrum Asset Management achieved the highest A+ score across all relevant categories in the Principles for Responsible Investment (PRI) 2019 assessment. These outstanding scores reflect our high-quality ESG integration approach (Environmental, Social, Governance) in both our corporate strategy and our equity and fixed-income investment expertise.

Twenty of our staff also took part in the PRI academy in June, and this reputed training course was rounded out by collaborative discussion sessions attended by Harald Walkate, Head of ESG at Natixis IM, in another illustration of our responsible investment focus and our efforts to fully meet our clients' expectations.

OSTRUM'S ABS EXPERTISE ACHIEVES *CITYWIRE* AAA RATING

Citywire awarded Ostrum AM's ABS portfolio managers Sébastien André and Alexandre Boulinguez AAA ratings in August.

This is the highest rating assigned by *Citywire* and rewards the risk-adjusted outperformance of the funds they manage against a benchmark consistent with the ABS category.

CITYWIRE AAA

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

CLOSING FOR SENIOR EUROPEAN LOAN FUND II

AEW and Ostrum Asset Management completed the investment plan for their second senior real estate loan fund, Senior European Loan Fund II*, with a total of 17 transactions across Europe with a gross investment value of €579M.

One of the latest investments, which was completed in April 2019, was the refinancing of Messeturm, a landmark office building in Frankfurt, which is currently undergoing a renovation program. This overhaul will considerably enhance its appeal on a highly dynamic rental market with strong demand for new or renovated property. The AEW/Ostrum AM real estate debt platform has been offering investors long-term investment solutions since 2012.

* Senior European Loan Fund II is no longer open to subscriptions. It is a sub-fund of the Senior European Loan Fund SCA-SIF, a specialized investment fund under Luxembourg law, managed by AEW Sarl. Ostrum Asset Management and AEW CILOGER act as consultants with AEW Sarl. SELF II is an Alternative Investment Fund (AIF) that is neither notified in all countries nor available to all investor types.

OSTRUM AM REITERATES ITS COMMITMENT TO ENVIRONMENTAL AND SOCIAL ISSUES

Ostrum AM is actively involved in several initiatives as part of its bold and ambitious CSR strategy.

The company makes an active contribution to several programs aimed at raising awareness of the importance of ESG and CSR issues among issuers, public authorities and regulators : these cover a full range of subjects such as human rights, the fight against climate change, deforestation, water supply and the overuse of antibiotics in farming, as well as tackling drilling for fossil fuel in protected areas, promoting a sustainable palm oil industry, and improving the sustainability of meat and dairy supply chains at fast food chains worldwide.

These initiatives further attest to Ostrum AM's resolve to use its influence to enhance issuers' responsible practices and create long-term value for investors.

OSTRUM AM AT THE ANNUAL PATRIMONIA CONVENTION IN LYON

Each year, more than 7,000 visitors and 300 exhibitors meet at an annual fund fair in the city of two rivers. Ostrum AM was amongst the affiliates selected by Natixis Investment Managers to be showcased at the event.

Philippe Waechter, Ostrum AM's chief economist, was also invited to participate in a 3-affiliate debate (Ostrum AM, Dorval AM and H2O AM LLP), focused on market risks and opportunities.

NOTES

ADDITIONAL NOTES

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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 IPE Top 400 Asset Managers 2019 ranked Ostrum AM as the 68th largest asset manager, as at 12/31/2018. – 2 Market share: 21.8% in customer savings deposits (source: Banque de France Q1-2019 – all categories of non-financial customers) and 21.1% in customer loans (source: Banque de France Q4-2018 – all categories of non-financial customers). - 3 Ostrum AM as at 06/30/2019. – 4 United Nations Principles for Responsible Investment 2019. More details: unpri.org.

www.ostrum.com

Ostrum Asset Management
Asset management compagny regulated by AMF under n° GP-18000014 - Limited compagny with a share capital of 27 772 359 euros – Trade register n° 525 192 753 RCS Paris – VAT : FR 93 525 192 753- Registered Office : 43, avenue Pierre Mendès-France – 75013 Paris – Tèl.: 01 58 19 09 80

Ostrum AM was created by the separation of Ostrum AM's fixed-income and equity investment management operations into a separate subsidiary on October 1, 2018 (registered on the Paris Trade and Companies Register under number 329 450 738, previously Natixis AM).

Ostrum ASSET MANAGEMENT

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