

## A CHANGE OF LEADERSHIP

### IN A NUTSHELL

*Financial markets are still benefiting from a confidence boost set off by Donald Trump's election. But the reflation trade has died down, while defensive investments have come back into favour. This change in market leadership is occurring in an environment of very low price volatility, but different signs of fragility have been emerging, justifying greater vigilance.*

### CORRECTION OR ROTATION?

Last quarter, this Market Outlook was mainly focused on the impact of Donald Trump's election victory. However, in the previous issue, we discussed the sharp drop in volatility observed for most financial asset prices. As of today, both themes are still hot topics in the news headlines.

Donald Trump's victory galvanised American business and investors around the world. The promise of fiscal stimulus and generally business-friendly measures have created fresh momentum in the markets. While the markets opted to disregard turnaround times, the potential hurdles and downsides of Trump's programme, we discussed his honeymoon period – unquestionably a desirable time, albeit an unsustainable one. Three months on, optimism still seems to be prevailing because markets continued to pick up momentum and were less volatile. That said, some signs of fragility have been emerging. What's more, the foreign exchange market, the US Treasury market, or even the relative performance of sectors and "styles" within equities, have been painting a more mixed picture.

Sooner or later there will be a market correction; the question is whether the on-going trend will merely be put on hold, or will other themes come to the fore, causing a change of leadership across markets. ■

### OUR STRATEGY

**No significant change has occurred since 16 November; we still remain overweight in equities and underweight in bonds. Risk exposure at the overall allocation level is somewhat offset within each asset class: our equity positions are limited to the core portfolio markets, while government bonds and investment grade private debt issuers largely dominate our bond compartment.**

**The indicators we have been monitoring have not yet pointed to a downturn, but surely the time for this is drawing near. As we discuss below, we will then have to decide between simply lowering exposure to risk and readjusting our allocation at the expense of recovery-related themes, or reflation trade.**

### BURST OF CONFIDENCE, LITTLE ACTUAL GROWTH

Donald Trump's arrival as US President has sparked a burst of confidence among most economic agents, from consumers to the financial community to SMEs. Most indicators in this area have shot up, and some have even hit a record high. But the reality on the ground tells a different story: the measures of actual activity and the growth achieved remain chequered. There was thus an unprecedented divergence between confidence, or "soft" indicators, and the actual business done, or "hard" indicators. Without reiterating the analysis we did last quarter, it should be noted that none of the measures Donald Trump promised came to pass, nor could they have barely three months into his presidency. In fact, after returning to its potential, the US economy has been growing for several years at its cruising speed and only strong stimulus could stave off its ineluctable end-of-cycle slowdown.

The inflation trend is as contrasted as that of activity. Labour costs have clearly continued to rise much faster than productivity. But there was no real surprise in recent statistical releases.



It is well-known that on 15 March the Federal Reserve hiked for the third time in this cycle, but despite this additional ¼%, Fed Funds rates remain well below inflation. Much more than in earlier cycles, monetary policy appears to be “behind the curve”, lagging on price pressures. That said, the bond market does not seem too concerned about this. It had weakened immediately after the elections, fearing that Donald Trump’s policy would widen the budget deficit, but it has since stabilised. To better understand the reasons for this easing, we should continue our tour of the world markets.

Growth accelerated in the eurozone<sup>1</sup> and divergences between Member States have lessened. This is a good result that was obtained to the detriment of unprecedented monetary stimulus, but it does not foreshadow a surge in the eurozone economy. It comes very late in the global cycle, while the United States – pending Donald Trump’s tax measures – has already begun to decelerate, while Japan is looking for a second wind in the new phase of Abenomics and China appears forced to accommodate a much lower growth rate than in the recent past. Conditions within the eurozone do not warrant an acceleration of economic growth much higher than the current pace. In several Member States, public finances are deadlocked, while the profitability of

many companies remains lacklustre. Against this backdrop, it is difficult to imagine infrastructure spending taking off, which political leaders of all stripes have been constantly calling for.

As all these points are common knowledge, we are not going to belabour political uncertainties, or the over-indebtedness of several Member States, or even the mounting delays in shoring up the financial sector compared to the United States and Switzerland. However, we would like to emphasise the growing divergence between inflation rates in Germany and the rest of the eurozone. Although growth tends to equal out among member countries, as we have said, Germany has full employment, which is certainly not the case elsewhere in the eurozone. By definition, there cannot be several monetary policies in a currency union, but the current one is increasingly less well-suited to the prevailing economic conditions in Germany. Even if the ECB proclaims loud and clear that its policy is the best suited for the eurozone as a whole, it knows that sooner or later it is going to take its foot off the stimulus pedal. But any hint of a gradual reduction in asset purchases, or of tapering them off, instantly causes shock waves on the bond market. Even more so than the Fed in 2013, the ECB is treading on delicate ground. To complicate matters further, the euro’s strength has been reducing Mario Draghi’s wiggle room. This last point merits further commentary. ■

### US Federal Funds and inflation



— Effective Federal Funds Rate. — Consumer Price Index for All Urban Consumers: All Items Less Food and Energy  
Source: Federal Reserve Bank of St. Louis. Shaded areas indicate recessions.

<sup>1</sup> Elsewhere in Europe too: in the United Kingdom, the probable effects of Brexit have not yet been palpable in terms of growth. In Switzerland, uncertainty about the future status of bilateral agreements with the EU, but also the sector-based problems, especially in the watch-making business, put a damper on growth, but the reacceleration that is emerging should soon close the gap with the eurozone.

## POLITICAL FACTORS HAVEN'T PREVENTED A STRONGER DOLLAR OR A WEAKER EURO

Donald Trump’s victory, on the one hand, and a very busy election schedule in Europe, on the other hand, had prompted many operators to bet on a strong dollar and the euro’s sharp decline. This was not our view, as we believed, on the contrary, that growth in the United States would barely accelerate, that dollar interest rates would remain negative in real terms despite the Fed’s decisions, and that stimulus measures would widen the Federal budget deficit. We believe that this development will not necessarily prove negative, as a fall in the dollar has been generally associated with greater investor diversification and increased risk appetite.<sup>2</sup>

Conversely, due to the economic upturn, the euro seemed to hold up better than in the past. As of late, the upcoming elections in France has been on everyone’s lips, but during this period, the euro got stronger against the dollar and even against the yen, a typical safe-haven currency. While the central bank had to intervene to curb the rise in the other major currency-safe haven, the Swiss franc, the amounts committed remained within the norm compared to other recent episodes. It is true that

the derivatives market has been particularly active, which we discuss later on. But overall, the euro has not gone against the worldwide trend of a weakening dollar.

In our opinion, the different forces mentioned above – growth disparities, real interest rates, external and budgetary deficits – will persist in the months to come. The dollar’s decline is expected to continue, even if this trend has partially run its course. With regard to the euro/dollar rate, we maintain our target of 1.12 over the next 9 to 12 months. ■

<sup>2</sup> See below discussion on equities and note 3.

## THINKING A FEW MOVES AHEAD ON THE BOND MARKET

For several years, global bond markets have been closely correlated. Weakened by the prospect of a fiscal stimulus in the United States, they have now found a modicum of serenity. Four factors are at work; we have already mentioned two, macroeconomic developments in the United States and the ECB's wait-and-see attitude regarding a possible tapering. In addition, the Bank of Japan's policy, which has so far stabilised 10-year JGB yields, once again has encouraged institutional investors to buy US securities. In China, finally, growth has stopped deteriorating and capital flight has slowed, such that the central bank was not forced to sell off its reserves.

## EQUITIES RIDING HIGH

The stock market was the big beneficiary of the burst of confidence sparked by Donald Trump's victory, and not only in the United States. Many foreign companies are highly exposed to the US market, and many others will benefit from the ripple effects from the US on the global economy. Upon closer inspection, several forces have been at work. The hope of a fiscal stimulus had triggered the so-called reflation trade, which particularly favours cyclical stocks, ranging from commodities to banks. Banks have also benefited from the steepening of the yield curve following the weakening of the bond market. Conversely, higher bond yields had logically penalised defensive stocks, but this effect had been mitigated through the dollar's rise, especially for European stocks.

These global factors should not make us lose sight of the fundamental developments in several continents or regions. We have already discussed Europe. Several emerging countries are reaping the benefits of their reforms. And the majority of the Far East economies have seen their growth accelerate, driven by both domestic demand and the uptick in exports, despite China's difficulties and uncertainties related to protectionist themes.

In this auspicious context, the earnings outlook has been revised upwards, but stock prices have been adjusted just as quickly, so valuations remain as generous as last fall, if not more so.

US equities in particular have become extremely expensive by historical comparison, especially if we take account of the risks of delays or even abandoning certain stimulus measures, falling productivity, rising interest rates, and tightening financing conditions – themes we have analysed in detail in the previous quarter.

European and Asian stock markets are less expensive, but their valuation gap with Wall Street remains within the historic norm. Macroeconomic conditions are certainly rosier, but from a structural standpoint, corporate profitability lags behind the United States, which should continue to squeeze valuations.

If one adopts a sectoral rather than a regional criterion, it is true that commodity-related themes, cyclical and financial stocks, in a word the "Value" style of investing, are far from having bridged the multi-year gap with regard to the Growth style. But betting on stimulus, the reflation trade, is particularly vulnerable to any challenge of the reforms promised by Donald Trump, to

For all these reasons, as we had hoped, yields in the main global markets have stabilised. This is probably only an intermediate plateau, but the subsequent rise should not be too sudden since the global economic cycle has reached maturity. Moreover, the previous phase of rising yields has already put the brakes on this economic cycle. In addition, two of the world's largest bond buyers, the ECB and the Bank of Japan, will have to postpone their plans of tapering, as mentioned above, as long as the euro and the yen rise in value again against the dollar. We therefore still believe that in the coming months, 10-year US Treasury yields will not exceed the 2¾% level, which according to our analysis of the previous quarter would be the first danger level. ■

any delay in their execution, or to any disappointment with regard to US or global growth.

This past 24 March, the strife in the Republican Party over health care reform marked a major setback for the programme that Donald Trump had previously tried to push through to the sound of a beating drum. At that time, however, the reflation trade had already ceased dominating world markets. Crude oil prices, for example, have already been falling for a month. Industry-specific factors have been at work, including the revival of shale gas and oil production in the United States, but most commodities and industrial metals have also declined.

Conversely, as we said, the bond markets stabilised a few days before the Fed Funds hike and have even improved since then. Within the equity markets, as of the beginning of March, defensive stocks started outperforming cyclical and financial stocks. This alternation would not be alarming if it were not accompanied by signs of fragility reappearing in the markets. In the United States, an increasing number of stocks are weakening as time ticks on, such that the rise of the indexes is being propped up by only an ever smaller number of securities. There is also a discrepancy between high-yield bonds and equities. The decline in oil prices partly explains this, but it should be borne in mind that in 2015, the high-yield bond correction preceded that of equities. Another divergence, this time in Europe: stocks continued to rise while the dollar weakened markedly. We know that the correlation between them is very close, at least in the short-term.<sup>3</sup>

These worrying signs emerged when the volatility of the main indices returned to extremely low levels by historical comparison. Without going back into our previous analysis, we would like to emphasise that such calm might be interrupted, if only for a short time. With various risk appetite indicators peaking, it is easy to imagine that markets are becoming increasingly vulnerable. Any nasty surprise that is political, economic or financial in nature can knock equities off their cloud. ■

<sup>3</sup> In the previous issue of this Market Outlook, we attempted to show that this correlation was reversed over the longer-term, and that in general the episodes of the dollar's decline coincided with sharp rises for global equities.

## SURFACE CALM, UNDERLYING TUMULT

Even though it is exceptionally calm on the surface currently, the massive derivatives market has been undergoing major upheavals. The most common hedging instruments are not in demand, so that the implied volatilities are close to their historical lows. This is particularly true for the VIX index, calculated on 30-day options on the S&P 500, but there is also a significant easing in instruments on exchange rates and bond yields.<sup>4</sup>

However, many operators have protected themselves against the risks of sharp declines. The SKEW index is also calculated on the S&P 500, but it measures the deviation from the normal distribution (skewness). Unlike the VIX, it reflects the demand for hedging extreme risks.<sup>5</sup> And it reached its all-time high this past 19 March.

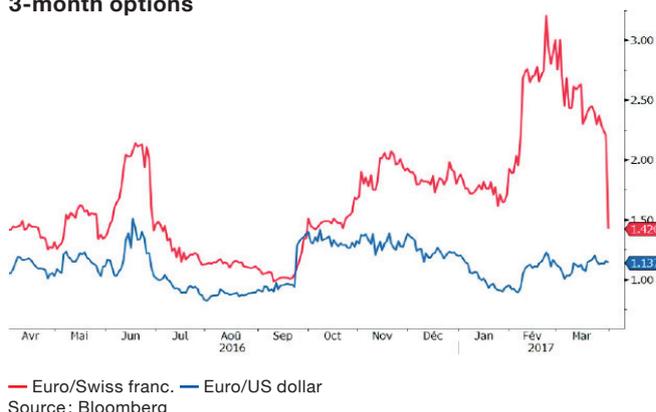
The time structure of the options also shows unusual configurations. For example, with the elections in France drawing near, there is an exceptionally strong demand for hedging on the euro/Swiss franc rate. The spot foreign exchange market gives the impression of surface calm despite risk of Marine Le Pen's election victory. Although this is highly unlikely, as is France starting the process to leave the euro, even if Mrs. Le Pen were to win the election. But in reality, many professional investors have hedged these risks in the derivatives market.

These are but two examples of the increasingly widespread use of advanced hedging techniques. This development certainly presents upsides for any investor, as it tends to limit the variability of asset prices and exchange rates. Indeed, if major operators have structured their exposure to the various risks, they will be less likely to be forced to sell the underlying positions.

But from another standpoint, the intensive use of derivatives contributes to instability, as strategies are increasingly complex and can interact in certain scenarios. This is illustrated by what

### Implied volatilities of FX options

#### 3-month options



happened on 21 March,<sup>6</sup> after a modest index decline in the absence of any significant news. This decline had activated numerous options and revealed an imbalance in the sensitivity of the bullish and bearish positions, which in finance jargon is called a gamma imbalance, forcing operators to liquidate their positions and thus exacerbate the downturn.

In today's markets, the savvy investor should not let his guard down. The surface calm can be deceptive and tumult may be in the offing. ■

<sup>4</sup> For example, options on the euro/dollar rate (EVN) or on US 10-year Treasury bonds (TYVIX).

<sup>5</sup> Defined as a 30-day decrease equal to or greater than two standard deviations.

<sup>6</sup> Up to that day, the S&P 500 Index was undergoing a period of exceptional stability. The day before, it had equalled a record dating back to 1995: 110 consecutive days with no daily variation greater than 1%.

## INVESTMENT CONCLUSIONS

Our scenario is based on continued global growth, but without significant acceleration. Monetary tightening will be gradual in the United States; in the eurozone, it will be mentioned more frequently but should not happen for a while. The tax cuts promised by Donald Trump will be a major stimulus, but with regard to other aspects of his plan, uncertainty lingers about their upsides, downsides, and timing.

Overall, the context will remain favourable for financial assets, chiefly for equities, but their upside potential from current levels is not significant, while the risks of correction increase. Wall Street will continue to set the tone, but the fundamentals are improving in Europe and Asia. The gradual weakening of the dollar should favour Asia ex Japan, but in the short-term, the European indexes could experience a sudden jolt when the political risks subside.

By 2018, global interest rates will certainly rise, but for now, the stabilisation that is occurring justifies maintaining some defensive positions in US Treasury securities, hedged against currency risk, if need be. As the cycle progresses, the risk of default on

over-leveraged debtors is going to increase. It is therefore necessary to remain selective regarding high-yield bonds. Finally, gold should remain in demand as long as interest rates on the major currencies do not offset inflation, however low it may be. ■



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