GONET MARKET OUTLOOK
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A DECEPTIVE CALM?

IN A NUTSHELL

Global market fundamentals have remained constructive overall, but the high valuation of bonds and equities has left little room for error, and extremely low volatility has spurred speculative excesses. The trend reversal in liquidity injections by world central banks is now a certainty, but its negative effects shall be dampened if the tax reform put forward by the Trump administration comes to fruition.

OUR STRATEGY

We remain underweight in fixed-income. Our main positions are shorter-dated US Treasury bonds hedged against exchange rate risk, and above all investment grade corporate bonds. Our exposure to more risky credit segments remains selective.

On 16 August, we expanded our exposure to Japanese and other Asian equities following on a growth theme.

The upcoming debate over the budget in the United States had led us to make a few tactical reductions on 30 August. Lately, markets have grown more confident on this issue, however. The pick-up in the dollar external value and in bond yields prompted us on 4 October to increase our Japanese holdings and to initiate a tactical exposure to pan-European banks in most portfolios.

As a result, our equity allocation has come back to neutral weight. It features a slight cyclical bias from the abovementioned themes but no wholesale bet across all cyclical sectors.

IMPERCEPTIBLE MOVEMENTS

In recent months, the news has been jam-packed with macroeconomic, financial and political events, one of the major ones being the nuclear threat that North Korea poses to the most developed countries in Asia and even to the United States. However, none of these news items have been reflected in the main equity or bond indexes. Some of them have evolved sideways over a few months but have not shown any trend reversal. Volatility has remained extraordinarily low, and did not surge as it usually does in August-September. In this picture that shows little movement, the foreign exchange market is an exception. The main currencies experienced major movements, though this did not drag equities or bonds in their wake, at least for the time being.

Do the fundamentals warrant this stability? In most regions, growth, inflation and external balances generally show positive signals, but the global cycle continues to unfold. The central banks ended up taking note; the slow ebb of excess liquidity[1] is now certain.

Immobility is therefore only surface calm. Although the movement is definitely slow, its direction is clear, pending a few political decisions, primarily in Washington, that could change its course; we discuss this in greater detail later on.

Ultimately, the main sources of risk derive from the market's current configuration. The high valuation of most equity indexes and especially of corporate bonds has not left any margin for error. These assets are priced for perfection.

Any upsurge in volatility would entail unprecedented risks compared to the recent past, as many markets have experienced

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very solid growth in recent years, without their liquidity being put to a test in a crisis. Volatility itself has become a growth market: quite a few instruments, and in particular exchange traded notes (ETNs), have allowed individual clients to do a record amount of short selling. The multiplier effect that has created a virtuous circle so far could be reversed.

Let us now discuss each issue in greater detail. ■

[1] A detailed analysis can be found in the previous issue of this *Market Outlook*.

WILL THE ECONOMIC CYCLE BEEN SUPPRESSED FOR EVER?

Thousands of macroeconomic statistics, both official and private, continue to be released weekly, but they seem to have less and less impact on the financial markets. As long as no data seriously calls into question the scenario of an exit strategy of the central banks that is as slow and painless as possible, what is the point of worrying?

The image of Goldilocks and her bowl of porridge that is "not too hot or too cold" is always found in the comments, but as we wrote the previous quarter, this snapshot does not fortell how the story will end. So what are the current trends?

In almost all developed economies, growth is above the potential of each country respectively. This is still the case in the United States, although the trend is decelerating. The Eurozone returned to its 2011 growth rate and confidence level. The Japanese economy is also hovering above its potential, even though this has elicited few comments in Europe. Other developed economies in Asia are also expanding rapidly.[2]

Current growth rates will be hard to beat. The expansion phase in the United States, one of the longest on record, is showing more and more signs of maturing, even though a recession seems unlikely at a 12-18 month horizon. The European cycle is much "younger," but exchange rate effects are now less favourable. In both regions, monetary tightening must also be reckoned with (we discuss this later on), and the same holds true in the longer-term for falling productivity. Unlike the large developed countries, the growth of emerging markets has fallen in most cases below its potential. The recent slump in commodity prices is compounding domestic problems in Brazil, South Africa, and Russia. However, we have noted encouraging signs of stabilisation virtually everywhere.

China is still garnering attention. Overall, the economic indicators have been disappointing, while political impulses are still hard to decipher. In recent months, the Chinese authorities have restricted capital flows to stabilise the renminbi and have focused on a few major infrastructure projects to the detriment of the official goal of boosting consumption and the new economy. Will this prove to be a lasting change of policy? It is impossible to answer this question for the time being, as the entire ruling class is gearing up for the 19th Congress of the Communist Party, whose preparatory work is not accessible to mere mortals.[3]

Almost everywhere inflation remains much lower than in previous cycles. However, based on a shorter-term outlook, there is acceleration in prices in Germany, while in the United States statistical releases have often proved to be below expectations. Several factors explain this difference: the ECB's monetary policy is too accommodating for the continent's strongest economy. In the United States, employment patterns have changed – almost all recent job growth is due to temporary or low-skilled positions. Simultaneously, technological innovation has been exerting strong downward pressure on retail prices, as is the case for Amazon's strategy, for example.

Central banks are still justifying their actions and intentions by the outlook for inflation, but the reality is far more complex. The Fed is preparing to offset the very accommodating level of broad-based financial conditions such as credit terms, yields on credit bonds, equity valuations as well as exchange rates. We analysed these issues in this publication in the previous quarter. ■

[2] Hong Kong, Singapore, Malaysia, Thailand, as well as South Korea and Taiwan, which are classified as emerging countries because of the structure of their financial markets, but are certainly very advanced in terms of the real economy.

[3] When it opens on 18 October, the main purpose of the Congress will be to validate appointments to the party's governing bodies. This will give an indication of the power struggles in Xi Jinping's entourage, and the amount of wiggle room available to Prime Minister Li Keqiang, whose reformist policy has been held in check as of late.

THE EBBING OF WORLD LIQUIDITY IS CONFIRMED

Since then, the intentions of Janet Yellen and Mario Draghi have materialised. The Fed will continue to raise its policy rates and above all, this month, it will begin to "unwind" its balance sheet – i.e. the gradual sell-off of the 4,300 billion in bonds acquired since 2008 under the quantitative easing programs. For its part, the ECB is going to cut back on the volume of its purchases. The groundwork is being laid to start tapering in January. As for the SNB, the decline in the Swiss franc enabled it to stop buying foreign equities and bonds; it could even take this opportunity to sell a small part of these assets, whose value has reached 119% of Switzerland's GDP. At the end of the day, only the Bank of Japan seems to be in no hurry to change its policy. Despite this notable exception, central banks on balance will become net bond sellers for the first time in almost ten years.

This ebbing of global liquidity will dampen risk-taking in all markets. In the short-term, there are thousands of factors that may revive investor appetite for risk, but the longer-term trend appears clear: the extremely high valuation of equity markets and especially of lower-rated bonds will gradually be put under pressure.

That said, neither equities nor bonds have experienced any real weakness in recent weeks. Their actual volatility, as well as even their implicit volatility (reflecting the demand for hedging) remain close to historical lows. This apparent stability conceals several major trends.

Yields on sovereign debt have not really responded to the launch of more restrictive Fed and ECB policies. As we have said, the US and Chinese economic releases have often been disappointing, and several major incidents such as the North Korean threat have rekindled demand for safe-haven assets. Nevertheless, yields on the US Treasury notes have barely budged, while the phasing out, albeit very gradual, of quantitative easing should drive long-term yields upward. On the contrary, the yield curve has flattened, having reached a low for this cycle. It is certainly far from an inversion, which would definitely raise serious concerns about macroeconomic growth and corporate earning power. The bond market has, nonetheless, dampened the decidedly euphoric tone that has been dominating the equity markets. ■

EQUITIES: A MORE CHEQUERED OUTLOOK THAN AT FIRST GLANCE

Equity investors have remained quite sanguine about earnings growth, focusing on the excellent current performance rather than on their future deceleration, which we discussed above. The valuations of the main markets appear to be very tight, first and foremost in the United States. Europe has maintained a certain discount, but the growth dynamics will slacken somewhat, also given the strength of the euro, which we will discuss below. Japan appears to be more appealing than it used to be due to its earnings momentum, relative valuation, and to currency effects less penalising than for the euro. As for emerging markets, their valuation is no longer so favourable based on a historical comparison, while the earnings outlook is very different from one country to another. It is important to make a distinction between the large, highly cyclical commodity exporters and the advanced economies: South Korea, Taiwan, and "New China", i.e., high technology and related sectors that raise the standard of living such as consumer products, health services, and leisure.

The sectoral theme is currently as important as the regional approach. We have repeatedly underscored the contribution of a few stocks – Facebook, Apple, Amazon, Alphabet (Google), Netflix – to the performance of US indexes, but the same holds true in the emerging world where Samsung, Alibaba, Tencent have been driving the indexes.

Most recently, the "growth" style has suffered some setbacks, but in our opinion, the world macroeconomic outlook does not warrant a sweeping outperformance of "value". Banks and diversified financials, though, are likely to benefit from rising bond yields.

Similar considerations apply to corporate bonds. Some segments of this market seem to be increasingly highly correlated with equities, but their sectoral composition is quite different. Compared to global equities, the high yield market, for example, has very low exposure to technology, whereas basic materials and energy are over-represented. ■

POLITICS MAKES A COMEBACK

It is time to discuss another important parameter, the political evolution in the main countries and regions. It should be recalled that the election of Emmanuel Macron had instilled new-found confidence in the Eurozone. Since he was elected, France's first structural reforms have been enacted, but they shall, provided they are rolled out without political or trade union opposition, only begin to catch up France with its neighbours. The cyclical improvement should allow the political climate throughout Europe to ease slightly. That said, the Italian government still lacks a reliable majority; Spain is tearing itself apart over its regional issue; the recent elections in Germany have restored the FDP's pivotal role in forming any coalition. As a liberal party, the FDP is opposed to Mr Juncker and Mr Macron's centralising impulses.

Since 2013, Japan has been undertaking ambitious structural reforms. The prime minister has just called for early elections in the hope of consolidating his majority and giving a fresh boost to *Abenomics*. The same sleight of hand did not really help Theresa May this past April, but Shinzo Abe still holds a few trump cards such as the improved performance of the Japanese economy and the opposition parties' disarray.

US policy is back at the heart of market concerns. While the barrage of presidential tweets grabs attention, serious negotiations began on the tax cuts promised by Donald Trump. This is a key variable, as fiscal stimulus could offset monetary tightening and avoid a serious growth slowdown. It should be recalled that last November Donald Trump's electoral victory had galvanised the markets. Cyclical stocks had clearly outperformed, government bonds had their worst period since 2013, and the dollar had rallied. This was a "Winning streak", which by definition does not usually last long. Then came "A change of leadership":[4] the deadlock in Washington had marked a strong resurgence of growth stocks, the stabilisation of bonds and the decline of the dollar. At the year's start, the consensus gave almost 100% chance of success to the fiscal stimulus. But afterwards, this hope has practically withered to zero. Although they hold a majority in both houses of Congress, prominent Republicans have distanced themselves from Donald Trump, and the Democrats have retreated to systematically opposing the Republican party, which is not very constructive.

That debate over the new budget and the debt ceiling coincide, which make getting them passed through both houses of Congress particularly risky business.[5] Nevertheless, President Trump caught everyone off guard by negotiating to keep the government funded through 15 December with the Democrats thereby bypassing his own party. Thereafter, he tasked the "Gang of Six" with the negotiations. This group includes his closest adviser, Gary Cohn, the Secretary of the Treasury, Steven

Mnuchin, as well as the prominent Republicans from both houses of Congress. The plan has just been unveiled and is going to undergo fierce debate. All avenues therefore remain open, but a minimum agreement before 23 November could avoid a budget deadlock. Thereafter, should the reform be finalised within six months, we could start feeling its initial effects in the autumn of 2018. ■

[4] These are the headlines we used in the January and April 2017 issues of this Market Outlook.
[5] In the United States, the Administration cannot make any expenditure whatsoever without the approval of the Congress, as per regular budget on 1 October, or through a temporary resolution. Moreover, the Treasury cannot issue new securities until Congress has raised the debt ceiling.

A SHORT-LIVED DOLLAR SURGE, UNLESS WASHINGTON HAS A PLEASANT SURPRISE IN STORE

In other words, we believe there is a 30% or higher chance of a successful US fiscal stimulus plan, which means the market could be in for a pleasant surprise. We believe, this variable will determine the short-term direction of the dollar, and accordingly dictate our tactical choices for equities and bonds as well.

As we have said, the foreign exchange market has been more volatile than equities or bonds. Even though yield spreads between currencies have stayed broadly stable, exchange rates have reacted to current political events. The movements got significantly stronger whereas the positioning of the operators was asymmetrical. In the main derivatives markets, short dollar positions had reached extremes at the beginning of the summer. That was one of the reasons we were thinking that the dollar would bounce back. The Fed's communication, tensions in Korea, Merkel's partially successful electoral bid eventually triggered it. If the horizon opens up in Washington, there is a good chance that the dollar will do some additional rallying.

That said, we continue to believe that the euro's upward trend is not over yet, and will resume in the medium-term. Just as the market had underestimated the Fed's determination to continue its monetary tightening, it looks like it is now understating the impact of ECB tapering. In the longer-term, the current account surpluses – mainly due to Germany – will constitute a force that will lift the euro, which the ECB is less likely to stymie going forward.

The same reasoning applies to the Swiss franc against the dollar and also against the euro: unless the SNB is forced to become hyperactive again, the underlying trend is that of appreciation, driven by the huge current balance surplus, which is well known, but also by carry, which is less so. In real terms, yields on the Swiss franc are less negative than those of the euro. ■

INVESTMENT CONCLUSIONS

The current low volatility is misleading. The fundamentals of global markets are not uniformly positive. Macroeconomic growth remains buoyant but has probably reached or even surpassed its peak. China should not provide as strong a boost as in years past, but the whole of East Asia, including Japan, is an increasingly diversified growth hub.

Despite moderate inflation, the major central banks confirmed their intentions to reduce monetary stimulus globally. The Fed has opened fire this month and the ECB will follow. Government bonds will be somewhat under pressure, but they should remain in demand, those of the US Treasury first and foremost, if the cyclical loss of momentum is borne out.

Higher-rated corporate bonds are a pillar of any fixed-income portfolio, but their valuation makes them quite vulnerable. Moreover, the forthcoming reduction in purchases by the ECB will have a direct influence on the euro market. Many investors have ventured into the high yield market in search of additional returns. The absolute level of the latter may suffice to cushion minor interest rate tensions but would not offset the losses in the event of a cyclical downturn and if there were more defaults. Certain segments of this market have grown so fast that their cash reserves could prove problematic should there be a trend reversal. We must therefore be more selective.

In our opinion, equities remain the preferred asset class, which is much more diversified and liquid than others. That said, valuations do not warrant blind optimism. In view of the deceleration of global growth, Asian equities are particularly attractive.

A nice surprise from Washington regarding tax reform could nevertheless prolong the current surge of the dollar and revive the recovery theme. In this generally positive outlook for equities, particular emphasis should be placed on Japan and on European banks. ■

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