

Asset Allocation

Our convictions

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No major changes on the macroeconomic front last month, but, rather, a confirmation of trends that we had already factored into our asset allocation. However, we did spot several key points:

- **Economic growth remains solid in most countries** and continues to be driven by domestic consumption but this time with a slight uptick in investment (particularly in the United States, the Eurozone and Japan) and foreign trade (mainly in Asia). We have been keeping an especially close eye on Brazil and Russia, two countries that we have overweighted for some time now. Last month strengthened our conviction. Not only have both countries continued to emerge from a recession in the past months, but inflation is retreating, giving central banks even more leeway to support economic activity.
- **The Fed is once again preparing the markets for a rate hike, most likely in March.** It will no doubt tighten its monetary policy twice in 2017, and for the first time since the financial crisis, it will be in line with its dot plot, not because it is accelerating the pace of its rate hikes, but simply because it has revised its rate-hike ambitions drastically. We are very far removed from the phases of monetary normalisation of February 1995–February 1996 (300bp in one year) and June 2004–June 2006 (+425bp in two years, or +25bp every six weeks).
- **The US political situation remains the major focus**, and cooler heads seem to have prevailed there in recent weeks, as Donald Trump has toned down the combative rhetoric, particularly with regard to China and Japan. Might the US president even stop accusing China of manipulating its exchange rate? If so, that would certainly be a step forward. Clearly, the RMB's steep rise for more than 10 years now vs. the USD and in effective terms shows how little sense Trump's criticism makes. The current weakness of the Chinese currency (with depreciation furthered by fears of customs duties, net capital outflows, month after month, over the past two years, and stepped-up capital controls in January, etc.) runs counter to what the US administering is targeting. **It now looks very likely that Trump will set aside both increased customs tariffs and his border tax proposal.** This is hardly surprising, as it has never been in our baseline scenario. We are also aware that it will be hard to enact measures that would seriously undermine public finances but it is highly likely that ambitious infrastructure and tax measures will go through. It's only a matter of how ambitious they will be. Fiscal measures will be announced within two or three weeks that could well be game changers. We are forecasting in particular a corporate tax cut from 33% to, probably, 20%. This would be more than a mere symbolic measure, for several reasons: i) for one thing, the US has one of the world's highest corporate income tax rates; ii) because such a measure would have the effect of facilitating and encouraging the repatriation of profits; and iii) because this would also encourage the repatriation of investment plans to the US. Given the currently tight job market, such a measure would no doubt push up wage expectations. Lowering taxes would obviously be more popular than raising customs tariffs. Lower taxes boost domestic growth, while higher tariffs would undermine global trade (which is already in retreat) even more and would trigger risks of reprisals from other countries (with the risk of an RMB devaluation?).
- **While things have calmed down somewhat in the US, this is not really the case of the political situation in Europe.** Additional stress has emerged, mainly involving the French elections. France is in the spotlight, to say the least, even though other important elections are also on the euro area agenda. We now know that **Italian general elections** will not be held until the second half of the year and that, given the votes that normally carry over (as there is no general will to reject "extremist" parties), the risk of Beppe Grillo's "Five Star" party winning the elections (as happened in the cities of Rome

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and Turin) is rather high. Keep in mind, however – and this is important – that while Grillo is openly anti-European, there is no consensus on this issue even within his own party. As Matteo Renzi, the previous prime minister, recently resigned as the head of the Democratic Party, it will have to summon back its forces before the elections, something that is adding uncertainty in the run-up to those elections. In **Germany**, where elections are scheduled for next autumn, the CDU, headed by Angela Merkel, and the SPD, headed by Martin Schulz (the former European Parliament president) are far out in front and now neck-in-neck, with 30% of voting intentions each (barely two months ago, the CDU was scoring 30% and the SPD, 20%). There is no risk to the EU, as both candidates are in favour of it. Things are more complicated in **France**, for at least three reasons: (i) because alliances there are being finalised: the Greens (Yannick Jadot) have joined up with the Socialists (Benoit Hamon) and the centre-right MoDem party (Francois Bayrou) has joined Macron's "En marche" movement; (ii) François Fillon's candidacy is becoming complicated; finally, (iii) because in the unlikely event that Marine Le Pen (National Front) wins, despite anti-Le Pen votes carried over to the second round, she would be unlikely to obtain a majority in the legislative elections. This may be the biggest risk – a stalemate after the general elections (see "the theme of the month", page 7).

All in all, we are sticking to the portfolio positioning that we presented in detail last month (refer to it for more details), albeit with a few tweaks:

- **A slight overweighting of European equities** at this point, but with prospects for a US rally when the aforementioned fiscal measures are announced. It should be noted that in the event of political difficulties in Europe, the dollar will appreciate further (there is an argument for macro-hedging that should not be ignored).
- **European long rates** are of course dependent on economic activity indicators (which are relatively solid at the moment, including in Europe), and inflation indicators (which are slightly to the upside), but they depend primarily on developments in Donald Trump's policies and the European elections in general – France's especially. This last factor is key and encourages caution.
- **Overweighting equities vs. sovereign bonds.** Our optimism is slowly returning, as profits are back, and the combination of solid growth and stronger inflation is good news. Europe could ultimately end up extricating itself (euro, dividend yield, valuation, future profits, dividend policy, lower breakeven rate than elsewhere, etc.).
- **Overweighting corporate bonds (especially Investment Grade) vs. sovereign bonds.** Keep in mind, however, that US bonds, given the releveraging of US companies, are more vulnerable than their European peers to any interest rate hike.
- **Reduced exposure to Eurozone peripheral debt and semi-core debt (mainly France and the Netherlands).**
- **Wait for better levels before returning to US Treasuries.** Keep in mind that US government bonds are attractive in particular for their carry opportunities, as well as their natural macro-hedging qualities in the event of problems in emerging markets or in Europe.
- **Don't bet on a sharp run-up in long bond yields in the Eurozone but don't expect them to pull back either on a sustainable basis, at least until the French elections.**
- Deemed attractive for their extremely low valuations and their steep underweighting in portfolios, we decided to return to **inflation-linked bonds** in the first quarter of 2016, due to their macro-hedging qualities. We are now invested for reasons more based on their own fundamentals, including the inflation cycle and stronger oil prices (in the case of short-dated real bonds).
- **We continue to gradually move back into emerging markets** but still prefer hard-currency debt to local-currency debt. EMG markets still offer lots of medium-term value. Attractive valuations, currencies that are often undervalued, heavy underweightings in the portfolios, potentially high capital inflows – this is why we are bullish.

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- **We are sticking to our long USD position.** The USD is likely to get a boost from both Fed policy moves and the coming fiscal announcements.
- **We are continuing to exercise great caution over the GBP.** Brexit represents an asymmetric risk, and the most natural and simplest expression of this actual or feared risk will fall on the currency. However, the GBP represents an attractive macro-hedge in the event of any turbulence in the eurozone. This is the GBP's most attractive quality at the moment in our opinion.
- **The euro is likely to remain more volatile than usual.** The polls and the French elections that are stoking fears of an anti-European party being elected would most likely weaken the euro substantially and for the long term.
- **Currencies such as the SEK and NOK are becoming an attractive option** once again: not only are they non-EMU and non-EU currencies, but they also appear substantially undervalued at the moment, with very (perhaps too) accommodating monetary policies.
- **We are also holding onto our macro-hedging strategies.** The global geopolitical context, diplomatic tensions between the US and certain major countries (China most of all), and the political environment in Europe call for some protection. The US Treasury markets, volatility, USD cash, and inflation-linked bonds are especially attractive here. Those who think things could really go to pot should have some long exposure to gold.

“ We are keeping our USD long position ”

“ The euro: rather weak and volatile ”

“ SEK and NOK are good alternatives to the euro at the moment ”

The table below summarizes our asset allocations for bond, equity, and multi-asset portfolios.

Portfolio type		
> Equity portfolios	> Bond portfolios	> Diversified portfolios
<ul style="list-style-type: none"> • Preference for eurozone equities vs. US • European Sectors: <ul style="list-style-type: none"> - Overweight: Healthcare - Neutral: REITs - Underweight: Banks of Greece and Portugal • US Sectors: <ul style="list-style-type: none"> - Overweight cyclicals, financials, small and mid caps (domestic plays) - Underweight global trade plays, utilities • Emerging markets: globally cautious. Within emerging markets: <ul style="list-style-type: none"> - Overweight: India, Peru, Philippines, Russia, Mexico - Underweight: Taiwan, Greece, Turkey, South Africa, Korea - Neutral: China • Positions in EMG currencies drastically revised down 	<ul style="list-style-type: none"> • Slightly underweight risky assets • Underweight US govies • Overweight position in Euro credit reduced • Overweight position in US credit • Long on European financials (but remain selective) • Duration: globally neutral to short, with a short bias on negatively yielding segments • Short duration on USD, GBP and JPY • Long on US and Euro real bonds • Emerging debt: <ul style="list-style-type: none"> - Prefer hard currency debt (long USD) - Local debt component underweighted • Long USD vs. EUR and JPY • Few long positions in EMG commodity currencies 	<ul style="list-style-type: none"> • Long positions on “value” factor and European financials • Overall positive on Japanese equities (JPY hedged) • Few long positions in EMG currencies, EMG debt (and EMG equities) • Significant preference for EMG debt in hard currencies • Keep the overweight in euro peripheral bonds vs. core • Long US govies (carry and macro-hedging purposes) maintained • Corporate bonds: positive on HY and IG, especially in the US • Positive views on breakeven inflation (all regions)

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