Asset Allocation

Our convictions

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Three major events during the past month:

1. **Economic activity continues to show encouraging signs**, with a confirmation of a slight upturn in investing (United States, eurozone, and Japan), and an improvement in trading (especially in Asia).
2. **Monetary policies are still accommodating**, but the debates over some of their components (the scale of interest rate hikes in the US, the continuation of QE, and negative interest rates in Europe) are driving – and will not stop driving – investment timelines and decisions
3. **The political situation is getting complicated in the United States** (President Trump's wrangling with Congress, threats of impeachment proceedings) **and is about to become clearer in Europe**, with less robust «extremist» parties than anticipated. The PVV did not win the elections in the Netherlands, and the Front National is no longer leading in the polls in France.

The Fed raised interest rates by 25 bp, but had so thoroughly prepared the markets for this possibility that it surprised no one. What was a surprise, however, is that it did not raise its GDP growth forecast, inflation forecast, or interest rate forecast. In other words, it did not validate any of the hopes that many had in the Trump administration and its fiscal and tax stimulus plans. We have repeatedly signalled that the Trump effect was clearly overestimated by the financial markets and, apparently, the Fed shares our viewpoint. Still, we are being slightly disingenuous: we did have some hopes on American corporate equities and bonds after Trump's election and still consider that a significant corporate income tax cut would likely give a boost to risky US assets, but on the one hand the economy seems to be gasping for air (Trump can trigger an extension in the cycle, but cannot create a new cycle), and on the other hand equities are clearly overvalued, indeed in a bubble. So the Fed's position is weakening US assets. The good news is that the Fed is still not gearing up for a normalisation of its monetary policy, which does not surprise us in the least.

Not only is the Fed not validating Trump's scenario, but the president is having more and more trouble politically: his remarks against Mexico and China (and, to a lesser extent, Japan and Europe); tensions with Angela Merkel (which were quite palpable during the German Chancellor's visit to the United States); his comments against the US Secret Service; Congress' reluctance to give in to measures worsening the budget deficit… all of this is isolating him. On top of all these troubles is the still quite present danger of impeachment. This does not necessarily mean that he would have to leave the White House: Andrew Johnson (1868) and Bill Clinton (1998) both faced proceedings, and the House of Representatives voted to impeach, and were then acquitted by the Senate. Impeachment proceedings were also launched against Richard Nixon (1974), but he resigned before they were over. No one can say what will come of the rumours of impeachment proceedings against Trump, but it does indeed seem as if this new affair complicates Trump's task. It's a situation worth watching.

While the Fed may have its doubts about US growth or government speeding up economic activity or inflation through fiscal and tax policy, the ECB is spreading confidence. Though it is true that the indicators are recovering, that access to financing is easier, that deflationary pressures are receding, inflation has reached the bar of 2% but core inflation is below 1%. In other words, all quiet on the inflation front. Again, full disclosure is in order. The end of disinflation is really here, and this justifies our taste for inflation-linked bonds, among other things. Yet the real problem lies elsewhere: it is in fact

> Economic activity: encouraging signs

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> The Fed is not validating the Trump scenario

the ECB's capacity to move out of negative rates and leave QE. The economic conditions do not justify the ECB making such decisions right now, but these issues will undoubtedly drive the financial markets.

Two comments:

1. **On interest-rate policy**, we have already stated our viewpoint (well before the actual establishment of such a measure, in truth). We remain convinced that it was not necessary to go into these «unchartered territories» and the problem is getting out of them without shaking up the fixed-income and equity markets, and without leaving the impression that the ECB knows it made a mistake. Our scenario is simple: growth, reflation, and a price increase will drive market rates up, and the ECB will support this movement and gradually raise its interest rates. Put simply, it will not act before the rate increase, but will follow it. And it will be well «behind the curve.»
2. **On asset-buying programmes (QE)**, we have also stated our viewpoint several times, without the slightest ambiguity. Without a doubt, unlike negative rates, these plans have very real virtues: ultra-low and sustainably ultra-low rates. But there is another side of the coin: by buying much more than governments' net issuances, the ECB is drying out the fixed-income markets and creating liquidity problems, and sending rates down abnormally low (with regard to their break-even value ex QE). In other words, an abrupt withdrawal of QE would cause interest rates to soar (150 bp on the German 10Y, 250-350 bp on the peripheral countries' 10Y... put plainly, it would trigger a true financial crash... not to mention the impact on the solvency of certain governments or the disappearance of fiscal leeway created by the lowered costs of debt financing (1.5%-2% of GDP for the peripheral countries). All in all, the ECB cannot abandon QE quite so soon... at best, it will further reduce its purchasing, explaining that it is not a tapering, but a need to watch over liquidity. On this point as well, the ECB will be more responsive (follower) than active... To exit QE without damage, more growth is needed, more fiscal rigour, tougher governments in terms of solvency, the guarantee that governments could contend with a rate hike... and none of these conditions is guaranteed right now.

The European political situation becomes clearer. The **Netherlands** have voted, and a coalition without the far-right party (PVV) is taking shape. Putting it together it will take a little time, but it is emerging, which is a good thing for the financial markets. In **Germany**, two very pro-European candidates will be facing off (Angela Merkel and Martin Shultz, previously president of the European Parliament), and between the two of them they have 60% of intended votes. Another way of saying we are unworried by that election. In **France**, Emanuel Macron has pulled ahead in the polls, the certainty of intended votes is increasing, and he is the only one who is seen as 'presidential' (in fact he is the only candidate for whom the percentage of people who think he is 'presidential' is higher than the percentage of people who do not). His platform is pro-European, pro-reform, pro-business, and pro-competitiveness... in other words, a plan that appeals to investors. In terms of clarity, we were also thinking of Brexit: the **United Kingdom** finally triggered Article 50 of the Treaty of Lisbon at the end of March, and the next meeting of the 28 (in late April) will cover the exit conditions. So we know more about the decision, but not really about the procedures. We recommend being conservative, considering that the markets are too ready to underestimate the issues and impacts. Of course, one of the central points will be how much - if any - access it will have to the entirety of the single market. Logic dictates this will not be the case (see Switzerland or Canada, for instance), but the negotiations will be arduous, pressures will be high, and the interests of London-based institutions may well be decisive. So it will be financiers vs. politicians, and politicians vs. voters... this will also be one to watch closely. The situation in **Greece** is still of concern. A recent IMF report stresses that the official scenario is highly implausible, especially in terms of the budget forecast. The tug-of-war has begun between one international organisation that wants greater efforts, and a country that is rejecting any further reforms or austerity... and at stake is the payment of the next aid tranche, a payment that is indispensable in terms of upcoming repayment deadlines in July.

> "The ECB is spreading confidence"

> "How do we get out of negative rates and QE without doing ourselves damage? That is the big question for the ECB... but it will have to wait"

> "The financial markets are too ready to underestimate the Brexit's issues and impacts"

> "France, United Kingdom, Germany, Greece... there's no shortage of political topics"

Overall, we've made some adjustments in our asset allocation.

- **Our preference for European assets persists**, even though there could be a rebound in the United States when tax measures are announced. But the American market is much too expensive (we've been talking about a bubble since mid-2016) with regard to the current economic situation (level) and to what Trump will really be able to do about growth (anticipation). He is clearly having trouble putting his plan in place, and the highly-anticipated tax measures are already late. We think the tax cut on businesses - if it really happens - is the right measure. It helps repatriating profits and investment plans and should boost US stocks, but that could be only temporary. In truth, we are concerned that once those measures are announced, the US market might head downward (in 2016, there was little reason to buy Europe or EMG markets... that's no longer the case). The crucial question is how far down it will go. If it is just 10% due to portfolio reallocations for reasons of relative value, the European markets and EMG will tolerate it. If the decline is steeper due to this US bubble bursting, then they too will be hit. Our position (long on European equities) addresses this question... but the situation should be watched closely.
- **European long rates** tightened a little over the month. Of course, they depend on indicators of economic activity (rather good right now, including in Europe) and inflation (slightly up: the inflation rate was 2% in the eurozone, but core inflation is still below 1%), but also depend on Trump's policy (fiscal and tax policy), monetary policies (rather accommodating), and the European elections - France's in particular. All in all, we think it legitimate not to go long.
- **We are staying overweight on equities vs. sovereign bonds.** Our optimism on Europe is back, because profits should be coming back, and the more solid growth/stronger inflation pairing is not unwelcome. Europe could at last benefit (euro, dividend yield, valuation, future profits, dividend policy, lower break-even rate than elsewhere, etc.).
- **We are also still overweight on corporate bonds vs. sovereign bonds**. However, note that US bonds, given the releveraging of American companies, are more vulnerable than their European counterparts to any increase in rates... and they are less liquid than their European counterparts, which is very likely the result of the type of investors and holders (more and more retail across the Atlantic, still held fast by institutional investors in Europe).
- **Risk-taking on debts in the eurozone periphery and semi-core (i.e. France and the Netherlands) has been reduced** in recent months, and we are not questioning this choice.
- **We are waiting for better levels before going back into the US Treasuries market**. For some time now, we've been drawing attention to the fact that US sovereign bonds hold a special interest for the carry they offer, as well as their natural macro-hedging qualities in case of difficulties in the emerging world or in Europe. The underlying assumptions bear repeating: if risky assets plummet, US sovereign bonds will be a good macro-hedging instrument... unless inflation is down sharply and/or the Fed continues to raise interest rates. However, this is highly unlikely.
- **Do not count on long rates to rise significantly in the eurozone, but don't expect sustainably better levels before the French electoral deadline**.
- **We are still partial to inflation-linked bonds**. In the first quarter of 2016, we decided to return to inflation-linked bonds, seen as promising for their extremely low valuation and enormous underweighting in funds, due to the macro-hedging qualities of this asset class. Now we are invested more for reasons related to their own fundamentals, including the inflation cycle and better oil prices (for the short maturities of real bonds).
- **We are still moving gradually back toward the emerging markets**; Trump's difficulties in implementing his plan, and the Fed's viewpoint (which guarantees the pursuit of gradualism), are two arguments in favour of a continued capital flow toward these asset classes (local currency, equities, currencies). However, we maintain our preference for debt in hard currency vs. local debt. In the medium term, the EMG markets still have many

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advantages. Attractive valuations, often undervalued currencies, significant underweighting in funds, potentially high capital flows... all of this justifies staying positive.

- **We are maintaining our long position in USD**. The Fed is not pushing for an appreciation of the dollar, but the inclination is still positive if tax measures are announced soon. Note that if there are political difficulties in Europe, the dollar will appreciate further (a macro-hedging argument not to be dismissed).
- **Even if the GBP is a promising macro-hedge in case of turbulence in the eurozone, we are staying highly cautious on this currency.** As we have stated repeatedly, Brexit is a one-sided risk, and the most natural and simple expression of that risk (real or perceived) will be on sterling.
- **The euro should maintain higher-than-normal volatility** if the French voter polls spread fears of a non-European party victory, with a political platform that could weaken the euro substantially and sustainably. The polls, which statistically become more representative and reliable as election dates draw nearer, are moving less and less in that direction.
- **Currencies like the SEK and NOK are still promising**: not only are these non-EU/EMU currencies, but in addition, we think they are quite undervalued at this stage, with very (or even overly) accommodating monetary policies.
- **Macro-hedging strategies are also maintained**. The global geopolitical backdrop, the diplomatic tensions between the United States and other major countries (especially China) and the political backdrop in Europe warrant some protection measures. The US Treasuries markets, volatility, equity market puts, USD cash and inflation-linked bonds are particularly attractive from this point of view. For those who would bet on more serious warnings, long gold positions are becoming essential. For those who wish to protect themselves exclusively from European risks, go long on volatility, long on USD, long on JPY and long on US Treasuries.

"Inflation-linked bonds have value in the current environment"

"Trump's difficulties? A "green light" for the emerging markets"

"The negotiations on Brexit are starting? Caution on the GBP"

"Maintain the macro-hedging strategies"

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

Portfolio type		
> Equity portfolios	**> Bond portfolios**	**> Diversified portfolios**
• Preference for eurozone equities vs. US • European Sectors: - Neutral: REITs - Underweight: Banks of Greece and Portugal • Within emerging markets: - Overweight: India, Peru, Philippines, Russia, Mexico - Underweight: Taiwan, Greece, Turkey, South Africa, Korea - Neutral: China	• Slightly underweight risky assets • Underweight govies expect US (neutral) and EMU peripheral countries (OW) • Overweight position in Euro credit • Underweight 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 GBP and JPY • Long on US and Euro real bonds • Emerging debt: - Prefer hard currency debt (long USD) - Local debt component underweighted • Long USD vs. EUR and JPY • Few long positions in EMG commodity currencies	• 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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