Asset Allocation

Our convictions

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What's new in recent weeks?

The lull has continued over the last few weeks, with virtually all political risks disappearing in Europe and encouraging and even reassuring economic indicators in all countries.

1. Growth continues

Confidence surveys and economic indicators continue to show continued global growth, which is still driven by domestic demand. In the **United States**, with GDP estimates showing a net rebound in the second quarter: after a relatively weak first quarter (which was revised upwards from 0.9% to 1.2%), growth is gaining ground. According to estimates, annualised GDP growth rates should be between 2.2% (New York Fed) and 3.7% (Atlanta Fed) in Q2. At the same time, the unemployment rate reached a 10-year low (4.4% versus a long-term unemployment estimated at 4.7% by the Fed). As inflation also drops (1.9% for core inflation), this is not a concern for the financial markets. Same sentiment on growth in **Europe** with more good messages coming from the investment.

Even **Japan** is getting better. The economy grew by 2.1% annually in the first quarter of 2017, the 5th consecutive quarter of expansion (above the median forecast of 1.7%). We have therefore revised our growth forecast for 2017 from 1.0% to 1.2%, but we maintain unchanged our forecast for 2018.

> Confidence surveys and economic indicators continue to show the continuation of global growth, growth that remains driven by domestic demand

2. China loses credit with Moody's

Moody's recently downgraded China's credit rating from AA3 to A1. This decision is justified by the feeling that "*China's financial strength continues to decline as debt increases as potential growth slows down*" (see our article in the latest monthly issue of the cross asset). Moody's notes that "*ongoing progress on reforms is likely to transform the economy and the financial system over time, but they do not prevent an additional material increase in debt and the consequent increase in contingent liabilities for government*". The deterioration of the Chinese rating has had no impact on the financial markets, and it will also have little impact on the Chinese economy:

- The downgrading of the rating concerns only foreign currency bonds, i.e. less than 1.5% of the total outstanding bonds. Foreign investors hold only about 4% of the Chinese government bonds.
- While Moody's downgraded China's credit rating, the rating agency also revised up the outlook from negative to stable.
- The four main Chinese rating agencies have retained a higher rating for the sovereign, which has the effect of reassuring domestic holders of Chinese debt.

> Moody's downgrades the rating of China… a decision without impact… rightly or wrongly?

Overall, Moody's decision has not led to any stress, although their comments on debt and long-term growth are not entirely reassuring, and we have shared their views for a long time.

3. Inflation is progressing, but remains contained

While overall inflation has increased worldwide (notably due to an oil-related base effect), core inflation remains under control and inflation expectations are well anchored. The ECB is even considering a downward revision (once again) of its inflation expectations for the euro area. Oil has stabilized in a range of $ 50-55, but it is well known that US supply becomes crucial, potentially driving crude oil to a lower range of $ 40-50. An issue of concern for producing countries (Venezuela is on the verge of breaking down… i.e. of default), but good news for consumer countries like China and India.

4. Eliminating political risk in the Eurozone and emerging risks in the United States?

Political risks have almost disappeared from radar screens in **Europe**, following the election of the pro-European Emmanuel Macron in France, and its program linking reforms, "flexi-security" and progressive elimination of public deficits.

- Legislative elections will take place in **France** on June 11th and 18th. The party of the new president is leading in the polls, with 31% of voting intentions, against the National Front at 19%, the right parties at 18%, "France insoumise" at 14%, and the Socialist Party at 7%. Having an absolute majority in the National Assembly should not be an unattainable challenge for the new French President.
- In **Germany**, Angela Merkel has increased her lead in the polls for the September 24th election: the CDU-CSU is at 34%, the SPD at 31% the AfD (extreme right) at 9%, The Greens at 7%, Die Linke (far left) at 7% and the FDP (liberal party) at 6%.
- In **Italy**, the situation remains complex, but not necessarily worrying. It is complex, because the divisions are important, and according to the polls, the democratic party and the 5-star movement would be very close, between 25 and 30% each. As we know, the leader of the 5-star movement wants to leave the euro but he will not have the means to force the organization of a referendum. A coalition between the Democratic Party (Renzi) and Forza Italia is still the most likely scenario. In other words, there is no systemic risk, knowing further that Italy is undoubtedly the country in the world with the greatest habit and ability to effectively manage coalitions. It should be noted that the European Commission has also adopted a more benign attitude on the Italian deficit.
- In **Greece**, Parliament approved most of the measures required by creditors, which should pave the way for the disbursement needed to meet the needs of this summer, which is already not bad.
- **Portugal**, for its part, has emerged from the European excessive deficit procedure.

In the **United States**, the increase in pressure on the Trump administration (on allegations of Russian influence) is evident, and the theme of "impeachment" is gaining ground. At this point, Republicans, who have a comfortable majority in the House of Representatives (55% of the seats) would probably oppose impeachment proceedings in the House. They are likely to change their minds only if the popularity of D. Trump collapses. Remember that an "impeachment" does not mean the end of the presidency. Under the constitution, indictment occurs in the House of Representatives (HoR) if a simple majority approves the indictments previously approved in committee. Then, the indictment goes to the Senate, where a two-thirds majority vote is necessary to cause the president's departure.

The other area of concern is D. Trump's ability to get his program through, especially tax policy proposals. He has certainly obtained the agreement of the House of Representatives for the abrogation of the Obamacare, but the Senate still has to decide. The White House presented its budget proposal May 23rd, including strong public spending cuts, but it seems likely that the probability of the adoption of the fiscal plan by the Congress during the summer is low. In other words, there is little to expect before the fall on the fiscal side. It can even be added that the ongoing investigation on an eventual Russian influence on the presidential election may slow (or even freeze) the negotiations between members of Congress on tax matters. All in all, the political risk and the risk on the tax policy have grown, it is obvious.

5. Monetary policies become more restrictive, but they remain accommodative...

In the **United States**, two rate hikes are expected in 2017 (one in June and one in September or December). This seems to us credible and without much risk for the US economy and the financial markets ... unless the Trump administration is unable to implement the proposed tax policy: the **Fed** may

> "Inflation is progressing, but is not out of control"

> "Political risks have almost disappeared from radar screens in the Eurozone"

> "The likelihood that the tax bill adopted by the Congress during the summer will be low"

> "Probably no big changes before the autumn in terms of US fiscal policy"

adopt a more restrictive policy if – and only if - fiscal policy becomes more accommodative. The United States cannot have a restrictive monetary policy, a restrictive fiscal policy and a neutral fiscal policy at the same time. This is a particularly important issue for bond markets and equity markets. This is all the more true as the Fed also plans to review its policy of purchasing assets and carry out the first operations to reduce its balance sheet. The latest FOMC reports revealed that the Fed was planning to introduce "ceilings" on the dollar amounts of Treasury and agency securities that would remain in circulation each month (i.e., it would cease to reinvest the entirety of the maturing papers). These "ceilings" would be re-evaluated every three months. This means non-Fed investors will have to absorb a surplus supply of paper, and that the market will be less and less administered / protected. We note that $ 427 billion of US Treasury securities held by the Fed will mature in 2018 and 357 in 2019, some of which (to be defined by the Fed) will not be reinvested. There is currently widespread consensus that the announcement of a change in reinvestment policy could take place during the fourth quarter of 2017. Expect a rebound in short and long rates in the United States.

> The Fed could change its reinvestment policy in the fourth quarter of 2017

The **ECB** has recently changed its communication because of the balance of risks. The ECB is confident about the economic recovery, and about inflation. According to its various comments, it is reasonable to rely on the maintenance of low rates for a significant period of time, "*far more than the deadline of the net purchasing policy of assets*". The debate on the mitigation of the asset purchase program is brisk and it is not unreasonable to expect the ECB to discuss further changes before the end of the current year.

> The ECB could mention a mitigation of its program of purchases of assets before the end of the year

Investment strategies globally maintained

From the above, we can deduce some key conclusions.

First, **our preference for risky assets should be retained**. Political risks in Europe have fallen sharply, and inflation concerns are largely offset by improved growth conditions.

However, **vigilance should not be relaxed. Low volatility, a decline in the correlation between equities, a decline in sovereign spreads, a decline in the level of sovereign CDS ... everything seems to indicate that the overall risk has diminished ... but it is of course not so simple, especially when we relate risk to valuation.** It has been known for a long time that the low-interest environment has puzzled valuations: long-term rates are much lower than their equilibrium values (i.e. levels calculated excluding central banks' quantitative easing), and any discussion of QEs calls into question the level of interest rate and of bond yields. In other words, the current environment cannot mask the asymmetric risk on these spreads: the potential for widening is now much stronger than the tightening potential, especially in markets with limited liquidity.

> Everything seems to indicate that the overall risk has decreased

While we must keep in mind the presence of asymmetric risks, we nevertheless retain a clear preference for European corporate bonds (compared with sovereign bonds). The search for spreads has resulted in extremely favourable corporate access to refinancing: companies are no longer very sensitive to immediate interest rate increases (should they occur), and this gives a respite of 18 to 24 months, no doubt. Both in the United States and in Europe, implicit and real default rates are low and should remain so.

> A better GDP growth, accommodative monetary policies and chasing spread and yield activities = a growing interest in corporate bonds, listed debt and private debt

The search for spreads and better economic performance, as well as future reforms in the labour market, are all factors that give a little more interest to European corporate bonds, listed debt and private debt. The search for spread becomes less comfortable in view of the discussions on monetary policies, but much more comfortable with regard to the health and profitability of companies. Given our expectations regarding the ECB (keeping rates low and pursuing a sufficient QE in terms of assets purchasing volume), we believe that these investments continue to be very coherent at this stage.

The presence of asymmetric risk also plays on equity markets. That is why for some time now we have preferred the Euro - as well as Japan and emerging markets - to the US (far too expensive). Low commodity and oil prices in particular are obviously warning signals for some countries, but it should not be forgotten that growth areas in emerging countries (especially Asia) are areas consuming raw materials.

Nor do we ignore the fact that monetary policies become more restrictive in practice (interest rates in the United States) or in expectations (QE in the United States, QE in Europe in particular), but the modulation is not yet sufficient to become disturbing. It is limited to certain countries and is often conditioned on other elements. In particular, the monetary tightening of the Fed seems to us strongly linked to the future of tax policy ... and on this point, there is no reason to expect much for now. Similarly, the debate on the European QE is growing, but interest rates will remain at very low levels and the ECB will continue to buy far more than the amount of net issues in the euro zone (itself falling). Moreover, the political risk has given way. **In other words, there is no reason left to be structurally short duration on the peripheral countries of the euro area.**

For once, we do not have very strong views on exchange rates. The "misalignments" do not seem to us major at present, and the current trends do not necessarily advocate for great movements. Certainly, some currencies are weakened by a domestic environment that has become more difficult (the Brazilian real, the Turkish lira in particular), others are helped by a better growth dynamic (the Russian rouble), others seem to fragil be in respite (GBP in the face of the challenges and negotiations of the Brexit, for example), but the USD - JPY - EUR exchange rates are expected to move very little in the short term (a small bias in favour of the euro seems reasonable, though).

> "For some time now we have preferred the Euro - as well as Japan and emerging markets - to the United States"

> "There are no major reason to be short duration on peripheral countries' debt"

> "BRL and TRY fragil, RUB more solid, GBP in respite, positive bias for EUR?"

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

Portfolio type		
> Equity portfolios	**> Bond portfolios**	**> Diversified portfolios**
• Strongest overweight: euro zone vs US equities • Overweight Japan and Emerging Markets vs. US • Overweight in value factor • Sector selection Europe - Overweight: technology, energy - Neutral: REITs - Underweight: utilities, healthcare, financials • Within emerging markets: - Overweight: Peru, Russia, Mexico - Underweight: Taiwan, Greece, Turkey, South Africa, Chile - Neutral: China India, Philippines, Thailand	• Slight overweight in risky assets • Underweight government bonds, except US (neutral) and peripheral (overweight) • Overweight euro credit • Overweight in US credit • Long financial in Europe … remaining selective: high beta bonds in the euro zone, low beta bonds in the US • Duration: Overall neutral / short, with short bias on negative-rate segments, and long bias on peripheral countries • Short duration in GBP and JPY • Long in US and Euros real bonds • Emerging debt: - Overweight in hard currency debt (long USD) - The continuation of the reconstitution of the local currency debt pocket continued (now also overweight) • Reduction of Long USD vs EUR and JPY • Few long positions in commodity currencies	• Overweight Euro zone equities • Long in value factor in Europe • Long in quality factor in the US • Overall positive on Japanese equities • Underweight US equities • Overall short duration on the bond pocket • Keep overweight (and long duration) in euro peripheral bonds relative to core • Slight overweight in US Treasuries • Corporate bonds: positive on HY and IG, Europe and US, long in financials and industrials • Overweight EMG hard currencies vs. Local debt • Currencies: slightly Long USD and JPY • Some macro-hedging positions maintained: volatility and US Treasuries • Positive views on breakeven inflation all zones

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