EQUITY DEVELOPED MARKETS

Sustainability of earnings under watch in a tactical year

The essential

Economic growth has hit its peak and the abundance of liquidity is now set to diminish. This environment will lead to a slowdown in profit growth, although it will remain on the positive side, and put pressure on price to earnings ratios (P/E), beyond likely rebounds. Caution is the watchword in this type of landscape, lending support to a gradual rotation towards more defensive sectors. At the regional level, profit convergence still does not lead us to take strong views; the US market remains favoured, although some temporary rebounds can be expected in other markets. The selection of stocks able to deliver sustainable earnings per share growth and meet market expectations will be key, as in a late cycle markets tend to be tilted more towards punishing weak performances rather than rewarding strong ones.

The cycle has reached its climax. How long will this transition phase last?

In 2017, growth was robust and synchronised (positive for equities). In 2018, it was robust and unsynchronised (higher volatility). In 2019, it will still be strong, but is poised to slow from the peak (cautiousness required). A global growth above 3% should be sufficiently high to warrant, for example, positive profit growth in Europe (see below chart). The combination of monetary policy tightening around the world and the economic deceleration, however, could be an headwind for equities, buoyed for the last 10 years by plentiful liquidity, especially considering the Fed is not very far from its neutral rate after a series of eight rate hikes. This makes the markets sensitive to risks. Many of these risks were highlighted in 2018 (protectionism, some vulnerability in emerging markets, Italian fiscal policy, Brexit, Iran) and have been partially priced in. Though it pays to be cautious, it is also important to remember that a temporary respite from these risks could trigger sharp rebounds on the equity markets. A global diversified approach with the ability to tactically recalibrate regional, sector and style allocations will be key to benefiting from these moves.

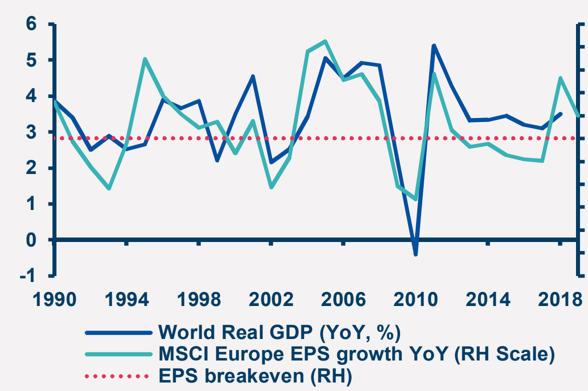
Low returns for equities on the horizon

Limited returns are on the cards for 2019. Excluding dividends, the return on an equity investment depends on two factors: profit growth and change in P/E ratios, both of which are looking shaky for 2019. Profit growth should return to normal in the wake of two years of sharp gains (+17% and +16% for the MSCI ACWI, according to the IBES consensus on 2017 and 2018, respectively). Margins have already rebounded across all regions of the globe. They are currently close to their cyclical peak amid rises in wage costs and oil prices, as well as the risk of breaks in the supply chain with protectionism on the rise. With economic growth having already peaked, profit revisions

IBES consensus forecasts on 2019 EPS growth	
World	+9.8%
US	+10.6%
Eurozone	+9.9%
UK	+7.7%
Japan	+4.4%
Pacific excl. Japan	+5.4%

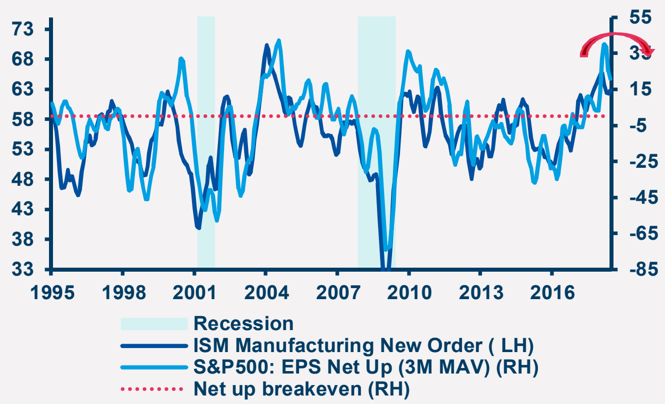
Data as of 15 October 2018 on MSCI indices.

1/ **Global GDP and European profits (annual %)**



Source: Datastream, Amundi Research
Data as of 19/10/2018

2/ **ISM and profit revisions in the US**



Source: Datastream, Amundi Research
Data as of 19/10/2018

are likely to slide (see the right hand chart) from current IBES consensus forecasts for 2019 (see table). EPS growth should nevertheless stay positive and somewhat higher in the US than elsewhere. Meanwhile, US P/E ratios have probably already hit their cyclical peak in 2018. Historically speaking, P/E ratios tend to decline towards the end of a monetary tightening cycle. A rebound is possible if risks ease up, but is unlikely to last as central banks further tighten their monetary policies, starting with the Fed. US investors should become more selective if multiples were nevertheless to increase further as sometimes happens at the end of the cycle, as this could eventually lead to bubbles. Otherwise, temporary P/E rebounds may be more pronounced outside the US, depending on how risk perception evolves.

Gradually more defensive rotation

Signals are still scrambled, but we think that the right move to make throughout the year is to gradually increase the proportion of defensive assets to pro-cyclical assets, potentially taking advantage of these counter-trend rebounds to gradually implement this view. The alarm was raised in 2018, with volatility making a comeback two years after the first Fed rate hike, margins hitting a ceiling in the US and credit spreads bottoming out.

There are two additional factors that traditionally point to a more defensive rotation:

- The "interest rate" factor. Mainly influenced by the US, it is still neutral to pro-cyclical at this point. Usually rising interest rates are more in favour of cyclicals, while defensives are often negatively impacted due to higher dividend yields and/or indebtedness. In light of the current fiscal boost in the US, the Fed is unlikely to stop hiking its rates before the end of H1 2019.
- The "industrial commodities" factor. Significantly influenced by China since the 2000s, this factor switched into cautious mode in summer 2018. It primarily reflects the negative impact of rising protectionism on global trade. We admit that if China's economic stimulus — particularly in terms of infrastructure — becomes visible, this risk will temporarily recede, further supporting the argument of a merely gradual rotation towards more defensive assets.

At regional level, the convergence of profit growth between regions argues for keeping a well-diversified approach against making major regional bets. Cyclical conditions call for a cautious approach and play in favour of the US market, where further deployment of capex by corporations could also support the positive trend (but in the short term, the consolidation of growth stocks bears watching). We should also expect some short-term counter-trends in favour of the cheapest regional markets (Eurozone, Japan and EM), potentially triggered by some relief in risk sentiment, and these movements may also be strong. All in all, we think that a focus on quality names that are not excessively priced will be key to navigating the more volatile market environment.

REGIONS: TRENDS VS COUNTER-TRENDS

US	EMU	UK	JAPAN	Pacific ex JP
The US market is the big winner of the cycle that started in 2009. The divergence in terms of performance with other markets, however, ended up triggering a consolidation of the leading stocks in this cycle (growth stocks), without undermining their trend at this point. Profit growth will also normalise, although the US market will maintain an advantage on this point given the weight of disruptive names. Our bias will thus remain fairly positive relative to the rest of the world, with a cautious approach in the short term. We are also mindful that this area could underperform in case of the return of risk-on sentiment, which could support a relief rally in other markets.	The Eurozone is a candidate to benefit from a growth/value correction. Otherwise, profits are sensitive to EM currency fluctuations, so the region would benefit from a drop in this risk (one-third of revenues generated in EM countries). This would be especially true if it did not prevent the yield curve from tightening somewhat, giving the banking sector some relief. In other words, the Eurozone would get a boost from a relief rally. There are several political challenges (starting with the European elections), however, that could dampen investor appetite with global growth on the path to a gradual slowdown.	The UK market is a proxy for the energy sector relative to the industrial sector. As a result, it was able to hold its own in 2018 while the looming Brexit deadline kept the GBP under some pressure. Another feature of this market is that it offers one of the highest dividend yields in the world (4.7% vs. 2.5% for the MSCI World), meaning that investors will make their way back once long rates have peaked. In the meantime, with Brexit just around the corner, now is not the time to take risk on a market that will not outperform if a risk-on rally gets under way, and which could be hurt by a soft Brexit (our favourite scenario) because of the possible appreciation of the GBP.	The political situation in Japan is clearer than in Europe. Corporate governance has improved a lot, but the profit cycle is one of the most mature, and not counting the Yen dynamics, the profit trend should now be one of the weakest in 2019. In the end, this market is still highly dependent on the JPY's impact on profits. This is clearly a case of a risk-on/risk-off play.	Australia makes up 57% of the region and Hong Kong 29%. Hence, it is highly affected by China's policy and its impact on industrial commodity prices and trade. A pro-infrastructure stimulus in China would help this regional market to bounce back, but the timing and sustainability of this movement are uncertain.

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