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OUR REVIEW FOR THE PAST YEAR AND OUTLOOK FOR 2019

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A LOOK BACK AT 2018

How could we begin this review of financial markets in 2018 without mentioning the trade war that put investors' nerves to a rude test? The blows that were thrown pell-mell in the brutal fight between the United States and China weighed heavily on many asset classes. The other economic, political and geopolitical concerns that arose during the year were particularly virulent and also weighed on investor confidence.

Last year, we pointed out that the global economy had recovered some synchronized momentum. The raw figures for 2018 show that global GDP rose 3.7% in real terms, which is slightly more than the 3.6% growth observed for 2017. However, a significant difference in 2018 is the considerable disparity in growth between countries and regions. In the United States, the economy continues to churn ahead at full steam with 2.9% growth and the job market is very strong. The situation is quite different however in Europe, with steady weakening of economic indicators like manufacturing sector sentiment surveys in particular. As a result of this sluggish environment, growth projections for the eurozone economy were reduced from 2.4% in March to 1.9% in December. On the other side of the planet, emerging economies also suffered, as China's economy felt the pinch of slowing domestic consumption and the threat of a trade war. As for some Latin American countries and Turkey, the collapse of their currencies in 2018 rekindled concerns about their medium-term economic stability.

Within this more difficult environment, central banks are striving to manage the normalisation of their monetary policies as best they can. Although the US Federal Reserve has maintained a gradual approach to raise its target range for the Fed Funds rate (currently 2.25% to 2.50%), this has not prevented financial markets from being agitated by fears of faster monetary tightening at times. In Europe, Mario Draghi announced that the ECB was terminating its bond purchasing program, which is the first stage of its exit strategy. The central bank will still remain active in the debt market for some time, since it will reinvest proceeds from the bonds on its balance sheet as they mature. Europe's monetary policy therefore continues to be stuck in ultra-accommodative mode, which seems to be a structural necessity.

2018 was a very tough year for equities worldwide, with no major index posting a positive return in the local currency. Even technology stocks, which were doing very well early in the year were in for a rough ride in the second half of 2018, in the wake of data theft scandals on social networks and lowered guidance for such behemoths as Amazon and Alphabet. Certain sectors were particularly disappointing, and above all the automobile industry which suffered from concerns about the business cycle, the trade war and the new WLTP regulations. Semi-conductor companies also had a rough time, with demand falling and overcapacity in memory chips. Although the oil sector was boosted by strong crude oil prices during much of the year, crude collapsed from its peak of October due to a global supply glut and fears of slowing demand. The OPEC meeting in late November was expected to calm these fears but its impact was short-lived as investors became concerned with record amounts of US shale oil coming into the market. All in all, European equity markets ended the year almost as deeply in the red as those of the emerging countries (the Eurostoxx 50 was down 14.34% vs. -16.64% for the MSCI Emerging Markets index in USD), with both suffering from the volatility induced by the trade war. Due to their specific sector orientations and correlation with the business cycle, some national equity indices were hit particularly hard, such as the DAX index, which lost 18.26%. Europe in general was also penalised by rising populism (particularly in Italy, France and Great Britain with Brexit) and a blatant lack of unity. Emmanuel Macron and Angela Merkel, two symbols of European co-operation who were expected to spearhead Europe 2.0, have never been so lacking in credibility in their respective countries.

It was difficult to obtain satisfactory performance in the bond market in 2018, although sovereign debt finally did pick up by the end of the year against a background of general risk aversion (+0.86% in the US and +0.98% in Europe). Ten-year US Treasury yields went on a roller coaster ride, peaking at 3.25% during the year and ending it at 2.68%. In Europe, the 10-year Bund yield was practically at its annual low of 0.24% at year-end. Although corporate debt was quite resilient through much of 2018, due in part to the increasing scarcity of new issues, tension in equity markets began to weigh on corporate bonds late in the year. Only US senior loans posted positive returns in 2018, thanks to the Fed's monetary normalisation.

As for currencies, 2018 saw the US dollar regain strength, not only as a result of its status as a refuge currency but above all thanks to the vigour of the US economy. The emerging currencies however suffered from the effects of monetary tightening in the United States and from various idiosyncratic events, mainly concerning Turkey, Argentina and Brazil.

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OUTLOOK FOR 2019

The global macroeconomic environment appears more complex today than it was 12 months ago, mainly due to greater disparity between geographic regions and the expected slowing of the US economic engine. Furthermore, most of the various political uncertainties that arose throughout 2018 have yet to be resolved and continue to weigh on business and consumer confidence. Still, we do not agree with those who foresee a sharp slowdown in 2019 or even an imminent recession, given the lack of overheating and of the major imbalances that historically precede a cyclical downturn. We do expect global growth to slow however, as a result of the recent tightening of financial conditions, the decrease in US fiscal stimulus, and the natural tendency of an economic cycle that will soon be 10-years old and in which some of the major economies have reached the limits of their productive capacity. However, we expect the global economy to grow at a satisfactory pace, slightly above its cruising speed, thanks to still solid job market fundamentals, fiscal stimulus in Europe and China and the recent correction in crude oil prices. As for underlying **inflation**, we expect a modest increase driven by continued economic growth and wage pressure from low unemployment. Yet this trend is no reason for concern given the tame level of inflation in the US and virtual lack thereof in the Euro Area.

We expect limited convergence between global **monetary** policies in 2019. The Federal Reserve, which is furthest ahead in its normalisation process, is gradually reaching the neutral point and can therefore be more flexible. It could therefore reduce the pace of its steady quarterly rate hikes by half and even suspend them for longer periods if necessary. In Europe, although Norway and Sweden recently began to raise interest rates, the ECB contented itself with terminating its asset purchasing programme at the end of the year. With modest inflation and lower-than-expected economic growth last year, it is likely to once again bide its time until economic stability is confirmed, before envisaging an initial rate hike in the last quarter of 2019. The Bank of Japan is now the only central bank that is seeking to increase the size of its balance sheet.

In this mixed environment, we are still cautious about **sovereign bonds** and long-duration assets in general, although they have regained their safe-haven status somewhat over the past few weeks. This has increased valuations, which are once again quite high, despite the deterioration of the supply/demand balance resulting from the financing of US fiscal stimulus and the now shrinking aggregate balance sheet of G4 central banks. The moderate increase in yields we expect in 2019 is likely to cause this segment of the public debt market to underperform cash. **Credit** was severely penalised by the spike in risk aversion late in the year. Corporate debt, which is exposed to volatility in both interest rates and stocks, now finds itself in a fundamentally more challenging environment, with the slowing of the US economy, the end of the ECB's asset purchases in Europe and more intense competition from cash in the US. However, widening spreads are making valuations more attractive and the risks of default and refinancing are still low. We therefore expect credit to post modestly positive returns, but more attention to security selection and diversification will be required.

In the **currency** market, 2019 could see the euro-dollar exchange rate reach an inflection point, provided that macroeconomic conditions follow the relatively benign scenario described above. Given the end of US cyclical outperformance and the structural fundamentals that will favour the euro over the long term (such as the euro's current undervaluation and the strong balance of payments), we believe the EUR/USD rate has the potential to appreciate to 1.20. We will therefore be reducing our exposure to the US dollar in 2019, but over the near-term will continue to appreciate the protection it offers from political risk and other macroeconomic and financial contingencies.

The outlook for risk assets is looking uncertain heading into 2019. Fears of a slowdown in the global economy, Brexit and numerous other geopolitical issues, trade tensions and rising populism will continue to make investors nervous. Volatility, which made a comeback in 2018, will also no doubt be a factor. Yet there are many tailwinds for **equity markets**. Current index valuations can only be justified by a recession scenario, which we do not foresee at this stage of the economic cycle. We believe that emerging markets, where we are beginning to see signs of stabilisation, offer attractive valuations. Of course, China is still a subject of concern and we will be closely monitoring any monetary and fiscal stimulus measures decided by authorities in Beijing. European equities are trading at a big discount (with dividend yields of almost 4%) which will not decrease until political risks subside. Nevertheless, global investors seem to forget that the largest listed European companies have significant exposure to the global economy. Thanks to strong earnings growth of 20%, made possible by tax reforms, and the recent correction in share prices, the valuation of US equities is currently in line with its long-term average. The prospect of much higher interest rates no longer seems to be a threat for Wall Street. One additional tailwind for risk assets is the sharp correction in the price of crude oil, which will free up purchasing power in the oil-importing countries, and particularly in Europe, China, India and Japan.