OUR REVIEW FOR THE PAST YEAR & OUTLOOK FOR 2020

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A LOOK BACK AT 2019

After the DotCom crisis of the early 2000s, globalisation and international trade were forecast to be the two engines of a promising 2.0 world. At that time, Donald Trump was just another businessman, managing his real estate empire and with no influence on financial markets. However, since his election in 2016 the global paradigm has changed and domestic interests have taken precedence over the ideology of the new globalised world. What is true for the United States also applies to the world's other economies, where popular uprisings that seem to challenge globalisation have arisen in such countries as Chile, Argentina, Hong Kong, France, Germany, Italy and Spain.

However, as was the case the previous year, all eyes were still on Donald Trump in 2019, even though the trade war's impact on the global economy is still a subject of much debate. Whatever the case may be, trade tensions have been creating turbulence in financial markets over the past two years. Fortunately, 2019 ended quite differently. While 2018 was a year of threats and sanctions, the past year saw appeasement between Xi Jinping and Donald Trump. With trade negotiations on an upbeat note (except for the Huawei affair), the two leaders had reached a "near-agreement" to *Phase 1* of their trade negotiations by the end of the year.

This good news, together with progress on Brexit after Boris Johnson took office, was the icing on the cake of a particularly good year for financial markets.

In this favourable, albeit highly unpredictable environment, economic indicators did suffer some collateral damage. The slowing annualised growth of global trade by volume since 2008 has made itself felt on some sectors of the economy. One example is manufacturing, which has contracted worldwide. Fortunately, the opposite is true of the services sector, which has been underpinning the global economy for many months. Leading indicators have generally improved and seem to suggest that manufacturing has hit bottom, barring an exogenous shock.

As for the global economy in general, its growth slowed more than expected early in 2019 and in all regions, although primarily in the euro zone. However, global GDP growth was still a healthy 3.1% by volume. This growth was of course led by China (6.1%) and the United States (2.3%). The labour market continued to be surprisingly vigorous, particularly in the United States where the jobless rate approached historic lows.

There were some drags however on the inflation horizon (in part due to energy prices, inflation being pushed lower by the unfavourable comparison with higher energy prices in the prior year), which caused central banks to take a more dovish stance. While the US Federal Reserve cut its policy rates by 75 bp since the beginning of the year, the ECB announced a new package of measures that included asset purchases, a further cut in the deposit rate and new terms for refinancing operations. Presented as unconventional measures just a few years ago, central bankers seem to have made these new tools of economic stimulus increasingly mainstream.

Financial markets did particularly well in this environment, with the MSCI World index gaining 28.44%[1] over the year. Supported by its technology stocks, the US equity market outperformed once again, with a gain of 31.48%. As for the emerging markets, they failed to match this performance due to the weaker and more disparate returns of the largest Chinese companies (+19.95% for Tencent) and turbulence in Latin America and especially in Argentina.

Differences in returns between sectors are sometimes quite substantial, with stocks that did poorly in 2018 bouncing back sharply last year. This is particularly true for the semiconductor industry, as may be seen by ASM International (+184.50%), Applied Materials (+89.88%), Lam Research (+119.31%) and STMicroelectronics (+94.45%). However, in the tech stock arena, Apple's share price continues to surge upward (+88.97%), as the group undertakes a major transformation one of the main objectives of which is to reduce its dependency on iPhone sales. In the US blue chip segment, Visa, Mastercard, Microsoft and Accenture continue their upward climb. Other market segments were not so lucky however, such as the aviation sector, where Boeing's problems with the 737 MAX caused investors to lose confidence in several value chains.

[1] The performance of individual stocks and indices is indicated as at 31/12/2019, on a total return basis, in the local currency and with dividends included.

In Europe, the small & mid cap segment, which was irrationally oversold in 2018, also picked up and its valuation premium over large caps disappeared completely. In the large-cap market and particularly in the *value*[2] segment, the share prices of some automotive stocks finally improved, with Daimler up 14.92% and Michelin 30.23%. Other sectors that had already been doing well for several years continued their upper trend, led by Luxury. Despite some turbulence in Hong Kong, Kering, LVMH and other luxury groups continue to achieve impressive growth in Asia and in China in particular.

The **bond** market in 2019 was marked by a substantial easing of yields, with a 10Y Bund firmly anchored in negative territory at -0.19%. In the United States, the 10Y Treasury yield hit a low of 1.46% in 2019, before recovering to 1.92% by the end of the year. These yield trends, which may be attributed to changes in monetary policies and global uncertainties, were a big factor in the excellent performance of the longer duration segments. However, higher beta bonds, such as hybrid and high-yield bonds, also did well.

In the **currency market**, the GBP was one of the big winners in 2019 (+6.32% against the euro) thanks to the good news about Brexit. The US dollar, which was a safe haven in the highly volatile environment of 2018, pursued its upward trend, rising 2.26% against the euro. Disruptions in global trade over the year were also beneficial to the JPY and the CHF. Lastly, we should not forget about gold, whose strong gains pushed the ounce price up to 1552 USD. Although this sort of performance is often attributable to investor distrust of financial markets, this time it also seems to be the consequence of the "dedollarisation" of countries which are currently in conflict with the United States, such as China and Turkey. Market dogmas are definitely changing across the world.

OUTLOOK FOR 2020

The global macroeconomic environment shows some encouraging signs of stabilisation. Despite its record longevity, this expansionary cycle could therefore be sustained if **growth** picks up just a bit. Political uncertainties will not be dispelled overnight, particularly with the approach of the US elections in November. But the recent positive turns that Brexit and the trade war have taken suggest that we may at least expect some respite over the coming months. Furthermore, the mixture of generous monetary and fiscal policies, favourable financial conditions and the resilience of the private sector provide a supportive foundation. It is hard however to imagine a return to very strong growth, at a time when some of the major economies are at the limit of their productive capacities and China's economy is undergoing a structural slowdown. However, a limited recovery just above the global economy's cruising speed does seem possible and would maintain a solid foundation for the labour market. **Inflation** is still astonishing low at this phase of the economic cycle and the easing of the risk of higher US customs rates eliminates one of the main inflationary risk factors. Although the low jobless rate should put some additional upward pressure on wages, during this expansionary phase there seems to be a particularly weak link between rising wages and higher prices. We therefore expect only a modest increase in core inflation in 2020, to a still benign level.

The world's major **central banks** are therefore likely to maintain the status quo over the year. The Fed, which lowered its policy rates three times in 2019, probably does not intend to go any further, given the easing of uncertainties and the recovery of cyclical sectors. But the low levels of actual and expected inflation are making Jerome Powell and his colleagues a bit cautious, and a return to monetary tightening seems very unlikely. In Europe, Christine Lagarde has taken over the reins of the ECB and has inherited a weak economy with feeble inflation. Although the improvement in the global economy should be enough to forestall new initiatives, after the series of measures taken last September, the monetary regime will continue to be extremely accommodative with a deposit rate of -0.50% and asset purchases of 20 billion euros a month.

After their very solid performance in 2019, we see very little opportunity in **sovereign bonds**. The cyclical recovery and the dissipation of extreme political risks should contribute to a moderate increase in long-term yields, considering that bond prices are still rather high. The efforts of central banks to anchor the short end of the yield curve and to purchase investment quality paper clearly limits the upside potential of yields in a low-inflation environment. However, even a moderate increase in yields would cause this segment of the public debt market to underperform relative to cash and to expected returns of zero or slightly less. The situation in the **credit** market at the end of 2019 is completely opposite from what it was at the end of 2018. Credit spreads narrowed sharply once this panic had subsided, despite the cyclical slowdown and slightly weaker balance sheets. Still the macroeconomic environment expected for 2020 is favourable though, as will be the ECB's role as a systematic buyer and the intense demand for assets that offer a positive absolute return. All in all, credit is likely to outperform sovereign bonds and provide modestly positive returns, although more attention to asset selection and diversification will be necessary.

In the **currency** market, the US dollar was largely unaffected by the Fed's monetary policy about-face in favour of lower interest rates, largely thanks to the relatively strong cyclical resilience of the US economy and the dollar's status as a safe haven during periods of market stress. The global recovery that we expect could mean the end of this support factor for the USD. Furthermore, long-term structural and fundamental factors – such as measures of intrinsic valuation and the solidity of the balance of payments – are favourable to the euro. Although negative returns will discourage investors over the near term, we believe the euro can strengthen to 1.15 to 1.20 USD. We will therefore continue to reduce the exposure of our portfolios to the greenback in 2020, when we have more visibility on our macroeconomic scenario.

Last, but certainly not least, the following three engines that were driving **equity** markets during the last months of 2019 should continue to support share prices over the coming months, by forestalling the near-term prospect of a much-feared recession:

Engine No. 1 *- the extremely favourable environment resulting from very low interest rates and the accommodative monetary policies*

[2] The market valuations reflect slow revenue growth.

of the major central banks, made possible by the Great Moderation of inflation:

As explained above, central bankers will think twice before normalising their financial conditions, particularly after the disruptions of 2018.

Engine No. 2 *- the trade truce between Washington and Beijing:*

The approach of the US presidential election should encourage the White House to be more prudent in its trade negotiations.

Engine No. 3 *- the end of the global economy's contraction phase with the stabilisation of manufacturing indices and the automotive sector, fiscal stimulus, and the stabilisation and possible recovery of emerging markets:*

The dynamics of the global economy are improving.

Of course, considering the spectacular gains of 20 to 30% that some equity indices have made, all markets do not offer the same potential. US equity markets are rather generously valued, with a 12-month price-to-estimated earnings ratio of almost 18 for the S&P 500 index, compared to an average of about 15 over the past 10 years. During times of great uncertainty, US assets, which are supported by share repurchase programmes and Donald Trump's tax reforms, have consistently served as a safe haven, to the detriment of foreign assets. But it is above all growth stocks (technology, consumer, luxury sectors) which have most benefited from the actuarial impact of lower interest rates. They have largely outperformed the other market segments since the financial crisis of 2008. There are still buying opportunities in European markets however, and particularly in the small-cap segment, as we mentioned above (with the contraction of the political risk premia linked to Brexit and Italy) and in the emerging markets and particularly in Asia. Sectors deemed as *value*, such as the financial sector and the more cyclical industrial stocks, also provide some good opportunities in an environment of improving economic visibility. The generally low level of volatility in financial markets is also a strong supporting factor. It shows that investors are significantly less skittish.

Although we now have significantly more visibility, some uncertainties still remain and particularly in areas that will definitely have a decisive influence on the long-term behaviour of financial markets. The main issues and challenges that pose a threat to their equilibrium are the energy transition (the cost of combating global warming), recurring geopolitical tensions (the struggle for global leadership between the United States and China), the euro zone's future (the reforms that are indispensable to ensuring the sustainability of monetary union), and lastly the questioning of globalisation and capitalism across the world (the leftward drift of political parties in response to populist pressure, challenges to the operation of the labour market and the sharing of added value, and efforts to correct revenue and wealth inequalities). Although it is extremely difficult to estimate what impact the above challenges may have on asset prices, they certainly may pose a threat to economic growth and to corporate profits over the long term. They also encourage us to be extremely vigilant and to take advantage of the relatively low levels of volatility to hedge portfolios that are most exposed to the risk of a severe loss (hedging strategies through put options on equity indices).

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