RIDERS ON THE STORM

DECEMBER 2018

The Doors, 1971

We are pleased to present our macro and investment themes outlook for 2019. We expect the year to be one of continued monetary policy normalisation, accompanied by increased market volatility:

- Tighter monetary policy and a stabilising of economic growth, but no recession
- 2019 will see inflation forecasts push higher on the back of increased wages and input prices, continuing the trend that we have witnessed this year
- Corporate profits should remain strong, though developed markets are likely to see downward adjustments from current expectations

From an asset allocation perspective, we believe that our economic expectations mean:

- Central bank actions will change the mechanics of supply and demand in the bonds space, requiring investors to de-sensitise portfolios to duration risk
- Expected returns from stocks and risky assets overall will remain positive, though at lower levels
- The opportunity set will shift from being directional to more cross markets/relative value oriented

2018 has turned out to be a year of transition, and one that could be summed up with the phrase "Goodbye Goldilocks, hello volatility". As we had expected at the beginning of the year, markets experienced more episodes of stress due to rising idiosyncratic risks. Whether it be the potential issues surrounding a US-China trade war, Italy-EU tensions or concerns around emerging markets, implied and realised volatilities have been pushed higher for most asset classes. However, some positive factors from the 'Goldilocks' period have persisted this year: global growth has stayed above potential and monetary policy has been accommodative despite the Federal Reserve's (the Fed) normalisation.

The landscape will likely be more difficult next year as these supportive elements become headwinds for growth-oriented assets: for the first time since the Great Financial Crisis (GFC), the aggregate central bank balance sheet will shrink, pushing investors into unfamiliar territory as they adjust to living without quantitative easing (QE). Moreover, this monetary policy normalisation will be concurrent with global growth stabilising at, or slightly below, its potential after years of cyclical improvement. This will raise questions about the age of the cycle and peak profitability. Although we do not forecast a recession in the coming quarters, our balance of risk for 2019 has clearly shifted toward the downside, and we are thus preparing our portfolios to 'ride out the storm'.

1. With its mission accomplished, QE rides off into the sunset

   Since the GFC, most economies have improved significantly and their levels of growth are now back to pre-crisis averages. The main contributor to these improvements has been, without doubt, the monetary policy support implemented by most central banks across the developed world. Non-conventional tools, such as asset purchases, helped smooth the negative effects of the necessary deleveraging in the financial and household sectors. In addition to the economic impact, the size and length of this accommodative monetary policy has also:

   i Boosted returns of most assets over the period;

   ii Modified correlations across assets;

   iii Pushed macroeconomic and financial volatility lower.

Cross Asset Solutions

Global Macro & Dynamic Asset Allocation Team

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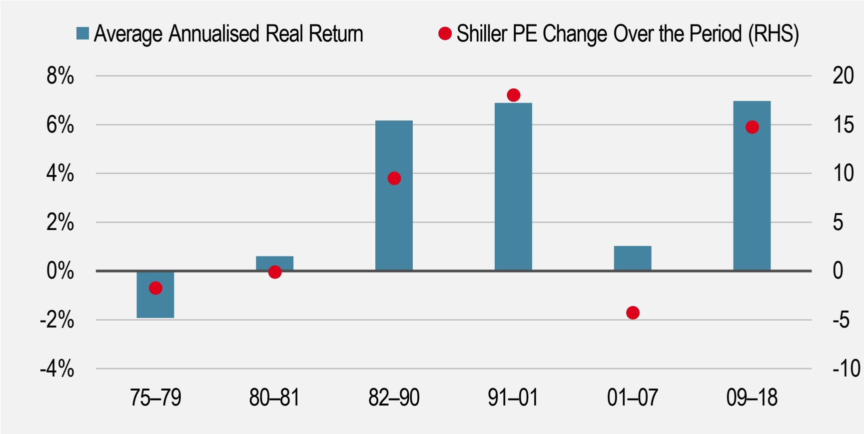
1. In 2019, we anticipates more challenging environment for investors
2. With a synchronisation of tightening from central banks, investors will have to get used to a world without quantitative easing
3. 2019 will be a time for adjustments in terms of economic growth, corporate profitability and expected investment returns

To illustrate the impact of QE, we have analysed the performance of the S&P 500 index after the last six US recessions, as dated by the National Bureau of Economic Research (NBER), and compared it to the post-GFC recovery. As presented in Figure 1, the current cycle exhibits the highest returns historically, slightly above the 1991–2001 period that was characterised by 'irrational exuberance' and a 'new economy bubble'. We have also computed the change in the Shiller price-to-earnings (P/E) ratio over those periods. Here again, the current period appears exceptional, with a net change close to 15, the second largest improvement after the 1991–2001 expansion.

Figure 1: S&P 500 Index Performance Post NBER Recession



Sources: NBER, Shiller, Unigestion. Data as at 30.11.18.

Although corporate profitability and a cyclical improvement explain a significant portion of this high return, the historical comparison highlights the extent to which QE also contributed to the returns of growth-oriented assets relative to other post-recession periods.

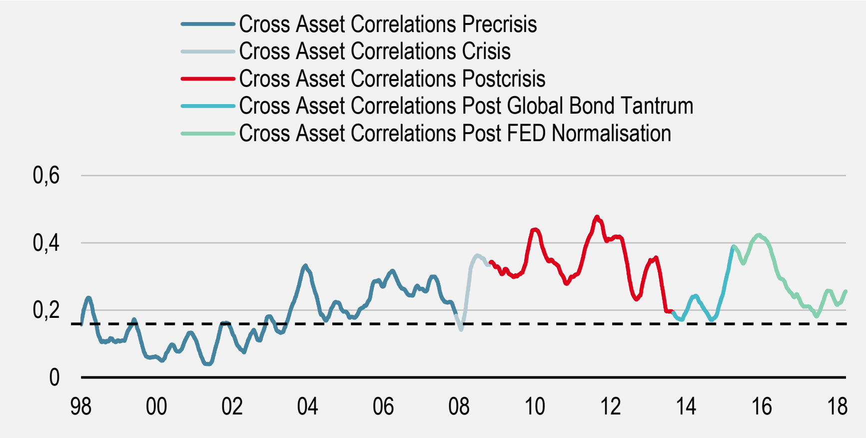
Historically, the negative correlation between stocks and bonds has been an important contributor to dampening volatility and boosting Sharpe ratios of multi asset portfolios. Thanks to QE, this relationship has been modified to the benefit of investors. Following the GFC, any bad economic news became good news for growth-oriented assets, as it justified further monetary support. This boosted assets such as equities and credit spreads that typically suffer during tough economic times. Multi asset portfolios benefited further from this positive correlation across assets because QE boosted the returns of all assets riskier than cash, including sovereign bonds.

As illustrated in Figure 2, the two episodes of QE – 2009 with Fed measures and 2015 with ECB ones – have pushed cross asset correlations higher. We think this boost will end in 2019 since monetary policy normalisation is largely on track. The risk is to have a correlation shift from a period of positive bond and equity returns to a period of negative returns for both assets.

QE has also pushed macroeconomic and financial asset volatility lower. The monetary policy support has allowed stable and synchronised growth with limited inflation pressure. That has created a search for yield that has significantly increased portfolio risk for investors that have either extended their duration, downgraded the average rating of their bonds portfolio or increased the leverage of their position.

"QE has been an important contributor to the returns of growth assets in recent years, but with that support coming to an end, investors will need to adjust their future expectations."

Figure 2: Cross Asset Correlations
Rolling six months correlations of daily return; average across sovereign bonds, credit spread, equities and commodities



Sources: Bloomberg, Unigestion. Data as at 30.11.18.

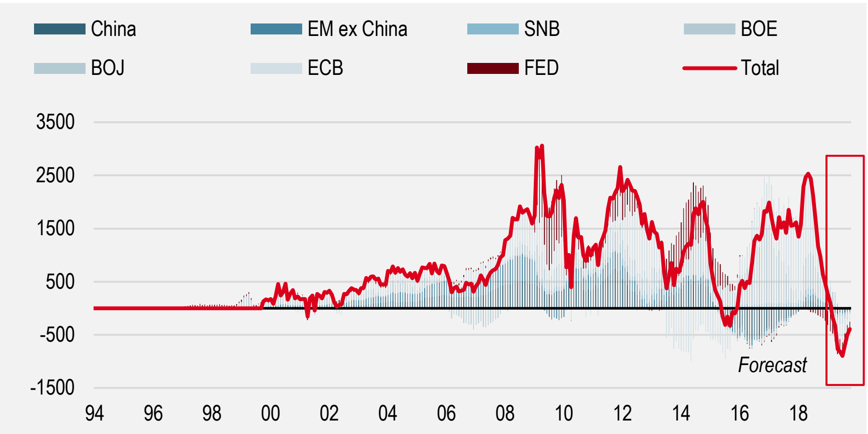
2. Time for adjustments

Monetary policy normalisation has already started in 2018, with more rate hikes than cuts, and will amplify in 2019 with the end of asset purchases from the European Central Bank (ECB) and expected rate hikes from many central banks, including Norges Bank, Riksbank, the Bank of Canada, the Bank of England (BoE), the ECB and the Fed. Therefore, next year will likely be a year of adjustments to this new monetary policy landscape.

Indeed, for the first time since 1990, investors will face a shrinking aggregate central bank balance sheet. As shown in Figure 3, after years of liquidity injections, the annual change in the aggregate balance sheet and foreign reserves of the world's key central banks will turn negative in 2019. This reversal will significantly affect asset behaviour and investors will need to adjust their expected returns.

"After being held back this year by factors such as Brexit and the Italian debt situation, 2019 should see both the BoE and the ECB increase the pace of their normalisation of monetary policy."

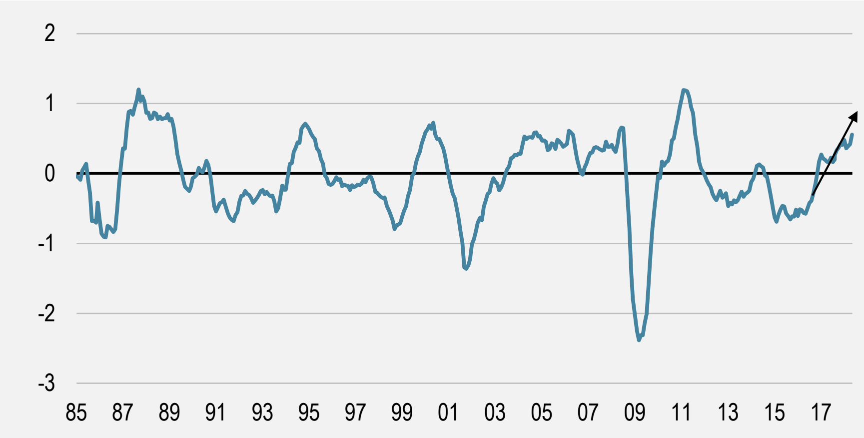
Figure 3: Yearly Change in Global Liquidity (USD bn)



Sources: Central Bank Balance sheet, Unigestion. Data as at 30.11.18.

The broad monetary policy normalisation forecast for 2019 is justified by the convergence of realised inflation toward central bank targets. As shown in Figure 4, our Inflation Nowcaster, which tracks the risk of seeing an inflation surprise, has been recovering since July 2016. The combination of higher wages due to tightening labour markets and higher input prices, as illustrated by the rebound of cyclical commodities in 2016 and 2017, has driven consumer prices higher over the last two years, pushing up inflation forecasts.

Figure 4: Inflation Nowcaster

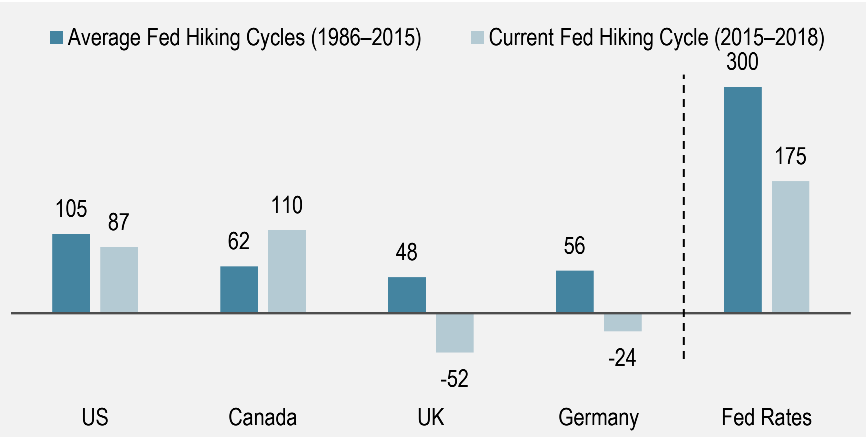


Sources: Unigestion, Bloomberg. Data as at 30.11.18.

This rising trend in inflation pressures should lead long-term bond yields higher in the coming months. Figure 5 shows the change in ten-year yields during periods of Fed tightening. As we can see, yields rose by about 100 bps on average for US Treasury Notes and around 60 bps for Gilts, Bunds and Canadian bonds. In the current Fed hiking cycle, US and Canadian bond yields are in line with their historical averages, but Gilt and Bund yields have declined contrary to their historical pattern. Even if Brexit uncertainty and the Italian situation can explain this delay in normalisation, we are convinced that it will require adjustments and we expect the ECB to hike rates in 2019, after ending asset purchases in 2018. We also expect the BoE to normalise their monetary policy after Brexit has been completed.

"Monetary policy has supported stable and synchronised growth with very few inflationary pressures – but the picture is now changing."

Figure 5: Ten-year Bond Yields: Change During Fed Hiking Cycles (bps)



Sources: Central Banks, Unigestion. Data as at 30.11.18.

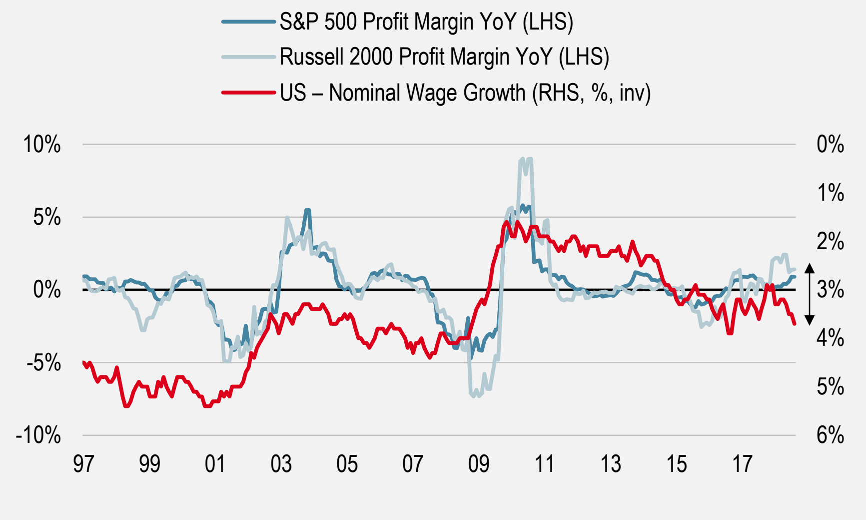
The combination of higher interest rates and rising production costs, as implied by wage growth, should weigh on corporate profitability. As illustrated in Figure 6, and as one would expect, profit margins for US companies have historically been negatively correlated to wage growth. With wage growth back to pre-crisis levels of around 3.5% year-over-year, we expect this trend will pressure margins and impact profitability.

Current analyst expectations for US earnings growth in 2019 are around 8%, which seems a bit optimistic given that the median annual earnings growth since 1980 has been 7%. It was also 7% between 2009 and 2017, despite accommodative monetary policy. Furthermore, there is a clear pattern of analysts revising their expectations down as time progresses, which additionally points to likely disappointment ahead.

Nevertheless, the situation is not homogenous across countries. The need for downside adjustments is found primarily in developed economies, such as the US, Europe and

Japan, which will face higher interest rates, higher costs and modestly lower nominal growth in 2019. On the other hand, the current pricing of flat earnings growth for emerging markets looks too pessimistic to us given that the average nominal GDP growth will likely stay above 6% for most of these economies, while the currency depreciation against developed market currencies has restored flexibility in profit margins.

Figure 6: Growth in US Margins vs. Wages



Sources: Bloomberg, Unigestion. Data as at 30.11.18.

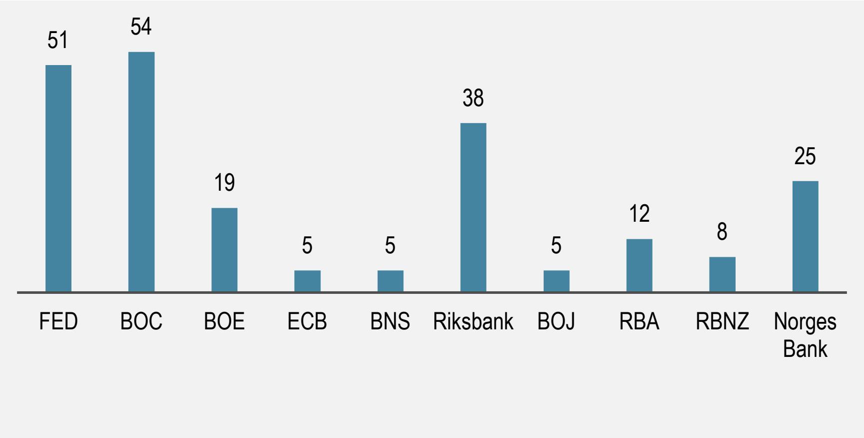
3. Time for repricing risks

We believe that the turn in the monetary policy stance from accommodative to normalisation implies a repricing of risks in addition to adjustments in bond yields and earnings expectations. In our view, there are two key risks that will need to be reassessed: firstly, the risk of a central bank surprise after years of telegraphed guidance and, secondly, the risk of macroeconomic deceleration.

Currently, monetary policy expectations for 2019 show a global tightening, as seen in Figure 7. However, as we have highlighted previously, market pricing tends to underestimate the ability of central banks to normalise. For example, there is currently a marked divergence between market pricing and Fed projections for rate hikes in 2019 (two hikes priced vs three projected by the Fed). For example, there is currently a marked divergence between market pricing and Fed projections for rate hikes in 2019 (two hikes priced vs three projected by the Fed). The situation is similar in Europe, with the market consensus being that the ECB will not raise rates in 2019 and the BoE will hike in Q4 2019. Any improvement on political issues such as a Brexit deal or compromise on the Italian budget will shrink the horizon for higher interest rates, which are very low from levels implied by a simple Taylor rule. We believe the sensitivity of central banks to the economic and political environment will increase in 2019, resulting in a higher risk premium on the bond yield curve.

"In our opinion, market expectations for corporate earnings growth in the US is a touch high and we will most likely see downward revisions."

Figure 7: Monetary Policy Expectations for 2019 (Cumulative bps)



Sources: Bloomberg, Unigestion. Data as at 30.11.18.

4. Asset allocation impact

   a. Don't fight the Fed – or any other central bank

      This well-known saying has never been more true than in the past decade. Market participants always underestimated central banks on their ability to push rates ever lower and, more recently, on their willingness to bring them back to more neutral, if not 'normal', levels. While getting caught wrong footed on the first meant investors missing out on the rally in bond markets, being wrong on the second will bring pain directly to portfolios with interest rates going up, and indirectly through the removal of ample liquidity and an end to complacency in risk taking.

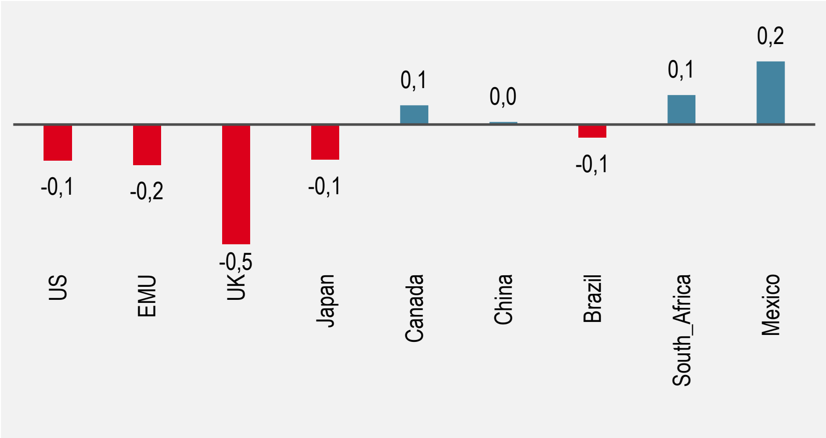
      2018 has been a transition year in terms of central banks' action, ranging from the termination of asset purchases in Europe to the gradual rise in rates in the UK or Canada and the combination of a balance sheet runoff and sharp rate hikes in the US. 2019 will witness the synchronisation of tightening from major central banks and the beginning of a global balance sheet reduction. This will change the mechanics of supply and demand in the bonds space, and investors will have to de-sensitise portfolios to duration risk for two reasons: firstly, government bonds will not provide the same levels of protection as they used to when risk aversion rises, and, secondly, they will detract from performance more than usual when risk appetite increases.

   b. Recession risk remains low, but growth premium would be lower

      Talking about the real economy, there are two elements one should focus on at any point in time: the level and the dynamic. While there is no reason to fear a recession any time in 2019, the deceleration observed in our proprietary Nowcaster (see Figure 8) has been clear throughout this year, and the continuation of this dynamic will rein economic growth back to potential levels, having previously been firmly above. We do not expect it to fall significantly below potential, so expected returns from stocks and risky assets overall will remain positive, though at lower levels.

"Markets often underestimate the actions of central banks and the current situation is now different, with divergences between what investors are pricing in and what the Fed is indicating."

Figure 8: Year-to-date Change in Growth Nowcaster



Source: Unigestion. Data as at 30.11.18.

c. Leverage is not your friend → Higher volatility and cross assets correlation imply lower market exposure

We expect the opportunity set to change next year, from being directional to more cross markets/relative value oriented. The desynchronisation within and across economies will be key to delivering positive returns. In this context, there is room for emerging markets to outshine their developed peers due to a number of factors, including higher nominal growth and the stabilisation (or weakening) of the US dollar. The synchronisation of tightening from central banks would be unfavourable for the US dollar which has appreciated against most currencies in 2018.

Finally, we do not expect the overall financial and economic backdrop to be supportive enough to maintain constant risk levels throughout the year. Combining central banks' global liquidity removal, together with decelerating macro momentum and increased volatility, investors will not only need to make nimble asset allocation changes, but to also dynamically adjust their overall market exposure to face this bumpier and less accommodative environment. Quantitative easing has been the perfect environment to increase risk and leverage, but as 2018 has started to show, the picture is now changing. With interest rates now creating shocks rather than acting as a pain soother during risk aversion, and an unfavourable asymmetry in asset correlation, reducing market vulnerability will be key to investment success in 2019.

"Investors will need to be on the ball and adjust their asset allocations as market conditions and risk levels change."

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