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MONTHLY INVESTMENT OUTLOOK

January 2020

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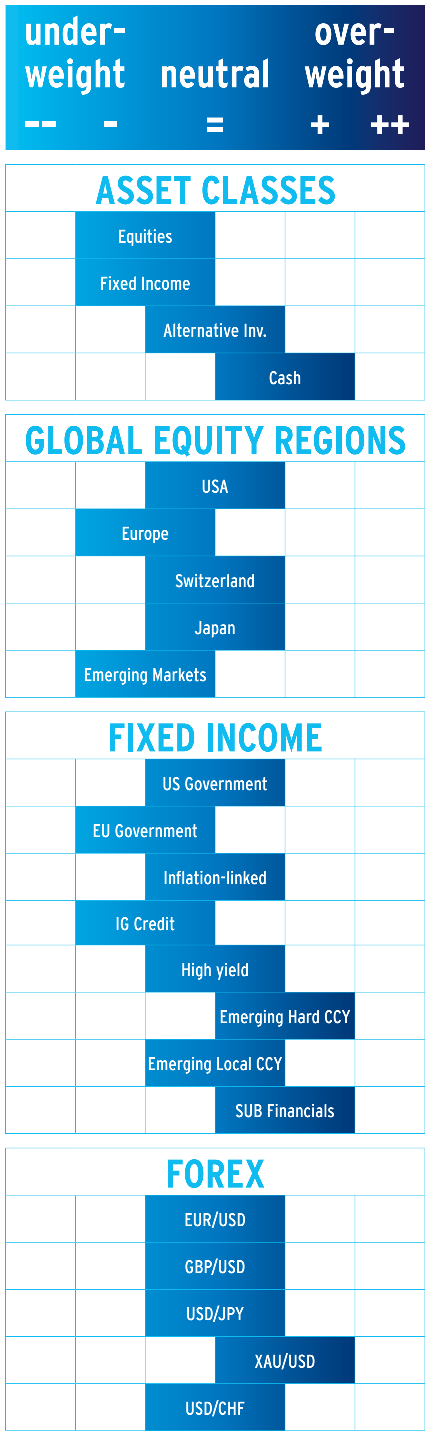
AT A GLANCE

- Greater dependence on liquidity rather than fundamentals
- Japanese equity market looks more attractive
- Surf the liquidity wave for now
- U.S. economic growth remains key for the greenback



INVESTMENT INSIGHTS

2019 was a stellar year for risky assets, with the surge of equity indices posting gains above 20% in almost all regions, with a special mention for the Nasdaq, up 35%. Recession fears of January 2019 abated as central banks reversed their monetary policies, moving from a hawkish stance to a new round of ultra-accommodative actions, notably in Europe where the ECB relaunched a Quantitative Easing (QE) programme of EUR 20 billion of assets purchase per month. The Fed also participated in the liquidity injections by adding billions of dollars in the repo market on a monthly basis, even if they refrain from calling it QE. Moreover, at the end of last year, two big geopolitical uncertainties dissipated as the US and China agreed on a phase one deal and as fears of a hard Brexit were drastically reduced after Boris Johnson won the UK elections by a large margin.

Did the macrœconomic indicators justify the rise in equity markets? Well, at least we noticed some improvement at the margin. In Europe, it appears that the momentum is becoming more positive, as highlighted by the Citigroup macro surprise index, rising to 43 from a depressed level of -80 back in October last year. Nevertheless, we should keep in mind that GDP growth in the region has been slashed to 1.2% (according to Bloomberg) and that manufacturing activity remains in the doldrums, with the PMI indicator at 44.6, well below the neutral point (50). This negative development is slowly affecting the German economy as well as the labour market, as evidenced by the last unemployment change (+8k).

Did companies' earnings per share (EPS) growth warrant the surge in risky assets? The answer is no. Indeed, we have been witnessing a sharp earnings slowdown in 2019 across different regions, ranging from negative growth in emerging markets (-9%) to a meagre growth of around 2% in Europe. Therefore, almost one hundred percent of the 2019 market price appreciation was driven by multiple expansion.

So, what has been the most important force behind such a rise in risky assets? We would argue that liquidity injections and accommodative central banks have been the main driver of solid equity returns. Based on the Bloomberg global proxy money supply indicator (exhibit 1), which sums up M2 for the main regions, the picture is clear: in 2018, liquidity removal was damaging for the S&P 500 while in 2019, the opposite was true, i.e. a sharp increase in aggregate money supply explained solid returns.

2019 was the year of relief, as many investors feared the worst was yet to come, namely a global recession. 2020 must therefore be the year of delivery, as both earnings and macro data cannot disappoint, given the high level of expectations. We are living in a new environment where there is a greater dependence on liquidity rather than fundamentals, and this decoupling cannot extend forever, as central banks' ammunitions are becoming more limited.

EXHIBIT 1: GLOBAL MONEY SUPPLY PROXY (YOY%) VS S&P 500 (YOY%)

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THE QUOTE OF THE MONTH

"It's generally true there is much less ammunition for all the major central banks than they previously had."

Mark Carney
BoE Governor

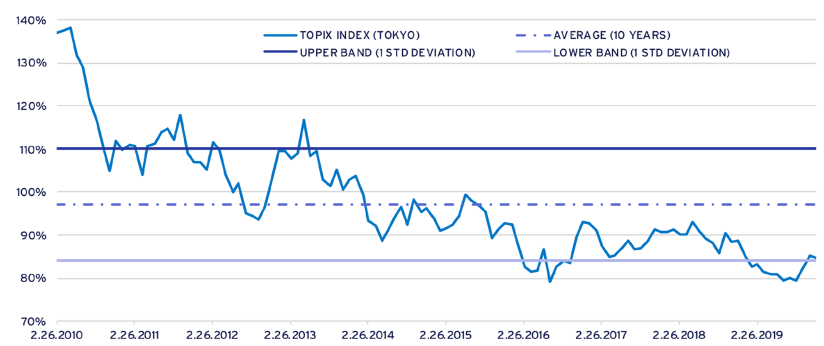
EQUITIES

In 2019, the S&P 500 enjoyed an amazing return of 29%, the second best annual performance over the last twenty years, even surpassing the 2009 gains (+23%). A stellar year indeed, despite an earnings recession. Profit expectations have been drastically trimmed, with sell side analysts revising down their EPS growth estimates to around 0%, from 10% at the beginning of 2019. Needless to say that the bulk of the increase in equity markets was driven by an impressive multiple expansion, with the S&P 500 forward P/E increasing by five points over the last 12 months (from 14x to 19x). Consequently, the US market is now trading at lofty valuations, reaching the expensive zone based on a historical perspective (one standard deviation above the 10-year average). Therefore, it appears that the potential in equity markets for the coming months is fading and to sustain the current rise, companies will need to achieve the 10% growth expected in 2020 by the analysts' consensus, as there is little room to tolerate any disappointment given the stretched valuations.

During 2019, investors' sentiment was extremely pessimistic, which translated into large equity outflows and a defensive positioning. However, after the relief rally in Q4 2019 (MSCI world +8%), we are entering 2020 in a different mood, with sentiment indicators reaching levels close to euphoria by some metrics (put call ratios, short VIX positioning, bull bear ratio, inflows etc.). Thus, in the short term, and if history repeats itself, we would not be surprised to see some equity market consolidation as complacency is often a good contrarian sell signal.

From a country standpoint, and whilst we still favour the US market (structural growth companies, more immune to external shocks, etc) in relative terms, we are contemplating (waiting for a better entry point) adding to the "value" regions such as Japan, which might benefit the most from an improvement in the global macrœconomic landscape. Last year, the Topix underperformed the MSCI world by 10% in local terms, on the back of a deteriorating economic backdrop. For 2020, there are different arguments justifying a more constructive view. Firstly, Japanese equities are the cheapest (FW P/E) in relative terms (exhibit 1), hence there is some room for a re-rating. Secondly, the BOJ is a strong supportive factor given the large annual amounts invested in the different ETFs, representing around 8% of the total outstanding shares, according to some analysts. Thirdly, the Yen strength of the last two years (safe haven status) should be less of a headwind in the coming months if the global macro picture improves. Finally, the government will launch a large fiscal package this year of around USD 120 billion, in order to mitigate the impact of the 2019 VAT increase on the Japanese consumer.

EXHIBIT 1: TOPIX: RELATIVE PE (BLENDED FW)



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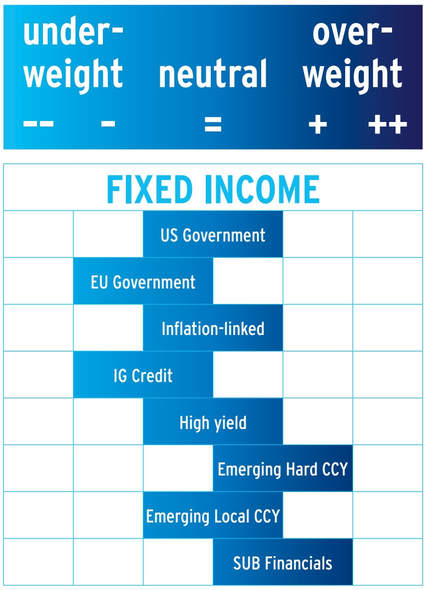
	under-weight --	-	neutral =	+	over-weight ++
GLOBAL EQUITY REGIONS					
			USA		
		Europe			
			Switzerland		
			Japan		
		Emerging Markets			
U.S. EQUITY SECTORS					
					Healthcare
			Industrials		
				Financials	
			Energy		
			Cons. Discret.		
		Cons. Staples			
				Technology	
			Utilities		
			Comm. Services		
	Materials				
EU EQUITY SECTORS					
			Healthcare		
					Industrials
	Financials				
					Energy
			Cons. Discret.		
				Cons. Staples	
				Technology	
			Utilities		
			Comm. Services		
	Materials				

BONDS



2019 will be remembered as a great year for financial assets, including fixed income. Indeed, all fixed-income sub-asset classes posted strong performances last year, ranging from a +17.1% performance for USD Subordinated Financials, +15.2% for Emerging Markets Latam bonds, +14.5% for US Investment Grade corporates, +10.7% for EUR High Yield, +10.5% for Italian Government bonds, to a more modest +6.9% for US Treasuries, +6.7% for European sovereigns, +6.3% for EUR Investment Grade corporates or +3% for German Bunds.

One thing is sure: we don't expect a repeat of this performance in 2020, which will clearly be far more challenging, at a time where both yields and credit spreads are near record low levels. This year should be more a story of carry, rather than risk premia compression. Despite this, we expect central banks - which are ultimately the ones to thank for these strong credit asset gains in 2019 – to remain strongly accommodative and to keep providing massive liquidity injections into the markets, in particular in the US with the Fed purchasing huge amounts of T-Bills to support the repo market.

Despite the relief that last year's economic slowdown didn't end up as a global recession, we must keep in mind that the US yield curve inverted in May last year (as expressed by the 3M Bill – 10Y Treasury spread) which is a reliable indicator of a recession to come. Historically, it has happened every time over the last 50 years (with the exception of a very short inversion in 1998 during a few days), within a time range of about 300 days on average. So the jury is out on whether it may be different this time, but a US recession this year is not off the cards yet.

Our strategy remains the same as the end of last year: we recommend putting in place a "barbell" position, combining relatively short duration high yielding credit assets (Emerging markets, subordinated financials and High Yield corporates) with longer "risk-free" duration, expressed as a position in 10-year US Treasuries, which is a good diversification complement to the credit position. The idea is to seize a higher carry over the short-term, as long as the market has its rose-tinted glasses on and is constructive on the economic outlook, further underpinned by strong money flows, before becoming more defensive within a few months, when the potential of disappointments may become a greater threat. We add to that an exposure to inflation-linked bonds, which look attractive in the light of low inflation expectation levels (see Graph 1) and would perform well in an alternative possible reflationary scenario of a declining US dollar and rising commodity prices. Risk management and nimbleness will be key skills to grab the best of fixed income markets in 2020.

EXHIBIT 1: US forward inflation breakeven and oil price

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FOREX

under-weight --	-	neutral =	+	over-weight ++
		EUR/USD		
		GBP/USD		
		USD/JPY		
			XAU/USD	
		USD/CHF		

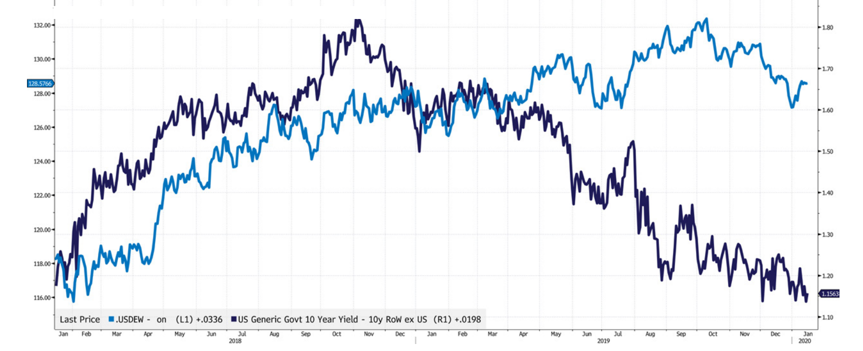
In 2019, the USD benefitted from a slowdown in global growth and from its defensive virtues amid geopolitical tensions with China. On the other hand, the U-turn of the Fed and a US economic soft patch weighed on the greenback. This global macro backdrop barely supported the US dollar, which averaged +0.1% vs G10 peers. In 2020, we expect FX markets to continue being driven by the triumvirate of growth expectations, monetary policy, and (geo) political uncertainties.

Given the narrowing trend of the US-RoW interest rate differential (c.f. Graph 1) and the greenback richness, going forwards we expect the USD to face stronger headwinds. Also, the fading of tail risks (trade war escalation, disorderly Brexit, US recession) reduces the appeal of the US dollar. However, in the short-term, the key issue for the USD is whether the US economy will remain robust and its expected growth differential versus the rest of the world will remain wide. There is little doubt the global economy is late-cycle, with GDP growth forecasts for 2020 and 2021 lower than in recent years. Nevertheless, we still expect the US economy to fare marginally better than most developed economies, at least in H1. The second key concern for the greenback is whether the Fed is done with its mid-cycle easing or whether we are in the midst of a full-blown easing cycle. We foresee that the Fed will continue to provide ample liquidity in the form T-Bills purchases to support the repo market. Given the contrasting impact of these drivers, we remain neutral on the US dollar for Q1 2020. We also expect FX markets to be, at times, driven by the ebb and flow of geopolitical tensions. The likelihood of several stress episodes happening during the year is high given the binary nature and uncertainties associated with the US-China trade war, Brexit negotiations, U.S. elections and President Trump's impeachment. We suspect the bulk of the headlines will continue to be dominated by US-China trade talks in H1 and by the U.S. elections in H2. How these tensions will influence the US dollar is uncertain.

Consensus is strongly positive about the pound vs the US dollar, but narrowly bearish vs EUR. Although we acknowledge that the risk of a disorderly Brexit is now much lower, GBP is still facing headwinds. First, we are skeptical that the UK and the EU can negotiate a trade deal in 11 months. Second, the market is expecting the BoE to cut rates as economists forecast a slowdown from 1.3% in 2019 to 1.1% in 2020. We remain neutral GBP.

Given our cycle extension scenario and constructive outlook for risk assets, we downgraded JPY back to neutral in Q4 2019, as its defensive properties might be more of a burden than a support in such a context. Another headwind might come from the trend of DM yields, as we see signs of US and Eurozone yields bottoming. Therefore, we stick with our neutral outlook for the JPY.

EXHIBIT 1: Equal Weight G10 FX Dollar Index vs 10y yield diff US-RoG10



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