2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly market review

April 2018

Editorial

This first quarter is finally over and will have put the nerves of the operators to a severe test. It will be marked by the return of volatility on risky assets and negative performance on equity markets. At the end of last year, however, the European stock markets, which were considered as the most promising both in terms of valuation and future earnings growth, ended the quarter down by 4.07% (Eurostoxx50), a figure that masks falls which were even more violent in some countries (-6.35% for Germany, -6.83% for Switzerland, -8.21% for the United Kingdom). As for the US stock market, this is the first quarterly decline since Q3 2015. In these 9 positive quarters until the end of last year, US markets rose by almost 40% (+/-16% annualized) and some would say that this was probably exaggerated in view of the earnings prospects of US companies. It might therefore be tempting to say that the correction observed during the past quarter is merely a normalization of a situation of valuations that are a little too tense. But the factors to be taken into account are probably a little more than that, and thus raise a number of questions about the market environment:

During the first half of the quarter, after the success of the American tax reform, operators have come to imagine that the current favorable environment, both macro-economic (synchronized global growth) and micro-economic (rising earnings per share), could only improve. Inflationary expectations have increased to the point of propelling long-term interest rates to levels that have not been observed for a long time. Thus, US yields at 10 years reached 2.95% on February 21 against 2.40% at the beginning of the year (and 2.04% at the beginning of September 2017). At the same time, European long-term rates have finally begun to normalize, with the 10-year German yield rising sharply from 0.30% in mid-December to 0.80% on 8th February. This acceleration in the rise in long-term interest rates, adding to the already stretched valuations on equities, coupled with uncertainties about the timing and extent of the rise in US short-term rates, led the global stock markets to fall sharply after the first three weeks of the rather idyllic January. Therefore, between January 23 and February 9, the Eurostoxx50 thus deviated more than 10%, before recovering during the second half of February. Unfortunately, some disappointing business surveys have cast doubts on the minds of operators, starting to make them doubt the long-term sustainability of the good momentum observed in recent months. And therefore, the rate of normalization of inflation. Such a period is still delicate for the markets, where the micro-economic prospects and the companies' publications are going in the right direction, whereas uncertainty is blossoming for some in the macro context. Be that as it may, European long-term rates were quick to pick up again, with Germany's 10-year ending the quarter at 0.49%, while its US counterpart eased to 2.75%.

The commercial policy of the Trump Administration is also fraught with uncertainty. Logically, the financial markets are quite sensitive on the issue of freedom of movement of goods. Any trade brake potentially has negative prospects on the dynamics and profitability of market activities. And de facto is a Damocles sword on global growth whose market makers would be doing well at this stage of the US cycle. For the moment, however, it seems that the White House's words speak louder than what it does. Thus, on steel and aluminum, $ 48 billion was to be allocated. To date, this actually amounts to 18 billion. The announcement of a rise in customs barriers is a way for Donald Trump to enter bilateral negotiations by creating a balance of power in

favor of the United States. There is a good deal of bluff in there. The American president thinks to obtain "Volunteer" restrictions to volumes exported to US soil and greater openness of the markets concerned, particularly China for US products. Up front, China appears as the real strategic competitor of the United States. It will therefore be necessary to pay attention to America's relationship with its great European and Asian allies and observe to what extent Trump considers that he needs them. The May 12 agreement on Iran's nuclear power will be a crucial step in this regard. Will the Americans get out? If so, it would be a particular complication for European diplomacy, which is still worried about the situation in the

	Q1 2018	YTD	Close 30/03/18
DOW JONES	-2.49%	-2.49%	24 103.11
S&P 500	-1.22%	-1.22%	2 640.87
FTSE 100	-8.21%	-8.21%	7 056.61
EUROST.50	-4.07%	-4.07%	3 361.50
CAC 40	-2.73%	-2.73%	5 167.30
FTSE MIB	2.55%	2.55%	22 411.15
MSCI EM	0.93%	0.93%	1 170.88
CRUDE OIL	7.48%	7.48%	64.94
GOLD	1.68%	1.68%	1 325.00
EUR/USD			1.2324
EUR/CHF			1.1754
EUR/GBP			0.8791
EURIBOR 1M			-0.372%

Middle East and its medium-term repercussions on the rest of the world.

Finally, the New York Times and The Observer articles cast doubt on Facebook as a pretext for major profits in the technology sector, which, it is true, had been particularly good in the last quarter of 2017. According to them, Cambridge Analytica (CA), a company specializing in strategic communication, has retrieved, without their consent, the data of 50 million users to feed a software that could predict and influence the voting of voters. The data would have been retrieved via an application of psychological tests downloaded by 270,000 users of the social network and developed especially by the Russian psychologist, Aleksandr Kogan, who, according to Facebook, then provided them unduly to Cambridge Analytica. Facebook said that the application also had access to the personal data of the "friends" of the users who downloaded the application, which, according to the press, led to CA's establishment of 50 million user profiles, useful for targeting advertisements. CA, who worked for Republican candidate Donald Trump's campaign, "strongly denied" using this data as part of the presidential campaign. It went on to stipulate that they "have not worked on the referendum on Brexit in the UK." The Facebook action fell by 6.77% on March 19, its largest decline since March 2014 and the fear of increased regulation of the Internet giants has affected the entire technology sector, pushing the Nasdaq Composite Index to 137.74 points (1.84%), which was expected to last until the end of March.

We observe thus a first quarter rich in twists for professionals in the financial sector. And European markets, having since returned to their early 2017 levels, even though the earnings growth of European companies has been up. Emerging markets have been a little more sheltered in the past three months, growing more strongly in January, and falling less than Europe and the United States in February-March, less affected by fears of rate hikes and the “sell-off” on technology. The coming quarter should also see a lot of ups and downs. The macro context is certainly still favorable, with, and this is important to emphasize, a strong and synchronized global growth in all major economic zones. But several unanswered questions for the moment are likely to pollute the long-term vision of the portfolio managers and create some epidermic movements. A few questions come to mind:

We are probably in the last part of the US business cycle. But how much longer can this very unusual cycle last? 12 months? 24 months?

How much rate hike does the Federal Reserve give us this year? 3? 4?

Or rather, will we have an acceleration of inflation in the United States favored by full employment and perhaps a trade war with China? Or have we seen the peak of inflationary expectations and should we expect a dip from now on? How far can the trade escalation with China go?

When will the US yield curve reverse? In 6 months, 12 months, 24 months? (Don’t forget that the inversion of the yield curve is often an excellent signal for reversing equity markets.)

Will the dollar stabilize against the EUR? If so, at what levels?

Will the monetary policy of the ECB remain accommodative for a long time? What about the European political risk (Brexit? Formation of a government in Italy?)

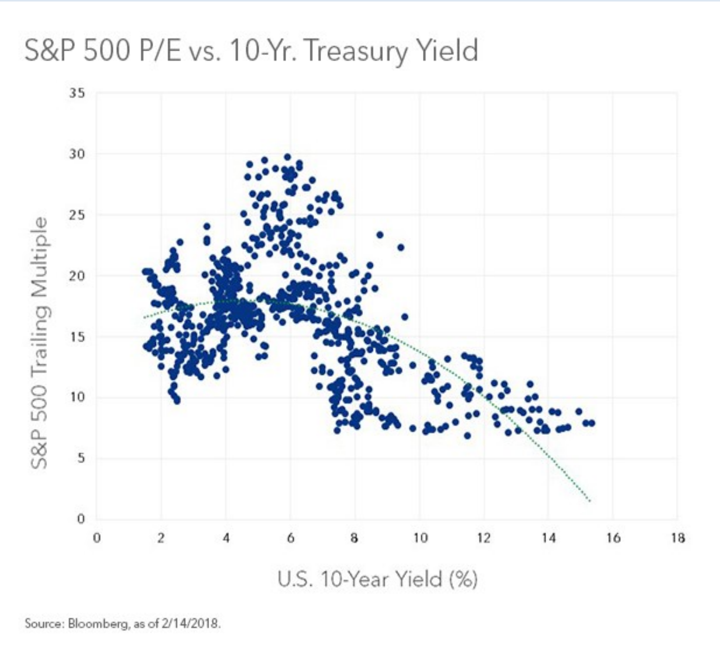
Will France succeed in reforming itself and, with Germany, once again constitute a credible locomotive for the Union?

Faced with all these diverse questions and issues, we continue to believe that diversification and quality of instruments are the two sine qua non conditions for portfolios that are able to cope with future uncertainties. We continue to favor European equities over US equities, which are more expensive; we maintain our positions on Alternative Funds, a good surprise this first quarter; as well as asset allocation funds and are beginning to consider strengthening credit quality within our bond pocket.

The Big Picture

This is one of those eternal stories reported in the media. Market commentators seem to think that the unusually low level of interest rates has fueled the current stock market overvaluation and that any rate hike should result in a fall in equities. In a nutshell, this means that equity markets and interest rates are not always correlated.

Intuitively, which may seem obvious. But the facts do not seem to corroborate this opinion. Indeed, contrary to widespread belief, a simultaneous rise in equities and interest rates is not without precedent. The rise in 10-year US interest rates, since their all-time low in mid-2016 in parallel with US stock markets, is a recent example. BlackRock recently published an interesting article on the subject. It showed that the relationship between interest rates and the value of equities is non-linear, that is, especially the relationship changes with the level of interest rates; the article highlighted the fact that when rates rise from exceptionally low levels, it is normal for equities and rates to move in the same way. The graph opposite (source: BlackRock) depicts this relationship by comparing since 1954 the valuations of the S & P 500 on the Y axis to the corresponding 10-year US rates on the X axis. Observe that interest rates and multiple equities (a synonym for "valuations") are more likely to increase in tandem when rates rise from exceptionally low levels, as is the case today. But once at a certain level, which can be estimated somewhere between 5% and 6%, the inverse correlation between rates and shares gets back on track, that is, the rates and the value. actions tend to evolve in opposite directions.



Based on the data today, we are clearly not there yet (at the time of writing, the 10-year US government bond rate is around 2.8%), suggesting that higher interest rates and share prices are likely to coexist, contrary to what is commonly reported by the media. Let's not forget that higher rates today result from a stronger economy that favors stronger nominal growth, coupled with robust earnings growth and fears of recession or deflation that are moving away.

Macro-economy

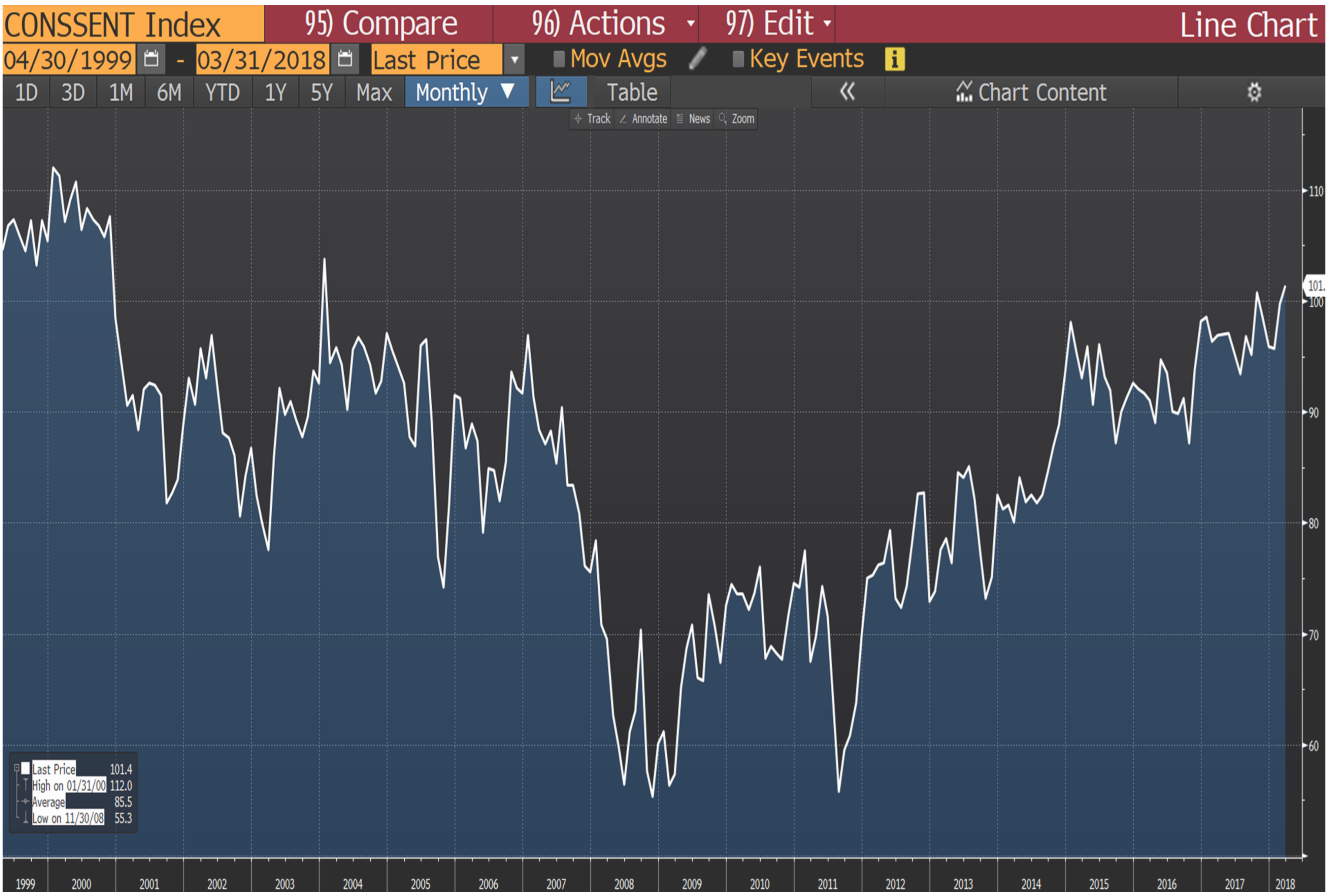
- **Overall indices of manufacturing activity and services** are still high, but the second derivative is not so good; the level of growth is slowing down. If it stabilizes in the US, it weakens in the euro zone and in China.

- **Economic surprise indicators** indicate that the Chinese slowdown was expected but of greater magnitude, while that of the Euro Zone, on the contrary, takes investors by surprise. This can be explained by a high 2017 comparison level (including a very good last quarter) as well as by the appreciation of the currency of the past six months, which is starting to weigh.

- Overall **inflation** remains under control, despite February worries in the United States on wage tensions. The US index since September is maintained between +2 and +2.8%, the core index stands at +1.8%. In Europe, inflation is relatively stable, but at lower levels around +1%, and +1.4% for core inflation. Given the evolution of leading indicators such as the ISM, there should be no worries on this front in the coming months. The only sources of tension could come from the inflationary effect of potentially higher tarifs and higher wages in the US.

As such, let us focus on the **American consumer**, the main contributor to US growth. At this stage of the cycle, and despite rising interest rates, everything seems to indicate that consumption should stabilize at very good levels. Sales of cars have reached a plateau for two years, but this can last as it did between 2000 and 2007. The increase in sales of new homes has doubled since 2009 but remains at very low levels compared to different cycles, and half as much as pre-crisis levels in 2008. US household income is rising and still supported by a low level of unemployment, well-established job creation and the indirect positive effects of tax reform. In this context, surveys show that confidence is high and default rates on different segments of consumption are falling, except on the automobile market with the return of sub-prime borrowers.

Evolution of the Consumer Sentiment Index of the University of Michigan since 1999



Special Topic

In the flash of September, also devoted to the evolution of the EUR / USD, we wondered if we had not arrived at the end of the strong structural appreciation movement of the dollar initiated in mid-2008 at €1.60. One of the conclusions was that it was necessary to take advantage of the rising phases of the greenback to gradually reduce exposure. However, these phases of appreciation have not occurred, we have even known during the beginning of this year a progression of the parity up to €1,25, then a zone of horizontal stabilization between this level and €1.22. Despite the sharp market correction since February, there has been no protection research generally favorable to the US dollar.

Yet, very objectively, the arguments in favor of the dollar are not lacking. Starting with the interest rate differential, which is at very high levels. Almost +2.6% on the 3-month rates, +2.9% at two years and +2.3% over the maturity at 10 years. These differences should naturally attract investors to the greenback.

On the other hand, the political uncertainties in the Euro Zone, even if the situation is more stable in France and Germany, should weaken the euro. They persist in Italy and Spain, not to mention the still uncertain consequences of the Brexit negotiations. Finally, the trade war that the United States and China may be waging should strengthen the dollar because it is a source of concern for global trade and potentially positive in the short term for US external deficits.

In spite of all this, nothing seems to encourage investors to provoke a change of trend, and the arguments in this direction are all quite valid. If we now look at the longer term, all these elements have probably already been anticipated as long as the foreign exchange market is efficient. Investors are already focusing on the end of the US cycle (recession or slowdown induced by rates and/or by this possible trade war), and remember that in times of rate hike, the dollar has rarely appreciated against major world currencies. Moreover, and this is a persuasive argument, the major political risk is no longer Europe or China, it has moved since President Trump took office. His anti-conformist diplomacy, opposition to it and future legal problems are all points of concern and tension. America has become a source of instability and the evolution of its currency is the witness.

From an economic point of view, this relative weakness is quite positive for the US economy, particularly from the point of view of exporters, unless these effects were to be offset by increases in Chinese taxes. Conversely for Europe, it is too early to have a strong currency because the cycle is less advanced and export dependence stronger. This could force the ECB to delay both the exit of its asset purchase policy planned for the end of 2018 and the expected rate increases in 2019.

From these levels of parity, everything is possible; the €/$ can be treated for a while in the range established since mid-January or break it up or down. It is very difficult to conclude, so on these levels and in doubt, it is advisable to refrain from taking risky bets. Are we waiting to sell the excess dollar at 1.20 and reposition ourselves at 1.30?