Monthly Investment Brief

In the mood for investing?

ODDO BHF ASSET MANAGEMENT ODDO BHF FRANKFURT TRUST

December 2017

"That was easy!", some might be tempted to say, with 20-20 hindsight. For portfolio managers, 2017 was a big year in both equities and bonds, with respective returns of almost 20% and 4% (USD-hedged), driven by an acceleration in global growth (+4% yoy in the third quarter) and weaker-than-expected inflation. Low volatility encouraged risk-taking and more aggressive behaviour by investors. This was stress-free performance – music to investors' ears and far removed from the sombre mood of 2008…

But was it really that easy? Well, let's take a look back at the year's highlights. True, who, in late December 2016, would have bet on a victory by Emmanuel Macron, the still obscure challenger of the historical pillars of French politics? Remember that on the eve of the first round of the presidential election, the top four candidates were almost neck-in-neck in the polls, two of whom were running on populist platforms. If either of those two had won, that would have changed everything. But there was general recognition that there was little chance of that happening.

Who would have expected those inflation figures, which not only didn't accelerate but actually surprised on the downside? This disinflationary episode, which was driven by specific factors (e.g., lower mobile phone fees in the US), is likely to end for several reasons:

- Post-recession excess capacities (production and labour) have been absorbed by far;
- Deleveraging is in its last phase;
- The deflationary impacts of technological innovation appear to have been overstated;
- Most of the knock-on effects of lower oil prices are behind us.

Who would have imagined that the markets would so easily shrug off such a run-up in political risk (in the Middle East and North Korea)? Yes, macro and micro indicators were solid, but should investors have been so complacent?

2017 ended on a positive note with US tax reform, but all this means is that we are looking ahead to 2018 to come up with a baseline scenario and convictions. Here are some possible leads:

Equities: Share prices are likely to be driven up next year by stronger company earnings. However, momentum is likely to slacken, as strong gains in 2017 have made valuations less attractive, and as global growth is slightly weaker. We will go into greater detail on which regions to overweight, with a basic question: should you maintain your exposure to US equities? We'll provide an answer in our January investment strategy report.

Bonds: We forecast negative yields on long-dated government bonds. Our baseline scenario is still a steepening in the yield curve in reaction to higher inflation and key rates. This is a scenario that a generation of managers has not experienced and that has taken aback even more experienced managers (Memories…).

We remain bullish on corporate bonds for the first half of 2018 but expect some profit-taking in the second half in the run-up to a possible downturn in the cycle.

The extreme weakness in volatility brought on by central bank policies is likely to vanish, leading to increased dispersion in performances and a marked return to selectiveness as a driver of performance. ODDO BHF AM is a conviction-based manager who creates value on a risk-adjusted basis. This looks like the right stance for 2018.

Happy holidays!

Our 6-month view

Central scenario: robust global growth (US, Europe, Emerging markets)

80%

Europe
- Growth acceleration fueled by improving credit conditions and decrease in unemployment
- Monetary policy normalization to be gradually set-in even if i/ it is still very accommodative, and ii/ financial market trends will be more dependent on the development of the real economy than on the support by the central banks

US
- Economy running at cruise speed
- Some positives to expect from Trump's tax reform plan
- Monetary policy normalization has been and should continue to be gradual but questioning about timing and pace

Assets to overweight
- Equities
- Europe credit (HY over IG)

Assets to underweight
- Sovereigns

Strategy
- Flexibility
- Hedging (options, gold,…)

Alternative scenario: inflation rebounds more than expected with some growth

15%

- Wage and/or oil price acceleration
- Reduction of growth potentials once again
- Rapid increase of sovereign yields

Assets to overweight
- Inflation-hedged bonds
- Alternative strategies
- Cash

Assets to underweight
- Equities
- Core Sovereigns
- High Yield credit

Alternative scenario: growth slowdown and risk on global trade due to protectionism

5%

- US: consumption & gross Fixed Capital Formation slow down again
- China: risks of economic rebalancing
- Japan: "Abenomics" fall flat
- Europe: a Japanese-like growth

Assets to overweight
- Money Market CHF & JPY
- Volatility
- Core government bonds

Assets to underweight
- Equities
- High Yield credit

Any opinions presented in this document result from our market forecasts on the publication date.
They are subject to change according to market conditions and ODDO BHF Asset Management SAS shall not in any case be held contractually liable for them.

Our current convictions for each asset class – Central scenario

		Change from the previous month ↗	Level of conviction				
Equities	Large cap Eurozone	→				1	
	Mid cap Eurozone	→				1	
	Small cap Eurozone	→				1	
	UK	→		-1			
	USA	→			0		
	Emerging markets	→		-1			
	Japan	↘			0		
Convertible bonds	Europe	→			0		
	USA	→			0		
Government bonds	Core Europe	→		-1			
	Peripheral Europe	→			0		
	USA	→		-1			

Source: ODDO BHF AM SAS. Data as of 11/30/2017

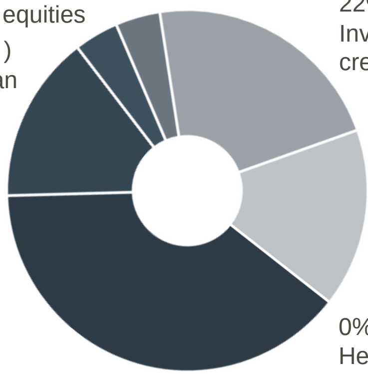
Our current convictions for each asset class – Central scenario

		Change from the previous month ↗	Level of conviction
Corporate bonds	Investment grade Europe	→	0
	Credit short duration	→	2
	High Yield* Europe	→	1
	High Yield* USA	→	0
	Emerging markets	→	-1
Money market	Developed markets	→	-1
Currencies	USD / €	→	0
	YEN / €	→	0
	GBP / €	→	-1
Commodities	Gold	→	1
	Crude oil	→	0

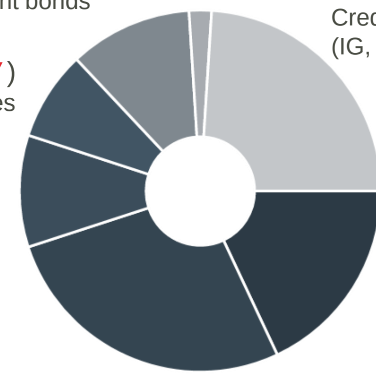
Source: ODDO BHF AM SAS data as of 11/30/2017

Our model portfolios

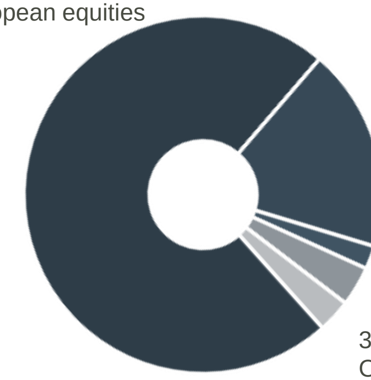
Moderate



Balanced - Dynamic



Dynamic



▶ Change from the previous month

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Source: ODDO BHF AM SAS | Data as of 11/30/2017

Portfolio positioning

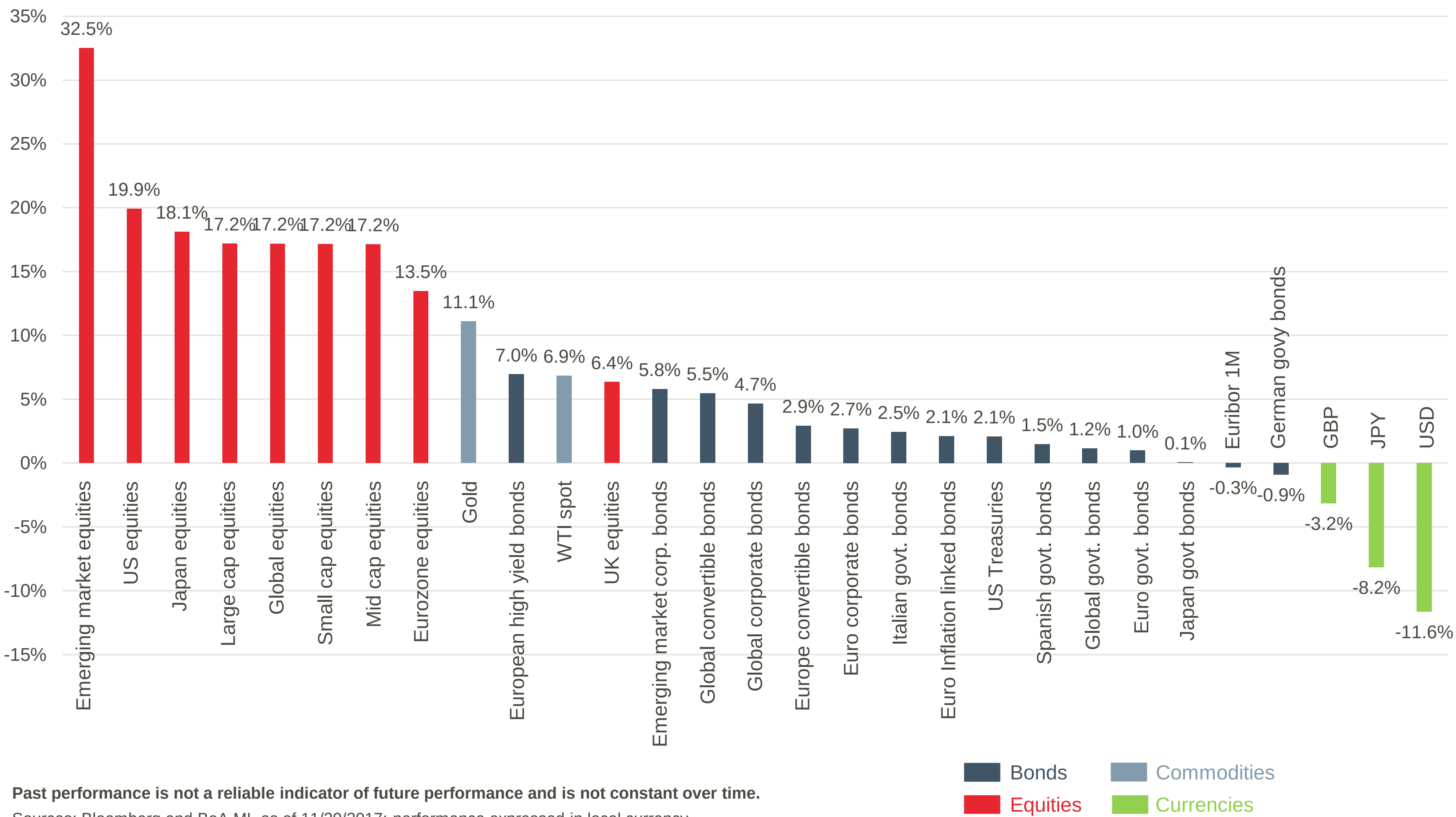
The MSCI World All Countries gained another 2% (in $) in November but with big differences from one region to another: +3.2% for the US, +1% for Japan, and +0.5% for emerging markets, but -1.8% for the Eurozone, which was undermined by a stronger euro (+2% vs. the dollar). Regarding government bonds, German yields levelled off (0.37% on 10-year paper) and US yields inched up (+2bp to 2.41%). Widening spreads penalised corporate bonds (-0.3% for high-yield debt, -0.2% for investment grade), while emerging debt also finished lower (-0.3% in dollars).

Within our balanced portfolio we reduced our equity exposure by taking some profits in emerging markets and partially hedging our European equity exposure (5%) as momentum is likely to be a little less favourable in the short term. Indeed, after a surprisingly strong third quarter, growth is likely to slow down in the fourth quarter. We might add that more and more central banks have announced plans to toughen their monetary policy, albeit very cautiously. Additionally, margins could be squeezed by the steep run-up in producer prices alongside sluggishness in consumer prices. Lastly, let’s not rule out the possibility of some profit-taking between now and yearend, especially in sectors that have performed particularly well, as the overall environment is still favourable to risky assets.
So we also took some profits on small caps, using the proceeds to increase our mid-cap exposure in order to reduce the portfolio’s volatility; we sold Nordic stocks to increase our exposure to European value funds; and we sold our position in European insurance shares to boost our exposure to Japanese shares.

Concerning fixed income, we took advantage of recent increases in yields on European high-yield to add to our weighting in them. And we reduced our dollar exposure by 4% to about 10%.

Year-to-date performance of asset classes

Emerging market equities still largely ahead

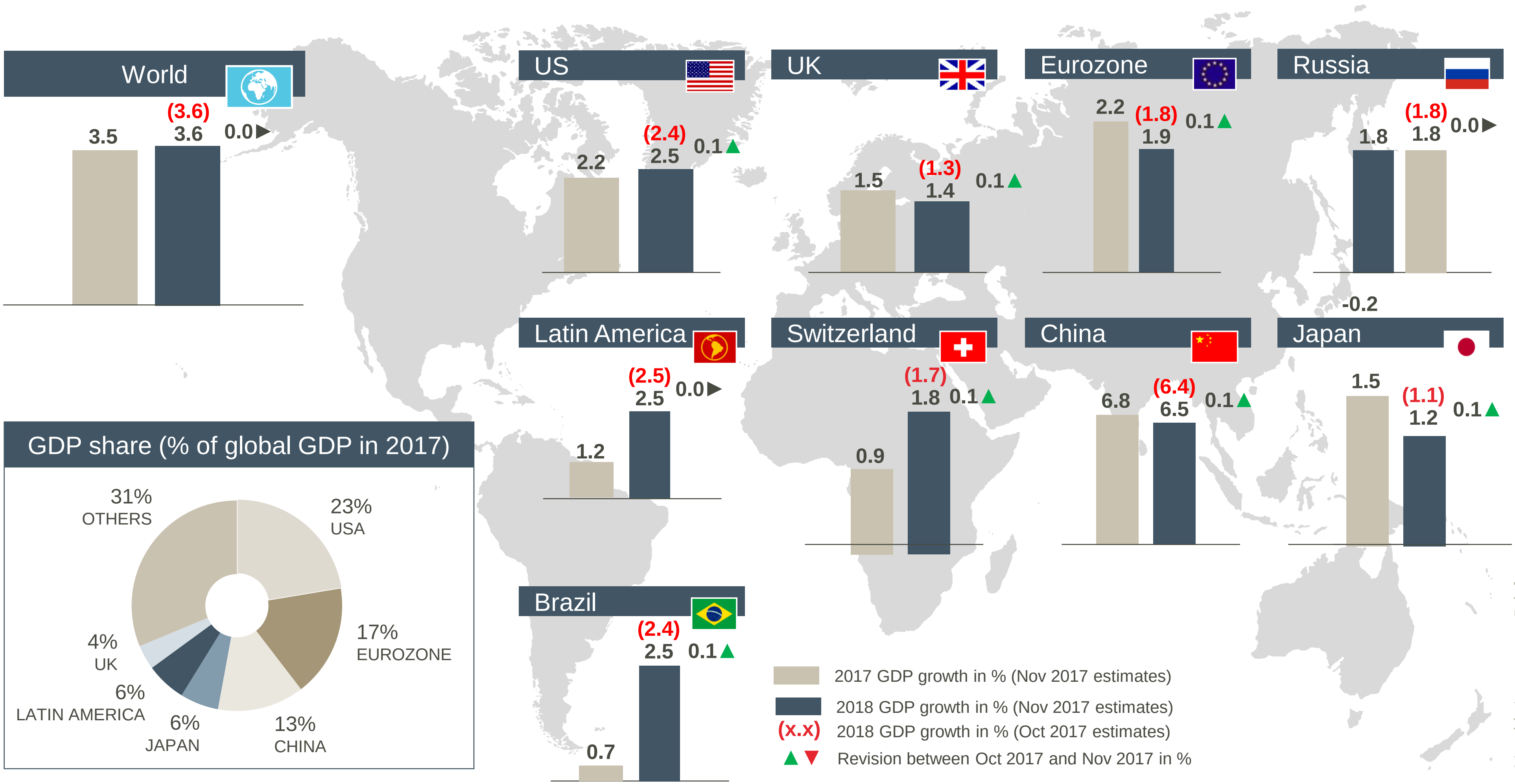


Past performance is not a reliable indicator of future performance and is not constant over time.

Sources: Bloomberg and BoA ML as of 11/30/2017; performance expressed in local currency

Global GDP* growth forecast

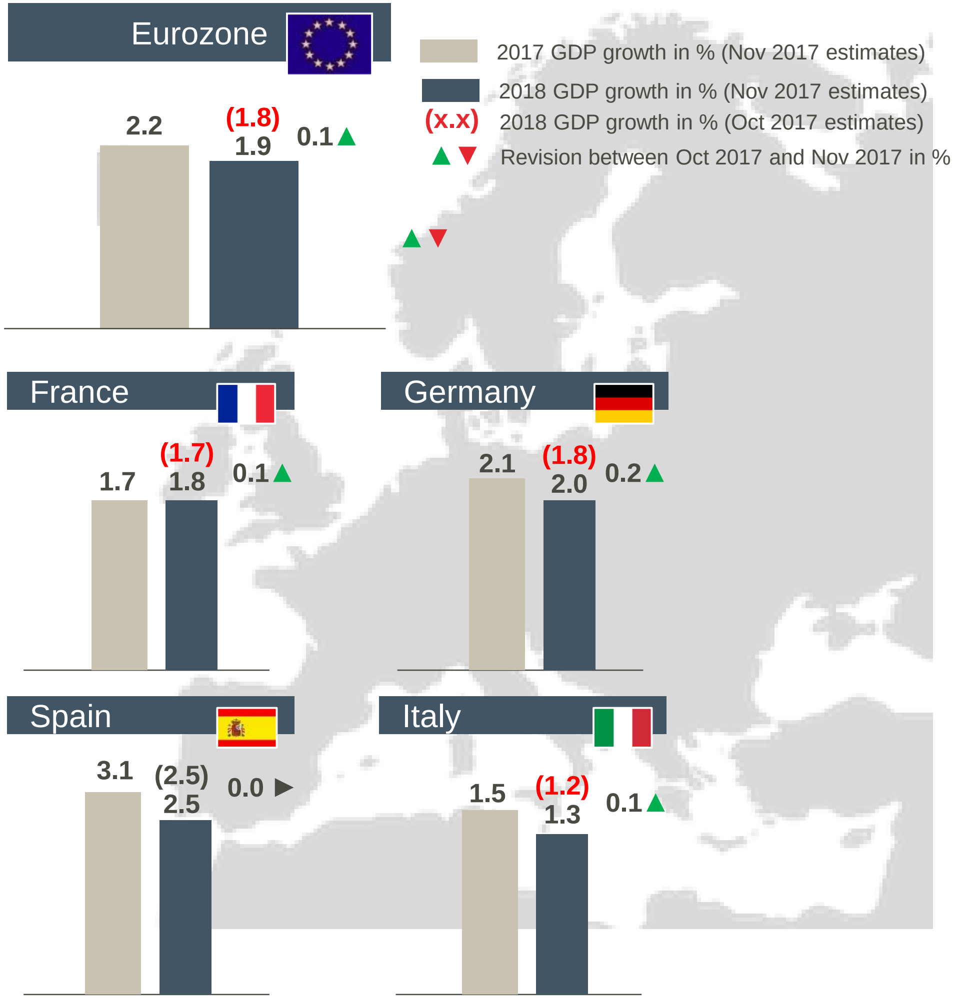
Good GDP growth dynamic

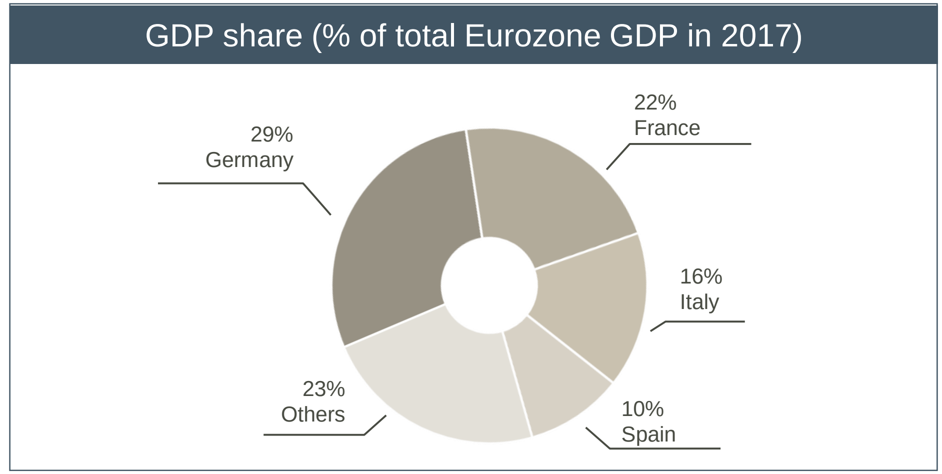


*GDP: Gross Domestic Product | Sources: ODDO BHF AM SAS, Bloomberg economist consensus forecast | Data as of 11/30/2017

Eurozone

Will structural reforms also (and finally) accelerate ?





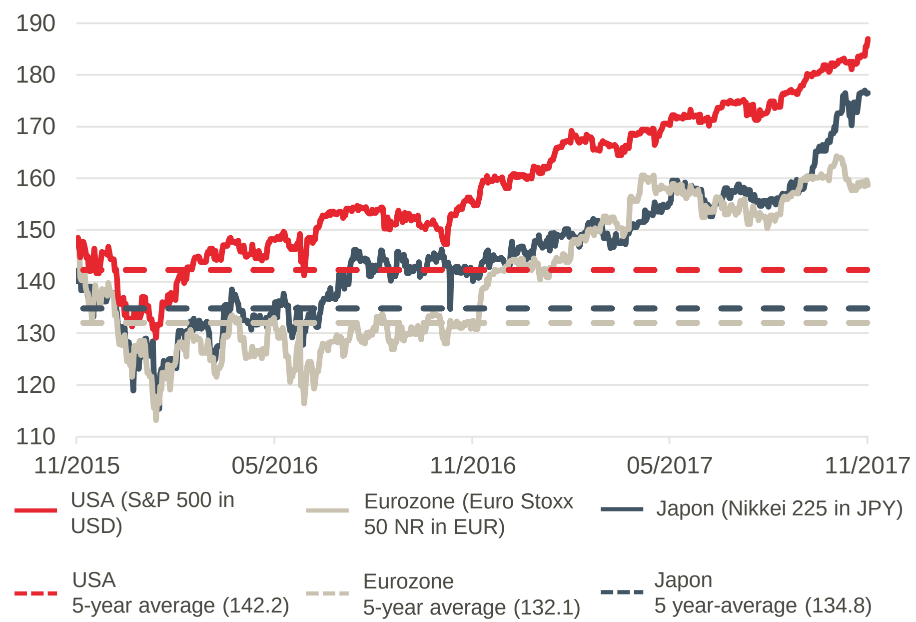
- Once again, growth expectations were revised upwards for almost all the European « big » economies, despite some political volatility.
- In Germany, the consensus as well as various official bodies – the Buba (Deutsche Bundesbank), syndicates, the group of Sages – all published a positive outlook about the German economy. The political situation remains unclear, with Mrs. Merkel so far unable to form a coalition.
- Despite great hopes, M. Macron faces the greatest difficulties in France to restore a march toward the equilibrium in public finances. It may condition significant advances for further European integration.
- In Italy, non performing loans have started to decline – as a % of total loans. The elections to come next Spring are not considered as a source of stress.
- In Spain, the Catalonian issue disappeared from the headlines and did not derail growth so far.

Sources: ODDO BHF AM S.A; Bloomberg Economist Forecast. Data as of 11/30/2017

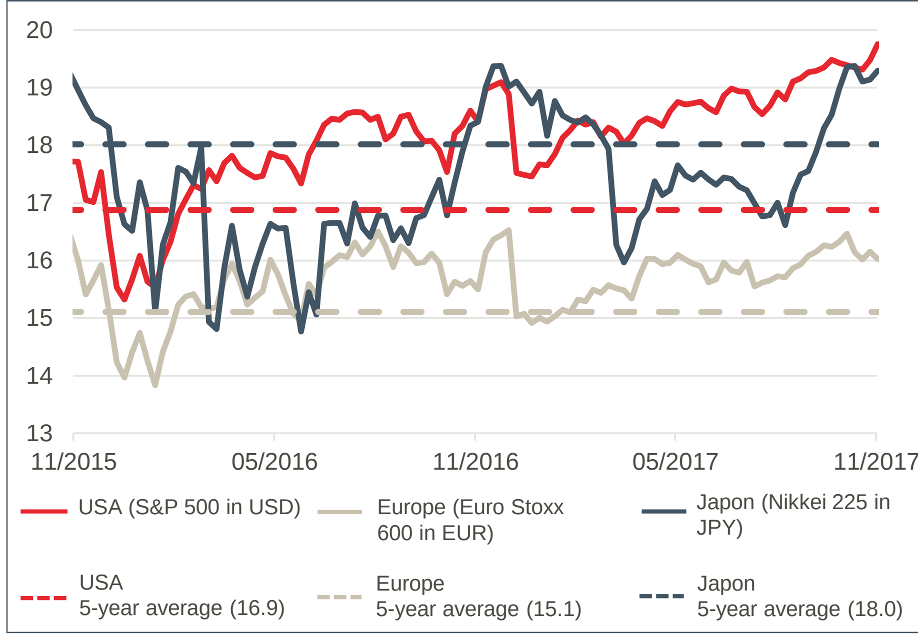
Equities – overview

Where will the US market stop ?

Two-year equity market performance (base 100 as of 11/30/2012)



Two-year price/earning ratio



- Significant divergence in terms of performance between the US (+3.2%) and Eurozone (-1.8%) in November.
- Q3 earnings publications and currency changes mainly explained the gap between to two areas
- Also interesting to mention the new positive developments for the Japanese market, up 1.4% in November and almost 12% in 3 months

- Another record month for US valuations with PE ratios now moving closely to 20x even if rotation has started to bite for some sectors in the last days of November
- On the other hand, the European market experienced another derating phase last month which has exacerbated the gap in valuations with the US
- Japan also strongly rerated in recent months but earning moment fully justifies this level in our view

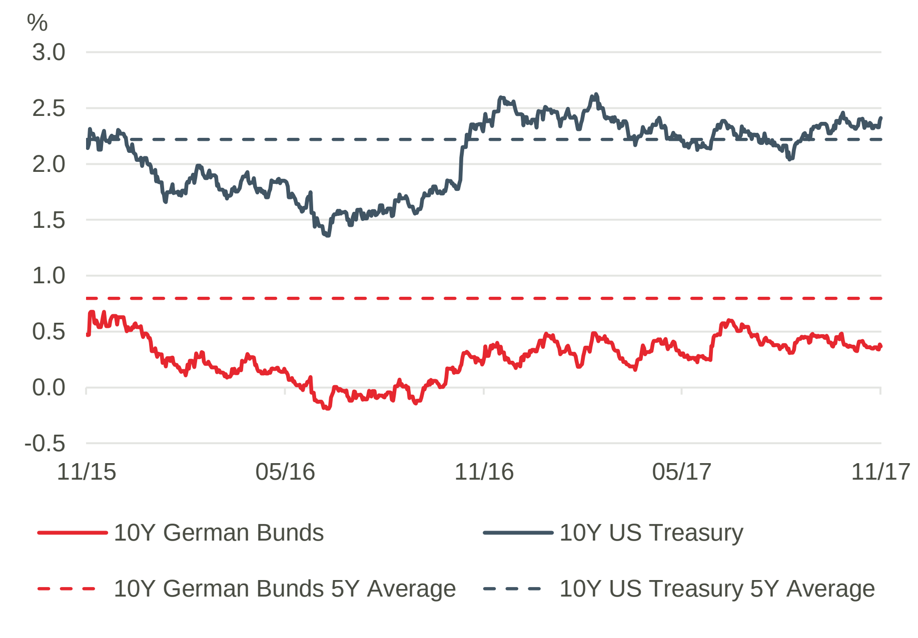
Past performance is not a reliable indicator of future performance and is not constant over time.

*Please refer to glossary on page 37 | Source: Bloomberg, ODDO BHF AM SAS | Data as of 11/30/2017

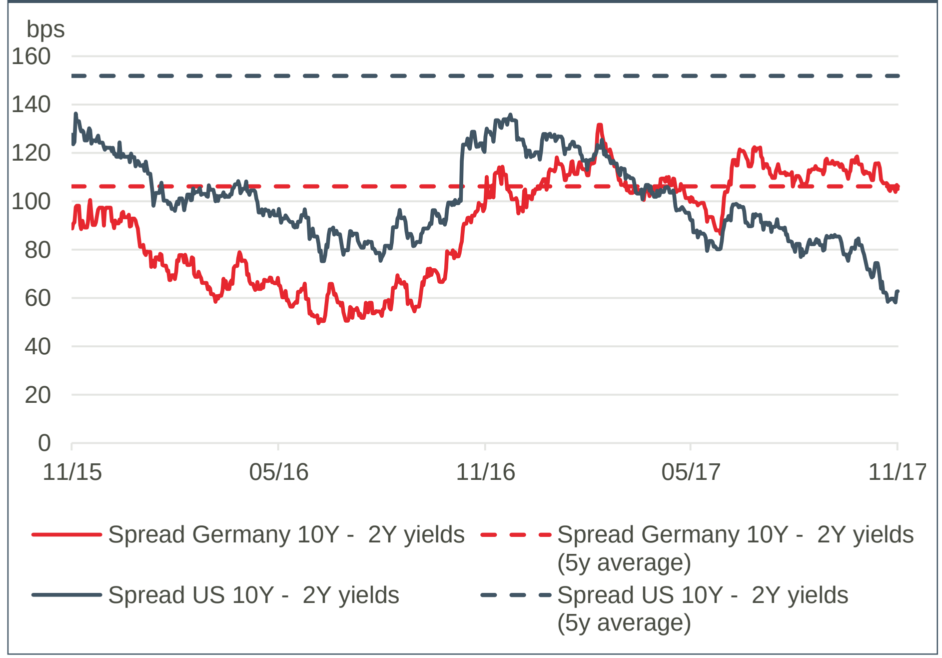
Fixed income – Rates

Beware of inflation surprises

German & US 10 - year bond yields (over 2 years)



German & US 2yr - 10yr yield curve (over 2 years)



- 10Y Bund and US-Treasury ranges are still holding given the extremely defensive unwinding of stimulus and undershooting inflation prints
- However, US-Treasuries and German Bunds are vulnerable to any positive inflation surprises and changes in the reaction function of central banks
- In particular US CPI has the potential to spark a recalibration of the FED normalization path

- Flattening of the US curve has been pronounced given inflation undershoots while policy is being tightened. Expect further bear flattening from here as FED is more aggressive than priced in
- Curve flattening is not a harbinger of increased recession risk in the US for the time being
- Bund curve steepening to continue after the recent pause as monetary policy normalization is continued, albeit in a very gradual mode

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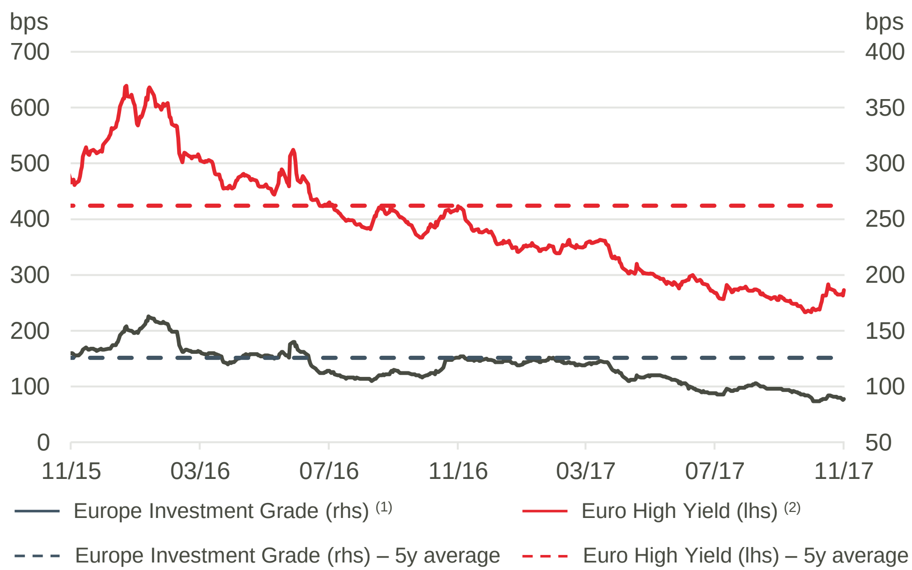
Sources: ODDO BHF AM SAS | Data as of 11/30/2017

Fixed income – Credit Spreads

Compression is mature but spreads can still grind lower

Credit spreads* IG & HY (over 2 year)

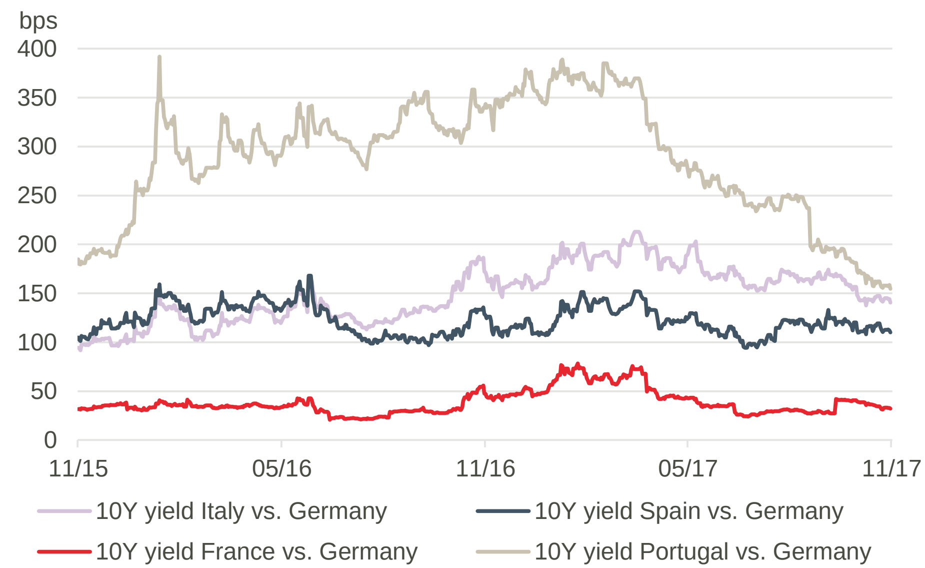


(1) BofA Merrill Lynch Euro Corporate Index (ER00)

(2) BofA Merrill Lynch European Currency High Yield Index (HP00)

- After a relentless spread tightening period, October recorded a first slight setback
- Credit will still be supported by an asymmetric tapering of ECB buying and a huge stock effect via balance sheet reinvestments
- Spread compression will be substituted by carry as the main performance contributor

Main Eurozone country spreads (over 2 years)



- Peripheral spread compression now more dispersed with Italy and Portugal gaining the most, while Spain stays flat
- Prospects are for slightly tighter spreads with a likely German grand coalition supporting Macron´s Eurozone friendly measures
- Italy still our preferred candidate, although the upcoming election may cause some ripples

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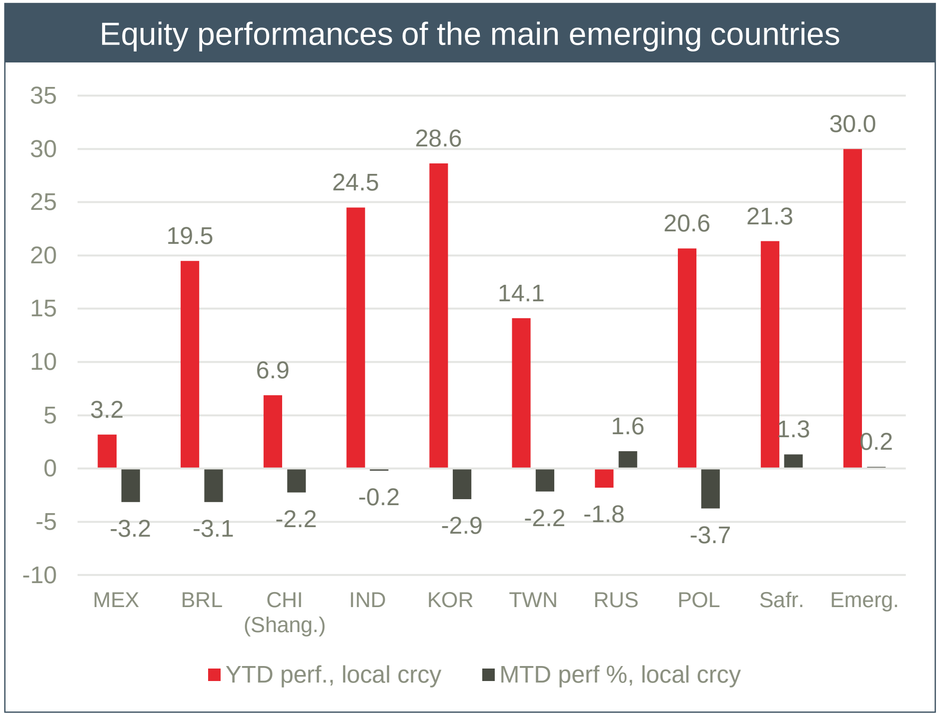
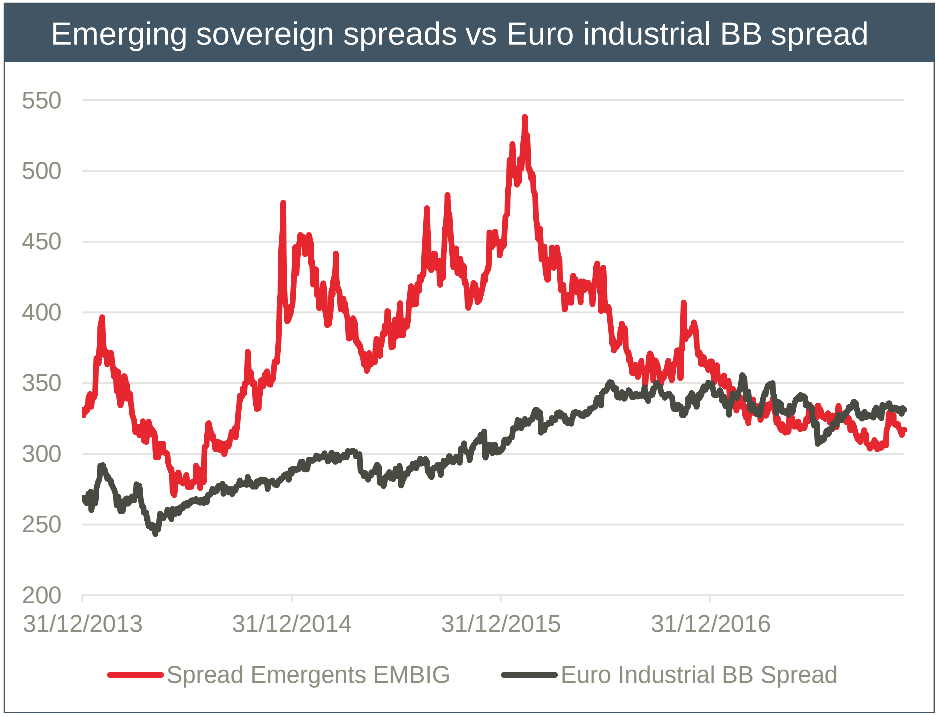
Sources: ODDO BHF AM SAS | Data as of 11/30/2017

Emerging markets

The tech cycle and Chinese reforms hit equity negatively





- Local equity indexes took a hit in October, following negative news coming from China and the tech sector globally. Furthermore, valuations look somewhat stretched, e.g. over their 5y and 12m averages for most of the countries
- In Emerging Markets, as in the rest of the world, sovereign spreads over Treasuries look tight. Over the month, they narrowed even more, as growth is not in danger and volatility remains in check. From a carry point of view, they are currently close to the spreads of BB rated European industrials (over the Bund curve).

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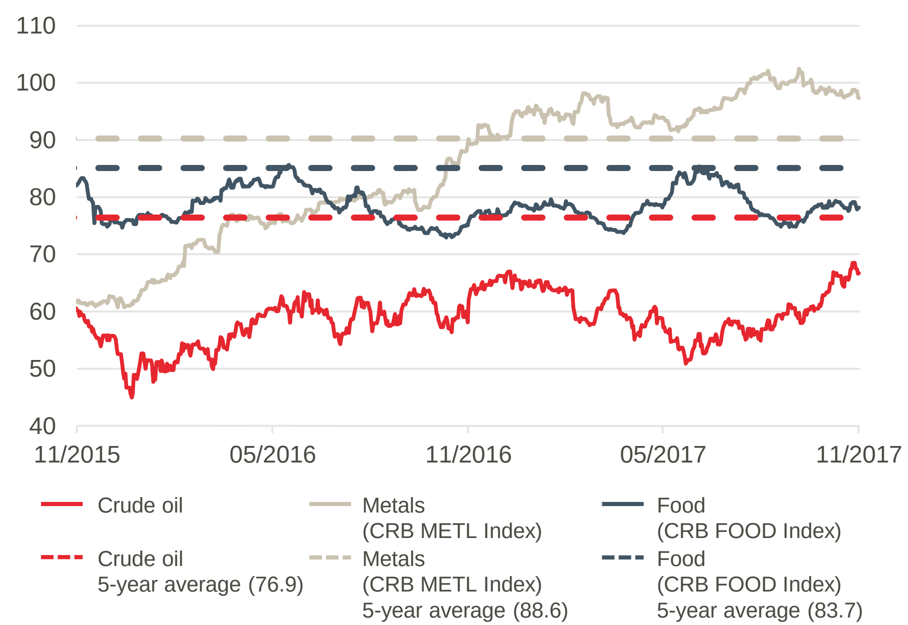
Sources: Bloomberg, ODDO BHF AM SAS | Data as of 11/30/2017

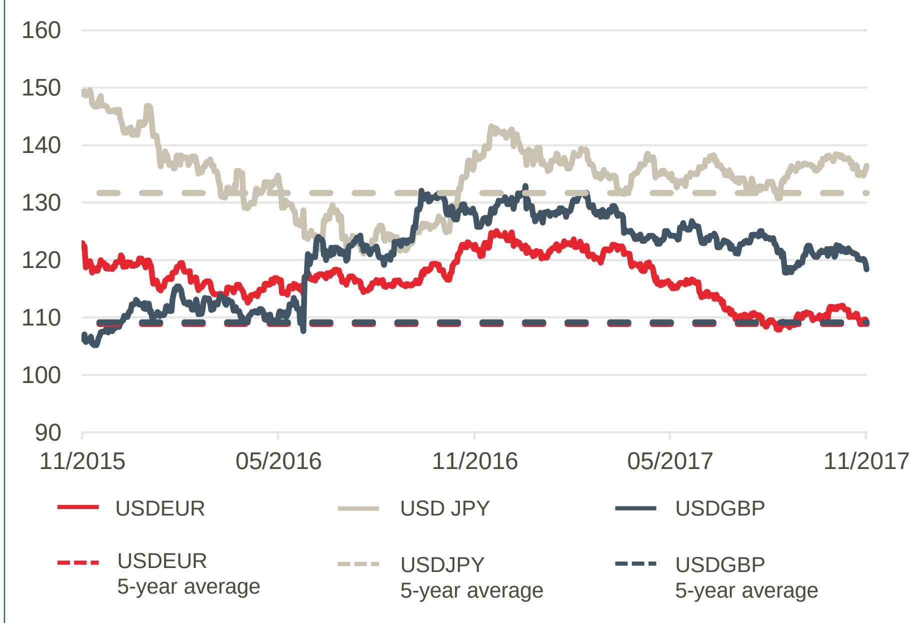
Currencies & commodities

Uncorrelated behaviours

Commodities- evolution over 2 years (base 100 as of 11/30/2012)



Currencies - evolution over 2 years (base 100 as of 11/30/2012)



- The oil rally went on over the month, helped by the (expected) extension of the agreement between the OPEC and Russia. They decided to stick to the agreed cuts until the end of 2018.
- The relative stability in metal prices hides a huge discrepancy : iron ore rebounded (+15%) after a sharp, whereas copper and aluminum prices declined slightly (-2% and -5% respectively). Battery metals (cobalt, nickel, lithium) remain on high demand.
- The main soft commodities do not currently suffer from shortages, even conversely for some of them (like wheat).

- Over October, the USD depreciated against the EUR by a bit more than 2%. At this stage, it can be considered as volatility inside a wider range, between 1.16 and 1.20.
- The greenback lost also ground against the JPY, mainly as a reaction to the risk on move in Asian equity: October macro data have disappointed over the region, the doubts about a possible peak in the tech sector emerged, and China took harsh measures to rein in its financial sector..
- The GBP appreciated, accelerating the uptrend after the announcement a deal had been found over the Brexit bill.

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Sources: Bloomberg, ODDO BHF AM SAS | Data as of 11/30/2017

Glossary

Performance calculation	Cumulative fund performance is calculated based on dividends reinvested. Annualised performance is determined on an annual, 365-day actuarial basis. A fund's performance relative to its benchmark index is expressed as arithmetic difference. Static indicators are generally calculated on a weekly tick that is taken on Fridays, or failing that, on the day prior to valuation.
Volatility	Volatility is a risk indicator measuring the level of fluctuations observed in a portfolio (or index) over a defined period. It is calculated as annualised standard deviation of absolute returns within a defined period of time.
Credit spread	The credit spread is the risk premium or the difference between the yields of corporate bonds and that of sovereign bonds with the same characteristics.
Investment grade	Investment-grade bonds are bonds issued by issuers rated between AAA to BBB- by Standard & Poor's.
High yield	High-yield bonds are speculative bonds rated lower than BBB- (Standard & Poor's) or the equivalent.
PE (price-earnings ratio)	A stock's price-earnings ratio is equal to the stock's price divided by the issuing company's earnings per share. It is also called the "earnings multiple". It depends mainly on three factors: the company's forecast earnings growth, the risk associated with these forecasts, and the level of interest rates.

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