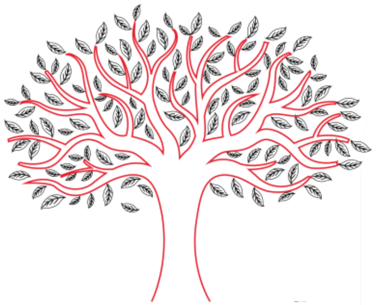
Monthly Investment Brief

Do trees grow to the sky?

March 2018



Although global growth is expected to slacken (to 3.7% in 2018), we remain very optimistic that the economy will remain at strong, synchronised levels, given little inflationary pressures and the support of accommodative monetary policies.

What risks could derail growth?

1. Inflation surprises: In January, the US consumer price index recorded its biggest monthly gain since 2005 at +0.35% month-on-month. On the wage front, inflation levels are reassuring, as hourly wages rose by just 0.1% on the month, its weakest increase since October. Let's face it: we don't see how it's possible to create so many jobs without wages moving up. Caution is clearly the watch-word.
2. Monetary policies: in the US, convergence between expectations of the Fed's monetary policy committee and investor expectations confirmed the general awareness that normalisation is in progress. Jerome Powell's recent statements about "avoiding an overheating of the economy" even suggest that four rates hikes are in the works, and not just three. At the ECB, Mario Draghi was perfectly clear: growth is solid but inflation remains weak. The pace of normalisation will therefore remain extremely gradual and no rate hike is expected until mid-2019. So there's lots of time.
3. Tariff barriers: the US is running trade deficits with more than 100 countries, including China (USD 380bn) and the euro zone (USD 132bn). The real risk is in potential reprisals affecting Chinese goods.

What are our convictions? Our scenario from early this year is still intact. We continue to overweight equities and to underweight bonds The recent sell-off has made equity market valuations attractive once again, with 12m forward P/Es at 17x in the US and 15x in Europe. We are shifting from mid/small caps to large caps in Europe, which, in our view, offer greater upside potential. On the bond front, we have stepped up our sales of German government bonds, are moving back into Italy and are tactically reducing our exposure to high-yield bonds, which no longer offer a high enough risk premium compared to equities. Ultimately, companies are adjusting very well to this new environment and recent analyst upgrades on earnings capacities (respectively, +18% in the US and +10% in the euro zone) attest to their solid health.

Let's stay the course while keeping an eye on volatility. If volatility were to rise on a sustained basis, we would reduce our risk budget.

Our 6-month view

Baseline scenario: robust global growth (in the US, Europe, and emerging markets)

75%

Europe

- Acceleration in growth, driven by improved credit conditions and receding unemployment
- Gradual normalisation of monetary policies, although they will remain highly accommodative, and markets driven more by trends in the real economy than central bank support

US

- An economy at cruising speed, and Trump's tax reform should have a positive impact
- The normalisation in monetary policy is gradual and is likely to remain so
- Uncertainties involving protectionism

Emerging markets

- At different points in the cycle: from "exit from contraction" (Mexico, South Africa) to "advanced maturity" (South Korea); no Chinese mishap
- Continued recovery in the credit cycle (except in China), although central banks will be less and less accommodative
- Prices continue to rebound

Assets to be overweighted

- Equities
- European corporate bonds (HY vs. IG)

Assets to be underweighted

- Government bonds

Strategy

- Flexibility
- Hedges (options, gold, etc.)

Alternative scenario: moderate growth and surprisingly high US inflation

15%

- Acceleration in wages and/or oil prices
- New trend decline in growth rates
- Rapid rise in government bond yields

Assets to be overweighted

- Inflation-linked bonds
- Alternative strategies
- Cash

Assets to be underweighted

- Equities
- Core government bonds
- High yield corporate bonds

Alternative scenario: slower growth and risks to international trade, due to protectionism

10%

- Geopolitical risks play out
- US: A new dip in consumption and gross fixed capital formation
- China: risks of economic rebalancing
- Europe: "Japanese-style" growth

Assets to be overweighted

- CHF and JPY money market
- Volatility
- Core government bonds

Assets to be underweighted

- Equities
- High-yield corporate bonds

The opinions expressed in this document correspond to our market expectations at the time of publication.
They are subject to change with market conditions and may under no circumstances incur the contractual liability of ODDO BHF Asset Management SAS.

Our current convictions by asset class – baseline scenario

	Change vs. previous month ↗	Level of our convictions
Equities	Euro zone large cap equities →	2
	Euro zone mid-cap equities →	1
	Euro zone small cap equities →	1
	UK →	-1
	US →	1
	Emerging economies ↗	1
	Japan →	1
Convertible bonds	Europe →	0
	US →	0
Government bonds	Core Europe →	-1
	Peripheral Europe →	-1
	US →	-1

Source: ODDO BHF AM SAS. Data as of 28 February 2018

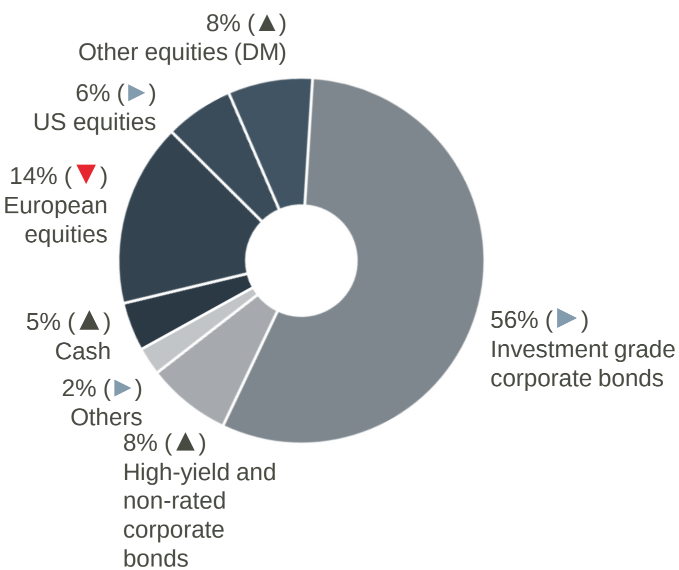
Our current convictions by asset class – baseline scenario

		Change vs. previous month	Level of our convictions
Corporate bonds	Investment grade Europe	→	0
	Short-duration	↘	1
	European high yield*	↘	0
	US high yield*	↘	0
	Emerging economies	→	0
Money market	Developed markets	→	-2
Currencies	USD / €	↗	1
	YEN / €	→	0
	GBP / €	↘	-1
Commodities	Gold	→	1
	Crude oil	→	0

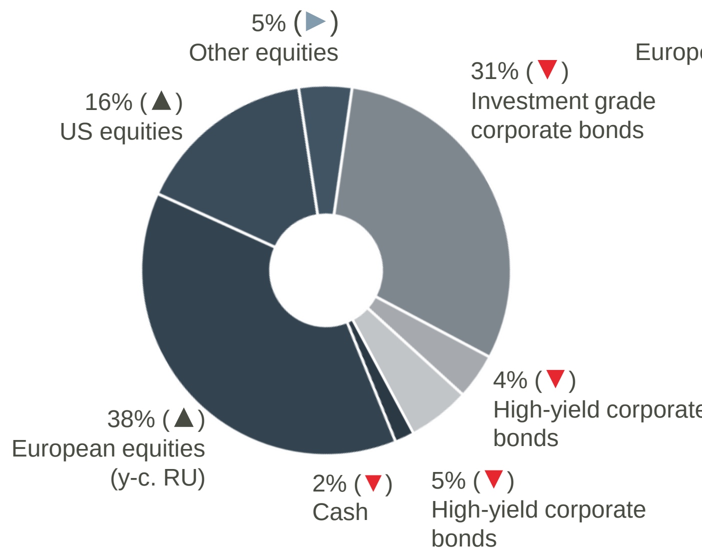
Source: ODDO BHF AM SAS, Data as of 28 February 2018

Our model portfolio

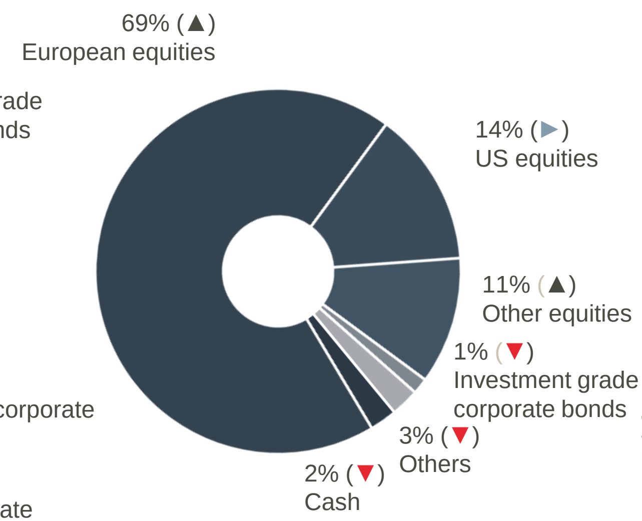
Defensive



Balanced - Dynamic



Aggressive



▶ Change vs. previous month

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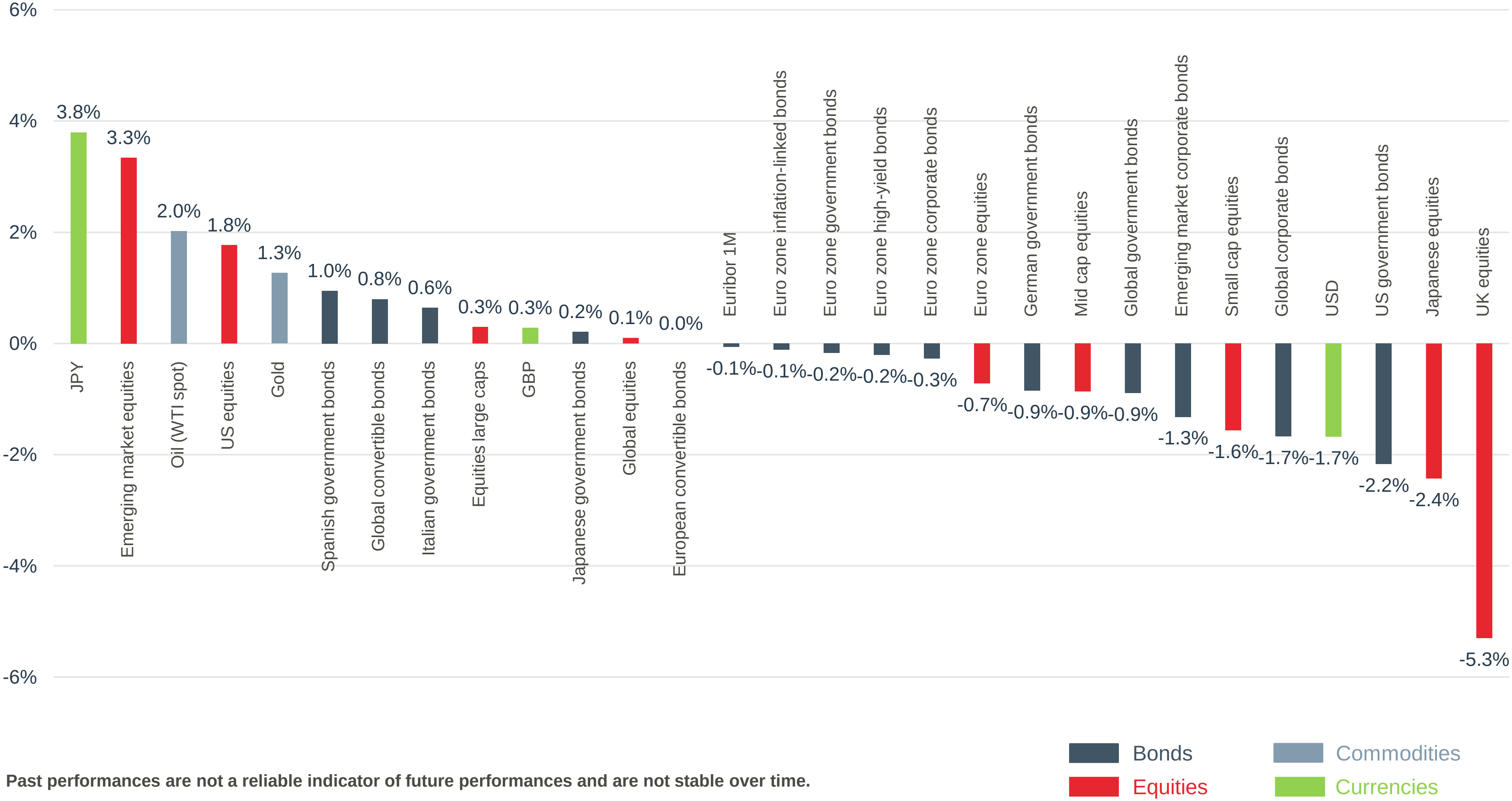
Source: ODDO BHF AM SAS | Data as of 28 February 2018

Year-to-date performance of asset classes



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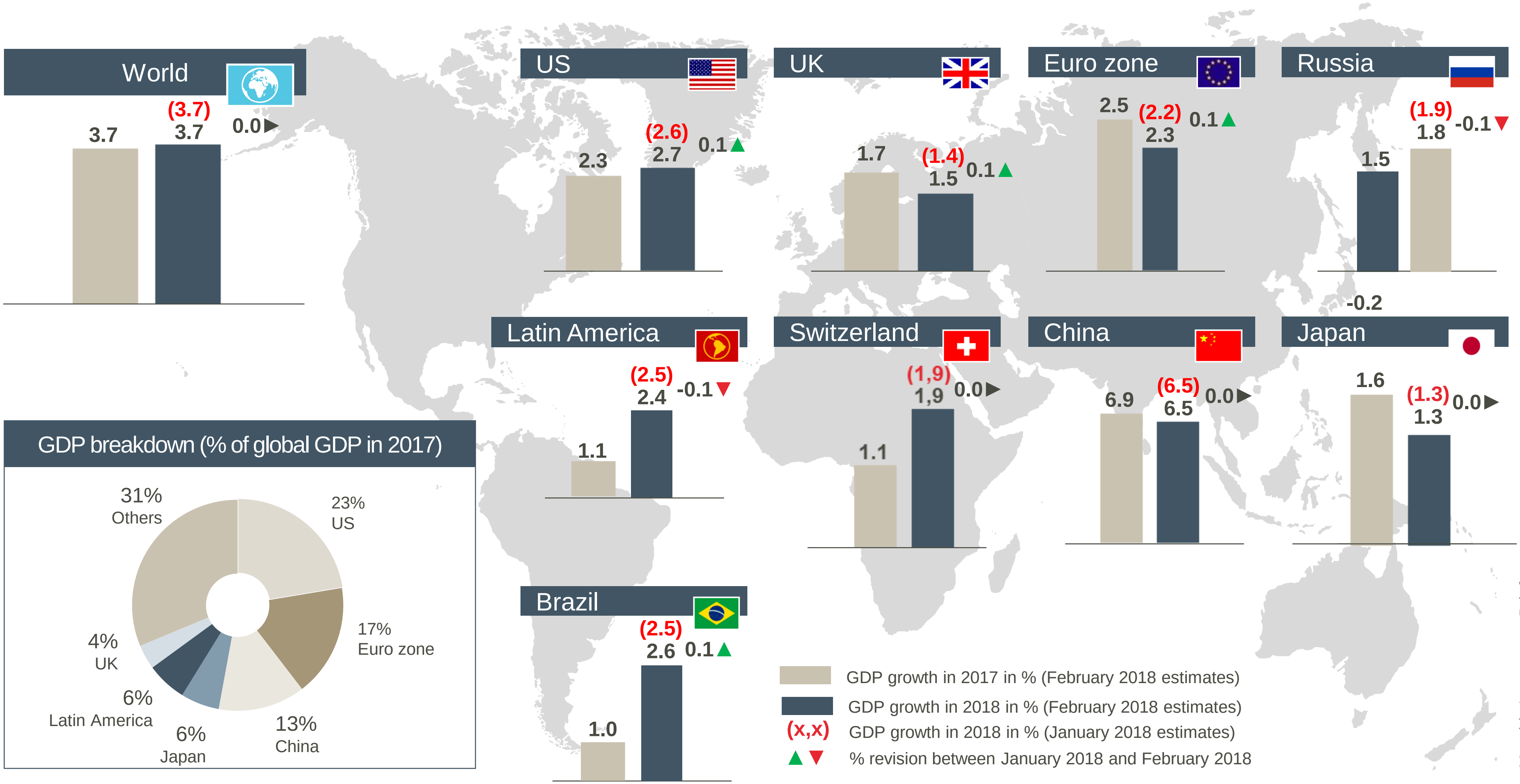
Past performances are not a reliable indicator of future performances and are not stable over time.

Sources: Bloomberg and BoA ML as of 28 February 2018; performances expressed in local currencies

Global GDP growth forecasts*

Growth may have levelled off but remains above its potential and with a positive output gap



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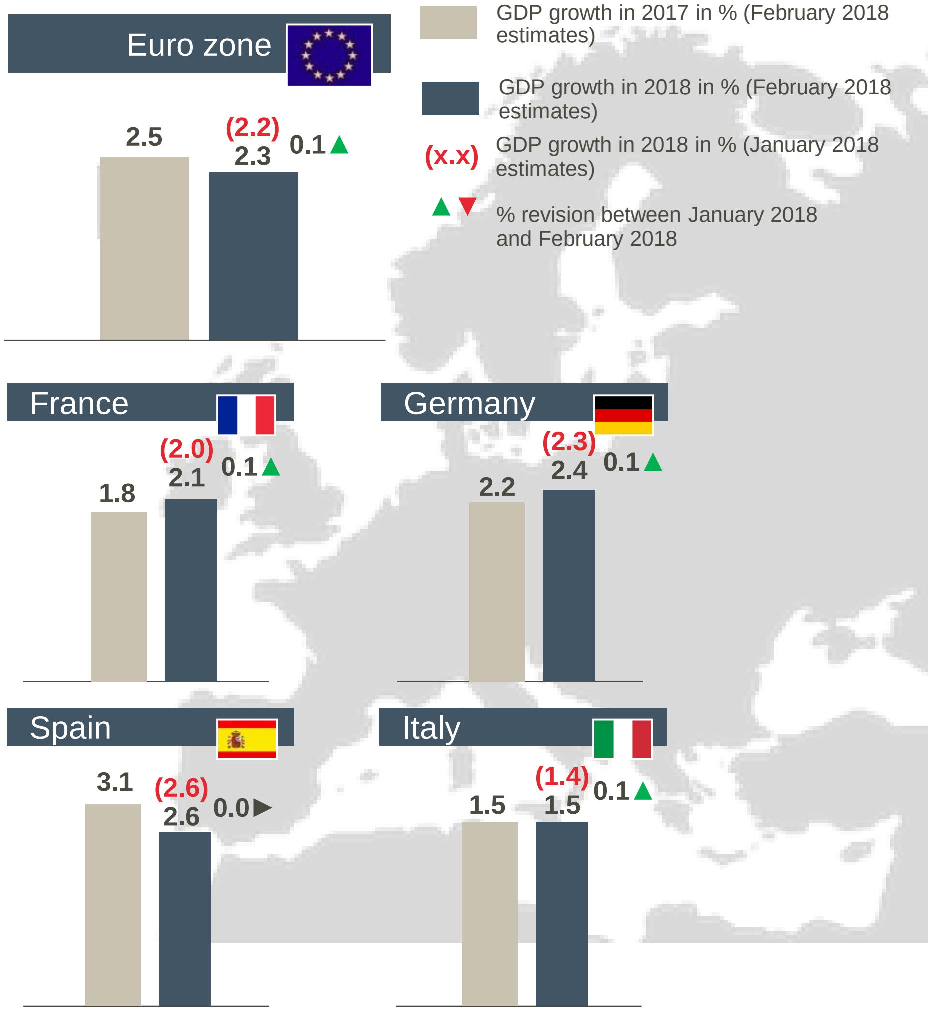
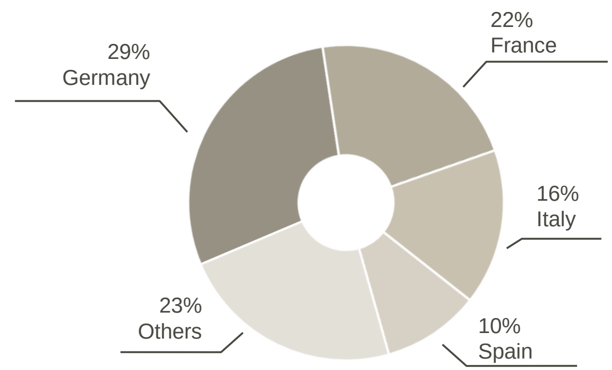
*GDP: Gross Domestic Product | Sources: ODDO BHF AM SAS, Bloomberg economist consensus forecast | Data as of 6 March 2018

Euro zone

The political agenda is not as busy



Breakdown in GDP (% of total euro zone GDP in 2017)



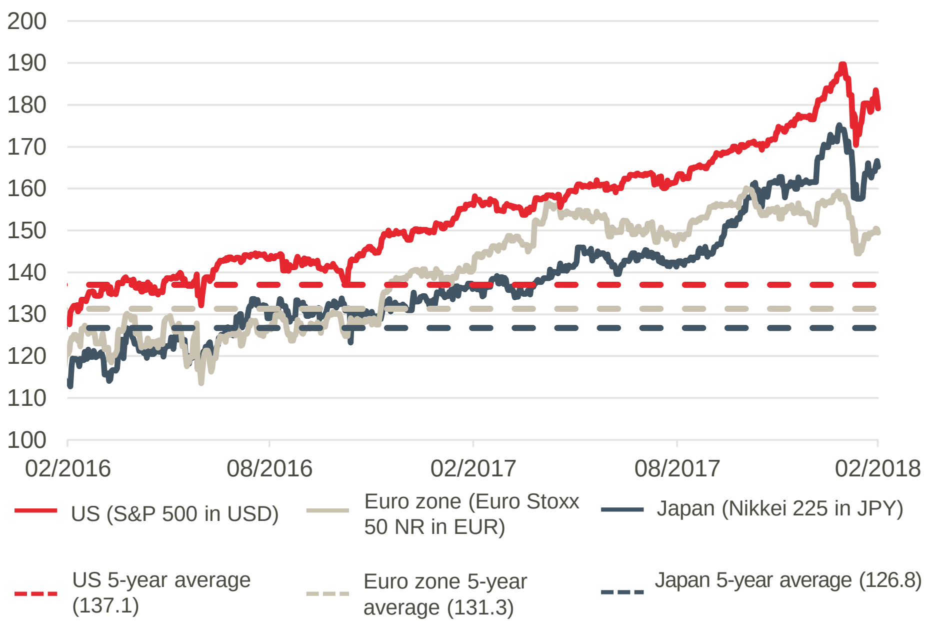
- Although the Italian parliamentary elections did not turn out as expected, the uncertainty hovering above the event itself has now vanished, with a “technical” government now in place for the coming weeks/months.
- Most importantly, the CDU-SPD coalition is now in place, and Franco-German cooperation will probably increase. An acceleration in tax convergence has already been announced and will at first apply to companies.
- The growth outlook continues to be revised upward by the consensus, to 2.3% for the current year, from 2.2% previously.
- The synchronisation of cycles between the main euro zone countries is likely to continue into this year.

Sources: ODDO BHF AM S.A, Bloomberg Economist Forecast. Data as of 6 March 2018

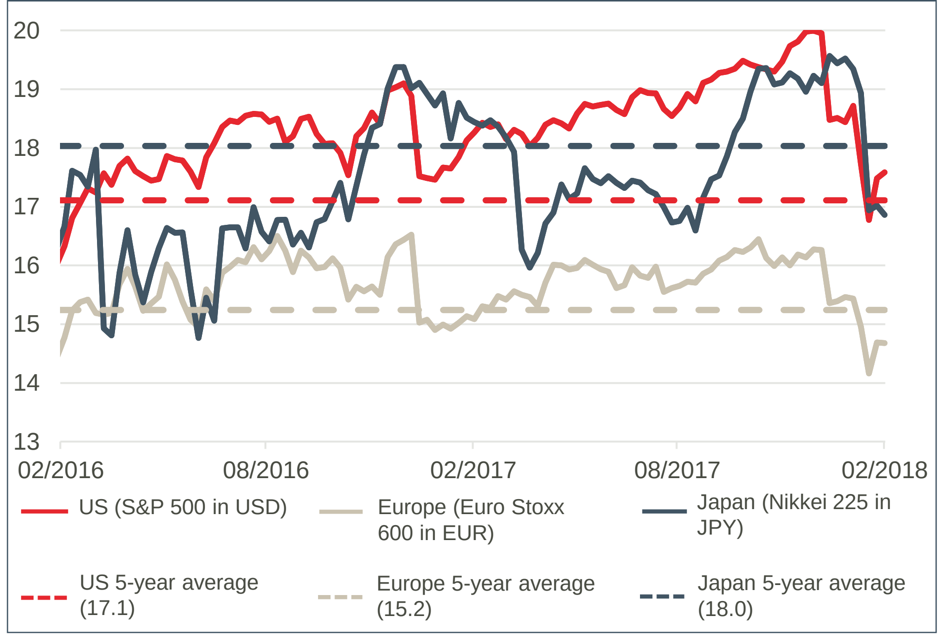
Equities – overview

Return of volatility in February

Two-year equity market performance (base 100 at 28 Feb. 2013)



Two-year trend in the price/earnings ratio



- The volatility that emerged on the equity markets in late January spilled over into February, with drops of about 4% on most global markets
- The S&P 500's flying start in January ended up keeping it in positive territory for the first two months of the year (+1.8%)…
- …unlike European (-1.6%) and Japanese (-3% in yen) markets

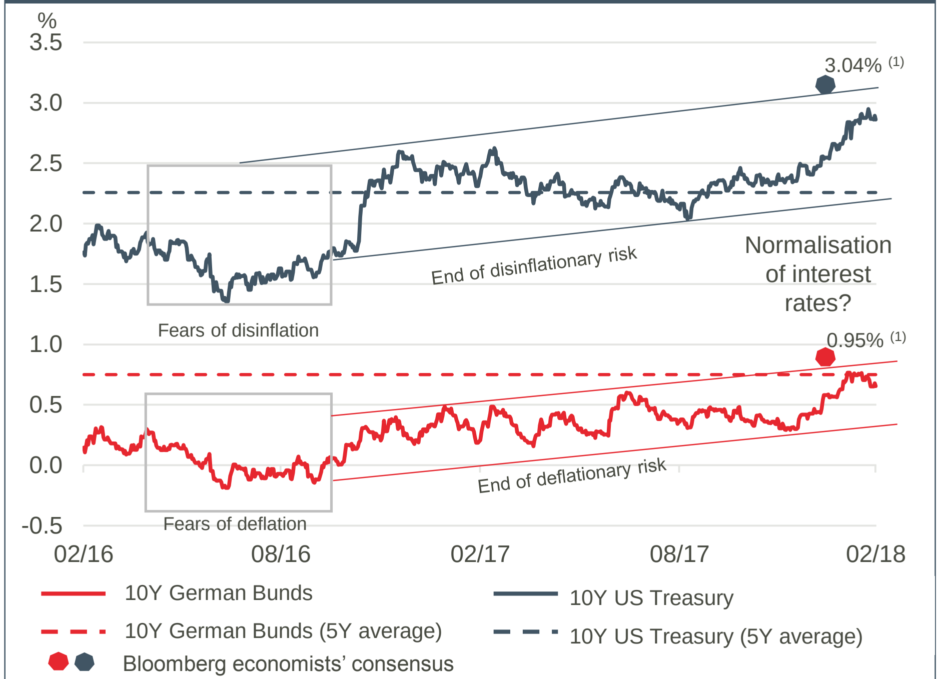
- Market drops and upgrades in earnings forecasts (see following page) have resulted in a sharp decline in valuations
- While the US market is still slightly more expensive than its 5-year average, European markets are now trading at a discount to their 5-year averages, and Japanese markets even more so
- Euro zone P/E has now moved back below 15x

Past performances are not a reliable indicator of future performances and are not stable over time.

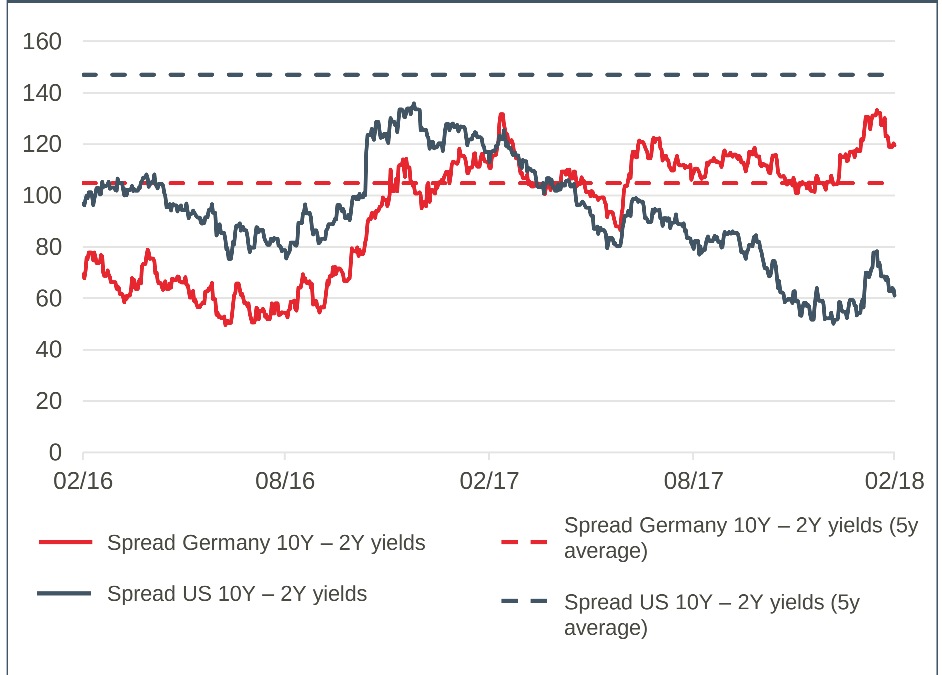
*See Glossary on page 37 | Source: Bloomberg, ODDO BHF AM SAS | Data as of 28 February 2018

Another false dawn for bond vigilantes?

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



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



- 10-year Bund and US-Treasury yield levels have temporarily peaked in February as investors have adapted to a steeper Fed Fund path in the US and slightly higher inflation prints
- We expect US-Treasuries and German Bunds to remain vulnerable to any sharper positive inflation surprises and changes in the reaction function of central banks and therefore have a defensive duration stance

- Flattening of the US and EUR curves has been pronounced given policy recalibration, while the market still does not buy the reflation theme
- That may change and result in a temporary steepening phase for both curves
- However, medium-term curves should flatten

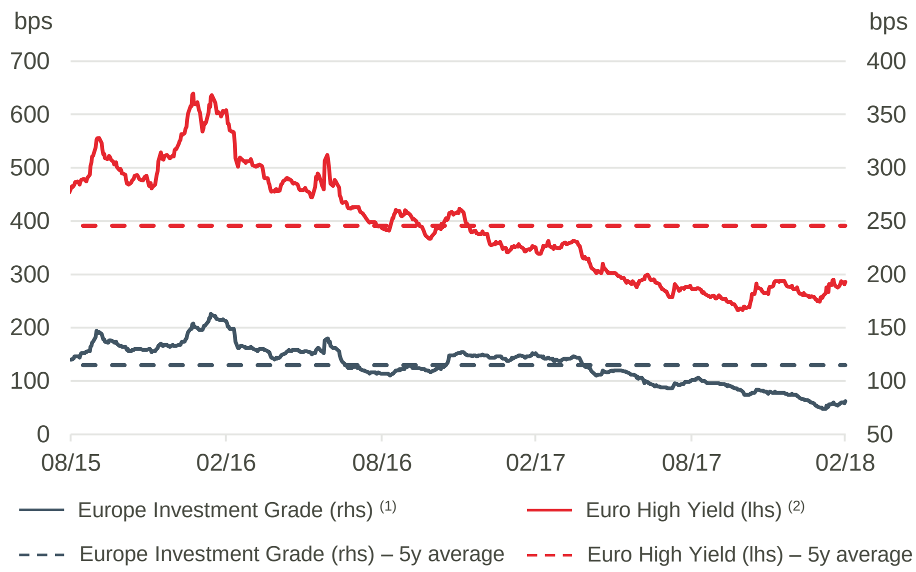
Past performance is not a reliable indicator of future performance and is not constant over time.

(1) Bloomberg Economic Forecast Sources: ODDO BHF AM SAS | LHS: Data as of 28/02/2018; RHS: Data as of 28/02/2018

Fixed income – Credit Spreads

Compression is mature but credit is still the default asset class

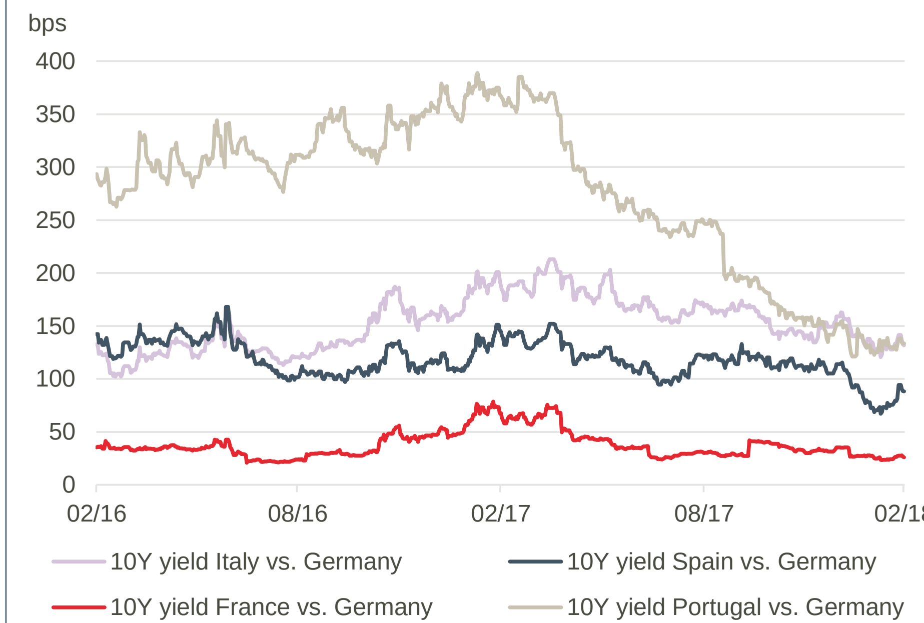
Credit spreads* IG & HY (over 2 year)



(1) BofA Merrill Lynch Euro Corporate Index (ER00)
(2) BofA Merrill Lynch European Currency High Yield Index (HP00)

- 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 clearly more dispersed with Spain and Portugal leading the ranks
- With the Italian election out of the radar screen and the forming grand coalition in Germany strengthening the Eurozone intergration, prospects are for tighter spreads
- Italy still our preferred candidate given the catch-up potential

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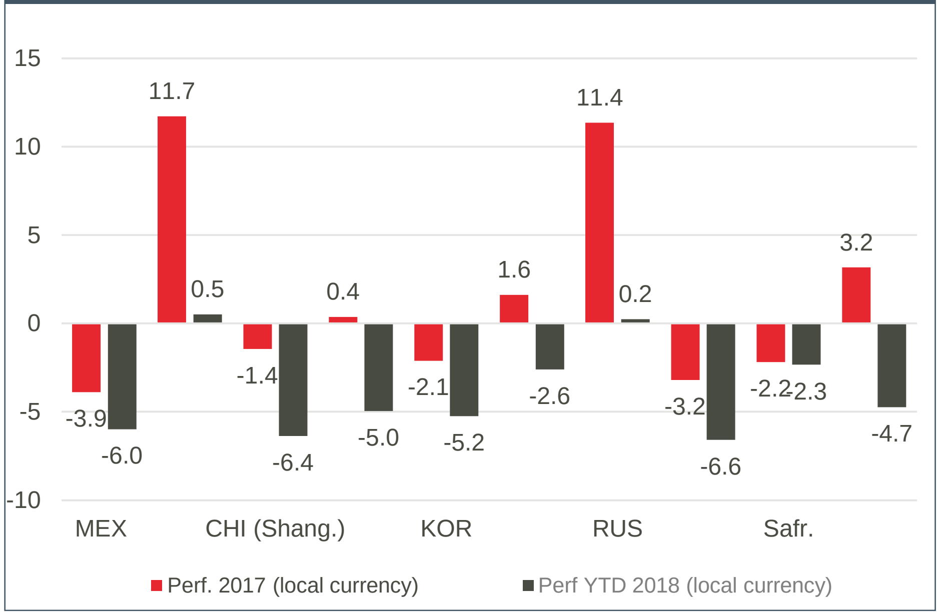
Sources: ODDO BHF AM SAS | Data as of 28/02/2018

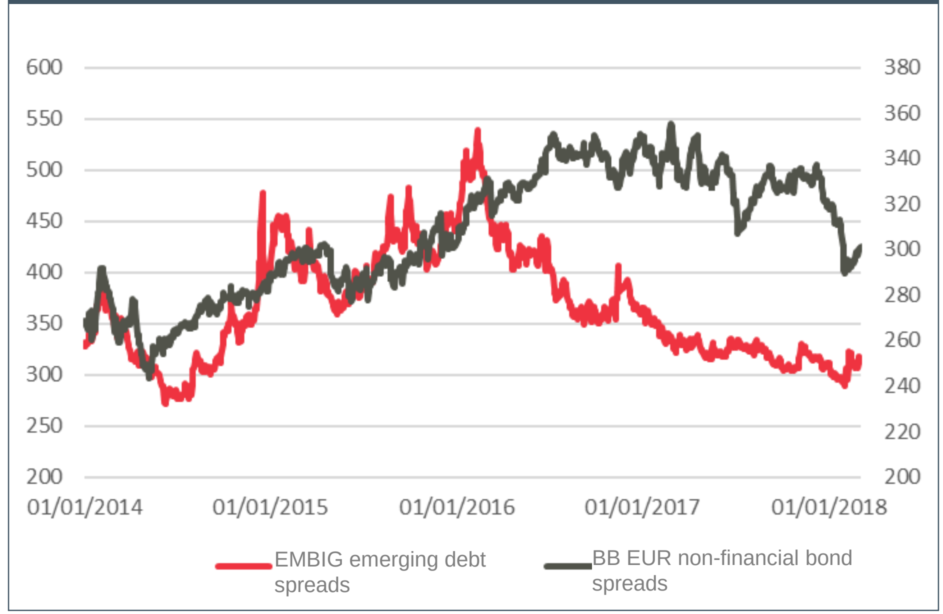
Emerging economies

Solid – and novel – resiliency during the recent spike in volatility

Equity performances in the main emerging economies



Emerging debt spreads vs. BB non-financial spreads in EUR



- Emerging economies were not spared by the recent spike in volatility, but the microeconomic and macroeconomic environments both remain favourable to risk-taking.
- Growth continues to accelerate in many countries, with positive surprises recently in Brazil and South Africa. Inflation is slowly moving back up, as is the credit cycle (except in China). As for the Fed, normalisation is unlikely to accelerate. Regarding the risks of a trade war: 1) the measures have triggered such fierce fallout that it is not sure that Mr Trump can adopt any others; and 2) reprisals must go through the World Trade Organisation, and that reduces the risk of an escalation.
- The muted reaction of local currencies to the recent spike in volatility suggests that emerging economies have made progress in terms of macro-financial stability.

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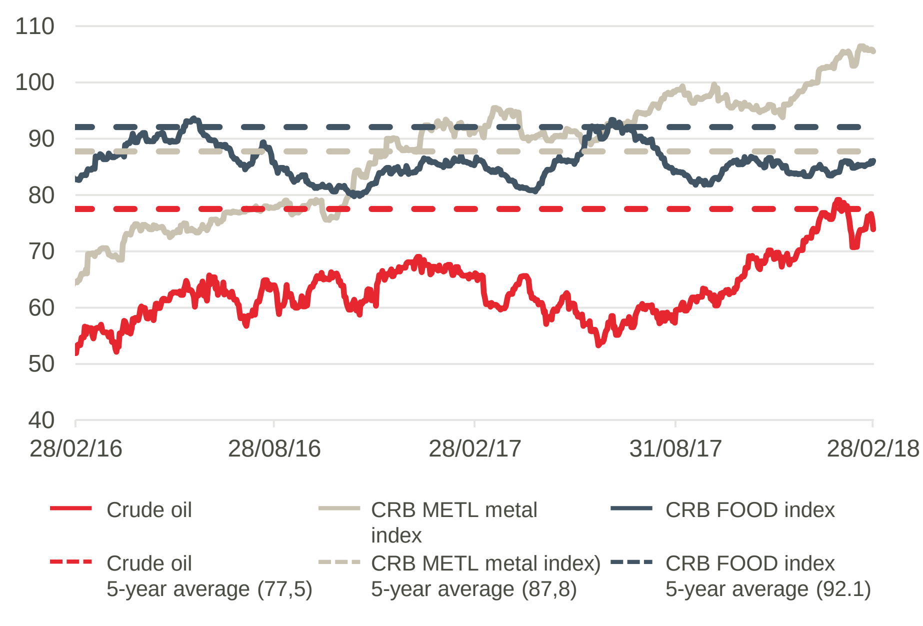
Sources: Bloomberg, ODDO BHF AM SAS | Data as of 28 February 2018

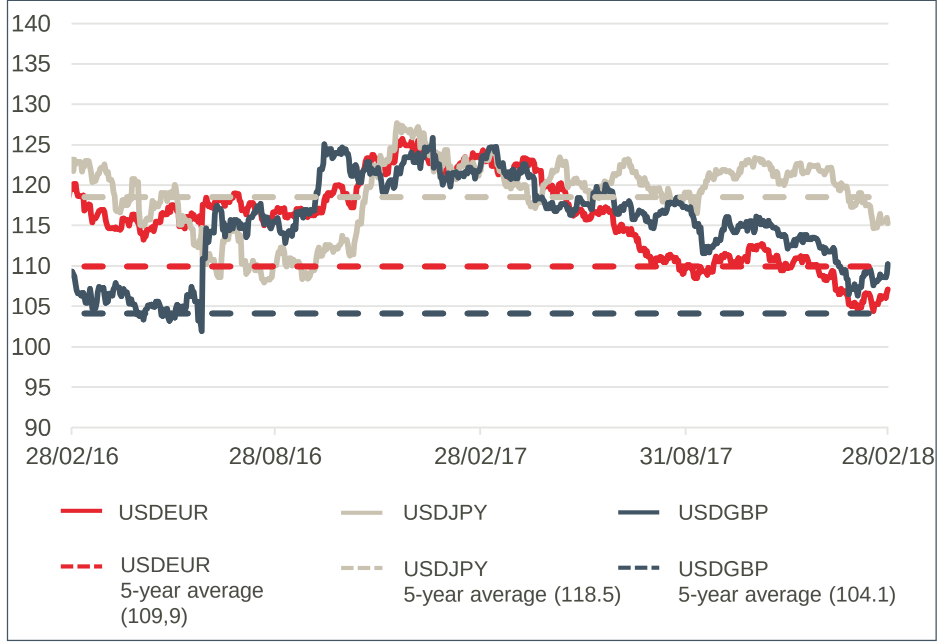
Currencies and commodities

A break in the dollar's depreciation

Commodities: two-year trends (base 100 at 28 Feb. 2013)



Currencies: two-year trends (base 100 at 28 Feb. 2013)



- Oil prices declined by about 6.5% in February, after rising by almost 60% between June 2017 and mid-January 2018. In addition to technical factors, the pullback was driven by the risk of a greater-than-expected Chinese slowdown, a risk that investors are currently concerned about.
- Metals ended the month where they began it. However, the global industrial cycle was extraordinarily strong in late 2017 and, now that inventories are high, metal prices could very well decline somewhat.
- Agricultural commodities were relatively stable, but an upward trend appears to be taking shape, and some prices are already high, such as for rice and Indian onions.

- The US dollar gained almost 1.7% vs. a basket of developed economy currencies. Between mid-November 2017 and end-January, it had lost more than 6.5% vs. the same basket.
- Most currencies were hit by this correction, in particular the euro (-1.8%) and sterling (-3.1%).
- Rather typically for a phase of heightened volatility, the yen strengthened during the period, by 2.3%.
- The main emerging economy currencies lost only 1.2% in February, which is a sign of that their macro-financial conditions have strengthened in recent years.

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Sources: Bloomberg, ODDO BHF AM SAS | Data as of 28 February 2018

Glossary

How performances are calculated	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 spreads (credit premiums)	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 of the equivalent.
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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Notes