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HORIZONS

1st quarter 2020

SPECIAL EDITION: 2020 OUTLOOK

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Finding equilibrium in a non-cooperative world

- FIXED INCOME -

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FINDING EQUILIBRIUM IN A NON-COOPERATIVE WORLD

Philippe Waechter
Chief Economist

The central banks are set to pursue monetary accommodation right throughout 2020, reluctant to risk curbing the world economy, which continues to develop at a pedestrian pace with no expectations of a swift upturn in growth. The world of today is less cooperative and the approach is less coordinated, as reflected in the United States' trade policy and the surge in populism in both developed and emerging countries. So it would be misguided to expect a major fiscal stimulus plan on a par with the G20's efforts in London in April 2009 to set growth on a stronger track.

Accommodative monetary policy helps keep a lid on risks, and this is particularly vital when we consider ongoing moderate price rise projections that are unlikely to trigger a quickening in inflation. Wage trends look unlikely to put a sufficient squeeze on corporate margins to push up sales prices, while the impact of competition is such that companies' ability to hike prices is also curtailed. This no-show for inflation also prompts the central banks to stick to their unrestrictive approach: the ECB has not managed to hit its inflation target over the past several years so it has no reason to take a tougher approach and risk potential deflation.

> ***"Wage trends look unlikely to put a sufficient squeeze on corporate margins to push up sales prices."***

War is set to last

Economic activity has failed to pick up the pace as a result of three factors. Firstly, potential growth in developed markets is weaker than before, which restricts the emergence of sustainably strong impetus for the economy. Secondly, growth is slowing in China, and the country's previous role as a driving force for world growth has dwindled with it. The country's economy is now less manufacturing-based and more services-oriented, so this means lower productivity gains. Meanwhile, private

sector debt is forcing the central bank to keep a handle on financial developments and prevent any potentially unsustainable future situations. Thirdly, Donald Trump's trade war – admittedly a more short-term factor – also accounts for the manufacturing sector's current slowdown worldwide. The US president's strategy on this issue fits perfectly with his economic viewpoint as he sees the world economy as a zero-sum game, and is unlikely to change tack in 2020. Outside nationalities can once again be used as the perfect scapegoat to sway voters during an election year, just like in 2016.

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It is also worth noting that the likely trade agreement with China will only involve agriculture. China has had difficulties with swine fever, which has decimated the country's pig livestock and sent prices soaring, leading to a recent uptick in inflation. In the US, protectionist measures have severely hit farmers, as soybean sales have plummeted with China now turning to Brazil for its supply. Any potential agreement will not address the fundamental issues, particularly on technology.

Political risk lying in wait

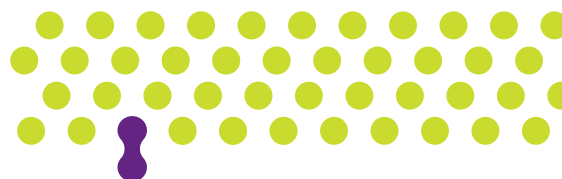
Long-term interest rates in the euro area are set to remain in negative territory, particularly in Germany, but probably also in France, and this situation looks likely to characterize the euro area for quite some time to come. However, the surprising aspect here is that this is not an issue in the US, as debt with negative interest rates is non-existent across the pond. This euro area phenomenon is due to the economic policy mix as fiscal policy has systematically been restrictive in the zone since 2011, thereby hampering growth – and inciting the ECB to pursue highly accommodative monetary policy to keep the risks on economic activity in check. Herein lies the explanation for negative interest rates. Fiscal policy that does not hinder economic growth would lead to a better balance and enable the euro area to steer clear of negative interest rates. The policy mix is more balanced in the US and fiscal policy has never acted as an impediment to growth since 2008. This marks a real difference, with an extremely worrisome impact for the European financial and banking sector.

A final factor to consider for the year ahead is political risk. In a less cooperative world, local political aspects can take on greater importance and extend their reach. Looking firstly to the US, 2020 is election year, with the presidential election slated for November 3. It is worth noting the extensive divergence in candidates' electoral platforms, reflecting a more disparate US society, as well as the incumbent's weaker position as a result of the impeachment process. Political aspects will also be key in China in

> ***In a less cooperative world, local political aspects can take on greater importance and extend their reach.***

two ways: on the one hand, growth is set to slide below the 6% mark, and this could trigger the social instability so greatly feared by Beijing, while on the other hand, the issue of Hong Kong still remains. Lastly in Europe, the new European Commission and Christine Lagarde – now at the helm of the ECB – will have to breathe some fresh life back into Europe and help set it on an equal footing with the US and China... this will be no mean feat.

Text completed on December 11, 2019



BOND MARKETS ON THE RIGHT TRACK DESPITE REGION-SPECIFIC RISKS

Fixed Income Management Team

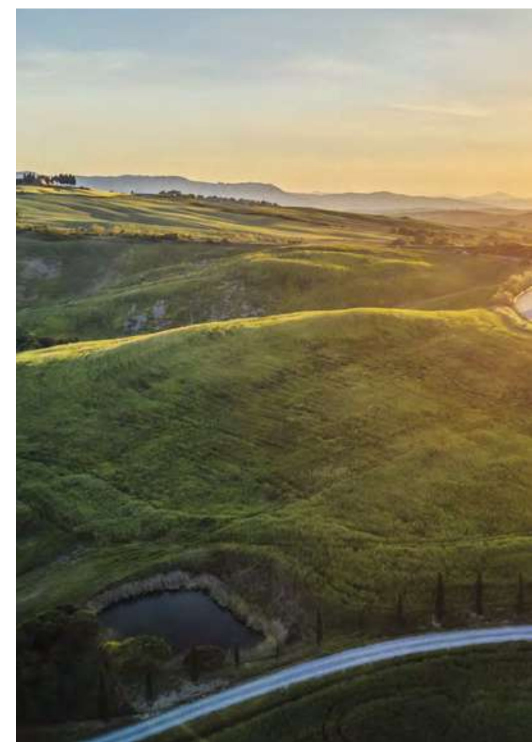
The bond markets' performances in 2019 were unexpected given negative yields in Europe and Japan. While 2020 will not post the same showings, a major correction looks unlikely. Central banks wrongfooted the markets as they stepped up financial repression to cut back risks on world growth, but their moves now look more predictable. The fixed income markets will be more of a reflection of bond risk perception than decisions from the main central banks. The growth cycle has now reached maturity. Extreme risks have dialed down, leading to decorrelation among asset classes. Investment flows are now pointing to new trends, but region-specific issues remain, and the US presidential election will make for a fresh source of volatility for the fixed income markets from the second quarter of the year.

> *The fixed income markets will be more of a reflection of bond risk perception than decisions from the main central banks.*

Lower absolute return

Core inflation in the US could move close to the 2% target in 2020, while the Fed's moves on key rates should be restricted to 25bps. Furthermore, fiscal stimulus has driven up the budget deficit, forcing the Fed to step in with T-bill purchases. The 10-year Treasury note is set to fluctuate in a range of 1.5-2.5% next year, short of its equilibrium rate. An improvement in the manufacturing sector would push up term premiums and inflation breakevens, without triggering a shift in monetary policy. The US yield curve is poised to steepen. Our investment strategy will not overlook duration, which will safeguard portfolios. However, directional exposure to the fixed income markets will probably provide less absolute return. Diversification on Canadian debt is warranted by the recent cautious message from the BoC, while elsewhere Australian and New Zealand sovereign bonds harbor some real opportunities, particular-

> *The US yield curve is poised to steepen.*



ly vs. Treasuries and especially if the RBA adds quantitative easing to its interest rate cuts.

Watch out for Italy

We also expect a moderate rise in long-term yields in the euro area. Extreme risks were pushed back after a no-deal Brexit was rejected and economic activity stabilized. Inflation remains low, so the ECB is set to continue its efforts under Christine Lagarde's leadership. Asset purchases focus on sovereign bonds, and this keeps them in relatively short net supply. Germany is likely to make few issues in 2020 as a result of its budget surplus, but the government will take a more relaxed fiscal approach in light of the economic slowdown. Growth in France has proven to be resilient, and the spread on the OAT is attractive at around 30bps. Spanish and Portuguese debt is sought after as a result of the steady improvement in fundamentals. However, Italy is a different kettle of fish, and growth in the country is too sluggish to stabilize the debt-to-GDP ratio, despite a drop in interest expense. The European Commission's complacency and the relative political calm only seem to be delaying questions on the sustainability of the country's pledges.

Looking to the UK, the Brexit question could well be positively resolved at last in 2020. We expect the 10-year Gilt to come to around 1.50% at end-2020 if the general election provides a majority with enough clout to force through the deal reached with the EU. Meanwhile in Japan, the increase in the consumption tax in October 2019 means downside risk for demand. The BoJ is likely to leave monetary policy as it is, and the Japanese 10-year will stick close to 0%.

Emerging markets – an obvious choice?

Lastly, the growth outlook for emerging economics is improving. China has acknowledged its structural growth slowdown and is striving to reduce imbalances. Elsewhere, leading indicators point to a stabilization across the board or even a recovery in 1H 2020, with the prospect of continued low inflation. Monetary policy is therefore likely to remain accommodative, although leeway is narrowing. Macro-financial stability makes up for some countries' external vulnerabilities for a while, as much as increased inequality for certain others, which is creating severe social tension, i.e. Chile, Lebanon, Peru.

The outlook is bright for emerging market bonds in 2020. Emerging market fixed income could even become an obvious choice for investors given low yields. The growth differential is set to widen in favor of emergings. We therefore favor emerging debt to provide yield and diversification in our international portfolios. We expect the emerging premium to widen by a slight 20bps in 2020.

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Absolute performances will remain broadly positive as a result of carry. Issue volumes remain low, while the quest for yield looks set to increase due to sustainably low US rates.

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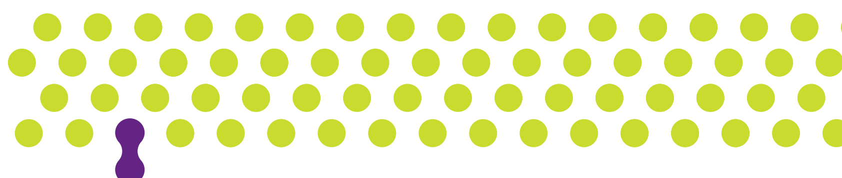

CREDIT WILL KEEP HOLD OF ITS ADVANTAGES IN 2020

Credit Management Team

2019 is ending on a remarkably high note, with gains of more than 6.3% for the investment grade market and a surge of more than 10% for the high yield segment. We need to look back ten years to the post-crisis rally to find performances on a par with these figures.
Despite the world economic slowdown, we think that the outlook for 2020 remains upbeat. The main performance drivers in 2019 will remain and continue to bolster investor confidence in the credit market's stability. Looking to the investment grade segment, the ECB's asset purchase program (QE or quantitative easing) will provide major support for the market and curb potential episodes of volatility or widening of spreads. Meanwhile on the high yield market, low amounts to be refinanced over the next three years in Europe will help keep default rates historically low at around 2% or even below, unlike the US where technical factors should lead to an escalation in defaults.

«The main performance drivers in 2019 will remain.»

Attractive positioning

Alongside these positive factors, we think that the credit asset class's intermediate positioning, sitting between the hazards of the equity markets (which admittedly carry returns but are exposed to severe volatility) and the risks of government securities (which combine political risk and lower returns), will provide a clear performance advantage in 2020, particularly in light of the expected economic slowdown and interest rates that are set to remain low in Europe for the long term, as the ECB has insinuated.
Valuations on the investment grade and high yield segments still remain far from their historical lows, so the substantial potential for tightening and compression of so-called high beta assets towards low beta remains promising and points to a relative outperformance for high yield over investment grade on the credit market. However, these valuations should be adjusted to take on board risk (asset class volatility, liquidity, etc.) and resilience to the slowing economic cycle. The investment grade market is doing well on the basis of these criteria and potentially provides greater safeguards, but the carry maximization logic that has reigned among credit investors for several years makes the European high yield market more attractive.

Opportunities for the short term

However, we do seek to take an opportunistic approach in terms of risk, particularly in the very short term. Current valuations on the credit market already price in an easing in the trade war, a soft Brexit scenario and a world economic recovery. Any potential US-China agreement in the short term is a "buy the rumor, sell the news"

> *The carry maximization logic that has reigned among credit investors for several years makes the European high yield market more attractive.*

scenario as it is already priced into risky asset prices, while any disappointment could spark off renewed volatility on the financial markets. It is also important to be realistic: after the UK effectively exits the EU – now confirmed for January 31, 2020 – negotiations on the future agreement on the relationship between the two former partners are set to be lengthy and complex, and drag down the UK economy.
Lastly, the Democratic Party primary in the US is one of the main risks hanging over the world markets out to the end of the first quarter of 2020, with 14 States gearing up to vote on so-called Super Tuesday on March 3. We will also pay particular attention to the ECB's new aspects with the new President Christine Lagarde now at the helm: this is set to potentially change the approach to European monetary matters, while also taking on board more ecological considerations in the central bank's market interventions and in its role in regulating the banking sector. So while we remain confident on 2020, we think that the short-term outlook carries risks and these should provide opportunities for us to ramp up our market allocations at attractive valuations.
A resolutely active approach to portfolio management should help take advantage of these opportunities to achieve attractive yields against this current market backdrop, where technical factors should give way to fundamentals as well as political and macroeconomic risks. Performance in 2020 will be dictated primarily by sector allocation, an in-depth insight into idiosyncratic risks and market timing – which requires a forward-looking view.

> *A resolutely active approach to portfolio management should help take advantage of these opportunities.*

Leveraged loans: default rates still low, but rising

After 2019 was characterized by a continued decline in leveraged loan issues (-16% currently, including -31% for LBO), we should see the European market continue to slow in 2020. Similarly the CLO market – which is to come close to a record of €30bn in issues in 2019 – should contract next year, with arbitrage remaining difficult for equity.
While default rates remain low, leverage continued to increase and credit quality deteriorated with a considerable jump in the percentage of single-B issues, particularly B-. We should therefore see an increase in default rate in 2020, although to a lesser degree than the historical average. Furthermore, low interest rates and in fine structures without covenants are not a cause for concern on borrowers' liquidity or their refinancing needs, at least on a one-year timeframe.
Insufficient depth on the European market will remain a hindrance to active fund management, whether CLO or not, so stock-picking will remain the key to outperformance on this type of asset.

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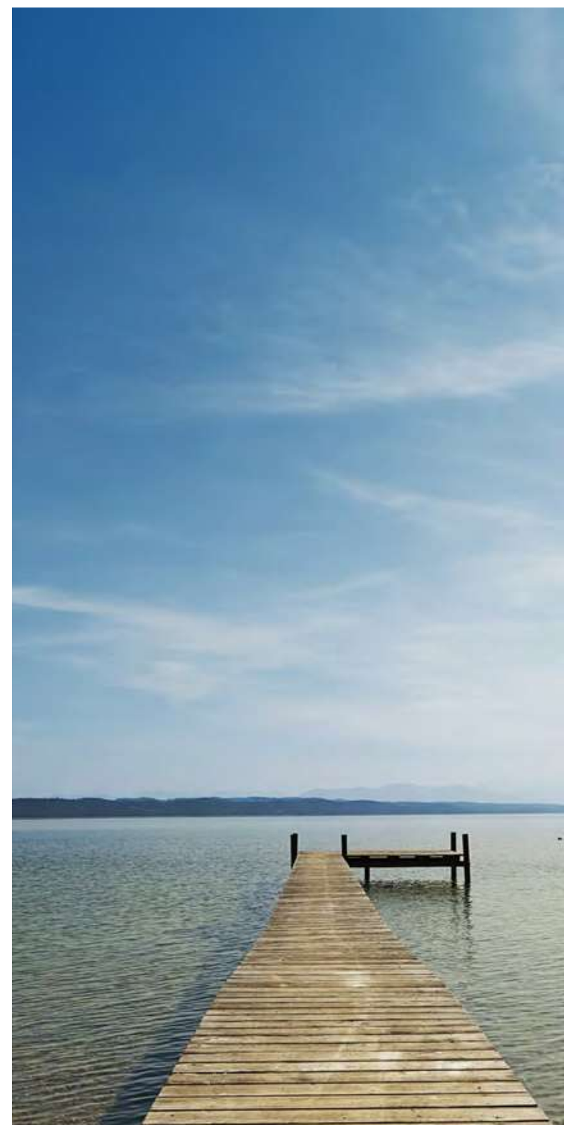


EQUITY MARKETS RUNNING OUT OF FUEL IN 2020

Equities Management Team

2019 is ending on a very upbeat tone for the equity markets. In the US, the S&P 500 surged more than 20%, in line with its European counterparts. Meanwhile the emerging markets and Japan are down, although with positive performances. Ironically most of the macro-financial risks acknowledged at the start of the year are still well and truly present: the US administration's moves on border duties are making for ups and downs on the markets, while in Europe, the risks created by Brexit still lie ahead. Equity market gains are mainly due to the Fed's – followed by the ECB's – turnaround on monetary policy. Support from the central banks has buoyed valuations, while the worldwide slowdown has put the brakes on corporate earnings growth. Gains on the stock-market since the third quarter were also a result of the lack of alternatives to equities.

Likely consolidation on Wall Street

The US market is a bellwether for world equities. Current valuations are not consistent with a deterioration in profits. EPS growth on the S&P 500 is expected to come in at close to 10% next year, which looks lofty considering the expected economic slowdown. Share buybacks have been the main factor shoring up US equity demand for the past several years, with around $700bn in 2019, but rising corporate debt for S&P 500 stocks will now hinder these deals, as net debt is close to 1.9x EBITDA. However, the accretive impact of corporate mergers will continue, with high valuations fostering share exchange deals.

Nevertheless, consolidation looks likely for 2020 and the S&P 500 would then move back below the 3,000-point mark. Based on our projections, downside risk could push the S&P 500 (3,112 as at December 4) to 2,850, which would wipe out any gains from the Fed's liquidity injections since September 2019, while a best-case scenario points to around 3,460 and assumes that international uncertainty disappears and operating margins stage a recovery (13% in the fourth quarter of 2019 vs. 13.3% a year previously), particularly in commodities-dependent sectors. The value theme that has come to the fore since September now seems to be coming to an end. Growth stocks that offer both visibility and high-quality balance sheets will take the lead again in 2020. Small caps (Russell 2000) have underperformed the S&P by 25% since mid-2018, and the discount carried by these types of stocks looks excessive.

> *Current valuations are not consistent with a deterioration in profits.*

«Small caps (Russell 2000) have underperformed the S&P by 25% since mid-2018, and the discount carried by these types of stocks looks excessive.»

Europe lags behind

Monetary easing and a brighter political outlook (Italy, Brexit) in the euro area this summer fueled renewed investor interest in the asset class. High dividend yield at 3.3% makes equities a vital investment in light of current negative interest rates. However, the upswing since September has gone hand-in-hand with a deterioration in profit projections. Underpriced cyclical stocks, including the automotive sector, have already priced in an improvement in business surveys and consolidation in the sector. Meanwhile, banking stocks enjoyed an uptick after implementation of the ECB's two-tier system, which exempts some €800bn in excess reserve holdings from the negative deposit rate (-0.50%). The European market is trading on 14x 2020 EPS, which is in the upper end of the range seen since 2015, and rerating potential is low. Our baseline scenario is for a wide trading range of between 3,250 and 3,890 with greater volatility.

Supporting factors will be few and far between in 2020. The euro-dollar rate has hit a low at $1.10. Profits as a proportion of GDP are deteriorating in the euro area and earnings projections look excessive (+9%) when we consider current lackluster growth, so Europe is likely to underperform the key US market. In a more gloomy scenario, the Euro Stoxx 50 would end the year at between 3,250 and 3,390 on our estimates. The re-emergence of the value theme reflects profit-taking on non-cyclical growth stocks, such as the luxury goods sector. If growth does not take an upturn, investors will gradually revisit stocks that offer the strongest earnings visibility. Looking to the various market cap categories, mid-caps should correct their underperformance as the segment harbors significant earnings growth potential.

«If growth does not take an upturn, investors will gradually revisit stocks that offer the strongest earnings visibility.»

Chinese markets dictated by trade talks

The UK market welcomed the agreement setting the Brexit date for January 2020. Stocks exposed to the domestic market have made up some of the performance lag racked up since June 2016, but asymmetrical political risk will require caution on these stocks over the year ahead. In Japan, low multiples curb downside risk, while in China, the markets still march to the beat of trade talks. The slide for Latin American currencies (Chile, Brazil) means that tougher monetary policy may be needed to address external imbalances, which will be to the detriment of stock-market indices that have benefited from the exchange rate adjustment so far. We favor Asia over South American markets.

Text completed on December 5, 2019

PHILIPPE SETBON APPOINTED CEO OF OSTRUM AM

Philippe Setbon took over as CEO of Ostrum AM on November 18. He is also a member of the Natixis Executive Committee and the Natixis Investment Managers Management Committee.

Philippe Setbon worked previously at Barclays Bank, Groupe AZUR-GMF, Rothschild & Co Gestion and the Generali Group where he held a succession of senior roles. He joined Groupama in 2013 as CEO of Groupama Asset Management. Philippe Setbon also serves as vice president of the French Asset Management Association (AFG), with particular responsibility for looking into savings solutions and responsible investment themes.

With his renowned expertise and strong experience, Philippe Setbon will support Ostrum AM's growth in this new role, and lead the company in the planned combination of the company's businesses with those of la Banque Postale Asset Management.

SRI LABEL OBTAINED BY SEVERAL OSTRUM AM STRATEGIES

Ostrum AM has been committed to responsible asset management for more than 30 years, and has now embarked on a program to achieve SRI certifications (Socially Responsible Investment), obtaining the French label[1] for three of its thematic equity strategies i.e. Euro Dividend Grower, Global New World and Global Alpha Consumer.
Ostrum AM's money market strategy Sustainable Trésorerie also achieved the SRI label, reflecting the high-quality responsible investment methodologies applied.
Ostrum AM will actively continue the SRI certification process across its range in 2020.

OSTRUM AM SUPPORTS PLANÈTE URGENCE IN ECUADOR

Ostrum AM has supported Planète Urgence since 2018 and is now working alongside the association to promote a new project, as it decided this year to open a national delegation in Ecuador. Planète Urgence has operated in the country since 2015 and this move makes Ostrum AM the first organization to finance the opening of a delegation.
This initiative is a result of the organization's increasing activities and the environmental challenges faced in this region of the world, as it aims to enhance relationships with local partners and extend its impact on the ground.

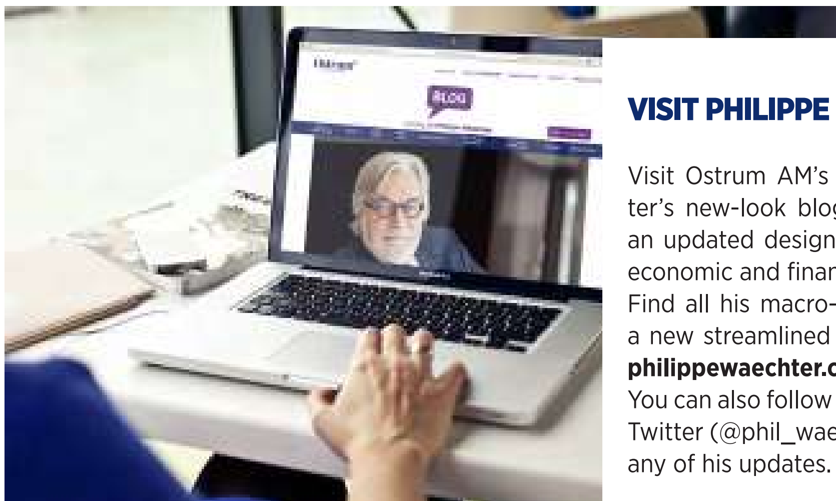
[1] *Find out more at www.lelabelisr.fr*

OSTRUM AM JOINS THE TOP 5 RESPONSIBLE ASSET MANAGERS

Ostrum AM ranks No.5 in the list of Top 10 responsible asset managers in the 2019 Hirschel and Kramer (RIBITM) Responsible Investment Brand Index™.
The H&K Responsible Investment Brand Index (RIBITM) was developed to find out which European asset management companies act as responsible investors and commit to sustainable development to the extent that they put it at the very heart of who they are: i.e. in their brand. The index aggregates the analysis of all 220 European asset managers listed in the Investment & Pensions Europe Journal Top 400 ranking as of December 31, 2018.
According to the report "the flurry of public awareness around ESG does not yet translate into visible action within the asset management industry. Despite clear progress in some areas, only 29 managers have a purpose connected to societal ambitions, and only five managers managed to craft and align a very well-expressed purpose". Ostrum AM is one of these five.

OSTRUM AM TAKES A STAND FOR GENDER EQUALITY IN THE WORKPLACE

Ostrum AM has long been committed to gender equality and joined a group of 66 investors representing more than €4 trillion in assets under management in an investor statement to companies on this issue.
A group of investors, led by Mirova[2], issued a statement calling on companies to enhance their commitment to gender equality in the workplace, marketplace and community where they do business, and to take decisive and concrete steps to promote this aim. This statement received the support of UN Women and the UN Global Compact, and is also part of the broader Women's Empowerment Principles (WEP).



VISIT PHILIPPE WAECHTER'S NEW BLOG

Visit Ostrum AM's Chief Economist Philippe Waechter's new-look blog with enhanced ergonomics and an updated design, and read his insight into current economic and financial events.
Find all his macro-economic news and analysis with a new streamlined browsing system at **www.ostrum.philippewaechter.com.**
You can also follow Philippe Waechter on LinkedIn and Twitter (@phil_waechter) to make sure you don't miss any of his updates.

[2] An affiliate of Natixis Investment Managers devoted to SRI management
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IN A TRICKY LANDSCAPE
EXPERIENCE MATTERS

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Our experienced experts have a full understanding of regulatory constraints. They anticipate change and help clients adapt to the evolving terrain of insurance investing. Ostrum AM manages 187.2 billion for 25 insurers** who rely on our expertise in asset allocation, security selection, research and risk management.

All investment presents significant risks, including the risk of capital loss, and must be carefully assessed for your financial needs and objectives.

** Ostrum AM was created by the separation of Ostrum AM's fixed-income and equity investment management expertise into a separate subsidiary on October 1, 2018 registered on the Paris Trade and Companies Register under number 329 450 738, previously Natixis AM.*
*** Ostrum Asset Management as of 09/30/2019*

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NOTES

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A TOP TIER ASSET MANAGER IN EUROPE[1]

Global perspective and local presence

Part of the 2nd largest banking group in France: Groupe BPCE[2].

ALONGSIDE OUR CLIENTS FOR MORE THAN 30 YEARS[3]

More than 1,000 institutional clients, private banks and IFA[2] trust us.

EXTENSIVE RANGE OF HIGH-QUALITY SOLUTIONS

13 fixed income strategies / 10 equity strategies
7 alternatives solutions / 1 global insurance platform[3].

RESPONSIBLE AND COMMITTED COMPANY

One of the 1st French asset manager signatories to the UN PRI in 2008[4].

Full carbon compensation of our direct greenhouse gas emissions since 2016[3].

1 IPE Top 400 Asset Managers 2019 ranked Ostrum AM as the 68th largest asset manager, as at 12/31/2018. – 2 Market share: 21.8% in customer savings deposits (source: Banque de France Q1-2019 – all categories of nonfinancial customers) and 21.1% in customer loans (source: Banque de France Q4-2018 – all categories of nonfinancial customers). - 3 Ostrum AM as at 09/30/2019. – 4 United Nations Principles for Responsible Investment 2019. More details: unpri.org.

www.ostrum.com

Ostrum Asset Management
Asset management compagny regulated by AMF under n° GP-18000014 - Limited compagny with a share capital of 27 772 359 euros – Trade register n° 525 192 753 RCS Paris – VAT : FR 93 525 192 753- Registered Office : 43, avenue Pierre Mendès-France – 75013 Paris – Tèl.: 01 58 19 09 80
Ostrum AM was created by the separation of Ostrum AM's fixed-income and equity investment management operations into a separate subsidiary on October 1, 2018 (registered on the Paris Trade and Companies Register under number 329 450 738, previously Natixis AM).

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