So far, so good.

After 2019, the year of Central Banks, comes 2020, the year of … Profits? Investors would certainly dream of it, but nothing is for certain: while fundamentals remain positive for equities and negative for rates in the short term, a major shift could arise. US corporate margins could erode; with that, the possibility of an American recession over the coming 12 to 18 months can't be excluded; uncertainty should be plenty. In this context, valuations are too expensive and a 10 to 15% stock market correction (on average, depending on the geographic area) sometimes during the year would be welcome to yield-seeking investors.

2019: a year in review

Following the downturn experienced by investors in global equities in late 2018, risky assets rebounded dramatically in 2019 buoyed by a sharp decline in interest rates and a concurrent strengthening of the US dollar. This atypical macro driven mix should prove to be of particular interest to investors because of the exceptional nature of this rebound, as it comes amidst no clear improvement in fundamentals but rather based on potentially overcorrected equity valuations.

Indeed, 2018 was a year where investors sharply re-assessed the true discount rate to be applied to political risk and building uncertainty around the world. Investors paid particular attention to the growing divide between US and Chinese relationship through the escalation of the trade war between the two superpowers, as well as the changing political landscape across an increasingly fragmented European Union, while ignoring the robustness of the worldwide fundamentals. In sharp contrast, 2019 brought a sense of optimism for investors with a path to a potential agreement on US-China trade relations, a new approach and potential Brexit deal in the new year and renewed confidence in accommodative Central Bank policies. Nonetheless, it is important to highlight that, just as investors ignored the good economic conditions in 2018, they continued to ignore the fundamentals in 2019, neglecting the major slowdown in world trade to which they attributed an exceptional and temporary character.

We produced a 2019 Minimum Spanning Tree (MST) to analyze the correlations between government bonds (in black, figure 1), foreign exchange (in blue, figure 1), global equities (in red, figure 1) and fundamental data (in green,figure 1). The closer two markets appear, the more correlated they are - positively or negatively.

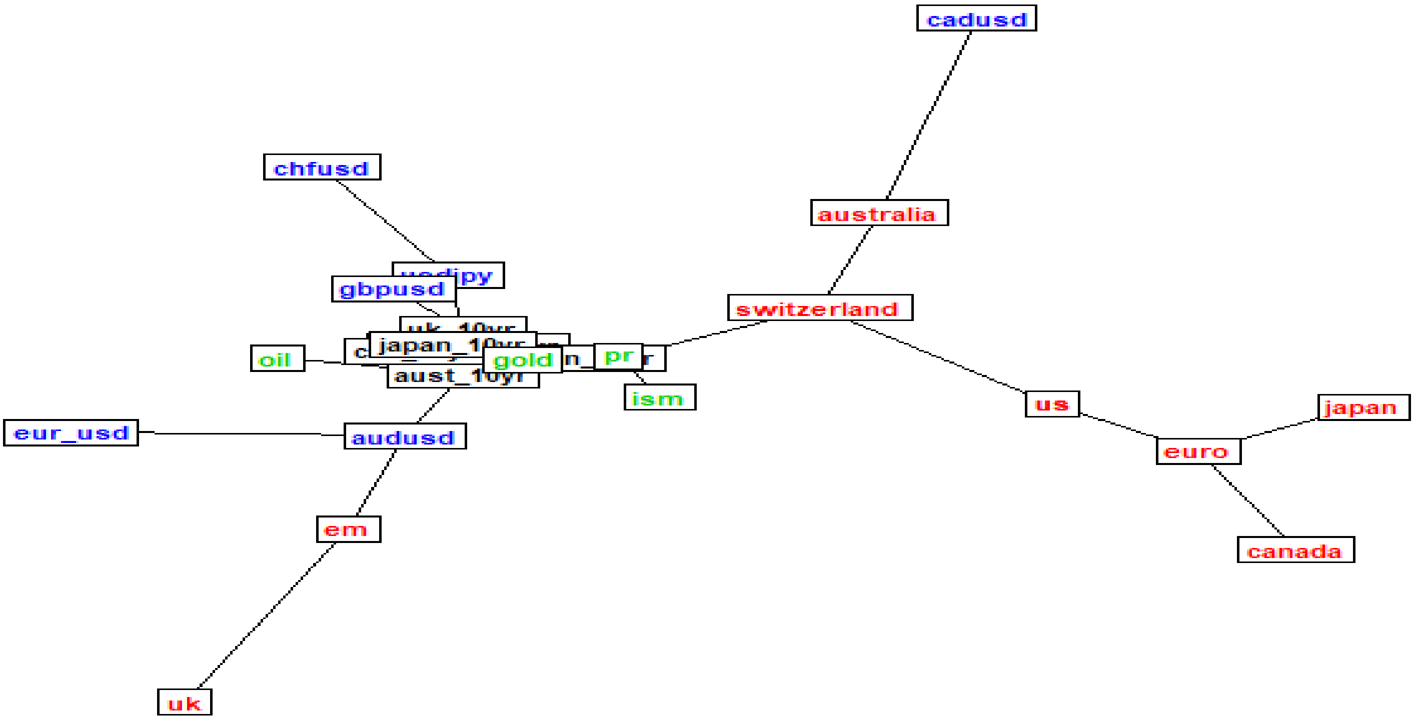


Figure 1 : MST – "Minimum Spaning Tree" on 10-year government bonds (black), international equities (red), foreign exchange (blue), and fondamental data (green) in 2019 – sources : Seeyond, Bloomberg*
**List of fundamental data ==> oil: oil price; gold: gold price; ism: manufacturing confidence index, pr: political risk indicator, as of end ofDecember 2019*

The global markets' MST (figure 1) is quite widespread; the correlations are generally weak, with the exception of rates; therefore, diversification opportunities are plenty.

With the MST we can infer the main drivers of the 2019:

- The accentuation of the accommodative bias of global monetary policies and the sharp fall in interest rates were the main catalysts of the markets, as evidenced by the central positioning of rates on the MST
- Only the interest rate markets have integrated the drop in global economic fundamentals; equities were complacent
- Interest rates have been highly correlated, offering few opportunities for geographic diversification
- Geographic diversification on the foreign exchange markets, and all the more on equities, was a major source of performance

Thus, if 2018 was be a poor performance year with exceptionally low diversification opportunities, 2019 turned out to be very positive for many portfolio managers on equities, fixed income and global macro.

2020 outlook

Following two polar opposite years animated by geo-political uncertainty and an artificial extension of the economic cycle — driven by accommodative monetary and fiscal policies — the matter of the end of the global cycle and subsequent US recession risk is again upon us. And if calling for a recession was premature twelve months ago… it is more debatable today.

In the short term: all lights are green

At first glance, the economic and financial environment remains favorable to risky assets. Based on our proprietary management models, the analysis of market fundamentals (figure 2) is positive for equities, and negative for global sovereign rates (figure 3).

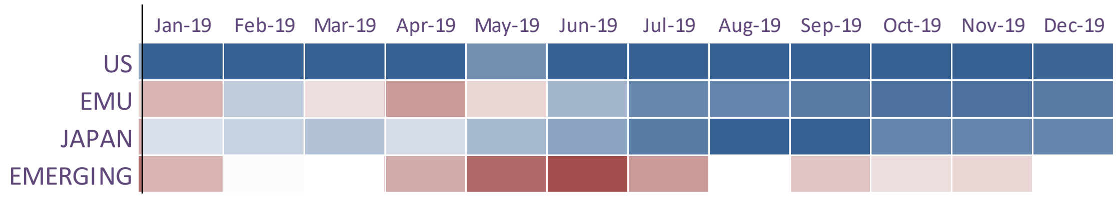


Figure 2 : Seeyond Strategic Models - Equity Fundamental Indicators – source : Seeyond, as of end of December 2019

On the equity market (figure 2), all geographic regions have buoyant macroeconomic and microeconomic fundamentals, with the exception of emerging countries. Emerging fundamentals, after being negative for most of 2019, became neutral in December.

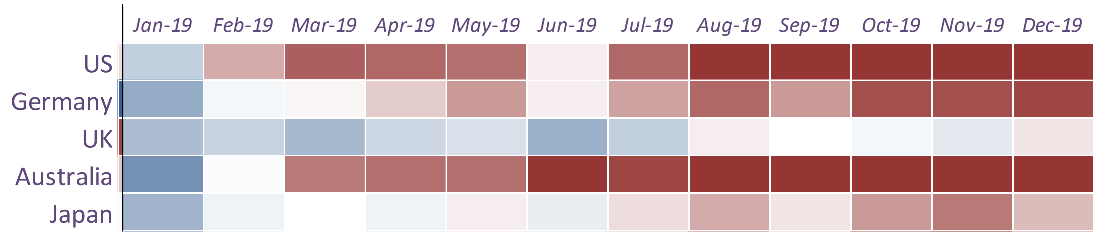


Figure 3: Seeyond Strategic Models - Bonds Fundamental Indicators – source : Seeyond, as of end of December 2019

On the sovereign rates' market (figure 3), signals are now negative on all regions. US, German and Australian rates are the most at risk.

Macro-and-microeconomic fundamentals, accommodative monetary and fiscal policies, and easing tensions over global trade (following phase 1 of the US-China trade agreements) all support risky assets in the short-term. Yet the question remains: are the positive news already priced into equity market valuations, and in which case: what level of risk can we expect in the foreseeable future? In addition, will healthy corporate margins pick up the baton from Central Banks as the next market catalyst?
In our view, those two major risks can't be ignored: on the US domestic market first, a more pronounced slowdown pressuring corporate margins, and secondly this lingering political risk looming over the American presidential elections (with an increasingly "Populist" campaign), and on the global scale between United States and Iran.

Medium term signals on the probability of a US recession and volatility dynamics are a concern, implying a risk over corporate margins

For the first time since 2007, our models are sending cautious signals on the likelihood of recession in the United States: the probability of a recession between the second and third quarters of 2020 appears high (figure 4). The factors that contribute most to the risk of recession are the level of US manufacturing confidence (*ISM manufacturing)*, the *US Yield Curve* and the *Gold to Copper* ratio; the ones that least contribute are weak *US interest rates* levels and the healthy performance of the US real estate market (*US Home Builders Confidence*). Should a recession materialize, one positive is that it could turn out to be small and short-lived, in the absence of strong discrepancies across US economic agents. Amongst already observable catalysts, we can note tightening credit conditions from US financial institutions since last October - which, historically, has negatively impacted the domestic economy with a 6 to 9 months' lag. If the structural weakness of interest rates and the unrestrained search for yield are likely to create behavioral biases in recession models incorporating yield curves, this signal should nevertheless draw the attention of investors to the fragility of the current fundamental situation.

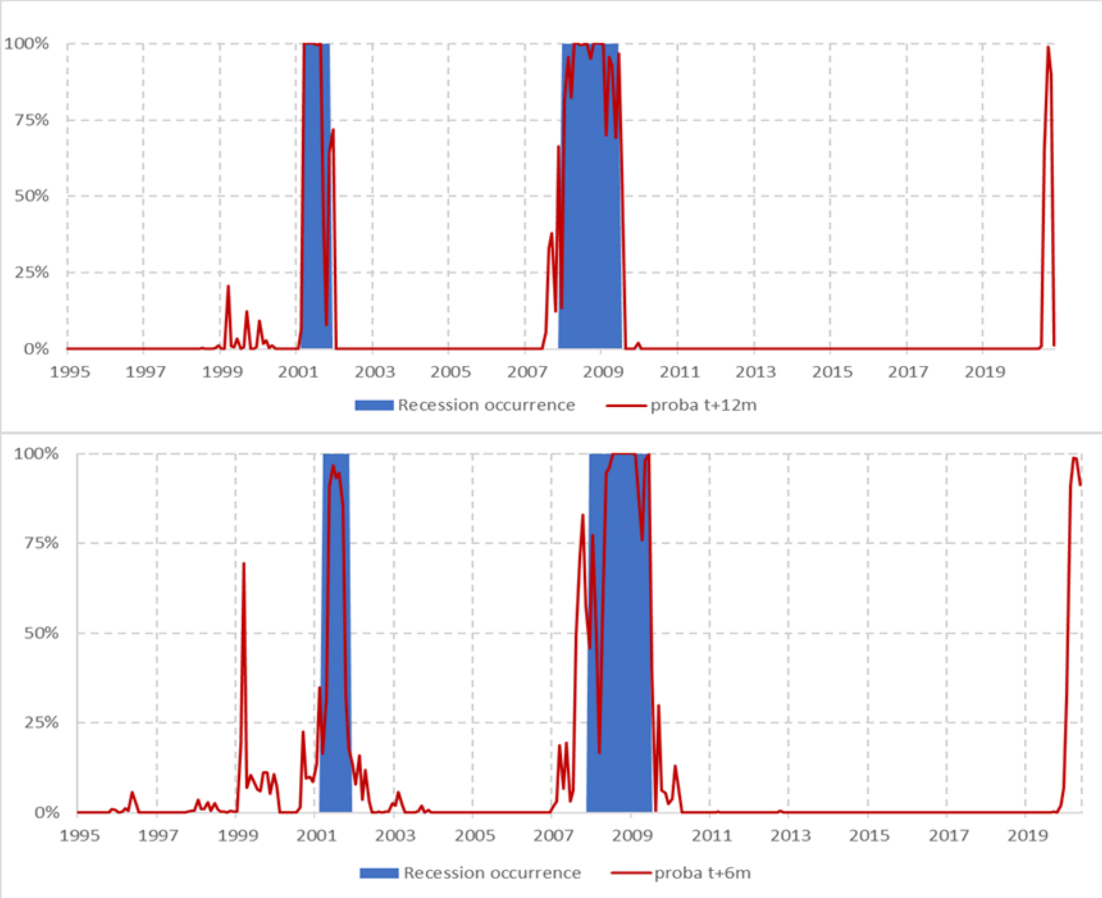
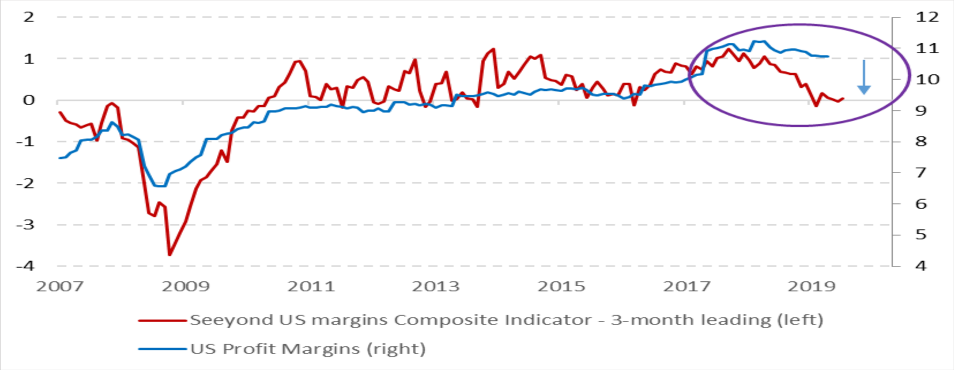


Figure 4: Seeyond US recession Probability – Logit Model – Exogeneous variables: ISM Manufacturing, US Fed funds rate, US 2-Y rate, US Ted spread, ISM price, US Yield Curve, SP500, US Home Builders Confidence, Gold to Copper ratio - sources : Seeyond, Bloomberg, as of end December 2019

As for US corporate margins, these could be the weakest link in 2020 (figure 5). Businesses could endure an activity decline combined with higher wage costs and waning effects of Trump's fiscal policy: these combined could translate into weaker profits… and take investors off balance. The earnings seasons upon us could trigger market volatility. In this context, we believe that analysts' expectations are too high; and US stocks thus overvalued.



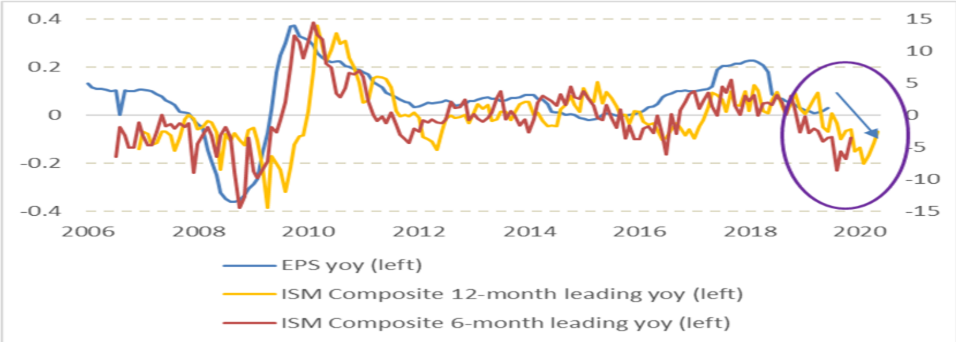


Figure 5 : US Profit Margins perspective (PCA on ISM Manufacturing, ISM Services, US weekly earnings, US weekly hours, US 10-year rates, US unit labor costs, US productivity, US core CPI, US unemployment, CRB Industrial metals price index, USD, US import price – sources : Seeyond, Bloomberg, as of end of December 2019.

Consequently, the probability of falling into a high volatility regime over the next 12 months has greatly increased (figure 6) to levels which, from an historic perspective… are synced with turbulent years for risky assets.

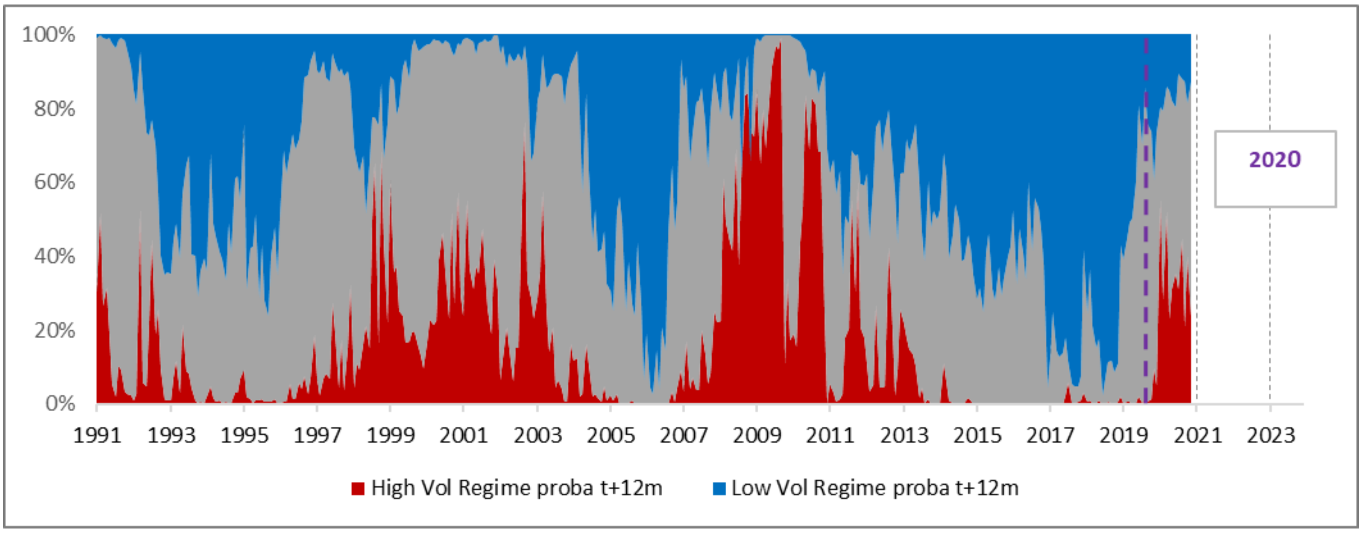


Figure 6 : Seeyond Volatiltity Regime Probability over the next 12 months – US equitiy – Logit Model – Exogeneous variables: ISM Manufacturing, US Fed funds rate, US Weekly claims, US Unemployment, EPU, US 2-Y rate, US HY spread, US Ted spread, US 10-Y rate, SPGSCI, US Yield Curve, Gold to Copper ratio - sources : Seeyond, GS, as of end of December 2019.

Equity markets could suffer in 2020 for being too complacent in 2019; potential on sovereign rates is positive albeit limited

Stocks valuations are not cheap: this will be the largest weakness of this asset class for the foreseeable future. At first glance, equity risk premia versus rates makes equities still very profitable. But looking at absolute valuations… the picture is not so bright.

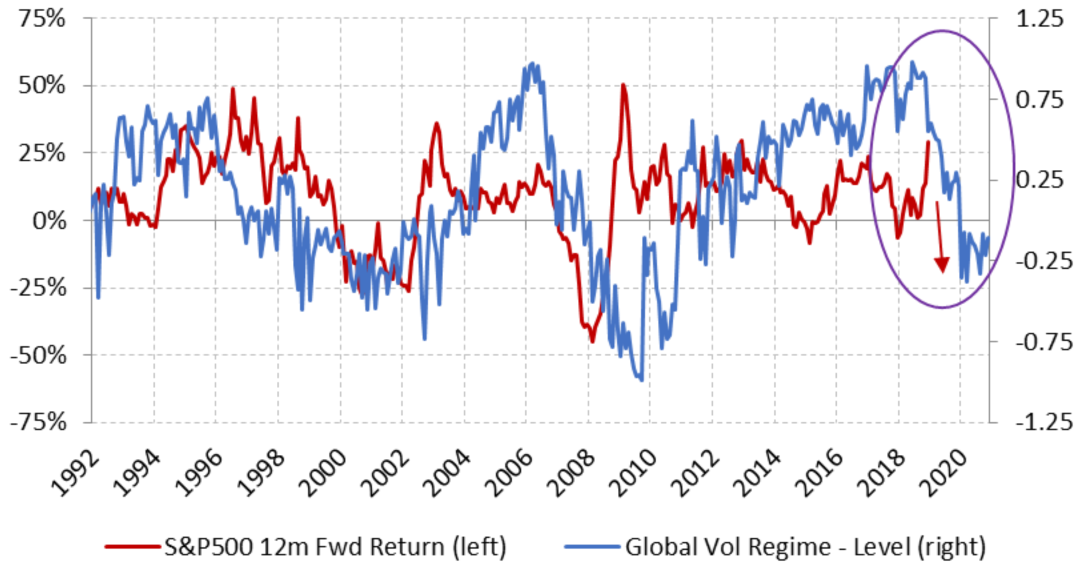
First, regardless the metrics (12-month PE, market-cycle-adjusted PE, economic-cycle-adjusted PE), long-term valuations for major global indices have returned close to twenty-year highs. Secondly, equity markets' short-term valuations (measured by the difference between market performance and change in EPS forecast over three-time horizons) indicates that stocks are overvalued. Worse, this level of overvaluation ranges from 10% in the UK to 17% in the US, 18% across the Eurozone, and 20% in Australia (figure 7). Overvaluation reaches 14% on average, offsetting 3 times the 2018 equity market crash; meaning that substantial margins 'recovery is widely anticipated and has already been priced by global equity markets.

In the event of a microeconomic reversal, the market correction could thus be substantial.

	US	Euro area	Japan	UK	Switzerland	EM	EM Europe	EM Asia	EM Latam	Australia	Canada
EPS forecast yoy	1	(3)	(7)	(6)	5	(9)	4	(10)	(11)	(3)	(1)
Perf yoy	14	14	2	4	17	5	16	5	2	21	11
Over/Under valuation yoy	*13*	*17*	*9*	*10*	*12*	*14*	*12*	*15*	*14*	*24*	*13*
EPS forecast sos	1	(1)	(3)	(4)	3	(0)	(2)	2	(9)	(5)	(3)
Perf sos	14	11	12	2	10	4	6	6	(1)	7	6
Over/Under valuation sos	*14*	*13*	*16*	*6*	*7*	*5*	*7*	*5*	*8*	*12*	*8*
EPS forecast ytd	2	(3)	(7)	(5)	5	(7)	7	(8)	(10)	(3)	(1)
Perf ytd	25	21	14	8	26	8	19	9	4	20	18
Over/Under valuation ytd	*24*	*24*	*21*	*13*	*21*	*15*	*12*	*17*	*14*	*24*	*19*
Average Over-Under valuation	**17**	**18**	**15**	**10**	**13**	**11**	**11**	**12**	**12**	**20**	**13**

Figure 7: %, short term Valuation – Over or Under valuation – Equity markets - sources: Seeyond, Bloomberg, as of end November 2019

In addition, our historical analysis of the correlation between expected volatility regimes and US equity performance raises the possibility of a 10 to 15% drop in 2020 (figure 8).



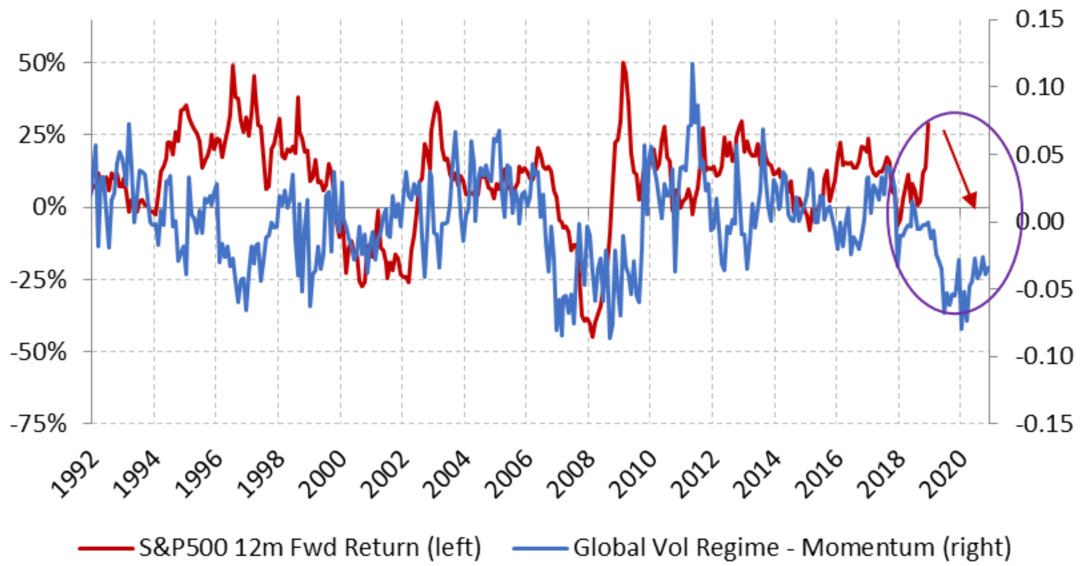
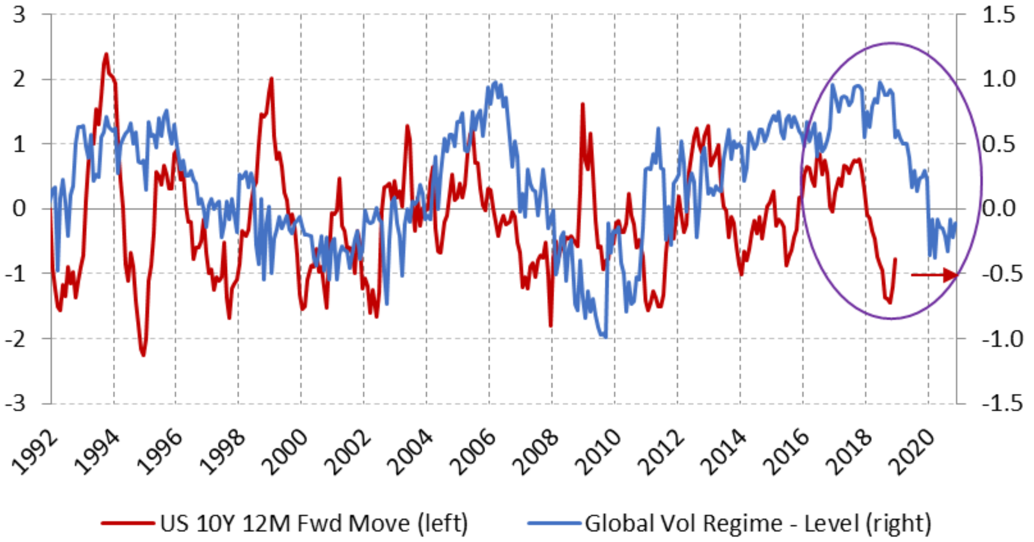


Figure 8 : SP500 12-month forward return & Seeyond Global Volatility Regime Indicator - sources: Seeyond, Bloomberg, as of end December 2019

The historical analysis of the correlation between the volatility regime and the evolution of US interest rates reveals that interest rate markets have already partly integrated the shift in the volatility regime (figure 9). Weak interest rates could thus limit the asset class' ability to act as a safe haven if-and-when risky assets experience a downturn. Besides, given historically high levels of speculative positions on the US dollar (another traditional protective asset), gold has become the current *de facto* safe haven. While the Gold to US 30-Year yield ratio is tight in the short term, it still offers value in the medium term.



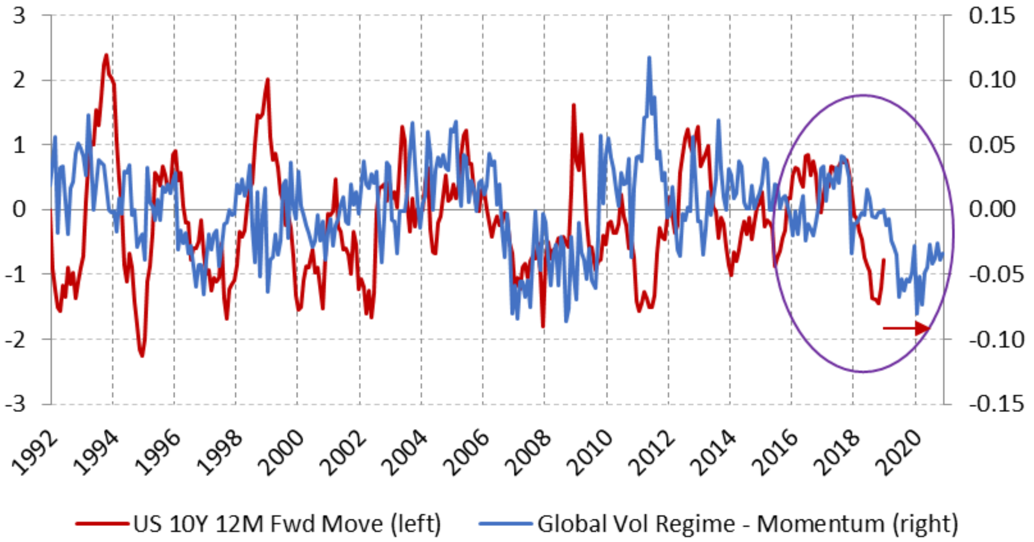


Figure 9 : US 10-year rates 12-month forward move & Seeyond Global Volatility Regime Indicator - sources: Seeyond, Bloomberg, as of end December 2019

Conclusion

The global economic and financial situation can be summarized in 6 points:

1- Monetary policies are and will remain accommodative, but surprises on that front should be limited.
2- A technical rebound in world trade is plausible in the wake of phase I of the US-China negotiations, and thanks to new Chinese tax measures. It should however be short-lived given persisting uncertainties (US elections, Brexit, US / Iran relations, German industrial transition, negative effects of the VAT hike in Japan). Political and economic uncertainties have shaken up the world trade way too hard for us to anticipate a quick - and lasting - recovery.
3- In the context of fading tax stimulus, US corporate margins could suffer from the decline in activity and the increase in wage costs.
4- Contrary to the end of 2018, investor sentiment level is relatively high.
5- 2019 yield-seeking and complacent investors rendered stock valuations unattractive for now.
6- Financing conditions tend to deteriorate, including in the United States.

With regards these factors, we anticipate higher volatility over the coming months. Global equity markets look overvalued. At best, assuming US interest rates remain at their end of year level, as is risk premium and expected earnings per share growth, stocks should see near-zero growth. Otherwise, the risk of an adjustment of 10 to 15% (on average, depending on the geographic area) sometimes during the year is high. Patience and cautiousness will prevail in 2020. How much longer can investors afford to ignore fundamentals? While a major crisis is not on the agenda, it is difficult not to foresee turbulence.

Written by Stéphanie Bigou, Portfolio Manager at Seeyond, January 20th, 2020.

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Seeyond, an affiliate of Natixis Investment Managers, specializes in active quantitative portfolio management. By adding active oversight to disciplined quantitative investment processes, Seeyond offers strategies that seek to optimally reward risk in three core areas of expertise: equity strategies, multi-asset strategies, volatility & overlay strategies. These strategies leverage Seeyond's proprietary quantitative research.

Seeyond, a team of 21 recognized professionals with 18 years of industry experience on average, manages around EUR 9 billion of assets[1]. Seeyond's solutions are marketed by the global Natixis Investment Managers' distribution platform, one of the largest asset managers in the world[2], and via the retail networks of Groupe BPCE, the second largest banking group in France[3].

> For further details: www.seeyond-am.com

1 Source: Seeyond, as of 31/12/2018

2 Cerulli Quantitative Update: Global Markets 2018 ranked Natixis Investment Managers (formerly Natixis Global Asset Management) as the 16th largest asset manager in the world based on assets under management as of 31/12/2017.

3 Source : BPCE S.A. – 31/12/2018

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