

# ASSET ALLOCATION STRATEGY

## MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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### “The longest days”

**Equity markets overall remained upbeat in March except for the US which suffered a bout of nerves. Following the failure to reform Obamacare, both US equities and the dollar were hit by investor doubts over Donald Trump’s ability to deliver on the economic stimulus promises in his election campaign.**

#### ► EUROPEAN EQUITIES ARE LOOKING ATTRACTIVE AGAIN

Our technical indicators are still suggesting markets have overshot: risk appetite is very high which means markets could be more vulnerable to any bad news. Last month, we trimmed equity exposure to give our portfolios a more balanced risk profile. And now we have slightly reduced exposure to US equities in favour of eurozone equities. If we ignore political risk, European equities look very interesting:

- The global economic recovery is now much more synchronised and is gaining traction. European companies are more cyclical and international than their US peers so they are benefiting more from this environment at the current stage in the cycle.
- Growth in France and Italy had largely missed out on the European recovery but both countries have now, judging from recent surveys, rapidly caught up with the others in the zone, a development which has boosted Europe’s economic upturn.
- European M&A deal-making had previously been modest but is now proceeding at a smart pace.
- Admittedly, the fact that it is now less clear if the ECB will stick with its highly expansionist monetary policy has pushed the euro slightly higher. This is bad news for European exporters but good for financials. Previously, they had been handicapped by a long period of negative interest rates but are now fully benefiting as the European yield curve steepens. And they have started to recover sharply from the very strong discount they were trading at. All this has led to a paradoxical environment: because of high financial sector index weightings, the risk of monetary tightening in Europe is not yet a negative for the market as a whole.
- The US market is historically very expensive compared to other markets, and Europe in particular.
- From the beginning of 2016, European equities saw strong outflows, first because of the Brexit referendum which encouraged investors to stay clear of political risk. And although there has been a slight reversal in fund flows in recent weeks, they are still negative for US investors who were put off by various upheavals in Europe. If the French Presidential elections are not won by a pro-Frexit candidate, it is highly likely the political horizon will be suddenly much clearer for at least a number of months and could see a significant switch into European equities. Germany’s elections seem relatively risk-free and Italy’s next elections are in theory scheduled for the beginning of 2018.

#### KEY POINTS

- Slightly underweight US equities
- Slightly overweight European equities
- Reduced exposure to core eurozone sovereign debt

## » MANAGING POLITICAL RISK

Clearly, the election of a French presidential candidate in favour of a referendum on leaving the euro would cause European equities to tumble, even if a subsequent return to the French franc would not be a foregone conclusion. At this stage, two weeks before the second round result, opinion polls suggest we should put this eventuality into perspective but we all know that the risks over Brexit and Donald Trump's election were badly miscalculated in 2016. Moreover, the electoral campaign has been constantly surprising - unseating an opinion poll favourite like Alain Juppé and undermining François Fillon, another previous sure-win in the polls- so the next days will be particularly long.

As markets eventually reacted positively to the Brexit vote and Donald Trump's election, we might wonder if they will greet the arrival of a populist President in France in the same way. But as far as France is concerned, this parallel does not hold. Brexit is an institutional event with potentially far-reaching economic repercussions but it does not constitute a systemic risk insofar as the UK is outside the eurozone. However, France exiting the single currency would be highly systemic: not all the assets and liabilities of economic agents are treated in the same way by French law and any return to the French franc would, for many French institutions, create severe financial imbalances.

This is why we are only slightly overweight European equities and why we are also sticking with some US dollar exposure, notably as a hedge. Both positions may shift tactically to reflect future risks and opportunities.

Elsewhere, we have reduced exposure to European sovereign debt; it strikes us as both very expensive and riskier due to the European economic environment and doubts over the ECB's commitment to its current monetary policy.

## NEXT HEADLINE EVENTS

- » *April 23: first round of the French Presidential elections*
- » *April 26/27: next BoJ meeting*
- » *April 27: next ECB meeting*
- » *May 2/3: next Fed meeting*
- » *May 7: second round of the French Presidential elections*

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