GADD INFINUM

Market Insight

WINTER 2019

Darkened growth prospects?

We will not fail to the tradition of resetting the counters on the financial markets at year-end, in order for them to make full resolutions and leave fresh and perky for the new year. Except that in 2019, we will have to cope with a fear that is gaining ground among economists: whether this new year will mark the return of the recession. We rule it out. But ... the question will rest more nagging in 2020. Especially if Central Banks insist on fighting against a threat of inflation which is far from significant and the President of the United States is just as eager to lead a real commercial war.

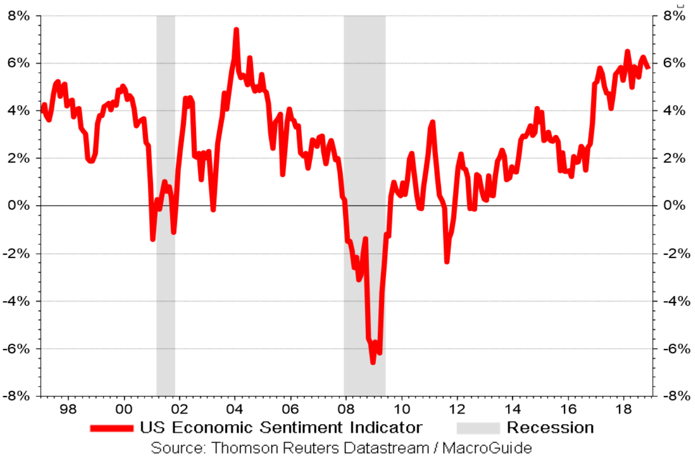
The United States fumbles in the dark

The President of the American Central Bank likes allegories. It is necessary to advance cautiously in a dark room he said recently, especially when barefoot. Intriguing, and worrying, the image used by Jerome Powell: thus, the Fed fumbles in the dark ... it, therefore, has no more visibility on growth than us, poor economists scrutinizing signs of cyclical downturns which could derail financial markets? Good Lord! And besides, she goes barefoot? Beware of the pitfalls!

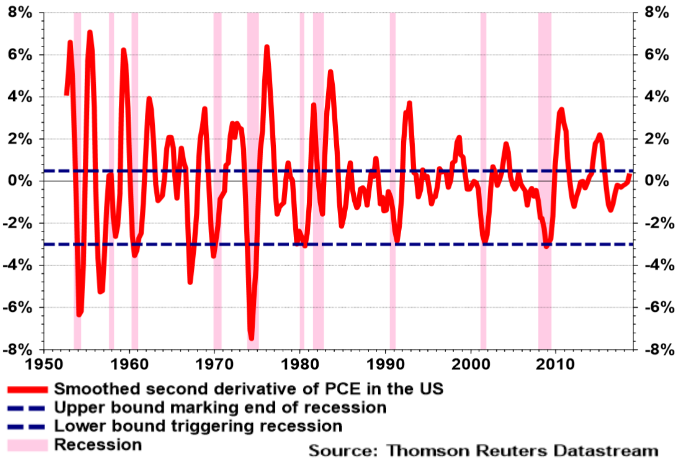
The statement of the President of the Fed is all the more surprising that it follows another announcement, also to say the least ... breathtaking. Barely a month before his confession of helplessness, Powell had declared that the health of the American economy was "remarkably positive" and "extraordinarily bright". But above all: the great Central banker did not see why we could not believe that this great cycle could be here to last ... indefinitely. A rare optimism, in full contradiction with the dark growth prospects. What is it really?

The US economy has so far been pushed ahead by three strong tailwinds: First, there has been a tremendous stimulus to monetary policy that has left its mark today: despite recent increases, interest remain below their threshold deemed "neutral" for growth. Then, in 2018, it was the tax cuts that boosted growth, helped as it were by the offset positive effects of the weak dollar during the first half of this decade. As a result, the world's economic leader is in full overheating, as evidenced by our first two charts. Chart 1 shows the evolution of a composite indicator of business and household confidence in the United States. The latter is at very high levels, which explains the good performance of consumer spending, as evidenced by the 2nd chart showing the variation in growth rates.

1. The United States is overheating



2. US household consumption remains buoyant



We should nevertheless be cautious going forward, as the engines of growth may misfire. That of the fiscal stimulus was extinguished at the beginning of the year, and the one linked to the dollar will squarely turn into a headwind, with the greenback recovering colors since 2015. But above all, it is on the side of the monetary policy that we must seek the main obstacle to growth! To be true, the US Central Bank has adopted a resolutely restrictive monetary policy, with, initially, the "quantitative tightening" which results in a decrease in the size of its balance sheet and, subsequently, interest rate increases that are currently materializing at a rate of one per quarter?

After lifting the foot of the accelerator, the Fed put it on the brake in 2018. Will she put both feet on the brake in 2019? This is the big question that is bothering investors in 2019. We believe that the US Central Bank will keep its reason and not risk a recession in the face of a danger of inflation that remains contained.

Still, the feeling that we are approaching the end of a cycle in the United States is widespread and ... it is in this fragile context that we must be wary of the arrival of black swans .

The debt overhang as the next black swan?

The black in which the US Central Bank gropes is also the dreaded color of the swan. Since Nassim Taleb made "Black swan" a book describing these exogenous shocks that are as highly improbable as damaging, we discovered that the scarcity of the black swan is no longer when we travel to New Zealand or Australia. Here, they are legion. Anyhow, let us keep in mind that they personify a terrible exogenous shock with a probability of 1 in 1 followed by many zeros. When talking about exogenous shocks, we point to unforeseen surprises, such as Fukushima for negative shocks or the Internet and, more recently, the Blockchain for say, more positive shocks.

But the shock can also be the fruit of the hand of the Man. In this instance, the black swan becomes endogenous. An example: the accumulation of debt or derivatives in the world. When does the pile crumble and causes serious recessions, like during the crisis of 2008? Three physicists from New York University have tried to estimate the fateful moment when a pile collapses due to avalanche, by carrying out a simple experience: you form a pile of sand by letting the grains drop by the top of the pyramid that forms under your eyes. The 3 researchers have reproduced on a computer this game we all played when we were kids, and this gives them a double advantage: to be able to add the grains one by one and, above all, color them differently according to the height of the pile: green when it is weak, red when it is marked. Their results: if a red grain rolls down the pyramid and slips in the middle of green grains, it increases more than proportionally the instability of the pyramid. It's the "bad seed" that causes the domino effect, sort of. Physicists do not find a critical height which would trigger the avalanche. But they note that the more solid the base of the pyramid - the more green grains are numerous - the more the avalanche will be marked. And this is where the link can be made with this form of "endogenous uncertainty" that plagues financial markets.

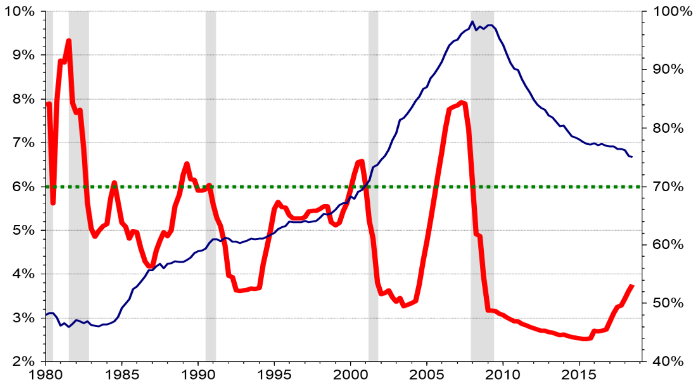
It is the economist Hyman Minsky who, in our view, has best illustrated the fact that stability leads to instability. And this for a very simple reason: the more comfortable we are with a given situation or trend, the more it will persist and, when the trend fails, the more dramatic the correction will be. The problem of lasting macroeconomic stability is that it tends to produce unstable financial mechanisms. If we think that tomorrow and next year will be the same as last week and year, we are more willing to increase our debt and postpone our savings to current consumption. Thus, says Minsky, the longer the period of stability, the greater the potential risk of instability when market players have to change their behavior.

In relation to our pile of sand, the more slowly a potentially critical state is built up in an economy, the greater the danger of a systemic avalanche. While it may seem odd to build a theory of instability from the persistence of stability, it is through the growing confidence in macroeconomic equilibrium that drives us to exuberance and excessive indebtedness that the loop is curly, until the fatal moment when "too much is too much". Sure enough, this " Minsky moment " is difficult to establish: hence, it is all the more fundamental to get a full grasp of economic cycles and their impact on the debt of all economic actors: households, companies, states.

Monetary policies that have been resolutely expansive since the 2008 crisis have - to varying degrees depending on the geographical areas - ultimately positively impacted growth. The good news in the United States is that this return to growth has not translated into excessive indebtedness of households, far from it. While it reached 100% of US GDP in 2007, their debt has even fallen to 75% today. That can be seen on chart 3.

To know if the " Minsky moment" is near, there is nothing better than to analyze the cost of debt. This is the curve in red and on the left scale. We know that for debt to be sustainable, the interest burden must not exceed the nominal growth of the gross domestic product. By multiplying the ratio of household debt and GDP by the reference interest rate in the United

3. US household debt remains sustainable...



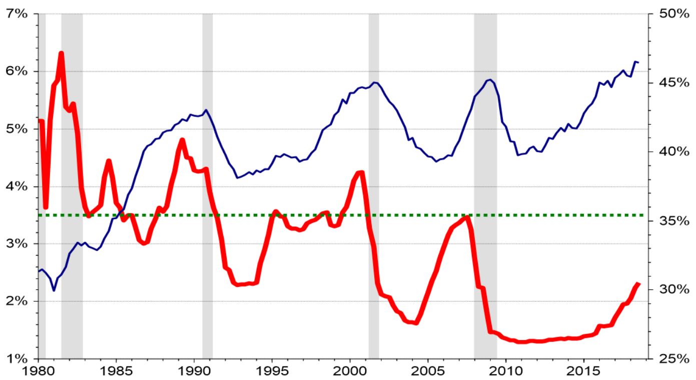
Prime rate * (Household debt/GDP)
US Household debt / GDP (RHS)
Sustainability threshold

Source : Thomson Reuters Datastream / MacroGuide

States (the "prime rate"), we have a measure of debt sustainability. Judging by past recessions - indicated by the vertical bars in gray - the latter is ensured when household debt service does not exceed 6% of GDP. At 3.5% currently, we still have some margin, helped as it were by the welcome trilogy of debt reduction, sustained growth and low-interest rates by historical standards.

Janet Yellen, the former Federal Reserve Chairman, noted in a recent interview that corporate debt is sky-high and needs to be addressed.

4. ...and that of American companies is also



Prime rate * (Corporate debt/GDP)
US Corporate debt / GDP (RHS)
Sustainability threshold

Source : Thomson Reuters Datastream / MacroGuide

At nearly 50% of GDP, the debt of the US corporate sector - outside the financial sector - is actually at a record peak, as we can see with the blue curve on the right scale of Chart 4. Are we close to the avalanche? Not really, if one judges by the evolution of the service of the debt, in red and on the left scale of this same chart. Today, it is less than 2.5% of GDP, which is 100 points less than the 3.5% that preceded recessions in the past. As a matter of fact, this chart shows us that corporate debt was much less sustainable in the early 1980s. At 33% of GDP, it was markedly less than today, but interest rates were much higher at that time: the clearly excessive interest charge of almost 6% had to be corrected by a severe recession in 1982.

The same reassuring message can be conveyed regarding public debt: it has certainly doubled since the crisis of 2008, from some 50% to almost 100% of GDP. But, thanks to the very accommodative policy of the Fed, the current debt service costs remain at controlled levels.

Debt is thus high but still sustainable in the country that remains the world leader in growth: this is our rather reassuring message for this new year. However, the pitfalls that could hinder the smooth running of business in the United States are not lacking. Among these, there is one of particular concern: the prospect that the United States will ignore the negotiations with China on customs agreements making the specter of a trade war resurface. Bold assumption as it were, we expect the President of the United States to return to reason and that negotiations will be concluded with a view to a compromise. At the time of writing, the partial shutdown of government services is worrying the markets. We believe that an agreement will be reached and that the debt ceiling will be raised, as has always been the case in the past.

Elsewhere in the world, growth will slow in 2019. In Europe, it should reach 1.9% in 2019, compared to 2.1% in 2018 and 2.4% in 2017. The slowdown is mainly due to the contraction in the world economy and world trade tensions. In the longer term, supply-side factors such as labor, capital and productivity will drive growth rates down to 1.4% over the next decade. In Japan, growth is also slowing down, and our indicators are indicative of a clear recession danger. Emerging markets are expected to grow by 3.7% in 2019, a slight decline from 2018.

On the bright side, the US Federal Reserve's low sightseeing is good news: the lack of visibility will keep the central bank from being too harsh on interest rates, which is good news for easing the debt burden and ensuring its sustainability.

Another reason to be cheerful: equity markets have returned to reasonable valuations and the comparison to lower bond yields is also favorable to them .

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

After no doubt peaking in mid-2018, global growth began to recede gradually in the fourth quarter. The global PMI index fell in December back to its level of September 2016, and the drop in new orders spread to the US, despite still solid domestic demand. Other signs of this downward trend were lower inflation figures and an oil price more than 30% off its high of last October. This economic slowdown was priced into bond yields, which in a few weeks fell from 3.23% to 2.70% for 10-year US bonds and from 0.50% to 0.10% for 10-year German paper. High-yield spreads widened considerably over the same period. Meanwhile, monetary policy divergences among the main central banks have broadened. While the ECB is sticking to its negative-rate policy, in order to boost the eurozone economy, the Fed raised its key rates for the fourth time in 2018, to a 2.25%–2.50% range, while flagging two additional rate hikes in 2019. The spread between the US 10-year yield and the overnight deposit rate in USD is now just 30bp, down from 98bp in November. In our balanced portfolio, we added to our investment grade allocation (20%) with sovereign euro bonds, floating-rate euro bonds, and USD-denominated corporate bonds. Cash holdings were lowered to 2%. We plan to sell into any rally in high-yield bonds to shrink our allocation (11%), which is still overweight. We are maintaining a low duration in our fixed income selection.

Equities

The global economic slowdown triggered a gradual slide in the markets during the fourth quarter of 2018, exacerbated in December by the Fed's restrictive language. Investors are fearing a worse-than-expected US economic slowdown, and risk aversion has been ratcheted up by China-US trade war fears, risks of a hard Brexit in Europe, and the impact of an extended US government shutdown. On the full year 2018, US markets fell by 6.72%, eurozone markets by 13.32%, Japan by 12.08%, and China by 25%. Valuations nonetheless returned to reasonable levels late in the year, at 4% below their long-term average in the US, 12% in Europe, and 19% in emerging markets, all of which justified the rally that began in January. Within our balanced portfolio, we continue to overweight Europe (17%) and Japan (5%) and to underweight the US (14%). We are now weighting Asia-Pacific ex-Japan at 5%, mainly in China, Korea, India, and Taiwan. Other emerging market regions account for about 1% of the allocation. By sector, investments are mainly focused on techs, consumer cyclicals, financial services, healthcare, and manufacturing. Our tactical hedges in 2018 helped mitigate the portfolio's negative performance. We are taking advantage of the current rally to phase back in a new hedge while holding on to a neutral strategic position of 45% in equities.

Currencies

The US dollar and yen were among the few assets to eke out gains in 2018. We are sticking to our 14% long USD exposure in the balanced portfolio.

Alternative

The alternative allocation (16% of the balanced portfolio) offered considerable support for other asset classes in the fourth quarter of 2018, including a positive performance in December. The strategies break down as follows: Equity-Market Neutral (48%), Global Macro (23%), Multi-Strategy (12%) and Event-Driven (6%), along with the additions of Protection (4%) and Cat Bond (7%) strategies. Our portfolio's risk-weighted return in 2018 was perfectly decorrelated from returns in alternative, equity and bond indices.

Outlook

Global growth has begun to slow, from 3.9% in 2017 to 3.7% in 2018. It could fall back to 3.2% in 2019, including 2.3% in the US, 1.3% in the euro zone, 1% in Japan, and 6% in China, hence a further slowdown to levels that are low but still in positive territory. Our baseline scenario assumes that the global economy will level off but without slipping into recession. True support for the markets in the coming months can only come from a medium-term improvement in risk appetite, something of a rerating, and some monetary policy support. Central bank attitudes and corporate earnings will thus be more decisive than ever in assisting what we hope will be a soft landing, in 2020.

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