

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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“Resilient growth and ECB pro-activity still favour European equities”

▶ MARKET ANALYSIS

October was a very good month for risk assets and equity markets in particular which enjoyed their biggest bounce since April 2009. The trend reversal was due to a number of factors: (i) markets had over done the correction during the summer and investors were relieved to see signs the Chinese economy was stabilising, (ii) the Federal Reserve made its intentions clearer after a period of hazardous communication, and (iii) Mario Draghi delivered very pro-active statements suggesting imminent ECB action to extend monetary easing.

On August 24, we decided to reinforce equity exposure in our portfolios, taking eurozone equities to a maximum overweight. In our view, that day marked the investor capitulation moment when market movements no longer reflected our appreciation of the situation nor our take on prospects. We recently decided to take some profits on European equities, thereby reducing our overweight but there are many reasons why investors should still focus on the zone:

- European growth is proving very resilient. It is striking to see how well European, and especially German, surveys have held up in recent months despite slowing emerging country growth, market volatility and the Volkswagen scandal. For example, expectations in the IFO business climate survey hit a record high in October, a sign of robust optimism among German industrial and export companies. In Italy, there have been more and more signs since the beginning of 2015 that the country is emerging from a very long crisis. And in France, manufacturing, services and household surveys point to a recovery, albeit to a lesser extent. France and Italy have so far missed out on the European recovery but now seem finally to be taking flight against a more complicated global backdrop. We estimate that European growth should continue to rise by 1.5-2% in coming quarters and that should help earnings increase at a faster pace in an environment where low interest rates, commodity price falls and stable wage trends will be enough to drive company margins.
- By highlighting the need for further easing (through more quantitative measures and/or a cut in its deposit rate), the ECB is being remarkably proactive given its history. Of course, the ECB is worried about tame inflation expectations but the bank is also performing risk management by looking to ensure a recovery that is potentially, but not yet visibly, threatened by the slowdown in emerging economies.
- Not very demanding European market valuations make the zone look interesting as we are clearly at the outset of an earnings cycle.

KEY POINTS

- ▶ European equity overweight reduced
- ▶ US bond underweight reduced
- ▶ Preference for HY euro credit

Generally speaking, we are still in the initial stages of a recovery in developed country growth but the global upturn will be limited by a lengthy slowdown in emerging countries which are grappling with a deflationary environment. Emerging countries are, in fact, caught between China's rebalancing - which is significantly undermining

foreign trade patterns in numerous countries – and the risk of private sector deleveraging after the rapid credit accumulation of recent years. This backdrop has led us to prefer equities to bonds.

» OUR CONVICTIONS

ON EQUITY MARKETS:

Following the recent European equity market rebound, we reduced our European equity overweight. However, we remain upbeat on European equity prospects and continue to prefer the eurozone, with a focus on domestic cyclicals.

ON BOND MARKETS:

We reduced our US bond underweight following the latest FOMC which caused bond yields to rise somewhat. Persistently tame inflationary pressure and emerging country fragility should see the Fed tightening at a slower pace than we had previously expected.

Upbeat prospects on European companies and the ECB's clear intentions have also led us to favour high yield euro credit.

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