ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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"Opportunities and volatility"

MARKET ANALYSIS

August's renminbi devaluation surprised investors and aggravated concerns over China. Deflationary pressure there is spreading abroad and the country's economy is now slowing significantly even if it remains the biggest engine driving global growth. Doubts over growth combined with uncertainty over the Fed's monetary policy in coming months triggered a global stock market correction and traditional safe havens like government bonds afforded little or no comfort.

We believe these worries are excessive:

- True, China's economy is slowing more than the government would like and is now probably running at around 6% but it is still up and running. Bear in mind that Beijing is looking to accelerate the transition from an industrial economy to a model that is more focused on services while reversing under-investment by companies and in property. This is sound policy because the previous economic model was unsustainable. But the shift means a de facto slowdown that the government is trying to manage using the powerful economic policy tools at its disposal. Competitive devaluation could be part of its arsenal but for the moment it looks as if the PBoC, China's central bank, has not fundamentally changed tack on its exchange rate policy in an attempt to bolster the economy. Rather, the fall in the PBoC's reserves in recent months suggest that it intervened on currency markets to stop the currency falling as a result of bigger capital outflows. In fact, the renminbi's actual exchange rate has risen by almost 20% in the last 5 years, a significant rise. With the US dollar continuing to strengthen throughout the world, China is thus distancing itself a little from the greenback so that the renminbi does not move into overvalued territory amid today's tricky economic conditions. Worries that China will embark on competitive devaluation therefore look groundless to us.

- China's slowdown is clearly having a negative impact on a good many emerging countries. The contrast between developed and emerging country momentum is widening to arguably unsustainable levels. So we cannot rule out some damage to the US, Europe and Japan. But, for the time being, US growth is still looking robust, especially after the upward revision in second quarter GDP, while European indicators have not yet shown any signs of weakness. For example, the IFO survey, which is a strong reflection of German exports, is doing very well. Given this resilience, China and other emerging countries would have to suffer more serious economic declines to have a material impact on developed countries. However, we are still convinced that Beijing will still seek to manage the slowdown and go for stimulus measures if required. And yet, the overall equity market correction, and the damage

KEY POINTS

- European equities reinforced to maximum rating
- Still overweight developed country equities vs. bonds
- Underweight emerging country equities

done to cyclicals in particular, already discounts a serious downturn in prospects although this has not yet started and may in fact never happen.

- Lastly, markets are probably worried by central bank inaction faced with what they see as a deteriorating situation. Both the Fed and the Bank of England are gearing up for a rate hike and the latest Jackson Hole summit showed they have still not changed their tune. The ECB reminded investors on September 3 that it was prepared to act due to greater uncertainty over the global economy, inflation forecasts that will necessarily have to be revised lower after fresh falls in commodity prices and the market's expectations of future inflation which have now fallen to very low levels. Last year, the ECB's chairman Mario Draghi used 5-year inflation expectations of 1.7% as one of his justifications for introducing quantitative easing. As the eurozone is not in the same situation as the US and UK- its recovery is only a few months old- the ECB could seek to reaffirm its reflationary stance and reassure investors.

OUR CONVICTIONS

ON EQUITY MARKETS:

Given the looming lift-off in the US monetary tightening cycle and low visibility on China's economy, we have been underweight emerging country equities since March 2015 while remaining overweight developed country equities. Convinced that markets were exaggerating the risk of emerging country woes contaminating developed country economies, we decided on August 24, when markets were collapsing, to tactically reinforce European equities. They are now at their maximum rating.

ON BOND MARKETS:

We are maintaining last month's neutral stance due to strong volatility in recent weeks. We prefer government bonds in core eurozone countries and high yield debt.

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