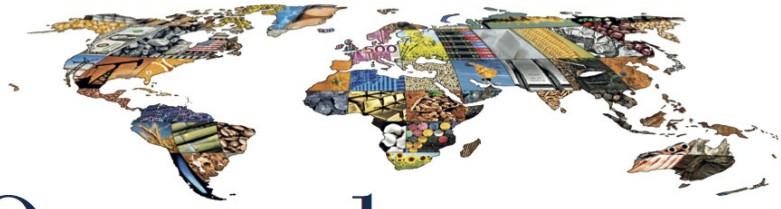
2pm PERSONALIZED PORTFOLIO MANAGEMENT



Quarterly marketreview

OCTOBER 2020

Editorial

2020: An Incredible Year!

A pandemic from China, the world economy almost at a standstill during the spring with population lockdowns, the deepest recession since the 30s, a stock market crash of incredible violence, and today, a few months later, an American stock market almost at its historic highs! What has happened in the past three months? This is what we will try to decipher in this editorial.

We are witnessing a strange phenomenon: the concomitance of a new post-Covid economic cycle with valuations on certain asset classes, more typical of an end of cycle. The equity markets, especially the US and emerging markets, are currently showing us rather high valuation levels on the strict P/E (Price Earnings Ratio) criterion, levels that we usually see after several years of stock market rallying, while credit spreads are relatively tight for the start of the cycle. This partly reflects the speed of the rebound in equity indexes since April. But it is also a consequence of ultra-low interest rates and asset purchases by central banks which have compressed risk premiums and boosted the price of risky assets. We will try to show at the end of this editorial that evaluation criteria other than P/E, such as Equity Risk Premium (ERP) may suggest that even after such a rally, there may still be potential in the shares markets.

The turning point is expected to come when developed economies return to full capacity. And we will see this when the unemployment rate stops falling and inflationary pressures begin to kick in. Central banks will then let the market know that the next moves in key rates will rise and bond yields will begin to tighten. But this scenario is likely not to happen for 18 to 24 months.

For now, the US Federal Reserve is maintaining its ultra-accommodating course. The US central bank indeed announced in mid-September that it was keeping its key interest rates at floor level and that this should remain the case at least until 2023. The Fed also continues to create money in buying securities in the markets while increasing the size of its balance sheet. What is more, this aspect of US monetary policy remains unlimited: the Fed is maintaining the pace of its acquisitions without setting a maximum amount. The Fed also confirms its new inflation target, which is no longer to achieve a 2% price increase, but rather an average inflation of 2% over time, which allows this threshold to be temporarily exceeded to compensate the inflation deficit of recent years. This is a significant paradigm shift. In its press release, the Central Bank specifies that it “expects to maintain an accommodating level of monetary policy until its objectives are reached.” In other words, the Fed links its "forward guidance" (its longer-term intentions) to the new inflation target that they established at the end of August, which will constitute significant support for stock market valuations.

In Europe, macroeconomic indicators have also rebounded in the past quarter, following the easing of lockdown restrictions. The number of people infected with Covid-19 is on the rise (as is the number of screening tests carried out in recent months), but for the moment, hospitalization and death rates remain low. Although Europe's fiscal response was half the size of the United States, it was nevertheless reinforced by state guarantees on corporate debt and by the ECB's support for bank loans, through the TLTRO program. But the most significant measure was the European stimulus plan, a package of 750 billion euros (6% of GDP) consisting of loans and guarantees that will be financed by the issuance of bonds jointly guaranteed by the 27 member states. A Europe now more exposed to world trade than the USA and which should benefit from the rebound in Chinese demand. For the moment, the European indexes have accumulated quite a bit behind the American indexes. The Eurostoxx 50 has thus only retraced 50% of the February-March decline, while the S&P 500 has, since August 24, exceeded the pre-Covid

	Q3 2020	FY 2020	Close 30/09/20
DOW JONES	7.63%	-2.65%	27 781.70
S&P 500	8.47%	4.09%	3 363.00
FTSE 100	-4.92%	-22.23%	5 866.10
EUROST.50	-1.25%	-14.73%	3 193.61
CAC 40	-2.69%	-19.65%	4 803.44
FTSE MIB	-1.86%	-19.11%	5 866.10
MSCI EM	8.73%	-2.93%	1 082.00
CRUDE OIL	2.42%	-34.13%	40.22
GOLD	5.89%	24.29%	1 885.82
EUR/USD			1.1721
EUR/CHF			1.0794
EUR/GBP			0.9072
EURIBOR 1M			-0.529%

highs of February. This phenomenon is very directly linked to the weight of sectors such as telecoms, financials, basic materials or energy, which were severely impacted by the pandemic context versus the American stock market, boosted by the excellent performance of large technological stocks, FAANGs as they are commonly called (Facebook, Apple, Amazon, Netflix and Google). These five companies, to which we should add Microsoft, constitute 25% of the market capitalization of the S&P 500 index and are the cause of its positive performance since the beginning of the year. It is estimated that without these values, the US index would be down about 4%. As of September 30, the S&P 500 was therefore up 4.09% while the Eurostoxx50 was down -14.73%! A colossal gap which confirms our efforts to diversify. As for the MSCI Emerging Market, it is down only -3.93% since the start of the year. It must be said that the Chinese economy has been surprisingly strong since the onset of the health crisis and it will likely be the only growing area this year. The service sector is catching up with the manufacturing sector and fiscal policy is expected to remain very supportive by the end of the year. Although tensions have recently reappeared between the US and China with the restrictions on some Chinese companies like Huawei or Tik Tok, it is likely that phase one of the agreement will remain intact beyond the US election, encouraged by the recent reports showing the increase in Chinese purchases of US agricultural commodities and energy.

What can we expect by the end of the year? A difficult question to answer. In fact for us, the equity markets still seem to have potential

over the 18-24 month horizon, given the positioning of the various developed economies in the cycle and the ultra-accommodating monetary policies which should be maintained to the minimum Q4 2022; short-term forecasting is tricky, for several reasons. Firstly, the health risk: Faced with the rise in infection rates, particularly in Europe, we can clearly see that some countries (Spain, England, France) are tempted to return to at least partial lockdown measures, or all cases towards significant restrictions in the daily life of consumers. If this remains marginal, the market should remain relatively calm. If, on the other hand, it appears to operators that the new health measures likely to be taken in the coming weeks, while awaiting for a vaccine, would lead to major disruptions in the real economy, the market could therefore become very nervous again. Likewise, the US election poses a risk of increased volatility for the market in the very short term. The ballot promises to be close and the first televised debate last week heralds a tough campaign in which fair play will be largely absent. With postal voting, it is not impossible to have to wait several days or even weeks before knowing the name of the next American president. The kind of uncertainty the market hates, even though as we analyze in The Big Picture below, the mid/long term stock market impact of one side winning over another is ultimately quite negligible. Finally, negotiations in Congress between Republicans and Democrats over continued tax support appeared to be at an impasse during the last few hours. If a deal does materialize, it will be great news, that should push the US market up again after the profit taking of the past four weeks. If, on the other hand, no agreement is reached, it will have a negative impact on US consumers of around 4% of GDP..

However, if we look to 2021, after the probable volatility surrounding the election period, and given a vaccine that should be found by the end of the year, we have good reasons to stay moderately optimistic on equity markets, even with already high P/E in certain sectors (a reminder that there are entire sections of the quotation still very reasonably valued). Indeed, with interest rates so low and for a long period of time, equities remain quite essential for the long-term investor. The yield spread between the S&P 500 dividend rate and the 10-year US government bond rate is at its highest since 1955. And if one leans not to the P/E, but rather to the ERP (Equity Risk Premium), a ratio that compares the high price of shares as compared to bonds (= inverse P/E - 10Y Treasury Yield), we see that the ERP is at its highest since 50 years, suggesting that equities are still very attractive in relation to bonds. Regardless, recent times have confirmed our belief that we are still well diversified, whether in terms of geographic areas, management styles or instruments. Our portfolios have held up fairly well in the turmoil experienced in recent months, in particular thanks to good equity allocation this year, boosted by our US, world and thematic funds and more than ever, we will be attentive to the quality of the portfolio managers that we will introduce in the future.

C.Carrafang

The Big Picture

The White House Election and Wall Street: From "Apocalypse Now" to "Much Ado About Nothing" (W. Shakespeare)

The election to the presidency of the United States is an event always eagerly awaited and commented upon, but which raises the question of its real impact in the United States on the evolution of the economy and on that of equity markets. Four years ago, the wind of the Apocalypse blew with the idea of Donald Trump coming to power. The upcoming presidential election on November 3rd is an opportunity to reflect on the real impact of the White House host's political color.

- *Democrat or Republican, does it really make a difference?*

Among misconceptions is that the Republican Party candidate is generally considered to represent Wall Street or at least the one whose "pro-business" agenda is most likely to espouse financial interests. What's the truth of the matter?

A study by the St. Louis Federal Bureau shows that since 1947, the US economy has grown at a rate of 3.6% per year under a Democratic president and 2.6% under a Republican administration. It appears that the political color of a President has no causal link with such phenomena as the oil crisis of the 70s, the bursting of the internet bubble at the turn of the year 2000, or the subprime crisis of 2008.

In these 3 cases, the strongest impact was felt under a Republican administration, not to mention the 1929 crisis under the Republican presidency of Herbert Hoover. As a result, the stock market performance of US stocks as measured by the S&P 500 index since World War II has been 10.8% per year compared to 5.6% for Republicans. Another interesting element to observe is that it is often during the second terms that the gaps widen: up for Bill Clinton between 1996 and 2000, down in the case of George W. Bush Jr. between 2004 and 2008.

Will Donald Trump get the opportunity to fit into the statistics?

In recent times, Wall Street's performance under the Obama administration (+ 12.4% per year) or under the Trump era (+ 13.9%) is very similar. Moreover, does the President have a real grip on the evolution of the stock market prices of innovative giants like Apple, Facebook or Tesla?

- *Is it true that as the election approaches, investors are becoming more nervous?*

Historical reality does not seem to validate this thesis. Over the past 30 years with the exception of 2000 and 2008, which took place against the backdrop of a deep financial crisis, volatility has not been particularly strained. There remains the last election which saw the arrival in the White House of Donald Trump. The harshness of the campaign between the two candidates, one of whom was very unusual, followed by the surprise of the verdict of the ballot box, certainly caused an increase in volatility.

This time around, Donald Trump is even more famous and whatever the result, it will not have the same surprise effect. The election takes place in the midst of a deeply destabilizing health crisis that naturally tends to push up the VIX index which measures the volatility of US stocks. It seems unlikely that the temperature of the fear thermometer will fall by the time of the ballot and possibly beyond. When G.W Bush Jr. was elected in 2000, it took 35 days to know with certainty the name of the newly elected President - a peculiarity of the American electoral system - with 500,000 votes less than his opponent. During this waiting period, the S&P 500 fell 4.4% as did the dollar. Bond yields tightened and volatility doubled. President Trump himself already speaking of the risk of fraud, some observers imagine the same type of scenario this time again in the event of a tight result. From this perspective, the big winner of the election from a market perspective is likely to be volatility.

In reality, the current election in the United States, like previous ones, should not deviate investors from their long-term goals.

G. de Villaines

Macro-economy

CHINA

- Exports rose sharply at a rate of +7.5% in August, i.e. the 4th positive month led by computers, textiles and medical equipment. Figures well ahead of the rest of the world.
- Manufacturing indicators, averaging 53 in recent months, are numbers not seen in many years.
- Retail sales on internal consumption are again positive, with a less buoyant return to normal than in developed economies. The holiday week in October will be decisive for the end-of-year consumption figures.
- The ODCE now forecasts growth in 2020 at +1.8%, one of the few countries with Taiwan not to be in recession this year.

EUROPE

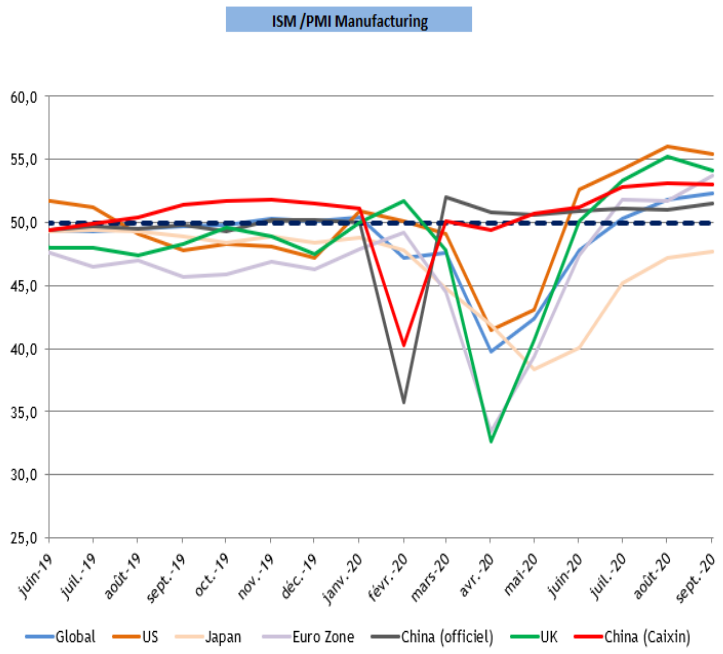
- For the moment, the big economic loser of this crisis compared to Asia and the United States.
- In 2020, GDP should decline by -7.9% (decline revised downward), with huge differences in the countries of the Zone.
- The recent new restrictions on activity will weigh on the service sectors for the end of the year. The PMI services at 48, was down 2.5 points in September.
- Manufacturing activity is driving the European recovery. The indicator is up from 51.7 to 53.7 over the last month, with Germany as the best performer at 56.4.

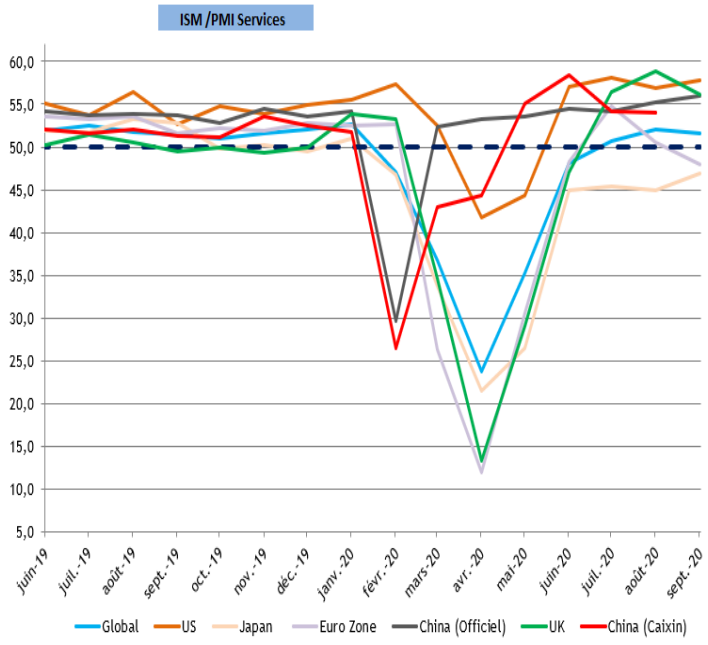
USA

- The decline in US growth estimated for 2020 has been revised by the OECD ; from -6% for this year, the GDP should ultimately decline "only" by -4.8%.
- Unlike Europe, the services activity is particularly robust, averaging 57.6 over the last quarter.
- Manufacturing activity for September is good with an index at 55.4 and a three-month average of 55.2.
- The decline in unemployment continues and the amount of job creation is encouraging, but there are still nearly 12 million benefit recipients and some sectors (notably aeronautics) are beginning to announce severance schemes.

D. Liegeois

ISM/PMI indices since june 2019





Special Topic

The return of major maneuvers: good news for the markets...

Despite the return of uncertainties related to the health crisis, Brexit negotiations and the approaching US elections, the past two months have been marked by a return to capital operations. Daily, many announcements punctuate the markets.

The current crisis is very discriminating and contributes to these great maneuvers. Some companies have to restructure, others refocus their activity by selling non-core assets, and still others take advantage of low valuations to embark on external growth, not to mention particularly vigorous IPOs in Asia (Ant Financial) and in the United States (Snowflake).

Even if in 2020 the activity remains in decline, we have to go back more than 20 years in order to have over two months more than 250 billion put on the table in the world with transactions of more than 5 billion.

Europe is not being outdone because beyond the operations announced pre-crisis and which are often in renegotiation (Alstom/Bombardier, LVMH/Tiffany, Peugeot/Fiat), the activity is restarting with large-scale operations: the Suez file (proposal to purchase Veolia), Lagardère (increase in Arnaud's capital), HSBC (increase in capital de Ping An) or Sanofi and its offer on the American biotech Principia Biopharma.

There is no shortage of supporting factors for the coming months:

- Significant liquidity with injections from central banks.
- Colossal stimulus plans focused on digitization and energy transition.
- Major activity that will also come from the world of Private Equity, which at the end of 2019 had nearly 1.5T dollars of capital to deploy quickly.

In Europe, we should see continued consolidation in certain sectors such as telecoms (Sunrise/Liberty Global) and banks (Bankia/Caixa), with, and this is new, the tacit support of the European Commission void of European champions. The sought-after profile of buyers remains rather with low-debt companies with good “cash-flow” in sectors little affected by the crisis: digital, pharma, new energies or even the industrial sector. The small and mid-cap segment will be in high demand. This is the first time within this crisis, and with the underperformance of small-caps since 3 years, that the values listed are cheaper than those unlisted.

The only downside in this positive context is that politicians will be particularly attentive to cross-border operations and to sensitive sectors: technology, defense… For example, it is becoming more and more complicated for Chinese capital to operate in the United States, and vice versa. On another note, the French government is seen meddling in the LVMH/Tiffany operations in the midst of trade negotiations with the Trump administration.

The authorities will have their say, but the needs of businesses and the surrounding liquidity are so great, that it will probably not be enough to slow the flow of operations.

Damien Liegeois