INDOSUEZ WEALTH MANAGEMENT

MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – FEBRUARY 2020

MARKETING MATERIAL

FOCUS

SPREADS TIGHTENING
AND LEVERAGE CREEPING UP

EQUITIES

MEDIUM-TERM CONSTRUCTIVE
FOR EQUITIES YET SHORT-TERM CAUTIOUS

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EDITORIAL

VINCENT MANUEL

Global Chief Investment Officer,
Indosuez Wealth Management

INVESTOR DILEMMAS IN 2020: ASSET VALUATIONS, STYLE ROTATIONS AND VOLATILITY NORMALISATION

Dear Reader,

The 2020 investment landscape seems to have started where we left things in 2019 with quality and growth stocks dominating value, with technology outperforming the market, and with a growing list of cyclical stocks disappointing and delivering poor results.

In a way, this is not really surprising. Recent data validates the low but positive growth scenario that is favourable to the consumer side, but detrimental to the producer; with wage inflation above price inflation, digital names with economies of scale and which are less labour intensive outperform the old economy.

Among the prominent elements thus far in the year, we should highlight China, which is at the centre of our 2020 scenario. 2020 started with additional monetary easing, resulting in a vote of confidence by the market and was also sustained by the conclusion of the phase one deal with the US.

After such a stunning year in markets, what is ordinarily the next step? Asset allocators often rely on a kind of mandala-type belief: the rotation of risk factors and investment styles. At this stage of the cycle, with central banks on hold and stretched fixed income valuations, we should be switching from quality to value and from credit to equities.

The dominant factor driving the markets this year should switch from monetary policy to fundamental growth and fiscal policy, from valuation multiples to asset fundamentals.

But the paradox is that, so far, investors continue to buy quality stocks and to pour money into credit ETFs, and American issuers opportunistically take advantage of this negative rate environment to launch euro bonds in to an oversubscribed market.

This trend has recently pushed investment positioning and equity market indicators into bullish territory. As long as equity yields relative to bonds remain favourable, this positive environment for stock markets should be firmly anchored. But what is noticeable in this bull market is that safe havens have enjoyed strong momentum, which defies the traditional inverted correlation with risky assets. This is probably another implication of negative rates, which increases the attractiveness of gold.

What could be the logical next phase in the market? To us, the law of gravity for financial markets are that short-term correlations should return to a more orderly behaviour: gold and treasuries performing opposite to equities and high yield. What would also seem logical would be to have a return of volatility to more normal levels.

But the notion of normality seems to have disappeared nowadays. Indeed, in this cycle, we have mostly witnessed the repetition of a risk-on/risk-off pattern, in which volatility is alternatively abnormally low or exceptionally high. As long as investors continue to use volatility as the measure for risk budgeting, we will have pro-cyclical behaviours exacerbated by heavy shorts on volatility.

So where does market risk sit and which catalyst could reverse this paradigm? To us, this could come less from the causes of this bull market but rather from its unwanted implications. Risk probably lies mostly in investors' aggressive positioning itself and in what investors give up when they run after yield: liquidity premiums, and diversification effects.

Among the undesired effects of this bull market, we see poor credit liquidity as something to monitor, especially when spreads evolve into thin air. A final dilemma is that rotations don't usually happen without volatility, which has interrupted these types of rotations several times in the past.

So in brief, long-term investors should stay reasonably exposed to equities, but with a higher likelihood of a technical correction they can start to accumulate a variety of hedges. 2020 is about patience and balance. And time is not that expensive after all...

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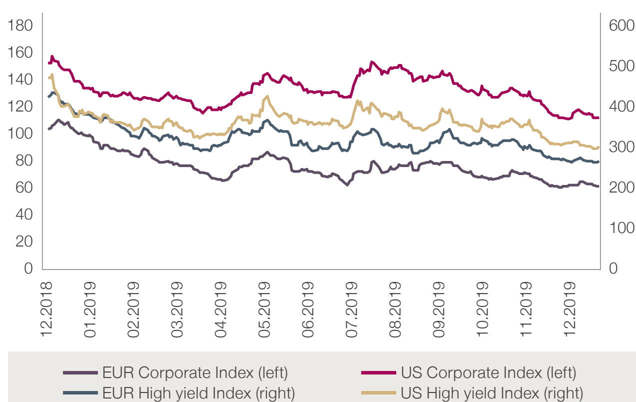
Kicking off 2020, US investment grade bond issuance hit USD 69 billion in the second week of January, the second highest weekly volume in history after a record issuance in September 2019. In the same week, Europe has also had its best week for corporate bond issuance, selling more than EUR 90 billion across both investment grade and high yield. For issuers, the risk-on factor seems to have returned as central banks continue their accommodative policies and trade-war risks have subsided – for the time being.

Credit conditions will continue to remain benign in 2020 given the stabilising macro backdrop as well as accommodative central bank policies on both sides of the pond which should provide space for positive performance amongst EUR and USD credits. However, relative to 2019, the risk is arguably skewed to the wider side given expensive valuations and rising idiosyncratic risk[1]. Thus, fundamentals should be at the front of investors' minds given the late cycle set-up and earnings headwinds.

SENTIMENT SUPPORTIVE IN THE SHORT TERM BUT MEDIUM TERM UNCERTAINTIES PERSIST

Credit indexes have continued to grind tighter thus far in 2020 as the phase one trade deal between the US and China has been signed, bringing an expected more benign macro environment. The signed deal has reduced (but not eliminated) the risks of a renewed escalation in tariffs and other punitive measures. However, the current tight credit spreads clearly do not reflect the event risk and corporates' weak fundamentals in general.

EUR AND USD IG AND HY SPREADS CONTINUE TO TIGHTEN, BPS



Source: ICE BaML Indexes (HE00, ER00, H0A0, C0A0), Indosuez Wealth Management.
Past performance does not guarantee future performance.

Furthermore, earning growth are likely to be sluggish in the industrial and cyclical sectors. The phase one deal has kept a 25% tariff on USD 250 billion of Chinese imports and a 7.5% levy on an additional USD 120 billion of products. Most of these products are electrical machinery, automotive parts, electric integrated circuits and parts, and electronic parts imported by US industrial companies. On the other side of Atlantic, German auto makers continue to face structural challenges in rising capex for electrification for complying with lower CO^2 emissions, which will inevitably lower cash flow generation while Chinese demand for passenger cars continue to fall year-over-year in December 2019.

The fact that the Trump administration did not impose tariffs on imported European cars by the 13 November 2019 deadline might provide some short-term relief for European car makers. However, that alone might not help these automakers turnaround their decelerating sales growth. French retailers are now feeling the pinch after massive nationwide strikes and very weak retail sales during the most important Christmas season.

To hedge the downside risks while capturing the short-term positive market momentum, being more selective and taking a deeper look in to company fundamentals will be imperative.

CORPORATE CREDIT FUNDAMENTALS AMID A LOOSE MONETARY POLICY

The net leverage ratio of European high yield companies is now higher than that of their US counterparts, driven by their more sluggish EBITDA[2] growth and the return of the ECB's Corporate Securities Purchase Programme (CSPP). Although the CSPP buys only European investment grade corporate credits, it has also had a spill-over effect on the European high yield sector enhancing demand. The CSPP has led to credit spread compression among investment grade credits and hence, European investors search for yield has led them to trade down into the high yield space.

Within the high yield market, leverage metrics continue to tick higher. We remain mindful that certain subsets here carry heightened secular and idiosyncraticrisks, even though some market participants might think these subsets would eventually catch up the performance in 2020. In fact, the most prominent re-leveraging occurred in CCC-rated corporates to almost unsustainable levels, with the median net debt-to-EBITDA of US CCCs rising to 7.9 times at Q3 2019 (Q4 2018: 5.6 times, Q4 2017: 6.3 times), while that of EUR CCCs surged to 8.6 times at Q3 2019 (Q4 2018: 5.8 times, Q4 2017: 4.2 times). These corporates continue to borrow more in a lower for longer environment. Their gross debt growth has strongly exceeded their EBITDA growth over the last three reporting quarters.

Between EUR investment grade and EUR high yield, although the latter still offers 270 basis points (bps) (or 2.7%) credit spread, the yield-per-net leverage (net-debt-to-EBITDA ratio) as a proxy of investment return per turn of risk, has more than halved over the past year to 58 bps, a sharp decline from 131 bps at year-end 2018.

Similarly, we acknowledge that a very few European single B-rated companies could be carry trade stories, but we see a further spread compression from the current 385 bps median

1 - Idiosyncratic risk : risk that affects a specific company and is unrelated to the general market conditions.
2 - EBITDA : Earnings before interest, taxes, depreciation and amortization.

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credit spread level as rather unlikely. European single Bs' spread per net leverage narrowed to 73 bps, from 170 bps at year-end. More spread volatility will become inevitable if their earnings continue to disappoint the market as the ECB has more limited space for monetary easing than last year. The lower for longer interest rate environment will continue to provide support and breathing space for leveraged companies. The median EBIT interest coverage of European high yield corporates has ranged between 2 to 3 times in the last 10 reporting quarters providing some comfort on issuers affordability.

With regards to US high yield corporates, whilst credit conditions remain benign we remain cautious given the late cycle set-up and earnings headwinds in the current spread environment. Politics also remains a wildcard both domestically and on the international front. The upcoming Presidential election in November could continue to surface various political concerns for US corporates. The US energy sector accounts for around 12% of the US high yield index. Many of these corporates already have limited leeway to improve their balance sheets because of inherently high capital expenditure, negative free cash flow and generous shareholder returns. The US high yield's investment return per turn of risk (credit spread-to-net-leverage) is trading at tight levels of 79 bps currently, down from 146 bps at year-end 2018. Thus, although starting the year on a stronger footing, risks for spread volatility are arguably higher this year.

Positively, US high yield corporates maintain a fairly consistent comfortable EBIT[3] interest coverage of around 3 times over the last 10 reporting quarters.

By rating category within high yield in general, the negative bond price impacts from any future downgrades on CCC and B- is likely to be higher in 2020 than in 2019. These highly-leveraged companies with weak business models would face material refinancing risk on bank loans amid a slower growth environment.

QUALITY TIME TO HEDGE ANY DOWNSIDE RISK

We reiterate our expectation for a growth stabilisation in 2020 while rating agencies forecast muted default rates in 2020, however, slowing global growth will weigh on the corporate performance. By sector, the retail sector in Europe and the media sector in the US including advertising, printing and publishing will be most vulnerable to severe financial difficulties.

As such, we should continue to be mindful of plausible sharp market volatility and increased dispersion of credit spreads between those corporates which are actively working to reduce debt and those which are not. Only high conviction trades with deep fundamental analysis would limit substantial downside risks.

SPREADS PER TURN OF RISK, 2018-YTD*

EUR	YE** 2018	Q3 2019	Current*	Median Net Leverage		Spread/Net leverage (bps)		
	Spread (bps)	Spread (bps)	Spread (bps)	YE** 2018	Q3 2019	YE** 2018	Q3 2019	Current*
Investment Grade	104	79	62	1.9	2.0	33	31	31
BB	337	231	193	2.6	3.5	128	67	56
B	621	465	385	3.7	5.3	170	88	73
CCC	935	832	700	5.8	8.6	161	97	82
USD								
Investment Grade	156	143	113	2.4	2.7	64	54	43
BB	344	237	184	2.8	3.4	122	70	55
B	528	397	316	4.3	5.1	122	77	61
CCC	903	851	763	5.6	7.9	162	108	97

* 20.01.2020
**YE: Year End
Net Leverage: Net debt-to-EBITDA ratio, current net leverage is based on the latest reported net leverage of Q3 19, Capital IQ.
Source: ICE BofA EUR Corporate Index, ICE BofA Euro High Yield Index, credit spread refers to asset swap, Bloomberg, Indosuez Wealth Management.
Past performance does not guarantee future performance.

3 - EBIT : Earnings before Interest and Taxes.

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Edited as per 23.01.2020.