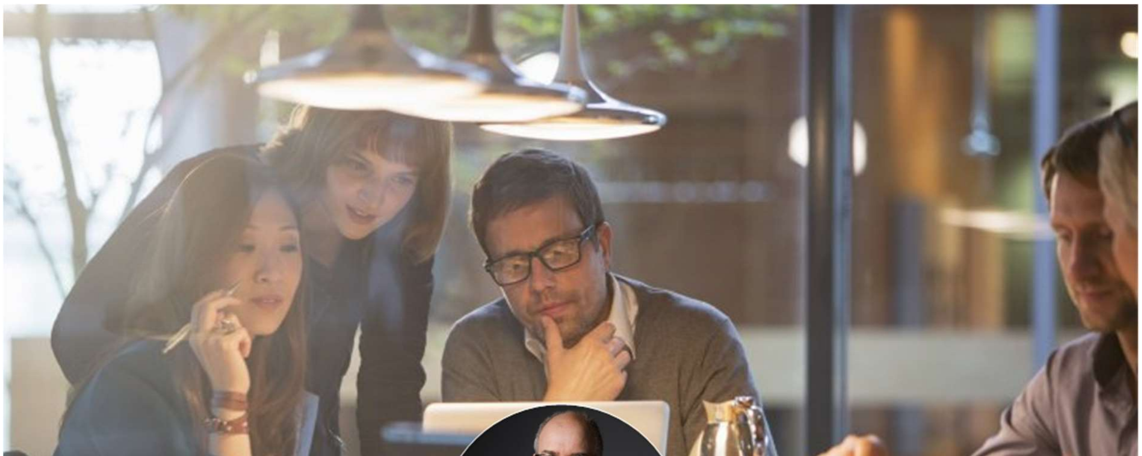
INVESTMENT STRATEGY LETTER

February 2020



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SUMMARY

1. The Coronavirus epidemic is a new risk, which is very difficult to analyse, but it is a temporary one. It will weigh on economic growth in the short term, especially in China, and then more widely in Asia. However, it does not change our core scenario for a rebound. The shape of the recovery in the manufacturing industry will be steeper. There is still room for more stimulus policy.

2. **Our convictions for 2020 therefore remain unchanged:**

   a) Economic growth will remain moderate and without inflation, so we exclude the risk of a recession. A truce has been signed between the United States and China.
   b) Bond yields will rise somewhat to current levels that are too low.
   c) Stock markets will deliver positive returns thanks to higher profits and dividends. Flows into equities will continue.
   c) We need to diversify our bets as volatility will return during the year.

3. The ongoing consolidation is not over in our view; it will provide an opportunity to strengthen positions in the markets we like, namely the eurozone, the US and the emerging markets. Our preferred sectors are financials and energy globally and technology, and building materials in Europe. We turn neutral on health care (profit-taking). Style-wise we prefer "Value" to "Growth", and small- and mid-caps to large-caps. We recommend buying European convertible bonds.

4. Our 12-month bond yield targets remain unchanged; 2% on the US 10-year rate and -0.25% on the Bund. As rates have fallen in recent weeks, we now expect a moderate rise in rates at current levels. Our forecast for the dollar is unchanged: 1.12 for €1 in 3 months, and 1.14 in 1 year.
5. We reiterate our positive view on gold for its diversification role (range revised up by $50 to $1450-1650). We keep our neutral recommendations on industrial commodities. We are now positive on oil (forecast range is $60-70 for the Brent).
6. In alternative strategies, we are now also positive on Event-Driven strategies, adding it to our favourite strategies, which include Global Macro and Long/Short Equity. We are neutral on listed real estate (REITs).

The Coronavirus

The Chinese authorities have taken drastic steps to limit (as far as possible) contagion of the Coronavirus. Nevertheless, it is spreading and is now an international concern. There is huge uncertainty about how long the epidemic will last and its overall impact. The financial markets will react quickly to any new information on this uncertain subject.

We have a few observations about the economic impact:

1) The measures taken by the Chinese authorities will have a significant short-term impact on economic activity.

2) Today the Chinese economy contributes much more to the global economy than in 2003, at the time of the SARS, the last episode of a viral contagion often used as a comparison.

3) Production chains are much more global today, and there are fears that the impact of the Chinese slowdown will be global.

4) There is room for manoeuvre in terms of economic policy to respond to this shock. In the first few days of February, the Chinese authorities injected considerable liquidity, cut interest rates, and took administrative measures to help beleaguered companies.

Owing to the inherently temporary nature of this viral epidemic, we do not believe, at this stage, that the ongoing shock is sufficient to change our core scenario for 2020. The impact will be significant in China in the first quarter, and will likely prolong the weakness in the overall manufacturing sector, and increase an additional risk in the financial markets. The general trend remains the same, but the V-shaped profile will be steeper.

Our scenario for 2020 remains the same

Let's examine the key elements of our economic and financial scenario.

Moderate economic growth and low inflation

For more than a year, the global manufacturing industry has been in a recession, and leading economic indicators predict that this trend is not about to reverse. The recession in the sector over the past 18 months stems from two factors. First, the trade tensions between China and the United States. This factor has diminished with the signing of the Phase One agreement, but it will not disappear completely as the challenging Phase Two negotiations are likely to last (at least) until the US presidential election. Second, the contraction in the automotive sector. The shock of the epidemic will reinforce the contraction in manufacturing during the first quarter of 2020, with a potential rebound as soon as the epidemic ends.

We believe that this industrial recession will not spread to the rest of the economy. Indeed, services and job creation remain strong enough (particularly in the United States and Germany) for the overall growth of the economies to be positive, albeit slowing. Wage growth is underpinning consumption without causing an acceleration in core inflation. The latest economic data were better than expected, particularly in Europe, but there are concerns that China may be slowing down with possible contagion to other Asian economies. Within this core scenario, the trough in the first half of the year will be deeper than expected because of the epidemic, but the rebound will also be stronger than expected in the second half. Growth is expected to accelerate once again in mature economies in 2021, albeit moderately.

Interest rates and bond yields will remain low for a long time

The US, European, UK and Japanese central banks are not expected to change their accommodative monetary policies in the coming months (our base-case scenario). The Fed, which has put its monetary policy on hold since cutting rates three times in 2019, confirmed this again at its meeting in January. The ECB continues to use all the tools at its disposal, with negative official rates, very favourable TLTROs, a tiering system to help banks and, above all, a new phase of Quantitative Easing, with monthly purchases of €20 billion worth of bonds on the markets. Ms Lagarde has started a strategic review of the ECB and it will take time before any changes are made.

Many other central banks are maintaining a dovish bias, particularly in emerging economies particularly China, in view of the current epidemic.

Bond rates are also very low. They have fallen by between 25bp and 40bp recently amid tensions in China. Nevertheless, as our economic scenario is unchanged, we are keeping our forecast at 2% in 12 months for the US 10-year rate, and at -0.25% for the Bund. Bond yields are likely to rise if the expected economic recovery materialises.

There is one scenario in which bond yields could rise more than expected, namely, if aggressive fiscal stimulus policies are adopted to take over from monetary policies at the end of the cycle. This is the wish of central banks, particularly the ECB, on condition that states invest. For now, however, reflation measures remain very moderate, particularly in countries such as Germany and China, which have room for manoeuvre but not the political will. In the event that reflation measures become stronger than expected, we may revise up our forecasts for bond rates.

We maintain our positive view on the stock markets

Leading indicators are improving and 2020 could be the first year in 3 years to see global economic growth accelerate. The acceleration will be especially strong as at the start of the year growth will slow down in the wake of the epidemic in China. With a V-shaped growth profile in 2020, a recovery will continue in 2021. There are many reasons for this improvement: lesser trade tensions between China and the United States, the most accommodative monetary policies since the 2007 financial crisis, and a resumption of (albeit moderate) fiscal expansion in several countries.

Companies are generally communicating on an improvement in sales. Semiconductor sales, which are still interesting and often a leading indicator, are recovering. The new orders component within the PMIs is showing a reversal. These indices point to an ongoing trend in rising profits in 2020, especially as wage growth remains moderate. However, after a decade since the last recession, corporate profit margins are high. We would be surprised if the consensus does not revise down its current forecast of a +10% total increase in profits that factors in a rise in margins. In the final stages of the economic cycle, it is still very difficult to increase margins. A rise in profits of around 5% (low single digit) seems more realistic. This means that the total rise in the stock markets should be the same extent as the rise in profits, bearing in mind that we also expect a rise in bond yields.

A short-term buy opportunity?

At the beginning of the year, stock markets were in a slightly "overbought" situation, i.e. after their sharp rise in the last quarter of 2019, they were 7-8% above their 200-day moving average (200DMA). So a consolidation has begun. A return to these levels of 200DMA typically offers a buy opportunity. This is our view because there is a lot of cash, and there is not much alternative to buying shares (TINA, There Is No Alternative). This will be the case as soon as investors put aside their concerns about the Coronavirus, but we are not there yet.

No change this month (regions and styles). We are taking profits on the health care sector (neutral instead of positive).

We favour the eurozone, the United States, the United Kingdom and the emerging markets. There is a window of opportunity for the "Value" segment (value with a discount) versus "Growth", and for small- and mid-caps. In terms of sectors, we highlight financials globally, the energy sector (since last month), technology and building materials in Europe. We turn neutral on health care this month because this sector has performed very well over the last 3 years. It is now expensive, and it could become central to the US election debate in view of the presidential election. We prefer to play health care via specific investment themes, particularly by focusing more on innovative companies in the sector.

The emerging markets have already corrected in the wake of the Coronavirus. Asia in general is the hardest hit. We still consider that the rebound in economic growth will be favourable to emerging economies whose economic growth has traditionally accelerated more than that of mature economies. In addition, central banks remain accommodative thanks to the slowdown in inflation, US rates will remain low (including the long end of the curve) and the dollar is likely to remain at around current levels. Our favourite three countries in Asia remain India (rapid economic growth, slowing inflation, but above all, structural reforms implemented by the Modi government), South Korea (weight of the technology sector, accommodative monetary policy) and Singapore (high and solid dividends). We are neutral on the Chinese market.

Style-wise, **we prefer** Value to Growth, and small- and mid-caps to large-caps**.**

Bonds and credit: no change in recommendations

Last month, we adjusted our long-term interest rate targets to 2.00% for the US 10-year rate, to -0.25% for the Bund, i.e. 25bp more than before. Given the fall in bond yields in recent days, this means we now expect rates to rise in the future.

We continue to highlight short maturities in dollars, which still offer an attractive risk/return ratio, but only for dollar-holders. The current level of the 2-year rate means that the carry is quite attractive for short maturities.

We still see some opportunities in Investment Grade Corporate bonds. In November, we adjusted our duration recommendation on European and US credit to neutral against the benchmark, instead of a medium-term duration previously, as bond yields are not far off our targets (at unchanged spreads). Furthermore, with the ECB resuming its purchases of European Corporate bonds, we have extended our positive recommendation to BBB ratings.

We remain positive on **European convertible bonds** in line with our overall optimism on equities, as the "equity" component is the main driver of the current performance of convertibles, with interest rates being so low. With a few large issues in 2019, the European convertible bond market has gained some liquidity. We remain neutral on High Yield Corporate bonds in euro and dollar terms. There is no change in the High Yield (HY) sub- fund, and yield spreads have remained low in the United States. It seems too early to us to change our recommendation on euro HY as nominal rates and risk premiums remain low, not compensating enough for the risk taken with these investments, in our view.

We remain neutral on EM Sovereign hard currency bonds (sensitive to the dollar and US rates, significant weight in the indices of Turkey, Argentina and Venezuela, three countries we are not comfortable with). We are positive on EM Corporate bonds in hard currencies and Sovereign and Corporate bonds in local currencies. They have a shock absorber thanks to their yield-to-maturity of close to 5%. Several central banks are likely to continue to cut official rates, which will be supportive for these Emerging Market bonds in local currencies. EM currencies offer some upside potential, but are still very volatile. The performance in 2019 was excellent, offsetting the bad performance of 2018. The movement is not over as the Fed remains dovish.

Currency markets: no change

Despite the "risk off" phase of recent weeks, volatility in exchange rates has remained low. We believe this low volatility environment will continue as we do not expect changes in monetary policies and bond yields are likely to rise only moderately.

We are still convinced that the dollar is likely to weaken against the euro in the long term, due to the twin US fiscal and trade deficits. In addition, the dollar is already overvalued against its purchasing power parity, at 1.31 per €1 (source: OECD). Nevertheless, we expect a slight movement to 1.12 in 3 months and to 1.14 in 12 months.

After the Phase One agreement and easing tensions, we revised our 12-month target for the yuan from 7.15 to 7.00 (value for 1 dollar). Indeed the Chinese currency has fallen in recent weeks, especially when the markets reopened in early February. It is likely to remain at around current levels.

Commodities: we are positive on gold and become positive on oil: no change

Fundamentally, gold **remains attractive, in our view.** The virtues of diversification in portfolios are still relevant. Another major supporting factor will be the risks of rising inflation, especially in America. Our forecast range is $1450-1650 per ounce over the next 12 months. This is exactly what has happened in recent days, with gold being an imperfect hedge against risk.

Change in conviction: from neutral to positive on oil

Since their highs in early January, as tensions between the United States and Iran are fuelling fears of the worst, crude oil prices have fallen by more than 20%.

The outbreak of the Coronavirus is fuelling fears of lower global demand as a result of restrictions on travel in and to China.

Our analysis is that a price around $50 per barrel for the West Texas Intermediate (WTI) is untenable for the US shale oil industry. Each major decline in crude prices has resulted in a decrease in wells in operation after a period of 3 to 4 months. The same will be true this time.

OPEC and associated countries ('OPEC+') decided in early December to cut production by an additional 0.5 million barrels per day and Saudi Arabia further cut its own quota by 0.4 mb/d, bringing the total production restrictions to 2.1 mb/d. The initial market reaction was moderate due to doubts about internal control within OPEC. But it is important to acknowledge that OPEC+ has generally complied with its commitments.

Russia has recently expressed its wish to discuss with OPEC additional measures to deal with the slump in prices. This is significant because in December Russia was kicking its heels.

A third argument relates to the geopolitical risks that have not disappeared in the Middle East. The extremely effective attack on Saudi oil facilities in September 2019 and the US-Iran tensions in early January should remind us that the lack of a risk premium in crude prices is an anomaly.

The 2-3 year outlook remains positive due to the lack of investment in conventional oilfields between 2014 and 2017. Without investments, the production of conventional fields fell by an average of 6 to 7% per year.

Our conclusion is that the lower consumption due to the health crisis linked to the Coronavirus is temporary. Brent crude oil prices are expected to rise from below $55/b (today's level) into the $60-70 range within 6 months. The greater the fall in oil prices in the future, the larger the rise. The fiscal position of OPEC+ countries and the profitability problems in the shale oil industry require a higher equilibrium price.

Real Estate: we are neutral on REITs in Europe including in the UK

Valuations have risen with the excellent stock market performance of recent quarters. This sector pays attractive dividends in the region of 4%, with income (at worst) stable, so that it can maintain its dividends without a problem. However, REITs will struggle to outperform the equity market in a more buoyant global environment.

Alternative Investments: We turn positive on Event-Driven strategies

We turn positive on Event-Driven strategies: Trading volumes remain high, both takeover bids and restructuring, particularly in Europe, where the number of transactions is increasing significantly. In the United States, companies are hurrying to finalise their operations before the presidential elections.

New opportunities in the Global Macro and Long/Short Equity segments will emerge thanks to the expected return of inflation, structural changes in technology and the ongoing rebound in volatility. We remain positive on the Long/Short Equity and Global Macro segments.

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