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# Investment Strategy
## Private Clients

2/4

April 2018 · 2nd quarter

**Macro insights**

Closing output gaps lead to a tradeoff between growth and inflation

p.03

### At a glance

- We hold to our scenario of sustained decent growth across the main economic blocs. But while all regions are currently in expansion territory, they are de-synchronized in terms of their phase within the cycle.
- The stage is set for inflation in the US this year: a tight labour market, the traditional lag between GDP growth and inflation, and pro-growth policies being implemented so late in the cycle.
- In Europe, the recovery-turned-expansion is firmly in place. As slack erodes, a pick-up in inflation will become increasingly likely, prompting a change in central bank policy during the coming quarters.
- Consistently positive GDP growth, an exceptionally tight labour market, and steady recovery in consumer prices also make a shift in Bank of Japan policy likely later this year.
- Cyclical winds are fading in emerging markets, but the structural case remains valid: imbalances have moderated, foreign currency debt has diminished, and international reserves have swelled.
- As expected, rising uncertainties pertaining to inflation and monetary policy are making for a more volatile financial market environment, in which nimbleness and investment discipline will be key.

**Also featured**

What if trade tensions escalate?

What level of bond yields would be a tipping point for equity markets?

Quarterly publication of Lombard Odier Investment Solutions - Strategy



Data as of 4 April 2018

# Closing output gaps lead to a tradeoff between growth and inflation

The economic and market upcycle will eventually come to an end, but odds are that its downfall will be caused by economic overheating in the US, amid rising financial and fiscal imbalances, rather than escalating trade protectionism.

We hold to our scenario of sustained decent growth across the main economic blocs – with no indicators pointing to a recession or serious slowdown in the US, China or the Eurozone. But while all regions are currently in expansion territory, they are de-synchronized in terms of their phase within the cycle. The first signs of overheating are becoming visible in the US, Europe is still in a comfortable "goldilocks" environment, while activity continues strong in most emerging economies.

To measure how advanced an economic cycle is, economists often refer to the concept of "output gap". This is computed as the difference between actual GDP (Gross Domestic Product) and the potential (or optimal) GDP that an economy could achieve if exploiting its resource base to its full. Although potential GDP sounds like the best output level that can be reached, it is technically possible for an economy to operate above potential (i.e. exhibit a positive output gap). To that effect, resources must be increased, which in turn leads to inflation, since higher wages/prices are needed to attract them. Simply put, a tradeoff between growth and inflation arises as an economy nears its full capacity.

Chart I (page 04) shows the output gaps of several developed economies. Calculations vary substantially, since based on potential GDP estimates that could be inaccurate or changing, but most measures indicate that output gaps are closing across the developed world – have already closed in the US and Japan. History thus suggests that inflation will trend higher going forward.

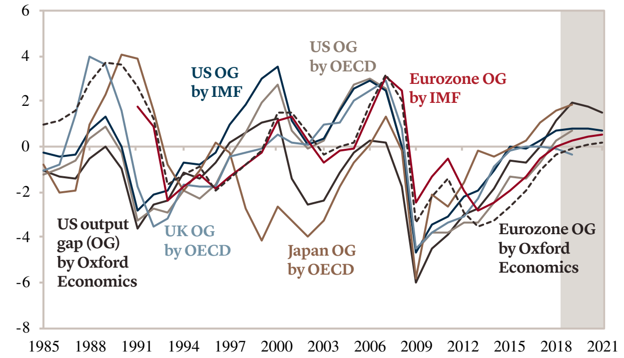
Near full utilisation of labour in the US is indeed leading to a creep-up in wages, with inflation also arising from scarcer resources. Further monetary tightening would be needed, however, to signal a pending slowdown or recession. In the Eurozone, overheating is still a remote prospect. The substantial slack in employment suggests that the cycle still has legs. As for emerging economies, particularly China, their recoveries from the 2014-2015 commodity shock are well engaged. The virtuous cycle of stabilising currencies and lower inflation has allowed for easier monetary policies. These cyclical tailwinds do now appear to be fading somewhat but are still far from turning into headwinds.

Could potential growth be improved, providing output gap measures – especially in the US – with extra breathing space? Given relatively sticky demographics, the main way to improve an economy's capacity would be to increase productivity. The ongoing expansion has been characterised by weak productivity, owing, in our view, to a combination of factors, including measurement error, weak investment and persistent slack in the labour market. This stagnation in productivity has damaged households' real living standards. However, some evidence suggests that productivity constraints are subsiding. Companies are finally starting to invest again, after a post-Great Financial Crisis decade of capital thriftiness. And, of course, as pertains to the US, the slack in the labour market has essentially been removed (see chart II, page 04).

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculation.

## I. Output gap measures

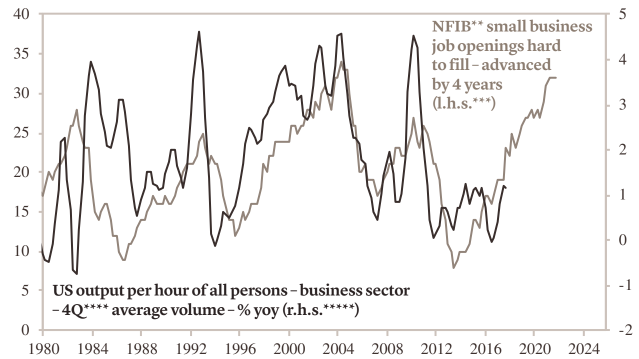
In %




Shaded area = projections
Sources: Datastream, Lombard Odier calculation

## II. US labour productivity versus supply of qualified workers

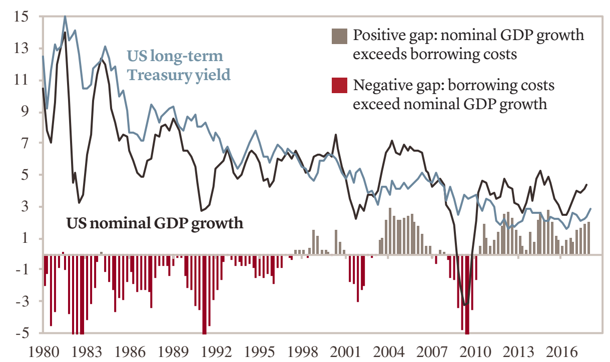
In % yoy* and index level




* year on year, ** National Federation of Independent Business, *** left hand scale,
**** quarter, ***** right hand scale / Sources: Datastream, Lombard Odier calculation

## III. US nominal GDP growth versus long-term Treasury yield

In %




Sources: Datastream, Lombard Odier calculation

A recovery in productivity during coming years might boost economic capacity – delaying the cycle end – but it remains a wild card on which we are not yet ready to fully bet (meaning that we have not integrated this assumption in our computations of potential GDP growth).

In the meantime, the hot issue for central banks and investors is how high US interest rates can go before they begin to hurt – before the underlying flaws (read: excessive debt) of the global economic and financial environment are exposed.

The typical course of events, in the face of a capacity-constrained economy, is that monetary authorities hike interest rates to keep inflation in check, which generally leads to an inverted yield curve, making it either unprofitable or risky for banks to lend.

Alongside the shape of the yield curve or the level of real rates, another way of identifying an excessively restrictive monetary policy is to look at nominal GDP growth relative to the prevailing Fed Funds rate, or even to long-term market rates (see chart III). When nominal growth dips below interest rates, debt servicing ability is compromised. This was true before the 1990 recession, the 2000 recession and the 2007 depression. But it is not the case today: US nominal growth fully supports debt servicing at current interest rate levels. The same is true in China, indeed across much of the global landscape.

*Samy Chaar, Chief Economist*

# United States
## Watch inflation, trade and the Federal Reserve

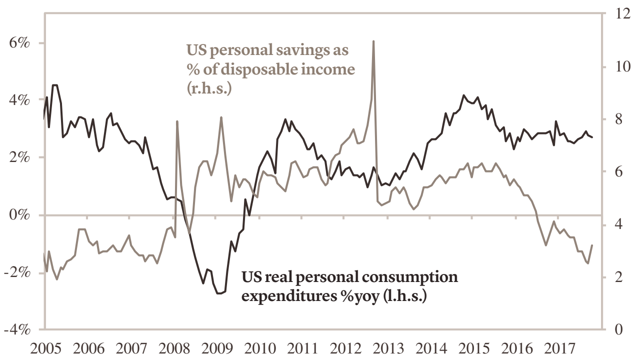
### In a nutshell

- The issue for 2018 is to what extent monetary tightening and trade protectionism offset the fiscal stimulus.
- We take Trump's words at the World Economic Forum seriously and literally: "America first" does not mean America alone.
- There is no reason for the Federal Reserve (Fed) to change its pace of quarterly interest rates hikes.

*"When the Democrats are in power, Republicans appear to be the conservative party. But when Republicans are in power, it seems there is no conservative party".*
US Senator Rand Paul's words speak eloquently of the two-year budget deal reached mid-February, made of spending increases and tax breaks – beyond those already legislated late 2017. While positive for nominal growth, this stimulus is of course negative for the deficit outlook (widening it by 1-1.5% over the next two years), leaving the government with less fiscal room to manoeuvre when the economy turns down.
All ingredients are thus in place for inflation in the US this year: a tight labour market, translating into faster wage growth (especially in manufacturing), the traditional lag between GDP growth and inflation, and pro-growth policies being implemented so late in the cycle. Private consumption could be one area of disappointment, with the personal savings rate now close to historical lows (see chart IV) and consumers having exploited credit card debt to spend well above their income growth. All told, we foresee 2.5% US real GDP growth in 2018, slightly below the upward-adjusted consensus of 2.7%.
On the trade front, we do not expect the announced punitive measures on China to escalate into a full-blown trade war. Chinese leaders know that their trade exposure to the US is larger than reverse flows, and could eventually offer some concessions to President Trump, for him to tout as "wins" ahead of the US mid-term elections. Expanding imports from China have admittedly hurt US manufacturing employment (see chart V), but odds are that even without China the US manufacturing base would have suffered from international competition.
Turning to the Fed, the prospect of higher inflation – with the core personal consumption expenditure deflator to approach 2% – has led us to revise our expectations of the number of rate hikes this year from 2-3 to 3-4, a once-per-quarter move being our base case. An seemingly more hawkish monetary decision committee played a part in this revised outlook, although we actually view new Fed Chair Powell as being presently bullish on the US economy but not necessarily hawkish by nature.
We would caution that this base case of a once-per-quarter hike is highly dependent on all continuing to proceed well in the real economy. There is also a big difference between following the upward move in the neutral rate and hiking with a view to slowing down the economy. The Fed may not be as friendly as it was, but it has certainly not – yet – adopted an aggressive stance.

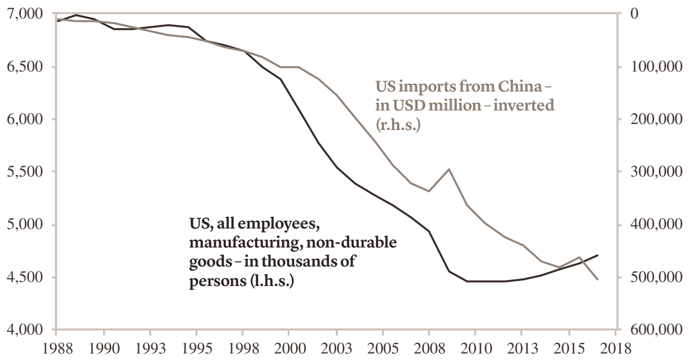
*Samy Chaar, Chief Economist*

IV. US household savings rate versus private consumption
In % and % yoy




Sources: Datastream, Lombard Odier calculation

V. US manufacturing employment versus imports from China
Level




Sources: Datastream, Lombard Odier calculation

# Europe

## Raising the bar: solid growth has become the norm

### In a nutshell

- The recovery-turned-expansion is firmly in place, even if growth appears to be moderating somewhat from very high levels.
- Few signs of inflation have surfaced as yet, allowing the European Central Bank (ECB) to leave policy changes for later.
- Price pressures are, however, not completely absent, making a monetary shift likely in coming months.

Persistently strong growth in the Eurozone has quelled most remaining doubts as to the sustainability of the recovery. Market participants and policymakers alike have substantially upgraded their forecasts since the fall of 2017 and we remain convinced that 2018 is on track for 2.5% growth. Evidence of the upturn is broad: unemployment is falling, investment is picking up, corporate earnings are rising, and government finances are improving.

Some moderation in cyclical indicators is under way (see chart VI), which is no surprise given the extremely high levels reached at the end of 2017 – consistent with above-3% annual GDP growth (compared with an estimated potential that barely exceeds 1%). Our outlook nonetheless remains very constructive, with the main drivers of the European expansion still firmly in place: accommodative monetary policy, easier credit conditions, still some spare capacity, a more growth-friendly fiscal mix, and improved external demand.

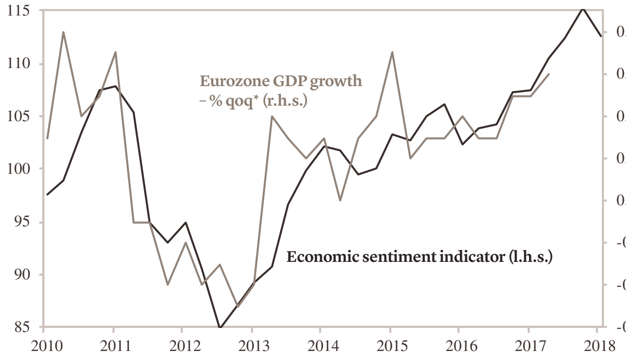
That said, the Eurozone's "goldilocks" world of strong growth and low inflation may not last that much longer. Survey data show clear signs that supply chains are becoming stretched (see chart VII), and employers are reporting intentions to raise wages as the labour market continues to heal. The recent wage agreement in Germany between the employers' federation and the metalworkers union was a case in point. As slack erodes further, a pick-up in inflation will become increasingly likely.

Although this process will be slow-moving, we foresee meaningful policy implications during the coming quarters. A crisis framework is now less appropriate for the ECB. Its commitment to quantitative easing runs through September, before which date we expect some clarity to be provided on the future path of action. Our belief is that the ECB will terminate asset purchases by the end of this year and start raising interest rates early in 2019.

Contrary to expectations, political factors have little affected the Eurozone economy over the past year. Euro-centric issues (such as political uncertainty in Italy) and external drivers (notably protectionism) have not vanished – meaning that political risk still bears monitoring. But, unless we see clear signs of deterioration, we expect increasingly solid Eurozone economics to dominate occasionally noisy politics.

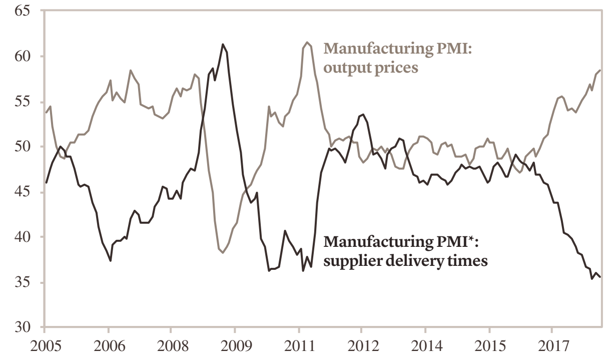
*Bill Papadakis, Macro Strategist*

VI. Some normalization in cyclical indicators but growth dynamics still solid




* quarter on quarter
Sources: Bloomberg, Markit, Lombard Odier

VII. Early signs of price pressures




* Purchasing Managers' Index
Sources: Bloomberg, Markit, Lombard Odier

# Japan
## A turning point approaches

### In a nutshell

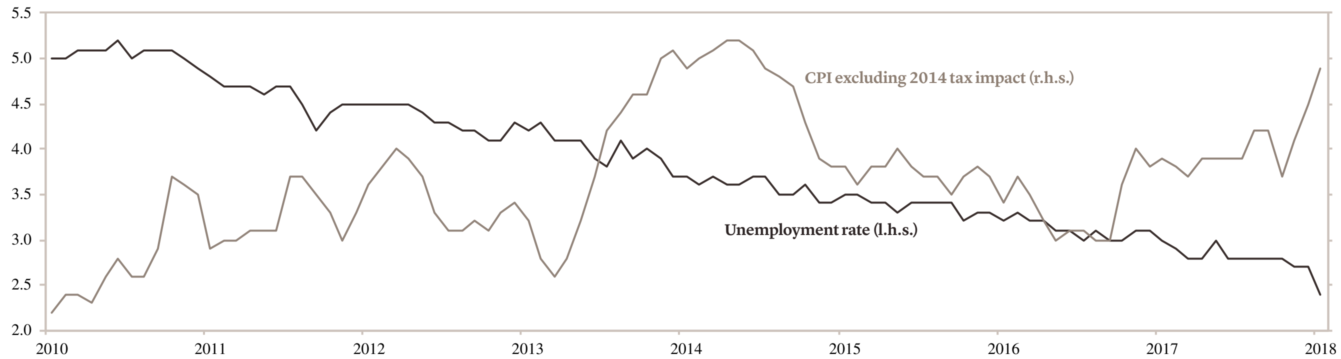
- The big picture in the Japanese economy is one of consistently positive GDP growth, an exceptionally tight labour market, and steady recovery in consumer prices.
- Against this backdrop, we think it is likely that the Bank of Japan (BoJ) will change its policy later this year, as a less accommodative stance becomes appropriate.

Evidence that the cycle is "maturing" in Japan is abundant. While some softness can be discerned in recent activity data, the big picture becomes clear when looking at the Japanese labour market. January saw the unemployment rate fall further to 2.4%, its low point since 1993 (see chart VIII). And, at 1.59, the jobs-to-applicants ratio has hit the highest level seen since the mid-1970s. Real GDP growth has been fairly consistently positive since late-2014. Cyclical indicators are providing constructive signs for the near future, pointing to continued growth, as Japanese businesses and households feel more confident. Finally, assuming a severe protectionism-driven downturn does not materialise, the improved global backdrop and ongoing recovery in global trade bode well for Japan's external sector, which has been a solid driver of the current upturn.
In such a context, it should not be surprising that a policy shift by the BoJ is in the cards. Financial markets have been speculating on this possibility, also hinted to by Governor Kuroda in public comments during recent months. We expect to see a BoJ policy adjustment in the latter part of the year.

The BoJ having thus far retained the most accommodative stance among major central banks, a change in policy looks increasingly justified based on both economic data and real-world considerations. The steady recovery in consumer prices, with headline inflation that exited negative territory in 2016 and has now reached an annual rate of +1.5% (also see chart VIII), offers macroeconomic support for such a shift.
Meanwhile, the BoJ also faces capacity constraints in its asset purchase programmes, having become an owner of huge portions of the domestic government bond and index ETF (exchange-traded funds) markets. The political and technical hurdles involved in expanding its purchases to other types of assets, such as municipal debt or foreign bonds, make such a scenario unlikely.

*Samy Chaar, Chief Economist*

VIII. Japanese unemployment and inflation




Sources: Datastream, Lombard Odier calculation

# Emerging Markets
## Cyclical tailwinds are fading, but the structural case still looks valid

### In a nutshell

- The period of easier monetary policies across the emerging world is coming to an end.
- Structurally, though, the case for emerging markets remains valid: imbalances have moderated, foreign currency debt has diminished, and international reserves have swelled.
- Selectivity is nonetheless warranted, with the most robust economic fundamentals to be found in Asia, but also Russia, Chile and Peru.

Our shift, early in 2016, to a positive stance on emerging markets was based on cyclical considerations. Commodity prices were beginning to recover after their massive fallout, amid subsiding fears of a Chinese hard landing. With the US dollar to eventually peak at the end of 2016, the stage was set for a virtuous cycle of stabilising currencies, falling inflation and easier monetary policies.

Two years down the road, these cyclical tailwinds are fading. Monetary policies are likely to tighten somewhat (see chart IX) – although not to the point of derailing the upturn, which remains young.

Meanwhile, the structural case for emerging markets is still valid. From a peak of over 6% just before the financial crisis, the growth differential between emerging and developed economies has fallen back to 2.4%, slightly above its historical average. In turn, the current account surplus accumulated by the emerging world has all but disappeared. Foreign currency debt has retreated, and the stockpile of international reserves accumulated by emerging markets at large – not only China – since the turn of the century greatly reduces their vulnerability to external shocks.

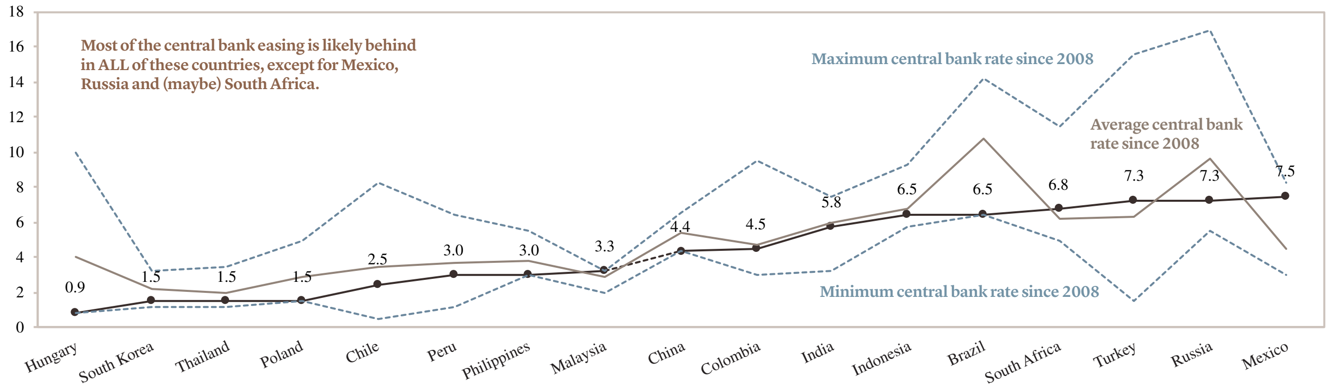
That said, we recognize that tail risks stemming from protectionism are growing. US-imposed tariffs on China could have knock-on effects on countries with closely integrated supply chains, notably Taiwan or Malaysia. Were US protectionist inclinations to broaden beyond China, the disruption could be greater even – with many Asian countries, but also Mexico, Chile or Colombia, exhibiting significant domestic value-added in US imports.

For now, though, Asian countries dominate our ranking. China is slowing with medium-terms risks linked to its debt profile but remains solid at this stage, while India presents an interesting long-term growth story thanks to its young population. Outside of Asia, Russia, Peru and Chile stand out with supportive fundamentals. Brazil's destiny hinges on its ability to reform the pension system, and Mexico's on NAFTA (North American Free Trade Agreement) renegotiations and the July presidential election. Lastly, we remain worried about Turkey given its weak fundamentals and large imbalances.

*Stéphanie de Torquat, Macro Strategist*

IX. Current central bank rates relative to their 10-year minimum, maximum and average

For 17 selected emerging economies




Sources: Datastream, Bloomberg, Lombard Odier calculation

# Asset Allocation
## 2018 will be all about navigating volatile investment waters

### In a nutshell

- Coming into 2018, we shared our view that last year's high equity valuations were consistent with the so-called "goldilocks" economic backdrop, but rising uncertainties pertaining to inflation and monetary policy would likely dampen the outlook – 1st quarter financial market volatility was a case in point.
- An extension of the positive trend in global trade remains the backbone of our pro-risk asset allocation.
- Economic overheating, fuelling a significantly higher cost of capital, and an intensification of protectionism are the two risks to our baseline scenario.

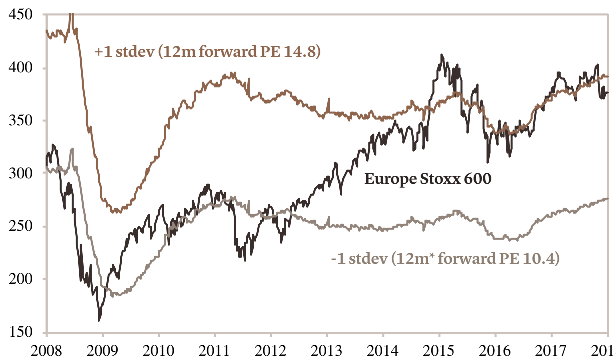
Despite the strong economic backdrop, and after record performance in January, market waters have been choppy of late. February saw the VIX index, the commonly-used measure of equity volatility, move back above 35 – a level not seen since the commodity and renminbi crisis of August 2015. In a context of inflation and monetary policy normalisation, the surge in US real rates appears to have triggered the market rout, joined more recently by concerns about trade tensions, internet privacy and general political discord. In effect, we see this quarter as having marked the return to a new (more normal) volatility regime, in which nimbleness and investment discipline will be key.

We still expect the positive trend in global trade to extend into 2018 and further underpin cyclical assets and sectors. Risks to our baseline scenario lie in economic overheating, fuelling a significantly higher cost of capital, or an intensification of protectionism. As regards interest rates, our take is that the US 10-year real yield can rise a further 80 basis points (bps) before hurting equity markets (see Box B, page 12). As for the protectionist threat, we still consider President Trump's rhetoric to be primarily a negotiation tactic, with limited odds of translating into a global trade war. The numerous exemptions on steel and aluminium tariffs finally afforded by the US buttress this view. Also, even though recent retaliatory measures by Chinese authorities are ground for concern, the world's largest two economies do currently appear to be open to further dialogue – albeit on an equal footing (see Box A, page 11).

For now, our pro-growth stance remains valid, justifying an overweight position in equities. The strong 4th quarter 2017 earnings season was a testimony to robust global fundamentals. **Companies in the US, Europe and Japan delivered upside surprises, high single-digit sales growth and double-digit earnings per share (EPS) growth, along with a positive outlook for growth and capex.** Some leading indicators have admittedly started to roll over, from historically high levels, but this comes as no surprise after more than 18 months of an almost uninterrupted upward trend. The supportive global macroeconomic backdrop makes it unlikely that corrections translate into a bear market. With a 2018 price-to-earnings (P/E) ratio below 17x for the S&P 500 and at 14x for the Euro Stoxx 600 (see chart X), we see episodes of volatility as buying opportunities – of which we recently took advantage to increase our equity exposure.

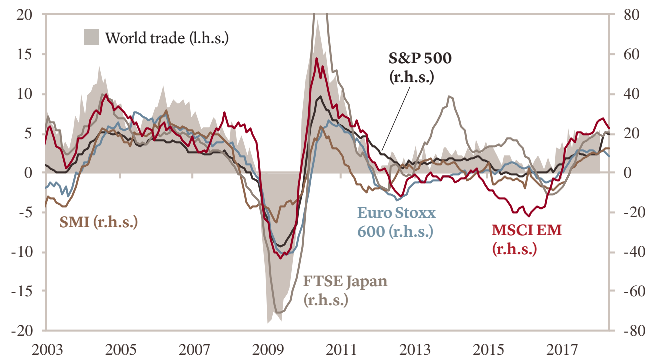
Regionally, emerging markets and Japanese earnings stand to benefit most from this global backdrop (see chart XI), with emerging

X. Europe Stoxx 600 valuation
Based on analysts' P/E forecasts +/- 1 standard deviation




* month
Sources: Datastream, Lombard Odier calculation

XI. Performances of main equity indices versus world trade
In % yoy




Sources: Datastream, Lombard Odier calculation

markets also supported by their ongoing domestic recoveries and an improved outlook for the commodity complex. In Europe, now that the Italian election risk is behind, we expect markets to recover, on the back of attractive valuations, a very supportive domestic-driven recovery (our 2018 European GDP forecast is consistent with double-digit EPS growth) and lesser currency headwinds. The US market, most advanced in the business cycle, should be more prone to profit-taking: valuation upside is limited, and the level of interest rates may become more challenging. At the sector level, current investor concerns are fueling volatility and profit taking in IT after four years of outperformance and in what had become an overcrowded long positioning. We would not, however, call into question the secular trend underpinning IT valuations. Style-wise, interestingly, our preference for small capitalisations has proved successful. Despite a historically higher beta, their domestic bias appears to have shielded them, to some extent, from trade war fears. Given the sensitivity of global equity markets to perceived US risk, **we treaded cautiously in increasing equity exposure. To keep our global risk profile in check, we elected to also increase cash holdings**. Indeed, we continue to see little hedging capacity in the bond space, preferring to maintain government bond exposure at a minimum level while moving underweight in credit markets.

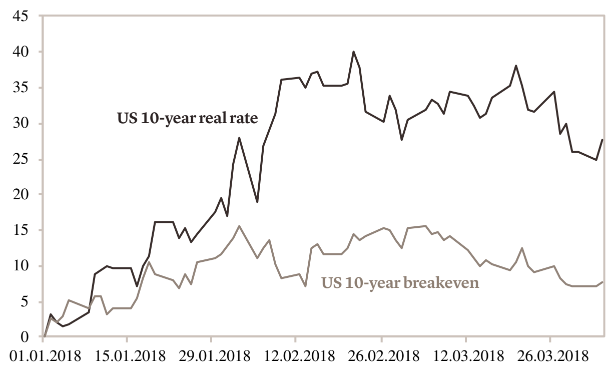
The US 10-year yield has risen by some 40 bps year-to-date, to near 2.8%. Unlike what occurred in the latter half of 2017, most of this move is attributable to the real rate component (see chart XII). Yields surged through mid-February, before pulling back over the past couple of weeks, as IT-related turmoil drove some demand for the relative safety of government debt. Going forward, the normalisation of inflation expectations around 2.1% (as per the US 10-year breakeven rate) appears well-advanced, and now in line with our baseline scenario. US markets have priced in Fed guidance of three rate hikes this year. There is still some room for market repricing as pertains to 2019 and beyond, but investors will want to assess the stance of the new FOMC (Federal Open Market Committee) before reviewing their medium-term expectations. That said, structural forces, such as lower potential growth, are likely to prevent a sharp rise in interest rates and drive further flattening of the US yield curve next year. **Still, even with US interest rates close to what we consider fair value, we believe it is probably too early to add exposure, particularly since additional pressure may come from Europe during coming months.** Ever since the ECB initiated its asset purchase programme, European long-term yields appear to have been extremely disconnected from fundamentals. Some normalisation did occur in January and February (with the German 10-year real rate up 40 bps), but most of the move was then undone in March on global trade war fears. This overvaluation of core European yields should reverse once the current market turmoil eases and the ECB can start to prepare markets for a normalisation of its policy. Against this backdrop, peripheral debt should offer better prospects on a relative basis. With benign financial conditions supporting corporates and preventing a surge in defaults, we continue to prefer credit over sovereign bonds. That said, the attractiveness of the asset class has deteriorated. Indices' duration is at historical highs (5.4 currently in Europe, vs. 3.8 in 2012), increasing the vulnerability of the asset class to interest rate volatility. As such, we think a risk-adjusted equity-cash position offers better relative value than holding credit.

**We continue to see greater value in convertible and emerging bonds.** Convertible bonds' risk/return profile is attractive in the current market environment, since they stand to benefit from their exposure to equity bull markets, while the value of the option tends to rise during episodes of volatility, not to mention the lower duration of the bond. As for emerging debt, stable growth and subdued inflation should allow central banks to maintain a generally accommodative stance (Russia, South Africa and Brazil even cut rates in March). With the US dollar likely to stabilise in coming quarters, investors should make a rapid comeback. After all, emerging bonds constitute one of the last pockets of returns in fixed income.

The currency space is where we see greatest stability for the months to come. After falling sharply in January, the US dollar is stabilising. With the market now largely pricing in the upcoming ECB tapering and improved Eurozone growth prospects, the euro looks less undervalued. We see no catalyst for further appreciation until the

**XII. Most of the rise in the US 10-year yield stems from real rates**

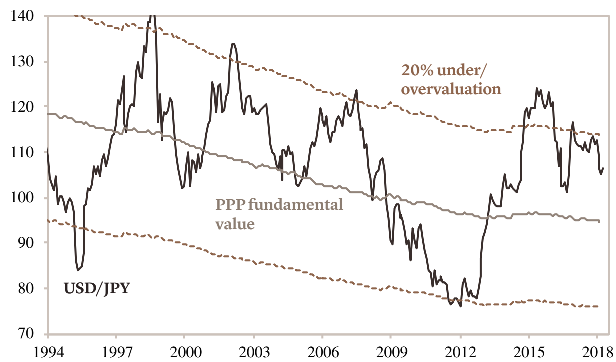
Cumulative rise year to date (bps)




Sources: Bloomberg, Lombard Odier calculation

**XIII. JPY still undervalued versus USD**

USD/JPY versus fundamental value (PPP*)




* Purchasing Power Parity
Sources: Datastream, Lombard Odier calculation

## A. What if trade tensions escalate?

An extension of the positive trend in global trade remains the backbone of our pro-risk asset allocation. Although we view the risk of a trade war as limited, we do admit that uncertainty is significant. From a geopolitical standpoint, a scenario in which the US and China engage in a struggle for global influence, economic leadership and technological high ground cannot be excluded. The recent launch of yuan-denominated oil futures on the Shanghai International Energy Exchange and the on-going "One Belt One Road" initiative are illustrations of China's resolve to pivot away from the US.

Should trade tensions escalate, the short-term fundamental impact would actually be quite modest. Assuming proportionate retaliation, tariffs are likely to generate more inflation and weigh on growth both in the US and abroad, but our estimates suggest that these effects will be limited (GDP loss no larger than 0.1-0.2% for China).

That said, the possibility of a trade war between the US and China could become a defining theme for markets. First and foremost, equity investors would then require a higher risk premium, with the IT, materials, apparel, home appliances and transport sectors particularly vulnerable due to large export exposure, and in some cases, a long overseas value chain (see chart XIV). Regionally, Japanese and emerging equities would certainly be most impacted given their exposure to the global trade theme – warranting a more neutral positioning.

Bond markets could also be affected. Protectionism and populism often lead to uncontrolled deficits, reducing the appeal of US Treasuries to foreign investors, just at the time of liquidity withdrawal by the Fed (assuming it stays the course amid higher inflation expectations). European bonds would then stand to be considered the safe haven asset (as illustrated by the widening spread between US and German 10-year real rates in March – see chart XV).

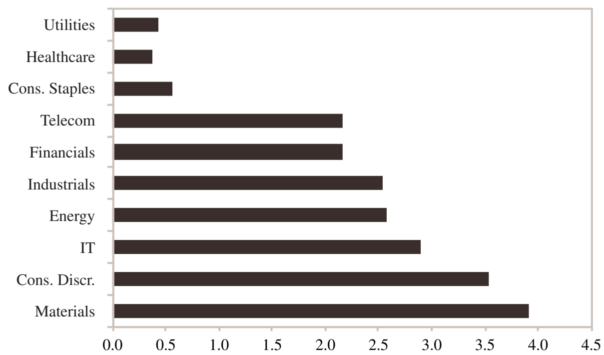
Turning to currencies, interest rate differentials and a tighter current account would appear to call for a stronger US dollar, especially against the trade-sensitive euro and emerging currencies – also suggesting a reduction in exposure to emerging assets. Safe haven currencies such as the Swiss franc or the yen should also benefit.

As for commodities, the perspective of a multi-polar economic world (US/Europe/China), marked by persistent geopolitical risk, is generally supportive.

For now, as stated above, a trade war is but a risk scenario. With the most likely transmission channel from markets to the real economy being business confidence, we will be closely monitoring the coming business sentiment survey releases and potential changes in management guidance that could be signalled during the next earnings season (starting mid-April). Disappointing figures might add to market concerns at a time when leading indicators are already rolling over for cyclical reasons.

XIV. Equity sectors' sensitivity to global trade

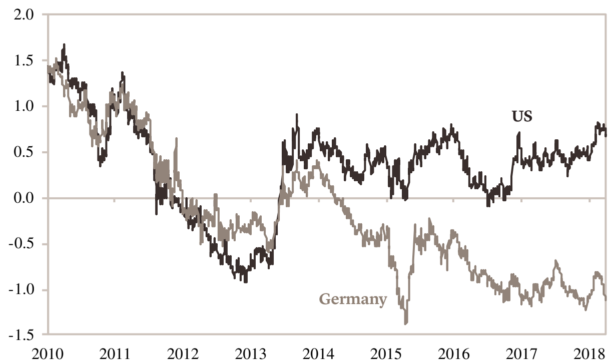
Impact on earnings growth of a 1% increase in global trade*




* estimates since 2000, MSCI World
Sources: Datastream, Lombard Odier calculation

XV. Widening spread between US and German 10-year real rates in March

US and German 10-year real rates (in %)




Sources: Bloomberg, Lombard Odier calculation

ECB starts to discuss its interest rates policy (our EUR/USD 1.25 medium-term target is maintained). In Switzerland, with inflationary signs absent, a change in central bank stance appears unlikely over the next few months, keeping the Swiss franc directionless against the euro. The two biggest outliers in terms of valuation are the British pound and Japanese yen. While the former should remain highly dependent on Brexit news flow, we have initiated a long position on the latter. Last quarter already, we highlighted the striking asymmetry between a very crowded short trade and significant valuation upside. Given the pick-up in economic activity and inflation expectations, the BoJ's very accommodative stance will likely be questioned during the course of 2018. The short USD/JPY position implemented in January has proved successful, first on a weakening dollar, then on a strengthening yen – confirming its traditional safe-haven status. Going forward, we maintain this position, expecting more comments from BoJ members about the potential exit strategy (our USD/JPY medium-term target has been revised down to 100). The JPY remains significantly undervalued according to purchasing power parity (see chart XIII, page 10).

Finally, commodities have proved resilient to equity market turmoil, providing the hoped-for diversification effect despite their high beta status and vulnerability to de-risking by systematic strategies. The Brent oil price is fluctuating around our medium-term target of USD 64/barrel, but recently benefitted from greater geopolitical risk (and a potentially tougher stance by the newly appointed US foreign policy team on Venezuela and Iran). Gold has enjoyed renewed investor interest, as evidenced by ETF holdings. As for base metals, speculative positioning on copper fell sharply during the volatility spike. Going forward, commodity performances at large should be driven by supply developments (OPEC – Organization of Petroleum Exporting Countries – and US shale producers in the oil market and capital expenditure cuts in base metals), implying a lower correlation with equities than in the past, while the downside should be limited by the favourable demand backdrop. We thus maintain our slight overweight.

*Sophie Chardon, Cross-Asset Strategist*
*Grégory Lenoir, Head of Asset Allocation*

## B. What level of bond yields would be a tipping point for equity markets?

The stock market turmoil experienced in February highlighted the strong link between interest rates and equities, especially when rates move abruptly. We have long viewed the ongoing reflationary environment as positive for cyclical assets, warranting a pro-risk portfolio positioning. Global equities have indeed outperformed bonds in past decades when US inflation accelerated above the 2% threshold. Empirically, though, we find no evidence of a link (whether positive or negative) between real rates and the performance of risky assets. From a theoretical perspective, the impact of higher interest rates and inflation on corporate earnings is ambiguous, with multiple transmission channels working in opposite directions:

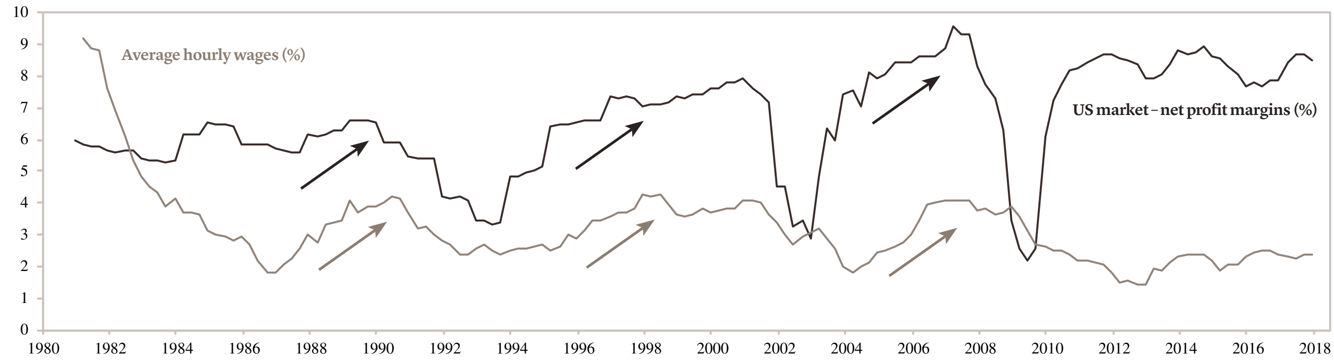
a/ higher inflation means higher revenues (+);
b/ higher inflation usually means higher wages, which may or may not, depending on operating leverage, hurt corporate margins (+/-);
c/ according to the stage in the cycle, higher nominal rates can be either a sign of improved activity or a catalyst for a slowdown in investment (+/-);
d/ higher nominal rates mean higher financing costs and interest burden (-).

The current level of inflation is not a problem per se: periods of moderate inflation (between 1% and 3%) are typically associated with the highest P/E ratios, while periods of rising wages coincide empirically with periods of rising margins (see chart XVI, page 13). Rather, it is the volatility of inflation that must be closely monitored. It could translate into a higher risk premium (if the Fed's ability to keep inflation in check is questioned) and lower valuations. Eventually, even if earnings remain robust, higher discount rates will reduce the net present value of future cash flows.

Looking at history, US 10-year yields of 5%+ have definitively been negative for equity returns. The tipping point will, however, likely occur sooner in this cycle, given the lower potential growth environment. We observe that the equities/rates correlation turns negative (i.e. rising rates start to hurt equity markets) when real rates approach the potential growth rate. At 0.7-0.8%, the US 10-year real rate is still well below US potential growth (estimated at 1.6-1.8%), **meaning that real rates have some 80 bps to go before derailing equity markets** (see chart XVII, page 13).

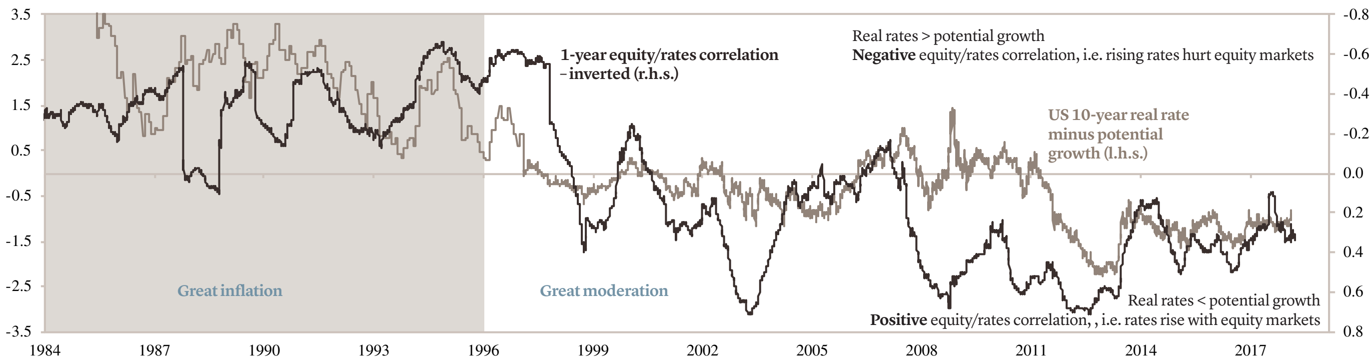
## XVI. Rising wages historically associated with higher margins

US wage growth and corporate net profit margins (in %)




Sources: Datastream, Lombard Odier calculation

## XVII. Equity/rates correlation, real rates and potential growth




Sources: Datastream, Lombard Odier calculation

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