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ASSET ALLOCATION - JULY 2020

OUTLOOK: IDENTIFIED – AND THEREFORE ANTICIPATED – RISKS IN THE SECOND HALF OF THE YEAR?

AN UNPRECEDENTED HEALTH, ECONOMIC AND FINANCIAL CRISIS

Is the health crisis that we experiencing a “black swan, a grey swan or a white swan” for financial markets? The colour given to the event hinges on its level of predictability. Nassim Taleb, author of this theory, refutes the idea of a black swan. An event of this kind was predictable and we had already imagined it rather well. In 2011, the movie Contagion provided a realistic description of a chain of events that could lead to a global pandemic such as the crisis occurring today. We had imagined the event but were not prepared for it, as Bill Gates warned us four years later in a speech – the title of which spoke for itself: “The next outbreak? We’re not ready.”

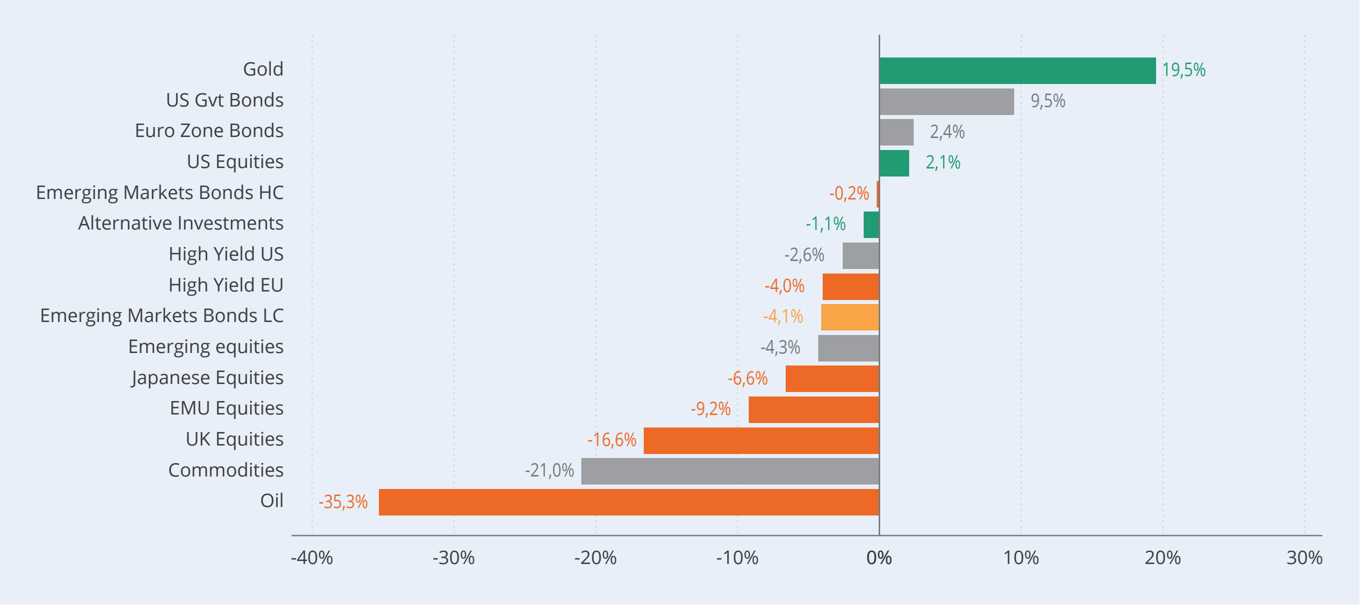
Furthermore, it was difficult for us to imagine the unprecedented consequences of the epidemic: lockdowns, the partial or total shutdown of major economies for a few weeks, the fast and massive response from central banks and governments in reaction to the health crisis. Here again, we found ourselves in uncharted territory.

In the space of just a few weeks, the world shifted from the final stages of a business cycle to a deep recession. Economic indicators appear to have bottomed out in April and May and a sharp rebound in business activity has been recorded in many countries since June. After a ‘catch-up’ phase that followed the lifting of lockdown restrictions, the time has now come to assess the speed at which our economies can recover, but also to understand the more structural changes that took place within them.

The year-to-date performances of various asset classes as of July 13th offer little sign of the major disruption that has occurred since the beginning of 2020. US equities are up 2% year-to-date, emerging equities are only down by 4%. Only European equities posted a slightly larger decline (-9% in the Eurozone and -16% in the UK) while commodity markets were the most impacted (with oil prices tumbling 35%).

> “The time has now come to assess the speed at which our economies can recover, but also to understand the more structural changes that took place within them.”

ASSET CLASS PERFORMANCES (IN LOCAL CURRENCY)



Sources: Bloomberg, Candriam. Data as at 13.07.2020. Past performance does not prejudge future performance.

FLEXIBLE ALLOCATION IN AN UNPRECEDENTED CONTEXT

What were the key tenets of our investment strategy during the first half? Flexibility, adaptability and responsiveness to navigate market volatility. How was this achieved? Reduced exposure to risk assets in January and February. At the end of March, the equity weighting was increased after the brutal sell-off during the month, followed by a larger allocation given to European Investment Grade credit and emerging debt in April and May. A core asset during this entire period: gold, which contributed positively to returns, both when markets corrected and when they rebounded.

How are we positioned today? Financial markets are caught between two opposing forces. On the one hand, economic data have produced positive surprises since June, indicating a swift recovery in activity. On the other, the spread of the virus is still far from being contained globally. The threat of the virus developing uncontrollably in a number of countries or fears of a second wave could weigh on the economic recovery, despite support from governments and central banks. Consequently, we increased our exposure to asset classes and regions displaying attractive valuations and that will benefit from the recovery, while also hedging our positions – particularly our equity exposure.

IN EUROPE: A POLITICAL AND AN ECONOMIC RECOVERY

The performance of European assets continued to lag their US and emerging counterparts. We believe Europe benefits from a number of advantages that could enable the region to deliver better relative performances in the second half. Although this preference for Europe remains tactical, over the longer term, we are finally seeing more structural reasons that would encourage us to favour the Old Continent.

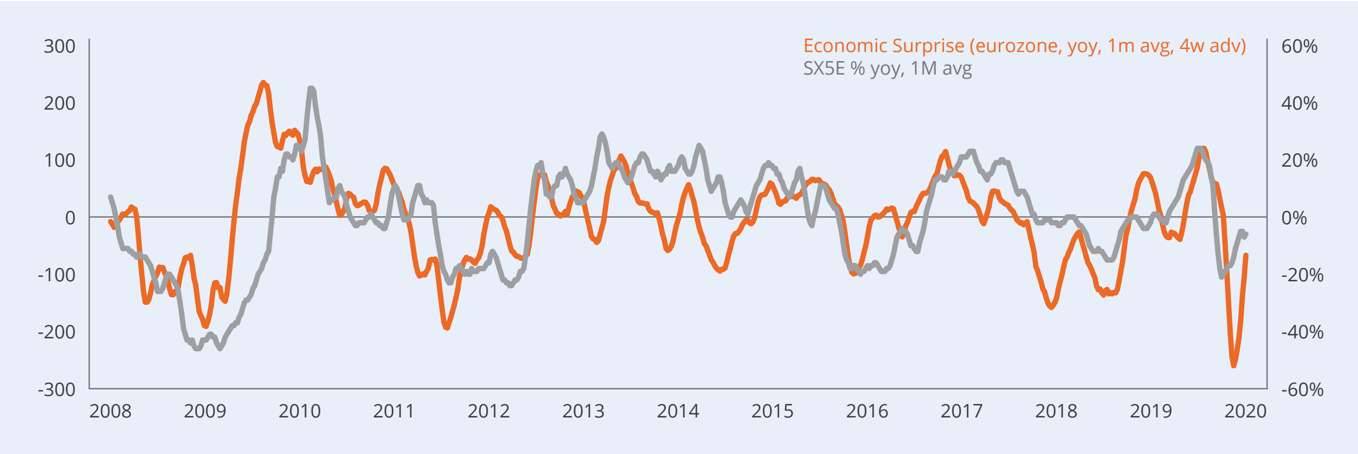
EUROPEAN ASSETS PERFORM BETTER IN PERIODS OF ECONOMIC REBOUND

European indices have a stronger cyclical component which enables them to outperform when the economy rebounds. After weighing on European countries, the strict lockdowns implemented in March in Continental Europe should now be beneficial: management of the virus appears to have been more effective than in the US and the economic rebound is likely to be stronger.

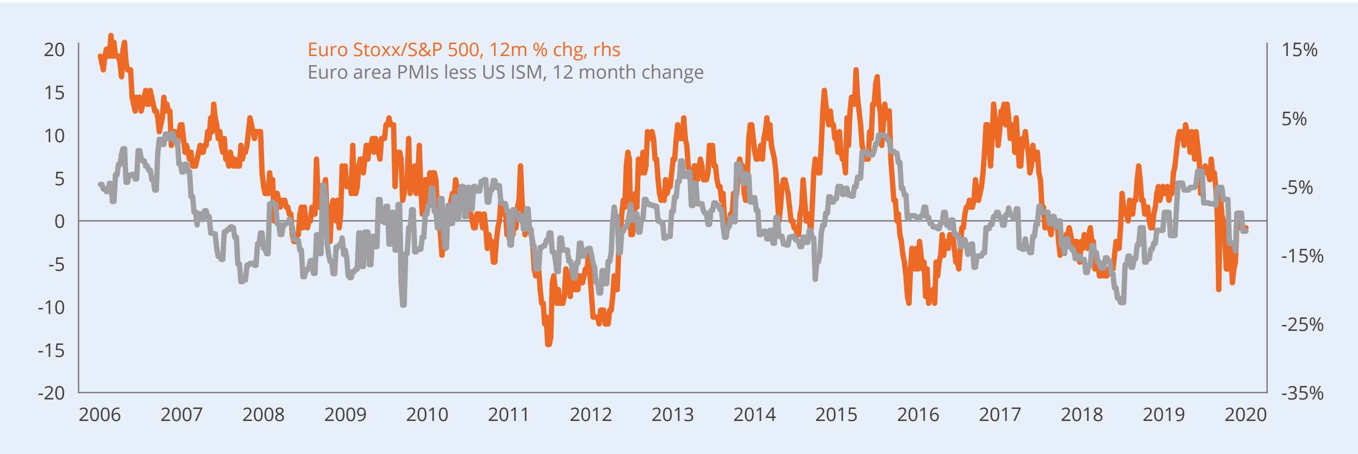
The job protection measures set up by governments in Europe should ensure that unemployment rises slower than in the United States and enable a faster recovery in business activity.

> “The disruption caused by the Covid-19 health crisis has been unprecedented. The usual stages of an economic cycle are happening in fast-forward mode.”

PERFORMANCE OF THE EUROPEAN INDEX AND ECONOMIC ACTIVITY



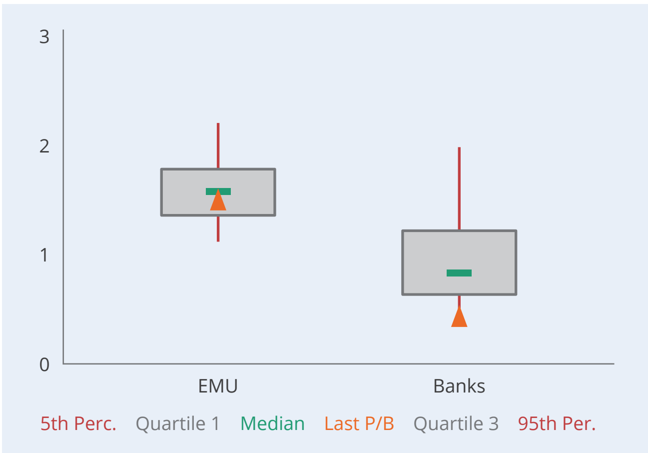
Sources : Bloomberg, Candriam



Sources: Bloomberg, Candriam

In this environment, we have also strengthened our exposure to more cyclical sectors and to Value stocks. We believe that the banking industry stands to gain from this rebound phase: banks are displaying historically attractive valuations; they perform well in periods of economic recovery and, this time around, they have benefited from support from the European Central Bank. The implementation of new TLTROs (Targeted Longer-Term Refinancing Operations) with particularly favourable terms for banks (paid 1% to borrow from the ECB) could add 5% to the sector's earnings growth (and more for several Italian banks). In the current crisis, and unlike 2008, banks are not part of the problem, but very much part of the solution. They should enable companies to survive an economic shutdown of a few weeks. We believe that investors are probably underestimating the potential rise in earnings in 2021 and 2022, which would enable the sector to catch up fast.

VALUATIONS WITHIN THE BANKING SECTOR REMAIN CLOSE TO HISTORICAL LOWS



Sources: Bloomberg, Candriam

IS THE RISK PREMIUM HEADING FOR A MORE DURABLE DECLINE?

Crisis periods tend to foster political progress in Europe. The disruption caused by the Covid-19 health crisis has been unprecedented. The usual stages of an economic cycle are happening in fast-forward mode. So far, Europe has been able to react efficiently and we have seen deep changes that could lead the risk premium to decline durably.

Germany very quickly gave up on its fiscal discipline and the golden rule of zero deficit. The fiscal stimulus package announced by the government weighs over 10% of current GDP. Several European countries had been requesting this fiscal easing for a while! The second institutional change concerns the European recovery fund. The plan, announced jointly by Angela Merkel and Emmanuel Macron, is a powerful first sign of European solidarity and will ultimately involve setting up a European budget, with its own resources.

Although the political gesture is powerful, the economic impact of the recovery fund remains limited: 750 billion euros over several years, or 6% of GDP, of which more than half will be grants allocated to the countries most affected by the crisis. This plan will be channelled through the European budget programmes and funded by debt issued by the European Commission. Its implementation carries a symbolic weight and has given new impetus to European construction, thereby reducing the risk of fragmentation between Eurozone states that appeared in the wake of the Great Financial Crisis of 2008.

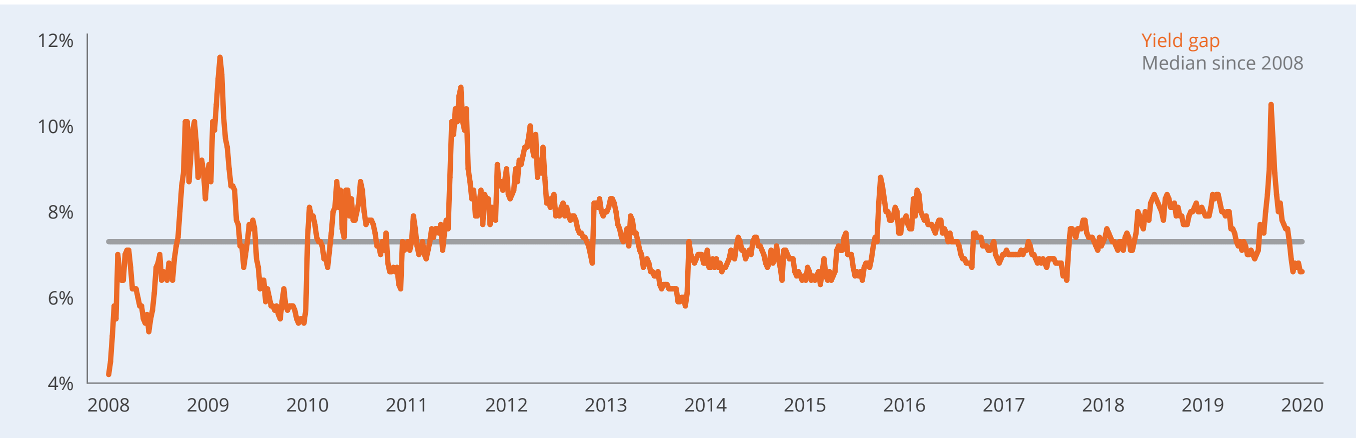
The European Central Bank has also taken measures to support the economy. Its balance sheet has swelled at a similar pace to the Fed's. And the ECB can now buy sovereign debt from the countries in greatest need (without necessarily having to comply with the previous capital keys). The central bank is also supporting companies directly through bond purchases. This massive liquidity injection has reduced the risk premium on peripheral country debt and corporate bonds.

The European risk premium has been lower than its median since 2008. However, it has stayed roughly around 6.5%, which is higher than the US risk premium (4.5%). If the trend can be reversed in Europe, after years of outflows from non-European investors, the risk premium could decline more durably and enable European risk assets to catch up with their US counterparts.

What are the implications? We increased our exposure to European equities (mainly from within the Eurozone) and to European Investment Grade credit. We are also constructive on European peripheral debt and negative on German sovereign bonds. Conversely, we have chosen to reduce our exposure to US equities since June, considering that risks are building up in the country and that the S&P 500 index has posted positive year-to-date returns.

> We believe Europe benefits from a number of advantages that could enable the region to deliver better relative performances in the second half.

THE RISK PREMIUM ON EUROPEAN EQUITIES* COULD CONTINUE TO DROP



* Risk premium = 2021e EPS / index price – 10-year rate
Sources: Refinitiv, Bloomberg, Candriam

RISKS ARE BUILDING UP IN THE UNITED STATES

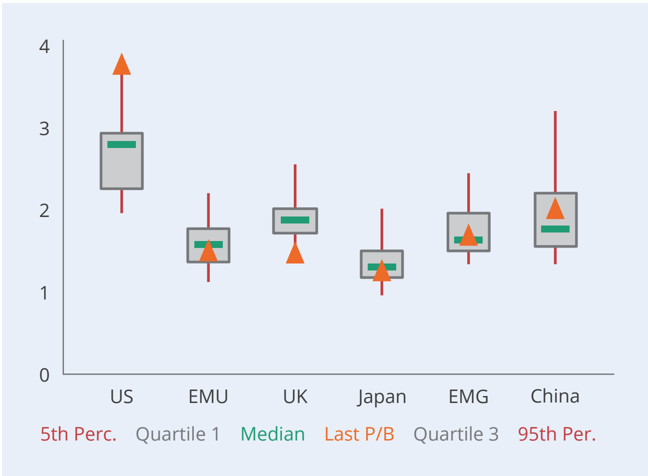
Uncertainty seems stronger in the US today than in Europe. These risks are mostly associated with two factors: on the one hand, management of the Covid-19 epidemic and of its economic impact, and, on the other, the likelihood of a "blue wave" after the Presidential election next November. The higher valuations observed in the US mean there is less margin for potential disappointment than in other parts of the world. Excluding technology and communications stocks, the US market remains more expensive than the European market in relative terms.

The Covid-19 epidemic has continued to spread significantly in the United States, whereas it appears under control in China, Europe, Japan and Canada.

Local or partial lockdown decisions could weigh on the economic recovery. This risk is already visible in the high-frequency data (Apple mobility trends, Harvard consumer data, ...) that track business activity in real time. The latest data indicate that the economic recovery has paused in the States most impacted by the second epidemic wave.

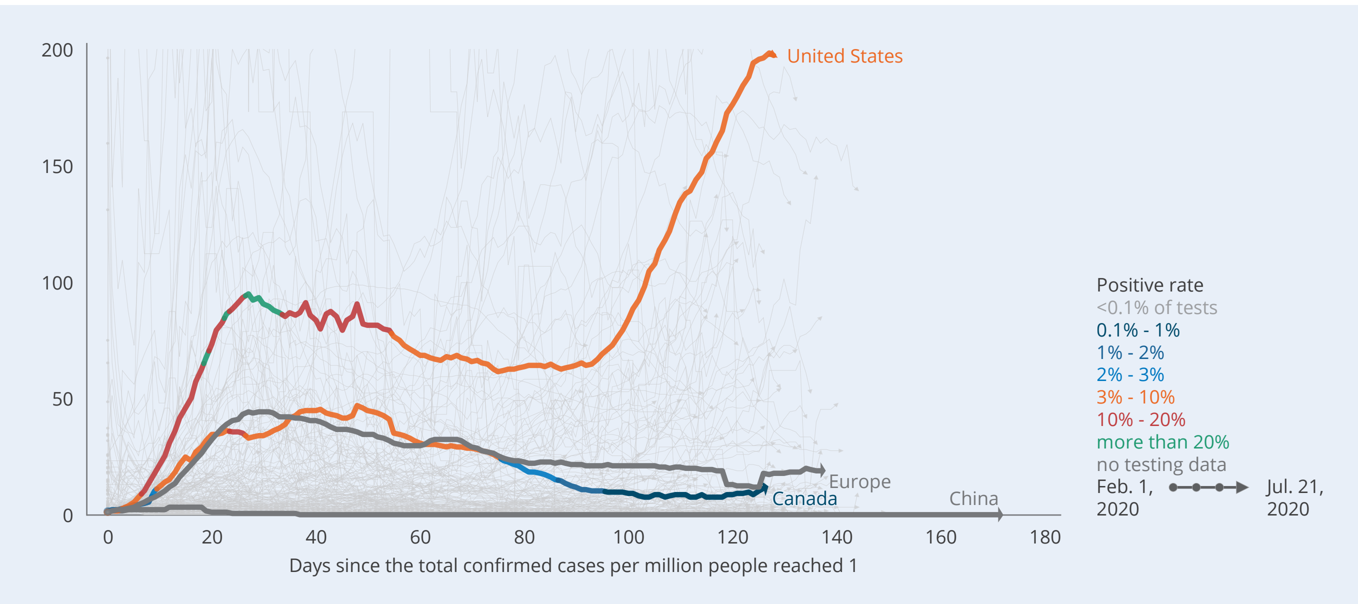
During the second quarter, the "poor" management of the epidemic has altered electoral forecasts that had pointed to the re-election of D. Trump in November. Today, the likelihood of a full Democrat victory – President and Congress – has significantly increased. A victory for Joe Biden would have a number of negative

VALUATION: US MARKET REMAINS MORE EXPENSIVE – PRICE TO BOOK VALUE



Sources: Bloomberg, Candriam

DAILY NEW CONFIRMED COVID-19 CASES PER MILLION PEOPLE
Shown is the rolling 7-day average.



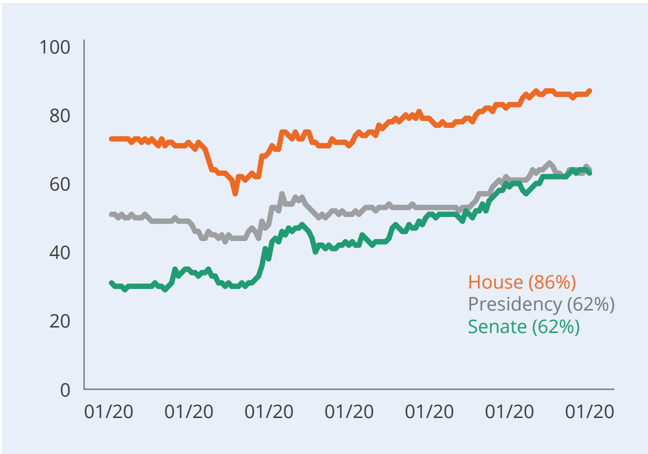
Source: European CDC – Situation Update Worldwide – Last updated 21 July, 09:38 (London time), Official data collated by Our World in Data CC BY

> The US does not seem to warrant its status as a "safe haven" as much as it did in previous crises. Economic and political risks seem much higher in the US than in Europe.

sector impacts (particularly for healthcare and energy). The overall impact on the US market is harder to determine. Some aspects of his programme could be detrimental, such as an increase in corporate tax or the minimum wage, while the launch of an environment-sensitive infrastructure programme and a possible appeasement in international relations would constitute rather more positive factors.

The US does not seem to warrant its status as a "safe haven" as much as it did in previous crises. Economic and political risks seem much higher in the US than in Europe. Growth stocks, the most resilient segment of the US market, saw valuations rise sharply in recent weeks, which could create an additional risk in the event of a turnaround in market forecasts.

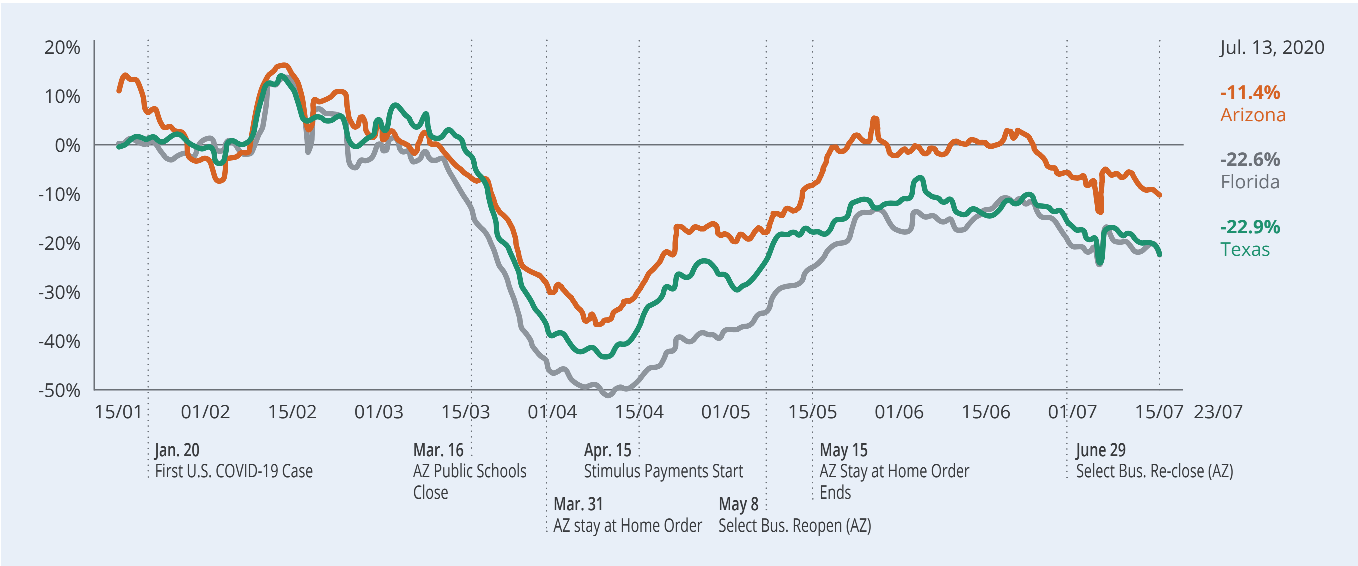
PROBABILITY OF VICTORY FOR THE DEMOCRATS



Sources: Bloomberg, Candriam

PERCENT CHANGE IN ALL CONSUMER SPENDING*

In Arizona, as at 13 July 2020, total small business revenue decreased by 11.4% compared to January 2020.



* Change in net business revenue for small businesses, indexed to Januaray 4-31 2020 and seasonally adjusted. This series is based on data from Womply.
Source : https://www.trackthe recovery.org/

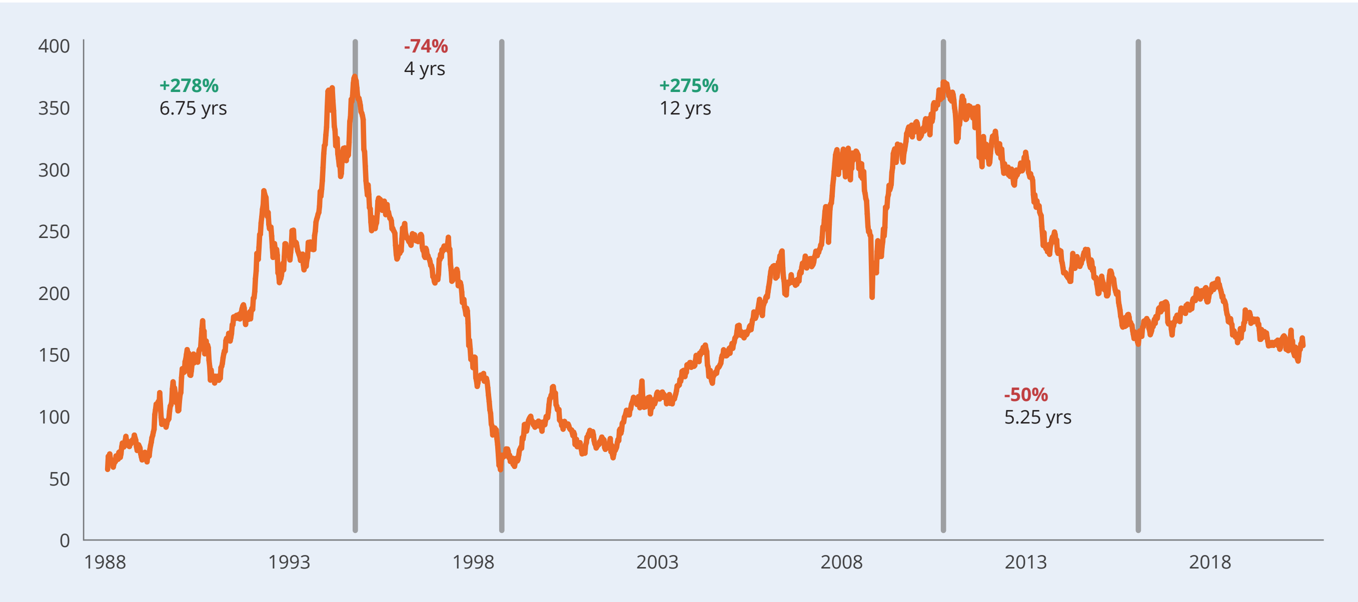
EMERGING COUNTRIES: ATTRACTIVE MID-TERM RETURNS FOR EQUITY AND DEBT MARKETS

We are positive on emerging market assets. We have notably strengthened our exposure to China and to Chinese domestic stocks.

Emerging equities are attractively valued. Two-thirds of the emerging equity index are made up of Asian stocks – China, Taiwan and Korea. These countries are benefiting from their efficient management of the health crisis and displaying a lower epidemic risk than other regions. Chinese growth was severely impacted at the beginning of the year, but has been recovering since the second quarter. Over the course of the year, China is expected to deliver positive growth (around 2%) and businesses should be able to recover their pre-Covid activity levels by the end of 2020. Emerging markets tend to outperform when the gap between their pace of growth and the pace observed in developed markets widens – which should be the case in the next couple of years. A halt in the dollar's upward path would also constitute an additional positive factor.

"Over the course of the year, China is expected to deliver positive growth (around 2%) and businesses should be able to recover their pre-Covid activity levels by the end of 2020."

GEM RELATIVE TO DM



Sources: Bloomberg, Candriam

BALANCED PORTFOLIO CONSTRUCTION

Our portfolio construction therefore focuses on assets and regions that are particularly exposed to the economic recovery. Risks exist and have been correctly identified by investors, which nevertheless limits the potential drawdown on financial markets: investor sentiment is far from overly optimistic and investors have kept high levels of cash in their portfolios. Our positioning is generally risk-on (preference for Europe, a number of Value sectors and emerging assets); however, we have continued to hedge equity risk within our portfolios in order to limit the impact of persisting volatility.

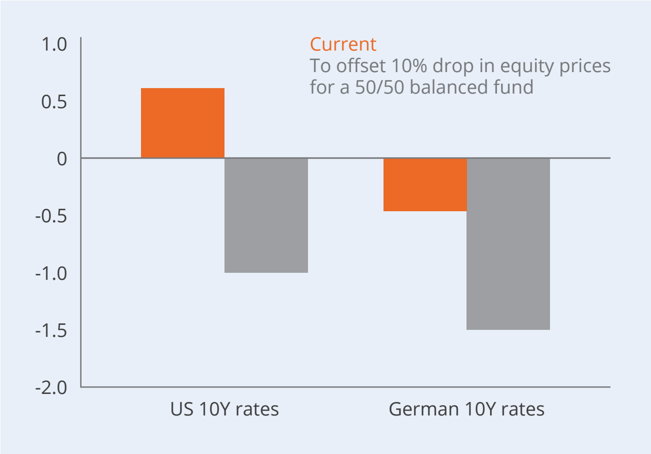
The low-rate environment, which has become widespread following massive central bank support, also remains a challenge for all balanced portfolios.

As shown in the graph below, deeply negative rates (-1% for 10-year rates in the US and -1.5% in Germany) would be needed to absorb a 10% equity drawdown within a 50% equity/50% bond balanced portfolio.

Consequently, we are looking to other asset classes that could potentially cushion the fall. Gold has contributed positively on a year-to-date basis. Its price is negatively correlated with the trend on real rates, which have fallen following central bank interventions. In light of the economic recovery, we believe that financial conditions will remain accommodative and therefore positive for gold.

The end of the year may continue to create surprises – both good and bad – for investors. We are holding onto our constructive view over the mid-term, but will continue to steer our allocation actively within the portfolios.

INTEREST RATES LEVEL TO BE REACHED TO COMPENSATE 10% EQUITY DOWNTURN



Sources: Bloomberg, Candriam

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