KBC Investment Strategy **Review**

October 2019

Review of the financial markets

Equity markets

The overall stock market (MSCI World AC in euro terms) fluctuated considerably but gained 6.7% over the past 6 months (up to and including 30 September 2019). Months of substantial corrections, in May and in August, alternated with good months in which lost ground was reclaimed and the exchange gain was even increased.

US shares underwent a particularly sharp correction in December 2018 - almost 10% - even though US growth and earnings remained solid and turned out better than expected. Investors feared lower growth forecasts for 2019 and much weaker earnings growth in the US. Markets feared that the chairman of the US central bank, Powell, would raise the key rate too much. Higher interest rates could cause growth to slow and the strong dollar, combined with the trade war with China, could weigh on foreign earnings. The market hit a low on Christmas Eve.

After recovering slightly from 26 December onwards, stock markets rallied strongly until the end of April 2019. Fed Chairman Powell did an about-face, opening the door for an end to monetary tightening and even an interest rate cut. The markets also realised that they had priced in an overly pessimistic economic scenario at the end of 2018. Hopes of a truce or even an agreement in the trade war between China and the US increased. However, these were dashed at the beginning of May with a tweet from President Trump, which reignited the trade war. New tariff increases were announced on Chinese imports into the US, and major Chinese technology companies, such as Huawei, were also targeted. Partly as a result of the escalating trade war, there were renewed fears of an economic recession, as well. From June onwards, stock markets found support in the anticipated easing of monetary policy, including in Europe. They have been rising consistently each time there are hopes of at least a truce in the trade war between the US and China. Negative reports on trade relations, an emerging conflict between the US and Iran, and weak economic indicators caused stock markets to plunge in August. The attack on oil installations in Saudi Arabia that put 5% of global oil production at risk, had only a very limited and temporary impact on oil prices and on stock markets.

All in all, the regional differences in the traditional markets have been limited over the last six months. The US (+8.8% in euro terms) beat the global average, which was also the return in the euro area (6.7%). One of the underperformers was the UK, with an increase of barely 1.3%. The increased likelihood of a hard Brexit after Prime Minister Johnson attempted to sideline Parliament, but also his inability to accomplish anything, weighed on the pound and this market. The Hong Kong stock market lost over 8% due to the continuing unrest and street violence. The big winner remains safe haven Switzerland with a +11.9% return.

Shares from emerging markets (countries or regions that are expected to experience rapid economic growth to make up their lag with the West) clearly underperformed the broad market (-0.8%). We see marked underlying differences here. Stock markets in Turkey and Russia shook off the weak growth and risk of an unpredictable president, and ended over 18% higher. Central European stock markets (-5.9%) are grappling with a slowdown in industrial growth. Latin American stock markets are dominated by political news. Since the middle of April, Asian stock markets have been unable to keep up with the broad market due to the escalation of the trade conflict with the US. As a result, the Chinese stock market is in the red (-5.8%).

After the first stock-market rally in January, in which the defensive sectors (sectors that are less influenced by economic developments and that enjoy stable revenues) lagged behind in relative terms, we have not observed a clear pattern within the sectors over the last six months. The strongest return in euro terms was registered in utilities (+11.4%), which stands to profit from the lower interest rates. But the technology sector (+11.2%) and consumer staples (+9.7%) too are clearly outperforming the broad market. The weakest performer was the energy sector (-3.8%), which suffered from the fall in the price of oil by approximately 10 dollars per barrel. Materials (+1.8%) are being hit by the further weakening of global growth and demand from China. Within the health care sector (+2.9%), mainly the pharmaceutical manufacturers are being adversely affected by claims in US courts.

There are also differences between subsectors within the same sector. In consumer discretionary for example, the Automotive subsector (+4.1%) is a notable underperformer, as weak car sales, particularly in China, and fears of trade sanctions weigh on stock-market returns. By contrast, the consumer goods and consumer services subsectors (mainly restaurants, hotels and casinos) have surged ahead by 11%. The job market and thus consumer spending therefore remain relatively strong.

Bond markets

In the most recent six months, government rates have fallen quite sharply. German 10-year rates dropped to record lows again in the summer. The US also saw striking falls in 10-year rates, heading towards 1.5%. There have been signs recently of a slowdown in economic growth as well as lower-than-expected inflation in many countries (due also to declining oil prices at the end of 2018). That is pushing down long-term bond yields. As a result of turbulence on the stock markets in the fourth quarter of last year, many investors have sought refuge in the bond markets. The US central bank (Fed) has cut its key rate for the first time in 10 years. The uncertainties surrounding the trade conflict, the weaker economic growth in the rest of the world and a below-target rate of inflation persuaded the Fed that a more accommodative rate policy is needed. Although the Fed is also stressing that it doesn't mark the start of a prolonged or deep series of rate cuts. These moves mark a reversal of the tightening of monetary policy in recent years and meanwhile the key rate is 0.5% lower than at the start of 2019.

The European Central Bank (ECB) also announced a whole raft of stimulus measures in September,including a reduction in the deposit rate from -0.4% to -0.5% and the relaunch of the bond purchase programme. The ECB also indicated that this ultra-easy monetary policy will be maintained as long as inflation does not near 2%. German bonds continue to fulfil their role as a safe haven and therefore remain in demand with investors, pushing down rates and leading to a negative compensation across almost all maturities. Peripheral risk premiums have also fallen sharply in recent months, specifically in Italy where investors are expressing confidence in the new government that will more likely steer clear of confrontations with the EU.

The risk premium on corporate bonds has fallen sharply in 2019, but the trend has recently become somewhat more stable. Companies remain fundamentally sound, as a result of which the risk of bankruptcy is low. Demand for corporate bonds was also boosted by a greater risk appetite on the part of investors. Furthermore, the restart of the ECB's bond purchase programme is favourable for this market.

Outlook for the financial markets

Investment climate

Is the US economy sending out warning signals?

- The American economy still appears to be growing peaceably, yet warning lights that growth is set to ease are beginning to flash in the distance.
  - Business confidence in industry has declined further below the 50 mark, indicating an ongoing slowdown. Industrial production and retail sales are also showing signs of weakness.
  - The American consumer remains the most important driver of the economy (good for two thirds of gross domestic product). Confidence remains strong overall and the labour market is still robust.

Euro area economy holding up

- Despite the worldwide uncertainties and the slowdown in German growth, Euro area growth is holding up.
- There is a split in both geographical and sector terms:
  - the weakness of the German economy is countered by relatively robust economic growth in France, Spain and the Netherlands;
  - industry's weakness contrasts with the relative strength of the service sector and retail.

Central bankers relax policy

- The European Central Bank (ECB) lowered its deposit rate to -0.5% on 12 September. The base rate was left at 0%.
  - The deposit rate is the rate banks have to pay to park their cash surpluses at the ECB overnight. A staged system was introduced to restrict the negative impact of this on the banks. Consequently, banks no longer have to pay penalty interest on the first tranche of their surpluses.
  - With effect from 1 November, the ECB is also launching a new bond purchasing programme to the value of 20 billion euros per month. According to the ECB, this programme will last 'as long as necessary'.
- The US central bank (Fed) also cut its policy rate again on 18 September by 25 basis points. It is now between 1.75 and 2%.

There has been a pause in the escalation of risk, but this has not disappeared.

- The unrest in Hong Kong, the fall of the Italian government, the US-China trade war and the appointment of Boris Johnson as UK Prime Minister generated a considerable amount of uncertainty during the summer months.
- The associated risks have diminished somewhat again, but have certainly not evaporated.

- Trade tensions between the US and China seemed to ease.
  - China announced several exceptions to tariffs on US products, seemingly making a gesture ahead of talks next month.
  - In turn, the US announced the postponement of increases in several tariffs.

- There is a smaller likelihood of a no-deal Brexit.
  - Prime Minister Johnson has suspended the current session of parliament for five weeks (until the middle of October), but his attempt to sideline MPs to allow him to push through a hard Brexit unimpeded was thwarted.
  - The UK parliament quickly approved a new Brexit law.
    - This law makes an exit on 31 October from the EU without a deal with Europe impossible.
    - If no deal has been agreed by 19 October, three months' postponement must be requested.
  - Postponement now looks like the most likely scenario.

Oil market temporarily disrupted

- The oil market has not been immune to the trade war or the weakening world economy.
- Demand for oil barely grew in the first half of 2019. As a result, it is substantially lower than the pace of growth over the past five years. No immediate improvement is likely.

- If geopolitical tensions cause a reduction in output, this could lead to (temporary) price spikes. These are unlikely to last for long, provided no large-scale Gulf war breaks out.
  - An attack on Saudi oil installations, for instance, resulted in a 5% fall in the global oil supply. The price of Brent crude rose sharply as a consequence.
  - Shortages at the pump can be avoided by drawing on the strategic reserves of Saudi Arabia and the US in particular. Over time, market equilibrium will be restored by higher production (of US shale oil, for instance) and the complete recovery of oil production in Saudi Arabia. As of the second quarter of 2020, the oil price could return towards 60 dollars per barrel.

Portfolio Allocation

Overall portfolio

Shares are the only alternative, but we remain cautious for the time being.

- Shares continue to be preferable to bonds. They offer the prospect of a higher return in the medium to long term and their relative valuation also remains attractive,
  - Shares are fairly valued, with price-earnings ratios around their historical average.
  - Dividend yields also exceed government bond yields, even in the US.

- However, we are cautious about shares, and continue to invest slightly below the benchmark level.
  - The mood of the financial markets has been very changeable in recent weeks due to the weaker economic news and geopolitical uncertainty. This will remain the case for the time being.
  - We're ready to step up shareholdings again on the back of potentially better economic news and/or an easing of tension in prevailing conflicts.
  - We are currently biased towards a selection of defensive shares and bonds

We're putting cash to one side

- We are parking our liquid assets in euros.

Bond portfolio

Selective approach to bonds

- Above all, the bond component forms a solid buffer relative to our share positions.
  - Despite low interest rates, the portfolio is focusing on short-term government bonds from strong euro countries in order to counterbalance fluctuations on the stock markets.
  - Positions in corporate bonds were increased recently, but remain below the benchmark.
- High-interest bonds are still one of the more interesting bond themes, due to the good currency spread and attractive current yield (2.6%), but are no longer a buying opportunity.
- Global risks are increasing, expectations towards the central banks are high and most currencies have risen against the euro. So, they have put in a fine performance.

Share portfolio

Bring stability to the portfolio

- Companies offering a high profit distribution form the core of the portfolio.
- Companies buying back their own shares are high-quality, stable businesses that pay out any surplus cash to their shareholders, as cash earns next to nothing at current interest rate levels. Earnings and dividends will then be divided among fewer shares. In a climate of low earnings growth, this significantly boosts earnings per share and that is appreciated by the stock market.

Seeking growth

- Drinking water is in scarce supply, due in part to problems with obsolete and inadequate water infrastructure, climate change and problems with water quality and waste-water. This ensures robust long-term revenue growth for water companies. These companies are generally valued a little more expensively and so are trading at a premium, but this is fairly usual given their higher-than-average turnover and earnings growth.
- Regionally, our preference goes to US rather than European shares.
  - US economic growth remains the strongest in the world, while we are still waiting for growth to pick up in Europe and Asia. The prospect of a trade war will weigh marginally on growth and on earnings as a result of higher import costs, but US companies are less sensitive to this than Asian or European companies. Not only are American consumers bolstering growth, but the US also has a more closed economy.

OPPORTUNITIES

Short-term

Within the equity component

US equities

- America first!
- Overall, a robust economic picture.
- Earnings growth continues to do surprisingly well.
- Both large and small caps.

Within the bond component

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Medium-term:

Within the equity component

Companies that buy back their own shares

- Companies that are doing well.
- Market is prepared to pay a premium for their shares.
- Relatively robust growth in earnings per share.

Water

- Scarcity of drinking water is engine of long-term growth.
- Benefits from the global recovery and growth.
- Good buying opportunity.

Within the bond component

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