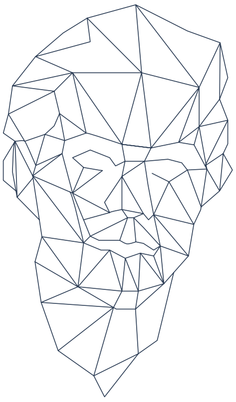
. July 2020 .

2020 OUTLOOK

by SILEX

Only for professional / qualified / institutional client and investor.

EDITORIAL



Xavier Laborde
CEO, Co-founder
SILEX

The first half of the year proved a real stress test for the global economy, financial markets and for a young asset management company like SILEX. In our yearly Outlook back in January, we had warned about unknown unknowns and how elevated valuations had made markets vulnerable to unanticipated shocks. This one certainly lived up to the promise.

Still, markets have proved resilient and so has SILEX. If anything, the exceptional circumstances have led us to be even more agile and even closer to our clients. We remain focused on growing our asset management franchise, with the recent launch of a convertible bond expertise that complements our fund range.

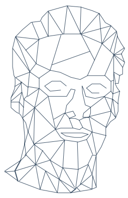
The first half of 2020 was unprecedented in many respects. The fastest bear market in history also proved to be the shortest. Many investors are now scratching their head as to what comes next. In this second edition of the SILEX Outlook, our portfolio management team shares specific, actionable ideas to help you navigate the coming months and capture attractive opportunities across asset classes and investment styles.

We hope you will enjoy it and look forward to getting the conversation going!

Xavier Laborde

ASSET ALLOCATION VIEW

By Maxime Alimi, Head of Macro & Allocation



Maxime joined SILEX in 2019 as Head of Macro & Allocation. He is in charge of both research and macro analysis on the one hand, and cross-asset portfolio management on the other. He began his career in London in 2007 as an economist at Lehman Brothers then as a multi-asset strategist at Goldman Sachs. In 2012, Maxime joined AXA Investment Managers and then became Head of Investment Strategy in Paris. Maxime holds a degree in international relations from Sciences Po Paris and the Freie Universität Berlin, and in economics from Paris I Sorbonne University and the London School of Economics.

BEST IDEA_ THE GREAT RE-RATING OF EUROPEAN ASSETS

The key theme for the remainder of the year is Europe. Investors have been disheartened by many false promises over the years, but I believe that this time is different. Paradoxically, the covid-19 shock has been helpful in that nobody can blame thrifty states or greedy bankers for what is happening. Rather, Angela Merkel is taking the opportunity to build her legacy: a critical step towards fiscal federalism.

As a result, the systemic risk premium that has built up since 2011 on all European assets starts unwinding, as a euro breakup becomes less likely.

How to play this idea? The most obvious way might be through peripheral government spreads, but it may be too late already after the forceful response from the ECB. Credit looks most compelling at this stage, and especially the financial sector, which has been penalised for years by the so-called "doom loop" between sovereigns and banks.

KEY RISK_ US PRESIDENTIAL ELECTION

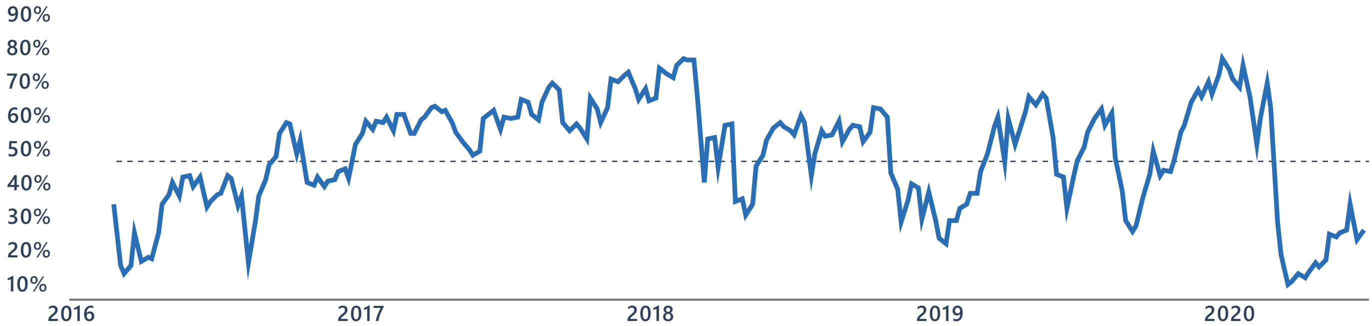
The US election was supposed to be risk no. 1 this year but has moved to the background since the Covid outbreak. Some worry that a Democratic victory by Joe Biden may hurt the stock market through higher corporate tax. Rather, we see the risks coming from a reckless political campaign from Donald Trump should he continue to trail in the polls as November looms closer.

Donald Trump could choose to deliberately escalate tensions with China in order to turn the tables in the domestic arena. That includes the economic and technological threats that markets have witnessed in 2019 but could well spill over to the military. He could for example use tensions around Hong Kong or Taiwan and leverage alliances forged in the region.

BEST CHART_ POSITIONING IS STILL A TAILWIND FOR MARKETS

This chart shows a proprietary composite positioning indicator built from 10 indicators ranging from surveys to prices and correlations on various cash and derivative markets. It suggests that investors remain defensively positioned despite the sizable market rebound, well below levels seen at the beginning of the year. This implies that significant cash remains on the side-line, which should be a tailwind for markets in coming months.

SILEX positioning scorecard



Source: Bloomberg, Refinitiv, AAII, BofA, SILEX

EQUITY VIEW_ RISK MANAGED

By Benoit Brochart, Senior Equity Portfolio Manager

Benoit is senior portfolio manager at SILEX IM since 2018. He started his career as a quantitative analyst at Total Oil Trading in 2004. From 2005 until 2011 he worked at Crédit Agricole CIB in the equity derivatives department as a prop trader, leading the development of index and statistical arbitrage. In 2011, Benoit became portfolio manager for Unigestion. As a member of the investment committee, he participated in managing Equity Risk Managed funds. In 2017 he joined SILEX, taking the lead on developing the asset management business. Benoit graduated from ENSAE.

BEST IDEA_ ESG INVESTING PASSED ITS STRESS TEST

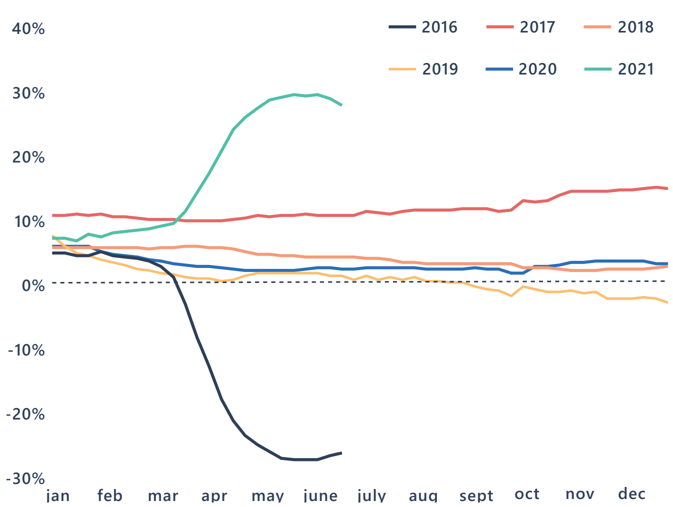
As economies begin to reopen, we see several structural shifts accelerating around consumption habits and an inflection point for businesses and governments. The pandemic was the first real test for companies regarding their social and workforce policies and environmental innovation. As a result, this period provides the first real case study of ESG stock performance in a bear market. Contrary to some investors' perception that ESG would only be a bull market phenomenon, ESG funds have maintained positive inflows, compared to strong outflows in passive equity funds year-to-date. More precisely, companies with the best ranking on social scores (training and development policies, flexible working hours, day-care services) outperformed blue-chip indices in emerging and developed markets. There is now evidence that social, healthcare, and reputational factors are metrics as important as style factors such as Value or Growth.

KEY RISK_ FLASH CRASHES ARE THE NEW NORMAL

The key risk with an equity market propped up by policy promises and divorced from fundamentals is that it leaves investors with low conviction. Many are forced to chase the trend against their better judgement. As a result, markets can get complacent, exhibiting much lower volatility than uncertain fundamentals warrant. This is a recipe for flash crashes. This market pattern is even more exacerbated by automatic flows coming from systematic, vol-target funds. We advise to continue hedging portfolios even if high volatility levels make that protection relatively expensive versus previous years. We believe it is worth it.

BEST CHART_ ARE CONSENSUS EARNINGS ESTIMATES TURNING ALREADY?

Consensus expectations on US earnings growth

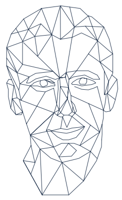


Source: IBES, SILEX

A key topic among investors remains the timing of a rotation into Value. For the past 12 months, the stocks ranking highest on the Growth factor have outperformed deep Value by more than 60%. Historical patterns suggest Value could catch up when earnings improve and bond yields rise. Today, the valuation gap is the largest on record. Thus, a style rotation could be long-lasting once a catalyst arrives. And the turn in earnings estimates may well be just that.

EQUITY VIEW_ SELECTION

By Barthélémy Debray, Head of Equities



Barthélémy began his career in 2006 as a junior equity portfolio manager at AXA Rosenberg in London. He then joined US asset manager Pinebridge in 2008 to help manage a $2bn small / mid cap technology fund and moved to Old Mutual 4 years later to manage a high conviction pan European equity strategy. He relocated to Geneva at Lombard Odier as a fund manager in 2018 before joining SILEX in 2019. Bart brings his expertise in stock picking and equity strategy. He holds a Master in asset management from Dauphine University and earned the CFA® qualification in 2011.

BEST IDEA_ A CYCLICAL ROTATION IN EQUITIES

The global economy has proved more resilient than feared and most leading indicators are pointing to strong sequential growth in earnings in the second half of 2020. This is positive for risky assets and has generally coincided with strong periods of cyclical and value outperformance.

Most metrics suggest that investors are underexposed to equities and even more so to cyclicals, which could prove very painful and could drive further portfolio rotation out of defensives into cyclicals. Whether this can become the beginning of a secular trend remains to be seen but the combination of the inflection in the data light positioning from investors, and a deep valuation discount for cyclicals could mean that the stars are finally aligning.

KEY RISK_ STAY UNDERINVESTED FOR TOO LONG

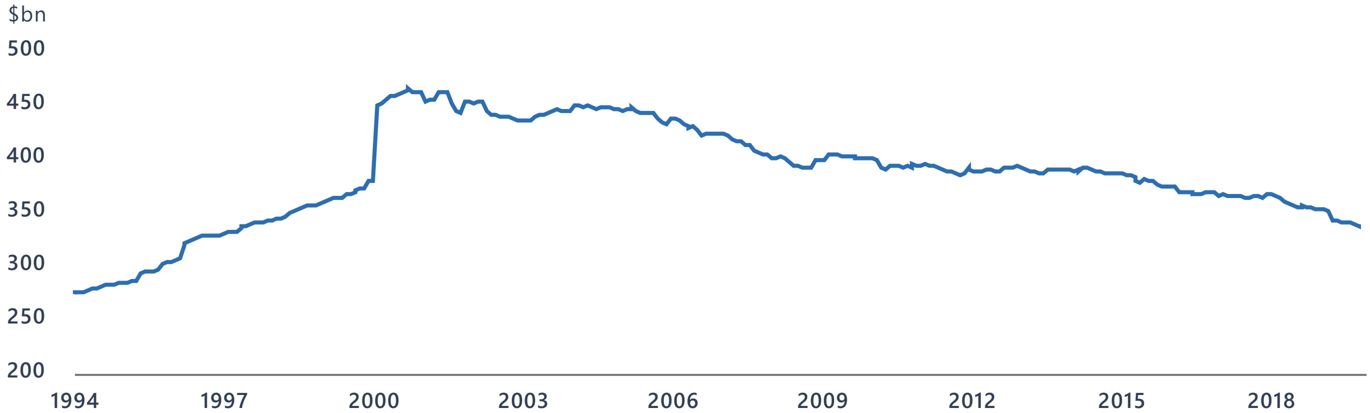
Uncertainty is the only certainty – that is an unsettling reality. In the end, the risk with the largest impact is always that which you did not expect. This year was a great example.

For the remainder of the year, many risks are on the radar and seem partially discounted in the market. Are we being too cautious? The Covid-19 crisis was so brutal and painful that many investors may experience recency bias and, as a result, be reluctant to come back to equities. The biggest risk in this case would be to stay underinvested and miss out on the potential to recoup previous losses.

BEST CHART_ TECH THEN AND NOW

The Nasdaq is now trading above 30 times Price to Earnings and investors are rightfully wondering if it is 1999 all over again with a bubble about to burst. I would argue that the technology sector is very different today. Back then, tech companies were issuing equity to finance their loss-making growth, while today is the complete opposite: they generate high margins and large cash flows which they partly reinvest in the business and partly use to buy back their own shares, reducing the availability of shares to buy in the open market and creating a scarcity effect at a time when investors are starving for structural growth.

Cumulative equity issuance in US technology sector



Source: Refinitiv, SILEX

FIXED INCOME VIEW

By Philippe Kellerhals, Head of Fixed Income

Philippe has been Head of Fixed Income at SILEX IM since 2019. He started his career in 2003 at BNP Paribas, as a credit portfolio manager. In 2008, he joined Cairn Capital in London with responsibility for corporate credit strategies covering trading, portfolio management and research. Philippe joined SILEX in 2018 as Head of Fixed Income. He manages the SILEX Financial Credit and the SILEX Flexible Bond funds. Philippe holds a master's degree in Finance from ESCP Europe and is a CFA® charterholder.

BEST IDEA_ US SENIOR SECURED DEBT FROM INVESTMENT GRADE OR FALLEN ANGEL ISSUERS

Large corporate issuers have tapped bond investors to bolster their liquidity position, considering the material impact from the economic shock. As credit spreads widened materially in March and capital markets open only progressively for issuers facing a sharper hit to top line, several companies resorted to issuing senior secured bonds as the bargaining power shifted from issuers to investors. These newly issued senior secured bonds prime the existing bondholders with priority of payments and attractive collateral.

These bonds offer a very attractive risk-reward as the downside is lower given attractive security packages whilst elevated yields translate into high expected returns. What is more, if one focuses on issuers that were still investment-grade rated before 22 March and issues whose maturity does not exceed 5 years, the bonds are eligible for the Fed's credit purchase programme, thereby benefiting from a strong technical support.

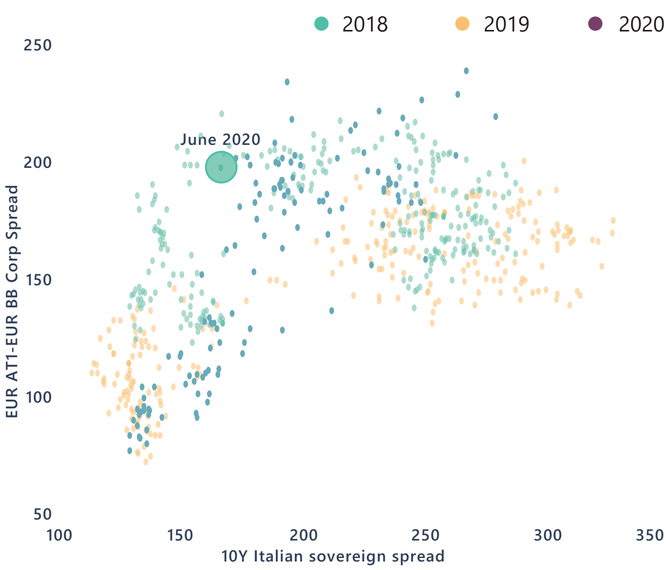
KEY RISK_ CENTRAL BANK POLICY EXTENSION

The recent central bank purchase programmes and guidance have helped contain interest rate volatility and normalise credit spreads in the context of record Q2 fixed income supply across most segments. Some of these programmes are due to expire by the end of the third quarter or may be depleted by year-end. If the economic and pandemic outlook remain uncertain, the discontinuation of these programs is likely to reignite interest rate and credit spread volatility. Whilst this is not our base case given the likely evolution of employment and inflation for the rest of the year, it is certainly worth monitoring as this may very well be the known risk factor with the highest impact.

BEST CHART_ FINANCIAL DEBT IS ATTRACTIVE RELATIVE TO EUROPEAN DEBT

The ECB's various asset purchase programmes have helped Italian spreads tighten back towards pre-Covid levels. We believe this spread is likely to continue grinding tighter as the ECB should extend its PEPP programme later this year. Joint EU issuance funding for the European recovery fund will also contribute to capping sovereign risk premia in Europe. Nevertheless, **relative valuations for financial credit remain very compelling.** The EUR AT1-EUR BB Corp spread currently stands at about 200bps despite much stronger issuer credit quality and due in large part to technical factors. This spread is likely to compress meaningfully as sovereign spread volatility remains subdued and market participants gain more evidence on the stability of credit metrics and capital buffers for systemically important institutions.

Financial credit vs. sovereign risk



Source: Bloomberg, SILEX

CONVERTIBLE BONDS VIEW

By Xavier Hoche, Head of Convertible bonds

Xavier has been Head of Convertible Bonds at SILEX IM since 2020. He began his career as fixed income portfolio manager at Crédit Mutuel in 1995, then joined Crédit Lyonnais AM and OFI Asset Management as Head of convertible bonds. From 2006 to 2008, he was convertible bonds manager at Schelcher Prince Gestion before taking responsibility for the convertible bonds and dated funds at Oddo Asset Management. In 2013, he founded AltaRocca AM dedicated to convertible bonds management and also served as a fund manager analyst there. Xavier graduated from ISFA in actuarial science.

BEST IDEA_ BUY EQUITY CONVEXITY

Most of us want to participate in the equity upside and be part of the changing economy but the experienced are afraid of equity valuations. Convexity (the asymmetrical profile that you can buy through options or convertible bonds) is a limited downside format for equity investing. It allows you to invest in tech companies in the US or Asia (33% of the US convertibles market are tech companies), and you can have access to value stocks in Europe without fearing the downdraft that occurred with Covid-19. Furthermore, when you buy convexity you also buy some volatility that protects you in bad times. Let's stay optimistic, but also bring our umbrella along.

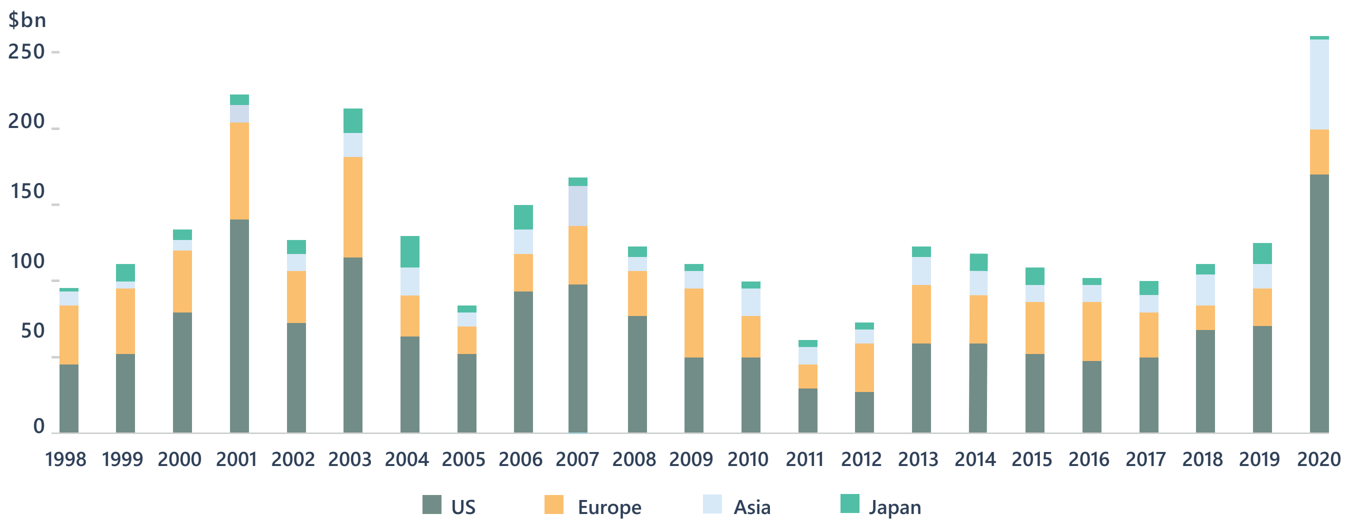
KEY RISK_ THE SECOND WAVE

One of the main risks for markets could be a second wave of Covid-19. This second wave does not have to be as hard as the first one (treatment and vaccine are in progress) and may not lead to a second lockdown. But the consequences on the real economy could be very serious. The V-shape of the economic rebound would look more like an L and corporate defaults would increase substantially.

BEST CHART_ RECORD ISSUANCES IN CONVERTIBLE BOND MARKETS

The global convertibles primary market has been on its strongest pace since the global financial crisis ($89.1bn has been issued since the beginning of the year, more than twice as much as in 2019). New convertibles issuances bring some new stories to the market, convexity to investors and help companies finance their projects.

Global issuances of convertible bonds



Source: BofA, SILEX

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This article was finalised on 30 June 2020.