EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

May 2018

Benjamin Melman
HEAD OF ASSET ALLOCATION
AND SOVEREIGN DEBT

"Back to fundamentals"

The protectionist issue has not gone away and will probably be with us for some time, but the time has come for talks between the US, China and the European Union, as well as with Mexico and Canada over NAFTA. There have been some indications that agreements might be reached but not enough to warrant any further speculation on a successful conclusion.

STILL SOME WAY FROM THE "BEGINNING OF THE END"

At least the lull in news flow on political and international trade questions has helped markets return to fundamentals, and notably first quarter earnings. The US earnings season is not yet over but the number of positive earnings and revenue surprises is particularly high. In other zones, profits have been high quality but less impressive. True, the pace of growth has certainly slowed since the beginning of the year, especially in Europe, but the fourth quarter of 2017 was particularly strong. There are no pointers suggesting we are at the "beginning of the end of the cycle" and recent trends look more like mini-cycles within the cycle itself.

At any rate, the fact that earnings have risen -while markets have trodden water- has reduced valuations to more normal levels. We are convinced that visibility on the cycle continuing is good and that the risk of an escalation in protectionism is still moderate. As a result, we remain overweight equities with a focus on the eurozone and Japan.

THE ECB SOFTENS ITS STANCE

US Treasuries have come under pressure with yields rising to around 3% due to core PCE inflation hitting 2% in March as well as fiscal blunders. But the knock-on effect on European bond markets has been very mild. Growth is slowing down, and even if the ECB thinks this is only temporary, it wants to avoid taking any risks and has softened its monetary normalisation stance. Emerging country debt markets have been hit harder as their sensitivity to US bond markets is still high.

We remain underweight bonds, but we are not particularly worried. US long rates should continue to edge higher, but Treasuries now offer satisfactory yields, limiting the capital loss risk over time. And they are now beginning to offer interesting diversification potential should adverse market conditions occur. That is why we have returned to neutral weightings after being underweight. On the other hand, we are still underweight European government bonds due to their meagre yields, a reflection of the ECB's recent caution. Company fundamentals remain strong, but we are neutral on credit markets overall because they look expensive.

KEY POINTS

- Equity overweight maintained
- Still neutral on credit markets overall
- Caution on the US dollar

However, we still believe that subordinated financial debt will deliver better returns.

The US dollar has been erratic year to date and trading has been disconnected from traditional fundamentals. But the fact that US inflation is returning to normal, and Europe slowing down, has led to a sharp move higher in the last two weeks and that too is a return to fundamentals. We remain cautiously exposed to the US dollar.

NEXT HEADLINE EVENTS

- ***June 12 & 13: next Fed meeting***
- ***June 14: next ECB meeting***
- ***June 14 & 15: next BoJ meeting***

Written on May 4, 2018. This document is for information only.

EDMOND DE ROTHSCHILD
ASSET MANAGEMENT (FRANCE)
47, rue du Faubourg Saint-Honoré – 75401 Paris Cedex 08
Société anonyme governed by an executive board
and a supervisory board with capital of €11,033,769
AMF registration No. GP 04000015 – 332.652.536 R.C.S Paris
edram.fr