EDMOND DE ROTHSCHILD

# ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

MAY 2019

## CAUTION OVER THE RALLY

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*CIO Asset Allocation and Sovereign Debt*

**KEY POINTS**

**Slightly underweight equities and bonds**

**Overweight money market funds**

*"I am prepared for the worst but hope for the best"*, said Benjamin Disraeli, a distinguished British prime minister in the 19th century. At Edmond de Rothschild, we are still a long way off getting ready for the worst but it has to be said that we should be approaching today's market euphoria with a minimum of caution. The short term signs are still positive, despite some risks being overlooked, but the medium term picture is turning slightly hazy.

After alarming investors by being hawkish during the fourth-quarter sell-off, the Fed and ECB have, for the moment, reassured investors by showing they can ease monetary policy to suit economic conditions. But looking beyond central bank complacency, the initial signs from China's recent economic rebooting suggest that the second-half drop in growth there and in the US was simply an air pocket. We believe that this upswing in China, along with fiscal stimulus in countries like France and Italy, should result in Europe's growth being a little less disappointing than expected.

So, if everything is dandy in the best of worlds, what are the risks?

### SHORT-TERM RISKS

- We had foreseen an upturn in China but are still convinced it will lack vigour. In other words, the chances of being pleasantly surprised by China will not last.
- Investors have gone overboard on central bank complacency, so much so that there are once again massive shorts on VIX volatility contracts, a token of market fragility. Bear in mind that in January 2018, when circumstances were similar, the S&P 500 plunged 10% for no real reason.
- Investors who were pessimistic over US China trade talks have now turned optimistic. They are, in fact, quite logically tracking Donald Trump's moods as he was responsible in the first place for fomenting tension and is now playing a key role in playing down fears. Even so, there are still serious sources of friction between the US and China, notably intellectual property, so we could well see a watered-down agreement, one that could store up fresh tension over unsettled business at some time in the future. Disappointments could therefore resurface.

- Lastly, there is a serious chance that trade tensions between the US and Europe could emerge. The NAFTA 2.0 agreement has ended up increasing production costs for US cars so Washington might consider increasing tariffs on imports, and especially those from Europe, to stop US auto producers losing market share on their home market. And France's refusal to include agriculture in trade talks has riled Washington, and also possibly irritated other European countries which are less sensitive over agricultural issues and keen on reaching an agreement. With only 18 months to go before the US presidential elections, Donald Trump could be tempted to act as a national champion by defending the livelihoods of US workers and farmers.

## MEDIUM-TERM RISKS

We see no signs of a US recession in the foreseeable future but advanced indicators clearly suggest we are approaching the end of this cycle. The short end of the yield curve, which for the New York Fed is the most relevant part, is now inverted and company margins in both the US and Europe have deteriorated. To be fair, not all yield curve inversions turn into recessions after a few months and company margins can go through mini-cycles that do not impinge on the overall cycle's momentum. And at this stage, it is not yet clear that company margins are on a structurally downward trajectory so we should treat these indicators with caution; in today's environment, they could go fully into reverse. However, given the cycle's maturity, we think it risky not to be warier. We are not expecting to see the end of the cycle but these indicators nevertheless suggest more caution, especially as the risks are asymmetrical. In other words, the upside after the risk asset rally earlier this year looks more limited than the downside should markets start to factor in the end of this long financial cycle.

That is why we have remained slightly underweight equities and bonds and overweight risk-free investments like money market funds.

## NEXT HEADLINE EVENTS

Next ECB meeting: June 6

Next Fed meeting: June 18 & 19

Next BoJ meeting: June 19 & 20



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