



EDMOND
DE ROTHSCHILD

LETTER FROM THE CIO

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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STILL BULLISH



BENJAMIN MELMAN

Global Chief Investment
Officer, Asset Management

▶ Since 9 November, when Pfizer announced the first vaccine, our investment framework has remained unchanged: the recovery will be strong and, despite stretched market valuations, it has not been fully priced in. Since that date, there has been a concrete recovery in value and cyclical sectors, but the recovery has, in overall terms, been modest given the extent of the underperformance recorded last year.

A similar story can be seen on the credit market: despite default rates being significantly lower than feared and the proximity of the recovery, the spread between an investment grade and high yield bond remains relatively high, even though all spreads have been compressed by the abundance of liquidity. Investors are certainly overexposed to risky assets but remain focused on defensive segments. There is therefore potential to make more of this expected recovery, which should be favourable to risky assets.

FEWER RISKS, MORE OPPORTUNITIES

Don't fight the Fed !

It may be argued that the consensus is somewhat too optimistic and that investors are now overweight in risky assets and the markets are expensive. But we should not forget that these market valuations are due to the massive «monetisation» initiated by central banks, carried out even before investors return to risky assets. Risks of a reversal are therefore much more likely to come from the policies of central banks than from valuations, which are high but not extreme. Jerome Powell, the Governor of the US Federal Reserve, dismissed the debate on tapering that which was beginning to emerge at the Fed. There is nothing to prevent the debate re-emerging this year, but the Governor nevertheless offered strong visibility over the coming months. From our perspective, investors remain keen to invest in risky assets, which will make the eventual unwinding of these ultra-accommodative monetary policies even more difficult. The earlier the Federal Reserve provides details of how the policies are to be unwound, the easier it will be for markets to absorb this change. While waiting for a change in monetary policy, don't fight the Fed!



KEY
FIGURE

-1.3%

The fall in business investment in the United States in the fourth quarter of 2020, year-on-year. By way of comparison, one year after the collapse of Lehman Brothers, it was still down 10.3%.



KEY POINTS

Overweight in emerging market assets for several months

Reduction in the weight of government and investment grade corporate bonds

Increased investment in convertible bonds

Reduced exposure to high yield bonds

An unprecedented environment for companies

Early fourth quarter GDP reports contain unusual information. In the United States, business investment was down only 1.3% year-on-year, showing surprising resilience in the aftermath of such a recession. By way of comparison, one year after the collapse of Lehman Brothers, it was still down 10.3%. This good performance is not only due to the logical surge in investment in computers and software. The same observation can be made for countries such as France, although the position there is slightly less favourable. Business formations soared in 2020 in industrialised countries. There is certainly a strong increase in the number of micro-enterprises, partly as a result of redundancies. These numbers therefore need to be analysed at several levels.

In France, excluding micro-enterprises, business formations were, however, stable in 2020, which is remarkable. This surprising dynamism of businesses, despite the environment, may result in some positive surprises when health conditions normalise. Especially since, in order to ensure the sustainability of the recovery, the Biden administration is discussing a new very ambitious stimulus plan with Congress. The most recent information therefore reinforces hopes of a recovery this year.

MUTANT VIRUSES & BROKERS

We have been surprised, in recent weeks, to see a degree of volatility return to the main markets due to the extreme movements in some stocks linked to trading on Robinhood-type platforms, while the waverings over the effectiveness of vaccines to protect against coronavirus mutations have been largely ignored by investors. On our side, we would be happy to reverse these priorities.

With regard to Robinhood-type platforms, beyond the issues of managing «long-short» strategies and the short-term technical effects that such issues may cause, we do not see them giving rise to any systemic risks. These events have multiplied market inefficiencies that can only be beneficial to fundamental managers that invest over a longer horizon than the «gamblers». Indeed, typical investors on these platforms diversify their investments very little (usually 1 to 3 securities), take considerable risks (options, leverage), and do not have sufficient financial strength to «hold» their position when faced by adverse conditions. Historically, these investors disappear at the first sign of a mishap and do not come back. Despite the current enthusiasm, it is likely that this phenomenon will not last.

On the other hand, we remain vigilant to the risk that vaccines will lose their efficacy as a result of mutations in the virus. That risk seems to be fading for the time being.

ASSET ALLOCATION STRATEGY

Against this backdrop of a strengthening recovery in which a certain degree of tension over long-term rates may continue, we have reduced the weight of government and investment grade corporate bonds. However, we have increased our investments in convertible bonds in order to raise the overall level of convexity in the portfolios. As we do not want to increase the risk to the portfolios, we have reduced our exposure to high yield bonds.

The return of emerging market assets

Investors, who were rather underweight in emerging equities and bonds in 2020, are coming back to these assets. Emerging market assets benefit from good visibility on key factors (excellent performance of Chinese growth, clarity from the Fed on the continuation of its monetary policy favourable to the revaluation of emerging market assets), a discount on comparable assets in developed countries, a possible easing or at least the end of the escalation of the geopolitical situation with the new US administration. We have been overweight in emerging market assets for several months and stand by this choice.

	Our convictions for february*	Changes compared to the previous month
ASSET CLASSES		
Equities	+	→
Fixed Income	-	↓
Cash	=	↑
EQUITIES		
US	+	→
Europe (ex-UK)	+	→
UK	=	→
Japan	+	→
China	+	→
Global Emerging	+	→
Convertibles	+	↑
SOVEREIGN BONDS		
US	-	→
Euro Zone	-	→
Emerging Markets	+	→
CORPORATE BONDS		
US Investment Grade	-	↓
Euro Investment Grade	-	↓
US High Yield	=	→
Euro High Yield	=	↓

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 22/01/2021.

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EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08

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www.edram.fr