



EDMOND
DE ROTHSCHILD

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

MAY 2020

THE MARKETS
AND,
ESPECIALLY,
THE CENTRAL
BANKS ARE
BACK IN FORCE

► Risky assets recorded a rebound in April, under the effect of the concerted actions of the central banks and tax authorities, in a context in which short and medium-term uncertainty remains high.



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SHORT-TERM UNCERTAINTIES

While we are nearing the lifting of the lockdowns in the main western countries, there is still a lot of confusion as to the length of this transition period and the risks of a new wave of the virus. With the notable exception of Germany, no western country is producing tests on a massive scale to accelerate the quarantining of people who are infected and it is not even certain that the quantity of masks available will be sufficient. The serological tests do not appear to be considered reliable for the time being. As for the immunisation of the population, it is not extensive enough according to the various studies (which often have reliability issues) to hope for a significant reduction in the risk of a new outbreak of the epidemic, bearing in mind that even the notion of the immunity of a person who has already had the virus is still not established. Unprecedented research efforts to find a therapy are underway, but at this stage no solutions have been found yet to reduce the deadliness of this virus and it is likely that it will be close to 12 months before a vaccine is available. In other words, we are entering a period of social distancing that everyone wants to estimate will last a few months without any certainty whatsoever and in which growth will be sharply impacted.

MEDIUM-TERM UNCERTAINTIES POST CRISIS

Some factors suggest that the next cycle is set to be more uncertain than the previous ones.

ZOMBIFICATION VERSUS NEW PLAYERS

Unlike ordinary recessions in which companies deleverage and restore their margins (the cycle restarts each time with companies that have been “cleansed”, which offers numerous opportunities), the ones that will get through this crisis will come out with even higher debt and most probably with more deteriorated margins. We are witnessing capital destruction, which means that new players could emerge and generate new momentum. But overall, there is no doubt that for one “zombie” company that will disappear and leave room for a more productive company, several companies that were not zombies will become



KEY POINTS

We are slightly
underweighting equities

Convertible bonds are
keeping their promises

There will be a rise in
mergers and acquisitions

ones, especially as economic policy consists of reducing bankruptcies as much as possible, with the corollary of maintaining the zombies active.

REDUCTION IN THE WEIGHT OF PUBLIC DEFICITS

The public deficits, which are shaping up to stand at unprecedented levels for a large number of countries, will have to be reduced. Too early would hinder the recovery cycle and would be counter-productive, too late would be extremely dangerous in light of the already very high public debt burden. This question will certainly create uncertainty on the economic, political and institutional fronts. Within the eurozone, the available data suggests that Germany will be less affected by this crisis than its partners, which would thus further widen the gap between the countries' economic performances. Italy, France and Spain would, conversely, come out of the crisis weaker, with very high public deficits. When the European rules regarding the convergence of public debt are reinstated, a satisfactory European political and economic agreement will have to be found.

1. A "zombie" company is a term coined by the economists Ricardo J. Caballero, Takeo Hoshi and Anil K. Kashyap. The official definition of a zombie company, according to the Bank for International Settlements (BIS), is "a listed firm, with ten years or more of existence, where the ratio of EBIT (earnings before interest and taxes) relative to interest expense is lower than one". In simpler words, zombies are companies that are not profitable – to the extent that they are unable to pay even the interest on their debt with their earnings. They are effectively failing but are kept alive by banks that continue to lend them money to reimburse their existing debt.

ALLOCATION

The level of uncertainty argues in favour of at least some caution. Following the market rebound that took place during the first weeks of April, strengthened by somewhat more normalised and even quite high valuations of US equities, we reduced our equity exposures via European equities ahead of the Eurogroup meeting on 23 April.

We are waiting to see how strong the institutional response will be, with a Europe that is increasingly heterogeneous, both economically and politically. Italy is in a very bad position and its political landscape is fragile and fragmented.

We mark a parenthesis for an asset class that deserves to be reconsidered and hail the behaviour of convertible bonds during this crisis: they have perfectly delivered the convexity hoped from them. For a long time, this sought-after characteristic of convexity had ensured the popularity of the asset class with investors. However, convertible bonds have tended to become scarcer over the past years, probably because they disappointed in the previous crises. As they were more present in portfolios, during the crises they fell prey to large sell-offs on a relatively thin market, resulting in liquidity problems and an excessive decline, therefore preventing the asset class from delivering its promises. This was not the case in March, on the contrary, clearly because there were less of them to sell. We consider that the loss of interest in this asset class is sufficiently substantial for us to reconsider it within our portfolios.

We are therefore currently slightly underweighted in equities and wish to remain on the alert as the current situation is rapidly changing and due to the novelty of this crisis. Beyond the trigger, the vertiginous aspect is what is new about this crisis: the unprecedented collapse in GDP and huge extent of the fiscal and monetary stimulus pro-

grammes. When everything occurs in traditional proportions, it is relatively easy to make parallels between concepts that are not exactly comparable and to estimate the global impacts. But given the amounts currently at stake, the juxtaposition of these extraordinary and contradictory forces reminds us that we must remain vigilant as the impacts are for a large part unknown.

By way of illustration, since 1 March, the Federal Reserve's balance sheet has increased by \$2.41 trillion. In comparison, it had grown by 3.6 trillion over six years following the big financial crisis and the implementation of four quantitative easing programmes. Thus, in eight weeks, the Fed's balance sheet increased by two thirds of the total amount of the biggest and longest monetary stimulus operation ever carried out in history! Just a month ago, even the US Treasuries market was out of joint. All of these problems were solved to an extent that makes us wonder whether the Fed has not more or less taken control of many of the markets. For example, the NASDAQ 100 index is down just 1% since the start of the year, after recording a plunge of 28% at 23 March...

OUR CONVICTIONS FOR MAY*

EQUITIES	=/-
US	=
Europe	=/-
Euro	=/-
United Kingdom	=
Japan	=
Emerging countries / Asia	=/+
Emerging countries / Latam	=/-
Global / Thematics	+
FIXED INCOME	=/+
US	=
Euro	=
Investment Grade	+
US	+
Euro	=/+
High Yield	=/-
US	-
Euro	=/-
Emerging markets	=
DIVERSIFICATION	
Convertible bonds	=
Dollar	=
MONEY MARKET	=/+

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 27/04/2020.

In general, the date of 23 March is far from trivial. It corresponds to the announcement by the Fed of unlimited quantitative easing with the ability to purchase corporate bonds for the first time. Note that the low point of the markets following the market crash in Q4 2018 corresponds to the day on which the Fed Chair announced a shift in US monetary policy (the restrictive nature of which had a major responsibility in the crash) and that the Fed's resumption of its balance sheet expansion in 2019 had favoured a sharp rise in all risky assets over the entire year...

Same causes, same effects? Are we going to witness the formation of a new bubble? This is fully possible as long

as the growth of the central bank's balance sheet and the authorities' will to support markets remain strong, in order to prevent the economic crisis from turning into a financial crisis. It is on the basis of this outcome that we maintain a near-normal exposure to risky assets. But it would be unreasonable to bet too high on this monetary argument. While there is a link between the balance sheets of central banks' and financial assets, it is poorly understood, even by the central banks themselves. Moreover, the return to normal on markets could lead the Fed to not over-force the decorrelation between asset prices and fundamentals, as its saving grace in the short term is matched by its potentially dangerous effects in the medium term.

THE GREAT COMEBACK OF ACTIVE MANAGEMENT

In the assumption that a bubble organised by the central banks does not form again, and in light of the valuation levels and current available data, we no longer have strong expectations in terms of the direction of the markets. Conversely, we believe that differentiation will be high and active management will regain its full significance. Within a same market there are indeed as many risks as opportunities, and the severity of this crisis makes this a clear-cut vision.

With respect to bonds, we are ineluctably heading towards a rise in bankruptcies, which calls for strong discrimination. To limit the risk within our portfolios, we continuously carry out stress tests on companies' balance sheets to gauge their positioning in this new environment. We have also become more selective on the issuers. If our analysis of the zombification of the economy is right, the ability to give credit analysis a key role, as we are doing, is what will be decisive in the coming years. While spreads provide high returns, what remains is obviously to avoid the defaults.

Within the equity markets, this crisis will have its winners and its losers. **We see new themes emerging** and that will durably take root in the landscape:

- ▶ **Reshuffling and concentration:** all players within a same sector will not get through the crisis in the same way. This crisis will thus be an unprecedented opportunity for those who will come out on top, with easy gains in market share and *pricing power*². There will be a rise in mergers & acquisitions in all sectors and there could even be major consolidation in retail, energy in the US and automotives in Europe.
- ▶ **The determination of a certain number of assets as strategic** and part of national/regional sovereignty such as healthcare and logistics. This means that certain companies will regain significant premiums.

Even within the very liberal European institutions, we note a change in tone, the need to no longer tolerate the weaknesses of a European Union that has become overly dependent on China in certain fields. This evolution, which will not imply calling globalisation into question but rather increased regionalisation of economies, is set to play a part in shaping the competitive landscape and the valuation of companies.

Lastly, **this crisis is likely to accelerate certain trends that had already emerged** before the crisis:

- ▶ The **intensification of digital** and the **use of Big Data**. Companies will continue to massively adopt technological changes.
- ▶ The **regionalisation of production**, a rising trend that our economists had already described well before the crisis.
- ▶ The **acceleration in healthcare spending**, which will generate progress in terms of research on vaccines, oncology, etc.
- ▶ The **energy transition**: we can anticipate stimulus plans for green infrastructure (trains, alternative energies, infrastructure for electric cars, etc.).

We are still swept up in the wave of this crisis. In this environment, we are adapting both our asset allocation and our management methods within each asset class. While the market potential does not look particularly attractive, in our view, we are convinced that the crisis now offers good opportunities within the asset classes, if they are seized.

2. Ability of a company to raise its prices, without it affecting the demand for its products or services.

Written on 27/04/2020. This document is for information only.

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