EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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"The reflationary trade is still going"

The reflationary trade, which kicked off in the spring of 2016 before being boosted by Donald Trump's election victory, is still going but has lost some vigour since December. Markets listened to the candidate's promises and are now focused on how the new President's policies will effectively be rolled out. In the meantime, global growth is still picking up speed and analysts are raising earnings estimates on the world's biggest stock markets. In other words, fundamentals are gradually adjusting to investor expectations. This is excellent news and allows us to maintain our equity market overweight focused on the eurozone and on US value and healthcare stocks.

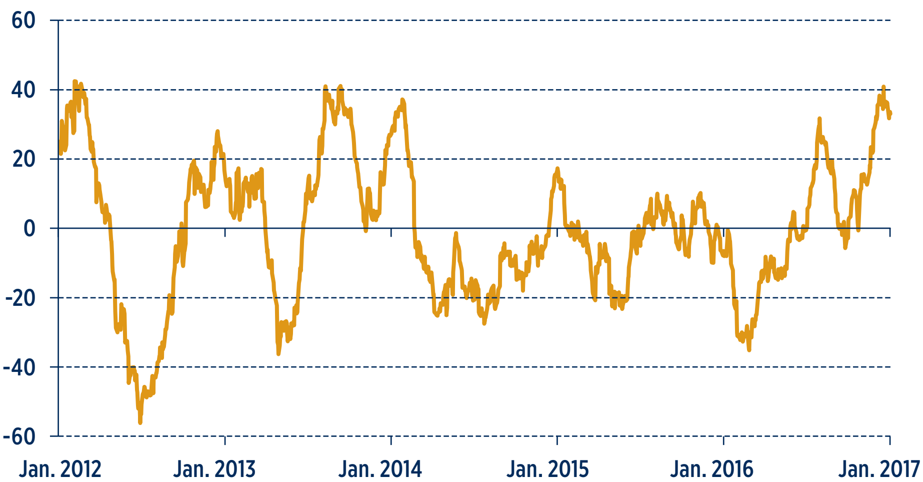
MONETARY TIGHTENING WILL BE FASTER THAN EXPECTED

From the economic standpoint, Donald Trump's first statements and executive orders suggest that deregulation will match his campaign's ambitions. So far, however, fiscal issues have not been discussed much. In fact, we need some clarification on whether such as far-reaching measure as the Republicans' border adjustment tax will be approved, a measure which aims to tax imports and abolish export levies. Overall, the White House's new communication style may sometimes be baffling but there are no real grounds for querying the financial market optimism seen in recent weeks.

KEY POINTS

- Equity overweight maintained
- Underweight bonds
- US dollar exposure upped

CITI ECONOMIC SURPRISE INDEX - MAJOR ECONOMIES



Source: Bloomberg

We should, however, take the protectionist implications of this new policy seriously, and especially suggestions from Donald Trump and his trade spokesman, Peter Navarro, that China, Japan and even Germany have been manipulating currencies. It is, of course, difficult to quantify the reach and timing of any protectionist measures. We can expect markets to be worried by this policy bias and they could end up reshuffling the regional performance cards. If protectionism is indeed on the agenda, we think Washington will first tackle the border adjustment tax, a programme that would be very positive for further US dollar appreciation. That, and the possibility that the Fed could tighten faster than markets expect, has led us to slightly increase US dollar exposure in our portfolios.

ARE WE MOVING TOWARDS THE END OF QUANTITATIVE EASING?

On bond markets, we have reduced ratings on investment grade and European government debt even if we do not expect interest rates to increase significantly. We are convinced the ECB will remain accommodating for some time to come but, in today's reflationary environment, markets could start to speculate on QE disappearing in 2018. European fixed income markets are expensive and so offer little yield to offset an increase in volatility risk. If the ECB were to end up winding down its quantitative easing programme, bond markets would fall and it is likely equity markets would also be dragged down. And any aggravation of European political risk would also have a negative impact on European bonds.

Generally speaking, we are in an environment where any fresh tension on bond markets could feed through to equities. This means asset allocation bond envelopes do not offer as much protection and diversification value. We have, as a result, reduced bond exposure in portfolios but continue to see opportunities in financials bonds, high yield and European investment grade debt.

NEXT HEADLINE EVENTS

- ***Next ECB meeting on March 9***
- ***Next Fed meeting on March 14-15***
- ***Next BoJ meeting on March 15-16***

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