

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

September 2017



“Today’s synchronised global recovery still gives pride of place to equities”

Markets were a little more nervous in August and equities and long bond yields both edged lower. Volatility was concentrated on currency markets amid mounting tension over North Korea and worsening impressions of the Trump administration’s performance. The US dollar’s fall in August was remarkable considering that it was unwarranted by interest rate trends both in the US and Europe and also because higher geopolitical risk is generally good for the dollar. These currency shifts hit European and Japanese equities but helped emerging country equities outperform US equities.

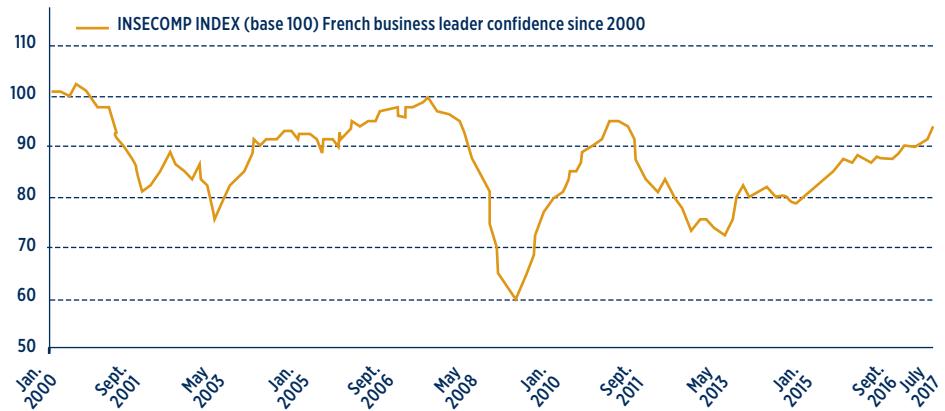
Benjamin Melman
HEAD OF ASSET ALLOCATION
AND SOVEREIGN DEBT

► US DOLLAR WEAKNESS IS A THREAT FOR EARNINGS MOMENTUM

Equity market valuations are more or less stretched, especially in the US, but the current period resembles 2004-2006 when equity market advances fed on strong earnings growth. This is why we favour zones with the best earnings momentum – the eurozone and to a lesser extent, Japan – and why we are underweight US equities. The accelerating European recovery and indications that Japan’s economy is truly on an uptrend both augur well.

However, the US dollar’s fall is undermining European and Japanese earnings momentum. The euro’s effective exchange rate has so far this year risen 7%, a move that could, according to estimates, shave 4% off earnings growth in coming months. German and French employer associations are already warning against the euro’s strength.

NEW GROWTH DRIVERS IN THE EUROZONE



Source: Edmond de Rothschild Asset Management (France), Bloomberg.

KEY POINTS

- Overweight risk assets
- Prefer eurozone and Japanese equities
- Focus on financial debt

We, however, think that US dollar weakness has been overdone and that a rebound could be on the cards. Markets have barely factored in one US rate hike by the end of 2018 so the risk is that the Fed might prove a little more restrictive. We can also not rule out US tax reform. Disillusioned investors currently think the US administration is bogged down but tackling tax would make them change their minds.

► LOW REWARDS FOR HOLDING CREDIT MARKET RISK

We have not changed our view that bond market valuations are stretched and yields modest. We remain rather defensive on:

- **duration.** Amid today's synchronised recovery, long bond yields have overreacted to softening inflation in recent months but we think lower inflation will be only temporary. At the same time, major central banks are proceeding with great caution but they are nevertheless moving towards tightening, with the ECB slowing its asset purchasing and the Fed shrinking its bond holdings.

- **corporate debt.** Fundamentals are good but yields offer insufficient rewards for the risk involved. We continue to prefer financial bonds which boast satisfying yields and with reduced risk.

Good fundamentals have led us to overweight risk assets like equities and, to a lesser extent, corporate debt, but current valuations suggest investors should be less exposed to risk than in recent months. And it also makes sense to take advantage of cheap volatility to take out hedges.

NEXT HEADLINE EVENTS

- *September 19/20: next Fed meeting*
- *September 20/21: next BoJ meeting*
- *September 24: German federal elections*

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