EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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STILL REASONS FOR HOPE

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The further along we go in this cycle, the more we see the equity markets reach ever-higher peaks and the more risk factors emerge. We are convinced that it is still too early to reduce our risk exposures in the portfolios, especially as some potential positive surprises still lie ahead.

A number of factors argue in favour of markets maintaining a positive trend over the coming weeks. On the one hand, monetary policies remain very loose and there is ample liquidity. Furthermore, second-quarter company earnings in the US and Europe were excellent, providing extra support to equity markets. Overall, companies have managed the rise in production costs very well and prospects are solid for many of them. There is a sharp rise in M&A transactions. Lastly, several potentially promising drugs (excluding vaccines) to treat Covid-19 are currently in phase 3. A new approach to treating the virus would of course be very favourable for the outlook. We therefore cannot rule out announcements between now and the end of the year allowing progress to be made in the treatment of Covid-19 and therefore reducing its impact. At the same time, the recent consensus among the Democrats in the House of Representatives over the two major stimulus plans (infrastructure, social measures) is a step forward, underpinning the possibility of a political majority emerging, probably in the fourth quarter, in favour of lasting and ambitious stimulus measures in the United States.

KEY FIGURE

+188%

Year-on-year EPS growth of the Stoxx 600 in Q2 2021.

Source: Bank of America Corp.

THE TWO MAIN RISK FACTORS

FURTHER DECOUPLING OF CHINA FROM THE REST OF THE WORLD

The persisting Chinese slowdown and especially the raft of measures aimed at increasing regulatory repression in numerous sectors (education, internet, healthcare, real estate, gaming, spirits probably soon) are in contrast with the rest of the world and have had a much greater impact on Chinese offshore stocks than onshore stocks. As for global markets, they began to feel more concerned when the fight against inequality was reiterated as a priority target, with certain sectors such as luxury goods having practically undergone a correction. However, the impact of these trends in China on the global economy and markets remains moderate at this stage.

Taken individually, many of these new measures are based on best antitrust or GDPR practices, while others such as education are more political and arbitrary. But the inevitable pace of these reforms, the way in which they were announced, and the administration's ability to arbitrarily fracture the business models of large corporations without prior warning - most often entities owned by non-residents - are a source of concern.

Why to this extent, why in some cases so abruptly, and why now? At a time when the content of "XI-ism" is raising many questions, all of the latest news is not unequivocal. The Chinese regulator is set to soon offer its US counterparts a solution for Chinese companies listed in the United States (ADRs) to have audit measures that comply with the constraints of both countries. This is a very politically sensitive issue, and suggests that the Chinese government wants companies to continue trading internationally in a more stable environment, which, if confirmed, is a reassuring factor.

We believe that a political risk premium has now been priced into the Chinese market. We stopped overweighting this market a month ago, given the loss of visibility. Offshore Chinese equities now offer a real discount, with potential that could be unlocked if the new Chinese strategy were to offer more visibility and stability. With respect to the slowdown in China, statements by the Beijing central bank regarding concerns about slowing credit and signalling its will to stabilise or stimulate it point in the right direction. China nevertheless remains a risk to be monitored, not only for local equities but also for global markets in general. For the latter, between the strength of the recovery in developed countries and the authorities having clearly acknowledged that the slowdown has gone too far, this risk seems to be under control at this stage.

THE TAPERING

The announcement by the Fed's Chairman at Jackson Hole of its plan to start its tapering before the end of the year was taken into stride by investors, who had been largely prepared for this news. The central bank's decision to disconnect tapering and the monetary tightening cycle appears to have been welcomed. Although the timing is now more specific, many of the terms of the tapering remain to be determined. However, the risk of a "taper tantrum" like in 2013 can pretty much be ruled out. The only historical precedent tells us that once the effect of the announcement was over, the negative impact of the tapering was observed during its implementation (particularly via credit spreads). In other words, we believe that the tapering will be a negative factor for the markets, but only next year.

In our asset allocation, in addition to the neutralisation of our position on Chinese equities, we increased the weight of US government bonds. Now that the tapering plan has been unveiled, we believe risks are much more symmetrical for the asset class.

	Our convictions*	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 24/08/2021.

KEY POINTS

It is still too early to reduce risk exposure

Neutralisation of the position on Chinese equities

Increase in the weight of US government bonds

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