EDMOND DE ROTHSCHILD

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

July 2016

Benjamin Melman
HEAD OF ASSET ALLOCATION
AND SOVEREIGN DEBT

KEY POINTS

- Still overweight European equities
- European credit markets currently offer the best risk/return profile

" Europe has the resources it needs to recover from this crisis "

The victory of the Brexit camp in the referendum - which came with a high participation rate and a relatively low majority (52% vs. 48%), but nevertheless stronger than recent polls had led us to believe – is sending shock waves across financial markets. Investors had settled on a "Remain" scenario. Furthermore, this political shock is a first in European history, particularly as it concerns a major country, and has sparked a flurry of uncertainties. The consequences, mostly unknown, could take the European political and economic agenda in all sorts of directions.

RISK PREMIUMS ARE UP - BUT NO SYSTEMIC OR MAJOR LIQUIDITY RISK

Unlike the Grexit issue which had caused turmoil on the markets between 2011 and 2015, the British decision does not cause systemic risk because the country was not a member of the monetary union. At the same time, there have not been any marked liquidity disruptions as central banks stand ready to intervene if necessary. As a result, our challenge is to integrate higher risk premiums and adjust our market outlook to this new economic and political situation.

UNCHARTERED WATERS

The ultimate decision is down to the British Parliament

The June 23 referendum was a public consultation and is not legally binding. Only the British Parliament is able to call upon article 50 of the European Union Treaty. The Parliament then has two years to organise the irreversible procedure for leaving the European Union, although this timeframe may be adjusted if both parties mutually agree. It seems unlikely that events will unfold differently. However, in a context of extreme political tension, no scenario should be excluded outright. The British people wanted their Parliament to regain its full sovereignty – so it is ultimately down to the Parliament and to the Parliament alone, to make the decision.

The economic impact of Brexit

A number of simulations have tried to assess Brexit's medium term impact. Almost all conclude by saying UK growth could be reduced by around 2% compared to pre-Brexit

estimations while the negative impact on growth in the eurozone would be around 0.5%. The medium term consequences will depend on what framework is agreed for future relations between the EU and the UK.

However, there is clearly negative momentum over the short term. The UK will remain in the EU for two years and will be able to export to the eurozone with sterling trading at a highly competitive level. On the other hand, so much uncertainty will almost certainly cause a sharp drop in investment in the UK. As a result, Europe's exporters will struggle to sell to a major trading partner with depressed domestic demand and such a weak currency. Some eurozone companies will therefore take a hit to profitability both over competiveness and sales.

The political impact of Brexit

It is very likely that the referendum result will galvanise the anti-EU forces that are already at work in Europe. The risk is that markets anticipate further European disintegration, possibly extending to the European Monetary Union.
We have naturally taken this risk into account in our analysis.

However we have also included other factors:

- It is not so easy for a country to leave the European Union when it is also a member of the Euro, as the economic and financial consequences would be that much more material and systemic. The Greek experience confirms this observation.
- The United Kingdom had always slowed down the European integration process. And yet – at the very least for Eurozone countries – further integration seems inevitable. The Brexit has removed a major hurdle. Nevertheless it remains to be seen whether there is enough political support for further integration in core European countries. Initiatives should be announced in the near-term to give Europe a new impetus. In the coming weeks, we shall be in a position to assess the direction taken by the Old Continent in the wake of this political tsunami.

While Europe may never have been as politically fragile as it is today, we believe excess pessimism is uncalled for. Europe has the resources it needs to recover from this crisis.

3 POST-BREXIT SCENARIOS

- **20% probability: No Brexit!** Political confusion is rife in the UK. Nigel Farage recognised that one of the Brexit campaign's flagship slogans, the promise to channel the UK's contribution to the EU straight into the National Health Service, was a mistake, raising the possibility that public opinion might prove less hostile to Europe when David Cameron's successor is appointed in the autumn. This could weaken the resolve to trigger article 50. Germany's unwillingness to press for a rapid UK departure, a stark contrast to the stance taken by its biggest neighbours, is perhaps an indication that Berlin is thinking along these lines. **No Brexit would trigger a rebound in risk assets**. But we will have to wait for a few weeks before such a scenario is rolled out.

- **35% probability: a strong response from Europe**. To counter the political shock, Europe might soon suggest extending the political scope of European institutions to areas like security and defence where demand is strong for action. That could be accompanied by more expansionist monetary and fiscal policies to stop growth faltering in the aftermath of Brexit. **Any possible shift in ECB policy** would be a good thing as it would provide **strong support to markets**.

- **45% probability: procrastination**. Europe only manages to find a merely symbolic response to the crisis. Governments go for a wait-and-see attitude as Europe has little leeway over economic policy. This would **keep risk premiums high** and they might rise even further ahead of delicate elections in certain countries.

NO SIGNIFICANT BREXIT IMPACT ON OUR INVESTMENT POLICY

Since the beginning of 2015, Europe has been our main regional conviction – both for equity and fixed income investments. During the past two months, we had reduced risk by lowering our overweight position on European equities and periphery country bonds, while increasing the weight of the dollar in our portfolios in order to factor in the Brexit risk.

Only time will help assess the new direction Europe decides to take. Nothing has yet been decided. From the economic standpoint, the expected acceleration of global economic growth in the second half is now more than jeopardised but we believe any slide back into recession can be ruled out, with the notable exception of the UK. Central banks will be more accommodating and the Fed is not expected to resume its monetary tightening cycle before the fourth quarter at the earliest.

Against this backdrop, we are sticking with our asset allocation choices and remaining overweight eurozone equities, high yield bonds and the US dollar. Eurozone equities are still volatile and underperforming but we believe that **fundamentals will move back centre stage** and help them rebound over the medium term. We are not reinforcing positions as poor visibility could still destroy value over the short term.

Elsewhere, we think European credit markets currently offer the best risk/return profile. If a European recession is avoided -our favoured scenario- corporate bonds will prove less sensitive to economic ups and downs and to changing risk premiums. And although the ECB's asset buying programme does not cover high yield bonds, it is unquestionably preserving all non-financial bonds from high volatility.

Faced with this more challenging environment, we remain on stand-by to adapt our investment policy as soon as we have more information on the various issues discussed above.

Written on July 1st, 2016. This document is for information only.

Disclaimer: The data, comments and analysis in this document reflect the opinion of Edmond de Rothschild Asset Management (France) and its affiliates with respect to the markets, their trends, regulation and tax issues, on the basis of its own expertise, economic analysis and information currently known to it. However, they shall not under any circumstances be construed as comprising any sort of undertaking or guarantee whatsoever on the part of Edmond de Rothschild Asset Management (France). Any investment involves specific risks. Main investment risks: risk of capital loss, equity risk, credit risk and fixed income risk. Any investment involves specific risks. All potential investors must take prior measures and specialist advice in order to analyse the risks and establish his or her own opinion independent of Edmond de Rothschild Asset Management (France) in order to determine the relevance of such an investment to his or her own financial situation.
Special warning for Belgium: Please note that this communication is intended for institutional or professional investors only, as mentioned in the Belgian Law of July 20th, 2004 on certain forms of collective management of investment portfolios This notice is also intended only for investors who are not consumers as described in the Belgian Law of July 14th, 1991 on trade practices and information and protection of consumers.

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)
47, rue du Faubourg Saint-Honoré – 75401 Paris Cedex 08
Société anonyme governed by an executive board and a supervisory board with capital of €11,033,769
AMF registration No. GP 04000015 – 332.652.536 R.C.S Paris
fr.edram.com