ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

October 2015

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“ The correction has been overdone, opportunities are now emerging ”

MARKET ANALYSIS

Equity markets lost further ground in September on concerns over slowing global growth (prompted by emerging country weakness), uncertainty after the Fed left its rates unchanged and the Volkswagen scandal.

As the impact of emerging countries on the global economy has risen significantly, there is no doubting that the slowdown across almost all the zone has heightened the risk of contagion in developed countries. Decoupling in today’s globalised environment can never last for long. And while it is true that falling commodity prices will offset the negative impact of the emerging zone’s slowdown in developed countries, there are still risks. Even so, there has not yet been tangible evidence of this in the latest developed country data in spite of market turbulence over the summer.

For example, there is still no sign of any slowdown in the US and Europe where September’s PMI industrial surveys hit 53 and 52 respectively despite being highly sensitive to international trade. The picture is even more favourable in services. This situation is all the more remarkable in a country like Germany which is a big exporter of capital goods to the emerging zone. Significant contagion will probably have to wait for a bigger emerging country accident.

Investors remain focused on China where September’s manufacturing PMI worsened to 47. The impact of the government’s latest measures should be seen towards the end of 2015 and Beijing is likely to take further action if its growth targets are missed. Investors have logically applied a risk premium to developed country markets but they have gone too far as emerging zone contagion has yet to surface. This risk premium, however, will probably remain in place as long as the emerging zone’s environment remains so hard to read. Economic stabilisation in China would certainly trigger a sharp rebound in risk assets. Market risk now strikes us as asymmetrical.

Elsewhere, the Federal Reserve triggered a fall in risk assets after postponing its decision to kick off monetary tightening. In our view, the Fed has won points for pragmatism but reduced visibility on its intentions. On the one hand, the Fed is very likely keen to introduce staggered monetary tightening so as to remain predictable. With today’s excessive uncertainty, it was in fact logical for the Fed to wait before acting on rates as there was no particular pressure to move. But on the other hand, the way it is likely to react has now become more complex.

At her press conference, Janet Yellen used the participation rate to put the strong labour market into perspective and she also seemed less confident that inflation could rise to 2%.

KEY POINTS

- Preference for European equities and, to a lesser extent, Japanese equities.
- Still underweight emerging country equities
- Reduced US dollar ratings

This came as a surprise after the speech by Stanley Fischer, the Fed's N° 2, at Jackson Hole in late July in which he appeared clearer about both subjects. This suggests that the Fed's views on these key variables have shifted in recent weeks even though the data have remained stable. As a result, the Fed is now less predictable: more sensitive to financial conditions (and therefore market pressure) and also to emerging country momentum, a much greyer area. This has removed the markers on which investors are so keen but it does, in our view, provide reassurance that the Fed is intent on keeping the recovery intact.

OUR CONVICTIONS

ON EQUITY MARKETS:

We remain overweight equities vs. bonds and are still focused on Europe and, to a lesser extent, Japan.

ON BOND MARKETS:

We continue to prefer fixed income in Europe -essentially in peripheral countries- high yield bonds and subordinated financial debt and remain underweight US Treasuries. Stabilisation in Greece and the ECB's clear message that it can do more to stimulate economic growth will provide decisive support for European asset prices.

US DOLLAR:

We have slightly cut our US dollar ratings after reinforcing them during the Greek crisis- this uncertainty now seems to have waned, a situation that could last for some time. And the lack of visibility over the Fed's future action does not augur for a stronger dollar against the euro.

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