EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

ANALYSIS

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HAS EUROPE FULFILLED ALL ITS PROMISE?

Visibility in Europe today is better than in most other geographical zones. First, the European Central Bank's (ECB) unprecedented, proactive stance is telling investors that it is strongly committed to getting growth back on track. And at a time when interest rates are set to stay low for a considerable period, companies are gaining from the euro's depreciation against the dollar and the collapse in commodity prices. All these supportive factors suggest 'Old Europe' still has further promise in store.

ASSET ALLOCATION

Europe is still in a recovery cycle based on solid fundamentals in spite of the economic slowdown in emerging countries. Economic surveys, especially in Germany, point to strong resilience in recent months despite turbulence in certain zones. As a result, European growth could remain on track and reach 1.5-2 percent in the coming quarters. After making huge restructuring efforts during the crisis, companies now have cleaned-up balance sheets. And they are operating in a favourable environment thanks to much lower commodity prices, the euro's depreciation against the US dollar, sustained pressure on wage costs and cheaper bond issuance costs due to historically low interest rates.

Increasingly divergent US and European monetary policy is also boosting investment convictions in favour of Europe. The US Federal Reserve (Fed) is moving towards policy normalisation and a rate rise in the near future while the ECB is determined to expand its asset purchase programme. Against this macroeconomic backdrop, the eurozone company theme is now looking particularly attractive. In asset allocation, we prefer equities to fixed income as they have a more favourable risk/return profile. On bond markets, the high yield segment offers some interesting opportunities.

EUROPEAN EQUITIES

European equity markets are riding on a favourable economic climate with healthy companies which offer attractive upside on margins. In addition, valuations are reasonable. The M&A theme is one of the main catalysts on the market. The cycle kicked off in the first half of 2014 and should continue for several months as cycles traditionally last from 3 to 4 years. Modest growth, low interest rates and persistently rock-bottom inflation are encouraging companies to go for external growth so as to maintain pricing, underpin margins and forge new synergies. Deals are increasing in size as the cycle progresses and are mostly equity financed. Price tags are rising but not excessively so.

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The low euro is whetting the appetite of US companies for European targets. In the US, large groups are now struggling to maintain profit growth. The fact that some acquisition projects are earnings enhancing could win over potential bidders. As far as sectors are concerned, non-cyclical consumption (luxury or spirits, for example), telecoms and media offer attractive prospects. We would, however, be cautious over the healthcare sector as high valuations could put the damper on new deals. Elsewhere, the oil sector is vulnerable to default risk.

CORPORATE DEBT

Today's modest growth and very low inflation favour corporate debt which offers protection against high equity market volatility as seen in the VIX risk aversion index. Asset purchases through the Quantitative Easing (QE) programme are also providing support. The ECB could soon go for another rate cut, sending yields into negative territory, while increasing the size of QE. However, it should stop short of extending the operation to other segments like corporate investment grade bonds. Currently, only companies closely associated with governments like utilities are concerned. The ECB's credit market safety net is boosting confidence and will encourage investors to maintain their presence on the market for some considerable time.

In today's low interest rate environment, high yield bonds offer attractive yields of around 5 percent with defaults running at approximately 2 percent. The segment also enjoys limited volatility and is benefiting from improving corporate profitability in Europe. Getting the most out of the segment means being very rigorous over bond selection. For example, B-rated bonds have a certain appeal, especially compared to BB issues. As for the investment grade segment, the prospect of gradually rising rates in the US means it should suffer more than others.

Subordinated financial debt is now one of the bond market segments with the most attractive yields. The new prudential framework for bank and insurance companies, which will mean lower but less volatile profits, is encouraging them to reimburse current subordinated debt as it will not qualify as regulatory capital. These new rules have also led to issuance of new capital instruments like Contingent Convertibles (CoCos) by banks while Solvency II has prompted insurance groups to issue new Tier 1 and Tier 2 debt. These are complex investments but they offer satisfactory yields, especially as issuer quality is improving.

Convertible bonds represent a satisfactory portfolio diversification tool. After cleaning up balance sheets, European companies are healthy, a positive point for convertibles. The convertible universe is gradually being refreshed in 2015 with issuance in line with 2014. Total issuance should come to USD 85bn this year[1]. In addition, the upbeat outlook on equity markets is an obvious source of support for convertibles which offer a credible alternative within the bond market universe. At a time of low interest rates and high equity market volatility, convertibles stand out because of their convexity, i.e. their ability to capture a relatively large percentage of equity market rises while cushioning losses in down periods thanks to their bond floor. As a halfway house between equities and bonds, convertibles help revitalise bond allocations or reduce risk in equity exposure, notably by reining in volatility. Selectivity is still a key criterion, especially as regards valuations.

[1] Data based on Edmond de Rothschild Asset Management's market assumptions

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The group's asset management division had more than EUR 54bn under management at June 30 2015 and employed 530 people including 100 investment professionals.

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