EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

April 2016

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"Indices should now advance in line with earnings growth"

MARKET ANALYSIS

Just as the market plunge up to the middle of February was fuelled by a number of concerns, the subsequent rebound in risk assets was driven by a number of factors:

- Oil prices rallied on strong demand and crowded short positions.
- China's central bank finally improved its communication on exchange rate policy, ruling out any sharp renminbi devaluation and thus soothing some investors' concerns.
- As the ECB demonstrated, central banks still have significant room to manoeuvre. The ECB showed that it could devise vigorous measures while taking on board concerns that negative deposit rates might damage bank profitability. At the same time, its decision to extend asset purchases to private sector bonds had a very favourable impact on Europe's credit markets.
- The global economy is nowhere near boom conditions but fears of a recession were overdone.

In short, volatility was very high on markets in the first quarter but we see no real change to the economic environment. The cycle is still progressing in the US and in Europe while growth in emerging countries has stabilised at a rather soft pace. Equity market valuations have returned to normal levels and that means indices should now advance in line with earnings growth. In our view, the biggest earnings rebound could come in the eurozone where low company margins should normalise.

KEY POINTS

- Eurozone equity overweight maintained
- Back to a neutral weighting on Japanese equities
- High yield overweight trimmed

OUR CONVICTIONS

ON EQUITY MARKETS:

We have stuck with our eurozone equity overweight. But we need to factor in the risk of volatility in coming weeks: the UK will vote on whether or not to leave the European Union on June 23 and the opinion polls are indecisive.

However, we have abandoned our Japanese equity overweight. Since 2013, the Japanese market has been dependent on the biggest Abenomic pillar, monetary policy. But the ability of the Bank of Japan to keep the Yen low now looks questionable. With its recent emphasis on lower rates rather than quantitative easing, the bank, which already has a much bigger balance sheet than other central banks, gave the impression that it was less convinced by the effectiveness of balance sheet expansion. But given the very disappointed reaction of Japan's financial sector to negative rates, the central bank's leeway could be temporarily impaired. Faced with the anaemic economy, the government appears to be mulling a budgetary solution. Even so, the Prime Minister is still scheduling a rise in VAT in April 2017 even if it would have been much simpler to postpone the move. As the pace of earnings revisions is deteriorating and the economic backdrop now looks more uncertain, we now see no reason to overweight Japanese equities.

ON BOND MARKETS:

We have taken profits by reducing our European high yield bond overweight after reinforcing the segment amid the market turbulence at the end of January. The ECB's inclusion of private sector bonds in its QE programme accentuated the rebound in corporate bond prices, especially high yield debt. We are nevertheless still overweight as today's environment still favours high yield bonds. Zero, and even negative, yields on a major part of the bond universe have reinforced the hunt for returns. High yield bond fundamentals are still rather robust. We are also marginally increasing exposure to highly-rated investment grade bonds.
Elsewhere, we have accentuated our underweight in US Treasuries. For investors, Janet Yellen's very cautious address to the New York Economic Club suggested that the Fed was more or less retreating from its monetary tightening cycle due to current risks. We are still struck by the continuing gulf between Fed statements arguing for some degree of monetary tightening and the market's much milder expectations. With US inflation moving back to normal - core PCE has risen from 1.3% to 1.7% in only 6 months - and with job creations still running at a smart pace, we believe further rate hikes in the US are inevitable, even if they will be carefully engineered to take the fragile global economy into account.

ON MONEY MARKETS:

We have increased our exposure to the US dollar. Any risk to European Union integrity will not only weigh on sterling, which has already fallen sharply, but also on the euro which has tended to strengthen since the beginning of 2016.

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