

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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“Markets always end up returning to fundamentals”

► MARKET ANALYSIS

The extent of the market fallout since the beginning of 2016 may surprise given the total lack of catalysts and news that might explain this brutal surge in investor risk aversion. True, the global economic environment seems to have deteriorated but only marginally. The sharp about turn in market sentiment is rather a case of three risks -clearly identified in 2015- coming together.

- **Fears that China might export deflationary risk by significantly devaluing the renminbi.** Markets reacted strongly at the beginning of the year due to downward pressure on China's currency. And yet, China's central bank had spelt out its new exchange rate policy in December. So as to avoid being caught up in further US dollar appreciation, the bank had moved to stabilise the renminbi against a basket of currencies and no longer only against the dollar. This was in response to the renminbi appreciating by 25% over the last 5 years, partly because of being too closely pegged to the US dollar. Beijing has since managed to calm currency markets down with massive interventions and technical measures to prevent speculation on the offshore currency. In our view, it is unthinkable that after defining a new strategy in December, Beijing could have changed direction so quickly. As a result, the market reaction looks overdone. But it can be explained: China's economic transition is a complex process which makes the country vulnerable. Add in unreliable Chinese data and poor government communication and the field is wide open for conflicting assessments of the situation. However, recent measures to stabilise the economy and the government's reiteration of its exchange rate policy should encourage investors to temper their concerns over China.

- **Is the oil price collapse a harbinger of global recession or a financial crisis?** WTI has plunged by 70% in only 18 months. But there are several examples of similar movements in recent decades, during the 2008 crisis, the 1986 oil counter-shock and the emerging country crisis in 1998. In mid-2008, oil prices tanked one year after the subprime crisis erupted or with the same sort of lag as global GDP (prices later rebounded in tune with the recovery in GDP). But today, we are in the midst of a slowdown in global growth and not a phase of serious economic disruption. During the 1986 oil counter-shock, prices fell due to excess supply driven by stiff producer country competition and the global economy benefited. During the 1998 crisis, the oil price fell on slowing emerging country demand but helped developed countries weather the storm without any impact on growth. So we should be cautious about interpreting today's price movements.

KEY POINTS

- Overweight equities vs. bonds
- European high yield bonds now look even more interesting
- Back to neutral on the US dollar

In our view, the fall in oil prices is due to a supply glut (as in 1986) and the risk of lower emerging country demand (1998). Lower oil prices will have less of a positive impact on developed countries today because of rising US production. Negative impacts will be greater as producer countries now play a bigger role in the global economy. Note, however, that cuts to investment mean the negative effects of cheaper oil spread more quickly through economies than positive effects. US households, for example, have so far channelled additional purchasing power from lower energy costs into savings. Estimates show that in general, it takes 12 months for households to start spending. In all, the general impact of cheaper oil will probably be less favourable than previously but the good news is that we have so far seen more negative than positive consequences and the situation should reverse. We will nevertheless have to watch out for possible country and producer defaults as well as financial accidents. For the time being, it is clear that producers have been remarkably quick in cutting costs, so much so that most will be able to survive with oil trading at USD 30 a barrel. Even so, they will need to be in a position to secure future funding as financial conditions have become much tougher for producers. There will probably be some bankruptcies but we are not facing systemic risk.

- **The FED's incipient monetary tightening cycle is still encouraging emerging country outflows**, prompting much tougher financial conditions in countries which had rapidly amassed debt in recent years. But the Fed will not change its political stance unless the deterioration in the global economy or in financial conditions starts to jeopardise the US recovery. This has not yet happened.

In the end, today's tricky market environment results from these big three risks feeding to some extent off each other. Markets could remain volatile as long as these risks show no signs of disappearing from one day to the next. We, however, see the potential for a market rebound. A massive gap has developed between the actual economic situation and the very pessimistic view taken by investors. But markets always end

up returning to fundamentals. Meanwhile, although investors will understandably query valuations on other markets long as markets fail to find the right price for oil, a major financial variable, it is more and more likely that prices will stabilise this year after such a steep fall even if the situation is uncertain. And central banks are acting as watch dogs: the ECB has promised to consider further monetary easing in March while the Bank of Japan could soon follow the same route.

» OUR CONVICTIONS

ON EQUITY MARKETS:

We are still convinced that European, and especially eurozone, equities have upside potential. The cycle is still gaining traction and companies continue to benefit from the low euro, cheap commodity prices, the economic recovery and lower unit labour costs. Moreover, consensus expectations for EPS growth are not, for once, excessive. We still prefer domestic cyclicals and yield stocks but are also keen on the M&A theme.

ON BOND MARKETS:

This has led us to raise ratings on European high yield bonds which have mirrored the fall in the US high yield market where energy companies have a much higher index weighting. Default risk is now fully factored into US energy sector bonds and overall spreads on the market match historic levels seen in previous recessions. In other words, we believe that unless the US scenario turns out to be radically wrong, the high yield market there should no longer weigh on European high yield bonds. Europe's high yield market now offers very attractive yields, company fundamentals are rather robust, European interest rates extremely low and the ECB could ease even further.

ON CURRENCY MARKETS:

We have returned to neutral on the US dollar. A good deal of the dollar's rise against the euro was driven by the Fed and ECB adopting diverging monetary policy. But markets are increasingly struggling to understand why US rates should tighten further in today's deflationary environment. Investors might reasonably conclude that pressing on with rate rises would be an economic policy mistake and that sooner or later, the process would have to go into reverse, hitting US dollar credibility on the way. Such a situation would be bad for the US dollar. On the other hand, if the Fed were to prove cautious and stop tightening, there would be no reason for the dollar to rise.

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