EDMOND DE ROTHSCHILD

ASSET MANAGEMENT

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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KEY POINTS

- Overweight equities vs. bonds
- Preference for eurozone investments
- European high yield offers a number of advantages

" Worries over Europe's banks look overdone while the Brexit referendum is a source of volatility "

MARKET ANALYSIS

January's sharp fall in risk assets continued in the first half of February amid the same concerns over further oil price declines fuelling deflation and the risk of a renminbi devaluation. In a new development, the decline was largely down to fears that the financial system might become unstable again- this was reflected in much wider credit spreads for banks, especially in Europe, up to February 11. As a result, European and also Japanese equities underperformed US and emerging country markets. In contrast, top-rated government bonds, the Yen and gold were all once again the clear winners in this highly risk averse climate. Amid such high uncertainty, it is important to remember that we are still dealing with risks; the economic picture has admittedly deteriorated but there is nothing abnormal about the situation.

In response to market tensions, several institutions and organisations stepped in to assuage concerns. This went some way to putting them into perspective and helped stock markets regain some lost ground in the second half of the month.

- **The governor of China's central bank** made a rare attempt at communication by clearly ruling out any devaluation and standing up for a "strong renminbi". A number of investors are still convinced China cannot avoid devaluing but they will now be facing a firm political commitment from Beijing. As shorting the Yen on futures markets is expensive, the strategy has become more dangerous.
- For a few months, there was no question of **OPEC members** cooperating but several **big oil producers** like Saudi Arabia, Qatar, Russia and Venezuela ended up saying they would not increase output as long as other countries did not jump on the opportunity to up theirs. The details on this agreement are so vague that our outlook on future oil price trends has not changed. Nevertheless, it does suggest that there is a will not to let oil prices fall further.
- **The chairman of the ECB's board of governors** acknowledged investor concerns over bank profitability and suggested that action in favour of banks might be taken as early as March depending on his analysis of the situation.

In our view, the perception that European banks face higher systemic risk seems largely overdone. Since the beginning of 2016, banks have sharply underperformed in both Europe and the US on renewed fears over the sector. This contaminated bond markets, triggering a significant widening in senior and subordinated financial debt spreads.

We are not underestimating the challenges facing the sector but we do not believe that these severe declines point to an imminent systemic crisis:

- There is no sign of liquidity risk in indicators that normally herald such events like Libor-OIS and the Ted spread. After taking steps to reinforce liquidity since 2008, banks now have significant cushions. If there is one area in which banks really have proved how efficient they can be, it is their capacity to maintain liquidity in the bank sector.
- Nor is there any danger of systemic insolvency as ratios have been massively reinforced since 2008 to meet increasingly demanding regulatory requirements.

But putting systemic risk to one side, banks are still facing a number of challenges:

- they are operating in a complicated economic environment with negative short rates in the **eurozone** -as well as in Sweden, Denmark and Switzerland- and flattish yield curves. This is putting a strain on their ability to make money from maturity transformation. Pressure on net banking margins was in evidence throughout the fourth quarter earnings season and led to substantial downgrades to earnings estimates which in turn fuelled further drops in share prices.
- the sector has to contend with escalating **regulatory requirements** which are sometimes poorly coordinated, reducing profitability on the one hand and increasing compliance costs on the other. This unprecedented wave of regulation is still good news for bank debt as the relative position of creditors will be enhanced by bigger capital buffers. But even bank debt has seen additional risk premiums in recent weeks due to impressions that regulatory action has been uncoordinated.
- **Banks** are a funding tool for the real economy and as such are exposed to all sectors, in particular oil and commodities, two areas which are worrying investors. However, recent bank results have mostly provided much finer breakdowns on exposure to these sectors, including information on maturities, geographical exposure, ratings and actual sensitivity to any wide price moves. In fact, the details showed that exposure was much lower than initial estimations had led us to believe. But in any case, we consider that these exposures are manageable across a provisions cycle. In short, there is pressure on profitability but no solvency risk.

None of these factors in isolation is capable of jeopardising bank liquidity or solvency. But they do as a whole illustrate a loss of investor confidence in the ability of banks to generate sustainable returns in excess of their cost of capital when they are struggling with a deflationary environment and specific obstacles which partially undermine profitability. The banking sector depends on trust but in today's climate of suspicion it has returned to its high market beta status and become a sounding board for any market fears whatever the sector's robust fundamentals. The reaction of UK banks to a possible Brexit is symptomatic.

Some risks are waning but political uncertainty has risen in recent days. The decision of London's mayor, Boris Johnson, to campaign for Brexit ahead of the referendum has increased the odds of the UK leaving the European Union. A deeply divided Tory party could reduce the impact of David Cameron's call to vote in favour of his renegotiated membership. This eventuality could foster a wait-and-see attitude among companies over the first half of 2016 and cause the UK economy to slow down. Over the medium term, a vote in favour of Brexit would lead to exit talks which could drag out, prolonging uncertainty for some time. Nobody knows the exact consequences Brexit would have but they would clearly be negative for Europe as whole:

- **the UK economy** would lose its position as the preferred platform for multinationals looking to invest in Europe. A number of UK-based companies are already talking about relocating, at least partially, to the continent should Brexit occur. Reduced free trade between the UK and the continent would hit growth in both areas. And a UK exit could lead Scotland to call for another referendum on independence.
- For **the eurozon**e, the Brexit referendum has created a precedent that could encourage others to act, a copycat move that would jeopardise the euro's irreversible status among investors.

But even if Brexit now seems more likely, it is not at all a foregone conclusion. The campaign to stay in will now start and the feel-good factor in a country where unemployment is low could work against a no-vote. But the wait could mean markets remain nervous, at least for a few weeks. Nevertheless, the risk is now being discounted in prices judging from the sharp fall in sterling since November and underperformance from UK corporate bonds.

OUR CONVICTIONS

ON EQUITY MARKETS:

We are maintaining our preference for equities, essentially in the eurozone, rather than bonds. A good many risks are now largely discounted by markets and even excessively so in our view. For example, we believe the positive impact of lower oil prices has not yet fed through completely to company margins. Year-to-date market performance has reflected a combination of concerns; the market will rebound as some of these are put into perspective.

ON BOND MARKETS:

Europe's high yield market offers attractive yields at a time when company fundamentals are rather robust, European interest rates extremely low and the ECB could ease even further.

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