ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

October 2016

Benjamin Melman
HEAD OF ASSET ALLOCATION AND SOVEREIGN DEBT

« A favourable wind for risk assets »

Those who think we are nearing the end of ultra-accommodating monetary policy argue that it is inefficient and blighted with too many disadvantages like the risk of creating bubbles or jeopardising the financial industry. Or they consider that quantitative easing will inevitably disappear as central banks will soon have run out of bonds to buy.

We, on the contrary, are convinced that the ECB and Bank of Japan will find the means to press on with their policies for at least a few more quarters. Inflation is still too weak. In our view, both central banks are likely to clarify this point during the fourth quarter. Only the Fed is likely to increase its benchmark rates by 25bp in December. But we can no longer expect to see a rate hike cycle in the US but rather a drip feed approach with action being taken only if the environment is free of problems. In other words, monetary policies are likely to stay very accommodating for some time to come.

KEY POINTS

- Equity weightings increased
- Buying Japanese equities
- Emerging equity weightings reinforced

WE ARE STILL FACING UNCERTAINTIES BUT THE ECONOMIC ENVIRONMENT HAS BEEN IMPROVING A LITTLE

The economic environment has been improving a little and certainly much more than we expected. US surveys suggest activity is still robust while China's economy is continuing to revive due to government stimulus. Moreover, Europe has, so far at least, been spared the shock from Brexit. Germany's IFO survey of business sentiment, for example, has just hit a two-year high. And oil prices have been underpinned by OPEC's surprise agreement to trim production. All of which means we are unlikely to revisit the crisis that shook markets at the beginning of 2016.

True, there are still many uncertainties. Deutsche Bank's situation remains a concern for investors, not because there is a high risk of it going bankrupt - an unlikely development thanks to all the measures introduced since Lehman Brothers went under - but because the bank is a significantly systemic player. And political risk is still with us. In the US, the possibility that Donald Trump might become the next president is a mystery for most if only because his programme is incoherent and could well rekindle protectionism. And in Italy, the outcome of the December 4 constitutional referendum is also very hard to predict. A 'no' vote could cause both Italian and European political risk to rise again.

THE BANK OF JAPAN IS NO LONGER IN DEADLOCK AND IS ESTABLISHING A POSITIVE YIELD CURVE

We have decided this month to lift equity weightings slightly. In spite of the risks mentioned above, we believe the main engines driving risk assets have strengthened now that the Fed's interest rate policy looks like remaining benign.

> 2 %

The Bank of Japan's inflation target

We have been buying Japanese equities and hedging our currency exposure. The Bank of Japan's latest measures have helped it to emerge from the deadlock it had dug itself into by embracing negative interest rates. By targeting yields on 10-year government debt, the bank has helped restore a positive yield curve that will support the financial industry which had suffered from its previous monetary bias.
And by targeting inflation **above** 2%, and not just equal to 2%, the bank is seeking to make a big splash even if that involves risking its credibility.
If inflation fails to move towards this new target, the bank will adopt new measures and we cannot rule out recourse to helicopter money in a move to monetise part of government spending. Such a switch would be very good news for equities although damaging for the yen.

We are also increasing overall emerging country equity weightings. This recognises an upward trend in earnings and growth expectations, signs that the Chinese economy is improving and the fact that the Fed will be more and more cautious over the medium term. Moreover, emerging countries are growing faster than developed countries and valuations there are undemanding and even attractive compared to markets in the developed zone.

COMING UP

- ***Next ECB meeting on October 20***
- ***Next Fed meeting on November 1-2***
- ***Next BoJ meeting on October 31 and November 1st***
- ***Italy's referendum on December 4***

Written on October 3rd, 2016. This document is for information only.

EDMOND DE ROTHSCHILD
ASSET MANAGEMENT (FRANCE)
47, rue du Faubourg Saint-Honoré – 75401 Paris Cedex 08
Société anonyme governed by an executive board
and a supervisory board with capital of €11,033,769
AMF registration No. GP 04000015 – 332.652.536 R.C.S Paris
fr.edram.com