

ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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“Equities: focus on zones with the most significant earnings rebound potential”

Valuations are starting to look a little stretched but the pace of global growth is satisfactory: no signs of overheating but no pointers either suggesting the cycle is about to end so the recovery looks reasonably sustainable. But despite this marked economic and financial stability, it would be wrong to conclude that there are no fragile areas.

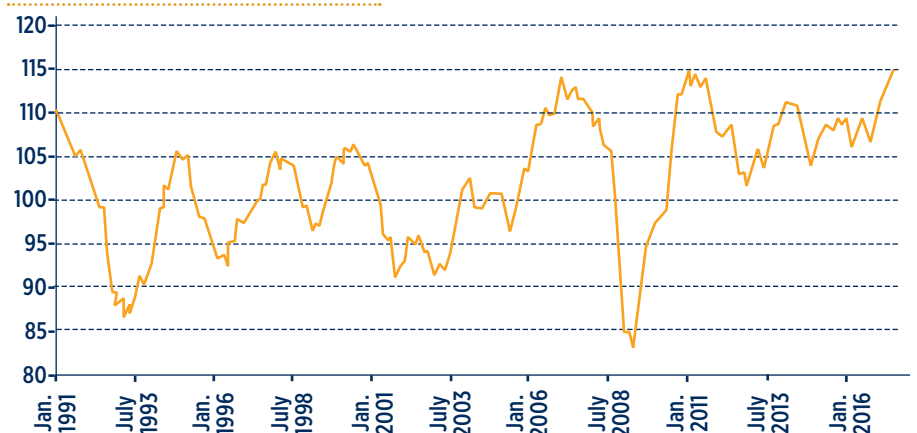
▶ A QUESTION MARK OVER REFLATION

Since the beginning of 2017, disappointing inflation data, the Trump administration's descent into stalemate and monetary tightening in China have led markets to query the reflation trade. This has pushed bond yields lower and created wide performance dispersion between sectors and investment styles on equity markets. In such an environment, earnings growth will play a much bigger role in equity market performance, just as in 2004-2007.

We are still slightly overweight equities but are now putting more emphasis on zones with better earnings growth potential. For example, we have reinforced eurozone equities, at the expenses of US equities, and for the following reasons:

- The recovery is gaining traction judging from the IFO index, Germany's industrial barometer, which is at a 26-year high.
- European company margins are still relatively depressed and so have some upside, unlike US companies. And margins have a pro-cyclical component. In other words, earnings potential is higher in Europe than in the US. And yet Europe is still trading at a slightly higher-than-average discount to the US.

IFO PAN GERMANY BUSINESS CLIMATE



Source: Edmond de Rothschild Asset Management (France), Bloomberg – 31/05/2017.

KEY POINTS

- ▶ Eurozone equity weightings reinforced
- ▶ Focus on subordinated financial debt
- ▶ Convertible bonds looking attractive

- Political risk in the eurozone has not been entirely lifted. We still have to get through Austria's parliamentary elections on October 15 while Italy might possibly go to the polls at the end of September. Opinion polls suggest Germany's elections pose no threat. But the chaotic start to Donald Trump's presidential term and persistently high uncertainty in the UK are a reminder that the eurozone is not the only area beset with political risk. In fact, we may well see political risk evaporating in the eurozone by the end of 2017, and even a reinforcement of the zone due to a number of initiatives, while the US and the UK could remain embroiled in political uncertainty.

- Even if the ECB's monetary policy is set to shift, Mario Draghi has reiterated the need to maintain a very accommodating monetary stance amid such weak inflationary pressure.

We also think Japanese equities have significant rebound potential, even more so than in Europe. Margins there could recover and boost earnings momentum. And equity valuations in Japan are still rather attractive. The recovery there seems to be strengthening but there are two reasons why we might hope to see some reflation in the economy:

- The government is mulling budgetary measures which could result in a more structural recovery.
- The labour market is so tight that wage pressures should finally reappear.

Elsewhere, we have taken tactical profits on emerging country equities after very strong year-to-date performance.

More generally, we think markets since January have moved from exaggerated optimism to excessive pessimism over reflation. But when the global economy is growing above its potential, simply maintaining highly accommodating monetary policy is in itself reflationary. This makes us think that markets should return to a more positive sentiment over what is actually a somewhat reflationary environment. Japanese equities are strongly leveraged on ongoing global reflation and on the reflationary trends which are taking shape in Japan itself.

We are still rather cautious on bond markets. They are generally expensive and we expect increased speculation in coming weeks on future monetary tightening from the ECB. We continue to prefer subordinated financial debt - attractive yields and risk under control- but bond picking must remain highly selective. We also think that convertibles are an inexpensive, low-risk way of getting equity exposure. Equity options benefit from very low implicit volatility in an environment that investors see as historically low on risk.

NEXT HEADLINE EVENTS

► *July 20: next ECB meeting*

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