ASSET ALLOCATION STRATEGY

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

July 2017

Benjamin Melman
HEAD OF ASSET ALLOCATION AND SOVEREIGN DEBT

"The monetary tone is turning more hawkish"

The global recovery continues apace. Recent trends suggest it has stopped accelerating and is now undergoing a temporary and very slight downturn. The recovery has become broad-based across the three main continents and nothing seems likely to seriously undermine the trend. Inflationary pressures have, however, abated in developed countries. In the eurozone, core inflation is still rather low and it is slowing in the US.

CENTRAL BANKS HAVE CHANGED THEIR TUNE

The biggest surprise in recent weeks has come from a shift in tone from almost all G7 central banks, notably the US, the eurozone, the UK and Canada. For markets, of course, the Fed and the ECB are the ones to watch. There are various reasons for this more hawkish tone in spite of inflation disappointing once again but the message in its various formats is practically the same. For the two leading central banks, the environment is generally reflationary so monetary policy must adjust to avoid becoming over-expansionist.

This central bank signal is potentially worrying for markets which were already worrying about dwindling reflation hopes. Generally speaking, aggressive central bank monetary policy has encouraged investors in recent years to take risks in the search for returns so any change is likely to create short term volatility. That said, the Fed has so far been very pragmatic, modulating tapering moves as well as monetary tightening in line with economic shifts. It is now hard to imagine that it will act differently if inflation continues to move off course.

Mario Draghi, speaking in Sintra, insisted that the ECB would be very careful to adjust its monetary stance to help the recovery. As a result, the ECB will probably start gradually slowing its bond-buying programme in 2018, a development that markets have already partly priced in. At this stage, we are unwilling to extrapolate this signal as we are not convinced it gives a meaningful indication of future Fed and ECB action. We have, however, reduced US Treasury exposure and have taken some profits on financial bonds.

EARNINGS MOMENTUM WILL BE DECISIVE

Despite the possible periods of volatility we refer to above, we believe that earnings momentum will be decisive in future equity market trends. We continue to overweight the eurozone and, to a lesser extent, Japan where the cyclical recovery is more established and likely to boost company margins. We are underweight US equities, where there seems almost no chance of margin improvement, and, more marginally, emerging country equities.

KEY POINTS

- Overweight eurozone equities
- Reduced exposure to US bonds
- Increased exposure to the US dollar

We have also slightly upped our US dollar exposure.
The dollar has fallen sharply against the euro since the beginning of 2017, notably due to reduced political risk in Europe but also because of increased expectations that the ECB will soon decide to start tapering. However, it has not benefited much from the Fed's persistent determination to tighten monetary policy over the next three quarters. This is because falling US inflation and slightly softer growth have overshadowed the Fed's message. Even allowing for this, the euro has probably risen too much. A dollar rebound would only require better news on the US economy and inflation.

	Our convictions for July*	Changes compared to the previous month
EQUITIES	=/+	→
US	-	→
Europe	+	→
Euro	+	→
United Kingdom	=	→
Japan	=/+	→
Emerging countries	=/-	→
FIXED INCOME	-	→
US	=/-	↓
Euro	-	→
Investment Grade	-	→
High Yield	=	→
Money market	=/+	→
DIVERSIFICATION		
Convertible bonds	=/+	→
Dollar	=/+	↑

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+).
Source: Edmond de Rothschild Asset Management (France). Ratings at 06/07/2017.

NEXT HEADLINE EVENTS

- ***July 19/20: next BoJ meeting***
- ***July 20: next ECB meeting***
- ***July 25/26: next Fed meeting***

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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
edram.fr