EDMOND DE ROTHSCHILD

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OUTLOOK &CONVICTIONS

EDMOND DE ROTHSCHILD, BOLD BUILDERS OF THE FUTURE.

ROUNDUP

MACRO OUTLOOK

- Higher customs tariffs and persistent US-China tensions will continue to weigh on trade and global growth...
- ...amid soft domestic demand in China and a slackening in US imports.
- But increased budgetary spending in Europe and monetary policy easing should limit the extent of the global slowdown we expect to see.

ASSET ALLOCATION

- Central banks have played a pivotal role in creating big market swings over the last 12 months.
- Markets have disconnected from fundamentals, a risky development.
- Given the current environment, we have left our asset allocation unchanged; it remains balanced but has become a little more cautious in recent months.

FIXED INCOME

- US Treasuries: we see opportunities in the intermediate part of the 5-year yield curve.
- We remain cautious on Europe but have overall maintained positive sensitivity.
- Subordinated debt and hard-currency emerging country bonds still offer attractive entry points.

EQUITIES

- Supportive near-term macro conditions remain in place.
- Key for us though is the medium term earnings outlook.
- Secular influences that have driven equities throughout the past four decades are waning and must be factored in by investors.

SRI MANAGEMENT

- Our integrated approach based on proprietary research is clearly a strong point.
- Bringing financial and extra-financial analyses together means reducing risk...
- ...and helps identify new investment ideas.

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SLOWING GLOBAL GROWTH

Higher customs tariffs and persistent US-China tensions will continue to weigh on trade and global growth...

...amid soft domestic demand in China and a slackening in US imports.

But increased budgetary spending in Europe and monetary policy easing should limit the extent of the global slowdown we expect to see.

THE NEGATIVE IMPACT FROM THE TRADE WAR SHOULD AMPLIFY

The trade war started by the US in March 2018 could have a more negative impact on trade and global growth than the one that is currently observed. First, the number of goods which have seen their tariffs rise keeps broadening and the amount of duty continues to increase. The result is likely to be a severe drop in the bilateral US-China trade. In May, Washington increased tariffs on $200bn of Chinese imports from 10% to 25%. China retaliated by raising tariffs on $60bn of US imports. Second, US growth rates should slow. Consequently, increasing demand from the world's biggest importer (17% of global imports -excluding trade between European Union countries- vs. 14.7% for the European Union and 12.9% for China according to the WTO) will no longer be able to offset the negative impact of higher import prices on global trade as was the case at the end of 2018 and the beginning of 2019. Third, Beijing has revised down its growth target to between 6% and 6.5% from 6.5% previously. We estimate that China's ongoing stimulus plan could help offset lower exports to the US but not enough to help growth accelerate to above 6.4% in 2019. Moreover, emerging countries which depend on commodity prices would be particularly hard hit by flat Chinese demand and slowing US imports. Emerging country growth could therefore be the big victim of this fresh wave of customs tariffs on Chinese imports and we calculate that it could slow from 4.8% last year to 4.1% in 2019. As a result, we continue to expect global trade to slow amid decelerating US growth and soft domestic economic activity in China.

CENTRAL BANKS REMAIN ACCOMMODATING

Faced with persistent US-China tensions, central banks will continue to control interest rates to keep them low. The Fed's rate hike cycle only began in 2015 and it has already put it on pause even if benchmark rates are still significantly below long term equilibrium rates. Furthermore, it has also announced that it was going to buy more US Treasuries, whatever their maturity, so as to continue guaranteeing low interest rates. This sort of action could help limit the US slowdown. The ECB, meanwhile, has stopped its bond buying programme but plans to follow the lead from the Bank of Japan and China's central bank by expanding its balance sheet. After contracting by 1.5% in the first half of this year, global liquidity levels should, according to our estimates, bounce by a significant 6% in the second half of 2019. Monetary assistance on this scale will reduce risk premia despite persistent US-China tensions.

A THRIVING US ECONOMY AND BUDGETARY EXPANSION IN EUROPE

The US grew by 3.2% in the first quarter of 2019 but should now see its pace slow as the positive impact from the 2018 tax reform starts to fade. And increased customs tariffs will continue to weigh on investment in those sectors hit by the trade war due to higher risk premia. Nevertheless, average private investment is expected to rise by 4.0% this year, a dynamic performance due to easier funding conditions (after the Fed turned more accommodating at the start of the year) and vigorous domestic demand. Public and private consumption levels could still accelerate. Lower inflation and the dynamic jobs market should drive household purchasing power as should the cut to income tax which will be effective in the third quarter of this year. In addition, higher productivity should provide a lift to growth.

In the eurozone, decelerating inflation and higher wages should also boost household spending. The increased budget spending in France, Italy, Germany and Spain should, according to our estimates, also add 0.4% to the average eurozone GDP. At the same time, falling US imports will hit European exports but at least any rise in tariffs on auto exports to the US has been put back to the autumn. And whoever the new chair of the ECB happens to be, he or she will be unable to seriously change monetary policy as the Eurosystem is facing fresh falls in lending in the south. Lending to companies fell 0.4% year-over-year in Italy in the first quarter and by 1.7% in Spain whereas it rose by an average 6.5% and 6.1% respectively in France and Germany. As a result, the Eurosystem should continue with its accommodating monetary policy while recommending macroprudential measures to avoid the sort of bubble have already been seen in France and Belgium.

For reasons inherent to the US and Europe, and in spite of the trade war aggravation in May, the growth differential between both should start to contract as 2019 progresses. This should help limit the global slowdown amid an improvement in global liquidity.

CONCLUSION: WILL 2019 SEE A PARADOXICAL RESYNCHRONISATION BETWEEN MAJOR ECONOMIES?

Xi Jinping and Donald Trump reverted to the status quo when they met on the sidelines of the G20 in Osaka, momentarily putting off any step up in the trade war. The prospect of a resumption in trade talks should also incite central banks to tread cautiously and increase liquidity so as to limit any risks to bond and currency markets. Nevertheless, higher import duties are already in place and they will cause US-China and global trade to shrink just when the US economy is slowing and China's growth has weakened. As a result, we continue to expect a moderate slowdown in global growth.

Further details and analysis on our macroeconomic scenario can be found in our 2019-2020 MACRO FORECASTS: A RESYNCHRONISATION OF ECONOMIES? (June 5 2019).

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UNPRECEDENTED POLICIES FOR A MATURE CYCLE

Central banks have played a pivotal role in creating big market swings over the last 12 months.

Markets have disconnected from fundamentals, a risky development.

Given the current environment, we have left our asset allocation unchanged; it remains balanced but has become a little more cautious in recent months.

The breadth of market swings in the last year has been a source of constant surprise. The fundamental picture has been slowing but these shifts are essentially a reflection of central bank activism. The Fed has led the trend, favoring monetary normalization in 2018 and then suddenly deciding this year to consider easing monetary and financial conditions through one or several rate cuts if the economy does not rapidly pick up. The Fed, and to a lesser extent the ECB, were chiefly responsible for the market plunge in the fourth quarter of 2018. And their about-turns are largely responsible for strong market performance since the start of 2019.

There is no doubt that a good deal of the slowdown that prompted the central bank policy switch was fueled by plunging company sentiment due to president Donald Trump's pre-election stress on protectionism. Companies are now confused and investment has fallen sharply almost everywhere in the world. It is not clear that the truce in the tariff escalation between the United States and China at the G20 summit marks an end to global uncertainty.

Looking at financial market flows, investors have also generally adopted a wait-and-see attitude, a sharp contrast with the euphoric mood on major stock markets. Given current economic and political uncertainty, and the surprising retreat in actual inflation, central banks can afford to be proactive while reassuring investors that waiting to see what happens will not end up provoking the sort of tightening that might create a vicious circle between markets and the economic cycle.

CENTRAL BANKS ARE ALREADY USING UP THE MUNITIONS THEY WANTED TO RECONSTITUTE AND SO THEY HAVE REDUCED THEIR ABILITY TO INFLUENCE MARKETS IN THE SAME PROPORTIONS.

WHAT'S DONE IS DONE

Central banks cannot do much to counter soft inflation and even less to settle trade disputes. Worse, any further S&P500 strength and/or an economic recovery might allow Donald Trump to accentuate a protectionist stance that he probably wants to extend up to the next presidential election. Yet, central bank desires for normalisation are essentially geared to rebuilding the munitions they will need to manage the next crisis. However, by allowing markets to expect a rate cut of up to 100bp over the next 12 months, they are already using up these munitions, forcing us to price in the fact that

their capacity to "control" markets has faded in the same proportions.

The fact that central banks have organized the disconnection between markets and fundamentals means there is a risk of a "return match". Let's assume, a textbook case, that Donald Trump ends up tweeting that he has decided to bury the trade war hatchet. Investors would then start to lose faith in the monetary easing expectations created by central banks. Bond markets would very likely go into shock and other asset classes would probably also be hit. It is difficult to say if markets would cheer the good news unless, of course, central banks undertook to continue with the sort of accommodating policy that markets are already factoring in. But in that case, they would clearly be creating a financial bubble. We have therefore to gauge their capacity to take such a risk. The question is not easy to handle leading to a tough task.

POLITICAL RISK IN THE UK AND ITALY HAS MADE US CAUTIOUS

It may be tricky estimating how sustainable this central bank-orchestrated rally might be but clearly investors are already pricing in a lot judging from the short end of the yield curve. At the same time, failing a fund flow change in coming weeks, investors are proving decidedly wait and see due to economic and political uncertainties. Fewer investors taking part in the rally means fewer chances that it can last. Consequently, this market surge has not encouraged us to change our asset allocation strategy; it remains balanced but has been a little more cautious in recent months.

POLITICAL RISKS CANNOT BE NEGLECTED

The other reasons in favour of more caution are still political. The risk of a hard Brexit has increased in recent weeks even if its impact on sterling has only been slight.

And there is now a greater chance of fresh elections in Italy, possibly giving power to a coalition of the Liga and Fratelli d'Italia, two extreme right parties. This is a crucial issue as Matteo Salvini and Liga MPs are noisily advocating the mini-Treasury bills or mini-BOT project, a scheme that would allow the Treasury to issue securities that could be used to pay taxes. In many ways, this would be tantamount to a parallel currency, an idea that even featured in the programme of the Liga-Forza Italia alliance. Note that Europe's main populist parties have stopped talking much about leaving the euro, probably because the idea terrifies electors. But the concept of a parallel currency looks like a covert way of achieving the same goals without running the same political risk. We will be keeping a close eye on future developments.

As a result, sovereign bond yields are excessively low while credit premiums have shrunk. This makes bond markets less attractive even if we still see opportunities in emerging country bonds and subordinated financial debt. We are therefore less exposed than usual to bond markets, pending more attractive opportunities. We are also still some way from maximum exposure to equity markets. The cycle is mature and the environment has turned choppy because of political risk. **We recognise that central banks are being proactive and that they have considerable influence on markets at the moment** but recent performance is not a reliable pointer to future returns and indices have already racked up serious gains in recent weeks. **In such an environment, it makes sense to remain invested but moderately so**. For a change, market opportunities and risk are currently very, and probably excessively, political (at the monetary, protectionist and populist levels). Nor is the fundamental picture particularly encouraging even if it is, at this stage, not very worrying either.

OPPORTUNITIES STILL EXIST EVEN IF THEY ARE RARER

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US Treasuries: we see opportunities in the intermediate part of the 5-year yield curve.

We remain cautious on Europe but have overall maintained positive sensitivity.

Subordinated debt and hard-currency emerging country bonds still offer attractive entry points.

Central banks took strong action by opening a new chapter in their accommodating policy book. The situation in the US is quite exceptional as unemployment is at record lows, funding conditions have rarely been as generous and equities are hitting new highs. Unlike the Fed's rate cuts in 1995 or 1998 which were preventive, this time uncertainty over economic policy is structural. There is also a more official reason: low inflation is creating inertia. Mario Draghi's recent shift at Sintra reflects this and echoes a famous Jackson Hole speech in 2014 when there was talk of a 5-year, 5-year forward inflation indicator which was the prelude to the introduction of unconventional tools. Even with a significant drop in bond yields and higher uncertainty, some bond segments still offer opportunities.

US BONDS

The risk premium from trade tensions has resulted in any prospect of higher Fed Funds evaporating but the almost inevitable end to the current economic cycle is still underpinning the US bond market. Nevertheless, given that the Fed wants to restore inflation symmetry with regard to its 2% target, and that federal debt is still rising, long-dated bonds could underperform.

As a result, while we are still close to neutral overall on US sensitivity, we see buying opportunities in duration allocation terms on 5-year Treasuries. We prefer to steer clear of the short end of the curve as the market has already priced in aggressive rate cuts, and also extra-long maturities as we think their term premium is too low.

EUROPEAN BONDS

The Sintra speech changed perception of deposit rate asymmetry even if it is in negative territory. By delaying its first rate hike, the ECB had led investors to believe that rates could go no lower (in any case ,they had not helped real interest rates to fall). But one of the most likely options now is a rate

cut in September. In which case, there might be a gesture in favour of banks involving the introduction of different deposit rates so as to lessen the financial cost for commercial banks with surplus reserves.

Boosting the TLTRO[1] programme should, in theory, be effective while increasing bond buying would require raising limits on sovereign debt holdings, sector limits on financials and rating limits on corporate debt.

With today's execution risks and rates, we remain cautious over investor expectations and have hedged bond exposure through shorts, essentially on 10-year German Bunds. We have nevertheless maintained positive sensitivity overall and at levels which are higher than they were at the beginning of 2019.

PERIPHERAL AND CORPORATE DEBT

Peripheral sovereign bond yields have tightened, leading us to turn more cautious, especially on Greece which is now trading above par although its high debt burden will require more adjustments. Given today's difficult talks between Italy and Europe over the country's worsening deficit and the likelihood of early elections dominated by anti-euro rhetoric, we remain neutral on Italian sensitivity. We are positioned for a flattening in the 10-30 year yield curve, an attractive bet given the above risks, especially as it is the only curve not to have flattened since Mario Draghi's intervention in Sintra.

We still have no exposure to US corporate debt, whatever the ratings, due to expensive currency hedging and increased indebtedness, but we have reduced hedging on Investment Grade[2] European credit and we remain upbeat on European High Yield[3] bonds as well as subordinated financial debt.

EMERGING MARKETS

We remain positive on hard-currency[4] emerging country bonds. There is no likelihood of a rate hike and valuations are still attractive.

1. Targeted longer-term refinancing operations
2. Bonds rated as high quality by rating agencies
3. Corporate bonds with a higher default risk than investment grade bonds but which pay out higher coupons.
4. Hard currency refers to money that is issued by a nation that is seen as politically and economically stable

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EQUITY BULLS IN CHARGE FOR NOW

US STOCKS LEADING THE WAY THROUGH OLD HIGHS

Supportive near-term macro conditions remain in place.

Key for us though is the medium term earnings outlook.

Secular influences that have driven equities throughout the past four decades are waning and must be factored in by investors.

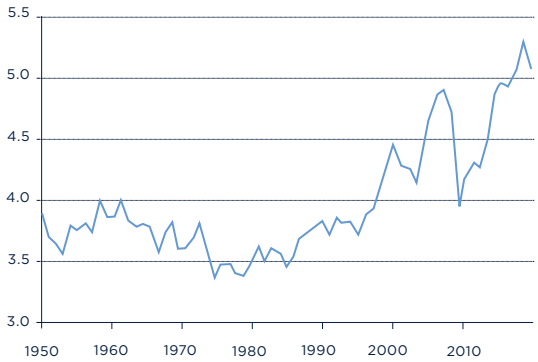
With trade, central bank commentary and political/ geopolitical tensions dominating the newswires, it's easy to conclude that corporate fundamentals are counting for little these days. Indeed, just looking at the sector leadership YTD (year to date) tells you more about where interest rates have gone rather than where corporate health and growth is heading.

This is often the case in the 'void' periods between quarterly corporate earnings releases, but it feels more so than usual and probably for good reason. Following the strong rates exhibited in 2017 and 2018, global earnings growth has become decidedly pedestrian, the most recent US Q1 releases delivering just around 3% across the S&P500. Expectations for the balance of the year are also light compared to recent quarters. In fact, US estimates for the next two quarters average around 1% and the tally for the whole of 2019 is not much above 2%. Nevertheless, 2020 is looking brighter with current estimates for the US and Europe and 10% and 9% respectively[1].

If the economic macro and micro factors aren't conducive to producing a higher growth rate for profits, then markets can only progress upwards if PE (price to earnings) multiples rise. And this is why there's so much focus on the Fed and ECB who decide interest rate policy. This in turn mathematically determines the discount rate for profits and dividends and thereby PE's. In this context, the more dovish rhetoric from both the Fed and the ECB as well as the actual decline in both inflation expectations and market interest rates have been welcomed by investors. Adding to the support has been an improving (though volatile) sentiment around a resolution to the trade war(s) as we have covered in previous sections.

But when is too much of a good thing a bad thing? The Japanese experience throughout the 1990s until now and Europe more recently show that ever declining interest rates past what the Fed has described as 'Lower Bounds' become next to useless in stimulating economic activity/inflation and, in the absence of profit growth do little for share prices either. Of course, investors should correctly distinguish between rate and yield reductions from today's near zero levels and those from much higher levels. Recall that by far the biggest driver of share price returns (and other asset prices) since 1981 (arguably

RATIO OF U.S. HOUSEHOLD AND NONPROFIT NET WORTH TO GDP



Sources: BEA, Federal Reserve, SED

the low point of the 1950-2017 cycle) has been the collapse in interest rates from 15% and 21% (government bond yields and Fed funds rate respectively) to today's paltry levels. That collapse not only propelled corporate earnings thanks to a slashing of the cost of capital, but it has also justified PE's rising from their paltry 1981 level of 7 to the mid to high teens levels seen today.

In the short to medium term, we think that investor's obsession with the Fed funds rate is decidedly unhealthy. The relationship between that interest rate and activity on 'Mainstreet' is much less relevant today than in the past as economic stability has increased thanks to a multitude of factors. These include a more service oriented economic base, dual incomes, the demise of the inventory cycle and a decline in the correlation of activities that make up the economy.

Instead of a fixation on short term interest rates, we think that investors should spend more time looking at the intersection of the still fairly benign short run situation (even if late cycle) and the longer term scenarios. The chart below shows the sixty year history of corporate profits as a % of GDP and confirms that we are close top record levels. At the same time as this ratio has risen, it has been mirrored by a 30 year decline in the share of National Income going to labour (as opposed to capital). In short, workers have lost out and today's social unrest, anti-elitist sentiment and rejection of most of the traditional political parties reflects this all too well.

The factors responsible for the huge earnings per share growth (notably much more dramatic in the US – which has explained the massive outperformance of the US stock market over this period) include the huge decline in interest rates (already discussed), an explosion of monopoly rents on the part of many new high tech firms, a record level of share repurchases, the ongoing reduction of bargaining power of labour in the private sector and the increasing 'returns to scale' that are being achieved by industrial concentration in many traditional industries (remembering that the bedrock of capitalist theory is the notion of decreasing returns to scale).

Some of the above factors are exhausted (decline in interest rates). Others have largely run their course, and we think investors should keep a close eye on how the various political incumbents deal with the growing inequality that has resulted from them. Timing is unclear but we think that we may be near an inflection point which means that what has worked well before, may not in the future. We may sound like a broken record, but the case for highly selective and very well researched active equity selection is upon us.

Thanks to the speed of innovation, the equity environment we envisage ahead will be one in which it should be much easier to spot the losers rather than the winners. Changes including the substantial reduction in the use of fossil fuels as energy source, the electrification of the transport system, the addiction to more and more data (and wireless transmission of it) and use of Apps for so many daily tasks are already transforming prospects for companies. Traditional business models are becoming obsolete at a terrifying pace and whilst some factions will complain about much of this change, it may be difficult to halt it.

The indexes will be full of companies that are enduring a secular decline in their business model - as well as those who will be taking their place. A well-diversified portfolio has always been central to our advice. Whilst this is still true at a total portfolio construction level, investors will need to have conviction in a few companies and industries that they know well - and to be patient.

1. Source: IBES/Bloomberg (June 2019)

WHAT IMPACTS FROM INTEGRATING ESG CRITERIA?

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Our integrated approach based on proprietary research is clearly a strong point.

Bringing financial and extra-financial analyses together means reducing risk...

...and helps identify new investment ideas.

Integrating ESG criteria in investment strategies means so much more than simply taking ratings and/or external data providers into account.

Marc Halperin and Jean-Philippe Desmartin talk about their shared experience.

This demanding and pragmatic approach translates into high selection rates rather than *a priori* exclusions.

This approach is made possible by a proprietary research which guarantees independence and responsiveness.

It is the corner stone for Edmond de Rothschild Asset Management's SRI investment strategy and means portfolio construction focuses on high-quality companies.

WHAT IS DIFFERENT ABOUT EDMOND DE ROTHSCHILD ASSET MANAGEMENT'S APPROACH TO SOCIALLY RESPONSIBLE INVESTING?

Marc Halperin : Our firm brings financial analysis and responsible investing teams together. Integrating extra-financial criteria rounds off our research, helping us to better identify investment risk factors. Historical observations show that reducing risk results in lower volatility. This integration is particularly important as it is based on an internal analytical model which not only offers depth but also more responsiveness. This independent approach is crucial, especially for new listings of small and midcap companies which are not much covered by extra-financial rating agencies even if they represent genuine opportunities to invest in high-growth companies.

Jean-Philippe Desmartin : This way of proceeding is the result of our company's heavy investment in proprietary expertise since 2010. As of today, only 20% of our industry peers do as much. And yet it is clearly a big plus for all our portfolio managers as well as our clients.

AN INDEPENDENT APPROACH IS CRUCIAL IN SRI MANAGEMENT

WHAT SORT OF CONTRIBUTIONS HAS ESG INTEGRATION MADE TO RUNNING A EUROPEAN EQUITY FUND?

Jean-Philippe Desmartin : In the past, investors first used ESG criteria to provide a holistic approach to risk. Governance risk naturally springs to mind but it goes further than that. The financial industry has shown in the last 10 years that it is vital to integrate business ethics as well. Elsewhere, the importance of environmental risk as a stock market concern has ballooned compared to the situation 20 years ago. Take, for example, the pollution track record of the energy sector or coal mines in electricity generation. Monitoring controversies also provides us with an advanced signal of this type of risk.

Marc Halperin : ESG integration within our investment strategy also helps with upstream identification of investment ideas which meet new corporate and consumer expectations. This embraces various themes such as energy efficiency, sustainable mobility, healthcare, security, new consumer trends and renewable energy. These approaches help us invest in models geared to sustainable development solutions found in large corporations which have managed to adapt their growth models to capture opportunities. But medium-sized companies, which create jobs in Europe and which are often close to the regions, are also concerned.

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