EDMOND DE ROTHSCHILD

PRESS RELEASE
6 JULY 2023

EVERY HALF-YEAR HAS ITS FAIR SHARE OF SURPRISES

- Liquidity will start to shrink following the move to raise the US debt ceiling
- Hopes will be raised by continuing disinflation over the coming months
- We prefer fixed income to equities

The first half was full of surprises for investors. Equity market returns were much better than expected. Most people expected a recession but it failed to have much impact and the US economy and its financial sector proved particularly resilient to a banking crisis which could have been much more serious. The artificial intelligence theme ballooned exponentially on markets, so much so that gains by the S&P 500 were due to a handful of stocks likely to benefit from this new craze. We were not expecting China's recovery to be strong and it has been chaotic so far. Chinese equities are still very volatile with zero or negative performance trends. On the other hand, the US and Europe have provided confirmation that disinflation has begun - just as we expected - thanks to production chain tensions almost evaporating and steep falls in energy and food prices.

DISINFLATION IS STILL SHAKY BUT GATHERING STRENGTH

We are at a halfway house stage. The trend is fragile as disinflation still relies on traditionally volatile commodity prices but falling inflation expectations among households and companies are providing a firmer footing. That said, we cannot take the trend for granted as long as wage momentum remains strong in today's persistently upbeat economic environment. Against this backdrop, the fact that the Fed and ECB are encouraging investors to expect further rate hikes is striking. Central bank credibility has taken a knock so banks are forced to hammer home policy in an attempt to regain respect. History also teaches us that premature easing during a period of raging disinflation can force central banks to go even further if they then have to tighten.

If Jerome Powell wants to go down in history for the same feats as Paul Volcker, we should bear in mind that Volcker only succeeded in beating inflation after several attempts. To be sure that inflation has really been brought under control, the Fed and the ECB have clearly stated that they first want the labour market to stop overheating. Wage increases of around 4% of 5% as seen in the US and Europe tally with inflation of around 3-4% and not the targeted 2%. The ongoing slowdown in inflation will probably soon weigh on wage increases but not as much as needed.

We see no indication of a switch to austerity from the lax budgetary stance which has dominated the post Covid/Ukraine war environment; inevitably, this only makes the mission of central banks more complicated. It is, however, interesting to see that greedflation has almost disappeared in the US and is slowing in Europe, so the chances of taming inflation have improved.

Paradoxically, the US banking crisis actually stimulated liquidity as commercial banks queued up at the Fed's emergency discount windows. But now that the debt ceiling has been raised, the US Treasury will have to replenish its coffers by asking for hundreds of billions of dollars from the Fed. This will act as a drain on commercial bank reserves and could trigger weakness in risk assets.

VALUATIONS ARE CURRENTLY AT A CROSSROADS

Take the case of a US investor having to choose from three benchmark asset classes, money market funds, investment grade bonds and the S&P 500. All three were offering the same yield in the middle of June, rather as if risk premiums had taken a back seat. Basically, the case for overweighting equities today -when there is still a risk of recession- has to be based on expectations that a growth shock is on the horizon. We could, for example, see the artificial intelligence revolution as a shock (even if the stocks directly concerned by AI are already very expensive). In this scenario, AI is a force capable of generating huge productivity gains across economic sectors.

Since Robert Solow's famous aphorism, "You can see the computer age everywhere but in the productivity statistics", new technology has generally failed to generate the hoped-for productivity gains. According to economist Robert Gordon, the internet revolution did in fact improve US productivity in the decade between 1995 and 2005 but only for that period. Elsewhere, the absence of any lift to productivity in the other developed countries has been puzzling to say the least.

It could of course be different for artificial intelligence but previous episodes warrant a minimum of caution. In addition, over the shorter term we will have to contend with unfavourable factors like central bank efforts to cool down the economy, a looming contraction in liquidity and the decline of greedflation. As a result, **our portfolios are only slightly underweight equities**.

As for bonds, the fact that central banks might tighten beyond current market expectation is not yet worrying for duration. The middle and long ends of the yield curve could in fact benefit from central bank determination to defeat inflation as a way of slashing interest rates later on. And hopes can only be raised by continuing disinflation over the coming months. This is why **we are overweight bonds and carry strategies on investment grade and good quality high yield bonds**.

The fact that (i) we have more confidence in disinflation playing out rather than a new era where artificial intelligence drives productivity and (ii) we prefer bonds to equities is simply based on the current environment. There is still a risk of recession and reduced liquidity from central banks overtightening and that could overshadow longer-term prospects based on game-changing developments.

WARNING

ABOUT THE EDMOND DE ROTHSCHILD GROUP

As a conviction-driven investment house founded upon the belief that wealth should be used to build the world of tomorrow, Edmond de Rothschild specialises in Private Banking and Asset Management and serves an international clientele of families, entrepreneurs and institutional investors. The group is also active in Corporate Finance, Private Equity, Real Estate and Fund Services.
With a resolutely family-run nature, Edmond de Rothschild has the independence necessary to propose bold strategies and long-term investments, rooted in the real economy.
Founded in 1953, the Group had nearly CHF 158 billion in assets under management at the end of December 2022, 2,500 employees, and 30 locations worldwide.

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