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PRIVATE BANKING

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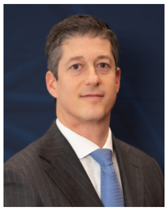
editorial



Nicolas Bickel, CFA
Group Head of Investment Private Banking

In many ways, 2024 was an exceptional year for the financial markets. Few asset classes posted negative returns. The S&P 500 set more than 59 valuation records this year, something that has happened only four times since 1928, and is on the verge of delivering a second consecutive year of above 20% performance after +24% in 2023. At the same time, safe-haven assets are also at their highest. This is the case for gold, which rose by 27% in 2024, benefiting in particular from demand from BRICS countries seeking to diversify their currency reserves and from the 146 rate cuts made by central banks around the world, the third-biggest move in history. As for oil, it is trading at levels close to those of a global recession, which is far from the economic reality.

As the year draws to a close, we are all asking ourselves the same questions: what will the financial markets look like in 2025? Are there still enough catalysts to repeat the 2024 performance?

There is room for doubt, as Europe is struggling to revitalise its economy. It is facing a series of political uncertainties that are holding investors back and weighing on consumer confidence. Emerging countries, led by China, are also waiting for a rebound in consumer spending and for investors to return to the financial markets. The latter are concerned about uncertainties linked to the possible impact of future trade wars under the new US administration. This explains why equity valuations are generally below their historical averages in both Europe and China. The US markets, meanwhile, are showing high valuations, even without taking into account the Magnificent 7, whose contribution to the performance of the flagship index has normalised over the past year. This situation is not unique to US equities. In fact, bonds of all types have also been affected, with risk premiums close to their all-time lows. Apart from the fact that absolute yields have remained relatively high following revisions to the outlook for rate cuts in the United States, this configuration does not at first sight suggest that bonds are tactically very attractive.

Some markets are certainly expensive, and they may well remain so for a long time to come. A number of factors currently underpin the high valuations of both US equities and bonds, such as the resilience of the economy against the backdrop of disinflation (although it has slowed since the start of the year) and expected productivity gains. The advent of artificial intelligence and the gradual shift in profits from producers to the companies that use these solutions are distilling their promises of efficiency gains and margin growth.

> In the United States, the election of Donald Trump and his promise to implement ultra-free-market policies have boosted investor hopes.

Businessman Elon Musk has likewise played an important role. As the year 2024 comes to an end, investors believe that the «MAGA dream» (Make America Great Again, Trump's campaign slogan) remains alive and well.

For many, Elon Musk is the epitome of American innovation and efficiency. He is the man who, in a decade, has brought major innovations to the space sector (at a fraction of the cost of his competitors), but also the man who has reduced Twitter's workforce by almost 90% since he took over at the end of 2022, while increasing efficiency gains and maintaining innovation. The desire to apply these methods to the US government, but also to encourage this quest for efficiency within the US economy, with fewer costly standards for companies, is one of the rays of hope for the financial markets, which accept the current valuations.

Trump's and Musk's dream is one of a more productive, more efficient America, with a less spendthrift government to offset the effects of tax cuts on public finances. Increased deregulation could further accelerate innovation, allowing the US to maintain the technological and economic lead that has established its dominance of global financial markets since the 2008 financial crisis. In this respect, the markets believe that Trump's second term could resemble Reagan's first, with the resulting rise in productivity. Productivity rose from 0.85% a year under President Carter to exactly double that under Reagan, or 1.7% year on year. Joe Biden is leaving behind a robust rise in productivity (+2%), hence the need for Trump to act quickly and decisively in order to confirm investors' expectations of the markets.

The markets currently seem to be buying into this paradigm shift, and paying less attention to the potential risks of abuse of power, conflicts of interest and a deterioration in public services.

The financial markets are therefore going into 2025 with a lot of hopes, but also a lot of expectations.

Which, if they are slow to be realised, could lead to contractions in the high multiples on which the markets are trading and to the widening of credit spreads, leading in turn to a correction in the equity or bond markets.

Selectivity and responsiveness will therefore be more important than ever in 2025, particularly in European and emerging markets, which could spring a surprise in the medium term with the return of consumers, political stability and measures to support growth and innovation. We believe that 2025 will also be a year in which the theme of security will be strenghtened. This will be underpinned by the rise of protectionism and geopolitical tensions, against the backdrop of ever-increasing cyber-attacks and the probable disengagement of the 'American policeman' worldwide.

In this issue, we present our economic outlook for the world's main economic regions and detail the implications of this 'American exceptionalism' for equity and bond markets. We analyse the situation on the European and Chinese financial markets and detail the opportunities they offer. Finally, we look at the attractiveness of high-yield bonds and trends in the currency markets.

I hope you enjoy reading this new issue and wish you a joyous holiday season and a happy new year 2025.

Watch the video

2025: INVESTMENT VERSUS HIGHER CUSTOMS DUTIES

- An increase in US customs duties would have a negative impact on growth… …but US and Chinese domestic fiscal policies are expansionary.
- The inflationary impact of customs duties could be limited by the depreciation of currencies against the dollar.
- The Eurozone is facing multiple disadvantages while suffering from its loss of competitiveness due to the energy crisis.
- An inflationary surge due to a sharp reduction in immigration to the United States would generate a destabilising «flight to quality» movement.

Despite geopolitical tensions and the re-election of Donald Trump, our macroeconomic scenario is still on track. **As we had anticipated, US growth is solid, economic activity has held up in China despite the persistent property crisis, and the Eurozone has stalled.** In the end, global growth has not slowed, reaching the same 2.7% in 2024 as it did in 2023.

Credit conditions have eased thanks to more accommodative monetary policies. The slowdown in inflation has consolidated household purchasing power. In the United States, buoyant investment has underpinned growth, which reached almost 3% in the first three quarters of 2024. Consistent with our previous analysis, investment policies aimed at carbon neutrality, sovereignty and reduced dependence on China provided strong support for economic activity and limited the extent of the slowdown.

Trump's election is, of course, a game changer, but is expected to reinforce the reconfiguration of the global economy currently underway in response to the Sino-American war. This reconfiguration is characterised by a stabilisation of flows between the United States and China; a sharp increase in trade between the United States and Asia excluding China; a strengthening of Asian regionalisation and of trade between Mexico and the United States; economic policies in the service of sovereignty, including the energy transition; higher energy prices for Europeans; and market share gains for Chinese companies vis-à-vis European companies.

My geo-economic structural analysis, which has underpinned our macroeconomic scenarios since Trump's first term in office, therefore remains central to our forecasts. It leads us to continue to expect dynamic growth in the US of 2.1% in 2025, Chinese growth of 4.7% and continued weak growth in the Eurozone of 0.6%. American and Chinese investment and the depreciation of currencies against the dollar could partially offset the negative impact of higher customs duties.

An increase in tariffs on US imports would have a negative impact on global growth and on US and Chinese growth in particular. However, the extent of the increase is not known, as it depends on the negotiations that the Trump administration will enter into with its trading partners. If we assume a 10% increase in customs duties on US imports and a 60% increase on US imports from China, world growth would be cut by 0.5 percentage point, world trade by 3.3 percentage points and US and Chinese growth by 1.3 percentage points each. Growth in the Eurozone would be impacted by -0.6 percentage point.

This theoretical exercise, without retaliatory measures, does not take into account the economic policies implemented. In return, the US economy would benefit from the extension of the Tax Cuts and Jobs Act and additional tax cuts to support private investment, despite geopolitical uncertainty. The Chinese economy should also be supported by measures to boost consumption and investment, as well as by accommodative monetary policy. As has been the case since 2018, the negative impact of customs duties could be partially offset by the depreciation of the RMB and the reorganisation of trade flows. ASEAN has become China's biggest customer, ahead of the United States and the European Union.

My geo-economic structural analysis leads us to continue to expect dynamic growth in the US of 2.1% in 2025, Chinese growth of 4.7% and continued weak growth in the Eurozone of 0.6%.

As for Europe, not only is it particularly vulnerable to the tariff war, but it has not put any shock absorbers in place. First of all, the European Union is the United States' second-largest trade deficit after China. It is a «mini-China» according to Trump. What's more, the new American president knows how easy it is to divide the Europeans. Yet the emergence of a cooperative process depends on the credibility of sanctions in the event of non-compliance with the rules of the game. This credibility will be all the weaker as European countries defend their national interests. Finally, Europeans are particularly sensitive to the development of coercive measures, sanctions and restrictions, as they are highly dependent on global value chains. European companies participate in global value chains twice as much as American and Chinese companies through imports and three times as much through exports of intermediate goods. The United States is far ahead of China as a supplier of products needed by the European production network.

The European export sector will be helped, however, by the depreciation of the euro, which is likely to be inflationary. The dynamism of the US economy will generate a slightly faster rate of inflation, although it will be contained by productivity that is eight times faster than in the Eurozone. There is a risk that the US will export its inflation to Europe, which would weigh on European household consumption and the property sector. Such a scenario would lead the European Central Bank to adopt a monetary policy that is disconnected from the weakness of European fundamentals. At the same time, fiscal consolidation would continue in the Eurozone, and France's public finances would impose a negative risk premium on the Eurozone as a whole, limiting the outlook for investment.

This is why we continue to forecast growth of 0.6% in 2025 in the Eurozone. This average masks major disparities between countries. Spain and Portugal should see more dynamic growth thanks to the deployment of the European NextGenEU Fund, as should the countries of Eastern Europe. Germany is likely to continue to be affected by the downturn in automotive demand and competition from China but, unlike France, it has room for manoeuvre in its budget.

Such a scenario would lead the Federal Reserve to prematurely halt its cycle of interest rate cuts, which could result in a rise in 10-year rates from our forecast of 3.8% at the end of 2025. This monetary policy would exert downward pressure on Asian currencies, but also on safe-haven currencies, if the increase in customs duties were to become widespread.

The real risk is the potentially inflationary nature of US policy, and in particular that of a drastic reduction in immigration. This is why, in addition to our central scenario, our US economist is proposing a second so-called extreme scenario, which would lead to a sharp fall in US growth with a significant pick-up in inflation. This would trigger a flight to quality and increase the likelihood of a public finance crisis in the Eurozone.

Dr. Mathilde Lemoine
Group Chief Economist

GROWTH STILL SOLID IN THE UNITED STATES, BUT COMMODITY PRICES MORE DEPENDENT ON US AND CHINESE POLICIES

Légende Gitana

» In our central scenario, the tax cuts and higher tariffs promised by Donald Trump during his campaign should result in growth of around 2% in 2025 and 2026, with inflation exceeding 3% in 2025 and falling slightly below this figure in 2026.

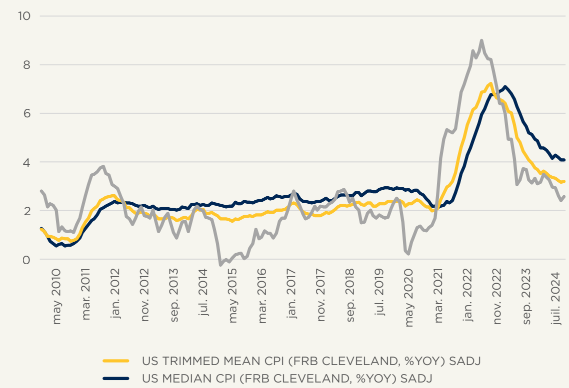
» We believe that sending 2 million people a year out of the United States would be an extreme scenario that would have a strong negative impact on growth, which could be as low as 1% in 2025, and would cause inflation to accelerate to 3.6%.

» At the same time, commodity prices are largely influenced by US policy through its impact on the dollar and by Chinese policy through stimulation of demand.

» However, commodity-specific factors are projected to have significant impacts. We expect the price of black gold to come under pressure, while energy transition metals could benefit from industrial policies and the gradual phase-out of fossil fuels.

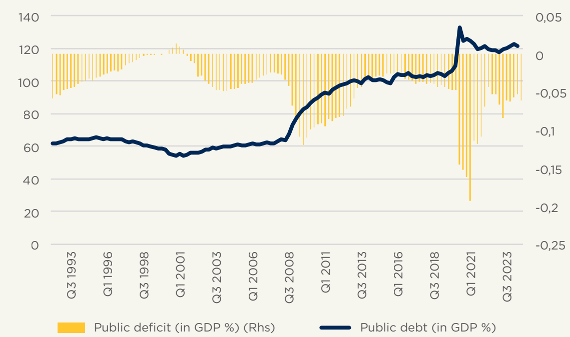
The election of Donald Trump should result in the implementation of some aspects of his programme. He is therefore expected to carry out his policy of cutting taxes and raising customs duties. At the same time, his immigration policy is likely to result mainly in a reduction in the number of arrivals rather than the mass expulsion of illegal immigrants. As a result, growth could be slightly less dynamic in 2025 and 2026 than in 2024 and, at the same time, inflation could accelerate in 2025 before slowing in 2026. Given the major uncertainties associated with Trump coming to power, we have drawn up two scenarios: a central scenario in which the new president implements all his tax cuts and tariff increases and reduces the flow of migrants without increasing deportations. The second scenario, which is not our central scenario, is an extreme scenario characterised by a migration policy in line with Trump's campaign programme, i.e. the removal of 8 million illegal immigrants in four years.

Various measures of inflation (YoY, in %)



Sources: LSEG Datastream, Edmond de Rothschild Economic Resarch

Public deficit and debt (as % of GDP)



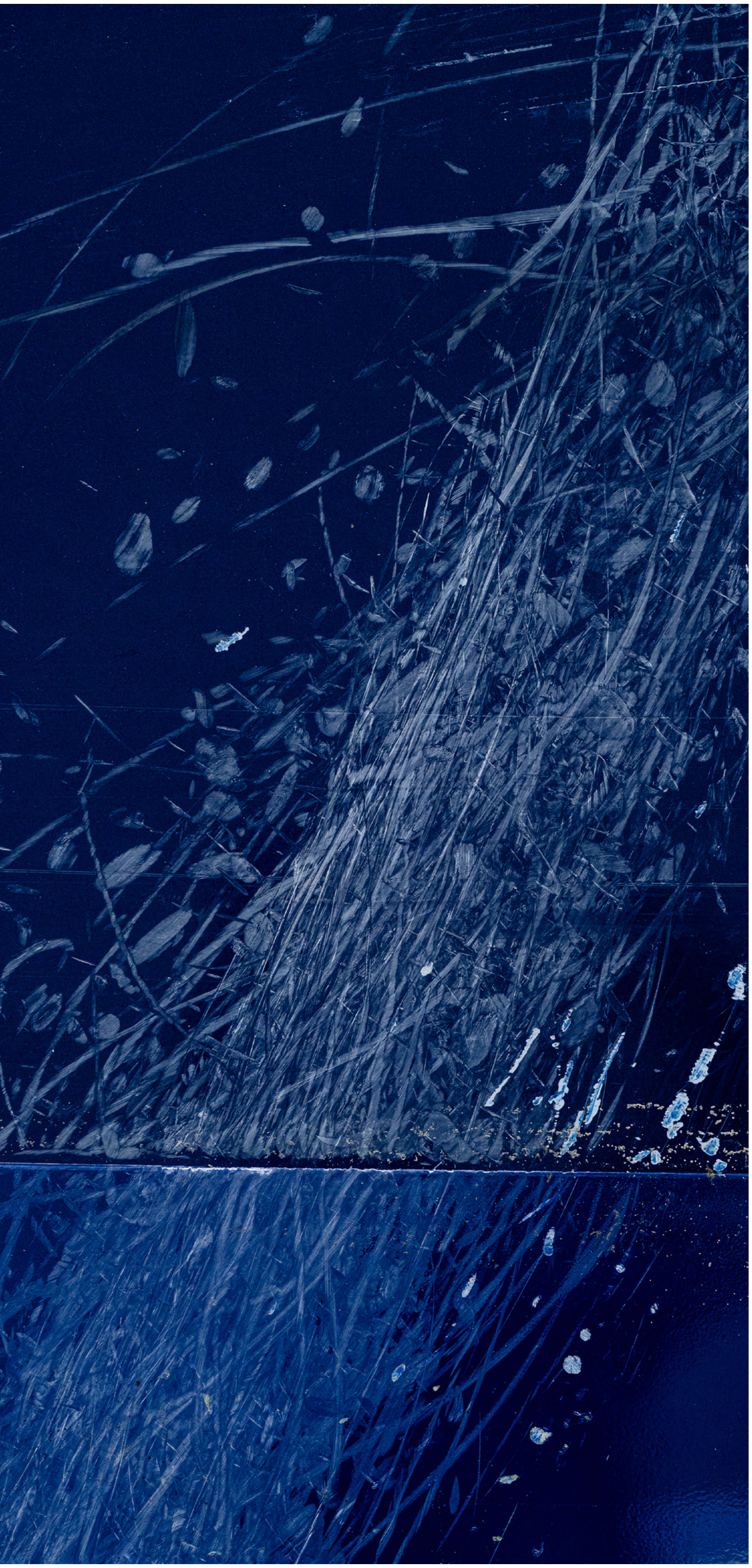
Sources: LSEG Datastream, Edmond de Rothschild Economic Resarch

CENTRAL SCENARIO: A LITTLE LESS GROWTH AND A LITTLE MORE INFLATION

After average annual economic growth of 2.4% in 2024, growth in 2025 is likely to be less dynamic, at an annual average of 2.1%. This slowdown should be rooted in weaker household consumption, linked to the normalisation of the labour market and a slight rise in unemployment, which should nonetheless remain below 4.5%. This should be accompanied by slower growth in purchasing power. At the same time, inflation should start to rise again, and could reach an annual average of 3.3% (after 2.9% in 2024) as a result of the protectionist policy of the new US president, who is expected to implement the promised increases in import taxes (60% for Chinese products and 10% for European products). This would increase the cost of imports by around $300 billion (bn), or 1% of GDP, putting a heavy strain on household budgets. This burden would only be partially offset by tax cuts, since it would take until 2026 for the full impact of lower taxes (around $700bn) to be felt. In 2025, new tax cuts, such as the exemption of tipping from taxes, could reach $200bn. Export growth would therefore remain slightly positive, while import growth would be negative, making foreign trade a slight engine of growth.

Trump's return to the White House is also characterised by a high level of uncertainty about the impact of his policies on businesses. Although tax cuts would be beneficial to businesses, higher tariffs and fewer immigrants entering the US could dampen their growth prospects. We therefore expect investment growth to slow in 2025 and 2026.

All these policies are likely to have an inflationary impact, with prices rising by an annual average of 3.3% in 2025 before falling back to 2.8% in 2026. Against this backdrop, public finances should continue to deteriorate, with a high deficit and rising debt.



Gitana base, Lorient

Naturally, the outlook for the US economy is subject to many uncertainties that could have a major impact on growth and inflation. For example, strict implementation of the new president's immigration programme could have a negative impact on growth and boost inflation, exposing companies to a number of challenges.

EXTREME SCENARIO: A RADICAL PROGRAMME THAT WOULD RESULT IN A LOT LESS GROWTH AND A LOT MORE INFLATION

The economic impact of full implementation of Trump's immigration programme would be significant, with growth of 1% as a result of the decline in household consumption and a sharp slowdown in investment due to the uncertainty generated by this policy. By 2026, the full effects of the tax cuts would be felt, helping to offset some of the negative impact of the expulsions. Inflation, meanwhile, would rebound sharply because of the labour shortage, which would trigger a supply shock with wage rises and production difficulties in many sectors, such as energy, where 4% of employees are undocumented. Average inflation would be 3.6% in 2025 and 2.9% in 2026. In addition, this shock to the labour market and the departure of two million people would have a negative impact on consumption.

COMMODITIES: US AND CHINESE POLICIES AS THE MAIN CATALYSTS

In addition to each product's specific characteristics, commodity prices are likely to be strongly influenced by two factors: the situation in China and developments in US policy and their impact on the dollar. Major support plans for the Chinese economy would be a factor in maintaining or raising prices, particularly for industrial metals and energy products. However, an appreciation of the greenback would have a negative impact on prices, as it would force non-US importers to pay higher prices for their products.

Commodity prices are likely to be strongly influenced by the situation in China and developments in US policy.

Oil prices could come under pressure as a result of sluggish demand growth and a higher supply forecast for 2025. Transition-related industrial metals, and copper in particular, could see their prices supported by the energy transition and industrial policies.

However, it is important to bear in mind that major geopolitical and pricing uncertainties could generate significant volatility on the commodities market.

In conclusion, in our central scenario, the United States, under the Trump administration's leadership, would continue to be an engine of growth despite a slight slowdown in growth (to 2.1% in 2025 and 2% in 2026) and an acceleration in inflation (to 3.3% in 2025 and 2.8% in 2026). An extreme scenario characterised by strict implementation of the campaign programme to expel 2 million illegal migrants a year would result in significantly lower growth, at 1% in 2025, and higher inflation, at 3.6% in 2025. With regard to commodities, price trends are likely to be linked to two main factors: the performance of the dollar and the extent of potential Chinese stimulus plans. Product-specific factors should also be taken into account. For example, oil prices could come under pressure from modest demand growth and more dynamic supply, while energy transition metals could benefit positively from decarbonation and reindustrialisation policies – all against the backdrop of high volatility.

Manuel Maleki, Ph. D.
Senior Economist US & Commodities

AMERICAN EXCEPTIONALISM STRENGTHENED BY TRUMP'S ELECTION

The US equity market performed exceptionally well in 2024, buoyed by a resilient economy and falling inflation and reinforced by the election of Donald Trump. The S&P 500 outperformed its peers, a trend that is likely to continue in the future given the likely strengthening of American exceptionalism with the new president.

A CLEAR OUTPERFORMANCE THAT IS HERE TO STAY

Even before the election, investor enthusiasm for US equities was high due to expectations of rate cuts and the resilience of the country's growth. Another driver was the continuing rise in profits, particularly in the field of artificial intelligence (AI), but also in most sectors of the economy since the second quarter of 2024. These expectations of higher profits have been further boosted by the prospect of the tax cuts promised by the president-elect. The US market even seems to be decoupling from the rest of the world, thanks to resilient US growth in the face of uncertainty in China and stagnation in Europe.

Many investors see Trump's «good» measures for the equity market, such as lower taxes and deregulation, as coming first and with more certainty than the «bad» measures for the stock market, such as the deportation of illegal migrants and import tariffs. The S&P, for example, is up almost 5% since Trump's election, the Brazilian Bovespa index has lost 9% in dollars, and the Hong Kong Hang Seng index has given up 5%, while the Stoxx Europe 600 index has lost 3% (also in dollars). American exceptionalism is thus reflected in the equity markets.

This US outperformance is expected to continue: Trump's programme (called the 'MAGA dream' by some financiers) is favourable to US corporate profits, the Fed is maintaining a downward bias in interest rates and US growth remains robust thanks to the resilience of the consumer and high levels of public spending. In the short term, market seasonality has historically remained positive until May, even after elections. Investors' exposure to equities is admittedly already very high, but less so than at previous market peaks. What's more, many observers report that Trump is very interested in the performance of the S&P 500, and even sees it as a barometer of his policies. The deregulation drive may not be substantially factored in at current levels.

As a result, there could be a great leap forward in productivity, as in the first Reagan or Thatcher terms. With Elon Musk at the helm of the new Department of Government Efficiency, it is difficult to see where the restructuring of public action will end. Some are even talking about the possibility of privatising the conquest of space, the regulation of communications, and potentially other public services. The aim is also to drastically reduce a large number of standards that are costly for businesses. This should open up new opportunities for large companies, and probably lead to productivity gains compared with public management.

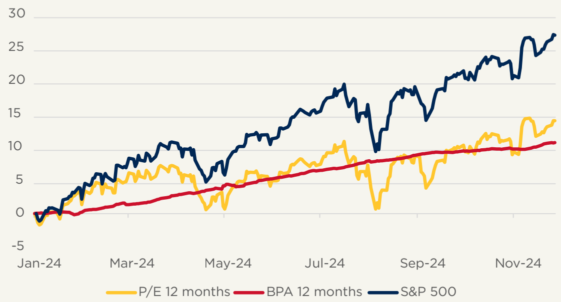
Trump's programme (called the 'MAGA dream' by some financiers) is favourable to US corporate profits.

Investors therefore expect the S&P to continue to perform well in 2025 against the backdrop of a pro-market policy push from the Trump administration. A recurring concern is the high valuations of the S&P 500, and of technology in particular. But this is only part of the equation. In 2024, half of the S&P 500's performance will come from earnings growth and half from multiple expansion. While we cannot expect multiples to expand in 2025 given current levels, we believe that earnings and margins should continue to support the market: EPS (Earnings Per Share) expectations are +10% for 2024 and +14% for 2025. This may seem high, but recent quarters have shown that US companies have an unparalleled ability to beat expectations, on average by 5% compared with forecast earnings (see Chart 1). What's more, Nvidia and Broadcom two of the S&P 500's earnings powerhouses, have unveiled above-expectations outlooks (even though Nvidia earnings growth was below the most optimistic expectations), which points to continued robust investment in AI.

A NEW DEAL FOR THE LONG TERM

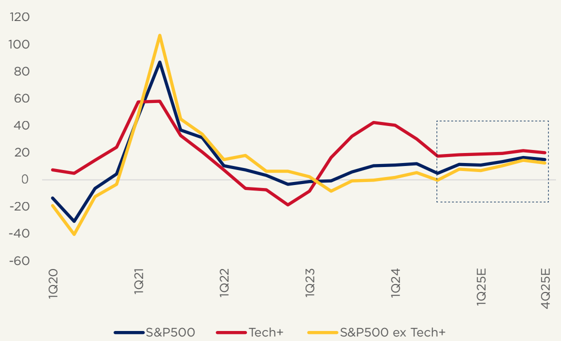
In the long term, we believe that American exceptionalism should be bolstered and boost the growth of the country's businesses. American consumers are spending, while Europeans and Chinese are saving. Tax cuts for individuals should reinforce this trend. Public deficits in the United States support businesses and consumers, but the Trump administration could result in a $7,500 billion increase in the deficit over 10 years, according to some projections. Social spending, already low in the US (19% of GDP, compared with 28% in Germany and 32% in France), is set to fall further. As a

The S&P 500's performance this year has been driven by an expansion in both valuation multiples and earnings per share expectations



Sources : Edmond de Rothschild, Bloomberg

Earnings growth within non-tech S&P 500 sectors is set to accelerate while the technology sector should normalise



Sources : Edmond de Rothschild

result, investment in the United States will be all the more focused on productivity, rather than on social welfare.

The likely cycle of deregulation under Trump is expected to ramp up the traditional laissez-faire approach in Washington, while Brussels and Beijing prefer to steer their economies. We have seen over the past 40 years which method is more favourable to business. Trump's America should move closer, at least in ambition, to the liberal model of the pre-New Deal 1930s: capitalism with few state restrictions, self-regulation and the market replacing the visible hand of the state, while protecting the domestic market. This comes after Joe Biden's more European-style policy, based on major public stimulus packages and tighter regulation.

In the long term, we believe that American exceptionalism should be bolstered and boost the growth of the country's businesses.

Finally, America should continue to enjoy a key advantage over Europe, China and Japan: its demographics. Even with the deportation of illegal migrants, Trump's first term in office demonstrated the difference between the figures announced during the campaign and the reality: from 2016 to 2020, 400,000 foreigners were deported. The demographic strength of the United States is set to continue. America is benefiting from significant productivity gains, thanks in particular to its mastery of technology and the important role played by technology companies in the index (38% of the S&P 500, compared with 7% of the Stoxx 600 in Europe).

At the sector level, we believe that the performance of sectors within the S&P 500 should continue on the trajectory seen since August 2024, i.e. a more linear performance between sectors. In fact, over 2024, only Nvidia, one of the «Magnificent 7» of 2023, remains in the S&P 500's top 10, alongside United Airlines, taser manufacturer Axon and utilities provider Constellation Energy! This less technology-led performance should continue into 2025. Earnings expectations are more uniform across sectors, whereas the S&P 500 excluding tech had negative earnings growth until the first quarter of 2024 (see Chart 2).

Another catalyst for sector performance is the new Trump administration, following its victory in the race for the White House and the new Republican majority in both houses of Congress. The market should continue to favour sectors exposed to his policies, particularly financials, consumer discretionary (including automotive and home building), oil, and technology, as well as certain industrial companies that produce and sell in the United States. Nevertheless, the severity with which Trump could restrict his trade policy remains a sword of Damocles for global companies. In the event of renewed tensions with China, in particular, the sectors most at risk are industrial exporters with a large proportion of their production in China, materials, certain areas of technology (semiconductors in particular) and renewable energy suppliers.

DECORRELATION FROM OTHER MAIN MARKETS

We remain neutral on international equities compared with our overweight recommendation on the United States. Trump's election is fuelling uncertainty in Europe and his programme, even if only partially implemented, will certainly penalise the economy and a number of European exporters. The rise in the dollar is advantageous for the European investor, which should boost the appetite for S&P stocks and limit the dollar investor's interest in buying euro-denominated securities. This is nothing new: the appeal of US equities is such that, since 2010, all S&P 500 sectors have outperformed their sector counterparts in the Stoxx Europe 600. This trend is likely to be reinforced by the strength of the US economy relative to Europe's, the new US president's plans for tax cuts, and economic and political concerns in France and now Germany.

As for Chinese equities, they are likely to be in the new president's sights, with tariffs potentially up to 60% on imports from the United States, the exact level of the difference in production costs between the two countries. This loss of competitiveness in exports to the United States may not be fully offset by measures to support domestic consumption in China.

In conclusion, US equities should maintain their momentum, with a broader range of sectors contributing more to the index's performance. However, selectivity remains the order of the day, with the aim being to gain exposure to sectors that are likely to benefit more from the new Trump administration. Sectors exposed to megatrends such as security (see page 34) could also continue to outperform.

Hervé Prettre
Head of Global Investment Research

SECTORS UNDER PRESSURE IN 2024, SELECTIVITY REMAINS THE KEY IN 2025

The luxury goods sector has been impacted by the weakness in spending by Chinese customers, its largest market, and the risk of tariffs in the United States, its second-largest market. However, the situation should stabilise by 2025. The European car industry could still come under pressure, while American manufacturers should be better protected from competition.

Château Clarke, Listrac-Médoc, France

LUXURY GOODS: HOW TO EMERGE BETWEEN A WEAK CHINESE MARKET AND TRUMP'S CUSTOMS DUTIES?

Global spending in the luxury goods sector is expected to reach nearly €1.5 billion in 2024, a figure that is relatively stable compared to 2023, with an estimated growth rate of -1% to 0% year-on-year, well below the +5% to +9% increases seen between 2020 and 2023.

The market for personal luxury goods may be experiencing its first slowdown since the 2008 financial crisis. Today, around 50 million luxury goods consumers have stopped buying bags and other branded items, according to a report by consultants Bain & Company. Only a third of luxury brands will end the year with positive growth, again according to Bain, compared with two-thirds last year. This situation can be explained by global economic uncertainty, particularly in China, where the decline in demand in this key market, following the property crisis and price deflation, is cause for concern. The second headwind is that the sharp rise in prices in the luxury sector since 2020 means that the so-called «aspirational» customers of generation Z, whose salaries have not kept pace with prices, are less inclined to buy luxury goods. This is less true for high-priced absolute luxury products, which are aimed at a very affluent clientele that is less affected by inflation. Finally, the risk of tariffs in the United States is another source of concern for European luxury brands.

> The luxury market should be on a positive trajectory by 2030, with a broader addressable market.

However, a gradual recovery between now and the end of 2025 is still possible, firstly in China due to the stimulus measures, secondly in the United States if Trump rapidly implements his tax cuts, and thirdly in Japan, which benefits from a favourable exchange rate effect for Asian tourists. In addition, emerging markets represent new avenues of potential growth, such as Latin America, India, Southeast Asia and Africa, which are collectively expected to have over 50 million upper-middle-class luxury consumers within five years. The market should be on a positive trajectory by 2030, with a broader addressable market. Innovation is also expected to boost sales, in particular the entry into new areas such as chic sportswear and high-end cosmetics.

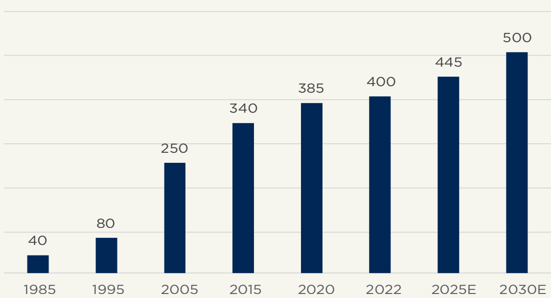
AUTOMOTIVE: STRUCTURAL DIFFICULTIES FOR EUROPEAN MANUFACTURERS, THE TRUMP SHIELD FOR AMERICAN MANUFACTURERS

The automotive sector has been plagued for several years by difficulties that have undermined its business. While the lockdowns of 2020 brought production to a standstill, the post-pandemic recovery of 2021 was limited by component shortages due to supply chain disruptions. The year 2023 was better due to price increases, the launch of new models and the success of electric vehicles (EVs) with the help of public subsidies. Hopes that the rebound would continue in 2024 for European manufacturers were dashed by the slowdown in EV sales following the expiration of the subsidies and reduced consumer appetite, but above all by the rapid emergence of Chinese models. In addition, the launch of a large number of models at a time when the market was slowing led to a fall in prices and a series of profit warnings from European companies.

> Carmakers in the United States are in a better position, with a protected EV market and less regulatory pressure

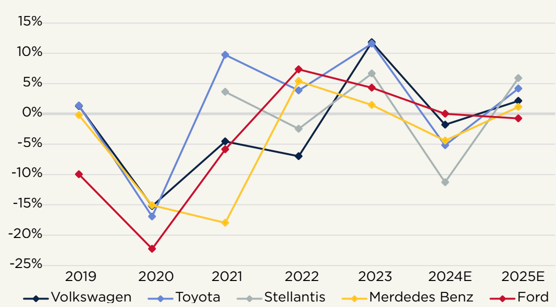
In addition to cyclical difficulties, there are structural threats to the European sector, such as the risk that Chinese manufacturers will continue to make rapid gains in market share, despite the European customs duties imposed on Chinese manufacturers in 2024. The threat of increased tariffs on exports to the United States is serious, and the European regulatory environment is not very favourable, as illustrated by the risk of colossal European fines for manufacturers who do not sell enough EVs in Europe in 2025. Finally, European demand is at a low ebb, even though production capacity has returned to high levels. The rapid electrification

The number of luxury sector customers could reach 500 million people by 2030



Sources : Kepler Cheuvreux

Vehicle sales for the world's five largest manufacturers



Sources : Edmond de Rothschild, Bloomberg

of the industry seems to be at risk due to the still patchy charging infrastructure, the withdrawal of financial aid and subsidies, and rising leasing costs. European carmakers need to restructure, but how much will they have to cut capacity?

Carmakers in the United States are in a better position, with a protected EV market and less regulatory pressure, allowing the two incumbent manufacturers to concentrate on higher-margin conventional models. Trump's arrival in power should strengthen the protection of the domestic market, limit Japanese competition in classic SUV-type vehicles, and boost Americans' purchasing power. American exceptionalism is more than relevant in this sector.

Darius Bakhtari
Research analyst, Global Investment Research

Clément Outin
Research analyst, Global Investment Research

EUROPEAN EQUITY MARKETS REMAIN UNDER PRESSURE, BUT OPPORTUNITIES EXIST

European markets are structurally underperforming their US counterparts due to a number of factors: sluggish economic momentum, industrial bias, exposure to China, and political uncertainty. There are opportunities, however, particularly in the Swiss market.

CHRONIC UNDERPERFORMANCE RELATIVE TO WALL STREET

The European equity market has been structurally underperforming its US counterpart since 2006! This underperformance was already well entrenched even before the «Magnificent 7» began to dominate. These stocks have been outperforming the S&P 500 since 2023, allowing the latter to continue to widen the gap with the Stoxx Europe 600. Looking back, we also note that, since 2010, none of the Stoxx sectors have managed to outperform their US counterparts, demonstrating the overall structural underperformance of Europe relative to the US. However, will this underperformance continue?

> The market is struggling to find positive catalysts for European stocks.

Between sluggish economic growth and political uncertainty, the likely impact of higher US tariffs and a European earnings growth outlook that is probably overestimated for 2025, the market is struggling to find positive catalysts for European stocks. We believe that the outperformance of the US markets will continue in the short term.

Firstly, Europe's economic momentum remains sluggish: the manufacturing sector has been in virtual recession since 2022, according to the purchasing managers' indices (PMIs), while activity in the services sector also remains weaker than in the US. There have of course been a few exceptions, such as France, which was able to benefit from a rebound in optimism within the services sector this summer thanks to the Olympic Games. But this rebound quickly ran out of steam, while other countries in the south were boosted in summer by seasonal tourism. Europe continues to contend with weak demand, with its industrial exposure facing high levels of unsold goods and deflation exported from China. In addition, the lack of qualified personnel remains one of the biggest concerns for business leaders, weighing even more heavily on the capacity of the private manufacturing sector. Household consumption remains weak, although consumer confidence has stabilised in recent quarters since its low point in 2022, boosted by disinflation which has increased purchasing power. However, the structural tendency of European households to save (with a rate across the bloc of more than 15% of disposable income, compared with less than 5% in the United States) continues to penalise consumption and therefore demand, weighing even more heavily on activity. European consumers are cautious and fearful of the future, especially in France, while their American counterparts spend in the belief that they will pay lower taxes tomorrow. There is, of course, one factor that could boost German growth in the long term: the abandonment of the debt brake enshrined in the Constitution since 2009, which could be implemented by the potential new German Chancellor Friedrich Merz. But this would require his party, the CDU, to win the February 2025 elections (either alone or in alliance with the centre-left SPD, which is similarly in favour of freeing up the budget), yet the German political landscape is also becoming increasingly fragmented.

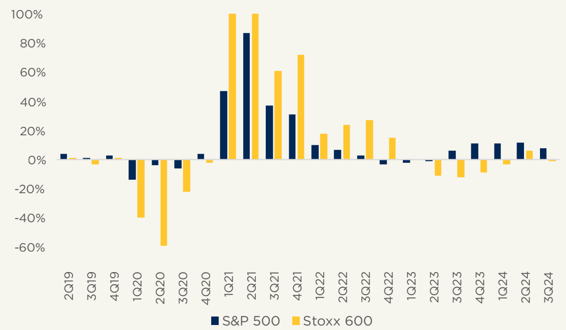
Europe faces another challenge relative to the US: the underweighting of the technology sector in the Stoxx Europe 600 index and, more generally, lower investment in technology, leading to lower productivity gains. Technology accounts for just 7% of the European index, compared with almost 40% in the United States. This gap explains why the European index is having difficulty outperforming its American counterpart, at a time when the latter is benefiting almost exclusively from recent advances in artificial intelligence. And although Europe has some specific leaders in the sector, the approach European lawmakers are taking is focused on regulating AI and trying to establish themselves as the global «policeman» rather than as a facilitator of innovation. This under-exposure and approach are likely to continue to penalise the growth of the European bloc relative to the US with the advent of artificial intelligence, a source of productivity gains in many sectors.

THE TWO POWERHOUSE COUNTRIES, FRANCE AND GERMANY, ARE IN STRUCTURAL CRISIS

Europe is also facing major political challenges, particularly in France, where political instability since the July 2024 parliamentary elections has left no party with a majority, while deficit reduction targets continue to be pushed back for lack of short-term solutions. As a result, several credit rating agencies have downgraded their outlook for the country. As for the stock market, the CAC 40 is set to be one of the worst performers on the Continent in 2024, suffering from government instability. Conversely, in the United States, the deficit will continue to widen, particularly with the tax policies expected from President Trump, which should boost supply with additional tax cuts for companies and individuals. Therein lies the main difference: European countries allocate a higher proportion of their spending to social welfare (28% of GDP on average, and 32% in France) than the United States (19%), which means a better-protected population in terms of health, but also higher taxes on companies. This partly explains the higher profitability of American companies.

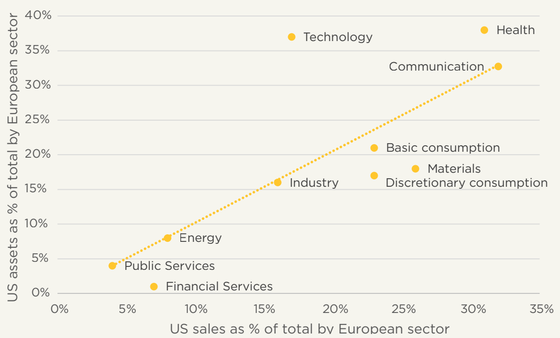
In Germany, trends continue to be clouded by questions surrounding a growth model based on exporting to emerging economies, with moderate energy costs and little competition from high-quality German products. The key example is the automotive industry, which is facing new, high-quality Chinese competition on electric vehicles and is losing market share in

S&P 500 EPS growth continues to outpace Europe's



Sources : Bloomberg, Edmond de Rothschild

Certain European sectors should benefit from exposure to assets and sales located in the USA vs. those that do not produce locally



Sources : Edmond de Rothschild, Bloomberg

China on conventional models (see page 17). In a symbolic move, Volkswagen recently announced its intention to close factories in Germany in order to improve its financial situation, a first since the company was founded 87 years ago. In addition, and as is the case in France, the political situation is becoming uncertain, with the radical far-right AfD party potentially at 20% of voting intentions.

> The European market continues to underperform the US due to economic challenges, political uncertainty and the lack of technological innovation.

WILL THE EXPECTED EARNINGS REBOUND IN 2025 AND EUROPE'S LOW VALUE SERVE AS CATALYSTS?

After a strong earnings rebound in 2022 of around 20%, earnings growth for the Stoxx 600 index slowed considerably in 2023 to 3% and is expected to be flat this year, reflecting the persistent weakness of European companies. In fact, earnings growth in the European Stoxx 600 has underperformed that of the S&P 500 every quarter since 4Q22! Thatis seven quarters in a row of underperformance.

Could this trend change in the near future? The consensus view is that Stoxx Europe earnings should rebound in 2025, with growth estimated at +8%, which would still be below the expectations for the S&P of +15% and would mark another year of earnings underperformance. We also believe that this growth expectation is too high, given the ongoing economic difficulties in Europe. Our model predicts growth of 3% to 5%. Moreover, in 3Q24, the results and outlooks for European companies were mixed, signalling the start of negative earnings revisions. Lower earnings call into question the classic argument for European stocks: their low valuation. This argument collapses with a weaker earnings outlook. Finally, although the European market has been attractively valued for several years and the US market has been expensive for several years, the outperformance of the US is clear to see.

WHAT ABOUT THE IMPACT OF TRUMP'S EXPECTED POLICIES?

Donald Trump's election in the United States will certainly not be without impact on European countries and sectors, with the implementation of a 10% increase in tariffs on all American imports topping the list. Although the timing and scale of this increase remain uncertain, European exports to the United States currently account for 3.1% of the eurozone's GDP, which is still moderate overall. On the other hand, exports to the US as a percentage of GDP are higher in Germany, the Netherlands and Switzerland, and lower in France and Spain.

> However, there are opportunities in certain regions, such as the Swiss market, and in sectors such as defence and healthcare

At sector level, the impact is mixed. The most negative impacts will certainly be on the European sectors that export the most to the United States and have little local production. These include automotive, capital goods, chemicals, luxury goods and agri-food. European renewable energy companies with exposure to the US are also likely to suffer from Trump's pro-fossil fuel measures. On the other hand, several sectors should benefit from the measures proposed by the Trump administration. One example is the defence sector, given the expected increase in European arms budgets under pressure from the new administration. We also note that the materials and media sectors, as well as certain technology stocks with operations in the United States, should be relatively insulated from protectionist measures on imports.

OPPORTUNITIES EXIST

The general observation that the European bloc is sluggish does not apply universally, and some countries and their equity markets should outperform the rest of the Continent:

- The Spanish market is benefiting from positive momentum (IBEX) and a still attractive valuation. Of course, three companies (Inditex, Santander, Iberdrola) account for 45% of the Spanish flagship index, and they are partly dependent on Spain's superior growth.
- Switzerland remains an attractive market: the valuation of the SMI index is higher than that of the European index, but remains in line with its historical premium. Nestlé,

Roche and Novartis account for 47% of the SMI, giving the index its defensive character. Swiss companies enjoy key advantages over their European counterparts: a stable political environment, significant tax advantages for companies, and legal and fiscal stability that allows for business continuity. The political authorities and the population are generally pro-business. A fitting coincidence: at the same as the French National Assembly was debating over-taxation of individuals, in November 2024 61% of Geneva's citizens voted in favour of a lower income tax. What's more, Swiss companies have been better than most at adapting to a strong franc and high labour costs by focusing on high value-added activities.

- Generally speaking, against the backdrop of a mixed view on the Continent, certain companies and sectors still present opportunities, for example, certain luxury good (see page 16), defence, and healthcare, as well as certain financial companies.

The European market continues to underperform the US due to economic challenges, political uncertainty and the lack of technological innovation. Limited consumption due to the savings trend and sluggish economic growth should continue to penalise the European equity market's momentum in the short term. Trump's tariff policies could exacerbate the situation for certain sectors in Europe. However, there are opportunities in certain regions, such as the Swiss market, and in sectors such as defence and healthcare. In the medium term, certain catalysts could reverse this trend, such as the lifting of the debt brake in Germany, the end of the war in Ukraine, a sharp recovery in the manufacturing sector, or a decline in deflation in China... but these factors are still uncertain. As long as Europe does not experience a productivity shock, like Trump's America, we confirm our preference for the US market (see our article on page 12).

Hervé Prettre
Head of Global Investment Research

Anthony Toupin
Senior Research analyst, Global Investment Research

CHINA IS EVERYONE'S BUSINESS

China is now struggling to overcome internal deflation.
But a series of monetary and fiscal measures have been announced
to tackle the weak points in the Chinese economy.

A SLOWDOWN WITH GLOBAL CONSEQUENCES

Once the engine of global growth, China is now struggling to overcome internal deflation caused by the self-inflicted collapse of the property market. It must respond to accusations of overproduction on its exports to developed markets and is also preparing for a confrontation with the United States under Trump 2.0 in 2025 and beyond.

The slowdown in China was the most frequently cited reason behind the weakness of multinationals during the latest quarterly results announcements by industrial companies, from consumer goods to luxury goods, especially in Europe.

The exceptionalism of the US stock market is also partly attributable to China. Although still number two in terms of market capitalisation behind the United States, the Chinese stock market has lost more than $6,000 billion since its peak in 2021. The gap between the two has widened from $29,000 billion to $43,000 billion in just three years (1).

International and domestic investors in Chinese equities have suffered substantial annual losses for more than three years in a row. The MSCI China's valuation has remained below its long-term average of 11.5x P/E since 2021, and below 10x P/E (i.e. a discount of more than one standard deviation) most of the time in 2023 and 2024 (2).

MAJOR STIMULUS MEASURES

But just like China's pivot from zero-Covid to zero restrictions, it turns out that China has decided to solve its own problems first!

Since the end of September, a series of monetary and fiscal measures has been announced to tackle the weak points in the Chinese economy: consumer confidence, i.e. the purchasing power of the more than 300 million middle-class people who have a higher post-Covid savings rate and are weighed down by the negative wealth effect linked to the slowdown in the property market; a trio of cuts to the RRR, policy interest rates and mortgage rates; RMB 800 billion in support for the stock market to encourage share buybacks; and an RMB 10 trillion local debt swap programme over five years, in addition to managing market expectations, marking a clear shift in its economic policy.

> China's stock market may not disappoint in 2025.

This is an important pivot, but not yet in the «whatever it takes» category. Chinese GDP growth could remain under pressure in 2025. But, unlike other economies, Chinese equity performance has historically not been strongly correlated with GDP growth. The total market capitalisation of Chinese equities is equivalent to just 65% of GDP, compared with almost 200% of GDP for the US stock market (3). So the Chinese stock market may not disappoint in 2025 (as it has done so far in 2024), if investors manage their expectations better, which may already be the case.

The Chinese market retreated after the latest meeting of the National People's Congress, particularly for consumer stocks, as reflation arguments have lost momentum. The outright Republican victory in the US elections has also put all investors on the defensive: higher tariffs mean greater scope for depreciation of the Chinese yuan (CNY) and the appointment of China-haters to the Trump administration means increased tension in trade negotiations (if they even take place). Similarly, the likely reorientation of the supply chain to avoid high tariffs would worsen the already thin margins of Chinese manufacturers.

A REBALANCING TOWARD PRIVATE COMPANIES

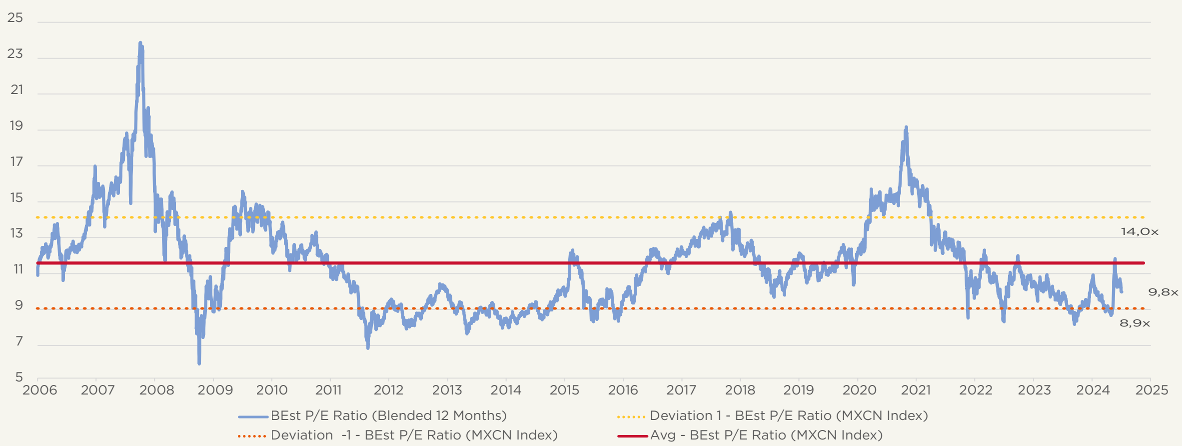
However, we believe that China is reassessing the balance between state-owned enterprises (SOEs) and private companies, as priorities have been revised this time: it is time for the private sector to shine again, as it contributes 50% of GDP, 60% of tax revenues, 70% of intellectual property patents, and 80% of job creation, and represents 90% of Chinese companies. Given the urgency of the situation, China's discourse is clearly shifting from Common Prosperity to Black Cat, White Cat (4): it doesn't matter whether a cat is black or white, as long as it catches mice.

Steering such a change in today's complicated circumstances is no easy task, but we believe the pendulum has swung. It may move slowly at first as it has just reached its end point and turned back, but it will accelerate until it reaches full momentum. We expect additional stimulus measures to offset potential tariff headwinds. A return to pragmatism is an indispensable antidote to China's deflation problem and will remain the best solution to the Trump 2.0 challenge, ultimately making China less of a problem for all its trading partners.

On the investment side, we still see strong potential for private sector companies in the Chinese market to change course in 2025, given low valuations, low expectations and the more nuanced profile of leaders in geopolitical affairs this time.

Xiadong Bao
Fund Manager, Edmond de Rothschild Asset Management

Chinese equities are too cheap to ignore



Sources : Bloomberg, EDRAM, Nov. 2024

(1) China + HK markets combined vs US market, Dec 2021 vs Aug 2024 vs Nov 2024 (2) Source: Bloomberg, Nov 2024
(3) Source : World Bank, Nov 2024 (4) Cat theory (Deng Xiaoping, former Chinese leader)

AMERICAN EXCEPTIONALISM: WHAT IS THE IMPACT ON BOND MARKETS?

With monetary easing by the Fed likely to be less than anticipated due to growth policy, deficits set to remain high and new US tariffs, sovereign and corporate bond yields are likely to remain higher in the US than in the rest of the developed world.

The outcome of the American elections and the total victory by the Republicans will accentuate American exceptionalism in the months and years to come. What are its characteristics? Stronger growth due to a highly expansionary fiscal policy, a monetary policy that is becoming less restrictive, a capacity for innovation supported by the world's largest capital market and a currency that remains the most widely used in world trade despite the emergence of new players. In the space of a few years, we have moved from a globalised world, where everyone traded with everyone else and the emphasis was on the lowest cost of capital and production, the construction of a globalised distribution network and a just-in-time-based delivery/storage model, to a world of relocation and proximity, a world where protectionism is on the rise and cooperation on the decline. In this context, the United States will do what is best for the United States, and if that means financing its spending through tariffs and more protectionism, that is what it will try to do. In our view, such a development should accentuate the economic divergences between the United States and the rest of the world and have a lasting impact on monetary policy trends and hence on changes in interest rates across economic regions.

HIGHER RATES IN THE UNITED STATES THAN ELSEWHERE

The markets' reaction to Trump's election as president of the United States and the Republicans' victory in Congress is clear: US assets have outperformed assets in the rest of the world, in both the equity and corporate bond markets. This outperformance stems from the upward adjustment of growth and inflation premia for the United States that the Republicans' expansionary fiscal policy should generate. As a result, following the post-election rally, yield spreads between investment-grade (IG) corporate bonds and US Treasury bonds with the same maturity reached levels that were almost the tightest in the history of the Bloomberg IG index, dating back to 1997.

For the US bond market, the prospect of a fiscal policy that supports spending and investment and a policy of raising customs duties has one major consequence: monetary easing by the Fed will be smaller than anticipated and less pronounced than in the other major developed countries, leading to higher sovereign rates in the United States than elsewhere. For example, the Bank of Canada has already cut its key rates by 125 basis points in 2024, compared with 75 basis points for the Fed. Although the two economies are very close in terms of the cycle, the yield spread between 10-year US and Canadian Treasury bonds has never exceeded 100 basis points since 1990. This yield spread has now risen from 77 basis points in January 2024 to 120 basis points in November 2024. The spread with German 10-year rates, which exceeded 2% following Trump's election, is also a high point and is at its widest since 2020; it represents less than 3% of occurrences since 1990. Only UK rates remain higher than those in the US, and this has been the case since Brexit due to greater inflationary risk and strained public finances following the period of stress during Liz Truss's tenure.

We believe that the total return on US sovereign bonds will remain higher than inflation and than the sovereign bonds of the other G7 countries.

This divergence, which stems from stronger growth and inflation prospects in the United States than elsewhere, is also reflected in monetary policy expectations for the various regions. In 2025, the money markets expect only two rate cuts from the Fed, compared with four from the ECB, four from the Bank of Canada and three from the Bank of England. So, in terms of key rates, the markets see Fed rates at the end of the year at 3.9% compared with 1.75% for the ECB, 2.75% for the Bank of Canada and 3.75% for the Bank of England. We believe that the total return on US sovereign bonds will remain higher than inflation and than the sovereign bonds of the other G7 countries.

WEAK EUROPEAN GROWTH WILL WEIGH ON DEBT SUSTAINABILITY

Since September 2024, the Bloomberg consensus 2025 growth forecast for Europe has fallen from 1.4% to 1.2%, while for the United States it has risen from 1.7% to 1.9%. Europe's sluggish growth stems from weaker Chinese demand for European, and particularly German, manufactured goods; higher energy costs than in the United States; and a lack of investment that is moderating productivity gains in industry and services. In addition, European consumers tend to save, whereas American consumers spend any extra income they earn. Finally, the risk of a political crisis has also increased in Europe in 2024, in France with the election of a hung parliament responsible for reducing the French budget deficit and in Germany with the announcement of new parliamentary elections following the collapse of the ruling coalition.

In this context, we believe that the sustainability of European countries' debt should become an increasingly important issue in the sovereign bond market in 2025. This is illustrated, for example, by the change in rating for the outlook for French debt and the increase in the yield spread between the German 10-year and the French 10-year: this spread was 80 basis points in December 2024 compared with an average of 53 basis points in 2023. France's cost of debt is even on a par with Greece's! The rating agencies could similarly change their outlook for Italy, which also has a high debt level and large deficits (more than 7% of GDP in 2024, i.e. higher than France's), in the coming quarters.

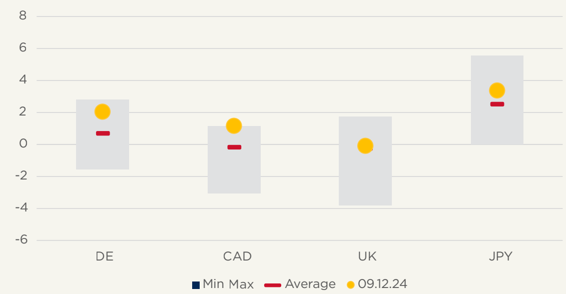
Although the ECB can ease its monetary policy because inflation is under control and the fiscal outlook is more restrictive than in the United States, we believe that the potential for a fall in long-term rates in Europe is limited. Indeed, the low-growth dynamic will not allow for a significant reduction in deficits and debt in most European countries, which should keep sovereign risk at a higher level than elsewhere and therefore limit the fall in long-term yields. We therefore believe that European sovereign bonds are unattractive and likely to suffer from increased volatility due to political uncertainties, both internal, with unstable governments in some countries, and external, with potential trade tensions with the United States. Volatility is likely to predominate in France, given the political uncertainties. Similarly, in Germany, the CDU candidate and potential future Chancellor Friedrich Merz has announced that he wants to revise the country's sacred debt brake mechanism, in order to finance the productive investment the country needs. This could lead to greater volatility in German bonds.

TIGHT CREDIT SPREADS FOR THE LONG TERM

What are the impacts for the corporate bond markets of higher sovereign rates in the US and higher sovereign risk and volatility in Europe? Although we do not yet know with certainty the extent or the timing of fiscal policy in the United States, the increase in US growth forecasts should support the profitability of large companies that are exposed to the US cycle. This applies to the vast majority of US companies, but also to the largest European groups that have significant exposure to the US economy, either through exports or through investment in the US.

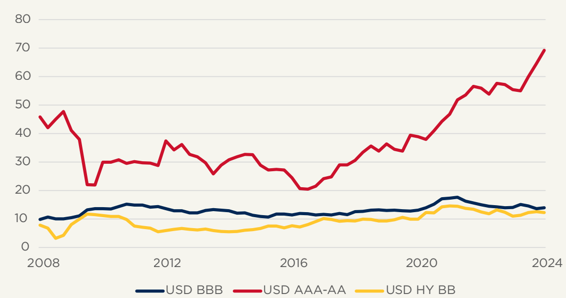
As long as the risk of recession remains low in the United States, credit investors are likely to focus on two key points. The first is the signal from the interest rate market. So far, spreads have been remarkably resilient to a significant rise in rates, keeping borrowing costs relatively moderate. However, any further rise in rates due to trade policy uncertainty would be more difficult to absorb and would put additional pressure on financing costs, particularly for the most heavily indebted companies. Secondly, while renewed trade tensions are likely to weigh on growth in the eurozone, we continue to believe that credit markets, unlike interest rate markets, are an imperfect indicator for expressing an opinion on the divergence in growth between the US and the eurozone.

10-year bond yield spreads between the United States and other countries (1990-2024 as %)



Sources : Edmond de Rothschild, Bloomberg

Cash flow to total debt ratio (%)



Sources : Edmond de Rothschild

> Higher US growth forecasts should support the profitability of large companies exposed to the US cycle.

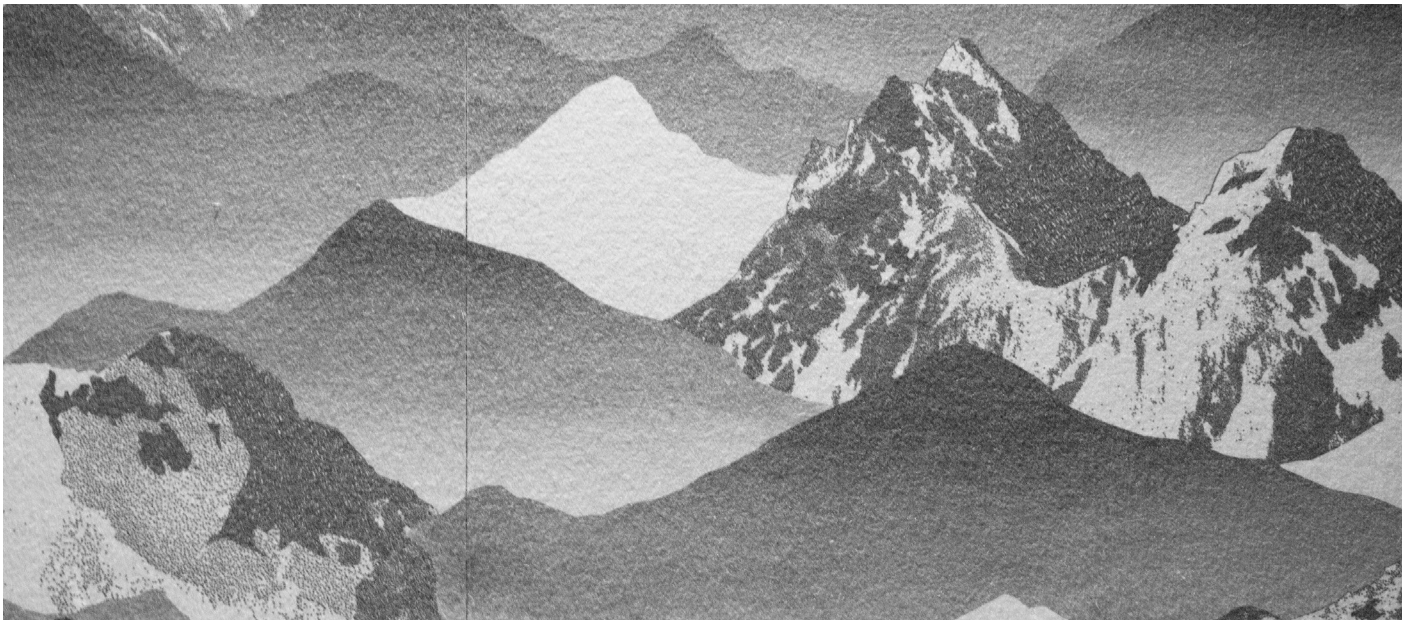
In our view, European credit spreads, particularly for the highest-rated companies, are unlikely to widen much in the quarters ahead. This is because the relatively low sensitivity of credit risk appetite to growth data protects this segment from a slowdown in the European cycle. What's more, the prospect of a more extensive easing cycle from the ECB and the strength of technical factors, such as structural demand from institutional investors in Europe (who have a large strategic allocation to high-quality bonds), should limit the risk of a significant widening of euro spreads. This is the case even in the event of a trade war or a European political crisis, which would lead to a lack of confidence in certain European sovereign bonds. Estimates of new issues for 2025 show that coupon payments will probably absorb more than 60% of the net supply of USD-denominated IG and HY securities during the year. Finally, third-quarter corporate earnings show that the interaction between earnings growth and interest expense growth has moved in a more positive direction, which should help to contain idiosyncratic risk. In addition, we believe that the current high level of yields will continue to support technical demand in the dollar and euro markets.

Taken together, these catalysts justify our positive view on high-quality corporate bonds, while uncertainty about the scope of economic policy, and its impact on interest rates, along with the burden of this uncertainty for the most heavily indebted companies mean that we remain more cautious on sovereign and high-yield bonds. Opportunities remain in the latter segment (see next page).

Guilhem Savry
Head of Strategy Research, Global Investment Research

IS THE CURRENT MARKET ENVIRONMENT FAVOURABLE TO THE HIGH-YIELD SEGMENT?

With economic growth generally showing signs of resilience and interest rates in the process of normalising, the high-yield market (or riskier bonds) is now benefiting from a more favourable environment. Bonds in this segment offer attractive yields, but it is important to remain selective.



Tapisserie, Four Seasons Hotel, Megève

This segment has had several difficult years, firstly because of the health crisis, then because of the conflict between Russia and Ukraine, and finally because of the rise in interest rates to counter inflationary pressures. The context is now more favourable. Interest rates are back on a downward trajectory and should gradually return to normal.

In addition, high-yield issuers should hold up well if the current soft landing scenario is confirmed. These issuers, who had stayed away from the credit market for some time, correctly anticipated the refinancing of the debt wall. Gross issuance, which fell to €15 billion in 2022, reached €45 billion last year and €75 billion this year (compared, historically, to €80 billion in a normal year). We expect the primary market to remain buoyant in 2025. This refinancing movement has resulted in a shift in bond maturities from 2024-2025 to 2029-2030, thereby reducing refinancing risk, at least in the short and medium term.

High-yield issuers should hold up well if the current soft landing scenario is confirmed.

Moreover, the default rate, even though it seems to be rising to around 3%, remains moderate and under control (except in the event of a recession, which would be very damaging for the high-yield market). It is true that some companies, such as Altice, Casino and Atos in France, have been forced to restructure their debt, but the difficulties they encountered were specific to their situation and did not generate a negative surprise effect that damaged the high-yield market as a whole.

HOW ARE YIELDS EVOLVING?

The overall yield on euro-denominated high-yield bonds is currently 5.5%, 1% above the average for the last ten years. The average coupon is rising as companies refinance and has reached 6.5% for all issues since the start of 2024 in Europe. In addition, high-yield bonds have relatively low sensitivity to interest rates, at around three years, which is lower than that of investment-grade bonds. For all these reasons, exposure to the high-yield segment has started to increase in asset allocations, especially as investors need to find alternatives to money market funds, whose yields are becoming less attractive as interest rates fall. In particular, there is a very strong appetite for bond carry strategies. Inflows into maturity funds, which enable investors to capitalise on current high yields, stand at €15 billion since the start of the year (all ratings combined), on top of the €25 billion in inflows in 2023.

Lastly, although average credit premiums are at 330bp, which is a rather low historical average, it is important to put this figure into perspective. Because of the lack of issuances in 2021 and 2022, the average maturity of the high-yield pool has become much shorter (implying a fall in the average maturity of euro-denominated high-yield bond indices), giving a lot of weight to short 1-3-year maturities, and therefore to very low-premium issues. On the other hand, new primaries in 2024 continue to offer very attractive premiums of close to 500bp on B ratings and 320bp on BB ratings.

HOW SHOULD INVESTMENT STRATEGIES BE GEARED?

Bear in mind that high yield is a niche universe – around 300 issuers for a total mass of debt in euros of €400 billion, compared with 900 issuers and €2.5 trillion for the investment-grade market in euros. Companies with this type of rating are more vulnerable to economic cycles, due to their smaller size and/or higher level of debt.

> In terms of sectors, there are huge disparities in performance, which we take into account in all our bond strategies, whether fixed maturity or short-dated.

We have therefore increased our exposure to the property sector, which had been hit hard by the rise in interest rates in 2022. Expectations of a rate cut, which have now come to pass, have breathed new life into the sector and enabled it to once again exhibit its defensive characteristics.

In our view, the performance potential of the sector, which remains at a discount, has not been exhausted, and some issuers could see their ratings upgraded.

We are also exposed to telecoms and pharmaceuticals, two traditional high-yield industries with high weightings. Both are by nature less exposed to the ups and downs of the cycle. We are keeping a close eye on all the sectors associated with new construction (materials, chemicals) in anticipation of a gradual rotation. These sectors are currently at the bottom of the cycle, but could benefit from the upturn in the property sector over the next few quarters.

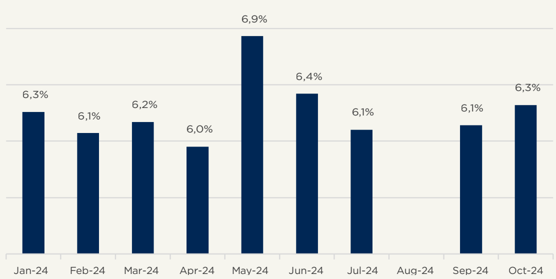
Lastly, we expect a strong return to mergers and acquisitions (M&A): favourable financing conditions and reasonable valuations in the mid-cap segment should encourage the return of private equity takeovers and the structuring of new leveraged buyouts (LBOs), while the need to remain competitive in certain regions and sectors (e.g. the automotive sector in Europe, see page 16) will encourage mergers and other strategic joint ventures. The US elections have been a catalyst, and spreads could be squeezed as a result.

Alexis Foret
Portfolio Manager - Head of High Yield,
Edmond de Rothschild Asset Management

All-in-Yield is above the 70th percentile

Sources : Bloomberg, Edmond de Rothschild

Euro High-Yield average coupon on primary YTD



Sources : Edmond de Rothschild, Bloomberg

AN OVERWHELMING NEED FOR RESILIENCE

After 30 years of «happy» globalisation, the world is a changed place post-pandemic, hit by geopolitical risk and plagued by daily cyber-attacks, with citizens seeking protection. The stock market outlook is particularly attractive for companies exposed to the security theme, which offer investors and the general public the resilience they so desperately need.

THE END OF THE ENCHANTED INTERLUDE

From the 1980s to the early 2020s, the world experienced what some might call an enchanted interlude. This cycle of some forty years saw the retreat of the great ideologies, the lowering of customs barriers, geopolitical warming and the acceleration of globalisation. In the West, we witnessed the rise of economic liberalism, the fall of the Berlin Wall and China's entry into the WTO.

Today, that period of détente seems a long way off. It goes without saying that the global environment has deteriorated. The rise of populism, the resurgence of politics, and geopolitical risk have all taken root in our environment.

This change will have major economic consequences, which is why it needs to be taken into account in the positioning of all investment strategies. Just as the cycle that began in the 1980s proved beneficial to companies that embodied happy globalisation (export industries, the fashion and luxury goods sectors, technology, leisure, etc.), the coming cycle will enable certain companies with very different profiles to outperform over the long term.

A NEW TYPE OF COMPANY FOR SUSTAINABLE PERFORMANCE

A number of trends already stand out as highly favourable. These include the rise in military spending and cybersecurity solutions. These two dimensions reflect the sustained rise in geopolitical risk and the inexorable growth in the need for investment. Looking at NATO alone, underinvestment in military equipment has reached $1.4 trillion over 30 years, compared with what was provided for in the organisation's founding charter. Similarly, the physical protection of individuals will benefit from sustained tailwinds. The same applies to demand for preventive healthcare solutions, namely equipment that can be used to deal with emergencies or sudden stress situations: vaccine production, molecular diagnostic equipment, etc.

> The current composition of financial indices embodies 30 years of "happy" globalization.

A common denominator among companies that will perform well will be their resilience, i.e. their ability to decide their own destiny irrespective of political, geopolitical and economic upheavals. Typically, these will be companies with a high level of vertical integration that are not overly dependent on imported components and generate a significant proportion of their sales in their home market. Their robustness will also depend on their proven financial strength, reflected in a low level of debt.

The current composition of financial indices reflects 30 years of «happy» globalisation, with a preponderance of exporting companies active in services and technology at the top of the rankings. Conversely, the weight of purely industrial companies has declined over the past 20 years under the yoke of competition from Asian countries. Resilient companies, on the other hand, have a relatively small presence in the top 100, which is why we believe their stock market prospects are particularly attractive. They are currently «under the radar» and relatively under-owned. Their ability to navigate the geopolitical context that is taking shape today will make them tomorrow's winners. There is still time to get in on the action!

Aymeric Gastaldi
Fund Manager, Edmond de Rothschild Asset Management

WHAT IF INFLATION WERE FINALLY BACK?

The widespread cycle of rate cuts by the main central banks has been a long time coming as it took a while to curb inflation and move closer on average to the magic 2% annual rise in the price index. Just when everything seemed to be under control, the election of Donald Trump as president of the United States reshuffled the deck. The protectionist measures announced in the form of punitive customs duties are reviving the spectre of economic warfare and the risk of a rebound in inflation at both national and international level.

TRUMP, A SUPPORT FOR THE DOLLAR

Long-term interest rates in the US began to rebound on 4 October in response to much higher-than-expected job creation (see chart 1). Such a figure implied a reduced need to support the economy with low rates and also the risk of renewed inflation through domestic consumption. Since then, the price index has rebounded from 2.4% in September to 2.6% in October. The new US president's plan to tax Chinese imports by 60% and imports from the rest of the world by 10% to 20%, to cut taxes and to reduce regulations is likely to push prices up again. The responses of the countries affected on the economic war front should have a similar effect internationally. The extent and duration of the general cycle of monetary easing is therefore being called into question, first and foremost in the United States. Even though Jay Powell has confirmed the independence of the Federal Reserve in the face of Donald Trump's desire for control, the better-than-expected health of the economy and the rebound in the price index justify a pause in the cycle, or even an upward revision of the final rate target. The positive effect this has had on the US dollar's carry is giving it solid medium-term support on the currency markets against most other currencies.

YEN UNDER PRESSURE DUE TO POLITICAL INSTABILITY IN JAPAN

This situation poses a major problem for the Bank of Japan, which is in the midst of a credibility crisis at a time when the country is facing its most serious political crisis in 15 years. The Liberal Democratic Party, which has ruled the country since the post-war period, has lost its majority in the House of Representatives against the backdrop of a financial scandal, and the newly appointed prime minister, Shigeru Ishiba, finds himself unable to act. Without political stability, the yen is losing much of its appeal as a safe haven for international investors. Lastly, the central bank is reluctant to raise its key rate despite an upturn in inflation, given the fragility of the Japanese economy. The clear risk of the yen depreciating beyond the level of 155 yen to the dollar should prompt the Bank of Japan and the Ministry of Finance to intervene on both interest rates and the foreign exchange market, to prevent a plunge in the yen from further damaging a faltering economy.

EURO REMAINS IN ITS CHANNEL, SWISS FRANC LIKELY TO REMAIN STABLE

In Europe, the context remains much different, with a rate cut justified by the fragile economy and the ECB able to make such a cut now that inflation is under control. All of which would favour a fall in the EUR against the USD. And yet, in her «step-by-step» policy, Christine Lagarde has cast doubt on the ECB's next decisions, suggesting that a pause is not out of the question. This stance is keeping the EUR/USD parity in its fluctuation channel between 1.0450 and 1.10.

The positive effect this has had on the US dollar's carry is giving it solid medium-term support on the currency markets against most other currencies.

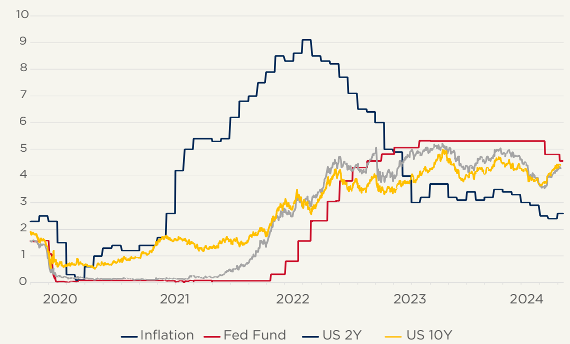
In Switzerland, the SNB is not concerned about the rebound in inflation, with the index falling to 0.6% in October (see chart 2). On December 13, the SNB reduced its key rate by 0.5%, lowering it to 0.5%.The relative strength of the Swiss franc also supports a further fall in rates to reduce the attractiveness of the Swiss currency, other than as a safe haven. Enough of a cut to prevent a surge in the franc, but not enough to allow a sustained fall. All signs point to a degree of stability close to current market levels.

CATALYSTS FOR GOLD PERSIST

Finally, gold is suffering from the rise in US interest rates, but should remain supported by the tense geopolitical environment, regular purchases by BRICS central banks and its diversifying effect in a market subject to inflation risk.

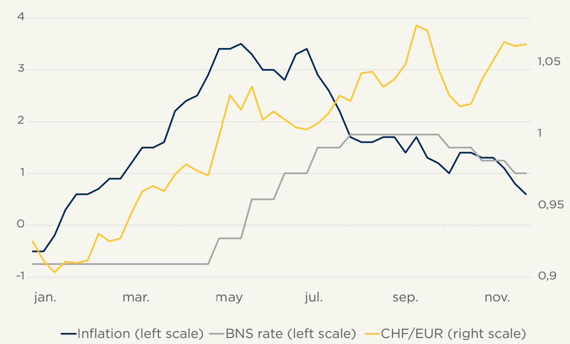
Jean-Marc Guillot
Trésorier Groupe

Inflation & interest rates



Sources : Edmond de Rothschild, Bloomberg

SNB & inflation



Sources : Bloomberg, Edmond de Rothschild