EDMOND DE ROTHSCHILD

MARKETING COMMUNICATION

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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WHAT HAS HAPPENED TO THE MARKET UPSIDE?

BENJAMIN MELMAN
Global Chief Investment Officer, Asset Management

Last May, our overweight was focused on both US and European equities, with a preference for the Big Data, healthcare and European small caps sectors.

On the fixed income markets, we decided to maintain our overweight, especially as oil prices had begun a downward correction that weighed on inflation expectations.

At present, signs of economic weakness are multiplying in most G20 countries.

AT FIRST SIGHT, THE ENVIRONMENT HAS BECOME MUTED

Risk asset valuations (equity risk premiums, credit spreads) are generally not attractive. The economic environment is slowing in most of the G20 countries (soft landing), with two weakest links: Germany – which is facing an economic crisis combining cyclical and structural issues with a contraction in domestic demand, and China – where the economy remains weaker than expected. In the United States, the speed at which the labour market has weakened is causing some concern, sustaining the debate on the risk of recession. NVIDIA's earnings may signal the end of accelerating spending on artificial intelligence (AI) which had spurred the stock market frenzy. While AI holds great promise for future productivity gains, we see little evidence of this so far even within the best positioned companies. Political uncertainty has continued to rise as the US election draws nearer (the key risk in our view is the impact of Donald Trump's programme on inflation). France and Germany are facing the risk of greater political standstill despite the urgent need for action (respectively on budgetary and economic matters).

BUT THERE ARE SIGNS OF HOPE

Will the Fed come to the rescue?

All eyes are on the US labour market which is weakening at an unusually fast pace and is starting to worry investors and the Federal Reserve - to be expected considering the Fed's dual mandate. Jerome Powell's Jackson Hole speech has opened many possibilities for monetary policy: employment has become the top priority, now that inflation is virtually ancient history. Rate cuts could, potentially, be considerable. According to the Federal Reserve's dot plot, the long-term (or neutral) rate would stand at 2.75%, 2.5% above current levels. If inflation is no longer a concern and the Fed wishes to revive the labour market, a return to the neutral rate – or even below – could be feasible. However, political uncertainty will be a hurdle for the central bank. For example, if Donald Trump wins the election, will he go ahead and apply his inflationary programme? It seems highly possible that the Fed would choose to cut its rates proactively before the end of the year, possibly further than markets are expecting today, to ensure it does not lag the business cycle. It would then take a more cautious stance next year while it assesses the country's new economic policy. However, such a scenario is far from a foregone conclusion, judging from the statements made by members of the central bank.

Employment is rear-view mirror, rather than a leading indicator

Nevertheless, employment is not a leading indicator for the cycle; at best, it is concomitant, and its deterioration has not been corroborated by economic indicators (according to the Nowcasts, growth is around 2% in Q3). So, the core issue for the US economy appears to be readability rather than actual direction. Furthermore, resilient corporate margins have failed to indicate any restructuring mechanisms that would herald a cycle of redundancies. We feel that recession risks should maybe be relativised, particularly as the credit tap is loosening.

The return of the credit impulse

Both in the United States and in Europe, as a corollary to monetary tightening, banks drastically restricted their lending standards and a contraction in bank credit was observed on either side of the Atlantic. Indeed, with the return of high interest rates, deposit banks - which had been starved of the opportunity in recent years - were able to restore their profitability without needing to take any considerable credit risk. The prospect of rate cuts and the absence of a recession have now prompted banks to resume their lending. The shift from a negative to a positive credit impulse will act as a tailwind for the economy.

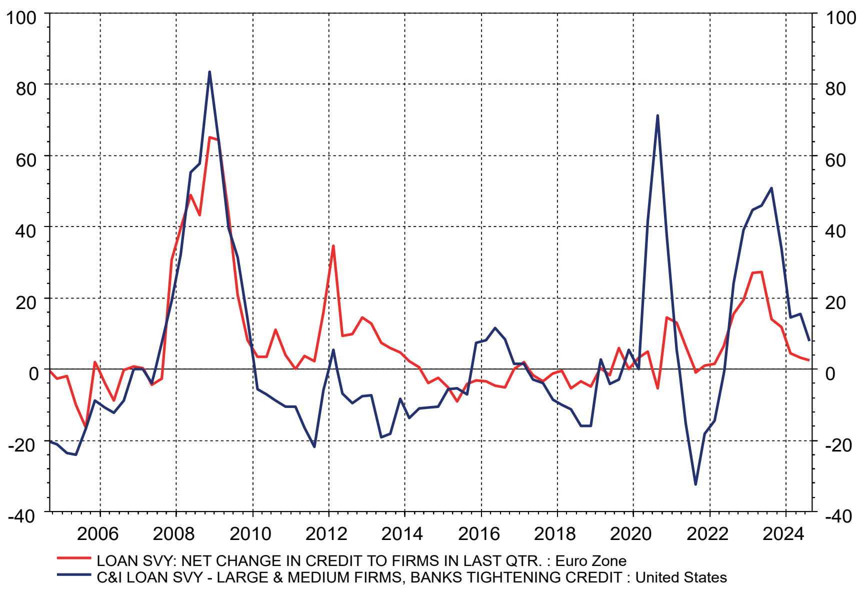
EMERGING COUNTRIES STAND OUT

Torn between the Fed's sharp tightening of monetary policy and the slump in China, investors have naturally steered clear of emerging markets for some time now. But times are changing. The Fed has entered a new cycle. And while the situation in China remains challenging, the gradual absorption of the property crisis does suggest that the worst of the turnaround may be behind us. Furthermore, now that several developed countries appear to have lost control of their national finances (United States, France…) and are facing rising populism – which is unlikely to offer viable solutions, emerging countries have for the most part stayed loyal to the "Washington consensus" (orthodox economic policy toolbox), with some countries such as Argentina or Turkey now actively implementing policies that will help restore their position.

INVESTMENT POLICY

These markets therefore offer potential upside but in light of the many uncertainties, our directional strategy is largely neutral today, and we are tactically lowering the weight of equities. The main regional bias within our asset allocation is an overweight on emerging countries - China excluded as far as equities are concerned, though our view on the Chinese market is not negative. Within our equity exposure, we remain overweight European small caps, as we believe that while the economic environment is currently rather unpromising, the looser lending conditions and the ECB's rate cuts will support a rerating. Our preferred themes remain big data and healthcare to ensure we are well positioned in the slowdown.

Banks are still tightening their lending conditions, but much less so than in 2023



Source: LSEG Datastream/ EdRAM

*The credit impulse was first introduced in 2008 by Michael Biggs, then an economist at Deutsche Bank. This economic indicator measures the acceleration or deceleration of the flow of new credit into an economy, and its impact on growth. Unlike the simple total volume of credit, credit impulse focuses on new loans granted in a given period, and compares this variation with GDP.

	Our convictions*	Changes compared to the previous month
ASSET CLASSES		
Equities	-	↓
Fixed Income	=	↓
Dollar	=	→
Cash	=	↑
EQUITIES		
US	=	→
Europe (ex-UK)	=	→
UK	=	→/★
Japan	=	→
China	=	→
Global Emerging	=	→/★
SOVEREIGN BONDS		
US	=	↓
Euro Zone	=	↓
Emerging Markets	+	→
CORPORATE BONDS		
US Investment Grade	+	→
Euro Investment Grade	+	→
US High Yield	=	↓
Euro High Yield	=	↑

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 12/09/2024.
★ Tactical score.

TO SUM UP

In light of the many uncertainties, our directional strategy is largely neutral today, and we are tactically lowering the weight of equities.

However, we overweight our equity exposure to emerging countries, excluding China.

We are focusing on the big data and healthcare sectors to ensure that we are well positioned during the slowdown.

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

47, rue du Faubourg Saint-Honoré, 75401 Paris Cedex 08

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www.edmond-de-rothschild.com