EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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SHORT-TERM RISKS, MEDIUM-TERM PROSPECTS

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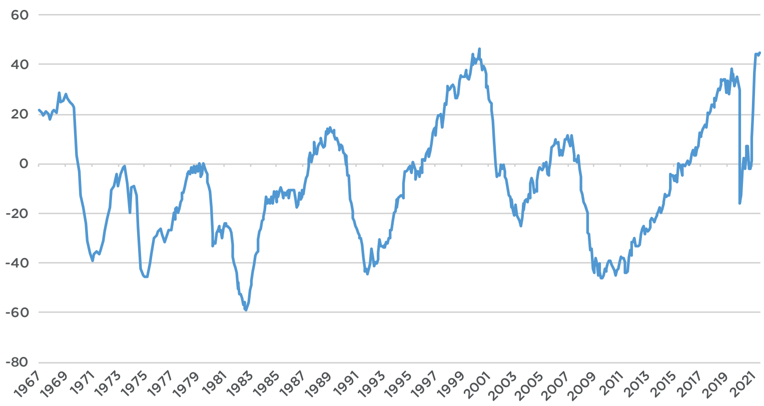
SOLID EARNINGS GROWTH

Global economic growth remains very robust, and the momentum is expected to continue. With the Q3 earnings season having begun, and despite the unexpected and significant pressure on production costs, notably due to the soaring energy prices, it is remarkable to see the very few warnings, suggesting that corporate margins are holding up well. The likely reason for this is that in a strong growth environment analysts tend to underestimate the effect of operating leverage on profits, and this effect therefore offsets the impact of the rise in costs. Support for earnings growth is therefore to be expected in the foreseeable future. And this is likely to continue to be the case, which is interesting in a context in which analysts are expressing a great deal of caution going forward, with EPS growth expectations for 2022 for the main developed markets at around 7%, below the traditional 10%. This provides a basis for reasonable optimism.

INFLATION JITTERS SET TO BE MITIGATED

The continued rise in energy prices and prolonged capacity constraints spark doubts about the transitory nature of inflation. These questions are gaining traction and many central banks, such as the Bank of England, are now communicating on a faster-than-expected rate hike cycle. The Fed and the ECB, which recently changed their inflation targets, notably to avoid having to react automatically when inflation temporarily rises above 2%, are not rushing their agenda. For the time being, the main indicators show that there is no de-anchoring of the long-term inflation expectations of either economic agents or investors, justifying the current assessment of transitory inflation and therefore the inertia of the two large central banks. However, the longer inflation continues in the short term, the greater the risk of de-anchoring of long-term expectations - like what happened with the UK inflation-linked bonds - and hence greater fears of a rapid tightening of monetary policy. Without a doubt, short-term energy prices will continue to play an important

NEAR-RECORD OPTIMISM OF AMERICANS ON EMPLOYMENT



Americans' perceptions of the labour market.
Source: Conference Board, Bloomberg. Data as of 27/10/2021.

role and investors will turn their focus to the next OPEC Plus meeting on 4 November to determine whether oil supply can be increased, as well as to the ongoing negotiations for putting the Nord Stream 2 pipeline - which will link Russia to Germany circumventing the Ukraine - into operation. The market analysis indicates that investors are currently anticipating that inflation will be temporary. Persistent inflationary pressure could therefore lead to more volatility. In the belief that both the Fed and the ECB will seek to delay action as much as possible, we are not changing our asset allocation for the moment, but will remain sensitive to this issue.

SIGNS OF A LULL IN CHINA

While Evergrande's situation continues to be hazy, the authorities are beginning to communicate on the commitment of financial institutions to maintain “reasonable” financing for developers and buyers, while the central bank has somewhat eased its policy of injecting liquidity. While it is impossible to draw any conclusions from these few new communications, that authorities are seeking to reassure and prevent the situation from deteriorating further is at least something positive. In other words, the Chinese economy remains a potential risk to global demand, but the good news is that the authorities are taking into account the dangers and reacting.

A BALANCED ASSET ALLOCATION

Within our asset allocation, in September we reduced the weight of European equities in favour of US equities, due to the higher sensitivity of Europe to Chinese uncertainties. We therefore have little geographical bias, with the exception of an overweighting of Japanese equities, which could benefit from the global recovery and a depreciated yen, and we continue to favour our main post-Covid themes: Big Data, healthcare, the energy transition and human capital. Our underweighting in bonds is a portfolio construction: we believe that there are more opportunities in equities than in bonds, and that at present the risks for both asset classes are the same (inflation, shift in the policy of the main central banks), reducing the ability of the bond market to diversify allocations. Financial and high yield bonds are still as attractive, in our view, especially for their carry.

	Our convictions*	Changes compared to the previous month
ASSET CLASSES		
Equities	=	→
Fixed Income	-	→
Cash	+	→
EQUITIES		
US	=	↑
Europe (ex-UK)	=	↓
UK	=	→
Japan	+	→
China	=	→
Global Emerging	=	→
Convertibles	=	→
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).

KEY POINTS

Overweight Japanese equities

Preference for post-Covid themes

Attractiveness of financial and HY bonds

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