EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS
AND PRINCIPAL INVESTMENT THEMES

MAY 2023

SOLID MARKETS IN A FRAGILE ENVIRONMENT

BENJAMIN MELMAN
Global Chief Investment Officer, Asset Management

► The equity markets have risen sharply overall since the start of the year, but this solidity is not what it seems when analysed, given that these surges are so focused on a few large caps in the US (and, to a lesser degree, in Europe). Although the S&P 500 index has gained more than 8% since the start of the year, its equal weighted version made zero gains, indicating an intrinsic fragility that is partly due to company earnings, but also to macro-economic uncertainties.

CENTRAL BANKS' LIQUIDITY SHOULD CONTRACT

The economic environment admittedly seems buoyant as activity and inflation are slowing relatively slowly in the US as well as Europe, where jobs and wages have retained their momentum. First quarter company profits were also ultimately higher than expected, especially in Europe. That being said, the tougher bank lending conditions and decreased credit demand indicated by the Fed and the ECB surveys, and the fall in the German ZEW survey for the third consecutive month, leave little room for doubt about the coming deterioration of the economic environment. The question of a recession, which is on everybody's lips and has so far been postponed, has therefore yet to be answered.

The risk of a banking crisis in the US is contained, but the situation is still delicate: as American regional banks continue their impressive fall on the stock market, bank deposits are eroding but not collapsing. Likewise, CMBS[1] spreads may be widening, commercial real estate being identified as a significant risk factor, but for the moment the crisis seems to be unfolding without too many shocks.

Central banks' liquidity is set to contract: as US banks are no longer using the Fed's facilities, and in view of the US Treasury's very limited reserves with the Fed, bank reserves should start trending downwards again as a result of quantitative tightening. At the same time, the ECB is starting its own quantitative tightening process, and the Bank of Japan no longer needs to increase its balance sheet to maintain its yield curve control policy as the Japanese bond markets are stabilising.

1. A commercial mortgage-backed security (CMBS) is an instrument that securitises commercial mortgage loans.

TENSIONS AROUND THE RAISING OF THE US DEBT CEILING

The issue of the debt ceiling is a cause of short-term tensions that the markets will be relieved to see resolved. We are not expecting the US to default, but we can't completely rule out this unlikely eventuality. As mentioned above, an increase in the debt ceiling will also prompt the replenishing of the Treasury's reserves with the Fed, which will put pressure on bank reserves. Good news could therefore be followed by bad news.

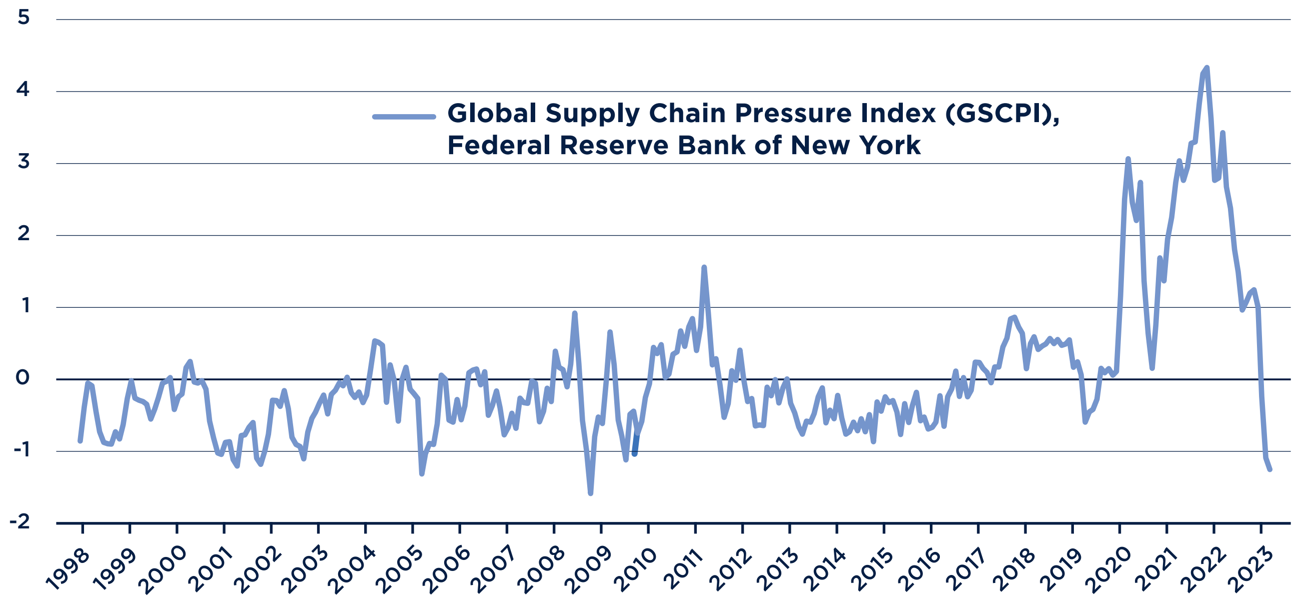
All in all, at the moment there is no reason to change our fairly prudent equity market exposure, but we wish to stay invested overall as, in this deteriorating environment, some good news can also be found that could have a positive impact if confirmed. This includes better inflation figures in the US for April, confirming the start of a slowdown of core inflation (inflation excluding energy, food and rent). Although it is too soon to draw conclusions, it seems possible that this trend will continue. Firstly, energy, soft commodity and freight prices are dropping sharply, pressures on production chains have fallen to a record low, and the most forward-looking leading indicators (such as temporary employment, which is contracting) suggest that the job market is set to deteriorate, which could help to normalise wages.

We are therefore taking advantage of the recent rise in yields to increase the bond weighting in our portfolios, as if the disinflation trend does indeed continue in the US the bond markets will benefit from this and will offer protection if the need arises (unless inflation takes off again, which we think is unlikely). Chinese equities, which are still volatile, remain a source of

	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	=	→
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). Ratings at 15/05/2023.

RECORD LOW PRODUCTION CHAIN TENSIONS



Sources: Bureau of Labor Statistics; Harper Petersen Holding GmbH; Baltic Exchange; IHS Markit; Institute for Supply Management; Haver Analytics; Refinitiv; authors' calculations.

extra performance in our view, as the recovery is taking hold and the social situation, exemplified by the very high rate of unemployment in young people, is leaving the government with no choice but to ensure that the economy picks up. We believe that the main risk factor is still geopolitics. Our preferred themes remain healthcare, Big Data that takes full advantage of the artificial intelligence revolution, and human capital. In the bond allocation, we are maintaining a diversified approach to ratings, while prioritising quality.

KEY POINTS

Slight prudence with regard to equities

We are increasing the bond weighting in our portfolios

Chinese equities, although erratic, may still offer some pleasant surprises

Our preferred themes remain healthcare, Big Data that takes full advantage of the artificial intelligence revolution, and human capital

EDMOND DE ROTHSCHILD ASSET MANAGEMENT (FRANCE)

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

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