EDMOND DE ROTHSCHILD

PRIVATE BANK

INVESTMENT LETTER

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Jean de Florette

In the early 20th century, when the hunchback Jean de Florette moved from the city to upper Provence to take possession of the farm he inherited, he didn't suspect that his neighbors, the Soubeyrands, had secretly obstructed the water source he needed to cultivate his land. By depriving him of resources, the Soubeyrands hoped that Jean would sell his farm to them for next to nothing.

But Jean continued to search desperately for the famous spring that he knew was somewhere on his land, until it cost him his health, and then his life. After his death, the Soubeyrands eventually recovered the land and unblocked the spring right in front of the hunchback's daughter, Manon des Sources, who discovered the Soubeyrands' criminal underhandedness. Manon unexpectedly ends up getting revenge for her father's death.

Claude Berri's 1986 film adaptation of Marcel Pagnol's novel brings a contemporary resonance to the importance of vital resources in any business endeavor. In upper Provence, the necessary resource is water. In economics, the primary resource is dollar liquidity. The US dollar is the source with which companies around the world can trade with one another.

Commodities, in particular (oil, wheat, soybeans, iron, etc.) are sold in dollars. No country is fully autonomous in terms of its commodity needs. Therefore, they must all have foreign exchange reserves in dollars so that their local businesses can carry out international trading via their banks.

Without a spring, Jean de Florette's land is uncultivable and practically worthless, and his life a living hell. In the same way, business gets increasingly complex when the availability of US dollars declines.

The US central bank is the only organization in the world that can create dollars. If you aren't the United States, there are only two options for accumulating foreign exchange reserves:

1- Sell goods and services abroad and get paid in dollars

2- Raise dollar debt with investors who have an excess savings in this currency and are willing to lend them to you

However, in order to implement solution number two, you will need to have put solution number one in place first, even if only to handle the interest repayments of the debt and capital, and even more importantly, so that creditors are reassured by your solvency and agree to lend to you.

Getting dollars out of the US, therefore, is a major issue for every country around the world. The more dollars leave the US and circulate throughout the rest of the world, the more dynamic and fluid world trade is.

So, to move dollars out of the United States, you simply have to export to the United States and get paid in dollars.

The ‘94 tequila crisis in Mexico and the ‘97 Asian crisis are painful memories that have led many countries to adopt mercantilist policies meant to ensure a steady flow of dollars into their national territory. To do this, countries must increase their competitiveness.

This usually leads to a policy wherein:

- wage income growth is maintained at a lower level than productivity,
- flexible labor markets result in more nimble companies, forcing employees toward precautionary savings in order to mitigate the uncertainty of the future,
- legislation is investment-friendly (jurisdiction that is favorable towards companies, low corporate tax rates, and administrative flexibility in terms of hirings and layoffs).

The application of such a policy has the effect of:

- encouraging savings at the expense of consumption,
- fostering business investment
- reducing structural unemployment
- increasing exports while reducing imports,
- lowering inflation, interest rates, and dependence on external financing

China (until recently), Germany, Northern European countries outside the Eurozone, Japan, and Southeast Asian countries are among those that have opted for this policy.

In recent years, they have outsourced large surpluses to the rest of the world and accumulated considerable foreign exchange reserves, making them much more resilient to contractions in dollar liquidity.

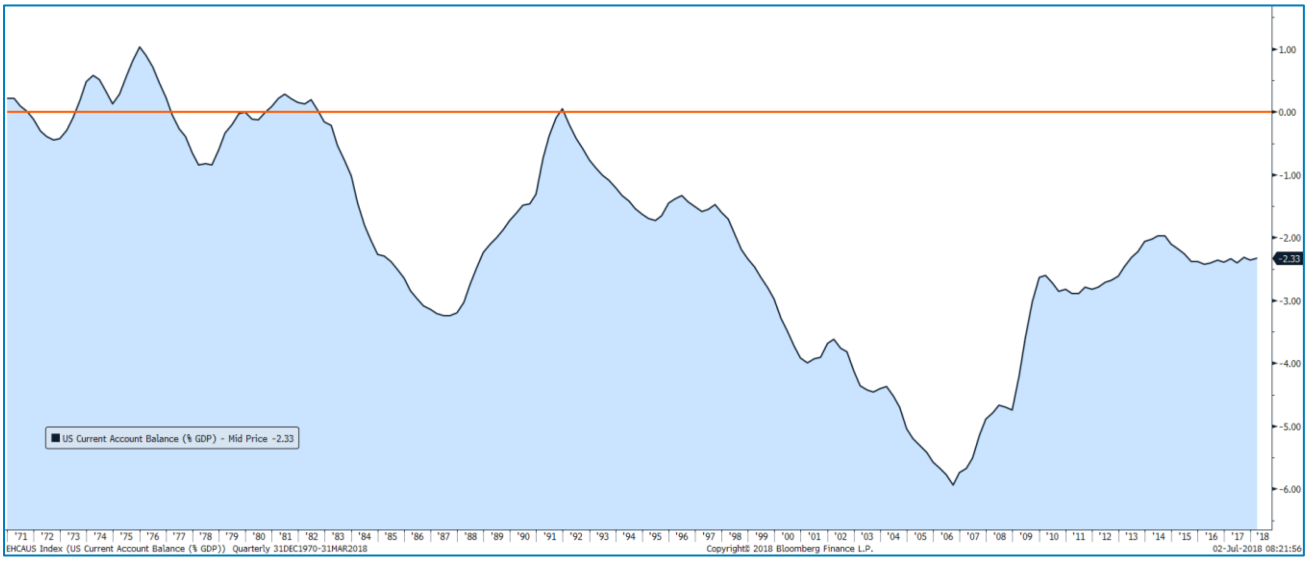
These policies have always had a certain economic success on paper, especially in terms of reducing unemployment. The flip side is that people don’t see their purchasing power grow at the same pace as the country's growth, which ends up creating wealth gaps within a nation's population. If these differences persist, a major political event has the potential to occur sooner or later.

The undeniable truth of accounting

One of the unbreakable national accounting rules is that the sum of the current balances of all countries in the world equals 0.

In other words, if a country has a current account surplus, it means that another country has a current account deficit of the same magnitude.

The United States, which has the "exorbitant privilege[1]" of owning the international reserve currency, served as an adjustment variable for the implementation of these policies by accepting a persistent current account deficit for many years. In doing so, it made the dollar essential, and the world dependent on its currency.



Evolution of the current account balance of the United States as a percentage of GDP: a near-permanent deficit. Source: Bloomberg, Edmond de Rothschild (Monaco).

<u>What happens when dollar liquidity declines</u>?

This is the situation we are currently faced with. Dollar liquidity has become more expensive for borrowers because of the rise in US interest rates, and it is becoming rarer because of:

1- the United States' desire to launch a trade war against the countries with the highest current account surpluses, and the introduction of customs duties
2- the rise in commodity prices

The result that these two phenomena have on the rest of the world is that more dollars are needed to purchase the same goods and services.

<u>The decline of globalization and a changing world order</u>

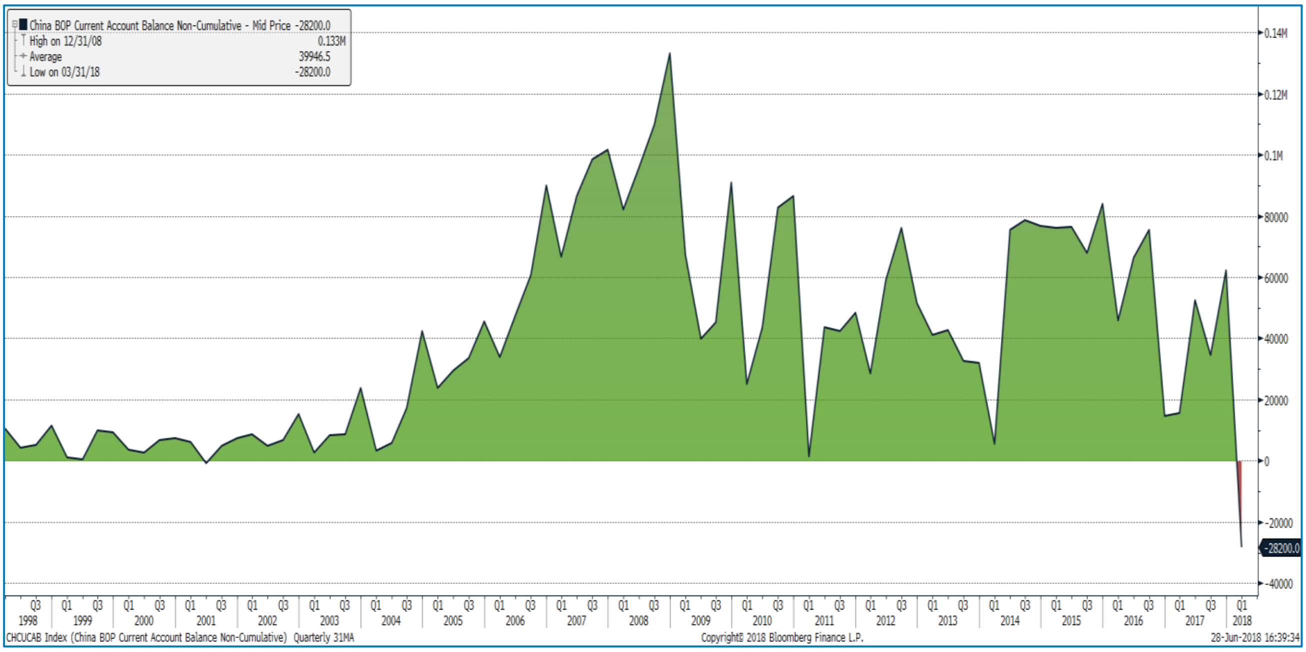
In the long term, the mercantilist policies described above have a tendency to create income inequality within a population. Feelings of injustice, resentment, and irritation from foreign trading partners spread slowly through the populations and sometimes lead to the overthrow of the established order.

[1] Expression attributed to Valérie Giscard d'Estaing in 1960, then the French Minister of Finance.

After Brexit and the election of Donald Trump, Italy elected an anti-European government. The world order is changing, bringing its share of uncertainties and tendencies toward isolation.

The United States' bitterness towards its partner countries (that have had structural trade surpluses for years) is palpable. On this basis, China, Germany, Canada, and Japan stand out as designated enemies in the event of a trade war.

No one wins a trade war, but in the end a new superpower eventually emerges and wins because its currency ends up financing the world. In the 18^{th} century, it was France; in the 19^{th} century, it was England. After the world wars, the Marshall Plan made the United States (and the dollar) the dominant power. The superpower in such a situation is obligated to live with a permanent structural current account deficit. The United States doesn't want to live with it anymore. Is it a sustainable position? Which country will dominate the 21^{st} century? The question remains unresolved, but it is interesting to note that China has just recorded its first current account balance deficit in 20 years. It should also be noted that China has signed an agreement that allows Russia to buy oil in yuan, and that the Asian zone is increasingly financed in yuan at the expense of the dollar.



Evolution of Chinese current accounts: first deficit since 2001. Source: Bloomberg, Edmond de Rothschild (Monaco).

If the United States refuses to live with systematic current account deficits, the dollar's hegemony will not endure, and a new international reserve currency will emerge. As such, the yuan (despite a 2% decline against the dollar since the beginning of the year) is an ideal candidate. This transition takes time, and on a financial level it would result in greater volatility with regard to asset prices.

In any case, the rise of a new currency with the potential to eventually acquire the status of international reserve currency is excellent news for emerging countries.

Investment Strategy

Despite fairly robust economic growth around the world, financial markets are faced with the fear of declining dollar liquidity worldwide. Rising Fed rates, rising commodity prices, a latent trade war, and political risks have characterized the financial environment over the first half of the year.

This is manifested in the negative performance of equity and bond markets around the world, with the exception of US assets which are benefiting from the positive effect of repatriating capital to the dollar zone.

"Only when the tide goes out do you discover who's been swimming naked". This Warren Buffet quote perfectly illustrates the current situation wherein investors are liquidating positions they consider most at risk in order to repatriate funds to the United States. Which means a drastic decline in emerging assets, a decline in Italian bonds and a rush to safe assets such as the yen, German and US government bonds, and technology stocks from across the Atlantic.

In the "every man for himself" movement that we witnessed in May and June, the most liquid assets were initially sold off. Thus, with regard to emerging countries, the Brazilian and Mexican markets—despite having healthy current account balances—underwent brutal adjustments at a time when the financial community was more worried about Argentina (which was asking for help from the International Monetary Fund) and Turkey.

After the drop of bond market prices (and the increase in interest rates and credit spreads), valuations returned to balanced, long-term levels. In any case, our opinion on short maturities remains unchanged. We prefer credit risk over duration risk, i.e. short-term corporate bonds over long-term government bonds.

On equity markets, only US stocks posted positive performances in the first half of the year. This positive performance can be attributed to a dozen heavyweight technology and consumer discretionary stocks (particularly Apple, Amazon, Microsoft, Facebook, Alphabet, and Netflix); the rest of the values display rather negative performances.

Whether or not these values will continue to outperform will also depend on the US-China negotiations on tariffs, intellectual property rights, and technology transfers.

In the second half of the year, asset price direction will be determined by interest rates, oil, and the dollar. If the combined rise of these three elements continues, dollar liquidity will become more expensive and even more scarce, which would put pressure on emerging assets as well as on the equities and bonds of international companies that make a large part of their revenue in this area. On the other hand, any easing on dollar liquidity pressure would be positive for asset prices.

As you can see, visibility has considerably decreased in the first half of the year. Volatility is likely to persist and domestic policy decisions will have a real impact on financial markets.

Caution is warranted. While we still prefer equity markets to bond markets, we must be responsive and prudent in the second half of the year in terms of maintaining a short duration in bond positions and a geographical focus on the United States (the source of dollar liquidity).

In the long term, within a context of “deglobalization”, the United States and the dollar run the risk of letting the yuan emerge as the international reserve currency. A good reason to favor Asia within asset allocations in the coming years.

“With a second reservoir, it will be much better.” Jean de Florette

Sébastien Cavernes
Chief Investment Officer

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EDMOND DE ROTHSCHILD (MONACO)
Les Terrasses – 2 avenue de Monte-Carlo
BP 317 – 98 006 Monaco Cedex
MONACO
T. +377 97 10 47 47
www.edmond-de-rothschild.mc