Monthly Letter

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Economic environment

After a hectic month of October, stock markets have recently recovered on the hope that the negative factors which battered the global economy earlier this year will eventually fade and allow a re-acceleration of the investment cycle as business confidence improves. That said, the latest leading economic indicators are mixed. Admittedly, the Markit business confidence index in the service sector improved slightly in October, buoyed by robust labor markets in most countries. However, this improvement was partly offset by the ongoing slowdown in the manufacturing sector, still impacted by the negative effects of the trade measures implemented by the Trump Administration and the weaker outlook for some key emerging countries.

The tightening of financial conditions also explains the deterioration of business confidence. The desynchronization of the global economy – reflected by strong growth in the US, but more modest in the rest of the world – makes US monetary policy all the more penalizing as it affects countries forced to adopt its restrictive aspects, without being justified by the strength of their own domestic economic activity. The Fed remains firmly convinced that it must continue its monetary normalization, adopting an autopilot approach. What's more, a majority of Fed members believe that monetary policy will have to be brought to a restrictive level in the coming quarters, a decision that is obviously not without risk. While a healthy labor market and a robust economy are all factors that may justify this position, the weakness of inflation expectations and the flattening of the yield curve nonetheless bring to mind the considerable uncertainty surrounding the concept of a "neutral" Fed fund rate. Therefore, the risk of a monetary policy mistake should not be underestimated.

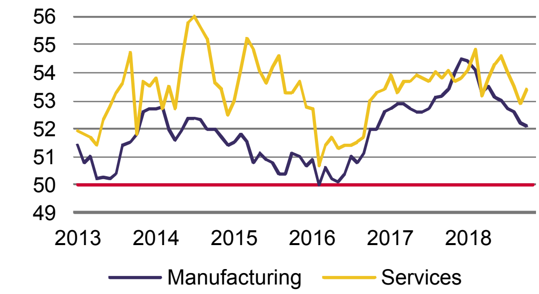
Paradoxically, the trade war supported China's growth in Q3 2018. Indeed, export growth was strong as many US companies decided to significantly increase their inventories in anticipation of a trade war, the outcome – and duration – of which remains uncertain. Yet, this support, most certainly temporary, cannot completely disguise the wider economic slowdown, reflected first and foremost in the Chinese manufacturing sector where the deterioration in business confidence is evident. For now, the effects of the measures adopted by the Chinese authorities to support the economy are slow to be felt and further adjustments are likely be made in the coming months. That said, the room for maneuver, particularly with regard to the use of credit and debt, is not unlimited in a country where the debt service ratio in the private sector has reached new heights. The depreciation of the

Performances in local currency

		Price as of 10/31/18	1 month % change	2018 % change
Equity markets				
	CAC 40	5 093	-7.3%	-4.1%
	Eurostoxx 50	3 198	-5.9%	-8.7%
	S&P 500	2 712	-6.9%	1.4%
	Nikkei 225	21 920	-9.1%	-3.7%
Currencies				
	1 € = ...USD	1.13	-2.4%	-5.6%
	1 € = ...JPY	128.15	-2.3%	-5.1%

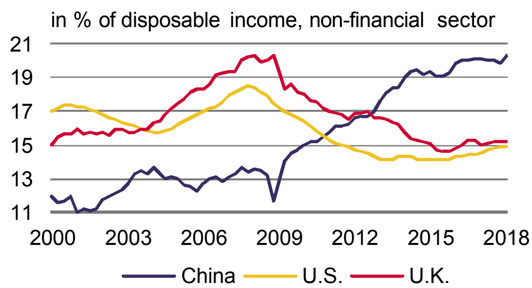
		Price as of 10/31/18	1 month bp	2018 bp
Government bonds				
3 M	Eurozone	-0.76%	-20	2
3 M	United States	2.33%	13	95
10 Y	Eurozone	0.39%	-9	-4
10 Y	United States	3.14%	8	74

World – Markit business confidence index



Source Datastream, Rothschild & Co Asset Management Europe

World – Private debt service ratio

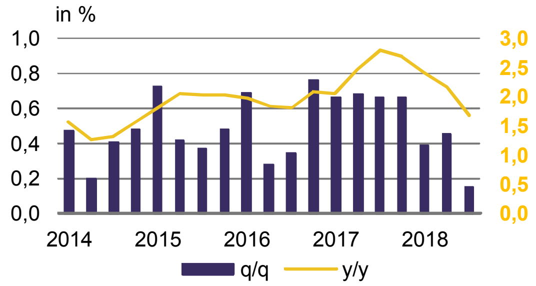


Source Datastream, Rothschild & Co Asset Management Europe yuan is also a tool likely to be used to support the economy, but the decline in foreign exchange reserves since the beginning of the year (-100bn USD), especially in the last three months, reminds us of the limits of its use.

In the Eurozone, economic growth in Q3 2018 (0.2% q/q) was rather disappointing. On the one hand, Spain (0.6%) remains, once again, one of the main drivers. French GDP (0.4%) rebounded thanks to the end of strikes in the rail sector, but it was also supported by business investment. The results in Germany and Italy, however, will have largely disappointed. Although German statistics will only be available in mid-November, growth has most likely been very weak, if not negative. That said, temporary factors explain this underperformance: the German economy has suffered from the weakness of vehicle production, while manufacturers had to adapt to the new pollution emission assessment procedures.

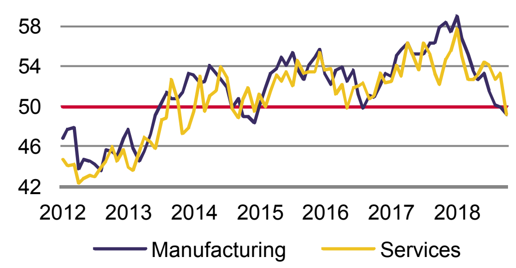
In Italy, on the other hand, the situation is becoming more and more worrying. Since the formation, last spring, of a populist government, the country has registered a marked economic slowdown. GDP stagnated in Q3 2018 – the worst performance since 2014 – and business confidence reached an almost five-year low. In fact, the Italian Markit index fell below 50 in October, thus in contraction territory, and therefore a further stagnation of GDP in Q4 cannot be ruled out. In fact, the expansionary fiscal policy pursued by the Italian government, and the widening of the fiscal deficit that accompanies it, may not produce the desired recovery, or even trigger recessive effects due to interest rate developments. Indeed, the rise in sovereign rates may affect the refinancing costs of banks in a context where the banking-sovereign link remains unbroken. Correspondingly, the cost of credit would increase and the distribution of loans to the private sector falter, with a depressing effect on domestic demand. In addition, political uncertainty is likely to create a wait-and-see climate, which may lead increased in precautionary savings by households and a delay in business investment. In the end, the confrontation between the Italian government and the European Commission is likely to continue and ultimately the latter could be forced to start an Excessive Deficit Procedure, resulting in financial penalties of up to 4 bn euros.

Eurozone – GDP growth



Source Datastream, Rothschild & Co Asset Management Europe

Italy – Markit business confidence index



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