# Monthly Letter

March 2019

## Economic environment

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Following the debacle seen in Q4 2018, the financial markets continue their ascent. Current investors optimism is not based on macroeconomic data, seeing as the global expansion continues to lose momentum, primarily in the manufacturing and industrial sphere. The Markit manufacturing business confidence index remains in a downtrend, with many countries – Germany, Spain, Italy, Japan, China, Taiwan, South Korea – now below the 50 threshold, in contraction territory. Rather, three pillars have been underpinning the bullish view: the hope surrounding the appeasement of geopolitical risks, the effectiveness as well as the magnitude of the measures put in place by the Chinese authorities and the Great Retreat by central banks, namely the Fed. However, investors will have to determine whether financial markets have yet fully discounted the extent of the weak data or whether the data will recover and align with the signal from markets. Meanwhile, the bond market remains circumspect as evidenced by the still flat US yield curve, as well as the low level of interest rates in Europe and Japan.

The appeasement of geopolitical risks is most visible in the US-China tariff truce. Indeed, in light of the progress made in recent discussions, the two countries could soon reach a preliminary trade agreement. The official signature could come during a visit by Chinese President Xi Jinping to the US in late March and would be a symbolic victory for US President Donald Trump, especially after the failure of his summit with North Korean leader Kim Jong-un. On the other hand, some obstacles remain, including the mechanism for monitoring and enforcing Chinese promises, first and foremost the clauses on the protection of intellectual property and China's openness to foreign direct investments. That said, other geopolitical risks remain. Uncertainty about Brexit may not dissipate for several months as the UK Government seems resigned to asking for an extension of Article 50. What's more, the question of the trade relationship between the European Union and the US could return to the front of the stage. The US Department of Commerce released its report on February 17, opening a three-month cooling-off period during which President Trump will have to decide whether to implement his threat to raise tariffs in the auto sector.

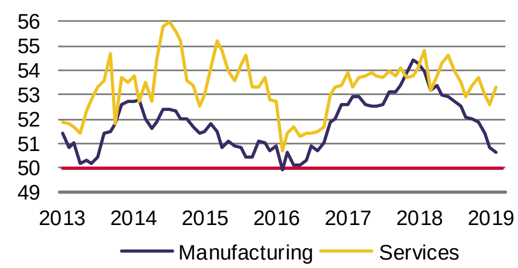
The second pillar is China, as the Government has rolled out tax cuts to stimulate its economy. It nonetheless lowered its goal targets to between 6.0% and 6.5% and the lower end of the GDP target would be the slowest pace of economic growth in almost three decades. It has been difficult to evaluate the effectiveness of the support measures put in place in the past year and this has been compounded by the Chinese New Year, as a result of which there has been a dearth of published economic data since the beginning of 2019. However, among the few statistics available, the larger-than-expected increase in the production of new credits will undoubtedly have been perceived as a tangible manifestation of a

### Performances in local currency

| | Price as of 02/29/19 | 1 month % change | 2019 % change |
|---|---|---|---|
| **Equity markets** | | | |
| CAC 40 | 5 241 | 5.0% | 10.8% |
| Eurostoxx 50 | 3 298 | 4.4% | 9.9% |
| S&P 500 | 2 784 | 3.0% | 11.1% |
| Nikkei 225 | 21 385 | 2.9% | 6.8% |
| **Currencies** | | | |
| 1 € = ...USD | 1.14 | -0.7% | -0.8% |
| 1 € = ...JPY | 126,67 | 1.6% | 0.7% |

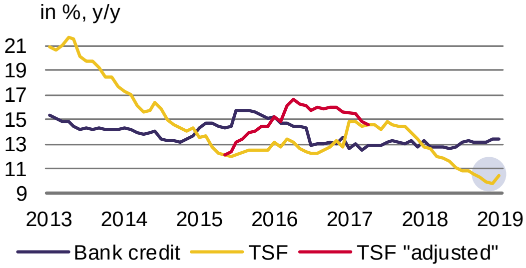
| | | Price as of 02/29/19 | 1 month bp | 2019 bp |
|---|---|---|---|---|
| | **Government bonds** | | | |
| 3 M | Eurozone | -0.51% | 2 | 34 |
| 3 M | United States | 2.43% | 5 | 8 |
| 10 Y | Eurozone | 0.18% | 3 | -6 |
| 10 Y | United States | 2.72% | 9 | 3 |

### World – Markit business confidence index




Source Macrobond, Rothschild & Co Asset Management Europe

### China – Credit growth

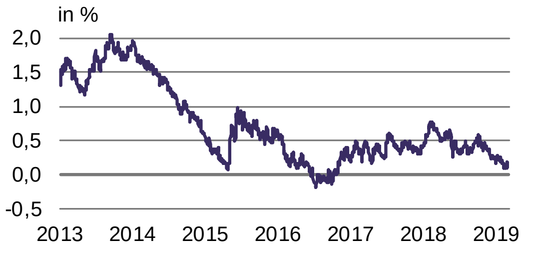



Source Macrobond, Rothschild & Co Asset Management Europe reduction in the banks' reserve requirement ratio, following various announcements on the topic. If such a trend were to continue over the next few months, this would significantly reduce the uncertainty surrounding the deceleration of the Chinese economy, but at the cost of an increased risk to its medium-term financial stability as debt has already reached record highs. In fact, Mr Keqiang's speech will have once again highlights the extent to which the authorities are currently caught between a desire to reduce indebtedness and that of promoting economic growth.

The shift in the rhetoric of many central banks will also have sparked optimism. The Bank of Japan seems willing to further soften its policy if the yen were to hurt the economy and threaten the path of convergence of inflation towards its goal. The ECB has renewed its confidence in the economic growth of the eurozone, but has nevertheless been forced to downgrade its macroeconomic projections. Correspondingly, the Governing Council now expects interest rates to remain at their present levels at least through the end of 2019 – compared to at least through the summer of 2019 – and launched a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), starting in September 2019 and ending in March 2021, each with a maturity of two years.

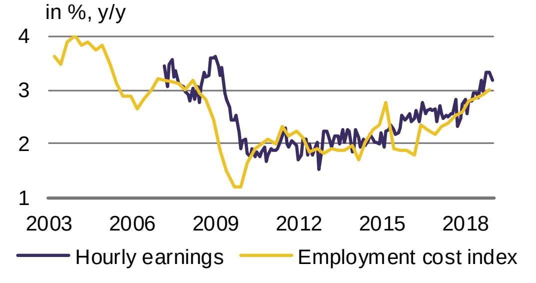
Finally, the Fed made a U-turn at its January meeting: not only did the FOMC seem to have come to the conclusion that its monetary policy normalisation was almost completed, but also that the process of normalising the size of its balance sheet was much more advanced than previously estimated As a result, according to the Fed funds futures, the probability of a rate hike this year has disappeared and that of a rate cut next year is somewhat elevated. Therefore it seems that Fed Chairman Powell has set expectations very high regarding how accommodative monetary policy might be. In that regard, two elements must be pointed out. First, the rise in wage costs is becoming increasingly apparent. In fact, the underutilisation in the labour market that had previously been present has since dried up, giving rise to the classic positive relationship between full employment and wage pressures. While the standard wage-price loop is less robust compared to previous economic cycles, the fact remains that many Fed members will be uncomfortable with a monetary policy status quo. Second, the strong rebound in the stock markets could paradoxically destabilize the Fed. Undoubtedly, the fall in stock prices last December shocked the FOMC and explained, at least in part, the change in tone. However, the recovery has been just as impressive and the resulting easing of financial conditions will be an element that the Fed can't ignore due to its stimulating effects on the economy. In short, it will thus be necessary to wait for the publication of the new macroeconomic forecasts at the 20 March meeting to attest the sincerity of this change of course.

**Germany – 10-yr sovereign yield**




Source Bloomberg, Rothschild & Co Asset Management Europe

**US – Labour costs**




Source Macrobond, Rothschild & Co Asset Management Europe