Monthly Letter

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Economic environment

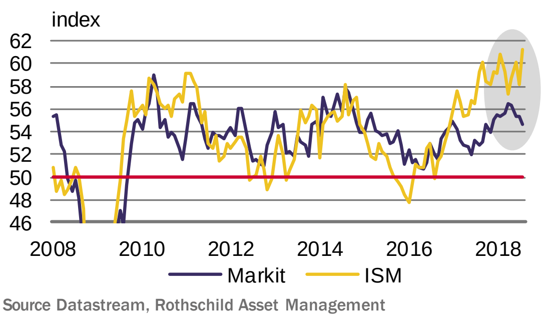
In the US, recent macroeconomic data suggest that activity remains robust. The labor market remains healthy which stimulates household consumption. In addition, since the election of President Trump and the Republican majority in Congress, public spending has increasingly supported economic growth, although with a clear negative impact on the budget balance. Business investment spending is also a supportive factor. That said, a recent study by the Fed shows that US businesses repatriating cash from abroad, as a result of President Trump's tax overhaul, have boosted share buybacks, but there is little evidence they have reinvested much of that money in machinery or equipment. What's more, there are mixed signals in relation to the optimism of manufacturing firms. On the one hand, the ISM manufacturing index reached its highest level since 2004, signaling a possible acceleration of economic activity in 2H 2018. On the other hand, the Markit manufacturing index, although remaining at a high level, is still in a downward trend, suggesting that uncertainties regarding the risks of a trade war are weighing on business expectations. With the exception of a few members, the Fed seems convinced of the importance of continuing the normalization of its monetary policy, recognizing nonetheless that the debate on the equilibrium level of its key rate has not been settled. Still, the desynchronization of the global economy is increasing and the negative effects of this monetary tightening are becoming apparent not only in certain segments of the US economy, notably the housing sector, but also beyond its borders.

Indeed, fragilities – especially financial – are increasingly visible in emerging economies (EM) and turmoil has intensified in recent weeks. If the completely chaotic situation in Venezuela is idiosyncratic, the economic environment has rapidly deteriorated in Argentina as well, where the Central Bank was forced to raise its key rate to 60% to defend its currency – which is down -52% against the USD since the beginning of the year. The country's president has asked the IMF for help to deal with the crisis. Meanwhile, South Africa officially entered into recession in 1H 2018, which weighed on the rand down -21%. In Turkey, the economic situation has also deteriorated. The inflation rate reached almost 18% for this country with very high external financing needs. Business confidence has plummeted and the various measures implemented by the government have barely stabilized the lira, down -43%. However, a major test will come in November, when US sanctions against Iranian oil exports come into effect. Indeed, Turkey's energy needs are partly based on Iran, making the already fraught diplomatic relations between the US and Turkey even more difficult.

Performances in local currency

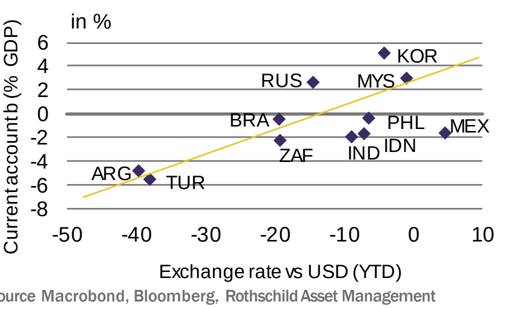
		Price as of 08/31/18	1 month % change	2018 % change
Equity markets				
	CAC 40	5 407	-1.9%	1.8%
	Eurostoxx 50	3 393	-3.8%	-3.2%
	S&P 500	2 902	3.0%	8.5%
	Nikkei 225	22 865	1.4%	0.4%
Currencies				
	1 € = …USD	1.16	-0.6%	-3.1%
	1 € = …JPY	129.05	-1.4%	-4.4%
		Price as of 08/31/18	**1 month bp**	**2018 bp**
Government bonds				
3 M	Eurozone	-0.55%	-1	23
3 M	United States	2.09%	7	72
10 Y	Eurozone	0.33%	-12	-10
10 Y	United States	2.86%	-10	46

US – Manufacturing business confidence



Source Datastream, Rothschild Asset Management

EM – Currency and current account

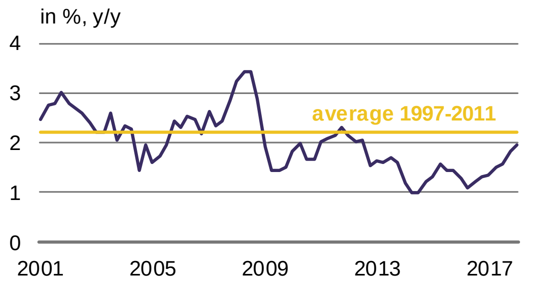


Source Macrobond, Bloomberg, Rothschild Asset Management

Contagion in EM has, however, spared some countries, particularly in Asia. In China, for instance, the Markit business confidence index fell in August, but the slowdown in economic activity remains gradual. In addition, the effects of the recent decline in interest rates decided by the Chinese authorities will gradually spread, as well as the recovery of infrastructure spending and tax reform, to restore purchasing power to households. These elements have become necessary to avoid a sudden slowdown in growth as a new round of US sanctions – on USD 200bn of imports – could be announced in the coming weeks, which would add to the 25% customs duties already levied on USD 50bn of Chinese imports.

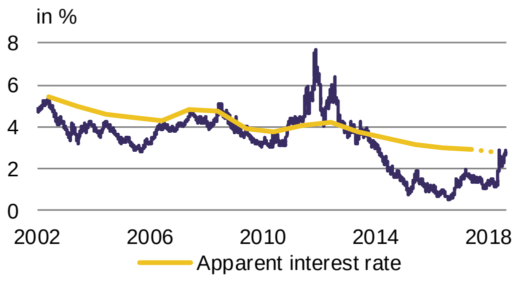
In the Eurozone, the impact of this rise in risk aversion affecting a majority of EM will be felt through the banking sector and the trade channel. Already, business confidence in the manufacturing sector, which is particularly sensitive to the global environment, has been declining for several months and reached an almost two-year low in August. However, internal dynamics remain buoyant, driven in part by a robust labor market. The unemployment rate remained stable in July at 8.2%, a low since November 2008. In addition, this favorable trend in employment finally seems to be reflected in wages, whose growth is close to 2% year-on-year, representing a significant supportive factor for households' purchasing power. Political uncertainty remains a clear cloud in the European landscape, but there is a glimmer of hope. Italy's Interior Minister and Vice-President, Matteo Salvini, has sought to ease fears over the Italian budget deficit by ensuring that spending increases and tax cuts announced during the last electoral campaign would only be implemented gradually. The rating agency Fitch recently confirmed Italy's long-term sovereign rating, but lowered its outlook to negative by citing a risk of fiscal slippage, which has likely convinced the government to send appeasement signals. That said, it remains to be seen what arbitrations will be retained in the budget, which will need to be sent to the European Commission no later than October 15.

Eurozone – Labor cost



Source Datastream, Rothschild Asset Management

Italy – 7-yr sovereign yield



Source Bloomberg, Macrobond, E.C., Rothschild Asset Management