Monthly Letter

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Economic environment

In recent months, the world economy has been influenced by the negative effects of the trade measures implemented by the Trump Administration, the weaker outlook for some key emerging countries arising from country-specific factors, tighter financial conditions, geopolitical tensions and higher oil import bills. Correspondingly, downside risks to global economic growth have increased. Business confidence also continues to deteriorate, both in the manufacturing sector, at its lowest level in two years, and in the services sector, where a similar dynamic seems to be starting. The leading exporting countries are particularly vulnerable to the slowing of international trade as a result of the continued and significant tensions between China and the US. Meanwhile, the outcome of the US's trade negotiations with the European Union and, separately, Japan, remain unclear in a context where US mid-term elections might result in President Trump's Republican Party losing control of Congress.

In the Eurozone, the uncertainty surrounding US trade policy is combined with a tense political situation in Italy and complicated Brexit negotiations. The probability of a disorderly UK exit from the European Union grows as a result of one of the main stumbling blocks: the introduction of a safeguard clause – the "backstop" – aimed at preventing the reappearance of a physical border between the Republic of Ireland and the British province of Northern Ireland. In Italy, despite the promise by Finance Minister Tria to respect past budget commitments, the Five Star Movement, anxious to stop its fall in the polls, has succeeded in pressuring the government to include its main campaign promises, notably the citizen's income and the pension reform, in the draft budget. In addition, there is a significant probability that Italy's budget deficit will worsen more than expected. Indeed, the economic growth assumptions used by the government – 1.5% in 2019 and 1.6% in 2020 – seem rather optimistic and could well revive fears related to the sustainability of the Italian debt. In fact, Italy could face a deterioration of its sovereign rating by the main rating agencies and the recent rise in sovereign rates may contribute to a tightening of the conditions of access to credit for households and businesses. The European Commission has expressed its concern and seems determined to oppose this budget because it fails to address the reductions to the cyclically-adjusted budget balance.

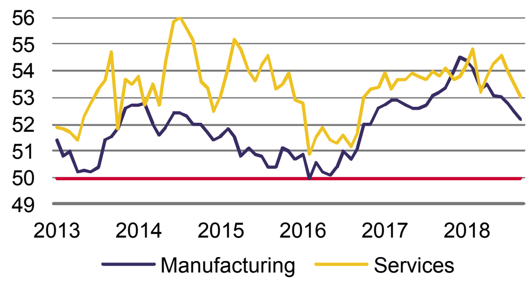
On the other side of the Atlantic, the economy remains well oriented, supported by a sizable fiscal policy, yet at the expense of an important widening of the external and budgetary imbalances. Interest rates have continued to rise, with the 10-year government rate surpassing 3.2% for the first time since 2011. In recent

Performances in local currency

	Price as of 09/28/18	1 month % change	2018 % change
Equity markets			
CAC 40	5 493	1.6%	3.4%
Eurostoxx 50	3 399	0.2%	-3.0%
S&P 500	2 914	0.4%	9.0%
Nikkei 225	24 120	5.5%	6.0%
Currencies			
1 € = ...USD	1.16	-0.2%	-3.3%
1 € = ...JPY	131.23	1.7%	-2.8%

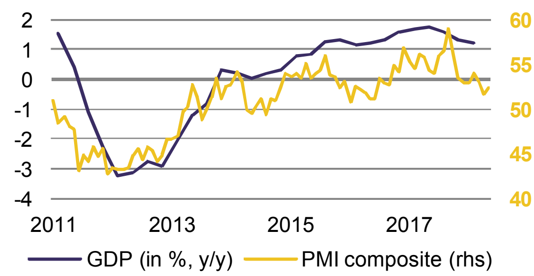
		Price as of 09/28/18	1 month bp	2018 bp
Government bonds				
3 M	Eurozone	-0.56%	-1	22
3 M	United States	2.20%	10	82
10 Y	Eurozone	0.47%	14	4
10 Y	United States	3.06%	20	66

World – Markit business confidence index



Source Datastream, JP Morgan, Rothschild Asset Management

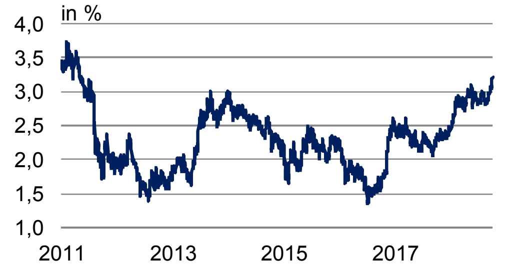
Italy – Business confidence and GDP growth



Source Datastream, Rothschild Asset Management months, some US business and household confidence indices have reached multi-year highs and the labor market is relatively tight, as evidenced by an acceleration of wage growth even though, for the time being, neither wage pressures nor higher tariffs have led to significant higher inflation. In this context, the Fed raised its key rate by 25 basis points (bps) for the third time this year and reiterated its firm willingness to normalize its monetary policy with a new increase planned at its meeting on 19 December, followed by three others in 2019.

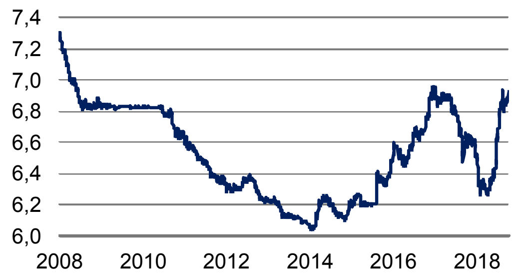
Yet, this tightening of US monetary policy is not without consequences for the emerging countries already facing significant capital outflows since the beginning of the year. In addition, the evolution of commodity prices is unfavorable for most of them. Indeed, the rise in energy prices contrasts with the decline in base metals and agricultural products, representing a deterioration in the terms of trade for net energy-importing countries, which may therefore weigh on their growth prospects. The negative sentiment surrounding emerging countries is further exacerbated by the slowdown in the Chinese economy whose excessive debt constrains the authorities in their desire to boost economic activity. The Central Bank has once again announced a 100 bps cut in the mandatory bank reserve rate to encourage credit production and lower the financing costs of companies facing trade war with the US. However, this announcement also contributed to the weakness of the yuan, which returned to its downward trend against the dollar and thus risks destabilizing the foreign exchange market of emerging countries, already shaken by the tightening of US monetary policy. In addition, the depreciation of the yuan could lead to a new wave of capital outflows as happened in 2015/16, when it endangered the country's financial stability and cost several hundred billions of foreign exchange reserves to reverse.

US – Sovereign 10-yr yield



Source Datastream, Rothschild Asset Management

China –USD/CNY exchange rate



Source Datastream, Rothschild Asset Management