Monthly Letter

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Economic environment

With the exception of the US, the slowdown in economic activity observed in recent months is still underway. In fact, the synchronization of the economic cycle that we saw last year has dissipated, contributing to the rise of the US dollar.

In Japan, GDP fell by -0.2% q/q in Q1 2018, led by the weakness of household consumption. Despite the undeniable vitality of the labor market and unemployment rate hitting its lowest level since the early 1990s, Japanese workers' cash earnings are struggling to accelerate, weighing on their purchasing power. In addition, net exports, one of last year's growth engines, have stalled. While the consensus anticipates a rebound in activity in Q2 2018, the recent data do not seem to corroborate the expected improvement.

The similarities between Japan and the Eurozone are evident: disappointing GDP growth in Q1, the loss of net exports as an engine to growth, and economic data that do not confirm the expected rebound. While some forecasters have tried to explain the loss of economic momentum by temporary factors or weather, it becomes difficult to not conclude that more structural explanations are at work, such as supply constraints or the deceleration of global trade, which can be explained by the Chinese slowdown and by the US Administration's protectionist rhetoric. In fact, President Trump's threat to move forward with tariffs on USD 50bn worth of Chinese goods and his decision to impose steel and aluminum tariffs on China and others seem to suggest that globalization might have peaked.

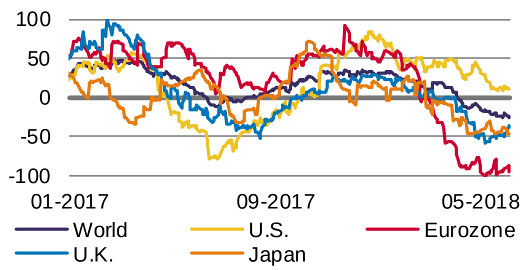
In addition, political uncertainty in the Eurozone has made a comeback, this time due to the situation in Italy. After many twists and turns, the formation of a new government composed by the League party (LN) and the Five Star Movement (M5S) has boosted Italian sovereign rates and weighed on the euro. Indeed, the incompatibility between the economic policy proposals of the new government – lower taxes, higher spending – and its commitments to the European Union could lead to a confrontation with Brussels, especially at the time of tabling the budget next fall. Meanwhile, recent speeches by several ECB members seem to confirm that the June 14 meeting will be an opportunity for the Governing Council to discuss the future of the asset purchase program. The ECB's Chief economist Peter Praet, a known dove, seemed particularly confident, estimating that the economy would accelerate in the second half of 2018, and that the outlook for inflation would continue to improve as the

Performances in local currency

	Price as of 05/31/18	1 month % change	2018 % change
Equity markets			
CAC 40	5 398	6.8%	3.9%
Eurostoxx 50	3 407	5.2%	0.9%
S&P 500	2 705	0.3%	-1.0%
Nikkei 225	22 202	4.7%	-1.3%
Currencies			
1 € = …USD	1.21	-1.8%	0.6%
1 € = …JPY	132.12	0.7%	-2.1%

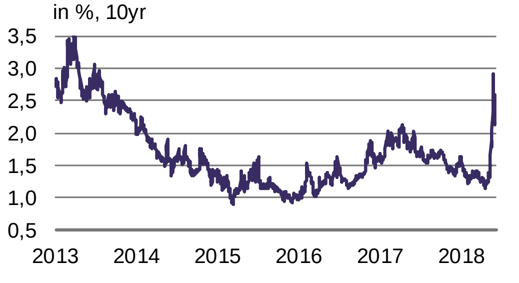
		Price as of 05/31/18	1 month bp	2018 bp
Government bonds				
3 M	Eurozone	-0.62%	-4	16
3 M	United States	1.89%	10	52
10 Y	Eurozone	0.34%	-22	-9
10 Y	United States	2.86%	-9	45

World – Economic surprise index



Source Bloomberg, Rothschild Asset Management

Italy – Sovereign spread vs. Germany

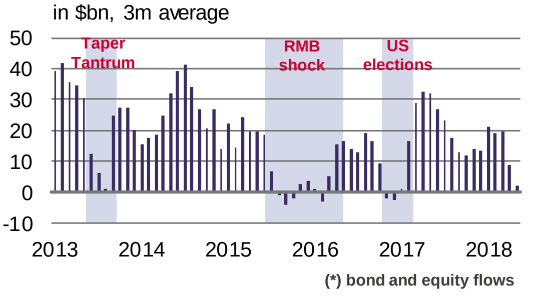


Source Bloomberg, Rothschild Asset Management reduction of the underutilization in the labor market would increase wage pressures. Yet, he did not say a word about the Italian situation. Thus, the ECB seems to have decided to let market discipline prevail, perhaps in the hope of pushing Italy to not increase its public deficit, especially as the new Italian government – mainly LN – has a rather negative position on the euro.

In the US, the Fed meeting on June 13 will undoubtedly lead to a further rise in the key rate, the second since the beginning of the year. As this has largely been priced in by the financial markets, the issue lies in the projection made by Fed members' regarding the future path of the fed fund rate: the dots. At the meeting last March, the Fed's Monetary Committee had shown greater confidence in its ability to raise its key rate by 2020, but left its projection for 2018 unchanged with three hikes. Given the still high level of most business and household confidence indices and the healthy labor market, the dots could move higher as some members may prefer to slightly accelerate the pace of monetary normalization against the backdrop of the expected positive effects from last year tax plan.

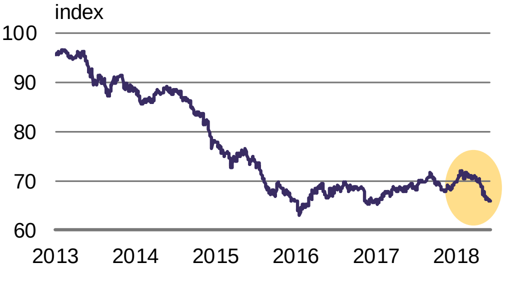
However, the economic and financial situations of several emerging economies have weakened in recent months while portfolio flows also turned negative in May. Indeed, many countries have been simultaneously hit by the Chinese slowdown, rising US interest rates and the rising dollar. In addition to Venezuela and Argentina, whose situations are unique, central banks in Indonesia and India have recently surprised the market by raising their key interest rates. In Turkey, the central bank was forced to raise rates by nearly 1,000 basis points in less than two months in order to stabilize the currency. In Mexico, the collapse of the peso and the uncertainty surrounding negotiations on the North American Free Trade Agreement and the elections next month could also lead to monetary tightening. In Brazil, monetary easing was stopped unexpectedly due to the fall of the real. In sum, the pressure exerted by interest rates and the depreciation of currencies could put the issue of high corporate debt in several emerging countries back to the forefront and, with it, bring increased volatility

Emerging countries – Porfolio flows*



Source IMF, Rothschild Asset Management

Emerging countries – Exchange rate vs. USD



Source Bloomberg, JP Morgan, Rothschild Asset Management