Monthly Letter

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Economic environment

The desynchronization of the global economy continues. On the one hand, many regions are experiencing a slowdown, although we also see a robust dynamic in the US where economic growth in Q2 2018 reached 1% q/q (or 4.1% q/q annualized), matching the pace last observed in 2014. That said, several temporary factors boosted economic activity. In deciding last April to tax imports of steel and aluminum, the Trump Administration unleashed hostilities with China, which responded by taxing US soybeans and other products. Thus, US household consumption expenditure rose sharply in Q2, fueled in particular by an increase in spending on durable goods, most notably cars. Several manufacturers have warned that rising steel and aluminum prices could force them to raise the price of cars, prompting some households to pre-empt their purchases. Another factor is net exports, which grew the most in almost five years. Soybean sales surged in the wake of the Chinese authorities' surtax, a move largely anticipated by foreign buyers who have stockpiles and full silos.

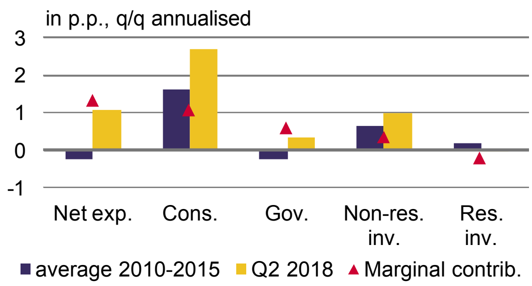
Yet, it is in the Euro zone that the global economy's loss of speed is most visible. In Q2 2018, the increase in GDP was only 0.3% q/q, equaling the pace of Q1, but far from the 0.7% q/q recorded on average each quarter last year. Although the composition of growth will only be published later, it seems that poor net exports partly explain the weaker dynamics. The Chinese slowdown, the past rise of the euro and protectionist measures can all explain the relative weakness of the external sector. On this last point, the visit to the White House of the President of the European Commission (EC) Mr Juncker arguably averted trade war. However, the consequences of the agreement reached during this visit remain unclear. A Brussels-Washington working group will be launched to discuss ways to reduce trade barriers between the two economic zones, but the conclusions will be released in November at the earliest. Most importantly, however, they will not be binding. In addition, the prospect of a trade agreement remains limited since the automobile sector has been deliberately excluded from the working group's terms of reference. Finally, the political uncertainty in Europe (Italy and Brexit) makes this negotiation all the more complicated.

In Italy, the recent rise in sovereign yields attests the market concerns about the risk of conflict within the government. The rumored resignation of the Minister of Finance, Mr. Tria – considered the only guarantee of budgetary orthodoxy – was perceived as a threat to the balance of public finances and caused renewed tensions. The funding of the tax cuts promised by the League Party, as well as the universal income promoted by

Performances in local currency

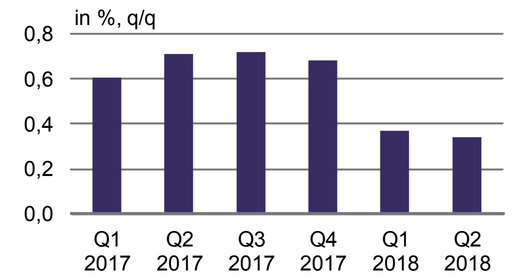
		Price as of 07/31/18	1 month % change	2018 % change
Equity markets				
	CAC 40	5 511	3.5%	3.7%
	Eurostoxx 50	3 525	3.8%	0.6%
	S&P 500	2 816	3.6%	5.3%
	Nikkei 225	22 554	1.1%	-0.9%
Currencies				
	1 € = ...USD	1.17	0.2%	-2.6%
	1 € = ...JPY	130.84	1.4%	-3.1%
		Price as of 07/31/18	**1 month bp**	**2018 bp**
Government bonds				
3 M	Eurozone	-0.54%	9	25
3 M	United States	2.02%	11	64
10 Y	Eurozone	0.44%	14	2
10 Y	United States	2.96%	10	55

US – Contribution to GDP growth



Source Datastream, Rothschild Asset Management

Eurozone – GDP growth



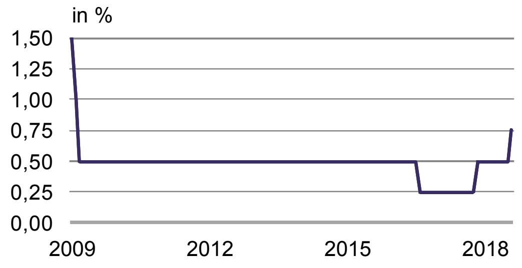
Source Datastream, Rothschild Asset Management the 5-star Movement (M5S), would require significant cuts in spending to meet the country's commitments to the EC ; cuts that are obviously not on the agenda of any party.

Meanwhile, the probability of the UK leaving the EU without a trade agreement seems to have increased in recent months. The British government, according to some sources, called for a special ministerial meeting in early September to prepare for a hard Brexit. Despite the uncertainty, the Bank of England (BoE) raised its key rate at its July meeting, justifying its decision by heightening inflationary pressures in connection with low unemployment. Still, the BoE has nevertheless considered the risk of a disorderly exit as uncomfortably high, while recognizing that the normalization of monetary policy would be very gradual, hardly contemplating more than a single rate increase per year. In this context, the pound has reached lows of almost a year against the euro and the dollar.

In China, economic indicators have showed clear signs of a slowdown in the past few months. While remaining in expansionary territory, overall business confidence fell to the lowest level since November 2015. Thus, the risks linked to a trade war have begun to weigh on the morale of companies and could affect investment decisions. However, the Chinese authorities have announced some supporting measures, including a further decrease in the required bank reserves ratio. On the currency, the magnitude of the recent depreciation did surprise some observers: nearly -10% against the USD since April. Foreign exchange reserves increased slightly in July, a sign that this movement in the yuan does not seem to be worrying the government for the moment. In fact, it may be a retaliatory action against the Trump Administration's imposition of 25% of USD50bn of Chinese imports tariffs, with the addition of another USD200bn of goods that could be announced by the end of September.

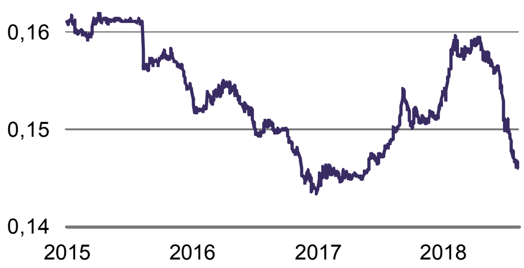
That said, the use of currency as a means of economic response has its limits, and it risks destabilizing emerging countries' currencies, which have already been shaken by the tightening of US monetary policy. The Chinese central bank has in fact decided to tighten the criteria for foreign exchange market transactions in order to prevent downward speculative movements on the yuan. Beijing fears a new wave of capital outflows as happened in 2015/16, which endangered its financial stability and cost several hundred billions of foreign exchange reserves to reverse.

UK – Bank rate



Source Datastream, Rothschild Asset Management

China – Exchange rate vs. USD



Source Datastream, Rothschild Asset Management