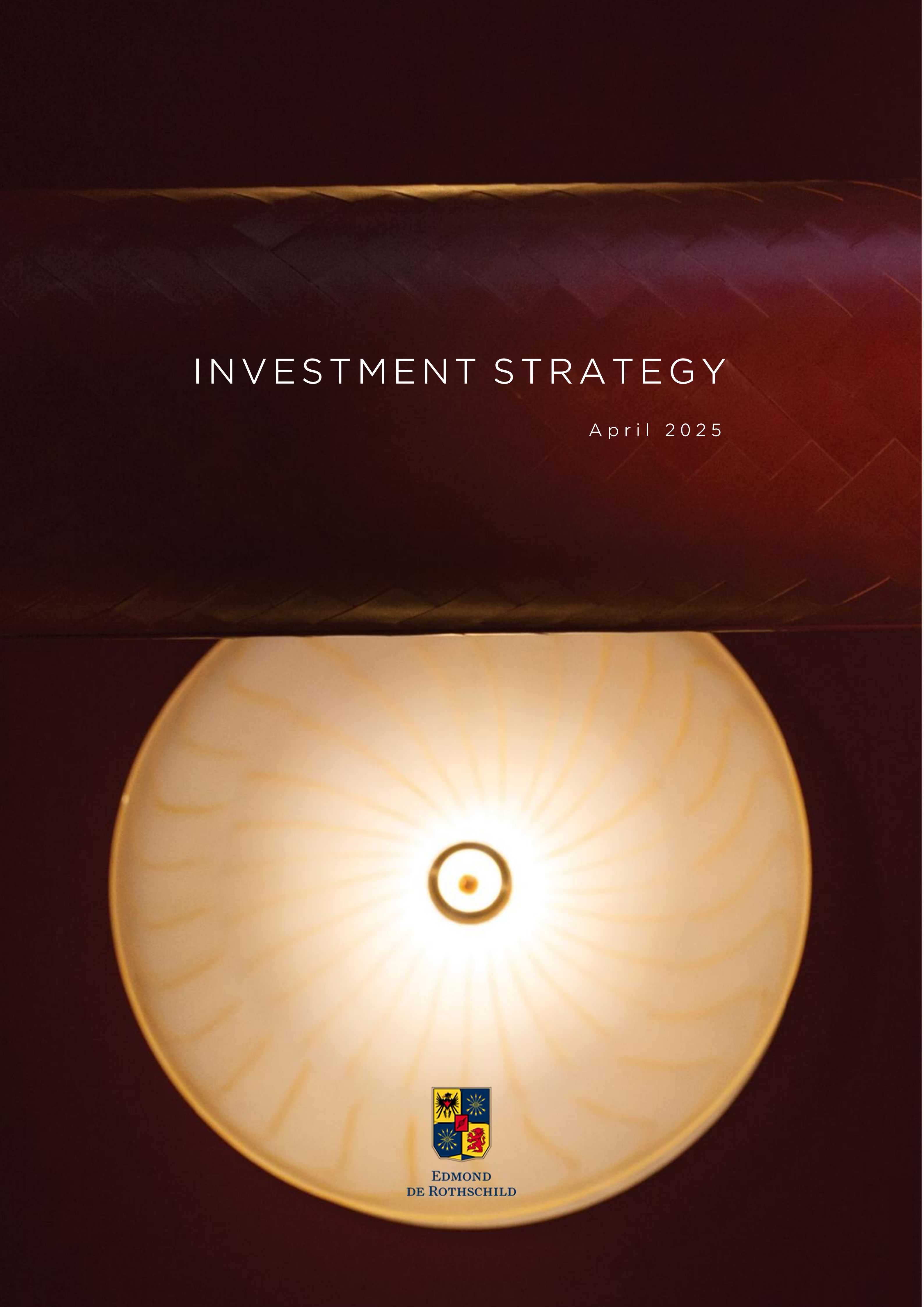

INVESTMENT STRATEGY

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EDMOND DE ROTHSCHILD

THE WOLF AND THE FOX

Wolves and foxes are both canines that share some common traits but have adopted very different survival strategies. While wolves usually belong to a pack and range over huge hunting grounds, foxes are more opportunistic and can adapt to different environments, including urban ones.

As the human population has expanded, natural habitat has been destroyed and the availability of large prey animals has declined, wolf populations have shrunk drastically in many regions. Meanwhile foxes, with their more flexible diet and lifestyle, have prospered, even in hostile environments like cities.

Looking at how these two species have evolved teaches us that the fundamental criterion for survival is the ability to adapt to a changing world. Those who cling to old models risk dying out; those who adapt survive and prosper.

A changing world is exactly what we must prepare for. Like the fox, portfolios are going to have to adapt.

As 2024 drew to a close, US artificial intelligence firms dominated the tech sector and the stock market. But things changed in the first quarter of 2025: the Magnificent Seven[1] lost some of their shine. The seven famed companies, which together account for a big chunk of America's flagship S&P 500 index, saw their share prices fall sharply.

Some will point to Chinese competition in artificial intelligence, the imposition of trade tariffs or geopolitical instability. But something deeper is at work. A structural change is happening before our very eyes: the decline of globalisation.

[1] Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla together accounted for 30% of the S&P 500 index.

Globalisation is the very foundation on which the US tech giants built their prosperity. It meant they were able to manufacture in countries where labour was cheap, sell all over the world and take advantage of low interest rates to borrow and carry out share buybacks to boost the performance of their publicly traded shares. The Trump Administration's initial actions are not what had been expected, to put it mildly. But let's be clear: Trump is merely stepping on the gas and hastening an onshoring process that began with the Ukraine war.

The new president's myriad comments and decisions may appear blunt and outrageous, but they take on a kind of consistency and logic in the words of his secretary of the treasury: the logic of industrial onshoring and reduced public spending.

"The market and the economy have become hooked, become addicted, to excessive government spending and there's going to be a detox period. […] And look, there's going to be a natural adjustment as we move away from public spending to private spending." – Scott Bessent, US Secretary of the Treasury

Among the new administration's most striking actions are the following:

- Elon Musk, through his DOGE programme, has been tasked with tracking down every possible opportunity to cut public spending.
- Doubts over continued US support for Ukraine and the administration's more or less evident desire to no longer play such a prominent role in international conflicts will help reduce defence spending.
- Import tariffs are aimed at boosting productive foreign investment on US soil, thus limiting the amount of dollars going overseas.

The initial visible impact of these decisions on markets is positive for the majority of assets all over the world… with the exception of US assets (equities and the dollar) in general and tech stocks in particular. If globalisation is associated first and foremost with US assets, regionalisation goes hand in hand with rest-of-world assets. At a time when US equities account for some two thirds of the total market capitalisation of all listed companies worldwide, regionalisation represents a huge change for investors.

REGIONALISATION SPELLS HIGHER PUBLIC SPENDING.

Among the most notable trends in this early part of the year has been the spectacular performance of European banks, whose share prices have risen 30% in the year to date. America's new foreign policy has awaked European countries to the need to become more independent, particularly when it comes to military defence.

US protection is no longer something that can be taken for granted. Europe must rearm, which means it must put in place the resources needed to address the challenges at hand. The European Commission has touted a figure of €800 billion. While it is difficult to know whether this number is the result of an in-depth study or merely a rough estimate, it is large enough to call Europe's fiscal rectitude into question. Even Germany has amended its constitution to allow for increased public debt. €800 billion equates to more than 4% of eurozone GDP and five times the revenue of all of Europe's weapons manufacturers combined. This is a major project that will probably require financial solidarity between European countries, which should lower the risk premium on European assets. Indeed, the sustainability of the shared currency has never been taken for granted. The risk of the eurozone breaking up – often seen as low but persistent – has helped keep the valuations of European assets lower than those of their US counterparts.

The prospect of shared European debt has been well received by markets. While it's true that long-term interest rates are rising, the euro and European equities are significantly outperforming their US peers. Arms-related businesses and banks – at the heart of the financial system – are prospering.

THE WORLD IS CHANGING BEFORE OUR EYES, WITH SERIOUS IMPLICATIONS FOR INVESTMENT.

Beyond the short-term trends that lead one sector to outperform another, the world and investments of the future appear to be being shaped by deep-rooted trends that include the following:

- Ageing populations and collapsing birth rates in developed countries and China
- Inexorable growth in public debt in those same countries
- The democratisation of artificial intelligence, which will transform work as we know it
- The prospect of countries around the world moving away from the dollar for trade, even in commodities
- US isolationism and a reduced role for Europe on the international stage

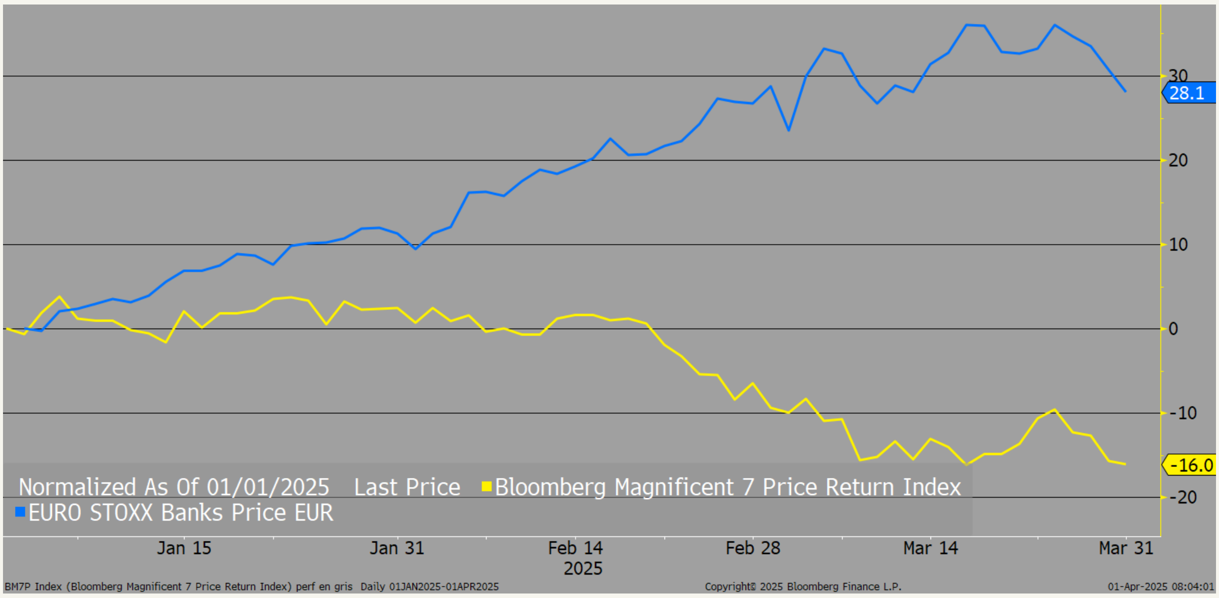
Everything suggests that the centre of power is shifting to the east and the US is isolating itself.

In financial terms, protectionism and regionalism usually result in structurally higher inflation, public debt and interest rates than we have been used to in Europe and the US over the past decade. This means the asset classes that should outperform bonds over the long term are equities and gold. Scarce, future-proof assets are the only ones whose valuations rise as the value of currencies is diluted (as a result of monetary inflation).

LIKE THE FOX, PORTFOLIOS ARE ADAPTING.

In major cities like London and Paris, foxes have learned to live side by side with humans. They dig through trash, cross streets while dodging traffic and have adjusted their clocks so as to be more active at night. In equity markets, adapting means seeking out investments in sectors that are not attracting attention. Diversifying investments beyond the United States in general and beyond major companies linked to artificial intelligence in particular has proved to be the winning strategy in the early part of this year. Rarely have rest-of-world equities so sharply outperformed US equities over such a short period. And, while a fairly positive trend seems to be taking hold in Europe, markets are not moving in a linear fashion. Globalisation is not something that can be unpicked in three months. So, following an initial period that has been good for Europe, we think the second quarter will tend to favour the United States, and specifically those tech companies that have seen their share prices fall particularly sharply even though their earnings growth outlook remains unchanged.

% performance of the Euro Stoxx Banks index and the Bloomberg Magnificent Seven (which combines the shares of the largest AI companies by market capitalisation). A 44% gap has opened up in the space of three months without the earnings outlook being called into question. While we consider this divergence excessive in the short term, it appears to point to a more structural change in the long term.



Sources: Bloomberg, Edmond de Rothschild Monaco.

However, the fact that banking stocks are outperforming tech stocks is not insignificant: it is often a harbinger of a coming structural change in the economic regime. The last time this situation arose was the period between 2000 and 2007, when China was offering to manufacture goods faster and cheaper for the rest of the world. Developed countries had just begun to deindustrialise and a wave of deflation was sweeping the world. Banks were prospering by providing the loans needed to fund the expansion of China's industrial capability.

During this first quarter, we saw the launch of DeepSeek (an AI-powered large language model developed at a fraction of the cost of its US counterpart ChatGPT) and the growing success of Chinese electric vehicles, which retail for substantially less than their European and American equivalents. These disruptive waves are reminiscent of the period 2000-2007.

While one quarter isn't really long enough to tell whether the world really has entered a new economic era, market movements of such magnitude tend to make one sit up and take notice. As is often the case, banks are once again at the forefront of structural change, and we see it as entirely appropriate to add more banking stocks to portfolios at the current time.

In bonds, yield curves are steepening across the board. Whether in Europe, Japan or China, long-term interest rates are rising while short-term rates are falling or stagnating. The only country where this not happening is the United States. However, reaching the debt ceiling has briefly created an environment in which the US yield curve cannot follow the same process. This should change over the coming months.

Staying invested in short-dated bonds has been part of our strategy for some time and we remain convinced that this is the right strategy. However, once yield curves have normalised – i.e. once the differential between short and long yields exceeds 120 basis points (1.2%) – it will probably be the right time to extend bond duration. As regards credit quality, despite the rapid pace of economic and geopolitical events, we are not seeing any strong signs of a deterioration in companies' financial health. We continue to prefer corporate bonds over sovereign debt.

We were expecting 2025 to be very different from 2024. The first quarter went beyond what we had anticipated. The Magnificent Seven's overwhelming dominance of the rest of the world appears to have peaked in December 2024. We are adapting accordingly.

"The greatest danger in times of turbulence is not the turbulence itself, but to act with yesterday's logic." **– Peter Drucker**

Sébastien Cavernes
Chief Investment Officer

DISCLAIMER :