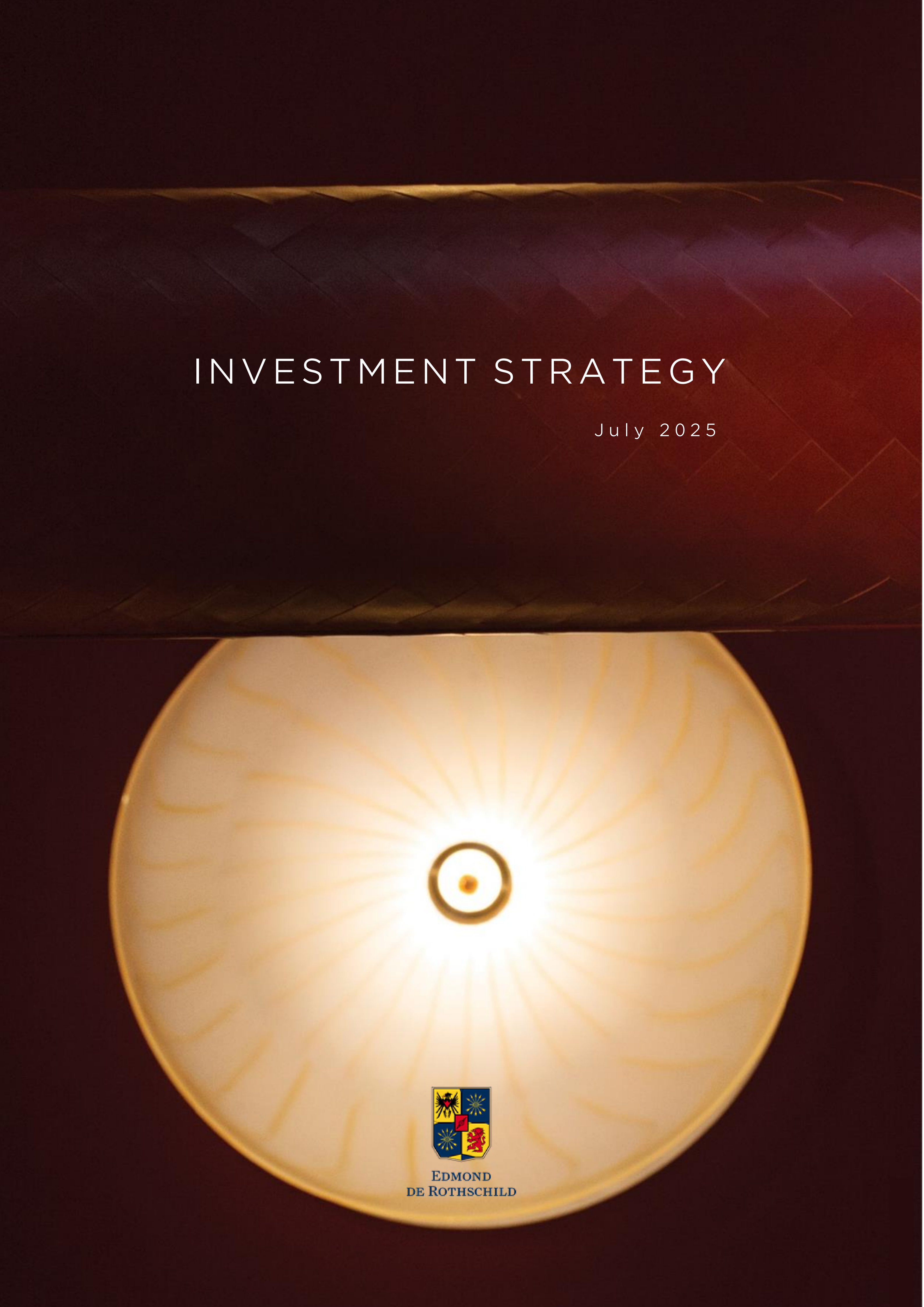

INVESTMENT STRATEGY

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THE WALKING DEBT

Fans of post-apocalyptic series know it: surviving means first accepting that the world has changed and that a new reality has taken over. In the series The Walking Dead, created by Robert Kirkman, Rick, Michonne, and Daryl's companions try to survive in a world where every death leads to a flesh-eating zombie. The undead move slowly but relentlessly toward humans to devour them. They grow in number, and no one can stop them. Survivors are not the strongest, but the most clear-sighted—those who understand that the dead will not turn back, and that the rules have changed.

We continue to believe that the transition to the 2020s marked a turning point in economic terms. Most developed countries and China have entered a phase characterized by structural budget deficits, impacting both political life and financial asset prices. Since 2020, the United States has recorded an average annual deficit of 8.4%, with no sign of slowing. Like zombies, public debt advances slowly but inexorably into financial markets, increasingly influencing political and investment decisions. The U.S. economy generates a $30 trillion GDP growing at 2% annually in real terms (around $0.6 trillion per year). To achieve this, the government plans to run a budget deficit equivalent to 7% of GDP—resulting in a $2 trillion annual debt increase. Such a deficit is unsustainable over the long term and has logically become a key economic issue, one that the new Trump administration is attempting to tackle, with only mixed results so far:

- The DOGE project, a bold initiative led by Elon Musk to reduce public spending, has had only a minor impact on the public accounts.
- Tariffs are another attempt to address the persistent public account imbalance by making the rest of the world help fund the U.S. deficit. However, they only solve a small part of the equation.
- Lowering interest rates would be a powerful lever to reduce the fiscal burden, but the Fed is not currently inclined to lower rates or reduce the government's interest expenses.

With debt exceeding 120% of GDP, a declining workforce, and unavoidable public commitments in defense, healthcare, and pensions, the rise in public debt and deficits seems inevitable. While economic growth might slow the pace of debt accumulation, monetary inflation (or debt monetization) appears to be the most likely economic environment.

Public debt is no longer a problem to solve. It's an environment to adapt to.

ADAPTATION THROUGH INNOVATION

Real economic growth comes from two sources:

1. Population growth
2. Productivity improvement

With aging populations, constrained migration policies, and birth rates below 1.7 children per woman, there is little hope for demographic factors to boost growth. Only productivity gains appear capable of enabling economic growth to outpace debt growth.

Innovation is the cornerstone of productivity gains. The rise of artificial intelligence (AI) is emerging as the most promising way to enhance the competitiveness of companies. Beyond language models—which are just starting to replace traditional internet search engines—AI is beginning to affect sectors far beyond just technology. The energy required to support these models requires a doubling of installed production capacity and far more sophisticated energy-saving systems. Industrial sectors, including nuclear, are now seeing a surge in revenue growth potential alongside rising stock valuations. As such, this investment theme remains central to how we build our financial asset portfolios.

ADAPTATION THROUGH MONETARY INFLATION

However, it is unrealistic to think that productivity gains alone can stabilize the public debt trajectory. Monetary inflation is as inevitable as the growth in public debt.

We refer here to an expansion of the money supply within the financial system to finance both public and private deficits. Money can be created either by central banks or the private financial system (banks, money market funds, hedge funds, etc.). While this new liquidity might impact prices of goods and services, it is certain that if it remains within the financial system, it will support or drive up financial asset valuations—especially scarce assets.

These are the economic foundations of our long-term investment strategy.

SCARCE ASSETS GAIN VALUE

In The Walking Dead, as most of humanity is wiped out, rare resources become more valuable and better protected. Weapons, food, and people with special skills—like doctors and engineers—are especially safeguarded. The same is true in the markets.

The rise in public debt creates a structurally favorable environment for equities, gold, and luxury real estate. Valuations supported by an expanding money supply have been the norm since 2020. Traditionally, valuations are assessed using long-term historical averages, and from this perspective, equities currently appear expensive. However, we believe the current era of large public deficits prevents valuations from reverting to historical means—and that this situation is likely to persist until the public debt trajectory is corrected. That is unlikely to happen any time soon in the U.S., Europe, Japan, or China. These countries face growing obligations in health, pensions, and now defense—while their working populations are shrinking.

S&P 500 Price-to-Earnings Ratio: Stocks are historically expensive.

Sources: Bloomberg, Edmond de Rothschild Monaco.

A favorable environment for rare assets does not mean that corrections are impossible. The second quarter was particularly volatile: all asset classes experienced renewed turbulence driven by U.S. tariff announcements. Still, in recent weeks, markets have ended on a positive note—with all asset classes in the green year-to-date, except for the dollar, which weakened against most global currencies and lost 10% against the euro.

What stands out in this situation is that financial markets remain highly sensitive to liquidity movements. In Europe, liquidity appears well-supported through year-end thanks to German and EU stimulus plans. In contrast, the U.S. is nearing a critical juncture as its debt ceiling (reached on January 21st) must soon be raised. Once lifted, large amounts of short-, medium-, and long-term U.S. Treasury bonds will flood the market, absorbing a significant portion of dollar liquidity.

As such, we maintain a long-term positive view on equities. After decades of fiscal discipline, Europe has embraced public spending, increasing the money supply and benefiting banks, for whom money is a raw material. Year-to-date, the U.S. has underperformed Europe. Nonetheless, the growth potential of leading AI companies encourages us to maintain a structurally positive stance on U.S. equities.

INVESTMENT STRATEGY

With the tariff episode coming to an end, markets should become less volatile—except for the looming U.S. debt refinancing, which will demand large amounts of liquidity. If the debt ceiling increase is accompanied by favorable financial measures (e.g., central bank bond purchases or relaxed banking leverage rules), this phase could be mild and lead to a strong year-end. If not, we anticipate a short-term downturn, which we would be prepared to capitalize on. In the meantime, as a precaution, we are temporarily reducing equity exposure in portfolios.

What struck us this past quarter was the lack of a rally in the dollar and U.S. Treasuries, even as recession risks rose and armed conflict erupted between Israel and Iran. These assets traditionally serve as safe havens, yet failed to fulfill that role—a puzzling development.

Could U.S. assets be losing their appeal after years of uninterrupted foreign investment flows? If the dollar falls, U.S. stocks underperform globally (despite their clear AI advantage), and U.S. Treasuries no longer rally in crises, what asset will attract global capital?

Gold is unquestionably emerging as a prime candidate. With a nearly 30% increase year-to-date, gold appears to be the main destination for converting dollar-denominated assets. This is surprising, as today's environment doesn't traditionally favor gold. Normally, gold is attractive when real interest rates are negative—i.e., when safe investments yield less than inflation. But today, in both Europe and the U.S., safe investments more than offset inflation's impact.

Gold's growing appeal since the start of the decade likely reflects the slow but relentless deterioration of public finances

"The world has changed. We're survivors. We adapt. We get back up. We fight." **–** Rick Grimes, The Walking Dead

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