NEWSLETTER

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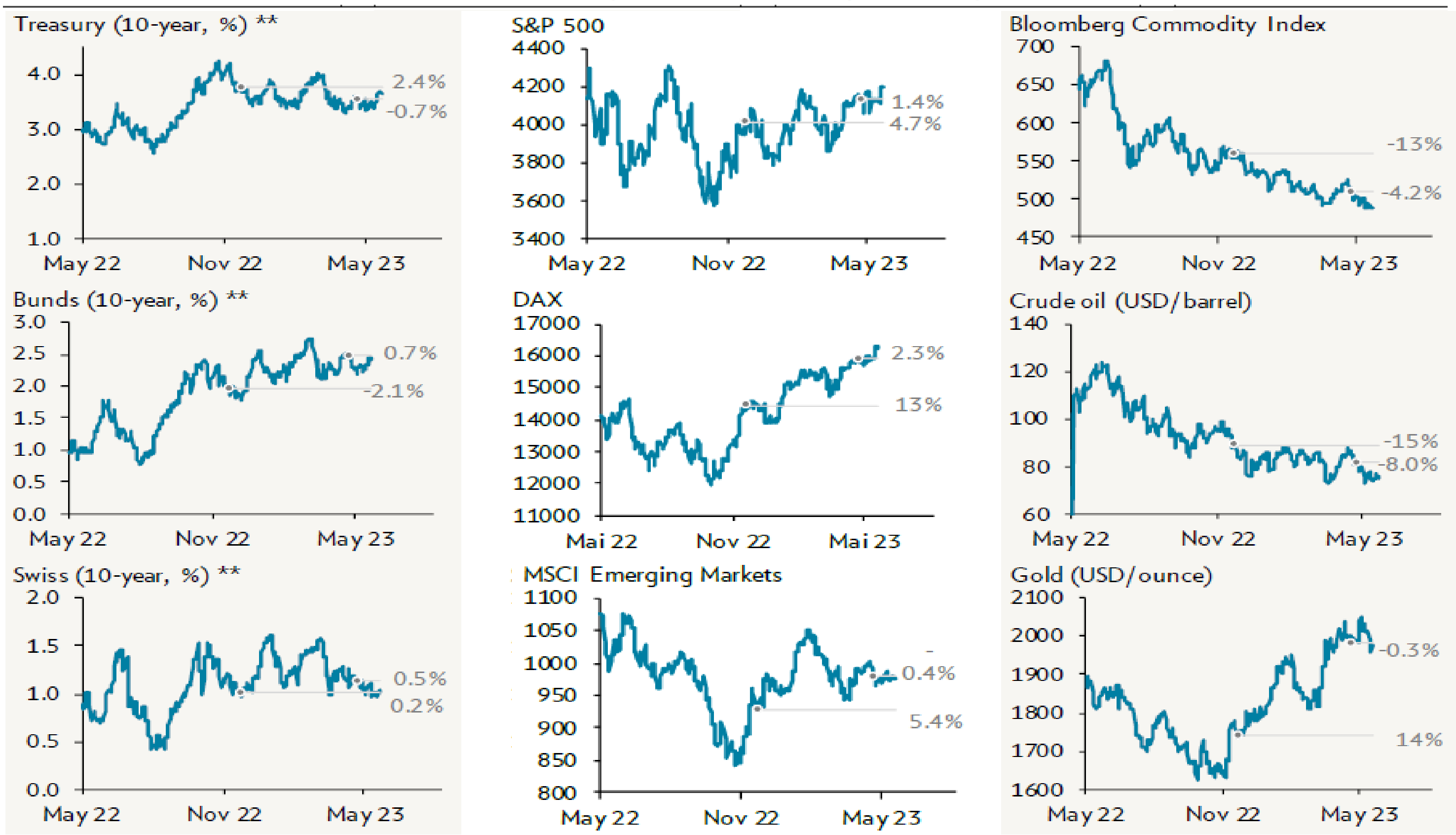
IN THIS MONTH'S NEWSLETTER

- Market overview
- Theme focus: Artificial Intelligence
- Graphs of the month

"How did you go bankrupt?"
Two ways. Gradually, then suddenly."
- Ernest Hemingway, The Sun Also Rises

MARKET OVERVIEW

Review (1-month and 6-month performance)



Source: Julius Bear, 22/05/2023

31/05/2023	Last	Month %	YTD %	5Y ann. %
MSCI World	2801	-0.9	8.82	8.37
S&P 500	4180	0.2	9.64	10.99
NASDAQ 100	12935	5.8	24.07	12.73
EURO STOXX 50	4218	-3.2	14.20	7.73
MSCI EM	959	-1.8	1.15	-0.49
HANG SENG	18336	-8.3	-6.42	-6.73
US Equities Volatility Index (VIX)	17.94	1.86	-3.73	

Source: Edmond De Rothschild

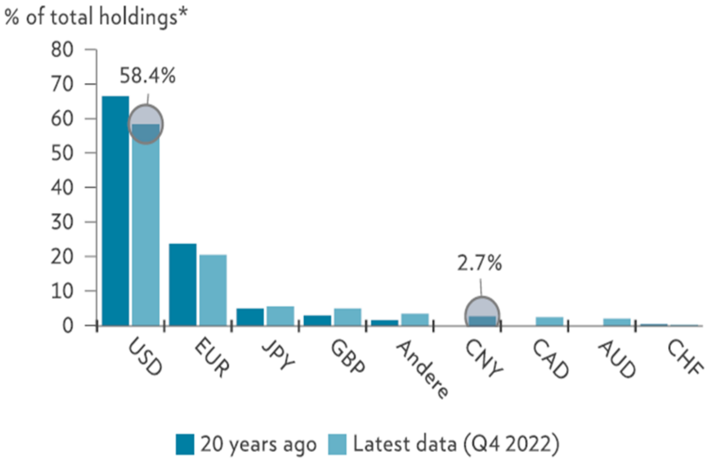
The recent retreat of the US Dollar from its recent highs, influenced by **peaking US interest rates** and ongoing **debt ceiling discussions**, has reignited the de-dollarisation debate. The newsletter will delve deeper into the topics of the US debt ceiling and de-dollarisation, providing detailed analysis and insights.

De-dollarisation

The debate is closely linked to developments in global geopolitics, where the rise of China to superpower status is shifting the landscape from a unipolar, US-dominated world, to a bi- or multi-polar one. In addition, Western sanctions against Russia due to the war in Ukraine have fuelled the desire of some nations to reduce their dependency on the greenback in order to avoid US hegemony.

Even though the US dollar share of total foreign exchange reserve holding decreased marginally over the past 20 years it is still by far the largest reserve currency (figure 1).

Figure 1: Development of global FX reserve holdings



Source: Julius Baer

Reserve currencies are part of the foreign exchange reserves held by central banks and monetary authorities to back their financial liabilities, balance their payments and influence exchange rates, thus providing stability during economic crises and instilling trust in financial markets. These reserves are comprised of banknotes, deposits, and government securities such as sovereign bonds.

While there are no official requirements or an authority that grants reserve currency status, we have identified the following qualities that a currency has to fulfill to be considered collectively by central banks and markets as one:

- A large stable economy
- Military force
- Financial market openness and depth

When a country's exports exceed its imports, it results in the accumulation of USD foreign currency reserves. These reserves flow into the country's domestic banking system and are ultimately managed by the local central bank. The central bank has the responsibility of ensuring the safety and liquidity of these foreign exchange reserves. Safeguarding the reserves involves minimizing credit risk and investing in highly liquid markets. The US Treasury market stands out as a global leader in this regard. With a market size of more than USD 20 trillion, it offers exceptional liquidity and is supported by a robust repo ecosystem. Investing in the US Treasury market provides central banks with a reliable avenue to preserve the value of their foreign exchange reserves while maintaining liquidity.

The alternatives to the US Dollar (USD) are:

Japan: Liquidity concerns. Its government bond market is 60% absorbed by the Bank of Japan and there have been multiple days in a row where no trade happened in Japanese government bonds.

China: Capital controls and a lack of financial market sophistication make doing business in yuan challenging.

Russia: A clear lack of democracy.

Brazil: Corruption and frequent episodes of double-digit inflation.

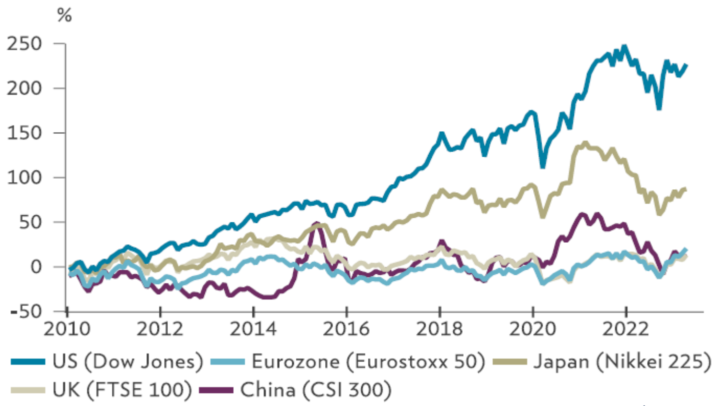
Possible **BRICS** (Brazil, Russia, India, China and South Africa) currency: While it is possible for the BRICS countries to create a new currency for trading purposes, there will be a few issues that need to be considered. It is in China's interests to warrant cheap commodity imports, but this contradicts with interests of the commodity exporters in the group. A currency for trading purposes would require some coordination in terms of monetary policy. However, the differing interests might make it hard to agree on coherent policies.

Another significant challenge associated with transitioning the foreign exchange reserve currency away from the US Dollar is the substantial amount of US Dollar-denominated debt that would need to be deleveraged. This debt includes various financial instruments, such as bonds and loans, issued by governments, corporations, and other entities in US Dollars. The process of deleveraging will be complex and time-consuming.

What would the implications be for exchange rates and investors if the US dollar (USD) was to be thrown out as reserve currency?

Ultimately, cyclical and fundamental drivers like US interest rates, which last year contributed to a nominal rise of the USD by more than 10%, appear to be more important in determining the exchange rate than structural drivers such as the reserve currency status alone. Accordingly, we currently face a cyclical rather than a structural weakening of the USD. Strong US equity performance also plays a role in keeping the dollar attractive. The only way investors are able to invest in these solid US companies is by buying shares in the US dollar.

Figure 2: Strong US equity performance keeps the dollar attractive



Source: Julius Baer

In summary, while it is not entirely impossible for the world to replace the US Dollar as the reserve currency, the likelihood of such a scenario is very low. This is primarily due to two key factors: the scarcity of viable alternatives and the complexities involved in unwinding US Dollar-denominated debt. Even if a replacement were to occur, the US Dollar is expected to remain an attractive currency to hold, considering the aforementioned reasons.

US Debt ceiling

In recent weeks, there has been significant discussion surrounding the US debt ceiling. The debt ceiling refers to the upper limit on the amount of debt that the Department of the Treasury is authorized to issue to the public or other federal agencies. This limit is established by law; however, it has been raised 78 times since 1960 in the past to facilitate additional borrowing necessary to finance the government's operations.

In January 2023, the United States reached its statutory debt ceiling, imposing a restriction on the accumulation of further debt by the government. Consequently, any spending must be financed using receipts, cash reserves, and extraordinary measures until policymakers reach an agreement to suspend or raise the debt ceiling.

The situation has raised concerns due to projections indicating that the available cash balance will likely last only until June 2023. Failure to reach a deal to raise the debt ceiling by June 2023 increases the possibility of the United States encountering difficulties in meeting its debt obligations, potentially leading to a default on certain debt.

It is worth noting that historically, there have been eight instances in the past 12 years where the government had no access to additional funding due to reaching the debt ceiling. However, in each of these cases, an agreement was eventually reached to either lift or suspend the debt ceiling. Currently, the delay in finalizing an increase in the debt ceiling can be attributed to ongoing negotiations between Kevin McCarthy, the Speaker of the House of Representatives, and President Joe Biden, who have differing views on the terms of the deal.

McCarthy conditions the debt ceiling increase on significant cuts in social spending, among other factors, while Biden seeks a prompt and unconditional increase. Given the importance of avoiding a debt default and the negative consequences it would have for all parties involved, we perceive an extremely low probability of a deal not being reached by June 2023. The relatively stable movement in credit spreads also indicates that the overall market does not exhibit significant concern. Considering the unfavorable outcomes associated with debt default, it is unlikely that such an outcome will materialise.

In summary, the prevailing sentiment suggests that the increase of the debt ceiling is not a matter of "if" but rather "when." Both Kevin McCarthy and Joe Biden acknowledge the necessity of raising the debt ceiling; however, they are currently engaged in negotiations to find a compromise regarding the terms of the increase.

CAPITAL GAINS AND DIVIDENDS – A POWERFUL COUPLE

Berkshire Hathaway still owns the roughly 400 million shares of Coca-Cola it bought for $1.3 billion in 1994. By 2022, the stake had grown to around $25 billion and Berkshire Hathaway received for that year alone $704 million in dividends, which translates into a 50%+ dividend yield on the original investment. While the time period of this example is admittedly very long, it goes to show not only the power of capital gains but also of dividends.

SOUTH AFRICA

31/05/2023	Last	Month %	YTD %	5Y ann. %
JSE All Share	75068	-4.03	2.76	5.56
JSE Resources	67512	-2.16	-4.65	10.85
South Africa 10Y Bond	11.30%			
Net Foreign Equity Flow	R22.8bn			
Net Foreign Bond Flow	R68.4bn			
USDZAR	19.7754	-7.43	-15.84	-9.49
EURZAR	21.0983	-4.27	-17.14	-7.50

Source: RMB

In May 2023, the JSE Alsi experienced a 4% decrease (+2.8% year-to-date), while the rand recorded a depreciation of 7.4% against the dollar and almost reached **R20 a dollar**. Notably, non-residents remained net sellers of South African incorporated entities.

South Africa has adopted an asserted **non-aligned** position regarding the war in Ukraine and has abstained from multiple United Nations votes denouncing Russia's actions. However, the country's neutrality was recently questioned when Reuben Brigety, the US Ambassador, accused South Africa of **supplying ammunition to Russia** through a Russian vessel (Lady R) that docked at the Simon's Town naval base in Cape Town in December 2022.

Brigety stated that the US government viewed the arming of the Russians as a grave matter and expressed dissatisfaction with the resolution of the issue. He urged South Africa to adhere to its non-alignment policy. Additional concerns raised by US officials included South Africa's involvement in military exercises with Russia and China during the anniversary of the Ukraine invasion.

Subsequently, the South African Reserve Bank (SARB) issued a warning that if South Africa's 'neutral' stance on the Russia-Ukraine conflict were perceived as insincere, it could have severe implications for the country's financial stability in the event of secondary **sanctions** being imposed.

The SARB's latest financial stability review highlighted the potential consequences, stating that secondary or indirect sanctions might result in a sudden cessation of capital inflows and an increase in outflows. The bank cautioned that South Africa's financial system would be incapable of functioning if its ability to conduct international dollar payments was hindered. The Society for Worldwide Interbank Financial Telecommunication System (SWIFT) processes over 90% of South Africa's international payments.

Furthermore, there are several other **significant risks** associated with South Africa facing sanctions, including the potential inability to finance trade or investment flows and difficulties in making or receiving payments from correspondent banks in dollars.

South Africa's heavy reliance on foreign investment inflows to support its current-account deficit could also be jeopardized. Additionally, the country's relationships with its main trading partners could suffer, leading to a loss of preferential trade access.

South Africa has already experienced a decline in favor among offshore investors, as foreign holdings of local government bonds currently stand at 25%, a decrease from 42% in 2018. The most pressing threat to the country's financial system continues to be persistent power shortages, which negatively impact domestic economic growth, investor confidence, and business activity, exacerbating pre-existing vulnerabilities.

Adding to the array of **major challenges** in South Africa, particularly for low-income households, is the issue of access to clean water. Private operators of water tankers are taking advantage of the government's failure to maintain water infrastructure and, in some cases, deliberately sabotaging municipal water supply to profit from their businesses.

This revelation follows a **cholera outbreak** centered in Hammanskraal near Pretoria, where 21 deaths have been reported and others have been hospitalized due to the consumption of contaminated water. Suspicions have arisen regarding the possible involvement of water tanker operators in the outbreak, as at least three cholera-related deaths in Hammanskraal were linked to the consumption of water from these tankers (according to Mybroadband).

Transactional Capital experienced a significant decline following the release of their half-year earnings report, which revealed a more substantial decrease than anticipated. In particular, the **SA Taxi business** encountered significant challenges, with attributable earnings plummeting by 77%. This decline can be attributed to various factors, including the adverse effects of floods and riots in KwaZulu-Natal, reduced commuter activity and soaring fuel prices. These circumstances have placed a severe financial burden on the minibus taxi industry and have negatively impacted the ability of taxi operators to fulfill their financial obligations, such as loan installments and insurance premiums.

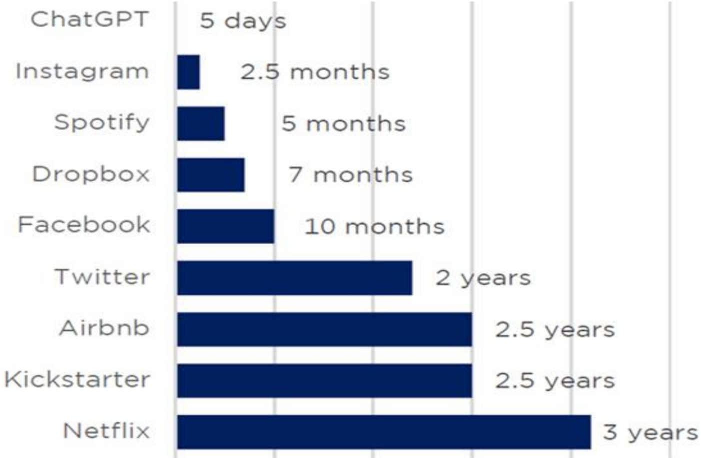
Figure 3: May 2022 Top 5 best and worst performing South African shares

Best performing	%	Worst performing	%
Steinhoff	+19%	Transaction Capital	-43%
City Lodge	+18%	Pick n Pay	-27%
DRD Gold	+13%	KAP	-27%
Alexander Forbes	+11%	Murray & Roberts	-27%
Textainer	+11%	Spar	-25%

Source: Factset

Artificial intelligence (AI) has transcended its previous abstract status and has emerged as a versatile technology with widespread applications across various domains, including healthcare, finance, advertising, and numerous others. The recent surge of interest in ChatGPT, a program specifically designed to enhance language models for conversational purposes, has intensified discussions surrounding the economic and societal implications of AI.

Figure 4: Time to reach 1 million users for various digital applications



Source: Statista, Edmond de Rothschild

The magic behind the machine

The objective of artificial intelligence (AI) is to enhance the intelligence and utility of machines, resulting in improved efficiency and productivity. By employing AI judiciously, companies can gain a competitive advantage, gain deeper insights into customer needs, and ultimately experience increased revenues or reduced costs. While the rationale behind investing in AI is primarily based on structural considerations, the evolution of AI will be shaped by two key factors:

1. **The availability of extensive data:** The abundance of data plays a crucial role in the development and advancement of AI. As data volumes continue to grow significantly in the coming decades, the speed and accuracy of AI systems are expected to improve correspondingly.

2. **Increasing computing power:** The progress in computing power is another pivotal factor influencing the evolution of AI. Continued advancements in computational capabilities will contribute to the refinement and effectiveness of AI technologies.

However, concerns regarding data collection, security, and privacy have emerged, leading to a public debate surrounding these issues. Despite the optimistic outlook for the growth of computing power and data availability, the unresolved concerns related to data handling have added complexity to the AI landscape.

There are three clusters of companies that are expected to reap the benefits of artificial intelligence (AI):

1. Large technology companies: These companies are poised to be the primary beneficiaries of the widespread adoption of AI. They possess extensive expertise in AI, accumulated through years of substantial investment. As a result, they are well-positioned to introduce and market AI-enhanced products and services. Furthermore, these companies have significant financial resources, enabling them to swiftly invest and allocate capital in high-growth areas, such as AI, which constitutes a pivotal component of their future growth strategies.

2. Software companies, cloud services, data analytics, and cybersecurity firms: The AI software market is projected to reach USD 192 billion by 2025, with a compound annual growth rate (CAGR) of 31%, according to IDC. Despite concerns about inflation and an impending economic downturn, spending on AI and automation technologies and solutions continues to surge, as stated by Ritu Jyoti, Vice President at IDC. Software companies, providers of cloud services, and firms specializing in data analytics and cybersecurity are well-positioned to capitalize on this growth.

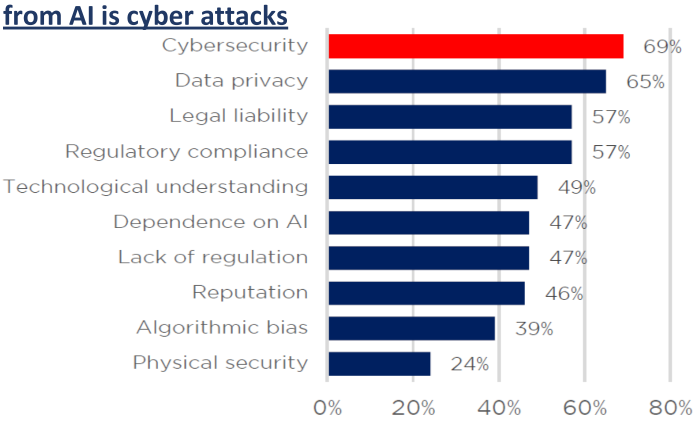
3. Semiconductors: The expansion of cloud computing and AI is generating substantial demand for semiconductors, including computing units, memory, and other components specifically designed for AI applications. Industry estimates project that sales of AI-specific chips will reach USD 77 billion by 2025, a significant increase from USD 11.2 billion in 2021. This heightened demand will greatly benefit chipmakers and companies involved in the production of semiconductor equipment.

What are the risks?

AI presents several risks that need to be carefully considered. These risks encompass both sustainability concerns related to the job market and the environment, as well as reputational and regulatory risks associated with misinformation and the potentially harmful use of AI. It is crucial to acknowledge that AI and natural-language models are susceptible to errors, leading to the generation of misinformation. Moreover, they may also raise issues regarding data privacy, security, and intellectual property rights.

Additionally, AI introduces the risk of a significant rise in cyber attacks due to the increased ease of creating viruses, scams, and manipulating data. The accessibility of generative AI, such as ChatGPT, lowers the barriers for entry for cybercriminals. According to a survey conducted by research firm Baker McKenzie, CEOs identify cybersecurity as the most significant risk associated with the widespread adoption of AI.

Figure 5: 69% of US executives believe the biggest risk from AI is cyber attacks



Source: Baker McKenzie, Edmond de Rothschild

The potential for automation through AI is substantial, with the capacity to replace repetitive and easily automatable tasks. This could result in job losses and a restructuring of the workforce to adapt to new roles. Numerous studies have attempted to quantify the global impact, estimating the number of jobs at risk.

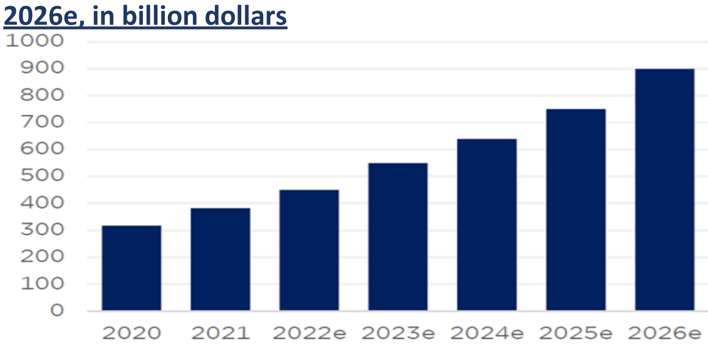
The OECD suggests that 14% of jobs worldwide are susceptible to automation, while PwC and Goldman Sachs estimate the figure to be around 326 million and 300 million jobs, respectively. According to a McKinsey study, it is the activities performed within jobs that are more likely to be automated, indicating that existing technologies can already automate approximately 45% of activities in the US, equivalent to USD 2 trillion in wages.

The extent of job automation will depend on **two key factors:** the amount of time spent on repetitive tasks within an activity and the level of training and qualifications required for the task. Sectors such as transportation, logistics, manufacturing, retail sales, fast-food kitchen staff, secretarial roles, and counter staff are among those identified by the OECD as being at higher risk of job automation.

Which are the opportunities for investors?

Based on the analysis conducted by consultancy firm IDC, the artificial intelligence (AI) market has the potential to reach a value of up to USD 900 billion by the year 2026. This estimation encompasses various segments of the AI market, including hardware, software, and services. If realized, this projection would represent significant growth, as it would be twice the value recorded in 2022.

Figure 6: Estimated global AI market between 2020 and 2026e, in billion dollars

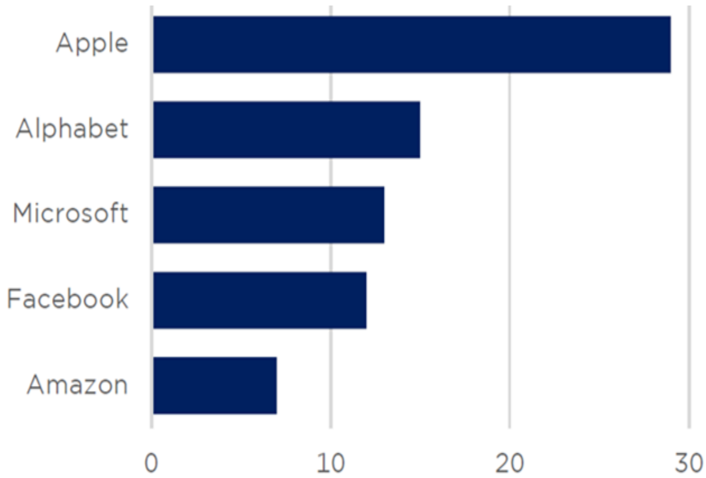


Source: OECD, Edmond de Rothschild

The significance of Artificial Intelligence (AI) became evident in the recent quarterly results of 1Q23, where references to AI during post-earnings conferences in the United States experienced a notable increase of 85% compared to the previous year. This substantial growth highlights the considerable interest and momentum surrounding AI within the private sector.

Bill Gates, a notable figure in the field, emphasized that entire industries will undergo a reorientation process centered around AI. He further stated that companies will distinguish themselves based on their ability to effectively leverage AI and derive maximum benefits from its utilization.

Figure 7: Number of acquisitions of AI companies by major technology groups, between 2019 and 2021



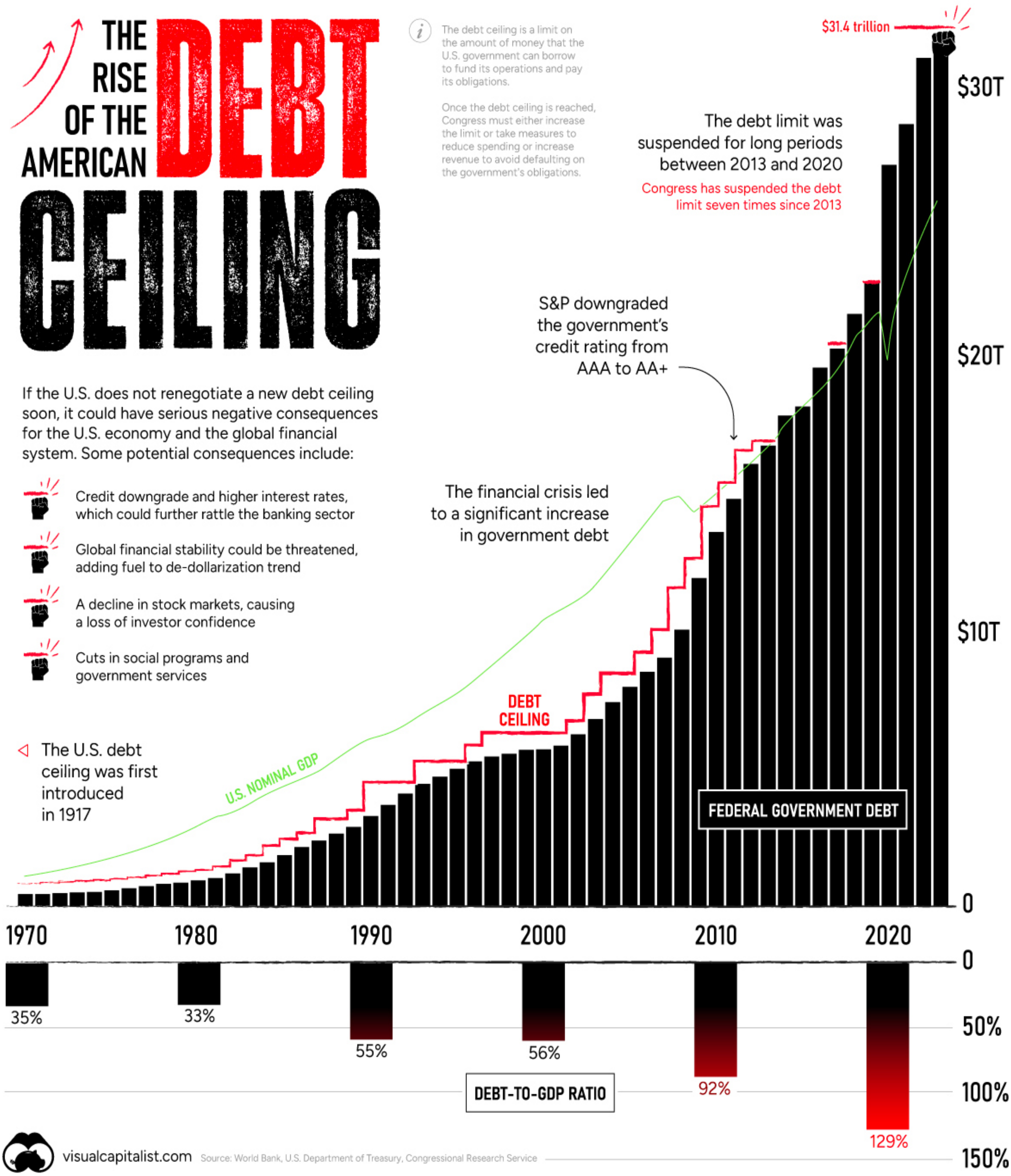
Source: CBInsights, Edmond de Rothschild

Numerous enterprises are making substantial investments in artificial intelligence (AI) with the aim of enhancing their operational processes, services, and products. This is motivated by the transformative potential of AI, which can yield significant competitive advantages across various sectors. Prominent technology conglomerates, including Google, Microsoft, Meta, and IBM, are channeling billions of dollars toward AI research and development.

For instance, Google acquired DeepMind, an AI startup, in 2014 for a substantial sum of $600 million. DeepMind notably achieved breakthroughs in AI by creating the first model capable of defeating a world champion in the game of Go, as well as the AlphaFold model, which accurately predicts protein structures.

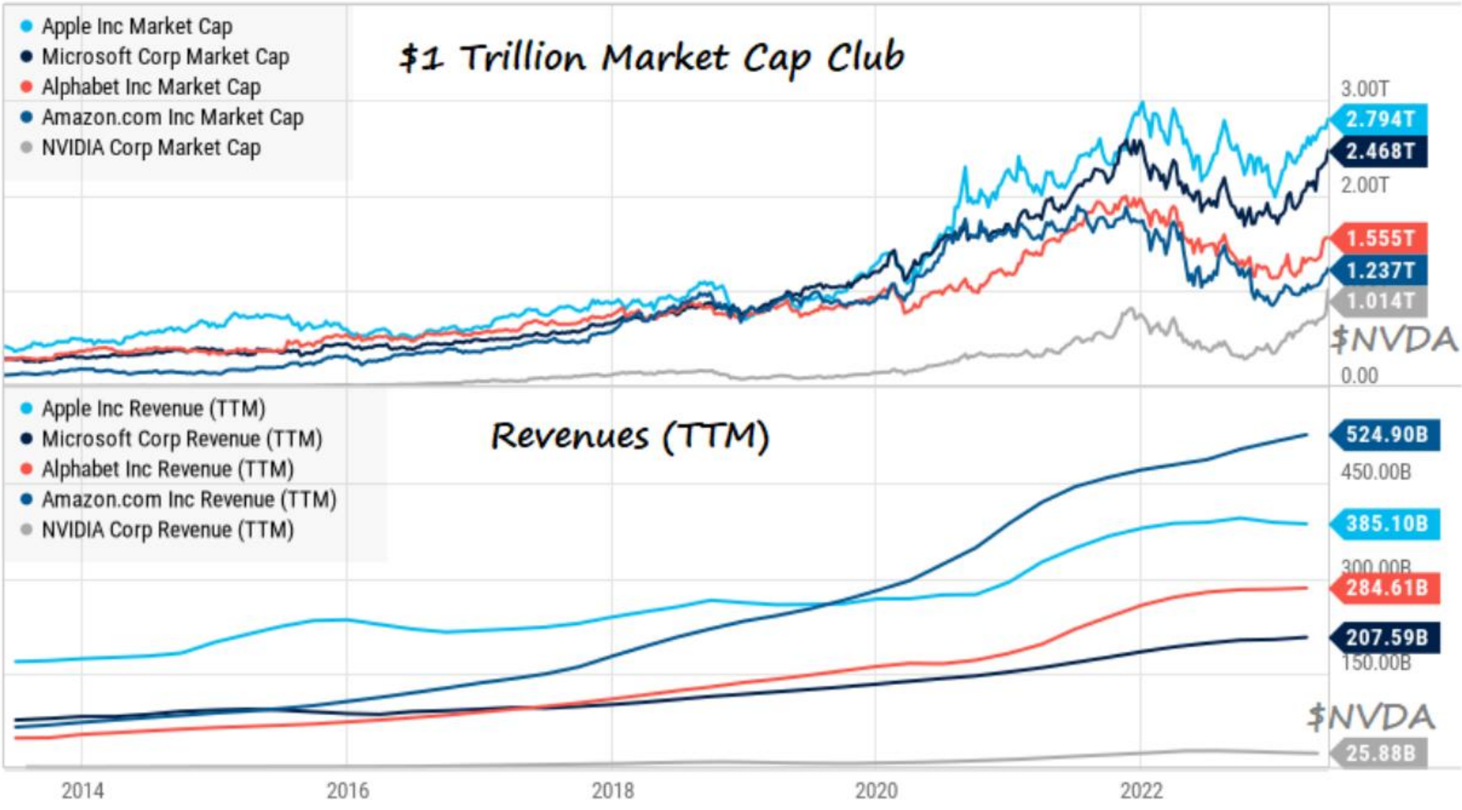
Microsoft, on the other hand, has made a strategic investment of over $10 billion in OpenAI, the developer of the generative AI model known as ChatGPT. Microsoft is actively integrating AI capabilities into its range of products and services.

GRAPH OF THE MONTH 1: THE RISE OF AMERICA'S DEBT CEILING



Source: Visual Capitalist

GRAPH OF THE MONTH 2: NVIDIA JOINS THE BIG 4 MARKET CAP CLUB



Source: Charlie Bilello

SOURCES

Sources: Bloomberg, BNY Mellon, Charlie Bilello, Credit Suisse, Compound Advisors, Edmond De Rothschild, ETFMG, FactSet, Haver Analytics, JP Morgan, Julius Baer, Morgan Stanley, Refinitive, RMB, Statista, Sygnia, Strategas, UBS

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