LETTER FROM THE CIO AM

MARKET ANALYSIS
AND PRINCIPAL INVESTMENT THEMES

OCTOBER 2022

HOPE FOR THE BEST, PREPARE FOR THE WORST

Since the Fed clarified matters at Jackson Hole, investors have been looking for the slightest indication that US inflation might have peaked. If so, and especially as the Fed's credibility has made a big comeback, long and then short rates could fall back, leaving markets expecting a re-run of the strong performance notched up after the end of the severe monetary tightening episodes in the 1980s or the second half of the 1990s. We are totally convinced that this scenario is possible. That is why, in spite of high volatility, we have kept portfolios invested at a minimum level; after all, we will only be certain that inflation has really begun to retreat when it has already started to happen.

BENJAMIN MELMAN
Global Chief Investment Officer, Asset Management

KEY FIGURE

-23.19%

the plunge in UK 30-year gilts between September 22, the day before the mini budget was unveiled, and September 27.

MARKETS HAVE NOT FULLY DISCOUNTED A RECESSION

US inflation is bound to slow but how exactly? Disinflationary forces are already in place: pressure on production lines is returning to normal, companies have been massively destocking, freight rates are plunging and commodity prices have fallen back significantly. Property prices are also starting to fall so there is some hope rents will follow suit. In fact, it would be tempting to bet on a disinflation rebound were it not for wages. The Employment Cost Index rose 5.1% over 12 months in the second quarter, or two percentage points higher than it should be if inflation were to be trending down to 2%. Unfortunately, previous cycles suggest that getting wage growth to slow to this level would necessarily entail a recession, one which markets have not yet completely factored in. For example, US high-yield spreads have been known to climb above 8% on recession fears but are currently trading at less than 6%. True, the S&P500 is now down 20% year to date and usually falls by at least that much when investors are worried about a recession but in today's atypical environment this does not indicate that recession risk has been fully taken on board: this year's fall is partly due to a rise in the discount rate for future earnings.

Naturally, we can always imagine situations where inflation returns to normal without a recession. Inflation expectations seem at last to have started falling, a key indication as they are supposed to play a big part in inflation. And excess savings built up during the Covid 19 crisis are now waning, possibly helping to reduce wage pressure and increase labour force participation. It can also be argued that inflation managed to fall back without a recession after radical monetary tightening in 1983 and 1994. The problem today is that inflationary tensions are stronger and the labour market much more stretched so the above points are probably too optimistic to make a convincing investment case. They nevertheless represent a relevant alternative scenario if only because most investors are still quick to believe in it.

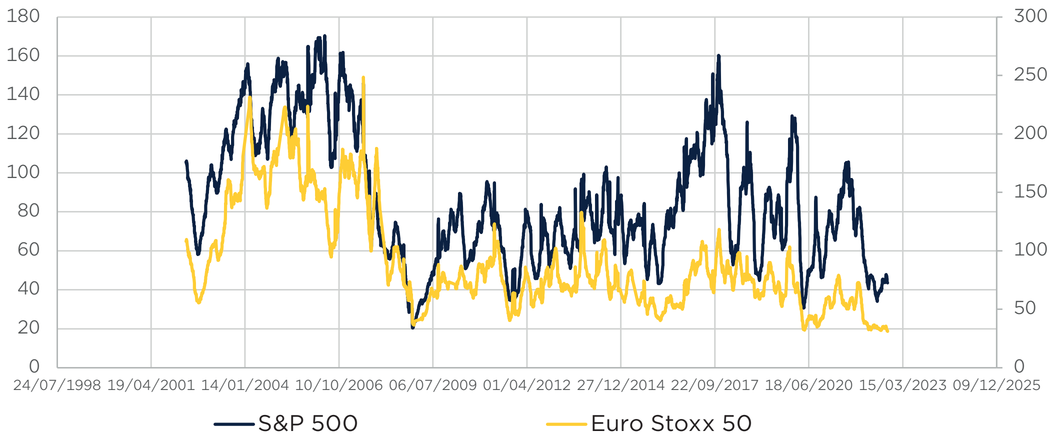
VOLATILITY LOOKS LIKE LASTING

As investors are relatively underexposed to risk and market volumes are rather thin, trading is likely to be volatile. There will inevitably be rebounds and downturns depending on news on inflation.

We intend to be more tactical over investing: until a US recession is more fully discounted in share prices, caution is the watchword. Another correction is possible, especially as a more comprehensive wave of earnings downgrades is likely to begin. At the same time, the UK bond market's violent reaction to the recent mini budget -and the fact that it spread to every other bond market- shows that there is currently no room for error in economic policy. Nevertheless, we need to offset this caution with the certainty that a sustainable rebound will end up happening. We cannot know for certain when but it is important not to stray too far from a strategic allocation.

We are still slightly underweight equities and generally neutral on fixed income although the US government bond market is finally trading at more reasonable levels. So far this year, equities and government bonds have moved in tandem but we believe they could part ways if a US recession were to weigh on equity and corporate debt markets. We are no longer overweight US equities vs. Europe. The European equity market has already been buffeted by lots of bad news, notably the energy crisis, while the US looks a little expensive given the move higher in US real bond yields.

Liquidity indicator



Source: Edmond de Rothschild Asset Management. Data at 07/10/2022.

	Our convictions*	Changes compared to the previous month
ASSET CLASSES		
Equities	-	→
Fixed Income	=	→
Cash	+	→
EQUITIES		
US	=	→
Europe (ex-UK)	=	↑
UK	=	→
Japan	-	→
China	+	→
Global Emerging	=	→
Convertibles	=	→
SOVEREIGN BONDS		
US	=	→
Euro Zone	-	→
Emerging Markets	-	→
CORPORATE BONDS		
US Investment Grade	-	→
Euro Investment Grade	-	→
US High Yield	-	→
Euro High Yield	-	→

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 07/10/2022.

KEY POINTS

We are still slightly underweight equities.

We are no longer overweight US equities vs. Europe.

We are generally neutral on bond markets.

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