EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

MARCH 2022

A LITTLE MORE TACTICAL AND STRATEGIC CAUTION

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THE SENTENCE OF THE MONTH

"There has been little empirical analysis of the financial market consequences of balance sheet normalization. This leaves central bankers with limited guidance on the realities of unwinding past asset purchases."

"The Financial Market Effects of Unwinding the Federal Reserve's Balance Sheet", Fed Kansas City, January 2022

► The market reaction to Ukraine's invasion is currently controlled. It is difficult to accurately estimate the premium linked to the geopolitical crisis. It must currently be around 7% on European equities (with the Euro Stoxx at -11% since the beginning of the year and which was -4% before the Ukrainian crisis became a cause for concern).

SLUGGISH BUT ULTIMATELY RELATIVELY QUIET MARKETS

We can be struck by the hiatus between the measure and orderly nature with which the market is pulling back in the face of the chaotic and disproportionate dimension taken by this conflict, which has continued to escalate so far. The term "nuclear" is sometimes used explicitly in threats and responses to these threats, and nothing happens as expected from the launch of the invasion. By way of comparison, the Euro Stoxx dropped nearly 20% in August 2015 following a 3% depreciation of the Yuan (which admittedly marked a sharp rise in concerns about Chinese growth). It is often said that geopolitical crises offer good entry points for investors, but it is often also because they have been accompanied by a "capitulation" of investors. However, this has not been the case until now. Furthermore, at this stage of the conflict, visibility is low and many scenarios are possible. It is still too early to know how much European and global growth and inflation will be affected, but we are undeniably moving towards a deterioration.

THE FED MAINTAINS A COURSE THAT LEAVES INVESTORS IN THE DARK

While the ECB suggests that it is ready to postpone certain elements of its monetary policy tightening until geopolitical uncertainty declines, the Federal Reserve is still far from sending such a message. In his latest statement to the Americans, the President focused on two subjects: Ukraine and inflation, showing clearly where the country's priorities are, priorities again reconfirmed by Jerome Powell. Historically, for the Federal Reserve to change its course in terms of monetary policy, there needs to be a very significant tightening of financial conditions. This still has not happened. In addition, the Fed is facing the management of an inflationary problem that is more threatening than in Europe, a first in decades. As we wrote last month, we are concerned about the prospect of quantitative tightening, which is not called into question by the war. In their communication, the Federal Reserve and some of its members readily acknowledge that they do not fully control the effects of this policy. A Kansas City Fed research note returned in more detail to the impacts of the only experience of quantitative tightening (end-2017 – end-2019), a period during which there was a stock market crash followed by the repo market crisis[1]. It comes to the conclusion that this policy is in no way the opposite of quantitative easing: the latter produces its effects as soon as it is announced, whereas the effects of quantitative tightening only materialised when it was effectively implemented. The link between this policy and the tightening of financial conditions is clearly established. It would therefore be risky to assume that the Fed's good communication on the issue means that quantitative tightening is already in market prices, especially since the terms of this policy are not even known yet. Much more than knowing exactly how many rate hikes the Federal Reserve will make, or whether there will be 50bp hikes - we assume that the Fed will seek to do neither too much nor too little - it is the choice to act on global liquidity without properly controlling the consequences that concerns us.

	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 28/02/2022.

A MORE TACTICAL ENVIRONMENT

We chose to adopt a more defensive positioning in our allocation by reducing the weight of equities through our exposure to Europe. In the short term, geopolitical visibility is far too low to take strong positions and, beyond the short term, the uncertainty related to quantitative tightening leads us to believe that this more defensive position could be a little more sustainable. It goes without saying that in the current exceptional environment, we are prepared to change our investment policy more tactically depending on the circumstances.

1. Sale and Repurchase Agreement. These money market financial instruments are repurchase agreements.

KEY POINTS

We reduce the weight of equities through our exposure to Europe

Geopolitical visibility is far too low to take strong positions

We are prepared to change our investment policy more tactically

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