LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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MARKETS LOOKING TO MAKE A FRESH START

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► After the downturn following the invasion of Ukraine, risk assets have been recovering since 8 March, pushing the major equity indices close to or above pre-war levels.

REASONS FOR THE REBOUND

All the parties around this conflict are doing their best to keep it local, carefully avoiding contagion. NATO countries are making the most of their latitude while ruling out any action that would qualify them as co-combatants. China is not openly supporting Russia, which has not launched a widespread cyberattack. It is even continuing to pay coupons on its dollar-denominated debt despite sanctions.

In addition, the Chinese authorities have made a series of statements aimed at reassuring investors on many issues (the situation of real estate and developers, the zero-COVID policy, their interest in the status of American Depositary Receipts (ADR), etc.).

Lastly, the Fed has drastically updated its forecasts on growth, inflation, and interest rates. Given that the central bank's actions are a concern in this inflationary environment in the run-up to the FOMC meeting, relief appears to be on the horizon once that date has passed.

THE FED WILL REMAIN A PROBLEM FOR THE MARKETS

However, we have not changed our asset allocation in this sequence and prefer to maintain a rather defensive bias. The stalemate of the situation in Ukraine in no way guarantees that its strictly local scope will remain in place forever. Moreover, while equity indices have returned close to or above pre-invasion levels, Brent crude oil has jumped by more than 25%, and agricultural commodity prices have risen sharply (S&P Agriculture up nearly 10%). This new surge in commodity prices is happening in a context where we are beginning to see some signs of inflation expectations loosening in the United States, not in terms of household surveys (Fed NY, University of Michigan) but in financial markets. US 10-year breakevens of inflation-linked bonds have become increasingly synchronised with shorter-term inflation-linked bonds movements since February. Against this backdrop, the revision of the Fed's scenario in mid-March this time shows a more drastic monetary tightening, beyond the 'neutral rate', to contain inflation. However, the sustainability of the scenario is again questionable. On the one hand, Jerome Powell acknowledges — and this is new in the Fed's message — that the labour market is very and probably too tight, while, on the other hand, the central bank expects the unemployment rate to stabilise at levels (3.5%–3.6%) even low-

KEY DATA

+10%

Increase in S&P Agriculture since the invasion of Ukraine

er than today. In other words, beyond the expected slowdown of inflation during the gradual normalisation of the global production chain, is it possible to return to a stable inflation environment if the economy remains above full employment? Within the central bank's scenario, we see an open door to revision towards more monetary tightening than what is currently envisaged by the institution and investors, especially since the fight against inflation is the subject of a very strong political consensus and is shared by the Fed.

THE US CURVE IS ALREADY PRACTICALLY INVERTED WHILE MONETARY TIGHTENING IS ONLY JUST BEGINNING

At a time when some segments of the US curve are already inverted, it cannot be ruled out that the markets are pricing in the risk that the Fed will have to break the recovery in order to regain control of inflationary dynamics. Lastly, keep in mind that the Fed is expected to implement a quantitative tightening policy in the near future (its timing and terms are still to be defined), which should result in tighter financial conditions as was the case last time.

	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 15/03/2022.

DO NOT BE OVERLY CAUTIOUS

It would be a little hasty to consider that the sharp rise in interest rates seen in recent weeks and the Fed's new scenario, this time taking into account a more serious programme to combat inflation, will put an end to the episode observed at the beginning of the year. The upward pressure on real rates persists, while liquidity will dry up. Other potential impacts on all the asset classes are still worrisome.

While the risk of contagion of the war in Ukraine appears to have diminished for the time being and negotiations between the two parties are underway, there is still no resolution on the table, and the stagnation of the conflict is weighing on growth and pumping up commodity prices at a critical time for inflation.

From a technical perspective, the market rebound has been accompanied by many buybacks of short positions (lifting of protections), leaving the market less covered and therefore more vulnerable to an environment lacking stabilisation on geopolitical issues or inflation issues, which confirms in the shorter term the reasons for some caution.

After stressing the risks associated with this environment, it should also be noted that even in anticipation of a sharp downward revision of European growth, the global recovery is expected to remain strong this year, particularly in the United States, even though Chinese momentum should pick up gradually. This global growth environment has historically been accompanied by rather commendable market performances, which also prompts us not to be overly cautious either.

At the beginning of the year, we were convinced that 2022 would be the year for European equities and expected more visibility on Ukraine in order to overweight the asset class. We still don't have that, and the European recovery is in jeopardy. We therefore remain underweighted. We continue to have an overweight position in Chinese equities, seeking to take advantage of the low valuation of this market, better management of the impact of the anti-COVID policy on activity, and the greater determination of the authorities to stabilise investor confidence. We remain rather defensive on the bond asset class.

KEY POINTS

We remain overweight on Chinese equities

We remain rather defensive on the bond asset class

We remain underweight on European equities

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