EDMOND DE ROTHSCHILD

LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

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A MORE UNCERTAIN CYCLE MEANS A MORE CAUTIOUS ALLOCATION

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A few months ago, our scenario was for a disinflation trend, albeit not necessarily in a straight line, accompanied with a somewhat modest recession. At the beginning of the year, disinflation appeared to be well under way along with signs of wage moderation in the US in the fourth quarter. Suddenly, investors could entertain hopes that disinflation was set to last and that a recession could be avoided. The data in the last few weeks have not only shown a recovery in western economies but also that the disinflationary trend has been losing steam. What is worrying is that the US residential market appears to be stabilising and even rallying: if even this highly interest-rate sensitive sector is no longer contributing negatively to overall growth, then how effective can monetary policy on the rest of the economy, which remains too dynamic? If the current trend were to persist, we might well ask whether financial conditions are restrictive enough to curb inflation. The ball would then be in the central banks' court with a possible double whammy for investors, i.e. higher interest rates and then a bigger chance of a recession.

For the moment, central banks are largely ignoring recent developments. Admittedly, recent data have been a surprise for everyone as all eyes were on a possible recession in the first half of 2023. Central banks have been wrong-footed by economic and market volatility so will probably look for a happy medium to avoid making a mistake. Faced with such an expected and inconvenient economic rebound, they can be expected to continue their policy tightening more slowly but for longer - by 25bp after the ECB makes its expected 50bp adjustment in March - as long as the economic recovery continues.

We are still convinced that disinflation remains the fundamental trend, one that is clearly anchored in the US despite economic shifts. After all, according to Milton Friedman, inflation is a monetary phenomenon over the medium to long term. And the M2[1] money supply in the US fell by an unprecedented 1.3% over 12 months. What's more, commercial banks can also have an impact on monetary growth and have slashed lending, according to the latest Fed Loan Survey. However, we cannot overlook today's fragile equilibria and the risk that we might once again be confronted with last years' problem, namely excessively high

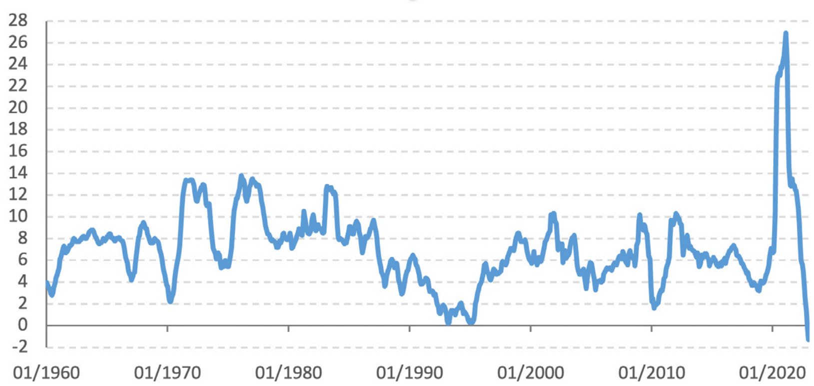
[1] M2 is defined as M1 (coins and notes in circulation and overnight deposits) plus short-term loans and savings deposits.

inflation with central banks playing catch up and ending up tightening more than expected. We prefer to reduce our portfolio exposures and have gone underweight equities while moving to a more neutral stance on bonds.

More specifically, we have reduced exposure to US equities and taken advantage of declines in China to slightly raise exposure to equities there. Recent geopolitical tensions could of course, add to volatility but the fundamental trend suggests a recovery. Signs China's property market is recovering have encouraged us to seize this opportunity. This recovery coupled with moderate inflationary pressures is the type of scenario we prefer to see.

On bond markets, we have trimmed our exposure to emerging-market bonds as they could be more adversely impacted than other markets by further Fed tightening.

FEDERAL RESERVE MONEY SUPPLY M2 YOY (% CHANGE)



Data as of 31/12/2022. Source: Bloomberg; Edmond de Rothschild Asset Management

OUR CONVICTIONS*

ASSET CLASSES	
Equities	-**
Fixed Income	=
Cash	+
EQUITIES	
US	-
Europe (ex-UK)	-
UK	=
Japan	-
China	+
Global Emerging	+
Convertibles	=
SOVEREIGN BONDS	
US	=
Eurozone	=
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). Rating as of 20/02/2023.

** Tactical score

KEY POINTS

Central bankers' reactions to the recovery and signs that disinflation is losing steam in western economies have been muted.

Faced with an unexpected economic recovery, we can expect monetary tightening to continue but at a slower pace and for longer.

We have reduced overall equity exposure, especially in the US, while slightly raising exposure to Chinese equities.

We have moved from positive to neutral on bond markets by trimming exposure to emerging country bonds.

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