LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

MAY 2022

THE MARKET CRISIS WILL END, BUT WHEN?

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Equity and bond markets have been severely undermined by rising real rates, persistently high inflation and worsening economic prospects. The sell-off has been impressive but we still detect no advance indicators suggesting we should seize the numerous opportunities that have emerged. We prefer to remain defensive.

VALUATIONS ARE STILL NOT VERY ATTRACTIVE

A defensive stance has, of course, become the norm and the consensus position can be dangerous. According to various surveys, investors are pessimistic and are now cautiously positioned, good news for rebounds but bounces need to last. Investor caution is only partly reflected in equity market valuations; they have indeed fallen but not to particularly attractive levels, especially on bellwether US markets. Bond market yields have risen along with higher interest rates and spreads but spreads could widen further if we have a recession. In other words, today's valuations are not per se a reason to buy the markets unless investors have a particularly long investment horizon. China, however, is a possible exception.

ALL EYES ARE ON CENTRAL BANKS

Our reasons for staying defensive are:

- **total lack of visibility on economic prospects**

China is still sticking to it zero-Covid policy and has for the moment refrained from adopting new stimulus measures, pushing growth prospects into troubled waters. Of course, Beijing could change its sanitary and economic approach but has refused to budge for political reasons despite numerous indicators suggesting it should do so. Europe, meanwhile, is confronting a possible recession and visibility is worsening. Energy supplies are at the mercy of geopolitical developments like Russia's decision to stop delivering gas to Poland and Bulgaria. The US is still enjoying solid growth -the first-quarter GDP contraction cloaked persistently strong domestic demand- but the outlook is still clouded by uncertainty over the pace of the Fed's tightening programme. Jerome Powell is arguing for a soft landing which will drag inflation back to targeted levels but he is not certain to avoid a recession. And even if he succeeded in preventing a recession, a fall-back in inflation to desired levels is not guaranteed. Each zone is struggling with its own problems and visibility remains low.

Markets have certainly factored in a marked slowdown in global growth but

KEY FIGURE

3.08%

the level Fed Fund futures are at for June 2023.

Markets are expecting a year of rate hikes with another 2.25% in store.

as investors need supports on the economic outlook, and there are none, we think it unlikely the decline is already discounted.

► central banks are tightening financial conditions

The Fed's quantitative tightening will kick off in June. Its effects are hard to anticipate as there has only been one other precedent. However, according to a paper by the Kansas City Fed[1], the impact on financial conditions will feed though when the policy is effectively rolled out and not when it is announced. By extrapolating, we cannot rule out that the phenomenon will occur again.

At a more anecdotal level, the ECB will probably have to provide more detail on its strategy. The Ukraine war has hit European growth but to a different degree for each country. Additionally, quantitative easing in Europe is to end and rates will start to rise in July, judging from recent statements from bank officials. In other words, peripheral country spread trajectories, hitherto under control because of strong liquidity, will be able to diverge again. The ECB says it will introduce a mechanism to rein in spreads but has given no details. Even with no specific news on Italy, the BTP-Bund spread has already widened by around 50bp since April. Markets could well test the ECB. Until the bank explains how it will manage to tighten financial conditions while limiting the impact on peripheral country spreads, funding could get tougher.

Given the circumstances, we have reduced exposure to Japanese equities. On the other hand, and even if we remain cautious on duration, we have upgraded US Treasuries, with a preference for short to medium-term maturities. In our view, markets are expecting a slew of rate hikes when the Fed appears to be aiming for a pause once its "neutral" levels of 2-3% are reached. This is already a broad range but markets expect Fed Funds to go beyond 3%.

	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 16/05/2022.

1. The financial market effects of unwinding the Federal Reserve's balance sheet, January 2022.

KEY POINTS

We have reduced exposure to Japanese equities

We remain cautious over duration

We have upgraded US Treasuries

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