LETTER FROM THE CIO AM

MARKET ANALYSIS
AND PRINCIPAL INVESTMENT THEMES

FEBRUARY 2022

FED UP MARKETS

► The environment is marked by ongoing tensions on real interest rates, particularly in the United States, triggered by a toughening of the Federal Reserve's message, as well as the announcement of a probable implementation of a quantitative tightening policy this year (reduction of the central bank's balance sheet). At the end of 2021, the high volatility of interest rates had a significant impact on the relative factor and sector performances of the equity markets. Since the beginning of this year, the absolute performances of the equity markets have also been affected, with a connection between interest rate volatility and the volatility of the equity markets, clearly depicting the image of tectonic plates in motion. In recent days, the escalation of tensions between Russia and the West over Ukraine has added to investor concerns. Thus, since the beginning of the year, the S&P 500 has undergone a correction (down 10%) and the VIX[1] has risen to 38, which is a very high level. Despite this very strong risk aversion, US long-term rates are still rising.

BENJAMIN MELMAN
Global Chief Investment Officer, Asset Management

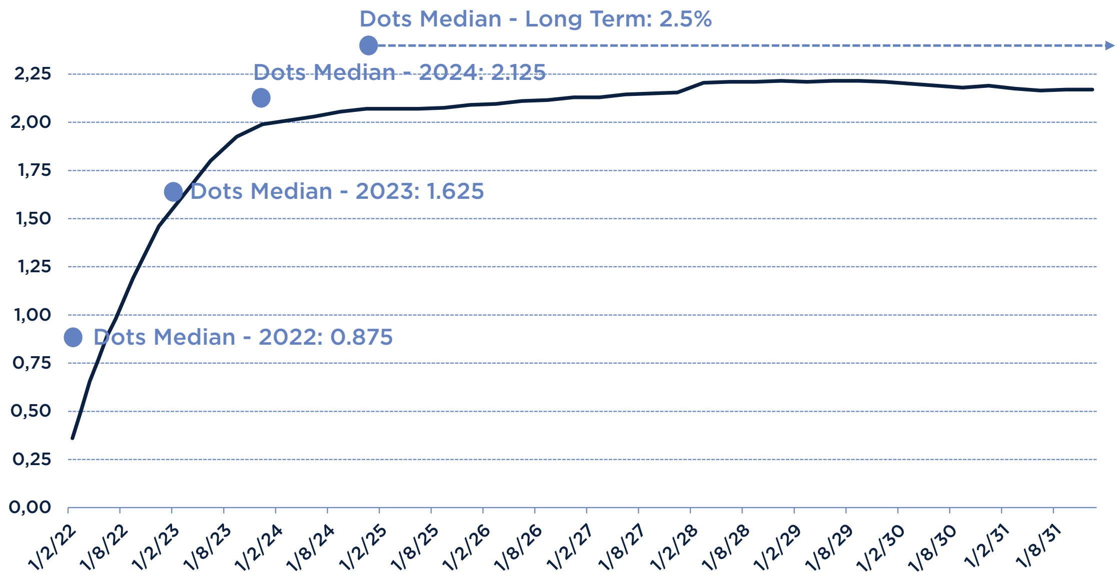
THE INFLATION ISSUE REMAINS IN SUSPENSE

At the beginning of October, the markets were expecting only one rate hike by the Fed in 2022. They now think there will be four. While it cannot be ruled out that investors will anticipate even more, as the tone of both the Fed and the Biden administration has become clearly counter-inflationary, it is possible, even probable, that most of the adjustment has taken place as market expectations are now a fairly good reflection of the median projections of the Federal Reserve. This said, we should not rule out that the Fed may need to once again revise its monetary tightening programme upwards if inflation does not slow like it anticipates. Indeed, it may seem surprising to note that the Fed, in view of its inflation forecasts, intends to maintain negative real fed funds rates up to 2024, an abnormally low level to "fight" inflation and even though the economy already appears to have reached full employment. We expect inflation to ease with the reduction in the bottlenecks that has probably started in recent weeks for certain goods. However, as wage growth continues to accelerate in the United States, it is too early to conclude that the inflation theme will not come back to haunt the Fed and investors.

AN UNFORTUNATE EXPERIENCE

The quantitative tightening that the Fed has announced it wants to implement this year in a few months is not good news. From the viewpoint of the central bank, which has noted that there is ample liquidity and financial conditions are still very accommodative, we can understand it not wanting to tighten rates too abruptly and to use other "easy" tools to accelerate the monetary tightening. However, as it itself recognises in the minutes of

Government bond yields have moved towards the Fed's dot plot but are still slightly below



Source: Bloomberg. Data as of 27/01/2022.

Past data are not indicative of future data and are not constant over time.

its last monetary policy committee meeting, the effects of an interest rate hike are better controlled than quantitative tightening. As a reminder, the only experience in this area (end 2017-mid 2019) saw a stock market crash in the fourth quarter of 2018 in the context of a global liquidity contraction, followed by a repo[2] market crisis in 2019. All the data and surveys nevertheless had led the Fed to believe that there was ample liquidity: the process was poorly controlled and, apart from some new technical provisions improving liquidity management, there is no reason to think that the process is better understood today.

While the correction on the US market started following the latest minutes published by the Fed, which introduced the possibility of a quantitative tightening this year, it is unlikely - despite the drop - that the markets have fully factored in a liquidity tightening. Indeed, the very good resilience of the US credit market in this correction does not match the outlook of a dry-up of liquidity, as corporate bond spreads are particularly sensitive to this notion. In 2018, credit spreads had quickly suffered from this monetary policy move, before the equity markets. In other words, the quantitative tightening remains a risk factor that should be monitored closely, in our opinion.

THE TENSIONS IN UKRAINE ARE RAISING CONCERNS

The Ukrainian crisis increases risk premiums with the dramatisation of the US and UK message about an imminent invasion. Among the many questions raised, in the event of massive sanctions against Russia, that of Europe's energy dependence on Russia arises for investors in a context in which supply and prices are already highly unstable.

EQUITY MARKETS SHOULD CONTINUE TO RISE

Against this backdrop, we are maintaining our exposure to the equity markets, considering that a lot of bad news has already been priced in. We had indicated a few weeks ago that we expected a rise in volatility linked to the normalisation of US monetary policy, but that in a context of strong growth, equity markets should continue to rise, especially as earnings growth expectations are relatively modest. With some major countries planning to lift health measures and the idea that the epidemic has peaked, we are even more convinced by this scenario. On the other hand, we are not convinced that it is already time to add risk into the portfolios.

With China's measures to ease economic policy and indicators showing a slight recovery in the country, we are increasing our exposure to Chinese equities. This is a tactical strategy as many uncertainties remain, including the sustainability of the "zero Covid" policy and the intrusion of political doctrines into business, but we believe that China, being the only country that can afford the luxury of relaxing its economic policy, offers potential for diversification. In return, we reduced our exposure to investment grade[3] credit and the US high yield[4] market, considering that the credit market will be the most sensitive to the problem of a global liquidity reduction.

1. Volatility index of the US financial market.

2. Sale and Repurchase Agreement: a transaction in which both parties agree on two transactions simultaneously, namely a sale of cash securities followed by a future repurchase at a pre-agreed date and price.

3. "Investment grade" bonds are bonds issued by companies for which the default risk varies from very low (almost certain redemption) to moderate. They correspond to a rating of AAA to BBB- (Standard & Poor's scale).

4. High yield bonds are bonds issued by companies that carry a higher default risk than investment grade bonds and offer a higher coupon in exchange.

	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 21/01/2022.

KEY POINTS

It is too early to add risk into the portfolios

We are increasing our exposure to Chinese equities

We are reducing our exposure to investment grade credit and the US high yield market

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Société anonyme governed by an executive board and a supervisory board with capital of €11,033,769 -

AMF registration No. GP 04000015 - 332.652.536 R.C.S Paris

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