MARCH 2022

REDUCING EXPOSURE TO PRICIEST MARKETS

More risks feeding into inflation. Recent developments regarding Ukraine invasion have sent investors into a flight to quality. How long these geo-political tension will last is uncertain, but these developments will undoubtedly tend to keep commodity prices high (starting with oil and gas) and sustain the general upward pressure on prices. With activity still strong in developed economies but inflation remaining high longer than expected, central banks will gradually tighten their monetary policies. This should mean a pursuit of the global rise in interest rates and greater volatility in high-valued assets.

We have reduced our global risk exposure, going from Overweight to Neutral on equity markets. We have notably reduced exposure to the US equity market, which still looks expensive on fundamentals compared to the other developed economies. Also, inflationary pressure remains higher in the United States than in the euro zone, suggesting the Federal Reserve is likely to tighten policy faster and harder than the ECB. At the same time, we are increasing exposure to the British market in line with our ongoing Overweight to the Euro area. European equity markets still look attractive in value terms and also because of their sector breakdown. They offer a way to hedge current risks. We are also adding exposure to hedge funds and retaining our Overweight to gold - both are attractive alternatives in uncertain times. Finally, meanwhile, we are yet further reducing our exposure to corporate bond markets, moving to strongly Underweight, as rates continue to rise and asset purchase programmes wind down.
Our Strongest Convictions

Continued recovery in the developed economies despite increased uncertainty
The new geopolitical context is accompanied by an increase in commodity prices, which will weigh on the strength of activity. Economic growth should nevertheless remain sustained in the coming quarters, due to the good financial health of companies and households.

The risk of inflation should be closely monitored, particularly in the United States
The pressure on commodity prices poses an additional risk to already high inflation levels. The risks are greater in the United States, where the central bank is expected to tighten more quickly and more sharply than in the Euro area.

Asia stands out from the rest of the emerging economies
Many emerging economies will experience sluggish growth, high inflation and high political risks. Asia stands out for its contained inflation levels and favorable medium-term growth prospects.

Reduced risk taking in equities and corporate bonds
We have opted for a more cautious allocation by going Neutral on the equity markets and very Underweight on the corporate debt markets.

A geographic allocation favoring the least valued markets
We are reducing our exposure to the US equity market, which is still high in terms of fundamental valuation compared to other developed markets. We increased our exposure to European markets, which remain attractive in terms of valuation and have a favorable sectoral breakdown.

Overweight gold, hedge funds and the dollar against the euro
We will overweight alternative investments to benefit from their attractive returns in times of strong volatility. The dollar could also continue to appreciate against the euro as a result of faster action by the Federal Reserve relative to the ECB.
The table below presents the conclusions of our lastest Global Investment Committee (GIC):

### Summary house views

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Doubts build on recovery and inflation

Recent geopolitical developments in Ukraine are stoking uncertainty on the global economic outlook without, at this stage, imperiling recovery in developed economies. How long this may last, and the likely consequences remain uncertain. However, the situation will clearly tend to keep commodity prices high and strengthen upward pressure on prices. With inflation running high for longer than expected, central banks will be tightening monetary policy, each at their own pace. Emerging economies outside Asia face the threat of embedded meagre growth and high inflation, coupled with political risks.

Fundamentals remain sound in developed economies. The rise in commodity prices will weigh on activity, particularly in Europe, which is more directly dependent on Russian supply. However, corporate and household finances look solid enough to allow economic recovery to continue. The lifting of COVID restrictions and the overhang of savings built up during lockdown should sustain consumption. Normalization of labour markets will be another source of support.

Inflationary risks need close watching, particularly in the United States. Ongoing commodity prices increases could further boost already intense inflationary pressure. Risks are greater in the United States where inflation is already higher and feeding through to wages and where the economy looks set to remain stronger. The Federal Reserve will launch its cycle of rate hikes in March and start to pay down its balance sheet (S2-2022). In the Euro area, the lack of pressure on wages and uncertainty as to the strength of recovery will encourage the ECB to delay its normalization of policy. The bottom line is that the Fed will tighten policy faster and harder than the ECB.

Emerging economies at risk of stagflation. Commodity price pressures will further stoke the stagflation (rising inflation and meagre growth) already affecting many emerging economies. Their central banks are also tending to tighten policy more than expected. One exception is China, where inflation remains under control and monetary policy is being eased to perk up a manifestly sluggish economy.

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The coming months will be marked by the beginning of the tightening of monetary conditions by central banks and the persistence of a high level of inflation. We remain very Underweight in developed market sovereign bonds and have moved to Strongly Underweight in European credit (Underweight in the high yield segment).

**Fixed income**

**United states.** Yields on US sovereign debt remain on a general upward trend as inflation stays high longer than expected and the Federal Reserve tightens monetary policy. The Fed is due to end net purchases of Treasuries in March and embark on a series of rate hikes. Financial markets are expecting six quarter-point rises over the year and the Fed to start shrinking its balance sheet in the second half. While the short end of the curve has reacted to the tighter policy outlook, long yields remain stubbornly below 2%, basically reflecting the rise in geopolitical risks. In light of an economy that should remain healthy, with inflation locked into a rising trend for the next few months and the start of Fed tightening, we remain strongly Underweight on Treasuries.

**Euro area.** Euro area sovereign yields also remain on an uptrend. The ECB said after its January meeting that it could halt asset purchases and start hiking rates faster than it projected at end-2021, as inflation continues to surprise on the upside. As a result, sovereign yields have been rising across the region, with the 10-year Bund paying positive returns for the first time since 2019. True, the Ukraine conflict could stop the ECB’s policy tightening in its tracks. However, high inflation and still vigorous economic activity continue to play against European bonds. We therefore remain Underweight.

**Royaume-Uni.** We also remain strongly Underweight on Gilts. The Bank of England has begun its tightening cycle, while suggesting it could move quickly and push the policy rate beyond neutral. Again, the Ukraine conflict might delay the schedule, but the environment suggests little upside for Gilts.

**Credit**

**United States and Europe:** We have gone from Neutral to Underweight on European high-yield credits. The prospect of a faster-than-expected monetary tightening by both ECB and Fed, and inflation driven more by energy prices than strong demand, should widen spreads on these assets.

**Emerging markets.** We remain Neutral on local currency EM bonds. Although the growth outlook is weak for emerging economies outside Asia, most offer attractive carry as the major economies are still sitting on substantial foreign currency reserves.

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The financial and economic environment is getting more challenging for risky assets. We expect a continuation of the market movement that will hit overpriced stocks the most. We have reduced our equity exposure to Neutral and reviewed our geographical recommendations based on valuation. We moved to Neutral on the US equity market. We are increasing exposure to the British market in line with our ongoing Overweight to the Euro area.

United States. Recent months brought high volatility and some big corrections to US equity markets. If all sectors posted declines during the months, the bigger corrections concerned IT values. Overall valuations may have come off their peak, but they remain high compared to other regions and vulnerable to a further correction. Also, price pressures in the United States remain strong, with a broadening to items less exposed to transitory effects. The Federal Reserve is likely to tighten policy and real interest rates are likely to go positive again. This monetary tightening will probably be negative for stock market segments that already look overpriced, notably Growth stocks. We have reduced exposure and moved to Neutral on a volatile US market with some segments still looking very expensive in valuation terms.

Euro area. The Ukraine conflict has taken a toll on Euro area equity markets, but they still appeal more than the US market because of the relatively cheap valuations. Also, while the euro area may be feeling inflationary effects, these are still less threatening than in the United States – the big difference being the lack of wage inflation in the Euro area. This will allow the ECB to remain more accommodative than the Fed. Monetary policy changes will be proportionately more modest, helping support equity markets. The Euro area is especially exposed to the Ukraine conflict and to pressures on energy prices. Short term, commodity prices will continue to hurt the zone economy. Longer term, we believe the fundamentals are strong and attractive prices of the region’s companies. We therefore remain Overweight.

United Kingdom. In contrast to the downward trend of the beginning of the year, the British equity indices are showing gains, thanks to very low valuations on the one hand and the weight of oil and mining companies in the indices on the other. Thus, the rise in commodity and energy prices is benefiting this market, which is rich in cyclical companies. We therefore increased our exposure to Overweight.

Japan. Global equity markets have underperformed since the turn of the year and Japan’s market was not spared. Japan is different, though. It still has very low inflation and a very accommodative central bank. That said, we are a long way from a favorable environment for equities, given the generally meagre yields paid by Japanese stocks and their relatively weak upside. We remain Neutral.

Emerging markets. In emerging countries, regional divergences continue to materialize. China appears attractive due to a controlled landing of its economy and a potential rebound of its activity. Latin American indices have shown gains in a context of high commodity prices and significant carry. Thus, we remain Neutral.

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FX RATES

Geopolitical tensions reinforce our conviction to be overexposed to the dollar

Intense geopolitical tensions and the Fed’s lead in the monetary policy tightening cycle will support the dollar over coming months.

Dollar index. The dollar has gained 2.5% against a basket of currencies in the last three weeks as geopolitical risks have mounted. The Federal Reserve is tightening policy before the other big central banks in developed economies and geopolitical risks should continue for the next few weeks, which should support the USD.

EUR/USD. We remain Overweight the dollar versus the euro. Rising geopolitical risks and the Fed set to tighten policy before the ECB will keep the dollar strong.

GBP/USD. Sterling stayed largely unchanged versus the euro at EUR 1.19. We remain Neutral on the cross, as the gap between nominal rates in the two regions is likely to remain stable.

USD/JPY. The yen stayed unchanged against the dollar over the month. The Bank of Japan left monetary policy unchanged, continuing to control the yield curve with underlying inflation still running at a negative -1.1% in February. The sharp divergence in monetary policies should help the dollar against the yen. But a number of risks (geopolitical, equity markets) and the inflation gap should limit downside pressure on the JPY. We remain Neutral on the USDJPY.

EUR/CHF. The Swiss franc has gained 3% against the euro in a month, thanks to its safe-haven status. While the Russo-Ukrainian conflict looks set to continue for months yet, the still negative Swiss interest rates and the SNB’s interventions on currency markets should cap any gains by the CHF. We remain Neutral on the EUR/CHF.

EM currencies. Before the invasion of Ukraine, emerging market currencies, especially in Latin America, were on an uptrend versus the dollar, buoyed by a high spread in real rates and high commodity prices. However, if political risks persist, they will tend to put downward pressure on emerging market currencies.

Rise in the dollar and in the spread between German and American sovereign rates

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Further diversification

Alternative investment strategies (hedge funds) and safe haven assets like gold would seem good options for hedging the geopolitical risk of Ukraine sliding into war and the economic risk of inflation becoming baked in. We retain our Overweight to gold, and we strengthen our position in hedge funds, which offer attractive diversification with low correlation to traditional assets.

Commodities

Oil. Crude is currently trading at over USD 100/bbl - for the first time since 2014 - mainly because of Ukraine. These geopolitical issues inevitably weigh on supply as Russia is the world’s second-largest oil exporter. Unless we see a de-escalation, price pressures will remain strong and major disruptions to delivery may emerge, squeezing supply still further. Other factors are also pushing up oil prices: strong demand as the world emerges from Covid, the end of health measures, the strategy of OPEC+ and the lack of producer investment in recent years. All of which points to expensive oil, at least for the short-term future. On the other hand, a ramp-up of shale oil production in the United States and the possible return of Iranian oil to the market would tend to ease price pressures. On balance, we remain Neutral on oil.

Gold. Gold prices are on the rise, impelled by geopolitical tensions, recent turbulence on equity markets and the spectre of inflation persisting for longer than expected. Gold has gained 8% over the month and now changes hands at nearly USD 1,950/oz, a high since August 2020. Its safe-haven status looks assured in these risk-averse times. And it gains too from the volatile climate affecting equities – gold having little correlation to traditional assets. We therefore, unsurprisingly, retain our Overweight.

Hedge Funds

Long/Short Equity. We still like L/S market neutral funds for their ability to provide “performance protection” in the current climate of high volatility and sector switching on equity markets.

Event Driven. Times are still good for these funds. Plenty of restructurings and M&A with companies sitting on ample cash or happy to raise finance on current bargain terms.

Fixed Income Arbitrage. We are still cautious on funds taking positions in sovereign debt, given our scenario of a gradual rise in interest rates. We prefer funds positioned on the credit side, which stand to profit from particularly tight conditions on this market. Such funds also offer protection against rate widening.

Global Macro / CTA. Commodity Trading Advisors (CTAs) offer traditional protection against market volatility, which looks set to persist. As for Global Macro funds, managers will have to pick particularly carefully amid uncertainty about the economic recovery.

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