MARKET FLASH

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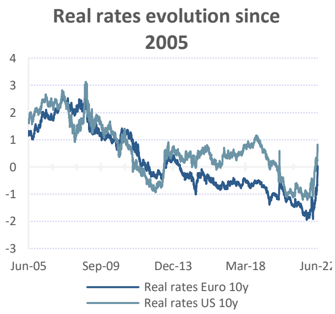
Highly-pressured financial markets

The inflationary crisis that we face is changing the very structure of financial equilibriums that we have known for about 20 years. This increase in prices has several causes : Covid crisis, supply chains disruptions, war in Ukraine, lack of fossil fuels investments, etc. with repercussions on all financial assets.

As a direct consequence, central bankers all have (or almost all) drastically changed their tone in recent months :

- **United States** : the Fed increased its key rate by 150 basis points. They have signaled their will to continue their restrictive monetary policy to arrive at a key rate of around 3-3.5%, while reducing its balance sheet
- **Europe** : the ECB abandons its asset purchase program and announced its first rate hikes in July.
- **Switzerland** : the national bank has started to raise its rates and will possibly be joined shortly by the Japanese central bank who is not satisfied with the hurtful depreciation of the yen.

This global monetary policy tightening logically leads to less accommodating financial conditions with real rates rising sharply in recent months (*see real 10-year Euro and US rates opposite*).



Since 2008 we have lived with an inflationary risk close to zero and very accommodating central banks. This has allowed real rates to fall and favorised financial assets' high valorisations (real estate, credit, shares, etc..). This trend is now behind us, and this should remain the case if inflation continues to be the main problem for central bankers.

Soaring inflation, skyrocketing energy prices for the consumer and increasingly restrictive credit conditions all have a negative impact on growth across all sectors and more specifically on the consumer. Consumption levels remain strong in most developed economies, led by the United States, thanks to the savings accumulated following the various support plans. It is very likely however that it will gradually decrease in the coming months. Although the inflation's source is mainly linked to supply issues, central bankers **want demand to crumble in order to curb inflationary pressures.**

This is especially true in Europe, with demand already showing tangible signs of a strong slowdown. Having no means of acting on supply, central banks will therefore try to achieve a difficult objective: slowing the economy without causing a recession; **a historically difficult balance to achieve.**

In light of all this, we believe that growth forecasts will continue to decline over the medium term, which should lead to lower earnings estimates for companies. These companies will find it difficult to counter more expensive financing, margins pressure and reduced consumption, whose price elasticity should increase. The decline in risky assets now reflects the tightening of financial conditions but are not pricing earnings' drop yet. In our opinion, **it seems too early to turn positive on bonds or equities, despite already pronounced declines.** Diminishing inflationary pressures appears to us to be the main condition for the financial markets to stabilize. It is currently extremely difficult to get an informed opinion given the determinants of this inflation.

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WHAT ARE THE IMPACTS ON OUR INVESTMENT APPROACH ?

HIGH YIELD

Since the start of the year, High Yield indices' performance varied between -11% to -16%[1] depending on the region. The rise in spreads of around 200 bps coupled with the rise in risk-free rates had a significant impact on the asset class.

Emerging High Yield, particularly in Asia, due to the specific in China, underperformed all of the other regions. From a sector point of view, apart from fossil fuels and raw materials which are benefiting from the current context, all sectors are penalized, especially Distribution; Industrials and other sectors sensitive to rising interest rates such as Real estate.

Our central scenario includes a continuation of central banks' restrictive monetary policies to curb inflationary pressure (even if a large part of the rise in rates has already been priced by the markets) as well as a risk of economic deterioration which extent will differ from country to country.

That said, we are trying to tailor our High Yield portfolio positioning the following way :

- **Geographical zones :** In Europe, we favor "Core" countries and remain very cautious on the peripherals, particularly Italy. The American market seems to be more resilient than the High Yield Euro market because it has been less impacted by the conflict in Ukraine. Arbitrage towards the US High Yield are made on a case-by-case basis considering the sharp rise in EUR/USD hedging costs. Emerging market exposure is unchanged and relates mainly to Asian and LATAM High Yield. We have no exposure to Eastern Europe and Central Asia (CEMEA). Our only exposures to emerging issuers in Europe relate to Slovenia and Croatia (between 1 to 2%). Finally, our African issuers exposure varies from 1% to 3% and mainly concerns sovereigns. Overall, we do not plan to increase our participation in emerging countries in the short-medium term (3 to 6 months).
- **Sectors :** we favor less cyclical sectors such as TMTs (Technology, Media, and Telecom); Services and Pharmaceuticals. We remain cautious on the most cyclical sectors such as the Automotive sector; Distribution (retail); Industrials. In this case, we prefer the most solid issuers (best in class) that have sufficient liquidities to face a cycle turnaround.

SUBORDINATED DEBT

Since the beginning of the year, subordinated debt segment's performance is no exception compared to the rest of the market, with -14,7% on AT1 CoCos €, -14.4% on Insurance subordinated debt, -14.3% on Hybrid Corporate debt, and -11.8% on Banks Tier 2 debt (Markit iBoxx indices)[2]. Since the beginning of June, the bearish movement intensified, with a performance of -6.8% on AT1€, -5.3% on Corporate Hybrids, -4.8% on subordinated insurance and -4.4 % on Tier 2. Note the relative outperformance of AT1$, which posted a lesser decline in June of 3.9%.

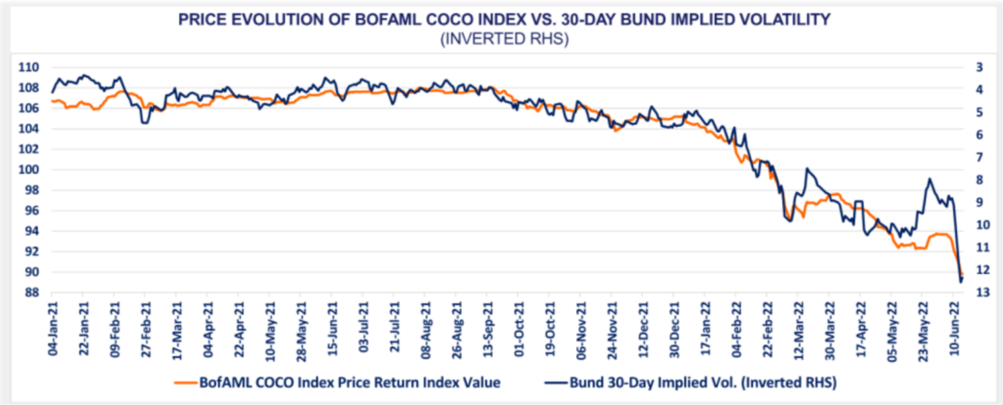
The common denominator of this movement is clear: the current European and American rates' volatility which is now being transmitted to equities and so-called High Beta credit (see graph below). In our view, as long as volatility remains at such levels, subordinated debt valuations will not recover stably, although brief and illiquid rebounds may occur. Considering the AT1s' typically higher "beta", we might have expected more significant underperformance. Nevertheless, the segment benefited from its shorter average duration and inherently higher spread component, that made it possible to somewhat mitigate rates volatility.

Subordinated securities' ranges are wider than usual. Unlike the steep fall experienced in February-March 2020, we do not feel the presence of "forced sellers" in these segments, which makes liquidity accessible. This is explained by (i) controlled flow dynamics, which are usual in a context of tightening rates, (ii) stable fundamentals on issuers and (iii) valuations at very high levels. On this last point, the AT1€ regained an average call yield of 8.8%[3], i.e. a level only reached in March-May 2020 and in 2016.

The spread widening and call yields exacerbation comes from call probabilities that are no longer "priced" by the market, regardless of the subordination segments. We consider that more than 80% of the

[1] *Source: Bloomberg, data as of June 15th 2022*
[2] *Source : Bloomberg, data as of June 16th 2022*
[3] *Source : Bloomberg, data as of June 16th 2022*

subordinated debt pool deals with prices below par (repayment value). This means due to their convexity, that a more global market rebound should translate into a stronger rebound in these callable securities.
In this environment, we are avoiding subordinated securities with close call dates, whose prices could underperform as their maturity approaches. We are also reducing Italian AT1s (which were only represented in a small amount) and are increasing our allocation in AT1$ and AT1€ with intermediate call dates and with more defensive coupon levels.



Source: Bloomberg La Française AM. Data as at June 15th 2022. Past returns are not a reliable indication of future results.

ESG FIXED INCOME

Since the start of the year, the various Investment Grade, subordinated Tier 2 bank, and High Yield BB-B bond markets are respectively negative in absolute performance at -12.1%, -12.3% and -13.5%[4].

These market conditions have impacted our portfolios. This is explained by two factors (i) the bond sensitivity, which has weighted on assets' valuation since the start of the year and (ii) the risk premium component (spread) which has widened, especially since the beginning of the month. Indeed, the hyper inflationary context and the associated central banks responses have accelerated the fears associated with the risk of recession, in a European environment of geopolitical fragility.

In view of our central scenario mentioned in the introduction, we have made changes in the portfolio, and will continue to do so depending on the liquidity windows that include the following themes :

- On the High Yield, we are cautious on peripheral exposure and on the most cyclical sectors. We turned towards more "Core" and defensive exposure, as explained in the asset class note.
- On the Investment Grade/dated Subordinated, a large part of the rise in rates is priced in by the market. Their current valuation levels are becoming attractive as this part of the pool is less exposed to issuers' repayment capacities risks.

EQUITIES

In this very volatile environment, the equity markets have posted a steep performance decline since the start of the year, amplified by recent economic data. In this context, the cycle in favor of low valuation stocks continued, implying a clear underperformance of so-called "green" stocks, growth stocks and high valuation stocks.

From a geographical point of view, no area is spared by the downward movement, with American indices posting the largest declines, followed by the European and Asian indices. From a sector perspective, unsurprisingly, the sectors posting positive performances since the beginning of the year are energy, Utilities, and materials, supported by the rises in the oil and construction materials prices as well as the need for the renewable energies development. Cyclical consumption (impacted by inflation and supply chains), technology stocks (long duration) and real estate (rate hike) clearly underperformed over the period.

[4] *Source : Bloomberg, data as of June 15th 2022*

In line with our central scenario and the objectives of the strategy, we have modified our exposures and will continue to move according to market conditions :

- **Geographical zones :** European exposure has been reduced following the emergence of the conflict, in particular stocks that are more cyclical and therefore more exposed to the current situation. We reduced our exposure to the American market and slightly increased our exposure to the Chinese's following announcements of reopening and economic support plans. The two highest weightings are the United States and Europe.
- **Sectors** : we reduced our overweight in real estate (impacted by rate hikes) and industrials (impacted by inflation, supply chain tensions and slowdown fears) to reposition ourselves in more defensive sectors (telecommunications) while maintaining a tilt on reopening securities or benefiting from recovery plans.

CONCLUSION

Although unprecedented inflationary pressures pushed central bankers to a radical change in their monetary policies, it is clear that their speeches have been heard and that a large part of the rate hikes announced have already been priced in. On the other hand, bad macroeconomic news that are being released and which confirm the current and expected slowdown, are allowing an easing on the yield curves. Bond markets are well aware that central banks will attempt the difficult challenge of "soft landing".

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