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Can the markets withstand the constant downward revision of growth, soaring inflation close to 10% and tightening of monetary policies orchestrated by central banks around the world?

Despite a very negative consensus and strong support from governments, the situation seems too unstable to answer this question positively.

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MARKET UPDATE

The summer period had ultimately been positive overall for the financial markets thus far, despite a still difficult macroeconomic situation, for several reasons. First, the perception by financial players of a lower inflation risk linked to a drop in commodities prices, particularly the price of the barrel of oil. This logically resulted in a widespread drop in sovereign rates, both on nominal rates, but also, and especially, for real rates. In our view, this played a key role in the risky assets' good performance until recently. Moreover, the market positioning, which was very pessimistic in June, and a good earnings season that was deemed satisfactory also undoubtedly contributed to renewed investors' risk appetite.

François RIMEU
Head of Strategy, La Française AM

However, the macroeconomic situation remains at least difficult, especially in Europe. Consumer confidence is close to bottom in almost all Eurozone countries, in connection with the sharp rise in energy prices since the beginning of the year. In Europe, although the price of the barrel of oil fell back over the summer, this has not been the case for gas prices, which have jumped by more than 200% since the beginning of June. As a corollary, electricity prices continue to rise, with consequences for individuals and businesses that are currently difficult to assess due to the various government support plans in place. But is this fiscal support sustainable? The latest announcements suggest that, although this support will not disappear, it will at least be reduced, resulting in a potentially significant rise in energy costs for all economic players. A reform of the electricity market in Europe could also limit the shock.

Thanks to US energy independence, the same risks do not weigh on US consumers. While the latter are also affected by high inflation, they are also supported by higher wage growth than in Europe and a still buoyant labour market, although some signs of weakness are beginning to appear.

China does not have inflation-related problems, but this does not make its situation more reassuring. The policies implemented in 2021 to rebalance certain segments of its economy continue to have a profound impact on the economy in general, and particularly on real estate. At the same time, the economy is also suffering from the government's zero-Covid policy.

In this context of continual downwards revisions of the global growth forecasts for 2022 (4.40% at the beginning of the year, 2.90% as of 19 August), the central banks nevertheless have no possibility of easing financial conditions. While the latest US inflation figure, which came out at zero month-on-month for July, was reassuring in the short term, we believe it is far too early for central banks to be satisfied with the current situation. The latter reaffirmed in Jackson Hole their desire to fight inflation by being less accommodating and by raising real rates.

Beyond the geopolitical risks, for which the future is uncertain by nature, it is undoubtedly the last point that makes us the most cautious for the coming months. It will be hard for the upcoming tightening of financial conditions to go smoothly in a context of deteriorating growth. We believe it is important to remain cautious in our allocations to risky assets, especially in Europe.

To end on a hopeful note, however, it is possible that the end of the year will bring some good news with a gradually lower inflation in the United States and a positive impact of the various Chinese stimulus plans.

EQUITIES – LARGE CAPS

Global equities fell by more than 20% in the first half of the year as European inflation accelerated due to the conflict in Ukraine. The central banks (Fed, ECB, BOE) tightened their monetary policies to limit the rise in prices despite the slowdown in economic activity. By mid-June, global equities seemed to have adjusted to this new environment that includes a sharp slowdown in growth in developed countries. Technology stocks and consumer cyclicals recorded losses of close to 30%, while the oil sector, supported by high oil prices, was the only positive sector, with a gain of nearly 25%.

However, following encouraging data on US inflation (peak probably reached in July), the decline in food commodities and fossil fuels and the beginning of a normalisation of global production chains, some investors were looking to a soft landing of the US economy and more moderate action by the Fed. Equity indices therefore rebounded strongly in the last two months (S&P: +18%, Nasdaq: +24%, Stoxx 600: +14%[1]) with an outperformance by growth and cyclical stocks. This rally was also supported by a strong earnings season. These reports highlighted robust demand despite significant price increases.

Coming into autumn the sources of concerns (inflation/demand) mentioned have not dissipated and **caution and selectivity** are therefore key. Earnings expectations now seem optimistic, in our view, and do not reflect the risk of an economic slowdown. Valuations are back to historical averages and are not a major support, while earnings guidance revisions could weigh on the markets.

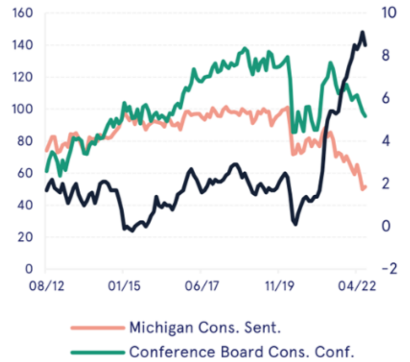
Therefore, in the context of the European geopolitical and energy crisis, **we favour** US equities over European equities.

We favour themes anchored in the climate transition promoting carbon emissions reduction:

- **Energy efficiency**: low-consumption products, energy optimisation services,
- **Sustainable construction**: "green" materials, low-energy buildings,
- **Digitalisation**: cloud computing, artificial intelligence, remote communication,
- **Renewable energies**: green hydrogen, hydro, wind, solar,
- **Circular economy**: waste recovery, secondary markets,
- **Green mobility**: batteries, electric vehicles, rail.

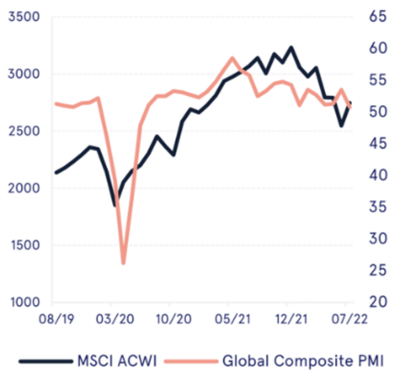
Conversely, **we remain cautious on the consumption theme**, which could suffer from the decline in household purchasing power.

Sentiment and inflation USA



Sources: Univ of Mich. , Conf Board, BLS, 31st of July 2022

MSCI ACWI and PMI Global Composite



Sources: S&P Global, as of 31st of July 2022

In conclusion, we approach September with caution, and we do not exclude further consolidation. We do not believe the economic slowdown has been sufficiently priced in by stock market indices. An improvement in inflation figures coupled with a more accommodative message from central banks will be necessary before adopting a more aggressive stance.

Thomas DHAINAU, *Head of Equities*

1 Sources: Bloomberg, 16 June 2022 to 16 August 2022

Equities – Small and Mid Caps

While 2021 had been an excellent year for the CAC 40, which exceeded the 7,000-point[2] mark, H1 2022 was the worst first-half since H1 2008!

It is true that the conflict between Russia and Ukraine did not incite optimism. On the contrary, the pressure on gas and oil prices, the shortage of certain commodities and the blocking of grain exports revived inflationary pressure already exacerbated by the strong demand for goods and the restocking linked to the end of the Covid crisis. Inflation has become the primary concern of the markets as well as the central banks, the vast majority of which have tightened their monetary policy.

For the Paris stock exchange, the decline of the indices was relatively similar for the different capitalisations. The CAC 40 recorded a drop of 17%, while the CAC Mid 60 lost 16% and the CAC Small 90 posted a lower performance at -20%[3].

Nevertheless, there is a dichotomy between the negative perception of the trends of the indices and the reality of publications in the small and mid-cap universe. Indeed, it should be noted that the revenues reported during the first half of this year for 2021 grew on a median basis by +11% with operating income up +26%. With a drop in share prices on the one hand and higher earnings on the other, this mechanically results in a decline in the valuation of the small and mid-cap universe. The median P/E of the CAC Mid&Small recorded a very sharp drop of around 50% from its 2020 peak to around 15.2. As a reminder, at the beginning of 2014 the 10-year OAT rate was around 2%, i.e., a rate equivalent to today's rate, and the median P/E was 16.3x. Similarly, at 1.6x, the median price to net asset value ratio works out in line with its historical average.

After a historic level in 2021, IPOs have remained on a good trend with 10 transactions, but which, unfortunately, have often resulted in disappointing share price trends. On the other hand, the decline in valuations seemed to be beneficial to takeover bids, as 11 bids were launched with an average premium of more than 50% above the average recorded since the early 2000s.

Coming months perspectives remains problematic due to geopolitics with the Russo-Ukrainian conflict and the China-Taiwan tensions that could deteriorate. Inflation is the other cause for concern that could really derail into the infamous negative wage-price spiral, which is often an indication of the end of a cycle announcing a recession. At this stage, we remain calm regarding this latter aspect as the current period does not have a comparable one. Indeed, the economy was put into an artificial coma during the Covid months with very slow production. As can be seen in their reporting, companies' revenue remains strong due to consumer demand, with a buoyant labour market and restocking trend. Over the coming months, this trend is set to persist, and revenue growth is expected to continue, in particular due to prices and the dollar effect. Regarding profitability, wage increases will be offset by lower raw materials and transportation prices.

In the context we have just described, we favour companies that are leaders in their segment, giving them high pricing power, as well as companies that we think could be subject to a takeover bid or delisting.

Jérôme FAUVEL, *Head of Small and Mid Caps*

2 Source: Bloomberg, November 2021
3 Source: Bloomberg, 30 June 2022

HIGH BETA – HIGH YIELD DEBT

Investors' appetite for the credit market, particularly high yield, remains weak for the moment due to the interest rate shock experienced at the beginning of the year and fears of an abrupt slowdown in the global economy. Although it is worth noting a slight improvement since the second half of July (with high yield spreads narrowing by more than 100 basis points in Europe and the US), the high yield market's rebound remains less significant than that observed on the equity markets and does not reflect the historical correlations between these two asset classes. The interest rates' volatility and the decreased support of the central banks certainly explain this disruption. The situation in emerging markets also remains complicated and performances are far below than the ones in developed countries with the massive withdrawal of investors, the appreciation of the dollar and specific cases of certain regions and countries (zero Covid policy and the situation of the property market in China with its disastrous consequences on the economy; the push of the far left in Latin American countries; and finally, the Russia-Ukraine conflict in Eastern Europe).

Valuation of the Euro High Yield credit market versus implied volatility of the Euro Stoxx 50

Euro credit HY market

Euro Stoxx 50 implied volatility

Source: Bloomberg, 10 August 2022

Our central scenario includes a continuation of the central banks' restrictive monetary policies to curb inflationary pressure and a risk of a deterioration in the economic environment, the magnitude of which will vary depending on the region/country.

We are neutral on US high yield. The US economy is better than the European one and credit risk premiums in the US high yield market overestimate the risk of recession, in our opinion. Furthermore, several lead indicators suggest that inflation has peaked in the United States (slowdown in the real estate market; drop in commodities and industrial input prices), which can reduce the tensions on US interest rates in the medium term.

We are cautious on euro high yield. The situation in Europe remains more complicated and credit risk premiums on the European high yield market will remain high until there is visibility on the current conflict and an improvement in the energy situation will not be materialized. The political situation in Italy and the early elections scheduled for the end of September 2022 will not help European assets compared to their US counterparts.

We are cautious on emerging high yield. Visibility remains low and incites to keeping a certain degree of caution, although it is important to recognise that the drop in US inflation, with a depreciation of the USD as a corollary, will help emerging assets, in particular sovereign and quasi-sovereign investment grade debt.

In conclusion, and consistent with our market views, here the positioning we adopt for the end of the year:

• Geographical regions: in Europe, we favour core countries and remain very cautious on the peripherals, particularly Italy. We believe the US market is more immune than the European market. Arbitrage toward US high yield is done on a case-by-case basis to consider the sharp increase in the cost of EUR/USD hedging. The exposure to emerging markets is unchanged and mainly concerns Asian countries and LATAM (Brazil). We have no exposure to Eastern Europe or Central Asia. Overall, we do not plan to increase our exposure to emerging countries over the next 3-6 months.

• Sectors: we favour less cyclical sectors such as technology, media and telecoms, services and healthcare. We remain cautious on the most cyclical sectors such as automotive, retail and industry. In cyclical sectors, we favour the strongest issuers (best in class) that have good liquidity to cope with a downturn in the cycle.

Akram GHARBI, *Head of High Yield Credit*

HIGH BETA – SUBORDINATED DEBT

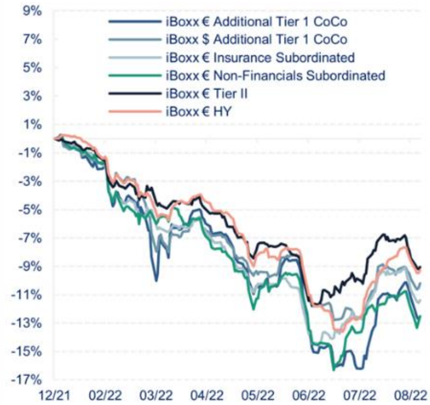
Like other risk asset markets, **subordinated debt rebounded sharply during the summer** due to (i) a very good corporate earnings season, which buoyed the equity markets, (ii) a significant rally in sovereign rates, (iii) a stabilisation of outflows on the credit markets, (iv) a very weak and pessimistic market positioning in June, which reinforced the July rally with short covering[4] despite very moderate buying flows and (v) valuations that had become extreme in credit and fully dislocated depending on the segment and decorrelated from the equity markets.

The "technical" aspect of this rebound in terms of the factors that favoured it may call into question its sustainability. Indeed, the volatility of sovereign rates remains high - which is never positive for credit - and the markets are torn between inflation figures and declining growth. **Resilient valuations and fundamentals are often cited as sufficient arguments to trigger a buy signal, but this is less true in an environment where even central banks are navigating their way on sight**.

For September, we are shifting our focus on the yield curves to calls on the subordinated debt segments, which remain dislocated (*see mapping opposite*), with **bank securities unlikely to be redeemed, due to the lack of replacement by new securities** (Banco Sabadell, Raiffeisen Bank International, Shawbrook and Bank of Nova Scotia in AT1 CoCos; BCP and potentially several Italian banks in Tier 2). **While non-calls are now a reality relatively factored in by investors** (already two European Tier 2 non-calls in the last three months by Deutsche Pfandbriefbank and Volksbank Wien, i.e., small issuers), **their rising number could weigh on the asset class's ability to rebound in the next two months**. Lastly, primary issues with higher coupons and reset spreads may tend to widen the spreads of existing securities with lower coupons.

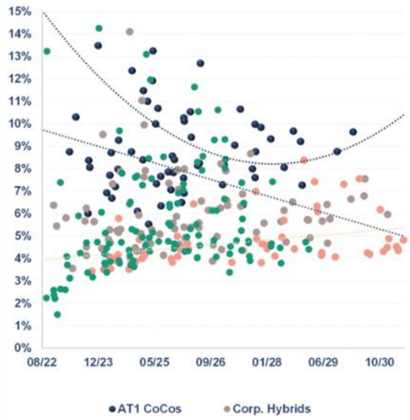
Despite less attractive valuations in relative terms, especially considering currency hedging costs, **we like European AT1 CoCos denominated in USD on banks of the core countries**, which offer higher liquidity and spread movements that are historically more contained, as well as AT1s from developed countries outside the European Union.

Total return performance of the iBoxx subordinated debt indices since the beginning of the year (in %)



Sources: Markit, Bloomberg, 25 August 2022.

Mapping of yield to call of a selection of € subordinated debt relative to their call date (in %)



Source: Bloomberg, 26 August 2022.

Despite excellent financial results and still attractive valuations, the environment is too uncertain for us to strengthen our positioning in subordinated debt. We prefer AT1s in $ on the very large European banks in relative terms.

Jérémie BOUDINET, Head of Investment Grade Credit

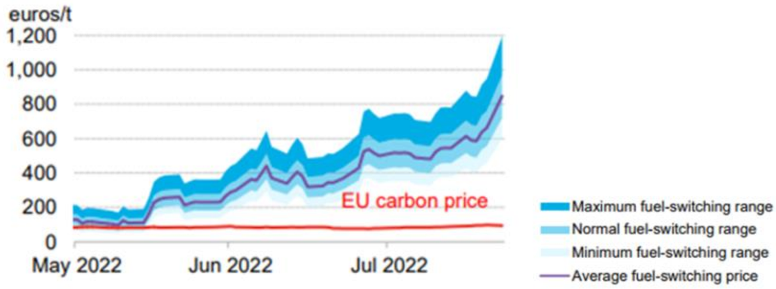
4 Repurchase of securities borrowed and previously sold in hope that their price will fall, in order to make a profit.

ESG – CORPORATE / SOVEREIGN DEBT

The 2022 dry spell, a historic event for many countries, endangers the agricultural yield of cereal crops and sparks fears of livestock's stock insufficiency. **This direct consequence of climate change highlights our current dependency and the slowness of adaptation processes**.

The climate crisis is not an isolated factor and is intertwined with our management of the war, the energy and food shortages and the inflationary crisis, leading us to foresee **a period of economic contraction for the end of 2022**. The extent of this slowdown will vary according to countries, sectors, and companies (more or less agile in the face of a growth's slowdown and margins' pressure).

Change in the relative gas/coal price range in Europe (Germany as proxy)



Sources: Bloomberg. Data at 23 August 2022

The COP27 in November will nevertheless have a potential for positive surprise. A historic spending program, voted in the United States, with the Inflation Reduction Act devotes **$370 billion to the energy transition** and aims to reduce US GHG emissions by -40% in 2030 vs. 2005. This puts the country back into action and positions it as a major challenger to China **by reducing its dependency on the latter by integrating over the decade the supply chain** necessary for the development of electric cars and solar panels.

For corporate debt, our objective is to **identify the entities benefiting from these long-term trends and with enough financial buffers to withstand the economic downturn in the short term**. Like with the other strategies, we favour **less cyclical sectors** such as telecoms, healthcare and consumer staples. In the **public services sector, we discriminate between players** according to their market (regulated or not) and **their vulnerability to the jump in energy prices**. Within **industry and the automotive sector**, we reduced our exposure to keep **the most financially resilient players who will be able to count on their agility advantage in the value chains linked to the energy transition**.

The energy crisis we are experiencing across every country could be a **Transition risk** for some governments or a **positive catalyst** to accelerate the deployment of renewable energy. Europe, a leader in the Transition, appears to be **the most exposed zone** because of its energy dependency on Russia. Short-term economic choices support the consumption of fossil fuels and outweigh climate emergency. This economic logic could jeopardize the Energy Transition and governments' abilities to meet their commitments under the Paris Agreements. On the other hand, the United States, which are much less affected by this crisis, **has voted for a very ambitious climate plan** in favor of the energy transition (IRA). Thus, from an allocation point of view, **we are underweighting Eurozone countries**. The United Kingdom, although a leader in the Energy Transition, appears particularly vulnerable and very exposed to an uncontrolled rise in inflation. **We prefer the United States**, where inflation seems to have peaked and monetary policy is being normalized.

Soaring carbon prices and the need to ensure the block's energy security is likely to accelerate the climate and energy agenda by the end of the year. The market will be very sensitive to any political developments on subjects relating to the aim to achieve 80% energy storage in November. Progress is expected that could result in a tightening of the cost containment mechanism of the EU ETS (regulated carbon credit market), advancement of the reforms related to the "Fit for 55" plan, a delay in nuclear exits and/or an increase in import orders for liquefied natural gas (LNG). All these factors could reduce demand for carbon credits in the latter part of the year and lower prices or at least slow the current increase.

Marie LASSEGNORE, CFA *Credit Manager and Head of Sustainable Investments*

Outlook and Asset Allocation

Despite a rebound across all asset classes during the two summer months, supported by a change in monetary expectations and the hope of a possible easing of inflationary pressure, we chose to maintain a defensive approach in our diversified allocations, underexposed to equities and still under-sensitive to bonds, sovereign and corporate debt.

On Friday 26 August, market expectations were dashed by the still orthodox central bankers' approach, which was reiterated and even reinforced at the annual conference in Jackson Hole. Finally, neither the Fed, the ECB nor the Bank of England are planning to ease their stance, and they have confirmed that the fight against inflation is a priority, even at the expense of short-term growth. The salary and minimum wage increases that have been initiated since mid-June should continue. Fiscal support from European governments to offset the impact of inflation on the consumer and thus support the cycle reinforce the conviction of central banks to act.

The central banks have thus firmly reminded to the markets the reality after 6 weeks of strong recovery and the calendar remains very dense for the next few weeks:

Concerning the asset allocation, we were penalised by our caution during the summer, which did not allow us to fully capture the market rally, before the trend reversal at the end of August. Presently, even more than at the end of June, we remain cautious on risky assets. We were surprised by the resilience of second-quarter corporate results and the lack of a downward revision to the outlook for late 2022. We believe that this microeconomic optimism will be corrected by the end of the year and that current equity valuations are likely to adjust. We therefore do not think it wise to increase the equity weightings in our portfolios, while still maintaining a preference for US and global equities, at the expense of the eurozone.

Regarding the bond allocation, volatility will remain high, and the greater threat of recession combined with already much more expensive credit conditions are weakening the balance sheets of the lowest-rated companies. In these conditions, we remain underweight in the High Yield market, while conversely, investment grade credit with medium-term maturities seems to offer a good compromise, in our view.

For absolute return funds, we do not hesitate to favour cash and variable-rate bonds.

Odile CAMBLAIN LE MOLLE, *Head of Cross Asset*