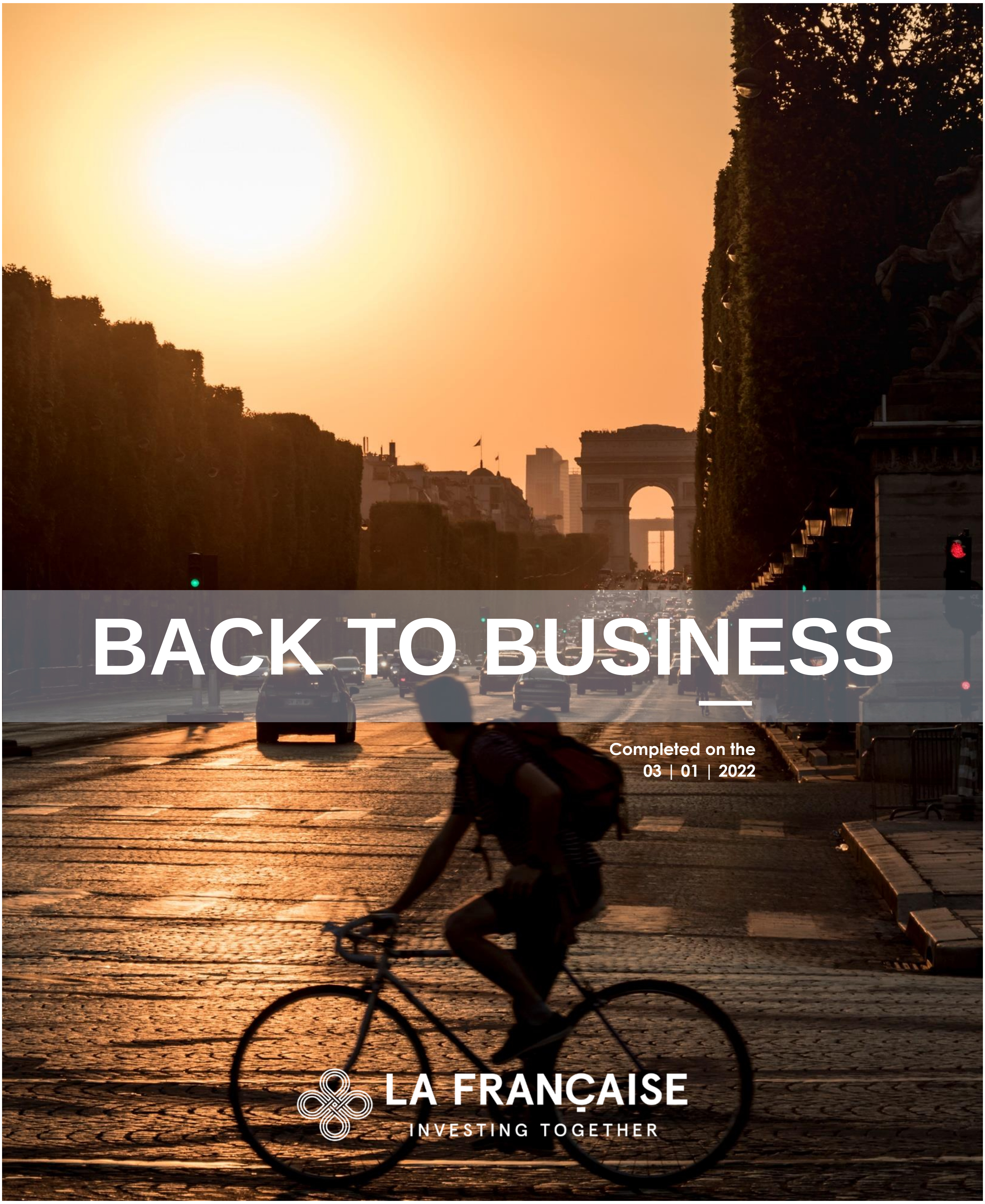

BACK TO BUSINESS

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LA FRANÇAISE
INVESTING TOGETHER

Against the backdrop of a return to growth, the reduction of monetary support programs, rate hikes and the Omicron variant, La Française AM shares its view regarding the markets stance as well as its outlook to start off the year on the right foot.

MARKET FOCUS

Jean-Luc HIVERT

Chairman and
Chief Investment Officer of
La Française AM

Despite disruptions in the production system and the oscillation of constraints linked to health risks, global growth continues. The instantaneous trend remains positive but is nevertheless difficult to assess precisely. The Chinese slowdown, which is mostly the product of political initiatives to fight against the pandemic, social disparities, and promote a cleaner economy, will be one of the major unknowns in 2022.

Short-term trends in the United States and Europe diverge slightly. After a slowing third quarter, the American growth accelerated in the fourth quarter. In Europe, the impressive third-quarter figures may soften slightly. Yet, multiple indicators suggest an interesting basis for 2022.

Indeed, **2022 is shaping up to be a strong economic year, barring a major health interruption**. Of course, the Chinese activity downturn in conjunction with the real estate finance crisis must be closely observed. However, supply disruptions should gradually ease and states will continue to support the economic players most affected by the pandemic. On the private sector side, household savings rates and corporate profits remain high. Despite recent inflation's impoverishing consequences, these variables will encourage final consumption and investment across a wide range of sectors, compensating for the recent period and responding to emerging problems, most notably climate change.

On the political side, the central issue is likely to be which version of President Biden's economic plan is finally adopted. Finally, the issue of inflationary risk will continue to preoccupy investors, even though the monetary environment has changed. We continue to believe that inflationary shifts will rapidly decline and **allow central banks to maintain financial conditions favourable to the economy** in regards of actual rates and financial market performance.

In this context, here are the themes we have identified as likely to benefit from the continuation of the global economic cycle:

Equities
Continuation of a positive trend

High Beta
Strategies uncorrelated from interest rate

ESG
Prospects for sustainable growth

EQUITIES – LARGE CAPITALISATIONS

As we enter 2022, we believe there is further upside for equities: despite a strong run, **the market is cheaper compared to the beginning of 2021**, thanks to continuous upside revisions (Earnings per share of 39.3 for 2021 by now compared to 29.2 at the beginning of the year).

In addition, the 3rd semester earnings delivery was strong with healthy top-line and bottom-line growth in Europe and North America. Earnings growth came in stronger than initial consensus expectations, resulting in another increase in blended EPS growth forecasts. Also, the current forecasts for the 4th semester are lower than September' levels, with consensus EPS estimates having, in fact, fallen over the autumn period. Typically, the 4th semester is much stronger than the 3rd semester, and this offers the potential for another quarterly surprise.

Fundamentally, we foresee further room for growth:

- **Employment,** key driver of consumer spending and hence the ultimate engine for growth, remains supportive.
- Tangible signs of supply constraints potentially passing their worst point and power prices returning to more normalized levels are encouraging us to believe that the bottom is behind us.
- **The deceleration in Chinese growth now seems behind us** and a more favourable policy environment is emerging, while credit concerns should remain under control.
- Blended activity indicators such as CESI appear to have bottomed and have turned outright positive in December. This is usually a supportive signal for equity returns over the next three to six months.
- **Economic recovery** in the service sector, accompanied by rising private and public investment, should continue to fuel growth in the coming years. 2022 will also be a year of ongoing M&A activity, **supporting current valuation levels.** In the mid-term, **accelerating research and innovation funding drives growth** and builds a large pipeline of highly innovative IPOs.
- Finally, given the relatively hawkish messages from Central Banks in December, **we do not expect further monetary tightening announcement.** Current futures pricing and inflation accompanied by growth are not detrimental to stocks. Growth stocks seem particularly sensitive to real returns, while yield stocks seem less sensitive. This is largely due to the long-term nature of growth stocks. However, given their higher quality profile, we would not dismiss them entirely. This positioning allows us to navigate the current volatile market environment with the sanitary deterioration (Omicron variant).

CESI indicators

Source: Bloomberg. Data as at 31/12/2021

MSCI ACWI vs P/E

Source: Bloomberg. Data as at 31/12/2021

In conclusion, we remain constructive on equities, given the potential for earnings improvement, reasonable valuation levels and their yield advantage. We continue to favour Europe and Japan over the US due to a more cyclical/value market structure in the current environment. For emerging markets, we remain very selective overall while staying away from Chinese investments that would be in the regulatory focus area.

Hugo BONNARD, *Equity portfolio manager*

HIGH BETA - HIGH-YIELD DEBT

For the first part of 2022, we do not anticipate any significant change compared to the trend observed in the market throughout 2021. Volatility is likely to be higher given the uncertainties about central banks' monetary policies and developments concerning the pandemic. Overall, global High Yield spreads should continue to move in a range of 350-400 basis points. Default rates are expected to remain very low in Europe (1-1.5%) and in the United-States (1.5-2.5%). By contrast, for emerging countries, default rates will continue to rise in the first half of 2022 (particularly in Asia) before falling in the second semester.

On US High Yield, we are slightly negative for the first half of the year. Valuations are less attractive, especially for B and CCC ratings. In addition, the technical indicators are less favourable than in 2021, given the FED's monetary tightening, which will favour the leveraged loan[1] market over High Yield. In addition, the rising cost of hedging should make US credit less attractive to foreign investors. Finally, we should see a resumption of M&A and LBO transactions in the United States with the risk of an increase in US corporate debt. The amounts available to be deployed by LBO funds are currently at record levels.

Amount of committed but unallocated capital in private equity funds ($bn)

Source: Preqin. Data as at December 2021.

On Euro High Yield, we are neutral. The beginning of the year could be marked by greater volatility given the ECB's maturity dates and the political agenda (elections in Italy and France). Overall, the technical factors remain well-positioned in Europe. The valuation is relatively attractive for both BB and B ratings, especially in the cyclical sectors. The lack of yield alternatives in Europe should favour assets with a high-risk premium.

On Chinese High Yield, we are positive. Indeed, valuations are very attractive compared to other High Yield markets. Current valuations broadly incorporate the risk of default by low quality, indebted issuers. In addition, further financial easing measures are expected to be announced by the Chinese government to boost the economy and the property sector. We ought to bear in mind that the objective of the latter is not to sweep away all market participants but rather to reduce the level of indebtedness and rationalise speculative behaviour (as in the case of Evergrande) given the size of the sector as a proportion of GDP (40%), of household savings (80%) and provincial tax revenues.

Spread differentials between the Chinese High Yield and the High Yield Global index

Source: Bloomberg. Data as at 09/12/2021.

In other emerging markets (LATAM and CEEMEA[2]), we are negative for 2022. Valuations are not attractive in two regions, in contrast with the Asian market. There are many political risks, particularly with the Brazilian elections. The economic situation is deteriorating significantly in the region, with a significant rise in inflation and a slowdown in economic growth. In addition, LATAM's credit markets are very sensitive to financial conditions in the United States. Also noteworthy is Turkey's political and economic situation and its significant negative impact on its banking and monetary system (the Turkish lira lost 75% of its value in 2021). We will avoid these two areas during the first half of 2022.

In conclusion, we expect a positive performance of high yield in 2022, particularly in Europe and Asia. Default rates should remain stable as global growth remains strong. Technical factors also remain favorable, and market valuations have not yet returned to pre-crisis levels.

Akram GHARBI, *Head of High Yield Credit*

[1] Type of loan provided to businesses or individuals who already have significant debt or a poor credit history

[2] CEEMA : Central Europe, Middle East & Africa

HIGH BETA - SUBORDINATED DEBT

We may start this section **by emphasizing how excellent the fundamentals of subordinated debt issuers are,** mostly European banks and insurance firms, **and how they should remain stable through 2022**. However, in the first few months of the new year, this is unlikely to matter.

Subordinated debt prices and spreads, and particularly those of € AT1 CoCos suffered in the 4th semester of 2021 **from the strong resurgence of volatility in sovereign rates,** which were buffeted by inflationary and health issues. In contrast, they had previously welcomed higher sovereign rates earlier in 2021, as shown by the performance of the $-denominated European AT1 CoCos.

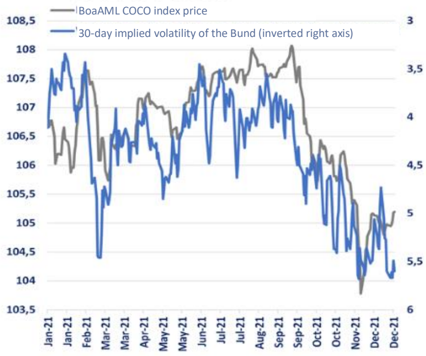
Volatility, we believe, should gradually decline now that central banks have announced their intentions for 2022 more explicitly during their December 2021 meetings. Thus, **while the performance path for spreads does not appear straightforward for H1 2022, we believe it should be favourable to tightening,** for two primary reasons:

1. **In historical terms, valuations are more attractive.** The rapid widening of spreads in the 4th semester of 20 21 wiped out the year's tightness. This has provided some breathing room for valuations, with the average yield to worst (YTW) on € AT1 increasing from 2.7 % in mid-September to 3.3 %[3].

2. The ECB is aware that **for financial stability to be maintained, it requires peripheral sovereign rates to be upheld through the reaffirmed flexibility of its asset purchases (APP/PEPP). This is a strong anchor for credit spreads.**

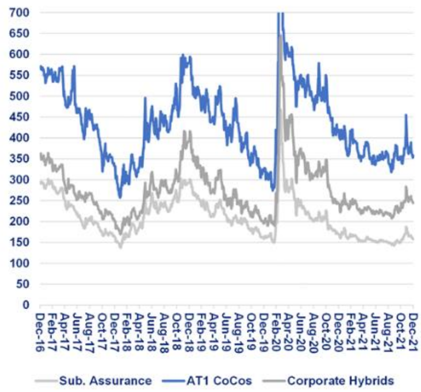
In terms of allocation, we prefer two types of bonds: **those with wide spreads and reduced interest rate sensitivity. € AT1 CoCos**, with far more attractive spreads than US dollar and British pound securities, and **Tier 2 banks rated in the High Yield category** (notably from so-called "peripheral" banks).

Comparative changes in the average price of a CoCos debt index and in the implied volatility of the 30-day Bund



Sources: BofA Merrill Lynch, Bloomberg. Data as at 31/12/2021.

Evolution of the average spread over sovereign bonds of subordinated debt indices (bp)



Sources: Credit Suisse index, Bloomberg. Data as at 31/12/2021.

Subordinated debt spreads are likely to remain correlated to sovereign rate volatility, and not so much to directionality. As the major central banks have now started to chart the way forward, the high spread subordinated debt segments (€ AT1 CoCos and bank Tier 2 High Yield) should outperform the market.

Paul GURZAL, *Head of Credit*

Jérémie BOUDINET, *Portfolio manager & Credit Analyst*

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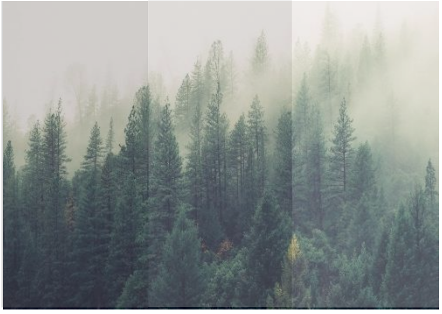
[3] Source : Indice Bloomberg Contingent Capital €, data as at 31/12/2021

ESG – SOVEREIGN DEBT



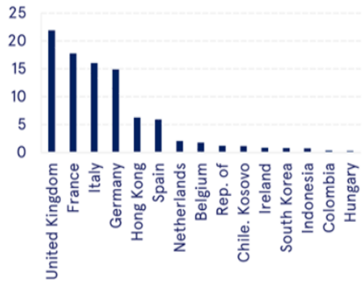
Climate change is a key issue for the coming decade, and the conclusions of COP 26 show that much remains to be done. Some countries need to step up their commitments to combat global warming. Global warming is estimated to be 2.7°C by 2100, well above the 1.5°C target.

Climate change, we believe, can no longer be ignored. As investors, **we must prepare for the transition to a low-carbon economy by incorporating climate risk and opportunity analysis into our management processes.**

Today, we distinguish two types of climate risks:

- **Adaptation risk**: the economic cost of damage related to the vulnerability of countries to extreme climate events, and the adaptive capacity to cope with them
- **Transition risk**: the financial impact of government climate policies (carbon tax, loss of income from fossil fuels, investment in renewable energy)

Sovereign green issues for the 2021 year (in M$)



Source: Bloomberg, data as at 30/11/2021.

While the physical risk is unpredictable and suffered by countries, the transition risk depends on the political will of the states. The costs associated with these different risks will become increasingly significant due to the acceleration of extreme climatic events and the increase in their severity. **It is, therefore, necessary to be able to evaluate these risks**.

To build portfolios resilient to climate and transition risks, we have developed a proprietary analysis model, which shows that not all countries are equal when it comes to climate risks. We also carry out climate stress tests based on the climate commitments of states. They make it possible to analyse the financial impact of climate risks based on different transition scenarios (Business as Usual, 2 °C compatible, 1.5 °C compatible). We convert the economic implications of physical and transition risks on countries' GDP into growth and interest rate shocks to quantify the financial impact and the risk of a country's rating being downgraded. Although these are complex and uncertain modelling exercises, some identifiable trends exist. **In our view, Sweden, France, Croatia, and Costa Rica are among the best positioned to cope with the costs of climate change.**

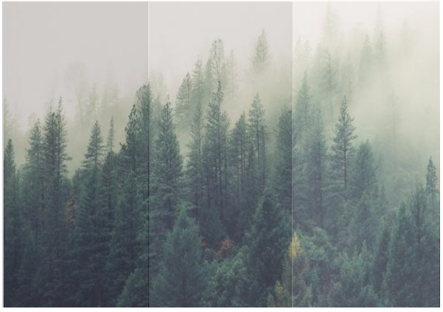
On the regulatory side, **Europe remains the leader in green financing**. **The Taxonomy,** which should come into full force at the start of 2023, **will become a benchmark for supervising and standardising the labelling of future "sustainable" bond issues, thus allowing greater clarity and transparency for investors.**

From a market perspective, new sovereign and quasi-sovereign green bond issuance have grown steadily since the Paris agreements at the end of 2015, from $12bn in 2016 to almost $132bn by November 2021. The UK and France lead the way, followed by Italy, Germany, and Spain. For the 2022 year, the political focus on the energy transition should encourage the continued issuing of "green" stocks in the EU (between +20% and +40%), prompting other countries to join the trend, such as Austria, Greece, and Portugal.

Investing in government green bonds allows investors to directly finance climate change projects, and to help countries meet their climate policy commitments (Nationally Determined Contributions, NDCs). Not all countries are at the same stage of development, and their decarbonisation policies vary in their level of ambition. Some countries have already decarbonised part of their economy, whereas others are just starting to do so. The challenges are not the same for developed and emerging countries. We will therefore continue to direct our investments towards countries that are committed to the green transition by supporting those that are making significant efforts.

Maud MINUIT, *Head of Fixed Income, Cross Asset and Total Return*

ESG – CREDIT



The increase in the price of gas and GHG emissions from electricity companies, combined with a reduction in the supply of carbon credits, have pushed **the price of carbon** on the European regulated market to **an unsustainable level in the short term** (the price of carbon is currently disconnected from our energy transition capacities). We identify several points of attention for 2022 in this respect:

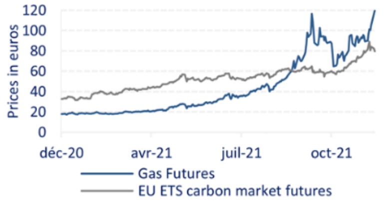
We expect European intervention to regulate the soaring carbon price by reviewing the cost-containment mechanism. The energy crisis we have experienced has not triggered this mechanism, demonstrating its ineffectiveness in its current configuration. **A cap or moderation of additional CO2 price inflation will directly benefit all sectors subject to the regulated carbon market in Europe. Particularly power producers whose cost base is inflated by the carbon tax with revenues potentially captured by fixed-rate contracts. We favour this sector in our allocations.**

Nature takes centre stage in 2022... Biodiversity and climate change are intimately linked, affecting the other and vice versa. COP15 and COP26 concluded with more than 100 countries committing to putting biodiversity and ecosystem protection at the heart of policy. **It goes towards a global biodiversity framework, which is expected to be completed in April 2022**. It could strongly amplify the trend towards creating and pricing carbon credits in the voluntary market based on nature conservation/restoration solutions. The agreement on Article 6 at COP26 will better regulate carbon trading and accounting worldwide**.**

We expect carbon prices to converge between the regulated and voluntary markets (average price graph to 2020). This will penalise companies that use carbon credits (purchased on the voluntary market) to offset their emissions rather than reduce them themselves.

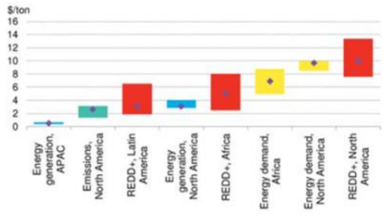
Our portfolio and trajectory analyses favour companies whose emissions reduction is structural and not those that only offset.

Changes in gas prices and the carbon market



Sources: Bloomberg, La Française AM. Data as at 14/12/2021.

Carbon average price on the voluntary market by sector



Sources: Bloomberg NEF, CBL. Data as at December 2021.

The regulatory environment and credit market support mechanisms continue to tighten in relation to the energy transition. In 2022 we expect central banks and regulators to implement more punitive measures affecting issuers that are not committed to the transition. The Bank of England has started this movement by being the first to green its CSPP through a grid of analysis by issuer.

Although several options are available to the ECB for greening its CSPP, we are convinced that the scenario that comes closest to market neutrality is an issuer-based approach as implemented by the BoE. If this shift is made, it will greatly favour issuers in the most polluting industries that have begun their energy transition, which are the issuers of choice in our Carbon Impact Credit strategies. Should the ECB choose to increase the share of Green and Sustainability-linked bonds, achieving market neutrality would mean buying half of the new issues labelled as such in the coming years. This will potentially create even more price dispersion for these assets, but will bring with it the more global risk premium compressions of these issuers, which will directly benefit us.

Marie LASSEGNORE, CFA, *Credit Portfolio manager and Head of ESG Fixed Income*

OUTLOOK FOR 2022 AND ASSET ALLOCATION

The recent emergence of the Omicron variant is a reminder that the epidemic will still be a significant risk factor in 2022, affecting growth prospects. Nevertheless, the possible and rapid adaptation of messenger RNA vaccines and the expected progress in Covid treatments should positively view the ongoing economic growth. **The pace of growth should only be temporarily slowed.**

The supportive factors for the markets - prolonged growth, modest earnings expectations in the consensus forecast today and therefore likely to be revised upwards as we go along, the first US fiscal stimulus package to be rolled out in 2022 and possibly the release of the *Build Back Better* plan, even heavily amended, as Senator Munchen still opposes it, resolution of the real estate crisis in China - should provide **a solid foundation for the markets to have another year of positive performance in 2022.**

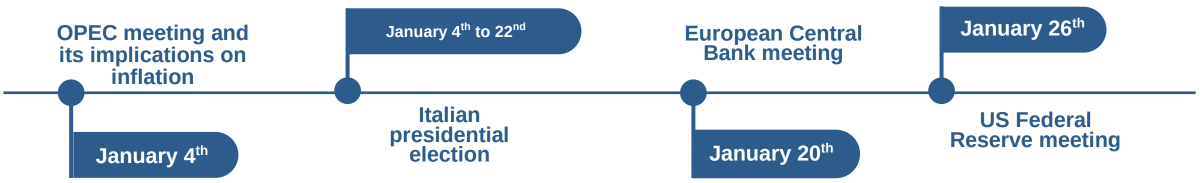
Of course, the high level of uncertainty about inflation expectations from both investors and central bankers is helping to dampen our optimism. It is affecting our convictions at the start of the year. However, central banks are marking out the path to higher rates as clearly as possible, and if they cannot act against volatility on the bond markets, they remain the guarantor of an uncontrolled rise in rates in 2022.

As in 2021, **we remain under-sensitive to bonds and favour floating-rate bonds for the investment-grade segment**, while the first-rate hikes will be piloted in the US's first half of the year. Moreover, we find it hard to imagine how the bond market in the eurozone could be disconnected from monetary policy decisions on the other side of the Atlantic.

Additionally, the recent sharp declines in high yield corporate credit risk premiums have reintroduced this asset class to a new audience, even if performance potential will be limited in the rising interest rate environment that we anticipate, particularly given the expected pace of increase. The asset class remains attractive from a carry perspective, while bonds with a high-risk premium remain the only assets that provide a return.

Finally, if we accept short-term volatility, **our preferred asset class remains equities**, which still have attractive upside potential. Allocations at the beginning of the year will be positioned almost in line with their indices on the equity side and still under-exposed to the bond markets, which will automatically reinforce the embedded beta.

As always, exposures to the various asset classes will be subject to change significantly as volatility will undoubtedly increase with the busy short-term calendar. In January, markets are expected to react to:



In parallel, we should have more details on the ability of vaccines to combat the Omicron variant and the continuation of forced vaccination pending future vaccines more targeted against the variant.

Odile CAMBLAIN LE MOLLE, *Head of Multi Management*

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