LA FRANÇAISE
investing together

Market flash

Written on the 28 | 02 | 2022

Jean-Luc HIVERT
Chairman and
Chief Investment Officer of
La Française AM

This weekend showed important developments in **the geopolitical crisis currently shaking up the world**.

The European sanctions that were thought to be moderate, despite the voluntarist declarations, turned out to be much more severe and beyond that, real geopolitical upheavals appeared in Europe. The psychological and political shockwave of this crisis can be seen in the historical change in Germany, which decided on a massive rearmament programme and a clear involvement in the conflict by sending equipment to Ukraine. But the European reaction was global and not limited to Germany. **The escalation becomes obvious** with the nuclear threat brandished by Moscow against this European commitment.

On the economic front, it is worth noting the massive sanctions decided against Russia and its leaders, particularly by Europe. The Russian banking system will be largely impacted, and the Russian economy as a whole, is under pressure.

Beyond the emotion we all feel about this crisis, **the economic impacts are worrying**. They are naturally **negative for the world economy and, in particular, for the European economy**. The issue of commodities and gas is more important than ever, as we can expect a Russian reaction to this package of sanctions and to the European involvement in Ukraine. We can now imagine that the European Central Bank (ECB) will have to change its position and quickly reconsider its priority objective of price stability. Indeed, inflation will eventually have a recessionary effect and the scenario of a price-wage loop is likely to become more distant.

Regarding our portfolios, we were not directly exposed to Ukraine and Russia. We see visibility as still very limited, and the latest developments call for **increased caution in the markets**. Even if central banks were to make further efforts to improve financial conditions, this will only have a stabilising effect on the markets at best.

EQUITIES

After a recovery in the equity markets on Friday 25 February, the downward movement of the equity markets resumed on Monday, February 28th in the face of the further deterioration of the situation in Ukraine and the sanctions deployed by the rest of the world. From a sectoral point of view, the most cyclical/valued stocks are showing the biggest declines, with financials, autos, and consumer goods. More defensive sectors are performing well, including healthcare, real estate and utilities, the latter supported by the looming energy crisis, which leads to renewed investor interest in renewable energy. The energy sector, although helped by rising oil and gas prices, is being hurt by the relationship between the major oil companies and Russia.

Our equity funds do not have direct exposure to Russia or Ukraine, but sectors such as **banking, consumer discretionary and some industrials are heavily affected by contagion**. We are monitoring the situation closely and **have reduced our overexposure to the most cyclical sectors**.

In the absence of positive developments, **the more defensive sectors should continue to play their protective role**. In terms of geography, the eurozone is likely to suffer from its higher exposure to the current conflict.

TOTAL RETURN

This very uncertain geopolitical context is likely to modify the very combative attitude of central banks with towards inflation. We are of course thinking primarily of the ECB, as the European economy will be the most affected of the developed countries. Thus, it seems likely that it will postpone the end of its purchases under the APP programme. This would lead investors to lower their rate hike forecasts, currently 20bps for 2022, from over 40bps at the peak. Given the strong movement in bond yields we have seen this year, a further decline in European yields seems likely. US growth should be less affected by this conflict, but it seems to us that the asymmetry is moving towards a bearish risk on US long rates. We will be watching the speeches of central bankers in the coming days to confirm this analysis.

Regarding the total return fund range that may invest in non-OECD emerging markets, exposure is essentially limited to South America (Chile, Mexico, Colombia) and should therefore not be directly affected by this crisis.

The risks in our funds have already been significantly reduced at the beginning of the year on high beta asset classes: high yield credit, peripheral bonds, and emerging debt. However, they still retain exposure to risky assets to benefit from a significant carry. We have thus retained a portion of financial subordinated debt, a portion of high yield debt and investment grade debt.

Given the difficult market environment, we chose to **raise our cash levels while the sensitivity of the funds is clearly in positive territory.**

HIGH BETA

1- High Yield

Recent events have **negatively impacted risk premia in Euro and Emerging Market High Yield Bonds**. In contrast, US high yield, due to its lack of direct exposure to Ukrainian and Russian issuers and the limited short-term impact of the negative consequences of Russia's invasion of Ukraine (higher energy and commodity costs, especially agricultural), has emerged as the clear winner in this highly risk-averse environment.

In detail, over the period from 18/02 to 25/02/2022[1] :

- Euro High Yield diverged by +16bps to 351bps, representing a performance of -1.0%
- EM High Yield diverged by +29bps to 612bps, representing a performance of -2.0%
- US High Yield tightened by -17bps to 353bps, representing a performance of +0.4%

However, it should be noted that **exposure of the Euro High Yield index to Ukrainian** (Metinvest, Kondor, DTEK Renewables) **and Russian** (Gazprom perpetuals, Credit Bank of Moscow) **issuers is extremely limited**. On the EM High Yield index, exposure to Ukrainian (Kernel, Kondor, MHP, Metinvest, Ukraine Railways, etc.) and Russian issuers (Gazprom perpetuals, Veon, Evraz, Eurochem, etc.) is more significant but relatively limited (< 5%).

In terms of positioning, we believe that in the short-term, **Euro High Yield risk premium will continue to underperform US High Yield** risk premium due to (i) a **geopolitical risk premium** and (ii) a **greater exposure to sectors that will be impacted by rising energy and commodity costs**, especially the automotive sector (9.7% of the Euro High Yield index versus 4.5% in the US High Yield Index), being the third largest sector in the Euro High Yield index.

Similarly, Euro High Yield will not benefit as much from rising energy prices compared to US High Yield, being less expose to the energy sector, 4.1% against 13.4% for US High Yield. We believe that the **fundamentals of Euro and US High Yield issuers will remain strong and that default rates should remain limited in 2022.**

[1] High Yield Euro (HE00), High Yield EM (EMUH), High Yield US (H0A0)

2- Investment grade & Subordinated debt

The effects of the war in Ukraine on the investment grade and subordinated debt segments can be distinguished between non-financial issuers and bank issuers on the other hand.

As for non-financial companies, some issuers export and/or import to Russia, and there will be both input cost consequences (higher commodity prices) and potential revenue shortfalls for exporting companies. We do not see any issuer for which the current developments would constitute a major credit risk issue. In addition, it is increasingly likely that **the ECB will postpone the end of its purchases of investment grade corporate debt** under its CSPP and PEPP programmes. This could provide a **source of stability** for the investment grade corporate debt market in the event of a significant deterioration in corporate financing conditions.

As regards the European banking sector, and more specifically Tier 2 and Additional Tier 1 CoCos subordinated debt, some banks are **directly exposed to Russia and Ukraine through local retail banking subsidiaries,** first and foremost the Austrian bank **Raiffeisen Bank International**, and to a much lesser extent **Société Générale, UniCredit and ING Groep**. For these groups, the worst-case scenario would be expropriation or abandonment of subsidiaries, and according to our first estimates, this would be a solvency issue for Raiffensen Bank International, but not for the other three banks, whose exposure to Russia is much lower as a proportion of the groups' assets. Secondly, the exclusion of some Russian banks from the SWIFT interbank messaging system and the confiscation of the Russian Central Bank's foreign assets will have impacts for internationally active European banks with direct clients in Russia, but these should be quite manageable in terms of profitability impacts.

We had taken a defensive stance on our funds since the beginning of the year, initially due to inflationary movements and their impact on central bank monetary policies, and we are maintaining this cautious stance, both in terms of name selection and portfolio exposure.

ASSET ALLOCATION

The large-scale conflict between Russia and Ukraine and the massive sanctions by the international community represent a scenario that no investor had built into their portfolio allocation. **First, let's keep in mind that we are making history. It is therefore perilous to construct scenarios, as the assumptions are so fluid and the possible outcome uncertain**.

In terms of allocation, apart from a few adjustment movements (reduction of our positions in financial subordinates, style arbitrages on equity funds), **we have maintained an underweight of equity indices and an underweight of bonds since the beginning of the year.**

Beyond military escalation risk, which could potentially justify further corrections, **the markets are beginning to price in some of the economic implications of the conflict with a negative shock on growth and a change in central banks' position.** Indeed, investors believe that the central banks, in particular the ECB, will **at least delay their monetary tightening** while waiting for more visibility and to **create conditions for stabilizing the financial markets**.

LA FRANÇAISE
INVESTING TOGETHER

[2] CSPP « Corporate Sector Purchase Programme » and PEPP « Pandemic Emergency Purchase Programme »