The war in Ukraine, a non-systemic crisis for the markets

31st of March 2022

H2O Asset Management

Dear Partners, dear Investors,

The global economy saw 2021 end with a spectacular momentum (strong growth in the fourth quarter across all countries of the world, historically intense and synchronised). This momentum has continued into January-February 2022 thanks to the following factors:

- Full employment & above potential growth ;
- Strong household spending due to increased savings during Covid;
- Inflation shifting from transitory to cyclical;
- Change in central banks' rhetoric admitting this scenario.

The consequence was the beginning of a long-term cycle of outperformance for cyclical and value securities across all asset classes, as well as a pronounced sell-off in G4 bonds (US, Germany, UK, Japan). This cycle was very favourable for our portfolio positioning at the beginning of the year and **we maintain our long-term view on this major rotation.**

Despite the violence and intensity of the conflict in Ukraine, **neither the war nor the sanctions on Russia constitute a systemic risk for financial markets.** This means that the reaction of the latter is similar to what we experienced during Brexit. The Covid crisis or the collapse of Lehman Brothers, on the other hand, triggered global crises with longer and deeper consequences for the markets.

During a localised crisis, the shock is symmetrical in nature with the following consequences:

- On the one hand, a sharp fall in assets which stand directly affected by the crisis (exit from global indices, increase in volatility, investment committee decisions, global redemption flows to be adjusted).
- On the other hand, a fall in other risky assets, peripheral to the crisis, within a limited contagion effect.

Assets affected by the contagion mechanically return to normal levels through the arrival of new opportunistic and unconstrained investors. For assets directly impacted by the crisis, normalisation may take longer if their fundamentals have deteriorated. For Russian assets, it would be very premature at this stage to talk about a deterioration of fundamentals. **They should therefore continue to normalise.**

Management of Russian Assets:

Given the depreciation of Russian assets up to March 7th, stressing the mechanical part of the movement, our exposure to the ruble fell, notably due to the price drop on local debt and adjustments made to some of our portfolios. We have therefore recently decided to rebalance our exposure to Russian assets through the acquisition of local debt at deep discounts (valued between 3% and 8% of par), which represents a form of optionality.

At present, sanctions continue to affect the free price discovery of Russian assets in the offshore markets to which international investors have access. However, the liquidity of such assets is improving in international markets as these same assets are trading at much higher prices on the « onshore » marketplace where local investors trade.

These more favourable price levels observed in the local market are justified by the fact that:

- Russia has already reopened its equity market for local investors;
- The country pays coupons in ruble locally and in US dollar on its foreign debt;
- Fundamentals remain generally good: an extremely low debt-to-GDP ratio (around 15%) and very high revenues due to rising oil and gas prices. Thus, no solvency problems are expected, even in an extremely adverse scenario;
- The Russian central bank has reopened the local sovereign debt market to local investors and has expressed its intention to buy bonds in order to benefit from low prices and improve its debt profile;
- Russia has a strong incentive to service future coupons as Russian banks would have to pay large sums to foreign banks in case of default (triggering Credit Default Swaps).

As a result, **the reopening of the local bond market** offers an asymmetric profile for the portfolios without affecting their liquidity.

Why are we maintaining our exposure to Russia despite the strong rebound in recent days?

The ruble depreciated sharply in the wake of a mechanical movement to reach RUB 163 against USD on March 7th. It now sits at around USDRUB 84, close to pre-conflict levels. Indeed, as the Russian economy exports in dollars instead of ruble, the country is reluctant to let its currency weaken as it would make its imports more expensive, bolster inflation, and create social disorder. Conversely, Russia favours preserving a strong ruble and its central bank has all the means necessary to steer the parity of the currency against other currencies, firstly via interest rates but also via the flows of USD received by Russian exporters of raw materials that the central bank forces to be converted into ruble.

Subsequently, Russia could decide either to lower its interest rates or stop imposing its capital control. In this case, the ruble could stop appreciating. But this course of action would be positive for bond prices. In the meantime, the yield for ruble holders remains very high.

Therefore, we are maintaining our currency exposure and debt exposure. The long ruble and Russian debt exposure of our funds as of 29.3.2022 is below the crisis entry point and the long ruble exposure of our funds as of 29.3.2022 is below 7.4% of overall gross currency exposure. The ability to access the local ruble market again would allow international investors to receive their coupon and dividend payments and would lead offshore prices to converge with onshore prices which trade at higher levels.

Global position management:

In terms of portfolio construction, we remain exposed to relative value strategies as directional strategies offer little return, even in a diplomatic solution scenario.

Market Scenario	G4 Bonds in directional strategy	Equities in directional strategy
Scenario 1: No diplomatic solution - Recession	No performance due to rising inflation	Negative performance
Scenario 2: Diplomatic exit - Reflation	Net cost as growth increases and maintenance of restrictive monetary policies	Neutral performance

H2O AM allocation in both market scenarios		
G4 Bonds in Relative Value Strategies	**Equities in Relative Value Strategies**	**Currencies in Relative Value Strategies**
- Net short position: positive performance of rising G4 rates - Bonds arbitrage with exposure to Italian debt for which rates are converging towards German rates (target spread: < 60 bps on 10-year rates) - Mexican and South African bonds that benefit from pension fund flows.	- Neutral directional risk in our portfolios and premium on cyclical and value stocks which are under-owned and interest rate sensitive: Buy : - European banks - European autos - Emerging markets Sell : - European Tech - European Agribusiness - US Mid-caps This allocation benefits from rising interest rates and above potential growth.	- High return on RUB positions and other cyclical EM currency strategies (BRL, MXN etc) - Buying JPY, which has depreciated since the beginning of the year via the actions of a very accommodative central bank. This movement is already reflected in prices and Japanese institutional repatriation flows will support the currency in case of a sharp depreciation. - Selling USD Risk: - Extreme holding; - Overvaluation; - Loss of global reserve currency status via the possibility of unidirectional sanctions on other countries (Russian conflict jurisprudence). Yield: -Negative real rates in the short and medium-term; -Tight monetary policy; -Loss of attractiveness of US assets due to rising rates and falling credit market.

What the conflict could change:

The political timeframe of the green transition has accelerated. Instead of managing the thermal/traditional to green/electric transition progressively (gradually cutting the former to ramp up the latter), Europe will have to invest heavily in its green transition without being able to reduce fossil fuel imports. This should greatly increase investment and job creation: the impact could be inflationary, but it is also a source of growth, especially for Europe.

What is the performance potential for our funds?

We have recovered a large part of the decline linked to the Russian crisis. Relative value strategies held in our portfolios offer a completely new opportunity for rebound. Our products could be of interest to investors:

- Invested in directional strategies and wishing to diversify into relative value strategies ;
- Seeking positive exposure to emerging market assets, the first winners of the current cycle;
- Seeking to protect themselves from rising inflation and benefit from the market rotation towards cyclical assets: the winning strategies of the last 10 years are becoming the losers of the next 10.

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