"Matches don't burn in a vacuum" What asset allocation for end 2022 and beyond?

Paris – 21 September 2022

Looking back over the year, it is fair to say that focus has been shifting. Q1 was marked by the realisation that inflation was here to stay, prompting a debate on a potential return of the much-dreaded stagflation. Such anxiety grew stronger with the war in Ukraine adding another layer to supply-side inflation, especially on the energy front, but also as cyclical inflation anchored itself throughout most economies. Q2 debates were centred on the speed and persistence of said inflation combined with the dual concern of an eroding purchasing power and of potential monetary policy calibration mistakes (with the risk of hard landing).

So far Q3 has provided further illustration of such 'flip-flopping' between optimism and pessimism when it came to interpreting macro data, as good news were often seen as bad news and vice versa. The July US non-farm payroll was a big surprise on the upside, printing at 528K, more than twice the consensus estimate (250K), highlighting once more the extreme dynamism of the US job market. Conversely, such demand-side pressure led FOMC participants to note in their July minutes that slowdown in demand would "play an important role in reducing inflation", while also highlighting that the strength of the labour market suggests that economic activity is likely stronger than implied by a rather weak Q2 figure.

What scenario:

With Central Banks left facing a conundrum, fears of an imminent recession became more and more embedded in the consensus view.

These were further vindicated in Q3 by:

- Slower Q2 growth (QoQ): slightly negative in the US and UK; slightly positive for European economies;
- Increasingly pessimistic expectations reflected across multiple surveys in Q2 and early Q3;
- Faster-than-expected pace of rate hikes implemented broadly by Central Banks across the world;
- The prolonged military conflict in Ukraine with its direct impact on food and energy inflation;
- Ongoing delays in China's recovery, with the resurgence of Covid-19 coupled with severe energy shortages in central provinces having an effect on domestic production.

While we certainly agree that these factors would generally constitute a perfect match to light the fire of a full-fledged recession, we are also reminded that "*matches don't burn in a vacuum*".

Indeed, one would need to add some fuel in the form of significant economic imbalances such as excessive leverage in the private sector to the initial spark in order for the negative shocks to percolate and scale throughout the economy, and for the recessionary loop to ultimately be fulfilled.

And while we do not discard the probability for most economies to experience flat growth or even a mild, technical recession in the coming months, we remain confident that the underlying global macro setup is favourable for synchronised growth and that as the temporary shocks to activity resorb with time, we should witness a V-shaped recovery, much like the aftermath of the pandemic.

In fact, as we pointed out in our previous H2O AM MacroNote "Another boost to Reflation" dated June 2022, the underlying pillars that give economies their robustness to withstand shocks are still present today. Consumer demand remains strong on the back of:

- **Large excess savings** accumulated during the Covid-related stress period, now ready to be spent as saving rates progressively fall below pre-pandemic levels for most DM economies;
- **Tight labour markets**: global unemployment is at an all-time low (<5%) and full employment increases purchasing power through its effect on workers' collective bargaining power and salaries.

The shocks outlined above are temporary in nature and will prove similar, in a way, to the successive Covid-19 waves that the world experienced. Past the initial shock, governments and economies determined the fiscal and monetary tools necessary to cope with a second, third or fourth wave. As each wave led to a temporary blow to activity, the reopening and accompanying supporting policies resulted in a mechanical and forceful recovery over time, with economies reverting to pre-Covid trends. In 2022, the means by which countries will weather economic disturbances appear rather clear.

Governments have clearly preserved their "Whatever it takes" approach to Covid-19 and are now determined to roll-over previous fiscal measures to protect the purchasing power of their citizens from the hardships of inflation. **Generous public transfers & subsidies**, aimed at mitigating the effect of rising prices, will see their terms extended throughout the rest of the year and in 2023.

Combined with the upward pressure on wages exerted by full employment, such policies are directly improving household's capacity to cope with inflation, shielding them from the strains of purchasing power erosion. But unlike during the pandemic, **consumers are not inclined to build-up precautionary savings**. Instead, the additional support to their disposable income is spent, thus generating demand and reinforcing inflation.

Decomposing demand, it appears that **services are progressively taking the lead as a driver to output growth**, already taking over durable goods which seem to pull back as financing conditions tighten. As we have all witnessed first-hand, the Service economy suffered the most from Covid-19 and has yet to recover its pre-pandemic levels. Services growth will therefore dominate the current macro framework, while other sectors are more advanced in their cycle.

Strong earnings were also announced by companies, proving again their capacity to protect their margins via cost pass-through. **Capex figures are sound and will continue to strengthen**, especially in Europe which should experience a strong upcoming investment cycle as firms seek to consolidate their market share in this context of improved sales, a clear signal of the confidence corporations hold in the future economic outlook.

Thus, absent of the economic imbalances necessary to fuel a sharp recession worldwide, and without the capacity for temporary, negative shocks to lengthen as governments prevent the apparition of economic casualties (i.e., firms facing bankruptcy, workers facing unemployment), the disruptions to growth mentioned above should only result in a technical slowdown rather than a full-fledged recessionary spiral, and should eventually be absorbed by the positive mitigating factors.

Our views over the medium term trajectory of output remain unchanged. We continue to assess the current business cycle as experiencing strong real momentum and remain convinced in the potential for growth synchronisation across global economies, a trend which should benefit our portfolio allocation over time.

Central Banks:

Today, one of the key debates among market participants is therefore the hike trajectory that Central banks intend to follow for the next few quarters. With the current US yield curve inversion implying steady rate hikes for the remainder of 2022 and potential rate cuts in 2023, our assessment is that the market is overstating the risk of recession, but also understating the stickiness of inflation, and thus, the need for further and stronger rate hikes. Indeed, such prediction in Central Banks backtracking would imply that by Q1 2023, cyclical inflation would have faded away, which we see as unlikely given the nature of the underpinning inflationary drivers. Downside drivers to CPI inflation are scarce given the fact that Central Banks have begun tightening monetary conditions from an extremely loose base. Such rate cuts, implied by the inverted yield curve, would also seem to imply a high risk of full-fledged recession in Q1 2023, which is inconsistent with the aforementioned lack of fuel necessary to provoke a slowdown of this magnitude.

There are two means by which financial conditions may contract in an economy. Either through the Central Bank's actions or through the mechanical adjustment of capital markets (i.e., lower equity valuations, higher spreads). While the former option always remains available, the latter is showing signs of exhaustion. Markets have already experienced a sharp correction in their trajectory year-to-date (S&P 500: -18%, Euro Stoxx 50: -19%). They now seem prepared to rebound as investors seek renewed investment opportunities. Hence, in the absence of easing signals from labour markets, and as financial markets lack the scope to further adjust to the downside on their own, Central Banks will have no other options than to hike rates higher and for longer so as to tighten financing conditions and slowdown demand.

However, slowdown in sectors that are most sensitive to higher rates should be put into perspective with the strength of demand in services. Should the latter dominate, as we expect since it is still well below its pre-Covid trend, then the elevated core inflation from tight labour markets will persist, keeping the Fed and other Central Banks in an uncomfortable situation for longer.

What is our positioning ?

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

Over the past months, the following changes were undertaken:

- Increase in the long Italian BTPs against German Bunds;
- The initial US dollar short stance against emerging currencies has evolved into a US dollar short against currencies from the rest of the world with few exceptions (i.e., China).
- Among emerging currencies, the initial allocation to a basket of MXN, BRL and RUB was actively managed and rebalanced in Q2 and Q3, with:
    - The reduction of RUB exposure in the summer to secure gains as the currency will likely face a slowdown now. The MXN allocation was also reduced in light of now "heavier" long positioning from market participants.
    - The redeployment of the risk budget towards central EU currencies (e.g. HUF, PLN) and on other LATAM currencies (e.g. CLP) offering upside potential given current valuation levels.
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Fixed Income

- In aggregate, **net short duration**: Continued to provide positive contribution year-to-date given the overall rise in yields and uncertainty surrounding future rate paths.
- European bond arbitrages, particularly **long Italian sovereign debt against German bunds**. We have been actively managing the exposure throughout the year, reducing it in Q2 and adding back some duration in Q3 as the spread had widened towards an extremely bearish level whereas the ECB's new anti-fragmentation tool is likely to prove an efficient backstop.
- Emerging bond arbitrages, particularly **long Mexican and South African bonds**, due to strong interest rate differentials between emerging and developed markets, with emerging central banks outpacing their developed market counterparts in their tightening cycle and flows also proving more supportive for the asset class as a whole.
- Allocation to **European credit (especially Additional Tier 1)**, thanks to a more positive outlook on the asset class as we assess risk premiums to be high enough to cover both inflation & solvency risks.
- Long optionality maintained over a marginal exposure on **Russian sovereign debt**, which would converge to prices on the Russian market if economic sanctions loosen.

Currencies

- **Long basket of emerging market currencies**, indexed on global growth and commodity export against USD.
- **Long JPY**. Despite short-term challenges to performance, the JPY represents a non-negligible source of protection in case of a recessionary scenario at an attractive entry point given recent valuations. Besides, recent growth outlooks proved favourable for Japan, and should prompt the BOJ to re-consider its stance as inflation picks up.
- **Long AUD**, likely to be supported as commodity prices trend higher around year-end.
- **Short USD**, maintained as currency appears strongly overvalued from its long term average (REER) to levels comparable to the peak of the Covid-19 or dotcom bubble crisis. Global synchronised growth should represent a catalyst for mean-reversion of the greenback.
- **Flat EUR**. Passed the winter and its round of energy rationing within heavily gas-reliant countries, the risk premium that we currently witness on the EUR and European assets will prove attractive again for our allocation, especially considering the output gap remaining in EU economies.
- **Short CHF**, although expected to grow at a favourable pace, the Swiss economy does not face the same inflationary pressure than its EU counterparts given its underreliance on external energy supply.

Equities

- **Slightly positive directional exposure** due to the overweighting of cyclical stocks and the de-rating of growth tech since early 2022 which reduced risks of "bubbly" valuations, allowing a more constructive outlook on global equities. Although markets will remain under pressure at least until October as central banks progress in their financial tightening, equities are expected to reach the bottom of the current downtrend as monetary policies become priced-in and inflation parameters eventually peak.

Long :

- **European banks**
  Benefiting from rising rates, depressed positioning, extremely low valuation levels, and improved balance-sheets overall.
- **Car-makers**
  Exhibiting pricing power, attractive valuation levels, and revenue growth potential supported by government's will to incentivise the purchase of electric vehicles.
- **Emerging equities**
  Global rotation of assets offering recovery potential for emerging stocks, particularly those whose activity depends on the price of commodities.

Short :

- **European Tech**
  High valuation multiples, although not comparable to US Tech in their capacity to have strong cash flows.
- **European Consumer Staples**
  High valuation multiples despite limited growth potential.
- **US Small and Mid caps**
  Very dependent on the market for their financing and therefore sensitive to rising interest rates.

As a reminder, our products may benefit investors looking to:

- Protect themselves from **rising inflation**;
- Go beyond market directionality by diversifying into **relative value strategies**;
- **Diversify** outside of traditional approaches;
- Gain exposure to **emerging assets** which will benefit from the current cycle;
- Benefit from the market turnaround towards **cyclical assets**: the winning strategies of the past 10 years will become the losers of the next 10.

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