

2022 Performance Review & Perspectives for 2023

From transitory to structural: what are the consequences?

Paris / London – 17th of January 2023

As anticipated, the year 2022 was characterised by high nominal growth and sustained demand. The Services economy took the lead as a driving force for growth, especially in the United States. Governments maintained their “Whatever it takes” stance to protect their citizens against inflation. Private consumption did not fall behind as workers preserved their pricing power in a tight labour market environment. In the United States, and even in Europe, households have continued to spend their savings cumulated during the pandemic.

Cyclical inflation has thus accelerated, forcing central banks to swiftly tighten their monetary policy. But most central banks, especially in the developed world, were too slow to react at first. The consequence will undoubtedly be higher structural inflation in developed countries, which will also face an international environment that is much less favorable to disinflation. This global reflation world should continue to benefit cyclical and emerging assets.

We invite you to rediscover some of the communications we sent to provide you insights into our macroeconomic scenario:

- **H2O AM Macro Insights** on December 16th, 2021: [Emerging Markets Strike Back](#)
- **H2O AM Perspectives 2022** on January 31st, 2022: [Video Link](#) (password: H2ooutlook2022)
- **H2O AM MacroNote** on June 13th, 2022: [Another boost to reflation](#)
- **H2O AM Market Views & Positioning** on June 2022: [In the face of rising inflation and rates, which allocation to favour?](#)
- **H2O AM Market Views & Positioning** on September 2022: [Matches don't burn in a vacuum](#)
- **H2O AM MacroNote** on December 16th, 2022: [Can the Bank of Japan afford to wait and see?](#)

2022 Performance Review

Throughout the year 2022, the highest contributor our funds' performance was found in **Fixed Income strategies**, which primarily benefited from the short G4 (US, UK, Germany, Japan) duration within a year marked by the resurgence of persistent inflation and the ensuing monetary contraction orchestrated by central banks. Relative value strategies, and more specifically the transatlantic arbitrage (long US Treasuries against German Bunds), also proved effective this year.

H2O AM's **Equity strategies** exhibited strong returns. Sector arbitrages that contributed to performance are:

- The long Banks and Auto makers against Tech, Industrial, and Consumer Staple firms.
- The long blue chips against small- and mid-cap companies, which are more sensitive to rate hikes and dependent on the markets to raise funds.

Currency strategies also proved positive in 2022. The emerging FX allocation (BRL, MXN, RUB, KRW, etc.) soundly performed against all other currencies, even the greenback if we account for the carry. In our view, the US dollar peaked in September 2022 and we continue to believe that the currency's appreciation has ended.

	Positive Contribution	Negative Contribution
Fixed Income	+ Short G4 duration + Transatlantic arbitrage	- Long Italian BTP vs. German Bunds - Long Emerging sovereign debt vs. US Treasuries
Currencies	+ Long EM FX (i.e., BRL, MXN, RUB, KRW ...)	- Short directional US dollar - Inter-bloc: Long JPY vs. EUR and CAD - Intra-bloc: Long EUR vs. CHF and AUD vs. CAD
Equities	+ Long EU Banks and Auto makers vs. Tech, Industrials, Consumer Staples + Long blue chips vs. Small & mid caps + Long EU vs. US stock markets + Directional (beta) management	

Product Range Performance								
Fund Name	ISIN	Minimum Recommended Investment Horizon	Inception Date	2020	2021	2022	Since Inception (ann.)	Since Inception (cumulated)
H2O LARGO I	FR0013282720	1 year	18/12/2017	-0.3%	0.8%	1.7%	1.9%	9.7%
H2O ADAGIO FCP I	FR0010929794	2 year	01/10/2020	5.4%	2.6%	5.9%	6.2%	14.5%
H2O MODERATO FCP I	FR0010929836	3 year	01/10/2020	18.3%	10.6%	8.5%	16.9%	42.0%
H2O ALLEGRO FCP I	FR0011006188	5 year	08/10/2020	18.7%	5.9%	35.9%	27.2%	70.8%
H2O VIVACE FCP I	FR0011006220	5 year	25/09/2020	36.5%	22.1%	24.1%	37.9%	106.9%
H2O MULTIBONDS FCP I	FR0010930438	5 year	05/10/2020	17.1%	4.0%	26.0%	21.1%	53.4%
H2O MULTISTRATEGIES FCP I	FR0010930446	5 year	08/10/2020	28.3%	24.2%	22.8%	35.2%	95.7%
H2O MULTIEQUITIES FCP I	FR0011008770	5 year	08/10/2020	35.2%	53.7%	3.4%	40.9%	114.8%
MSCI World TR EUR			01/10/2020	8.7%	31.1%	-12.8%	10.2%	24.3%
JP Morgan Government Bond Broad Index EUR			01/10/2020	-1.6%	2.3%	-11.4%	-5.7%	-12.3%

Source: CACEIS. Data as of 30 Dec. 2022. Performance presented relates to the respective fund's reference share class and is computed net of fees, on a NAV to NAV basis. Past performance is not a reliable indicator of future performance.

Perspectives for 2023

With the aggressive monetary policy tightening, the fall of real revenues on the back of surging inflation, China's Covid restrictions and property slump, and the Russia-Ukraine war, global growth slowed through 2022. However a recession was avoided thanks to the continued recovery of labour markets, the global capex cycle and the spending of excess savings cumulated during Covid.

The year 2023 starts with a significant number of tailwinds that should continue to support the global demand: i) the fast reopening of China, ii) the global economy at full employment, iii) the recovery of the European economy, iv) the decline in energy prices which should support the purchasing power of consumers, and last but not least, v) the remaining excess saving of 8% of global GDP. It seems rather difficult to envisage an imminent recession in this context.

Yet there is a clear appetite from the market to roll over its gloomy perspective into 2023. Some economists are still bracing for an upcoming recession, pointing to higher interest rates, a recessionary manufacturing sector and inverted yield curves as strong signs in favour of a slowdown. But these parameters must be put back into perspective.

- Higher interest rates become recessionary when they have a negative impact on private sector balance sheets. But this is not currently the case. The pandemic remarkably improved households' balance sheets as lockdowns depressed spending and government support programs sustained incomes. The backdrop for corporates at the start of the year was healthy and rising inflation boosted firms' earnings. In addition, the impact of tighter financial conditions should be cushioned by the progressive fading of supply chain and commodity price shocks.
- The Manufacturing sector represents 17%¹ of the world GDP and is likely to bottom-out with the reopening of China. In addition, the Services sector, which accounts for approximately 70%¹ of the world GDP, has shown resilience in its capacity to support growth in 2022 and has yet to catch-up with pre-pandemic levels in numerous countries.
- Due to its technical nature, it would be hazardous to infer any economic consequence from US yield curve inversion at this stage. We estimate that the curve is at least 100 bps more inverted than it would have been without a decade of QE and the recent commodity shock. At the very least, it takes a lot more inversion before the signal can be deemed consistent, most likely with a longer lag.

From H2O AM's macro perspective, the current global reflation is still ongoing as the world economy is running through the late phase of its business cycle. This phase is bound to last longer than it usually would as the legacy of Covid policies generated a significant demand shock and very tight labour markets, producing higher wages. Thus, cyclical inflation is likely to remain above Central Banks' targets even as supply-side shocks fade. On a more structural level, the post-Covid world should be more inflationary due to regionalisation and more price-inelasticity from an autonomous demand fuelled by investments in green energy and defence. The combination of both cyclical and structural factors should encourage Central Banks to continue their monetary policy tightening or, at least, to keep their interest rates at restrictive levels for longer.

¹Source: World Bank

Portfolio Positioning

	Sovereign Bonds	Currencies	Credit	Equities
DIRECTIONAL	Short G4 duration	Short USD	Positive Credit & EM debt exposure	Marginal long Beta
RELATIVE VALUE	Short Transatlantic spread	Short USD vs JPY Long EUR vs CHF Long AUD vs CAD & NZD	Long European AT1	Long Banks & Auto makers vs Tech, Industrials, Consumer staple Long EU and EM vs US markets Long blue chips against small-and mid-cap firms
SPECIFIC	Long Italian BTP vs German Bund Long Local EM Sovereign Bonds (Mbono & South-Africa)	Long EM currencies (BRL, CLP, MXN, PLN, KRW) vs USD	Long external EM Sovereign Bonds	

Source: H2O AM Front office data, as of Dec. 2022

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

- **Diversify** outside of traditional approaches;
- Go beyond market directionality by diversifying into **relative value strategies**;
- 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;

Edited by H2O AM – in Paris / London, 17th of January 2023

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The legal and regulatory documentation of the funds managed by H2O AM is available free of charge on the website h2o-am.com

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