

Central Banks' new conundrum

Systemic risk, Growth and Inflation

Paris / London – May 15th, 2023

The March banking stress was a good test for the global economy: it proved the lack of viable channels of contagion which could have accelerated the downturn now faced by most economies in the late business cycle phase. US deposits are moving from failing banks into institutions with stronger balance sheets, thus further consolidating the sector with marginal impact on credit standards from large cap banks beyond the Fed's own measures to restrict liquidity. In Europe, the euro area bank lending survey (BLS) indicated that, although the pace of financial tightening increased substantially, **tightening conditions did not accelerate following the recent banking stress**. And besides regulators' resolve to deploy swift macro-prudential measures, the lack of systemic risk also finds roots in the sound balance sheet conditions of economic agents, underscoring the capacity of households and firms to weather stricter financial conditions.

The financial sector undeniably bore the brunt of this confidence shock as investors offloaded highly detained positions such as banks and took refuge in defensive stocks and mega tech. And while real money investors might be restricted from deploying capital to the sector in the coming months due to the volatility shock, we still view banks as a source of outperformance within H2O AM's equity sector arbitrages due to their deep undervaluation, a state which has prevailed long before the recent tightening of financial conditions. Overall, the investment team remains of the opinion that **value stocks will gain ground during the end of the economic cycle**, thus leading H2O AM to preserve its allocation to cyclical (EU) Autos and Banks, with marginal adjustments such as investments in energy and basic resources to diversify the basket of value securities.

Macro Landscape

The global economy is expected to cool-off in the second quarter. But the resilience of economic structures points toward a progressive and controlled contraction, consistent with a **soft landing scenario**. Core inflation remains elevated in the euro area on the back of ever-tight labour markets, real labour income advancements, and expanding Service industries. Even the US, which stands ahead in the economic cycle and experienced a local shock over its mid-sized banks, is on the path of moderate slowdown as labour conditions remain strong (April unemployment rate at 54-year low: 3.4%) while the economy is supported by exogenous factors: China's reopening, Europe's robustness, and higher purchasing power from lower energy prices (headline disinflation). In fact, these economies are still under the effect of measures undertaken in the aftermath of Covid and are yet to bear the brunt of rate increases despite cracks emerging in specific sectors. The situation thus warrants the need to remain data-dependent and adapt the central macro scenario should circumstances require it.

At their current level of valuation, bonds hold no value in the absence of a global hard landing, which is not our central scenario. Investors seem very optimistic in pricing six cuts over one year in the Fed policy rate. However, the current market sentiment overlooks the likelihood of **further rate hikes to come as Central Banks are met with renewed signs that inflation will remain structurally above-target**. And even though our long-term view is that Central Banks will favour growth to inflation, we believe this is not yet the case as they are still concerned with their credibility.

Performance Overview

At the start of 2023, H2O AM's strategic allocation strongly benefited from this economic resilience as well as the end of the Fed's predominance in this ever-hawkish tightening cycle. Chief among the value segments which had a major contribution to its funds' performance was the investment in emerging FX (especially Latin American currencies) which, thanks to the high carry and weakened positioning following the banking stress, still represent a major opportunity this year (cf. [H2O AM MacroNote - Emerging Market Currencies: Still a good investment](#)).

To a lesser extent, other strategies proved favourable in their contribution such as the duration and yield curve management (i.e., US curve steepener), equity geographic and sector arbitrages, as well as FX intra-bloc strategies (i.e., shorting the EURHUF within the EUR block).

While not adding to performance yet, the portfolios' long stance in undervalued currencies from countries which stand behind the curve in the tightening cycle and are well positioned to benefit from China's reopening (i.e., Japan, Australia) remains key to return potential in 2023. Inflation in such economies is relatively high compared to the level of their respective nominal rates. This situation will soon prove untenable and justify stronger action from their Central Banks. On this note, the RBA recently surprised investors by lifting the cash target rate in May after keeping the policy rate steady in the previous month, reasserting the need to address Australia's cost of living crisis.

Performance Chart for H2O AM's Product Range as of May 10th, 2023

Fund Name	ISIN	Min. Recommended Investment Horizon	Inception Date	2021	2022	2023 YTD	Since Inception annualised	Since Inception cumulated
H2O Multibonds FCP	FR0010930438	5 year	05/10/2020	4.0%	26.0%	16.7%	23.9%	73.3%
H2O MultiStrategies FCP	FR0010930446	5 year	08/10/2020	24.1%	22.8%	12.0%	34.5%	113.1%
H2O MultiEquities FCP	FR0011008770	5 year	08/10/2020	53.7%	3.3%	14.9%	41.3%	141.8%
H2O Adagio FCP	FR0010929794	2 year	01/10/2020	2.6%	5.9%	4.1%	6.8%	18.3%
H2O Moderato FCP	FR0010929836	3 year	01/10/2020	10.6%	8.5%	5.8%	16.6%	48.5%
H2O Allegro FCP	FR0011006188	5 year	08/10/2020	5.9%	35.9%	9.9%	26.7%	83.0%
H2O Vivace FCP	FR0011006220	5 year	25/09/2020	22.1%	24.1%	11.0%	36.7%	124.7%
MSCI World TR EUR			01/10/2020	31.1%	-12.8%	6.2%	11.3%	31.7%
JP Morgan Government Bond Broad Index EUR			01/10/2020	2.3%	-11.4%	0.6%	-5.0%	-12.4%

Source: CACEIS. Data as of 10th of May 2023. 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.

Portfolio Positioning

	Sovereign Bonds	Currencies	Credit	External Emerging Bonds	Equities
DIRECTIONAL	Short G4 duration	Short USD	Positive Credit exposure	Positive EM debt exposure	Neutral exposure
CYCLICAL VALUE	Long Italian BTP Long Local EM Sovereign Bonds (Mbonos, South A.)	Long EM currencies with a Latam bias (MXN, BRL, COP)	Long European AT1	Long basket of diversified EM sovereigns value or distressed	Long European Bank, Auto and Energy Long EM equity Short European Tech & Consumer Staples Short US Small & Mid cap
RELATIVE VALUE & DIVERSIFICATION	US steepening	Short CHF and GBP vs. HUF and PLN Long NOK vs SEK Long AUD vs. NZD and CAD			

Source: H2O AM Front office data, as of May 2023

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