

Sticky Inflation: A self-love story

Paris and London – July 12th, 2023

Our analysis of the macro landscape depicts a scenario of gradual slowdown of the global economy initiated by central banks, with a mild US recession at the end of 2023 or early next year.

In addition to low unemployment and high excess savings, consumers around the world now benefit from decreasing commodity prices. Although labour markets may exhibit slowing momentum in some regions, they remain historically tight and inflationary. What's more, the stickiness of core inflation, which fails to decline fast enough, anchors expectations of future price increases at elevated levels and heightens the risk of much-dreaded, second-round effects (i.e., wage-price spirals). In this context, central banks ought to keep rates at their terminal level for longer than the market expects (e.g., the Fed paused for 3 years in 1995-1997 and it took 18 months for them to cut following the Asian crisis). In fact, the more time they spend in this configuration, the stricter financial conditions will become as banks, corporates and households eventually adapt to this higher-yield environment. To have a broad impact over an economy with no major imbalances, **higher rates must become the norm rather than the exception.**

However, the probability of inflation relapse, which would warrant further monetary tightening, has increased significantly in the past months across economic regions. The Federal Reserve may have paused its monetary policy, but it also reasserted its data-dependency, leaving the door open to further rate hikes if indicators continue to outperform. Core inflation in the UK, now standing at 7.1% annually (May 2023), has kept surprising investors on the upside since February, thus confirming the presence of second-round effects in the economy (e.g., on-going wage negotiations, low participation rate pressuring labour costs, firms passing down costs, etc.).

Europe showed signs of lowering momentum as Q1 GDP releases produced mixed results within the eurozone, with Germany leading the bearish sentiment after revealing negative growth in two consecutive quarters on the back of declining private and public consumption. Conversely, Italy emerged as the big winner of the post Covid recovery. Consumption in the country benefited from sound endogenous dynamics (e.g., rising employment and labour income) while investment, supported by the country's predominant access to the Next Generation EU (NGEU) package, rebounded. Overall, several factors still point towards economic resilience in the continent (e.g., low unemployment rate, high excess savings, rising wages, and lower energy prices) and should continue to support above-target core inflation and real growth.

In Asia, recent concerns over China's 2023 growth are in part driven by Real Estate uncertainties given the large stock of unsold apartments. Despite these anxieties, the Chinese post-pandemic economy should improve as the unemployment rate normalises and pent-up demand is released through the spending of Covid savings on services such as entertainment and tourism. High Q1 credit growth and upcoming policy supports are yet to have an impact on the country's growth rebound.

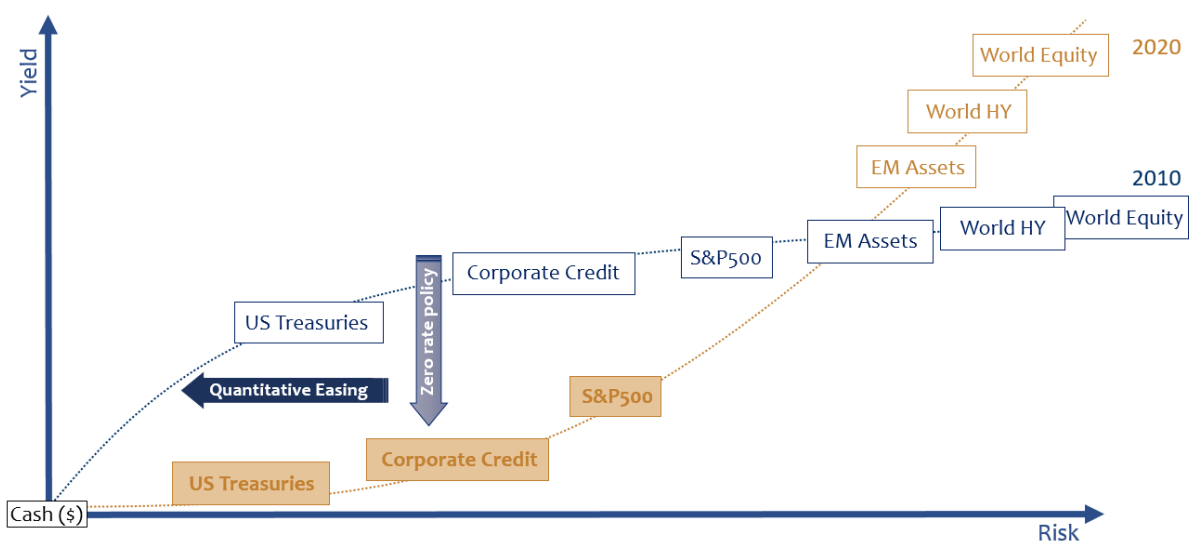
Performance and investment style

Performance Chart for H2O AM Funds as of June 30th, 2023

Fund Name	ISIN	Min. Recommended Investment Horizon	Inception date	2021	2022	Performance 2023 YTD	Since Inception ann.	Since Inception cum.	Volatility Since Inception ann.
Absolute and Total Return Funds									
H2O Multibonds FCP EUR	FR0010930438	5 year	05/10/2020	4.0%	26.0%	18.9%	24.6%	82.4%	27.6%
H2O MultiStrategies FCP EUR	FR0010930446	5 year	08/10/2020	24.1%	22.8%	14.5%	34.4%	124.0%	32.4%
H2O MultiEquities FCP EUR	FR0011008770	5 year	08/10/2020	53.7%	3.3%	25.1%	43.7%	168.6%	31.3%
H2O Adagio FCP EUR	FR0010929794	2 year	01/10/2020	2.6%	5.9%	3.4%	6.3%	18.4%	7.0%
H2O Moderato FCP EUR	FR0010929836	3 year	01/10/2020	10.6%	8.5%	7.2%	16.6%	52.3%	16.0%
H2O Allegro FCP EUR	FR0011006188	5 year	08/10/2020	5.9%	35.9%	12.7%	27.2%	92.6%	28.8%
H2O Vivace FCP EUR	FR0011006220	5 year	25/09/2020	22.1%	24.1%	12.5%	35.8%	132.8%	31.6%
JP Morgan Government Bond Broad Index EUR			01/10/2020	2.3%	-11.4%	-1.4%	-5.4%	-14.2%	
MSCI World TR EUR			01/10/2020	31.1%	-12.8%	12.6%	13.0%	39.9%	
Benchmark Anchored Funds									
H2O MultiAggregate USD	IE00BD8RGM75	3 year	04/02/2016	2.3%	-10.2%	7.9%	6.5%	59.6%	8.7%
Benchmark: Bloomberg Barclays Global Aggregate Total Return Index Value				-1.4%	-11.2%	3.0%	1.4%	10.5%	3.3%
H2O EuroSovereign EUR	FR0013410867	3 year	19/06/2019	1.4%	-6.6%	5.6%	5.3%	23.1%	6.8%
Benchmark: Bloomberg Barclays EuroAgg Treasury Total Return Index Value				-3.5%	-18.5%	2.5%	-3.8%	-14.3%	6.5%

Source: CACEIS. Data as of 30th of June 2023. Performance presented relates to the respective fund's reference share class and is computed net of fees, on a NAV-to-NAV basis. The volatility of benchmarks is computed since the inception of the reference share classes. Past performance is not a reliable indicator of future performance.

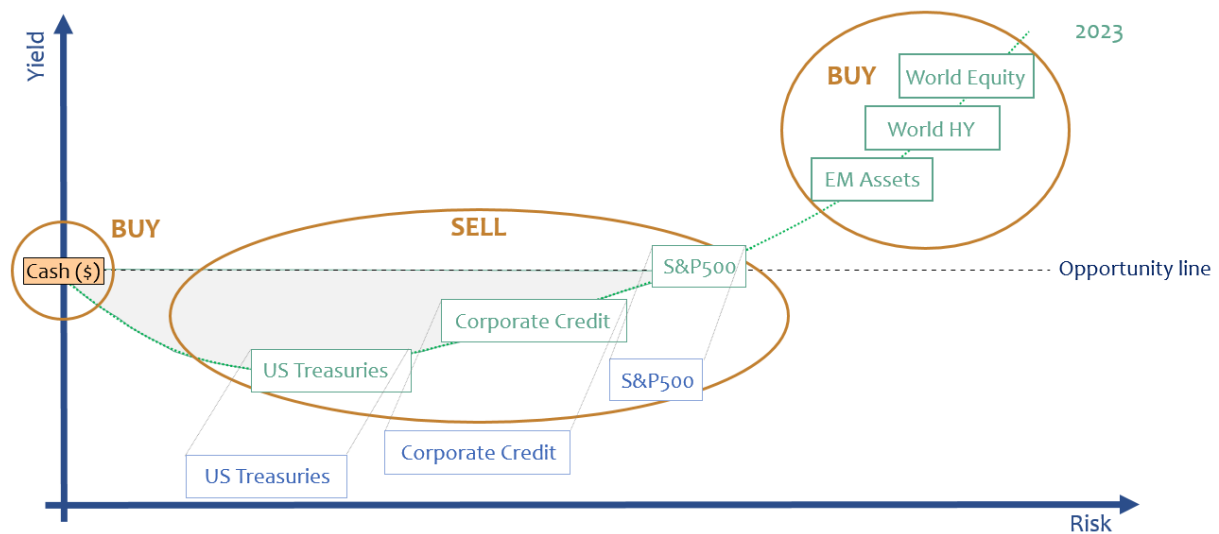
Policies enacted in the previous decade had a significant impact over the set of expected return and risk between asset classes. Years of low-to-negative interest rates, aimed at encouraging credit expansion, enticed investors into buying the next assets with better returns along the Efficient Frontier (Treasuries, S&P 500, Corporate Credit) since money market instruments were not yielding much, if anything. Large quantitative easing programmes then limited the risk embedded within local instruments. Combined with the Fed's resolve to ensure the smooth functioning of capital markets (i.e., the Fed Put), this trend of the past decade explained, to a large extent, the outperformance of Growth against Value.



Source: H2O AM as of June 2023

And although outsized fiscal measures and monetary injections during Covid further prolonged this trajectory, their implementation set in motion a cascade of events which, combined with robust initial conditions, extended the late phase of the global economic cycle and laid the ground for the comeback of cyclical inflation. Central banks were forced to react and initiate the reversal of loose monetary guidelines through rising rates and shrinking balance sheets. This turning point led to the market adjustments witnessed in 2022.

Together with the uncertainties surrounding the country’s macro setup (e.g., more leverage, overvalued currency, regional bank mismanagement, twin deficits, etc.), **this durable change of trajectory prognosticates the end of US exceptionalism**, which should benefit discounted alternatives such as emerging assets, but also non-US cyclical value stocks and HY credit.



Source: H2O AM as of June 2023

Fitted to analyse and exploit such deep value alternatives, H2O AM’s investment style also benefits from this environment of risk diversity. Falling correlations since the last global stress (Covid) have provided renewed diversification opportunities across assets and geographies, thus enabling the investment team to mitigate volatility and extract the carry from each position at a lower VaR. **And given the high carry of these value trades (e.g., Latam FX provide 7% above cash on average), H2O AM funds are, by design, paid to hold these opportunities.** In fact, the longer it takes for investors to regain interest in these value pockets and fuel waves of asset catch-ups, the higher the premium which can be captured. Besides, the size of these markets, not to mention the fact that they were left out by investors in the past decade (low positioning), suggests that it would not require much capital inflows for them to experience impressive rallies.

Additional value is captured through H2O AM’s portfolio construction approach, delivering the money market rate via ample cash and bond holdings while implementing relative value investments using bond futures and options.

Edited by H2O AM in Paris and London - July 12th, 2023

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