2023 Performance Review

Mind the Market Mechanisation Trap

Paris / London – January 8th, 2024

One year ago, economists surveyed at the onset of 2023 issued cautionary warnings about an impending recession, heightening the concerns of already apprehensive investors. This came on the heels of a challenging year (2022), marked by one of the worst periods for bonds due to escalating inflation and the ensuing policy rate adjustments. Yet the synchronised tightening of labour markets globally, the absence of balance-sheet imbalances among households and corporations, and the delayed impact of restrictive monetary policies on growth, collectively served as countering factors against the anticipated downcycle. **Indeed, the market pessimism observed in early 2023 proved to be more of a trap than a warning for investors.**

And despite not having a material impact on financial conditions, the March crisis, triggered by the bank run on the Silicon Valley Bank, provoked a strong volatility shock that also served to remind the significance of upholding a balanced portfolio construction which provides resilience in market stress cycles. Although impacted via their allocation to bank credit and equity, H2O AM portfolios mitigated the shock through their yield curve strategy (buying the short-end of the US yield curve and selling the long-end) and short dollar against emerging FX. This positioning jointly benefited from the perceived dovish stance of the Federal Reserve and the US regional bank mismanagement.

Now guided by the conviction that inflation is poised to return to target, without necessitating a more forceful and detrimental monetary response from central banks, the market enters the year 2024 on an exceptionally positive trajectory, buoyed by references to a "Goldilocks economy" or a "Fed loosening cycle" in the media. However, **within a market framework characterised by increasing mechanisation, we perceive this heightened optimism as entailing additional risks.**

Market mechanisation is the prevailing trend wherein participants increasingly mirror each other's behaviour and positioning, under the strong pressure of regulators to adopt similar practices in risk management. Mechanised investors tend to react with exaggeration during adverse periods and amplify their positions during favourable ones. As such, unforeseen developments trigger sharp responses due to the absence of diversification among investors (including banks, as they are now restricted from providing contrarian liquidity).

The cumulative impact of surprise, combined with uniform and elevated positioning, heightens both the likelihood and potential magnitude of a market shock. The year 2024 will be riskier, not due to macro developments, but because the market will react more dramatically to deviations from the prevailing macro consensus. **Thus, evading the mechanisation trap necessitates avoiding 2024's optimism trap.** Consequently, H2O AM will seek to adopt a more tactical approach to proactively mitigate vulnerability to tail risks.

Overall, the H2O AM UCITS fund range demonstrated strong performance across its asset class allocation, encompassing Fixed Income, Currencies, Credit, and Equity. As a reminder, the firm relies on a top-down, discretionary process to formulate the base macro scenario from which investment views and themes are derived.

Fund Parameters				*Performances*				
Category	Fund Name	Minimum Recommended Investment Horizon	Inception Date	2021	2022	**2023**	Last 3 Years	Since Inception (annualised)
Absolute return	***H2O Adagio FCP*** *I EUR*	*2 years*	01/10/2020	2.6%	5.9%	**7.3%**	16.6%	6.5%
	H2O Moderato FCP *I EUR*	*3 years*	01/10/2020	10.6%	8.5%	**10.7%**	32.9%	15.0%
	H2O Allegro FCP *I EUR*	*5 years*	25/09/2020	5.9%	35.9%	**20.5%**	73.4%	24.8%
	H2O Vivace FCP *I EUR*	*5 years*	25/09/2020	22.1%	24.1%	**19.1%**	80.6%	31.9%
Unconstrained	***H2O Multibonds FCP*** *I EUR*	*5 years*	05/10/2020	4.0%	26.0%	**26.4%**	65.6%	22.7%
	H2O MultiStrategies FCP *I EUR*	*5 years*	05/10/2020	24.1%	22.8%	**22.3%**	86.4%	31.0%
	H2O MultiEquities FCP *I EUR*	*5 years*	08/10/2020	53.7%	3.3%	**35.2%**	114.8%	39.2%
	MSCI World TR EUR		01/10/2020	21.8%	-18.1%	**19.6%**	36.7%	13.0%
	JPM Gov Bond Broad Index EUR		01/10/2020	-2.3%	-12.0%	**0.8%**	-10.0%	-3.7%
Benchmark Anchored	***H2O MultiAggregate*** *I USD*	*3 years*	04/02/2016	2.3%	-10.2%	**15.7%**	6.4%	7.0%
	BBG Global Agg TR Index Value			-1.4%	-11.2%	**7.1%**	-6.2%	1.8%
	H2O MultiEmerging Debt *I USD*	*3 years*	12/05/2016	-3.7%	-24.0%	**32.7%**	-2.9%	3.5%
	50 % JPM GBI-EM, 50% JPM EM Global Diversified			-5.3%	-14.7%	**11.9%**	-9.6%	2.0%
	H2O EuroSovereign *I EUR*	*3 years*	19/06/2019	1.4%	-6.6%	**11.2%**	5.2%	5.9%
	BBG EuroAgg Treasury TR Index Value			-3.5%	-18.5%	**7.1%**	-15.7%	-2.4%

Source: CACEIS. Data as of 29 Dec. 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.

A key driver behind this year's overall performance was the **constructive view on emerging markets held by the investment team**. This perspective was executed through a long position in a thoughtfully selected basket of emerging market currencies, predominantly financed against the US dollar. These markets, often overlooked in the past decade, currently present a rare combination of low valuation and high carry. Factors such as the nearshoring trend, improved terms of trade and ensuing capex cycle further contribute to the positive outlook for emerging markets.

The global equity allocation also performed well, primarily based on **H2O AM's view that funding-deprived firms face elevated risks in a monetary contraction environment**, a condition often correlated with their size or development stage. To capitalise on this theme, the team adopted a long position in US blue-chip stocks (S&P500) against small and mid-caps (Russell 2000). Additional returns were generated through **sectorial arbitrage, favouring EU Banks and Autos against growth or defensive stocks (i.e., Tech, Consumer Staple).** These selected industries not only benefited from the extension of the business cycle in 2023 but also exhibited sound fundamentals and an undervalued state.

The fixed income segment also delivered positive returns; **an outcome primarily attributed to yield curve strategies, notably the positive performance of the US yield curve steepener view** (long short-term treasuries against long-term treasuries). This position acted as a counterbalance in March (SVB crisis), but also in Q3 2023, attenuating the underperformance stemming from penalised emerging markets due to the US cyclical outperformance and the pronounced rise in term premium following the deterioration of the developed markets fiscal outlook. Finally, the **funds' active management of G4 (US, Japan, UK, Germany) 10-year government bonds** proved attuned with the general direction of yields this year.

We invite you to rediscover some of the communications sent in 2023 to provide you insights into our macroeconomic scenario:

- **H2O AM Market Views & Positioning** on January 17th, 2023: [2022 Performance Review & Perspectives for 2023]
- **H2O AM Macro Update** on March 2023: [Video Link] (password: H2oAM2024?)
- **H2O AM MacroNote** on April 6th, 2023: [Emerging Market Currencies: Still a good investment]
- **H2O AM Market Views & Positioning** on May 15th, 2023: [Central Banks' new conundrum]
- **H2O AM Market Views & Positioning** on July 12th, 2023: [Sticky Inflation: A self-love story]
- **H2O AM MacroNote** on October 20th, 2023: [So far, so good]

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