In the face of rising inflation and rates, which allocation to favour?

Paris – June 2022

After a first quarter marked by the realisation that inflation was here to stay (drop in value of growth stocks, upturn in favour of "discounted" cyclical stocks), followed by global disbelief in the resurgence of a military conflict on European soil, the first three months of 2022 ended with the inversion of the US 5-year 30-year curve.

All of these events provoked a profound change in market participants' expectations throughout the second half of the year: the fears of some regarding the risks of stagflation are now overshadowed by the concerns of many regarding the risk of an imminent recession in the United States. Moreover, the fear of central banks' inaction allowing inflation to shoot up is giving way to the fear of policy error causing overly restrictive monetary policies. The backdrop to this is the continued synchronised decline in value of global equities and bonds.

However, despite this complex and worrisome context, the trajectory of strong, synchronized global growth initiated in 2021 has not vanished and a number of macroeconomic factors demand a more nuanced reading of the current situation.

What scenarios?

We continue to assess the global macroeconomic situation and **our view remains in favour of a reflation scenario (sustained growth and inflation), which is more likely to occur than a stagflation/recession scenario, partly due to the following factors**:

- strong consumer demand ;
- low unemployment rates: global unemployment is at an all-time low (<5%) and full employment is generating inflation ;
- large excess savings remaining. This Covid-related demand is a strong support for future growth.

Market scenarios	G4 directional FX	Directional Equity
STAGFLATION Inflation and absence of growth, or possibly recession	Estimated **neutral** performance: The rate hikes set up to contain inflation would limit the upside potential in the event of a flight towards assets considered less risky (G4 bonds).	Estimated **negative** performance: Growth stocks would continue to suffer from both increases in rates and negative prospects in the event of a recession, while cyclical stocks would struggle to take over.
REFLATION Inflation with growth	Estimated **negative** performance: Further rate hikes aiming to curb the inflationary spiral would weigh heavily on the valuation of G4 bonds.	Estimated **neutral/positive** performance: The rotation to cyclical value stocks would only partially offset losses generated on growth stocks (because of their weight in indices) which would continue to suffer from interest rate increases. However, as this market correction is already under way, equities still hold upside potential provided overall growth is sustained.

The key issue today is to determine the scenario we are in and to anticipate the level at which inflation will stabilise. Looking ahead, we believe that demand-led inflation and rising wages should support cyclical inflation above the Fed's 2% target for longer than the market expects. Ultimately, U.S. inflation should also be supported by synchronised, above-potential global growth. Global supply capacity is at saturation point, which is inflationary for the U.S, which no longer benefits from imported disinflation (unlike during the Asian or European crises).

Moreover, the political timetable for the green transition has been accelerated by the conflict in Ukraine. Instead of managing the energy/traditional to green/electric transition in a progressive manner (by gradually phasing out from the former to increase reliance on the latter), Europe will have to invest heavily in the green transition without being able to reduce imports of fossil energy. This should strongly increase investments and job creation in the sector: the impact could be inflationary, but could also be a source of growth, especially for Europe.

What is our positioning?

In terms of portfolio construction, we remain exposed to relative value strategies as directional strategies offer little return, even in a reflationary scenario.
In this context, we find fewer opportunities in traditional bond markets and more opportunities in currencies. This environment is also likely to see the beginning of a long-term cycle for carry trade strategies.
Our funds can deliver a current yield in excess of 1%* per unit of ex-ante volatility. This means that a fund with a 10% volatility and therefore an associated risk, could have an embedded return equivalent (10%)* (expected Sharpe ratio above 1).

**The amounts shown are indicative and are based on an analysis of past performance and do not take into account any fees and expenses associated with the subscription/redemption of units.*
It is essential to remember that historical performance is not a reliable indicator of current or future performance.
Any type of investment involves risks, in particular the risk of loss of capital (partial or total).

The funds managed by H2O AM are invested in various asset classes, including fixed income securities and currencies. Bond investments are particularly sensitive to changes in interest rates, and the fund may lose value if interest rates rise. The Funds are exposed to specific risks including: risk of loss of capital, discretionary management, credit, interest rate, counterparty, volatility, currency exchange rates as well as arbitrage, overexposure and investment in emerging markets. The capital invested is not guaranteed. For a fuller description of the risks, see the relevant fund prospectus.

ALLOCATION H2O AM

Fixed Income

- In aggregate, **net short duration:** Positive contribution year-to-date following the overall rise in yields.
- European bond arbitrage, particularly **long Italian sovereign debt** against German bunds, based on the expected convergence of European yields, sustained by a weak net bond issuance and the ECB's purchase and reinvestment policy at maturity.
- Emerging bond arbitrage, 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.

Currencies

- **Long emerging currencies** benefiting from global growth and commodity export (e.g BRL, MXN) against the USD in an environment of persistent inflation, high risk premiums and historically low valuations, offering a good entry point.
- **Long JPY** on the basis of strong performance asymmetry: Low valuation and net seller market, offering limited additional downside potential and a non-negligible source of protection in case of negative macroeconomic development (recession).
- **Long AUD** in the midst of the commodity price spiral.
- **Short USD:** The currency is overvalued from its long term average (REER) to levels comparable to the peak of the Covid or dotcom bubble crisis, which would be justified only in the event of an immediate and pronounced recession. Historically, the dollar also tends to depreciate following the first rate hikes in the context of a synchronised growth environment.
- **Short CHF:** As a safe haven, the currency depreciates during periods of economic improvement. The CHF was sold against the EUR due to the low persistence of Swiss inflation compared to the eurozone.

Equities

- **A slightly positive directional** exposure in aggregate terms for our portfolios, due to the overweighting of cyclical stocks and 'values' that are not held, and which tend to perform better than growth stocks in an environment of rising interest rates.

Long :

- **European banks** (benefiting from rising rates)
- **European cars** (pricing power, can preserve margins)
- **Emerging equities** (global rotation of assets offering a potential for recovery to emerging stocks, particularly those whose activity depends on the price of commodities).

Short :

- **European Tech** (high market multiples but not comparable to U.S. Tech in terms of capacity to generate strong cash flows)
- **European Consumer Staples** (high company 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).

What is the return potential for our funds?

The end of central bank support leads to higher volatility and asset appreciation (fall in value of equities and bonds), but also to stable asset correlations in the medium term: this is the type of environment in which we have historically reached the best outcome. Indeed, it tends to be less favourable to directional strategies (less market beta) and offers more opportunities for relative value strategies (more alpha). This is favourable to our investment style, and the relative strategies we hold in our portfolios therefore offer a fully renewed recovery potential. In this context, the volatility of our portfolios will remain high, but with a likely high reward.

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 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, 17 June 2022