LETTER FROM THE CIO AM

MARKET ANALYSIS AND PRINCIPAL INVESTMENT THEMES

FEBRUARY 2023

IS THE MARKET GETTING AHEAD OF ITSELF?

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► China's decision to abandon its zero-Covid policy reduces the risk of recession but investors are betting more on disinflation in the US which is why bond and equity markets soared in January. Inflation has fallen back in the US and Europe, but the US has also seen confirmation that wage growth is slowing, a good indication that US disinflation is having an underlying economic impact. Energy prices were generally unchanged in January but it was a different story for commodities. Copper started rising again on expectations China's economy would recover. Disinflation has some potential in the US but the picture is less clear in Europe even if there are signs the process has begun.

KEY FIGURE

+1%

The rise in the US Employment Cost Index in the fourth quarter of 2022 compared to the previous quarter. This sort of trend is consistent with inflation moving towards 2.5-3%, or significantly down on 2022 records.

Fed chairman Jerome Powell himself recognised that disinflation had begun so the Fed could be nearing the end of its tough monetary tightening programme. The ECB's intentions are harder to read but we note that the bank is trying to prevent investors from revising down their expectations for rate hikes. Markets are currently pricing in a terminal rate of 3.25-3.5% which looks reasonable given the bank's statements so far even if the ECB, unlike the Fed, has tried to say the least possible about the subject.

BOND MARKETS ARE STILL ATTRACTIVE

We believe that visibility on inflation and the Fed's policy will help stabilise bond markets at current levels, even in Europe where economic fundamentals are less clear. This optimism triggered a bond market rally in January with lower yields and tighter spreads but the chances of capital gains from now on look slim. Bond markets are nevertheless still attractive: they offer historically high yields and any risk of falling prices is limited by today's ongoing disinflation and the approaching end to tightening in the US. As a result, we remain overweight bonds.

EQUITY MARKETS STILL HAVE UPSIDE

Since the beginning of 2023, equity markets have ridden on incipient disinflation, reinforced confidence in China's recovery and improved resilience in Europe thanks partly to energy price falls. But this extraordinary cocktail of positive factors is unlikely to last long. China's stock market has already rebounded by 50% since the end of October. And room for more energy price falls looks narrow if only because China's economy will start up again soon. As for disinflation, some of the fall back has already been discounted.

On the one hand, even if the global economy is now more balanced, we should not underestimate downward pressure on company margins and the risk of recession in the US. On the other, equity markets still have upside from buying on anticipation of a Fed pivot, i.e. a more neutral monetary stance, and even hopes for more accommodating policy. We are still overall neutral on equities. We continue to focus on emerging countries but we have relatively little geographical bias and are investing in our three investment themes for 2023, namely healthcare, big data and human capital.

OUR CONVICTIONS*

ASSET CLASSES	
Equities	=
Fixed Income	+
Cash	-
EQUITIES	
US	=
Europe (ex-UK)	-
UK	=
Japan	-
China	=
Global Emerging	+
Convertibles	=
SOVEREIGN BONDS	
US	=
Eurozone	=
Emerging Markets	+
CORPORATE BONDS	
US Investment Grade	+
Euro Investment Grade	+
US High Yield	+
Euro High Yield	+

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 02/02/2023.

PROVIDING MARKETS WITH ADDITIONAL IMPETUS

In an environment where inflation is the biggest problem, the fact that the recovery is taking shape in China is the best possible news. China was flirting dangerously with inflation and the recovery is expected to be driven by consumption and services, thereby capping any inflationary impact on the global economy. For the moment, it is difficult to imagine what other good news could give markets additional impetus. As long as disinflation continues amid modest but accident-free economic growth -our core scenario- there is every justification for bond and equity markets to rise but it is very unlikely that they will make gains as fast as in January.

KEY POINTS

We remain overweight bonds

Overall, we are still neutral on equities

We continue to focus on emerging countries

We prefer healthcare, big data and human capital

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Société anonyme governed by an executive board and a supervisory board with capital of €11,033,769 -
AMF registration No. GP 04000015 - 332.652.536 R.C.S Paris

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