Banque Richelieu
FRANCE

# STRATEGY SYNTHESIS
# RICHELIEU GROUP
# MONTHLY REVIEW

Alexandre HEZEZ, Strategist

January 30th 2022

**SUMMARY**



*"With inflation well above 2% and a strong labor market, the Committee expects that it will soon be appropriate to raise the federal funds rate range," FOMC*

## Covid and inflation fade before the Fed and Russia

We believe that the trajectory of the equity markets in 2022 will depend primarily on economic growth and the evolution of earnings after an exceptional year in 2021. Of course, companies have demonstrated their ability to adapt not only to pandemic waves but also to input inflation by optimizing their production costs and passing on certain price increases to the end consumer. **Based on the first results of the fourth quarter, we expect earnings growth in 2022 of 7-8% in both Europe and the US, partly reflecting economic growth that should normalize.**

Yet the month of January saw the equity and bond markets begin a violent decline and significant sector rotation, leaving little room for evasive action.

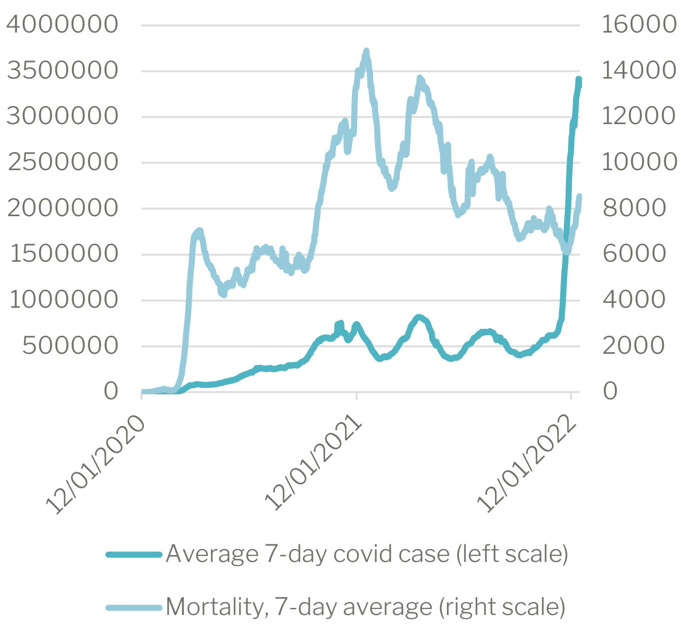
We were already anticipating volatility shocks that would punctuate the year as a whole due to growing uncertainties, not about the intrinsic health of companies but mainly related to risk premiums subject to health, geopolitical and monetary hazards. **In this context, it seems interesting to us to analyze each catalyst to assess whether market movements reflect temporary stress or, more generally, a change in trend.**

**Health and inflationary risks have captured our attention in recent months.** The Omicron wave resulted in a further sharp decline in spending on many services at the beginning of the year, with tourism and leisure being particularly hard hit. Paradoxically, the latest indicators show that it is realistic to expect an improvement in a few weeks.

According to the World Health Organization, it is possible to end the severe phase of the pandemic this year.

According to the organization, it is "*dangerous to assume that Omicron will be the last variant or to talk about the end of this pandemic*". That said, the Omicron variant, which could infect 60% of Europeans by March, has started a new phase of the Covid-19 pandemic and could bring it closer to an end. **Economies retain important leverage for growth that will be even stronger in 2022 as the health challenges recede, with the hope that Omicron will prove less dangerous as studies point out.** The recovery is not expected to falter much thanks to a strong labor market, rising demand for services and healthy corporate balance sheets. The high level of household savings can also cushion a new shock (the IMF forecasts a historic global gross savings rate of 28% in 2022).

Worldwide Covid cases and mortality




*Sources : Bloomberg & Richelieu Gestion*

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**The inflation factor remains a concern for most central bankers, who hardened their tone at the end of 2021.** The increasing number of statements by FED members tends to confirm the consensus within the institution to quickly adjust its monetary policy in a less accommodating direction. The normalization of monetary policy is a difficult process to calibrate. An overly aggressive action by central banks could have a strong impact on equities. Interest rate markets are already anticipating much of the movement on the monetary side. Although the Fed announced the end of its bond-buying program and telegraphed imminent rate hikes, the sudden discussion of its balance sheet caught investors off guard.

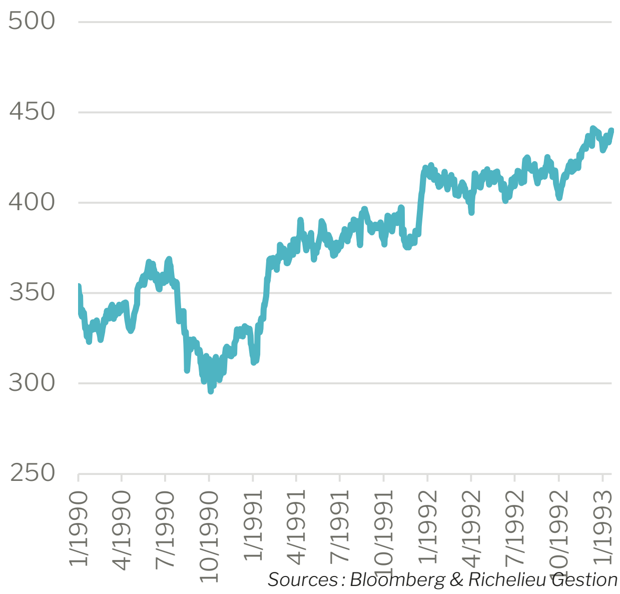
One may wonder why the financial markets reacted so badly this month, as there were no fundamental changes compared to the end of the year. The FED has certainly shown determination, but it remains flexible and credible.
**We think the market can absorb rate hikes that are actually more than necessary.** The question is whether the FED can raise rates to the point of causing a recession. A reasoning by the absurd leads to a negative answer. The lesson for us is that the economy can probably withstand higher rates for some time, at least longer than the market fears, and history confirms this. In fact, the only two times that recessions have occurred within three years of each other since World War II were the Volcker rate shock in 1981 and a very mild recession in 1960 after a rapid 200 basis point increase in the discount rate.

**The geopolitical factor is undoubtedly the element that will generate a real surprise.** We feared that geopolitics would return to the forefront of market concerns for 2022. At the heart of the geopolitical developments that are structuring the markets are the confrontation between the United States and China on the one hand and Russia's plans to invade Ukraine on the other. It is the latter that is crystallizing all attention.

**The evolution of geopolitical tensions around Ukraine, after the American authorities asked the families of their diplomats to leave the country, is worrying.** This geopolitical risk is exacerbating the risk aversion movement that has been at work in the markets since the beginning of the year.

Nato countries are strengthening their defense against Russian military activities on Ukraine's borders. The tensions are redoubled by the announcements and concrete actions of the United States and NATO. Apart from the invasions of Kuwait in 1990 or Iraq in 2003, we have no equivalent. At that time, the S&P 500 fell by 16% and recovered its level only 6 months later.

S&P 500 between 1990 and 1992




*Sources : Bloomberg & Richelieu Gestion*

This episode occurred the week the FED made its normalization clear. **Whenever the FED withdraws its stimulus, it can have unintended consequences.** With its unlimited asset purchase program, the FED has left a significant footprint on the US Treasury market. By acquiring U.S. government debt during the pandemic, it became one of the largest owners of Treasury securities. A responsibility for the FED that it never had and one that we believe will force it to be more temperate. In addition, **the market has raised a whole generation that believes that stocks can only go up with quantitative easing and liquidity from the FED. It is good news that the FED is moving towards normality, as it signals that the economy is improving.**


# STRATEGY SYNTHESIS RICHELIEU GROUP

## CONVICTIONS

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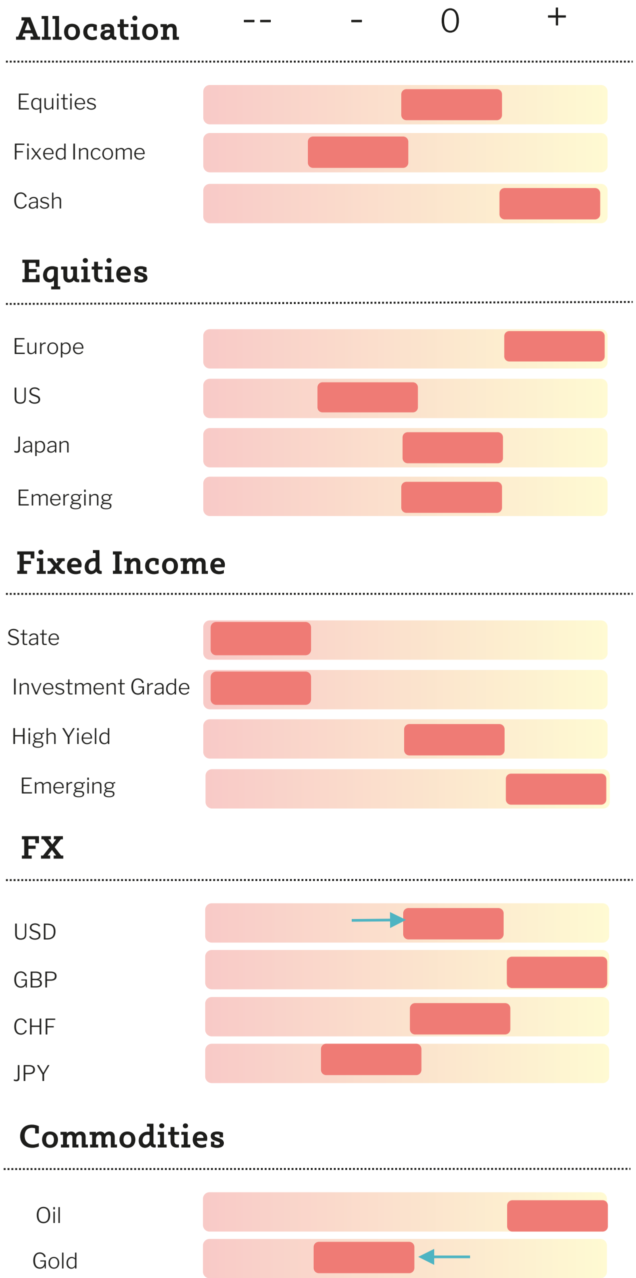
## POSITIONING IN RELATION TO RISK CRITERIA




### PREFERENCES

SECTOR : CONSUMPTION, VALUE

EMERGING ASIA CORPORATE BONDS / BANK SUBORDINATED BONDS

ASIA PACIFIC EQUITIES

## VOLATILITY TO BE EXPLOITED

The integration by investors of a FED that is rushing to raise its key rates continues to fuel the current turbulent phase until the situation shows signs of stabilization. **We expect four rate hikes this year.** Omicron risks further delaying the expected improvement on the employment and supply front. Only then will the return of Americans to the labor market, which we are still waiting for, and the first signs of reduced inflationary pressures provide more room for the central bank to maneuver. In 2018, until Powell signaled the end of QT, real rates rose during this period from 0.5% to 1.1%. Today, the starting level for real rates is much lower, at -0.5%. In other words, **a further increase in real interest rates seems likely. This clearly supports the value rotation. This should be negative for gold and keep additional pressure on the bond segment**. Issuance remains ample at the beginning of the year and a rise in risk premiums should continue. Duration will have to be limited on dollar strategies given the risk of higher rates and higher yields. In the euro, duration may be slightly higher due to a monetary policy favorable to financing conditions. **Overall, we maintain a negative bias on this segment, even if opportunities appear**. On the dollar, our negative bias with a target of 1.15 suffers from the more hawkish tone than expected but, above all, from the Ukrainian situation, which largely weakens the euro. **We are cutting this bias in the short term while waiting for the ECB meeting and a lull in geopolitical tensions (neutral position on the dollar with the same target of 1.15 at the end of 2022).**

**From an overall equity market perspective, the pivot suggests further pressure on valuations and we believe that in the near term technology stocks are clearly targeted.**

In the January monthly update, we wrote "*the equity market will be like the last two months of the year: it will be more volatile in this context where each piece of unfavorable health or inflationary information will bring quick and short-lived shocks that will have to be taken advantage of via the liquidity kept in the portfolio*". **However, we believe that the equity market cycle could prove resilient this year.**

We will significantly increase our positive risk budgets on equities, particularly in the US, once real rates stabilize (barring a geopolitical escalation). **In terms of sectors, certain sectors such as luxury goods,** which combine consumer spending, pricing power and profitability, **are once again becoming attractive** given the downturn. **Emerging markets seem to be the most isolated**, as valuations have already fallen and the monetary policy cycle in China is becoming more favorable. Initial signs of easing in the POBC and the Chinese government's willingness to generate growth through consumption support our belief in the Asian zone in terms of equities and bonds, which now offer attractive yields (negative on Latin America and Russia, which is too politically complicated).

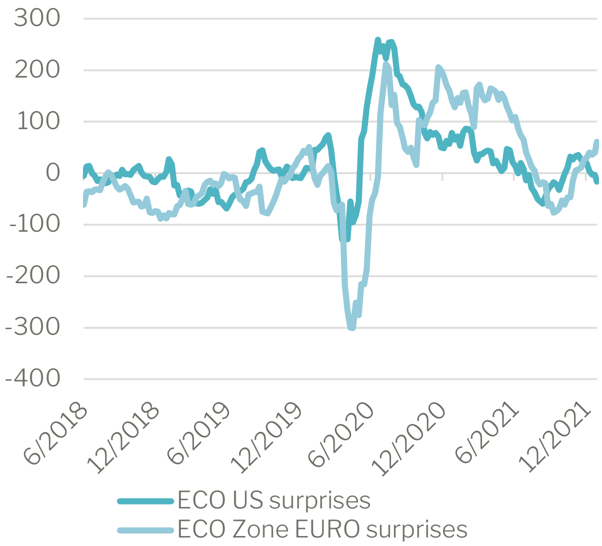

# STRATEGY SYNTHESIS RICHELIEU GROUP
# MACROECONOMIC REVIEW

January 30th 2022

## EUROPE VERSUS US : ADVANTAGE EUROPE

The publication on January 24th of the January PMI indicators in the euro zone once again demonstrated the impact of the health situation on activity. However, the impact is no longer as major as in the past, as economies have adapted particularly well to the restrictive measures; but the very rapid circulation of the Omicron variant is still causing disruptions, particularly in terms of labor, which are further complicating economic activity. **Activity remains resilient and forward-looking indicators are surprisingly positive.** The US is showing more mixed indicators and disappointing releases. Our growth expectations for 2022 remain in favor of Europe, given the failure of Joe Biden's stimulus plan negotiations and the end of many consumer subsidies. European households will also be able to rely on the savings accumulated over the last few quarters. The monetary policy differential should allow Europe to outperform without any escalation in Ukraine. **We are now overweight on European equities at the expense of U.S. equities** to reflect the ongoing rotation toward more cyclical, financial and value stocks that are more present in the Eurozone indices.

Economic surprise indicator

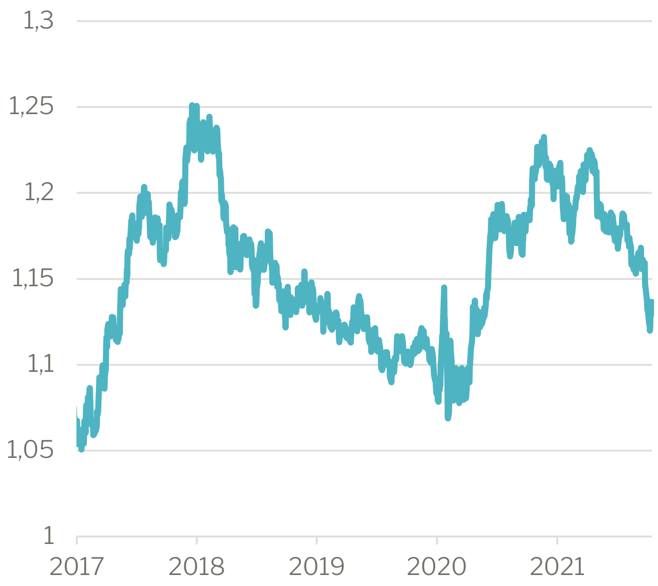



*Sources : Bloomberg & Richelieu Gestion*

*« I guarantee that we, the European Central Bank and the Banque de France, will do what is necessary to ensure that inflation returns to around 2% over time »*
*F. Villeroy de Galhau, Chairman of the BdF*

## UPCOMING INFLATION NUMBERS

EUR VERSUS DOLLAR




*Sources : Bloomberg & Richelieu Gestion*

The sensitivity of central bankers to inflationary risks has indeed increased in recent weeks, including in Europe, as evidenced again yesterday by the speech of the French governor F. Villeroy de Galhau. He reminded us that the ECB is in a position to accelerate the exit from its accommodative monetary policy if high inflation is more persistent than expected. January's figures, the central issue of 2021, will remain a concern. Inflation is the highest it has been in decades. Consumer price indexes have only accelerated, buoyed by volatile items like energy prices but also more structural, making it seem that inflation may not be so transitory. The rise in energy could be a negative surprise with a double effect: more central bank action and an impact on the consumer. The disappearance of some base effects could take the pressure off, but other elements would keep prices higher, such as labor market pressures as well as rents. Timing will be important and we expect a peak at the end of the first quarter.


# STRATEGY SYNTHESIS RICHELIEU GROUP

# MARKET REVIEW

January 30th 2022

## LUXURY : PRICING POWER + CHINA

As we enter 2022, our main message is: another strong year for luxury. We believe that 2022 will be an opportunity for the sector to deliver double-digit growth and see further improvement in EBIT margins. Despite China's common prosperity program focusing on "buy Chinese", the Chinese consumer, has the potential to come back strongly in 2022 after market share losses for almost 2 years. The level of savings remains high, especially in Europe, and strong brand companies have the ability to adjust their prices upwards. Europe is expected to grow very significantly this year. Initial Q4 results continue to show strong demand in the US and a marked recovery in Europe, compensating in the short term for less buoyant Chinese demand. On the innovation side, luxury brands in general (LVMH, Hermès, Moncler, Richemont, Porsche, Ferrari, Prada...) are at the forefront of the Metaverse, as are L'Oréal, Estée Lauder and Beiersdorf. The current decline is a good entry point. The sector is clearly well positioned in the current environment with companies with strong pricing power.

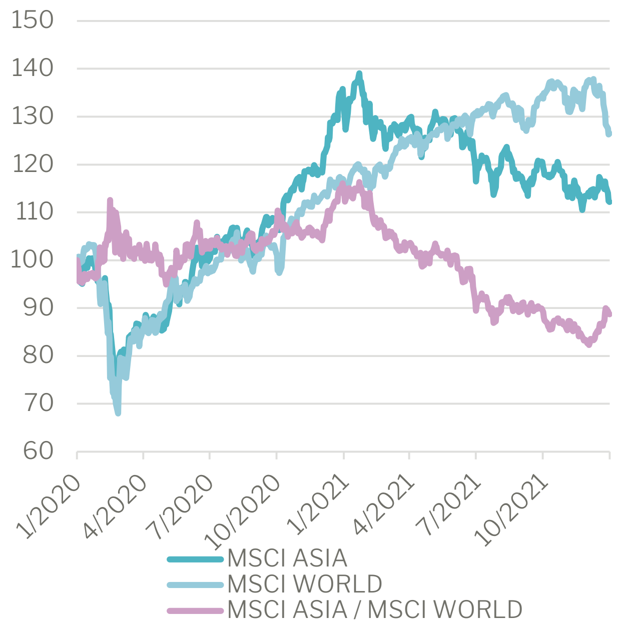
S&P Global Luxury Index ( base 100 1/1/2021)


*Sources : Bloomberg & Richelieu Gestion*

*« The only point of concern for the coming weeks remains the attitude of the Chinese authorities towards Omicron variants »*

## CHINA: THE SHIFT IS ON

MSCI ASIA EX JAPAN VERSUS MSCI WORLD



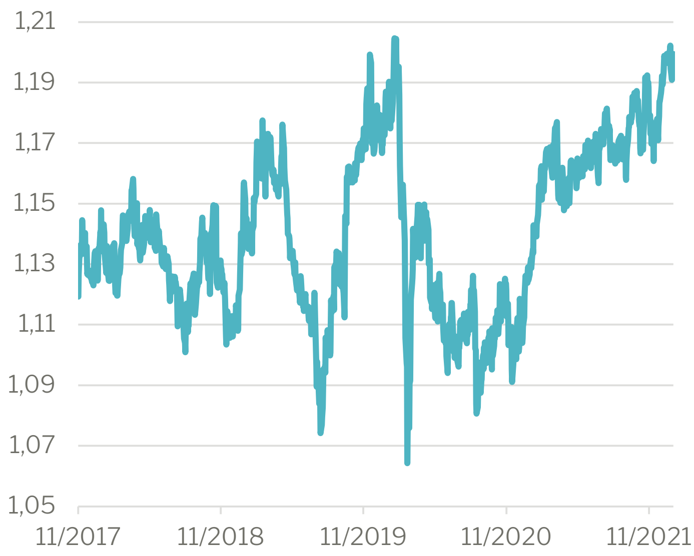

*Sources : Bloomberg & Richelieu Gestion*

**Despite the strong performance in 2021, China's economic growth is faltering.** China continues to send signals in favor of easing, which will provide reassurance on the growth trajectory. Despite the positive surprise of the year-end GDP (published on January 24), the authorities' communication is becoming more and more urgent in order to support an activity that remains fragile. The Omicron variant could further dampen consumption at the beginning of the year. **The new monetary support decided in China by the PoBC is once again adjusting its monetary policy in a more accommodating direction, this time targeting rates relative to the property market.** This goes against the trend of other central banks, the Yuan still does not react and remains at very high levels, which tends to show the credibility of the central bank. This decision shows once again the need to implement measures to support growth while health and real estate risks remain important. The only point of concern for the weeks to come remains the approach of the Chinese authorities towards the Omicron variants and the new confinements faithful to the Zero-Covid policy put in place since the beginning of the crisis.

## GBP VERSUS EURO: AN INFLATIONARY SPIRAL THAT FORCES THE BOE TO ACT

UK economy argues for more monetary tightening. The Central Bank of England has been the canary in the mine of monetary policy tightening by major central banks over the past year. As such, its behavior is widely scrutinized as a leading indicator. **The risk of inflationary spiral through UK wages, and wage growth, is expected to be significant in 2022, settling well above 3% and peaking around 4% in Q4**. Beyond that date, a gradual return to an average of 3% is expected. So there is no uncontrollable inflationary spiral, but these figures are well above the projections in the BoE's November Monetary Policy Report. We expect inflation to remain around 5% through the winter, with a peak around 6% in April. Inflationary pressures are stronger in the U.K. and labor shortages are higher, partly due to the Brexit effect. Economic growth is going to be strong in 2022. Property prices need to be contained to avoid more restrictive wage demands. This supports the case for continued monetary policy tightening this year, particularly at the February meeting, with a risk that tightening will accelerate beyond that. This should continue to support the pound against the euro.

GBP VERSUS EURO

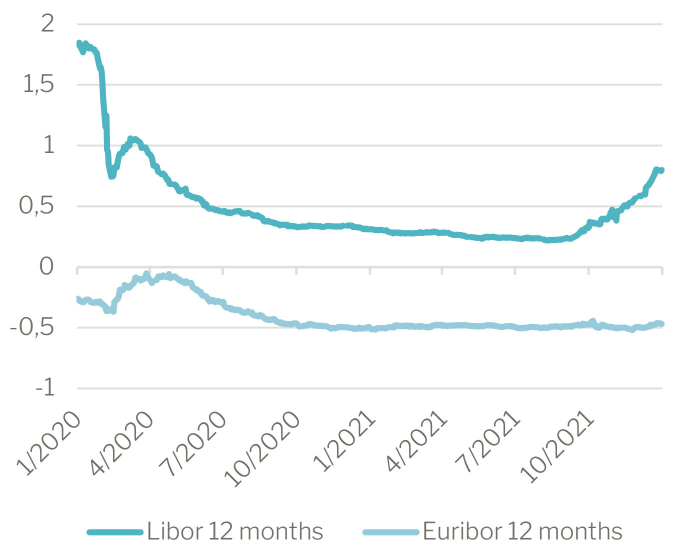



*Sources : Bloomberg & Richelieu Gestion*

*«The ECB will have to be cautious given the economic consequences and will not be as restrictive as expected in its next interventions».*

## USD VERSUS EURO: SHORT-TERM PRESSURE

Libor 12 months (USD) versus Euribor 12 months (Euro)



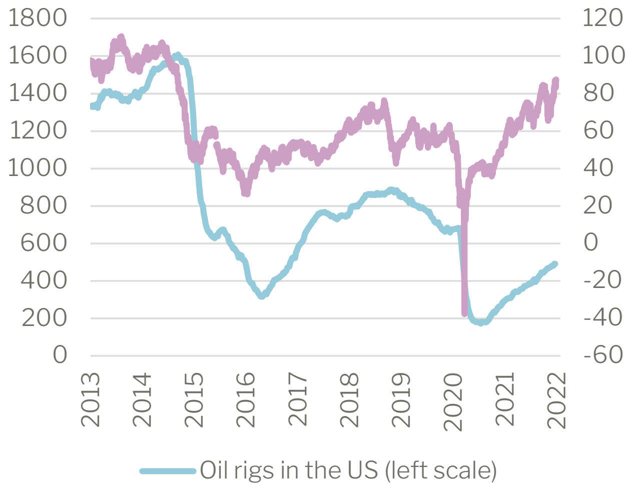

*Sources : Bloomberg & Richelieu Gestion*

**The fear of a stronger pandemic situation in the US had led us to remain negative on the dollar**. After reaching 1.1481 in the middle of the month, **two elements came to contradict our expectations of 1.15 on 2022**. On the one hand, **the situation between Ukraine and Russia** has added a risk premium to the European currency and, on the other hand, **the clearly less conciliatory tone of Jerome Powell on his monetary policy** due to the risk of a price/wage spiral in the United States. **Our 2022 target has not changed, but the current interest rate differential between the Eurozone and the US no longer provides opportunities**. The euro remains extremely sensitive to the geopolitical situation. The ECB will have to be cautious given the economic consequences and will not be as restrictive as expected in its next interventions. This determined tone from the FED benefits the dollar in the short term, while the euro is suffering from the caution of the European Central Bank, which will meet for the first time this year in early February. With deteriorating financial conditions and many uncertainties weighing on the economic recovery, we think a more aggressive message on February 3 is unlikely.

## OIL: UPWARD PRESSURE PERSISTS

With robust oil demand, capital discipline, and negligible non-OPEC projects, **the odds are that spare capacity will reach historic lows by mid-year. This means that commodity prices look better supported, increasing the chances of oil prices reaching USD 100 per barrel.** The geopolitical situation adds a premium to energy commodities. **We believe that high gas prices will persist as will the volatility in oil prices**. The lack of investment in commodities is constraining supply and pushing prices higher. Last year, it was linked to a cyclical phenomenon: demand after the Covid-19 shock grew faster than the capacity of production to restart. For 2022 and 2023, we are in a structural constraint, after eighteen months of underinvestment. Added to this is a final factor, which is the uncertainty about the energy transition that is constraining some projects. We are starting to see an increase in investment in shale oil. But producers no longer want to overinvest to increase production at all costs, as they did in 2016 and 2017.

Oil prices and active oil platforms in the US

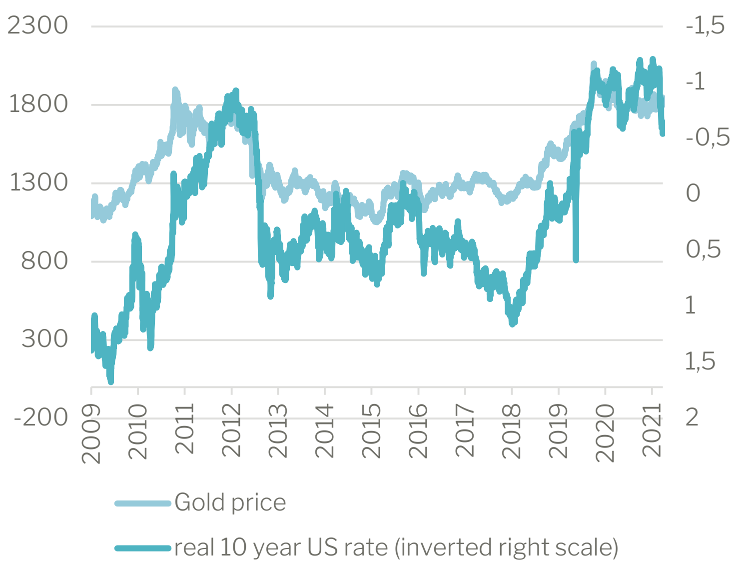



*Sources : Bloomberg & Richelieu Gestion*

*«Producers no longer want to overinvest to increase production at all costs, as they did in 2016 and 2017 ».*

## GOLD: THE ONLY REAL SAFE HAVEN AGAINST GEOPOLITICAL RISKS BUT THE RISE OF REAL RATES WILL BE NEGATIVE

Gold price versus real 10 US rate




*Sources : Bloomberg & Richelieu Gestion*

**Gold is still trading around USD 1,800 despite the strong rebound in the US 10-year real rate and the dollar from their 2021 lows.** This is all the more remarkable since real rates and the dollar are the historical catalysts for performance. Despite the difficult macroeconomic environment, inflows into gold from central banks in particular have remained strong. But why has gold disconnected from its usual explanatory elements? In part, it is due to the dislocations under inflation numbers, rates and currency fluctuations that make gold attractive. **We expect gold to be at USD 1,600 in 2022**. Inflation in the US is unacceptable to the FED, but unfortunately, raising rates may not be enough. While inflation is partly due to domestic factors, it is also due to bottleneck constraints, which means that temporary and lasting factors are combining. Real rates will rise at a lower level than 2013. Our scenario is not one of geopolitical escalation. **In a geopolitically uncertain environment, however, gold remains the safe haven asset by definition in contrast to crypto-currencies which are largely uncorrelated with traditional assets.**



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