
# STRATEGY SYNTHESIS RICHELIEU GROUP MONTHLY REVIEW

Alexandre HEZEZ, Strategist

March 30th 2022

## SUMMARY



*«Russia's invasion of Ukraine could have significant effects on the global economy and the U.S. economy. The magnitude and persistence of these effects remain highly uncertain and depend on events yet to come. » J.Powell*

## THE UKRAINIAN CRISIS SEEN FROM THE UNITED STATES

This month we had the opportunity to attend the 43rd annual Raymond James Institutional Investor Conference in the U.S., where 273 companies from a wide range of industries commented on current trends. And more importantly for the markets, **companies updated their projections to take into account the economic impact on their costs and operations related to the Russia-Ukraine conflict.**

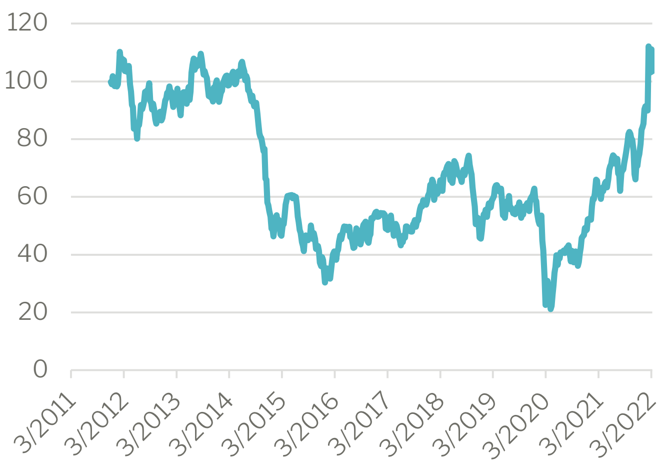
- At first glance, **the consensus is that demand is outpacing supply.** Overall, demand has continued to impress positively since the Omicron peak in mid-January, particularly in "reopening" related sectors such as airlines, restaurants, and lodging, where demand levels appear to have recovered to the highest levels since the pandemic began.

- **Supply chains are going to be tight well into 2022 and probably longer for many sectors**, as most companies reported little to no improvement in supply chain stress. In other words, the point at which supply and demand come into balance keeps getting pushed back in all sectors. It would take a tremendous effort to bring inventories back to trend before 2025.

- **The Russia-Ukraine conflict seems far away from the United States**. We were there a week after the Russian military operation began and there was a lot of discussion about the military operation but the direct implication on the US economy was not. The United States is now in a much better position to withstand oil shocks as it is not only the world's largest oil producer but also has a much less oil consuming economy than in the 1970s.

Unlike in Europe, where social issues and stress are still present, **the questions were more about the increase in raw material prices and their future impact on fundamentals.** The direct economic impact is therefore not at the heart of the matter as in Europe. **Endemic US growth seems robust.** Certainly, Russia is one of the world's largest commodity producers and Ukraine is also a key producer of several commodities, including wheat and neon, which is used in the production of computer chips. In addition to the direct effects of higher global oil and commodity prices, **the invasion and related events are likely to dampen economic activity and further disrupt supply chains.**

WTI price (2nd futures expiration)




*Sources : Bloomberg & Richelieu Gestion*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*"In fact, we are once again headed for further Covid-related supply disruptions from China. It still seems likely that the hoped-for healing on the supply side will come over time as the world settles into a new normal, but the timing and extent of that easing is very uncertain." J.Powell*

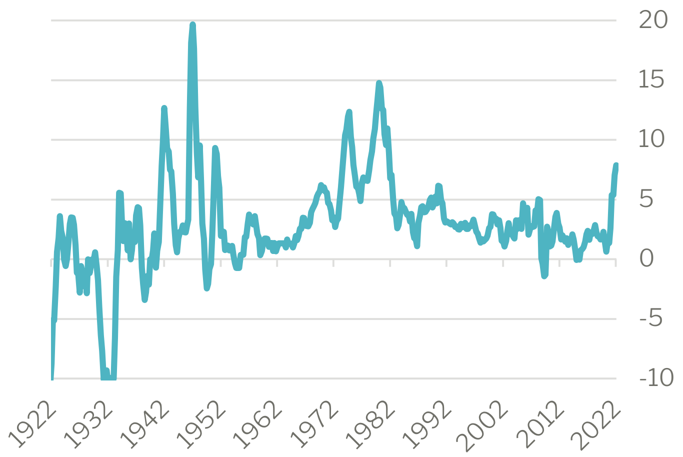
Equity markets have been volatile for a month now, with mostly commodities rising and stocks falling or vice versa. All with high intra-day volatility. While Russia can potentially end the war, the global economic damage will be there as it relates to the sanctions and responses between the U.S., Europe and Russia over the past few weeks.

It seems to us, all things considered, that there are many similarities with 2020 since it is ultimately not the cause (Covid in 2020 or the Russian military operation in 2022) but the actions of governments to counter the latter (containment in 2020, economic sanctions in 2022) that will impact the global economy.

It is unclear how the sanctions will "fade away" from then on. The consequences that seem certain to us, however, are an increase in the complexity of an already stressed supply chain, a drag on overall demand, and a more pronounced negative impact in Europe and emerging markets than in the United States. In short, a net negative effect on global economic activity.

Inflation is on everyone's lips, and in a way it is the only concern. The combination of booming demand for goods and bottlenecks in supply chains has led to a sharp rise in goods prices.

Annual inflation in the United States

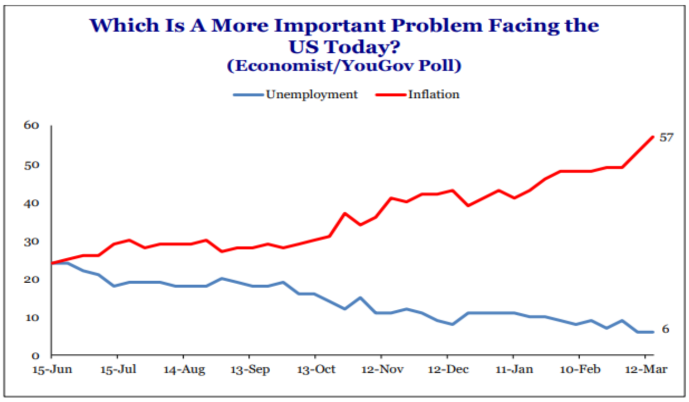



*Sources: Bloomberg & Richelieu Gestion*

We understand why the Fed is determined to fight inflation, which is, as we have been pointing out for many weeks, the priority issue.

Even if consumption remains robust, household confidence is deteriorating month after month. The problem is neither Covid nor the war in Eastern Europe. It is the disastrous consequences of inflation that Americans are concerned about. It is a matter of using all the tools at its disposal in order to counter any risk of a new surge in prices and of inflation expectations becoming unbalanced. However, the FED considers that this will weigh on demand without breaking growth.

Opinion poll in the United States




The words of Jerome Powell in a speech at the NABE* are clear: "Inflation is far too high. We have the tools and we will use them to restore price stability. So the Fed wants to use its tools to moderate demand growth, thereby facilitating continued and sustained increases in employment and wages.

Our discussions with political analysts confirm that inflation will be a key issue in the mid-term election. The latest polls show that Americans are anxious about the issue, despite the fact that savings are still plentiful.

**National Association for Business Economics*

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# STRATEGY SYNTHESIS
# RICHELIEU GROUP
# MONTHLY REVIEW
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*« A record number of people are leaving their jobs each month, usually to take other, higher-paying jobs. And nominal wages are rising at the fastest pace in decades » J.Powell*

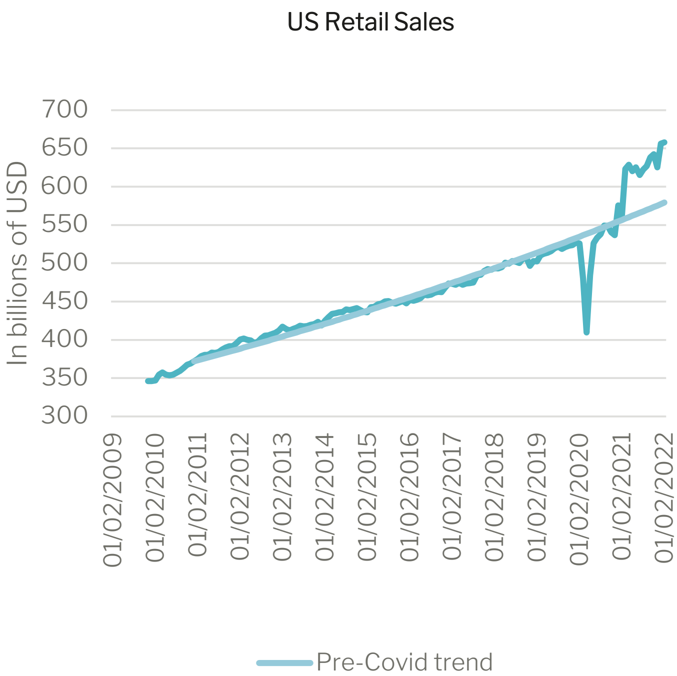
**In microeconomic terms, U.S. companies are generally confident in their ability to pass on input prices to the end consumer.** In 2021, they have clearly demonstrated that they are able to do so. However, there is room for doubt on our part for this year given the faster rise in inflation and the implication of an ongoing price/wage spiral in the US.
In many ways, **the labor market is extremely tight, much tighter than it was before the pandemic**. There are more unfilled job openings today than there were two years ago, although the unemployment rate is higher. In fact, there are a record 1.7 vacancies for every person looking for work.
In some restaurants, we have seen the inability to meet the (high) demand. A restaurant owner could not take any more reservations because of a lack of staff in the dining room, even though the establishment was only ¾ full. The same imbalances were mentioned in some industrial sectors where the salaries offered in transport jobs are largely above the standards to attract candidates. Proof if it were needed that the tensions on employment are really present.

Some major trends are emerging in these sectors:

- **Energy:** In the course of numerous presentations, few players in exploration and production appear ready to increase their volumes unless shareholder or political pressure increases. While the short-term supply and demand environment for crude oil and natural gas is concerning, the longer-term market environment is equally so. Peak oil prices are likely several years away, while long-term oil supply increases remain uncertain.

- **Industry:** Cost pressures will accelerate again. Those with immediate pricing power will benefit. However, those with price/cost mismatches will face a new round of downward revisions to profit estimates due to the recent general commodity boom.

- **Consumption:** The consumer is in a strong position, at least, there is no indication of stress due to rising prices. In many areas, demand has accelerated since the Omicron dropped since mid-January. However, no company can answer the question of how this will change when commodity price inflation intensifies significantly with the war.




*Sources: Bloomberg & Richelieu Gestion*

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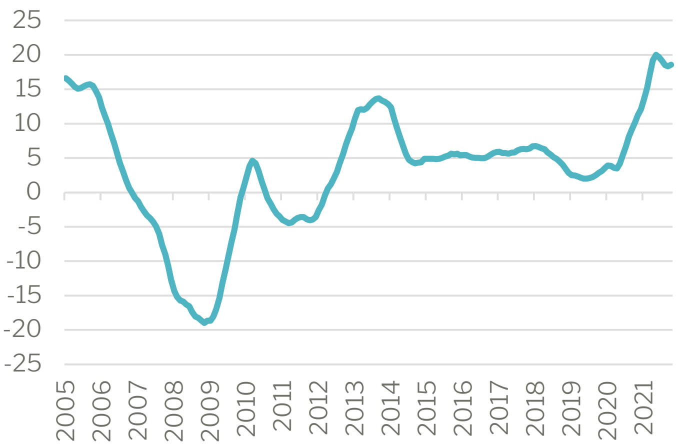
*« The past two years have been extraordinarily difficult for many Americans. Two years ago, more than 20 million people were losing their jobs, millions were getting sick, and their lives were turned upside down. We have made tremendous progress since then. Today, as I said, the labor market is very strong. But, to end where I began, inflation is far too high. We have the tools and we will use them to restore price stability.»*
*J. Powell*

- Financials: Credit is good, loan demand is improving despite less accommodating financial conditions, and rate hikes are expected to drive earnings growth in the sector.
- Technology: Bottlenecks continue to constrain supply as it attempts to meet strong demand.
- Housing: Demand is such that, despite rising mortgage rates, home prices continue to appreciate. This demonstrates once again, the momentum on wages announced in the US to compensate for the deterioration in household purchasing power.

Annual variation of house prices in the United States (Case-shiller)




*Sources: Bloomberg & Richelieu Gestion*

In short, what we can say is that the U.S. economy is entering this period of uncertainty, but in a remarkably strong economic position. The likelihood of a recession in 2022 or even 2023 remains low, unlike in Europe, which has been hit hard by the current geopolitical crisis.

Speech by Jerome Powell

*Restoring Price Stability*
*Chair Pro Tempore Jerome H. Powell*
*At "Policy Options for Sustainable and Inclusive Growth"*
*38th Annual Economic Policy Conference National Association for Business Economics, Washington, D.C*


https://www.youtube.com/watch?v=8-HG8qd5Z8U


# STRATEGY SYNTHESIS RICHELIEU GROUP
## CONVICTIONS

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## POSITIONING IN RELATION TO RISK CRITERIA

| Allocation | -- | - | 0 | + |
|---|---|---|---|---|
| Equities | | | ■ | |
| Fixed Income | | | → | ■ |
| Cash | | ■ | ← | |

| Equities | -- | - | 0 | + |
|---|---|---|---|---|
| Europe | | ■ | | |
| US | | | | ■ |
| Japan | | | ■ | |
| Emerging | | | ■ | |

| Fixed Income | -- | - | 0 | + |
|---|---|---|---|---|
| State | | ■ | | |
| Investment Grade | | | ■ | |
| High Yield | | | → | ■ |
| Emerging | | | | ■ |

| FX | -- | - | 0 | + |
|---|---|---|---|---|
| USD | | | | ■ |
| GBP | | | | ■ |
| CHF | | | ■ | |
| JPY | | | ■ | |

| Commodities | -- | - | 0 | + |
|---|---|---|---|---|
| Oil | | | | ■ |
| Gold | | ■ | | |

### PREFERENCES

SECTOR: CONSUMER, ENERGY, TECHNOLOGY, DEFENSIVE GROWTH

LARGE CAPS

HIGH YIELD EUROPE

## IN SEARCH OF OPPORTUNITIES

We stated last month that, apart from forecasts concerning the geopolitical situation, **the only conviction we have at this stage is that the Western countries will do everything possible to avoid causing a major financial accident in the world, which would legitimize the action of the Russian president in destabilizing the Western world.** For the time being, the equity markets have shown good resilience, even if some geographical areas are showing excessive price variability. **The war in Ukraine is undoubtedly a negative shock for the global economy, especially for Europe, and our GDP forecast for 2022 we decreased our GDP forecast as a result of that.** Inflation problems and supply shocks could have a much larger impact on global GDP growth if they lead to a much more abrupt tightening of monetary policy. This is not our central scenario at this time.

**As for the equity market, we are maintaining our positions with a preference for U.S. companies that benefit from a strong economy.** Earnings growth expectations remain strong, especially for growth stocks. The Fed should skillfully manage the normalization of interest rates without causing a recession.

**The Fed's expected rate hike has been widely anticipated and valuations have already partially corrected for the changes in monetary policy.**

**Europe is in a different situation, as earnings expectations have not yet taken into account the impact on manufacturing activity.** However, from a contrarian perspective**, we believe that the banking sector could outperform** (equities and credit) in the coming months. It was one of the first to be affected by the transparency of bank balance sheets, but rising interest rates should boost their profitability. **In Asia, the Nikkei should benefit from the accommodative attitude of the BOJ, which does not want to see rates rise sharply.**

**The most important movements have been in interest rates, the various interventions of central bankers and the fear of inflation.** This time we have a contrarian attitude, especially on high yield credits. We had detected some opportunities last month, and the downgrades in spreads now bring a positive view on the segment. **The markets are anticipating a large part of the rate hikes and the valuation of credit bonds gives a large cushion to digest them.** Emerging market bonds retain their diversification power with attractive yields and a good correlation to commodities (in terms of currency).

**In terms of currencies, we remain positive on the currencies of the least accommodative central banks (FED, BOE), but the volatility on currencies will be very high depending on geopolitical elements.** A quick resolution would be beneficial for the Euro.

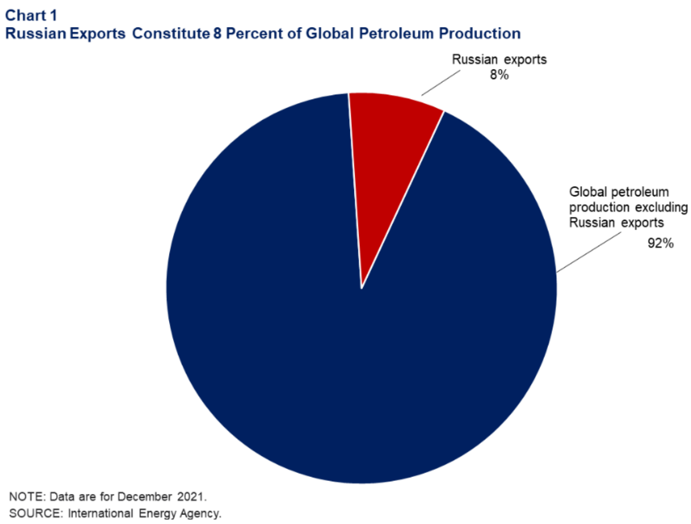
**The geopolitical situation remains uncertain, but there are several sources of resilience:** strong growth dynamics, a large surplus of household savings, solid corporate balance sheets, a monetary policy that is still accommodative and an activist fiscal policy.




## A RECESSION WITHOUT RUSSIAN OIL

**The global economy may not be able to avoid a recession if Russian energy exports do not pick up this year,** according to a study by economists at the *Federal Reserve Bank of Dallas**, and the downturn could be longer than in 1991 (when Saudi Arabia partially mitigated the impact by pledging to increase production). **The refusal of financial institutions to support Russian energy exports is the main fact that puts these exports at risk.** "*This outcome was largely unexpected, as U.S. and European sanctions deliberately excluded Russian energy exports.*"
**Replacing this supply may be difficult, as Saudi Arabia and the United Arab Emirates have indicated they will not provide additional support.** The authors point out that U.S. shale producers are "*constrained by supply chain bottlenecks, labor shortages, and investors' insistence on capital discipline.*"
**Without a supply-side response, it would be demand that would have to be squeezed by excessive prices.**
A rational that demonstrates the complexity of the conflict and the need for short-term compromise.

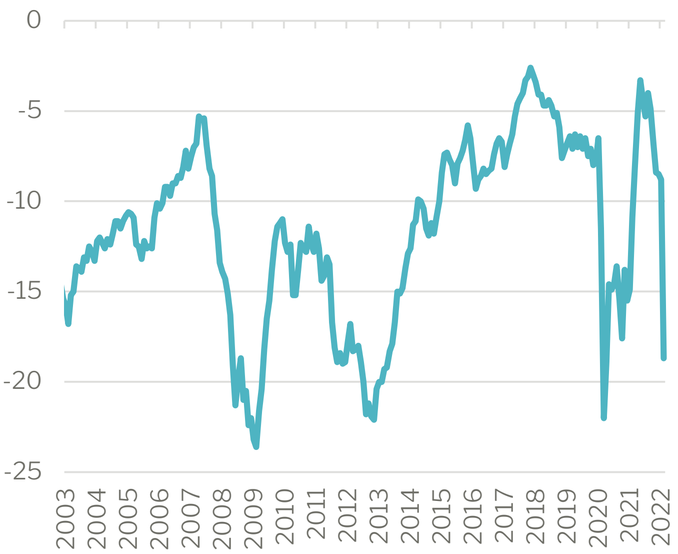
* https://www.dallasfed.org/research/economics/2022/0322




*Sources : Bloomberg & Richelieu Gestion*

*The war in Ukraine affects Eurozone consumer confidence, inflation affects US consumer confidence.*

Consumer confidence in the Eurozone




*Sources : Bloomberg & Richelieu Gestion*

## EUROPEAN CONFIDENCE UNDER PRESSURE

**Consumer confidence statistics in the Eurozone show the impact that the conflict will have in the coming months.** Indeed, strong inflationary pressures and supply difficulties will continue to intensify, reinforcing the current climate of uncertainty.
In this context, governments will continue to provide support to households, which will help cushion some of the additional shock to their purchasing power.
At the European level, the joint response of governments will also be key to limiting the impact of the Ukrainian crisis on growth prospects, and governments continue to debate the implementation of a price ceiling on electricity and gas prices, while seeking alternatives to Russian energy supplies.
**Thus, while we expect activity to contract in Q2 in the Eurozone, a number of factors including fiscal support, post-pandemic recovery and a strong labor market will help maintain positive growth.**
Germany seems to be the most at risk given its economic and geographic proximity to the Russian-Ukrainian conflict.

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# STRATEGY SYNTHESIS RICHELIEU GROUP
# MARKET REVIEW

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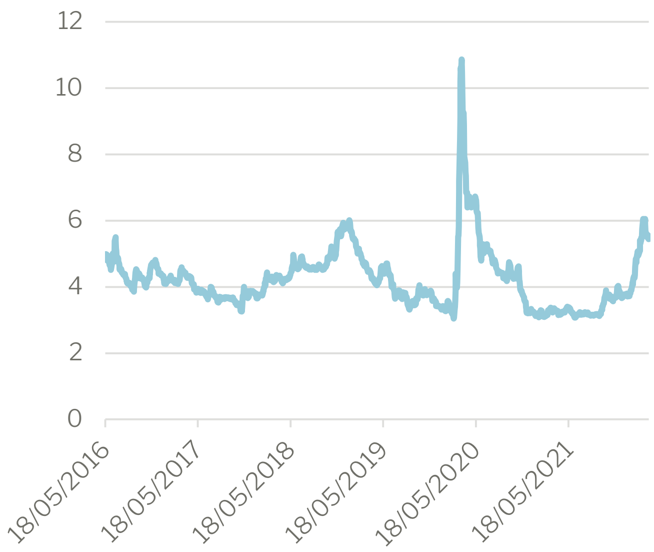
## HIGH YIELD CREDIT: AN ENTRY POINT

**Companies entered the year with strong balance sheets and solid liquidity profiles.** After the Covid liquidity crisis in 2020, issuers have increased maturities, so their refinancing needs over the next two years are generally low, which provides a hedge against a rise in major defaults. **We believe that high yield bonds should be a safe haven for investors as the year progresses.**
The factors favoring high yield should be an economy that remains resilient and above all a lower sensitivity to rising interest rates thanks to the wide spreads.
**We are confident that not only will their level offset the interest rate hikes, but also that these levels will protect us against an unfavorable scenario.**
**We prefer the Eurozone**, which has suffered from geopolitical conditions, because the monetary authorities will act to avoid any significant deterioration in credit distribution. The visibility desired by the FED should allow volatility to decline significantly and participate in this movement.
Within the High Yield market, **we largely prefer the more conservative BB/BB+ segments** with a large portion remaining focused on restoring their ratings.

High Yield euro rate of return




*Sources : Bloomberg & Richelieu Gestion*

*" No one expects making a soft landing to be simple in today's environment - very few things are simple in today's environment" J.Powell*

2 year versus 10 year US


*Sources: Bloomberg & Richelieu Gestion*

## WHAT IS THE LIMIT TO THE RISE IN US RATES?

The fight against inflation is a priority for central banks and in particular the FED, which has shown its willingness to use all the tools in its possession.
**The main objective is to avoid a recession.**
Thinking for a while that inflation would be temporary, the central bank has been very late in its normalization and must accelerate the movement while growth is still achieved.
The next rate hike will be 50 bps. **We expect Fed rates to be 2.25% by year end.** We expect almost all rate hikes to occur in 2022 and early 2023. We expect core CPI inflation to fall to 3.9% by the end of 2022, when the surge in goods inflation caused by supply shortages and rising commodity prices subsides.
**Inflation expectations should eventually become anchored.** Long-term 10-year rates should stabilize around 2.60%. Volatility over the next few months is likely to remain high given the markets' fears about inflation and the consequences of the conflict in Ukraine.
**The inversion of the 2-10 curve for Treasuries will not be a good leading indicator of recession but an indication of central bank credibility.**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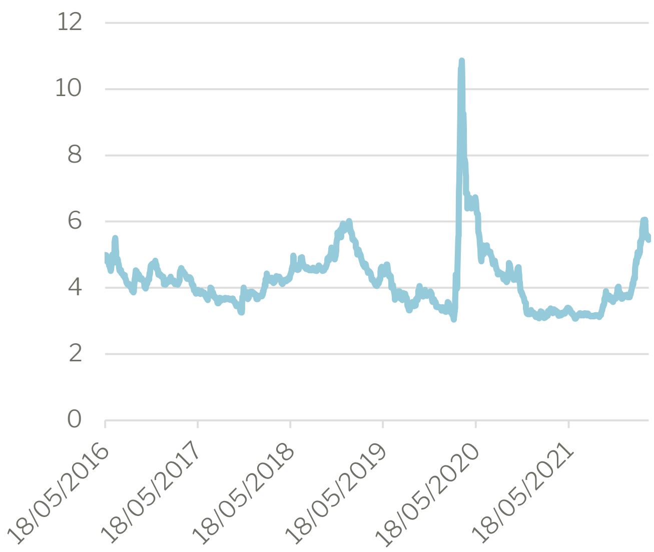
## JAPAN: A MONETARY POLICY AT THE OPPOSITE END OF THE SPECTRUM

**The Bank of Japan underscored its firm commitment to ultra-accommodative monetary policy** on March 28 by offering for the first time to purchase an unlimited amount of bonds for three consecutive days (total amount $4.8 billion).
The central bank said the three-day bond purchase was to implement its zero yield policy and that it could change the timing and amounts depending on market reaction.
Even in the current environment, with significant strains on global production chains and energy prices, the inflation rate remains far from the central bank's 2% target.
**Annual inflation is 1.3% and core inflation is -0.4%.**
This unlimited accommodative policy that has pushed the Yen vs. USD to its lowest level since August 2015 should support the Nikkei index. Moreover, any increase in policy rates would have a much greater impact on the country's public finances than in Europe or the US, given Japan's debt burden. A case that makes us think about the action to be taken in the EURO zone, where certain countries such as Italy, Greece or Portugal will prevent any uncontrolled rise in rates.

YEN versus EUR




*Sources: Bloomberg & Richelieu Gestion*

*" The rise in commodity prices should improve the budget balance of many Middle Eastern and LATAM countries."*

## EMERGING DEBT: COMMODITY OPPORTUNITIES

J.P. Morgan Emerging Market Currency Index (EMCI) Live Spot


*Sources : Bloomberg & Richelieu Gestion*

**Emerging countries have faced a number of adverse factors.**
Inflation is high and rising. China's economy is decelerating as the country's zero-covid-19 policy takes effect.
Central banks, both in emerging markets and globally, are adopting less accommodative policies. However, central banks have been far ahead in normalizing interest rates. Risk premiums remain high. **Russia's invasion of Ukraine has caused a significant sell-off beyond the countries concerned.**
**Certain zones are to be favored.** Eastern Europe is under pressure and continues to be in an uncertain dynamic. Asia benefits from the high quality of its issuers, but risk premiums are low compared to Western countries. China's real rate level provides good insurance against a slowdown and a more accommodative CBOP.
LATAM and the Middle East should take advantage of rising commodity prices to improve their fiscal balances and see their currencies rise.
**We believe that emerging markets debt remain a good diversification for 2022 given the expected volatility in core rates.**

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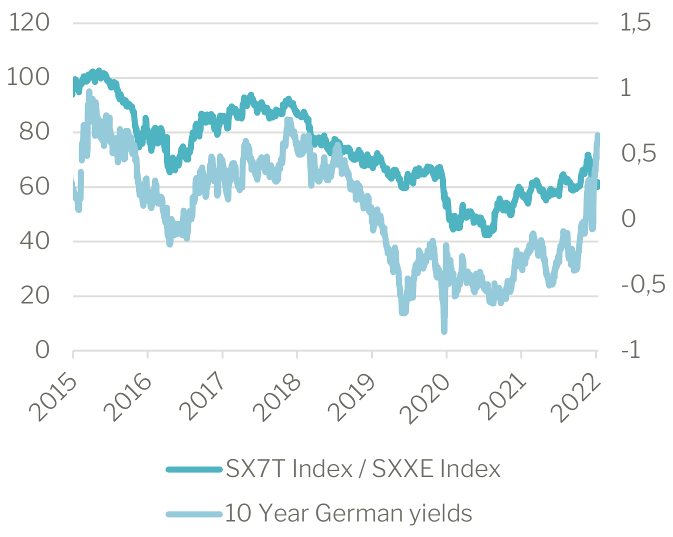
## BANKS: TRANSPARENCY SHOULD BE WORTH IT

2022 was supposed to mark the beginning of a new era for European banks: that of the first rate hikes with fruitful revenue prospects.
This was before Russia's invasion of Ukraine.
Indeed, the conflict in Ukraine may have broad implications for European banks, including higher loan loss provisions, trading losses and a delayed rate hike cycle. Shareholders will be affected in 2022, especially if European banks affected by the Ukraine crisis decide to reduce and stop their dividend payments.
At this stage and in the absence of information on the duration of the war as well as its final magnitude, it is difficult to estimate the full impact.
However, the main European banks exposed to Russia, Ukraine and Belarus are issuing press releases to inform investors of their exposures and are being very transparent. Direct exposures are low overall for the banking sector, but are highly concentrated in a few banks, notably Raiffeisen Bank International. We believe that the implications are already anticipated by the market given the underperformance of the sector. Their capital base is more than sufficient to handle the situation. If the conflict is resolved, the sector will be one of the main beneficiaries.

Relative performance banks versus interest rates

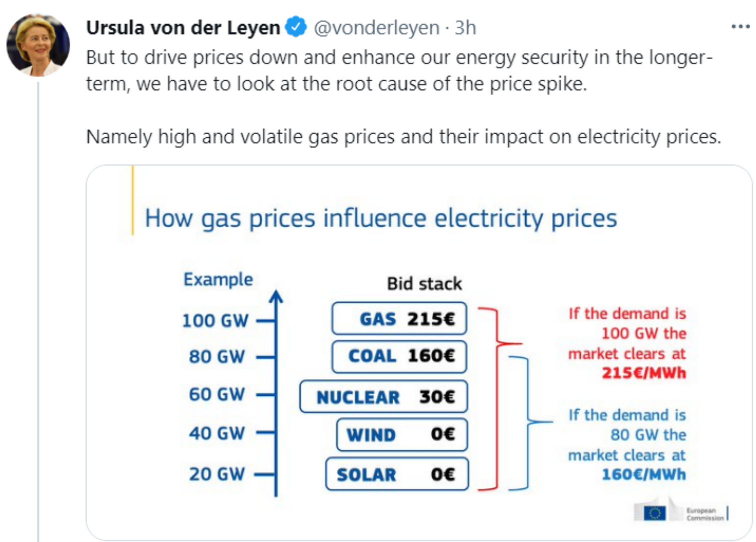



*Sources : Bloomberg & Richelieu Gestion*

*« Energy independence is the number one strategic priority. It will take a long time »*

## EUROPE: ENERGY TRANSITION IN ALL ITS FORMS ACCELERATES

Ursula von der Leyen's tweet




*Sources : Bloomberg & Richelieu Gestion*

The Russia-Ukraine war is one of those events in history that will reshape geopolitics, societies and markets, especially for Europe.
Energy independence is the number one strategic priority. It will take a long time - we think longer than most people expect - and it will require significant investment in gas infrastructure, low-carbon energy sources and carbon capture.
We believe that gas prices in Europe will remain high. The energy transition is the catalyst for Europe's goal of energy independence.
We expect more investment in what were already growth industries. This is not without its challenges, but it means more growth in renewables, hydrogen, electricity and gas infrastructure, nuclear, biofuels, electric vehicles and energy efficiency.
All companies related to the latter are to be favored in Europe and concern many industrial sectors that should allow to optimize energy consumption in the coming years.
Relocation and security of supply are necessary to be more independent. Europe wants to bring back key industries to Europe. This means capital expenditure.



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