LIQUIDITY WILL CONTINUE TO RISE

Nicolas Leprince, Fund Manager of Edmond de Rothschild Fund Bond Allocation, delivers his analysis on the bond market, for which monetary policy is key, and gives its views on the most attractive geographic areas and segments currently.

NICOLAS LEPRINCE
Fund manager
Edmond de Rothschild Fund Bond Allocation

WHAT IS THE OUTLOOK FOR THE BOND MARKET IN THE SECOND HALF OF THE YEAR?

The bond market is caught between a cyclical deceleration in growth and spike in inflation. On the one hand, the lower momentum in Chinese growth since the end of 2020 on the back of tighter monetary and fiscal policy and exacerbated by the sudden lockdowns during this summer is spreading to world growth figures. On the other hand, inflation spikes in most developed and emerging countries are pressurizing real income for consumers. These effects will continue to be felt until the end of this year. This leaves us however with decent nominal and real growth numbers on an absolute basis but not accelerating anymore. To complexify the picture, bond investors are waiting for the main central banks to draw their plan for 2022 and their expected removal of extraordinary accommodation.

HOW DO YOU ASSESS THE RECENT ANNOUNCEMENTS OF FED AND ECB?

Fed and ECB will be very cautious in removing accommodation. Both of them are judging the evolution of inflation as mostly transitory and do not believe in a sustained path upward when looking at their projections for 2022 at 2.2% for the Fed and 1.7% for the ECB. The ECB in particular has been quite dismissive of inflation as they attribute the current increase to factors coming from the reopening of the economies (supply bottlenecks issues or specific services inflation) for which the prolonged effects to inflation is uncertain. We think that this position will be challenged by bond investors in the coming months. In addition, they both are data dependent and will wait for actual numbers in employment and inflation to reach their goals or even overshoot before raising their key interest rates. That is still years down the road for the ECB and not until the end of 2022 at the earliest for the Fed.

Edmond de Rothschild Fund Bond Allocation is a sub fund of the Luxembourg-regulated SICAV which is approved by the CSSF and approved for marketing in France, Luxembourg, Switzerland, Austria, Germany, Spain and Italy.

WHAT ARE THE MOST FEARED UNKNOWNS?

How will investors react to a reduction in global liquidity? One way to look at it in 2022 is on an absolute basis. Tapering in the US and some reduction of accommodation in the Eurozone will not see global liquidity shrink and on the contrary, it will continue to rise and this is in line with central banks focusing much on the “stock effect” and “reinvestment policies” compared to the “flow effect” of new additional purchases. However, investors since the Great Financial

Crisis have a tendency to focus on the "flow effect" and its trend. This trend (or second derivative) will be negative next year. What could help the investor sentiment is still the "central banks' put" where every investors rightfully believe that central banks will step in during an adverse environment.

WHAT IS THE CHINA'S CURRENT ROLE IN THE BOND MARKET?

Its role has been increasing since its inclusion in global fixed income indices. Chinese bonds now make up for 7% of global aggregate indices and 6% of global treasury indices. First the carry of these bonds is still very appealing compared to developed markets with real yields still positive where US and Eurozone are currently standing between -1% to -2% respectively. Second, Chinese monetary policies are somewhat contra cyclical to the rest of the world giving a good decorrelation advantage in a global bond portfolio. These factors result in very positive bond inflows from international investors starving for positive yields and stable macro environment.

CAN INFLATION-LINKED BONDS HAVE GROWTH PROSPECTS?

One important aim, especially for the ECB is to maintain favorable financing conditions. Real interest rates have reacted by going lower and lower reaching -2% on the 10 year point in the Eurozone and -1% in the US currently. We expect these real yields to stay low in the coming future but do not expect a significant performance from these positions. Breaking down real yields into two components: nominal yields and inflation breakeven, we are still positive on the latter in the Eurozone and remain exposed. The ECB has been revising upwards their inflation forecast for 2022 and 2023 recently but we feel it still has room to go higher in the coming quarters. Supply disruptions issues leading to higher input prices are forcing corporates to increase prices to the consumer and most companies are able to do that given the current high demand on the consumer side. From a valuation perspective, breakeven in the US have found their way back to 2010-2012 levels but this is not similar in the Eurozone where we are still 0.20% below the same period average.

IS IT BETTER TO PREFER THE GOVERNMENT OR CORPORATE SEGMENT?

Experience tells us that what central banks are doing matter. In the Eurozone, investors focused on "investment grade" (IG) positions have a choice between government bonds or corporate bonds. As the ECB is using the corporate purchases as a transmission of the monetary policy, this puts "IG" credit in a position very resilient to any widening of the spreads. Yields in the "IG" credit space are still offering 85 bps above government bonds for similar maturity and still positive but low yield. Risks to this preference for "IG" credit over government could be a recessionary environment or abrupt change in central banks direction, which is not our base case in the next 18 months.

WHAT ARE THE MOST ATTRACTIVE GEOGRAPHIC AREAS AND SEGMENTS FOR THE BOND MARKET?

Outside of euro inflation breakeven positions, we find that European credit offer an appealing growth momentum, good fundamentals and balanced prospects between bond issuances and inflows into the market with a credible ECB backstop. Subordinated financials bonds especially still offer an attractive 2.70% yield, which stands 1.0% above similarly rated High Yield bonds. Finally, in this environment where carry is king, we think it is worth taking on higher default risk through selective risk on short-term deeply high yield positions (single B); this would be one of our preferred exposure.

KEY POINTS

Active and flexible allocation across all bond market segments

A broad range of bond classes and strategies for access to varied investment opportunities

A fund which capitalises on Edmond de Rothschild Asset Management's broad expertise in bond management

Active management of modified duration within a [-2;+8] spread

The fund is exposed to credit risk

FUND INFORMATION*

Inception date:
30/12/2004

ISIN Codes:
'A' Share: LU1161527038
'B' Share: LU1161526907
'I' Share: LU1161526816

Maximum management charges:
'A' and 'B' Shares: 0.80% net
'I' Share: 0.40% net

Variable management fees:
15% of annual performance in excess of the benchmark

Minimum initial subscription:
'A' and 'B' Shares: 1 share
'I' Share: €500,000

Front load charge:
'A' Share : 1% maximum
'B' Share : 3% maximum
'I' Share : None

Redemption charges: None

Income attribution:
'A' and 'I' Shares: Capitalisation
'B' Share: Distribution

Benchmark: 50% of the Barclays Capital Euro Aggregate Corporate Total Return index and 50% of the Barclays Capital Euro Aggregate Treasury Total Return index

Recommended investment horizon: > 3 years

* Shares described herein are the main euro-denominated shares. The fund also has shares in USD, GBP, CHF. Please ask you sales contact for any further information.

REPRESENTATIVE AND PAYING AGENT IN SWITZERLAND
EDMOND DE ROTHSCHILD (SUISSE) S.A.
Rue de Hesse 18 / 1204 Geneva

www.edmond-de-rothschild.com