CBH | Asset Management

Quarterly Insight

Outlook 2022

Creativity within Excellence

Composition abstraite - Félix AUBLET
1961 - Huile sur toile

Index

Asset Allocation

		Neutral	Underweight		Overweight	Change
CASH	**$** **€**	**5%**		**13%** **15%**		
Cash	$	5%			13%	3%
Cash	€				15%	-2%
CORE BONDS	**$** **€**	**50%**		**23%** **23%**		
Government 1-5Y	$	15%	0%			-5%
	€		0%			
Government 5-10Y	$	10%	5%			
	€		5%			
Investment Grade 1-5Y	$	15%		15%		
	€			15%		
Investment Grade 5-10Y	$	10%	3%			
	€		3%			
SATELLITE BONDS		**0%**		**13%**		
High Yield 1 - 5 years					4%	
EM Hard currency					4%	
EM Local currency				0%		
Senior loans					3%	3%
Convertible					2%	
EQUITIES		**40%**		**40%**		
North America		17%		17%		
Europe		8%		8%		
Asia Pacific & Japan		4%	3%			
China		2%			3%	-1%
Emerging Markets		3%		3%		
Global		6%		6%		
OTHERS		**5%**		**11%**		
Gold		2%			3%	
Other investments		3%			8%	

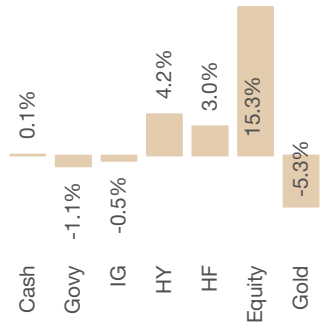
Asset Commentary

The last leg of the global economic recovery is underway and we see the gathering clouds on the covid front as more likely to moderate temporarily rather than altogether cancel the strong upswing momentum in global demand that is currently in full swing. As signals for higher policy rates from the Fed grow brighter, we reduce our allocation to short dated treasuries further. Similarly, we raise the weight of senior loans to gain further exposure to high credit spread/low duration assets. In same vein, we retain our overweight in High Yield within the Fixed Income Asset class. We trim our Chinese equities exposure slightly amid the current uncertainties but remain overweight, in line with our long term view. Our cash position rises as a result with the aim to seize opportunities should volatility rise in the short term.

Economic background

This year was marked from a full blown recovery after the economic winter of 2020. Inflation was the accompanying phenomenon with broken supply chains resulting in scarcity effects in a number of key components, notably microchips. As we go to print, uncertainties rise on the potential impact of the omicron covid variant. Key jurisdictions are seemingly keeping a cool head at this stage. However, should restrictions be implemented, these would likely have less of an economic impact than previously and merely represent a delay in the return to more normal conditions.

Market performances (in %)



The Fed is certainly projecting itself past this this risk and its potential impact. In December, the Central pivoted towards a less accommodative monetary policy, accelerating the tapering of its treasury purchases. The Bank of England followed through by raising rates whilst the ECB keeps its guns cool in support of the European economic recovery. China on the other hand will likely have to start stimulating its economy more aggressively to counter the effects of the unfolding property crisis.

Cash

It will take a few more quarters for the Fed to start raising rates but money market conditions should be more interesting in the dollar market from the second half of next year. In euros, we expect current conditions to continue for longer.

Fixed Income

Reduced treasury purchases from the Fed, the prospect of rising interest rates and treasury supply are likely to weigh negatively on the US yield curve with high duration bonds looking particularly vulnerable. We thus continue to favor credit over duration in bonds, as companies will continue to benefit from the rise in overall global demand. This is reflected in our overweight positioning on High Yield as well as the increase in our senior loan allocation. Selectively and for investors with the right risk profile, subordinated debt should continue to deliver.
Emerging debt is poised to perform better, after a checkered year marked by the Chinese property crisis and the overall impact of rising government bond yields. Within this segment, the China high yield segment presents an attractive proposition, which naturally comes with high risks.

Equities

This has been another year of strong performance for the asset class in the US and Europe under the combined forces of the reflation trade and rising tech valuations. We see additional potential for further performance amid current inflation conditions and the positive effect of rising policy rates in certain sectors. Chinese equities have been buffeted by the heavy handed government intervention in tech and the onset of a significant property crisis. The prospects for recovery in valuations are real but all the necessary parameters - including a firm government support for its economy are not fully present yet in our view. Lastly, in Europe we tend to favour the small and mid-cap segment over the large caps for the next phase of the recovery.

Others

Gold has seen some of its shine taken off by the economic recovery and the stronger dollar. That said, we see limited downside at current levels and maintain our positioning. We continue to see strong momentum in the private debt and equity segment in the current environment.

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

Macroeconomic Scenario

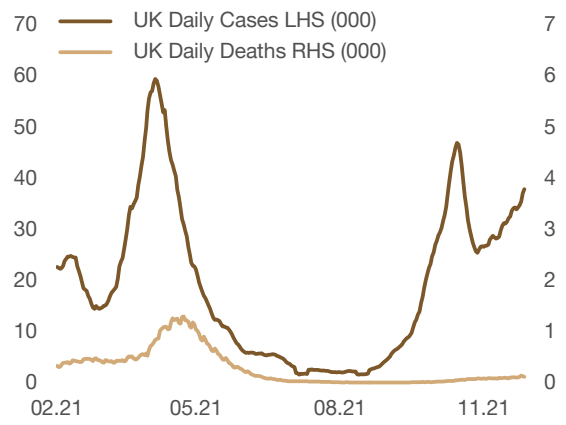
The emergence of the omicron variant is a powerful reminder that the global economic recovery remains dependent on relatively clear sanitary skies. As cases rise globally – of all covid types - concerns are surfacing around a potential return to movement restrictions. However, the situation is markedly different from a year ago with significant proportions of the population having gained immunity to severe covid cases. We thus view any set back on the covid front as delaying rather than cancelling the last phase of the economic recovery. Under our scenario, the global economy should continue to exhibit healthy growth next year – albeit at a smaller pace than what 2021 delivered. The gradual removal of monetary policy support mechanisms, inflation persistence, political as well as geopolitical risks are likely to feature heavily in 2022.

The winter covid season makes a swift return

After a reasonably quiet summer on the covid front, the onset of winter in Europe led to a large increase in cases compounded by the emergence of the highly transmissible omicron variant. This created a renewed climate of prudence with governments and decision makers. Interestingly, the initial measures restricting travel were quickly removed to favor testing, tracing and isolation procedures despite a sharp increase in cases. Recent communications from vaccine manufacturers seem to indicate a reasonable level of efficacy from boosters against the new omicron variant against severe cases. If confirmed – alongside the variant's reported milder effects – this could help mitigate the effects of the new variant on health systems.

In the meantime, the delta variant rages on and could in our view result in restrictive measures in the months ahead, particularly in the jurisdictions where the vaccine and booster take up has been comparatively low.

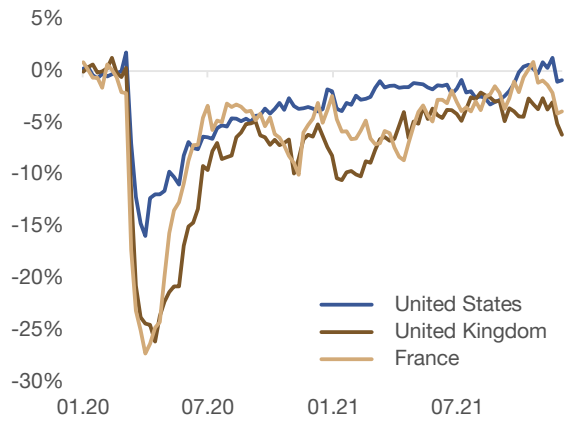
Monitoring the UK for clues



We continue to monitor the situation in the UK where the economy has reopened fully since July and which exhibits a high vaccination rate – 70% of the population is double jabbed with a booster received for 27% of the population. As the chart shows, the nexus between rising cases and rising hospitalizations and deaths has been broken so far. Clearly, the advent of a new variant that can escape the first line of defense will increase contagion and potentially raise concerns over health systems saturation. That said, early studies seem to show that the second lines of defense holds well for vaccinated individuals, which in turn should cushion the overall omicron effect on health systems.

In any event, we believe that governments will be reluctant to re-impose lengthy lockdowns or strict restrictions, the acceptance of which may be limited in a vaccinated population. In addition, as the chart below shows, the economic effects of each lockdown are diminishing as progress has been made at the collective and individual level on contingency plans.

OECD weekly indicators point at a lower impact of lockdowns



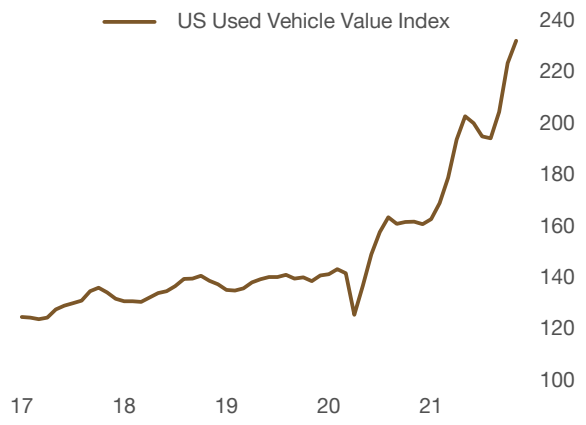
Lastly, the turnaround period for adapting vaccines to variants is less than 4 months, according to the companies involved. This is another indication that potential covid related restrictions are likely to delay rather than cancel the last leg of the economic recovery. The negative effects will thus likely be affecting the usual suspects the most i.e. the air travel, tourism and hospitality sectors.

Reserves of future growth

This past year has been one marked by scarcity effects linked themselves to the breakdown of supply chains that

followed the strict lockdowns of early 2020. Nowhere have these effects been more felt than in the semi-conductor sector. The lack of availability of microchips throughout the year has had profound negative consequences for new car sales. Conversely, the price of used cars skyrocketed, fuelling the rise in inflation.

US used cars prices skyrocket



These scarcity effects have frustrated demand and created reserves for future economic growth for the time when products using such components will be more widely available. Finally, significant sectors with high value add have been operating well below capacity: car manufacturing and civil aerospace spring to mind. The return of global demand towards these sectors should support global growth next year.

Recovery to continue and even out next year

Whereas the US delivered strongly this year with a GDP growth of c5.5%, the Eurozone surprised on the upside, showing a GDP growth yoy of 5.1%. France came out particularly strongly in the recovery whilst Germany lingered, having suffered far less of an economic drag during covid lockdowns.

Barring the emergence of vaccine resistant lethal and contagious variant, we see the following development for the main blocs of the global economy.

World : after this year's recovery at 5.8% GDP growth, we expect the global economy to grow at 4.5% but in a more even fashion as trade flows and scarcity effects get evened out.

United States : the various stimulus packages voted this year will provide additional support to the recovery into 2022. Delays and setbacks on the USD1.75bn Build Back Better Act package are unlikely to derail the momentum gained from previous stimulus programs at this stage. A more hawkish Fed will increase interest rates in the second part of the year with a likely limited impact on full year economic activity. We believe that the US economy will likely beat consensus and grow at 4 to 4.5%.

China : after a year of checkered political intervention and a damaged real estate sector, the Chinese leadership has indicated that it is targeting GDP growth of 5.5% and will use all tools at its disposal to achieve it. We have no reasons to doubt the government's resolve.

Eurozone : the continent managed to turn around a catastrophic start to its vaccination campaign and has delivered a strong economic performance this year. Consensus is marked at 4.2% and we see limited reasons at this stage to argue against that number.

India : the country has recovered strongly after a disastrous Spring on the covid front. The government has a significant stimulus package in place that is coming on top of strong underlying growth. Consensus for the year 2021-22 is at 7.5%.

Emerging markets : away from China and India, economic performances have been generally strong with Latam and South East Asia recovering well. For next year, the picture will likely be more contrasted with Asian countries powering ahead and Latam taking a breather. Caution should be exerted on Turkey where political risk is causing highly volatile currency conditions. Russia also is under surveillance with rising risk of sanctions attached to the currently developing situation in the Ukraine.

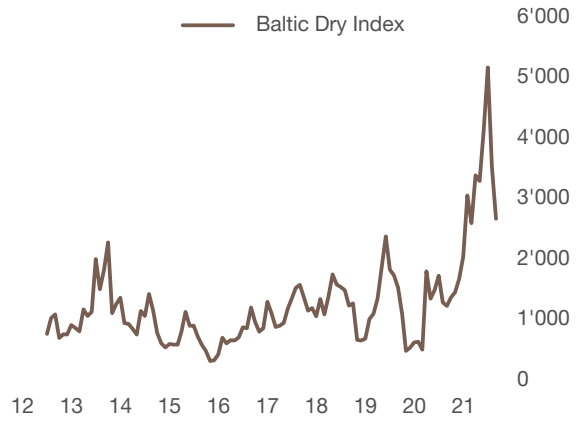
2022: the supply chain reset

As we argued in our previous editions, the more complex the supply chain, the longer the reset and the return to normal pricing conditions. Looking at iron ore prices, the acute scarcity conditions that were prevailing at the start to the year have diminished and prices have now retreated closer to their long term average.

Iron ore prices: the summer bubble deflates

Similarly, the container costs are somewhat retreating from the peaks attained three months ago in the run up to the year end. Whilst these remain at elevated levels historically, the recent retracement points at lower levels of stress in global logistics. The trend is roughly the same when looking at the Baltic Dry Index, which measures the cost of carrying dry bulk merchandise.

Dry bulk price declines



The inflation hype should subside

The evolution of these costs feeds directly into the drivers of what has been a truly exceptional inflation vintage. As the availability of chips feeds through production systems and demand patterns get more streamlined, we expect less volatility in input prices and therefore calming effects on inflation at the mid-year point.

Looking at both the PPI (producers) and the CPI (consumers) data in the US, we see levels that developed economies had not experienced since Mr Volcker was Fed governor. Interestingly and to mitigate potential mental anchoring dissonances, the fall in PPI and CPI that we saw in 2020 was also of historical proportions – admittedly more so on the producers front.

We are somewhat skeptical about the Fed and the Bank of England Christmas pivots and what effects this will likely have on the next leg of the recovery and even inflation. As the governor of the Bank of England said himself in November: higher rates are not going to put more gas in pipes. This remains true even after the December rate hike.

We believe that this year's catch up was necessary rather than scary. After the economic winter of 2020 and a difficult start to 2021, a price catch up led by rising demand was foreseeable and healthy to a degree. Even if further tightness continues in global supply chains, deflationary forces will continue to push costs down structurally.

Technology is disseminating through all economic processes, increasing overall efficiency and pushing costs down structurally.

Demographics : the reduction of the dependency ratio globally over the next years will continue to have a deflationary impact.

Globalisation : according to the World Trade Organization, merchandise trade volumes globally will be 4.5% higher than they were right before the Covid lockdowns of 2019-2020. Despite vocal statements about shorter and safer supply chains, globalization and its deflationary forces are still in rude health.

For the best part of the last 40 years, productivity gains have been transferred to companies and their shareholders as countries eliminated the price to salary ratchet mechanisms that were in existence before the 1980s and liberalized their economies. This has in effect cut the correlation between prices and salaries. True, cost pressures are rising in sections of the market where demand increases are causing scarcity effects. That said, the increase is far from being broad based and for many, rising prices are likely to feel like a tax on their purchasing power. This could in turn result in a rise in political risk and government intervention.

Political risk on the rise

Next year will be election heavy with potentially significant consequences on the global economy. We have also highlighted in our previous editions the rise in geopolitical risk between China, Russia and the United States. Tensions have clearly not abated.

April 2022: French presidential election. Whilst the election of a anti EU candidate is a more remote possibility than in 2017, debates will likely rage on until the decider. This could in turn affect negatively French assets, particularly given the relative size of the country's debt after Covid.

May 2022: Philippines general elections. Rodrigo Duterte will have to bow out under the single term constitutional rule. Many candidates, including boxer Manny Pacquiao are running and the election is significant for a country that is rapidly becoming an economic powerhouse in South East Asia.

October 2022: Brazilian presidential and general elections. Pollsters and pundits are likely to pit Jair Bolsonaro against Lula, who is vying for a comeback. Sentiment on Brazil has been negative throughout the year. We see little reasons for this to change until we get closer to the election date. We would add that the uncertainty over a potential exit from Paulo Guedes as the minister of the economy is the more significant negative, regardless of who is in charge at the top.

November 2022: US midterm elections. Since the end of WW2, only two presidents have won their midterm challenge: Bill Clinton in 1998 and George W Bush in 2002. The current administration will most likely lose the Senate and possibly the House. This will in turn hamper the current administration's expansionary agenda and raise risks on the economic outlook for 2023 and beyond. Forced austerity in the current economic recovery phase in the US would indeed be creating an easier path for a Republican to win in 2024.

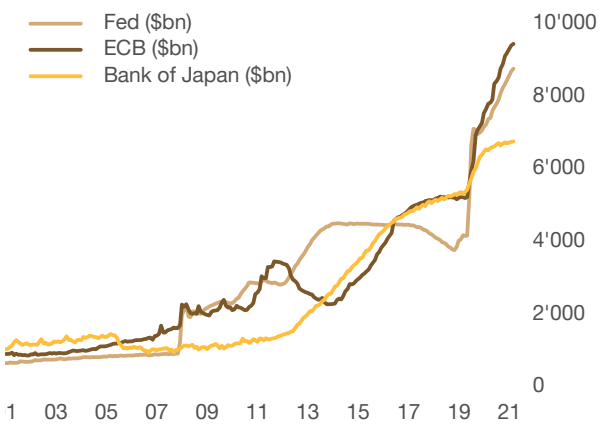
The story of the Fed and the ECB

The Fed has pivoted. In its December meeting the Fed indicated that it would taper its treasury purchases by USD30bn a month with a so called dot plot pointing at

three rate increases next year and another three in 2023 and two in 2024. The double mandate of the US Central Bank has now firmly veered towards containing inflation, which the Fed does not want to see becoming entrenched.

Despite its recent change in tack, we are skeptical that the Fed should tighten its monetary policy with reckless abandon given the phenomenal amount of debt raised at all levels during the Covid lockdowns. Indeed a 25bp increase in the Fed fund rate will have a significantly larger impact on debt service costs at all levels than the equivalent increase from 5 years ago. We thus doubt very much that the US central bank will manage to get significantly beyond 1.75% in the next cycle without having to engineer another pivot – this time December 2018 style.

Central Banks balance sheets – continued expansion



By contrast, the ECB is keeping its guns cool, anticipating inflation to come down to 2% from 2023 onwards. This means that the ECB will likely continue to follow an accommodative monetary policy for some time to come. Christine Lagarde, governor of the ECB has already indicated that the institution would in all likelihood not be raising rates in 2022.

The Chinese puzzle box

This year has been difficult for Chinese assets, buckling under the weight of government intervention in the technology sector and the unfolding of a property crisis. At the time when China is becoming the largest economy in terms of Purchasing Power Parity, the Xi shared prosperity agenda is causing the country to turn inwards. This is not the first time it has happened in China's long history but one cannot help feeling ambivalent about the decisions recently made by the Chinese leadership.

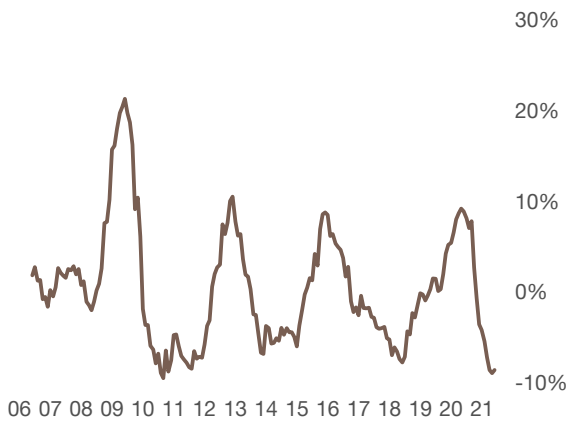
The crackdown on the tech industry: Following Jack Ma's outburst about a year ago, the Chinese leadership went fast and hard at the tech industry by starting regulatory and ant-trust action – partly for security reasons. This attempt to show who's boss was successful in its aim but did destroy a lot of value in the sector. As the sector is ailing, it remains to be seen whether the country continues to be as innovative as before these actions.

The property crisis: The implementation of the three red lines and curtailed funding options in the ABS market for the main property developers precipitated a crisis of significant proportions. The demise of Evergrande, Kaisa, Fantasia and a few other issuers is likely to cause a significant slowdown in the Chinese consumption numbers if left unchecked. Saying that houses are for 'living in, not for speculation' is all fine and well but the sector, at 25% of GDP is too large to be left alone. About 55 million Chinese worked directly and indirectly in the construction industry in 2020. This represents about 7% of the country's labor force. If large enough dismissals start taking place in the way they did after the Great Financial Crisis, we contend that the government will have to intervene in order to mitigate the risk of social unrest - considering also that a significant amount of the Chinese population's wealth sits in real estate.

As one recalls, Japan's pullback of 30 years started with a major property crisis, the impact of which was profound and left initially unchecked by the authorities.

A reluctance to stimulate: The current Chinese leadership has been loath to add stimulus to the economy following the covid lockdowns. As a result of tightening credit conditions, the China credit impulse is now close to a year low. This is somewhat contradictory with the government's stated aim to get GDP growth to 5.5% next year. This in our view is unlikely to be easy to achieve in the absence of meaningful monetary and government stimulus.

The China credit impulse



The Chinese economy seems to be at a crossroad with a leadership caught between contradictory desires: more innovation but more equality, less leverage but economic growth, less dependency on exports but a contracting internal demand. The Trump trade wars had caused the country to turn inward with internal consumption bolstered by rising property prices and affluence. The decline in property prices and the fall in construction activity are now challenging the model. As sporadic covid outbreaks cause

local lockdowns and quarantines, growth will likely be challenged in the months to come.

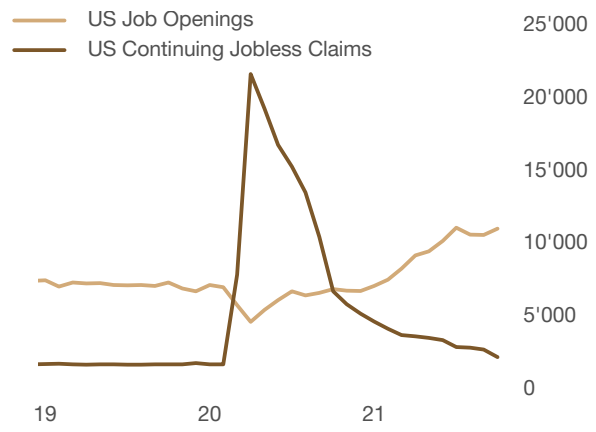
Our view is that China's leadership will have no choice but to support its economy significantly more than it has signaled to date. This is likely to be positive even if the decision.

China property prices changes

This dollar has a lot of strength

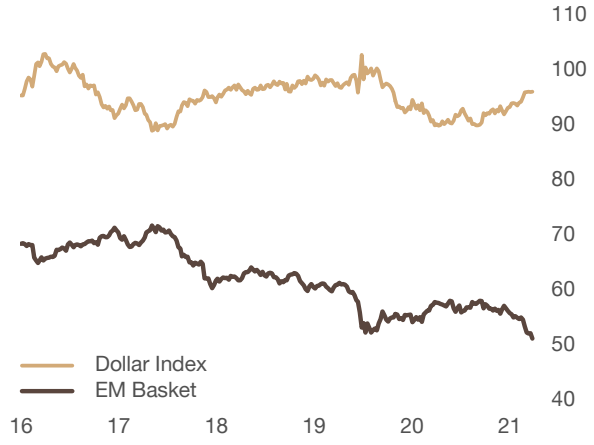
The fast economic recovery of the US as pushed jobless claims close to where they were before the covid lockdowns. An accommodative Central Bank and significant government stimulus engineered a fast pull out from the economic consequences of the pandemic. In the absence of Omicron led restrictions, the Fed will likely start normalizing its monetary policy.

US jobless claims : strong recovery



This will add strength to the dollar, which has been the star currency this year. The policy differential between the US and the rest of the world seem so entrenched that we struggle to see what could dent that trend at least over the short to medium term. This is not good news for all assets that tend to weaken when the dollar is strong: in particular gold and local currency emerging market bonds.

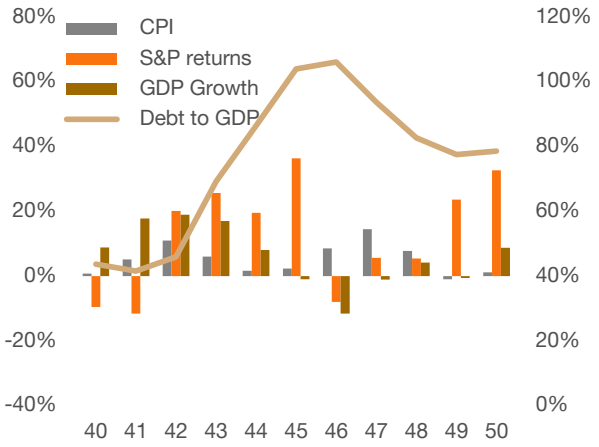
The dollar Index Emerging and Developed currencies



Historical perspective: the US of 1940-50

When searching for historical parallels with the situation that the world is experiencing, the war and post war world springs to mind. Indeed, the covid lockdown have caused the largest sovereign debt increase in peacetime. The first good news is that the human and economic destruction of war have not taken place. The other good news is the restart of moderate inflation is gradually eroding the Covid debt in relation to a fast rising GDP – a situation that we are currently experiencing. The bad news however is that it increases the risk of a policy error that would be veering too quickly towards austerity and financial repression.

The US in the 1940s and 1950s



We have actually seen this in the same period right after WW2. The prevailing thought in the US was that the European economy could rise on its own after the war. However, after two years and rising geopolitical risks at the beginning of the cold war, the US realized that a large stimulus effort would be necessary – the Marshal plan then came to fruition.

Although this was done in a world where the Fed was not independent and was actively targeting long rates to remain low, the similarities with the post covid economic world are uncanny. One cannot help but notice that the winning asset class over the period was equities with the S&P500 rising by 38.3% to 16.8 points.

Our 2022 economic scenario in brief

US GDP growth 3.5%

After this year's strong economic catch up, we expect the combination of rising living costs and less accommodative monetary conditions to cause US GDP growth to revert to trend.

US CPI 3%

This year's 4.6% rise in CPI should remain an exceptional vintage. Further supply chain decongestion should cool off price increases.

US Fed Funds rate 0.50%

The Fed pivot should progress towards a 25bp increase in Fed Funds in the late summer – early autumn period of next year.

US 10-year yield: 2% to 2.25%

After some flattening caused by rising rates anticipation, we expect the yield curve to start steepening again.

China GDP growth 5%

The Chinese leadership has stated targeting a 5.5% GDP growth in 2022. With the current deceleration that followed this autumn's real estate crisis, it will only be achieved with significant stimulus roll out.

Eurozone growth 3.5%

The Eurozone should continue to de-liver on the growth front with significant stimulus still to be rolled out.

Eurozone CPI 2.4%

Interestingly, the Eurozone's CPI increase has been more muted than that of the US as a result of structural differences. This should also be the case next year.

EUR Refinancing Rate 0bp

The ECB is helping the forecast considerably by indicating that in all likelihood, it would not be raising rates in 2022.

German 10-year yield 0%

After years spend in negative territory, we see Bunds rising – albeit in a more muted and de-correlated fashion relative to it US counterpart.

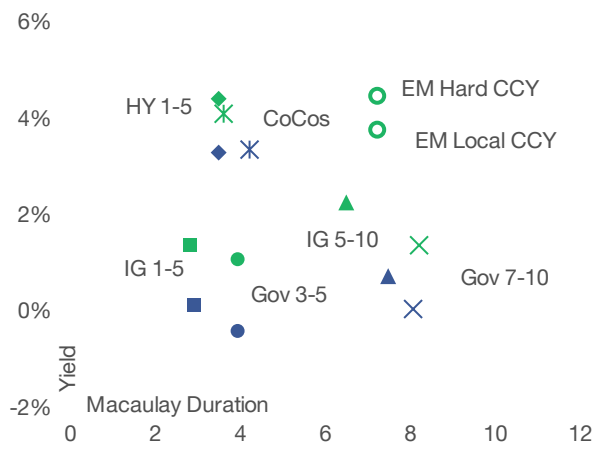
Fixed Income

After a disastrous 2021, the asset class is likely to struggle again in 2022 under the twin pressure of rising policy rates in the US, higher defaults and a less buoyant economic recovery than in the past year. Our expectations for lower inflation numbers in the US should in time help real yields. Protecting returns will be the name of the game by going for instruments with high carry and low duration for moderate credit risk. We thus favour the better quality high yield names, subordinated debt as well as emerging market high yield, particularly in China where implied default risks are exaggerated. We continue to stay away from duration risk as we expect further curve steepening in the US and the Eurozone. Similarly, we stay away from the riskier end of the high yield market, expecting defaults to increase over time.

The Fixed Income value map

We set out below the various sub asset classes of the Fixed Income market showing yield vs duration to maturity. In the case of Additional Tier 1 instruments (Contingent Convertible bonds), we are showing yield and duration to the first call date.

The Fixed Income value map – EUR in blue – USD in green

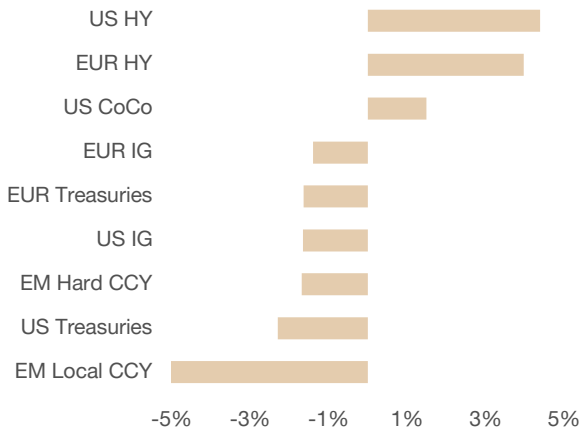


2021 – a year to forget in duration assets

We expected it to be bad but not that bad. As we close in on the year end, 2021 ranks amongst the worst performing year in US govies and US Investment Grade over the past 20 years.

The main driver of underperformance has been the steeper yield curves in the US and in the Eurozone - but to a much lesser degree. The overall carry at the start to the year was insufficient to protect performance against the increase in long dated yields - in line with our view throughout the year.

Fixed Income sub asset class performance



As the performance chart above shows, only sub asset classes that offered decent carry at the start to the year performed with flat credit spreads helping to offset part of the damage to performance inflicted by duration. As we expect more of the same next year, we continue to favor credit over duration.

Sovereign debt and real rates

The rise in inflation this year has had a very negative effect on real returns for the asset class, particularly in the dollar denominated world where inflation conditions were much stronger than in the Eurozone.

This is evidenced in the chart on the next page where real yields were actually better for investors in local currency debt in China and Brazil than they were for bond investors in the US, the UK or the Eurozone.

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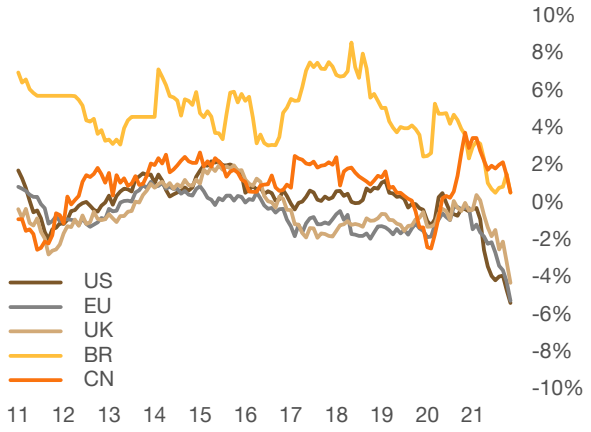
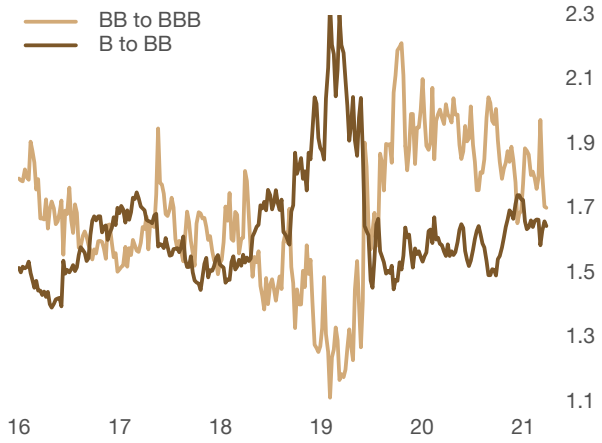
Real Yields current 10y yields – next year's CPI by country



BB multiple to BBBs and Bs – still interesting



The main conclusion is that real yield is to be found in non-investment grade dollar denominated debt, EM dollar debt (China and ex China) and certain local currency debt markets.

Fed tapering removes a significant marginal buyer

The pain for holders of duration in dollar bonds is likely to be continuous in 2022 under our macroeconomic scenario. Expectations for higher policy rates coming faster are likely to continue to flatten the US treasury yield curve at least in the initial stages. At a second stage, we expect the longer end of the yield curve to start backing out. The spring of 2021 was a powerful reminder as to how quickly things can go considering that we went from a 90bp yield on the US 10y treasury to 1.75% in a matter of four months.

With an accelerated reduction in Fed purchases, the overall technical picture looks poor for US treasuries. Amid the economic recovery and despite the funding of the recovery plans, net issuance should decline significantly to reach USD1.7trn equivalent - a 40% yoy decrease. With Fed treasury purchases ending in March of next year, the net US treasuries overflow will be around USD1.5trn against USD1.3trn in 2021. The Fed's role as a marginal buyer of treasuries will thus diminish heralding a period of rising volatility for rates. This in our view should be felt even more acutely after the end of the taper point.

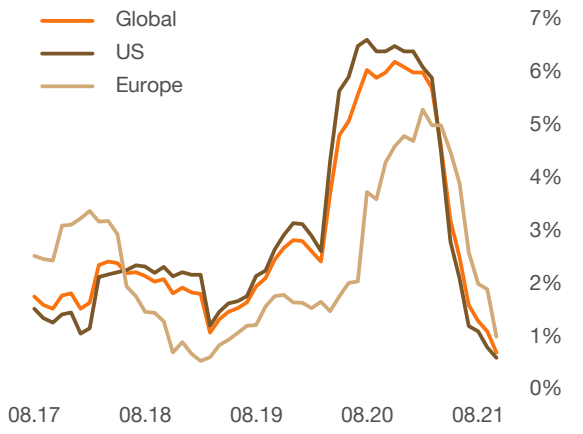
Again, the situation in the Eurozone looks less fraught with a still accommodative central bank and better real yields than in the US.

We continue to favour BBs in credit

Throughout the Covid crisis, we have liked the qualities of BB rated issuers, fallen angels from the crisis that have now improved significantly in terms of their credit fundamentals. This is further evidenced in the chart below with credit spreads closing in on the BBB segment. Selectively, we also like high single B issuers selectively given their premium relative to the BB segment.

When looking at defaults, it clearly feels like the only way is up. The reality of easy monetary conditions and government stimulus has masked the real fundamental position of a lot of companies. To be more precise, we expect defaults in Asia to increase significantly on a dollar basis in the wake of the property crisis currently engulfing the country. The rise should be contained however as we expect the government to intervene in order to stem the tide.

Default rates by jurisdiction



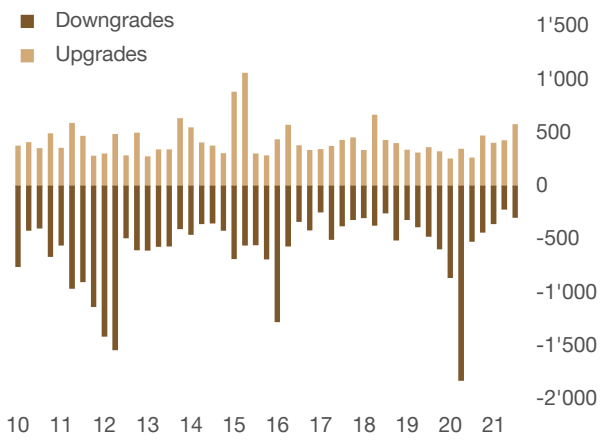
CCC rated companies have been large contributors to the positive performance of the US high yield segment this year given their offered carry. The prospect of rising defaults is likely to cause that rally to stall, which in turn means that credit investors will have to be extremely selective or focus on the better rated part of the high yield segment.

Stars on the rise

Outside of China, where the property crisis rages on, rating agencies have on the whole affirmed or placed positive outlooks on credit ratings or even placed ratings under review for upgrade. This reinforces our positive view

on the BB rated segment, which will continue to benefit from improved fundamentals in the next phase of the economic recovery.

Rating agencies are cooling the guns

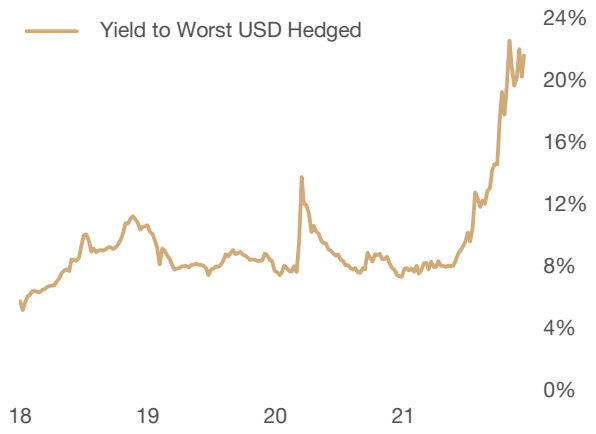


Conversely we expect the lower end of the non-investment grade spectrum to struggle significantly more than it has to date amid tighter monetary conditions. This could lead to a higher downgrade activity from rating agencies at the bottom end of the credit rating spectrum.

China and EM High Yield look poised to perform

The High Yield segment in China has been buffeted by the property crisis that has engulfed the country. With c50% of real estate bonds in indices, yields in the sub asset class have jumped at times to levels close to 25%. As we go to print, the yield on the sub asset class is close to 20%, having experienced wild gyrations over the last few weeks.

China High Yield - too wide

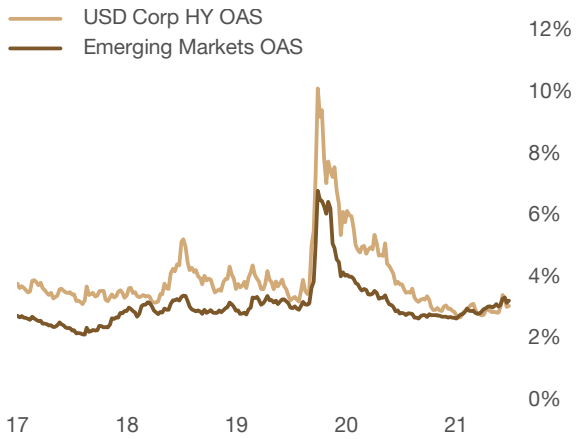


We contend that for investors with the right risk profile, this could be an interesting opportunity. Assuming a 30% recovery rate for creditors, the implied default probability in the index comes out at a thumping 30%. Even considering the average time to maturity of c3 years for the bonds in the index, such an implied default probability seems excessive. For context, default rates in China reached 13% after the great financial crisis, triggering a large government stimulus program.

The reality of default rates tends to be that beyond a certain rate, they become socially and politically unacceptable, triggering a positive government response. This time will unlikely be different.

We also expect Emerging Market debt in hard currency to perform better next year but would stay away from local currency bonds, consistent with our anticipations for a stronger dollar. Credit spreads in EM debt have moved out despite generally improving fundamentals on the back of rising raw material prices. For a better overall credit rating, EM debt offers significantly more generous rewards as the chart below shows.

EM debt in hard currency looks increasingly attractive



China High Yield: clearly the section of the EM spectrum where the risk/reward relationship is the most dislocated. This is an area for investors with high tolerance for risk and volatility.

China Investment Grade: there has been some spillover from the high yield segment into the investment grade part of the Chinese credit spectrum. For illustration, the China investment grade index offers a yield of c3% for a 5y average duration. This compares to a 1.25% yield for a 7.6 year duration for the US equivalent.

Asian issuers ex China: another potential area of interest that should benefit from the global recovery as well as any uptick from the Chinese economy.

Latam: Mexican bonds have had a strong year and we expect this to continue in 2022. We stay away from Brazilian issuers until we get more clarity on the programs from the various election candidates.

Russia: the risk of sanctions is increasing as tension around the Ukraine/Russia border develop. This is getting

increasingly reflected in the main Russian issuer curves but we believe it is too early to jump in.

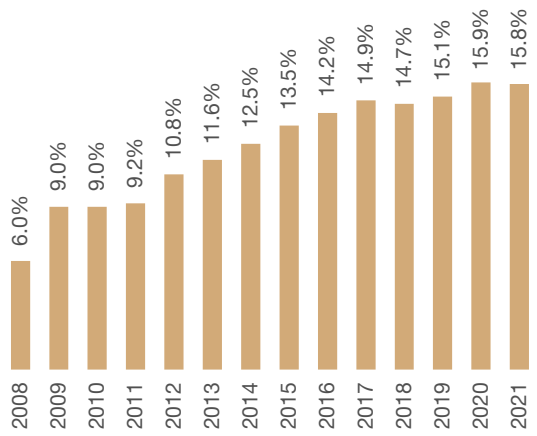
Turkey: the currency has been demolished by the various measures taken by the regime. We believe this is likely to spill over into even strong names, potentially opening interesting entry points.

The continuous appeal of subordinated debt

We have been positive on the sub-asset class for some time and expect it to continue delivering decent carry for bond investors. Bank's capitalization and liquidity ratios continue to improve and the prospect of rising policy rates, mostly in the US, helps the overall picture further.

It is none the less likely that shareholders will increasingly want a greater share of the pie. This does not necessarily mean that regulators, particularly in Europe will likely give in easily and open the dividend and share buyback taps for the sector.

CET1 ratio and non-performing loan ratios – European banks



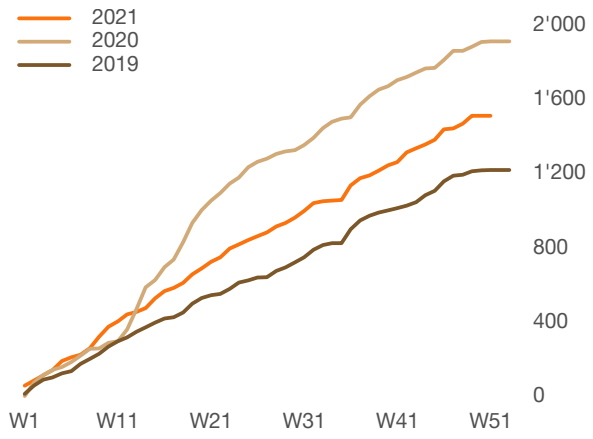
Given the limited supply needs at this stage in the cycle, the additional tier one asset class should continue to be well supported.

Issuance likely to rise in credit

After the bumper year 2020, issuance activity this year was distinctly more muted – particularly in the investment grade segment. First, companies have raised a lot of liquidity to face the consequences of the 2020 covid lockdowns and benefit from the various support mechanisms offered by Central Banks and governments. In addition, rising levels of cash flow generation this year have reduced immediate funding needs.

As the cycle becomes more expansionary, rising capital expenditures and debt funded M&A are likely to cause issuance levels to rise slightly. In addition, we expect issuers to try and use the last window of opportunity to raise funds before Central Banks start raising rates in earnest – at least in the dollar market.

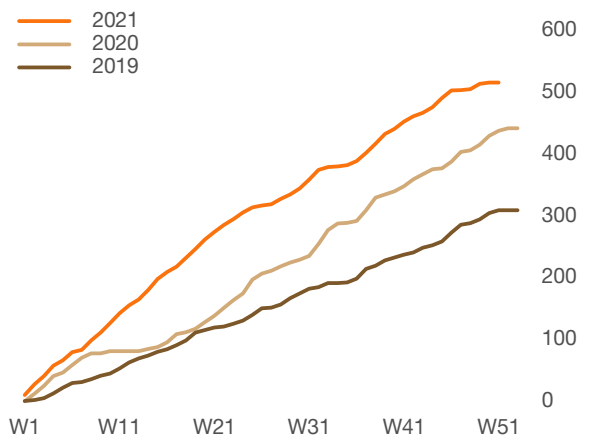
Investment Grade issuance: lagging on 2020



By contrast, issuance in the High Yield sector has been strong. The main factors behind this flurry of activity include the number of large capitalization issuers that have become fallen angels in 2020 as well as the intense re-capitalization activity that took place in the LBO part of the High Yield market.

In our view, next year's issuance activity should be sustained, particularly considering the amount of funds that are being channeled into private equity investment.

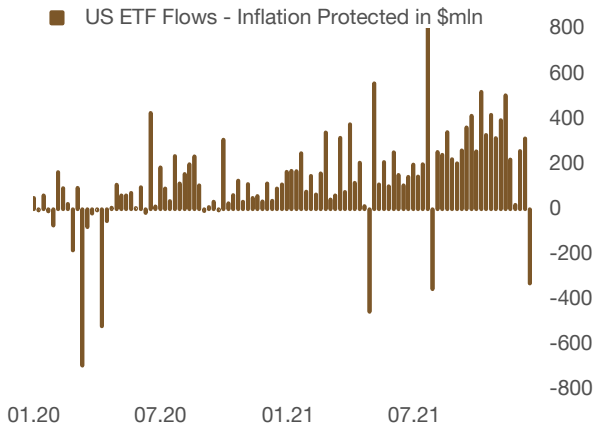
High Yield Issuance : 2021 high volumes



Beware those long TIPs exposures

We have long argued that TIPs are a less than perfect tool to hedge fixed income exposures against inflationary pressures. Typically these bonds tend to have a coupon ceiling and limited liquidity. After a year of success on the performance front with a 4.5% return this year, we fear that TIPs have probably given the extent of their potential in the current environment.

TIPs overflows



Looking at liquidity patterns in this market, we believe that these positions could prove difficult to exit should inflation number start coming below expectations next year. The relative expensive characteristics of the asset class are certainly cause for caution.

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

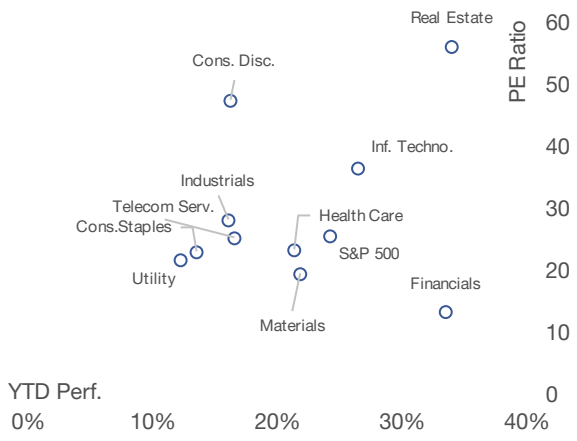
Equities

The star asset class of the year – and one prior has more to offer in an inflationary environment. A measured increase in policy rates is likely to be beneficial overall with financials likely to benefit strongly. Sectors in the doldrums such as China tech and more generally Chinese equities could also surprise on the upside given how far valuations have decoupled from fundamentals. Relative valuations also point at emerging market equities as an interesting area. European equities present a more mixed picture. The larger groups have closed a large part of the valuation gap with their US counterparts and could experience some loss in momentum. Conversely, the small and mid-cap segment presents more potential, particularly as it should benefit from the various stimulus plans about to be deployed on the old continent.

The value map in US Equities

We have been through an eventful autumn with the advent of the omicron variant that caused volatility to flare up, followed shortly by the Fed and Bank of England hawkish dispositions. This has not it seems dented the enthusiasm for the asset class where fundamentals have improved strongly across sectors.

The US Equities value map – ex energy

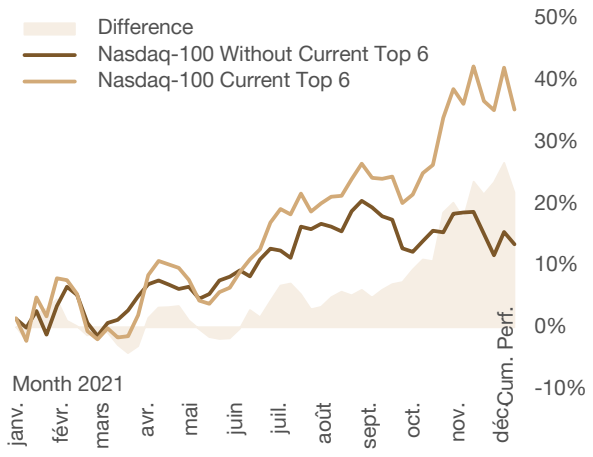


As we have done in our previous edition, we have excluded the US energy sector from our chart given its outsize catch up performance: 45% year to date.

US Equities: inflation and tech buoyancy

For the second year running, US equities have delivered very strong returns across the board. The continued appreciation of the larger tech groups combined to the reflation in the valuations of sectors that had been negatively affected by the lockdowns pushed indices to new highs. Interestingly, there has been strong discrimination at work between the larger tech groups and the riskier and less cash generative companies that have come down to earth in the last couple of months. As the chart below shows, there has been some rationalization within the tech sectors since the summer ended.

Concentrated performance – the top 6 performers



This year's Nasdaq performance comes from 6 names: Apple, Amazon, Alphabet, Nvidia, Microsoft and Tesla. Outside of the last one, all issuers are very large groups with impressive cash flow generation capabilities. To a degree, it feels like the feared tech bubble partly deflated over the last couple of months.

Performance of the most US hated stocks

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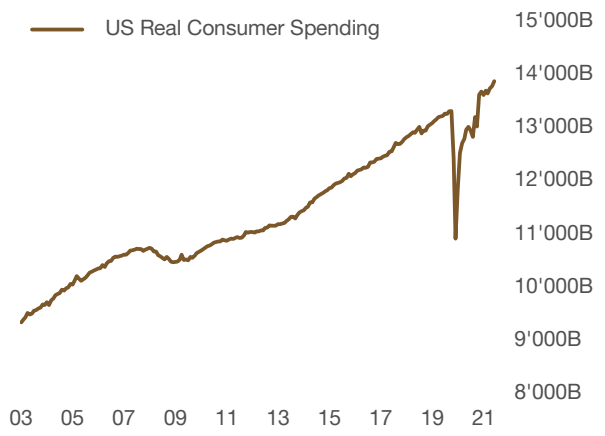
As economic data continue to show strength – despite a relative slowdown over the last few weeks – we continue to be constructive on the US economy and stock market. As shown below, the US consumer is running ahead of pre pandemic levels, indicating further potential upside to come.

American consumers are at it



In addition, even if the prospect of rising rates is likely to act as a coolant on the US economy, these will favor certain sectors such as financials. Higher policy rates will also not be an issue for the larger technology issuers, which present extremely strong credit profiles and large cash balances.

Lastly, the last leg of the re-opening trade- is travel and hospitality - is now facing variant pressure again. Should conditions improve in the Spring, this will provide some reserve for further appreciation.

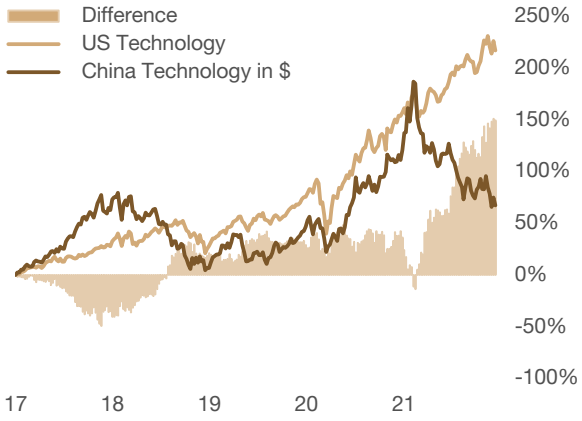
The only potential uncertainty rooted in tangible elements that we have at this stage is on the ability of US firms to continue beating consensus on results. Results for the fourth quarter of this year are still against the low base of last year but this effect will gradually disappear as we progress into 2022.

Chinese equities: hostage to sentiment

This has been a year to forget for Chinese equities with the property and real estate sectors pushing indices sharply down year to date. The over-interventionism in the technology sector combined to the ill-timed decision to rein in leverage in the property sector have been powerful drivers of underperformance.

That said, certain cross sections of the market have been doing rather well, in particular companies that are active in the electrification of transportation.

China tech: the fear discount



At this point, the disconnect between fundamentals and valuations is striking, considering that the Chinese tech issuers will continue to de-liver strong growth in the years to come as the country continues to expand.

To gain exposure to China, we continue to favor A listed shares, considering that the risks around the US ADR structures are unlikely to abate any time soon, reducing their recovery potential.

Emerging Market Equities: value to be found

Away from China, it has been a patchy year for emerging market performance. India is clearly leading the pack whilst south East Asian jurisdictions such as Thailand or Indonesia delivered a subpar performance. VietNam continues to power ahead as the resetting of global supply chains continues to benefit the country.

EM Equities performance

We continue to see appreciation potential within emerging markets in particular for the jurisdiction that will benefit from the supply chain changes that followed the covid pandemic. Such trends are likely to accelerate the

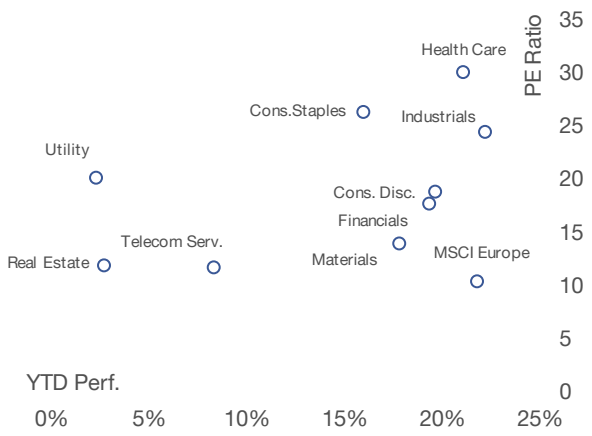
transition of these jurisdictions into the next economic development phases.

European Equities: smaller could be better

After a painfully slow start to the year, European equities have caught up nicely. Despite the initial fears and drawdowns linked to the delta variant as well as the omicron episode from the year end, most exchanges have held up to their gains. Spain and the UK were two notable exceptions. In the case of Spain, underwhelming household consumption, slower conditions in the construction sector as well as a tepid tourist recovery were the main culprits. Sadly, none of these factors are easy to turnaround.

Performance in UK stocks has been hobbled by the political uncertainties linked to Brexit and the many shortages that affected the country. These have in turn affected retail stocks negatively. Some impetus could return to UK equities into next year given the country's relatively high inflation readings and a now hawkish Central Bank.

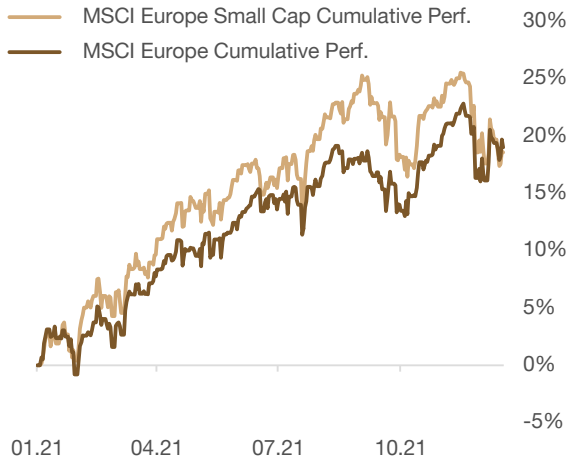
The European equities value map



In the high performing jurisdictions, the reflation trade seem to have run its course and additional sector momentum is less likely to materialize. To be sure, given the very dovish stance of the ECB, European bank shares are unlikely to repeat their 2020 performance.

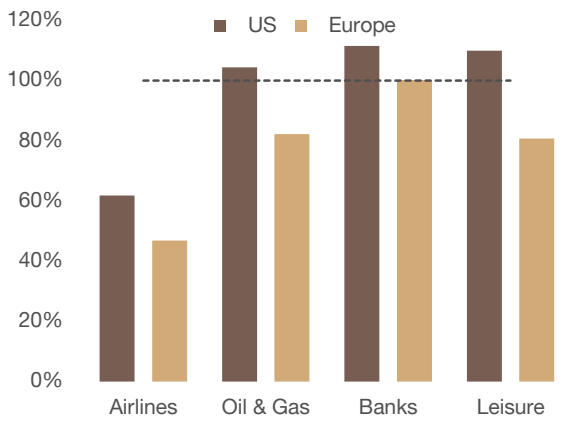
Within European equities, we like small and mid-cap equities better as these should benefit from the various economic support plans being rolled out in the European Union. As shown below, the performance of the European small and mi-cap segment this year has been in line with the larger cap indices, suggesting relative upside potential

Small and mid cap European companies look interesting



Lastly, Europen equities are at their core a reflation trade given how small the technology component is in main indices. The implication is that a potential Omicron led valuations drawdown will open up opportunities faster than in any other jurisdictions. As the chart here shows, outside of financials, European sectors still trade at a discount to their US counterparts but also at a discount to their pre-covid levels.

US vs Europe vs pre-Covid



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Commodities

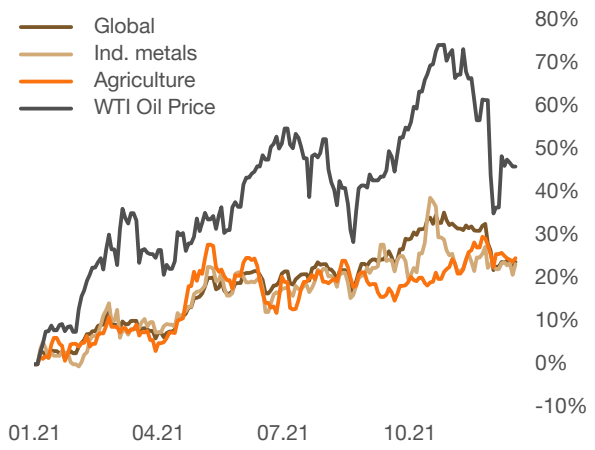
Fossil fuel prices have been doing exceedingly well this year, fully catching up on last year's historically abysmal performance. Supply discipline at OPEC + is anchoring prices around the USD70p.b. in spite of the potential negative impacts of the recent covid resurgence. That said higher US shale production could weigh negatively. Industrial metals have had a very volatile year and normalization of supply conditions and subsequent excess supply have affected prices negatively. It has been a poor year for Gold and we struggle to see significant momentum away from sudden risk off market moments in an environment underpinned by a strengthening dollar. Other precious metals with broad based industrial applications should benefit from a normalization of microchip flows into the car market.

Oil and Gas: supply constraints do the job for now

Opec + is taking the view that demand will increase slightly next year to 99.13mb.p.d. The organization does not anticipate Omicron to alter the picture significantly with demand remaining sustained next year. Rising travel restrictions have altered sentiment however and the barrel has now declined from its autumn peak.

That said, the cartel is showing supply discipline by targeting increases of 400 000 b.p.d in January and expects a supply glut of 275m barrels in the first quarter of the year. The cartel indicated that it is could to reverse course and cut production should the expected supply glut push prices down too much.

Commodity price panorama

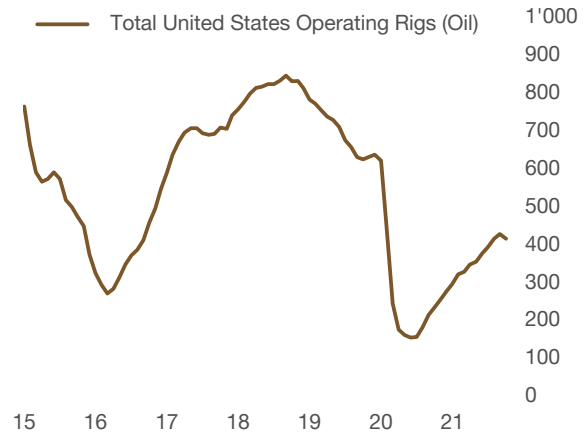


Two main elements could affect oil prices negatively at this juncture in our view.

The first one takes the form of a US administration worried about the political impact of inflation on the half term elections.

The release of emergency oil reserves in the autumn by the US administration was largely symbolic but none the less shows the concerns surrounding high petrol prices. Increasing US shale production would need the US administration to come back on its fossil fuel paring down agenda but is certainly an easy tool to use. As shown in the chart below, there is definitely some untapped production potential in the US.

US Rigs in operations



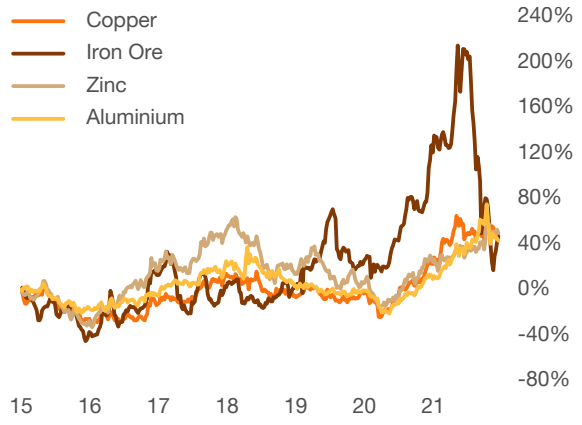
The second one revolves around the negotiations over the Iran nuclear deal. Lower oil prices are a powerful incentive for US administration to raise global supply by steering the Iran talks towards a positive conclusion. This is clearly not the only item in the discussion and we expect the US administration to be vigilant for geopolitical reasons. That said, a positive outcome would result in significantly higher global supply without having to push US shale oil production up significantly and dent the current administration's environmental credentials.

Base metals: definitely transitory

We expect base metals to follow the same trend as iron ore and gradually return to levels more aligned with overall fundamentals.

Aluminium prices have also cooled off from their autumn peaks and are now back to their summer levels. Certain base metals will keep on benefiting from the vehicle electrification trend –copper in particular.

Base metals : elevated prices under threat

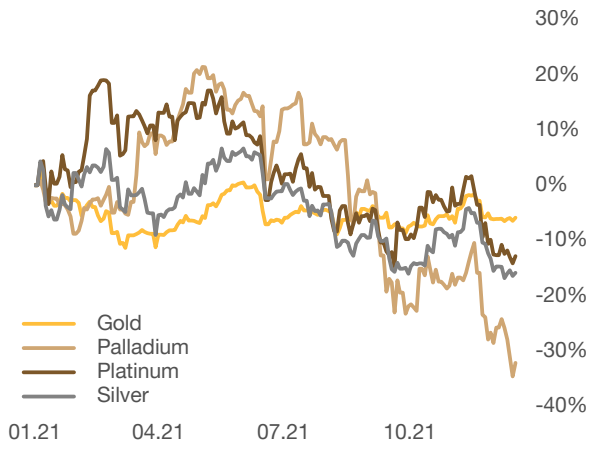


As we go to print, the rapid spread of the omicron variant is likely to reduce naturally activity in the first few weeks of the year, which historically tend to be weak anyway. This in our view creates a point of fragility in the otherwise strong base metal prices at least in the short term.

Gold: strong dollar takes the shine off

This has not been a very good year for gold. The yellow metal has suffered under the twin pressure of the economic recovery and the stronger dollar. Gold, which remains a true hedge against inflation seems to have been left alone despite heightened fears of rising prices. There has been a short reprieve of late confirming our 1750 level as a decent entry point in the current environment. Seeing through omicron, the outlook is not phenomenally supportive as a more hawkish Fed will continue to support the dollar higher and take some of the shine off the yellow metal.

Precious metals: autos need chips to help prices



The fluctuations around global automotive production linked to microchip shortages have negatively affected precious metals linked to industrial processes namely platinum, palladium and to some degree silver. Conditions should remain tight in the first few months of the year but as the microchip supply chains thaw in the early summer, demand for precious metals should call for higher prices.

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Currencies Market Expectations

Major Currencies

		Q1-22	Q2-22	Q3-22	Q4-22	Q4-23
EURUSD	1.13	1.12	1.13	1.15	1.16	1.18
EURCHF	1.04	1.06	1.07	1.08	1.09	1.11
EURGBP	0.85	0.84	0.84	0.85	0.84	0.84
EURJPY	128	129.0	129.0	130.0	130.0	135.0
EURNOK	10.10	9.95	9.87	9.80	9.70	9.50
USDCAD	1.29	1.25	1.24	1.24	1.23	1.22
USDCHF	0.93	0.94	0.94	0.94	0.94	0.94
USDJPY	114	114.5	115.0	115.0	115.0	115.0
USDCNY	6.37	6.40	6.41	6.44	6.46	6.30
GBPUSD	1.32	1.34	1.35	1.36	1.37	1.40
NZDUSD	0.67	0.70	0.71	0.72	0.72	0.74
AUDUSD	0.71	0.73	0.74	0.75	0.75	0.78

Other Currencies

		Q1-22	Q2-22	Q3-22	Q4-22	Q4-23
USDMXN	20.7	21.1	21.3	21.4	21.1	20.6
USDBRL	5.75	5.6	5.7	5.8	5.8	5.4
USDARS	102.2	115.0	127.0	140.0	140.0	186.6
USDTRY	12.84	14.0	13.5	12.5	13.0	14.0
USDILS	3.16	3.2	3.2	3.2	3.2	3.4
USDHKD	7.80	7.8	7.8	7.8	7.8	7.8
USDINR	75.6	75.0	74.8	74.8	75.0	75.6
USDRUB	74.0	72.0	71.0	71.5	71.7	73.0
USDPLN	4.10	4.2	4.1	4.0	4.0	4.0

The table above provides an overview of market forecasts for major currencies. It is composed of dozens of individual forecast providers and delivers a consensus forecast. These consensus forecasts represent a median number and all forecasts evaluated correspond to calendar quarter-end dates.

Future forecasts do not guarantee future performance and should only be used for indicative purposes.

Market Performances

	Name	QTD *	YTD**	2020	2019	2018	2017	2016
Cash	Dollar 3m Total Return	0.0%	0.1%	1.0%	2.5%	2.4%	1.1%	0.6%
	Euro 3m Total Return	-0.1%	-0.6%	-0.5%	-0.4%	-0.4%	-0.4%	-0.2%
Government bonds	US 3-5	-0.8%	-1.8%	6.2%	5.3%	1.5%	1.0%	1.3%
	Eurozone 3-5	0.1%	-0.6%	1.3%	1.9%	0.1%	0.1%	1.5%
	US 7-10	0.9%	-2.5%	10.0%	8.5%	0.9%	2.6%	0.8%
	Eurozone 7-10	0.9%	-1.2%	4.5%	6.7%	1.4%	1.3%	3.5%
Corporate bonds IG	USD Corp 1-5	-0.7%	-0.5%	5.4%	7.0%	1.0%	2.6%	2.9%
	EUR Corp 1-5	-0.1%	0.2%	1.1%	2.8%	-0.5%	1.2%	2.6%
	USD Corp 5-10	-0.5%	-1.6%	9.7%	14.3%	-1.7%	5.6%	5.6%
	EUR Corp 7-10	0.3%	-0.7%	4.4%	10.9%	-2.4%	4.2%	7.0%
Corporate bonds HY	USD Corp 1-5	-0.2%	4.2%	5.8%	13.9%	-1.8%	7.0%	16.5%
	EUR Corp 1-5	-0.3%	3.4%	2.3%	11.3%	-3.8%	6.9%	9.1%
	USD Corp 5-10	0.3%	3.7%	-2.0%	9.1%	-1.9%	7.6%	7.3%
	EUR Corp 5-10	-0.7%	2.2%	2.8%	13.2%	-4.4%	8.0%	10.8%
EM bonds (in $)	Hard currency	-0.8%	-1.9%	6.5%	13.1%	-2.5%	8.2%	9.9%
	Local currency	-0.1%	-2.1%	5.3%	9.5%	-3.4%	14.3%	5.9%
	Chinese Yuan	2.1%	8.0%	9.3%	2.8%	3.0%	5.0%	-4.7%
Others	S&P Leverage Loan Index	0.5%	4.9%	3.1%	8.6%	0.4%	4.1%	10.2%
	Global Convertible	-3%	1%	26%	18.2%	-1.2%	7.2%	4.6%
Equities	North America	5%	20%	19%	29%	-6%	19%	9%
	Europe	3%	17%	-5%	22%	-13%	7%	0%
	Japan	-3%	9%	7%	16%	-17%	18%	-3%
	Asia Pacific	-5%	-6%	17%	16%	-16%	29%	2%
	Developed Markets	3%	15%	14%	25%	-10%	20%	5%
	China	2%	-11%	23%	38%	-21%	32%	-7%
	Latin America	-7%	-16%	-16%	14%	-9%	21%	28%
	Emerging Markets	-5%	-8%	16%	15%	-17%	34%	9%
Other investments	HFRX Alternative	-1%	3%	7%	9%	-7%	6%	3%
	VIX	-3%	-2%	65%	-46%	130%	-21%	-23%
	G7 Currency Volatility	9%	-8%	23%	-34%	21%	-36%	22%
	DJ Global Commodity	-4%	24%	-4%	5%	-13%	1%	11%
	Gold	2%	-6%	24%	19%	-2%	14%	8%
	Industrial metals	5%	26%	16%	5%	-21%	28%	20%
	Agriculture index	5%	25%	16%	0%	-13%	-12%	2%
	WTI Oil	-6%	45%	-21%	34%	-25%	12%	45%
Currencies (vs. $)	Dollar Index	2%	7%	-7%	0%	4%	-10%	4%
	EM Currency Index	-5%	-10%	-6%	-1%	-11%	6%	0%
	Euro	-3%	-8%	9%	-2%	-5%	14%	-3%
	British Pounds	-2%	-3%	3%	4%	-6%	10%	-16%
	Swiss Francs	1%	-4%	9%	2%	-1%	5%	-2%
	Japanese Yen	-2%	-9%	5%	1%	3%	4%	3%
	Chinese Yuan	1%	2%	7%	-1%	-5%	7%	-6%

* Quarter to date
** Year to date

Past performance is not a reliable indicator of future performance and should not be solely relied upon.

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