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L'esprit de conquête

INVESTMENT CONFERENCE

SEPTEMBER **2023**

Monaco • Paris • Lyon

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INVESTMENT OUTLOOK • SEPTEMBER 2023

MACROECONOMIC REVIEW

*By **Alexandre Hezez**, Chief Investment Officer*

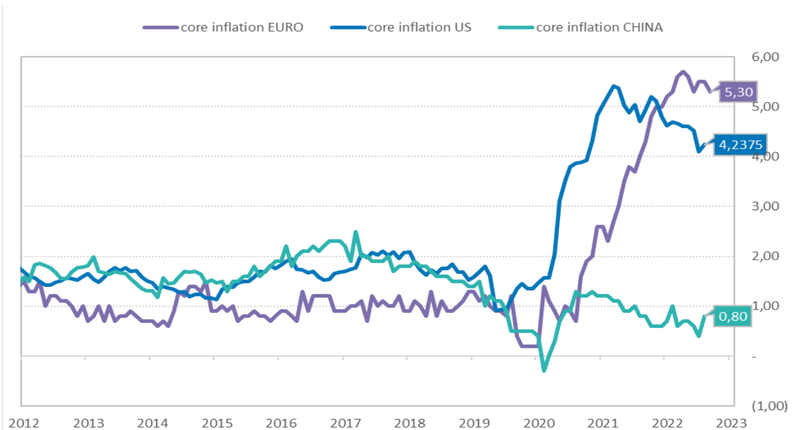
A PRECARIOUS BALANCE BETWEEN GROWTH RISK AND GRADUAL DISINFLATION.

Inflation seems to be under control: we are witnessing a slow, steady deceleration in price rises in the US. Monetary tightening appears to be coming to an end. The rise in goods prices has been decelerating sharply for over a year, starting with commodities and energy products. **Even as disinflation takes hold, the dynamics remain very different, leading to a decoupling of the economies.**

Globally, we expect average annual real GDP growth to slow to 2.6% year-on-year in 2023, driven by tighter monetary policy and tighter bank lending in the US and Europe. Slower growth in China is also likely to weigh on global activity. We expect global core inflation to fall below 3% in 2024, reflecting supply chain improvements and slower wage growth.

Core inflation (inflation excluding energy and food)

Sources: Bloomberg, Richelieu Group

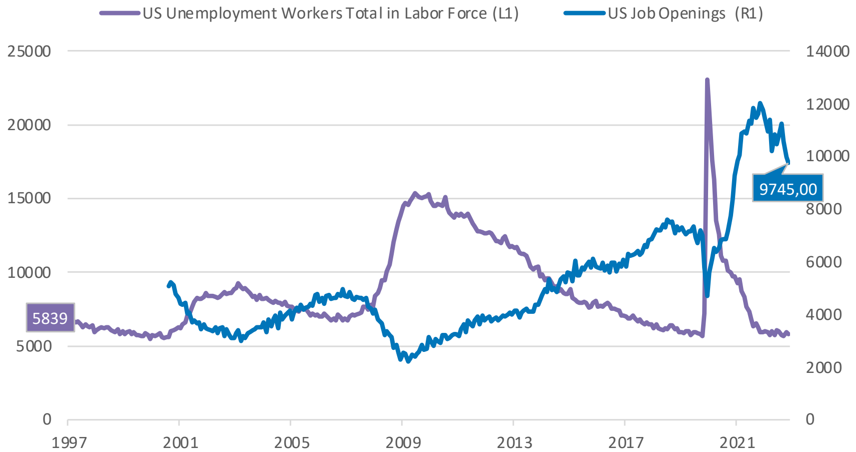


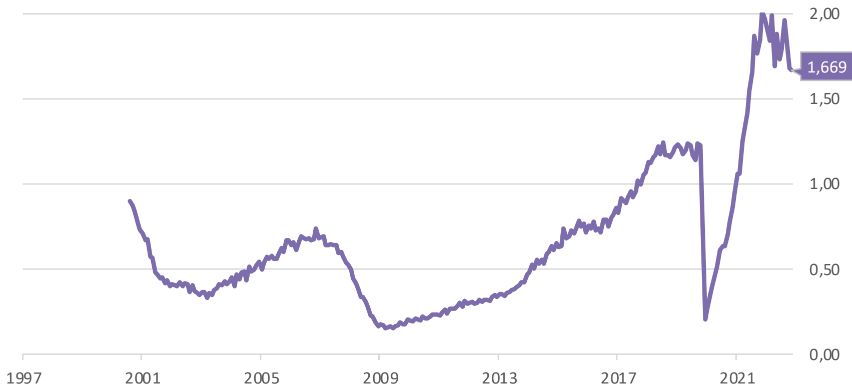
USA: DISINFLATION UNDERWAY

We expect core inflation to fall to 3.5% by December 2023, reflecting the continued recovery of the supply chain, lower housing inflation and a slowdown in services inflation as wage growth continues to moderate. **Job market normalisation is underway**, as evidenced by the latest published data (Job Openings, ADP report).

Number of job offers versus total jobs

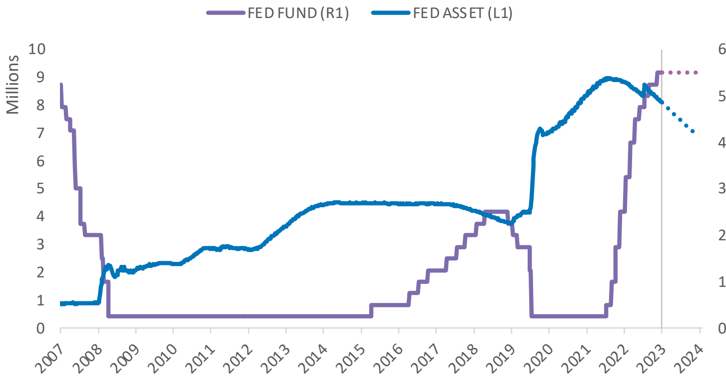
Sources: Bloomberg, Richelieu Group





We anticipate a slight deterioration in the unemployment rate towards the end of the year. **This phenomenon will not be sufficient to have a tangible impact on wage dynamics.** We believe that the Fed's rate hike cycle is now over, and that it will maintain the current federal funds rate range of 5.25-5.5% until 2024. We do not expect the first rate cut to take place before the end of Q2 (25 bp), **while remaining on the alert for inflation.**

At the risk of repeating ourselves, we are convinced that the Fed will continue, whatever happens, to keep up the pressure to avoid a resurgence in inflation. In August 2022, Jerome Powell, at Jackson Hole, already stressed his frank intention to 'use all our tools forcefully' and **'sustained period of below-trend growth'** as well as 'a softening of labour market conditions' before concluding that 'while higher interest rates, slower growth, and softer labour market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain.' **For the time being, this is not the case.** Paradoxically, the resilience of the US economy could now be a subject of stress for central bankers and for the markets.

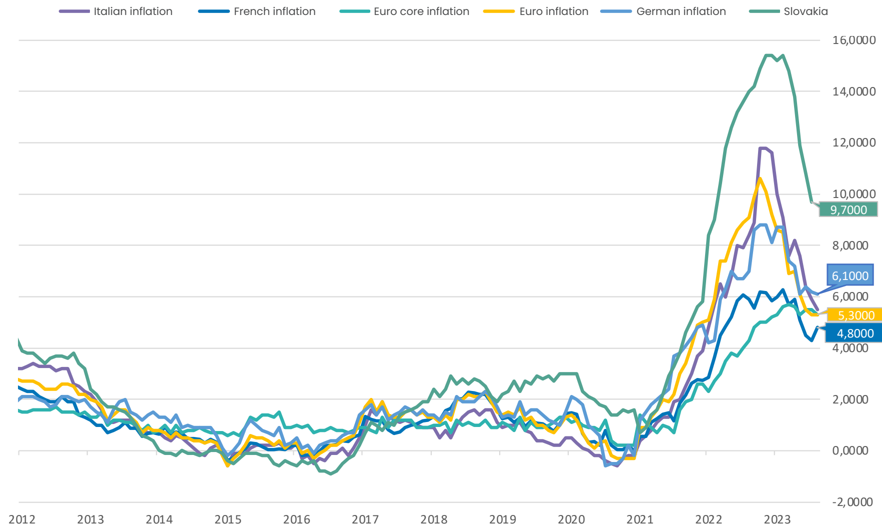


EUROPE: THE RISK OF STAGFLATION RETURNS

Inflationary pressures will continue to prevail. Preliminary inflation data for August in Germany, Spain, and France offered little reassurance that eurozone inflation is slowing. The movement will be slow and gradual and will continue to open the door to the end of key rate hikes by the ECB at the end of the year. PMIs showed that the European economy weakened, driven mainly by services. **These figures point to a weakening in demand and the impact of tighter monetary policies on the economy.** European growth stalled during the summer. In the eurozone, we expect GDP growth to slow to 0.6% in 2023, reflecting historically high energy prices due to the war in Ukraine and tighter bank lending standards. We expect core inflation to gradually fall to 4.0% year-on-year by the end of 2023, reflecting the indirect impact of lower energy and food prices, although we expect services inflation to remain high due to the tight labour market.

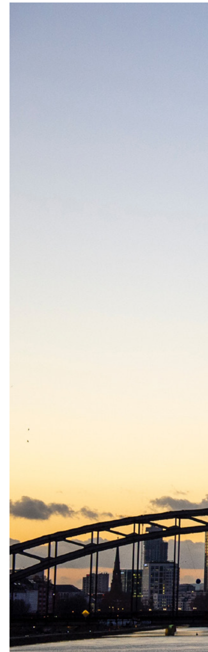
Headline inflation in the eurozone

Sources: Bloomberg, Richelieu Group



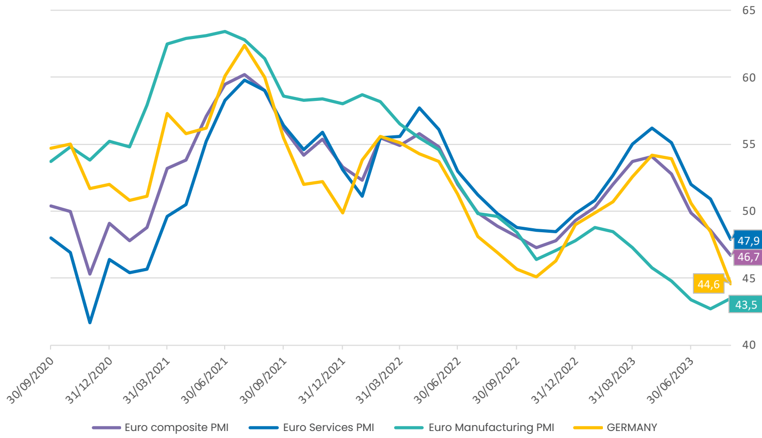
We expect the ECB to carry out two further hikes (25 bp) in September and December, for a terminal rate of 4.50/4.75, given vigorous core inflation, driven by services. Subsequently, we believe the ECB will remain on hold in 2024, even though we expect a deteriorating European economy. Christine Lagarde can only remain unmoved until inflation is anchored on her 2% target. **China, which is struggling to rebound, will affect global growth and mainly the more dependent European economy.** Despite worrying figures, the ECB, which has not yet succeeded in regaining control of inflation, will not take the risk of recession into account for the time being. A more rapid reduction in the ECB's balance sheet is likely to be the subject of debate, with reference to a possible halt in the reinvestment of securities acquired under the Pandemic Purchase Programme (PPP), which are nevertheless scheduled to run until the end of 2024 by the Governing Council. Indeed, the reduction in core inflation is less advanced than in the US.

At Jackson Hole, Christine Lagarde stressed the persistence of several sources of uncertainty, including those that could structurally lead to higher inflation than in the past (increased investment needs and supply constraints linked to climate change, stronger bargaining power for employees, and the ability of companies to raise prices more quickly). For the ECB, reaching these targets could require a significant slowdown in activity, due to the relentless determination of central banks 'to kill the beast' (Gita Gopinath, IMF Deputy Managing Director). In Europe, we are seeing a return to the risk of stagflation.



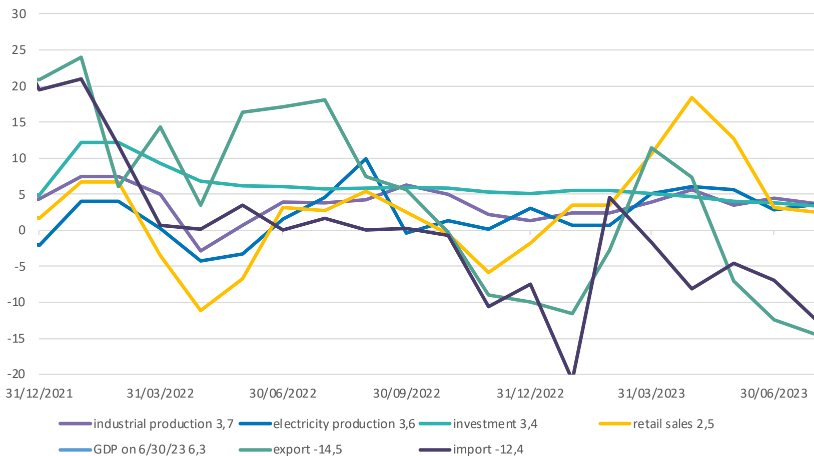
Eurozone economic indicators

Sources: Bloomberg, Richelieu Group



CHINA: DEFLATION ON THE HORIZON

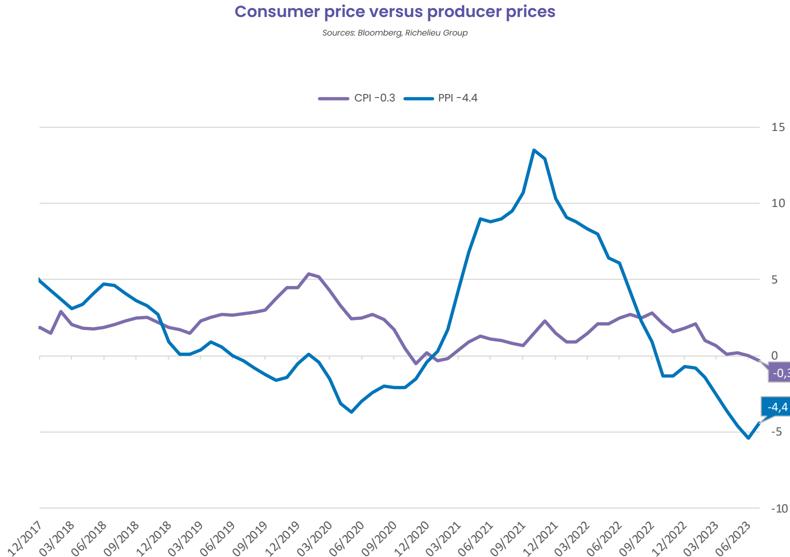
The Chinese economy has not rebounded as expected, despite three years without lockdown due to the pandemic. The limited pace and scale of budgetary and monetary support measures failed to stimulate growth. Medium-term challenges, such as demographics, persistent real estate slowdown, government debt, and geopolitical tensions, could weigh on future growth.



These factors are compounded by delays in real estate payments and a flood of local debt obligations. To stimulate demand, China is acting cautiously. A minor improvement in monthly statistics could allay concerns. **PMI indices for August were slightly positive, indicating expansion.** However, real estate instability suggests a long way to go before a beneficial impact. We anticipate GDP growth of 5.4% in 2023, following the post-opening recovery. Although current data is lacklustre, we expect sequential growth in H2 thanks to a lesser effect of destocking, the increase in easing measures, and stabilising exports. The central bank will increase monetary support, while limiting the impact on the foreign exchange and real estate markets. **Previous stimulus plans have led to harmful speculative bubbles.** Although worrying in the short term, this situation could be reversed with the end of the Fed's aggressive policy. The Chinese central bank is expected to cut rates to stimulate consumption and investment. The timing remains uncertain. **Beijing is avoiding increasing debt, particularly at local level, due to systemic risk. Options are scarce, but efforts are needed to achieve 5% growth.**

A delicate situation for the world

Current challenges are prompting us to readjust our forecasts for China. Negative data for June could lead to further stimulation of domestic demand by the end of the year. Faced with weakened global trade and Western sanctions, **China is looking for growth levers.** Lower growth may influence global disinflation, especially for commodities, but it is also likely to have an impact on Europe.



Uncertainty surrounds the real estate slowdown, perceived as a major economic threat. The situation in China is bound to have an impact on global growth. Although detrimental on a global scale, China's difficulties have one short-term advantage: they are easing inflationary pressures in the US and Europe. **Unlike the rest of the world, China is not suffering from inflation.** Pending a recovery in industry, its weakness is helping to curb inflation. Conversely, a rebound at the end of the year could stimulate it, putting the ECB in a tricky position. If China continues to decline, this will affect the global economy. **This is a complex situation for the US, faced with a weakening adversary.** If China weakens too much, it risks upsetting the global economic balance. US Commerce Secretary Gina Raimondo's visit to China reflects these concerns. **The two superpowers, seeking to reduce tensions, have stepped up their meetings.**

The Fed is no longer a guarantee against the crisis

The global growth momentum is mainly driven by the macro cycle in the US. The full impact of the aggressive monetary tightening of 2022 could soon be felt. In previous downturns, the Fed has always acted to support the economy.

We remember, in 2019, the reversal of US monetary policy during the trade war between Trump and China after a steady rise in rates in 2018. COVID has obviously left its mark on us all. We have the 2007 crisis in mind (fewer of us are doing it...). This time, the situation is different: the US economy is one of the most resilient. Growth expectations were raised throughout 2023, and US growth is more robust.

Western consumers have seen their purchasing power dwindle, affecting their morale and their ability to consume. The savings built up during the lockdowns served as a cushion. Nevertheless, the scale and duration of price hikes are raising fears of a drop in consumption. Wage demands remain high, especially in Europe and the US, even though employment is deteriorating. Continued wage inflation will impact the actions of central banks and businesses alike. Household consumption, which accounts for around two-thirds of GDP, is seen as the driving force behind this dynamic, with Americans continuing to spend at a steady pace to date. While they face a resumption of student loan repayments and high borrowing costs in the months ahead, a strong job market should continue to boost spending. **A scissor effect could occur if employment deteriorates.**

The ability of US households to acquire real estate has never been so low, which presupposes a fall in real estate prices or wage restraint.

Household ability to buy real estate

Source: X (formerly Twitter)

If China gets bogged down and Europe becomes entangled in unmanageable inflation, being forced to adopt a restrictive monetary policy despite the risks (slower growth, Ukraine, gas, China), US monetary policy will not compensate. Worse, it will continue to do so by lowering its balance sheet over the coming months. Jerome Powell's obsession remains the fear of a repeat of the 1970s, with its successive waves of inflation. Central banks cannot let up. The risk of a global recession is increasing, while at the same time the US economy remains resilient. There is nothing to expect from the FED (or the ECB) as in previous crises.

After a start to the year which saw a gradual decline in risks (gas restocking in Europe, reopening of the Chinese economy, effective disinflation in the US), the coming months could well see a resurgence of risks on these same themes. Geopolitics remains a key factor to watch. In Europe, tensions with Russia remain high, particularly over Ukraine. Sanctions, trade wars and rising nationalism could hamper global growth a year ahead of the US presidential elections. **Until China demonstrates its ability to manage the real estate crisis and return to sustainable growth, the macroeconomic balance will remain fragile.**

ASSET ALLOCATION

*By **Alexandre Hezez**, Chief Investment Officer*

CHINA, CORPORATE MARGINS, INFLATION...

The decoupling of economies has increased over the past month. The defensive positioning of investors at the start of the year and the resilience of the economy despite rising interest rates are the two pillars supporting equity markets. Geopolitics remains a key factor to watch. In Europe, tensions with Russia are still palpable, particularly regarding Ukraine. Sanctions and trade wars could hamper global growth a year ahead of the US presidential election. Until China demonstrates its ability to manage the real estate crisis and return to sustainable growth, we will remain vigilant.

EQUITIES

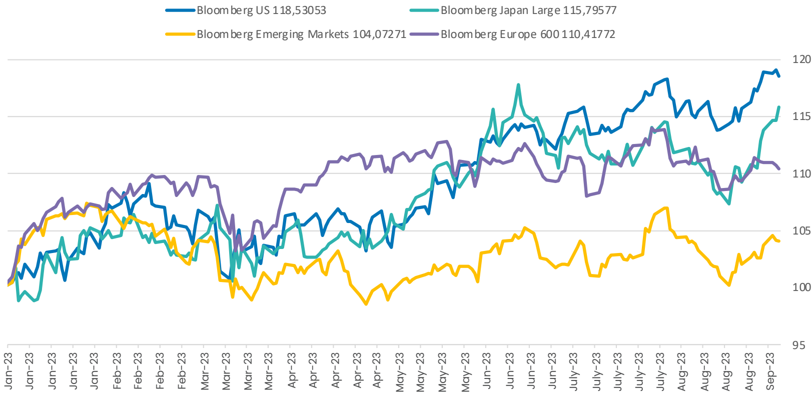
We have lowered our short-term equity outlook from neutral to underweight, taking into account uncertainties related to China, European monetary policy and pressure on corporate margins.

The market is now adopting a 'bad news is good news' approach. Negative employment and corporate indicators were well received by investors. A few years ago, this would have been justified, as central banks sought to support growth in an inflation-free environment. **The market wants to be convinced that if macroeconomic data deteriorates, central banks will revise their monetary policy. We are convinced of the contrary.**

Over the next few quarters, the drop in inflation, which had benefited companies, will lead to a sharper slowdown in nominal growth than in real economic growth. Production costs will remain high, and wage growth will not decline as rapidly as nominal growth. Corporate profit margins could therefore come under pressure.

Year-to-date performance of equity indices

Sources: Bloomberg, Richelieu Group



Consumers resisted the rise in interest rates and the loss of purchasing power, thanks to a solid job market. The deterioration of the latter will have a negative impact on the economy, especially as wages will remain at the heart of demands, as illustrated by the current negotiations between the powerful United Auto Workers union and Ford on wage increases. The union is demanding +45%, while the manufacturer is offering +15%.

The economic downturn, coupled with increasingly restrictive central bank policies, has prompted us to adopt a cautious stance on European equities. The risk of a contraction in bank lending will encourage investors to favour quality defensive stocks over cyclicals. This rotation is also fuelled by falling PMI indicators.

The services dynamic in Europe, which is still driving growth, is gradually running out of steam. This will lead to below-potential growth in the eurozone over the next few quarters, but not enough to win the battle against inflation. China will continue to weigh on European corporate earnings, particularly in the capital goods sector.

Corporate results showed some resilience, including in Europe, although they were more mixed this time around, starting from low expectations.

As a general rule, we will avoid companies with too high a debt ratio. The preferred geographic segment remains the US for its visibility, both in macroeconomic and monetary terms, and it is now a little complacent to think that the markets' new macro scenario of reflation doesn't anticipate the ever-present risk of recession at all. It expects earnings growth to accelerate, which seems optimistic to us.

With regard to emerging countries, and China in particular, we have noted further setbacks in the real estate sector and have lowered our positive outlook. However, after the meeting of the Politburo, the Chinese Communist Party's governing body, which confirmed the increase in economic measures, the equity markets responded very well. Given the current stakes, Beijing's measures to stimulate growth remain moderate, reflecting the authorities' caution in the face of financial risks. Defending its currency remains its top priority.

As long as Chinese growth shows no tangible signs of recovery, caution will prevail in risky assets. We are convinced that stimulus measures will take shape, but the timing is uncertain. We are not negative on the Chinese market, as we believe that the leverage is much greater in terms of performance, given the valuations and already significant capital outflows in the region.

THEMES AND SECTORS

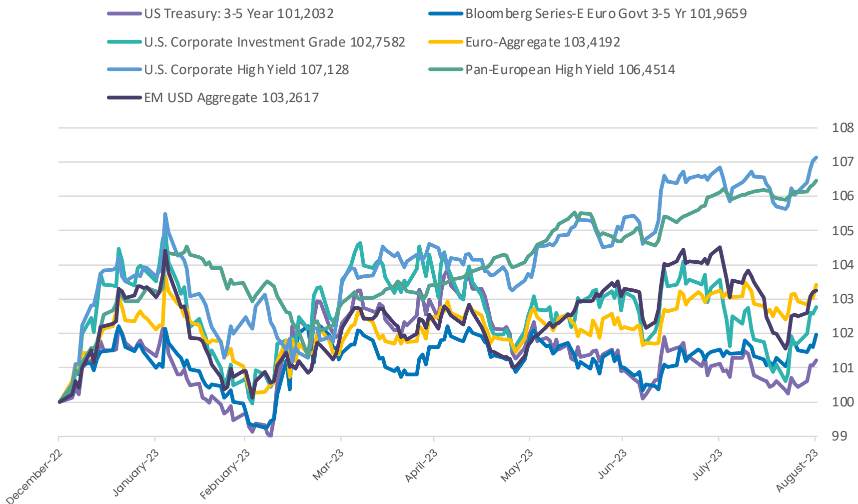
In sector terms, we are focusing on defensive stocks rather than cyclicals which benefited from a readjustment in the economic outlook during the first half of the year. This rotation seems to show that investors realise that a lot of good news has already been priced in. From now on, a further rise in the market will become more difficult. The macroeconomic environment is not simple, and it will become more complicated for companies to defend margins that are at historic highs. Large technology companies are benefiting from the as yet untapped prospects of AI. The banking sector remains highly resilient in this environment. The themes of relocation and energy transition remain at the heart of our portfolio.

RATES & CREDIT

Bond segments continue to deliver appreciable profitability, despite increasing bankruptcies. We favour quality assets in all segments. We favour short durations and the most balanced segments in terms of risk/return (BBB/BB). We believe there could be some rate pressure to take advantage of during the quarter. We have upgraded our view on bonds, in view of the rate hikes that took place over the summer months. We expect rates to stabilise again as growth weakens. Now that yields on 10-year US Treasuries have risen above 4%, we can build up positions in US sovereign bonds to diversify and protect the portfolio in the event of a major crisis.

Year-to-date bond index performance

Sources: Bloomberg, Richelieu Group



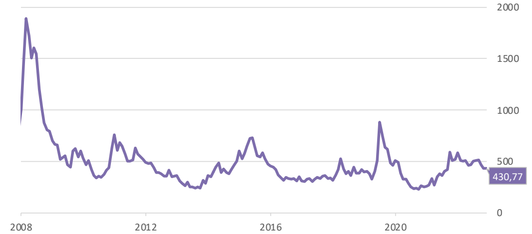
Regarding corporate bonds, we have seen a striking and undifferentiated tightening of credit spreads. Although this may indicate that investors see the current macroeconomic environment as positive for carry trades, **we are more selective.**

As rates rise in the US, higher interest charges could lead to market tensions and waves of defaults by the most indebted companies, particularly in commercial real estate and the private market. The credit industry is underestimating the current level of macroeconomic uncertainty, and the risk of corporate default is bound to increase. Equity volatility is set to increase, driving up spreads. **We are reducing our conviction in US High Yield** after the sector's good performance.
Overall, interest rates will remain high, and, as in previous cycles, we cannot count on rate cuts or substantial price increases. Coupon yield remains the main interest for these investments. Taking into account curve inversions, **we recommend short terms** (3 to 4 years).

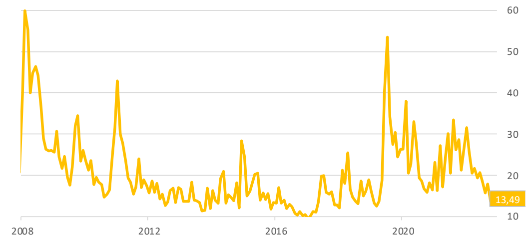
US HY spreads versus implied equity market volatility (VIX)

Sources: Bloomberg, Richelieu Group

spreads 10 y High Yield US on 8/31/23 430,77

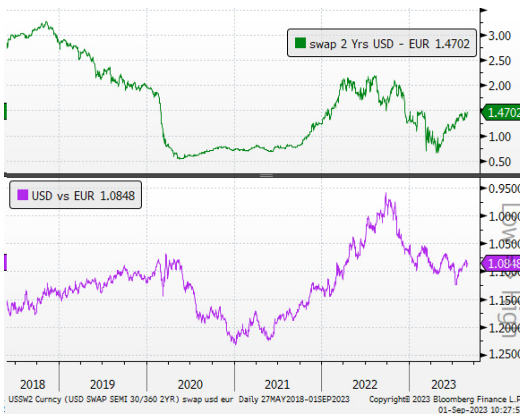


VIX Index - Last Price 13,49



2-year USD/EUR versus USD-EUR swap differential

Sources: Bloomberg, Richelieu Group



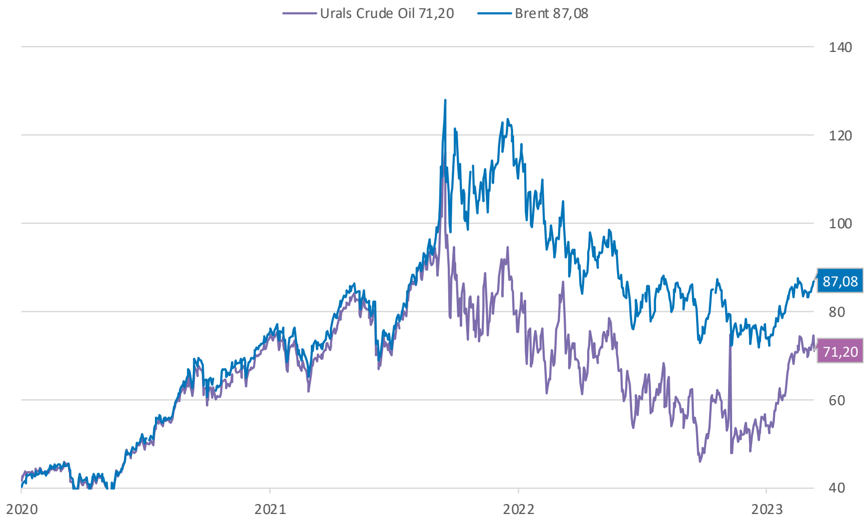
CURRENCIES & COMMODITIES

Regarding the dollar, we reached our first target in July (1.12). **We continue to believe that the euro should rise against the dollar towards the end of the year.** In recent months, the euro-dollar exchange rate has been strongly linked to the spread between short-term interest rates in the US and Europe. This gap was very wide before the start of the European Central Bank's rate hike cycle a year ago, but has narrowed steadily since. Recently, there have been offensive statements from some FOMC members and economic data showing the US economy to be holding up well. However, this should be temporary, as the ECB needs to catch up with the Fed, given Christine Lagarde's persistent determination.

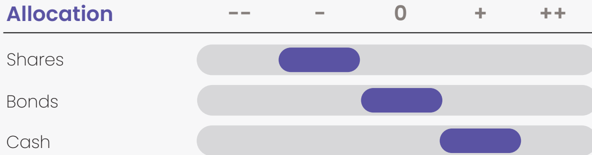
Thanks to these factors and OPEC+'s efforts to reduce oil supply, the price of Brent crude has moved closer to our $90/b target. While the positive catalysts took time to manifest themselves, their impact is now embedded in the market, limiting the upside potential of oil prices. We recommend caution, as the economic slowdown is set to continue, affecting the commodities market. After a long period of hesitation, Russia finally seems determined to meet its OPEC+ commitments, as reflected in the marked reduction in its oil exports. Saudi Arabia, as a partner and leader within OPEC+, also played a crucial role in voluntarily reducing its production. US oil production remains stable, a sign of the caution shown by local producers. Furthermore, no agreement on the Iranian nuclear issue is expected, although Iran continues its unofficial exports, providing a useful additional supply for the market. **Global demand for oil is expected to hit a record high in 2023.** China will make a massive contribution to this growth, despite recent signs of normalisation. US demand is also robust, supported by positive economic data. The energy sector should benefit from a stabilisation in oil prices. This framework could be a further catalyst for the sector, especially with recent dividend increases and share buybacks.

Brent and ural crude oil prices

Sources: Bloomberg, Richelieu Group



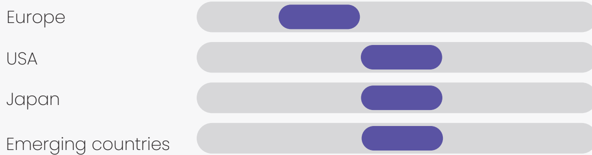
ASSET ALLOCATION TABLE



Risk of deflation in Europe / Margin risk in Q3/Q4 / Economic policy in China / Decline in global economic growth

Growth rate hike during the summer / Yield / Short Duration / Restrictive monetary policy for longer than expected. We expect rates to stabilise again as growth weakens.

Return on cash / Awaiting reinvestment



ECB more restrictive / Risk of stagflation / Impact of Chinese growth Focus on: Banks / Oil / Growth company

Profit-taking on valuation / Fall in consumption. Focus on: Transition / Reshoring / Innovation & AI

Hedge currency in case of change in monetary policy / GDP growth

Uncertain timing on China. We are not negative on the Chinese market, as we believe that the leverage is much greater in terms of performance, given the valuations and already significant capital outflows in the region.

Currencies

Monetary policy gap between the FED and the ECB

Commodities

Chinese growth picked up in H2 versus persistent disagreement at OPEC+

Real rates set to remain high

Yields on 10-year US Treasuries have risen above 4%, we can now build up positions in US sovereign bonds to diversify and protect the portfolio in the event of a major crisis

Rising yields / Short duration

We favour quality assets in all segments

We favour quality assets in all segments

Rising defaults / Impact of the FED / We are reducing our conviction in US High Yield after the sector's good performance / The credit sector is underestimating the current level of macroeconomic uncertainty and the risk of corporate defaults

We favour short durations and the most balanced segments in terms of risk/ return (BBB/BB).

We are more selective / Search for carry / Less restrictive central banks

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INVESTMENT OUTLOOK • SEPTEMBER 2023

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FOCUS #01

COMMODITIES AT THE HEART OF GLOBAL GEOPOLITICS

*By **Philippe Chalmin**, Commodities Market Specialist & Founder of Cercle Cyclope*

For a long time, men dreamed of getting rid of materials. Modern alchemy would have led to a perpetual cycle of destruction and rebirth: the material loop would make it possible to forget fossil fuels and minerals and the plants would be enough for themselves. This dream remains an ultimate goal, but the world is still so far away from achieving it in the third decade of the twentieth century.

A quick review of autumn 2023 news is in order, after the summer months: the war in Ukraine, instability in the Sahel, tensions with China, climate concerns, and the return of El Niño made the headlines, but the commodities markets were never far away.

Ukraine made grain market news due to Russia's decision not to renew the grain corridor agreement. Russia also bombed the Ukrainian ports on the Danube. It is increasingly difficult for Ukrainian cereals (wheat, but especially maize) to get out of the country, and Russia, the world's largest wheat exporter, is using this 'food weapon', particularly with regard to Africa, in addition to Wagner's turpitudes. In the field of energy, Europe has learned to live without Russian gas, but, as a result, it is increasingly dependent on its liquefied natural gas (LNG) suppliers, such as the US, Qatar, and Australia. In late August, threats of strikes in the Australian gas industry caused a fairly sharp rise in prices, albeit in no way comparable to the 'madness' of 2022 when gas prices in Europe and Asia increased tenfold. Regarding oil, the unlikely alliance between Saudi Arabia and Russia is bearing fruit: prices rallied despite sanctions on Russian exports (but Russian crude oil may become Indian diesel...).

To avoid dependence on fossil fuels as well as the geopolitical nature of oil and gas, the time for renewable energies has come, but, here too, new dependencies must be taken into account: 'electric' metals, of course, such as lithium, cobalt, and nickel, but primarily copper. But, in these areas beyond the mine, metallurgy is the real bottleneck with China's often dominant position: China demonstrated this position in July by deciding to limit its germanium and gallium exports (among other things). Regarding nuclear power, it still depends on its uranium suppliers, Kazakhstan first (in Russia's orbit, but with some ambiguity) and then Niger, which brings us back to the instability in the Sahel. The final straw was the coup in Gabon, a small oil and manganese producer.

In many other countries, it is obvious that the commodities market is the source of a genuine geopolitical curse: it maintains the obtuse and general kleptocratic sovereign power. From Venezuela to the Democratic Republic of Congo, there are plenty of examples. China often exploits this, finding the resources it lacks in Africa and Latin America. Only a few countries resist, such as Australia, which held firm in the face of the Chinese embargo on Australian products including coal, barley, cotton, and... wine. Australia had insisted that an investigation be conducted into the Chinese origins of Covid. Beijing had not appreciated this, but the sanctions taken (which did not apply to iron ore) hurt China more than Australia.

In late August 2023, for the first time in three years, a vessel transported Australian barley to China. Chile is considering nationalising lithium production.

Finally, summer 2023 was marked by strong weather instability and the highly probable return of El Niño, a marine current inversion phenomenon in the Pacific that affects Oceania, Asia, the Americas, and East Africa and results in droughts or, on the contrary, higher precipitation. El Niño is expected to strongly influence agricultural yields in 2023/2024. Already, the monsoon will not provide enough precipitation in India: the government has decided to embargo a large portion of rice (India is the world's largest exporter) and sugar exports. Australia could see its wheat production decrease by a third (following, it is true, a bumper year). After surging in 2022, global agricultural prices could once again be stretched in 2024, with another threat, that of purchases by China, which has also become the world's leading importer.

From this point of view, the geopolitical nature of Chinese imports of commodities is very bright: in terms of energy, oil comes from Russia (as for India, by the way), Saudi Arabia, Iran, and Venezuela. Natural gas comes from Russia via pipelines (the famous 'Power of Siberia'), but LNG comes from Qatar, in particular. China, on the other hand, was unable to limit its dependence on Australian coal and iron ore and was forced to ignore Australia's impertinence about the origin of Covid. More and more minerals and metals are being mined and processed by Chinese companies that dominate nickel in Indonesia, cobalt in the DRC, and iron ore in Guinea, which are present in Peru and, to a lesser extent, in Chile. Finally, regarding agriculture, China sought to resolve its dependence on the US by favouring purchases of soybeans and maize from Brazil and Argentina. They are China's BRICS partners (Brazil and Russia) and participants of the August 2023 summit (Saudi Arabia, Iran, Emirates, and Argentina).

This quick review of global commodities market news in early autumn 2023 illustrates their geopolitical dimension, both at the origin of many internal and external conflicts, as well as being a sounding board with direct consequences for the global economy. In the late 1930s, a study on a circle close to the Labour Party (the Fabian Society) was published in the UK. Its title 'Raw Materials, War Materials' is still very topical.

FOCUS #02

INFLATION TARGET, WHY 2% AND NOT 3%?

*By **Alexandre Hezez**, Group Strategist*

Inflation seems to be under control, but we are witnessing a slow, steady deceleration in price rises in the US. Monetary tightening appears to be coming to an end. The rise in goods prices has been slowing fairly sharply for over a year, starting with commodities and energy products. Persistent inflation is largely attributable to the service sector, in particular to rising rents.

Housing services account for a third of inflation. The correction in the real estate sector should further moderate inflation in the second half of the year. Globally, we are seeing the same trends, with varying degrees of temporal variation. It seems as if the war waged by central banks against the scourge of inflation is about to be won. **The markets are even anticipating rate cuts as early as 2024, as if we were on the verge of returning to the normality we once knew.**

However, if we assume that inflation in recent years has remained low thanks to accelerated globalisation, cheap commodities and an absence of major conflicts, the year 2021 has marked a certain reversal of all these factors. The hardest task lies ahead: bringing inflation down from 8-9% to 3-4%, as base effects are in action. **The transition from 1.5% to 2% will certainly be trickier.** Clearing these final hurdles is likely to be difficult, and could require a substantial slowdown in activity due to the continued aggressive action of central banks.

This is a real headache, even though **colossal investments are needed to ensure a vital energy transition** in parallel with equivalent levels of debt. Calls to halt interest rate hikes by central banks are multiplying.

But what would be the basis for such action, when the inflation target enshrined in central bank mandates is clear: 2%? In the many debates we have had over the last few months, more and more economists, academics and investors are discussing the inflation objective enshrined in central bank mandates. **The 2% dogma seemed to have been established many years ago** and is the very foundation of the monetary policy models of all the major central banks.

In the eurozone, for example, the question might seem irrelevant before 2021. Since the 2000s, we have moved from a long period of stable inflation or close to 2% to a period close to 1% where the risk of deflation was constant.

In an article published in the Nihon Keizai Shinbun, a Japanese business daily, Christine Lagarde insisted that the ECB must 'be extremely vigilant in the face of these potential risks... particularly with regard to wage increases in various European countries'. 'We have a mandate that assigns us one objective, not two like the Federal Reserve. **Our objective is price stability**', she declared, reaffirming that she would focus on controlling inflation.

Central banks remain committed to their primary objective of price stability, which for both the ECB and the Fed is to maintain an inflation rate close to 2%. In their view, their credibility is at stake.

At the European Central Bank forum in Sintra, **the IMF called on European central banks to 'kill the beast' without 'pause'.** For the IMF Managing Director, the ECB's monetary tightening policy must continue 'until mid-2024, in order to bring inflation back to its target of 2% somewhere in 2025'.

However, in a recent article, **Olivier Blanchard, former IMF Chief Economist, suggested raising the central banks' inflation target from 2% to 3%** to prevent monetary tightening from causing too much damage to the job market. His arguments, while provocative, make sense, especially given the widely accepted 2% 'dogma'. His objections are not new. Already in 2010, as a senior economist at the IMF, he proposed in a speech to the Club Finance HEC that the inflation benchmark currently at 2% be raised to 4%, i.e. that central banks should only start to worry when this new limit is reached.

Does the 2% target really have a theoretical basis? Is it possible to modify it? **Paul Krugman, Nobel Prize Winner 2008, also advocates for a 3% inflation target.**

According to him, the changes brought about by the pandemic in the way we work and our purchasing choices have shown that adjustment problems are more important than we thought. These would perhaps be more easily resolved if we accepted inflation at 3% or even 4%, rather than insisting on bringing it down to 2%.

Jerome Powell, Chairman of the Federal Reserve, spoke out in March against changing the 2% target, arguing that the central bank's commitment to this rate was helping to reinforce confidence in price stability, despite current inflationary pressures.

Tweet

Paul Krugman
@paulkrugman

Next newsletter probably about inflation target. Here's something I wrote early this year including new thoughts about the downside of raising the target gc.cuny.edu/sites/default/...

Traduire le Tweet

6:39 PM · 1 déc. 2022

An unnoticed past change was made by the ECB in July 2021, but it remains significant. Originally, the definition of price stability announced in October 1998 corresponded to 'an increase in the harmonised consumer price index for the eurozone of less than 2%'. In 2021, it was indicated that the objective was now symmetrical, suggesting that the ECB would be just as concerned about inflation that was too low as inflation that was too high.

According to Article 127 of the Treaty on the Functioning of the European Union, **the ECB's primary objective is to maintain price stability.** However, the Treaty does not give a precise definition of 'price stability', and it is up to the ECB to determine an operational formulation.

Official Journal of the European Union Article 127

Sources: Bloomberg, Richelieu Group

7.6.2016 FR Journal officiel de l'Union européenne C 202/102

Article 127

(ex-article 105 TCE)

1. L'objectif principal du Système européen de banques centrales, ci-après dénommé "SEBC", est de maintenir la stabilité des prix. Sans préjudice de l'objectif de stabilité des prix, le SEBC apporte son soutien aux politiques économiques générales dans l'Union, en vue de contribuer à la réalisation des objectifs de l'Union, tels que définis à l'article 3 du traité sur l'Union européenne. Le SEBC agit conformément au principe d'une économie de marché ouverte où la concurrence est libre, en favorisant une allocation efficace des ressources et en respectant les principes fixés à l'article 119.

2. Les missions fondamentales relevant du SEBC consistent à:

— définir et mettre en œuvre la politique monétaire de l'Union;

— conduire les opérations de change conformément à l'article 219;

— détenir et gérer les réserves officielles de change des États membres;

— promouvoir le bon fonctionnement des systèmes de paiement.

3. Le troisième tiret du paragraphe 2 s'applique sans préjudice de la détention et de la gestion, par les gouvernements des États membres, de fonds de roulement en devises.

4. La Banque centrale européenne est consultée:

— sur tout acte de l'Union proposé dans les domaines relevant de sa compétence;

— par les autorités nationales, sur tout projet de réglementation dans les domaines relevant de sa compétence, mais dans les limites et selon les conditions fixées par le Conseil conformément à la procédure prévue à l'article 129, paragraphe 4.

La Banque centrale européenne peut, dans les domaines relevant de sa compétence, soumettre des avis aux institutions, organes ou organismes de l'Union appropriés ou aux autorités nationales.

5. Le SEBC contribue à la bonne conduite des politiques menées par les autorités compétentes en ce qui concerne le contrôle prudentiel des établissements de crédit et la stabilité du système financier.

6. Le Conseil, statuant par voie de règlements conformément à une procédure législative spéciale, à l'unanimité, et après consultation du Parlement européen et de la Banque centrale européenne, peut confier à la Banque centrale européenne des missions spécifiques ayant trait aux politiques en matière de contrôle prudentiel des établissements de crédit et autres établissements financiers, à l'exception des entreprises d'assurances.

The primary objective of the European System of Central Banks is to maintain price stability. This does not necessarily mean 0% inflation. Indeed, if price stability was the main objective, why not aim for 0%?

Over and above all the theoretical aspects and debates between economists, a pedagogical response was given at the Rencontres de la politique monétaire at the Banque de France. Interviewed by influencer Jean Massiet on his Twitch channel, Chairman François Villeroy de Galhau compared inflation to the temperature of the human body: deflation would be like severe anaemia, and inflation above 2% would be comparable to fever. According to Olivier Garnier, Chief Executive Officer of Banque de France, **2% is seen by the main central banks as a precautionary margin compared with 0%.**

According to him, there is inherent uncertainty in inflation measures. For example, it is difficult to take into account improvements in the quality of goods and services in consumer price indices. Actual inflation could therefore be slightly lower than measured inflation. By targeting 2%, central banks ensure that they have a safety margin against deflation, even if actual inflation is slightly lower than measured inflation.

Secondly, slightly positive inflation can help facilitate economic adjustments. For example, it can be difficult for employers to reduce nominal wages, even when economic conditions justify it. Slightly positive inflation means that real wages can be reduced without affecting nominal wages.

Moreover, if inflation is too low, nominal interest rates are also likely to be very low, limiting the scope for central banks to cut rates in the event of an economic slowdown.

Finally, **it is important to note that the 2% target has been widely adopted by central banks around the world,** reinforcing its credibility. Changing this objective could cast doubt on central banks' commitment to maintaining price stability, which in turn could undermine their credibility and ability to influence inflation expectations.

However, some economists, such as Olivier Blanchard and Paul Krugman, have suggested that central banks might consider raising their inflation targets. The debate over the appropriate inflation target is a complex one, involving trade-offs between different economic policy objectives.

There are therefore two opposing schools of thought, with arguments of varying origins. For Blanchard and Krugman, what matters most is the suffering on the job market, while, on the other hand, it is the promise of price stability to ensure sustainable growth.

From the central banks' point of view, the 'famous 2%' is simply a way of achieving price stability (i.e. close to 0%!) without risking deflation.

It is also important to note that monetary policy cannot solve all economic problems. **Governments must also implement appropriate fiscal and structural policies to stimulate economic growth and stability.**

The inflation target debate reflects the complex and interconnected challenges facing modern economies. Ultimately, the 2% inflation target is based on a judgment of balance between the risks of deflation, the constraints of lower interest rates and the credibility of central banks. If economic conditions change significantly, it would be possible to revise this target, but this would require a careful assessment of the potential benefits and drawbacks. We are convinced that it will be impossible to get out of the dogma, at least as long as the risks of structural inflation remain in place.

There is no one-size-fits-all solution to these challenges and the best path will depend on the specific circumstances of each economy. Decisions taken today will have repercussions on tomorrow's economy, which is why it's crucial to maintain an open and informed debate on these issues.

FOCUS #03

ARE YOU MORE OF A FOX OR A HEDGEHOG REGARDING YOUR FORECASTS?

*By **David Autin**, Fund Manager, Richelieu Gestion*

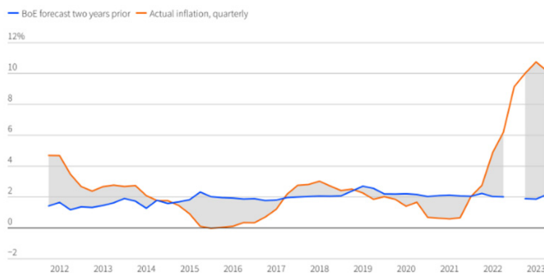
FOCUS #03

The list of forecasting errors in the economic and financial world is growing daily. Last May, the powerful central bank of England publicly admitted that 'major lessons were to be learned' from the failure to model inflation and its persistence.

This is not insignificant in a central bank's quest for credibility. And that thinking of consensus forecasts on annual nominal growth in Europe, which has approached +8/+10% on average for 15 years, while the reality (year end) is between 0 and 1%. These forecasts, often presented with an accuracy that far exceeds their true reliability, can give investors a false sense of security and bias capital allocation. Still in May, the consensus of financial analysts covering Nvidia raised its revenue forecasts by almost 50% (from $7 billion to $11 billion) and profits by almost 100% for the current quarter! 'Crowd wisdom', represented by a sample of 57 research offices covering the facts and gestures of this 'mega cap', really underestimated this 'home run'. As Yogi Berra summarised: 'it's tough to make predictions, especially about the future'. And we would happily knock this door down by adding that the longer the time horizon the more the forecast deviates from reality, even though equity investment is based on the development of companies' long-term fundamentals.

Differences between projections and real inflation figures by BoE

Source: Berenberg, AF Alias, Breakingview, June 2023



Note: Series excludes Q2 2020 when the BoE did not produce projections due to the Covid-19 pandemic

Expected nominal profit growth at the beginning of the year in Europe

Source: Bernstein, MSCI, IBES (18/01/2023)

What does some research work on forecasts say?

While we focus on estimates for listed companies, many studies have looked at the accuracy and reliability of financial analysts' forecasts. These studies highlight that, while these can offer useful information, they are far from infallible and can be affected by a range of factors, from analyst experience to corporate transparency policies.

These statements can be seen in these three papers:

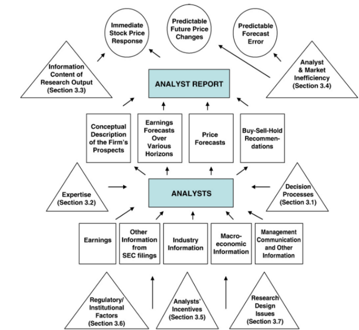
- Gong, Louis, and Sun (2008, Analysts' Forecast Accuracy and Corporate Policies): this study suggests that corporate communications can influence analysts' forecasts and their accuracy. In practice, analyst consensus forecasting differs little from corporate guidance;
- Almeida and Gaspar (2020, Accuracy of European Stock Target Prices): one of the main conclusions is the observation that the price target defined by sell-side financial analysts for 12 months between 2004 and 2019 on the first 50 European caps did not have predictive value in the future direction of the stock market price;
- De Silva and Thesmar (2023, Noise in Expectations): forecasts may vary depending on the information available and selected, cognitive biases (some of which may be corrected), and the impact of noise in expectations (or random fluctuations in forecasts).

As this graph shows, forecasts are based on a multitude of variables and assumptions, which are inherently unpredictable and can be mutated at any time. An unexpected economic crisis, war, or natural disaster radically changes the situation, as we have seen in recent years (Covid, Russia-Ukraine, etc.).

In addition, forecast credibility largely depends on who establishes them and how, as well as the cognitive biases commonly cited:

Factors that can influence analyst forecasting

Source: The financial analyst forecasting literature, Ramnath, Rock and Shane (2008)



- Confirmation bias: this is the tendency to favour information that confirms our own beliefs, while ignoring or minimising information that contradicts them. For example, an investor could pay more attention to positive news about a company in which they have invested, while neglecting negative news;

- Overconfidence: some investors may have excessive confidence in their own forecasting abilities, leading them to take excessive risks or neglect red flags;

- Anchoring: this is the tendency to stick to a specific value or information when making decisions, even if it is no longer relevant;

- Recency effect: investors may place too much emphasis on recent events and extrapolate these recent trends in the future.

All these biases can have a negative impact on estimate quality and, therefore, on the information to be integrated into investment decisions. In short, Professor Elroy Dimson wrote, *'Risk means more things can happen than will happen.'*

How can we minimise this risk of errors?

In their book, Superforecasting: the art and science of prediction, Tetlock and Gardner identified 'superforecasters', individuals who are highly adept at predicting the future. The authors give some keys or avenues to explore, to develop this skill, such as:

- Probabilities: it is important to reason in terms of probabilities rather than the absolute. Superforecasters avoid making categorical predictions, instead they strive to assess a range of possibilities and assign probabilities to them;

- Updates: forecasts, like the economy, are not static. Forecasts need to be constantly updated as new information becomes available. This is the Bayes' principle according to which each new piece of information is used to update previous forecasts;

- Critical thinking: you need to be open to new ideas, ready to change your mind, and actively seek information that could contradict current beliefs. In other words, being able to hear divergent opinions and use them to fine-tune forecasts.

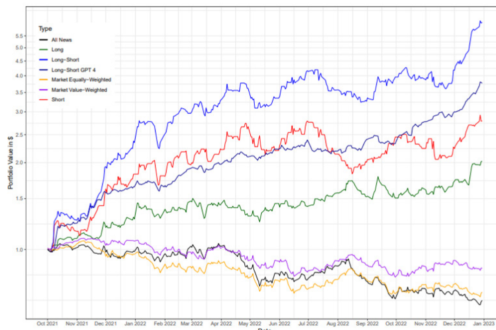
The authors emphasise that these techniques require practice, patience, and a good dose of humility.

Will generative AI that has been accessible to all for a few months save us?

It would have been difficult not to mention the elephant in the room, namely generative AI. A recent paper by Lopez-Lira and Tang[1] discusses a subject that is probably simpler, but gives an idea of what is possible. The authors examined the potential of ChatGPT and other Large Language Models (LLMs) in predicting stock market returns using language nuances or sentiment analyses from written text in articles, press releases, and publications related to listed companies. After analysis, the tool decides to buy or sell shares, at a daily frequency. The exercise therefore differs somewhat from the determination of future quantified figures, but the aim (purchase and/or sale) is similar to that of investing. In this exercise, the most successful version of ChatGPT, the 4, is proving effective as illustrated by the graph below.

Cumulative returns from various strategies based on ChatGPT4 decisions (excluding transaction costs)

Source: Can ChatGPT Forecast Stock Price Movements? Return Predictability and Large Language Models, Lopez-Lira and Tang, May 2023



The midnight blue line, the best-yielding blue line, is an equally weighted portfolio that buys securities publishing positive news and sells securities with negative publications. It should be pointed out that the returns generated remain theoretical, as returns do not include transaction costs, nor the impact of the transactions (purchases or sales) on market balance. There is no doubt that these tools will expand and be enriched with new data that can, this time, lead to reliable... and quantified forecasts.

Fox or hedgehog?

Looking forward to two thousand years, the ancient Greek poet Archiloqua said: 'The fox knows many things, but the hedgehog knows one big thing.' This parable was used by the 20th century philosopher Isaiah Berlin to distinguish between two types of thinkers, the fox and the hedgehog, a concept that can be applied to various fields, including financial and economic forecasts. According to this parable, foxes are people who know a lot, i.e. who obtain information from various sources and use a variety of strategies to understand the world. Hedgehogs, on the other hand, know one thing deeply, i.e. they have a master idea or a unifying vision that guides their understanding of the world.

In their book on superforecasting, Tetlock and Gardner tend to suggest that 'foxes' are generally better forecasters because they are more open to uncertainty, more willing to adjust their beliefs in response to new information, and less likely to fall into the trap of overconfidence. However, the distinction between foxes and hedgehogs is not always clear and many forecasters may have characteristics of both.

This conceptualisation of fox and hedgehog can also be applied to investors using (or not using) forecasts. A fox could be George Soros who, known for his 'reflexive principle', is often willing to challenge his assumptions and adapt his strategy accordingly. Or Ray Dalio, founder of Bridgewater Associates and famous for his holistic approach to investing which encompasses various asset classes, multiple strategies, and the systematic application of rules and algorithms. Or Jim Simons, the mathematician and founder of the Renaissance Technologies fund, who uses a variety of complex quantitative approaches to take advantage of market anomalies.

In contrast, the legendary partners of Berkshire Hathaway, Warren Buffett and Charlie Munger, are generally considered hedgehogs. Both adhere to the investment philosophy of 'value investing' and focus on the quality and understanding of corporate fundamentals and intrinsic value when making investment decisions.

While the stock market may be impacted by expectations, it is important to note that it is also influenced by investor behaviour. Their actions can be unpredictable as they are driven by fear and greed, resulting in asset prices diverging from their fundamental value. So the 'right' forecast does not necessarily mean a 'right' decision or a 'right' stock price response. And then, although it is important to improve your fox or hedgehog profile, you must differentiate this skill... from luck[2].

....

Sources:

[1] Lopez-Lira and Tang (Can ChatGPT Forecast Stock Price Movements? Return Predictability and Large Language Models, May 2023)

[2] Michael Mauboussin: 'Untangling Skill and Luck in Business, Sports, and Investing'

FOCUS #04

PRESENCE OF OIL STOCKS IN SUSTAINABLE FUNDS: WHY AND HOW?

*By **Stanislas Duval De La Guierce**, Sustainable Finance Manager*

FOCUS #04

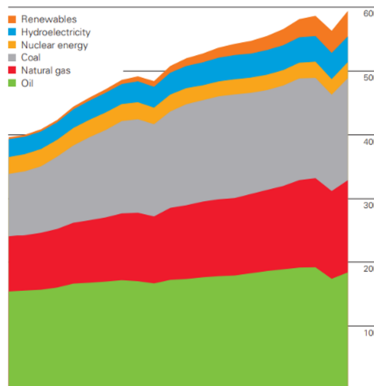
Numerous reports, including that of the IPCC, confirm that climate change is unprecedented, and that the role played by human activity is indisputable. Since the Paris Agreement at COP 21 adopted in 2015, all signatory countries have been planning their greenhouse gas emission reductions. These emissions come from primary energy sources, of which oil and natural gas are the most polluting, just after coal.

This agreement has put the spotlight on sustainable finance; the number of 'sustainable' assets has increased, as well as the implementation of multiple regulations. 'Sustainable' or 'ESG' (Environmental, Social and Governance) investment funds have gained momentum over the last decade. Their names indicate that they invest in companies that respect the environment without forgetting the social impact, so as to be aligned with climate objectives. At first glance, the presence of oil companies in these funds seems contradictory. There are, however, some nuances that come up against reality. **Indeed, in order to meet emission reduction targets while maintaining economic and social stability, we are talking about a transition to a more sustainable world.**

This nuance between alignment and transition can be found in European regulations, for example in the two types of European climate index. These are called 'Paris Agreement' indices (PAB), which exclude companies exposed to fossil fuels, and 'Climate Transition' indices (CTB), which include them. The regulations therefore imply that oil industry companies cannot be aligned with the Paris Agreement, but, for economic and social reasons, can participate in the transition.

Transition: environment vs. social vs. economy

This transition comes up against many opposing environmental, social and economic considerations. We need to strike the right balance between meeting rising global energy demand and solving the environmental and social problems caused by fossil fuels, which are currently the main source of energy. Worldwide, they account for 82%[1] of primary energy sources, including 31% oil and 24% natural gas.



World consumption
Exajoules

Source: BP Statistical Review of World Energy, June 2022

These fossil commodities are mainly extracted for energy purposes, but not exclusively. For example, 86%[2] of crude oil is used for fuels (diesel, kerosene, etc.), while the remainder is used to produce plastics or asphalt.

As a result, without a controlled transition, rising demand and the restriction of fossil fuels will drive up prices, and households, especially the poorest, will suffer.

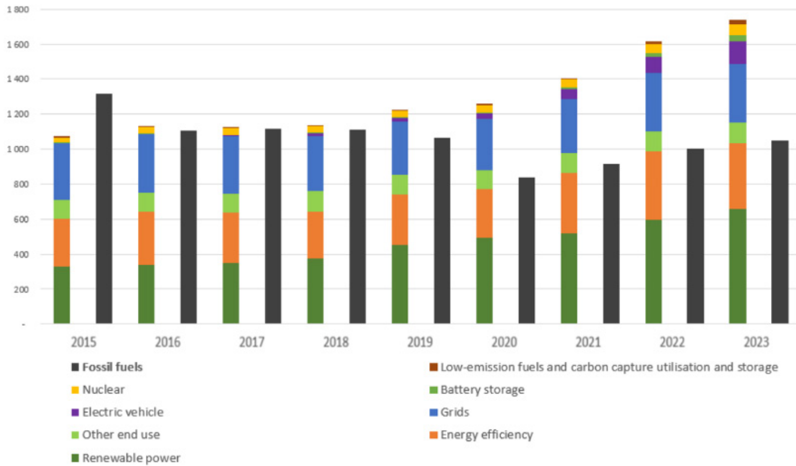
Adaptation and geopolitics

Adaptation is also necessary for two closely related reasons: geopolitics and resource depletion. For the latter, we speak of an oil peak. This is the peak of the global oil extraction curve. Estimates of global peak oil are regularly updated by specialised research organisations. This is due to the gradual discovery of new deposits. Some of Europe's supplier countries have already peaked, such as Algeria in 2007[3]. The Old Continent is the world's third largest consumer by volume, behind China and the US, as well as the world's largest importer of crude oil. This situation can be explained by both the number of inhabitants and the level of economic and industrial development. This is how geopolitical issues come into play, most recently with the Ukrainian conflict. In 2020, Russia supplied 29%[4] of all oil imported by the EU. Even today, despite the sanctions, the EU continues to import oil from Russia.

All these challenges are triggering a wave of financing both in fossil fuels (finding and exploiting new deposits) and in green energies (the famous transition). The oil and gas majors are reportedly developing 195[5] 'carbon bombs' that would shatter climate targets. At the same time, investment in 'green' energies, in part by oil companies, is increasing rapidly. On a positive note, the International Energy Agency (IEA) estimates that by 2023, investment in solar energy should outstrip that in oil. It should also be noted that the falling cost of renewable energies[6] makes them more competitive. IRENA estimated that, given fossil fuel prices, the lifetime cost per kWh of new solar and wind capacity added in Europe in 2021 would be on average at least four to six times lower than the marginal production costs of fossil fuels in 2022.

Annual energy investment, 2015-2023, in Billion USD
Clean energy VS Fossil fuels

Source: World Energy Investment 2023



The 'best in class' strategy

All these issues have an impact on oil stocks, which begs the question: how are they taken into account in sustainable finance?

The inclusion of oil stocks in ESG investment funds may vary according to the specific criteria used by each fund. Some ESG investors may exclude oil companies altogether because of their environmental and social impacts, as is the case for those wishing to follow the Paris Agreement, while others may include them in their portfolios because of their efforts to transition to more sustainable practices.

They use a so-called "best in class" strategy. It consists of giving preference to companies with the best extra-financial ratings within their sector of activity, in relation to the defined investment universe. Frequently used by French managers of SRI (socially responsible investment) funds, it enables them to avoid excluding or favouring a given sector. **Ratings are based on multiple sources, including company declarations and reports (CSR policies and reports), plus malus depending on controversy. Corporate transparency therefore plays a key role in the value of ratings.**

This SRI strategy answers the question: which oil companies are best prepared to adapt to the transition to a more sustainable world?

Ratings are based on the environmental, social and governance pillars. The extra-financial rating agencies that produce them do not have the same calculation methodologies, but, on the whole, they arrive at a similar hierarchy of oil companies. There are three regions: Europe, North America and other oil superpowers (Russia, China, and Saudi Arabia).

ESG

With regard to the Environment pillar, several distinctions between regions are highlighted. Thanks to stricter regulations in Europe, European stocks are tending to become more committed to and involved in various environmental issues. Pollution management with regard to transport and extraction structures, and biodiversity protection top the list. These policies and commitments are challenged by controversies, particularly over water management, which is one of the most common.

One difference concerns the extraction type. European stocks use less non-conventional extraction in total proportion[7], which is generally more costly and more polluting than conventional oil extraction. For example, oil sands extraction involves removing layers of soil and sand to access bitumen, which is then separated and processed to obtain oil. Similarly, extracting shale oil requires fracking techniques (hydraulic fracturing), which are also costly. The latter is widely used in the US. Some oil companies use fracking almost exclusively, such as Devon Energy Corporation, where fracking accounts for 96% of its total production[8].

Investing in renewable energies is one of the most popular solutions for European stocks, helping them to make the transition to a low-impact economy. Most companies have started producing biofuels, but it's mainly European stocks that are investing the most in renewable energies such as solar and wind power. For example, French giant Total Energies is ahead of its European rivals ENI, Shell, and BP in the renewable energy race. The giant claims to have a total of 10 gigawatts (GW) of net installed renewable energy capacity as at the end of 2021, with a target of 100 GW[9] by 2030. In comparison, BP has a capacity of 3.3 GW and is aiming for 50 GW[10] for 2030. By way of comparison, US oil companies are investing less in renewable energies, with ExxonMobil focusing on biofuels[11] and carbon capture technologies for the time being.

From a Social point of view, regulations in different geographical areas highlight the differences. As a result, issues such as transparency of operations, health and safety standards, and social responsibility towards local communities appear to be more advanced among European companies. The way in which these standards are implemented and followed may differ. European companies have often been at the forefront of the adoption of stricter safety and accident prevention standards. As for US companies, they have also invested in these areas, but may present certain variations depending on the specific regulations in each state. Oil companies may operate in politically unstable geographical areas. This exposes companies to controversy, particularly when it comes to human rights.

Differences within the Governance pillar are smaller. Oil companies have a solid governance system. **Controversies tend to focus on corruption, anti-competitive practices and lobbying.**

And the winner is?

The extra-financial rating agencies therefore place European oil stocks above all others. Despite this, major efforts are still required, such as aligning their scope 3 emissions with the Paris Agreement.

In order to meet the Paris Agreement objectives, the transition must be accelerated. As a result, oil stocks are among the most exposed to physical and transitional risks. Asset managers, whether SRI or not, are being called upon, particularly in Europe, to integrate these climate risks into their risk management as part of their fiduciary duty. Another tool used by managers to manage these duties is shareholder engagement.

Engagement

The presence of oil companies in sustainable funds creates a dialogue. The role of shareholders is to push companies to make the transition to meet climate objectives, without neglecting the social aspect.

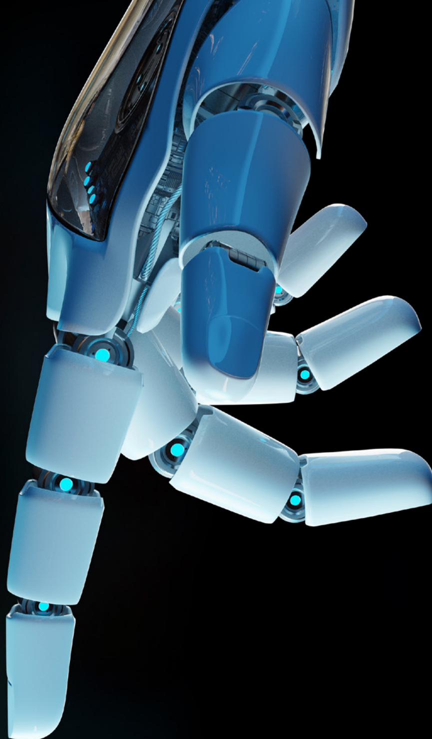
In 2023, there will be an increase in the number of climate resolution filings known as *'Say on climate'* at general shareholders' meetings, as well as social resolutions. Whether initiated by the company itself or by a coalition of shareholders. This is the case for Chevron[13], where the general shareholders' meeting on 31 May 2023 will consider five shareholder proposals on environmental issues and one on social issues. At the meeting on 26 May, Total Energies also tabled a climate resolution of its own, and an advisory resolution was tabled by the activist shareholder group Follow This. The first was approved by 89%[14] while the second, with 30% of the vote, was rejected.

Conclusion

Far from being universally accepted, the transformation of oil stocks plays a key role in the fight against climate change. There are still areas for improvement and opportunities for sustainable funds, such as more green bonds from the oil industry.

Sources:

[1] BP Statistical Review of World Energy, June 2022
[2] Canadian Association of Petrolum Producers (CAPP)
[3] The shift project: future oil supplies for the European Union
[4] Eurostat data
[5] The Guardian
[6] International Renewable Energy Agency (IRENA)
[7] GOGEL list from Urgewald
[8] GOGEL list from Urgewald
[9] Total Energies website
[10] BP website
[11] Moody's ESG Solution
[12] Moody's rating / Sustainalytics / MSCI / S&P / Bloomberg
[13] ISS
[14] La Tribune



FOCUS #05

SHOULD WE BE AFRAID OF AI IN PORTFOLIO MANAGEMENT?

*By **Nicolas Touvet**, Discretionary Portolio Manager, Richelieu Gestion*

Artificial intelligence is already present in many fields, including voice assistants and chatbots for client communication, search engines and product recommendations for online commerce, autonomous vehicles for transportation, surveillance systems for security, image recognition for healthcare, financial services for fraud detection and risk analysis, recommendation systems for entertainment and media...

These examples are just a small part of the areas where AI is already present and expanding. **But, since November 2022, in a free, non-internet connected version, through ChatGPT, developed by the start-up OpenAI and enjoying wide media exposure, artificial intelligence has entered the public domain.** What about the portfolio management field?

Artificial intelligence (AI) is having an increasing influence on management decisions in the stock market. AI algorithms can help analyse massive amounts of financial data in real time, detect patterns and trends, identify trading opportunities and optimise investment decisions.

The use of AI for portfolio management and investment decision making has increased dramatically in recent years. Large financial institutions use algorithmic trading systems to execute transactions at high speed and with great accuracy. Portfolio managers can also use AI algorithms to optimise their portfolios, based on their goals and risk tolerance.

AI can also help predict future business performance by analysing financial data and market trends. Machine learning models can identify factors that affect a company's financial performance and predict how it will behave in the future, but they can also be influenced by biased data or unforeseen events that are not accounted for in the model.

AI therefore has an increasing influence on management decisions in the stock market. **While it offers many benefits, it also presents risks and regulatory challenges.** Investors and portfolio managers must therefore be aware of these risks and ensure that AI is used responsibly and ethically in their investment decisions.

Can AI predict everything?

No, don't we say that there is no such thing as a martingale in the stock market? (See insert). While AI is capable of processing massive amounts of data and detecting patterns that can help predict future trends, it cannot predict the future with absolute certainty!

Machine learning models used in financial applications can be influenced by historical data that may not reflect future events. In addition, economic, political, and social factors can change rapidly and unpredictably, making it difficult to predict long-term trends.

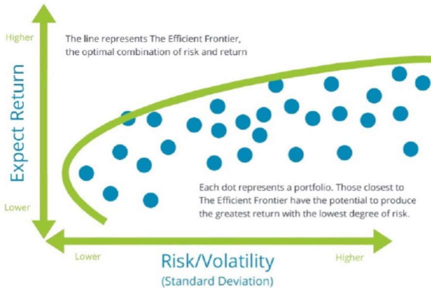
In addition, investment decisions can be influenced by factors that cannot be easily quantified or measured, such as consumer trends, a company's reputation or changes in government regulations. **Ultimately, AI can provide useful information and insights to help make investment decisions, but it cannot completely replace human judgement and experience.** Investors and portfolio managers should therefore use it with caution and with an eye to the limitations of the technology.

A martingale is a gambling or investment strategy based on the idea that previous outcomes of a random event have no bearing on future outcomes. In other words, a martingale assumes that if you keep betting on the same random event with the same bet, you will win sooner or later...

For example, let's say you're playing roulette and you always bet on red. If you use a martingale strategy, you would double your bet every time you lose until you eventually win. This strategy is based on the assumption that if you play long enough, you will eventually win, and that your winnings will offset any losses you have incurred up to that point.

It is important to note that this assumption is false in many cases, as random events can be influenced by external factors such as chance or systematic errors. As a result, martingale strategies can often lead to significant losses if used carelessly.

Already in its time, **the 'modern portfolio' theory, a financial theory developed in 1952 by Harry Markowitz,** could be used to optimise the allocation of an investment portfolio by maximising the expected return while minimising the risk.



This model does not directly predict stock price movements, but rather uses historical data on the returns and risks of different financial assets to calculate the correlations between these assets and construct a diversified portfolio.

The Markowitz model is a proven method for building well-diversified and balanced portfolios, **but it does not guarantee a positive return or protection against market losses.** Indeed, the real performance of a portfolio depends on many factors, such as economic conditions, market trends, geopolitical events, increasingly unfathomable monetary policy decisions, or an unexpected corporate governance event. **It should also be noted that this model is based on simplifying assumptions, such as the normality of return distributions and the absence of transaction costs.** These assumptions may not be fully realistic in practice, which may affect the actual performance of the portfolio.

The Markowitz model is therefore a useful method for constructing well-diversified portfolios, but it cannot directly predict the evolution of the stock price. This leads to the same conclusion as with artificial intelligence: **investors should use this method in combination with other analyses and their own judgement to make informed investment decisions.**

Is the human being still indispensable to manage a portfolio?

While AI can provide useful analytics and insights to help make investment decisions, **the human being remains indispensable to manage a portfolio in a global way.** Investing is a complex and evolving business, and portfolio managers must use their judgement and expertise to evaluate and take into account a variety of non-quantifiable factors, such as a company's reputation, consumer trends, macroeconomic factors, and geopolitical events.

In addition, client relationships are an important aspect of portfolio management, and it is essential to understand each client's needs and objectives in order to provide personalised advice and solutions. **Ultimately, AI can be a valuable tool to help portfolio managers make informed investment decisions, but it cannot completely replace human expertise and experience.**

What about algorithmic trading in all this?

Algorithmic trading is a common practice in the financial markets, where computer algorithms are used to make automated trades. Algorithms can be designed to make buy or sell decisions based on criteria such as market trends, price patterns, economic news and technical indicators.

Algorithmic trading is becoming increasingly popular due to its potential benefits, including speed, efficiency and accuracy. Algorithms can trade at a much higher speed than humans, which can be an advantage in a market where price fluctuations can occur in milliseconds. In addition, algorithms can analyse complex data in real time and make trading decisions accordingly, which can lead to better performance than manual trading.

However, this type of trading can also be risky. Algorithms can be subject to programming errors or bad data, which can lead to significant losses. Algorithmic trading can exacerbate market movements when a large number of algorithms react to the same market events simultaneously, which can lead to significant volatility effects.

Ultimately, algorithmic trading is a common practice in the financial markets, but it is important to understand the benefits and risks before deciding to use it. Investors should be aware that this type of trading is not infallible and that it is important to constantly monitor the performance of their trading strategies.

Ultimately, the manager remains at the heart of the client relationship...

While AI technologies can provide valuable insights and analytics, they cannot replace the value of a trusted human relationship.

Portfolio managers play an important role in managing client expectations, communicating risk and assisting with investment decisions. Clients may have different needs and specific investment objectives, which require a personalised approach to managing their portfolio.
The portfolio manager can help clients understand the risks and rewards of different investment strategies, determine their risk tolerance and identify appropriate investment objectives. The manager may also provide advice to adapt the investment strategy to changes in the market and the client's needs. **Ultimately, the relationship between the portfolio manager and the client is based on trust and open communication.**

There are many statistics and figures that support the importance of the client relationship in portfolio management and the impact of AI on management decisions in the stock market. According to a 2019 Deloitte study, 60% of online investors surveyed said they would rather work with a financial advisor than use an automated online portfolio management platform, that was 4 years ago! And according to a 2020 Capgemini study, 78% of private banking and wealth management clients said relationships with their advisor were important to them. Finally, algorithmic trading accounts for a significant portion of the volume of transactions on the financial markets. According to a report by the Association for Financial Markets in Europe (AFME), algorithmic trading accounted for 40% of total trading volume in European markets in 2018. In the US, it accounts for approximately 60-73% of global US equity trading (source: Wall Street).

This data suggests that while AI and algorithmic trading technologies are becoming more prevalent, many clients still value the human relationship with their financial advisor and that is a good thing!

FOCUS #06

FAMILY BUSINESSES AND ESG: CHAMPIONS OR PARIAHS?

*By **Clémence de Rothiacob**, Richelieu Family Fund Manager*

As a preamble, we feel it is appropriate to point out that it would be difficult to highlight one or another ESG ranking of family businesses, as the extra-financial rating of a company depends on the criteria used and their weightings, which differ from one rating agency to another and would therefore be a source of confusion.

Indeed, since there is sometimes only a weak correlation between the ESG ratings of the different rating agencies, it seems to us to be of little relevance to favour one or the other. This is also why, for our fund invested in family businesses, Richelieu Family, we have opted for our own methodology, developed by us with the help of experts, **to adapt to the specificities of family businesses.**

In addition, the ratings of family businesses should also be differentiated according to their size of capitalisation. Indeed, due to a lack of data (most often due to a lack of resources) and not to a lack of compliance, small and medium-sized companies are sometimes poorly rated, and family businesses are no exception to the rule. A poor rating should not be attributed to their family nature but sometimes to their status, knowing that the majority of listed family businesses are SMEs.

On the other hand, in terms of stock market performance, studies, based on factual elements, converge, demonstrating the long-term outperformance of family businesses (see Credit Suisse, Sept. 2020). **We who are convinced of the causal link between strong ESG ratings/ absence of serious controversies and long-term performance** see, in the long-term stock market outperformance of family businesses, a possible **consequence of their solid treatment of ESG issues.** Family businesses are already champions in the rankings when it comes to fundamental criteria such as balance sheet strength, sustainable growth, profitability and investment in innovation.

Family businesses have, by nature, a strong environmental and social orientation

Let's not forget that the notion of **sustainability** is at the heart of the economic model of family businesses and their mission, since the transmission of the business to future generations is their primary vocation. They take a long-term perspective in most of their decisions and feel responsible for their commitments to their stakeholders.

Favouring long-term value creation over short-term profits, companies are naturally and pro-actively organising themselves to best meet ESG and sustainability requirements. Contrary to certain preconceived ideas that family-owned companies are 'lagging behind' and less inclined to change, academic studies show that they have been working harder than their non-family-owned competitors for more than eight years to improve their ESG criteria (see Credit Suisse, Sept. 2020).

The social issues at the heart of their mission

When we talk about family businesses, **the affectio societatis** that they generate is rightly highlighted. There is often a positive feeling of belonging to the family company on the part of its employees, the awareness that having an embodied shareholding is beneficial, the image of a more human capitalism is often evoked.

The evidence is that family businesses often have lower employee turnover than other businesses (see Harvard Business Review, March 2019 'the turnover rate for a non-family business is 11% compared to 9% for family businesses'). These companies are also at the top of the 'best workplaces' rankings drawn up by business schools, which give priority to the quality of life at work (every year, Michelin, Wavestone, Décathlon, Dassault Systèmes, Hermès and L'Oréal, among others, are cited). It also appears that during the health crisis, family businesses were more supportive of their employees.

The environmental issue at the heart of their agenda

Family businesses are often aware of their **need to set an example, if only to avoid any reputation risk that would taint the family,** which often participates in a whole local ecosystem.

They take environmental issues very seriously, which are crucial to their survival, and this in the highest places. At LVMH, for example, it was Antoine Arnault who very early on took charge of the company's Corporate Social Responsibility (CSR) policy, ensuring that the group's roadmap and its environmental commitments were communicated and applied.

We believe it is crucial that these emblematic family businesses are pioneers in these issues, that they lead the way and show smaller family businesses the importance of putting Sustainable Development at the heart of their long-term perspectives.

The great challenge of family business governance

It is on the criterion of governance that family businesses are regularly attacked by the rating agencies. Governance is thus their Achilles heel, where the problem lies.

They are often **perceived as having weak governance structures:** rating agencies criticise the lack of independence within their Boards of Directors and therefore the absence of countervailing power to defend the interests of minority shareholders, and the fact that the functions of Chairman and CEO are often the prerogative of family-owned companies. Added to this is the fear of exaggerated remuneration of family managers.

Nevertheless, we question the relevance of these criteria. Are they so decisive in assessing governance? Since sound corporate governance is undoubtedly necessary to create long-term value, **how can we explain that family businesses outperform over the long term if their governance is deemed to be far from good practice?** If we go into more detail, we can also observe that returns on capital employed (ROCE) are better in family businesses (see Credit Suisse): isn't that the consequence of good governance?

Isn't the judge of peace that, creating value and being sustainable? Shouldn't the rating agencies revise their criteria when it comes to a family business which has specificities intrinsic to its status?

For example, one of the things we like about a family business is the long-term vision of the family members: why then judge it on the number of self-employed people on the board of directors (the rating agencies recommend 50% self-employed people), self-employed people who might be less inclined to deploy a long-term vision? In addition, noting the independence of the board seems justified by its link to better financial discipline. Yet, this is a quality that is specific to family businesses, despite the fact that the board of directors is mostly family-owned! It is precisely because they take a long-term view that family businesses are **more orthodox than others in terms of balance sheet strength***, which is **key to capital preservation.** What we value when we analyse the composition of a Board of Directors or Supervisory Board is above all the **real added value that a member will bring to the Board and not whether or not they belong to the family.**

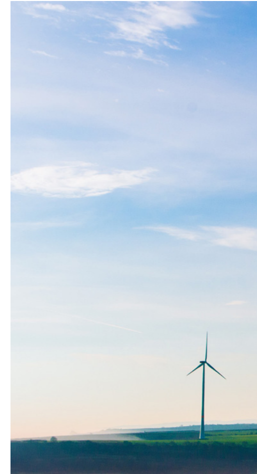
In our opinion, the independence of the Board is not an essential qualitative criterion; on the other hand, the independence of the other committees (nomination, audit, and remuneration) seems, to us, to be much more relevant, and the practices of family businesses in this area do not differ much from those of non-family businesses. Moreover, we, who systematically vote at the AGMs of the companies in our portfolios, pay particular attention to **the remuneration of corporate officers** and have no reason to report excessive remuneration in family businesses: they follow, at least for those listed on the stock exchange, market standards. In any event, **the independence of the remuneration committee** should be monitored.

For a listed family business, there is an **alignment of the interests** between the family corporate officers and the minority shareholders towards a sustainable increase in the share price. Moreover, aren't public companies inspired by this to motivate their managers in the long term, since they multiply stock option plans that make their managers shareholders?

**cf. Credit Suisse study comparing 10 years of Net Debt/EBITDA ratio of family businesses versus non-family businesses*

More work to be done in some areas

There are, however, a few caveats to be made, areas in which family businesses still have some way to go to be exemplary. Asymmetric treatment of shareholders is one such issue. Families may tend to set up special legal structures to maintain control. The dual share class (ordinary and preference) is widely used by more than 20% of listed family businesses and is notably the speciality of Swiss and German family businesses. Extra-financial rating agencies value, and rightly so in our opinion, a pari passu treatment of minority shareholders, the overriding principle being 'one share one vote'. To ensure that the interests of the company do not take precedence over those of the family, an in-depth analysis of the corporate culture and of any controversies that may arise is essential.



Another special legal structure, the status of limited partnership with shares, is also a prerogative of family businesses in Germany (Merck, Fresenius, or Henkel) and in France (notably Michelin, Hermès International, Bonduelle, or Lagardère in its time). The managers have broad powers to govern the company, in exchange for liability on their personal assets. Hermès International justifies its legal form (SCA since 1990) by the need 'to preserve its identity and culture and thus ensure the long-term survival of the company, in the interests of the group and all its shareholders'. The stability of family businesses, necessary for a long-term strategy, is at stake. It is an anti-hostile takeover shield that will allow the company to avoid dispersing itself by defending itself against predators.

The influence of long-term shareholders is often perceived as an asset that should be favoured in voting policies (as opposed to the decisions of short-term shareholders, notably pure financial speculators), and many Think Tanks are pushing for an acceleration of regulations in this sense. Among the recommendations of the PRI (Principles for Responsible Investment), in the Practical Guide to Active Shareholding, it is indicated that 'the new version of the European Union directive on shareholders' rights (...) also recognises that shareholders can exert short-term pressure on the companies in which they invest, at the expense of long-term value creation and ESG issues'. They also state that it is interesting 'to strengthen the loyalty of long-term investors', which are the family shareholders!

Nevertheless, opinions differ, with some believing that short-term objectives, which are so important in the stock market since results are published quarterly, may be sacrificed by family businesses in favour of the long term, and thus minority shareholders who cannot afford the patience of a founding family may be harmed, particularly if they hold shares without dividends or voting rights to make their voices heard.

In addition, there are also issues specific to family businesses, such as the question of harmony within the family which must be the object of constant attention and a clear formalisation of the roles of each one at the risk of an imbalance of the motivations of the members of the family (around the questions of the employment of certain members and the policy of distribution of the dividends in particular), of dissidence at the time of the successions, of risk of dynastic temptation, etc.

Family businesses thus have specific characteristics that invite us not to be dogmatic when assessing their extra-financial characteristics. Even if, as we stated in the preamble, it is not easy to generalise ESG ratings, it is interesting to note that some statistics (notably via historical data from Refinitiv analysed by Credit Suisse) indicate that multigenerational family businesses have better ESG scores than newer family businesses. One of the explanations could be that they benefit from more seasoned business models, but also that they have a greater number of young members involved in the company, who are certainly more sensitive to ESG issues. Let's bet that the generation that takes up the torch is certainly the one that will move the lines forward, that will reshuffle the cards, while keeping the strengths and values inherent to family businesses, towards more pro-active initiatives towards sustainability, in order to transform the intention and ambition, clearly identified, into concrete actions.

And the stakes are high because family businesses contribute significantly to the creation of jobs in the world, so they have a leading role to play in Sustainable Development!

INVESTMENT OUTLOOK • SEPTEMBER 2023

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