CHIRON TOTAL RETURN

INVESTOR LETTER – AUGUST 2022

Flexible, with the focus on European markets. This fund can invest in equity and bonds issued by both European and non-European companies and in investment funds, options and futures with a view to protecting portfolio value or increasing the level of investment. Investment decisions are based on in-depth analyses of companies and due diligence on the ground.

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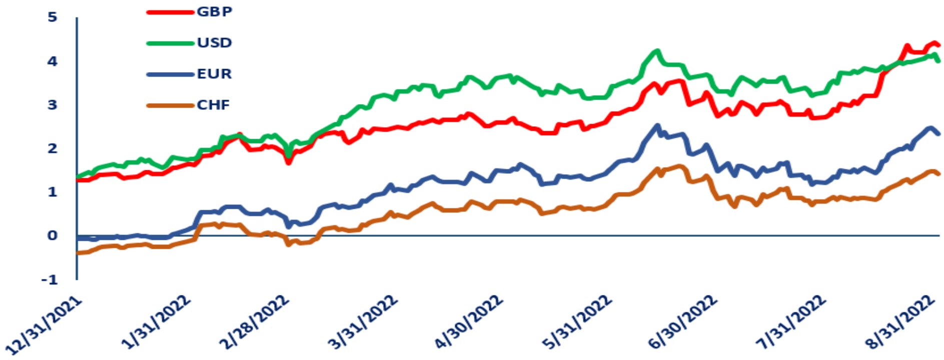
Too early to pivot

Once a year, central bankers from around the world converge to the scenic retreat of Jackson Hole, in Wyoming, where they spend a few days in the mountains sharing their thoughts with colleagues and occasionally broadcasting some medium-term message to investors. In recent years, Fed Chairs have used this opportunity to convey the direction of travel for the rest of the year. Jay Powell did not disappoint his audience, delivering a strong and painful message: the Federal Reserve is firmly focussed on the inflation risk. While being officially guided by a dual mandate (taking care of inflation while supporting full employment), the Fed believes that, in a medium-term perspective, its target is best achieved by bringing down inflation immediately, even though this may request some painful adjustments in the immediate future. To reinforce the message, Powell hinted at the neutral rate (the interest rate that should grant the economy a cruise speed): the current level, using Fed estimates, is not far from neutral, which implies that the Fed must do more to slow down the economy. Inflation, despite slowing, remains too high and economic growth is surprisingly resilient. A new 0.75% increase is very much likely at the September meeting.

Fixed income and equity markets were caught off guard by the aggressiveness of Fed rhetoric: the market was hoping of some sort of Fed pivot, either with rates hikes slowing down or the Fed taking a pause. None of this is likely to happen in the near future. On top of this, the Federal Reserve will tighten its policy even further, with a new round of quantitative tightening (i.e. a further reduction in Fed reinvestment of its bond portfolio).

In the meantime, headwinds continue to depress the chances of economic recovery in Europe:

- Among external factors, we are particularly vulnerable to interruption of gas supplies from Russia. We deem very likely some forms of broad-based state support (in the form of a EU packages). While this should avert a worst-case scenario (such as a -5% GDP recession), an economic contraction appears inevitable.
- Double digit inflation is extending well beyond the energy sector. The unexpected resilience of the labour market has not been able, however, to support real wages (which continue to contract in all the Western world at an unprecedented pace). This dynamic will further reinforce the risk of an economic contraction. However, this phenomenon is likely to take the shape of a slow-burn economic depression (different from the sudden, deep contraction seen in 2008).
- Confronted with double digit inflation, European monetary policy will continue to move tighter and the summer has seen a new round of repricing in the expectations for the next 12 months.



Evolution of 3-months rate expectations, in different currencies

In our view, low earning employees are likely to see a double-digit decline in their real income in the space of a single year: while strikes and protests have been so far manageable, we believe the risk of social unrest is clearly rising. The best-case scenario, in our view, will be socializing the costs at a European level. But we should cautiously expect more negative outcomes, with European political balance being challenged and more political instability.

A slow-burn recession will certainly see an increase in credit risk but should avoid a scenario of mass default. Nevertheless, we continue to see high yield bonds as a challenged asset class. While June and July saw a decline in spreads, we believe the market will continue to trade sideways until we have more clarity about the economic recovery. Spreads tend to experience sharp tighten in the early stage of an economic cycle, but a buy signal always included some positive hint of future recovery: you need to see some light at the end of the tunnel, while today we are firmly driving in complete darkness. Given the attractive level of spreads, we decided to increase our exposure to credit investments less exposed to default risk, such as subordinated bonds issued by top quality financial institutions, industrial hybrid issues. In high yield, we prefer to stick to solid, BB-rated issuers, preferably in stable sectors. Activity during the month of August was fairly light, with limited primary issuance and a generalized lack of liquidity in secondary trading. We took some tactical hedging opportunities in the derivatives space: after a strong tightening in Italian BTP spreads, we entered a hedging position, ahead of the elections; from a financial perspective, we don't see any particularly negative outcome in the Italian elections, but some volatility should be expected in the next 2 months. With the 10-year Bund-BTP spread moving to the high end of its recent range (230), we decided to take profit.

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