Investment View

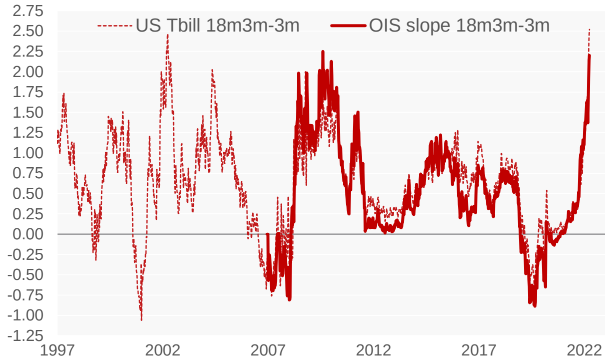
Mission Impossible

March 30, 2022

Our Investment View provides our quarterly macro & market outlook and investment implications

- The Russia-Ukraine war has exacerbated two of the key risks we had identified for 2022: much higher energy prices and tougher central banks.
- The latter have been handed a "mission impossible": bringing unacceptably high inflation rates down, without causing a hard landing. This will be a very difficult task indeed, considering the other economic headwinds coming from falling purchasing power, much lower confidence levels and deteriorating financial conditions.
- We expect central banks to slightly undershoot ambitious market pricing, given our relatively soft economic views.
- We recommend reducing the cyclicality of portfolios and turn very selective in picking risk assets. We stay overweight Credit, following the relatively large increase in EUR IG spreads and more generous carry, but do that through defensive strategies. In contrast we see little value in chasing the March equity market rebound at this level of valuation; the sharp fall in equity volatility relative to bond volatility is not sustainable. We stay short Govies and duration, but much less so following the sharp increase in yields.

US money market slope



Source: Bankrate.com, Bloomberg

CONTENT

MISSION IMPOSSIBLE

Vincent Chaigneau

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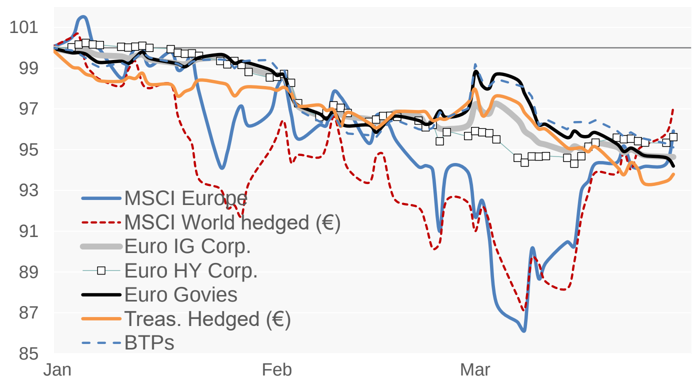
A tough year for balanced portfolios

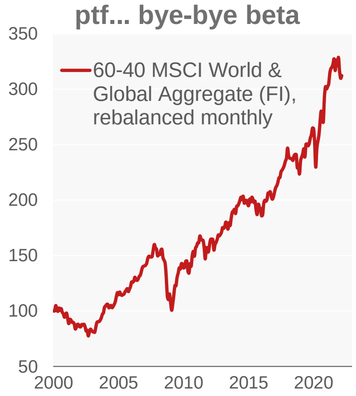
When risks materialise. Our 2022 Outlook, "Bye-bye beta" warned about poor beta performance this year, and among the key risks we highlighted both a disorderly energy transition leading to a surge in energy prices and a much sharper hawkish turn from central banks. Both risks have materialised, making financial returns in core asset classes even weaker than expected. The Russia-Ukraine conflict has been the key surprise factor, along with persistent upside inflation surprises. Graph 1 shows that performance among key stock and bond indices has been relatively uniform, poor that is, though equities have been staging a remarkable come-back in the last three weeks of March, partly on rising cease-fire hopes. The drawdown recorded in a typical 60-40 global stock-bond portfolio stands around -5% for Q1 – challenging for traditional asset managers, but less than half of that recorded in early 2020 (Covid-19). What is far more impressive however is the historical drawdown in the US Treasury Bloomberg bond index, down by just over 10% from the peak of August 2020 (right-hand chart).

Year-to-date total return (€)



Source: Bloomberg, GIAM calculations

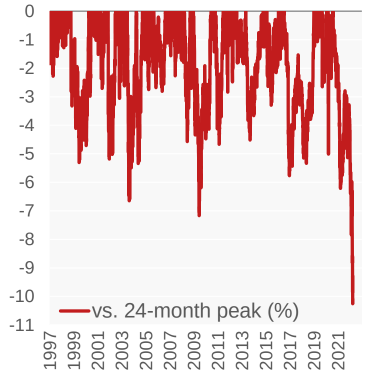
60-40 stock-bond ptf... bye-bye beta



Source: MSCI, Bloomberg, GIAM;calculations

US Tsy index drawdowns

Total Return index, % drop from peak



Source: Bloomberg, GIAM calculations

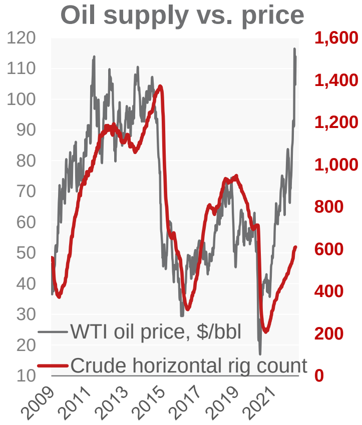
Ukraine - Three scenarios, and a global slowdown

Quagmire the central case. The situation in Ukraine remains very fluid. Our central case assumes a protracted crisis, keeping the country in a state of instability and energy prices at an elevated level. Alternative scenarios cover a very wide spectrum that cannot *all* be scenarized. By and large, the optimistic scenario sees a quick shift to the diplomatic route; while hopes of a military de-escalation are rising, as we go to press, a quick agreement is still not our core scenario. On the other side of our central scenario, the pessimistic one implies an escalation such as the invasion of another country, the usage of unconventional weapons (chemical or nuclear), or some form of third-party support to Russia making the crisis more global.

We cut our EA growth forecast to 2.2%, compared to the ECB's 3.7%

Uncertainty is high, but a sharp slowdown is in the offing. The war has made the forecasting environment far more difficult, and indeed the standard deviation of forecasts has surged. We are taking a rather downbeat view, and more so for the Euro Area (EA), with a 2022 growth forecast at just 2.2%. This is not much at all, considering the 1.9-point carry-over effect. This would prove too low in case of a quick and durable cease-fire. The ECB only cut its forecast by half a point to 3.7% at the March meeting, which is even higher than what we would expect in our optimistic scenario. In our view, the transmission channels are many. The largest one of course lies in the surge of commodity prices, which will impact both global demand (EA consumers fact the worst shock on purchasing power since the launch of the euro) and supply (global supply chain). As the charts below show, the shock is broad-based and not limited to the energy sector. The price of cereals has increased sharply, and the surge of fertilizer prices will cause second-round effects on production costs. Russia is also a large producer of selected base metals, the price of which also reached new record highs around mid-March. Other transmission channels include the negative shock on confidence – which will depend on the duration of the war and inflation itself – and financial conditions. The latter have not tightened as much as in spring 2020 but are now much stricter than at the end of 2021, let alone before the Covid crisis.

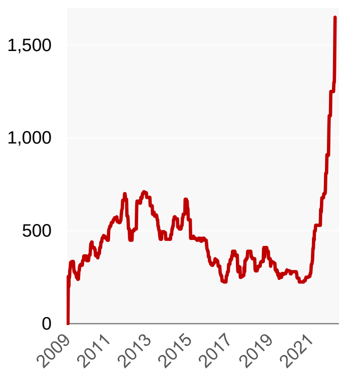
Oil supply vs. price



Source: Baker Hughes, Bloomberg, GIAM

EU fertiliser price

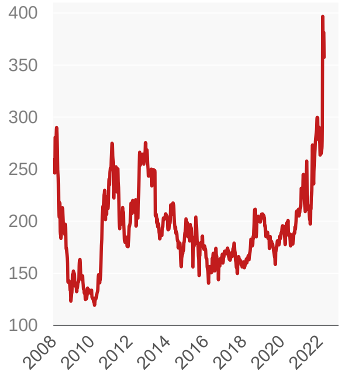
USD/metric tonne



Source: Green Markets, Bloomberg, GIAM

Wheat price

EUR/Metric ton



Source: Bloomberg, GIAM

Base metal prices

BBG index, based Jan. 1996

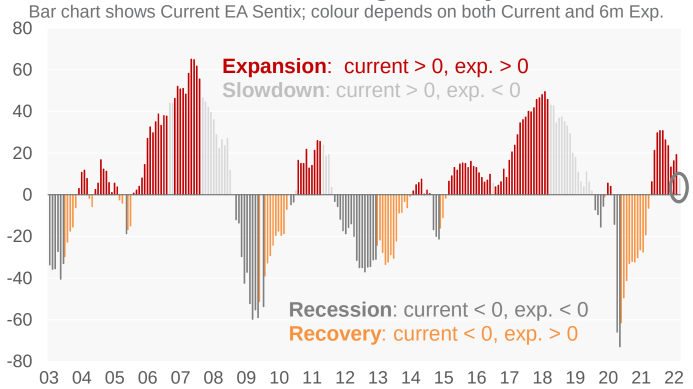
Source: Bloomberg, GIAM

Euro Area more exposed to Ukraine crisis, but US not immune

Luckily investor sentiment about the economy, especially in the euro area, has already tanked. This is very visible in the Sentix survey, where the 6-month expectation component have dropped to deep negative levels, as low as in March 2020 (Covid-19). This looks a bit extreme, given that the shock will not be as brutal. Still, expectations are likely to stay negative in the coming months, confirming that the cycle has shifted from Expansion to Slowdown, the latter being characterised by a broad flattening out of corporate profits. Mind that equity multiples often continue to expand during the slowdown phase. In the present case, however, the bar is higher in the context of central banks' fast tightening policy and real yields recovering from very depressed levels. Importantly, the focus has been on the EA slowdown – sanctioned by the underperformance of EA equities relative to the World MSCI – but the US economy is not immune to the Ukraine crisis. The concomitant rise in energy prices, rates and the US dollar points towards a sharp pullback of the manufacturing PMI in the coming months. Both the equity market pullback and soaring producer prices are not a good omen for manufacturing activity (see charts). This slowdown will make the life of central banks ever harder, as they are torn between that and much too high inflation rates.

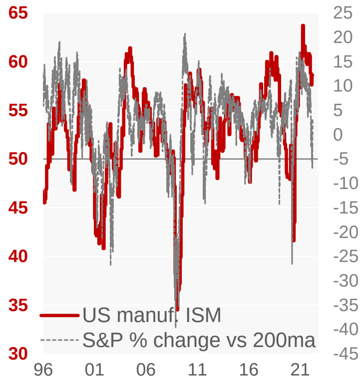
EA Sentix-based growth cycle

Bar chart shows Current EA Sentix; colour depends on both Current and 6m Exp.



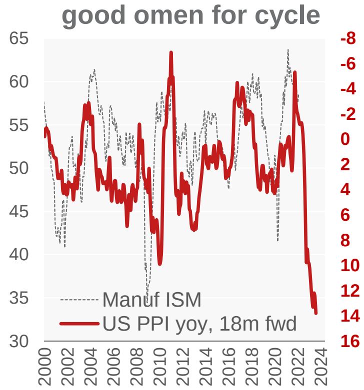
Source: Sentix, Bloomberg, GIAM calculations

S&P vs. manuf. ISM



Source: Bloomberg, GIAM calculations

Sharp rise in PPI not good omen for cycle



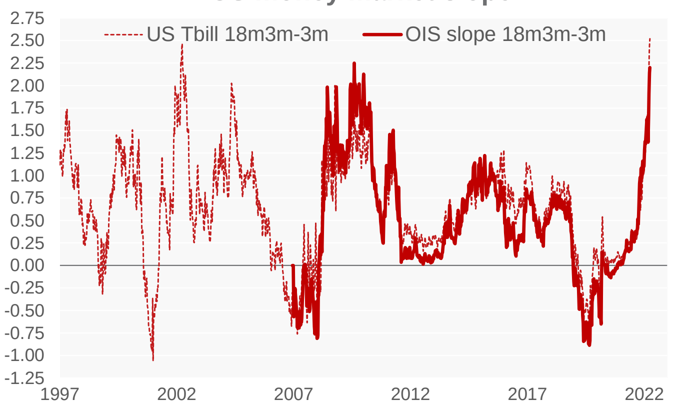
Source: BLS, ISM, Blomberg, GIAM

Mission impossible

Forwards are pricing at least another 8 hikes from the Fed in 2022. Can the economy and markets really digest that much?

The growth-inflation trade-off. Forwards are pricing at least another 8 hikes from the Fed in 2022, following the first of the series in March. There are only six meetings left, so this implies at least two 50bp hikes along the way. The market also sees the Fed peak around 3.25% by end-summer 2023, more than 300bp above the starting point. This is indeed a very steep implied path by historical standards (chart below). In the post-Volcker era, the largest tightening cycle was in 2004-06, when the Fed went from 1% to 5.25%; a liquidity crisis ensued in summer 2007, followed by the GFC in 2008. The second largest hiking cycle was 1994-95 (+300bp to 6%). The other two cycles (1999-2000 and 2015-2018) were smaller, around 200bp. In this cycle, the quantitative tightening (QT), from this summer, will also add a very significant measure of policy tightening. Arguably this is the first time since the 70s that the Fed and other central banks must tighten to push inflation *firmly down*, rather than merely keeping it under control. Yet we question whether the Fed can deliver so much tightening without threatening financial stability and causing a hard landing. Already higher bond yields are weighing on funding conditions (including mortgage rates), High Yield spreads are exposed to the cyclical slowdown and US equities to a pullback in currently elevated multiples – hence the cost of capital is set to increase. We suspect that as economic data start to disappoint, the Fed's stance will turn slightly less aggressive.

US money market slope

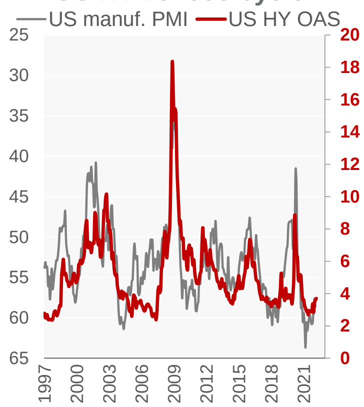


Source: Bankrate.com, Bloomberg

Mortgage rates surge

Source: Bankrate.com, Bloomberg

US HY vs. eco cycle



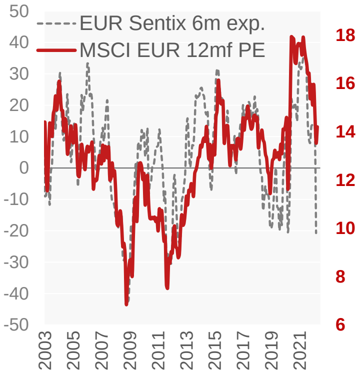
Source: ISM, Bloomberg, GIAM

What is priced in risky assets?

Investors more bearish than short. As investor sentiment about the EA economy crashed, European equity funds suffered substantial outflows. But global equity funds have still recorded generous inflows this year, some $15bn per week on average. The average of the 4 weeks to mid-March was still well above water, at +$6bn per week. Cash positions are relatively large by historical standards, and sector positioning has readjusted towards defensives, but overall positions are not short equities. In other words, we have not seen a proper clean-up of positions. Even in Europe, the de-rating of equity valuation has been mild relatively to that about the economy (left chart below). Also, cyclical stocks have pulled back a bit relative to Defensives, but the move has been remarkably mild (second chart). This leaves us relatively uncomfortable with the equity market melt-up observed in the last three weeks of March.

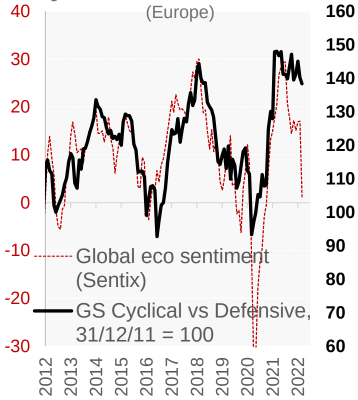
Global equity funds have still recorded inflows this year, some $15bn per week on average

EUR equity valuation vs eco sentiment



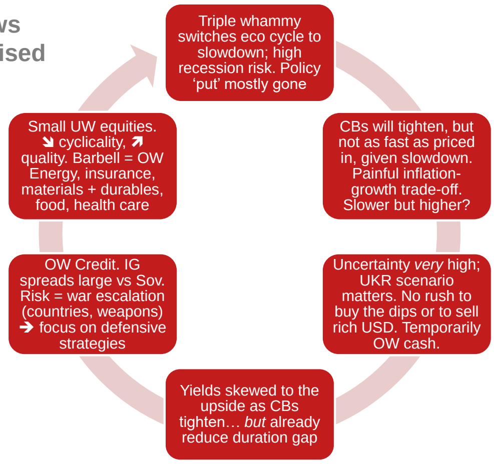
Source: Sentix, MSCI, Bloomberg, GIAM

Cyclicals vs Defensives



Source: GS, Bloomberg, GIAM

Key views summarised

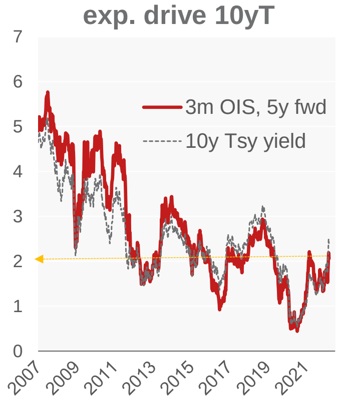


How to invest

Short Govies and duration but less so. Our key recommendations are exposed in the right-hand chart above. As the economy faces a triple whammy – the war, tough central banks and Covid still disrupting the global supply chain – we have reduced the cyclicality of portfolios. We stay short Government bonds, but much less than before, following the sharp increase in bond yields. Likewise, we keep a short duration position, but a small one. The less aggressive position in the rates space reflects our more downbeat economic forecasts, less aggressive central bank views and expectations of self-correcting mechanisms (a surge in yields threatens debt sustainability and financial stability). We keep a government bond underweight and a small short duration, however, given the residual space for higher long-term yields. Though the market is pricing a Fed peak around 3.25%, the longer dated forwards are much lower, e.g. 5y3m just above 2.0%. We see a slower Fed, but a potential upside repricing of the neutral rate – which should support slightly higher yields.

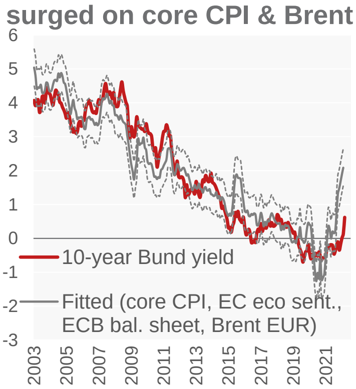
Forwards are pricing at least another 8 hikes from the Fed in 2022. Can the economy and markets really digest that much?

Medium-term Fed rates exp. drive 10yT



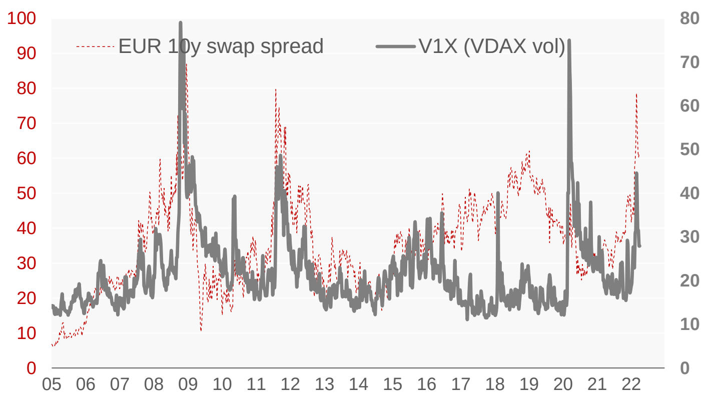
Source: Bloomberg, GIAM

Bund 'fair value' has surged on core CPI & Brent



Source: Bloomberg, GIAM calculations

Swap spreads vs. equity vol



Source:www. Bloomberg, GIAM

Likewise, our fair value models for Bund suggest there is still ample upside, should core inflation trends stay elevated. That said, we also expect the FV to ease off as core inflation falls back in H2, and the economy slows, and we assume that the rise in bond yields is set to slow sharply from here.

We find that credit spreads, especially in Europe, have been hit relatively severely among other risk metrics, e.g. equity volatility

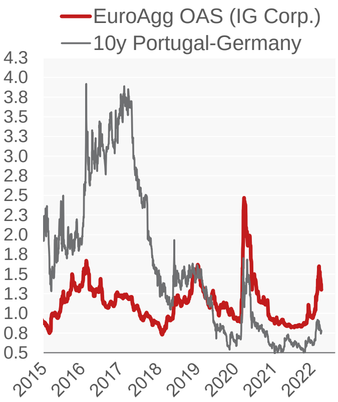
Overweight Credit. We find that credit spreads, especially in Europe have been hit relatively severely among other risk metrics, e.g. equity volatility. This, combined with the rise in risk-free yields, imply that EUR Credit offers a more generous carry, for a limited risk in the IG space. In part the widening between Credit and risk-free Government bond yields (Bund) reflects a large widening of swap spreads (top-right chart above) – equally disproportionate relative to other risk measures. IG credit spreads now appears wide relative to country spreads, e.g. Germany-Portugal. IG credit also offers a substantial pick-up relative to long-dated Bund, and historically such opportunity has generated generous excess return (see chart). That said, as we discuss in the Credit section, our Overweight (OW) is executed through defensive strategies, IG rather than HY, subordinated debt rather than pure HY, non-financial rather than financial, and defensive sectors rather than cyclicals. EM Credit also offers selected opportunities, both in hard and local currency debt (EM central banks have been front running the rate hike cycle), but this too is sensitive material at the inception of a steep Fed hike cycle.

Our Overweight (OW) is executed through defensive strategies

We cut equities to small underweight. We see no rush in chasing the strong recovery from the early March lows. Equities face significant headwinds, not least from the global slowdown under way and central banks walking their tough talk for now. Our sector and style allocations are fairly balanced, reflecting opposite forces from the slowdown (bad for Cyclicals vs Defensives) and rising yields (supporting Value vs. Growth). Our barbell strategy combining Value and Defensive stocks implies an overweight in Energy, Insurance, Materials, Durables, Food, and Health Care. Underweight Diversified Financials, Media, Real Estate, Hardware, Telcos and Utilities.

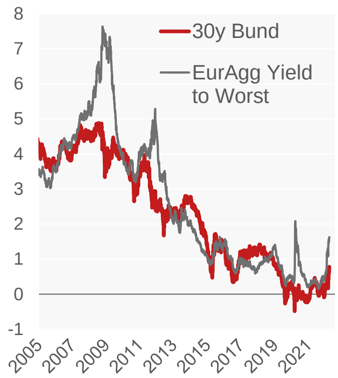
Equity barbell strategy combining Value and Defensive stocks.

IG vs PGB spreads



Source: Bloomberg, GIAM

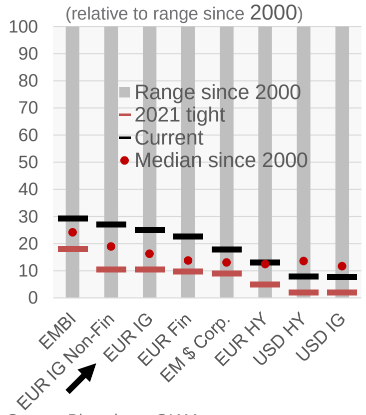
IG - 30y Bund = 85bp



Source: Bloomberg, GIAM

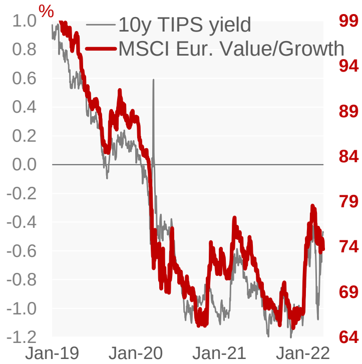
Spread position

(relative to range since 2000)



Source: Bloomberg, GIAM

US 10y real yld vs MSCI Europe Value/Growth

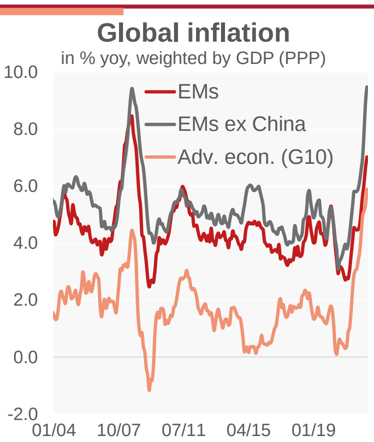


Source: MSCI, Bloomberg, GIAM

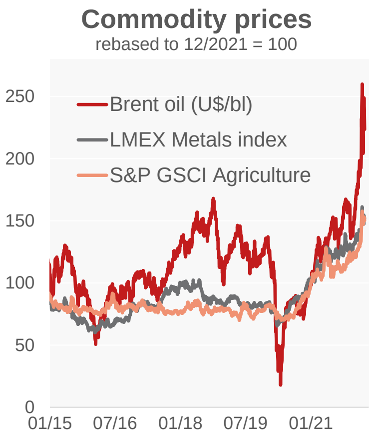
Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

- **Russia's war in Ukraine and the West's tough sanctions response exacerbate stagflationary forces.**
- **Soaring energy prices and looming supply disruptions will keep inflation high for longer. Growth is set to suffer most in Europe (curbed purchasing power, supply uncertainty), with new fiscal measures and eased Covid restrictions only a partial relief.**
- **Amid an unusually uncertain outlook, we see euro area growth grinding to a temporary halt in our central scenario. A risk case of deeper military escalation and disruptions of energy supply would entail a marked recession.**
- **US growth will suffer, but to a lesser extent. Fresh fiscal stimulus in China will not prevent a marked speed bump amid a renewed spike in local Covid cases and the fallout from the Russian war.**
- **Major central banks will prioritise inflation fighting over growth worries in our central scenario.**
- **We expect the Fed's March lift-off to be followed by at least another cumulated 150 bps hikes this year, with the risks tilted to faster moves. Quantitative Tightening (QT) is likely to be announced by June. Amid the looming material economic slowdown, the ECB is likely to stand pat on rates until December, but will phase out its asset purchases by autumn.**

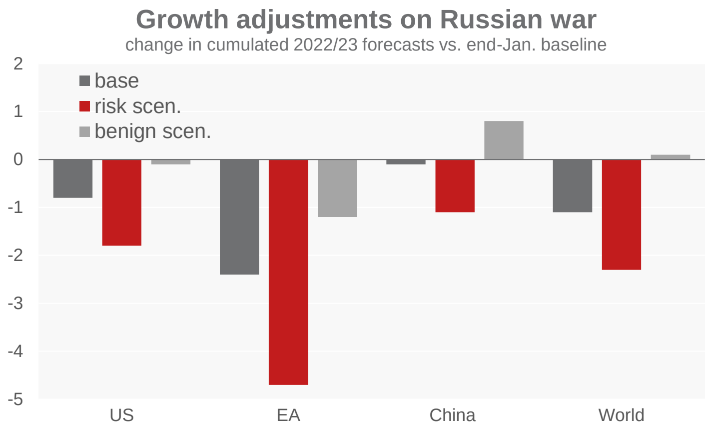
The Russian war in Ukraine is a human tragedy in the first place. It is also sending shockwaves through global economy and markets. This may be surprising as the size and direct economic links to Russia and Ukraine are moderate. Their economies account for 2% of global GDP and below 3% of euro area exports (with other advanced economies much less exposed). Also, exposure by BIS banks is very low.



Source: Datastream, GIAM; EMs ex Venezuela



Source: Datastream, GIAM



Source: GIAM

The Russian economy is small by global standards, yet its key role for commodities raises stagflation risk at a delicate moment

Yet, Russia is an important commodity exporter, with Europe's dependency on Russian gas particularly high. Ukraine and Russia account for almost a third of global wheat exports, raising fears of food shortage and costs in many EMs. Fears of supply shortages have sent the prices for energy and commodity soaring as Western countries and Japan imposed tough sanctions on Russia. High energy prices and fears of supply disruptions hit the global economy just at a moment when stagflationary forces have been building in the wake of the Covid-19 pandemic.

Rising energy prices are curbing purchasing power while geopolitical uncertainties weigh on confidence

High inflation is curbing consumers' purchasing power, while geopolitical and policy uncertainty over central bank impacts business confidence and investment. First evidence from surveys in March revealed a slump in European investor confidence, with the Sentix and ZEW index plunging. While activity thus far seems less impacted, an unprecedented monthly plunge in Ifo expectations and a general fall of forward-looking components in key euro area sentiment surveys point to severe trouble ahead.

The size of the adverse economic impact will hinge on the further military and political events of the Russian war, which can unfold in various unknown ways. Our central scenario assumes prolonged fights and persistent sanctions. We assume the price of oil and gas to settle at higher levels for longer. Stagflation pressures will be particularly acute in Europe with 57.5% of the EU's gross energy needs covered by imports. We cut our cumulated 2022/23 growth forecasts for the euro area by a 2.4 pp vs our January forecast, mostly owing to the fallout of the war (chart on previous page). Also the US and to a lesser extent China will be impacted. Many poor countries, especially on the African continent, will feel the pain from soaring food prices, raising the risk not only for growth but also of social unrest.

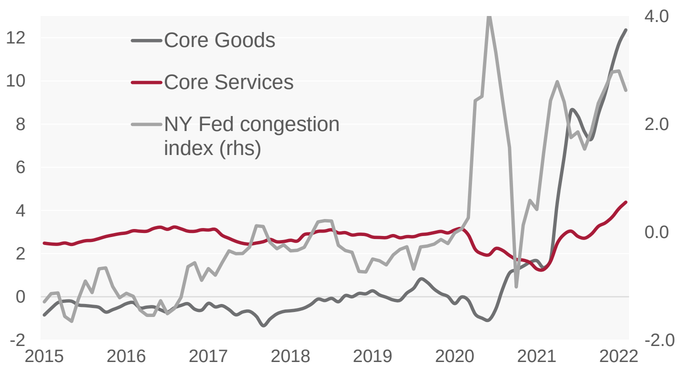
Annual GDP growth (in %)	central scenario		risk scenario		upside scenario	
	2022	2023	2022	2023	2022	2023
US	2.7	2.1	2.0	1.8	3.0	2.5
Euro area	2.2	1.6	1.0	0.5	3.0	2.0
China	3.7	6.3	3.0	6.0	5.2	5.7
RoW	2.7	3.6	2.8	2.3	4.1	3.6
World	**2.8**	**3.6**	**2.5**	**2.7**	**4.0**	**3.6**

Annual Inflation (in %)	central scenario		risk scenario		upside scenario	
	2022	2023	2022	2023	2022	2023
US	7.3	2.2	7.7	1.9	7.0	2.3
Euro area	6.2	2.5	7.0	1.8	5.3	2.2
China	2.5	2.1	3.0	2.3	2.1	2.0
RoW	7.6	5.0	7.2	3.8	6.3	4.1
World	**6.5**	**3.7**	**6.5**	**3.0**	**5.5**	**3.2**

CB key rates*)	central scenario		risk scenario		upside scenario	
	2022	2023	2022	2023	2022	2023
US	2.00	2.50	1.00	1.00	2.50	3.25
Euro area	- 0.25	0.25	- 0.50	- 0.50	0.00	0.75
China	3.40	3.60	3.30	3.40	3.70	3.70

*) US: upper bound of FFR; Euro area: ECB deposit rate; China: Loan Prime Rate 1Y

US: Supply bottlenecks and core inflation



Source:BLS, NY Fed, Datastream, GIAM

Central banks' response options to the crisis are very much restricted by the mounting stagflationary threat

Fiscal policy will be tailored to cushion the inflationary blow to households' budget, mostly via temporary energy subsidies or outright transfers. This will only mitigate the headwinds though. Central bank will prioritize curbing inflation over growth worries in this base case to keep inflation expectations anchored. This clearly distinguishes the current situation from the GFC and the 2020 pandemic hit, when central bank slashed rates and injected liquidity in a disinflationary context.

A less likely favourable scenario sees an early ceasefire and a return to diplomacy. Sanctions would still be eased only very gradually. But de-escalation would bring down energy and commodity prices faster while business confidence could rebound quickly, limiting the global stagflation damage.

An adverse scenario of further market military actions and sanctions would send energy prices soaring further and dive the euro area into recession

In an adverse scenario of a further marked military escalation and punitive sanctions including Russian gas and oil exports, however, would send energy prices soaring further. The euro area would face a sizeable spring/summer recession. Extended fiscal support would only partially mitigate the drag. Overshooting inflation will keep hands at central banks largely tied, even if to variant degrees. Most would soften their hawkish stance, but only moderately so to avoid losing control over prices.

US: Fed's pledge to tame inflation tested by slowdown risks

US firms are little involved in supply chains including Ukraine or Russia. The country is also almost self-sufficient in energy, keeping the direct impact of the war less acute than in Europe. However, the boost to already surging commodity price will

Commodities add to home-grown inflation. The core rate to well stay above 4% by year end

exacerbate inflationary pressures. With more than 1.7 jobs available per unemployed person the labour market is extremely tight. Fast rising wages may add to accelerating rents and the persistent impact of supply bottlenecks on goods prices. Core inflation reached 6.1% in February and is set to remain at that level, or even increase marginally, for the next quarter. We do not expect it to fall below 4.5% by the end of the year.

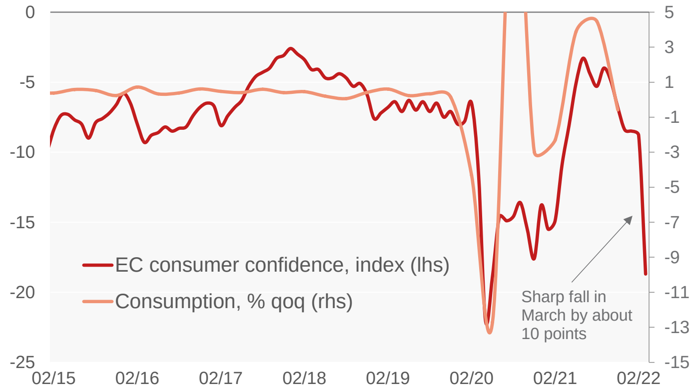
As evidence has piled up that strong inflation is only in part due to temporary factors, the Fed has scrambled to reinforce its commitment to keep price rises credibly in check. After the 25 bps rate rise in March, it now pencils in a total 175 bps increase in the fed funds rate this year, with a substantial risk of additional tightening, delivered mostly in the first part of the year. Large rate increases (of 50 bps) are likely over the coming meetings. We expect a 175 bps increase in rates too for this year, with the possibility of more aggressive and frontloaded action.

The reduction of the Fed's balance sheet will likely start in June: it should run roughly twice as fast as in the previous episode of QT. Asset holdings should decrease by around US$ 680 bn this year, reducing monetary accommodation by the equivalent to another 25 bps rate increase. We expect the Fed balance sheet to shrink from currently 36% of GDP to just above 20% by the first half of 2025.

Fed's Strong commitment to fight inflation will lead to rate hikes by a total of at least 175 bps this year, increasing downside risks to growth

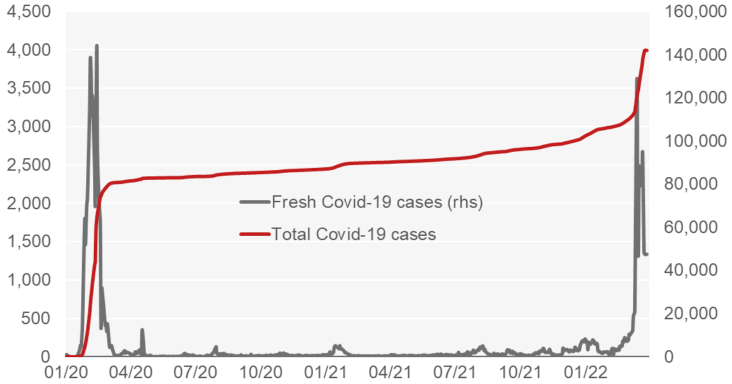
The need to stem demand pressure to tame inflation raises worries about the impact of tighter policy on economic activity in the second half of 2022 and 2023. Fiscal policy has already turned into a drag to growth with the end of the income support measures. And household consumption will likely slow down with the drop in confidence and the fast depletion of Covid-related savings. The prospect of tighter monetary policy and uncertainties related to commodities led us to cut the growth forecast for 2022 to 2.8% GDP will then decelerate to trend growth, around 1.8%, next year.

Euro area consumer confidence plummets



Source: Datastream, GIAM calculations

China: Covid-19 cases



Source: Datastream, GIAM

Euro area in the centre of the war-related economic fallout

The proximity of the euro area to Russia and the Ukraine contributes to a stark fall-out on sentiment and activity. The primary channel is the the region's high dependence from Russian gas imports. It accounted in 2020 for about 45% of all gas imports for the EU. Among countries, Germany and Italy are particularly exposed, making both countries especially vulnerable to the fallout from potential supply disruptions and sharply rising gas prices.

Strong headwinds from high inflation and bottlenecks to bring growth to a halt in summer

Euro area inflation rates north of 6% yoy over the months to come will be a drag on purchasing power and consumption. March saw already a sharp fall in consumer confidence heralding a strong blow to growth. Moreover, while manufactures are advancing in repairing supply chain disrupted over the pandemic, the Russian invasion creates new disturbances. Hence, while only slightly below 3% of all goods exports go to Russia, we look for a strong deceleration of activity over the summer half. Forward-looking components in key sentiment indicators weakened considerably as of late. However, there are still pandemic-related excess savings to be deployed and fiscal support measures of about 1 ½%. in 2022 and ½ % in 2023 mitigating the fallout. All in all, we expect activity to come to halt over the summer half and even see the risk of a technical recession. Output is set to grow by 2.2% and 1.6% in 2022/23, but this year's growth will be largely technically driven by a statistical overhang from H2 2021.

ECB will need to act to react to sky-rocketing inflation but will proceed as gradual as possible

The Russian war against Ukraine has pushed the ECB further in a dilemma. On the one hand sky-rocketing energy and commodity prices add to already elevated inflation pressure which will persist. Import, producer and commodity prices as well as business surveys all indicate unabated inflation pressure. And with the labour market in good shape, we see the potential for significantly rising wages. On the other hand, the looming sharp slowdown warrants rather policy easing than tightening. Financing conditions also deteriorated due to the more aggressive stance by the Fed.

In this dilemma we expect the ECB to proceed with caution. It will likely end its QE purchases in Q3 but only act in December (by a 25 bps hike) when activity should improve again and the expectation of higher wages materializes. Thereafter we look for ongoing measured policy normalization. The risks are clearly tilted towards an earlier first hike, e.g. due to the de-anchoring of inflation expectations. Conversely, the hurdles for not acting or even extending QE are high. It would in our view need a deep recession to prevent the ECB from reacting to the substantially changed inflation environment.

China: Torn between Covid, fallout from the war and ambitions growth target

China's economic outlook has recently become much less visible. On top of continuing problems like in the real estate sector, fresh headwinds are stemming from a strong Covid outbreak as well as globally rising energy/commodity prices. Regarding Covid, new infections are broadly comparable with numbers in January 2020. China's handling of is "zero-tolerance" policy will be decisive for the growth impact. So far, lockdowns have been widespread but turned out to be shorter than with the delta variant.

China likely to develop a more flexible response to the strong Covid outbreak.

However, Omicron is much more contagious. We expect China to modify its policy once the effectiveness of current strategies can be better assessed. Moreover, the damage will likely lie more with services than industrial production. This also points to only a limited interruption of international supply chains as harbours are still open but show a reduced turnover. On top, China has to cope with rising energy and commodity prices. China did not join sanctions against Russia but oil imports from its neighbour only cover 15% of its total oil intake. Thus, PPI and CPI inflation (0.9% yoy) are set to rise. We expect inflation to average 2.5% this year.

Before these headwinds materialised, China's government announced a rather ambitious growth target of around 5.5%. Growth will be backed up by a broad fiscal deficit expansion of about 3 pp of GDP and more support from monetary policy (we see three rate cuts by 10 bps to medium-term lending facility loans (MLF) and a 50 bps cut in the reserve requirement ratio, RRR). China will struggle to meet the target in a year when President Xi likely intends a re-election. We cut our growth forecast in a first response to the severe Covid outbreak to 3.7% but stress elevated uncertainty, also due to high hurdles for official growth numbers to undershoot targets ahead of Xi's re-election.

GOVERNMENT BONDS

Florian Späte

- **After the worst quarter for decades there is no sustainable recovery of international government bonds in sight. Market participants finally acknowledged that central banks are serious and will raise interest rates significantly to bring inflation rates down.**
- **Having said that, the sell-off is expected to lose momentum going forward as future key rate hikes are more than adequately priced in. What is more, the war in the Ukraine dampens the growth outlook severely, particularly in the euro area.**
- **The strong performance of euro area non-core government bonds amid the turmoil on financial markets is unlikely to continue. The combination of less ECB support and weaker growth does not bode well. However, we expect the spread widening to remain moderate and orderly.**

The first quarter was a nightmare for international bond investors and there was no place to hide. Across all maturity buckets all developed bond markets recorded massive losses. Indeed, it was the worst quarter in decades (total return year-to-date -5.4% and -6.4% for EMU government bonds and US Treasuries, respectively).

Going forward, we expect the sell-off to lose momentum but the general trend for yields is likely to point still upwards. The main driver for government bond yields will remain central banks. While at the end of 2021 just three hikes (each 25 bps) by the Fed were priced for 2022, market participants now forecast the US central bank to increase the key rate by around 240 bps (including the March hike) over the course of the year. This implies at least two 50 bps steps. Faced with surging inflation expectations central banks have stressed their willingness to act decisively to get rampant inflation back under control.

Although hikes will be forthcoming, current priced-in key rate expectations are exaggerated

While short-dated government yields always tend to be closely correlated with forecast key rate movements long-term yields are currently also largely determined by key rate expectations. However, we think that financial markets are exaggerating the key rate cycle. For the US we expect only further key rate hikes totalling 150 bps (compared to 225 bps priced) and for the ECB we see in our base scenario one hike by 25 bps (currently discounted 60 bps) until the end of 2022. However, for the time being central banks are likely to keep the hawkish rhetoric. Hence, the forecast adjustment of key rate expectations is unlikely to occur near term and yields have leeway to increase further in the months to come.

Self-correcting mechanisms to limit increase in long-dated yields

Further down the road, however, there are some self-correcting mechanisms which are expected to slow the key rate cycle. To start with, we regard current growth expectations as too optimistic. The ECB lowered in March the growth forecast for 2022 to 3.7%. For this to be achieved a ceasefire between Ukraine and Russia would have to be signed quickly and sanctions would have to be unwound (at least gradually). While it is not completely unrealistic it remains only a positive scenario and deviates from our base view which involves ongoing fights and sanctions for the time being. In this case growth is seen to slow sharply worldwide and in the euro area even a technical recession in Q2 and Q3 cannot be excluded. This will give central banks some room for manoeuvre and to slow down the key rate cycle.

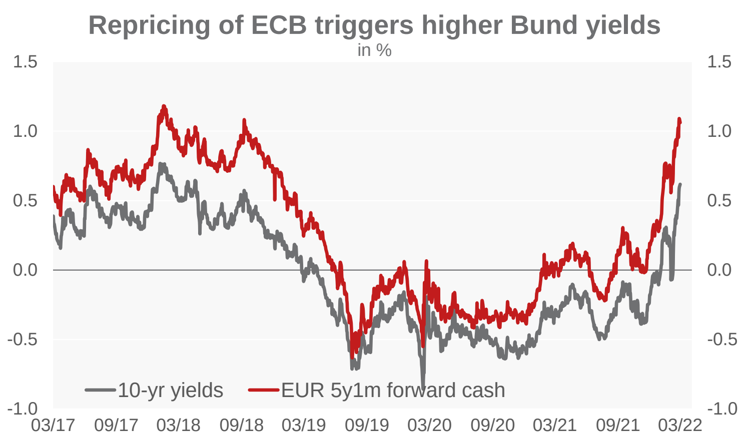
What is more, the valuation of asset prices is dependent on a rather low level of (real) yields. Especially US real yields have already backed up strongly in Q1. A further deterioration of financial conditions serves the same purpose as key rate hikes. It is unlikely that financial markets can withstand hikes in US rates currently priced in. Finally, the combination of a meagre growth outlook and rising yield levels will bring debt sustainability concerns back to the fore. Debt ratios are still on an elevated level as governments have buffered the fallout from Covid-19, and further fiscal expansion is likely in Europe.

In view of the more cautious central bank outlook, we doubt that yield curves will flatten (or even invert) as much as currently discounted by financial markets. While an inversion of the US curve is likely we doubt that the 2-yr/10-yr yield gap will reach 40 bps until the end of 2022. We also do not expect the euro area yield 2-yr/10-yr yield curve to flatten out to 40 points (from 70 bps currently).

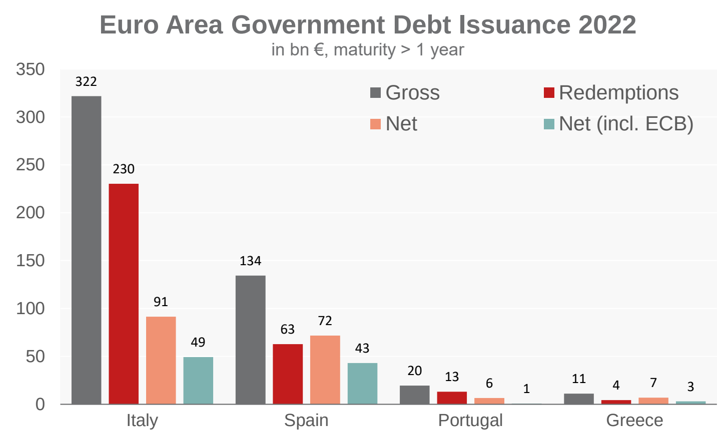
While inflation expectations appear elevated and have little leeway to rise further real yields have scope to increase going forward

Regarding the composition of nominal yields we forecast the bulk of the yield increase to be driven by real yields. With 10-year inflation swaps above 2.7% in the euro area and even above 3.0% in the US the current elevated inflation environment appears sufficiently priced. While a further escalation of geopolitical tensions and another leg up for commodity prices cannot be excluded this will mainly impact short-dated inflation expectations. Long-dated ones are less affected as a spike in inflation rates would drop out of the annual calculation after a while. On the contrary, real yields are not on a sustainable level (particularly in the euro area). Although they have recovered from the lows 10-year real Bund yields are still at -2.1%.

Beside these more tactical considerations we think financial markets will have to adapt to a changing environment in the long term. Among others, the transition to green energy and higher military defence expenditure will contribute to a more expansionary fiscal policy. At the same time, central banks will raise key rates to a higher level to keep inflation in check. This represents a fundamental change in policy mix compared to the last few years and tend to favour a rise in yields.



Source: Bloomberg, GIAM



Source: Bloomberg, Datastream, GIAM calculations

Strong performance of EA non-core government bonds unlikely to continue

While other risky fixed income assets have come under pressure, spreads of EA non-core government bonds have tightened since the start of the war in the Ukraine. We doubt that this will continue as the mix of weaker growth and higher yields does not bode well for this asset class. We regard speculations about a new joint EU facility (like NGEU) as premature and doubt that it will be realized soon.

Highest net-net supply of EA government bonds since 2014 to remain a burden factor

The technical picture has worsened since the start 2022. Three months ago, we expected the ECB to take down €500 bn government bonds in 2022. We now estimate that the central bank will purchase only €300bn (it spent already most of it). It implies a net-net supply of €200 bn (risks to the upside amid the elevated fiscal needs) which constitutes a sharp swing of around €400 bn compared to 2021. However, as the ECB could step in case of an unorderly development and rating agencies will remain on the side-lines for the time being, we expect the spread widening to remain moderate.

CREDIT

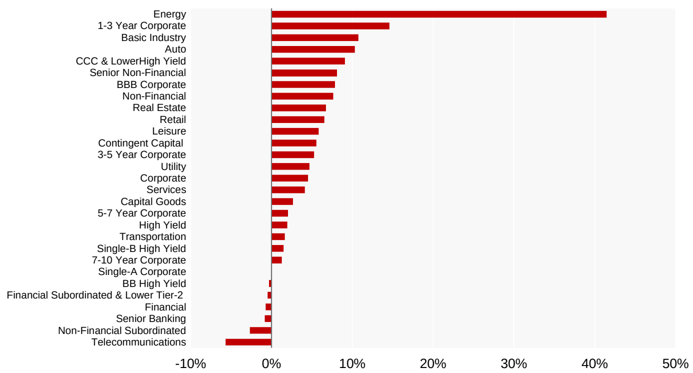
Elisa Belgacem

- **Credit markets have been facing three shocks this year: 1/ much higher rates in January, 2/ anticipated QE in February, and 3/ soaring commodity prices & growth slowdown.**
- **Less bright than expected macroeconomic prospects will necessarily translate into weaker corporate funda-mentals and higher defaults but to a manageable extent.**
- **Technicals should prove resilient in the near term, with flows stabilising and high absolute yields attracting yield-sensitive investors back into the asset class**
- **• Credit spreads have already erased a large part of Russia/Ukraine widening. We continue to see volatility in the near term but see room for modest tightening by the end of 2022.**
- **We remain OW credit in our overall asset allocation, with defensive positioning, favouring IG over HY, non-financials over financials, and subordinated bonds over pure HY.**

Extreme inflation prints force the ECB to unwind its support to credit market.

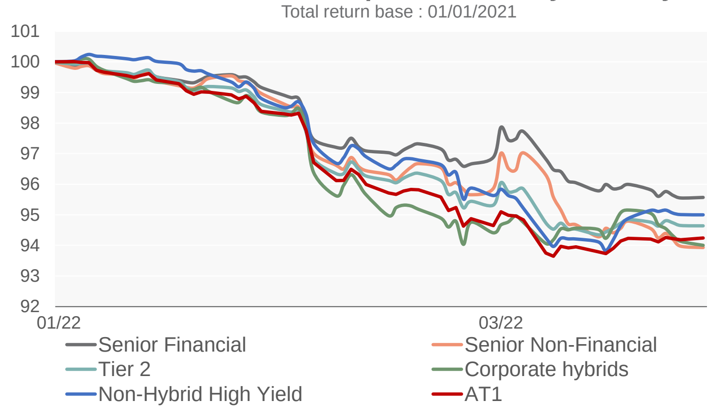
This year credit spreads have faced three major shocks. First, a very rapid rise of interest rates in January, second, the anticipation of the ECB tapering in February, and third the surge in commodity prices leading to an unexpected economic slowdown in March. This led to a significant repricing of corporate spreads across the board, although not to the extent of levels seen at the worst of Covid or the great financial crisis. We have seen corporate spreads reacting more than peripheral sovereign spreads in general and versus BTP in particular. As always, when systemic risk spikes, financials have been under-performing corporates, and in general names with prominent exposure to the Russia/Ukraine area pricing several notch downgrades. The ECB has been a powerful stabilising force for the credit market over recent years. ECB officials have made very clear several times that credit spreads are a key component of their financing condition assessment. As long as inflation was significantly below target, the ECB has successfully used the flexibility of its asset purchase programs to fight financial fragmentation across sectors and geographies. But the higher inflation outlook is now reshuffling the cards, reducing the central bank's headroom to fight any disorderly spread widening. The ECB asset purchase program will likely end in Q3 this year, notwithstanding the geographical tensions removing substantial support for credit markets.

EUR IG Credit market since Feb 23 spread perf.
by segment in % (OAS)



Source:BofAML indice, Bloomberg, GIAM own calculations

EUR Credit market performance by maturity
Total return base : 01/01/2021



Source:Bloomberg, BofAML, GIAM own calculations

We expect a worsening in default rates in Europe

Historically defaults are highly correlated to the business cycle. Covid has been the exception. The phenomenal monetary and fiscal support granted during Covid helped

Weaker corporate fundamentals will translate into higher defaults and more downgrades.

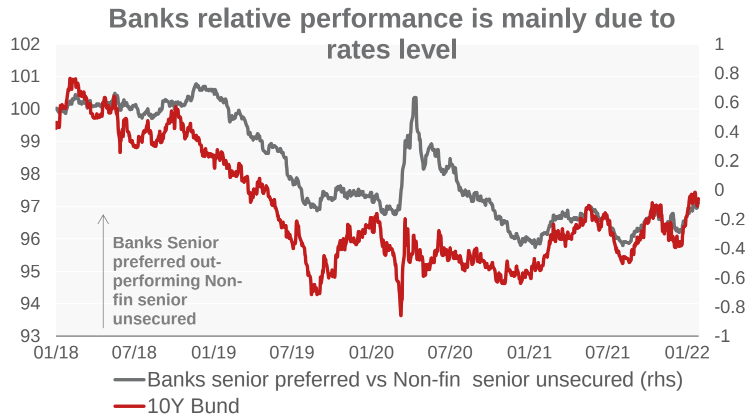
default rates to remain around 5% in Europe, half of the peak of the great financial crisis. In 2021, defaults returned below the long-term average at an exceptional speed. Starting into the year, we were expecting HY defaults to remain at those very low levels, but the growth slowdown due to the peak in commodity prices changed the outlook. According to Moody's, defaults have already started to pick up in February from 1.2% to 2.1%. In our central scenario, we expect now defaults to reach 3.5%, but the uncertainty surrounding the outlook remains very elevated and correlated to the evolution of the macroeconomic backdrop.

Similarly, we expect the rating dynamic to deteriorate, with rating agencies gradually incorporating the cyclical slowdown into corporate leverage metrics. In our central scenario, the magnitude of the rating drift change should remain moderate. We expect both HY and cyclical sectors, in general, to be re-rated first.

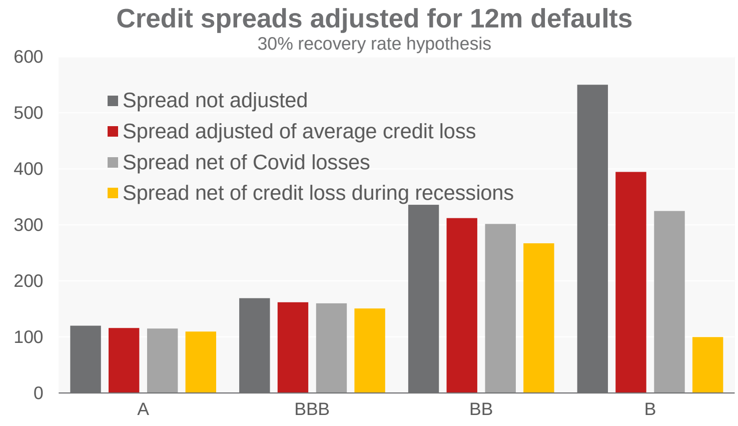
We favour IG over HY on further upcoming economic downward revisions

IG spreads can drift wider near term but should be more resilient than HY.

Over the Ukrainian conflict, IG has been materially underperforming HY for three reasons. First, swap spreads have been rising fast, making credit less attractive compared to swap rates. Second, IG is far more liquid, and at peak market volatility, investors were somewhat in a "sell what you can" mode. Finally, the higher inflation prints implied by the rising commodities further reduced the ECB's possibilities to remain interventionist in the corporate bond market. As a result, the cyclical slowdown will affect HY more than IG gradually. Liquidity could also become an issue at some point, and we have seen the IG primary market reasonably active since the beginning of the war but much less so in HY. Also, yield-sensitive players like insurance companies can now take advantage of the higher interest rate landscape to operate a trade-up in quality while they were forced to dip their toes into HY when yields were negative. At current levels, in relative terms, we view IG as relatively cheaper than HY as the latter widened more and is likely to be more volatile going forward. Hence, we favour IG over HY.



Source:Bloomberg, BofAML indices, GIAM own calculations



Source:S&P, Bloomberg, GIAM own calculations

At the sector level, which ones present the best opportunities?

In line with our overall cautious allocation bias, we decide to retain a prudent approach in terms of sector allocation. We believe financials should be more vulnerable than non-financial corporate in any downside scenario as they are less cyclical and less sensitive to the level of systemic risk. Hence, we favour the latter. We also believe that subordinated bonds should resist better than pure HY. Therefore, we like corporate hybrids and additional Tier 1 versus pure HY. In terms of sector allocation, we prefer the defensive sectors over cyclical ones as we believe they will be better positioned to resist higher input prices, lower growth, and supply chain disruptions.

EM SOVEREIGN CREDIT

Guillaume Tresca

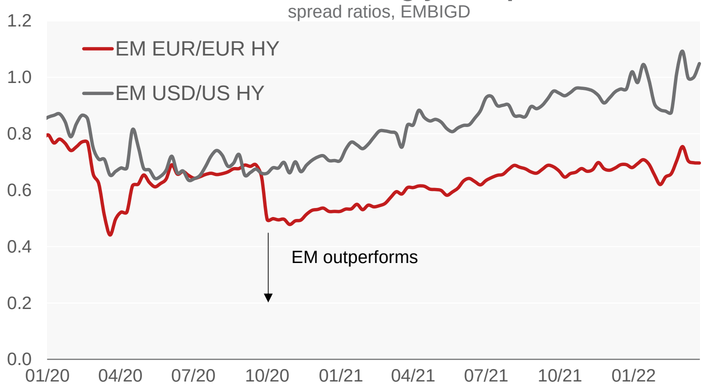
- **The EM outlook will gradually normalise, albeit remaining challenging. Valuations have cheapened and we expect a heterogenous retracement as dispersion is wide. That said, spreads will stabilise at higher pre-war levels.**
- **We maintain our OW for EM bonds vs. other FI assets, but it remains more a carry play than a directional one. Duration will continue to matter, and rising core rates will cap total returns.**
- **LatAm and Asia are the least vulnerable regions. MENA will benefit from higher oil prices, but valuations are rich. CE4 fundamentals are solid, with Europe providing a fiscal solid anchor.**

After the worst start to the year since 1994, the EM external debt outlook will gradually normalise, albeit remaining challenging. EM assets continue to face a trilemma with the Chinese Covid-induced slowdown, the core rates volatility, and the consequences of the Russia/Ukraine war.

We maintain our OW for EM bonds vs. other FI assets. EM spreads have overshot, and like during the March 2020 Covid episode, we expect a gradual decline of spreads by year-end. However, spreads should stabilise at higher pre-war levels to incorporate a higher risk premium, higher inflation risk, and fiscal easing to absorb the impact of inflation on households 'real income. The progress of peace talks has supported spread compression of late, but risks are still skewed to the upside in our view. The spillover of the Russia/Ukraine conflict is yet to unfold entirely in EM countries, be it on inflation or growth.

EM increasingly cheap

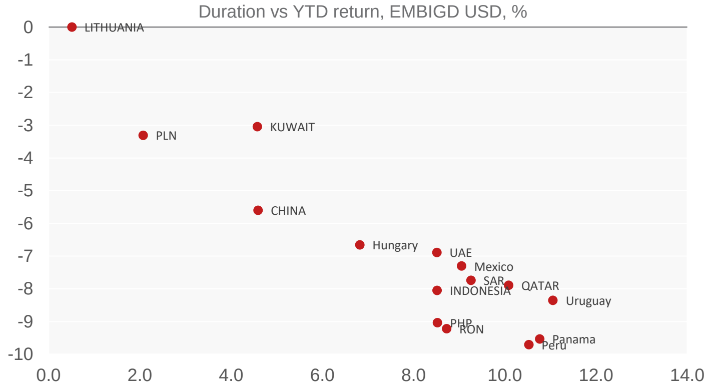
spread ratios, EMBIGD



Source: Bloomberg, JP, GIAM

Duration still matters

Duration vs YTD return, EMBIGD USD, %



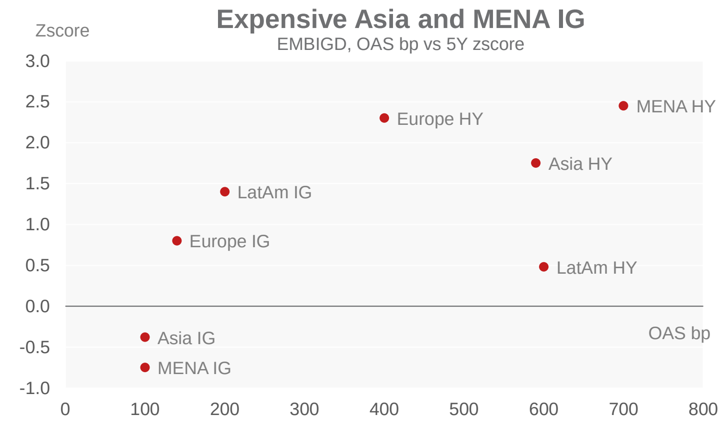
Source: Bloomberg, JP, GIAM

Cheaper valuations, but mind the core rates rise

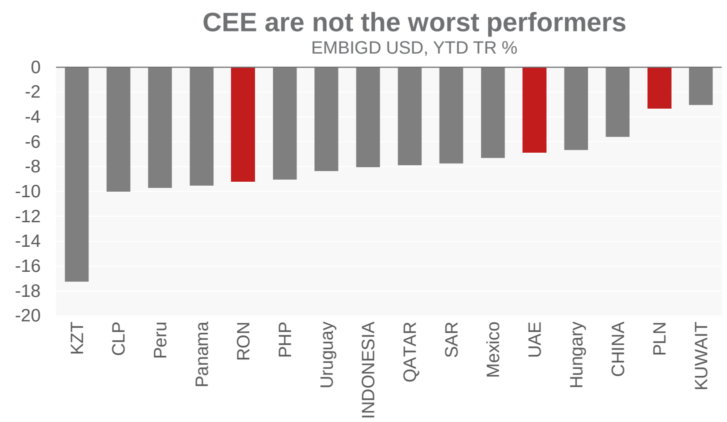
Spreads have turned cheap but dispersion is wide

Spread valuations have turned cheap by historical standards. EM USD spreads stand at the 70% percentile and are cheaper than EUR HY and USD HY. That said, we will increase our exposition only gradually. Dispersion is wide, and all segments of the EM complex are not attractive at the spread level. For instance, EM IG spreads have even outperformed US IG recently, and most of the IG names have been tightening or are close to their lows. Most of the value is in the HY space, but again the cheapness is mainly driven by the distressed names, and the C segment has been the best-performing segment year to date.

We do not expect the post-war spread retracement to be heterogeneous, and EM EXD remains more a carry and a relative value play than a directional play. Indeed, even if the global risk appetite has recently improved, EM EXD remains at the mercy of the core rate volatility. Duration continues to matter, and the further rise of core rates will continue to dent total return in the medium term. In our view, it will be difficult for EM EXD to post a positive total return this year, especially for the tightest segments of the market like the A and BBB+ parts.



Source: Bloomberg, JP, GIAM



Source: Bloomberg, JP, GIAM

LatAm and Asia are the least vulnerable regions

More discrimination. CEE fundamentals remain solid

Given the upside risks, we keep favouring IG over HY. HY surprisingly outperformed in the sell-off (less liquid, oil support, Russia), but it should ease as EM growth is due to slow and financial conditions have tightened. Moreover, HY countries tend to be the poorest countries that will be the most affected by the rise in the food price. Globally, countries with the strongest CA/fiscal balances and good ESG scores will outperform, in particular in the HY space.

MENA benefits from higher oil prices but valuations are rich

At the region level, LatAm is the least vulnerable benefiting from higher commodity prices, and we will favour the likes of Brazil, Colombia, and in a lesser extent, Chile and Peru, given the political risks. Asia is less immune as manufactured goods exporters in North Asia will be affected by lower trade. That said, the share of food in the CPI basket is lower than elsewhere. In EMEA, GCC countries benefit from higher oil prices, especially Saudi Arabia but valuations are very rich. CEE countries are far from being the worst performers, with a clear distinction between EA countries and the rest. Europe provides a strong fiscal anchor, and relationships will be even closer post the war.

Negative technicals to weigh on the weakest names

Issuance overhang to weigh on HY spreads

After a weak January, Q1 issuance has been even lower than in 2020. The latest Turkey and Nigeria issuances showed a strong concession, and the upcoming issuance overhang will weigh on spreads, especially in HY. That said, funds have been cash-rich, and inflows will gradually resume, helping to absorb new issuances partially.

The risk of a Russian external debt default has declined markedly as Russia shows a surprising willingness to pay in USD, even for bonds with a RUB fallback clause. The outlook is more uncertain after May 25th, when the General OFAC license expires. A default would not be systemic: foreigners likely hold less than USD20bn of Eurobonds, and Russia already defaulted on its local debt without systemic ramifications.

ESG to matter more than before

More important is the growing focus on ESG factors. First, the inclusion of Russia and Belarus in ESG portfolios indexes raises concerns about the quality of the ESG assessment. As a result, investors will review more deeply their portfolios. Second, in the future, it can deter investment in countries with a weak G component or that do not reach minimum standards. For instance, it is worth highlighting that China experienced large outflows over the past weeks, underperforming all EM countries.

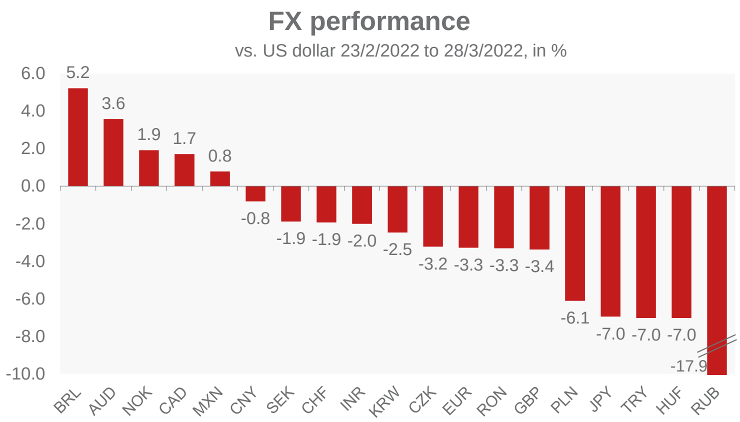
Thomas Hempell

- **Geopolitical risks and growth worries centred around Europe are unlikely to reverse soon, keeping USD and CHF bid. Commodity exporters will see continued support from high energy prices.**
- **With high volatility (Ukraine, CB tightening, inflation) sustaining USD demand and the euro area economy set to flirt with recession, the EUR/USD may suffer short term.**
- **Yet, the USD's rise already looks quite stretched. It would take a more severe further escalation and a recession to drive EUR/USD below recent lows (close to 1.08). With the ECB still on track to tighten its policy stance and the recovery likely to resume in H2, EUR/USD still has moderate upside medium term.**
- **Monetary policy divergence has sent JPY selling off. While we acknowledge the risk of a further USD/JPY overshooting near term, the yen already looks extremely cheap. More limited upside to US yields and rising risk of a slightly more hawkish twist by the BoJ may floor the JPY's descent in the medium term.**

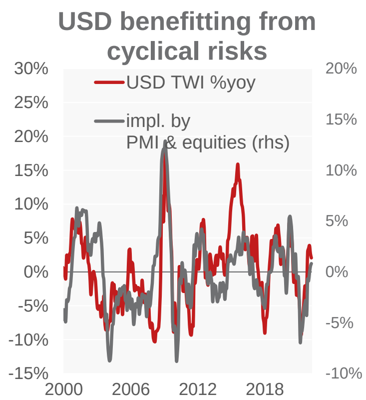
USD boosted by geopolitical uncertainties and the stagflationary hit to Europe

The Russian war against Ukraine and the resulting stagflation jitters have helped to boost the USD against European currencies. The rouble and CEE currencies have been suffering most heavily, with also the EUR taking a hit on recession fears. Conversely, commodity exporters including BRL, AUD, NOK and CAD are enjoying the tailwinds from soaring terms of trade.

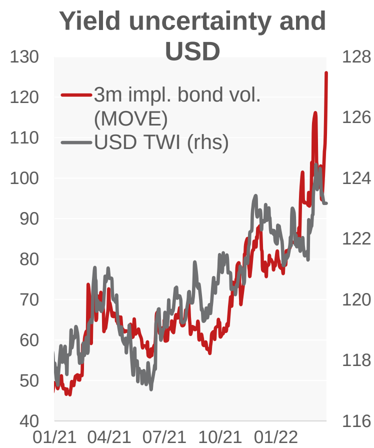
With the war in Ukraine dragging on in our central scenario (see our Macro Outlook), uncertainty is set to keep the USD bid. For one, deteriorating activity and weaker equities tend to boost the USD, and the reaction thus far matches historical patterns



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations; model 2000-2019 based on MSCI World %yoy and



Source: Datastream, GIAM calculations

of the USD's countercyclical appeal (see mid chart below). Stagflation worries also add to policy uncertainties, with central banks facing the dilemma of neither allowing runaway inflation while not choking off growth prematurely either. Resulting high bond volatility is a boon for the USD, too (right chart). Furthermore, with the US most acutely plagued by rising inflation, the Fed will lead the G-10 hiking cycle, with wider yield differentials boosting the Greenback. As the euro area faces the risk of recession owing to its exposure to rising import bills for energy and risks of supply chain disruptions, the EUR/USD remains burdened near term.

EUR/USD is already pricing deeper worries

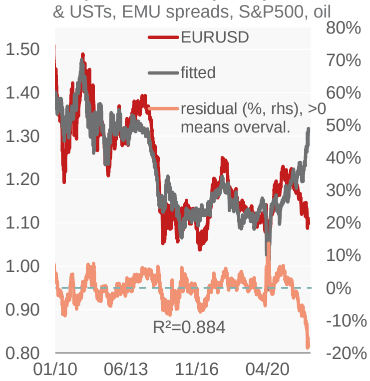
Yet on other dimensions, FX markets and EUR/USD in particular are already pricing deeper worries. Compared to long-standing yard sticks, incl. yield gaps, spreads, oil price and risk sentiment, the EUR/USD exhibits a double-digit undershoot (left charts overleaf). The real effective (trade-weighted, inflation adjusted) USD is 11% dear vs. its longer run average. We assume USD bids to prevail short term. An escalation of the Russian war could drive the USD even substantially higher, making it an interesting hedge for pessimists on Putin's intentions. But in our base case we think that owing to pricing the EUR/USD is less likely to break below the March lows of 1.08.

Barring a severe escalation of the Russian war in Ukraine, the EUR/USD is set to find its feet over H2

It will likely require a ceasefire in Ukraine and a return to the diplomatic table for the EUR/USD to find its feet. Easing geopolitical worries and more visibility on central banks' path will curb the recent USD boost. And following a spring/summer stagnation, the euro area is still likely to continue its economic recovery later this year. This will allow the ECB to gradually raise interest rates into positive territory over 2023. The USD is also set to face headwinds from global reserves diversification, even if this will only mutedly benefit the EUR (and more the CNY) stretched over a long-time horizon. On a 12-month horizon, we still see the EUR/USD gaining some ground again closer to 1.15.

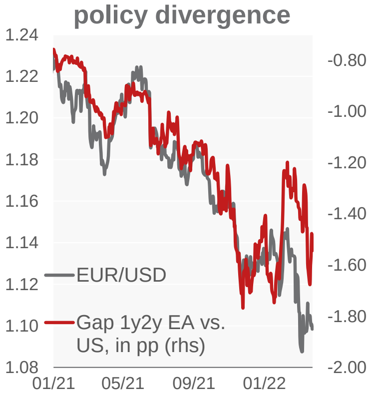
EUR/USD model

daily EURUSD on 2y & 10y Bunds & USTs, EMU spreads, S&P500, oil



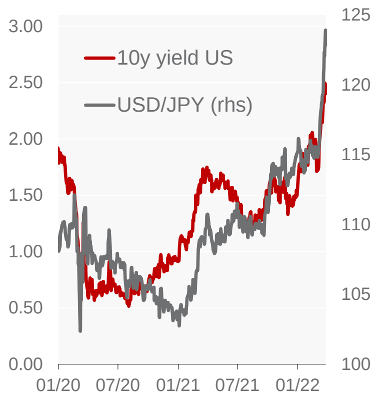
Source: Datastream,

EUR/USD and monetary policy divergence



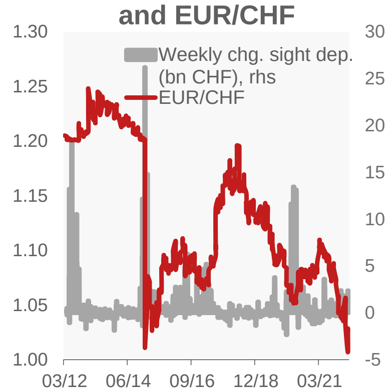
Source: Datastream, GIAM calculations

USD/JPY and 10y UST



Source: Datastream, GIAM calculations

Swiss FX intervention and EUR/CHF



Source: Datastream, GIAM calculations

CHF to remain underpinned by geopolitical uncertainties

The CHF may benefit short term from safe haven demand and stagnating European growth

Alongside the USD, the Swiss franc has enjoyed healthy demand on global uncertainties and cyclical worries, with the EUR/CHF temporarily hitting parity. Strikingly, the SNB has also become more tolerant about CHF strength (right chart), with changes in sight deposit proxying FX intervention on a timely basis. Swiss inflation is much more muted than in the euro area or the US, but still picking markedly up too. A stronger exchange rate helps to offset the inflationary impulse. With the Russian war lingering and the euro area flirting with recession, we see the near-term risks to EUR/CHF geared to the downside – even if further out we expect the EUR to regain some ground against the CHF on the factors mentioned above.

The Japanese yen is usually sought, too, as a safe haven amid global strains. Not so this time. Since the Russian invasion, the USD/JPY has soared 7% as the sharp rise in US yields has widened the yield gap. The JPY response has been exacerbated by the BoJ's recent pledge to buy unlimited amounts of JGBs to defend the 0.25% yield ceiling of 10y JGBs, which may herald further yen weakness in the near term.

Protracted slide in JPY as a sharply wider yield differential with the US dominates safe haven appeal of the yen

But the yen is already very cheap, trading 25% below its long-term average in real effective terms. Similarly, it is heavily discounting the yield divergence with the US (see mid-right chart above), while we deem the further upside for US yields much more limited going forward. Also, as the BoJ's costs of defending its yield target are mounting and the yen weakens further, market doubts may arise about the sustainability of the BoJ's commitment. The risk of outright FX intervention is rising, even though this would likely require a further slide in the JPY. Bottomline, while risk of a further JPY undershooting is high, more fundamental forces or even a hawkish twist by the BoJ may floor the JPY's descent.

EQUITIES

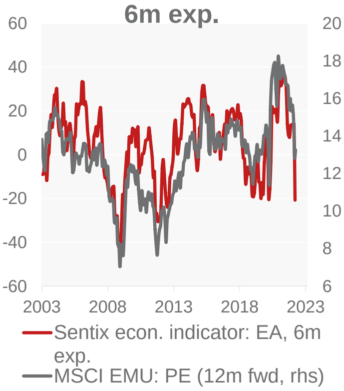
Michele Morganti and Vladimir Oleinikov

- **Equities recovered above pre-invasion levels due to hopes of a peace deal, coming from oversold territory. Equity volatility vs. bonds' one decreased substantially to cyclical lows, sustaining lower risk premia.**
- **These are back to historical average for EMU (6.5%), remaining lower for the US (2.6% vs. 4.2%). The US is less impacted by the crisis; thus, EMU-US ERP differential is likely to stay above the average of 3pp short term.**
- **Despite hopes of a diplomatic solution mounting, we see lower growth and higher inflation ahead. Short-term risks remain high: hawkish CBs, rising real yields, lower financial conditions, economic slowdown, still bold analysts' earnings estimates, high credit spreads. Tactical indicators and positioning are not oversold, yet. We are tactically slightly UW and reduce cyclicality and Value OW. Reduced OW of the US and UK vs the EA. Neutral on EMs.**
- **Equities still offer value mid term, hence the limited UW. Using a lower PE target, TR is at +6% in 12m for EMU (4% for the US). The forecast factors in our lower EA GDP estimate by 1.7 pp for 2022 (to 2.2%) and zero earnings growth from 6% (below consensus by 5% and 7.5% in 2022 and 2023).**
- **Furthermore, on a mid-term horizon, high cash flows and earnings yield gap (CAPE yield) vs real yields add to the historical evidence that in periods of high inflation equity returns, while lower, still beat bonds' ones.**

Equities surpassing pre-crisis levels via de-escalation and lower vola (VIX) vs bonds (MOVE)

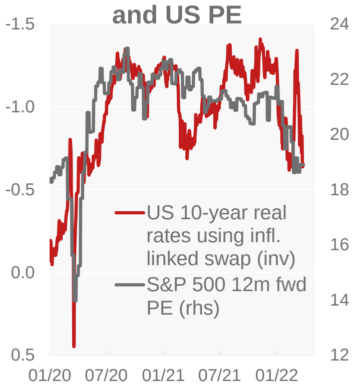
Since the start of the Russian invasion, markets have been subject to elevated levels of volatility (current 30d volatility at 24% and 40% for S&P500 and MSCI EMU, respectively). More recently, they recovered above pre-invasion levels due to market oversold signs and early signs of possible ceasefire. In our base scenario, economies will avoid recession, but a slowdown will occur representing headwinds to earnings growth. Sticky high inflation will add to the negatives as CBs will still remain on the hawkish side for some time. Monetary policy is inducing higher yields and credit spreads which ultimately reduce financial conditions for firms. Geopolitical risks will also stay high as further tensions with Russia and China can certainly not be excluded going forward: a source for higher risk premium than norm. Positioning, when meas-

EMU: PE and Sentix 6m exp.



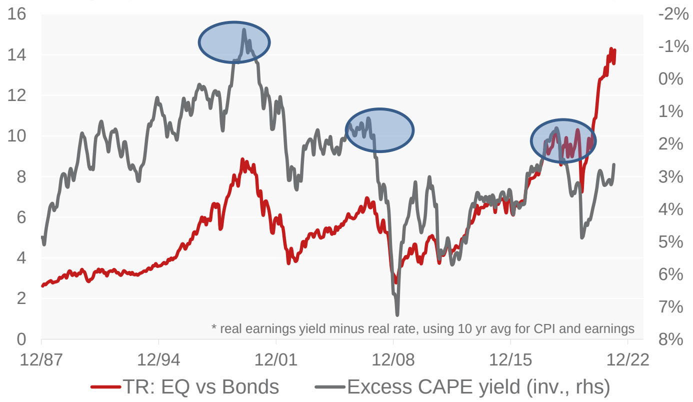
Source: Datastream, GIAM

Real 10-year rates and US PE



Source: Datastream, GIAM calculations

US equity total ret. vs bonds and excess CAPE yield *



Source: Datastream, GIAM calculations

ured by equity inflows year-to-date, remains elevated, too. Such risks are not fully priced in the short term as markets are now higher than pre-crisis levels (Feb. 24th). Current market levels are not too distant from our 12-month TR targets (+5%) and risk premia back to average in EMU and even lower than norm in the US: not a comfortable environment when CBs are still showing their teeth. For this reason, we are slightly UW equities.

That said, there is still a scope to remain in equities (hence the limited UW). Using a lower PE target (13.2X vs 14.2 of hist. norm for EMU), 12-month TR is seen at +6%

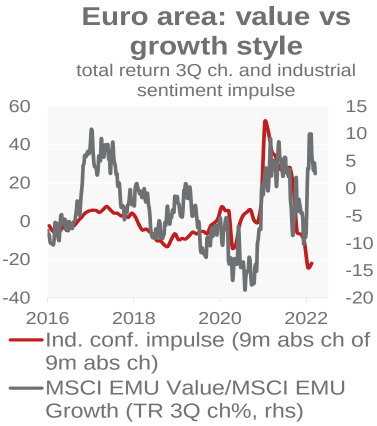
for EMU (4% for the US), should recession be avoided as we think (no deep negative earnings growth). This comes even having decreased our EMU GDP estimate by 2 pp for 2022 (to 2.2%) and used zero earnings growth from 6% (below consensus by 5% and 8% in '22 and '23). Furthermore, on a mid-term horizon, high free cash flow and earnings yield gap (CAPE yield) vs real yields adds to the historical evidence that in periods of high inflation equity returns, while lower, still beat bonds' ones.

Economic slowdown and CBs stance keep us refraining from buying, yet

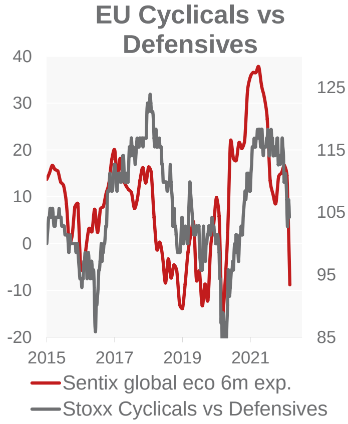
Regionally, we OW US vs. EA, but we reduced the OW stance due to mounting hopes of a peace deal. EMU is cheaper than the US: premium of 8% on market multiples vs history vs. 33% for the S&P 500. The PEG (PE/exp. EPS growth) adjusted for beta and ROE is 1.2X for EMU and 1.5X for the SPX. The same is true for the CAPE level. The EA has also started to use fiscal policy in an anticyclical way, representing a put for markets in future severe slowdowns. Progress towards greater EU cohesion represents an additional plus. That said, the EA is more cyclical, has more to lose from the Ukraine and energy crisis, being far less energy-independent. Other structural US advantages are doing business conditions, Tech governance rank, spending on Innovation and R&D other than population growth, rank in competitiveness and trend in productivity growth. Indeed, when we look for global sectors with the lowest correlation to EU but higher sharper ratios, we find that 15 out of 40 sectors are from the US. Finally, US volatility is lower and our 5-year TR forecasts not too different for the two indices.

Mid term still a case for equities: high free cash flow, high yield gap vs 10y real yields and superior returns vs bonds during high inflation periods

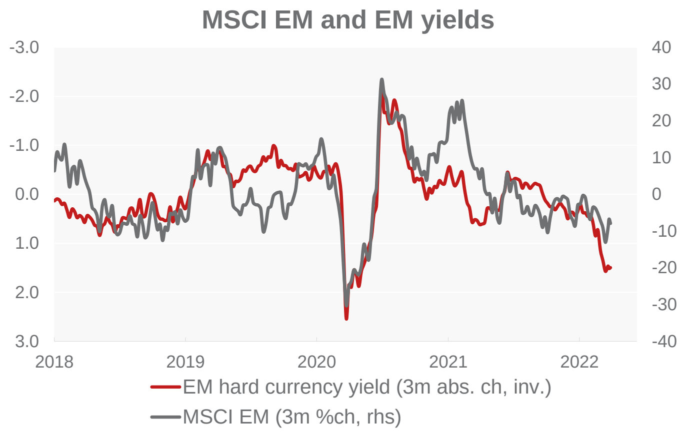
On EU sectors, high geopolitical risks plus spiking inflation and weaker economy ahead represents headwinds for Value-Cyclicals. We still favour a barbell strategy: Value is reduced and in part also cyclicals. Banks are neutral, after having cut its OW progressively in the last weeks, due to higher spreads and lower GDP growth, notwithstanding our expectation of mildly higher 10-year yields. Energy, insurance, and materials are still OW together with durables, food, and health care. UW: cap. goods (dear), div. financials, media, RE, hardware, Tlc and utilities.



Source: Datastream, GIAM calculations



Source: STOXX, Bloomberg, GIAM



Source: Datastream, GIAM

EM Equities: downgrade to neutral

Under pressure from China's renewed lockdowns and increased geopolitical tensions

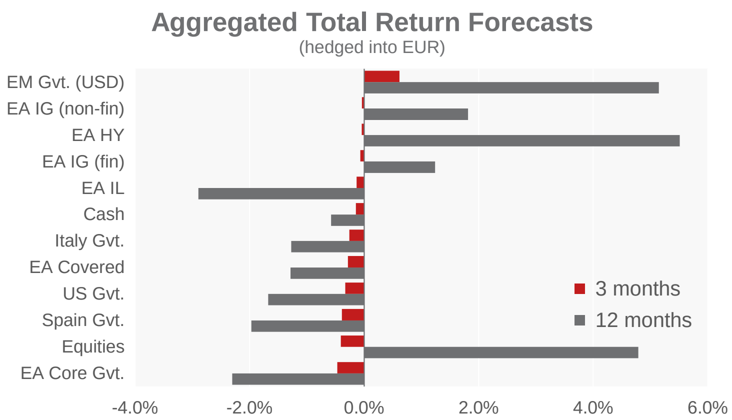
EM equities look attractive vs the MSCI World as the relative 12-month forward PE is 0.6 stdev below average and the yoy underperformance is extreme at -1.6 stdev. The Russia-Ukraine conflict has caused a flight to quality and wider EMBI spreads, inducing a surging firms' COE (cost of equity) also due to a stronger dollar and increasing yields. As a result, our valuation indicator (12-month fwd earnings/10-year yields) still shows a negative fair value gap of 10%, notwithstanding the poor performance. Historically, EM equities underperform amid a period of heightened global uncertainty and geopolitical tensions. Furthermore, China's renewed Covid-related lockdowns and tech supply bottlenecks will continue to pressure earnings momentum short term. We are neutral on EMs, OW Korea and A-shares vs. MSCI China.

ASSET ALLOCATION

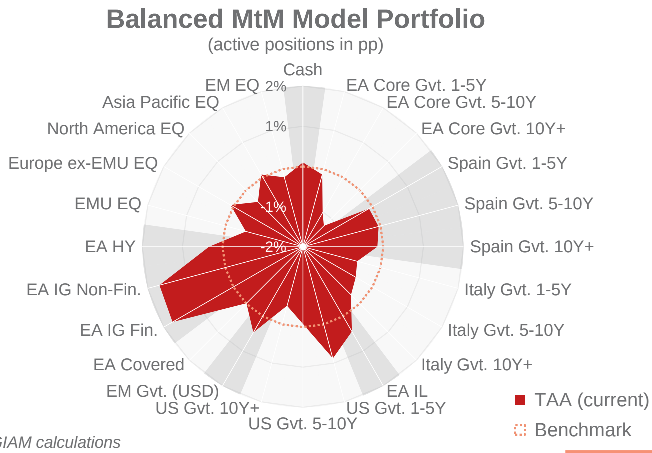
Thorsten Runde

- **In line with our expectation of rising market volatility across the board our cautious allocation stance appeared quite reasonable until mid-February. Given the Russian invasion in Ukraine this stance might even prove not cautious enough any longer.**
- **The war and the western world's comprehensive sanctions add to stagflationary risks, not to mention the danger posed by a further escalation (e.g., the use of chemical or even nuclear weapons) of the conflict.**
- **We expect economic activity to be primarily hit by the Russian invasion through higher inflation and supply-chain bottlenecks which translate into reduced confidence and earnings. Given the weaker growths prospects the overall effect on yields should be muted.**
- **For the time being, we recommend a small UW in Equities thereby reducing the cyclicality of the exposure. The UW in Government Bonds should be maintained, particularly in the long-dated ones. We stick to our OW in Credit, preferring IG to HY and reallocate the IG part in favour of Non-Financials. Together with a muted OW in Cash this adds up to a moderately short duration stance.**

We had already expected market volatility to rise across the board and the circumstances on financial markets to be less clear-cut than in the last year. That said, like all other market participants, we did not have an outright war between Russia and Ukraine on the cards. Uncertainty has risen to an unusual extent weighing on growth prospects and sentiment. With inflation overshooting the risk of central banks' activities is tilted towards more and faster action.



Source: GIAM calculations



Source: GIAM calculations

All in we only see limited upside potential for yields and recommend maintaining an UW in long-dated Government Bonds. Amid the recent market corrections Equities and Credit have gained attractiveness on valuation grounds. Howerver, for the former we advise a moderate UW and to stay on the side lines with a muted OW in Cash before rebuying on dips into the market given the risk of a further escalation. After the recent spread widening IG Credit appears like an attractive source of carry with a limited downside risk compared to HY. Thus, we recommend a sizable OW here with a clear preference for IG. Growth is set to suffer if not even to come to a temporary halt (at least in the EA). Against this backdrop, we opt for a more defensive allocation stance in general by reducing the cyclicality of the model portfolio. For IG Credit in particular we recommend reallocating exposure from Financials into Non-Financials.

Although yields are skewed to the upside as central banks tighten, we maintain just a small duration gap being prepared to close it before the economy slides into a recession.

FORECASTS

Macro Data

Growth	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.7	2.7	- 1.0	2.1	- 0.4	1.7
Euro area	5.3	2.2	- 1.7	1.6	- 0.9	1.6
Germany	2.9	1.0	- 2.5	1.8	- 0.9	1.4
France	7.0	3.0	- 0.8	1.3	- 0.8	1.5
Italy	6.6	2.2	- 1.9	1.5	- 0.8	1.8
Non-EMU	6.3	3.2	- 0.7	1.7	- 0.3	1.7
UK	7.5	3.3	- 1.0	1.6	- 0.4	1.6
Switzerland	3.7	2.5	- 0.4	1.5	- 0.4	1.8
Japan	1.7	2.5	- 0.3	1.8	0.0	0.8
Asia ex Japan	7.8	4.3	- 1.2	5.6	0.4	5.2
China	8.1	3.7	- 1.3	6.3	1.1	5.2
CEE	6.5	- 2.7	- 5.9	4.3	1.3	3.6
Latin America	6.5	1.9	0.0	2.1	0.0	2.3
World	**6.3**	**2.8**	**- 1.4**	**3.6**	**0.0**	**3.2**

Inflation	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	4.7	7.3	2.1	2.2	- 0.4	2.6
Euro area	2.6	6.2	2.3	2.5	0.8	2.0
Germany	3.2	7.0	3.6	2.7	0.8	1.9
France	2.1	6.5	3.9	2.6	1.1	1.3
Italy	2.0	6.0	2.4	2.0	0.7	0.6
Non-EMU	2.3	5.6	1.5	2.8	0.7	1.6
UK	2.6	7.4	2.0	3.5	0.8	1.6
Switzerland	0.6	1.8	0.8	1.5	0.9	1.0
Japan	- 0.3	1.8	0.8	1.1	0.4	0.8
Asia ex Japan	2.0	3.5	0.7	3.2	0.4	2.5
China	0.9	2.5	0.3	2.1	- 0.2	2.0
CEE	9.3	25.0	7.8	14.0	5.9	7.1
Latin America	6.6	4.9	0.7	3.7	0.5	3.1
World	**3.5**	**6.5**	**1.7**	**3.7**	**0.8**	**2.8**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

Financial Markets

Key Rates	Current*	3M	6M	12M
USD	0.50	1.00	1.75	2.13
EUR	-0.50	-0.50	-0.50	0.00
JPY	-0.10	-0.10	-0.10	-0.10
GBP	0.75	1.00	1.00	1.25
CHF	-0.75	-0.75	-0.75	-0.50
10Y Government Bonds	**Current***	**3M**	**6M**	**12M**
US	2.44	2.60	2.65	2.70
Euro-Area	0.56	0.65	0.70	0.80
France	0.99	1.10	1.15	1.25
Italy	2.01	2.20	2.30	2.50
Japan	0.24	0.25	0.30	0.35
UK	1.65	1.70	1.75	1.80
Switzerland	0.56	0.65	0.70	0.80
Spreads	**Current***	**3M**	**6M**	**12M**
GIIPS	115	125	130	135
BofAML Covered Bonds	67	70	70	75
BofAML EM Govies (in USD)	373	360	355	350

Corporate Bond Spreads	Current*	3M	6M	12M
BofAML Non-Financial	142	140	140	130
BofAML Financial	140	145	145	135
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.10	1.10	1.11	1.14
USD/JPY	123	122	120	118
EUR/JPY	135	134	133	135
GBP/USD	1.32	1.31	1.32	1.34
EUR/GBP	0.84	0.84	0.84	0.85
EUR/CHF	1.02	1.02	1.04	1.06
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	4,546	4,530	4,615	4,650
MSCI EMU	138.3	134.5	138.5	141.5
TOPIX	1,979	1,970	2,010	2,040
FTSE	7,475	7,420	7,560	7,630
SMI	12,136	11,920	12,155	12,180

*as of 28.03.22 (3-day-average)

Forecast Intervals*

3-Months Horizon

Government Bonds (10Y)	US	2.08	2.60	3.12
	Germany	0.38	0.65	0.92
	UK	0.87	1.70	2.53
	Switzerland	0.32	0.65	0.99
Spreads	10Y-GIIPS Spread	101	125	149
	BofAML Covered Bonds	58	70	82
	BofAML IG Non Financial	284	140	436
	BofAML IG Financial	103	145	177
	BofAML EM (in USD)	99	360	191
Forex	EUR/USD	1.07	1.10	1.13
	USD/JPY	119	122	125
	EUR/GBP	0.82	0.84	0.86
	EUR/CHF	1.00	1.02	1.04
Equities	S&P500	4,226	4,530	4,834
	MSCI EMU	123.5	134.5	145.5
	TOPIX	1,832	1,970	2,108
	FTSE 100	6,902	7,420	7,938
	SMI	11,198	11,920	12,642

12-Months Horizon

Government Bonds (10Y)	US	1.78	2.70	3.62
	Germany	0.20	0.80	1.40
	UK	0.43	1.80	3.17
	Switzerland	-0.03	0.80	1.63
Spreads	10Y-GIIPS Spread	86	135	184
	BofAML Covered Bonds	51	75	99
	BofAML IG Non Financial	210	130	490
	BofAML IG Financial	62	135	198
	BofAML EM (in USD)	52	350	218
Forex	EUR/USD	1.08	1.14	1.20
	USD/JPY	111	118	125
	EUR/GBP	0.80	0.85	0.90
	EUR/CHF	1.03	1.06	1.09
Equities	S&P500	4,083	4,650	5,217
	MSCI EMU	121.0	141.5	162.0
	TOPIX	1,774	2,040	2,306
	FTSE 100	6,660	7,630	8,600
	SMI	10,827	12,180	13,533

*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5-year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three-month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

IMPRINT

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