



## Natixis Investment Manager | Solutions

### Market convictions: September 2022

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**NIM Solutions  
Central Scenario**

## Key messages September's CAT meeting

The major economic areas returned to growth in Q2.22, supported by the continued reopening of the economies – this trend should continue in Q3.22. However, persistent inflation will push the main central banks to be very firm with tightening policy.



### ***Macroeconomic views: All is well so far, but the...***

The resilience of the major economies was reflected in the data published for the second quarter. Available information shows that activity on both sides of the Atlantic is holding up in the third quarter, particularly driven by the services sector. However, there are a growing number of threats to the business cycle for the last third of the year: a sharp slowdown in China, a severe energy crisis, a contraction in the real estate sector, increased political tensions.



### ***Market trend: Increased volatility is expected to spread across all asset classes***

The restrictive turn of central banks reflects the need to address the inflation challenge. Price growth has now spread to every economic area, raising fears of self-sustaining effects and a de-anchoring of inflation expectations. Central bankers are likely to tighten monetary policy further than currently expected, increasing the volatility of risky assets.



### ***Portfolio orientation: Protection is the key word***

The accumulation of risk factors and the prospect of tighter monetary and financial conditions have led us to reduce the exposure of multi-asset portfolios to both developed and emerging equity markets. The defensive orientation of our investments is also reflected in our continued under-exposure to corporate debt. However, we do believe that current yield levels offered by long-dated US Treasuries provide a protective cushion.

## Overall macroeconomic scenario China weighs on the growth projection

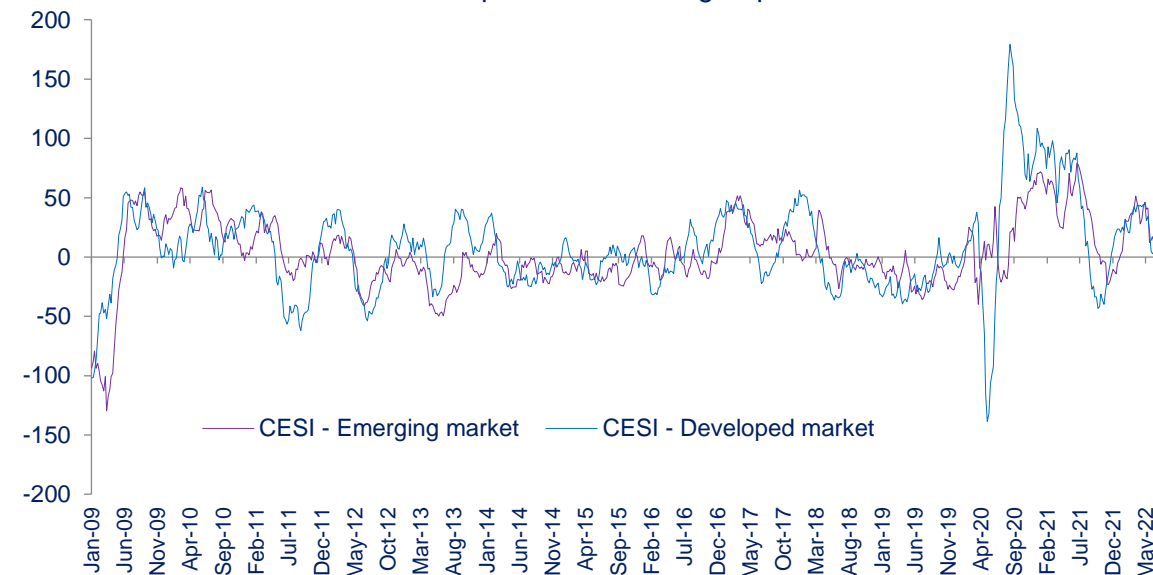
Central Scenario: Real GDP Forecasts

	2020	2021	2022*	Revisions 2022	2023*	Revisions 2023
<b>World</b>	-2.9%	5.0%	2.3%	-0.1%	2.9%	-0.1%
<b>Advanced Economies</b>	-5.0%	5.0%	1.7%	0.1%	1.4%	-0.1%
United States	-3.5%	5.4%	1.5%	0.1%	1.7%	-0.2%
Euro Zone	-6.8%	4.9%	2.1%	0.2%	1.1%	0.0%
United Kingdom	-10.0%	6.3%	2.7%	0.1%	1.4%	0.0%
Japan	-5.2%	2.0%	1.2%	0.0%	1.0%	0.0%
<b>Emerging Economies</b>	-1.3%	4.9%	2.8%	-0.3%	4.4%	-0.1%
China	2.3%	7.8%	3.5%	-0.6%	5.4%	-0.1%
Brazil	-4.1%	2.3%	2.1%	-0.1%	2.3%	0.3%
India	-8.0%	9.2%	6.6%	0.1%	6.0%	-0.1%
Russia	-3.0%	3.1%	-7.3%	0.2%	-1.3%	-0.2%

Sources: NIM Solutions

- Our latest global growth projection has again been revised downwards (-0.1pp compared to July), driven by emerging economies, which are expected to grow at a rate of less than 3.0% in 2022. China's strong slowdown accounts for almost all the region's outlook deterioration.
- The rebound in growth observed in the Euro Area in the second quarter and the upward revision of activity data in the US explain the slight upward revision of the pace of activity in the advanced economies. However, the growth path for 2023 could fall below the psychological threshold of 3.0% for the second year in a row.

Surprise index – Citigroup



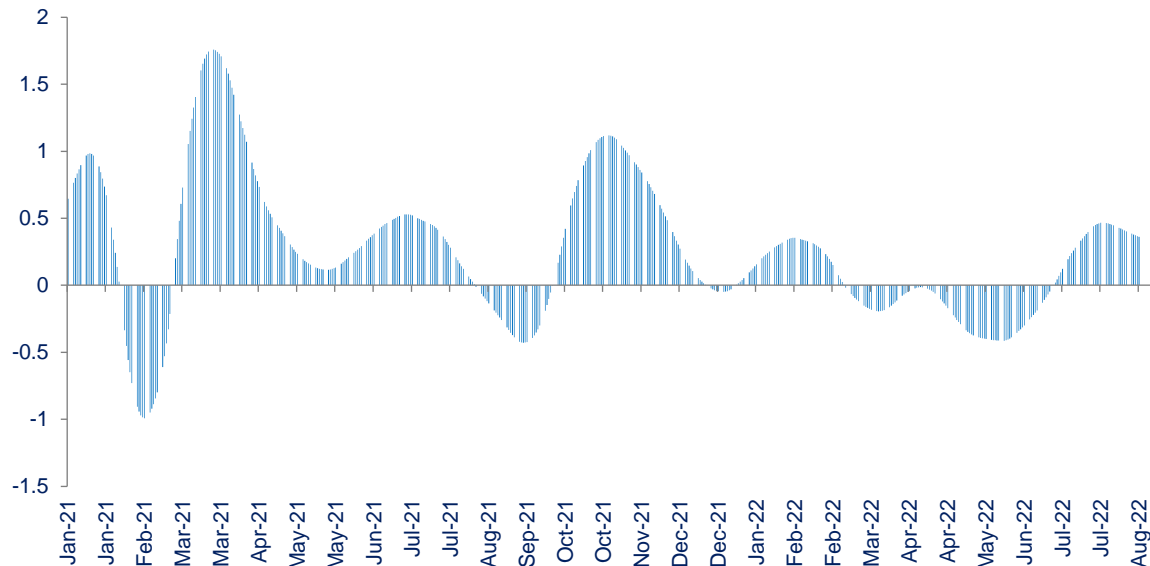
- Despite China's difficulties, Citigroup's Economic Surprise Index shows that business momentum in emerging markets remains positive. This is the case thanks to the strong performance of Latin American economies, which are benefiting from only moderate weakening of energy prices.
- The Surprise Index for developed markets indicates that the situation is improving, driven by the UK and economies directly connected to the energy-commodities sphere, such as Norway and Australia. Economic activity is expected to be solid in Q3.22, but there is substantial uncertainty for Q4.22.



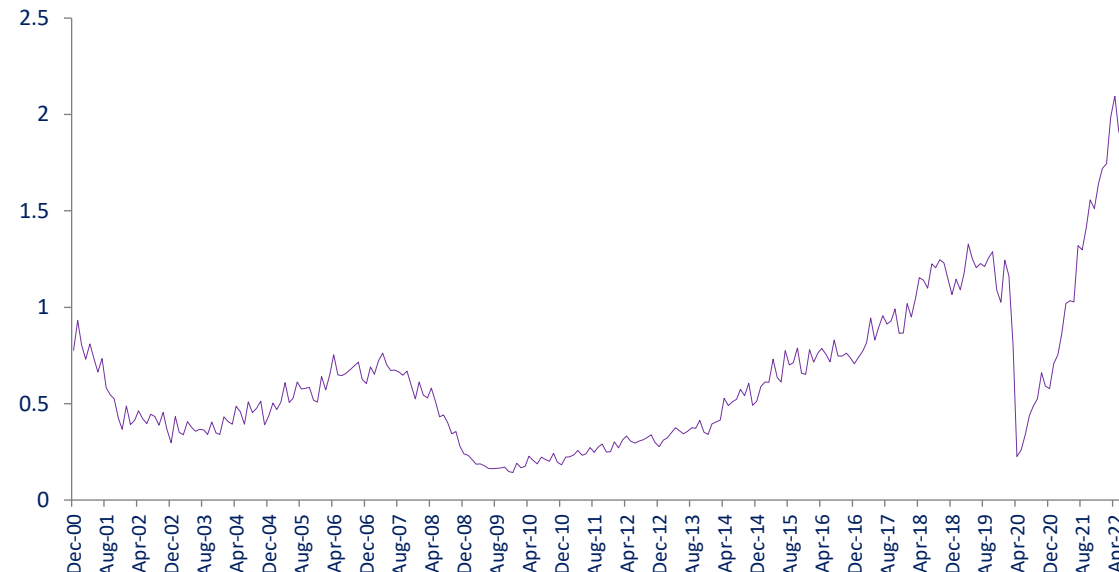
# US first half of the year under the sign of a technical recession

## Activity picks up supported by a strong labor market

High Frequency Activity Indicator (HFA) - Philadelphia Fed



Number of job vacancies per job seeker

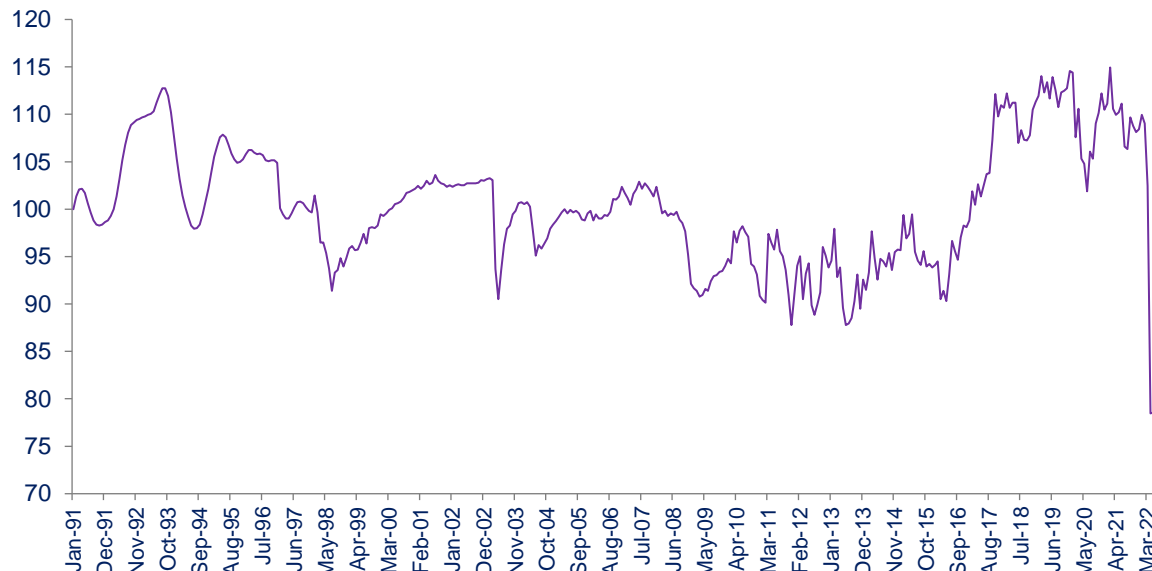


- The new contraction of economic activity in the US (-0.6% in the second quarter on an annualized basis) is mainly explained by strong destocking realized by companies and by the weakening of domestic demand. The US is in a technical recession, meaning two consecutive quarters of GDP contraction.
- However, the US economy is expected to emerge from this technical recession in Q3.22. The high-frequency indicators (see graph above) indicate that growth momentum is back in positive territory. Household confidence in the US has risen again over the summer and the PMI survey shows a recovery in activity, particularly in the services sector.

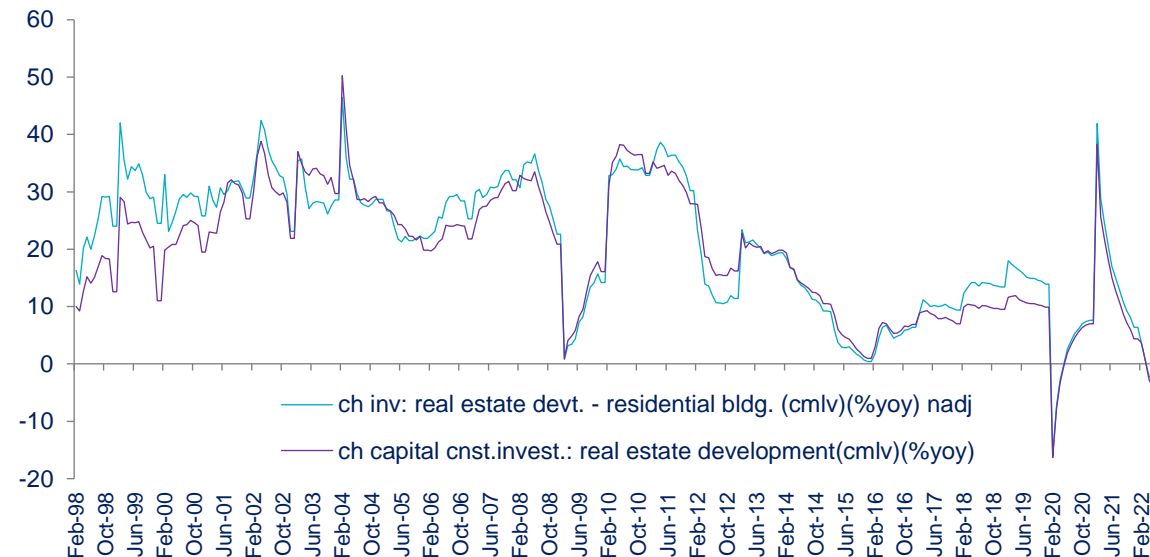
- Nevertheless, the reference to a technical recession is strongly challenged by the robust labor market. Job creation has been massive over the last two months, the unemployment rate is still at a historically low level (3.7%) and the stock of job vacancies remains extremely high. There are now two job vacancies for every jobseeker (see graph above), an all-time high.
- The strength of the labor market is both a bulwark for economic confidence and a source of income for US households. It is also the argument used by the Federal Reserve to justify the more restrictive stance of its monetary policy.

## China: sluggish recovery and poor outlook Cyclical and structural difficulties are piling up

China: Household confidence indicator



China: Gross Fixed Capital Formation in the real estate sector (annualized)

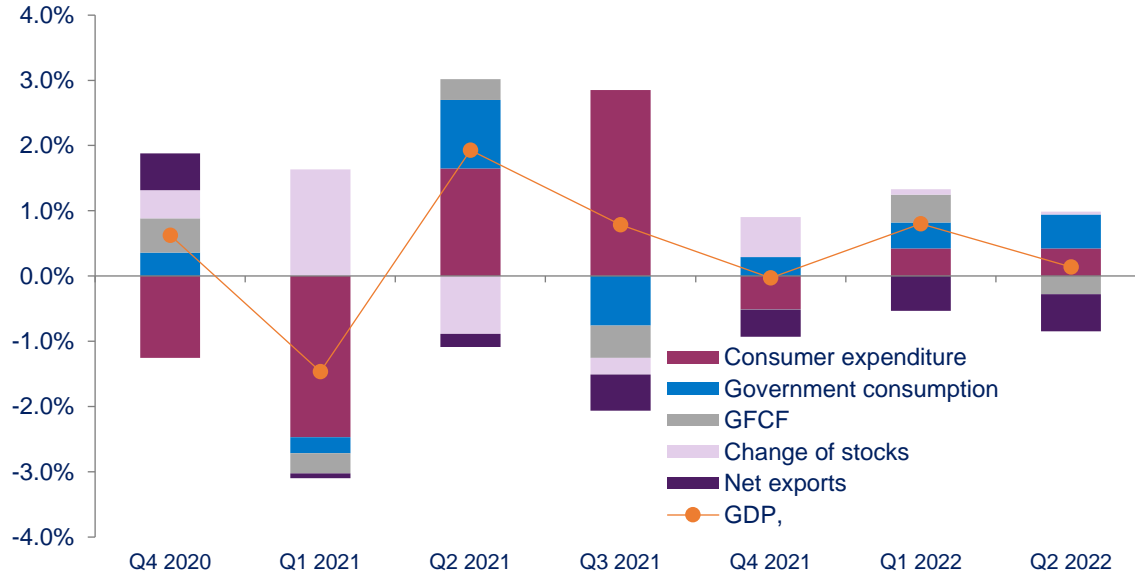


- President Xi's pledge to grow the Chinese GDP by 5.5% in 2022 is now out of reach. Beyond the sluggish growth in the first half of the year, the successive containment measures decided by the administration have taken their toll on household morale and therefore on consumption. Confidence recorded its sharpest drop in history in April (see graph above) and has remained at around 80 points since then.
- The deterioration in household confidence has been reflected in retail sales, which are only modestly up (+2.7% in July), as well as in accumulated savings, which have increased substantially. It is not clear that these savings, or pent-up demand, can be released in a context where the residential sector is showing signs of weakness.

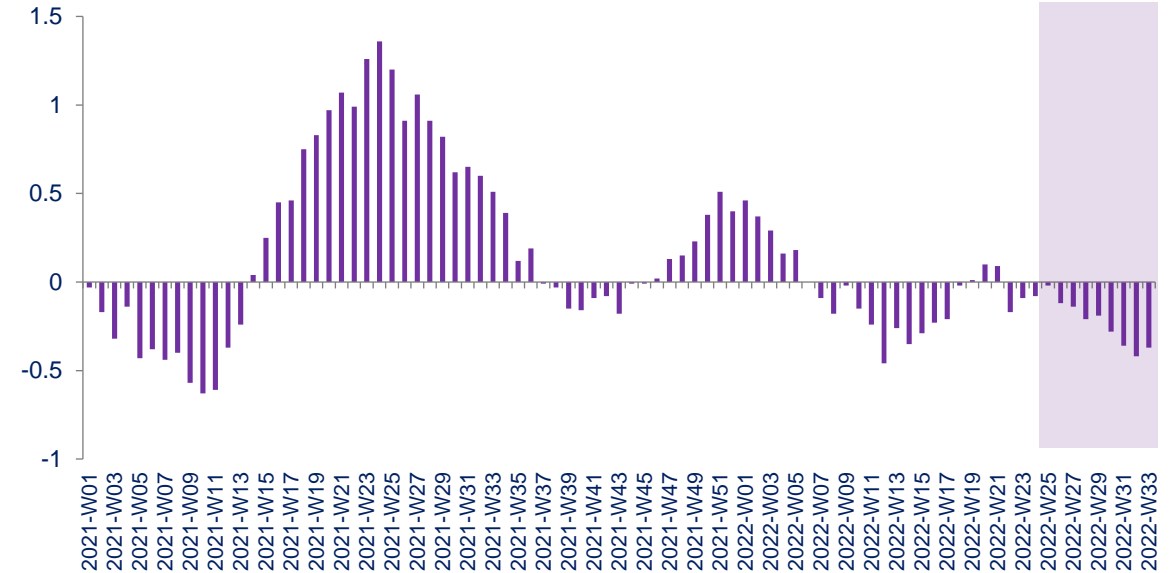
- The housing sector continues to suffer. For the second time in its history, residential investment is contracting, and payment delinquencies are on the rise. The timid support provided by the PBoC, which modestly lowered its interest rates, testifies to the government's strategy of wanting to purge the excesses of the past. However, this strategy may be dangerous for two reasons: a significant part of Chinese households' savings is invested in the residential sector and the banking sector could see its financial situation deteriorate rapidly.
- China is still managing to benefit from external demand. China's exports have remained strong and ensuring capital inflows.

# The German situation differs from that of the other major countries in the Eurozone Towards a Q3 close to zero or even negative again

Decomposition of German growth



Weekly activity indicator - Bundesbank



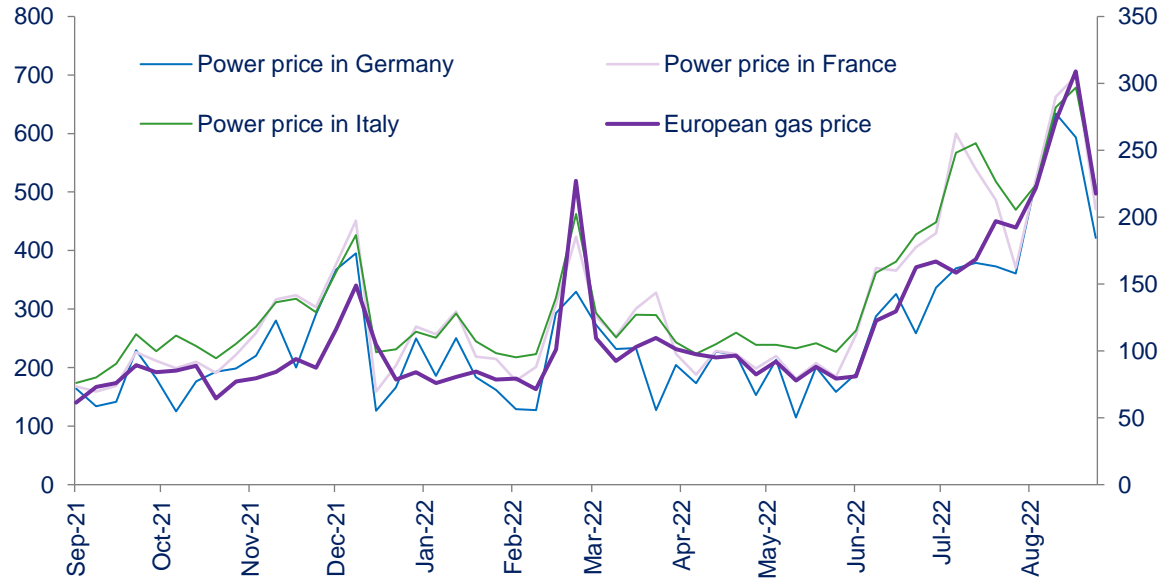
- Eurozone GDP grew by +0.8% in Q2.22, driven by Spain and Italy where activity increased by 1.1% and 1.0% respectively. The German economy, which is among the most dependent on Russian gas, saw its activity stagnate in Q2.22, while French GDP growth rose by 0.5% (after -0.2% in Q1.22).
- The analysis of the contributions to German growth shows that private and public consumption contributed positively to wealth creation while foreign trade and investment both weighed on activity. Investment was weighed down by a contraction in gross fixed capital formation in the manufacturing and construction sectors.

- The outlook for Germany's businesses is sluggish. The Bundesbank's weekly business cycle indicator (see chart above) shows that German growth is likely to be close to zero or even negative for the current quarter. This outlook is supported by economic indicators (IFO surveys, PMI indices) which show that activity is in a marked slowdown phase close to recession.
- Gas reserves in Germany are at 90% (source: Gas Infrastructure Europe), which is enough to cover three months of consumption. Nevertheless, the German government is not ruling out possible energy cuts this winter and is preparing a budgetary response against a likely new negative supply shock.

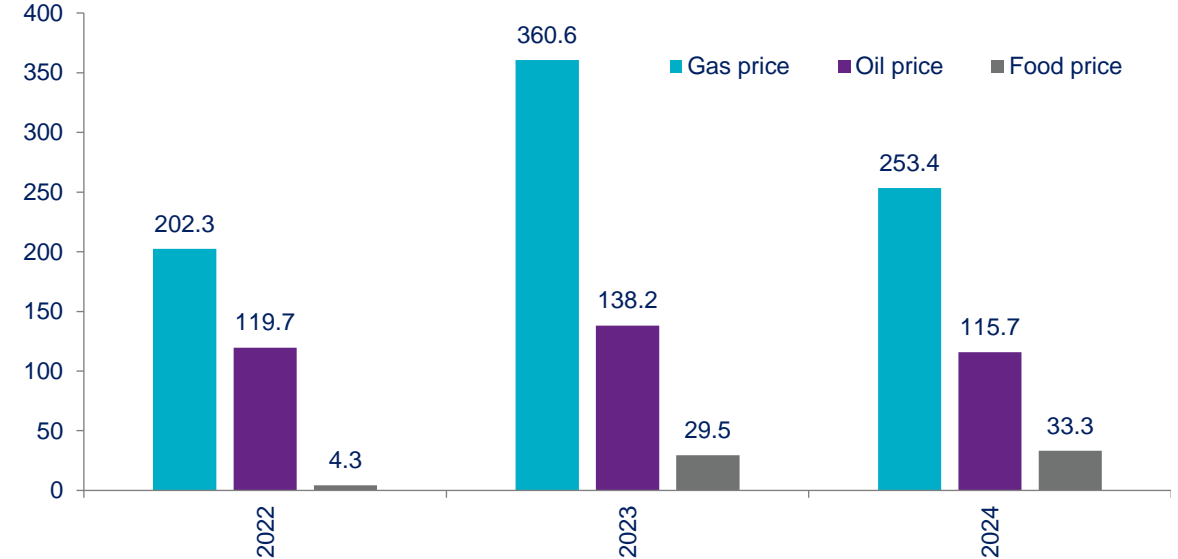
# Supply cuts: gas and electricity prices have reached record levels

## The outlook for 2023 is even more worrying

Electricity and gas prices in Europe



ECB projections for energy prices and the food component

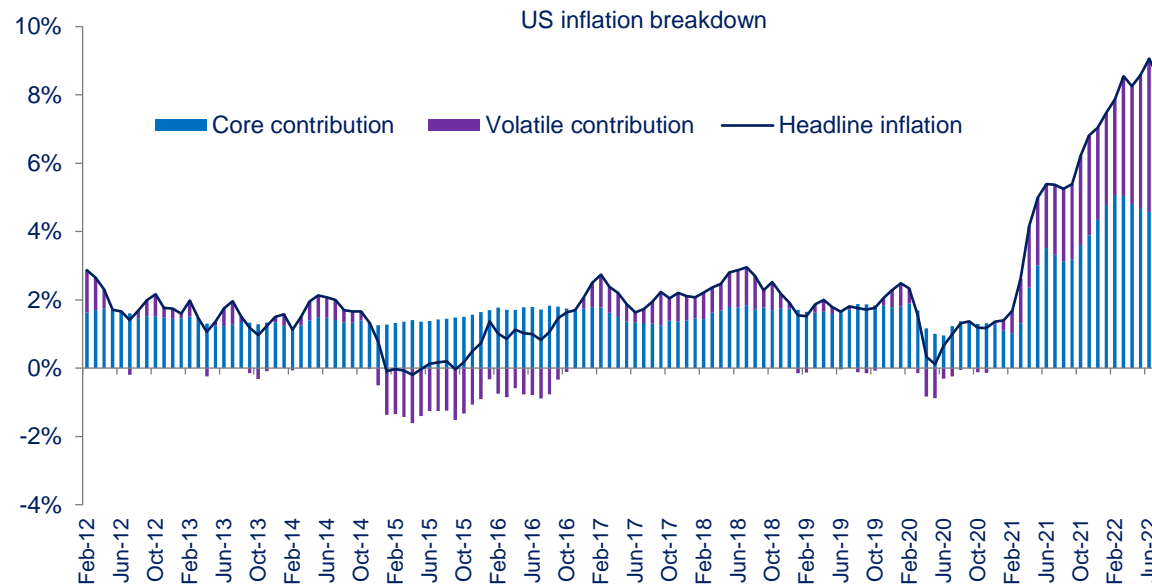
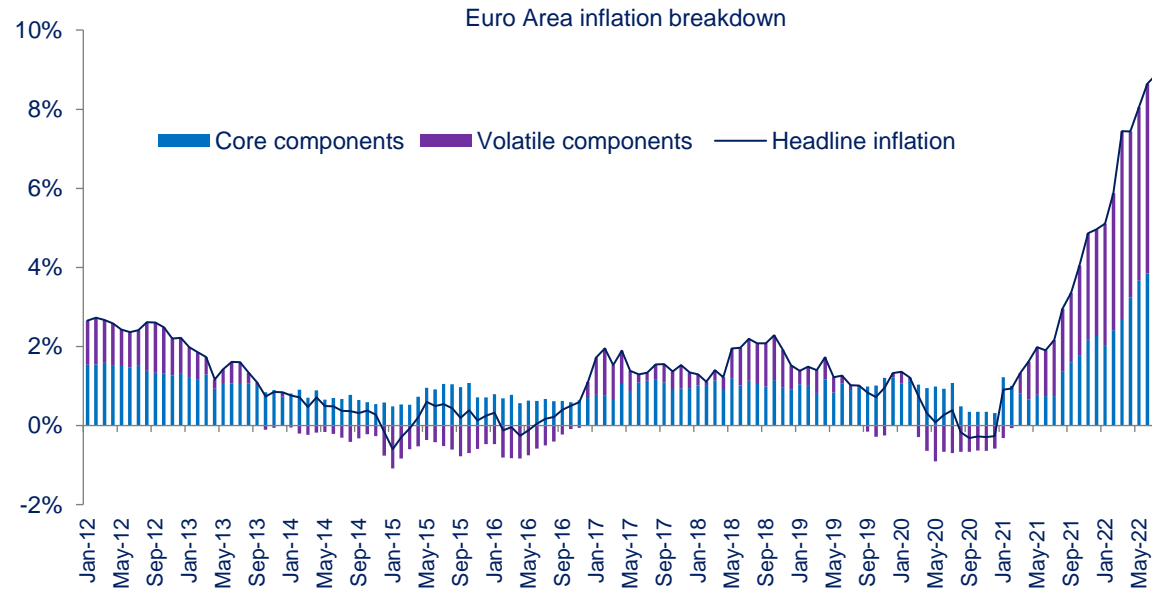


- The series of maintenance processes during the summer and subsequent gas cuts have put strong pressure on energy prices in Europe. Electricity prices reached unprecedented levels in major eurozone countries (see chart above). Russia confirmed that it had completely halted gas flows to several European countries.
- Although several countries have almost filled up their strategic reserves, these reserves represent only two to three months of consumption. The volatility of energy prices will therefore remain at very high levels and weighing on consumption and businesses. An increasing number of countries and companies that have based their development strategy on cheap and abundant energy will have to review their growth plans.
- The ECB's projections for gas prices over the coming years are markedly pessimistic. Gas prices are expected to rise by an average of 78%. However, the item that is expected to see the largest surge is food (see chart above), which accounts for almost 8% of the harmonized consumer price index (HICP). Households with a high propensity to spend are likely to suffer the most, strongly hindering their consumption capacity.
- Eurozone governments are warning against the risk of power cuts in the event of severe winters. As a result, fiscal support plans are being prepared to help households and businesses cope with soaring energy bills.



# Overall macroeconomic scenario

## The inflation peak is still ahead in Europe



- Headline inflation in the Euro Area exceeded that of in the United States. Prices rose by +9.1% in August year-on-year, driven in equal measure by the energy and underlying components. The continued rise in the underlying components is one of the major concerns of the ECB Board.
- US inflation started to fall in August driven by the drop in the energy component. Note that core inflation did not decline (+5.9% year-over-year) compared to the previous month. The real estate component, which stands for nearly 30% of the index, should continue to rise and maintain significant pressure on core inflation and prevent it from falling until Q4.22.

### Central Scenario: Inflation Forecasts (Headline)

	2020	2021	2022*	Revisions 2022	2023*	Revisions 2023
World	1.6%	3.8%	6.4%	0.0%	3.8%	0.0%
Advanced economies	0.8%	3.5%	7.6%	0.0%	4.1%	0.0%
United States	1.2%	4.6%	7.9%	0.0%	4.4%	-0.1%
Euro Zone	0.3%	2.5%	8.2%	0.1%	4.4%	0.2%
United Kingdom	0.9%	2.7%	8.5%	0.7%	5.0%	0.1%
Japan	0.0%	0.2%	2.4%	-0.1%	0.6%	0.1%
Emerging Economies	2.3%	4.0%	5.3%	-0.1%	3.5%	-0.1%

\*Sources: NIM Solutions and Refinitiv

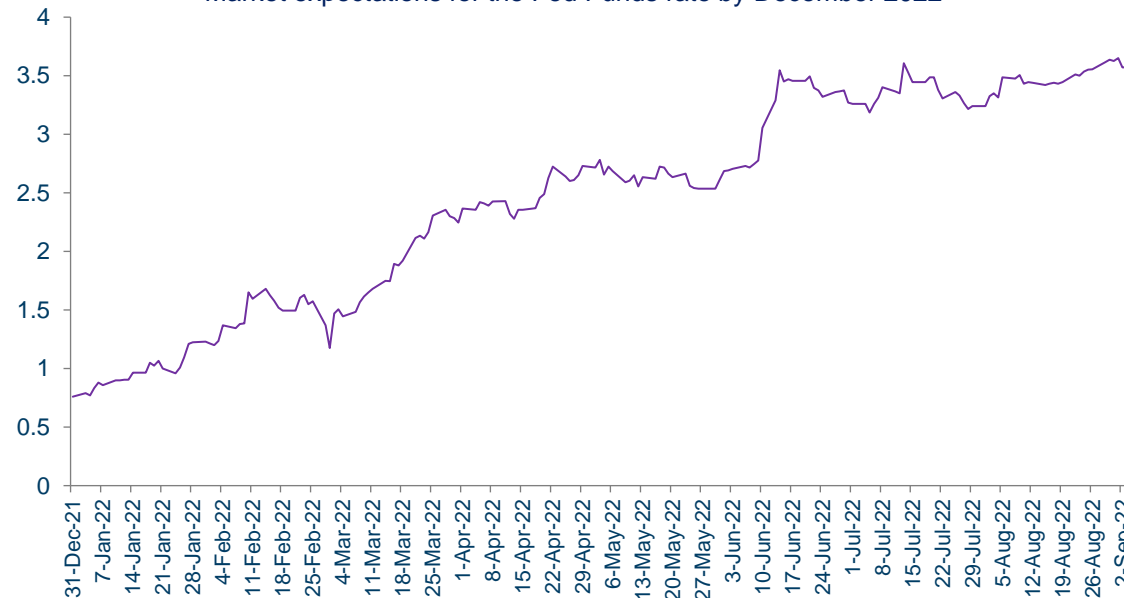
## Monetary policy: central banks are sending out the same message The market underestimates their determination to curb inflation

### Monetary Policy Forecasts

Main Central Banks	Key Interest Rates	Forecasts - NIM Solutions				
		Sep-22	Oct-22	Dec-22	Jan-23	Mar-23
US - Fed - Funds Rate Range	[3.00% - 3.25%]	[3.75% - 4.0%]	[4.25% - 4.5%]	[4.5% - 4.75%]	[4.5% - 4.75%]	
Eurozone - ECB - Main Refinancing Rate	1.25%	2.00%	2.50%	2.50%	2.50%	
ECB - Deposit Rate	0.75%	1.50%	2.00%	2.00%	2.00%	
Bank of England	2.50%	3.25%	3.75%	4.00%	4.25%	
Bank of Japan	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%	

Sources: NIM Solutions

Market expectations for the Fed Funds rate by December 2022



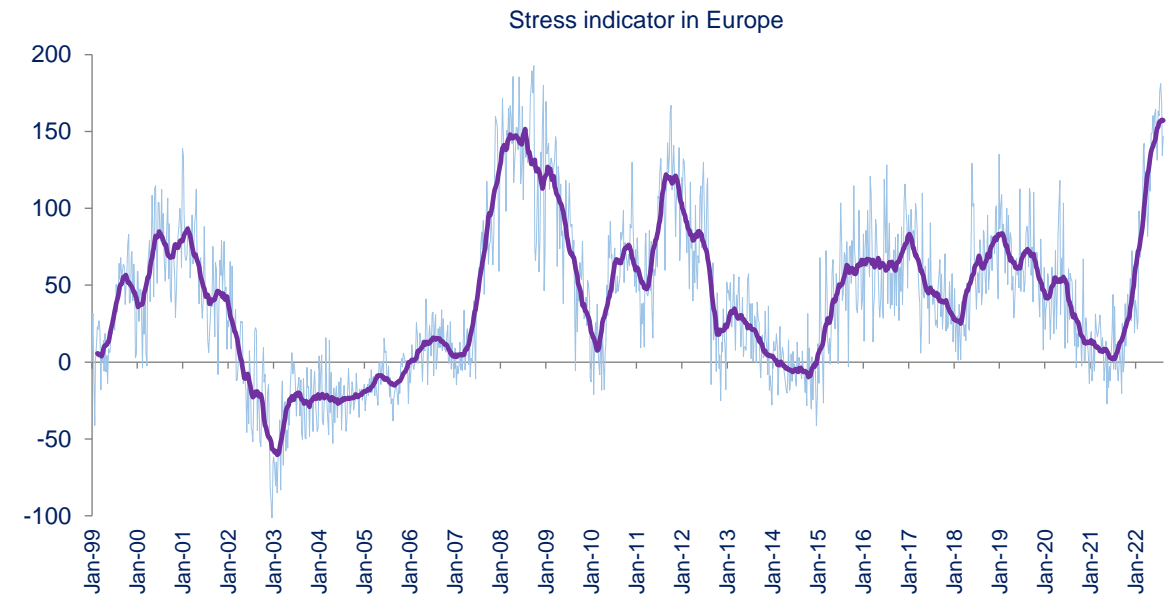
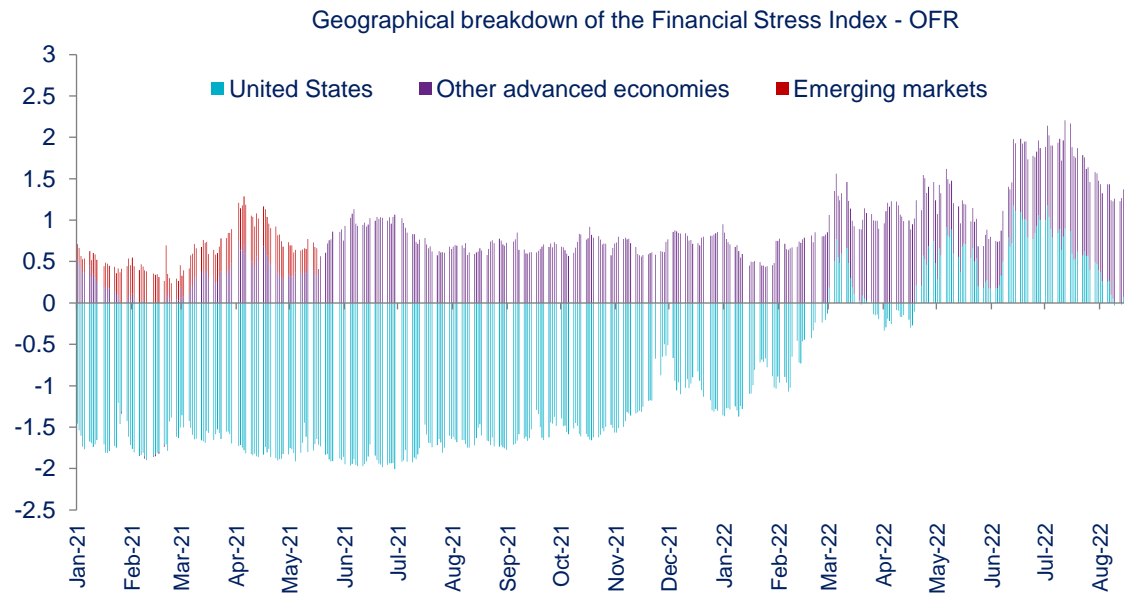
- The volatility of the macroeconomic cycle and the persistence of inflation have led central banks to deliberately set aside their forward guidance. They need to steer their monetary policy as closely as possible to the indicators to take the decisions best suited to the economic context.
- August’s Jackson Hole symposium was an opportunity for the three major central banks to make two clarifications on monetary policy: "higher for longer". These two words imply that the tightening cycle is far from over and that financial conditions will have to remain restrictive for a longer than expected in order to achieve the objective of price stability.
- From September onwards, the ECB and the BoE will step up their pace of their monetary tightening and deliver 75bp rate hikes. The Fed is also expected to again hike by 75bp in September. Our rate projections for the end of the year sees policy rates at 4.25% - 4.5% in the US, 2.5% in the eurozone, and 3.75% in the UK.
- Our projection is above market expectations for the Fed funds rate, which see it reaching just 3.9% by yearend. Investors are likely to be surprised by a more aggressive Fed than expected, leading to increased volatility in risky assets in Q4.22.



## Asset Class Views



## Towards a new market regime characterized by renewed stress Stress is concentrated in the Euro Area



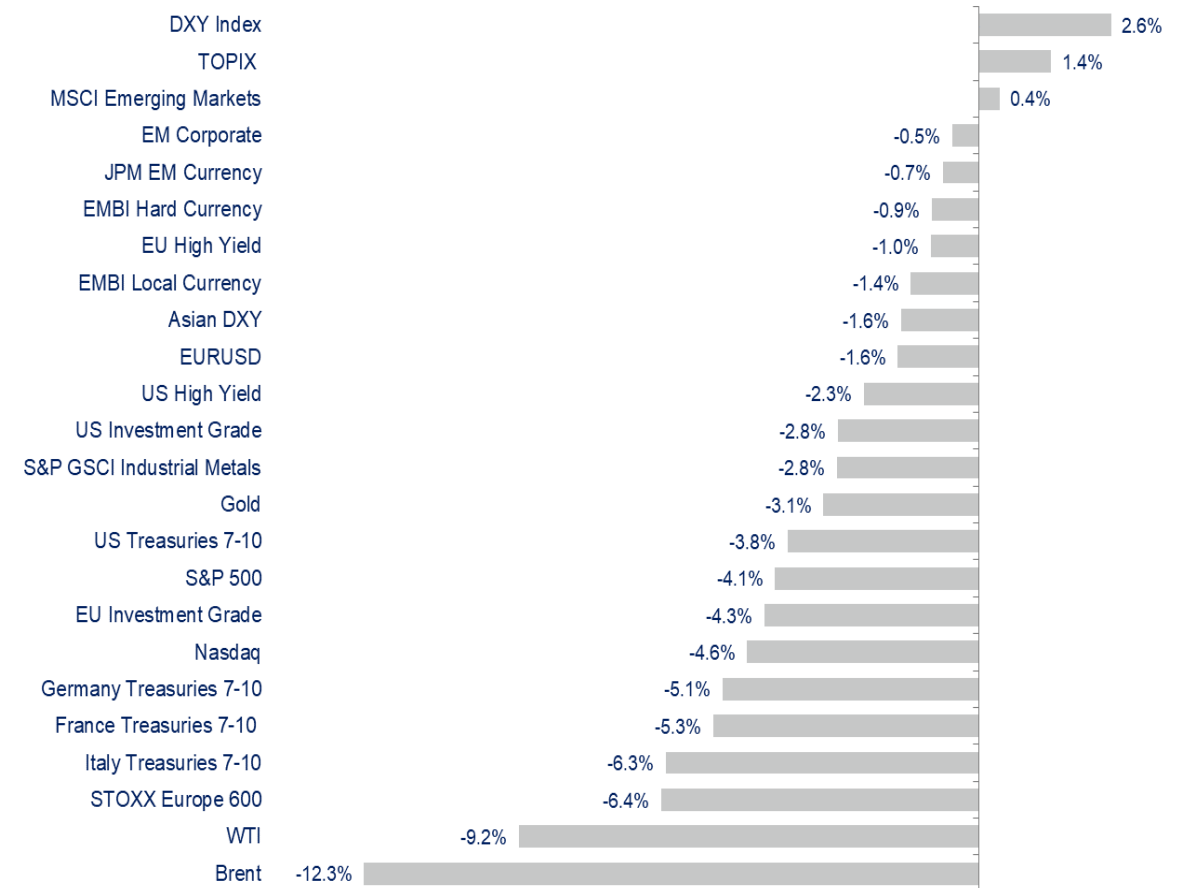
- Risk indicators had eased during July, particularly in equity markets. This reduction in market stress was mainly attributable to a misguided expectation of a possible central bank pivot before the end of the year. The remarks made at the Jackson Hole symposium have swept away this expectation and trigger both rates and equity volatility to jump again. There are now plenty of reasons to believe that this high volatility regime should accompany us over the next few months.
- The geographical decomposition of the OFR index (see graph above) shows that neither Emerging markets nor the US have contributed to the recent rise in market stress. The plausible hypothesis is that the risk is concentrated in Europe and more precisely in the Euro Area.
- The hypothesis that most of the risk is being concentrated in the Euro Area is supported by the indicator shown in the chart above. This indicator, which represents the difference between the implied volatility of the equity and bond markets in the Euro Area, has risen above the levels observed during the 2008 crisis, indicating that the tensions in the bond market have reached previously unobserved levels.
- The sharp rise in this indicator results from the combination of economic, political and financial uncertainties weighing on investors' sentiment. Since the beginning of the invasion of Ukraine, the Euro Area has seen outflows in risky assets, especially in equities. The poor sentiment of investors in the Euro Area is mainly benefitting the US market, which is recording significant inflows.

## Market views





### Nervousness in the bond markets is spreading

- Market Regime:** Stock prices have benefited both from a strong earning season in the second quarter and from expectations that central banks would moderate the tightening of their monetary policy. However, governors undermined any hopes of a pause in their rate hikes in August. As a consequence, the gains seen during July have now been erased and investors are now anticipating a less favorable financial environment. Implied volatility indices have risen significantly, reflecting the increased cost of protection that investors are willing to pay to protect themselves from a market downturn. We believe that we are entering a regime of sustained higher volatility.
- Equity markets:** The outlook for corporate earnings growth for 2022 remains high overall, given the many risk factors mentioned. Note that the outlook within the eurozone is mixed. The difference between Germany and France's 12-month earnings expectation reflects the fragmentation in stock markets. In addition, the relative valuation level between the US and the Eurozone stands at a levels not seen since the 2009 crisis, suggesting how expensive the US market still remains and the downside risk that investors face.
- Bond markets:** Bond markets as a whole have continued to decline significantly. We believe that the low point has not yet been reached, particularly in the eurozone, as the ECB begins its monetary tightening cycle. The corporate debt market also remains under strong pressure, regardless of the segment considered (High Yield or Investment Grade), penalized by the rise in sovereign rates as well as by the widening of credit spreads.

Performance of major asset classes in August (denominated in US dollars)



# Equity Markets


Asset Class	Tactical View	Comments
<b>Overall View</b>	0	
<b>Developed Equity</b>	EMU 	Despite the good growth figures for Q2 and the positive surprise from corporate earnings, we have decided to accentuate our underexposure to the eurozone equity market by closing our exposure to the banking sector. The equilibrium relationship between long-term interest rates and banking stocks has been broken since the beginning of the year, and the prospects for a tightening of credit demand in the eurozone is set to weigh further on these stocks.
	Europe ex-EMU 0	Unlike with the Eurozone, we have decided to maintain a neutral position (0) on European ex EMU equities. Several economies continue to benefit from the tensions in the energy sector, providing an additional avenue for diversification.
	North America  0 1	The strength of the US economy, particularly of its labor market, trims the prospects for recession in the near term. Nevertheless, we have decided to return to neutral on US equities, considering that the relative overvaluation of US equities (compared to European ones) constitutes a risk in a context where monetary policy tightening would continue to be implemented. Moreover, it is rather unlikely that there will be any net upward revisions to corporate earnings prospects.
	Japan 0	We have maintained our neutral position (0) because of the diversification potential that Japan can offer. The weakness of the yen is a support factor for Japanese companies, particularly those for whose activities are export-oriented. This position remains dependent on the dynamics of the exchange rate, which beyond a certain depreciation threshold could hinder the margins of Japanese companies.
<b>Overall View</b>	-1	
<b>EM Equity</b>	Emerging Asia  -2 -1	We have significantly reduced the exposure of the diversified portfolio to Asian equities. The economic difficulties in China (latent real estate crisis, negative shock on household confidence) combined with the continuation of the zero-Covid policy (new restrictive measures have been announced) are clouding the outlook for the region as a whole. The renewed tension between the US and China over the Taiwan issue adds an additional risk factor.
	Latam  0 1	We are taking a tactical bet in favour of Latin American equities. The still existing tensions on the price of energy goods, the good monetary policy management by most central banks, who correctly anticipated the movements of the Fed, reinforced by a quieter political climate compared to that in Asia, makes us favor these markets in our diversified portfolios.






## Sovereign and Corporate Debt Markets

Asset Class	Tactical View	Comments
<b>Overall View</b>	<b>-2</b>	
<b>Sovereigns</b>	Euro	-2 The positioning of our diversified portfolios to the public debt of the eurozone member countries is unchanged. The comments made by the ECB Board members (Isabelle Schnabel) during the Jackson Hole symposium leave no doubt about the central bank's determination to strengthen its hawkish stance. We do not expect much less than 175bp of rate hikes by yearend, which should result in further appreciation of long-term rates.
	US	0 → 1 We have adjusted the exposure of our portfolios to US government debt by extending the duration through the purchase of bonds with longer maturities (beyond 15 years). The aim is to take advantage of the carry offered by these bonds, whose yield is well over 3.0%, and to build up a protective cushion that could serve as a buffer if the markets were to take an adverse turn.
<b>Overall View</b>	<b>-2</b>	
<b>Corporate Debt</b>	Euro Credit	-2 We have maintained our strong underweight (-2) on the corporate debt market. Tighter monetary conditions and exogenous risks to the business outlook are likely to push default rates higher and cause credit spreads to widen.
	US Credit	-2 Although the macroeconomic outlook is more favorable in the US, the structure of corporate debt (funding via the debt market unlike their European counterparts that use the banking sector) exposes them to a de facto rate hike that could be more significant than expected. We have maintained our strong underweight (-2).
	EM Credit	-2 We maintain our view and strong underweight (-2) on EM credit. The strength of the US dollar, due to the uncertain environment in particular, constitutes a main factor weighing on the asset class.

# Cash and Currencies

Asset Class	Tactical View	Comments
<b>Overall View</b>	<b>2</b>	
<b>Cash</b>	Euro	 <p>The liquidity pocket increases mechanically as a result of adjustments made within the equity pockets. This liquidity pocket constitutes a cushion that will allow us to look out for investment opportunities.</p>

Asset Class	Tactical View	Comments
<b>Overall View</b>	<b>1</b>	
<b>Currencies</b>	USD/EUR	 <p>In the short term, we maintain a positive view on the US dollar against the euro. The European currency faces many headwinds while the greenback continues to benefit from the global economic concerns and from the Fed's tightening monetary policy.</p>
	EUR/GBP	 <p>Both currencies face the same risk factors: rising and persistent inflation and significant tightening of monetary conditions by central banks. We believe that both currencies should remain weak, especially against the US dollar.</p>
	USD/YEN	 <p>We have maintained our tactical exposure to the yen. Its valuation continues to be attractive and a shift in monetary policy stance, even a slight one, would support the Japanese currency's rise. The yen is currently at its lowest level in two decades.</p>

## Wall of Worries

### Economic Risks

- Economic uncertainty is gaining ground and weighing on consumer and business confidence. The only support for economic momentum, namely domestic demand, is deteriorating and leading to a more severe economic slowdown than expected
- A monetary policy mistake: central banks have vastly underestimated the persistence of inflation. The main central banks are forced to raise rates even more aggressively to preserve their main asset: their credibility
- The emergence of new variants or viruses that lead to further restrictions and lockdowns
- Central banks fail to control inflation and stagflation becomes the new framework → hard landing of economies and sustained inflationary pressures
- Collapse of the housing markets in the US and China leads to an increase in delinquencies and jeopardises the financial situation of households and weakens the banking system

### Financial Risks

- The rise in interest rates and the slowdown in economic activity leads to a deterioration in the credit market, driven by the increase in default rates, both in the IG and HY universes
- The Italian elections are giving rise to an anti-European coalition that raises fears of a risk to Italian public finances that could lead to a substantial widening of interest rate spreads
- Standard monetary policy tools can no longer be used as in the past to deal with inflation. Currencies are used by central authorities to stabilise and sustain the economic cycle; currency volatility ahead
- Emerging sovereign debt and the domino effect. The deterioration of the economic and financial conditions of small emerging countries causes a chain reaction and affects medium-sized economies

### Tail Risks

- Threatened food security: supply shortages and high transport costs due to the war could cause a food crisis and trigger social unrest
- Complete disruption of energy supply in Europe and severe winter in a context where strategic reserves have not been fully filled → recession and political crisis
- The emergence of new variants or viruses that would lead to further restrictions and closures
- War scenarios: i) V. Putin eventually resorts to extreme solutions after Russian forces fail to make strategic gains, ii) more countries take part in the conflict
- The escalation between China and the United States over Taiwan leads to a new economic clash (new trade sanctions and retaliatory measures) and increases tensions between the two superpowers



## Disclosure

**All investing involves risk, including the risk of loss.** Investment risk exists with equity, fixed income, and alternative investments. There is no assurance that any investment will meet its performance objectives or that losses will be avoided. Past performance is no guarantee of, and not necessarily indicative of, future results.

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