Market Perspectives

The Fed has left the party

GIAM Macro & Market Research

February 2022

- Fed tightening will start in March. They promise to be nimble, not gradual, i.e. less predictable, more data-dependant, and possibly faster.
- We still expect the unfinished global recovery and decent earnings growth to lend support to risk assets. Yet two key risks are materialising: a tougher Fed and rising energy prices. We scaled back our Equity overweight (OW).
- In FI we retain an OW in Credit given residual ECB support and resilient fundamentals; we stay UW long-dated Govies. Both positions are paying off.
- The USD still has legs on Fed support, but we expect a reversal of fortune later this year.

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Global View – The Fed has left the party

Thomas Hempell / Vincent Chaigneau

- **Fed tightening will start in March. They promise to be nimble, not gradual, i.e. less predictable, more data-dependant, and possibly faster.**
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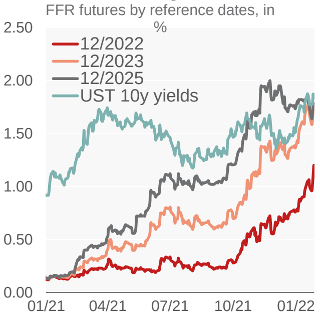
It is hard to keep a party going when the music is switched off abruptly. Many investors headed for the exit as the Fed signalled a much sharper pivot towards policy normalisation in January. The almost 30 bps rise in 10y UST yields has caused some clean-up in equities (MSCI World -7% by Jan 28). In our 2022 Outlook we had cautioned against a looming rise in volatility on policy headwinds, promoting a very prudent OW in risky assets.

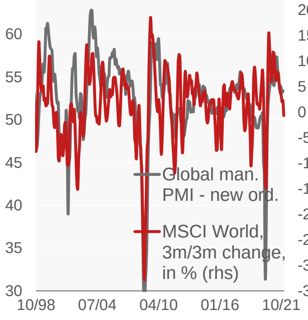
Despite stronger headwinds from the Fed and energy prices, we look to buy the dips. First and foremost, the global recovery still has legs in 2022, and more so than 2018 (an often-cited reference of Fed hikes and QT). The fast spreading of Omicron has triggered another speed bump in growth, but many countries are lifting restrictions given the lower lethality. Look for an economic reacceleration into spring. We see risks from China's zero-Covid strategy that seems increasingly ill-equipped for more contagious, less lethal variants and may trigger new supply disruptions and shortages. Yet policy support is broadening in China (rate cuts, lending push, less strict energy policy, room for fiscal spending to rebound).

Fed Funds Futures and US yields



Source: Datastream, GIAM calculations

Global economy and equities



Source: Markit, Datastream,

We are most concerned about rising monetary policy uncertainties. We now look for at least four Fed hikes (starting in March) and balance sheet reduction (mid year); the market is priced for between four and five. Powell's recent denial to rule out even much faster tightening bears substantial risks for market valuations.

Geopolitical tensions in Ukraine have not helped either. A full-fledged Russian invasion and disruptive sanctions may well be avoided. But lingering worries about European energy supply are adding to price pressures as global supply chain bottlenecks are easing sluggishly. The situation is most delicate in the US, where a hot labour market and rising housing costs risk making price increases becoming entrenched.

Persistent opportunities in market dips

The terminal Fed Funds Rate (still priced below 2%, implying persistently negative real yields) remains too low. This leaves further upside for US yields, even if at a more muted pace than seen recently. A priced 2022 ECB lift-off seems overdone. Yet the pull from UST yields and preparations for a 2023 ECB rate hike will continue to burden EUR fixed income, Italy's presidential election outcome will help to ease pressure on BTPs.

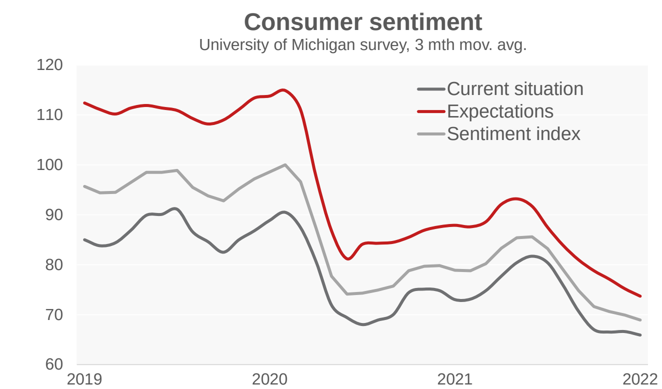
10-Year Bond Yields	Current*	3M	6M	12M
US	1.81	1.90	2.00	2.20
Germany	-0.07	0.00	0.10	0.20
Italy	1.26	1.40	1.55	1.75
Japan	0.14	0.15	0.15	0.15
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.12	1.11	1.12	1.14
USD/JPY	115	117	114	112
EUR/GBP	0.83	0.83	0.84	0.85
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	4344	4400	4520	4750
MSCI EMU	147.3	149.5	151.5	160.0

** 3-day avg. as of 27/1/2022*

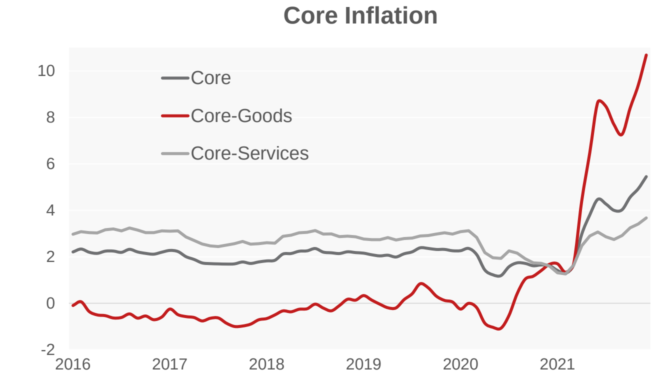
The rise in long-term real yields is a headwind to equity valuations. That said, equity multiples have retrenched faster than real yields have increased. The 12-mth forward PE for MSCI World has dropped to 17.5, from a peak above 21.0 a year ago. Fed policy will stay far from restrictive in 2022 and earnings growth is slowing but not stalling. This leaves some muted upside for equities (right chart), albeit in a much more volatile setting. We continue to prefer Value over Growth. We expect Credit to stay resilient amid the recent spike in risk aversion, still benefitting from ECB support, low defaults and solid profits. The USD has further upside on the Fed, but we expect a reversal of fortune later in the year as the global recovery keeps a lid on the anticyclical currency.

USA

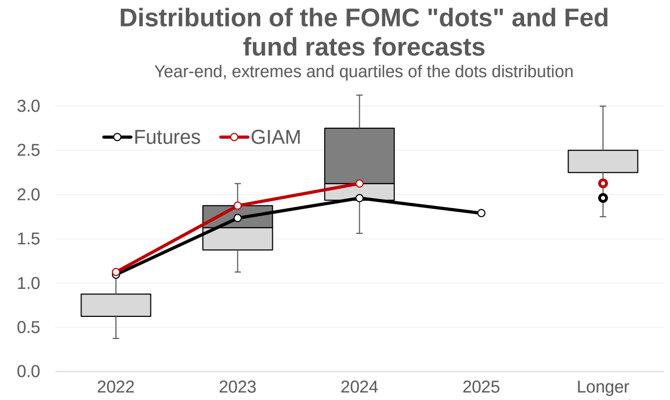
Paolo Zanghieri



Source:Univ. of Michigan, Datastream, GIAM



Source:Datastream, GIAM



Source:Federal Reserve Board, Datastream,GIAM estimates

- **Data for the last weeks of 2021 and the beginning of the year weakened due to the Omicron variant and persistent supply bottlenecks. Headwinds are likely temporary and growth should resume leading GDP to increase by 3.7% this year**
- **Inflation continues to edge higher and appears widespread. The core rate will remain above 3% at year-end. Sustained wage growth is a key upside risk factor.**
- **The Fed surprised on the hawkish side and we now expect four rate hikes in 2022 with balance sheet reduction beginning in the summer.**

After an overall strong Q4, with GDP up by 6.9% annualised, the economy has turned the year on a weaker note, especially for consumption. In December, retail sales dropped by 2.1% mom and in January the Michigan sentiment index fell from 70.6 to 78.8, dragged down by the expectation component. Fears related to the Omicron variant and high inflation, coupled with supply disruptions, weight on the mood. Yet, the effects will be transitory, and a weakish Q1 should be followed by a bounce back in the second quarter. We expect GDP to grow by a below consensus but still solid 3.8%. Risks are balanced: the negative tail has increased due to the Fed's more aggressive stance and the political gridlock blocking any further fiscal stimulus.

Inflation continues to surprise on the upside, with core CPI at 5.4% yoy in December. Price pressures are extending to the services sector and this may dampen the decrease in goods prices we expect as supply returns to normal. A very tight labour market, with less than two unemployed available per three job openings in November, is sustaining wage growth, with the employment cost index up by 4% yoy in Q4. Surveys show that firms feel confident to pass a large part of the extra costs to retail prices. This will limit the drop in inflation we expect in the second half of the year, and core CPI will remain above 3% yoy at the end of the year. Risks remain tilted to the upside.

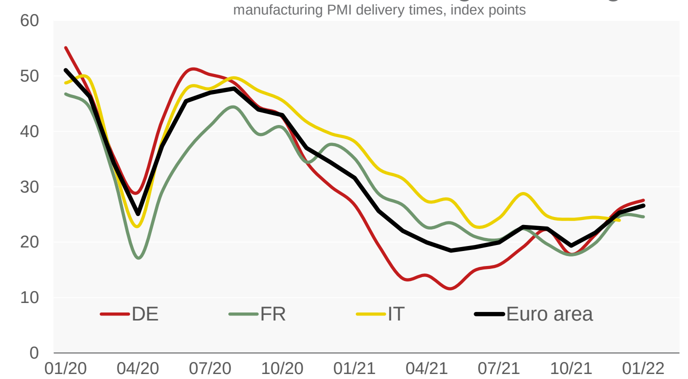
Bad news on inflation accentuated the hawkish tilt of the Fed. In the January meeting the FOMC cited the strong labour market as evidence that the economy can withstand a quick removal of monetary stimulus. We therefore expect four rate hikes this year, without ruling out a fifth one, and the beginning of the balance sheet reduction in July; it should be fast but predictable, ending by mid 2025.

Euro Area

Martin Wolburg

Bottlenecks show some signs of easing

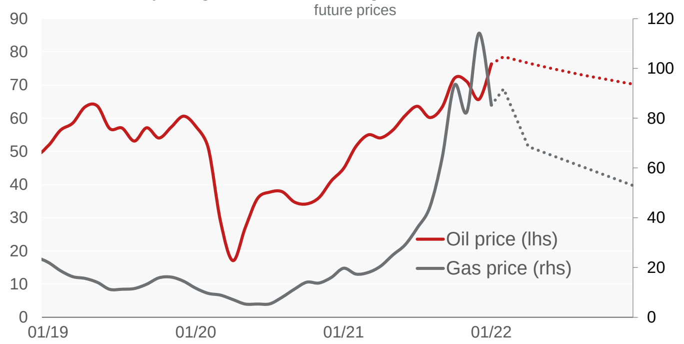
manufacturing PMI delivery times, index points



Source: Datasteam, GIAM calculations

Persistently high energy prices ahead

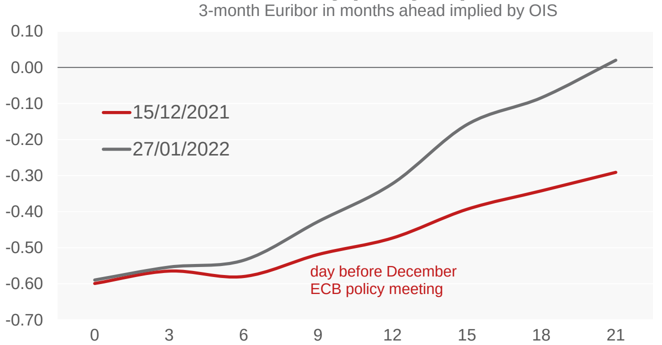
monthly average; oil: EUR/barrel brent, gas: EUR/ Mwh; dotted lines: latest future prices



Source: Datastream, GIAM calculations

ECB monetary policy expectations

3-month Euribor in months ahead implied by OIS



Source: Datastream, GIAM calculations

- **Signs of easing manufacturing bottlenecks amid receding Covid cases in some countries back our view of again stronger activity in spring.**
- **Headwinds emerge from further energy price increases and geopolitical tensions. We trimmed our 2022 growth forecast to 3.7%.**
- **We expect the ECB to again make clear that a 2022 rate hike is very unlikely at its February policy meeting but now look for a hike in 2023.**

The worsening of the pandemic situation in autumn amid persisting bottlenecks in the manufacturing sector triggered the expected cooling of GDP growth. But with a reading of just 0.3% qoq it was surprisingly weak. The key reason was strongly (-0.7% qoq) falling German growth. Nevertheless, the recovery will continue. Bottlenecks are easing (see top chart) and in some economies (summing up to 33% of euro area GDP), new cases (7-day average) have already come down from their latest peaks. With likely even more tailored pandemic measures and higher consumer confidence activity is set to gain traction again.

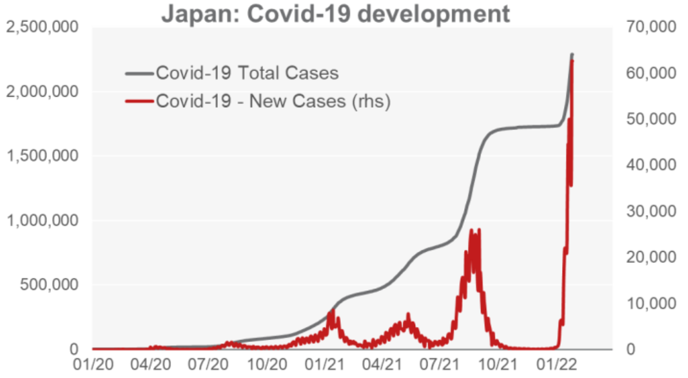
Headwinds to growth come from another push in inflation. The increased tensions related to the Ukraine pushed energy prices further up. Therefore and because of signs for stronger underlying price pressure we again revise our inflation forecast up and look for an annual average of 3.3% in 2022.

In sum, these factors will not derail the recovery but drag on activity. We reduced our 2022 euro area growth expectation to 3.7%, from 4.1% before.

The ECB will need to adjust to an environment of higher inflation for longer. Governing Council members increasingly emphasize upside risks to inflation in their speeches. We now expect that higher energy prices and second-round effects in the 2022 wage negotiations trigger a first 20 bps rate hike already in June 2023. That said, market expectations about a 2022 rate hike are clearly overdone. The euro area economy currently undergoes a period of weak growth, financing conditions already tighter because of forthcoming Fed rates hikes and the ECB has committed itself to a sequence of policy normalization with stopping QE before hiking rates. Hence, the hurdles for a 2022 rate hike are very high and we expect President Lagarde to again communicate that this remains "*very unlikely*".

Japan

Christoph Siepmann



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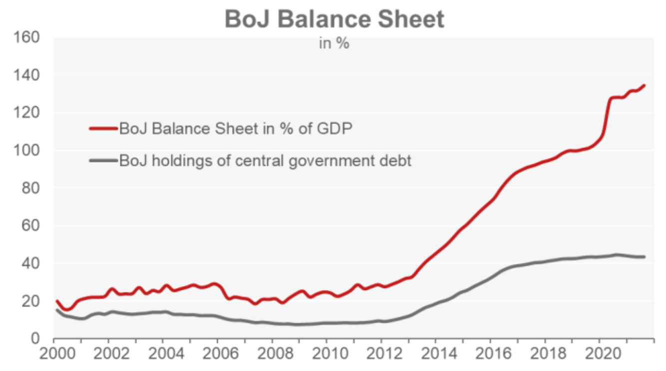


Source: Datastream,GIAM calculations

- **Japan's Q4 2021 GDP growth is likely to rebound substantially from the further downward revised Q3 result. We see 2021 growth now at 1.6%.**
- **Given the new Omicron wave, we scaled back our expectations for Q1 2022. Large parts of Japan are back in a "quasi-emergency state".**
- **There were market speculations about an early BoJ exit from its ultra-loose monetary policy. But Governor Kuroda rebuffed these expectations.**

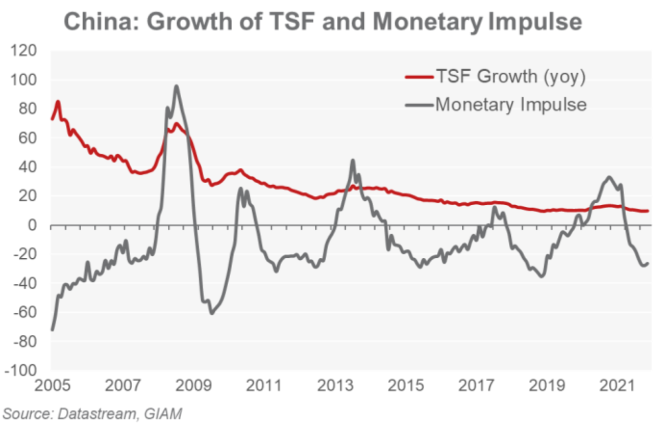
Japan's Q3 GDP growth has been further revised down to -3.6% qoq annualised. However, Q4 is expected to see a strong rebound, mainly driven by private consumption, but also investments and net exports contributed. Nevertheless, we revised our 2021 forecast slightly down to 1.6% to reflect revisions. The outlook for Q1 2022 is again blurred by the strongly rising Omicron wave. At the time of writing already 34 of 47 prefectures in Japan were in a quasi-emergency state, including Tokyo. This emergency state allows to restrict social activity, mainly meaning a reduction of opening hours of bars and restaurants. In the previous waves, private consumption typically dropped quite substantially. Omicron may have a milder effect. Nevertheless, the outlook component of the economy watchers survey receded already to below 50 index points, while its current component as well as the manufacturing PMI remained well in expansionary territory. Given that lower (but still markedly positive growth) will additionally be compensated in Q2, we stick to our forecast of 2.8% GDP expansion in 2022.

Japan's headline inflation rose to 0.8% yoy in December, but core-core inflation (less fresh food and energy) remained in negative territory with -0.7% yoy. Energy plays the largest role in rising headline inflation. However, next April the reduction in mobile phone charges will drop out of the statistics, leading to a rise of headline inflation to around 1.7% yoy and also core-core inflation will turn positive to about 0.5% yoy. Together with the strongly diverging monetary policy path compared to the US and the weakness of the yen, markets speculated about an early exit of the ultra-loose monetary policy. However, Governor Kuroda clearly ruled out early actions, stressing the temporary nature of the price increases. We do not expect a rate hike within the Kuroda term, which will last until April 2023. Japan's PM Kishida called for uniform wage hikes of 3%, which is unlikely to come true. We expect inflation at 1.1% this year.

China

Christoph Siepmann

Source: Datastrem, GIAM calculations



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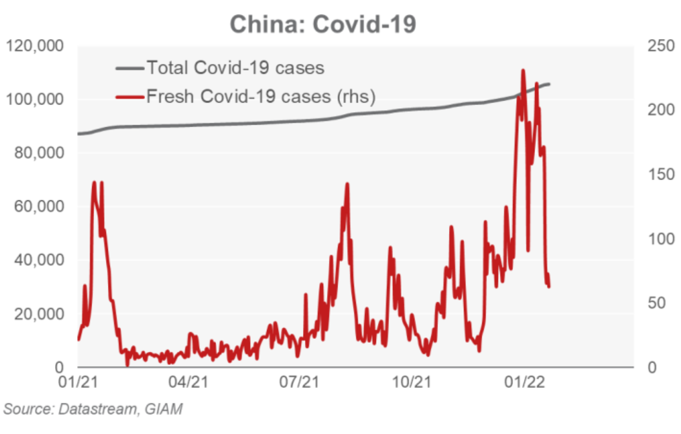


Source: Datastream, GIAM

- **China's Q4 GDP growth surprised on the upside with 4% yoy, lifting the annual reading to 8.1%.**
- **The PBoC cut the 7-day reverse repo and the 1-year medium-term lending facility (MLF) rate by 10 bps, but did not touch the RRR. Accordingly, the Loan Prime Rates (LPR) also moved down.**
- **Going forward, we expect more policy support from both monetary and fiscal policy, but still see no full reflation cycle.**

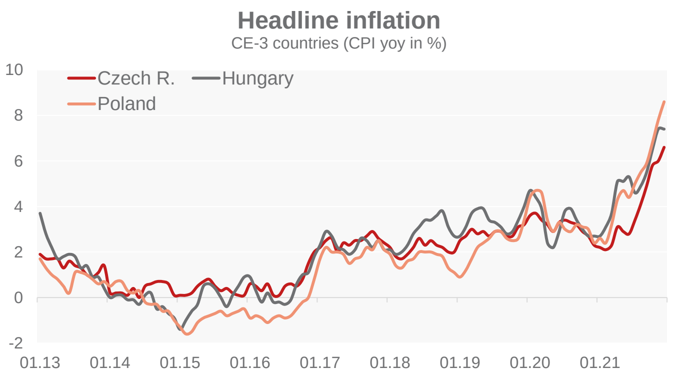
China's real GDP growth surprised on the upside in Q4, advancing by 4% yoy and lifting the full year rate to 8.1%. Seasonally adjusted qoq growth rose from 0.7% qoq to 1.6% qoq. Clearly, China benefitted in Q4 from ongoing strong external demand, combined with the easing of power supply restrictions. This was also felt in industrial production growth which rose by 0.5 pp to 4.3% yoy in December. Regarding investment, real estate outlays continued to deteriorate while infrastructure improved. Overall, fixed asset investment declined to 4.9% yoy ytd. However, the biggest downside surprise came from retail sales which posted a drop in the growth rate to 1.7% yoy, after 3.9% in November.

Only hours before the GDP data release, the PBoC cut the 7-day reverse repo and 1-year MLF rates by 10bp to 2.1% resp. 2.85%. Accordingly, also the LPR rates softened. Total social financing (TSF) growth improved marginally further, rising to 10.3% yoy which is an increase by only 0.3 pp since its trough. Accordingly, also the monetary impulse improved slightly.

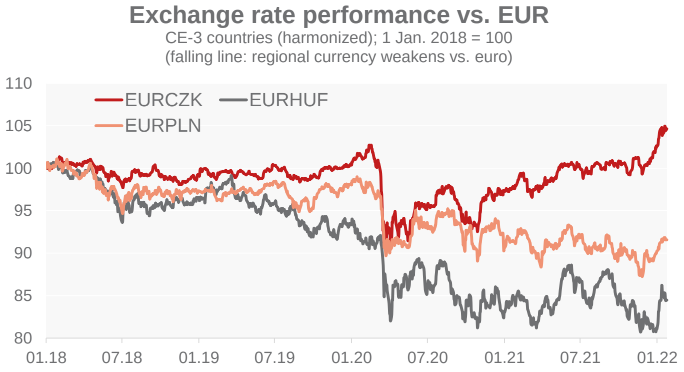
Going forward, we expect more support from both monetary and fiscal policy. The PBoC pledged a more active stance in its first press conference. Its actions will likely mostly depend on the development of private consumption, trying to prevent another weak spot in the economy on top of the real estate sector. Private consumption in turn will be much influenced by Omicron spread and the need for local lockdowns. After advice from authorities, travelling during the Chinese New Year (Feb 1) is likely to be soft. Infection prevention will also affect the Winter Olympics (4.2.-20.2.2022). We expect the PBoC to cut the interest rates twice by 10 bps and a 50 bps reduction in the RRR. Furthermore, we see the NPC meeting (from March 5) to announce additional targeted help from the fiscal side, supporting private consumption, infrastructure and perhaps social housing. We stick to our GDP growth forecast of 4.8% this year.

Central and Eastern Europe

Radomír Jáč



Source: www.czso.cz, www.ksh.hu, www.stat.gov.pl, GIAM



Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

Main Forecasts

Czech Republic	2020	2021f	2022f	2023f
GDP	-5.8	2.8	3.8	3.8
Consumer prices	3.2	3.7	7.4	2.3
Central bank's key rate	0.25	3.75	3.25	2.50
Hungary	**2020**	**2021f**	**2022f**	**2023f**
GDP	-4.9	6.7	4.0	4.0
Consumer prices	3.3	5.1	5.4	3.4
Central bank's key rate	0.60	2.40	4.50	3.50
Poland	**2020**	**2021f**	**2022f**	**2023f**
GDP	-2.5	5.3	5.1	4.4
Consumer prices	3.4	5.1	7.2	4.7
Central bank's key rate	0.10	1.75	3.50	3.50

Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

- **All three CE-3 central banks remain in a process of monetary policy tightening, mainly via rate hikes but also via cancellation of non-standard measures including QE. We expect further key rate increases in Q1 and very likely also in Q2.**
- **The regional currencies started to firm since early January and while global factors recently led to a correction, stronger currencies should tame inflation in the CE-3 in the months to come.**
- **Upward price pressures will be affecting inflation in early 2022. However: statistical base effects on commodity prices and impact of stronger currencies will start to act in a disinflationary way from spring onwards.**

Headline CPI in the CE-3 reached multi-year highs in late 2021. While price pressures were in the pipeline also in early 2022, headline inflation will be reduced in H1 by cuts in taxes on foods and energy or by price caps in some cases (Hungary and Poland). Base effects from commodity prices and the impact of CE-3 FX appreciation should start to lead headline inflation lower from spring on. The CE-3 central banks remain on a tightening wave with interest rate hikes looming in H1. However, key rates may stabilize in H2 and some central banks may even embark on a path of gradual rate cuts if the scenario of a decline in inflation materializes.

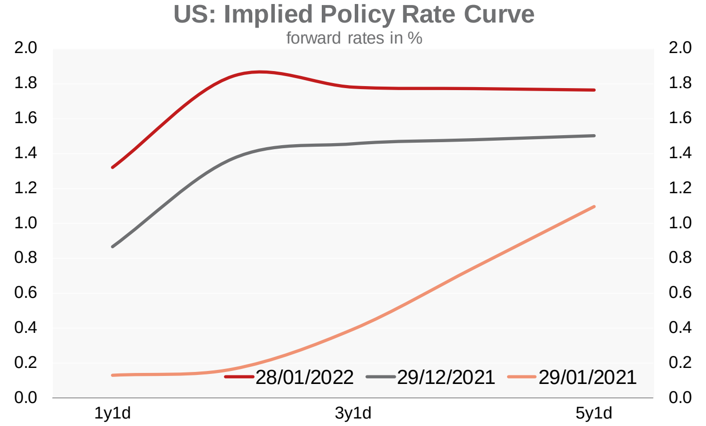
The Czech CNB raised its key interest rate by 100 bps to 3.75% in December and should deliver at least a 50 bps hike in early February at its first monetary policy meeting in 2022. The CNB indicates that the key rate will grow well above 4% but that a 5% level is unlikely to be exceeded. We expect a peak at 4.75% in Q1 and rate cuts to follow in H2 with a decline in inflation.

The Hungarian MNB increased its base rate by 50 bps to 2.90% in January. The 1-week deposit rate, which currently plays a role of the key policy rate, was raised by 30 bps to 4.30% and the MNB expects the base rate to gradually reach the deposit rate‘s level in H1. The monetary policy stance may change in H2 if both the headline and the core CPI trend down again.

In Poland, the NBP raised its key rate by 50 bps to 2.25% in January. We expect further cumulative hikes of 125 bps with a 50 bps move in February. Pro-CPI base effects may act in H2, as the impact of temporary measures taken by the government will evaporate.

Government Bonds

Florian Späte



Source: Bloomberg, GIAM calculations

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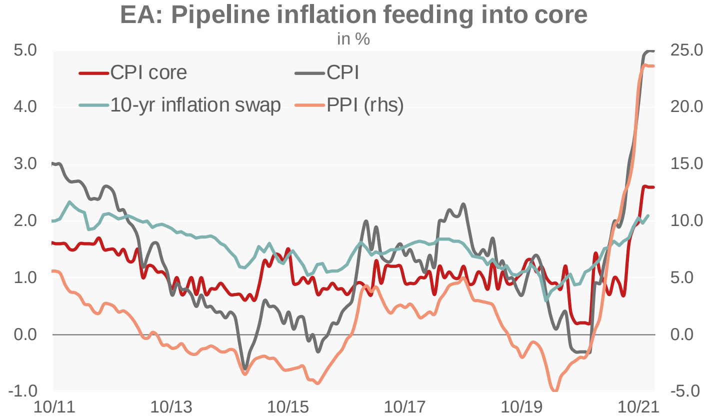


Source: Bloomberg, GIAM

- **International government bonds made a poor start into 2022 as yields rose across the curve. The main driver for the upward trend in yields was a hawkish turn by the Fed amid stubbornly elevated inflation rates.**
- **The sell-off has not run its course yet as forthcoming key rate hikes by several central banks will set the tone going forward. For a more significant move upwards, however, financial markets will have to price higher terminal key rates.**
- **The ultimate re-election of Mattarella as Italian head of state has contributed to on balance stable euro area non-core spreads. Looking further down the road, political risks remain and the scaling back of ECB support is likely to trigger a moderate spread widening.**

Since the start of the year 10-year Bund yields have risen more than 10 bps and 10-year US yields even almost 30 bps. The sell-off at the short end of the US curve was even more pronounced with 2-year Treasury yields rising more than 40 bps. Despite higher energy and commodity prices inflation expectations fell slightly. Hence, the upward movement in real yields was even more noticeable.

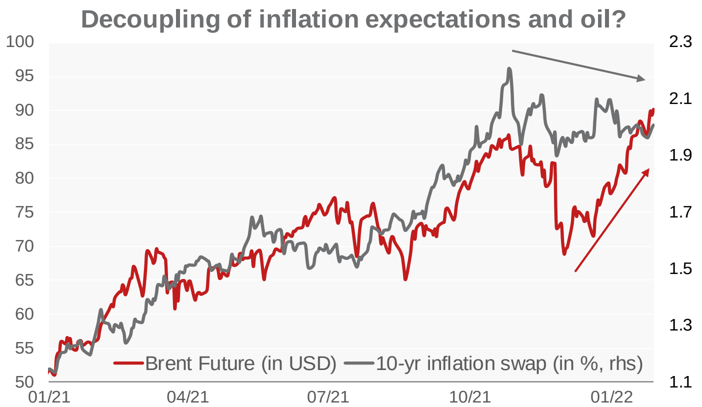
Beside receding concerns about the Covid-19 pandemic the main factor was the hawkish shift by several central banks. Particularly the Fed clearly signaled quarterly hikes in 2022 (starting in March) and did not rule out hikes by 50 bps and/or additional increases. The shrinking of the balance sheet will likely start in summer which will give yields an additional boost equivalent to one rate hike in 2022 and two hikes in 2023.

Although we consider more than 100 bps rate hikes in 2022 as unlikely, we forecast the Fed to remain hawkish. Furthermore, we expect the cycle to last longer than currently priced. While financial markets expect the Fed to stop at 1.75% in 2023, we forecast the cycle to continue until mid of 2024 and see the terminal Fed's target rate above 2%. Once financial markets adjust expectations, the way is clear for a further rise in yields.

As changing key rate expectations impact particularly the short end of the curve, we forecast a continuation of the recent bear flattening trend. Until the end of this year we expect 2-year US Treasury yields to rise to around 1.7%. However, Quantitative Tightening (QT)

Government Bonds

Florian Späte



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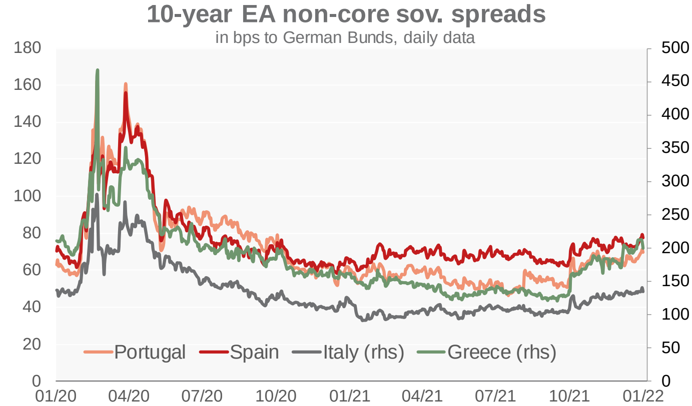
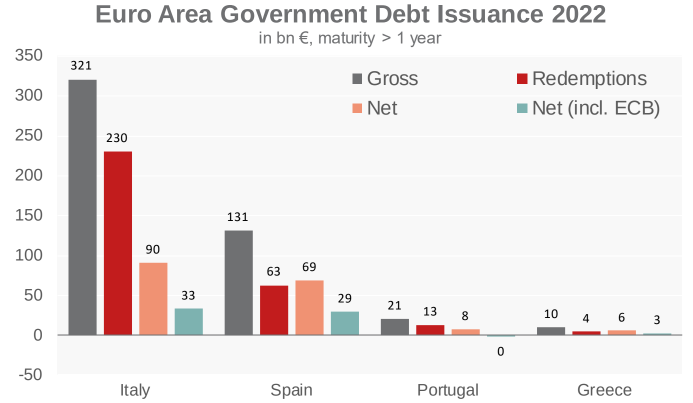


Source: Datastream, GIAM calculations



Source: Bloomberg, Datastream, GIAM calculations

will impact the long end as well. Despite a decrease of around US$ 1000 bn in gross supply the net-net supply of Treasuries will hardly fall. Accordingly, we forecast 10-year US yields to rise well above 2% over the course of the year and to finish the year at around 2.2%.

A lasting move above this level is hardly sustainable as the valuation of risky assets depends on low real yields. Although inflation is seen to remain on an elevated level during 2022 it will moderate. Hence, a significant increase in inflation expectations is unlikely. Over the course of 2022 central banks will have the challenging task of communicating on the one hand to fight inflation but on the other hand to limit the rise in (real) yields to keep financial conditions easy.

The situation in the euro area is somewhat different. The ECB is seen to buck the global trend of imminent rate hikes and we expect the start of the ECB key rate cycle only in 2023. Hence, the current market pricing for 2022 (one hike by 25 bps) appears too aggressive. Accordingly, the leeway for short-dated Bund yields to rise is rather limited. Only once financial markets start pricing a higher terminal key rate (currently a total of 75 bps key rate hikes are priced) short-dated Bund yields can rise more.

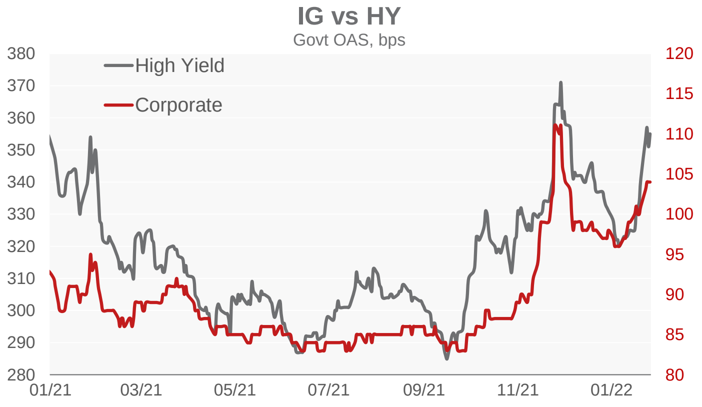
However, the long end of the Bund curve is essentially determined by US yields and the forecast increase in US yields will spill over to the euro area. Moreover, higher energy prices and underlying price pressure are likely to push inflation well above 3% on average in 2022. All in, we forecast 10-year Bund yields to rise to 0.2% by the end of 2022. The muted increase is also due to the still negative net-net supply of Bunds – despite the scaling back of QE by the ECB.

The re-election of Mattarella as Italian head of state in the eighth ballot triggered a moderate positive reaction of non-core bond spreads. However, financial markets did not price a political disaster before. Accordingly, we doubt that the spread tightening has legs. The elections have highlighted the differences between the coalition parties that form the current government. Although the situation has stabilized for the moment, tensions cannot be ruled out in the coming weeks. Moreover, the election campaign in France will gain momentum in the months to come.

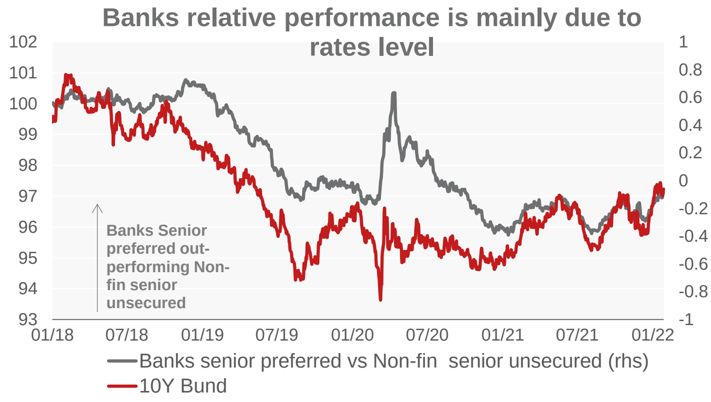
All in, positive net-net supply in 2022 (and even higher in 2023) and still rather low spread levels by historical standards are likely to trigger a moderate upward trend in non-core bond spreads.

Credit

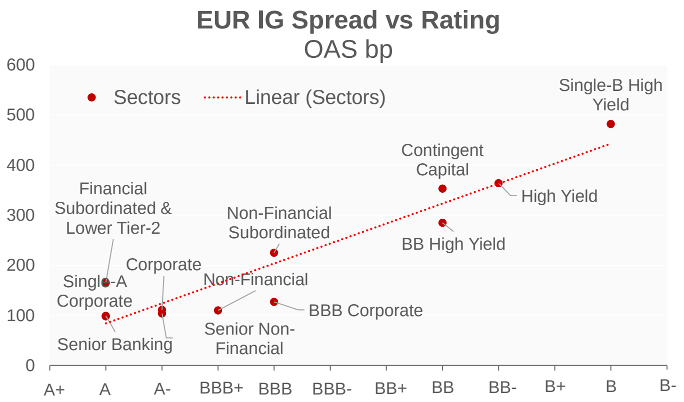
Elisa Belgacem



Source:Bloomberg, BofAML Indices, GIAM



Source:Bloomberg, BofAML indices, GIAM own calculations



Source:Bloomberg, BofAML indices, GIAM own calculations

- **We keep our OW on credit markets, albeit a mild one, as we continue to expect credit to be more resilient than the rest of the FI space.**
- **Over a 3m horizon, we continue to expect spreads to tighten by 5-10% (10bp for IG, 25bp for HY) from current levels before rewidening in H2 on lesser institutional support.**
- **We expect asset purchases to end in December 2022. Therefore, we believe it will continue to support credit spreads in H1 2022. But the pricing out of the APP will start in H2, likely pressuring spreads.**
- **Fundamentals will continue to improve in 2022 in credit, albeit at a slower pace compared to 2021.**
- **Technicals should also remain decent next year, with net supply in IG likely negative and marginally positive in HY.**

Fundamentals will remain strong in 2022. On one side, defaults numbers in the US and Europe will remain below their long-term average. But the rating trend will remain supportive, with the upgrade to downgrade ratio likely to remain significantly positive. Yet the normalization will be slower than in 2021. In our view, neither the rate increase nor higher inflation will be in a position to challenge this improvement.

Fundamentals to remain strong in 2022

The primary market has started on a strong footing in January. Still, we continue to assume that supply overall will be down in EUR IG by 10% as corporates continue to have a record cash position on their balance sheet.

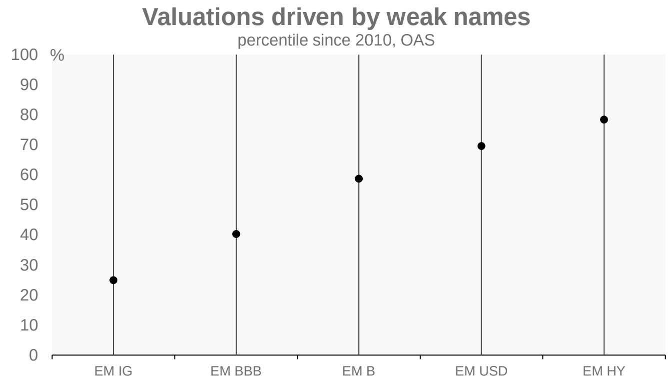
We also believe the ECB's APP will end in 2022, but it will continue to purchase between EUR5bn to EUR7bn corporate bonds per month over the course of the year. Hence technicals will also remain strong in 2022.

Also, primary market will soon pause as the reporting season is ongoing. As a result, credit should feel the headwinds but may still prove resilient from here against a sharper sell-off.

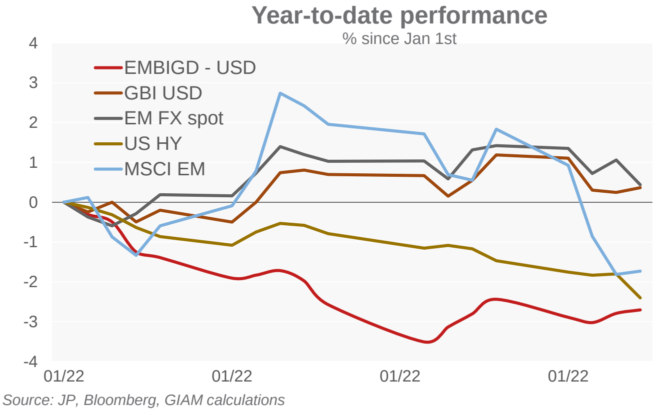
Hence both technical and fundamentals should continue to support resilience in credit spreads compared to the rest of the fixed-income space. We expect spreads to tighten by 5% (10bp for IG, 25bp for HY) over a 3m horizon, with an elevated level of volatility. Yet we like to take a defensive carry position with BBBs, BBs corporate hybrids, and AT1 with a neutral duration position.

EM sovereign bonds

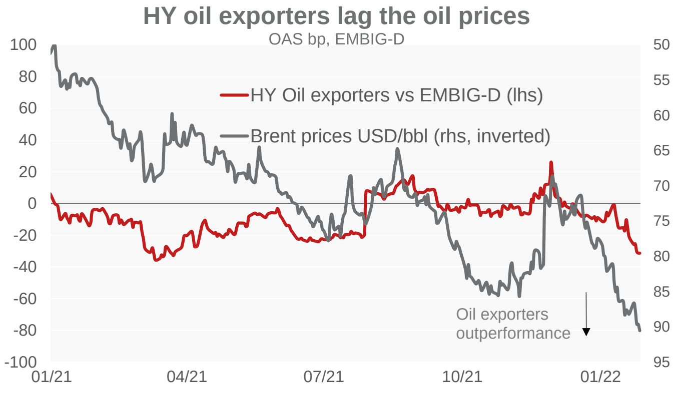
Guillaume Tresca



Source: Bloomberg, JP Morgan, GIAM calculations



Source: JP, Bloomberg, GIAM calculations



Source: Bloomberg, GIAM calculations

- **We maintain a MW stance with several headwinds that will continue to fuel volatility. The environment is not yet supportive.**
- **EM credit is still a carry play and higher US real yields are the main threat. We reiterate that EMs should not face a 2013-style market rout.**
- **The recent sell-off is providing selective opportunities but valuations are tight. We like the oil complex, several LatAm names and we avoid Asia IG.**

After the recent sell-off, we maintain a MW stance with several headwinds that will continue to fuel volatility. It has been the worst start to the year since 1995 and EM credit has underperformed other EM assets, reflecting already tight valuations. The underperformance creates some value at the local level, but the global environment is not yet supportive to take a positive global view.

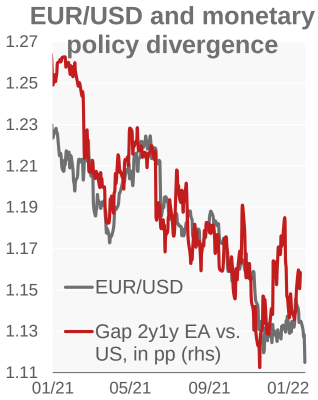
Firstly, US real yields are still expected to rise further, and EM spreads have started to widen rapidly. Indeed, there is no total return cushion. Secondly, valuations remain tight especially at the IG level. It is countries with large tails risks that led the widening. Median CCC country widened by c. 70bp and two-thirds of the index widening can be attributed to 5 names. Thirdly, technicals are not supportive as there is a backlog of issuance that will come. EM bonds funds seem to be still OW EM HY and fund flows turned negative year-to-date. Thus, primary market demand will be subdued. Finally, idiosyncratic risk remains after the pandemic with weak balance sovereign balance sheets and the Ukraine/Russia situation is fluid.

In the current environment, EM credit is still a carry play than a directional play. For instance, the duration return contributed to 77% to the negative return year-to-date. That said, we reiterate that EMs should not face a repetition of the 2013 Taper Tantrum given their better stance. We are neutral IG over HY with a focus on BBBs and BBs names. The lower duration of HY is not enough protective given the upside risks on the front-end of the US curve while weak fundamentals of the B and lower rated countries are unsupportive within the current backdrop.

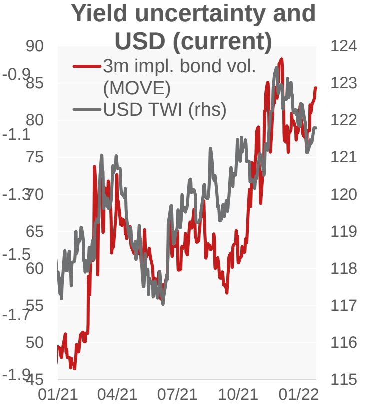
At the country level, we continue to avoid Asia IG, especially long-duration names like the Philippines but we favour the oil complex like Qatar, Saudi Arabia. We revised lower our view on Panama, Kazakhstan. We upgrade Peru and Romania to like.

Currencies

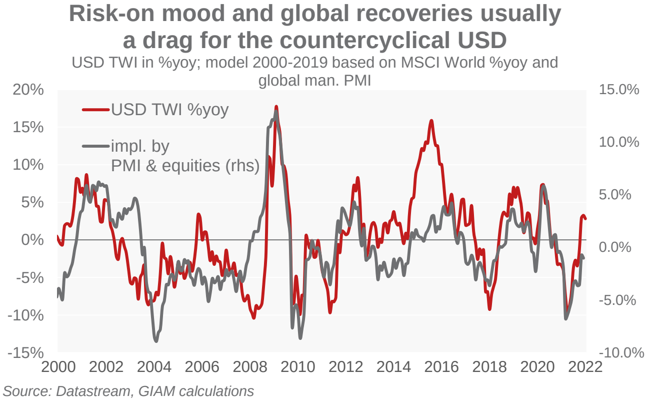
Thomas Hempell



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations



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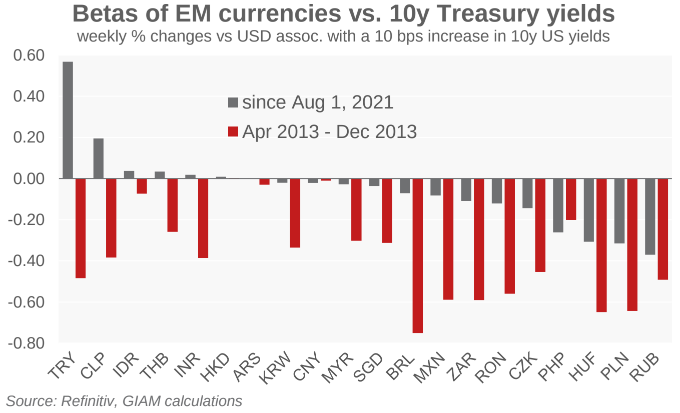


Source: Refinitiv, GIAM calculations

- **The Fed's sharp hawkish pivot is set to keep the USD underpinned short term, with EUR/USD headed closer to 1.10.**
- **Yet the USD is not far from peak. Once the Fed's hawkish turn is fully priced, we expect the persistent global recovery, ebbing equity inflows and reserves diversification to reverse fortunes for the Greenback.**
- **EM currencies may extend their resilience. Commodity producers will be underpinned by higher energy prices while CEE currencies remain exposed to tensions around Ukraine.**

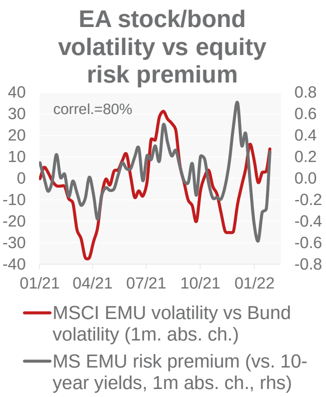
The USD has gained new traction after a lacklustre start into the new year. As we have argued earlier, the Fed's hawkish pivot provides some further upside for the USD over the coming weeks. Furthermore, Fed Chair Powell's emphasis to be 'humble and nimble' while not ruling out much a faster policy normalisation is adding to yield uncertainties that benefit the Greenback (top charts).

Yet a rebounding global economy is likely to cap the USD's gain and trigger a reversal of fortune later in the year (mid chart). Elevated speculative net long positions make the USD vulnerable once the hawkish Fed tilt is fully priced. US equity inflows may ebb as the outperformance of US growth stocks dissipates. Global reserves diversification is neither to the USD's favour. Markets are too aggressive in pricing a 2022 ECB rate hike. But elevated inflation and a continued recovery will strengthen the case for policy normalisation also in the euro area (incl. a rates lift-off in 2023), rendering EUR support into H2.

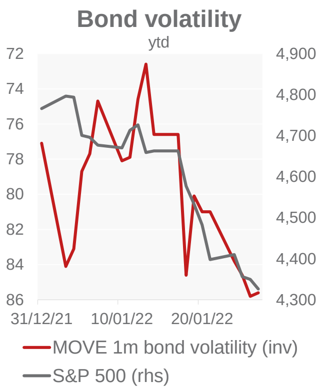
EM FX resilient amid mounting Fed headwinds

EM FX may well extend their resilience shown over recent weeks, also helped by a strong CNY that defied the law of gravity from divergent US/China rates. While the repricing of Fed rate hikes is lifting the USD globally, commodity exporters are benefitting from surging energy prices. EM effective exchange rates are trading historically on the cheap side into the Fed's tightening. And as many EM central banks embarked on rate hikes much earlier, the headwinds are likely to prove limited. FX reserve endowments and external balances of most EMs are also more robust than just before the 2013 taper tantrum. While we fundamentally like CEE currencies, we watch mounting near-term risks though from rising tensions around Ukraine.

Michele Morganti, Vladimir Oleinikov



Source: Datastream, GIAM calculations



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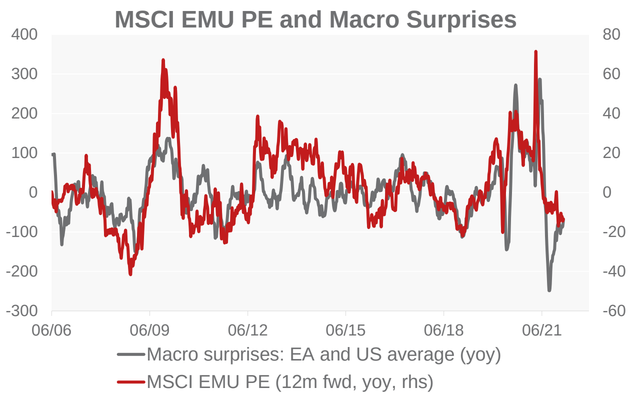
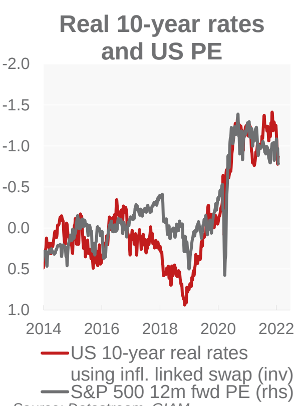
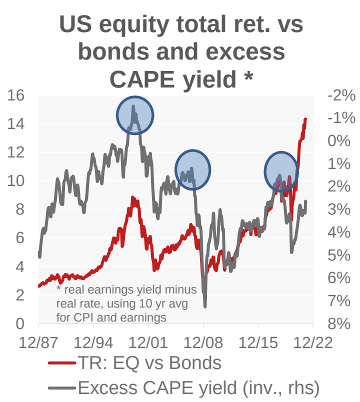


Source: Datastream, GIAM calculations



Source: Datastream, GIAM



Datastream, GIAM calculations

- **Our expectations of high volatility were realised. Peaking cycle, hawkish central banks, decreasing policy support and sticky high inflation will keep uncertainty high.**
- **Fundamentally, bottoms are not far away and could eventually be reached as bond volatility stays high. That said, real rates remain low, CAPE yield gap vs 10y yield high and earnings growth encouraging. We see 10% upside in 12 months for the US and slightly more for Europe.**
- **EU sectors: we are still favouring a barbell. OW financials, energy, plus Staples, Durables and materials. UW capital goods, IT hardware, div. financials, utilities, telecoms and real estate.**

The playbook of higher volatility that we predicated by the end of last year seems to have fans. It originates from lower monetary and fiscal support plus peaking growth, confidence and financial conditions, and, finally, high and sticky inflation. Ukraine tensions represent an additional negative trigger.

Since the beginning of the year Central banks' tone has become more hawkish and the cycle of monetary support withdrawal anticipated. The rising uncertainty and the spike in real rates (+45 bps in January), have kept bond volatility elevated. This has, in turn, pushed equity volatility (VIX), and the equity risk premium, higher. The negative effect has been particularly felt on long duration sectors like the US Tech sector. The latter remains quite expensive. For example, the Tech PEG (PE adjusted for earnings growth) ratio differential vs. the S&P is as high as only in the period around the 2000-2001 Tech bubble. In addition to this, the Tech earnings trend vs. price one shows still an at least a 10% premium gap when compared to the S&P 500 index. This all means that the risks for the US Techs remain high as long as rates are, as we think, increasing.

Concerning peaking growth, some indicators like capacity utilization, ISM and monetary aggregates confirm the cyclical highs have been reached. We are witnessing a decreasing growth momentum, albeit our GDP growth, notwithstanding some slight reduction in 2022 forecast, remains above potential for the next quarters. That said, margins are going to stabilize, while earnings growth is already declining.

We think rates will continue to increase and central banks remain hawkish for the time being. Does it mean we get bearish? Not quite.

Equities

Michele Morganti, Vladimir Oleinikov

Risk-premium based approach to valuation, using long-term Shiller series

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.78	7.04	-5.26	223.1	4.80
Scenario 3 (GI 12m fwd in 1 year)	2.20	4.53	-2.33	231.0	4.97

yield at 2.2% in scenario 3	40% of hist. ERP standard deviation		20% of hist. ERP standard deviation		
	Scen. 1	Scen. 3	Scen. 1	Scen. 3	AVG
Avg S&P500 valuation	4,051	4,195	**4,572**	4,733	4,388
	-8.1%	-4.9%	3.7%	7.3%	-0.5%

yield at 1.7% in scenario 3	40% of hist. ERP standard deviation		20% of hist. ERP standard deviation		
	Scen. 1	Scen. 3	Scen. 1	Scen. 3	AVG
Avg S&P500 valuation	4,485	4,643	**5,134**	5,315	4,894
	1.7%	5.3%	16.4%	20.5%	11.0%

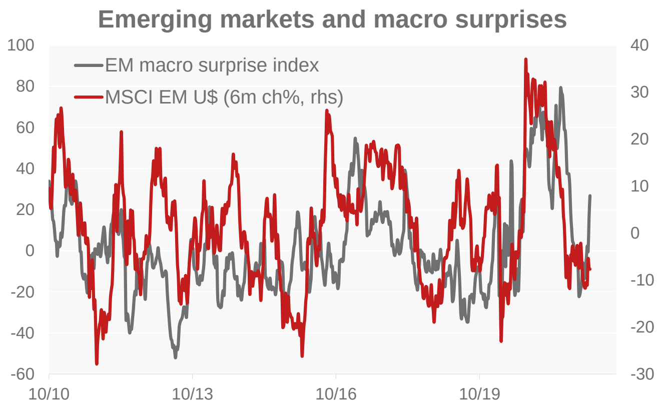
Note: using 40%/20% of risk premium's stand. deviation (SD=2.9%) adds around 120/60 bps to the average risk premium calculated since 1872 (4.1% + 120 bps = 5.3% / 4.1% + 60 bps = 4.7%).
Target ERP is calculated assuming CPI in the range b/w 2.0% and 3.2%.

Source: Shiller data, GIAM calculations

S&P	*167 reported*	*146 reported*		
Sector	earnings growth, yoy		sales growth, yoy	
	Q3 2021	Q4 2021	Q3 2021	Q4 2021
S&P	**39.5%**	**26.7%**	**16.6%**	**13.1%**
Median (all sectors)	40.5%	15.7%	16.5%	12.3%
Median, ex. Energy & Material	31.8%	10.2%	12.8%	12.1%
Median stock	**28.0%**	**16.2%**	**14.8%**	**12.3%**

Sector	earnings surprise %		sales surprise %	
	Q3 2021	Q4 2021	Q3 2021	Q4 2021
S&P	**11.1%**	**4.5%**	**1.9%**	**2.3%**
Median (all sectors)	4.6%	4.0%	1.9%	2.2%
Median, ex. Energy & Material	6.4%	4.0%	1.7%	2.2%
Median stock	**6.5%**	**5.0%**	**1.3%**	**1.5%**

Source: Bloomberg, GIAM calculations



Source: Datastream, GIAM

First of all, we have already adopted a cautious OW in equities with a barbell sector allocation. This overweighs Value like financials, energy plus material (new) but also staples, durables at the expenses of telecoms, utilities, RE, diversified financials, capital goods (new) and hardware (new). In general, we avoid high valuations and keep the sectors positively correlated to higher inflation and bond yields.

Second, we tried to assess a fundamental support for the market based on the 2018 experience and our fair value analysis for 2022: the lower band of valuation range should be around 4,100 – 4,200 for the S&P 500 index, representing a 5% decline from current levels, which is not too far, indeed. Of course, the market could reach temporarily lower levels: in 2018, deepest lows than fundamental ones lasted for nearly 3 weeks.

Finally, while uncertainty and bond volatility remains dangerously high, the levels of real yields is still not, and the earnings growth stays decently high for this year (nearly 10%). The reporting season in Q4 has so far shown nice positive surprises (5%), positive guidance for Q4 and a less benign one for Q1 2022. The latter is probably due to the low visibility induced by Omicron, bottlenecks, inflation and geopolitical frictions. That said, since mid-December, Q4 yearly earnings growth has been revised by +2% and the 12-month earnings estimates by 2.7% globally, 1.3% for the S&P 500 and 3.4% for the euro area (EA). Margins (on sales) were also revised up, at both net earnings level and EBITDA one.

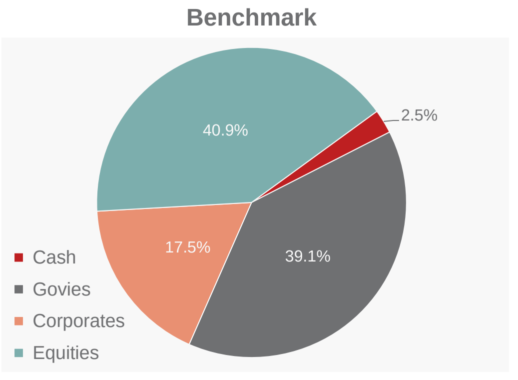
Notwithstanding this, we decided to be more prudent on 10-year yields assumption, by adopting implicitly a 40 bps further upside corresponding to a 5% cut in the fair value. As a result, our new S&P 500 fair value is now worth 4,500-5,000, with a 10% total return in 12 months. Europe is cheaper, positively correlated to yields and inflation, and also less exposed to the expensive Tech sector. It could overperform. In sum, we would carefully profit from the current set-back.

EM: supported by increasing sentiment short-term

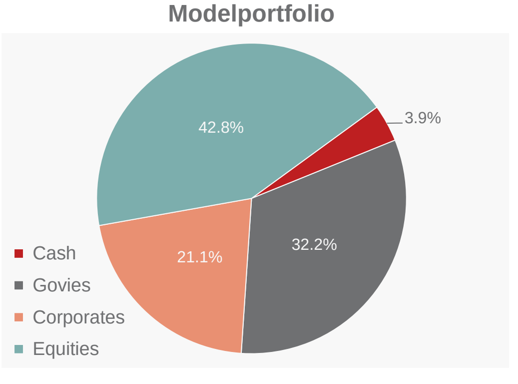
We still remain neutral on EMs: weaker earnings growth but attractive valuations, significant underperformance and improving macro surprises. That said, we are getting more constructive as monetary and fiscal policy in China is getting more supportive. Furthermore, the aggressive monetary tightening in other EMs is very advanced and will likely be reversed soon. We OW Korea and Chinese A-shares and stay neutral on MSCI China.

Asset Allocation

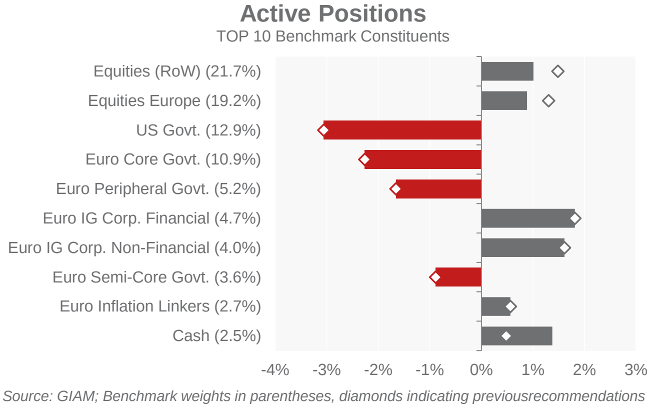
Thorsten Runde



Source: GIAM



Source: GIAM



Source: GIAM; Benchmark weights in parentheses, diamonds indicating previousrecommendations

- **In the first month of 2022 the performance of all actively covered asset classes remained in negative territory *(27.01.22)*.**
- **Equities suffered particularly from the Fed's hawkish pivot, with the North American market hit most strongly (-9.6%).**
- **In general, USD-denominated assets fared particularly poorly in January, just like long-dated govies. Accordingly, Y10+ USTs performed second worst (-3.9%) amid a significant US bear-flattening.**
- **On the fixed income side short-dated govies performed best. Not surprisingly, Cash turned out to be the most attractive choice (±0.0%) under these conditions.**
- **We still expect the persistent global recovery and decent earnings growth to lend support to risk assets, maintaining a prudent pro-risk stance. Acknowledging for a generally riskier market environment, however, we further trim our overweight in equities to the benefit of cash.**

In the first month of the new year *(27.01.22)*, our model portfolio lost -8.7 bps in relative terms. With the new recommendation being in place since mid-January larger losses could at least be avoided. Nevertheless, equities contributed the most (-5.1 bps) to this negative result directly after government bonds (-6.4 bps). Corporate bonds proved to be comparatively resilient. Thus, with +10.3 bps the overweight paid off quite well this month. Contributing +3.7 bps Cash is in the second place on the positive side.

Although widely expected, the Fed's announcement of a first rate hike in March caused significant declines on the American stock and bond markets, even if less so in the rest of the world. This might be seen as a foreshadowing of the increase in market volatility that we expect in 2022 in general and for equities in particular.

Trim the overweight in equities

All in, we still prefer a prudent stance in favour of risk assets. That said, acknowledging for the more challenging market environment on a more hawkish Fed, we recommend to shift some of the overexposure from Equites to Cash. We keep a sizeable OW in IG Credit. We keep in OW in HY Credit and an UW in Core Govies and US Treasuries.

FORECAST TABLES

Forecast tables

Growth[1]	2020	2021		2022		2023
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	- 3.4	5.7	0.1	3.7	- 0.3	1.9
Euro area	- 6.5	5.2	0.1	3.7	- 0.5	2.5
Germany	- 4.9	2.8	0.1	2.7	- 1.3	2.5
France	- 8.0	7.0	0.4	4.2	0.4	1.8
Italy	- 9.0	6.4	0.1	3.8	- 0.5	2.2
Non-EMU	- 7.2	6.0	0.0	3.9	- 0.4	2.0
UK	- 9.4	7.0	0.0	4.2	- 0.5	2.0
Switzerland	- 2.5	3.5	0.0	3.0	0.0	1.4
Japan	- 4.5	1.9	0.1	2.8	- 0.4	1.4
Asia ex Japan	- 1.0	7.2	0.1	5.2	- 0.2	5.1
China	1.9	8.1	0.1	4.8	- 0.3	5.3
CEE	- 1.6	5.9	- 0.1	3.5	0.2	3.5
Latin America	- 8.5	5.9	0.0	2.2	0.0	2.9
World	**- 3.4**	**5.9**	**0.1**	**4.1**	**- 0.2**	**3.4**

1) Regional and world aggregates revised to 2015 IMF PPP weights

Inflation[1]	2020	2021		2022		2023
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	1.2	4.7	0.1	4.8	0.6	2.7
Euro area	0.3	2.6	0.1	3.3	0.7	1.7
Germany	0.4	3.1	0.0	3.6	0.9	1.8
France	0.5	1.7	0.0	3.0	0.9	1.2
Italy	- 0.1	1.8	- 0.0	2.0	- 0.2	0.6
Non-EMU	0.6	2.2	0.1	3.7	0.4	1.9
UK	0.9	2.6	0.1	4.7	0.6	2.2
Switzerland	- 0.7	0.5	0.0	0.8	0.0	0.8
Japan	0.0	- 0.2	0.0	1.1	0.4	0.4
Asia ex Japan	2.8	2.1	- 0.1	2.9	0.2	2.7
China	2.5	0.9	- 0.1	2.3	0.2	2.1
CEE	5.5	9.2	- 0.6	16.1	6.4	8.1
Latin America[2]	3.2	8.4	1.5	4.5	0.8	3.2
World	**2.1**	**3.7**	**0.0**	**4.5**	**0.9**	**2.9**

1) Regional and world aggregates revised to 2015 IMF PPP weights ; 2) Ex Argentina and Venezuela

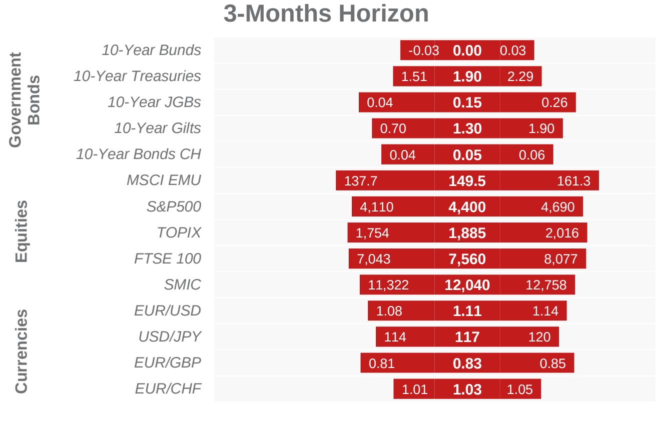
Financial Markets

Key Rates	27/01/22*	3M	6M	12M
US	0.25	0.25	0.75	1.25
Euro area	-0.50	-0.50	-0.50	-0.50
Japan	-0.10	-0.10	-0.10	-0.10
UK	0.25	0.50	0.75	1.00
Switzerland	-0.75	-0.75	-0.75	-0.75
10-Year Bonds	**27/01/22***	**3M**	**6M**	**12M**
Treasuries	1.81	1.90	2.00	2.20
Bunds	-0.07	0.00	0.10	0.20
BTPs	1.26	1.40	1.55	1.75
OATs	0.34	0.45	0.45	0.55
JGBs	0.14	0.15	0.15	0.15
Gilts	1.20	1.30	1.40	1.50
SWI	-0.02	0.05	0.15	0.20
Spreads	**27/01/22***	**3M**	**6M**	**12M**
GIIPS	105	110	110	115
BofAML Covered Bonds	51	50	50	55
BofAML EM Gvt. Bonds (in USD)	325	315	323	330

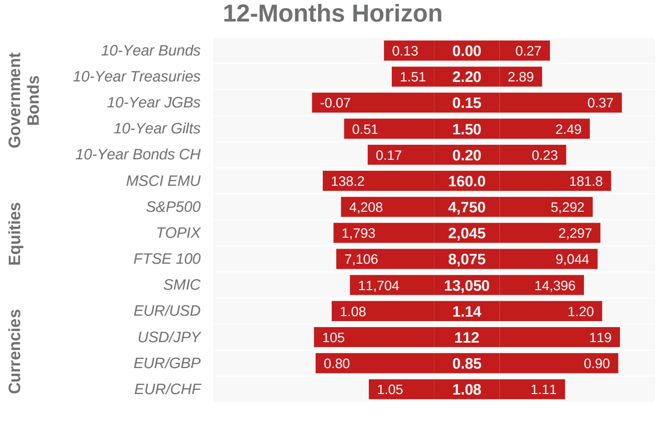
Corporate Bond Spreads	27/01/22*	3M	6M	12M
BofAML Non-Financial	103	95	95	100
BofAML Financial	106	95	95	100
Forex	**27/01/22***	**3M**	**6M**	**12M**
EUR/USD	1.12	1.11	1.12	1.14
USD/JPY	115	117	114	112
EUR/JPY	129	130	128	128
GBP/USD	1.35	1.34	1.33	1.34
EUR/GBP	0.83	0.83	0.84	0.85
EUR/CHF	1.04	1.03	1.05	1.08
Equities	**27/01/22***	**3M**	**6M**	**12M**
S&P500	4,344	4,400	4,520	4,750
MSCI EMU	147.3	149.5	151.5	160.0
TOPIX	1,877	1,885	1,945	2,045
FTSE	7,465	7,560	7,735	8,075
SMI	12,074	12,040	12,335	13,050

**average of last three trading days*

3-Months Horizon



12-Months Horizon



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