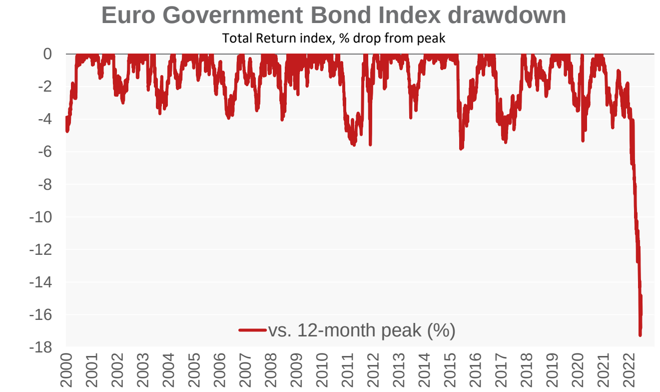
Investment View

Whatever it takes, in reverse

June 30, 2022

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

- **Central banks (CBs) are on a mission to fight the inflation beast – whatever it takes, even a recession. The financial mood will remain gloomy this summer as economic data deteriorates while central banks walk their hawkish talk.**
- **We expect the Fed to turn less aggressive this autumn, as it faces a deterioration of the economy and, eventually, employment data. Inflation headlines will also cool off by then, and more so in Q1.**
- **But for now, CBs are left lamenting about second-round effects. The 'wishful-thinking' approach to policy (inconsistent ECB and Fed forecasts) have also delayed the market reckoning about the economic pain. We also question the ECB's political and legal capacity to reallocate its huge balance sheet as it tries to lean against fragmentation.**
- **We stick to our guns, with an underweight in equities and an overweight in high-quality credit. Increase cash over summer, whilst reducing the shorts in both core Govies and duration.**



Source: Bloomberg, GIAM calculations

CONTENT

WHATEVER IT TAKES, IN REVERSE

Vincent Chaigneau

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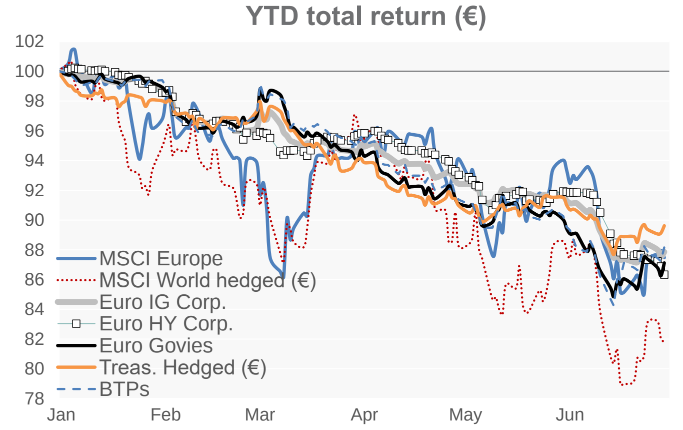
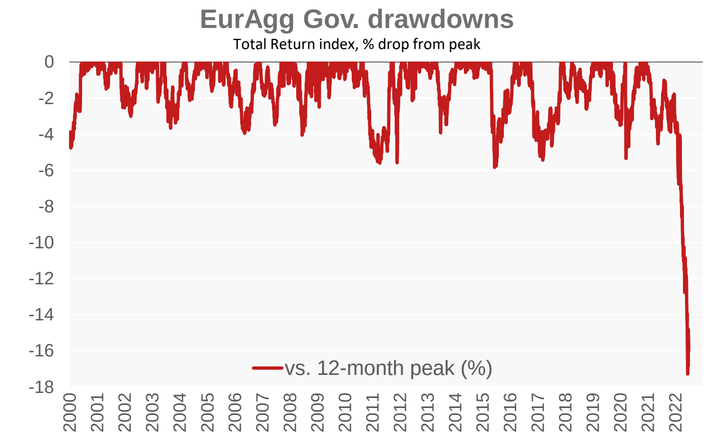
The NATO rhetoric has turned resolutely hawkish. And the recent G7 statement highlights the transition towards a new world order

Summer of discontent. 2022 was always going to be a difficult year. Our 2022 Outlook, "Bye-bye beta" presented a difficult case for asset performance this year. Our Q2 Investment Views, "Mission impossible", laid out the daunting task of monetary policy makers: crushing inflation without causing a hard landing. No doubt, the war on Ukraine, and its stagflationary impulse, have made the year far worse for investors. Year-to-date performances are deeply negative in stocks and bonds. There has been virtually no place to hide except for cash and commodities, though the rally there has started to fizzle on fears of deteriorating demand. On a relative basis our preference for Investment Grade Credit has paid off; so have the underweights in equities and Govies, as well as the residual short in duration. The drawdown in the EUR government bond index, -17% from the peak of August 2021, is nearly three times the worst ever recorded since the launch of the euro – call it a Black Swan. A lot of bad news is now priced in, both in terms of recession risks and global monetary tightening. But we are still positioned for a difficult summer, as central banks walk their hawkish talk while economic data continues to deteriorate. Ukraine remains a wild card, but the hopes of a quick shift towards the diplomatic route look rather slim as we go to press. Instead the NATO rhetoric has turned resolutely hawkish, with dissuasion efforts being scaled up dramatically following the failure to prevent the Russian invasion. The recent G7 statement, with no less than 14 mentions of China, highlights the transition towards a new world order, as the US desperately resists the transition to a multipolar system – a process likely to imply greater geopolitical volatility.



Source: Bloomberg, GIAM calculations



Source: Bloomberg, GIAM calculations

Getting the inflation genie back into the bottle will not be easy

Central banks are on a mission. The Fed's put and the ECB's 'Whatever it takes' are virtually working in reverse: it is no longer about preventing a recession/deflation or preserving the EA stability, but re-anchoring inflation expectations and restoring credibility, notwithstanding the recession risk. To a large extent, central banks face a supply shock, and there is little they can do against that. Still, they are ready to act in a way that will undermine demand and restore a supply-demand equilibrium at a lower level of inflation. China's zero-Covid policy has added to global supply chain disruptions this year; restrictions there are now being eased and this should offer some relief. Commodity prices are also seemingly cooling off as demand ebbs. Assuming market prices stabilise, the base effect will start to improve this autumn, and much more so in 23Q1. But central banks must still lean against the much feared second-round effects. Employment costs have surged in the US (left chart) as the labour market has tightened. Even in the euro area, where data lags significantly, negotiated wages are flirting with 3% yoy, and clearly on the way up. The latest announcements, e.g. in France where public sector employees get a 3.5% hike on July 1st while pensions and social benefits are set to be raised by some 4%, will be noticed at the ECB. The two right-hand charts below show the market expectations about inflation: still very high in the next 12 months (about 6% in the EA and 5% in the US), above target in the 12 months that will follow (1y1y at respectively 2.5% and 2.9%) and returning closer to target in the following year. This looks possible but such a relatively quick normalisation would most likely require forceful policy tightening and a sharp economic slowdown. The Fed's projections show core PCE inflation down to 2.7% already in 2023, with unemployment rising to just 3.9%. This looks rather optimistic: we fear that it will take more economic pain for inflation to recede so quickly.

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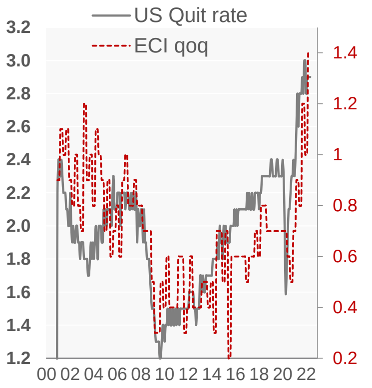
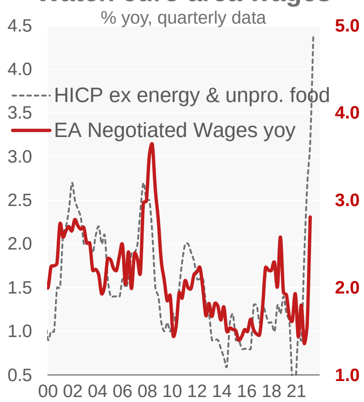
US Emp. Cost Index rising



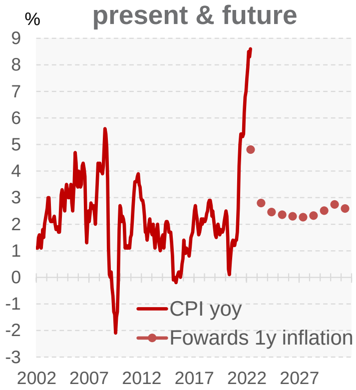
Source: BLS, Bloomberg, GIAM

Watch euro area wages



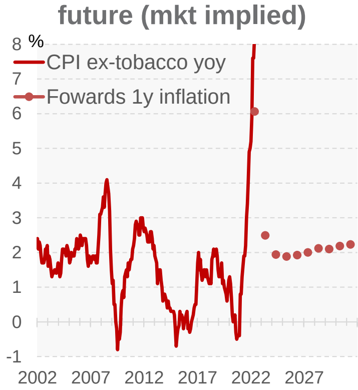
Source:ECB, Bloomberg, GIAM

US inflation, past, present & future



Source: Bloomberg, GIAM calculations

€ inflation, past, present & future (mkt implied)



Source: Bloomberg, GIAM calculations

Recession risks rising

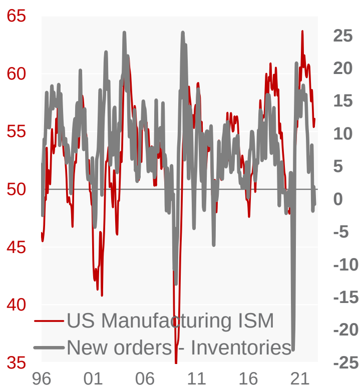
Risks to our growth forecasts are skewed to the downside. Our growth forecasts have been clearly below consensus since the invasion of Ukraine but may still be too high. We see US growth at 2.2% this year and 0.9% next, almost 1 point p.a. below consensus. The US is less exposed than Europe to the war, but the triple shock of higher yields, commodity prices and US dollar is however recessionary. Q1's negative number was mostly an inventory and net trade issue, but the latest revisions also warn about a dispirited consumer. The coincident surge in gasoline prices and mortgage yields has contributed to a collapse in confidence. We also see clear signs of a slowdown in the manufacturing sector: the order-inventory component of the ISM suggest that the headline will quickly fall below 50. Employment has been rock-solid but leading indicators such as the momentum in NFIB hiring plans indicate a sharp turn in the coming months and quarters.

Leading indicators indicate a sharp US employment turn in the coming months and quarters

ECB's wishful thinking approach to policy and communication: how would the economy run above potential in H2 following such a large shock on confidence and financial conditions?

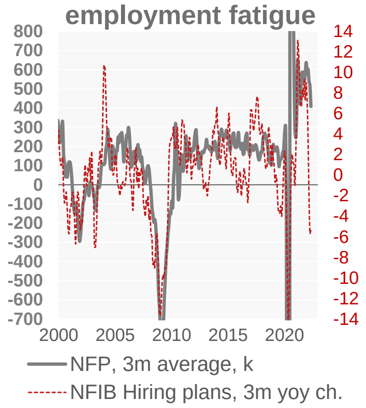
The euro area economy is coming to a halt. We have had to slightly raise our 2022 growth forecast to 2.6% – following an Ireland-driven anomalous gain in Q1 – but we see a flattish profile for the rest of the year (Q2-Q4); it would not take much – e.g. Russia cutting off its gas supply – for a couple of consecutive negative readings (technical recession). Our 1.6% forecast for 2023 is 0.6pp below consensus but could well still be too high. The ECB has a very rosy 2.1%, which also reflects generous carry-over given the rosy predictions for 22H2 (+0.4-0.5% qoq in the last two quarters of the year). This has been the frustrating part with the ECB's wishful thinking approach to policy and communication. How would the economy run above potential in H2 following such a large shock on confidence and financial conditions? Puzzling. For investors, it all smells of recession already, if we follow the cycle clock measured via the Sentix survey (right-hand chart below).

Manuf. ISM cooling



Source: Bloomberg, GIAM calculations

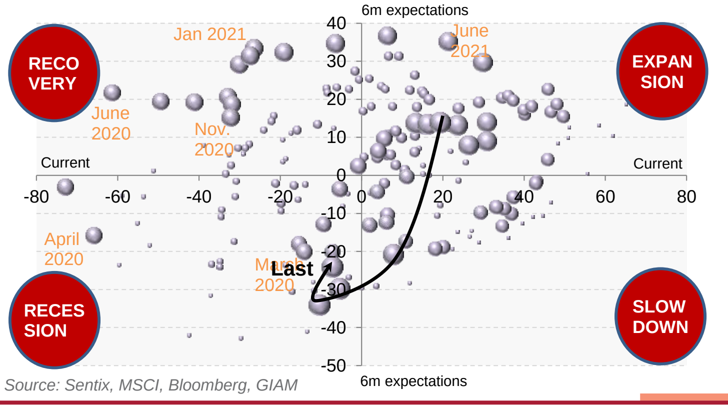
Early signs of US employment fatigue



Source:NFIB, BLS, BBG, GIAM calc.

EUR Sentix Current Situation vs 6m Exp.

Since 2007; the bigger the bubble, the more recent



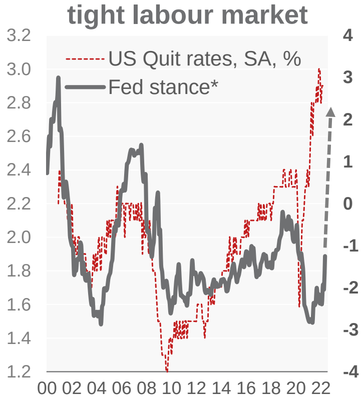
Source: Sentix, MSCI, Bloomberg, GIAM

How much monetary policy tightening needed?

We expect the Fed to turn less aggressive this autumn as the economy deteriorates

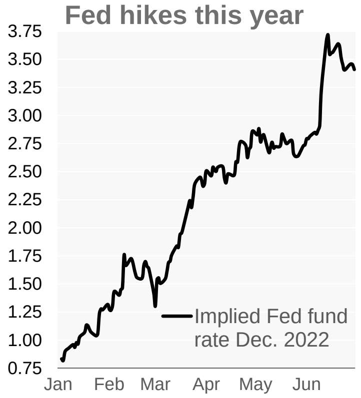
Fed to cool off this autumn. No doubt, US monetary policy remains very accommodative at this stage of the cycle, with employment being very tight (left chart below). We had highlighted faster normalisation as a major risk in 2022, but clearly sharply underestimated the inflation shock and the resulting hawkish turn. As we go to press the market is pricing another 180bp of Fed hikes this year, on top of the 150bp already delivered. Already market pricing has come off some 30bp as recession fears have increased. It still looks a bit ambitious: we expect the Fed to turn less aggressive this autumn as the economy deteriorates. ECB pricing has also come off by some 30bp, to now +150bp this year. We see 125bp, as poor economic news and tighter financial conditions – including wider peripheral spreads – force the ECB into a more balancing act.

Super "easy" Fed vs. tight labour market



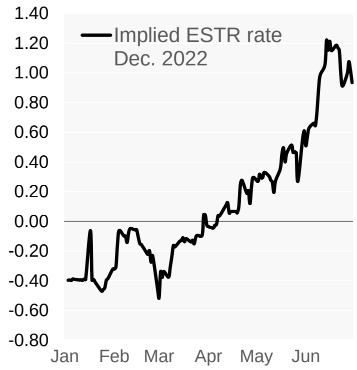
Source:CBO, BEA, Lubik-Matthes, BBG, GIAM

Market pricing 330bp of Fed hikes this year



Source: Bloomberg, GIAM

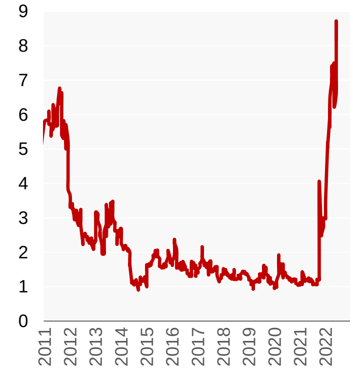
Market pricing 150bp of ECB hikes this year



Source: Bloomberg, GIAM

EUR 1y1y implied vol

bp/day



Source: Bloomberg, GIAM

ECB task of leaning against fragmentation much harder now

The ECB printing money would be seen as contrary to bringing inflation back towards the 2% target

No printing. The ECB has a single primary mandate – inflation – in contrast to the Fed (inflation and employment). Yet the ECB has always considered the stability of the euro area as a top of priority – it is the essence of its mere existence. There was no conflict of objectives when inflation was consistently too low. The ECB could then print money and buy bonds, to safeguard the EA against the risk of deflation and/or fragmentation risks. The situation today is far more complicated as printing money would be seen as contrary to bringing inflation back towards the 2% target. This brings into focus the questions about the ability of the ECB to separate tools, e.g. allocate rate hikes to the inflation target and bond programmes to financial stability.

The original flaws of the monetary union remain and the solidarity shown with NGEU may be lacking again if and when selected countries face market pressure

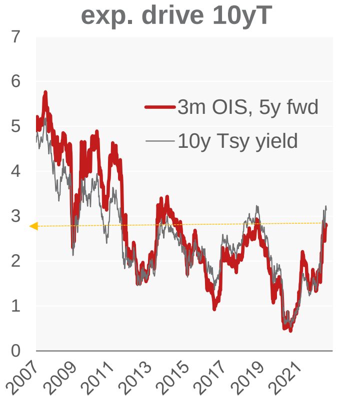
Arguably the ECB has a strong track-record on fighting financial fragmentation, but this was in a very different environment. We fear that flexibility around PEPP re-investment – say around EUR 20bn per month – will not be enough in case of serious market test, even if the ECB accepts some front loading (reinvesting even before selected issues come to maturity), which does not seem to be part of the initial set-up. We will be looking at the details of potential new programme, whatever its inspiration (SMP or OMT). The details to be watched include the seniority issues (SMP purchases were senior, i.e. failing to bring any relief to investors in case of restructuring) and the conditionality of the programme. We remain to be convinced about the ECB's political and legal capacity to reallocate its gigantic balance sheet. The original flaws of the monetary union remain – banking union is unfinished business, no fiscal union – and the solidarity shown with NGEU may be lacking again if and when selected countries face market pressure. We take a cautious approach on non-core exposure as this political resolve may be tested at a time of deteriorating debt sustainability metrics: real yields rising, real GDP growth falling and selected governments facing a near impossible trinity: how to finance energy and military transition while ensuring public debt remains sustainable and the social and political environment stable.

How to invest

US Treasuries a good asset to own as a hedge against the risk of a full-blown recession or financial crisis

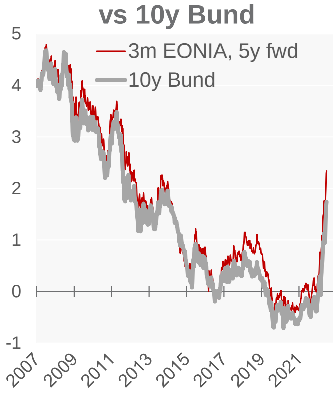
Reduce both the core Govies underweight and duration short. Long-term yields have come a long way – much faster than we expected – but we see the upside as now more limited. This is particularly true for US Treasuries, which we see as a good asset to own as a hedge against the risk of a full-blown recession or financial crisis. 10-year Treasury yields have risen faster than medium-term Fed expectations (left chart below), which offers some cushion: any faster than expected Fed tightening would probably see greater flattening of the curve. In contrast, 10-year Bund yields still appear low relative to medium-term ECB expectations: we see room for the term premium to rise as the ECB balance sheet no longer expands.

Medium-term Fed rates exp. drive 10yT



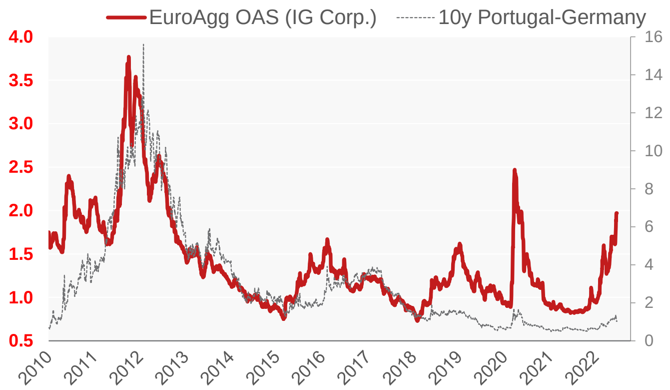
Source: Bloomberg, GIAM

Medium-term ECB rates vs 10y Bund



Source: Bloomberg, GIAM

IG vs PGB spreads

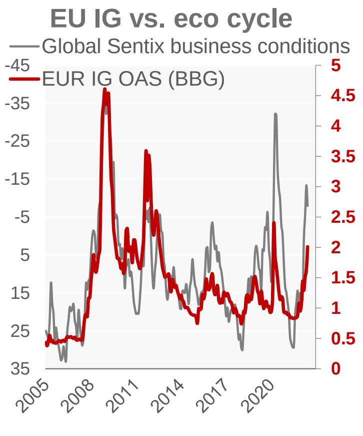


Source: Bloomberg, GIAM

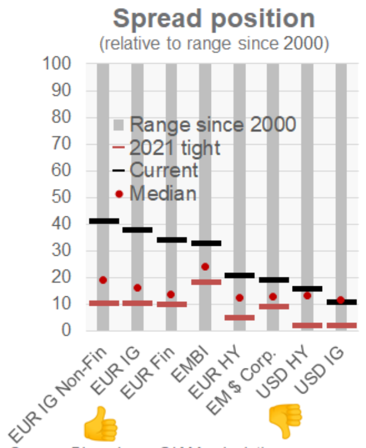
Still, we now reduce our shorts in both core Govies and duration. Our short in non-core Govies has increased relative to that of core, for the reasons discussed above.

On a beta-adjusted basis EUR IG spreads have widened much more than EUR High Yield spreads

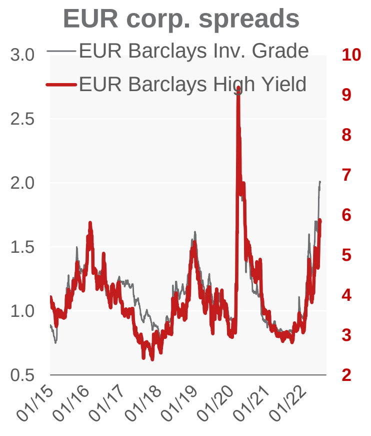
We stick to an overweight in IG Credit, if a defensive one. Swap spreads are large relative to other risk measures, and this makes high-quality credit such as covered bonds and IG corporate bonds relatively attractive. Investment Grade spreads can still widen of course as the economy continues to slow, but the left-hand chart below shows that they are already larger than in 2016 and 2018 and pricing the risk of a mild recession. The second chart shows that EUR IG non-financial spreads are the cheapest, in terms of positioning relative to the historical range, among various credit sub-asset classes. At the other end of the spectrum US IG credit appears much richer, and so does HY. On a beta-adjusted basis EUR IG spreads have widened much more than EUR High Yield spreads – which likely reflects the pricing out of ECB purchases. This makes us much keener on EUR IG credit than HY, which are very sensitive to cyclical conditions and set to widen further (right-hand chart below).



Source: Sentix, Bloomberg, GIAM



Source: Bloomberg, GIAM calculations



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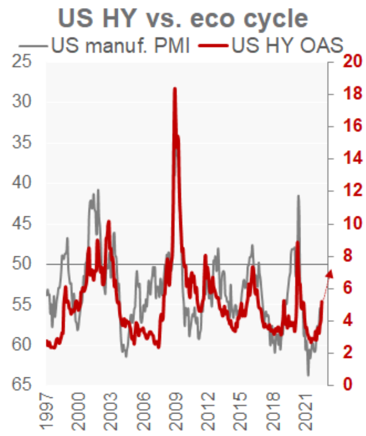
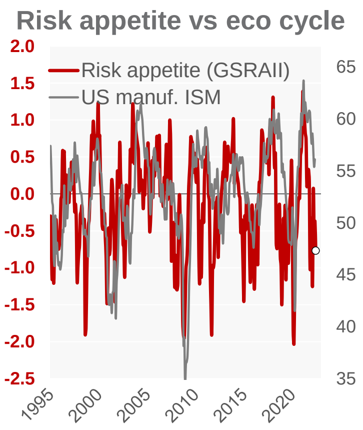


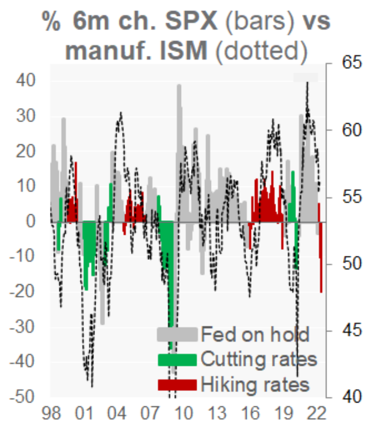
Source: ISM, Bloomberg, GIAM

Equity valuation is not extreme. Also we find earnings expectations too generous.

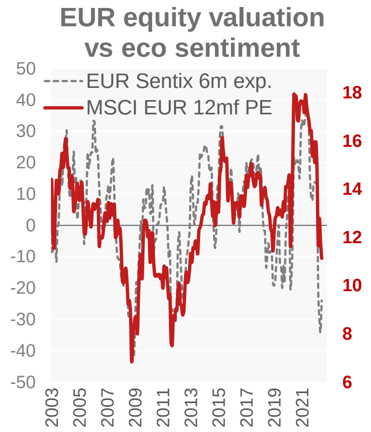
We strongly increase our cash position over summer and retain an underweight in equities. Arguably a lot of bad news is priced already, as the two left charts below indicate. Risk appetite has deteriorated much faster than US growth. But valuation is not extreme, e.g. EUR equity multiples have not dropped as fast as economic sentiment. Also we find earnings expectations too generous and failing to reflect the deteriorating economic environment. This is also reflected in the residual downside in cyclical stocks relative to defensives. What would make us more positive? Three things: 1/ a de-escalation in Ukraine (but President Biden seems to be focused on long-term strategic issues rather than short-term electoral costs). 2/ A softer stance from the Fed, which we see coming but *after* the summer. 3/ Leading economic indices bottoming out – still a long way.



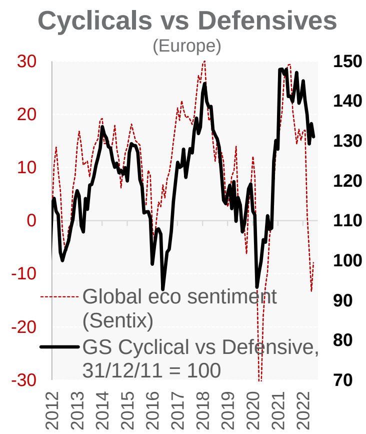
Source: GS, ISM, Bloomberg, GIAM



Source: MSCI, Bloomberg, GIAM



Source: Sentix, MSCI, Bloomberg, GIAM



Source: GS, Bloomberg, GIAM

MACROECONOMIC OUTLOOK

Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

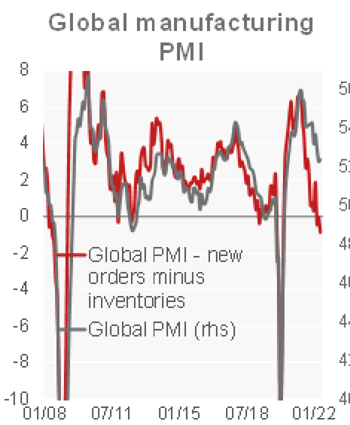
- **Persistent supply disruptions (Covid, war in Ukraine) keep weighing on activity as soaring energy/food prices squeeze disposable income. This hits consumer confidence amid tighter financial conditions. Eased Covid restrictions and large excess savings from the pandemic only cushion these headwinds.**
- **We expect global growth below and inflation above consensus. Activity is set to come close to stagnation in the euro area and to slow from a technical rebound in the US. China's recovery from severe lockdowns will be bumpy.**
- **Recession risks are rising, not least as sticky inflation triggers front-loaded monetary tightening. Europe is most at risk near term as further cuts in Russian gas supplies are looming. US recession risks are tilted towards 2023 as the lagged effects from sharply tighter financial conditions add to inflation's curb on real consumption.**
- **Inflation pressures will ease only very gradually, as supply disruptions abate, growth slows and energy prices flatten out. Second-round effects (wage pressure, rising price expectations) keep the risk tilted towards persistent overshoots of central banks' targets.**
- **Central banks are front-loading their rate hikes. Yet, we expect them to proceed more cautiously than priced by markets later in the year as rates approach neutral levels and growth slows more materially.**

The fallout of the war in Ukraine and strong inflation are severely blurring the economic outlook. For much of the past weeks, key economic indicators have been holding up, even if manufacturing growth slowed markedly. In Europe in particular, eased Covid restrictions have helped the important services sector to rebound. Also, consumption proved relatively resilient amid the severe slump in consumer confidence across the advanced world as strong labour markets and large excess savings from the pandemic cushioned private spending.

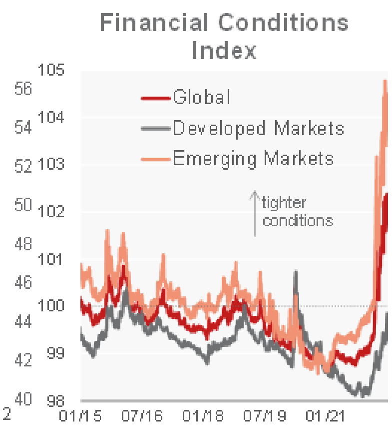
As inflation is weighing on sentiment and real income, leading indicators point to mounting growth headwinds

Forward-looking indicators spell trouble

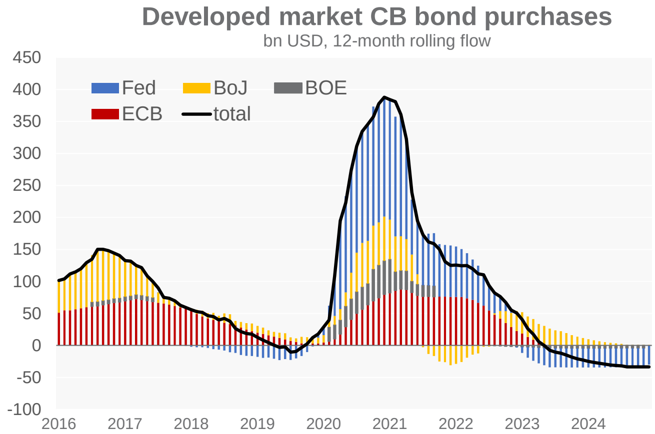
Yet, forward looking indicators are spelling trouble. The G7 OECD leading indicator is consistent with a marked growth deceleration. The new orders over inventory reading of the global manufacturing PMI turned negative, pointing to a looming mild manufacturing contraction. The global surge in energy and food prices is weighing heavily on real disposable income. US consumers have already trimmed savings well below the long-term norm, while consumer confidence remains depressed as recession fears add to inflation uncertainties.



Source: Datastream, GIAM calculations



Source: Goldman Sachs, GIAM



Source: Datastream, GIAM calculations

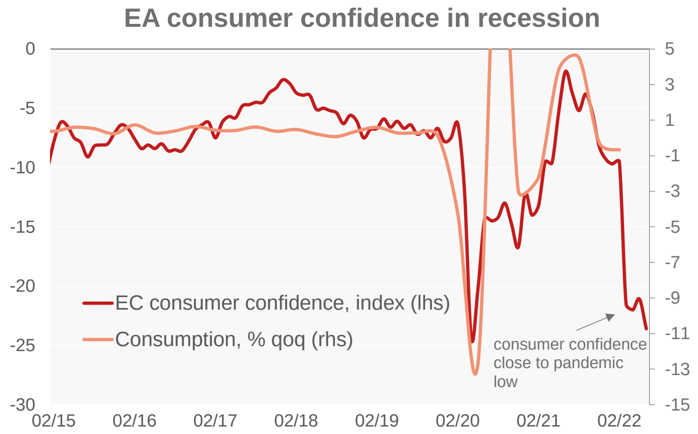
Recession is not our base case, but risks are rising as sharp central bank tightening is adding to the adverse effects from the war and high inflation

Our forecasts reflect greater stagflation concerns than consensus. In contrast to markets, we expect central banks to decelerate their tightening earlier as growth worries weigh

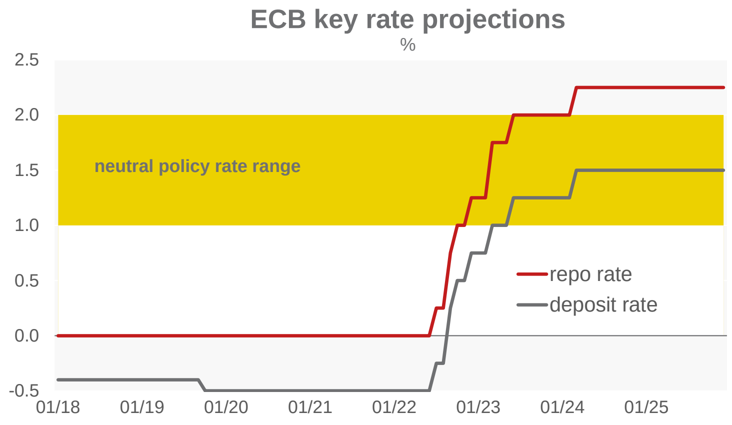
Central banks are walking a delicate balancing act. Much of the current inflation overshoot is owing to pandemic supply/demand disruptions and the surge in commodity prices amid the war in Ukraine, both being beyond the control of monetary policy. We also expect inflation pressures to ease gradually, as supply disruptions abate, growth slows and energy prices flatten out. Yet, labour markets are tight, too, (especially in the US), risking that high inflation perpetuates itself via higher inflation expectations and a wage/price spiral. The Fed and the ECB are playing catch-up after dismissing the inflation threat for too long, flagging their 'unconditional' (Fed) commitment to price stability.

There is still a good chance that the global economy can escape recession. But the sharp acceleration of monetary tightening is adding to the cyclical risks as higher rates and mounting risk aversion are tightening financial conditions. For Europe, the biggest recession risks still accrue from the Ukraine war and disruptive cuts in energy supply. In the US, a sharper slowdown is looming for H1 2023 when the lagged effects of monetary tightening will bite demand most. Financial conditions across most of the EM world have tightened rapidly, with the rate hike cycle generally much more advanced. A bumpy recovery in China (see below) and resuming traffic and tourism may benefit suppliers in Asia, but cooling growth in the advanced world and the strong US dollar do not bode well for a strong EM expansion.

Our global macroeconomic forecasts thus reflect stronger stagflation concerns than consensus, with our global growth forecasts for this year (2.9%) and 2022 (3.0) 0.2pp and 0.3pp *below* and our inflation forecasts 0.4 and 0.6% *above* consensus. We agree with market pricing that central banks will heavily front-load their further tightening. The stubborn overshoot of price pressure necessitates a strong response to underpin central bankers' commitment to their inflation targets and to keep inflation expectations in check. That said, we expect a faster growth slowdown and more volatile markets to lead key central banks to terminate their policy normalization closer to neutral rates than markets currently reckon.



Source: Datastream, GIAM calculations



Source: Datastream, ECB, GIAM calculations

Euro area activity weakening amid elevated inflation

Euro area activity to stall in H2/2022 with a high risk of a recession

Euro area activity over the first half of the year was torn between two main forces: The activity push from the unwinding of Covid restrictions especially in services sector and sky-rocketing inflation rates denting purchasing power amid a weakening global environment. A strongly upwardly biased Irish number boosted Q1 growth to 0.6% qoq, while expansion in Q2 was likely much shallower (0.2% qoq in our books). Looking ahead, the boost to activity from re-opening will largely have run its course while we see headline inflation peaking only around the end of Q3 north of 8% yoy. Moreover, looming gas-supply bottlenecks and the risk of a complete stop of Russian deliveries are clouding the outlook and drag on sentiment. Excess savings from the pandemic (of about € 850 bn) and a healthy labour market (unemployment rate at 6.8% in April) will cushion the fallout on activity. All in all, we foresee euro area activity hardly expanding in the second half of the year and see the risk of a recession at around 40%. Only thanks to a huge statistical overhang from last year and artificially strong Q1 growth we look for annual growth of 2.6% in 2022. We see growth receding to 1.6% in 2023, with downside risks to this already below-consensus view.

ECB needs to hike while keeping a lid on fragmentation

The unforeseen spike of inflation as well as its persistence have finally pushed the ECB to decisively remove accommodation. At the June meeting, the Governing Council (GC) not only announced the end of QE but also committed on a 25 bps rate hike and another (likely bigger) rate increase in September. Notwithstanding growth risks a clear policy turnaround became inevitable as some of the ECB's key signposts moved into dangerous territory: Various measures of inflation expectations are on the verge of de-anchoring while negotiated wage growth accelerated to 2.8% yoy in Q1.

High inflation, inflation expectations and strong wage growth force the ECB into rate hikes

Looking ahead, high pipeline inflation pressure (e.g. producer prices at 37.2%yoy in April) and signs for accelerating wage growth will leave the ECB no choice than to reduce policy accommodation. We think that the ECB will hike at each of the remaining meetings in 2022. In September, we expect a 50 bps hike otherwise 25 bps so that the key rate will rise by a total of 125 bps to 0.75% by year-end, somewhat less than market expectation (>150 bps). As the latest ECB inflation projections foresee headline as well as underlying inflation above the 2% target for the time being, we pencilled in further rate increases in 2023. Accounting for temporarily slowing activity we see the key rate at 1.25% at the end of next year.

New anti-fragmentation tool still subject to many question marks

The ECB's forthcoming policy normalisation have already unsettled peripheral bond spreads. The return of fragmentation risk triggered an ECB emergency meeting in June, in which the GC announced to flexibly reinvest PEPP redemptions and to come up with a new anti-fragmentation tool. While markets cheered this message, key details are still missing. How to ensure that a (OMT like) stigma is avoided but some form of conditionality remains? Which is the intervention threshold and shall it be triggered by a country or the ECB? The latter would be faster but how could conditionality then be established? It needs to be consistent with the overall policy stance. Should purchases be sterilized by selling other bonds or through the money market? Will there be unwelcome side-effects? We doubt that the new tool will be able to match high-flying expectations.

US: recession risks on the rise…

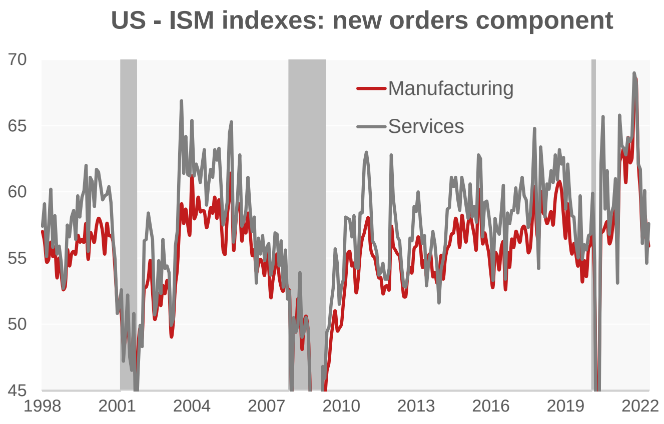
Persistently high commodity prices and the Fed's strong determination to cool demand to fight inflation have worsened the growth outlook. We now project US GDP to grow by 2.2% in 2022 and 0.9% in 2023. In the first half of next year a quarter of slight GDP contraction appears likely. At the same time, the rise in financing costs has increased the likelihood of a recession to above 40% over the next twelve months.

Forward looking indicators and higher rates point to a growth slowdown in the US

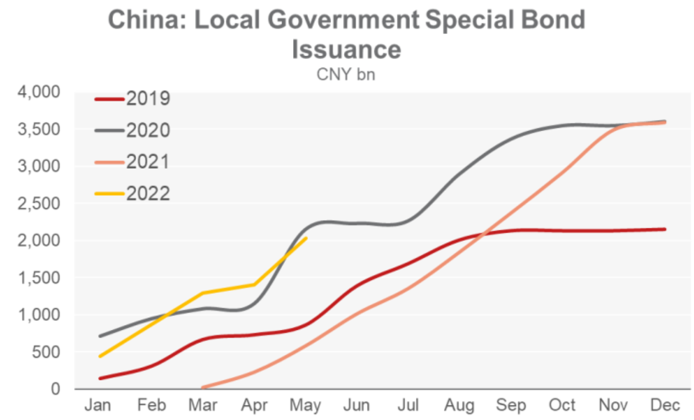
The disappointing Q1 GDP print (-1.6% saar) resulted from volatile components like net trade and, in part, inventories. Evidence for Q2 is mixed thus far. Household consumption is holding up (2.7% yoy in April) despite the steep fall in confidence and durable orders surprised to the upside in May. However, activity in interest rate sensitive sectors like construction is weakening and the latest readings of most business surveys point to a forthcoming slowdown, with the manufacturing ISM sliding closer to the contraction threshold. Employment growth remains steady, decelerating only a bit. Data on openings, hiring and quits for April show that the labour market remains extremely tight, with employment costs (ECI) up by a record 4.5% yoy in Q1. Disaggregated wage indices show that wages are growing faster for lower paid workers, which is supportive for consumption.

…likely to temper the Fed tightening despite persistent inflation

May inflation surprised to the upside, both in terms of overall figures (core 6% yoy , headline 8.6%) and of composition, with shelter costs accelerating to 5.5% yoy. Business surveys shows that firms are at pain with rising costs but feel capable – amid strong demand – to largely pass the increases onto consumers. As global supply gridlocks persist, inflation prints will ease only very sluggishly. We see core CPI to end the year at 4.6%.



Source:Datastream, GIAM



Source: Datastream, GIAM

The Fed is set to further front-load its tightening, but we expect a deteriorating growth outlook to moderate the pace of rate hikes later in the year

Concerns over stubbornly high inflation and the spike in consumers' long-term expectations drove the Fed to step up tightening, raising the Fed fund rate by 75 bps in June and disclosing its intention of further hikes to 3.25% by year end. Curbing inflation remains by far the Fed's top priority and the risk that this will trigger a recession cannot be dismissed. Short term, we expect the Fed to act consistently with its pledge and see another 75 bps hike in July followed by another 50 bps in September. We think that a less benign outlook for growth in autumn will then force the Fed to moderate the pace of tightening.

China: All hopes on regular testing

After China had removed its widespread Covid lockdowns, it already saw some setbacks, thus far confined to local or neighbourhood levels. To prevent "Shanghai-comparable" disasters, the government changed its zero-Covid strategy from mass to regular testing. The rationale is to early detect fresh infections and thus quickly ringfence any outbreak. However, with the Omicron variant much more infectious, there is no guarantee that this strategy will work even if authorities give it the highest priority.

We expect a bumpy recovery. Even if China manages to prevent a large outbreak, small ones may also induce temporary setbacks.

Economically, the lockdowns have likely induced Q2 GDP growth to drop to around 1% yoy, after 4.8% in Q1. Under the assumption that the Covid strategy will overall be effective and fresh outbreaks remain limited (it looks unlikely that setbacks can be fully prevented), we expect a bumpy recovery. Latest data support this view. Production growth already turned slightly positive while consumption is lagging. PMIs advanced into expansionary territory with services surprising on the upside. China will support growth in H2. It already unveiled a set of 33 initiatives with strong focus on credit support. Disclosed fiscal policy measures sum up to about 1.7% of GDP. Infrastructure investments will play an important role and local governments already stepped up their bond issuances (right graph above). The still battered real estate sector received some help from the PBoC. More monetary measures are likely to come (cut in the MLF rate by 10 bps, RRR by 25 bps). All in, we see growth to reach 3.5% this year, much below the official target of 5.5%.

GOVERNMENT BONDS

Florian Späte

- **After a horrible H1 for international government bond markets there is little sign of a sustained improvement in Q3. Central banks are expected to continue hiking rates as inflation rates are seen to remain on elevated levels.**
- **Having said that, there are some indications that the yield increase will slow down in Q3. Financial market pricing for international key rates appears slightly overdone and growth concerns are likely to manifest themselves more strongly.**
- **The downward pressure on euro area government non-core bonds is forecast to persist. The weakening growth environment in combination with a less supportive ECB creates an environment in which spreads are likely to widen further. The forthcoming ECB's anti-fragmentation tool is a wildcard but the potential for disappointment is great in view of lofty expectations.**

International government bond yields maintained their upward trend in Q2 amid a broad-based hawkishness by central banks. Yield curves have shifted further upwards (and steepened slightly) since the end of March. Bunds underperformed their US counterparts and the 10-year transatlantic yield spread tightened to the lowest level since December 2020. These movements cover the very high volatility on bond markets, which in some cases led to historically strong daily movements.

Sell-off continued in Q2 – and the leeway for a lasting rebound in Q3 is still bleak

Amid central banks' focus on fighting inflation key rate expectations increased across the board. In addition to a higher terminal rate financial markets have brought forward the timing of the peak. At present, the Fed is seen to raise key rates to 3.6% in Q1 2023 and the ECB is expected to reach 2.0% in Q1 2024. Although we regard this as somewhat overdone the hawkish stance of central banks is unlikely to change significantly already in Q3. Accordingly, we do not expect our more cautious stance to impact long-dated yields in the short term.

In fact, we expect a further yield increase in Q3. In the current market environment, the development of long-dated yields depends to a large extent on expectations about key rates. Particularly US key rate expectations had temporarily soared (peak above 4%). Given the ongoing tense inflation environment market pricing for the Fed has leeway to rise again going forward. What is more, amid the high level of political, economic, and geopolitical uncertainty we see scope for a further rise of the US and euro area term premium. This applies even more in case the Bank of Japan will end its Yield Curve Control (which is not our base scenario in the near term though). In addition, despite an expected drop in US government bond net supply in 2023 net-net supply (which accounts also for CB purchases) is seen to remain on a high level and might even increase slightly as the Fed's Quantitative Tightening is taking its toll.

At least in the US, an end to the upward trend in yields is in sight

Nevertheless, the extent of the forecast US yield increase is likely to remain limited. Considering our slightly more cautious key rate forecast and the forecast growth weakening (recession fears have already left their mark in recent weeks) we do not see 10-year US yields to rise significantly above 3.5% (even temporarily). What is more, 10-year US yields have overshot the priced medium-term key rate (proxied by 5y3m OIS) by around 35 bps and 10-year OIS above 3% looks too high as well considering cuts in a future recession. This offers some cushion against a continuation of the sell-off. Essentially, we forecast long-dated US yields to turn to a slight downward trend at the beginning of 2023. Accordingly, the approaching peak makes long-dated US Treasuries (hedged) an attractive alternative to euro-denominated bonds.

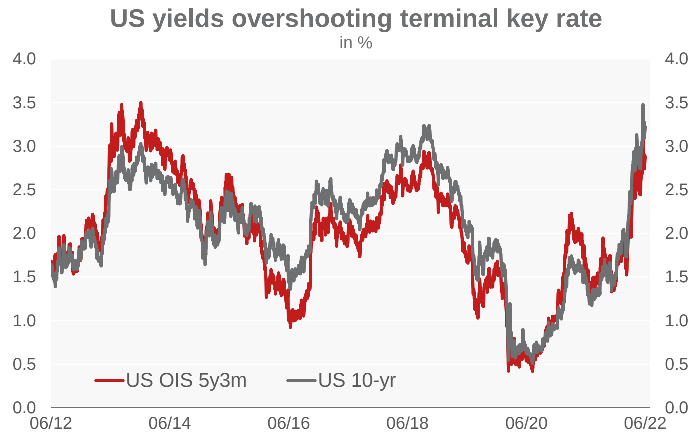
The leeway for euro area core yields to rise is somewhat larger – at least in the medium term. While we have a more cautious view on ECB key rates (1.5% vs. 2.0%

Long-dated Bund yields still well below the priced medium-term key rate signaling further upside potential

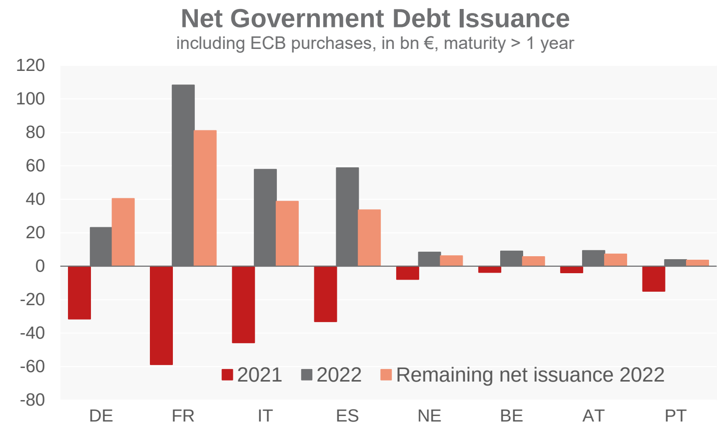
in 2024) in the medium term, our forecast for 2022 does not differ much from markets' view. In contrast to the US market 10-year Bund yields are still significantly below the priced medium-term key rate (1.55% vs. 2.25%). Although we regard the current pricing of 5y3m OIS as somewhat ambitious there is leeway for Bund yields to catch up. Additionally, the fair value for 10-year Bund yields is seen to be between 1.75% and 2.0% currently. Therewith, in contrast to US yields, Bund yields are still somewhat below the long-term fair value. Accordingly, we expect the 10-year transatlantic yield spread to narrow a bit more. Our 12-month forecast is 150 bps (3.3% vs. 1.8%), from a current level of 165 bps. In principle, however, we assume that most of the sell-off is behind us. Fears over financial and economic stability should limit the rise in government bond yields going forward.

Euro area non-core government bonds: all eyes on the anti-fragmentation tool

Euro area non-core government bonds have underperformed again in Q2. Particularly highly indebted countries suffered a considerable spread widening which was however, partly reversed when the ECB signalled more flexibility regarding PEPP redemptions and pre-announced an anti-fragmentation tool. Consequently, the spread widening remained contained on balance and euro area non-core bonds even outperformed other risky fixed income assets leaving them particularly vulnerable in case elevated expectations will be disappointed.



Source: Bloomberg, GIAM



Source: Datastream, Bloomberg, GIAM calculations

The environment will remain challenging going forward. While the NextGeneration EU funds remain supportive and rating agencies have not yet become concerned the weakening growth and rising yield environment is seen to ultimately bring debt sustainability concerns back to the fore.

Increased flexibility regarding PEPP redemptions unlikely to be sufficient and expectations for the forthcoming ECB anti-fragmentations tool are high

What is more, the net issuance (incl. ECB purchases) will reach almost € 300 bn in 2022 (and is unlikely to come down substantially in 2023 in case the ECB stays on the side-lines). Around 70% of this will have to be placed in H2. The flexibility regarding PEPP redemptions which is the first line of defence against fragmentation is unlikely to be sufficient as less than €100 bn will redeem in H2 (less than €200 bn in 2023). Even considering some front-loading (and abstracting from legal issues) it will not be enough to defend spreads in case of turbulent markets.

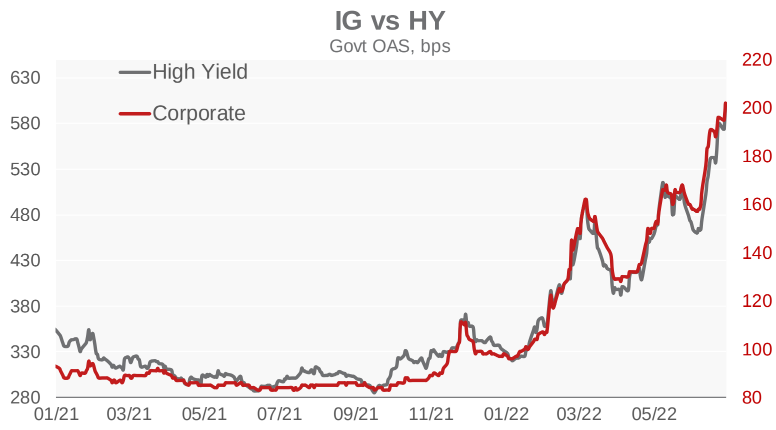
Accordingly, the design of the new ECB anti-fragmentation tool is of paramount importance for the future development. However, the inability to print money in a high inflation environment weakens the threat of intervention and there are several legal risks looming. Accordingly, there is a risk that the announcement will fall short of expectations. Therefore, we see leeway for euro area non-core government bond spreads to widen further. Consequently, we forecast the underperformance to persist and recommend a cautious stance going into Q3.

Elisa Belgacem

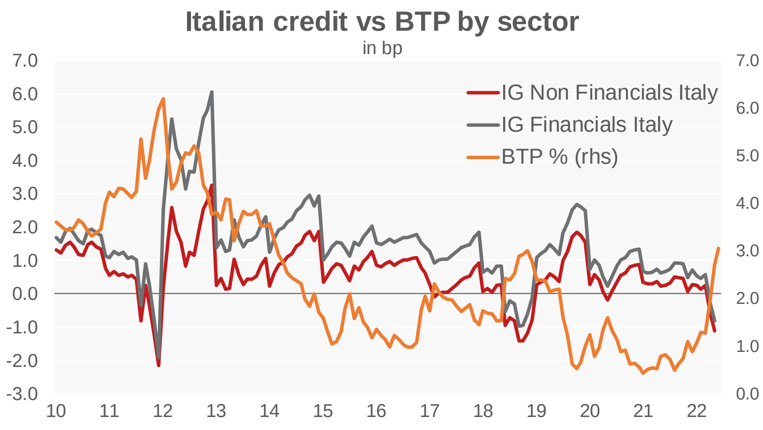
- **We continue to like IG credit, in particular, non-financials, as it is trading very wide compared to historical standards and sovereigns. At the same time, we see risks to fundamentals as limited.**
- **A key driver for credit in the coming weeks will be the inclusion or not of credit in the ECB anti-fragmentation tool. We view the fears of credit being sold as part of the sterilisation exercise as overdone and expect the ECB to be sensitive to the current distress in credit markets and support this segment.**
- **The heart of credit market distress is the real estate sector, under the pressure of the rising rates, that is pricing a likely restructuring of the whole sector. For good reasons, some names are under pressure, but we view the price action as too extreme.**
- **We are still expecting the ECB to be a catalyst for a climate premium in the credit market in 2022, as the ECB is still due to release its climate policy that will tweak its corporate reinvestments according to climate criteria.**
- **Hence, we recommend a prudent OW IG favouring defensive sectors, non-financials over financials, hybrids to pure high yield, and core to peripherals.**

We expect credit to be supported together with peripheral sovereigns by the ECB.

Will credit be part of the ECB anti-fragmentation tool? Whether the European Central Bank will also support credit remains wide open as no comments have been made in one sense or the other. Since the ECB emergency meeting, credit spreads have largely underperformed peripheral sovereigns, and some market participants expect the ECB to possibly sterilise the purchase of BTP or Bonos via selling other bonds, including corporate ones. We are of the view that credit will be supported as the corporate bond market is already showing signs of a significant vulnerability in the private space and lower end of the high-hield market.



Source:Bloomberg, BofAML Indices, GIAM



Source:Bloomberg, GIAM calculations

We favour IG over govies

We do prefer Investment Grade to semi-core and peripheral sovereigns. IG levels are currently incorporating a severe recession scenario and expect spreads to tighten moderately from current extreme levels into year-end. For High Yield, we are more cautious as we think corporates will feel the pressure of the economic slowdown that has not yet been reflected in companies' earnings during the last reporting season. IG spreads are also wider versus their long-term average compared to high yield. This is mainly because the HY primary market has been extremely quiet since the invasion of Ukraine. Either corporates will come to the market at very elevated prices, repricing secondary spreads, or investors will reconsider the liquidity premium attached to their high yield investment.

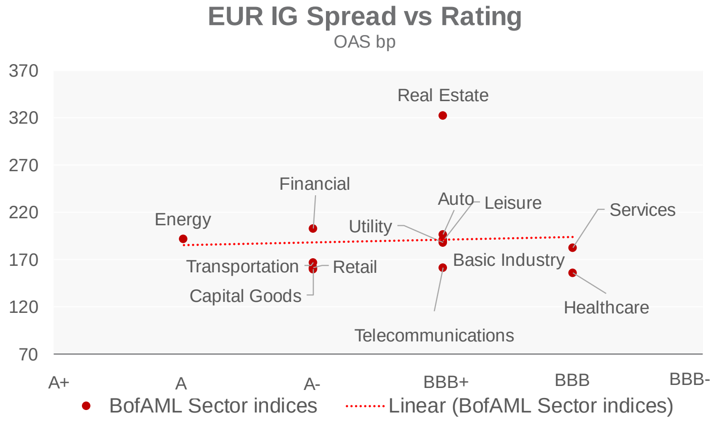
Peripheral credit has been resilient comparatively to peripheral sovereigns. We favour Italian non-financials to reload Italian risk.

Italian financials seem relatively expensive to BTP. Over the recent phase of peripheral rates increase, peripheral credit has been comparatively resilient. Historically Italian financials are not able to withstand long-lasted widening in BTPs. Consequently, shall the European fragmentation risk further materialise, non-financial credit has been able to trade inside the BTP, while we view financials as less attractive than the BTP itself both in a tightening and widening BTP scenario.

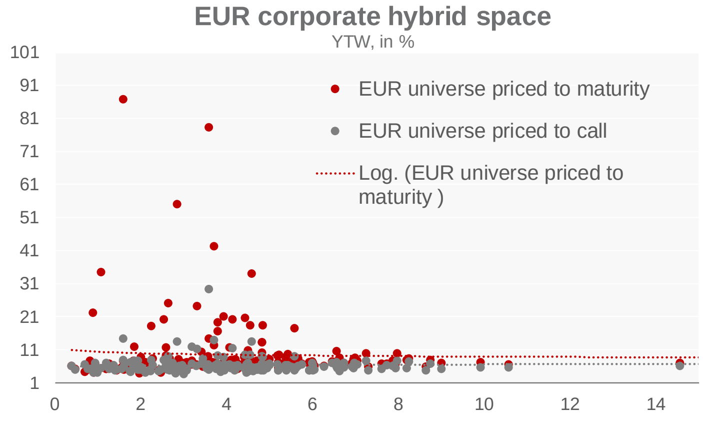
In terms of sector, we do favour a very defensive positioning with a preference for non-financials to financials, the latter being more cyclical and exposed to the fragmentation risk. Within IG we do prefer defensive sectors like Utilities and Telco.

The real estate sector is under intense pressure

Among credit markets, the real estate sector shows particular vulnerability, immediately affected by the rising rates environment. The negative price action has been particularly severe on real estate hybrids. Some of them are approaching their first call date and the possibility for real estate companies to come to the primary market



Source:Bloomberg, BofAML indices, GIAM own calculations



Source:Bloomberg, GIAM own calculations

to refinance those hybrids seems very low, making extension the base case for some of them. We reckon some issuers are at risk considering a stressed case of a drop in property prices from 10 to 20%. Yet, at the sector level, we think the current price action has gone too far in pricing a generalised restructuring of the sector at the senior and hybrid levels. In our view, the movement of extension risk rise has also started to propagate to other sectors on unjustified grounds. We continue to expect the vast majority of corporate hybrids to be called at the first call date and find "defensive" corporate hybrids as attractive, in particular versus BBs.

The ECB climate policy will be a credit market driver

A key idiosyncratic driver in the second semester will likely be the release of the climate strategy from the ECB. They have announced that their credit purchases will be adjusted according to climate criteria. Even after the end of QE in July, the reinvestments in private bonds are sizable, and the antifragmentation tool could also incorporate a climate twist. In Europe so far, it is primarily the energy sector that was trading at a premium compared to its rating on the back of its poor ESG profile. We do expect this ESG premium to grow and become more broad-based over the coming months. This may further contribute to the reduction of the greenium, the differential between comparable green and conventional bonds, as the focus gradually shifts from the instrument to the issuer.

Guillaume Tresca

- **EM countries continue to face multiple headwinds that are compounded by the more hawkish stance of central banks. We maintain an OW for EM bonds on a relative basis in our allocation as carry provides a significant buffer.**
- **However, the outlook is not supportive, and spreads will widen further. Valuations have turned attractive historically, but they reflect a new environment with higher refinancing risks. High discrimination is required.**
- **We would expect the end of the year to provide better entry points and adopt a cautious stance in favouring EM IG over HY. We focus on countries with strong fiscal and CA balances, especially in the HY space, as repayment risk is rising for small frontier markets.**
- **The commodity bull theme will fade further, and we will essentially focus on MENA IG producers.**

Unsupportive outlook but high carry to boost the total return

EMs facing multiple headwinds. The global economic and market environment has been deteriorating for EMs that continue to face multiple headwinds, compounded by more hawkish DM and EM central banks. In addition to a duration issue, EM external debt is also under pressure from spread widening.

Even if the outlook is not supportive for the asset class, we maintain an OW for EM bonds on a relative basis because carry has turned increasingly high, around 7.5%. As a result, the total return can be positive in the next half of the year, even if spreads will likely widen further. However, risks continue to be heavily skewed on the downside. Uncertainty is high to benefit from the current attractive valuations, and we expect the end of the year to provide better entry points if central banks change their stance. Within this environment, we maintain a defensive stance being OW EM IG as EM HY will keep suffering from the economic slowdown and risk of rising defaults.

TR can be positive in H2 thanks to the carry

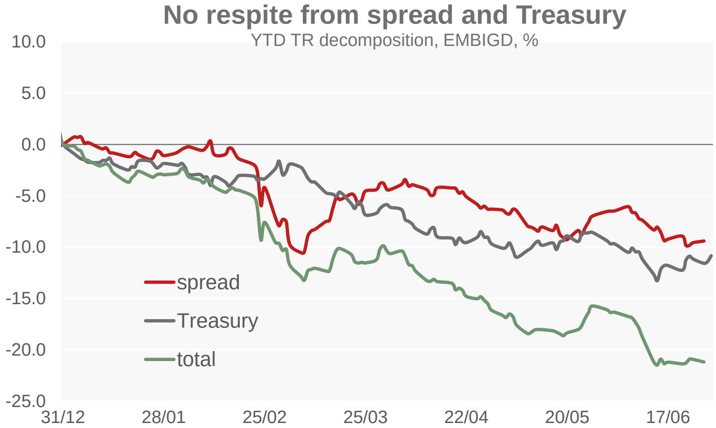
6M TR for different scenarios, BofA index

OAS spread / US 8Y	2.80%	2.90%	3.00%	3.10% (current)	3.20%	3.30%	3.40%	3.50%
411	7.8%	7.1%	6.3%	5.6%	4.8%	4.1%	3.3%	2.6%
416	7.4%	6.7%	5.9%	5.2%	4.5%	3.7%	3.0%	2.2%
421	7.1%	6.3%	5.6%	4.8%	4.1%	3.3%	2.6%	1.8%
426	6.7%	5.9%	5.2%	4.5%	3.7%	3.0%	2.2%	1.5%
431	6.3%	5.6%	4.8%	4.1%	3.3%	2.6%	1.8%	1.1%
436	5.9%	5.2%	4.5%	3.7%	3.0%	2.2%	1.5%	0.7%
441	5.6%	4.8%	4.1%	3.3%	2.6%	1.8%	1.1%	0.3%
446	5.2%	4.5%	3.7%	3.0%	2.2%	1.5%	0.7%	0.0%
451	4.8%	4.1%	3.3%	2.6%	1.8%	1.1%	0.3%	-0.4%
456	4.5%	3.7%	3.0%	2.2%	1.5%	0.7%	0.0%	-0.8%
461	4.1%	3.3%	2.6%	1.8%	1.1%	0.3%	-0.4%	-1.1%

Source: Bloomberg, GIAM calculations

No respite from spread and Treasury

YTD TR decomposition, EMBIGD, %



Source:Bloomberg, JP, GIAM

We maintain a cautious stance. Valuation is cheap but high discrimination is needed

Increasing fragmentation

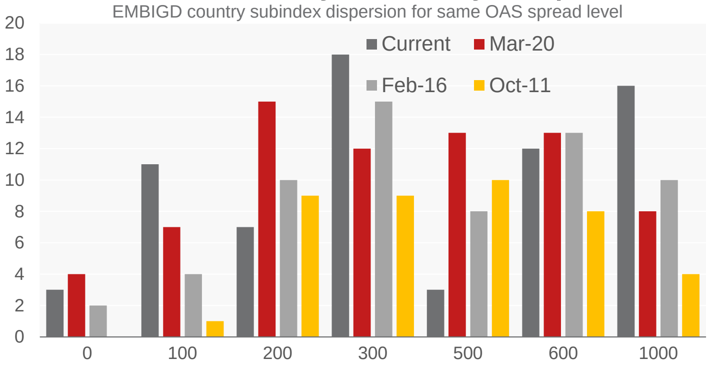
Within the sell-off, fragmentation has been intensifying across the EM spectrum. On a historical basis, EM external debt is cheap, but the EM universe is fragmented with a fat-tail distribution. Indeed, EM IG is expensive, but it is a safe haven while distressed names have been numerous. Moreover, many countries are now in the 300bp spread bucket. In other words, the cheapness of the global index is optical and high discrimination is needed.

Likewise, average cash prices have reached new lows vs. history and the US

Treasury level. It can provide some convexity protection in case of higher core rates. For distressed names, the average price is lower than the historical average recovery rate. However, it reflects a higher risk premium and a new environment: low coupon, the end of the QE, and higher refinancing risk, so a selective approach is required.

Fat tails: very rich or very cheap

EMBIGD country subindex dispersion for same OAS spread level



Source: Bloomberg, JP Morgan, GIAM calculations

Current account has barely improved

20 EM countries, % of GDP

Source: Bloomberg, GIAM

We favour MENA IG producers. EM HY oil producer to lose further momentum

The commodity support is fading

We expect the commodity theme to gradually fade even if higher commodity prices have cushioned the risk-off environment. The bull commodity theme should fade as market prices in a higher recession risk, and all EMs are not equal. We would expect a growing distinction between food and metal exporters whose prices start declining and the energy producer countries. MENA IG countries remain the best option because they will keep benefiting from low breakeven prices and still have a large oil production capacity. Moreover, they benefit from their safe-haven status.

On the other hand, EM HY producers lagged in the last oil moves, and they are sensitive to global risk aversion. It is worth highlighting that high commodity prices remain a global negative shock for EMs. Even commodity exporters must, for instance, subsidy food prices via fiscal measures. Globally, fiscal balance will barely improve for EMs, and CA surplus has already started to decline on average.

Countries with solid fiscal and CA balances will be more resilience. Default risk is due to rise

Mind the recession risk

Historically, EM assets reached their peak performance well before US recessions, and bear-market rallies for EMBIGD were limited, c. 2%. Therefore, we will adopt a cautious stance focussing on countries with strong fiscal and CA balances. In our view, this factor is even more discriminative in the HY space. For instance, in Europe, we focus on CEE countries with a strong fiscal anchor to Europe that provides a solid buffer for their rating.

With tighter financial conditions, refinancing risk resurfaces, and default risk rises. According to the IMF, the debt level for EMs has stabilised at c. 70%, but interest-to-revenue keeps growing. There is a risk of more pressure on weak and small HY countries, even more since the primary market has been almost closed since March and issuance costs have been rising fast for B and BBs. Frontier market payments will peak in 2026, and they continue to have large twin deficits on average. Based on the current spread level, market is already pricing a c. 22% default probability in 1Y time for EM HY, and the default cycle is not over. High food prices will also incite governments to a trade-off between debt servicing and food support, as it was the case in Sri Lanka. Therefore, EM HY default rate could reach 10% of the EMBIGD index in 2023, but it will only concern small EM countries. It will not have systemic consequences on the broad EM spectrum.

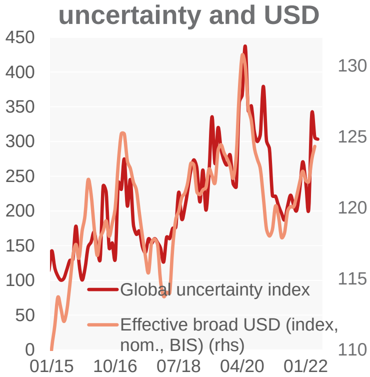
Thomas Hempell

- **Geopolitical and policy uncertainties will keep the USD bid near term, while the looming stagnation in the euro area and higher peripheral spreads are set to weigh on the EUR.**
- **Yet, the USD is broadly overvalued. Once tensions over Ukraine ease and activity in the euro area recovers momentum, EUR/USD is likely to bounce from very cheap levels. The Fed still renders support but historically the USD tended to peak around lift-off dates. Mid-term, we stay positioned for a higher EUR/USD.**
- **The Japanese yen keeps suffering from strong monetary policy divergence as the BoJ bucks the global trend of policy normalization.**
- **The Swiss National Bank (SNB) not only lifted rates but – in a sharp policy turn – also signalled tolerance about CHF strength. This will benefit the CHF for longer.**

Persistent geopolitical tensions and policy uncertainties are set to keep the USD bid near term

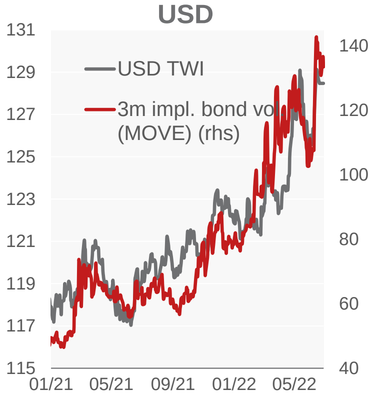
The war in Ukraine, high uncertainties about monetary policy and the depth of the slowdown are set to keep investors cautious. The USD is an anticyclical currency which benefits amid a global slowdown and higher risk aversion. Despite having climbed to stretched valuations, its support is unlikely to give in soon. In particular, uncertainties about geopolitics and the further path of central banks (how fast and how much of tightening?) is unlikely to abate quickly, keeping the USD underpinned (see charts below).

Global policy uncertainty and USD



Source: www.policyuncertainty.com, Datastream, GIAM calculations

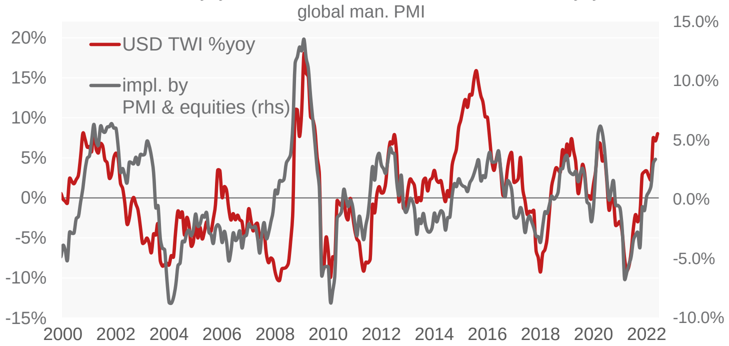
Yield uncertainty and USD



Source: Datastream, GIAM

Risk aversion and global growth worries tend to boost the countercyclical USD

USD TWI in %yoy; model 2000-2019 based on MSCI World %yoy and global man. PMI



Source: Datastream, GIAM calculations

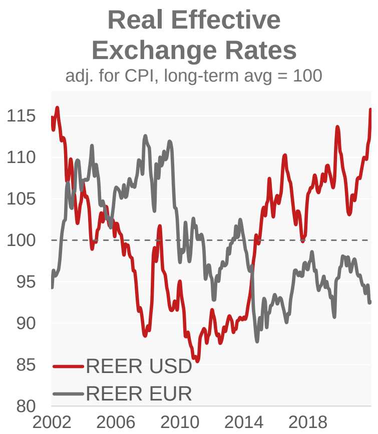
Further safe haven support to USD unlikely to persist through year-end

Yet, it is hard to ignore the USD's already stretched valuations. Its effective real (inflation adjusted) value is 15% above the long-term average. Our EUR/USD financial market model even points to an 20% overshoot. And the USD stands out with an almost 8% stronger move compared to what tight yield/FX corelation would suggest for this year (see second chart overleaf). The EUR/USD also looks cheap when compared to economic surprises and the expected monetary policy divergence between the Fed and ECB.

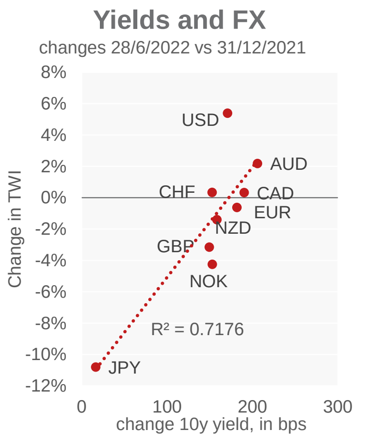
The USD's fortune is set to turn once tensions in Ukraine are past peak and evidence of slowing inflation pressure emerges

The key element to watch is a reversal of unusually high geopolitical and policy uncertainty. Once tensions over Ukraine ease and the risk of a euro area recession recedes, the USD's fortune is likely to turn and the EUR to bounce from very cheap levels. The other ingredient for a trend reversal is ebbing policy uncertainty. Inflation is set to hover around 8% among advanced economies over the summer months. Once evidence of peak inflation emerges, policy uncertainty is set to recede too, eroding a key element of USD support.

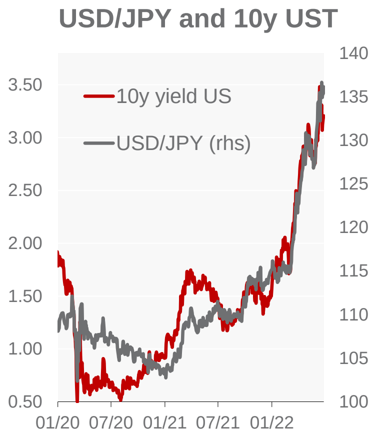
As the ECB is set to end a period of more than eight years of negative rates, we expect the EUR to benefit from easing portfolio outflows. The Fed still renders support to the greenback, but historically the USD tended to peak around lift-off dates. Meanwhile, heavier US sanction risks will incentivise global reserves manager to keep diversifying their portfolios' heavy tilt towards the USD which, even after an 8 pp decline since 2015, still accounts for almost 60% of allocated reserves. Overall, we see the outlook tilted towards further USD strength near term followed by a rebounding EUR/USD later in the year and into 2023.



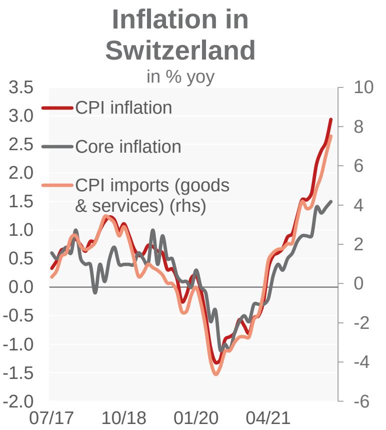
Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

Meanwhile, the JPY continues to suffer from monetary policy divergence, as the BoJ bucks the global trend of monetary tightening. This comes at substantial costs in terms of required bond purchases as the BoJ keeps defending the upper limit of its yield curve control (YCC), while the fate of the yen is mostly in the hands of US yields (third chart above). This bears some further downside for the yen near term. But doubts about the BoJ's commitment to its extraordinary support may rise. Rising costs of imported goods are squeezing consumer budgets and the risk of outright FX intervention is rising. In our baseline it will take until next April, when the term of BoJ's head Kuroda ends, to see a material change in the BoJ's policy stance. But the abrupt abolition of YCC in Australia last year and of the CHF peg in 2015 are healthy reminders that policy makers may be overwhelmed by market pressures. The yen is fundamentally heavily undervalued and we expect a recovery in the mid- to long-term view.

GBP burdened by politics and stagflation dilemma, CHF with new SNB support

We expect some moderate upside in the EUR/GBP, as political risks (the UK's attack on the Northern Ireland protocol; PM Johnson's eroding support) and a wider C/A deficit are weighing on the outlook. Also, the global stagflation dilemma is particularly acute for the UK (strong inflation overshoot vs. a particular bleak economic outlook), rendering further weakness against the EUR (even if it may hold ground vs. a generally weaker USD in the medium term).

The hawkish surprise by the Swiss National Bank (SNB) in June leaves somewhat more upside for the CHF. The SNB not only front-ran the ECB's tightening by raising rates by 50 bps. It also signalled more rate hikes to come and a much higher tolerance of a stronger exchange rate, dropping its long-standing reference to CHF overvaluation and signalling FX asset sales as part of policy normalization. This means that amid rising inflation concerns also at the SNB, the earlier worries about a too strong exchange rate have given way to embracing it as a tool to outright tame inflation pressures. We thus now expect the CHF to pass beyond parity vs. the EUR short term, even if a later recovery in risk sentiment may take EUR/CHF back above the 1.00 threshold in the medium term.

EQUITIES

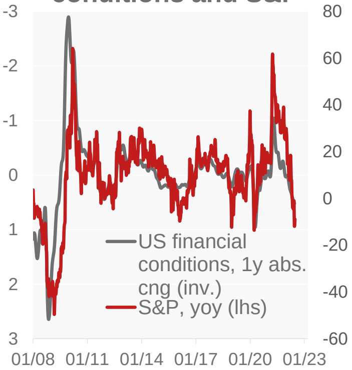
Michele Morganti and Vladimir Oleinikov

- **Equities remain under pressure at least for the short term. The war is not going to stop soon and sanctions as well as energy supply issues are causing inflation to surprise analysts on the upside.**
- **Central Banks' (CBs) hawkishness and higher 10-year rates continue to cause deteriorating financial conditions for longer, raising firms' cost of capital and inducing investors to demand a high-risk premium.**
- **We see PEs to remain under pressure (target is 16X US and 12.5X EMU) due to higher yields and inflation. Furthermore, our Machine Learning models see equity not favoured vs bonds yet. As CBs stay quite hawkish, the risk of a marked economic slowdown increases, and markets have yet to discount a hard landing (-14% is the downside risk, i.e., 3,170 for the S&P 500). The US Tech remains at risk: valuation bubble has not dissolved yet (20%).**
- **For the short term, we increase the underweight (UW) equity position notwithstanding potential positive total return in 6-12 months (ca. 3%). We are slight overweight (OW) China, US & UK vs. EMU, neutral on Japan and UW SMI. Sector OWs: Oils, Materials, Diversified Fin., Durables, Utilities. UWs: Cap. goods, Food, RE, Media, Pharma, Insurance, Comm.& professional services.**

Short-term pressure to continue via higher rates and sticky high inflation

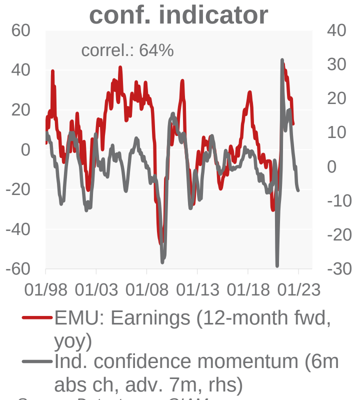
Equities remain under pressure at least in the next few months. The war is not going to stop soon and sanctions as well as energy supply issues are causing inflation to surprise analysts, especially in the euro area (EA). Furthermore, inflation itself is broadening to reach core subcomponents. That is alarming CBs and they will not stop anytime soon. Such CBs hawkishness and higher rates continue to cause deteriorating financial conditions for longer, raising firms' cost of capital and inducing investors to demand a high-risk premium for equities, if not even higher than current one. Bonds' volatility stays also extremely high, another headwind for equity's appeal. In the end, we see PEs to remain under pressure. Thus, we lowered our PE target (16X US and 12.5X EMU) due to higher yields and inflation. Historically, with inflation between 2.5% and 5%, the risk premium historically demanded by the market is such to produce a higher-than-current S&P 500 level in 12 months: 4,129 or more. But for higher inflation levels like 5%-6% or 6%-7%, which we will probably experience in the next months, the risk premium demanded historically increases to produce much lower price target levels. Moreover, such higher inflation ranges also produce a dangerously higher standard deviation of the equity risk premium (higher uncertainty).

US financial conditions and S&P



Source: Datastream, GIAM

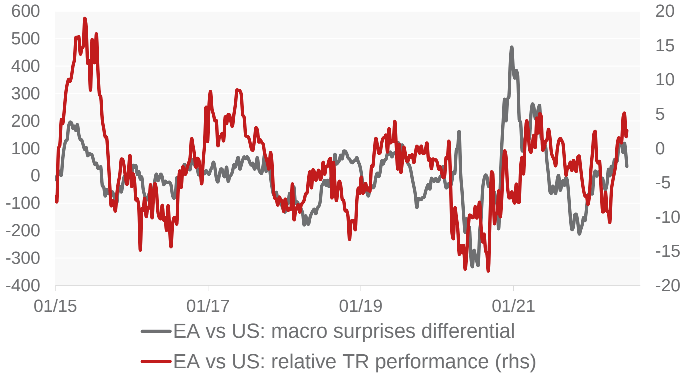
EMU: Earnings & Ind. conf. indicator



Source: Datastream, GIAM

Macro surprises and market performance

Euro area versus US (relative total return, 6m changes)



Source: Datastream, GIAM

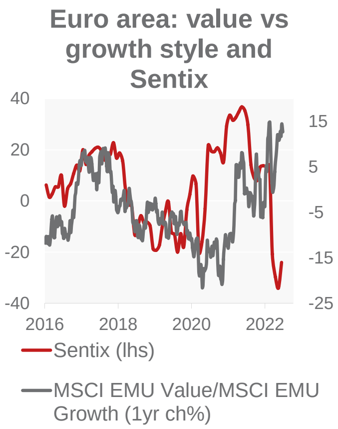
Market has yet to discount a possible hard landing

Furthermore, our Machine Learning models see equity TR not favoured vs bonds' ones yet. Lastly, as CBs remain quite hawkish, the risk of a marked economic slowdown increases, and markets have yet to discount a hard landing. So far, Q1 reporting

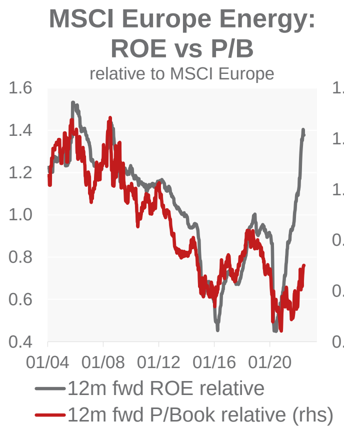
Positioning is rather low but relative equity/bond flows still near a cyclical high. High corporate savings are a positive mid-term

season and macro surprises have held well in the EA but we see reasons to worry due to the real income and global activity deterioration plus prolonged war uncertainty. Consequently, we maintain a lower-than-consensus earnings growth in 2022-2024. Another source of risk is represented by the US Tech which valuation bubble has not dissolved yet (+20%, from an initial +40% overvaluation). In conclusion, for the short term we increase the UW equity position notwithstanding: 1) potential positive total return in 6-12 months (ca. 3%; using 12.5X PE and lower-than-consensus EPS growth); 2) high firms' free cash flows and good inflation-hedging characteristics of real asset; 3) contained positioning. Positioning is indeed rather low but relative equity flows vs bonds still linger near a cyclical high. In a worst-case scenario, EMU and US equities could still have a downside of 14% (3,170 for the S&P 500). Cease-fire, then less hawkish CBs (autumn?) and a cyclical economic bottom would represent triggers for buying again. We are slight OW US & UK vs. EMU, neutral on Japan and UW SMI: defensive plus guarding against slowdown.

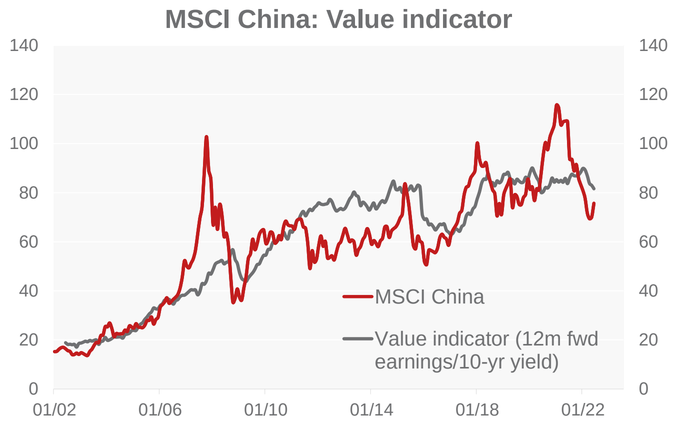
On EU sectors, we look for contained valuations, positive correlations to a peaking USD and protection from high volatility and inflation. We lowered slightly expensive defensives like pharma and food, also decreased exposure to expensive and poor earnings-revisions Value ("expensive" from our fair Value indicator and ML models,



Source: Datastream, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

other than based only on market multiples): Telecoms. Increased Tech Hardware, Div. Financials, Durables and Utilities. Value enjoys higher rates, but ML models show increasing overbought signals vs Growth in the short term. Confidence indicators are also not playing well for Value. Growth is at risk, too – higher rates – but looks more oversold (ML, slowdown). Energy and Materials are still OW but starting to look overbought on ML models. OW: Oils, Materials, Div. Financials, Durables, and Utilities. UW: Capital goods, Food, RE, Media, Pharma, Insurance, Commercial & professional services.

EM Equities: keeping neutral stance but OW China

EM: at risk from falling export orders and weak earnings. OW China and Korea

We judge the recent EM rally potentially at risk. Our value indicator gives indication of slight overvaluation and falling export orders and still weak earnings should put EM equities under pressure in the short term. Longer term, peaking dollar and the EM credit yield advantage (vs the US HY) should be favourable.

Chinese equities are undervalued on different measures (value indicator, good internal country score, attractive PEG adj.) and should benefit from China's improving credit impulse, the increasing government's policy support and an easing of lockdowns and tech regulation. Additionally, China's inflation remains contained as compared to that of the developed markets. Possible renewed lockdowns represent a risk.

Within EMs, we OW also Korea (high internal country score, based on several valuation metrics), which should also benefit from improving Chinese economic activity.

ASSET ALLOCATION

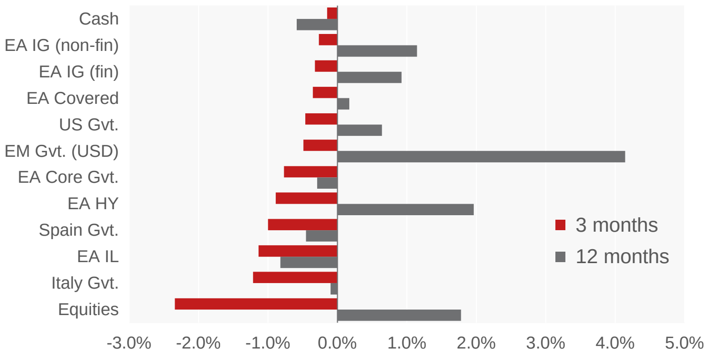
Thorsten Runde

- **Most of the factors identified as market triggers in the previous quarter have not lost their significance three months later.**
- **Russia's war against Ukraine and the resulting sanctions imposed by the West will continue to drive up energy and food prices, squeezing disposable income in an environment of tightening financial conditions.**
- **Reliefs from eased Covid restrictions as well as catch-up effects from consumption will not prevent economic activity from almost stagnating in the euro area and from slowing down in the US.**
- **Given these growths prospects we generally confirm our underweight (UW) in cyclicals. With more rate hikes in the cards Equities remain highly exposed to rising real yields. Thus, we recommend marked UWs in Equities and peripheral debt. On the credit side we avoid HY while putting an OW in IG with a defensive bias. With yields expected to rise, we stick to a moderate short position in duration while expanding our OW in Cash.**

Although we have been basically correct with our tactical positioning (as confirmed by the outperformance of our model portfolio since the end of March) we clearly did not expect such a strong surge in yields, as did most of the other market participants. Looking at the corrections on the govie and equity markets, the former were outstanding in the past 20 years whereas the latter were not too extreme from a historical perspective.

Aggregated Total Return Forecasts

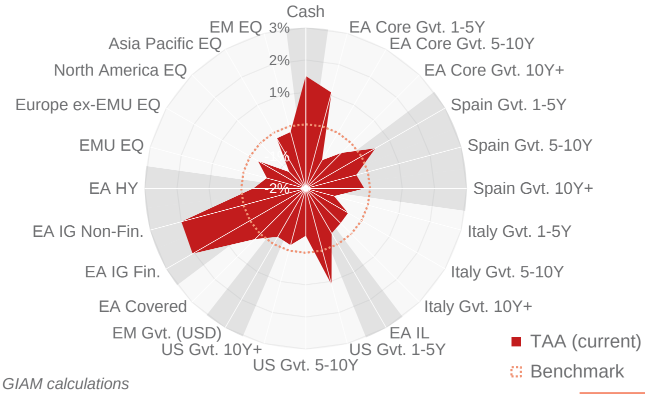
(hedged into EUR)



Source: GIAM calculations

Balanced MtM Model Portfolio

(active positions in pp)



Source: GIAM calculations

Against this backdrop, we consider the potential for further losses in Core Government Bonds as limited. Equities, on the other hand, appear much riskier in an environment of geopolitical uncertainties, gloomy growth prospects and rising real yields. On the fixed income side, weakening growth, rising yields and an ECB scaling back its support will particularly weigh on BTPs. Thus, Equities and BTPs represent the strongest underweight positions in our model portfolio. The UWs should be increased compared to our last quarter’s recommendation. The high level of swap spreads makes safe Credits appear comparatively attractive. In this sense, we suggest an overweight in EA IG with a defensive bias, while avoiding HY due to its cyclical sensitivity. USD exposure might serve as a hedge against rising EMU worries even on a FX-hedged basis.

Expecting an environment of moderately rising yields across the board in the months to come, we do favour a modest short duration stance on the fixed income side. Furthermore, we significantly increase the overweight position in cash.

FORECASTS

Macro Data

Growth	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.7	2.2	- 0.6	0.9	- 1.2	1.4
Euro area	5.3	2.6	- 0.1	1.6	- 0.6	1.8
Germany	2.9	1.3	- 0.7	1.7	- 0.7	1.5
France	6.8	2.3	- 0.6	1.3	- 0.4	1.5
Italy	6.6	2.2	- 0.3	1.5	- 0.3	1.8
Non-EMU	6.4	3.2	- 0.2	1.0	- 0.3	1.6
UK	7.4	3.5	- 0.3	0.6	- 0.4	1.5
Switzerland	3.7	2.5	- 0.1	1.5	- 0.3	1.8
Japan	1.7	1.5	- 0.5	1.6	- 0.3	0.8
Asia ex Japan	7.8	4.3	- 0.9	5.1	0.0	5.1
China	8.1	3.5	- 1.2	5.5	0.4	4.8
CEE	6.7	- 0.7	1.9	2.3	1.1	3.6
Latin America	6.6	2.0	0.0	1.9	0.0	2.4
World	**6.4**	**2.9**	**- 0.3**	**3.0**	**- 0.2**	**3.2**

Inflation	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	4.7	7.5	0.3	3.6	0.3	2.3
Euro area	2.6	7.1	0.3	3.4	0.8	2.0
Germany	3.2	7.5	0.9	3.6	0.6	1.9
France	2.1	5.6	1.1	3.0	0.7	1.8
Italy	2.0	6.0	- 0.2	2.0	- 0.1	0.6
Non-EMU	2.3	6.9	0.4	4.5	1.0	1.6
UK	2.6	8.4	0.6	5.8	1.5	1.6
Switzerland	0.6	2.0	- 0.1	1.0	0.0	1.2
Japan	- 0.3	2.4	0.7	1.5	0.4	0.9
Asia ex Japan	2.0	3.9	0.5	3.2	0.3	2.6
China	0.9	2.4	0.2	2.2	- 0.1	2.0
CEE	9.3	29.9	0.4	16.2	3.6	7.6
Latin America	6.6	7.7	1.1	4.2	0.6	3.3
World	**3.5**	**7.5**	**0.4**	**4.4**	**0.7**	**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	1.75	2.88	3.13	3.38
EUR	-0.50	0.25	0.75	1.25
JPY	-0.10	-0.10	0.00	0.00
GBP	1.25	1.75	2.25	2.25
CHF	-0.25	0.00	0.25	0.75
10Y Government Bonds	**Current***	**3M**	**6M**	**12M**
US	3.18	3.30	3.40	3.30
Euro-Area	1.54	1.70	1.80	1.80
France	2.08	2.30	2.40	2.45
Italy	3.51	3.90	4.00	4.05
Japan	0.23	0.25	0.30	0.40
UK	2.39	2.55	2.60	2.55
Switzerland	1.35	1.45	1.50	1.50
Spreads	**Current***	**3M**	**6M**	**12M**
GIIPS	153	170	170	175
BofAML Covered Bonds	76	80	80	80
BofAML EM Govies (in USD)	414	410	410	400

Corporate Bond Spreads	Current*	3M	6M	12M
BofAML Non-Financial	190	195	185	175
BofAML Financial	204	215	205	195
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.06	1.04	1.08	1.13
USD/JPY	136	137	130	123
EUR/JPY	143	142	140	139
GBP/USD	1.23	1.20	1.24	1.28
EUR/GBP	0.86	0.87	0.87	0.88
EUR/CHF	1.01	0.99	1.01	1.03
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	3,878	3,745	3,790	3,870
MSCI EMU	126.0	121.0	128.0	124.5
TOPIX	1,887	1,805	1,915	1,885
FTSE	7,264	7,040	7,330	7,205
SMI	10,847	10,420	10,810	10,590

*as of 28.06.22 (3-day-average)

FORECASTS

Forecast Intervals*

3-Months Horizon

Government Bonds (10Y)	US	2.62	**3.30**	3.98
	Germany	0.95	**1.70**	2.45
	UK	1.36	**2.55**	3.74
	Switzerland	0.64	**1.45**	2.27
Spreads	10Y-GIIPS Spread	138	**170**	202
	BofAML Covered Bonds	66	**80**	94
	BofAML IG Non Financial	326	**195**	494
	BofAML IG Financial	146	**215**	244
	BofAML EM (in USD)	148	**410**	282
Forex	EUR/USD	1.01	**1.04**	1.07
	USD/JPY	134	**137**	140
	EUR/GBP	0.85	**0.87**	0.89
	EUR/CHF	0.97	**0.99**	1.01
Equities	S&P500	3,486	**3,745**	4,004
	MSCI EMU	110.9	**121.0**	131.1
	TOPIX	1,674	**1,805**	1,936
	FTSE 100	6,537	**7,040**	7,543
	SMI	9,775	**10,420**	11,065

12-Months Horizon

Government Bonds (10Y)	US	2.10	**3.30**	4.50
	Germany	0.16	**1.80**	3.44
	UK	0.57	**2.55**	4.53
	Switzerland	-0.50	**1.50**	3.50
Spreads	10Y-GIIPS Spread	110	**175**	240
	BofAML Covered Bonds	52	**80**	108
	BofAML IG Non Financial	245	**175**	555
	BofAML IG Financial	84	**195**	266
	BofAML EM (in USD)	74	**400**	316
Forex	EUR/USD	1.08	**1.13**	1.18
	USD/JPY	115	**123**	131
	EUR/GBP	0.83	**0.88**	0.93
	EUR/CHF	1.00	**1.03**	1.06
Equities	S&P500	3,387	**3,870**	4,353
	MSCI EMU	105.8	**124.5**	143.2
	TOPIX	1,632	**1,885**	2,138
	FTSE 100	6,262	**7,205**	8,148
	SMI	9,381	**10,590**	11,799

*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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