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Equity markets have held up rather well to war, inflation and rising yields...



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After insisting that inflation was only transitory, central banks now believe they must combat it immediately. Inflation now appears to be their main concern, more than growth. Their about-face has sent bond yields upward rather quickly. What's more, the war in Ukraine is not over and could undermine the global economy... So, with all this going on, how have equity markets held up so well?

Our allocation

at 30/03/22

Underweight		Neutral	Overweight	
--	-	=	+	++

ASSET CLASSES

This period of rising interest rates is undermining bond performances, which could continue to get worse before levelling off. Then it will be time to buy back into them. In relative terms, equities are still attractive but offer little upside in the short term.

Money market	→
Bonds	→
Convertibles	→
Equities	→
Commodities	→
Alternative / Abs. return	→

BONDS

Corporate bonds have been made attractive once again by the recent increase in yields and widening in spreads in both investment grade and high yield.

Euro core sov. debt	↑
Euro periph. sov. debt	→
Euro Investment Grade	→
High Yield	→
Inflation linked/Breakeven	→
Hard-currency emer. debt	→
Local emerging debt	→

EQUITIES

US equities have outperformed once again, as is often the case during crises. European equities have underperformed but that's because they are more heavily exposed to the war, which is unfolding in Europe.

United States	→
Eurozone	↓
United Kingdom	→
Japan	→
Emerging markets	→
China	→

EQUITIES BY SECTOR / STYLES

Segmenting growth and value is hard to do right now, as market momentum is flowing through several different channels, including exposure to rising yields, defensiveness, cyclical exposure, and others.

Growth	↑
Value	↓
Small / Mid caps	→
Cyclicals	→
Financials	→

CURRENCIES

The dollar is likely to continue being supported by a yield gap that is now far more favourable. In the longer term, the dollar's share of several countries' international reserves could shrink in the wake of the US's recent decision to freeze Russian reserves.

USD	→
Yen	→
Livre sterling	→

The figures cited deal with past years.
Past performances are not a reliable indicator of future performances.

ASSET ALLOCATION

CONTEXT AND ANALYSIS

Back in January we were expecting a volatile year to play out in 2022. And it certainly has been that. After a shaky start to the year on fears of tighter US monetary policy, initially held scenarios were further disrupted by the war in Ukraine. And yet, amidst the anxiety of war and rising interest rates, equities have performed surprisingly well. **Indices are back to where they were just prior the invasion of Ukraine** and are down by just 3% on the year to date in the case of the S&P 500 and by just 6% on the EuroStoxx. Meanwhile, bond yields have risen significantly, from 1.50% to 2.45% on the 10-year T-Note, and from -0.17% to 0.57% on the 10-year Bund. This is one of the bond market's worst starts to a year ever. The Euro MTS Global is down by almost 5.0%, and its peer US indices by 6.4%...

While the outcome of this horrible conflict is still highly uncertain, **the markets appear to be pricing in an exit scenario that would avoid the worst**, i.e., an escalated conflict involving several more countries. They also seem to be betting that economic damage from the conflict will remain moderate – a risky assumption at this point. But, perhaps most of all, investors believe that Western sanctions (mainly decided by the US) are working, are dissuasive and are likely to throw cold water on any other countries' expansionist plans (we are thinking chiefly of China and Taiwan).

This positive exit scenario is still open to question, but one thing that does look certain in the short term is that there will be more inflation and less growth.

For Jerome Powell, the US Federal Reserve chairman, **inflation now looks like a more important issue than growth**. Inflation is now over 8% in the US, and the recent rise in commodity prices could very well keep it high. The unemployment rate is now back to its pre-Covid lows, and the outlook is pointing to an even tighter job market in the coming months, raising fears of a possible spillover into wages. This inflationary surge is also beginning to spread into investors' and economic agents' long-term expectations. This can be seen in the inflation that is being priced into inflation-linked bond prices. And this is what central banks, which are keeping a close eye on this indicator, want to avoid. This has opened up a window of opportunity for the Fed to announce a new tightening cycle in its key rates, its first since 2018. The markets have gotten the message, with Fed Funds Futures trading in ranges of 2.50%/2.75% for December 2022 and 3.00%/3.25% for mid-2023, or well above the 2.40% rate the Fed regards as neutral. The Fed therefore believes the US economy is strong enough to bear the impact of these rate hikes, but that remains to be seen in the coming months. The ECB has also moved to a more hawkish stance on inflation, which is approaching 6% in the euro zone. The markets see the main key rate at 0.00% by yearend and at 0.80% at the end of this cycle, in 2023.

Meanwhile, growth forecasts have been adjusted downward. Rising commodity prices will undermine household consumption and slow down investment by companies, whose margins will suffer. This conflict in Ukraine will have a direct impact on Europe and a more moderate one on the US, while China is expected to be affected only marginally.

Global growth, which was forecast at almost 4% at the start of

the year, is therefore likely to be around 3%, according to the latest forecasts, which assume that oil prices will level off at about USD 110/120. According to the main econometric models, a USD 10 rise in oil prices subtracts about 0.2 percentage point from GDP. If we factor in rising natural gas prices, which are hitting Europe the most, it's easy to see why the economic growth forecast was lowered so much. On top of all this, higher agricultural prices will also end up hitting consumption.

In the **United States**, growth is expected to slow to 3% this year. In the **eurozone**, forecasts are also hovering around 3%, but with greater probabilities of downward revisions. **China** is a special case. It has reiterated its 5.5% growth target for 2022, but this looks ambitious after a challenging year in 2021, marked by a regulatory crackdown and a real-estate crisis and as partial lockdowns have been rolled out in some major cities to head off a new Covid wave. But this is a crucial year for the authorities, with the 20th Congress of the Communist Party in November, at which President Xi Jinping is seeking re-election to a third term or even for life. The government is therefore likely to put through stimulus measures.

The global Covid crisis had begun to shape some new trends. The current serious geopolitical crisis is of a different nature but is also very instructive for the medium term.

The US remains an undisputed global power. If the West has managed to show a united front, it's mainly thanks to the US, even if the Ukrainian crisis is unfolding in Europe. With NATO in a heightened posture, financial sanctions have illustrated the still unequalled power of the dollar, and the US will ultimately sell more gas to Europe and also more weapons. On the other hand, some countries that are still holding a large portion of their international reserves in dollars may be tempted to diversify into other currencies after the decision to block Russia's access to its reserves held in dollars. The Chinese RMB could be the medium-term beneficiary, while cryptocurrencies have demonstrated the advantage they enjoy in being disconnected from central banks' international systems. Meanwhile, the steadfast, US-led Western reaction suggests a positive outcome that could pour cold water on China's expansionist temptations and encourage it to keep communications channels open with America and Europe, who are very important trade partners and with which its economy is so intertwined that any obstacles would end up hurting everyone. This is also probably one of the reasons why the markets have rallied. Financially, Russian has been wiped off the map of the international indices. As for the real economy, it will also take a hit from the decision taken by very many Western companies to pull out of the country. More broadly, recent events are pointing in the same direction – i.e., that **the globalisation that came has accompanied global growth since the fall of communism and since China joined the WTO in 2001 is reaching its limits**. The Covid crisis had already underscored the dangers of having to depend on suppliers on the other side of the world. This new awareness will now be accelerated by the tense geopolitical posture between the US and China and the almost universal awareness of the need to reduce carbon footprints in trade.

Lots of plans are already being rolled out for new manufacturing facilities in Europe and the US, particularly in critical areas such as

The figures cited deal with past years. Past performances are not a reliable indicator of future performances.

microprocessors and electric batteries. They will create a less fluid world from the trade perspective, a world in which enhancing efficiency and controlling costs will become less paramount. This, in turn, will probably generate greater inflation, along with a structural deterioration in company margins. Meanwhile, the current context is hardly conducive to bringing public deficits and government debt under control. With this in mind, the Maastricht treaty is now a dead-letter, and a reorganisation of the euro zone will have to be thought out over the coming years.

One more thing: this crisis has laid bare, if not the contradictions, than at least the challenges, of the notion of ESG (environmental, social and governance). Many market watchers are surprised that Russia was included in some so-called “ESG” indices. This a complex, almost philosophical issue. Democratic regimes are in the global minority and represent only a portion of the world’s population. If we are concerned, say, about our planet’s environmental future, it is not by limiting ourselves to Western countries – which are virtuous on the whole and ultimately account for few CO2 emissions (outside of the US) – that we are going to address those concerns. On the contrary, good practices must be developed in emerging markets, starting with China. The same goes for strengthening good practices in the areas of corporate governance and gender equality. Along these lines, we took note recently of a Scandinavian bank that plans to invest once again in the weapons sector, which it deems essential to defence against aggression from “non-virtuous” countries. This is a vast issue that will enliven discussion on ESG investment in the coming months. ESG investment management currently takes so many different approaches that it is hard to figure out what’s what. A clearer nomenclature of the products on offer and internationally standardised accounting standards should be developed in the coming years to avoid mixing up concepts.

In short, the coming years will see a world less open, with more inflation, less growth and tighter corporate margins. With that in mind, what’s the best way to invest?

Expectations of higher key rates have been rapidly priced in, so much so that the US yield curve is flat. Generally speaking, yield curves flatten late in the economic cycle and point to slower growth. That means that it’s best to begin now preparing to move back into bonds, which will soon offer more attractive entry points, even though real yields will remain negative for some time to come. Equities are likely to be penalised by the double-whammy of economic slowdown, which will drag down earnings, and higher interest rates. But, paradoxically, equities are safer than bonds in an inflationary environment, and global valuations look decent. Moreover, as during each period of disruption, there will be innovative and growth sectors that are ripe for long-term investment. We nonetheless believe that, on the whole, equities offer limited short-term potential and we are accordingly sticking to our “neutral” stance.

INTEREST RATES

Central banks are fighting inflation!

While the outcome of the Russian invasion of Ukraine is subject to endless speculation, one thing does look clear – **it will be one**

factor in keeping inflation in 2022 at levels that go far beyond the central banks’ tolerance. This, in spite of the findings of their recent strategy reviews that accepted “symmetry” on either side of their 2% inflation target. Moreover, central banks are taking a tougher line. **The Fed will accelerate its monetary tightening;** it is not ruling out 50 basis points hikes; and it plans to move into “restrictive” zone in 2023, i.e., beyond the rate that deems to be “neutral” on the economy (2.4%). The ECB, meanwhile, will complete its net asset purchases well before the end of the year, perhaps as early as the end of June, which would leave the door wide open for an initial rate hike as early as this autumn. The market, for its part, is pricing in hikes of more than 50 basis points by the end of 2022. **These actions are a clear demonstration of central banks’ objective to combat inflation.** There is little they can do against war-related inflation, but, in reaction to the steep rise in inflation expectations and the risk of “second-round effects”⁽¹⁾, they cannot afford to leave their monetary policies in expansion mode, despite downgraded growth forecasts. This is especially the case for the ECB, which must pull its rates out of a negative zone that is hard to justify.

Central banks’ shift into “inflation-fighting” mode will, in the medium-term, keep inflation break-evens⁽²⁾ under control. Real rates will therefore continue to soar spectacularly. In the US, they are likely to move back into positive territory some time in 2022 (vs. - 0.45% currently). In Europe, the rise in interest rates is likely to be mainly in the form of real rates, which are still far into negative territory, at about - 2.00%.

For the short term, we would not rule out a further rise in nominal 10-year yields, perhaps even as far as the terminal rate in the US (2.75%/3.00%) and to 0.75% in Germany, driven by upcoming inflation figures that seem to have come from another age entirely. Nevertheless, the shift by central banks and pressure on growth are likely to bring the long section (10 years) back to our 2.25%/2.50% target in the US and 0.50% in Germany in the medium term. After a phase of widening in spreads, alongside the rise in interest rates, yields in **investment grade** and **high yield** bonds have returned to the attractive levels of 1.6% and 4.5%, respectively. Carry is once again meaningful and offers greater protection in the event of a rise in rates when projecting out to the medium term. Companies’ financial standing will allow them to absorb the shock of higher costs, especially as they have recovered the capacity to pass on these higher costs into their prices. **We therefore reiterate our positive view on high yield in euros and regard investment grade as an “initial entry point”.**

EQUITIES

Volatility to exploit?

Who would have thought that after one month of fighting in Ukraine and with the 10-year US yield higher than 2.5%, equity markets would be trading above their pre-invasion levels? With nothing resolved geopolitically, the markets at first dove furtively to levels seen in 2002 and 2008.

How have they held up so well? The markets are betting that the war won’t last forever and that a negotiated solution will be reached in the coming weeks. They are also betting that, ultimately, no embargo will be imposed on Russian oil and gas. This is indeed a touchy issue for investors, who have seen commodity prices skyrocket. This

⁽¹⁾ Inflation passed on by economic agents that are having to cope with higher commodity prices.

⁽²⁾ The inflation breakeven rate is the difference between the yield on a traditional bond (nominal yield) and the yield on its inflation-indexed equivalent (real yield). The figures cited deal with past years. Past performances are not a reliable indicator of future performances.

ASSET ALLOCATION

would squeeze companies' profit margins or consumers' purchasing power, which would end up doing the same thing. To date, we have seen very few downward revisions in company earnings forecasts. Financial analysts, who were probably overly conservative early in the year, are taking advantage of the leeway they had to make mere adjustments. Indeed, based on the correlation between global growth and the year-on-year change in earnings, global growth, even on downgraded 3% forecasts, is unlikely to trigger a slump in earnings, either in the US or in Europe. With that in mind, P/E ratios of 13 in Europe and 18 in the US do not look particularly excessive, especially if interest rates continue to move up in the short term, making bond investments less attractive. **While this is a clear argument for equities, the still-uncertain geopolitical environment is keeping us, for the moment, from recommending this asset class. That's why we have decided to stick to the neutral stance we adopted in February.** From the "style" viewpoint, in another environment, rising rates would have been a clear signal to continue rotating into cyclicals, value and financials, as some investors began doing late last year. However, in the present environment, revised growth forecasts will drag down industrial cyclicals and banks, which will be pushed into extensive write-downs of businesses in Ukraine and Russia. Banks will also have to deal with a resulting increase in their cost of risk. That's why we prefer not to take sides on any particular style over another. The same goes for our geographical stance. US indices have higher weightings of tech stocks, which are more negatively exposed to higher bond yields but better protected in the event the war goes on or spreads. And, lastly, in a context in which China has decided to stick to a certain politically motivated neutrality, preferring to focus on domestic growth, targeted at 5.5%, Chinese equities will recover some attractiveness as soon as threats engendered by the Covid resurgence have subsided.

Our central scenario

Central banks have switched into inflation-fighting mode and are therefore tightening their monetary stances. Fixed-income markets have adjusted accordingly to these new expectations on the cycle peak in key rates. Long bond yields could continue to adjust upward before the economic slowdown stabilises them, before turning downward in the medium term. Yields already reached in corporate bonds now look attractive. Equities are still promising for the medium term in both absolute and, even more, relative, terms. However, the lack of short-term visibility keeps us from overweighting them in the short term. Volatility will remain high on the markets and will open up some better entry points, such as in recent weeks, for investing on a medium-term horizon.



AGENDA

4

APRIL

Eurogroup meeting

14

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ECB Governing Council meeting

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Bank of Japan Monetary Policy Meeting

3

MAY

US Federal Reserve (Fed) meeting



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