Market Perspectives

The hour of the hawks

GIAM Macro & Market Research

May 2022

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Global View – The hour of the hawks

Thomas Hempell / Vincent Chaigneau

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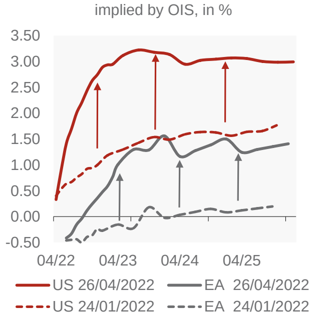
- **We keep a mild underweight on equities. Further upside for yields is more limited as global inflation is near peak and markets already discount a (too) long series of aggressive rate hikes. Credit offers a juicy carry, but we prefer safer segments in IG.**

In a painful month for bonds and equities alike, rising inflation and hawkish central banks sent yields soaring while geopolitical and growth worries drove risk premia up in April. Global equities suffered their biggest monthly setback since the pandemic sell-off in March 2020, with our defensive stance on risk and duration paying off.

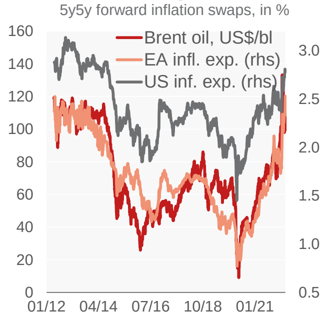
Amid plentiful bearish news, it is easy to overlook some silver linings. Following the slump in March, key confidence indicators (incl. PMIs, Ifo) defied expectations of a further fall in April, keeping economic surprises positive and even marginally rising. Services account for much of the relief, as eased lockdowns in Europe unleashed pent-up demand in sectors battered by the pandemic. Macron's victory in French elections has also removed a key tail risk of extreme right populists undermining EU integration.

Key rate expectations for US and EA
implied by OIS, in %



Source: Refinitiv, GIAM calculations

Oil price and LT inflation expectations
5y5y forward inflation swaps, in %



*Source: Datastream, GIAM calculations; * 5Y5Y*

Yet, caution is set to prevail among investors over the coming weeks. The conflict is morphing into an attrition war, with human atrocities and increased western supply of weapons to Ukraine thrashing hopes of a quick negotiated solution. Sanctions on Russian energy exports are set to be extended towards oil, while Russia may extend curbs to gas proliferation. This keeps the risks for energy prices geared to the upside. Recent Covid worries in China are just adding to central banks' stagflation dilemma. Lockdowns due to China's increasingly desperate zero-Covid strategy are weighing on global growth while risking renewed supply chain disruptions and price increases.

Inflation credentials trump growth worries – for now

Persistent inflation overshoots (and surprises) keep the hawks in the driving seat at central banks – at least for now as inflation credentials are prioritised over growth concerns. The Fed is set to front-load its hiking cycle, with 50 bps rate increases likely in May and June. We also see mounting risks that the ECB will bring its rates lift-off forward to as early as July.

Bonds	27/04/22*	3M	6M	12M
10-Year Treasuries	2.81	2.80	2.85	2.90
10-Year Bunds	0.82	0.85	0.90	1.00
Corporate Bonds				
BofaML Non-Financial	141	140	140	130
BofaML Financial	153	145	145	135
Forex				
EUR/USD	1.06	1.06	1.08	1.12
USD/JPY	128	133	130	120
Equities				
S&P500	4218	4180	4410	4400
MSCI EMU	134	131	140	139

** avg. of last three trading days*

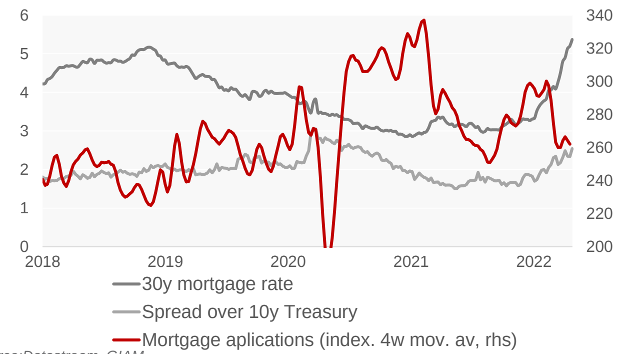
Further out, however, the higher fragility of the recovery and markets alike may ultimately make the Fed and the ECB tread more carefully. Markets seem complacent on the growth risks from these combined headwinds (our forecasts are below consensus). With US rate hike expectations priced by summer 2023 looking excessive, we only see moderate further upside for yields from here.

Equities may find some support from already very bearish sentiment, with the share of bullish respondents in the AAII investor survey dropping to the lowest in three decades. Yet actual positioning is not aggressively defensive, with investors wary of cutting equity exposure more drastically as a shift into bonds is neither appealing amid persistent inflation worries. This keeps us tactically underweight, most so in cyclicals and euro area. We see residual value in Credit due to the attractive carry and spreads (e.g. large relative to country spreads), but we favour defensive segments. USD strength is stretched, but may extend short term amid persisting war concerns in Europe and a strikingly dovish BoJ eroding the yen.

USA

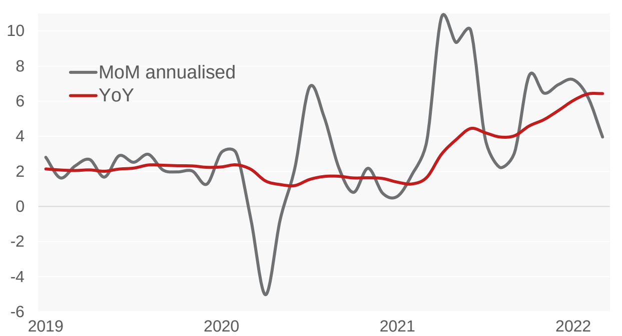
Paolo Zanghieri

Mortgage rate and applications



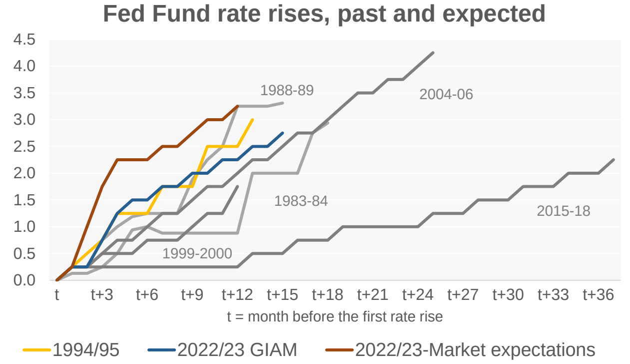
Source:Datastream, GIAM

Core inflation



Source:BLS, Datastream, GIAM

Fed Fund rate rises, past and expected



Source:Federal Reserve Board, CME, GIAM

- **In Q1 2022 GDP fell by 1.4% ann. on destocking and falling export. Consumption grew by just below expectations, but investment was steady.**
- **Yet, consumer surveys show increasing concerns about purchasing power. Moreover, high prices and mortgage cost are starting impacting the construction sector.**
- **Core inflation is showing signs of peaking, but remains stubbornly high and is not set to decline quickly. The Fed will react swiftly with a 100 bps rate increase over the next two meetings.**

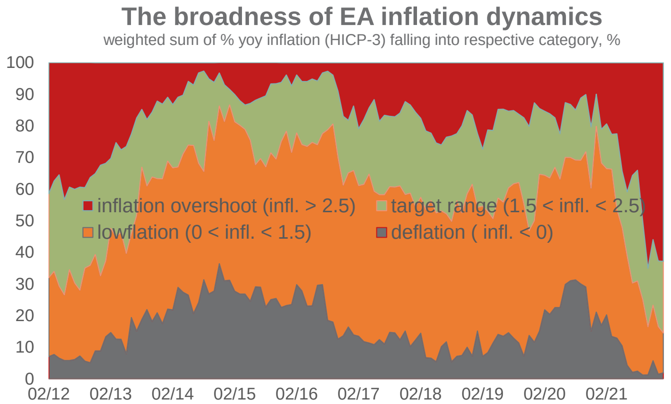
The first release of Q1 GDP shows an unexpected 1.4% ann. contraction after a solid 6.9% ann in Q4 2021. The figure is heavily affected by declining net exports and destocking. Consumption growth was limited by high fuel prices, but investment kept domestic demand growth steady. We expect a rebound in Q2, but the impact of tighter financial conditions and global instability will likely lead to a deceleration in H2. We forecast for 2022 a below-consensus 2.7% growth, with some downside risk. Indeed, tighter rates start affecting demand for durables, and especially construction.

Accelerating prices (the Case Shiller index keeps growing at nearly 20% yoy) and fast increasing mortgage rates have triggered a drop in mortgage applications. Pending home sales fell 1.2% in March, for the fifth consecutive month. This will moderate house prices, which in turn will cap the rise in shelter prices, which are increasingly contributing to high core inflation. On this front, the March print, while at a 40 year high (6.4% yoy), shows some tentative signs of stabilisation, driven mostly by some goods categories. The gradual rebalancing of consumption to services should bring goods prices down and contribute to the resolution of the supply bottlenecks, assuming the harsh lockdown in China is solved quickly. Still, with sustained wage pressures (the Atlanta Fed media wage measure was up by 6% yoy in March), and likely second round effects from high commodity prices, core inflation will not end the year below 4% yoy. We expect the Fed to respond with a 50 bps hike in each of the next two meetings. A faster tightening before the end of the summer is possible; afterwards we see a less steep path than what markets price, with the policy rate peaking at 2.7% (versus 3.2% implied by forwards), as the weakening of the economy in H2 will eventually require more caution. Still, the path will be among the steepest in the last forty years.

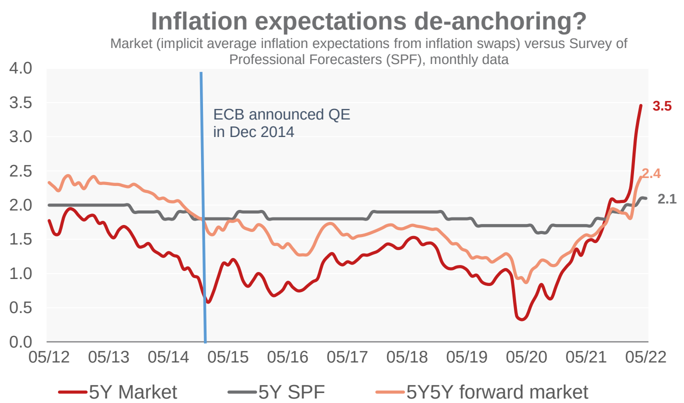
Euro Area

Martin Wolburg

Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

- **The unwinding to lockdown measures and a so far relatively moderate fallout from the war hints at ongoing expansion of activity in H1/2022.**
- **Q1 GDP grew by a meagre 0.2% qoq supporting us in our view to maintain our below-consensus growth forecast of 2.2% for 2022.**
- **Sky-rocketing prices, inflation expectations above target and huge pipeline pressure increase the risk of a July rate hike significantly.**

After two months of war in the Ukraine the fallout on euro area economic activity has been moderate so far. A first estimate reported growth of 0.2% qoq in Q1. According to PMIs the start into the second quarter was good. The composite PMI increased to 55.8 (from 54.9), a level clearly consistent with ongoing growth. This rise was driven by higher services sector sentiment which in turn largely benefitted from the unwinding of Covid stringency measures.

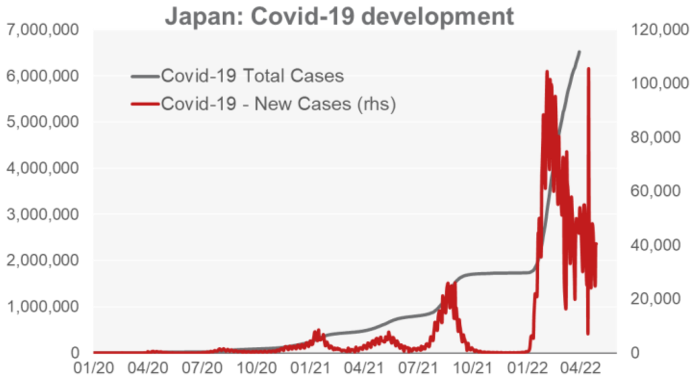
However, sentiment in the more export-oriented manufacturing sector sentiment receded. Persisting bottlenecks, the fallout from sanctions and new risks due to harsh lockdown measures in China are clouding the outlook. Moreover, consumer confidence plummeted and is set to fall further. Sky-rocketing inflation that reached 7.5% yoy in April. We expect headline inflation to stay around these levels over the coming months thereby eroding real incomes. And the risks are clearly tilted towards even stronger headwinds, e.g. if Russia were to completely stop gas supply to the euro area. We are looking for a protracted period of low or even negative growth.

All in all, given a poor start into the year, the Ukraine war persisting and further supply shocks increasingly likely we to our 2022 growth outlook of just 2.2%, well below the consensus expectation of 3.2%.

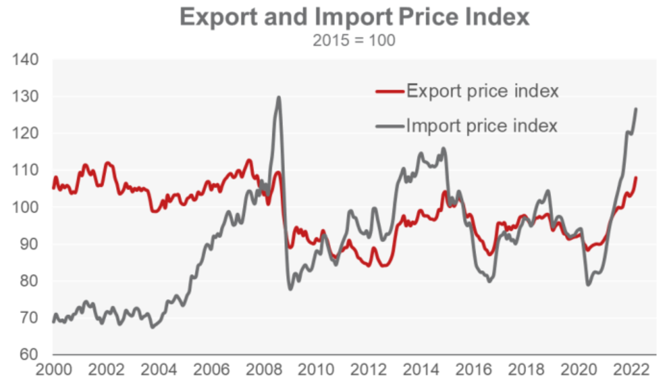
The ECB currently faces a perfect storm made of broadening inflation (see med-chart), huge and increasing pipeline pressure (e.g. PPI 31.4% yoy in 02/22) and inflation expectations above the 2% target. Quite noteworthy, the 5Y SPF inflation expectations (see bottom chart) rose to 2.1% for the first time. At its April meeting the ECB adopted a hawkish tone. Latest comments from Governing Council members were even more hawkish. This hardened our case that the ECB will stop QE by July. Moreover, the risks of an early start of the normalisation cycle in July increased significantly in our view.

Japan

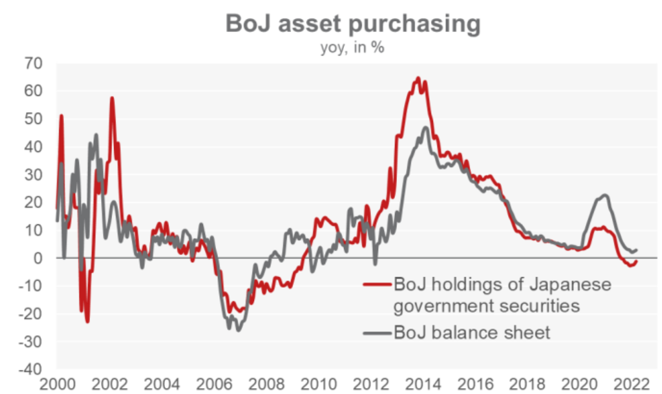
Christoph Siepmann



Source: Datastream, GIAM



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

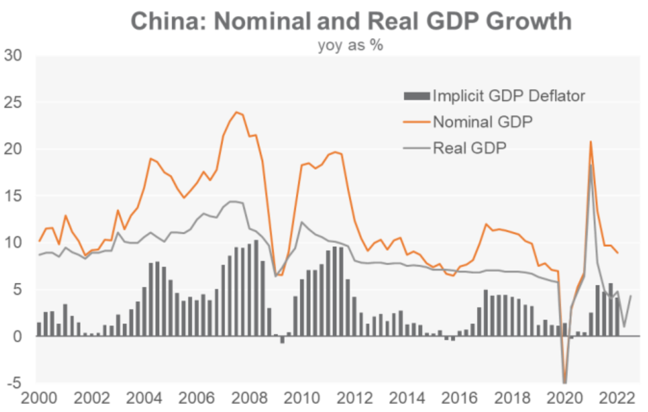
- **The Japanese yen currently trades at a 20-year low against the US-dollar due to the strong BoJ-Fed monetary policy divergence.**
- **The BoJ prefers to keep its policy unchanged on "wrong" inflation, still subdued growth, slowing China demand and high Covid cases.**
- **Ultimately, we see it more likely than not that the BoJ will be forced to give in, if the loss in real income generates enough political pressure.**

The BoJ's and the Fed's monetary policy stances are hugely diverging. While markets are pricing an ever-faster US rate hike cycle, the BoJ would prefer to maintain its expansionary stance. This has caused the yen to depreciate against the US-dollar to a 20-year low. At its policy meeting on April 27/28, the bank held firm and announced daily unlimited fixed-rate purchases of 10y JGBs at 0.25%. In the BoJ's view, the time has not yet come to start tightening monetary policy: In March, headline inflation has risen to just 1.2% yoy while core-core inflation (ex food and energy) is still in negative territory (-0.7% yoy). Rising inflation is mainly due to energy and food prices, with energy also showing up in import prices (+33% yoy). April inflation will jump up to more than 2% yoy as the past cut in mobile phone charges will drop out of the statistics. We expect headline inflation to average 1.8% in 2022. Nevertheless, this is not the "kind" of inflation the BoJ was hoping for, i.e., not a "virtuous" wage-price spiral. Moreover, Q1 GDP growth will likely come in on the negative side, private consumption is still suffering from a flare up in Covid cases and the lockdowns in China will weigh negatively on exports.

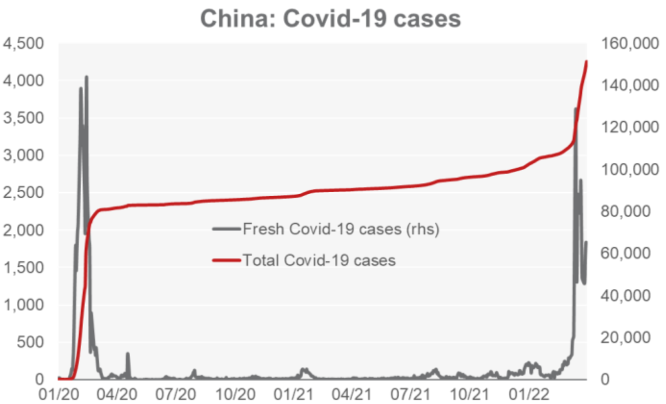
So far, the BoJ has sent the strong signal to stick to its policy. However, the deterioration of the terms of trade is reducing consumers' purchasing power as wages will not go up meaningfully. SME's might also not be able to pass on rising input costs. The government already finalized emergency countermeasures including assistance for SMEs and cash handouts for households. Nevertheless, we expect the loss in real income to generate more and more political pressures which eventually would force the BoJ to give in. In that case, a simple widening of the 10y JGB trading band is not considered sufficient anymore. Instead, the most likely measure is to shorten the 10y yield curve control (YCC) policy target to five years.

China

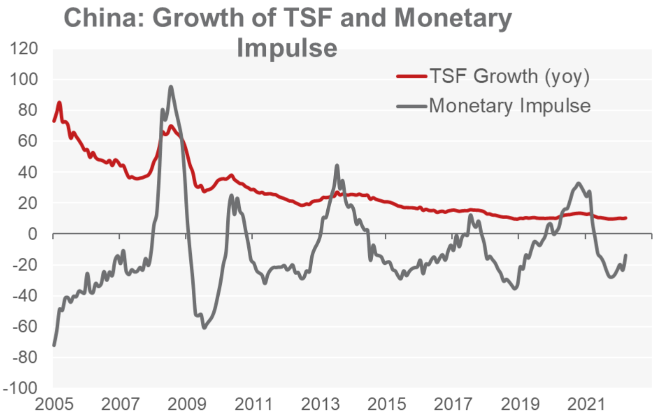
Christoph Siepmann



Source: Datastrem, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

- **With a reading of 4.8% yoy, China's Q1 GDP growth surprised on the upside.**
- **March data already showed a strong downturn in retail sales. April data will deteriorate markedly given the Omicron lockdowns.**
- **The GDP outlook will depend much on China's lockdown strategy. While we expect some modifications, visibility is low. Due to the Q1 upside surprise, we revised 2022 growth to 4.0%.**

China's Q1 GDP growth surprised markedly on the upside. This was especially true for growth dynamics which came in at 1.3% qoq (4.8% yoy), just 0.2 pp below the previous result. The reading was more than twice as high as the Reuters consensus forecast (0.6% qoq) and thus greeted with some scepticism. The data contrasted with March retail sales which dropped by 3.5 yoy (after +6.7% yoy in February). Positive growth contributions came from exports, industrial production and urban investment. Infra-structure investment improved but real estate data showed strong Covid scars.

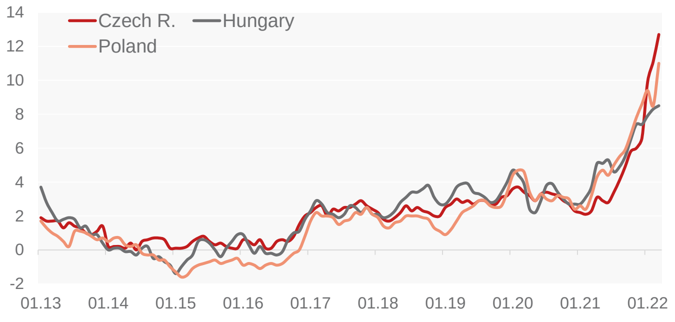
Real activity data are set to deteriorate strongly in April. Shanghai's lockdown is only one example of various forms of restrictions across 43 other cities. Fears are flickering that Beijing might be next. The lockdowns imply a heavy dropping of retail sales. Experience from 2020 suggests long delays for its recovery. Production might have held up better as partially organised in closed "bubbles". Logistics are also under strains in ports but also on surface. This will also stress international supply chains and have a negative impact on inflation in Western countries.

Visibility on the growth outlook is currently very low. Much depends on the Covid lockdown policy (we expect it to be modified after the current outbreak) and the further spread of the virus. Moreover, officials continue to see growth at about 5%, in order not to deviate too much from the NPC target. Missing the 5.5% by a wide margin could be embarrassing for President Xi. This implies intensifying policy efforts in H2 2022. The PBoC cut its RRR by 25 bps but left policy rates unchanged. Recently, "window guidance" was more stressed than rate cuts, not least in order not to widen the interest spread to US rates. We still see a reduction in the MLF rate by 10 bps. We revised our 2022 growth outlook to 4.0% to incorporate the Q1 result, but otherwise see GDP under severe pressure.

Radomír Jáč

Headline inflation

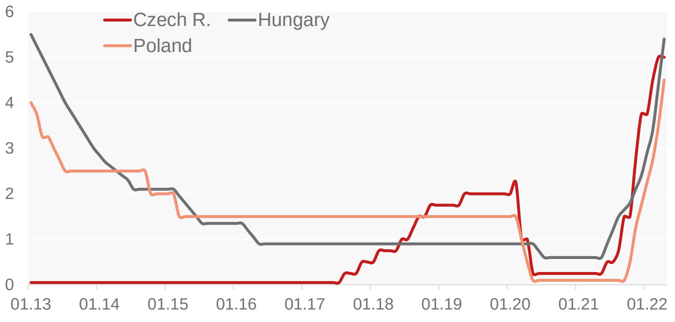
CE-3 countries (CPI yoy in %)



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

Monetary policy interest rates

CE-3 countries (end-of-month level, in %)



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

Main Forecasts

Czech Republic	2020	2021	2022f	2023f
GDP	-5.8	3.3	1.0	3.0
Consumer prices	3.2	3.8	11.3	3.5
Central bank's key rate	0.25	3.75	5.00	3.00
Hungary	**2020**	**2021**	**2022f**	**2023f**
GDP	-4.9	7.1	2.8	3.0
Consumer prices	3.3	5.1	8.5	4.2
Central bank's key rate	0.60	2.40	6.00	4.50
Poland	**2020**	**2021**	**2022f**	**2023f**
GDP	-2.5	5.7	3.3	3.5
Consumer prices	3.4	5.1	10.0	5.5
Central bank's key rate	0.10	1.75	5.50	4.50

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

- **High inflation dominates monetary policy stances in the region: the CE-3 central banks increased their policy rates further in March and April and more is still to come.**
- **The CE-3 currencies recovered from their initial weakening which was caused by the outbreak of the war. However, geopolitics still represent a risk for the regional FX.**
- **While inflation is likely to grow further in Q2 mainly due to commodity prices, GDP growth is likely to slow because of weaker consumption. The CE-3 monetary policy interest rates may reach their peak by mid-2022.**

Inflation in the CE-3 has been accelerating despite the effort of some governments (Hungary, Poland) to mute the impact of growing price pressures via tax cuts or price caps. Inflation is mainly driven by commodity prices and is likely to grow further in Q2. This keeps the regional central banks in a tightening mood. However, growing energy and food prices will have negative impact on the real disposable income of households, which will lead to weaker consumption. While statistical base effects and tighter monetary conditions should drive annual inflation lower in H2, GDP performance is likely to weaken from spring onwards. We think that the CE-3 central banks may abstain from more interest rate hikes in H2.

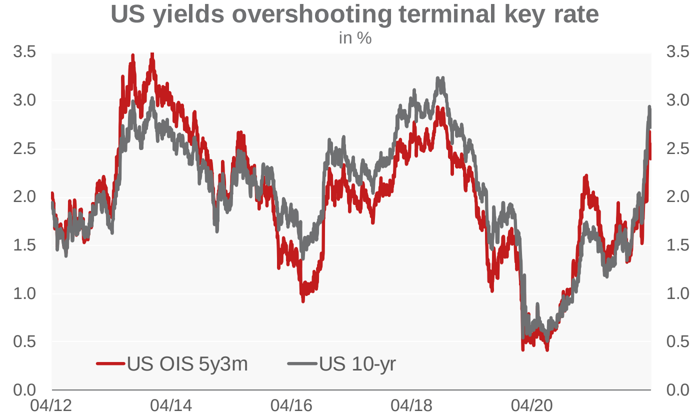
The Czech CNB increased its key rate by 50 bps to 5.00% in March. The CNB Board is becoming split in the view on how much of rate hikes is still needed: while some of them keep a hawkish stance, many speak about fine-tuning hikes for the future. We expect a 50 bps hike in early May, to 5.50%. Thereafter, the key rate may stabilize at that level for several quarters.

The Hungarian MNB raised its base rate by 100 bps in late April to 5.40%. The 1-week deposit rate was subsequently raised by 30 bps to 6.45% and the MNB keeps saying that the base rate will gradually catch the 1-week deposit rate level. Besides commodity prices, fiscal stance and strong wage growth contribute to inflation risks in Hungary.

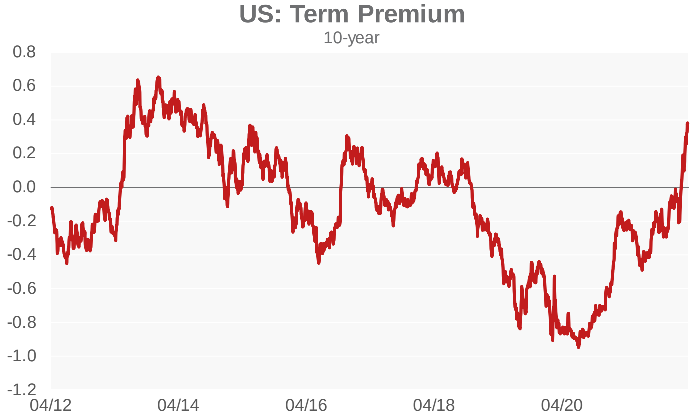
In Poland, the NBP raised its key rate by 100 bps to 4.50% in April (after a 75 bps hike in March) in a response to an unexpectedly high CPI data for March (11% yoy). Hawkish comments still prevail but some of the MPC members said that interest rates may be approaching their peak, which we expect at 5.50%.

Government Bonds

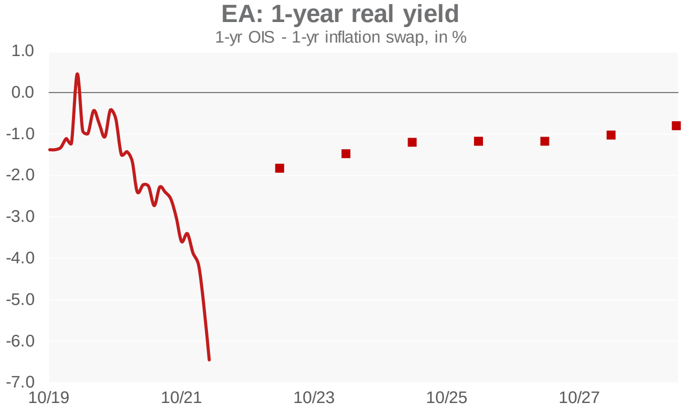
Florian Späte



Source: Bloomberg, GIAM



Source: US Fed, GIAM



Source: Bloomberg, GIAM calculations

- **International government bonds continued to sell off across the curve in April as financial markets continued to adjust future key rate hikes upwards.**
- **Going forward, the movement is likely to lose momentum – particularly in the US. Current market expectations regarding the peak in the US key rate cycle appear too high. Key rate hikes in the EA will be more gradual. As we do not forecast the peak to be already achieved in 2024, we see more leeway for Bund yields to rise.**
- **The ECB's more hawkish comments have put upside pressure on peripheral bond spreads. While the deteriorating growth outlook will prevent a lasting spread tightening in the months to come, a further significant spread widening is not on the cards either.**

After a poor start in Q1, April did not bring any relief for international government bond markets (EMU and US total return around -8% ytd). The upward trend continued unabated across the curve as particularly US yields rose further. Both real yields and the inflation component advanced further but the bulk of the increase is due to higher real yields. At -0.1% 10-year US real yields marked a long-time high and the transatlantic yield spread climbed to a new peak.

Going forward, the main drivers for bond markets will remain in place. As a sustainable trend reversal of inflation rates is not on the cards yet and as we expect global central banks to strive to maintain their credibility, we forecast the upward trend to remain. However, as financial markets have priced it more than adequately the sell-off is seen to lose momentum in the weeks to come.

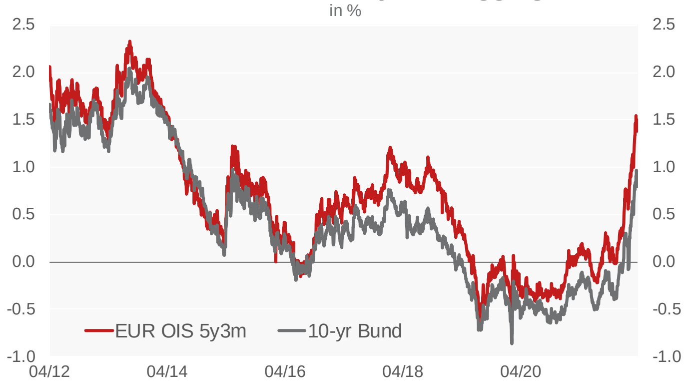
Financial markets expect the Fed to raise key rates by another more than 230 bps in 2022. Next year further hikes are discounted. However, we think a peak well above 3.0% looks exaggerated as markets do not take sufficient account of the growth slowdown triggered by the tightening of financial conditions. Given our below growth forecasts for 2022 and 2023 (2.7% vs. 3.3% and 2.1% vs. 2.4%) we forecast the upper bound of the band to not exceed 2.75%.

Moreover, long-dated US yields have already overshot the terminal key rate. US 5y3m OIS are trading around 2.5%. We regard this level in line with our long-term models and see scope for 10-year yields to converge to 5y3m OIS in the long run. Furthermore,

Florian Späte

Bond Market: Bund yields lagging

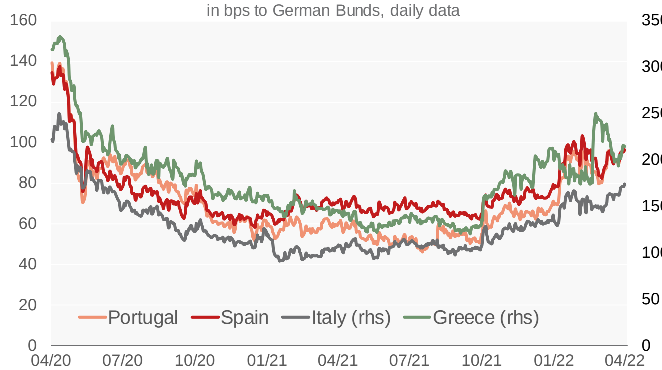
in %



Source: Bloomberg, GIAM

10-year EA non-core sov. spreads

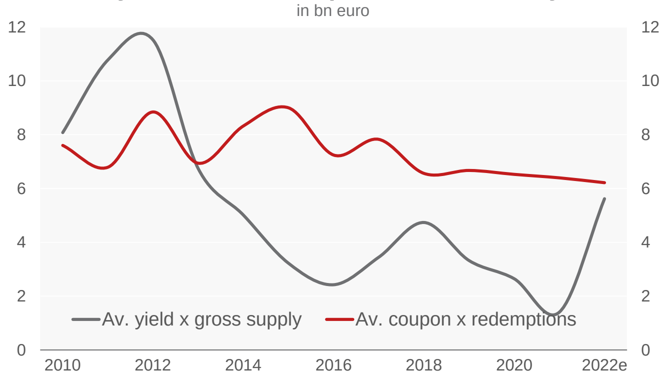
in bps to German Bunds, daily data



Source: Datastream, GIAM calculations

Italy: Gov. interest expenses decrease - yet

in bn euro



Source: Bloomberg, GIAM calculations

the 10-year US term premium has risen into positive territory again (see chart). Accordingly, we see only limited further upward pressure for long-dated US yields in the months to come.

On the contrary, there is more scope for Bund yields to rise. While markets price aggressive key rate hikes in 2022 (+75 bps in 2022) a reversal is already discounted in 2024. In conclusion, this implies that the ECB is expected to pursue a permanently accommodative policy with 1-year real yields remaining well below -1% in the years to come.

Additionally, contrary to its US counterparts, 10-year Bund yields are lagging 5y3m OIS (0.8% vs. 1.35%). We regard the current level of 5y3m OIS as the lower bound of the fair value for 10-year Bund yields. Finally, the 10-year real yield level of around -2.15% (still close to the historical trough) does not look sustainable.

Overall, in the short term we forecast international yield levels to stabilize. On a 1-year horizon, 10-year US yields can rise to 2.90% and 10-year Bund yields to 0.9%. Looking further down the road, US yields are forecast to come down moderately while Bund yields have scope to increase more. In the long run, we expect the transatlantic yield spread to narrow to 100 bps.

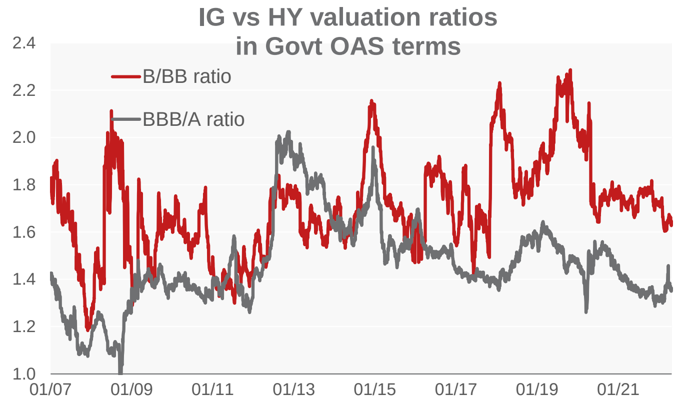
Despite the confirmation of Macron as French president, particularly long-dated EA non-core government bond spreads have widened further in April. The environment is expected to remain challenging for non-core government bonds. The higher yield level reduces the search for yield and it might bring debt sustainability back into focus. Moreover, the looming end of QE will trigger a deterioration of the technical situation with a strong swing from negative to positive net supply considering ECB purchases. Finally, the weakening growth outlook and a higher risk aversion amid the geopolitical tensions are also likely to contribute to continued weakness of non-core bonds.

Having said that, there are also some stabilizing factors which will limit the spread widening. To start with the burden from supply will ease somewhat as issuance activity is already quite advanced. Moreover, the high level still held by the ECB (including re-investments) will have a dampening effect. Finally, non-core spreads have already reached an elevated level and the ongoing disbursement of NGEU means remains supportive.

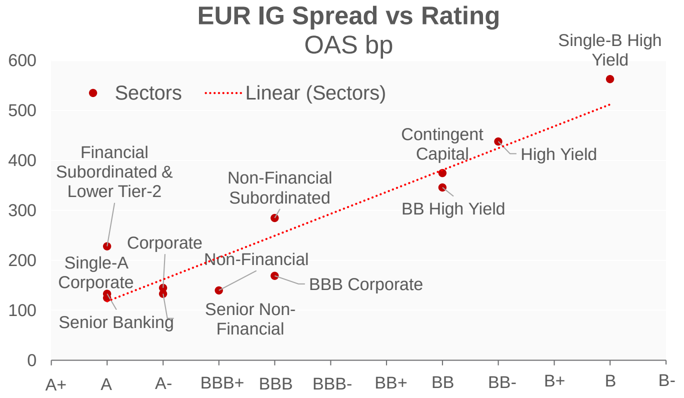
Credit

Elisa Belgacem

Source:Bloomberg, BofAML Indices, GIAM



Source:Source:Bloomberg, BofAML Indices, GIAM own calculations



Source:Bloomberg, BofAML indices, GIAM own calculations

- **We stay overweight Credit, considering that spreads are consistent with our economic in-house scenario and that the carry post rate repricing and spread widening is attractive.**
- **Fundamentals of developed credit markets are not immediately threatened by the situation in Ukraine, but will deteriorate on the sharp economic slowdown we are expecting.**
- **The removal of the ECB support, although priced in terms of levels, will likely trigger further spread volatility in the coming quarters.**
- **Hence, we continue to recommend a very defensive allocation, we suggest to reduce exposure to financial credit relative to non-financials. We also underweight the periphery versus the core, favour IG over HY, and subordinated versus pure HY.**

After the very sharp widening in Q1 following the signalling by the ECB that it would frontload its tapering and the shock of the war in Ukraine, credit spreads have been relatively well behaved compared to other liquid assets. This is particularly notable in a context where interest rates have gone up very rapidly. Yet into late April the gradual repricing of the stagflationary risk has led to renewed, if moderate, weakness. We consider that current spread levels are consistent with our expectations of very low growth but no near-term recession. It is now very clear that the ECB will stop purchasing bonds in a few weeks. This is largely reflected in credit spreads levels but nevertheless it should trigger greater volatility.

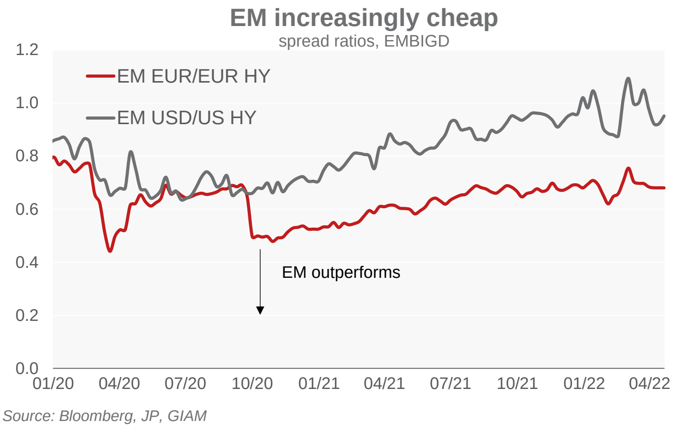
Corporate fundamentals will become more volatile as companies face higher costs and lower demand, pressuring margins in the most cyclical sectors. Hence, we expect defaults to increase from 1.5% at the start of the year to 3% by year-end. Credit rating will also stop improving and marginally deteriorate in particular at the lower end of the HY spectrum.

A defensive OW Credit

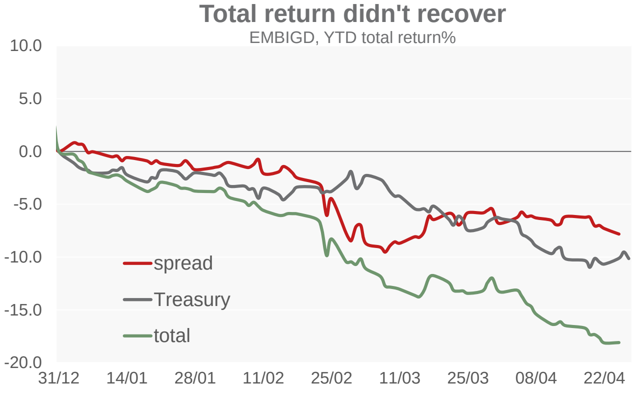
We stay overweight, as we continue to expect better total return prospects for Credit than other fixed-income assets. Nonetheless we remain very defensive, recommending to be OW IG versus HY and underweight the periphery versus the core. Moreover, as we expect volatility to remain for the months to come, we suggest to reduce exposure to financial credit relative to non-financials. We favour defensive sectors versus cyclical ones. Finally, we favour subordinated bonds to pure HY and corporate hybrids.

EM sovereign bonds

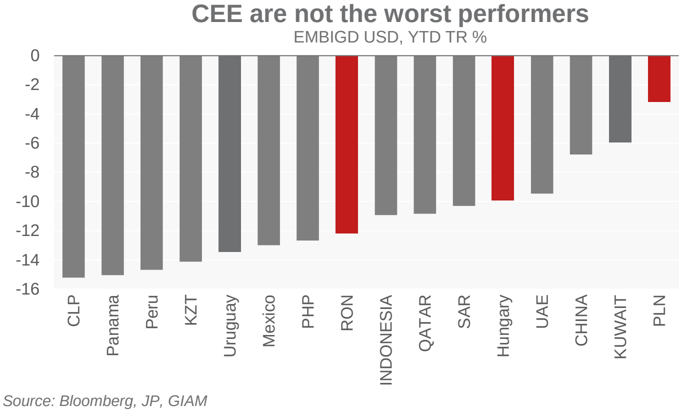
Guillaume Tresca



Source: Bloomberg, JP, GIAM



Source:Bloomberg, JP, GIAM



Source: Bloomberg, JP, GIAM

- **We maintain an OW for EM bonds vs. other FI assets but the EM outlook has turned more challenging.**
- **Room for spread normalisation is limited with upside risks with more value in EUR spreads**
- **EM valuations are cheap on average, but dispersion is large. EM IG is rich, and value is in the HY space where we focus on BBs only.**

We maintain an OW for EM bonds vs. other FI assets. After the initial shock triggered by the Russian invasion of Ukraine, the EM environment has been normalising but it turns out to be even more challenging. Discrimination is even more required as EM countries are facing a trilemma. Firstly, the Fed is embarked to tighten more its monetary policy than earlier expected. Secondly, the protracted war will continue to hurt EM growth via lower real income and tighter financial conditions. The default of Sri Lanka, the EGP devaluation and the Peru unrests are good examples of the direct war consequences on EMs. Thirdly, the prolonged Covid-induced lockdown in China will weigh more on EM growth than expected. EM growth will be on par with DM growth in Q2 with higher fiscal risks.

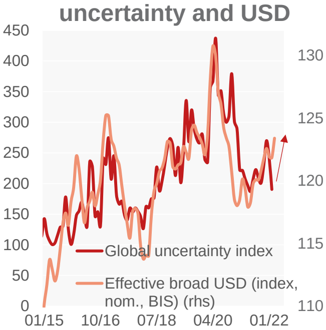
Thus, the global macro outlook has turned less supportive but EM valuations are globally cheap. The absolute yield provided by EM bonds is attractive by historical standards and we repeat our long-held view that EM FI is a carry play. Spreads have cheapened, especially vs US HY but we see limited room for a further tightening. In the medium term, EM spreads will likely stand at higher pre-war levels because of higher fiscal and geopolitical premium. If anything, EUR spreads are more attractive as they have not retraced their February/March sell-off.

Relative value and discrimination is the name of the game. Dispersion is large: EM IG is rich and value is in the HY space. Given the expected cyclical slowdown and risk of rising defaults, we only focus on BBs and avoid countries with large external refinancing needs. Region-wise, LatAm is the least vulnerable, but given the heavy political cycle, we focus on Brazil and Mexico. Peru politics has to be monitored but a lot is priced in. Elections in Colombia can be disruptive. Despite the war, CEE fundamentals are still solid, benefiting from the European fiscal anchors. We expect a catch-up, especially for Romania. Kazakhstan’s balance sheet is strong, but the weak governance and the Russian trade relationships lead us to adopt a neutral stance.

Currencies

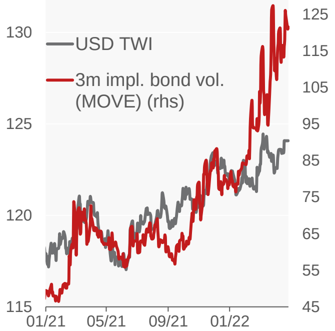
Thomas Hempell

Global policy uncertainty and USD



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

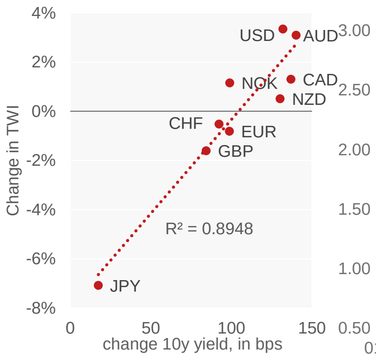
Yield uncertainty and USD



Source: Datastream, GIAM

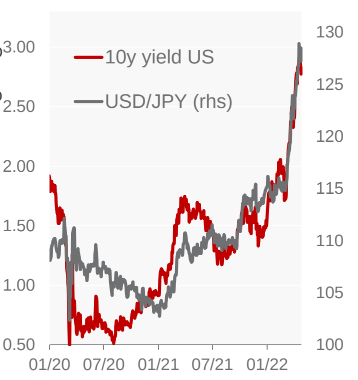
Yields and FX

changes 27/4/2022 vs 31/12/2021



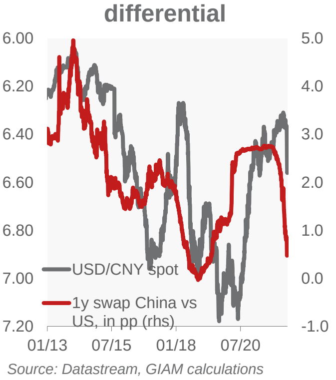
Source: Datastream, GIAM calculations

USD/JPY and 10y UST



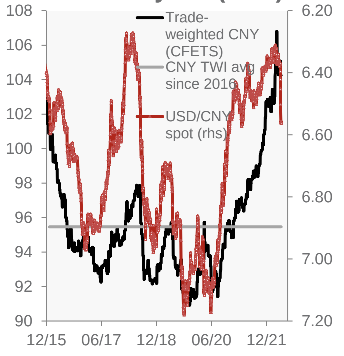
Source: Datastream, GIAM calculations

USD/CNY and swap differential



Source: Datastream, GIAM calculations

Chinese yuan (CNY)



Source: Datastream, GIAM calculations

- **Geopolitical worries around Russia's war in Ukraine and rates uncertainty are set to keep the USD bid near term.**
- **Yet the EUR/USD is already trading at a heavy discount, leaving scope for a sizeable recovery later this year once war tensions start to ease.**
- **The BoJ keeps bucking the trend of global monetary tightening, leaving the fate of the yen very much in the hands of US yields.**

Geopolitical worries and monetary policy divergence has driven the USD DXY to its highest in almost 20 years. Persistent geopolitical worries around the war in Ukraine (battering EUR/USD) alongside uncertainties about central banks' tightening path are set to keep the USD bid near term (see top charts).

Historical experience shows the USD peaking around the Fed's lift-off dates, with much of USD strength happening in advance. With US inflation pressures particularly acute, however, the US may continue to front run the global rate increases for a while. Trade-weighted currency moves are extraordinarily tied to the speed of yield increase in G10 this year (left chart).

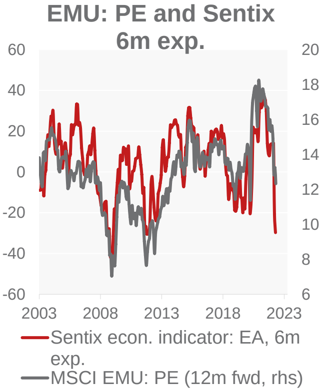
ECB officials are mulling a rate hike as early as July. This is not yet our base case but would provide some EUR/USD relief, which in April was headed for its deepest monthly drop (>5%) since 2015, temporarily breaking below 1.05. Yet it will require peaking tensions in the Ukraine conflict for a material rebound. Given sharp USD overvaluation, we still eye a return to levels above 1.10 by year-end in our base case.

With the BoJ bucking global policy normalisation (and just reaffirming its yield curve control with unlimited bond purchases), the JPY may test new troughs even after plunging to 20-year lows vs the USD as it remains tied to the mercy of US yields (mid chart). Once broader economic damage from deteriorating terms of trade triggers second thoughts at the BoJ, however, the massively undervalued JPY may stage a material rebound, potentially seconded by FX intervention, but that still seems months off.

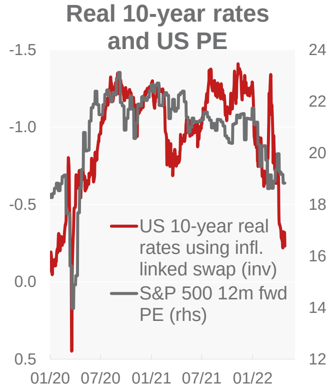
Covid worries, a narrowing yield advantages and regulatory uncertainty are likely to continue to weigh on the CNY near term, after the trade-weighted value had been soaring to more than 10% above post-2016 averages (lower charts). That said, the PBoC will be keen to avoid too violent moves in the USD/CNY.

Equities

Michele Morganti, Vladimir Oleinikov



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

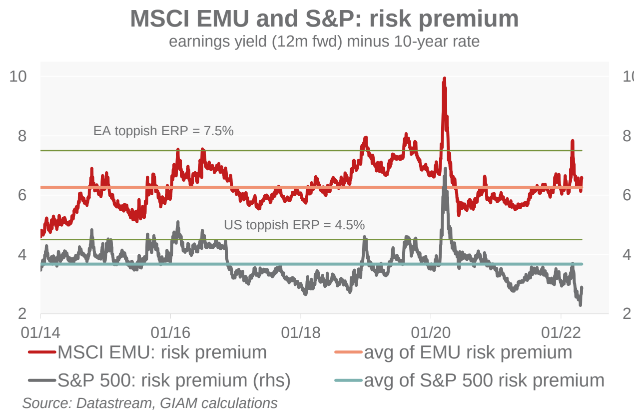
Analysis of the median stock: Q1 2022 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q4 2021	Q1 2022	Q4 2021	Q1 2022	Q4 2021	Q1 2022	Q1 2022
S&P	14.4 %	9.1 %	11.5 %	9.3 %	2.9 %	(0.2)%	39.7%
Stoxx	16.3 %	11.1 %	11.0 %	13.7 %	5.3 %	(2.6)%	29.2%
Euro Stoxx	24.4 %	18.4 %	13.1 %	15.5 %	11.3 %	2.9 %	26.0%
Topix	7.2 %	15.7 %	4.1 %	6.3 %	3.1 %	9.4 %	15.3%

Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q4 2021	Q1 2022	Q4 2021	Q1 2022	Q4 2021	Q1 2022	Q1 2022
S&P	4.0 %	5.3 %	1.5 %	1.4 %	2.5 %	4.0 %	39.7%
Stoxx	5.6 %	7.8 %	2.3 %	2.4 %	3.3 %	5.4 %	29.1%
Euro Stoxx	9.8 %	8.1 %	2.2 %	3.4 %	7.6 %	4.6 %	26.0%
Topix	9.6 %	5.1 %	1.1 %	1.0 %	8.5 %	4.1 %	19.9%

Note: margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations



Source: Datastream, GIAM calculations

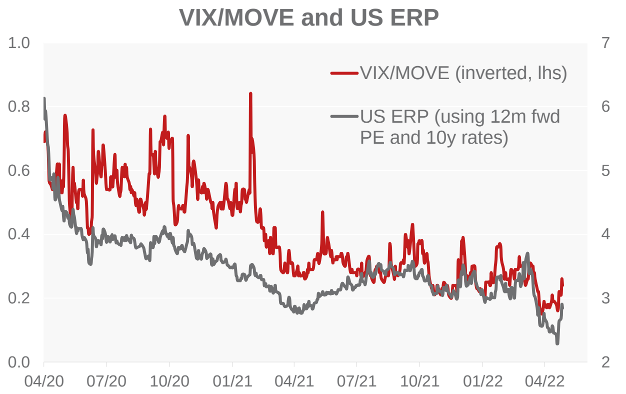
- **Fears of a GDP slowdown and hawkish central banks will linger short term, further pressuring PEs and triggering negative earnings revisions.**
- **Furthermore, recent spike in equity vs bond volatility is causing higher risk premia. The positive effects of the good Q1 reporting season and activity reopenings could also be short lived.**
- **Short term, we maintain a slight UW position in equities as risks are rendering market prices extremely volatile notwithstanding potential positive total return in 6-12 months of ca. 6%.**
- **We favour US and UK vs EMU, to be more defensive and guarding against a big eco slow-down. The US is more resilient based on energy independence and a better economic outlook.**
- **Sectors: favour a less cyclical portfolio with a barbell strategy: Value look are at risk and in part also cyclicals. OW: Energy, Food, HC, Materials. UW: Div. Fin., Cap. Goods, Media, Tlc, RE, Hardware.**

Investors are challenged by a widening sentiment gap between fears of a GDP slowdown and increasing pressure from hawkish central banks (CBs). Unfortunately, such an uncomfortable situation is likely to persist, at least, in the next weeks. War-related risks are not abating, and sanctions will probably be reinforced, with the well-known consequences on higher inflation and CBs hawkish response. The latter are clearly focusing on inflation and not yet on the negative consequence of a tighter monetary policy on the economy and corporate earnings. While oil and gas prices have come down from peak, other sources of inflation are not abating. Like wages or the owner equivalent rent component of the US core inflation which, with a lag, is linked to still strong house price momentum. According to the last Beige Book from the Fed, US firms have also significant pricing power, which is not promising for peaking inflation in the very short term.

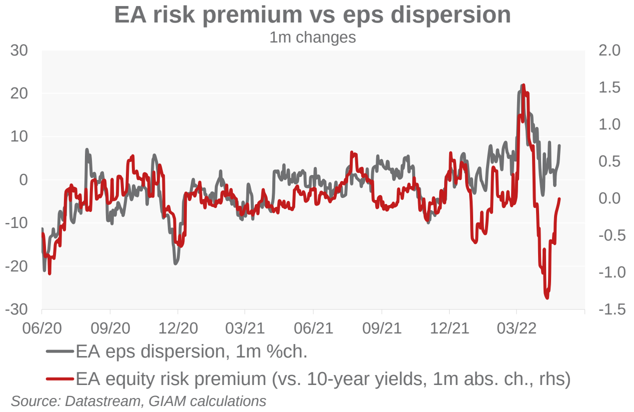
Such challenging scenario continues to be coupled with dangerously high bond volatility: the MOVE index is at 130, with the readings above 90 having a potential headwind for equities. The US risk premium (ERP) has finally reacted, surging from an unsustainable lowest levels in the past 15 years. The trigger was an increased equity volatility - VIX – which passed from 21 to 32 in one month. A higher dispersion in earnings estimates contributed to such ERP move, too.

Equities

Michele Morganti, Vladimir Oleinikov



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

Source: Datastream, GIAM

Short term, we maintain a slight UW position

Cited risks are rendering market prices extremely volatile notwithstanding potential positive total return in 6-12 months of ca. 6%. We add to the previous considerations an increasing policy uncertainty index and higher real yields plus a plunging Sentix index, all putting pressure on 12-month PEs. Furthermore, our US Value indicator is dangerously low now – 3,600 – and the Tech sector remains vulnerable from a valuation point of view, albeit to a lesser extent vs. the start of the year. Lastly, our equity/bond models still point to an equity underperformance vs. bonds.

We remain below consensus earnings in 2022 and 2023 by 7% and 8%, respectively (US and EU). Macro surprises are holding well also due reopenings and the Q1 reporting season is looking good, showing decent positive surprises versus expectations. But both seem to be backward-looking: economic conditions and earnings revisions are most probably set to weaken from here. The EA slowdown is more linked to the Ukrainian war, the related sanctions, and a weakening capacity utilisation momentum. US earnings, on the other hand, should feel the pressure from weakening leading indicators (ISM new orders) as well as a stronger USD and a decreasing CPI/ULC ratio (ULC = unit-labour costs), a proxy for margin momentum.

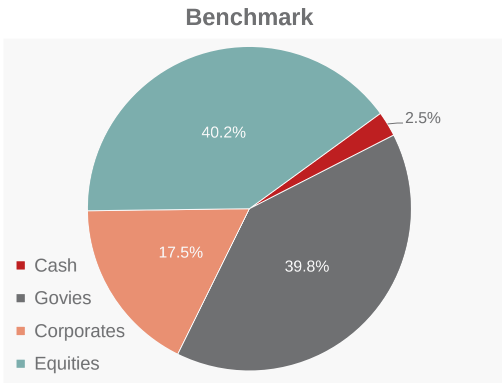
Eventually in H2, equities could behave more favourably after slowdown signs are discounted and yields next to peaking. Our long-term models show possible upside at nearly 6% with lower-than-norm PE and zero EPS growth in '22. Ex-recessionary slowdowns still keep equity attractive vs bonds, the CAPE yield minus real rate remains attractive together with Cash Flow minus Capex spread (Free CF). In terms of country allocation, we favour US and UK vs. EMU, to be more defensive and guarding against eco slowdown. The US is more resilient based on energy independence and a better economic outlook. In sectors, we continue to favour a barbell strategy: Value look are at risk and in part also cyclicals. OW: Energy, Food, HC, Materials. UW: Div. Fin., Cap. Goods, Media, Tlc, RE, Hardware.

EM: neutral. Pressure from plunging export orders

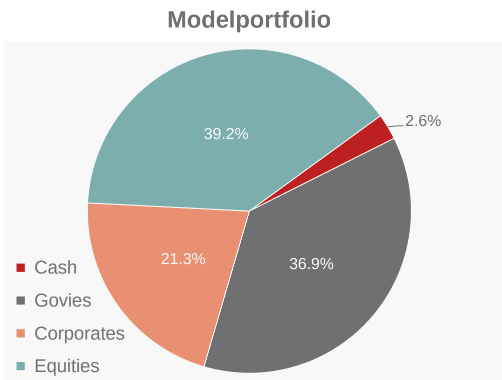
EM equities remain vulnerable in relative terms due to weaker earnings momentum and higher credit spreads. Lockdowns in China and plummeting export orders add to the negatives. We OW Korea and Chinese A-shares.

Asset Allocation

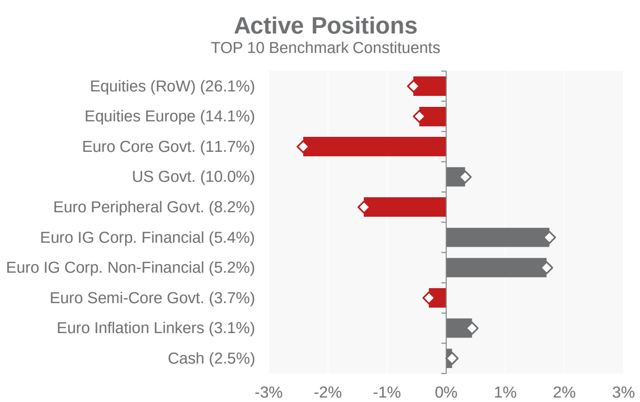
Thorsten Runde



Source: GIAM



Source: GIAM



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

- **Apart from Cash, all actively covered markets finished the month of April *(27.04.22)* in negative territory.**
- **On average, equity markets suffered the most (-4.6%), followed by Government Bonds (-3.2%) and Corporates (-2.3%).**
- **Together with long-dated US Treasuries (-8.3%) and Italian BTPs (-7.5%), North American Equities (-7.9%) form the lower end of the performance ranking.**
- **Long-dated govies continued to loose value relative to the short-dated ones. The average under-performance was -600 bps (Y10+ vs. 1-5Y).**
- **In the corporate section EA IG outperformed EA HY by roughly +34 bps. Within IG, Financials were superior to Non-Financials (+ 22 bps).**
- **A mix of price pressures, hawkish central banks, and geopolitical risks makes us stick to the current TAA recommendation: a distinct UW in long-dated govies, OW in Credit (defensive segments) and a slight UW in equities.**

In April *(27.04.22)*, our model portfolio gained +12.7 bps in relative terms. With +5.8 bps the overweight position in Corporates paid off particularly well, closely followed by US Treasuries +4.8 bps, and Equities +2.4 bps. On the European govie side there is a clear dichotomy between the first and the second half of April. Driven by the strong performance gains of the short-dated segments in the second half of the month the corresponding underweight positions particularly hurt. That said, given the compensating positive contributions from the first half, the largest negative overall effect turns out to result from the underweight in Italian BTPs with just -1bp.

Stay on the side line

So far, economic activity has proven quite resilient. Nevertheless, the Ukraine war, its economic fallout, and Chinese lockdowns are severely weighing on expectations and confidence. Central banks are likely to remain – if not even become more – hawkish amid elevated inflation levels and still missing signs of a recession. Against this backdrop, we confirm our UW in Govies, particularly in the log-dated ones. We also refrain from rebuilding Equity exposure already and thus stay with the small UW. We keep our sizable overweight in Credit with an investment focus on defensive sectors, which are expected to offer the most value.

FORECAST TABLES

Forecast tables

Growth	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.7	2.7	-0.6	2.1	-0.3	1.4
Euro area	5.4	2.2	-1.0	1.6	-0.7	1.8
Germany	2.9	1.2	-1.2	1.7	-0.9	1.5
France	7.0	2.7	-0.6	1.3	-0.4	1.5
Italy	6.6	2.2	-1.2	1.5	-0.5	1.8
Non-EMU	6.4	3.2	-0.4	1.4	-0.3	1.6
UK	7.4	3.3	-0.6	1.2	-0.4	1.5
Switzerland	3.7	2.5	-0.2	1.5	-0.2	1.8
Japan	1.7	2.2	-0.1	1.8	-0.0	0.8
Asia ex Japan	7.8	4.5	-0.9	5.3	0.1	5.3
China	8.1	4.0	-1.0	5.7	0.5	5.1
CEE	5.3	-2.9	-0.3	2.3	0.6	3.6
Latin America	6.6	1.9	0.0	2.0	0.0	2.4
World	**6.2**	**2.9**	**-0.6**	**3.3**	**-0.1**	**3.2**

Inflation[1)]	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	4.7	7.4	0.8	3.3	0.3	2.3
Euro area	2.6	6.6	0.9	2.6	0.5	2.0
Germany	3.2	7.0	1.8	2.8	0.4	1.9
France	2.1	5.5	1.6	2.6	0.7	1.7
Italy	2.0	6.0	0.2	2.0	0.1	0.6
Non-EMU	2.3	6.1	0.8	3.1	0.3	1.6
UK	2.6	7.9	1.2	3.8	0.2	1.6
Switzerland	0.6	1.8	0.0	1.5	0.8	1.2
Japan	-0.3	1.8	0.4	1.0	0.1	0.9
Asia ex Japan	2.0	3.5	0.5	2.9	0.1	2.6
China	0.9	2.5	0.3	2.1	-0.2	2.0
CEE	9.3	27.4	0.3	15.1	3.9	7.6
Latin America[2]	6.6	6.0	0.8	3.8	0.5	3.3
World	**3.5**	**6.9**	**0.6**	**3.9**	**0.5**	**2.8**

1) Regional and world aggregates revised to 2020 IMF PPP weights ; 2) Ex Argentina and Venezuela

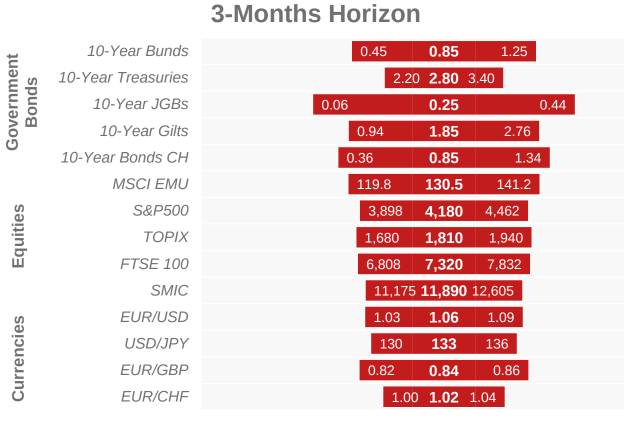
Financial Markets

Key Rates	27/04/22*	3M	6M	12M
US	0.50	1.75	2.00	2.75
Euro area	-0.50	-0.50	-0.25	0.25
Japan	-0.10	-0.10	-0.10	0.00
UK	0.75	1.00	1.25	1.25
Switzerland	-0.75	-0.75	-0.75	-0.50
10-Year Bonds	**27/04/22***	**3M**	**6M**	**12M**
Treasuries	2.81	2.80	2.85	2.90
Bunds	0.82	0.85	0.90	1.00
BTPs	2.50	2.55	2.65	2.75
OATs	1.31	1.30	1.35	1.45
JGBs	0.25	0.25	0.30	0.35
Gilts	1.82	1.85	1.90	1.95
SWI	0.80	0.85	0.90	1.00
Spreads	**27/04/22***	**3M**	**6M**	**12M**
GIIPS	131	135	140	140
BofAML Covered Bonds	74	75	75	75
BofAML EM Gvt. Bonds (in USD)	360	340	345	350

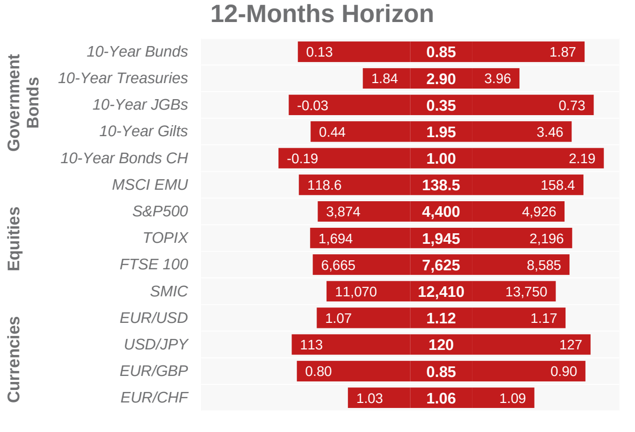
Corporate Bond Spreads	27/04/22*	3M	6M	12M
BofAML Non-Financial	141	140	140	130
BofAML Financial	153	145	145	135
Forex	**27/04/22***	**3M**	**6M**	**12M**
EUR/USD	1.06	1.06	1.08	1.12
USD/JPY	128	133	130	120
EUR/JPY	136	141	140	134
GBP/USD	1.26	1.26	1.29	1.32
EUR/GBP	0.84	0.84	0.84	0.85
EUR/CHF	1.02	1.02	1.04	1.06
Equities	**27/04/22***	**3M**	**6M**	**12M**
S&P500	4,218	4,180	4,410	4,400
MSCI EMU	134.4	130.5	139.5	138.5
TOPIX	1,872	1,810	1,970	1,945
FTSE	7,397	7,320	7,740	7,625
SMI	12,023	11,890	12,595	12,410

**average of last three trading days*

3-Months Horizon



12-Months Horizon



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