Perspectives

By **James Beaumont & Nuno Teixeira**, Natixis Investment Managers Solutions FEBRUARY 2022

IN SHORT

- Our base case is that fewer rate hikes will be actually implemented in 2022
- Inflation is expected to subside but still remain higher than before, forcing central banks to carefully balance off their policy
- We remain constructive on risk assets given that economic growth should remain solid and above its potential

Finding the sweet spot

US inflation in January surprised once again to the upside, with the headline and core figures jumping 7.5% and 6% year-over-year, respectively. However, we note that, although these prints are the largest since 1982 and, thus, do worry market participants, there is a strong case for them to be a result of lagged consequences of the pandemic.

Although durable goods' consumption has slowed recently, it continues to be materially above its pre-pandemic trend and, thereby, maintaining pressure on the improving but still stressed supply chains. This strong demand for goods should keep decreasing as restrictions and Covid fears decline, leading to a pickup in services consumption. In addition, on the biennial change in category weights of the Consumer Price Index (CPI), the Bureau of Labour Statistics, the organism in charge of producing the CPI, decided not to adjust for the atypical spending patterns experienced during the pandemic, which has likely tilted the relevance of goods prices to the upside. All this, is setting the scene for an inflation slowdown as soon as the strong price base effects begin to play out, especially in the second half of the year.

Moreover, even though we do not foresee a wage-price spiral, risks for a sticker inflation driven by rising wages have increased due to the strong and tight stance of labour markets. In fact, the latest US job report showed wages advancing 5.7% year-over-year in January, and, while wage increases in Europe are not yet clear, an increasing number of firms are reporting hiring difficulties. Besides, the longer energy prices remain elevated, which European households are more sensitive to, the more likely there are to trigger second round effects that could indeed affect demand, where monetary policy would have a bigger role to play. Though central banks' reaction function is likely to vary considerably among regions.

Since last December, the Bank of England (BoE) has already hiked twice and the Federal Reserve's (Fed) forward guidance has hinted an acceleration of its tightening cycle on all fronts. Markets are expecting the Fed to deliver over six rate increases in 2022, the first taking place in March, and the runoff of its balance sheet to begin shortly after, very likely in June. Even the European Central Bank (ECB) has turned more hawkish on inflation recently, paving the way for a theoretical hike in late 2022. Market expectations, however, have already fully priced a first hike as early as July, and the policy rate to rise above zero one year from now.

Our base case is that fewer rate hikes will be actually implemented, at least during this year. Although market expectations tend to overreact and, thus, may still go higher, we believe that they are too stretched considering that economic growth will be slowing throughout the year and that policy makers remain ultimately data-dependent. Therefore, we expect central banks to acknowledge sometime by mid-year—when a couple of hikes have already taken place—that tackling a supply driven inflation by aggressively tightening financial conditions might be counterproductive and end up dampening demand and, eventually, growth. This is the case because current inflation is being largely driven by energy imbalances and supply bottlenecks, issues on which monetary policy has a limited effect. In addition, central bank's policymakers would likely be inclined to wait for more economic data to be released in order to correctly calibrate their policies and avoid overtightening.

Against this backdrop, the risk for a policy misstep, i.e., either tightening too much that growth is excessively slowed, or tightening too little that expectations for higher prices become entrenched, remains elevated as no central bank would like to be seen as being behind the curve with regards to inflation. Hence, we see central banks facing a difficult balancing act in the months ahead, where forward guidance is likely to be key to avoid market stresses.

Asset Class Details

Equities

Sentiment has suffered from central banks' hawkish pivot and markets' aggressive repricing in favour of numerous policy rate hikes. However, following the robust rebound in 2021, growth is set to slow this year but should remain solid and above its potential. In addition, companies have successfully passed through cost increases so far, and we believe this will the case again in 2022. But, rising rates and higher commodity costs are likely to challenge those companies with less pricing power.

Thus, we remain constructive on risk assets with a slight overweight on equity as they are likely to outperform fixed income during this macro environment.

On a regional basis, we keep our Value bias and prefer Europe and the UK due to their historically attractive valuations. However, we still look out for good entry points in long-term secular growth opportunities in the US, particularly in the small-caps space since they tend to outperform large-caps in rising rates environments and valuations are attractive. In addition, although we prefer to remain neutral on emerging markets for the time being, sentiment is rebounding in the region.

The People's Bank of China (PBoC) has introduced a number of accommodative measures to support growth, and the regulatory crackdown seen last year has contributed in making valuations appealing. In fact, emerging market equities offer the biggest price-to-book discount versus the S&P500 index in almost 20 years.

Fixed Income

Despite the high inflation prints, break-evens have been declining since they last peaked in November while nominal yields have sharply moved higher. The US 10-year Treasury yield is back to 2%, up 49 basis points year-to-date, and 10-year Bund yield is back to positive territory, up 44 basis points year-to-date to 0.25%, its highest level since early 2019.

It is noteworthy how fast yield curves have tightened, for instance, the 2y10y and 5y30y US Treasuries spreads are at 43 and 36 basis points, respectively. This reflects, in part, the aggressive repricing of tightening expectations, which mainly affects the front-end of the curve. Markets now see a 70% probability of a 50 basis points hike in March (just two days ago that probability was 30%).

However, we still believe that hiking expectations are likely overdone, and that fewer rate hikes will be actually implemented, suggesting a dovish surprise over the coming months. Especially in Europe, where President Lagarde has already softened her tone following the rise of peripherals spreads, particularly that of Italy, which was triggered the last ECB meeting.

Moreover, bond yields should stabilize around current levels, but overshooting remains a risk in the first quarter, and to cool down in the second half of the year, as investors weigh growth concerns and policy uncertainty has improved.

In this context, we remain cautious on duration as the macro environment still offers some further upside risk. Thus, we prefer credit over duration risk but remain slightly underweight on IG given its high duration, which leaves less room to compensate potential losses from rising rates.

We remain positive on emerging hard currency corporate debt, as the carry level remains attractive compared to developed markets, we see additional room for spread convergence, and corporate balance sheets are strong. However, selection remains key in this area.

Currencies

Although the US dollar is likely to remain supported by rate differentials and its safe haven feature amid rising geopolitical tensions, we do not expect additional upside. In fact, a possible aggressive reduction in the Fed balance sheet could weigh on the greenback. The ECB's more hawkish tone may offer some catch up potential for the euro, especially if volatility decreases. Considering that there still some Brexit-related pain ahead, the BoE may be pricing in too many rate hikes, which could weigh on sterling's strength.

Commodities

The reopening is pushing energy prices higher at a moment when inventories are particularly low and producers are not being able to meet output quotas. Although we might see some short-term improvement on Russia/Ukraine tensions following next week's Germany's Chancellor, Olaf Scholz, visit to Moscow, energy prices are likely to remain elevated given the overall market shortage

Gold has remained relatively bid-less despite macroeconomic and geopolitical backdrop. However, although the monetary outlook does not look supportive, gold remains a safe haven against long term black swans and a good diversifying asset.

Asset Allocation Views

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43, Avenue Pierre Mendès-France, 75013 Paris
www.im.natixis.com

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