# Market Perspectives

## Tectonic shifts

GIAM Macro & Market Research

March 2022

- **Russia's invasion of Ukraine adds to the series of tectonic shifts from Covid, the return of inflation and central banks' search of a smooth exit.**
- **Limited trade and financial links to Russia keep the direct risks to the EU and US recovery muted.**
- **Yet energy supply is the key vulnerability. Sanctions have thus far eschewed Russia's energy sector, but actions against the CBR and selected financial institutions may gravely hamper trade while sending Russia deeper into recession.**
- **We see no rush to buy the dips, waiting for more stability in the geopolitical and energy complexes. We further trim our prudent pro-risk bias, reducing both the Equity exposure in favour of Cash and the Cyclicals and Value bias.**
- **Exposure to energy offers hedging vs. the risks of further escalation and hectic climate transition.**

## CONTENT



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# Global View – Tectonic shifts

Vincent Chaigneau / Thomas Hempell

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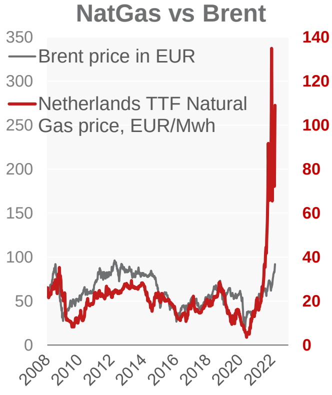
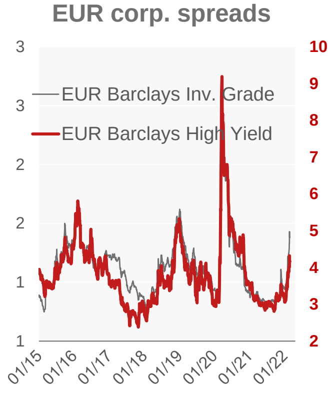
The massive Russian invasion is casting long shadows over the European security order. The ruble and Russian equities plummeted on news of the aggression. Risk premia and energy prices soared on fears of new supply disruption threatening both the energy complex and the global recovery.




Source: Bloomberg, GIAM




Source: Bloomberg, GIAM

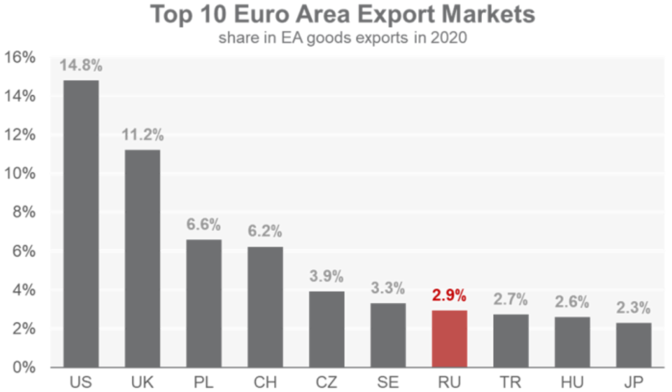
Indeed, the surprise effect has been significant: President Putin escalated the crisis despite severe economic and potentially military costs. While he declared the demilitarisation of Ukraine a key goal, his true plans remain opaque. Hopes that he may only try to achieve a better negotiation position to stop NATO's expansion have been dashed. It is not clear either that the demilitarisation simply aims at securing the full separatist control of the Donbas provinces. Putin will likely try to impose a pro-Russian government in Ukraine, and may even annex the country; given the size of Ukraine and its army, this may mean prolonged fights and human victims. In a worst-case scenario, Russia would deliver a full-blown invasion that may reflect ambitions to redraw European borders.

## Far reaching sanction still eschew energy

Western allies will not send their armies to Ukraine but are already offering military support (e.g. selling arms). They have also announced far-reaching sanctions, curtailing Russia's financial sector, sovereign and corporate financing, technology exports and key individuals. Sanctions on the CBR – a first ever for a G20 central bank – will restrict it in from deploying its FX reserves and mitigating the broader sanctions. The CBR then had little choice and delivered a massive rate hike and capital controls that will only add to the economic misery. EU leaders have already agreed sanctions targeting 70% of the Russian banking market (including selected bans from SWIFT payments) and important state-owned companies. Also the trading of Russian sovereign debt will be severely curtailed.

Western allies have so far preserved Russian commodity producers from direct sanctions that would cause significant collateral damage for Western economies. Given Russia's heavy dependence on energy exports (about 15% of GDP), this would severely hurt the local economy. Yet financial restrictions may still hamper trade flows. There is also the distinct possibility that Russia would retaliate and curtail commodity exports towards the EU, hoping that the price impact would offset the negative volume effect.

**What direct economic impact on Europe?** While the crisis will surely cause a recession in Russia (as well as double-digit inflation), deeper ties with China, a lower dependency on USD funding and the development of its own payment system may reduce the blow.




Source: Datastream, GIAM calculations

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Meanwhile, the war's direct impact on the US and European economy should be relatively mild. Russia accounts for only 3% of EU exports. And the exposure of European banks is small especially following a reduction of loans in the wake of the 2014 Crimea crisis. The repercussions on business and consumer confidence are a wildcard. But with consumers awash with excess savings and the easing of Covid restrictions helping a rebound from the winter speed bump, sentiment is unlikely to plummet.

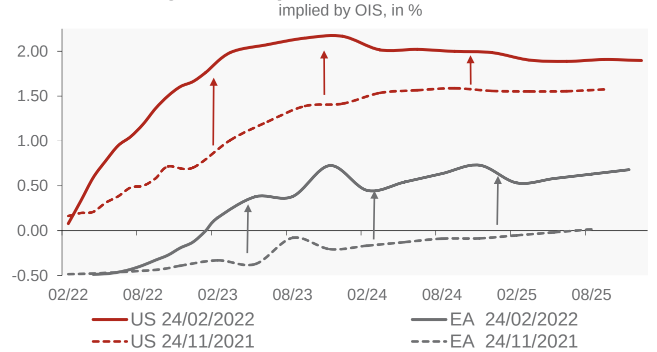
## Energy supply is the key vulnerability

The key vulnerability lies in the energy supply. Europe is heavily dependent on energy imports from Russia, which accounts for nearly 40% of EU gas and more than 20% of oil imports. While the mild winter and negotiations with alternative providers may partly compensate for potential energy supply disruptions, the conflict and potential sanctions are **likely to drive energy prices higher for a longer period**. Oil prices are up by almost a third year-to-date, and natural gas prices have spiked on the invasion; if persistent, such moves could well add one point to EA inflation this year and take more than half a point of GDP growth. Energy inflation is adding to already elevated price pressures and central banks will be wary of inflation spikes turning into wage/price spirals.

As we see elevated risks of oil prices moving even higher over the coming months, we have materially raised our inflation forecasts and moderately trimmed our growth forecasts for the euro area and the US.

**Key Rate Expectations for US and EA**

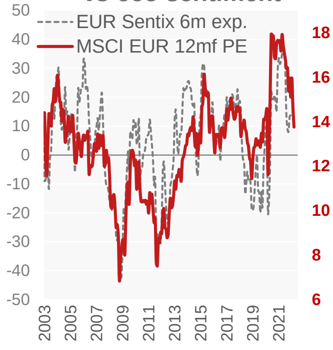
implied by OIS, in %




*Source: Refinitiv, GIAM calculations*

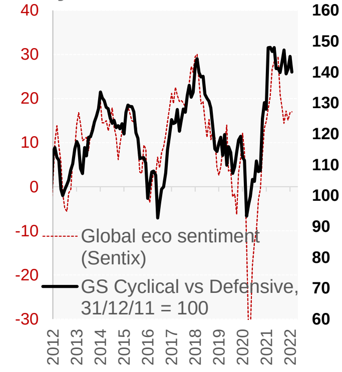
Soaring inflation is also causing tectonic shifts within central banks (see chart). The war in Ukraine is just making headaches worse as they amplify price pressures, but may also sap confidence. We see the Fed sticking to a March lift-off (followed by a series of rate hikes), but it is very unlikely to unsettle markets with a 50 bps step. The ECB will probably not reverse its hawkish pivot in February either. But in the upcoming key meeting on March 12, Lagarde will likely flag a high degree of data dependency and optionality regarding the looming tightening steps: the QE tapering may be slower than initially envisaged. With inflation constraining central banks, expect governments to use the fiscal lever again, to soften the blow on consumers and corporates from higher commodity prices.

**EUR equity valuation vs eco sentiment**




*Source: Sentix, MSCI, Bloomberg, GIAM*

**Cyclicals vs Defensives**




*Source: GS, Bloomberg, GIAM*

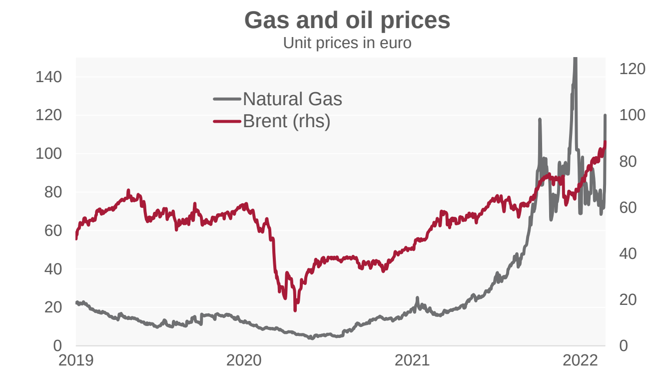
## Markets: risk premia ≠ cyclical impact

Markets quickly discounted the sharp rise in political uncertainty. Investors need to differentiate between risk premia (temporary risk aversion) and cyclicality (more durable risk via financial conditions and energy prices). Equity multiples have sharply retrenched already (chart), and another 5-7% decline would push EU and US risk premia to levels that historically have proven rather attractive (though things got much worse with Covid and the GFC). But we see the risks tilted towards a more protracted rise in energy costs, which may threaten the growth and earnings outlook. So buying the dips looks premature in this highly volatile environment. Increase cash positions for now with the aim of redeploying risk when we get more geopolitical and energy price stability. Intensifying stagflation worries suggest reducing the cyclicality of portfolios. However, we maintain a favourable view on Credit, considering that the ECB will cautiously consider CSPP tapering in the view of keeping funding conditions healthy.

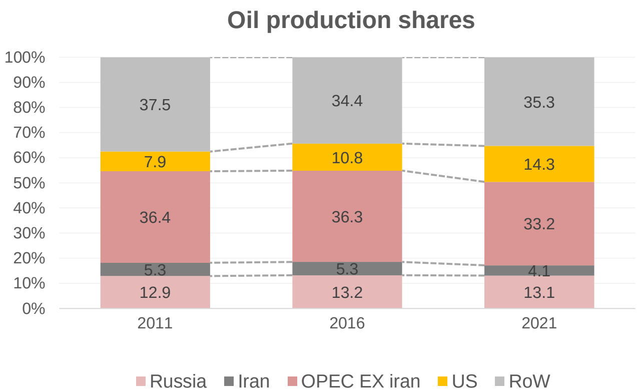
The flight to safety status of Bunds and Treasuries is partially offset by rising inflation worries. Exposure in commodities may offer a more straightforward hedge to risks from Russian warfare. Continued escalation may favour some further (moderate) bull flattening of the "risk-free" yield curves in the near term. Southern European bond spreads have widened and may remain under some pressure on worries of unwinding ECB purchases.

# COMMODITIES

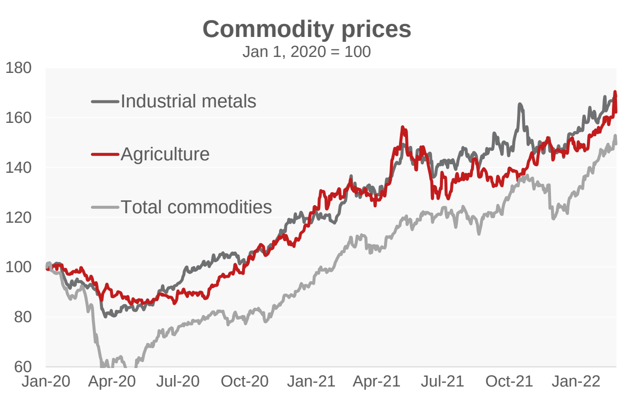
Paolo Zanghieri




*Source:Refinitiv*




*Source:EIA, Datastream, GIAM*




*Source:S&P/Goldman Sachs, Datastream, GIAM*

- **Fears related to the Russian invasion and the added to already undersupplied energy markets. Risk premia put upside pressure on prices.**
- **Longer term, the severity of sanctions and the possibility of retaliation will drive prices. So far Western measures have spared the energy sector, but a further escalation may lead to permanent disruption. Moving permanently away from Russian oil and gas will be costly too.**
- **Tensions spilled over to agricultural commodities and some materials in which the global economy is heavily reliant on Russia and Ukraine, and will not ease soon.**

The disruptions on energy markets are set to last for longer. Brent prices are likely to peak above the > US$ 100/bn seen on Feb. 28, as anxiety is adding to an already tight market; gas prices soared too but remain below the peak seen in December. So far sanctions applied to the Russian financial sector spared transactions related to energy. Extending them entails political and economic costs that are probably too big to endure, especially in Europe. Russia could retaliate by cutting oil and gas exports to Europe, but has not signalled any intention to do this so far.

Some relief to oil prices could come from higher supply from Saudi Arabia and other Gulf countries. But only few of them have enough spare capacity to make up for significative supply shortfalls. A more substantial contribution could result from a positive outcome of the nuclear talks with Iran leading to the end of sanctions on oil export. Yet, we would not get carried away. Iran's technical capability and political commitment to significantly step up export remain unclear.

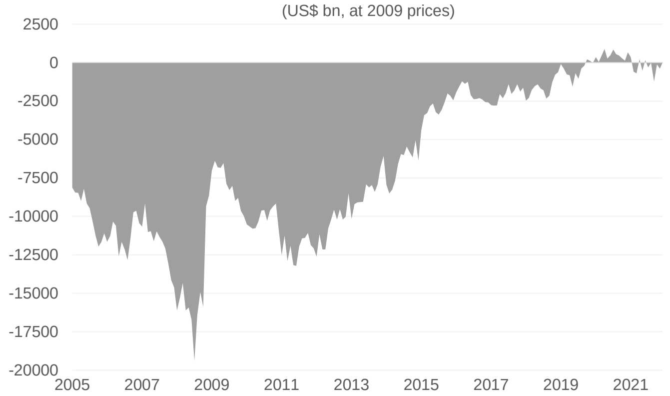
Then, risks for oil prices are titled to the upside. Gas markets appears even trickier; the heavy EU dependence on Russia cannot be unwound quickly and liquified gas can provide only limited help, as global additional capacity looks scarce. Longer term, diversifying supply away from Russia will add to costs related to the green transition.

Agricultural commodities, already under pressure from bad weather spiked as Russia and Ukraine account for around 30% of global wheat production. Metal prices soared, too, given the large role Russia plays in palladium and aluminium. However, markets may start pricing the risk of high energy prices to manufacturing activity, possibly leading to some softening in metals used for downstream production like iron ore.

# USA

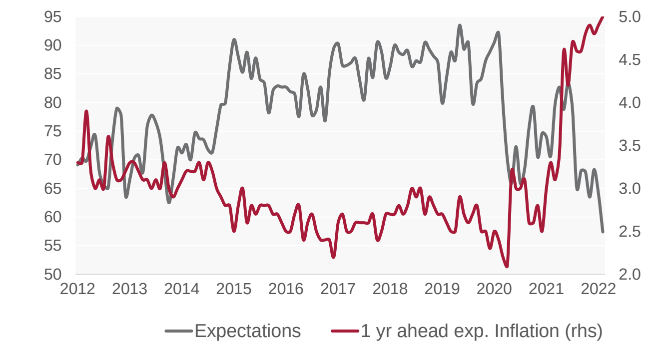
Paolo Zanghieri

**US oil Balance**
(US$ bn, at 2009 prices)



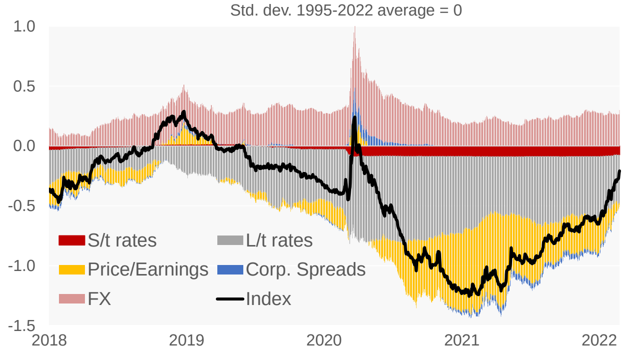

*Source:www.xxxxyyyyyyy.com*

**Uni. Michigan consumer survey**




*SourceUniversity of Michigan, Datastream, GIAM*

**Financial Conditions**
Std. dev. 1995-2022 average = 0




*Source:Datastream, GIAM*

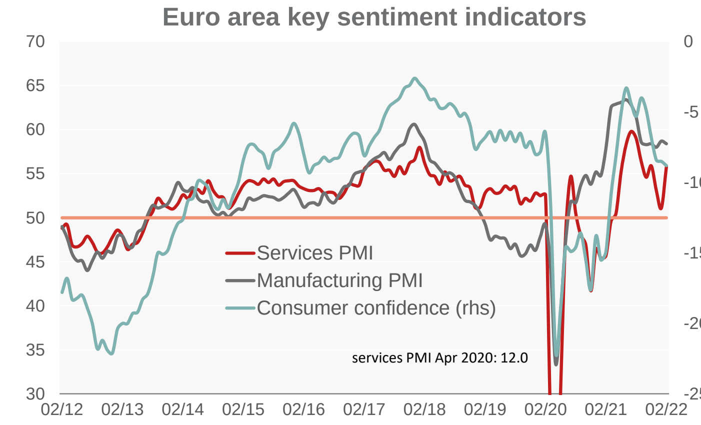
- **Its small reliance on energy import and limited trade as well as financial exchange with Russia reduce the direct impact from the war against the Ukraine on the US economy.**
- **Yet, the surge in global prices will take its toll. We now expect CPI inflation to remain well above 4% by year-end with substantial upside risks. Higher prices are already harming confidence. We revise our 2022 growth forecast down to 3.4%.**
- **The high uncertainty drastically reduced the odds of a 50 bps rate hike in March. But given high inflation pressures, it will not deter the Fed from a series of rate hikes over the coming months.**

Being almost self sufficient for energy consumption and with limited trade exposure to Russia, the US economy is insulated from the risk of direct retaliation. The main threat is that the surge in commodity prices and global inflation adds to the unabated domestic pressures. Therefore, despite some tentative signs that supply bottlenecks are easing, we expect CPI inflation to stay above 7% yoy for the next couple of months at least. Accounting for second round effects on the core rate, inflation will end the year substantially above 4%. High prices (especially for fuels) are heavily affecting confidence, which has dropped to a 8-year low in February. Fundamentals remain supportive to domestic demand, especially the labour market, which further buoyed by the fast reduction in COVID cases. But higher inflation and low confidence will likely slow down consumption and limit the increase in investment, at a time when the fiscal impulse to growth has turned slightly negative. We then cut our growth forecast for 2022 to 3.4% due to a lower pick up in Q2 and a more marked deceleration in H2, when the first effects of tighter financial conditions will be felt.

The balance of risk remains tilted toward more inflation rather than to weaker growth. Then, geopolitics should not derail the Fed's monetary normalisation path. The prospects of several weeks of market volatility has drastically cut the probability of a shock 50 bps rate hike in March but the Fed remains in a position to deliver a series of rate rises over the next three-four meetings and to begin quantitative tightening in July. Normalisation will be paused or delayed only if an escalation triggers a global recession or financial conditions accelerate over and above what is implied by the expectations of reduced monetary support.

## Euro Area

Martin Wolburg



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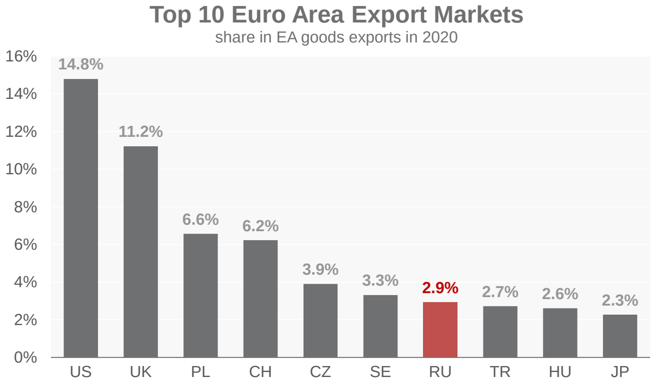
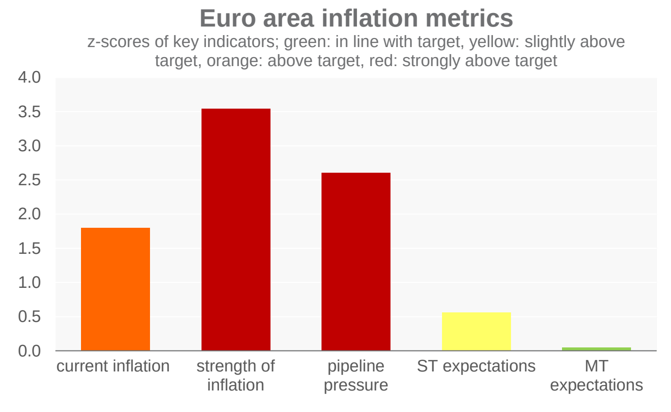


Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

- **The Russian invasion of Ukraine deteriorated the outlook. Spiking energy prices and sanctions will drag on activity and are key downside risks.**
- **As it stands now, we see the recovery continuing. We raise our 2022 inflation forecast to 5.5% and mildly lower expected growth to 3.3%.**
- **The combination of record-high inflation and increased risks for growth makes the ECB's policy course highly uncertain.**

After two years of fight against Covid the Russian invasion of Ukraine comes at a time when the euro area economy is about to recover. The Feb. composite PMI rose to 55.8, the strongest since Sep., with forward-looking components trending further up.

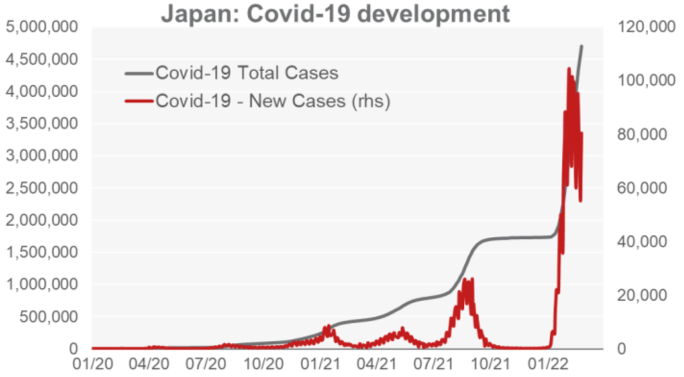
From the Russian war against Ukraine headwinds will emerge. The direct trade link is relatively small (see mid-chart) but soaring energy prices – we look for above € 100 $/b brent throughout 2022 - will significantly lift inflation and dent purchasing power. Especially energy-intensive firms (e.g. basic metals, chemical and printing industry, mining) will face stiff margin pressure and may need to reduce capex spending. Some might even go bankrupt. Sanctions by the West and retaliation by Russia comes on top. Bottlenecks in certain area are likely.

That said, we also look for government support measures to partly offset the effects from a further rise in inflation. The labour market is in good shape, households still have huge pandemic-related excess savings they can deploy and the further unwinding of stringency measures will also support activity. Therefore, we reduce our growth expectation to 3.3%/2.0% for 2022/23, down from 3.7%/2.3%, but still see the recovery fundamentally intact. We see the growth risks clearly tilted to the downside

Following a new inflation high of 5.1% yoy in January our comprehensive inflation indicators hint at persistently high pressure, the effects from the Russian invasion not yet included. We now expect 2022 inflation to average 5.5% in 2022. The inflation outlook alone underpin the need for ECB policy normalization. Yet, headwinds to activity, deteriorating financing conditions and huge uncertainties will likely make the Governing Council less decisive on the future policy path. The tone at the March 10 meeting will reflect this. QE is likely to prevail for the time being and the risk is that the first rate hike is postponed beyond September or maybe even December.

# Japan

Christoph Siepmann

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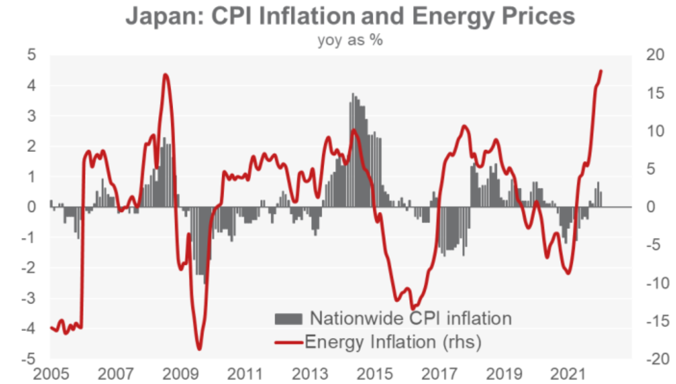
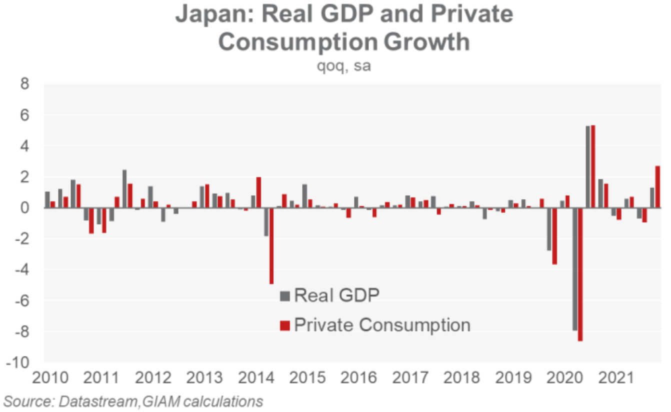



Source: Datastream, GIAM calculations




Source: Datastream,GIAM calculations

- **The Ukraine war will likely affect Japan mainly via energy and commodity prices. This could exacerbate the jump in CPI inflation in April (due to the end of base effects) to close to 1.9% yoy.**
- **We consider it likely that the BoJ will be forced to widen the 10y JGB trading band, but see a larger monetary policy revision only after Kuroda's term will have ended in April 2023.**
- **Japan's Q4 2021 GDP growth came in at 5.4% qoq annualized. We expect GDP in Q1 2022 to stagnate and revise our 2022 growth forecast slightly down to 2.5%**

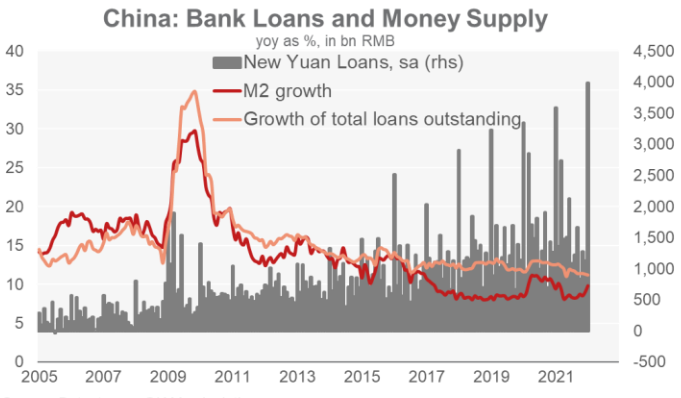
The Ukraine war will likely affect Japan mainly via energy and commodity prices. Japan's headline CPI inflation eased to 0.5% yoy in January. However, in April, headline and core inflation will jump higher as base effects from the cut in mobile phone charges fall out of the statistics. Rising energy prices following the Ukraine war will exacerbate this move to likely close to 1.9% yoy in April. We revised our inflation outlook up to 1.3% (1.1% before) this year and 0.7% in 2023.

Given the higher inflation and the expected Fed hikes, markets again speculated on an early revision of monetary policy. While Governor Kuroda rejected this call, the BoJ policy could come under pressure to maintain the long end of its yield curve control policy, i.e. the 10y JGB at 0% +/- 25 bps. The BoJ already defended this limit by a "limit price operation", offering to buy an unlimited amount at a fixed interest rate of 0.25% on February 14. We can well imagine that the BoJ may be forced to widen the band (e.g., to 0.35 bps) but see a larger revision of the BoJ policy only after Kuroda's term will have ended in April 2023. However, monetary policy action has globally become a bit less imminent due to the Ukraine war.

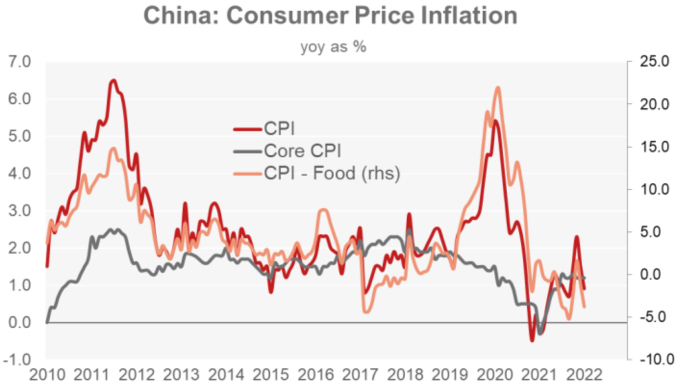
Regarding growth, Japan's Q4 2021 real GDP advanced by 5.4% qoq annualised. In the current quarter, Japan extended the Covid-19 "quasi-state of emergency" measures, now covering 31 of Japan's 47 prefectures, into March. This state of emergency mainly implies early closing of bars and restaurants, but in the past, people's precautionary measures have typically involved less overall spending. Therefore, we see growth to about stagnate in Q1, followed by a stronger rebound in Q2. Rising inflation will cut into disposable income. In sum, we adjusted our 2022 GDP forecast to 2.5% (2.8% before).

# China

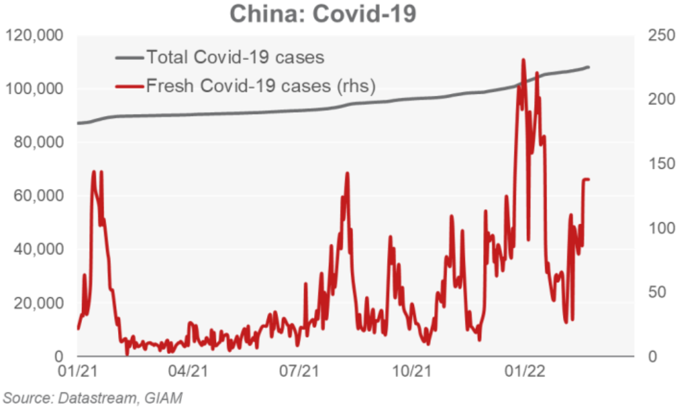
Christoph Siepmann



Source: Datastraem. GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

- **China will try to continue a low profile stance in the Ukraine war.**
- **China publishes only a limited data set in February. Monetary data support the view of an ongoing moderate policy easing by the PBoC.**
- **The NPC meeting could announce fiscal policy measures, expected to amount to more than 1 pp of GDP.**

As an ally, China fell short of condemning the Russian war on Ukraine but also demanded a peaceful approach from all parties. There are fears that China could help to take the sting out of sanctions by providing credit, but Beijing would also want to avoid a rupture in relations with the West. We expect China to try a low profile stance.

Rosneft accounts for 7% of China's total annual oil demand and more oil and gas projects are underway. As these are long-term contracts, China is slightly more shielded against internationally rising energy prices. January CPI headline inflation receded to 0.9% yoy, driven by lower pork prices. Overall, food prices dropped by 3.8% yoy, while core inflation remained constant at 1.2%. PPI inflation fell further to 9.1% yoy. Against the backdrop of the renewed downturn in food prices but likely rising energy prices, we left our inflation forecast unchanged at 2.3% for 2022.

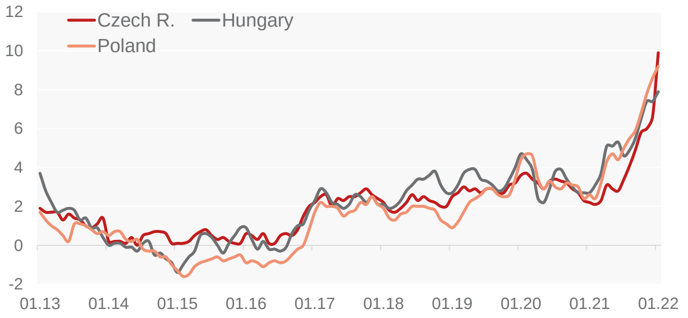
As usual, China publishes only a limited data set in February. Softening manufacturing and service PMIs suggested some weakness at the outset of the year. Meanwhile, monetary data showed an ongoing uptick. We expect more easing by the BPoC to come, including two interest rates cuts by 10 bps and a 50 bps reduction in the RRR. In contrast to most AEs, inflation will most likely not stay in the way of further PBoC action. Moreover, the Ministry of Finance already announced tax and fees cuts to be larger than last year. Announcements will come at the latest at the NPC meeting starting from March 5 on. While the narrow defined deficit could stay at 3.2% of GDP, the broad deficit could rise by more than 1 pp of GDP. It is also expected that the quota for Local Government Special Bonds could increase to RMB 4 tr. (average 2020/21 at RMB 3.7 tr.), not least to boost infra-structure investment. Given the monetary and fiscal support, China's economy could manage to slowly improve provided the Ukraine war does not damage global growth and thus exports too much.

# Central and Eastern Europe

Radomír Jáč

### Headline inflation

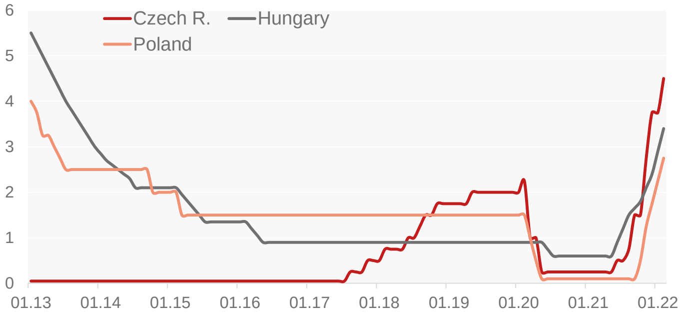
CE-3 countries (CPI yoy in %)




*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 | 3.8 | 3.8 |
| Consumer prices | 3.2 | 3.8 | 8.6 | 2.3 |
| Central bank's key rate | 0.25 | 3.75 | 3.50 | 2.50 |
| **Hungary** | **2020** | **2021** | **2022f** | **2023f** |
| GDP | -4.9 | 7.1 | 5.0 | 4.0 |
| Consumer prices | 3.3 | 5.1 | 5.7 | 3.4 |
| Central bank's key rate | 0.60 | 2.40 | 4.50 | 3.50 |
| **Poland** | **2020** | **2021** | **2022f** | **2023f** |
| GDP | -2.5 | 5.8 | 5.6 | 4.3 |
| Consumer prices | 3.4 | 5.1 | 7.2 | 4.7 |
| Central bank's key rate | 0.10 | 1.75 | 4.00 | 3.50 |

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

- **All three CE-3 central banks raised their interest rates further in February and made it clear that more rate hikes should follow as inflation risks remain tilted to upside.**
- **The situation in Ukraine forms stagflation risks via higher energy and commodity prices and via a negative impact on economic activity. Possible consequences for monetary policy are far from being unequivocal.**
- **The CE-3 currencies weakened in response to the escalation of geopolitical factors but the size of their negative reaction is limited by the attractive interest rate differentials.**

CPI data for January showed that price pressures in the CE-3 remained significant at start of 2022. While measures adopted by government (tax cuts, price caps) may lead to lower headline CPI in some cases in the months to come, the regional central banks will remain in a tightening mood. The recent developments in Ukraine are likely to have ambiguous impacts in the region due to their stagflationary character but are unlikely to derail the CE-3 central banks from their commitment to fight inflationary risks. We still expect monetary policy interest rates in the CE-3 region to peak in Q2 but they may stay at the peak for longer than expected so far.

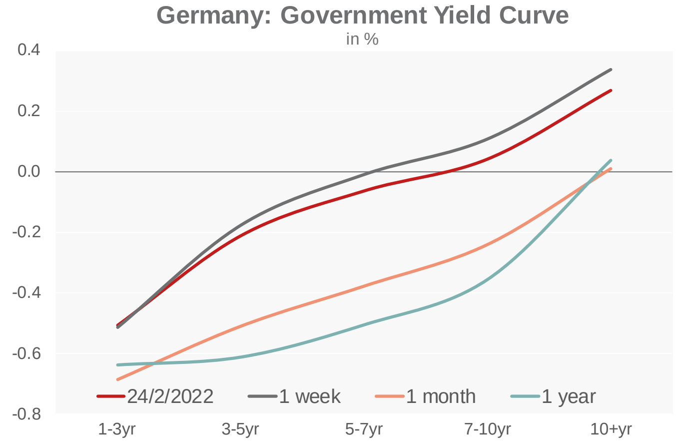
The Czech CNB raised its key interest rate by 75 bps to 4.50% but its quarterly forecast sounded dovish: it says that rates basically reached their peak and will decline from H2 on. The CNB Board members said that a fine-tuning of interest rates to higher levels was still possible but they did not want to predict whether the key rate will have to exceed 5%.

The Hungarian MNB increased its base rate by 50 bps to 3.40% in late February and the 1-week deposit rate was subsequently raised by 30 bps to 4.60%. Higher inflation data for January support speculations that the base rate and 1-week deposit rate may meet each other above 5% in Q2. The MNB has been so far sceptical about a possibility of policy easing in H2.

In Poland, the NBP raised its key rate by 50 bps to 2.75% and its comments were hawkish. The central bank calls for a stronger zloty and says it may limit the size of its own conversion of the flows from the EU budget via its FX reserves, which step would support further gains of the zloty. We expect the key interest rate to peak at 4% in Q2 and stay there until H2 2023.

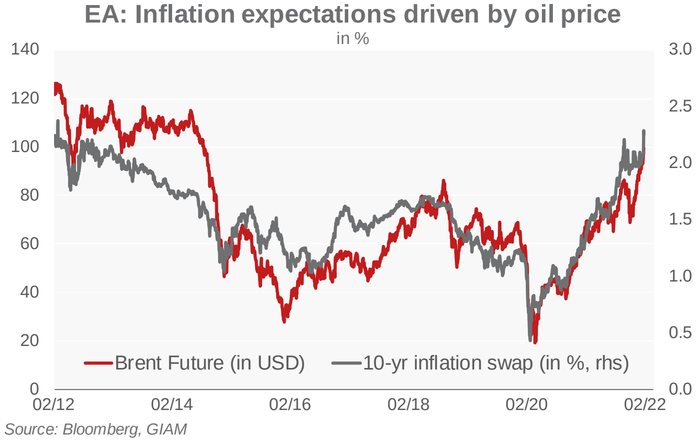
# Government Bonds

Florian Späte



Source: Bloomberg, Datastream, Eikon, GIAM calculations

Source:Bloomberg, GIAM



Source: Bloomberg, GIAM

- **While other assets have been shaken by the Russian invasion of the Ukraine, international government bond markets coped rather well with it. This is unlikely to change going forward as fears of higher energy prices are balanced by growth concerns.**
- **In our base scenario we expect central banks to continue on the rate cycle path mapped out. Despite somewhat lower growth forecasts we keep our 12 months targets for core government bond yields unchanged.**
- **The forecast end of QE will remain the main driver for EA non-core government bond spreads going forward. However, this is likely to remain orderly. In a more adverse risk scenario driven by geopolitical developments the ECB is likely to slow its retreat from bond markets.**

International core government bond yields continued their upward trend in February amid hawkish central banks and rising energy prices. The escalation of the Ukrainian crisis and ultimately the invasion of the Ukraine triggered a temporary decrease in yields. Core government bonds acted as safe havens despite surging energy prices and, hence, rising inflation expectations. However, as the imposed sanctions did not include energy exports and Russia was initially not excluded from Swift core yields recovered to almost pre-crisis levels.

However, the geopolitical escalation and the associated fears of a prolonged and sustained rise in energy prices have pushed up inflation expectations – especially in the EA. The combination of on balance almost stable nominal yields and surging inflation expectations triggered a sharp decrease in real yields with 10-year real Bund yields back to around -2.0% (from -1.65% mid of February).

While the news flow is expected to remain fluid and financial market participants are advised to act flexibly to a changing geopolitical situation, we do not materially change our medium-term yield forecast in our base scenario. However, tighter sanctions (e.g., partial exclusion of Russia from Swift) will increase particularly energy prices. While this will lead to a stronger increase in inflation and will amplify the growth impact, the effects on yields partially offset each other. Overall, central banks are forecast to remain on the key rate path marked out before the Russian invasion. However, the subdued sentiment on

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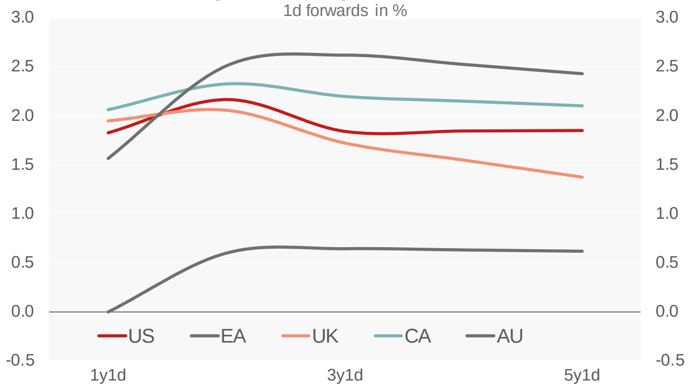
Implied Policy Rate Curves

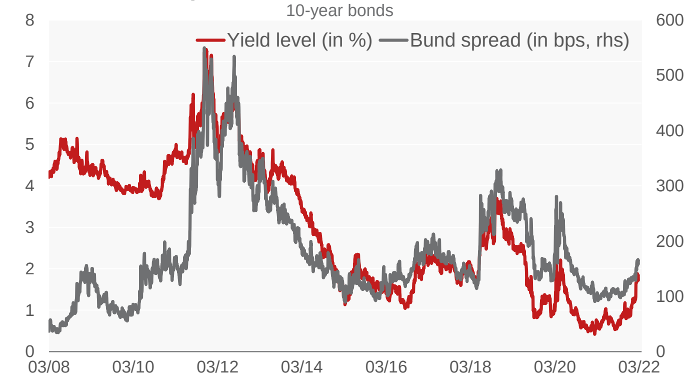
1d forwards in %




*Source: Bloomberg, GIAM calculations*

Italy: Government Bond Market

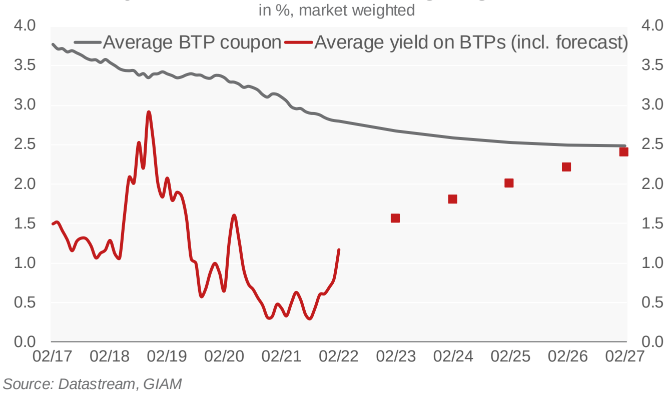
10-year bonds




*Source:Datastream, GIAM calculations*

Italy: Cost of Debt to decline going forward

in %, market weighted




*Source: Datastream, GIAM*

financial markets, tighter financial conditions and the negative growth fallout from the escalation will likely trigger a somewhat more cautious path than envisaged before.

In a risk scenario (e.g. complete stop of Russian exports and/or intensifying risks of a spillover to NATO countries) the inflation growth trade-off could become even more severe, and it would put central banks in a more difficult situation. In case central banks will delay the kick-off of the rate cycle amid the negative growth impact (accepting the spike in inflation as an exogenous supply shock) and investors will appreciate core government bonds as a safe haven the forecast increase in core yields is likely to not materialize – at least in the short term. Still, if history is any guide, it also shows that the influence of geopolitical developments is not sustainable.

Overall, the downside risks to our forecasts have increased. This is reflected in an only small expected yield increase on a 3-month horizon. On a 12-month horizon we still forecast 10-year Bund yields to rise to 0.5% and 10-year US yields to achieve 2.2%.

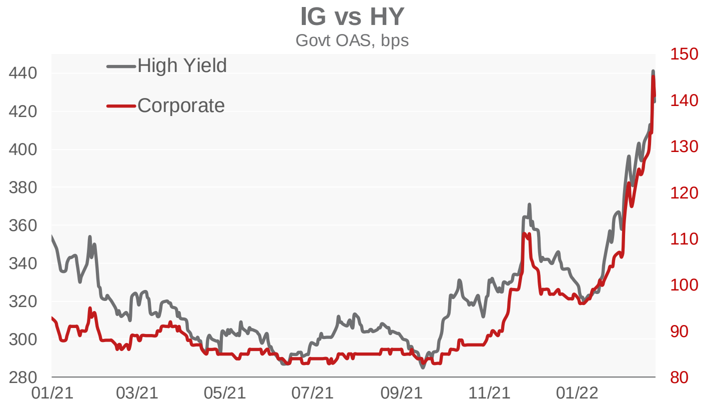
EA non-core government bond spreads have widened sharply over the course of February. However, this is not due to the geopolitical escalation but the increase in risk premia happened already in the first half of the month as the ECB's monetary policy path was repriced. Soothing comments by ECB officials helped to limit the spread widening in view of the Russian invasion and even reversed it for the time being.

While the negative growth fallout and a potential further escalation remain a burden for EA non-core spreads going forward, we expect in our base scenario the looming end of QE to remain the main driver. It triggers a deterioration of the technical situation. Amid slowing ECB purchases we expect a positive net supply (incl. ECB purchases) in 2022 (a swing of around €60 bn for Italy and Spain compared to 2021).

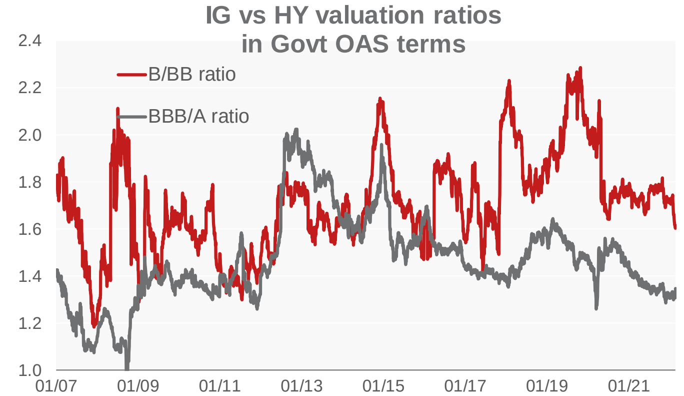
However, after the frontloading in January and February the supply burden will come down a bit. Moreover, extended duration of debt and the yield level still well below average coupons ensure debt sustainability. Hence, most of the spread adjustment to incorporate the more aggressive ECB stance has already taken place. Accordingly, we forecast only a moderate further spread widening over the course of 2022. While this is likely to happen in an orderly way the geopolitical news flow can trigger bouts of volatility.

# Credit

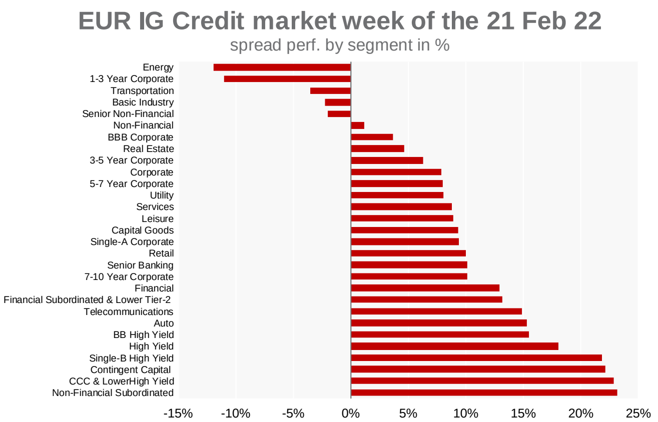
Elisa Belgacem




Source:Bloomberg, BofAML Indices, GIAM




Source:Bloomberg, BofAML Indices, GIAM own calculations




Source:BofAML indice, Bloomberg, GIAM own calculations

- **We stay overweight Credit, considering that either growth will not be derailed by the Ukrainian crisis, or the ECB will cautiously consider CSPP tapering in the view of keeping funding conditions healthy.**
- **Fundamentals of developed credit markets are not immediately threatened by the situation in Ukraine, but the impact on growth could hurt, and even more the potential resurgence of debt sustainability risk.**
- **Hence, in contrast to our previous recommendations, 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.**

Credit spreads had already widened early February following the signaling by the ECB that it would likely end the CSPP in the third quarter of 2022. Last week, the Ukrainian conflict has triggered another round of repricing. The effect has been stronger on cash than on CDS. Moreover, despite their strong capital position and the rising rates environment, financials have underperformed during the Ukraine-related sell-off. Among financials, Russia-exposed names have been the worst performers, but right after peripheral banks have been also under strong pressure.

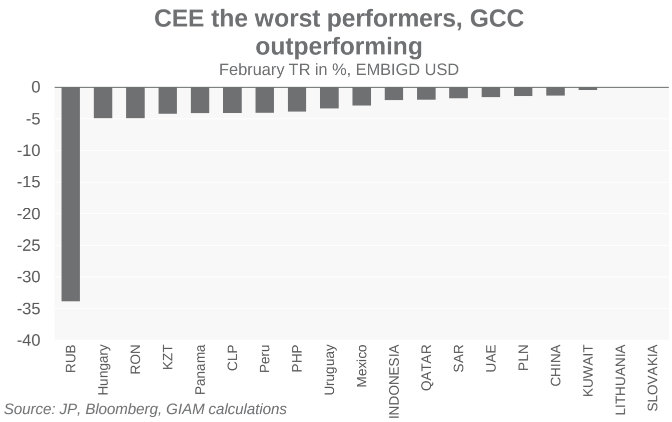
Indeed, beyond risk sentiment, the likely downward revision of the growth outlook caused by the disruption of the energy complex is a clear negative for credit spreads as they are highly correlated to the cycle. The underperformance of peripheral banks are likely linked to the resurgence of stagflation fears that may bring back on the table the debt sustainability concerns. This could be particularly the case in a context of energy led upward revisions to an already elevated inflation outlook, that is constraining the ability of the ECB to fight financial fragmentation.

## Moving OW IG and UW financials

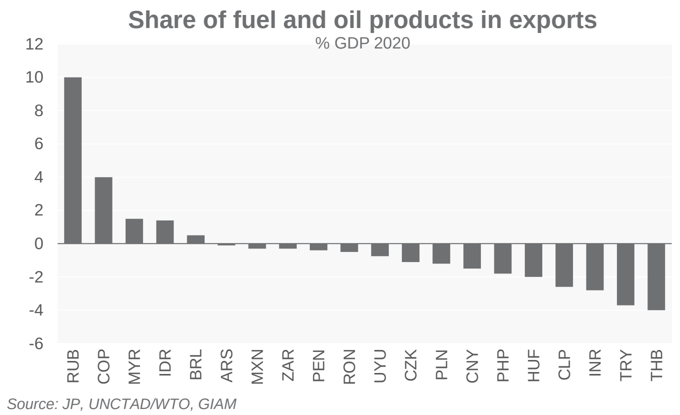
We stay overweight Credit, as we continue to expect better total return prospects than the rest of the fixed-income space. Nonetheless we decide to reduce the beta by moving OW IG versus HY, and also underweight the periphery versus the core. Moreover, in contrast to our previous recommendations, we suggest to reduce exposure to financial credit relative to non-financials. Finally, we favour subordinated bonds to pure HY.

# EM sovereign bonds

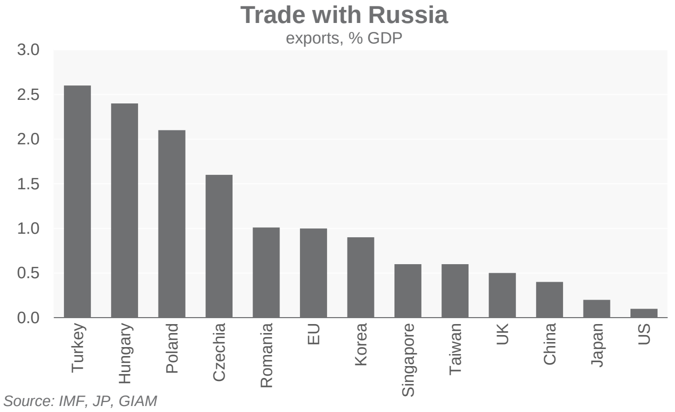
Guillaume Tresca




Source: JP, Bloomberg, GIAM calculations




Source: JP, UNCTAD/WTO, GIAM




Source: IMF, JP, GIAM

- **We maintain an OW but reduce risk. Headwinds are rising in an already unsupportive environment.**
- **We revise spread forecasts higher. They will recoup some of their losses but not return to their pre-crisis levels. Risks are still skewed to the upside.**
- **The outlook is highly heterogenous. We favour IG over HY, oil names, especially in GCC. LatAm is the least vulnerable region while CEE will underperform.**

Despite the sharp sell-off, we maintain an OW on EM external debt, but the Ukraine/Russia crisis and the geopolitical tensions are a new headwind in an unsupportive environment. We reduce risk and revise higher our spread forecasts. Spread volatility will remain high driven by geopolitical gyrations and high DM rates volatility. Spreads will recoup some of their losses but should not return to pre-crisis levels. Risks are skewed to the upside given the uncertainty on harsher sanctions and new geopolitical risk premium.

Technicals are turning negative. Issuance activity has been light YTD and the pipeline will turn busy when volatility recedes, weighing on spreads. Above all, we fear a negative feedback loop where negative total return triggers further outflows, especially from ETF and crossover funds, leading to forced selling. That said, outflows have been contained so far and Russia/Ukraine names represent one third of the global negative return of the index.

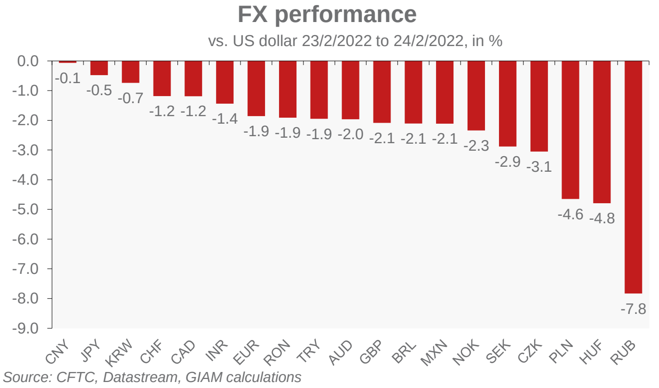
The outlook is turning more differentiated, and the post sell-off tightening will be heterogenous. Non-oil names and consensus longs will suffer. Region wise, LatAm is the most immune region benefiting from higher commodity prices while Asia can slightly be impacted by a marginal deterioration in trade. In EMEA, CEE countries, especially Romania, will suffer from their proximity even if the crisis is an incentive to get closer to the EU in the long run. Turkey is the most vulnerable given its energy importer status, a large CA deficit and Russian tourism receipt (27% of visitors).

We recommend IG over HY given its low beta status and less cyclicality. More precisely, we recommend adding selectivity in the GCC, both in IG and HY. Saudi Arabia and Oman are the ones who can benefit the most. Commodity name in Africa can benefit via the energy diversification, but we are careful and prefer to pick South Africa (metal prices).

# Currencies

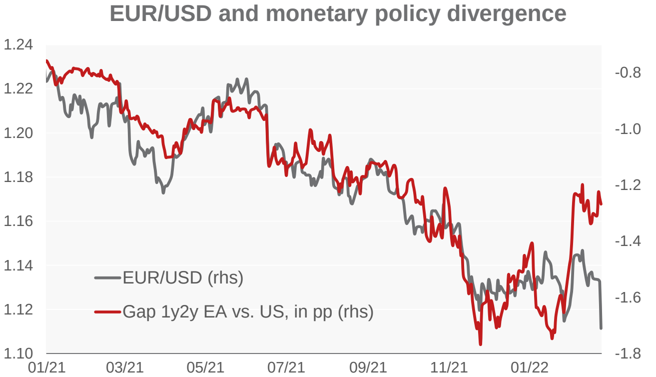
Thomas Hempell

- **Short term, the war in Russian war in Ukraine will keep weighing on European currencies while safe havens including USD, JPY and CHF are enjoying strong demand.**
- **Yet with the ECB's recent hawkish pivot unlikely to be reversed and the recovery still capable to weather the headwinds from inflation and geo-political risks, we see upside for EUR/USD further into the summer.**
- **Safe haven bids and a more tolerant SNB may keep CHF on the strong side short term, before a generally stronger EUR bears upside also for EUR/CHF further out.**



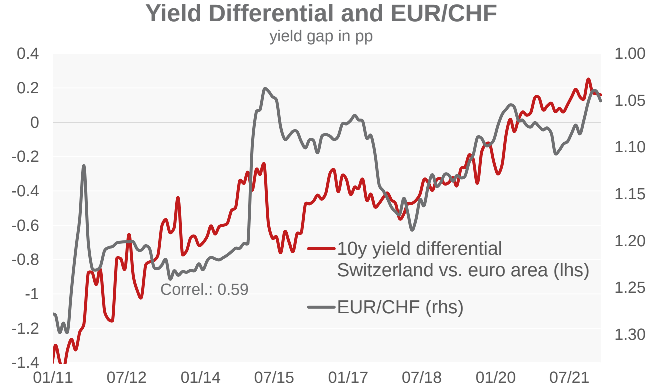

Source: CFTC, Datastream, GIAM calculations

The Russian invasion of Ukraine is particularly detrimental for Europe, both due to geographic proximity and the high dependency on Russian energy supply. Unsurprisingly, alongside the slumping RUB, European FX faced the strongest pressures, with CEE currencies particularly penalized (upper chart).




Source: Datastream, GIAM calculations

Barring a severe military escalation beyond Ukraine or sanctions/restrictions on Russian energy supply, we expect euro area growth to suffer only moderately in our base scenario, while price pressures will persist for longer. This is unlikely to strongly alter the ECB's markedly hawkish pivot in early February (see Euro area part). Higher European risks will keep a lid on the EUR and headwinds to the USD from the global spring recovery will turn out milder. Yet we still see EUR/USD benefiting from the nearing end of negative rates and the still decent outlook of a sustained recovery, also given already a sizeable discount vs. relative policy expectations (mid chart).




Source: Datastream, GIAM calculations

## Safe havens still in demand

Meanwhile, the strong exposure to geopolitical risks and worries about energy supply disruptions continue to expose CEE currencies to particular regional risks.

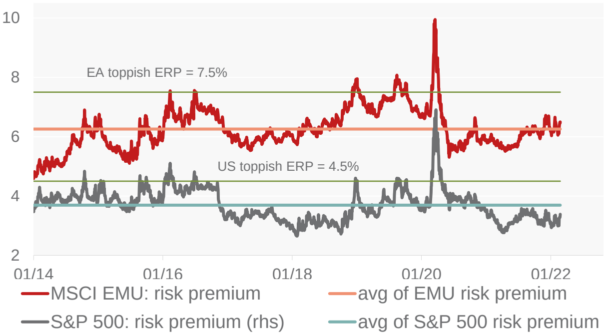
Conversely, safe havens JPY and CHF are set to remain in demand for longer amid lingering tensions near term. Swiss longer dated yields continue to exceed those of Bunds, pointing to no major misalignment of EUR/CHF (bottom chart). And due to higher inflation risks, the SNB is also more tolerant about a strong CHF. Demand for the fundamentally very cheap JPY may benefit from higher political uncertainty but also speculation that the BoJ may be starting to rethink its yield curve control over the coming months. A trend increase in US yields, however, should keep JPY upside muted.

# Equities

Michele Morganti, Vladimir Oleinikov

- **The situation in Ukraine is set to remain fluid. We don't see a rapid de-escalation and volatility is to stay high. That said, our comprehensive analysis of past peaks in equity risk premia suggests that downside in the short term is limited to ca. 5%.**
- **Currently, earnings and margins remain safe (Q1 season) - firms declaring to have good pricing power. But risks are tilted to the downside given the chance to see lower GDP growth ahead, triggered by even higher energy prices and inflation hurting sentiment.**
- **We see mid-single digit positive returns in 12 months and suggest a minimal OW on equities also due to rising real yields and spreads ahead. Given the current high risks we go neutral EMU vs. USA from OW (lowering cyclical exposure), while remaining OW on UK, Japan and EMs.**
- **Sectors: favour a lower cyclical mix. OW Value (↓) plus defensive and quality (↑). OW Financials, Energy, Food, Durables, Healthcare equip., Materials and Semis (new). UW: Cap. Goods, IT Hard., D. Fin., Media, Utilities, Tlc and RE.**

**MSCI EMU and S&P: risk premium**
earnings yield (12m fwd) minus 10-year rate



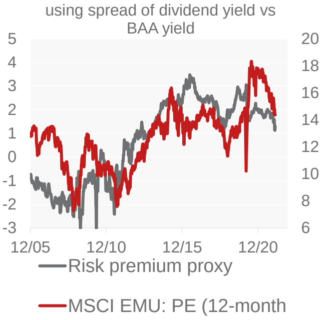

*Source: Datastream, GIAM calculations*

| RISK PREMIUM TARGETS IN RISK AVERSION SCENARIOS | | | | | |
|---|---|---|---|---|---|
| **USA** | **Current 23/2/22** | **tgt 1** | **delta** | **tgt 2** | **delta** |
| **EPS** | **227** | **227** | | **227** | |
| 10Y | 1.95% | 1.50% | -0.45% | 1.50% | |
| **ERP** | 3.28% | **4.21%** | 0.93% | **4.50%** | 1.22% |
| **SPX** | 4,225 | 3,975 | **-5.9%** | 3,783 | **-10.5%** |
| PE-implied | 18.6 | 17.5 | | 16.7 | |

| EMU | Current 23/2/22 | tgt 1 | delta | tgt 2 | delta |
|---|---|---|---|---|---|
| **EPS** | **14** | **14** | | **14** | |
| 10Y | 0.79% | 0.34% | **-0.45%** | | |
| **ERP** | 6.46% | **6.90%** | 0.44% | **7.50%** | 1.04% |
| **MSCI EMU** | 199.4 | 196 | **-1.7%** | 181 | **-9.2%** |
| PE-implied | 14.0 | 13.8 | | 12.8 | |

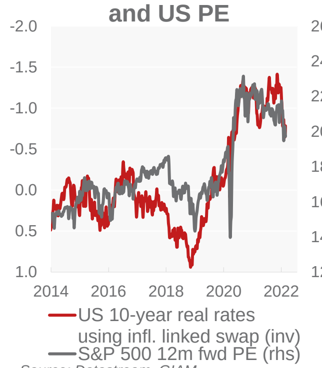
Note: Tgt 1 and Tgt 2 are derived from historical evidence during periods of high risk aversion.

**MSCI EMU: PE and risk premium**
using spread of dividend yield vs BAA yield




*Source: Datastream, GIAM*

**Real 10-year rates and US PE**



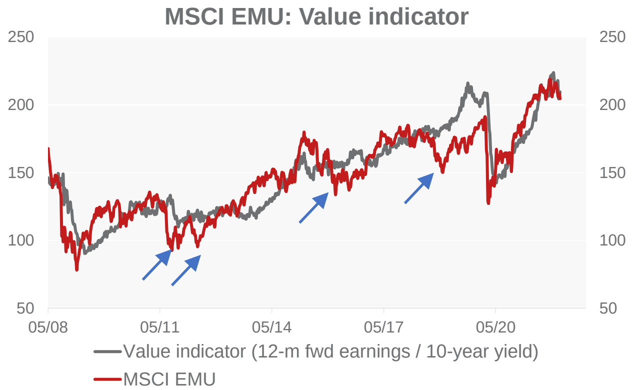

*Source: Datastream, GIAM*

As the Ukraine crisis turned to the worse, markets are on down by 10% from November peak, with the US overperforming EMU. The situation in Ukraine remains fluid: SWIFT ban and sanctions on CBR mark a clear escalation. That said, looking to a worse case scenario in the short term (still not a very extreme one), we think the downside is limited to a ca. 5% downside. That's the conclusion drawn looking to previous spikes in the risk premium since 2014 (ERP of 7.5% for EMU and 4.5% for the US), once we exclude the Covid (Q1 2020) and GFC drawdowns. Those peaks were quite short-lived, representing good buying opportunities.

Looking to historical discounts to theoretical valuation would likely imply an additional c. -5% to reach the maximum discount registered in periods of high-risk aversion. The same looks true analyzing past peaks in volatility to 1-2 SD from current 0.6. On Feb. 23rd, the AAII Net Bulls, survey of the US retail investor, was down at -30%, the lowest level since 2013. Additional tactical indicators by brokers are also neutral or slightly in buy territory, albeit not stressed yet: we suggest a minimal OW position on equities and see mid-single digit positive returns in 12 months. Our fair value targets use as input 10-year rates at 0.5% (Bund) and 2.2% (Tres.) in 12 months and an earnings growth in 2022 of 3.7% and 6%, respectively for EMU and the US.

# Equities

Michele Morganti, Vladimir Oleinikov




*Source: Datastream, GIAM*

We are at 5% discount to earnings consensus. Such discount is aimed to consider possible negative spillovers on growth from higher-than-expected energy prices and inflation plus a negative impact on consumptions. These would affect GDP forecasts and earnings growth. A GDP growth estimate of -1% would roughly correspond to -4% eps growth and target value. Albeit with a lower momentum, earnings, sales and margins currently remain firm (Q1 season, see table) with firms declaring to have good pricing power, but, as said, risks are tilted to the downside. For 2023, our earnings figures are 10% below consensus as we see risks of tighter financial conditions to trigger a meaningful negative earnings revisions by analysts.

Notwithstanding the cited positive TR in 12 months, we refrain from buying aggressively current dips as risks remain high. We recommend a minimal OW position, looking for further downside to eventually increase the exposure. In the next months, higher credit spreads and real yields, plus high bond volatility could maintain the risk aversion high. Given the current high risks we turn neutral on EMU (cyclical) vs. the US from OW, remaining OW on UK and EMs. We suggest also an OW on Japan due to lower valuations, and more supportive monetary and fiscal policy vs US and EMU.

**Analysis of the median stock: Q4 2021 reporting season**

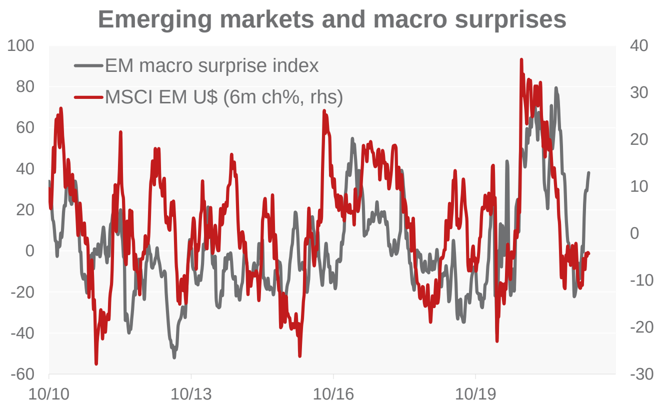
| Median stock | Earnings Growth | | Sales Growth | | margin trend * | | availability |
|---|---|---|---|---|---|---|---|
| | Q3 2021 | Q4 2021 | Q3 2021 | Q4 2021 | Q3 2021 | Q4 2021 | Q4 2021 |
| S&P | 20.5 % | 15.3 % | 13.1 % | 11.9 % | 7.4 % | 3.5 % | 90.0% |
| Stoxx | 18.9 % | 19.1 % | 11.8 % | 11.7 % | 7.1 % | 7.4 % | 71.0% |
| Euro Stoxx | 19.9 % | 21.1 % | 12.6 % | 12.5 % | 7.3 % | 8.6 % | 63.5% |

| Median stock | Earnings Surpr | | Sales Surpr | | margin trend * | | availability |
|---|---|---|---|---|---|---|---|
| | Q3 2021 | Q4 2021 | Q3 2021 | Q4 2021 | Q3 2021 | Q4 2021 | Q4 2021 |
| S&P | 6.3 % | 4.1 % | 1.8 % | 1.8 % | 4.5 % | 2.3 % | 90.0% |
| Stoxx | 4.8 % | 3.9 % | 1.3 % | 2.3 % | 3.5 % | 1.6 % | 71.0% |
| Euro Stoxx | 7.8 % | 8.1 % | 1.5 % | 3.2 % | 6.3 % | 4.8 % | 63.5% |

Note: margin trend = earnings growth - sales growth

*Source: Bloomberg, GIAM calculations*

Sectors: We favour a less cyclical stance and sector mix where Value (energy in particular) is OW (↓) together with defensive and quality names. The Value style looks more at risk as a result of its significant outperformance so far, higher credit spreads and lower GDP momentum. We lower Banks and Energy OW and cut HH to N (margin pressure). We put Health Care Equipm. and Semis on OW (new) and Media on UW and decrease the UW position in Tech Hardware.



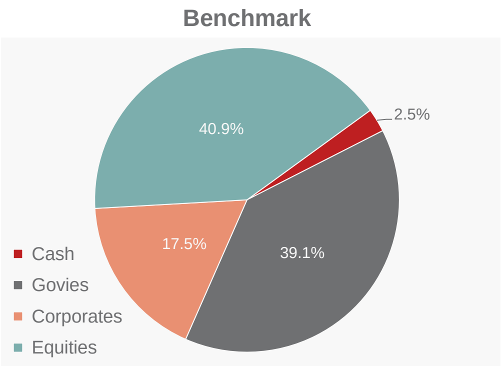

*Source: Datastream, GIAM*

### EM: slight OW

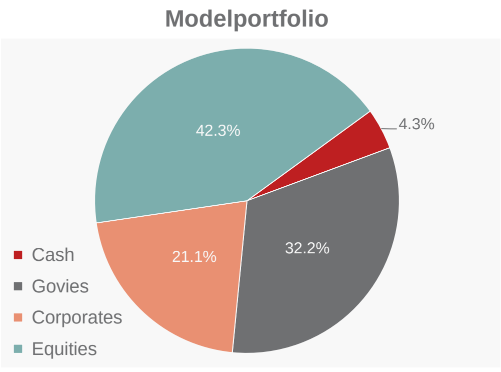
While Ukraine conflict is a negative trigger in the short term, positives are represented by improving macro surprises and the expectations of China's economy reaching bottom in Q4 2021. Earnings growth is weaker than for DM but valuations are much cheaper. We believe that China's monetary and fiscal policy have chance to increase further their support, with clearer signs of peaking Omicron wave. Furthermore, the aggressive monetary tightening in many other EM countries is also very advanced and the EM CBs are expected to hike less than CBs in the DM world. OW: Korea and Chinese A-shares. Slightly OW MSCI China. We recommend long CH Tech and short US Tech (huge valuation gap, historically).

# Asset Allocation

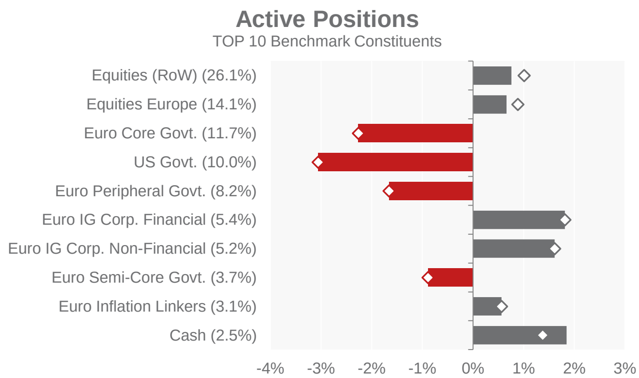
Thorsten Runde




*Source: GIAM*




*Source: GIAM*




*Source: GIAM; Benchmark weights in parentheses, diamonds indicating previous recommendations*

- **In the course of February all actively covered asset classes remained in negative territory *(24.02.22)*.**
- **On average, equity markets suffered the most (-4.4%). With -7.8% for the MSCI EMU they are also bringing up the rear in the performance ranking, like in the previous month.**
- **Long-dated govies continued to underperform the short-dated ones. The average underperformance was -320 bps (Y10+ vs. 1-5Y).**
- **In the corporate section EA IG outperformed EA HY by roughly +63 bps. Within IG, Financials were superior to Non-Financials (+ 40 bps).**
- **Energy markets are already pricing a high degree of the substantial uncertainties about gas and oil supply to Europe. That said, a further escalation may drive energy prices further up and weigh on risk assets. Thus we recommend to cut back Equity exposure and shift it to Cash.**

In February *(24.02.22)*, our model portfolio lost another -9.1 bps in relative terms. On the positive side, Cash (+5.2 bps) and Corporates (+2.0 bps) were the only significant contributors, whereas the underweight positions in EA Core Govies (-4.5 bps) and US Treasuries (-5.6 bps) hurt the most. While the first half of February was still clearly in favour of Equities (+380 bps Equities vs. Govies), the picture reversed in the second half (-600 bps). Thus, the underperformance of the model portfolio was exclusively generated from mid-February onwards (-15 bps). Some of the recent market developments are certainly due to the materialization of risks. However, the warlike invasion of Ukraine by Russia, which was completely unexpected in this brazenness, has clearly reinforced them.

## Reduce risk in general and cyclicality in particular

Given the risk of a full-blown energy crisis jeopardizing the earnings outlook through an economic slowdown, we recommend to further reduce Equity exposure. To meet intensifying stagflation worries and decreasing real yields we suggest reducing the cyclicality within Equities by increasing defensive stocks at the expense of cyclical ones as well as reducing the overweight in value stocks. A further correction of Equity prices might represent attractive re-entry levels once energy-price and geopolitical stability increase. Until then, Cash should serve as a temporary safe haven.

## Forecast tables

| Growth[1] | 2021 | 2022 | | 2023 | |
|---|---|---|---|---|---|
| | | forecast | Δ vs. cons. | forecast | Δ vs. cons. |
| US | 5.7 | 3.4 | -0.5 | 1.9 | -0.7 |
| Euro area | 5.2 | 3.3 | -0.7 | 2.0 | -0.5 |
| Germany | 2.9 | 2.7 | -1.0 | 2.1 | -0.4 |
| France | 7.0 | 3.5 | -0.3 | 1.8 | -0.2 |
| Italy | 6.5 | 3.5 | -0.7 | 1.9 | -0.3 |
| Non-EMU | 6.2 | 3.5 | -0.4 | 1.8 | -0.4 |
| UK | 7.5 | 3.7 | -0.6 | 1.6 | -0.6 |
| Switzerland | 3.7 | 3.0 | 0.0 | 1.9 | 0.0 |
| Japan | 1.7 | 2.5 | -0.6 | 1.8 | 0.3 |
| Asia ex Japan | 8.0 | 5.2 | -0.2 | 5.1 | -0.1 |
| China | 8.1 | 4.8 | -0.2 | 5.3 | 0.0 |
| CEE | 6.6 | 3.3 | 0.0 | 3.1 | 0.0 |
| Latin America | 6.4 | 2.0 | 0.0 | 2.2 | 0.0 |
| **World** | **6.4** | **4.0** | **-0.3** | **3.3** | **-0.2** |

*1) Regional and world aggregates revised to 2020 IMF PPP weights*

| Inflation[1] | 2021 | 2022 | | 2023 | |
|---|---|---|---|---|---|
| | | forecast | Δ vs. cons. | forecast | Δ vs. cons. |
| US | 4.7 | 6.4 | 1.6 | 2.3 | -0.3 |
| Euro area | 2.6 | 5.5 | 2.4 | 1.7 | 0.1 |
| Germany | 3.2 | 6.0 | 3.1 | 1.8 | -0.1 |
| France | 2.1 | 4.8 | 2.6 | 1.5 | 0.0 |
| Italy | 2.0 | 5.3 | 2.6 | 1.5 | 0.2 |
| Non-EMU | 2.3 | 4.7 | 1.1 | 2.1 | 0.0 |
| UK | 2.6 | 6.3 | 1.7 | 2.6 | 0.1 |
| Switzerland | 0.6 | 0.9 | 0.0 | 0.6 | 0.0 |
| Japan | -0.3 | 1.3 | 0.5 | 0.7 | 0.0 |
| Asia ex Japan | 2.0 | 2.9 | 0.1 | 2.7 | -0.1 |
| China | 0.9 | 2.3 | 0.1 | 2.1 | -0.2 |
| CEE | 9.3 | 13.9 | 0.0 | 7.4 | 0.0 |
| Latin America[2] | 6.6 | 4.7 | 0.6 | 3.7 | 0.5 |
| **World** | **3.5** | **4.9** | **0.8** | **2.8** | **-0.0** |

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

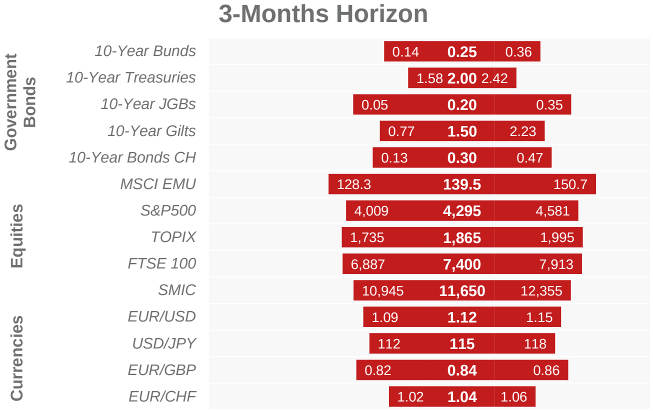
## Financial Markets

| Key Rates | 24/02/22* | 3M | 6M | 12M |
|---|---|---|---|---|
| US | 0.25 | 0.50 | 1.25 | 1.63 |
| Euro area | -0.50 | -0.50 | -0.50 | 0.00 |
| Japan | -0.10 | -0.10 | -0.10 | -0.10 |
| UK | 0.50 | 1.00 | 1.00 | 1.25 |
| Switzerland | -0.75 | -0.75 | -0.75 | -0.50 |
| **10-Year Bonds** | **24/02/22*** | **3M** | **6M** | **12M** |
| Treasuries | 1.97 | 2.00 | 2.10 | 2.20 |
| Bunds | 0.23 | 0.25 | 0.35 | 0.50 |
| BTPs | 1.81 | 1.85 | 2.00 | 2.20 |
| OATs | 0.71 | 0.75 | 0.80 | 0.90 |
| JGBs | 0.19 | 0.20 | 0.20 | 0.25 |
| Gilts | 1.47 | 1.50 | 1.60 | 1.70 |
| SWI | 0.28 | 0.30 | 0.40 | 0.50 |
| **Spreads** | **24/02/22*** | **3M** | **6M** | **12M** |
| GIIPS | 125 | 125 | 130 | 135 |
| BofAML Covered Bonds | 66 | 65 | 65 | 70 |
| BofAML EM Gvt. Bonds (in USD) | 359 | 345 | 340 | 340 |

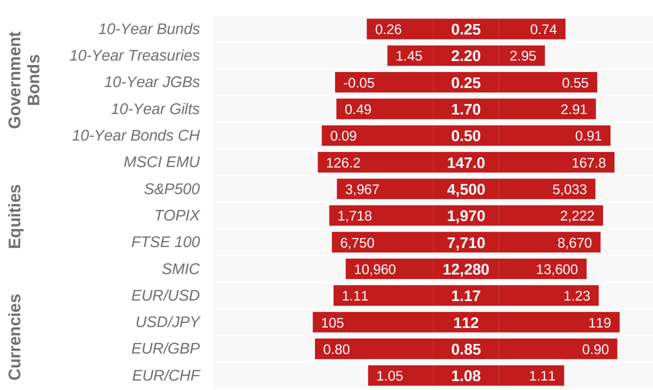
| Corporate Bond Spreads | 24/02/22* | 3M | 6M | 12M |
|---|---|---|---|---|
| BofAML Non-Financial | 135 | 120 | 125 | 125 |
| BofAML Financial | 143 | 125 | 125 | 125 |
| **Forex** | **24/02/22*** | **3M** | **6M** | **12M** |
| EUR/USD | 1.13 | 1.12 | 1.13 | 1.17 |
| USD/JPY | 115 | 115 | 114 | 112 |
| EUR/JPY | 130 | 129 | 129 | 131 |
| GBP/USD | 1.35 | 1.33 | 1.35 | 1.38 |
| EUR/GBP | 0.84 | 0.84 | 0.84 | 0.85 |
| EUR/CHF | 1.04 | 1.04 | 1.06 | 1.08 |
| **Equities** | **24/02/22*** | **3M** | **6M** | **12M** |
| S&P500 | 4,273 | 4,295 | 4,365 | 4,500 |
| MSCI EMU | 140.7 | 139.5 | 141.5 | 147.0 |
| TOPIX | 1,873 | 1,865 | 1,905 | 1,970 |
| FTSE | 7,400 | 7,400 | 7,490 | 7,710 |
| SMI | 11,846 | 11,650 | 11,860 | 12,280 |

**average of last three trading days*

### 3-Months Horizon




### 12-Months Horizon



# IMPRINT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