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Outlook
Prepare for landing

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY

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Central banks... The impossible task of a perfect balance

As we reached the end of the first half of 2022, market participants continue to face downward revisions of global growth expectations and significant headwinds. In particular, the war in Ukraine has further pushed up commodity prices and inflation is now eroding household purchasing power and weighing on corporate margins. Faced with high inflation, central banks are having to tighten their monetary policy.

However, the extent of the economic slowdown is not the same everywhere, with difference becoming particularly pronounced between commodity-importing and commodity-exporting emerging countries.

China: still the engine of global growth?

That is how the Chinese economy has been often described over the past couple of decades. But in 2022, its economic growth is very unlikely to reach the official target level of 5.5% a year. As the health situation around the country continues to weigh on economic activity, the authorities remain cautious in their monetary easing. Despite local governments being actively encouraged to accelerate their infrastructure investment spending, China's GDP is expected to grow by about 4% over 2022.

As for the economies of the US and Eurozone, inflation remains their major challenge. In the US, the Federal Reserve (Fed) must succeed in both slowing economic growth to below 2% by the end of 2022 and in keeping inflation down. Its objectives will be helped by the end of fiscal support, the erosion of household purchasing power and the appreciation of the US dollar. In addition, the rise in mortgage rates is already weighing on property sales. While we continue to favour a soft-landing scenario, the risks of a harder landing are far from negligible. Nevertheless, as long as the economy does not show clear signs of slowing down, the Fed has no choice but to continue to press the brake pedal.

Across the Atlantic, the European Central Bank (ECB) faces an even more delicate task. Apart from its key tasks of nurturing a fragile economic growth, it also faces its own credibility test. If inflation continues to surprise on the upside, the central bank must be able to move faster - by raising rates not by 25 basis points but by 50, or by speeding up the pace of interest rate rises, but without causing a "financial fragmentation" of the Eurozone. The ECB must convince the markets that its actions will not let sovereign spreads widen "too much" without the central bankers taking countermeasures.

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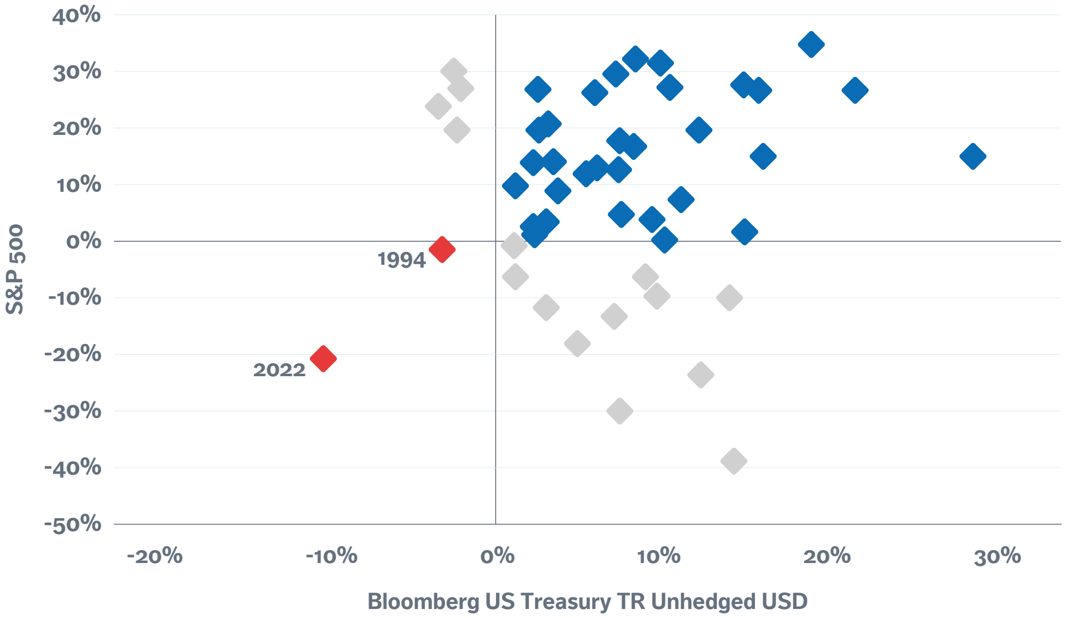
Asset Allocation: Flexibility, the only road to stability

Bonds and equities fall

The first half of 2022 has shown the worst performance of US equities and bonds at the same time (-20.6% and -9.1% respectively as of 30.06.2022) that we have seen over the past 50 years. In 1994, the year we used as a reference, bonds fell but equities remained broadly unchanged. Moreover, in 2022, most other assets did not provide effective mitigation to these declines, and that included energy, UK equities, gold and some alternative strategies. Conversely, US equities (and especially technology) suffered the most in this context. The sharp declines this year meant that the volume of assets that suffered worst declines over the past two years has exceeded those that rose. Cheap valued stocks and sectors have outperformed assets whose valuation has risen markedly since the onset of the pandemic in 2020.

Figure 1: Negative returns on equities and bonds



Source: Bloomberg. Yearly data from 1973 and YTD for 2022 as of 30.06.2022.
Past performance does not guarantee future results and is not constant over time.

Two grey swans

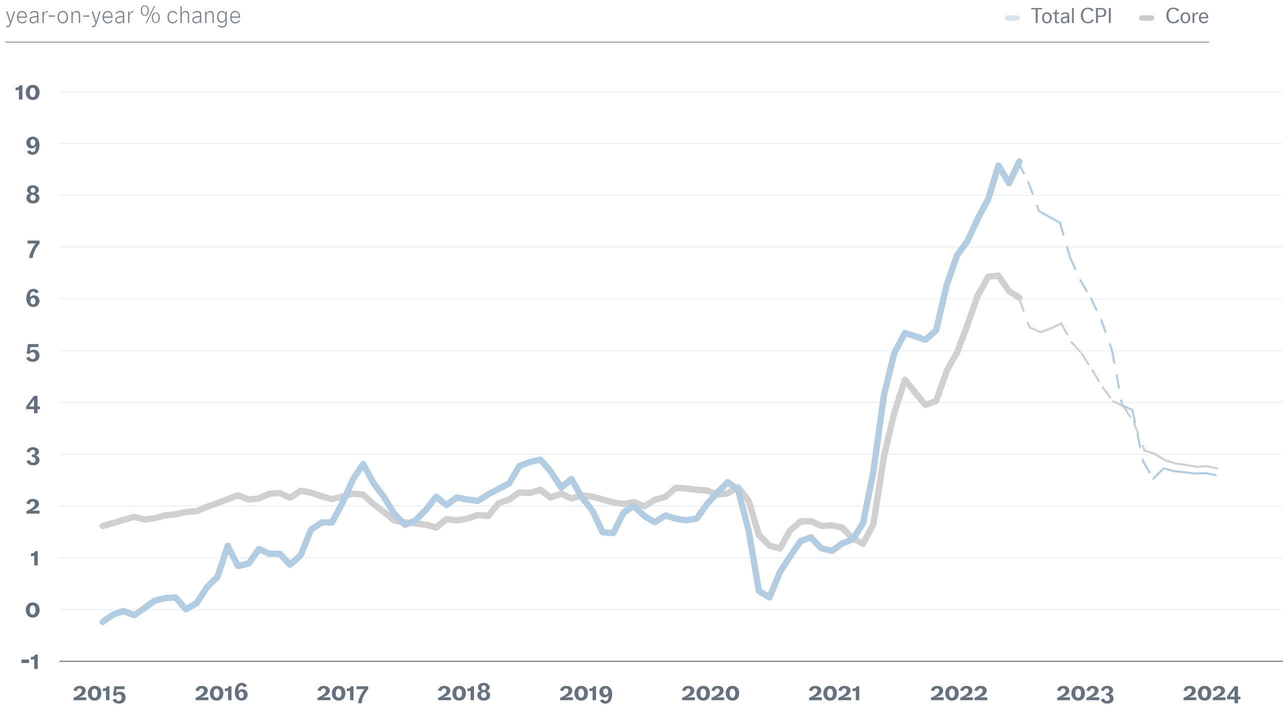
The sudden market declines over the past six months are mostly due to the successive and partly unexpected shocks that have brought us much quicker towards the end of the cycle. The first "shock" occurred in February, despite persistent and vocal warnings based on intelligence from the US government, when Putin's Russia launched a full-scale invasion of Ukraine. The resulting surge in commodity prices (oil prices jumped by 47.6% as of 30.06.2022) increased inflationary pressures. In response, central banks, and in particular the Fed, adjusted their monetary tightening path, causing a further rise in rates.

The second major "shock" came from China and its decision to maintain a strict Zero-Covid Policy, whose appropriateness for the Omicron variant had been questioned. The large-scale shutdowns taking place in April and May had impacted both Chinese economic growth (downgraded consensus estimates from 5.5% to 4.3% for 2022) and global growth, including supply chains. This has created a much more stagflationary environment globally, negative for both bonds and equities. Therefore, market participants are faced with potential interest rate rises not seen since the 1970s, both in the US and in Europe, with central banks forced to react strongly to contain persistent inflation.

The inflation vs tightening dynamics will set the market scene for months to come

So what's next? The real change will only come when inflation finally starts to ease and the US labour market tensions ease. The road ahead remains very difficult for central banks. They are now maintaining their credibility at the cost of a very rapid tightening of financial conditions. The "mistake" in monetary policy is not inevitable, but at the current pace of tightening expectations, its probability is high. Our asset allocation for this stage in the market will naturally depend on how successful central banks will be in their efforts to achieve a soft landing.

Figure 2: US CPI inflation trajectory

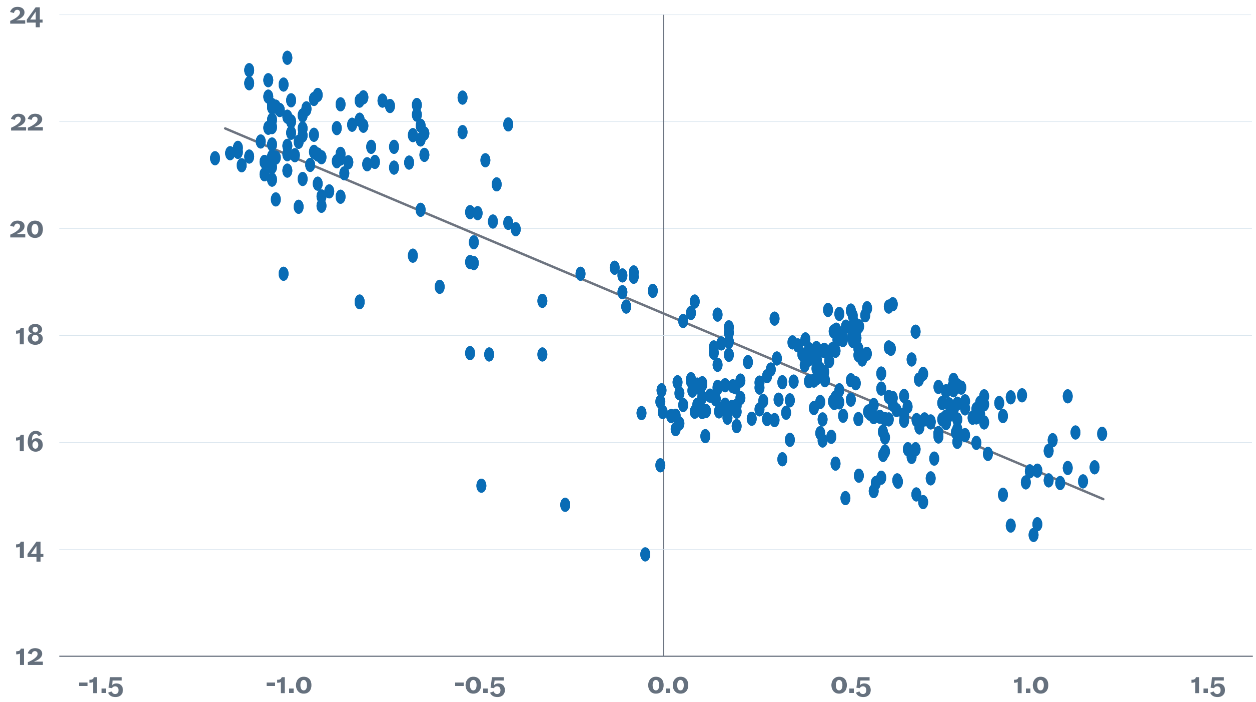


Source: Bloomberg. Data from 15.01.2015. Projections by Candriam.
Past performance does not guarantee future results and is not constant over time.

When should portfolios turn the Risk back On?

We believe that it is still premature to take a structural "Buy" position on the financial markets. While equity valuations have fallen, corporate earnings have actually continued to grow, if we judge from the Q12022 results. This valuation decline in the US reflects only the impact of rising US real rates. Expected earnings growth is still too high for 2022 and, depending on the economic scenario, we expect downward revisions of various magnitude.

Figure 3: US equity valuations: in line with real rates

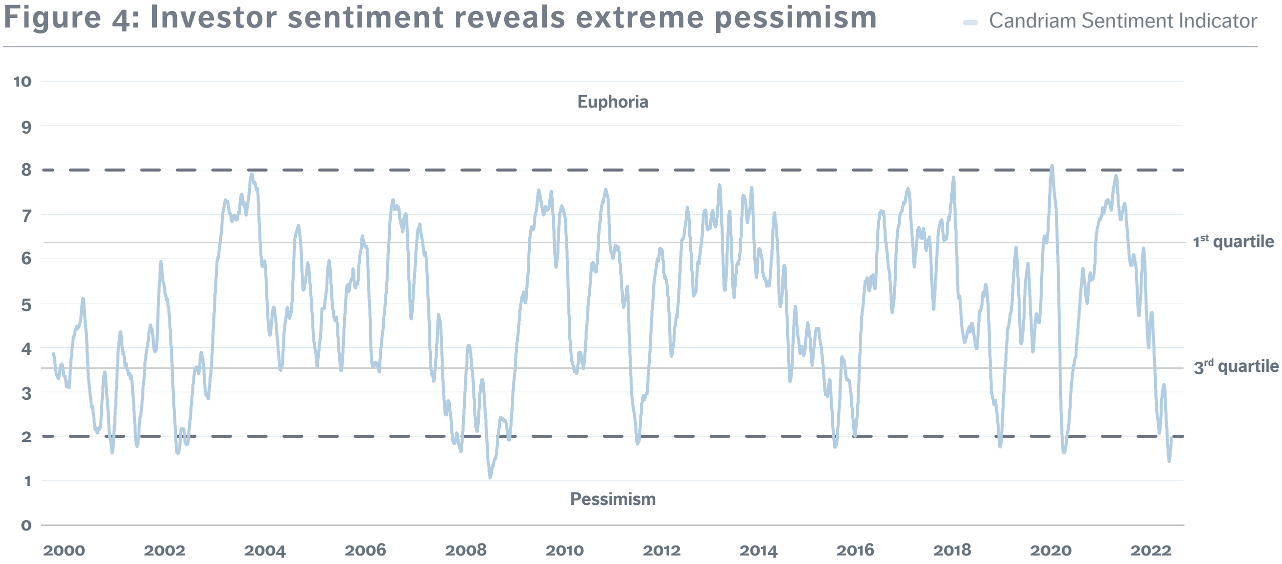


Source: Refinitiv Datastream. Data since 22.06.2015 as at 27.06.2022.
Past performance does not guarantee future results and is not constant over time.

We also expect to see more pronounced regional divergences appearing in 2022. European equities have also suffered from rising interest rates, but unlike US equities, they carry an additional risk premium. The evolution of interest rates is therefore not the only driver of performance in Europe, they are also affected by other factors, such as geopolitical risks linked to a worsening confrontation with Russia or the risk of fragmentation of the Eurozone. Chinese equities are probably closer to the bottom of the cycle and should benefit from fiscal and monetary support measures once the COVID-19 epidemic is under control.

In this environment, if volatility has risen sharply across all asset classes (stocks, bonds and currencies), the main positive signal we have is the extreme level of investor pessimism.

Figure 4: Investor sentiment reveals extreme pessimism



Source: Bloomberg, Candriam. Data from 01.01.2020 as of 17.06.2022

Short-term: positioned for a slowdown

For the time being, our allocation remains defensive and positioned for an economic slowdown, with a gradual deceleration of inflation from this summer.

Therefore, **in equities**, we favour defensive sectors such as healthcare and consumer staples. Technology stocks could be increasingly attractive in this context, due to a strong correction in valuations and a more limited impact of inflationary pressures on margins. We have also gradually lengthened our duration (notably with US government bonds) and remain cautious on high yield credit, preferring investment grade. We also keep our portfolios well diversified, and use mitigation of downside market risks through exposures to gold and decorrelated alternative strategies.

"Our long-term themes of innovation and energy transition should also be beneficiaries thanks to their pricing power, which enables them to pass on inflation to final prices."

What are the next steps?

It will depend on inflation data, activity data and the pace of monetary tightening. We are positioned to deal with the current slowdown, but we are ready to change gear depending on how the economy develops and how central banks react. In our most conservative scenarios, the slowdown gather pace and require a reduction in exposure to risky assets (equities and high yield credit) while our exposure to government bonds and our diversification and hedging strategies would increase. Conversely, an exit from this downturn with a 'soft landing' would allow us to return to a more sustainable risk level and cyclical allocation to equities and credit. On the currency side, an exit from the current phase should be detrimental to the US dollar.

Until we have more visibility, we believe that the market will have to acknowledge the slowdown in the economy. The interest rates market should be the first to react by anticipating a drop in growth and a stabilisation, or even a drop, in central bank rates expectations. This movement should lead to a decline in sovereign rates. In anticipation, we have put an end to our short duration position to neutral, and have taken a positive duration position on US rates.

The equity market should react in a second phase, as it needs the downward revision of earnings growth to start in order to rebound in a sustainable way. However, the downward movement in interest rates should be a catalyst for a new rotation towards growth stocks. In this context, we have recently increased our exposure to growth stocks, notably via the Nasdaq. Our long-term themes of innovation and energy transition should also be beneficiaries thanks to their pricing power, which enables them to pass on inflation to final prices. This last movement leads us to have a balanced allocation in terms of style.

The biggest challenge for investors today is to remain on top of things in this crazy acceleration of cycles we have seen since the start of the Covid-19 pandemic, accompanied by high volatility across all asset classes. It is still too early to draw definitive conclusions about the post-Covid investment environment, but we must remain prepared to challenge some of the biases and beliefs that have been ingrained since 2008.

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