NATIXIS
ASSET MANAGEMENT

ADAPTABILITY AND FLEXIBILITY WILL BE KEY TO MARKETS IN 2018

OUR EXPERTS' OUTLOOK FOR THE NEW YEAR

6 major challenges for investors in 2018

MACROECONOMICS
"A tricky year for central banks"

FIXED INCOME
"Dare to dare in 2018!"

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"Stay alert"

editorial

Matthieu Duncan
Chief Executive Officer
of Natixis Asset Management

“Normalization will raise its fair share of **challenges**”

2017 was full of pleasant surprises: after political concerns clouded the first part of the year, these risks did not materialize in the end and the threat of populism dwindled; world growth is robust, while in Europe the pace has even stepped up a gear; and more significantly, businesses and households are resolutely confident in the future.

Yet we should be careful not to get too carried away on the wave of optimism, as 2018 will not be entirely devoid of events that could throw a spanner in these well-oiled works. Unpredictable behavior from the US could hamper its growth and international trade as a whole, which is at the heart of renewed growth. More importantly, central banks and in particular the Fed have embarked on a period of normalization, but have the financial markets reached a sufficient degree of maturity to deal with the end of monetary policy accommodation?

So investors will need to be alert, adaptable and flexible in 2018, and this year more than ever, Natixis Asset Management and its experts will be on hand to help you steer your way through this market context, away from the pitfalls and towards the best opportunities. This dimension lies at the very core of our role as an active investment manager, relying on our convictions to support you and provide sustainable investment solutions to address your needs.

I hope you enjoy reading our 2018 Outlook and on behalf of all the teams at Natixis Asset Management, I would like to wish you a very Happy New Year.

6 major challenges for investors in 2018

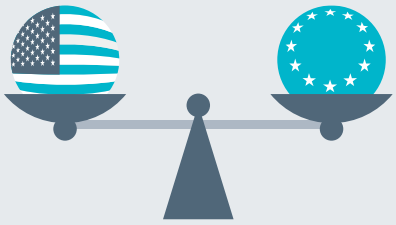
1 World growth to withstand monetary policy normalization

World growth is set to remain on a strong trend in 2018, with the euro area making a significant contribution to this performance. Growth is catching up and this process is poised to continue. Against a backdrop of weak inflation, central banks will maintain monetary accommodation, although the Federal Reserve has started to normalize its strategy by pushing up interest rates and pruning its balance sheet. Meanwhile, the ECB is staying on course, albeit reducing its asset purchase program, which is slated to end in late-2018 at the earliest with no rate hikes before the end of 2019. The Bank of England has started raising its base rate, although it has not really ventured to take its policy any further, reflecting uncertainty currently shrouding the UK economy.

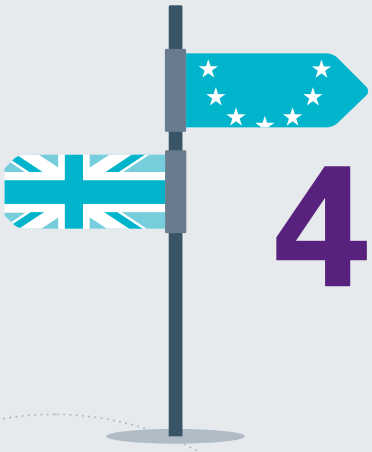
2 Inflation poised to remain low

Inflation stayed low in the absence of tensions on production capabilities and on develop countries' labor markets, despite robust growth. Upward pressure on oil prices as a result of stronger demand should not change the scenario in the short-term and long-term interest rates are therefore set to remain low in 2018.

3 Geopolitical cards to be reshuffled



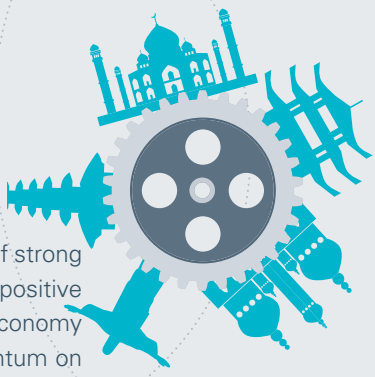
With the US renegotiating NAFTA and withdrawing from the Trans-Pacific Partnership, the country seems to be bowing off the international stage. This is a threat for momentum worldwide as American behavior could have repercussions in other areas across the world, but it also provides an opportunity for Europe to play a greater role and even bolster its potential growth at a time when political risk has declined.



4 Brexit impact set to materialize

The United Kingdom's Brexit negotiation strategy has been weakened by the united front presented by the remaining EU 27 and by their chief negotiator Michel Barnier's unwavering stance. The UK will have to abide by Brussels' rules without being able to have a say in them if it wants to keep access to the single market, but this position would be unsustainable for the country. An agreement must be reached swiftly in the interests of countries across Europe, as failure to draft a trade framework would be bad news for a number of sectors.

5 Emerging markets will remain buoyant



Emerging market growth is set to remain robust against a backdrop of strong demand from developed countries, rising commodities prices and a positive outlook on US rate hikes. The risk of a hard landing for the Chinese economy has been ruled out and this is a key factor in understanding momentum on emerging markets.

6 Renewed volatility on the equity markets

Volatility is set to stage a comeback on the equity markets, after they hit fresh highs in 2017, especially in the US. The situation is looking more favorable in Europe as the catch-up in growth should fuel corporate earnings and thereby underpin the markets. M&A moves are poised to gather speed during this catch-up period and this should also drive performances.

Philippe Waechter
Chief Economist

"A **tricky year** for central banks"

All lights are on go. The acceleration in world trade since the start of 2017 has buoyed economic growth and triggered a "virtuous" circle. In developed and emerging markets, business leaders now have a positive outlook on their environment and this stance is set to lead to more jobs and investment. Households are confident and the risk of deflation has been averted. The macroeconomic situation has recovered a more normal framework for growth, and meanwhile further support is provided by more relaxed fiscal policies, or even expansionary policies in the US with Donald Trump's tax reform.

2018 may be the cycle peak but it will certainly be a turning point.

2018 may just follow on from 2017 with more of the same, yet one question remains: how will these expectations of very strong economic performances fit with ongoing monetary accommodation? Central banks have had a fundamental role in this growth recovery, but they are walking on eggshells: they must take on board this optimistic view of the economy but maintain an accommodative slant. Normalization is set to be very gradual, even in the US, although inflation seems to be a bit higher due to labor market showings. The ECB is poised to continue with its very accommodative strategy in 2018.

We also need to keep an eye on a number of other risks. In Europe, Brexit will not only hit the UK economy, but also some business sectors in Europe, such as aviation, banking and automotive, so an agreement is vital before end-March 2019, although the UK is going to have to agree to EU rules without being able to negotiate them. Meanwhile in the US, the review of banking regulation is worrying after more stringent rules had reined in the financial system, and negotiations on NAFTA are more of a concern as changes to the agreement would be bad news for the three member countries with the ensuing decline in trade and failure to bring jobs back from Mexico to the US, despite Donald Trump's claims. Could this be a taste of things to come, with the renegotiation of other free trade agreements threatening the world momentum at the very heart of today's renewed growth momentum?

2018 may be the cycle peak but it will certainly be a turning point, and in Europe it must be the starting point for a new age. Leaders in the euro area must take the opportunity of a sturdy economic backdrop and a decline in populism to take their economic policy and reform of institutions a step further and bolster European growth potential.

KEY FIGURES

GROWTH

	2017	2018*
USA	2.2%	2.3%
EURO AREA	2.3%	2.1%
UK	1.4%	0.9%
CHINA	6.7%	6.5%

INFLATION

	2017	2018*
USA	1.6%	1.9%
EURO AREA	1.4%	1.4%
UK	2.7%	2.4%
CHINA	1.6%	2%

10-YEAR INTEREST RATES

	2017	2018*
USA	2.3 to 2.6%	2.5 to 3%
EURO AREA	0.3 to 0.7%	0.6 to 1%
UK	1.3 to 1.5%	1.4 to 1.7%

*Estimations 2018 / Source: Natixis Asset Management

Ibrahima Kobar
Deputy Chief Executive Officer and
Co-Chief Investment Officer
in charge of Fixed Income

"Dare **to dare** in 2018!"

Bond funds will offer attractive opportunities for the most daring investors in 2018. We are embarking on a positive period for bonds, with a virtually "virtuous" circle as monetary policies are well defined and the interest rate trend ahead is clear. On the one hand in Europe, the European Central Bank's policy has been plainly outlined, with a fresh reduction in asset purchases from January onwards, reinvestment of redemptions and no rate hikes until 2019 at the earliest. On the other hand in the US, the Fed will be led by Jay Powell, a pragmatic leader who will follow in Janet Yellen's footsteps, and policy is set to remain very cautious in the face of persistently low inflation, with three rate hikes announced (we expect two) and solid steering of balance sheet reduction. Political risks seen at the start of 2017 are now far off, particularly in Europe, and while external shocks cannot be ruled out (terrorism, oil shock, North Korea), the markets now know how to price them in. Meanwhile, world growth is robust and inflation is set to remain low in the long term: we are now witnessing the age of the New Economy, which is pushing prices down. Lastly, the distortion in bond valuations is poised to ease as a result of a reduction in the ECB's asset purchase program.

Against this backdrop, 2018 is set to be a good year for bond holders and investors, with issues largely oversubscribed due to the shortage of securities. In a context of ongoing broadly negative real rates, it is still key to look for yield and so investors must be daring. They must dare to look to sovereign debt in peripheral markets in Europe, but especially in emerging countries, which have managed to fight off inflation and get back on the path to growth, so they should harbor attractive opportunities unless there is a shock on US rates and the dollar. And they should dare to look to High Yield, which provides returns despite narrow spreads, especially for well-informed investors with sufficiently solid credit research to be selective. Investors should also dare to look to convertible bonds, which lock in yield in a positive context on the equity markets. Lastly, it will be vital to skilfully manage duration, the historical aspect of performance, via products that combine short- and long-term securities in order to adapt to all circumstances.

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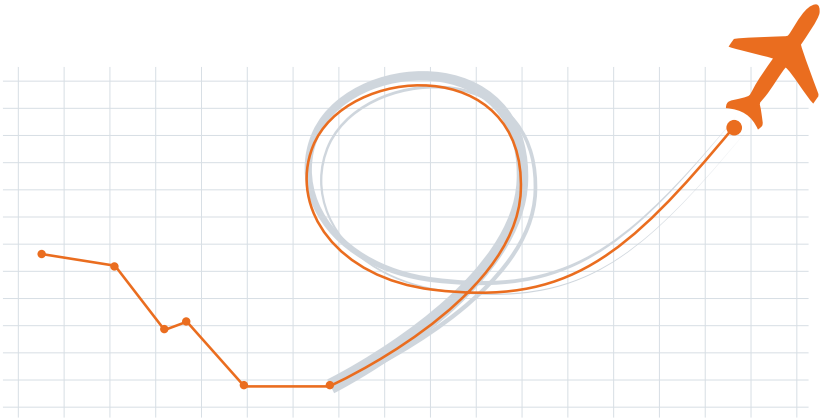


Yves Maillot
Head of European equities

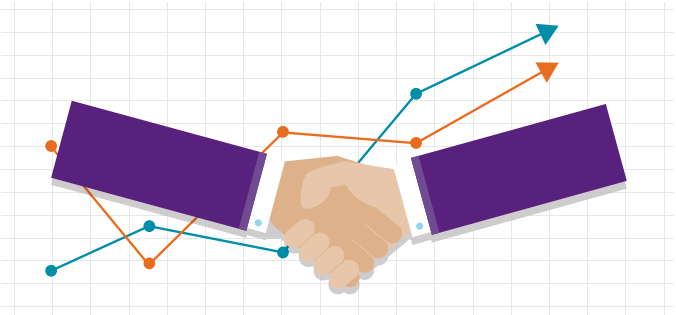
"M&A set to offer some **attractive opportunities**"

Momentum and flexibility will be the watchwords on the equity markets in 2018, after cyclical stocks provided the best performances in Europe and the US in 2017, particularly technological and industrial companies (transport, materials and commodities). The markets favored neither value nor growth stocks, so investors went after momentum, focusing on sectors where the earnings growth outlook was the most robust.

The backdrop for the equity markets is now almost perfect: robust and synchronized growth, recovering world trade, and continued structurally absent inflation. This scenario even triggered an upgrade to initial earnings projections in Europe for the first time since the 2008 financial crisis. This situation is set to linger over the months ahead, but will be hampered by uncertainties fueled by the normalization of monetary policy. The ECB's path is clearly laid out, but the Fed's future actions are much less so. Other factors may also disrupt: fluctuations in exchange rates or a likely return to volatility, traditionally 18 months after the first hike to US rates. And lastly, we must not overlook political risk from Brexit, difficulties in the euro area and the US.

Momentum will be the leitmotiv on the European markets in 2018 more than ever.

Momentum will be the leitmotiv on the European markets in 2018 more than ever, but a stock-picking approach must remain flexible. We also have a focus on M&A as the pace is poised to pick up in Europe, particularly in the food & beverages sector, healthcare & pharmaceuticals, telecoms and technology. Small and mid caps should continue to perform well. Meanwhile, emerging markets will harbor attractive opportunities as they benefit from strong growth, prospects for an improvement in earnings and attractive valuations, with a 25% discount to developed markets. Emerging Asian markets are the most attractive in our view, but just as in developed countries, flexibility will be needed in light of persistent risks: the 2017 winning trio may not last (weaker dollar, rising commodities prices and improvement in earnings growth), while risks on Latin America still remain.



Franck Nicolas
Head of Investment
& Client Solutions

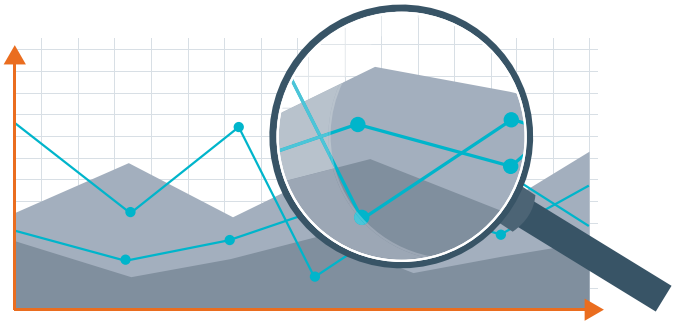
“Stay **alert**”

Investors will need to be alert and adaptable in 2018. The combination of robust economic growth worldwide, low inflation and monetary accommodation in developed economies will promote asset classes that carry the highest yield, particularly equities. However, this market context is fragile and it could all slide out of control. Investors have massive and broadly similar exposure, so the slightest disruption (a disappointing growth indicator, burgeoning inflation, a decline in the dollar or concerns on the Chinese financial system), or even just profit-taking for technical reasons could send them into a sell-off one after the other like lemmings and push the markets into a downward spiral.

We must be careful not to see this coming year as linear and the challenge will be to build up a portfolio with attractive yield while remaining flexible and adaptable to react quickly to any changes. Against this backdrop, we have a preference for Europe and emergings over equities. The day of reckoning has come in the US, with the end to the infatuation with Donald Trump’s politics and disappointing growth projections. We have a reduce stance on US equities, which are pricey, while maintaining our buy stance on dollars. We have a preference for European equities, where growth arrived latest, monetary policy is the most accommodative, and valuations are still lagging, although the political risk premium is set to persist. In the old world, we prefer debt with strong spreads, particularly High Yield which carries an attractive premium in the absence of interest rate risk.

Another key theme in 2018 will be emergings, which are buoyed by high commodities prices.

Another key theme in 2018 will be emergings, which are buoyed by high commodities prices. We will steer clear of Latin America (Mexico is hit by US policies and Brazil suffers internal strife) but focus on emerging Asia and Eastern Europe, particularly Russia. The priority on these markets will be hard currency debt, while emerging currencies remain risky. However, we will have to pay close attention to the Fed’s stance if we are to avoid a similar scenario to 2013, when the announcement of tapering triggered massive capital outflows on emerging markets. Lastly, gold has admittedly lost its appeal but will remain a safe haven in the event of volatility on the equity markets.



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