

PERSPECTIVES

By **Esty Dwek**, Head of Global Market Strategy, Dynamic Solutions

OCTOBER 2019

Cautious optimism

IN SHORT

- **Tentative optimism on trade and central bank easing** was relatively short-lived, but we could see further encouraging geopolitical steps for investor sentiment in the coming months. We therefore maintain a constructive view on risk assets.
- **Bond yields are likely to drift higher** as markets digest less easing from the Federal Reserve and hope for better global geopolitical developments. We still do not expect a sharp move.
- **Global growth is still not pointing towards recession**, as the US, China and others hold up. Germany, on the other hand, is likely to need more than low rates to boost growth.

OVERVIEW

September brought cautious optimism to markets, with yields backing up and value sectors rallying, as tentative signs of trade truce and expectations for additional monetary support by the Federal Reserve and the European Central Bank buoyed risk appetite. In part though, this was also a reversal of some of the extreme yield moves we witnessed in August. Nonetheless, the momentum was rather short-lived and both moves have stalled. So where do we go from here?

Economic data has been disappointing in recent weeks, but, in our view, it is still not pointing to a US or global recession. The US consumer is still solid, as is the labour market, and housing is showing signs of improvement on lower interest rates. Chinese data has held up, barring some expected trade-related weakness, and policymakers have started targeted stimulus measures. That said, Europe remains a weak spot and Germany is likely to show a second consecutive quarter of negative growth when Q3 data is released. Overall though, while risks abound – trade, Brexit, Middle East tensions, fragile sentiment – we do not see an imminent recession.

Sovereign yields have retreated from this summer's lows, though their climb ended following the attack on Saudi oil production. We expect yields to remain within a broad range, and do not expect a sharp back-up given still soft growth and low inflation expectations. Credit spreads have held in well, and we maintain our preference over sovereigns.

The rotation from growth into value lasted only as yields rose. Following a number of similar false starts, we believe that a pick-up in inflation, and therefore rates, is needed for a more durable move. For now, we believe that growth and more defensive sectors will continue to outperform, as investor caution prevails late in the cycle. The same applies to regions: upside potential in Europe is higher than in the US, if obstacles are cleared, but we believe that higher growth and earnings will continue to support US markets over the medium term.

Geopolitical uncertainties are likely to continue to drive headlines and asset performance. We still do not expect a sweeping agreement between the US in China in the short term, but a series of mini-deals starting in October are likely. The Brexit saga could end with a deal before the 31 October deadline, if enough tweaks to Mrs May's Withdrawal Agreement are done, but the more likely scenario is a further extension with general elections in November – which is likely to yield the status quo. From a growth perspective, German fiscal stimulus is needed, and while we believe it will arrive, it might take some time. The latest Trump development with the Democrats starting impeachment proceedings could however throw a wrench into these assumptions, but for now we maintain our positioning.

ASSET CLASS DETAILS

Equities

The risk-on move at the beginning of September showed that equity markets are more focused on (positive) trade developments and central bank support than on growth concerns. We believe that equities can continue to grind higher in the coming months and we maintain an overweight to the asset class, especially as some encouraging developments on trade could help. Nonetheless, volatility and quick reversals in risk appetite are unlikely to disappear.

The recent sector pivot showed that undervalued sectors can benefit in a higher rates environment, but we do not see this as a sustainable scenario for now. As such, we believe that more defensive sectors will continue to do well, even if they underperform over short periods, as investor caution persists. We prefer developed markets over emerging markets that remain more vulnerable to trade tensions. We expect US markets to perform better over the medium term, but European markets could benefit from ECB support and any hint of a German fiscal stimulus package or Brexit deal.

Valuations are not cheap, but they remain more attractive than in fixed income. Nonetheless, we believe that some earnings growth will be needed as we enter the Q3 earnings season. Expectations have been downcast, lowering the bar for positive surprises.

Fixed Income

We believe that sovereign yields are likely to trade in a broad range around current levels, and could even drift somewhat higher again in the next few months on better trade news, higher inflation, or markets adjusting to reduced expectations for Fed easing.

We remain below fair value levels, with US 10-year yields trading around 1.7% and German Bunds around -0.6% but, with ongoing central bank support and little inflation pressures, we do not expect a sharp move upward. Indeed, US impeachment proceedings could even push yields lower in the short term.

Credit spreads have held in relatively well in recent weeks, and should remain contained even if sovereign yields drift higher. High yield has proved more resilient than investment grade in the US, while European IG has been stable as well. We remain more comfortable with the IG segment given ongoing growth concerns, though we see no systemic risk on lower ratings for now.

Emerging market debt has held up well given idiosyncratic events. Yield-providing hard currency bonds should remain in demand as long as the US dollar doesn't strengthen too much.

We maintain a preference for US over European sovereigns, and for credit over all sovereigns given valuations and carry.

Currencies

Currency markets have remained broadly stable, with some weakness in EUR following the broad ECB package and poor German data, and some improvement in GBP on expectations that a no-deal Brexit is less likely. The US dollar has maintained underlying support from safe haven demand, as have JPY and CHF. The Yuan has remained in a range around 7, falling below as risk appetite and trade tensions improve, and reversing course as easily. Emerging market currencies have held up relatively well, but idiosyncratic risks remain.

Commodities

The recent attack on Saudi production sparked a rally in oil prices that faded once officials confirmed that production would be back to full capacity quickly. We believe that a slightly higher risk premium is likely to remain as security concerns persist, but believe that ample supply and slower growth are likely to keep prices capped.

Gold continues to see safe haven demand thanks to low rates and inflation. With ongoing growth fears and trade uncertainty, the momentum is likely to continue in the short term.

Alternatives

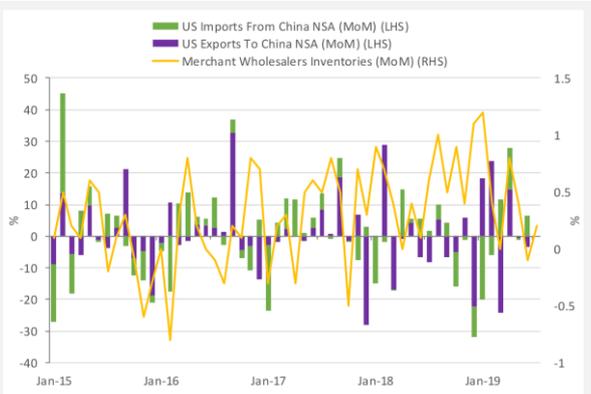
We continue to see a place for alternatives in portfolios, as we look for de-correlating and diversifying strategies to complement traditional asset classes, particularly with liquid alternatives.

INSIGHT – Assessing geopolitical scenarios

We hold a relatively constructive view on markets, expecting risk assets to grind higher in the coming months. We also believe that sovereign yields might drift higher, though they will not back-up sharply given low inflation and ongoing central bank easing. But this view implies a number of assumptions on major geopolitical uncertainties and how they could play out. Here are our views on these scenarios.

Trump & Trade

Global trade tensions, initiated by President Trump and the US, have been the biggest source of uncertainty for markets in the past year. And while we have seen many reversals, our base case has not changed much. We continue to believe that a sweeping trade agreement is unlikely before 2020.



Source Bloomberg, Dynamic Solutions, 26 September 2019

Being ‘tough on China’ has worked well for President Trump, and being able to announce a big win during his re-election year would be welcome, implying little incentive for a deal in the short term. Since the May, and mainly the August re-escalations, we became even more cautious on this expectation, as both sides have grown further apart, making a far-reaching agreement more difficult. Indeed, intellectual property and technology development are difficult topics to agree on. As such, we have been expecting a series of mini-deals to cover easier ground, starting with an October agreement of more agricultural purchases in exchange for easing of Huawei-related export bans. These mini-deals should also lead to a reduction in tariffs – or at least a further postponement of pending tariffs.

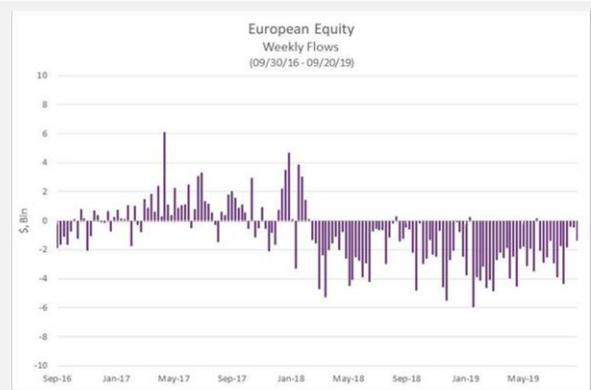
Recent impeachment proceedings could however impact this view, as Mr. Trump may want to deliver a win amid these tensions. President Xi could also think his hand has strengthened and it is worth getting a bigger agreement now. In addition, Mr. Trump needs to avoid a US recession in the coming 12 months, and will therefore navigate trade more carefully, finding ways to ease the tariff burden without looking like he is making too many concessions.

Elsewhere, other countries have been waiting to see if the US President would turn his trade ire on them. Japan seems to have escape for now, though it is embroiled in a trade dispute with South Korea. But the bigger trade question lingers over Europe, which is already facing a significant slowdown due to slower global trade and demand. Our view is that Mr. Trump would only start a bigger trade dispute broader than the Boeing/Airbus case once his dispute with China concludes. However, he could also want to distract from impeachment proceedings with a new focus on European trade.

From an investment perspective, we remain optimistic that growth concerns on the US and domestic political issues mean that a further escalation is unlikely, and that smaller agreements are likely in the coming months.

Brexit

Over three years have passed since the UK voted to leave the European Union, and the Brexit saga still has no end in sight. We see four possible scenarios ahead. The risk of a no-deal Brexit on 31 October rose following Mr. Johnson’s nomination as Prime Minister, but we still see this as only a remote possibility (15%). Indeed, Parliament has made it clear it wants to avoid such a scenario, and has taken steps to force Mr. Johnson to ask for an extension. With the proroguing of Parliament deemed unlawful, MPs are back and they will ensure their law is airtight. Moreover, while some EU leaders are growing impatient with the Brexit stagnation, we do not believe any will want to singlehandedly force a no-deal scenario.



Source Facset, Dynamic Solutions, 26 September 2019

We have long held the view that a version of Mrs. May’s Withdrawal Agreement could still get approved, delivering a soft Brexit (20%). This seemed less likely over the summer, but this may now be Mr. Johnson’s best chance of delivering Brexit by his October deadline. While there has been little progress, we believe that some tweaks to the Irish backstop, possibly changing the language to resemble the accompanying letter, could be enough to

INSIGHT – Assessing geopolitical scenarios

get Parliament’s (reluctant) approval. To many, a soft Brexit is better than no Brexit at all – a ‘risk’ if the UK holds a new referendum.

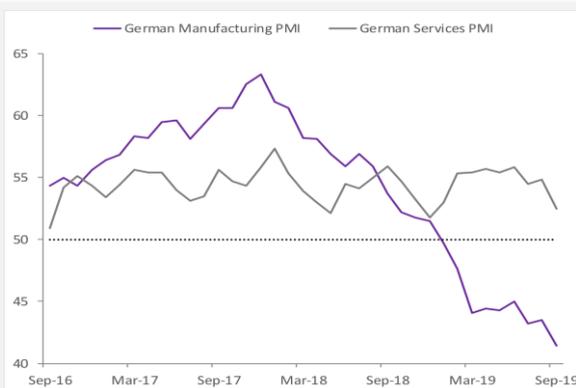
So how likely is a second referendum? A number of parties have stated their willingness to ask the people again, including Mr. Corbyn, the Labour leader. As such, if Labour wins (unlikely) or if we do not get a majority at the next general elections, this might be the next step (25%). In such a scenario, the possibility of no Brexit at all rises.

But our view is that Mr. Johnson will be forced into a new extension, thereby setting up new elections in November. He will win a majority, albeit small, and remain constrained by Parliament, thereby prolonging the saga further. Indeed, Parliament will continue to ensure he cannot have a no-deal exit in January, either forcing him into new negotiations with the EU or asking for more extensions. As such, status quo is likely to persist for some time yet (40%).

In this context, we believe that sterling should remain range-bound, with upside potential should an agreement get done in October. European assets would also be lifted by the removal of a great uncertainty, though other obstacles remain.

German fiscal stimulus

While we do not expect a US or global recession for some time, the same cannot be said with as much conviction about Europe, given its largest economy is likely already in recession. Indeed, we expect Q3 data to show that Germany has had another quarter of negative growth. With these expectations, hope has grown that Germany would finally relax its purse strings and provide some much-needed fiscal stimulus to its ailing economy.



Source Bloomberg, Dynamic Solutions, 26 September 2019

However, the answer is not so simple, as German policymakers locked themselves into fiscal discipline following the global financial crisis. As such, fiscal easing is only possible if there is an “emergency”. There are a number of ways they can get around this, by announcing an emergency (but two quarters of mildly negative growth

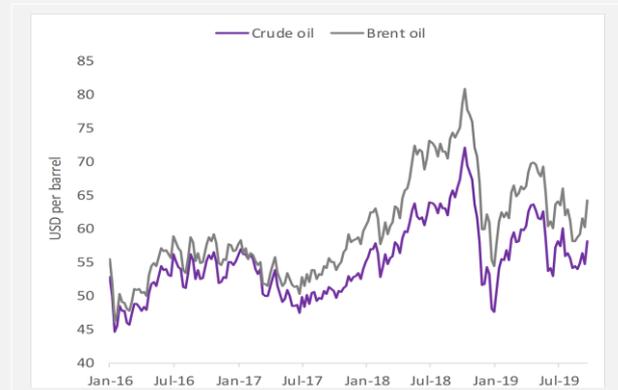
might not qualify), they can add to infrastructure projects and they can expand their climate initiative. The latter was started in September with a ten year spending plan, though the size was below expectations and the initiative is meant to be deficit neutral. But it was a first step.

Pressure has come from the European Central Bank, and is likely to increase with Mrs. Lagarde’s arrival in November, and other European countries have shown more inclination towards fiscal leniency to boost a fragile European economy. As such we believe that some stimulus will materialize, but it will take some time.

Any expectations or serious possibility for German spending is likely to halt the fall in Bund yields, thereby lifting yields globally. In addition, European equities should see more demand, though good news on Brexit might be needed as well.

Middle East tensions and Oil

When wrote about oil over the summer, growth concerns were the main driver of prices, as simmering Middle East tensions and OPEC+ production cuts had failed to support prices. However, with the recent attack on Saudi’s largest production facility, oil prices have climbed. The news that production would be back online quickly capped the initial spike, but we expect oil prices to embed a higher risk premium going forward, implying they will settle higher than over the summer as production security concerns persist.



Source Bloomberg, Dynamic Solutions, 26 September 2019

In terms of the geopolitical risks in the region, we could see an escalation of such actions, as we have seen little repercussions from the US or Saudi Arabia, which could embolden Iran and its war-by-proxy. We still not expect military conflict or on-the-ground US action, as actions are likely to remain non-civilian.

US domestic politics

While we try not to speculate on politics, we must still mention Mr. Trump’s possible impeachment in light of

INSIGHT – Assessing geopolitical scenarios

the latest US political developments. The Democrat-controlled House has started the proceedings, and while it may pass this vote, it appears unlikely that enough Republican will support this measure in the Republican-controlled Senate. Nonetheless, this could be a lengthy process and a distraction.

Mr. Trump could ease pressure on Beijing to announce a deal sooner than anticipated. Or he could toughen his stance on trade and even announce tariffs on Europe – on automobile, not just airlines, opening a new page in his trade wars.

In terms of global market impact, markets are likely to ignore proceedings unless it looks like some Republicans are turning on their President. Heightened uncertainty could lead to volatility, which should dissipate if Mr. Trump pulls through. We tend to agree; until we see conclusive moves against Mr. Trump from Republicans, we maintain our overweight allocations to equities.

Conclusion

Overall, we look at these situations with relative optimism, expecting some form of improvement or resolution, though the timing remains in question. As such, we maintain our constructive view on risk assets, believing that equity markets can continue to grind higher in the coming months. We still hold some core sovereign debt as protection, and we look for flexible, absolute return strategies to help navigate what promises to be a volatile and fast-evolving environment.

Equity securities are volatile and can decline significantly in response to broad market and economic conditions. **Fixed income securities** may carry one or more of the following risks: credit, interest rate (as interest rates rise bond prices usually fall), inflation and liquidity. **Currency exchange** rates between the US dollar and foreign currencies may cause the value of investments to decline. **Commodity-related investments**, including derivatives, may be affected by a number of factors including commodity prices, world events, import controls, and economic conditions and therefore may involve substantial risk of loss. **Alternative investments** involve unique risks that may be different from those associated with traditional investments, including illiquidity and the potential for amplified losses or gains. **All investing involves risk, including the risk of loss.** No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The views and opinions expressed may change based on market and other conditions. There can be no assurance that developments will transpire as may be forecasted in this material. This material may not be distributed, published, or reproduced, in whole or in part. Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information.

In the E.U. (outside of the UK and France): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. **Italy:** Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via San Clemente 1, 20122 Milan, Italy. **Germany:** Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. **Netherlands:** Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. **Sweden:** Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. **Spain:** Natixis Investment Managers, Sucursal en España. Serrano n°90, 6th Floor, 28006, Madrid, Spain. **In France:** Provided by Natixis Investment Managers International – a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. **In Switzerland:** Provided for information purposes only by Natixis Investment Managers, Switserland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich. **In the British Isles:** Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. When permitted, the distribution of this material is intended to be made to persons as described as follows: in the United Kingdom: this material is intended to be communicated to and/or directed at investment professionals and professional investors only; in Ireland: this material is intended to be communicated to and/or directed at professional investors only; in Guernsey: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; in Jersey: this material is intended to be communicated to and/or directed at professional investors only; **in the Isle of Man:** this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Isle of Man Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates. **In Japan:** Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo. In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2018 FSC SICE No. 024, Tel. +886 2 8789 2788. **In Singapore:** Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Ostrum Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 5 Shenton Way, #2205 UIC Building, Singapore 068808. **In Hong Kong:** Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only. In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only. **In New Zealand:** This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A. **In Uruguay:** Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. **In Colombia:** Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors. **In Mexico:** Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

In Canada: This material is provided by Natixis Investment Managers Canada LP., 145 King Street West, Suite 1500, Toronto, ON M5H 1J8 In the United States: Provided by Natixis Distribution, L.P., 888 Boylston Street, Boston, MA 02199. Natixis Distribution, L.P. is a limited purpose broker-dealer and the distributor of various registered investment companies for which advisory services are provided by affiliates of Natixis Investment Managers. This material should not be considered a solicitation to buy or an offer to sell any product or service to any person in any jurisdiction where such activity would be unlawful.