NATIXIS INVESTMENT MANAGERS

# PERSPECTIVES

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# Status quo enough for markets

## IN SHORT

- Central banks and trade headlines continue to be the main drivers of markets, with equities shrugging of uncertainty and advancing on status quo trade news and stimulus expectations. We expect this trend to continue, but decent earnings will also be needed.
- Global economic data are not pointing to recession, but rather towards trend levels, although manufacturing remains weak. Nonetheless, ongoing uncertainty could eventually hurt sentiment, adding to downside risks.
- Yields have stabilized, but are still pricing in an aggressive easing cycle. Markets might need to adjust, but a sharp back-up is unlikely given growth concerns. We prefer shorter durations but maintain some exposure to core positions as protection.

## OVERVIEW

The biggest market drivers remain trade and central banks. The dichotomy we have been witnessing with both equities and bonds rallying continues, as expectations for easing and growth concerns support fixed income, while supportive central banks and a welcome truce in trade tensions buoy equity markets.

We remain of the view that the rally in equities can continue, although decent earnings results will be needed to maintain momentum. Earnings growth expectations have come down sharply already, but the early days of the Q2 season has been mixed. We are more focused on guidance given the uncertain trade and growth outlook, which so far isn't pointing to a significant deceleration. Valuations are not cheap, especially in the US, but there is still a lot of cash on the sidelines. Indeed, flows are still absent, a welcome technical support.

The bond rally has faded somewhat and sovereign yields have stabilized. We believe that yields below 2% in US 10-year Treasuries are too low, pricing in too much easing from the Federal Reserve. Nonetheless, with an even more dovish European Central Bank readying itself for a rate cut in September and the possibility of further bond purchases pulling Bunds and other Europeans yields down, there is little risk of a sharp backup in yields in the coming months.

Global growth concerns persist, and have contributed to lower yields, but for now, we do not see data pointing towards a recession. Indeed, while manufacturing remains weak, and will likely continue to do so given ongoing trade disputes, service sectors are strong and consumers healthy, across major economies. Labour markets are also showing resilience, and the US housing market should benefit from lower rates.

Politics will remain in the spotlight. The US may have averted a fiscal cliff, but tensions between Italy and the European Union, as well as difficult Brexit negotiations under Boris Johnson, imply ongoing headlines. Investors may continue to shy away from European equities, which have not benefitted from expected ECB stimulus has much as bonds yet, but the threshold for upside surprises in Europe is low.

Geopolitical tensions in the Middle East are on the rise, with the Iran-US-Europe situation bringing underlying support to oil prices. We do not expect a military escalation, and Iran has struggled to close the Strait of Hormuz in the past, but energy prices are likely to remain supported in the short term, though a spike in prices appears unlikely given global growth concerns.

# ASSET CLASS DETAILS

## Equities

We expect equity markets to remain supported by the US-China trade truce and accommodative central banks. However, we believe that decent earnings growth will be necessary for the next leg up. We also look to corporate guidance for the rest of the year, which so far has not pointed to a sharp slowdown. At the same time, earnings expectations had been slashed already, leaving room for announcements to surprise on the upside. Political and geopolitical headlines are also likely to add volatility, whether in Europe with Brexit and Italy, or with US-China-Japan-Europe trade developments.

Valuations aren't cheap, especially in the US, and could cap the rally if earnings disappoint significantly. Nonetheless, we expect the US to outperform over the medium term, as stronger growth and earnings support performance. In Europe, valuations are more attractive, and a lot of bad news is already priced in. In addition, the ECB is back into easing mode, which should support markets. One hurdle remains the euro, which might have only limited room to depreciate from here given the renewed currency war. Emerging markets will go along for the ride, as long as Chinese growth stabilizes and the dollar does not strengthen too much.

## Fixed Income

The fixed income rally has slowed, with sovereign yields retreating and spreads widening somewhat in recent weeks. We believe that yields below 2% in US 10-year Treasuries implies too many interest rate cuts by the Fed, and too negative a growth outlook. At the same time, with the ECB set to be even more dovish than the Fed, Bund yields are likely to remain close to the deposit rate, dragging down bond yields everywhere. Negative yielding debt now tops USD13 trillion, and includes some European high yield bonds, a trend that is unlikely to reverse for some time. We believe a sharp backup in yields is unlikely given central bank support, muted inflation expectations and global growth concerns. We favour shorter durations but maintain some exposure to core assets as protection.

Credit spreads have stabilized, though high yield spreads even widened in recent weeks. We expect spreads to range-trade from here, unless a much more negative growth scenario materializes, with carry providing most of the performance going forward. The current environment remains supportive of emerging market debt, which still offers attractive carry and should remain in demand as long as we the US dollar remains stable.

## Currencies

Despite a dovish Federal Reserve, the US dollar isn't winning in the currency (depreciation) wars. Indeed, a new battle has started, where the Japanese Yen is the clear loser, as JPY remains supported by safe haven demand. The ECB looks to exceed the Fed's dovishness, ensuring the euro doesn't appreciate too much. As such, we expect broad range-trading across major currencies.

One exception is likely to be sterling, which remains under pressure given Brexit woes and a deal or no-deal exit Prime Minister. At current levels, downside is more limited, but it cannot be excluded during a difficult negotiation period. Emerging Market currencies should do well in the current environment, as long as risk appetite holds up and USD doesn't strengthen too much, but idiosyncratic risks remain.

## Commodities

Oil prices are balancing between worsening geopolitical tensions in the Middle East, and ongoing concerns about the global growth outlook. For now, growth concerns have prevented a spike in prices, but oil should still find some underlying support. Over the medium term, we expect shale production to keep prices capped.

Gold continues to see safe haven demand amid lower real rates, expectations for further rate cuts, and a stable USD. With ongoing growth fears and trade uncertainty, this trend can persist.

## Alternatives

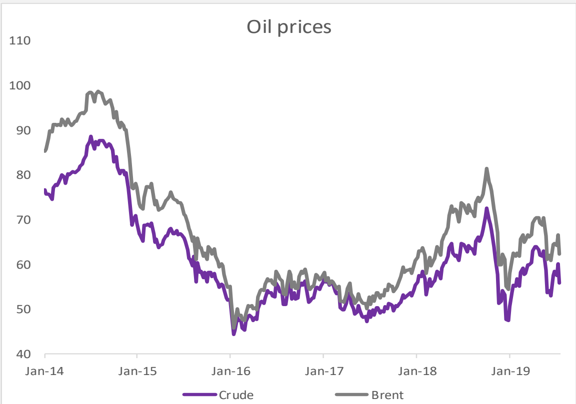
We continue to see a place for alternatives in portfolios, as we look for de-correlating and diversifying strategies to complement traditional asset classes, particularly with liquid alternatives.

# INSIGHT – Oil prices in a balancing act

## Geopolitical meddling

The rise in geopolitical tensions in the Middle East has brought oil prices back into headlines. The deterioration in relations between the US, Europe and Iran has led to growing incidents in the Gulf, bringing some underlying support to oil prices.

Indeed, in an attempt to pressure Europe into telling the US to remove the sanctions it put back in place after pulling out of the Geneva nuclear accord, Iran has been misbehaving. For now, Iran has stopped short of any human casualties. The same has been true of the US, which cancelled planned military strikes in retaliation for the downing of its drone at the eleventh hour. As long as the dispute remains confined to isolated incidents without casualties, we do not expect a military escalation.

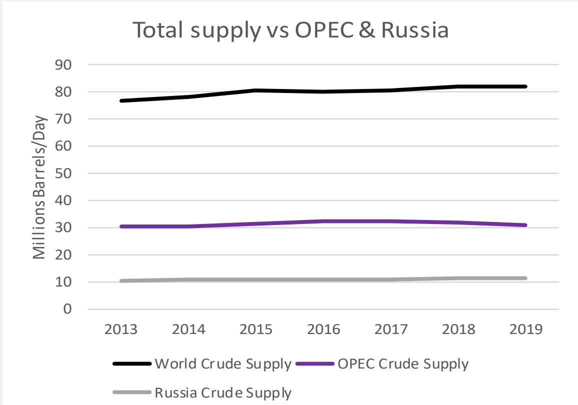



The Strait of Hormuz, which forms a chokepoint between the Persian Gulf and the Gulf of Oman, represents the world's most important energy waterway. Indeed, about a third of the world's liquefied natural gas and more than 20% of total global oil consumption (~21 million barrels per day) passes through the Strait. As such, any escalation in tensions could lead to severe supply disruptions, leading to a spike in prices. That being said, Iran has struggled to close the Strait in the past, but the fear of disruption is not negligible. This would nonetheless require a significant escalation.

## OPEC no longer dominates pricing

In an effort to underpin prices amid growth concerns, OPEC+ – which includes Russia – has agreed to production cuts, currently extended to March 2020, to attempt to balance supply and demand. OPEC consists of the world's major oil producers and about 37% of global oil production. Adding Russian production, they represent more than 50% of global oil production. As such, OPEC has historically managed the supply side to set prices around the USD70 per barrel they deemed appropriate.

The production cuts have helped to maintain oil prices in a context of decelerating global growth, though probably not to the extent OPEC+ would have liked – or been able to achieve in the past. Indeed, while OPEC was the ultimate decider of prices for many years, the rise of shale production has changed this.




OPEC is no longer the single largest oil price determinant, and the coming years are likely to change that dynamic even further. The rise in non-OPEC production is set to outpace OPEC production growth in the future, which is expected to gradually decline in the coming years.

## Shale, the game-changer

The arrival of shale oil production has revolutionized the energy industry. The fracking process, a technique designed to recover gas and oil from shale rock, has boosted the US and other's ability to produce their own oil. Indeed, the US currently produces as much oil as Saudi Arabia or Russia. This technique has been used broadly, where possible, in an effort to become less dependent on Middle East oil. Shale oil can be produced at lower extraction costs than traditional oil, though the breakeven price can vary greatly.

In a competition for market share and to challenge shale producers that have higher breakeven costs, Saudi Arabia has been happy to continue to produce near maximum levels, even at lower than breakeven prices. At the same time, shale producers need the revenues and have continued to produce at maximum capacity. This implies that supply has been ample, especially as demand has softened.

By 2021, the US is set to become a net oil exporter, which means the world's largest economy will no longer be energy dependent on the Middle East. The US will account for 70%

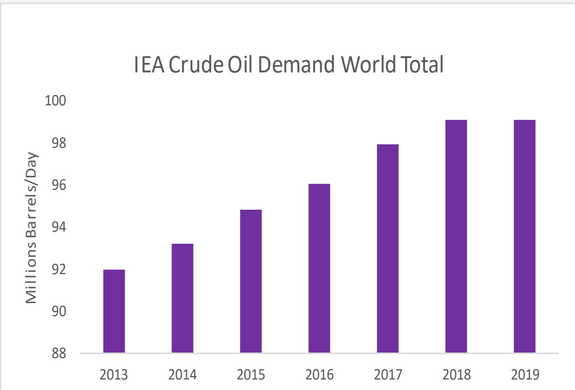
# INSIGHT – Oil prices in a balancing act

of the increase in global production capacity to 2024, adding a total of 4 million barrels per day. With Brazil production rising as well, non-OPEC production is set to rise in the coming year, while OPEC production is expected to fall slightly.

## Recession fears

Oil prices are intrinsically tied to global growth, and recent worries about the growth slowdown have outweighed rising geopolitical tensions with Iran. The impact of trade wars cannot be ignored, as there is a direct link with energy demand.

Oil demand is expected to grow only mildly in 2019, and again at a similar pace in 2020, meaning that demand growth is not increasing, but staying stagnant in a decelerating world. In addition, most of the increase in demand has come from China in recent years, which now consumes 13% of global oil production, but slower manufacturing and trade uncertainty could weigh even further on demand. At the same time, supply levels continue to grow, and Saudi Arabia has made up for the decreased production due to US sanctions on Iran. Moreover, inventory levels across the OECD have continued to grow, reducing pressure on prices as stocks are ample.




Overall, oil prices are likely to range-trade in the coming months, as these counterbalancing headlines pull and tug at prices.

## Changing dynamics

Over the medium term, demand from the emerging markets, as well as the changing structure of oil demand are likely to determine price action.

We are moving away from industrial and transportation uses to more consumer needs, such as petrochemicals, aka plastic, despite environmental concerns. As such, petrochemical demand is set to account for 30% of global oil demand growth.

**But the bigger driver will be emerging market growth, where the incremental demand change in energy can have the biggest impact.**

Indeed, China and India are expected to account for 44% of the expected growth in oil demand by 2024. The rest of Asia remains will also remain the largest source of demand, as economies catch up with the developed world. But demand from the developed world is likely to continue to fall. Whether these balance out will determine prices, but with growing supply from shale, prices shouldn’t skyrocket.

## Conclusion

For now, the tug-of-war between geopolitical tensions and growth concerns is being won by recession fears, capping prices despite worries about Iran. Nonetheless, we cannot exclude slightly higher prices in the short term, despite ample supply. Over the medium term however, we believe that changing demand dynamics, and especially growing supply from non-OPEC and shale producers is likely to act as a cap on prices.

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