NATIXIS INVESTMENT MANAGERS

PERSPECTIVES

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Geopolitical clouds start to clear

IN SHORT

- While some data misses continue, especially in manufacturing and in Europe, we believe that economic releases are pointing towards a stabilization in growth.
- Optimism is spreading that the worst may be behind us, thanks to improvements in the trade dispute between the US and China, and the hope of a Brexit deal. We remain constructive on risk assets.
- Sovereign yields are likely to continue their upward move on better geopolitical developments, though low growth and inflation should eventually act as a cap.

OVERVIEW

Recent improvements in geopolitical tensions carried into October to see optimism spread across regions and sectors. Indeed, the trade truce between the US and China continues, with encouraging news that a "phase one" deal is on track, to be potentially signed in mid-November at the APEC summit. While we have seen little substance to this mini-deal so far, we are hopeful that trade tensions will not escalate again, but rather gradually ease, with potential for further improvements in 2020. We continue to believe that President Trump needs to navigate the US growth environment carefully for his re-election campaign, which suggests he may not want to exacerbate the situation or increase tariffs again.

Brexit developments also moved in the right direction, as Boris Johnson negotiated a Withdrawal Agreement with the EU, and Parliament voted for it 'in principle'. Parliament then rejected an accelerated timeline but Labour has finally agreed to early elections where Johnson could win the majority to pass his deal without amendments or a second referendum attached. Uncertainty persists, but we may finally see the end of the saga before the new 31 January 2020 deadline.

Economic data releases remain mixed, with misses in Europe in particular, but we believe that growth appears to be stabilizing. Manufacturing surveys in the US appear to be rebounding, consumption remains solid and housing is pointing up. Chinese Q3 GDP came in just below expectations, but recent releases have rebounded as well, suggesting growth will stabilize around 6%, in part thanks to ongoing targeted stimulus. Germany is likely in a technical recession, and we may not have seen the bottom yet. Unfortunately, fiscal easing might be slow to materialise, even though we believe it is needed as the ECB alone will not be able to spur growth.

Equity markets reached new record highs in the US, and should continue to do well as geopolitical clouds clear and uncertainty gradually fades. While accommodative central banks will remain a support, we believe that decent earnings from the Q3 season – which we are seeing so far – will also be needed to bring fundamental support to the rally. With a trade truce and better news on Brexit, some optimism that we reaching the bottom in German growth could lead European assets to bounce in the coming months.

Sovereign yields continue to drift higher on improved investor sentiment, a trend we expect to continue into year-end if geopolitical tensions ease. However, with ongoing growth concerns, low inflation and central bank easing, a sharp back up remains relatively unlikely. Credit spreads have benefited as well, and we maintain our preference for corporates over sovereigns. As we move along in the cycle, we favour IG over HY debt. We still see attractive opportunities in emerging market credit.

ASSET CLASS DETAILS

Equities

Recent improvements in the US-China trade dispute have continued to support equity markets, as have expectations for another interest rate cut by the Federal Reserve. Economic data releases have showed ongoing weakness in some areas, notably Europe, but also potential for stabilization in the US and in China, easing fears of an imminent recession.

The Q3 earnings season kicked off with slashed expectations, and also a very high mark to beat given last year's stellar Q3 results. So far, earnings have beaten expectations, with results pointing to flat growth on a year-on-year basis. In our view, this is already an encouraging development given fears of an earnings 'recession'. Nonetheless, we look to forward guidance for signs of improvement into 2020, helped by potentially reduced uncertainty, and continue to believe that decent earnings will be needed to support the recent rally.

We maintain our constructive positioning, acknowledging that higher volatility is to be expected. We continue to favour developed markets over emerging markets, though the latter could do well if trade improvements last. We believe that European assets could benefit from an improved outlook on global trade and demand, implying a possible bottom in German growth in the coming months and better Brexit news. Somewhat higher yields should also help the more Value sectors in European indices, such as financials.

Fixed Income

Sovereign yields are likely to continue their upward move, as better trade news is helping to alleviate growth fears and unwind some of August's extreme yield moves. Nonetheless, given still weak growth, low inflation and ongoing central bank support, we do not expect an overly sharp move. Indeed, this has been accompanied by better investor sentiment and rising equity markets.

We maintain our preference for credit over sovereign debt, as sovereigns remain richly valued despite the recent move. US 10-year yields still sit around 1.83%, while 10-year German Bunds remain in negative territory, around -0.34%. Credit spreads have also benefitted from the recent improvement in risk appetite, tightening as sovereign yields have retreated. We believe that IG should hold in better than HY given we are still advanced in the cycle and growth concerns are unlikely to vanish in the short term, but we see no systemic risk on lower ratings for now.

Emerging market debt should continue to do well given improved trade prospects and a weaker USD, despite some idiosyncratic events. We maintain a preference for hard currency corporates that offer attractive carry with low volatility.

Currencies

Improved risk appetite, renewed expansion of the Fed's balance sheet and lower interest rate differentials have weighed on USD, a trend which is likely to continue, to some extent, in the coming months. The euro has benefited from improved trade developments and encouraging prospects on Brexit. Better growth expectations could also lift EUR, though this may take some time as data is still disappointing. GBP has benefited from the receding of no-deal Brexit fears, and an agreement would see it move higher still. Emerging market currencies should benefit from recent trade developments and a weaker USD, but idiosyncratic risks remain.

Commodities

Oil prices have advanced on better growth expectations and reduced trade worries. Recent Middle East developments are likely to suggest a somewhat higher risk premium as well. That being said, medium-term term supply is expected to remain ample thanks to shale production, capping prices.

Gold retreated as safe haven demand softened, and we believe we may have seen the top for now. Nonetheless, growth concerns and low rates and inflation should maintain some underlying support.

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. We believe that real assets can also help provide income in a low yielding world.

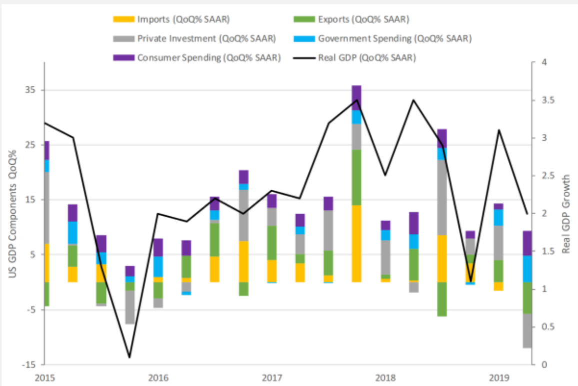
INSIGHT – Recession not imminent

Growth concerns and recession fears have weighed on sentiment for the past few quarters, but we still do not see a recession as imminent. Today, we believe that we are more likely to see stabilization or even possibly improvements in data, rather than ongoing deterioration. That being said, this relatively rosy picture does not apply across all regions and it relies on improving geopolitical developments. Moreover, plenty of risks remain.

US still solid

We do not believe that one could have a global recession without a US recession, and we find US growth still solid. Q3 data is likely to show growth below 2%, but we expect overall 2019 numbers to remain around 2%, in line with trend levels.

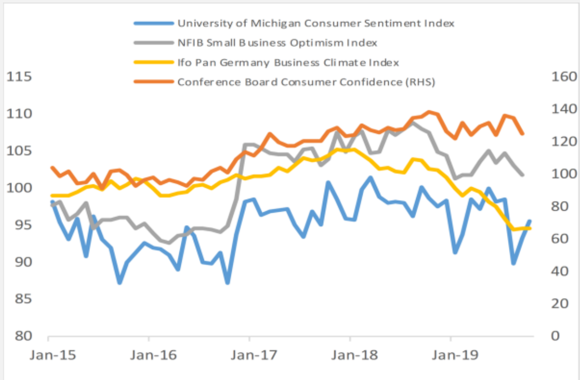
The US economy is domestically oriented, underscoring the importance of the US consumer. So far, US consumption data has remained buoyant, barring a weaker retail sales figure for September – though a drop following a difficult August and especially following many strong months should not be a surprise. We do not expect this to be the start of a weaker trend. Consumer confidence has also help up, though again some weakness given waning tax cuts effects was to be expected.



Source Bloomberg, Natixis IM Solutions, 28 October 2019

A resilient labour market and an uptick in the housing market are acting as added supports. While a slowdown in payrolls is to be expected as we advance in the cycle, employment data remains strong. In addition, jobless claims have not risen significantly, and job openings remain abundant. The housing market has shown signs of improvement thanks to lower interest rates. One more Federal Reserve cut this year should be an added boost. Existing home sales, new home sales, and housing starts have all started to tick upwards. Such improvements, have helped support confidence, thereby keeping underlying consumption solid.

Manufacturing has, as elsewhere, been the weak spot in US growth. With a fall in the Services PMIs last month, concern grew that the manufacturing slowdown could spill over into the rest of the US economy. This does not seem to be materializing, and the recent trade truce and possible further improvements in the trade dispute between the US and China should help alleviate these fears. The global environment remains weak, and will not recover immediately even if, as we expect, we see a "phase one" trade deal signed this month, followed by ongoing gradual improvement in 2020, though a grand deal could prove illusive. Nonetheless, hope is growing that the worst is behind us, as Mr. Trump needs to ensure US growth does not slow too much for his re-election campaign.



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In addition to still-solid hard data, a few thoughts to note. We believe the adage that cycles do not die of old age. Recessions do not happen because it's time for one. They typically occur when there is overheating in the economy, which is not the case today. Moreover, given very low interest rates, solvability is not a big concern – at least for now. Finally, with renewed Fed easing, reduced interest rate differentials, less demand for safe havens, the US dollar may no longer appreciate. It might in fact continue its recent weaker trend, another support for the US economy.

Overall, we expect growth to remain close to trend levels, and we could see some improvements in the coming quarters if trade continues to improve. Nonetheless, risks have not all dissipated: weakness elsewhere could still weigh on US growth, and worries could grow about a Warren presidency, maintaining uncertainty and limiting business investment.

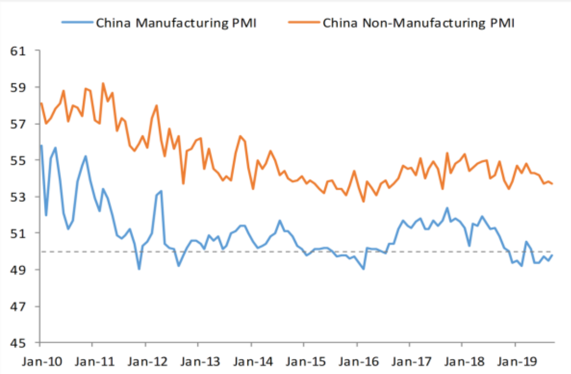
China turning a corner?

The Chinese economy is also showing signs of stabilization, and even potentially a rebound. Leading indicators such as money supply growth and credit growth appear to be rebounding, and PMIs are also

INSIGHT – Recession not imminent

showing encouraging signs of bottoming. Indeed, policymakers' ongoing targeted stimulus seems to be bearing fruit, and should have a lasting effect.

Improvements in the trade dispute with the US are also a big boost for growth prospects, helping to alleviate pressure on the manufacturing sector and lifting global demand. While China has navigated the dispute relatively well, the economy has not remained unscathed. As such, President Xi has shown willingness to move forward with gradual agreements, in order to prevent further tariffs and hopefully lead to their removal over time.



Source Bloomberg, Natixis IM Solutions, 28 October 2019

Nonetheless, China remains in a structural slowdown, albeit managed, and we expect growth to stabilize around 6% before gradually decelerating the coming years. Encouragingly, we believe that China has done a painful, but successful rebalancing of their economy, which has allowed them to be less dependent on exports.

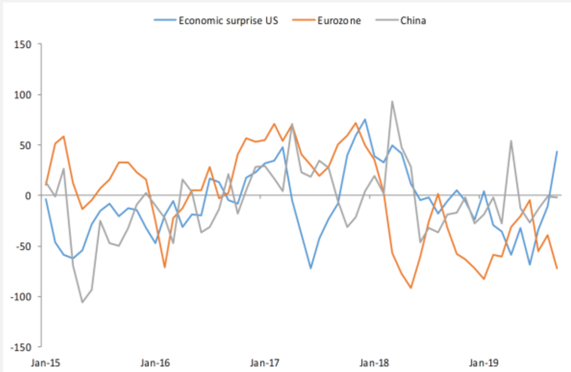
Elsewhere in the emerging markets, we are also seeing improvements as PMIs have started to recover. EM central banks were quick to cut interest rates as the Fed eased, reducing risk on their currencies and supporting growth. We are seeing on fiscal reforms, and a weaker USD should act as an added boost. As such, we are now seeing improvement in the global PMI.

Europe needs fiscal support

The Eurozone, and Germany in particular, remain the weak spots in the global economy. Given ongoing week PMIs, we believe that we have not yet seen the bottom in German growth – even as we expect Q3 data to show Europe's largest economy is already in a technical recession. Indeed, the export-oriented economy is suffering the consequences of trade woes and weak external demand. Fears of contagion to other areas of the German economy and other European countries have risen, with reason, as other data has started to suffer. If we see improvements in global trade, Q4 could prove to be an inflexion point, but we do not expect a rebound, rather just less deterioration.

The European Central Bank has pledged renewed support and a new QE program without and end date (expected by markets to last a few years), but we do not believe this will suffice to spur European growth. Fiscal stimulus will be needed to boost the Old Continent, but it may be slow to come. Unless there is an "emergency", Germany cannot break its budget rules – and we believe it may take further poor data before policymakers feel their economy has reached that point. As such, it may still be a while before significant help comes. Still, very low debt servicing costs should allow for some 'fiscal space' in many European economies, bringing some support, though not, in our view, on the scale necessary.

Good news could, finally, come from clarity on Brexit. The UK and EU have come to a Withdrawal Agreement, which was agreed 'in principle' by the UK Parliament, though an accelerated timetable was then rejected. Europe has agreed to a three-month extension of the Brexit deadline to January 2020, eliminating the no-deal risk for now, and Mr. Johnson managed to get early general elections. As such, we could move forward with the current Brexit deal, and, after three and a half years, have closure on this chapter. This is by no means certain, but Brexit fatigue has everyone ready for a conclusion, and many 'hard Brexiteers' would prefer a softer deal rather no Brexit at all, increasing Mr. Johnson's chances of getting his deal through.



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Risks

We have a relatively optimistic view of the global economy, believing that recent developments point to stabilization or improvement rather than a further slowdown. That being said, risks remain, and we are not yet out of the woods from this year's slowdown in global growth.

INSIGHT – Recession not imminent

Both Mr. Trump and the UK Parliament have proven unpredictable and while we are hopeful that we have seen the worst already, further reversals cannot be excluded. In addition, the domestic political picture in the US has become more complicated with the impeachment proceedings. If improvements do materialize, we will need to keep an eye on inflation, which could start to tick up in 2020, potentially limiting the Fed's ability to remain accommodative. Earnings results have been decent so far for 2019. In our view, this earnings season need to be looked at in the context of stellar Q3 2018 results and slashed expectations. Nonetheless, we believe that markets will need some indication of ongoing earnings growth to maintain confidence, indication that forward guidance will be ever more key. In addition, profit margins are already squeezed, and could impact the corporate outlook. Finally, as the prospects of a Warren candidacy grow, fears over regulation and anti-business decisions could grow as well.

Conclusion

We believe that the gradual clearing of geopolitical clouds will be a welcome and needed boost for the global economy. Removing some of the bigger uncertainties will help support investment, hiring, spending and overall sentiment. Improvements in the US-China trade dispute are a great first step, and world trade picked up month-on-month already as a result, as would be a Brexit deal.

Central bankers are keen to extend the cycle as much as possible, and to avoid a sharp slowdown, implying ongoing support as needed by their respective economies. As already mentioned, we do not believe that monetary policy will be sufficient, especially in Europe, where fiscal easing is needed. Mrs. Lagarde is likely to increase pressure on European governments even further.

Overall, we do not see data pointing towards an imminent US or global recession. We believe that growth is likely to stabilize around current trend levels, and could even recover in 2020 if geopolitical developments remain supportive. Risks remain though, and a renewed deterioration could easily unfold, but that is not our base case scenario.

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