NATIXIS ASSET MANAGEMENT

ALLOCATION PERSPECTIVE

Document intended for professional clients

Fiscal tantrum(p)

February 2018

- US authorities' move to massive fiscal stimulus against backdrop of full employment points to dangerous overheating for the US economy in 2018.

- Complacent reaction from the Fed: faced with the prospects of an investment boom from tax incentives and deregulation, the right response would be to tighten monetary policy, yet Powell sought to reassure the markets on the continuation of the Fed put after the stockmarket correction at the start of the month. A real appreciation of the dollar will therefore take place through a rise in inflation

- More severe reaction on the markets: jump in the dollar on a weaker forward curve (weaker dollar, higher rates). The depreciation in the dollar's long-term equilibrium value penalizes a deterioration in the country's external solvency.

- Unlike previous dollar downcycles, the greenback's slide is not halted by intervention from emerging central banks, who are concerned about protectionist retaliation from the Trump administration on the back of claims of currency manipulation.

- Without a strong stance from the Fed or a stabilization agreement from the G7/G20, the dollar's decline triggers a dangerous steepening in the US yield curve. In addition to a spiraling budget, steepening is worsened by the prospects of the sale of part of US multinationals' bond portfolios currently held abroad.

- This steepening is not compatible with an extension in the world growth cycle. US rates close to 3% are dangerous for asset valuations (equities, real estate) which are the basis for wealth effects. The rise in US 5-10 year rates and expected eurodollar liquidity rarity act as powerful monetary tightening factors.

- We therefore continue to cut back risk in our portfolios by going neutral on equities. We continue to underweight bonds and take positions on gold as a hedge against the risk of a temporary stagflation scenario in the US.

Raphaël Gallardo
Multi-asset strategist
Investment and Client Solutions

Tactical views

GLOBAL	--	-	=	+	++
Equities			○	●	
Fixed income	○	●			
Money Market		●		○	
EQUITIES	**--**	**-**	**=**	**+**	**++**
US		○	●		
Europe				○●	
Japan				○●	
Asia ex Jap			●○		
EM		○		●	
FIXED INCOME	**--**	**-**	**=**	**+**	**++**
Sovereign	○	●			
Euro IG		○	●		
Euro HY			○	●	
EM Debt			○	●	

○ : monthly views
● : views of the previous month

Editorial: Of barrels and bubbles

Oil soared on the back of speculation towards $70 fuelled by the prevailing euphoria at the start of the year. This speculative zeal played an active role in the financial markets' fervor, as pricey oil drives up the stockmarket value for the energy sector, which accounts for a hefty proportion of many indexes, while high oil prices often go hand-in-hand with a weak dollar, which drives the markets' risk appetite. February's stockmarket correction pushed oil down 10%, but we think that Brent's fundamental value stands at around $50 in a scenario of continued risk appetite worldwide, and more towards $40 in a cyclical slowdown scenario in 2019.

Bullish speculation stepped up a gear when OPEC highlighted the rebalancing of world stocks towards their 5-year average. The oil curve and the divergence in OECD stocks away from their 5-year average are closely connected. A 5-year average made sense when it took several years for marginal wells to start production, but now that marginal wells involve horizontal drilling in the Permian basin, which are operational in the space of just a few months, the supply adjustment time is sub-annual, no longer multi-annual. It is precisely because of this fresh supply elasticity that stocks (61 days) have not normalized towards pre-crisis levels (53 days) since the economic recovery in 2009. The gap has closed between stocks and their 5-year moving average because the level of stocks has still not adjusted three years after the 2015 excess production crisis and the moving average is quite simply converging towards current stocks due to the mere passage of time, and this illustrates the failure of OPEC's price strategy.

Looking beyond the stockmarket correction in early February, investors seem to have readjusted their projections for a rebalancing of the oil market following the publication of optimistic data on US production at the end of the year. As we expected, the increase in 12-18 month futures prices above the $50 per barrel mark has sparked off substantial investment in the main shale basins, where marginal costs stand at between $35 and $45 per barrel. Funding plans have been set up, including a futures sale program on production out to 12 months and beyond. This hedging policy will safeguard the sector's resilience in the next bear market.

The pace at which new wells are being set up indicates that US shale production, combined with traditional oil and condensate production, should alone match the increase in world demand this year (1.4m bpd).

Admittedly, the business model for tight oil is inherently fragile due to the speed at which pressure decreases in wells, so frackers constantly have to drill new wells in order to maintain production, thereby creating huge funding requirements. US producers therefore always have very negative free cash flow yield. For the moment, the credit market remains willing to finance fresh investment, combined with hedging contracts on future production. In the sell-off seen at the start of the month, spreads on the HY Energy index widened but merely returned to their November levels (420bps).

In the current cycle, the trigger for a long-lasting turnaround in worldwide risk appetite could come from a sharp deterioration in liquidity on the credit market and the drying up of the high yield primary market. In this case scenario, OPEC's ideal situation would be a collapse in US production as a result of the shortage of fresh capital. But the sector could continue to renew its production for several months at a lower cost by completing wells that are drilled but not yet in production: the sector has no less than 7,493 DUCs (Drilled UnCompleted), which are just sitting waiting due to a lack of pipelines, the unavailability of equipment or because profitability is not optimal but the concessions contract requires drilling otherwise it is terminated. Lastly, beyond the DUC capital 'stock' effect, we expect that a shock on HY credit would considerably slow US oil demand, pushing oil prices down towards $40 and at these levels, the US shale industry would see a fresh wave of adjustment and consolidation, but not a full-blown crisis. However, Saudi Arabia would have to shelve its planned Saudi Aramco IPO, the key measure in the Crown Prince's modernization program. The sad reality is that despite their geological disadvantage, frackers can still cope with oil at $40 per barrel, while oil monarchies cannot safeguard their political and geopolitical survival at that price. In their stand-off with US frackers, oil monarchies have won a battle, but the final victory will be decided in a war of attrition whose length will be controlled by the credit market alone.

Asset allocation: *Fiscal tantrum(p)*

Last month, we warned about the broad-based market momentum in its '**Brave New World'** with eternal growth, impossible inflation and ignored solvency constraints. We highlighted the key role of the cost of capital in dollars in driving world growth. However, this market configuration pointed to **renewed inflation in the US as** a result of the dollar's decline and the surge in commodities, with one event fuelling the other. Inflationary concerns on the bond markets could therefore hamper this smoothly running worldwide euphoria.

Surprisingly high hourly wage figures for January (volatile figure, which was distorted this month by exceptionally cold weather conditions) set things ablaze: long term rates shot up against a backdrop of rising inflationary expectations, triggering a collapse on the equity markets and the bursting of the bubble on short volatility products. An inflationary shock is by definition a correlation shock on the markets (recorrelation of equities and bonds) which points to a second wave of de-risking via risk parity strategies.

Beyond these issues of financial flows, the entire US policy mix points to a dangerous **steepening of the yield curve**. As we feared, the only way to get out of the budget deadlock in Congress was to grant fiscal concessions to both sides, so the 2018-2019 budget agreement provides for a $300bn increase in spending, worsening the deficit alongside the Republicans' very generous tax reform. The deficit is set to come to 5% of GDP in 2019, which is probably the cycle peak year. The Fed's withdrawal from Treasury auctions (balance sheet reduction) will admittedly be offset by the increase in issues of short-term notes, but the bond market will have to digest the net increase in issues (increase in deficit), while multinationals' cash lodged abroad (estimated at $3,000bn) and invested in sovereign and corporate bonds, will be gradually liquidated and returned to the taxman and shareholders via dividends, share buybacks and M&A.

Lastly, the dollar worryingly returned to a downtrend in the phase of market rebound, despite announcements of some simultaneous fiscal generosity moves (budget, infrastructure). Conversely, economic theory points to a rise in the dollar in response to the import of capital required to make up for the growing external deficit. The dollar's continuing decline suggests that the market does not think that the Fed will take a strong stance on overheating of the economy triggered by Trumpian fiscal stimulus. A permanent increase in expected inflation in the US then triggers a slide in the entire dollar forward curve. This scenario, confirmed by the paradoxical rise in gold (against a context of rising long-term real rates) therefore includes a reasonable chance that Powell will follow in the footsteps of Arthur Burns, the chairman who allowed inflation to take root in the 1970s, under political pressure from Nixon.

It is true that the Fed's projections in December for three rate hikes this year look cautious in an economy running on full employment overheated by fiscal stimulus and a credit bubble. The market now only expects 2.5 judging by the latest position on forwards. Powell has done nothing to counter these expectations, drawing attention to the risks on financial stability in his inaugural speech, a reference to the surge in volatility on the day he took over. He has a hard task ahead: stuck in the middle of a bubble on Wall Street, soaring investment (tax incentives), consumers addicted to credit (increase in defaults across all segments of household debt) and the risk of inflationary resurgence (weak dollar), the Fed got itself into a tricky position during the Yellen years (on the pretext that the figure after the decimal point on inflation was not right). There is no ideal course for avoiding a hard landing for the economy and the markets in the medium term. In a best case scenario, the Fed can manage a slightly less painful outcome, but the worst strategy for Powell would be to start his term by losing control of the yield curve by letting the bond market build up an inflationary premium in long-term rates and the forex market downgrades the dollar on an ever-weaker forward curve (decline in dollar despite rising rates). The effects would be disastrous for a debt-laden US economy (especially households) that is dependent on wealth effects on overvalued assets (equities, real estate). For the rest of the world, the decline in the greenback is a stimulus for borrowers who already have dollar-denominated debt, but this route implies an increase in the marginal cost of capital. Furthermore, we think that eurodollar liquidity will continue to become increasingly rare. We think that the 2.8-3.0% range for the 10-year is a critical area for the world economy, which points to fresh turbulence on the markets.

In the absence of a drop in US long-term rates towards more reasonable levels, we therefore continued our moves to de-risk our portfolios. We are now neutral on equities, with a continued long play on the euro area (restricted to banks and small caps) and Japan vs. US and emergings. We now underweight credit and still strongly underweight sovereign bonds in the euro area and the US. Lastly, we hedge a Nixon-Burns scenario by overweighting gold.

Equities: back to neutrality

- **The risk of inflationary overheating in the US is a systemic threat for the cycle and the world equity markets. We therefore continue to de-risk and return to a neutral stance on equities in our model portfolios.**

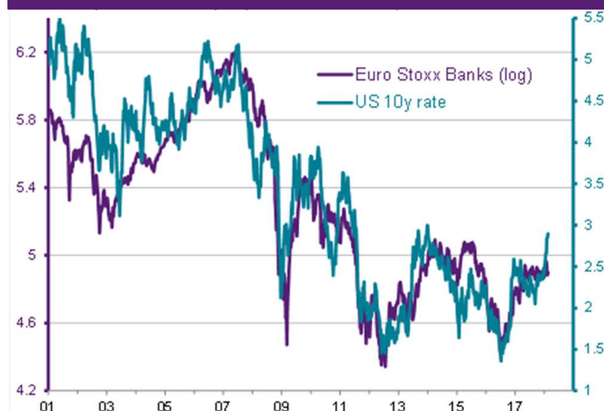
- Our geographical choices still focus on markets that rely on solid domestic demand that can temporarily decorrelate from the world cycle. China (consumption, new technologies), India, Japan and the euro area meet this criterion. We maintain our overweight stance on these markets. Conversely, we move to underweight on the US market as it is pricey (risk premium vs. swaps too low, P/E still high even after correction).

- In the euro area, we still prefer small caps to large groups: ongoing favorable funding conditions (easing in bank credit, ECB support for credit market) and a strong euro in a domestic growth cycle make for a perfect configuration for small and mid caps to outperform, despite their relatively demanding P/E.

- In addition to small caps, our overexposure to the euro area includes bank stocks. Their absolute valuation remains attractive and resteepening of the swap curve suggests the much-awaited rebound in interest margins, especially in France where regulated deposit rates had prevented banks from passing on the drop in key rates towards zero and then into negative territory. For now, the strength of the recovery in the cycle points to a continuation in demand for credit, with no deterioration in borrowers' solvency.

- We remain positive on Japan due to its solid domestic consumer spending cycle. It is the only G7 economy where steepening of the yield curve seems ruled out due to the Bank of Japan's actions across the entire JGB curve. Despite some signs of a recovery in wages (for part-time work), the Bank of Japan remains very far from its inflation target (2%) so we think that the JGB 10-year will remain capped at around 10-15bps in the months ahead. Our preference goes to domestic stocks due to the risk of a continued rise in the yen. The Finance ministry however suggested that the dollar-yen rate was getting close to levels that would warrant government intervention. Unlike the euro area, the banking sector is still hampered by the flat yield curve.

European banks enjoy yield curve steepening in G7



Source: Datastream

Tactical views

Equities	--	-	=	+	++
Developed Markets					
US		○	●		
Europe				●○	
Japan				●○	
Asia ex Jap			●○		
Emerging Markets					
Asia				●○	
Europe		○	●		
LatAm		○●			

○ : monthly views

● : views of the previous month

- Meanwhile, on the emerging markets, we still prefer Asian countries. We have a positive view of the Indian market (recovery in growth after shock from Modi's reforms), China (index heavily weighted to large tech stocks enjoying near-monopoly with state support) and stocks exposed to the semiconductor cycle (Korea, Taiwan). We continue to underweight other emerging markets due to their high beta, their oil exposure (Russia, Mexico), political risk (Mexico, Brazil, South Africa) and vulnerability to a shock on dollar-denominated capital flows (tapering from the Fed).

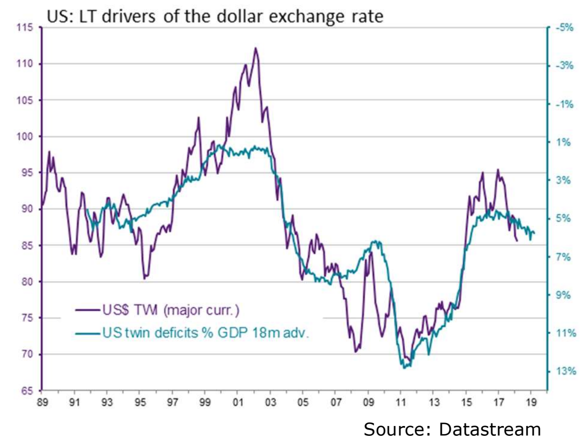
Bonds: dangerous steepening

- Last year we wrote that the continuation in the worldwide boom depended on the continued flattening of the US yield curve. We maintain this stance and expect a worldwide slowdown due to a dangerous steepening in the US curve. Fiscal stimulus against a backdrop of full employment, tax incentives to invest, very high business confidence, increasing wages, rising commodities prices and a weakening dollar all combine to push up long-term rates in both their real and inflationary components. And to top it all off, Powell's inaugural speech pointed to a continuation in the Fed put in light of the stockmarket correction in early February, while doubts are beginning to emerge on the solvency of the US faced with an administration that doesn't even pretend to worry about intertemporal solvency (Mulvaney, Trump's director of the OMB, recognized that a budget balance scenario is impossible in the next ten years). The shock on interest rates will be further heightened by sales of sovereign and corporate bonds from multinationals' war chest, currently sitting in tax havens. Against this backdrop, the dollar's continued decline when equity markets return to an uneasy calm further accentuates the steepening trend. In theory, the tax reform induced capex boom implies an increase in policy rates (and inversion of the yield curve) if the Fed were appropriately Wicksellian, thereby warding off the least profitable investments and increasing foreign investment in the US. Powell seems to rule out this move from the Fed, but in a world where key rates are close to zero, exchange rates tend to react more to long-term rate differentials. The rise in the US 10-year should have acted to underpin the dollar, but this was not the case, despite a widening in the spread since mid-2017. The forex market simply does not believe in an increase in the rate of return on investment in the US as a result of the White House's pro-business policies (deregulation, tax cuts, infrastructure, capex incentives). The currency markets think 'business-friendly Trump's moves on the rate of return on investment are wiped out by the threats arising from protectionist (NAFTA, TPP, China, etc.) and isolationist (immigration) Trump's agenda and even serial defaulter Trump's moves. But the prospects of a boom in investment, going beyond the manufacturing sectors (weak dollar) and energy (shale oil) is visible in all surveys. So 2018 could see the US economy hit growth of 3% with the Fed still as restrained, and long-term rates soaring towards 3%. A foray for long-term rates towards the 3% mark would soon burst the bubble on financial and real assets (real estate) and trigger a chaotic end to the cycle. We therefore continue to underweight US bonds and remain exposed to inflation breakevens.

- In the euro area, steepening has been our core scenario since last year (inflation, gradual end to QE) and still remains relevant as a result of the sound showing from cyclical indicators, despite continued downward surprises on inflation and the euro's strength. The coalition agreement in Germany, which remains to be confirmed, provides for an increase in social spending, and just like in the US, fiscal discipline has been sacrificed to end the political deadlock. The timing is as disastrous for the economy as it is in the US: so another large developed economy is set to implement economic stimulus against a backdrop of full employment. This points to an erosion in the vast German current account surplus, which is likely to come as good news to its euro area partners, but will also trigger overheating of the economy and an increase in inflation next year, at a time when Spain, France and Italy will be feeling the negative effects of rising interest rates, a surging euro and soaring oil. And the icing on the cake – this is all happening amidst the debate on Draghi's successor as he steps down in November 2019. We maintain our steepening positions. We have wound down our peripheral spread tightening plays ahead of the Italian election on March 4.

- Continuing on with our risk-reduction moves, we underweight European Investment Grade credit.

Twin deficits dent dollar



Source: Datastream

Tactical views

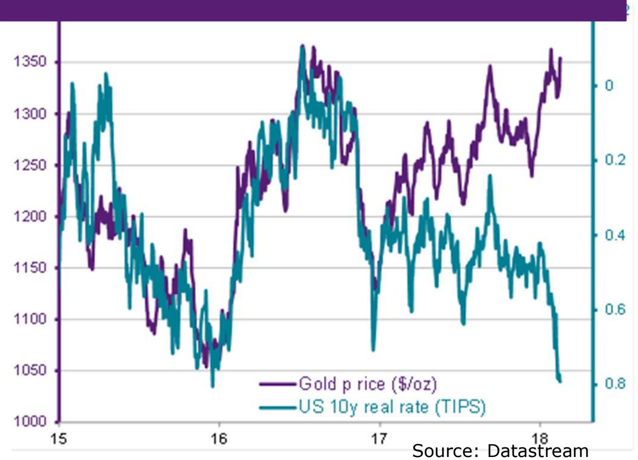
Fixed income	--	-	=	+	++
Sovereign bonds					
Euro Core		●○			
Euro Periph			○	●	
UK			●○		
US		○●			
Japan			●○		
Inflation				●○	
Credit					
Euro IG		○	●		
US IG			●○		
€ High Yield			●○		
$ High Yield			●○		
EM Debt			●○		

○ : monthly views
● : views of the previous month

Commodities: gold recovers its shine

- The transition from a "strong inflation-free growth" market profile to renewed worldwide inflation since the end of 2017 has triggered an acceleration in commodities prices. Despite some real tension on industrial metals (zinc, lead, nickel) and precious metals (palladium), we highlighted that fundamentals still remained lackluster due to the prospects of a contraction in demand for industrial input from the Chinese construction industry (recession in residential investment, slowdown in infrastructure investment as a result of Beijing's debt paydown efforts). But speculation got the better of fundamentals, as shown by the surge in oil towards the $70 mark following soaring long positions on the Nymex.

Gold disconnects from US real rates



Source: Datastream

- We had factored in the extremely powerful speculation momentum by taking a neutral stance on commodities at the end of the year. The acceleration in the dollar's decline since the US budget agreement confirms the appeal of commodities futures as an inflationary hedge.

- However, we remain cautious on the fundamentals for Chinese construction demand and remain neutral on metals. The latest figures still suggest that adjustment is continuing on the Chinese real estate market and that it is only beginning in Oceania, Canada and Scandinavia.

Tactical views

Commodities	--	-	=	+	++
Oil			●○		
Industrial metals			●○		
Gold			○	●	

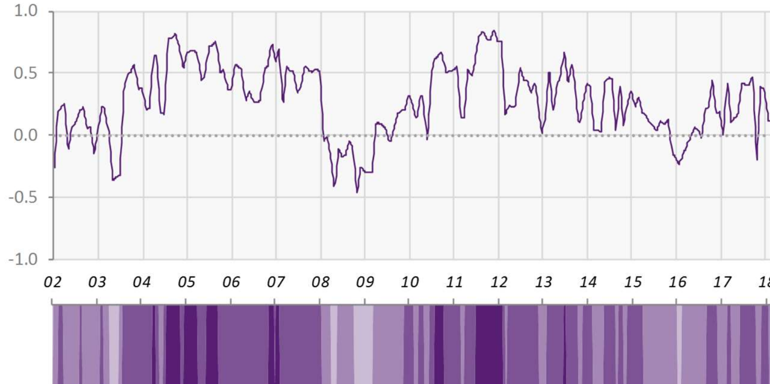
○ : monthly views
● : views of the previous month

- The decorrelation between prices and fundamentals is most striking on the gold market (see chart). The rise in US real rates (deficit, inflation) should have triggered a correction in gold of around a hundred dollars per ounce. Easing tensions between North and South Korea suggest that is not an increase in the geopolitical premium that is behind gold's levels. This divergence shows that inflationary expectations are taking over from real rates as decisive factors in gold prices, thereby reflecting the declining credibility of the US policy mix: the Fed is no longer as credible as it was in its inflation targeting role, and many are concerned about the country's solvency, to the extent that international investors look to the "barbarous relic" as a safe haven. In view of Powell's inaction, there is a strong risk that the dollar will continue to fall. We therefore go long on gold.

- Pressure from bullish speculation remains extremely strong on oil, and we maintain our tactically neutral position for such times as the dollar remains under pressure. However, our fundamental view remains bearish (see p.2). In the euphoric 2006-2008 period, oil saw the greatest rise, against the backdrop of oil shortage scenarios (peak oil) and climbing convenience yield. Today's situation is completely different: whatever OPEC boasts, industrial stocks remain very high, the cartel's spare capacity is comfortable (reflecting its voluntary production restrictions), and as mentioned in our editorial page, the US' ability to swiftly adjust production warrants a long-term reduction in the industry's security stocks. Lastly, the 7,500 DUCs or drilled but uncompleted wells, provide another layer of production that is poised to come on the market in the event of a supply shock (Venezuela, Libya, etc.). Furthermore, the fact that the marginal producer is now American implies that production costs and marginal revenues are now dollar-denominated, which would tend to reduce the negative feedback loop between oil and the greenback. Unlike 2008, the task of putting an end to the cycle of world monetary expansion that has become inflationary should not fall on oil's shoulders.

Quantitative Indicators

ECONOMIC SITUATION

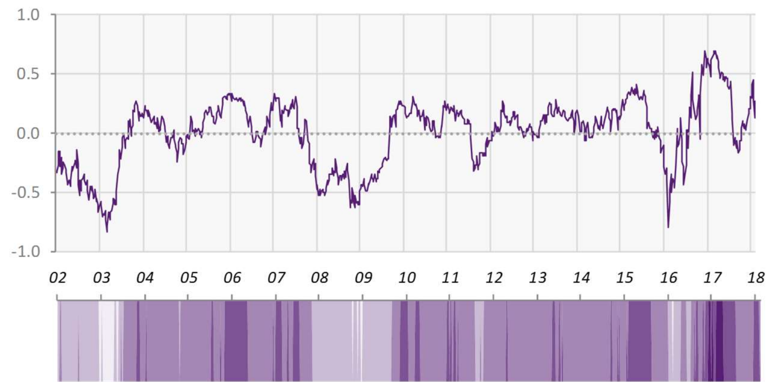


Poor Good

This continuous indicator, which stands between -1 and +1, allows us to assess the world economic outlook. It is based on the level and/or momentum of a range of macroeconomic data (growth, inflation, valuation, earnings).

▶ ***The higher this indicator, the more we favor risky assets.***

MARKET TRENDS

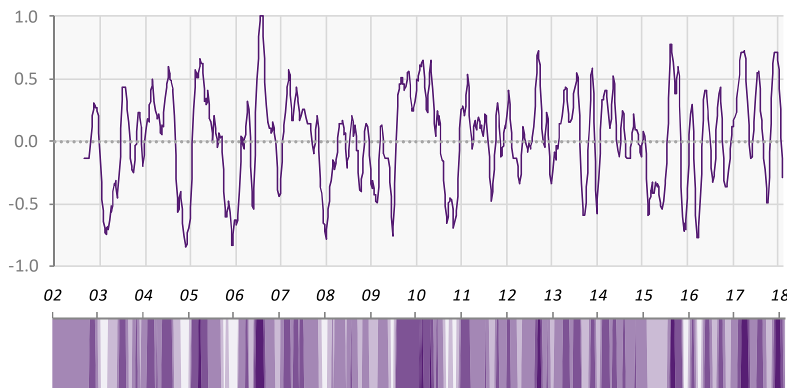


Downtrend Uptrend

This continuous indicator, which stands between -1 and +1, reflects medium-term momentum on the equity markets relative to the fixed income markets. It is based on moving averages of variable length, defined on the basis of volatility.

▶ ***If the indicator is positive, we prefer risky assets.***

RISK APPETITE

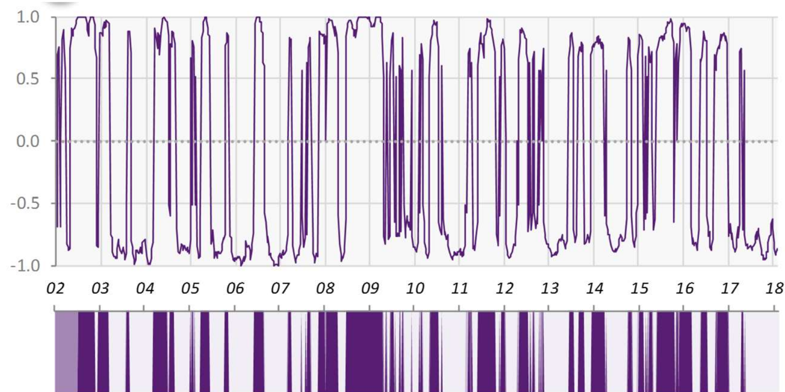


Low High

This continuous indicator, which stands between -1 and +1, shows the extent to which various market players are looking for risk in the short term. It is based on an analysis of the level of risk (measured by volatility) and how it is remunerated by the market (measured by premiums or spreads).

▶ ***The higher this indicator, the more we favor risky assets.***

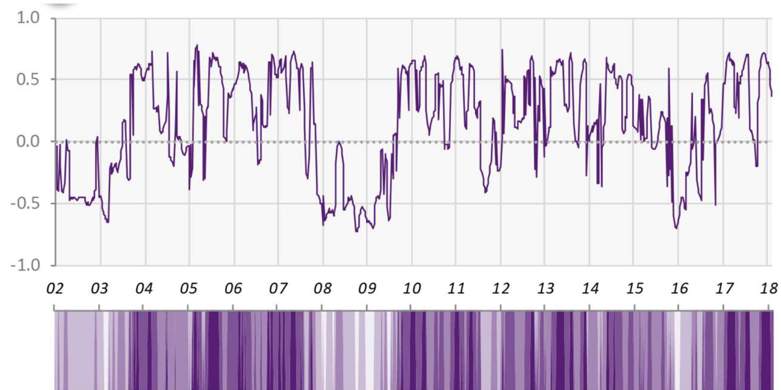
FLOW



This flow indicator measures the investor sentiment for equities, bonds and money markets, calculated using investor flows (data from EPFR) and volumes. The indicator is continuous and lies between -1 and 1.

▶ ***How to interpret this indicator: When the indicator enters into positive territory, we favor risk assets***

AGGREGATED INDICATOR



Our proprietary aggregated indicator is a measure of the equiweighted average of our 4 signals: Economic Outlook, Market Trend, Risk Tolerance and Flow. The indicator is continuous and lies between -1 and 1.

▶ ***How to interpret this indicator: When the indicator enters into positive territory, we favor risk assets***

Model portfolio

Asset classes	Benchmark	Current portfolio	Deviation/ benchmark	Change/ previous month
Cash	**10.0%**	**22.0%**	**12.0%**	↑
Eonia	10.0%	22.0%	**12.0%**	↑
RUB / USD	-	-		↓
Governement bonds	**40.0%**	**27.0%**	**-13.0%**	↓
Euro	32.0%	25.0%	**-7.0%**	
Euro Inflation	4.0%	-	**-4.0%**	
US	4.0%	-	**-4.0%**	
Gilt	-	-		
Spain	-	-		↓
US Inflation	-	2.0%	**2.0%**	
Spreads	**15.0%**	**14.0%**	**-1.0%**	↓
Euro Credit	15.0%	14.0%	**-1.0%**	↓
Euro High Yield	-	-		↓
US High Yield	-	-		
CB Euro	-	-		↓
Emerging bonds	**-**	**-**		↓
EMD $	-	-		
Local EMD	-	-		↓
Developed equities	**20.0%**	**20.5%**	**0.5%**	↓
EMU	2.0%	2.0%		↓
Europe ex-EMU	3.0%	1.0%	**-2.0%**	
North America	12.0%	11.0%	**-1.0%**	
Japan	2.0%	3.0%	**1.0%**	↓
Pacific ex-Japan	1.0%	1.0%		
Euro SmCap	-	1.5%	**1.5%**	↓
Euro Bank	-	1.0%	**1.0%**	
Emerging equities	**10.0%**	**9.5%**	**-0.5%**	↓
Emerging Asia	7.0%	8.5%	**1.5%**	
Latam	1.5%	0.5%	**-1.0%**	
EMEA	1.5%	0.5%	**-1.0%**	
China	-	-		↓
Russia	-	-		↓
Commodities	**5.0%**	**7.0%**	**2.0%**	↑
Energy	2.5%	2.50%		
Industrial Metals	1.3%	1.25%		
Precious Metals	1.3%	3.25%	**2.0%**	↑
	100.0%	**100.0%**	**0.0%**	**-**

Contributors

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Click here to view the Natixis Asset Management financial glossary

Natixis Asset Management

Limited liability company - Share capital €50,434,604.76
Regulated by AMF under no. GP 90-009 RCS Paris n°329 450 738
Registered Office: 21 quai d'Austerlitz – 75634 Paris Cedex 13 - Tel. +33 1 78 40 80 00
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