NATIXIS INVESTMENT MANAGERS

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Pulse

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IN SHORT

- We believe that as the year progresses the economy will continue to recover, which should help sustain the bull market in stocks.
- We believe that yields will only rise gradually and that, if they were to rise too rapidly, the Fed would react.
- We remain constructive on risk assets and believe that the rotation toward cyclicals will continue to gather steam in the coming weeks.

Macroeconomic overview

- February has been a relatively quiet month so far, with encouraging news on the health front despite a slow start to many vaccination programs and a good corporate earnings season. This has supported equity markets, which have rebounded strongly and are again at record levels. We believe that the economy will continue to recover to pre-pandemic levels on the back of monetary and fiscal policy support as well as the progressive easing of restrictions, which should help sustain the bull market.

- Still a short-term deterioration due to the spread of new variants cannot be excluded. Germany has extended its current lockdown until the second week of March and the UK has toughened restriction on returning passengers. On a positive note, cases and hospitalizations continue to fall across most developed countries. France, Italy and Spain, for instance, have already started to progressively reopen their economies.

- In the US, inflation and jobs data came in below expectations in January, as continuing claims remain significantly higher than pre-pandemic levels. Headline inflation declined from 1.6% to 1.4% and core inflation stayed flat for the second consecutive month at 1.4% year-on-year. Inflation expectations continue to rise with the Biden administration's spending plan, as well as pent up demand (and of course base effects). In our view, inflation will rise in the coming months, but we do not expect this move to be sustained and we expect the Federal Reserve to view it, as we do, as transitory.

- With little likely support from Republicans for President Biden's USD1.9 trillion American Rescue Plan, the Senate approved a budget resolution that will allow for a fast-tracking of approval, now expected by mid-March, though it will still likely be smaller than USD1.9 trillion. In other Senate news, Mr. Trump was acquitted of inciting the Capitol Hill riots, though 7 Republicans voted with the Democrats to convict, for a final tally of 57-43, still short of the two thirds majority needed for conviction.

- Former European Central Bank President Mario Draghi was sworn in as Italy's new Prime Minister this Saturday, after obtaining the backing of most of the major political forces in the country. His arrival has been taken very positively by financial markets: the FTSE MIB has increased over 8.5% (making it the best performing developed market of late) and BTP's yield have fallen 17bp since the start of the month.

- The USD, as measured by the DXY Index, retreated from its recent rebound as risk appetite came back at the start of the month. It currently stands just above 90. However, we believe that USD weakness should be more muted going forward, as much of the move is already done. Indeed, with better

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growth, earnings and higher yields, some underlying support should remain, and the dollar should soften more against EM currencies. Gold remains stuck in its USD1,800 to USD1,850 per ounce range, though we expect demand to pick with the recovery in emerging markets, negative US real yields and higher inflation expectations.

Market outlook

- After coming under pressure at the end of January, equity markets have since rebounded strongly and reached fresh record highs, supported by fiscal stimulus expectations, progress on vaccine distribution and a solid Q4 2020 earnings season.

- At the sector level, communication services outperformed within the S&P500, followed by energy stocks, while the consumer discretionary sector lagged. Small and mid caps built on their substantial YTD lead over large caps, and value also outperformed. In Europe, the rebound was primarily driven by financials, which were up more than 10%. Moreover, Chinese markets rallied ahead of the Lunar New Year holiday. In our view, EM Asia should continue to benefit from China's booming growth, the regional free-trade agreement and a better management of the health situation.

- Of the 74% of the S&P500 companies that reported Q4 2020 earnings as of last week, 80% reported actual earnings above estimates (beating by 15.1%). Within the top contributors to this good performance, we find financials, information technology and communication services. As a result, the earnings growth rate for Q4 2020 is expected to be 2.9% YoY compared to a decline of 9.3% initially expected at the end of year. Moreover, in Europe, 20% of the Stoxx600 companies have reported earnings as of last week, 72% exceeded earnings estimates. Currently, the earnings growth rate for Q4 2020 is expected to be -18% YoY compared to a decline of almost 27% initially expected at the end of year.

- Bond yields in the US rose further, despite softer than expected inflation in January: the 10-year yield reached 1.2%, the 30-year 2.%. The yield curve steepened to its highest level since early 2017, with a spread of 112 basis points between 2s and 10s. So far, the rise in long-term yields has been driven by reopening, spending and higher inflation expectations. In Europe, yield curves also steepened, but to a lesser extent. The German yield curve has slightly steepened (~6bp), suggesting a somewhat improving, but still fragile, outlook. In this context, we maintain our preference for credit risk over duration risk, favouring the pick-up in carry in credit, even though there is less room for spread compression following strong performances.

- Credit spreads narrowed further in February. US IG and HY spreads narrowed 6bp and 39bp respectively, European IG and HY spreads 6bp and 31bp, and CEMBI IG and HY 13bp and 22bp. We continue to see potential for further tightened and some room for the absorption of higher sovereign yields. We also see opportunities in hard currency emerging market corporate debt, where the carry is attractive and there is more room for spread compression.

- Overall, we remain constructive on risk assets and believe that the rotation towards cyclicals will continue to gather steam again in the coming weeks. We are more cautious on sovereign debt, although we believe that yields will only rise gradually and that, if they were to rise too rapidly, the Fed should act to cap them.

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