NATIXIS INVESTMENT MANAGERS

Perspectives

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IN SHORT

- Despite the move I the dot plots, we think little has changed for the Federal Reserve
- Yields have remained well behaved, but upside risks persist
- The road could be bumpier, but we expect risk assets to continue to move higher

Change? What change?

This month delivered a surprise from the Federal Reserve, which appeared more hawkish due to the shift in the dot plots. However, after listening to Chairman Powell speak, we believe that little has actually changed. Yes, the Fed has an eye on inflation and is therefore not “asleep at the wheel”, which should help contain inflation expectations, but interest rate hikes are still a long way off and the Fed is only at the beginning of its journey to reducing asset purchases. Indeed, after sharp initial reactions, markets are back to where they were before the meeting.

US Treasury yields remain in a tight range and are likely to continue to consolidate around current levels. They could see upward pressure as the US labour market strengthens over the coming months, but we do not expect a significant move in yields, especially as inflation should start to recede as base effects from last year’s lockdowns dissipate. Moreover, with the Fed working on forward guidance around QE tapering and yields more reactive to interest rate moves than asset purchases, pressure should remain limited. European yields could see some upside as the recovery accelerates with reopening, and questions remain about whether the European central Bank will maintain such a high pace of asset purchases beyond the third quarter. In this context, we continue to favour credit over duration, especially as credit spreads have remained tight across recent volatility episodes.

The lingering question is on the reflation trade, with the rally in cyclicals fading and the technology sector once again seeing strong gains before the Fed meeting. We have long said one should not dismiss tech as a medium-term allocation, but we also do not believe the cyclical rotation is over. We prefer to think of it in terms of reopening, and we do not think it is entirely priced in already. As such, we remain constructive on risk assets and maintain our cyclical tilt. We believe that financials, energy, and materials should continue to advance in the coming months, as growth remains strong in the US and ramps up elsewhere. We therefore expect European equities to continue to do well, supported by a strong H2 outlook for the region thanks to accelerating vaccination and a cyclical bias in most major equity indices. We believe that the bad news is now priced in and discounted for Japan and that the region should improve over the coming months.

With fundamental support still present even if they are past their peak, risk assets should continue to perform well. Indeed, vaccination is accelerating globally, monetary policy remains extremely accommodative, fiscal policy is expansionist and earnings are set to continue to rebound with the reopening of economies. While these tailwinds will not be as strong going forward, it is still difficult to imagine too negative a scenario for the months ahead.

Asset class details

Equities

The tailwinds that boosted markets in the first half of the year are set to recede over the coming months, suggesting a bumpier road ahead. Still, they all remain present and should continue to act as fundamental supports for equities. Indeed, with vaccination accelerating around the world, monetary and fiscal policy still accommodative and earnings rebounding, we expect markets to continue to move higher.

Along with reopening, we expect the cyclical rotation to continue, as reopening is not yet fully priced in. We therefore continue to favour sectors such as financials, energy, and materials. We also believe that European markets will benefit from the growth recovery in the second half of the year and EU Recovery Fund disbursements. Japanese stocks should benefit from improving sentiment surrounding the Olympics, the fact that bad news is priced in, and the second half should be stronger.

While plenty of concerns are occupying investors, we keep an eye on sentiment. We want to ensure markets do not fall into complacency, especially given high valuations. But given high levels of cash on the sidelines and ongoing worries, we do not believe investors are there yet.

Fixed Income

Quiet still reigns across sovereign yields, which have remained stable despite a surprise from the Fed with regards to its dots plot. Indeed, with the Fed acknowledging inflation risks, bonds appear more confident that the Fed will not allow inflation to spiral, flattening the curve.

Given how much news yields have absorbed in recent months, we expect the consolidation to continue, though yields could drift higher as the US labour market improves and the European recovery accelerates, especially with the ECB possibly reducing the pace of its asset purchases into the end of the year.

We therefore remain more prudent on sovereign debt and prefer taking credit risk rather than duration risk. The longer duration of IG indices and the very tight spreads suggest less room to absorb higher rates than in HY, though we remain selective.

We continue to see opportunities in hard currency emerging market corporate debt, where the carry is attractive and there is further room for spread compression.

Currencies

The dollar is benefitting from the more hawkish view of the Fed, but the upside may be rather limited as growth outside of the US picks up and risk-on sentiment persists. Still, strong growth and earnings, and higher carry should eventually limit the downside for the dollar as well. As such, we expect broad range-trading against major currencies, though some EM and commodity-linked currencies should benefit.

Commodities

Oil producers have navigated this period well, with OPEC+ maintain production cut discipline, and only increasing production mildly, to protect higher prices. With reopening prospects improving, oil prices could move higher still, though overall supply remains abundant, which is likely to limit appreciation potential at some point.

We expect demand for gold to improve with the reopening of EM economies leading to better physical demand, along with low real yields, and high medium-term inflation expectations.

Alternatives

Alternatives continue to provide diversification and de-correlation opportunities. We believe that real assets can also help provide income in a world where interest rates will remain lower for longer.

Asset Classes	Negative	Neutral	Positive
Equities			●
Fixed Income		●	
Equities			
US		●	
Europe			●
Japan			●
Asia ex Japan			●
Emerging Markets		●	
Asia		●	
Latam		●	
Europe		●	
Fixed Income			
Sovereign US	●		
Sovereign EUR	●		
IG US		●	
IG EUR		●	
HY US		●	
HY EUR		●	
EM Hard Ccy		●	
EM Local Ccy		●	
Commodities			
Oil		●	
Gold		●	
Base Metals		●	

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