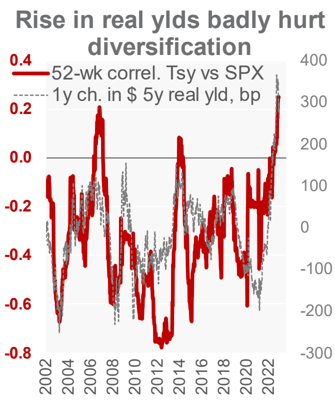
OUTLOOK 2023

Blowing hot and cold

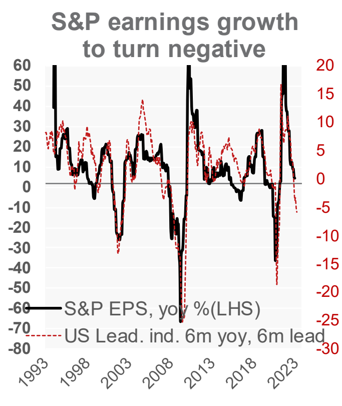
December 12, 2022

Our Annual Outlook provides our key views and investment implications for the coming year

- **The new world order is brewing a *cold* war that marks a regime change likely to see a less friendly growth/inflation mix and a more volatile economic and financial environment. Climate change (*hot*) will also exacerbate migration issues and competition for natural resources.**
- **Economic growth is set to *cool* off further, while inflation is still too *hot*. We warn against inferring market direction from previous cycles and positioning too early for a policy pivot. Policy is more severely constrained in this cycle.**
- **Our core scenario sees a mild EA recession, and an even milder US one. Risks are skewed to the downside: such brutal tightening of monetary policy and financial conditions rarely leaves the economy and markets unscathed.**
- **2022 was bad for portfolio diversification but we expect the bond-stock correlation to fall in 2023 as long-term real yields plateau or even recede. Though rates volatility is set to fall further, we question how long this can drive the risk asset revival. We will start the year with a preference for High Grade Fixed Income, especially UST and EUR IG Credit (including Financials), and a defensive approach on Equities and High Yield. The Fed put will be missing in 1H23 but we see selected EM markets as a good target for those decided to position early for a policy turn.**



Source: Bloomberg, GIAM calculation



Source:Conf. Board, BBG, GIAM

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BLOWING HOT AND COLD

Vincent Chaigneau

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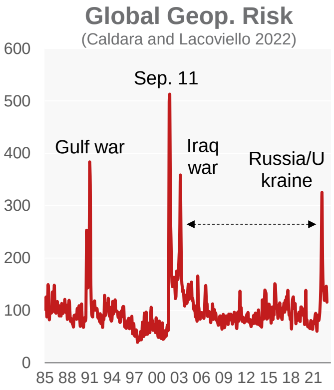
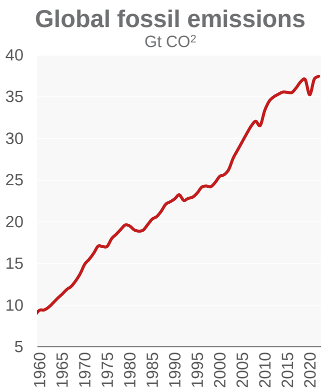
> Greater geopolitical volatility – potentially fanned by climate change – marks a regime change

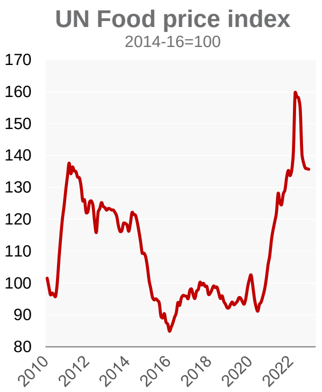
Structurally hot and cold. If there is one thing that our 2022 Outlook got right, that was in the title: "Bye-Bye beta". As expected, the surge in real yields led to a rise in the stock-bond correlation – bad for diversification. It was a horrible year for beta, admittedly far worse than we had expected, as the war on Ukraine deteriorated the growth-inflation mix. Russia's invasion ended two relatively quiet geopolitical decades (first chart). The war has gravely disrupted the energy supply chain, after the Covid pandemic had exposed already the risks associated to global trade interconnections. A greater focus on the supply chain security, rather than its sole efficiency, and new geopolitical risks will likely support some re- and friend-shoring. This will stop or even reverse the globalisation wave seen since China joined the WTO in 2000.



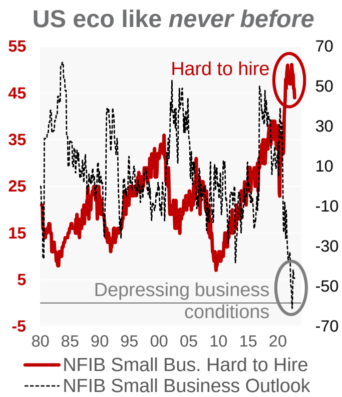
Source: www.matteoiacoviello.com, GIAM



Source: www.globalcarbonproject.org, GIAM



Source: United Nations, Bloomberg, GIAM



Source: NFIB, Bloomberg, GIAM

The new *cold* war. Greater geopolitical volatility marks a regime change that deserves a mention at the start of this annual outlook. President Biden's ban on semiconductor exports to China highlights the increasingly tough stance towards its main rival. The US is also stepping up pressure on Europe to harden its stance towards China. The multipolar world order thus sees rising tensions, dubbed the new *cold* war. One known risk for 2023 lies in China making a move towards Taiwan – probably not a military one, more a blockade. While timing is highly uncertain, the constant rise in the share of the population feeling “Taiwanese only”, to now above 60%, suggests that time is playing against China. The US is also planning $10bn in security assistance and fast-tracked weapons procurement for Taiwan – a move that will also add time pressure on China.

Climate change – the *hot* reference – is not a new feature for 2023 but continues to profoundly impact the economic and financial world. One immediate implication is the very rare ‘triple dip’ La Niña, which fans risk of more flooding and drought in 2023 – potentially keeping food inflation elevated (see chart 3 above). Global fossil emissions reached a new high in 2022 (chart 2), and the Global Carbon Project 2022 report estimates that on the current path, there is a 50% probability that the 1.5 degrees will be surpassed within just 9 years. Research shows that the presence of natural resources (oil, gas, minerals) tends to exacerbate conflict risk. Climate change only adds to that risk, in part because of greater resource competition.

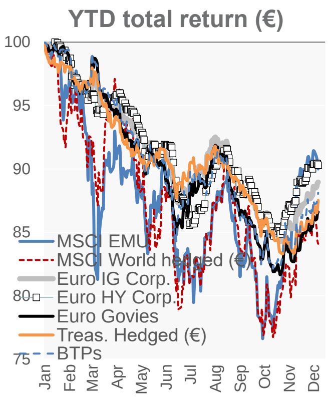
> Cyclically hot and cold: economic slowdown but still elevated inflation

Cyclically hot and cold. The start of 2023 is also dominated by a global – if desynchronised – economic slowdown (cold) but still elevated inflation (hot). Inflation will fall, but for central banks the key question is how fast core trends will slip towards 2%. The top-right chart describes a situation unseen for more than 40 years: US SMEs are very pessimistic about the global business outlook, but still report labour shortages. This unusual situation will likely keep wage and core inflation sticky for longer. This implies that central banks, and the Fed in particular, will not be as pre-emptive and reactive as they have been historically in leaning against recession forces.

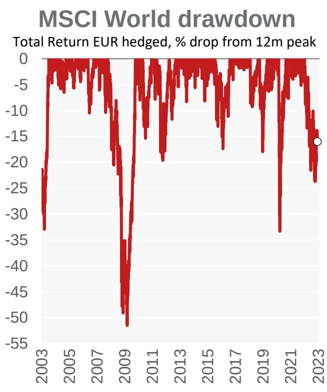
Positive stock-bond correlation likely to fall in 1H23

> Peak inflation, rates volatility, 10-year Treasury yields, China lockdown and maybe US dollar. But Fed pivot, EU energy security and soft landing remain elusive.

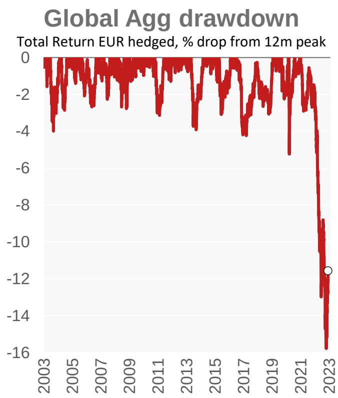
4Q22 a bear market rally or a true turn? Asset prices managed an impressive bounce in 4Q22, reducing the drawdown in the MSCI World (total return, EUR hedged, vs. 12-month peak) from -26% on 12 Oct. to -16% on 9 Dec., and that of the Global Aggregate (Fixed Income) from -16% on 21 Oct. to -11.5% (charts below). There was genuine good news behind this, but also head fake, in our view. Legitimate hopes to have seen *peak* inflation, rates volatility, 10-year Treasury yields, China lockdown and maybe US dollar are no small feat. Yet the relief rally has also been driven by a large but fragile pullback in energy prices, not least for EU natural gas (mild weather at the start of the autumn), premature hopes of a Fed pivot, and excessive confidence in a soft landing (cyclical stocks have outperformed).



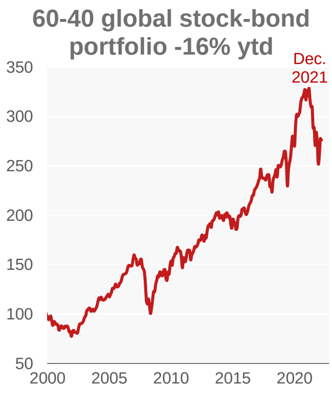
Source: Bloomberg, GIAM



Source:Bloomberg, GIAM calculations



Source: Bloomberg, GIAM calculations

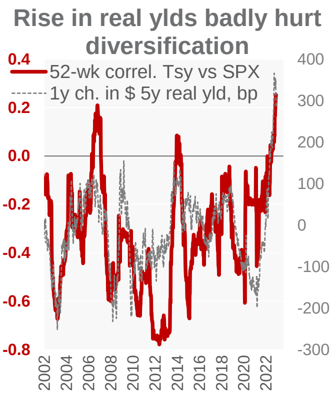


Source: MSCI, Bloomberg, GIAM calculations

Even after the Q4 rebound, 2022 was a poor year for balanced portfolios (right-hand chart above). 2023 will be better (famous last word). At least we expect the stock-bond correlation to recede as long-term US real yields plateau or even pull back while

A greater focus on cyclical matters, risk appetite or fiscal policy – rather than monetary policy – tends to push stock-bond correlations down

recession forces grow (left chart below). The two middle charts confirm the strong correlation between US Treasury yields (or bond volatility) and stock prices: 2022 indeed was much about monetary policy, with tightening fears driving bond and stocks prices down for about three quarters, before ebbing in Q4. Monetary policy-driven markets tend to see positive correlation between stocks and bonds. Uncertainty about the Fed peak remains, yet we see further downside for rates volatility as the end of the tightening cycle approaches. Will that be enough to propel risk asset prices higher still? It is possible that this pattern continues for a bit, however we rather see a different correlation regime in 1H23. A greater focus on cyclical matters (including margins and earnings), risk appetite or fiscal policy – rather than monetary policy – tends to push correlations down. In this case, the consensus may not be properly pricing the risk of an earnings recession (right-hand chart below).



Source: Bloomberg, GIAM calculation

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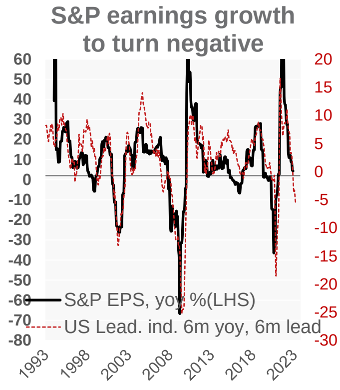
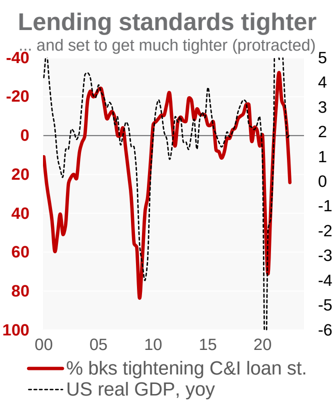


Source:Conf. Board, BBG, GIAM

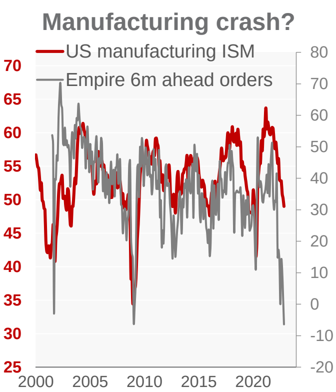
Mild recession, with risks much to the downside

The consensus view on global growth has got too cosy

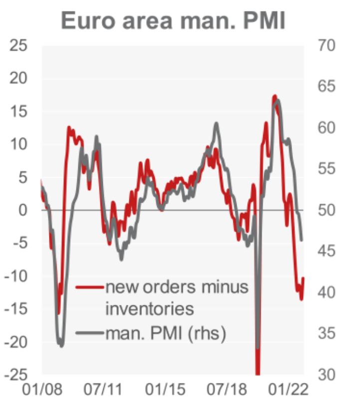
Desynchronisation. We forecast a drop in global growth from 3.2% in 2022 to 2.1% in 2023. Europe is likely entering recession at the turn of the year, while the Covid policy relaxation in China, along with a better credit impulse, will support a mild recovery (from 2.6% in 2022 to 4.8% in 2023, with risks to the downside given the ongoing challenges, not least in the property sector). We expect the US economy to show resilience in the near-term as the US consumer remains alive and well, despite the worst shock on real disposable income in 2022 since WWII, before heading into a very mild recession into summer.



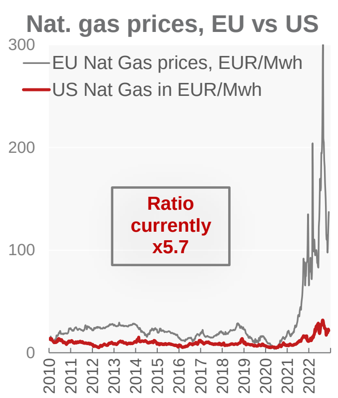
Source: Fed, Bloomberg, GIAM



Source: ISM, NY Fed, GIAM



Source: Datastream, GIAM calculations



Source: Bloomberg, GIAM calculations

Do not get too cosy. The implied consensus by late 2022 seems to be priced near perfection – with hopes that inflation will normalise quickly, and the US will avoid

We see the economic risks firmly to the downside, as tighter financial conditions finally take their toll

Will downside pressure on margins lead to layoffs or new price increases? Former hurts demand, latter leads to more rate hikes

In previous crises, central banks were quick to deliver rate cuts and QE. This time is different.

recession. Arguably, as US inflation recedes while wage inflation remains high, US real disposable income should recover in 2023 about one third of the record 2022 losses. But the consumer may still wobble as employment deteriorates and the saving ratio finds a floor at the currently extreme level (2.3%). We see risks firmly to the downside, as tight financial conditions finally take their toll on the economy – not least because lending standards continue to tighten (left chart above). Already the manufacturing sector is headed to a deep recession, and this will trickle down to other sectors. Europe is navigating tougher waters already, while the relatively elevated energy prices will put the region in a weak competitive position for many years (charts above).

Mind what you wish for. One major uncertainty for 2023 lies in the function reaction of the corporate sector. Margins are starting from a very high level, which may cushion the economic landing indeed. Yet as consumer demand slows, pricing power will likely diminish. With wages buoyant for longer, margins will be under pressure. Will corporations cut costs and lay off workers, as they usually do? Probably. Or will they continue to raise prices, as they fear it may be hard to re-hire later? This of course would force central banks to tighten policy further – potentially reviving some of the bearish pressures of 1H22.

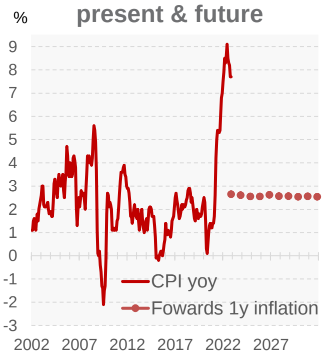
Central bank put gone till inflation gets well below 3%

Too early to position for a Fed pivot. Markets are pricing that US CPI inflation will cool to 2.65% over the coming year – implying a PCE inflation low enough for the Fed to consider easing. Inflation is (rightly) seen stickier initially in the Euro Area (EA), but then quickly falling to below 2.4%. This looks rather optimistic, given the second-round effects at play. We see the Fed peak at 5% in March (market pricing top end of the FF range between 5.0 and 5.25%), but the risks lie towards the Fed hiking more as consumer demand and capex initially prove resilient. We do not see Fed rate cuts before 4Q23, i.e. not as fast as the implied curve is suggesting (chart below).

Our ECB rate views are less hawkish than the market (deposit rate peak at 2.50% instead of 2.75-3%) given i) the quicker fall into recession, ii) the ECB's focus, historically, on energy prices (which have retrenched) and iii) part of the job will be done via QT (LTRO repayments and APP run-down). That said, we see limited chances for a full ECB turn in 2023 – given the pass-through into wages.

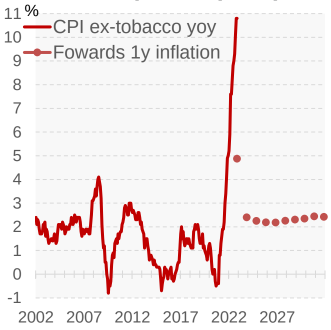
This time is different. In all we warn against the temptation of inferring market patterns from previous market experiences, e.g. historical asset price dynamics around the final hikes. In contrast to previous crises, where central banks were often quick to deliver bold rate cuts and QE, stickly inflation will imply a slower and tamer reaction.

US inflation, past, present & future



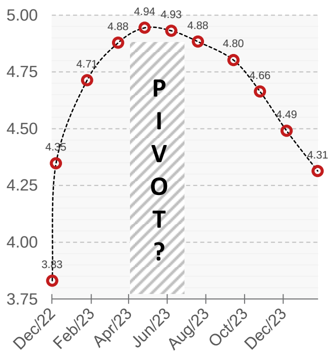
Source: Bloomberg, GIAM calculations

€ inflation, past, present & future (mkt implied)



Source: Bloomberg, GIAM calculations

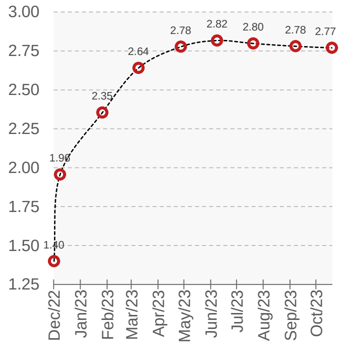
Implied Fed path



Source: Bloomberg, GIAM

Implied ECB path

Implied ESTR rate



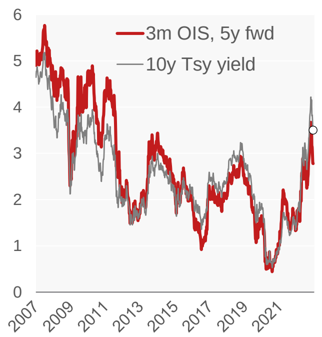
Source: Bloomberg, GIAM

The year of Fixed Income?

> We see 10-year Treasuries trading at 3.25% at the end of 2023; less confident about downside in 10-year Bund yields

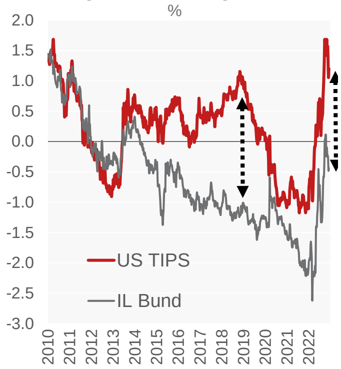
After the crash. The drawdown in Fixed Income indices was exceptional in 2022, with the Global Aggregate drawdown about 4 times the size of those generally seen over the past two decades. The inflation shock and repricing of the central bank paths have been brutal. We cannot exclude that the persistence of inflation and initial economic resilience would lead to a further repricing, yet over the past few months 10-year Treasury yields have fully decoupled from the implied Fed Fund peak. Instead, they continue to move in sync with the terminal rate (proxied by 3-month OIS, 5 years forward). Though Treasury term premia are still generally low from a historical perspective, 10y Treasury yields, above 3.50%, are trading significantly above that terminal rate (2.80%). Looking at 10y rates as the compounding of short-term rates, this gap can be explained by the high-level of short-term rates in the first years, as the Fed fights unusually high inflation. However this gap will narrow as we get closer to Fed cuts. We see 10-year Treasuries trading at 3.25% at the end of 2023.

Medium-term Fed rate expectations cooling off



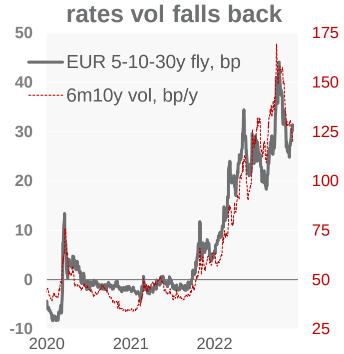
Source: Bloomberg, GIAM

10y real bond yields



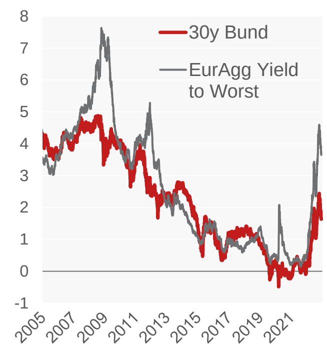
Source: Bloomberg, GIAM

EUR belly set to richen as rates vol falls back



Source: Bloomberg, GIAM

IG-30y Bund = 200bp



Source: Bloomberg, GIAM

> Long-term EUR real yields set to rise relative to USD. Prefer the EUR belly to the wings.

We are less confident about Bunds, despite our slightly less hawkish ECB views (relative to market pricing). In contrast to Treasuries, 10-year Bund yields (1.92%) are trading some 26bp through 5y3m ESTR (2.18%). The terms of trade shock coming from the energy crisis has sharply deteriorated the EA current account, which will make Europe more dependent on foreign investors. This comes as a times of elevated net supply, while the ECB is set to (cautiously) run down its APP portfolio. Also, fiscal policy will be more expansive in the EA, especially Germany, than in the US in 2023. In this context, it is hard to justify that long-term German real yields continue to trade at a large premium relative to US TIPS (second chart above). That said, for choice in EUR rates we prefer the belly of the curve (say, 7-10y) relative to the wings. That trade has worked well already over the past few months, and we expect follow through as rates volatility continues to retreat (third chart above).

> Average Yield to Worst of Euro Aggregate Corporate some 200bp above the 30y Bund, with a much lower volatility

We continue to favour EUR Investment Grade credit, which is cheaper from a historical perspective than other credit segments (especially global High Yield and US credit). The average Yield to Worst of the Euro Aggregate Corporate index, above 3.5%, is more than 200bp above the 30y Bund, with a much lower volatility. IG spreads also appear very large relative to EUR sovereign spreads, although the latter are exposed to a combination of higher yields and negative real GDP growth that threaten the debt dynamics. Our central case sees only a moderate widening of sovereign spreads in 2023, but the original EMU flaws – which the governance discussion under discussion fails to address – put risks much to the widening side as the EA recession develops. Of course, Corporate IG spreads may also widen as the global

EUR IG spreads attractive relative to sovereign spreads; IG Financials offer carry

economic outlook darkens, but for buy-and-hold investors IG credit offers good value (and historically no default). Within the EUR IG space, we are warning up to Financials, where spreads have widened relative to non-Financials, despite financial equities outperforming the index. We do not necessarily expect spread reconvergence, since issuance in Financials is expected to stay relatively buoyant; but carry there is now attractive.

High Yields spreads too complacent about the cycle

We stay defensive on High Yield, as defaults are starting to pick up and spreads seem to be mispricing the developing recession pressures (left-hand chart below). High Yield was one of the best performing asset classes in 2022 (EUR HY still down nearly 10% YTD as we go to press), largely thanks to its relatively low duration. This will no longer be an advantage in 2023, and spreads are set to widen in 1H23.

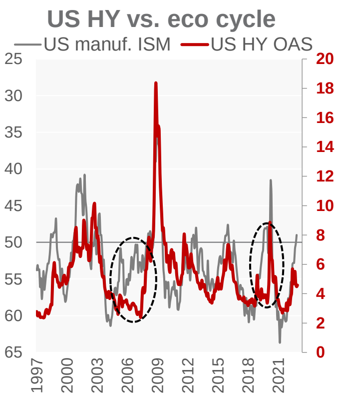
BoJ a low probability / high impact risk for high-grade FI

One wild card in the high-grade sovereign and corporate bond space will come from Japan. The JGB curve is relatively steep already, making long-dated western bonds unattractive to Japanese investors on a currency-hedged basis. Our central scenario is that the BoJ will adjust the YCC policy only cautiously but this will depend on inflation and the new governor. Unexpectedly large moves once the current 25bp cap on 10-year JGBs is adjusted would potentially disrupt global bonds as western markets become increasingly unattractive to Japanese investors.

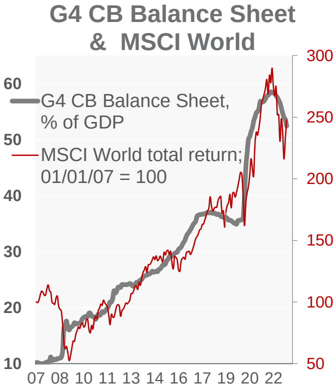
Fade the equity bounce for now, but seize opportunities into Q4 Fed cut

Equity valuation and earnings unattractive at the turn of the year; we will likely warm up to the asset class in 2H23

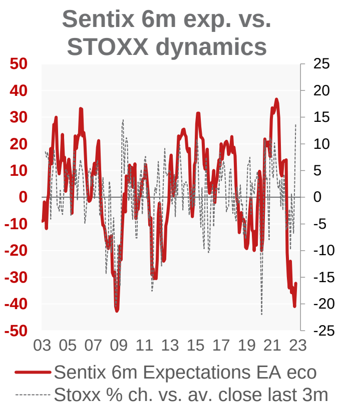
Dissonance. We will start the year with an underweight in equities. The policy environment remains unfriendly, with QT unkind to equities (chart 2 below). The recent outperformance of cyclical stocks is dissonant with the depressed economic sentiment (chart 3) and the recession signal from inverted yield curves. We hear that such inversion simply reflects the future normalisation of monetary policy from very restrictive territory eventually – yet we struggle to see why such restrictive policy would leave financial stability unscathed. Equity multiples dropped in 2022 but appear too high still relative to real bond yields (final chart). Earnings consensus for 2023 (single digit positive) also appears too optimistic. Our sector/style preference is mixed (see Equity section), but cyclicals look rich at the turn of the year, while the 2022 outperformance of Value will run out of steam along with bond yields. Selected EM markets offer value after years of underperformance, with the USD fatigue and China (mild) rebound both helping – we see EM as a target for positioning early for the post-recession environment.



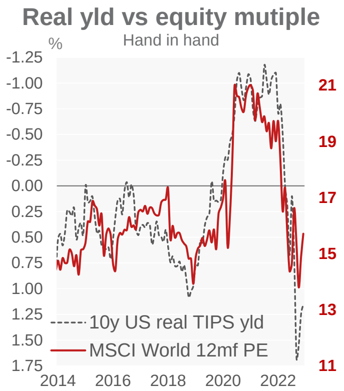
Source: ISM, Bloomberg, GIAM



Source: MSCI, Bloomberg, GIAM



Source: Sentix, Bloomberg, GIAM



Source: MSCI, Bloomberg, GIAM

MACROECONOMIC OUTLOOK

Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

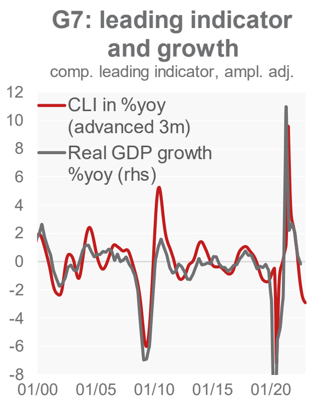
- **Headwinds to the global economy are set to intensify before they give way to a more synchronized rebound by late 2023. The energy and confidence shock from Russia's invasion of Ukraine will cast a long shadow over the winter.**
- **The drag from high inflation and energy prices will continue to erode real incomes in Europe. The monetary squeeze is likely to also send the US into a (mild) recession while complicating the European recovery from the winter lows.**
- **Supply chain bottlenecks are losing their sting, helping to ease price pressures in manufacturing. Yet high energy costs, tight labour markets and adaptive expectations keep feeding through the economies. The pace of disinflation will thus prove painfully slow.**
- **The Fed and ECB will continue to prioritize their inflation fight over cyclical support in early 2023. Yet easing price pressures and mounting economic headwinds (recession in Europe) will slow the pace of tightening. Peak rates may be reached by end-Q1, with the Fed likely to eye first cuts in Q4 as recession bites over the summer.**
- **China has started the reopening process from its very costly zero-Covid strategy. A choppy path over winter amid still low vaccination will be followed by a stronger reopening bounce in the spring.**

It will be a tough start into 2023 as the spectre of stagflation keeps haunting Western economies. Headwinds to the global economy will intensify into winter. Europe is dipping into recession as the war in Ukraine and curtailed energy supply hit confidence and constrain production. Central banks' unfinished fight against inflation will draw on demand over 2023 while sticky inflation keep eroding real income.

Global inflation is past peak - but central banks' uphill battle is not finished as price pressures will ease only very sluggishly

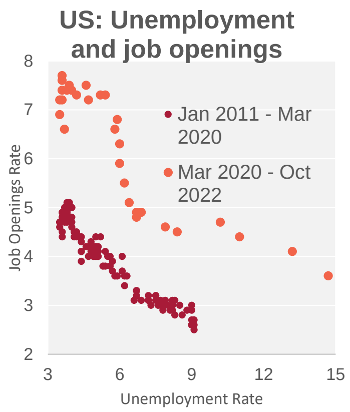
The inflation descent will prove painfully slow

Global inflation is past peak, but its descent will prove very sluggish. Encouragingly, supply chain disruptions are losing their sting fast as global bottlenecks ease and new orders plummet, curtailing price pressures for goods more lastingly. Yet risks to energy costs are tilted to the upside, while tight labour markets keep underpinning wage growth. Central banks still face an uphill battle in preventing inflation overshoots from becoming entrenched. Inflation is unlikely to reach targets by year-end 2023.

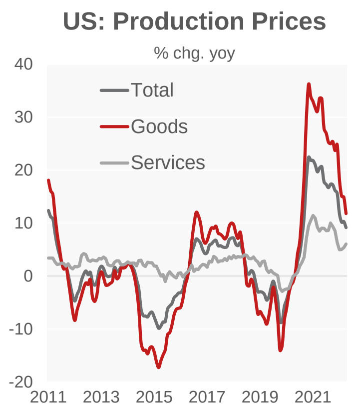


Source: OECD, Datastream, GIAM calculations

Source: Datastream, GIAM



Source:BLS, Refinitiv, GIAM



Source:BLS, Refinitiv, GIAM

Declining exports, tight global financial conditions and a strong USD still weigh on emerging markets (EMs) near term. But China's prospective spring reopening and a weaker US dollar will help further into 2023. Inflation pressures (ex CEE) are already easing helping EM central banks to fade their tightening cycles, while some (incl. China, Russia, Turkey) keep eyeing further monetary easing.

Downside risks to our base case prevail, with an escalation of Russia's war in Ukraine and cracks in the financial plumbing ranking high

Substantial risks surround our outlook. A surprising road to negotiations between Ukraine and Russia, a smooth reopening of China and a swift easing of disruptions on energy and goods markets may herald a faster recovery. Yet overall risks are skewed to the downside. First, an escalating war in Ukraine plus cold weather could send Europe into a deep recession. The hands of policy makers would be tied by mounting energy prices and fading fiscal space. Second, tighter financial conditions and the euro area recession may trigger deeper cracks in the financial plumbing. Banks would suffer from rising provisioning needs and larger vulnerabilities may be hidden in the non-bank sector. Drained liquidity and slumping sentiment would force central banks to reverse their tightening course, but the scope for fiscal support would be much more limited given higher public debt and rates.

US: mild recession, but risks are tilted to the downside

Tight money leads to a mild contraction of US activity in mid-year. The unemployment rate will exceed 5% by year end, with core inflation still above 3%.

We expect barely positive US growth (0.3%) in 2023, with even a mild contraction over the central quarters of 2023. Cooling activity amid higher interest rates and a difficult global environment will bring inflation back on a downward path, consistent with the ensuing moderation in producer price inflation. Still, we expect core CPI inflation to end 2023 slightly above 3% yoy. The contraction in the most rate-sensitive parts of the economy, like construction, will continue, non-residential capex will remain flat (also due to falling margins), and consumption growth will drop from 3% in 2022 to around 0.7%. The large pool of savings accumulated during the pandemic is shrinking fast, and at some point, consumers will prop up their savings rate, which has dropped in autumn to a record low of 2.5%.

The labour market will be crucial: in H2 2022 job openings have decreased without boosting unemployment, in line with the Fed's plan of a "softish" landing. Yet thus far the labour market remains tight, with nearly 1.8 job openings per unemployed. A more significant drop in job availability is needed to moderate wage growth: It will be hard to accomplish without a rise in the unemployment rate. The 4.4% year-end 2023 forecast posted by the Fed looks too rosy, we expect a figure above 5%.

After lifting rates to 5% by Q1, the Fed will likely start cutting in Q4. A harsher downturn could lead to a pause or early halt of QT

The Fed will continue to hike in Q1 2023 to peaks at 5% (upper bound). Yet the Fed is unlikely to keep rates at this level throughout the year. More fragile activity and the downward trend in inflation should convince the Fed to cut rates by 50 bps in Q4. Risks to the growth outlook are tilted to the downside, as the economic impact of monetary tightening could prove more damaging, which may trigger earlier and deeper rate cuts but also pausing of even halting the quantitative tightening before the expected end date (mid-2024).

Euro area in a winter recession

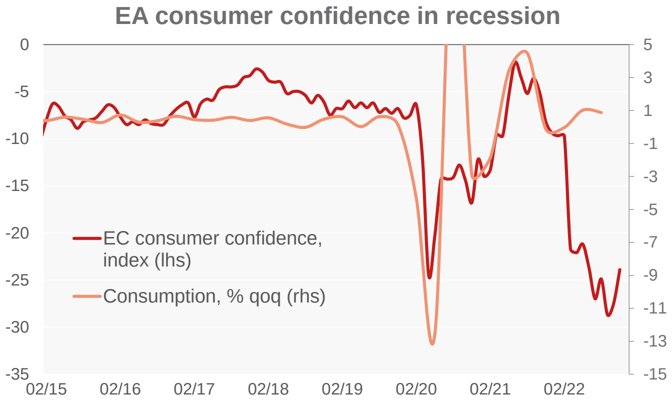
Euro area economic activity held up well so far. It expanded by +0.3% qoq in Q3. Latest sentiment indicators showed signs of improvement. The labour market stayed solid; consumer confidence detached from its lows. Still, we caution to become too optimistic and think that a more significant downturn is ahead. Key indicators remain in clearly recessionary territory and real M1 growth even heralds a worsening.

High inflation and tighter financing conditions will restrain recovery after winter recession

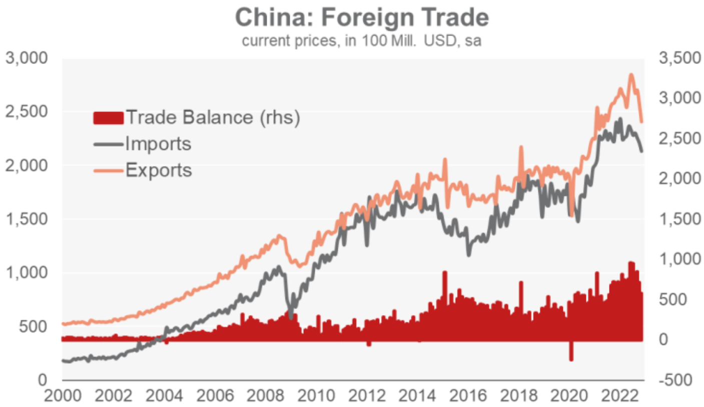
Stubbornly high inflation remains a drag on activity. While the 10.6% yoy October 2022 inflation rate likely marked the peak, we expect readings to come down only slowly and to still average 6.0% in 2023, after 8.5% in 2022. More importantly, underlying inflation will prove sticky as past input prices increases keep feeding through the economy and wage growth will remain high. But for consumers, wage increases will fully compensate for inflation, thus denting real income. Consumption is still supported by the deployment of pandemic-related excess savings. But the jury is out to which degree that can be maintained in 2023.

ECB policy tightening to continue in spite of recession but QT to become more important

The ECB will lift rates further into restrictive territory to a peak at 2.5% in Q1 and keep it at this level through year-end. The risks are tilted towards an even higher peak. Moreover, the ECB announced already that it will start reducing the stock of purchased assets. We expect this quantitative tightening (QT) to start in Q2 – confined to not reinvesting maturing bonds bought under the asset purchase programme (APP). We think that the volume will amount close to € 30 bn from April onwards. Hence, financing conditions will further deteriorate thereby also dragging on activity. All in all, we look for a recession in the 2022/23 winter half and see the economy recovering only moderately thereafter so that output shrinks by -0.1% in 2023.



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

China is pivoting away from its strict zero Covid policy

China's Covid strategy is fraught with uncertainties

Despite near record-high fresh infections, China recently pivoted away from its strict zero-Covid policy amid public protests, but also due to the damage widespread lockdowns as well as the ailing real estate sector have done to the economy. The last politburo meeting clearly signalled that the policy focus has shifted to prioritising growth, as domestic demand has been contracting and export support is vanishing quickly.

Amid a global cyclical downswing, China is set to concentrate on reviving domestic demand. Steps to support private consumption have been incorporated in the relaxation of Covid restrictions. Help for the real estate sector is also underway. The PBoC laid out a 16-point plan for financial institutions in mid-November to greatly support the property sector's access to funding. The central bank also injected liquidity via a cut in the reserve requirement ratio (RRR) by 25 bps. We expect a slight reduction (10 bps) of key rates, followed by another RRR cut by 25 bps early next year. We see the winter to remain bumpy in China. Especially the Covid development is fraught with uncertainties. An adverse scenario could involve a strong Covid wave with a heavy death toll and a back-and forth of Covid restriction. To avoid this, a fresh vaccination campaign plays a crucial role, and seems to have already started. Thus, we expect more Covid easing steps in spring which would allow growth to subsequently rebound, with an average of 4.8% in 2023.

GOVERNMENT BONDS

Florian Späte

- **The parallel development of Treasury and Bund yields is not expected to continue in 2023. US yields are seen to continue their recent downward trend in the face of declining inflation and cautious key rate cuts by the Fed in Q4.**
- **Bund yields are likely to escape this trend. Given the slower decline in inflation and missing key rate cuts in 2023, we still expect some upside leeway in the short term. For the year, we forecast a sideways trend.**
- **Euro area non-core government bond spreads are set to widen over the course of 2023. Considering a higher underlying yield level, they look overvalued compared to other risky fixed income assets.**

Transatlantic yield spread to tighten. The peak in long-term US yields is very likely behind us and we forecast a further downward trend over the course of 2023. While we regard the currently priced Fed stance as largely fair (peak of upper bound Funds Rate at 5.0%, year-end 2023 at 4.5%) medium-term key rate expectations which tend to drive 10-yr yields will guide US long-term yields lower. The gap between USD 5y3m OIS and 10-yr US yields even widened indicating further leeway for US yields to fall. This development will be supported by a further decrease in inflation. Both headline and core inflation have passed their high point and headline inflation will come down to around 4% in 2023 (from 8.0% in 2022). A split US Congress will prevent expansionary fiscal policy and there are now also signs of cooling of the US labour market preparing the ground for very weak growth in 2023.

US yields to continue to fall despite further Fed key rate hikes

On the contrary, the still high level of key rates and inflation will counteract a strong decline in US yields. All in all, we forecast 10-year US yields to decrease to around 3.15% by year-end 2023. The drop will be even more pronounced at the short end of the curve but given a current record high 2-yr/10-yr inversion of 80 bps, the yield curve will remain inverted.

Bund yields are expected to decouple from this trend to some extent. This rather unusual pattern comes mainly from the belated ECB's reaction to the pick-up in inflation compared to the Fed. According to current market pricing, the deposit rate is priced at almost 3.0% in Q2 (we assume a slightly lower peak at 2.5%). We agree with financial markets that no key rate cut will occur anytime soon. Still, the monetary policy stance in the euro area will not reach restrictive territory. As the chart below shows real short-term yields (approximated by 1-yr OIS minus 1-yr inflation rates) are still in negative territory and will hardly cross the zero line. Hence, in contrast to the US, real short-term yields will not reach a restrictive level and will therefore contribute to a slower decline in inflation compared to the US. Accordingly, the inflation gap versus the US will widen with the CPI rate in the euro area almost higher by 2 pp in 2023.

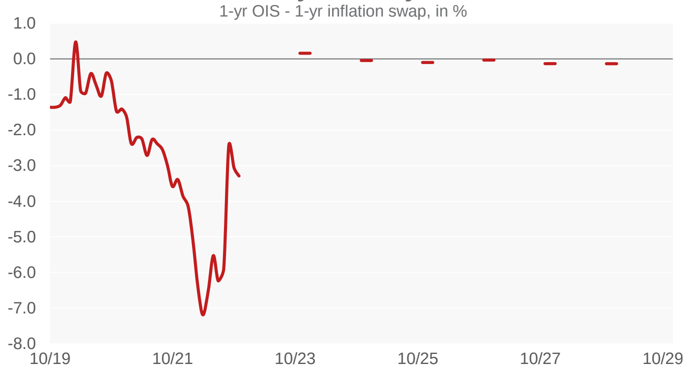
10-yr Bunds still trading at a premium indicating some upside in Bund yields

What is more, TLTRO redemptions and the ECB's Quantitative Tightening (QT), which is forecast to start in Q2, will be uncharted territory for euro area government bond markets. As a result, this should somewhat raise the term premium. Moreover, given the looming recession and the energy crisis which hit the euro area particularly hard, there is upside potential to fiscal policy (implying an ongoing high level of net issuance, see below). Finally, in contrast to the US, 10-yr Bund yields are still trading below the priced medium-term key rate (despite the declining gap still around 25 bps between 5y3m OIS and 10-yr Bund yields).

Overall, there is leeway for Bund yields to rise a bit in the months to come. Particularly very long-dated yields have the potential to increase (but not completely reversing the current 10-yr/30-yr inversion again). As soon as it becomes clear that the ECB has reached the high point of the cycle and inflation rates fall noticeably, yields are likely to fall somewhat again. This results in a sideways trend in 10-yr Bund yields at around 1.80% for the year.

EA: 1-year real yield

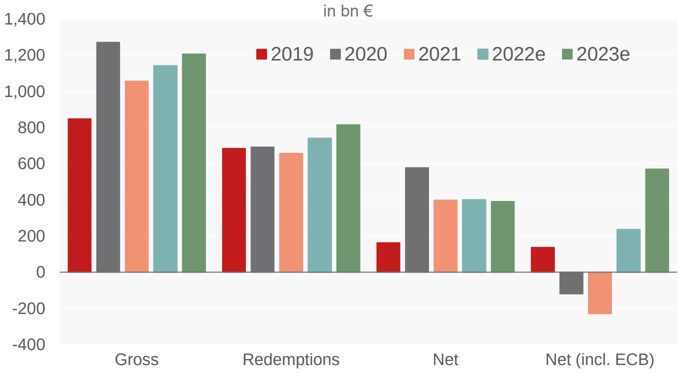
1-yr OIS - 1-yr inflation swap, in %



Source: Bloomberg, GIAM calculations

Euro Area: Government Bond Issuances

in bn €



Source: Bloomberg, Datastream, GIAM calculations

Euro area non-core government bonds overvalued

Withdrawal of ECB support a major head-wind for euro area non-core government bonds in 2023

The tightening of euro area non-core government bond spreads over the course of Q4 driven by a rebound in risk sentiment does not appear sustainable and we expect a re-widening in 2023 – although the 2022 peak will most likely not be reached again. The environment for non-core bonds is challenging and an improvement is not in sight. To start with, the government net issuance is forecast to remain at an elevated level. If anything, there are upside risks triggered by a positive fiscal policy stance. The situation will be exacerbated by the fact that the ECB will not only any longer appear as a buyer but will also not reinvest maturing bonds (QT). We expect a net-net supply of almost EUR 600bn (a new historical high) in 2023. This is likely to affect highly indebted countries and push up spreads. The decision to put fiscal consolidation on the back burner has led to a significant deterioration in fundamentals. Larger non-core countries (Italy, and Spain) are characterized by a fiscal deficit well above the euro area average (and this will not change until at least 2024 either). They will not achieve any noticeable debt/GDP ratio improvement in the years to come. Given the higher yield level, the deterioration in debt metrics is particularly severe and might come on market participants' radar screens again.

However, the market environment is also not conducive to non-core government bonds. The spread tightening over the course of Q4 has occurred although the core yield level is still comparatively high. As we forecast core yields to remain on an elevated level (or even rise temporarily) spreads look dislocated. Additionally, from a relative value perspective euro area non-core spreads have tightened much more than spreads of other risky fixed income assets (e.g., corporate bonds). This decoupling appears unsustainable and is expected to reverse over the course of 2023. Finally, with the upward shift of very long-dated JGB yields (30-yr yields up by 70 bps to 1.4% since the beginning of 2022) and the high hedging costs for investors, support for euro area non-core bonds from Japanese investments will continue to decline.

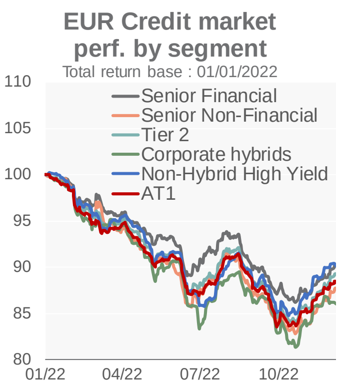
Overall, we expect a spread widening for Italy and Spain in particular. We forecast yields on 10-year BTPs to rise to around 4% by the end of 2023 (a spread of 220 bps over Bunds). Smaller non-core countries will not be able to completely escape the widening of spreads but will probably perform somewhat better.

CREDIT OUTLOOK

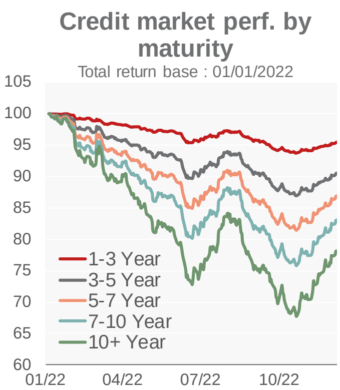
Elisa Belgacem

- **We remain overweight Investment grade as 1/ valuations are attractive both versus other asset classes and within the credit space 2/ fundamental deterioration should remain limited 3/ technicals should be relatively supportive despite QT.**
- **On HY we keep a cautious stance as we consider that the poor economic landscape is not reflected in valuations, and we expect fundamentals to deteriorate significantly in 2023. Both defaults and downgrades will trend up, especially in smaller and more cyclical companies.**
- **To get extra yield, we recommend going for long duration in IG, although curves are already very flat, and to favour subordination risk to credit risk except in the real estate sector.**
- **Finally, a trend that will go on next year is the growing share of sustainable financing that could amount to up to 40% in IG including all green, social sustainable bonds and SLBs. Moreover, we expect the climate profile of companies to become an increasingly important driver of idiosyncratic valuations.**

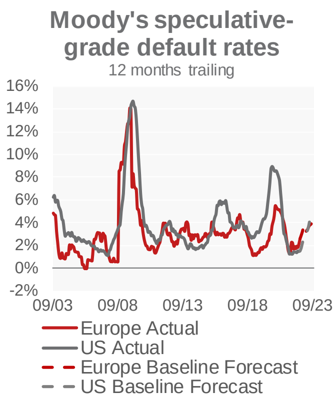
After a storm comes a calm: 2022 was the worst year in history for EUR IG total return performance, allowing 2023 to start on more attractive levels. Valuations metrics among the credit universe are currently showing that the European IG space is the cheapest compared to US IG and both EU and US HY. Technical should be relatively neutral in EUR IG, with QT starting on the negative side in the first half of 2023 but supply should also be limited especially in non-financials. As rates should also be more stable, the carry of the IG space coupled with extremely low historical defaults should help flows stabilise. In HY the picture will likely be more challenging. Supply has been almost inexistent in 2022, forcing HY corporates to issue more next year in a challenging market environment.



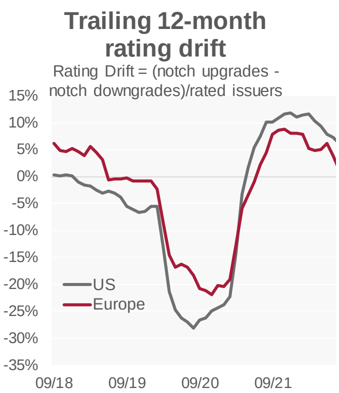
Source:Bloomberg, BofAML, GIAM own calculations



Source:Bloomberg, BofAML, GIAM own calculations



Source: Moody's, GIAM

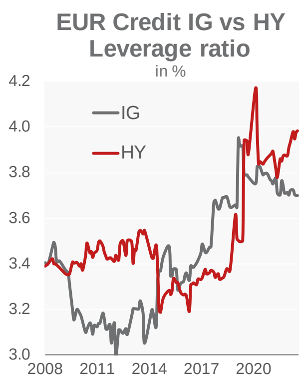


Source: Moody's, GIAM

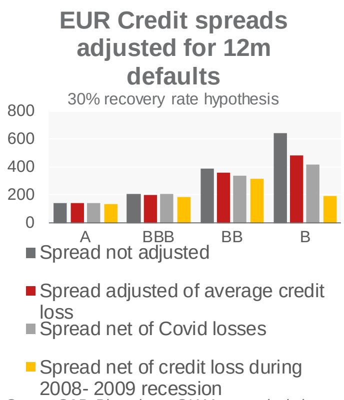
Higher carry but higher defaults

> Defaults will likely jump from around 2% currently to above 4% by the end of 2023

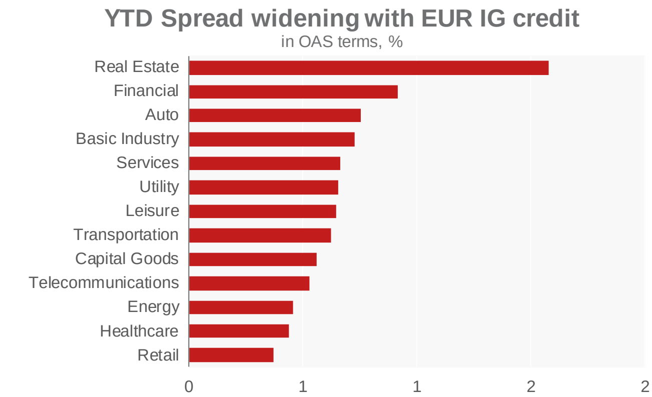
Rating agencies will logically start with the most at-risk companies. As they did in 2020, we expect rating agencies to revise in priority the notations of companies at the lower end of the rating spectrum. Indeed, nearly 50% of HY-rated companies were downgraded by at least one notch, while IG has been mostly put on a negative outlook. Predicting defaults in this context is also a rather complex exercise. On one side, Europe's gas situation will command a recession that could vary according to winter temperatures. And on the other side, the government support that helped contain defaults to 5% in Europe during Covid will be smaller due to lesser fiscal leeway from governments. Also, we expect smaller companies to be the most at risk. Hence banks' asset quality should also deteriorate, which leads us to remain underweight financials versus non-financials in spread terms. However, as the carry is now higher in the financial space as spreads have substantially diverged over the course of 2022, we expect the total returns of the financial index to surpass the non-financial one. Hence, we do upgrade financials in our tactical asset allocation.



Source:iBoxx, GIAM own calculations



Source:S&P, Bloomberg, GIAM own calculations



Source:Bloomberg, BofAML indices, GIAM own calculations

Prefer long IG and subordination risk to pure HY

The dispersion of total return performances across the various credit segments, has been relatively low. The true discriminant factor in 2022 has been duration. The 10Y+ segment of EUR IG is closing the year with nearly 25% of negative performance. We think 2023 will be different, although credit curves are relatively flat after the 5Y point, but for a good reason. With rates likely plateauing, in a context of high uncertainty regarding defaults in the HY space, it makes sense to go long IG to enhance returns in credit. Similarly, subordinated bonds are mostly compensating for extension risk and coupon risk. At current level we do estimate that the former is well compensated for, while coupon risk is very low as most of those bonds are issued by solid IG rated companies. We even see upside in spread terms as we do expect more companies to call their bonds than what the market is expecting in corporate hybrid and in AT1s.

Strong influence of climate profile in valuations

> The E component of ESG scores is becoming a key determinant of idiosyncratic valuations

ECB just started to tilt its corporate purchases according to climate criteria. While this is a crucial step for the ECB, the fact that the quantitative tightening is fast approaching, potentially reducing the reinvestments in the APP already in Q123, may reduce the market impact initially envisaged. That said, as most private investors are concomitantly attempting to improve the carbon footprint of their portfolio, we are still expecting the “E” component of the ESG scores to further feed into credit market valuations, mostly in the most polluting sectors (Energy, Utilities). Also we do expect the labelled ESG issuances to account for 40% of the 2023 supply.

Decompression trade still on

Overall, we do prefer IG to semi-core and peripheral sovereigns, and we prefer Europe to the US on valuation grounds. In Europe IG levels are currently incorporating a severe recession scenario. We expect spreads to trade around current levels over the course of next year. For HY, we think that positioning is already very short, but risks remain elevated and current levels do not reflect for the downside risks to our economic scenario. Consequently, we expect spreads should widen nearly 100bp in the first half of 2023 before ending the year 50 -60p wider compared to current levels.

EM SOVEREIGN CREDIT

Guillaume Tresca

- **We expect some moderate widening in EM hard currency spreads as recession in advanced economies will weigh.**
- **Yet, total returns will likely turn positive in 2023, driven by a significant positive duration effect and elevated carry. Technicals will also be supportive, while China's reopening and mounting hopes of a Fed pivot later in the year will support sentiment.**
- **We continue to favour IG over HY, given the level of uncertainty. While the systemic risk is low, valuations are not cheap. We see value in BBBs and avoid frontier economies as refinancing risk is high.**

Better narrative to come with a positive total return. After the worst year for EM assets since 1994, the EM outlook will be far more constructive in 2023, with a total return in the high single digit for sovereign credit, a level close to the long-term average. Positioning has been cleaner, valuations are fair on average, core rates have reached their peak, and China is on its way to reopening.

Strong carry and positive duration effect to lead to positive total return

The positive return does not mean that all risks have been cleared. Several headwinds remain in place, but the starting point is much better, and EM fixed income should fully benefit from the decline of US rates and the USD peaking. A significant negative duration effect essentially drove EM underperformance while spreads even tightened for the highest-rated countries. Even in a stable rate environment with no spread change, total return would be close to 6-7% thanks to a huge carry. Yield-to-worst will be at its highest level for the start of the year since 2009, providing a large buffer to various headwinds, both for HY and IG

Positive carry and duration effect

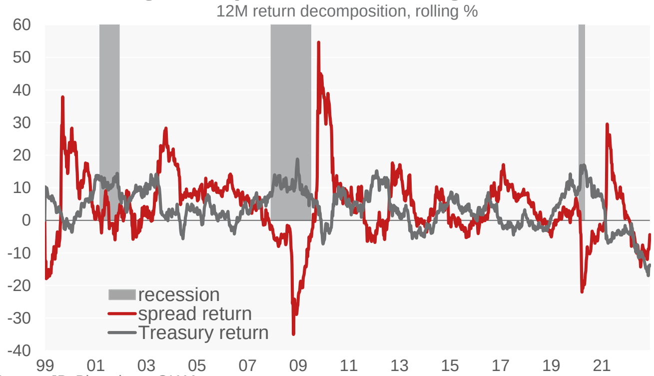
1Y total return for different scenarios, EMBIGD

OAS spread	US 7Y 3.3%	3.4%	3.5%	3.6%	3.7%	3.8%	3.9%	4.0%
425	13.9%	13.2%	12.5%	11.8%	11.1%	10.4%	9.7%	9.0%
435	13.2%	12.5%	11.8%	11.1%	10.4%	9.7%	9.0%	8.3%
445	12.5%	11.8%	11.1%	10.4%	9.7%	9.0%	8.3%	7.7%
455	11.8%	11.1%	10.4%	9.7%	9.0%	8.3%	7.7%	7.0%
465	11.1%	10.4%	9.7%	9.0%	8.3%	7.7%	7.0%	6.3%
475	10.4%	9.7%	9.0%	8.3%	7.7%	7.0%	6.3%	5.6%
485	9.7%	9.0%	8.3%	7.7%	7.0%	6.3%	5.6%	4.9%
495	9.0%	8.3%	7.7%	7.0%	6.3%	5.6%	4.9%	4.2%
505	8.3%	7.7%	7.0%	6.3%	5.6%	4.9%	4.2%	3.5%
515	7.7%	7.0%	6.3%	5.6%	4.9%	4.2%	3.5%	2.8%
525	7.0%	6.3%	5.6%	4.9%	4.2%	3.5%	2.8%	2.1%

Source: Bloomberg, GIAM

Negative spread return during recession

12M return decomposition, rolling %



Source: JP, Bloomberg, GIAM

Recession risk to push wider EM spreads

The main risk and uncertainty for 2023 is the recession in the US and Europe, leading to wider EM spreads in our view. Based on the history of previous recessions, EM spreads widen in the recession period. Likewise, in the last Fed tightening cycles, EM fixed-income underperformed in the run-up to the Fed peak rate and then performed for a short 3-6M period before underperforming as recession occurred. It is hard to draw definitive conclusions as all previous cycles are not homogenous, but we expect the first part of the year to be more supportive than the second half. EMs have already started to rally on the relief of a Fed peak rate and should continue at a more moderate pace until the peak in Fed rate. As macro data deteriorates, we expect a rewidening of the spreads but not the wides seen in 2022. It is difficult to see a meaningful tightening as long as real rates remain at a high level and global PMIs deteriorate.

Uncertainty and duration favour IG.

Keep a preference for IG

The recession risk and the positive duration effect favour EM IG over EM HY. Even if the EM narrative has improved, uncertainty is high to take risky exposure. In the EM IG, valuations have very expensive for the highest-rated buckets. We favour the BBB bucket, where valuations are more attractive given the past spread correction, and it has the largest duration to benefit from the US rate decline. We like Mexico, Romania, and Indonesia. In EM HY, valuations are cheap but only optically. Nearly a quarter of the EMBIGD index is at distressed levels, and half of the index spread widening has been driven by CCC names. EM spread ex-distressed countries is close to its long-term average, suggesting that the risk premia is not high. EM HY will be hit by the recession risk, especially the B bucket. We prefer the BBs, which have a larger duration and better balance sheets. Colombia is trading cheaply, and we have a neutral view on Brazil, given the political risk. Bond prices are already low and return in HY will be very idiosyncratic. From a regional point of view, European names will underperform due to the recession, energy supply risk and the Ukraine-related geopolitical risks.

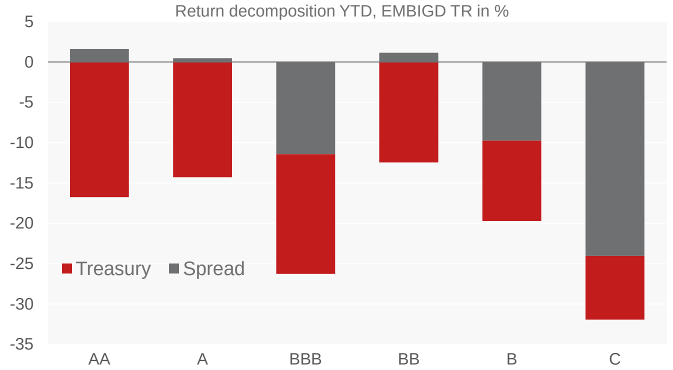
Refinancing risk for frontier economis is high but no systemic risk

Pressure on frontier markets but no systemic risk

EMs enter the expected recession with weaker balance sheets due to Covid. Some compartments of the EM spectrum, EM frontier economies, are still fragile, facing refinancing risks. EMs 'growth resilience has been at the expense of the depletion of domestic private savings cushions and larger fiscal gaps, leading to wider CA deficit. Large EM economies have been more insulated from global market sentiment than in 2013, but frontier markets have seen a deterioration in their reserve adequacy ratio. The weakest-rated EM countries continue to exhibit weak ratios. Their interest-to-revenue ratio has increased, and the higher marginal interstate rate will limit their room to manoeuvre. Repayment risk will remain in focus, but it will not be a systemic risk.

Duration drove the sell-off

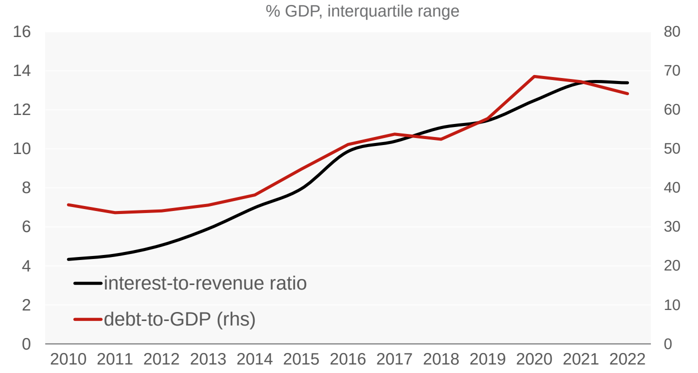
Return decomposition YTD, EMBIGD TR in %



Source: JP, Bloomberg, GIAM

Frontier markets debt services doubled

% GDP, interquartile range



Source: IMF, GIAM

The Chinese grand reopening to lift sentiment up

The latest Politburo meeting has paved the way for a swifter-than-expected reopening. Arguably, the risk is that it will lead to a rise in cases in Q1, but ultimately it creates more upside economic risk in the medium term and alleviates one of the headwinds faced by EMs. North-Asian countries and some LatAm economies will benefit the most in Q2-Q3, but the impact will not be disruptive as it should boost more services than exports/imports of goods. Hence, it will not be a game changer for global EM sovereign credit, and China still deals with the real estate market, but at least it will support EM sentiment.

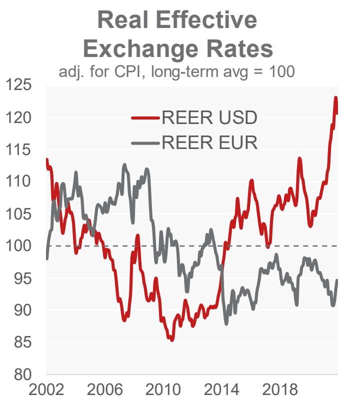
CURRENCIES

Thomas Hempell

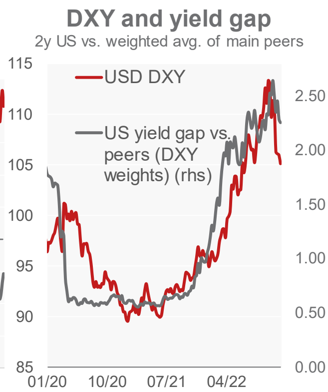
- **The fundamentally overvalued USD is past peak. The Fed's final hike looming for early spring 2023 is set to reduce rates uncertainty (a previous USD boost) and path the way to narrowing yield gaps vs major peers.**
- **Initially, the transition is likely to prove volatile, though. The EUR is still to feel the pain from recession and the energy crunch, leaving EUR/USD shaky near term. But fading recession forces by early spring may mark the start of ensuing capital inflows to the euro area and a more sustained EUR recovery.**
- **Lower US yields and tweaks to the BoJ's policy stance in spring will tighten US/Japan yield gaps. This will benefit the JPY, defying the drag from high energy prices on Japan's trade balance and terms of trade.**
- **EM FX will recover ground against a weaker USD as the Fed tightening matures and the US economic resilience gives way to a mild mid-year recession. Yet CNY will struggle well into spring as diverging monetary policy and Covid complications weigh on the currency.**

As the Fed slows its pace of tightening and may pivot in late 2023, yield differentials will turn from tailwinds into headwinds for the USD

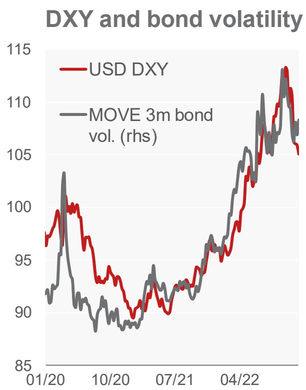
Even after the USD's sharp correction over autumn (DXY -8% from late Sept. to early Dec.), the greenback remains fundamentally dear (left chart) and is poised for a reversal over 2023. A key driver of US strength in 2022 was the Fed's lead in the tightening cycle and the rates uncertainty emanating from soaring inflation. While price pressures are set to ease only sluggishly, the Fed will slow down its pace of tightening, with a pivot towards rate cuts likely in Q4. This will erode the yield gap vs. other major central banks, while – more imminently – easing rates uncertainty will also continue to weigh on the USD (mid charts).



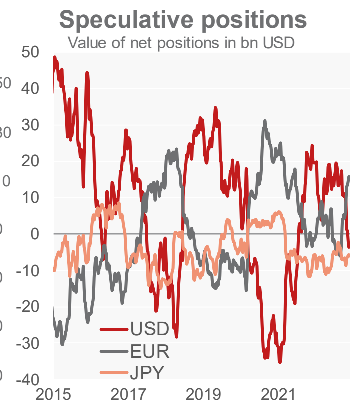
Source: Datastream, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM



Source: CFTC, Datastream, GIAM

The EUR/USD is burdened near term by the impending euro area recession, but a closing yield gap and easing rates uncertainty will lift the undervalued EUR/USD

Yet near term, the USD decline is unlikely to happen in a straight line. The recent USD correction looks somewhat exaggerated against yield and volatility developments, as it was underpinned by a sharper shift in speculative positions that may run out of steam. Most strikingly though, Europe is yet to dip into a winter recession, with the risk of a deeper energy crunch not yet tackled, while the outlook of persistently higher energy prices weighs on the euro's terms of trade and its international competitiveness. We are also sceptical that the recent rally of Southern European debt vs. Bunds is sustainable, making the euro prone for short-term weakness (left charts overleaf).

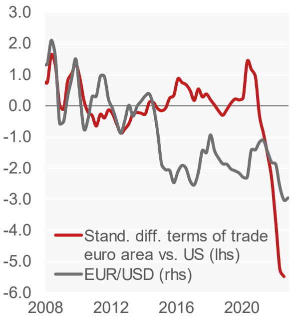
Further into 2023, however, the euro area's recovery from the winter recession, reverting capital flows from the US and China's spring reopening will contrast eroding growth in the US. This will weaken the USD also to the benefit of the euro. More generally, a recovery of global growth and risk sentiment will prove key headwinds for the anticyclical USD from lofty levels (mid-right chart) with a year-end target of 1.10 for EUR/USD in our books.

JPY to shine over 2023

A tighter yield gap with the US will benefit the JPY, even if the high trade deficit remains a drag

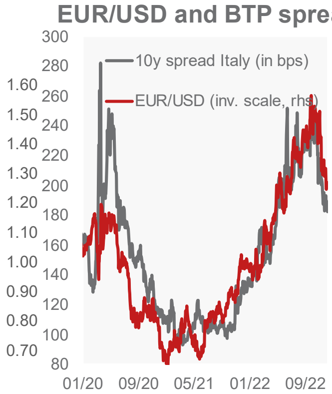
USD weakness is also set to benefit the cheap JPY. Admittedly, the adverse impact of high energy prices on the trade balance and terms of trade will continue to weigh. Yet US yields are likely to retrace further, while the BoJ is likely to amend its yield curve control (YCC), favouring a tighter yield gap and stronger yen (right chart). In our base scenario of persistently subdued inflation pressures in Japan, the BoJ will achieve to tweak its YCC gradually. The key tail risk, however, is that a faster increase of wages triggers a rebound in underlying inflation pressures that would force the BoJ into a disruptive unwinding of YCC. Such a sudden reversal of policy would send Japanese yields and JPY soaring in tandem, taking the USD/JPY well below the 130 target for our base scenario.

EUR/USD and terms of trade



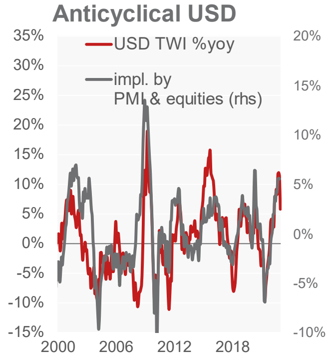
Source: Datastream, GIAM
terms of trade as std. from long-term mean

EUR/USD and BTP spread



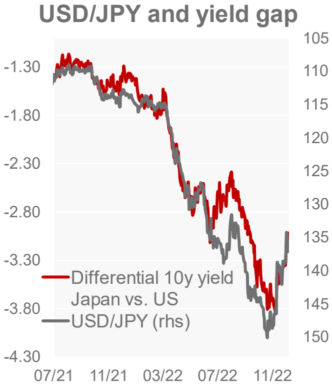
Source: Datastream, GIAM calculations

Anticyclical USD



Source: Datastream, GIAM calculations; model 2000-2019 based on MSCI World %yoy and

USD/JPY and yield gap



Source: Datastream, GIAM calculations

Sterling is not out of the woods yet as it faces the sharpest stagflation dilemma among advanced economies

We do not see the British pound (GBP) out of the woods, its impressive recovery since late September notwithstanding (+3.5% vs EUR, +13% vs USD). Given its gas dependency and tight labour market, the UK faces the most striking stagflation dilemma with the deepest 2023 contraction (-1.2%) among major advanced economies while inflation (7.5%) is ranking among the highest. Furthermore, the widened C/A deficit (likely >5% of GDP for 2022) is weighing on sterling. GBP may gain some modest ground against the broadly weaker USD but is likely to weaken against the EUR (with EUR/GBP at 0.89 in our books for YE 2023).

Emerging Markets (EM) currencies are headed for choppier seas in the near term amid the global growth slowdown. Yet with the Fed scaling back its tightening and US yields softening, the outlook for 2023 as a whole is constructive. Monetary easing and the challenging winter in China, where rising infections will cast shadows over the enthusiasm about the reversal of zero-Covid policies, will keep a lid on CNY near term. But the Chinese currency may later join the EM bounce against the USD as a recovery bounce takes hold. Increased activity in China will also benefit commodity exporters further into the year. Finally, given its high beta to EUR/USD, CEE currencies carry upside potential – but they are also particularly exposed to the further evolution of the war in Ukraine.

EQUITIES

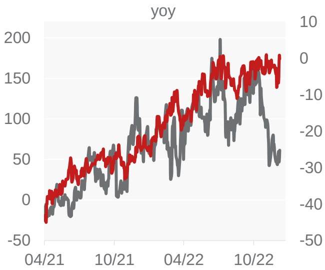
Michele Morganti and Vladimir Oleinikov

- **Peaking inflation and slowing growth should ensure peak Fed rate by spring, causing a fall in bond volatility (MOVE). More stable macro surprises, still low investor positioning, and Chinese policy changes on fiscal support and Covid are providing some support through the turn of the year.**
- **However, in addition to war uncertainty, sticky inflation, and our expectations of a deteriorating growth environment, we remain concerned about valuations being too high vs levels of real rates and BAA spread.**
- **Falling earnings are likely to reach a trough in summer 2023 at best, whilst monetary policy tightening continues near term (QT included). Thus, equities would be prone to reach again the lower band of the recent price range.**
- **Over 12 months though, thanks to bottoming earnings, the end of CB tightening, and a continuing fall in bond volatility, we expect positive total returns of 3 to 6%. This is coherent to target PEs of 17X and 12.5X (US and EMU) and a profit rebound by some 10% in 2024. For now we remain slightly underweight on equities. We overweight (OW) UK & Japan, marginal OW EMU vs. US, neutral on EM but with an OW on China. Within sectors, we OW Banks, KG, Div. Financials, Food, HCE, Transp. & Software. Our UW: Media, Com. Prof. svs, Retail, TLC.**

Too early to bet on a macro bottom: sticky inflation and valuations can hurt. Slightly UW

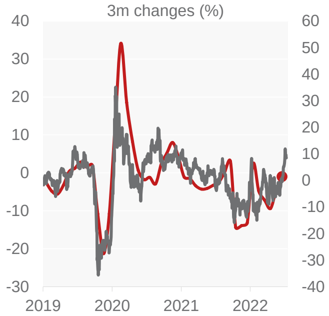
The recent rally has been supported by factors some of which are going to last, inducing us to be less UW on equities. Indeed, macro surprises have unexpectedly trended up in the euro area (EA) thanks probably to accumulated savings, fiscal spending, and strong labour market. US 10-year yields and bonds' volatility have most likely reached the peak, as inflation trend looks less strong and the Fed's pivot moment is nearer. We add to this a still low investors' positioning and Chinese policy change on fiscal support and Covid rules. Having said this, equities remain under pressure short term. The war uncertainty is lingering, and a broadened price pressure is causing inflation to remain sticky - albeit slowly declining, especially in the euro area (EA). Moreover, further CBs tightening plus QT will continue to worsen liquidity con-

US bond volatility and B/E rel. return
yoy



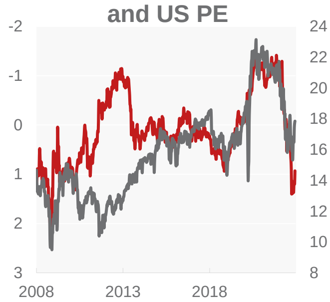
MOVE (1m bond vilatility index yoy)
US bond/equity returns (yoy rhs)
Source: Datastream, GIAM

MSCI EMU & IFO
3m changes (%)



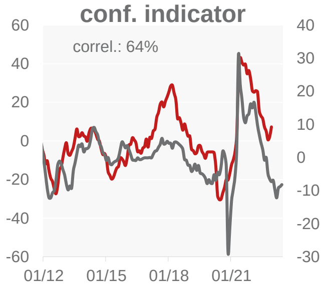
IFO expectations (3m %cng)
MSCI EMU (3m %cng, rhs)
Source: Datastream, GIAM

Real 10-year rates and US PE



US 10-year real rates using infl. linked swap (inv)
S&P 500 12m fwd PE (rhs)
Source: Datastream, GIAM

EMU: Earnings & Ind. conf. indicator



EMU: Earnings (12-month fwd yoy)
Ind. confidence momentum (6m abs ch adv. 7m rhs)
Source: Datastream, GIAM

ditions. Current economic resiliency and still strong labour markets could also induce CBs to maintain policy rates around the terminal rate for longer in 2023. While declining, current bonds' volatility stays too high as well, representing an obstacle to inducing a definitive upward move in equities. We see contained 12-month forward PEs at 17X for the US and 12.5X for EMU, due to high yields, credit spreads and inflation. Historically, with a reduced level of US inflation between 2.5% and 5% (we see 4% by end-2023), the resulted risk premium would induce the S&P 500 to reach 4,130 or more. But for higher inflation levels like 5%-6% or 6%-7%, which we will probably experience in the next months, the risk premium demanded historically goes up triggering much lower index levels (s. table below). Moreover, higher inflation ranges produce a higher standard deviation of the equity risk premium.

Furthermore, as CBs remain hawkish, the risk of a more pronounced economic slowdown increases, and markets have yet to discount the lowering of macro surprises. Earnings trend is already declining and has further to go: we see -4% yoy in 2023 (EMU and US), remaining under consensus, mostly in 2023 (-8 points for EA & US) and less in 2024 (-3 points). Earnings growth should bottom only in summer 2023 at best. Risks are skewed to the downside due to declining global activity, real income, a fall in accumulated savings and a prolonged war. Finally, the US Tech remains at risk: the bubble has not disappeared yet (+30% from an initial +40% overvaluation).

For the next 12 months, instead, we see potential positive total return, around 3% for the US and 5.5% for EMU.

For the next 12 months, instead, we see potential positive total return, around 3% for the US and 5.5% for EMU. Slightly more for Japan, UK and EMs. First, earnings growth should rebound in 2024 (above 10%) and the market will be increasingly prone to discount such growth in H2 2023. Second, target PE multiples and consequently TR are coherent with our projections of GDP, earnings, credit spreads, and inflation for 2023-2024. Thirdly, in the next months, CB tightening should come to an end, with bonds' volatility declining further and positioning still acting a positive trigger.

On European sectors, we maintain a balanced allocation as signals remain mixed: based on machine learning (ML) and earnings momentum, Value looks neutral versus Growth; and Cyclicals appear overbought (still based on ML and US 10-year rates' momentum). We look then to a combination of market valuations, ML quant models ranking and correlations with cycle (ISM), MSCI China (rebounding), Bond Volatility (MOVE, declining) and USD (declining). The last two could continue to influence markets in the short term. OW: Banks, KG, Div. Financials, Food, HCE, Transp. & Software. UW: Media, Com. Prof. svs, Retail, TLC.

S&P500 valuation: risk-premium based approach, using long-term Shiller series since 1872

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	3.7	7.76	-4.1	227.2	5.4
Scenario 2 (consensus 12m forward in 1 yr)	3.6	4.62	-1.1	247.4	5.8
Scenario 3 (GI 12m fwd in 1 year)	**3.6**	**3.40**	**0.2**	**241.5**	**5.5**
Scenario 4 (downside macro scenario)	2.0	2.10	-0.1	174.1	4.1
Scenario 5 (upside macro scenario)	4.3	4.10	0.2	259.8	5.9

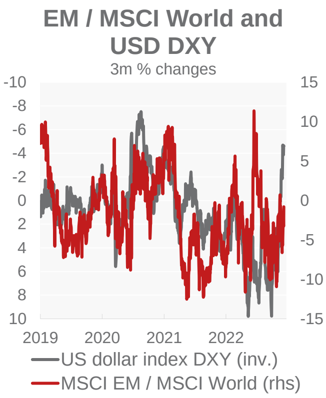
using 50% of hist. ERP st. dev.	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	18.0	19.6	18.3	13.8	19.8
Avg S&P500 valuation	3,912	4,258	**3,936**	2,997	4,312
	-2.8%	5.8%	-2.2%	-25.6%	7.1%

avg S&P500 valuation for different cpi ranges/target ERP, using GI input for eps and 10yr rates

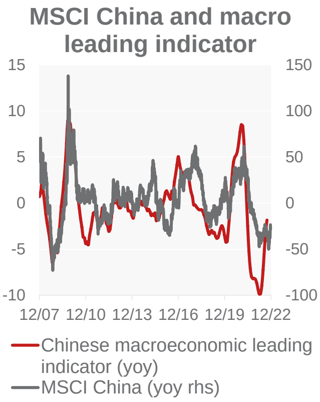
Scenario 3 (GI 12m fwd in 1 year) *)	50% of hist. ERP standard deviation	25% of hist. ERP standard deviation	AVG
CPI b/w 3.0 & 4.0, avg ERP=4.3, stdev=3.2	3,936	4,559	**4,247**
CPI b/w 3.5 & 5.0, avg ERP=5.1, stdev=3.3	3,470	3,969	3,720
CPI b/w 5 & 6, avg ERP=6.8, stdev=2.8	2,871	3,148	3,010
CPI b/w 5 & 7, avg ERP=8.3, stdev=3.1	2,279	2,494	2,386

Note: * Target ERP is calculated assuming CPI in the range specified in each table above. Inflation today is 7.7.

Source: Shiller data, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM

EM Equities: upgrading to neutral while keeping OW on China

EMs to benefit from peaking dollar and inflation in the next months

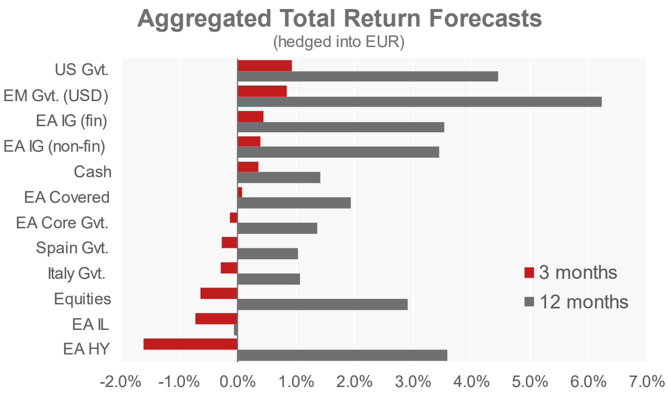
Short term, global economic weakening, a stronger USD dollar, higher inflation, and tighter financial conditions are expected to maintain pressure on EMs. That said, by the end of Q1, clearer signs of peaking USD and inflation plus slowing growth will halt aggressive monetary policy tightening. This will add to a better relative earnings momentum, thus contributing to the next outperformance cycle of EM versus DM equities. Low valuations are an additional positive factor. We OW China due to the recent newsflow (s. above) and improving credit impulse and asynchronous monetary policy vs other major central banks.

ASSET ALLOCATION

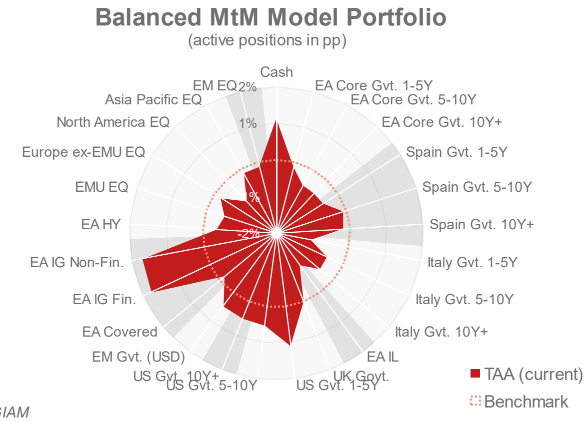
Thorsten Runde

- **At the end of 2021, we expected Covid-19 to retain its dominant influence on the markets. However, already in February this year, over the reopening catalyst was dwarfed by Russia's war of aggression on Ukraine, with all its serious economic implications for global supply chains, energy supply and not least inflation.**
- **The headwinds to the global economy are likely to mount further into 2023. Real income will continue to be eroded by only sluggishly receding inflation while central banks (CBs) deem the risks stemming from a too sloppy fight against inflation higher than those of stifling economic growth.**
- **We expect the key drivers for risk assets to switch from rate policy to the cyclical outlook. Economic risks are tilted towards the downside. The currently positive correlation between equities and bonds may not be sustainable and is likely to move back into (normal) negative territory in 2023.**
- **For now, we recommend a small underweight in Equities (and HY), which we stand ready to increase once the current rebound wanes. Further into 2023, a more risk-prone stance may become suitable once the Fed starts to envisage first rate cuts and recession risks are adequately priced. We still see value in IG Credit which is attractively priced and offers some carry pick-up. The peak in the USD and US Treasury yields is likely to benefit EMs. Thus, we overweight EM Govies and US Treasuries.**

Economic developments in 2022 was dominated by the war in Ukraine. Its direct and indirect impact on global economic dependencies, and thus on price stability, has eroded real income while political uncertainties weighed on sentiment. High energy costs, tight labour markets and adaptive expectations will keep the inflation decline sluggish. Now that the CBs cannot rush in as saviours, at least a moderate recession is on the cards, beginning in the EA (Q4/2022) but later in 2023 and somewhat lighter also in the US. In both cases risks are skewed to the downside. Not least China, which is beginning to relax its zero-Covid policy in a phase of strongly rising new cases and under growing social and economic pressure, adds to this risk.



Source: GIAM



Source: GIAM

There are no easy times ahead for risk assets. Thus, we propose a small UW in equities (and HY) to be enlarged possibly as the recent rebound fizzles out. Later in 2023 a more positive view on risk assets may become more appropriate. We start the new year with and OW in IG Credit on carry grounds (notably Financials). We see mildly opposed yield potential for the US (down) and EA (up), thus preferring US Treasuries to EA Govies. The peak in US yields and the USD is likely to support EMs. For now, we prefer an overweight in EM Govies (in USD) as the high carry is compensating for the threats from a sharper global downturn.

FORECASTS

Macro Data

Growth	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	5.9	1.9	0.1	0.3	0.1	1.4
Euro area	5.3	3.3	0.1	-0.1	0.0	1.2
Germany	2.6	1.7	0.2	-1.0	-0.1	0.8
France	6.8	2.5	0.0	0.0	-0.2	1.0
Italy	6.7	3.4	-0.1	-0.4	-0.2	1.3
Non-EMU	6.5	3.7	0.0	-0.6	-0.1	0.9
UK	7.5	4.2	-0.0	-1.2	-0.3	0.3
Switzerland	4.2	2.5	0.4	1.5	1.0	1.8
Japan	1.7	1.4	-0.1	1.1	-0.3	1.3
Asia ex Japan	7.8	3.9	-0.4	4.7	0.2	4.6
China	8.1	2.6	-0.6	4.8	0.3	4.6
CEE	6.7	1.7	1.1	0.4	0.9	3.1
Latin America	6.4	3.1	0.0	1.0	0.0	2.0
World	**6.4**	**3.2**	**-0.0**	**2.1**	**0.2**	**2.8**

Inflation	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	4.7	8.0	-0.1	4.2	0.1	2.4
Euro area	2.6	8.5	0.0	6.0	-0.0	2.5
Germany	3.2	8.6	0.4	7.3	0.4	2.7
France	2.1	5.6	0.1	4.5	0.0	2.4
Italy	2.0	8.2	0.2	5.2	-0.4	0.6
Non-EMU	2.3	8.0	0.1	6.4	0.2	2.6
UK	2.6	9.1	0.2	7.5	0.4	2.6
Switzerland	0.6	2.9	0.0	2.2	0.0	1.5
Japan	-0.3	2.5	0.2	2.8	1.1	1.3
Asia ex Japan	2.0	3.6	-0.0	3.4	0.2	2.9
China	0.9	2.1	-0.1	2.4	0.0	2.3
CEE	9.3	29.7	0.5	17.4	0.9	8.2
Latin America	6.6	7.8	1.1	4.9	0.7	4.0
World	**3.5**	**7.9**	**0.1**	**5.4**	**0.3**	**3.2**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

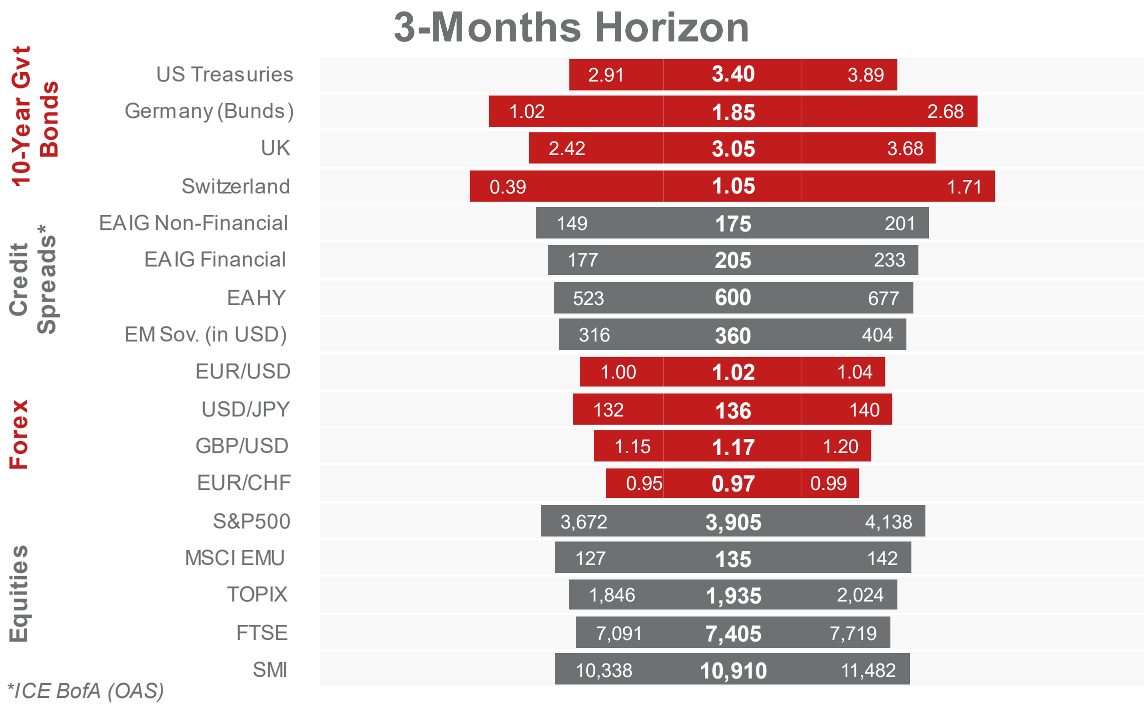
Financial Markets

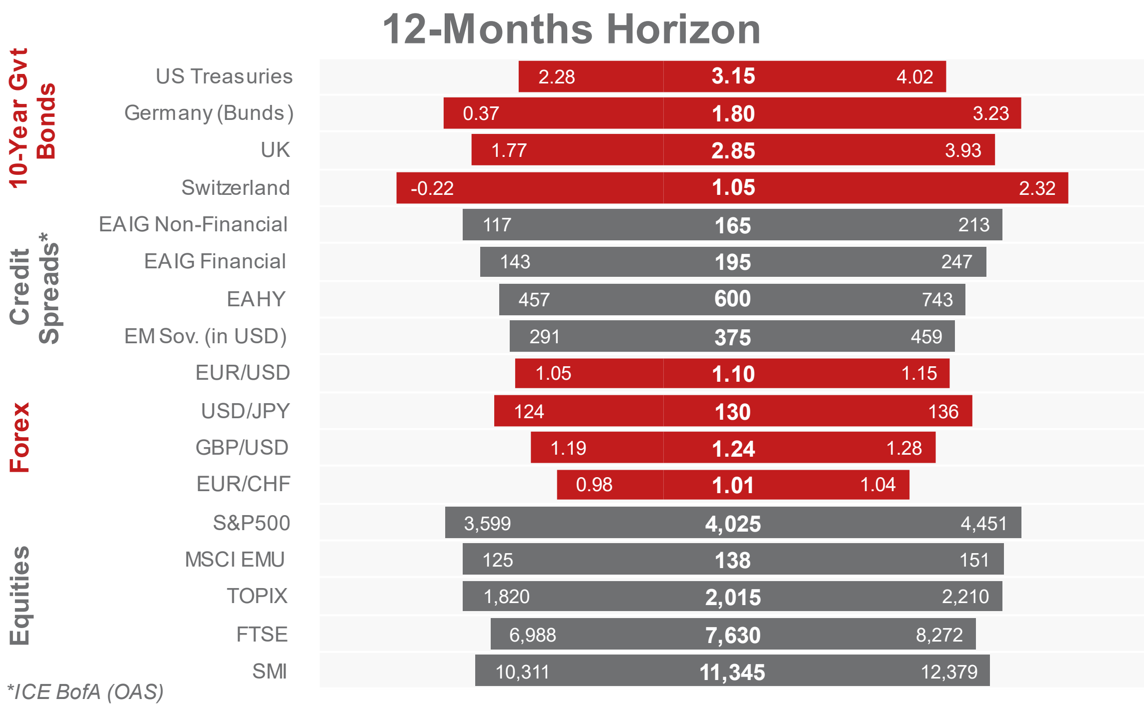
Key Rates	Current*	3M Forecast	3M Forward	6M Forecast	6M Forward	12M Forecast	12M Forward
US	4.00	5.00	4.83	5.00	4.92	4.50	4.19
Euro area	1.50	2.50	2.53	2.50	2.80	2.50	2.64
Japan	-0.10	-0.10	-0.02	-0.10	0.06	0.00	0.17
UK	3.00	3.50	4.13	4.00	4.53	4.00	4.39
Switzerland	0.50	1.50	1.00	1.50	1.19	1.50	1.24
10-Year Gvt Bonds							
US Treasuries	3.47	3.40	3.47	3.30	3.43	3.15	3.38
Germany (Bunds)	1.80	1.85	1.81	1.80	1.80	1.80	1.78
Italy	3.54	3.80	3.68	3.85	3.71	4.00	3.75
Spread vs Bunds	*174*	*195*	*187*	*205*	*190*	*220*	*198*
France	2.26	2.35	2.29	2.30	2.30	2.35	2.31
Spread vs Bunds	*46*	*50*	*48*	*50*	*50*	*55*	*54*
Japan	0.25	0.25	0.33	0.50	0.38	0.50	0.48
UK	3.07	3.05	3.12	2.95	3.12	2.85	3.17
Switzerland	1.03	1.05	1.01	1.05	1.00	1.05	1.00

*3-day avg. as of 08/12/22
**ICE BofA (OAS)

Credit Spreads**	Current*	3M Forecast	3M Forward	6M Forecast	6M Forward	12M Forecast	12M Forward
EA IG Non-Financial	162	175		180		165	
EA IG Financial	186	205		210		195	
EA HY	511	600		630		600	
EM Sov. (in USD)	350	360		370		375	
Forex							
EUR/USD	1.05	1.02	1.06	1.07	1.07	1.10	1.08
USD/JPY	137	136	135	133	133	130	130
EUR/JPY	144	139	143	142	142	143	140
GBP/USD	1.22	1.17	1.22	1.22	1.23	1.24	1.23
EUR/GBP	0.86	0.87	0.86	0.88	0.87	0.89	0.88
EUR/CHF	0.99	0.97	0.98	0.99	0.98	1.01	0.97
Equities							
S&P500	3,946	3,905		3,945		4,025	
MSCI EMU	135.6	134.5		134.0		138.0	
TOPIX	1,947	1,935		1,955		2,015	
FTSE	7,494	7,405		7,465		7,630	
SMI	11,041	10,910		10,890		11,345	

Forecast Intervals





*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5-year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three-month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

IMPRINT

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