# A LOOK AT THE MARKETS

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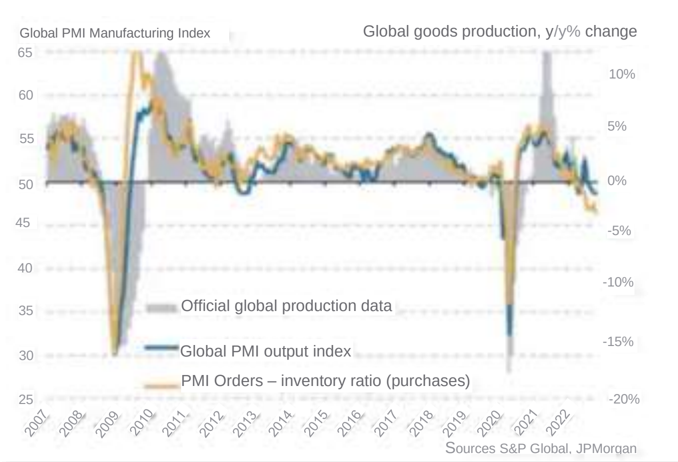
## Govies sensitivity / Investment Grade* Credit => It's time to gradually come back with an MT horizon of 6-9 months.

***A strong sense of uncertainty still lingers in the financial markets as they approach the year's end, but certain events have led us to change our position on risk-free or low credit risk bond assets.***

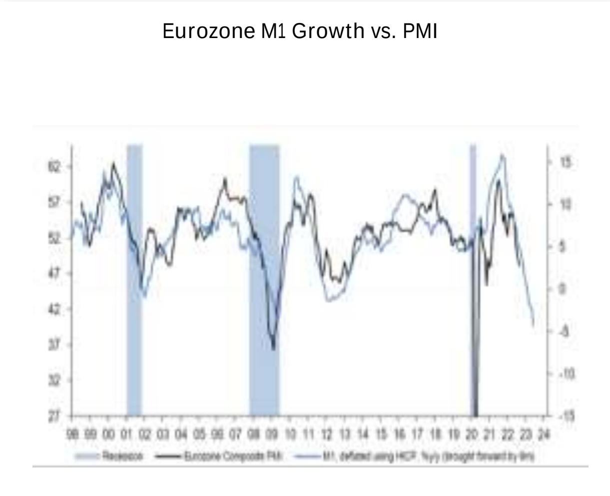
**Investment grade securities are bonds issued by borrowers rated AAA to BBB- by the rating agencies.*

### The macroeconomic cycle

We can confidently state that it is on the growth front that the situation has changed the least. Growth forecasts had been on the decline for many months, and this is precisely what we are observing.
The latest PMI[1] figures show that the vast majority of major economies are now below the 50 mark, meaning that activity is shrinking. This is the case in the United States, in the eurozone (especially in Germany) and also in China. Diving into the detail, we see that the latest S&P Global reports show employment indicators correcting, new orders decreasing and pressure on prices also falling.



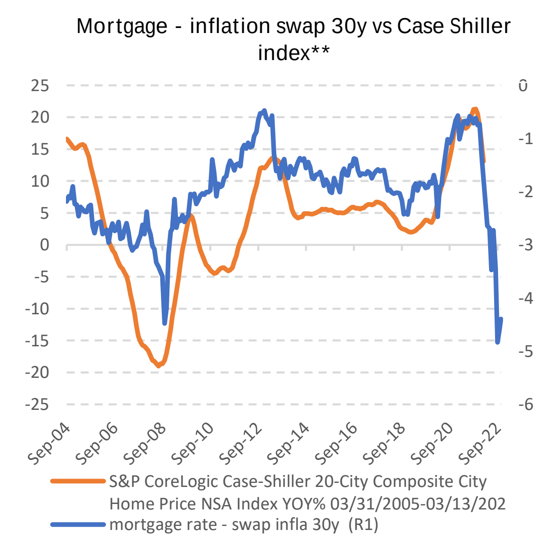

According to the various leading indicators we follow, the PMIs and other coincidental indicators (ISM[2], ZEW[3], IFO[4], etc.) should continue to decline in the coming months, which should translate into further reductions in growth forecasts in both Europe and the United States.



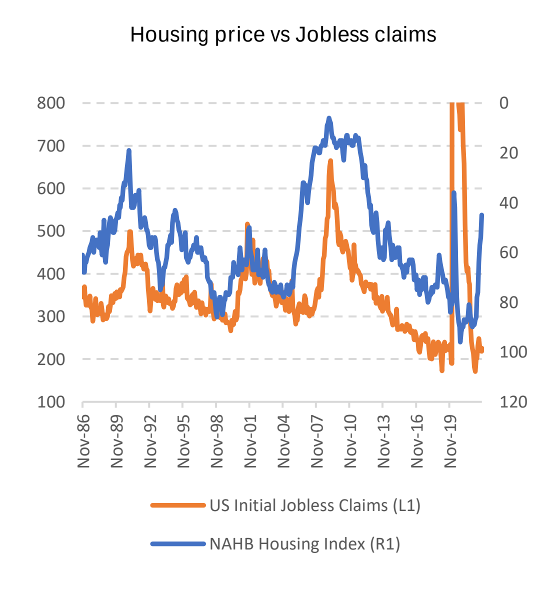


[1] Purchasing Manager Index: an indicator of the economic state of a sector.
[2] Composite index showing the evolution of manufacturing conditions in the United States.
[3] This indicator measures the expectations of analysts and institutional investors regarding the development of the German economy.
[4] The index assesses the business climate in Germany.

While the situation in the US is better, the implications of the coming downturn in activity on the housing market are as yet unclear. Historically, such a sharp rise in mortgage rates has led to a sharp drop in prices and an almost immediate halt in activity, which in turn tends to lead to an uptick in the unemployment rate.



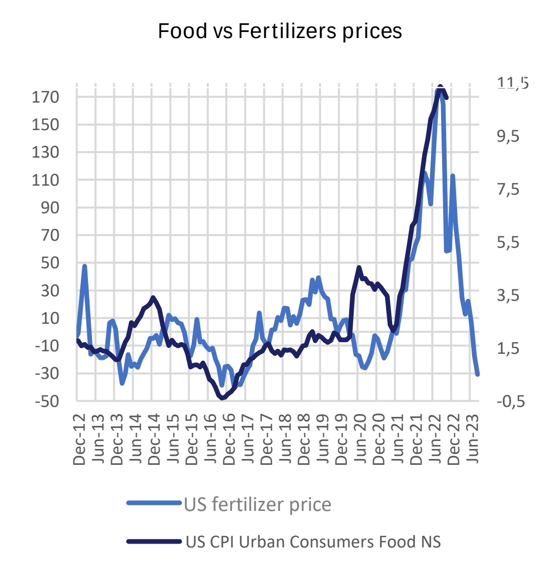

**This index measures the price of retail apartments in major cities, and measures changes in these prices

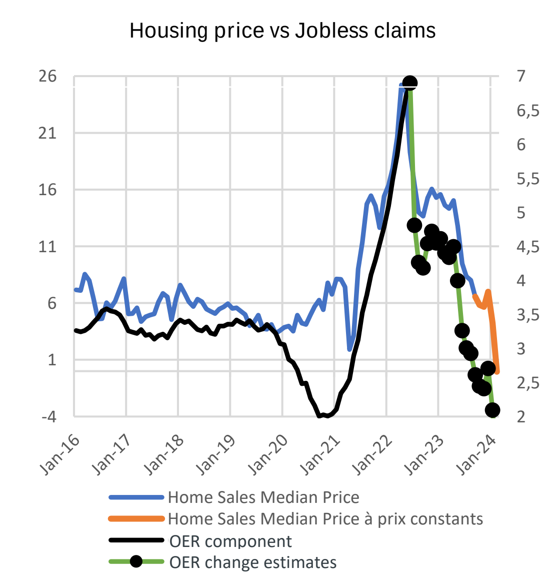



Although this means there is no dramatic new trend, we can see that real business data is gradually dropping off, the job market is slowing down and the risk of recession is becoming increasingly significant across Europe. This is important for central banks, as it shows them that monetary tightening is working.

## Inflation

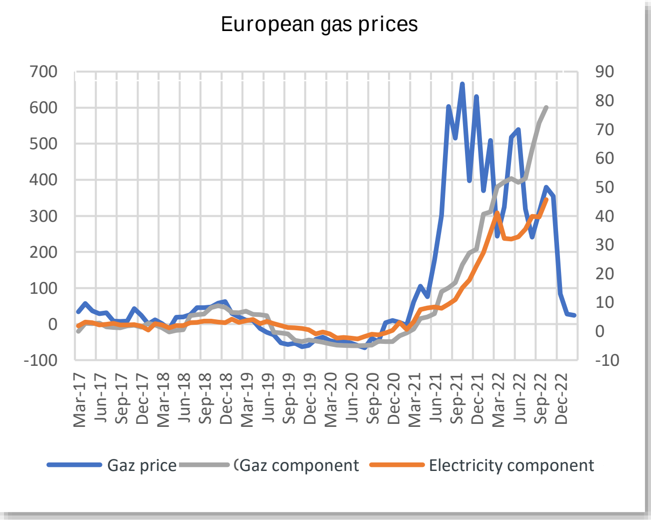
The latest US inflation figures, which fall below expectations, will please the US Federal Reserve, and have resulted in the bond market rising significantly.
Going beyond this negative surprise, which stems mainly from a sharp drop in used car prices, several indicators point to a gradual slowdown in US inflation over the next 3-6 months. This decline is already affecting certain goods and stands to gradually spread to services.



This does not mean that inflation will necessarily return to the Fed's 2% target, nor does it mean that inflation cannot then rise again in late 2023 or 2024. The latest consumer surveys (Michigan and New York Fed) show that economic agents are still expecting substantial price increases over the next 12 months. However, this could calm the situation for the markets regarding inflationary risk over the coming months.

The situation is different and more difficult to predict in Europe, as it is mainly linked to factors beyond our control: the war in Ukraine and its impact on the price of oil, the climate and its impact on gas prices, and finally the extent of fiscal support from European governments in the months and quarters ahead. The differences between European countries in terms of supportive measures and the energy mix of each country further complicate the reading of European inflation.
The graph on the right shows, for example, that state aid measures had kept energy inflation "under control" even as the price of gas soared, even though some of these measures being withdrawn has not recently led to inflation falling quickly either while the price of gas has fallen significantly.




## Central banks

Overall, the message from central banks in recent weeks can be summarised as follows:

- We have already tightened monetary conditions significantly,
- We know there is a significant lagg between rate hikes and their impact on the economy,
- We will therefore continue our monetary tightening due to high inflation, but at a slower pace.

Compared to comments made over the last 6 months, this represents a change in posture and a less aggressive tone than previously. Some institutions are clearly taking a less restrictive stance, such as the Bank of England or the Canadian central bank. Others, such as the US Federal Reserve, are only suggesting this change.
Either way, central banks are now taking a less aggressive stance than they were a few months ago, and given the likely evolution of macroeconomic data, we believe that the pace of rate hikes and monetary expectations will continue to decline in the coming months. However, there is no reason to expect the Fed or the ECB to cut rates, as this would require a very sharp deterioration in the employment markets and inflation coming close to targets, which is not likely to happen in the short term.

## Conclusion:

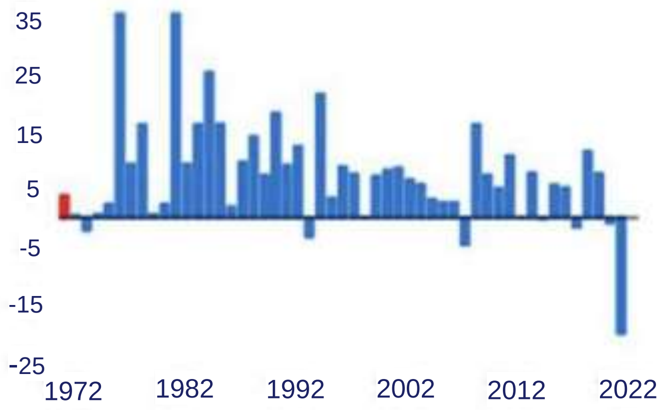
The bond markets are experiencing the worst year in their history, with almost identical performances between the different market segments as shown in the table below. Some parts of the market have suffered because of very wide spreads, and others because of their high sensitivity to interest rate movements, but the fact remains: there has not really been a safe haven for a bond portfolio up until now in 2022.

| | | YTD performance at 14/11 |
|---|---|---|
| US Gov | BarCap US Treasury 7-10 Y TR Unhedged USD | -15.5% |
| US Inflation | US 7-10 year real rate | -16.2% |
| US IG | US Corporate IG | -17.4% |
| US HY | Bbg Usd Hy Corp | -11.7% |
| Euro Gov | EuroMTS Gbl | -16.5% |
| Euro Inflation | German 10-year real rate | -10.8% |
| Euro IG | BarCap Euro Aggregate Corporate Index TR | -13.5% |
| Euro HY | Bbg Eur Hy Corp | -11.5% |
| Australian rate | Australia 10 yr | -14.0% |
| UK rate | UK 10 yr | -15.0% |
| Sub Fin | Bloomberg Barclays Global CoCo High Yield | -19.2% |
| Sub Corp | iBoxx € Non-Financials Subordinated | -13.3% |
| Emerging HC | Bloomberg Barclays Emerging Markets Hard Currency Aggregate | -19.7% |
| Emerging LC | JPM GBI - EM Global Diversified (Unhedged $) | -11.1% |

The likely further deterioration of macroeconomic figures now seems to us to be a brake on a significant recovery of risk in the riskiest assets. On the other hand, this deterioration should make it less likely that rates will rise sharply, especially with inflation expected to continue its downward trend. The situation seems clearer in the United States, where inflation is "easier" to understand and anticipate and where the macroeconomic situation is also clearer.
Some markets therefore currently appear interesting with a medium-term investment horizon:

- Short-term government debt, especially in the US, with historically flat yield curves.
- US real rates, now in restrictive territory and at their highest since 2008 despite lower potential growth.
- Investment-grade debt, which had by far the worst year in 50 years (see below)

**Chart 2:2023 shaping up to be a lot better for IG returns (%)**
Global.IG total return history: 3 consecutive years of losses unheard of




**Source**: ICE Data Indices, LLC Using IG index pre 1998, global IG index from 1998-today.
2022 returns annualised

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Obviously, the situation remains unstable and dependent on external factors (reopening in China? rumours of negotiations in Ukraine? budgetary support?) but in our opinion, as things stand today, the valuation levels of these assets compensate for these uncertainties.

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