PERSPECTIVES

MARKET AND ALLOCATION

Our experts monthly overview

March 2023

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Ofi invest
Asset Management

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OUR CENTRAL SCENARIO

Interest rates rose sharply over the month, as we had predicted the previous month, returning to levels that now seem more consistent with our expectations for the monetary tightening cycle. Short-term interest rates reached a high point, having risen slightly (to around 5.50% for the US Federal Reserve and 4% for the European Central Bank). Furthermore, the fixed income markets pushed back the first interest rate cuts by central banks until much later. This is in keeping with our scenario that interest rates are going to remain in restrictive territory as long as it takes for core inflation to begin trending downwards, and the latest statistics show no real signs of this happening.

We have therefore resumed a neutral stance on bonds. There is a possibility that interest rates are going to stretch further in the short term as and when inflation and growth statistics are released, and investors could take advantage of this to overweight sovereign bonds as an asset class. Given the attitude adopted by central banks, interest rates should ease off moderately in the second half of the year if growth slows down as expected.

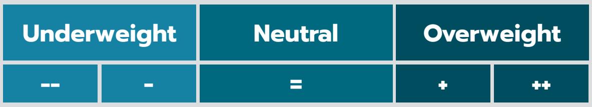
On the credit side, carry levels are already such that we have increased our exposure to both Investment Grade and High Yield bonds a notch.

The equity markets continued to hold up well against this backdrop of rising bond yields, driven by surprisingly resilient growth and expectations of a less severe slowdown than initially thought. Earnings forecasts were revised upwards as a result, enabling share prices to hold steady at current levels. There is plenty of uncertainty surrounding central bank action going forward - both in the short term as regards how high rates need to go in order to keep inflation in check, and in the medium term as regards their impact on growth. We are therefore sticking with our cautious stance for the short term, but see no reason to question our positive outlook for the full year.

The recent drop in the Chinese market has made us somewhat more bullish given the country's economic growth prospects for this year.

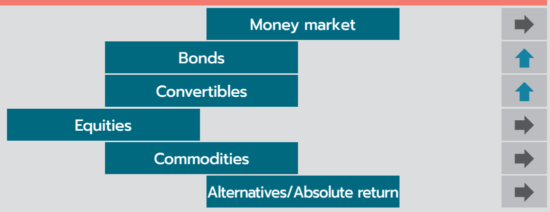
The analyses presented in this document are based on the assumptions and expectations of Ofi Invest Asset Management, These analyses were made as of the time of this writing. It is possible that some or all of them may not be validated by actual market performances. No guarantee is offered that they will prove to be profitable. They are subject to change.
A glossary listing the definitions of all the main financial terms can be found on the last page of this document.

Our allocation as of 10/03/23



ASSET CLASSES

The surge in sovereign yields over the course of February was driven by expectations that central banks are going to tighten monetary conditions more sharply and for a longer period of time. At this stage, our view is that the market's key interest rate expectations are now high enough to take profits on our underweight sovereign bonds position. We remain cautious about equities given the possible risks surrounding inflation (upside risks) and growth (downside risks).



BONDS

The scenario that central banks are going to keep interest rates higher and, above all, for longer spread throughout the market, wiping out the effects of January's bond rally. The market's current key interest rate expectations now seem more coherent. We have therefore revised our position on duration and resumed a neutral stance on sovereign debt. Yields on Investment Grade and High Yield credit are all the more attractive thanks to this rise in interest rates. However, credit spreads (particularly in the High Yield segment) have narrowed in recent weeks, partly absorbing the uptrend in interest rates. We would therefore not rule out the possibility that risk premiums might widen a little if sovereign yields consolidate.

EQUITIES

Valuation levels on the equity markets look coherent given that the bond markets have not experienced any further tension and corporate earnings forecasts have not been revised downwards at all severely. In the short term, concerns about central bank monetary policies and inflation indicators could create more volatility. In these circumstances, we appreciate the Chinese market from a relative viewpoint as it has recently turned downwards.

EQUITIES BY SECTORS / STYLES

Stretched interest rates have recently taken a toll on growth stocks. Such stocks might be penalised further if tensions appear in the bond markets, but they have a defensive profile so are unlikely to underperform cyclical stocks any more than they have done. The financial sector (banking especially) is undervalued and should continue to benefit from a more propitious interest rate environment.

CURRENCIES

The dollar has been buoyed up by a vigorous US economy and thus by expectations of more aggressive monetary tightening by the Fed. The ECB remains hawkish on inflation and is against monetary tightening. Pending the arrival of the Bank of Japan's new chairman on 20th March, the yen continues to mirror the dollar and the US interest rate outlook.

Notice: the allocation policy presented applies to multi-asset funds managed by Ofi Invest Asset Management (including profile funds). The investment horizon of this allocation policy is short term and subject to change. This investment policy therefore does not constitute an indication for building a client's long-term allocation.

MACROECONOMIC VIEW

INFLATION SURPRISES ON THE UPSIDE ONCE AGAIN

Ombretta SIGNORI
Head of Macroeconomic Research and Strategy
OFI INVEST ASSET MANAGEMENT

Central banks are rightly concerned about how sticky inflation is proving to be, and they have by no means won the inflation battle yet. On an annualised basis, the least volatile components of inflation are still too high at 5.6% in February in the euro zone and at 5.6% in January in the USA. Central bankers have already explained that services inflation is the key component to watch as it is the mostly closely correlated with wage inflation and therefore with conditions in the job market, and this in turn is what drives demand and pricing pressure.

Tight job markets on both sides of the Atlantic are boosting consumer spending, but this is not the only factor. US households have tapped into the savings glut that built up during the Covid crisis, whereas the data available in Europe shows that European consumers have not yet used up their Covid-related savings surplus, and it is therefore the various measures introduced by the region's governments that have helped them absorb the energy shock. Alongside these internal upside inflation risks there are other external risks, above all the impact that the Chinese economy's reopening is going to have on commodity prices.

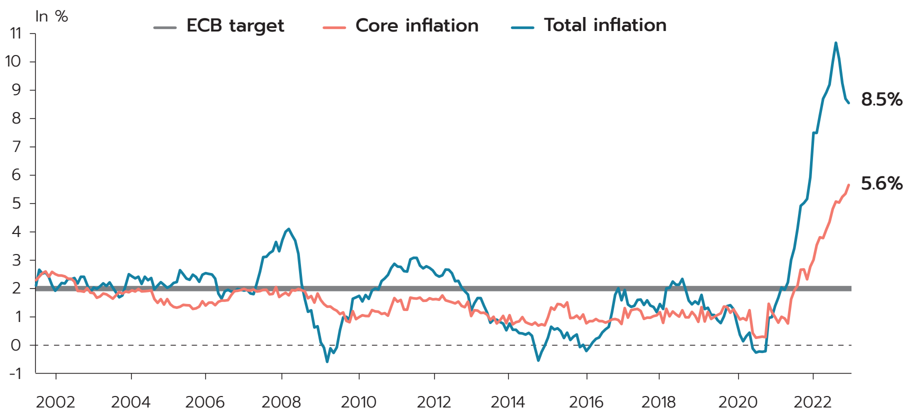
CENTRAL BANKS UNDER PRESSURE

For the time being, the markets are pricing in a soft landing for the US economy thanks to growth in both jobs and consumer spending. But there are clear signs that these factors are running out of steam (not including the real estate sector). For instance, the manufacturing sector has contracted for 4 months now according to survey results, and financing terms and conditions have worsened significantly for businesses, which suggests that lenders are rationing credit. In all logic, these signs should point to a steeper slowdown over the coming quarters. But the longer it takes for the slowdown to materialise, the greater the risk that the US Federal Reserve (Fed) will have to do more to calm inflation. So a risk analysis leans towards higher key interest rates than in our current scenario, which sees them peaking at 5.25% in this cycle; we might therefore revise our scenario upwards next month. The Fed will present its new projections during the FOMC monetary policy meeting on 22nd March, and the FOMC members' interest rate forecasts might already signal an upward revision to those issued in December; the scale of this upward revision will undoubtedly depend on the February job and inflation statistics published in March.

MARKETS SEE INFLATION REMAINING ABOVE 2% FOR SOME TIME

The situation in the euro zone differs from that in the USA: not only is its core inflation rate likely to exceed the USA's in absolute terms, but it is also still trending upwards and set to continue doing so until at least the spring according to our central scenario. The markets currently see inflation remaining above 2% for some time and across all horizons. This undermines the ECB's credibility and sets the scene for it to adopt a hawkish tone when it announces its next 50-basis point hike in interest rates at the monetary policy committee meeting scheduled for 16th March.
As far as good news is concerned, production prices in January were rather reassuring and suggest that inflation in industrial goods and food prices could peak within the next few months. However, when it comes to services inflation - which is correlated with wage inflation, as mentioned earlier - there is not enough evidence to suggest that the uptrend is about to reverse. For the time being, the cycle is proving more resilient than expected - surveys currently indicate that growth in economic activity is going to remain positive in the first quarter of 2023. And this poses upside risks both to inflation and to our predicted trajectory for ECB interest rates: our 3.5% target for the deposit rate is now a floor level rather than a ceiling for key interest rates in 2023.

EURO ZONE INFLATION OVER 1 YEAR



Sources: Macrobond, Ofi Invest Asset Management as of 07 March 2023

STICKY INFLATION AND BOND YIELDS ON THE RISE

Geoffroy LENOIR
Co-CIO, Mutual Funds
OFI INVEST ASSET MANAGEMENT

The big central banks are still moving forward with their monetary tightening cycles. Key interest rates are rising gradually, pushing short-term interest rates on the money markets up with them. As a result, the 3M Ester swap rate increased from 2.58% to 2.95% over the space of a month. Bond yields are more exposed to the continued uncertainty (in Europe but also in the USA) about how long the monetary tightening will last and how far it will go.

The downtrend in bond yields observed in January came with encouraging signals about inflation and growth, suggesting that the cycle would soon come to an end. As we said last month, we thought it was too early to expect bond yields to fall any further. The market proved us right in February as bond yields picked up again after the US and European inflation statistics came out stronger than anticipated. The German 2Y rate jumped from 2.65% to 3.20% over the month and the 10Y rate increased by almost as much to a new high of 2.75% in early March. Meanwhile, the US 10Y rate rose from 3.50% to over 4.00%.

WHEN CAN WE EXPECT THE MONETARY TIGHTENING CYCLE TO END?

We still think inflation is going to prove stickier than the markets expect. Inflation expectations were indeed already revised significantly higher in February. The euro zone's 5Y5Y inflation swap rate monitored by the ECB climbed from 2.30% to 2.60%, its highest level for more than 10 years... and above the US equivalent, which is something that happens only rarely. The ECB will thus have to take an even firmer stance in its efforts to tackle inflation. Two forces are therefore likely to come up against each other over the coming months: the signals sent out by central bankers on the one hand, and bond market valuations on the other. Current valuations seem particularly attractive for long-term investors but also for more speculative investors.

The markets seem to be pricing in an already strong reaction from the central banks. In these circumstances, we see little upside potential for bond yields in the short term, and so we have a somewhat neutral position on duration.

STILL PLENTY OF APPETITE FOR RISK AND CARRY

The main market sentiment indicators remain healthy, as reflected in bond and credit spreads. Italy's 10Y spread, for instance, is still low at just 180 basis points above the German 10Y rate; this is well below the 2022 peak of 250 basis points. Similarly, credit spreads held relatively steady in February. The Investment Grade credit market's performance was therefore mainly penalised by the interest rate component, whereas credit spread fundamentals remain solid. High Yield credit proved more resilient as this segment is less sensitive to interest rates and spreads narrowed a little. Within this High Yield segment, however, we have a preference for the best-rated issuers. The credit market is being buoyed up by revisions to growth projections in Europe and by sound corporate earnings, underpinning our constructive approach to this asset class and our view that it offers carry opportunities.

In the short term, we expect the interest rate component to bolster the bond markets; this is likely to benefit sovereign bonds but also corporate bonds, again from a carry perspective. The Investment Grade credit market, however, might have to compete with money-market products, whereas High Yield credit should fare well if spread volatility remains low.

FIGURE OF THE MONTH

The market has factored in higher inflation in the euro zone:

2.60%

This is the average 5-year 5-year forward inflation expectation rate, its highest level in 10 years.

PERFORMANCES

Bond indices with coupons reinvested

	February 2023	YTD
JPM Emu	-2.24%	0.06%
Bloomberg Barclays Euro Aggregate Corp	-1.44%	0.75%
Bloomberg Barclays Pan European High Yield in euro	0.11%	3.32%

Sources: Ofi Invest Asset Management, Refinitiv, Bloomberg as of 28 February 2023.
Past performances are not a reliable indicator of future performances.

EUROPEAN EQUITIES: ARE INVESTORS WEARING ROSE-TINTED GLASSES?

Éric TURJEMAN
Co-CIO, Mutual Funds
OFI INVEST ASSET MANAGEMENT

To infinity and beyond! Europe's equity markets remain in remarkably good health despite the upward pressure on long-term interest rates on both sides of the Atlantic and despite all the international geopolitical tension. The EuroStoxx 50 index closed in on its historical high in February while the CAC 40 overtook it. The euphoria was muted in the USA and China as their main equity indices have not made even half of the gains that Europe's have year-to-date.

GROWTH FORECASTS BEING REVISED UPWARDS

The International Monetary Fund has raised its global growth forecast for 2023 from 2.7% to 2.9% as China's economy is poised for a recovery, the energy situation in Europe is returning to normal (with gas prices down by a further -19%, i.e. -39% YTD) and consumer spending is proving resilient. Meanwhile, companies have reported healthy results and, perhaps more importantly, issued solid guidance for this financial year. The picture would look almost perfect if the inflation statistics hadn't surprised on the upside both in the USA and the euro zone.

For now, investors are clearly opting to focus their attention more on the upward revisions to global growth forecasts than on those being made to inflation forecasts. We all know that corporate earnings are closely correlated with global economic growth. By approaching the 3% mark, economic forecasters are beginning to factor in the possibility of (albeit modest) earnings growth in 2023, at least in Europe.

WHICH COULD BOLSTER EARNINGS GROWTH

A geographic analysis shows that the US market (where stocks are trading on about 18 times estimated 2023 earnings) is indisputably dearer than its European counterparts (where valuation multiples average no more than 13). And yet the US appears to be more of a safe haven whenever volatility picks up. This is why we have not incorporated a hierarchy between these regions into our recommendations. China's equity market, on the other hand, has shed more than 10% since peaking in January and appears more attractive in relative terms.

HIGHER INTEREST RATES IMPACTING ON SECTOR PERFORMANCES

Sector performances partly reflect the upward movement in interest rates, with the banking sector performing well but the real estate sector doing badly and profits being taken on sectors that are trading on high multiples such as luxury and technology. They also partly reflect the pleasant surprises delivered by this earnings season. Going forward, we do not expect to see a major difference between growth stocks and more cyclical stocks in terms of performance, but we do think that rising long-term interest rates will continue to shore up bank stocks which are trading on rather low multiples.

Paradoxically, the main risk to the equity markets could be that of more good economic news. This might push interest rates higher, especially as inflation statistics remain slightly above expectations. The coming weeks are unlikely to threaten our year-end double-digit growth targets for equity markets across the board, but they could create opportunities for investors to beef up their exposures at slightly lower levels. This is why we remain somewhat cautious for the short term.

FIGURE OF THE MONTH

3%

The global growth rate that would enable European corporate earnings to avoid a downturn in 2023

PERFORMANCES

Equity indices with net dividends reinvested, in local currencies

	February 2023	YTD
CAC 40	2.62%	12.39%
EuroStoxx	1.92%	11.40%
S&P 500 in dollars	-2.49%	3.60%
MSCI AC World in dollars	-2.87%	4.10%

Sources: Ofi Invest Asset Management, Refinitiv, Bloomberg as of 28 February 2023.
Past performances are not a reliable indicator of future performances.

CHINA: A "SPONTANEOUS" RECOVERY WITH NO REAL GLOBAL IMPACT?

Jean-Marie MERCADAL
Chief Executive Officer
SYNCICAP ASSET MANAGEMENT

For the first time in 15 years, China's economic recovery is not being driven by government stimulus. Growth disappointed in 2022 at 3% and the growth target for this year has been set at "just" 5%. With the 14th National People's Congress having just begun, the real objectives announced for the medium term are stability and balance. So, this time, China's recovery is probably not going to have the same impact on the global economy...

China's abrupt reopening has triggered a spectacular upturn in the country's economic activity. As is the case each time China's economic growth bounces back, questions are being asked about the impact this will have on global economic activity because of the country's size (about 20% of the world's population) and large share of global GDP (around 25%). China's influence on the global economy over the past decade has been huge: with its annual GDP growth ranging between 5% and 10%, its contribution to global economic growth has varied from 30% to 50% depending on the year. But things look different this time around, for various reasons:

- **China's previous recoveries in recent years have been boosted by investment plans,** focused mainly on infrastructure and real estate. Funding was secured by local government-issued debt and by fiscal and monetary incentives. This is what happened after the global financial and economic crisis of 2008/2009 and after China's slowdown in 2015. But it will not be the case this time.

The central government wants to avoid reviving property speculation. It has only taken certain emergency measures in an effort to stabilise the market, which has plummeted in recent months, and to enable ongoing building projects to be completed. But confidence in this sector appears to have been shaken for good, on top of which the population is shrinking due to a very low birth rate. So we can see why the real estate sector is unlikely to shore up the economy in the years ahead.

Meanwhile, the Chinese authorities **are beginning to pay closer attention to the country's overall debt level,** especially as the costs of their zero Covid policy have also taken a heavy toll on public finances. So the logic this time around has been turned on its head: **the government now wants the economy to recover in order to improve its balance sheet rather than to boost growth.**

- **The current recovery** is therefore being driven mainly by the effects of pent-up demand among consumers. As a result, the consequences for the commodity markets could prove quite moderate. The extra demand for oil as the country gets moving again is likely to be fuelled by purchases from Russia at far lower prices than on the global market. The consumer goods and services sectors will therefore be among the main beneficiaries of this economic recovery: household spending could jump by 14% this year, accounting for 80% of the total growth expected in 2023!

In the medium term, the Chinese authorities seem to be aiming more for a certain degree of financial equilibrium and a stable economy and society, rather than rampant growth fuelled by the real estate and infrastructure industries. The 5% GDP growth target set for 2023 thus seems very conservative indeed for a "reopening" year. The 3% budget deficit target is also below expectations. This means that China's recovery this time around might have a smaller impact on the global economy and might curb the rise in commodity prices and in inflation more generally. This would be good news in helping to secure market equilibrium this year; longer term, it could be an early indication that China's economy is going to become more disconnected from the rest of the world.

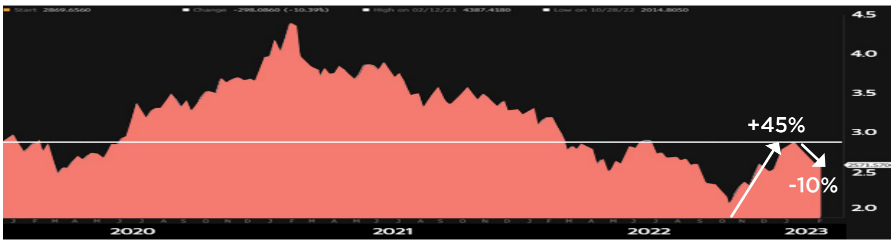
FIGURE OF THE MONTHS

22.8%

Bloomberg's earnings consensus out to 12 months for companies in the MSCI China All Shares index, pointing to a 12-month PER of around 11.8.

Source: Bloomberg as of end-February 2023

MSCI CHINA ALL SHARES INDEX SINCE 31/12/2019 *Source: Bloomberg as of of 28/02/2023*



Having gained 45% between the start of November and end of January, the MSCI China All Shares index - comprising of 50% Chinese stocks listed locally and 50% listed in Hong Kong - has lost around 10% since peaking in January.

Syncicap AM is a portfolio management company owned by Ofi Invest (66%) and Degroof Petercam Asset Management (34%), certified on 4 October 2021 by the Hong Kong Securities and Futures Commission. Syncicap AM specialises in emerging markets and provides a foothold in Asia, from Hong Kong.

Glossary

Investment Grade / High Yield credit: Investment Grade bonds refer to bonds issued by borrowers that have been rated highest by the rating agencies. Their ratings vary from AAA to BBB- under the rating systems applied by Standard & Poor's and Fitch. Speculative High Yield bonds have lower credit ratings (from BB+ to D, according to Standard & Poor's and Fitch) than Investment Grade bonds as their issuers are in poorer financial health based on research from the rating agencies. They are therefore regarded as riskier by the rating agencies and, accordingly, offer higher yields.

Spread: difference between interest rates. Credit spread is the difference in interest rate between a corporate bond and a same-dated benchmark bond that is regarded as the least risky (benchmark government bond). Sovereign spread is the difference in interest rate between a sovereign bond and a same-dated benchmark bond that is regarded as the least risky (German benchmark government bond).

Volatility: a measure of the amplitudes of price variations of a financial asset. The higher the volatility, the riskier the investment is considered to be.

Inflation: the loss of a currency's purchasing power, translating into a widespread and lasting increase in prices. Core inflation refers to inflation excluding energy and food.

Duration: the weighted average life of a bond or bond portfolio expressed in years.

Carry: a strategy that consists in holding bonds in a portfolio, possibly even till maturity, in order to tap into their yields.

PER: Price to Earnings Ratio. A stock market analysis indicator consisting in dividing price by earnings.

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