ALLOCATION PERSPECTIVE

Interpreting the economy: which market is wrong ?

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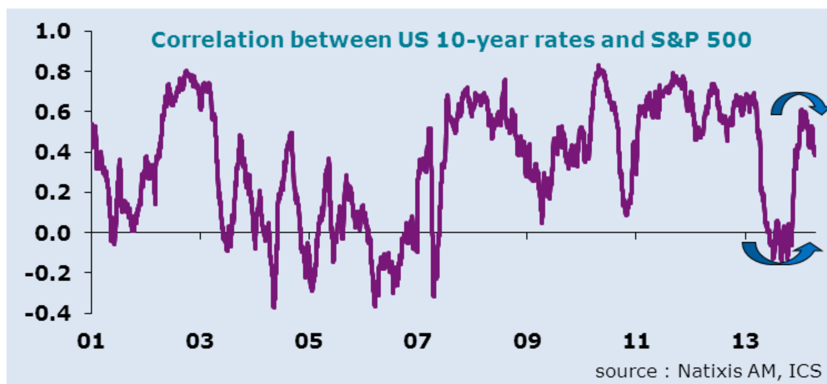
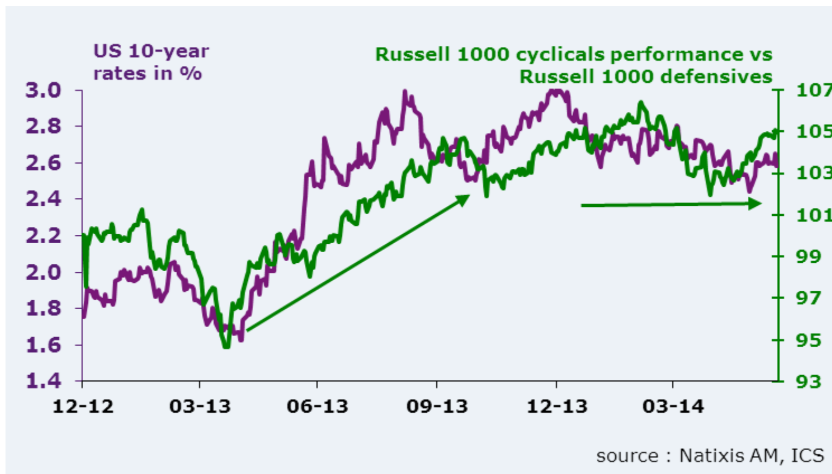
US equity and bond markets have performed in-line over the past few weeks. As a result, the correlation between 10-year rates and the S&P 500, which had turned positive since the announcement of Fed tapering (steepening rates and stronger equity markets), is now weakening once again.



At this level of long-term rates, circumstances have become abnormal, signifying that one of the two markets is undoubtedly misinterpreting the situation.

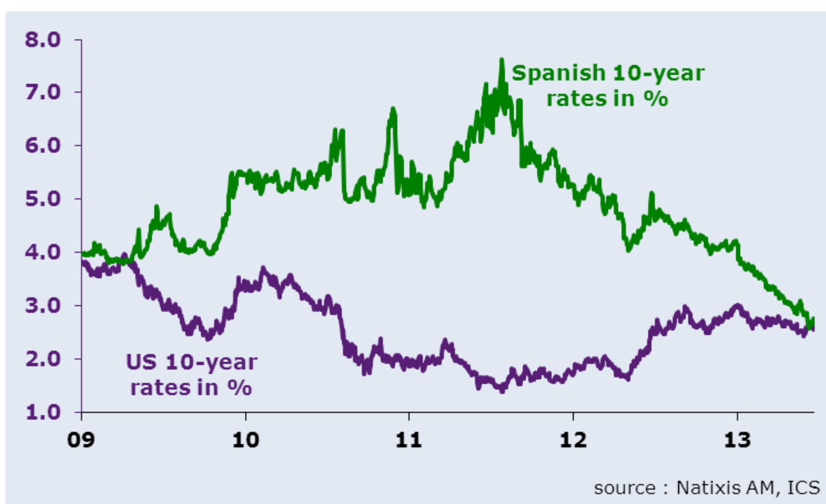
Either equity markets are correctly indicating that US growth is probably soundly on track and certainly likely to accelerate. In this case, however, the output gap will soon narrow and forthcoming inflationary tension will oblige the Fed to tighten monetary policy, involving a hike in long-term rates.

Or alternatively, bond markets are providing a correct reading of the situation by indicating that growth is bound to level off, with the Fed adopting a wait-and-see attitude. In this case, US equities are clearly overpriced and a correction is highly likely in this market.



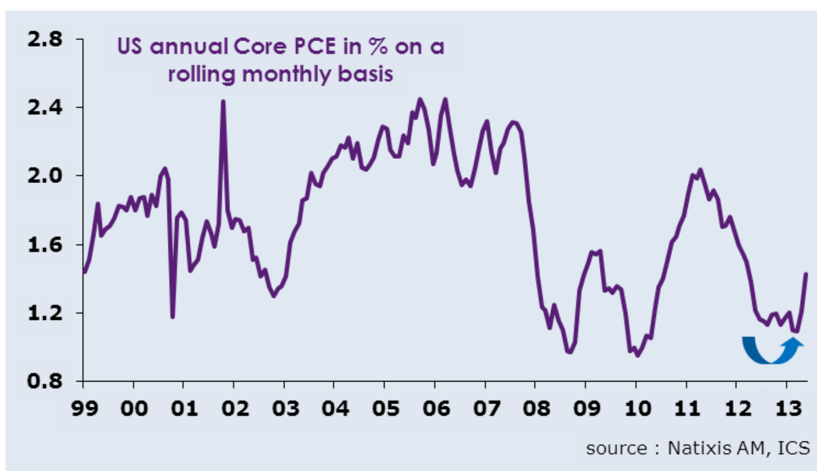
source : Natixis AM, ICS

This leads to a multitude of implications, for the respective markets and also for potential trends within the equity asset class. As recent experience has shown, the sector rotation during the spring was particularly difficult to comprehend. The monetary guidance criteria used by the Fed to pilot the pace of QE tapering was initially based on unemployment alone, but now includes a whole range of indicators, thus decreasing the market's ability to interpret the situation. Cyclical stocks have underperformed defensives as a result, whereas cyclicals had nonetheless been the market darlings when the Fed was implying a tougher stance in mid-2013.



source : Natixis AM, ICS

It now seems more urgent than ever for the Fed to delay. Bond markets have accurately anticipated until now. But how can equity markets therefore remain bullish? The only possible explanation is that investors are anticipating global growth, which despite being sluggish, will be more evenly balanced across the geographical regions, amid very low inflation, with debt being progressively reduced and monetary policies remaining accommodating. These conditions constitute an ideal combination to underpin an indefinite equity market rally. We have to concede that this scenario is relatively unlikely however. Risky assets have already risen sharply on free money supplied by the central banks. Spanish 10-year yields are currently at the same level as US rates, with assets being increasingly allocated to carry trades.



It may be that we are moving inexorably closer to a correction in the market, which is misinterpreting the situation. It is therefore vital to remain vigilant regarding inflation in the US. There will be little change as long as inflation remains at the current level.

Tactical positioning

The global macroeconomic backdrop and relative valuations make us stick to our overweight in equity and high yield credit versus core sovereign bonds. We remain cautious on emerging market equity, as these countries are still in the midst of a painful external adjustment.

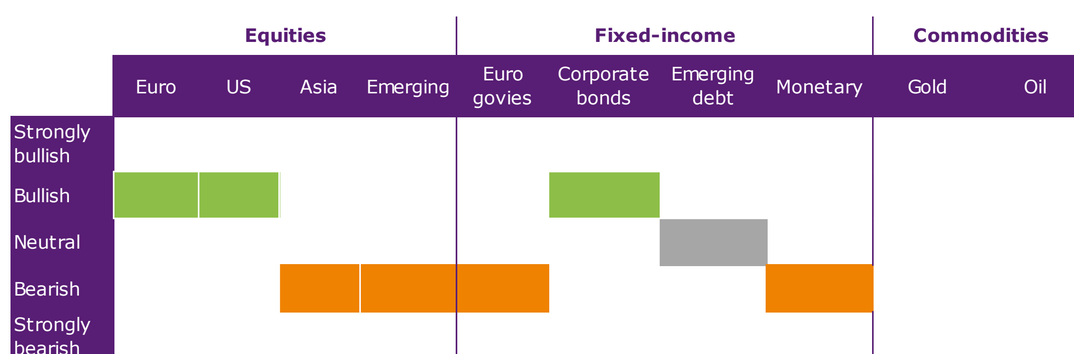
<u>Fixed-income</u>: The divergence between the conduct of monetary policy across the Atlantic is widening. In the US, given the gradual extinction of quantitative easing and the improving macro newsflow, we keep our underweight stance on the duration of government bonds. In the euro area, in order to fight deflation risk, the ECB has just cut its policy rates and offered 400b Euros in liquidity to banks which lend to the private sector. This has further cut yields on core Euro area government bonds. We favor higher yields via long positions on peripheral debt and corporate bonds.

<u>Equities</u>: ECB action has strengthened the bullish trend on equity markets, and a possible weakening of the Euro would offer a new catalyst for Euro area equity. We thus stick to our bullish view on equity markets, keeping in mind that a correction phase might be getting closer.

<u>Currencies</u>: The pre-announcement of the June easing measures by the ECB took the EURUSD parity back to the 1.3600$ level. The fight against deflation risk being now a priority for the ECB, the Euro strength is thus a topic particularly scrutinized; the 1.4000$ was clearly identified as a pain threshold.

<u>Commodities</u>: Apart from industrial metals (+3%) buoyed by restrictions on Indonesian exports and hopes of new stimulus in China, commodities corrected downwards in May (-3%). The de-escalation of the Ukrainian crisis and expectations of bumper crops in the US reduced tensions on agricultural prices (-7%).The rise in the dollar and investor risk appetite weighed on precious metals (-3%). Lack of tensions on fundamentals and the Chinese slowdown keep us cautious on the asset class.

Tactical view by asset class



Strongly bullish view on the selected asset class
Bullish view on the selected asset class
Neutral view on the selected asset class
Bearish view on the selected asset class
Strongly bearish view on the selected asset class

Annex : Theoretical model portfolio

Benchmark	Min	Strategic Allocation	Max	Asset Classes	Tactical Allocation	Change from previous Month	Previous Month
50%	**30%**	**50%**	**70%**	**Bonds**	**45.0%**		**45.0%**
40%	20%		60%	Bonds €	35.0%		35.0%
				Inflation €	0.0%		0.0%
10%	0%		20%	World Bonds*	0.0%		0.0%
				Emerging Debt***	5.0%		5.0%
				Investment Grade €	0.0%		0.0%
				High Yield €	5.0%		5.0%
35%	**20%**	**35%**	**50%**	**Equities**	**39.0%**		**39.0%**
12.5%	5%		20%	Euro	9.5%		9.5%
				Europe ex Euro*	7.0%		7.0%
12.5%	5%		20%	USA*	14.5%		14.5%
5.0%	0%		10%	Japan*	3.0%		3.0%
				Developed Asia*	0.0%		0.0%
5.0%	0%		10%	Emerging Asia**	3.0%		3.0%
				Emerging Europe - Africa - Middle East**	1.0%		1.0%
				Latin America**	1.0%		1.0%
5%	**0%**	**5%**	**10%**	**Commodities**	**2.0%**		**2.0%**
				Energy	0.0%		0.0%
				Industrial Metals	0.0%		0.0%
				Agriculture	0.0%		0.0%
				Precious Metals	2.0%		2.0%
10%	**0%**	**10%**	**20%**	**Currencies**	**14.0%**		**14.0%**
5.0%	0%		20%	Cash €	0.0%		0.0%
1.0%			5%	Dollar / €	10.0%		10.0%
1.0%			5%	Pound / €	4.0%		4.0%
1.0%			5%	Swiss Franc / €	0.0%		0.0%
1.0%			5%	Yen / €	0.0%		0.0%
1.0%			5%	Emerging currencies / €	0.0%		0.0%
100%		**100%**			**100.0%**		**100.0%**
				Volatility	6.8%		6.8%
				Tracking error	1.1%		1.1%

* Hedged against currency risk
** Unhedged against currency risk
*** Debt issued in dollar hedged in €uro

The views used as input for the model portfolio are consistent with specialist's ones but may lead to different relative weighting versus benchmark compared to single asset class model portfolios.

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