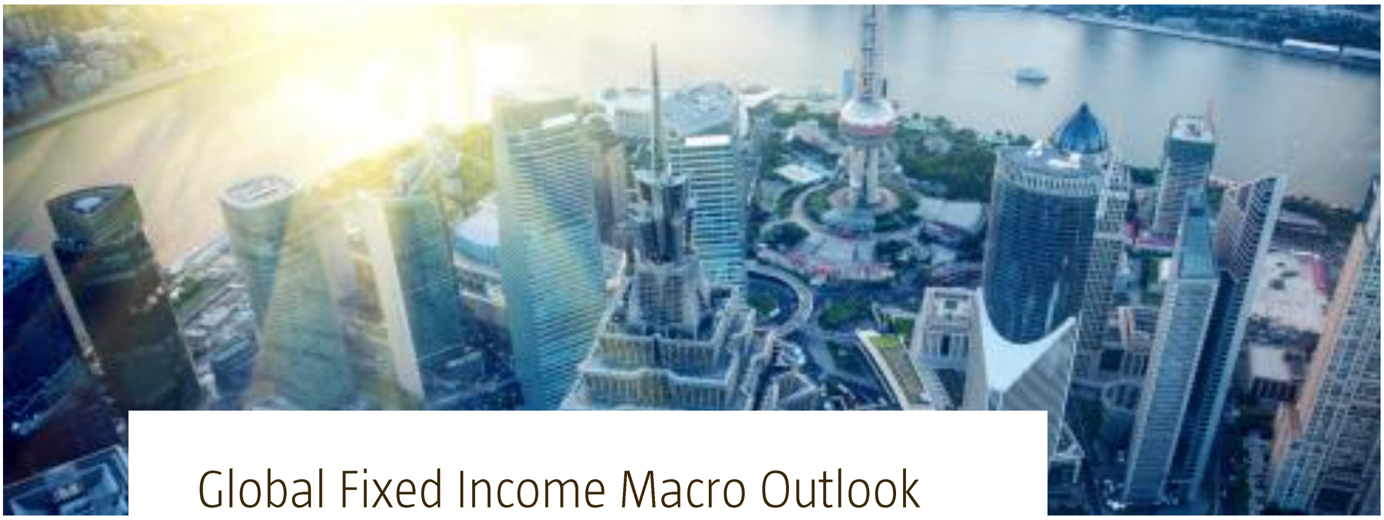

Global Fixed Income Macro Outlook

Czech mate

- The Ukraine war leaves the inflation path higher and more persistent...
- Forcing monetary response that may end in curve inversion and recession
- Credit spreads have cheapened, but swap spreads are cheaper

Summary

Last quarter, in 'Pricing sigma', we wrote that multiple sigma events are back in fixed income. The first few months of 2022 have accelerated this, with US 2-year yields up over 140 bps so far this year, EUR swap spreads approaching Eurozone crisis levels and the China offshore high yield market seeing an OAS of more than 3000 bps. After nearly a year and a half of an expensive and generally dull landscape in fixed income, with opportunities mainly on the short side, value is beginning to return.

At our last Global Macro Quarterly Outlook, we thought market participants might be overlooking three themes in 2022: the breadth of deterioration in China real estate credit, Covid-19 trends and geopolitics. We noted "a broad range of flashpoints along the EU's eastern front (...) from Polish sovereignty matters, to Belarus geopolitics, Russia-Ukraine tensions...". Into Q2 2022, all three concerns remain, although the focus of Covid trends has shifted to the People's Republic of China, and the world's attention is now fully centered on geopolitics.

Looking into Q2, we should acknowledge some uncertainties. The oil price could trade in the USD 80s or above USD 130: we have seen both in the past 30 days

Outlook
For professional investors
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Robeco Global Macro team

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alone. Furthermore, the scale and coordination of the EU fiscal response in energy and defense is unclear (although the fiscal architecture is also potentially at stake; as 2020 showed, Federalist Eurozone politicians tend to make structurally cohesive steps during crises). The full effects of Russia's unplugging from the global financial system are arguably still not yet known. Deciphering the next military calculations that will take place from inside the Kremlin are best left to academics, but decisions taken here may cast a long economic shadow.

Recession questions

Before the Russian invasion of Ukraine, inflation was already rising, and markets were pricing in more hawkish central bank profiles – even for the ECB. It's worth remembering the US 2-year yield was at 0.73% on 31 December 2021; it has just risen to over 2.15%. Since military action began, the subsequent rise in oil to well over USD 100 and the further sharp flattening of the US yield curve have led economists globally to raise their inflation targets, to extend the forecast period of higher inflation and to cut growth. The Fed, for example, have slashed their 2022 growth forecasts from 4% to 2.8%. Their inflation forecast is the mirror image, having been revised up sharply from 2.6% to 4.3%. Coming into 2022, expectations were for substantially above-trend growth. Indeed, 2.8% would compare well with the post-2008 growth trend, and a modestly above-trend outcome could still be delivered amid reopening and order backlogs – if there were to be an early conclusion to the Russia-Ukraine war. But we note financial markets often tend to underestimate the length of shocks of this nature, and there are evident and growing risks. The debate is rapidly shifting to what probability to place on a recession over the medium term. We note a number of senior economists already calling for recession within the next year or two.

Policy responses...

The growth-inflation mix that central bankers now face is the opposite of the high-growth, low-inflation paradigm of the 1990s – when Russia and Eastern Europe were welcomed back into the west's financial and economic networks. Now, with inflation soaring above central bank targets, the question for policymakers is who will tighten by how much and when. In chess, there is a term 'zugzwang', which describes a situation in which the obligation to make a move may lead to a serious, often decisive, disadvantage. For central banks, if they do not tighten, expectations for higher inflation could become embedded, leading to wild misses of mandate targets and undesirable spirals. Should they overtighten, however, the risk of recession looms. Don't forget that the Fed's delayed decision to taper QE in 2021, will this year bring a triple tightening of tapering, hiking and balance sheet contraction. All this was due in any case, before the recent commodity price spike.

...and yield curve inversion

For bond markets, this has meant a continuation of the yield curve flattening trend we wrote about through much of the past nine months. And sharply so. The US 2s10s spread (now below 20 bps) stands at less than a quarter of what it was on 1 January 2022 (above 80 bps).

To understand what might transpire from here, we recommend starting in Prague. The Czech local yield curve is usually not top of most global bond investors' monitoring list. But this cycle, it was the first to invert. Central and Eastern Europe (CEE) central banks have hiked rates aggressively in response to the same inflation pressures we are all experiencing. The CZGB yield curve has tipped over as the market's estimation of the neutral (or r*) level of rates has been eclipsed by the Czech National Bank's rate hike activity and the prospect of further near-term hikes. Why should we care? Because, since then, the Czech trend has spread to bond markets as diverse as Poland, South Korea swaps and UK Sonia. The US yield curve 12 months forward is now almost completely flat with almost all tenors trading close to 2.60%. In fact, with the US 1yr1yr forward the highest point on the curve, forward curve inversion has already begun.

Flat or inverted yield curves do not always mean recessions (see 1994 and 1998, for instance, when we had emerging market (EM) crises, but developed market (DM) economies escaped recession). There is also often a time lag, such that recessions may occur some time after curve inversions, particularly if the actual real borrowing costs faced by private sector agents have yet to rise materially. It is also mathematically likely that, in markets with low r*s, recessions can occur without yield curves inverting at all: Japan has had seven recessions since its curve last inverted, and Germany has had three. So it is neither a sufficient prerequisite, nor the automatic cause of an outcome. Yet the historic track record (and the reasons behind it) of yield curves, should not be dismissed.

Critically, from current levels of inflation, the Fed has never tightened just enough to make inflation come back down to target without causing a recession. Commodity strategists already talk of 'demand destruction' as the central scenario for wheat and energy prices to come back down in due course. For the likes of Fed Chair Powell and the BoE's Governor Andrew Bailey, who are facing an unwelcome policy version of *zugzwang*, the path shown by CEE curves and the historically unlikely challenge of pulling off the feat of dampening inflation without causing recession, it might just be Czech mate.

Contents

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Macroeconomic and policy outlook

Growth outlook: first the '*flation*' now the '*stag*'?

Sadly, the downside growth risk posed by developments around Ukraine has become part of our central scenario. This was just as economic prospects for the (contact-intensive) services sector had brightened. After another virus-hit early winter, confirmation of the less-virulent nature of Omicron and improved protection against severe disease due to earlier infections and/or vaccinations have allowed for some reopening of services in many western countries, providing a welcome boost to hard-hit sectors such as hospitality.

For manufacturing, however, the trade effects from the war and sanctions on Russia have arguably come at a difficult time. Recovery had just resumed, amid still-high order backlogs, replenishment of low inventory levels and some signs of easing of supply-chain bottlenecks. Now with war in Ukraine, fresh supply-chain disruptions have emerged, with German carmakers reportedly having been forced to halt production due to a shortage of parts from Ukrainian factories. Disruptions in semiconductors could also flare up again given Ukraine's importance in the production of semiconductor-process gases such as neon, and due to the latest virus-related lockdowns in China. There is also a tail risk of possible disruptions to imports of Russian gas, where German and Italian industry look especially exposed.

While the military scenarios and the extent and length of disruption to commodity markets is unclear, it seems prudent to assume that the further near-term rise in already-elevated inflation will dent household spending capacity, weighing on consumer spending volumes and overall economic growth. Remaining excesses in savings might provide some cushion, but we note that these are non-existent among vulnerable lower-income cohorts. Furthermore, commodity price shocks in the 1970s and the associated weakening of consumption occurred in the face of even higher aggregate European household saving rates. In order to dampen the blow, governments – especially those in Europe – have announced various measures aimed at capping the rise in household fuel and energy costs, mainly by scaling back the high tax burden.

The economic impact of the latest, war-related commodity price shock also depends on the monetary policy response. Most US recessions since 1970 were preceded by oil price shocks; they were all preceded by monetary tightening. Unlike in the 1970s, when central banks were forced to tighten, supply-led commodity price shocks to headline inflation in the past 20 years generally saw DM central banks aiming for a look-through approach. The trouble now, though, is that inflation has already risen well above central bank targets, inflation expectations have moved and wage pressures have been building. This has reduced the leeway for monetary policy to stand pat.

An alternative demand channel through which economic growth could be propped up is government investment. While we do not downplay the recent ambition for more European defense and energy investments, this might not offer much *near-term* solace – and could be more of a medium-term consequence of the war (which also includes, among others, the impact of the migration flows).

US economic growth seems less vulnerable than Europe to the trade and financial shock from the war in Ukraine. Moreover, the USD 1.5 trillion omnibus government funding package somewhat dampens the decline in the fiscal impulse referred to in the Fed's *Monetary Policy Report*. That said, the commodity shock is global and we take seriously the growth warning implied by the sharp net flattening of the UST yield curve.

In China, downside economic risks linger. Indeed, while policymakers are propping up infrastructure investment and exports have been doing well, the fragility of consumer spending and ongoing weakness in most property data mean we struggle to see how the growth target of around 5.5% for full-year 2022 can be reached without much more policy easing or a change in the zero-Covid strategy.

With many developing economies generally having a higher sensitivity to China's growth path than developed economies do, and with monetary policy tightening in Eastern Europe and Latin America being much more advanced than in many DMs, we are concerned about the growth impact of the latest wave of food price inflation in emerging markets.

All considered, we think consensus growth expectations for 2022 will have to be revised quite a bit lower over the coming months. On the upside, still-buoyant US and European housing markets and an ambitious fiscal policy response in Europe could mitigate the latest shock. On the downside, potential risks include a sharper-than-expected monetary tightening (to reel in inflation), the emergence of a new, more virulent, Covid-19 variant and political unrest in EM countries in the wake of sharply higher food price inflation and further commodity price stress. Either way, the current consensus growth revisions are heading down, not up.

Inflation – that 70s feeling

Consumers will probably reason there is no such thing as 'good' inflation. But economists and central bankers typically try to distill whether a rise in consumer price inflation is driven by stronger consumer demand ('good') or by supply-side factors such as, for example, goods shortages or supply-chain disruptions ('not so good'). The sharp rise in inflation of 2H 2021, led by goods prices, arguably was dual in nature. It reflected energy price normalization amid economic recovery and the effects of strong demand – especially in the US – for goods (rather than services); but also disruptions to global value chains and labor markets due to the pandemic.

The latest rises in food and energy prices are supply-led. Hence, rather than being the *result* of strong consumer end-demand, may erode consumer purchasing power and put a brake on spending volumes. Yet more supply-chain disruptions in manufacturing as well as lockdowns in China threaten to delay the normalization of some goods prices.

For central banks, this prolongs and worsens the episode of above-target consumer price inflation. It also raises the risk of medium to longer-term inflation expectations becoming unanchored from targets (echoing the 1970s) and spilling over into wage growth. This risk seems more pronounced in the US and the UK than in the Eurozone, though the Eurozone is not immune. Despite the rise in Eurozone headline inflation to 5.9% in February – a fresh record high – the peak has not yet been reached: it will likely be (well) above 6% – with further energy and food price rises beckoning and the core rate also set to rise further. Note that the monthly inflation profile over the coming quarter could be somewhat bumpy as various government initiatives across the Eurozone kick in to reduce the rise in household fuel and energy costs. It could also vary depending on the precise trajectory of oil and gas prices.

In the US, the Fed is aware of the increased risk of elevated inflation becoming more embedded in price setting: they will probably act more forcefully if they see warning signs in prices in rents, labor-intensive services and education. Atlanta Fed data show that 'sticky' inflation (at 4.5%) is already at the highest level since 1991. With rental inflation rising and wage pressures broadening, underlying inflationary pressures will be closely watched. Ultimately, we expect a moderation from early summer onwards, but from a higher level and at a slower pace than the consensus previously forecast.

We expect UK inflation to keep rising till April, where we would expect a first peak just shy of 8%. Depending on the path of oil and gas prices, the UK might see another peak of roughly 9% in October as many of those energy prices are passed through to end-users twice per year. Inflation will remain above the BoE target well into 2023. Meanwhile, labor markets are relatively tight and we expect wage growth to remain above the BoE target of 3%. We note shortages of younger low-skilled labor following the pandemic and Brexit. While that should eventually abate, it is likely to be an uneven process. The challenge is particularly acute in services, leading to upward pressure on service sector inflation.

In parts of EM, the challenge for central banks to get inflation under control seems even bigger, especially in CEE. In selected Asian countries, food prices constitute a relatively big share of the CPI index. Many of these countries also have large food import shares and some are experiencing nascent currency weakening. Central banks might spring into action, to counter a terms of trade shock.

Fiscal & monetary policy: less of a friend

Even as fiscal policy continues to support recoveries across many DMs, the fiscal *impulse* – which measures the change in incremental support – is turning less favorable. More so in the US than in the Eurozone, due to the ongoing support from the NextGenerationEU recovery fund, measures to cap the rise in household fuel and energy costs, and potential defense spending plans. How ambitious a common EU approach will be should become clearer in a few months.

Central bank balance sheet policies have also turned less supportive amid stickier inflation concerns. Following the earlier example of the RBNZ, BoC, BoE and Riksbank, the Fed and RBA decided to end net bond purchases in Q1 this year. Among the G10, only the ECB is still actively growing its bond portfolio – despite ending its PEPP program in March – and that at a much slower pace than signaled in December. Net QE via the APP is due to end by Q3, though, data-permitting. Meanwhile, both the BoC and Fed will probably start to run off their Treasury holdings in Q2, while the BoE might soon start to contemplate gradually selling its Gilt holdings (i.e. active QT).

In March the Fed also joined the G10 rate-hike bandwagon, following the example of the RBNZ, Norges, BoE and BoC. So far steps have been smaller than the 50 bps (or even bigger moves) seen in the EM space or in hiking cycles in the 1970-1990s. But quite some work is seen as being needed to keep inflation under control and the door remains open to larger steps. Thus far the ECB and Riksbank are still dragging their heels, but both central banks look on track to deliver a first hike later this year. In the ECB's case, this will be the first in eleven years.

Rates strategy

US curve flattening is mostly done

Yield curves have flattened significantly over the past twelve months – across a variety of countries. The US Treasury curve, for instance, flattened by over 150 bps between 2-year and 10-year maturities since summer 2021 to now trade below 20 bps. We have been positioned in curve flatteners since last June and discussed at our quarterly outlook sessions whether it is time to say goodbye to these profitable trades and prepare our funds for a cyclical change in the curve dynamic. We conclude that, although the US curve in particular is much flatter than usual given the stage of the tightening cycle, it might still be a bit too early to call a curve trend shift. At the front end, there are upside near-term risks to inflation; at the long end there are the downside risks to growth.

On front ends, while taking cross-country differences in 'neutral' policy rates into account, considerable rate tightening is already discounted across DM fixed income markets. Still, we take the lessons from the 1970s at heart (that inflation can be persistent), as well as the experience of 1994 (that just when you think rate hikes are over, they aint). Further, curve inversion can go some way: see the UK in the late 1990s amid pension fund demand, for example. This cycle, the Czech, Hungarian and Polish curves show how deep inversion can go. All in, we think there would need to be very bad news indeed for markets to price out rate hikes.

In fact, we can't rule out that some DM central banks, such as the Fed, might still be forced to tighten quicker and the market could hence price in a more restrictive stance. This might amplify doubts about the longer-term sustainability of the economic recovery and push spot curves into inverted territory. (Note segments of the Eurodollar curve are already inverted.) For curves to re-steepen, the market would need to rethink what the direction of monetary policy could be in 1-2 years' time. This moment is cyclically destined to occur, but we are probably not quite there yet. The transition from flattening to steepening is rarely smooth and fraught with timing challenges, but the good news is that not all parts of the curve have flattened equally: US 5s10s have moved a lot, 2s5s somewhat, but the momentum of curve flattening has recently shifted to 10s30s, where we still see value. So for now, we stick with 2s5s and 10s30s, and contemplate adding to flatteners elsewhere where curves have remained relatively steep, such as in euros. Note the duration betas of long-dated bonds are falling, at least relative to the front end. This makes for more attractive risk-adjusted relative returns at the long end: should US yields for example continue to rise overall, it will probably be due to inflation, rate hikes and further bear flattening in our view, rather than steepening pressure led by the long end.

When to make the cyclical shift to steepeners?
The front end forwards are elevated, so a longer-term opportunity is clearly building. But the cost of being early could be painful. To help provide a framework, an analysis of historical data for a range of markets indicates that 2s10s curve inversion can be a useful timing signal for going long the 2-year point. For the US, UK, Poland and South Korea, for instance, we found an outperformance of 2-year notes versus their 12m forwards after curve inversion in at least 70% of the observations over various historical timescales. Still, historical data also showed that the first months after inversion can be quite challenging for long positions. With inflation risks still tilted towards the upside, this cycle looks no different. As well as waiting for inversion, our conviction in front-end longs will likely grow with the first signs of moderation of the sticky parts of inflation (rents, labor-intensive services, education, etc.). Those markets that are at or close to curve inversion, with the Visegrad countries, South Korea, the UK, the US and dollar bloc – in that order – are the first ones to watch.

Our conviction on curve strategies, as is often the case, remains higher than on duration. Geopolitical risks remain elevated and could overpower any sort of fundamental judgement on where fair value for yields could be. Even aside from developments in international relations, r* assumptions from credible external analysts vary wildly and are subject to many prior assumptions. Still, an estimate of fair value for 10-year yields based on what is priced in front-end forwards points to levels of approximately 2.5% for US Treasuries and 0.75% for German Bunds: the 1-year-10-year US Treasury forward and long-dated EUR OIS forwards are already in line with where we would pitch the neutral rate. After having run sizeable underweight duration positions during most of 2021 and early 2022, we have been buying back duration and moving much closer to neutral levels recently, and are devoting more portfolio risk to yield curve and cross-market strategy. On the latter, we favor short positions in 3-5 year USD rates versus similar points on the EUR curve. Cross-market spreads have remained relatively modest in comparison to our expectation of differences in longer-run neutral rates. We think the possibility of increased global inflation pressures eventually reaching Japan is underpriced, and hence remain short the belly of the JGB curve.

Fixed income asset allocation

Credit markets – wider and cheaper

Fundamentals – nascent recession questions, China secular credit boom unresolved

The deterioration in the growth-inflation mix is no longer in doubt. To frame the growth debate another way, the question is how many economies will enter recession. Taking the 'concentric rings' approach we have used to manage the geographic, economic and market effects of the Russia-Ukraine crisis, a recessionary outcome in Russia and Ukraine is a given; in CEE countries risks remain high; in the UK the cost-of-living crisis (given additional likely fiscal tightening) is clear and medium-term risks have risen for the US. In the Eurozone we now expect stagnation for most of H1 and note the German economy was already contracting in Q4 2021 (itself marking a triple-dip in terms of quarterly growth contractions since March 2020).

From here, we must be humble about the uncertainties. As mentioned, an oil price of USD 80 portends quite different things from an oil price of over USD 130. Fed hikes of 50 bps versus steadier hikes of 25 bps pose different scenarios for the speed and extent of US curve inversion. We are surprised at some strategists calling for a 'this time is different' approach to the curve, viewing it as a benign or irrelevant signal. More broadly, we would heed the concern shown by Larry Summers, among others. Either way, medium-term recession probabilities into 2023 are rising and not falling.

Meanwhile, in China, we note that the high yield property market has gone from very bad to even worse. We wrote extensively on this topic last quarter (and in September) so for now we will just update some facts:

- The OAS on the China offshore high yield market has now touched over 3000 bps
- Spreads in Q1 2022 are now wider than at any point in the global financial crisis of 2007-09
- Over 70% of the market is now trading distressed. As we warned before, this is no mere idiosyncratic problem
- The updated BIS data for China private sector non-financial credit now stands at the equivalent of over USD 37 trillion – the most of any economy ever in history.

We continue to think the four-decade secular credit boom in China may have ended. With questions now being belatedly asked about the quality of accounting in real estate financial statements, historical precedent suggests it is likely that debt and broader liabilities have been undercounted during the boom years. The distress among borrowers who overdid things on the balance sheet side is now no longer a matter for debate. The bigger question in our view is on the financial system. It is quite clear to us that for every borrower there is a lender. It is an accounting identity. We think markets may be reminded of this fact in due course.

Market factors – central bank withdrawal, unplugging risk

Last quarter, we highlighted central bank liquidity withdrawal as a key theme for 2022. Markets have been quick to price this in with US rate hike assumptions for the year quickly moving from three to seven hikes, and the ECB's announcement of an abrupt policy turn in early February. EUR IG markets have enjoyed net QE for 28 out of the past 31 quarters. A world without ECB net QE is therefore unfamiliar in recent times and renders spread levels of the past 8 years (2018-19 aside) less relevant to the upcoming monetary regime. Since 2019, we have referred to CSPP as an 'umbrella' protecting euro credit markets. In early February, the ECB announced the umbrella is being largely removed.

The good news is that US quantitative tightening scenarios and ECB net CSPP removal – what we call the '2018 scenario' – is now more or less priced in. The bad news is that further tightening is possible, given the inflation scenario, and there are other factors to consider.

The Russia-Ukraine war raises many questions that could be of historic significance. On the financial side, these include sanctions policy, SWIFT access and dollar weaponization, before one even considers broader international relations networks, nuclear deterrence theory, China's relationship with Russia relative to the west, NATO architecture and European defense policy. Right now, the most important channel seems to be commodities, followed by systemic financial questions, and trade economics. But it is early days and we simply don't yet know what the potential ramifications may be of removing Russia from the global financial community. While Russia's exclusion from SWIFT has already been enacted, its sovereign default has not yet occurred. We cannot assume that unplugging the world's eleventh-largest economy from the global financial system will be a smooth process that is priced and over in a couple of weeks.

As for corporate bond supply, we note that new-issue volumes in lower-quality credit have dried up significantly. This points to our long-held view that one has to watch for credit market risks during times of sparse primary market conditions – as opposed to during times of plentiful supply. That is because supply is, to a large degree, a mirror and outcome of demand.

Volatility rose to elevated levels, with the VIX above 35 and our own Risk Aversion Barometer in the 'Risk Averse' zone. Still, FX moves have not been overly volatile, and while rates and CDS indices have seen large one-day moves, on a weekly basis these moves have at times been small given choppy price action. Looking at Russia-Ukraine events, for volatility to rise further, we would need to see a big new negative event, beyond what has occurred so far. A decade of low-level urban counter-insurgency (as seen in Syria, for example, or in Iraq post-2003), would be very destructive from a humanitarian perspective, but from a clinical financial market perspective, it would not necessarily lead to new increases in volatility. Similarly, threats of nuclear response from Moscow have become weekly occurrences lately. We should therefore look out for new on-the-ground shocks or significant Russia-NATO escalations: any significant escalation in Ukraine could create moral pressure on Germany to cut Russian oil and gas supplies much faster. In that scenario, credit spreads are undoubtedly heading wider. Conversely, a stalemate or protracted insurgency would have huge civilian consequences, but would not necessarily lead to wider credit spreads.

Valuations – getting cheaper, now a question of scenarios

Credit spreads have cheapened substantially in Q1. The US IG OAS has risen as much as 66 bps and EUR IG 79 bps since the tights in early Q4 last year. However, one challenge for Euro credit valuations is that the EUR IG ASW has only risen 45 bps, given the sharp widening in swap spreads. With the latter already at levels not far from those during the Eurozone crisis, the relative cheapness of EUR credit is less impressive – and indeed uncompetitive for those investors that can put on swap spread tighteners. Why take credit risk when you can grab a more historically attractive opportunity taking collateralized counterparty risk?

Readers may recall our commentary in 2021 was consistently downbeat on valuations. This is because strategic investing – as opposed to trading – requires patience. Last year's credit excess returns, in euro terms, were wiped out in the first five weeks of 2022. We think investing with cyclical returns in mind, even if that means foregoing the full annual target, gives a better risk-adjusted outcome for clients in the long run.

The good news is that value is being restored in 2022. From here, the USD IG market is already pricing in a rerun of 2018 – in other words, a scenario of Fed rate hikes (at 25 bps clips) and QT following the past few months tapering.

What is not (yet) in the price in the short term is any further fallout from a future Russian default. In 1998, spreads widened over 75 bps amid default and the collapse of Long Term Capital Management. In the end, that credit bear market was over relatively quickly, as the Fed cut rates three times in what some regard as the first financial market bailout of the modern era. But rate cuts and QE seem less likely in the next few months. Given the Fed's dual mandate, one cannot simply cut rates when headline inflation is rising towards 10%, against a PCE target of 2%. The good news is that, should a Russian sovereign default occur soon, the financial fallout from Russia's unplugging should be known relatively soon.

Further out, what is also not priced is recession risk. Recessions typically coincide with high yield spreads of close to 1000 bps OAS, not the current 400 bps in USD and 450bps in EUR. Looking at spreads to swaps, USD IG looks the most closely priced for recession risks, but even here, recession implies an OAS level of 200+.

Coming into the year, we were underweight betas in spread products in our portfolios. We have since raised these to above 1, via two methods. The first is closing out CDS index shorts in the European iTraxx and US CDX indices. Skews became very positive after the Russian invasion of Ukraine, and spikes wider on volatility increases are good environments to take profits on short credit positions. We were implicitly short both Russia and Ukraine in our portfolios in Q1 via the CDX EM index, which helped protect portfolios in what has been a tough quarter for total returns across asset classes. Second, on the constructive side, we added swap spread tighteners in euros given the very wide level of swap spreads. While swap spreads may be volatile in the short term, we know from history that episodes of wide swap spreads do not last forever and that some mean reversion is very likely.

We have not yet taken our corporate credit betas into positive territory, though. While the pricing of the 2018 scenario makes US IG spreads interesting, swap spread valuations have a crowding-out effect in corporates in an uncertain economic environment: there is no need to take credit risk into a potential recession if there are better opportunities elsewhere. Meanwhile, in China, we retain our short CDS basket on the banks and sovereign, given what we view to be long-term asymmetric risks.

For more details, please see the forthcoming Q2 2022 *Credit Quarterly Outlook*.

Peripheral bonds; how much ECB do they need?

The war in Ukraine is clouding the macro outlook for the periphery. Given Italy's dependence on Russian gas, for example, the prospects for Italian GDP growth on a one-year view depends enormously on whether a ceasefire is reached soon or whether we see a complete shutdown of Russian pipelines in the coming weeks.

Fiscal help, monetary headwinds

Direct investments via the NGEU framework will be supportive for European countries. The potential new fiscal plans to provide for energy and defense costs may help medium-term too. Notwithstanding the increasingly uncertain macro outlook, the ECB has announced an acceleration in its reduction of APP purchases, thereby paving the way for the first rate hike in late Q3. Lower ECB purchases will significantly increase net peripheral issuance, which will likely be a dominant headwind for peripheral bonds in the coming years. The change in net issuance relative to last year will become particularly large. It remains to be seen how much of that issuance, and at what price, markets are able and willing to take up. Nonetheless, we noted in our discussions that recent spread widening between peripheral bonds versus Germany already reflects some of these changed issuance dynamics. The ECB has stressed they will prevent financial fragmentation, and can use full flexibility in PEPP reinvestments and/or the still unused part of the PEPP envelope. While the precise threshold for intervention remains unclear, our view is that the risk of a huge blow-out in spreads is limited. But, compared to recent years when ECB purchases were more supportive, the equilibrium level of spreads at which issuers and investors will meet is most likely going to be higher.

The current political developments in Italy and France are more supportive for spreads. Italian elections will take place twelve months from now and there is currently broad consensus on a pro-Europe stance. The conflict has shown European countries the advantages of being part of one bloc. Also in France, which holds national elections from late April, incumbent President Macron has recently gained significantly in the polls and seems on track for a second term. When we factor in valuations, also versus swaps, we are cautious towards Spanish and Portuguese bonds, especially in shorter maturities. In Italian BTPs we have a preference for curve positions, without taking too much directional risk. For example, we see value in the steepness in the belly of the BTPs curve. Valuations in peripheral bonds overall versus Germany are more or less in the middle of our expected range. In our opinion there are more attractive alternatives out there in current markets, such as in swap spreads and SSAs.

EM debt: still a challenging outlook

The EM outlook remains challenging given the additional supply-chain shock and higher energy and food/agricultural prices. The latest spike comes on top of already sticky inflation, increasing FX volatility and triple tightening from the Federal Reserve. Many EM central banks have been ahead of the curve and raised policy rates in advance of DM central banks. But there are still divergences within the EM universe. Persistent high inflation across CEE remains a concern for policy makers, with the latest commodity spike adding more fuel to the tightening cycle there. The prolonged supply-chain constraints across Asia and tapering global demand amid higher commodity prices will dampen the outlook for growth and corporate profitability through the year. Moreover, a potential Russia default and heightened political risk will continue to weigh on investor sentiment and risk asset volatility. We remain cautious on EM fundamentals. While EM rates have corrected and spreads are at the wider end of historical valuation ranges, there is a reason for this and it remains too early to be overweight EM bonds and spreads.

In China, policymakers are going against the global tightening flow. They have outlined extra fiscal support measures aimed at supporting SMEs and boosting infrastructure investments. Moreover, after the 10 bps policy rate cut in January, some further rate easing and lowering of banks' required reserve ratio beckon, as underlying inflation remains subdued, and downside growth risks related to property and Covid-19 developments linger. We remain overweight Chinese government bonds, with the realistic possibility of further monetary easing by the PBoC not yet properly discounted in our view. The Chinese economy faces a triple challenge in 2022 of property market travails, the ongoing disruption in China from Covid and the rise in commodity prices for the world's largest commodity consumer. All this raises the risk of a growth miss, and potentially a hard landing.

FX: USD to remain strong

The world has changed since our last outlook three months ago, and so too has the FX macro landscape, with the broad price acceleration across the commodity complex as the dominant factor. These prices are likely to stay elevated even if a peace deal or ceasefire were brokered. From an FX perspective, the deterioration in the growth-inflation mix looks more challenging in the Eurozone and among EM commodity importers than in the US. Indeed, even the ECB prioritized inflation in their recent evaluation of the potential economic outcome of the conflict, where we would argue that the Eurozone is one of the most economically sensitive regions.

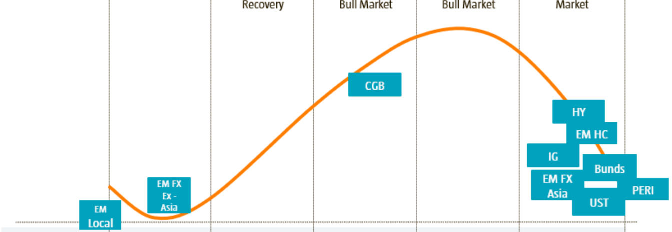
'we expect weaker currencies of countries dependent on energy and food imports typically in Africa, the Middle-East and Asia'

The geopolitical situation remains fluid in our view, with a wide range of outcomes possible. But our view is that the combined impact of the conflict, monetary tightening, decelerating growth and inflation being elevated for longer warrants a stronger USD. It also suggests potentially more weakness for CEE FX, because of the traditionally closer trading relationship of these countries with Russia and Ukraine, and also due to potential geopolitical spillover risks from the conflict. Current conditions could also give rise to a larger divergence between the currencies of commodity importers and exporters. We note the potential optimism of markets in a possible de-escalation scenario. Discerning the near-term future is fraught with uncertainty here, but we would be inclined to fade this sentiment. The sanctions and supply constraints in various commodities from Ukraine and Russia will not disappear any time soon (on the contrary even…).

Historical analysis of Fed tightening cycles reveals that cyclical FX on average does surprisingly well during the hiking episodes, but tends to underperform before the first hike and after the last hike. Market participants tend to remember the idiosyncratic casualties (Mexico in 1994, Argentina in 1999-2000, Turkey and Argentina in 2018). So there is a distinction between idiosyncratic FX losers among more vulnerable sovereigns compared to the less dramatic performance for the average EM or DM cyclical sovereign. The same analysis showed that the USD mildly appreciates in anticipation of the first hike. The combination of weak cyclical FX and strong USD is more common in periods of weaker global growth, geopolitical stress, and moments of financial and/or sovereign crisis. The supply-led (as opposed to demand-led) nature of the current inflation shock may have ramifications, too. Putting this historical analysis into the current context of expected weaker growth, stronger monetary tightening, elevated geopolitical stress and the potential for a near-term Russia sovereign default, we conclude by expecting a stronger USD as well as stronger DM commodity currencies, such as the NOK. It also implies currency weakness for countries that rely heavily on energy and food imports, typically in Africa, the Middle East and Asia. Here we would single out IDR, INR, JPY, PHP and KRW. One place of potential relative strength within EM FX, in our view, is Latin America, and BRL and MXN in particular. These currencies have a stronger foundation thanks to the aggressive manner in which the Brazilian and Mexican central banks hiked rates during the pandemic, to combat inflation. Also, historical analysis shows that currencies typically perform well during a Fed tightening cycle if they have completed their own hiking cycle before that. In today's markets, only Latin America and Eastern Europe have hiked, while most Asian peers have not. In fact, some have even cut policy rates.

Asset class positioning

Figure 1 | The market cycle



Market Phase	Bottom	Early Stage Recovery	Mid Stage Bull Market	Peak of Bull Market	Bear Market
Fundamentals	20% Improving but ignored	30% Solid underlying performance	40% Prolonged phase of supportive trends	20% Optimistic, long-duration projections	30% Over-awareness of deteriorating conditions
Valuation	20% Attractive, but no takers	50% Abundant bargains	30% Willingness to pay up	20% Revised models justify stretching	20% Shocked recognition of outlandish prices paid
Psychology, Technical and Liquidity	60% Exhaustion, disbelief and demoralization	20% Doubt, reflection and conversion	30% Faith, hope and charity	60% Euphoria, greed and extrapolation	50% Fear, panic and loathing

Source: Robeco, March 2022, Morgan Stanley cycle characterization

Source: Robeco, March 2022

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