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Q&A-Pro-growth rotation in stocks may not last long; Dollar downtrend intact, but flows to limit fall: Esty Dwek, Natixis Investment Managers

The "risk-on" stock market rotation of recent weeks may not last long into 2021 as it has largely priced in the roll out of COVID-19 vaccines and an economic recovery next year, **Esty Dwek, head of global markets strategy at Natixis Investment Managers,** which manages about $1.06 trillion in assets, told the Reuters Global Markets Forum on Wednesday, December 2.

Investor allocations in December would suggest how far the trade, where some of the "cyclical," growth-dependent stocks hit hardest in the coronavirus crisis recover, has to run, Dwek said in a conversation during the Reuters Global Investment Outlook Summit 2021.

"Once we add November and December, how much catch up will be done already?"

Following are edited excerpts from the conversation:

Q: What do you see as the post-pandemic fallout for markets and investments, assuming a vaccine is rolled out in 2021?

A: I think we are already seeing most of the moves now. The rotation from defensives to cyclicals, from the U.S. to international. We are preparing for the vaccine rollout. The concern is this has become very consensus, so the question becomes how long this lasts. For now, it is definitely risk-on and the rotation, but we seem to be zipping through phases of the cycle.

Q: How do you see the global recovery playing out and what are the biggest risks to your outlook?

A: We are going to have a painful first quarter, and that is assuming we get fiscal stimulus in the U.S., and the EU recovery fund in Europe. From there we continue to bounce back, and we'll see very strong growth as we start to get back to normal -- assuming all goes smoothly with vaccines -- but it will all take time.

In terms of risks, the virus -- mutation, short immunity, vaccine hiccups -- lack of fiscal stimulus, geopolitical tensions come to mind.

Q: On geopolitical tensions, where do you see the biggest risks?

A: The risk is in some of the optimism that has been baked in with (President-elect Joe) Biden's victory. Expectations are for an easing in tensions with China, but it will not be as smooth as people expect. Relations with Europe should improve, but challenges remain on digital tax, trade and even on green initiatives, as they are domestic focused and could clash unintentionally.

Q: How do you see the political situation in the U.S. impacting markets in 2021?

A: Like most, my base case is that the Republicans win at least one of the two Georgia seats and the Senate remains Republican. So, it's about stimulus mostly as we are going to have gridlock on the bigger policies Biden has in mind. As long as we get stimulus, and I think we will, markets will be supported as vaccines roll out and the Federal Reserve stays ultra-accommodative.

Q: The EU recovery fund seems underwhelming. Do you think it will make much impact?

A: The EU recovery fund is more about messaging and cooperation, bringing some support -- agree it is too small -- and keeping servicing costs low for the periphery. In that, it is a success, but the scale is not big enough, especially considering second lockdowns -- and hopefully not third ones. But politics are getting in the way here too, so we have to keep an eye out for that.

Q: Any thoughts on a potential euro zone debt crisis?

A: The ECB is buying so much of it (debt), I do not expect a euro zone debt crisis. No euro zone breakup either.

Q: What do you make of Janet Yellen for Treasury Secretary?

A: For markets, Janet Yellen is a great pick. She is clearly on the dovish side, she will work seamlessly with the Fed, and she will try to put in place mechanisms to get money to consumers.

Q: Given you expect a rocky first quarter, will the rotation to value take a breather?

A: I think a poor first quarter of growth is expected by markets. So, unless we get a bad surprise with renewed lockdowns, problems with the vaccine or something else, the rotation can continue. But i am not sure it lasts all of 2021. We also need to see how much it runs this month. Once we add November and December, how much catch up will be done already?

Q: So which sectors would you recommend at this point?

A: I still see room in industrials, materials, financials, consumer discretionary and energy. And there is room for Europe and emerging markets to catch up to the U.S. too.

Q: What are you expecting from Brexit negotiations, and how does that impact your outlook for the UK and EU markets?

A: I think they (UK and EU) will manage a bare-bones agreement. The UK will make concessions on fishing and Boris Johnson will try to spin it back home. It is in everyone's interest to have an agreement. Hopefully they manage this week or early next week, but it will be a harder Brexit than anticipated even a year ago. The outlook assumes such an agreement, but the virus impact means growth will still suffer, and UK growth will still have Brexit costs in 2021. For GBP though, some upside is still likely.

Q: In terms of fund flows and asset allocation at Natixis Investment Managers which asset classes/strategies and geographies are your clients positioning themselves in?

A: We are seeing a move towards value and international equities at the moment, but the biggest trends are towards ESG, thematic investments and private assets. These are more structural changes and I assume elsewhere clients are doing the same. We still see demand for U.S. equities, even if in the short-term people are trying to play the catch-up game elsewhere. The solid environment and earnings backdrop, and the technology revolution continue to support the U.S. markets.

Q: Have emerging markets turned a corner after a decade of poor performance? If so, what are the primary risks?

A: There is plenty of scope for EM to catch-up, but risks remain. Asia should outperform thanks to better management of the health situation, the roaring Chinese growth engine and the regional trade agreement. LatAm can play catch-up, but a number of countries are still facing challenges. Risks are mostly idiosyncratic: domestic politics, global trade, U.S.-China tensions, debt levels, but for now we see more tailwinds than hurdles.

Q: Regarding gridlock in U.S. politics, do you think most policies won't be able to change much in the first term?

A: As long as Republicans retain the Senate, I do not expect corporate tax increases or additional regulation. Biden can do more on energy with executive orders, but there are limits. Infrastructure probably won't happen given all the recent spending, even if there is some bipartisan support. Iran will be slower than people expect - Biden will resume talks, but it will take time for actual change.

Q: Do you think the market is under-pricing a possible rise in inflation? If so, what are the best ways to hedge?

A: We've started to see a move in break-evens, but the inflation we will probably get in the middle of next year will be transitory and due to base effects, and I do not think we will see enough fiscal spending for the inflation picture to change materially for the medium-term. Treasury-Inflation-Protected-Securities have done well regardless and that can is useful to have.

Q: How do you see the dollar performing in the next year?

A: That is the big question. The downward trend is intact, but it has become so consensus and positioning is so short that I think some [of] the downside will be limited. Better growth, earnings, fiscal impetus, carry in the U.S. will keep some flows and limit downside.

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