MUSINGS

POLICY PICTURE

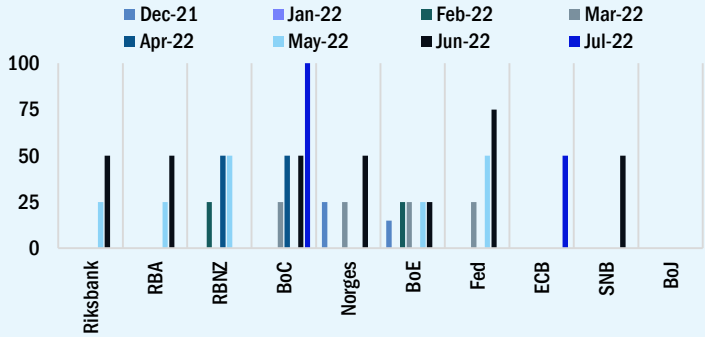
The ECB raised rates for the first time in 11 years, surprising with a 50bps hike, taking policy rates out of negative territory. ECB president Christine Lagarde justified the deviation from June guidance for a 25bps increment on the basis of upside inflation risks, including potential de-anchoring of inflation expectations, and the announcement of the new Transmission Protection Instrument (TPI). The TPI seeks to counter "unwarranted, disorderly market dynamics" that may challenge policy transmission, is ex ante unlimited in size and subject to a list of eligibility criteria, including compliance with a EU macro-surveillance framework.

Looking ahead, the ECB has side-lined forward guidance in favour of a "meeting-by-meeting" approach that is "data-dependent". With inflation running above 10% in nine Eurozone economies, a level expected to be exceeded across the region in September, and wage growth accelerating to decade highs, we believe the ECB will deliver a 0.5% hike at its September meeting. However, we anticipate 0.25% in October and December due to a weakening growth picture and challenges from the ongoing war and gas supply disruptions.

Elsewhere, the BoJ maintained the status quo across all policy parameters—yield curve control (YCC), asset purchase programs, and forward guidance—as expected. The BoJ revised up its inflation outlook to 1.4% and 1.3% for 2023 and 2024, respectively, both from 1.1% previously. Despite the revisions remaining below 2%, we see scope for the BoJ to opt for gradual policy normalization over the coming year. In the US, with recent data reflecting the slowdown desired to alleviate inflation pressures (see page 2), we expect the Fed to proceed with its planned 75bps rate hike next week.

Voila – the ECB exits negative interest rates!

Central bank policy rate hikes (basis points)



Source: Goldman Sachs Asset Management, Macrobond. As of July 12, 2022.

"What happens in September is going to depend on what data we have, but we are definitely on a normalization path in order to reach our medium-term objective of 2% [...] that doesn't mean to say that we are changing the ultimate point of arrival. We are accelerating the exit, and we are following the path of normalization that we have flagged."

President of the ECB, Christine Lagarde

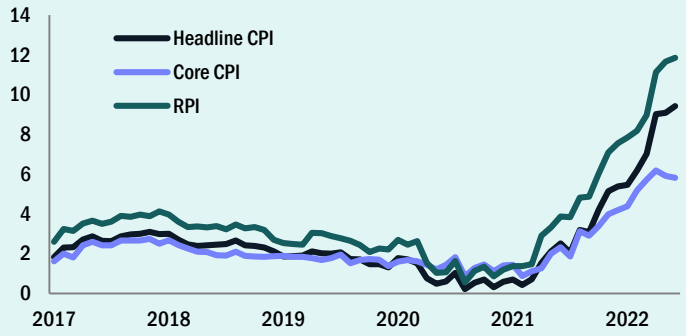
MACRO AT A GLANCE

Strength in UK inflation and labour market data led BoE Governor Andrew Bailey to note that "a 50bps increase will be among the choices on the table" at the next meeting. Headline CPI inflation increased from 9.1% YoY in May to 9.4% in June, the highest reading in 40 years, largely driven by further increases in food and energy prices (see Chart). Annual core CPI inflation moderated from 5.9% to 5.8% and the unemployment rate held steady at 3.8% in April.

Recent US data reflect a moderation in growth and the labour market. The Philadelphia Fed manufacturing index—a timely business sentiment gauge—decreased by 9 points to -12.3 in July. The composition showed 6-months-ahead business conditions and new orders components falling to the lowest levels since 1979 and 2009, respectively. Meanwhile, initial jobless claims continued their recent upward trend. Both indicators have typically been useful forward-looking indicators of the economic cycle.

UK headline inflation continues to reach historic highs

Year-on-year (%)



Source: Goldman Sachs Asset Management, Haver Analytics. Consumer price index (CPI), retail price index (RPI). As of June 2022.

NAVIGATING FIXED INCOME

Fixed income markets were volatile this week as investors digested the ECB meeting outcome, the resignation of Italian Prime Minister Mario Draghi, resumed gas flows through the Nord Stream 1 pipeline (albeit at 40% capacity), mixed corporate earnings releases and key economic data releases.

The initial response to the ECB meeting outcome was a sharp rise in European sovereign bond yields. However, those moves later retraced somewhat and the euro failed to strengthen as investors were disappointed by a lack of clarity on when the new anti-fragmentation tool—the TPI—would be utilised. Meanwhile, the spread between the Italian 10-year BTP yield and the 10-year German bund widened on political uncertainty.

The outlook for core government bond yields remains uncertain and asymmetric in nature. A weakening growth backdrop may check the sell-off, while strong inflation pressures curb the extent to which rates can rally. As a result, we hold moderate exposure to interest rates on a directional and relative value basis.

Notwithstanding the complex macro backdrop of high inflation, slowing growth and tightening monetary policy, we remain overweight investment grade and high yield corporate credit. We view carry and roll prospects as attractive and expect downgrade and default activity to remain muted given strong corporate balance sheet positions. Alongside the impact of high inflation, we are closely monitoring the consequences of a strong dollar on second quarter earnings for US multinational companies. Read more in Credit Check-In: Balance Sheet Status Check.

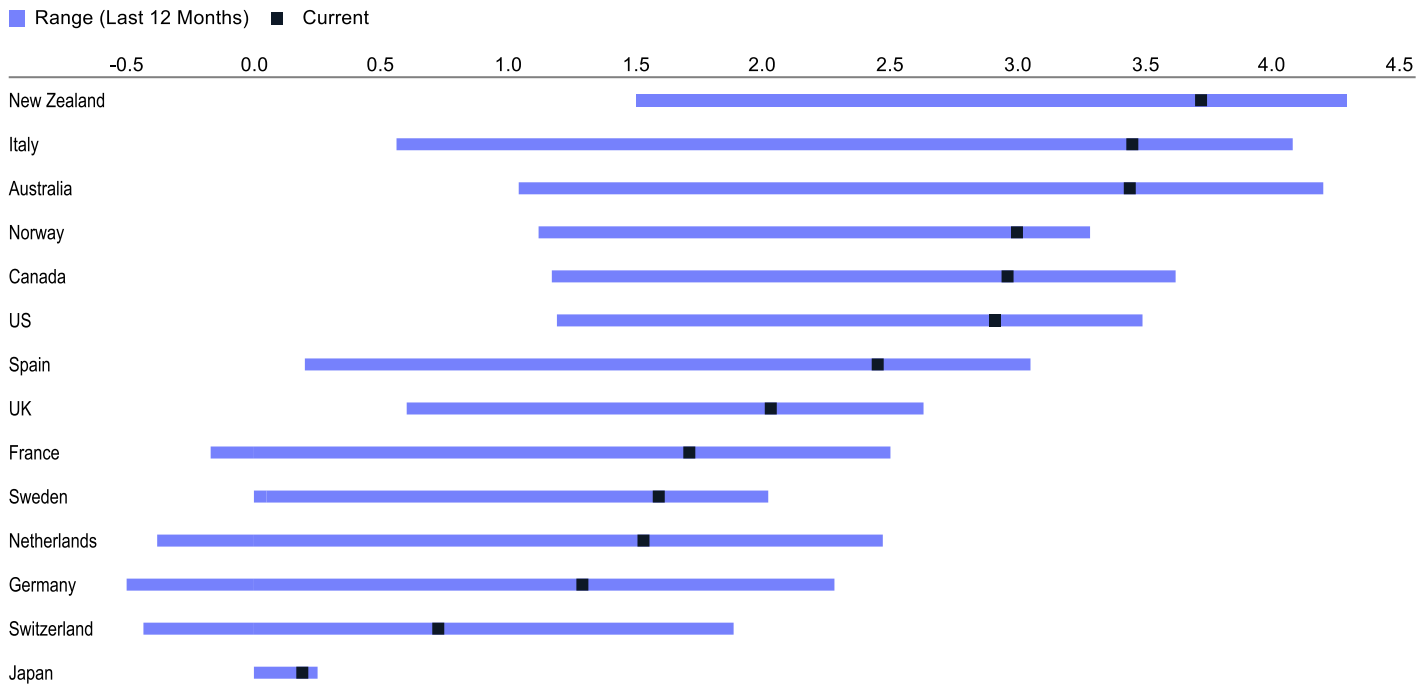
Elsewhere, we maintain modest overweight exposure to Agency MBS. See Navigating Agency Mortgages Through QT for more details.

CENTRAL BANK SNAPSHOT

	Interest Rate Policy	Balance Sheet Policy	Outlook	Our outlook relative to market-implied pricing
Fed	Federal funds rate: 1.50%-1.75% Last changed: June 2022 (+75bps) Prior changes: May 2022 (+50bps) March 2022 (+25bps)	Started reducing the monthly pace of its net asset purchases in November 2021 and ended net additional purchases of Treasuries and agency MBS in early March. Balance sheet runoff begins in June; an eventual monthly cap will be set at $95bn—split $60bn-$35bn between US Treasury and mortgage-backed securities (MBS)—and the caps will initially be set at half of those levels for the first three months of runoff ($30bn UST-$17.5bn MBS). Balance sheet size: 37% of GDP	We expect a 75bps rate hike in July. This would reset the policy rate to 2.25-2.5%, the Fed's median estimate of the neutral rate. Thereafter, we expect a 50bps rate hike in September followed by a reversion to 25bps rate hikes.	Slightly hawkish
ECB	Deposit facility rate: 0.0% Last changed: July 2022 (+50bps), the first hike since 2011	The ECB will end net APP purchases from July 1, 2022. Reinvestments under the PEPP will continue until at least the end of 2024. On July 21, the ECB announced a new anti-fragmentation tool, the Transmission Protection Instrument (TPI), used to ensure monetary policy is transmitted smoothly across all euro area countries. Balance sheet size: 65% of GDP	We expect a 50bps hike in September and two further 25bps rate hikes at the October and December meetings.	Slightly dovish
BoE	Bank Rate: 1.25% Last changed: June 2022 (+25bps) Prior changes: May 2022 (+25bps) March 2022 (+25bps) February 2022 (+25bps) December 2021 (+15bps)	BoE members voted in February 2022 to begin to reduce the stock of UK government bond purchases by ceasing to reinvest maturing assets, as well as to begin to reduce the stock of sterling non-financial investment grade corporate bond purchases by ceasing to reinvest maturing assets and by a program of corporate bond sales. Balance sheet size: 30% of GDP	We think the BoE will hike rates further to 1.75% before pausing its hiking cycle. We expect the BoE to commence bond sales at their September meeting.	Slightly dovish
BoJ	Policy deposit rate: -0.10% Last changed: January 2016, when the Bank introduced its negative interest rate policy (NIRP) 10-year JGB yield target: ~0%, with tolerance band of -/+25bp (yield curve control policy)	The Bank voted in January 2021 to purchase ETFs and Japanese REITs as necessary with upper limits of ~¥12tn and ~¥180bn, respectively, on annual paces of increase in their outstanding amounts, as well as to purchase commercial paper and corporate bonds with an upper limit on the outstanding amount of ~¥20tn in total until the end of March. Balance sheet size: 135% of GDP	We expect unchanged policies through 2022 but see scope for a rate hike in 2023.	Slightly dovish

Source: Goldman Sachs Asset Management. As of July 22, 2022. The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this presentation.

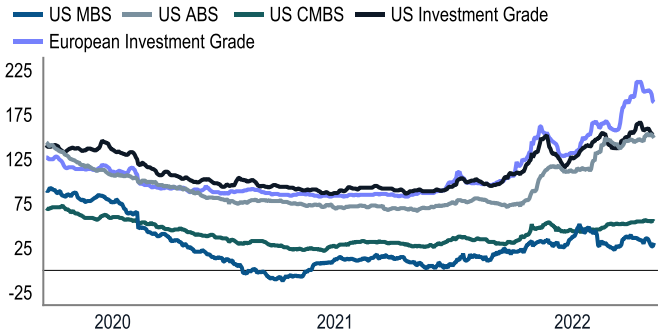
10-YEAR SOVEREIGN BOND YIELDS (%)



Source: Macrobond, Goldman Sachs Asset Management. As of July 22, 2022.

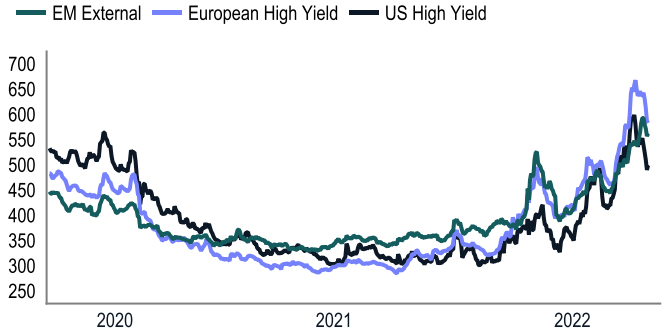
FIXED INCOME SECTOR SPREADS

Investment Grade and Securitized Spreads (bps)



Source: Macrobond. ICE BoAML indices. As of July 22, 2022.

High Yield and Emerging Market Spreads (bps)



Source: Macrobond. ICE BoAML, J.P. Morgan indices. As of July 22, 2022.

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Sector Spread Indexes

US Investment Grade Corporates: ICE BofAML US Corporate Index
US High Yield Corporates: ICE BofAML US Corporate High Yield Index
European Investment Grade Corporates: ICE BofAML Euro Corporate Index
European High Yield Corporates: ICE BofAML Euro High Yield Index
ABS: ICE BofAML US Fixed Rate Asset-Backed Securities Index
MBS: ICE BofAML US Agency Mortgage-Backed Securities Index
CMBS: ICE BofAML US Fixed Rate Commercial Mortgage-Backed Securities Index
EM External Debt: J.P. Morgan, EMBI Global Diversified Face Constrained Index

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Abbreviations: US Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BoE), Bank of Japan (BoJ), Quantitative Easing (QE), Quantitative Tightening (QT), Pandemic Emergency Purchase Program (PEPP).

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