MyStratWeekly

Market views and strategy

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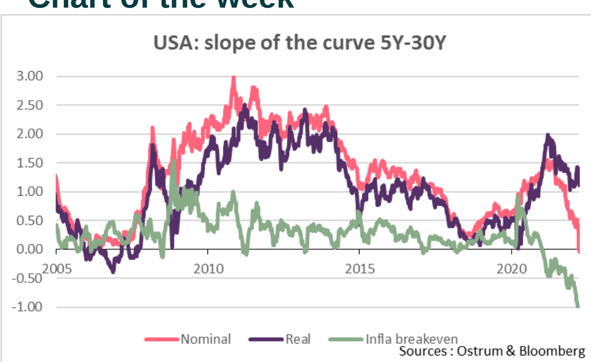
Topic of the week: The European Union at a turning point

- **Beyond the humanitarian drama, the conflict in Ukraine has revealed the weaknesses of the EU in terms of its heavy dependence on Russian energy and in terms of European defense policy;**
- **The Versailles summit set an ambitious roadmap constituting a 180 degree turn of the EU on these two levels;**
- **Massive investments must be made to reduce dependence on Russian energy and strengthen European defence;**
- **To address these challenges, common EU funding is needed in addition to the reallocation of available EU funds.**

Market review: Beyond warfare

- **The US-EU deal on natural gas, a symbol of Russia isolation;**
- **Upward pressure on yields as bond funds record outflows;**
- **Equities turn more upbeat in US, led by energy;**
- **Extended weakness in the yen, commodity currencies up.**

Chart of the week



Much has been written about the fact that the American curve is inverted. For example on the 5-30 years as on the graph opposite. But if you look at the real rates, the slope is actually quite steep, and it has actually increased recently.

Many commentators interpret inversion as the signal of an impending recession. In fact, the inversion is more related to the inflation curve and the actual steepness is likely to increase with the QT. The growth signal is probably weak and we have to be very careful.

Figure of the week

55%

Source : Ostrum AM

The majority of Japanese are for the first time in a decade for the operation of nuclear reactors. According to a Nikkei poll.

Stéphane Déo
Head of markets strategy
stephane.deo@ostrum.com

Axel Botte
Global strategist
axel.botte@ostrum.com

Zouhoure Bousbih
Emerging countries strategist
zouhoure.bousbih@ostrum.com

Aline Goupil- Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

● Topic of the week

The European Union at a turning point

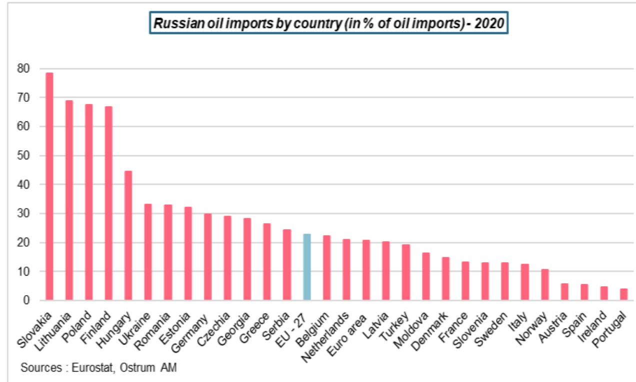
The war in Ukraine is a humanitarian tragedy. It also reveals the weaknesses of the European Union due to its heavy dependence on Russian energy and certain precious metals as well as in terms of European defense policy. To meet these challenges, European countries set themselves an ambitious roadmap at the Versailles Summit. A war had to break out on the doorstep of the EU for it to show strong unity and determination and to set priorities in terms of strategic independence and the strengthening of European defense. Massive investments will be needed to achieve this. The EU must give itself the means to meet these challenges.

The Versailles summit on March 10 and 11 had been planned for a long time and was to focus in particular on the need to strengthen the EU's strategic independence in certain sectors. The Covid-19 crisis has cruelly highlighted the fragility of the EU resulting from its strong dependence on China for certain medicines and health protection materials as well as on certain Asian countries for semiconductors, key components for certain industries (such as automotive). The war in Ukraine has only accentuated the need to strengthen and expand the EU's strategic independence in the energy market and to increase its defense capabilities.

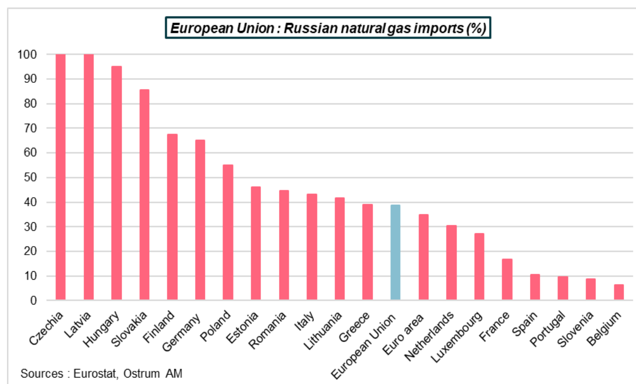
Gradually reduce dependence on Russian energy

Russia is the 1st energy supplier of the EU

The European Union is very dependent on Russia in terms of energy, the latter being its leading supplier of oil, natural gas and coal.
More than 20% of EU oil imports come from Russia. As the following graph shows, while Eastern European countries are the biggest importers of Russian oil, Germany and Greece import nearly 30%.



The dependence of the European Union on Russia is even stronger for its natural gas. It imported nearly 40% in 2020. Beyond the strong dependence on Eastern countries, Germany (65%), Italy (43%) and Greece (39%) are also at considerable risk.



The conflict is generating fears of disruption in the EU's energy supply, which has resulted in a sharp rise in the price of gas and oil.

Heavy dependence of the EU on certain metals

Another factor weakening the EU comes from its strong dependence on certain precious metals from Russia. Palladium and titanium are part of the list of the 30 critical raw materials of the European Union, Russia being the origin of 40% of the world production of palladium and the 1st world producer of titanium. This particularly affects the automotive sector, palladium being used in the production of catalytic converters, and the aeronautics industry which depends on the supply of Russian titanium. The European Union is also dependent on nickel and Russian aluminium, though to a lesser extent.

Ukraine also produces wiring harnesses for automobiles that are essential for production. The shutdown of factories following the conflict thus constrained the production of car manufacturers.

Reduce dependence on Russian energy

At the Versailles summit, some countries such as the Baltic states and Poland, pleaded for an immediate halt to Russian energy imports to further punish Russia by depriving it of crucial revenue currently used to finance the war in Ukraine. Other countries such as Germany, Italy and Hungary opted for more gradual measures because of the shock it would represent on their economy.

A consensus was finally able to be found on a gradual reduction in dependence on Russian imports of oil, natural gas and coal. Even though the Versailles declaration remains vague, the President of the European Commission, Ursula Von der Leyen, has announced that she wants to achieve this objective in 2027.

How to reduce energy dependence?

Seven tracks were announced at the summit:

- accelerate the reduction in dependence on fossil fuels;
- diversify supplies via, in particular, liquefied natural gas and biogas;
- gradual establishment of a hydrogen market in Europe;
- accelerate the development of renewable energies;
- complete and improve the interconnection of European gas and electricity networks;
- reinforce the EU emergency plan for security of supply;
- improve energy efficiency.

In order to succeed in reducing energy dependence on Russia, the European Commission (EC) must present a REPowerEU plan by the end of May.

The REPowerEU plan

A first draft was presented a little less than a month ago. The EC proposes to cut EU demand for Russian gas by 2/3 by the end of the year. This will be achieved through the diversification of natural gas supply, the acceleration of the deployment of renewable gas and the development of renewable energies. It also proposes to make compulsory the use of at least 90% of the gas storage capacities of the EU and this by October 1st of each year. Finally, it recommends urgent measures in terms of price regulation, state aid and taxation for the most affected households and businesses.

The Versailles Summit was followed by major announcements last week aimed at reducing dependence on Russian energy in a short period of time.

Agreement between the United States and the EU on deliveries of liquefied natural gas

On March 25, the United States and the EU announced an agreement aimed at significantly increasing US deliveries of natural gas to Europe and thus reducing its dependence on Russian energy. For 2022, the United States is committed to delivering at least an additional 15 billion cubic meters by the end of the year. This amount will be gradually increased to reach 50 billion m^3 per year until at least 2030. This is to be compared to 150 billion m^3 supplied by Russia to the EU each year by pipeline to which must be added 14 to 18 billion in liquefied form. It was unclear where these additional deliveries would come from, with some expected to come from a diversion of ship cargoes that were destined for other markets (Asia) given the lack of infrastructure in the EU to bring LNG back to the state of gas.

Germany aims for independence on Russian gas by 2024

Germany has announced a timetable to reduce its imports of Russian energy. It intends to become independent of Russian coal by this fall and of oil by the end of 2022. Regarding natural gas, it intends to do without Russian gas imports by summer 2024. This will be done via the diversification of suppliers (United States, Qatar in particular), the construction of two LNG terminals, the development of renewable energies and the increase in hydrogen production. These objectives seem ambitious in view of Germany's lack of infrastructure and a tight natural gas market.

Strengthening European defense capabilities

To strengthen its security and defense, the EU has pledged to “significantly increase” defense spending, mainly through investment, but also in the area of cybersecurity and connectivity. It also aims to develop synergies in research and innovation in the civil, space and defense fields. Investments will be made to develop and strengthen the defense industry, including in SMEs.

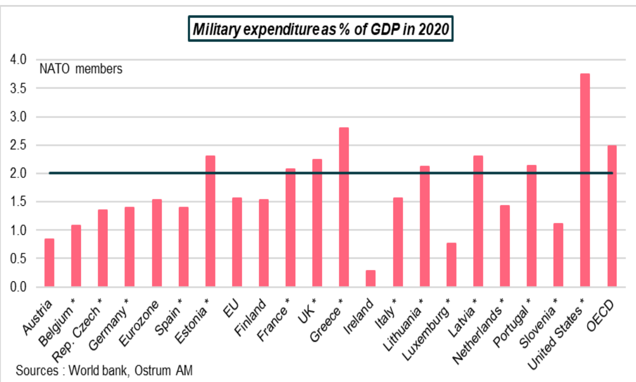
The European Commission must present an analysis of defense investment gaps by mid-May, in coordination with the European Defense Agency, and propose measures to strengthen the industrial and technological base in this domain.

In order to achieve this, the EU will in particular make greater use of the European Peace Facility.

These measures require a sharp increase in public investment

Increase in defense investments

Strengthening EU defense capabilities means significantly increasing defense investments for some countries. As the following graph shows, military spending varies significantly with economies. While NATO recommends that its members devote at least 2% of their GDP to military expenditure, the European Union lags behind with a ratio of 1.6% in 2020. Whilst France, Greece, Lithuania, Latvia and Portugal are above the threshold, this is not the case in particular with Germany, Italy and Spain. This can be explained in particular by the history of certain countries.



The war in Ukraine led Germany to make a 180 degree turn in defense. While it was lagging behind on this plan at the international level, favoring a policy of influence through diplomacy and trade after the 2nd World War, the government announced a special fund of 100 billion euros in order to modernize the German army. The latter will make it possible to devote 2% of GDP to defense in 2022 and exceed this ratio thereafter. By way of comparison, military spending in 2021 represented 47 billion euros. This special fund, which will be spread over several years, will not be subject to the debt brake as are the expenses included in the budget.

Italy has followed Germany's lead in saying it wants to increase defense spending to 2% of GDP.

Investments to reduce energy dependence on Russia

Many investments are necessary for this purpose considering that Russia is currently the 1st supplier of the EU. These measures will aim to accelerate the energy transition, via the more rapid deployment of renewable energies, to find other sources of supply, in particular via the construction of LNG terminals to obtain supplies of liquefied natural gas from other countries (United States and Qatar in particular), and investments to increase natural gas storage capacity.

The EU must give itself the means to respond to these challenges

This strategic reversal of the EU in the field of energy and defense requires a response from the European Union. Added to this are the expenses related to help provided to Ukrainian refugees and the measures taken by governments to reduce the shock of energy prices on households and businesses. This happens as the European Union is barely recovering from the shock linked to the Covid-19 crisis. This external shock on the prices of energy, metals, cereals and on household and business confidence affects the whole of the EU while the countries have reduced fiscal room for maneuver due to the crisis and a high level of public debt. Moreover, the countries are not affected in the same proportions due to their greater dependence on Russian energy for some and their proximity to Ukraine. A common response is therefore necessary to deal with the crisis and the challenges raised by the war in Ukraine.

Extension of the suspension of budgetary rules?

To allow governments to take the necessary measures to absorb part of the shock on energy prices, the EC could decide to extend the suspension of the rules of the stability pact again. This was decided in March 2020 to enable countries to cope with the shock linked to the Covid-19 crisis. It is planned to reintroduce them in 2023 but given the reduced growth prospects, following the conflict in Ukraine, the EC could postpone them to 2024 and make this announcement in mid-May, when presenting its new forecasts.

A common EU response is needed

The massive investments that will be made to strengthen EU security and reduce its dependence on Russian energy argue for a common EU response. Mario Draghi estimates between 1,500 and 2,000 billion euros the expenditure necessary at EU level to finance the strategic changes to be made in energy, climate and defense. France and Italy are urging other European countries to move towards pooling this additional debt at European level, as was the case during the Covid-19 crisis with the creation of Next Generation EU.

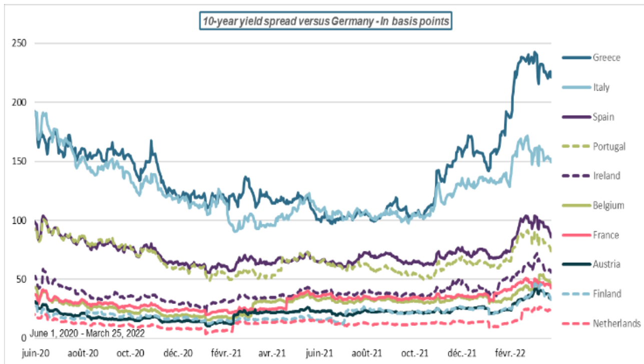
So-called “frugal” countries like the Netherlands, Germany and Finland are currently reluctant to the idea of a new

European plan given that EU funds are available. These include unsolicited loans from member countries under Next Generation EU. The amount available is 220 billion euros (only Italy, Greece and Romania have requested the entire loan envelope). The structural funds, amounting to 350 billion euros, can also be used flexibly.
The European Union has also just announced an aid of 4.2 billion euros for countries hosting more than 3.5 million Ukrainian refugees, as part of the React-EU program which is part of Next Generation EU.

If part of the Next Generation EU loans could be used to accelerate the energy transition or even be redirected, just like other available European funds, this will not be sufficient to finance the massive investments to be made over the long term. Discussions are ongoing to create new instruments alongside Next Generation EU. The European Commissioner for the Economy, Paolo Gentiloni, thus pleads for new tools, going beyond Next Generation EU, to finance investments in defense and energy independence.

What impact on the bond markets?

Bond yields in the euro zone have risen sharply since the end of 2021, due in particular to the rise in inflation expectations following the sharp rise in energy prices. To contain them, the ECB has decided to normalize its monetary policy more quickly than expected by stopping its asset purchases, possible as of the 3rd quarter of 2022, if inflation expectations evolve as expected. Added to this are higher deficit and debt expectations on the part of investors in order to finance the measures to deal with the energy shock as well as the massive investments to come. In this context, the spreads (interest rate differential vis-à-vis the German rate) of the peripheral countries widened in the prospect of an imminent end to net purchases by the ECB and an increase in government bond issuance. This comes at a time when deficits and debt levels are high due to the measures taken to cushion the shock linked to Covid-19.



Sources : Bloomberg, Ostum AM

The progress of discussions on the pooling of part of this new debt and then the announcement of new instruments available for the European Union would make it possible to reduce sovereign spreads and more particularly those of peripheral countries. The latter already have very high levels of debt and will be more strongly affected by the consequences of the crisis.

Conclusion

The war in Ukraine has brought to light the weaknesses of the European Union in terms of its heavy dependence on Russian energy as well as in terms of European defense policy. The 27 have set themselves a roadmap at the summit of Versailles to remedy this. Vast investments are needed to strengthen European defense and guarantee its strategic energy independence. This 180-degree turn requires a joint EU response in terms of funding. The European funds available will not be enough and the member countries have limited budgetary leeway and high debt levels due in particular to the measures taken to deal with the Covid-19 shock. Ongoing discussions must succeed in order to give the European Union new tools, alongside Next Generation EU, to meet these challenges.

Aline Goupil-Raguénès

Market review

Beyond warfare

The US-EU deal on natural gas, a symbol of Russia isolation

Financial markets no longer seem solely focused on Ukraine and are now trying to get a sense of the full consequences of Russia isolation. Fear gradually gives way to the resumption of risk taking in some markets. Yet, the stalemate in the conflict raises fears of a catastrophic escalation as US President Joe Biden warns Russia against the use of nuclear or chemical weapons. The West's economic response to Russia's invasion of Ukraine is getting further traction. The US are committed to supplying 15 billion cubic meters of LNG to the European Union by the end of the year and 50 billion per year by 2030. The infrastructure may still be insufficient to manage these gas flows but the reduction of European dependence on Russian gas already symbolizes a new world order.

At the same time, sanctions on Russia now include gold trading. The US Treasury will sanction any entity that facilitates the Russian Central Bank's liquidation of its gold stockpile. It is undoubtedly a warning to Chinese authorities, as the remaining Russian foreign exchange reserves available are yuan assets. Gold holdings made illiquid will force the CBR to accept the risk of hyperinflation. The use of yuan reserves for the defense of the ruble had caused an rush out of China as outflows from Chinese bond funds hit historical highs in February. The massive capital outflows may explain the recent reluctance of the PBoC to ease its policy further in order to contain the downward pressure on its currency.

On the economic front, data releases still depict a US strong economy. Weekly jobless claims (187k as of March 19) are at their lowest since 1969. Local Fed manufacturing surveys rose in March. The only caveat is that durable goods orders fell in February. Transportation and military orders, however, will pick up with new federal defense spending. In the euro zone, activity signals appear to be contradictory. The composite PMI rose to 54.5 in March whilst both INSEE and IFO surveys dropped sharply. The energy shock is violent in Europe and producer prices range from +22% in France to +40% in Spain over 12 months.

Besides warfare in Ukraine, the fixed income markets remain subject to monetary tightening pressure from the Fed. Central bankers come and go to prepare the market for possible Fed funds hikes of 50 bps. The tightening announced by the Fed in response to rising inflation amplifies the inversion of the inflation breakeven curve so much that the nominal 5-10 year spread has now plunged into negative territory (-4 bp). Demand for TIPS remains strong and the asset class is attracting inflows unlike most other parts of the US fixed income market. Cash remains king as the 10-year bursts through successive thresholds of 2.30%, then 2.40%, and soon 2.50%? A short duration stance remains warranted. Mortgage rates are at their highest for 3 years at about 4.5%. Refinancing activity is drying up and the negative convexity effect (extension of duration) is penalizing the MBS asset class, which keeps recording outflows. In the euro area, fiscal measures follow one another to cushion the energy shock. Germany thus announced €16 billion transfers, which only added to the Bund yield uptrend towards 0.57% at weekly close. The primary market woke up last week posting its highest volume since January. Supranational (EU for SURE and NGEU, KfW) and agency debt accounted for more than half of total weekly issuance of €60bn. Indeed, the level of swap spreads (65 bp at 10 years) entails an attractive entry point for swap proxies including covered bonds, agencies or illiquid sovereigns (Finland, Austria). In the UK, the market raised its rate projections after another upward surprise on inflation.

As regards the euro credit market, sentiment turned more upbeat. However, there was a rare underperformance of hybrids despite the tightening of IG indices. Issues total €15 billion with a variety of issuers and maturities. The new issue premiums attracted solid demand reaching up to 6-7x the amounts borrowed. It is however recommended to remain more cautious on high yield. CDS indices are underperforming cash bonds despite poor liquidity fueled by ongoing high yield fund outflows. That said, selling pressure seems to be easing somewhat.

Equity markets have rebounded in the United States. The Nasdaq and the S&P recover by 1%. Tech stocks are now more resilient to the rise in long-term rates, especially as sentiment towards Chinese technology has improved since the government's latest communication. The rise in the oil prices (WTI at $113) remains a major support for energy stocks, which are clearly outperforming (+5% over the week). The balance of flows is also recovering, even if the bulk of global flows is concentrated in large US caps. Small stocks and the “value” theme were still under selling pressure. In the euro area, announcements of companies reducing their activities or even leaving Russia follow one another. The risk of expropriation must be analyzed in the light of the reputational risk. Lastly, the decline in volatility is less marked in Europe than in the United States (V2X at 32% against VIX at 21%).

Finally, the yen continued to fall dropping almost 2% in five sessions to 121.6 at the weekly close. The BoJ did not oppose yen weakness, encouraging investors to increase their short positions. The Australian ($0.75) and New Zealand ($0.69) dollars are gaining ground, while the euro is hovering around $1.10. The South African rand and the peso reacted favorably to Central bank rate hikes.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	28-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	-0.12%	+17	+41	+50
EUR Bunds 10y	0.57%	+10	+44	+75
EUR Bunds 2s10s	68.4bp	-6	+2	+25
USD Treasuries 2y	2.32%	+20	+89	+159
USD Treasuries 10y	2.44%	+15	+61	+93
USD Treasuries 2s10s	11.7bp	-5	-27	-66
GBP Gilt 10y	1.63%	-1	+22	+66
JPY JGB 10y	0.25%	+4	+0	+1
€ Sovereign Spreads (10y)	28-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
France	42.15bp	-3	-5	+5
Italy	151.63bp	-2	-6	+17
Spain	87.76bp	-6	-10	+13
Inflation Break-evens (10y)	28-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
EUR 10y Inflation Swap	2.73%	+15	+44	+64
USD 10y Inflation Swap	3.13%	+5	+24	+35
GBP 10y Inflation Swap	4.56%	-5	+1	+38
EUR Credit Indices	28-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Corporate Credit OAS	138bp	-8	+0	+43
EUR Agencies OAS	59bp	-3	+0	+10
EUR Securitized - Covered OAS	67bp	-3	+2	+21
EUR Pan-European High Yield OAS	413bp	-25	-3	+95
EUR/USD CDS Indices 5y	28-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
iTraxx IG	79bp	0	+8	+31
iTraxx Crossover	361bp	-11	+18	+119
CDX IG	72bp	0	+5	+22
CDX High Yield	368bp	+1	+8	+75
Emerging Markets	28-Mar-22	1wk (bp)	1m (bp)	2022 (bp)
JPM EMBI Global Div. Spread	452bp	-7	+21	+83
Currencies	28-Mar-22	1wk (%)	1m (%)	2022 (%)
EUR/USD	$1.097	-0.409	-2.211	-3.5
GBP/USD	$1.308	-0.691	-2.548	-3.4
USD/JPY	JPY 124	-3.474	-7.086	-7.0
Commodity Futures	28-Mar-22	-1wk ($)	-1m ($)	2022 (%)
Crude Brent	$112.9	-$2.8	$14.9	46.75
Gold	$1 936.2	$0.2	$27.2	5.85
Equity Market Indices	28-Mar-22	-1wk (%)	-1m (%)	2022 (%)
S&P 500	4 546	1.91	3.94	-4.6
EuroStoxx 50	3 907	0.65	-0.44	-9.1
CAC 40	6 620	0.57	-0.58	-7.5
Nikkei 225	27 944	4.16	5.34	-2.9
Shanghai Composite	3 215	-1.20	-7.16	-11.7
VIX - Implied Volatility Index	21.40	-9.05	-29.02	24.3

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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