GENERALI INSURANCE ASSET MANAGEMENT

Investment View

One Year Later: Credit Crunch

March 31, 2023

'Investment View' provides our quarterly macro & market outlook and investment recommendations

- **Despite gains in economic confidence and inflation stickiness in Q1, bouts of banking stress have led the market to reprice the Fed path lower: a friendly combination for markets. Such a win-win situation will prove short-lived.**

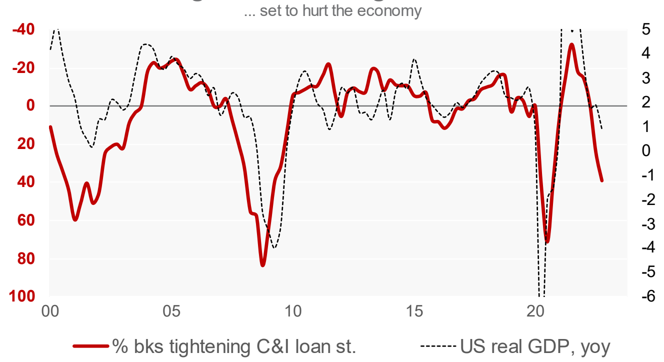
- **Central banks face the arduous task of juggling between their inflation targets and financial stability. This will be difficult, but we expect them to judge that financial conditions tend to lead the cycle, while inflation, and wages in particular, are lagging. The tightening cycle is either finished, or close to the end.**

- **The only predictive certainty, following recent banking events, is that lending standards will *continue* to tighten. Already credit production is spluttering. This is not good news for growth; respect the lags, and the recession risk.**

- **Known unknowns include the US debt ceiling negotiation, the so-far dormant EU bank-sovereign nexus, and US-China tensions. That said, 2023 is not 2008: rate-induced (unrealised) losses are less toxic than bad loans, policy makers have learnt the GFC lessons, the global consumer is still alive and investor positioning is already prudent. Still, we prefer cash, IG credit and core Govies to Equities, High Yield, and peripheral bonds.**

Tigther US lending standards

... set to hurt the economy



Source: Fed, Bloomberg, GIAM

CONTENT

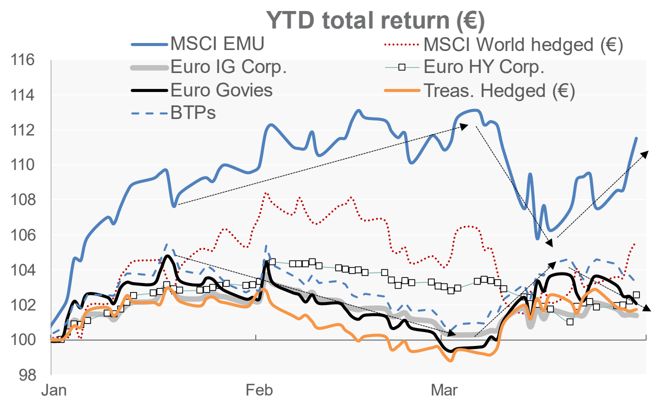
ONE YEAR LATER: CREDIT CRUNCH

Vincent Chaigneau

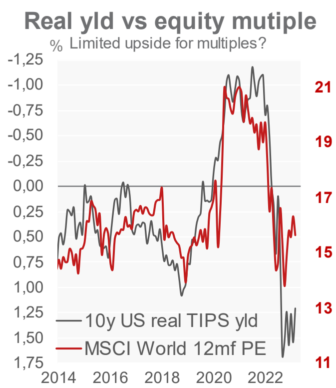
- **Despite gains in economic confidence and inflation stickiness in Q1, bouts of banking stress have led the market to reprice the Fed path lower: a friendly combination for markets. Such a win-win situation will prove short-lived.**
- **Central banks face the arduous task of juggling between their inflation targets and financial stability. This will be difficult, but we expect them to judge that financial conditions tend to lead the cycle, while inflation, and wages in particular, are lagging. The tightening cycle is either finished, or close to the end.**
- **The only predictive certainty, following recent banking events, is that lending standards will *continue* to tighten. Already credit production is spluttering. This is not good news for growth; respect the lags, and the recession risk.**
- **Known unknowns include the US debt ceiling negotiation, the so-far dormant EU bank-sovereign nexus, and US-China tensions. That said, 2023 is not 2008: rate-induced (unrealised) losses are less toxic than bad loans, policy makers have learnt the GFC lessons, the global consumer is still alive and investor positioning is already prudent. Still, we prefer cash, IG credit and core Govies to Equities, High Yield, and peripheral bonds.**

A good combo: economic sentiment has largely improved in Q1, while banking stress has reduced rate hike fears

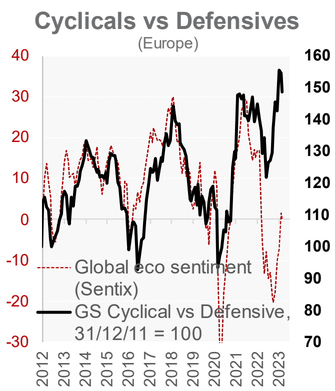
Soft landing hopes to be challenged. We had said that following the 2022 debacle global markets would find their feet in 2023, but did not expect equities to deliver such strong performance in Q1. Chart 1 below shows the year-to-date returns. It is striking that, in a sharp break from last year's market dynamics, government bonds and equities have started to move in opposite directions. This suggests that global markets are driven by investor sentiment and cyclicals forces, rather than mostly inflation and monetary policy. While we expected the stock-bond correlation to progressively reverse, indeed, we did not expect this to be so much to the advantage of equities. We continue to be concerned by the cognitive dissonance observed in late 2022: equity multiples have surged much faster than long-term real yields have dropped, and cyclical stocks – despite the overshooting of 4Q22 – have strongly benefitted from a surprisingly fast recovery in economic sentiment in Q1 (right-hand chart). We expect hopes of a soft landing to be challenged in the coming quarters, and more so as banking events by late Q1 aggravate the tightening of lending standards.



Source: Bloomberg, GIAM calculations



Source: MSCI, Bloomberg, GIAM



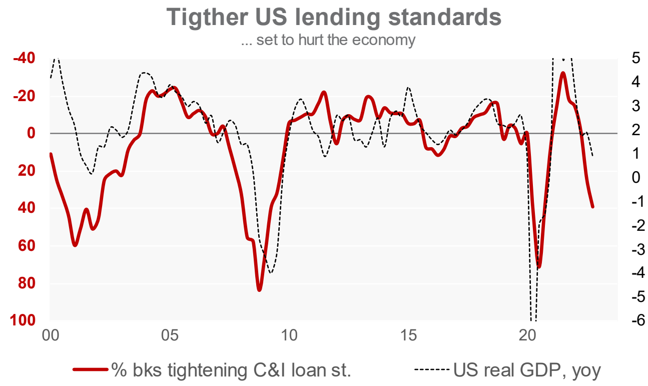
Source: GS, Bloomberg, GIAM

Policy tightening starting to bite into credit momentum

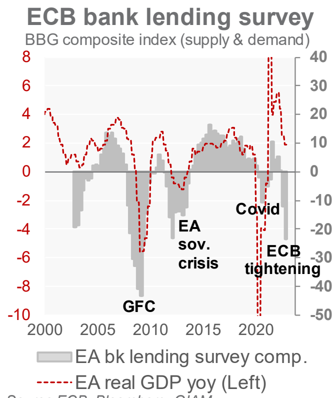
Tailwinds to fade, headwinds growing. The global economy is entering spring in a decent shape, with the global compositive PMI consistently rebounding in Q1: the sharp fall of energy prices since summer 2022, residual tailwinds from the formidable policy easing and excessive savings built up through the pandemic and the reopening of China have all provided support. The pullback of headline inflation, while wages benefit from a delayed boost, will support real incomes and may keep global consumer spending supported for longer. That said, US leading indicators continue point to the downside, suggesting recession risks have not diminished. We trust bank lending standards as offering solid forward-looking guidance about the economy and expect them to continue to deteriorate following the failure of Silicon Valley Bank, Signature bank, and the rescue of Credit Suisse.

Leading indicators still pointing South; lending standards are sure to be tightening further after the toughest Fed hike cycle in more than 40 years

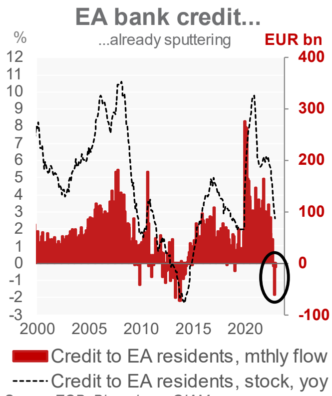
Unrealised losses, liquidity stress, and balance sheet rationalisation. Those bank failures are largely idiosyncratic, but one should not ignore their systemic dimension. They have come after 475bp of rate hikes from the Fed over the past year. The rise in yields has created large unrealised losses in portfolios. This creates an intrinsic fragility, leading banks to protect their liquidity, which accentuates the battle for deposits and eats into net interest margins. The decline in bank shares, as well as the widening of financial spreads, imply an increase in the cost of capital, which will inevitably lead to a rationalization of balance sheets. The scarcity of bank credit will weigh on the economy, spread to disintermediated finance, and cause a repricing of credit. This is true not just in the US: in Europe, credit production has been negative for the past 3 months (right-hand chart below).



Source: Fed, Bloomberg, GIAM



Source:ECB, Bloomberg, GIAM



Source:ECB, Bloomberg, GIAM

Excess leverage exposed. Sectors of the economy that saw a sharp rise in leverage, in the not-so-distant period of negative rates, will suffer most. US non-systemic banks hold almost half of bank assets and play a key role in the distribution of credit – more than two thirds in the commercial real estate sector. This sector, as well as credit risk in general and the most vulnerable areas in particular (incl. High Yield, leveraged loans and the less regulated private markets) will come under pressure – those who have got carried away on leverage or have compromised on the quality of investments will be exposed. We expect this to make financial conditions more fragile over the next couple of quarters.

The tightening of bank lending standards will propagate to disintermediated finance, exposing leveraged sectors

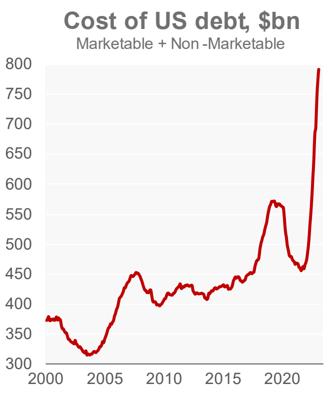
The known unknown

US debt ceiling. Whilst the tightening of lending standards looks to us the most certain predictive outcome, there are many known unknowns that will shape the rest of 2023. The US debt ceiling issue will surely be a market mover this summer. As we go to press House Speaker McCarthy laments that that there has been “no progress”: “I’m always an optimist. I’m not now.” Republicans have refused to lift the debt ceiling without promises of spending cuts. This happens in the context of a large increase in the US budget deficit over the past 6 months (war, infrastructure, Social Security), the current Administration proposing a budget seen as somewhat provocative and the indictment of former President Trump being– which the Republicans will portray as a witch hunt. US debt ceiling discussions tend to be more complicated with a democratic President and a split Congress. The Congressional Budget Office estimates the administration will exhaust its emergency tools sometime this summer. Failure to reach an agreement would roil the economy and markets and expose the US to a 2011-like rating downgrade.

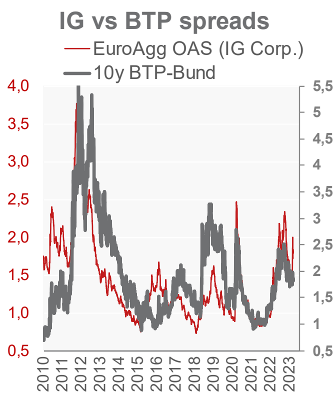
Three know unknown: US debt ceiling, the EU bank-sovereign nexus and US-China tensions

EU stress a low-probability but high-impact case. Public debt is much less of an issue in the EU just now, but the original fragilities revealed in the euro area (EA) crisis of 2011-12 have not been fully addressed (unfinished banking union, no fiscal union). EA country spreads have been very resilient so far this year, with the 10-year BTP-Bund down some 30bp, when IG corporate spreads are marginally wider. While banking stress contagion has been very contained so far, the risk lies in pressure building on selected European banks (those for instance that saw significant CDS widening through the Credit Suisse crisis), and a revival of the sovereign-bank nexus. On March 1st he ECB also started quantitative tightening (QT) after eight years of balance sheet expansion – which sooner rather than later may contribute to pressure country spreads wider.

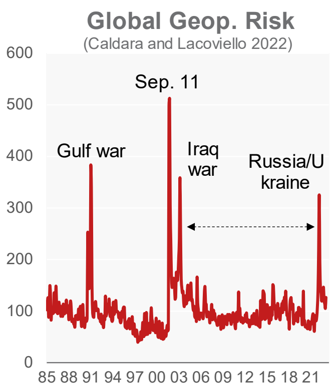
Finally, the wild card lies in the US-China relation. Should China provide substantial military assistance to Russia, heavy western sanctions would immediately kick in – as well as a deglobalisation shock. Again, we see this as a low-probability event, but its economic and financial impact would be huge. Another risk is that China may consider that it would be difficult for the US to support both Ukraine and Taiwan, which may precipitate a Chinese intervention.



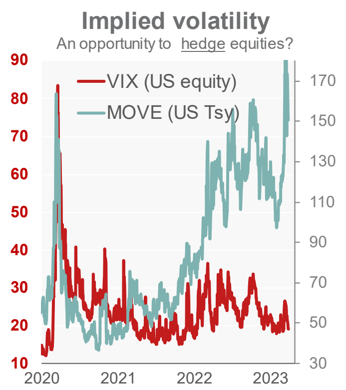
Source: Treasury, Bloomberg, GIAM



Source: Bloomberg, GIAM



Source: www.matteoiacoviello.com, GIAM



Source: Bloomberg, GIAM

Volatility. While those three factors are unknown, they have the potential to cause financial disruption. So far this year, it is rates volatility that has surged – particularly at the front ends, and more so in USD, where the implied Fed policy path has varied greatly under the influence of high inflation prints and financial instability. We expect the central bank uncertainty to pull back as they reach the end of the rate hike cycle, and rates volatility to pull back. In contrast, equity volatility has remained suspiciously low and offers good value to those willing to hedge equity exposures.

US rates volatility pulling back; equity volatility looking low

Cautious not anxious

Savings graces. Whilst our investment thesis remains defensive, we do not want to max out on the risk asset underweight. We see four saving graces indeed.

- **A resilient economy**. As discussed above, although lending standards and other leading indicators point to the downside, we also see areas of resilience, not least in China and better global real income developments for consumers (though the evaporation of the excess savings will be an offsetting force).

Four saving graces arguing against a full-blown crisis: resilient economy, investor positioning, end of the rate hike cycle, policy reactivity

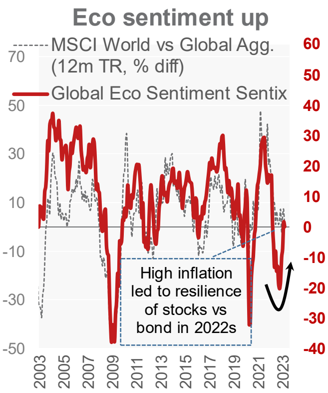
- **Investor sentiment** and positioning has remained respectively negative and defensive. The second chart below shows that pessimism at the individual investor level, but the same applies to institutional investors. This suggests that a wall of concerns has already been built, which tends to limit the potential for downside price action on risk assets.

- **Fed**: we assume that the Fed is done with the rate hike cycle. This is a tight call as the Fed is now trying to catch two birds, with one policy but various tools: bringing inflation back to target and ensuring financial stability. Recent developments suggest that the policy rate (5% upper bound) might already be above the financial stability neutral rate (R**), but it is less clear whether it has reached the economic neutral rate (R*) – we cannot be sure, given the lagging nature of inflation. In any case, the end of the cycle has either been reached, or is very close.

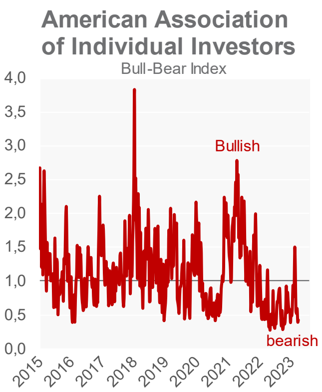
- **Policy makers have learnt the lessons of the GFC**. The strong policy reaction to the SVB/Signature/CS crises makes clear that policy makers want to contain financial stress and stop contagion from rates-induced to credit-induced losses. The Fed has been very prompt to provide emergency liquidity to the banking system. We also see rates-induced (unrealised) losses as being less toxic than those coming from bad loans in 2008: should pessimism rise, rates would drop, mechanically reducing those losses. Banks are much better capitalised than in 2008.

Persistently high core inflation, elevated public debt and post-GFC regulation may limit the scope or credibility of interventions

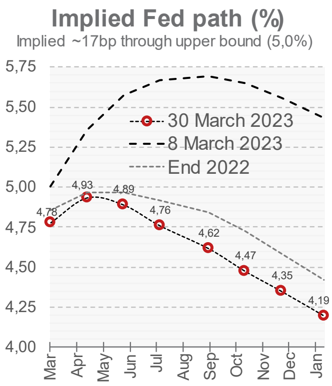
Although those saving graces argue against a financial meltdown, we also see limits to policy intervention. Persistently high core inflation, elevated public debt and post-GFC regulation, which are here to reduce moral hazard and taxpayer exposure, may limit the scope or credibility of interventions. For instance, it seems difficult for the FDIC to satisfy the request of the regional banks for a total protection of bank deposits, beyond the limit of 250k dollars. Policy intervention has reassured investors, but underlying stress remains, for instance US regional bank stocks have not recovered and real estate stocks have remained under pressure.



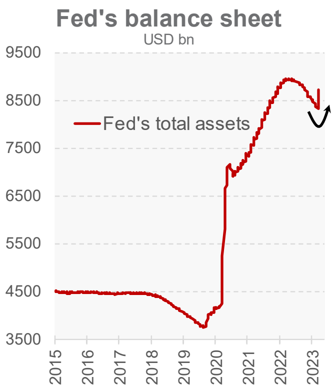
Source: Sentix, MSCI,



Source: AAII, Bloomberg, GIAM



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM

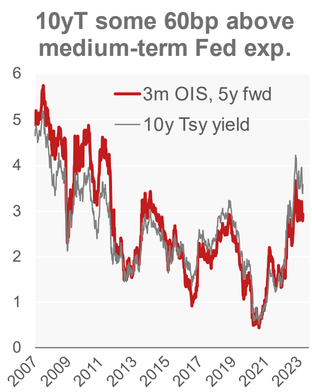
Fixed income: prefer 'risk-free' yields to credit risk

'Risk-free' yields skewed to the downside. The first chart below shows that 10-year Treasury yields usually track medium-term expectations about the Fed's policy rate (5y3m OIS currently around 2.90%). 10-year yields are currently trading at 3.55%, Risk-free yields skewed to the downside, more so in the US

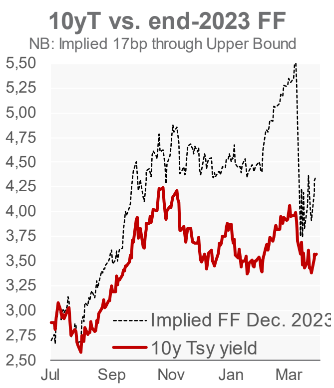
which offers a comfortable margin by historical standards. We expect measures of the neutral rate to be revised down as the US economy slips towards a mild recession later this year, which suggests downside potential for long yields. Interestingly, and unsurprisingly, the second chart indicates that long yields have become relatively insensitive to expectations relative to the near-term Fed path. Any further hikes would only make a recession more likely, which would shield longer yield from the influence of rising short-term rates. We see more downside for US long-term yields than for EUR, if only because that latter does not trade as cheaply (10-year Bund currently trading some 25bp through 5y3m ESTR) and the ECB has just started QT and plans to accelerate the reduction of the APP portfolio this summer (though financial stability considerations may well challenge that plan).

EUR IG spreads, at current level, offer good risk-reward, particularly for buy-and-hold investors, and relative to other credits (HY, EM, US)

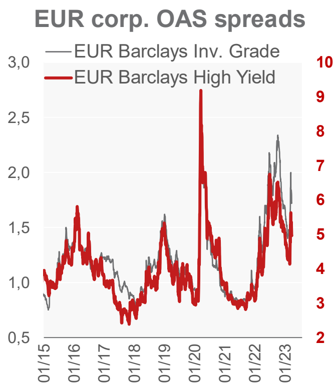
Stay long IG, under-weight High Yield. EUR IG credit offers a yield-to-worst of 4.30%, nearly 200bp above 30y Bund, 150bp above 10-year OAT and some 110bp above 10-year Portugal (BBB+/Baa2, neutral outlook). That's a good pick-up, for historically no default. Of course, IG spreads are exposed to widening pressure in a recession scenario, but at current level we like the risk-reward, particularly for buy-and-hold investors; any spread widening would likely be partially offset by a fall in risk-free yields, which limits the total downturn. The third chart below shows that widening in IG has been large, on a beta-adjusted basis, relative to that of High Yield; we continue to be defensive on the latter, given that the asset class under-prices the risk of a recession, in our view (4th chart below). In contrast, the widening in EM hard currency debt has been fairly contained relative to that of High Yield, and at this level of valuation we turn slightly less bullish on the asset class.



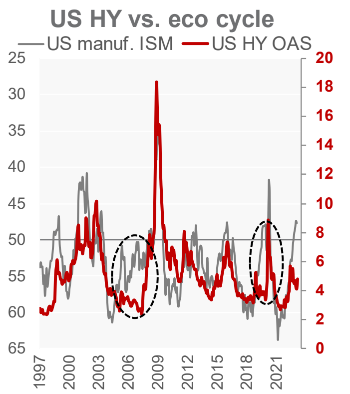
Source: Bloomberg, GIAM



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM



Source: ISM, Bloomberg, GIAM

Defensive equity allocations

Equity rally driven by multiple expansion, and to a lesser extent upside earnings expectation revisions (for Europe); overdone?

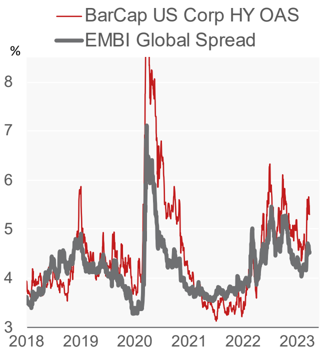
Equities priced for a soft landing, not a recession. Equities performed better than we expected in Q1, especially so in Europe where the Stoxx50 has delivered a total return of some 13%. That reversal owes to the recovery in economic sentiment, and the pullback in long rates, which have both contributed to significant multiple expansion. The better economic news and decent earnings reports have also led to a bounce back in European Earnings Per Share (EPS) expectations (not in the US), but the bulk of the rally has come from (re)valuation. We fear downside in both earnings and multiples:

- Earnings consensus expectations are not high for this year (at +0.6% for the US and +1% for the EA), but generous for 2024 (resp. 10% and 8%). We fear this fails to integrate the risk of a recession. Typically, US leading indicators are pointing to a more severe earnings recession (2nd chart below). The final US 4Q22 GDP already showed a slowdown in nominal revenue growth, and upward pressure on compensation/revenue ratios; we expect this to continue as wage growth proves stickier for some time while the tighter lending standards finally produce pressure on final demand, reducing the firms' pricing power.

Diversification benefit returning with a vengeance: the cycle and risk appetite are the key drivers

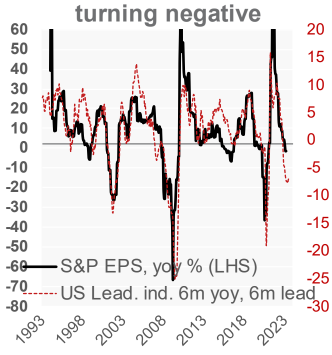
- As we outlined at the very start of this article (cognitive dissonance), we find the multiple expansion surprisingly fast relative to the pullback in long-term real yields. As such, the US equity risk premium (ERP) has dropped towards just 2%, still well above the level of the internet bubble, but low by historical standards. Such low ERP may be partly justified by the surge in rates volatility relative to bond volatility, but we expect this to reverse. As the stock-bond correlation turns negative, bonds will offer some safe-haven value again, and we expect this to exert upward pressure on the ERP. The final row of charts dives into this correlation turn. The one-year stock-bond correlation has remained positive and high, and this what one should have expected in the context of a sharp rise in real rates. The latter is however over; as real rates start to pullback, so will the correlation. This has already started, with the penultimate chart highlighting the spectacular change in correlation this year. Stocks, as well as stock volatility, have been remarkably resilient to the surge in rates volatility – yet again, we see much room for a reversal of those relative volatility patterns through the rest of the year. All in all, stocks have front run the improvement in economic sentiment (4th chart below, for Europe). Likewise, we see the outperformance of cyclical stocks as exaggerated; we retain a small preference for European and EM stocks over the US, though this preference has diminished now that bond yields have peaked, offering relief to the Growth factor.

HY (USD) vs EMBI



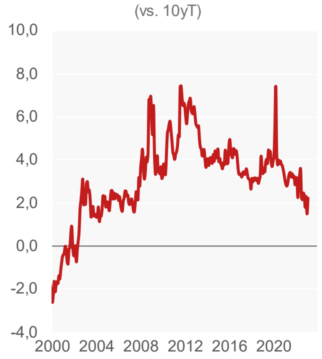
Source:JPM, Bloomberg, GIAM

S&P earnings growth turning negative



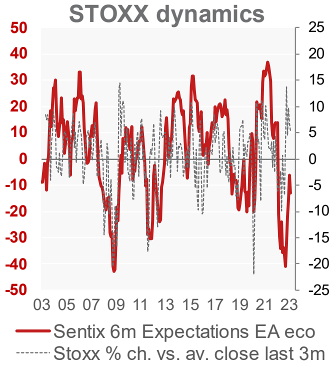
Source:Conf. Board, BBG, GIAM

SPX risk Premium
(vs. 10yT)



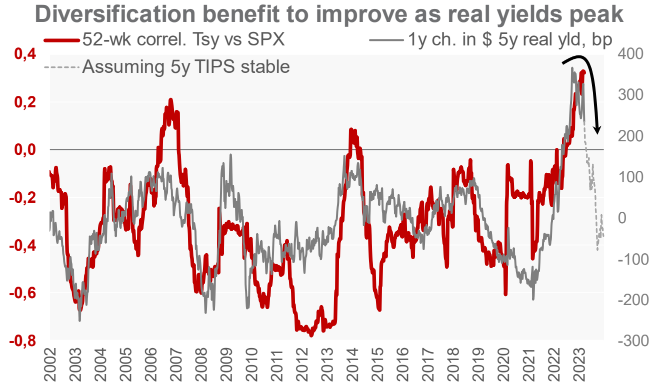
Source: MSCI, Bloomberg, GIAM calculations

Sentix 6m expectations vs. STOXX dynamics



Source: Sentix, Bloomberg, GIAM

Diversification benefit to improve as real yields peak

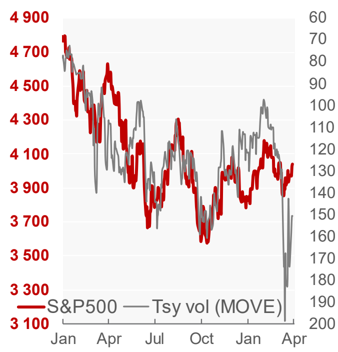


Source: Bloomberg, GIAM calculation

SPX vs. 10yTsy yield

Source: Bloomberg, GIAM

SPX vs. rates vol



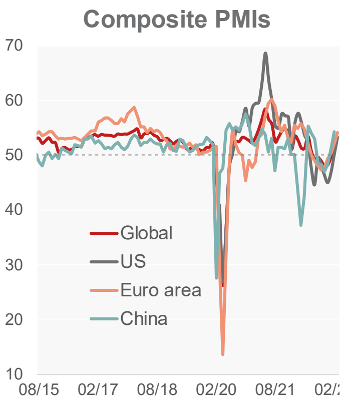
Source: Bloomberg, GIAM

MACROECONOMIC OUTLOOK

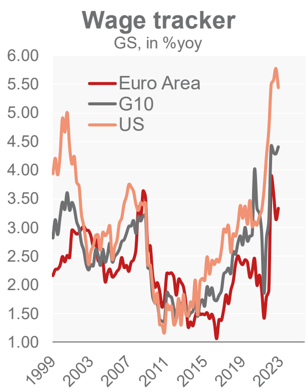
Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

- **The global economy is headed for an early spring warming. Europe will benefit from the relief on eased energy worries, and – like the US – from still sizeable excess savings and a tight labour market. China's fast reopening will accelerate its economic rebound near term, with Asia and Europe partially benefitting.**
- **Yet sharply increased banking sector woes are casting long shadows over the outlook. Stress at US banks (SVB) has quickly spilled over to Europe. Even if a severe banking crisis is avoided (as we expect), a credit crunch is on its way, intensifying the drag on growth from past rate hikes. A much tougher H2 is looming.**
- **The previously expected mild US recession will prove deeper and likely start already in Q2. With the strains having having crossed the Atlantic, activity is set to decelerate markedly also in the euro area.**
- **Meanwhile, the inflation 'monster' (Lagarde) keeps showing its ugly head, as easing headline inflation is overshadowed by stubbornly high core inflation and wage pressure. The disinflation path is still intact, but will prove bumpy and require restrictive monetary policy for longer.**
- **Torn between inflation fighting and financial stability uncertainties, we see the Fed and ECB largely done hiking rates, even if the risks in the euro area are tilted towards further hikes.**

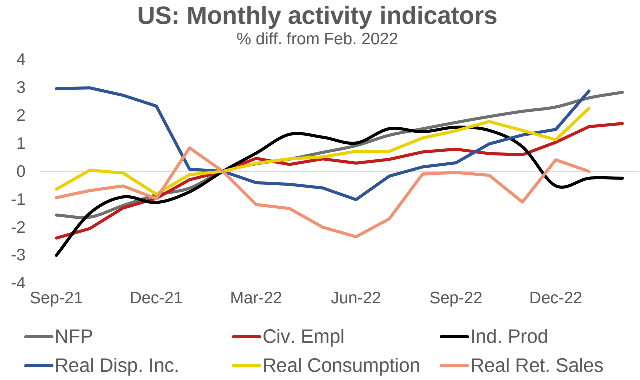
Eased energy worries and China's reopening make the global economy headed for an early spring bounce. Low unemployment, strong wage growth and excess savings continue to underpin the economic resilience. China's reopening is supporting ailing global manufacturing and trade. Yet do not get carried away by robust indicators as much of the relief in Europe is owing to receding energy prices.



Source: S&P Global, Datastream, GIAM



Source: Goldman Sachs, GIAM



Source:BLS, BEA, Fed, Refinitiv, GIAM;

Pain from drastic monetary tightening still to be felt

> Cracks in the banking sectors are complicating central banks' tasks

However, the Western economies are still to feel the full pain of the sharp monetary tightening, with US rates up by almost 500bps in just one year, and ECB rates by 350bps. The resulting lagged effects will cause substantial headwinds into H2 2023. The fast tightening has also laid bare the cracks in the financial plumbing, with two mid-sized banks in the US (SVB, Signature) failing. As shown by the domino collapse of Credit Suisse in Europe, the banking sector as a whole is suffering on intensified market scrutiny, higher funding costs and deposit flight especially from weaker institutions. This will severely curb bank lending over the coming quarters. This complements central banks' inflation fight and substitutes for further rate hikes we had in our books before the recent crisis. Yet this form of tightening is much riskier and less predictable, with central banks facing a delicate balancing act of inflation fighting and preserving financial stability.

Fortunately, bank failures so far are mostly due to idiosyncratic issues. Banks are much better capitalized and can resort to stronger liquidity buffers than in 2008, notably so in Europe. Also, bank stress from rising yields is partially self-correcting amid safe haven flows and a reversed rates outlook. That said, there is no scope for complacency as high rates may cause further casualties, with less regulated mid-sized US banks and commercial real estate particularly exposed. And while central banks, governments and regulators stand ready to provide quick and massive liquidity support, the broad tools of central banks are severely constrained by the inflation fight.

US: projected slowdown will lead to rate cuts in Q4

The looming credit crunch will trigger an outright US recession in H2

We lowered our US growth forecast for 2023 from 1.1% to below-consensus 0.4%. The SVB collapse will lead to an additional tightening in lending standards, on top of the impact of the interest rate increase. The data for Q1 issued so far mostly surprised to the upside. Consumption remains resilient, as the impact of high inflation is cushioned by the stock of excess savings. Household purchases are increasingly tilted to services which explains the relative weakness of manufacturing. Yet tighter credit will lead to a steep slowdown with growth slowing from 2% annualised in Q1 to an outright contraction in Q3 and Q4, followed by well below mean growth in H1 2024.

Employment growth decelerated, but remains strong, also helped by unusually warm weather in January and February. Labour market participation is starting to edge up responding the rapid rise in wages, with the notable exception of older workers. This may reduce supply persistently, contributing to a labour market that by almost any metric (unemployment rate, quits, jobs available) remains extremely tight. This will dampen the impact of slower activity on employment and wages. Inflation surprised to the upside, too, with core CPI still at 5.5% yoy in February. Weakening import and producer price inflation will help a deceleration of core good inflation. Shelter costs are still increasing at a fast pace. However, rents on recent leases decelerate markedly and will moderate this part of core inflation. Inflation in the rest of services remains remarkably persistent, driven by increasing labour costs and high markups. Therefore, disinflation will be slow, with the core rate likely to be still at around 4% yoy by year-end

The banking woes further complicate the Fed's task making a soft-landing a 'mission impossible'. The Fed's March meeting showed a marked shift in the forward guidance, after the aggressive communication seen in February. The FOMC now sees it appropriate to rise rate by just another 25 bps, to a peak in the 5% to 5.25% range, and – importantly – does not envisage any cut this year. This is in sharp contrast with markets' expectations, which entail rate cuts already starting in the summer, based on the view of a swifter decrease in inflation. In our projections, the deterioration of the economy in Q2 will prevent any further rate hike, but cuts will start only at the end of the year (-50bps in Q4).

Euro area to avoid recession but to suffer from banking woes

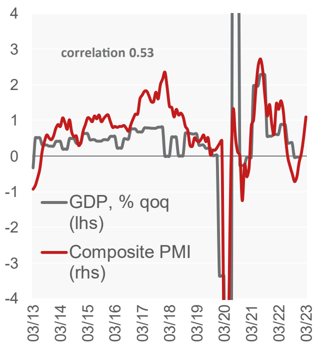
Euro area growth to lose momentum

The euro area economy started very well into the year. Key sentiment indicators like the PMIs clearly herald an expansion of activity in the first quarter, following stagnation in the quarter before. With the unemployment rate staying at the low of 6.7% and plenty of excess savings still on the shelve, key ingredients for a sustained recovery are in place. Moreover, the reopening of the Chinese economy will boost activity in spring.

High uncertainty surrounding ECB outlook due to banking sector woes

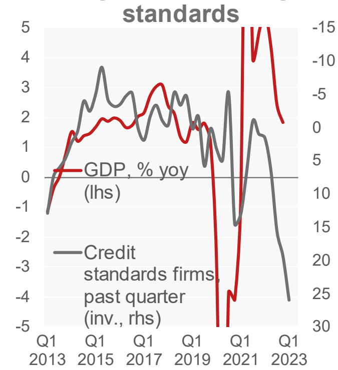
However, looking further ahead, lagged effects from one year of decisive monetary policy tightening will leave their mark. A huge uncertainty concerns the effect of the latest banking woes. While we do not think a GFC like crisis is on the cards, banks will in the end substantially need to tighten their lending standards. Therefore, we look for a deceleration of activity in H2 while the supporting factors likely shield the euro area from a recession. All in all, we somewhat reduced our growth expectations but still see output growing by 0.7% in 2023 (cons.: 0.4%), mostly due to a strong Q1.

EA PMI and growth



Source: Datastream, GIAM calculations

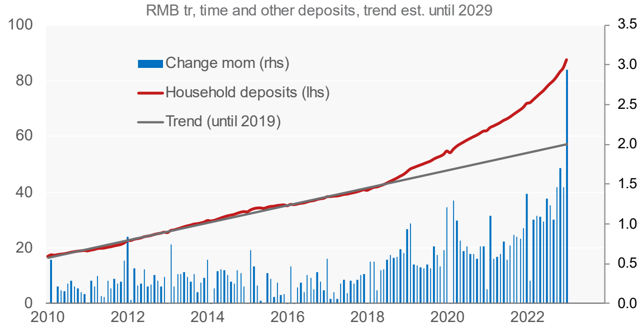
Tighter EA lending standards



Source: Datastream, BLS, GIAM

China: Household deposits

RMB tr, time and other deposits, trend est. until 2029



Source: Datastream, GIAM calculations

The banking sector woes complicate the ECB's life further. While headline inflation came down from the peak of 10.6% yoy in October to 6.9% yoy (flash est.) in March, it is still way above target and broad based. Underlying inflation showed no signs of moderation yet and with strong wage growth ahead it will only slowly recede. ECB Governing Council members made clear that the fight against inflation is not yet completed and see it as "too high for too long". That said, there are mounting signs that inflation pipeline pressures ease and energy inflation became disinflationary. Huge uncertainty emanates from the banking sector fallout. The ECB therefore adopted a truly data dependent policy approach. We deem it likely that tightening lending standards will substitute for rate hikes. Following a 50-bps rate increase to 3.0% (deposit rate) in March we have no further hikes in our books. Yet amid high uncertainties, the risks are tilted towards further tightening.

China: Post-Covid recovery underway

China likely not strongly affected by banking woes as recovery driven by domestic factors.

China's post-Covid recovery is underway. The rebound has been so far most visible in PMIs. We expect private consumption, especially services, to support the rebound on the reduction of excess savings (see graph) which we estimate at least of about 2% of disposable income. The rebound will likely be less driven by investment. Infrastructure investment growth is expected to decelerate as the official general government budget deficit will increase only slightly (3.0% of GDP vs. 2.8% in 2022). The real estate sector showed first signs of stabilisation and is expected to generate overall a small plus in 2023. Credit supply was ample at the outset of the year and the PBoC unexpectedly cut the RRR by 25bp. The monetary impulse turned positive again. We see another RRR cut in Q2, with the PBoC not very much restricted by inflation. February inflation dropped to 1.0% yoy, but the consumption-driven recovery will likely induce higher rates of around 3% yoy by the end-2023. We see inflation to average 2.4% in 2023 and GDP growth at 5.4%.

GOVERNMENT BONDS

Florian Späte

- **Government bond yields were on a rollercoaster ride in Q1. Overall, core government bond yields fell moderately driven by banking sector concerns. The inversion of yield curves intensified in Q1.**
- **Going forward, we expect bond market volatility to remain on a high level and see further leeway for somewhat lower yields as concerns about a banking crisis are likely keep lingering. Hence, current key rate expectations appear exaggerated and are unlikely to materialize.**
- **In this environment EA non-core government bond spreads proved to be resilient and have even tightened a bit since the start of the year. Notwithstanding that, we continue to urge caution amid weak fundamentals and ECB's Quantitative Tightening (QT).**

Government bond markets presented themselves in Q1 without a clear overall direction but were driven by very strongly changing influencing factors. After a good start fuelled by falling key rate expectations, sticky inflation rates, and hawkish central bank interventions caused a noticeable decline in bond prices since the beginning of February. Later, the systemic concerns emanating from US banks quickly spread to the EA banking sector and caused a flight to quality. Despite a slight increase in yields recently, they fell over the quarter, particularly at the long end of the yield curve. These market movements were also reflected in the development of bond market volatility. Initially declining, it rose sharply in mid-March before returning to somewhat more normal levels more recently.

Banking sector risks unlikely to dissipate soon – prepare for lasting high bond market volatility

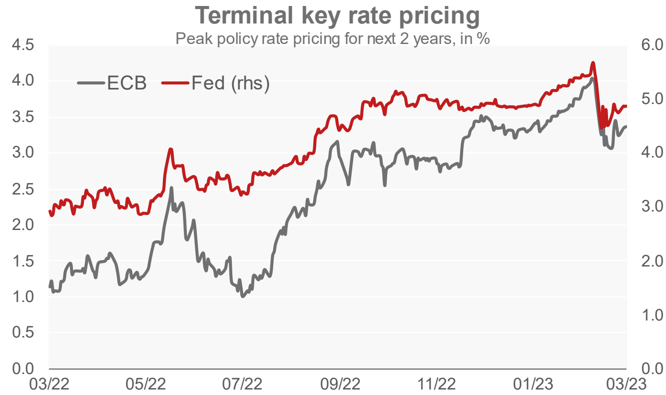
Going forward, we send a note of caution and think it is premature to move to the usual agenda. Although idiosyncratic factors have played an important role, we consider the problems to be at least partly systemic and we do not forecast banking sector risks to dissipate soon. The losses in the financial sector caused by the increase in yields are still on the balance sheets and it cannot be excluded that there will be new banking woes going forward. Lending standards, which were already tightened before the turmoil, will be further stepped up.

The resulting negative growth and inflation effects in combination with much tighter financial conditions will enable the ECB and the Fed to refrain from further key rate hikes. Although it is a tight call for the ECB in particular, we consider the two key rate hikes of 25 bps each currently priced to be excessive. We are also more cautious for the Fed. While financial market participants currently expect a hike of 25 bps in May with a 50% probability and one cut by the end of the year, the Fed, according to its dots, sees key rates even rising by 25 bps by the end of 2023. It is worth mentioning that price action tends to be noisy towards the end of a key rate cycle – and this time is no exception. Moreover, the dispersion of Fed dots is particularly high currently. While dots for year-end 2023 show a range of 100 bps, dots for year-end 2024 are characterized by a particularly high variation of 225 bps (from 3.375% to 5.625%).

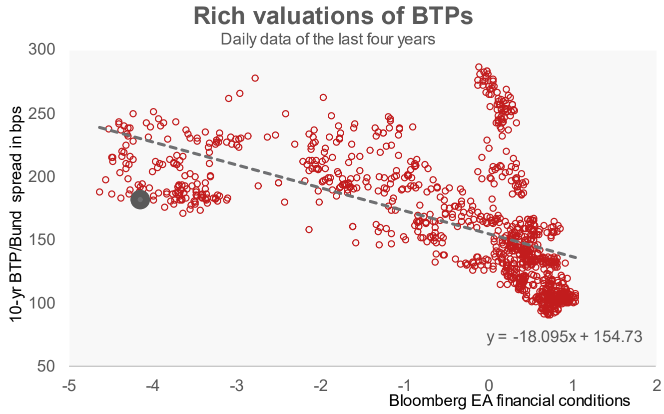
While it cannot be ruled out that bond markets will indeed remain calm and yields will move sideways in the months to come (in case the crisis resolves earlier than expected), our yield forecast reflects the downside potential and our more cautious assessment. We incorporate these banking woes and consider periods of flight to quality. Accordingly, we do not (yet) expect a lasting decrease in bond market volatility but forecast it to remain at a rather elevated level in the coming months.

Transatlantic yield spread to tighten further as the ECB is unlikely to embark on key rate cuts in 2023 (in contrast to the Fed)

Overall, short- and long-dated EA and US government yields are forecast to trend downwards. Driven by our more cautious central bank outlook we expect particularly short-dated yields to fall once financial markets adjust key rate expectations. The steepening of the curve is likely to be more pronounced in the US amid the higher level and as the Fed will start the rate-cutting cycle. We forecast US key rates below 3% by the end of 2024. On the contrary, as the ECB has still some ground to cover given the inflation outlook, we forecast at most two 25 bps cuts in 2024 (no cuts in 2023). Hence, the transatlantic yield spread has leeway to tighten more in Q2.



Source: Bloomberg, GIAM



Caution indicated for EA non-core bonds – despite shown resilience

While other fixed income assets perceived as risky experienced a strong spread widening during the banking woes, EA non-core government bonds have weathered the turmoil rather well. Particularly, BTPs have performed well and even show a slight spread tightening versus Bunds year-to-date. Meanwhile, BTPs are rich by most approaches (see chart above). Even the increase in bond market volatility has not led to a sustained spread widening. It is noteworthy that the volatility of spreads (in contrast to the volatility of yields) remained low throughout Q1.

High budget deficits and high debt ratios in combination with ECB's QT indicate a spread widening going forward

Nevertheless, we advise caution and expect EA non-core government bond spreads to widen moderately going forward. To start with, the current upheavals have the potential to bring the fundamental weakness of EA non-core countries to the fore again. Amid the high deficits and elevated debt levels particularly large EA countries are at risk. Additionally, interest expenditures will increase as bonds with low coupons mature and will be replaced by higher-yield paper. What is more, it has become increasingly less attractive for Japanese investors to purchase EA government bonds and the withdrawal of portfolio investments which began in 2022 is forecast to continue.

The technical environment has deteriorated further since March. The ECB has begun to reinvest maturing bonds only partially. We assume that a volume of € 160bn will be withdrawn from the sovereign bond market by the end of 2023. Net-net issuance (including ECB's QT) will reach the highest level since the Great Financial Crisis in 2023 (more than € 600bn) implying that the absolute volume that still needs to be placed is noticeably higher than in the past.

However, given the EA non-core countries are not at the centre of the banking woes and the ECB has several instruments at hand we forecast only a moderate spread widening going forward.

CREDIT

Elisa Belgacem

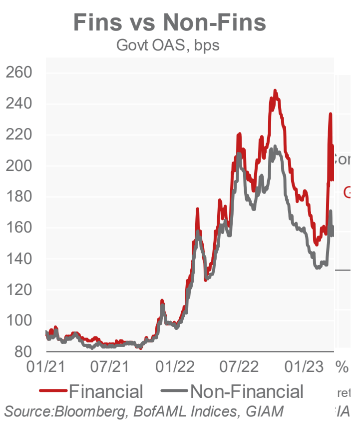
- **We do remain overweight Investment grade as 1/ valuations are attractive both versus other asset classes and within the credit space 2/ the deterioration of fundamentals should remain limited 3/ technical factors should be relatively supportive despite QT.**
- **On HY we keep a cautious stance as we deem the poor economic landscape not reflected in valuations, and we expect fundamentals and technicals to deteriorate significantly. Both defaults and downgrades will trend up, especially in smaller and more cyclical companies.**
- **To get extra yield, we recommend either going for long duration in IG, although curves are already very flat. We also favour subordination risk to credit risk except in the real estate sector even after the Credit Suisse write down of AT1s.**
- **CDS are tighter than cash, and we like to buy credit protection here.**

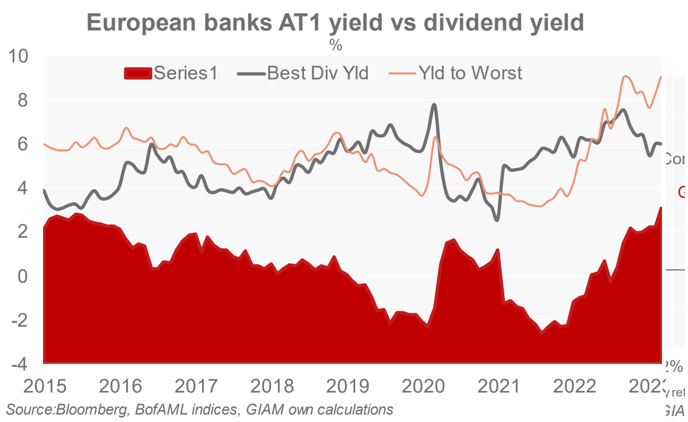
It's not 2008 but the banking sector will still feel the pressure. Banks are much better capitalised than fifteen years ago. Yet the events of the past months are showing that financial stability concerns will have a negative impact on credit, directly via the financial sector accounting for 40% of credit markets, but also indirectly because of eve, tighter lending standards.

> Lower credit creation from the banking sector means highly leveraged companies will face more financing difficulties

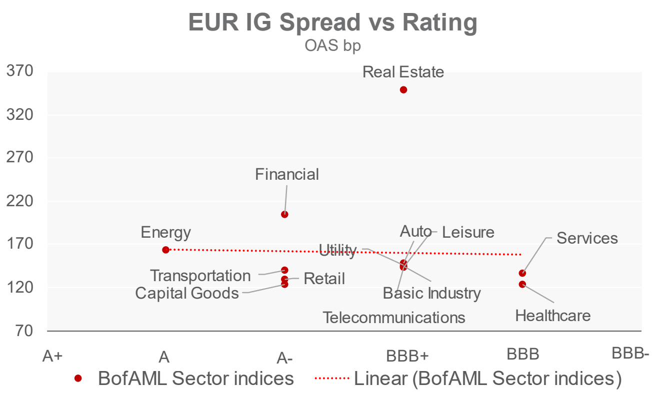
Credit Suisse's AT1 burden sharing means broader credit risk repricing

The failure of SVB bank and the forced takeover of Credit Suisse by UBS are both the result of poor governance. But they also emerge out of a context of extreme fast monetary policy normalisation that created billions of unrealised losses in the financial system which put them under pressure. This resulted in a loss of confidence from clients that led them to quickly remove their funds from the perceived weak banks. Even though banks are better capitalised than in 2008, especially in Europe, the flights of deposits from smaller banks to big and safer ones is likely to go on. The lending

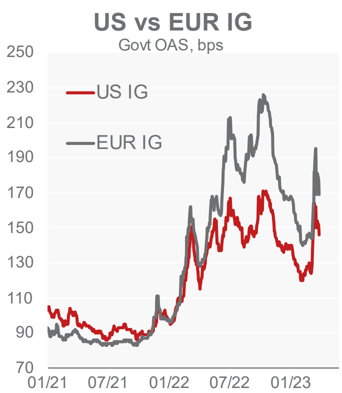




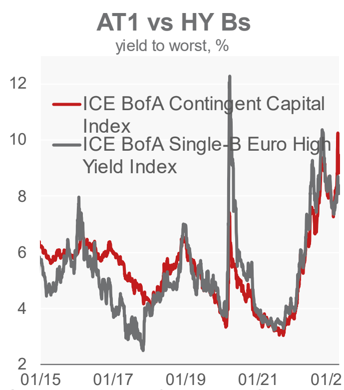
standards both in the US and in Europe had already meaningfully tightened recently. Now regional banks facing outflows will not be able to lend much while larger banks will also prove cautious in this context. Slower credit being a very robust leading indicator of GDP, all other things being equal the events of the last ten days mean that the developed world will see lower growth and potentially lower inflation. Hence, the price of credit risk will have to be revised up. For credit markets it will start with AT1 as the Finma decided to ignore the creditor hierarchy by fully writing down Credit Suisse's most junior debt but not the equity. In our view, the fact that both the BoE and the ECB have confirmed that AT1 are senior to equity are not making AT1 riskier than before in other jurisdictions. However, this is a reminder that credit risk comes with a price and HY spreads should also continue to widen to reflect the weaker economic outlook but also likely difficult liquidity conditions, the most leverage sectors will be under pressure, starting with VC and PE and possibly Real Estate.



Source:Bloomberg, BofAML indices, GIAM own calculations



Source: Bloomberg, BofAML indices, GIAM



Source:Bloomberg, BofAML Indices, GIAM own

> Defaults will likely jump from around 2% currently to above 4.5% by the end of 2023

Tighter liquidity conditions mean higher defaults

HY ratings will deteriorate more than IG ones. As they did in 2020, we expect rating agencies to revise in priority the notations of companies at the lower end of the rating spectrum. Indeed, nearly 50% of HY-rated companies were downgraded by at least one notch, while IG has been mostly put on a negative outlook. Governments' support that helped contain defaults to 5% in Europe during Covid will be smaller due to lesser fiscal leeway from governments. Also, we expect smaller companies to be the most at risk. Hence, we expect defaults to double from current levels both in the US and in Europe jumping to 4.5% from above 2% currently. In such context banks' asset quality should also deteriorate more than compensating the positive, which leads us to remain underweight financials versus non-financials in spread terms. However, as the carry is now higher in the financial space as spreads have substantially diverged recently, we expect the total returns of the financial index to surpass the non-financial one.

Decompression trade still on

Overall, we prefer IG to semi-core and peripheral sovereigns, on valuation grounds. In Europe, IG levels are consistent with a mild recession scenario. We prefer European credit to US credit on wider spreads and relatively lower economic risks. IG spreads will likely trade around current levels over the next months. However, the valuation of the HY market does not reflect elevated economic risks. Hence, spreads should widen nearly 100bp in the first half of 2023 before ending the year slightly tighter compared to current levels. CDS are tighter than cash, and we like to buy credit protection here. Even after Credit Suisse, with rates likely plateauing, in a context of high uncertainty regarding defaults in the HY space, it makes sense to go long IG to enhance returns in credit. Similarly, subordinated bonds are attractive versus pure high yield and we continue to prefer corporate hybrids ex Real Estate to BB rated companies and AT1s to single-B rated companies.

EM SOVEREIGN CREDIT

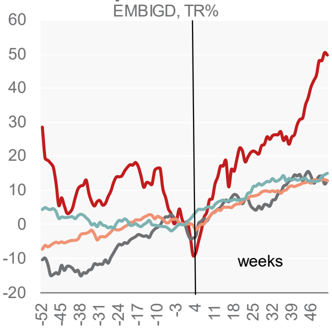
Guillaume Tresca

- **The EM outlook has been deteriorating amid higher uncertainty on the growth outlook and tighter global financial conditions. That said, EM growth resilience and Chinese reopening provide support.**
- **We maintain our overweight for external debt in our global allocation but with a more defensive approach.**
- **EM frontier markets are the most vulnerable to tighter credit conditions, but we do not see systemic risk. EMs are in a better shape than in 2008 and 2013.**
- **Risk premia are too low given the growing uncertainties. EM spreads are still very tight and will continue to widen. We continue to favour EM IG over HY, especially Europe IG and LatAm IG.**

Be defensive. The outlook for EM has been deteriorating as they face a late-cycle environment with the first cracks triggered by tightening financial conditions. The window of opportunity for EM is shrinking rapidly, and risks are becoming less symmetric. The positive news is the resilience of the growth dynamic, particularly with China reopening. However, EM remains a beta play that is sensitive to global risk aversion and global growth prospects. It cannot escape the repricing of tail risks and growth concerns. This environment calls for reducing risk in EM fixed income, especially since EM inflation has eventually proved to be stickier than expected, leading EM central banks to adopt a hawkish hold.

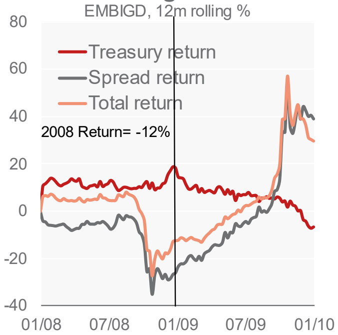
We continue to prefer EM local debt over external debt, although local debt offers a limited risk premium given the current level of DM yields. In our allocation, we maintain a slight overweight for EM external debt, primarily due to the strong carry. Growing uncertainties and rising tail risks require a higher EM risk premium for both local and external debt, leading to wider spreads. However, the total return will remain positive in the medium term, boosted by positive duration effects and resilient carry.

Performance around Fed peak rate
EMBIGD, TR%



Source: Bloomberg, GIAM

2008 return was manageable
EMBIGD, 12m rolling %



Source: Bloomberg, JP,GIAM calculations

Carry offers a 70bp protection
9M TR for different scenarios, BofA index

OAS spread	US 8Y 3.31%	3.41%	3.51%	current 3.61%	3.71%	3.81%	3.91%	4.01%
261	15.0%	14.3%	13.5%	12.8%	12.1%	11.3%	10.6%	9.9%
281	13.5%	12.8%	12.1%	11.3%	10.6%	9.9%	9.1%	8.4%
301	12.1%	11.3%	10.6%	9.9%	9.1%	8.4%	7.7%	6.9%
321	10.6%	9.9%	9.1%	8.4%	7.7%	6.9%	6.2%	5.5%
341	9.1%	8.4%	7.7%	6.9%	6.2%	5.5%	4.7%	4.0%
361	7.7%	6.9%	6.2%	5.5%	4.7%	4.0%	3.3%	2.5%
381	6.2%	5.5%	4.7%	4.0%	3.3%	2.5%	1.8%	1.1%
401	4.7%	4.0%	3.3%	2.5%	1.8%	1.1%	0.3%	-0.4%
421	3.3%	2.5%	1.8%	1.1%	0.3%	-0.4%	-1.1%	-1.9%
441	1.8%	1.1%	0.3%	-0.4%	-1.1%	-1.9%	-2.6%	-3.3%
461	0.3%	-0.4%	-1.1%	-1.9%	-2.6%	-3.3%	-4.1%	-4.8%

Source: Bloomberg, GIAM calculations

EM not immune to the tightening of lending standards

EM are less fragile than in 2008 and 2013

Even though EM assets have weathered the latest bout of risk aversion well, they are not fully immune to the upcoming tightening of credit conditions. We have long argued that more EM defaults will happen, and the credit tightening is not a game-changer. The risk is shifting from a rate shock to a credit shock, which should highlight the weak EM frontier economies that have seen a deterioration of their twin deficits over the past few years. That being said, we do not expect systemic events as global EMs are less fragile than in 2008 and 2013, with a better FX reserves adequacy ratio and lower external refinancing needs. The IMF has even implemented new backstops, and now thirteen countries are under IMF programs or assistance.

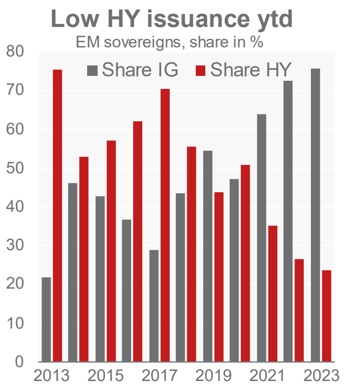
Return can be positive even if tight valuations require a larger risk premia

> We expect wider EM spreads but return to remain positive in the medium term

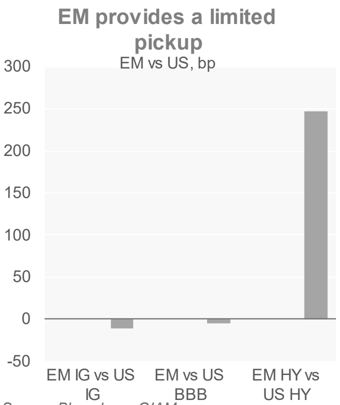
As the end of the cycle approaches, EM external debt will become more vulnerable. In the past four tightening cycles, EM external debt performance was negative in the run-up to the peak of the cycle, but it performed positively afterward. In the medium term, we would expect the return to be positive, supported by the decline in core rates and a significant carry. Even in 2008, returns stabilized at -11%, only to be boosted by a strong contribution from duration.

We still expect EM spreads to continue widening, particularly as the deterioration of credit conditions spreads throughout the economies. A higher risk premium is needed as valuations have continued to be historically tight. Indeed, the EMBIG index spread is distorted by distressed countries, and the EMBIG ex-distressed countries spread is close to its long-term average. Additionally, EM offers little or no pickup over US corporate equivalents.

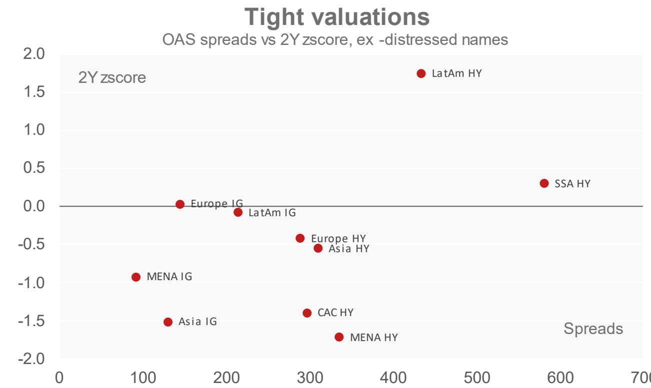
Within this riskier and more uncertain environment, we maintain our overweight position on EM IG over HY. There is too much uncertainty regarding growth prospects to favour riskier and more cyclical assets. Within IG, we continue to see value in Europe IG (Romania, Hungary) and LatAm IG (Mexico).



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM



Source: Bloomberg, JP, GIAM

Poor primary market access

EM primary markets have reopened strongly for investment-grade (IG) countries, with the best start since 2017. January was exceptional as issuers caught up after a weak 2022. Since then, issuance has been below average, with only a few high-yield (HY) names coming to the market. High rate volatility has limited access to primary markets for both IG and HY, but it is not expected to become problematic.

In a surprising move, the primary market has reopened despite rate volatility, with even HY names tapping the markets (such as Costa Rica and Panama), suggesting that it is possible to attract demand currently. More structurally, debt redemptions will decline until June, and there is no immediate threat until 2024 in terms of debt redemption. Low-rated countries are already covered by IMF programs or aids. The only issue would be for low BB countries that will lock in high yields, which will negatively weigh on the future debt dynamic.

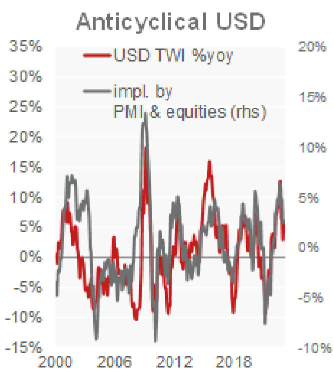
CURRENCIES

Thomas Hempell

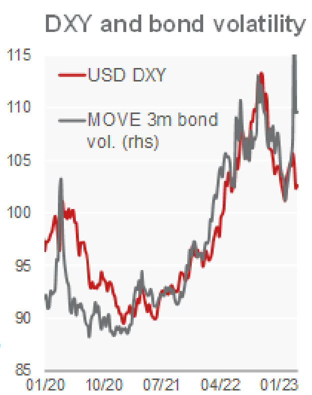
- **Defying usual patterns of global economic stress, the countercyclical USD did not benefit from strains in the banking sector. The sharp repricing of rates expectations more than offset the support from safe-haven bids.**
- **Yet barring a severe escalation of banking woes, we expect an even weaker dollar and a higher EUR/USD by year-end.**
- **With the Fed likely largely done in tightening policy and a pivot on the cards for Q4, the greenback is facing headwinds from tighter yield gaps. Sluggishly easing inflation will ultimately help to bring downs rates volatility, whose rise was another pillar of USD support last year.**
- **The EUR will recover from fundamentally cheap levels as the terms of trade shock from high energy prices eases and capital flows are turning more favourable. The upside of the EUR vs. CHF and GBP is more limited, though.**
- **The USD/JPY is past peak, driven by prospective lower US yields and the BoJ's likely exit from yield curve control. Lower energy prices and a recovering current account balance will also support the JPY against a broadly weaker USD.**

USD weakens as reversed Fed expectations trump safe haven appeal

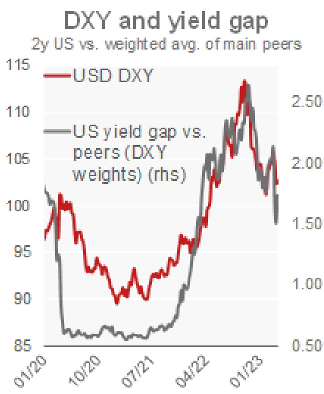
The USD weakness amid recent banking woes (USD DXY down 3% since March 8) is striking as it defies the dollar's usual appeal as a safe haven amid rising risk aversion and/or global growth worries (left chart below). Scrutinising the offsetting forces behind the recent move reassures us in the view that – barring a sharp escalation of the banking woes into a global crisis – the USD is headed for further weakness into year-end.



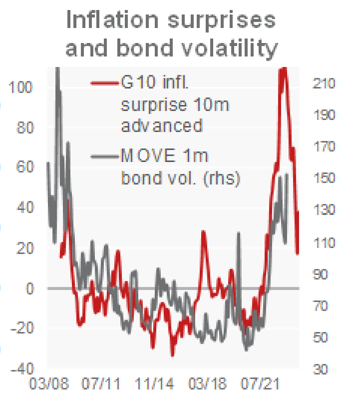
Source: Datastream, GIAM calculations; model 2000-2019 based on MSCI World %yoy and



Source: Datastream, GIAM



Source: Datastream, GIAM



Source: Citi, Datastream, GIAM

Global risk aversion and a renewed spike in rates uncertainty (2nd chart below) would usually have bolstered the US currency. Yet with the US at the heart of current banking woes and the odds of a pronounced recession rising, markets sharply revised Fed rate expectations. The narrowing of yield gaps versus major peer currencies more than offset the safe-haven response (3rd chart).

Amid simmering banking woes, tighter credit substitutes for rate increases, with adverse USD impact

Credit crunch to substitute for Fed rate hikes

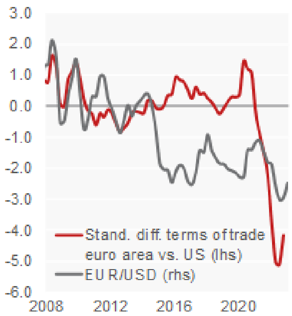
Looking ahead, we expect the banking woes to keep simmering, causing a credit crunch but much less likely a deep banking crisis. Tighter credit conditions will substitute for further Fed hikes, turning a USD booster by a drag. Disinflation – even if sluggish and bumpy amid a tight labour market – is set to proceed. This means bond volatility will reverse at some point (upper right chart). By contrast, the yield advantage is set to erode further, as a more pronounced US recession makes rate cuts as soon as in Q4 2023 likely. We expect the 2-year UST/Bund gap to fall by at least some 40bp by year-end.

An easing term-of-trade shock will help the EUR

Conversely, an easing terms-of-trade shock amid lower energy import bills will help the EUR. With the recovery likely to proceed and energy supply risks ebbing, the drag from net FDI outflows is likely to recede too, supporting the single currency (left charts below). As a result, while the near-term outlook is more balanced amid the banking woes, we expect the EUR/USD to settle visibly above the 1.10 threshold by year-end.

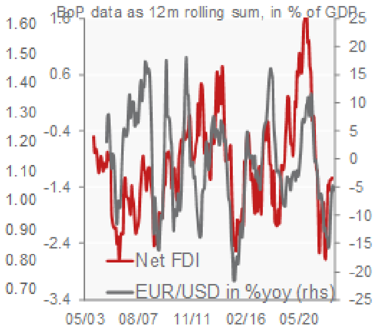
The key risk to the outlook emanates – apart from an escalation of the war in Ukraine – from sharply rising banking stress in the euro area that could also challenge the resilience of EMU premia reflected in BTP spreads (3rd chart below) on renewed worries about the sovereign/banking loop in the euro area.

EUR/USD and terms of trade



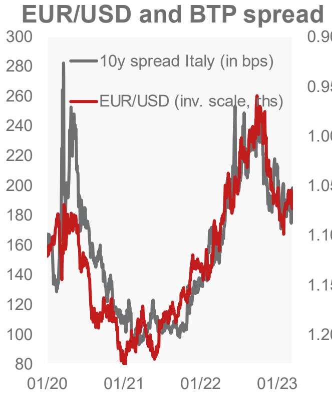
Source: Datastream, GIAM
terms of trade as std. from long-term mean

Euro area: net FDI flows and EUR/USD



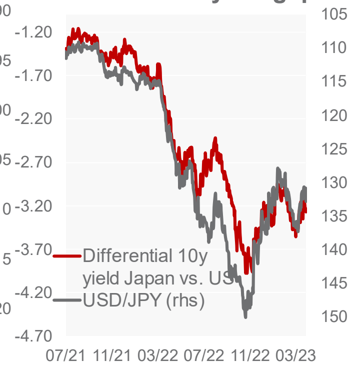
Source: Datastream, GIAM

EUR/USD and BTP spread



Source: Datastream, GIAM calculations

USD/JPY and yield gap



Source: Datastream, GIAM calculations

Against the CHF, the EUR may struggle to advance amid persistent banking worries – even though concerns about the Swiss banking sector has dented the CHF safe-haven appeal. GBP remains burdened by the UK's large C/A account deficit and the particularly adverse stagflation setup in the UK. Yet the agreement on the Northern Ireland protocol with the EU have clearly reduced political risks and we see the outlook for EUR/GBP only mildly tilted to the upside.

USD/JPY headed lower

Lower US yields and policy reversal at the BoJ point to a stronger yen

Lower US yields will tighten the yield US/Japan yield gap, a still very powerful driver of the USD/JPY (right chat above). While the Fed is at (or at least close to) peak rates and first rate cuts seem likely for Q4 owing to a looming recession, the BoJ – reversely – is preparing the ground for a less accommodative policy stance. Uncertainties are high, but in our base case we expect the incoming new BoJ governor Ueda to gradually remove the yield curve control by widening the targeted yield band before then moving to targeting shorter yield maturities. This will not only add to the tightening of the yield gap vs. the US but also bring the risk case of a much faster reversal of policy to investors' mind.

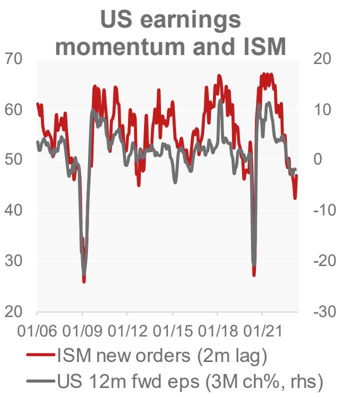
The JPY will also benefit from an easing drag from the balance of payments. First, lower energy bills and the J-curve effect from the yen depreciation last year are set to moderate the high trade deficit. Second, enticed by the outlook of less painful yields at home and the risk of a protracted USD reversal, institutional investors may repatriate foreign bond exposure. Overall, we expect the USD/JPY to continue its retracement and settle in the mid-120s by the end of the year.

EQUITIES

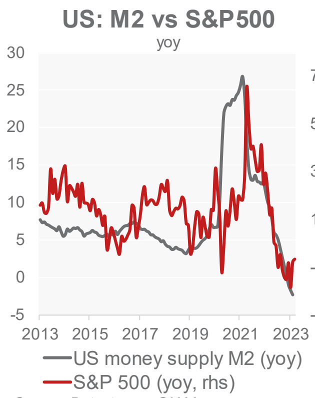
Michele Morganti and Vladimir Oleinikov

- **We maintain an UW position on equities. Lagged effects of CBs' tightening plus the current banking crisis bring higher risk aversion and lower GDP. We see only limited positive TR over the next 12 months, looking for better entry levels once the bank crisis, economic slowdown and further policy tightening are fully priced in.**
- **S&P 500 valuations point to negative returns in the short term, with risks on the downside as recession chances increased and credit crisis spillovers do linger. Low positioning should help to limit the downside potential.**
- **Earnings will see downgrades: not a major profit downturn but analysts' consensus is likely to be reduced. In the US, the ISM manufacturing has declined visibly, consumers' excess savings are depleting while wages, inventories and debt service costs are on the rise. A rebounding CPI/unit-labour costs momentum (from very low levels), a weaker USD along with China growth recovery represent earnings stabilizers for the future.**
- **Valuations also remain expensive (PE vs. 10y real rate or BAA), discounting a GDP growth acceleration from here, which is not our base case. Rates are set to be lower than expected but we doubt this will help equities short term.**
- **We overweight (OW) China, UK, Japan, and EMU vs. US (albeit a reduced one). Sector OWs: Food Staples Retail, Food BT, Software, Telecoms, Utilities. UWs: Banks, Cap. Goods, Commercial & Prof. Svs, Insurance, Media.**

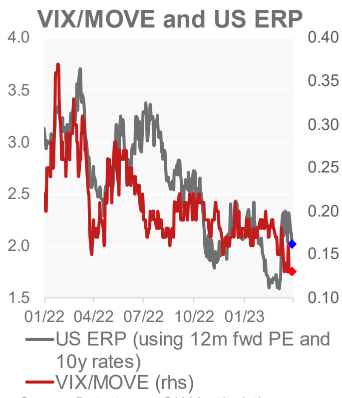
Lagged effects of CBs tightening plus banking crisis should cause a higher risk aversion and lower GDP. We do not forecast a major profit and margin downturn but analysts' consensus is likely to be reduced as lending standards stay tight or even tighter. Going forward, US margins will be pressured by a decelerated ISM manufacturing, consumers' savings deterioration, higher wages, and inventories plus increased debt service cost. A rebounding CPI/ULC momentum (unit-labour costs, bottoming from very low levels) and a weaker USD, represent two future earnings stabilizers together with China growth recovery, but not immediately.



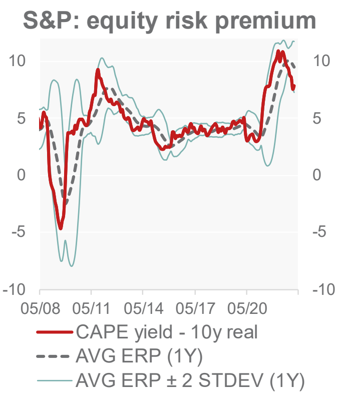
Source: Datastream, GIAM



Source: Datastream, GIAM



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

Tighter lending standards and higher chance of recession to increase downside risks

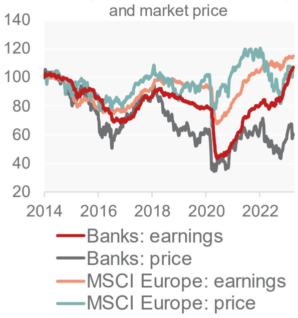
EMU margins have been resilient so far but going forward they will also face headwinds, as testified by the plunge in 12-month margin revisions (earnings/sales). Among the reasons are a stronger euro, weaker GDP growth and capacity utilization plus banks' lower propensity to lend. A weaker fiscal support, lower supply constraints and higher employment costs will add to the negatives. In sum, we see lower earnings growth ahead, notwithstanding the macro resiliency shown so far and better Chinese growth perspectives. Lower growth, coupled with reduced expectations of yield increases, will also reduce the potential outperformance of the EMU index, given its tilt to financials and Value. Our corporate earnings (EPS) models see yoy growth at around -5% in 2023, remaining under consensus by nearly -9% for EA & US in 2023-2025. We expect an average growth of 7% (EMU and US) in 2024 and 2025. Risks are skewed to the downside. Additional negative signs for markets come from the US Tech overvaluation (40% based on Fed model), declining M2, inverted yield curve, low housing confidence, and the risk premium (too low). Bank credit events are getting more frequent, and the US commercial real estate looks particularly at risk. Valuations are stretched (PE vs. 10y real rate or BAA), discounting a GDP growth acceleration from here, which is not our base scenario. Rates are set to be lower than expected, though not helping equities immediately. That said, potential downside in the short term is likely to be limited due to declining headline CPI, China reopening, high cash to shareholders, below-average positioning, and net equity/bond flows. Over the next 12 months, we see only low-digit positive TR (+1%-4%), looking for better entry levels once the bank crisis, eco slowdown and further policy tightening are fully priced in.

EU Banks: valuation still ok but higher credit risk plus lower GDP & rates are headwinds

We OW UK, China, and Japan, and we reduce the OW EMU vs. US (quant models, toppish yields, and macro surprises plus a stronger euro). The S&P 500 valuation in 1-year, based on long-term series of risk premium and inflation, looks fair-to-slightly overvalued (3,982). This figure declines to 3,686 shorter term, once a lower estimates for GDP growth is included, with risks on the downside. Should we factor in a bank crisis spillover, plus more robust GDP downgrade, the market bottom could be found near 3,200. The cheaper EMU index should show a higher resiliency on the downside.

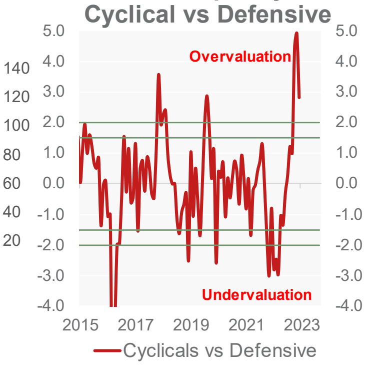
European banks and the MSCI Europe

earnings estimates (12-month fwd) and market price



Source: Datastream, GIAM

MSCI Europe Styles: Cyclical vs Defensive



Source: Refinitiv, GIAM calculations

EM earnings and macro surprises

Source: Datastream, GIAM

MSCI China and macro leading indicator

Source: Datastream, GIAM

Overweight (OW) China, UK, and Japan. Reduced OW EMU vs. USA. EU sectors: given the lower growth perspectives, cyclical sectors enter in a dangerous zone. We adopt a more defensive stance. Our ML models see cyclicals still overbought by 3 SD vs. defensives. We UW Cap. Goods (cyclical, high valuation, and toppish orders). We cut Banks to UW, notwithstanding the high degree of undervaluation: credit risk and lower GDP. Sector OWs: Food Staples Retail, Food BT, Software, Telecoms, Utilities. UWs: Banks, Cap. Goods, Commercial & Prof. Svs, Insurance, Media.

EM Equities: OW tilted to the MSCI China index

EMs: to benefit from China reopening and undergoing easing cycle

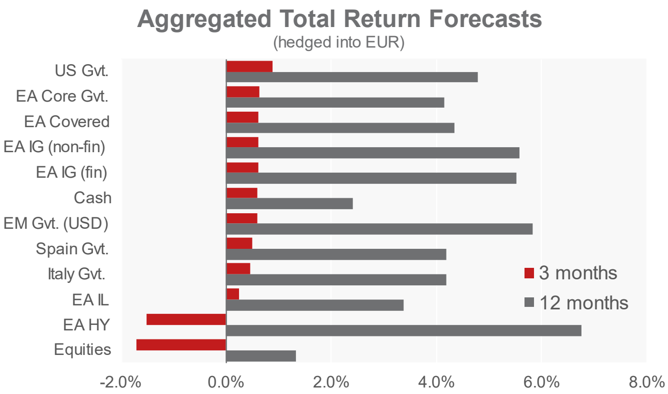
EM's PE vs. MSCI World is aligned to history but our machine-learning (ML) - based model shows an undervaluation of almost 1 SD. Furthermore, a more accommodative monetary policy, increasing PMI, including global export or-ders and EM macro surprises, all support the continuation of the bottoming-out in earnings and GDP. China's reopening is an additional positive together with rebounding money supply momentum (M2) and low valuations. We OW China, while acknowledging a volatile geopolitical risk.

ASSET ALLOCATION

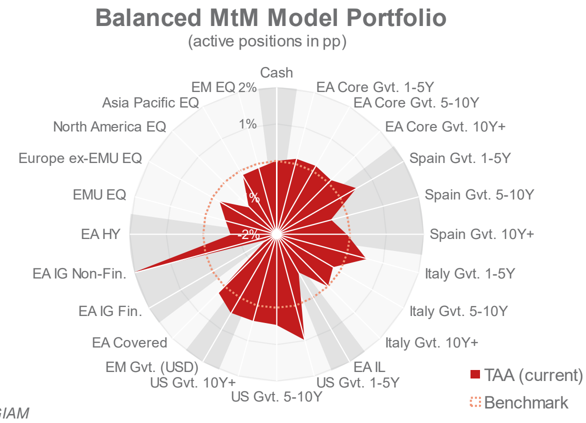
Thorsten Runde

- **Easing energy concerns relieving Europe, a still strong labour market supporting the US economy and China's rapid reopening should make for a pleasant spring for the global economy. However, we expect it to be followed by a marked slowdown in the second half of the year, fuelled by recent banking sector concerns.**
- **We now look for a deeper US recession in H2 than initially anticipated. For the euro area, we also see increasing risks of a stronger than previously assumed growth weakening.**
- **Even though the current problems in the banking sector could work in the same direction as the monetary policy of central banks through stricter lending standards, they will in any case increase general uncertainty and risk aversion.**
- **Given the affectedness of risk assets and also of the financial sector we increase the underweight in Equities and EA HY. Additionally, we switch our active position in EA IG Financials from over- to underweight too. We stay overweight in EA IG Non-Fin. due to still attractive carry perspectives. As we continue to see US Treasuries as a good safe haven, we confirm our overweight here. All in, we prefer a neutral duration stance with risks skewed towards the downside in yields.**

There are still quite some positive aspects (easing energy concerns, excess savings, pent-up demand, solid labour markets, China's reopening…) arguing for a rather benign economic spring. That said, the recent events in the banking sector (SVB, CS) are clearly amplifying the headwinds to the financial system in the US, but also in Europe. The threat from huge unrealized losses might hit the economy at a time when not even the CBs' tightening policy had its full effect yet. All in, we expect a much weaker H2 characterized by a generally risen uncertainty, risen risk-aversion, and depressed demand through the credit crunch.



Source: GIAM



Source: GIAM

Against this backdrop, we confirm our overall reluctance towards risk assets. In particular, we increase our underweights in Equities and EA HY. Furthermore, with the financial sector expected to be affect most by the "banking woes", we are reverting our active position in EA IG Fin to a distinct underweight. We stay overweight in EA IG Non-Fin and EM Govies (USD) due to the strong carry. As US Treasuries are seen to serve as safe haven, we maintain our overweight there. Toppish yields foster the attractiveness of bonds. We overweight Core Govies (with a preference for the belly) and short-dated BTPs. Overall, we stay neutral on duration grounds. The risk in yields is skewed towards the downside.

FORECASTS

Macro Data

Growth	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.	2025 forecast
US	2.0	0.4	- 0.3	0.2	- 0.9	1.5
Euro area	3.3	0.7	0.3	0.6	- 0.6	1.4
Germany	1.7	0.1	0.2	0.6	- 0.8	1.7
France	2.5	0.4	0.1	0.5	- 0.7	1.8
Italy	3.9	0.5	0.2	0.7	- 0.3	0.9
Non-EMU	3.6	- 0.2	0.3	1.0	0.0	1.6
UK	4.1	- 0.3	0.5	0.7	0.0	1.5
Switzerland	2.1	0.8	0.2	1.6	0.0	1.2
Japan	1.2	0.8	- 0.3	1.1	0.0	1.0
Asia ex Japan	4.1	4.9	0.1	4.9	- 0.2	4.9
China	3.0	5.4	0.2	5.0	- 0.1	4.7
CEE	1.8	0.8	0.9	3.2	0.9	2.9
Latin America	3.8	0.8	0.0	1.7	- 0.1	2.2
World	**3.3**	**2.3**	**0.1**	**2.6**	**- 0.3**	**3.0**

Inflation	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.	2025 forecast
US	8.0	4.5	0.6	2.5	- 0.0	2.2
Euro area	8.4	5.3	- 0.2	2.5	0.1	2.3
Germany	8.6	6.0	- 0.2	2.7	- 0.0	2.5
France	5.9	4.5	- 0.3	2.4	0.1	2.2
Italy	8.7	6.4	0.0	2.4	0.2	0.6
Non-EMU	8.0	5.8	- 0.2	2.2	- 0.4	1.8
UK	9.1	6.4	- 0.3	2.3	- 0.6	1.7
Switzerland	2.9	2.2	0.0	1.2	0.0	1.3
Japan	2.5	2.5	0.4	1.5	0.3	1.3
Asia ex Japan	3.5	3.3	0.2	3.0	- 1.7	2.8
China	1.9	2.4	0.0	2.3	- 0.0	2.3
CEE	29.6	17.7	0.3	8.3	- 2.5	6.2
Latin America	7.8	5.6	0.8	4.0	0.6	3.1
World	**7.8**	**5.4**	**0.2**	**3.3**	**- 0.8**	**2.9**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

Financial Markets

Key Rates	Current*	3M Forecast	3M Forward	6M Forecast	6M Forward	12M Forecast	12M Forward
US	4.88	5.00	4.88	5.00	4.45	4.25	3.62
Euro area	3.00	3.00	3.25	3.00	3.36	3.00	2.95
Japan	-0.10	-0.10	0.01	-0.10	0.06	0.00	0.13
UK	4.25	4.25	4.48	4.25	4.54	3.75	3.96
Switzerland	1.50	1.50	1.69	1.50	2.01	1.50	1.87
10-Year Gvt Bonds							
US Treasuries	3.55	3.40	3.55	3.30	3.53	3.20	3.52
Germany (Bunds)	2.27	2.20	2.27	2.10	2.26	2.05	2.25
Italy	4.02	4.05	4.17	4.00	4.21	4.00	4.30
Spread vs Bunds	*175*	*185*	*189*	*190*	*195*	*195*	*205*
France	2.79	2.70	2.83	2.60	2.84	2.60	2.87
Spread vs Bunds	*52*	*50*	*55*	*50*	*58*	*55*	*62*
Japan	0.30	0.50	0.39	0.70	0.43	0.90	0.51
UK	3.43	3.30	3.43	3.25	3.42	3.15	3.44
Switzerland	1.18	1.15	1.18	1.05	1.17	1.00	1.16

**3-day avg. as of 29/03/23*
***ICE BofA (OAS)*

Credit Spreads**	Current*	3M Forecast	3M Forward	6M Forecast	6M Forward	12M Forecast	12M Forward
EA IG Non-Financial	160	165		170		165	
EA IG Financial	207	225		225		215	
EA HY	503	575		550		525	
EM Sov. (in USD)	365	390		400		390	
Forex							
EUR/USD	1.08	1.08	1.09	1.10	1.09	1.12	1.10
USD/JPY	132	130	130	127	128	125	125
EUR/JPY	143	140	141	140	140	140	138
GBP/USD	1.23	1.22	1.23	1.24	1.23	1.24	1.23
EUR/GBP	0.88	0.89	0.88	0.89	0.89	0.90	0.89
EUR/CHF	0.99	0.99	0.99	1.01	0.99	1.03	0.98
Equities							
S&P500	3,992	3,890		3,910		3,940	
MSCI EMU	143.3	137.0		139.5		143.5	
TOPIX	1,975	1,930		1,955		2,005	
FTSE	7,507	7,300		7,360		7,490	
SMI	10,863	10,435		10,620		10,900	

Forecast Intervals

3-Months Horizon

10-Year Gvt Bonds	US Treasuries	2.91	**3.40**	3.89
	Germany (Bunds)	1.31	**2.20**	3.09
	UK	2.63	**3.30**	3.97
	Switzerland	0.50	**1.15**	1.80
Credit Spreads*	EAIG Non-Financial	139	**165**	191
	EAIG Financial	192	**225**	258
	EAHY	496	**575**	654
	EM Sov. (in USD)	344	**390**	436
Forex	EUR/USD	1.05	**1.08**	1.11
	USD/JPY	126	**130**	134
	GBP/USD	1.20	**1.22**	1.24
	EUR/CHF	0.97	**0.99**	1.01
Equities	S&P500	3,661	**3,890**	4,119
	MSCI EMU	129	**137**	145
	TOPIX	1,846	**1,930**	2,014
	FTSE	6,972	**7,300**	7,628
	SMI	9,905	**10,435**	10,965

*ICE BofA (OAS)

12-Months Horizon

10-Year Gvt Bonds	US Treasuries	2.30	**3.20**	4.10
	Germany (Bunds)	0.38	**2.05**	3.72
	UK	1.95	**3.15**	4.35
	Switzerland	-0.36	**1.00**	2.36
Credit Spreads*	EAIG Non-Financial	115	**165**	215
	EAIG Financial	154	**215**	276
	EAHY	379	**525**	671
	EM Sov. (in USD)	303	**390**	477
Forex	EUR/USD	1.07	**1.12**	1.17
	USD/JPY	118	**125**	132
	GBP/USD	1.20	**1.24**	1.29
	EUR/CHF	1.00	**1.03**	1.06
Equities	S&P500	3,504	**3,940**	4,376
	MSCI EMU	129	**144**	158
	TOPIX	1,825	**2,005**	2,185
	FTSE	6,834	**7,490**	8,146
	SMI	9,913	**10,900**	11,887

*ICE BofA (OAS)

*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5-year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three-month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

IMPRINT

Issued by:	**Generali Insurance Asset Management S.p.A.** **Società di gestione del risparmio, Research Department**
Head of Research:	**Vincent Chaigneau**
Head of Macro & Market Research:	**Dr. Thomas Hempell, CFA**
Team:	**Elisabeth Assmuth |** Research Operations **Elisa Belgacem |** Head of Cross-Asset Quant & Dev, Senior Credit Strategist **Radomír Jáč |** GI CEE Chief Economist **Jakub Krátký |** GI CEE Financial Analyst **Michele Morganti |** Head of Insurance & AM Research, Senior Equity Strategist **Vladimir Oleinikov, CFA |** Senior Quantitative Analyst **Dr. Thorsten Runde |** Senior Quantitative Analyst **Dr. Christoph Siepmann |** Senior Economist **Dr. Florian Späte, CIIA |** Senior Bond Strategist **Guillaume Tresca |** Senior Emerging Market Strategist **Dr. Martin Wolburg, CIIA |** Senior Economist **Paolo Zanghieri, PhD |** Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan, and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."