

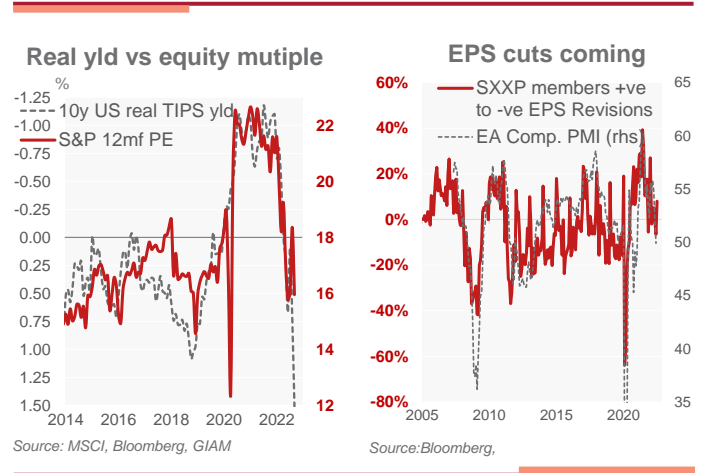
Investment View

Waiting for Godot pivot

September 30, 2022

Our Investment View provides our quarterly macro & market outlook and investment implications

- The fast-track monetary tightening and the EU energy crisis are powerful headwinds for the global economy: recession forces are set to grow over the turn of the year.
- The depth of the EA recession will partly depend on winter temperatures. Europe's large negative terms of trade shock is already damaging its competitive position and may persist for years.
- Tails risks are unusually fat. The Fed's pivot and eventual opening of the diplomatic route in Ukraine are great bullish triggers, but unlikely in the near term.
- We are still focused on the downside for now, as risk assets fail to price enough bad news. Investor positioning is arguably defensive, but equity funds globally have still seen inflows this year. Worryingly, we see cracks in the global financial plumbing, in part sourced in a shortage of safe collateral and extreme policy uncertainty.
- High inflation will mostly prevent central banks to act as a credible lender of last resort in this difficult economic and financial environment. The attack on UK markets epitomises the limited policy room and contradictions.
- We retain our defensive portfolio positioning for now, with a long cash position, and shorts in equities and High Yield. We keep a small duration position for now but see limited upside for risk-free yields from here. Treasuries are a better haven than Bunds. We find IG credit relatively cheap and offering attractive carry.



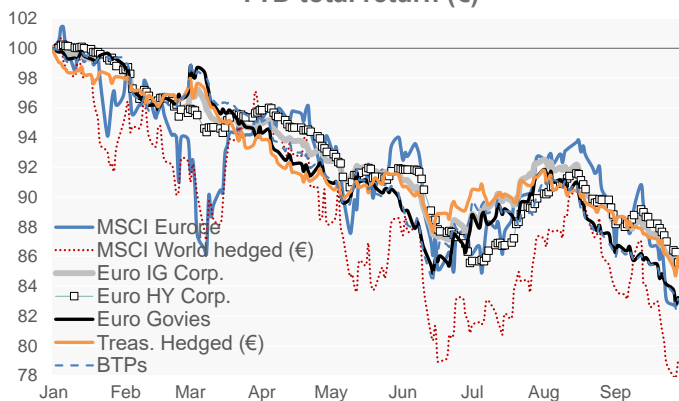
CONTENT	
WAITING FOR GODOT PIVOT	2
MACROECONOMIC OUTLOOK	7
GOVERNMENT BONDS	10
CREDIT	12
EM SOVEREIGN CREDIT	14
CURRENCIES	16
EQUITIES	18
ASSET ALLOCATION	20
FORECASTS	21
IMPRINT	22

WAITING FOR GODOT PIVOT

Vincent Chaigneau

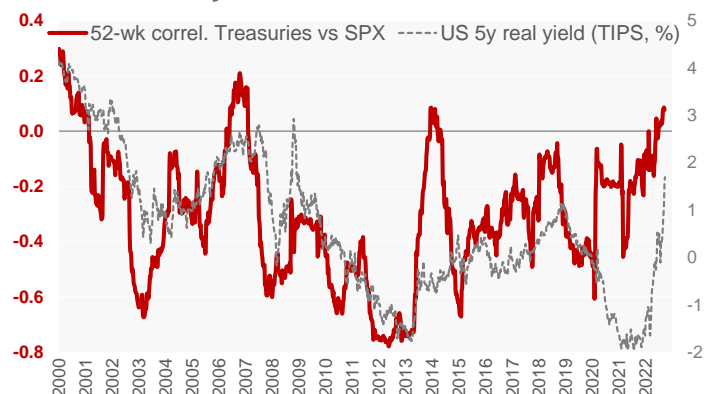
- The fast-track monetary tightening and the EU energy crisis are powerful headwinds for the global economy: recession forces are set to grow over the turn of the year.
- The depth of the EA recession will partly depend on winter temperatures. Europe's large negative terms of trade shock is already damaging its competitive position and may persist for years.
- Tails risks are unusually fat. The Fed's pivot and eventual opening of the diplomatic route in Ukraine are great bullish triggers, but unlikely in the near term.
- We are still focused on the downside for now, as risk assets fail to price enough bad news. Investor positioning is arguably defensive, but equity funds globally have still seen inflows this year. Worryingly, we see cracks in the global financial plumbing, in part sourced in a shortage of safe collateral and extreme policy uncertainty.
- High inflation will mostly prevent central banks to act as a credible lender of last resort in this difficult economic and financial environment. The attack on UK markets epitomises the limited policy room and contradictions.
- We retain our defensive portfolio positioning for now, with a long cash position, and shorts in equities and High Yield. We keep a small duration position for now but see limited upside for risk-free yields from here. Treasuries are a better haven than Bunds. We find IG credit relatively cheap and offering attractive carry.

YTD total return (€)



Source: Bloomberg, GIAM calculations

Rise in real yields hurts diversification benefits



Source: Bloomberg, GIAM calculation

Double pain: fast-track monetary policy tightening and an EU energy crisis

With inflation so high, central banks will struggle with rescue missions

Tails risks are getting fat. Two large shocks are simultaneously hitting the global economy: the fast-track monetary policy tightening and the EU energy crisis. We turned defensive towards risk assets on the invasion of Ukraine, and warned about further deterioration three months ago (Whatever it takes, in reverse). Financial respite early in the summer, on rising hopes of a Fed pivot, was a head fake: central banks ended the short party in Jackson Hole and are now in panic mode as they look to tame unacceptably high inflation. 75bp hikes have become the norm of 2022 central banks, even in Developed Markets. Europe faces a second crisis, as energy prices have stayed very elevated. Governments are trying to shield corporations and households, partly through the taxation of energy companies, partly through fiscal expansion. But the latter has limits, especially as central banks are not in a position to print money and buy bonds. The ECB's status prevents the monetary financing of public debt. While bond purchases (QE) were acceptable in a period of low inflation, they would be much harder to justify now. The BoE's experiment to do just that (starting QE again) is a terrible predicament for Sterling, now competing with the yen for worst G10 currency performance of the year (the BoJ being the outlier, still easing). These dual crises imply fatter tail risks, both for the economy and financial markets.

Worrying cracks in the financial plumbing

Overshooting fears and impaired market functioning. Global markets are showing signs of stress. First, the reaction function of the central banks is unclear, and extreme policy uncertainty tends to cause financial volatility, raising risk premia and destroying the “animal spirits”. For sure, central banks are focused on killing the inflation beast. But inflation lags the economic cycle. The risk is that hysteresis forces in the inflation cycle (see below) keep central banks on a war path for too long, causing policy overshooting. Such extreme uncertainty can be seen in the surge of implied volatility in short-dated rates, e.g. EUR 1y1y (chart below). This supports a preference for safety, reflected for instance in the particularly large level of EUR swap spreads. Arguably this also reflects a shortage of safe collateral, following years of QE – a lot of the float is now immobilised in the balance sheets of the central banks. Yet this makes investor rushes for safety more immediately reflected in financial stress measures. Remarkably, while the Fed is now trimming bank reserves via its (Quantitative) Tightening (QT), Reverse Repo operations are rising, suggesting a great appetite, from Money Market Funds, for safety. Finally, the US dollar has reached very extreme levels (bottom-right chart), on a trade-weighted and inflation-adjusted basis. This of course is helping the Fed fight domestic inflation, as US import price inflation is set to collapse; but it makes the life of most other central banks much tougher – in particular, in countries with a large current account deficit and high commodity imports. We all remember the 1998 Asian crisis. Current account imbalances are smaller today – but recent large shocks on terms of trade are reversing the trend – another threat to financial stability.

Extreme front-end rates volatility

The shortage of safe collateral, following years of Quantitative Easing – makes investor rushes for safety more immediately reflected in financial stress measures.

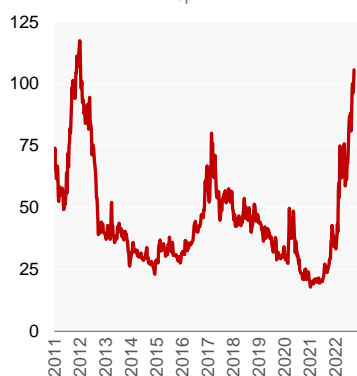
Extreme dollar strength also destabilising

EUR 1y1y implied vol
bp/day



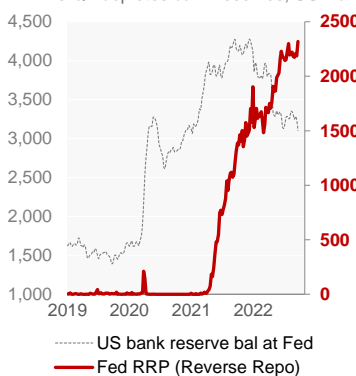
Source: Bloomberg, GIAM

EUR 2y swap spread
bp



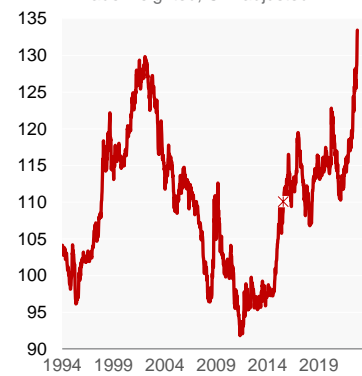
Source: Bloomberg, GIAM

MMF run for max security...
...while QT depletes bank reserves; USD bn



Source: JPM, Bloomberg, GIAM

Real effective USD
Trade-weighted, CPI-adjusted



Source: JPM, Bloomberg, GIAM

As inflation rises the BoJ will need to adjust its YCC policy, and the 0.25% cap on 10-year JGB yields – mind the impact on global bonds and markets

Is the UK financial crisis a canary in the coal mines for highly indebted EA countries?

Attack against unsustainable policies. In this more unstable environment, countries are under pressure where the policy mix carries clear contradictions, even in the usually more stable G10 space. The BoJ is the last dovish survivor, but its outlier policy has caused a historical depreciation of the yen. The MoF has thus instructed the BoJ to intervene in the FX market, for the first time in nearly 25 years. The BoJ cannot have its cake and eat it, though. As inflation rises it will need to adjust its YCC policy, and the 0.25% cap on 10-year JGB yields. This may not even wait for the departure of Kuroda and threatens to cause an additional shock in global bond markets, as the relatively steeper JGB curve makes long-term western bonds less appealing for Japanese investors on a currency-hedged basis. The UK is another case in point, potentially a canary in the coal mines for highly indebted EA countries willing to rely too heavily on the fiscal lever. PM Truss has launched a fiscal stimulus – never a great idea in the middle of an inflation crisis (let alone the fact that tax cuts will only fan inequalities, and the energy shield does little towards “nudging”). Gilts and GBP have been under intense selling pressure, to a point where the BoE has had to delay QT and even start a new round of QE. The aim is to protect financial stability, but such

actions do not help the fight against inflation, and only accommodate reckless fiscal policy – which may cause larger GBP selling, which the BoE may have to fight with larger rate hikes. Such dissociation of policy tools (quantity vs. price of money) is most unusual, and its effects uncertain.

This only serves to highlight the defining danger of these times: high inflation will deter central banks from large-scale interventions, such as QE or rate cuts, at least in the coming months, if not quarters. This may deprive financial markets and investors from the usual lenders of last resort.

Recession showing its ugly head; temperatures do matter!

US economy on the verge of recession. The US economy – now self-sufficient – is relatively insulated from the energy crisis. But the fast-track monetary tightening has led to a sharp deterioration of financial conditions, which will inevitably hurt growth following the short-leave Q3 rebound (left-hand chart below). A manufacturing recession is all but certain, though we expect a better resilience of the broader economy (+0.3% in 2023, with risks heavily skewed to the downside).

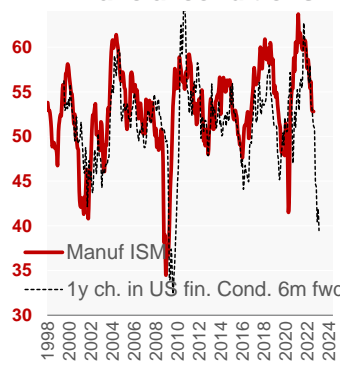
Europe’s energy crisis will leave long-lasting marks. The second chart below highlights the extraordinary natural gas market price difference between Europe and the US. With EU power prices tightly correlated to gas prices, Europe has turned much less competitive. Energy-intensive sectors, such as Aluminium/Steel, Glass, Chemicals, Agro-Food etc. are seeing production cuts and/or delocalisation outside the continent. The energy supply chain has been quickly reshuffled, and gas reserves have built up quickly; but the price effect remains, and rationing may still happen in case of a harsh winter. Europe has suffered a large terms of trade shocks, causing a spectacular deterioration of its trade balance. As the current account turns negative too, the excess domestic savings will vanish, and Europe will become more dependent on foreign investors. This may cause a relative increase in long-term real interest rates, and suggests **Treasuries are a better haven than Bunds right now.** We predict a mild recession (-0.3% in 2023) but macro simulations of adverse natural gas scenarios indicate a potentially much larger drawdown (3% or more).

High inflation will deter central banks from large-scale interventions, such as QE or rate cuts

Sharp deterioration of financial conditions will bring the US on the verge of recession

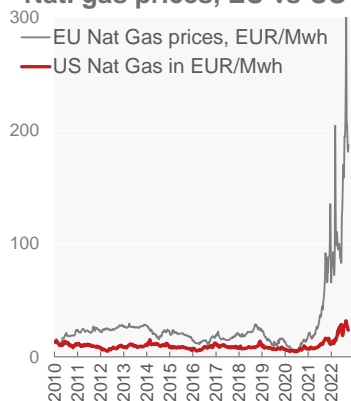
Energy-intensive sectors, such as Aluminium/Steel, Glass, Chemicals, Agro-Food etc. are seeing production cuts and/or delocalisation outside the EU

Sharp tightening in US financial conditions



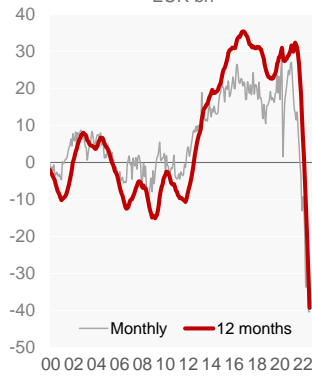
Source: GS, ISM, Bloomberg, GIAM

Nat. gas prices, EU vs US



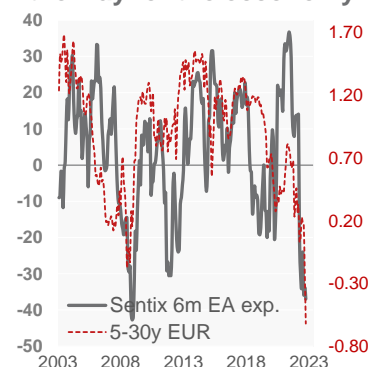
Source: Bloomberg, GIAM calculations

EA trade balance



Source: Eurostat, bloomberg, GIAM

EUR 5-30y curve shows the way for the economy

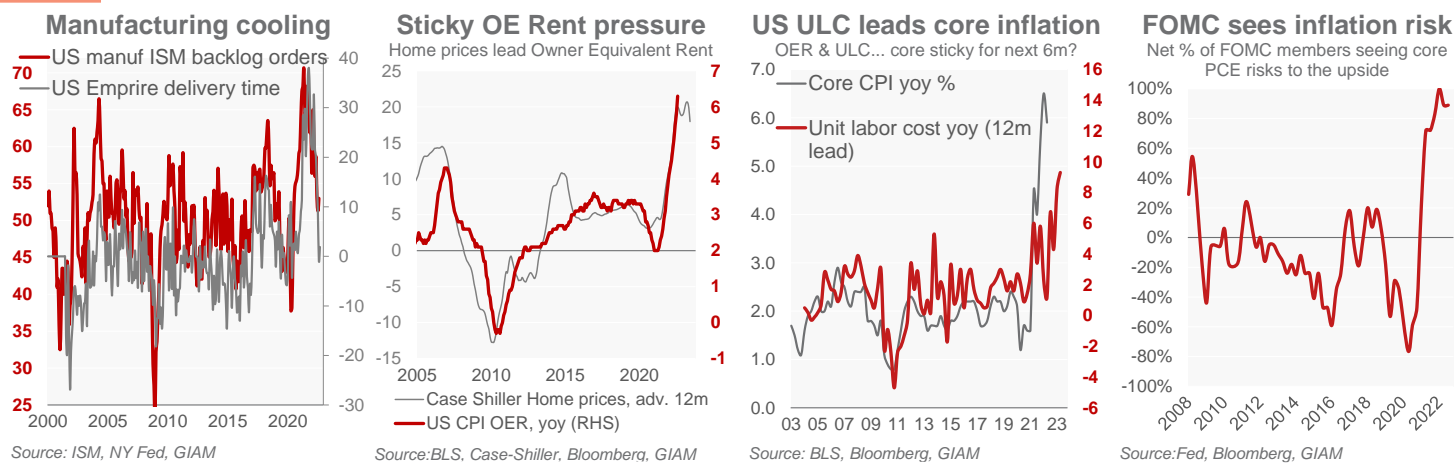


Source: Bloomberg, GIAM

Waiting for Pivot

Watch the FOMC’s insider inflation risk survey. It is not clear how far beyond “neutral” central banks will want to go: the repricing of the implied terminal rates has been a great lesson of humility for investors (and us) this year. On our own measure, the Fed’s policy stance (FF rate – 10y inflation breakeven – neutral rate) is now slightly restrictive, but probably not enough in the face of a (still) tight labour market. The quicker the Fed tightens and the faster the labour market cools off, the quicker the pivot. Already global supply chain pressures are diminishing, and US import prices

have turned. But sticky components will keep inflation higher for longer: annual changes in rents (especially OER) will stay high for another 6-9 months, and elevated wages will keep underlying inflation higher for longer, especially in Services. We will watch all those measures, and more particularly the inflation risk survey inside the FOMC (right-hand chart below). We need to see FOMC members become less certain of upside inflation risk before they can pivot.



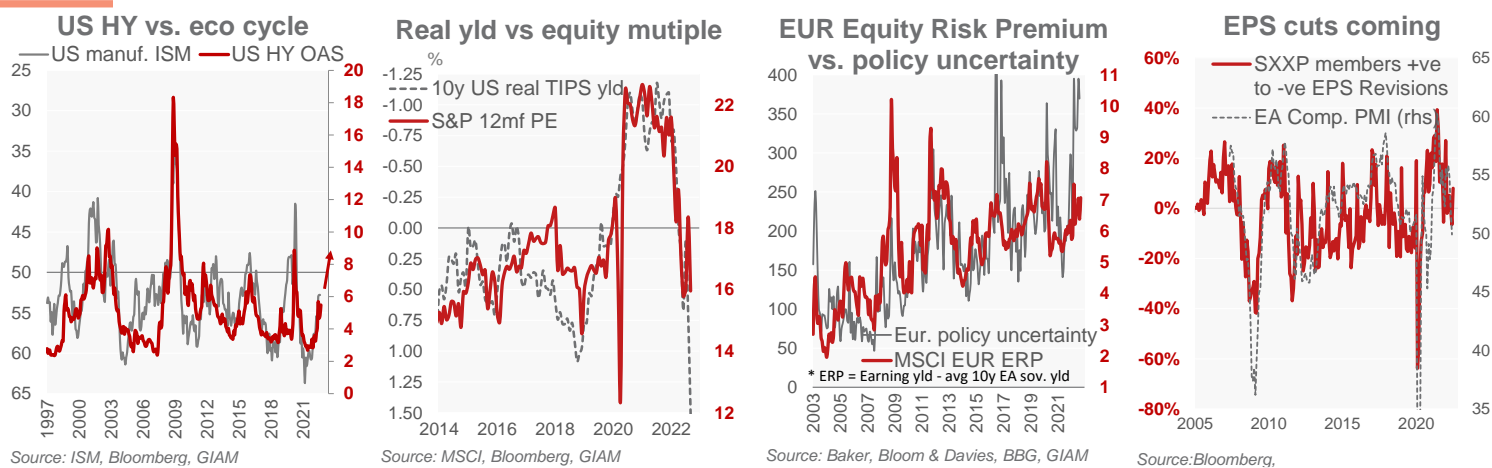
Fat tails also to the upside, but we prefer to play this optionally

Upside risks? A Fed pivot will likely mark a significant turn for global markets. This provides some upside risks, but we see limited scope for a decisive turn in the near term – for now inflation is too high. A reopening of the diplomatic route on Ukraine would be an even more explosive bullish impulse, but this looks even less likely before the turn of the year. If anything, the sabotage of gas pipeline in Europe, as we go to press, marks an escalation in the conflict.

Defensive positioning, but risk assets are not pricing enough bad news just yet

Equity multiples have declined, but the derating has not been as large as the surge in long-term real yields

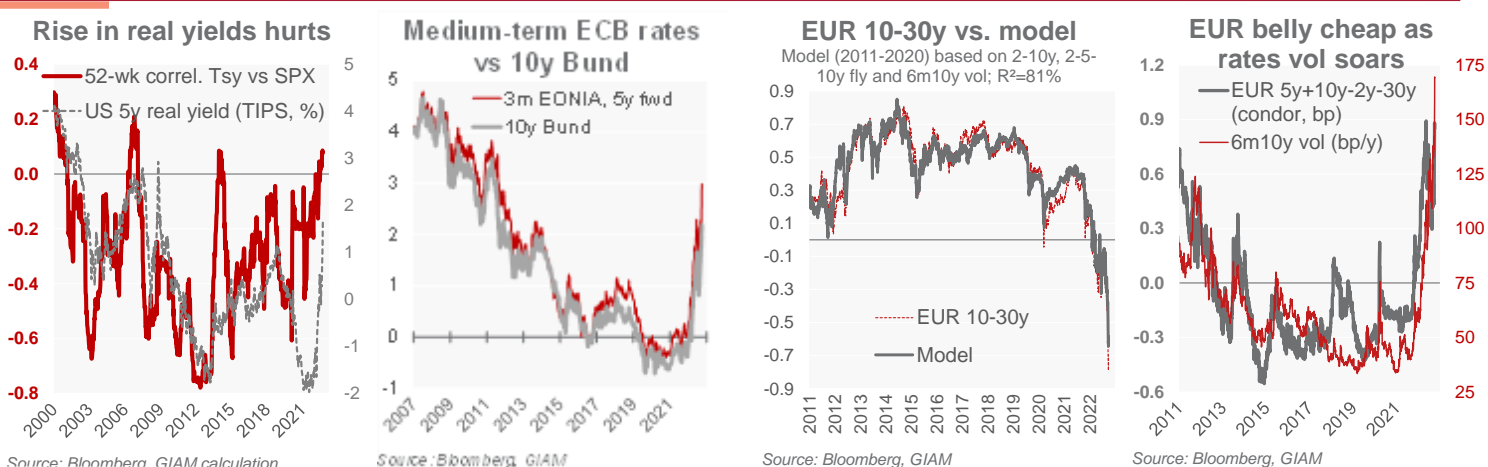
Too early to lean against bearish pressures. The four chart below summarise our reluctance to try and catch the falling knife. Credit spreads have widened, but **High** Yield spreads have ample upside – more than the cushion offered by carry – over the next 3-6 months. As the manufacturing ISM quickly drops below 50, spreads will widen. Equity multiples have declined, but around x16 (12-month forward earnings) the S&P is not that cheap; worryingly, the derating has not been as large as the surge in long-term real yields. The Equity Risk Premium is larger in Europe (~7%) but that may still not be enough in the face of an exceptionally high policy uncertainty. Finally, we expect earnings expectations to fall as recession forces grow (bottom-right chart). In all, we keep an underweight in both Equities and HY, and an OW in cash.



Selective Fixed Income allocations

Positive stock-bond correlation a headache. Cross-asset portfolios have suffered from a positive correlation between stocks and bonds – a typical development through sharp rises in real yields (left-hand chart below). That process is likely not over, yet we see limited upside pressure on US – and to a lesser extent EUR – risk-free yields. Indeed the repricing of terminal rates has already been very large, with expectations now around 4.50-4.75% for the FF target (spring 2023) and above 3% for the ECB deposit rate (late summer 2023). However, 10-year Bund – in contrast to 10-year UST – is still trading at a relatively large discount vs medium-term ECB rate expectations (5y3m ESTR around 3%), leaving upside room for long-term EUR yields. EUR 10-30y flattening has also been extreme, though this is mostly in line with standard curve models and largely explained by surging rates volatility. In all, we still recommend a small short in duration and much prefer Treasuries as a risk-off hedge. We also find the belly of EUR curve attractive relative to the wings, though again such cheapness is largely related to surging volatility.

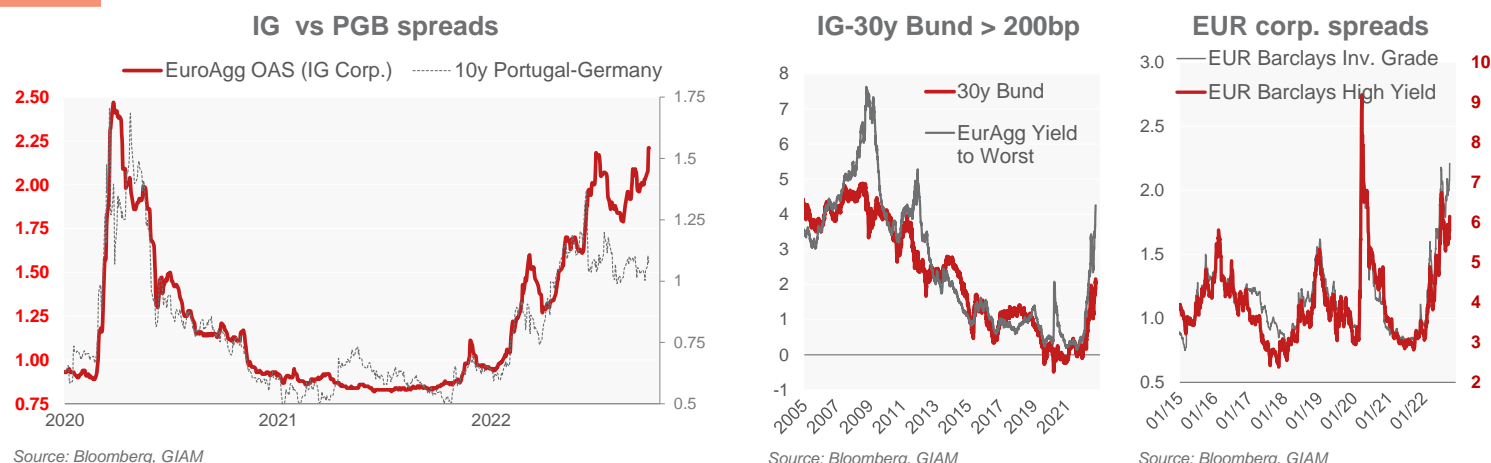
We still recommend a small short in duration and much prefer Treasuries as a full risk-off hedge



We find sovereign spreads now unattractive relative to IG credit spreads

Euro Aggregate now yielding 4.30% – very high compared to long-term risk-free yields

Long IG Credit, defensive High Yield and peripheral sovereigns. Non-core sovereign spreads have been relatively resilient, maybe because the ECB has reassured that it would protect this space through tweaked bond reinvestment and the Transmission Protection Instrument (TPI), if needed. Yet we find sovereign spreads now unattractive relative to IG credit spreads (left chart below) – with relative valuation looking even more stretched on a longer-term basis (including the 2011-12 EA crisis). Of course, IG spread can and will probably widen further in the early stage of the recession, but the average YtW in the Euro Aggregate has surged from 0.5% early this year to now 4.30% – now very high compared to long-term risk-free yields. We find EUR IG credit spread too large relative to HY (on a beta-adjusted basis).



MACROECONOMIC OUTLOOK

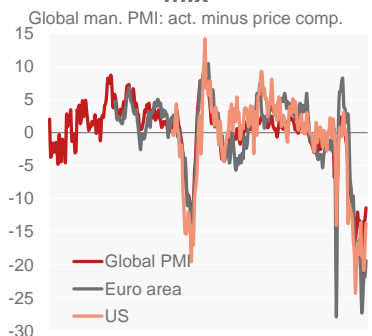
Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

- With the summer boost from reopening services fading, the EA is headed for a recession amid a looming energy crunch, curbed production, tighter financial conditions and eroded real incomes. Outright gas rationing would mean a deeper and longer recession.
- A US Q3 growth bounce will prove short-lived as financial conditions tighten, the housing sector cools, and consumption softens. China's growth will struggle to recover as the zero-Covid policy and the ailing property sector curb the effectiveness of fresh policy stimulus.
- Despite easing supply chain bottlenecks, price pressures will not ease quickly amid a red hot US labour market and soaring energy prices in Europe.
- Central banks (CBs) will further front-load monetary tightening as the Fed and ECB doubled down on their pledge to bring down inflation. Both CBs are likely to deliver another 75 bps 'jumbo' hikes at their next meetings.

A global slowdown is looming amid strong headwinds from inflation, tightening financial conditions and risks to energy supply in Europe

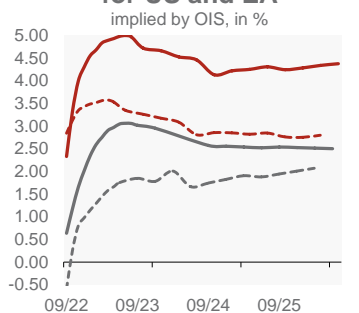
The global economy is headed into a chilly autumn and winter. While the boost from reopening services is fading, the headwinds keep mounting. Runaway inflation keeps eroding real disposable incomes, with Europe hammered by soaring gas and electricity prices. Central banks are slamming on the brakes to deliver on their inflation pledges. Rising risk aversion exacerbates the tightening of financial conditions from higher rates, which are yet to feed through the economy via lower investment. Energy supply uncertainties add injury to insult, with a slump in consumer and business confidence pointing to a marked global slowdown in Q4.

A tricky growth/inflation mix



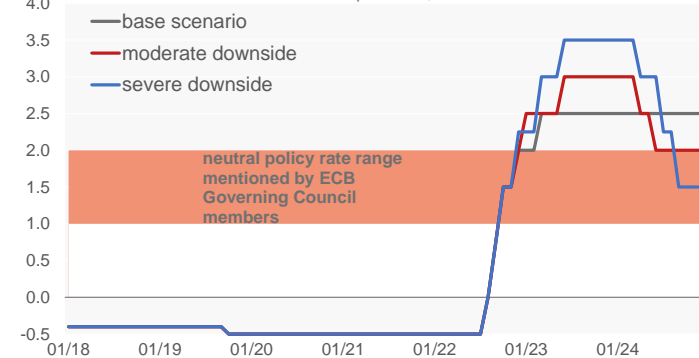
Source: Markit, Datastream, GIAM calculations

Key rate expectations for US and EA



Source: Refinitiv, GIAM calculations

ECB key rate scenarios



Source: Datastream, ECB, GIAM calculations

Global headwinds to mount further into autumn

The US economy is mostly indirectly exposed to the geopolitical and energy uncertainties from the Russian war in Ukraine and thus far showing striking resilience. Yet a mild economic contraction still looks more likely than not for early 2023. The euro area is much more directly involved and is headed for at least a moderate recession, which could turn into a severe one on further gas supply cuts, an unusually cold winter or a military escalation. China keeps struggling to recover from the H1 Covid slump, with adherence to zero-Covid policies and property woes rendering fiscal and monetary stimulus much less effective. Other emerging markets (bar energy exporters) are feeling the headwinds from weaker external demand, a sharp deterioration in global financial conditions. The strong USD is burdening highly indebted EMs and those with a high exposure to global trade.

Major central banks keep front-loading their monetary tightening with jumbo hikes as high inflation threaten to trigger second-round effects via rising wages and inflation expectations. The risks to the bleak outlook are tilted to the downside. Further gas supply disruptions may send Europe into a much deeper recession, while the risks from a military escalation in Ukraine remain high.

Euro area in the eye of the storm

The euro area's high pre-war reliance on cheap Russian energy makes it particularly vulnerable not only to energy shortages but also to the energy-induced price shock. Headline inflation soared to 10.0% yoy by September. This looks close to peak (acknowledging for higher uncertainties from planned gas price caps), but we expect only a very gradual easing. Elevated inflation averaging 8.2% in 2022 and 5.0% in 2023 will dent real incomes. Encouragingly, EU gas storage has currently reached a level of about 88% of capacity, covering energy needs for about two winter months. Gas demand will need to be curtailed further, but with average weather conditions the euro area may be able to just muddle through winter amid curtailed gas supply from Russia, though the margin of error is small. Elevated uncertainty will further drag on confidence and investment spending. Especially energy-intensive firms will suffer sharply from higher input costs. Forward-looking indicators have come down into recessionary territory. Notwithstanding a solid labour market and government measures to cushion the fallout from high energy prices, we expect the euro area economy to fall into recession from Q3/22 to Q1/23. While in 2022 our growth expectation of 3.0% benefits from a strong first half of the year, the forecast growth rate of -0.3% in 2023 reflect the winter recession and an only sluggish recovery afterwards.

Unlike to previous downturns, the ECB will not come to the rescue. With about 75% of the items in the ECB's consumer price index reporting inflation rates above 2.5% and ongoing strong pressure in the pipeline, the focus has narrowed on bringing inflation down. To contain price pressures, the ECB is clearly focused on dampening demand, keeping inflation expectations contained and avoiding second-round effects. After having lifted the key rate by cumulatively 125 bps in July and September we look for further big rate hikes of 75 bps in October and 50 bps in December, bringing the deposit rate to 2.0% by year-end. That would be the upper end of the neutral policy range. In 2023 policy tightening is set to shift after a further 50 bps hike toward phasing out the reinvestments if purchases made under the Asset Purchase Program (APP). The expiring of a large TLTRO of around € 1.5 tr by mid-2023 will also contribute to ECB balance sheet reduction and help to tighten the policy stance.

We see the euro area activity risks clearly tilted to the downside. But as they primarily relate to increased bottlenecks amid an energy crunch, we see inflation even higher and unabated need for ECB action. In such a risk scenario, the policy rate would then be lifted above the 2.5% envisaged in the base case in 2023. However, due to increased spare capacity, rate cuts would come on the table in 2024 (see graph above).

US: Fed turns even more hawkish despite clear recession risks

After a weak H1 and a tentative rebound in Q3, growth in the US is set to slow markedly starting from the last months of the year. We have revised down our forecast for 2023 to 0.4%, and we see a higher than 60% probability of a recession in H1. Despite a still solid labour market and wage gains, the surge in energy prices will dampen consumption. The most interest rate-sensitive parts of the economy are already feeling the pinch from tighter monetary conditions. Non-residential investment will remain weak and construction will continue to shrink, as mortgage rates are back to 2007/2008 levels and curbing house sales and building permits. This is already affecting house prices: over summer the Case-Shiller index stabilised, and its annual growth rate eased to 16%, off the historical high of just above 20%.

High inflation and energy shortages key for our expectation of a euro area winter recession

Further ECB rate hikes above the neutral policy rate and a shift to quantitative tightening in 2023

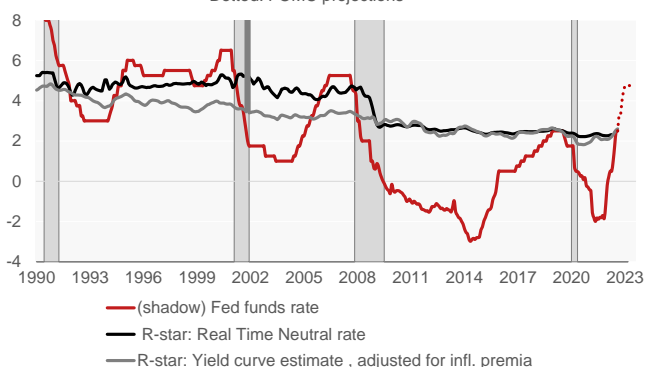
US recession increasingly likely in H1 2023 as tighter monetary conditions weigh on demand...

...but this will not deter the Fed from keeping a restrictive stance

The moderation in house prices rise will only gradually feed through the important rent component of the CPI index. Its acceleration is one of the key drivers for the unsustainable level of core inflation (6% yoy in August), only in part offset by the decline in goods prices inflation, as demand decline and global supply bottlenecks start unclogging. While the headline rate has already peaked and is moderating thanks to lower oil prices, core inflation will remain sticky. It is unlikely to fall below 5% before the first months of 2023. This outlook has pushed the Fed to another hawkish twist at the September meeting, as it seems determined to raise the Fed funds rate to 4.5% by the end of the year. Despite acknowledging that this vastly increases the risk of a hard landing, the Fed flagged that the policy rate is set to remain well above the neutral level by around 200 bps until 2024, as a prolonged period of below trend growth is the price to pay to rein in inflation. The tension between the Fed's front-loaded tightening and a slowing economy will be a key theme over the coming months, but a pivot seems unlikely over the remainder of this year. We expect that the rebalancing between labour demand and supply and a downward trend of inflation will allow the Fed to start cutting rates in H2 2023, to prevent too big a spike in unemployment.

Policy and neutral rate

Dotted: FOMC projections



Source: Federal Reserve Board, Atlanta Fed NY Fed, GIAM

China: Investment in Real Estate and Property Sales

yoy in %, 3mma



Source: Datastream, GIAM calculations

Unlike to previous downturns, Beijing's economic support comes at a measured pace, most likely in order to limit non-financial sector debt.

China: Headwinds not easy to overcome

China's macro data have been volatile amid local Covid lockdowns and a weak real estate sector. We do not expect a change in China's Covid policy in the near term as the medical system could be quickly overwhelmed. We neither expect the Covid policy to change much after the Communist Party Congress (starting October 16) where President Xi is likely to be re-elected for the third time as general secretary – a historical event that underpins Xi's powers. As Xi backs the Covid strategy, a Covid policy U-turn seems unlikely and thus the macro development is likely to stay bumpy.

The second cause of concern is the real estate sector. On top of the debt and funding problems of developers, sales failed to recover. The problems could evolve into a vicious circle with a large impact on growth. Help is coming at local levels while centrally, the PBoC lowered mortgage rates slightly via the 5-year Prime Lending Rate. Beijing also provided (among others) funds to foster finishing stuck projects and to thus mitigate the "mortgage strike". However, all in all these initiatives look underwhelming. We expect more help at a measured pace. A debt restructuring could also come into focus. Measured support is also the name of the game for the overall public stance. The PBoC lowered rates once and we expect cuts of the MLF by 15 bps in Q4. We expect another fiscal package, whose size may be similar to the latest one (RMB 1 tr or 0.8% of GDP). We see GDP growth at 2.7% this year and 5.2% in the next. Risks are on the downside. Headline inflation may temporarily surpass the 3% threshold, but core inflation is low (0.8% yoy) amid weak domestic demand.

GOVERNMENT BONDS

Florian Späte

- **After a short setback in summer, international government bond yields continued their upward trend unabated in Q3. The central banks' focus on fighting inflation set the scene.**
- **Going forward, we do not see a lasting trend reversal in Q4 yet. Although signs of a recession particularly in the euro area are likely to become more pronounced, further key rate hikes are expected to contribute to a further rise in yields. Having said that, the leeway for much higher yields appears limited as self-correcting mechanisms will slow the trend.**
- **Euro area non-core government bond spreads widened moderately in Q3 as the ECB's new anti-fragmentation tool has so far proved to be sufficiently credible. However, the challenging environment is likely to contribute to a further spread widening. It is however assumed that this will happen in an orderly manner.**

International government bond yield climbed to new long-time highs over the course of Q3. The further tightening of central banks' rhetoric and subsequent key rates hikes have contributed. Particularly at the short end of the curve yields rose triggering another flattening of international yield curves. It is noteworthy that the ongoing rise in nominal yields was exclusively driven by real yields as inflation expectations moderated a bit despite upwardly surprising inflation rates. Meanwhile, 10-year US real yields have risen to the highest level since 2010 (1.5%) and their German counterparts have reached the highest level since 2014 (but remain in negative territory).

Going forward, we see more scope for yields to rise as the central banks' commitment to bring inflation down looks credible. Nevertheless, the implications for US and Bund yields differ as the Fed is forecast to reach its peak already in H1 2023 and embark on key rate cuts afterwards. Accordingly, the long-term expectation for key rates (proxied by US 5y3m OIS) is around 3.35%. If anything, we regard this already as too high given the forecast decline in inflation longer term and the looming weak growth environment. But even this level is well below current 10-year US yields implying some scope for lower yields further down the road. The real yield level mentioned above also appears unsustainable and is likely to correct in the medium term. That said, in the short term the hawkish Fed is likely to dominate and push US yields up bit.

By contrast, a peak for the ECB is only priced at earliest in H2 2023. This implies that euro area government bond markets will continue to face headwinds from the ECB for the time being. What is more, at around 3% the ECB is priced to reach restrictive territory but not to the same extent as the Fed. Accordingly, subsequent key rate cuts are likely to be more moderate than those of the Fed. Additionally, 10-year real Bund yields do not appear excessive at -0.1%. Considering a higher term premium, we regard this as appropriate and even see some further upside potential for long-dated Bund yields. What is more, EA 5y3m OIS above 2.8% signal further upside potential for 10-year Bund yields. In contrast to the US, the yield on 10-year bonds is thus still well below the expected medium-term key rate level (which has shown a tight correlation to long-term yields in the past). Additionally, the technical situation will worsen significantly going forward. Assuming the ECB will start Quantitative Tightening in 2023 (we forecast about EUR 180bn) we get a net-net supply of more than EUR 600bn. This would be the highest supply ever. Finally, the development in the UK is an indication of how bond markets react to an unexpectedly expansive fiscal policy. 10-year UK yields (and 2-year yields even more) have sky-rocketed after the release of new fiscal measures and the accompanying additional net financing requirements. While we do not expect fiscal policy in the euro area to become so expansive it clearly

Scope for much higher US yields limited as Fed cycle is sufficiently priced

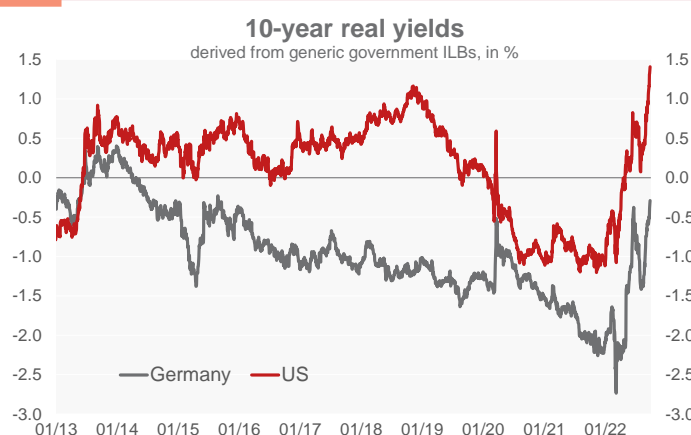
shows the vulnerability of bond markets to a higher government bond supply and an even tighter monetary policy. Finally, the Bank of Japan remains a wildcard. In case it gives in to market pressure and adjusts its Yield Curve Control by lifting the cap of 0.25% for 10-year JGBs the attractiveness of foreign bonds for Japanese investors is reduced. However, for the time being this is just a risk scenario.

Still, there are some balancing effects which are seen to prevent yields going through the roof. To start with, our fair value models see 10-year Bund yields at 1.7% (10-year US yields at around 3.0%). This points to some caution regarding a continuation of the recent trend. Moreover, there are some self-correcting mechanisms. Financial conditions have already tightened and the weak growth outlook (a recession in the euro area appears unavoidable) is likely to cap any yield increase. Moreover, there is so much debt circulating which increases the vulnerability of the financial system that even for long-dated Bund yields the forecast increase is likely to be moderate. Finally, fears about increasing fragmentation in the euro area will help to cap the core yield increase. Overall, on a 3-month horizon we expect 10-year Bund yields to rise to 2.3%.

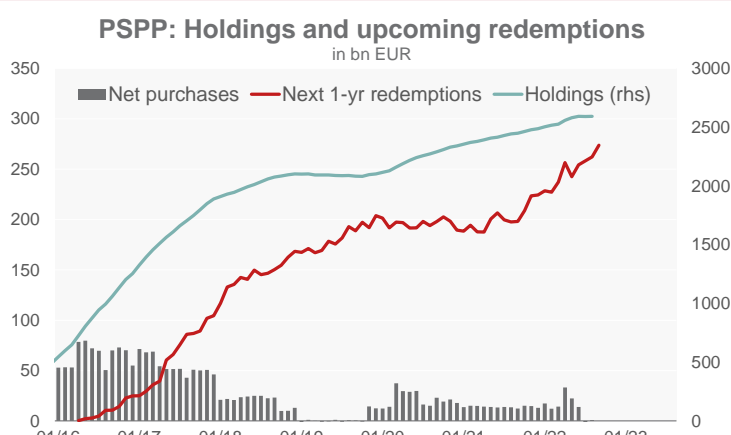
Looming recession and fragmentation fears to cap increase in Bund yields, but trend is still upwards

Challenging environment to trigger widening of EA non-core bond spreads

While there was a moderate upward trend for euro area non-core bond spreads in Q3 Italian BTP spreads widened more as markets digested the victory of the centre-right coalition in Italy. However, there was no strong flattening of the BTP spread curve indicating the movement proceeded in an orderly manner. The ECB's new instrument to prevent fragmentation has a meaningful degree of credibility so far.



Source: Bloomberg, GIAM



Source: Datastream, ECB, GIAM

Flexible reinvestments of maturing PEPP bonds not sufficient to prevent spread widening

Going forward, we see a continuation of the spread widening as the combination of a hawkish ECB, higher core yields, a looming recession, and (more generally) an expected weakness in risky assets does not bode well for euro area non-core bonds. However, in our base scenario we do not forecast a further significant underperformance of Italian BTPs assuming the new government will broadly comply with the fiscal rules and follow the EU regulations. However, in case excessive fiscal spending triggers uncertainty about the disbursement of Next Generation EU funds the inevitable recession in Italy would be even deeper triggering rating risks. There would then be a danger that a vicious circle of debt sustainability concerns and wider spreads emerges.

In addition to the now higher spread level our only moderate spread widening expectation is based on that the ECB is using reinvestments of maturing PEPP holdings flexibly to support non-core bond markets. Finally, the Transmission Protection Instrument is another tool that the ECB will not hesitate to use if necessary. Overall, we forecast the 10-year BTP/Bund spread to reach 270 bps on a 12-month horizon.

CREDIT

Elisa Belgacem

- We remain OW IG within our global asset allocation as we like the carry versus sovereign bonds in particular.
- On HY, we also retain our UW position on the back of fast deteriorating fundamentals and complicated technicals, with a HY primary market that remained nearly closed since the war in Ukraine. We do expect further 50 bp widening into year-end.
- Rating agencies have only started to incorporate recession projections into their rating assessment. They should start with the lower end of the rating spectrum and the most cyclical sectors. We now expect defaults to end at 4.5% in 2023, but the amount of government support and the depth of the recession will be the key drivers.
- The impact of "E" scores on idiosyncratic pricing should also increase under the influence of the ECB's new climate strategy, which will tilt the central bank's private purchases towards climate-friendly issuers.

Corporate fundamentals will result in lower ratings mostly in IG in 2023

Fundamentals will deteriorate and weigh on HY. Throughout 2022, IG and HY have diverged in leverage trajectory to the latter's detriment. The war in Ukraine has been a turning point for macroeconomic expectations, but rating agencies have only started recently to adopt a cautious stance in their global rating assessments. As they did in 2020, we expect them 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. Predicting defaults in this context is also a rather complex exercise. On one side, Europe's gas situation will command a recession that could vary according to winter temperatures. And on the other side, the government support that helped contain defaults to 5% in Europe during Covid will be smaller due to lesser fiscal leeway from governments. Should this not be the case, and government to decide massive fiscal support to their private sector via debt financing, it would cause interest rates to rise and, in the end, also have a negative impact on defaults as the absolute level of interest rates is a key driver of company insolvencies. Also, we expect smaller companies to be the most at risk. Hence banks' asset quality should also deteriorate, which leads us to remain underweight financials versus non-financials.

Valuations already incorporate a pretty dark scenario, but technical will add pressure. When looking at valuations, the European HY market is already incorporating nearly 9% defaults which is significant.

EUR Credit market performance by segment

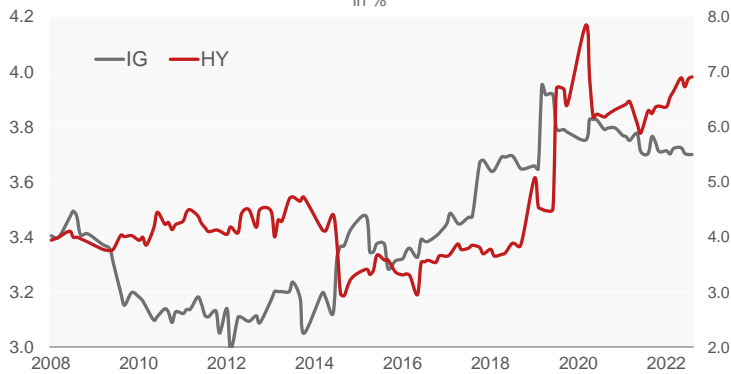
Total return base : 01/01/2022



Source: Bloomberg, BofAML, GIAM own calculations

IG vs HY Leverage ratio

in %



Source: iBoxx, GIAM own calculations

Hence in our view, the main point of attention in HY is the absence of supply since the start of the war in Ukraine. Even if we have only approximately EUR20bn of bonds having their final maturity within HY benchmarks next year, we believe that the market

will have to reopen at some point. For doing so, corporates will have to pay very sizeable premiums to investors which will pressure secondary levels. Conversely, in IG, the amount of cash on corporate balance sheets remains at record high levels, which means that, given the current context of higher spreads and rates, supply should be less of a headwind over the coming months.

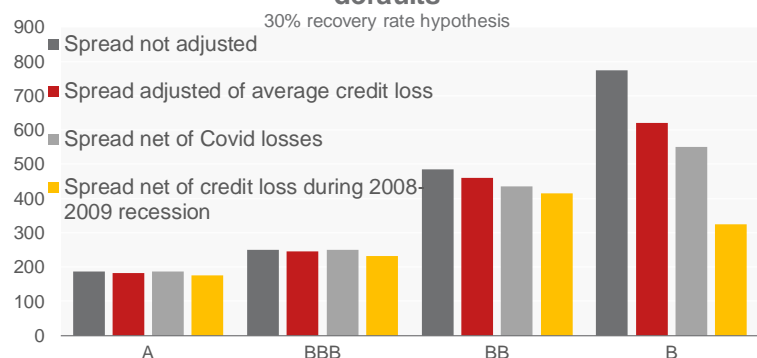
The ECB will start applying climate criteria

Green tilting but on how many purchases? The ECB has announced (see [link](#)) that it will tilt its corporate purchases starting 1 October according to the following three criteria: 1. A backward-looking sub-score is based on issuers' past carbon emissions. 2. A forward-looking sub-score calculated according to the objectives set by issuers to reduce their greenhouse gas emissions in the coming years. 3. Finally, a climate disclosure sub-score will reflect the issuers' quality reporting of greenhouse gas emissions. According to our analysis, within the ECB private bond portfolio based on scopes 1 and 2 emissions normalised by sales, the sectors with the heaviest carbon issuances are 1/ Utilities, 2/ Materials, and 3/ Energy. The fact that the ECB scores are not only discriminating among peers within sectors but also across the entire portfolio may eventually penalise 'dirty' sectors and relatively favour clean ones.

This is an essential step for the ECB. Yet quantitative tightening (QT) is fast approaching, potentially reducing the reinvestments in the APP already in Q123. This may reduce the market impact that could have been initially envisaged. That being said, as most private investors are concomitantly attempting to improve the carbon

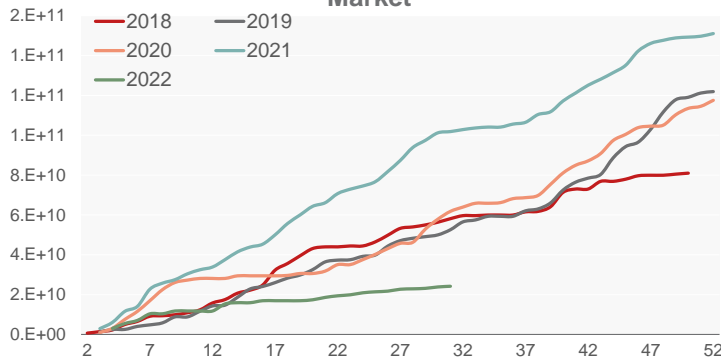
The ECB climate policy might trigger some sector rebalancing towards cleaner sectors

EUR Credit spreads adjusted for 12m defaults



Source: S&P, Bloomberg, GIAM own calculations

Weekly evolution of the EUR HY - Primary Market



Source: iBoxx, GIAM calculations

footprint of their portfolio, we are still expecting the "E" component of the ESG scores to feed into credit market valuations gradually.

Decompression trade still on

Hence, we do prefer IG to semi-core and peripheral sovereigns. IG levels are currently incorporating a severe recession scenario. We expect spreads to tighten moderately from current extreme levels into year-end. For HY, we are more cautious as we think corporates will feel the pressure of the economic slowdown that has not yet been reflected in companies' earnings during the last reporting season and expect a further 50bp widening. Overall, we recommend a defensive sector positioning and expect real estate and consumer cyclicals to be the sector the most at risk. Also, in this context of rising defaults, we prefer subordination risk to credit risk. Within subordinated bonds, we prefer AT1s as we expect them to be more resilient than single-bs for a marginal yield give-up.

EM SOVEREIGN CREDIT

Guillaume Tresca

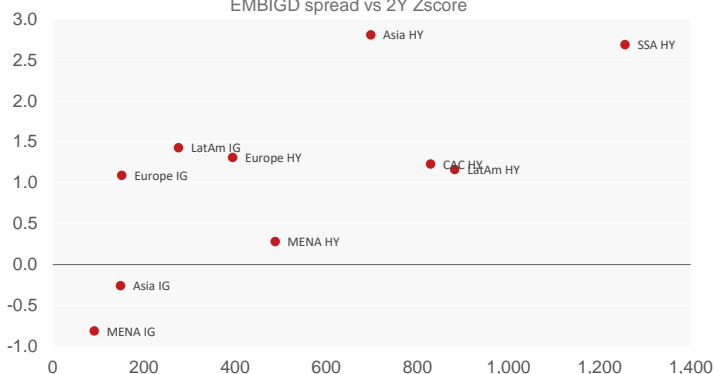
- We turn underweight EMs external bonds as EMs continue to face multiple headwinds with the risk of further deterioration. The carry is not enough to offset the spread widening risk any longer.
- Spreads will continue to widen as long as global real rates do not decline substantially and EM growth does not improve. China is still a drag on the EM growth momentum, and we do not expect the October Congress to change the outlook.
- Given the cyclical risk, we maintain a defensive stance, favouring EM IG over HY. EM fixed income valuations are not attractive in our view.
- Lowest-rated EM countries are facing increasing financing pressures, compounded by the closing of the primary market. That said, it is not an imminent threat.

Turning underweight EMs. The global EM environment has remained challenging, facing multiple headwinds with risks skewed to further deterioration. Uncertainty is running high with the distribution of risk has fat tails. While we adopted a defensive stance on EMs since Q1, we now turn underweight EMs external bonds in our global allocation. The high carry is not enough to offset further spread widening and the duration risk, in our view

First, while the Chinese outlook was expected to improve, it remains a drag on the global economy, and the October Congress will likely not be a game changer. As long as there is no significant improvement on the global growth front, we expect EM spread to widen globally in the coming quarter. Second, DM central banks have reaffirmed their hawkish stance with force. EM spreads can not tighten as long as US real yields do not decline meaningfully. The early summer rally was driven by the false impression of a Fed pivot that was annihilated by the Jackson Hole’s rhetoric. We can not rule out a Fed pivot in the medium term, but it is too early, and EMs face their own challenges. Third, the only positive development is the recent deceleration of inflation in particular EM countries. It has to be confirmed, and we will expect inflation to remain high in EM Europe over the winter, given the energy risks.

EM IG is rich, HY optically cheap

EMBIGD spread vs 2Y Zscore



Source: Bloomberg, JP, GIAM

EMBIGD is not so cheap

EMBIGD ex CCC and NR, OAS bp



Source: Bloomberg, JP, GIAM

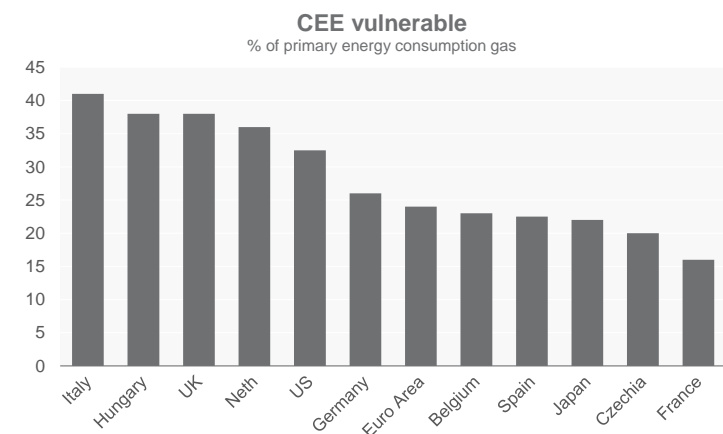
We prefer EM IG over HY. Valuations are not attractive

High cyclical risk, stay defensive

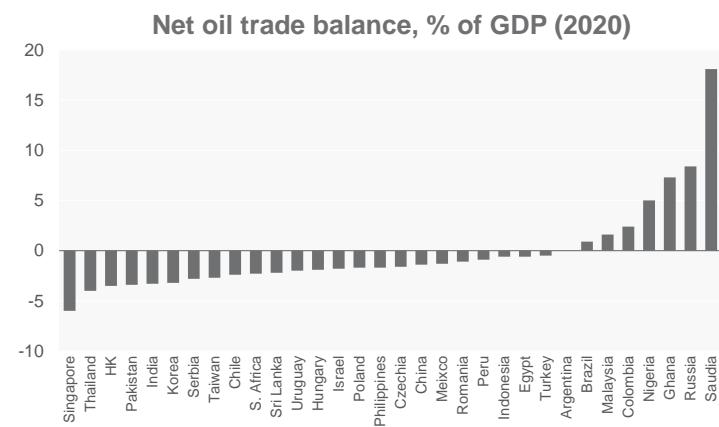
It is not yet time to buy EM assets. It is better to offer to maintain a defensive stance given the wide range of risky events in the quarter to come. We maintain our EM IG preference vs. EM HY. Within the EM HY space, CCC will continue to suffer from refinancing risk in a strong USD environment. That said, we do not see value in the

BB and B space either, given the close of the primary market and the risk of issuances later this year and in Q1 that will weigh on the secondary market.

Moreover, in our view, EM fixed income valuations are not yet attractive in absolute levels. It is always hard to make historical comparisons for EMs, given the structural changes at play. If anything, EM IG has been rich while EM HY is cheap, but only optically. The EM HY index is now concentrated in the 600bp area. Many distressed countries – 13 countries traded above 1000bp - distort the index to high spread levels. For instance, the EMBIGD spread ex CCC and non-rated countries is just above its long-term average.



Source: DataStream, GS, GIAM



Source: JP Morgan, GIAM

EM HY refinancing is not a short-term issue.

Increasing financing pressure

Lowest-rated EM countries are facing increasing financing pressures, compounded by the closing of the primary market. Net issuance has been negative since March 22, reaching a record of c. USD50 for EM sovereigns year-to-date. It should weigh on BB spreads, especially, and B spreads, as they will need to regain access to primary markets. However, access is not urgent and is more of a long-term issue. There are not many bonds maturing in the next 18 months. The most at risk are Tunisia, Salvador, and Pakistan. The latest statements from authorities and the level of FX reserves suggest that a missed payment is unlikely.

Lowest rated countries can, fortunately, rely on the IMF support that has been recently more relaxed on debt sustainability and swift in its support. Likewise, EM countries have been more open to asking for IMF support – for instance, Serbia. It remains that half of the frontier markets are at high repayment risk in the next three years (25 countries). It is essentially countries with small external financing gap below USD1bn

The commodity trade turning negative

The positive commodity trade is over, while most EM HY commodity exporters are lagging the index. Despite the decline in commodity prices, energy prices still remain 30% higher than a year ago. Only the largest oil exporters benefit from the current environment, while the revenue from agricultural and metal exports is declining for EMs. Therefore, the high energy prices are detrimental for EMs that are no longer benefiting from the positive commodity trade experienced in Q1/Q222. EMs current account balances are deteriorating on average, turning negative. We will focus on countries with solid CA balances within a strong USD environment and refinancing pressure. On the one hand, MENA countries are the clear winner given their low oil price breakeven. That said, governments have not reduced their fiscal vulnerability to a future oil price decline. Non-oil revenue is still low. On the other hand, EM Europe countries like Hungary are vulnerable because of a large CA deficit and high gas intensity in primary production.

CURRENCIES

Thomas Hempell

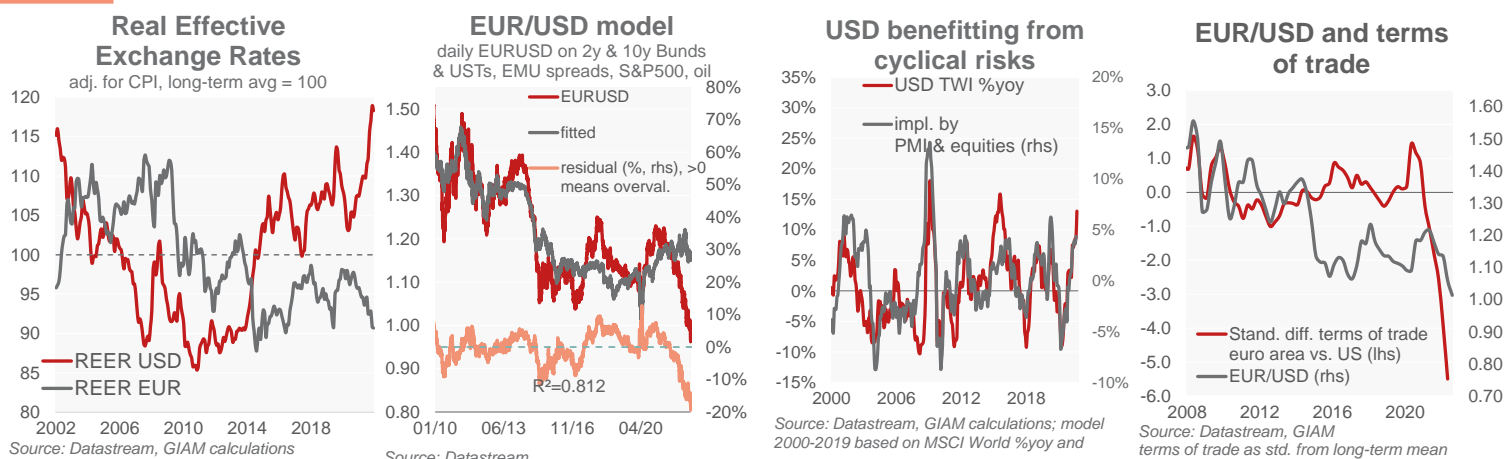
- Geopolitical tensions, a meaningful global growth slowdown and the Fed's determined inflation fight are set to keep the USD bid, even after a rally to lofty values this year.
- The dollar's strong outlook is mirrored by weakness among its peers. The EUR is burdened by the energy crisis, a looming recession and sharp deterioration in its terms of trade.
- Japan's attempts to stabilize the plunging yen via FX intervention look futile as long as a policy reversal by the BoJ is not in sight (yet). Sterling is being eroded by ill-suited fiscal policy amid one of the deepest stagflation dilemmas among advanced economies.
- The Swiss franc stands out as the most attractive European alternative to the USD amid continued safe-haven flows, an SNB now tolerant about CHF appreciation and favourable inflation differentials that keep the real value of the CHF at bay.

The USD is keeping its ascent towards lofty valuations – and may well advance further. First, with the US showing striking resilience and the labour market red hot, the Fed is set to deliver on its pledge to keep front-loading its monetary tightening. Another 75 bps 'jumbo' hike is likely on Nov. 2. With another 50 bps step looming for December the Fed will keep leading the global tightening cycle.

The USD is dear – and yet there is scope for an extended ascent

Persistent USD dominance

Having soared by 17% (DXY, i.e. vs. major peers) and 12% (trade-weighted terms), the USD has climbed to lofty valuations (see first two charts below). And yet a reversal is not on the cards. On the contrary, the looming energy crunch in Europe and a further deterioration in risk sentiment is likely to render even further USD strength over the coming weeks (third chart).



The EUR remains burdened by the energy crunch and an ensuing recession

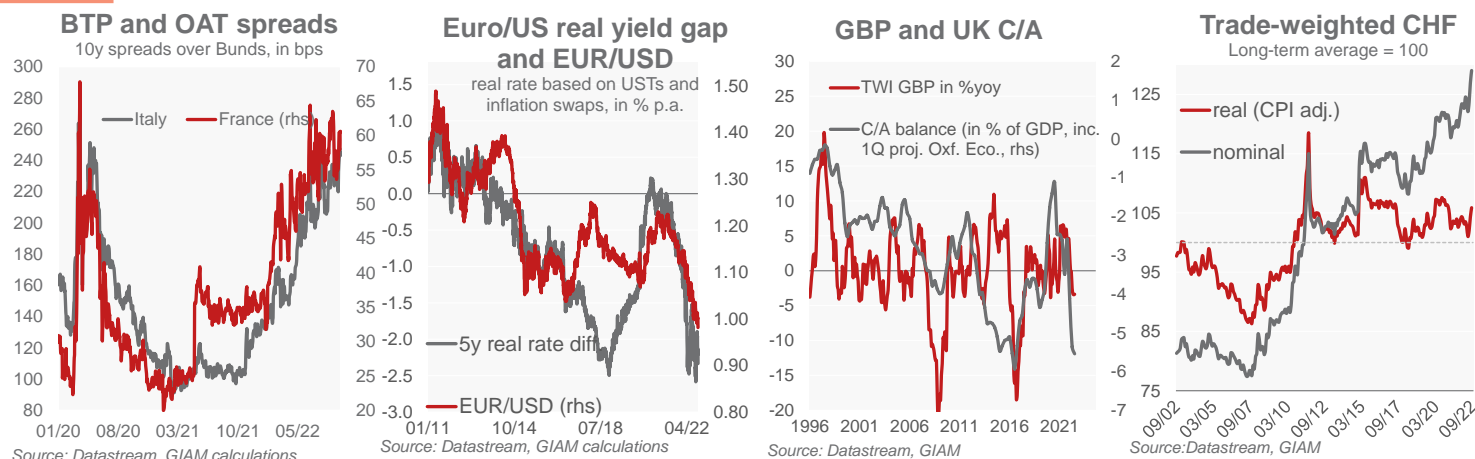
The USD dominance is compounded by the cracks undermining its main peers. The EUR is headed for further weakness amid looming energy crunch and recession. Furthermore, soaring costs of (energy) imports have turned the euro area's current account surplus into a deficit, while the term-of-trade (the relative costs of exports vs. imports) have been deteriorating sharply, with the ratio vs. the US plummeting to more than five sigmas below historical average (right chart). While the ECB is tightening the screws, too, this provides only very limited tailwinds for the EUR. First, it adds to financial fragmentation in the euro area, with higher BTP spreads unfavourable for the EUR. Second, despite the ECB's catch up, the significant real yield gap against the USD remains consistent with an even lower EUR/USD (see chart left charts

below). We therefore confirm our bearish view on the EUR/USD and lower our forecast to 0.94 and 0.95 on a 3- and 6-month view (from 0.99 and 1.03).

FX intervention in Japan is not a game changer for the yen

The JPY keeps suffering from the ever-wider yield gap with the US, as the BoJ sticks to its ultra-accommodative policy stance and yield curve control (YCC). As the USD/JPY hit a 24-year high, Japan's Ministry of Finance (MoF) started to intervene, which brought some short-term relief to the battered yen. But this is likely to prove futile. First, interventions are not backed by other central banks, as the strong USD is helping the Fed in its inflation fight. Second, they do not remove the underlying source for yen weakness, i.e. monetary policy divergence.

FX intervention in Japan is likely to prove futile as long as it is not backed by a policy reversal by the BoJ



Inconsistent policy responses further undermine the outlook for sterling

Sterling has suffered a deep blow. Cable dropped by almost 10% in Q3, making it the worst performing G-10 currency. The risks are tilted towards further weakness. The inconsistent policy mix (untargeted fiscal stimulus and monetary tightening) is eroding credibility in sterling among foreign investors, which is needed to finance the deepening C/A deficit (mid chart). The BoE's emergency resumption of QE amid the recent turmoil of Gilts markets is just compounding investors' doubts about policy makers' ability to effectively address the UK's stagflationary dilemma.

Most EM currencies are also headed for some more weakness, though not disaster. While the USD/CNY has broken through the 7.0 threshold, the yuan is likely to remain pressured by a widening yield gap, Chinese property woes and the persistent drag from the zero-Covid policy. Generally, EM currencies have proven relatively resilient to the sharp spike in US yields (in contrast to the 2013 taper tantrum). Most EM currencies have entered this year fundamentally cheaper than in 2013, current account positions are more balanced today and many EM central banks started their tightening cycles well ahead of the Fed and the ECB. Yet the tightening of global financial conditions and capital flows out of EM amid higher risk aversion are still set to maintain the headwinds. CEE currencies are particularly exposed, also given their high beta exposure to the EUR/USD and the energy crisis in Europe.

The looming recession in Europe and higher FX tolerance by the SNB make the CHF an attractive European alternative to the USD

This means that the USD has scope to extend its strength quite broadly over the coming weeks. The CHF, however, stands out as the most attractive European alternative to the greenback. Continued safe haven flows are likely to persist as the recession hits the euro area but not necessarily Switzerland while peripheral spreads may rise further. Also, the SNB has become much more tolerant about CHF appreciation as it helps to contain import price inflation. Finally, despite the CHF's recent ascent, the more muted inflation in Switzerland compared to most peers has kept the real effective value of the franc much more muted than nominal exchange rates suggest (see right chart).

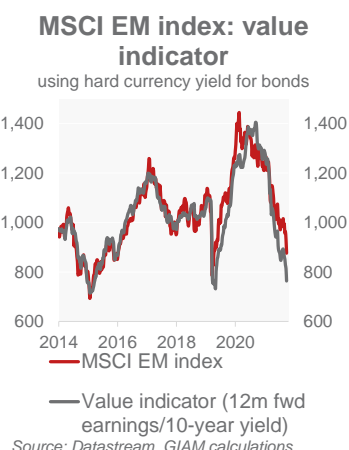
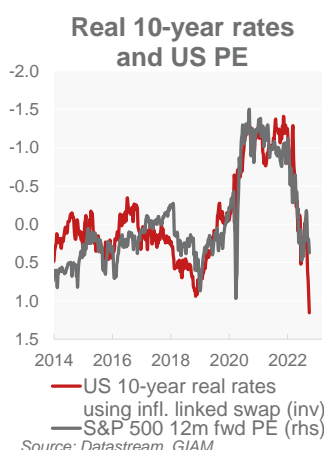
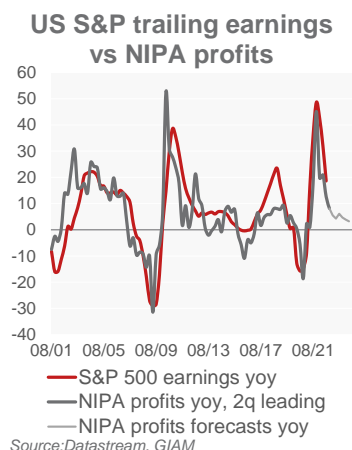
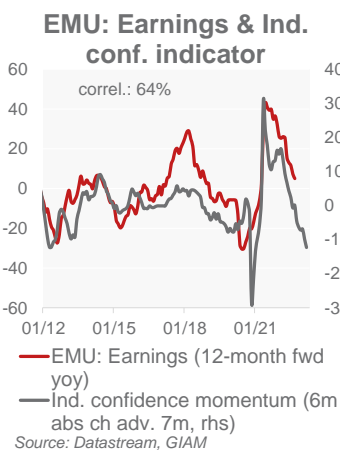
EQUITIES

Michele Morganti and Vladimir Oleinikov

- We continue to hold an UW position on Equities. The war is giving signs of escalation and both sanctions as well as energy supply issues are causing negative growth revisions and high inflation to linger.
- Furthermore, as Central Banks (CBs) have increased their hawkishness during the summer, 10-year rates reached new highs and will trigger continuing deterioration in financial conditions, raising firms' cost of capital and inducing investors to demand an even higher risk premium while lowering PEs.
- Due to ongoing negative GDP revisions, we expect earnings to surprise current consensus on the downside for the period 2023-2024, at least by 10%. As inflation will remain at very high levels for the next two quarters at least, we see a higher and even more volatile risk premium going forward. The US Tech represents an additional risk for the market as its valuation bubble has not dissolved yet (nearly 30% expensive on our fair value model).
- Inside equities, we are slight overweight (OW) China, UK and Japan. Neutral USA vs. EMU and UW SMI. Sector OWs: Oils, Banks, Cons. services, Div. financials, Durables, Health Care Equip., Food, Software, plus Defensive style. UWs: Cap. goods, RE, Media, Comm.& professional services and Transportations.

Equities remain under pressure, inducing us to maintain our UW position. The war gives signs of escalation and CBs have become even more dovish since the summer as inflation data remained stickily high. They reaffirmed their priority in bringing back inflation to target, openly affirming this could provoke a temporary economic recession by the tightening of financial conditions. Indeed, we see ongoing negative GDP revisions which ultimately will induce a reset of earnings growth projections, especially for the euro area (EA). Here, risks are quite skewed to the downside due to severe energy crunch which worsen firms' confidence and decrease capacity utilization and margins' perspectives. Our earnings' assessment sees 2023 growth of about 5% for the US and zero for EMU (base scenario). The recent events are putting such esti-

Markets pressured by higher real rates, credit spreads, war risks and lower confidence



Falling net corporate savings and tightening loans add to our expectations of falling consensus earnings

mates at high risk. We see the concrete chance to see -5% for the US and -10% for EMU. A full recession would increase the negative growth at -15% and more for EMU. In our base scenario the gap vs. IBES in 2022-2024 is 3%-10% and 6%-14%, in the US and EMU, respectively. Indeed, in addition to negative GDP re-revisions and lower capacity utilization, unit labour costs are clearly trending up. At the same time, the US will also feel the pressure from the stronger USD and increasing US bank tightening standards plus lower corporate financial surplus (cash flow minus capex). The latter are also contributing to the worsening in financial conditions and profitability. Indeed, non-fin. firms remained surprisingly in expansion mode during H1 2022, inducing also higher capex. Now, as they turn down, the positive free cash flow gap is

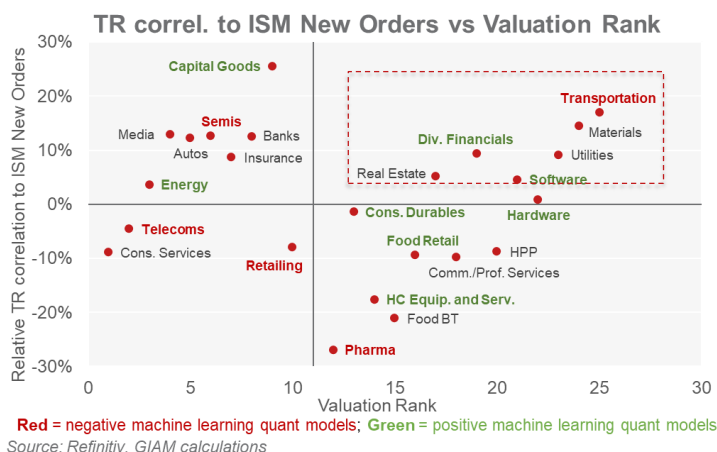
Looming recession and high energy prices and inflation will negatively affect demand and profitability

increasingly at risk. Furthermore, tightening credit conditions would persist, given the aggressive stance of central banks (increasing QT included) and recession fears.

Expected poor earnings momentum should be seen in combination with the market PE perspective. As 10-year real rates increased further, the US PE is not in equilibrium yet. Theoretically, current yields would demand the US PE to decline further by 1-3 pp. The same is true in the EA, judging by the Sentix indicator and BAA spreads. Net-net, we see marginal positive returns in 12 months which are still very much at risk. Indeed, looking to history, with inflation remaining above 4-5% for longer, the average requested risk premium could translate into lower target prices. Such risk premium has also been extremely volatile in periods of high inflation, inducing fair value swings of nearly 12%. In a worse-case scenario, we see the SPX index to reach 3,150. Having said this, one positive factor is represented by the extremely low investors' positioning. SPX futures net short are very extreme, just like the combined BoFA Bull-Bear indicator, which flags a contrarian buy signal. Net equity-bond flows are also declining rapidly and are currently not distant from a cyclical trough.

Inside equities, we are slight overweight (OW) China, UK and Japan. Neutral USA vs. EMU and UW SMI and EM. EU sectors: looming recession plus high energy prices and inflation will negatively affect demand and profitability. A positive correlation with ISM New Orders implies an underperformance in a recessionary environment. We

	Median return												
	10Y yield			10Y real yield (using breakeven)		Fed funds rate		Real Fed funds rate (using CPI)		realized bond vola	move		
	current*	[2.5 3]	[3 3.5]	[3.5 4]	[0.5 1.0]	[1.0 1.5]	[3 3.5]	[4 4.5]	[-4 -2]	[-2 0]	[>8.6]	[90 109]	[>109]
Equity vs Govies	✓	=	=	=	✓	✗	✗	✓	✓	✗	✗	✗	✗
Equity vs IG	=	✗	✗	=	✗	✓	✗	✗	✓	✗	✗	✗	✗
Equity vs HY	✓	✗	✗	✓	✗	✓	✗	✗	✓	✗	=	✗	✗
IG vs Govies	✓	=	✓	✓	✓	✓	✗	✗	✓	✓	✓	✓	✓
HY vs Govies	✓	✗	✗	✓	✓	✓	✗	✗	✓	✓	✗	✗	✗



also look to valuations, including our proprietary quant ML models, which favour green names (see chart). Sector OWs: Oils, Banks, Cons. services, Divers. financials, Durables, Health Care Equip., Food, Software, plus Defensive style. UWs: Cap. goods, RE, Media, Comm.& professional services and Transportations.

EM Equities: slight UW while keeping cautious OW on China

We have recently downgraded our EM stance on EMs. The equities are pressured by deteriorating financial conditions and falling macro surprises. While the yield advantage (vs the US HY) looks favourable, we expect the persistently strong USD to represent headwinds over medium term. Furthermore, our adjusted Fed model gives indication of overvaluation while falling export orders and weak earnings should maintain EMs at risk in relative terms.

Chinese equities are undervalued on different measures (Fed model, combined valuation score, attractive PEG - PE adjusted for expected EPS growth) and should benefit from higher government's policy support, and rebounding credit impulse. Additionally, China's inflation remains contained as compared to that of the developed markets. The self-imposed Covid restrictions have chances to be phased out in the short term (20th Communist Party Congress in October). China's real estate and geopolitical risks must be monitored, representing the source of volatility.

EMs: pressured by strong USD and deteriorating financial conditions and macro surprises

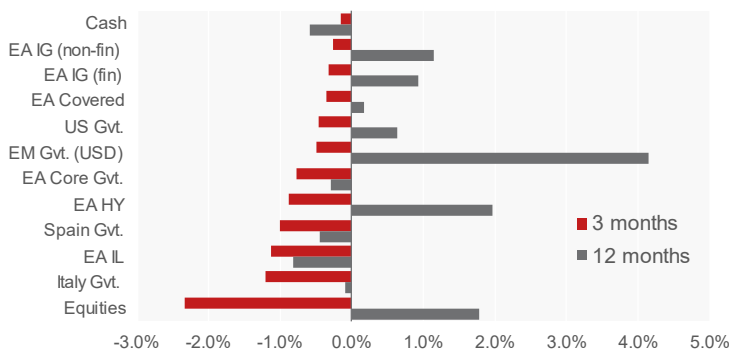
ASSET ALLOCATION

Thorsten Runde

- While the positive stimulus of reopening services over the summer is petering out, the euro area (EA) finds itself at the verge of a recession.
- Soaring energy prices in Europe are directly weighing on disposable income but also by fuelling inflation through higher production costs.
- With curbing inflation being the top priority of central banks further significant rate-hikes will keep real yields rising and thus burdening risk assets.
- Recession fears, rising real yields, energy strains (maybe even a gas rationing) and thus imminent earnings downgrades let us confirm our UW in Equities and HY Credit. Due to rising yields and political imponderables, we take a cautious stance on Southern European debt. We also confirm our preference for IG Credit. With yields set to rise further, we stick to a moderate short position in duration and keep our OW in Cash.

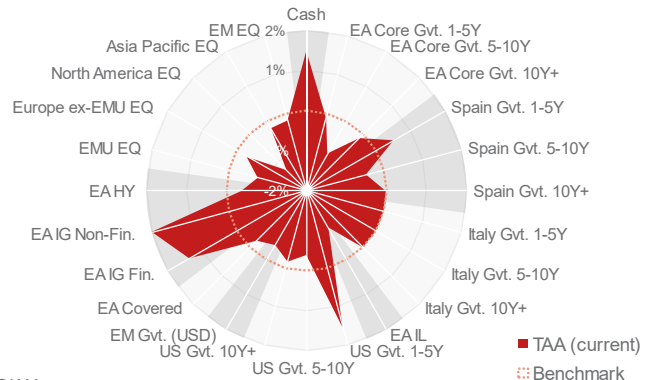
Basically, maintaining a defensive tactical allocation stance since mid-March has so far proven quite rewarding, except for the short recovery phase over summer. In the current environment of economic and geopolitical uncertainties, good arguments for switching to a more offensive stance right now are hard to find.

Aggregated Total Return Forecasts
(hedged into EUR)



Source: GIAM

Balanced MtM Model Portfolio
(active positions in pp)



Source: GIAM

With the energy crunch hitting the economy profoundly, the EA is facing a recession in the cold season. Its depth and length will largely depend on whether it comes to an outright rationing of gas supply. Price pressures will stay high, melting down disposable incomes and straining consumption. Financial conditions will tighten further. With the central banks' commitment to fighting inflation as the one and foremost priority, the way for further rising real yields is paved.

Under these conditions none of our actively covered asset classes is expected to perform positively over the next three months. We deem Cash and EA IG Credit to be the most attractive ones. IG Credit appears undervalued on duration grounds and still provides some attractive carry. With rising yields on the cards, we prefer to stay moderately short duration. All in, we confirm our overweight positions in EA IG Credit and Cash. As real yields are rising too, the circumstances for risk assets should stay unfavourable for the time being. We thus maintain our underweight positions in Equities and EA HY. On Southern European debt we are slightly more positive than on EA Core Govies, given the distinctively higher carry and only a moderate expected spread widening. That said, we stay cautious given the political uncertainties in Italy and a further scaling back of ECB support.

FORECASTS

Macro Data

Growth	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	
US	5.7	1.6	- 0.1	0.4	- 0.3	1.4
Euro area	5.2	3.0	0.2	- 0.3	- 1.2	1.2
Germany	2.6	1.3	- 0.2	- 1.5	- 2.2	1.5
France	6.8	2.5	0.1	- 0.1	- 1.3	1.5
Italy	6.6	3.2	0.2	- 0.2	- 1.3	1.3
Non-EMU	6.5	3.2	0.1	0.5	- 0.0	1.6
UK	7.4	3.5	0.1	0.0	- 0.1	1.5
Switzerland	4.2	2.5	0.0	1.5	0.3	1.8
Japan	1.7	1.2	- 0.2	1.4	- 0.2	0.8
Asia ex Japan	7.8	3.9	- 0.7	4.9	- 0.2	5.1
China	8.1	2.7	- 1.0	5.2	- 0.2	4.8
CEE	6.8	1.1	1.9	1.3	1.1	3.5
Latin America	6.4	2.5	0.0	1.2	0.0	2.2
World	6.4	2.9	- 0.1	2.3	- 0.2	3.1

Inflation	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	
US	4.7	7.8	- 0.3	3.9	0.1	3.1
Euro area	2.6	8.2	0.4	5.0	0.9	2.6
Germany	3.2	9.0	1.5	6.5	2.3	1.9
France	2.1	6.7	1.2	4.0	0.8	1.8
Italy	2.0	7.6	0.6	4.2	1.1	0.6
Non-EMU	2.3	7.8	0.3	5.7	1.0	2.2
UK	2.6	9.1	0.5	7.0	1.4	2.5
Switzerland	0.6	2.7	- 0.0	1.8	0.2	1.2
Japan	- 0.3	2.5	0.5	2.1	0.7	0.9
Asia ex Japan	2.0	3.8	0.1	3.5	0.3	2.6
China	0.9	2.4	0.0	2.7	0.2	2.0
CEE	9.3	29.5	0.2	16.8	1.8	8.0
Latin America	6.6	8.2	1.1	4.9	0.7	3.3
World	3.5	7.8	0.2	5.0	0.5	3.1

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

Financial Markets

Key Rates	Current*	3M		6M		12M	
		Forecast	Forward	Forecast	Forward	Forecast	Forward
US	3.25	4.50	4.23	4.50	4.55	4.25	4.38
Euro area	0.75	2.00	2.02	2.50	2.72	2.50	3.09
Japan	-0.10	-0.10	-0.00	-0.10	0.04	0.00	0.15
UK	2.25	3.25	4.79	3.50	5.85	3.50	5.95
Switzerland	0.50	1.00	1.24	1.50	1.72	1.50	1.81
10-Year Cvt Bonds							
US Treasuries	3.85	3.90	3.90	3.85	3.89	3.70	3.89
Germany (Bunds)	2.16	2.30	2.19	2.30	2.21	2.25	2.21
Italy	4.50	4.75	4.66	4.85	4.71	4.95	4.78
Spread vs Bunds	234	245	247	255	250	270	257
France	2.77	2.90	2.81	2.95	2.85	2.95	2.90
Spread vs Bunds	61	60	62	65	64	70	69
Japan	0.25	0.25	0.33	0.30	0.38	0.40	0.46
UK	4.25	4.35	4.33	4.35	4.33	4.20	4.35
Switzerland	1.41	1.50	1.41	1.50	1.41	1.45	1.43

Credit Spreads**	Current*	3M		6M		12M	
		Forecast	Forward	Forecast	Forward	Forecast	Forward
EA IG Non-Financial	196	200		195		190	
EA IG Financial	224	225		220		215	
EA HY	582	660		630		610	
EM Sov. (in USD)	413	418		415		400	
Forex							
EUR/USD	0.96	0.94	0.97	0.95	0.98	1.02	0.99
USD/JPY	145	146	143	140	141	135	138
EUR/JPY	139	137	139	133	138	138	136
GBP/USD	1.08	1.02	1.08	1.06	1.08	1.13	1.07
EUR/GBP	0.89	0.92	0.90	0.90	0.91	0.90	0.92
EUR/CHF	0.95	0.93	0.95	0.94	0.95	0.97	0.94
Equities							
S&P500	3,674	3,600		3,640		3,725	
MSCI EMU	117.7	114.5		117.0		119.5	
TOPIX	1,864	1,835		1,860		1,930	
FTSE	7,004	6,845		6,935		7,140	
SMI	10,140	9,880		9,980		10,185	

*3-day avg. as of 28/09/22

**ICE BoFA (OAS)

FORECASTS

Forecast Intervals*

3-Months Horizon

10-Year Gvt Bonds	US Treasuries	3.43	3.90	4.37
	Germany (Bunds)	1.40	2.30	3.20
	UK	3.57	4.35	5.13
	Switzerland	0.73	1.50	2.27
Credit Spreads*	EAIG Non-Financial	168	200	232
	EAIG Financial	192	225	258
	EAHY	573	660	747
	EM Sov. (in USD)	368	418	468
Forex	EUR/USD	0.92	0.94	0.96
	USD/JPY	142	146	150
	GBP/USD	1.00	1.02	1.04
	EUR/CHF	0.91	0.93	0.95
Equities	S&P500	3,418	3,600	3,782
	MSCI EMU	109	115	120
	TOPIX	1,749	1,835	1,921
	FTSE	6,569	6,845	7,121
	SMI	9,371	9,880	10,389

*ICE BofA (OAS)

12-Months Horizon

10-Year Gvt Bonds	US Treasuries	2.84	3.70	4.56
	Germany (Bunds)	0.70	2.25	3.80
	UK	2.86	4.20	5.54
	Switzerland	-0.03	1.45	2.93
Credit Spreads*	EAIG Non-Financial	133	190	247
	EAIG Financial	153	215	277
	EAHY	449	610	771
	EM Sov. (in USD)	304	400	496
Forex	EUR/USD	0.98	1.02	1.06
	USD/JPY	128	135	142
	GBP/USD	1.09	1.13	1.18
	EUR/CHF	0.94	0.97	1.00
Equities	S&P500	3,375	3,725	4,075
	MSCI EMU	109	120	130
	TOPIX	1,745	1,930	2,115
	FTSE	6,560	7,140	7,720
	SMI	9,267	10,185	11,103

*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.

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. Martin Pohl GI CEE Economist 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.”

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio periodically updating the contents of this document, relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible changes or losses related to the improper use of the information herein provided. Opinions expressed in this document represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. Certain information in this publication has been obtained from sources outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representations are made as to the accuracy or completeness thereof. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..