GENERALI INSURANCE ASSET MANAGEMENT

Market Perspectives

Laws of gravity

May 2023

GIAM Macro & Market Research

‘Market Perspectives’ provide our monthly macro & market outlook and investment recommendations

- **Markets have climbed a wall of banking worries, with the help of resilient economic data and earnings, more dovish Fed expectations and fresh central bank liquidity.**
- **Yet we expect the looming credit crunch, lower earnings and rising defaults to still take their toll – and the laws of gravity to still apply. The war in Ukraine, simmering US/China tensions and the US debt ceiling are adding to the downside risks.**
- **We maintain a cautious stance on Equities and HY, while favouring carry from Government Bonds, non-financial EUR IG Credit and – more prudently – EM bonds. We also like US Treasuries for their hedging properties against more adverse scenarios.**

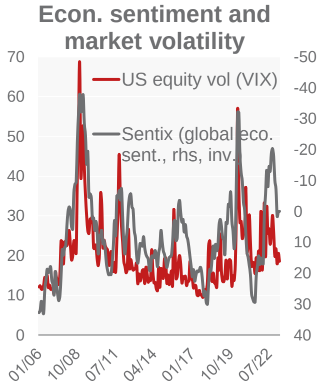
Content

Global View – Laws of gravity

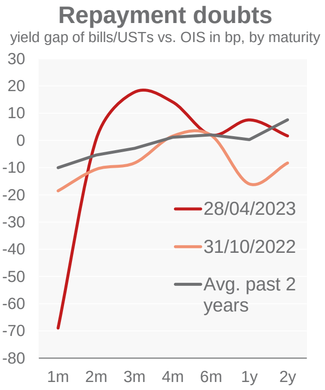
Thomas Hempell

- **Markets have climbed a wall of banking worries, with the help of resilient economic data and earnings, more dovish Fed expectations and fresh central bank liquidity.**
- **Yet we expect the looming credit crunch, lower earnings and rising defaults to still take their toll – and the laws of gravity to still apply. The war in Ukraine, simmering US/China tensions and the US debt ceiling are adding to the downside risks.**
- **We maintain a cautious stance on Equities and HY, while favouring carry from Government Bonds, non-financial EUR IG Credit and – more prudently – EM bonds. We also like US Treasuries for their hedging properties against more adverse scenarios.**

The banking turmoil into mid-March was a stark reminder that rapid and synchronized monetary tightening tends to cause accidents. Yet the S&P in the second half of March reversed its 8% drawdown, with the help of the Fed's liquidity injection, before seesawing in April. Euro area equities even surpassed the pre-SVB crisis highs.



Source: Datastream, GIAM



Source: Refinitiv, GIAM

Arguably, the collapses of SVB, Signature and Credit Suisse saw limited contagion, but lastingly curbed rate expectations – a looming credit crunch is partially doing the Fed's job. The end-24 Fed Fund Futures is now below 3% vs. 4.20% pre-SVB. Acute banking worries have receded, but the (equity market) support from lower yields has prevailed (10yT yield down ~50bp from early March). Strong Q1 data (China reopening, revenge spending in US/EA services) feeds into the Q1 earnings season. Liquidity injections by central banks (Fed providing emergency liquidity, BoJ defending YCC, PBoC providing stimulus) have boosted markets globally.

Yet we caution against getting lured into risky assets by the recent market strength. Unusually, cyclicals have lagged vs. Defensives in this rebound. The banking crisis keeps resonating, with e.g. First Republic still at the brink. Equity multiples have expanded more than justified by the real yield decline. With the credit crunch harming growth, earnings will suffer and defaults will rise. The liquidity injections by central banks will prove temporary, as quantitative tightening proceeds. The reversal of this support will also send volatility higher. The VIX, back to pre-war levels at around 17%, looks detached from economic sentiment (left chart).

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	3.44	3.35	3.25	3.10
Germany (Bunds)	2.42	2.40	2.35	2.20
Credit Spreads**				
EA IG Non-Financial	144	155	160	155
EA IG Financial	180	195	205	195
Forex				
EUR/USD	1.10	1.11	1.13	1.15
USD/JPY	134	130	127	125
Equities				
S&P500	4088	3990	4005	4030
MSCI EMU	149	144	146	150

**3-day avg. as of 26/04/23 **ICE BofA (OAS)*

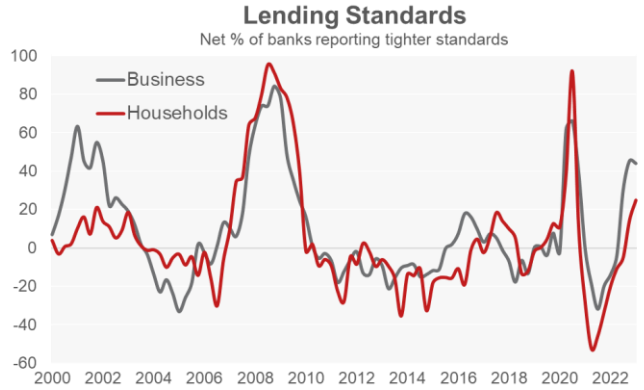
Furthermore, geopolitical risks abound, with the war in Ukraine set for a spring offensive and US/China tensions (Tech war & Taiwan) simmering. Markets are also right in getting nervous about the political stalemate on the US debt ceiling, that will likely start to bite in July. Investors now pay more than 1.6% for insuring against a US default over the next twelve months, more than the 0.82% paid at the height of the 2011 debt ceiling crisis. The short end of the US Treasury market is strongly disrupted by mounting repayment worries over summer (right-hand chart).

Risk complacency unlikely to pay off for long

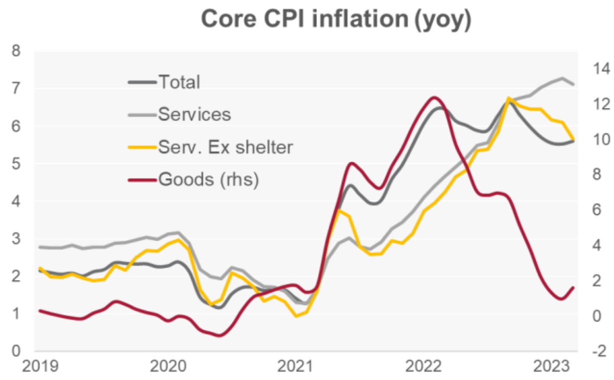
Against these risks and the looming US recession over the second half of the year, we sense an elevated degree of market complacency. The laws of gravity from a darkening macro outlook should still prevail, and more so as the recent easing of financial conditions and sticky inflation prints will keep central banks rather hawkish in the near term. We maintain a cautious stance on risky assets such as Equities and HY Credit. By contrast, we keep overweights on Govies, with a preference for mid-dated Bunds and shorter maturities for BTPs. The outlook for yields is skewed to the downside, but we avoid strong duration bets amid persistent curve inversion. We also like (mostly non-financial) IG Credit in EUR, which are decently priced and – more prudently – EM bonds. We also see value in US Treasuries, which offer good hedging properties. We see more downside for the USD by year-end amid the looming US recession and the prospective lead of the Fed in a global easing cycle.

US

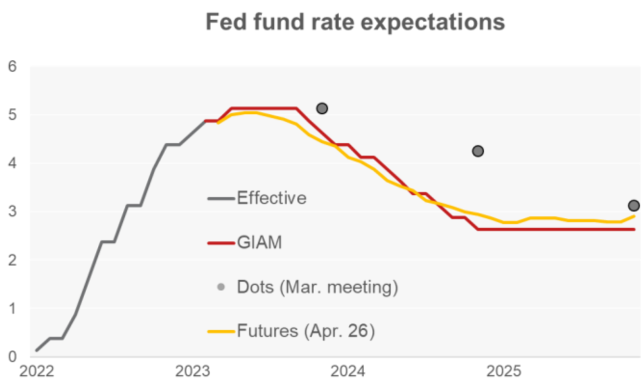
Paolo Zanghieri



Source:Federal Reserve, Refinitiv,GIAM



Source:BLS, P.Skrzypczyński , Refintiv, GIAM



Source: Federal Reserve Board, Refinitiv, GIAM

- **Despite a poor headline GDP number, domestic demand remained strong in Q1. Tighter monetary policy and loan standards will lead to a contraction in activity in H2, with just 0.3% growth in our books for 2023.**
- **Core CPI inflation is easing very slowly and should remain at around 4% by year end. Wage pressures are unlikely to abate soon.**
- **We expect another, final, rate hike at the May meeting. Despite the FOMC hawkish rhetoric the first cut should occur in November.**

The first release of Q1 GDP came in lower than expected (1.1% ann. versus 2%), but domestic demand posted an healthy 3.2% annualised growth. The crisis following the collapse of Silicon Valley Bank has not spiralled out of control yet, but the worries about First Republic Bank and the still elevated use of the Fed liquidity facilities show that the banking sector is feeling the pinch. We expect lending conditions to tighten further, adding to the negative effect of higher rates on demand. This will lead GDP to contract in H2, limiting growth to 0.3% for the year as a whole.

Core inflation eased marginally in March (6.4% yoy), and the ex-shelter services component (which the Fed is mostly concerned about) edged visibly down. A combination of base effect, disappearing supply bottlenecks and weaker demand will help disinflation. But the process will be slow; despite the deceleration in job creation, with nearly 1.7 openings for unemployed person, wage growth is not set to decline soon from the 6.4% yoy posted by the median wage in March.

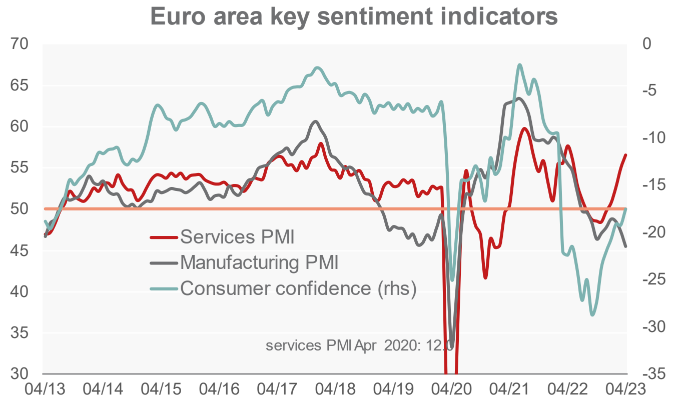
Final rate hike in May, first cut in November

Despite the concerns for the banking sector, disinflation remains too timid and demand too solid for the Fed to tune down its hawkish rhetoric. Yet the minutes of the March meeting show an increasing divergence within the FOMC about the extent of further tightening. Given the steadiness of the labour market, we expect another rate hike, which will bring the policy rate to the 5% - 5.25% range indicated by the March dots. The FOMC communication is signalling no cuts for this year, but markets remain convicted that the first one will take place already in September. Our growth forecast is less optimistic than the Fed's one and we expect rate cuts in the two final meetings of the year.

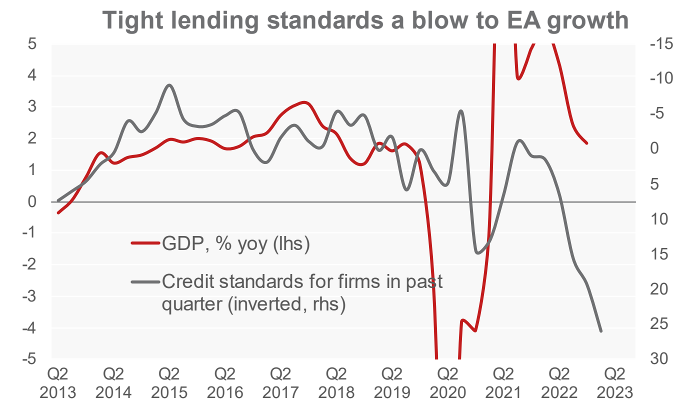
Political risk will re-emerge, as by July the Congress will have to find a deal to lift the debt ceiling. In the past, a compromise, involving budget cuts, has always been found; this remains our base case. Yet the current high polarisation and the Republicans' insistence to scale back the funding of part of the Inflation Reduction Act increase the likelihood of an accident.

Euro Area

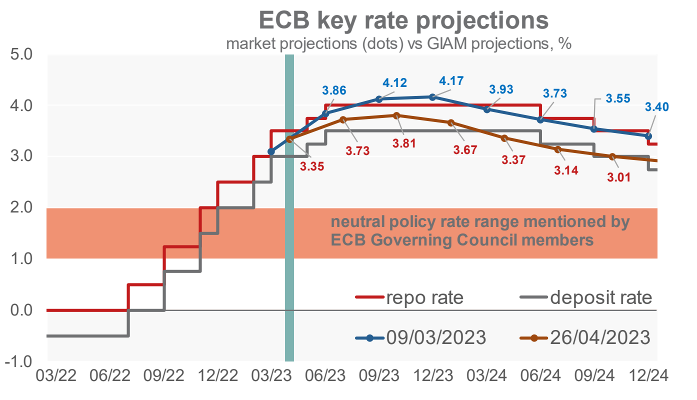
Martin Wolburg



Source: Datastream



Source: Datastream, BLS, GIAM calculations



Source: Datastream, ECB, GIAM calculations

- **The euro area started the year with only a slight expansion in Q1.**
- **Amid energy price induced disinflation, activity is set to accelerate in Q2, with the April composite PMI at the highest in almost a year. But the fallout from higher rates and banking turmoil will keep a lid on the speed of the recovery in H2.**
- **While headline inflation will recede further, stubbornly high core inflation amid rising wage pressure will induce further rate hikes, in spite of increasing financial stability risks.**

Over the past month economic activity indicators surprised on balance on the positive side, even if GDP expanded by only slightly by 0.1% qoq according to the first (flash) estimate. The uptrend in sentiment continued with the composite PMI at 54.4 in April, the highest since May last year and consistent with a quarterly growth rate of 0.5% qoq. Likewise, consumer confidence trended up to the highest level since the Russian invasion in Ukraine started. Ongoing energy-price driven disinflation was a key factor with consumer price inflation receding to 6.9% yoy in March, a one-year low, and it will drive inflation further down in the months to come.

That said, we caution to become overly exited about the activity outlook. The unprecedented monetary policy tightening of 350 bp within one year amid further hikes will increasingly drag on activity. Bank lending standards have already risen and are set to advance even more in response to higher refinancing conditions. The payback of a large TLTRO by June (of € 476 bn) will tighten financing conditions further. Moreover, we expect that at least some of the US induced banking sector wows to be felt in the euro area, aggravating credit standard tightening further.

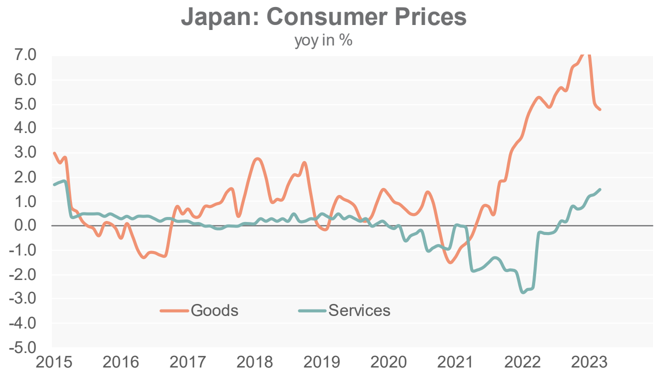
All in all, we increase our 2023/24 growth forecasts slightly by 0.1 pp each to 0.8%/0.7%, which is above consensus in 2023 but below in 2024.

Limited banking sector stress allows for more rate hikes

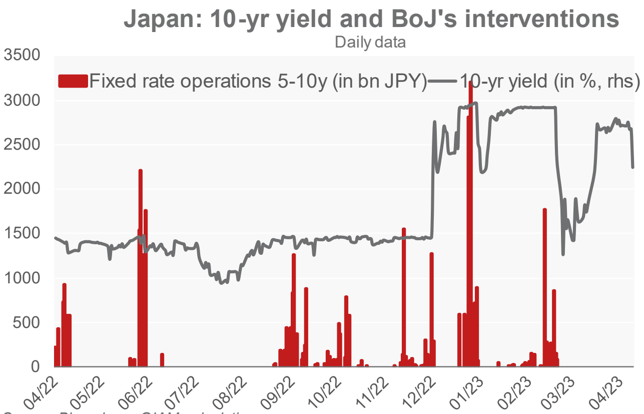
For the ECB the situation remains challenging. Core inflation will ease only gradually, high German public wage increases (~6% yoy) add to the risk of second-round effects while activity holds up well so far. Against this backdrop latest comments from Governing Council (GC) members were clearly hawkish. There are so far no signs of a financial crisis emanating from the banking sector stress and GC members made clear that they do not expect that either. Hence, we deem it most likely that the ECB sticks to its tightening script. But given high uncertainty and key rates already in restrictive territory, we look for only two remaining 25 bps hikes in May and June bringing the terminal (deposit) rate to 3.5%.

Japan

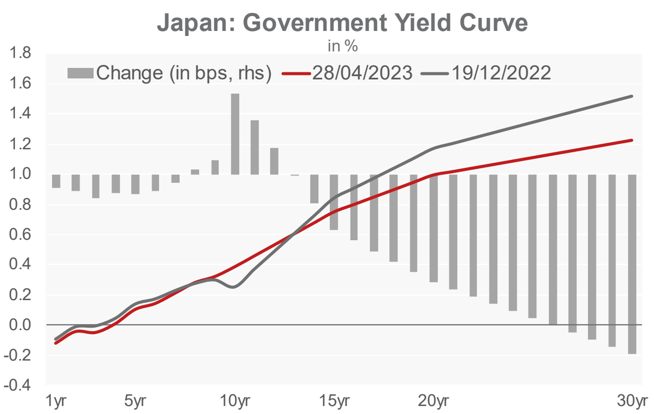
Christoph Siepmann



Source: Datastream, GIAM calculations



Source: Bloomberg, GIAM calculations



Source: Bloomberg, GIAM calculations

- **Bank of Japan (BoJ) Governor Ueda kept the yield-curve-control (YCC) policy constant, but modified forward guidance and embarks on a policy review.**
- **We expect the BoJ to drop the 0.5% cap for 10y JGBs and shorten the YCC policy to a 5 year tenure over summer, but risks are for a further delay.**

The two-day (27./28.4.) Bank of Japan board meeting ended with no change in its current yield–curve-control (YCC) policy. However, the bank modified its future guidance, removing a pledge to keep interest rates at "current or lower levels" while adding that it would "patiently continue with monetary easing" given economic uncertainty. The fresh Governor Ueda confirmed a policy review, that could take up to one and a half years. This all shows that the BoJ is in no rush to change its stance. However, fundamentally, the BoJ must balance the chances of establishing a virtuous wage-price cycle against the negative side effects (market distortions, interventions) of its YCC policy. The spring negotiations of large firms have resulted in a wage increase of 3.8%, with a base pay rise of about 2.2%. While the results will decrease a bit with adding small firms, the rise is historically strong. Major doubts exist if such a pace can be repeated next year. Headline CPI inflation has receded to 3.2% yoy. By contrast, core-core inflation is rising, as the BoJ–style core-core inflation version (ex energy, fresh food) accelerated to 3.8% yoy, the traditional one (ex energy, food) remained still low at 2.3% yoy. The BoJ expect core inflation at 1.8%, 2.0% and 1.6% yoy in the fiscal years 2023-2025. We are more sceptical regarding 2025 with 1.3%. The BoJ will also need to weigh the business cycle risks. The March Tankan saw a larger than expected drop in the headline manufacturing business conditions. Japan will benefit to some extent from China's recovery, but a recession in the US would hurt, especially the car industry. In sum, in our view wages and inflation developments could justify a less expansionary monetary stance but an outright monetary tightening is not warranted.

Opportunity for the BoJ to scrap long end of YCC policy

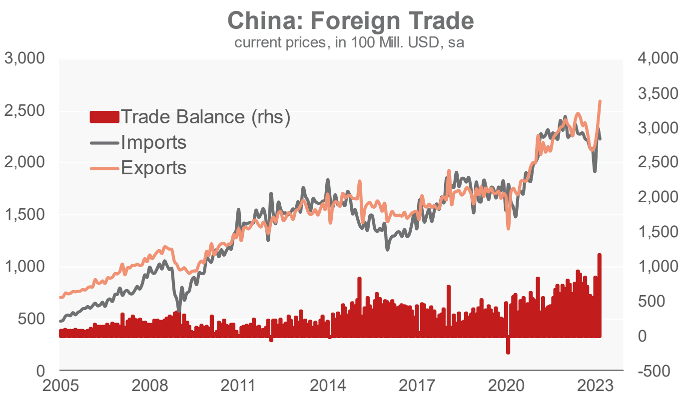
After the recent banking turmoil, 10y JGB yields remained below the 0.5% upper cap, likely also due to receding Treasury yields. They even fell further on the slow moving monetary policy. The BoJ did not intervene while the yield curve normalised. 10y JGB yields below the upper band provide the BoJ the opportunity to scrap the long end of the YCC policy without having to fear a monetary tightening. We expects the BoJ to use this option and shorten the yield curve control policy to 5y (remove the 10y cap) over summer, provided Treasury yields recede further. At the same time, we expect the overnight policy rate of -0.1% to be kept for (at least) the rest of the year.

China

Christoph Siepmann

Source: Datastrem, GIAM calculations

Source: Datastream, GIAM



Source: Datastream, GIAM calculations

- **China's GDP growth surprised on the upside, mainly driven by private consumption. However, the recovery remained uneven and CPI inflation subdued.**
- **Given these data, we revised GDP growth for 2023 up to 5.7%, and CPI inflation down to 2.0%.**

After China's Covid reopening, real GDP growth accelerated more than expected to 4.5% yoy (2.2% qoq) in Q1 2023, after 2.9% yoy (0.6% qoq) in Q4 2022. The recovery was driven by (service) consumption. By contrast, growth in the manufacturing and primary (mining, agriculture) sectors even softened slightly compared to Q4. This uneven recovery continued to be visible in March activity data. Although industrial production (IP) growth picked up to 3.9% yoy, it remained below expectations and could not benefit more strongly from the huge jump in exports (+14.8% yoy compared to consensus forecast of -7.0% yoy). Urban investment growth receded to 5.1% yoy ytd, after 5.5% yoy ytd before. Underlying reasons were an easing of manufacturing and infrastructure investment while property investment continued its contraction. Meanwhile, property sales seem to have turned the corner, but its positive growth readings are still hugely supported by base effects.

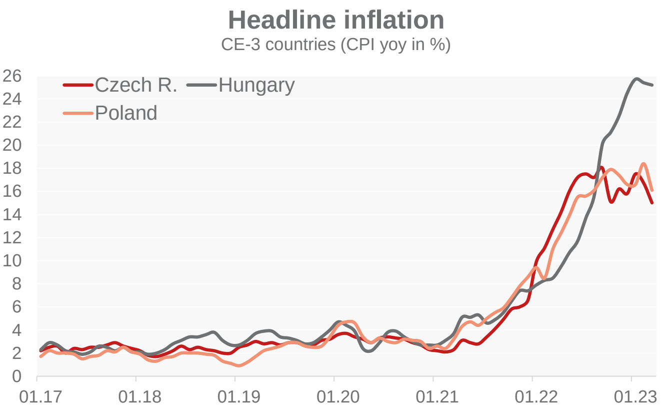
Uneven recovery likely to continue

We expect China's recovery to continue, mainly driven by private (service) consumption as PMIs strongly suggest (see graph). However, growth dynamics are likely to slow after the already rapid start into the year. Nevertheless, in yoy terms Q2 growth will be pushed up by a large base effect as last year's Q2 witnessed the severe Shanghai lockdown. We are more sceptical regarding exports and IP. In many countries, latest flash manufacturing PMIs could not recover from their previous drops. China's manufacturing PMIs export orders subcomponent also remained in contractionary territory on average. We expect China's infrastructure investment to soften as a trend, given the only slight increase in the overall budget deficit (while the government nevertheless announced extending tax and fees cuts and support for electric vehicle purchases). In terms of floor space, new buildings "starts" remained deeply in the red, so that investments in the real estate sector will need time to improve. Monetary policy has been more supportive than previously announced. Recently, it guided deposit rates further down, likely to help sustaining a reduction in excess savings. Monetary data show new yuan credit growth especially strong with 27% yoy ytd, which should support investment over time. CPI inflation came again in on the weak side, but we expect it to rise alongside rising consumption. All in all, given the Q1 result we revised our growth forecast up to 5.7%, but see lower inflation of 2.0%. in 2023.

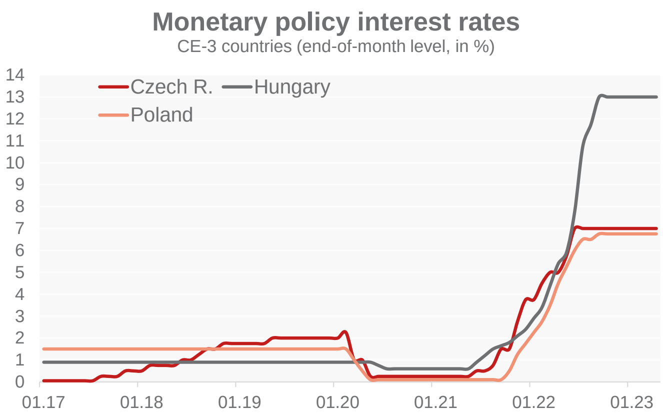
Central and Eastern Europe

Radomír Jáč

- **Headline CPI moderates across the CE-3 but inflation targets will be reached only in 2024 or later. Core CPI was still growing in some cases in March.**
- **High inflation has negative impact on real wages and on household consumption. GDP across the CE-3 is likely to show a quarter-to-quarter contraction or at best stagnation in Q1. We keep our call of a weak full-year GDP growth across the region in 2023.**
- **The Czech and Polish central banks are in no hurry to ease their monetary policy. The Hungarian MNB cut a top-end rate of its interest rate corridor from 25% to 20.50% in April. In May, the first cut the MNB's key 1-day deposit rate from the current 18% may follow.**



Source: www.czso.cz, www.ksh.hu, www.stat.gov.pl, GIAM



Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

Czech Republic	2021	2022	2023f	2024f
GDP	3.5	2.5	0.3	2.8
Consumer prices	3.8	15.1	10.7	2.3
Central bank's key rate	3.75	7.00	5.50	3.00
Hungary	**2021**	**2022**	**2023f**	**2024f**
GDP	7.1	4.6	0.3	3.5
Consumer prices	5.1	14.5	17.0	5.0
Central bank's key rate	2.40	13.00	10.00	4.50
Poland	**2021**	**2022**	**2023f**	**2024f**
GDP	6.9	5.1	0.2	3.7
Consumer prices	5.1	14.3	13.1	5.0
Central bank's key rate	1.75	6.75	6.75	4.50

Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

Headline inflation moderates across the CE-3 region. Czech headline CPI reached 15% yoy in March, Hungary reported 25.2% yoy, while Polish headline CPI declined to 16.1% yoy. The decline in inflation was broad-based across the CPI basket in the Czech economy with a moderation of core CPI. Hungary and Poland reported an increase of core inflation in March but underlying inflation should start to moderate in Q2 due to weaker household consumption and statistical base effects. The vicinity of the inflation target is expected to be reached in 2024 in the Czech Republic and Hungary, and in 2025 in Poland.

The CE-3 economies contracted in Q4 2022 and monthly data for Q1 indicate further GDP decline or at best stagnation in qoq terms. Household consumption suffers due to the falling real wage and mixed signals have been coming from industry. While a GDP recovery is likely from Q2 (thanks to a gradual improvement in real wage), the full-year GDP growth in 2023 will be meagre across the CE-3.

CE-3 central banks: A signal rate cut in Hungary in April

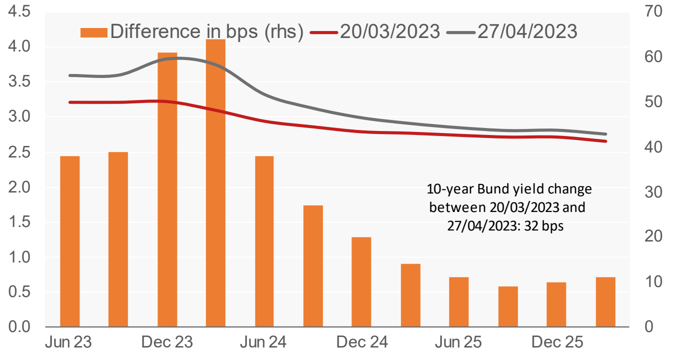
The central bank of Hungary was the first in the CE-3 to change interest rates in 2023. The MNB cut its rate for O/N collateralized loan from 25% to 20.50% in late April, which was a signal move. A cut in the 1-day deposit rate (for now the key rate, at 18%), should come in late May. The Czech CNB's key rate stands at 7% and we think the first cut may come in late Q3 amid falling inflation and a strong Crown. However, the CNB does not talk about rate cuts for now and it even mentioned the possibility of a rate hike if wage growth were to accelerate. The CNB meeting scheduled for May 3 will be important, as it will publish an updated macro forecast. For Poland we expect the key rate to remain stable at 6.75% in 2023, rate cuts should come in 2024.

Government Bonds

Florian Späte

EA Money Market: Increasing exp. 3m rates

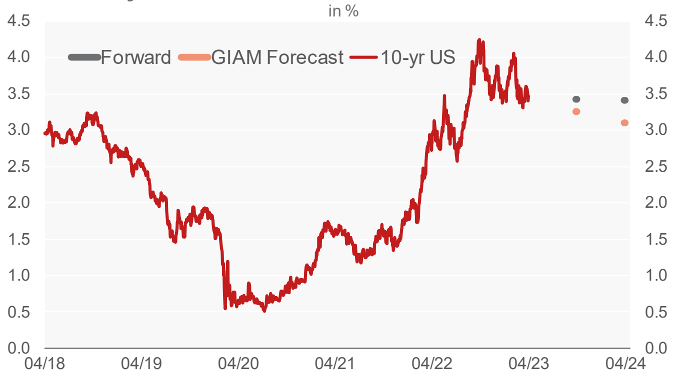
Change between 20/03/2023 and 27/04/2023



Source: Bloomberg, GIAM

US yields to decrease in H2, below forwards

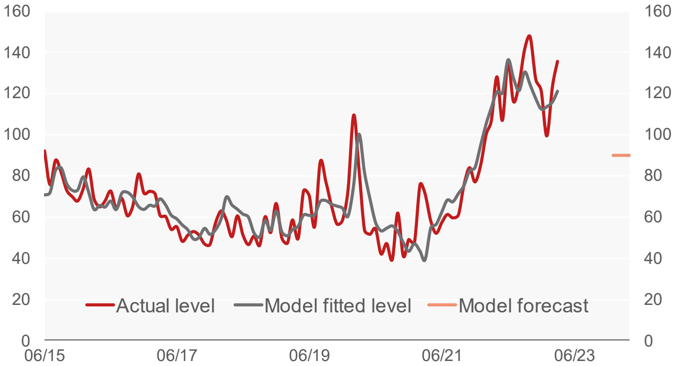
in %



Source: Bloomberg, GIAM

US Implied Volatility on 1m Treasury options

Input: CPI (yoy), CPI range proj., Fed Funds range proj., fin. cond., ISM



Source: Bloomberg, Datastream, GIAM

- **We do not consider the increase in government bond yields to be sustainable and expect moderately declining yields in the months to come amid excessive key rate expectations and the lasting risks in the banking sector.**
- **The decline is likely to be more pronounced in the US than in the EA. However, most of the transatlantic yield spread tightening is likely already behind us.**
- **Despite the slight spread widening of EA non-core bond spreads in April, it can be assumed that they will tend to crawl up further over the coming months. Draining liquidity and a still high valuation are seen to pave the way for a moderate spread widening.**

After the hefty movements in March, the situation in international government bond markets calmed down noticeably in April. The trading range of US and Bund yields was rather tight. On balance, Bund yields rose across the curve while US yields traded broadly sideways. Hence, the transatlantic yield spread has fallen to a multi-year low across all maturities.

Going forward, we regard the increase in yields as not sustainable and forecast moderately declining core yields. Although we have lifted our ECB key rate expectations (two more rate hikes of 25 bps each in May and June), we see the currently priced 75 bps as excessive. This harbours the potential for disappointment should the ECB prove not to be as hawkish as recently or as expected by financial markets. What is more, we regard the situation of the banking sector as still shaky and the return to normal to be premature. Despite normalization in some indicators, there is still a lot of stress in the system. While it is apparently difficult to make a forecast regarding the timing and the extent of future turmoil, we assume that distortions will tend to increase over the coming weeks.

Having said that, the gap between the medium-term expected ECB key rate and 10-year Bund yields which have a high correlation and tend to be at similar levels has recently risen again to around 30 bps. This limits the immediate downside potential for Bund yields. Accordingly, we forecast 10-year Bund yields to crumble slightly in the near term and expect a level of around 2.20% on a 1-year horizon.

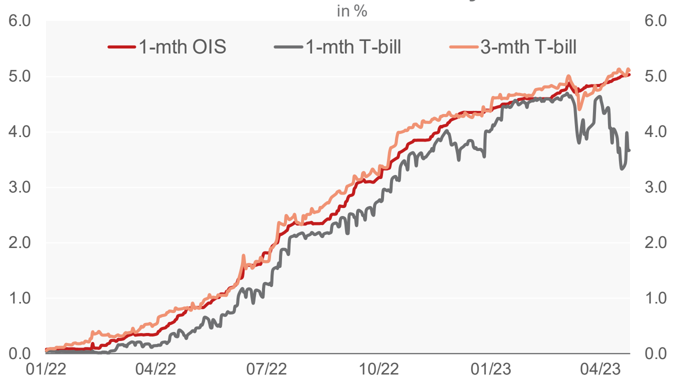
The reasoning is basically similar for US yields. However, we only expect one more key rate hike by the Fed (while markets do not rule out an additional one) and in contrast to the ECB (which is expected to cut only in summer 2024), the Fed is forecast to start a new cycle of falling key rates

Government Bonds

Florian Späte

US: Distortions on US Money Market

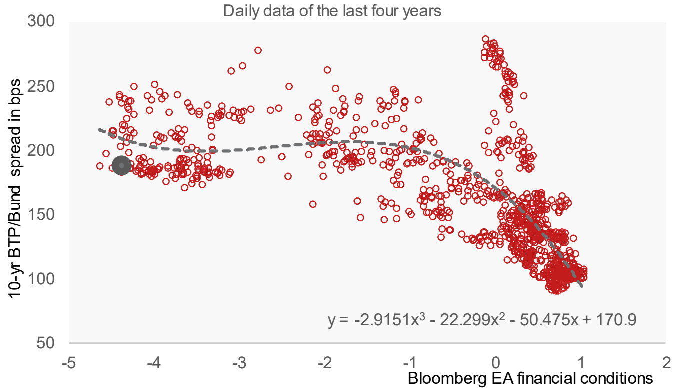
in %



Source: Bloomberg, GIAM

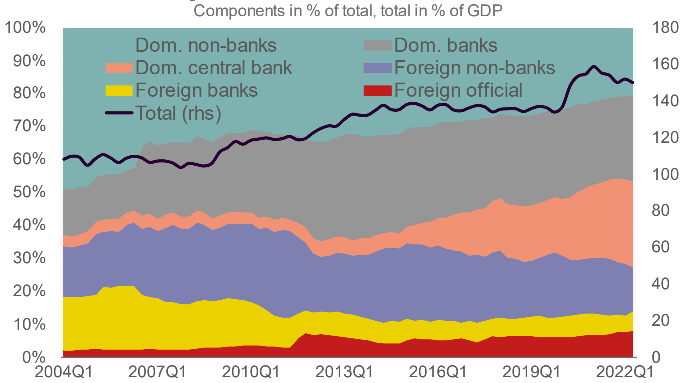
Rich valuations of BTPs

Daily data of the last four years



Italy: Holders of Government Debt

Components in % of total, total in % of GDP



Source: IMF. GIAM calculations

already in Q4. The recent news flow concerning the US regional banks reminded us that the banking crisis in the US can by no means be finally dismissed. Despite these uncertainties, we see leeway for (still high) US bond market volatility to fall further. Inflation rates (level and volatility) and dispersion of expectations about economic development are forecast to decrease. This bodes well for somewhat lower yields.

Although we forecast liquidity to drain off in the months to come amid the reversal of extraordinary monetary policy measures (e.g. QT) we expect US yields to fall a bit more than Bund yields. Nevertheless, most of the transatlantic 10-year yield spread tightening is likely over (the spread was around 200 bps in April 2022). We expect another tightening by 15 bps to 90 bps on a 1-year horizon. This implies a 10-year US yield level of 3.10%.

On the contrary, we do not expect the US debt ceiling debate to have a lasting impact on the US government bond market. Although market stress is currently visible in the money market (and will continue until a solution is reached), since the default is only a tail risk and an agreement shortly before the ultimate deadline is much more likely, we assume for the time being that the discussion will have no lasting influence on US Treasuries (as in 2011).

Underperformance of EA non-core gov. bonds to last

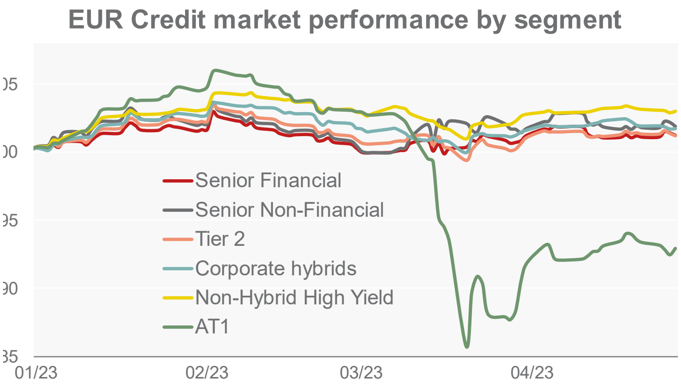
While fixed income assets perceived as risky performed well in April the spread of EA non-core government bond spreads widened. However, the extent was limited and the movement was orderly. We forecast the moderate upward movement to continue in the coming weeks.

This is mainly due to the unfavourable technical situation. An ongoing high government bond net supply meets a crumbling demand. The ECB is expected to double the QT volume to € 30bn from July. This implies that the central bank will withdraw a volume of € 160bn from the sovereign bond market by the end of 2023 – meaning the highest annual net-net issuance since the Great Financial Crisis. The upcoming redemption of TLTRO funds at the end of June fits into this picture. Furthermore, recent data shows that Japanese portfolio investments in EA bonds continued to decline. What is more, concerns over deteriorating fundamentals can re-emerge. The combination of a rather high yield level and weak growth has the potential to trigger new debt sustainability concerns.

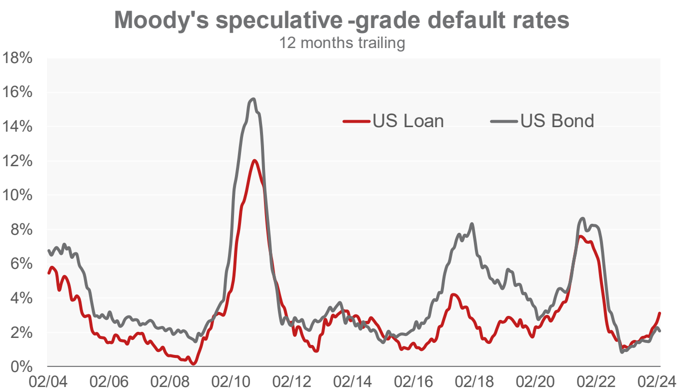
Overall, EA non-core government bond spreads are forecast to widen moderately in the months to come. The ECB has the tools to oppose a stronger upward movement (initially verbally) and limit the widening in this way.

Credit

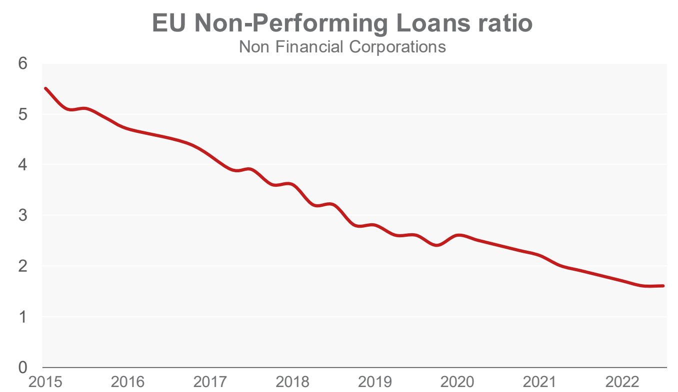
Elisa Belgacem



urce:Bloomberg, BofAML, GIAM own calculations



Source: Moody's, GIAM



ource:Bloomberg, EBA, GIAM

- **Credit spreads retraced half of the post SVB / Credit Suisse widening, even more in the CDS space, we expect IG spreads to trade in a range. We see some widening potential for HY (+100bp) over a 3-to-6-month horizon.**
- **We maintain our OW stance on IG, and even more, after the rally. Current CDS levels are attractive to buying credit protection.**
- **We do like IG duration even though curves are already very flat. We maintain our underweight stance on financials versus non-financials and our preference for subordination risk versus credit risk.**

. Valuations metrics among the credit universe show that the European IG space is the cheapest compared to US IG and both EU and US HY. In 2022 Europe was considered as the most impacted from the Ukrainian conflict and its consequences, and IG credit widened substantially compared to US credit. The picture looks different now with Europe likely avoiding recession and the US possibly entering one later this year. Technicals should be relatively neutral in EUR IG, with QT acting as a negative in the first half of 2023, but supply should also be limited, especially in non-financials.

Corporate defaults to continue rise in 2023

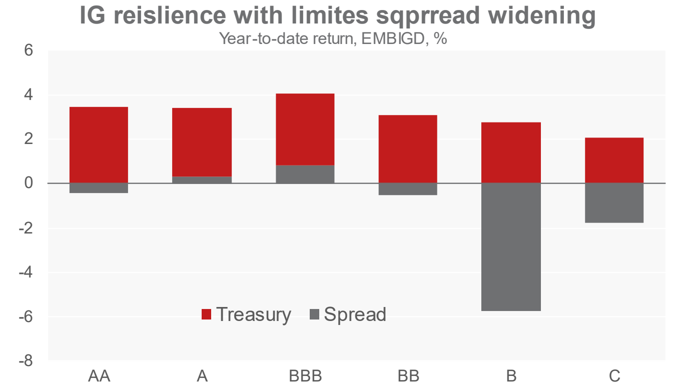
On the fundamental side, default numbers have been higher in Europe in 2022 compared to the US which has be rare over the past 15 years. Yet US defaults are likely to not only catch up but also surpass European default numbers by the end of the year. We do expect both economic zones to end 2023 with 4.5% default, almost doubling from current numbers. Hence, we do favour European credit to US credit.

Prefer long IG as fundamentals deteriorate

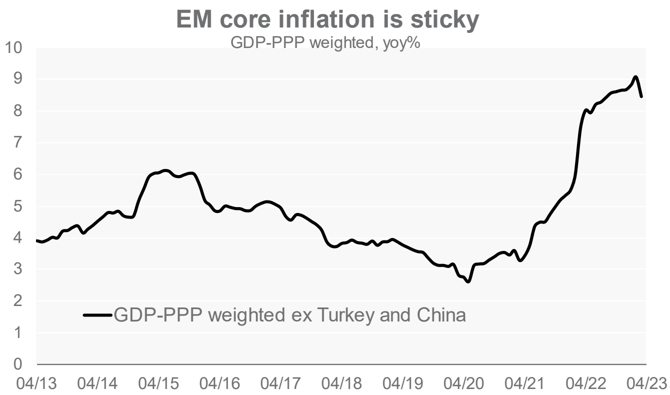
Overall, we prefer IG to semi-core and peripheral sovereigns, on valuation grounds. In Europe, IG levels are still attractive after the rally versus historical standards. We expect spreads to trade around current levels over the course of next year. For HY, we think that current valuations do not reflect elevated risks. Consequently, we expect spreads should widen nearly 100bp in the first half of 2023 before ending the year 50 -60p wider compared to current levels. CDS have tightened much faster than cash, and we like to buy credit protection here. 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 in spread terms.

EM sovereign bonds

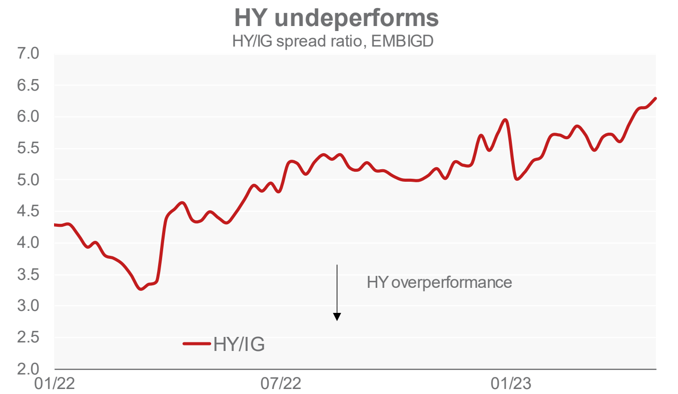
Guillaume Tresca



Source: JP, Bloomberg, GIAM



Source: Bloomberg, countries, GIAM calculation



Source: Bloomberg, ICE, GIAM

- **The EM environment has gradually deteriorated with growing growth concerns and inflation stickiness.**
- **EM local debt should keep outperforming. Within EM external debt, we continue to favour IG vs HY. The decompression trade will gain momentum.**
- **Valuations are tight. We see wider spreads, but positive return. Europe IG offers value while EM USD bonds are now more attractive than EM EUR.**

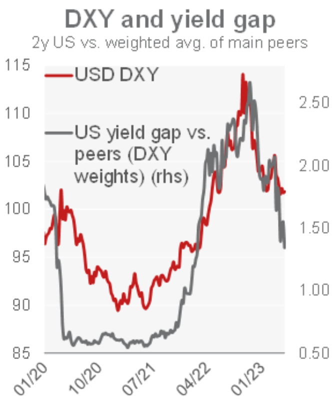
The EM outlook has gradually deteriorated with risks becoming asymmetric as the economic cycle is ending and uncertainty rises. It is not a worrying EM environment, but it is not one to cheer up. We continue to prefer EM local debt, but we see still modest positive return for external debt thanks to the carry. Indeed, most of the risky assets have been recently well supported but EM assets hardly benefited from the post-SVB rally. Growing growth concerns in the US will leave EM assets on the back foot in our view. EM remains above all a beta play that is sensitive to global risk aversion and global growth prospects. Locally, EM growth has been so far resilient, especially in the service sector, but core inflation is stickier than envisaged, postponing the expected rate cut cycle. The silver lining remains the Chinese growth that keeps surprising to the upside but most of the positive news has already been priced in and the potential positive spillover onto other EM economies could be more limited than initially envisaged.

Favour EM IG over HY

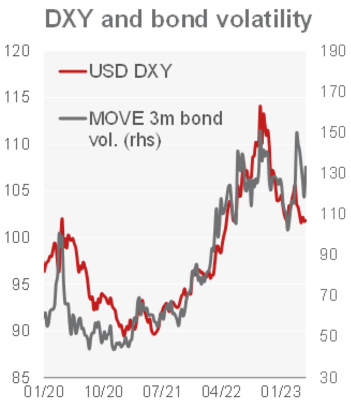
We maintain our preference for EM IG vs HY which has finally performed. The decompression trade will gather momentum. Indeed, EM external debt spreads will keep widening as the deterioration of credit conditions spreads throughout the economies. It has been a world of two halves as EM IG spreads have barely moved YTD, but EM HY spreads keep widening. Fund positioning is still overweight HY, and the risk is to see further de-risking. Within IG, a nimble and selective approach is required as valuations remain very tight. Europe IG, especially Romania, and to a lesser extent LatAm IG offer reasonable valuations on a historical basis. Asia and GCC IG are too expensive. Within HY, we only favour BBs so far. It is true that EM HY still offers a pickup over the US equivalent, but it is due to distressed names. Almost 1/3 of the EMBIGD index is under an IMF program and there is still a risk to see more defaults in low Bs and CCC with the upcoming wall of maturities in mid-2024. On an FX basis, EM EUR pickup over EM USD bonds disappeared. So, we will favour EM USD over EM EUR given the current pickup and the better duration prospects

Currencies

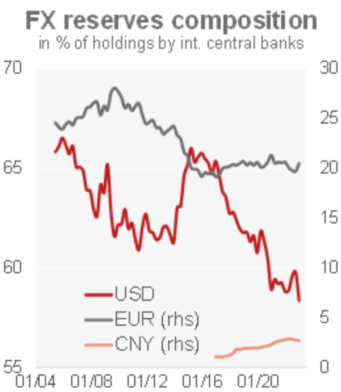
Thomas Hempell



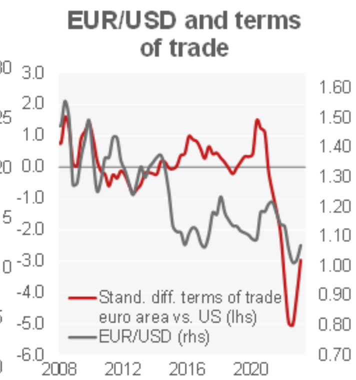
Source: Datastream, GIAM



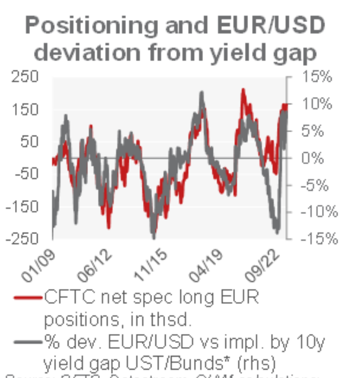
Source: Datastream, GIAM



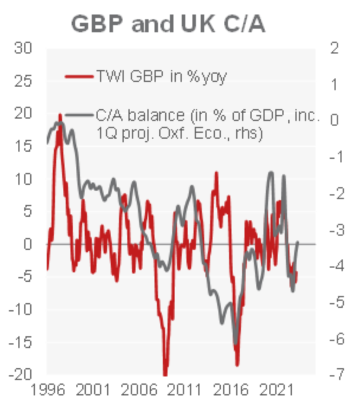
Source: IMF COFER, Datastream, GIAM



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



Source: CFTC, Datastream, GIAM calculations; *based on 3y rolling regression of EUR/USD vs. 10y yield gap



Source: Datastream, GIAM

- **There is more downside looming for the USD, as rates volatility is set to subside and the Fed is close to terminate its hiking cycle.**
- **This means more upside for the EUR/USD, with the single currency benefitting from the fading terms-of-trade shock.**
- **Be prepared for recurrent setbacks, though, as speculative positions are stretched and EMU risk pricing somewhat complacent.**
- **JPY should benefit from lower US yields, but is dragged by the new BoJ's new governor's dovish tilt. An easing C/A deficit will mitigate headwinds to GBP from the UK's adverse growth/inflation mix.**

The USD has extended its losses over the past weeks, in line with our call into spring (see e.g. here and here). The banking crisis in the wake of the SVB collapse has even accelerated the decline. Following a period of volatile repricing, the Fed's lead in global rate hikes has been eroded (top left chart), with a looming US credit crunch substituting for most of further rate hikes anticipated in early March. Meanwhile, the offsetting USD boost from higher rates uncertainty is fading (top right). With UST yields tilted to the downside (see bond section), this leaves the greenback vulnerable to further losses. The erosion of the USD reserve currency status (mid left) in the wake of far-reaching US sanctions is neither helpful.

Meanwhile, the EUR is benefitting from resuming capital inflows. The sharp drag from the terms-of-trade shock on high energy bills is reversing as gas prices hover below pre-war levels. We also expect the ECB to provide more rate hikes and stick to the peak levels for longer than the Fed.

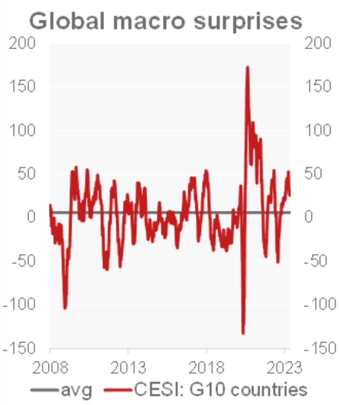
Prepare for a more volatile path for the EUR/USD

And yet, at the levels already reached prepare for a more volatile path from here. Speculative positions are stretched, leaving scope for EUR/USD setbacks. What is more, EMU risks (mirrored in BTP/Bund spreads) has weathered the headwinds from the ECB's QT and the banking woes remarkably well – but we caution against extrapolating this resilience too much into the future.

We expect the JPY to remain largely at the mercy of US yields for now, with our expectations of lower US yields pointing to more JPY upside. Yet the dovish tilt by the new BoJ governor Ueda will keep any gains limited. Sterling is still facing headwinds from a particularly adverse stagflationary setting in the UK. But the incipient recovery of the UK's current account is a welcome offset, rendering the outlook for EUR/GBP more balanced (bottom right chart).

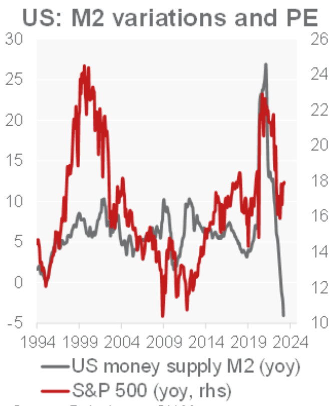
Equities

Michele Morganti, Vladimir Oleinikov

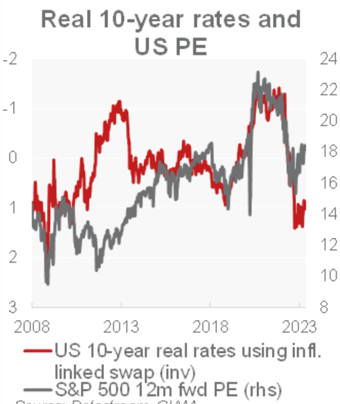


Source: Datastream, GIAM

Source: Datastream, GIAM



Source: Datastream, GIAM



Source: Datastream, GIAM

Analysis of the median stock: Q1 2023 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q4 2022	Q1 2023	Q4 2022	Q1 2023	Q4 2022	Q1 2023	Q1 2023
S&P	7.3 %	5.4 %	7.1 %	6.1 %	0.2 %	(0.8)%	32.2%
Stoxx	8.7 %	8.1 %	13.5 %	12.6 %	(4.7)%	(4.5)%	23.9%
Euro Stoxx	1.6 %	5.9 %	14.5 %	11.4 %	(12.9)%	(5.5)%	22.0%
Topix	(2.1)%	3.0 %	8.9 %	7.1 %	(11.0)%	(4.1)%	13.2%

Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q4 2022	Q1 2023	Q4 2022	Q1 2023	Q4 2022	Q1 2023	Q1 2023
S&P	3.7 %	4.7 %	0.9 %	1.6 %	2.8 %	3.2 %	32.2%
Stoxx	4.4 %	5.2 %	1.4 %	2.1 %	3.0 %	3.1 %	23.9%
Euro Stoxx	4.2 %	3.3 %	1.7 %	2.1 %	2.4 %	1.2 %	22.0%
Topix	3.0 %	2.1 %	1.3 %	0.4 %	1.7 %	1.7 %	13.2%

Note: numbers for Q3 are calculated only for the companies which have so far reported in Q4
proxy for margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations

- **Notwithstanding the strong market resiliency showed so far, a decreasing growth and earnings momentum plus elevated valuations vs. real yields and credit spreads are set to weigh on equities.**
- **Lower credit growth (see macro section above) would cause negative effects for both the economy, profits and capex. Bank and real estate turmoil has also decreased but not dissipated yet.**
- **We maintain a tactical UW position on equities, but not a large one. This is because pessimism is already high and investors positioning remains below average. Furthermore, the earnings' picture is set to brighten into 2024. Chinese growth remains reassuring, and ex-US, 12-month total returns (TR) should be limited but positive.**
- **We overweight (OW) World ex-US. Additionally, we increase - on valuation grounds - the exposure to the SMI vs. UK.**
- **Within EU sectors, we OW Food Retail, Food Bev. Tob., Telecom. Svs., Software and Utilities. Our underweights (UW) are Banks, Capital Goods, Comm. Prof. Services, Insurance, Media, and Transportation (new).**

Notwithstanding the strong market resiliency shown so far, we think that decreasing growth momentum ahead could represent headwinds. Investors have discounted several positive news in the last weeks. We refer, for example, to positive macro surprises which are not distant from a cyclical high. Recent industrial production and capacity utilization data were above consensus (US and EA ones). This, together with a strong IFO and positive surprises from the Q1 reporting season, shows that the expected earnings slowdown has been postponed to Q2 or Q3 of this year. Furthermore, both the huge investors' pessimism, and their lower-than-average positioning, have maintained the VIX contained, contributing to pushing the VIX/MOVE ratio to a cyclical low. Of course, the equity risk premium has benefited from such a trend, declining as well.

As a result, valuations remain expensive when compared to current 10-year rates or credit spreads (US IT in particular, 40% premium). Eventually, high valuations could not represent a threat should the economic cycle be bottoming out. Instead, we see the concrete risk to experience a slowing growth momentum in the next quarters. Indeed, the lagging effects of the aggressive tightening by central banks continue to hurt. Bank and real estate turmoil has decreased but not dissipated. Furthermore, tighter lending standards are causing a lower credit growth, with negative effects ahead for both the economy, firms' profits and capex.

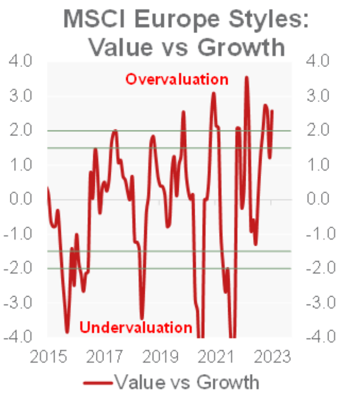
Equities

Michele Morganti, Vladimir Oleinikov

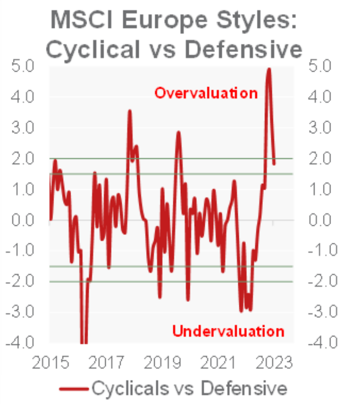
US Return of Equity minus Fixed income after peak in CPI

peak in h.line CPI	peak in core CPI	TR of Equity vs	3M	6M	12M
Dec 74	+2m	10Y Treas	19%	21%	1%
		IG	21%	29%	24%
Mar 80	+3m	10Y Treas	-9%	10%	20%
		IG	0%	5%	19%
Oct 90	+4m	10Y Treas	2%	21%	20%
		IG	4%	21%	18%
		HY	6%	9%	-1%
Jun 22	+3m	10Y Treas	2%	4%	
		IG	2%	2%	
		HY	1%	0%	

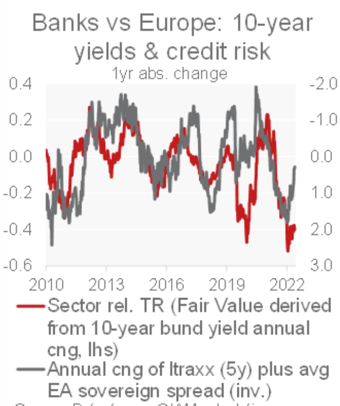
Source: Datastream, GIAM



Source: Refinitiv, GIAM calculations



Source: Refinitiv, GIAM calculations



Source: Datastream, GIAM calculations

Source: Datastream, GIAM

We expect a light recession ahead in the US, and NIPA profits' yearly growth to deteriorate sensibly in Q2 and Q3 2023. This should reduce the IBES consensus estimates. Other indicators suggest the economic and profit trend are at risk: among others, plunged growth in US money aggregate (M2) and existing home sales, prolonged inverted yield curve, drop in the US leading indicator, very weak manufacturing ISM and declining household excess savings.

Slightly UW equities

In sum, we maintain a tactical UW position on equities, but not a large one. This is because pessimism, as said, is already high and investors positioning remains below average. In addition to this, 2024 should see an earnings recovery. Furthermore, China's growth remains reassuring, and 12-month total returns (TR) should be limited but positive, especially for ex-US equity markets. Lastly, historically, equities have shown a reduced, but still positive relative TR vs. fixed income in periods of high inflation, especially after headline inflation started to decline from a previous extended surge. Risk: should we envisage an increased chance of a deeper US recession ahead, we should incorporate a large fall in earnings and market prices..

Recommended allocation: still OW ex-US equities

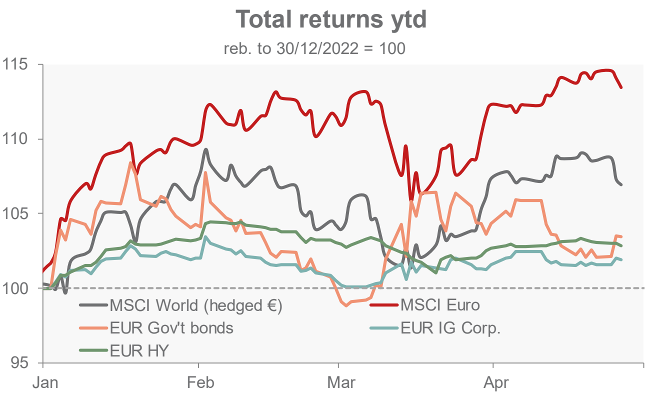
We maintain a reduced OW on the cheaper EMU vs the more expensive US, as ML (machine-earning) models, the strong euro and lower EMU macro surprises suggest a more prudent stance on the former. We increase our recommended weight on the SMI at the expense of the UK, on valuation grounds. Still OW Japan and China. China IT is very attractive vs. US IT (PEG & Fed Model). EU Sectors: we lower Software (neg. revisions) and transportation (high valuation, neg. revisions, credit spread) to reduce our UW in Media (low valuation and pos. revisions). Low valuation for Banks but credit risk remains high. Value and Cyclicals still look overvalued for our ML models. OW Food Retail, Food Bev. Tob., Telecom. Svs., Software and Utilities. UW Banks, Capital Goods, Comm. Pro. Services, Insurance, Media, and Transportation (new).

EMs: to benefit from China's continuing recovery

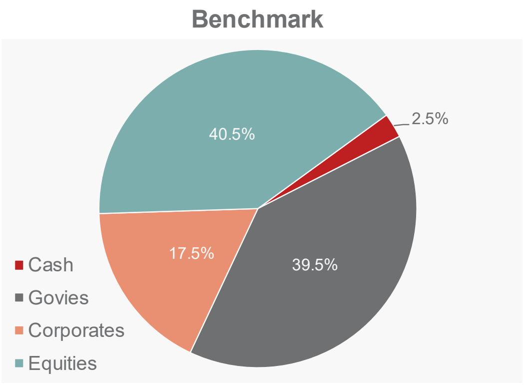
EM PE vs. MSCI World looks slightly attractive vs history and the easing monetary cycle seems to be undergoing. Besides, increasing PMI, better global export orders and macro surprises support the continuation of the bottoming-out in EM earnings. OW China: continuing GDP growth, M2 good momentum and low valuations. Risks: volatile geopolitical concerns. India is increasingly looking attractive (improved relative valuation score) and could deserve to be put on the radar for a future overweight.

Asset Allocation

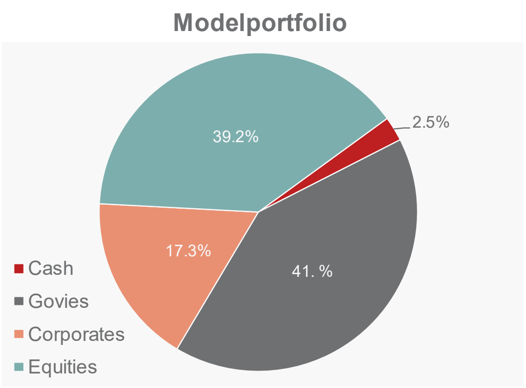
Thomas Hempell



Source: Datastream, GIAM calculations

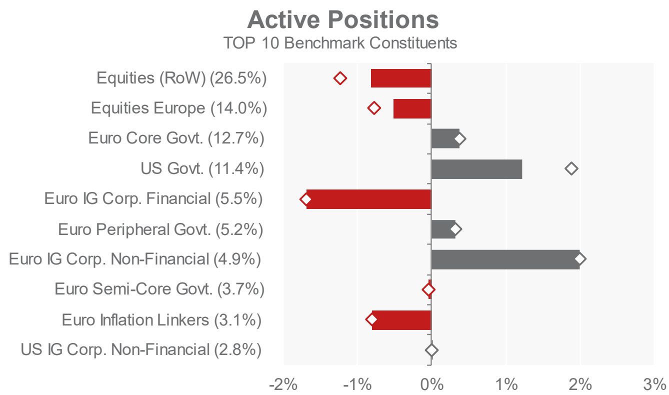


Source: GIAM



Source: GIAM

- **Markets have extended their recovery from the drawdown amid the banking woes prevailing in March. We do not chase this recovery, though, and keep a prudent stance in our tactical allocation.**
- **As recently exemplified by the ongoing trouble at First Republic bank, banking worries are set to keep lingering, and the looming credit crunch will weigh on growth, earnings and drive up defaults.**
- **We maintain a cautious stance on the most risky market segments in the model portfolio such as Equities and HY Credit.**
- **By contrast, we keep overweights on Govies, with a preference for mid-dated Bunds (belly of the curve) and shorter maturities in Italian BTPs also thanks to the attractive carry.**
- **The outlook for yields is skewed to the downside, but we avoid strong duration bids amid persistent curve inversion.**
- **We also like (mostly non-fin.) EUR IG Credit which is decently priced and – more prudently – EM bonds.**
- **We also see value in US Treasuries, which combine a decent carry and good hedging properties against a deterioration in risk sentiment.**
- **We see more downside for the USD by year-end amid the looming US recession and the prospective lead of the Fed in a global easing cycle.**



Source: GIAM; Benchmark weights in parentheses, diamonds indicating previous recommendations

Forecasts

Macro Data

Growth[1]	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.	2025 forecast
US	2.0	0.3	- 0.7	0.2	- 0.7	1.5
Euro area	3.3	0.8	0.2	0.7	- 0.4	1.4
Germany	1.8	0.3	0.3	0.6	- 0.7	1.7
France	2.6	0.4	- 0.0	0.5	- 0.7	1.8
Italy	3.9	0.5	- 0.0	0.7	- 0.4	0.9
Non-EMU	3.6	- 0.1	0.3	0.9	- 0.0	1.6
UK	4.1	- 0.1	0.4	0.7	- 0.0	1.5
Switzerland	2.1	0.8	0.1	1.6	0.0	1.2
Japan	1.2	0.8	- 0.2	1.1	- 0.0	1.0
Asia ex Japan	4.1	5.0	0.1	4.8	- 0.4	4.8
China	3.0	5.7	0.4	4.8	- 0.4	4.7
CEE	1.8	0.8	0.6	3.2	1.0	2.9
Latin America	3.8	0.7	0.0	1.6	- 0.1	2.0
World	**3.3**	**2.3**	**- 0.0**	**2.6**	**- 0.3**	**3.0**

1) Regional and world aggregates revised to 2020 IMF PPP weights

Inflation[1]	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.	2025 forecast
US	8.0	4.4	0.2	2.4	- 0.2	2.2
Euro area	8.4	5.3	- 0.3	2.5	0.1	2.3
Germany	8.6	5.8	- 0.2	2.7	- 0.0	2.5
France	5.9	4.7	- 0.2	2.4	- 0.1	2.2
Italy	8.7	6.4	0.2	2.4	0.0	0.6
Non-EMU	8.1	6.0	0.1	2.5	- 0.1	1.8
UK	9.1	6.6	0.2	2.7	- 0.2	1.8
Switzerland	2.8	2.5	0.0	1.4	0.0	1.3
Japan	2.5	2.6	0.3	1.9	0.6	1.3
Asia ex Japan	3.5	3.0	- 0.2	3.0	- 1.5	2.8
China	1.9	2.0	- 0.3	2.4	0.0	2.2
CEE	29.6	17.7	- 0.3	8.3	- 2.7	6.2
Latin America[2]	7.8	5.7	0.8	4.0	0.6	3.1
World	**7.8**	**5.3**	**- 0.0**	**3.3**	**- 0.8**	**2.9**

1) Regional and world aggregates revised to 2020 IMF PPP weights ; 2) Ex Argentina and Venezuela

Financial Markets

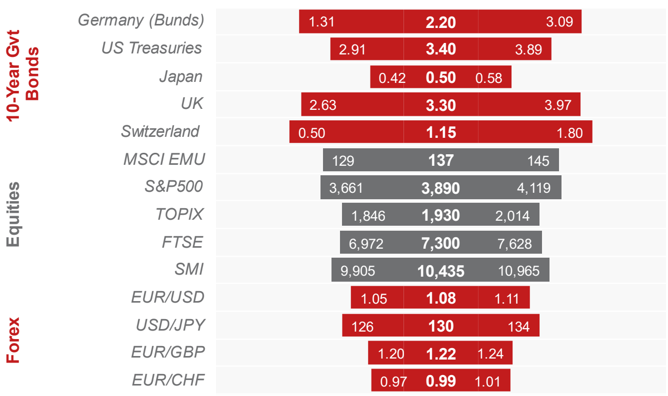
Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US (upper bound)	5.00	5.25	5.01	5.25	4.54	4.25	3.40
Euro area	3.00	3.50	3.56	3.50	3.68	3.50	3.22
Japan	-0.10	-0.10	0.01	-0.10	0.04	0.00	0.10
UK	4.25	4.50	4.75	4.50	4.88	4.00	4.29
Switzerland	1.50	1.75	1.70	2.00	1.98	2.00	1.94
10-Year Gvt Bonds							
US Treasuries	3.44	3.35	3.43	3.25	3.41	3.10	3.39
Germany (Bunds)	2.42	2.40	2.43	2.35	2.42	2.20	2.39
Italy	4.22	4.25	4.35	4.25	4.40	4.15	4.48
Spread vs Bunds	180	185	192	190	198	195	209
France	2.99	3.00	3.00	2.95	3.01	2.80	3.02
Spread vs Bunds	57	60	57	60	59	60	63
Japan	0.47	0.50	0.52	0.60	0.56	0.70	0.65
UK	3.74	3.70	3.74	3.60	3.72	3.45	3.73
Switzerland	1.09	1.10	1.06	1.05	1.06	1.00	1.07

*3-day avg. as of 26/04/23
**ICE BofA (OAS)

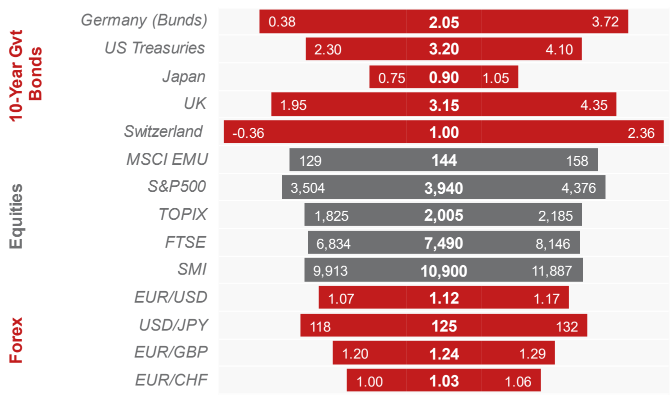
Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	144	155		160		155	
EA IG Financial	180	195		205		195	
EA HY	465	565		540		515	
EM Sov. (in USD)	377	380		390		370	
Forex							
EUR/USD	1.10	1.11	1.11	1.13	1.11	1.15	1.12
USD/JPY	134	130	132	127	130	125	127
EUR/JPY	147	144	146	144	145	144	142
GBP/USD	1.24	1.25	1.25	1.27	1.25	1.28	1.25
EUR/GBP	0.89	0.89	0.89	0.89	0.89	0.90	0.90
EUR/CHF	0.98	0.98	0.98	1.01	0.97	1.03	0.96
Equities							
S&P500	4,088	3,990		4,005		4,030	
MSCI EMU	149.1	143.5		146.0		149.5	
TOPIX	2,034	1,955		2,030		2,065	
FTSE	7,885	7,670		7,720		7,820	
SMI	11,448	11,200		11,405		11,560	

Forecast Intervals

3-Months Horizon*



12-Months Horizon*



*Forecast ranges of ±1 stdv. centred around point forecasts; based on historical volatilities; length of bars indicative only

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. 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 was completed on 28. Feb. 2023.