GENERALI INSURANCE ASSET MANAGEMENT

# Market Perspectives

## Mind the gap(s)

June 2023

GIAM Macro & Market Research

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

- **Hopes of a last-minute deal on the US debt ceiling, resilient US activity and an AI boost to IT chip producers have helped risk assets to digest rising yields well in May.**
- **But mind the various gaps that are emerging. Pent-up demand in services is deeply overshadowed by mounting trouble in manufacturing. Equity and HY Credit resilience contrasts strong signs of a looming US recession, markedly higher real yields and evidence of a credit crunch.**
- **We stick to a prudent tactical tilt in our portfolios, moderately underweighting (UW) Equities and HY. We favour the carry from IG Credit and Government Bonds while avoiding unhedged USD exposure.**

## Content



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# Global View – Mind the gap(s)

Thomas Hempell

- **Hopes of a last-minute deal on the US debt ceiling, resilient US activity and an AI boost to IT chip producers have helped risk assets to digest rising yields in May.**
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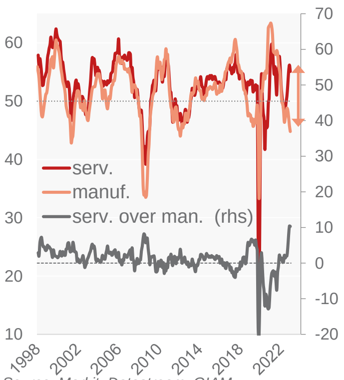
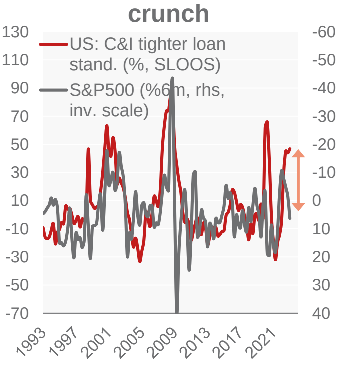
As acute banking woes moved to the back burner and US president Biden and House leader McCarthy struck a last-minute deal on the debt ceiling (with final Congress vote still pending at the time of writing), markets were headed to end May on a resilient note. Global equities are only slightly in the red (MSCI World -0.4% per 30/5), shrugging off repriced rates expectations and a 27bp rise in 10y US yields.

**Euro area PMIs**




Source: Markit, Datastream, GIAM

**US stocks defying credit crunch**




Source: Datastream, GIAM

But mind the widening gaps. Markets feel emboldened by resilient services activity that is underpinned by hot labour markets and post-Coving pent-up demand. Yet the bell-weather manufacturing is sending downbeat signals. Despite the Chinese reopening from Covid restrictions, the global manufacturing PMI signals stagnation (and contraction in Europe). Globally, the gap vs. the services index is at its widest since the GFC, and in the euro area even at the highest on record (left chart). Services may hold up for a while but we anticipate much stiffer headwinds into H2.

Most importantly, the sharpest tightening of monetary policy since the 1980s is still to unfold. Don't be lured by still robust US activity. Recession is looming for the coming quarters. Banks are severely tightening credit standards, a reliable leading indicator for the cycle.

The global picture is neither encouraging. The Chinese reopening rebound has disappointed before it even started. Global trade is in the doldrums. Economic surprises are heading south, diving into negative readings for the first time since autumn last year. Headline inflation will recede on base effects and lower energy prices. But sticky underlying price pressure will keep major central banks stick to restrictive policies for longer. A Fed pivot is not on the cards before Q4 and not before mid-2024 for the ECB.

| 10-Year Gvt Bonds | Current* | 3M | 6M | 12M |
|---|---|---|---|---|
| US Treasuries | 3.80 | 3.55 | 3.45 | 3.25 |
| Germany (Bunds) | 2.49 | 2.25 | 2.20 | 2.15 |
| **Credit Spreads**** | | | | |
| EA IG Non-Financial | 154 | 160 | 160 | 155 |
| EA IG Financial | 186 | 200 | 210 | 200 |
| **Forex** | | | | |
| EUR/USD | 1.07 | 1.09 | 1.12 | 1.15 |
| USD/JPY | 140 | 137 | 132 | 125 |
| **Equities** | | | | |
| S&P500 | 4187 | 4095 | 4115 | 4160 |
| MSCI EMU | 146 | 143 | 146 | 149 |

**3-day avg. as of 29/05/23 **ICE BofA (OAS)*

The continued yield curve inversion on bond markets seems to agree on recession worries, but Equity and HY investors seem to believe that this time is different (right chart). Admittedly, market positioning remains bearish, leaving scope for contrarian bounces. Robust US consumption and payroll numbers may still defy the looming headwinds for a while. And low energy prices are mitigating headwinds to battered manufacturers in Europe.

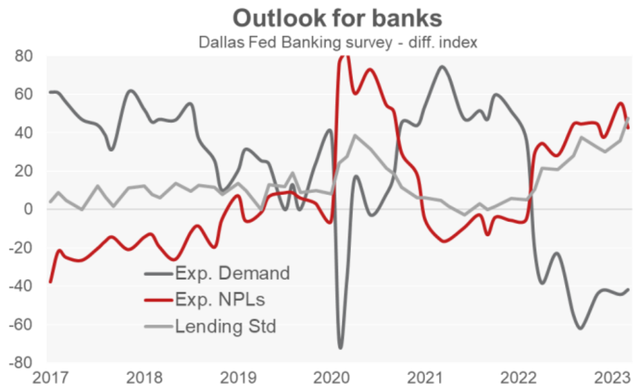
## Equities and HY Credit look most vulnerable

But earnings are set to suffer more visibly from weaker growth and higher debt costs, with consensus earnings forecasts prone to adjustments. Valuations are dear – the S&P500 forward price/earnings ratio matches last summer's levels, but 10y real yields have risen from virtually zero to above 1.5% meanwhile, another gap worth minding. Similarly, risk premia on HY spreads are lower than at the start of the year, defying evidence of much tighter credit, mounting refinancing costs and rising defaults.

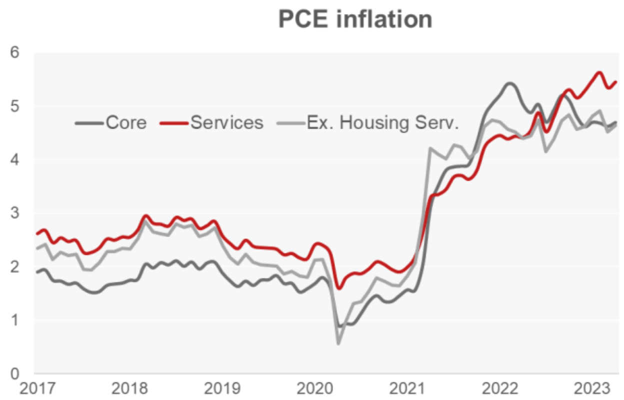
Government bonds and EUR IG Credit have not lost their appeal, mostly thanks to an attractive carry. US Treasuries also benefit from the prospect of lower yields medium term and good hedging properties in case of risk drawdowns. We like the belly of euro area core bonds, while preferring shorter-dated maturities in Southern European that are less exposed to some widening in spreads. The looming US recession and Fed's prospective lead in an easing cycle point to renewed USD weakness over the coming months.

## US

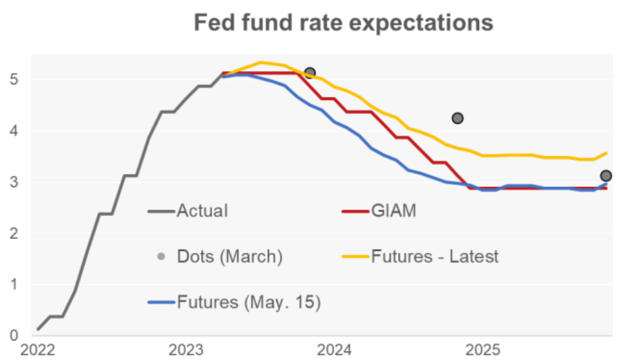
Paolo Zanghieri




Source:Dallas Fed, GIAM




Source:BEA, Refinitiv, GIAM




Source: Federal Reserve Board, Refinitiv, GIAM

- **Consumption remains strong at the beginning of Q2. But we still see a deterioration in activity as tight credit standards will start to bite. We expect a below consensus growth of 0.6% this year.**
- **Steady demand continues to support inflation. Our projection of 3.5% core CPI inflation is subject to some upside risk.**
- **The Fed has stopped hiking rates. We now expect a first cut in December. Risk are titled to the upside, more in the form of a longer period of high rates rather than via additional increases.**

The first indication for Q2 points to somehow surprising strength of domestic demand but also to additional evidence of tighter credit conditions. In April real personal consumption rose by 2.3% yoy, with positive surprises from durables and despite the bleak mood visible in surveys. At the same time industrial and housing activity seem to have plateaued, at relatively low level. However bank data continue to show an outflow in deposits, and the lenders' sentiment continues to deteriorate, resulting in expectations of even tighter lending standards and lower demand. We expect the hit from the past (and ongoing) tightening in credit conditions to become material in the second half of the year, when GDP will contract. GDP will grow by just 0.6% this year, in our below consensus view. The agreement on the debt ceiling, removes temporarily the risk of a destabilising crisis, but the public expenditure cuts requested by the Republicans will provide a further drag to 2024 growth.

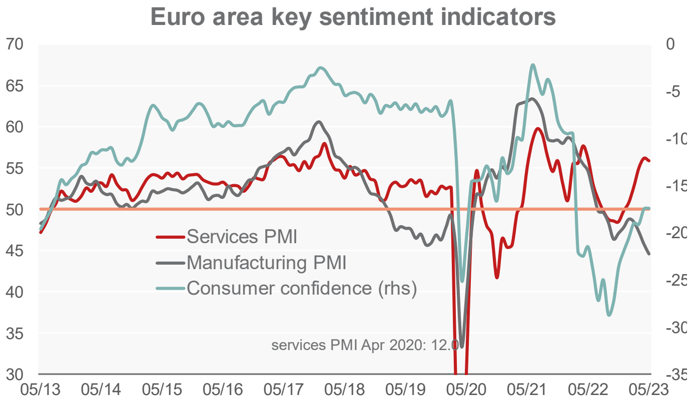
Strong demand is preventing a quick descent of inflation. In April core services inflation ex. housing (the measure the Fed is currently looking at) ticked up to 4.6% yoy. Production and import prices are cooling and data on job openings and quits point to a loosening in the labour market, which should tame wage growth. This will push inflation down over the coming month, but risks to our year-end 4% core CPI inflation forecast (3.5% for PCE) are tilted to the upside, also as the stabilisation in the housing sector may put a floor to house price increases, and therefore to shelter inflation.

### First cut in December, with upside risk

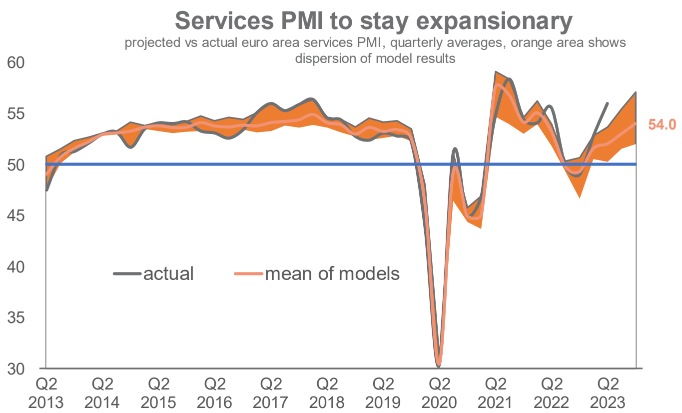
Mounting evidence of resilient demand and stickier inflation have led to an hawkish twist in the FOMC rhetoric, after the strong hints chair Powell made in the May meeting to an end of the tightening cycle. This triggered a sharp market repricing of the Fed's next moves. Expectations of a rate cuts this year are gone and markets are now pricing the concrete possibility of another rate rise during the summer. We have slightly flattened our expected path of rate cuts, with a cut in December followed by a cumulative 175 bps reduction in 2024.

# Euro Area

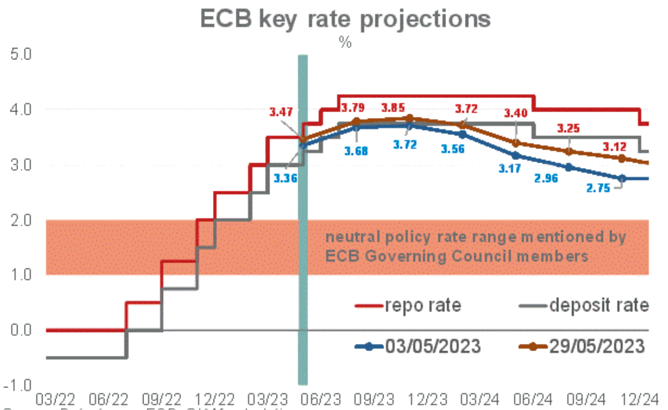
Martin Wolburg




Source: Datastream




Source:Datastream, GIAM calculations




Source: Datastream, ECB, GIAM calculations

- **The May composite PMI peaked, in line with our view of weak growth in H2. But an outright euro area recession may still be avoided thanks to resilient domestic demand.**
- **A downwardly revised Q1 GDP pushed Germany into recession and prompted us to revise our euro area 2023 growth projection down to 0.7% (from 0.8%).**
- **Stubbornly high core inflation and receding EU banking sector concerns led us to lift the terminal ECB policy rate to 3.75%, with the risk of even 4.0%.**

In May, key euro area sentiment indicators signalled a weakening of activity. Most noteworthy, the composite PMI receded for the first time since October. With a reading of 53.5 in May (from 54.1) it remained in clearly expansionary teritory. But forward-looking components like new orders deteriorated signalling a further deceleration of activity in the months to come. That said, looking ahead we continue to think that the euro area will not fall into recession.

The backbone of activity is consumption which we expect to stay resilient. The unemployment rate is at a low (of 6.5%) while nominal wage growth accelerates and employment is set to expand further. Amid lower inflation we see potential for the savings rate to come down further thereby boosting demand additionally. As explained in greater depth elsewhere, we deem these tailwinds strong enough to buffer the dampening effects from faltering global growth and monetary policy tightening over the remainder of the year. The divergence between domestically-driven services sentiment and more globally-driven manufacturing sentiment is set to persist for the time being.

German Q1 GDP was surprisingly revised down to -0.3% qoq, from flat before. One-off effects related to the expiry of support measures for eco-friendly cars probably played a role. As a result we now expect German output to shrink in 2023 (by -0.1%) and we reduced our euro area growth expectations to 0.7% for 2023 and 0.6% for 2024. The latter is below the consensus of 1.0%.

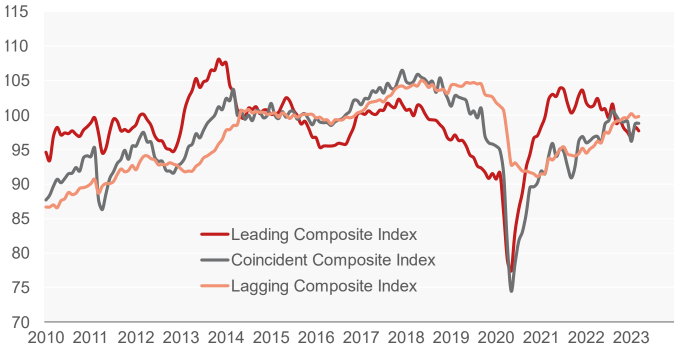
## ECB policy rate peak is nearing

For the ECB the situation remains challenging. Especially stubbornly high core inflation, inflation expectations well above target, and the risk of second-round effects warrant a restrictive policy stance. Governing Council members were very clear on that and also emphasised that potential banking sector woes could be separated from the policy stance. That said, the ECB research finds that the impact policy tightening so far will only have passed through by 2025. With weaker activity ahead we therefore think that the ECB will lift its depo rate until 3.75% by Q3 and then stay on hold. The risk, however, is tilted to a terminal rate of 4.0%.

# Japan

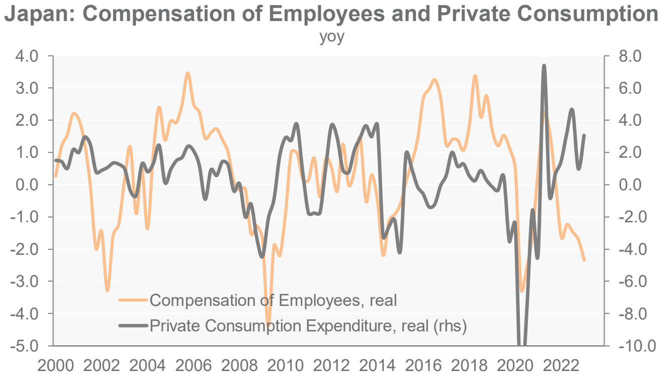
Christoph Siepmann

Cabinet Office: Composite Indicators



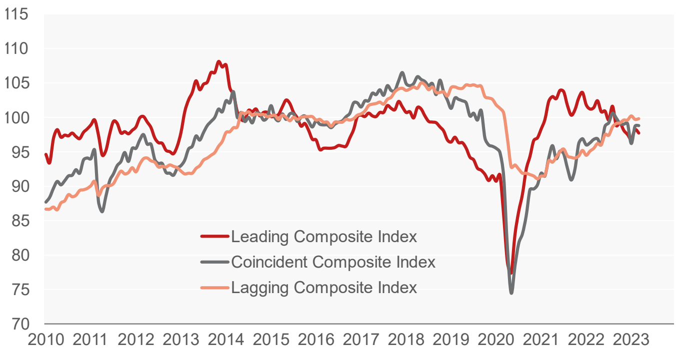

*Source: Japan Cabinet Office, GIAM*

Japan: Compensation of Employees and Private Consumption




*Source: Datastream, GIAM calculations*

Cabinet Office: Composite Indicators




*Source: Japan Cabinet Office, GIAM*

- **Japan's Q1 GDP growth surprised on the upside with consumption and capex the main drivers.**
- **Looking ahead, private consumption should provide some buffer to the drag from net external demand, but we see its scope as limited.**
- **However, Japan will not suffer from rising key rates and the BoJ stressed its patient approach.**

According to the first print, Japan's Q1 2023 GDP surprised on the upside with 1.6% qoq annualized (ann), well above the consensus forecast of 0.8% qoq ann. The recovery was primarily driven by private consumption (2.4% qoq ann) and capex (3.8% qoq ann). Surprisingly, consumption was mainly pushed up by durable goods purchases (5.9% qoq) while non-durables and services (0.7%/0.8% qoq) contributed much less, casting doubts about the strength of pent-up services demand. Despite China's recovery in Q1, exports dropped by 15.1% qoq ann while imports receded by 9.0% qoq, resulting in a net drag of external demand on GDP growth by 1.5 pp ann.

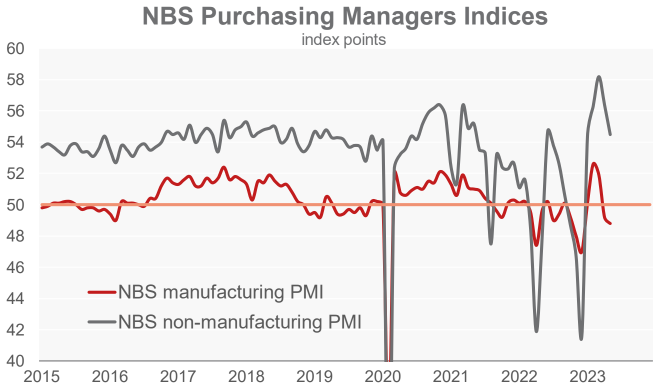
## Domestic demand to buffer external weakness for now

Looking ahead, we see China's growth dynamics to slow while the US could well fall into recession in H2. Thus Japanese exports are bound to stay soft on average. This implies the question if domestic demand, esp. private consumption can buffer the gap. Like in other countries, Japan's service PMIs showed high readings. Consumer confidence and household-related expectations from the Economy Watchers' Survey continued to improve. The Reuters non-manufacturing Tankan is also on high levels, while the BoJ's Tankan forecasts a marked slowing for the non-manufacturing sector in its March survey. Latest yoy retail sales remained upbeat, but other high frequency service indicators stalled while industrial production contracted slightly. Fundamentally, the discrepancy between real household consumption and real compensation of employees (see mid-graph) is elevated. Japan's flow of funds statistics show households' financial assets to have only risen by 0.4% yoy in 2022 (4.4% yoy in 2021) and households' deposits increased by 2.1% yoy in Q4 2022. Thus, we consider funds as more limited and pent-up demand may well help in the shorter run while longer-term the situation is not sustainable. The recent deposits rise is below headline (3.5% yoy) and traditional style core-core inflation (2.5% yoy). Meanwhile BoJ governor Ueda stressed the patient approach of monetary policy, reducing the odds of shortening of the YCC JGB tenors.

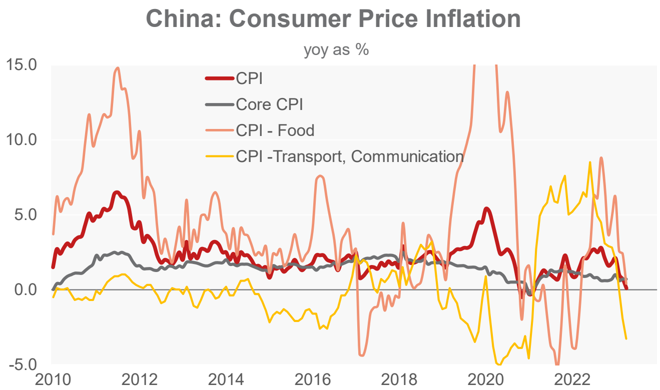
# China

Christoph Siepmann

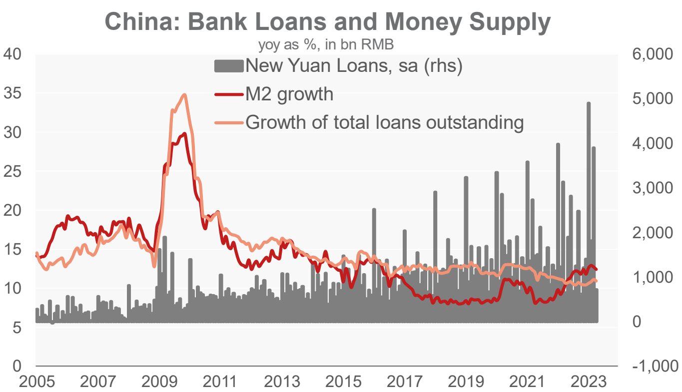
- **Although we already expected China's growth dynamics to soften, April's macro data came in under-whelming and remained uneven.**
- **This prompted already a discussion of more policy support and we take up again our call for a 25 bps RRR cut. However, quantitative tools will dominate.**
- **Fiscal policy is likely to stay rather calm. We see downside risks for our 2023 growth forecast of 5.7%.**




*Source: Datastream, GIAM*




*Source: Datastream, GIAM calculations*




*Source: Datastream. GIAM calculations*

After China's growth surprised on the upside in Q1, we already expected growth dynamics to recede. However, April activity data surprised on the weak side and MayNBS PMIs receded further. While some yoy data may appear high, they must be judged against very favourable base effects as the Shanghai lockdown started to bite in April 2022. On face value, April's industrial production (IP) picked up to 5.6% yoy (cons. exp. 10.9% yoy), after 3.9% yoy in March. However, in mom terms it contracted slightly. Moreover, fixed asset investment growth moderated to 3.9% yoy ytd (from 4.8% before), with the property sector also loosing momentum. Meanwhile, nominal retail sales scored an impressive 18.4% yoy (after 10.6% yoy in March) but this compares to a drop last year by 11.1% yoy. Imports reflected this disappointing domestic demand while exports held up better.

## Weakness suggest more policy support

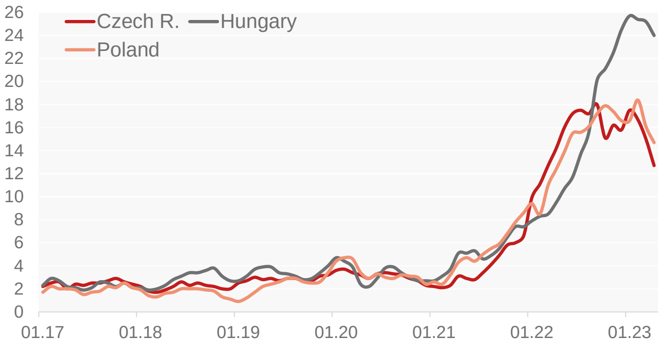
In sum, China's growth remained very uneven while overall losing momentum. Post-Covid services demand remained the main driver but started to ease. Both manufacturing PMIs (NBS and Caixin) are in slightly contractionary territory. This is in line with global developments (driven by the tightening of monetary policy around the globe), suggesting spill-over effects from international demand expectations into local production to play a role. Forward looking PMI subcom-ponents as "New Orders" and "New Export Orders" as well as the global backdrop point to weakness in manufacturing to persists for now. We expect fiscal policy support to be rather selective, given the already high credit to the non-financial sector of 295% in terms of GDP. Hopes rely more on monetary than fiscal support. In Q1, monetary policy had been more expansionary than announced with new yuan loans rising quite substantially. However, in April this development broke up but we expect the PBoC to turn more supportive again. Especially, we take up our previous call of a RRR cut by 25 bps in Q2, while the main measures will remain quantitative. CPI inflation will not stand in the way as it surprised again on the downside with just 0.1% yoy. We revise our CPI forecast down to 1.4% in 2023 but stick to the expectation that it will rise over time. We keep our GDP growth forecast of 5.7% but acknowledge downside risks,

# Central and Eastern Europe

Radomír Jáč

**Headline inflation**

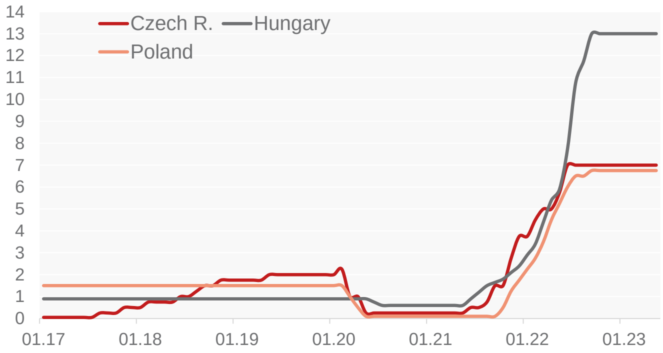
CE-3 countries (CPI yoy in %)




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

**Monetary policy interest rates**

CE-3 countries (end-of-month level, in %)




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

| Czech Republic | 2021 | 2022 | 2023f | 2024f |
|---|---|---|---|---|
| GDP | 3.5 | 2.5 | 0.4 | 2.8 |
| Consumer prices | 3.8 | 15.1 | 10.4 | 2.3 |
| Central bank's key rate | 3.75 | 7.00 | 6.00 | 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 | 0.9 | 2.8 |
| 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*

- **Inflation is moderating across the region but the CE-3 central banks are focused on strong wage growth and fiscal developments.**
- **The Polish central bank stays firmly on hold for now and the MPC is divided in the view whether a small rate cut will be possible later this year.**
- **The Czech CNB also kept its rates steady in May but a small hike was seriously debated at the meeting.**
- **The Hungarian MNB cut its O/N deposit rate by 100 bps to 17% in May and the monetary policy easing should continue in the months to come.**

Inflation – both headline and core CPI – is moderating across the region. The development has been driven by a decline in energy prices, slower annual growth of food prices and underlying price pressures that have softened in a reflection of weak household consumption. The disinflation should continue but the area of inflation targets set by the CE-3 central banks is likely to be reached only during 2024 at the earliest. Inflation remains high and central bankers focus their attention on wage growth and on fiscal policy stance, which are seen as potential pro-inflationary risks.

Household consumption remained weak in Q1 with the real disposable incomes being compressed by the high inflation. Preliminary data for GDP for Q1 presented a mixed picture with a contraction in Hungary (GDP down by -0.2% qoq), stagnation in Czechia and a sharp increase in Poland (3.9% qoq). We expect detailed data for Poland to show that GDP performance was impacted by volatility in inventories and we keep a view that the full-year GDP growth will be rather weak across the CE-3 in 2023, including Poland.

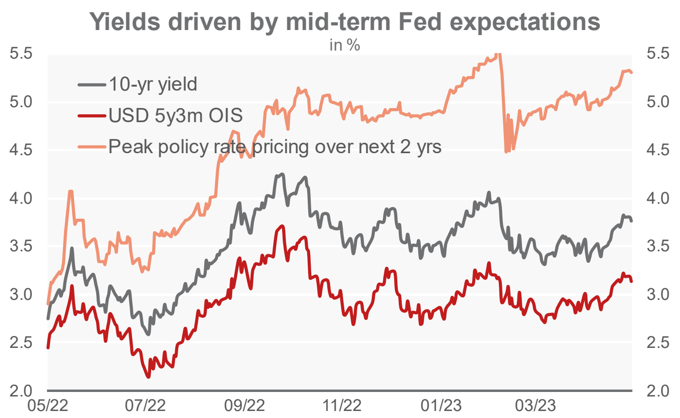
## Monetary policy: Hungary started a process of rate cuts

The Hungarian MNB started its policy normalization with a 100 bps cut in the O/N deposit rate to 17% in May. The step was enabled by firming of the forint seen in the past weeks. The MNB intends to cut its O/N depo rate further as long as the market sentiment is favourable. The Czech CNB kept its key rate at 7% but a 25 bps hike was debated at the May meeting. We share a view that the CNB will not increase its interest rates. We expect the CNB to start a cycle of rate cuts in Q4. In Poland, the NBP keeps its key rate at 6.75%. The MPC is divided in a view on the possibility of interest rate cuts in late 2023, as the hawkish camp calls for a longer stability of rates at their current levels. We expect the NBP to start cutting rates in 2024 in our baseline scenario.

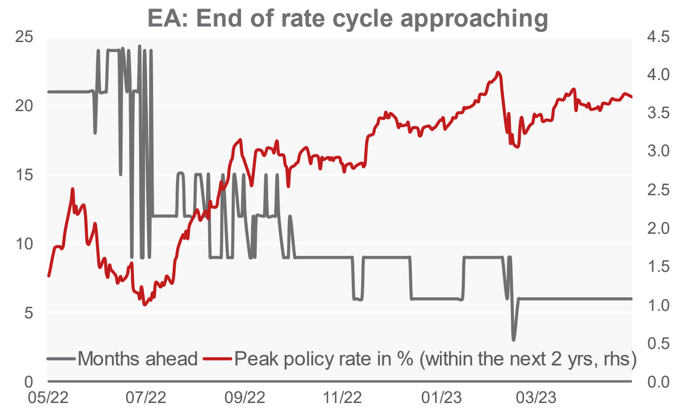
# Government Bonds

Florian Späte

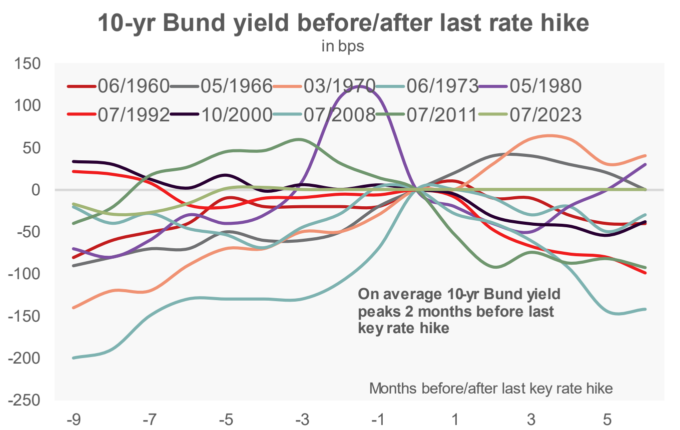
- **We do not regard the increase in government core yields as sustainable and forecast lower yields across the curve going forward.**
- **Amid ambitious key rate pricing for the Fed and an inevitable recession towards the end of the year we expect particularly US yields to fall going forward. However, yields in the euro area are seen to trend slightly downwards as well given the expected end of the ECB's key rate hike cycle in the summer.**
- **Euro area non-core bond spreads are expected to widen slightly amid a challenging growth environment and an accelerated Quantitative Tightening (QT). The development is forecast to remain orderly.**



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM

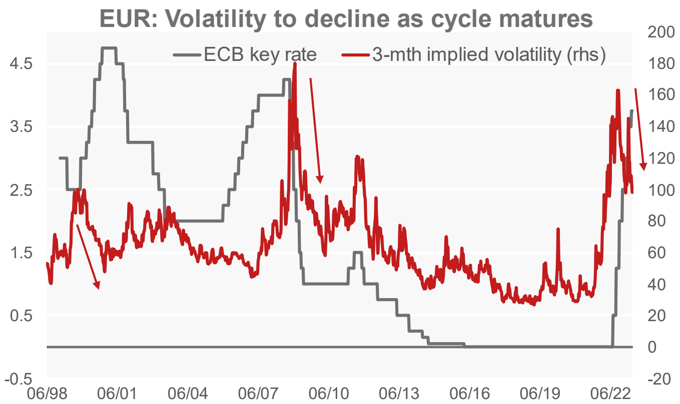



After moving sideways in the first half of May, core government bond yields rose almost daily in the second half of the month shrugging off any concerns about the health of the banking sector. Particularly US yields advanced forcefully driven by strong macro data and a significant upward revision of key rate expectations. Meanwhile, an additional (final) Fed hike is priced and the expectation that the central bank will cut in H2 is no longer the central scenario for financial markets. Consequently, international yield curves inverted further over the course of the month.

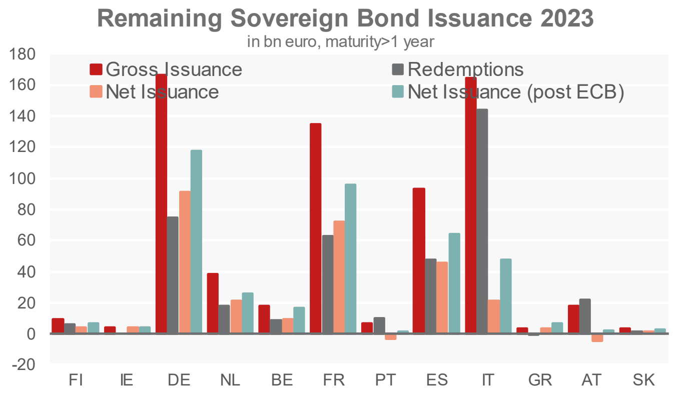
We do not consider the rise to be sustainable and expect lower US yields going forward. Notwithstanding robust US macro data, we regard a recession in H2 as inevitable. As annual inflation is already on a downtrend and considering the time lags of monetary policy we do not expect the Fed to hike going forward. Although a first key rate cut is only forecast for Q4 and the Fed is seen to stress its vigilance in the near term, current Fed pricing looks overdone. This contains the potential for disappointment. As soon as the signs of a recession increase (which we expect in the coming weeks), medium-term yield expectations in particular will also start declining. As the chart on the left shows, they have an even stronger correlation with long-dated US yields. What is more, the gap between 10-year yields and 5y3m Fed expectations appears unsustainable and implies also some leeway for US yields to fall. We forecast 10-year US yields to fall to 3.55% on a 3-month horizon and to 3.25% on a 1-year horizon. The decrease at the short end of the curve is expected to be even stronger.

The momentum is likely to be weaker in the EA but the trend for Bund yields is also seen to point to the South. Given the stubbornly high inflation and the respective hawkish comments from the ECB, we forecast two more hikes (each 25 bps) over the summer. However, the effect on long-dated

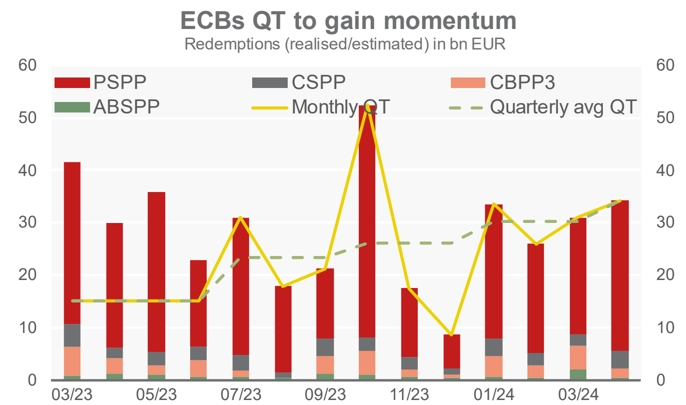
# Government Bonds




*Source: Bloomberg, GIAM*




*Source: Datastream, Bloomberg, GIAM calculations*




*Source: ECB, GIAM*

Bund yields is expected to remain contained. Historically, 10-year Bund yields peaked on average two months before the last yield hike (in most recent key rate cycles the average peak was even earlier). Moreover, medium-term EA inflation expectations look too high. Notwithstanding the only slowly declining inflation rate, 10-year inflation expectations of around 2.5% appear unsustainable.

Having said this, current market expectations of the first ECB cut appear overdone. While we agree with market pricing of a deposit rate of 3.75% by year-end we doubt that the ECB will cut aggressively in 2024 despite the weak growth environment. We forecast only two cuts next year (in contrast to almost four cuts priced by markets). Additionally, the ECB's QT will gain momentum from July onwards which stands in the way of a more significant downward trend as well. Overall, we forecast 10-year Bund yields to drop only slightly to 2.25% on a 3-month view and to 2.15% on a 12-month view. The 2-year/10-year curve is expected to steepen but the dynamic is likely to be weak in the near term. The bulk of the steepening will not occur until summer.

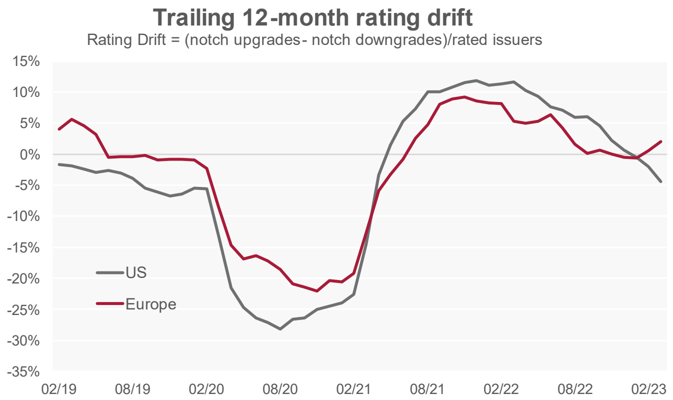
### EA non-core spreads: Factors balance each other out

EA non-core bond spreads moved sideways in May. Going forward, we do not expect any significant change in the environment, which is characterised by very low spread volatility. The declining yield volatility was an important driver for stable (or even declining) spreads in the past. This environment is favourable for carry trades. Moreover, some countries' issuance activity is well-advanced. Most noteworthy, Portugal but also Italy have already placed a large part of their planned volume on markets (Spain and to some extent, France is a bit lagging).

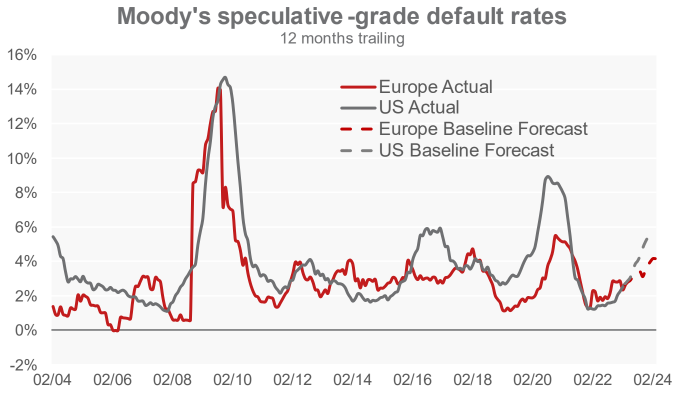
On the other hand, QT will start in earnest only in summer and it will gain momentum in the coming months. Additionally, valuations appear rich and most spreads are trading at the lower end of the trading range. This urges some caution going forward. Moreover, Japanese investors have reduced their investments abroad and we do not expect a turnaround anytime soon. Finally, the fundamental situation of some countries (particularly the large ones) calls for caution. With yields on a rather high level, the relief from lower coupons in recent years has turned around and is increasingly becoming a burden. With an average maturity of around 8 years and 25% of outstanding bonds coming due in 1-3 years Italy stands out. Concerning the structural budget deficit, the situation in France and Spain in particular appears challenging. Overall, we expect a moderate spread widening in the coming months with shorter-dated tenors being particularly attractive versus Bunds.

## Credit

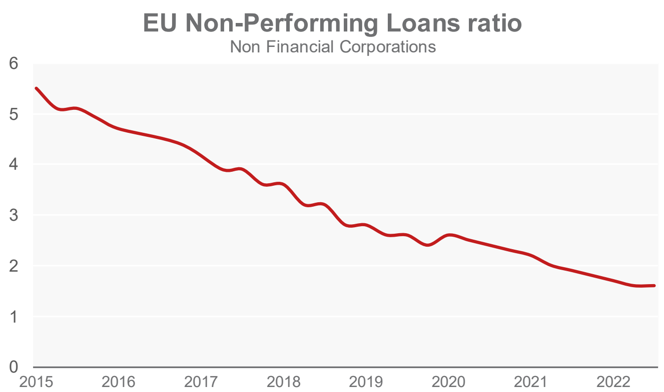
Elisa Belgacem




*Source: Moody's, GIAM*




*Source: Moody's, GIAM*




*ource:Bloomberg, EBA, GIAM*

- **Fundamentals will deteriorate from here. We expect IG spreads to be relatively resilient and to trade in a range. We see widening potential for HY (+100bp) over a 3-to-6-month horizon.**
- **We maintain our overweight (OW) stance on IG. Current CDS levels are attractive to buying credit protection.**
- **We do like IG duration even though curves are already very flat. We maintain our neutral stance on financials versus non-financials and our preference for subordination risk versus credit risk.**

The recession expectations have been postponed a few times over the recent months, but we think that decompression across the credit space is coming now. 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. As they did in 2020, we expect rating agencies to revise in priority the notations of companies at the lower end of the rating spectrum. Indeed, nearly 50% of HY-rated companies were downgraded by at least one notch, while IG has been mostly put on a negative outlook. Governments' support that helped contain defaults to 5% in Europe during Covid will be smaller due to lesser fiscal leeway from governments.

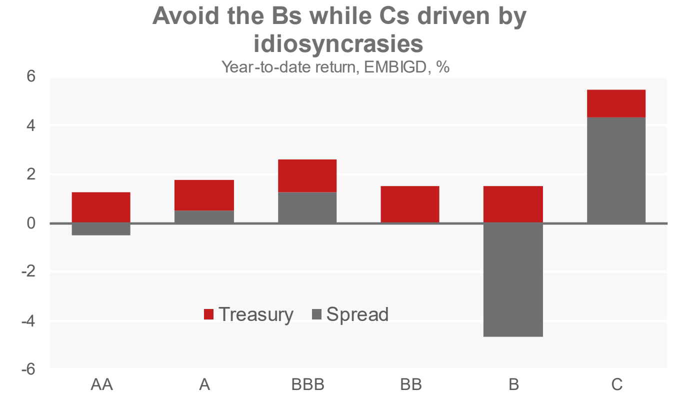
Also, we expect smaller companies to be the most at risk. Hence, we expect defaults to double from current levels both in the US and in Europe jumping to 4.5% from above 2% currently. In such context banks' asset quality should also deteriorate more than compensating the positive, which leads us to remain underweight financials versus non-financials in spread terms.

### Position for weaker fundamentals

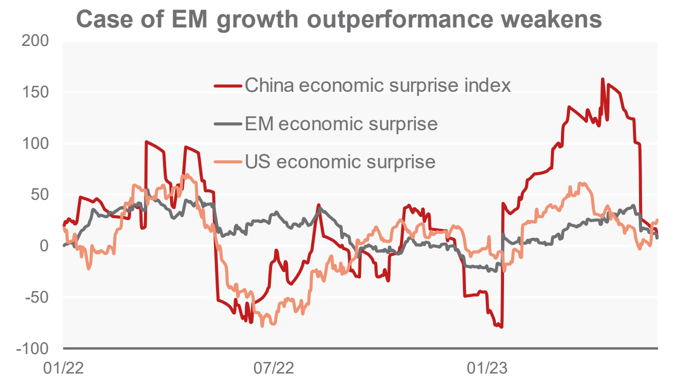
Overall, we prefer IG to semi-core and peripheral sovereigns, on valuation grounds. In Europe, IG levels are still attractive after the rally versus historical standards. We expect spreads to trade around current levels over the course of next year. For HY, we think that current valuations do not reflect 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. However, as the carry is now higher in the financial space as spreads have substantially diverged over the course of 2022, we are neutral in total return terms..

## EM sovereign bonds

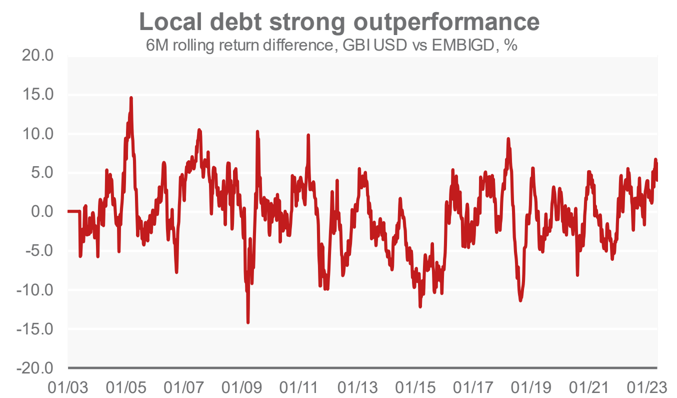
Guillaume Tresca




*Source: JP, Bloomberg, GIAM*




*Source: Citi, Bloomberg, GIAM*




*Source: JP, Bloomberg, GIAM*

- **EM assets will keep range trading in a bumpy environment. We maintain our overweight (OW) on external debt, but prefer a selective and defensive approach.**
- **EM growth outperformance is weakening, and valuations are tight. EM local debt is more attractive, especially in LatAm, than EM external debt.**
- **For EM external debt, quality carry is the silver lining. Spread will widen and we favour IG, especially BBBs (Mexico, Romania).**

EM assets have been facing a noisier and difficult trading environment with debt ceiling uncertainties, rising US front-end rates, and mixed growth signals. EMs should continue to range trade, and we maintain an overweight stance in EM external debt in our global allocation.

### Quality carry is the silver lining

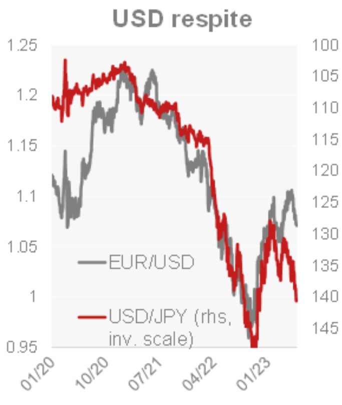
The global EM environment has continued to deteriorate, and the approach has to be selective and defensive. The most significant change is the gradual repricing of the Chinese reopening theme and the weakening case for EM growth outperformance that drove strong performance in early 2023. Thus, market direction is currently lacking, and we still expect a shallow US recession in H2 that should lead to differentiated EM asset returns. EMs are in a late-cycle situation where historically the Fed's late rate hike is a positive signal, but uncertainties on growth/inflation prevent from taking a fully positive stance. In this uncertain environment, the silver lining remains the EM carry.

### Favour EM local over external debt on tight valuations

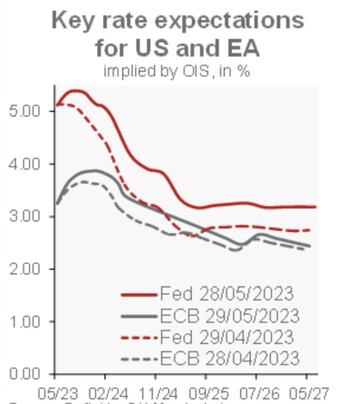
Both EM local and external debt will provide positive returns, but we favour EM local debt, whose performance will be driven more by duration than FX, given the expected growth /inflation slowdown. The front end has to be avoided given the stickiness of core inflation and the excessive pricing of monetary easing. Region-wise, we favor high-yielders in LatAm and CEE. EM external debt valuations have remained tight, barely widening YTD. Given the recession risk and expected spread widening, we still favor IG over HY and quality carry in BBB and BBs. Bs remain to be avoided, while Cs are driven by idiosyncrasies. In EM IG, there is plenty of dispersion, and CEE names like Romania are attractive. Israel's valuation has improved, while in LatAm, Mexico remains a compelling buy. FX-wise, EM EUR bonds have outperformed since Q4 2022, but they now offer a less compelling pickup over EM USD bonds (FX-hedged). The EM USD index will now outperform the EM EUR index until year-end driven by better duration prospects and higher carry.

## Currencies

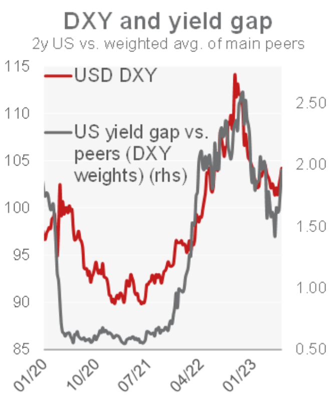
Thomas Hempell




Source: Datastream, GIAM




Source: Refinitiv, GIAM calculations

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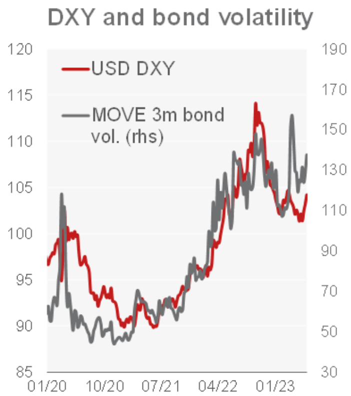
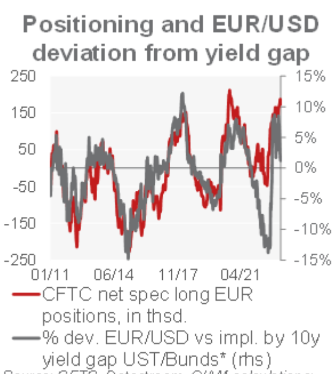
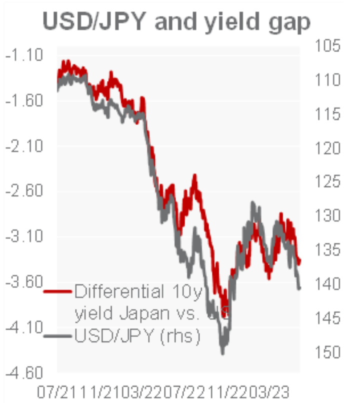



Source: Datastream, GIAM




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




Source: Datastream, GIAM calculations

- **The USD respite over May is not a trend reversal. Tightening yield gaps, easing rates volatility and a H2 US recession will still erode the greenback's appeal.**
- **Yet the path is set to be choppy near term. Global growth worries and fragile risk aversion are set to offset some of the dollar's headwinds. Also, speculative EUR long positions look stretched. And JPY strength may still need to await a drawdown in US yields and clearer signs of BoJ questioning its YCC.**
- **We see some more upside for CHF on safe haven bids and persistent inflation worries at the SNB.**

The USD has pared some of this year's steep losses, boosted by a repricing in Fed rates expectations and rising yields (top charts). The US debt ceiling debate has had only limited effect on the greenback, with yield differentials and uncertainties still in the driving seat (mid charts). Any worries about the adverse effects of US default were widely offset by safe haven bids. Near term, the countercyclical appeal of the USD may still proof a support, as global cyclical concerns are on the rise and risk sentiment is shaky. Speculative EUR long positions remain stretched and keep EUR/USD detached from levels suggested by pure 10y yields differentials on a 3y rolling basis (bottom left). This may add more volatility if positions mean-revert to less EUR supportive levels.

### Persistent case for USD weakness by year-end

Yet the overall case remains for renewed USD weakness. First, we still expect the credit crunch to drive the US into recession, with our cumulative US growth forecasts for 2023/24 one percentage point below consensus. This will also, second, likely keep the Fed from further hikes and bring it into pool position among major peers for a pivot later this year. The resulting erosion of the US yield advantage is key for expected USD weakness into next year. Finally, as inflation gradually normalizes (even if very sluggishly for core pressures) and a Fed pivot comes into sight, bond volatility will ease and remove a key pillar of US strength over the past years (mid right chart).

Rising US yields and the BoJ's new governor's dovish stance on YCC have created a perfect storm for JPY (bottom right). Yet both drivers are likely to ultimately reverse. Policy makers have become alert on the yen's weakness. We expect USD/JPY to settle below 140 again soon, with the 130 threshold in sight for later in the year. We also have a favourable view on the CHF, that may be bolstered by higher risk aversion. Also, the SNB will keep its preference for CHF strength amid persistently high inflation.

# Equities

Analysis of the median stock: Q1 2023 reporting season

| Median stock | Earnings Growth | | Sales Growth | | margin trend * | | avail-ability |
|---|---|---|---|---|---|---|---|
| | Q4 2022 | Q1 2023 | Q4 2022 | Q1 2023 | Q4 2022 | Q1 2023 | Q1 2023 |
| S&P | 8.3 % | 4.6 % | 6.7 % | 5.9 % | 1.6 % | (1.3)% | 97.2% |
| Stoxx | 8.9 % | 11.2 % | 13.7 % | 10.5 % | (4.8)% | 0.7 % | 91.8% |

| 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 | 3.3 % | 5.0 % | 1.0 % | 1.7 % | 2.2 % | 3.3 % | 97.2% |
| Stoxx | 3.8 % | 8.0 % | 1.5 % | 1.8 % | 2.4 % | 6.3 % | 91.8% |

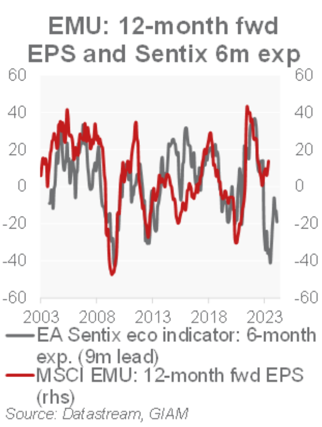
Note: numbers for Q4 2022 are calculated only for the companies which have so far reported in Q1 2023; proxy for margin trend = earnings growth - sales growth

*Source: Bloomberg, GIAM calculations*

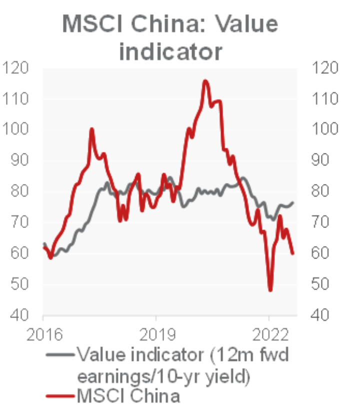
| | US NIPA profits pre-tax | | S&P earnings | | EMU earnings | |
|---|---|---|---|---|---|---|
| | bl$ | yoy | level | yoy | level | yoy |
| 2022 Q2 | 3,001.3 | 7.7 | 214.5 | 34.7 | 15.1 | 41.7 |
| 2022 Q3 | 3,000.0 | 5.5 | 218.1 | 21.4 | 15.5 | 23.6 |
| 2022 Q4 | 2,939.5 | 2.6 | 217.6 | 9.9 | 16.1 | 19.1 |
| 2023 Q1 | 2,788.0 | -2.8 | 216.8 | 4.0 | 16.3 | 17.5 |
| 2023 Q2* | 2,786.3 | -7.2 | 212.5 | -0.9 | 16.0 | 5.7 |
| 2023 Q3* | 2,852.7 | -4.9 | 211.9 | -2.8 | 15.5 | 0.1 |
| 2023 Q4* | 2,884.9 | -1.9 | 212.8 | -2.2 | 15.6 | -3.3 |
| 2024 Q1* | 2,922.8 | 4.8 | 216.6 | -0.1 | 16.0 | -1.9 |
| 2024 Q2* | 2,966.4 | 6.5 | 216.6 | 1.9 | 16.6 | 3.9 |
| 2024 Q3* | 3,021.8 | 5.9 | 219.8 | 3.7 | 16.2 | 4.9 |
| 2024 Q4* | 3,045.1 | 5.6 | 224.1 | 5.3 | 16.5 | 5.5 |

*Source: Datastream, GIAM calculations*

*Note: earnings are derived from NIPA; forecasts are from 2023Q2 on.*




*Source: Datastream, GIAM*




*Source: Datastream, GIAM calculations*

- **Financial conditions should continue to tighten, while macro surprises and confidence indicators are pointing south.**
- **Monetary policy's disinflationary power acts with a lag of some quarters, and in H2 2023 - at least till Q1 2024, the economy should feel the hit.**
- **After a strong Q1 reporting season, we see a slowdown in earnings growth of around 2%-3% for the US and EA in 2023, with positive growth thereafter. We remain below consensus by 5pp to 9pp for 2024 and 2025.**
- **These factors, along with an increased equity positioning by investors to neutral levels, are set to weigh on stocks, particularly since valuations vs. real yields and credit spreads look still elevated. Volatility for out-of-the-money puts has increased visibly.**
- **We remain cautions on equities short term, in particular on cyclicals and value names, favouring ex-US equities. We significantly reduce our relative OW on EMU vs. US to a very slight one.**
- **EU sectors: OW Food Retail, Food Bev. Tob., Health Care Equip. & Svs. (new) and Software. UW Banks, Capital Goods, Insurance, Media, and Transportation.**

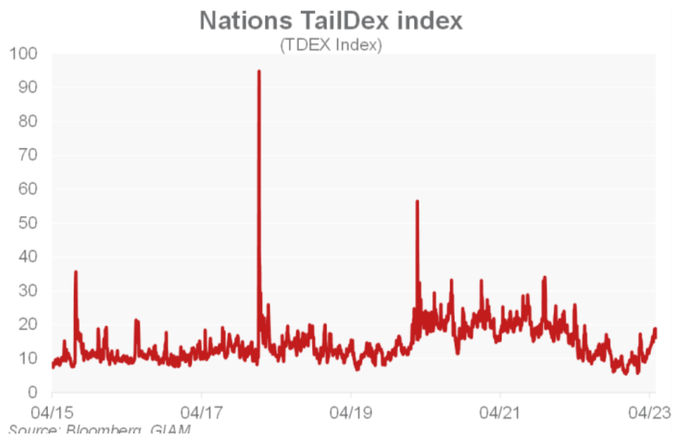
The Q1 reporting season has surprised positively analysts' expectations. Indeed, before firms started reporting, growth expectations fell substantially (-6.5% yoy since January 2023 and –13% since April 2022) such that they became easier to beat. World Q1 GDP estimates improved since January together with global macro surprises, which reached a cyclical peak by the end of March. In particular, euro area (EA) surprises beat visibly US ones.

For the median stock, Q1 US earnings (EPS) growth is at 4.6% yoy vs. 8.3% in Q4 2022. Sales are rather stable around 6% yoy. Earnings surprises were higher than in Q4, 5% vs. 3%. European figures are as positive or even better than US ones: EPS growth at 11% and surprises at 8%, both better than in the previous quarter.

Looking forward, we see a slowdown in EPS growth. Global macro surprises are already in contraction territory, inflation is decreasing, lending standards will continue to tighten, and confidence indicators are weakening. Monetary policy's disinflationary power acts with a lag of some quarters, and in H2 2023, till most probably Q1 2024, the economy should feel the hit. Indeed, a negative yield curve, decreasing loans and plunged money aggregates all paint a slowdown scenario ahead. This was recently mirrored by the Sentix and IFO confidence indicators which would lead to a slow-

# Equities

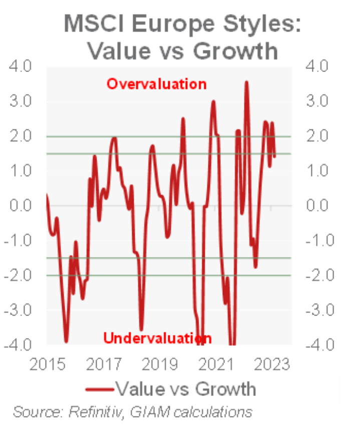
Michele Morganti, Vladimir Oleinikov

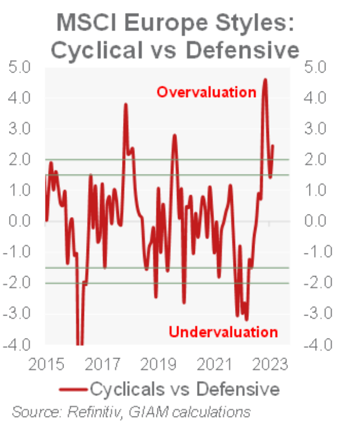



| Markets | Price / Earnings* | Multiples Avg. Discount, | PEG adj.* | Value Gap (Fair V. - Price): Pos = Upside, pp | excess CAPE yield * | excess CAPE yield, 1yr fwd | excess CAPE yield, AVG | excess CAPE yield, 1yr fwd (point f'cast for 10y real rate) | excess CAPE yield, 1yr fwd (point f'cast for 10y real rate), AVG |
|---|---|---|---|---|---|---|---|---|---|
| WORLD | 16.5 | **16.0** | | 16.5 | - | - | - | - | - |
| USA | 18.5 | **24.1** | 2.3 | -28.7 | 3.0% | 3.6% | **4.3%** | 4.3% | **4.7%** |
| JAPAN | 13.6 | **-7.3** | 2.1 | -1.9 | 5.7% | 5.3% | **4.8%** | 6.6% | **5.2%** |
| UK | 10.3 | **-15.6** | 2.6 | -7.4 | 6.2% | 7.3% | **6.4%** | 9.5% | **7.0%** |
| SMI | 16.6 | **12.6** | 1.8 | -18.3 | 4.3% | 4.1% | **4.9%** | 5.6% | **5.0%** |
| EMU | 12.1 | **-0.2** | 1.8 | -10.8 | 5.8% | 6.4% | **6.8%** | 8.2% | **7.2%** |
| EM | 11.7 | **-9.8** | 2.1 | -23.6 | - | - | **-** | - | **-** |
| BRAZIL | 7.4 | **-36.1** | 1.3 | 39.3 | - | - | **-** | - | **-** |
| INDIA | 22.5 | **14.6** | 1.8 | -12.6 | - | - | **-** | - | **-** |
| CHINA | 12.4 | **-17.8** | 1.4 | 27.0 | 9.2% | 8.9% | **5.7%** | 9.1% | **5.5%** |

Note: **data since 1993**; World and EMs are based on MSCI, for other markets local indices are used. Multiples are based on 12m forward estimates. PEG is PE divided by expected EPS long-term growth. PEG adj. (higher = expensve): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it. 12m fwd real BY is calculated using Bloomberg consensus forecasts in 12m. COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs). Fair Value Indicator = 12M FW EPS / (10Y Rate + α); Value Gap = % diff. between Fair Value and Price; Negative Value Gap = Downside Risk; Fair Value Indicator Change = increase/decrease of theoretical fair value due to EPS or yields delta. CAPE (cyclically-adjusted PE) = index price divided by earnings averaged over a 10-year period adjusted for inflation. excess CAPE yield = 1/CAPE - (10yr rate - avg inflation over 10yr)

Source: Thomson Reuters Datastream, IBES estimates.




down in earnings growth (see chart). In such conditions we expect a more limited pricing power and lower margins.

### Earnings models pointing south in the next quarters

Our models see -2/-3% yoy growth in 2023 for both the US and EMU, with a recovery thereafter, with decreasing margins albeit to a limited extent (see table previous page). Our forecasts remain below consensus by 3-to-5% this year, 5% in 2024 and 9% in 2025.

### Slightly UW equities, still OW ex-US equities

We remain cautious on equities in the short term, in particular for cyclicals and Value names. Positioning is not low any longer but rather neutral. In this respect, the volatility cost for out-of-the-money puts has recently increased rapidly from 10-year lows, reaching average levels during Covid.

On a 12-month horizon we see mid-single digit total returns, favouring ex-US indices. Both declining inflation and bond volatility plus appealing equity earnings yield gap vs. 10-year real rates look supportive for ex-US countries. Short term, we stay with a reduced OW on EMU vs. US to a very slight one: relative macro surprises are weakening, and a stronger trade-weighted euro should act less positively for the EA relative performance. On valuation ground instead, EA still looks more attractive for the mid term. We stay OW on the SMI and on UK (less), on valuation grounds. We diversify our OW in Asia through Japan, China and India (new). China IT is very attractive vs. US IT (PEG & Fed Model).

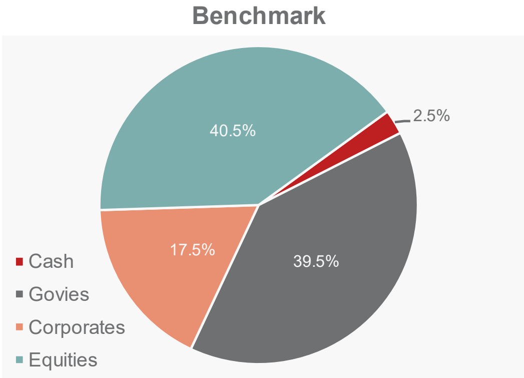
EU Sectors: in line with a cautious stance on equity outlook we maintain a defensive – growth allocation. But we suggest a few switches towards growth: we lower Telecoms and Utilities to Neutral (high valuation, neg. revisions) to increase Software, Food Retail and Health Care Equip. & Svs. (better earnings momentum and valuation rank). Banks show low valuation, but credit risk remains high together with decreasing fundamental momentum (lower GDP and rates plus higher defaults ahead). OW Food Retail, Food Bev. Tob., Health Care Equip. & Svs. (new) and Software. UW Banks, Capital Goods, Insurance, Media, and Transportation.

### EMs: supportive investment sentiment and easing cycle

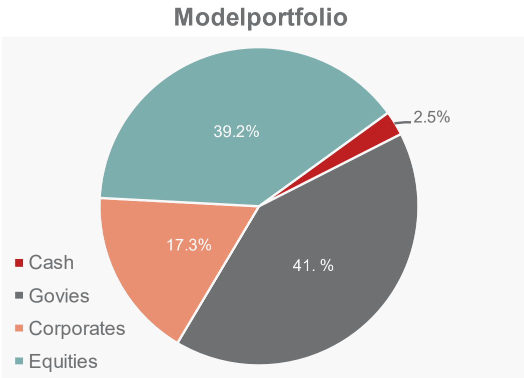
EMs should benefit from increasing Sentix investment sentiment and earnings revisions. While recent China (OW) data showed weakness, we judge the Chinese economy's cyclical upturn to linger. Additionally, the easing monetary cycle in the EM space is undergoing. OW China (good ML models and country valuation score) and India: improved valuation score, GDP growth slowly to increase, inflation peak passed, good Q1 rep. season.

## Asset Allocation

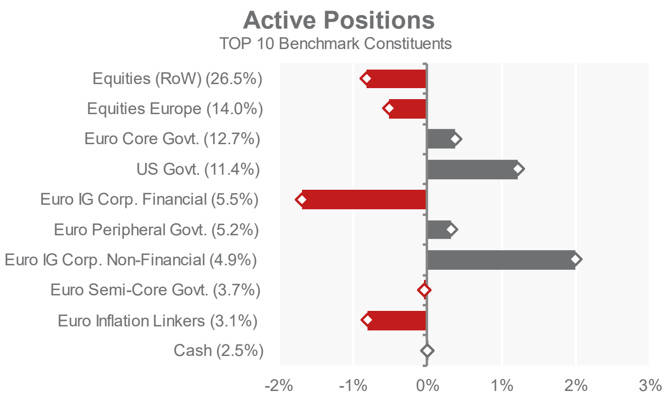
Thorsten Runde




*Source: GIAM*




*Source: GIAM*




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

- **In May (29.05.23), the returns of most of our covered asset classes find themselves in negative territory.**
- **Just the MSCI Pacific & North America, EA HY Credit, Inflation Linkers, and Cash made it above the zero line. Together with short-dated fixed income these assets represent the top of the performance ranking.**
- **The bottom of the ranking is clearly dominated by long-dated fixed income and EM Govies.**
- **Overall EA HY Credit outperformed IG by roughly +95 bps. Within IG, Fin was superior to Non-Fin (+47 bps).**
- **The smouldering banking crisis is adding to the strong credit tightening amid much higher rates, which is casting a long shadow over H2.**
- **Thus, we keep the underweights in the most risky assets like Equities and EA HY Credit. All in, we still like EA IG Credit with a clear preference for Non-Fins. We stay overweight in Core Govies, BTPs, and US-Treasuries and to a lesser extent in EM bonds.**

With -6.2 bps the relative performance of our model portfolio was negative in May (29.05.23). The active positioning in Bonos and short-dated BTPs proved most rewarding with an aggregated performance contribution of +0.6 bps. On the negative side the active positions in US Treasuries, EM Govies, Corporates and Equities particularly hurt (-6 bps).

So far, excess savings, wage growth and European fiscal support kept consumption and services underpinned. That said, the massive monetary tightening and refuelled banking worries will kick of a credit tightening by banks and a US recession in H2. The China reopening bounce is mostly domestic, with global export orders pointing south, thus global trade offers no relief.

### Elevated risk of further accidents

Against this backdrop we maintain a cautious stance on the most risky market segments in the model portfolio like Equities and HY Credit. We still like IG Credit in total, but with a significant tilt in favour of Non-fins. In the Govie segment, we generally stay overweight with a preference for the belly of the Core curve and the short end of the BTP curve. We expect US Treasuries to deliver value across the curve, due to a decent carry and as a safe haven against a deterioration in risk sentiment. We see more downside for the USD by year-end amid the looming US recession and the Fed prospectively leading a global easing cycle.

# Forecasts

## Macro Data

| Growth[1] | 2022 | 2023 forecast | 2023 Δ vs. cons. | 2024 forecast | 2024 Δ vs. cons. |
|---|---|---|---|---|---|
| US | 2.0 | 0.6 | - 0.5 | 0.2 | - 0.5 |
| Euro area | 3.3 | 0.7 | 0.0 | 0.6 | - 0.4 |
| Germany | 1.8 | - 0.1 | - 0.1 | 0.5 | - 0.7 |
| France | 2.6 | 0.4 | - 0.1 | 0.5 | - 0.6 |
| Italy | 3.9 | 0.8 | 0.2 | 0.7 | - 0.3 |
| Non-EMU | 3.6 | - 0.0 | 0.1 | 0.9 | - 0.1 |
| UK | 4.1 | - 0.1 | 0.1 | 0.7 | - 0.1 |
| Switzerland | 2.1 | 0.8 | 0.1 | 1.5 | 0.0 |
| Japan | 1.2 | 0.8 | - 0.3 | 1.1 | 0.0 |
| Asia ex Japan | 4.1 | 5.0 | 0.0 | 4.8 | - 0.4 |
| China | 3.0 | 5.7 | 0.2 | 4.8 | - 0.3 |
| CEE | 1.8 | 0.8 | 0.4 | 3.2 | 1.0 |
| Latin America | 3.7 | 0.7 | 0.0 | 1.6 | - 0.0 |
| **World** | **3.3** | **2.4** | **- 0.1** | **2.6** | **- 0.2** |

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. |
|---|---|---|---|---|---|
| US | 8.0 | 4.4 | 0.1 | 2.4 | - 0.2 |
| Euro area | 8.4 | 5.5 | 0.0 | 2.5 | 0.1 |
| Germany | 8.6 | 5.9 | - 0.2 | 2.7 | - 0.1 |
| France | 5.9 | 4.8 | - 0.5 | 2.4 | - 0.3 |
| Italy | 8.2 | 5.2 | - 0.8 | 2.4 | 0.0 |
| Non-EMU | 8.1 | 6.1 | 0.1 | 2.5 | - 0.1 |
| UK | 9.1 | 6.6 | 0.2 | 2.7 | - 0.1 |
| Switzerland | 2.8 | 2.6 | 0.0 | 1.5 | 0.0 |
| Japan | 2.5 | 2.6 | 0.1 | 1.8 | 0.4 |
| Asia ex Japan | 3.5 | 2.7 | - 0.4 | 3.0 | 0.1 |
| China | 1.9 | 1.4 | - 0.8 | 2.3 | - 0.1 |
| CEE | 29.6 | 17.7 | - 0.4 | 8.3 | - 3.2 |
| Latin America[2] | 7.8 | 5.8 | 0.8 | 4.0 | 0.6 |
| **World** | **7.8** | **5.2** | **- 0.1** | **3.3** | **- 0.2** |

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

## Financial Markets

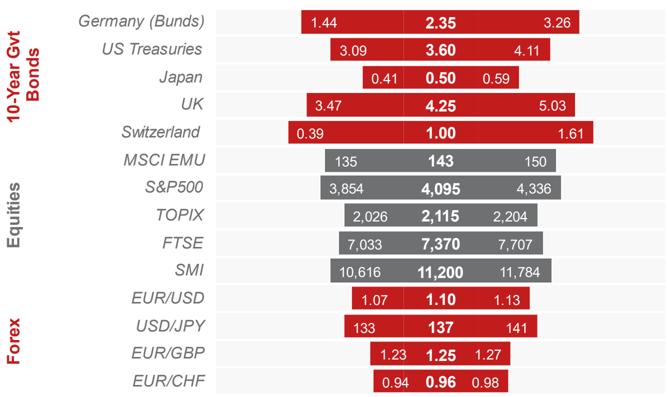
| Key Rates | Current* | 3M Forecast | 3M Fwd | 6M Forecast | 6M Fwd | 12M Forecast | 12M Fwd |
|---|---|---|---|---|---|---|---|
| US (upper bound) | 5.25 | 5.25 | 5.32 | 5.25 | 4.98 | 4.50 | 4.07 |
| Euro area | 3.25 | 3.75 | 3.63 | 3.75 | 3.75 | 3.75 | 3.28 |
| Japan | -0.10 | -0.10 | -0.02 | -0.10 | 0.02 | 0.00 | 0.09 |
| UK | 4.50 | 4.75 | 5.11 | 4.75 | 5.50 | 4.25 | 5.16 |
| Switzerland | 1.50 | 1.75 | 1.78 | 2.00 | 1.92 | 2.00 | 1.91 |
| **10-Year Gvt Bonds** | | | | | | | |
| US Treasuries | 3.80 | 3.55 | 3.78 | 3.45 | 3.75 | 3.25 | 3.71 |
| Germany (Bunds) | 2.49 | 2.25 | 2.51 | 2.20 | 2.50 | 2.15 | 2.48 |
| Italy | 4.30 | 4.10 | 4.41 | 4.05 | 4.46 | 4.10 | 4.54 |
| *Spread vs Bunds* | 182 | 185 | 190 | 185 | 196 | 195 | 206 |
| France | 3.06 | 2.85 | 3.09 | 2.80 | 3.09 | 2.75 | 3.11 |
| *Spread vs Bunds* | 58 | 60 | 58 | 60 | 60 | 60 | 63 |
| Japan | 0.43 | 0.50 | 0.49 | 0.60 | 0.53 | 0.70 | 0.60 |
| UK | 4.35 | 4.20 | 4.36 | 4.10 | 4.34 | 3.95 | 4.35 |
| Switzerland | 1.12 | 0.95 | 1.05 | 0.90 | 1.03 | 0.85 | 1.06 |

*3-day avg. as of 29/05/23
**ICE BofA (OAS)

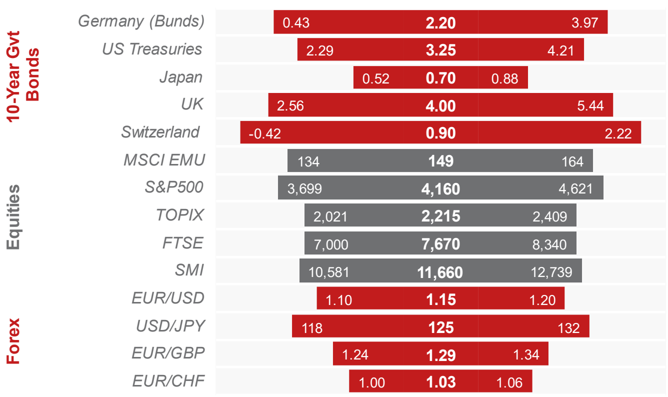
| Credit Spreads** | Current* | 3M Forecast | 3M Fwd | 6M Forecast | 6M Fwd | 12M Forecast | 12M Fwd |
|---|---|---|---|---|---|---|---|
| EA IG Non-Financial | 154 | 160 | | 160 | | 155 | |
| EA IG Financial | 186 | 200 | | 210 | | 200 | |
| EA HY | 459 | 565 | | 540 | | 515 | |
| EM Sov. (in USD) | 359 | 380 | | 385 | | 370 | |
| **Forex** | | | | | | | |
| EUR/USD | 1.07 | 1.09 | 1.08 | 1.12 | 1.08 | 1.15 | 1.09 |
| USD/JPY | 140 | 137 | 138 | 132 | 136 | 125 | 132 |
| EUR/JPY | 150 | 149 | 149 | 148 | 147 | 144 | 144 |
| GBP/USD | 1.23 | 1.25 | 1.24 | 1.27 | 1.24 | 1.31 | 1.23 |
| EUR/GBP | 0.87 | 0.87 | 0.87 | 0.88 | 0.88 | 0.88 | 0.88 |
| EUR/CHF | 0.97 | 0.96 | 0.97 | 0.99 | 0.96 | 1.03 | 0.95 |
| **Equities** | | | | | | | |
| S&P500 | 4,187 | 4,095 | | 4,115 | | 4,160 | |
| MSCI EMU | 146.4 | 142.5 | | 145.5 | | 149.0 | |
| TOPIX | 2,151 | 2,115 | | 2,150 | | 2,215 | |
| FTSE | 7,608 | 7,370 | | 7,480 | | 7,670 | |
| SMI | 11,398 | 11,200 | | 11,455 | | 11,660 | |

## 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

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