GENERALI INSURANCE ASSET MANAGEMENT

Market Perspectives

Third time lucky?

GIAM Macro & Market Research

November 2022

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- That still looks premature as big inflation overshoots keep steering central banks' hands for now. Yet markets may take some comfort from a slower pace of Fed and ECB tightening after fresh Oct/Nov jumbo hikes. Warm weather and falling natural gas prices are also helping sentiment just now.
- Amid strong headwinds from a developing euro area recession and cracks in the financial plumbing, we stick to a prudent allocation stance.
- We keep a underweight in risky assets (Equities, HY), while preferring IG Credit and Cash. A reversal of stretched USD strength is not (yet) due.

CONTENT

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Global View – Third time lucky?

Thomas Hempell / Vincent Chaigneau

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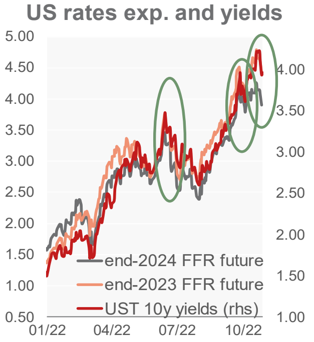
With markets bearishly positioned and panicking central banks raising rates aggressively, even faint hopes of a looming Fed pivot can send markets soaring. For the 3rd time since summer, Fed pivot optimism has pushed rates lower (left chart) and equities higher, helping the MSCI World to end October in the green (+7.7% by Oct 28).

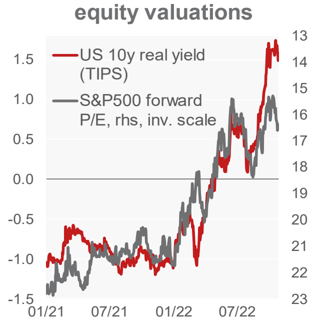
Risks of a policy mistake are rising as the euro area nose-dives into recession. US housing and business surveys point to a more severe slowdown than resilient hard data. The economic impact of past rate hikes will materialize only with a lag. As rates move deeper into restrictive territory, central banks will slow the tightening and need to pivot at some point to not risk economic and financial havoc. Markets are ready to quickly price these hopes and did so following last week's ECB meeting.

US rates exp. and yields



Source: Datastream, GIAM calculations

US real yields and equity valuations



Source: Datastream, GIAM

As flagged earlier, a full pivot may be a key trigger for a more sustained market recovery – but we are unlikely there yet. Inflation pressures have broadened so much that the Fed and ECB are still more worried about pivoting too early than too late. The continued overshoot in actual inflation continues to steer their hands for now.

The economic setup remains challenging, too. A warm autumn has helped Europe to refill gas storage and see gas futures falling back to June lows. Yet fundamentally, the energy crisis is not behind us. Cold weather into winter may see gas storage deplete quickly, with outright rationing and a deep recession a significant risk. Exceptionally high uncertainties about inflation, policy and geopolitics will keep business and consumer confidence depressed. Risk positioning is bearish and equity valuations have corrected sharply, but still look elevated vs. surging real yields (right-hand chart).

Financial risk on the rise

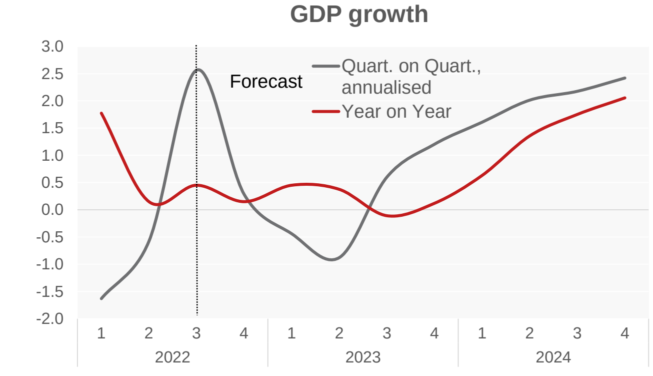
The UK turmoil has laid bare the limits of fiscal relief, as did a poorly received Bund auction to finance the €200bn energy relief package. The looming unwinding of the ECB's APP holdings will add to net bond supply. And as the US Treasury's OFS financial stress index remains close to 2-year highs, mounting margin calls, tightening financial conditions and persistent USD strength provide little relief.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	4.02	4.00	3.95	3.80
Germany (Bunds)	2.09	2.20	2.20	2.15
Credit Spreads**				
EA IG Non-Financial	209	210	205	200
EA IG Financial	238	245	235	225
Forex				
EUR/USD	1.00	0.95	0.97	1.02
USD/JPY	147	146	140	135
Equities				
S&P500	3832	3765	3805	3880
MSCI EMU	126	124	125	128

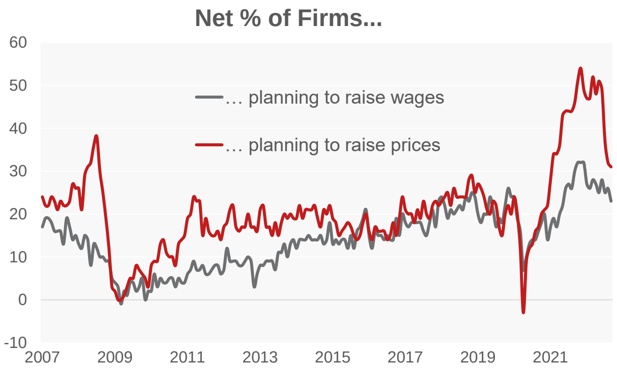
**3-day avg. as of 27/10/22 **ICE BofA (OAS)*

Amid the conjecture of depressed positioning vs. severe headwinds from economics and policy, we stick to a prudent allocation – with an underweight (UW) in riskier assets (Equities, HY Credit) – but are likely to partly neutralise positions into yearend. We continue to overweight (OW) safer buckets in Fixed Income benefitting from a higher carry, incl. IG Credit. We trimmed the exposure to financials – exposed to the recession and punitive policy measures, e.g. TLTRO reform – to the benefit of USTs and Cash. We keep a tactical UW in EM bonds amid the headwinds from tighter global financial conditions, the strong USD and global growth weakness, even if the long-term outlook looks more benign. USD looks stretched, but still has upside near term thanks to its countercyclical properties and a more resilient US economy.

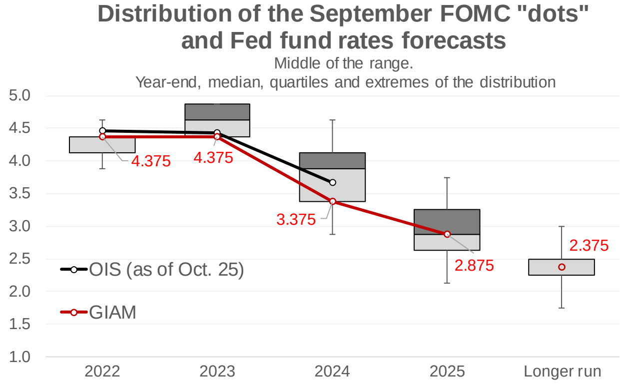
Paolo Zanghieri



Source:BEA, GIAM



Source:NFIB, Refinitiv, GIAM



Source:Federal Reserve Board, Datastream,GIAM estimates

- **Q3 GDP rebounded from poor H1 readings, but consumption weakened. We expect GDP to rise by just 0.2% in 2022, with a contraction in H1.**
- **Goods inflation is cooling on easing gridlocks, but services continue to stage a strong price increase, favoured by a hot labour market.**
- **Sticky inflation and an optimistic outlook for the economy sustain the Fed's hawkish stance. Rates should peak at 4.75% in Q1 2023, but we expect a first cut by the end of next year.**

According to the first release, in Q3 GDP increased by 2.6% QoQ annualised, better than expected. However most of the rebound was due to net export, as consumption and imports slowed down, in line with the worrisome signals sent by household surveys and retail sales. We expect a marked slowdown and a contraction in activity in H1 2023 (top chart) , with 2023 average growth at just 0.2%. The past tightening in financial condition is already affecting heavily the construction sector (the 30-year mortgage rate now exceeds 7%, the highest level in 20 years). It will gradually dent consumption, adding to the loss of purchasing power due to persistently high inflation.

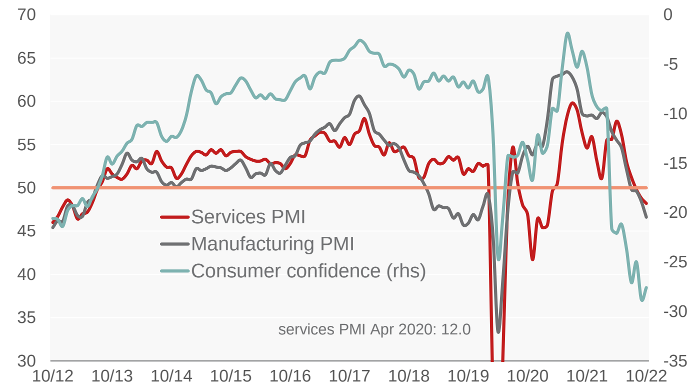
September CPI data provided a nasty surprise, with the core rate rising to 6.6%%: easing supply gridlocks have driven down inflation to 6.6% after the 11% peak earlier this year, but services inflation continues to trend higher (6.5%, against 4% in January). According to surveys, firms expect a reduction in their pricing power, and a less tight labour market should moderate wage growth. However, growth in the important rent component of the price index is not set to moderate soon, as it adjusts to a three/four quarter lag to changes in house prices, which have just started to abate: in August the yoy growth of the Case Shiller index dropped from 21% to a still high 13%.

After another 75bps hike in November, the Fed should moderate its pace of normalisation, with a 50bps increase in December and a final 25 bps one in Q1 2023; rates will then peak at 4.75%. FOMC members have reiterated the need to bring rates to well above neutral and keep them for long in order to tame inflation, confident that the economy can withstand it. However, the slowdown of the economy will push unemployment above the 4.4% expected by the FOMC for the end of 2023, forcing the Fed to cut rates in the second half of next year.

Euro Area

Martin Wolburg

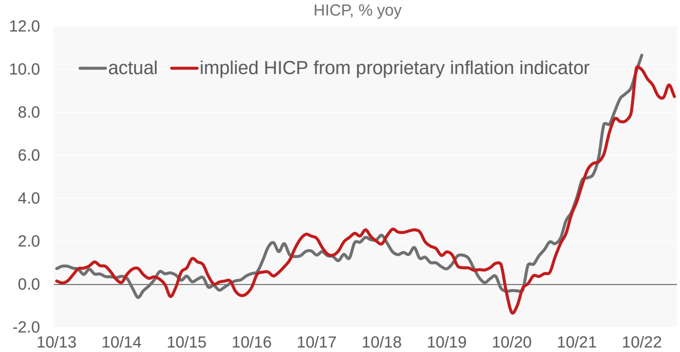
Euro area key sentiment indicators



Source: Datastream, GIAM calculations

Euro area inflation prospects

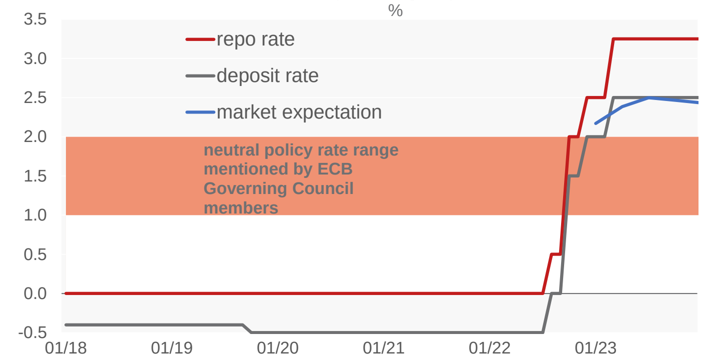
HICP, % yoy



Source: Datastream, GIAM calculations

ECB key rate projections

%



Source: Datastream, ECB, GIAM calculations

- **Output growth of 0.2% qoq surprised positively in Q3 but key sentiment indicators still herald a euro area winter recession.**
- **Headline inflation was at 10.7% yoy in October and we see the peak reached. That said, it will only recede sluggishly, staying very elevated.**
- **Following another 75 bps ECB rate increase in October further policy tightening is ahead.**
- **The Governing Council (GC) became less hawkish on rate hikes and will lay out future steps on quantitative tightening (QT) in Dec.**

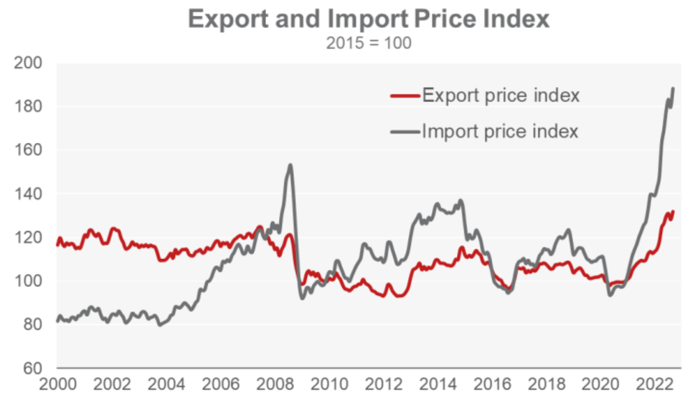
Quite surprisingly, euro area output did not recede but expanded by 0.2% qoq in Q3. A key factor was Germany growing by 0.3% qoq, defying expectations of a contraction. However, looking ahead we continue to look for a recession: The composite PMI went with a reading of 47.1 further into contractionary territory. And forward-looking indicators in sum trended further South. Consumer-related sentiment indicators stabilized but also stay clearly in recessionary territory. With a reading of 10.7% yoy headline inflation likely peaked but it will recede only very sluggishly (see mid-chart) thereby continue to drag on real incomes. Also the labour market will probably start to weaken somewhat. All in all we see GDP now expanding by 3.2% (up from 3.0%) in 2022 and to shrink by -0.2% in 2023 (up from -0.3%).

At the October meeting meeting the GC lifted its key rates by another 75 bps, in line with expectations, bringing the deposit rate to 1.5%. It also announced new measures incentivizing banks to repay TLTRO holdings earlier. It will link TLTRO III interest rates to less favourable terms (the average of applicable key rates) and it also decided to lower the remuneration of minimum reserves to the ECB's deposit facility rate.

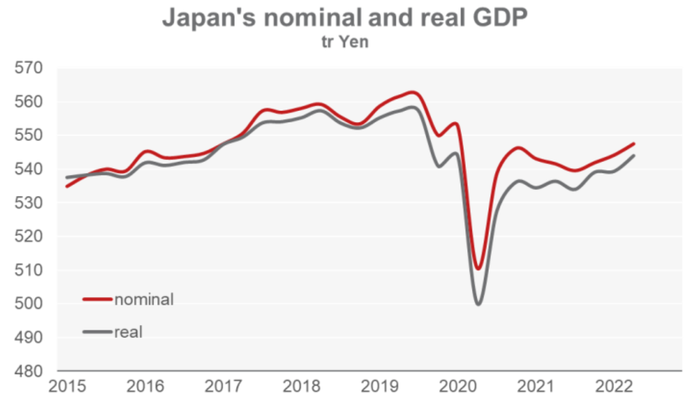
Looking ahead, President Lagarde was very clear that further rate hikes are in the offing but also emphasized data-dependence and the increased recession risk. We continue to look for another 50 bps key rate hike in December and another 50 bps in Q1/2023. This is now in line with markets that adjusted their rate expectations down. Moreover, balance sheet reduction will come into policy focus. The worsened TLTRO III conditions are a first step and Lagarde stated that at the December meeting the key QT principles will be released. This confirms us in our view that the policy rate will not be lifted above 2.5% in 2023.

Japan

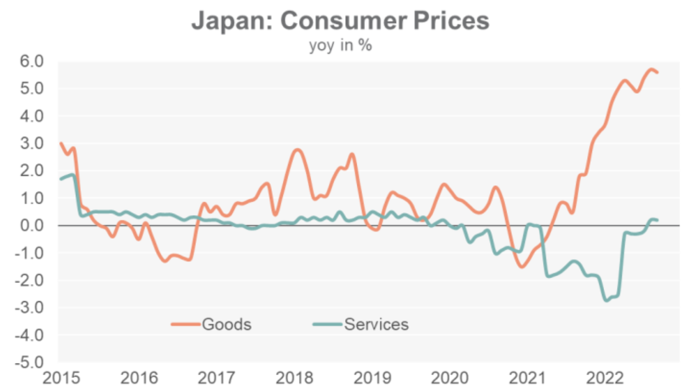
Christoph Siepmann



Source: Datastream, GIAM



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

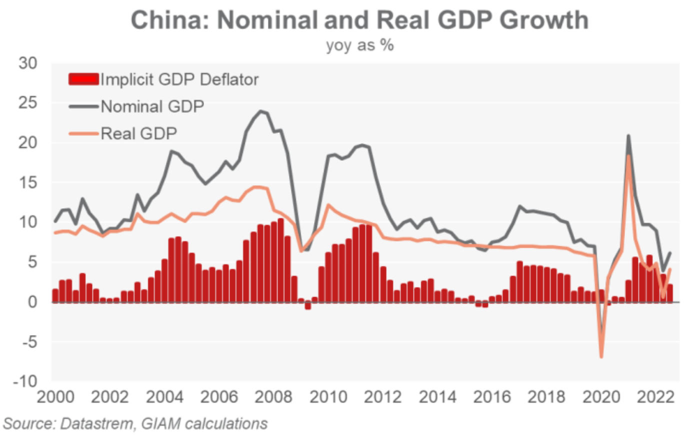
- **The Yen depreciated strongly against the US-dollar. However, the BoJ continues to see its ultra-loose monetary policy as warranted.**
- **Headline CPI inflation has risen to 3.0% yoy but core-core inflation is low. The government tries to mitigate the negative side effects of the BoJ stance, which we expect to remain in place at least until spring 2023.**

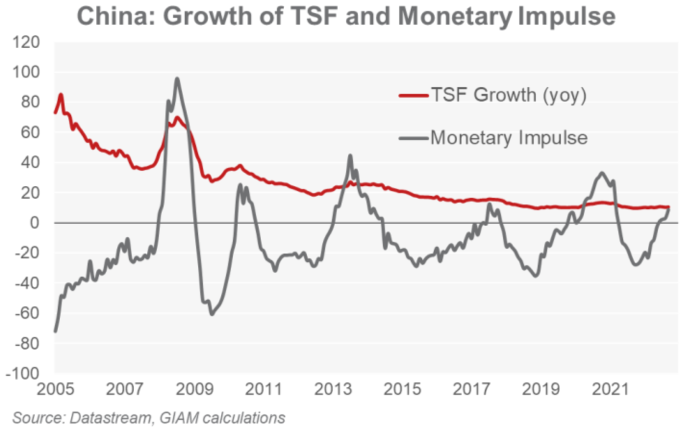
Japan is firmly stuck in the "impossible trinity", showing that an independent monetary policy, free capital flows and a stable exchange rate cannot be achieved at the same time. Recently, the Japanese yen temporarily depreciated below USD/JPY 150 (see FX part). Nevertheless, in its policy meeting, the BoJ kept all monetary policy parameters unchanged, as widely expected. It sees the loose monetary policy as warranted. Clearly, GDP is still below the pre-Covid level. The export mechanism has started working as the export volume is rising (+3.3% yoy in September) while real imports decline (-1.8% yoy). We expect GDP at around 1.5% in this year and the next. However, the policy-induced depreciation also pushes up imported inflation (by 48% yoy of late), hitting especially consumers and firm's input costs. Headline inflation (and Japanese style core inflation) reached 3% yoy in September, mainly driven by food and energy prices (energy inflation is stuck around 17% yoy due to government price controls). By contrast, inflation ex food and energy reached only 0.9% yoy, mainly held back by services prices with 0.2% yoy. Commentators often suggest that the current inflation could be able to break Japan's deflationary mindset. We are more sceptical that this supply side shock would result in a lasting virtuous inflation cycle. The BoJ sees next spring wage negotiations as crucial. Important unions already announced higher wage demands. Thus, a change in policy is unlikely before the Kuroda term ends in next April. We expect headline inflation at 2.4% this year and 2.5% in 2023.

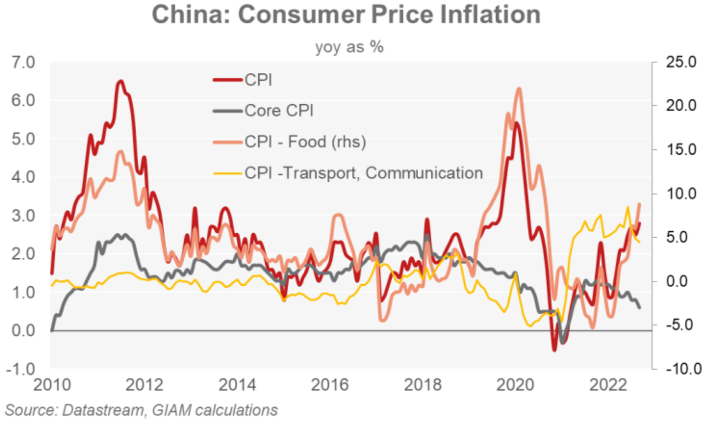
PM Kishida ruled out any political pressure on the BoJ. Thus, the current policy coordination could continue for a while with fiscal policy to mitigate the negative side effects of the BoJ stance. The Ministry of Finance will intervene against "speculation" but accept the trend. The government buffers the negative inflation effects (it set up several measures for low-income households, subsidizing energy prices, etc). It also announced a new fiscal package to help dealing with inflation and spurring wage growth among other goals.

China

Christoph Siepmann







- **The 20th Communist Party Congress ended with the re-election of President Xi as General Party Secretary for a third term.**
- **China's Q3 GDP growth surprised on the upside with 3.9% yoy. Therefore, we updated our 2022 growth outlook to 3.2%. New Covid outbreaks and the real estate sector will remain the most pressing issues.**

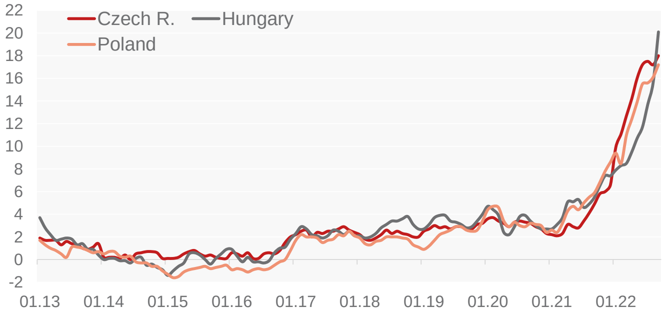
In contrast to a long-standing tradition of only two terms, China's Communist Party (CCP) Congress confirmed President Xi for a third period as General Secretary. This also implies another five years as President. The Politburo Standing Committee saw four new members, of which Li Qiang will likely become the next PM in spring. All fresh members are said to be close Xi allies, instead of representing (as before) different factions of the CCP. The Party Congress typically discuss structural instead of cyclical issues. There are neither stronger signs that the Covid policy will change soon, nor that the government would change course concerning its longer-term de-leveraging policy in the real estate sector. National security was broadly discussed, and "common prosperity" elevated as a core principle to the Party's constitution. This suggest that the regulatory reform will continue.

In terms of data, China's Q3 GDP growth surprised on the upside with 3.9% yoy. This prompted us to revise our growth forecast to 3.2% for 2022 (from 2.7% before). However, given the repeated Covid outbreaks and the ongoing problems in the real estate sector, which likely also extend into 2023, we revised down our 2023 outlook to 4.8%. October data remained mixed. Industrial production (6.3% yoy) and infrastructure investment (12.8% yoy) came in on the positive side, while retail sales (2.5% yoy) disappointed. In the real estate sector, housing investment "improved" slightly from -14% yoy to -12% yoy, while housing sales "rose" further from -23% yoy to -16% yoy. Policy support comes mainly on the local levels. On the monetary front, total social financing well exceeded the consensus forecast and the monetary impulse improved. Inflation moved up to 2.8% yoy, but core inflation receded to 0.6% yoy, confirming the weakness in demand. We expect China's economy to stay on a bumpy path (fresh Covid lockdowns reported in major cities) and the real estate sector to improve only gradually.

Radomír Jáč

Headline inflation

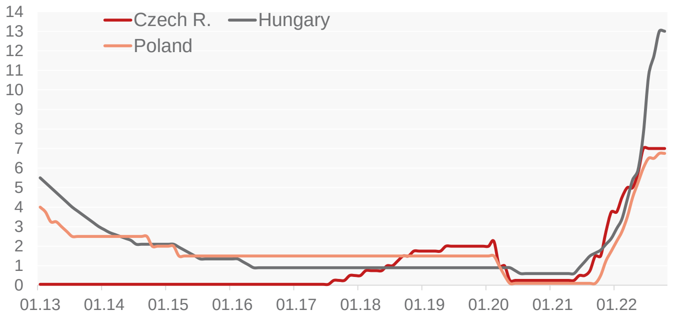
CE-3 countries (CPI yoy in %)



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

Main Forecasts

Czech Republic	2021	2022f	2023f	2024f
GDP	3.5	2.2	1.0	3.5
Consumer prices	3.8	15.7	7.8	2.2
Central bank's key rate	3.75	7.00	4.25	3.00
Hungary	**2021**	**2022f**	**2023f**	**2024f**
GDP	7.1	4.5	0.9	3.9
Consumer prices	5.1	14.0	11.8	4.2
Central bank's key rate	2.40	13.00	8.50	4.00
Poland	**2021**	**2022f**	**2023f**	**2024f**
GDP	5.7	4.4	1.9	3.4
Consumer prices	5.1	14.2	11.3	4.3
Central bank's key rate	1.75	7.25	6.00	3.50

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

- **The monetary policy outlook in the CE-3 countries is becoming diversified due to the developments of inflation and FX rate pressures.**
- **We keep our view that the Czech key rate reached its peak at 7% while the Polish NBP may have to raise rates further due to high inflation. The Czech CNB intervenes in the FX market in order to protect the CZK against weakening.**
- **In Hungary, the MNB had to raise short-term rates sharply due to the weakening of the forint.**

Inflation in the CEE is likely to reach its peak in Q4. However, the recent data were not always in line with the central banks‘ expectations. Czech CPI (18% yoy in September) came in well below the CNB forecast, while Polish inflation rose more than expected, from 16.1% to 17.2%. This leads us to maintain our call that the Czech interest rates are already at their peak but the Polish NBP may have to deliver some rate hikes in the rest of 2022. Hungary is a special case: annual CPI exceeded 20% and the central bank tightened monetary conditions sharply in a response to the weak forint. High inflation will weigh on consumption and GDP performance in H2 across the region.

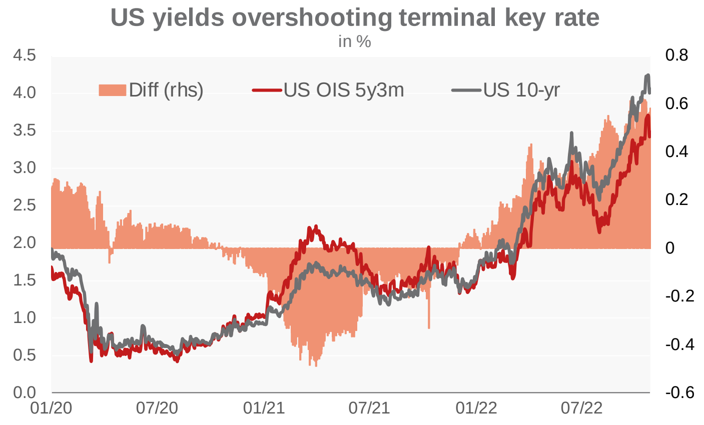
The Czech CNB left its key rate unchanged at 7% in September, which was a second on-hold decision in a row. A majority in the CNB believes that interest rates are already sufficiently restrictive. Wage growth and fiscal stance were mentioned as pro-inflationary risks. We expect interest rates unchanged for the rest of 2022 and a first rate cut to follow in H1 2023.

In Hungary, the MNB raised its base rate by 125 bps to 13% in late September and declared the end of the cycle of rate hikes. The central bank intended to keep financial conditions tight via liquidity management. However, the forint FX rate started to depreciate. This led the MNB to raise the upper limit of its interest rate corridor from 15.5% to 25% and to introduce O/N deposit as the main policy tool. The O/N deposit rate is announced daily, so far always at 18%. We expect this regime to remain in place at least until the next MPC meeting scheduled for November 22.

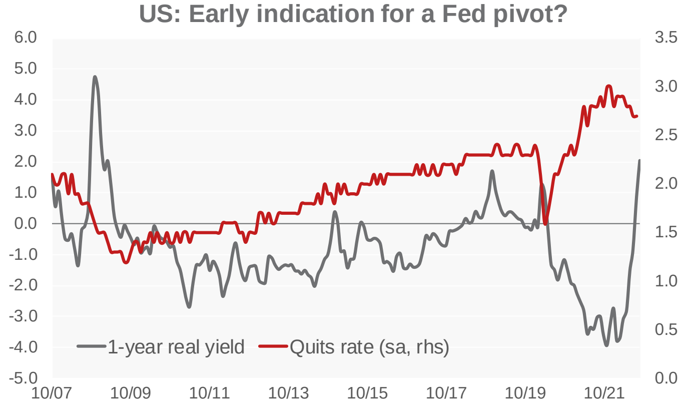
The Polish NBP raised its key rate by 25 bps to 6.75% in September but left it on hold in October. A majority in the MPC says room for more rate hikes is limited, if any. We think that high inflation will lead to two hikes by 25 bps in November and December and that the key rate will find its peak at 7.25%. Signals of a cooling economy represent a downside risk to our call.

Government Bonds

Florian Späte



Source: Bloomberg, GIAM



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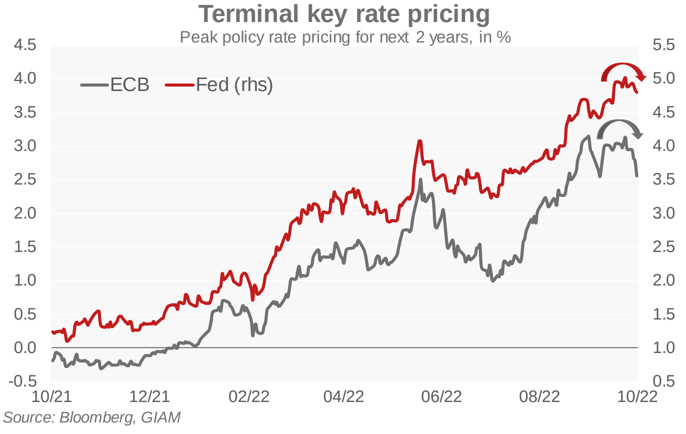


Source: Bloomberg, GIAM

- **Although government bond yields rose across the curve in October, the recent sharp drawdown highlights a fading structural momentum, notably in the US and for longer-dated yields.**
- **On the contrary, Bund yields have some more leeway to rise as the priced inflation environment on a medium-term horizon looks a bit too benign. Moreover, the sharply deteriorating supply environment is seen to trigger somewhat higher yields.**
- **The recent spread tightening of EA non-core government bond spreads looks premature and is unlikely to be sustainable. The challenging environment justifies moderately higher spreads.**

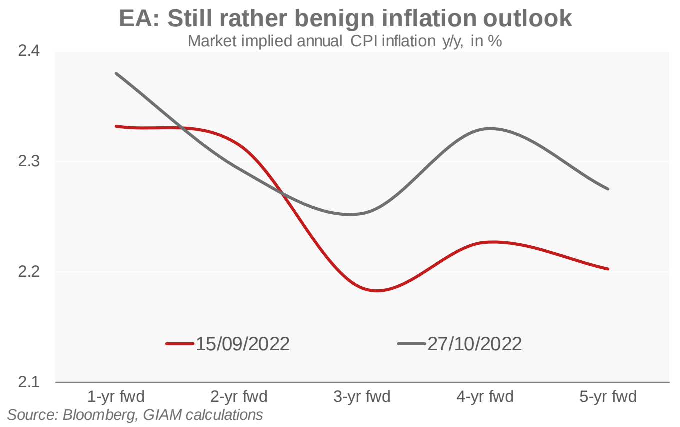
At first glance, the bear market continued in October. Government bond yields continued to rise across all maturities. Various measures of inflation pressure in the EA continued to surprise on the upside and the rate is still on an upward trend. While the peak in US inflation is likely behind us the decrease is expected to be cumbersome and data can continue to surprise. At the same time, central bankers are never tired of emphasising their willingness to do whatever is necessary to bring down inflation (notwithstanding a more moderate statement from the ECB in Oct.).

Nevertheless, we see some signs that the phase of sustained and steadily rising yields is slowly coming to an end. To start with, financial market participants seem to have adjusted to upwardly deviating inflation data. The respective market impact was much more muted than before in October. Moreover, the trend towards upward adjusting key rate expectations looks to be broken. While further key rates in the near term are still priced, financial markets struggle to price a peak of 3% for the ECB and more than 5% for the Fed. This is also supported by the fact that some central banks have reduced the pace (most recently the Bank of Canada, which only increased 50 bps instead of the expected 75 bps). Additionally, financial conditions have tightened and there are clear signs that they are leaving their mark on the yield-sensitive sectors of the economy. Ultimately, although it is too early to call it a sustainable trend, the recent significant decline in the gas price, especially for the EA, may be a signal of easing inflationary pressures (and thus fewer ECB key rate steps) in the medium term.

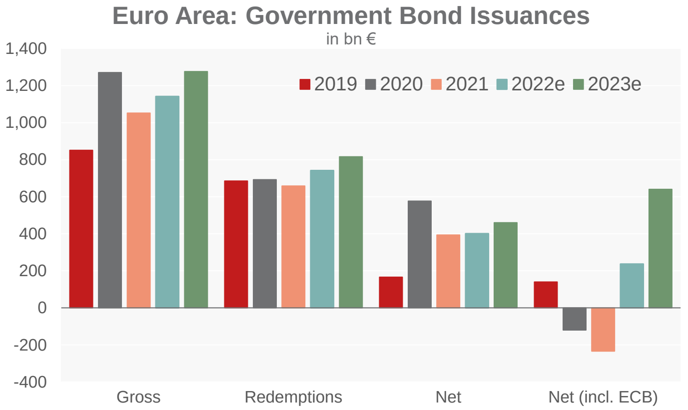
Overall, we do not see an imminent end of the bear market but the leeway for much higher government

Government Bonds

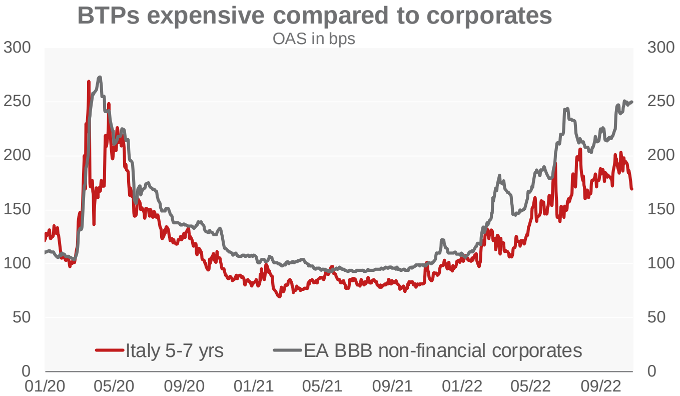
Florian Späte



Source: Bloomberg, GIAM calculations



Source: Bloomberg, Datastream, GIAM calculations



Source:Datastream, GIAM calculations

bond yields appears limited. Particularly in the US, the gap between the yield on 10-year bonds and the expected medium-term key rate has widened further. This does not appear sustainable. We forecast 10-year US yields to move largely sideways in the short term and to fall over the year.

We still see some upside potential for Bund yields. Financial markets expect inflation to quickly move towards the ECB target. The expected decrease in inflation looks a bit too optimistic to us given its persistence and the delayed effects of wage increases. Furthermore, in contrast to the US, the priced medium-term key rate is substantially above the current 10-year yield. Finally, the technical situation also points to further potential for higher yields. Assuming Quantitative Tightening of around EUR 180bn in 2023 the net-net supply (incl. ECB) will be above EUR 600bn next year. This would be the highest net-net supply ever. Accordingly, we expect 10-year Bund yields to rise by around 10 bps on a 3-month horizon and do not yet forecast a lasting downward movement within one year.

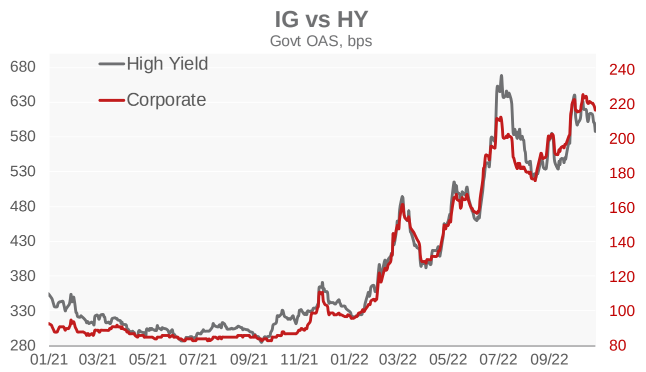
EA non-core bond spreads have tightened significantly across countries and maturities in October. This is remarkable as there was no broad tightening trend for risky fixed income assets in the market. Recent less hawkish comments by the ECB and an European-friendly and stability-oriented statement of the new Italian government might have helped. Nevertheless, we take it with a pinch of salt and remain on the cautious side as the relative valuation of EA non-core bond spreads has become ambitious (see chart).

The first point to monitor is whether the Italian government will back up its words with deeds. It will have to present a budget plan for 2023 soon. The financial leeway is small and it will be problematic to keep the promises made in the run-up to the elections. This is all the more true as the stability of the right-wing government is at least questionable.

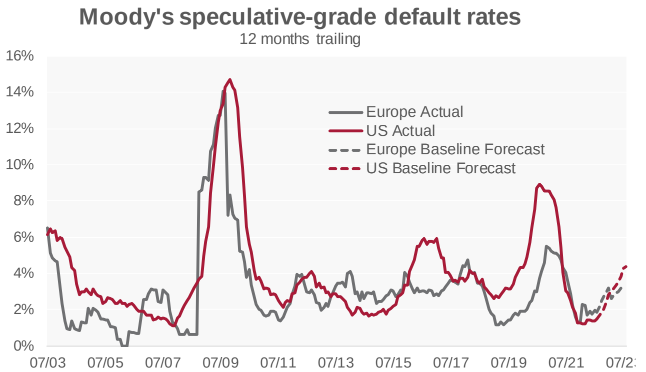
Moreover, the economic environment remains challenging as well. The combination of a looming recession and a less accommodative monetary policy stance does not bode well for EA non-core bond spreads. This applies even more as the supply situation will deteriorate (as described above). The flexibility of PEPP reinvestments will not be sufficient to prevent spreads from widening. However, the existence of the TPI should be enough to allow this to take place in an orderly manner.

Credit

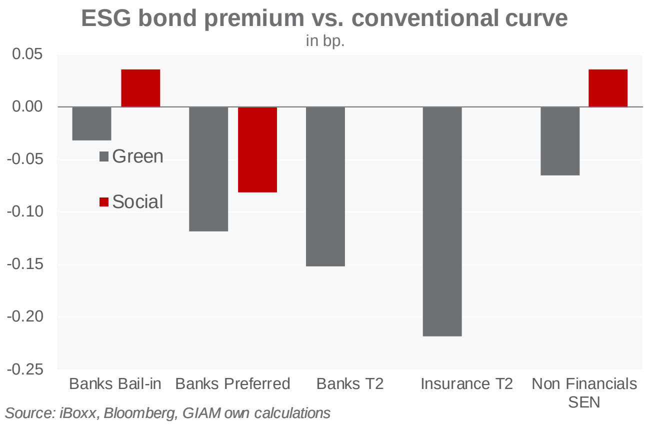
Elisa Belgacem



Source:Bloomberg, BofAML Indices, GIAM



Source: Moody's, GIAM



Source: iBoxx, Bloomberg, GIAM own calculations

- **After Credit has been lagging in the recent rebound of equities, we expect IG spreads to remain resilient. However, HY appears vulnerable on the back of the rapid monetary policy normalization.**
- **The reporting season has so far confirmed our expectations of a heterogeneous deterioration of corporate fundamentals over the coming months.**
- **A key concern is the liquidity of the HY segment as the primary market has been almost closed since the beginning of the war in Ukraine.**

Credit has been lagging in the recent rebound of equities. IG spreads will remain resilient, but HY appears vulnerable near term on the back of the rapid monetary policy normalization.

Fundamentals and liquidity will be concerns for 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. Predicting defaults in this context is also a rather complex exercise. On one side, Europe's gas situation will command a recession that could vary according to winter temperatures. And on the other side, the government support that helped contain defaults to 5% in Europe during Covid will be smaller due to lesser fiscal leeway from governments. 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.

A key concern should be the liquidity of the HY segment as the primary market has been almost closed since the beginning of the war in Ukraine.

Decompression trade still on

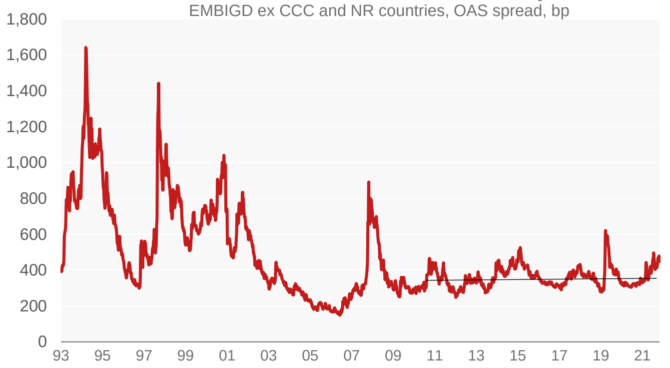
Hence, we do prefer IG to semi-core and peripheral sovereigns. IG levels are currently incorporating a severe recession scenario. We expect spreads to tighten moderately from current rather extreme levels into year-end. For HY, we think that positioning is already very short, but risks remain elevated. Hence, we think spreads should end the year 50-60p wider. We continue to prefer subordination risk to credit risk.

EM sovereign bonds

Guillaume Tresca

EM external debt is not cheap

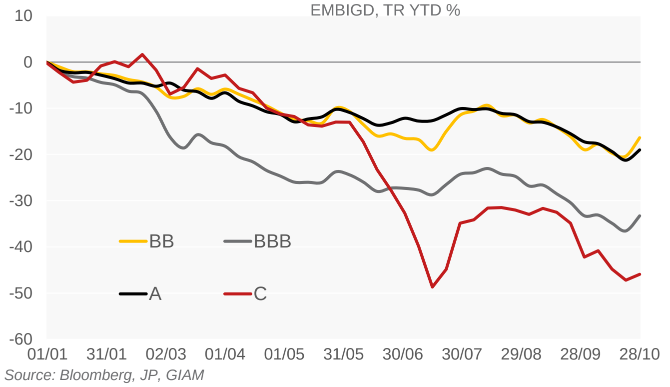
EMBIGD ex CCC and NR countries, OAS spread, bp



Source: Bloomberg, JP, GIAM

Strong BB performance

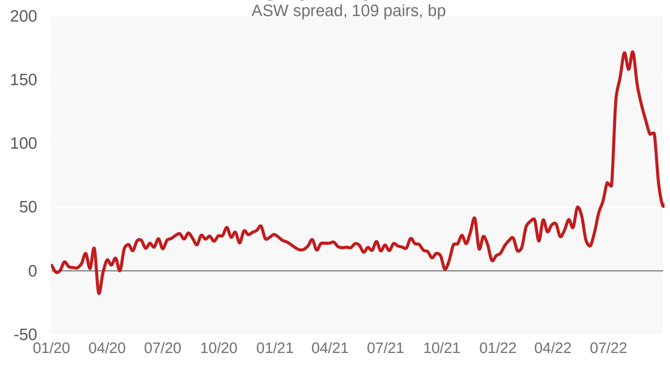
EMBIGD, TR YTD %



Source: Bloomberg, JP, GIAM

EM EUR: large pickup over USD bonds

ASW spread, 109 pairs, bp



Source: Bloomberg, GIAM calculation

- **We maintain a defensive stance, favouring EM IG over HY. Spreads will likely widen further.**
- **Risks are more symmetric, but valuations are not yet attractive. Technicals only offer a temporary support.**

The EM environment remains a volatile one with a wide range of significant risks and so we maintain a defensive stance and an underweight position (UW) in our allocation. EMs continue to face multiple headwinds – lower global growth, high US real rates, and the Ukraine war - that have not eased since the summer. Like, the Chinese Communist Party Congress did not alter positively the outlook as it did not bring anything new. EM spreads should continue to widen, even if risks have recently turned more symmetric as global central banks have exhibited signs of a less comfortable hawkish stance. It has led to a recent positive performance, but it will be hard to be sustained as EM countries face their own challenges that require a significant risk premium. As long as US real rates stay at high levels and EM growth does not reaccelerate, EM external debt will trade on a defensive stance.

Valuations not yet attractive, stay defensive

Valuations are not yet attractive. First, we prefer EM IG over HY. Arguably, EM HY recently outperformed, but it was essentially driven by the BB bucket. The Bs will be the most at risk of the re-opening of the primary market and the lowest-rated countries are still facing significant refinancing risks. The only positive development is the implication of the IMF, e.g. Egypt. Second, EM IG has been rich while EM HY is cheap, but only optically. The number of distressed countries distorts the index and the EMBIGD spread ex-CCC countries just stands above its long-term average. Likewise, technicals are still providing support but it is temporary. EM funds cash position has never been so large and net negative issuance is close to $ 50 bn year-to-date. However, the appetite for EM assets is low and the reopening of the primary market will mechanically weigh heavily on spreads.

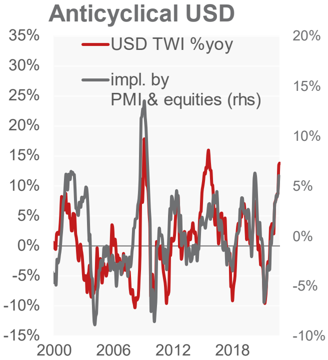
Favour relative value

High uncertainty favour relative value trades. EM EUR bonds offer a historical pickup over EM USD bonds (same issuer). Region-wise, we dislike EM Europe given the winter and recession risks. The Middle East is expensive but safe. LatAm is losing some of its appeals while EM Asia now stands in a relatively better position.

Currencies

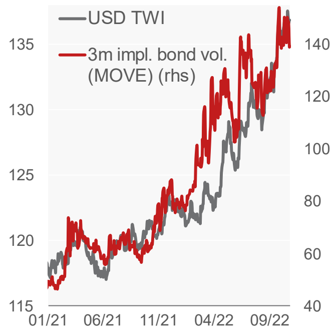
Thomas Hempell

Anticyclical USD



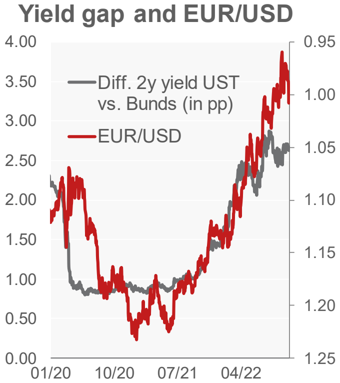
Source: Datastream, GIAM calculations; model 2000-2019 based on MSCI World %yoy and

Yield uncertainty and USD



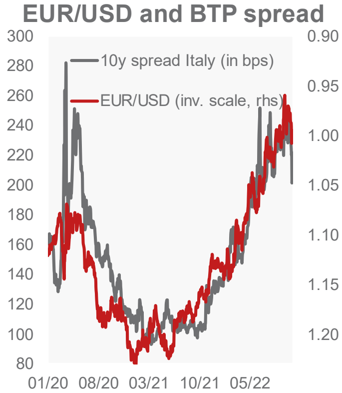
Source: Datastream, GIAM

Yield gap and EUR/USD



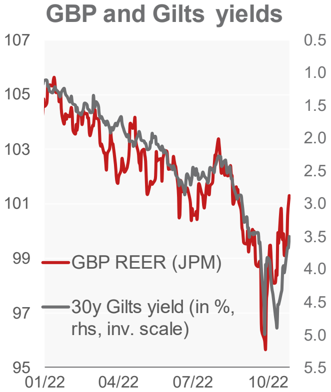
Source: Datastream, GIAM

EUR/USD and BTP spread



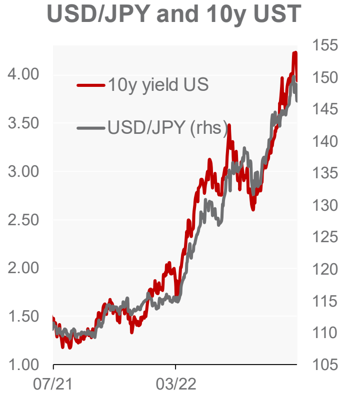
Source: Datastream, GIAM calculations

GBP and Gilts yields



Source: Datastream, GIAM

USD/JPY and 10y UST



Source: Datastream, GIAM calculations

- **The USD's ascent has stalled but is set to resume into winter as recession in Europe bites and geopolitical risks keep lingering. We expect EUR/USD to settle more visibly below parity.**
- **GBP staged a relief rally from its slump on ex-PM Truss' reckless tax plans. Yet deeper economic trouble point to weakness ahead.**
- **JPY hit fresh 32-year lows, with the MoF's FX intervention a futile relief. With US yields close to peak, we do not expect a marked further slide.**

The broad-based USD rally stalled in October. While rallying against JPY, CNY and various EMs, the USD lost ground against most European currencies, with falling gas prices, tighter BTP spreads and a fpolicy U-turn in the UK helping. Yet the USD peak is likely still ahead of us, before a more sustained reversal may kick in over 2023. Weak global growth and high risk aversion still leave scope for another leg higher in the USD (top left chart). Policy uncertainties keep lingering as inflation overshoots. Clearer hints of a Fed pivot may be the first key trigger for having USD peak as rates uncertainty would start to fall (top right chart).

The ECB's catch up in tightening policy renders no visible boost to the EUR as the benefits from higher rates have been offset by rising fragmentation worries (mid charts). BTP spreads have eased recently on a swift government formation in Italy but may well re-widen as recession bites and the ECB envisages quantitative tightening in 2023. We expect the EUR/USD to fall back below parity again over the coming weeks.

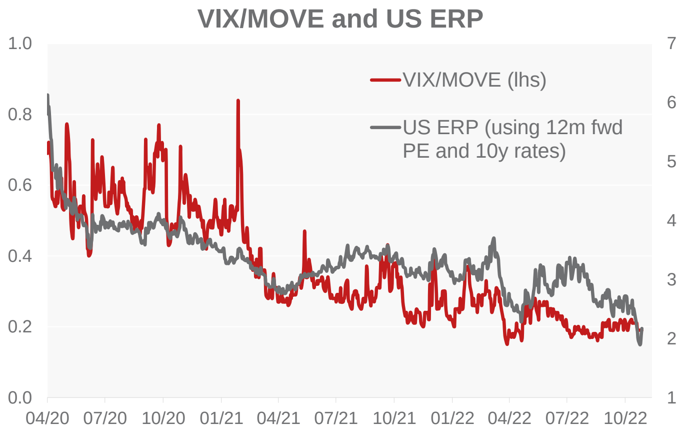
New UK gov't to prove only temporary GBP relief

Sterling staged a strong rebound after the swift installment of a new UK government under PM Sunak ended weeks of fiscal and political mayhem (bottom left). Most of the relief should be priced now, while structural headwinds (one of the sharpest stagflation dilemmas among AEs and a widening C/A deficit) point to further downside.

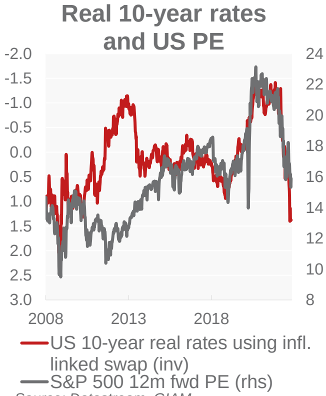
Soaring US yields took the USD/JPY to a 32-year high, triggering renewed FX intervention by the BoJ/MoF. This has helped to limit JPY losses but will not reverse course as the Fed does not join buying yen and the BoJ sticks to ZIRP and YCC. Yet with US yields now close to peak and intervention adding more two-sided risks to speculators, the bulk of JPY weakness is likely behind us (bottom right).

Equities

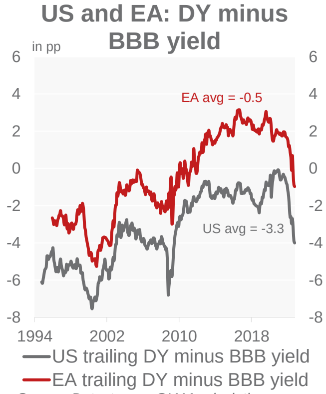
Michele Morganti, Vladimir Oleinikov



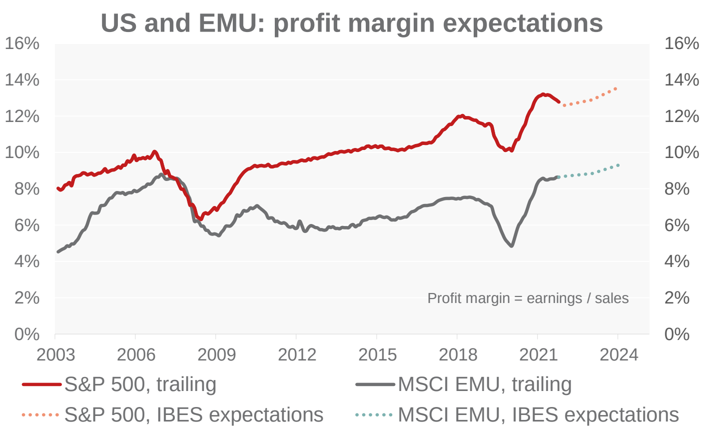
Source: Datastream, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

- **Depressed positioning plus low relative equity volatility vs. bonds are igniting temporary rallies, which we do not deem to be sustainable yet.**
- **While the Fed's pivot is getting nearer, PEs are still at risk of downgrades due to high real rates and deteriorating financial conditions. Earnings estimates also remain too high, currently justifying our underweight equity position.**
- **In 12 months, though, we expect slightly positive total returns in the range between 3% and 6%.**
- **Within countries, we overweight (OW) UK versus EMU and US and remain OW on Japan, while preferring a slight UW on EMs.**
- **Sector overweights: Banks, Div. Financials, Energy, Food, HC equip., Transportation (new) and Software. Underweights: Capital Goods, Comm. Services, Media and Materials (new).**

October data revealed a stickier inflation than previously forecasted but, nevertheless, markets were able to rally. In particular, the cyclical EMU index increased by +7.5%. Indeed, CBs started signalling economic weakness ahead when they made their last jumbo rate hikes. Thus, the cycle clock is ticking and the time for the Fed's pivot is getting nearer. Positioning is also key. It remains depressed and probably, with no big credit event in sight, it helps to explain a relatively contained equity volatility (VIX). The latter declined from 31.6 to 27.4 in the month. But, most importantly, it declined further in comparison to bond volatility (MOVE index). The ratio (VIX/MOVE) reached a bottom since 2020.

In sum, positioning and relative equity volatility vs bonds, plus the recognition of economic weakness ahead by CBs are giving some reasons of optimism to investors and inducing temporary rallies. In our opinion, the latter could not be sustainable in the short term, though.

Valuation not comfortable yet

Indeed, the US risk premium is currently not attractive, having reached a historical low. The US Tech sector also shows signs of overvaluation (30%) notwithstanding the 30% decline year-to-date. PE looks too high vs. real rates and increased credit spreads make the dividend yield much less attractive vs. BBB yields. In sum, valuations are not comfortable yet and would, theoretically, demand the SPX to fall to around 3,400 before starting to look attractive again.

Equities

Michele Morganti, Vladimir Oleinikov

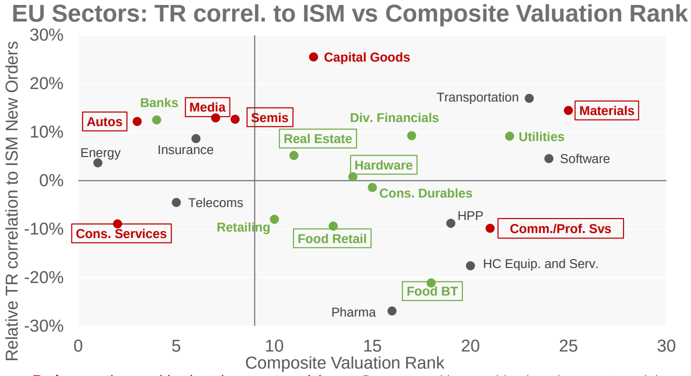
Year	S&P earnings GIAM base yoy	GIAM downside yoy	IBES yoy	GIAM vs IBES * base gap (levels)
2022	6%	0%	9%	-3%
2023	2%	-5%	7%	-7%
2024	4%		9%	-11%

Year	EA earnings GIAM base yoy	GIAM downside yoy	IBES yoy	GIAM vs IBES * base gap (levels)
2022	9%	1%	17%	-7%
2023	0%	-10%	4%	-10%
2024	2%		8%	-15%

Note: gap is in per cent vs earnings levels of the S&P or MSCI EMU

Source: Refinitiv IBES, GIAM calculations

EU Sectors: TR correl. to ISM vs Composite Valuation Rank

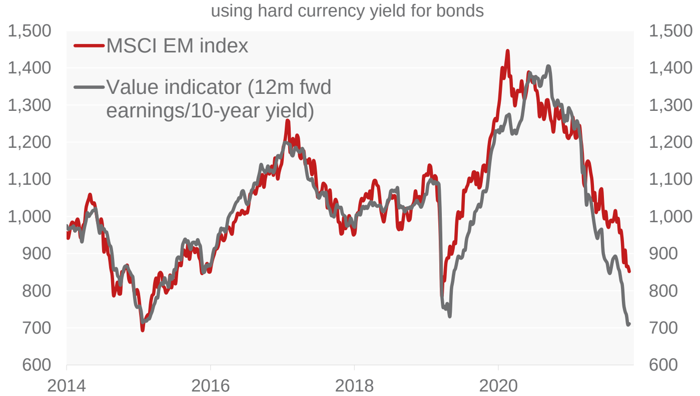


Red = negative machine learning quant models; **Green** = positive machine learning quant models; ▭ = stronger signals (> 2 SD)

Source: Refinitiv, GIAM calculations as of 27/10/2022

MSCI EM index: value indicator

using hard currency yield for bonds



Source: Datastream, GIAM calculations

Furthermore, as earnings are also most probably at risk, we see our underweight equity position to be justified in the short term. In the next future, we could turn neutral, should CBs recognize the economic weakness even more, or the market to become cheaper and the slowdown in earnings more visible.

Q3 earnings resiliency masks a decline ahead

The US earnings momentum has been resilient so far, and the Q3 reporting season is expected to see a reduced but still positive yearly growth. Ex-Energy expectations receded already by 9pp since the end of June to -3.5% yoy, leaving scope for positive surprises vs. analysts' expectations. Still, we see the tone of firms' guidance to be more subdued compared to Q2. We estimate 2023 earnings growth to be at +2% yoy for the US and nearly zero for EMU. Our earnings fore-casts are below consensus, with risks still tilted to the downside, mainly due to ongoing surging costs and negative GDP revisions. The gap vs IBES in 2022-2024 is increasing from -3% to -11% and -7% to -15%, for the US and EMU, respectively.

Recommended allocation

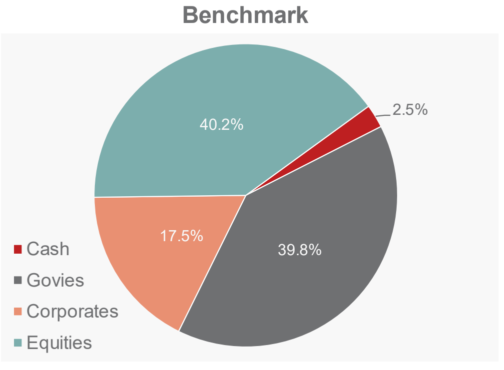
Within countries we continue to set on UK vs. EMU and the US, remaining OW Japan. EMU equities start to look appealing vs US ones: better internal country score, attractive proprietary short-term models' results and lower adjusted PEG ratio (1.6 vs 1.8). Short term, given the still dormant gas supply related risks, we prefer to remain neutral on EMU vs US. As for sectors, we remove the OW on the Defensive style, and put Materials to UW. We increased the OW on Banks and Transportation, becoming neutral on RE. OWs are Banks, Div. Financials, Energy, Food, Healthcare equipment, Transportation and Software. UWs: Capital Goods, Comm. Services, Media and Materials.

EM equities: slight UW warranted

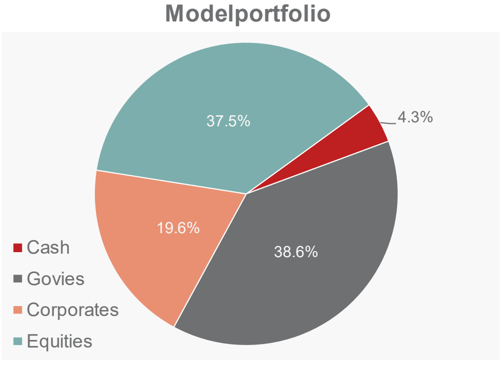
EMs continue to be pressured by deteriorating financial conditions. While the higher bond yield advantage (vs US HY) looks favourable, we expect the strong USD to still represent headwinds. Our adjusted Fed model gives indication of overvaluation while falling export orders and weak earnings should maintain EMs at risk in relative terms. Despite significant China's undervaluation (20%), we turned cautious on this market after recent changes to the new CCP Standing Committee, due to increased uncertainty in China's reforms, fresh lockdowns and simmering geopolitical risks.

Asset Allocation

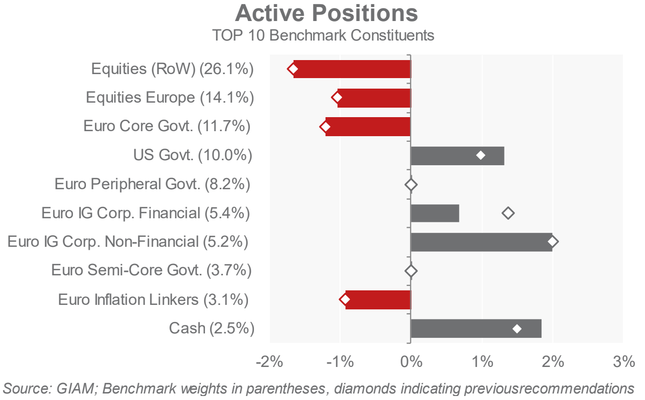
Thorsten Runde



Source: GIAM



Source: GIAM



Source: GIAM; Benchmark weights in parentheses, diamonds indicating previousrecommendations

- **In October *(27.10.22)*, apart from the MSCI EM (-1.6%) and medium- to long-dated US Treasuries, all actively covered asset classes rendered positive returns.**
- **Euro Area Equities are ranked number one with slightly below +7.7% performance followed by North American Equities with +6.0%.**
- **Long-dated USTs performed worst (-4.1%), whereas Euro Inflation Linkers and long-dated BTPs proved to be best performing fixed income asset classes with +4.5% each.**
- **In the Credit segment EA IG non-fin. and fin. both revealed performance figures around +0.7%, thereby underperforming HY by roughly -38 bps.**
- **Despite October's bear-market rally in equities and the yield reactions to the most recent ECB decision, we expect downside risks for the markets to remain prevalent.**
- **For now, we stick to our UWs in Equities, longer-dated govies, and HY. We reduce our OW in EA IG fin and reallocate to short-dated US Treasuries and Cash. Yet we are prepared to unwind our cautious stance on risk in parts year-end.**

In October *(27.10.22)*, the relative performance of our model portfolio was around -19.7 bps. Most of the asset classes make a negative contribution to the relative performance. This largest losses so far can be fed back to Equities (-7.4 bps), Corporates (-5.5 bps), and Cash (-5.0 bps). The only significant positive contribution results from the UW in Core Govies (+1.9 bps). The second half of October proved to be particularly painful. The strong performance of Equities in that period and the positive reaction of long-dated non-US Govies to the last ECB decision has hurt significantly: directly by being underweighted in these asset classes and indirectly by turning the overweighted Cash and short-dated US-Treasuries into clear underperformers.

Still cautious but prepared to unwind

We deem markets reading too much dovishness into the most recent ECB decision and thus consider their reaction overdone. For Equities we see the bad news flow still not fully priced in. Conversely, we acknowledge the risk of a year-end bounce rising given less aggressive Central Banks. Thus, for the time being we confirm our UWs in risk-assets but are prepared to unwind if risk indicators start to materialize.

FORECAST TABLES

Forecast tables

Growth[1]	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	5.9	1.8	0.1	0.2	- 0.3	1.4
Euro area	5.3	3.2	0.3	- 0.3	- 0.5	1.2
Germany	2.6	1.7	0.3	- 1.1	- 0.4	0.8
France	6.8	2.5	0.1	- 0.1	- 0.7	1.0
Italy	6.7	3.4	0.1	- 0.4	- 0.7	1.3
Non-EMU	6.5	3.6	0.5	- 0.3	- 0.5	1.3
UK	7.5	4.1	0.7	- 1.1	- 0.8	0.9
Switzerland	4.2	2.5	0.2	1.5	0.7	1.8
Japan	1.7	1.2	- 0.3	1.4	- 0.1	1.3
Asia ex Japan	7.8	4.2	- 0.2	4.6	- 0.2	4.9
China	8.1	3.2	- 0.1	4.8	- 0.2	4.6
CEE	6.7	1.5	1.2	0.7	0.9	3.1
Latin America	6.4	2.9	0.0	1.0	0.0	2.0
World	**6.4**	**3.2**	**0.1**	**2.1**	**- 0.1**	**2.9**

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

Inflation[1]	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	4.7	7.8	- 0.2	3.9	0.1	3.1
Euro area	2.6	8.3	0.1	5.6	0.2	2.6
Germany	3.2	9.0	1.2	7.0	1.2	2.8
France	2.1	6.7	1.2	5.0	1.4	2.5
Italy	2.0	7.6	0.2	4.2	- 0.1	0.6
Non-EMU	2.3	7.9	- 0.1	6.3	0.5	2.6
UK	2.6	9.1	- 0.1	7.8	0.8	2.6
Switzerland	0.6	2.7	- 0.2	1.8	- 0.2	1.5
Japan	- 0.3	2.5	0.3	2.1	0.7	1.0
Asia ex Japan	2.0	3.8	0.0	3.4	0.2	2.5
China	0.9	2.3	0.0	2.5	0.2	1.9
CEE	9.3	29.6	0.5	17.1	1.2	8.1
Latin America[2]	6.6	8.1	1.1	4.9	0.7	4.0
World	**3.5**	**7.8**	**0.1**	**5.1**	**0.3**	**3.2**

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

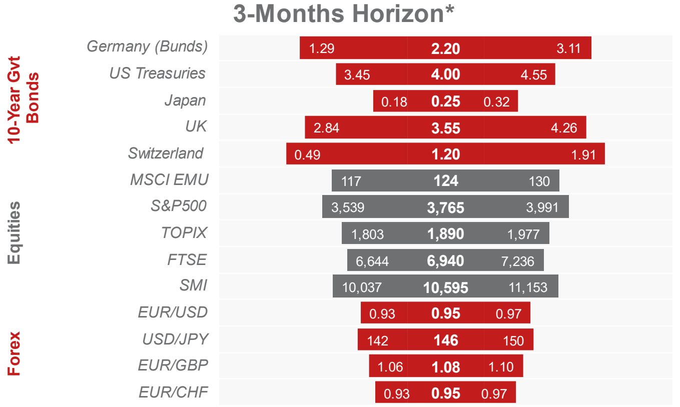
Financial Markets

Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US	3.25	4.75	*4.70*	4.75	*4.82*	4.75	*4.39*
Euro area	0.75	2.00	*2.21*	2.50	*2.54*	2.50	*2.69*
Japan	-0.10	-0.10	*-0.02*	-0.10	*0.07*	0.00	*0.13*
UK	2.25	3.50	*4.09*	4.00	*4.71*	4.00	*4.76*
Switzerland	0.50	1.00	*0.98*	1.50	*1.16*	1.50	*1.29*
10-Year Gvt Bonds							
US Treasuries	4.02	4.00	*4.05*	3.95	*4.04*	3.80	*4.05*
Germany (Bunds)	2.09	2.20	*2.13*	2.20	*2.14*	2.15	*2.14*
Italy	4.12	4.40	*4.27*	4.50	*4.32*	4.60	*4.39*
Spread vs Bunds	*203*	*220*	*214*	*230*	*218*	*245*	*225*
France	2.61	2.75	*2.65*	2.75	*2.68*	2.75	*2.73*
Spread vs Bunds	*52*	*55*	*52*	*55*	*54*	*60*	*59*
Japan	0.25	0.25	*0.32*	0.30	*0.37*	0.40	*0.48*
UK	3.54	3.55	*3.59*	3.50	*3.57*	3.40	*3.67*
Switzerland	1.18	1.20	*1.14*	1.20	*1.15*	1.15	*1.19*

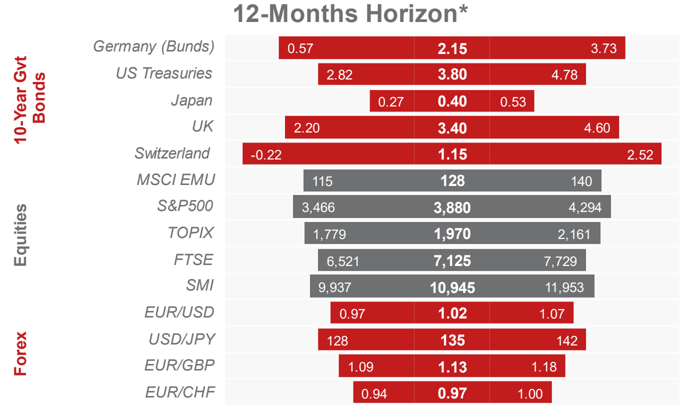
**3-day avg. as of 27/10/22*
***ICE BofA (OAS)*

Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	209	210		205		200	
EA IG Financial	238	245		235		225	
EA HY	604	660		630		610	
EM Sov. (in USD)	416	418		415		400	
Forex							
EUR/USD	1.00	0.95	*1.01*	0.97	*1.01*	1.02	*1.03*
USD/JPY	147	146	*145*	140	*143*	135	*139*
EUR/JPY	147	139	*146*	136	*145*	138	*143*
GBP/USD	1.15	1.08	*1.16*	1.08	*1.16*	1.13	*1.16*
EUR/GBP	0.87	0.88	*0.87*	0.90	*0.87*	0.90	*0.88*
EUR/CHF	0.99	0.95	*0.99*	0.96	*0.98*	0.97	*0.98*
Equities							
S&P500	3,832	3,765		3,805		3,880	
MSCI EMU	126.0	123.5		125.0		127.5	
TOPIX	1,910	1,890		1,900		1,970	
FTSE	7,048	6,940		6,975		7,125	
SMI	10,766	10,595		10,570		10,945	

3-Months Horizon*



12-Months Horizon*



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

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