GENERALI INVESTMENTS

Market Compass

April 2022

MARKET OUTLOOK

- The Russia-Ukraine war has exacerbated two of the key risks for 2022: much higher energy prices and tougher central banks.
- Central banks have been handed a "mission impossible": bringing unacceptably high inflation rates down, without causing a hard landing.
- We expect central banks to slightly undershoot ambitious market pricing, given our below-consensus growth forecasts.
- We recommend reducing the cyclicality of portfolios and turn very selective in picking risk assets. We see little value in chasing the March equity market rebound at this level of valuation.

Edited by

MACRO & MARKET RESEARCH TEAM

A team of 13 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

US

- (+) Despite fall in confidence, consumption is holding well...
- (+) ...backed by a healthy labour market
- (−) Inflation will remain near 8% for a few months
- (!) The Fed is strongly committed to fight inflation with a steep path of rate increases

UK

- (−) BoE raised key rate to 0.75%
- (−) Retail sales unexpectedly dropped, rising stagflation fears
- (−) Inflation surprised again on the upside with 6.2% yoy

EUROZONE

- (−) War in Ukraine drags sentiment and expectations
- (−) March inflation soared again
- (+) Mitigating fiscal policies against high energy prices
- (+) ECB not rushing into premature tightening

CHINA

- (−) China hit by strong Covid outbreak
- (−) PMI fell into contractionary territory but much less than in early 2020
- (+) More monetary and fiscal support will help stabilise the economy

EMERGING MARKETS

- (−) EM to be affected by higher commodity prices, especially food prices. First devaluations in Egypt and Sri Lanka.
- (!) LatAm keeps outperforming but inflation is due to rise everywhere.
- (−) EM risk premium has been declining but volatility will remain high, driven by war headlines.
- (+) Russia exhibited a willingness to pay its USD debt so far. A default is not a systemic risk.

(+) Positive
(−) Negative
(!) Topics to watch

DIRECTION OF TRAVEL

- Moderate underweight (UW) in equity despite attractive valuation
- Sizeable preference for Credit, clear preference for IG
- Within credit, reallocate exposure from financials to non financials
- Keep UW in long dated sovereign bonds
- Minimal Cash overweight (OW)

Equities

- With hawkish central banks, we expect lower growth ahead but inflation to remain elevated.
- Thus, we are tactically slightly UW, reducing cyclicality. US and UK are OW vs EA over EMs. Keep moderate UW on China.
- We still see a scope to remain in equities mid-term and forecast a TR of around 5% over 12 months.

Bonds

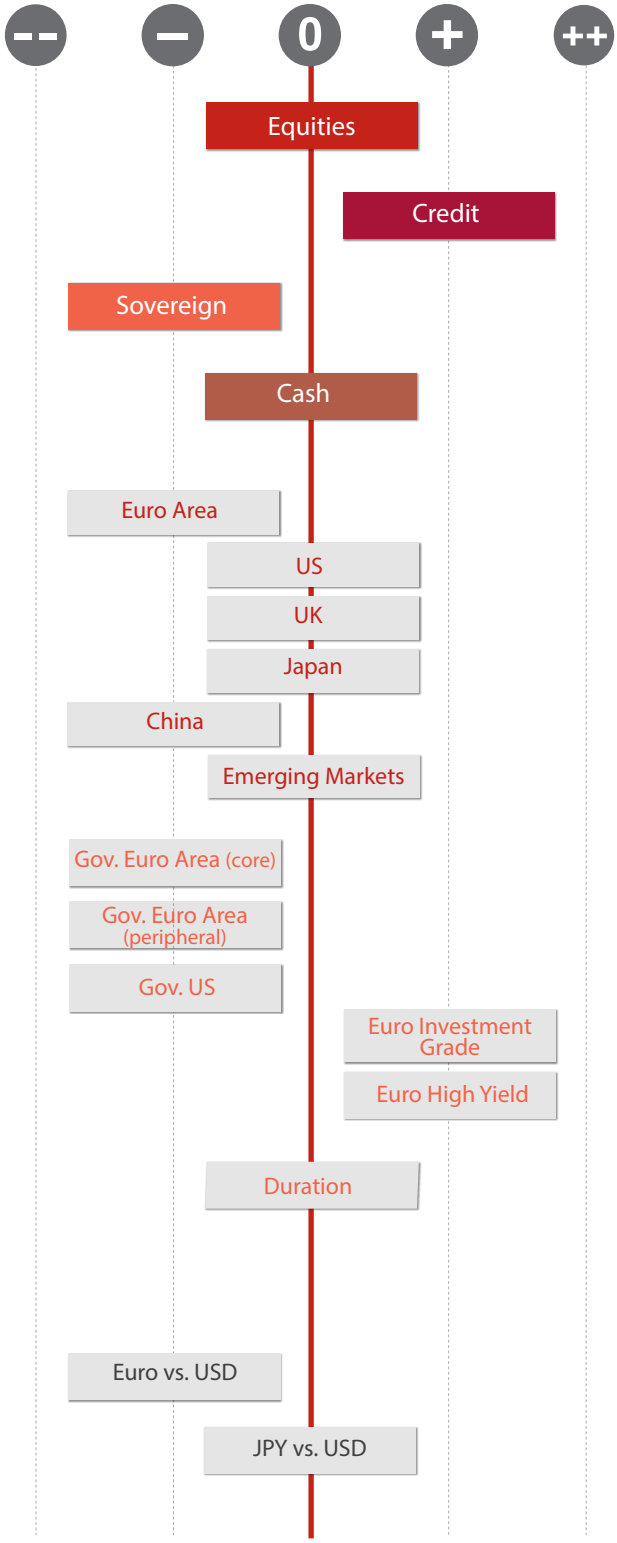
- Bond markets remain dominated by hawkish central banks and elevated inflation.
- However, as rate hikes are more than adequately priced.
- Strong performance of EA non-core bonds unlikely to continue amid rising core yields and less ECB support.

Duration

- Moderately short duration.

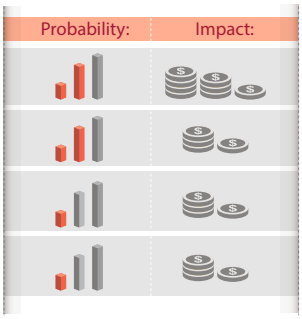
Currencies

- Geopolitical risks and growth will continue to support the USD bid near term.
- Yet, the USD rise already looks stretched and we see renewed upside for EUR/USD once the fallout of the Russian war has faded.
- Monetary policy divergence will continue to weigh on the JPY though it looks very cheap vs. fundamentals.



TOPICS TO WATCH!

- War in Ukraine further escalates disrupting global energy supplies
- War driven plunge in sentiment triggers a global recession
- Geopolitical tension spills over to Asia (Taiwan) disrupting global trade
- Need to hedge high oil prices might trigger large inflows into brown assets



Probability: High ⟷ Low
Impact: High ⟷ Low

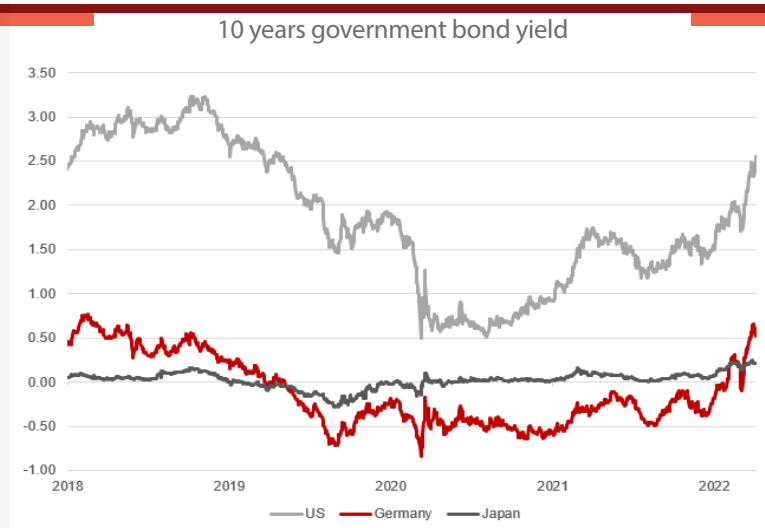
SPECIAL FOCUS

Risks from commodities and central banks call for lower risk in the portfolios

The situation in Ukraine remains very fluid. Our central case assumes a protracted crisis, keeping the country in a state of instability and energy prices at an elevated level. Our forecast for the EA is below consensus and entails the risk of a mild recession in the central part of the year. The largest headwind is the surge of commodity prices: the shock is broad-based and not limited to the energy sector. The price of cereals has increased sharply, and the surge of fertilizer prices will cause second-round effects on production costs.

Forwards are pricing at least another 8 hikes from the Fed in 2022, following the first of the series in March. This is indeed a very steep implied path by historical standards.

The reduction of the Fed balancesheet, from the summer, will add further tightening - yet we question whether the Fed can deliver so much tightening without threatening financial stability and causing a hard landing.



Source: Datastream as at 05/04/2022

As the economy faces a triple whammy – the war, tough central banks and Covid still disrupting the global supply chain – we have cut the cyclicality of portfolios. We reduced the government bond UW and keep a small short duration, however, given the residual space for higher long-term yields. We turn to a small UW in equities, as they face significant headwinds. Our sector and style allocations are fairly balanced, reflecting opposite forces from the slowdown (bad for Cyclicals vs Defensives) and rising yields (supporting Value vs. Growth).

Credit spreads, especially in Europe have been hit relatively severely among other risk metrics, e.g. equity volatility. This, combined with the rise in risk-free yields, imply that EUR Credit offers a more generous carry, for a limited risk in the IG space. Our OW is executed through defensive strategies, IG rather than HY, subordinated debt rather than pure HY, non-financial rather than financial, and defensive sectors rather than cyclicals.

GLOSSARY

SISTEMIC RISK

A systemic risk is the possibility that an event at the company or individual country level could trigger severe instability in the whole financial system.

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