GENERALI INSURANCE ASSET MANAGEMENT

Market Perspectives

Climbing a wall of worries? It is very slippery

GIAM Macro & Market Research

August 2022

- Central banks (CBs) are still showing their teeth, frontloading rate hikes and asserting their inflation credentials. But the Fed and ECB's distancing from forward guidance is likely coinciding with a pivot towards less aggressive tightening.
- Indeed, risks to growth are rising steadily. A moderate H2 recession is now our base case for the euro area. This will strengthen the case for a more calibrated monetary tightening after summer.
- Also expect the Fed to turn less hawkish by then. Investors may be front running this already, hence the recent bounce in equities. Yet we keep a prudent risk stance for now, in a fast deteriorating economic environment: underweight Equities, HY Credit and non-core debt (TPI unconvincing). We see value in safer Credit segments and USD.

CONTENT

1.	Global View	2
2.	USA	3
3.	Euro area	4
4.	Japan	5
5.	China	6
6.	Central and Eastern Europe	7
7.	Government Bonds	8
8.	Credit	10
9.	EM Sovereign Bonds	11
10.	Currencies	12
11.	Equities	13
12.	Asset Allocation	15
13.	Forecast Tables	16
14.	Imprint	17

This document was completed on July 29, 2022

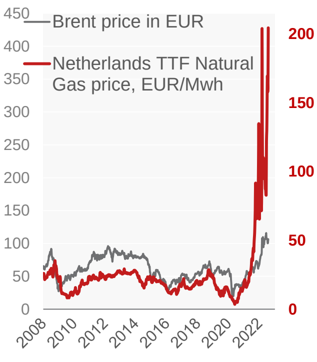
Global View – Climbing a wall of worries? It is very slippery

Thomas Hempell / Vincent Chaigneau

- **Central banks (CBs) are still showing their teeth, frontloading rate hikes and asserting their inflation credentials. But the Fed and ECB's distancing from forward guidance is likely coinciding with a pivot towards less aggressive tightening.**
- **Indeed, risks to growth are rising steadily. A moderate H2 recession is now our base case for the euro area. This will strengthen the case for a more calibrated monetary tightening after summer.**
- **Also expect the Fed to turn less hawkish by then. Investors may be front running this already, hence the recent bounce in equities. Yet we keep a prudent risk stance for now, in a fast deteriorating economic environment: underweight Equities, HY Credit and non-core debt (TPI unconvincing). We see value in safer Credit segments and USD.**

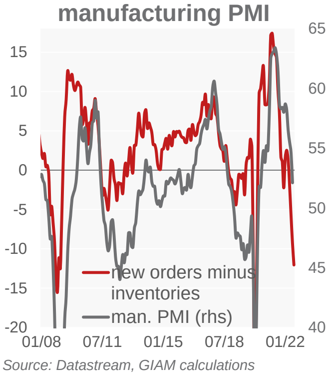
Just as central banks keep rushing to tame the inflation beast, the energy crisis and political uncertainties are complicating their tasks even further. Yet both Equities and Bonds climbed a wall of worries in July (lots of bad economic news and rate hikes priced in). Still, the toxic combination of a deeper global slowdown and sticky inflation requires a prudent allocation stance, in our view.

NatGas vs Brent



Source: Bloomberg, GIAM

Euro area manufacturing PMI



Source: Datastream, GIAM calculations

Sticky inflation overshoots have left CBs far behind the curve, requiring a drastic catch up to fortify inflation credentials. With policies generally still accommodative, front-loaded rate hikes will continue over the summer.

Euro area recession looming for H2

Yet the inflation threat is only one part of the policy dilemma. Soaring prices alongside supply disruptions have severely blurred the economic outlook. We have propagated below-consensus growth forecasts for the euro area for longer, and now pencil in a moderate recession over H2. The US manufacturing slowdown is also spilling over to the rest of the economy, supporting our earlier view that 2023 growth will be below 1%, with the risk of a recession only slightly below 50%. The recession spectre will increasingly feed into central banks' reaction function, keeping our expected CB rate paths below market pricing.

Bonds	27/07/22*	3M	6M	12M
10-Year Treasuries	2.78	2.85	3.10	3.05
10-Year Bunds	0.96	1.05	1.15	1.35
Corporate Bonds				
BofaML Non-Financia	180	185	180	175
BofaML Financial	195	205	200	190
Forex				
EUR/USD	1.02	1.00	1.06	1.10
USD/JPY	137	136	130	123
Equities				
S&P500	3971	3835	3875	3965
MSCI EMU	128	123	125	127

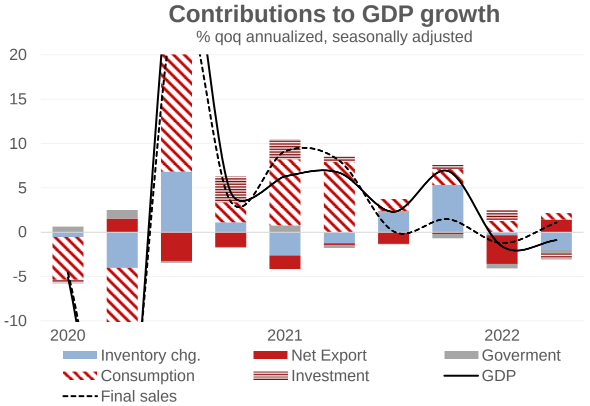
** avg. of last three trading days*

Once central banks start signalling that the tightening process is close to the end, we will feel more confident with rebuilding risk positions. But some more patience is required. First, CBs will need to see receding inflation rates before they can put more weight on growth weakness. Second, risks are tilted towards an even more toxic stagflation dilemma if the energy crunch in Europe deepens. EU natural gas prices have surged back to the dizzy levels seen in March on fears of sustained cuts in Russian deliveries. EU member states' deal on gas savings will fall short of what is needed if Putin decides to turn off the taps. Political uncertainties in Italy do not help either. The right wing coalition is comfortably in the leads, but the weight of Brothers of Italy, and its not-so-friendly views towards EU policies, are a concern. Snap elections in September will also slow the reforms and may jeopardize the disbursement of NGEU funds.

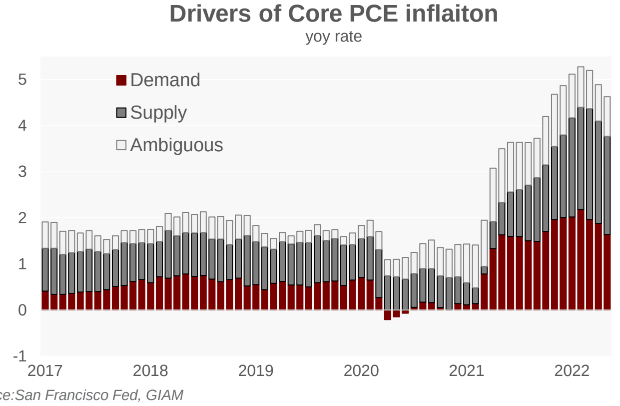
We thus continue to favour a prudent risk stance, with an underweight in Equities and riskier (HY) Credit. We are also cautious on Southern European debt. The ECB's new TPI will help to keep spread moves contained, but looks too discretionary – it is not clear if and when the hawks will ever agree that the spread moves are "fundamentally unjustified". We keep our duration stance at near neutral (minor residual short), though we have been surprised by the pace of core yield retreat. We favour an overweight in IG Credit mostly on the attractive carry reached. The USD is dear, but still set to benefit near term from monetary policy divergence, global policy uncertainties and the European energy crisis.

USA

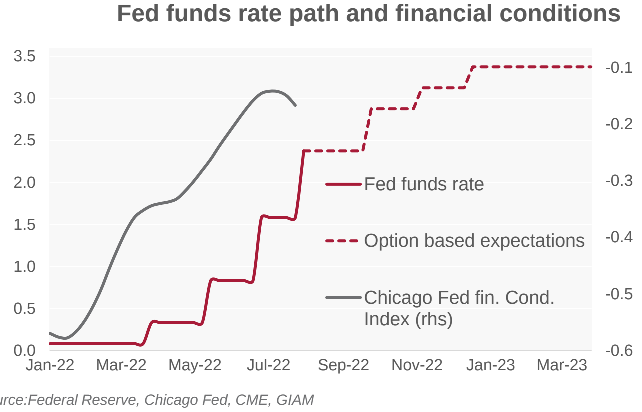
Paolo Zanghieri



Source: BEA, GIAM



Source:San Francisco Fed, GIAM



Source:Federal Reserve, Chicago Fed, CME, GIAM

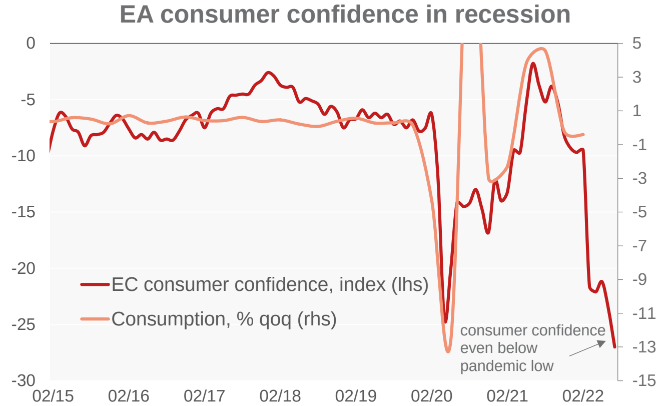
- **Q2 GDP figures showed the damage higher rates are already having on demand. This led us to further cut our growth forecast, to 1.7% this year and 0.7% in 2023. The risk of a recession in H1 2023 approaches 50%.**
- **Inflation shows timid signs of cooling and we expect the core CPI rate to remain well above 4% yoy by year end. Lower oil prices are driving down expectations.**
- **The 75 bps hike in January has likely marked the peak in hawkishness. Monetary tightening will continue at a slower pace and will be more attentive to real activity.**

According to the first release, in Q2 GDP contracted by 0.9% annualized after the 1.6% drop in Q1, matching the definition of a technical recession. The disappointing reading was driven to a large extent by destocking, but also showed a bigger than expected impact of tighter rates on demand, especially residential investment, only in part offset by moderately rising consumption. We cut our GDP forecast for 2022 to 1.7%. Still unfavourable financial conditions and the lack of any fiscal stimulus will constrain 2023 growth to 0.7%. The GDP numbers will heighten fears of a looming recession in the US: we think that it has an almost 50% probability in H1/23. The economy is indeed weakening but the labour marker remains strong, keeping consumption afloat despite high inflation. Lower oil prices will drive down headline inflation and are already taming expectations. Yet, the descent towards sustainable levels remains hampered by ongoing supply disruptions. According to the San Francisco Fed, supply accounts for more than a third of the latest core PCE reading. And the weakening in home sales will take time to feed through shelter inflation; we expect core CPI inflation to end the year just below 5%.

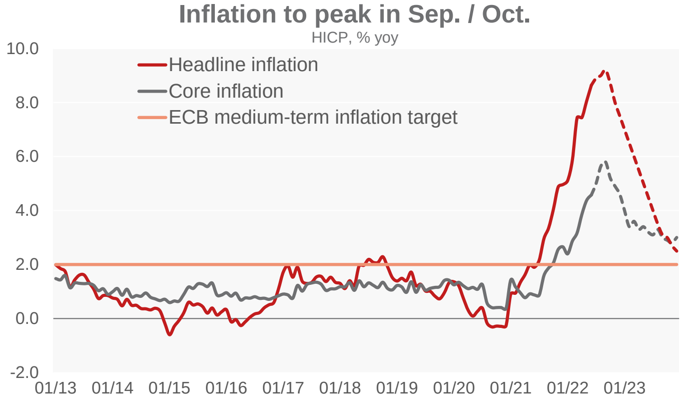
While unanimously deciding for another 75 bps hike in July, the Fed signalled that going forward the pace of tightening could be slower if inflation does not surprise to the upside, as the slowdown of the economy will gradually restore the supply demand imbalances. Powell signalled that the rate path indicated in June, with the Fed funds rate peaking at 3.8% and reaming there throughout 2023 remains relevant. This carries two messages: first rate rises will continue, second, and more important, the market pricing of rate cuts already in 2023 is too extreme.

Euro Area

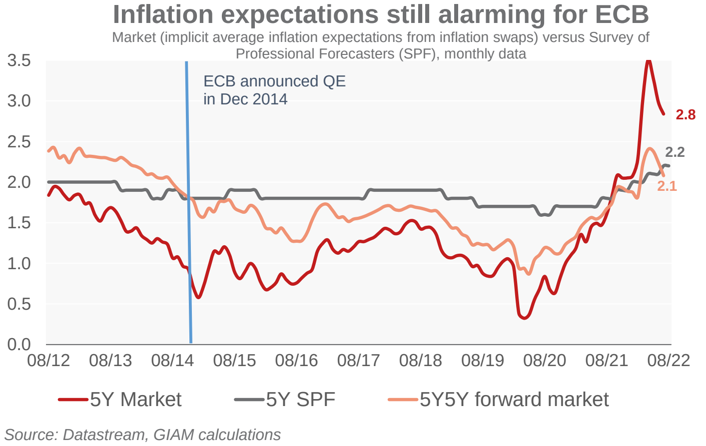
Martin Wolburg



Source: Datastream, GIAM calculations



Source: Datastream, ECB, GIAM calculations



Source: Datastream, GIAM calculations

- **The activity outlook deteriorated significantly. Most important, we now expect gas supply shortages to restrict activity, esp. in Germany.**
- **A euro area recession in H2/22 is now our base case. We revised our 2023 growth expectation down to 0.8% and see negative German growth.**
- **At the same time, the inflation outlook worsened further. We still expect the ECB to keep on tightening but see the risks now more balanced.**

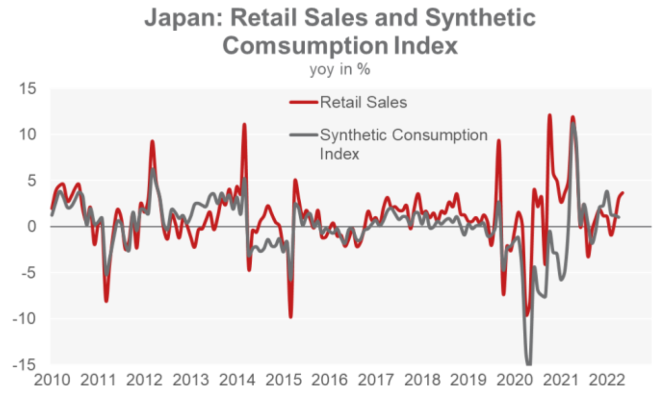
The euro area outlook clouded further. A nasty mixture of ever new inflation highs with a July reading of 8.9% yoy and the announcement of Russia to cut gas supply to a low level (of North Stream 1 to just 20%) for the time being are the key reasons. On top, the economic environment also worsened with the US already in a technical recession most noteworthy. The July composite PMI dropped to 49.4, implying a contraction of growth by -0.1% qoq. Forward-looking indicators like new orders and economic expectations deteriorated strongly across the board. Quite outstandingly, consumer confidence fell even below the pandemic trough in April 2020.

Looking ahead, we now deem it most likely that (at least) temporary gas shortages will induce production shortfalls. We are also sceptical whether households are willing to reduce their savings rate much further (latest available Q4/21: 13.7%) including Covid-related excess savings. We also see the need to revise our 2022/23 inflation forecasts further up to 7.8%/4.4%. All in all, we now make a H2/2022 recession with mildly negative growth our base case. Following a 2022 annual growth rate of 2.9% amid a surprisingly strong (flash) output growth of 0.7% qoq in Q2/22, activity is set to decelerate strongly to just 0.8% in 2023. Germany will be hit hardest and we expect its recession to last into 2023 bringing annual growth down to 1.1% in 2022 and make it with -0.1% even negative in 2023.

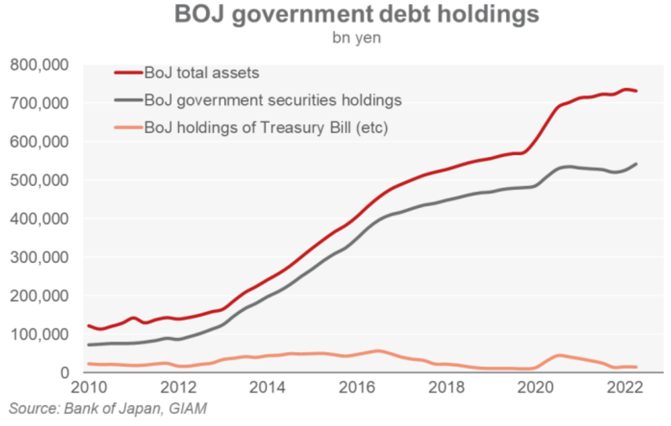
The ECB surprisingly hiked its key rates by 50 bps lifting the depo rate to zero in July, maintained a hawkish tone but left the future path of policy rate deliberately open. With headline inflation likely coming close to 9% yoy, medium term inflation expectations (see bottom graph) above target and the neutral policy range (1% to 2%) not yet in sight, there is plenty of leeway for further hikes. However, with the economy in recession the urgency of rate hikes falls. In sum, we stick to our year-end key rate forecast of 0.75% but see the risk now more balanced.

Japan

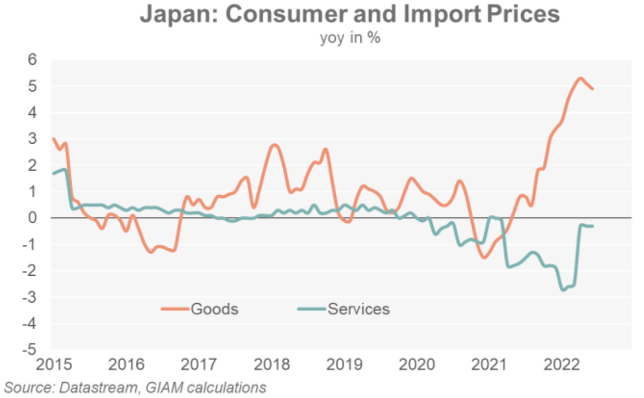
Christoph Siepmann



Source: Japan Cabinet Office, Datastream, GIAM calculations



Source: Bank of Japan, GIAM



Source: Datastream, GIAM calculations

- **The Bank of Japan (BoJ) Governor Kuroda rejected any monetary policy change. Nevertheless, we continue to signal a necessary overhaul with a minimal increase in the key rate next year.**
- **Headline CPI was 2.4% yoy in June. Real activity is set to benefit from China's recovery near-term but to slow later alongside the global downturn.**

At its July meeting, the BoJ kept its monetary policy unchanged (-0.1% overnight, 0% +/- 25 bps for 10y JGBs). Governor Kuroda looks determined to maintain this approach during his term until April 2023. This internationally unique stance caused the yen to further depreciate. June data show that the BoJ intervened in the JGB markets with a record amount of JPY 16 tr (almost 3% of nominal GDP) to defend the 0.25% upper bound. In July, as depreciation pressures temporarily reached fresh highs, thus interventions will likely have even increased. While Kuroda sees the yen's volatility as "undesirable", he (correctly) argues that supply side inflation pressures will not help to establish a virtuous wage-price spiral. Nevertheless, after almost 10 years of extreme easy monetary policy without tangible effect, we expect a more fundamental revision (although an abrupt shift is unlikely). We continue to signal this expectation by a minimally positive overnight rate in 2023. Recently, a BoJ board reshuffling brought in less dovish members.

Headline inflation rose to 2.4% yoy in June, while core-core inflation (ex fresh food and energy) was 1%. The reason for these rather low rates (in comparison to other AEs) is still slightly deflationary service prices. By contrast, good prices rose by almost 5% yoy, energy by 16.5% yoy, and import prices by 46.3% yoy due to the yen depreciation. To mitigate the negative terms-of-trade effect, PM Kishida's (whose LDP won the upper house election comfortably after former PM Abe was assassinated) policy is to subsidise key prices (esp. gasoline). It is estimated that subsidies lower CPI inflation by 0.7 pp. We expect headline inflation at 2.5% this year and 1.5% in the next.

In terms of real activity, Japan sees divergent forces. Exports are benefitting from the China recovery but will more and more suffer from the global downturn, together with supply shortages in the auto industry. Consumption is still recovering from the last lock-downs, while recently multiplying fresh cases will probably sour the mood again. All in, we see growth at 1.0% this year and 1.3% in 2023.

China

Christoph Siepmann

Source: Datastrem, GIAM calculations

Source: Datastream, GIAM calculations

Source: Datastream, GIAM calculations

- **China's Q2 GDP growth dropped to 0.4% yoy amid the Covid lockdowns. We fine-tuned our 2022 growth forecast to 3.2% (3.5% before).**
- **June data showed an ongoing recovery in exports, IP and retail sales while the real estate sector remained in the doldrums.**
- **Government support will be stepped up in H2, but risks from real estate and possible larger Covid outbreaks remain tilted to the downside.**

China's Q2 GDP growth dropped to 0.4% yoy (-2.6% qoq) due to the Covid lockdown disruptions. News about the Covid situation in China remain mixed, but shutdowns have so far been limited to local or neighbourhood levels. Nevertheless, there is no guarantee that a large outbreak can be prevented, going forward.

Despite this uncertainty, June data continued to recover. IP and retail sales advanced to 3.9% yoy resp. 3.1% yoy. Fixed asset investments also improved in yoy terms, but its subcomponents "infrastructure" and "real estate" strongly diverged. The real estate sector remains in a weak shape. Property investment contracted further, while home sales only dropped less intensely than before. News about a "mortgage payments strike" worried markets. While small in the beginning, it seems to widen. The "strike" was largely triggered to protest prolonged construction suspensions on pre-sold houses. Principally, missing payments could lead to fresh non-performing loans at banks. But mortgages in China typically carry large buffers, with down payments at least 30%. Thus, for the time being, these strikes appear rather a liquidity than a solvency problem. Secondly, the long building delays also risk to sour the mood for fresh property buyers in terms of pre-financing developers, and thus increase their funding stress. We expect policy to respond and add to existing efforts to support the smooth flow of credit to viable firms.

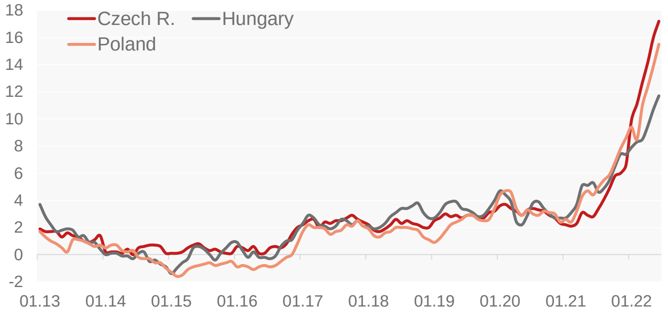
Authorities repeatedly confirmed their "great efforts" to sustain the H2 recovery. A big focus will lie on infrastructure. Press reports about bringing forward RMB 1.5 tn in additional special LGB issuance quotas into H2 have not yet been confirmed. The Politburo dropped the official growth target of 5.5% but fell short of more specific announcements. Total Social Financing rose markedly, and the credit impulse reached positive territory. We finetune our growth forecast to 3.2% in 2022 but see continued downside risks from Covid and the real estate sector.

Central and Eastern Europe

Radomír Jáč

Headline inflation

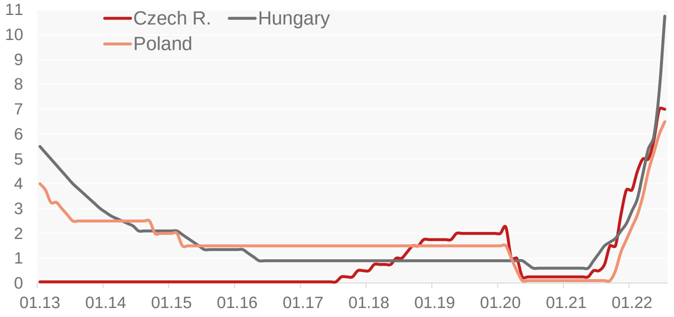
CE-3 countries (CPI yoy in %)



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

Main Forecasts

Czech Republic	2020	2021	2022f	2023f
GDP	-5.5	3.5	2.2	1.0
Consumer prices	3.2	3.8	14.9	5.8
Central bank's key rate	0.25	3.75	7.00	4.25
Hungary	**2020**	**2021**	**2022f**	**2023f**
GDP	-4.9	7.1	5.0	2.0
Consumer prices	3.3	5.1	13.2	9.0
Central bank's key rate	0.60	2.40	12.00	7.00
Poland	**2020**	**2021**	**2022f**	**2023f**
GDP	-2.5	5.7	5.7	2.5
Consumer prices	3.4	5.1	13.0	9.0
Central bank's key rate	0.10	1.75	7.00	5.75

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

- **Spiking inflation induced further key rates hikes. However, the CEE central banks may start to focus on weaker economic growth and the hiking cycle may end or at least take a pause in Q3 in some cases.**
- **The Czech CNB may end the cycle of rate hikes, also due to the substantial personnel changes in its board. The Polish NBP said that monetary tightening could be near its end. The Hungarian MNB is likely to raise rates further, as inflation risks have intensified in Hungary.**

Inflation in the CE-3 has accelerated further in June driven by external factors (energy prices) and domestic developments (a still strong pricing power on the supply side). Particularly energy and food prices are expected to drive inflation to new highs in Q3 and it is now uncertain whether inflation will reach its peak in Q3 or only later. The story is becoming even more complicated, as the high inflation is accompanied by clear signals of slower economic growth. This can force the regional central banks to think twice about further monetary tightening.

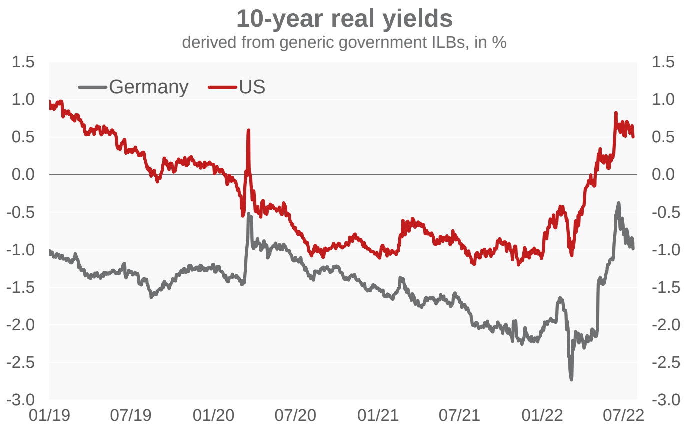
The Czech CNB raised its key rate by 125 bps to 7.00% in June. This was the last meeting under „the old Board“. The new governor is opposing rate hikes and 3 new members joined the CNB Board in July. This makes the support to more rate hikes uncertain. The CNB will decide on interest rates on Aug. 4 and we see a good chance for unchanged rates. The CNB is active in the FX market where it intervenes in order to protect the Czech crown against weakening.

In Hungary, the MNB raised interest rates sharply since June, as it tried to oppose the HUF weakening. The base rate now stands at 10.75% (the last hike: 100 bps in late July). The MNB's stance is hawkish because of the FX rate volatility but also due to the outlook for a higher CPI. The government will cut household energy subsidies from August on, which will lead to a further increase in inflation. We expect at least two more rate hikes by 50 bps but the MNB may do more, depending on CPI and the FX rate behaviour.

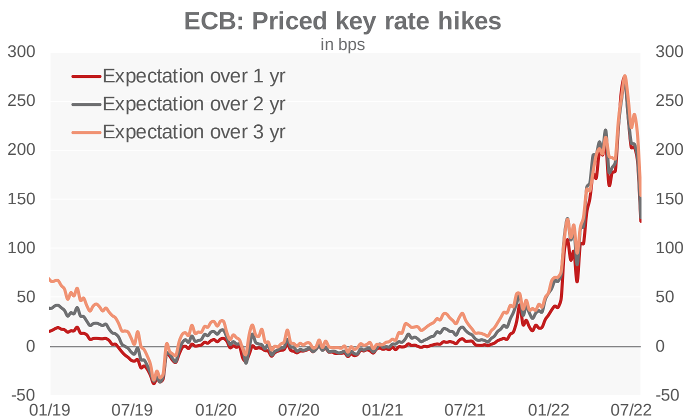
The Polish NBP raised its key rate by 50 bps to 6.50% in July. This was less than expected and the governor came with dovish comments: he warned against technical recession and stated that the monetary tightening was nearing its end. The next rate decision is due in early September, we expect a 50 bps hike to 7.00%, which could be the peak for Polish key rates.

Government Bonds

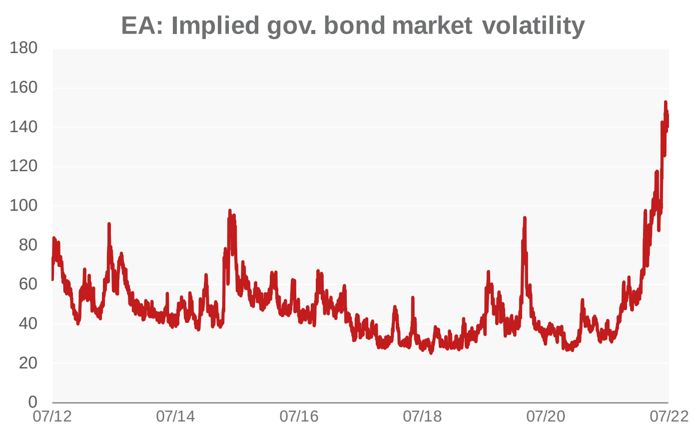
Florian Späte



Source:Bloomberg, GIAM



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM

- **Notwithstanding hawkish central banks and upward surprises on inflation international government bond yields continued to decrease amid growing recession fears.**
- **Much of the looming growth deterioration seems already priced in fixed income. With the peak in inflation still to come and further key rate hikes still in the offing, we expect yields to trend moderately upwards again in the weeks to come.**
- **Given the absence of details regarding the activation of the ECB's Transmission Protection Instrument (TPI) we expect financial markets to test the central bank's commitment. This applies even more as upcoming snap elections in Italy are hardly a trigger to use the new tool.**

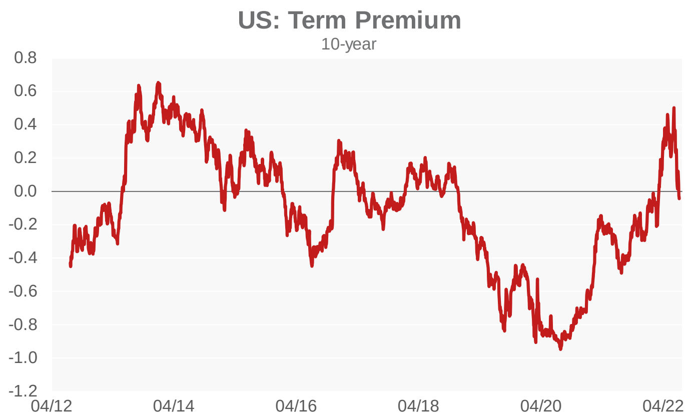
Since mid June, international bond markets have shown a clear change in direction compared to the previous months. Yields have dropped significantly driven by both receding real yields and lower inflation expectations. Disappointing macroeconomic releases have triggered concerns about a forthcoming recession. At the same time, central banks kept their hawkish rhetoric and backed up their words with action. Market expectations still price further steep rate hikes for most major central banks (except the BoJ), but these have come down as of late with the expected peak of the cycle trimmed and brought forward. Hence, financial markets forecast that central banks will act quickly but the end of the cycle is seen to occur already in Q4 2022 (Fed) and Q1 2023 (ECB), respectively.

Going forward, we do not expect yields to plummet. Inflation readings are yet to peak on rising energy costs and broadening price pressures. Furthermore, central banks will continue to stress their commitment to tame inflation and front-load hikes in the months to come. The US 2-yr/10-yr curve already inverted amid the additional downward pressure on long-dated yields. Following the 90 bps decline in 10y Bund yields from the peak, markets have already priced a good chunk of the deteriorated macroeconomic outlook.

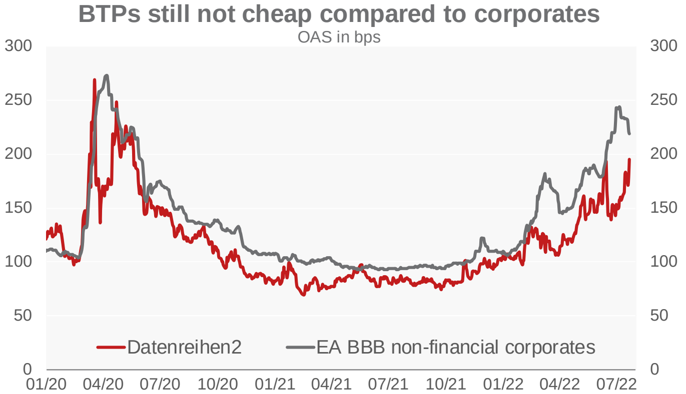
Furthermore, term premiums have decreased in recent weeks despite a high level of volatility. As both the Fed and the ECB have effectively abolished their forward (mis)guidance and turned to a data-dependent, meeting-by-meeting approach, yield uncertainty is set to rather increase and will keep bond market volatility on a high level.

Government Bonds

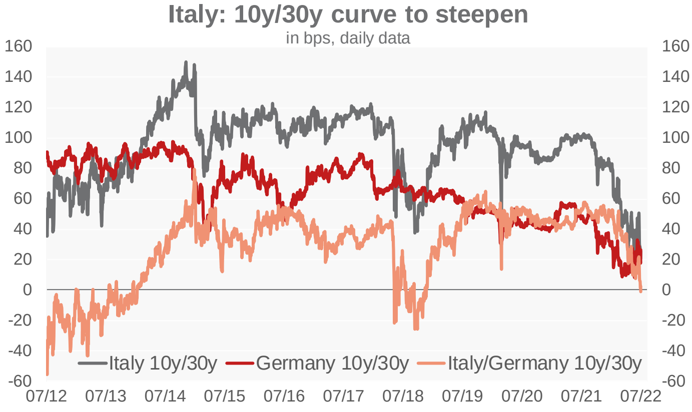
Florian Späte



Source: US Fed, GIAM



Source:Datastream, GIAM calculations



Source: Bloomberg, GIAM calculations

Accordingly, we see scope for term premiums to rise again going forward.

However, given the macroeconomic environment, we expect only a limited yield increase of core benchmark bonds as the growth slowdowns is set to extend. We now expect the euro area to enter a moderate recession in H2. Gas supply remains a key risks: Russia has resumed its deliveries, but now at only 20% capacity. A full stoppage of delivery would deepen the recession and bears a downside risk also for Bund yields.

Overall, we forecasts core bond yields to rise only moderately on a 3-month horizon (US: 2.85%, EA: 1.05%). Furthermore, we assume that the high point in the US (together with the approaching peak in the key rate cycle) will already be reached in the next few months. In contrast, the rise in EA yields should continue over the year.

Euro area non-core bonds still facing headwinds

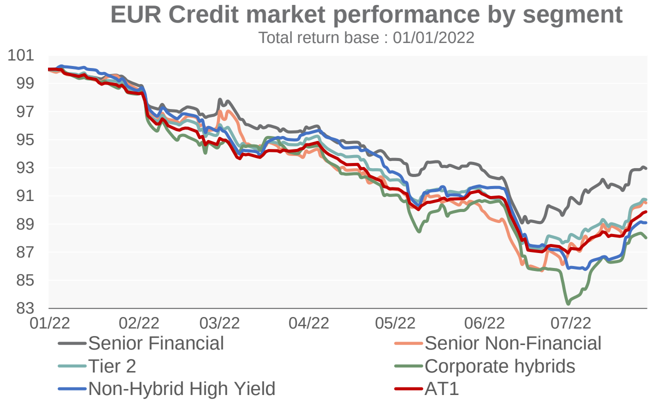
EA non-core government bonds remained under pressure in recent weeks as a number of factors (e.g. uncertainty about ECB policy, political imponderables in Italy, recession fears) contributed to the underperformance.

Despite the increased spread levels we do not forecast a trend reversal as non-core bonds are still not cheap yet (see chart on the left). What is more, the ECB remained rather vague with respect to the TPI. We regard the unlimited size and the pari passu clause as necessary conditions to be able to exert any impact at all on markets. But the conditions defined for activating TPI appear vague and leave plenty of discretion for the ECB. We expect financial markets to test the ECB's commitment.

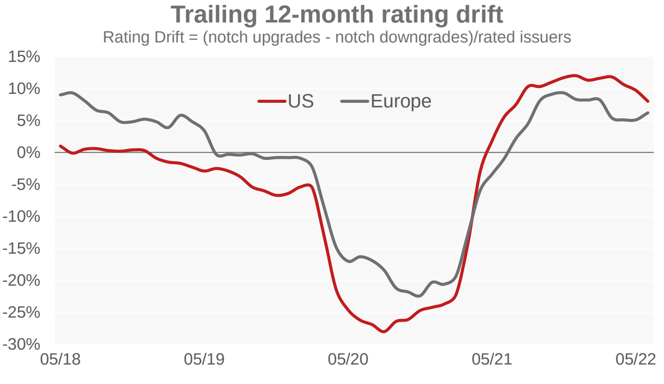
Furthermore, TPI is announced in an environment of political uncertainty in Italy. On September 25 general elections will take place and the formation of a new government might take some time, triggering problems regarding the distribution of NGEU funds. According to current polls a right-wing government with the participation of Fratelli d'Italia – which is deemed to be much more euro-sceptical than the former government – is possible. Even in case TPI will be activated (which is far from certain as it is not designed to prevent idiosyncratic factors) the maximum remaining maturity of purchased bonds is 10 years. This leaves very long-dated BTPs particularly vulnerable and we expect the 10-yr/30-yr BTP spread to widen further down the road.

Credit

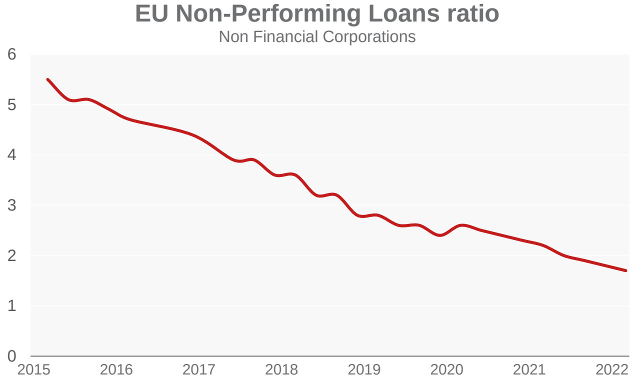
Elisa Belgacem



Source:Bloomberg, BofAML, GIAM own calculations



Source:Moody's, GIAM



Source:Bloomberg, EBA, GIAM

- **We remain OW IG credit as we see the carry as attractive versus the rest of our investment landscape. We continue to play the decompression trade IG versus HY.**
- **Technicals will remain decent as there will be fewer issuances and flows are stabilising in IG while still on a downward trend in HY.**
- **Fundamentals will deteriorate amid the weak economic outlook but valuations are already incorporating a severe deterioration of credit metrics.**

The technicals should remain neutral into year end for three main reasons: 1/ The ECB has halted its corporate bond purchases at the end of June, as widely anticipated, but could possibly resume some net purchases of private thanks to the flexibility in PEPP reinvestments should the fragmentation become even more apparent in the credit market. 2/ Except for financials, that need to refinance the TLTROs amounts with corporate bonds, the primary market has been very calm, with levels being issued inferiors to those of the last five years. 3/ On the flow side, after a very negative start to the year, flows are stabilising for EUR IG while EUR HY continues to face outflows.

Fundamentals will also be affected by the economic slowdown, causing defaults to rise and ratings to deteriorate but this should mainly be a problem for HY than for IG. The more adverse economic environment will start affecting smaller businesses first, causing banks NPLs to rise, and sub-investment grade defaults to increase from 2% currently, to around 3% by year-end. Similarly the rating drift turning negative from still positive currently, will likely be the result of rating agencies downgrading the most cyclical compartments of the HY space first.

Valuations are the most extreme compared to historical standards in EUR versus USD, in IG versus HY and in Non financials versus financials.

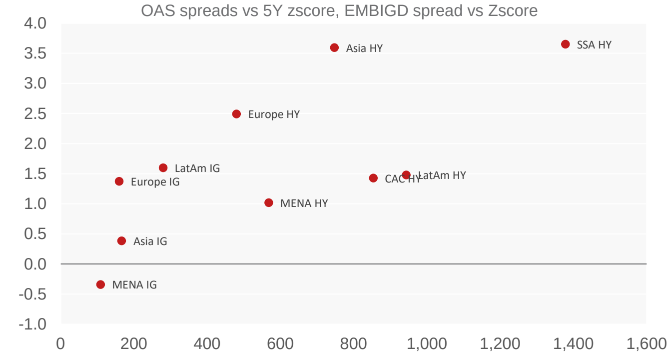
Consequently, we do reiterate our OW position in IG credit versus the rest of our investment landscape, including versus HY as we do expect the decompression trade in credit to continue. Within IG we favour core and semi core countries to peripherals, non-financials to financials, cash versus CDS and defensive sectors versus cyclical ones. Within HY we have a strong preference for BBs and subordinated instruments versus pure HY.

EM sovereign bonds

Guillaume Tresca

EM IG is rich

OAS spreads vs 5Y zscore, EMBIGD spread vs Zscore



Source: Bloomberg, JP, GIAM

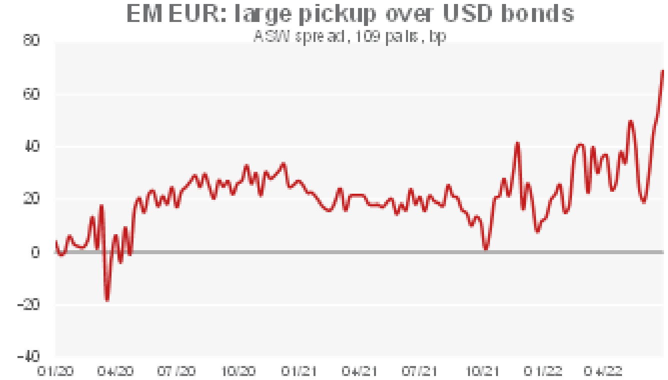
EM USD: carry provide a buffer

6M TTR for different scenarios

OAS spread	US 7Y 2.38%	2.48%	2.58%	2.68%	2.78%	2.88%	2.98%	3.08%
494	9.66%	8.96%	8.26%	7.56%	6.87%	6.17%	5.47%	4.77%
504	8.96%	8.26%	7.56%	6.87%	6.17%	5.47%	4.77%	4.07%
514	8.26%	7.56%	6.87%	6.17%	5.47%	4.77%	4.07%	3.37%
524	7.56%	6.87%	6.17%	5.47%	4.77%	4.07%	3.37%	2.68%
534	6.87%	6.17%	5.47%	4.77%	4.07%	3.37%	2.68%	1.98%
544	6.17%	5.47%	4.77%	4.07%	3.37%	2.68%	1.98%	1.28%
554	5.47%	4.77%	4.07%	3.37%	2.68%	1.98%	1.28%	0.58%
564	4.77%	4.07%	3.37%	2.68%	1.98%	1.28%	0.58%	-0.12%
574	4.07%	3.37%	2.68%	1.98%	1.28%	0.58%	-0.12%	-0.81%
584	3.37%	2.68%	1.98%	1.28%	0.58%	-0.12%	-0.81%	-1.51%
594	2.68%	1.98%	1.28%	0.58%	-0.12%	-0.81%	-1.51%	-2.21%

EM EUR: large pickup over USD bonds

ASW spread, 109 pairs, bp



Source: Bloomberg, GIAM calculation

- **We maintain our overweight (OW) stance to benefit from the highest carry since 2008. EM debt remains a carry and relative value play.**
- **Tailwinds are numerous, and spreads will widen further. EM HY will see rising risk default.**
- **Fragmentation intensifies further, and the index cheapness is only optical. Idiosyncratic factors will dominate in the HY space.**

The EM environment has been very volatile, with a significant spread widening in early July driven by the HY part and some rapid retracement recently, following the rebound in risk appetite. Due to the considerable carry, we maintain an OW for EM debt in our allocation. Still, we continue to highlight the downside risks as multiple headwinds are here to stay: higher real yields, subdued Chinese activity, stronger dollar. Despite the recent improvement in risk appetite, EM spreads are still due to widen further as economic activity is still slowing down with the risk of seeing more defaults for the weakest EM countries. We see two silver linings: the decline of core rates that can help ease the market pressure and spur fund inflows and the high effective yield at the highest since the GFC. EM debt can post a positive total return in H2 as the carry will more than offset the spread widening

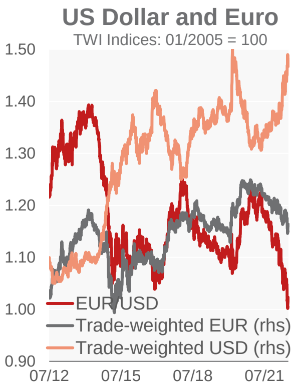
Fragmentation and optical cheapness

Fragmentation continues to intensify. The EMBIG index is very wide historically, but it is essentially due to the HY bucket that drove wider the index spread in June/July. EM IG stands at a rich level with 20% of the index spreads below 200bp, while EM HY is almost as cheap as in March 2020. In the recent spread rally, IG and BB tightened, but the low-rated countries kept widening. It shows idiosyncratic factors offset any improvement in global risk sentiment.

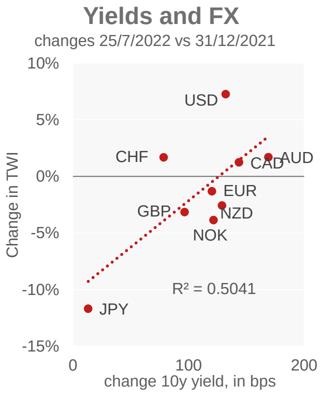
Selective allocation

Given the tailwinds and its optical cheapness, the allocation approach must be tactical and selective. We still favour IG over HY, with now a focus on BBB. In the HY segment, we focus on BB only as we continue to see rising default risk in low-rated countries. It is not a systemic risk, and it will be gradual. The IMF has shown a more benign view on PSI and debt sustainability. FX wise, EM EUR bonds offer the most significant pickup since the Covid over EM USD bonds for USD investors, especially in Romania, Chile, and Mexico EUR curves.

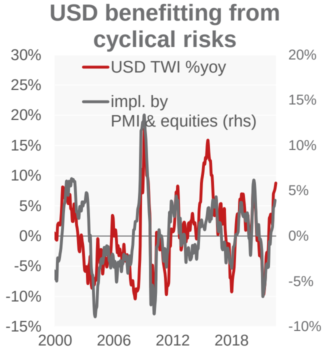
Thomas Hempell



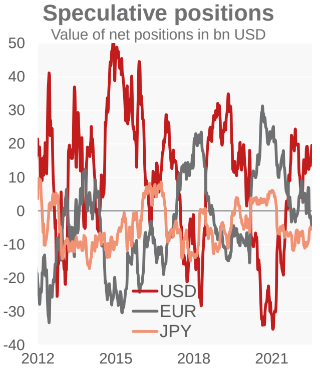
Source: Datastream, GIAM calculations



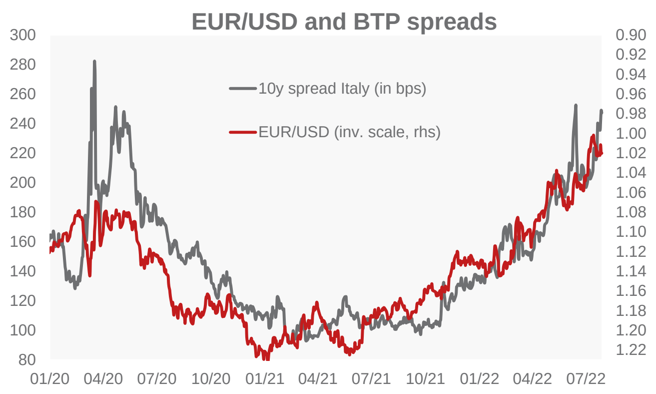
Source: Datastream, GIAM calculations



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



Source: CFTC, Datastream,



Source: Datastream, GIAM calculations

- **The USD is dear but is still set to benefit short term from monetary policy divergence, global policy uncertainties and the European energy crisis.**
- **Amid political uncertainties and a particularly acute stagflation dilemma in the UK, GBP is headed for more weakness. The CHF is the most compelling safe haven in Europe amid more intense energy and recession worries, leaving more downside for EUR/CHF over the summer.**

The USD is keeping the momentum on its side. It temporarily reached parity with the EUR for the first time in almost 20 years. This is about USD strength in the first place and EUR weakness only in the second. Year-to date, the trade-weighted USD has gained broadly almost 7% while the effective EUR lost only 2.5% (top left chart).

Stretched USD with even more upside short term

Monetary policy divergence is set to keep the USD underpinned. True, the USD is dear and looks stretched vs. relative yield moves (top right chart). Meanwhile, most other major central banks are catching up in raising rates (with the notable exception of the BoJ). Speculative net long USD positions are high (mid right chart), even if not excessively.

Yet as argued earlier, geopolitical tensions and rates uncertainties are unlikely to ease soon, keeping the USD bid as a safe haven (mid left chart). Europe is deeply struggling with the energy crisis engineered by Russia. Meanwhile the collapse of the Italian reformist government under Draghi is sending risk premia up again (bottom chart). Despite already stretched valuation, EUR/USD has leeway to temporarily break through below parity.

Our medium term outlook remains for a EUR/USD rebound. Yet, the prospects for this look even more remote today than a month ago amid the deteriorated outlook for Europe. We therefore trim our 12-month forecast to 1.10 (from 1.13 before).

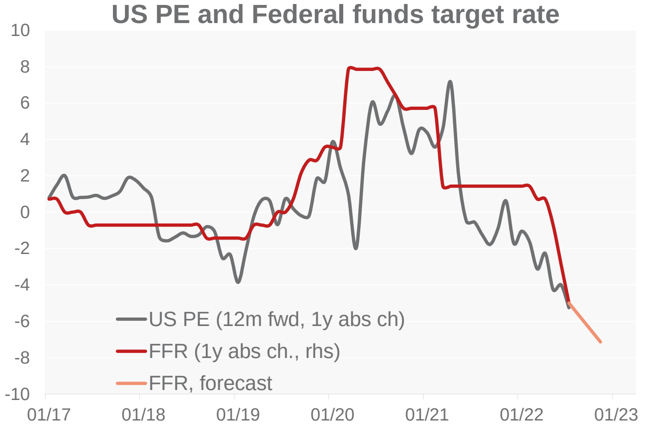
The CHF is set to benefit further short-term, with the SNB prepared to tolerate a lower EUR/CHF for taming inflation. The UK is probably facing the most adverse stagflation dilemma among advanced economies. Coupled with political uncertainties (Johnson succession, NI protocol showdown with EU) and shaky risk sentiment, this leaves more downside for GBP vs. USD, but less so against a similarly troubled EUR.

.

Equities

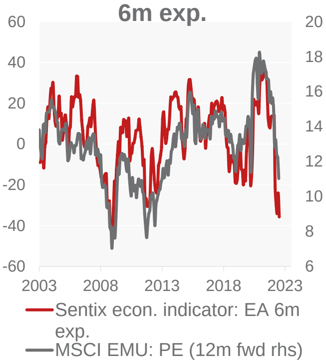
Michele Morganti, Vladimir Oleinikov

US PE and Federal funds target rate



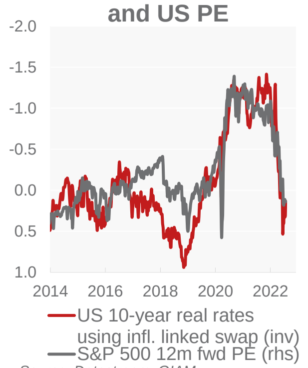
Source: Datastream, GIAM

EMU: PE and Sentix 6m exp.



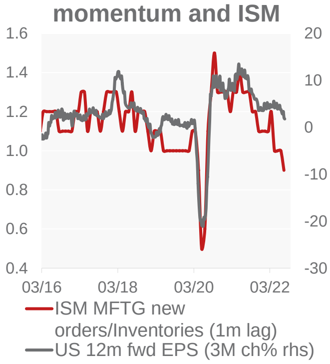
Source: Datastream, GIAM

Real 10-year rates and US PE



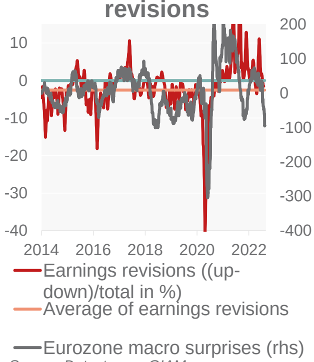
Source: Datastream, GIAM

US earnings momentum and ISM



Source: Datastream, GIAM

MSCI EMU: earnings revisions



Source: Datastream, GIAM

- **Hawkish CBs weigh on risk premium due to sticky and broadening inflation. PEs remain pressured by lower macro confidence and a further deterioration in financial conditions.**
- **More recently, depressed sentiment, declining inflation expectations and the Fed signalling a possible future slower pace of monetary tightening, are providing a temporarily relief.**
- **We stay underweight on equities as they are too early in anticipating future positives. We expect slightly positive total returns in 12 months.**
- **Within countries, we maintain a defensive bias: OW US and UK vs. EMU and Japan and an UW on Switzerland. We remain neutral on EMs.**
- **Sectors: we lower further Value vs. Growth. OW: Durables, Div.Fin., Energy, Food and Software. UW: RE, Media, PH, Insurance, Commercial & prof. services, Transportation. Style bets are on Defensives and Growth/Value.**

Year-to-date, market PE de-rated by 20% (-30% in mid-June). Hawkish CBs increased pressure on risk premium due to broadening inflation. Going forward, the market will likely continue to be pressured by low confidence and a further rapid deterioration in financial conditions along with lower earnings expectations.

More recently, there were supportive factors which could continue to sustain markets at least temporarily. First, investors' surveys showed a very low positioning and diffused negative sentiment. Secondly, the Russian gas supply cut is still not 100% certain and, more importantly, both inflation expectations and oil prices have declined together with bond yields. Furthermore, the VIX/MOVE ratio looks supportive for equities. Lastly, this week, the Fed signalled a possible slower pace of monetary tightening ahead.

That said, our Machine Learning models (ML) see equity TR not favoured vs bonds yet. Bonds' volatility (MOVE) remains too high for equities @120 (>90, equity tends to suffer in rel. terms). Positioning is low but relative equity vs. bond flows still at a cyclical high. Market has yet to discount future slowdown. So far, Q1 earnings held well but macro surprises are falling and both real income and global activity deteriorate. Prolonged war is still a threat as the overvaluation of the US Tech is (> 20% premium). Thus, we stay underweight on equities with market possibly tempted to price in a more severe economic slowdown.

Equities

Michele Morganti, Vladimir Oleinikov

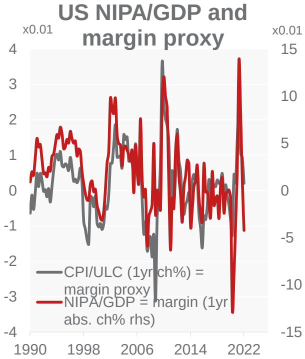
Analysis of the median stock: Q2 2022 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q1 2022	Q2 2022	Q1 2022	Q2 2022	Q1 2022	Q2 2022	Q2 2022
S&P	7.3 %	7.8 %	9.3 %	9.2 %	(2.0)%	(1.4)%	48.8%
Stoxx	15.6 %	11.7 %	14.3 %	15.2 %	1.3 %	(3.6)%	43.6%
Euro Stoxx	25.2 %	16.8 %	15.2 %	15.2 %	10.0 %	1.6 %	36.3%
Topix	3.4 %	4.4 %	6.2 %	6.5 %	(2.8)%	(2.1)%	19.9%

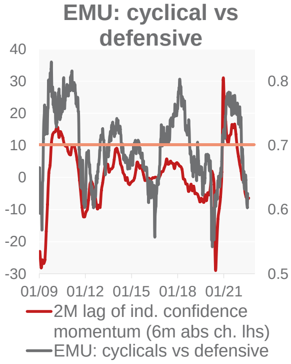
Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q1 2022	Q2 2022	Q1 2022	Q2 2022	Q1 2022	Q2 2022	Q2 2022
S&P	5.8 %	3.7 %	1.4 %	1.1 %	4.4 %	2.6 %	48.8%
Stoxx	7.7 %	2.0 %	2.4 %	2.3 %	5.3 %	(0.2)%	43.6%
Euro Stoxx	7.7 %	4.8 %	2.0 %	3.6 %	5.7 %	1.2 %	36.3%
Topix	7.6 %	8.9 %	0.7 %	0.8 %	7.0 %	8.1 %	19.9%

Note: margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM

Source: Datastream, GIAM calculations

Decent Q2 season but guidance at risk

Despite decent expectations for the Q2 earnings season, equities remain at risk. Overall, Q2 won't be a bad reporting season and earnings results should beat analysts' expectations. US preannouncements were better vs. Q1, and higher than mean. For the S&P 500 index, analysts expect a positive yearly growth but weaker than in Q1: 6.4% vs 11.4%; +23% vs 42% in Q1 for Europe. We expect margins to stay under pressure and we expect earnings deterioration ahead and maintain our earnings forecast below analysts' expectation in 2022, 2023 and 2024 (-8% on average).

Indeed, the weaker economic momentum and consumer demand combined with the rise in costs and lingering bottlenecks is producing more concern in CEOs' guidance. This both in relation to pricing power as well as for corporate margins. As macro surprises, confidence indicators (ISM, IFO, PMIs) and capacity utilization are falling – and mid-term recession risks rising – we expect analysts to cut estimates for H2 2022 and 2023.

Recommended allocation

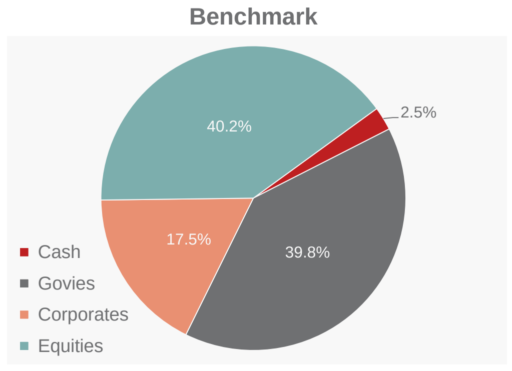
Within countries we want to be relatively defensive and guarding against slowdown. Thus, we are OW US & UK vs. EMU, neutral on Japan, and UW SMI. Net-net, we lower Value vs. Growth: despite enjoying increased rates, ML models for Value show overbought signals and macro fears do not play well. We decreased OW on Energy and are N on Materials, while increasing exposure on Food and Software. Our OW: Oils, Diversified Fin., Durables, Food, Software (new). UW: Cap. Goods, RE, Media, PH, Insurance, Commercial & prof. services, Transportation (new). We implement a small overlay to our sector allocation with style bets: OW Defensives and Growth/Value (increased).

EM: neutral. Pressure from falling macro surprises

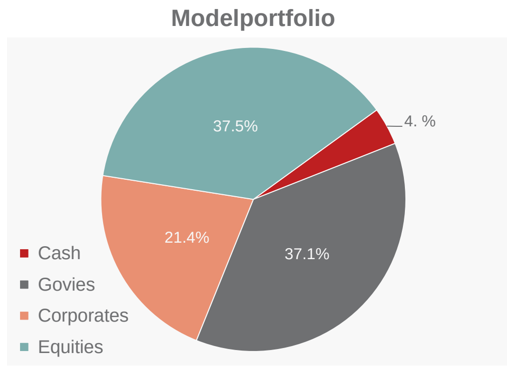
Resilience suggests a mature underperformance vs DMs. Valuation gap and increased yield vs US HY could trigger an extended EM outperformance later this year. China stocks look relatively attractive notwithstanding short-term volatility and to benefit from increasing government's policy support, rebounding credit impulse, easing lockdowns as well as increased signs of easing tech regulation. We are getting neutral on Korea due to increased recession risks.

Asset Allocation

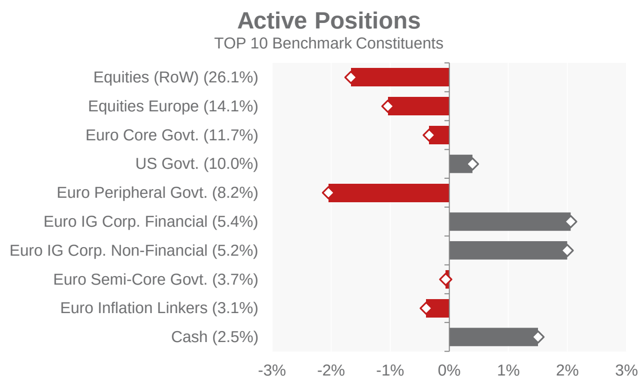
Thorsten Runde



Source: GIAM



Source: GIAM



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

- **In July, nearly all our actively covered asset classes remained in positive territory *(27.07.22)*. Just short- to medium-dated BTPs fell below the zero line and mark the lower end of the performance ranking.**
- **The top positions in the ranking are occupied by long-dated EA Core Govies and the MSCI Pacific which account for +6.7% and +6.2% respectively.**
- **In the EA Credit segment EA IG non-fin and EA HY generated total returns of +4.2%, followed by EA IG fin which made +3.0%.**
- **Growth prospects remain gloomy. Thus, we generally confirm our UW in cyclicals. Recession fears and further rate hikes keep weighing on equities. We recommend maintaining the UWs in Equities and peripheral debt. On the credit side we avoid HY while putting an OW in IG with a defensive bias. We keep our substantial OW in Cash and try to avoid duration risk by keeping the short position small.**

In July *(27.07.22)*, the relative performance of our model portfolio was -8.5 bps. Whereas the underweight position in Equities hurt as they were lifted by lower yields (-4.3 bps), the underweight in Peripherals paid off very well (+6.6 bps) as spreads suffered most recently from the political woes in Italy. Although underperforming EA Core Govies driven by worries about a faster withdrawal of monetary support and growth weakness, IG Credit's relative performance remained well in positive territory. Thus, the overweight position here contributed positively to the overall result (+1.2 bps). That said, lower yields hurt the underweight position in EA Core Govies that per-formed extremely well in the long-dated segment (-3.9 bps). Given this setup, being overweighted in Cash could not be rewarding (-4.9 bps).

Stay on hold over summer

Equities were the beneficiaries of the lower yields in recent weeks. Looking ahead, however, recession fears and further rate hikes keep weighing on them. We deem it too early to rebuild exposure and stay distinctively underweight. The same stance applies to Peripheral Bonds which will continue to be burdened by the scaling back of ECB support and weakening growth. All in all, we still see resilience in EA IG Credit and confirm our overweight here. Assuming slightly rising yield, Cash remains attractive. Thus, we maintain our substantial overweight.

FORECAST TABLES

Forecast tables

Growth[1]	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.7	1.7	-0.9	0.7	-1.1	1.5
Euro area	5.3	2.9	0.2	0.8	-1.2	1.8
Germany	2.9	1.1	-0.7	-0.1	-2.2	1.5
France	6.8	2.5	0.0	0.7	-0.9	1.5
Italy	6.6	3.4	0.8	0.6	-1.1	1.4
Non-EMU	6.4	3.2	0.0	0.7	-0.3	1.6
UK	7.4	3.5	0.0	0.3	-0.5	1.5
Switzerland	3.7	2.5	-0.0	1.5	-0.1	1.8
Japan	1.7	1.0	-0.7	1.4	-0.5	0.8
Asia ex Japan	7.8	4.2	-0.8	5.1	-0.0	5.1
China	8.1	3.2	-1.1	5.5	0.3	4.8
CEE	6.7	0.5	2.1	1.4	0.9	3.5
Latin America	6.6	2.2	0.0	1.6	0.0	2.4
World	**6.4**	**2.9**	**-0.3**	**2.7**	**-0.3**	**3.2**

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

Inflation[1]	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	4.7	7.5	-0.2	3.6	-0.0	2.3
Euro area	2.6	7.8	0.6	4.4	1.2	2.0
Germany	3.2	8.0	1.1	6.0	2.6	1.9
France	2.1	6.0	1.0	3.2	0.6	1.8
Italy	2.0	7.0	0.6	3.5	0.9	0.6
Non-EMU	2.3	7.3	0.2	4.8	0.6	1.6
UK	2.6	8.8	0.3	6.0	0.8	1.6
Switzerland	0.6	2.7	0.4	1.8	0.6	1.2
Japan	-0.3	2.5	0.6	1.5	0.3	0.9
Asia ex Japan	2.0	3.8	0.3	3.2	0.2	2.6
China	0.9	2.4	0.2	2.2	-0.1	2.0
CEE	9.3	29.8	-0.2	16.4	3.0	7.9
Latin America[2]	6.6	8.0	1.1	4.5	0.6	3.3
World	**3.5**	**7.7**	**0.2**	**4.6**	**0.6**	**2.8**

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

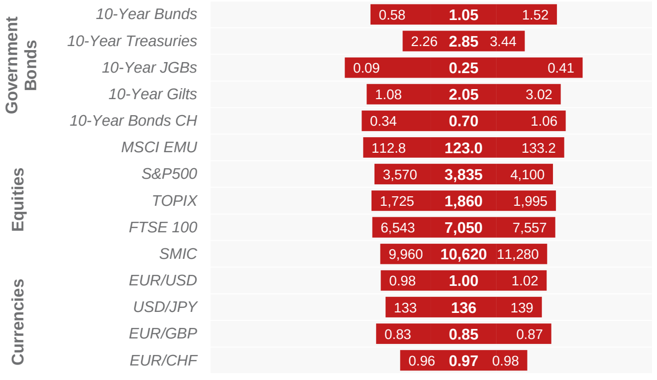
Financial Markets

Key Rates	27/07/22*	3M	6M	12M
US	2.50	2.88	3.13	3.38
Euro area	0.00	0.50	0.75	1.25
Japan	-0.10	-0.10	-0.10	0.00
UK	1.25	2.00	2.25	2.25
Switzerland	-0.25	0.25	0.50	0.75
10-Year Bonds	**27/07/22***	**3M**	**6M**	**12M**
Treasuries	2.78	2.85	3.10	3.05
Bunds	0.96	1.05	1.15	1.35
BTPs	3.29	3.45	3.65	3.90
OATs	1.56	1.65	1.75	1.95
JGBs	0.20	0.25	0.30	0.40
Gilts	1.94	2.05	2.10	2.10
SWI	0.59	0.70	0.80	1.00
Spreads	**27/07/22***	**3M**	**6M**	**12M**
GIIPS	172	180	185	190
BofAML Covered Bonds	92	90	90	90
BofAML EM Gvt. Bonds (in USD)	440	480	470	400

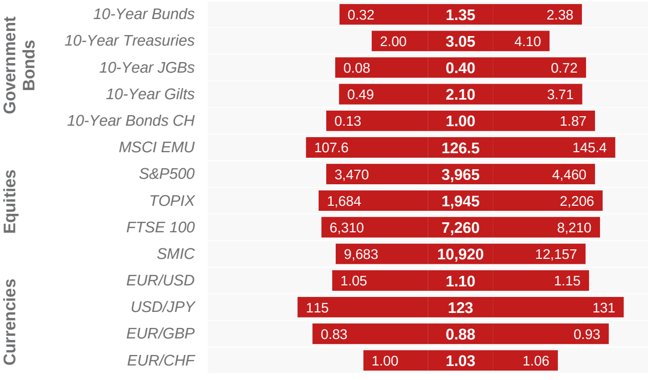
Corporate Bond Spreads	27/07/22*	3M	6M	12M
BofAML Non-Financial	180	185	180	175
BofAML Financial	195	205	200	190
Forex	**27/07/22***	**3M**	**6M**	**12M**
EUR/USD	1.02	1.00	1.06	1.10
USD/JPY	137	136	130	123
EUR/JPY	139	136	138	135
GBP/USD	1.20	1.18	1.22	1.25
EUR/GBP	0.84	0.85	0.87	0.88
EUR/CHF	0.98	0.97	1.00	1.03
Equities	**27/07/22***	**3M**	**6M**	**12M**
S&P500	3,971	3,835	3,875	3,965
MSCI EMU	127.9	123.0	125.0	126.5
TOPIX	1,944	1,860	1,895	1,945
FTSE	7,320	7,050	7,140	7,260
SMI	11,096	10,620	10,825	10,920

**average of last three trading days*

3-Months Horizon



12-Months Horizon



IMPRINT

Issued by: **Generali Insurance Asset Management S.p.A.**
Società di gestione del risparmio, Research Department

Head of Research: **Vincent Chaigneau**

Head of Macro & Market Research: **Dr. Thomas Hempell, CFA**

Team:

Elisabeth Assmuth | Research Operations

Elisa Belgacem | Senior Credit Strategist

Radomír Jáč | GI CEE Chief Economist

Jakub Krátký | GI CEE Financial Analyst

Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist

Vladimir Oleinikov, CFA | Senior Quantitative Analyst

Dr. Martin Pohl | GI CEE Economist

Dr. Thorsten Runde| Senior Quantitative Analyst

Dr. Christoph Siepmann | Senior Economist

Dr. Florian Späte, CIIA | Senior Bond Strategist

Guillaume Tresca | Senior Emerging Market Strategist

Dr. Martin Wolburg, CIIA | Senior Economist

Paolo Zanghieri, PhD | Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."