



GENERALI
INVESTMENTS

Market Perspectives

Economic Hardship vs. Policy Deluge

June 2020



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Global View – Economic Hardship vs. Policy Deluge

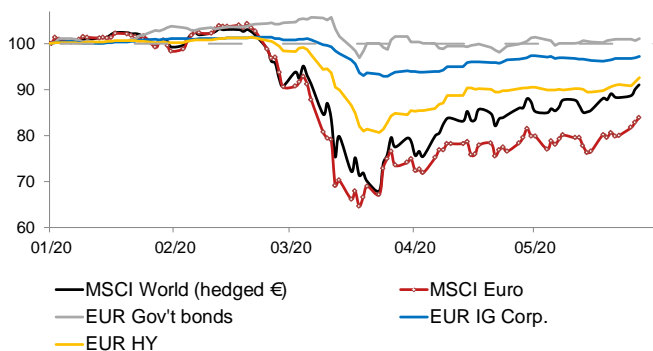
Thomas Hempell / Vincent Chaigneau

- Defying the deepest global post-war recession, risk assets have continued to climb the wall of worries.
- Flattening new cases in the advanced economies and the continued policy deluge will help to keep sentiment underpinned.
- The air is getting thin, though, with US equity markets back to autumn 2019 levels. Key risks are a second wave of infections and the fast deterioration in US/China relations.
- We stick to a pro-risk tilt concentrated in the higher quality buckets of risk assets, even as cyclical assets are showing signs of life. Keep a small long duration bias given the ‘swoosh’ recovery, disinflation and continued central bank activism.

Our pro-risk bias in the portfolios paid off in May, with the market recovery turning out even more pronounced than expected despite the deep global economic slump. The MSCI World has recouped roughly two thirds of its Feb/March drawdown. Even cyclical assets took off in late May, underpinned by strong policy action and the gradual re-opening of key economies.

Total returns by asset classes

rebased to 31/12/2019 = 100



European leaders are (finally) addressing the huge reconstruction challenge. After dragging their fiscal feet and leaving risk sharing hidden within the ECB's balance sheet (via QE and €750 bn PEPP program), France and Germany have agreed on a big step forward to fiscal transfers. Ironically, a controversial ruling by the German Constitutional Court on the ECB's PSPP may have helped realizing that a clear signal of fiscal solidarity is needed to contain the pandemic's centrifugal forces in the EU.

Intra-EU arm-twisting will be required. An agreement to an enriched multiannual financial framework (incl. large-scale bond issuance) will take time (beyond the June 19 European Council). But the depth of the recession will help find a compromise with the 'frugal four' and CEE countries to support regions and sectors most hit by the pandemic.

Investors are also getting comfort from the re-opening of

advanced economies, with worries about second waves of infections diminishing for now (more risk in the autumn). The economic fallout from the virus will still be huge – and we have just further downgraded our 2020 global growth forecast to -4.8%, with Euro area growth cut to -10%. Yet the exit from the lockdown alongside bold and expanding policy action (with the ECB and Fed set to respectively expand PEPP and strengthen the forward guidance) will help data to bottom in June. We will not get carried away by resurgent news on vaccines, though: it will take at least till early next year (but probably longer) until an effective substance is robustly tested and rolled out widely.

Watch the US and Chinese squabble

So while the recovery in risk assets may still have legs, the air is getting thinner. The S&P500, above 3000, is back to Oct '19 levels, when mounting green shoots pointed to global growth of almost 3% in 2020. Apart from the risks of a second wave of infections, we are most concerned about the deterioration in US/China relations amid a blame game on the Corona pandemic. Markets have largely shrugged off punitive US measures against Huawei and China's tight grip on Hong Kong. But a renewed escalation of the frozen trade war may break this resilience as it would hit the world economy in a most delicate moment.

Bonds	27/05/20*	3M	6M	12M
10-Year Treasuries	0.68	0.65	0.80	1.00
10-Year Bunds	-0.45	-0.50	-0.35	-0.25
Corporate Bonds				
BofaML Non-Financial	176	150	140	130
BofaML Financial	179	160	150	130
Forex				
EUR/USD	1.10	1.10	1.12	1.14
USD/JPY	108	107	106	105
Equities				
S&P500	2994	2995	3005	3035
MSCI EMU	107.8	107.5	108.6	108.5

* avg. of last three trading days

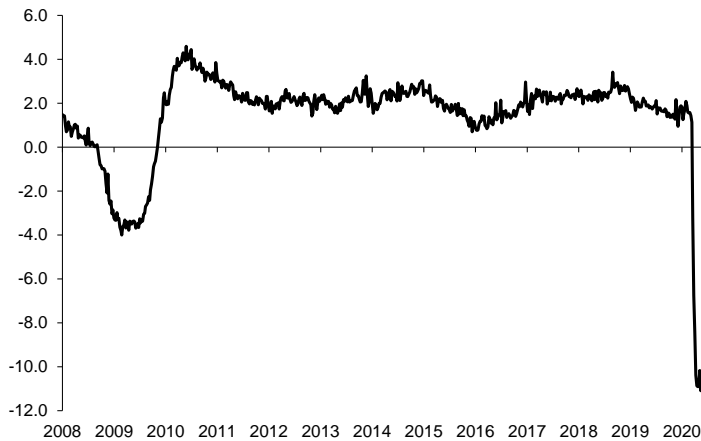
We thus stay only mildly overexposed to the most risky buckets in our portfolio (notably equities, HY). By contrast, high quality Credit remains supported as a focal point of central bank support. Subdued inflation and massive bond purchases by central banks will keep a lid on core yields, keeping us at the longer side of duration. The stronger signals of pan-European solidarity will support peripheral debt – and also keep the EUR underpinned. Yet it may take clearer and more reassuring signs both on the pandemic and US/China for denting the USD more sustainably and for pushing EUR/USD on an upward trend in H2.

USA

Paolo Zanghieri

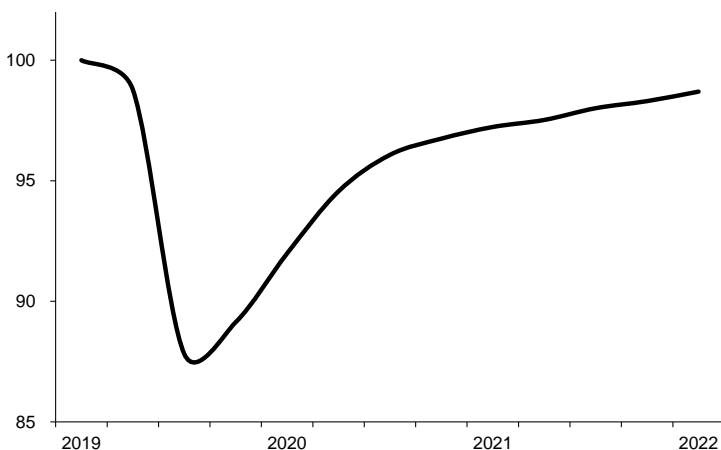
Weekly Economic activity

Scaled to yoy GDP growth. Source NY Fed



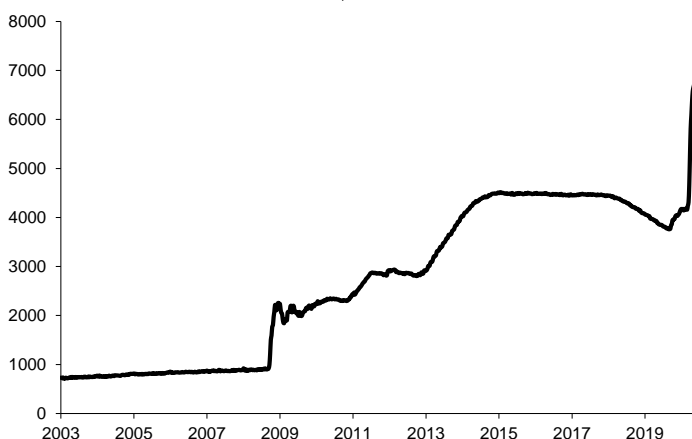
GDP: projected level

Q4 2019 = 100



Fed balance sheet

US\$ billion



- We expect GDP to plunge by around 40% (qoq annualized) in Q2. A relatively muted recovery will lead to a 7.5% contraction for the year as a whole. Risks are heavily tilted to the downside.
- The unemployment rate rose to 14.7% in April. It is likely to peak at above 20%. Persistently high unemployment and uncertainty will drag on the recovery in consumption.
- After the unprecedented measures taken, the Fed is pausing to assess their effect. Additional tools like negative rates have been discussed, but are unlikely to be implemented soon.

After a near 5% annualized contraction in Q1, GDP will feel the full impact of the lockdown in Q2. Weekly indicators point to a 12% yoy GDP (40% qoq annualized) fall, but also provide tentative indications that activity has bottomed out at the end of April. Despite the unprecedented policy stimulus, high unemployment and uncertainty will prevent a quick recovery: we see GDP down by at least 7.5% for the year as a whole. We project a 4.5% recovery for 2021. Still, economic activity will not be back to the pre-crisis level before the end of 2022. Risks are tilted to the downside: reopening the economy when contagion is not fully under control in several states may trigger a second wave leading to another lockdown in the second half of the year.

Unemployment rate to reach 20%

In April, the unemployment rate rose to 14.7%. However, this may underestimate the damage. Labor market participation is falling as laid off workers stop looking for employment. The large measures taken by the Congress (increase of unemployment benefits and direct transfers to households) are supporting income, but will stop at the end of July. Discussion in Congress about an extension is stuck as Republicans push for a quicker reopening of the economy while Democrats prioritize transfers to households. If a compromise is not reached by the end of June, the ensuing uncertainty will be a further drag on consumption on top of that created by the need to relocate a large amount of workers away from sectors structurally weakened by the crisis, which will create persistently high unemployment. This will limit the impact of the stimulus on growth in H2.

The Fed takes stock of its measures

The minutes of the April meeting and the speeches by Chair Powell other FOMC members show that the Fed has planned a pause to assess the impact of the vast measures taken to support the economy and to secure they are implemented smoothly. The Committee remains strongly against pushing the Fed funds rate to below zero as the benefits are estimated to be much lower than the potential damages to the banking and money market funds sectors. The tailoring of some measures, like forward guidance on rates and asset purchases is more likely to be announced once the worst of the crisis is over.

Euro Area

Martin Wolburg

- In May, key sentiment indicators left their ultra-low levels while remaining in strongly contractionary territory.
- The news flow is consistent with our view that activity bottoms in Q2 but we lowered our 2020 growth forecast to -10.0%.
- We expect the ECB to extend its emergency QE (PEPP) well into 2021 at the June policy meeting.

The Covid-19 induced temporary knock out of the euro area economy has been increasingly showing up in the data. In Q1 activity receded by 3.8% qoq with all economies reporting contracting output. Sharply falling industry orders (-13.2% mom) amid a turnaround of the unemployment rate (7.4%, from 7.3% before) in March imply that Q2 will be much worse. In April, the economy was in full lockdown and key sentiment indicators plummeted to unprecedented low levels. In May, sentiment advanced while remaining in territory clearly consistent with a very sharp recession.

Recession worse than previously thought

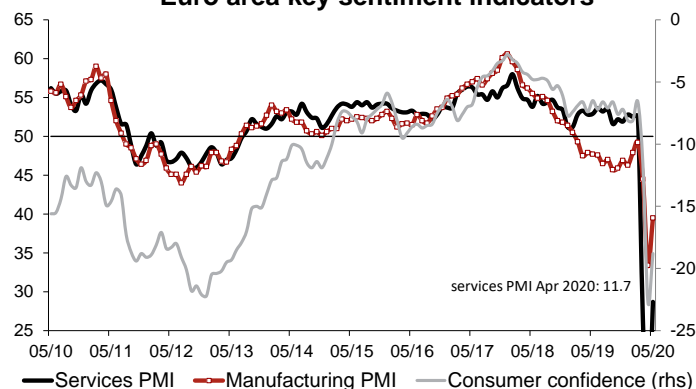
Over the past weeks the growth outlook for 2020 deteriorated. First, the Q1 contraction was worse than expected. Second, in spite of policy measures to secure employment, there is indication for massively increasing unemployment. Third, in May the lockdown started to be cautiously reduced only. It stayed at a high level suggesting ongoing strong headwinds to activity. Fourth, the global environment deteriorated strongly (global comp. PMI ex euro area at 29.1 in April) and we expect it to recover only sluggishly given insufficient Covid-19 responses in key economies. In 2021, some fiscal tightening is on the cards, even if the recent [Recovery Fund proposal](#) of the European Commission would be adopted.

As a result, we expect Q2 GDP to fall by more than -10% qoq envisaged before and let us deem a reading of -15% qoq most likely. The only gradual lifting of the lockdown given the risk of second Covid-19 wave lets us looking for an annual output contraction by -10.0% (from -8.0%) in 2020, followed by a rebound of 5.0% (from 4.5%) in 2021.

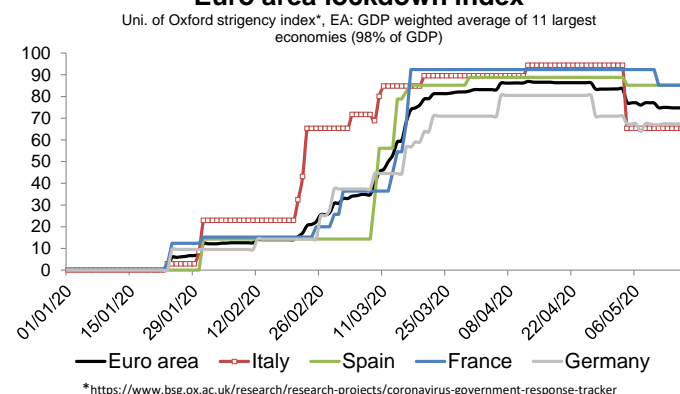
ECB to extend PEPP well into 2021

The ECB will take the further deteriorated outlook at its June 4th meeting into account and likely extend the [PEPP](#) well into 2021 while increasing its size (by at least € 500 bn). Unlike to fiscal policy the ECB will try to broadly maintain its current stance in 2021. Given the latest ruling of the [German Constitutional Court](#) (GCC) we expect President Lagarde to give a strong message of ECB independence. Comments on the GCC's criteria of monetary financing, especially capital keys, are especially interesting for assessing future policy leeway.

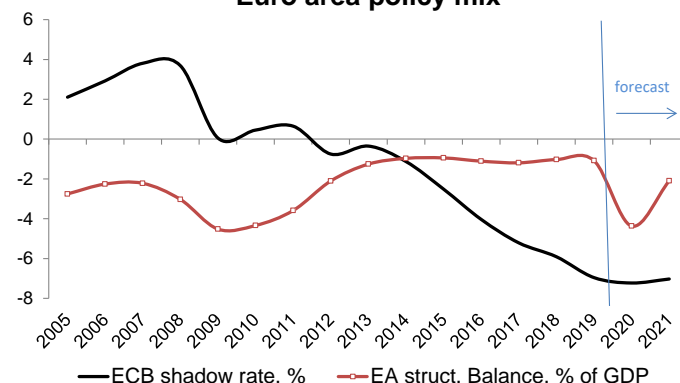
Euro area key sentiment indicators



Euro area lockdown index

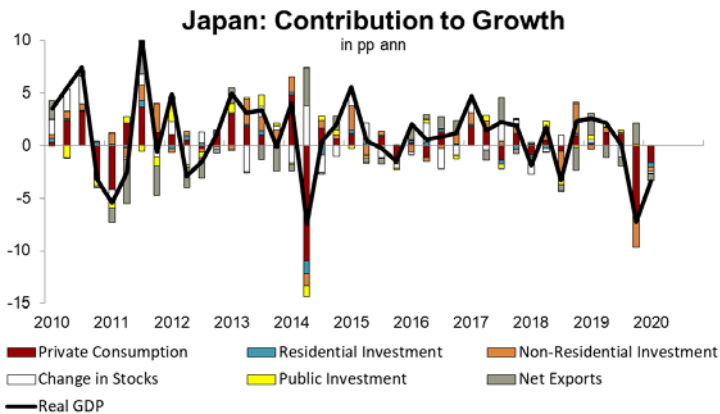


Euro area policy mix



Japan

Christoph Siepmann

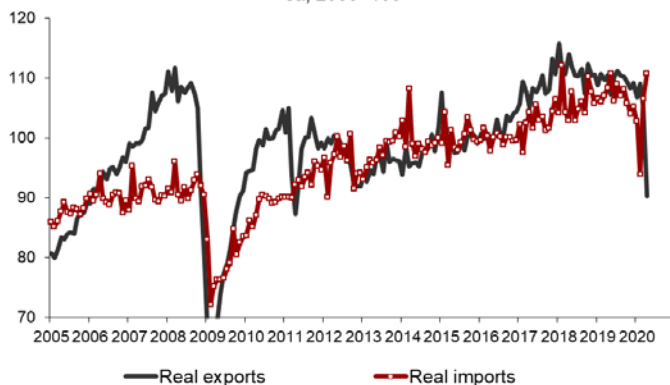


Japan's Second Fiscal Package (¥ tr)

	Total size
Total	31.8
1. Measures to strengthen corporate cash flows	11.6
2. Rent support schemes	2.0
3. Medical provisions	3.0
4. Expansion of employment subsidies	0.5
5. Other measures	4.7
Local government grants	2.0
Sustainability benefit enhancement	1.9
6. Increase in reserve for COVID-19	10.0

Real Exports & Imports

sa, 2000=100



- Japan is already in recession and Q2 GDP is likely to plunge by almost 40% qoq ann. We expect 2020 GDP to drop by around 7%.
- The government announced a second, sizable fiscal package. We expect the BoJ to absorb the necessary JGB issuance while keeping its yield curve control unchanged.

Japan's economy is in recession. After Q4 2019 was hit by the sales tax hike, recently published Q1 GDP growth figures showed another decline by 3.4% qoq ann. While private consumption and investments receded only slightly, construction and export were hit hard by the cancelling of the Olympics and the international loss in demand due to the COVID-19 crisis. Japan's government declared the state of emergency early April and ended it (ahead of time) in late May. Accordingly, Q2 will see the major hit from the shutdown. As Q2 indicators are still rare, GDP growth estimates differ significantly between -20% to -40% qoq ann. We tend to lean to the lower bound for the following reasons: Japan's leading indicator dropped much more severely than during the GFC. The Economy Watchers Survey extended its GFC-level for the second months in a row. Real exports slumped already in April by 14.2% qoq. Industrial production receded by 9.1% in April. However, a steeper drop in Q2 will also likely lead to a somewhat higher initial recovery in June and in Q3. Similar to other countries, we expect aggregate demand to respond with a lag to the supply side, mainly due to measures to prevent a second outbreak. Overall, we stick to our 2020 forecast of about -7%. CPI inflation has already responded to the crisis. The nationwide core CPI dropped by 0.2% yoy in April, a significant downward move +0.4% yoy in March. Overall, we see Japan's consumer prices in a mild deflation of -0.2% this year.

Abe announced a second fiscal package

Against this backdrop, fiscal and monetary policy responded repeatedly. In April, the Abe administration already revealed a package with a headline figure of ¥117 tr (see last month's Market Perspectives). End of May, a second policy package with an identical headline figure was announced. In sum, both packages amount to almost half of Japan's GDP. However, as usual de-facto fiscal spending is much lower. A second supplementary budget is planned to amount to ¥31.9trn (5.9% of GDP). The package will be funded by additional JGB issuance. The two supplementary budgets add up to a ¥57.6 tr (10% of GDP) rise in primary expenditures. This implies that the BoJ will increase its purchases significantly. It is well prepared as it already dropped its limit of ¥80 tr per year. The bank also repeatedly supported corporate finance by various measures, of late with special focus on SMEs (for details see [here](#) and [here](#)). We do not expect the BoJ to change rates in its yield curve control policy.

China

Christoph Siepmann

- **China's recovery will continued to be restrained from the demand side. Fresh US-China conflicts will additionally deter investments while inflation is set to slow.**
- **Against this background, the National People's Congress (NPC) revealed a measured approach to support the economy. It also refrained from announcing a growth target.**

In China, the COVID-19 outbreak is to a large extent contained, but clusters of new cases were reported in Wuhan and also in the Jilin Province. Social distancing measures continue to be in place. Accordingly, China's economic performance was predominantly restrained from the demand side, while industrial production almost reached the end of 2019 level. International demand surprised on the upside, but PMI new export orders slumped. Moreover, Korean exports, a bellwether for the region, dropped by more than 25% yoy in April. Domestically, retail sales were still 7.5% lower than compared to April 2019. Given the social distancing measures, we expect that private consumption will not fully recover soon. Especially the leisure and travel sectors will continue to suffer from hygiene measures. On top, fixed investment also did not fair well so far with a cumulative yoy loss of 10.3% yoy ytd. Here, we expect the uncertainty regarding the domestic as well as the international developments to frustrate a quick uptrend. Rising US-China conflicts regarding Huawei and listings of Chinese companies on US exchanges will additionally deteriorate the mood. The lack of demand is also strongly visible in inflation numbers. Here, CPI inflation dropped by more than 2 pp since the beginning of the year to 3.3% yoy of late. The main effect came from food and oil prices, but also core inflation is on a downtrend. Producer prices are clearly in deflation. We expect CPI inflation to continue receding and average 2.5% this year, after 2.9% in 2019.

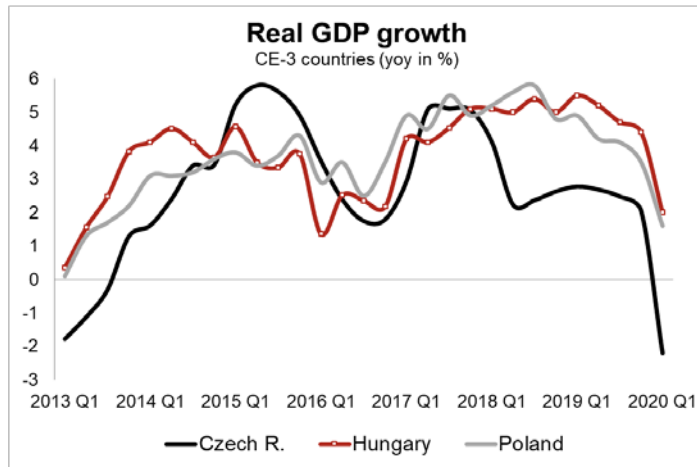
Economic support at a measured pace

Against this background, this year's postponed National People's Congress was eagerly awaited for policy guidance. China's leadership sensibly refrained from announcing a GDP growth target. However, economic support will be stepped up, but at a measured pace. While not all numbers are fully clear yet (due to widely used shadow budgets), the augmented fiscal deficit will likely amount to around 8% of GDP. This would be an increase by around 3 pp. Thus, the fiscal impulse will probably be limited. Support measures will focus on enterprises, esp. SMEs via tax and fee cuts and infrastructure investment. SMEs provide the bulk of employment. An explicit target for the surveyed urban unemployment rate (6%) reveals that the government aims at stabilizing the current situation. Monetary policy will further loosen compared to last year. We expect cuts of the Loan Prime Rate by 30 bps via MLF cuts and RRR cuts by 100 bps in 2020.



Central and Eastern Europe

Radomír Jáč



- GDP fell in quarter-to-quarter terms in CE-3 in Q1. The drop was moderate in Hungary and Poland. However, the sharpest contractions are yet to be seen in Q2, followed by a gradual recovery in H2.
- Increase in the unemployment was moderate so far but the impact of economic contraction is yet to be fully reflected by the labor market with disinflationary consequences.
- Central banks try to ease monetary conditions but with interest rates already too low, non-conventional tools are being deployed.

Economic activity in the CE-3 region fell in Q1 due to the negative impact of restrictions related to the coronavirus. However, GDP data were actually better than expected in case of Hungary (-0.4% qoq / +2.0% yoy) and Poland (-0.5% qoq / +1.6% yoy), while the Czech GDP delivered result close to expectation (-3.6% qoq / -2.2% yoy). The activity fall should deepen in Q2 across the region but a recovery is expected in quarter-to-quarter terms in H2. Still: data for Q2 will be crucial for estimates of the full-year 2020 GDP performance and on top of that there will remain uncertainty regarding the speed of recovery in H2.

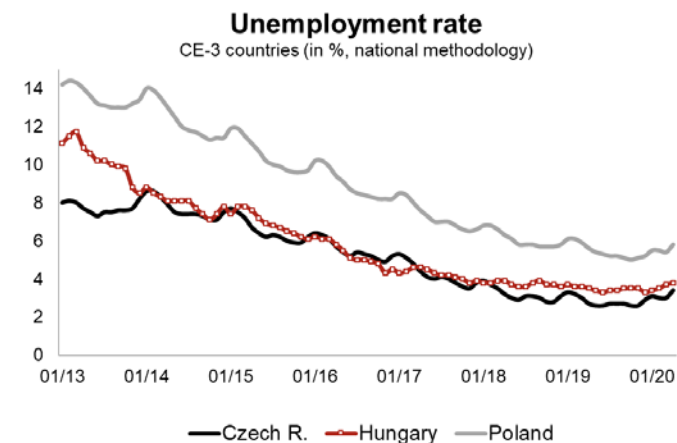
The decline in economic activity is expected to lead to weaker price pressures and to worsening labor market conditions in the region. Data for April showed only a moderate increase in the unemployment rate but they indicate that the favorable trends were broken and the number of job seekers is expected to grow in the rest of 2020 and very likely also in 2021. All these effects lead regional central banks to ease monetary conditions further – via interest rate cuts (the Czech Rep., Poland) or / and via non-conventional measures (Hungary, Poland).

Monetary policy: non-conventional tools at frontstage

The Czech CNB cut its key interest rate in May, by 75 bps to 0.25%. The new forecast actually recommended to cut rates only to 0.50% and to keep them stable until end-2021 but policy makers opted for a bolder step due to risks related to the pandemic. The CNB also said that non-conventional tools could be deployed if interest rate falls to zero. It seems that negative interest rates or FX rate cap would not be the favored options in such case.

The Hungarian central bank kept its policy unchanged in May and declared its satisfaction with the new framework, which is based on tighter monetary conditions at the short end of the yield curve and on liquidity supply via longer tenors. The QE program had a slow start in terms of debt purchases, as strong demand in government bonds auctions showed no need for a bolder action via QE.

The Polish CB cut its key rate by 40 bps to 0.10% in late May. With interest rates close to zero, QE should be the key tool for easing of financial conditions in Poland with hefty purchases of state bonds and state-guaranteed debt already made since the introduction of QE in March.



Main Forecasts	2018	2019	2020f	2021f
Czech Republic				
GDP	2.8	2.4	-7.3	5.0
Consumer prices	2.1	2.8	2.8	2.0
Central bank's key rate	1.75	2.00	0.25	0.25
Hungary				
GDP	5.1	4.9	-6.0	4.5
Consumer prices	2.8	3.4	3.2	3.0
Central bank's key rate	0.90	0.90	0.90	0.90
Poland				
GDP	5.2	4.1	-4.2	4.6
Consumer prices	1.6	2.3	3.0	2.5
Central bank's key rate	1.50	1.50	0.10	0.10

GDP and consumer prices: annual % change; CB interest rate: in %, year-end

Bonds/Fixed Income Strategy

Florian Späte

- Driven by hopes for lockdown easing measures and an overall upbeat risk sentiment particularly euro area sovereign yields climbed over the course of May.
- Looking further down the road, the leeway for a continuation of this trend appears limited. As the inflation outlook remains grim in the short term and central banks are likely to even step up their accommodative policy measures the path of least resistance is a decrease in core government bond yields.
- Speculations about and eventually the presentation of a bold proposal for a European Recovery Fund by the European Commission (EC) supported euro area non-core bonds in the second half of May. However, the devil is in the details and we see only limited scope for a further spread tightening.

While US yields remained range-bound in May, an upward trend in core yields was established in the euro area. Financial markets focused on the widespread easing measures in developed countries and the corresponding expectation of an improving economic situation in H2. In the wake of an improving risk sentiment euro area core yields rose as well. Particularly, long-dated euro area yields increased triggering a steepening of the yield curve. The transatlantic yield spread tightened across the curve.

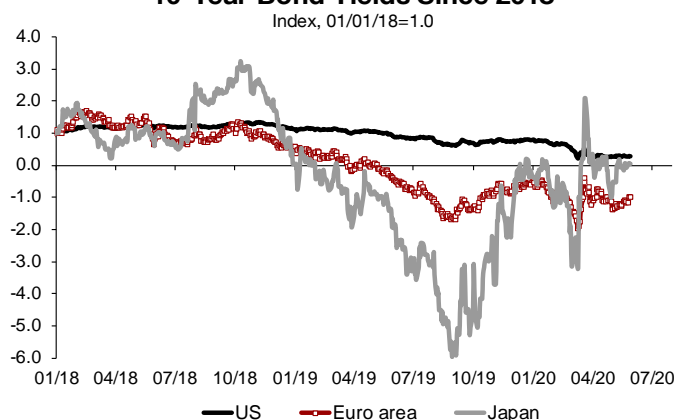
It is noteworthy that euro area inflation swaps hardly moved on balance. Initial decreases were only balanced over the course of May. Accordingly, the improving economic outlook is reflected in higher real yields.

Yield increase on shaky feet

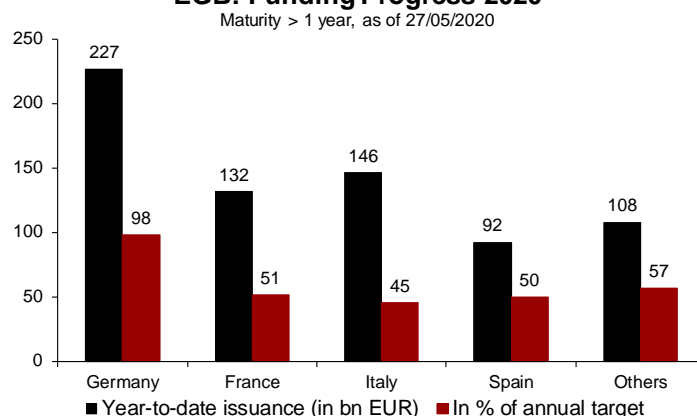
Despite the strong fiscal response by governments worldwide we doubt that the trend towards higher yields will continue going forward. On the one hand, estimates of upcoming government bond supply have been revised upwards in recent weeks. The gross issuance will set a new record in 2020 requiring strong demand by financial markets. On the other hand, euro area treasuries have already issued more than 50% of the (upwardly revised) annual target. Especially smaller countries are even ahead of this. Quite noteworthy, Germany's issuance activity looks overstated due to €100 bn tap of already issued securities which serve as a liquidity reserve and are currently still in the government's own holding (see chart).

What is more, global central banks signaled that they will make every effort to ensure that financial markets will be able to take down the supply burden. In addition to liquidity measures, they stand ready to extend existing QE programs. Although this will lift the share of government bonds held by central banks to new highs over the course of the year this is currently no matter of concern.

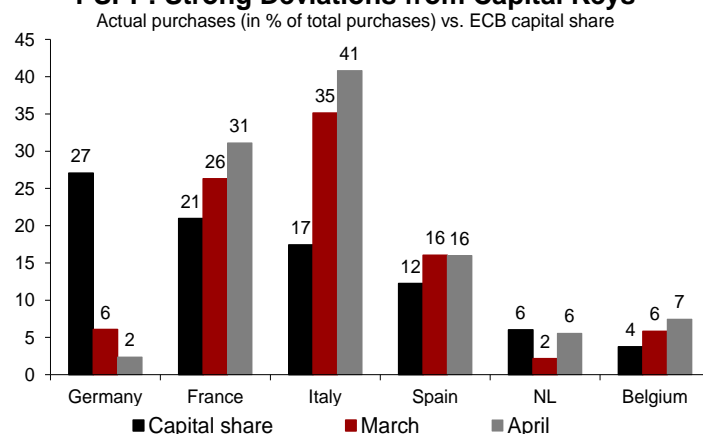
10-Year Bond Yields Since 2018



EGB: Funding Progress 2020

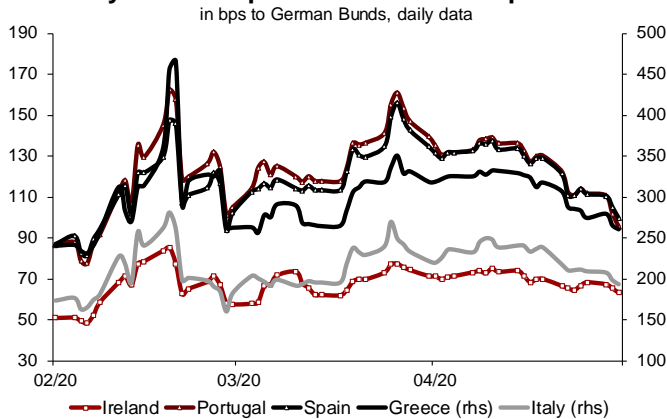


PSPP: Strong Deviations from Capital Keys

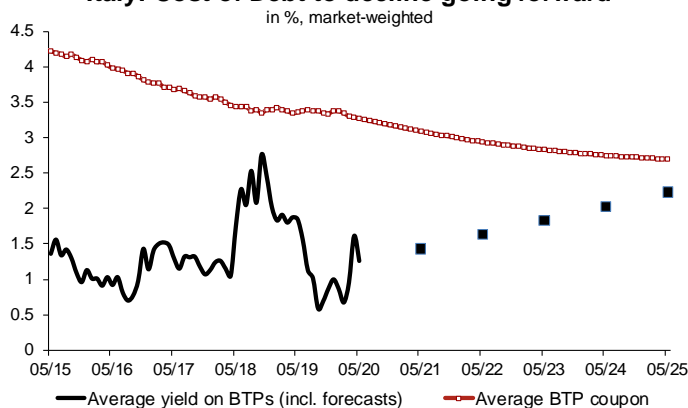


Bonds/Fixed Income Strategy

10-year Sov. Spread Euro Area Peripherals

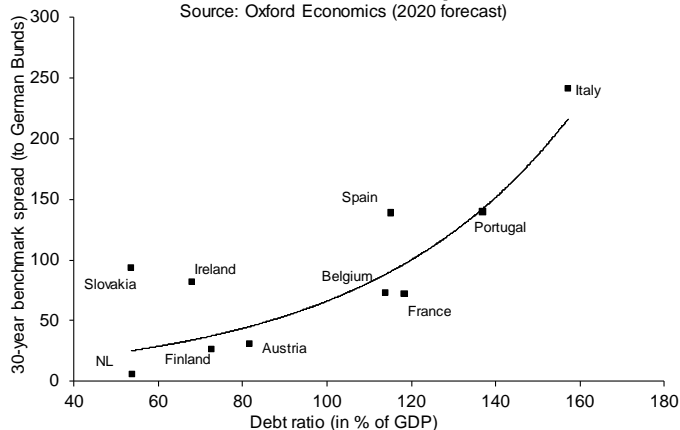


Italy: Cost of Debt to decline going forward



EGB: Debt Ratio and Spreads

Source: Oxford Economics (2020 forecast)



Additionally, the economic recovery is unlikely to be a strong and fast one. Hence, the inflation pressure is likely to remain low and inflation will only start to inch up from low levels over the course of H2. Therefore, we forecast US and euro area yields to remain on a low level in the months to come. If anything, there is even scope for yields to crumble.

Looking further down the road, we continue to see some upside potential. Most notably, long-dated inflation expectations have some scope to inch higher amid new health standards and lower productivity growth given the de-globalization tendencies. However, the expected yield increase remains modest with 10-year US and euro area yields forecast to reach 1.0% and -0.25% on a 12-month horizon, respectively.

Limited potential for euro area non-core bonds

Despite the ruling of the German Constitutional Court (GCC) at the beginning of May that the ECB sovereign bond purchases exceed partly EU competences non-core euro area sovereign bonds performed very well. The spread tightening by far more than compensated for the core yield increase. The spread tightening was particularly pronounced at the long end of the curve. The narrowing was mainly driven by expectations about the forthcoming Recovery Fund. Eventually, the EC presented a program which went even beyond a Franco-German plan submitted in the middle of the month.

We regard the EC proposal as an important step given the size of the Recovery Fund and the significant share of grants. It is a strong signal of risk sharing and – once passed – will alleviate the situation for countries plagued by a high debt ratio. But, the difficult part is still to come. All EU members have to agree to the plan and some countries have already raised objections regarding the high share of non-repayable grants. In any case this will take some time and a final (probably watered down) agreement is unlikely to be reached before autumn.

In the meantime, the load remains with the ECB. Although there are rumors about scrapping the capital key constraint for PEPP purchases we doubt that this will happen anytime soon. This applies even more as the GCC emphasized the need to stand to the capital keys. Hence, the deviations in March and April are unlikely to be sustainable. Accordingly, we regard the ECB purchases not as triggering a further spread compression but rather a spread control.

The reduced ECB flexibility amid the GCC ruling and the possibilities of further downgrades in the months to come in combination with the worsened fundamental situation of non-core countries will stand in the way of a further significant tightening. This applies even more as adverse political events cannot be excluded (the situation appears particularly unsettled in Italy).

Corporate Bonds

Elisa Belgacem

- Credit markets have continued their recovery in May with a significant spread tightening.
- Both IG and HY have benefitted from unprecedented purchases of corporate papers by the ECB and – since May – also by the Fed. Direct government support via guarantees further buffeted the market.
- Issuance volumes are set for a record year. Yet we continue to recommend an OW in IG as we expect near zero defaults and positive total returns.
- By contrast, we are neutral on HY as defaults will continue to rise (though moderately as counterbalanced by the strong policy support).

The public support to the global economy continues to reach unprecedented levels. On the monetary front, the ECB has temporarily allowed for fallen angels as collateral. An expansion of the PEPP program may also include those fallen angels (potentially to be announced as soon as at the June meeting). This would further support the Xover space.

IG corporate bond spreads (OAS) have already tightened by 16 bps while HY spreads contracted by more than 74 bps in May. Both financials and non-financials have performed in synchrony. Subordinated bonds have also massively performed, led by AT1 (-55 bps), which are benefitting from the temporary suspension of the Bank Recovery and Resolution Directive (BRRD), while corporate hybrids tightened by 33 bps.

Strong tightening despite heavy issuance

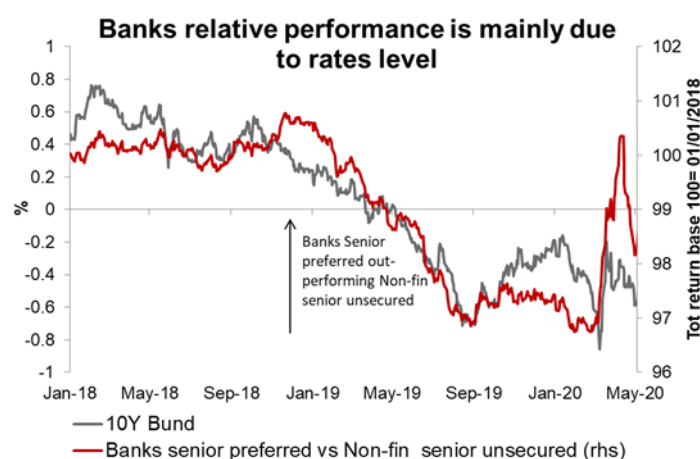
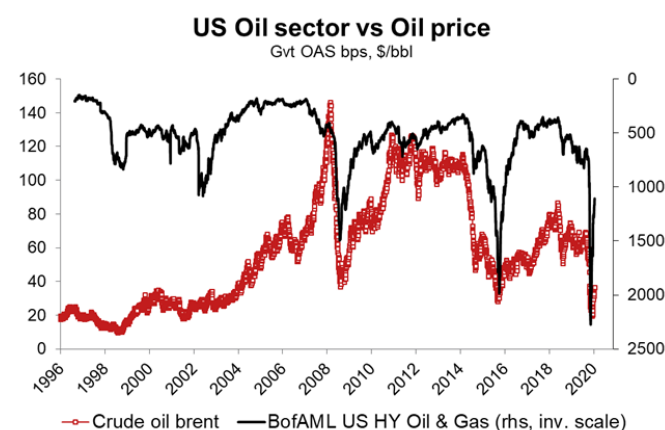
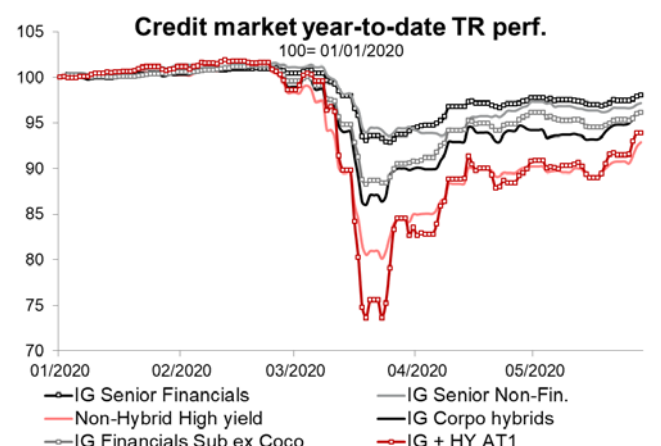
Recovering oil prices are alleviating pressures on US credit markets (where oil producers account for more than 10% of the HY market), helping to stop global outflows from credit funds.

With the reporting season drawing to an end, the primary market has restarted at a very fast pace, with 2020 possibly headed for a record year of issuances.

Prefer the higher quality buckets

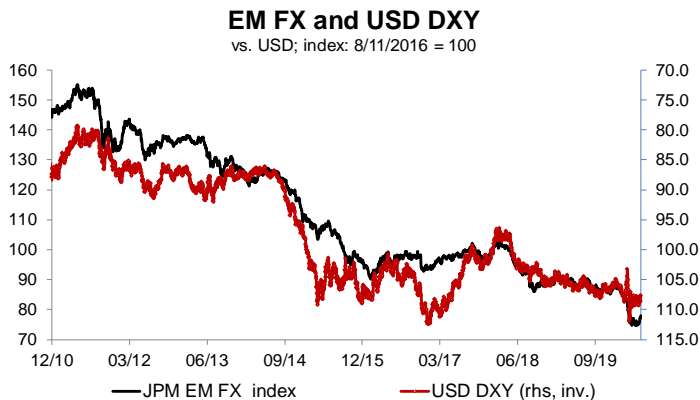
Going forward, we still prefer the higher quality buckets in Credit markets. There is still room for further valuation divergence between IG and HY, with the latter burdened by rising default rates into 2021 despite record public support.

By contrast, we expect near zero default rates in the IG space, while the pick-up versus govies continues to attract investors' interest. We acknowledge that here will be migration risks. But these seem well reflected in the price already while the heavy purchases by the ECB will help to sustain in particular the IG non-financial market segment. Hence we recommend an OW on IG skewed toward EUR non-financials. Among high beta we continue to favour corporate hybrids.



Currencies

Thomas Hempell



- Steps towards bolder fiscal transfer in Europe are underpinning the outlook for the EUR.
- Yet it may require a more reassuring global recovery and effective containment of the pandemic for a sustained USD descent in H2 and for the EUR/USD to rise.
- Hard Brexit concerns and a likely missed end-June deadline in the EU/UK negotiations will burden GBP over the next weeks.

Following its spike into mid-March, the US dollar continued to retreat amid recovering global risk sentiment, flattening new Covid-19 infections in the advanced world and a rebound in oil prices. Even EM FX could benefit, despite the fast spreading of Covid-19 in several larger EM economies (LatAm, India). This shows how much of bad news had been priced before. Even after a recent rebound, BRL and ZAR are still down 20-25% against the USD year-to-date.

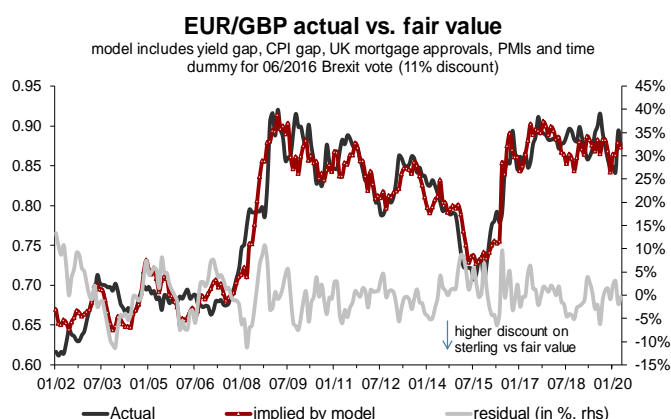
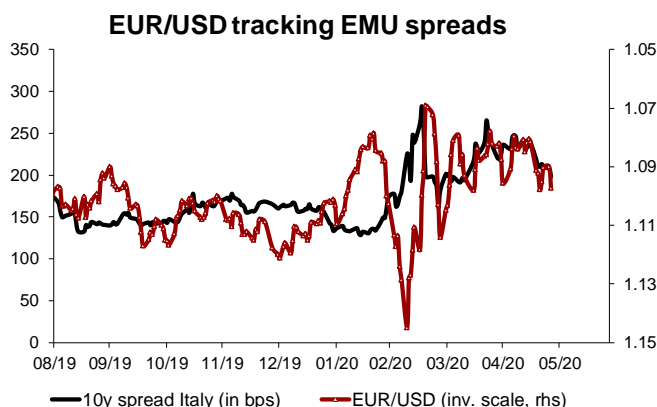
We expect the USD to descend further from dear levels – even though at a gradual and back-loaded pace. Short term, EM FX are still vulnerable to sharply deteriorating US/China relations (risk of a escalating trade war) and an eroded carry. Most EM central banks have drastically eased monetary policy, accepting weaker exchange rates as a necessary cost amid the fight against the Covid-19 slump. The recent bounce may embolden further monetary easing, capping the EM FX recovery.

Shift towards fiscal transfers support EUR

EUR/USD has kept tracking EMU concerns. Higher Covid-19 optimism and the bold French/German proposal of a €500 bn EU Reconstruction Fund have tightened Southern European spreads and boosted the EUR/USD alike (see mid chart). Many other metrics keep pointing to further upside over H2: valuation gaps (USD dear, EUR cheap), an eroded US yield gap after Fed rate cuts and opposed external balances (US C/A deficit, surplus in the EA).

The constructive outlook for a joint EU response to the crisis brightens the EUR/USD outlook, helping to offset earlier concerns from a controversial ruling by the German Constitutional Court on QE. Yet it will require more reassuring signals on the pandemic, recovering economies and an outright agreement to the new EU Recovery Fund for a sustained pick up in EUR/USD, which will more likely happen in H2.

Hard Brexit concerns will keep weighing on GBP. The June 30 deadline line for extending the transition period beyond YE 2020 will likely be missed amid stuck negotiations and stringent positions. Current EUR/GBP levels are largely in line with fundamentals, leaving scope for a rising political GBP discount short term. That said, we still see scope for an (last minute) agreement in autumn, so we caution against writing off GBP too easily.



Equities

Michele Morganti / Vladimir Oleinikov

- The massive policy response, both fiscal and monetary, is supporting a rather spectacular expansion of equity multiples.
- Macro surprises have started to stabilize, while major economies are turning around. Financial conditions are easing off quickly.
- Positioning remains low and tactical indicators we follow are still in buy territory. Still slightly OW.
- We give up our preference for safer countries and recommend a more balanced portfolio.
- We reshuffle our sector allocation as some of the previous bets have become stretched. This involves pharma, utilities, IT. Insurance, media and energy are now on OW (just like staples and telecoms). UW: auto, transportation, real estate and commercial & professional services.

Markets	Price / Earnings *		Price / Book *		Price / Cash Flow *		Dividend Yield *		Avg. Discount, %	PEG adj. *
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.		
WORLD	19.9	16.0	2.2	2.0	12.1	8.9	2.4	2.7	21.6	
USA	21.7	15.4	3.2	2.4	14.5	10.1	2.0	2.2	31.7	2.1
JAPAN	14.9	15.3	1.1	1.2	7.9	7.1	2.6	2.0	-9.2	3.2
UK	15.4	13.8	1.4	1.8	8.4	7.9	4.4	4.1	-2.8	4.2
SWITZERLAND	17.4	15.4	2.6	2.3	11.8	11.2	3.4	3.3	7.6	3.0
EMU	16.5	14.1	1.3	1.5	8.0	6.6	3.4	3.8	10.0	2.8
FRANCE	16.7	14.3	1.3	1.5	8.7	7.0	3.4	3.7	9.4	3.3
GERMANY	16.1	14.9	1.3	1.5	8.1	6.8	3.1	3.4	5.8	2.6
GREECE	14.1	12.8	2.4	1.6	6.8	6.1	5.7	4.1	8.2	1.0
ITALY	13.8	15.0	1.0	1.2	5.2	4.7	5.1	4.7	-5.5	3.2
PORTUGAL	19.2	12.9	2.0	1.7	5.9	5.9	4.9	4.5	14.6	4.2
SPAIN	14.0	12.8	0.9	1.6	4.3	5.1	4.4	5.1	-8.5	2.2
EURO STOXX 50	15.6	13.2	1.4	1.5	7.8	6.3	3.6	4.2	12.0	2.7
STOXX SMALL	20.3	14.6	1.6	1.7	9.5	8.4	2.8	3.2	15.2	3.5
EM, \$	12.9	14.4	1.4	1.6	7.5	7.5	3.0	3.1	-5.4	1.9
BRAZIL	14.7	9.2	1.6	1.7	7.0	13.2	3.8	4.3	3.7	2.4
RUSSIA	7.4	6.9	0.7	0.9	5.3	4.4	8.0	4.2	-22.6	3.6
INDIA	18.0	14.7	2.2	2.6	10.8	11.5	2.0	1.6	-5.3	1.8
CHINA	12.3	12.9	1.5	1.7	8.4	7.5	2.2	3.0	4.3	1.4

Note: The first four markets are based on the main local indices, the rest on the corresponding MSCI indices.

* Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003. PEG is PE divided by expected EPS long-term growth.
 PEG adj. (higher = expensive): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it.
 COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs).
 Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
 Source: Thomson Reuters Datastream, IBES estimates.

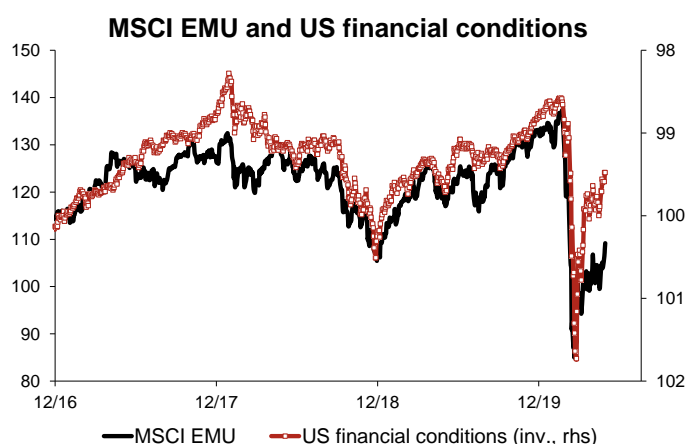
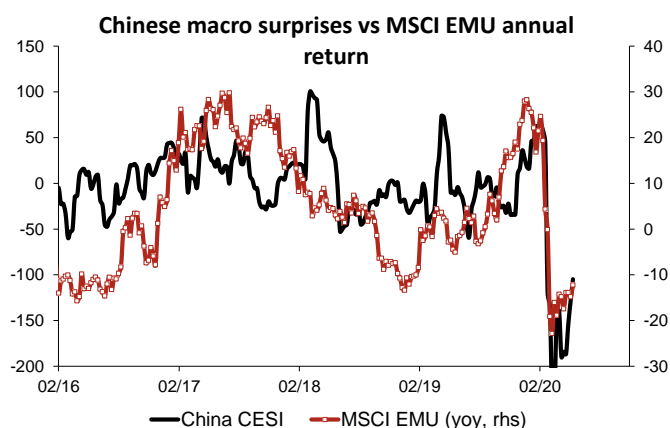
Policy interventions and long lasting equity appeal

In May, equities continued to be supported by policy initiatives, fiscal and monetary ones. Furthermore, in different speeches, the Fed and the ECB made clear they remain highly flexible and recognize the need of further fiscal stimulus. Their message will soon be reinforced by additional measures aimed to provide further support to liquidity needs, resulting in cutting tail risks even further. The ECB should reinforce the PEPP program while the Fed reassured markets for the long term, announcing a probable use of the forward guidance which ultimately will maintain rates low for longer. This will also provide a long lasting attractive environment for equities as the alternative bond and corporate asset classes will continue to show a lower yield (though characterized by a lower risk profile). The new Recovery fund is an additional step in the right direction (Fiscal Union) which contributed to a better performance of Value stocks and European indices. It represents a shield against tail risks for periphery and financials, in particular. Peripheral states would be “pressured” to reform as they accept grants and loans but on the other side we know that those productivity and growth-enhancing reforms are increasingly needed anyway, to consolidate the growing debt ratios.

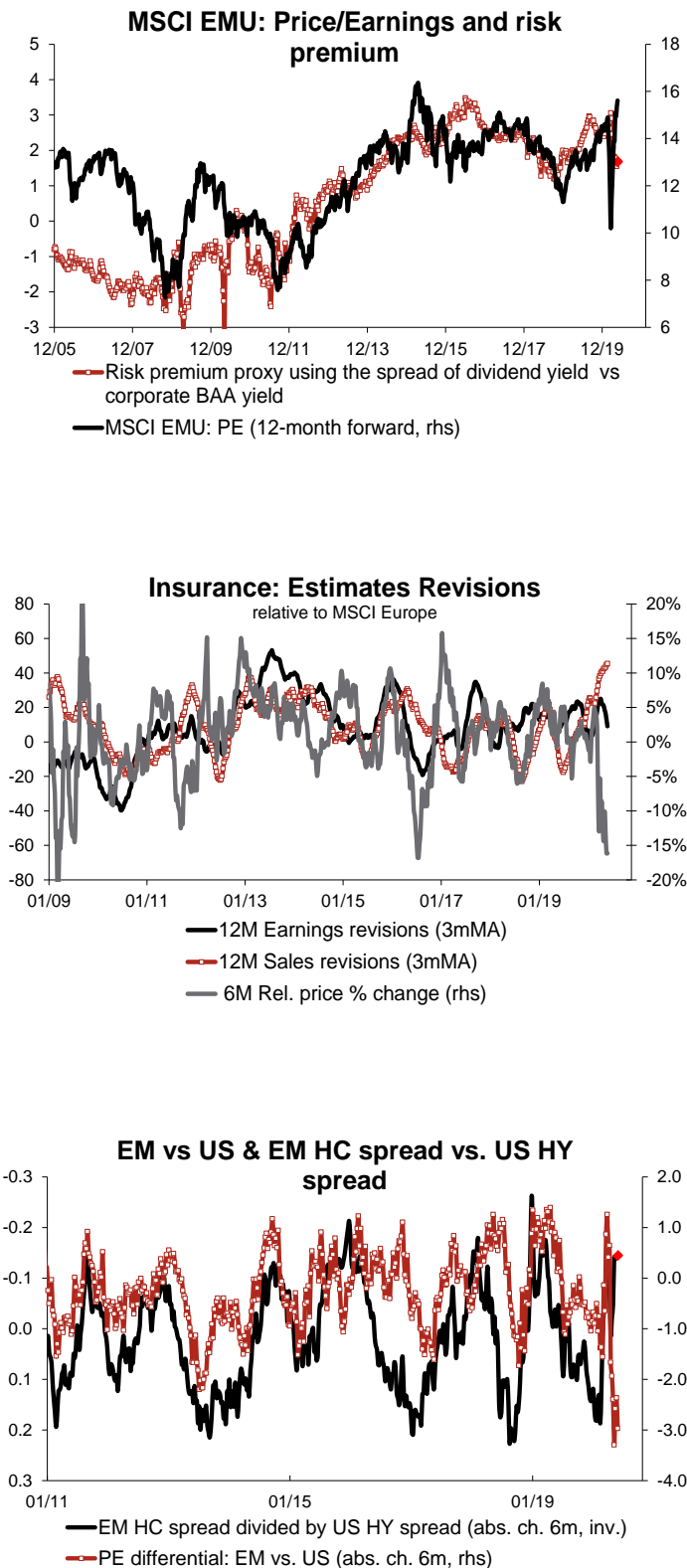
Better macro surprises, improving financial conditions

Macro surprises have started to stabilize, while major economies are turning around. Signs of an initial turnaround are especially visible in China and more recently in the US and euro area (EA).

Thanks to the huge fiscal initiatives, liquidity measures and improving financial conditions, volatility and earnings dispersion (standard deviation of analysts' forecasts - a proxy for uncertainty) stayed at a very low level, near pre-Covid levels. As a consequence, the risk premium continues to decrease (54 bps for EMU and 27 for the US).



Equities



Higher multiples not an obstacle to performance, yet

We continue to see the S&P 500 in the range of 2,500-3,000. Still, additional measures in the last month could somewhat enhance the target in the short term. The reporting season produced positive surprises though not too significant as Q2 will be a much more negative season and revisions will continue to decline. That said, we already know this and most importantly we didn't have to change our earnings decrease estimate for this year (-35% for the EA, which corresponds to a peak-trough of -40%). Possibly we could increase our estimate for 2021 from +20% (well below previous recoveries after recession) to nearly +30%. In this case markets would be near a fair value. But then there are additional positives. Our quant models are only timidly in negative territory as they were in June and September 2009 when market then continued to rise. The oil price is increasing and the oil market technical seem to have passed the worst. This is good for earnings but also for credit quality (US HY). Positioning remains low and tactical indicators we follow are still in buy territory. PEs are higher by 7 points from the lows as in June-September 2009. At that time it didn't represent an obstacle to performance. In the end we remain cautiously positive with a very limited overweight position in equities. Risks: Brexit, geopolitical frictions, second wave contagion and enduring low capex.

A more balanced portfolio inside equities

We give up our preference for safer countries assuming a neutral view on country allocation. In the sector/style arena, we notice some of our bets to be stretched and we bring them to **neutral**: pharma, utilities, IT. We put in **OW** insurance, media and energy from N, together with staples and telecoms (unch.). **UW**: auto, transportation, real estate and comm. & prof. services. We remove Momentum from OW (to N). We are slightly OW defensive vs cyclicals and neutral Value, Growth and Quality. Our model shows a huge deterioration in the Value appeal due to an increase in earnings dispersion. We are UW low leverage (overvalued).

EM: relative attractiveness has improved

In May, EM underperformed S&P and EMU by 4% mostly due to renewed US/China tensions. While such pressure is set to continue, we highlight reasons to be increasingly optimistic. Financial conditions improved and both the TW USD and EM yields have started to stabilize. Our value indicator has increased (lower yields by 190 bps) together with the earnings revision index and macro surprises. Finally, the momentum of the EM spread gap relative to US HY is such that the EM PE could increase relative to the S&P 500 PE. In sum, we could soon revise our neutral stance on EM, upgrading it to OW. In the meantime we continue to favor Korea and Taiwan.

Asset Allocation

Thorsten Runde

- In the course of May (until May 27th) the developed equity markets roughly gained 4.0% on average, thereby clearly outperforming the emerging markets whose performance just reached positive territory (+0.2%).
- Core government bond markets suffered, above all the Y10+ bucket, it lost round about -2.1%. That said, semi-core as well as peripheral govies could make up ground, with performance figures ranging from +0.5% (Spain 1-5Y) to +3.2% (Italy Y10+).
- On the credit side, the HY segments clearly outperformed, in the EA (+2.4%) as well as in the US (+4.1%). EA IG credit performance was distinctively weaker (+0.1% fin; -0.2% non-fin).
- However, the best asset class to be in May was USD-denominated EM govies that made +5.8% on a EUR-hedged basis.
- With the dynamics of new Covid-19 cases apparently abating but uncertainties about second waves of infections persisting, we confirm our last recommendation. I.e.: Maintain very prudent OW in riskier assets (EQ, HY). Retain substantial OW in high quality credit (especially non-fin). UW Cash. Long duration after rates rebounded.

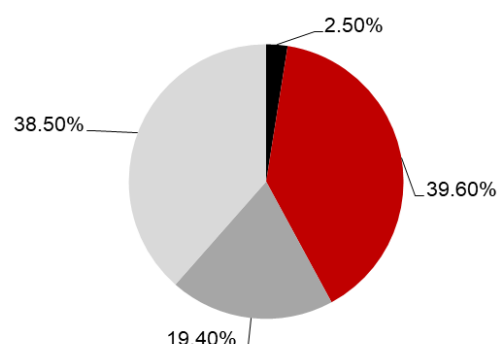
Receding new Covid-19 cases in Europe together with first cautious steps towards rebooting the economic engines helped to underpin risk sentiment. Global central banks embarking on a further round of policy easing and the recovery of the oil price worked in the same direction. This was counteracted by poor economic figures, growing tensions between the USA and China and worries about a second wave of infections.

Thus, the model portfolio was able to benefit from its prudent pro-risk stance. All in, so far it outperformed its benchmark by +9.5 bps in May, even though the bet on quality credit did not pay off (-10.5 bps). All other active positions contributed positively to the overall outperformance at aggregate levels. The underweight positions in cash and short-dated core govies turned out to be the most significant contributors to the TAA success, both contributing around +4.8 bps, followed by the overweight in USD-denominated EM govies (+ 3.9 bps). Furthermore, the overweight in equities has also paid off (+1.3 bps).

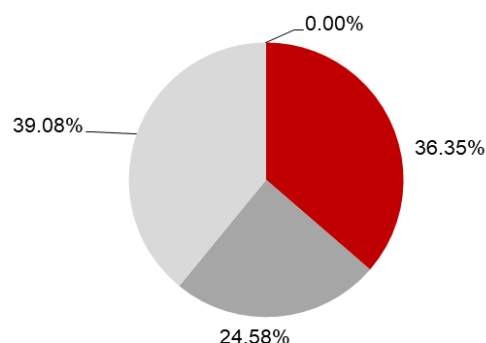
Keep prudent pro-risk stance favouring quality credit

Based on the assumption that the aforementioned conditions should continue to apply for the time being, we confirm the current TAA stance. We maintain a very prudent overweight in riskier assets (EQ with a focus on defensive sectors/markets, HY). We retain a substantial overweight in high quality credit (especially non-fin). We underweight cash and prefer long duration.

Benchmark

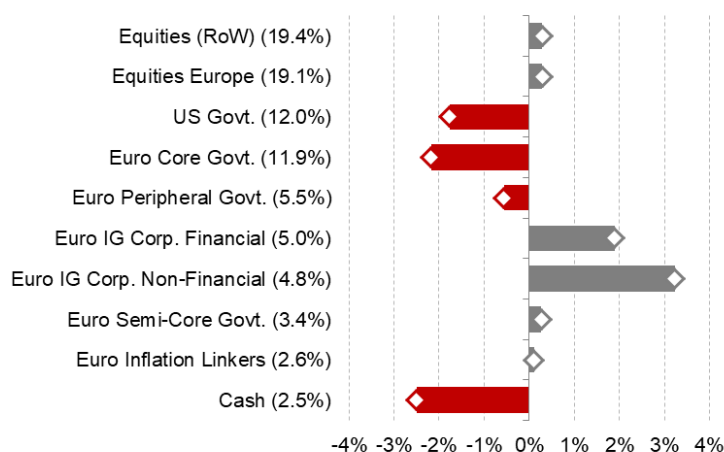


Modelportfolio



■ Cash ■ Govies ■ Corporates ■ Equities

Active Positions in TOP 10 Benchmark Constituents*



*Benchmark weights in parentheses, diamonds indicating previous recommendations

Forecast Tables

	2018	2019f	2020f	2021f
US	2.9	2.3	- 7.5	5.0
<i>Euro area</i>	1.9	1.2	-10.0	5.0
Germany	1.5	0.6	- 9.0	5.5
France	1.7	1.3	-10.0	5.0
Italy	0.7	0.2	-12.0	6.0
<i>Non-EMU</i>	1.6	1.5	- 9.2	6.5
UK	1.3	1.4	-10.0	7.0
Switzerland	2.7	0.9	- 6.5	4.0
Japan	0.8	0.8	- 7.0	4.2
<i>Asia ex Japan</i>	6.2	5.2	- 0.7	7.3
China	6.6	6.1	1.3	8.0
CEE	3.1	1.9	- 4.4	3.8
Latin America	0.1	- 1.1	- 6.9	3.1
World	3.5	2.7	- 4.8	5.6

	2018	2019f	2020f	2021f
US	2.4	1.8	0.4	1.4
<i>Euro area</i>	1.8	1.2	0.3	1.0
Germany	1.9	1.4	0.3	1.4
France	2.1	1.3	0.3	1.3
Italy	1.1	0.8	- 0.1	0.9
<i>Non-EMU</i>	2.3	1.7	0.8	1.2
UK	2.5	1.8	0.8	1.2
Switzerland	0.9	0.4	- 0.5	0.5
Japan	1.0	0.5	- 0.2	0.0
<i>Asia ex Japan</i>	2.6	2.8	2.3	2.2
China	2.1	2.9	2.5	1.7
CEE	6.0	6.7	4.6	4.9
Latin America	4.0	4.0	3.5	3.3
World	2.6	2.6	1.7	2.1

Financial Markets

3-month LIBOR	27/05/20*	3M	6M	12M
USD	0.37	0.40	0.50	0.70
EUR	-0.32	-0.20	-0.45	-0.45
JPY	-0.03	-0.10	-0.10	-0.10
GBP	0.25	0.55	0.55	0.55
CHF	-0.64	-0.60	-0.75	-0.75
10-Year Bonds	27/05/20*	3M	6M	12M
Treasuries	0.68	0.65	0.80	1.00
Bunds	-0.45	-0.50	-0.35	-0.25
BTPs	1.55	1.45	1.55	1.55
OATs	-0.01	-0.10	0.00	0.10
JGBs	0.00	0.00	0.00	0.05
Gilts	0.19	0.15	0.30	0.45
SWI	-0.47	-0.50	-0.35	-0.25
Spreads	27/05/20*	3M	6M	12M
GIIPS	153	150	145	140
BofAML Covered Bonds	51	50	50	45

*average of last three trading days

Corporate Bond Spreads	27/05/20*	3M	6M	12M
BofAML Non-Financial	176	150	140	130
BofAML Financial	179	160	150	130
Forex	27/05/20*	3M	6M	12M
EUR/USD	1.10	1.10	1.12	1.14
USD/JPY	108	107	106	105
EUR/JPY	118	118	119	120
GBP/USD	1.23	1.22	1.26	1.31
EUR/GBP	0.89	0.90	0.89	0.87
EUR/CHF	1.06	1.06	1.07	1.08
Equities	27/05/20*	3M	6M	12M
S&P500	2994	2995	3005	3035
MSCI EMU	107.8	107.5	108.6	108.5
TOPIX	1529	1535	1540	1550
FTSE	6068	6040	6060	6070
SMI	9791	9825	9950	9950

3-Months Horizon

Government Bonds	10-Year Bunds	-0.60	-0.50	-0.40
	10-Year Treasuries	0.58	0.65	0.72
	10-Year JGBs	-0.01	0.00	0.01
	10-Year Gilts	0.11	0.15	0.19
	10-Year Bonds CH	-0.62	-0.50	-0.38
Equities	MSCI EMU	101.8	107.5	113.2
	S&P500	2853	2995	3137
	TOPIX	1444	1535	1626
	FTSE 100	5747	6040	6333
	SMIC	9389	9825	10261
Currencies	EUR/USD	1.07	1.10	1.13
	USD/JPY	103.30	107	110.70
	EUR/GBP	0.87	0.90	0.93
	EUR/CHF	1.04	1.06	1.08

12-Months Horizon

Government Bonds	10-Year Bunds	-0.43	-0.25	-0.07
	10-Year Treasuries	0.84	1.00	1.16
	10-Year JGBs	0.07	0.05	0.03
	10-Year Gilts	0.37	0.45	0.53
	10-Year Bonds CH	-0.48	-0.25	-0.02
Equities	MSCI EMU	96.1	108.5	120.9
	S&P500	2771	3035	3299
	TOPIX	1352	1550	1748
	FTSE 100	5492	6070	6648
	SMIC	9075	9950	10825
Currencies	EUR/USD	1.07	1.14	1.21
	USD/JPY	96.82	105	113.18
	EUR/GBP	0.81	0.87	0.93
	EUR/CHF	1.02	1.08	1.14

*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, exponentially weighted. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

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