

Q3 2020



GENERALI
INVESTMENTS

Investment View Cov-ideologies



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Global View – Cov-ideologies

- The aftermath of the Global Covid Crisis (GCC), marked by elevated government and non-financial corporate debt, differs from that of the GFC (households and bank debt). Bigger states, interventionism, deglobalisation, QE for longer, more taxes, bond-friendly regulations etc. are all part of the post-GCC world.
- We analyse ‘new behaviours’ in more depth in our upcoming White Paper: ‘Life after Covid: the LDI view’. They do not bode well for potential growth. The illusion of a V-shape recovery, however, will support risk sentiment over summer.
- The autumn looks more challenging, as the pandemic might put more pressure on the health systems, the recovery flattens out and political risks rise (“blue wave” at US elections? “Bare bone” Brexit deal?)
- Because timing market turns perfectly is so hard, we enter summer with an only moderate pro-risk bias, focused on IG Credit. We take selective credit risk: prefer hybrids, AT1 and Fallen Angels to High Yield. Expect corporate defaults to peak below the post-GFC level, but to stay high for longer, while recovery rates risk being lower.
- We argue against short duration positions, even in the context of the V-shape illusion. Tactically, cyclical stocks are better positioned than Value, but the structural challenge is to source new Growth engines. The US dollar is set to pull back further.

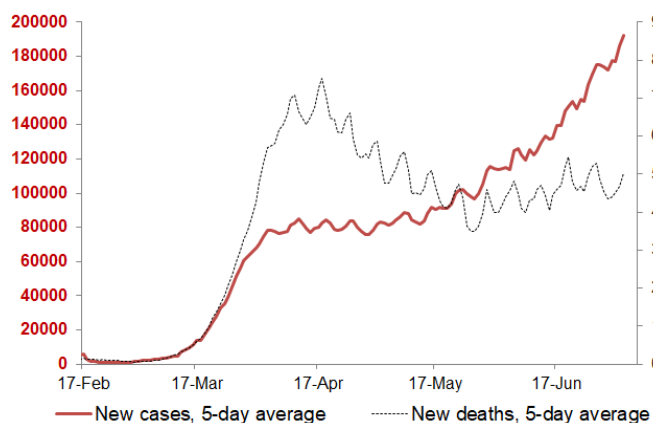
Covid-19 still lurking around; deaths a more reliable barometer than cases, if a lagging one

Pre-crisis situation differs sharply from that of the GFC: focus on sovereign and non-financial debt, as opposed to household and financial

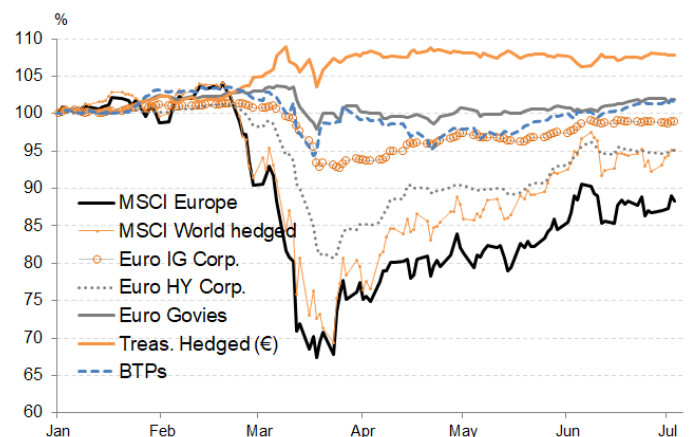
After the rescue. As we enter the 20H2, Covid-19 is still lurking around, and influencing our social and economic behaviours. The number of new daily cases globally is at a new high (Graph 1). Partly, this reflects more intensive testing. The latter now captures a broader and younger population. This also explains that the mortality rate (total numbers of Covid deaths / total cases) has declined from near 7% in late April to 4.7% in early July. The global number of daily deaths, off the peak and rather stable, is probably a more reliable barometer of the pandemic, if a lagging one. This relative stability, in a context of reopening economies, and formidable policy support since late March, explain that global risk assets recovered sharply in Q2 (Graph 2). Our pro-risk bias, abandoned in [late February](#) but restated in [early April](#), has been rewarded, though in hindsight the rebound was sharper than expected.

Cov-ideologies. As the global economy reopens, the aftermath of the Global Covid Crisis (GCC) looks different from that of the Great Financial Crisis. This [IIF Global Debt Monitor](#) does a good job illustrating the contrast. Into the GFC, global (and particularly US) financial (bank) and household leverage had increased sharply. The post-crisis environment saw a permanent rise in the saving ratio and a regulatory tightening of the financial sector. Into the GCC, it is sovereign and (to a lesser extent) non-financial corporate debt that had been rising fast – a trend that the pandemic has accelerated. We estimate that global public debt will increase by more than 15pp of GDP in 2020.

Graph 1: COVID-19, NEW CASES AND DEATHS, 5-DAY AVERAGE



Graph 2: YEAR-TO-DATE TOTAL RETURNS



Cov-ideologies: bigger states, interventionism, de-globalisation, QE for longer, more taxes, government bond-friendly regulations etc.

Watch out for our upcoming Investment White Paper: “Life after Covid: the LDI view”

Swoosh recovery ahead; but first, the illusion of a V-shape this summer

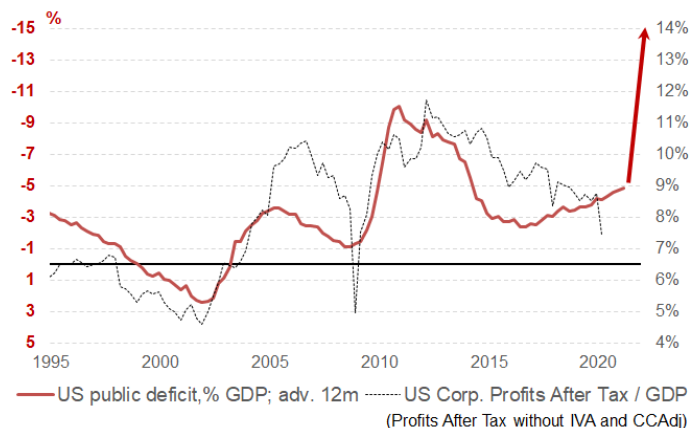
The post-GCC will see financial repression reach a whole new level: policy makers will focus on keeping the debt path (government debt, with an eye also on corporate debt) sustainable, which will require low yields for longer. Central bank buying is definitely a major tool in the repression box. The GCC has seen the frontier between fiscal and monetary policy being blurred like never before; expect not just low policy rates for longer, but also **QE for longer**. Financial repression may play out in other ways, for instance a **rise in taxation** (greater income tax progressivity, wealth tax, corporate tax). The median global corporate tax rate has dropped from 40% in 1980 to about 20% today; reversing that trend will be easier said than done, without stronger international cooperation, but the heightened post-crisis focus on inequality will be a powerful driver. The demands for a **stronger safety net** will make it harder to cut public spending, hence governments may have to rely on higher taxes within fiscal consolidation programs. The post-GCC environment will see **bigger States**, following massive rescue intervention to limit the economic destruction; the bans on dividends are only the early signs on rising interventionism. Unfortunately, capital in the process may not always be allocated in the most efficient way, e.g. some businesses are being rescued when in fact some should be part of the creative destruction that contributes to economic efficiency. Repression will also continue to be shaped via **regulations that channel savings into government bonds**, e.g. European banks were recently offered a capital contribution holiday when facing a loss of value in their government bond holdings. Government interventionism is also likely to imply a further reversal of the globalisation that has dominated the past 40 years. A greater leverage of digitalisation and automation may only partially offset the negative impact on productivity.

We will dig deeper into ‘**new behaviours**’ (governments, households and corporations) in a very soon-to-be-released Investment White Paper: “Life after Covid: the LDI view”. Unfortunately, the trends described above will likely participate to a further erosion of potential GDP growth, which will complicate the absorption of the debt.

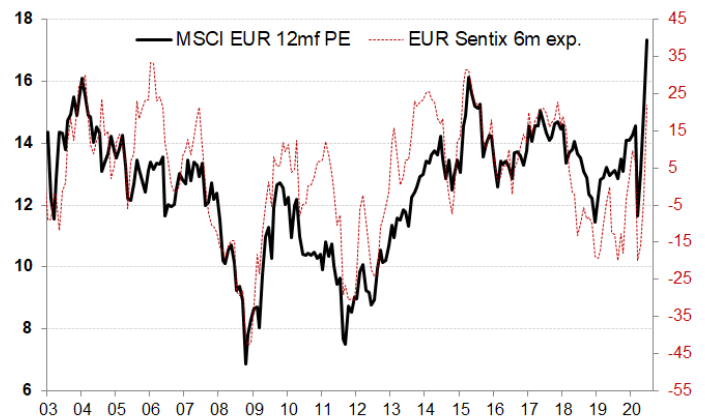
20H2, a half-year with two halves?

Just an illusion. Our view of a “swoosh” recovery implies that Developed Market GDP may not return to pre-crisis level before end-2021. But the reopening of the economies has seen a strong initial bounce in most regions. As businesses catch up with unfilled orders and pent-up consumer demand follows months of record saving, the illusion of a V-shape recovery will persist over summer. Only later will the second-round effects (fading benefits, impaired balance sheets a drag on capex, higher unemployment hurting consumer spending) vindicate our view of a “swoosh”.

Graph 3: US PUBLIC DEFICIT & CORPORATE PROFITS / GDP



Graph 4: EQUITY VALUATION SOMEWHAT STRETCHED



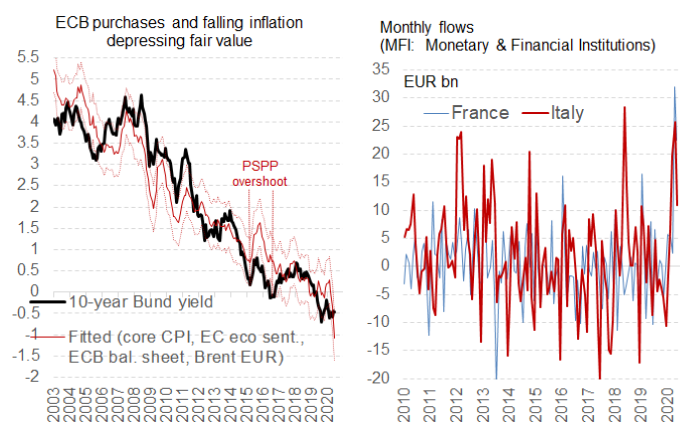
V-shape illusion, cautious positioning and policy support likely to keep risk assets supported over summer

The autumn looks more challenging, as the pandemic might put more pressure on the health systems, the recovery flattens out and political risk rises

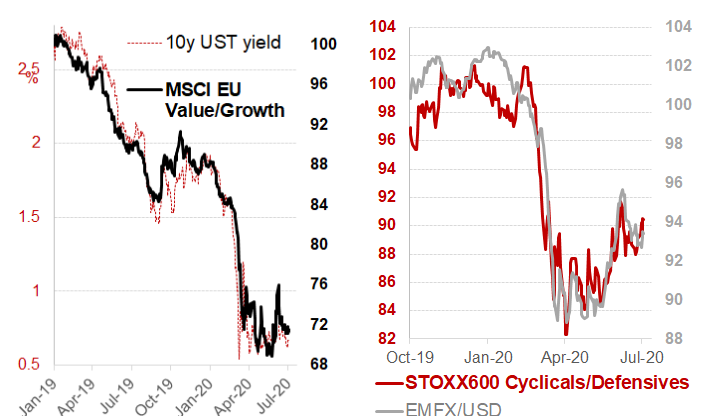
Summer joy... This V-shape illusion may well support investors' appetite for risk over summer. While they progressively turned more daring over Q2, following massive de-risking in the dark days of late February and March, investors overall have remained cautious, both in terms of **sentiment and positioning**. Cash positions are still large; credit funds have seen strong inflows over the past three months, reversing sharp outflows through the crash, but equity funds haven't. In surveys, investors also advertise a rather cautious view of the economy and markets. We suspect that FOMO (fear of missing out) and TINA (there is no alternative) will dominate the summer months. Governments will also deliver more support, e.g. we expect the German EU presidency to align views and deliver on the European Recovery Fund (ERF). The US Congress is also working on a bi-partisan infrastructure plan (1.0 to 1.5 trillion dollars, or 4-6% of GDP). The US public deficit is likely to flirt with 20% of GDP this year; usually rising budget deficits benefit corporate profits disproportionately: after-tax profits take a larger share of the GDP pie (Graph 3). And of course, central banks are still heavy buyers of assets, front-loading QE early in the recovery. This tends to stretch valuation of the risk-free assets, then the safest risky assets (IG Credit) and finally trickling down to most assets. Ride this wave over summer.

... but risks rising in the autumn. It is not all rosy. Offsetting forces are likely to grow over the autumn. First, the virus is still galloping, and we fear that the autumn conditions will make that much more challenging from a sanitary and public health capacity point of view. Governments will resist full lockdowns – the economy cannot afford it – but local ones may well mushroom. By the autumn, the initial economic bounce is also likely to flatten out, sending investors into a deeper introspection about the post-Covid environment. The political environment will also be more challenging, given the risk of a “blue wave” at the US elections: should Biden win and enjoy a majority in both chambers, investors may prepare for less economy-friendly policies (taxes, higher minimum wage, pressure on big tech, pharma and shale oil etc.). The UK and EU, preparing for the end of the transition period at the turn of the year, may also strike a “bare bone” deal that will do no favour to the economies on both sides of the Channel. And of course, by then, valuations may be even more stretched. By some measures, equities valuation is already looking quite impressive (Graph 4).

Graph 5a: BUND FAIR VALUE SUGGESTING YIELDS WILL STAY LOW; MFI HOLDINGS OF DOMESTIC GOVERNMENT BONDS



Graph 5b: DEPRESSED TREASURY YIELDS A DRAG FOR VALUE STOCKS; CYCLICAL ASSETS ON THE MEND



Retain but reduce positive risk bias in portfolios

Timing turns in markets always a challenge

Timing is everything. Of course we must be very humble when predicting such turn, which is always very tricky to time. We did relatively well in cutting positions (late Feb.) and cautiously re-risking (early April) but may not be so 'lucky' next time.

As such, we will enter the summer with a moderate pro-risk bias, looking forward to reduce risk further as some of the aforementioned risks materialise.

Disinflationary pressure and CB purchases to keep bond yields low, despite pressure from recovery

Non-core sovereign complex well supported despite long-term challenges

Retain but reduce Credit OW, focus on IG; we add up risk on a selective basis

Small OW in equities; Cyclical better positioned than Value over summer

USD likely to pull back further

Long rates to stay low, despite pressure from recovery. While the summer illusion may contribute to a small rise in government bond yields, we expect them to be stuck at very low levels. In fact inflation remains the largest driver of 10-year Bund yields, and the recent pullback in core HICP measures suggest yields will stay low; add the large ECB buying, and the fair value of the Bund has been pushed further down. By our measures, the Bund yield is currently not stretched at all (Graph 5a). In this context, we argue against short duration positions; LDI players, if anything, will be forced into closing residual shorts there. That said, we find that the 10-30y slope is currently trading below fair value, especially in EUR swaps (less so in cash government curves); upcoming issuance from the EC (2021 and beyond) could support a correction there. Despite a challenging debt path, expect the non-core sovereign complex to stay well supported over summer, and more so as 1/ the ERF is finalised and 2/ rating agencies show patience now that sovereign funding is being facilitated. The banks have borrowed record amounts from the ECB at the super-cheap TLTRO (-1%), and this will initially foster the sovereign carry trade. Already Italian and French banks have been heavy buyers of their domestic sovereign bonds (Graph 5b).

Investment Grade (IG) Credit still favoured, if less so. Three months ago Credit was already our favourite pick; we had singled out EUR Investment Grade and EMBI (EM hard currency sovereign debt) as the cheapest credits from a historical point of views. Those two have outperformed on a beta-adjusted basis over the past three months, and do no longer stand out. Still, we continue to prefer IG credit, both in EUR and USD, as we focus on a cautious pro-risk bias. We take risk by going down the capital structure of safe companies (hybrids, AT1), rather than High Yield. We expect the peak in default to be lower in this cycle than in the GFC one, but defaults could be high for longer, and the recovery rates lower. In an adverse scenario we would expect the ECB to include Fallen Angels to the CSPP, so also prefer those to older High Yield issuers.

Equities: tactical positioning over summer favours Cyclical rather than Value. We retain an overweight (OW) in equities, but a very small one indeed, following the sharp rebound of Q2. With bond yields stuck at depressing levels, the chances of the Value style making a come-back are rather low (Graph 6a). Cyclical assets are a better tactical bet, as they could benefit from the V-shape illusion. Tactically, cyclical assets however could enjoy the ongoing pullback of the US dollar (Graph 6b), driven by extraordinary debt monetisation, dovish Fed signals (Yield Curve Control next?), better global economic data and rising local political risk. EM equities could particularly benefit from the USD pullback. Structurally, the lower-for-longer growth environment argues against a durable catch-up of cyclical assets. The challenge instead will be to diversify the sourcing of the Growth factor, as technological progress reaches new shores (MedTech, CleanTech, FinTech etc.).

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Macroeconomic Outlook

- While likely having passed its peak in China and the euro area Covid-19 still worsens in key EMs. In the US new cases are on the rise again.
- Therefore and because of the gradual unwinding of lockdown measures amid persisting uncertainty we look for a swoosh type of recovery only. The pre-crisis output level is unlikely to be reached by 2021 in the US and the euro area.
- Fiscal policy will be the key tool to stimulate activity further. Monetary policy has largely run its course in our view unlike a second wave of the pandemic triggers additional easing which would imply the breaking of further taboos.

Pandemic passed its peak in China and the euro area, no so in the rest of the world

The world economy continues to struggle with the Covid-19 pandemic. Globally confirmed cases surpassed 10 mill and the death toll rose to more than 500K. While fresh infections in China and Europe have typically been diminishing to rather low levels and governments fight to contain local clusters, globally new cases are accelerating. This is true for the US where numbers are on the rise mainly in those states which opened up from previous lockdowns rather quickly. It is also true for Brazil and India, where restrictions were either soft or lifted due to economic needs. This clearly complicates the outlook. In China and Europe – a second wave notwithstanding – the economic trough induced by the Covid-19 restrictions should be behind us and Q3 should substantially accelerate compared to the previous quarter. In the US, there seems to develop a political fight whether fresh restrictions will be introduced. In the large EMs restrictions will probably stay rather weak out of economic need. Q3 might be driven by pent-up demand. Medium-term, however, we are sceptical to see a V-shaped recovery even in countries where lockdowns were successful. The labour market is deteriorating and thus weighing negatively on private consumption. Firm's balance sheets have suffered and so will investments. Basically, the demand side could prove the limiting factor. Sectors which rely on close consumer contact are prone to be hit the most. We rather look for a Swoosh-type of recovery.

Governments and central banks around the world responded forcefully to the crisis. By and large, monetary policy aimed at providing liquidity so that together with credit guarantees from governments large-scale insolvencies shall be avoided. Fiscal policy moved to mitigate the loss in income for people as well as for firms. In several regions, monetary policy expanded QE to an extent that it is able to absorb total bond issuance from governments. Notwithstanding a second wave, monetary policy largely seems to have run its course. Fiscal policy still continues to contemplate stimuli to bring the economy back on track. According to the IMF, the global fiscal debt-to-GDP ratio is expected to rise to 96.4% in 2020, a rise by 13.1 pp from 2019. Consolidation will hence be a major policy challenge for the coming decade.

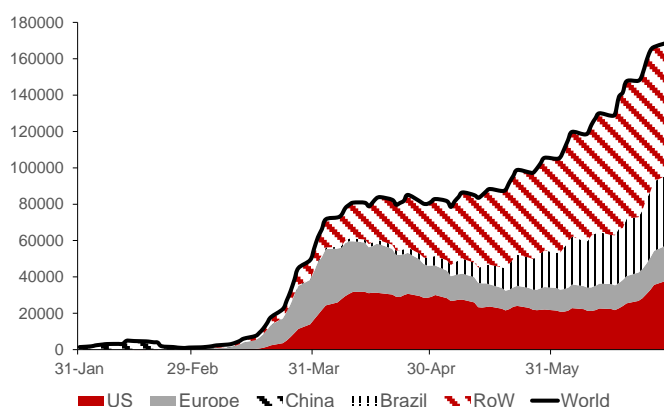
US

US: H2 recovery at risk from a second wave of contagion. Additional fiscal stimulus in the pipeline.

Q2 data indicate that activity snapped back as restrictions are lifted. In May real household consumption was up 8.1%, after contracting by 12% in April, remaining some 12% below the February level. The labour market will take time to recover; in June the unemployment rate fell to 11.1%, down from the peak of 14.7% seen in April. However, data were collected before a second wave of cases erupted in several large states in the second half of the month. We project US GDP to fall by around 7.5% in 2020 and to stage a 5% recovery in 2021. Risks are clearly tilted to the downside and relate primarily to the evolution of the pandemic. The resurgence in COVID cases is likely to lead to a second, more localized, wave of restrictions. Very high uncertainty on the possibility of a virus resurgence and on the evolution of the labour market will keep precautionary savings high and deter investment.

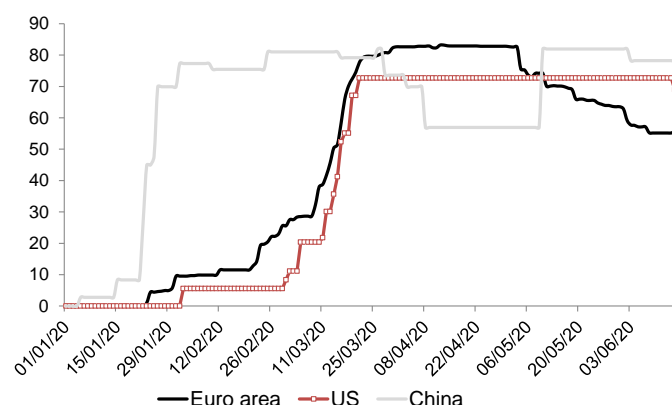
On the policy front, the Congress will have to extend the income supporting measures to household due to expire on July 31; this will be part of the fifth rescue package (worth around US\$ 1.5 trillion) that is being discussed and should be approved by the beginning of August. This will bring the size of the overall fiscal measure to above US\$ 3.5 trillion, more than 15% of GDP. In the June meeting, the Fed stressed again the large uncertainty surrounding the recovery and reiterated its aim to bring back the unemployment rate to the pre-outbreak record low of 3.5%. After the extension of QE to “fallen angels”, the central bank has not announced any new measures and stressed the need to assess how the measures are performing. FOMC members are discussing anyway new tools that may be needed in case growth undershoots expectations. Negative policy rates are still ruled out, while yield curve control (i.e. targeting directly the level of bond yields to loosen further in monetary conditions) are being assessed.

Graph 1: NEW COVID-19 CASES



7-day moving average; World Health Organization

Graph 2: LOCKDOWN INDEX



Uni. of Oxford stringency index*, EA: GDP weighted average of 11 largest economies (98% of GDP)

Cumbersome recovery in the euro area with pre-crisis activity only reached by 2024

Euro area

Following a drop of Q1/2020 GDP by -3.6% qoq, April and May are likely to mark the period of strongest contraction as the economy was almost under full lockdown then. With the gradual unwinding of the lockdown, sentiment has started to improve again and business indicators suggest that the economy returned to the verge of expansion at the outset of the third quarter. That said, the recovery will be cumbersome. We expect the underutilisation of capital and labour to unwind only slowly given structural changes in the post-Covid-19 world and persistent uncertainties (e.g. second wave, trade tensions, post-Brexit agreement). And the export environment will brighten more slowly given that the pandemic is not yet receding in various EMs. All in all, we expect euro area GDP to contract by -10.0% in 2020 and to recover by 5.5% in 2021. We see pre-pandemic activity levels being reached only by 2024.

Further ECB policy action only in case of a second wave likely

The ECB acted swiftly and boldly with monetary policy measures to cushion the inevitable recession. Apart from various liquidity and credit enhancing decisions it first extended its QE and later launched the Pandemic Emergency Purchase Program (PEPP). Its initial size of € 750 bn (by YE 2020) was beefed up to € 1.35 tr and extended to mid-2021. With the unwinding of the lockdown continuing and the pandemic receding we see no need for further policy action. Stimuli will primarily come from the various national fiscal policy packages implemented as well as from the Recovery Fund that is scheduled to become effective in January. That said, in the risk case of significantly accelerating Covid-19 cases we would expect the ECB to launch additional measures. With a wave of Covid-19 related corporate rating

downgrades following we would expect the ECB to enlarge the PEPP further, both in terms of volume and of lasting, and to include also purchases of Fallen Angels and to possible break further taboos like capital key buying or yield curve control.

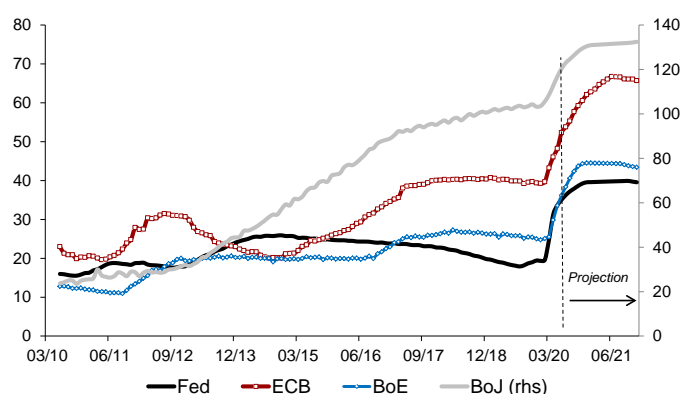
Asia and Emerging Markets

China was first into the crisis and now looks to be the frontrunner into the recovery. Latest data in May continued to improve. Industrial production is back into a yoy positive growth territory while investments benefit from government support. Nevertheless, consumption and private investments are lagging behind. We expect both components to limit the speed of the recovery going forward. Exports held up comparably well so far due to health related goods deliveries (masks etc.), but the weakness in global trade will remain a headwind to this rather open economy. Fiscal and monetary policy are supportive but with a measured approach. The 2020 fiscal impulse as announced at the National People's Congress will likely amount to 3.5 pp of GDP. Money supply is ample (in terms of M2 and total social financing) but well below the GFC response. We see another 50 bps RRR cut in 2020 and a reduction of the Loan Prime Rate by 20 bps via MLF cuts. We expect growth this year at 1.3% and 8% in the next while CPI inflation should slow strongly to 2.5% in 2020 and 1.7% in 2021.

China's supply side recovery is on track but private demand lags behind

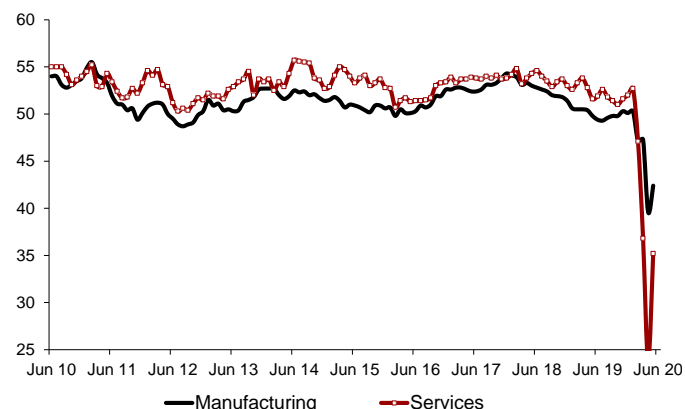
By the time of writing, India is fourth in the number of Covid-19 cases and fresh infections are accelerating. The government started lifting the shutdown from June 8 on in a step-by-step fashion, following economic needs. High frequency indicators show some improvement. Public debt is limiting the space for further fiscal action. However, we expect the RBI to cut its key further by 50 bps (after having cut the repo and reverse repo by 115 resp. 155 bps so far.) We see only a rather shallow recovery due to the ongoing Covid-19 uncertainties, resulting in a drop of GDP in 2020 by 4.3%, followed by 6% next year. In the Latin American region, a combination of insufficient contagion measures, commodity-driven dependence on global growth and political quarrels pushes key EMs like Brazil into severe recessions.

Graph 3: CENTRAL BANKS BALANCE SHEET PROJECTIONS



in % of nominal GDP

Graph 4: GLOBAL ACTIVITY



Global PMI sentiment, index points

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Fixed Income

- International government yields were range-bound in Q2. While dovish central banks exerted some downward pressure hopes for a swift economic recovery and a risk-on sentiment on financial markets pulled in the other direction.
- Looking ahead, there is some scope for a modest rise in yields amid an ongoing high supply and a further normalisation of inflation expectations over the course of Q3. But, the leeway is rather limited as central banks stand ready to prevent a too strong increase and current expectations of a V-shaped recovery are likely to be disappointed at last.
- Euro area non-core spreads tightened significantly in the light of an extremely accommodative ECB policy and moves towards an increased risk sharing on the European level. These factors are likely to trigger a further moderate spread tightening in the months to come.

After the strong decrease in government bond yields in Q1 the trading range was much tighter in the past quarter. The market-influencing factors cancelled each other out to a large extent. On the one hand, central banks remained committed to support financial markets and concerns about a possible second lockdown amid the swelling of new Covid-19 infections exerted some downward pressure. On the other hand, the released macroeconomic data were not as weak as initially feared triggering expectations of a quick economic rebound and risk-on sentiment in and of itself contributed to upward pressure.

Higher yields and curve steepening due to increase in inflation expectations

On balance, international yields rose slightly over the course of Q2. While the short end remained well anchored given central banks' commitment to keep key rates low for long the rise of longer-dated yields triggered a steepening of yield curves both in the US and in the euro area. It is noteworthy that the increase is exclusively attributable to higher inflation expectations as real yields even decreased in Q2.

Increase in inflation expectations has not run its course yet

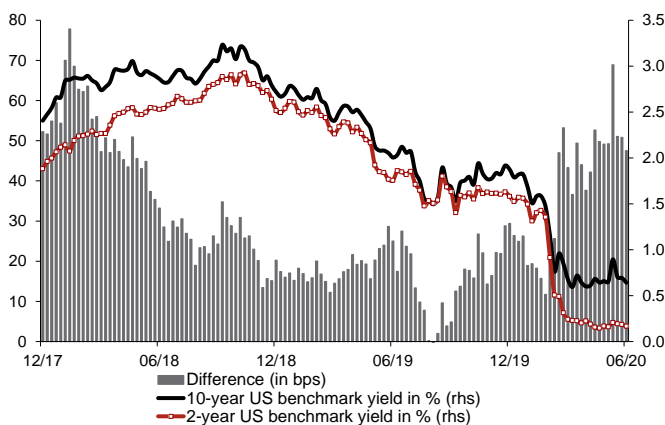
Going forward, we see some limited scope for higher yields. Initially, there is leeway that forthcoming macroeconomic data releases nurture hopes for a V-shaped recovery. In particular, ballooning US economic surprises signal leeway for higher yields. Eventually, however, financial markets are likely to adjust towards a more swoosh rebound. Moreover, as we assume risk appetite to creep upwards and financial conditions to ease further it will dampen demand for safe government bonds. In addition, treasuries are still in the process of reversing the issuance plans. Above all, the US bond market will have to digest an ongoing high supply. Although the Fed will continue to purchase bonds it is likely that it will reduce the volume – after being particularly active at the height of the crisis (positive net issuance in H2). In general, the pattern looks similar in the euro area. However, the ECB is unlikely to scale down to the same extent. What is more, the funding is already well advanced in the euro area. Despite the massive upward revisions, euro area governments have already issued well above 50% of their annual target on average.

Inflation expectations have more leeway to rise triggering a moderate steepening of yield curves

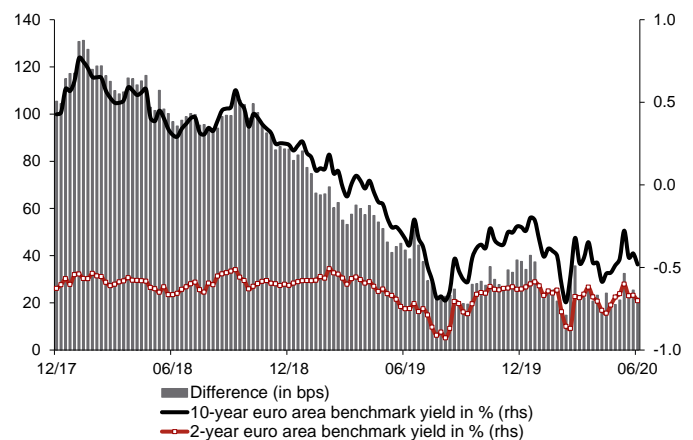
Additionally, there is some leeway for inflation expectations to increase in the medium term. Although an inflationary environment is not on the cards (even in the long run), current expectations are still well below the long-term average and at an unsustainable level. While the short-term outlook for inflation is rather grim, there is scope for moderately higher inflation rates further down the road – not least due to the aggressive fiscal and monetary policy measures. The tendency of deglobalization can exert some upward pressure on inflation, too. Finally, the priced inflation premium in the US and in the euro area (measured as 5-yr/5-yr inflation expectations minus current core inflation) is still rather low. The forecast increase implies a higher term premium and will eventually contribute to a further moderate steepening of yield curves.

However, the central banks' commitment to an accommodative policy (and potential steps towards an even more explicit strategy to keep rates low for a prolonged time) will balance the upward pressure. Central banks stand ready to do even more in case they assess a significant deterioration of financing conditions. In combination with expected weaker data releases this will keep a lid on any yield increase. Accordingly, we expect 10-year US yields to rise to 0.75% on a 3-month horizon (0.90% on a 12 month view). Their euro area counterpart is seen to rise to -0.40% in the short term and to -0.30% until the mid of 2021. As the short end will hardly move, this upward tendency will be accompanied by a moderate curve steepening.

Graph 1: US – SHORT- AND LONG-DATED GOVERNMENT YIELDS



Graph 2: EA – SHORT- AND LONG-DATED GOVERNMENT YIELDS



Notwithstanding a weakened fundamental situation, euro area non-core bonds likely to benefit from massive policy response

Environment to remain friendly for euro area non-core bonds

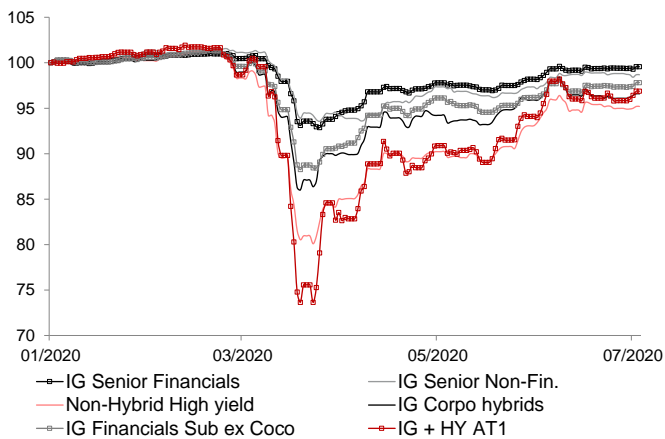
We maintain the positive assessment of euro area non-core government bond markets. The factors that supported these markets and triggered a strong spread tightening in Q2 are likely to underpin non-core bond markets in the months to come, too. In particular, we expect some form of agreement regarding the EU Recovery Fund. While it is likely that the final result will be a (somewhat) watered down compromise and it will take some time until it will pass all parliaments, the entry into a risk sharing system on a euro area level will likely be welcomed by financial markets. This keeps rating agencies at bay for the time being (assuming that the economic momentum strengthens in H2). Especially, lower-rated issuers will benefit from the decreasing threat of a rating downgrade. Moreover, the ECB continues its QE programs. While there is still some uncertainty regarding the future composition of the programs (e.g. share of public sector papers, split between bills and bonds), the central bank is forecast to purchase government bonds with a volume of at least €360bn in H2 2020. As stated above, euro area funding is already well advanced and ECB purchases ensure that net issuance of all euro area countries will be negative until the end of the year.

Finally, the search for a yield pick-up resurfaces amid the stabilizing risk appetite and the very generous provision of liquidity by the ECB increases the attractiveness of carry trades. Overall, there is some leeway for tighter euro area non-core spreads in the months to come. Although eventually structural problems in some countries have to be tackled, this is unlikely to come to the fore in Q3 and does not stand against a solid performance of euro area non-core bonds.

Credit

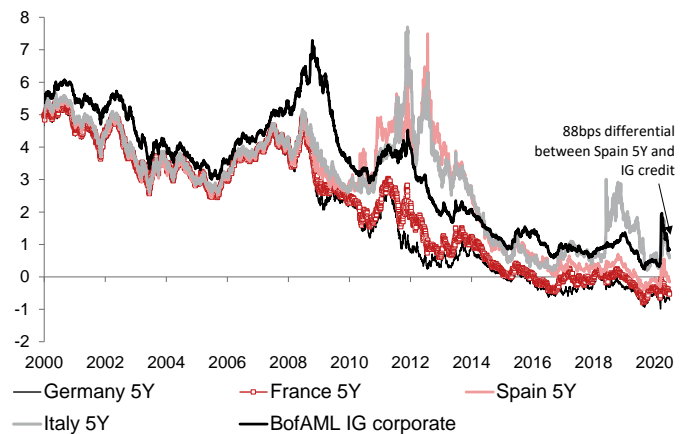
- Credit markets have recovered extremely rapidly over the last quarter, with Investment Grade (IG) close to posting positive total returns since the start of the year.
- The central bank support has continued to increase with five major central banks now buying corporate bonds, with Fallen Angels being now an eligible collateral for the ECB, and with the Fed even buying HY at a large scale. Rating agencies have continued to review corporate ratings to the downside but the pace of downgrades is stabilizing.
- Hence we recommend an overweight in (IG while staying cautious on High Yield (HY).

Graph 1: CREDIT MARKET YTD PERFORMANCE



Base 100 = 01/01/2020

Graph 2: EA – CORPORATE VS. GOVERNMENT YIELDS



We expect European defaults to jump to 5-6%.

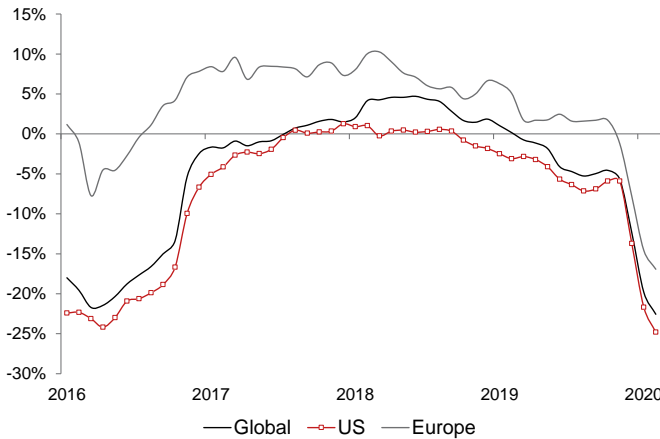
A recession for history books but defaults to jump only mildly

Corporate defaults are currently the main focus for HY investors while the biggest threat to IG remains rating migration. Indeed, credit carry remains attractive, at least in comparison to sovereigns but the question is whether it is enough to compensate for both risks above mentioned.

We have little historical references to derive default patterns given the extraordinary nature of the Covid-19 crisis: it is, taking its toll from the supply as well as the demand side, its ultimate cause is exogenous and it is affecting the world almost simultaneously.. Being highly correlated with diffusion indices, we expect European defaults to jump in the region of 5-6% versus slightly above 2% currently. Hence they should remain below those of 2008 of nearly 10% globally for HY while for EUR IG the historical average is very close to zero on a five year horizon. However, the damage could come from recovery rates which could end up lower than the historical average of 40% because companies' leverage is currently at historical highs. If we assume that our default forecast is correct, we would say that HY is just fairly valued. But given the uncertainty surrounding it, we retain our preference for IG, where we think valuations are stretched but central banks are capping the downside while the search for yield is likely to bring spreads 15bps tighter before year-end.

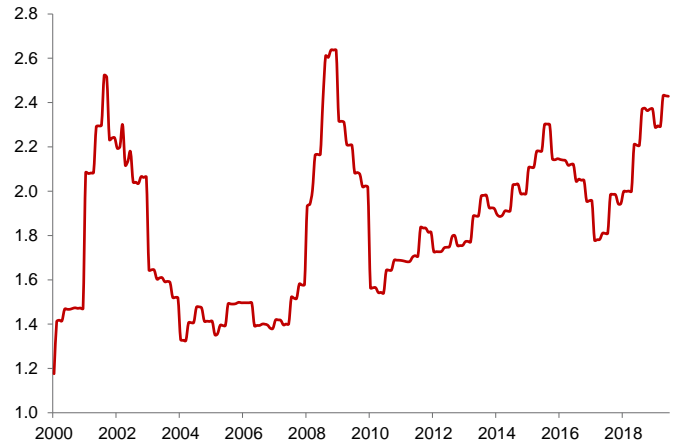
Regarding HY, we expect an out-performance of the BB bucket vs the rest of the market, since they will indirectly benefit from IG support, but also because historical defaults statistics are much below those of Bs.

Graph 3: MOODY'S TRAILING 12-MONTH RATING DRIFT*



*Rating drift = (notches upgrades - notches downgrades)/rated issuers

Graph 4: NON-FINANCIALS LARGE EUROPEAN CORPORATES – NET DEBT TO EBITDA



Fallen angels could be included to the purchases of the ECB.

We favour subordination risk to credit risk in AT1 and corporate hybrids.

Public support to creditors is unprecedented

Non-financial corporates have been, together with governments, the weakest link in the Covid-19 crisis as they entered 2020 with a much higher leverage than in 2007. Nonetheless, an unprecedented combination of fiscal and monetary support measures has been taken, to ensure preservation of decent financing conditions for European corporates. Most major central banks are now buying IG, while the Fed is also actively buying HY. Regarding the ECB, the debate remains open and strongly related to the risk of a second Covid-19 wave whether it could extend its PEPP program to Fallen Angels. Some mutual guarantees could be provided to the ECB to preserve its balance sheet, possibly via the Recovery Fund. Buying traditional HY remains a last resort option for a black swan scenario.

While the Great Financial Crisis emerged out of the US financial sector and led to stricter rules for banks, the Covid-19 crisis is very different by nature. Indeed the European banking sector has entered 2020 much better capitalised than in 2007, but is also treated with better consideration by public authorities, being a key transmission element of the credit channel. Of course, later on, the public support to the non-financial sector will start fading, implying a risk transfer from corporates to banking books, but we think it will be mitigated either by monetary, fiscal or regulatory easing. Hence we retain a neutral stance regarding financials versus non-financials.

Favour subordination to credit risk

The supply has been very heavy in IG over the last quarter, and we expect better primary market conditions to now benefit HY issuers. The effect on spreads will then be more favourable for IG relative to HY also supporting our overweight in IG. In terms of sectors, we also decide to retain a prudent approach as we think macro-economic data won't point to a V shaped recovery for long, hence we keep a defensive bias. However, as the search for yield continues to intensify, we like to go down the capital structure of strongly IG rated issuers, either via corporate hybrids or AT1s, as we think the coupon skip and extension risk remain very low for them.

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Currencies

- The strong recovery in risk sentiment has taken the USD off its March peak, reversing half of this year's gains.
- The USD remains dear, though, and a global Q3 recovery will guide it further down over the months ahead. The largely eroded US yield advantage and higher odds of a 'sweep' Democrat victory in the upcoming November elections should further support this move.
- The undervalued EUR is set to benefit, helped by the ECB's PEPP support to peripheral bonds and political steps towards stronger fiscal burden sharing. The biggest risk to the outlook arises from a broad global resurgence of new Covid-19 cases, which may push investors back into the safe-haven USD.
- The UK's strong hit from Covid-19 and the threat of a failure of negotiations with the EU leave us tactically bearish on GBP, even though we remain more constructive on a 'fudge' deal towards year-end.

Countercyclical features of USD particularly apparent amid Covid-19 crisis

The USD is a countercyclical currency, sought amid global recessions and in risk-off episodes. These characteristics became particularly apparent amid the Covid crisis (Graph 1). EM FX seem to have recovered less, even though if we index by FX turnover and exclude the severely strained TRY. EM currencies overall match the performance of major peers rather well. In this crisis, FX moves are indeed mostly about the dollar!

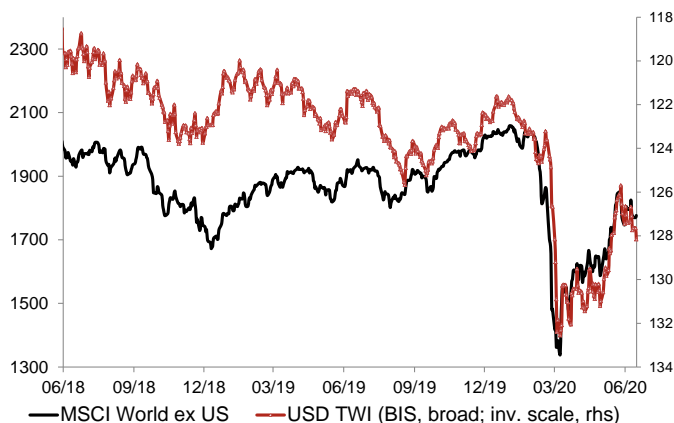
USD weaker, but not headed for a slide

Following the risk-off spike in March the USD is headed for gradual further weakness until year-end

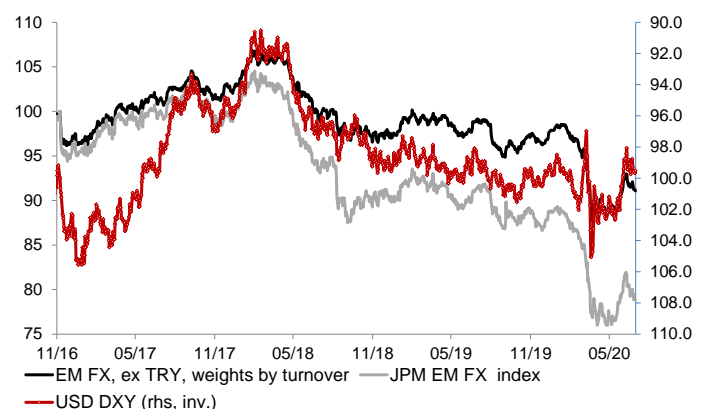
After paring half its gains by March, the USD seems headed for further gradual weakness from still dear levels. First, the rebound of global activity data in Q3 will further unwind investors' rush into the Greenback at the peak of the crisis. This holds all the more as, second, normalisation of US rates is far off. Following the Fed's cumulated 150 bps rate cuts this year, the dollar's carry appeal among G-10 currencies will remain eroded for longer. Political uncertainties ahead of the US elections in November and concerns about a less business-friendly agenda by Democrats are weighing too. Finally, with a ballooning US fiscal deficit monetized and the current account deficit elevated, also structural drivers are not in favor of the US currency. That said, the dollar's reversal is likely to happen gradually. Uncertainties about the pandemic persist, and in case a second Covid-19 wave in autumn requires renewed widespread lockdowns, the USD will be back in investors' favour.

Rebounding data, US political uncertainties and monetized fiscal expansion to weigh on the USD

Graph 1: USD IN TIGHT GRIP OF RISK SENTIMENT



Graph 2: EM FX and USD DXY

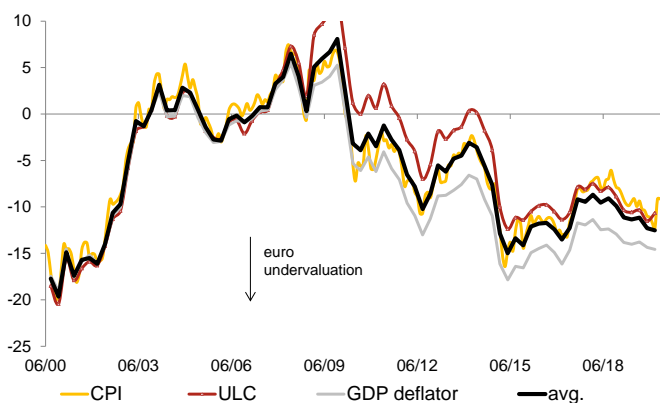


vs. USD; index: 8/11/2016 = 100

The generally still cheap
EUR will benefit from easing
peripheral concerns

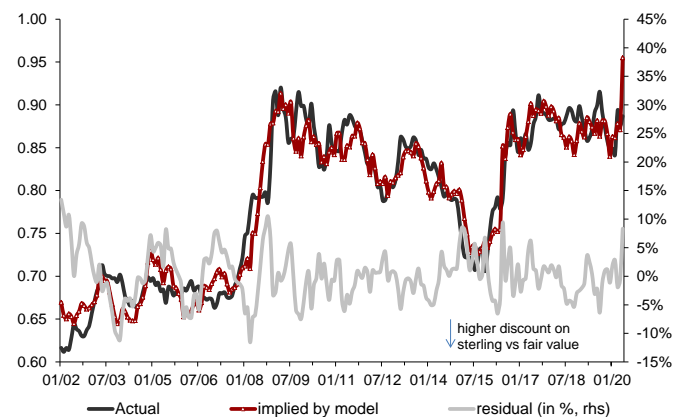
The EUR/USD is about to benefit. The EUR is still dear (Graph 3) and eased concerns on Southern European debt (strong ECB support and rising ‘solidarity momentum’ in the EU) help the EUR to gain some ground. In fact, while enhanced monetary policy support usually tends to weigh on a currency, the more targeted support to indebted EMU members via the PEPP program outweighs this via its EUR support from lower bond risk premia, especially for Southern European economies. The euro’s further advance will be more gradually than the 5% bounce since mid-March, though. After a strong Q3 rebound, the euro area’s recovery will be more sluggish. Stuck UK/EU negotiations about a post-Brexit deal will weigh not only on sterling (see below) but on the EUR/USD, too. Overall, we upgrade our 12-month EUR/USD forecast to 1.17 (from 1.15).

Graph 3: REAL TRADE-WEIGHTED EURO STILL DEAR



ECB Harmonised Competitiveness Indicators based on different TWI adjustments, in % vs Q4/1998 (time of euro introduction)

Graph 4: EUR/GBP VS FAIR VALUE



model includes yield gap, CPI gap, UK mortgage approvals, PMIs and time dummy for 06/2016 Brexit vote (11% discount)

Rising concerns about a no-deal outcome in UK/EU negotiations will weigh on sterling over summer – even though a recovery into year-end still is feasible

Near-term risks to EUR/CHF are balanced, but we ultimately expect the cross to move towards 1.10 on a 12-month view

Tactically bearish on GBP on no-deal risks

Negotiations between the UK and EU on a post-Brexit trade deal are stuck, with the June 30 deadline for an extension of the transition period beyond year-end passed. Concerns about a hard-deal will weigh more heavily on sterling. Option markets so far reflect only muted concerns and our EUR/GBP model points to further upside risks (Graph 4). The UK is among the countries most severely affected by Covid-19, while the BoE’s slashing of rates has removed another earlier pillar of support to the pound. Given the severe damage a no-deal outcome may have, we still think that a ‘fudge’ deal is likely – which is why we keep short GBP positions much as a tactical call, with a recovery into year-end still feasible.

The euro may also regain some further lost ground against CHF, which had been boosted by safe haven bids in March. That said, with deflation risks in Switzerland rising, the SNB had shown great determinedness to cap the franc – and was strongly helped in its efforts by recovering risk sentiment. After the EUR/CHF rebound and its consolidation between 1.06-.07, the risks seem balanced near term, with easing EMU debt risks and improving macro outweighed by higher Brexit concerns. Further out, with the Covid crisis easing and Bund yields inching up, we see scope for a resuming upwards trend in EUR/CHF, with our 12-month target slightly raised to 1.10.

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Equities

- In the last 3 months, equities rallied substantially with US, Nasdaq and EU cyclicals overperforming the rest.
- The massive policy response, both fiscal and monetary, is supporting a rather spectacular expansion of equity multiples. This momentum can continue for a while like H2 2009 experience shows. Macro surprises have started to stabilize and even surged for the US, while major economies are turning around.
- Financial conditions are easing off quickly and spiking Fed's assets support higher US PEs.
- Positioning remains contained and tactical indicators we follow are in neutral or buy territory.
- That said, markets discount already – albeit not in full – a respectable earnings growth in 2021 and rotation into Value and Cyclicals is quite advanced, too. Furthermore, as market multiples stay high, markets are more exposed to negative news flow and risks. That is why we hold a lower OW position in equity and we see mid-single digit total returns (TR) in 12 months.
- We recommend a balanced portfolio (the US aligned with the EMU) with a marginal tilt to EMs.

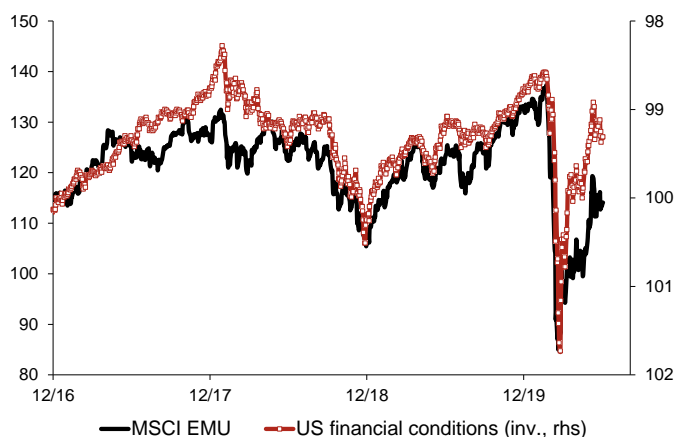
In the last 3 months, equities rallied substantially with US, Nasdaq and European cyclicals overperforming the rest. The Swiss market performed the worst (+13%).

Policy action and macro data support high multiples

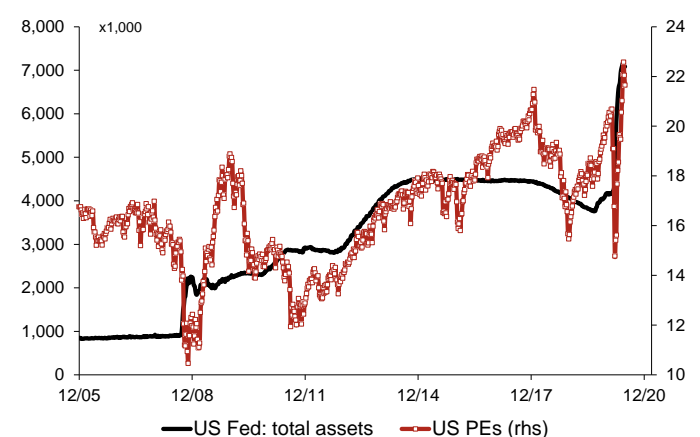
Strong fiscal expansion and surging central banks' assets provide support to higher-than-history market multiples

The massive policy response, both fiscal and monetary, is supporting a rather spectacular expansion of equity multiples. Such policy trend will linger in the next months, at least. Furthermore, an orderly conclusion of Recovery Fund initiative would increase the appeal of the euro area assets in international comparison. Easing financial conditions, lower volatility, plus stabilizing macro surprises (even surging in the US) have increased attractiveness of equities (also in relative terms) while positioning remains overall contained.

Graph 1: MSCI EMU AND US FINANCIAL CONDITIONS



Graph 2: US PEs AND FED'S ASSETS



Judging from our models' results and historical recession experience, we are able to forecast a nearly 35% recovery in earnings by 2021, which is to mitigate substantially thereafter. Our valuation models (driven by macro forecasts), along with the analysis of the effects of low real rates and increasing CCBB's assets on PEs, support the high chance of enduring high multiples in the months to come. Furthermore, making use of the average risk premium (earnings yield minus 10-year real rate) experienced in the last century in the periods of low inflation, Shiller data as well as consensus and our own assumptions, we perform the theoretical valuation of the

Lingering high multiples and robust earnings growth in 2021 translate into a +5% total return for equities in 12 months

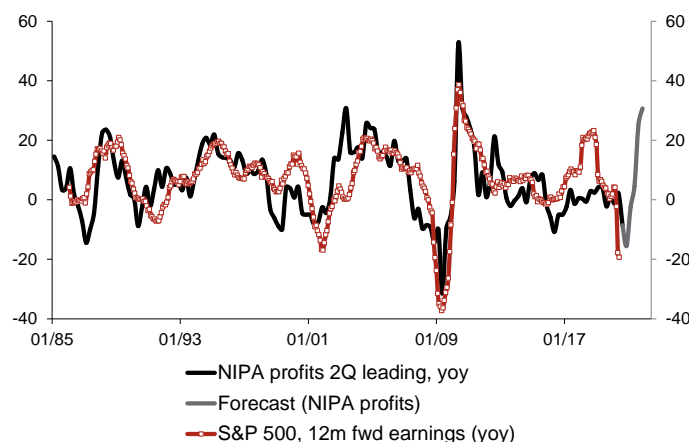
S&P 500 and come up with the range of (2,750-3,350). Due to improving financial conditions amid extraordinary policy support (both fiscal and monetary one), we set our target tilted towards the higher band of the range. This in turn translates into positive total returns - at least in the mid-single digit range - over the next 12 months.

Of course, as market multiples stay high, markets are more exposed to negative news flow and risks (like second wave contagion and slower investment recovery). For these reasons we prefer to maintain a limited OW in equities. We give up our preference for safer countries and recommend a balanced portfolio with a marginal tilt to EMs. Sector/style: OW Insurance, diversified financials, media, telecoms, energy (only slightly) plus capital goods. We are driven by earnings revisions, relative valuation, quant models and profitability trend. UW: durables, transportation, real estate, commercial & professional services, Low leverage and Momentum. Risks: Brexit, geopolitical frictions, second wave contagion, US elections and enduring low capex.

EM: relative attractiveness has improved

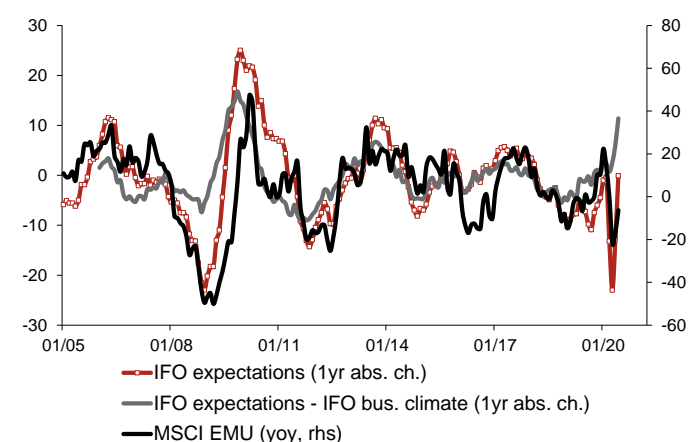
Since last ISF, the MSCI EM (+24%) has benefitted from falling yields, EMBI spreads and weaker trade-weighted dollar (-250 bps, -180 bps and -3.0%, respectively), underperforming MSCI World by 1.0pp in total return terms.

Graph 3: S&P EPS vs NIPA PROFITS



yoy

Graph 4: MSCI EMU AND IFO



USD stabilization together with lower-than-average valuations and attractive EM HC spreads induce us to put EMs on OW for the next months

In term of multiples, EMs are trading at a slight premium of 6% vs historical average, while higher PEs are supported by lower yields. The cyclically-adjusted PE is one standard deviation below average. The momentum of the EM spread gap relative to US HY shows relative attractiveness of EM PEs vs US ones. That said, the EMs are set to also benefit from improved financial conditions. In the mid- to longer term a moderately weakening US dollar and relatively low valuations will provide tailwinds.

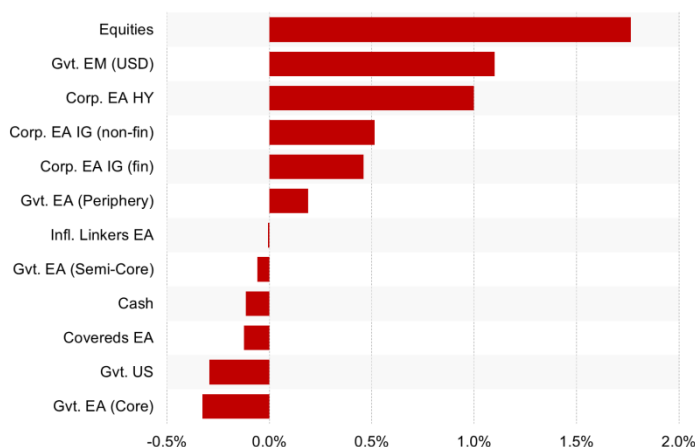
We favour Korea, Taiwan and Poland within EMs, having better Covid contagion trend, supporting M1 momentum, and high internal score rating (countries are scored based on different valuation measures and expected total return). Risks: stabilizing US dollar short term, US-Chinese frictions, a pandemic worsening in some EMs (Brazil, India, Mexico, etc.) and a general lower monetary and fiscal support compared to DMs.

Asset Allocation

- With everyday life gradually returning to normality in the advanced economies after a month-long phase of almost full lockdown, the way seems to be paved for a rebound in Q3 data. Yet, as the global economy will experience its worst slump since WWII hopes for a V-shaped recovery will likely not materialise.
- As lockdown measures have been eased risk assets already started to rally. The massive fiscal and monetary policy stimulus measures should be able to foster these developments at least in the short term.
- Although risk assets already discount a substantial degree of recovery hopes and policy support, the investors' overall positioning is still rather restrained.
- In that sense we recommend to stay cautiously overweighed in equities and stick to a sizable positive active position in credit with a focus on high quality. First and foremost this should be funded by underweighting cash, short-dated govies and covered bonds. We still favour a moderately long duration mostly in credit and peripherals.

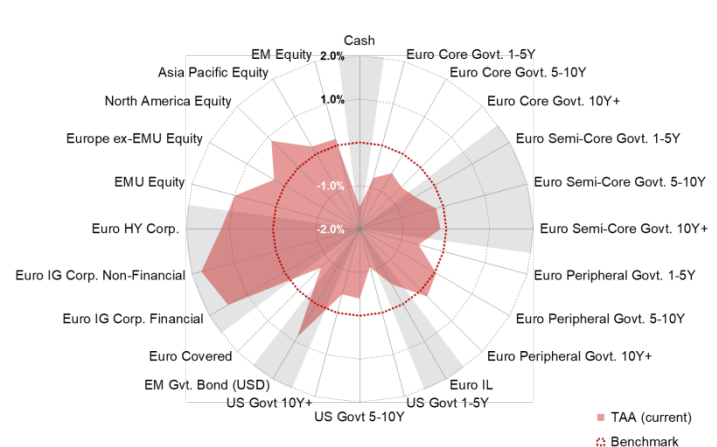
The further easing of lockdown measures flanked by substantial policy support will pave the way for a rebound in Q3 data. That said, higher unemployment, some lasting supply-side damage and weaker corporate balance sheets will keep the recovery subdued. The global economy is facing its worst slump since WWII. As a V-shaped recovery is belonging to the land of dreams the prospects towards the end of the year appear much bleaker with the major risk of a second pandemic wave clearly highlighting that risks are remaining on the downside.

Graph 1: SELECTED AGGREGATED TOTAL RETURN FORECASTS



3-months horizon; Hedged into EUR; Semi-Core = Spain; Periphery = Italy

Graph 2: RECOMMENDED ACTIVE POSITIONS



In pp; Semi-Core = Spain; Periphery = Italy

Cautiously constructive view on risk assets in the near term

Yet, the investors' overall positioning is still rather restrained. Together with a rebound in macro data this should continue to keep risk assets underpinned in the short term. Particularly high-rated credit should still be favourable on comprehensive support from central bank purchase programs. Peripheral bonds remain appealing from a carry perspective although the leeway for a further spread tightening seems to be largely exhausted.

In that sense we keep our cautiously constructive view on risk assets. We maintain a prudent overweight in equities and stick to a sizable positive active position in euro area credit preferring high quality to high yield. The main funding should be done via underweighting cash, short-dated govies and covered bonds. We still favour a moderately long duration mostly in credit and peripherals.

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Forecasts

GROWTH

	2018	2019f	2020f	2021f
US	2.9	2.3	- 7.5	5.0
<i>Euro area</i>	1.9	1.2	-10.0	5.5
Germany	1.5	0.6	- 8.0	5.5
France	1.8	1.3	-12.0	5.0
Italy	0.7	0.2	-13.0	6.5
<i>Non-EMU</i>	1.5	1.5	- 9.2	5.8
UK	1.3	1.4	-10.0	6.1
Switzerland	2.7	1.0	- 6.5	4.0
Japan	0.8	0.8	- 5.8	2.5
<i>Asia ex Japan</i>	6.2	5.2	- 1.0	6.8
China	6.6	6.1	1.3	8.0
CEE	3.1	1.9	- 4.4	3.8
Latin America	0.1	- 1.1	- 7.6	3.3
World	3.5	2.7	- 5.0	5.4

INFLATION

	2018	2019f	2020f	2021f
US	2.4	1.8	0.4	1.4
<i>Euro area</i>	1.8	1.2	0.3	1.2
Germany	1.9	1.4	0.3	1.4
France	2.1	1.3	0.3	1.2
Italy	1.1	0.8	- 0.1	0.9
<i>Non-EMU</i>	2.3	1.7	0.6	1.3
UK	2.5	1.8	0.6	1.3
Switzerland	0.9	0.4	- 0.5	0.3
Japan	1.0	0.5	- 0.1	0.0
<i>Asia ex Japan</i>	2.6	2.8	2.2	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

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

FINANCIAL MARKETS

3-month LIBOR					Corporate Bond Spreads				
	Current	3M	6M	12M		Current	3M	6M	12M
USD	0.30	0.40	0.50	0.70	BofAML Non-Financial	147	130	125	130
EUR	-0.41	-0.20	-0.45	-0.45	BofAML Financial	143	130	125	130
JPY	-0.05	-0.10	-0.10	-0.10	Forex	Current	3M	6M	12M
GBP	0.15	0.15	0.15	0.15	EUR/USD	1.12	1.13	1.15	1.17
CHF	-0.68	-0.60	-0.75	-0.75	USD/JPY	108	107	106	105
10Y Government Bonds	Current	3M	6M	12M	EUR/JPY	121	121	122	123
US	0.67	0.75	0.85	0.90	GBP/USD	1.24	1.23	1.31	1.34
Euro-Area	-0.43	-0.40	-0.35	-0.30	EUR/GBP	0.90	0.92	0.88	0.87
France	-0.10	-0.10	-0.05	0.00	EUR/CHF	1.06	1.07	1.09	1.10
Italy	1.21	1.20	1.25	1.25	Equities	Current	3M	6M	12M
Japan	0.04	0.00	0.00	0.05	S&P500	3115	3170	3195	3245
UK	0.19	0.25	0.30	0.35	MSCI EMU	115.0	117.0	118.0	117.5
Switzerland	-0.41	-0.40	-0.35	-0.30	TOPIX	1547	1560	1575	1590
Spreads	Current	3M	6M	12M	FTSE	6189	6240	6265	6280
GIIPS	125	120	120	115	SMI	10108	10300	10395	10310
BofAML Covered Bonds	42	40	40	35					
BofAML EM Gvt. Bonds (in USD)	401	395	390	380					

As of 02.07.20 (3-day-average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Government Bonds (10Y)	US	0.68	0.75	0.82
	Germany	-0.50	-0.40	-0.30
	UK	0.21	0.25	0.29
	Switzerland	-0.50	-0.40	-0.29
	10Y-GIIPS Spread	94	120	146
Spreads	BofAML Covered Bonds	33	40	47
	BofAML IG Non Financial	111	130	149
	BofAML IG Financial	112	130	148
	BofAML EM (in USD)	355	395	435
Forex	EUR/USD	1.10	1.13	1.16
	USD/JPY	103	107	111
	EUR/GBP	0.89	0.92	0.95
	EUR/CHF	1.05	1.07	1.09
Equities	S&P500	3,023	3,170	3,317
	MSCI EMU	110.9	117.0	123.1
	TOPIX	1,468	1,560	1,652
	FTSE 100	5,941	6,240	6,539
	SMI	9,850	10,300	10,750

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Government Bonds (10Y)	US	0.74	0.90	1.06
	Germany	-0.48	-0.30	-0.12
	UK	0.27	0.35	0.43
	Switzerland	-0.50	-0.30	-0.10
	10Y-GIIPS Spread	68	115	162
Spreads	BofAML Covered Bonds	20	35	50
	BofAML IG Non Financial	95	130	165
	BofAML IG Financial	97	130	163
	BofAML EM (in USD)	300	380	460
Forex	EUR/USD	1.10	1.17	1.24
	USD/JPY	97	105	113
	EUR/GBP	0.81	0.87	0.93
	EUR/CHF	1.04	1.10	1.16
Equities	S&P500	2,970	3,245	3,520
	MSCI EMU	104.3	117.5	130.7
	TOPIX	1,390	1,590	1,790
	FTSE 100	5,690	6,280	6,870
	SMI	9,407	10,310	11,213

*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, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

Imprint

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