



GENERALI
INVESTMENTS

Market Perspectives

Reflation boon and bane

March 2021



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Global View – Reflation boon and bane

Thomas Hempell / Vincent Chaigneau

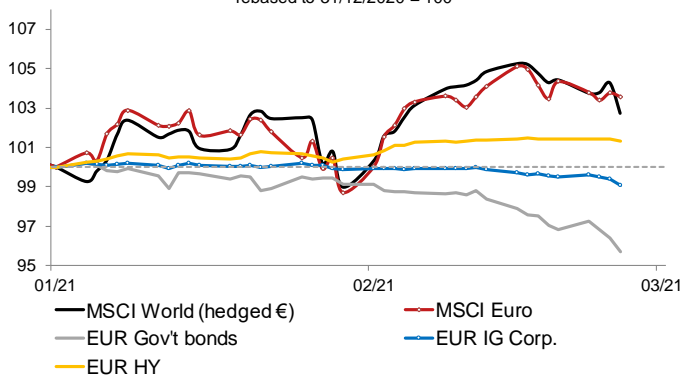
- While acknowledging stretched investor positions and residual risks from Covid-19 mutations, we expect a strong economic rebound in the spring to keep financial conditions underpinned.
- An intensifying US inflation debate, however, poses risks for fixed income. Equities should prove resilient, but the recent pick-up in real yields deserves to be watched. It is more toxic for highly valued risk assets, incl. Growth stocks.
- Overall, we maintain a moderate pro-risk tilt in our portfolios, with potential equity setbacks providing buying opportunities into a broader ‘spring reopening’.

An accelerated global reflation trade and solid Q4 earnings propelled equities to fresh highs by mid-February. The sharp rise in global yields through February has started to shake lofty valuations, but our maintained pro-risk tilt has paid off, with Govies underperforming other assets.

Looking ahead, the fortune of global economies and markets still hinges on the control of the Covid-19 pandemic. New infections and deaths have been falling sharply since January, but in many instances only amid renewed lockdowns. Fortunately, their economic harm has proven much milder than in spring, as we have learnt how to cope with restrictions. Front-runners in the vaccine race (Israel, UK) are reporting promising results.

Total returns by asset classes

rebased to 31/12/2020 = 100



Fast vaccination is the surest way to economic reopening. EU is lagging the UK and US, but accelerated production and improved logistics may still allow for inoculating the most vulnerable people and front-line health care workers by May. Encouragingly, evidence thus far suggests that vaccines still cover new variants, if less effectively. Faster mutations may require vaccine adjustments and booster shots, but the central scenario sees a boom into summer.

Intensifying inflation debate

Meanwhile, the already vivid inflation debate will intensify. The US administration is set to deliver another fiscal

package whose size may be quite close to President Biden's plan (we assume US\$ 1.6 tr). This will greatly amplify the economic rebound and coincide with a sharp increase in annual inflation rates in spring (mostly in the US, but also EA) on statistical effects from last year's collapse in prices for oil and other temporary items. The Fed will continue to flag the temporary nature of the looming inflation spike, while employment is still almost 10m short of pre-crisis levels. But amid a powerful cyclical rebound, markets may question the dovish Fed commitments, fuelling speculation about the tapering of its US\$120 bn bond purchases and the timing of rates hikes.

As long as the rise in yield remains orderly, as we expect, this will cap but not derail the overall friendly risk environment. Risks are rising, however. First, negative convexity hedging may cause a yield overshoot. Second, the whole investor community is not prepared for a significant rise in yields, following a secular decline; broader hedging could hurt. Third, the early move in yields was driven by inflation breakevens, but real yields have picked up of late – a more toxic development for risk assets. A larger move there is unlikely before we get closer to tapering, but the recent ‘stress’ is an early warning of possibly chaotic developments this autumn.

10-Year Bond Yields	Current*	3M	6M	12M
US	1.37	1.50	1.60	1.70
Germany	-0.32	-0.30	-0.25	-0.20
Italy	0.61	0.60	0.65	0.75
Japan	0.12	0.15	0.15	0.20
Forex	Current*	3M	6M	12M
EUR/USD	1.21	1.23	1.25	1.26
USD/JPY	105	105	104	102
EUR/GBP	0.86	0.85	0.86	0.87
Equities	Current*	3M	6M	12M
S&P500	3894	3910	3940	4000
MSCI EMU	132.7	132.0	133.0	135.5

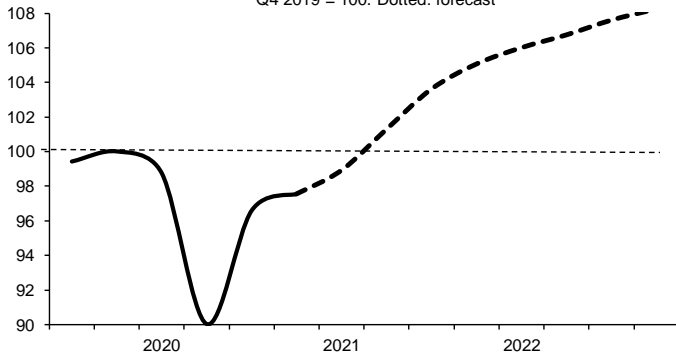
For now we retain a pro-risk bias, if only because Govies are least attractive. While we acknowledge pro-risk positioning among investors and frothy valuations, we note that the recent rise in real yields (+40 bps in 10y TIPS) has been small compared to the 2013 taper tantrum (+150 bps). We are also less concerned about a sell-off in EUR fixed income. True reflation is much more distant in the EA, and the ECB will lean against the rise in real yields via QE. The new Italian government intends to complement Recovery Fund spending with reforms (legal system, public administration), keeping risk premia low. Credit spreads are tight but contained default rates and persistent ECB support help. We more carefully watch EM exposure on headwinds from higher US yields. The short-term USD outlook is more balanced as US yields rise faster, but the global cyclical upswing supports a bearish bias.

USA

Paolo Zanghieri

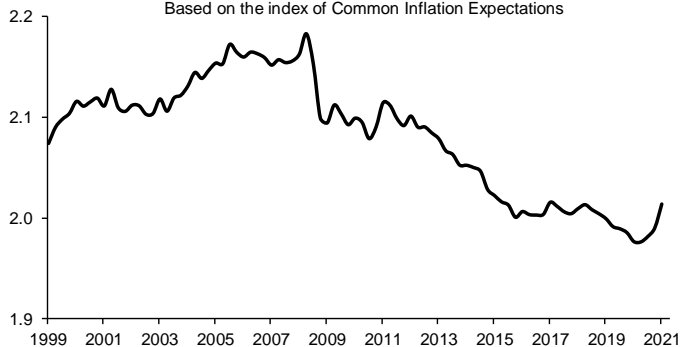
Real GDP level

Q4 2019 = 100. Dotted: forecast

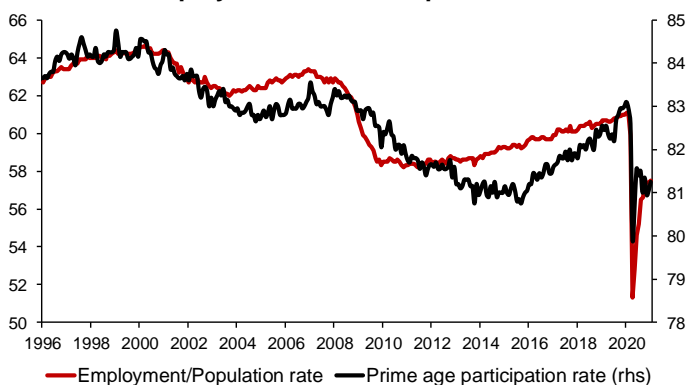


10-year expected PCE inflation

Based on the index of Common Inflation Expectations



Employment and Participation rate



- **Positive surprises for Q1 and the prospect of a bigger fiscal stimulus led us to revise again up our 2021 growth forecast to 6.8%.**
- **The expected large jump in domestic demand has raised fears of an inflation overshooting. But following some volatility in the short term, inflation will moderate again.**
- **Fed officials stressed that the priority remains healing the labour market and that inflation is not a concern: QE tapering is only expected for the first half of next year at the earliest.**

The first data for Q1 are surprising on the upside. Real retail sales were up 5% mom in January (6% yoy), signalling that consumption is catching up with the steady growth in manufacturing and construction. Moreover, the Biden administration is clearly willing to go ahead with its US\$ 1.9tn fiscal plan, bypassing the Republican opposition in the Senate. We updated our expectation for the final size of the package from US\$ 1tn to 1.6tn. The strong start into the year and a bigger fiscal push translate into an upward revision, to 6.8%, of our growth forecast for 2021. Strong growth should continue in 2022, with GDP up by another 4.8%.

Inflation fears rise...

The unprecedented increase in domestic demand is fuelling concerns about a return of inflation, as shown by measures based on asset prices. The 5year-5year inflation breakeven has climbed to above 5% a level last seen in spring 2019. Our new gauge of inflation expectations, which extracts information from financial markets and surveys, show that expected inflation has rapidly risen back to the 2018 level, but remains substantially below the ones seen before the oil price collapse in 2014/15. Looking through the Q2 volatility due to base effects and the reopening of the economy, we expect inflation to build up moderately in the second half of the year. PCE inflation should reach the Fed's 2% objective in the final part of next year. Risks are tilted to the upside, as the sheer size of the demand push may be too strong for the existing productive capacity, but only a prolonged period of high inflation would affect significantly expectations.

...but employment remains the Fed's priority

This is essentially the Fed's point of view as well. The recent statements by Chair Powell and other FOMC members insisted on the ongoing weakness of the labour market and the marked slowdown in employment growth seen over the last months. Given the still low level of expected and actual inflation (Core CPI was up by just 1.4% yoy in January), the usual unemployment-inflation trade-off gives way to a hierarchy, with addressing the labour market as a clear priority. This means that any tapering would have to wait for clear signs of improvement in employment and labour market participation. Our estimate is for tapering to begin no earlier than in the first half of next year.

Euro Area

Martin Wolburg

- Efforts to contain the pandemic proved successful. Amid ongoing vaccination we see scope for a gradual easing of lockdown measures.
- We stick to our 2021 growth forecast of 4.0% but now see the risks broadly balanced.
- At its March meeting the ECB will make clear that it looks through the forthcoming, mainly oil-price driven temporary inflation spike.

Over the past weeks the pandemic situation slightly turned to the better. The number of new cases came down and in various countries first steps towards an easing of lockdown measures are in the pipeline. Vaccination continues albeit still being hampered by supply shortages and logistical problems. Bottom line, we stick to our view that by May the vaccination of the critical groups will be completed laying the ground for a significant and lasting unwinding of stringency measures thereafter, in line with our base case.

Firms believe in recovery and the global environment

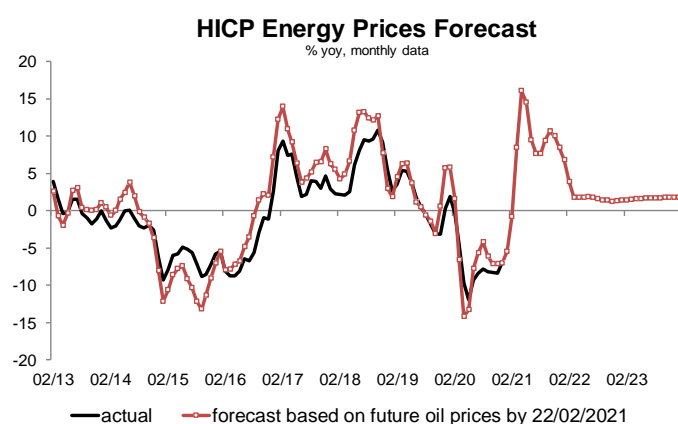
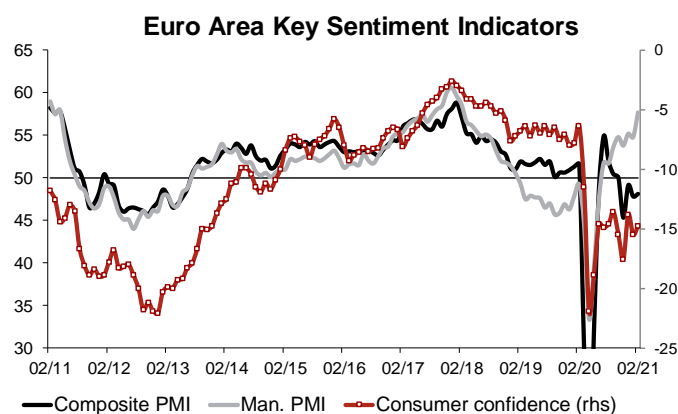
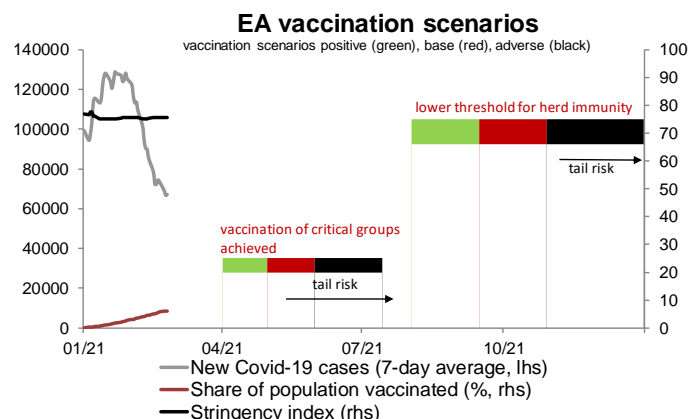
This view is also reflected in latest business surveys. The February composite PMI advanced by 0.3 index points to 48.1. This level still remains consistent with shrinking activity. But expectations also in the hard-hit services sector improved to the highest since 04/2018 reflecting a high degree of confidence that the pandemic restrictions will soon be overcome. The second key reason for improving business confidence is the favourable external environment. Strong growth in China and in the US (with even some more upside risk) bode very well for the export-dependent manufacturing sector whose confidence rose to a three-year high amid increased export orders.

All in all, we see no reason to revise our growth forecasts of 4.0% for 2021 and 5.3% for 2022. We view the surrounding risks as broadly balanced: Positive external growth risks are to be weighted against the worsening of the pandemic (e.g. mutations) and the fallout from rising NPLs which will increase with the length of the crisis.

ECB to look through forthcoming inflation spike

Following the jump of headline inflation back into positive territory in January (from -0.3% yoy to 0.9% yoy), it will rise further in the months to come. Mainly on the back of base effects and the latest increase of oil prices, inflation rates above the ECB's target of 2% in April/May are likely before abating later in the year again (see also our latest [Focal Point](#)). Annual inflation is set to average 1.5% in 2021 (from 0.3%) and to recede again to 1.2% in 2022.

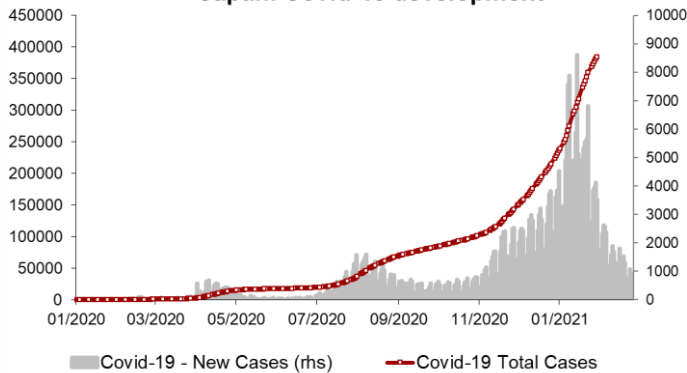
We expect the ECB to signal at its March 11 meeting that it will look through this short-term volatility but focus on the longer term outlook making clear that a discussion about unwinding the highly accommodative policy stance is premature. Instead, the Governing Council will maintain its dovish tilt.



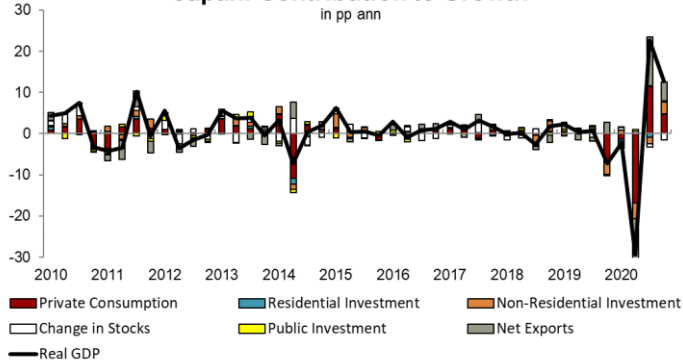
Japan

Christoph Siepmann

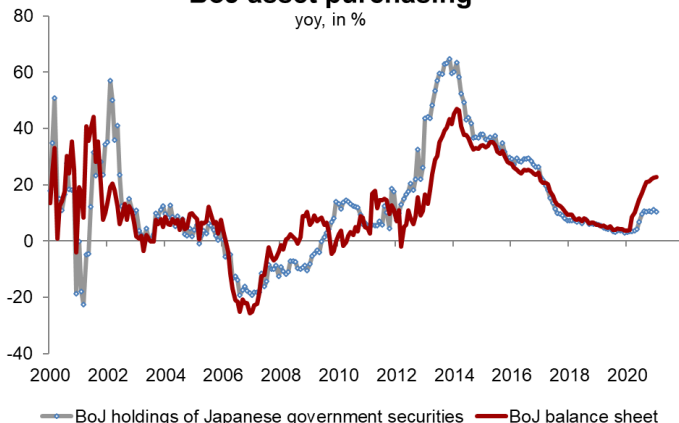
Japan: Covid-19 development



Japan: Contribution to Growth



BoJ asset purchasing



- Japan's Q4 GDP growth surprised on the upside, leading us to revise our 2021 growth outlook up.
- Rising oil prices will likely help to lift CPI inflation into positive territory by early Q2.
- The BoJ policy review will not touch “yield curve control” but could modify ETF purchases and possibly widen the long-term yield band.

According to a first estimate, Japan's Q4 2020 GDP surprised on the upside. The economy grew by 3.0% qoq or 12.7% qoq annualized (ann), after 22.7% qoq ann in Q3. Exports were a major driver (+52.3% qoq ann), benefitting from the strength in China. However, the main surprise came from business investment which rose by 19.4% qoq ann, after -9.2% qoq ann in Q3.

With regard to Q1 2021, we expect GDP growth to fall back into negative territory, caused by the lockdown measures to fight the third wave of Covid-19 infections. The measures officially extend until March 7, but receding fresh cases have led to demands from some prefectures to exit more early. Vaccination has started on Feb. 17 but PM Suga's pledge to vaccinate the whole population in H1 2021 looks hard to fulfil. Moreover, opinion polls showed some scepticism within the population. About 38% said that they do not intend to get inoculated. These headwinds may delay a full recovery of private consumption. Nevertheless, we see Japan's GDP to start recovering in Q2. The early lifting of the state of emergency and the base effect from Q4 made us revise our growth outlook for 2021 to 2.3% (from 1.8% before), which translates in a growth rate of 3.5% in Japan's fiscal year 2021.

CPI inflation narrowed to -0.6% yoy in January (after -1.2% yoy in December) as subsidies from the “Go Travel” program dropped out. Inflation excluding fresh food and energy rose 0.1% yoy. The latter already hints at the high importance of energy prices. Accordingly, the recent rise in oil prices is likely to lift Japan's inflation out of the negative territory around the turn of the quarter. We revise our inflation outlook up to 0.1% (from -0.3% before) in 2021.

BoJ policy review intended to improve sustainability

The BoJ will publish its monetary policy decision and review yoyo on March 18-19. The bank is likely to leave its yield curve control approach untouched but announced to improve its sustainability and efficiency. Markets have discussed a range of options: E.g. ETF purchases could be handled more flexibly (target to be dropped) in order not to add to stock market strength. Moreover, the BoJ could widen the range around its 10y yield target (0% +/- 20 bps) by 10-20 bps. This would indirectly allow to mitigate pressures on very long-term yields and thus reduce negative side-effects on bank's profitability.

China

Christoph Siepmann

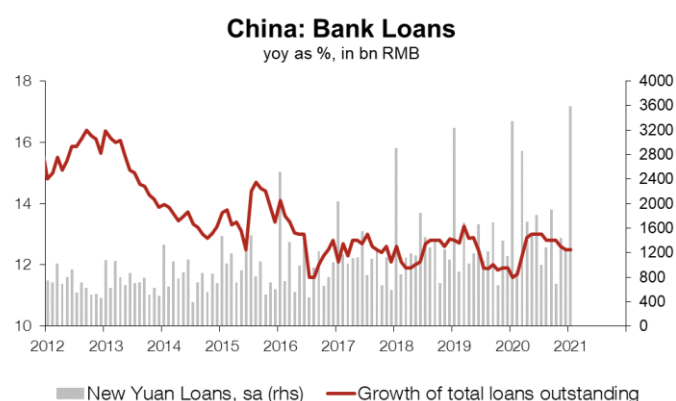
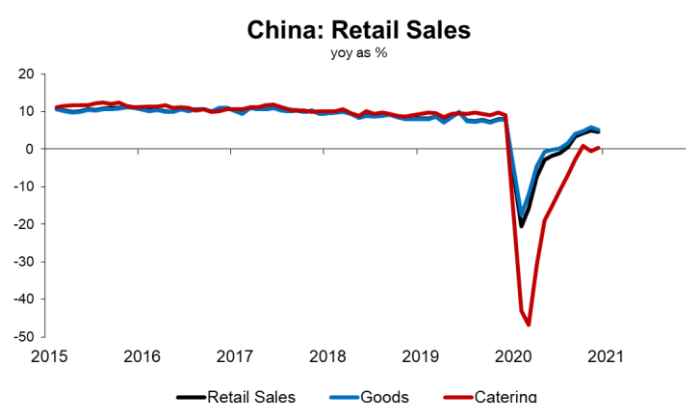
- China largely managed to keep the latest Covid-19 outbreak in check with likely only a limited impact on private consumption.
- Given the continued recovery, Beijing will embark on more policy normalization. Accordingly, we see less growth dynamics over the course of the year.

China looks to have largely managed the recent Covid-19 outbreak. Authorities had introduced drastic quarantine measures and urged people to stay put during the Chinese New Year holiday season (Feb. 11–17). There were fears that private consumption could suffer significantly from these measures. This would be rather unwelcome as retail sales have already proven to be the laggard in the recovery. However, while travel and accommodation suffered, some data suggest that entertainment, catering and related sectors benefitted significantly. Thus, the overall impact – given only partial information – seems limited for now, adding to the expectation that the private consumption recovery will continue.

As usual, China publishes only a reduced macroeconomic data set in February due to the holiday season. Manufacturing PMIs slowed, mainly caused by weaker new export orders following fresh lockdowns around the globe. However, this PMI component and de-facto realized exports (not published) were rather disconnected of late as special pandemic-related demand overcompensated lower exports otherwise. This will likely again be the case. Further out, global vaccination programs and the related recovery in international demand combined with large fiscal programs (esp. in the US) will continue to benefit China's exports. However, the net effect will become slightly smaller with the ongoing recovery in China's consumption.

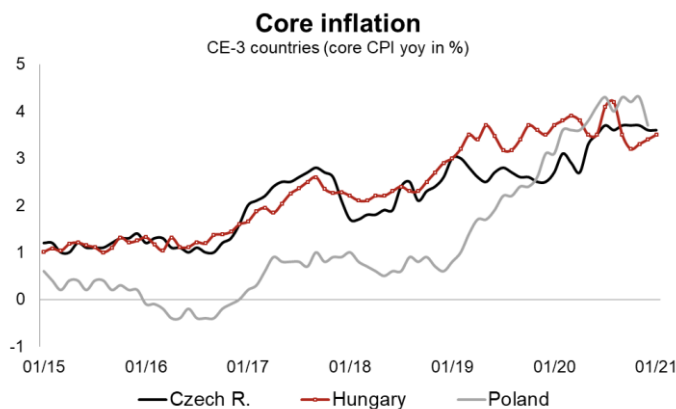
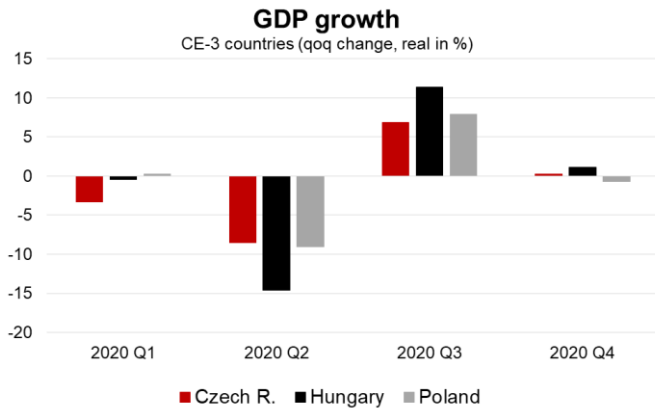
Growth dynamics to slow but Q1 yoy rate buoyant

Monetary data were strong in January with new yuan loans and TSF reaching a record/near-record high. However, January data typically involve a heavy seasonal pattern. By contrast, outstanding loan and TSF growth edged down. Together with less liquidity supply the data support our view of a cautious shift of monetary policy toward more normalisation. The effect will likely become more visible in H2 2021, while less support from the fiscal side will be felt more immediately. The fiscal impulse is likely to diminish by about 2.5 pp in 2021 compared to the previous year. More details will likely come up on the next NPC meeting, which is scheduled to open on March 5. Accordingly, we expect some slowing in qoq growth rates. Nevertheless, Q1 GDP growth in the usual yoy terms will likely be buoyant (around 18% yoy) due to the large base effect. We revised our growth forecast for 2021 up from 7.8% to 8.2%. Inflation has returned into slightly negative territory in January mainly due to base effects. This will vanish over the course of Q1. We kept our inflation expectation unchanged at 1.5% for 2021.



Central and Eastern Europe

Radomír Jáč



- The CE-3 region reported a better than expected GDP performance in Q4 2020. The scenario of economic recovery stays in place for 2021 but lockdowns create heightened uncertainty.
- Core inflation increased or was stable at a high level in all CE-3 economies in January.
- The Czech CNB forecast assumes interest rate hikes for 2021. The Hungarian MNB prefers stable rates for now as it expects volatility in CPI. Poland is likely to stay on hold throughout 2021.

The region proved a solid resilience against pandemic restrictions in the late 2020 with the Czech Republic and Hungary reporting GDP increases in Q4 and Poland showing only a slight contraction in quarter-on-quarter terms. The ongoing lockdowns create uncertainty for 2021 but the recovery scenario remains in place. The Hungarian central bank said it expects strong GDP growth for 2021 in a range between 5% and 6%.

Price pressures at the same time remain relatively strong with core CPI stable or even higher (3.5% yoy and more in all CE-3 countries) at the start of the new year. Central banks in Hungary and Poland are unlikely to cut their interest rates in such constellation while the Czech CNB may consider a rate hike in H2.

Czech central bank may tighten its policy in late 2021

The Czech CNB left its key interest rate on hold at 0.25% in February but its fresh quarterly forecast gave the same message as the previous one released in November. It expects three rate hikes for 2021, the first one in Q2. The CNB Board says that risks related to pandemic are likely to lead to a later start of normalization in key rates. However, we think that a rate hike will become a relevant topic in H2 if the scenario of economic recovery materializes.

In Hungary, the MNB is bullish on GDP outlook and sees inflation at or slightly above 3.5% on average in 2021 vs. its target set at 3%. This leads the MNB to keep the base rate stable at 0.60% and the deposit rate at 0.75% while the central bank states that it is key to keep short-term yields at a safe distance above zero in the current environment. The MNB at the same time tries to keep longer yields at relatively low levels via QE and liquidity operations.

The Polish NBP is likely to keep its key rate on hold at the current level of 0.10% at least until early 2022. The central bank says that a rate cut cannot be ruled out if economic conditions were to worsen drastically but we note that such scenario does not seem likely as GDP exceeds the NBP expectations while inflation will stay at or above the 2.5% target. In contrast, the possibility of a rate hike in 2021 was excluded by several members of the Polish MPC.

Main Forecasts	2019	2020	2021f	2022f
Czech Republic				
GDP	2.3	-5.6	3.0	4.5
Consumer prices	2.8	3.2	2.4	2.0
Central bank's key rate	2.00	0.25	0.50	1.25
Hungary				
GDP	4.6	-5.2	5.2	4.0
Consumer prices	3.4	3.3	3.3	3.0
Central bank's key rate	0.90	0.60	0.60	0.90
Poland				
GDP	4.6	-2.7	4.0	4.2
Consumer prices	2.3	3.4	2.5	2.5
Central bank's key rate	1.50	0.10	0.10	0.75

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

Government Bonds

Florian Späte

- The sell-off on international bond markets continued in February. In contrast to the previous months, real yields were the driving force.
- Notwithstanding the strong increase in recent weeks, we see the way paved for even higher yields going forward. This applies all the more to US yields as the Fed is unlikely to intervene as strongly as the ECB in bond markets.
- Euro area non-core markets entered choppy waters. Although the successful formation of a new Italian government supported Italian BTPs in the first half of February, the bearish bond market environment ultimately weighed on non-core bonds.

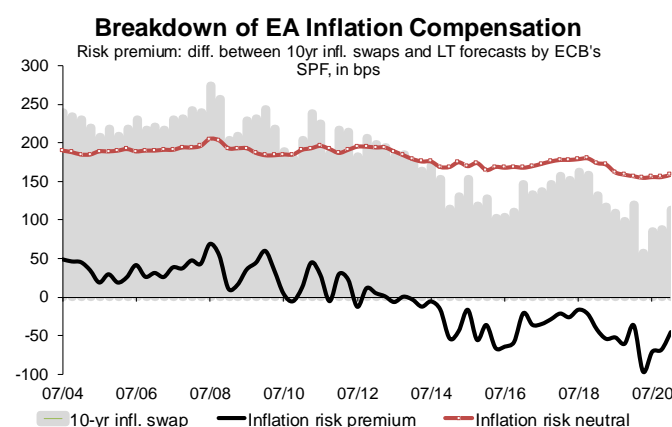
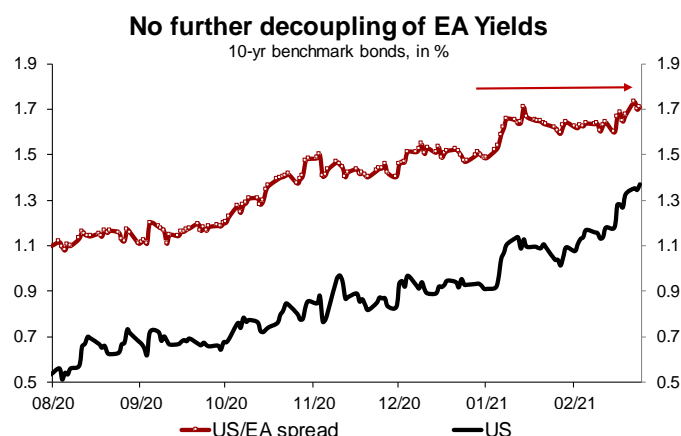
After a long phase of sideways movement international yields have started to rise noticeably upwards. Triggered by the victory of the US Democrats in Georgia and the accompanying expectation of a bolder fiscal package due to a majority in the Senate, US yields have risen already in January. In February, the rise was more broad-based and other bond markets sold off as well. On balance, 10-year US yields rose by almost 40 bps and 10-year Bund yields by almost 30 bps. In light of the still dovish monetary policy stance the short end of the curve unsurprisingly lagged behind so that yield curves bear steepened.

It is noteworthy that in contrast to preceding months inflation expectations were not the main driving force for higher yields. In fact, 10-year inflation swaps even slightly decreased in the US and rose only moderately in the euro area. Processing vaccination and an emerging strong economic recovery (particularly in the US) has triggered higher real yields on both sides of the Atlantic. Although real yields are still on a very low level they have noticeably broken away from their lows.

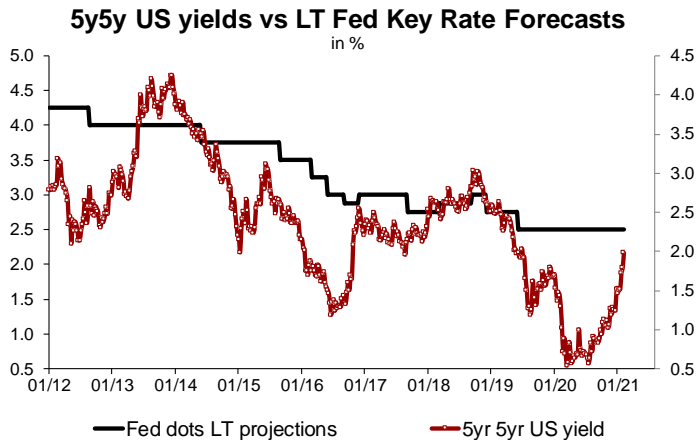
Further increase in euro area inflation expectations

However, the majority of the increase in yields since spring 2020 continues to be due to rising inflation expectations. The combination of expansionary monetary and fiscal policy and an expected strong economic recovery created the perfect storm for inflation expectations. But, it should be noted that US inflation swaps are meanwhile close to a long-term high while euro area inflation expectations are still slightly below their long-term average. Accordingly, we see more scope for euro area inflation expectations to rise lastingly further (although a spike in US headline inflation in spring might trigger a further rise in the US as well).

Inflation compensation can be divided into an inflation risk premium and a risk-neutral (basically the expectation) component. The chart on the right shows that the bulk of the rise in the euro area is due to a soaring inflation risk premium (the pattern in the US looks similar). The inflation risk neutral component hardly moved and is forecast to rise



Government Bonds



only more palpably in case the economic rebound gains momentum and if there are signs of increasing price pressure. However, the inflation risk premium is still rather low and amid the high degree of uncertainty there is scope for the term premium to rise more.

While the scope for sustainably higher US inflation expectations appears limited there is still leeway for US yields to rise. The cyclical rebound in the US will be particularly strong and the government bond net supply is forecast to reach new highs. In contrast to 2013 ('taper tantrum') real yields have hardly risen so far, leaving much leeway for a further rise. This applies even more as the Fed is unlikely to step up its QE buying. In fact, the central bank will take down less than in 2020 leaving the bulk of the supply to be absorbed by the private sector.

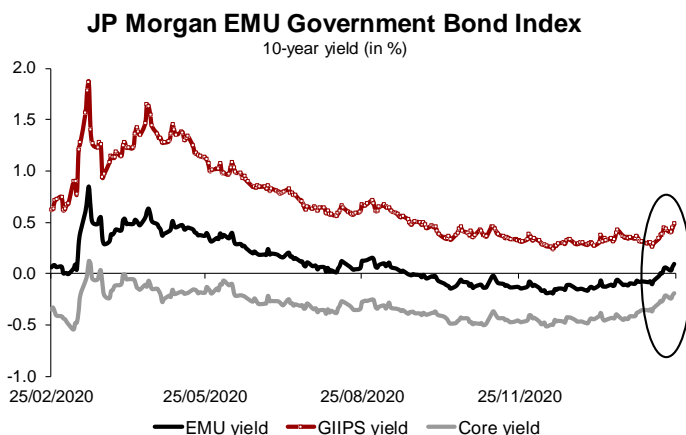
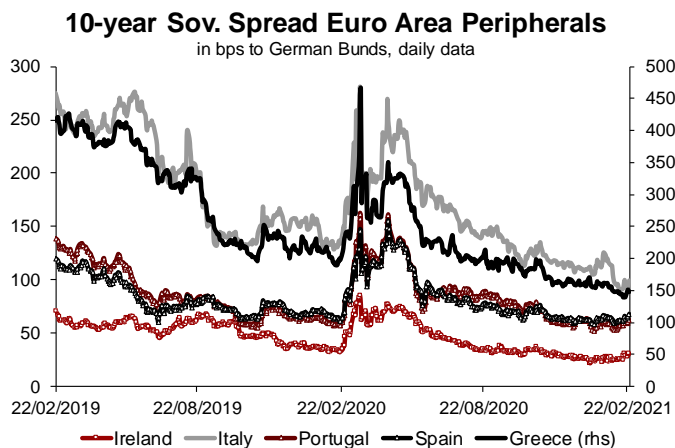
One caveat, however, is the current pricing of future Fed hikes. Financial markets have brought forward the first key rate hike in recent weeks. Meanwhile, a lift-off is expected already in Q3 2023. This appears a bit premature as the central bank stressed that it is in no hurry to hike rates. Our expectation of a first hike not before Q1 2024 indicates some future market re-pricing. Then again, the level of the 5-yr 5-yr forward yield indicates further leeway for higher yields. All in, we forecast long-dated US yields to rise further (12-month forecast for 10-year yields: 1.70%).

This will trigger somewhat higher euro area core yields as well. However, the lower economic momentum and a more active ECB are likely to limit the extent of the yield increase. In recent days, several ECB officials have already expressed their concerns about the speed and the scale of the yield increase. Ultimately, the ECB has the tools (e.g. PEPP) to intervene and it appears committed to apply its instruments. Accordingly, the forecast 10-year euro area yield increase on a 12-month horizon is more muted (-0.20%).

ECB unlikely to stand idly and watch yield increase

Driven by a supportive news flow euro area non-core sovereign bond spreads tightened at the beginning of February. Particularly, Italian BTPs benefitted from the formation of a new government led by former ECB President Mario Draghi.

Later on, the sentiment deteriorated as the increase in core yields was no longer balanced by tighter spreads. In contrast, risk premia increased amplifying the effect of higher core yields. Meanwhile, the non-core yield level is back to September 2020 levels triggering new concerns about the debt sustainability of heavy indebted countries. Yet, we doubt that the ECB will risk the emergence of a vicious circle of higher yield levels and increasing debt sustainability concerns. Rather, we assume that the ECB will follow its words with action and step up its weekly PEPP purchases in order to prevent (real) yields from rising significantly above current levels.



Credit

Elisa Belgacem

- The compression trade is still on, after IG in January, HY spreads are now very close to pre-Covid levels.
- High carry products are the best performers in the context of fast-rising rates.
- Expensive valuations continue to be counterbalanced by extraordinary technical.
- HY rated companies will benefit the most from rising inflation, that supports the deleveraging.

The past few days have seen government bond yields make new highs, but this time the composition of the selloff has shifted towards real yields as opposed to breakeven inflation. For credit markets, this shift has not derailed risk appetite.

Both IG and HY cash spreads tightened over the period demonstrating the ability of credit markets to digest higher rates. The current expensive valuations will constrain the ability of spreads to materially tighten in this context of rate upward moves, but thanks to extraordinary technicals, we expect a further 10bp of IG credit spreads tightening for the remainder of the year. Indeed, we remain confident credit spreads will not necessarily drift wider as the reflation theme continues to push real yields higher.

We also received the confirmation that the ECB will act as a stabiliser of credit markets at rather tight levels via the PEPP program as the first weeks of January, with credit spreads approaching 100bp versus Bund, the European central bank has resumed small purchases of credit in its emergency program while it barely bought any corporate bonds in October and November last year.

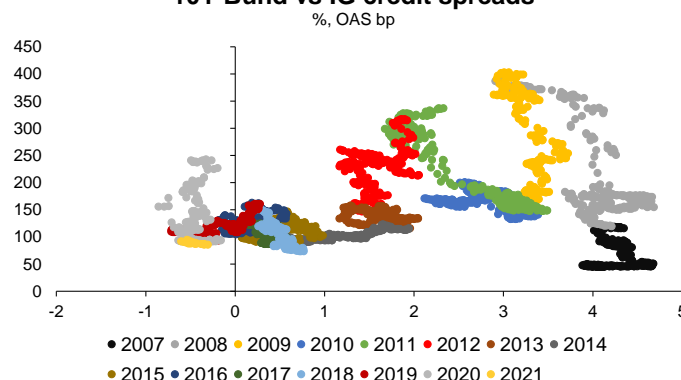
The moment of truth for default rates approaches, we expect the confirmation that European default rates will be peaking between 5% and 6% at the end of this quarter, which remains way below 2009 numbers. However, unlike Moody's, we expect those default rates to remain above LT average at around 4% by the end of 2021 when the fiscal support starts to be withdrawn.

We remain overweight HY

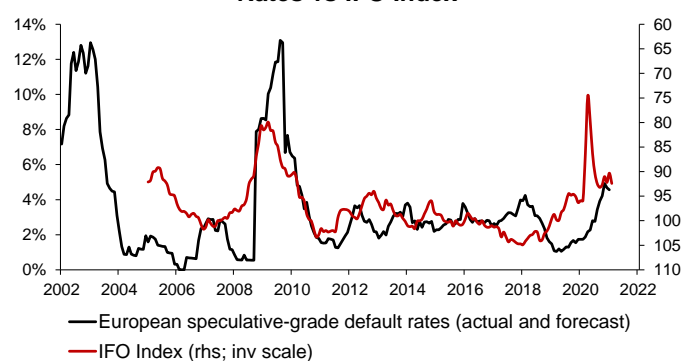
Hence going forward, we expect IG to grind gradually tighter while HY should outperform, providing better cushioning effect to higher rates. Moreover higher inflation is benefiting credit in general but is a true tailwind to HY in supporting the deleveraging of companies although it might be more positive for some sectors like real estate and financials while retail would have more difficulties passing on the extra cost to customers.

Within IG we keep a pro-cyclical bias and favour BBB and subordinated bonds but within HY, we retain a preference for BBs as they are lagging single-Bs while still displaying decent carry, and retain our preference for corporate hybrids and AT1s which are more protective than pure HY.

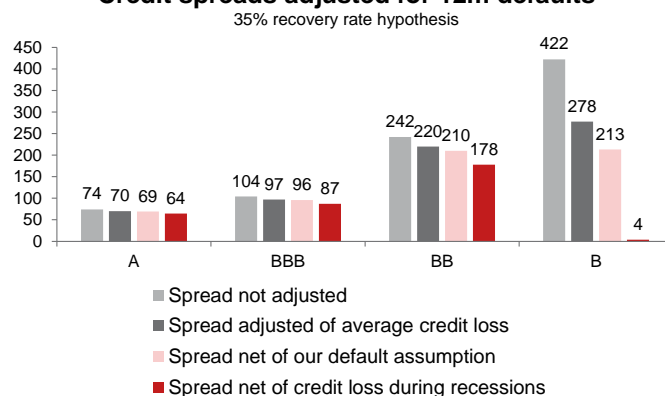
10Y Bund vs IG credit spreads



Moody's European Speculative-Grade Default Rates vs IFO Index

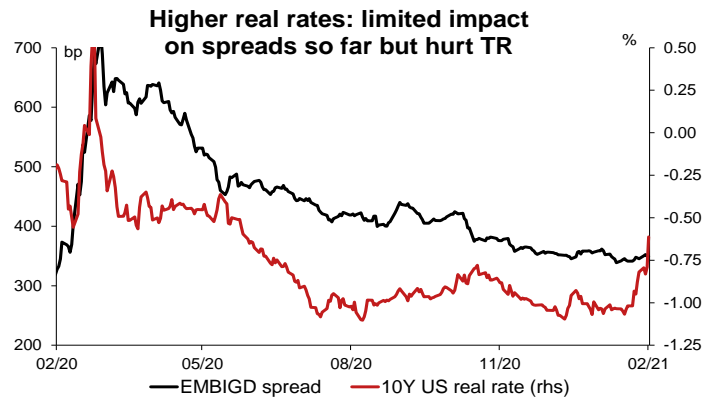


Credit spreads adjusted for 12m defaults



EM sovereign bonds

Guillaume Tresca



- We reduce risk further and turn neutral on EM sovereign bonds amid higher US rate volatility
- Medium-term outlook is still supportive and we do not expect a repetition of 2013.
- We favour BBs and EUR bonds offer an attractive pickup over USD bonds. A new SDR allocation after the G20 could temporarily help weak names.

After reducing risk last month, we reduce further our position and turn neutral on EM sovereign bonds. The acceleration of the 10Y US nominal yield rise has been recently driven by a rapid increase of the real yields and there could be further rate volatility that would be detrimental to EM fixed income total return. That said, we keep a positive medium-term outlook as we do not expect a repetition of the 2013 drama when the taper tantrum was the start of an EM bear market. We are more like in Q1 2017 during the reflation trade following the President Trump election. Fed Chairman Powell has been clear that tapering was not on the cards. More globally, EM external vulnerabilities are less acute, current accounts are more balanced and above all the US bond sell-off has been partially driven by better growth prospects and a large US fiscal stimulus that will ultimately be beneficial to EMs. Likewise, the global rise of commodity prices will support EM growth. As evidence of a still supportive EM environment, the widening of EM external debt spreads have been contained to only c. 7bp.

Still positive. Carry provides a buffer to the TR

1Y TR for different scenarios, BofA index

OAS	US 8Y	current							
spread	0.80%	0.90%	1.10%	1.30%	1.50%	1.70%	1.90%	2.10%	
230	8.68%	8.60%	8.42%	8.25%	8.08%	7.91%	7.74%	7.57%	
240	7.83%	7.74%	7.57%	7.40%	7.23%	7.06%	6.89%	6.72%	
250	6.97%	6.89%	6.72%	6.54%	6.37%	6.20%	6.03%	5.86%	
260	6.12%	6.03%	5.86%	5.69%	5.52%	5.35%	5.18%	5.01%	
270	5.26%	5.18%	5.01%	4.84%	4.66%	4.49%	4.32%	4.15%	
280	4.41%	4.32%	4.15%	3.98%	3.81%	3.64%	3.47%	3.30%	
290	3.55%	3.47%	3.30%	3.13%	2.96%	2.78%	2.61%	2.44%	
300	2.70%	2.61%	2.44%	2.27%	2.10%	1.93%	1.76%	1.59%	
310	1.84%	1.76%	1.59%	1.42%	1.25%	1.08%	0.90%	0.73%	
320	0.99%	0.90%	0.73%	0.56%	0.39%	0.22%	0.05%	-0.12%	
330	0.14%	0.05%	-0.12%	-0.29%	-0.46%	-0.63%	-0.80%	-0.98%	

one month ago

Turning even more selective

Given the new backdrop, there are few EM names we like and we remain very selective. We continue to favour the BB bucket while we avoid the IG segment that does not offer any buffer to a US rate rise. We also avoid the B sector and frontier countries that could suffer from tighter liquidity conditions. We reduce the duration and prefer quasi-sovereigns and lower cash price bond. FX wise, despite the USD rate rise, EUR bond offer a better pickup over USD bonds especially in the HY segment for the same issuer and on an FX-hedged basis. The backend of the Romani EUR curve and the Kazakhstan EUR curve are offering an attractive pickup.

Mind the Common framework and the IMF SDR

Within the lower end of the rating spectrum, more differentiation is needed. The G20 meeting could lead to progress on a larger SDR allocation that could boost FX reserves and lead to tactical spread tightening on a selective basis. This positive short-term factor could be more than offset by the developments of the new G20 Common framework. Following the Ethiopia case, rating agencies have taken a harsh approach. Countries with unsustainable debt according to the IMF-WB DSA analysis could see some higher risk premium.



Currencies

Thomas Hempell

- Higher US yields and a strong US fiscal package make us trim, but not cancel our call for more USD weakness over the course of 2021.
- Tailwinds to GBP from fast vaccination and the fading spectre of negative rates may persist until a broader European recovery takes centre stage.
- EUR/CHF is more likely to plateau after the recent sharp rise, with the ECB determined to keep a lid on European yields.

The global reflation trade in February has left the USD broadly unscarred. A further brightening in global risk sentiment (a USD negative) was largely offset by the prospect of near term growth divergence (fast vaccination and an impending big new stimulus in the US).

We continue to think that the near-term outlook for the EUR/USD remains largely balanced, but that the ensuing spring recovery will trigger the next leg higher. The easing of political risk in Italy on the new government led by Mario Draghi has removed another drag to the euro. Given the likely sizable new US stimulus and higher US yields, however, we have moderately trimmed our 12-month target to 1.26 (from 1.28).

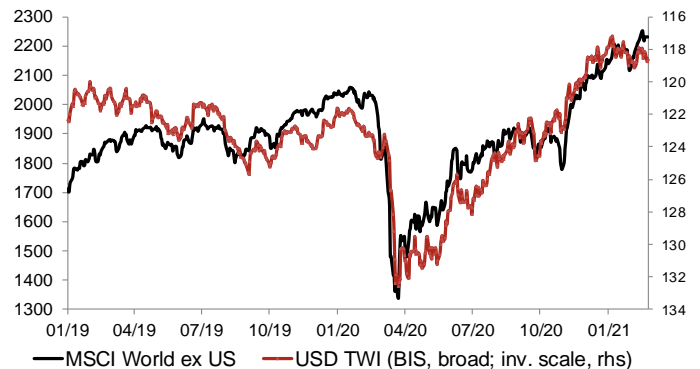
On similar grounds, we lift the 1-year USD/JPY forecast to 102, even though we stick to our expectations of broader USD weakness amid the global recovery around mid-year (incl. an EM FX bounce). This is based on our expectations that the Fed will look through a strong US inflation spike in April/May, keeping real rates in the US very low.

GBP benefitting from vaccination lead

The GBP has outpaced all major peers year-to-date (mid chart), gaining 4% against the EUR propelled by a significant lead in UK vaccination rates. With almost 30% of the population vaccinated, the UK and its dominant service sector is set to emerge from the lockdown with a significant lead vs. most advanced economies. The BoE virtually ruled out negative rates for the coming six months – and effectively for much longer given the economy's likely strong rebound by then. The resulting boost to yields and sterling (bottom chart) may still have legs short term. The lead in the economic rebound will peter out later in spring, however, with the euro area catching up, keeping a lid on sterling's mid-term upside. We lowered our 3-month target for EUR/GBP to 0.85 (from 0.88), but less so on a 12-month view (0.87).

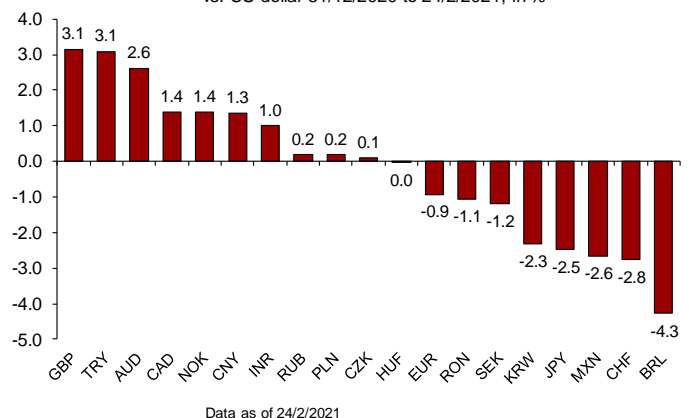
Meanwhile, EUR/CHF seems more likely headed for a pause, following a significant leg higher over the 2nd half of February hitting our summer target, helped by rebounding Bund yields. While the latter may consolidate at around current levels for a while, a further unwinding of safe-haven funds amid easing EMU worries should keep the CHF on a more gradual weakening trend further out.

Anticyclical USD

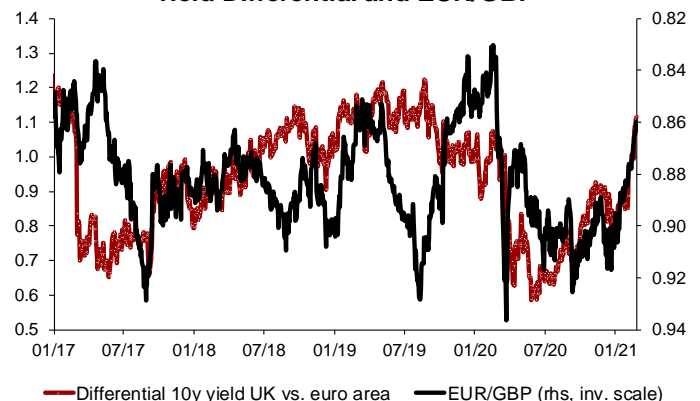


FX performance

vs. US dollar 31/12/2020 to 24/2/2021, in %



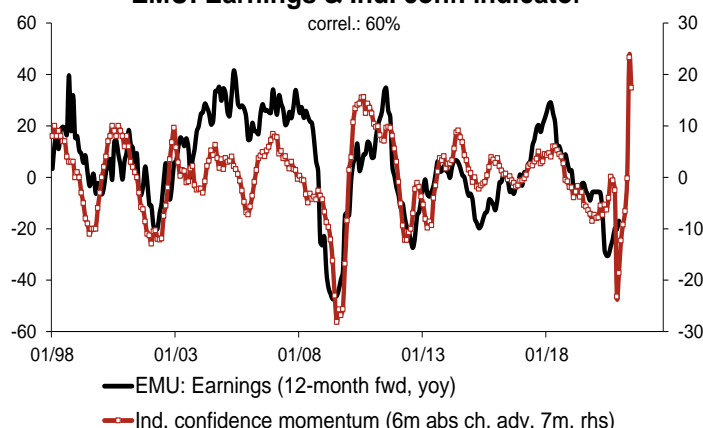
Yield Differential and EUR/GBP



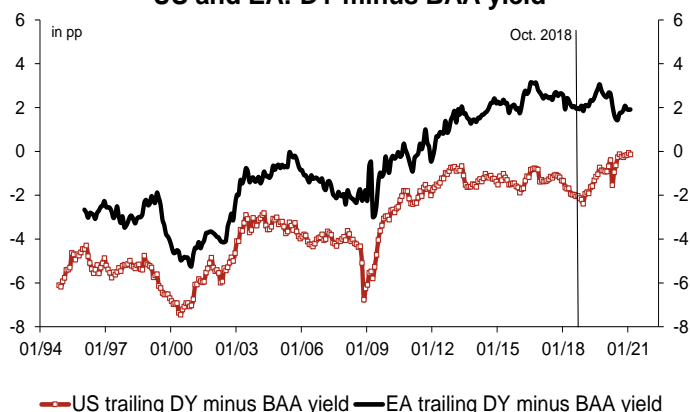
Equities

Michele Morganti / Vladimir Oleinikov

EMU: Earnings & Ind. conf. indicator



US and EA: DY minus BAA yield



MSCI EMU: Value indicator



- Continuing higher yields represent a game changer into a more reflationary scenario.
- PEs are increasingly at risk but, differently from 2018, earnings have not reached their peak yet. On the contrary, they will improve further in the US and the recovery in the EU is at the outset.
- A fall in PE with accelerating earnings can still produce a – milder – positive total return.
- Higher growth and yields in addition to policy support bode well for continuing sector rotation into Value (especially) and Cyclical.
- Risk: higher yields and positioning but we think investors should buy into market setbacks.
- We maintain a lower equity OW vs last month, favouring Japan, UK and EMs and EMU vs US over 12 months.

Over the last month, US 10-year rates increased by 35 bps, reaching 1.4%. This changes the equity environment into a more “inflationary one” in which market multiples (PE), especially in the US, should stabilize or even decrease from here (see our equity [focal point](#)). On the other side, higher yields induce more rotation into Value and Cyclical sectors (shorter duration) at the expense of Growth and Defensive ones (higher duration). Indeed, the EMU index (Value) was up 3.3% vs 2% of the S&P 500 and -1.3% of the Nasdaq index (Growth). The EU Value style outperformed the Growth one by 4pp and the Cyclical outperformed Defensives by 8pp.

A different picture from 2018 market peak

In October 2018, while yields increased, US 12-month earnings started to stabilize: The upturn in profit cycle came to an end. In our view it is different this time. Earnings have scope to increase further. In the US, growth looks accelerating in Q1, with the rising contribution of consumption. This is visible in the upbeat number of retail sales and credit card activity. Declining new Covid cases and good progress in vaccination are inducing a better sentiment by consumers. Most of all, Biden is pushing hard for the next fiscal stimulus which could reach 1.6 TN USD, higher than our previous expectation around 1 TN USD. This in turn will bring our GDP growth forecast to 6.8% (from 6.1%) this year and 4.7% the next. Earnings will receive a boost of an additional +4-5%, with a possible target for the S&P 500 around 4,200 (including the negative effect of higher 10-year rates by 30 bps). The point is that PE should decrease but given bold earnings growth (+40% in the euro area – EA – and +20% in the US this year) the index price could increase, too, albeit at a much lower pace. Furthermore, the dividend yield spread vs BAA yield linger near historical highs. In sum, we expect equity total returns for the next 12 months to remain in positive territory at nearly 5%.

Equities

Robust earnings growth ahead

The reporting season in the US is approaching its final stage, with 83% of US companies having communicated their results vs 56% for Europe. US companies are having a turnaround for earnings yearly growth to 6% yoy (+2.5% for sales). EU is lagging (negative growth) as also the earnings beat: 66% vs 82% of the US. For 2021, we see risk of continuing positive revisions due to vaccination measures taken, re-opening activities and global policy support (fiscal and monetary). A lower US weight in energy and financials and a higher one in tech explains a faster recovery in US earnings.

In sum, while risks are higher (we decreased our OW in equities last month), we think investors should profit from further set-backs. The macro momentum will remain upbeat, with bold policy support and restarting rotation into laggard sectors (value and to a lesser extent cyclicals).

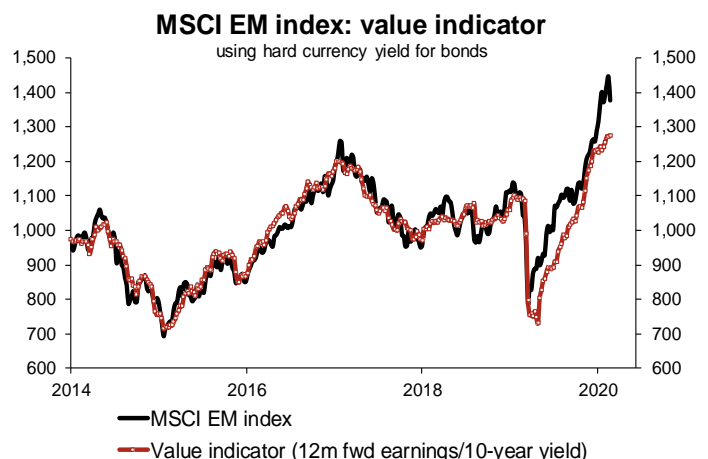
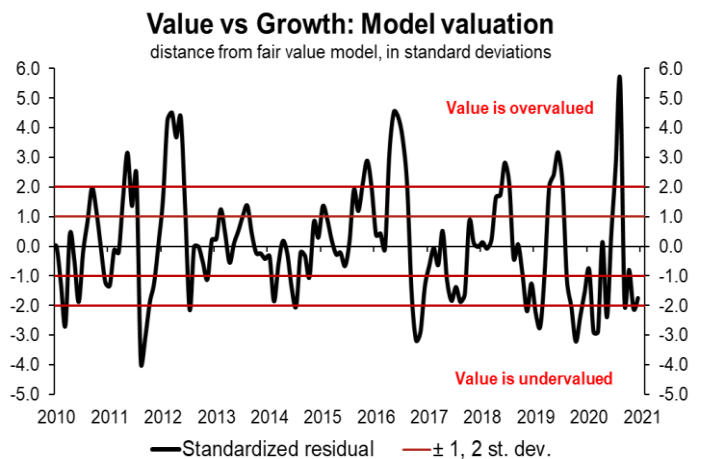
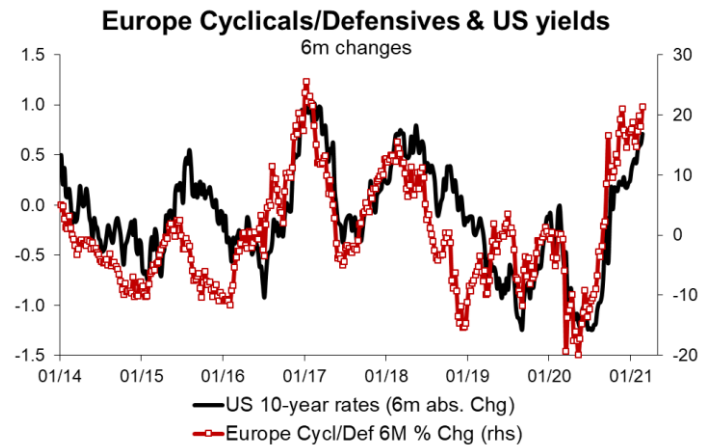
Country allocation: OW EMU vs US, due to ongoing cyclical recovery, higher US rates and increasing funds' flows. We also overweight EMs, Japan and UK due to valuation and rotation vs ex-US cheaper indices.

We maintain our preference for Value and Cyclical.

For Value sectors, we see relatively strong earnings momentum vs the market: financials, energy and materials. Our quant models still see a huge undervaluation for Value but not so much for cyclicals, such as capital goods. Banks look particularly vigorous in terms of relative earnings momentum and deserve a slight OW, just like energy. Others OWs: Financials, materials and software. UWs: media, telecom, transportation and HPP. We bring semis to neutral due to stretched valuations and performance.

EM: re-enter on market setbacks

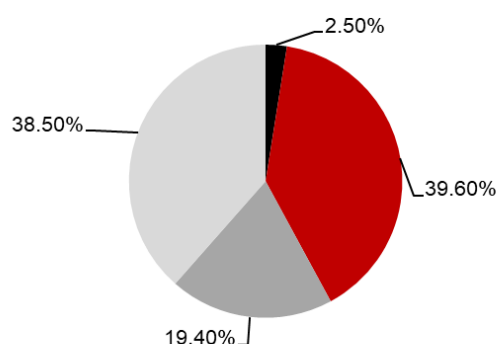
In February, the MSCI EM (+3.6%) has been especially supported by a weaker dollar vs EM FX (-0.6%) and higher oil prices (+20%) but underperformed the MSCI World by 1.7pp. In terms of multiples, EMs are trading at a discount of 25% vs historical average relative to the US. Having rallied since October 2020, the MSCI EM has closed the gap to the Fed financial conditions. The market looks somewhat overvalued vs its value indicator (s. chart). The Sentix investor sentiment has become quite toppish, increasing the likelihood of a further short-term correction. That, said we remain constructive on EM equities as the relative valuations are still attractive and EM stocks would further be supported by the ongoing rebound in growth, a weakening US dollar and higher commodity prices. Additionally, long-term positioning on EM stocks remains below average. For now, though, we are waiting to re-enter the position on market setbacks. We favour India, Korea, and Poland.



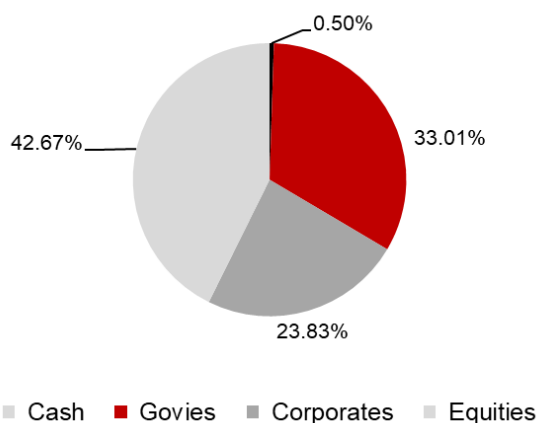
Asset Allocation

Thorsten Runde

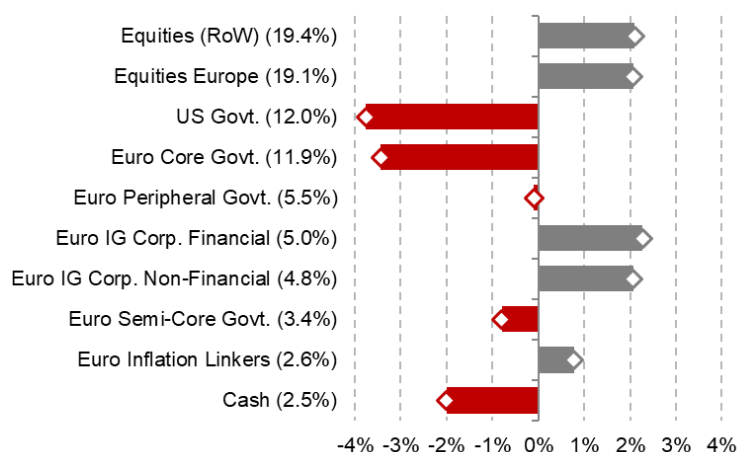
Benchmark



Modelportfolio



Active Positions in TOP 10 Benchmark Constituents*



*Benchmark weights in parentheses, diamonds indicating previous

- In the course of February, just Equities and EA HY corporates have made it so far (February 24th) into positive performance territory.
- The equity performance ranges from +3.1% (MSCI EUROPE ex EMU) to +5.7% (MSCI NORTH AMERICA).
- Apart from EA HY (+1.0%) the complete fixed income side performed negatively so far.
- Like in January, long-dated US-Treasuries lost most on a euro-hedged basis (-6.5%) followed by long-dated Core Govies (-5.0%) and BONOs (-4.7%).
- On the EA Credit side, HY clearly outperformed IG by round about +140 bps on average.
- The prospects of a strong economic recovery in Q2/Q3 as well as the monetary and fiscal policy framework conditions still back risk assets. With markets appearing overly enthusiastic in part, we stick to our recently slightly trimmed Credit and Equity overweights.

In February, the model portfolio has outperformed its benchmark by +30 bps so far. Like in the previous month there is a clear dichotomy, characterized by strong outperformance in the first half of February (+33 bps) followed by a small loss afterwards (-3 bps). The bulk of this result (+17 bps in the first half) is due to the strong equity performance which was +6.4% on average over that period. For the same reason just underweight positions contributed positively to the overall result until mid-February with Core Govies and US being the most relevant ones (+11 bps each). The equity market correction in the second half of February (-1.8% on average) made EA Corporates outperformers, delivering the only significantly positive performance contribution (+4 basis points) in this period.

The prospects of a strong economic recovery in Q2/Q3 as well as the monetary and fiscal policy framework conditions still back risk assets. With markets appearing overly enthusiastic in part, we stick to our recently slightly trimmed Credit and Equity overweights.

Moderate pro-risk stance to be maintained

We fully confirm our tactical risk-taking stance characterized by sizeable overweight positions in equities and in IG Credit, avoiding low-income markets like EA Core Govies, US Treasuries and Cash. Short-term risks cannot be ignored. Nevertheless, we consider setbacks as potential buying opportunities in view of the economic recovery expected later in the year.

Forecast Tables

Growth¹⁾

	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.3	- 3.5	6.8	2.4	4.8	1.4
Euro area	1.2	- 6.8	4.0	- 0.4	5.3	1.3
Germany	0.6	- 5.0	3.3	- 0.4	4.7	1.1
France	1.3	- 8.8	5.5	- 0.1	6.0	2.2
Italy	0.2	- 9.0	4.1	- 0.4	3.6	0.0
Non-EMU	1.5	- 8.7	4.3	0.4	4.6	- 0.3
UK	1.4	-11.0	4.8	0.5	5.3	- 0.5
Switzerland	1.1	- 3.7	3.6	0.4	2.9	0.0
Japan	0.8	- 4.8	2.3	- 0.1	2.4	0.2
Asia ex Japan	5.2	- 1.0	7.5	- 0.2	5.2	- 0.2
China	6.1	2.3	8.2	- 0.1	5.4	0.0
CEE	2.0	- 2.1	4.2	0.6	3.1	- 0.5
Latin America	- 1.1	- 8.5	3.1	- 0.4	3.1	0.1
World	2.7	- 3.8	5.6	0.4	4.5	0.3

1) Regional and world aggregates revised to 2015 IMF PPP weights

Inflation¹⁾

	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	1.8	1.2	2.2	0.1	2.3	0.1
Euro area	1.2	0.3	1.5	0.6	1.2	- 0.1
Germany	1.4	0.4	1.7	0.2	1.6	0.0
France	1.3	0.5	1.0	0.2	1.1	0.0
Italy	0.8	0.4	0.5	0.1	0.9	- 0.1
Non-EMU	1.5	0.6	1.3	- 0.6	1.6	- 0.7
UK	1.8	0.8	1.5	- 0.9	1.9	- 1.0
Switzerland	0.4	- 0.5	0.3	0.0	0.5	0.0
Japan	0.5	0.0	0.1	0.2	0.4	- 0.1
Asia ex Japan	2.8	2.9	2.2	0.0	2.6	- 0.2
China	2.9	2.6	1.5	0.1	2.1	- 0.0
CEE	6.9	5.6	6.5	0.6	5.0	- 0.0
Latin America ²⁾	3.6	3.1	3.1	0.2	3.4	0.6
World	2.5	2.2	2.4	0.2	2.4	- 0.0

1) Regional and world aggregates revised to 2015 IMF PPP weights ; 2) Ex Argentina and Venezuela

Financial Markets

3-month LIBOR		24/02/21*	3M	6M	12M
USD		0.18	0.20	0.20	0.20
EUR		-0.55	-0.55	-0.55	-0.55
JPY		-0.08	-0.10	-0.10	-0.10
GBP		0.06	0.05	0.05	0.05
CHF		-0.75	-0.75	-0.75	-0.75
10-Year Bonds		24/02/21*	3M	6M	12M
Treasuries		1.37	1.50	1.60	1.70
Bunds		-0.32	-0.30	-0.25	-0.20
BTPs		0.61	0.60	0.65	0.75
OATs		-0.07	-0.10	-0.05	0.05
JGBs		0.12	0.15	0.15	0.20
Gilts		0.71	0.75	0.80	0.90
SWI		-0.25	-0.20	-0.15	-0.10
Spreads		24/02/21*	3M	6M	12M
GIIPS		75	70	70	75
BofAML Covered Bonds		31	30	30	35
BofAML EM Gvt. Bonds (in USD)		281	278	278	265

*average of last three trading days

Corporate Bond Spreads		24/02/21*	3M	6M	12M
BofAML Non-Financial		86	85	80	75
BofAML Financial		87	85	80	75
Forex		24/02/21*	3M	6M	12M
EUR/USD		1.21	1.23	1.25	1.26
USD/JPY		105	105	104	102
EUR/JPY		128	129	130	129
GBP/USD		1.41	1.45	1.45	1.45
EUR/GBP		0.86	0.85	0.86	0.87
EUR/CHF		1.10	1.10	1.11	1.12
Equities		24/02/21*	3M	6M	12M
S&P500		3,894	3,910	3,940	4,000
MSCI EMU		132.7	132.0	133.0	135.5
TOPIX		1,927	1,925	1,950	1,985
FTSE		6,632	6,635	6,665	6,760
SMI		10,678	10,530	10,655	10,905

3-Months Horizon

Government Bonds	10-Year Bunds	-0.65	-0.50	-0.35
	10-Year Treasuries	0.89	1.10	1.31
	10-Year JGBs	-0.12	0.05	0.22
	10-Year Gilts	0.23	0.30	0.37
	10-Year Bonds CH	-0.53	-0.45	-0.37
Equities	MSCI EMU	117.9	130.0	142.1
	S&P500	3,541	3,845	4,149
	TOPIX	1,720	1,865	2,010
	FTSE 100	6,111	6,635	7,159
	SMIC	10,105	10,830	11,555
Currencies	EUR/USD	1.20	1.23	1.26
	USD/JPY	100	103	106
	EUR/GBP	0.86	0.89	0.92
	EUR/CHF	1.07	1.09	1.11

12-Months Horizon

Government Bonds	10-Year Bunds	-0.70	-0.40	-0.10
	10-Year Treasuries	1.00	1.35	1.70
	10-Year JGBs	0.49	0.10	-0.29
	10-Year Gilts	0.27	0.40	0.53
	10-Year Bonds CH	-0.64	-0.40	-0.16
Equities	MSCI EMU	114.8	134.5	154.2
	S&P500	3,495	3,990	4,485
	TOPIX	1,684	1,945	2,206
	FTSE 100	6,041	6,915	7,789
	SMIC	10,052	11,275	12,498
Currencies	EUR/USD	1.21	1.28	1.35
	USD/JPY	93	100	107
	EUR/GBP	0.82	0.88	0.94
	EUR/CHF	1.07	1.11	1.15

*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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