GENERALI INVESTMENTS

MARKET COMMENTARY

Cross assets analysis - positive relative equity returns ahead, but lower and more volatile

Author: Federica Tartara

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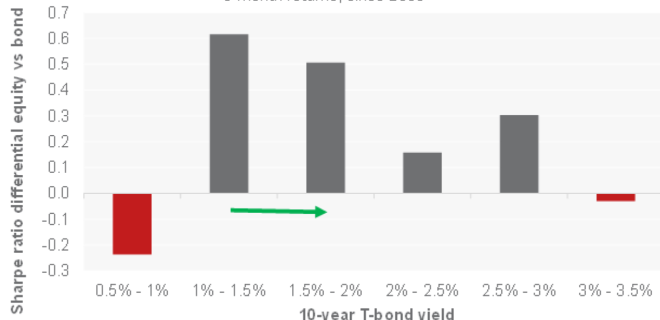
- **We have updated our analysis on US relative asset performance based on historical patterns (see Core Matters: Relative asset performance, August 11, 2021).**
- **While we expect the global economy to stay firmly in "expansion", according to our Margin indicator the US is approaching a "slowdown" phase of the business cycle, in which historically US Equity still outperforms long- and short-term government bonds, IG and HY.**
- **Should nominal 10-year US government bond yields rise moderately (+50bp from current level), historical patterns suggest that the return of US Equity would still be higher than the one of 10-year Treasury bond, IG and HY, but the outperformance would be lower than before. The pain threshold should be +100bp for equity vs IG and +150bp for equity vs Treasury bonds and HY.**
- **Should real 10-year US government bond yields (nominal minus breakeven inflation) move in a range of +/- 50 bp from current level, the return of US Equity vs 10-year Treasury bond, IG and HY could stay positive. The pain threshold should be above 50bp for equity vs IG, +150 for equity vs government bond and +200 bp for equity vs HY.**
- **The realized bond volatility seen in the last months is potentially harmful to equity and could trigger larger than average drawdowns. We expect positive but lower and more volatile relative equity returns in 2022.**

The recovery is alive and well, ang growth will still be above potential next year. Yet global growth will be slower in 2022 than 2021 (4.2% vs. 5.8%). Also earnings momentum will decelerate from the stellar pace of the past quarters, even if our forecasts are for a still solid growth (+10% in 2022). As a consequence our **Margin Indicator**, based on the trend in the pre-tax US NIPA profits/GDP, transformed into the distance from its 5Y rolling peak, is pointing towards a "slowdown" phase. This is not necessarily bad news for Equity: According to history, the median excess return of the S&P500 over 10-year Treasuries has been positive during Margin slowdown. The same holds also for Equity versus IG and HY bonds.

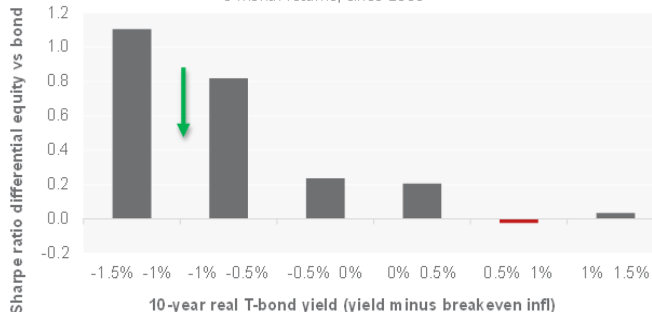
Our projected move in yields should theoretically not harm equity relative returns either. GIAM Macro & Market Research expects the **10-year US government bond yield** to increase from the current level (1.4%) towards 1.65% in the next 6 months and 2% in one year. In the last 20 years, US equities have performed better than Treasuries, IG and HY when nominal yields have been in the [1.5% 2%] bracket. However, the (risk-adjusted) extra return, albeit still positive, has been quite lower than when the 10-year US government bond yield was below 1.5%.

Moving to real yields (nominal minus inflation breakeven), should the **10-year TIPS real yield** move in a range of +/- 50bp from the current level (-1%) the Equity return vs fixed income would stay positive but lower in case of higher real yields (and vice versa). Also looking at what historically happened as a consequence of shifts in the **yield curve** (10Y-3m), we do not see warning signals yet. In the past month, because of long-term rates decreasing, we observed a bull flattening (typically associated with a slowdown). Nevertheless should it switch into bear flattening (short-term rates rising more than long-term rates), equity returns to Treasuries would not be compromised.

If we control for changes in yields, rather than yield levels, we observe that the current move in US 10-year yields (3m change vs 3y average, divided by standard deviation) historically produced lower returns of equity vs government bonds than average, but still positive. Less supportive is the lesson coming from **bond volatility** levels. Bond volatility has started to rise, the current realized one is potentially harmful to equity.



Source: Datastream, GIAM calculations



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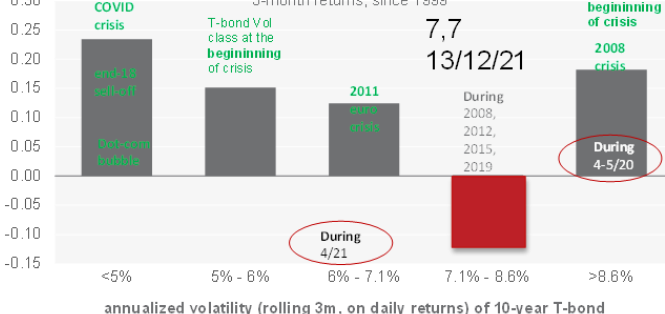

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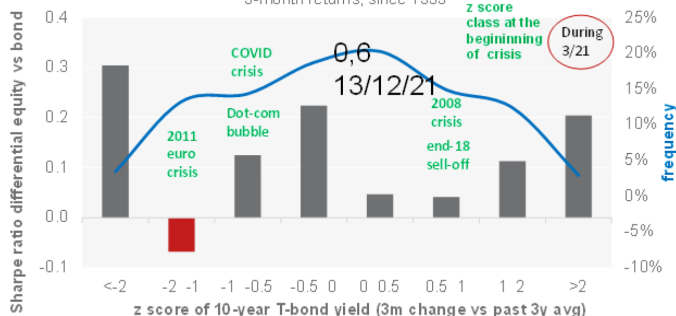

Source: Datastream, GIAM calculations

The key message coming from the metrics analysed is that equity 3m relative returns are still in a comfort zone (albeit with a reduced upside going forward) and that they are well placed against fixed income assets (but HY looks tactically cheap relative to stocks). However persisting bond volatility at current levels could trigger temporary set-backs of equities.

	Median returns						Drawdowns					
	10Y nominal yield			10Y real yield			10Y nominal yield			10Y real yield		
	-50 bp	current	+50 bp	-50 bp	current	+50 bp	-50 bp	current	+50 bp	-50 bp	current	+50 bp
Equity vs Gov bonds	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
IG vs Gov bonds	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
HY vs Gov bonds	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓	✗	✗
Equity vs IG	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓
Equity vs HY	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

	Equity vs Gov bonds
Business cycle phase	✓
Yield curve	✓
Bond volatility	✗
3m yield ch vs avg	✓

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