GENERALI INVESTMENTS

Market Compass

May 2021

MARKET OUTLOOK

- Macro data area improving strongly in the US, with the Euro area lagging behind, but surveys show higher optimism.
- The strong global rebound and higher inflation risks keep upside pressure on yields in both the US and Euro area.
- The Fed has reiterated that it is too early to withdraw monetary support and this may reinforce inflation fears. The acceleration in bond purchases by the ECB has not stopped the rise in bund yields, while inflation remains subdued. This puts the ECB in a difficult situation.
- However, real yields remain under control. This adds to progress on vaccination, ample liquidity and rising earning to maintain our preference for risk assets.

Edited by

MACRO & MARKET RESEARCH TEAM

A team of 13 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues.

The team translates macro and quant views into investment ideas that feed into the investment process.

EUROZONE

- ⊕ About 1/4 of population vaccinated…
- ⊕ …and campaign gains momentum
- ⊕ Business and consumers sentiment improves in the expectation of the re-opening
- ⊖ Euro Area Core inflation stuck at 0.8%

JAPAN

- ⊖ Japan sees another Covid-19 wave
- ⊖ Partial lockdowns to weigh on recovery
- ⊖ Olympics Games again jeopardized

UK

- ⊕ UK well advanced in vaccination…
- ⊕ …with GDP growth to benefit
- ⊖ BoE expected to start tapering QE

US

- ⊕ Consumption pushes up Q1 GDP Growth expected at 7.5% in 2021
- ⊕ Prospects for 2022 improved by fiscal boost
- ⊕ Fed remains dovish: no rate hikes before the end 2023. Tapering not on the cards
- ! CPI inflation up to 2.6%, breaching temporarily 3% at the end of Q2

CHINA

- ⊕ Very strong Q1 growth rate (in part on base effects)
- ⊕ Spill-over from rising input prices to consumer inflation likely limited
- ⊖ Decreasing monetary and fiscal support over the course of the year

DIRECTION OF TRAVEL

-- | - | 0 | + | ++

- More moderate overweight (OW) in Equities and High Yield (HY) Credit
- Maintain the OW in Euro Investment Grade (IG) Credit
- Maintain the underweight (UW) in Core bonds
- Emerging Markets: trim the OW in Equity and small UW Bonds
- To protect from inflation risk: OW in inflation linkers and small OW in Cash

Equities
Credit
Sovereign
Cash

Equities

- Equity rally continues also thanks to a surprisingly good earnings momentum
- We see yields increasing, possibly putting moderate pressure on PEs. Not a threat to positive returns as earnings will do the job
- We remain positive due to strong macro momentum and policy support
- We favor EU and Japan vs US and EM

Euro Area
US
UK
Japan
China
Emerging Markets

Bonds

- Transatlantic yield spread to widen again amid increasing US yields. More upside potential for EA yields in H2
- Accommodative fiscal and monetary policy to support EA non-core bonds in the short term
- More cautious outlook once support by the ECB fades

Gov. Euro Area (core)
Gov. Euro Area (peripheral)
Gov. US
Euro Investment Grade
Euro High Yield

Duration

- Moderate short duration recommended

Duration

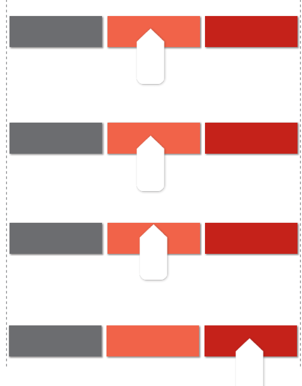
Currencies

- After a short-lived Q1 bounce, we see more headwinds to the USD into the global rebound over spring/summer amid a dovish Fed and rising US twin deficit
- Into autumn, a mounting Fed tapering debate may help to limit USD weakness
- Higher US yields largely offset the drag lower in USD/JPY from valuations and portfolio flows

Euro vs. USD
JPY vs. USD

TOPICS TO WATCH!

- US/China tensions on Taiwan escalate
- US/international corporate tax increase and tightening of tech regulatory
- Spring inflation jump triggers tapering concerns and stronger yield rise
- Correction of crowded position in risk assets



Risk Min. Risk Max.

SPECIAL FOCUS

Fast rebound and trigger fears of higher rates

The global economy is enjoying a grand reopening. The US is enjoying a strong rebound, with the boost from re-opening sectors seconded by strong fiscal packages and persistent Fed support. Risks from mutations persist, but a much improved vaccine supply will help the EU to catch up over the spring and summer. Fiscal policy in the euro area will fall short of the US stimulus. But various governments are expanding their fiscal plans for this year, adding to the Recovery and Resilience Facility, whose disbursement should start in H2.

Upside pressures on yields are therefore unlikely to abate. In the US, the fiscal impulse and temporarily high inflation will keep concerns high. In Europe, stronger growth prospects will encourage investors to diversify excess savings out of low-yielding safe government bonds into more juicy (and risky) alternatives. In the US, the Fed's patience may keep real yields low for longer, but fan inflation concerns in the process. Meanwhile, the ECB faces a tricky June meeting as the higher bond purchases have not stopped 10-year Bund yields from reaching new post-Covid highs.

Long-term expected inflation since the beginning of the year
Based on inflation-linked swaps

Source: Datastream as at May 4th, 2021.

A too rapid bounce in yields is still a threat for risky assets, alongside lofty valuations, surging equity inflows over the past six months and stretched positions in selected segments.

Yet there are good reasons to believe that the further rise in yields can be controlled and well digested. Excessive inflation remains a remote threat in Europe given the significant output gaps. Arguably the Fed and ECB will need to start considering the future of their asset purchase programs in summer. Nevertheless, they still have ammunition to counter a disorderly rise in real yields (which matter most for risky assets) via increased QE, strengthened forward guidance, or duration extension.

GLOSSARY

TWIN DEFICIT

Economies that have both a fiscal deficit and a current account deficit are often referred to as having «twin deficits». A fiscal deficit, or budget deficit, occurs when a nation's spending exceeds its revenues while the current account is a measure of a country's trade and financial transactions with the rest of the world - such as the difference between the value of its exports of goods and services and its imports, as well as net payments on foreign investments and other transfers from abroad.

GENERALI INVESTMENTS