GENERALI INVESTMENTS

Market Perspectives

A stony path to normality

September 2021

Content

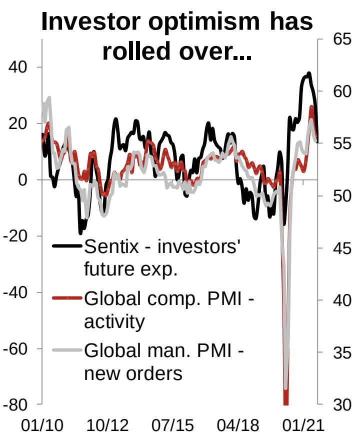
This document was completed on August 31, 2021

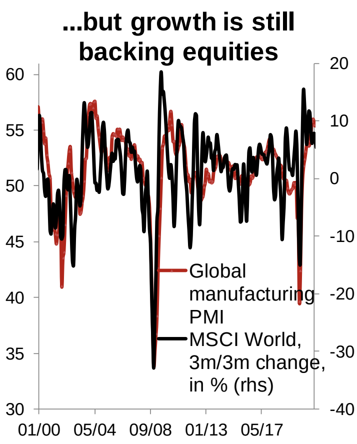
Global View – A stony path to normality

Thomas Hempell

- **Toppish data, rising Covid worries and China's regulatory clampdown are weighing on the outlook.**
- **Yet the recovery will not run off the rails and policy makers will tread cautiously in removing accommodation.**
- **Low real yields and solid expansion still leave risky assets with legs, while rates will creep higher only sluggishly.**
- **We maintain a prudent pro-risk bias, but acknowledge a higher risk of setbacks in the more mature phase of the cycle.**

A challenging summer is drawing to a close, with extreme weather (wildfires, floodings, typhoons) giving a whiff of what climate change may mean longer term. Cyclical indicators have peaked and global data surprises dived, as the Covid delta variant and resurgent infections poured cold water on hopes of a quick return to normal. China severely extended its clampdown on tech companies. Yet global financial markets have taken the news in a stride. Global equity markets have advanced further, testing new highs (MSCI World +2.5% in August as of 30/8), while Credit markets extended their resilience. This has further benefitted our maintained pro-risk stance.





The path towards a post-pandemic normality will indeed prove stony. Vaccinations in the US and (and increasingly Europe) are running into the speed limit of reluctant demand. Rising cases in Israel and scientific research suggest that the efficacy of jabs may fade more quickly; vaccinated people still seem to carry a high virus load, making herd immunity an increasingly distant dream.

Yet while resurgent Covid worries will retard the global recovery, they will unlikely derail it. Mobility tracker still recover in most advanced economies. Vaccines' protection against hospitalization and death is still supported by studies. And with the majority of people in most advanced economies vaccinated and vaccines available for elder children too, governments will not risk a fallback into harmful lockdowns. Booster shots are increasingly rolled out to vulnerable groups addressing fading protection.

Meanwhile, policy support will be withdrawn only very gradually. The fiscal impulse in the US will wane over the coming quarters, but chances have risen that Congress ultimately agrees on a bipartisan U$ 1 tr infrastructure package and an (amended version of) Biden's U$3.5 tr new budget package. The Fed eyes to start tapering its QE programme in Q4. But Chair Powell also stressed in his Jackson Hole intervention that the bar for raising rates will be distinctively higher. The ECB may delay any tapering decision of its PEPP programme to Q4 or even next year.

Risk assets still with legs, yields creeping higher

Toppish growth indicators and the more mature phase of the cycle may well herald higher volatility and more frequent setbacks among risky assets. But with investors having already cooled their exuberant optimism and the global expansion still strong (see charts), we maintain a pro-risk bias in our tactical recommendations. Corporate earnings upgrades are still reassuring. Fallen real yields (back below -1% at 10y for the US) underpin equity valuations, with equity risk premia still looking favourable. Credit is set to extend its resilience shown throughout the year. While spreads are already tight, a persistent search for yield, easing default rates and ongoing policy support from the ECB's bond purchases are boding well. We are growing more cautious about the more risky HY segments, though, especially in the US market amid looming Fed tapering and a pick-up in M&A activity.

Bonds	**27/08/21***	**3M**	**6M**	**12M**
10-Year Treasuries	1.33	1.40	1.60	1.90
10-Year Bunds	-0.42	-0.30	-0.15	0.15
Corporate Bonds				
BofaML Non-Financial	86	80	75	75
BofaML Financial	86	80	75	75
Forex				
EUR/USD	1.18	1.18	1.19	1.20
USD/JPY	110	111	109	107
Equities				
S&P500	4492	4520	4545	4600
MSCI EMU	151.1	153.0	154.5	154.5

* avg. of last three trading days

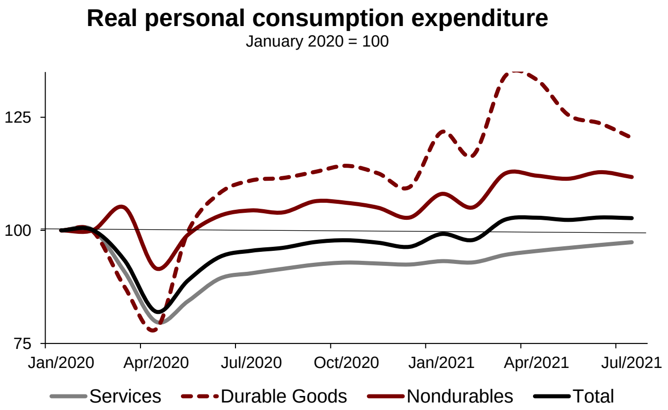
Core yields are geared to the upside amid above-potential growth and lingering US inflation worries. Yet the looming conflict in Congress about lifting the reinstated debt ceiling may require the Treasury to further draw on its accounts at the Fed instead of bond issuance. Any sharper increase in yields may also prove self-defeating given the higher fragility of the recovery, debt sustainability concerns and potential larger impacts on risk sentiment and financial conditions. We thus prefer only a moderate short position in fixed income duration.

USA

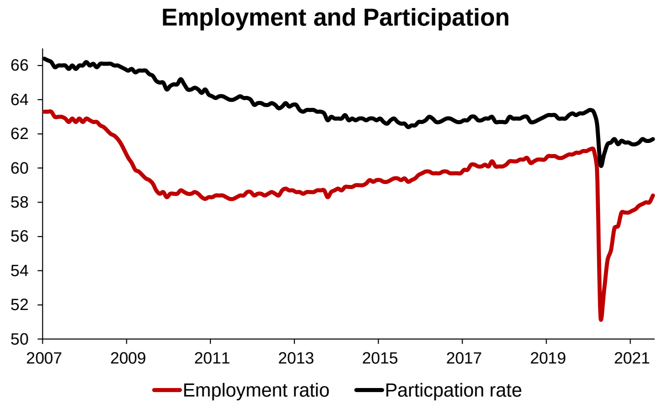
Paolo Zanghieri

- **We further trimmed our 2021 growth projections to 6.3% as evidence of a deceleration piles up. The spreading of the delta strain constitutes a significant downside risk to our outlook.**
- **Despite slower growth we expect job creation to remain solid, boosted by increased labour supply. Inflation is set to remain temporarily high, but the abnormal increases in some sectors are moderating.**
- **The Fed is ready to start tapering QE this year. If the labour market continues to power on at the current speed it could begin in November.**

With surveys indicating a reduced consumption bounce back, we trimmed down our forecast for 2021 to a still healthy 6.3%. The surge in goods purchases (especially durables) during the pandemic is moderating quickly. But higher consumption of services should largely offset this sustained by increasing labour income offsetting dwindling government transfers. That said, the fast spreading of the delta variant in some large states could lead to another wave of voluntary or forced restraint in activity. This remains the biggest downside risk to our growth outlook. On the fiscal front, after the US$ 1tn bipartisan infrastructure package, the Democrats pushed through Congress a US$ 3.5tn budget resolution geared on an expansion of welfare expenditures in part financed by higher taxes. The strong opposition of Republicans could lead to tensions in the Senate, which may complicate the bipartisan agreement needed to increase the debt ceiling at the end of September. A partial shutdown in early October remains a possibility.

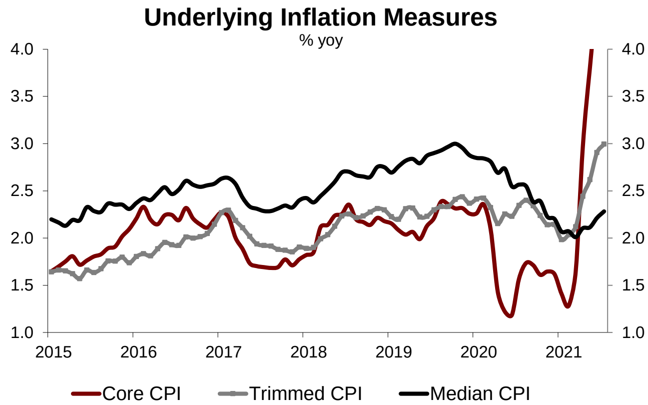


The strong (+943k) jobs growth in July was underpinned by the public sector, but we expect private employment to continue to increase at around 700k per months. Initial evidence shows that the reduction of unemployment benefits has had a minimal impact on labour market participation. Yet, it should increase over the coming months when schools reopen and if the delta variant does not force further lockdowns. Inflation remains high (headline CPI at 5.3% yoy, core at 4.2%), but the few sectors responsible for the surge (like used cars or airfares) are cooling. Headline inflation should end the year at around 4%.



Tapering could start as early as in November

Chair Powell used his speech at the Jackson Hole conference to advertise again the optimistic outlook for the economy, but also drew explicitly the implications for tapering. The progress on inflation is consistent with tapering, and labour market continues to improve at a sustained pace. If the delta variant does not disrupt activity tapering can begin before the end of the year (in November, as our base case). However, Powell reassured markets on the fact that monetary policy will remain broadly accommodative: the reduction of asset purchases is not mechanically linked to the increase in the Fed fund rate, which we expect in mid-2023.



Euro Area

Martin Wolburg

- **Activity gained momentum in summer and stayed strong according to key indicators like the PMIs.**
- **Weakening expectations amid another Covid-19 wave are clouding the growth outlook.**
- **At the September ECB meeting a dovish tone will prevail. A worsening pandemic situation even increases the risks of a PEPP extension.**

The post-lockdown recovery is proceeding. Strong activity in Q2/2021 (GDP 2.0% qoq) pushed euro area output up to just 3% below the pre-Covid-19 level. This was stronger than expected. The average reading of the PMIs for July and August (composite PMI at 60.2/59.5 vs. Q2 av. of 56.8) signals that activity even accelerates in Q3.

Clouded economic outlook

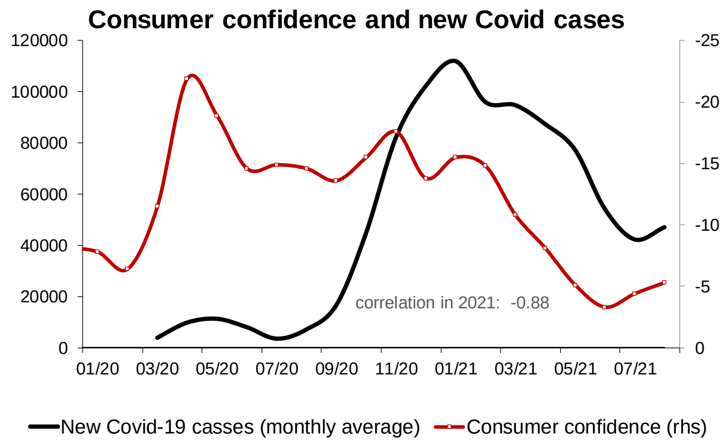
That said, there are clear signs for decelerating activity at the horizon. First, the pandemic situation is worsening again. The spreading of the more infectious delta variant will push new Covid-19 cases further up, a burden for consumer sentiment (that started to deteriorate in July) and purchasing activity (see top chart). If the vaccination progress was to be considered insufficient even a tightening of stringency measures could take place.

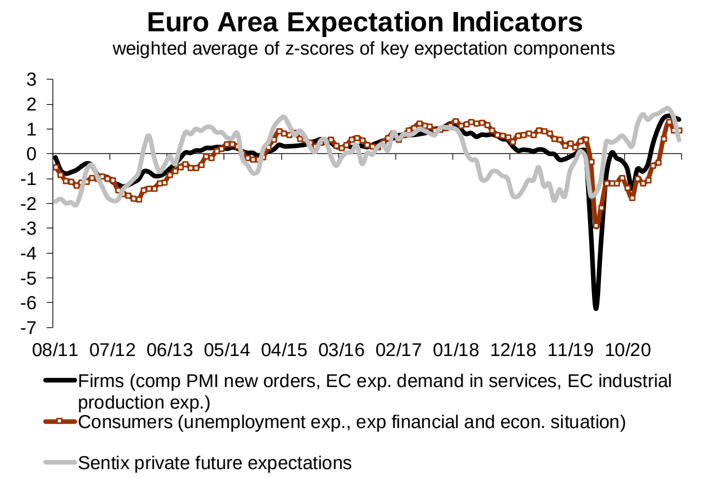
Second, semiconductor shortages persist. Delivery times in manufacturing are still close to the Q2 highs. This will continue to drag on industrial production. Likewise, unfavourable weather events and strikes in some economies will dampen activity.

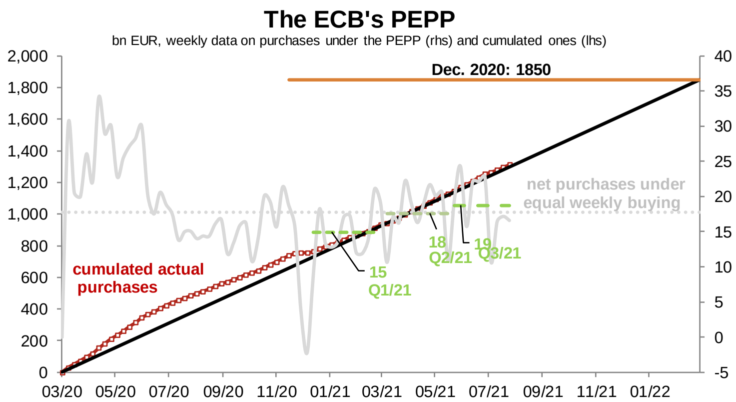
Therefore, it is not surprising that forward-looking components in key sentiment indicators worsened (see mid chart) heralding decelerating activity. Hard data for Q3 are not yet available but we expect them to paint a less rosy picture than the PMIs. All in all, we look only for a slightly accelerating activity in Q3 (to 2.2% qoq) and stronger deceleration thereafter. In spite of strong Q2 GDP reading we adjust our 2021 growth forecast up to only 4.9% (from 4.6%) and leave our 2022 number of 4.5% unchanged.

Another dovish message from the ECB in September

The forthcoming policy meeting on September 9 will likely reaffirm the ECB's dovish wait-and-see stance. The outlook update will result in higher growth and inflation numbers. The expected increase of inflation will not have policy ramifications as it will still be considered transitory and not alter the ECB's forward guidance on rates. Moreover, in a recent interview of Chief Economist Lane suggests that PEPP tapering might once again be postponed. This is in line with our view. As the PEPP is clearly tied to the pandemic, its worsening could even increase the risk that the PEPP might be extended beyond March 2022. In any case, the recent data flow plays in the hands of the doves and this should also be reflected in President Lagarde's comments.

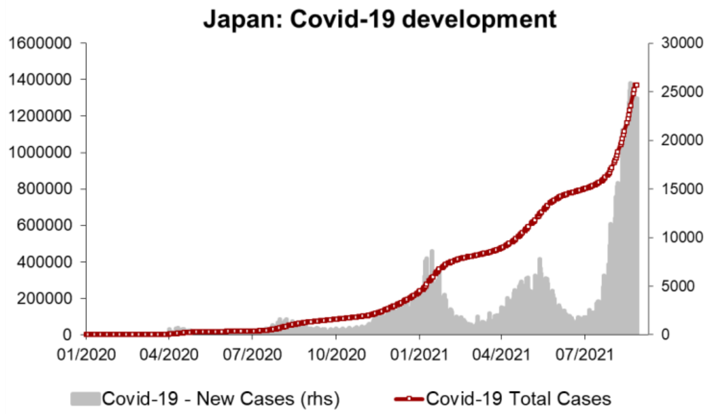


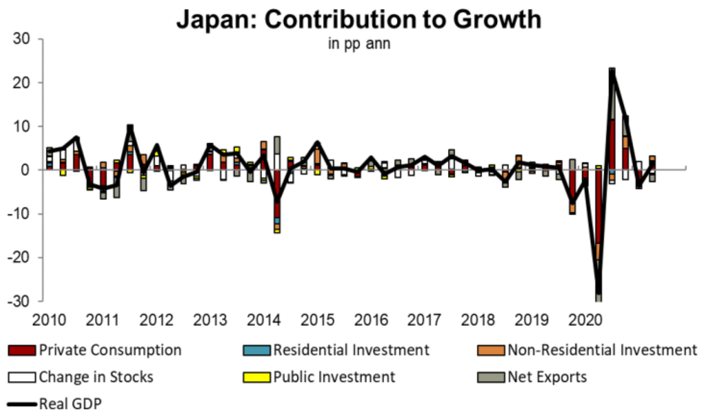


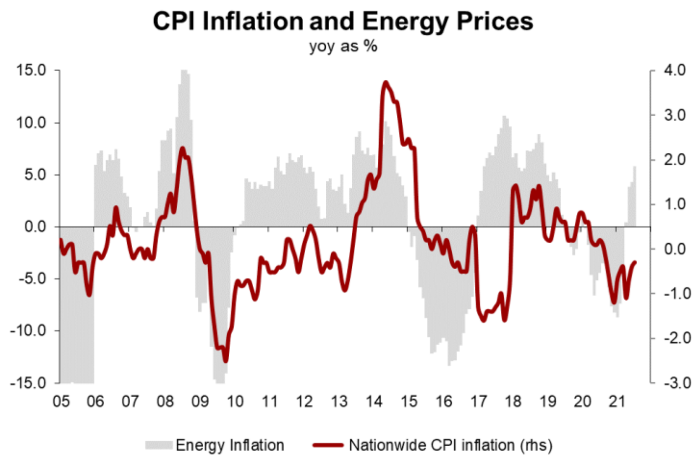


Japan

Christoph Siepmann







- **Japan is in the midst of another strong Covid-19 outbreak. This will render Q3 growth again lack-lustre before a rebound could take place in Q4.**
- **PM Suga will be challenged by Fumio Kishida in the end-September LDP presidency election. He could also well become next PM in Q4.**

Japan is in the midst of a new, so far strongest Covid-19 outbreak due to the spread of the delta variant. The government extended resp. added more prefectures to the (quasi) State of Emergency (SoE), which covers now 70% of all prefectures including Tokyo. The (preliminary) end date has been pushed back to September 12. A further (at least partial) extension looks likely. Warnings have increased that intensive care units (ICUs) could easily be overwhelmed.

Accordingly, growth forecasts remain unusually uncertain. Meanwhile, Q2 GDP growth surprised on the upside with 1.3% qoq annualised (ann) compared to an consensus expectation of 0.7% qoq ann. While this is nevertheless a rather lacklustre recovery after the drop by 3.7% qoq ann in Q1 (due to Corona), particularly consumer spending proved stronger than expected. Business investment improved on the heels of rising exports. The lockdowns in the current quarter will likely lead to another quarter of rather meagre growth. Given that consumption may remain a more resilient than previously expected and due to the implementation of fiscal policy support, we expect Q3 quarterly growth only slightly below the Q2 result. Under the assumption of the corona crisis ebbing in Q4 and rising inoculation rates, we expect a stronger rebound in Q4. As a result, we only marginally modify our growth forecast for this year to 2.3% (from 2.2%), which translate in a FY2021 growth rate of 3.4%.

Large downward revision of CPI not to influence BoJ

As announced, Japan's CPI index was rebased from the year 2015 to 2020. The expected downward revision in monthly inflation rates was much stronger than the expected -0.4pp. The June core index (all items less fresh food) was revised down from +0.2% yoy to -0.5% yoy. The core-core rate (less food and energy) fell to-0.9% yoy. However, July nationwide CPI inflation data surprised on the upside, narrowing to -0.3% yoy. We now see CPI headline inflation to come in at -0.1% in 2021, before rising to 0.6% in 2021. We do not expect the BoJ to respond to the data revision.

On the political front, Fumio Kishida has declared his candidacy for the LDP presidency, challenging PM Suga. The election will take place on September 29, most likely quickly followed by the Lower House election in October-November. Given the low public approval ratings for PM Suga, Mr Kishida could also well become next PM. Then, economic policy is expected to focus more on distribution issues.

China

Christoph Siepmann

- **China's economy is facing a fresh Covid-19 outbreak, a range of policy crackdowns as well as weak activity and monetary data.**
- **Accordingly, we revised down our down our 2021 GDP growth forecast to 8.1%. Policy will likely ease but we see no full-fledged reflation cycle.**

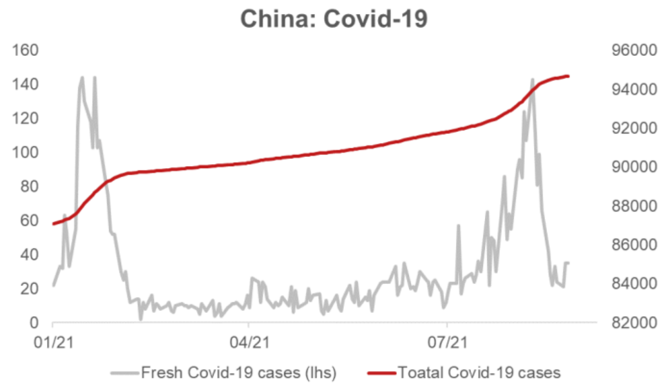
China's economy is currently facing three major headwinds. Firstly, another outbreak of the Covid-19 delta variant has spread to multiple provinces. In line with its zero-tolerance policy, Beijing responded with strict local lockdowns. While the number of fresh cases already slowed, the outbreak will weigh on consumption near-term.

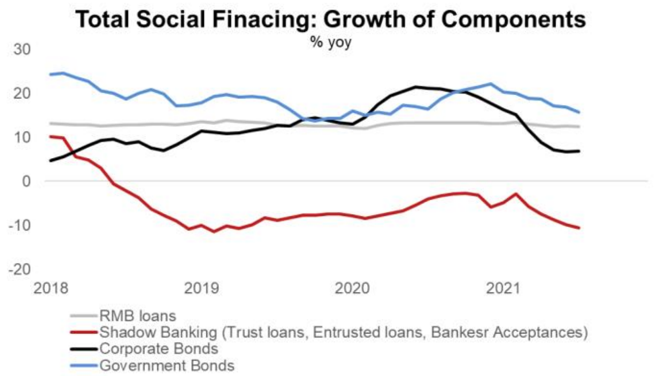
Secondly, Chinese authorities launched a number of harsh crackdowns, mainly on high-tech internet platforms for undermining competition but also on for-profit tutoring. Other measures concerned flexible workers rights, undue private data collection, harmful drinking, etc. The likely unifying theme is a new focus on "common prosperity". President Xi also called for high incomes to return more to society. We consider the regulatory tightening a structural break, taking "equality issues" more into account. The launch of a blueprint for building "a law-based government" suggests that more measures are likely to come.

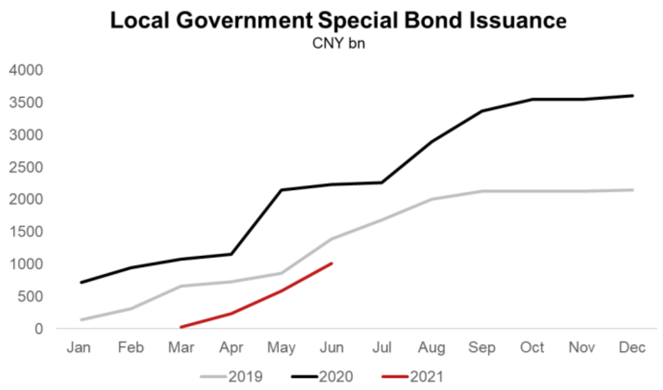
Thirdly, July real activity and monetary data surprised on the downside. Calculated in 2-year compounded annual growth rates (intended to exclude the base effects), IP slowed to 5.6% yoy, FAI and retail sales to below 3%. Manufacturing PMIs came down to the weakest levels since March 2020. The NBS service PMI dropped strongly amid the consumer restrictions. Exports also look to peak but still provide a strong boost to the economy with a cumulative growth rate of more than 35% yoy ytd in July. Total social financing growth softened by 0.3 pp to 10.7% yoy, implying a more negative credit impulse.

More government support but no full reflation cycle

The combined headwinds have several implications. Q3 GDP growth will likely come in on the weak side. Accordingly, we revise down our 2021 GDP growth forecast to 8.1%. Moreover, we see more policy support, but no full reflation cycle. We expect the PBoC to cut the RRR by 50 bps and improving liquidity via its medium-term lending facility. While the odds of a rate cut are rising, we do not price it in yet. We expect the PBoC to still resort to targeted instead of global measures (bearing in mind that it had cut thee MLF policy rate by only 25 bps during the whole 2020 Covid-19 crisis). Fiscal policy is able to play a larger role in H2, even within the bounds set by he NPC. Total government bond issuance reached only 36% of the allowed quota so far. Also special local bonds issuance lagged behind. However, the strong surveillance of shadow local government debt will likely put a lid on a stronger upside for infrastructure investment. This led to speculation for more support for consumption or a greening program instead.

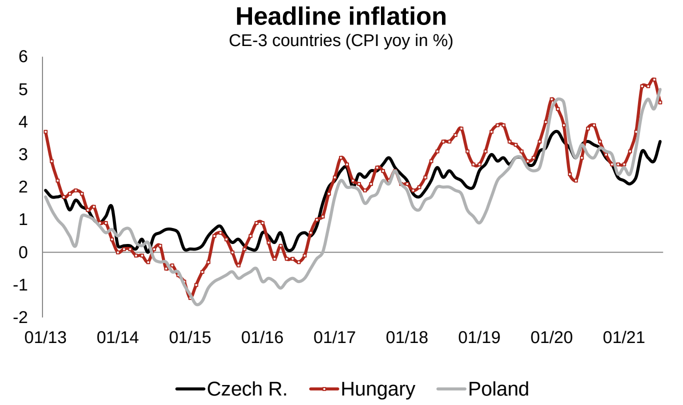


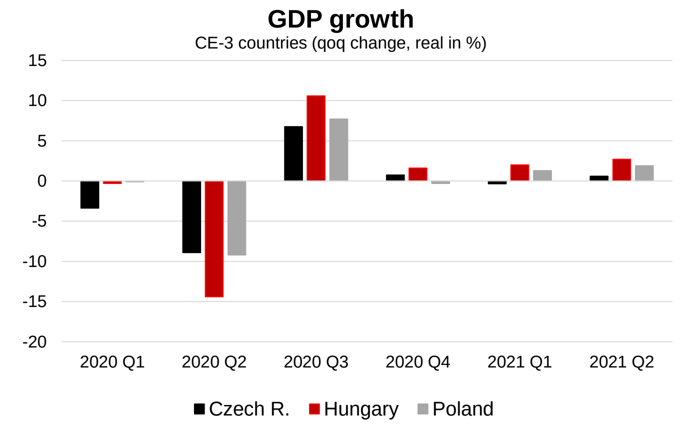




Central and Eastern Europe

Radomír Jáč





Main Forecasts	2019	2020	2021f	2022f
Czech Republic				
GDP	3.0	-5.8	3.1	4.9
Consumer prices	2.8	3.2	3.1	2.6
Central bank's key rate	2.00	0.25	1.50	2.00
Hungary				
GDP	4.6	-5.0	7.5	4.3
Consumer prices	3.4	3.3	4.4	3.5
Central bank's key rate	0.90	0.60	2.00	2.25
Poland				
GDP	4.8	-2.6	4.8	4.5
Consumer prices	2.3	3.4	4.2	3.5
Central bank's key rate	1.50	0.10	0.25	1.00

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

- **The CE-3 economies reported a positive GDP quarter-to-quarter growth for Q2 with a strong pace in Hungary and Poland and a somewhat below expectations growth in Czechia.**
- **Inflation keeps monetary policy makers in the Czech Republic and Hungary on alert: both central banks increased interest rates further in August and more rate hikes should follow.**
- **The Polish MPC did not meet in August: we keep our call for a first slight rate hike in Poland in Q4.**

Preliminary data for Q2 GDP reported growth at 0.6% qoq in the Czech Rep., 2.7% qoq in Hungary and 1.9% qoq in Poland. The Czech growth was slowed by supply-side problems in manufacturing, which hit production and exports. We cut Czech GDP growth outlook for 2021 but we increased projection for 2022. At the same time, we raised forecast for Hungary's GDP growth for 2021.

The economic recovery, commodity prices and supply chain delays continue to cumulate price pressures in the CE-3. Headline CPI increased in the Czech Rep. (to 3.4% yoy) and Poland (to 5%) in July and declined in Hungary (to 4.6%). Base effects may lead to a further rise in inflation in autumn. However, even if inflation moderates in late 2021 and early 2022, it is expected to stay above central banks' targets in 2022 across the CE-3 region.

Hungary: MNB is likely to slow pace of rate hikes

The Czech CNB raised its key rate by 25 bps to 0.75% in August, which was the second hike in the cycle launched in June. The CNB forecast published in August reveals rate hikes for each monetary policy meeting in the rest of 2021, i.e. in September, November and December. We expect the CNB to increase rates by 25 bps per a step, which would lift the key rate to 1.50% by year's-end. For 2022 we expect two more hikes with the key rate at 2%.

The Hungarian MNB increased its base rate by 30 bps to 1.50% in August, for the third time in a row in the current cycle. The MPC said that it will assess impact of interest rate hikes at the September meeting when the MNB will also present a fresh macro forecast. We expect the MNB to slower pace and frequency of rate hikes and our call for a year-end level of the base rate now stands in a range between 1.75% and 2.00% (more likely closer to 2%).

In Poland, the key rate stands at 0.10% and a majority in the MPC argues COVID-related doubts to represent a risk to the economy. However, we see a growing chance that the NBP's next forecast, due in November, will project headline CPI for 2022 and 2023 above 3.5%, i.e. above the upper limit of inflation target set at 2.5% +/-1pp. Such forecast would justify a rate hike also for the current dovish majority in the MPC and we expect a 15 bps rate increase in Q4 with more hikes to follow in 2022.

Government Bonds

Florian Späte

- **After trending sideways initially long-dated nominal yields increased moderately towards the end of August as some of the supporting factors started to weaken.**
- **Peaking indicators and ongoing concerns about the next Covid wave are likely to prevent a significant increase in yields. However, the recent moderate upward trend is seen to continue.**
- **Euro area non-core government bond spreads are expected to remain rather stable in the short term. Further down the road some spread widening is in the offing.**

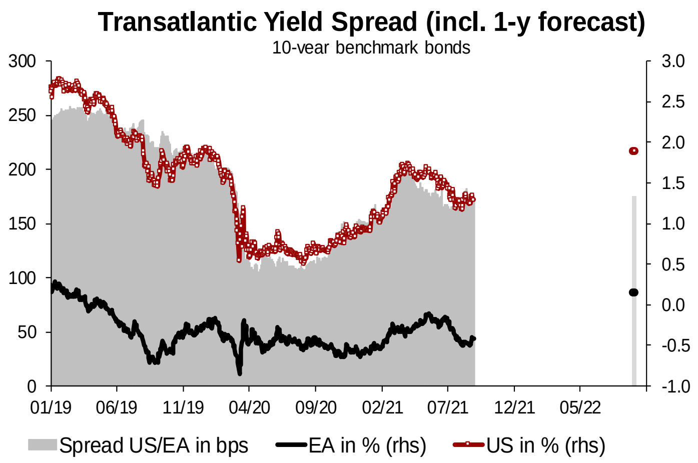
Global government bond yields trended sideways for most of August but inched up towards the end of the month. Overall, 10-year US yields rose by 6 bps while Bund yields rose by a meagre 2 bps. Inflation expectations did not follow a clear trend as 10-year US inflation swaps decreased by 2 bps and euro area ones rose by 4 bps. Generally, international bond markets were characterized by thin trading in a calm environment during summer.

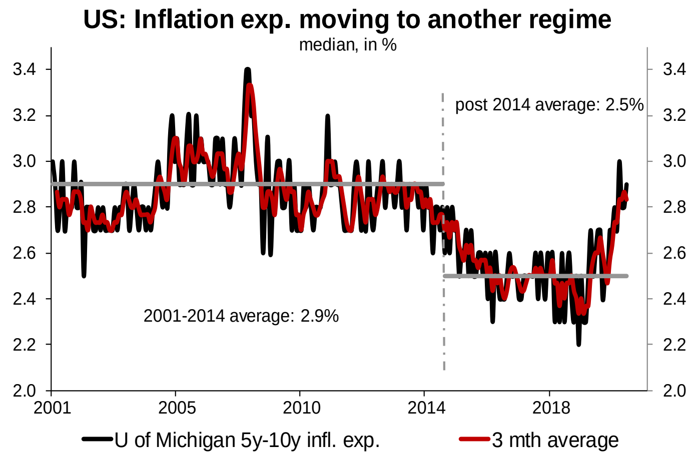
Slight upward trend in yields to continue

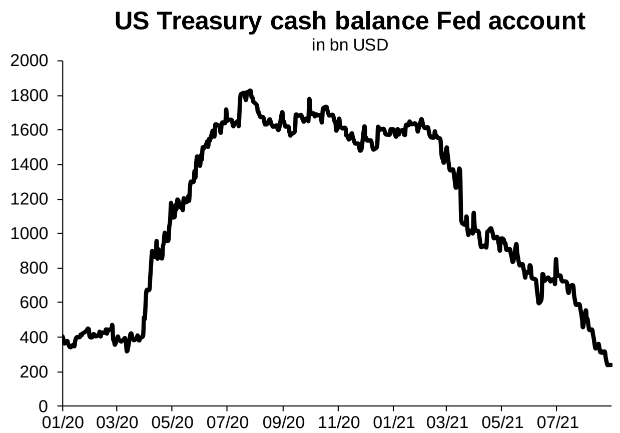
We see leeway for the recent upward movement in yields to continue in the weeks to come as fundamentals come to the fore again. To start with, the macroeconomic environment is seen to remain supportive. Although macro indicators have started to roll over and growth momentum is forecast to weaken growth will remain above potential. Meanwhile, financial markets should have adjusted expectations and economic surprise indicators are likely to bottom out. Disappointing macroeconomic data in China on the back of tighter policy and regulatory interventions also contributed to growth concerns but the policy mix is expected to become more accommodative further down the road.

Very much related to the economic outlook is the development of the pandemic. Rising cases and the spreading of the delta variant contributed to the decrease in yields at the beginning of summer. However, amid the available vaccines and signs that Covid cases are plateauing we doubt that there will be a new complete lockdown and the trend towards opening of the economies is expected to be at least not reversed. A new wave is likely to dampen the expected economic rebound but it is not seen to derail the upswing. The more cautious outlook is reflected in our slightly lower quarterly US growth forecasts as well.

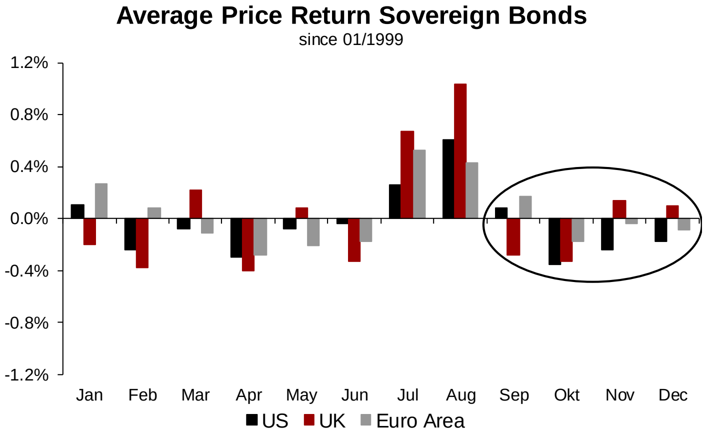
Additionally, financial markets remain rather relaxed regarding inflation. We forecast US inflation rates to remain on a very high level for the time being and in the euro area annual inflation rates are even expected to rise in the months to come (mainly for technical reasons). With 5-year 5-year US inflation priced at around 2.2% we see some upside potential for long term inflation expectations as other indicators point to a regime shift after the very low inflation environment between 2014 and 2020.

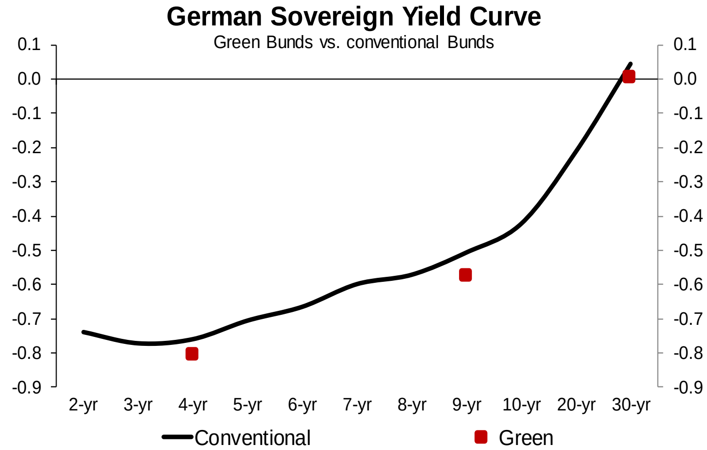


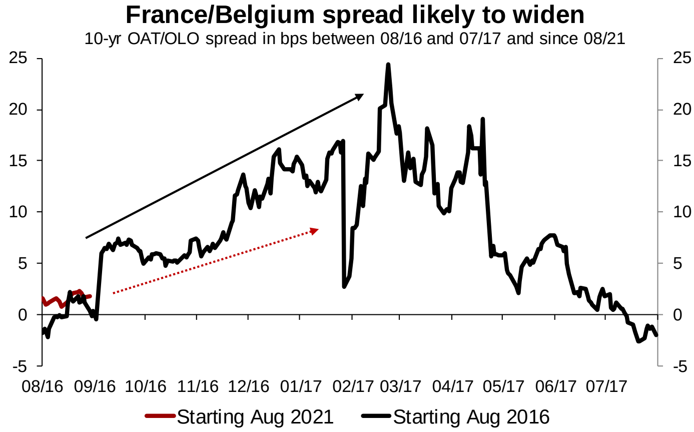




Government Bonds







The impact of US politics is twofold. On the one hand, the time line for a US fiscal impulse accelerated amid the recent passage of the budget resolution (implying a higher bond issuance further down the road), on the other hand the debt ceiling is approaching and is seen to limit any yield increase. As long as this is not resolved (and a near term solution is not in sight) the reduction of the Treasury's cash balance continues, which ultimately works like stealth QE.

Furthermore, the US central bank has turned a bit more hawkish and tapering is not a question of if, but mainly when. In case it will start in Q4 with a reduction of US-$ 15bn/meeting we regard it to be market neutral. A stronger and/or sooner tapering would drive up yields (and vice versa).

Finally, after driving yields down over summer we expect seasonal factors to trigger lower yields (particularly in Q4). Summing up, we see leeway for long-dated US yields to rise to 1.4% on a 3-month view and to 1.9% on a 1-year horizon.

This moderate upward trend is expected to spill over to the euro area. The level of real yields is even less sustainable there. 10-year German real yields are below -2% - a historical trough. It is clearly at odds with the ongoing recovery and the expansive fiscal policy, but it reflects a high degree of uncertainty and an insurance against a new spreading of the pandemic. The primary market will reopen after the summer lull as well. Although the ECB is seen to speed up its purchases as well we expect the upcoming supply (among others a new 10-year green Bund and the first 20-year green Bono) to contribute to the moderate upward trend in euro area core yields as well. 10-year Bund yields are expected to rise to -0.3% on a 3-month view and to 0.15% on a 12-month horizon.

No sustainable widening of non-core spreads yet

The main factor for euro area non-core and semi-core government bond spreads remains the ECB. We regard concerns about an early tapering in September as overdone and expect the central bank to continue its purchases without tapering at least until the end of the year. Given that the euro exchange rate has weakened for the last three months and the weighted average of long-dated euro area yields is close to a historical trough we doubt that the ECB would like to give a hawkish signal.

What is more, the cash flow remains positive for the remainder of the year. Accordingly, we forecast on balance a sideways movement of spreads in the weeks to come.

An exception are French OATs. In the run-up to the French presidential elections in April 2022, we recommend being underweight French OATs as the election campaign is likely to lead to increased nervousness. To capture the political risk, we trade OATs versus Belgian OLOs.

Credit

Elisa Belgacem

- **Tapering discussion will intensify in Europe but credit markets in Europe should be resilient.**
- **The key support to the credit market from the ECB is the APP, not the PEPP that will remain in place until 2023 at least.**
- **Volatility will remain low into year end on IG on the back of both positive fundamentals and technicals.**
- **We downgrade HY to neutral from OW previously and upgrade IG to neutral from UW on a less bright macro picture and a lesser duration aversion.**

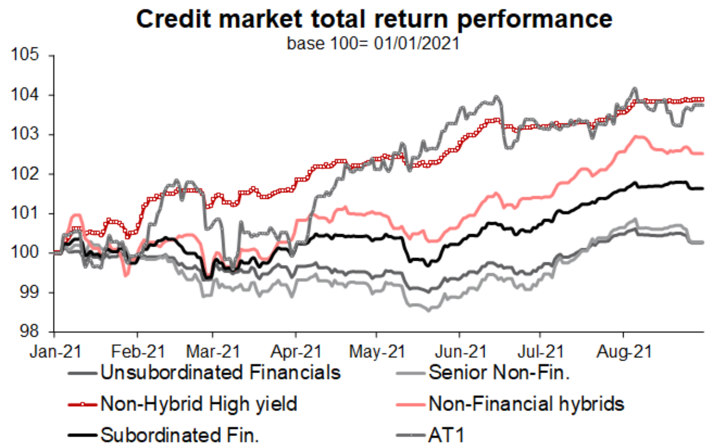
The ECB is the largest player in the corporate credit market in Europe, holding close to 25% of the eligible space. However, we expect the discussion on the tapering to leave corporate bonds mostly insensitive as only the ECB's emergency program, the PEPP, will be halted. Indeed, the amount of credit within this program is very low. The ECB is mostly supporting the private bond market through its APP which will run shortly before the ECB starts to raise rates. Although the medium-term outlook on inflation remains uncertain to some extent, the APP will run until 2023 at least and possibly much beyond since the ECB has modified its forward guidance to allow for some temporary inflation overshooting before starting to hike rates. Moreover, the ECB focus on financing conditions will remain and the amount at stake to stabilise the credit market is much lower than on the public side.

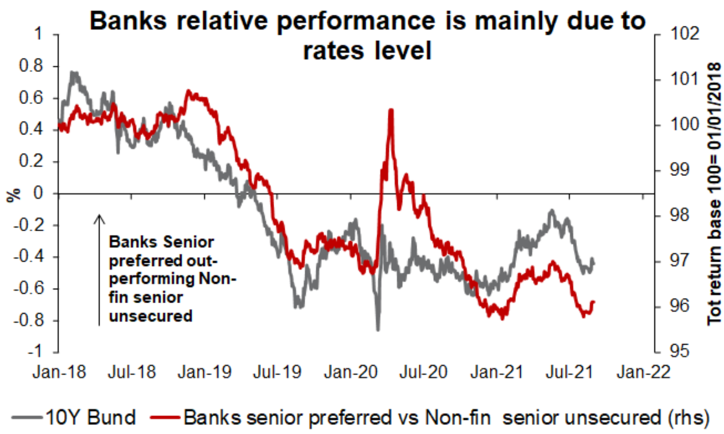
Low volatility of credit spreads here to stay in Europe

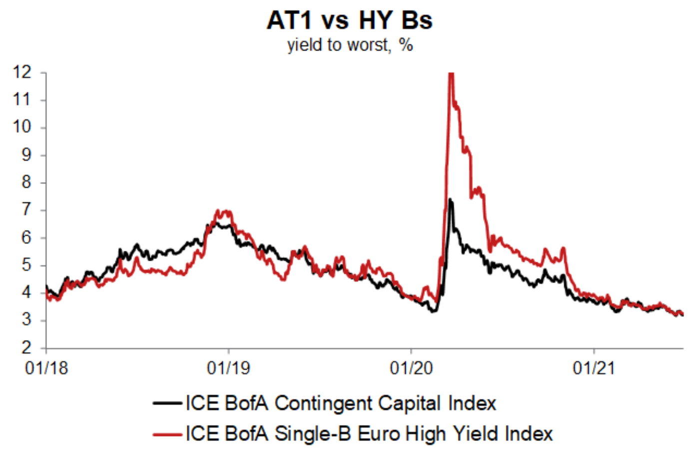
Consequently, we can expect credit to remain directly supported by the ECB in the foreseeable future leading to low volatility of spreads in IG. The question is to what extent it is going to benefit to the high yield market, and whether the compression trade is exhausted. HY market valuation is undeniably expensive while it does not directly benefit from the ECB support. Moreover, policy normalisation is faster in the US and consequently, US HY could become more volatile by year-end, leading potentially to some imported volatility into Europe as HY is very sensitive to flows. Yet when looking at potential medium-term's total returns, HY appears as one of the best places to hide in the fixed income world in the years to come.

Cautious carry trade warranted

We continue to recommend an aggressive positioning in IG and a more defensive one in HY. We downgrade HY to neutral from OW previously and upgrade IG to neutral from UW on the back of a cloudier macro landscape and less negative duration stance. At the end of 2021, we see both IG and HY spreads nearly 10% tighter than their current levels. We like BBBs and BBs, and corporate hybrids versus BBs and AT1s versus single Bs as they offer a similar carry for a lower volatility in case of turbulences.



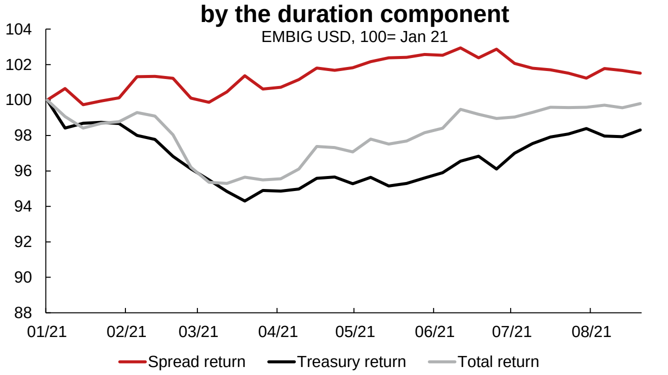




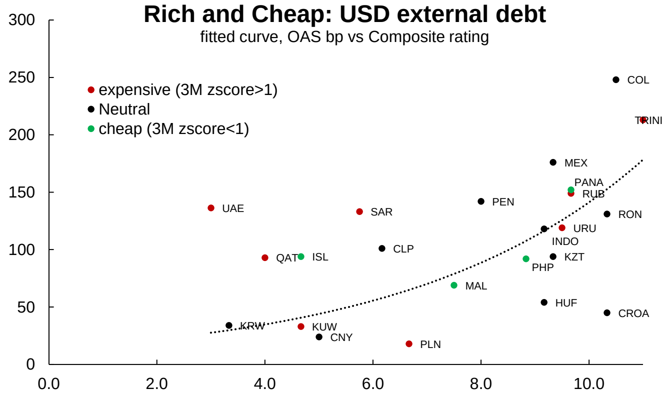
EM sovereign bonds

Guillaume Tresca

Total return barely turns positive hurt by the duration component



Rich and Cheap: USD external debt



New SDR allocations boost lower rated countries

	New SDR (% of GDP)	New SDR (% FX reserves)
Suriname	7.1	30.2
Zambia	7.1	129.8
Jamaica	3.6	14
Seychelles	3.3	5.7
Tajikistan	3	12.7
Trinidad	2.9	9.8
Barbados	2.8	12.7
Nambia	2.3	6.8
Mozambique	2.2	7.7
Kuwait	2.1	5.2
Saudi Arabia	1.7	3
Mexico	1	6.3
South Africa	1.2	8

- **We maintain our MW view. Tight spreads and higher US rates will continue to cap total return.**
- **Tail risks have abated and are more balanced. We are still favouring marginally EM IG over EM HY with a focus on BBBs and BBs.**
- **The LatAm outlook has improved but we favour the EMEA region. We downgrade our Asia view.**

We maintain our MW view on EM external debt with a low risk profile. It is still a tug of war between spreads that can tighten modestly and the long-term US rates. The second part of the year should prove challenging to generate positive TR given the expected rise of US rates and the already tight levels of spread. Likewise, spread volatility will increase with the *Taper* discussion and the growth slowdown. That said, tail risks have abated: risks are more balanced. Indeed, Jackson Hole is passed: the US rate rebound could be less than initially feared. A surprising support is the new decline of real yields. On the sanitary front, Delta variant has rapidly spread but except in some Asian countries, mobility has hardly been affected and cases have even declined in LatAm. Finally, deterioration in the China credit market as well as the clampdown on the tech sector should continue to have limited impact on the sovereign space.

Focus on BBBs and BBs

Within this environment, we are still favouring marginally EM IG over EM HY with a focus on BBBs and BBs. The environment is not ideal for EM IG but the less feared US rate rise would hurt less than expected tight spread and high duration names. We do not avoid EM HY names specifically, but the less appealing growth story and lower commodity prices make them less attractive.

In the IG space, valuations are still tight and so one must focus on BBB names. We continue to like Romania and Mexico which are cheap compared to their rating peers.

In the HY space, the SDR allocations and some progress on the vaccine front are providing some relief. That said, we dislike CCC and below names. Several EM countries will see wider fiscal deficit in 2021 and it is unclear how low-rated names will use the G20 Common Framework.

LatAm is back? Mind Asia

The LatAm outlook has been improving. Latest growth figures showed a pickup in activity while Covid cases have been declining despite the Delta variant. However, the political outlook is still heavy and unclear. We keep avoiding Peru and we favour Mexico and we now see opportunities in Chile given its cheapness despite the upcoming presidential elections. On the other hand, we downgrade temporarily our Asia view in the wake of the Covid and growth disappointment.

Currencies

Thomas Hempell

- **The USD may benefit near term from looming Fed tapering and persistent Covid worries into autumn.**
- **Yet as the global recovery will be tempered but not derailed, the anticyclical USD is ultimately headed for some renewed losses.**
- **The EUR will benefit only little as a cemented dovish ECB stance keeps the EA rebound from translating into higher rates for longer.**
- **We slightly upgrade our view on GBP after the BoE's hawkish twist in August.**

Resurgent pandemic worries and hawkish comments by Fed officials have extended the dollar's strength somewhat further over August. Short-term, USD tailwinds may persist, as the Fed may commit more clearly to a start of tapering at its September meeting amid elevated inflation and a robust labour market recovery.

Yet there are signs that Covid worries may have triggered a mild USD overshoot. The USD is anticyclical, benefitting from global setbacks in growth and risk sentiment. Against these yardsticks, the recent USD bounce seems overdone (top and mid chart). Furthermore, a more persistent USD bounce will need to be backed by rising short-term rates. These are not imminent, given the Fed's emphasis that there is no mechanical link between the tapering decision and the timing of rates lift-off. Markets already price a Fed rates lift-off for late 2022 vs. our call for mid-2023. Furthermore, the minutes to the Fed's July meeting and Powell's Jackson Hole speech suggest that the Fed will maintain a high bar for lifting rates, with much of the recent inflation jump to prove temporary.

Shift in USD positions unlikely to extend much further

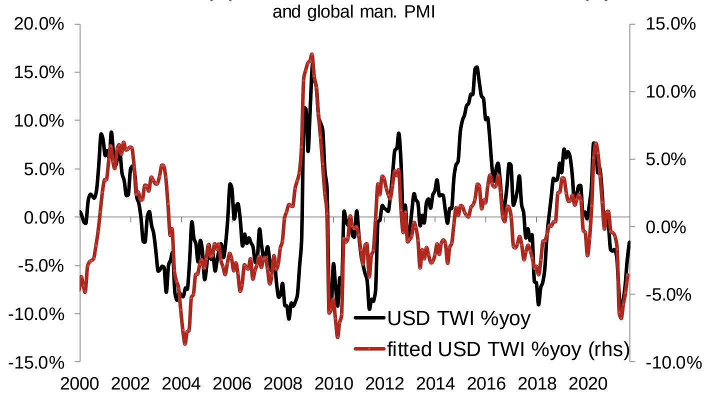
The USD has also benefited from a substantial shake-out in positioning. CFTC positions jumped from US$35 bn net shorts in January to US$ 5 bn net long in early August. A converse swing in EUR positioning explains much of the reversal in EUR/USD over that period (bottom chart). With the global recovery dented but not derailed amid progressing vaccinations, we do not expect the shift in positioning to extend into more material USD net longs.

Yet the EUR/USD will struggle to gain traction. Apart from renewed Covid worries, the ECB's dovish strategy twist in summer, which has cemented the low-for-long rate bias, has prevented the EUR from benefiting from the economic rebound in the euro area. We cut our forecasts slightly to 1.18 (3m) and 1.20 (12m).

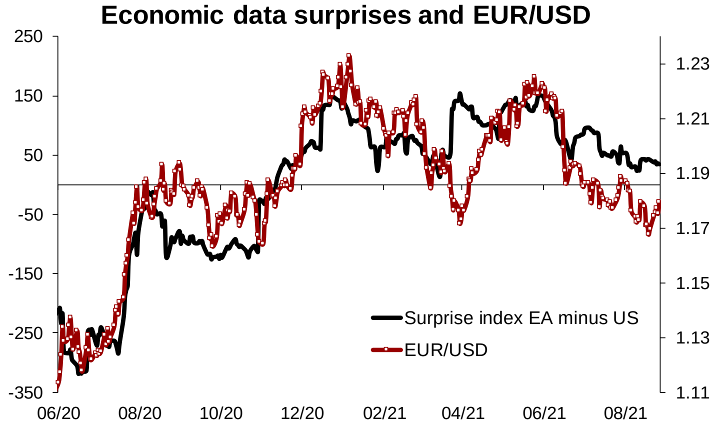
We mildly upgrade our view on sterling. Given a vanishing vaccination lead of the UK, eroded post-Brexit appeal and a persistent C/A deficit, we do not anticipate any protracted rally in sterling. That said, pencilling in an earlier BoE move and the ECB's more dovish stance, we mildly lower our EUR/GBP forecasts to 0.86 short and medium term.

Anticyclical USD

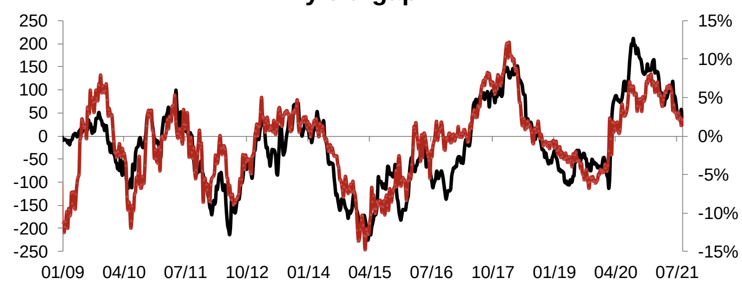
USD TWI in %yoy; model 2000-2019 based on MSCI World %yoy and global man. PMI



Economic data surprises and EUR/USD



FX positioning and EUR/USD deviation from yield gap

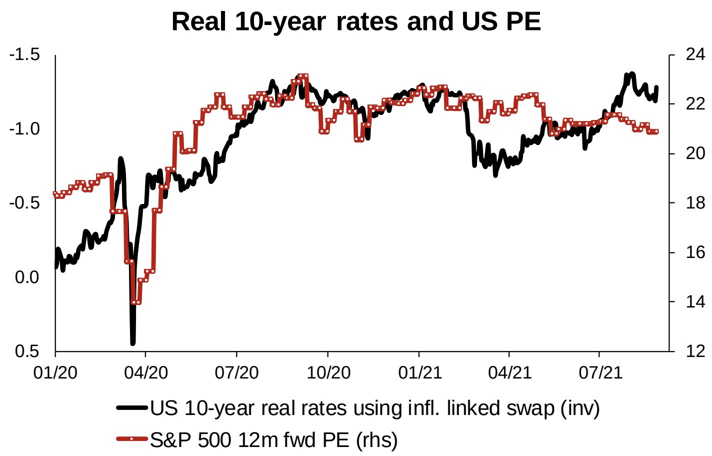


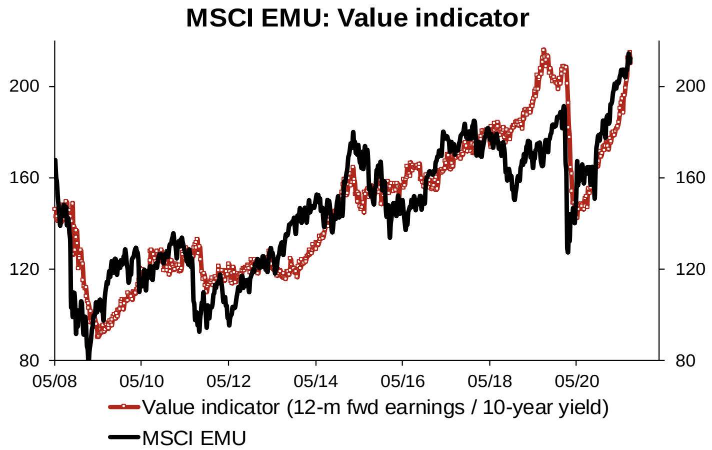
* based on 3y rolling regression coefficient EUR/USD vs. 10y yield gap

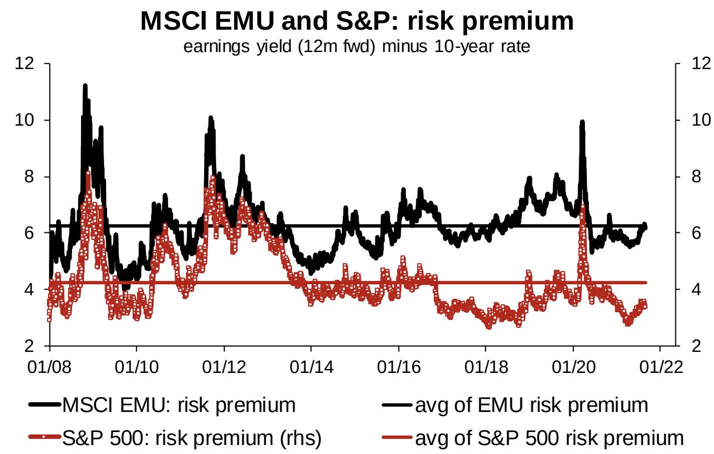
Equities

Michele Morganti / Vladimir Oleinikov

- **Equity markets continue to climb a wall of worry amid resurgent Covid cases, US monetary policy normalization and a toppish macro momentum**
- **Indeed, real yields declined further while earnings and dividend estimates continued to rise. As a result, the risk premium increased notwith-standing the good performance achieved.**
- **Monetary policy normalization should not be too disruptive in the US, and it will be lagging in the euro area. We maintain a cautious OW position on equities, with a preference for EMU vs US.**
- **Cyclicals and Value look well undervalued now, judging by market multiples as well as by our quant (machine learning-based) models.**
- **We see total returns of 5% in 12 months for EMU and 4% for the US.**
- **MSCI China is still at risk due to lingering regu-latory uncertainty. We are more positive on A shares and on Korea, Poland and Taiwan.**







Equities do not seem too frightened of new Covid risks or signs of toppish leading indicators. That said, the good performance achieved in the last two months went in parallel with an increasing risk premium. Such positive outcome has indeed rational explanations. To begin with, earnings continued to rise: by 5.7% in the US and +7.2% in the euro area (EA), thus more than compensating for the total return experienced in the same period. The 12-month dividend estimates surged, too, particularly in the EA: +12% in the last 7 months (+5% for the US), with the cash-to-asset ratio remaining very high in both areas.

Real yields backing current high PEs

Another support for markets came from lower 10-year real yields, theoretically backing a higher US PE (from current 21X to 23X). Thanks to the combination of low yields and higher earnings, the risk premia increased in the last two months for both US and EMU indices. The EMU risk premium, in particular, is now close to the historical norm since 2008 and the price trend is fully aligned to our fair value indicator for the same index (i.e. market not expensive, see charts). Furthermore, at current level of PE, equities look fairly priced with respect to the current lower macro surprise index, which recently reached the neutral/ contractionary level. Additionally, the earnings dispersion index (st. deviation of analysts' estimates) - a proxy for uncertainty - has decreased visibly. Such trend in the past has favored a lower risk premium, while recently, as said, it has increased. Finally, when we incorporate higher earnings estimates and lower yield target, our Shiller-based approach to valuation shows a fair value for the S&P 500 of nearly 4,600 vs the previous target of 4,400. The approach uses historical risk premium during times of inflation levels comparable to the

Equities

current one. We remain cautiously positive on equities and suggest to maintain an OW position not-withstanding a probable imminent US monetary policy normalization (not disruptive for markets in our view) and signs of a peaking economic momentum. We continue to prefer EA at this stage as valuation is more attractive, 10-year yields are probably bottoming and the undervaluation in Value and Cyclicals is now quite extreme. Lastly, we expect the ECB to remain dovish for longer.

Sectors allocation with a higher tilt to Value-Cyclicals

As we entered into a more mature phase of the cycle, starting from May, we pushed towards higher diversification with a bigger weight in more secure sectors. Currently, as financials have become cheaper again (see chart showing attractive fair values for Value and Cyclicals), we decided to increase our exposure to the sector, maintaining a higher tilt on Banks. On the contrary, we downgraded Households to neutral from overweight in coherence with the unsupportive signals from our proprietary quant model and negative revisions' trend. This comes about notwithstanding the already recent adverse price action (6% underperformance in the last 2 months) due to negative earnings surprise (Unilever). We also reduced our overweight on Software on the back of an already positive performance that leaves limited space for further upsides. Finally, given the improved signals from our quant models, we reduced our underweight on Media, increasing at the same time our position on Pharma due to a better relative earnings momentum. OW: financials, cons. durables, energy, food, pharma and software. UW: cons. services, media, real estate, telecoms and utilities.

EM: maintaining a neutral stance short term

The recent regulatory crackdown in China caused a market rout (-18% for the MSCI China since the recent peak in June), with our market's fair value indicator falling from an appreciable overvaluation of 38% in mid-February to 5%. Due to a possible lingering high volatility as a result of lingering regulatory uncertainty, we are less positive on MSCI China than on Chinese A shares. The latter have a lower tech weight and more attractive valuations.

Conventional EM PEs have already normalized, reaching a comfortable absolute level (13X), looking also attractive vs MSCI World (0.8 st. dev. below average). That said, EM earnings could continue to lag DMs' ones: temporarily slowdown of Chinese economy in Q3, lower vaccination rates vs DMs, and weaker export orders. Mid-term, lower valuations should play out in favour of EMs as they would see the ongoing rebound in domestic growth, further benefitting from a mildly weaker US dollar and higher commodity prices. We OW Korea, Poland and Taiwan.

Shiller-based approach to valuation

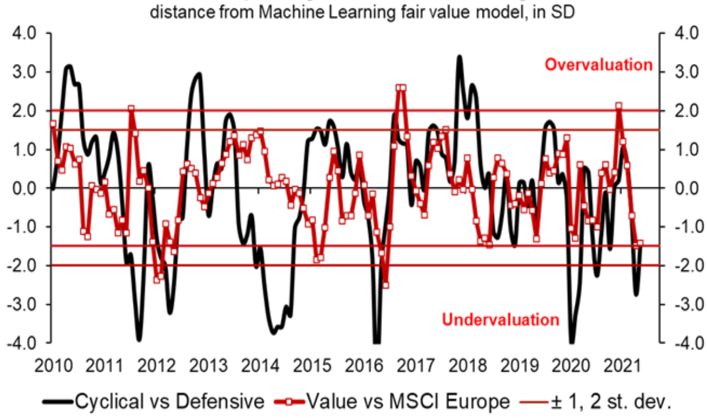
US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.56	2.64	-1.08	196.5	4.43
Scenario 2 (consensus 12m forward in 1 year)	2.00	2.25	-0.25	219.0	4.94
Scenario 3 (GI 12m fwd in 1 year)	1.90	2.30	-0.40	223.0	4.71
Scenario 4 (downside macro scenario)	0.90	1.60	-0.70	128.0	2.61
Scenario 5 (upside macro scenario)	2.80	2.50	0.30	228.8	4.86

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	25.3	28.1	25.5	16.5	27.6
Avg S&P500 valuation	4,035	4,489	**4,573**	2,628	4,408
	-4.1%	6.7%	1.8%	-37.6%	4.8%

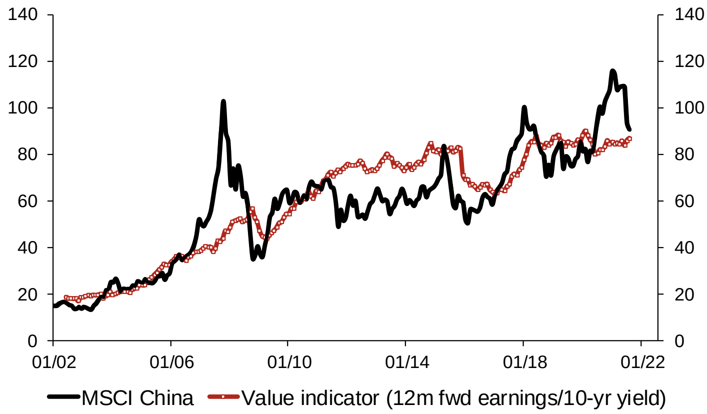
Note: **Base risk** scenario: using 20% of risk premium's stand. deviation (SD=2.7%) adds around 50 bps to the average risk premium calculated since 1872 (4.6% + 50 bps = 5.1%). Target ERP (4.6) is calculated assuming CPI in the range b/w 1.3% and 2.3%. We reduced the 10-year target from 2.15 to 1.90.

MSCI Europe Styles: Value and Cyclicals

distance from Machine Learning fair value model, in SD

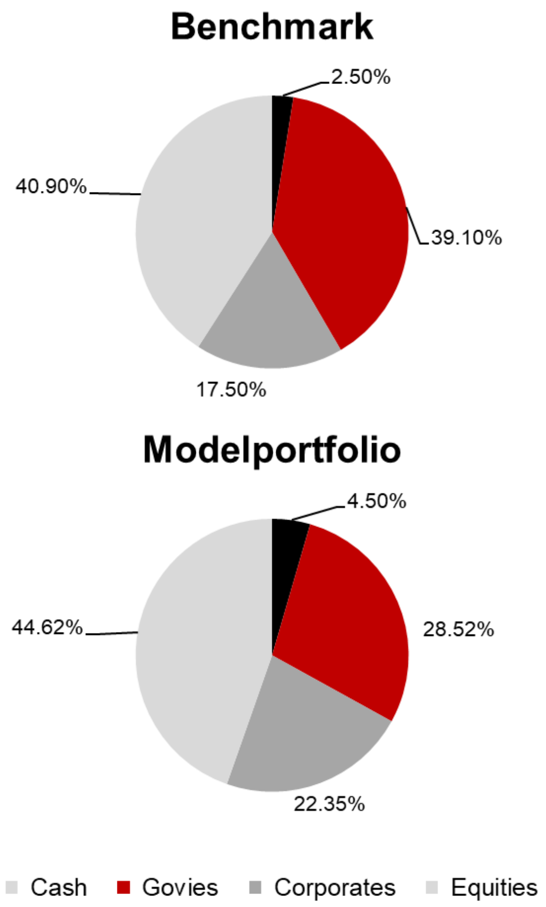


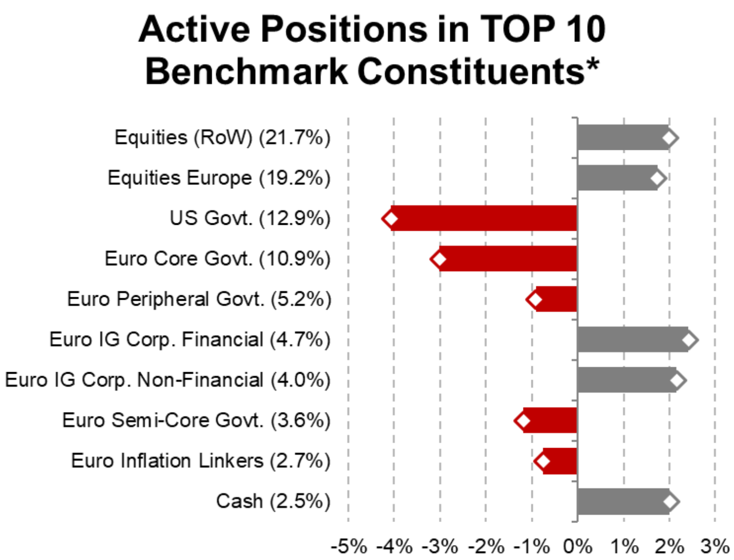
MSCI China: Value indicator



Asset Allocation

Thorsten Runde





**Benchmark weights in parentheses, diamonds indicating previous recommendations*

- **In August, the signs on the financial markets turned again compared to the previous month.**
- **Until August 27th, the performance of almost all asset classes covered remained in negative territory. Only Equites, EA HY and EM Sovereigns made it above the zero line.**
- **European and North American equity markets are leading this month's performance ranking (+2.5%). Long-dated EA Core and Semi-Core Government Bonds bring up the rear with values around -0.6%.**
- **Also opposite to July, HY outperformed IG by roughly +53 bps on the EA Credit side.**
- **Despite initial signs of a slowdown, global growth is still strong and will continue to be able to build on a benign monetary policy environment.**
- **With persistently low real yields underpinning valuations and yields geared to the upside, we once again confirm our TAA recommendation in favour of Equites and EA Credit at the expense of Government Bonds.**

With an outperformance of almost +9.5 bps in August, the model portfolio more than compensated for its poor performance in the previous month. More or less, markets seem to be back on track. Thus, our basic alignment in favour of risk assets at the expense of Government Bonds started to pay off again. The OW position in Equites and the UW position in US Treasuries were particularly successful with values of +5.2 bps and +4.6 bps respectively. Underweighting EA Core Govies bonds brought another +3.6 bps. On the other hand, the OW positions in corporate bonds (-5.4 bps) and cash (-1.8 bps) weigh on the overall result.

As summer draws to a close, doubts about the efficacy of vaccinations have even grown amid a rapidly spreading delta variant. However, central banks will continue to act cautiously and real interest rates will remain at low levels. Both factors together continue to provide a fundamentally favourable environment for risk assets. The broad framework conditions appear little changed compared to the previous month. Overall, however, the situation appears more fragile.

Moderate constructive pro-risk stance

In that sense we leave our tactical recommendations unchanged for the time being. We still like EA Credit and Equities due to ongoing above potential growth and low real yields. At the same time we stay underweight low-carry fixed income markets, with yields geared to the upside.

Forecast Tables

Growth[1)]

	2019	2020	2021		2022	
			forecast	*Δ vs. cons.*	forecast	*Δ vs. cons.*
US	2.3	-3.4	6.3	*-0.3*	4.5	*0.1*
Euro area	1.4	-6.6	4.9	*0.3*	4.5	*0.1*
Germany	1.1	-4.9	3.5	*0.1*	4.2	*-0.1*
France	1.8	-8.0	5.7	*0.1*	4.1	*0.1*
Italy	0.3	-8.9	4.8	*-0.1*	4.2	*-0.0*
Non-EMU	1.5	-7.5	5.9	*0.1*	4.4	*-0.3*
UK	1.4	-9.9	7.0	*0.2*	4.9	*-0.4*
Switzerland	1.1	-2.7	3.6	*0.0*	2.9	*0.0*
Japan	0.0	-4.7	2.3	*-0.2*	3.1	*0.1*
Asia ex Japan	5.3	-0.8	7.2	*-0.4*	5.2	*-0.5*
China	6.4	2.3	8.1	*-0.5*	5.2	*-0.4*
CEE	2.3	-1.8	5.1	*0.4*	3.5	*0.0*
Latin America	-1.7	-8.6	3.1	*-2.0*	2.8	*0.0*
World	**2.7**	**-3.4**	**5.7**	***-0.3***	**4.4**	***-0.1***

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

Inflation[1)]

	2019	2020	2021		2022	
			forecast	*Δ vs. cons.*	forecast	*Δ vs. cons.*
US	1.8	1.2	3.8	*0.1*	2.4	*-0.4*
Euro area	1.2	0.3	2.0	*0.1*	1.5	*0.1*
Germany	1.4	0.4	2.6	*0.0*	1.8	*0.0*
France	1.3	0.5	1.6	*0.1*	1.2	*0.0*
Italy	0.6	-0.1	1.1	*-0.3*	1.2	*0.0*
Non-EMU	1.5	0.6	1.8	*0.2*	2.0	*0.1*
UK	1.8	0.9	2.2	*0.3*	2.5	*0.1*
Switzerland	0.4	-0.7	0.4	*0.0*	0.5	*0.0*
Japan	0.5	-0.0	-0.1	*-0.1*	0.6	*0.1*
Asia ex Japan	2.7	2.8	2.3	*-0.1*	2.5	*-0.2*
China	2.9	2.5	1.1	*-0.4*	1.9	*-0.4*
CEE	6.6	5.5	8.2	*0.3*	6.8	*0.8*
Latin America[2)]	3.6	3.2	3.1	*-1.4*	3.7	*0.7*
World	**2.5**	**2.1**	**3.0**	***-0.1***	**2.7**	***-0.0***

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

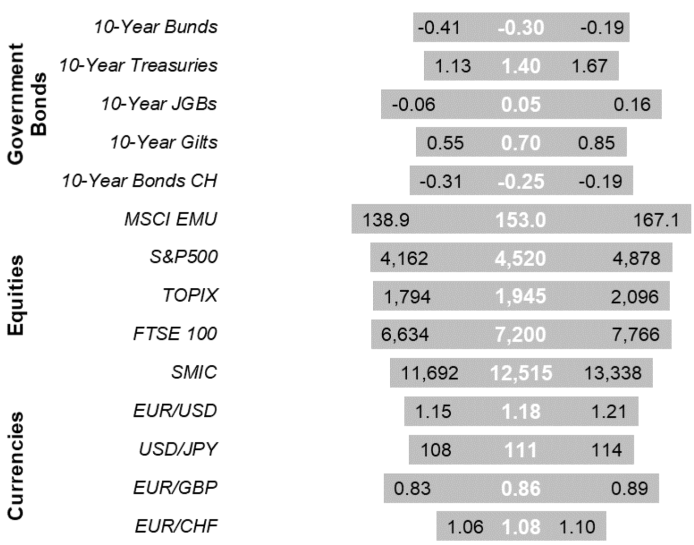
Financial Markets

3-month LIBOR	**27/08/21***	**3M**	**6M**	**12M**
USD	0.12	0.15	0.20	0.20
EUR	-0.56	-0.55	-0.55	-0.55
JPY	-0.10	-0.10	-0.10	-0.10
GBP	0.07	0.10	0.10	0.25
CHF	-0.77	-0.75	-0.75	-0.75
10-Year Bonds	**27/08/21***	**3M**	**6M**	**12M**
Treasuries	1.33	1.40	1.60	1.90
Bunds	-0.42	-0.30	-0.15	0.15
BTPs	0.66	0.75	0.95	1.30
OATs	-0.06	0.05	0.30	0.55
JGBs	0.02	0.05	0.10	0.15
Gilts	0.59	0.70	0.90	1.20
SWI	-0.34	-0.25	-0.10	0.15
Spreads	**27/08/21***	**3M**	**6M**	**12M**
GIIPS	86	85	90	95
BofAML Covered Bonds	39	35	35	40
BofAML EM Gvt. Bonds (in USD)	283	275	275	260

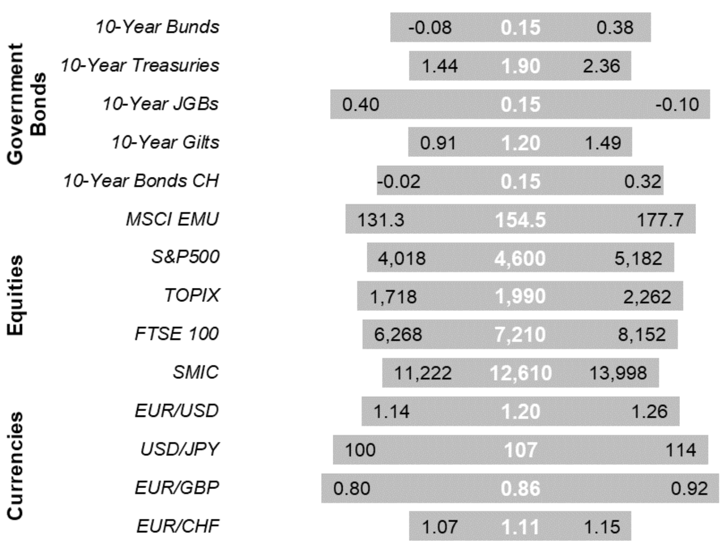
*average of last three trading days

Corporate Bond Spreads	**27/08/21***	**3M**	**6M**	**12M**
BofAML Non-Financial	86	80	75	75
BofAML Financial	86	80	75	75
Forex	**27/08/21***	**3M**	**6M**	**12M**
EUR/USD	1.18	1.18	1.19	1.20
USD/JPY	110	111	109	107
EUR/JPY	129	131	130	128
GBP/USD	1.37	1.37	1.38	1.40
EUR/GBP	0.86	0.86	0.86	0.86
EUR/CHF	1.08	1.08	1.09	1.11
Equities	**27/08/21***	**3M**	**6M**	**12M**
S&P500	4,492	4,520	4,545	4,600
MSCI EMU	151.1	153.0	154.5	154.5
TOPIX	1,933	1,945	1,965	1,990
FTSE	7,141	7,200	7,225	7,210
SMI	12,404	12,515	12,630	12,610

3-Months Horizon



12-Months Horizon



*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.

Imprint

Issued by: **Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Research Department**

Head of Research: Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

Head of Macro & Market Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team:
Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)
Elisa Belgacem (elisa.belgacem@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Guillaume Tresca (guillaume.tresca@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

Sources for charts and tables: Refinitiv/Datastream, Bloomberg, own calculations

Version completed on August 31, 2021

In Italy:
Generali Insurance Asset Management S.p.A. Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Piazza Duca degli Abruzzi, 1
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management S.p.A Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com