GENERALI INSURANCE ASSET MANAGEMENT

Market Perspectives

Tricky last mile(s)

August 2023

GIAM Macro & Market Research

'Market Perspectives' provide our monthly macro & market outlook and investment recommendations

- **Fresh US soft landing hopes have kept risk appetite underpinned, with central banks approaching peak rates and US disinflation on track.**
- **Yet we sense rising market complacency. The last mile(s) towards inflation targets may indeed prove the trickiest. Either the US economy finally slows, or the Fed will need to bite further. The expansive US fiscal policy makes the job harder.**
- **With valuations stretched and investors having re-built risk positions, a setback seems likely. We keep prudent underweights in Equities and HY Credit, but like the carry in IG Credit and EM debt.**
- **Yields are geared to the downside, if only moderately so. USD weakness is unfinished, but we tactically turn more prudent on EUR/USD.**

Content

Your Partner for Progress.

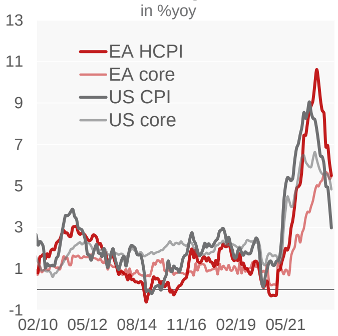
Global View – Tricky last mile(s)

Thomas Hempell, Vincent Chaigneau

- **Fresh US soft landing hopes have kept risk appetite underpinned, with central banks approaching peak rates and US disinflation on track.**
- **Yet we sense rising market complacency. The last mile(s) towards inflation targets may indeed prove the trickiest. Either the US economy finally slows, or the Fed will need to bite further. The expansive US fiscal policy makes the job harder.**
- **With valuations stretched and investors having re-built risk positions, a setback seems likely. We keep prudent underweights in Equities and HY Credit, but like the carry in IG Credit and EM debt.**
- **Yields are geared to the downside, if only moderately so. USD weakness is unfinished, but we tactically turn more prudent on EUR/USD.**

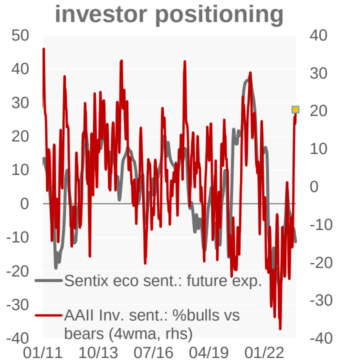
Solid US growth, a decent earnings season and softer inflation measures (US core CPI up only +0.16% mom) are keeping global risk sentiment underpinned, with equities advancing in July (MSCI World: +3.1% by 28/7). Yet the exceptional resilience of the US economy (Q2 growth reaccelerated to 2.4% saar) raises questions about whether inflation can quickly return to target. The market is still pricing, rather optimistically, headline US inflation at 2.15% in 12 months, but 10y UST yields rose some 10bp in July.

Inflation: US leading the way?



Source: Datastream, GIAM

Econ. exp. and investor positioning



Source: Datastream, GIAM

With the Fed and ECB rates at or close to peak, a big source of market unease may be removed – which risk assets seem to be celebrating already. The Fed's job looks largely done, with the US disinflation path intact for now, but risks are heavily skewed to the upside, given the resilient demand and tight labour market. Likewise, ECB's Lagarde sounds less hawkish, but core inflation at 5.5% remains way too high.

Peak rates for longer

We indeed caution against complacency. Markets are priced for Goldilocks, with the Fed staff and consensus no longer looking for a recession, inflation seen receding fast in the coming year and the earnings consensus looking for strong gains (some 10% in the US) both in 2024 and 2025.

The path to such perfection is narrow. Energy prices are bouncing, while food prices are exposed to the collapse of the deal with Russia that allowed Ukraine to export grain via the Black Sea and *El Niño* causing extreme weather. Rising commodity prices will deteriorate the growth-inflation mix.

Eradicating stubborn core inflation (still more than double the Fed target and almost triple the ECB's) will require more economic pain. While exorbitantly high inflation rates seem overcome, the last mile(s) to the 2% target may prove the hardest. Central banks will need to stick to their guns for an uncomfortably long period. First rate cuts now seem unreasonable to expect before spring 2024 in the US and even summer in the euro area.

Our base case remains that the sharp US monetary tightening of the last 16 months will lead to a moderate recession over the turn of the year. Meanwhile the euro area, which has already gone through a technical recession, will only sluggishly escape stagnation amid stalling credit extension and tighter lending standards. China keeps struggling to restart its growth engine as the reopening boost ran out of steam rapidly and the ailing property sector fails to recover. **The key risk** to our views increasingly lies towards a boom-and-bust scenario, whereby surprisingly expansive US fiscal policy and consumption resilience would push the Fed to go higher for longer, causing a later but sharper downturn.

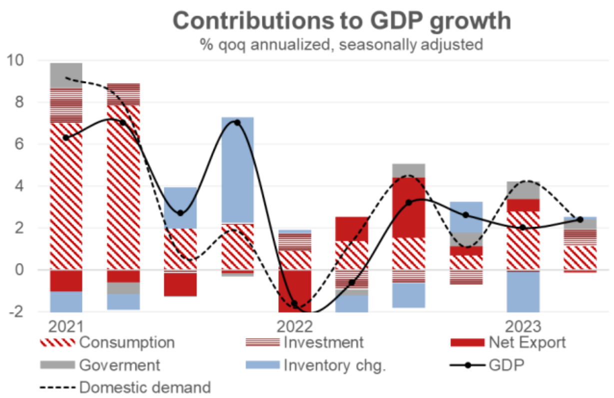
10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	3.92	3.80	3.60	3.40
Germany (Bunds)	2.43	2.45	2.40	2.30
Credit Spreads**				
EA IG Non-Financial	139	150	155	150
EA IG Financial	164	190	200	195
Forex				
EUR/USD	1.10	1.10	1.11	1.12
USD/JPY	140	138	135	132
Equities				
S&P500	4557	4450	4440	4650
MSCI EMU	150	146	146	155

**3-day avg. as of 27/07/23 **ICE BofA (OAS)*

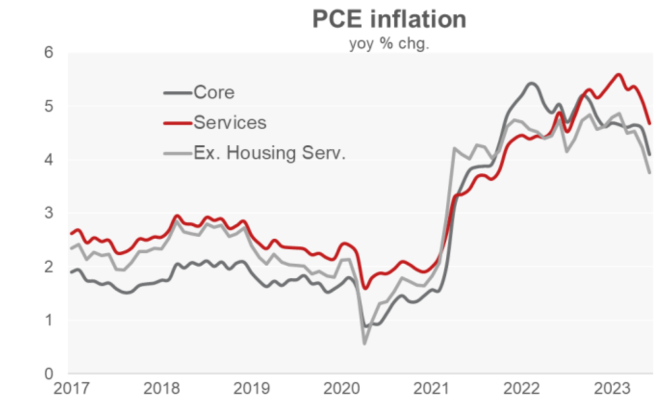
The continued rise in equities and more risk-prone investor positioning has a smack of complacency (right chart). We thus keep an underweight in the riskier market segments, incl. Equities and HY Credit. We see yields geared to the downside, as mounting growth concerns and risk aversion will invigorate safe-haven demand; but the downside potential in yields looks modest for now, and the key risk scenario argues against an aggressive duration position. We still like the carry in non-fin IG Credit and IG EMs debt that should cushion a slight widening of spreads. We foresee more USD weakness into next year as the US economy gets off its pedestal, but are more prudent on EUR/USD near term amid ongoing growth worries in the euro area.

US

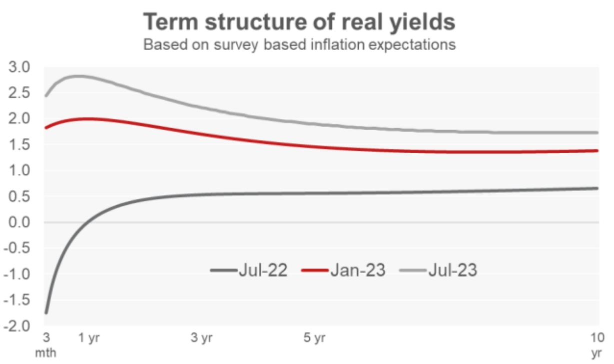
Paolo Zanghieri



Source: BEA, GIAM



Source:BEA, Refinitiv, GIAM



Source:Philadelphia Fed, GIAM

- **Q2 GDP surprised to the upside adding to evidence that demand is stronger than expected. A recession around the turn of the year remains our base case, but it is likely to be shallower than we expected.**
- **Steady demand prevents a faster disinflation, but there are signs of wage deceleration. Core inflation is set to remain well above 3% by year end.**
- **After the July rate rise, the Fed should stop, but sticky inflation may require another hike in September. We see no cuts before the end of Q1 2024 at the earliest.**

According to the first release, in Q2 GDP rose by 2.4% saar above expectations. Growth was driven not just by steady consumption but, also by a pickup in investment. Domestic demand does not appear to be affected much by the 500+ bps rise in the policy rate yet. Private consumption is boosted by residual savings accelerating real labour income and by its tilt to service, which are not very rate sensitive: government spending continues to provide a positive contribution. Investment enjoys the fact that, before the beginning of the hiking cycle, firms were able to lock in very low borrowing rates. Yet, this boost to capex will fade as debt will have to be rolled over at much higher rates. A longer lasting push will come from the kicking in of the Inflation Reduction Act-related (IRA) capex. Demand will remain strong in Q3, but we expect the economy to enter a shallow recession around the turn of the year, with some weakness extending into early 2024. The new IMF forecast for growth (1.8% in 2023 and 1% in 2024) looks optimistic to us, but we acknowledge the outlook has brightened.

Strong demand is preventing a quick descent of inflation. In June core PCE services inflation ex. housing (the measure the Fed is currently looking at) eased, but, at 3.8% remains very high. The cooling of the labour market has led the Employment Cost index to growth in Q2 at the slowest q/q pace in two years (1%); yet, at 4.6%, it is still some 1pp above the level consistent with 2% inflation. Slower production prices will also bring inflation down in he coming months, but risks to our year-end 4% core CPI inflation forecast (3.5% for PCE) remain tilted to the upside.

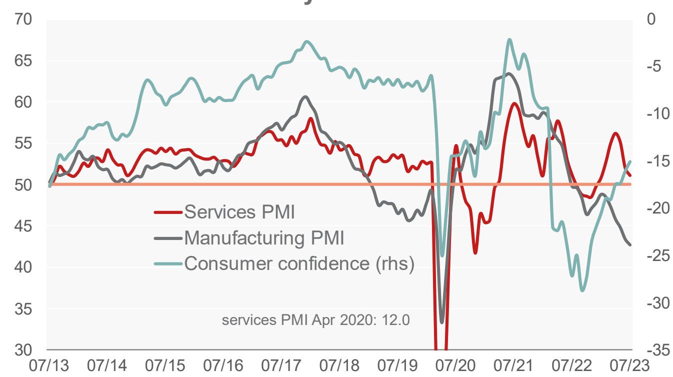
First rate cut no earlier than in March, with upside risks

The July rate rise brought the Fed funds rate in line with the June dots: the FOMC did not provide any strong guidance about the next moves. Further rate hikes are not our baseline scenario, as real rates are deeply in positive territory across all maturities and the concerns for financial stability remains especially given the rise in defaults. However, they cannot be ruled out should the tentative signs of deflation prove temporary. The deceleration of the economy will warrant a rate cut at the end of Q1 or slightly later.

Euro Area

Martin Wolburg

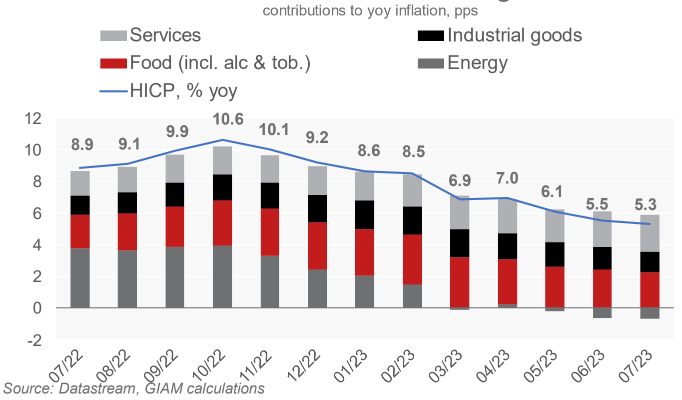
Euro area key sentiment indicators



Source: Datastream

EA inflation breakdown at a glance

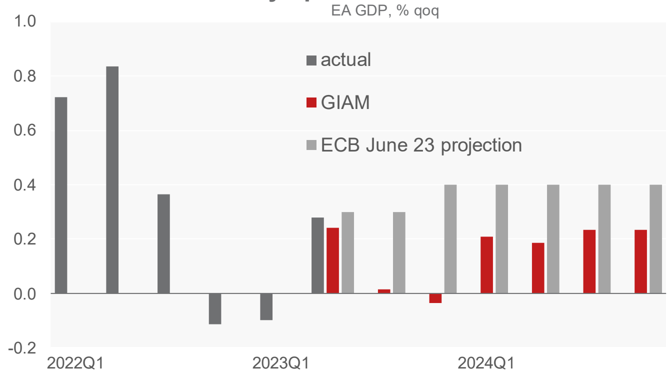
contributions to yoy inflation, pps



Source: Datastream, GIAM calculations

A very optimistic ECB outlook

EA GDP, % qoq



Source: Datastream, ECB, GIAM

- **While GDP showed an expected rebound of 0.3% qoq in Q2, the July PMI release highlights the risk of receding activity in Q3.**
- **Mainly owing to further receding inflation amid a healthy labour market we still make a recession not our base case but look for stalling activity only.**
- **At its July meeting, the ECB adopted a truly data-dependent stance. A much more balanced rhetoric makes our call of a further 25 bps hike to 4.0% in September a very tight one.**

The euro area defied concerns about another quarter of stalling activity and reported an surprisingly strong increase of GDP by 0.3% qoq in Q2. Information from countries suggest that foreign trade (France) and stabilising consumption (Germany) were key drivers. However, looking ahead a cooling of activity is clearly underway. At the outset of the third quarter key sentiment indicators deteriorated across the board. The composite PMI receded to 48.9, a level consistent with shrinking output while forward-looking components in various business surveys also weakened.

Still we think that stalling activity but not a recession is the base case for the second half of the year. A key stabilizing factor will be further moderating inflation. In July, headline inflation fell to 5.3% yoy. Receding energy and commodity prices and less pipeline pressure will drive inflation to below 3% yoy by the end of the year. Improved real income growth amid a solid labour market will be major stabilizing pillars. Consumer confidence rebounded to the highest since February 22 in July and will likely advance further ultimately coinciding with higher spending.

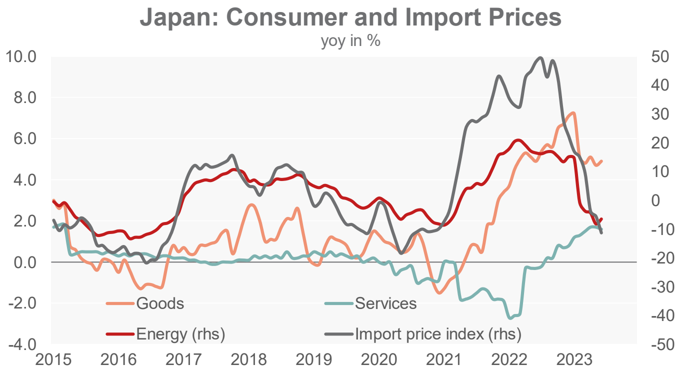
Overall, we left our below consensus (of 0.6%/0.9%) 2023/24 growth forecasts of 0.5%/0.6% unchanged but see risks tilted on the downside.

ECB policy rate peak to be reached in September

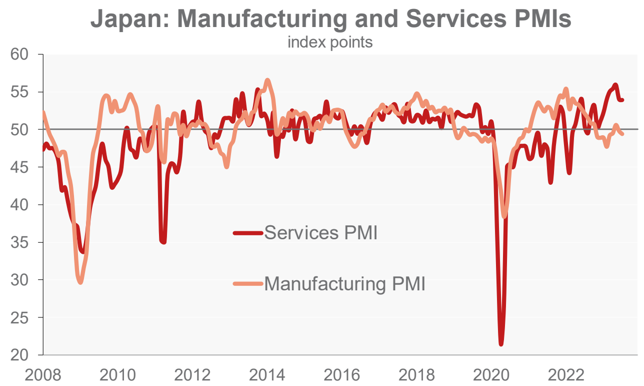
At the July meeting, the ECB lifted the (deposit) rate to 3.75% as expected. However, while considering inflation still as too high (with core inflation stable at 5.% yoyo in July) for too long, it no longer sees the need to necessarily hike rates further but adopted a truly data-dependent stance now. Inflation data and the updated macro projections will be key. We think that the ECB's growth forecast is far too optimistic (see bottom chart). But we doubt that the updated inflation outlook will be benign enough to stop hiking. It became clear that the ECB remains worried about domestic inflation dynamics. We therefore stick to our view of a final 25 bps hike to the peak level of 4.0% but acknowledge that this has become a very tight call now. In any case we think that the peak rate level will be reached in Q3 and held there for about one year.

Japan

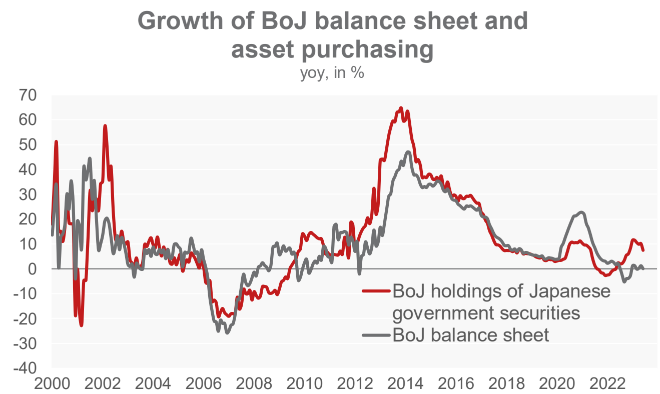
Christoph Siepmann



Source: Datastream, GIAM calculations



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

- **The Bank of Japan announced more flexibility to its yield curve control policy, de-facto raising the upper intervention bound to 1%. We still see the BoJ to be exiting this policy rather calmly.**
- **While Q2 growth has likely held up by post-Covid private consumption, we expect a softening in H2.**
- **Inflation shows first signs of stabilising as services inflation was edging down.**

The Bank of Japan (BoJ) announced to conduct its Yield Curve Control (YCC) policy with “greater flexibility”. Basically, the BoJ maintained the official 10-year JGB yield target of 0% and the ±0.5 pp band (as before), but will not enforce the upper bound anymore. Instead, it will offer fixed-rate purchases at 1.0%. Moreover, it will make “nimble responses for each maturity” to encourage the formation of a consistent yield curve, which would allow for a steepening if 10-year yields were to rise more substantially. Nevertheless, de facto the BoJ has begun the exit of its YCC policy but any further (complete) exit will likely remain a lengthy process.

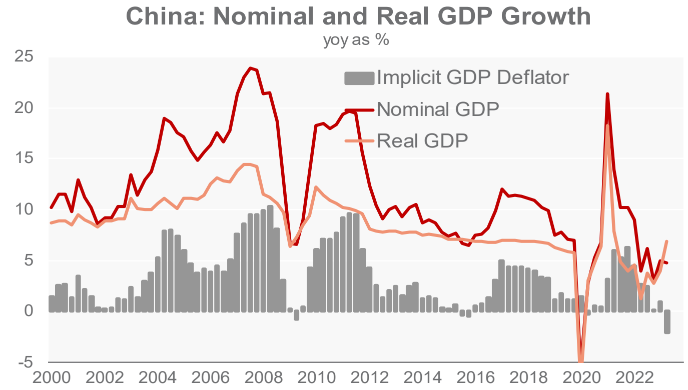
BoJ scepticism regarding sustainable wage increases

Moreover, in its quarterly Outlook Report, the BoJ revised markedly up (as expected) its inflation outlook (core CPI) for FY2023 to +2.5% (1.8% before), but lowered slightly the outlook for the following two years (1.9% resp. 1.6%). This shows (rightly in our view) limited confidence that sufficient wage growth after this year’s 3.6% yoy can be maintained. Meanwhile, June headline inflation re-advanced slightly to 3.3% yoy (after a peak at 4.3% yoy in January). Core-core inflation ex fresh (!) food & energy edged down to 4.2% yoy while the core-core measure ex food & energy remained constant at 2.6% yoy. Thus, much of inflation is still food-driven. By contrast, services inflation receded by 0.2% mom to 1.6% yoy. We see headline inflation at 2.8% this year and 1.8% in the next.

We expect GDP growth to have held up in Q2 by post-Covid consumption strength and a payback effect in exports. However, global growth is expected to slow and signs increased that Japan will not go unscathed. The manufacturing PMI turned deeper into contractionary territory (49.4). The services PMI has started to slow but is still on comfortable levels (53.9). The same is true for Japan’s Economy Watchers’ Survey while consumer confidence still improved. Nevertheless, business investment look to have already entered a downward trend. We see the post-Covid consumption support to slow in H2, which will leave Japan more exposed to global headwinds. We forecast growth at 1% this year and 0.9% in the next.

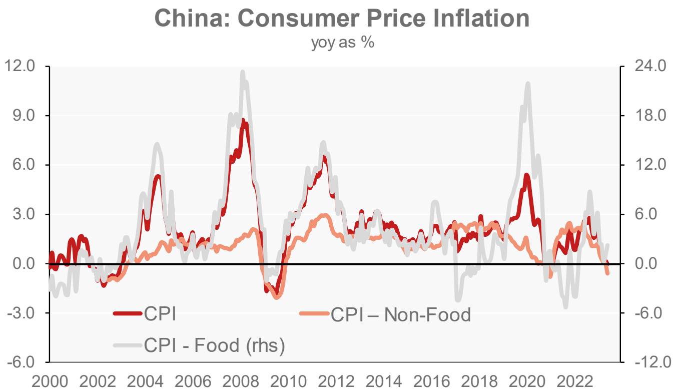
China

Christoph Siepmann



Source: Datastrem, GIAM calculations

Source: Datastream,GIAM



Source: Datastream, GIAM

- **China's growth dynamics have slowed markedly in Q2. Together with backward revisions even the official 5% growth target now looks jeopardized.**
- **Fiscal policy pledged support but did not specify any amount. We expect targeted measures to prevent a drop below the 5% floor, aided by monetary policy.**
- **We see further downside risks to our inflation forecast of 0.6% in 2023.**

After the post-Covid reopening boost, China's growth dynamics slowed substantially from 2.2% qoq in Q1 2023 to 0.8% qoq in Q2. However, the reading was better than consensus and our expectations (i.e. 0.5% qoq), while the yoy rate surprised on the downside (6.3% yoy vs exp. 7.3% yoy). This inconsistency can be largely explained by back-ward revisions. They also have a large negative impact on this year's growth forecast, which we revised down to the officially target of 5%, and additionally see downside risks. To achieve this target, China's business cycle needs to gather some pace again, while historically growth dynamics tended to slow slightly in H2. Fiscal policy holds the key, but the much highlighted Politburo meeting on July 24th failed to announce any quantified measures.

Piecemeal approach to fiscal policy so far

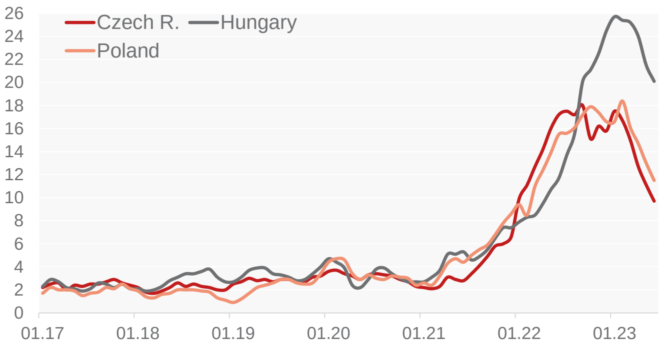
However, it pledged to "make good use of policy space" and "strengthen countercyclical support". A targeted approach remains our base case. For domestic demand, policy makers (in part) reiterated to support consumption, particu-larly of cars, electronics, and home-related goods as well as services such as sports, leisure activities and tourism. China's households have so far not tapped into Covid excess savings but only slowed their additional build-up. Domestic demand is widely seen to be in a confidences crisis, with (see graph) consumer confidence still way below levels before the Shanghai lockdown shock. While June data saw some improvement of overall industrial production and investment growth, the real estate sector remained in the doldrums. Accordingly, policymakers hinted at an easing of local policies. Infrastructure investment will continue to play key role. Beijing called for an accelerated issuance of special local government bonds, which has been slower than last year (currently 57% of this year's quota). Weak domestic demand weighed on inflation. Both, CPI (0.0% yoy) and PPI (-5.4% yoy) missed market expectations in June. Markets started to discuss Japanification scenarios (given strongly rising debt, real estate crisis and demography issues) but Tokyo's (credit financed) stock market and real estate bubbles (which broke down in the early 1990s) lock not comparable. However, we see downside risk to our CPI inflation forecast of 0.6% for 2023.

Central and Eastern Europe

Radomír Jáč

Headline inflation

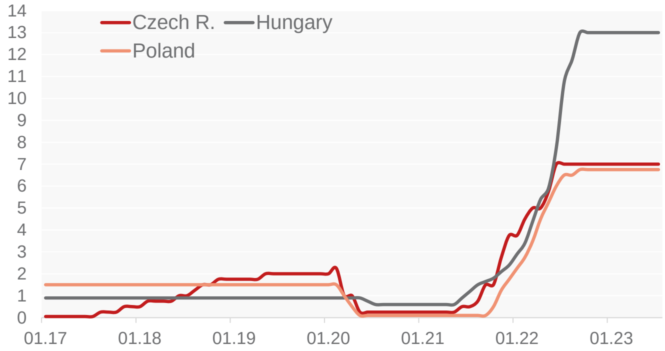
CE-3 countries (CPI yoy in %)



Source: www.czso.cz, www.ksh.hu, www.stat.gov.pl, GIAM

Monetary policy interest rates

CE-3 countries (end-of-month level, in %)



Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

Czech Republic	2021	2022	2023f	2024f
GDP	3.5	2.4	0.1	2.5
Consumer prices	3.8	15.1	10.8	2.5
Central bank's key rate	3.75	7.00	6.50	3.00
Hungary	**2021**	**2022**	**2023f**	**2024f**
GDP	7.1	4.6	-0.1	3.5
Consumer prices	5.1	14.5	17.0	5.2
Central bank's key rate	2.40	13.00	11.00	5.00
Poland	**2021**	**2022**	**2023f**	**2024f**
GDP	6.9	5.1	0.8	2.6
Consumer prices	5.1	14.3	12.2	5.2
Central bank's key rate	1.75	6.75	6.25	4.75

Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

- **Inflation continues to fall, while data on activity are signalling weakness in some segments of the CE-3 economies. All this leads to a gradual dovish shift in the policy stance of the CE-3 central banks.**
- **The Hungarian MNB kept a steady course with cuts in its O/N deposit rate by 100 bps in July.**
- **The Polish NBP indicates that rate cuts will come in H2, the first one possibly as early as in September.**
- **The Czech CNB does not want to hurry policy easing but speculations on cuts in 4Q remain alive.**

Inflation continues to moderate across the region. The CE-3 economies at the same time show weakness in some of their segments (industry and for the most of Q2 also retail sales), which led us to revise down GDP forecasts for 2023. For Hungary we now expect a slight full-year GDP contraction, while Czech GDP may show only a marginal increase. However, we keep expecting a recovery of GDP growth in quarter-to-quarter terms during the current year. For 2024 we expect a healthy GDP performance for the CE-3, which should be driven by a recovery in household consumption due to the mix of a lower inflation and a solid wage growth.

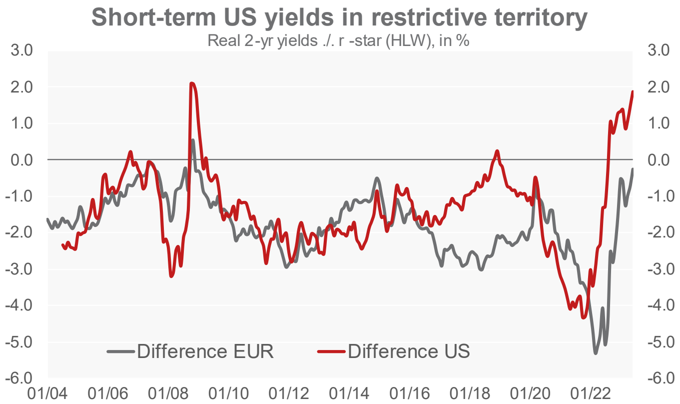
The macro developments and a quite good performance of the national currencies are impacting monetary policy stances in the CE-3. However, the picture is mixed in the individual countries. Hungary was the first one to start normalization of its policy already in May, while the other central banks are more cautious. That said, the Polish central bank started to talk about possible rate cuts, while the Czech CNB at least does not signal a high probability of a rate hike anymore.

Monetary policy: Poland likely to start cutting rates

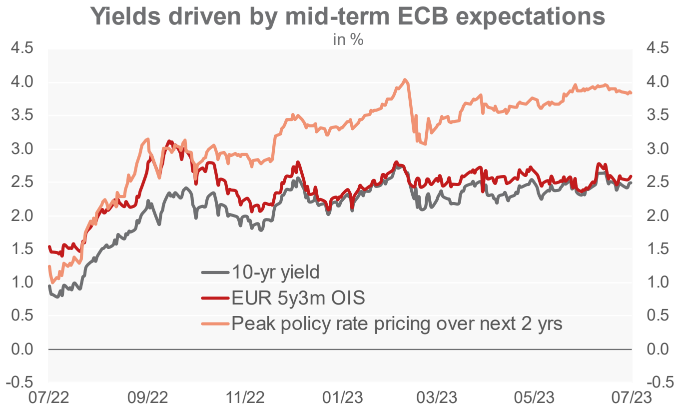
The Hungarian MNB continued its policy normalization with 100 bps cut in the O/N deposit rate within a month: to 15% in July. We expect the same steps in August and September. For Q4 we expect the MNB to start cutting its base rate (currently at 13%). In Poland, the NBP maintains its key rate at 6.75%. However, there are speculations that the NBP may cut rates already at its next meeting in September. Such speculations are fuelled by declining inflation and by comments made by MPC members. We share the view that the NBP will start cutting rates this year. However, we think that the first cut is likely to come only in Q4, after inflation reaches a single-digit area. The Czech CNB is likely to keep its key rate unchanged at 7% in Q3. The CNB will present an updated macro forecast at its next policy meeting scheduled for August 3. The forecast is likely to keep alive market speculation for rate cuts in Q4.

Government Bonds

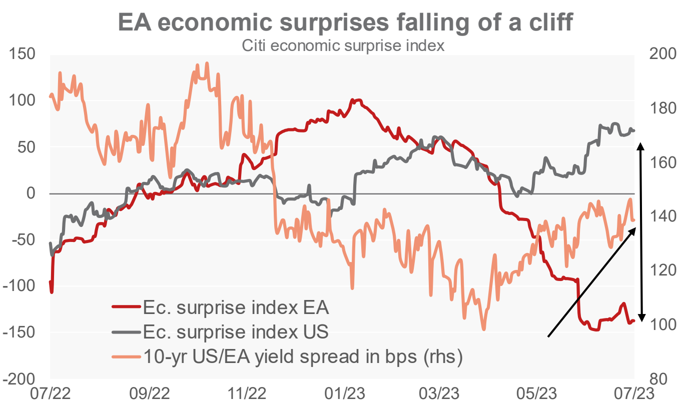
Florian Späte



Source: Bloomberg, NY Fed, GIAM



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM

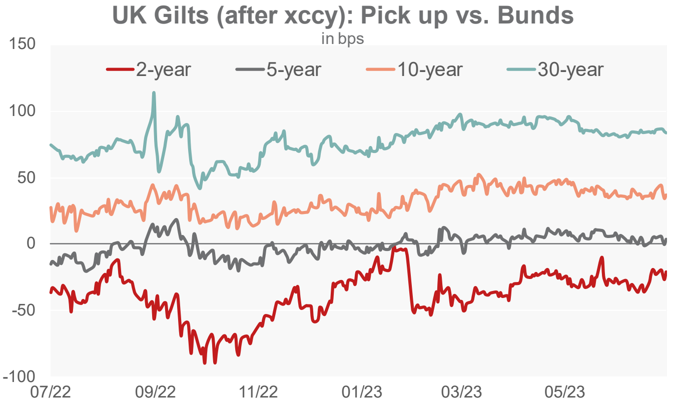
- **With the key rate cycle is nearing its end in the US (no more hike) and in EA (potentially one final step), yield curves have steepened in July.**
- **Bond markets are now in a wait-and-see mode. We do not expect a noticeable decline in yields short term. If anything, US yields have more downside potential amid a moderate recession later this year. This is seen to lower the transatlantic yield spread.**
- **Manageable supply, seasonality, and decreasing volatility are supportive factors for EA non-core bond spreads. However, deteriorating risk sentiment and still dear valuations are likely to win the upper hand. Spreads are expected to widen modestly.**

Developments on the international bond markets did not show a clear picture in July. While international central banks have softened their rhetoric regarding further key rate hikes leading short-dated yields modestly southwards, good US economic data in particular have lifted yields on long-term bonds. In particular, the 2-yr/10-yr EA yield curve has steepened back to the levels of mid of June.

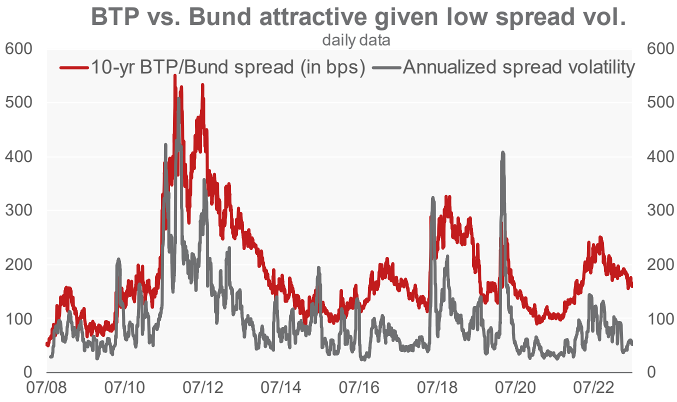
We do not expect major movements in the international bond markets during the summer break. While inflation rates should continue to decline moderately, the resilient US economic data and 10-yr yields well below the policy rate argue against a noticeable decline in yields in the short term. The term premium is low both in the US and in the EA and while central banks stressed the data dependency a key rate cut already in 2023 can almost be ruled out.

Although moderate, we see the downward pressure in the US as somewhat more pronounced for various reasons. The Fed and the ECB avoided any strong forward guidance in July. Nevertheless, financial markets still see a 25% probability of a Fed hike and a 70% probability of an ECB hike in September. We expect expectations for the Fed to be disappointed. In contrast, we continue to forecast a further move by the ECB. This divergent development should not fail to have an impact on longer-dated bonds either. Although it should be emphasised that medium-term key rate expectations, in particular, determine the yields of 10-yr bonds, there is also more downside potential in the US, as the degree of monetary policy tightening in the US is much more pronounced than in the EA (see chart). We do not foresee key rate cuts by the ECB until mid of 2024, but forecast 3 cuts (each 25 bps) by the Fed within a year (on average 10-yr US yields fall by 60 by within a year following the last hike). What is more, the divergence of macro indicators looks unsustainable. Catching up with the US will support a tightening of the transatlantic yield spread as well.

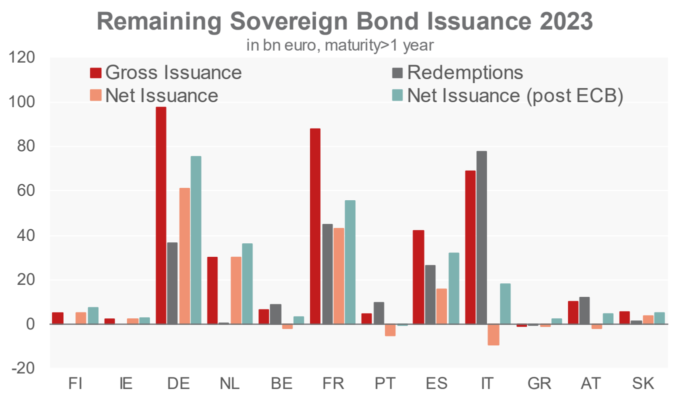
Government Bonds



Source: Bloomberg, Datastream, Eikon, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, Bloomberg, GIAM calculations

However, there are three caveats: firstly, US activity data are still strong and as long as there are no signs of an economic slowdown, US yields will not fall noticeably either. Secondly, the high US fiscal deficit is slowing down a drop in yields. Moreover, it will remain at a very high level not only in 2023 but also in the years to come (if the medium-term forecasts of the Congressional Budget Office are confirmed, even the US rating is at risk in the long term). Thirdly, the tweaking of the BoJ's monetary policy (effectively widening the band to +1%) removes an anchor for global bond markets and will put some upward pressure on global yields.

Overall, we consider US Treasuries to be the better investment, even taking into account the hedging costs. In addition, very long-dated UK Gilts are also attractive. The expected further key rate hikes by the BoE have been priced in and should no longer trigger a sustained rise in UK yields. As the top chart shows, euro investors can achieve a pick-up compared to Bunds (considering hedging costs) and thus exploit the historically high yield gap of at least 180 bps compared to Bunds for long and very long-dated bonds.

Only modest widening of EA non-core bond spreads

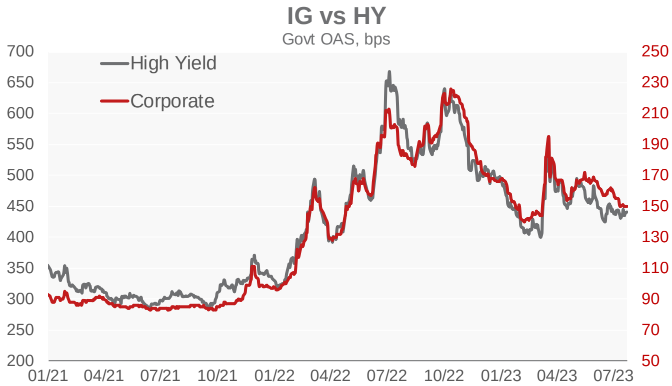
EA non-core bond spreads initially widened further before falling again on supportive ECB comments in the last few weeks. However, the lows of mid-June were not reached. This reflects the current, ambiguous data situation quite well. On the one hand, declining bond market volatility, advanced issuance activity (particularly the Italian situation appears quite convenient until the end of 2023), a nearing end of the hiking cycle and favourable seasonality should support EA non-core bonds over the next few weeks. On the other hand, we forecast risk sentiment to deteriorate going forward. Moreover, the valuation appears less dear than in mid-June but it still looks ambitious. Additionally, and this is more of a medium-term aspect, the combination of lacklustre fiscal consolidation, a higher yield environment, and lower nominal growth does not bode well for debt sustainability. The approval for the disbursement of the delayed NGEU tranche for Italy is clearly positive. However, receiving the next tranche within 2023 is still hard work (and it is mostly in loans). Overall, we forecast a slight upward trend for spreads in August.

We consider discussions about speeding up QT to be premature. Although the QT momentum will rise going forward due to increasing PSPP redemptions, the ECB recently confirmed again that the PEPP redemption flows will be reinvested at least until the end of 2024.

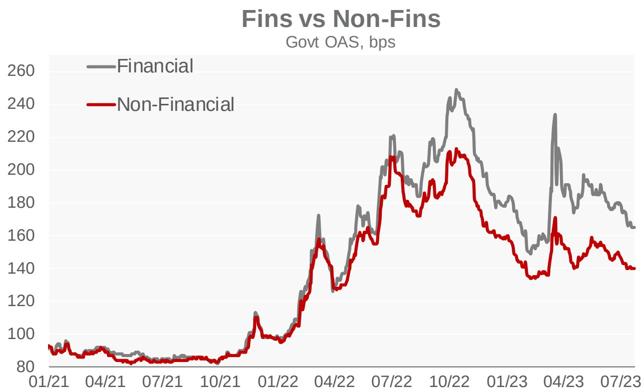
The Spanish elections have not resulted in a clear winner. New elections later in the year are likely and could put a modest strain on Bonos.

Credit

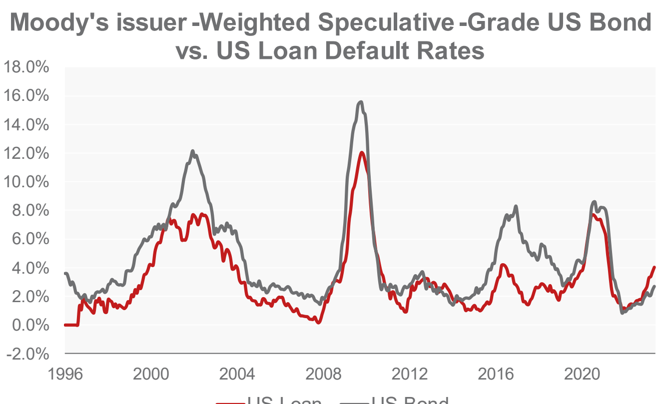
Elisa Belgacem



Source:Bloomberg, BofAML Indices, GIAM



Source:Bloomberg, BofAML Indices, GIAM



Source: Moody's, GIAM

- **The current reporting season is providing a decent picture on earnings, but credit fundamentals are already deteriorating. We continue to play the decompression in credit with IG expected marginally wider while HY could widen up to +100bp wider over a 3-to-6-month horizon.**
- **We maintain our OW stance on IG, even more, after the rally. Current CDS levels are attractive to buying credit protection.**
- **We do like IG duration even though curves are already very flat. We maintain our preference for non-fin. vs. financials and of subordination risk versus credit risk.**

The recession expectations have been postponed a few times over the recent months, but we think that decompression across the credit space is coming now. Valuations metrics among the credit universe show that the European IG space is the cheapest compared to US IG and both EU and US HY. Also, we expect smaller companies to be the most at risk and defaults are already visible.

Liquidity risk is emerging in HY

First, US loan default rates currently surpass US bond defaults mostly because companies facing maturities in 2024 are proceeding to distressed exchange. But this might effectively result in higher effective defaults down the line. HY defaults are also accelerating in the US and in Europe and the liquidity of the market will be tested after summer as bonds maturing in 2024 will have to be refinanced.

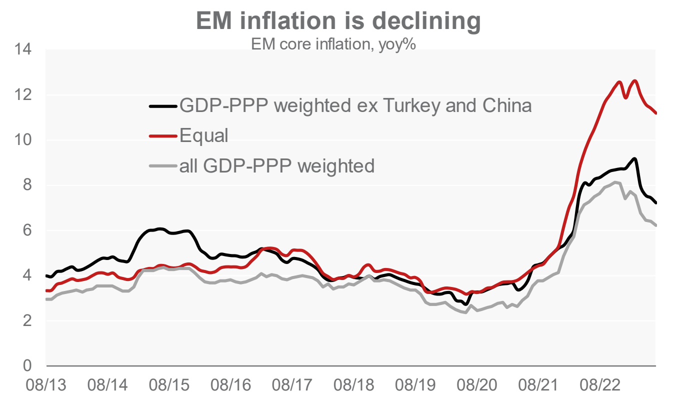
The ECB is likely to sell climate laggards

During its July meeting, the ECB reiterated that it is committed to be Paris Agreement-aligned and will release the means by which it intends to do so by the end of the year. Since they are not buying corporate bonds anymore, selling climate laggards seem the most likely option. Looking at the period over which the climate policy was applied it seems that the ECB should mostly take a sector neutral approach pressuring the laggards within each sector.

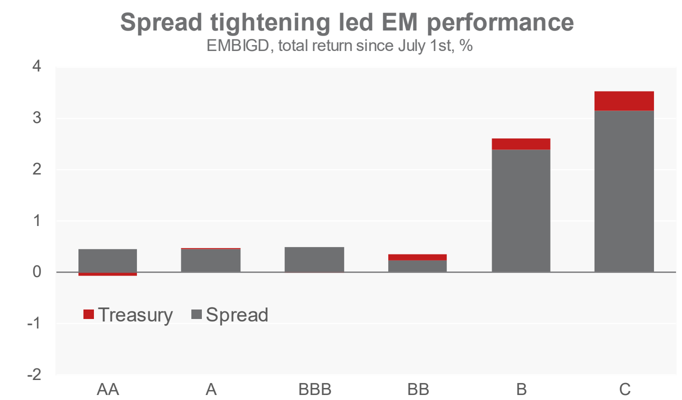
Overall, we prefer IG to semi-core and peripheral sovereigns, on valuation grounds. In Europe, IG levels are still attractive after the rally versus historical standards. We expect spreads to trade around current levels over the course of next year. For HY, we think that current valuations do not reflect elevated risks. Consequently, we expect spreads should widen nearly 100bp by year end. CDS have tightened much faster than cash, and we like to buy credit protection here. Banks' asset quality should also deteriorate, which leads us to remain underweight financials versus non-financials in spread terms.

EM sovereign bonds

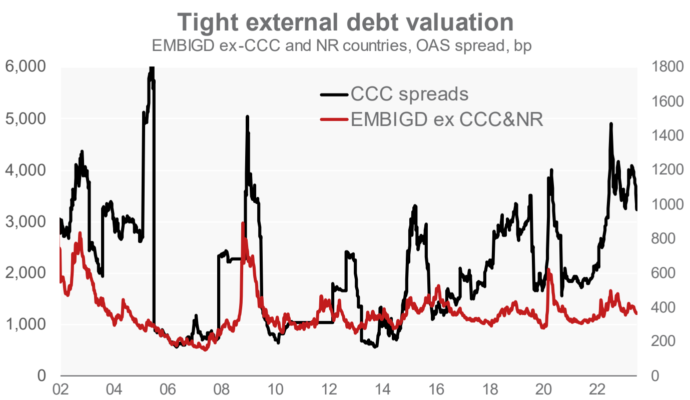
Guillaume Tresca



Source: Bloomberg, countries, GIAM calculation



Source: JP, Bloomberg, GIAM



Source: Bloomberg, JP, GIAM

- **EM fixed-income will further benefit from the EM growth resilience and the EM disinflation trend despite tight valuations. We maintain our OW stance.**
- **We keep our preference for EM local over external debt. EM carry trades will go on but mind the heavy positioning and the choice of funding currency.**
- **We revised lower our external debt spread widening as recession fears declined. We prefer EM BBBs and BBs in the EM HY space.**

The EM fixed-income complex has continued to outperform benefiting from the better risk appetite and the last positive US CPI reading. It should remain supported until the end of the summer. Indeed, the EM macro environment has gradually improved with the confirmation of the disinflation trend that is more powerful and started earlier than in DMs. EM central banks will keep cutting with now the first cuts in LatAm. EM economic activity also shows signs of resilience and while we expected a tightening of the EM-DM gap growth, risks are now skewed for stronger growth. However, China is the elephant in the room. Activity is disappointing and it will drag the Asia complex, but expectations are low and peak pessimism has likely passed. Therefore, it is an environment for EM where we maintain an overweight stance in our global allocation, and even increase the beta exposure as recession risks have been pushed back

Summer carry for local debt

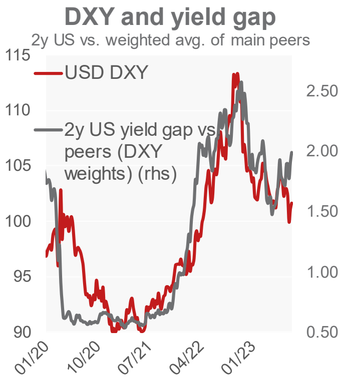
The confirmation of the disinflation trend incites us to maintain our preference for EM local over external debt. We agree that valuations are not compelling historically, but they are more attractive in relative terms than for external debt. We are selective, favouring only high-yielders (Brazil, Mexico, Hungary) and the belly of the curve. More EM FX appreciation will also provide further support to local debt. Carry trades have been fashionable and the continuation of the soft-landing narrative this summer should not change the trend. However, there is a concentration risk, and the turnaround can be rapid in the case of a risky event.

External debt: less spread widening

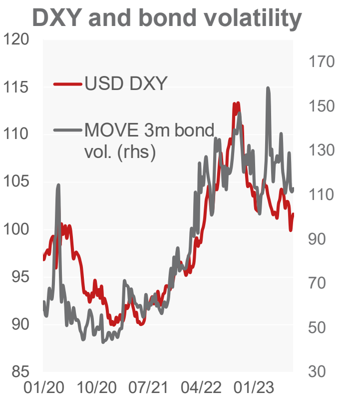
We revise lower our spreads widening expectation as the US recession and EM economic slowdown fail to materialise. That said, we remain of the view that valuations are tight and central banks tightening will at some point start biting. Positive duration effect and carry will lead to positive returns despite valuations. In the IG space, we favour EM BBB (Romania, Mexico) while in the HY space, EM BB (Colombia) will benefit from the better risk environment.

Currencies

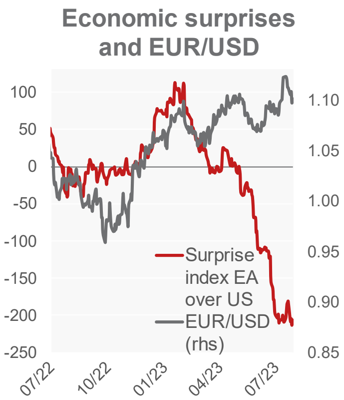
Thomas Hempell



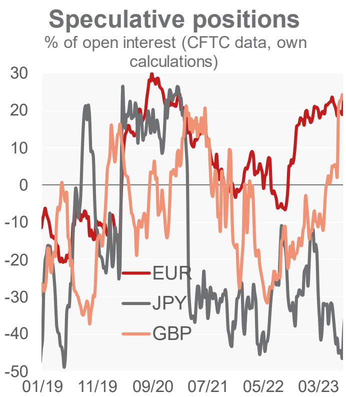
Source: Datastream, GIAM



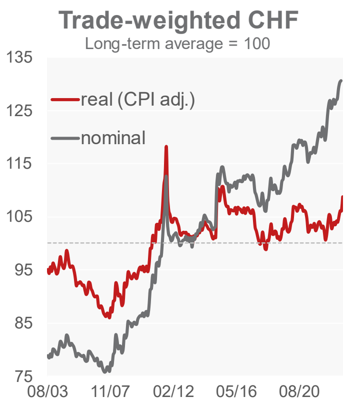
Source: Datastream, GIAM



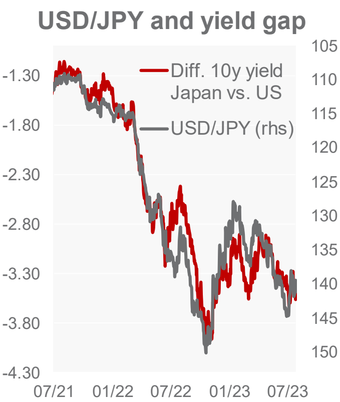
Source: Citi, Datastream, GIAM calculations



Source: CFTC, Datastream, GIAM



Source:Datastream, GIAM



Source: Datastream, GIAM

- **Further USD downside is looming by year-end on easing rates volatility and narrowing yield gaps.**
- **Tactically, however, the recent EUR/USD bounce looks stretched, with more two-sided volatility likely.**
- **CHF will remain bid amid safe haven flows and extended EA stagnation for now.**
- **We see the JPY geared towards moderate further strength as the US/Japan yield gap is set to narrow.**

Even as the US economy extends its resiliency and Europe seems trapped in stagnation, the USD weakened in June. With June US CPI prints fuelling hopes of faster disinflation, the USD suffered, though paring some losses on a strong Q2 GDP print. We keep our view of a weaker USD by year-end as lower rates uncertainty will erode a key USD support, while the Fed is set to lead the 2024 easing cycle.

EUR/USD: upside medium term, but tactically neutral

Yet the recent EUR/USD bounce looks detached from various FX drivers. The yield gap has barely moved while the EA and Chinese economies are dragged by stronger headwinds for now. Deteriorating risk sentiment may also keep the USD bid. The EUR has benefitted from a currently very low risk premium on Southern European debt, which may rather increase than tighten further. For the next leg up in the EUR/USD, we will also need to see stronger evidence for the EA escaping stagnation, which is unlikely to happen over summer. So while we stick to our positive EUR/USD by year end and into 2024, we would not be surprised to see temporary setbacks over the coming weeks and favour a neutral USD exposure tactically.

The CHF is benefitting from sticky inflation in Europe and safe haven flows amid disappointing data in the euro area. Our call for a stronger CHF has played out well. But with the real effective CHF now quite a leg higher, we turn more prudent on the Swiss currency. The SNB may gradually turn more reluctant to support the franc given the levels reached and with core inflation finally budging. Medium term, we still have a reversal to parity for EUR/CHF in our books.

The British pound GBP has benefitted from the repricing of BoE rates expectations and a massive shift in speculative positions. We do not expect any sharp reversal, but worries about the economic fallout from the BoE's slamming on the brakes will increasing come to the fore also on FX markets.

The BoJ has tweaked its YCC regime further, effectively allowing Japanese yields to move higher. With the Fed likely done with its rate hikes, the prudently more hawkish direction of BoJ policy will help to narrow the US/Japanese yield differential, leaving further downside for the USD/JPY from still elevated levels.

Equities

Michele Morganti, Vladimir Oleinikov

Analysis of the median stock: Q2 2023 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q2 2023
S&P	6.1 %	6.2 %	5.9 %	5.9 %	0.1 %	0.3 %	42.8%
Stoxx	11.4 %	11.9 %	11.4 %	6.6 %	(0.0)%	5.3 %	43.1%
Euro Stoxx	12.7 %	8.3 %	8.4 %	5.0 %	4.3 %	3.3 %	37.0%
Topix	5.3 %	9.1 %	7.1 %	7.7 %	(1.9)%	1.4 %	15.5%

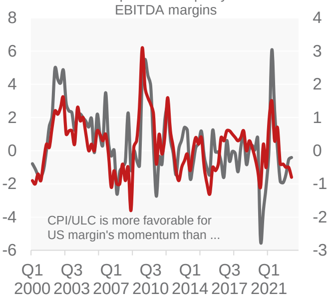
Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q2 2023
S&P	4.8 %	4.6 %	1.6 %	1.1 %	3.2 %	3.5 %	42.8%
Stoxx	7.6 %	2.7 %	1.8 %	0.7 %	5.8 %	2.0 %	43.1%
Euro Stoxx	8.7 %	0.5 %	2.0 %	0.7 %	6.8 %	(0.2)%	37.0%
Topix	1.8 %	15.7 %	0.4 %	0.7 %	1.4 %	15.0 %	15.5%

Note: numbers for Q2 are calculated only for the companies which have so far reported in Q1
proxy for margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations

US Margins & CPI/ULC

NIPA profits/GDP proxy for EBITDA margins

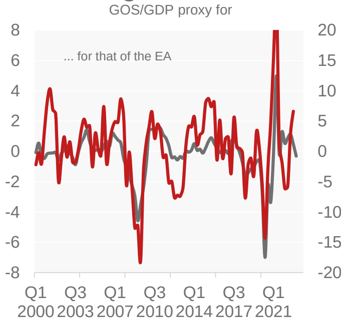


—core CPI/ULC (1y ch%)
—NIPA profits/GDP (1y abs chg, rhs)

Source: Eikon, GIAM

EA Margins & CPI/ULC

GOS/GDP proxy for



—core CPI/ULC (1y ch%)
—GOS/GDP (1y abs chg, rhs)

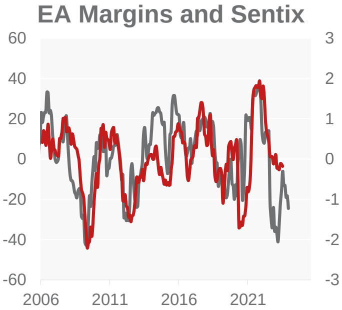
Source: Eikon, GIAM

US Margins & new orders / inventories

—ISM new orders/inventories (1yr abs cng, 10m lead)
—S&P500 EBITDA/sales (12m fwd, 1y abs cng, rhs)

Source: Datastream, GIAM calculations

EA Margins and Sentix



—Sentix future expectations, 5m leading
—MSCI EMU EBITDA/sales (12m fwd, 1y abs cng, rhs)

Source: Datastream, GIAM calculations

- **US macro resiliency together with declining headline inflation is fuelling a sentiment of goldilocks scenario, with investors buying more equities to cover their previous shorts.**
- **Q2 EPS season is showing positive surprises, but the market reaction is contained as positioning has increased above average (albeit still not exuberant) and firms' guidance is less upbeat than in Q1 2023.**
- **Margins should weaken, though, showing negative revisions, particularly in the euro area (EA). Disinflationary force of monetary policy acts with a lag of some quarters, and in the next quarters the economy should feel the hit.**
- **Valuations are not attractive vs. real 10-year yields and credit spreads. Furthermore, equity-bond total return (TR) models (ML) are strongly in favour of bonds. We remain cautious on equities.**
- **12-month view: total returns of +3% for the US and +6% for the EMU. Regional recommendation: OW Japan, SMI, China, India and slightly US vs EMU, notwithstanding a significant EMU undervaluation.**
- **EU sectors: Overweight (OW) Food Retail, Food, Diversified Financials, Health Care, HPP, Durables, and Software. UW Capital Goods, Telecoms, Insurance, Media, and Transportation.**

US macro resiliency together with declining headline inflation is still fuelling a sentiment of goldilock scenario, causing investors to increase their positioning on equities. The US Beige book as well as NFIB small firms' sentiment and macro surprises added recently to the strong Q2 GDP and consumer spending. Furthermore, while US bond volatility remained flat in the month (MOVE index), the equity vol (VIX) declined slightly, which is positive for equity returns vs. bonds' ones. Indeed, relative US equity TR vs 10-year bond ones were positive by +5.4% (+4.5% for EMU).

Positive Q2 surprises but margins about to weaken

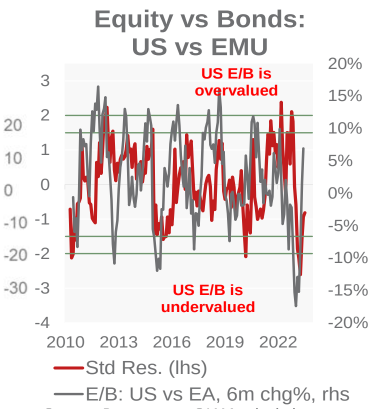
The Q2 reporting season is showing nice positive surprises vs. consensus (nearly 40% reported). This comes after noticeable negative revisions before the season started. While US firms' beats are near historical average, the EU ones are more muted. The market reaction is contained, too, as positioning has increased above average (albeit still not exuberant) and firms' guidance is less upbeat than in Q1.

We remain cautious on equity. To start with, EMU macro surprises, in contrast to those in the US, have plunged. Other confidence indicators (Sentix or IFO) are also weaker (but less so for the ISM). In general, we still believe that the

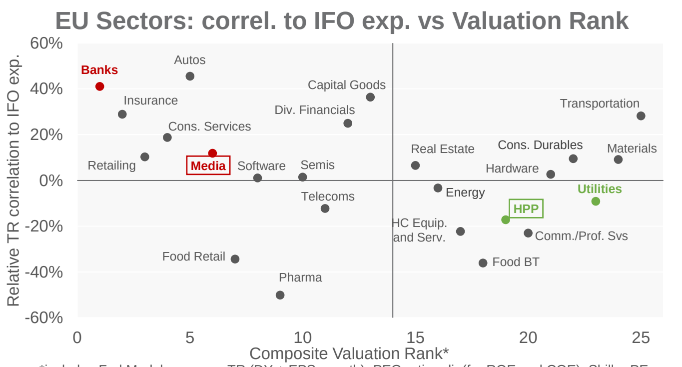
Equities

Michele Morganti, Vladimir Oleinikov

Source: Datastream, GIAM calculations



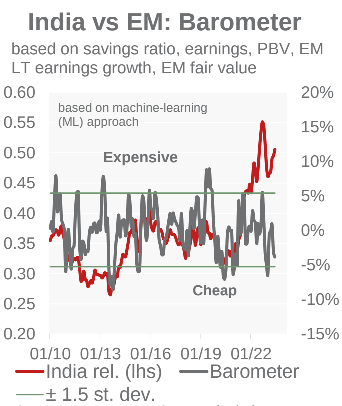
Source: Datastream, GIAM calculations



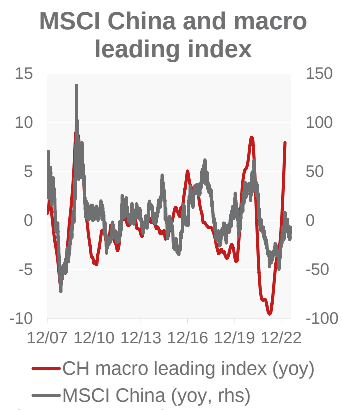
*includes Fed Model gap, exp. TR (DY + EPS growth), PEG ratio adj. (for ROE and COE), Shiller PE, 3-stage EPS growth model, mkt multiples, and PE vs hist. avg. excl. bubble years

Red = negative machine learning quant models; Green = positive machine learning quant models

Source: Refinitiv, GIAM calculations as of 27/07/2023 ▭ = stronger signals (> 2 SD)



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

lagged effect of the monetary policy can hurt, most probably till Q1 or Q2 2024. While peaking, CB key rates can remain high for longer (with lingering QT) as core inflation is sticky, labour markets solid, wages increasing and US growth resilient. Lending standards are tighter, demand for new loans decreasing, excess savings declining and money aggregates very low (M2). Not surprisingly, defaults are on the rise (we are cautious on HY spreads, see credit section).

Currently, price earnings are high, when considering the level of 10-year rates or BAA spreads. This would be justified under the assumption of a strong macro acceleration from here, which we don't envisage. Furthermore, markets now discount even the bullish consensus EPS forecasts, and our ML quant models, which forecast equity TR vs. bonds' ones, are now in expensive territory for equities. Even if we don't forecast a deep recession in the next months, a weaker economic momentum should induce earnings revisions to fall vs. consensus, especially in the EA. Less so for US margins which are already near a cyclical low. We gauge this view looking to the CPI/unit-labour costs (ULC) momentum, confidence indicators (Sentix and ISM) and the weaker trade-weighted USD (positive for USA). Our models see -2% yoy growth in 2023, with a recovery thereafter. Our forecasts remain below consensus by 5% in 2024 and 9% in 2025.

Slightly UW equities. OW: JP, CH, IN, SMI, US vs EMU

We remain cautious on equities in the short term. We are more positive over 12-months, expecting TR returns in the range of 3%-6%. Regional allocation: OW Japan (valuation), SMI (earnings), China and India (eco), and slightly US vs EMU (margins & macro momentum, ML equity-bond models, undervaluation of ex-IT SPX), notwithstanding a significant EMU undervaluation. **EU Sectors**: we move to a slightly more defensive-growth allocation, while maintaining an unchanged beta (1.1). We lower Materials to Neutral (valuation, negative revisions) and Transportation (valuation, stretched performance vs. earnings) to increase Health Care Equip. & Svs. and Div. Financials (valuation, earnings revisions). **OWs:** Diversified Financials (new), Durables, Food Retail, Food Bev. Tob., HC Equip. & Svs., HPP, Pharma, Software. **UWs:** Capital goods, Insurance, Media, Telecoms, Transportation.

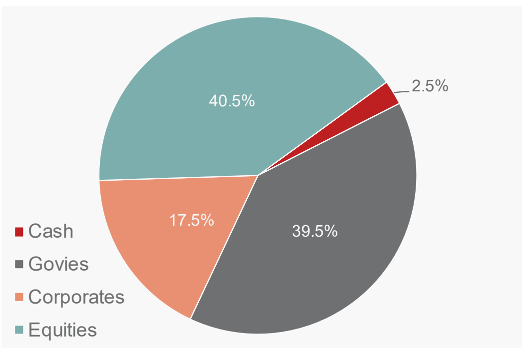
EMs: to benefit from likely bottoming in macro surprises

Bottoming macro surprises and improving earnings revisions represent tailwinds for EM. We OW China due to low valuations and probable fiscal and monetary supports. India (OW) should benefit from comfortable macro conditions, i.e. structurally higher GDP growth and falling inflation.

Asset Allocation

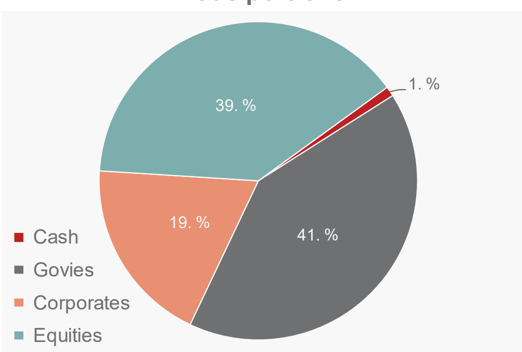
Thorsten Runde

Benchmark



Source: GIAM

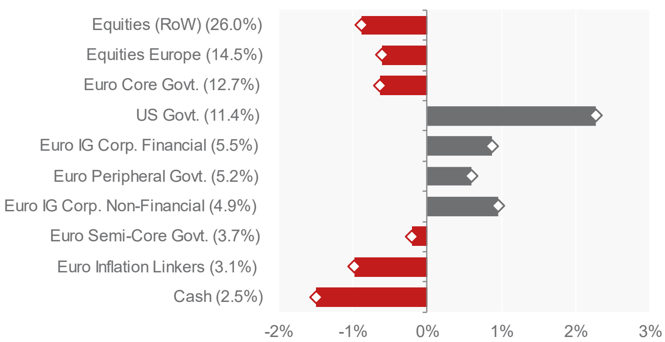
Modelportfolio



Source: GIAM

Active Positions

TOP 10 Benchmark Constituents



Source: GIAM; Benchmark weights in parentheses, diamonds indicating previous recommendations

- **Apart from long-dated European government bonds and US Treasuries, our covered asset classes rendered positive returns over July (per 27/7).**
- **Equities ranging from +3.9% (MSCI EM) to +1.2% (MSCI Pacific), are at the top of the performance ranking together with the EM Govies (+1.3%).**
- **The bottom of the ranking is clearly dominated by long-dated fixed income, led by US Treasuries (-2.9%) and EA Core Govies (-1.6%).**
- **Overall, the performance of EA HY Credit was in line with EA IG (+7 bps). Within IG, Fin was superior to Non-Fin (+33 bps).**
- **We expect a slower pace of US economic activity eventually capping bond yields, while risk assets will suffer from a more pronounced cyclical turn. This requires caution in tactical allocation.**
- **Thus, we keep the underweights in the most risky assets like Equities and EA HY Credit. We continue to favour low-risk credit, especially the carry from IG and short- to medium-dated peripheral bonds. We stay overweighted in US Treasuries and USD-denominated EM govies on an FX-hedged base.**

With -2.7 bps our model portfolio slightly underperformed its benchmark in July (27.07.23). All in, the underweight positions in Cash and long-dated Core Govies (+0.9 bps each) proved most rewarding whereas the OW in US Treasuries (-4.1 bps across all maturity buckets) and the UW in the MSCI Pacific (-0.8 bps) were the most painful ones.

Despite the remarkable resilience of the US economy, there is no denying that the economic slowdown is becoming more and more apparent. On the one hand, this restricts the scope for further increases in bond yields and, on the other hand, it weighs on risk assets.

Risk assets to suffer from cyclical turn

All in, this argues for a continuation of our prudent tactical allocation stance. We stick to our UW positions in Equities. With recent resilience of High Yield looking suspicious, given the credit cracks and recession risks, we confirm our UW here too. We still favour the carry from lower-risk Credit like EA IG and short- to medium-dated BTPs. We prefer US Treasuries in general due to a decent carry and a higher downside tilt in yields feeding through EMs too. For the EA (Core, Bonos) we just favour the belly of the curves. We consider the case for a weaker USD structurally intact. Thus, USD-denominated investments should be hedged.

Forecasts

Macro Data

Growth[1]	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.
US	2.0	0.9	- 0.4	0.3	- 0.2
Euro area	3.3	0.5	- 0.1	0.6	- 0.3
Germany	1.8	- 0.3	- 0.1	0.5	- 0.6
France	2.6	0.3	- 0.3	0.8	- 0.1
Italy	3.9	1.0	- 0.0	0.7	- 0.1
Non-EMU	3.6	0.1	- 0.1	0.9	- 0.0
UK	4.1	0.0	- 0.1	0.7	- 0.1
Switzerland	2.1	0.8	0.1	1.4	0.0
Japan	1.2	1.0	- 0.1	0.9	- 0.1
Asia ex Japan	4.1	4.7	- 0.5	4.9	- 0.1
China	3.0	5.0	- 0.7	4.8	- 0.1
CEE	1.2	1.2	0.5	2.8	0.6
Latin America	3.7	0.9	0.0	1.6	- 0.0
World	**3.3**	**2.3**	**- 0.2**	**2.6**	**- 0.1**

1) Regional and world aggregates revised to 2020 IMF PPP weights

Inflation[1]	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.
US	8.0	4.3	0.2	2.8	0.2
Euro area	8.4	5.5	0.1	2.5	0.1
Germany	8.6	6.1	0.1	2.7	0.1
France	5.9	5.3	0.0	2.6	- 0.1
Italy	8.2	5.2	- 0.9	2.4	- 0.1
Non-EMU	8.1	6.8	0.3	2.6	- 0.3
UK	9.1	7.7	0.4	2.7	- 0.5
Switzerland	2.8	2.5	0.1	1.5	0.1
Japan	2.5	2.8	- 0.0	1.8	0.3
Asia ex Japan	3.5	2.2	- 0.3	2.8	- 0.1
China	1.9	0.6	- 0.7	2.1	- 0.2
CEE	29.6	16.8	- 1.0	10.4	- 1.2
Latin America[2]	7.8	5.9	0.0	4.0	0.0
World	**7.8**	**5.1**	**- 0.2**	**3.5**	**- 0.1**

1) Regional and world aggregates revised to 2020 IMF PPP weights ; 2) Ex Argentina and Venezuela

Financial Markets

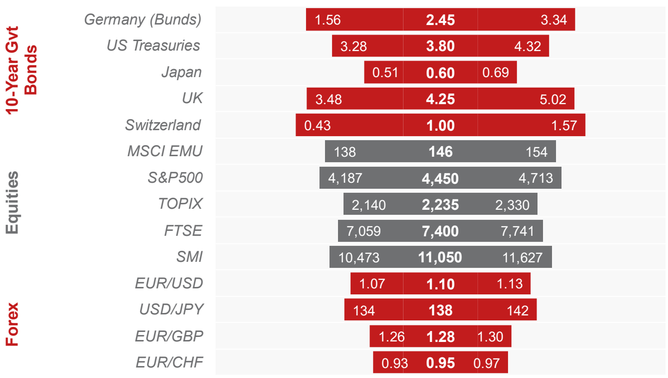
Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US (upper bound)	5.50	5.50	*5.43*	5.50	*5.28*	4.75	*4.44*
Euro area	3.75	4.00	*3.82*	4.00	*3.83*	4.00	*3.35*
Japan	-0.10	-0.10	*-0.05*	-0.10	*-0.02*	0.00	*0.06*
UK	5.00	5.50	*5.70*	5.75	*5.85*	5.75	*5.53*
Switzerland	1.75	2.00	*1.82*	2.00	*1.91*	2.00	*1.90*
10-Year Gvt Bonds							
US Treasuries	3.92	3.80	*3.90*	3.60	*3.87*	3.40	*3.81*
Germany (Bunds)	2.43	2.45	*2.43*	2.40	*2.41*	2.30	*2.36*
Italy	4.08	4.15	*4.08*	4.15	*4.11*	4.10	*4.16*
Spread vs Bunds	*165*	*170*	*165*	*175*	*170*	*180*	*180*
France	2.99	3.00	*2.99*	2.95	*2.99*	2.90	*2.98*
Spread vs Bunds	*56*	*55*	*56*	*55*	*58*	*60*	*63*
Japan	0.45	0.60	*0.50*	0.65	*0.54*	0.75	*0.62*
UK	4.29	4.25	*4.27*	4.15	*4.23*	3.95	*4.22*
Switzerland	0.97	1.00	*0.91*	1.00	*0.90*	0.95	*0.88*

*3-day avg. as of 27/07/23
**ICE BofA (OAS)

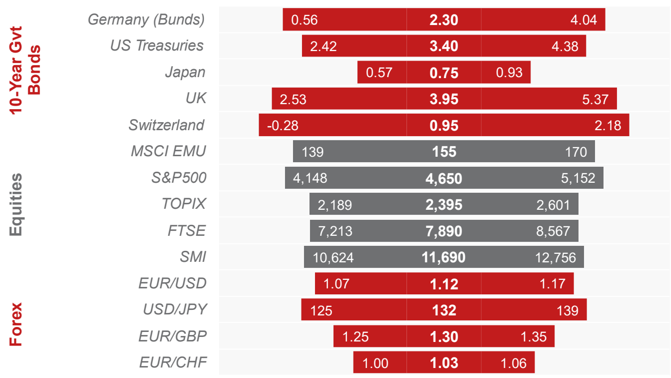
Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	139	150		155		150	
EA IG Financial	164	190		200		195	
EA HY	434	540		550		520	
EM Sov. (in USD)	308	335		350		330	
Forex							
EUR/USD	1.10	1.10	*1.11*	1.11	*1.11*	1.12	*1.12*
USD/JPY	140	138	*139*	135	*137*	132	*133*
EUR/JPY	155	152	*154*	150	*152*	148	*149*
GBP/USD	1.29	1.28	*1.29*	1.29	*1.29*	1.30	*1.28*
EUR/GBP	0.86	0.86	*0.86*	0.86	*0.87*	0.86	*0.87*
EUR/CHF	0.96	0.95	*0.95*	0.97	*0.95*	1.03	*0.94*
Equities							
S&P500	4,557	4,450		4,440		4,650	
MSCI EMU	150.0	146.0		145.5		154.5	
TOPIX	2,288	2,235		2,235		2,395	
FTSE	7,687	7,400		7,360		7,890	
SMI	11,263	11,050		11,065		11,690	

Forecast Intervals

3-Months Horizon*



12-Months Horizon*



*Forecast ranges of ±1 stdv. centred around point forecasts; based on historical volatilities; length of bars indicative only

GENERALI INSURANCE ASSET MANAGEMENT

Imprint

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

Head of Research: **Vincent Chaigneau**

Head of Macro & Market Research: **Dr. Thomas Hempell, CFA**

Team:
Elisabeth Assmuth | Research Operations
Elisa Belgacem | Head of Cross-Asset Quant & Dev, Senior Credit Strategist
Radomír Jáč | GI CEE Chief Economist
Jakub Krátký | GI CEE Financial Analyst
Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist
Vladimir Oleinikov, CFA | Senior Quantitative Analyst
Dr. Thorsten Runde | Senior Quantitative Analyst
Dr. Christoph Siepmann | Senior Economist
Dr. Florian Späte, CIIA | Senior Bond Strategist
Guillaume Tresca | Senior Emerging Market Strategist
Dr. Martin Wolburg, CIIA | Senior Economist
Paolo Zanghieri, PhD | Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 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."

This document was completed on 31. May 2023.