GENERALI INVESTMENTS

Market Compass
February 2022

MARKET OUTLOOK

- Fed tightening will start in March. Compared with the previous rate hiking cycle it will be less predictable, more data-dependant, and possibly faster.
- We still expect the unfinished global recovery and decent earnings growth to support risk assets. Yet two key risks are materialising: a tougher Fed and rising energy prices. We scaled back our Equity overweight.
- In Fixed Income we retain an overweight in Credit given residual ECB support and resilient fundamentals; we stay UW long-dated Govies.
- The USD will continue in the short term to enjoy the support from higher US rates, but we expect a reversal later this year.

Edited by
MACRO & MARKET RESEARCH TEAM

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

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

US

- (−) High inflation depresses sentiment and hit consumption
- (−) Strong wage growth points to slow cooling of inflation...
- (+) ... but strong labour income point to a Q2 snapback in demand
- (!) We expect this year at least #4 rate increases and the beginning of Quantitative Tightening in the summer

UK

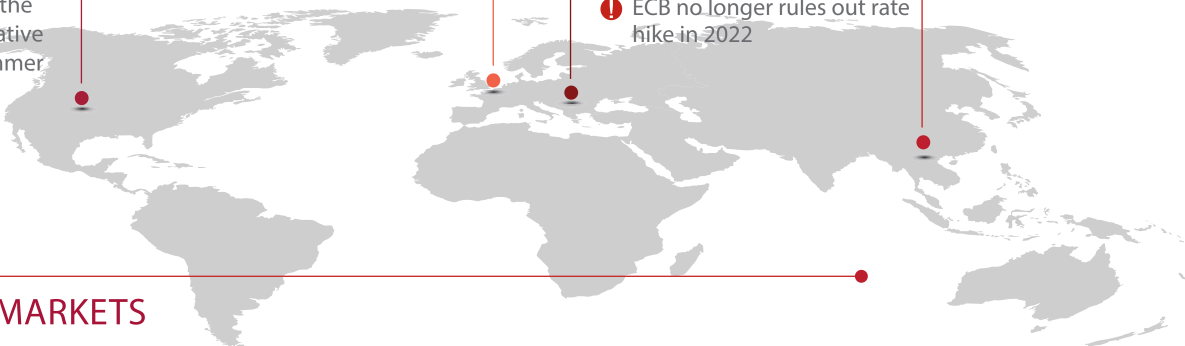
- (−) BoE increased rates by 0.2 in February
- (−) Inflation accelerates
- (!) PM Johnson under increasing pressure over «Party-gate»

EUROZONE

- (−) Weak Q4 growth, omicron-wave and energy prices further up…
- (+) … but the slowdown is only temporary, recovery not derailed. Bottleneck issues easing
- (+) Inflation to ease from 5.0% YoY peak in Dec. 2021
- (!) ECB no longer rules out rate hike in 2022

CHINA

- (+) Better than expected GDP growth in 2021 (8.1%)
- (+) More monetary and fiscal support will help stabilise the economy
- (−) Omicron weigh on demand in Q1



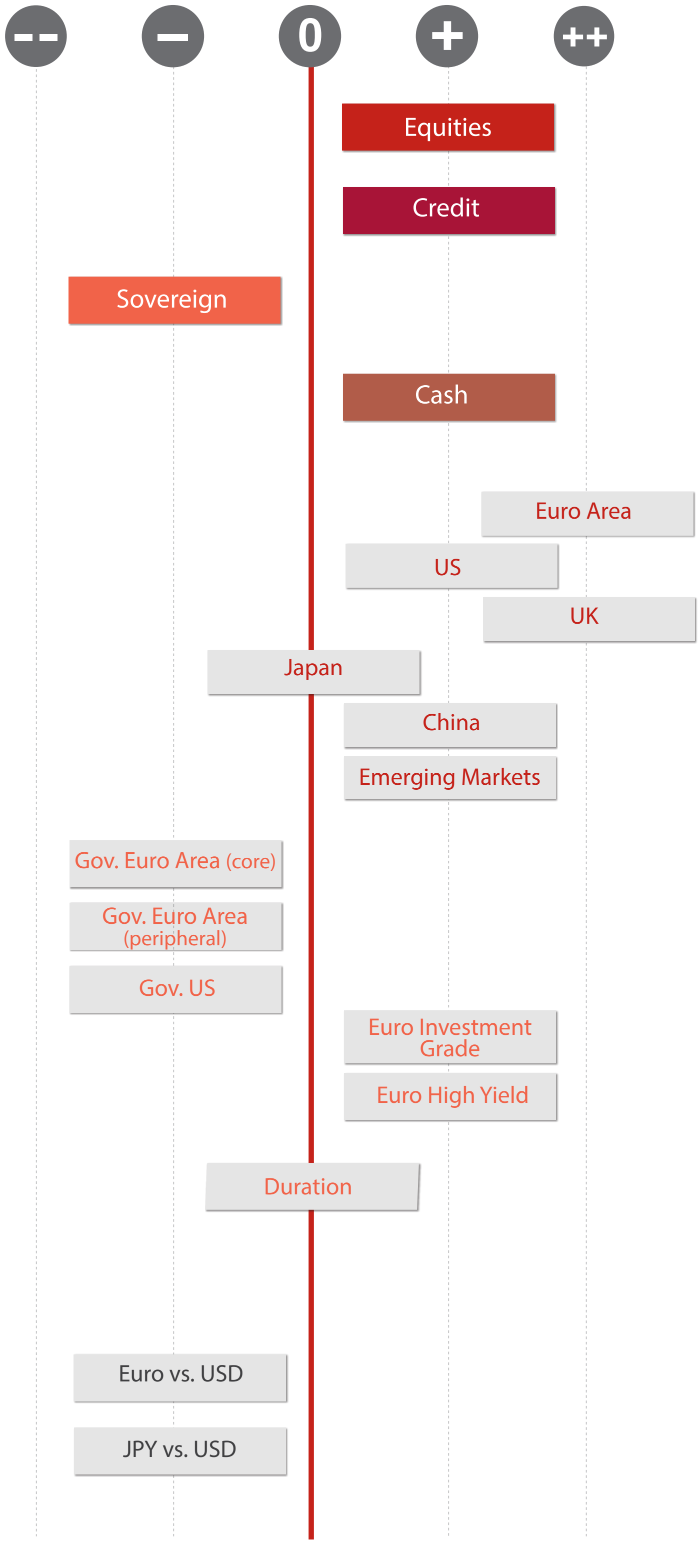
EMERGING MARKETS

- (+) Limited impact of Omicron in EM Growth, Inflation will peak soon
- (−) Resilience of EM assets to the global rise of risk aversion
- (!) Fluid situation between Russia/Ukraine. Direct impact on the EM complex has been limited so far

(+) Positive
(−) Negative
(!) Topics to watch

DIRECTION OF TRAVEL

- Further reduce equity overweight (OW)
- Keep sizeable OW in credit
- Underweight (UW) in sovereign unchanged
- Limited OW in EM debt: prefer BBB and quality BB
- Keep short duration stance to a minimum to protect from risk of ECB early tightening
- Increase OW in cash shifting part of the equity overexposure



Equities

- Volatile environment is likely to persist: peaking cycle, hawkish central banks, decreasing policy support and persistently high inflation.
- That said, real rates remain low, CAPE yield gap vs 10y yield high and earnings growth still encouraging.
- We see around 10% upside in 12 months for the US and slightly more for Europe.

Bonds

- The hawkish tone of central banks amid elevated inflation is seen to trigger a further increase in government yields.
- While the path of the ECB rates is uncertain, it will wind down QE in 2022. Further leeway for EA non-core government bond spreads to widen.

Duration

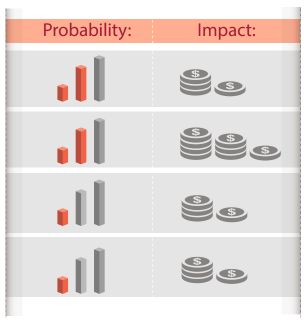
- Moderately short duration recommended.

Currencies

- The Fed's sharp hawkish pivot is set to keep the USD underpinned short term.
- Yet the USD is not far from peak. Further into the year, we expect the persistent global recovery, ebbing US equity inflows and reserves diversification to reverse fortunes for the Greenback.

TOPICS TO WATCH!

- Higher inflation forces central banks to a more aggressive tightening
- Withdrawal of policy support hurting risk appetite and precipitating slowdown
- Supply bottlenecks push inflation high enough to compress demand
- Geopolitical tensions disrupt energy markets (Russian/Ukraine) and/or global supply chains (China/Taiwan)



Probability: High ←→ Low

Impact: High ←→ Low

SPECIAL FOCUS

The global recovery continues, but an hawkish Fed is not the only risk

Despite stronger headwinds from a more aggressive Fed and energy prices, we look to buy the dips, as the global recovery still has legs in 2022. The fast-spreading of Omicron is harming growth, but many countries are lifting restrictions so the economy should reaccelerate in spring. But risks abound. China's zero-Covid strategy seems ill-equipped for Omicron and may trigger new supply disruptions, but policy support is broadening. We now look for at least four Fed hikes (from March) and balance sheet reduction (mid-year). Powell's denial to rule out even much faster-tightening bears substantial risks for market valuations. A full-fledged Russian invasion of Ukraine and disruptive sanctions may well be avoided. But worries about European energy supply are adding to price pressures as global supply chain bottlenecks are easing slowly.

The terminal Fed Funds Rate, still priced below 2%, leaves further upside for US yields. The priced 2022 ECB lift-off seems overdone. Yet the pull from US Treasury yields and the risk of an early ECB rate hike will continue to burden EUR fixed income.

Real interest rate

Based on the yield of 10 yr. inflation linked government bonds rate

Source: Datastream as at 04/02/2022

The rise in long-term real yields is a headwind to equity valuations, but the Fed policy will stay far from restrictive in 2022 and earnings growth is slowing but not stalling. This leaves some residual upside for equities but with much more volatility. We expect Credit to stay resilient, still benefitting from ECB support, low defaults and solid profits. The USD has further upside on the Fed, but we expect a reversal later in the year as the global recovery reduces appetite for safe havens.

GLOSSARY

QUANTITATIVE TIGHTENING (QT)

Quantitative tightening (QT) is the process of reduction of the size of securities held by the central banks. The runoff is normally implemented by not rolling over maturing bonds. The aim is to reduce the monetary stimulus to the economy (i.e. to raise real rates) in a gradual and predictable way.

WHY INCREASE CASH IN A PORTFOLIO TO PROTECT FROM SPIKES IN VOLATILITY, DESPITE INFLATION?

Increasing the share of cash in a portfolio when inflation increases clearly leads to negative returns. Yet it is meant as an insurance policy to avoid the risks from spikes in volatility that in this period can affect risk assets .

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