

Market Perspectives

A cloudy plateau

November 2023

GIAM Macro & Market Research

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

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- Major central banks have reached peak rates, which are set to prove protracted plateaus. Yet markets now embrace an excessively hawkish outlook by pricing restrictive US rates far into the future.
- This, as well as a bleaker growth outlook and safe-haven flows amid geopolitical risks, may help yields to recede from recent peaks. But heavy supply and quantitative tightening will keep the decline modest.
- The relief on risk assets should be limited, given the deteriorating earnings outlook. The MSCI World, down 10% over the past three months, remains under pressure, despite positive seasonals into year-end.
- We keep overweights in IG Credit and EM bonds and underweights in Equities and HY Credit, but slightly trim the extent of the positions. We favour a moderately long duration in core and quasi Govies.

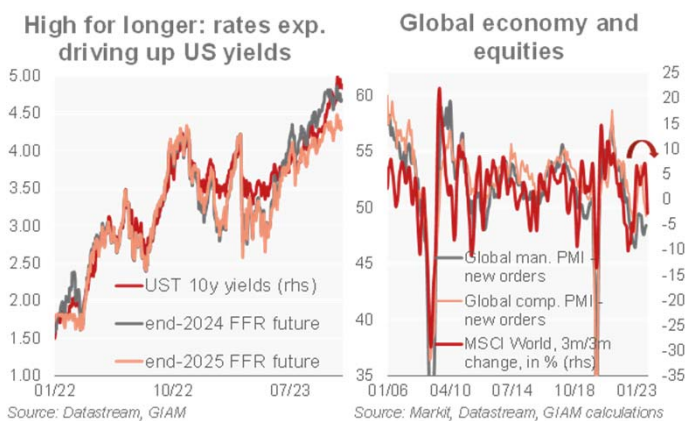
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Global View – A cloudy plateau

Thomas Hempell

- **Major central banks have reached peak rates, which are set to prove protracted plateaus. Yet markets now embrace an excessively hawkish outlook by pricing restrictive US rates far into the future.**
- **This, as well as a bleaker growth outlook and safe-haven flows amid geopolitical risks, may help yields to recede from recent peaks. But heavy supply and quantitative tightening will keep the decline modest.**
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Year-to-date gains in equities have melted since late July, as worries about high-for-long rates and the Israel/Hamas war dented risk appetite. Even the S&P500, despite solid US corporate earnings, has hit correction territory, down 10%. The Fed and ECB are sticking to the option of another rate increase for now. But their hiking cycles have likely drawn to a close – if for slightly different reasons. In the US, resilient growth has defied the laws of gravity from the 525bp rate hikes thanks to residual excess savings, a solid labour market and a pro-cyclical fiscal policy. The last miles towards price stability may prove the hardest, but continued disinflation (core PCE at 3.7%, a 2-year low) and a looming slowdown justify a more patient Fed. Surging yields (10y UST up 75bp since late August) and risk asset drawdowns have substituted for the need of any further active tightening.



In the euro area disinflation is lagging amid sticky wage growth and upside risks from energy prices. But poor sentiment (the EA flash comp. PMI hit a 3-year low at 46.5 in

Oct.) and monetary data (the BLS showing further tightening of credit standards and demand; M3 down 1.1%yoy) make a Germany-led recession more likely.

Clearly, central banks' inflation fight is far from over. Peak rates will prove an extended plateau – with first rate cuts unlikely before H2 2024. Markets reluctantly acknowledged this, but may recently have got ahead of themselves, pricing the 3-month OIS rates at 4.30% in five years. That would require either 1/ a sharp rise in the neutral real rate; 2/ the Fed strongly lifting its inflation target; or 3/ a persistent inflation overshoot that requires very tight Fed policy for years. None of these triggers seems very plausible in a base scenario. This makes longer-dated rate expectations prone for a reversal. Yields should follow suit, supported by a looming US slowdown, but only reluctantly so as continued heavy supply backs the increase in the term premia from very low levels. This makes us favour a prudently long duration stance in fixed income.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	4.87	4.60	4.40	4.10
Germany (Bunds)	2.86	2.65	2.60	2.55
Credit Spreads**				
EA IG Non-Financial	150	150	145	140
EA IG Financial	177	180	170	165
Forex				
EUR/USD	1.06	1.05	1.08	1.10
USD/JPY	150	148	140	137
Equities				
S&P500	4147	4110	4085	4300
MSCI EMU	136	135	133	143

*3-day avg. as of 27/10/23

**ICE BofA (OAS)

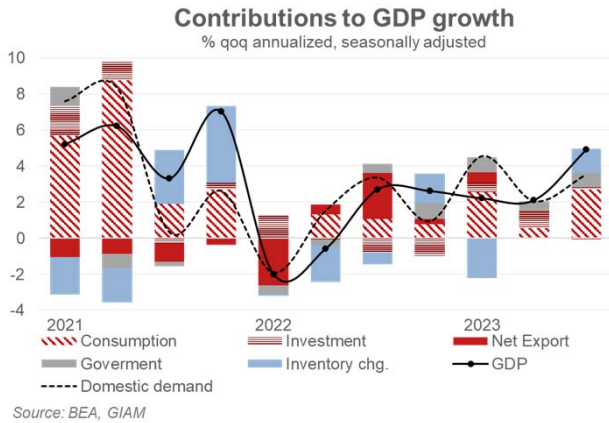
Easing yields to render only partial relief to risk assets

Lower yields may provide some relief to risk assets. Also, investor positioning – usually a contrarian factor – has turned more bearish again. Seasonals turn positive for equities in November. Hence we trim our underweights in Equities and High Yield. Yet risk sentiment still looks vulnerable short term with the euro area at the verge of recession and a US slowdown looming as tight monetary policy (finally) bites. Despite the recent correction, equities are not accounting properly for a more challenging backdrop (right chart).

We continue to see value in IG Credit, with the levels of risk compensation still attractive. Spreads on Southern European sovereign debt may widen somewhat further amid persistent growth concerns, ECB's QT and higher interest costs. Yet we expect the move to be orderly, with the return impact on bonds large compensated by the decent carry.

United States

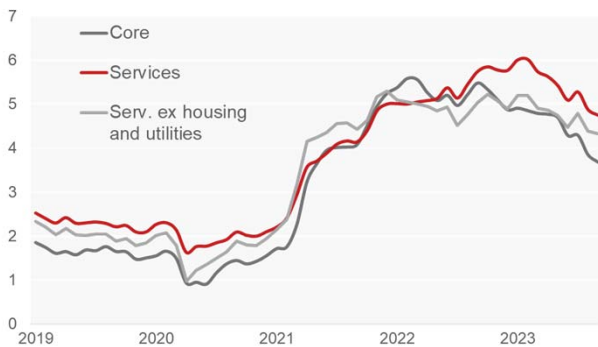
Paolo Zanghieri



- **Q3 GDP surprised at 4.9% annualised growth. Consumption remained the main driver, but it was increasingly driven by lower savings. We expect a marked deceleration at the beginning of next year and see GDP growth at 1.1% in 2024.**
- **Core inflation is weakening, but the PCE rate will remain higher than 3% until spring. Upside risks remain related to a still tight labour market.**
- **The Fed has most likely reached the peak in rates, but more positive surprises to growth may trigger a further hike. The policy rate will likely be kept at the current level until at least June.**

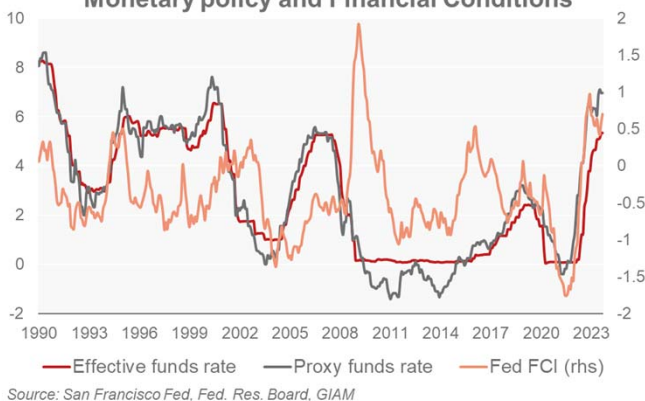
Closing a string of positive surprises over the summer, Q3 GDP came much higher than expected (4.9% ann. vs 4.1% consensus and 2.1% in Q2). Such a performance will find stronger headwinds going forward Consumption was up by 4%, but this was largely due to lower savings (the rate fell from 5.2% to an historical low 3.8%), inventories contributed 1.3pp, but firms are signalling excessive stockpiling, and non residential investment fell burdened by tight finance. Finally the contribution from government consumption will fade as the automatic spending cuts will kick in at the end of the year. Q4 should see still steady growth, but we expect stagnation in the first half of the year, followed by a gradual recovery lifting GDP by 1.1% in 2024.

PCE inflation



The cooling of the labour market is slow: payrolls increased by a very strong 336k in September, but this was driven mostly by government and hotels and restaurants. Meanwhile the median wage rose in September by 5.2% yoy, it was 6.2% one year ago. Disinflation remains slow and choppy. In September core PCE inflation moderated from 3.8% to 3.7% year on year. The service component ex. housing, the focus of the Fed attention, remained stable at 4.3% yoy. Core inflation should remain above 3% into Q1.

Monetary policy and Financial Conditions

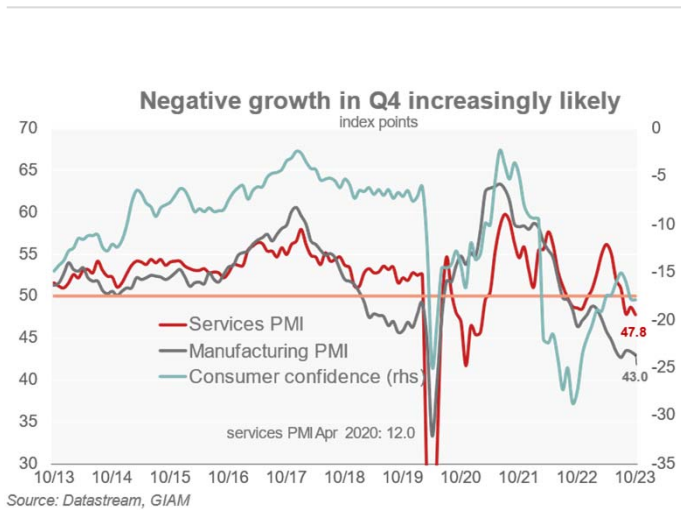


Fed: no more rises, with upside risks

Before the release of the GDP data, chair Powell and other FOMC members hinted that the tightening of financial conditions will add to the hike in rates in containing inflation. Powell added, however, that a persistent period of above trend growth would force the Fed to tighten again. The Q3 results increase the risk of another hike in December, but given our assumption of a sizeable growth moderation we think that the Fed is done with raising rates. The hawkishness of the communication remains aimed at quelling hopes of a fast return to cheaper money. We do not expect the first rate cut before the June meeting, and stronger growth would force the Fed to delay cuts well into H2 2024.

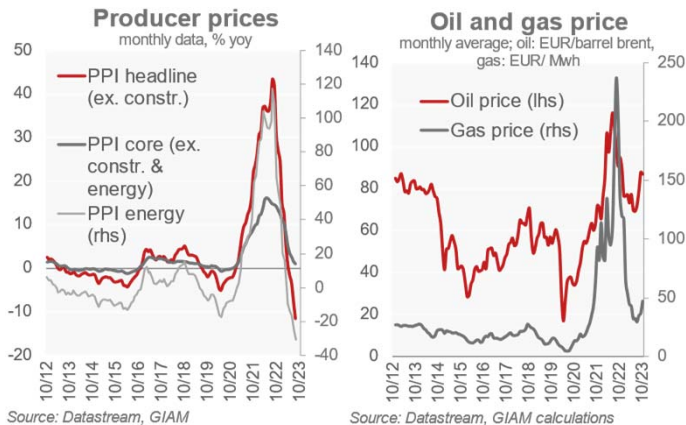
Euro Area

Martin Wolburg



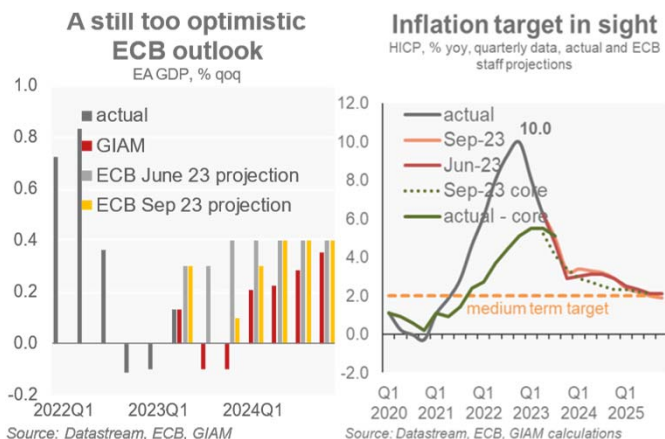
- Following some green shoots, October flash PMI disappointed with another fall, with employment receding for the first time in more than two years.
- After a mild Q3 contraction in the EA, we see an increased risk of receding activity also in Q4 which would send the euro area into a technical recession.
- In October, the ECB left its policy rates unchanged and suggested that a first rate cut was still very distant.

Euro area activity is currently again undergoing a period of weakness, pointing at downside risks towards year-end. In the third quarter, a key sentiment indicator (composite PMI) fell into outright contractionary territory. Hard data so far have confirmed this signal. Based on July and August data, industrial production and retail sales were -1% and -0.6% below the resp. Q2 average. Loan growth to firms almost came to a halt by September while receding inflation and an improved trade balance stabilized activity. The preliminary GDP release shows a fall of -0.1% qoq for Q3.



Looking into the last quarter of the year, further clouds arrived at the horizon. The latest oil price spike might gain momentum due to an escalation of the Hamas-Israel war. Sentiment darkened further with the October flash composite PMI falling to the lowest level since May 2020 while signalling for the first time for more than two years that employment recedes. If confirmed by hard data, that would be another blow to domestic activity, the backbone of growth. But given further receding inflation (October flash estimate is at 2.9 % yoy) and a stronger than previously thought US economy there is also some stabilizing forces at work. For now we stick to our growth forecasts of 0.4%/0.5% for 2023/24 but see the risks clearly on the downside.

ECB on hold amid heightened uncertainty

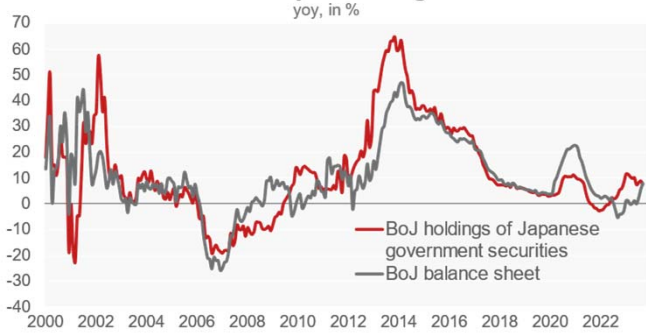


At the October policy meeting the too-high-for-too-long inflation narrative was maintained. At the same time there was less confidence bringing back inflation back to target but also more concerns about the growth outlook. The update of the macro projections in Dec will likely bring the ECB growth expectations closer to our long-held much more muted outlook. That said, rate cuts were not on the table and discussion about that qualified as totally premature by President Lagarde. But neither were other policy measures like QT of the PEPP nor higher reserve requirements discussed. We think that the Governing Council will become much clearer about its further course at the next meeting. For the time being we look for constant rates and see a first cut only by Sep. 2024, with risks clearly skewed towards earlier action on the back of weak activity data.

Japan

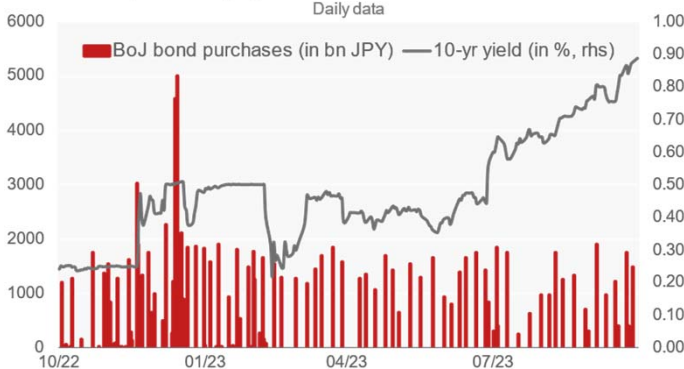
Christoph Siepmann

Growth of BoJ balance sheet and asset purchasing



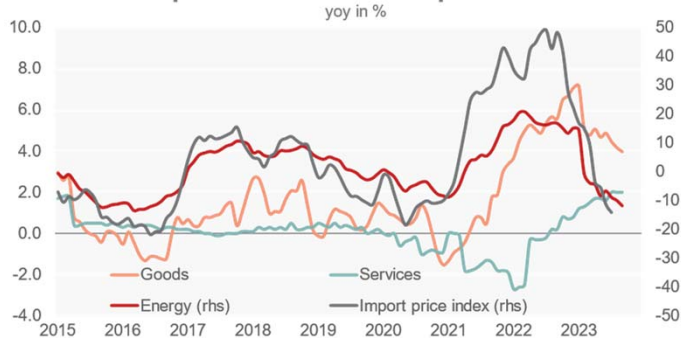
Source: Datastream, GIAM calculations

Japan: 10-yr yield and BoJ's interventions



Source: Bloomberg, GIAM calculations

Japan: Consumer and Import Prices



Source: Datastream, GIAM calculations

- **The Bank of Japan (BoJ) added flexibility to its yield curve control policy (YCC) by considering the 1% cap now as loose upper bound. The risk of further action remains on the table.**
- **The government is mulling a fiscal package which not only will announce more help for private consumption but also may prepare snap elections. We revised our growth outlook for 2024 up to 1.4%.**

The Bank of Japan (BoJ) decided at its latest meeting (Oct. 30./31.) to add flexibility to its yield curve control policy (YCC) by considering the 1% cap now as loose upper bound. The Bank had come under pressure from the ongoing depreciation of the Yen vs the US dollar, following the Fed's "higher-for-longer" interest rate discussion and the rise of 10y US Treasury yields by about 100 bps since the BoJ's July meeting. As a consequence, 10y JGB yields had already risen and increased further to almost 0.95% after the BoJ statement. The yen re-depreciated. With this step, the BoJ fended off bond market intervention needs but also diluted further the meaning of YCC. Our base case remains for the BoJ to remove the YCC policy in Q1 2024. The main reason is that according to Rengo, the labour union umbrella, base-pay (not including seniority) rise for 2023 was 2.12%. That is below the target of around 3% and could cause reluctance at the BoJ, waiting for next spring's developments. Nevertheless, the negative side effects of the weakness of the yen remain on the table and may force the BoJ to act earlier. Moreover, while Japan's nationwide headline inflation receded in September to 3% (with core-core inflation ex fresh (!) food and energy at 4.2% yoy and ex food and energy only at 2.6% yoy) the latest Tokyo inflation, which is typically a precursor, reaccelerated in October. Rates were driven up by strong monthly increases in fresh food (+6.0% mom) and energy (+7.9% mom). The rise in oil prices coupled with the weakness of the yen has played a role.

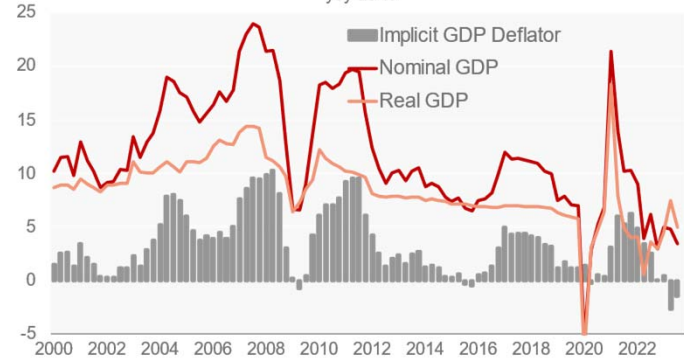
Another fiscal package amid rumours of snap elections

The yen weakness and the associated terms-of-trade driven loss in income prompted the government to prepare another fiscal package. Core elements are the support of households against rising living costs, the extension of energy subsidies and incentives for wage hikes for firms. We expect the effective size (amid typically outsized headline numbers) at around 1%-1.5% of GDP. The fiscal package may also be connected to rumours of a snap election for the lower house by the end of the year. Given the package estimate, we have revised our GDP growth forecast up to 1.4% in 2024 but will become more precise with more details of the package to become public.

China

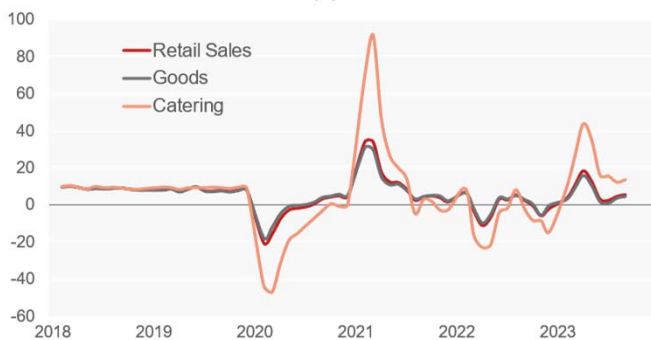
Christoph Siepmann

China: Nominal and Real GDP Growth
yoy as %



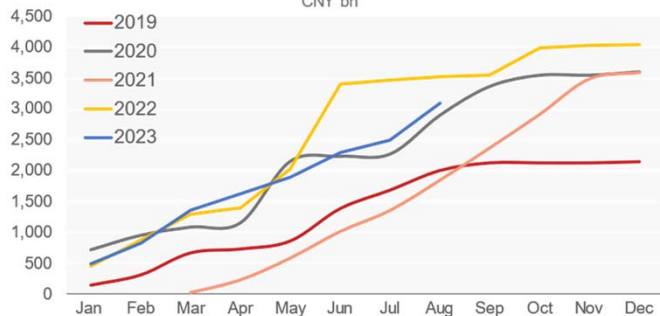
Source: Datastream, GIAM calculations

China: Retail Sales
yoy as %



Source: Datastream, GIAM calculations

China: Local Government Special Bond Issuance
CNY bn



Source: Datastream, GIAM

- **China's Q3 real GDP growth surprised on the upside, but nominal growth was soft. Given these numbers and more fiscal policy support, we revised our forecast up to 5.2% resp. 4.3% in 2023/24.**
- **We expect monetary policy to cut the MLF rate by 15 bps and the RRR ratio by 50 bps to support growth and help digest government bond issuance.**

China's Q3 real GDP growth surprised on the upside, officially advancing by 4.9% yoy or 1.3% qoq. The data prompted some suspicion, especially in the light of monthly readings which showed the economy to almost stagnate at the beginning of the quarter. In part, this can be explained with downward revisions for Q2. More importantly, nominal growth receded to 3.5% yoy (down from 4.8% yoy in Q2), and it was the "working" of the (questionable) deflator (-1.5% yoy) that pushed up real output. According to our calculations, nominal growth dynamics was only 0.7% qoq. Given the official data, China's annual growth target of 5% will now be "easily" reachable.

Despite all uncertainties in the GDP picture, monthly data suggest that the government's incremental (but not unimportant) support measures are having a positive effect. This was especially true for private consumption growth which advanced to 5.5% yoy, after 4.6% yoy in September. Incentives for car purchases played a helping role. Higher frequency data suggest an improved willingness to spend amid promotions of retailers and vacation travel. However, whether this will be lasting remains doubtful, given slightly receding house prices. Both housing sales and starts were slightly less negative than before, but still in the doldrums. Given recent policy support measures, some improvement could become visible with the October data. Overall fixed asset investment stabilised as infrastructure investment gathered again some pace.

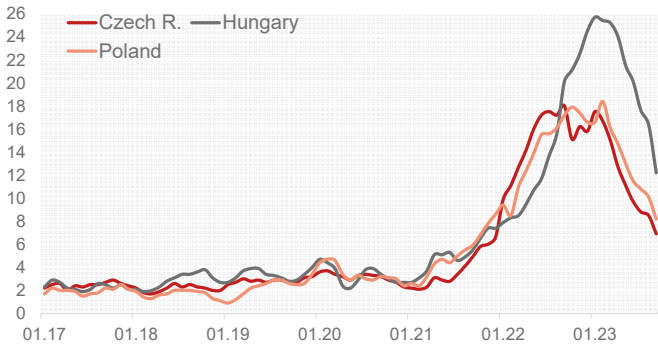
Beijing expanded its fiscal deficit by 0.8 pp

The latter will remain a source of stabilisation as Beijing announced additional issuance of RMB 1 tr sovereign bonds (the budget deficit to rise to 3.8% from previous 3.0%). The proceeds will be channelled to local governments for infrastructure and disaster-relief projects. It was also approved that local governments may front-load next year's quota. Both should help avoid shortfalls in funding infrastructure projects amid stressed local coffers but will be less of an extra fiscal push. Monetary policy is expected to support growth and bond issuance by a 15 bps cut in the MFL rate and a 50 bps reduction in the RRR. We see the gradual recovery in China to continue but stick to our L-shaped view, supported by the setback of the NBS PMI to 49.5.

Central and Eastern Europe

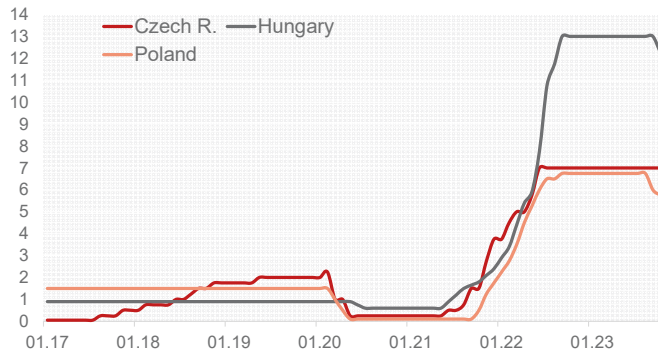
Radomír Jáč

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

Main Forecasts

Czech Republic	2022	2023f	2024f	2025f
GDP	2.4	0.0	2.3	3.0
Consumer prices	15.1	10.8	2.4	2.0
Central bank's key rate	7.00	6.50	3.50	3.00
Hungary	2022	2023f	2024f	2025f
GDP	4.6	-0.6	3.4	3.4
Consumer prices	14.5	17.6	4.8	3.2
Central bank's key rate	13.00	11.00	5.00	4.50
Poland	2022	2023f	2024f	2025f
GDP	5.1	0.0	3.2	3.4
Consumer prices	14.3	11.7	5.2	3.0
Central bank's key rate	6.75	5.50	4.50	3.75

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

- Inflation in the CE-3 region has been declining while the full-year GDP performance in 2023 will likely be meagre, even if the economies recover in H2.
- Hungary and Poland are in a process of interest rate cuts, the Czech CNB may start cutting rates in Q4.
- The parliamentary election results in Poland led to a positive reaction of the zloty. The forint received support from signals that the EU may unfreeze funds for Hungary before the end of November.

Economic developments in the region are characterized by a sharp decline in inflation and concurrent recovery in private consumption. Further moderation in inflation is in a pipeline for Q4. While stronger private consumption should lead to GDP recovery in H2, the full-year 2023 GDP growth will be close to zero in Czechia and Poland, while Hungary is going to report a GDP decline. The full-year GDP performance should improve across the region in 2024 with a substantial contribution of private consumption. Inflation will decline further in 2024, despite the expected GDP recovery.

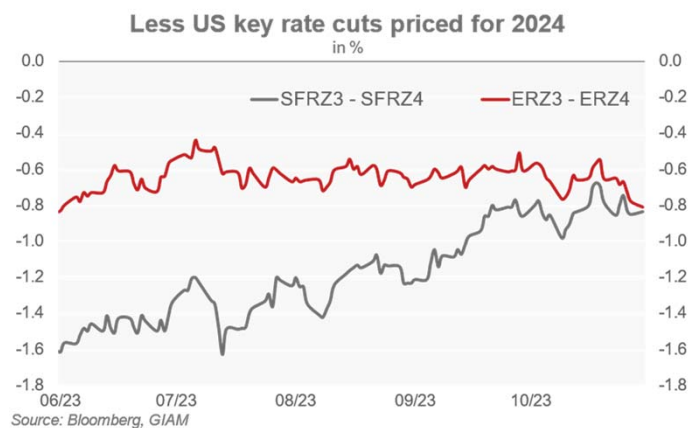
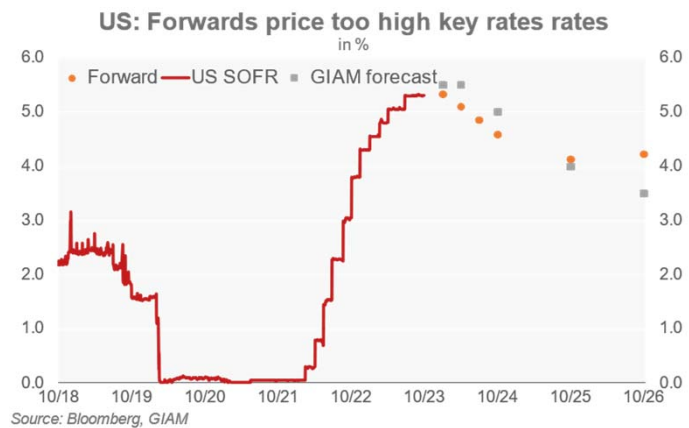
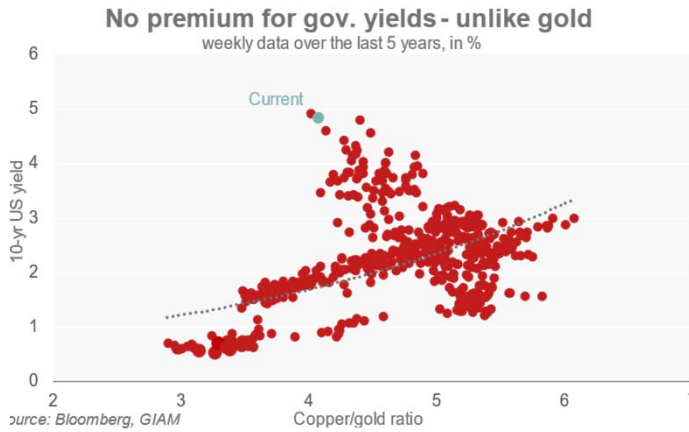
The macro picture therefore provides a room for monetary policy easing in the region. Worth mentioning is also the recent firming of the Hungarian forint and Polish zloty. The forint was supported by signals that the EU may unfreeze EUR 13bn in funds for Hungary before the end of November. The zloty firmed after pro-EU opposition won majority of seats in parliamentary elections held on October 15, which should result in the formation of a pro-European ruling coalition.

Monetary policy: Czech CNB likely to start cutting rates

The Hungarian MNB finished the first part of its policy normalization in September when it cut the O/N deposit rate by 100 bps to 13%. The O/N deposit rate was aligned with the base rate. The base rate regained the status of the key policy rate and in October it was cut by 75 bps to 12.25%. We expect cuts by 50 bps or even 75 bps in the months to come, which means that the base rate may reach 11% at the end of 2023. Poland delivered a first rate cut in September: by 75 bps to 6%. A 25 bps cut to 5.75% followed in October. We see room for one more 25 bps cut by the NBP in the remainder of 2023. For 2024 we expect a gradual policy approach with rate cuts by 25 bps per quarter. The Czech CNB kept its key rate steady at 7%. Its next policy meeting is scheduled for early November and we see a good chance that it will start cutting rates gradually (by 25 bps). A delay of cuts until early 2024 would imply the need for bigger steps (by more than 25 bps) later.

Government Bonds

Florian Späte



- While long-dated euro area (EA) core yields trended sideways in October the US counterparts moved noticeably upwards.
- The striking steepening of international yield curves still has legs, but in a more benign overall environment for bonds. Given the expected economic slowdown, real yields and medium-term key rate expectations appear too high..
- EA non-core government bond spreads tightened moderately after marking long-term highs over the course of the months. Particularly Moody's rating decision on Italy will be in the spotlight in November.

The volatility in international government bond markets increased in October reflecting the high uncertainty about future developments. 10-year US yields moved between 4.3% and 5.0%, their EA counterparts between 2.7% and 3.0%. On balance, US yields moved significantly upwards by more than 30 bps in October. Strikingly, EA core yields decoupled and trended sideways. The movement is all the more remarkable as equity markets have weakened and spreads of corporate and EM bonds have risen. There has not been a flight to quality and US Treasuries in particular have thus not built up a premium due to the war in the Middle East – while the gold price, for example, has risen significantly (in absolute terms but also relative to the copper price). The copper/gold ratio is very low and, as the chart shows, the yield based on this ratio is too high.

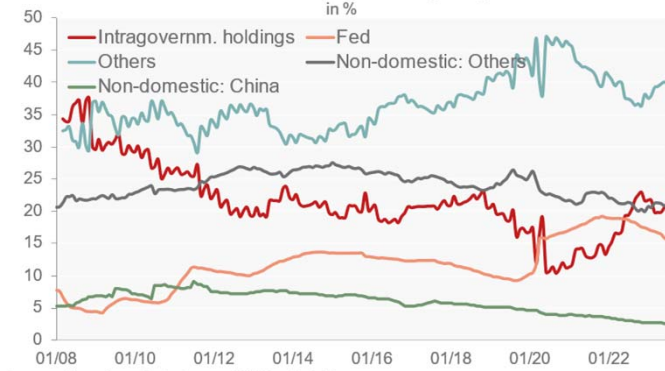
A change in the near-term assessment of future central bank policy is not the reason for the strong rise in long-dated US yields. US key rate expectations for 2024 hardly changed compared to the previous month (they even fell slightly for the ECB). Ultimately, the yield on short-dated US Treasuries has not changed, the EA core yield has fallen significantly, so as a result both the US and the EA curve have steepened considerably. Meanwhile, markets are pricing for both the Fed and the ECB about 3 rate cuts for 2024. In spring, key rate cuts totalling 150 bps were expected for the Fed.

While we largely agree with the markets' key rate expectations for 2024, we consider the medium-term expectations to be exaggerated. For example, the markets are pricing in a 4.25% key rate (upper bound) for the end of 2026 (and thus even 25 bps more than at the end of September). This is well above the Fed's expectations of 3.0% and also above the GIAM's expectations of 3.5%. As we do not consider current market expectations to be sustainable, we recommend overweighting short-dated US Treasuries.

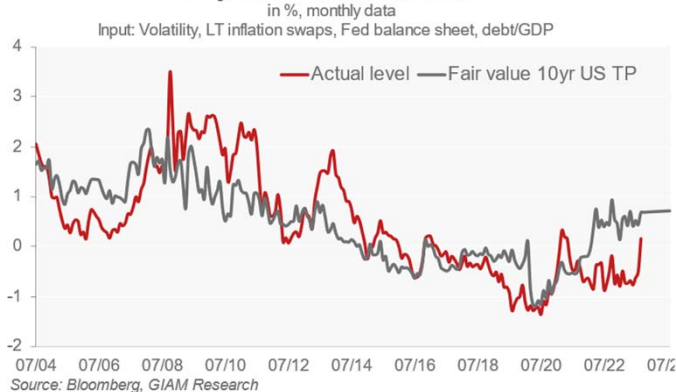
Government Bonds

Florian Späte

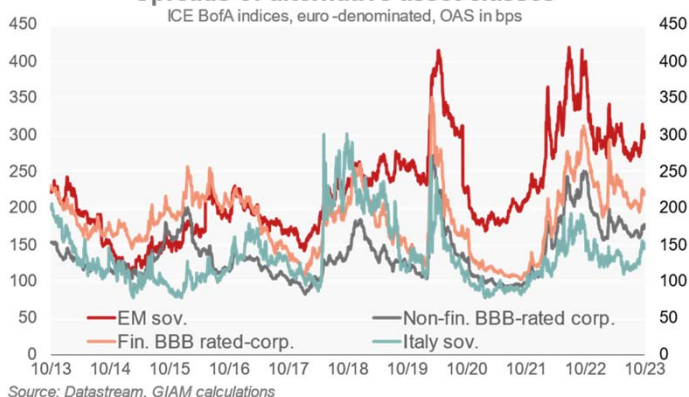
US Treasuries: Total Holdings by Sector



10-year US Term Premium



Spreads of alternative asset classes



Besides the upward adjustment of medium-term US key rate expectations, the main reason for the increase in long-dated US yields is the increase in the term premium. It has been on the rise for some time but concerns about an ongoing increase in Treasury supply contributed to a further rise. This applies even more as the demand from non-domestic investors for US government bonds peaked in 2014 and has been on a downtrend since then. Particularly, China has reduced its share (since 2011) and even in absolute terms (since 2013). Meanwhile, China holds only 2.5% of US Treasuries (down from more than 9%). Moreover, the Fed will continue to reduce its share and private investors will have to absorb an increasing volume. Hence, the demand picture will remain complicated and we do not see a trend reversal in the term premium yet. Accordingly, we see some more upside potential for the US term premium. While most of the adjustment has already taken place we expect an increase of up to 30 bps over the next 12 months.

Having said this, we see other factors to gain the upper hand. With the rate cycle finished (weaker growth ahead), 10-year US real yields at an unsustainable level (2.5%), and a less expansionary fiscal policy going forward, we expect 10-year US yields to fall to 4.6% on a 3-mth and to 4.1% on a 12-mth horizon. This will also impact EA core yields. As the mispricing is less pronounced, we forecast a smaller decline to 2.65% on a 3-mth horizon and to 2.55% on a 1-year view.

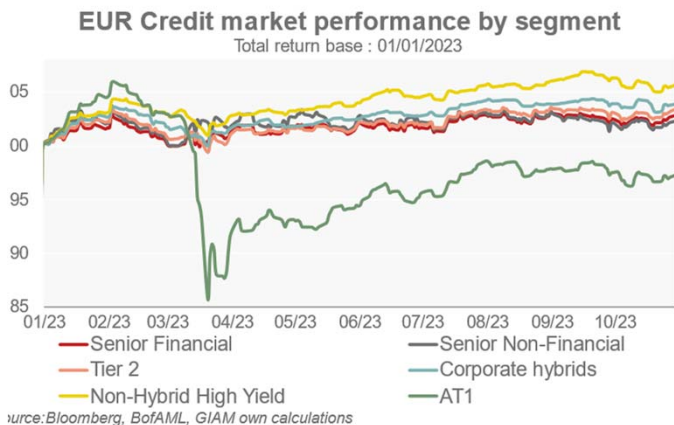
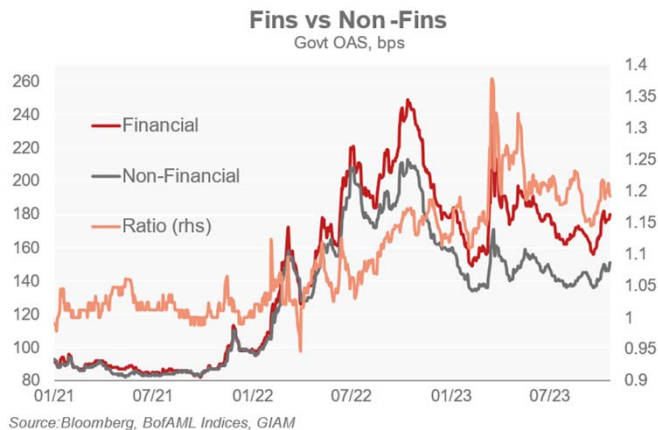
Stabilization of EA non-core bond spreads

EA non-core government bond spreads tightened slightly. However, this covers a volatile development with 10-year BTP/Bund spreads temporarily reaching 210 bps. Ultimately, the affirmation of Italy's BBB rating by S&P, the upgrade of Greece to IG, and the fact that the ECB did not discuss the start of PEPP Quantitative Tightening (QT) helped.

Going forward, we forecast EA non-core bond spreads to widen a little. On the one hand, contrary to some market participants we do not expect the ECB to start PEPP QT in 2024 but to continue reinvestments until the end of 2024. The issuance activity is on track and will be no issue for the remainder of 2023. The ECB's Transmission Protection Instrument remains a backstop and the expected decrease in bond market volatility will increase the shine of more risky fixed income assets. On the other hand, the challenging supply outlook for 2024 (incl. QT) will increasingly come into focus, and debt sustainability concerns are unlikely to disappear given the weak growth environment and the rather high yield level. The rating decision by Moody's on Italy (Nov 17) represents an event risk, as Italy is already rated at the lowest IG level (NGEU implementation is key).

Credit

Elisa Belgacem



- **As credit spread widening continues, we maintain caution.**
- **Yet due to an elevated carry and a stable default outlook, We are reducing our underweight in HY.**
- **Default rates are expected to reach 4.5% in Europe and 5-6% in the US for 2023.**
- **We favor subordination risk over credit risk in this context. We also decrease our overweight in non-financials relative to financials.**

The escalating crisis in the Middle East has sent shockwaves through the global financial markets, particularly impacting credit markets with a typical 'risk-off' trade pattern emerging. The most immediate consequence of this conflict would be the surge in oil prices, which poses a threat to corporate profit margins worldwide. While European firms have limited direct exposure to the Israeli and Middle Eastern economies, unlike their counterparts in cases involving Russia, the energy sector is set to benefit from robust revenues.

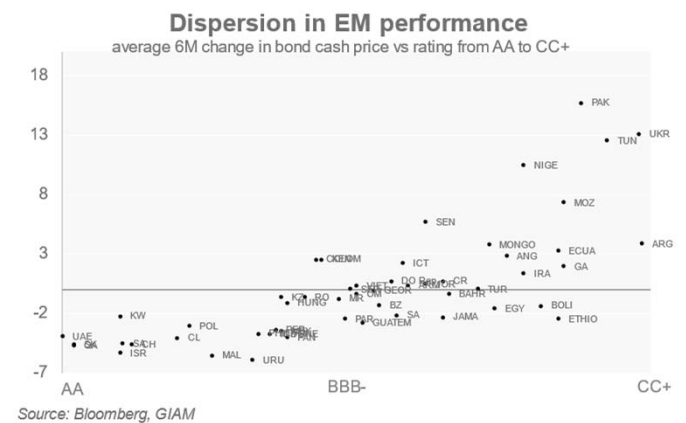
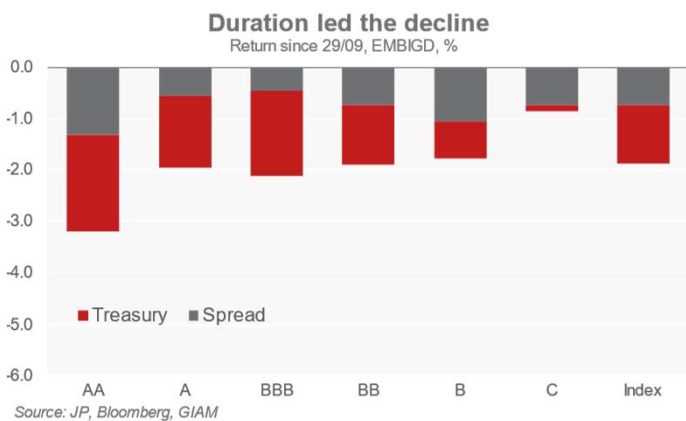
While not our base case, in an escalating conflict investors would likely adopt a risk-averse stance, with defensive IG and the energy sector likely to outperform others. However, financials are likely to underperform due to the prospect of lower economic growth, which implies diminished asset quality. As US credit indices have a higher share of energy bonds and a lower share of financials, US credit should prove more resilient over EU credit in a more pronounced war scenario.

Reducing our short in HY and financials

We remain cautious amid the ongoing widening of credit spreads and, given the elevated carry and no significant deterioration in our default outlook, we have decided to reduce our high yield underweight position. Despite this adjustment, we still anticipate YE 2023 default rates to reach 4.5% in Europe and 5 to 6% in the US. In this challenging environment, we continue to favor subordination risk over credit risk. While our rationale for reducing our overweight position in non-financials relative to financials remains intact, we believe this adjustment is more likely to bear fruit in 2024. The deterioration in asset quality, as per our baseline scenario, appears to be already priced into the market. However, we must remain vigilant regarding tail risk and the potential for heavy supply, as these factors are not yet fully accounted for. At the broader economic level, liquidity concerns are primarily concentrated in the non-financial sector, particularly affecting small and medium-sized enterprises (SMEs) and private credit markets.

EM sovereign bonds

Guillaume Tresca



- Risks have been rising. Yet as the carry provides a large buffer, we keep a slight even if reduced overweight stance on EM bonds and expect a positive return by year-end.
- In MENA, our central scenario is a localised conflict, but a higher geopolitical risk premium may be needed. We maintain a nimble and selective approach with a preference for BBBs (Romania).

As the tailwinds for EMs have returned, we have reduced risk and have trimmed our overweight on EM bonds in our global allocation, taking a cautious and selective approach. EM fixed income is still likely to post a positive return by year-end, thanks to a high carry and lower underlying yields. However, risks are skewed to the upside as EM countries adjust to the higher-for-longer environment. The macro environment is also less supportive. LatAm growth is resilient, while EMEA is slowing. The positive surprise is China, where the peak of pessimism is likely behind us. EM central banks have become more cautious and inflation is not expected to return to target until 2024/25. In this environment, EM external spreads have widened, leading to some underperformance, but the move has been relatively contained compared to the deterioration in risk sentiment. EM assets continue to show some resilience and we see only a modest spread widening over the medium term.

MENA: resilience but a higher geopolitical risk premium

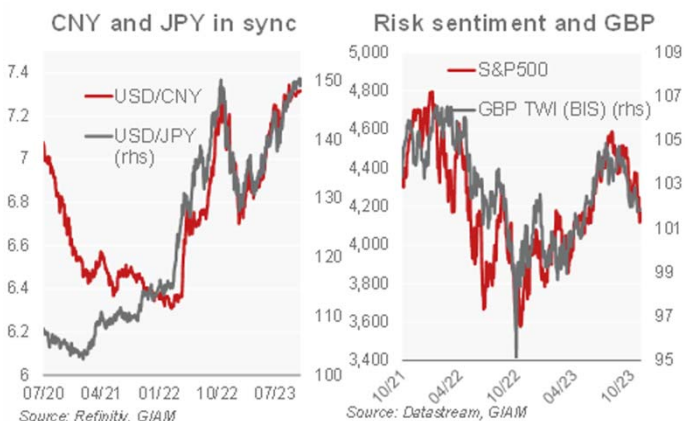
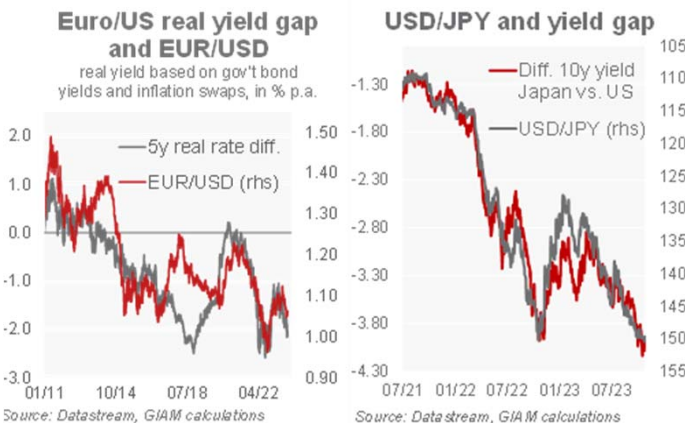
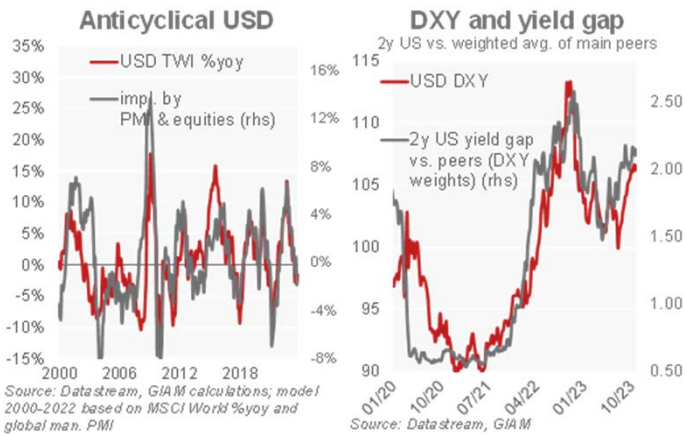
The Middle East is more important for external debt than for local debt. The geopolitical situation is fluid but certainly requires a higher premium as regional spreads are tight. Our central scenario is one of contained local conflict, so the impact on the EM complex is small. So far, MENA spreads have hardly widened. The UAE should be more resilient than Qatar and Saudi Arabia. In the event of a deterioration, higher oil prices are not necessarily positive for EM assets globally. Weak importers such as Jordan/Egypt will underperform even in a localised conflict. As for Israel, there is a risk of a downgrade given the slowdown in growth, but macro fundamentals, external metrics and buffers are solid.

Stay focus on BBBs

The higher rate environment and spread widening reinforce our preference for IG over HY. However, the increase in risk leads to an even more nimble approach. We remain focused on BBBs, which offer the highest yields, versus AA/A names, which are hurt by duration: Romania (wide spreads, European fiscal anchor) and Colombia. In an uncertain and late-cycle environment, carry is the best trade to protect against spread widening and the negative impact of duration.

Currencies

Thomas Hempell



- With the global growth outlook weak and risk sentiment vulnerable, we see some further USD upside. The EUR remains burdened by recession worries, high energy prices and mildly wider EGB spreads for now.
- A sustained JPY recovery will require markedly lower US yields or a material adjustment in the BoJ's policy. Both triggers are likely materialize only over the course of 2024, which will keep the yen scrambling for a boost for a while.

It seems the global backdrop could hardly be more friendly for the USD: striking economic resilience (US Q3 GDP surprising at +4.9% saar) contrasts an ailing euro area while soaring US yields and global risk aversion should boost USD demand (top charts). And yet the USD was almost unchanged against major peers in October (USD DXY: -0.1% by Oct. 30).

The sluggish USD response came amid recent Fed comments leaning against further rate hikes that weighed on shorter-dated US yields while 10-year ones rose by 30bp. Shorter yield maturities tend to have the biggest FX impact. Still, the mute reaction has opened a gap vs. yields (incl. real rates, see also mid left chart) that leaves scope for a USD catch-up. Somewhat wider EMU spreads amid European debt worries (higher interest expenses, ECB QT) and euro area recession worries will keep weighing on the EUR for now. We stick to [our view](#) of a EUR/USD recovery next year, but tactically we position for some further pullback.

The yen keeps scrambling for an upside trigger

The USD/JPY keeps hovering around the 150 mark, having resisted following US 10-year yields higher (mid right). In parts that is owing to CNY stability, which has been receiving support from Chinese official fixing and to which JPY has been tied (bottom left). More importantly, however, markets were anticipating a further relaxation of the BoJ's yield curve control (YCC). On Oct. 31 morning, the BoJ indeed redefined the 1% cap on 10-year JGBs from a "cap" into a mere "reference". This minor tweak disappointed JPY bulls and sent the USD/JPY back above 150. While we see a slightly stronger JPY from here on mildly lower US yields, the yen will keep struggling to gain traction for a while, with energy prices weighing on Japan's import bill and terms of trade. A sustained JPY recovery will require a larger leg lower in US yields and/or a material adjustment in the BoJ's policy. Both triggers are likely materialize only over the course of 2024.

Sterling was a star performer in H1 but has pared most of its gains since summer. One reason is the dovish central bank reaction to somewhat softer services inflation and weak growth figures, with the BoE hiking cycle now likely over. But risk sentiment matters hugely too (bottom right chart) which is why we see the risks around our stable EUR/GBP forecast tilted to the upside.

Equities

Michele Morganti, Vladimir Oleinikov

Analysis of the median stock: Q3 2023 reporting season

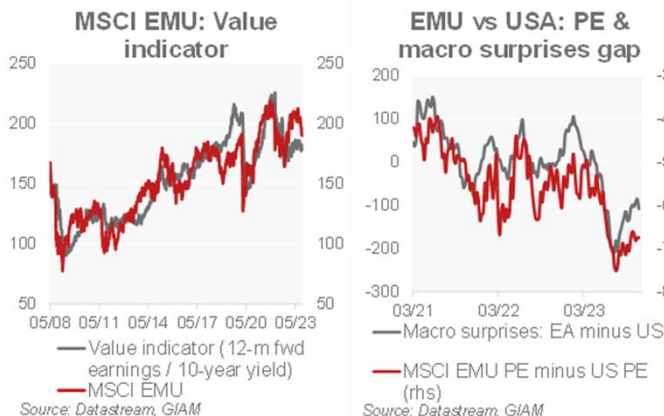
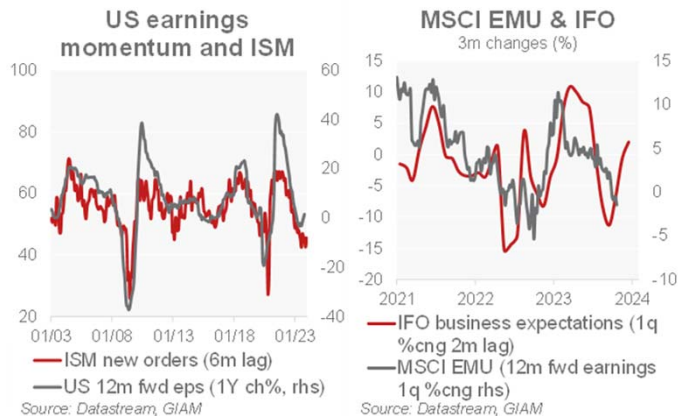
Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q2 2023	Q3 2023	Q2 2023	Q3 2023	Q2 2023	Q3 2023	
S&P	5.9%	5.8%	5.8%	4.8%	0.1%	1.0%	46.6%
Stoxx	10.3%	3.4%	7.5%	2.4%	2.8%	1.1%	44.7%
Euro Stoxx	1.4%	0.4%	6.2%	0.9%	(4.8)%	(0.4)%	39.2%
Topix	8.8%	8.5%	7.4%	6.5%	1.4%	2.0%	16.8%

Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q2 2023	Q3 2023	Q2 2023	Q3 2023	Q2 2023	Q3 2023	
S&P	4.4%	3.8%	0.9%	0.4%	3.5%	3.4%	46.6%
Stoxx	3.3%	2.9%	0.4%	(0.6)%	2.9%	3.5%	44.7%
Euro Stoxx	1.5%	2.5%	0.6%	(0.7)%	0.9%	3.3%	39.2%
Topix	12.2%	2.6%	1.0%	1.0%	11.2%	1.6%	16.8%

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



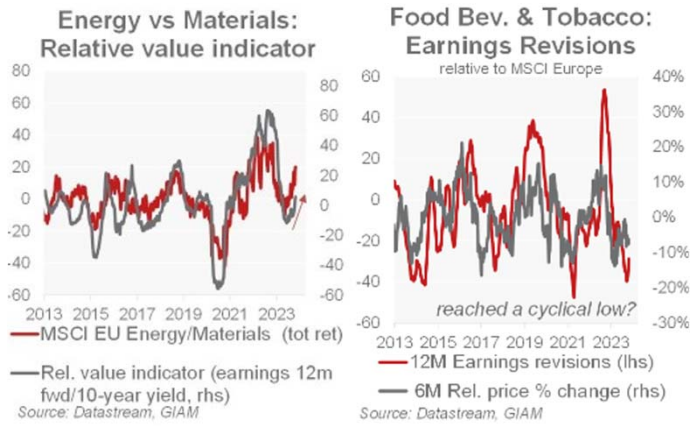
- We reduce the UW in equity due to better equity/bond models, US positive macro surprises, lower valuations and more bearish investor positioning.
- That said, high yields, the Hamas/Israel war and signs of slowdown maintain short-term risks: we would refrain from becoming overly positive just yet.
- Improving margin proxies have proven supportive for the Q3 reporting season, also thanks to US macro resilience. Indeed, Q3 results reaffirm US leadership over the EMU.
- Overall, we do not change our EPS forecasts, which remain around 6% below consensus in 2024 and 2025. These estimates underpin potential positive 12-month total returns (5%-10%), more so for the EU than for the US.
- We maintain a neutral position on the US vs. EMU and OW Japan (valuation, reforms), SMI (valuation), China (val.), and India (eco). Neutral US vs EMU.
- EU sectors: OWs: Banks, Durables (new), Energy (new), Food Retail, Food Bev. Tob. (new), HC Equip. & Svs., Pharma, Utilities. UWs: Capital goods, Comm. Prof. Svs. (new), Insurance, Materials, Media, Real Estate.

We have recently reduced our equity underweight on the back of better equity/bond models, positive macro surprises in the US, much reduced investor positioning and lower valuations (markets are down -11% from the July peak). At current levels, the EMU index shows only a limited premium of around 6% to a fair valuation (using current EPS forecasts and 10-year interest rate levels as inputs). However, high yields, the Israeli war and signs of an economic slowdown keep risks high in the short term: We would refrain from becoming overly positive just yet. Political uncertainty would already potentially demand a higher risk premium, and a possible Iranian involvement in the Israeli conflict would be a trigger for lower-than-expected earnings (EPS) growth and higher inflation. In a base case scenario (war doesn't escalate to include Iran), 12-month TRs are in positive territory and more for the World Index ex-US.

Concerning US earnings, macro resilience, improved margin proxies and the TW USD helped the Q3 reporting season, which reaffirm US leadership. Indeed, the EU EPS momentum remains weak. US year-on-year EPS growth (13%) is higher than in Q2, while sales growth is stable (4.7%). For the median stock, EPS growth is more subdued at 6% yoy. The surprise vs. expectations is positive at 8.6% and higher vs. Q2 (worse for the median stock, 3.8%). However, the sales surprise is lower and declining vs. Q2.

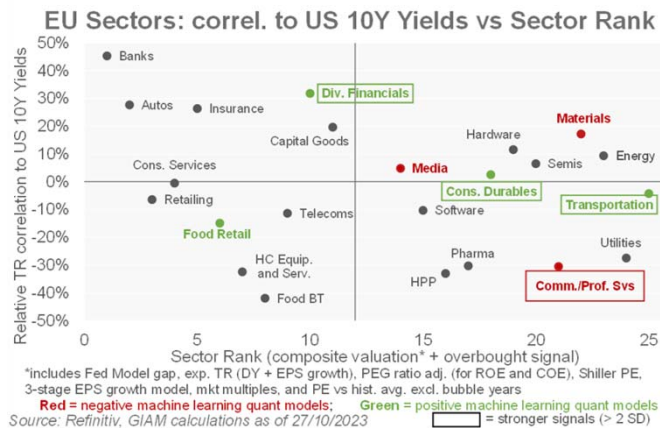
Equities

Michele Morganti, Vladimir Oleinikov



US positive beats in percentage of total results have declined vs. Q2, especially for sales. As expected, EU STOXX 600 results are much weaker. EPS growth is -11% and -6% for sales. Surprises are negative at -10%, although the median EU sector surprise is positive (+4%). In fact, results are very dispersed, with industrials showing an 80% negative EPS surprise vs. consensus, materials -11% and discretionary +8%. While EA guidance remains at risk, some macro indicators (capacity utilization's momentum, IFO exp.) suggest that EA margins should not fall off the cliff too soon, either. We see also some macro stabilisation in Q4.

For the US, the EPS trend remains positive, although the sales trend and EPS revisions point to a less strong momentum ahead. For both the US and EMU, EPS estimates for 2023 and 2024 are largely unchanged, since the start of the season (5 October). Overall, we do not change our EPS forecasts, which remain around 6% below consensus in 2024 and 2025.



Positive TR over 12-months

These earnings estimates underpin potential positive 12-month total returns, more so for the EU than for the US: 10% and 5%, respectively. Regionally: OW Japan (valuation and reforms), SMI (valuation), China (val.), and India (eco). Neutral US vs EMU (peak US valuation premium, quant models and less divergent macro surprises).

European sector allocation

We adopt a barbell approach with a defensive tilt to manage short-term uncertainties. Overall, we suggest a few tweaks in our allocation, reducing our portfolio beta slightly below 1. Notably, we slightly increase Energy vs Materials (earnings momentum, edge to war escalation) and Food vs Comm. Prof. Svs. (valuation). We marginally increase Media (still UW) and Durables (OW, bottoming revisions), and we move to neutral Transportation (from UW), Div. Financials (from OW) and Software (from OW). OWs: Banks, Durables (new), Energy (new), Food Retail, Food Bev. Tob. (new), HC Equip. & Svs., Pharma, Utilities. UWs: Capital goods, Comm. Prof. Svs. (new), Insurance, Materials, Media, Real Estate.

EMs: supported by China's sentiment short term

As China took further action to support its economy (+0.8% of GDP), the sentiment started improving. This is likely to be supportive at least in the short term. We see the need for further positive developments for sentiment recovery to be sustained. EMs are also to be supported by higher macro surprises, but we continue to have a neutral stance due to expectations of a weaker global trade, which is to affect the EM earnings momentum. We are OW on China and India.

Market Index	Quant models	ML models	composite valuation score **
S&P 500	+	-	--
MSCI EMU	+	=	+
FTSE 100	--	+	--
SMI	+	++	+
TOPIX	+	=	+
Brazil	n.a	--	--
China	n.a	+	+++
India	n.a	+	+

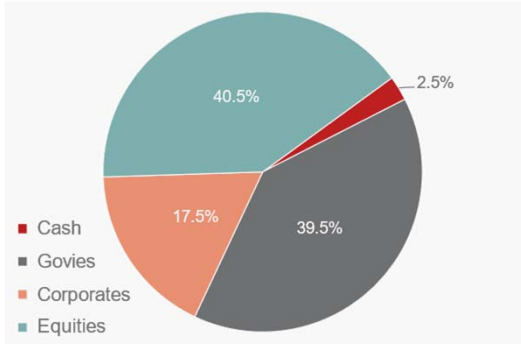
* for DMs, the valuation is vs MSCI World, for EMs it is vs MSCI EM

** composite valuation score is taken across 45 equity markets and is based on various valuation measures

Asset Allocation

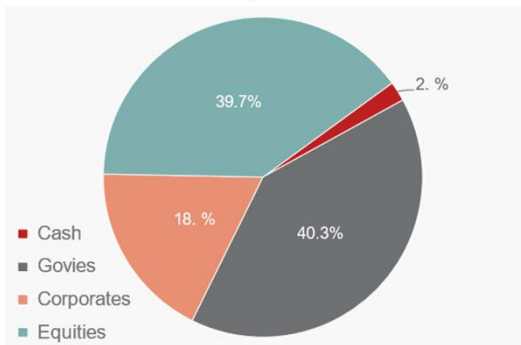
Thorsten Runde

Benchmark



Source: GIAM

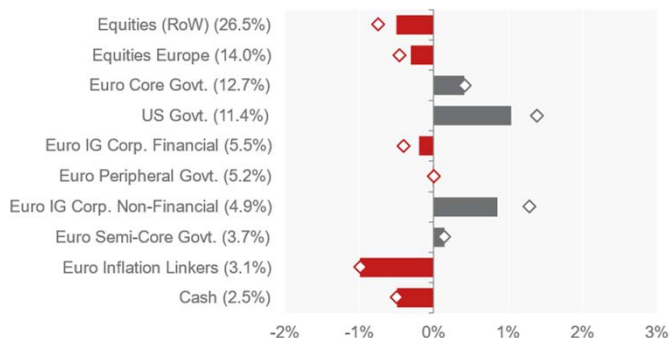
Modelportfolio



Source: GIAM

Active Positions

TOP 10 Benchmark Constituents



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

- In October (per 27.10.23), our covered asset classes mostly rendered negative returns except for Cash and short- to medium-dated European government bonds and short-dated USTs.
- Over the entire month, all covered Equity markets lost between -2.8% (MSCI Pacific) and -4.5% (MSCI EMU). Together with long-dated US Treasuries (-4.1%) they represent again the bottom of the performance ranking.
- Overall, EA HY Credit underperformed EA IG by around -80 bps. Within IG, Fin was slightly superior to Non-Fin (+15 bps).
- Amid weakening growth, higher geopolitical risks and renewed upside risks to inflation from energy prices, we anticipate risk sentiment to remain fragile. That said, improved valuations after recent setbacks and the earnings season might be supportive. We do not expect a full blown escalation in the Middle East in our base case, but risks are non-negligible.
- Thus, we stay underweight in Equities and EA HY Credit, however, to a reduced extent. We slightly trim the OWs in EA IG Non-Fin, EM Govies, and US Treasuries. We keep a moderately long duration stance.

With +0.3 bps our model portfolio slightly outperformed its benchmark in October (27.10.23). All in, the overweight positions in medium-dated Core Govies (+2.2 bps) and the underweight in EMU Equities (+1.9 bps) proved most rewarding. With -2.7 bps, the underweight in short-dated Core Govies was the most painful active position.

Despite an amazingly resilient US growths, past rate hikes keep feeding through the economies, thus dampening the outlook for the remainder of the year. Together with geopolitical risks and renewed upside risks to inflation from energy prices, we anticipate the correction in risk assets to extend further. That said, the recent setback and the earnings season might prove supportive.

Risk assets still look vulnerable

Thus, we stay underweighted in Equities and EA HY, but to a reduced extent. To do so, we primarily reallocate from EM Govies and US Treasuries. Furthermore, we mitigate the imbalance in the EA IG segment by shifting exposure from Non-Fins to Fins. After the recent sell-off in bonds, we see the risks tilted towards lower yields and hence keep our moderately long duration stance.

Forecasts

Macro Data

Growth ¹⁾	2022	2023		2024		2025	Inflation ¹⁾	2022	2023		2024		2025
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast			forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	2.0	2.4	0.3	1.1	0.1	1.8	US	8.0	4.1	0.0	2.5	- 0.0	2.2
Euro area	3.3	0.4	- 0.1	0.5	- 0.2	1.4	Euro area	8.4	5.6	0.1	2.8	0.3	2.3
Germany	1.8	- 0.5	- 0.1	0.5	- 0.1	1.7	Germany	8.6	6.1	0.1	2.9	0.2	2.5
France	2.5	0.3	- 0.5	0.8	- 0.0	1.6	France	5.9	5.3	0.3	2.8	0.1	2.2
Italy	3.9	0.7	- 0.1	0.6	- 0.1	0.5	Italy	8.2	5.2	- 0.8	2.4	0.0	0.6
Non-EMU	3.5	0.2	- 0.2	0.7	0.0	1.5	Non-EMU	8.0	6.6	0.0	2.8	- 0.1	2.1
UK	4.1	0.1	- 0.2	0.5	0.1	1.5	UK	9.1	7.5	0.1	3.0	- 0.1	2.1
Switzerland	2.1	0.8	0.0	1.3	0.0	1.2	Switzerland	2.8	2.3	0.0	1.5	- 0.1	1.3
Japan	1.2	2.0	0.2	1.4	0.5	1.2	Japan	2.5	3.2	0.1	2.4	0.4	1.5
Asia ex Japan	4.1	4.9	0.1	4.5	- 0.2	4.9	Asia ex Japan	3.5	2.1	- 0.1	2.4	- 0.1	2.4
China	3.0	5.2	0.2	4.3	- 0.2	4.5	China	1.9	0.4	- 0.3	1.5	- 0.3	1.7
CEE	1.9	2.1	0.3	2.4	0.5	2.9	CEE	29.6	20.7	0.7	15.9	0.5	8.2
Latin America	4.0	1.9	0.0	1.4	- 0.0	2.1	Latin America ²⁾	7.8	5.2	0.0	3.9	0.0	3.1
World	3.3	2.8	0.1	2.5	- 0.0	3.0	World	7.8	5.3	0.0	3.9	0.0	2.9

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

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

Financial Markets

Key Rates	Current*	3M		6M		12M		Credit Spreads**	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd			Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
US (upper bound)	5.50	5.50	5.42	5.50	5.22	5.00	4.59	EA IG Non-Financial	150	150	145	140	140		
Euro area	4.00	4.00	3.91	4.00	3.74	3.75	3.11	EA IG Financial	177	180	170	165	165		
Japan	-0.10	-0.10	0.02	-0.10	0.09	0.00	0.28	EA HY	486	530	515	500	500		
UK	5.25	5.25	5.28	5.25	5.24	5.00	4.76	EM Sov. (in USD)	345	340	350	335	335		
Switzerland	1.75	1.75	1.70	1.75	1.64	1.50	1.33	Forex							
10-Year Gvt Bonds								EUR/USD	1.06	1.05	1.06	1.08	1.07	1.10	1.08
US Treasuries	4.87	4.60	4.89	4.40	4.89	4.10	4.90	USD/JPY	150	148	148	140	146	137	142
Germany (Bunds)	2.86	2.65	2.86	2.60	2.85	2.55	2.84	EUR/JPY	159	155	157	151	155	151	152
Italy	4.86	4.70	4.90	4.70	4.95	4.70	5.05	GBP/USD	1.21	1.21	1.21	1.24	1.22	1.28	1.22
Spread vs Bunds	200	205	204	210	210	215	221	EUR/GBP	0.87	0.87	0.87	0.87	0.88	0.86	0.88
France	3.49	3.25	3.49	3.20	3.50	3.20	3.54	EUR/CHF	0.95	0.95	0.94	0.97	0.94	1.01	0.93
Spread vs Bunds	63	60	63	60	65	65	70	Equities							
Japan	0.87	0.90	0.93	0.95	0.99	1.00	1.10	S&P500	4,147	4,110	4,085	4,300	4,300		
UK	4.59	4.40	4.61	4.30	4.59	4.20	4.63	MSCI EMU	136.4	134.5	133.0	143.0	143.0		
Switzerland	1.14	1.05	1.10	1.00	1.09	0.95	1.10	TOPIX	2,244	2,230	2,195	2,390	2,390		
								FTSE	7,353	7,230	7,110	7,780	7,780		
								SMI	10,364	10,310	10,025	11,000	11,000		

*3-day avg. as of 27/10/23

**ICE BofA (OAS)

Forecast Intervals



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

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