

Market Perspectives

It's not over till it's over

GIAM Macro & Market Research

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Global View – It's not over till it's over

Thomas Hempell / Vincent Chaigneau

- **Omicron is unsettling markets – and uncertainty will remain high until the variant's impact on Covid hospitalisations and deaths becomes clearer.**
- **May central banks delay the policy normalisation? Don't expect too much help: amid a deteriorating growth-inflation mix and persistent global supply bottlenecks, policy makers are running short of silver bullets.**
- **We favour a very prudent tactical stance amid high near-term uncertainty. But with the earnings consensus looking reasonable and valuations supported by rock-bottom real yields, the recent correction may ultimately render opportunities for reloading risk assets as Omicron fears recede.**

Will the pandemic ever end? Vaccines have done a great job reducing the risk of severe cases, but the new infection wave suggests they are not circuit-breakers – as the WHO itself starts to [admit](#). Worries about the new variant Omicron have more than wiped out earlier November equity gains, with 26 Nov. seeing the deepest daily drop in over a year. The new variant seems highly infectious owing to numerous spike mutations and may quickly turn dominant globally, adding to worries over fast accelerating new Covid cases in Europe.

Yet thus far, little is known about the prospective health damage. The key question is whether Omicron will severely undermine vaccines' effectiveness in preventing hospitalizations and deaths. Early evidence does not point to severe diseases, but scarce data and usual lags suggest firm conclusions are premature. Producers have expressed confidence they could adjust mRNA jabs within 100 days. But this lag and the subsequent roll-out would still leave plenty of scope for the virus to disrupt supply chains and force renewed lockdowns.

Policy makers may help and cushion the market impact in case renewed lockdowns become necessary. Central banks may slow or even pause the removal of strong monetary accommodation. Yet aggravating supply disruption (left chart) and a prolongation of crowded global demand for goods will increase the inflation headache, preventing a particularly strong kind of support.

Recent market setback also bears opportunities

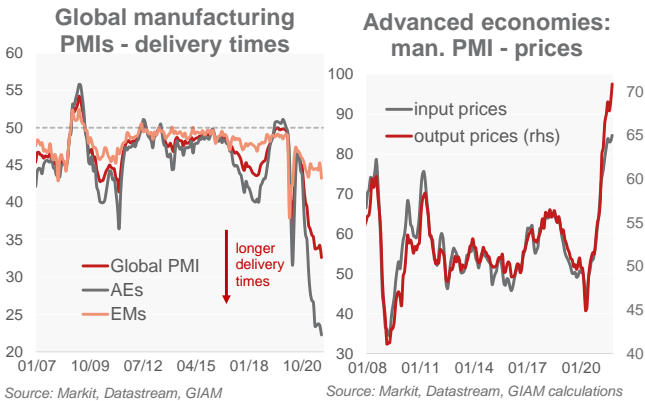
In the near term we thus favour a very prudent approach to tactical risk taking. Still, unless the variant's health impact turns out to be a game changer in vaccines' efficacy, the recent market correction may provide opportunities in cautiously overweighting risk assets in the portfolios.

Bonds	26/11/21*	3M	6M	12M
10-Year Treasuries	1.59	1.65	1.80	2.10
10-Year Bunds	-0.27	-0.25	-0.10	0.20
Corporate Bonds				
BofaML Non-Financial	105	95	75	75
BofaML Financial	107	95	75	75
Forex				
EUR/USD	1.12	1.11	1.13	1.15
USD/JPY	115	115	113	110
Equities				
S&P500	4666	4700	4765	4900
MSCI EMU	152	154	154	159

* avg. of last three trading days

For one, economic data surprises have bottomed into autumn. Also, with consumers sitting on large savings, firms still enjoy high pricing power, allowing them to pass higher input prices. This protects margins (right chart) and underpins the earnings outlook. Central banks will proceed carefully, helping ultra-low real yields to underpin valuations. Governments and firms have also learnt to better cope with measures aiming at a lower circulation of the virus. Investors will also hope that vaccine innovation will help the health sector to tackle even disruptive Covid mutations. New drugs are also coming to the market, and although efficacy and volumes are disputed, should also contain the social and economic impact.

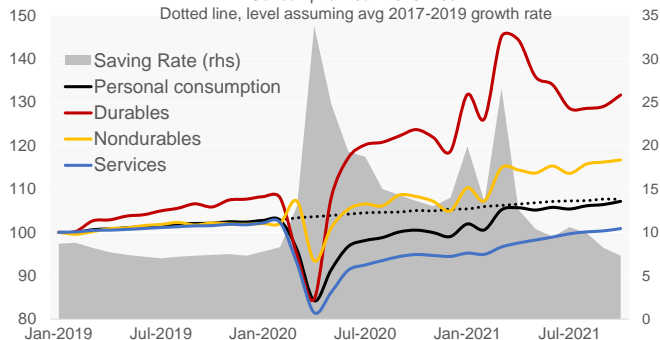
IG Credit in Europe looks favourable following the recent widening, not least because non-financials remain a key policy tool for the ECB. While we expect higher yields into 2022, we caution against any strong duration bias, with the risks of safe haven bids and growth concerns still sizeable. The USD looks dear after a near 7% advance (DXY) since early June, but policy divergence and global Covid worries may still underpin the greenback short term.



Consumption and saving rate

Consumption: Jan 2019=100.

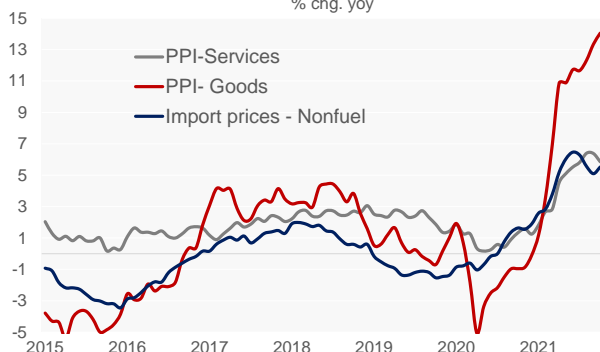
Dotted line, level assuming avg 2017-2019 growth rate



Source: Bureau of Economic Analysis, Datastream, GIAM

Production and import prices

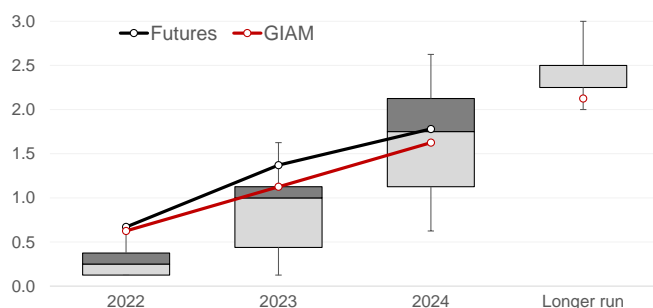
% chg. yoy



Source: ISM, NFIB, Refinitiv, GIAM

Distribution of the FOMC "dots" and Fed fund rates forecasts

Year-end, extremes and quartiles of the dots distribution



Source: Federal Reserve Board, Datastream, GIAM estimates

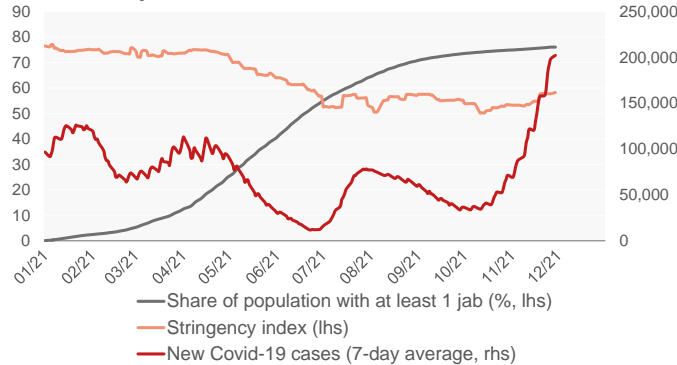
- After a weak Q3, activity has rebounded in the final months of the year, driven by consumption. We expect capex and inventory building to drive growth next year, when GDP should increase by just above 4%.
- The bout of inflation continues to be more stubborn and widespread than expected; it will likely remain at around 5% well into H1 2022.
- To respond to the risk of higher for longer inflation we think that the Fed will quicken its tapering, with net purchases ending in March/April, and lift rates twice next year.

Short term indicators point to Q4 growth at above 6% annualised, putting some upside risk to our 5.8% growth forecast for this year. Consumption is growing steadily, as restrictions are lowered, and is almost back to the pre-pandemic trend. However, purchases are still heavily tilted to goods, which exacerbates the effect of supply bottlenecks which are the main root of high inflation. Next year the fiscal boost to purchase power will be replaced by steady growing labour income so that consumption growth will moderate. Business surveys show a rise in capex spending plans. This and the need to beef up stocks (fallen well below the historical average) will become a key driver of the 4.2% growth we project for 2022.

Inflation remains high: headline CPI rose by 6.2% yoy with the core rate at 4.6% yoy. Wage pressures are building and production and import prices show more upside for CPI over the coming months, as surveys show that firms plan to pass through higher input costs. Expectations from surveys and financial markets remain high and consumer confidence has already taken a hit. We see both core and headline CPI inflation remaining above 5% well into next spring, and risks are tilted to the upside.

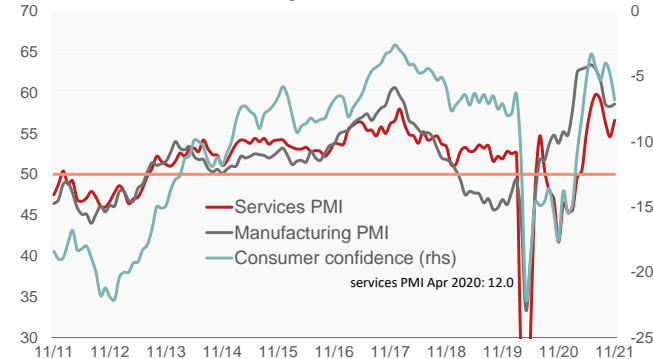
This further weakens the case for transitory inflation the Fed has so far been advertising and this is reflected in the tone of the latest communication. Given the strength of the labour markets, as employment continues to grow at a sustained pace, we think the Fed can safely start to reduce accommodation. Therefore, if the Omicron variant is not disruptive for activity, we now pencil in a quicker tapering, with net bond purchases ending in March or April. This will open the door to a first rate increase in June/July, followed by another one in Q4. A cautious approach will then lead to two more increases in 2023.

EA pandemic tracker: next wave arrived



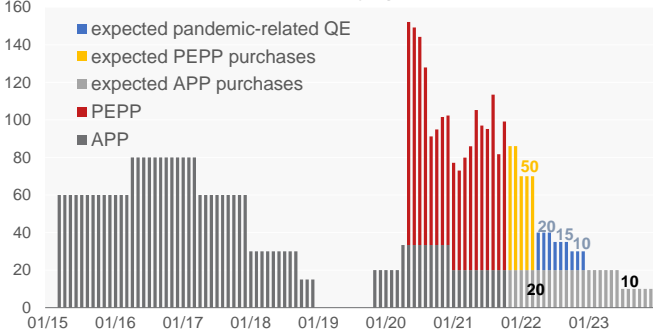
Source: Datastream, GIAM calculations

Euro area key sentiment indicators



Source: Datastream

ECB QE outlook
bn EUR



Source: Datastream, ECB, GIAM calculations

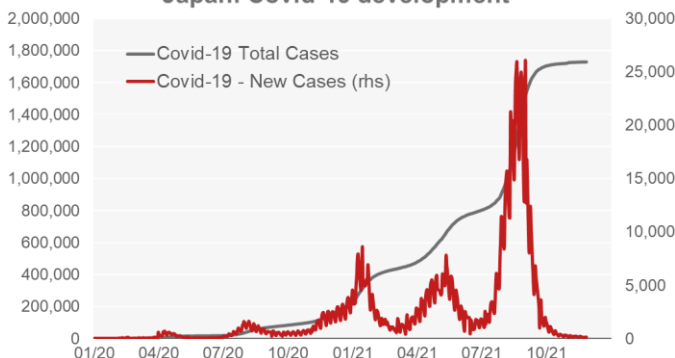
- The latest pandemic wave and the arrival of the omicron variant have already and will probably trigger more stringency measures.
- Economic activity will be dampened over the winter half. We adjusted our growth expectations slightly down to 5.1%/4.4% for 2021/22.
- At its policy meeting on Dec. 16 the ECB will reiterate that no rate hike in 2022 is ahead. Given the omicron variant we see potential for a more dovish stance on post-PEPP QE.

The arrival of the omicron variant in Europe raised concerns about a repetition of last year's winter recession. We do not share these (extreme) worries. The key reason is that unlike to last year when no vaccine was available about ¾ of the population received at least one inoculation. The hurdles for a renewed full lockdown are high making tailored measures to tackle the pandemic most likely. Also, the economy has embarked on a recovery trajectory with the labour market improving and consumer confidence above normal. The November composite PMI was at 55.8, still in line with ongoing healthy expansion. And demand from euro area export markets remained stable.

We think that against this backdrop the worsened pandemic situation will dent some growth over the winter half 2021/22 before (not least due to seasonal reasons) the Covid situation improves again. But it will not derail the recovery. We adjusted our growth expectations slightly down to 5.1%/4.4% for 2021/22 (from 5.2%/4.6%).

The appearance of the omicron variant on the screen will also impact the outcome of the ECB Governing Council (GC) meeting on Dec. 16. While adjusting the inflation outlook to the upside, it will continue to make clear that a rate hike in 2022 is not on the cards. More interesting will be the communication on the post-PEPP QE. The awareness for upside risks to medium term inflation increased and the ECB committed itself to stop QE just before the first rate hike. In order to be prepared while avoiding a policy cliff we expect the ECB to unwind its QE purchases smoothly next year (see bottom graph). Uncertainty about the concrete design is still high. But given increased pandemic risks again, there is a good chance that the GC becomes more dovish on post-PEPP QE than currently thought and announces this in December.

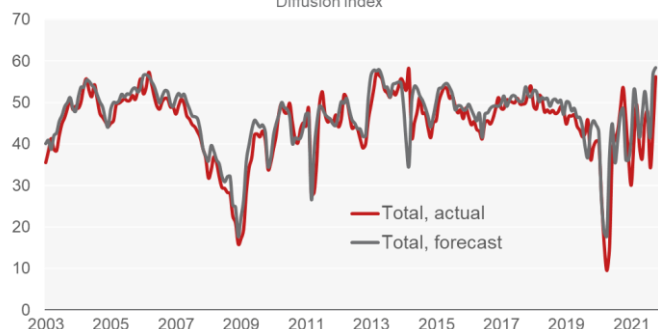
Japan: Covid-19 development



Source: Datastream

Economy Watchers' Survey

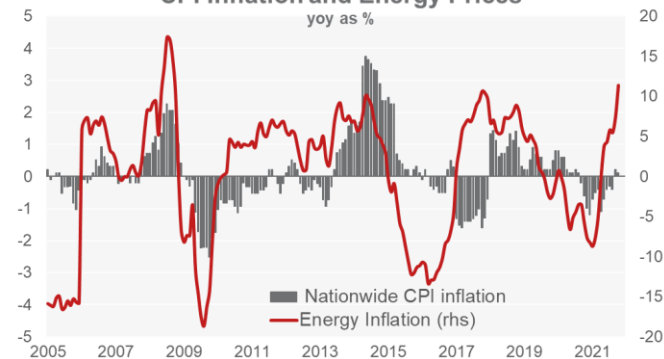
Diffusion index



Source: Datastream

CPI Inflation and Energy Prices

yoy as %



Source: Datastream

- After dropping by 3% qoq ann. in Q3 on Covid restrictions and supply bottlenecks, Japan's GDP is set to recover in Q4.
- Fresh PM Kishida announced a large fiscal package. However, markets (and us) estimate its impact as only limited.
- We revise our growth outlook for this year and the next down to 1.9% resp. 2.8% and inflation to -0.2% and 1.1%.

In Q3, Japan's GDP decreased 0.8% qoq or 3.0% qoq annualized. This was much lower than expected and the result of the Covid-19 lockdown as well as supply bottlenecks, esp. in the auto sector. When the Covid-19 wave receded and restrictions were lifted at end-September, private consumption started to pick up. The household related data of the Economy Watcher's Survey jumped to the highest level since the pandemic broke out. The situation on the production (auto) side remains less clear, but some car producers reported rising capacity utilisation again: Thus, bottlenecks appear to be easing. Nevertheless, the restrictions could over the short run not only dampen production but also durable goods consumption.

Meanwhile, the Japanese government announced a new fiscal stimulus package with record-high fiscal spending of JPY 55.7 tr (about 10% of GDP). While the Cabinet Office suggested a rather impressive impact on the economy, markets see it more in the range of 0.5% to 1.5% of GDP. We integrated both the weak Q3 GDP rate and the package into our forecasts and now see GDP growth at 1.9% this year and 2.8% in the next, given that Covid (Omicron) stays out.

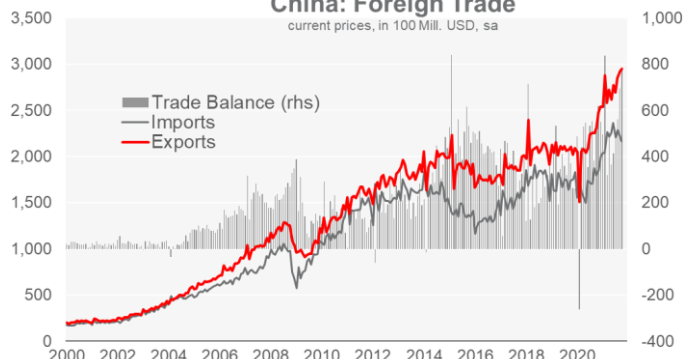
Inflation has been low so far in Japan. Headline inflation came in in October at 0.1% yoy while core-core inflation (excluding fresh food and energy) receded to -0.7% yoy. By contrast, energy inflation accelerated to 11.4% yoy, pushing up utility costs. However, goods prices rose by 1.9% yoy, while service inflation diminished by 1.8% yoy, still reflecting the cut in mobile phone charges (in April) and the Covid-19 lockdown. *Rising energy and service prices, fresh demands from Japan's new PM Kishida to increase wages by 3% as well as base effects from the mobile charges will likely push up inflation next year to 1.1%, after -0.2% in 2021. We do not expect the BoJ to respond to the temporary hike in inflation.*

China: Investment in Real Estate and Property Sales
yoy in %, 3mma



Source: Datastream, GIAM

China: Foreign Trade
current prices, in 100 Mill. USD, sa



Source: Datastream

China: Covid-19

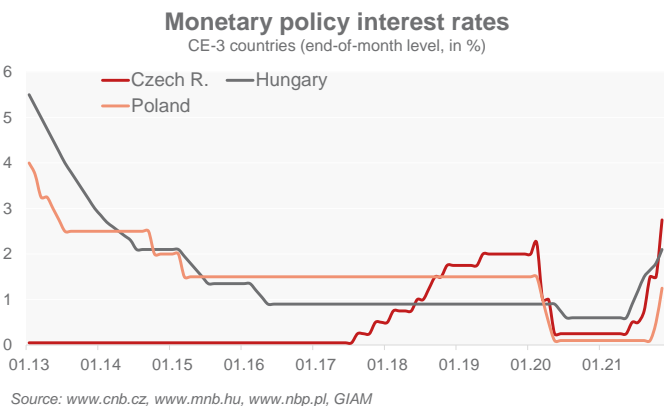
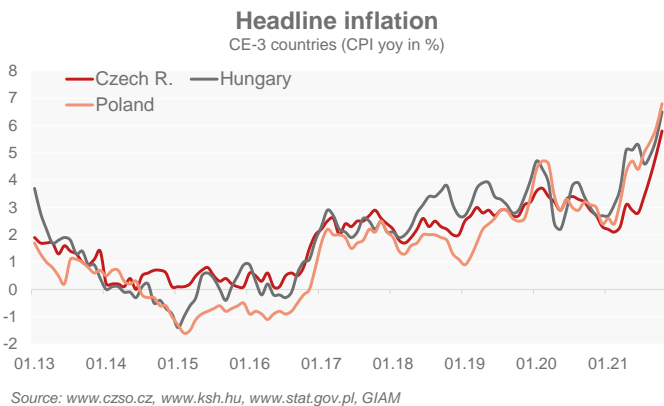


Source: Datastream

- China's October data moderately improved on average, except for real estate. The monetary impulse did not deteriorate further.
- Looking ahead, headwinds to the economy are still plentiful. We continue to expect some policy easing and stick to our view of a 50 bps RRR cut but are less convinced that it will come already in Q4.

China's October real activity data came in better than expected on average. Industrial production rebounded to 3.5% yoy (up from 3.1% yoy in September), much supported by increasing mining activity and still strong exports. Retail sales growth increased to 4.9% yoy (4.4% yoy in September), thus surprising on the upside given the multitude of local Covid-19 lockdowns. Infrastructure and manufacturing investment also looked a bit brighter, but real estate investment and property sales continued to cool. Moreover, the growth rate of "floor space started" (in sqm) continued to slump, which implies a negative outlook for future property investment. Also, house price inflation reflected the weakness in the sector, slowing to the lowest level since early 2016. Unmitigated, the sector could become a serious drag on growth next year. However, as the government's deleveraging policy is at the heart of the downturn, it will also be able to soften the impact. First, weak signs may have emerged. Reportedly, the BPOC authorised developers to resume the issuance of onshore bonds and banks stepped up lending to developers under the government's window guidance. At least, it looks that authorities are trying to protect sound developers from too negative credit developments.

Overall, China's economy continues to face substantial headwinds. Power restriction, fresh Covid-19 local lockdowns (risk of omicron), the high PPI inflation and real estate worries amid the regulatory crackdown measures suggest the need of some policy easing. However, there are just only few signs from monetary policy and infrastructure investment that signal more policy easing ahead. At least, total social financing growth stopped declining. This also implies a stabilisation of the monetary impulse which could be close to a lower turning point. We stick to our view of a 50 bps RRR cut but are less convinced that it will come already in Q4. We see GDP growth at 4.8% in 2022, after 7.8% this year.



Main Forecasts

Czech Republic	2020	2021f	2022f	2023f
GDP	-5.8	2.8	3.8	3.8
Consumer prices	3.2	3.7	5.5	2.3
Central bank's key rate	0.25	3.25	2.75	2.50
Hungary	2020	2021f	2022f	2023f
GDP	-4.9	6.7	4.0	4.0
Consumer prices	3.3	5.1	5.3	3.4
Central bank's key rate	0.60	2.40	3.00	3.00
Poland	2020	2021f	2022f	2023f
GDP	-2.5	5.3	5.1	4.4
Consumer prices	3.4	4.9	5.6	3.3
Central bank's key rate	0.10	1.50	2.75	2.75

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

- Monetary policy has tightened further in the CE-3 region in November as upside price pressures intensified. The regional central banks increased interest rates and some of them openly declared preference for a somewhat stronger currency.
- The regional currencies were negatively affected by the firming of the dollar against the euro and they underperformed expectations that interest rate hikes will lead them to strengthen.
- The new mutated coronavirus variant „Omicron“, which appeared in late November, will test commitment of the central banks to fight inflation as the new variant increases uncertainty regarding the economic activity outlook.

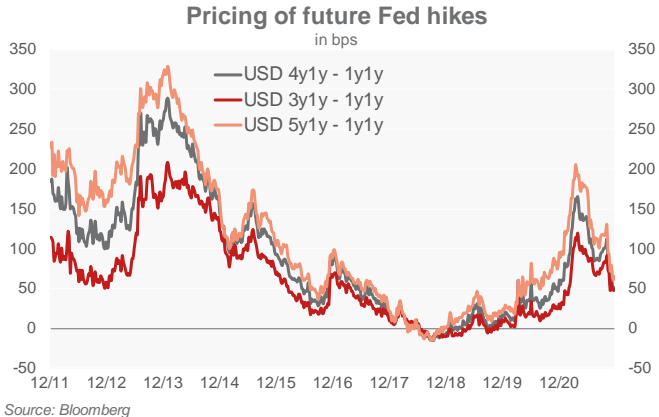
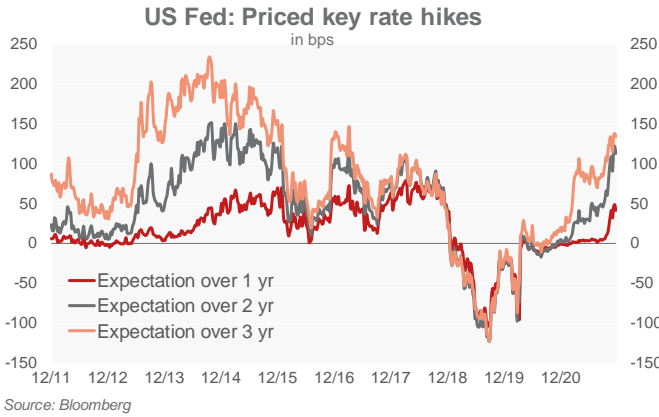
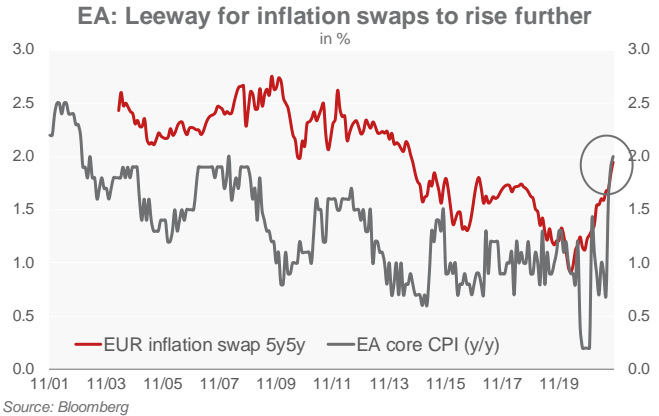
The CE-3 economies show different impacts of supply-side bottlenecks on the overall activity, which reflects the degree of their export exposure and the role of car industries. Small open economies (Czechia, Hungary) report a sharper impact of unfavourable global factors on manufacturing and GDP growth compared to Poland, which has a bigger role of domestic demand and more diversified manufacturing sector. This led us to cut GDP forecast for 2021 for Czechia and Hungary, while outlook for Poland improved.

Growing price pressures are seen across the region. Inflation jumped sharply in the past months and is driven not only by commodity prices incl. energy but also by underlying price pressures, inbuilt in the domestic economies. The CE-3 central banks therefore hiked interest rates further in November. The Czech CNB raised its key rate by 125 bps to 2.75%, the Hungarian MNB increased its base rate by 30 bps 2.10% but its policy was actually tightened more significantly, as the rate used for 1-week deposit operations was lifted by 110 bps to 2.90%. In Poland, the NBP increased its key rate by 75 bps to 1.25%.

The MNB and NBP also made clear that they would like to see their currencies slightly stronger against the euro, as global factors and their impact on EURUSD exchange rate led to underperformance of the regional currencies. While all three CE-3 central banks made clear that further tightening of monetary conditions is needed, it is a question to which extent their near-term steps will be impacted by the new coronavirus mutation. For now we operate with further interest rate hikes for December but for the CNB and the NBP at a slower pace than in past months.

Government Bonds

Florian Späte



- International government bond markets remain hostage of Covid-19 worries. This is seen to keep market participants on their toes for the time being and is likely to prevent a sustainable strong upward movement of yields.
- As soon as the vaccine efficacy is ensured we expect yields to resume their upward trend again. Amid a broadening of US inflation, expectations about the terminal key rate are likely to shift upwards. This will not only trigger higher long-dated US yields, but also EA yields.
- Given the uncertainty over the ECB monetary policy EA non-core government bond spreads have little leeway to tighten again. On the contrary, in view of the emerging scaling back of policy support, we consider a further spread widening to be likely.

The Covid-19 pandemic continues to have a major impact on international government bond markets. Rapidly increasing case numbers and the emergence of a new virus variant led to a decrease in yields across the curve in November. Uncertainty about the effects of the new omicron variant is currently very high and it is unlikely to disappear quickly. It is to be expected that it will take some time to analyze the aggressiveness and the associated mortality of the new variant. In the meantime, fundamental factors will take a back seat and a lasting increase in yields is rather unlikely.

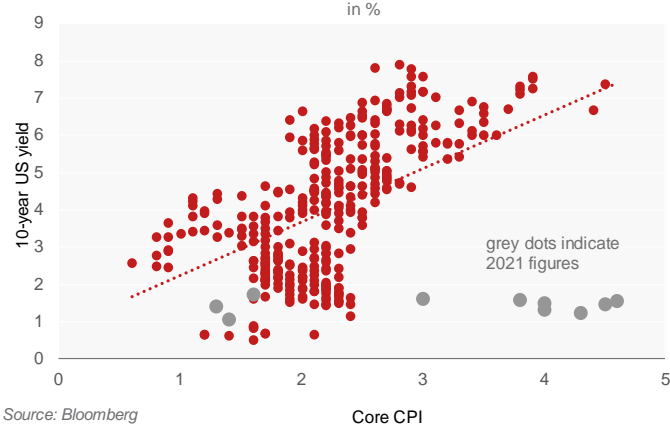
However, should the existing (or modified) vaccines prove effective, the upward trend in yields is likely to continue. In the US in particular, there are signs of a broadening of the inflation trend. Nevertheless, long-term inflation expectations are still at a comparably moderate level. 10-year US inflation swaps have come down from the highs and are currently trading around 2.75% and 5-year 5-year US inflation swaps are well below 2.5% again. Even in the EA there is the very unusual pattern that 5-year 5-year inflation swaps are below the current CPI core rate (see chart on top). Hence, although short-term inflation expectations have risen significantly in recent months, markets remain rather relaxed about the long-term outlook.

This is reflected in US key rate expectations as well. While expectations about a first US key rate hike have been brought forward in recent months (the emergence of omicron led to a correction recently, however) the expected level for the terminal rate has

Government Bonds

Florian Späte

US: 10-year yield and core inflation



come down significantly since spring (from above 2% in spring to around 1.5% currently). This explains to a large extent the decoupling of actual inflation and nominal yields (long-dated US yields have moved sideways since the start of the year although actual inflation rates have surged). In fact, US core inflation has tripled within one year which is unprecedented for many decades. Eventually, financial markets are forecast to adjust expectations upwards.

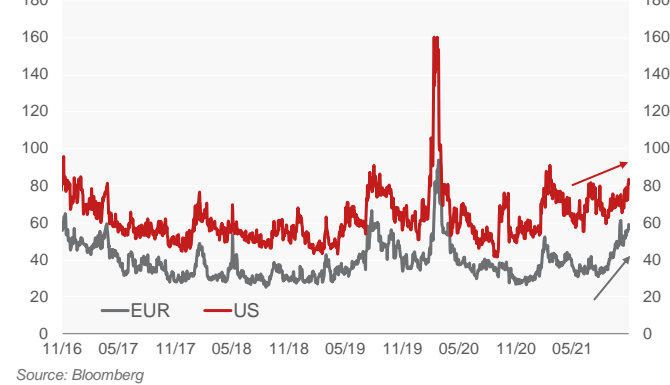
As soon as financial markets will start to price a higher terminal key rate we see upside potential for long-dated US yields. More patient central banks may delay the key rate hikes, but ultimately they will have to deliver to curb inflation pressure. In fact, the more relaxed monetary policy stance is supportive for steeper yield curves as later hikes allow for a stronger growth and employment effect and necessitate a higher terminal rate. The growing uncertainty and the lack of a reliable framework, such as the weakening of connections between inflation and yields that were considered certain, is also reflected in the rising volatility on bond markets.

Other factors point to higher yields in the medium term, too. Fiscal policy will remain rather ease (the fiscal impulse in the EA might even turn out to be positive again in 2022). New restrictions due to the pandemic may slow growth, but it is likely to remain above potential in 2022 amid easy global fiscal and monetary policy. Finally, government net supply will remain on a high level (in the US) or even increase (in the EA) in 2022. Overall, we forecast government bond yields to move only moderately upwards on a 3-month horizon. **But in the further course of 2022, 10-year benchmark yields are forecast to rise to 2.1% in the US and to 0.2% in the EA.**

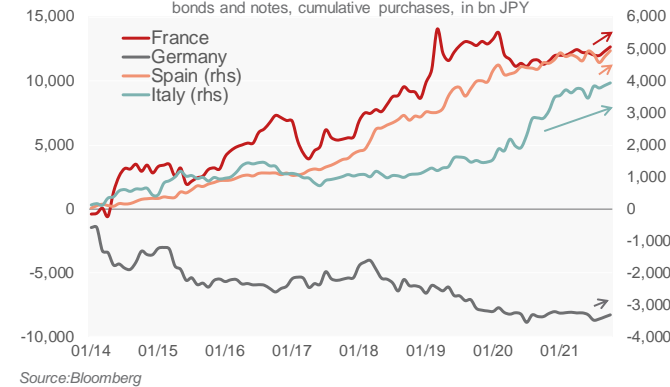
The recovery of EA non-core government bonds proved only temporary as towards the end of November concerns about the future ECB course came to the fore again. ECB QE purchases post PEPP will be key. Uncertainty is high, but it seems that the central bank will likely retain some flexibility regarding the shape and form of ECB purchases.

Although demand from abroad has picked up recently (largest inflows from Japanese investors this year in September) we think non-core bonds remain vulnerable to any shift in the narrative from the ECB. Hence, we see scope for spreads to widen further over the course of 2022.

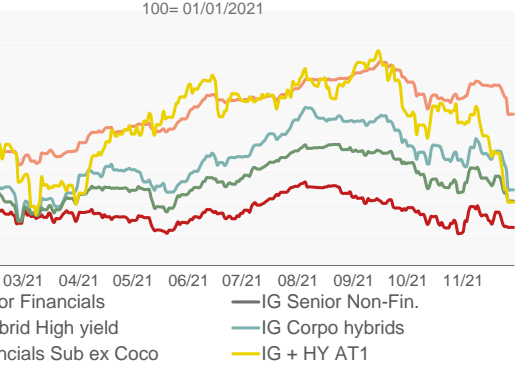
1-mth Implied Bond Market Volatility



Japan Net Portfolio Investments



Credit market year-to-date TR perf.



Source: Bloomberg, BofAML Indices, GIAM own calculations

- We keep our mild OW on credit markets.
- The Omicron variant risk should not derail credit fundamentals as both fiscal and monetary support would be reinitiated in case of new lockdowns.
- Our ECB scenario is more dovish than consensus with APP running until 2023, which will continue to support credit spreads in 2022. Hence, we believe the pricing out of the APP is premature.
- Fundamentals will continue to improve in 2022 in credit albeit at a slower pace compared to 2021.
- Technicals should also remain decent next year with net supply in IG likely negative and marginally positive in HY.

The Omicron risk has also led to stronger repricing of equity markets compared to credit ones which can be easily understood looking back at policy makers behaviour in 2020.

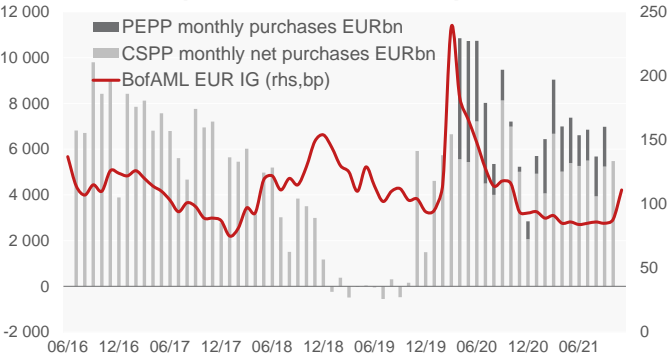
Until we know more about the vaccine efficiency on the Omicron variant, we are seeing travel and leisure names under particular pressure.

For Credit as a whole, uncertainty is adding to an already fragile environment which is in part pricing the removal of the ECB's APP in 2022 (which is not our scenario, though, as we believe the ECB will continue to buy credit until end-2023) and of supply indigestion. Yet a prolonged lockdown will most likely be cushioned by more reassuring signals from fiscal and monetary policy.

Also, primary market will soon pause as December is traditionally light in terms of issuance. Investment grade Credit will feel the headwinds but may still prove resilient against a sharper sell-off.

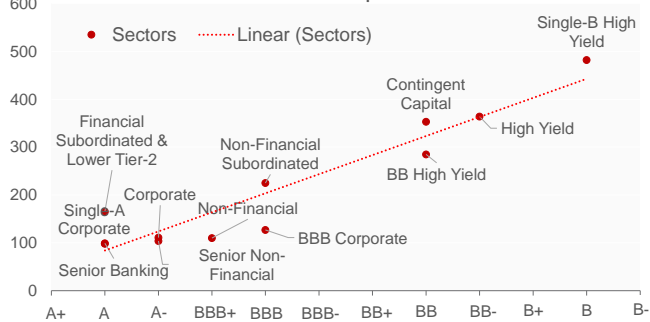
We assume a likely negative net supply for IG credit in 2022. Hence both technical and fundamentals should continue to support the low volatility in IG spreads, which we expect to tighten by 5bp by year-end. For HY we expect marginally positive supply implying flat spreads as HY is traditionally more sensitive to global flows while the expected end of Fed net purchases and rate hikes will be more disruptive for fixed-income markets.

Credit spreads vs central bank purchases



Source: Bloomberg, BofAML indices, ECB, GIAM

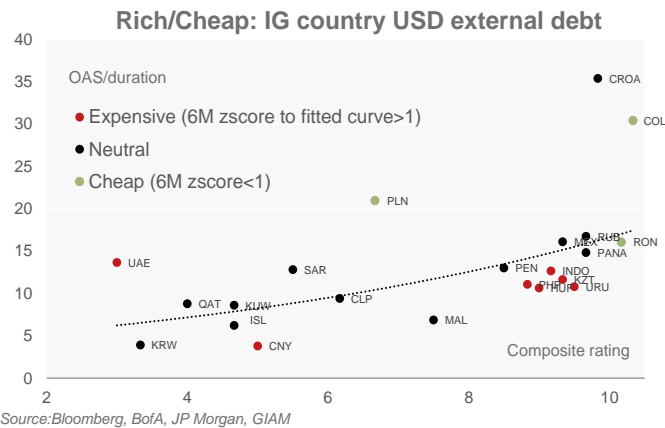
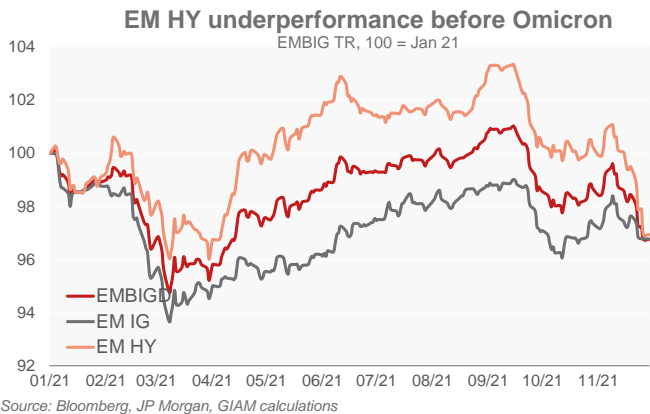
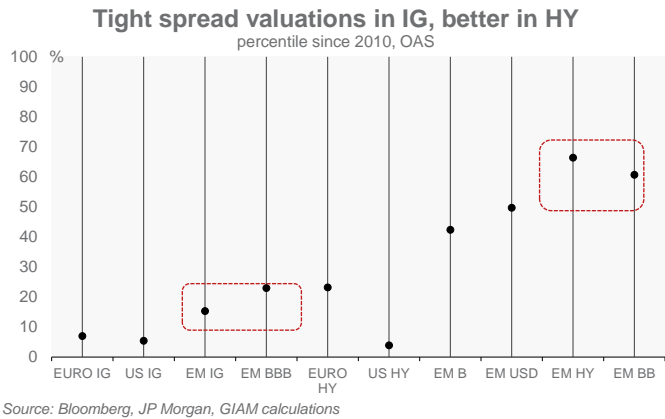
EUR IG Spread vs Rating



Source: Bloomberg, BofAML indices, GIAM own calculations

EM sovereign bonds

Guillaume Tresca



- We maintain our MW view, but downside risks are significant.
- We could see some spread compression after the Omicron overshooting. Uncertainty is high and the EM outlook is structurally not supportive
- We prefer BBBs and quality BBs. We like MENA IG and dislike Asia, see value in Mexico and Colombia.

We maintain our MW, but downside risks have substantially increased. The short-term outlook has changed abruptly with the emergence of the Omicron strain. Uncertainty is still running high, but EM market has rapidly priced a very negative scenario, with an HY overshooting. We will expect some retracement in the very short-term, barring any surprise.

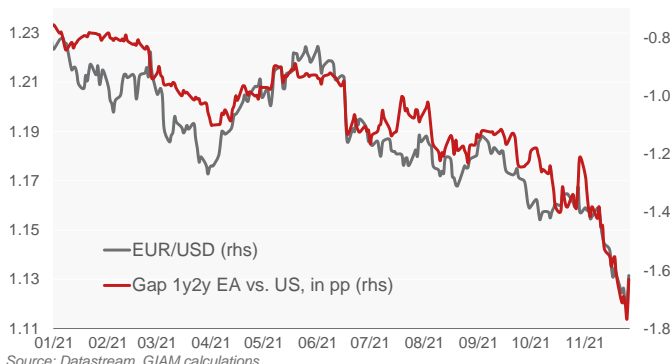
However, it will not mean that the EM outlook is structurally supportive. We do not see the potential for a more sustained compression. EM spreads were already widening before the variant concerns on the back of a more hawkish Fed policy and return prospects were meagre. This new bout of concerns is a reminder of (1) the fragility of EMs given low vaccination rate, (2) the growth uncertainty.

Beyond Omicron, EM external debt is still a carry play as interest rate volatility will be higher and DM central banks should reduce their support. Likewise, valuations are rich, especially on the IG side. We still focus on BBBs and quality BBs as we continue to see weak idiosyncratic stories in the low-rated countries. EM growth will be above trend, but it will slow down, making the fiscal consolidation difficult on average.

Dispersion will help relative value trades. In the IG space, it has been low, and valuations are tight. In the HY space, dispersion is more significant, clearly distinguishing between the distressed names and the low BB and B countries. Rising real yields will put more pressure on external refinancing needs, and we would expect the dispersion to widen further.

Region wise, we maintain our positive view on MENA IG with a preference for Qatar over KSA. We still dislike Asia IG given its low spread buffer and duration, like the Philippines. LatAm is facing a busy electoral cycle, but Mexico is offering an attractive yield-to-risk profile. We see value in Peru and Colombia while in Chile it is too early to take positions.

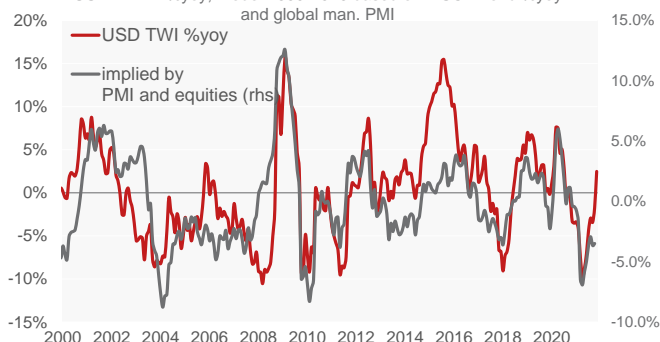
EUR/USD and monetary policy divergence



- Monetary policy divergence keeps driving FX markets. Inflation risks remain highest in the US and may still push rate expectations and the USD further up over the next weeks.
- Yet, the advance of the USD looks increasingly stretched. With the fast-spreading omicron variant threatening vaccine effectiveness and the recovery, second thoughts about policy normalization by the Fed may cap USD upside.
- We see some moderate downside risks to EUR/USD prevailing short term, with the cross likely to bottom out in H1 2022.
- CHF and JPY may benefit short term from uncertainties over omicron. The GBP may struggle to advance further amid easing rate expectations and a bleaker economic outlook.

USD defying drag from global rebound

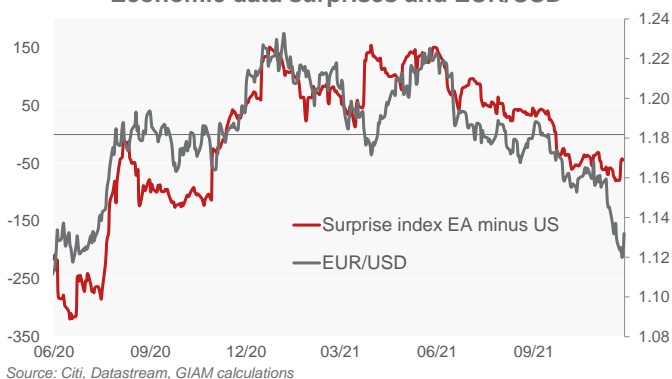
USD TWI in %yoy; model 2000-2019 based on MSCI World %yoy and global man. PMI



Global inflation concerns remain most virulent in the US, giving rate hike expectations and the USD a boost (top chart). With the ECB strongly pushing back against expectations of a 2022 rate hike, monetary policy divergence has sent the EUR/USD temporarily to 1.12, the lowest level since June 2012. With US inflation worries to persist, we see the risks tilted towards some further USD strength short term.

Yet the greenback's advance looks increasingly stretched. The USD TWI has overshot levels consistent with the strength of the global recovery and risk sentiment (mid chart) and financial market models (including yields, EMU spreads, oil, risk) point already to an overshoot by more than 10%. Economic worries in the euro area amid resurgent cases may be partly to blame, but also on this dimension the USD looks dear (bottom chart).

Economic data surprises and EUR/USD



Covid risks keeping CHF and JPY underpinned

The jury on the new omicron variant is still out, but economic uncertainty may delay the prospective tightening by the Fed and BoE, whose hawkish shift has been most advanced among the major central banks. This may keep low yielders like JPY and CHF underpinned as safe haven assets short term, while the GBP will struggle to gain. At the same time, the USD headwinds may be mitigated by higher global growth concerns.

While moderate downside risks to EUR/USD still prevail over the coming weeks, most of the EUR/USD slide seems now behind us and we expect a bottoming into 2022.

Equities

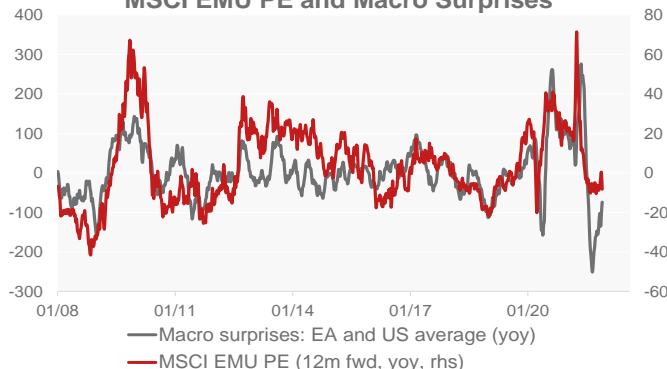
Michele Morganti, Vladimir Oleinikov

US S&P trailing earnings vs NIPA profits



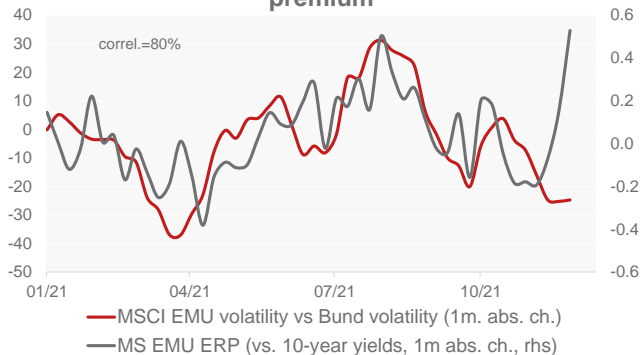
Source: Datastream, GIAM calculations

MSCI EMU PE and Macro Surprises



Source: Datastream, GIAM calculations

EA stock/bond volatility vs equity risk premium



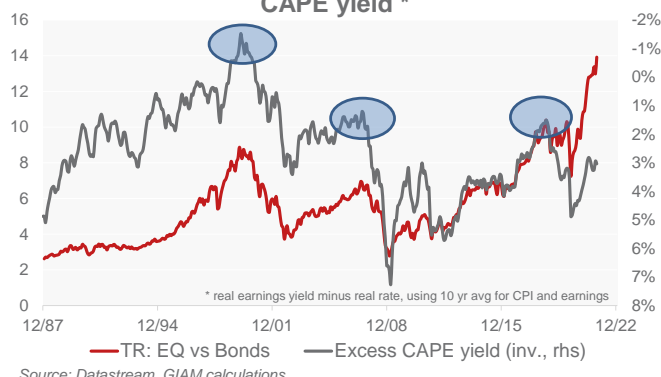
Source: Datastream, GIAM calculations

- For 2022, equities remain appealing due to solid earnings growth (+10%), notwithstanding a mild PE compression. Negative real bond yields will continue to score badly vs. positive equity ones.
- That said, our OW is still a cautious one due to lower policy support, Covid mutations and higher uncertainty caused by the less predictable response by central banks in a context of high inflation for the next 6 months.
- With good growth ahead and higher yields, Europe and Value sectors in particular look more attractive than the US. This is one of the few times in which the European PEG adjusted for beta, long yields and ROE is lower than US PEG. Our EU country score is also very supportive.
- EU sectors: we are still favouring a barbell. OW Value plus Staples, Durables and Pharma.

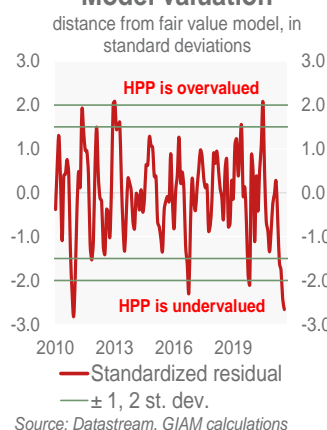
Should Omicron represent a non-disruptive event, (our base scenario), the 2022 will be positive for equities due to a sustained nominal GDP growth triggering a respectable positive momentum in earnings. We forecast an earnings growth of nearly 10% in 2022, for both US and EMU, with risks tilted on the upside under current macro expectation, unless we will be surprised by higher input cost or a more damaging Omicron evolution. This scenario comes from several hints. First, our models see US NIPA profits growing at 6%-8%. Theoretically, this corresponds to a quite high IBES 2022 figure for the S&P 500: 225 USD p.s. vs 202 of 2021 (+12.5%). We run also specific IBES models for the S&P 500 earnings which outcomes are lower, +10%. As we could see surprising pressure from input costs and wages, we prefer this last forecast. But we must be clear: even a +15% earnings growth should not look too crazy when we forecast an above-potential GDP growth in excess of 4%. Indeed, the earnings multiplier for a given real GDP growth is around 3X.

Such growth will offset the PE contraction we expect next year (-4%) due to a more mature phase of the cycle and lower policy support, coupled with sticky high inflation. Omicron represents a risk (see chart on ERP) but recent news from S. Africa shows so far no critical hospitalization of people infected. Should Omicron risk remain high but not escalate, the lower earnings growth could be in part offset by lower 10-year rates and a more accommodative central banks' stance. Of course, in this case Growth and Defensive should outperform Value-Cyclicals.

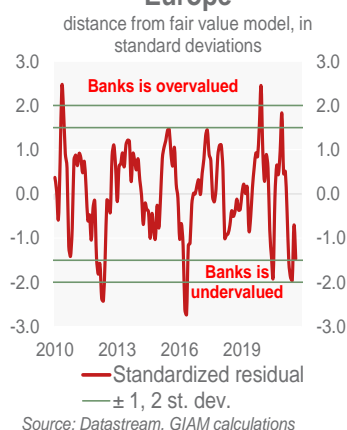
US Equity Total Ret. vs Bonds and Excess CAPE yield *



HPP vs MSCI Europe: Model valuation



Banks vs MSCI Europe



Global export orders and EM vs World



EM rel. to DM and EMFX



Total return (TR) of +7% in 2022: still cautious OW

Thanks to higher earnings and lingering low real yields (s. CAPE yield chart), we see a positive TR of at least 7% in 12 months, with Value and EMU outperforming. PEs already derated quite substantially following lower macro surprises (with only a marginal PE compression left) and tactical indicators (based on valuation, PMI, flows, funds' beta, etc.) are neutral. That said, our OW is a cautious one because we have just entered in a lower policy support environment. Furthermore, as high inflation will remain with us in the next months, markets will suffer a higher uncertainty due to the less predictable response by central banks to future inflation and macro data. This in turn commands a higher risk premium, keeping total returns more volatile. A lingering Omicron diffusion could also keep volatility and risk premium higher for longer.

EMU shows an appealing assessment

Our composite country score, which includes several valuation and growth scores, sees EMU much more attractive than the US. UK score looks even better. In a scenario of sustained recovery and higher yields (our base one) we expect Europe to outperform. Currently, the EMU PEG adjusted by ROE, Beta and 10-year yield is lower than US one (1.2X vs 1.4X).

Sectors allocation: still a barbell

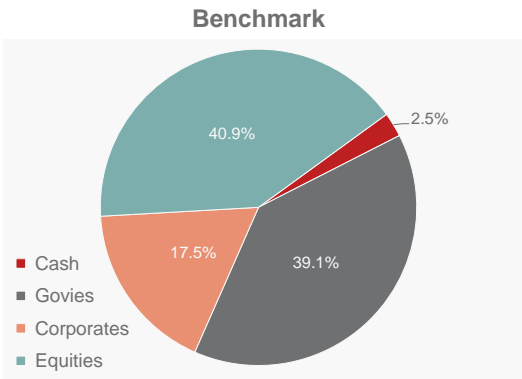
We OW Value (Banks, Insurance and Energy) but we also like more secure ones like staples, pharma and durables. The reasons behind are: point of the cycle, valuation, revisions. Lower confidence indicators from cyclical highs typically induce Growth and Quality to outperform. Second, the cited higher uncertainty driven by policy support and inflation would request the same. Finally, the sectors we OW all score well in terms of quant model results, valuation and revision trends. This month we lower Cons. Services to neutral, Div. Financials to UW and put Staples on a higher OW. Other UW: RE, telecom and utilities.

EM: supported by increasing sentiment short-term

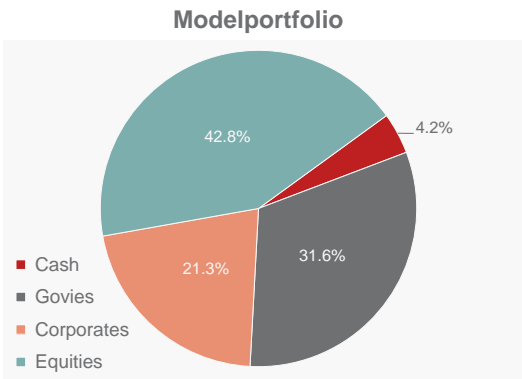
We remain neutral on EMs. Headwinds are monetary tightening, weaker earnings trend, slow-down in China and high real interest rates. On the positive side we see extreme underperformance vs. the MSCI World (Z-score of -1.8), low relative valuation and better domestic growth plus higher policy support from Q1 2022. We OW Korea and Chinese A-shares (good country score) and stay neutral on MSCI China.

Asset Allocation

Thorsten Runde



Source: GIAM



Source: GIAM

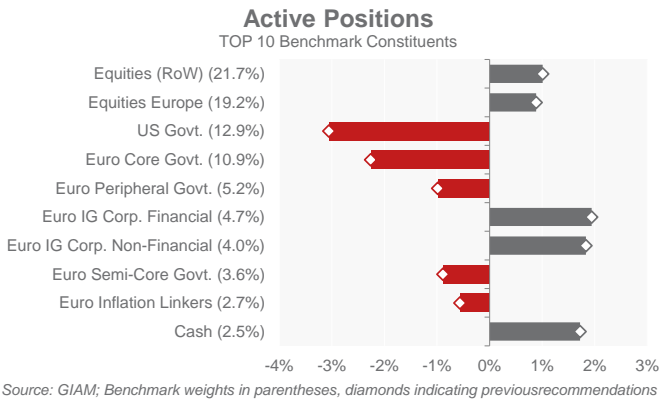
- With the appearance of the Omicron variant, the November performance ranking was completely shuffled within a single day.
- Equities as a whole fell back to the rear ranks with figures ranging from roughly -3% for the euro area to slightly below zero for the US.
- On the fixed income side just EM Govies (USD) (-1.8%) and EA HY Credit (-0.5%) lost value, the remainder made it safely into positive territory.
- Euro area IG Financials and non-Financials nearly moved in lockstep (+0.1%) outperforming HY by roughly +60 bps.
- Long-dated Govies were the beneficiaries, now leading the ranking with figures ranging from +1.5% (Spain) to +2.4% (EA Core).
- In the short term Omicron will add to market volatility. Following the recent correction, we maintain a prudent pro-risk tilt in our portfolio, favouring Credit and (more prudently) Equities.

In November (26.11.21), our model portfolio so far lost -10.5 bps compared to its benchmark. The second half of the month had already been slightly negative. But just the last day accounts for a relative loss of -11 bps. Risk assets suffered the most from the worrying news about the appearance of the Omicron virus variant, whereas non-spread fixed income assets were the beneficiaries. Just the overweight positions in Corporate Bonds and Cash paid off in November as Equities dragged down the benchmark performance. With -3.6 bps the underweight in EA Core Govies proved to be particularly painful.

As the case of Omicron shows, Covid might stay with us for much longer than initially thought. That said, we deem the most recent market reactions somewhat overdone given the current poor information status. Acknowledging that this will add to market volatility in the short term, we currently act on the assumption that first signs pointing towards the new virus variant being highly contagious but less severe will probably be confirmed. Thus, we see the global recovery delayed but not derailed.

Cautiously positive for risk assets

Although short-term risks have risen, we thus maintain a pro-risk bias in our portfolio. We keep a sizeable OW in IG Credit and Cash, a prudent OW in Equities and HY Credit and an UW in Core Govies and US Treasuries.



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

FORECAST TABLES

Forecast tables

Growth ¹⁾	2020	2021		2022		2023
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	- 3.4	5.7	- 0.0	4.1	- 0.0	2.0
Euro area	- 6.5	5.2	0.1	4.6	0.2	2.0
Germany	- 4.9	2.6	- 0.2	4.1	- 0.3	1.6
France	- 8.0	6.9	0.8	5.0	1.2	1.8
Italy	- 9.0	6.3	0.4	4.3	0.0	1.6
Non-EMU	- 7.4	5.9	- 0.0	4.2	- 0.3	2.1
UK	- 9.7	6.9	- 0.0	4.6	- 0.5	2.1
Switzerland	- 2.5	3.4	0.0	3.1	0.0	1.4
Japan	- 4.7	1.9	- 0.4	2.8	- 0.2	1.4
Asia ex Japan	- 1.0	7.0	- 0.2	5.1	- 0.5	5.1
China	1.9	7.8	- 0.4	4.8	- 0.7	5.3
CEE	- 1.7	5.9	0.2	3.6	0.2	3.4
Latin America	- 8.5	5.8	0.0	2.5	0.0	2.5
World	- 3.5	5.8	- 0.1	4.3	- 0.2	3.2

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

Inflation ¹⁾	2020	2021		2022		2023
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	1.2	4.5	0.1	4.7	1.3	2.7
Euro area	0.3	2.3	- 0.0	1.9	- 0.1	1.4
Germany	0.4	3.1	0.1	2.4	0.2	1.8
France	0.5	1.7	0.0	1.6	0.0	1.2
Italy	- 0.1	1.8	0.1	1.5	- 0.2	0.6
Non-EMU	0.6	2.1	0.1	3.1	0.5	1.9
UK	0.9	2.5	0.2	4.0	0.7	2.1
Switzerland	- 0.7	0.5	0.0	0.6	0.0	0.8
Japan	- 0.0	- 0.2	0.0	1.1	0.6	0.2
Asia ex Japan	2.8	2.0	- 0.2	2.4	- 0.3	2.8
China	2.5	0.8	- 0.4	1.7	- 0.4	2.3
CEE	5.5	9.0	0.2	9.0	2.0	6.7
Latin America ²⁾	3.2	3.1	- 2.9	4.1	0.7	3.2
World	2.1	3.2	- 0.3	3.4	0.4	2.8

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

Financial Markets

3-month LIBOR	26/11/21*	3M	6M	12M
USD	0.18	0.15	0.40	0.60
EUR	-0.59	-0.55	-0.55	-0.55
JPY	-0.09	-0.10	-0.10	-0.10
GBP	0.11	0.25	0.50	0.75
CHF	-0.78	-0.75	-0.75	-0.75
10-Year Bonds	26/11/21*	3M	6M	12M
Treasuries	1.59	1.65	1.80	2.10
Bunds	-0.27	-0.25	-0.10	0.20
BTPs	0.99	1.05	1.25	1.60
OATs	0.10	0.25	0.35	0.55
JGBs	0.08	0.10	0.10	0.15
Gilts	0.93	0.95	1.15	1.40
SWI	-0.18	-0.15	-0.05	0.20
Spreads	26/11/21*	3M	6M	12M
GIIPS	102	105	110	115
BofAML Covered Bonds	51	50	50	55
BofAML EM Gvt. Bonds (in USD)	316	295	300	300

Corporate Bond Spreads	26/11/21*	3M	6M	12M
BofAML Non-Financial	105	95	75	75
BofAML Financial	107	95	75	75
Forex	26/11/21*	3M	6M	12M
EUR/USD	1.12	1.11	1.13	1.15
USD/JPY	115	115	113	110
EUR/JPY	129	128	128	127
GBP/USD	1.33	1.31	1.33	1.35
EUR/GBP	0.84	0.85	0.85	0.85
EUR/CHF	1.05	1.05	1.06	1.10
Equities	26/11/21*	3M	6M	12M
S&P500	4,666	4,700	4,765	4,900
MSCI EMU	151.5	153.5	154.0	159.0
TOPIX	2,010	2,035	2,050	2,110
FTSE	7,214	7,275	7,330	7,500
SMI	12,348	12,460	12,395	12,770

*average of last three trading days

3-Months Horizon

Government Bonds	10-Year Bunds	-0.38	-0.25	-0.12
	10-Year Treasuries	1.31	1.65	1.99
	10-Year JGBs	0.04	0.10	0.16
	10-Year Gilts	0.49	0.95	1.41
	10-Year Bonds CH	-0.26	-0.15	-0.04
Equities	MSCI EMU	141.4	153.5	165.6
	S&P500	4,388	4,700	5,012
	TOPIX	1,895	2,035	2,175
	FTSE 100	6,775	7,275	7,775
	SMIC	11,725	12,460	13,195
Currencies	EUR/USD	1.08	1.11	1.14
	USD/JPY	112	115	118
	EUR/GBP	0.83	0.85	0.87
	EUR/CHF	1.03	1.05	1.07

12-Months Horizon

Government Bonds	10-Year Bunds	-0.09	-0.25	0.49
	10-Year Treasuries	1.50	2.10	2.70
	10-Year JGBs	0.03	0.15	0.27
	10-Year Gilts	0.63	1.40	2.17
	10-Year Bonds CH	-0.06	0.20	0.46
Equities	MSCI EMU	136.6	159.0	181.4
	S&P500	4,318	4,900	5,482
	TOPIX	1,840	2,110	2,380
	FTSE 100	6,564	7,500	8,436
	SMIC	11,394	12,770	14,146
Currencies	EUR/USD	1.09	1.15	1.21
	USD/JPY	103	110	117
	EUR/GBP	0.80	0.85	0.90
	EUR/CHF	1.07	1.10	1.13

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