

Market Perspectives

Supply shock

= central banks' headache

GIAM Macro & Market Research

November 2021



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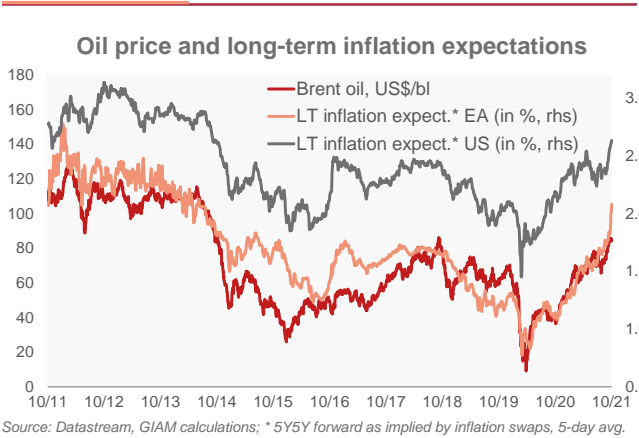
- The global recovery still has legs, keeping corporate earnings and risk sentiment underpinned.
- Yet mounting uncertainties over the energy crunch and central banks' response to more sticky inflation are making us more prudent.
- We scale back our overweight in Equities and HY Credit, adding to overweights in IG Credit and Cash. We keep a prudent short duration stance, anticipating only a gradual further rise in yields.

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Markets have climbed a wall of stagflation worries in October. Global equities have basically unwound the September drawdown (MSCI World: +5% as of Oct 28), defying soaring inflation expectations and benefiting the maintained (though trimmed) pro-risk tilt in our portfolios.

Risk sentiment still has legs going forward. Vaccination progress will prevent harsh lockdowns, leaving more scope for post-Covid recoveries. Consumers are sitting on huge excess savings, parts of which will be gradually deployed as labour markets recover further. Corporate earnings have been stellar; growth there will slow but stay positive. And while nominal yields have risen, the surge in inflation expectations has depressed real yields even deeper below zero, keeping valuations supported.



Yet we turn more prudent as the inflation spike looks less transitory and uncertainties over monetary policy rise. First, **multiple supply shocks** (energy, chips, containers, labour) are proving more persistent. With the reopening of services proceeding only slowly, goods demands (e.g. IT) remains crowded, while suppliers are facing backlogs and higher input costs. Second, the **energy transition** may – ironically – keep prices on

fossil fuels well bid for longer. Already harmed by years of underinvestment, energy supply is struggling to meet the recovering demand. ESG concerns and harmed balance sheets of shale producers are holding back capex. Third, the Fed and ECB's new policy frameworks lack clarity. They tolerate moderate inflation overshoots, but how much exactly? The Fed in particular is ambiguous about the period covering average inflation and the inclusiveness of the employment recovery.

10-Year Bond Yields	Current*	3M	6M	12M
US	1.59	1.65	1.80	2.10
Germany	-0.14	-0.05	0.05	0.20
Italy	0.92	1.05	1.20	1.40
Japan	0.10	0.10	0.10	0.15
Forex	Current*	3M	6M	12M
EUR/USD	1.16	1.16	1.15	1.14
USD/JPY	114	114	113	110
EUR/GBP	0.84	0.84	0.83	0.83
Equities	Current*	3M	6M	12M
S&P500	4564	4585	4615	4680
MSCI EMU	151.2	152.5	153.5	154.5

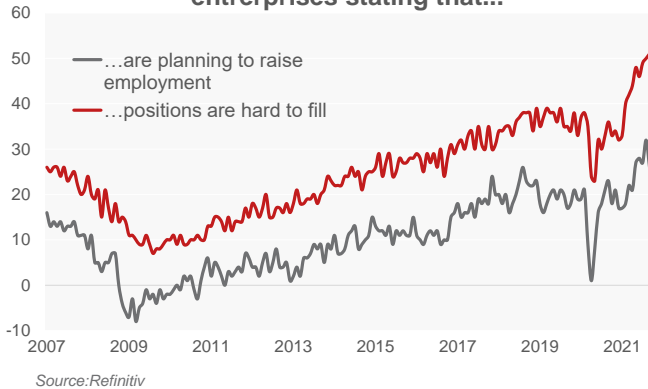
* 3-day avg. as of 27/10/2021

Central bank are ill-equipped to tackle supply-side shocks (particularly global ones). Yet they may still feel forced to act to prevent second-round effects in a wage-price spiral. Any pre-emptive action may adversely hurt growth expectations and risk assets, which will mechanically cap any rise in long-term yields. The recent flattening of the yield 5-30y curves signals burgeoning concerns, though strong earnings have kept equities alive and well so far. The BoE and BoC are already preparing for a rate hike soon. Among other risks, we also carefully watch the seasonal increase in Covid cases and the US debt ceiling dispute, whose deadline has been kicked to early December.

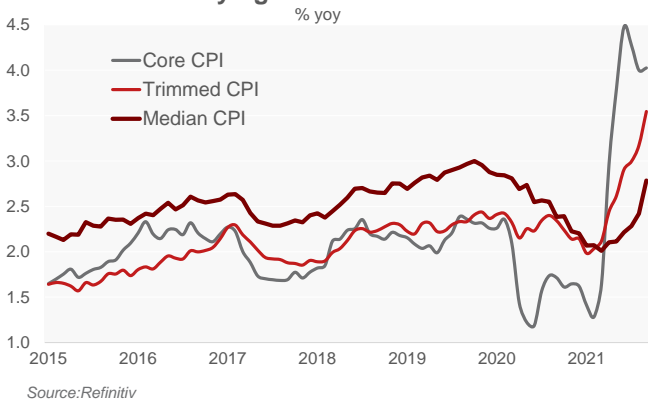
More prudent amid rising policy uncertainties

Overall, we maintain but mildly scale down our overweights in the riskiest segments (Equities, High Yield) and EM bonds to the benefit of IG Credit and Cash. We maintain a prudent stance on duration as more persistent price pressures and the removal of monetary policy will sustain upside pressure on yields. Yet the increase in longer-dated bonds will be capped by excess leverage and the dependence of global asset valuation on low long-term real yields (self-correction mechanisms).

Net % of small/medium enterprises stating that...

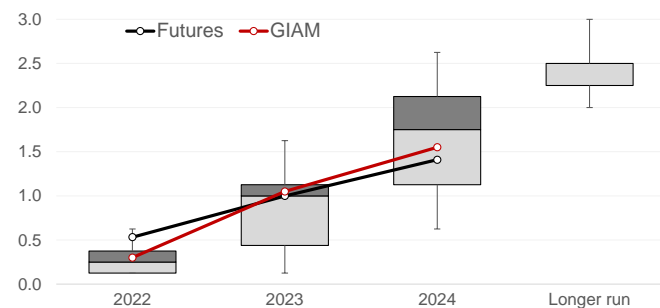


Underlying Inflation Measures



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

Year-end, extremes and quartiles of the dots distribution



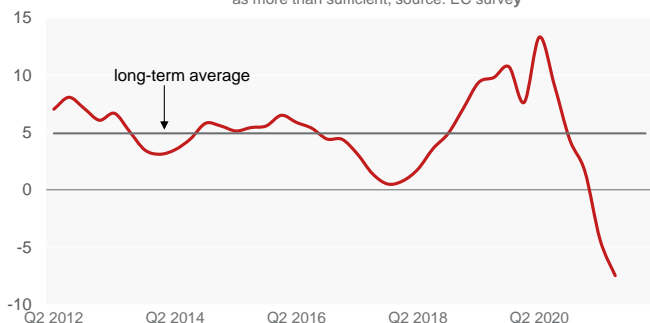
- In Q3 GDP decelerated markedly due supply gridlocks. We cut our growth forecast for 2021 to 5.6%, but GDP will rise by more than 4% in 2022.
- There are tentative signs of easing strains in chips production, and infection fear is reducing, which should prop up employment. Yet, core inflation will remain above 4% until spring.
- The Fed will start tapering by December, with net bond purchases ending in mid-2022. We still expect the first rate hike in Q4 2022.

The persistent disruption in supply chains and residual Covid fears put a brake on consumption, with GDP expanding by 2% annualised in Q3. We expect some relief in the final months of the year, as infections seems to recede, but we have downgraded our growth forecast for 2021 to 5.6%. The impact of supply disruptions will fade gradually during the first half of 2022, and growth should exceed 4% next year. The short-term outlook for activity, inflation and employment depends on how quickly bottlenecks are overcome. Chip production is slowly recovering, and this will spur activity in key sectors like automotive and electronics, while port congestion remains high. As restrictions are lifted, consumer demand will be increasingly tilted away from goods and services, and this will ease pressures, but not before the first months of 2022. The sluggish return of people into the labour market despite strong demand has capped employment growth. If the reduction in COVID cases continues, worries about contagion, which are preventing around 2.5 million people from looking for a job, should decrease, leading to an acceleration in employment. The impact of supply troubles on prices is proving very persistent; core inflation should peak at 4.8% in Q1 2022 and stay above 3% until Q3.

Supply disruptions have made growth more fragile and are keeping inflation stubbornly high. Uncertainty on how the Fed will respond is augmented by its untested and somehow ambiguous new average inflation strategy. While this will not impact the decision to start tapering by mid-December (with net purchases likely ending in mid-June), it creates uncertainty on the timing of the first rate hike. Our baseline is Q4 2022. A sustained rise in inflation expectations may tilt the balance towards an earlier rise and steeper path, but only if the labour market recovers fast. The possible replacements in the Board should temper the hawkish bias in the 2022 FOMC composition due to turnover of the regional presidents.

Inventories

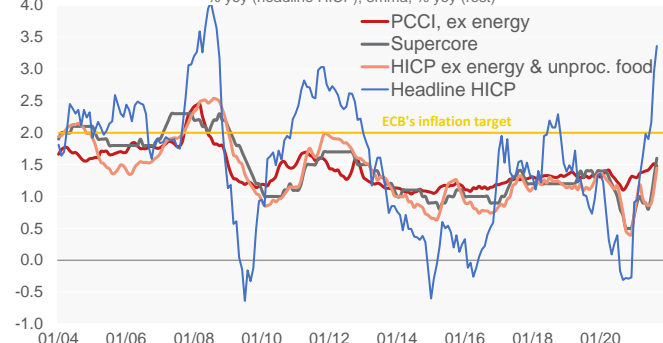
share of firms in the euro area industry considering the present level of stocks as more than sufficient, source: EC survey



Source: Refinitiv, GIAM calculations

Headline vs underlying inflation

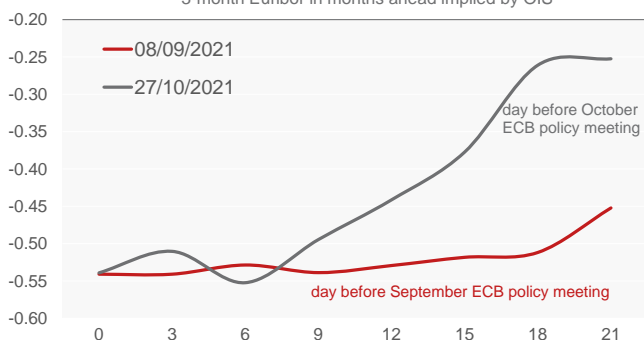
% yoy (headline HICP); 3mma, % yoy (rest)



Source: Refinitiv, ECB

ECB monetary policy expectations

3-month Euribor in months ahead implied by OIS



Source: Refinitiv, own calculations

- Forward-looking indicators show some signs of stabilization, supporting our view that the post-Covid euro area recovery still has legs.
- Persisting bottlenecks in key inputs amid high or even rising energy prices are now the key risks to our growth and inflation outlook.
- The ECB tried to soothe market concerns of falling behind the curve. We do not expect a first rate hike in 2022 but the risk increased that the ECB will be forced into a swifter policy turn.

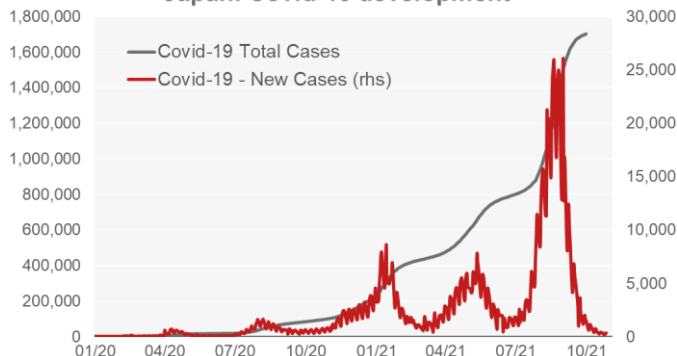
Following an output expansion of 2.1% qoq in Q2, the (preliminary flash) estimate of 2.2% qoq for Q3 showed an acceleration. This is surprising given that the record low level of inventories suggests a strong drag on activity. Due to shortages in key intermediates firms had to de-stock rather than producing. And the spike in inflation (Oct: 4.1 % yoy) dragged on real incomes and spending.

Repairing production chains will hence be key for the sustainability of the recovery. We look for improvement starting in early 2022. In our view, bottlenecks will dampen but not derail the upswing. Due to the high vaccination rate a relapse into lockdown is not on the cards. Forward-looking indicators related to the services sector even suggest some improvement. Confidence hovers around elevated levels while consumers are still sitting on excess savings that they want to spend. And once bottlenecks ease, firms will re-stock their inventories. Due to the surprisingly strong Q3 GDP data we increased our growth forecasts for 2021 (5.2%, from 4.9%) and 2022 (4.6%, from 4.5%).

ECB sticks to transitory inflation view

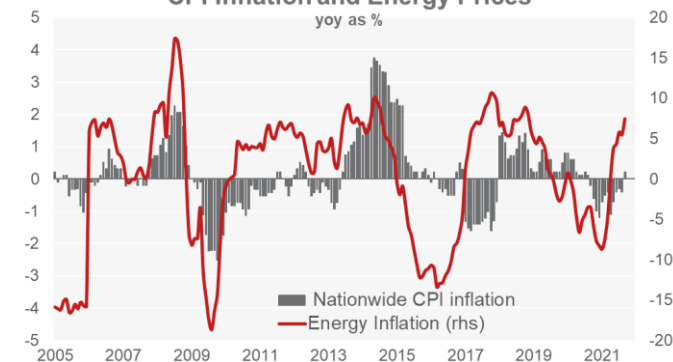
At the October meeting, as expected the Governing Council did not change its policy stance. The key message is that the ECB continues to stick to its view of only transitorily higher inflation. But it acknowledges that its abating is taking longer than previously thought. A combination of base effects (e.g. temporary German 2020 VAT cut), energy price increases and post-pandemic shortages is currently at work postponing the fall in inflation. The conditions for higher policy rates were not satisfied at present and “*certainly not in the near future*” according to Lagarde. While markets remained more sceptical about the inflation outlook we stick to our view that there will be no hikes in 2022. That said, the risks that the ECB is pushed into a more hawkish stance increases the longer the inflation spike lasts.

Japan: Covid-19 development



Source: datastream

CPI Inflation and Energy Prices
yoy as %



Source: datastream

Real Exports and World PMI
sa, 2000=100



Source: datastream

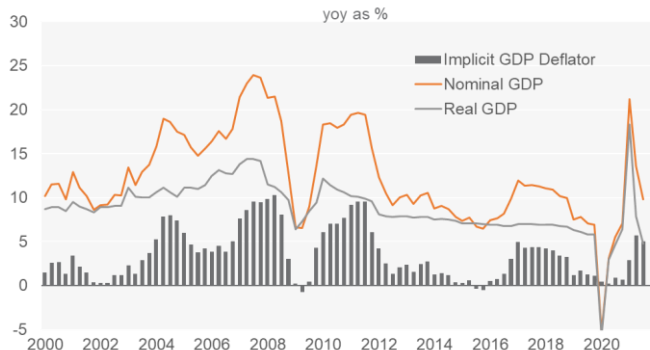
- Fumio Kishida has been elected as the new PM in Japan. The lower house election will most likely bring a majority for the ruling LDP/Komeito coalition. Apart from a fiscal package, distributive issues played a larger role in the short election campaign.
- Q4 growth is likely to see a rebound, after a likely flat Q3 result due to Covid-19 lockdowns.
- The BoJ kept its monetary policy but revised growth down and held inflation forecasts constant. This suggests that the BoJ policy will remain very accommodative.

Fumio Kishida was elected Japan's 100th PM on October 4. The lower house election has been brought forward to Oct. 31. The ruling parties (LDP and Komeito) are likely to maintain their majority, but recent opinion polls generated doubts whether the LDP will be able to secure a majority on its own. If not, it is widely expected that fiscal packages may be stepped up ahead of the upper house election in 2022.

PM Kishida is advocating a stronger focus on distributive policies and a strengthening of the middle-class. This includes proactive tax support for corporate wage hikes (tax deduction), cash payments (Komeito proposed JPY 100K for children up to the age of 18), tourism support (restart of "Go To Travel" depending on the Covid situation) as well as higher income for nurses and care workers. He also sees the need for a fiscal stimulus of "several tens of trillion", which could include about JPY 30 tr from the Covid related budget. Thus, headline figures and fresh spending may be much different.

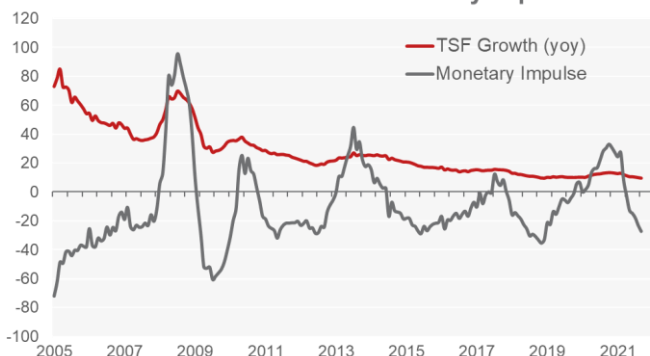
Q3 growth was dominated by the strong Covid-19 outbreak. Private consumption will likely have slightly suffered even compared to the lockdowns in Q2. Exports receded due to supply side constraints. Accordingly, we expect GDP growth to come in almost flat, but see a rebound mainly via private consumption in Q4. We expect GDP growth at 2.1% in 2021 (which translates into 3.1% in FY21) and 2.9% in 2022. The BoJ held its monetary policy constant but revised down growth for FY21 to 3.4% and inflation (ex fresh food) to 0% in FY21 while keeping FY22 unchanged at 0.9%. This suggests that the BoJ's policy will remain very accommodative and an outlier in international central banks' stances. We revised our headline inflation forecast up to 1.1% for 2022.

China: Nominal and Real GDP Growth



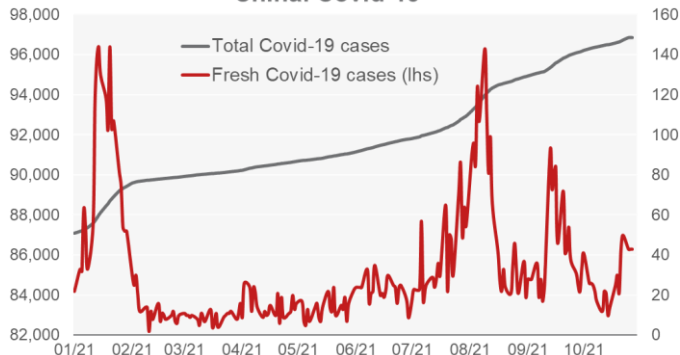
Source: datastream

China: Growth of TSF and Monetary Impulse



Source: datastream

China: Covid-19



Source: datastream

- China's Q3 GDP growth diminished to 4.9% yoy, after 7.9% in Q2. Growth dynamics were especially weak reflecting multiple headwinds.
- Looking ahead, we expect a slightly softer policy stance. Thus, growth dynamics could improve a bit provided power outages and Covid-19 lockdowns will remain under control. Nevertheless, yoy growth will further diminish in Q4.

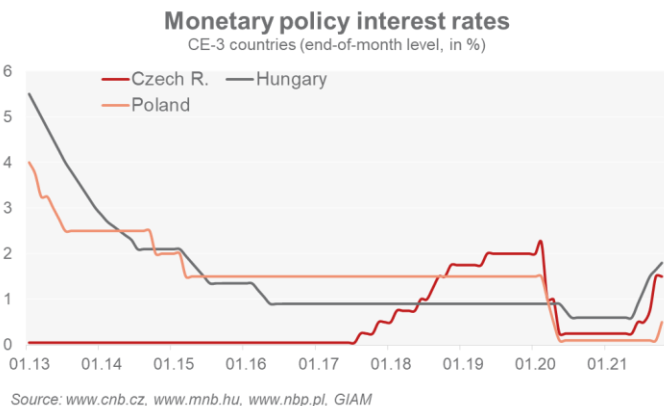
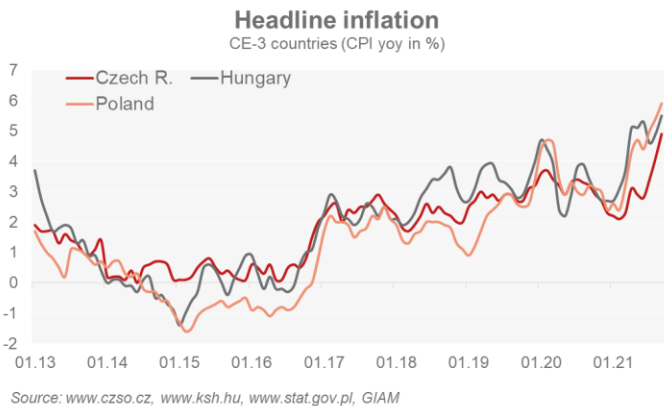
China's Q3 2021 GDP growth came in at 4.9% yoy, down from 7.9% in the previous quarter. While base effects played a role, the weak growth against the previous quarter (0.2% qoq) was the main reason. China faced multiple headwinds in Q3 like several Covid-19 outbreaks, power outages, real state sector woes (Evergrande) as well as regulatory tightening measures. September data especially showed the marked hit from power cuts on industrial production. Property investment slowed by about 2 pp to 4% yoy. Retail sales were soft but surprised on the upside compared to expectations. By contrast, exports remained a bright spot.

So far, there have been no signs of a broader policy easing. The reasons are likely structural in nature, as China pursues a deleveraging and common prosperity policy to raise efficiency and productivity over the longer term. However, China also needs to balance cyclical versus structural needs. Thus, we continue to expect Beijing to tweak structural headwinds but not to embark on a full reflation cycle. We thus stick to our view of a 50 bp RRR cut (but are now less convinced that it will come already in Q4) as a signal. Beijing also tries to ensure credit flow to healthy property developers and is relaxing mortgage and property buying restrictions on local levels. Nevertheless, more defaults of property developers are likely. At the same time, a more broad-based trial of the property tax was announced, hinting at a continued political will to reform the real estate sector.

Private consumption was off to a soft start amid the Golden Week holiday travel reduction and yet another Covid-19 outbreak. Power supply look to be better under control. Together with the assumption that Covid-19 outbreaks will stay limited and tweaks of policy towards easing, we expect growth dynamics to improve a bit in Q4. Nevertheless, yoy growth will continue to weaken. We adjusted out GDP growth forecast to 7.8% in 2021 (5.0% in 2022) while CPI (but not PPP) inflation stays soft.

Central and Eastern Europe

Radomír Jáč



Main Forecasts				
Czech Republic	2019	2020	2021f	2022f
GDP	3.0	-5.8	3.2	4.8
Consumer prices	2.8	3.2	3.7	4.6
Central bank's key rate	2.00	0.25	2.25	2.75
Hungary	2019	2020	2021f	2022f
GDP	4.6	-5.0	7.5	4.4
Consumer prices	3.4	3.3	4.8	4.9
Central bank's key rate	0.90	0.60	2.20	2.75
Poland	2019	2020	2021f	2022f
GDP	4.8	-2.6	5.0	4.6
Consumer prices	2.3	3.4	4.7	5.1
Central bank's key rate	1.50	0.10	0.75	2.25

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

- Inflation has been growing in the CE-3 region and this trend is expected to last for the rest of 2021 and quite likely also into early 2022. The price pressures are driven by both supply-side and demand-side factors.
- Forecasts for 2022 show inflation above levels targeted by the regional central banks. This triggered interest rate hikes by all CE-3 central banks.
- Economic activity in some sectors is hit by supply-side disruptions. This holds mainly for the car industry, which plays an important role in the region and the disruptions imply downside risk to GDP performance in Q4 and early 2022.

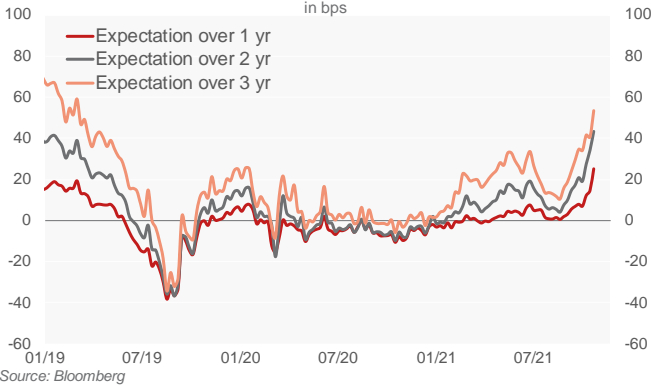
The situation in the CE-3 region is characterized by signals of a slowing pace of economic growth and rising inflation risks. The economic slowdown is caused by supply-side bottlenecks (e.g. shortage of semi-conductors in the car industry) but also by the impact of higher inflation on consumer confidence. Apart from further supply-side factors (growing commodity prices incl. energy and food, cost pressure related to supply disruptions) also demand factors (wage growth, fiscal impulses, normalization of households' excess savings) push CPI higher. Inflation advanced above central banks' forecasts (and well above their targets) in Q3 and a further increase is expected in Q4.

While the supply side bottlenecks create downside risk to the GDP growth outlook for Q4 and for the start of 2022, the regional central banks started to concentrate on risks related to the faster price growth and growing inflation expectations in the economy. The Czech CNB raised its key rate by 75 bps to 1.50% in September. The next monetary policy meeting will take place in early November and the CNB is expected to debate a rate hike of 50 bps or even of 75 bps. The Hungarian MNB moderated the size of rate hikes from 30 bps per a step to 15 bps in September and October (when it raised its key rate to currently 1.80%) but recently indicated that rate hikes are likely to be stronger in the coming months. The Polish NBP delivered a 40 bps hike in October when it raised the key rate to 0.50%. The move was unexpected but the NBP will present a new forecast at its MPC meeting scheduled for Nov. 3, which may provide some light on the next monetary policy steps in Poland. We expect a 25 bps rate hike in Poland in the rest of 2021 and more to follow in 2022.

Government Bonds

Florian Späte

ECB: Priced key rate hikes



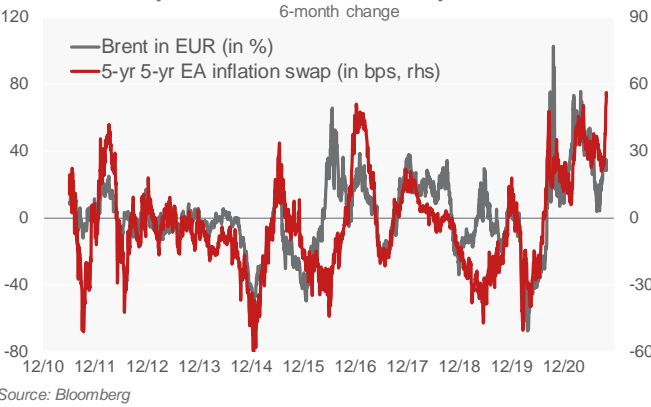
- Due to repricing hawkishness of central banks and future inflation development financial market participants appear to have got ahead of themselves.
- That said, the trend for long-dated yields is likely to remain upwards driven by above par growth in combination with a new inflation regime.
- The recent widening trend in EA non-core sovereign bond spreads is unlikely to continue as the cash flow remains supportive and exaggerated expectations regarding future ECB policy are adjusted.

While long-dated international bond yields rose further in October it covers a more stunning development at the short end of the curve. Not least driven by hawkish comments from central bank officials (e.g. by the Bank of England and more recently by the Bank of Canada) expectations regarding future key rate hikes have surged. Meanwhile, investors expect the Fed to lift the key rate above 0.5% and the BoE even above 1% within a year. Moreover, even for the ECB a deposit rate of -0.10% (from -0.5% currently) on a 2-year horizon is priced (we forecast a first deposit rate hike in our base scenario only in 2024).

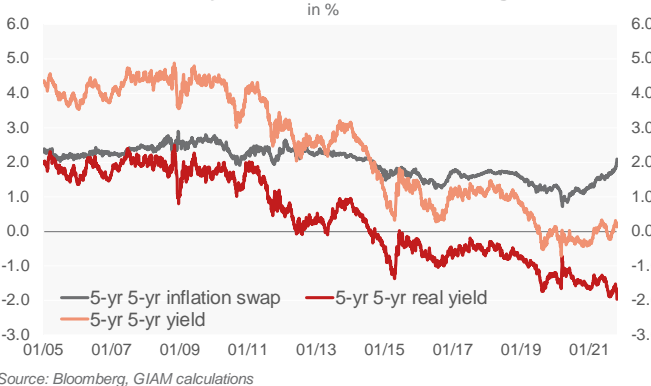
The development is very much driven by the sticky inflation development. In the last few weeks, central banks have increasingly voiced their concerns about the high level of inflation. Additionally, they have conceded that the situation will not calm down any time soon (e.g., we expect US core CPI to reach its peak at 4.8% only in Q1 2022). Still, we regard recent market pricing as overdone. Although key rate hikes are looming central banks will act rather cautiously. This is mainly because monetary policy affects demand. But the current inflation spike is to a large extent driven by supply bottlenecks and surging commodity prices. Monetary policy is almost powerless against such supply shocks and is likely to eventually accept them as a change in the price level.

However, the timing of the expected correction of key rate expectations is difficult. This applies even more as the upward trend in commodity prices and inflation expectations is still intact. 10-year US and EA inflation swaps have reached 2.90% and 2.20%, respectively. Even the closely observed EA 5-yr 5-yr inflation swaps have surpassed the 2% threshold for the first time since 2014. Considering the factors raising increasing inflation long-term (e.g. climate change, de-

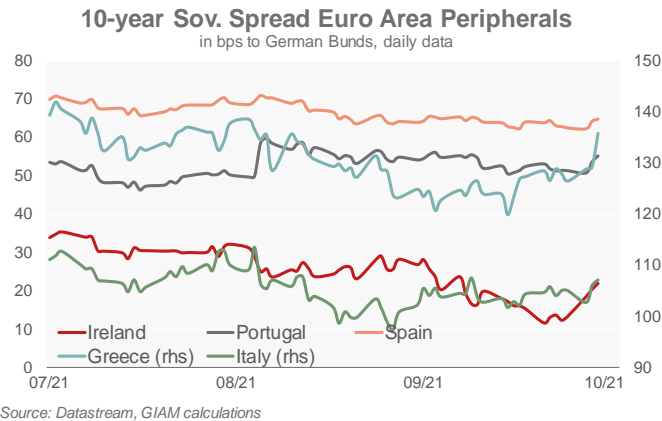
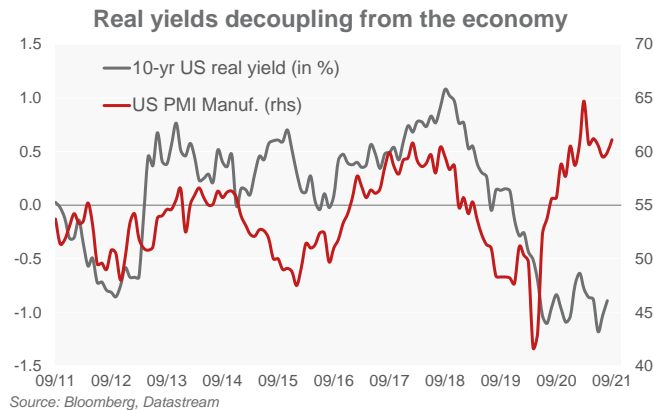
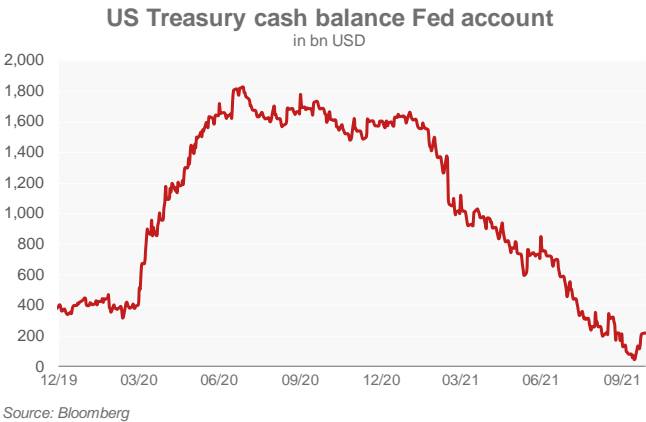
Oil price drives inflation expectations



EA real yields on a historical trough



Government Bonds



Globalization) a return of the inflation rate and expectations to pre-Covid levels is not on the cards. The longer the current development continues, the greater the concern that inflation expectations will become entrenched.

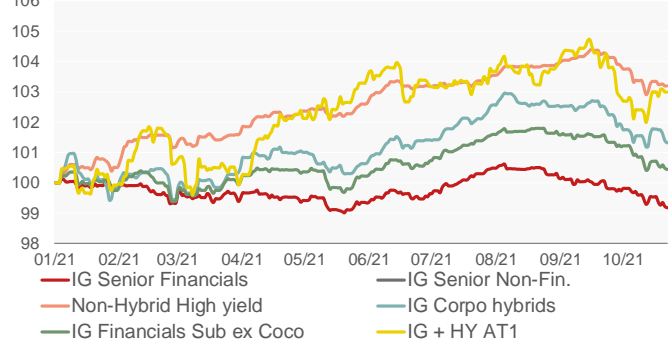
While the leeway for short-dated yields to rise further appears limited near term we see scope for long-dated ones to continue to climb. To start with, long-dated real yields have fallen back to historical lows. 10-year US and EA real yields below -1.1% and -2.1%, respectively, are not sustainable. This applies even more as high energy costs and supply bottlenecks may delay the economic recovery, but they do not prevent it. We forecast quarterly growth rates above potential for the time being. What is more, the technical situation will become less benign. If anything, amid sticky inflation central banks will be even more inclined to taper as soon as possible. The Fed will complete its purchase programme by the mid of 2022 and the ECB is seen to reduce its purchase volume by more than 50% next year (the Bank of England will terminate its programme even in 2021). At the same time consolidation efforts are restrained. The US fiscal deficit will decrease but it is forecast to still be the second highest in history. According to the draft budgets the EA countries submitted to the EU Commission the headline budget deficit will improve to 4.1%. But this is around 1% of GDP less than envisaged in spring. Finally, we expect that the US debt ceiling debate will be resolved for good in the weeks to come. As soon as this is the case, the Treasury cash balance will increase further and contribute to the rise in yields.

All in, we forecast 10-year US and EA yields to rise to 1.65% and -0.05%, respectively, on a 3-month horizon. Over the year they should rise further to 2.1% (increased from 1.95% previously) and 0.2%.

EA non-core spreads came under pressure after the latest ECB meeting as financial markets questioned the ECB's forward guidance and challenged the ability to defend current spread levels. However, we think the ECB will be eager to defend its credibility and will act accordingly. The well-advanced issuance activity in combination with solid demand from abroad are seen to support spreads as well. Having said that, the less benign technical picture will create a more challenging environment (and a widening of spreads) in 2022. Still, we think the combination of rather high inflation rates and growth above trend will keep debt sustainability concerns at bay.

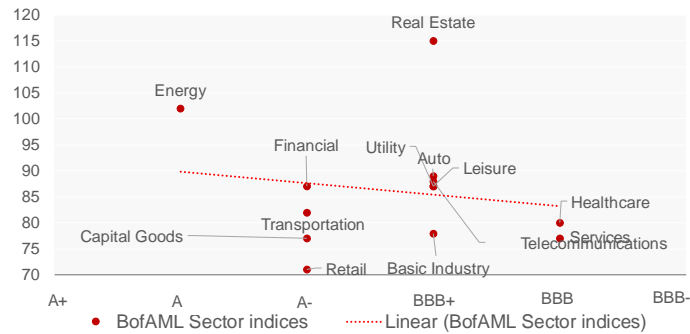
Credit market year-to-date TR perf.

100= 01/01/2021



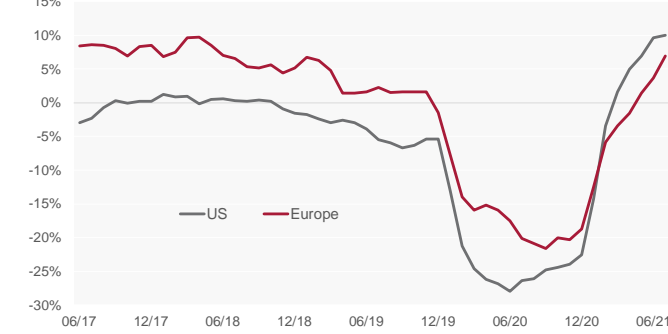
EUR IG Spread vs Rating

OAS bp



Moody's trailing 12-month rating drift

Rating Drift = (notch upgrades - notch downgrades)/rated issuers



- The resilience of Investment Grade Credit should extend into 2022, thanks to still strong and improving fundamentals and negative net supply.
- We continue to reduce our overweight position in HY on the back of both mounting macro risks and the related interest rate volatility.
- The energy sector will not be a good hedge against commodity prices as it used to be. Moreover, its poor ESG profile makes it structurally less attractive.
- A key risk to our scenario would be a sooner than expected end of the ECB's APP.

In our central scenario, we assume that the ECB will increase the APP in March 2022 to avoid a cliff effect when the PEPP expires. This implies 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, and we expect spreads to tighten by 5bp by year-end.

We further reduce our overweight position in HY, despite still solid and improving fundamentals. Indeed we believe that HY is more exposed to the current uncertain environment related to higher commodity prices. Also, net supply in HY will likely be positive next year.

Theoretically, inflation is good for credit as it helps companies to deleverage. However, the peculiarity of this recovery makes things different. Credit is highly reliant upon the central support that is likely to be challenged by high inflation prints.

In terms of sectors, we believe that the most vulnerable ones to higher inflation would be non-food retailers, building materials, and OE suppliers because of their lack of ability to pass on higher costs to end customers.

On the other hand, metal and mining companies and oil companies have been historically performing well in times of rising commodity prices. Nonetheless, we believe that they might not be as much of a good hedge of what they used to be because of their poor ESG profile.

A key risk to this scenario would be further inflation pressures forcing the ECB to hike rates and stop asset purchases sooner than our scenario, i.e., before end-2023.

EM sovereign bonds

Guillaume Tresca

Higher UST to lead to very modest TR by year-end

3M TR for different scenarios, BofA index

OAS spread	US 8Y	current	current	current	current	current	current	current	current
247	1.24%	1.34%	1.44%	1.54%	1.64%	1.74%	1.84%	1.94%	
257	7.90%	7.04%	6.19%	5.34%	4.48%	3.63%	2.77%	1.92%	1.07%
267	7.04%	6.19%	5.34%	4.48%	3.63%	2.77%	1.92%	1.07%	0.21%
277	6.19%	5.34%	4.48%	3.63%	2.77%	1.92%	1.07%	0.21%	-0.64%
287	5.34%	4.48%	3.63%	2.77%	1.92%	1.07%	0.21%	-0.64%	-1.50%
297	4.48%	3.63%	2.77%	1.92%	1.07%	0.21%	-0.64%	-1.50%	-2.35%
307	3.63%	2.77%	1.92%	1.07%	0.21%	-0.64%	-1.50%	-2.35%	-3.20%
317	2.77%	1.92%	1.07%	0.21%	-0.64%	-1.50%	-2.35%	-3.20%	-4.06%
327	1.92%	1.07%	0.21%	-0.64%	-1.50%	-2.35%	-3.20%	-4.06%	-4.91%
337	1.07%	0.21%	-0.64%	-1.50%	-2.35%	-3.20%	-4.06%	-4.91%	-5.77%
347	0.21%	-0.64%	-1.50%	-2.35%	-3.20%	-4.06%	-4.91%	-5.77%	-6.62%

Source: Bloomberg, GIAM calculations

- We maintain a MW view on external debt. A modest spread compression is expected, but the outlook is challenging
- Despite the pricing of the recovery slowdown and a better sanitary situation, EM external debt remains vulnerable to the rise of DM rates.
- We prefer EM IG over HY with a preference for BBBs and BBs. High-beta names will underperform.
- EMs are in a better stance in 2013 to withstand a Fed tapering. That said, the EM tightening could marginally affect spreads

Outlook has remained challenging, and despite the ease of some tail risks, we expect the volatility of EM spreads to grind higher with rising global yields. Accordingly, we maintain our MW view with a low-risk profile. Even if we expect a modest spread compression, total return will be barely positive. Chinese growth concerns have been priced in, the Covid sanitary situation has been improving, but the duration of the EM external debt leaves it vulnerable to the rise of EUR and USD rates.

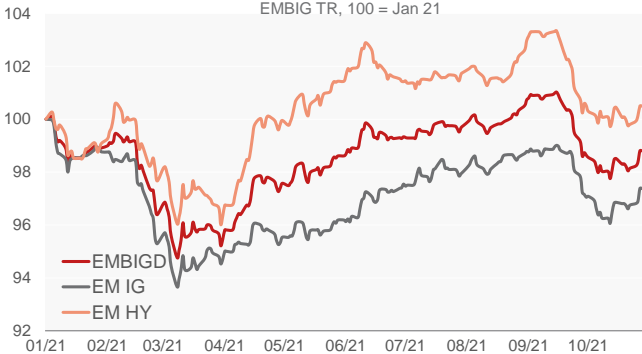
We prefer EM IG over HY. Even if EM IG offers a more limited spread buffer in case of higher core yields, EM HY tends to underperform in a rising real yield environment. Moreover, the EM growth recovery is losing steam, so high-beta assets like EM HY should underperform.

In the EM IG space, we focus on the BBBs with low-duration names like Romania. The recent sell-off provides opportunities in EM Europe that has been underperforming or in IG MENA that will benefit from higher oil prices. However, we avoid Asia IG. In the HY space, valuation looks optically cheap, but it is driven by distressed names, and dispersion is wide. We like Colombia and, to a lesser extent South Africa that could benefit from the budget's release.

In the rising yield environment, we will not expect a repetition of 2013. Global financial conditions have been loose, and EM external vulnerabilities are less important on average with weaker EM FXs. Moreover, EM central banks have turned increasingly hawkish, front-loading DM central banks. The direct impact on external debt is manageable. In the medium term, it helps to attract portfolio inflows. That said, it could have a marginal effect on spreads. In the long run, it affects demand, and it can jeopardise the tightening of the fiscal deficit.

End of the EM HY resilience

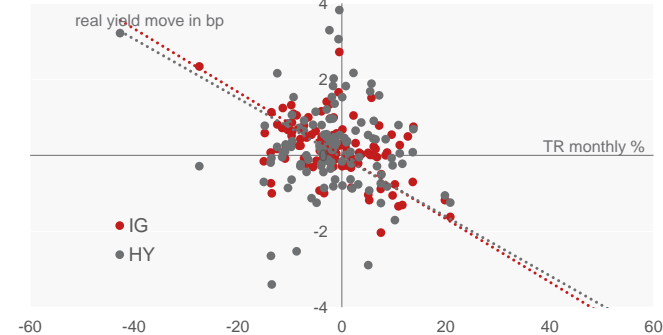
EMBIG TR, 100 = Jan 21



Source: Bloomberg, JP Morgan, GIAM calculations

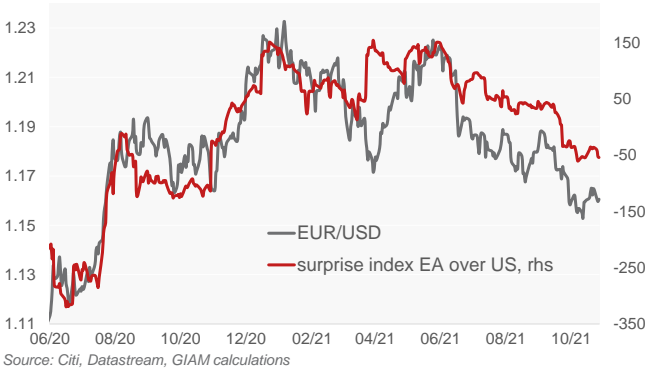
EM HY vulnerable to a real yield rise

Monthly TR vs 10Y US real rate move since 2010

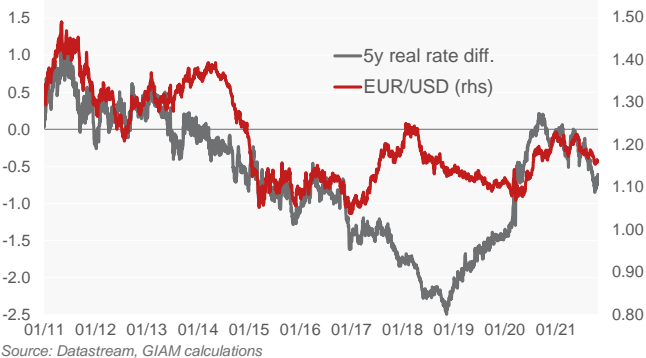


Source: Bloomberg, GIAM calculations

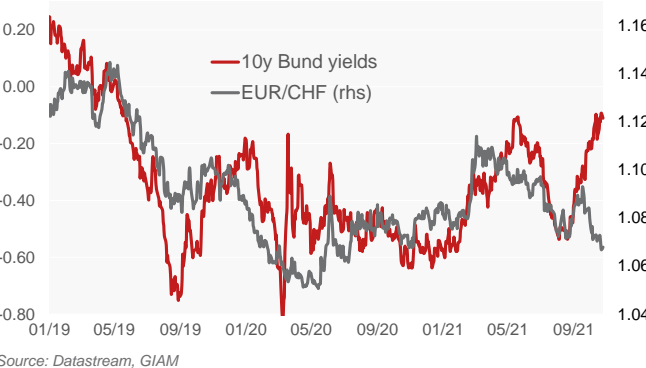
Economic data surprises and EUR/USD



Euro/US real yield gap and EUR/USD
real rate based on USTs and inflation swaps, in % p.a.



Bund yields and EUR/CHF
yields in % p.a.



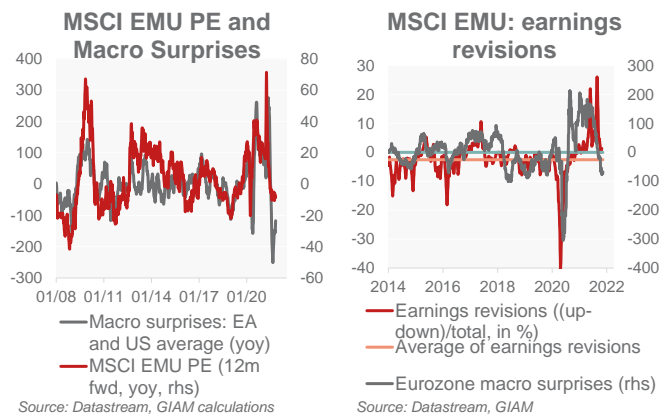
- After undershooting in summer, the EUR/USD is likely to extend its recent stabilization. Yet monetary policy divergence amid uneven inflation risks in the US and euro area tilt the outlook to a lower EUR/USD into 2022.
- USD/JPY may trace US yields further to the upside short term.
- The recent CHF bounce seems stretched amid rising Bund yields and mounting risks of SNB intervention.
- We slightly upgrade our GBP view on the more hawkish BoE, envisaging 0.83 for EUR/GBP on a 12-months view.

The EUR/USD has bottomed in October, ending the month roughly flat at levels close to 1.16. Our fair value model based on financial market variables points to a sizeable EUR/USD undershoot. Disappointing euro area data (top chart) and a continued swing in speculative positions towards the USD may explain part of the misalignment. But also stagflationary concerns have depressed EA real yields more strongly than in the US (mid chart), with the ECB seen less responsive to recent inflation pressures than the Fed.

The Fed's imminent QE tapering is well telegraphed and the likely rate lift-off for mid-2022 well discounted. Stabilizing speculative positioning may help EUR/USD extend its stability seen in October. Yet even if EUR/USD is overall cheap, any relief recovery will likely be capped by more sticky stagflation worries amid a more moderate global recovery. Monetary policy divergence points to a lower EUR/USD into 2022. Markets' excessive ECB rates pricing (+40 bps) by end-2024 seems excessive, leaving scope for wider short-term yield gaps and USD support.

We see some upside for USD/JPY which remains closely tied to US yields. We do not expect a stronger sell-off, though, as more favourable real yields and cheap fundamental valuations support the yen. But monetary policy divergence is likely to keep USD/JPY at above 110 well into 2022.

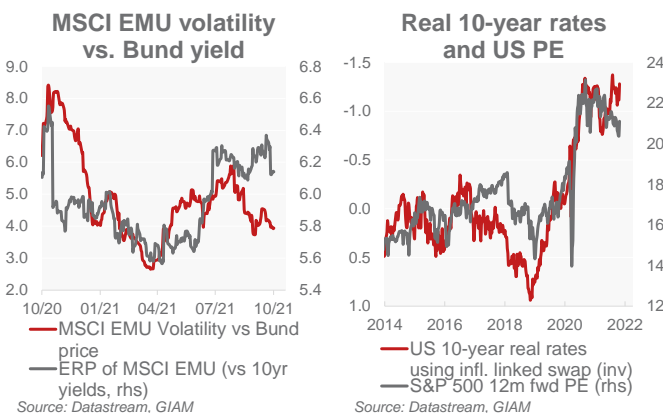
The recent CHF bounce has defied the headwinds from rallying risk assets and rising Bund yields, with inflation worries likely to have boosted the appeal of CHF alongside gold. Yet with EUR/CHF having fallen below 1.07, the SNB may step up FX intervention soon while a further rise in Bund yields should also tame demand for the Swiss currency.



Analysis of the median stock: Q3 2021 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q2 2021	Q3 2021	Q2 2021	Q3 2021	
S&P	48.6 %	25.4 %	20.6 %	13.0 %	33.2%
Stoxx	48.3 %	17.2 %	14.2 %	9.6 %	34.5%
Euro Stoxx	50.0 %	25.8 %	17.5 %	11.9 %	27.8%
Topix	32.6 %	15.7 %	11.8 %	6.3 %	15.3%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q2 2021	Q3 2021	Q2 2021	Q3 2021	
S&P	10.9 %	6.3 %	2.9 %	1.7 %	33.2%
Stoxx	8.2 %	5.8 %	2.2 %	1.4 %	34.5%
Euro Stoxx	11.1 %	5.9 %	3.3 %	1.8 %	27.8%
Topix	8.9 %	13.8 %	2.0 %	(0.6)%	15.3%



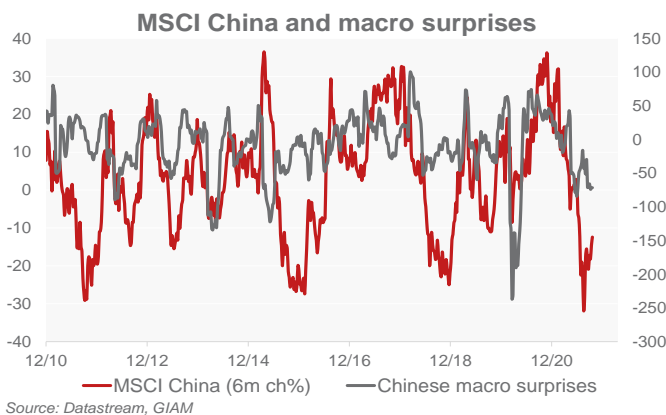
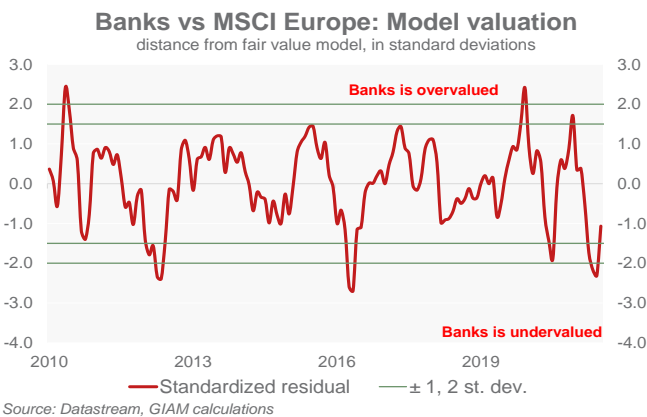
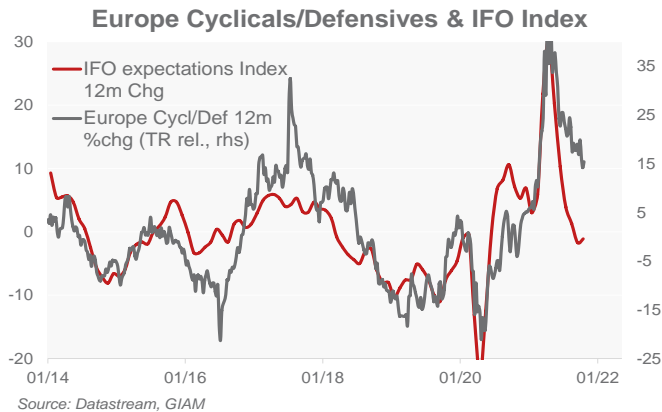
- The good reporting season is triggering positive equity returns also thanks to lower volatility and still subdued real rates.
- Firms are reporting higher earnings, margins and sales vs expectations, but with considerably lower surprises versus previous seasons.
- We maintain lower-than-consensus earnings forecasts for 2022/2023: higher input costs, probably peaking margins, lower policy support.
- That said, our 12-month total return expectations still show positive mid-single digit figures.
- EU sectors: coherently to our models, higher yield expectations and peaking confidence (“slowdown” phase), we OW Value – Energy, Banks – plus Food, Pharma and Durables.

Equities continue to see earnings upgrades: +1.3% in the last month, also thanks to the good Q3 reporting season. This, together with other factors, is triggering a renewed resiliency of stocks which is helping to offset risks. In the end we maintain a cautious OW stance on equities, albeit lower than before the summer. We see mid-single digit positive returns in the next 12-months.

Good Q3 reporting season, more similar to norm

The US reporting season (33% reported) will come back to norm after the positive excesses of the last 5 quarters for both qoq growth and positive surprises. Some results and guidance are negatively affected by a slowing macro momentum, bottlenecks and higher input costs. That said, while lower, both the guidance and the net positive preannouncements re-main solid. Since September, analysts have also become cautious, reducing their expectations for the quarter. But still supporting confidence indicators and resilient high margins are triggering positive earnings surprises (+13% in the US, similarly to EU), in line with history (+5%) for the median sector. This is much lower than during the last year (15-20% the previous 5 seasons).

Unit-labour costs remain contained and cyclicals sectors benefit from a positive operating leverage, triggered by higher capacity utilization. Still, we think that toppish macro momentum and increasing input costs can cause negative revisions beyond the Q3 reporting season which we expect to be good. Thus, we remain below consensus by 4.5% and 6.5% in 2022 and 2023 (average US and EMU), respectively, having some scope to absorb future negative earnings revisions without impacting our fair value target.



Volatility and rates: two additional positives

Other than good earnings results, equities enjoyed a declining volatility (VIX at 15), also versus bonds' one. This produced a lower risk premium. Furthermore, macro surprises, while still negative, gave signs of bottoming. Tactical indicators became neutral from slightly overbought before. In addition to this, real rates remain low, providing cushion to the high PEs. Increasing CPI expectations, instead, are usually not detrimental for equity, unless the 10-year yield goes too high as in 2018: the US one first surpassed the level of 2.5% and then 3%, triggering the market setback. At that time, real rates reached +0.2%, while currently they remain in negative territory (-1.1%).

OW on equity confirmed, a more cautious one

The cited positives induce us to maintain an OW on equities, but a more cautious one. To be sure, while bottlenecks and energy shocks complicate the forecast exercise for the business cycle, nevertheless we have increasing clues to be in a slowdown phase. This will bring negative revisions for earnings and margins in the next months. We add alarming signs from a sticky inflation, more hawkish central banks and expectations of higher rates ahead. That said, even assuming lower earnings estimates versus consensus, we see a 12-month total return of nearly 5% (average of US and EMU). The risks mentioned above keep such targets potentially more volatile than in the past, that is why we have lowered further our OW position in equities.

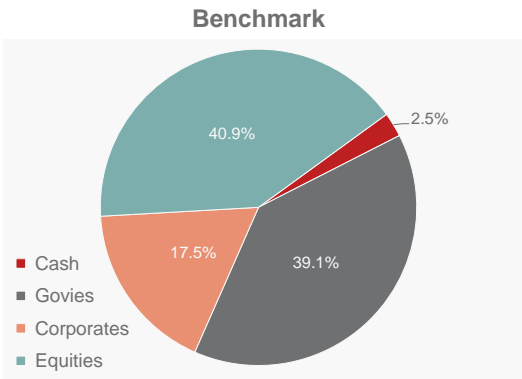
EU Sectors: we reduced the OW on energy and banks after the big rally (less appealing quant models). Due to higher risks and a mature phase of the cycle we keep an OW on secure sectors like food, durables and pharma, while overall reducing our tracking error. We go neutral on div. financials (from OW), software (from OW) and media (from UW). OWs: cons. services and insurance. UWs: RE, telecom and utilities.

EM: upgrading MSCI China from UW to neutral

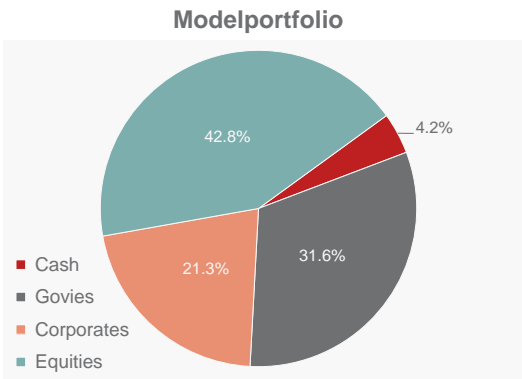
Our EM stance is still neutral due to weaker global export orders and earnings, slowing Chinese growth and more hawkish Fed. But valuation is getting more attractive. China policy support, including monetary one, could positively differ from average EM one. A further MSCI China weakness would merit an OW (currently N from UW). OWs: Korea, Chinese A-shares. N: Poland and Taiwan (expensive for the first, political risk for the second).

Asset Allocation

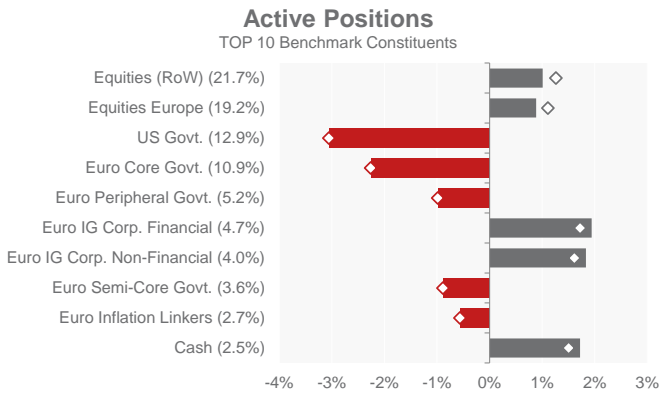
Thorsten Runde



Source: GIAM



Source: GIAM



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

- In October, the relative performance picture on the financial markets was almost unchanged compared to the previous month.
- Equities topped the performance ranking by a significant margin, having been the only asset class to stay as a whole in positive territory so far (October 27th). Equities delivered between +0.2% (MSCI PACIFIC) and +5.7% (MSCI NORTH AMERICA).
- On the bond side, just Inflation Linkers (+2.6%) as well as long-dated Government Bonds made it over the zero line, within a range from +0.6% for Italian BTPs to +2.3% for US Treasuries. EA HY Corporates are marking the lower end of the performance ranking (-0.5%), underperforming EA IG by roughly -18.5 bps.
- Amid rising inflationary risks, yields are still moderately geared to the upside, weighing on valuations. Drags on growth are adding to volatility. Yet, the recovery is still in place.
- Thus, we do not reverse, but just trim down our overweight positions in risk-assets (Equities, EA HY) in favour of Cash and EA IG which we still deem resilient.

In October, our model portfolio so far added another +7.4 bps of outperformance. Again, the alignment of the portfolio in favour of risk assets paid off quite well. On the underweight side, US Treasuries (+6.9 bps) and EA Core Govies (+4.7 bps) contributed to the result. On the overweight side, just Equities delivered a positive performance contribution (+6.6 bps). The overweight positions in corporate bonds (-11.1 bps) and cash (-3.8 bps) weigh on the overall return.

The post-pandemic recovery still proceeds. Yet, risks are rising. Energy shortage and supply chain bottlenecks will turn the higher inflation less transitory than initially expected. Thus, yields are still geared to the upside. Furthermore, we witnessed an impressive recovery on the Equity markets starting from the second week in October. Both facts argue for a more cautious stance with respect to risk assets.

Still cautiously positive for risk assets

Thus, we trim down our overweight in Equities and EA HY by 20% and reallocate the exposure in equal parts to Cash and EA IG. The latter in particular is seen as continuing to be well backed by the ECB's ongoing support.

FORECAST TABLES

Forecast tables

Growth ¹⁾	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.3	- 3.4	5.6	- 0.3	4.3	0.0
Euro area	1.6	- 6.5	5.2	0.2	4.6	0.2
Germany	1.1	- 4.9	2.6	- 0.5	4.1	- 0.3
France	1.8	- 8.0	6.9	0.8	5.0	1.2
Italy	0.4	- 9.0	6.3	0.6	4.3	0.0
Non-EMU	1.7	- 7.4	5.8	0.1	4.2	- 0.5
UK	1.7	- 9.7	6.8	0.1	4.7	- 0.7
Switzerland	1.3	- 2.5	3.5	0.0	3.0	0.0
Japan	0.0	- 4.7	2.1	- 0.2	2.9	- 0.1
Asia ex Japan	5.3	- 0.8	7.0	- 0.4	5.1	- 0.5
China	6.4	2.3	7.8	- 0.6	5.0	- 0.6
CEE	2.3	- 1.7	6.0	1.3	3.9	0.4
Latin America	- 1.7	- 8.6	3.3	- 2.2	2.8	0.0
World	2.7	- 3.4	5.6	- 0.2	4.4	- 0.1

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

Inflation ¹⁾	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	1.8	1.2	4.4	0.1	3.8	0.7
Euro area	1.2	0.3	2.3	0.1	1.9	0.2
Germany	1.4	0.4	3.1	0.2	2.4	0.4
France	1.3	0.5	1.7	0.1	1.5	0.0
Italy	0.6	- 0.1	1.8	0.3	1.5	0.1
Non-EMU	1.5	0.6	1.9	0.1	2.5	0.3
UK	1.8	0.9	2.3	0.1	3.2	0.4
Switzerland	0.4	- 0.7	0.5	0.0	0.6	0.0
Japan	0.5	- 0.0	0.0	0.2	1.1	0.6
Asia ex Japan	2.7	2.8	2.3	- 0.0	2.5	- 0.2
China	2.9	2.5	1.1	- 0.2	1.9	- 0.3
CEE	6.6	5.5	8.9	1.0	8.2	2.3
Latin America ²⁾	3.6	3.2	3.1	- 1.9	3.8	0.7
World	2.5	2.1	3.2	- 0.0	3.2	0.4

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

Financial Markets

3-month LIBOR	27/10/21*	3M	6M	12M
USD	0.14	0.15	0.20	0.40
EUR	-0.56	-0.55	-0.55	-0.55
JPY	-0.08	-0.10	-0.10	-0.10
GBP	0.20	0.10	0.25	0.50
CHF	-0.77	-0.75	-0.75	-0.75
10-Year Bonds	27/10/21*	3M	6M	12M
Treasuries	1.59	1.65	1.80	2.10
Bunds	-0.14	-0.05	0.05	0.20
BTPs	0.92	1.05	1.20	1.40
OATs	0.20	0.35	0.40	0.55
JGBs	0.10	0.10	0.10	0.15
Gilts	1.08	1.15	1.25	1.50
SWI	-0.10	0.00	0.10	0.20
Spreads	27/10/21*	3M	6M	12M
GIIPS	84	85	90	95
BofAML Covered Bonds	43	45	45	50
BofAML EM Gvt. Bonds (in USC	295	280	275	265

Corporate Bond Spreads	27/10/21*	3M	6M	12M
BofAML Non-Financial	87	80	75	75
BofAML Financial	87	80	75	75
Forex	27/10/21*	3M	6M	12M
EUR/USD	1.16	1.16	1.15	1.14
USD/JPY	114	114	113	110
EUR/JPY	132	132	130	125
GBP/USD	1.38	1.38	1.39	1.37
EUR/GBP	0.84	0.84	0.83	0.83
EUR/CHF	1.07	1.08	1.09	1.12
Equities	27/10/21*	3M	6M	12M
S&P500	4,564	4,585	4,615	4,680
MSCI EMU	151.2	152.5	153.5	154.5
TOPIX	2,009	2,025	2,030	2,060
FTSE	7,251	7,285	7,280	7,335
SMI	12,099	12,190	12,100	12,310

*average of last three trading days

3-Months Horizon

Government Bonds	10-Year Bunds	-0.12	-0.05	0.02
	10-Year Treasuries	1.31	1.65	1.99
	10-Year JGBs	0.02	0.10	0.18
	10-Year Gilts	0.61	1.15	1.69
	10-Year Bonds CH	-0.06	0.00	0.06
Equities	MSCI EMU	140.4	152.5	164.6
	S&P500	4,280	4,585	4,890
	TOPIX	1,885	2,025	2,165
	FTSE 100	6,783	7,285	7,787
	SMIC	11,470	12,190	12,910
Currencies	EUR/USD	1.13	1.16	1.19
	USD/JPY	111	114	117
	EUR/GBP	0.82	0.84	0.86
	EUR/CHF	1.06	1.08	1.10

12-Months Horizon

Government Bonds	10-Year Bunds	0.05	-0.05	0.35
	10-Year Treasuries	1.50	2.10	2.70
	10-Year JGBs	-0.01	0.15	0.31
	10-Year Gilts	0.61	1.50	2.39
	10-Year Bonds CH	0.05	0.20	0.35
Equities	MSCI EMU	132.1	154.5	176.9
	S&P500	4,111	4,680	5,249
	TOPIX	1,790	2,060	2,330
	FTSE 100	6,394	7,335	8,276
	SMIC	10,961	12,310	13,659
Currencies	EUR/USD	1.08	1.14	1.20
	USD/JPY	103	110	117
	EUR/GBP	0.78	0.83	0.88
	EUR/CHF	1.08	1.12	1.16

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