



GENERALI
INVESTMENTS

Market Perspectives

Monetary balancing acts

June 2021



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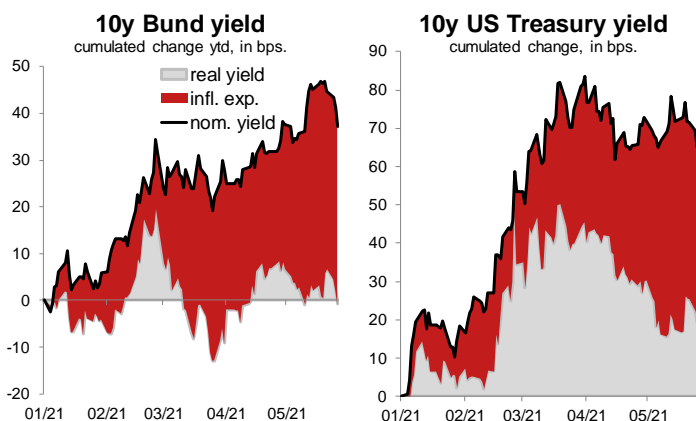
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Global View – Monetary balancing acts

Thomas Hempell

- Markets have already priced a lot of growth optimism, but the **'grand reopening'** is unlikely to disappoint, with vaccinations now proceeding swiftly in Europe.
- Central banks face a balancing act in preparing markets for an unwinding of emergency measures. We expect this to happen in a controlled fashion over the summer, though we acknowledge the risk of communication accidents amid overheating concerns in the US.
- We keep a moderate pro-risk tilt favouring Equities and Credit over longer-dated Govies. Inflation swaps remain attractive amid mounting overheating worries in the US. Avoid unhedged USD exposure.

The US economy, boosted by a massive fiscal stimulus, is powering ahead, but the growth momentum is shifting towards Europe. After contracting over winter, the euro area has started to enjoy a strong rebound. Accelerated vaccinations and receding infections will allow for lifting pandemic restrictions. Consumers will draw on large piles of excess savings, while extended fiscal support in the US and Europe and rising investment will lend further support.



Inflation is on the rise, partly due to a technical payback from depressed prices a year ago. But amid the big fiscal stimulus overheating risks are mounting in the US. Job openings have hit record highs and selected sectors have seen upside wage pressure, pointing to labour shortages. The Fed is assuming that price pressures from bottlenecks and supply chain constraints will prove transitory but investors are less certain. For now the Fed deems even talking about tapering its US\$120 bn monthly bond purchases premature. But the **minutes** to the April meeting showed first cracks in the FOMC emerging.

Markets are alert. Risk assets continued to moderately advance in May, benefiting our **tactical stance**, but only after temporary setbacks amid spikes in volatility. High valuations discount persistently low rates and prolonged asset purchases by central banks. The ECB has recently

flagged again the risk from higher interest rates also to corporate bonds, whose compensation per unit of duration is close to post-GFC lows despite corporate releveraging.

Central banks to tread very carefully

Policy makers are aware and will proceed cautiously. Encouragingly, the recent first taper announcements by the BoC and BoE have not caused any markets disruptions. And while the ECB hawks will push for removing emergency measures, recent dovish interventions by ECB President Lagarde and others suggest that the ECB will tread very carefully in paring back on its PEPP program at the June 10 meeting, likely stressing its flexibility in using the almost €800 bn remainder of its PEPP envelope. We expect the 16 June FOMC meeting to be rather uneventful, but the Fed may start discussing tapering at Jackson Hole, in August. After the inflation spike in Spring, we will be looking for an accelerating employment recovery over summer, which will have an impact on the Fed stance.

For market valuations, it is real rates that matter most. Rising inflation prospects are less harmful as higher prospective nominal earnings can make up for a higher discount rate. In this regard, this year's yield backup looks less worrying, with most of the rise in yields attributed to expected inflation (charts). We do expect rising yields to be partially backed also by **upside in real yields** into the recovery and strong bond issuance. But central banks will remain keen to prevent sharper spikes in real yields.

| 10-Year Bond Yields | Current* | 3M | 6M | 12M |
|---------------------|----------|-------|-------|-------|
| US | 1.58 | 1.80 | 1.95 | 2.15 |
| Germany | -0.18 | -0.05 | 0.05 | 0.20 |
| Italy | 0.86 | 1.00 | 1.15 | 1.35 |
| Japan | 0.07 | 0.10 | 0.15 | 0.20 |
| Forex | Current* | 3M | 6M | 12M |
| EUR/USD | 1.22 | 1.25 | 1.25 | 1.27 |
| USD/JPY | 109 | 110 | 108 | 106 |
| EUR/GBP | 0.86 | 0.87 | 0.87 | 0.88 |
| Equities | Current* | 3M | 6M | 12M |
| S&P500 | 4195 | 4235 | 4245 | 4265 |
| MSCI EMU | 144.3 | 146.0 | 147.0 | 147.0 |

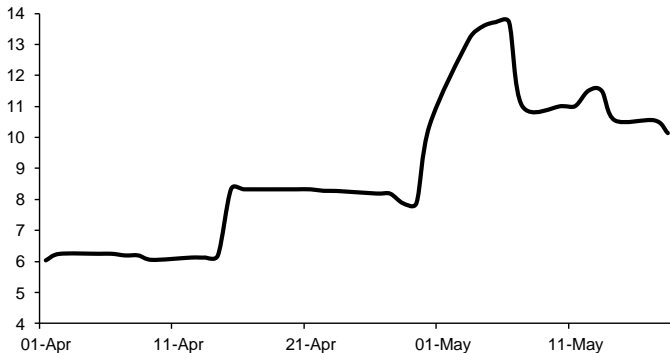
* 3-day avg. as of 27/5/2021

Envisaging a further rise in yields amid an overall still supportive earnings and risk sentiment, we keep our preference for riskier asset with an overweight in Credit and Equities over Government Bonds. Within equities, we favour Europe over the US due to more attractive valuations and a more favourable sector composition (higher weight in Value sectors like Financials that tend to outperform amid rising yields). We also keep a preference for Cash and shorter duration in Fixed Income. We see more USD downside into a broadening global recovery.

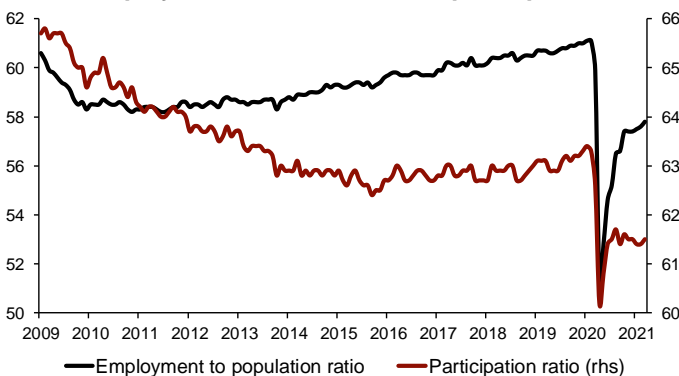
USA

Paolo Zanghieri

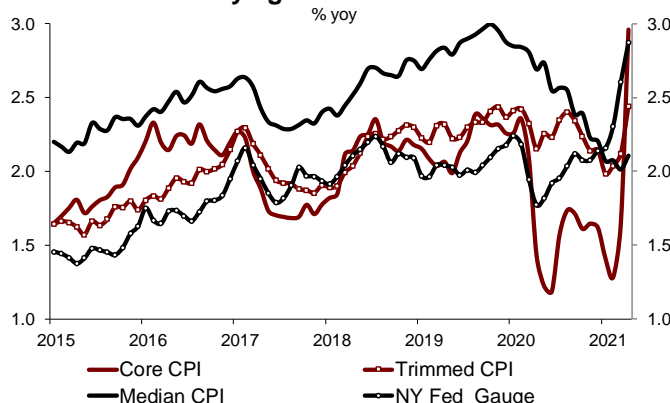
Q2 GDP Growth nowcast
(% qoq annualized). Source: Atlanta Fed.



Employment and labor market participation



Underlying Inflation Measures
% yoy



- The first data for Q2 point to a further acceleration in activity. We confirm our above consensus forecast of 7.5% GDP growth in 2021.
- April inflation proved stronger than expected. We still think that the overshoot is temporary but revise our year-end core CPI inflation forecast up to 2.6%.
- The Fed sticks to its patient approach, but some members have started mentioning a discussion on tapering. We continue to expect it to be announced during the summer and implemented in Q1 2022.

With one half of the adult population fully vaccinated, the reopening of the economy gathers speed. The pent-up demand for services will quickly add to the strong, but levelling off, purchases of goods. Nowcasts show that growth in Q2 should shot up to a record of 10% qoq annualized, consistent with our view of extraordinary activity in Q2 and Q3 pushing GDP up by 7.5% in 2021. However, the dismal April labour market report shows that the recovery may be less smooth than expected. The sharp slowdown in job creation (266k against 770k in March) is largely due to labour supply failing to catch up with the surging job openings, as a result of the less than full lifting of restrictions. But this shows that the reopening of the economy may lead to volatility in employment growth and temporary bottlenecks, which may blur the signal provided by wages about labour market slack.

Inflation surprises to the upside

April headline CPI inflation of 4.2% yoy came in way above expectations, increasing doubts about the strength and transitory nature of the inflation spike. A large part of the spike can be explained by the rebound in energy prices and strong movements in specific sectors (like used cars, up by over 10% in the month). Moreover, the transition out of the pandemic will entail a strong rebalancing in household consumption away from goods and back to services which will create volatility in prices. Yet as demand ramps up supply bottlenecks emerge, and this will keep inflation well above 2% until Q4. Higher inflation may get engrained in expectations, which will add to the upward pressure of inflation expected from a market tightening in the labour market from the end of the year. Expectations based on surveys have already risen to multi year high.

Fed: beginning of taper discussion slowly approached

Despite the upside surprise to inflation, the Fed sticks to its view of a temporary burst that will be offset by a still substantial labour market slack. Therefore, it will remain deliberately **behind the curve** as far as inflation is concerned, as it has to convince markets that no rate lift-off is in sight before the economy is back at full employment. By the same token, tapering will wait until the economy has shown substantial improvements. Given our macro scenario, we expect the issue to feature at the Jackson Hole conference in August, a formal announcement in autumn and the beginning of implementation in Q1 2022.

Euro Area

Martin Wolburg

- With 38% of the population vaccinated, restrictions are being eased and sentiment continues to improve. We look for a sharp rebound of GDP in Q2 and raised our 2021 growth forecast to 4.2%.
- With the pandemic abating the unwinding of the ECB policy measures comes into focus.
- At the June 10 meeting we expect the ECB to acknowledge the improved situation but without announcing a reduction in PEPP purchases.

The pandemic situation is quickly losing its grip on the euro area. Currently almost 40% of the population received at least one inoculation. Against this backdrop the improvement of sentiment continued in May (comp. PMI with 56.9, at the highest since 02/2018) with the services sector catching up as restrictions are lifted. The news flow remains in line with our expectation of a return to growth in Q2 and a further acceleration in Q3. We adjusted our 2021 growth forecast to 4.2% (from 4.0%) which is now in line with consensus.

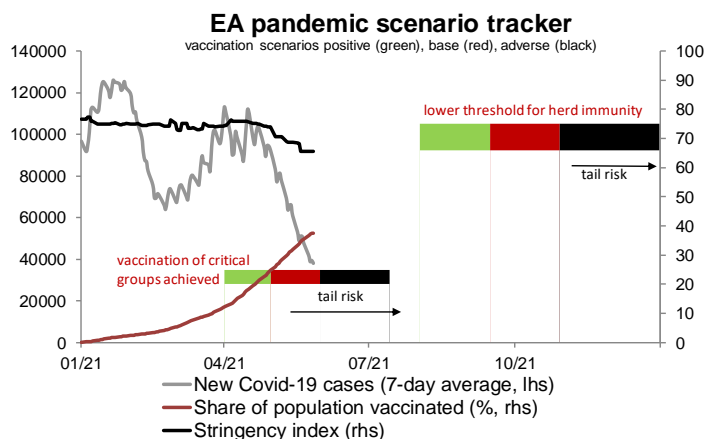
ECB to acknowledge improved situation

At the forthcoming Governing Council (GC) meeting on June 10 the ECB will have to decide on the adjustment of PEPP purchases for Q3. At the March meeting it had announced a “significant higher pace” of PEPP purchases compared to Q1. As it stands now, weekly purchases increased by € 3 bn to € 18 bn in Q2.

Looking ahead, with the pandemic situation improving significantly and vaccination proceeding well, the GC will likely acknowledge the reduced risks. Also, the update of the staff projections will likely result in a higher 2021 GDP growth projection (currently 4.0%) and we also see higher inflation projection (of 1.5%/1.2% in 2021/22 currently). Our ECB financial conditions dashboard summarizes the key indicators mentioned by GC members to assess financial conditions. It shows that they have not changed much and will likely be still characterised as favourable (with credit standards still remaining tight).

That said, over the past weeks a series of dovish comments by GC members including President Lagarde supports the idea that the ECB wants to defuse tapering expectations in order to avoid any kind of tantrum. It could afford continuing buying around the present pace without exhausting the PEPP envelope before March 2022.

We therefore deem it most likely that the GC refrains from giving a clear indication about the change in the magnitude of PEPP purchases for Q3. While it might want to reduce purchases, it will likely restrain from stating this and instead emphasize its flexibility and that it so far managed to preserve favourable financial conditions. We expect the communication to remain centred on Q3 and look for indication about the post-pandemic policy at earliest at the September meeting.

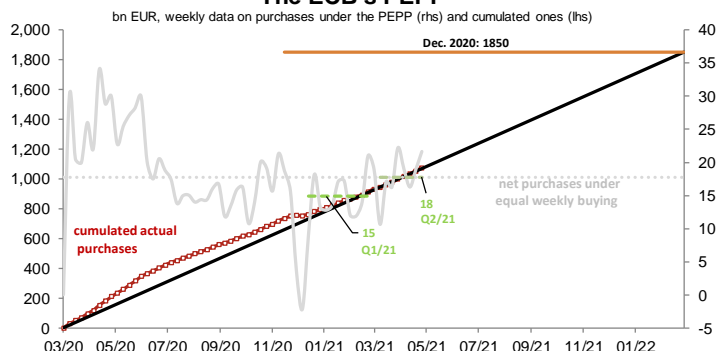


The ECB's Financial Conditions Dashboard

z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations

| | 2020 | Q4 2020 | Jan-21 | Feb-21 | Mar-21 | Apr-21 | May-21 |
|---------------------------------|-------|---------|--------|--------|--------|--------|------------------------|
| Gov. bond spread (GDP weighted) | 0.82 | 1.38 | 1.52 | 1.58 | 1.55 | 1.49 | 1.20 |
| Term premium (10Y-1Y OIS) | 1.55 | 1.63 | 1.54 | 1.17 | 1.00 | 0.91 | 0.77 |
| BLS credit standards | -1.76 | -2.55 | -2.45 | -2.46 | -1.97 | -1.48 | -0.99 |
| BLS credit demand | -0.71 | -0.65 | -0.84 | -1.00 | -1.01 | -1.03 | -1.05 |
| High Yield spread | -0.89 | -0.06 | 0.68 | 0.93 | 0.96 | 1.15 | 1.12 |
| Lending rate | 1.28 | 1.37 | 1.40 | 1.44 | 1.35 | #NV | #NV |
| unweighted mean | 0.05 | 0.19 | 0.31 | 0.28 | 0.31 | 0.21 | 0.21 (ex lending rate) |

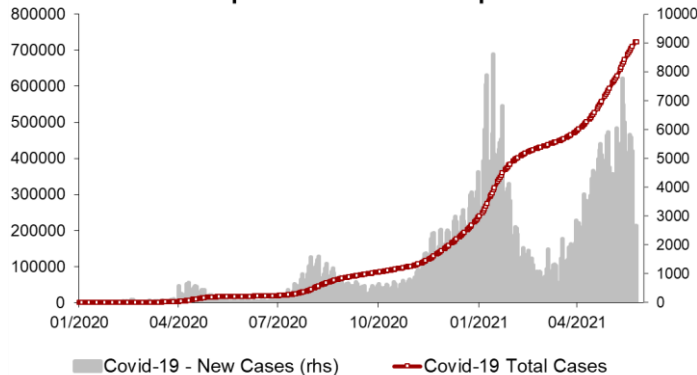
The ECB's PEPP



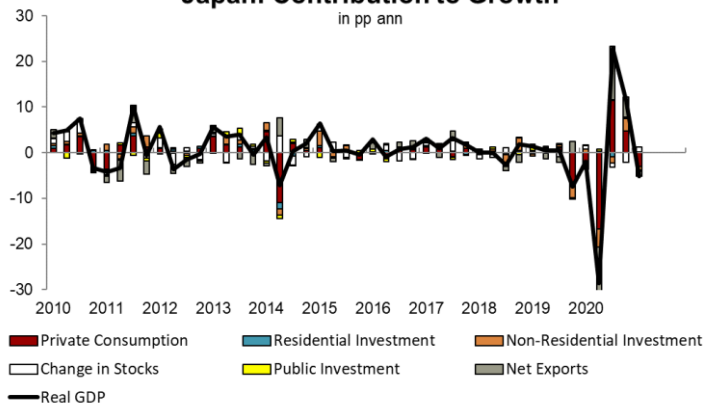
Japan

Christoph Siepmann

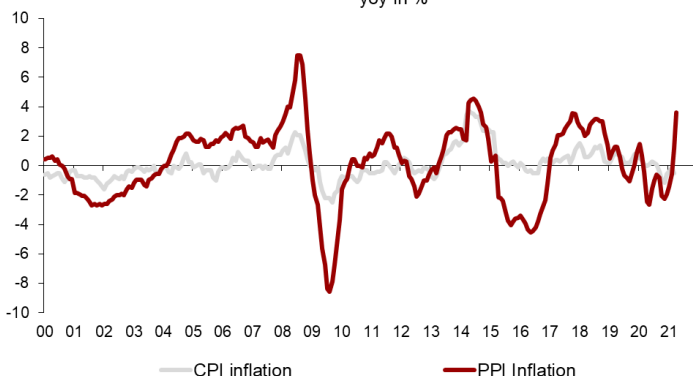
Japan: Covid-19 development



Japan: Contribution to Growth
in pp ann



Consumer and Producer Price Index
yoy in %



- The Covid-19 related State of Emergency will primarily weigh on private consumption again. The effects could be similar to Q1. We see 2021 GDP growth at 1.9% with risks on the downside.
- CPI inflation receded again, driven by a cut in mobile phone charges. A change in the base year will additionally weigh on inflation from summer on. We do not expect the BoJ to respond, but the bank could extend its Covid-19 related measures.

In mid-May, the Japanese government extended the Covid-19 related State of Emergency (SoE) to 10 prefectures (covering about 50% of GDP) and recently lengthened the shut-down again until June 20. Although 70% of Japan's population wants to postpone Olympics (start: July 23) the government looks likely to keep the date as the International Olympic Committee has ruled out another postponement. Games will largely be held in "isolation".

On the economic side, Q1 real GDP decreased by 5.1% qoq annualized (-1.3% qoq), slightly worse than expected. The main drag came from private consumption as a result of the previous Covid-19 wave and the related SoE. However, also Q1 business investment receded while exports could benefit from global demand (esp. China and the US). International demand continued to help Japan's exports in April, which also had a positive effect on machinery orders. However, private consumption, especially on services, has already dropped again. The development of household demand will crucially depend on how fast fresh Covid-19 infections can be brought under control. Assuming broadly the same volatility as with the last wave in Q1, private consumption would not fall dramatically further against this already low base. Thus, we see the additional drag from private consumption to be limited. Accordingly, we stick to our view of a calendar year growth rate of 1.9% in 2021, but downside risks prevail.

Turn in inflation further postponed

Headline inflation relapsed to -0.4% yoy in April while core inflation was slightly better than expected with -0.1% yoy. The drop was basically due to reductions in mobile communication charges, mitigated by higher energy inflation. While energy inflation will likely push up rates going forward, the statistical office announced a CPI base revision (shift from 2015 to 2020) in August. Typically, base revisions have a disinflationary effect which will postpone the turn of CPI inflation rates into positive territory further into autumn. We do not expect the BoJ to respond, but it could well extend its Covid-19 measures. PPI is also on the rise, mainly due to raw materials prices. Historically, the impact on CPI inflation has been limited, but for the BoJ any help would be welcome.

China

Christoph Siepmann

- **China's economy benefitted from strong exports but private consumption is still lagging. In H2, driving forces will likely become more equal.**
- **PBoC policy normalization is underway. PPI inflation has got policymakers' attention, but we do not expect the PBoC to respond for now.**

China saw several smaller, local Covid-19 outbreaks again. However, given the strong government response the likelihood that they turn into a nationwide problem remains low. Beijing accelerated its vaccination pace and China could reach herd immunity by the end of the year.

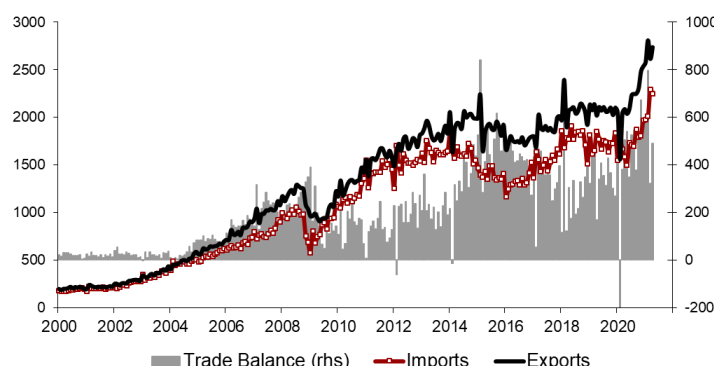
April economic data continued to suffer from base effects but to different degrees. Industrial production (IP) growth moderated to a healthy 9.8% yoy (from 14.1% yoy in April), supported by a strong upside surprise in exports (32.3% yoy with minor base effects). The latest NBS manufacturing PMI shows that the growth momentum will broadly be kept in the short run, whereas the influence of base effects will further diminish. Domestic demand paints a more nuanced picture. While manufacturing and property investment growth recovered further, infrastructure investment growth eased most likely due to less fiscal support. Retail sales rather disappointed and are still the laggard of the recovery. Looking ahead, China's growth drivers will likely be more equal in H2. On the one hand, the urban unemployment rate decreased to 5.1%, which is in line with pre-crisis levels and thus bodes well for income and an improvement in consumption. On the other hand, Covid-19 related goods exports into AE will probably slow, given the progress in vaccination and the shift in AEs to local services sector.

Money creation dropped markedly in April

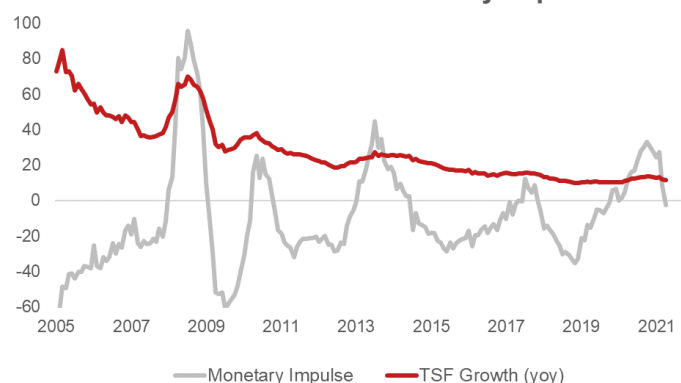
Given less support from monetary and fiscal policy, we expect some cooling of growth dynamics over the course of the year. Monetary data suggest that the PBoC is underway to limit money creation although the latest stronger drop might be due to special circumstances. M2 growth decreased to 8.1% yoy (9.4% in the month before) which is in line with pre-crisis expansion rates. China's credit impulse turned negative, which will weigh on growth in H2. PPI inflation accelerated to 6.8% yoy and is likely to rise further over the coming months. High level policy committees sounded alert. Nevertheless, historically the spill-over effects into CPI inflation were typically limited. Accordingly, we do not expect the PBoC to respond markedly to rising PPI inflation. CPI headline inflation increased to 0.9%. Given the recovery we expect CPI inflation to increase further and reach close to 3% by year-end but to average 1.7% in 2021. Fiscal policy will also scale back its support which will become more visible after the 100th anniversary of China's Communist Party on July 1. Moreover, Beijing will continue with its deleveraging agenda. We stick to our view of a GDP growth rate of 8.4% in 2021.

China: Foreign Trade

current prices, in 100 Mill. USD, sa

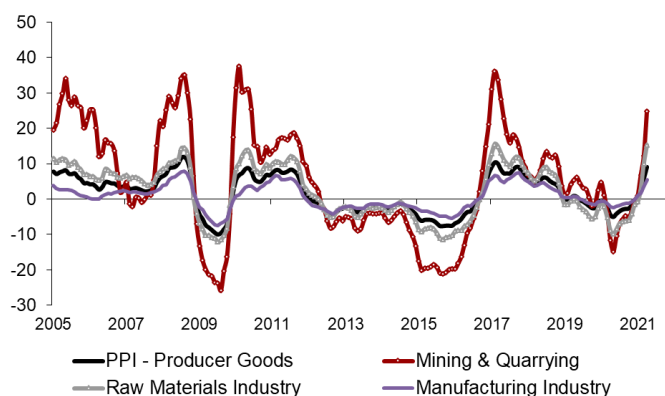


Growth of TSF and Monetary Impulse



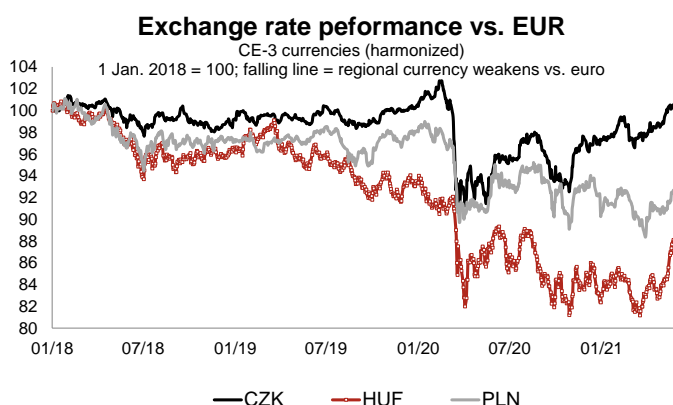
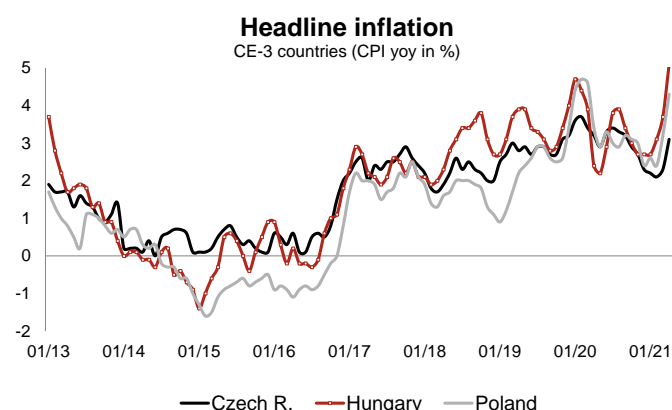
China: Producer Price Inflation

yoy as %



Central and Eastern Europe

Radomír Jáč



- The outlook for GDP growth in 2021 improved across the CE-3 region and particularly in Hungary due to better GDP data for Q1. Easing pandemic restrictions will boost activity in Q2.
- The economic recovery is accompanied by growing inflationary pressure and central banks have become more vigilant. Hungary and Czechia may hike their key interest rates already in June.
- The regional interest rate outlook combined with the better global sentiment contributed to firming of the CE-3 currencies against the euro.

Preliminary GDP data for Q1 were solid across CE-3 and surprised positively in most cases. Hungary was an outperformer with growth at 1.9% qoq and substantial positive revision of 4Q 2020 growth. If strong GDP growth for Q1 is confirmed, Hungary may record full-year growth close to 7%. We also revised up full-year forecasts for the Czech Republic and Poland vis-à-vis Q1 GDP data and easing of pandemic-related restrictions.

Economic recovery is accompanied by increasing price pressure. In April, inflation grew in year-on-year terms in all CE-3 economies and exceeded 3% in the Czech Rep., 4% in Poland and 5% in Hungary. While majority of the Polish MPC still keeps a view that factors behind higher inflation are temporary, central bankers in the Czech Rep. and Hungary take the price risks more seriously and signalise readiness to increase interest rates.

Expect rate hikes in Hungary and the Czech Republic

The Czech CNB published a fresh forecast, which operates with at least three interest rate hikes in 2021. This would lift the key rate to 1.00% by year-end from its current level of 0.25%. A similar scenario was already presented by the two previous forecasts but now the CNB Board seems to follow the guidance, as uncertainties related to pandemic declined substantially. A 25 bps hike is widely expected for August but there is a non-negligible chance that the CNB will act already at the meeting on June 23.

In Hungary, the MNB sent a clear signal that it will tighten monetary conditions at the MPC meeting scheduled for June 22 via increase of the base rate from its current level of 0.60%. The MNB says that the upside risks related to the inflation outlook continue to strengthen. We expect rate hikes in a cautious manner, as the central bank may want to avoid a too sharp firming of the forint FX rate.

In Poland, a majority of MPC keeps a view that the key rate (now at 0.10%) will not be raised before Q1 2022 when terms of most of the current MPC members expire. A minority camp calls for a rate hike by ca. 15 bps and for termination of QE program. Inflation is projected above the 2.5% target in the next three years and forecast for Q2 is likely to be overshoot by both headline and core CPI.

| Main Forecasts | 2019 | 2020 | 2021f | 2022f |
|-------------------------|------|------|-------|-------|
| Czech Republic | | | | |
| GDP | 2.3 | -5.6 | 3.3 | 4.3 |
| Consumer prices | 2.8 | 3.2 | 2.9 | 2.2 |
| Central bank's key rate | 2.00 | 0.25 | 0.75 | 1.25 |
| Hungary | | | | |
| GDP | 4.6 | -5.1 | 6.9 | 4.1 |
| Consumer prices | 3.4 | 3.3 | 3.9 | 3.4 |
| Central bank's key rate | 0.90 | 0.60 | 1.20 | 1.50 |
| Poland | | | | |
| GDP | 4.8 | -2.6 | 4.5 | 4.5 |
| Consumer prices | 2.3 | 3.4 | 3.8 | 3.2 |
| Central bank's key rate | 1.50 | 0.10 | 0.10 | 1.00 |

GDP and consumer prices: annual % change; CB interest rate: in %, year-end

Government Bonds

Florian Späte

- The sideways trend in nominal yields in the US and in the euro area in May masks another drop in real yields.
- Regardless of the coming central bank meetings and its short-term impact on yields, the way is paved for higher yields in the months to come. This is likely to be accompanied by noticeably steeper yield curves.
- Dovish comments by ECB officials eased concerns about a looming tapering and triggered a tightening of euro area non-core spreads. This is expected to last for the time being – before entering more troubled waters in H2.

The initial upward trend in international government bond yields did not last. Following dovish comments by central bank officials yields dropped again and finished the month under review almost unchanged. The transatlantic yield spread tightened marginally in May.

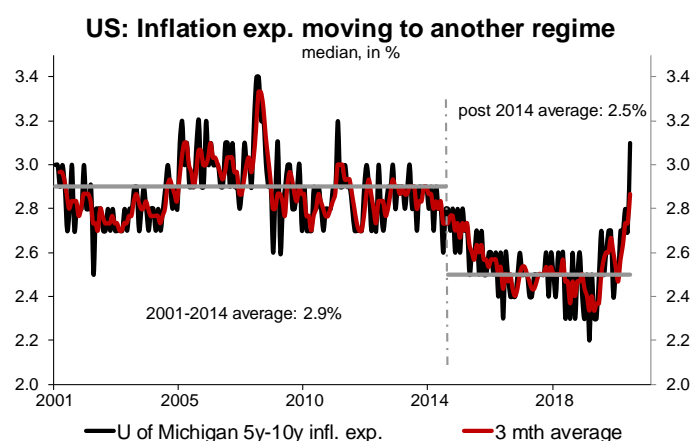
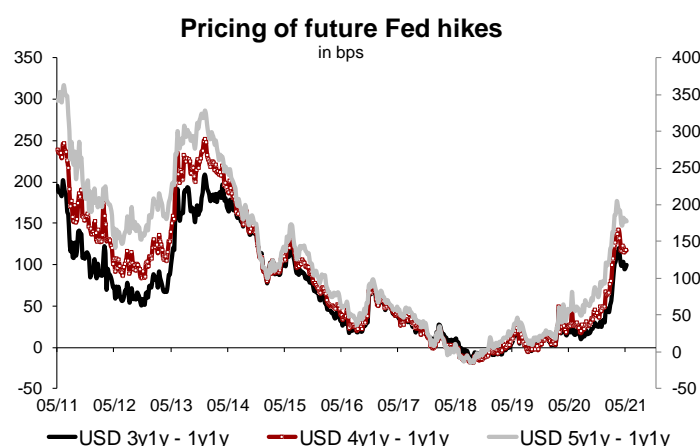
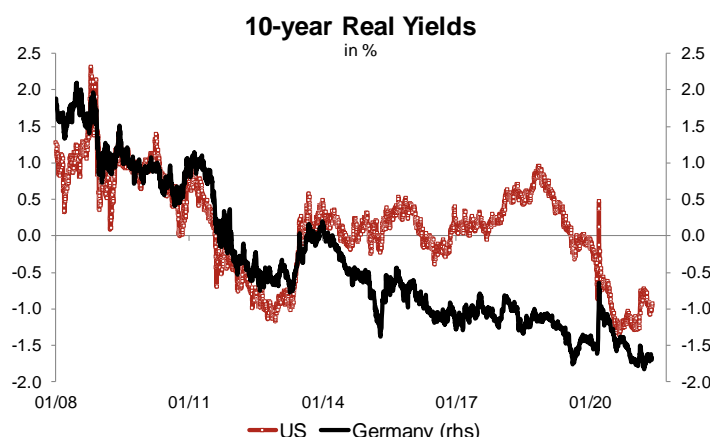
It is noteworthy that real yields have fallen further in an environment of easing lockdown restrictions, a looming economic rebound, easy financial conditions and an increased level of uncertainty. 10-year US real yields are only 20 bps above their historical trough and their euro area counterparts have hardly risen from their low. While this can be seen as a success of the central banks' communication it does not look sustainable. A fast recovering world economy in combination with high fiscal deficits (the US administration has just released a budget plan for the fiscal year including \$6 tn of fiscal spending) and central banks which are expected to withdraw sooner or later from extraordinary measures is at odds with these real yield levels.

Government yield curves to steepen

While the easiest way for long-dated yields is upwards, we are more cautious with respect to short-dated yields. This is mainly driven by the current pricing of future central bank hikes. In the US, the lift-off (by 25 bps) is priced for Q1 2023 and in the euro area a first cautious deposit rate hike by 10 bps is expected for Q4 2023 by financial markets. Amid the only slowly recovering labour market in the euro area and the APP persisting well beyond the PEPP we forecast the ECB to wait until the end of 2024. Considering the new Fed strategy we forecast the lift-off in the US to be around the turn of the year 2023/2024.

The aggressive expectations are reflected in short-dated yields. While it is uncertain when markets will adjust key rate expectations the already aggressively priced key rate hikes limit the upward potential for short-dated yields. Although they will inch up on the economic recovery and slowly approaching key rate hikes, a sell-off is not on the cards.

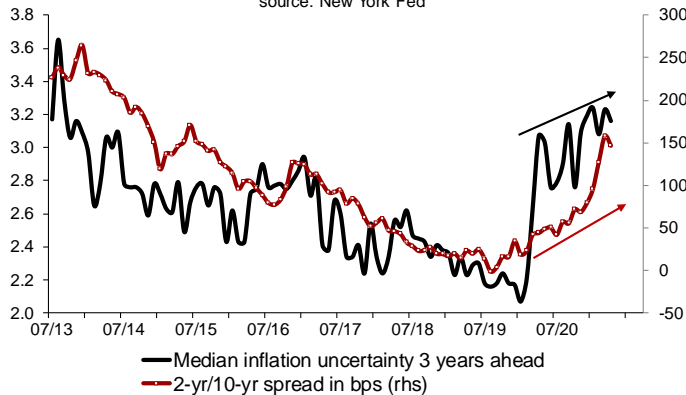
The opposite is true for the long end of the curve. In addition to the unsustainable low real yield level the



Government Bonds

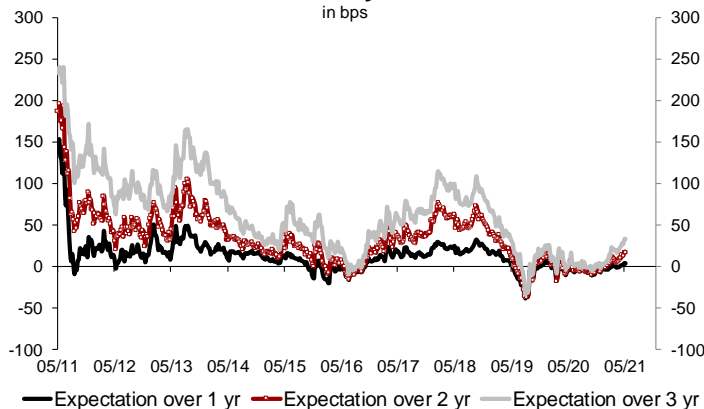
US: Rising Uncertainty steepens Yield Curve

source: New York Fed



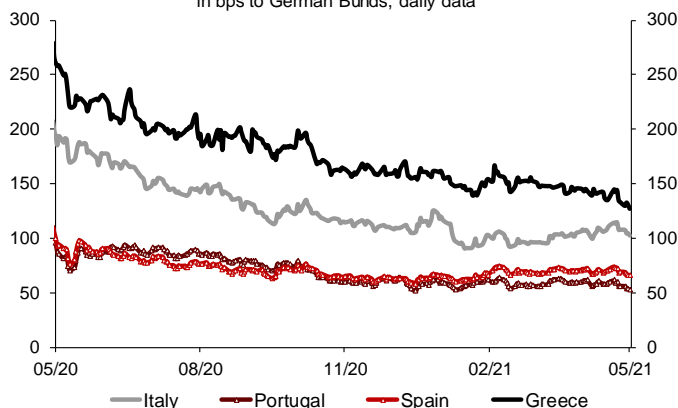
ECB: Priced key rate hikes

in bps



10-year Sov. Spread Euro Area Peripherals

in bps to German Bunds, daily data



coordinated expansive fiscal and monetary policy will eventually generate a different inflation environment. This applies in particular to the US. The long-dated inflation expectations by consumers have risen strongly. At 3.1% they have reached the highest level since 2008 and are back to the inflation regime pre-2015. This is only partially reflected in financial markets' inflation expectations.

First, despite the strong increase since spring 2020 the inflation risk premium is not at excessive levels. Amid the high level of uncertainty a higher premium both in the US and in the euro area appears sensible. Second, genuine inflation expectations have risen only slightly in recent months. Hence, not only the risk premium has upside potential but also the pure inflation expectations can adjust to a different inflation regime. This applies in particular if the current supply side constraints turn out more lasting and the de-globalization trend remains.

On balance, we expect 10-year US yields to reach 2.15% on a 12-month horizon (1.80% on a 3-month horizon) and 10-year Bund yields to rise to 0.20% (12-mth) and -0.05% (3-mth). While the euro area 3-month target is fairly uncertain amid the ECB decision (June 10), the big picture remains unchanged at 12 months. Accordingly, we recommend a short duration and investors should avoid long-dated maturities.

OATs slowly moving into focus

Euro area non-core sovereign bond spreads were on a roller coaster in May. After some widening in the first half of the month dovish comments by ECB officials eased taper concerns and helped to stabilize spreads. On balance, they were little changed (or even slightly tighter).

The short term outlook for spreads will depend to a large extent on the next ECB meeting and the accompanying wording. Overall, the ECB is expected to stress its flexibility and any reduction in PEPP volume (if any) is seen to be small. Anyway, in terms of issuance Q3 is forecast to be a friendly quarter anyway (EGB issuers have already completed around 50% of bond funding).

Later on, we expect French OATs to slowly move into the focus. The first round of the French presidential election will take place only in April 2022. However, in the run up to the 2017 elections financial markets started to price election risks already in autumn. This is unlikely to change this time, even more as this period coincides with ECB tapering discussions and additional competition from EU issuances (Recovery Fund). Hence, markets are likely to be vulnerable to any bad news anyway.

However, given the less anti-European rhetoric by Le Pen and the still fairly low probability (although not impossible) to not only enter the second ballot but to ultimately win the run-off we do not forecast a pronounced spread widening. However, depending on the news flow investors are well advised to prepare for volatile markets and some weakening of OATs from autumn onwards.

Credit

Elisa Belgacem

- Credit spreads have been very stable over the course of May amid elevated rate volatility.
- Hence, we continue to expect 10bp tightening for IG into year-end and 25bp for HY. We do not expect the ECB June meeting to be a trigger.
- We continue to expect HY to outperform IG in TR terms over the coming months, backed by fast-improving default rate and fundamentals.
- We see the most value in BBBs, BBs and above all in AT1s and corporate hybrids.

The credit market has been so far extremely resilient to interest rate volatility for several reasons:

1/It is more real rates than nominal ones that matter for risky assets and they have remained very low. Also, inflation is rather a tailwind to credit and HY in particular as it helps corporates to deleverage.

2/ Fundamentals of corporate bond issuers continue to improve at a rapid rate, with twice more upgrades than downgrades currently in Europe. Besides, defaults numbers are declining since the peak of 5% in November 2020 to currently stand at 4.6%.

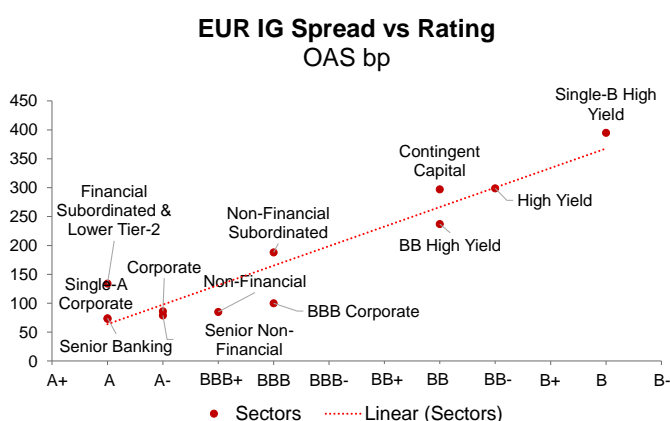
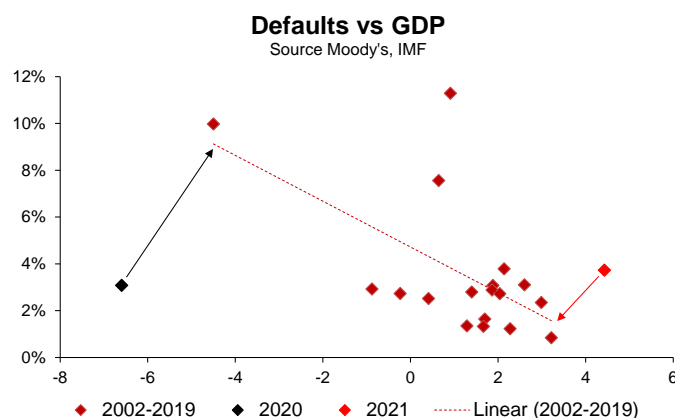
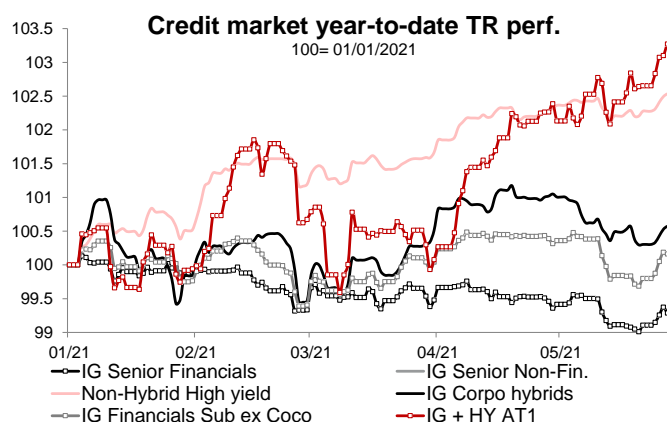
3/ The strong focus on financing conditions from the ECB associated with the flexibility of purchases under its PEPP and CSPP is helping to keep credit spreads volatility low. Notwithstanding the current debate on the reduction of the PEPP purchases, the amounts at stake to stabilise the credit market are small enough to say that credit should remain indifferent to the debate on the ECB tapering over the next few months. Indeed, the bulk of the credit purchases are made within the CSPP that will continue after the end of the PEPP.

4/The positioning is and should remain resilient while not being exuberant. Investors have mostly kept their corporate bond spreads positions despite negative YTD total returns for IG possibly because insurers are supplanting traditional asset managers on higher yields.

We remain overweight HY

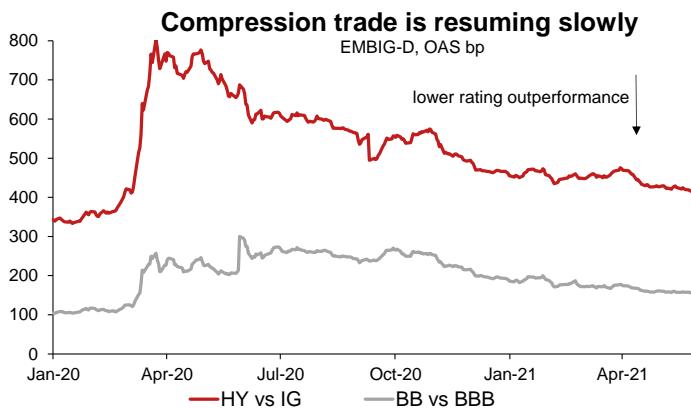
Hence going forward, we expect IG grinding gradually tighter (-10bp) while HY should outperform in total return terms (-25bp), providing better cushioning effect to higher rates but also because higher inflation is benefiting credit in general: it is a true tailwind to HY in supporting the deleveraging of companies.

Within IG, we keep a pro-cyclical bias and favour BBB and subordinated bonds but within HY, we retain a preference for BBs as they are lagging single-Bs while still displaying decent carry. We continue to prefer capital structure risk to credit risk, and so we prefer corporate hybrids and AT1 to pure HY as we see them as a better risk-reward alternative, despite already strong performance YTD for the latter.



EM sovereign bonds

Guillaume Tresca



- Negative factors have been receding, and we turn more positive on EM external debt.
- Spreads will tighten modestly, and return is low single-digit. We focus on relative-value trades, HY and prefer EUR vs. USD bonds.
- Technicals are positive with resilient inflows and lower issuance.

We turn MW on EM external debt from neutral as negative factors have been receding. Most of the negative news flow has been well priced in. US rates have been stabilising, or at least EM spreads have been resilient to US rate rebounds and taper concerns. Likewise, the Chinese slowdown is well-integrated, as well as the Covid resurgence in some EM countries.

No enthusiasm but tighter spreads

Only a modest spread compression is expected, and valuations are close to fair-value within a range-bound environment. Expected return is still low single-digit, and with higher core yields, EM external debt is more a carry play than a directional play. We continue to notice a lack of conviction from investors and favour relative-value trades. We keep a mild OW on EM HY, focusing on BB and expecting some HY/IG compression. Prudently, we add risk on BBB names given the stabilisation of core rates. We will favour EUR bonds over USD bonds, still offering a better pickup in asset-swap.

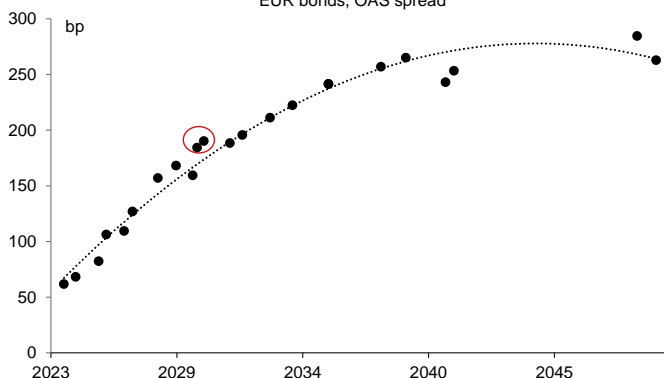
Regional divergence: risky LatAm, safer EMEA

Growth recovery has been recently diverging. Asia is seeing a weaker growth momentum in Q2, while LatAm benefits from the commodity price rebound and EMEA from the vaccine rollout. Monetary policy discrepancy is also emerging with hawkish rhetoric in CEE and LatAm. We keep our preference for EMEA and Asia over LatAm. Indeed, LatAm is facing a heavy political cycle that could have disruptive ramifications on economic policy. Fiscal reforms are slow, and we continue to avoid Colombia, where we expect further downgrades. Mexico is cheap, and risks are positively skewed. In EMEA, we like Romania in the EUR 10Y sector benefiting from the ease of downgrade concerns, favour Qatar and Saudi Arabia in the GCC and Philippines and Indonesia in Asia.

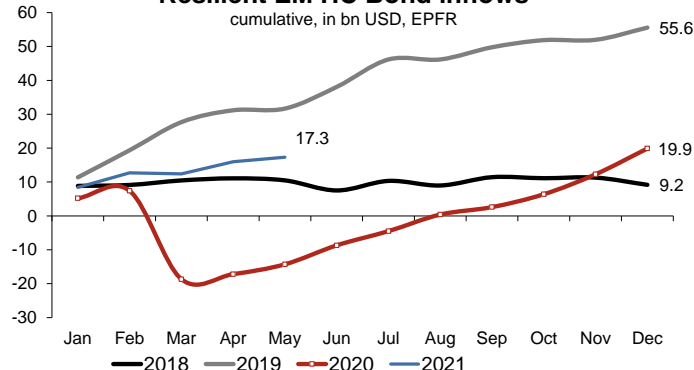
Welcome support from technicals

Despite the lack of conviction and the duration risk, portfolio inflows have been resilient to the poor YTD performance. Taiwanese lifers have been back, and crossover demand remains steady. The recent return improvement will provide further impetus. On the supply side, issuance surprised to the downside: EM sovereign issuance should be lower, rather close to USD200bn, due to higher commodity prices benefiting MENA.

Romania: cheapness in the 10Y sector
EUR bonds, OAS spread



Resilient EM HC Bond inflows



Currencies

Thomas Hempell

- After paring its Q1 gains, the USD is headed for further losses into summer as the growth momentum is shifting from the US to Europe.
- The accommodative Fed will stick to its guns, but faces a nascent tapering debate. The 2013 experience suggests that resulting USD support will be transient, hinging on temporarily higher bond volatility rather than yield levels.
- Further yen weakness on higher US yields and lagging vaccinations is likely near term. But favourable real yield gaps, portfolio flows and cheap valuation, though, should help the yen to bottom over the summer.

Massive fiscal stimulus keeps the US leading the economic recovery. Yet the growth momentum is shifting towards Europe and – with a lag – to the rest of the world, with Covid-19 vaccinations setting the tone for sequential reopenings. As [laid out earlier](#), a global rebound means headwinds for the anticyclical USD (top chart), proving its Q1 bounce a blip rather than a trend reversal.

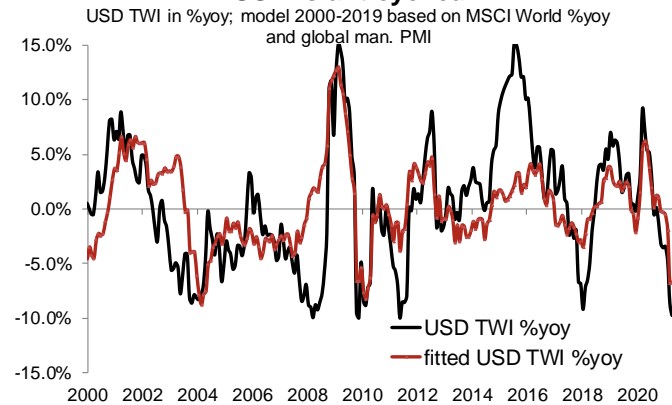
The broader EUR has been virtually stagnant since last summer (mid chart); it is now headed for its next leg up into the grand economic reopening with higher yields and earnings attracting capital inflows. Larger issuances of commonly backed EU debt for the Recovery Fund will strengthen the euro's international role. We thus see upside for EUR/USD, but also for EUR/CHF on unwinding safe haven flows alongside somewhat higher euro yields.

Fed tapering: it's the uncertainty, stupid!

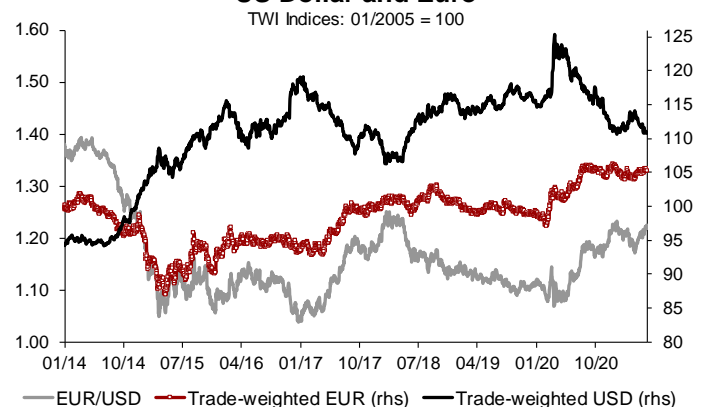
The Fed will stick to its [highly accommodative policy](#), flagging the spring inflation spike as transitory. Yet the tapering debate around the Fed's US\$120bn monthly asset purchases will intensify into summer. This may put a lid on the EUR/USD in the mid 1.20s, but is unlikely to trigger a trend reversal. The 2013 taper tantrum caused a 140 bps rise in 10y US yields from May to Dec, but the broader USD gained only 2% (and was even down 5% against a resurgent EUR). Also, USD spikes coincided with peaks in rate volatility, not levels (bottom chart). The tapering debate will thus likely prove a transitory USD tailwind. The better the Fed manages its communication, the less USD impact to expect. And the ECB is facing its own tapering challenge, with PEPP purchases to be trimmed at some point, even though the ECB may stick to its guns at the upcoming June meeting (see euro area section).

Rising US yields, lagging vaccinations in Japan and higher commodity prices (burdening Japan's import bill) leave some scope for further yen weakness near term. Yet the yen is fundamentally cheap. And more supportive *real* yields suggest that JPY may bottom over the summer, helping the JPY to recover against a broadly weaker USD.

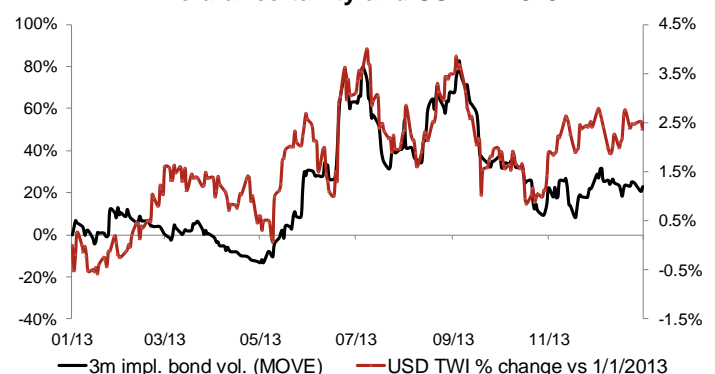
USD is anticyclical



US Dollar and Euro



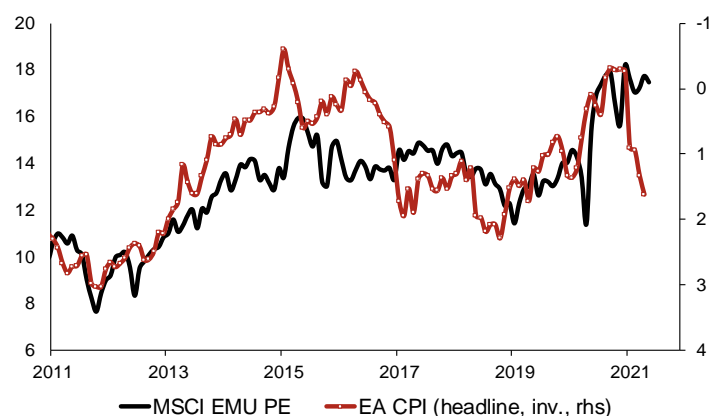
Yield uncertainty and USD in 2013



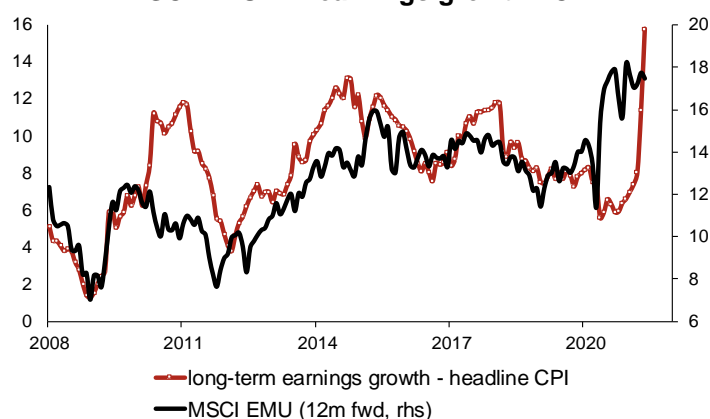
Equities

Michele Morganti / Vladimir Oleinikov

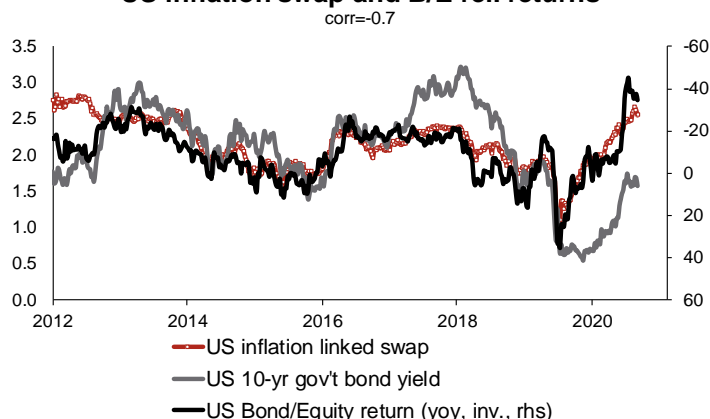
MSCI EMU PE and EA headline CPI



MSCI EMU PE: earnings growth - CPI



US inflation swap and B/E rel. returns



- Notwithstanding lingering low yields, increasing inflation expectations are backing the continuation of the Value and euro area outperformance.
- Higher inflation and input costs are not yet a threat for equities. Indeed, margin and earnings revisions are surging, with real rates still far from representing a valid alternative to equity yields.
- The reporting season was extremely good, and the earnings growth will peak only in Q2. Crowded positioning (a negative) could linger further as lower volatility should push CTA flows to a cyclical high.
- We see total returns of 5% in 12 months. Value (more) and cyclicals (less) are still OW, albeit the bulk of rotation is behind us. We favour EU vs US and have a lower OW in Japan and EM. We increased Households' OW at the expense of Media. Further OWs: financials, energy, materials, hardware and software.

In the last month equities were able to advance further thanks to a lingering good macro momentum with central banks reassuring against a bold hawkish change in stance. Furthermore, vaccinations progressed well, and the activity reopening in the euro area (EA) continued.

Yields volatility was rather low as credit spreads' one and 10-year yields remained quite low versus expectations. This ultimately didn't stop the rotation into value names at the expense of Growth ones: Nasdaq lost 2% and the European Value outperformed Growth by 1%, while EMU beat US by 1.5%. This is because inflation expectations continue to drift higher and market expects inflation and yields will continue to rise.

PE theoretically pressured by a higher inflation

Usually PEs tend to move lower when inflation moves higher for some time as happened in 2017-2018. Of course, another condition to threaten investors is also a level of US 10-year rates above the 2.5% level. These happened during Q3 2018 and caused a market's setback.

But low yields and earnings growth come to rescue

Things are currently different for two reasons. First, real rates in the US remain at bay. At present, they are even able to justify current market multiples without signs of exuberance. Indeed, in time we expect PEs to move lower as rates will increase (we expect 10-year rates at 2.1% in one year) but with surging earnings, total return can stay in positive territory. The second difference versus 2018 is the strength in earnings revisions and expected long-term earnings growth. When we adjust inflation with earnings growth, PEs look much less at risk. Indeed, as yields remain overall contained, increasing inflation expectation tend to favour equity performance

Equities

versus bonds' one. Furthermore, CTA funds may increase their equity positions due to lower volatility.

Firms are increasing dividends and buyback activity, leveraging on higher capacity utilization and margins, notwithstanding higher input costs. As the Q1 reporting season draws to a close, companies showed a record breadth of positive earnings upgrades, underscoring the strength of the current business cycle. The median EA and US stock experienced positive surprises of 11% (20% for the S&P 500). Q1 earnings growth was nearly 50% in the US and above 120% in the EA. Growth is expected to accelerate further, with the yoy peak mostly reached in 2021 Q2 (62% for the US and 117% for EU).

The MSCI EMU index is expected to outperform US. As a Value index it has a higher sensitivity to growth - EA GDP growth is now accelerating vs the US, reducing its previous gap - and higher yields. Valuation still lags US one and, finally, investors' positioning is definitively lower.

Maintaining a positive stance on equity

We maintain an OW position in equities and see total returns of around 5% in 12 months. OW EA vs US, together with UK and to a lesser extent EM and Japan. For the last, a weaker yen, a kicked-off vaccination campaign and concluded reshuffle of the MSCI AC Asia Pacific Index (which penalized Topix weight) should begin to favour the cyclical and Value Japanese index.

As for sectors, we maintain the bulk of the overweight in Value sectors, financials and energy, to leverage on higher 10-year yields and CPI. We increased even further the exposure to households (HH) (bottoming earnings revisions), which would serve as a relative performance hedge as we approach tempering discussion, the peak in confidence indicators and GDP quarterly growth with also sign of overvaluation in the cyclical/defensive performance by our quant models. We finance HH by a further increase in Media's underweight (poor revisions, quant models and valuation). OW: financials, energy, materials, HPP, software, and tech. hardware. UW: cons. services, insurance, media, real estate, telecoms und utilities.

EM: getting cautiously optimistic

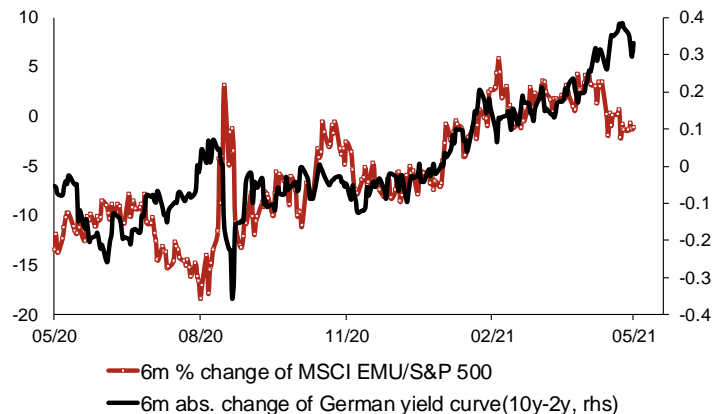
In May, the MSCI EM (+0.5%) has been particularly supported by a weaker dollar (+1.6%) and higher oil prices but underperformed the MSCI World by 0.6pp. Short term EMs should benefit from improving Fed financial conditions, global export orders, and high macro surprises. Furthermore, earnings revisions started to be stabilizing, having reached a cyclical low. The EM performance is lagging significantly its earnings' one. Mid-term, EMs will further be supported by the ongoing rebound in domestic growth, low relative valuations, a weaker US dollar and higher commodity prices. We continue to favour India, Korea, and Poland.

Analysis of the median stock: Q1 2021 reporting season

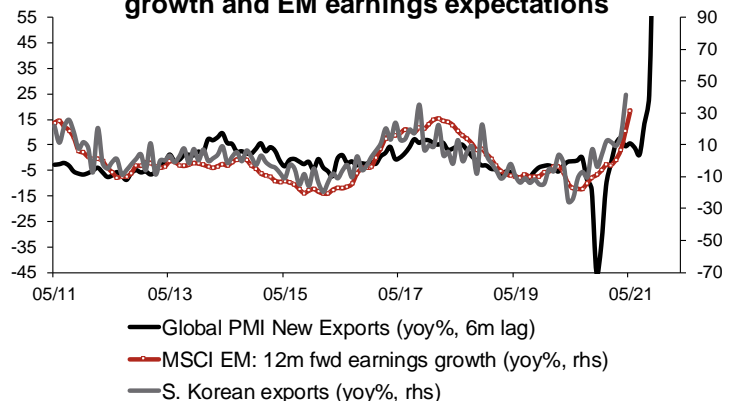
| Median stock | Earnings Growth | | Sales Growth | | availability |
|--------------|-----------------|---------|--------------|---------|--------------|
| | Q4 2020 | Q1 2021 | Q4 2020 | Q1 2021 | Q1 2021 |
| S&P | 9.85 % | 22.64 % | 3.48 % | 7.94 % | 92.2% |
| Stoxx | 1.86 % | 28.90 % | (1.61)% | 3.21 % | 90.5% |
| Euro Stoxx | 0.00 % | 23.55 % | (1.91)% | 3.55 % | 92.3% |
| Topix | 13.03 % | 20.30 % | (0.78)% | 1.70 % | 94.6% |

| Median stock | Earnings Surpr | | Sales Surpr | | availability |
|--------------|----------------|---------|-------------|---------|--------------|
| | Q4 2020 | Q1 2021 | Q4 2020 | Q1 2021 | Q1 2021 |
| S&P | 7.67 % | 11.53 % | 2.27 % | 2.37 % | 92.2% |
| Stoxx | 7.60 % | 10.61 % | 0.87 % | 1.54 % | 90.5% |
| Euro Stoxx | 7.03 % | 10.90 % | 0.94 % | 1.59 % | 92.3% |
| Topix | 19.57 % | 16.45 % | 2.11 % | 2.16 % | 94.6% |

MSCI EMU/S&P and the German yield curve

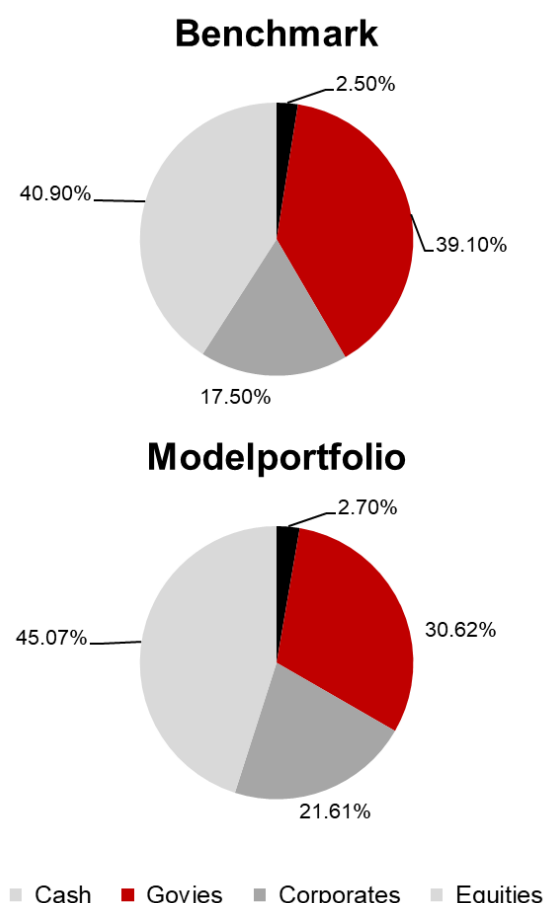


Global export orders, S. Korean export growth and EM earnings expectations

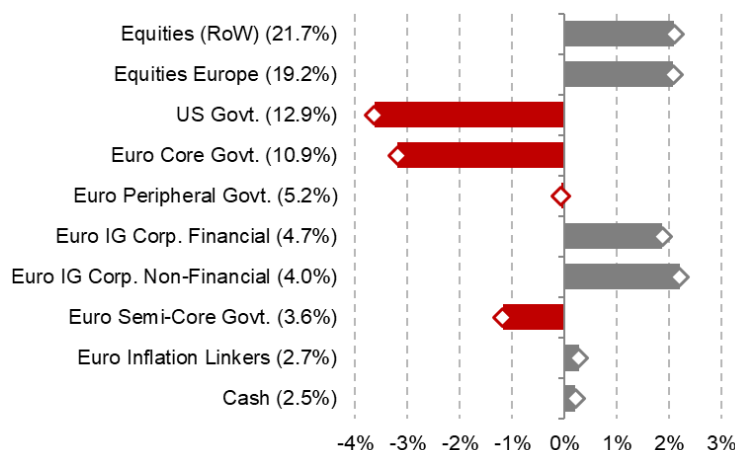


Asset Allocation

Thorsten Runde



Active Positions in TOP 10 Benchmark Constituents*



*Benchmark weights in parentheses, diamonds indicating previous

- Apart from EA IG Credit (-0.2% on average) all actively covered asset classes finished the month of May (*until May 27th*) in positive territory or at least very close to the zero-line.
- The top end of the return ranking is again marked by equities that advanced +1.2% on average. The best performance was achieved by European equity markets (+2.4%), whereas the EMs slightly lost ground (-0.1%).
- In contrast to the previous months the long maturity buckets distinctively outperformed the shorter ones, triggered by the developments in the second half of the month.
- On the EA Credit side, HY outperformed IG by about +29 bps on average.
- Rising earnings and progress in vaccination continue to support risk assets. Pressure on nominal yields resulting from rising inflation expectations will keep on limiting Govie performance. Thus, we maintain our TAA recommendation in favour of Equities and EA Credit at the expense of Government Bonds.

In May, the model portfolio has outperformed its benchmark by +4.9 bps so far. With +3.4 bps Equities are again adding the most to this overall result, followed by EA Core Government Bonds (+2.5 bps) and US Treasuries (+1.7 bps). Thus, the top-three-contributors did not change compared to April. Indeed, the intra-monthly development differs somehow from last time. Whereas Equities built up their contribution continuously, EA Govies (US Treasuries) only did so in the first (second) half of May. This was due to the strong rise in yields and peripheral spreads at the beginning of May induced by mounting inflation concerns. The bottom end of the ranking is clearly marked by Corporate Bonds (-3.7 bps).

The global economy continues to rebound from the pandemic, with Europe clearly catching up with the US sustained by hopes of a grand reopening as vaccinations accelerate. Flanked by ongoing fiscal and monetary policy support the way for risk-assets seems to remain paved for the time being.

Pro-risk stance to be maintained once again

Against this backdrop, we confirm our last month's TAA recommendation, thus keeping the model portfolio structure unchanged throughout the entire Q2. We keep a reasonable overweight in Equities and EA Credit. We stay underweight in US Treasuries and EA Govies as their prospects clearly suffer from rising inflation risks. Furthermore, we recommend to keep a small overweight in Cash and a moderately short stance on duration.

Forecast Tables

Growth¹⁾

| | 2019 | 2020 | 2021 | | 2022 | |
|---------------|------------|--------------|------------|--------------|------------|-------------|
| | | | forecast | Δ vs. cons. | forecast | Δ vs. cons. |
| US | 2.2 | - 3.5 | 7.5 | 1.3 | 4.7 | 0.6 |
| Euro area | 1.3 | - 6.7 | 4.2 | 0.0 | 5.0 | 0.7 |
| Germany | 0.6 | - 5.1 | 3.2 | - 0.1 | 4.7 | 0.6 |
| France | 1.5 | - 8.2 | 5.7 | 0.4 | 4.5 | 0.6 |
| Italy | 0.3 | - 8.9 | 4.0 | 0.1 | 4.1 | 0.0 |
| Non-EMU | 1.5 | - 7.6 | 5.6 | 1.0 | 4.6 | - 0.2 |
| UK | 1.4 | - 9.9 | 6.8 | 1.4 | 5.3 | - 0.3 |
| Switzerland | 1.1 | - 3.0 | 3.3 | 0.0 | 2.9 | 0.0 |
| Japan | 0.0 | - 4.7 | 1.9 | - 0.9 | 2.9 | 0.5 |
| Asia ex Japan | 5.3 | - 0.8 | 7.4 | - 0.9 | 5.4 | 0.1 |
| China | 6.4 | 2.3 | 8.4 | - 0.3 | 5.4 | - 0.1 |
| CEE | 2.2 | - 1.8 | 4.6 | 0.7 | 3.7 | 0.1 |
| Latin America | - 1.7 | - 8.6 | 3.3 | - 0.8 | 2.8 | 0.0 |
| World | 2.6 | - 3.5 | 5.8 | - 0.1 | 4.6 | 0.2 |

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

Inflation¹⁾

| | 2019 | 2020 | 2021 | | 2022 | |
|-----------------------------|------------|------------|------------|-------------|------------|-------------|
| | | | forecast | Δ vs. cons. | forecast | Δ vs. cons. |
| US | 1.8 | 1.2 | 3.2 | 0.6 | 2.3 | 0.0 |
| Euro area | 1.2 | 0.3 | 1.6 | 0.0 | 1.3 | 0.0 |
| Germany | 1.4 | 0.4 | 2.0 | - 0.1 | 1.5 | - 0.1 |
| France | 1.3 | 0.5 | 1.0 | - 0.2 | 1.1 | 0.0 |
| Italy | 0.6 | - 0.1 | 1.1 | 0.0 | 1.2 | 0.2 |
| Non-EMU | 1.5 | 0.6 | 1.6 | 0.2 | 1.7 | - 0.0 |
| UK | 1.8 | 0.9 | 1.9 | 0.3 | 2.1 | - 0.0 |
| Switzerland | 0.4 | - 0.7 | 0.4 | 0.0 | 0.5 | 0.0 |
| Japan | 0.5 | - 0.0 | 0.0 | - 0.0 | 0.3 | - 0.2 |
| Asia ex Japan | 2.7 | 2.8 | 2.4 | 0.1 | 2.7 | - 0.1 |
| China | 2.9 | 2.5 | 1.7 | 0.2 | 2.3 | 0.1 |
| CEE | 6.6 | 5.5 | 7.6 | 0.6 | 5.9 | 0.4 |
| Latin America ²⁾ | 3.6 | 3.2 | 3.1 | - 0.4 | 3.5 | 0.6 |
| World | 2.5 | 2.1 | 2.8 | 0.2 | 2.6 | 0.0 |

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

Financial Markets

| | | | | |
|-------------------------------|------------------|-----------|-----------|------------|
| 3-month LIBOR | 27/05/21* | 3M | 6M | 12M |
| USD | 0.14 | 0.20 | 0.20 | 0.20 |
| EUR | -0.54 | -0.55 | -0.55 | -0.55 |
| JPY | -0.09 | -0.10 | -0.10 | -0.10 |
| GBP | 0.08 | 0.10 | 0.10 | 0.10 |
| CHF | -0.75 | -0.75 | -0.75 | -0.75 |
| 10-Year Bonds | 27/05/21* | 3M | 6M | 12M |
| Treasuries | 1.58 | 1.80 | 1.95 | 2.15 |
| Bunds | -0.18 | -0.05 | 0.05 | 0.20 |
| BTPs | 0.86 | 1.00 | 1.15 | 1.35 |
| OATs | 0.18 | 0.30 | 0.50 | 0.60 |
| JGBs | 0.07 | 0.10 | 0.15 | 0.20 |
| Gilts | 0.79 | 0.95 | 1.05 | 1.20 |
| SWI | -0.18 | -0.10 | 0.00 | 0.15 |
| Spreads | 27/05/21* | 3M | 6M | 12M |
| GIIPS | 84 | 85 | 90 | 90 |
| BofAML Covered Bonds | 32 | 30 | 35 | 35 |
| BofAML EM Gvt. Bonds (in USD) | 272 | 270 | 265 | 263 |

*average of last three trading days

| | | | | |
|-------------------------------|------------------|-----------|-----------|------------|
| Corporate Bond Spreads | 27/05/21* | 3M | 6M | 12M |
| BofAML Non-Financial | 85 | 80 | 75 | 75 |
| BofAML Financial | 88 | 80 | 75 | 75 |
| Forex | 27/05/21* | 3M | 6M | 12M |
| EUR/USD | 1.22 | 1.25 | 1.25 | 1.27 |
| USD/JPY | 109 | 110 | 108 | 106 |
| EUR/JPY | 133 | 138 | 135 | 135 |
| GBP/USD | 1.41 | 1.44 | 1.44 | 1.44 |
| EUR/GBP | 0.86 | 0.87 | 0.87 | 0.88 |
| EUR/CHF | 1.10 | 1.12 | 1.13 | 1.15 |
| Equities | 27/05/21* | 3M | 6M | 12M |
| S&P500 | 4,195 | 4,235 | 4,245 | 4,265 |
| MSCI EMU | 144.3 | 146.0 | 147.0 | 147.0 |
| TOPIX | 1,917 | 1,950 | 1,955 | 1,970 |
| FTSE | 7,025 | 7,100 | 7,115 | 7,120 |
| SMI | 11,332 | 11,450 | 11,540 | 11,450 |

3-Months Horizon

| | | | | |
|------------------|--------------------|--------|--------|--------|
| Government Bonds | 10-Year Bunds | -0.10 | -0.05 | 0.00 |
| | 10-Year Treasuries | 1.48 | 1.80 | 2.12 |
| | 10-Year JGBs | -0.28 | 0.10 | 0.48 |
| | 10-Year Gilts | 0.75 | 0.95 | 1.15 |
| | 10-Year Bonds CH | -0.13 | -0.10 | -0.07 |
| Equities | MSCI EMU | 132.5 | 146.0 | 159.5 |
| | S&P500 | 3,901 | 4,235 | 4,569 |
| | TOPIX | 1,800 | 1,950 | 2,100 |
| | FTSE 100 | 6,544 | 7,100 | 7,656 |
| | SMIC | 10,698 | 11,450 | 12,202 |
| Currencies | EUR/USD | 1.22 | 1.25 | 1.28 |
| | USD/JPY | 107 | 110 | 113 |
| | EUR/GBP | 0.84 | 0.87 | 0.90 |
| | EUR/CHF | 1.10 | 1.12 | 1.14 |

12-Months Horizon

| | | | | |
|------------------|--------------------|--------|--------|--------|
| Government Bonds | 10-Year Bunds | 0.30 | 0.20 | 0.10 |
| | 10-Year Treasuries | 1.61 | 2.15 | 2.69 |
| | 10-Year JGBs | 1.05 | 0.20 | -0.65 |
| | 10-Year Gilts | 0.81 | 1.20 | 1.59 |
| | 10-Year Bonds CH | 0.24 | 0.15 | 0.06 |
| Equities | MSCI EMU | 124.9 | 147.0 | 169.1 |
| | S&P500 | 3,721 | 4,265 | 4,809 |
| | TOPIX | 1,700 | 1,970 | 2,240 |
| | FTSE 100 | 6,193 | 7,120 | 8,047 |
| | SMIC | 10,182 | 11,450 | 12,718 |
| Currencies | EUR/USD | 1.20 | 1.27 | 1.34 |
| | USD/JPY | 99 | 106 | 113 |
| | EUR/GBP | 0.82 | 0.88 | 0.94 |
| | EUR/CHF | 1.11 | 1.15 | 1.19 |

*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, exponentially weighted. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

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