

Market Perspectives

Tightening pain

GIAM Macro & Market Research

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- Hawkish speeches at Jackson Hole have poured cold water on nascent hopes that policy setters may blink soon amid rising recession risks.
- Equity valuations and (thus far resilient) earnings will face stiffer headwinds into winter, with a recession in Europe looming amid an energy crunch and higher rates.
- Investor positioning remains very bearish, leaving scope for selective bounces. Yet we still favour an underweight in riskier assets. Strong demand for the stretched USD is unlikely to reverse soon.

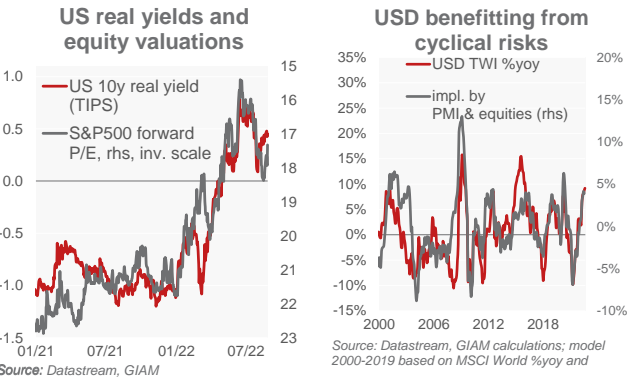
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Global View – Tightening pain

Thomas Hempell

- Hawkish speeches at Jackson Hole have poured cold water on nascent hopes that policy setters may blink soon amid rising recession risks.
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- Investor positioning remains very bearish, leaving scope for selective bounces. Yet we still favour an underweight in riskier assets. Strong demand for the stretched USD is unlikely to reverse soon.

Central banks' (CBs) hawkish message at Jackson Hole could hardly have been more striking. Selective dovish remarks of Fed Chair Powell back in July (mulling that a slower pace of tightening may be appropriate "at some time") had sparked an interim summer rally. Now, the unconditional, hawkish pledges to determinedly fight inflation by Fed and ECB officials at Jackson Hole gave equities the final straw into the red in August (benefiting our prudent allocation stance). Powell prepared Americans for "some pain" (weaker economy, less jobs), while ECB's Schnabel predicted a larger "sacrifice" than in earlier tightening periods.



This will also set the tone for the coming weeks. With both the Fed and the ECB underpinning their inflation commitment despite rising economic headwinds, we now look for steeper rate hikes beyond September. Markets' increased rate expectations (pricing +140 bps for the Fed by YE, +160bps for the ECB) have already gone pretty far. But a quick reversal seems unlikely.

Fortunately, there are some silver linings. US GDP is set to bounce in Q3, thanks to the consumer, after two negative quarters. Business surveys show easing price increases; US inflation expectations and prints may be

past peak; agricultural and metals prices have retraced to pre-war levels (in USD terms); supply bottlenecks are easing; and demand destruction is starting to bite, leaving scope for a dovish CB pivot in late autumn.

Yet the US labour market is still red hot, with the Atlanta wage tracker at 6.7% in July. Single month's improvements fall "far short" of what Powell wants to see. In Europe, strong pipeline pressures (PPI +36%yoy), soaring gas and electricity prices and a weaker EUR will dwarf any price relief on selected items.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	3.06	3.15	3.25	3.20
Germany (Bunds)	1.41	1.60	1.65	1.75
Credit Spreads**				
EA IG Non-Financial	182	180	180	170
EA IG Financial	202	200	200	190
Forex				
EUR/USD	1.00	0.99	1.03	1.10
USD/JPY	138	138	130	123
Equities				
S&P500	4096	3925	3980	4090
MSCI EMU	128	123	125	127
*3-day avg. as of 29/08/22 **ICE BofA (OAS)				

Investor positioning remains (very) bearish and still leaves the scope for selected market bounces. But earnings estimates – buffeted by a good Q2 reporting season – still face stiffer headwinds amid an intensifying energy crunch and recession in Europe. Consumers will be less and less inclined to compensate squeezed real disposable income by drawing on excess savings from the pandemic.

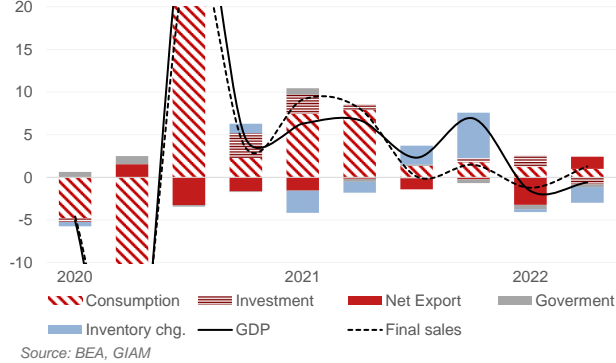
Balance of risks also warrants caution

Also the balance of risks to the macro outlook remains to the adverse side. The war in Ukraine may still escalate further – hopefully not up to a nuclear accident at Zaporizhia's power plant. Europe's gas shortages and price pressures would intensify quickly if NordStream I was not to reopen after the three-day maintenance in early September.

We thus retain an underweight in the riskier portfolio buckets (Equities, HY Credit), while anticipating further resilience in IG Credit. On Government bonds, we avoid stronger duration positions (marginal short). We prefer core European bonds over Southern Europe given the tighter ECB stance and political uncertainties ahead of the Italian elections. The rallying USD is highly valued fundamentally, but the global slowdown and risk aversion may still benefit the greenback tactically (right chart).

Contributions to GDP growth

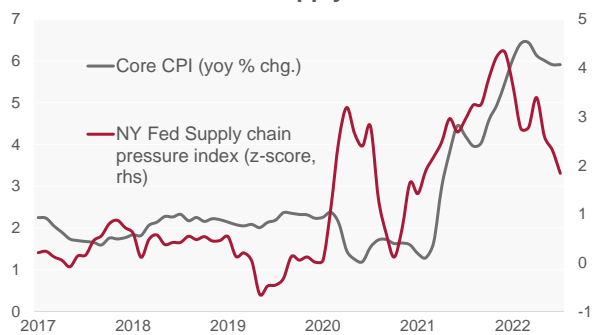
% qoq annualized, seasonally adjusted



- After the dismal H1 figures, GDP is set to rebound in Q3 on higher consumption. We expect GDP to rise by 1.7% this year and 0.7% in 2023. The risk of a recession in H1 2023 is near 50%.
- Low energy prices are cooling inflation, but we expect the core CPI rate to remain well above 4% yoy by year end.
- Following Chair Powell's hawkish Jackson Hole pledge to fight inflation, we raise our Fed rate forecasts, now envisaging another 100 bps this year and 25 bps next despite weakening growth.

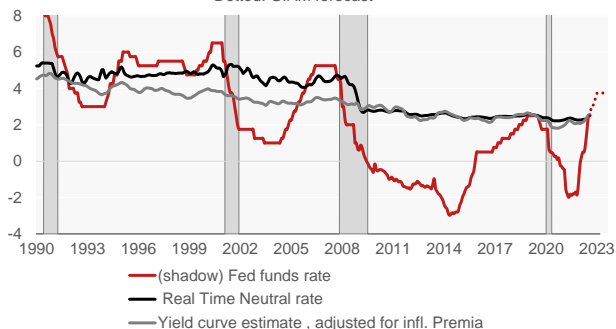
After a dismal H1 growth performance, driven to a large extent by destocking, the early indications for Q3 point to a substantial rebound of activity driven by consumption; however the drag from monetary policy will persist and intensify in Q4 leading to another deceleration in demand. Therefore we expect GDP to grow by just 1.7% this year. Tight money and no further fiscal help will cap growth at just 0.7% in 2023 and we expect for 2024 that it will remain below the 1.8% potential rate. Higher interest rates and the prospects of further tightening are increasing fears of a recession: we think there is a slightly higher than 50% probability of that happening in H1 2023, but the lack of imbalances in the economy should guarantee that it should not last long. Shorter term, the economy will be supported by strong consumption: employment growth has moderated at a still sustained pace (430k new jobs per month in the last months) and the drop in oil prices is boosting confidence. Lower energy prices were driving down headline inflation to 8.5% in July, from 8.9% but the core rate edged down only marginally. The slow unwinding of supply bottlenecks will help reduce inflation, which however will end the year at around 4.5% as shelter prices will continue to rise fast.

Inflation and Supply bottlenecks



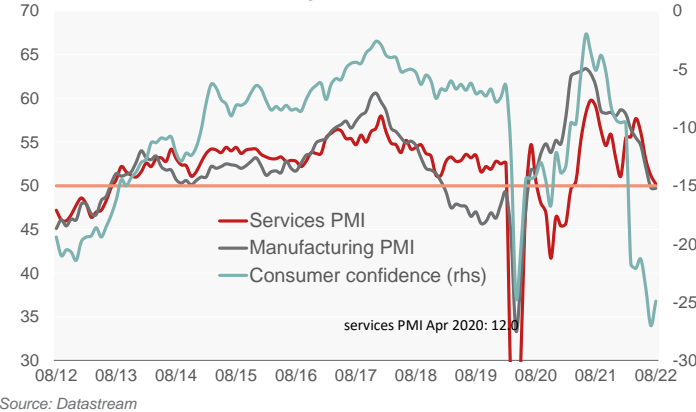
Policy and neutral rate

Dotted: GIAM forecast

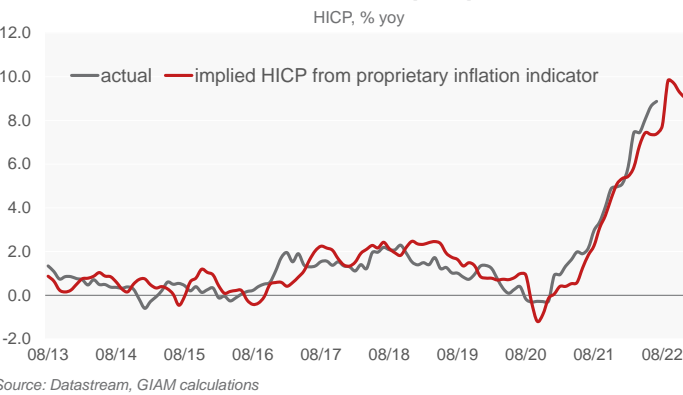


The strong hawkish message delivered by Chair Powell at the Jackson Hole conference dashed market expectations of a sudden U-turn of monetary policy in 2023. Rates will continue to rise and will remain above neutral for long, regardless of the hit to growth that this will entail. Still we think that the indications of a moderation in inflation and the attempt to deliver a difficult soft landing will slow down the pace of hiking. We expect another cumulative 100 bps increase this year, with the Fed funds rate peaking at 3.75 in early 2023. We see the first rate cuts in Q1 2024 at the earliest

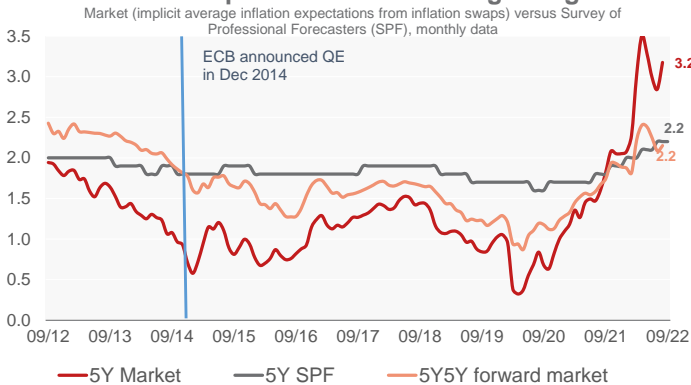
Euro area key sentiment indicators



Euro area inflation prospects



Inflation expectations trended higher again



- There are mounting signs that our expectation of a euro area recession materialises. That said, data hint at a rather shallow contraction.
- There is also indication that inflation will likely peak in Sep./Oct but price dynamics will remain way above the ECB target for longer.
- As Governing Council (GC) members turned more hawkish, we raise our ECB rate forecasts. We look for at least a 50 bps hike at the Sept. 8 meeting with a total of 100 bps increases to follow by year-end.

There are more and more signs that our call of a euro area recession materializes. In July and August the composite PMI readings were below the threshold dividing expansion from contraction. Supply disruptions exacerbated by looming gas shortages and a less supportive global environment will leave their mark. Consumer confidence is still close to its low. That said, the labour market remains in good shape with the unemployment rate at 6.6% while employment continues to be built up. And forward-looking indicators are a mixed bag, not uniformly trending South. We therefore look for a rather shallow recession and see GDP expanding by 2.8% in 2022 and 0.8% in 2023.

While activity risks are clearly on the downside, we think that the peak in headline inflation is ahead. In Sep./ Oct. readings at around 10% yoy are likely but thereafter some moderation is in the offing. Survey-based output prices as well as PPI inflation have come down from its highs but stay elevated. Given the latest gas price rises we again adjusted our inflation forecast up, to 8.1 % (from 7.8%) for 2022 and 4.5% (from 4.4%) for 2023.

Market-based inflation expectations and the Survey of Professional Forecaster's projections all continue to see inflation above the 2% target medium term and some metrics have further deteriorated as of late. Not surprisingly, GC members adopted a more hawkish stance and in her Jackson Hole speech, GC member [Schnabel](#) emphasized the need to act swiftly and decisively to bring inflation down and tame inflation expectations. All other factors like recession risks currently take a backseat. We therefore look for a 50 bps hike at the Sep. 8 meeting and even see the risk of a 75 bps hike. For the remainder of the year we also expect 50 bps hikes lifting the policy rate to 1.5% by year-end which would be the middle of the neutral policy range.

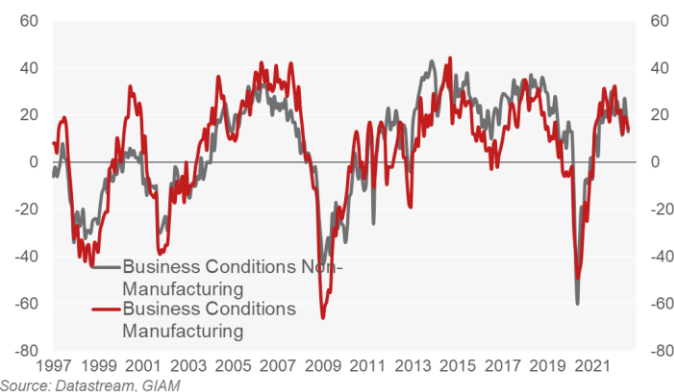
Japan: Real GDP and Private Consumption Growth
qoq, sa



Export and Import Price Index
2015 = 100



Reuters Tankan: 3-month forecast



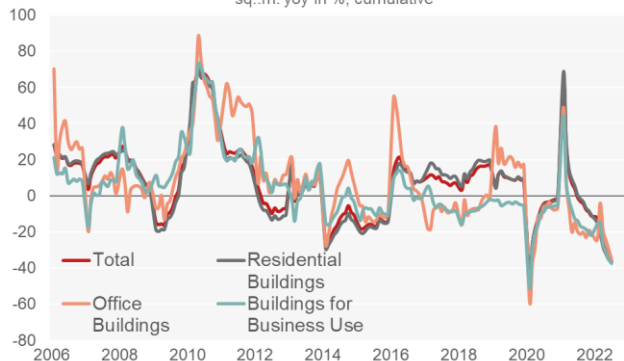
- **Headline CPI inflation has risen to 2.6% yoy but continues to be driven by rising prices for imported energy and goods. Domestic services inflation is likely to remain subdued.**
- **Against this inflation background and softening growth, the Bank of Japan (BoJ) is expected to keep its policy stance unchanged.**

Japan's Q2 GDP growth recovered from the Covid lockdown induced weak (but upwardly revised) result in Q1. It grew by 2.2% qoq annualised (ann.), mainly driven by private consumption and rising capital expenditures, while the contribution from net exports was almost flat and the inventory component a substantial drag. Looking forward, household demand growth is likely to soften but to stay positive for the following reasons. The government currently does not intend to impose fresh Covid restrictions. While the number of new cases is high, Covid seems now less likely to hinder not yet exhausted pent-up demand to materialise. Moreover, although inflation is rising and slightly squeezes real incomes, this effect is small compared to other Western countries. Headline inflation rose to 2.6% yoy while core-core inflation (less food and energy) increased only to 0.4% yoy. In addition, inflation is concentrated in the goods sector (5.4% yoy) whereas services prices diminished by 0.2% yoy. As wage negotiations in spring have resulted in subdued hikes for regular workers (better results for part-time employees), wage pressures in the domestic part of the economy will likely remain very subdued. In fact, (imported) energy prices together with the strong depreciation of the yen are the main inflation drivers. Headline inflation may temporarily come close to 3.5% yoy in autumn and winter. However, on average we see inflation at 2.5% this year and 2.1% in the next.

Exports could well soften, going forward, given the cyclical slowing in the US and Europe but mitigated by the weakness of the yen. Moreover, we expect China's recovery to be more subdued. As private investments follow exports typically with a lag of about two quarters, the recent upturn could also well soften again in the medium term. In sum, we expect growth to stay relatively low but solid with 1.2% resp. 1.4% in this year and the next. The BoJ gave no indication to tweak away from its current stance. We expect a more fundamental overhaul of monetary policy only after Gov. Kuroda's term will have expired in April 2023.

China: Floor Space "Started"

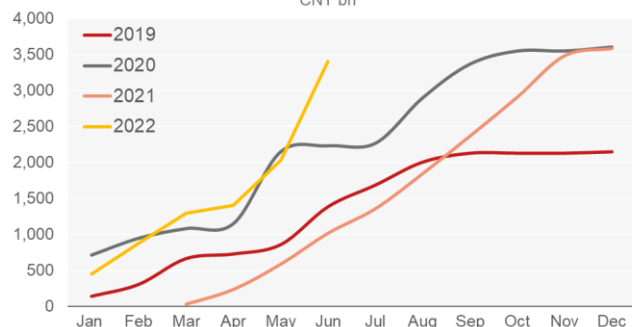
sq..m. yoy in %, cumulative



Source: Datastream, GIAM calculations

China: Local Government Special Bond Issuance

CNY bn



Source: Datastream, GIAM

China: Bank Loans and Money Supply

yoy as %, in bn RMB

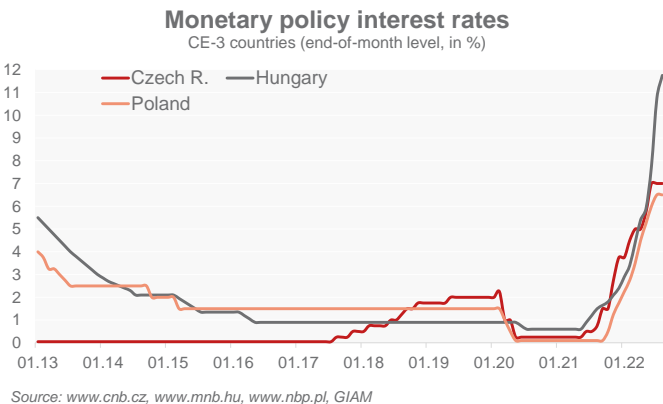
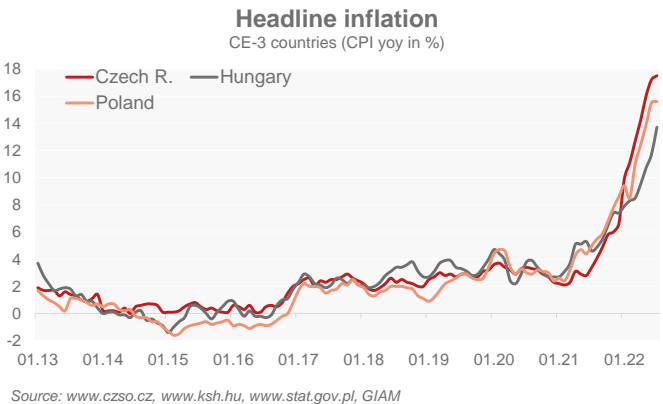


Source: Datastream, GIAM calculations

- China's latest macroeconomic dataset came in on the weak side. The PBoC responded with rate cuts and the government added more stimulus.
- Nevertheless, support still looks underwhelming. This is especially true for the real estate sector. We expect more help as otherwise growth could suffer significantly.
- All in all, we revise down our growth forecast to 2.7% in 2022 (from 3.2% before).

After China had recovered for two months following the severe Covid lockdowns, this acceleration saw a pronounced setback in July. Manufacturing PMIs fell back, IP growth stalled, while retail sales and investment growth diminished. The only positive surprise came from exports (+18% yoy), strongly outpacing import growth (2.3% yoy). There is no single, clear-cut reason for this development but local Covid-related lockdowns (which increased again of late), the headwinds in the real estate sector together with droughts and a deteriorating mood clearly contributed. The jury is still out whether the recovery will resume. Apart from Covid, risks are concentrated in the real estate sector with the property investment slump widening again to -12.3% in July and sales falling to fresh lows. Given the 25% weight of the real estate sector including up- and downstream businesses, stabilisation is urgently needed. A pro-longed real estate crisis could potentially damage the whole economy substantially.

Monetary and fiscal policy responded to the setback, but rather measured. The PBoC cut the 7-day reverse repo rate resp. the 1y MLF rate by 10 bps to 2% resp. 2.75%. The 1y resp. 5y Loan Prime Rates (LPR) diminished by 5 bps resp. 15 bps. As the long-term LPR influences mortgage rates, there is a clear intention to support the property sector. We expect the 1y MFL to be cut by another 15 bps until the end of the year. Fiscal policy set up a special loan program to complete stalled housing projects (RMB 200 bn) and may set up a real estate fund (RMB 200-300 bn) to help developers. Most recently, the government announced a 19 points RMB 1 tr. package (0.8% of GDP) including LGB issuance, infrastructure and energy support. More help will be needed. Given the measures, we deem it still more likely than not that the real estate sector will see some stabilisation, but we expect more delays. Q3 growth is expected to remain rather soft. Therefore, we revise our growth forecast down to 2.7% in 2022 and 5.1% in 2023.



Main Forecasts				
Czech Republic	2020	2021	2022f	2023f
GDP	-5.5	3.5	2.2	1.0
Consumer prices	3.2	3.8	15.7	7.2
Central bank's key rate	0.25	3.75	7.00	4.25
Hungary	2020	2021	2022f	2023f
GDP	-4.9	7.1	5.3	1.5
Consumer prices	3.3	5.1	13.7	11.0
Central bank's key rate	0.60	2.40	12.75	7.75
Poland	2020	2021	2022f	2023f
GDP	-2.5	5.7	4.4	2.6
Consumer prices	3.4	5.1	13.6	9.5
Central bank's key rate	0.10	1.75	7.00	5.75

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

- High inflation, driven mainly by energy prices, keeps the CE-3 central banks vigilant. However, monetary policy rates are probably close to peak in the Czech Republic and Poland (we see the peak at around 7%) while the Hungarian MNB is likely to remain in tightening mode.
- GDP data surprised positively in Hungary and also in Czechia, while disappointing in Poland. High inflation will hit households' real incomes and consumption in H2, which will have negative impact on GDP across the CE-3.

Energy prices are now the key drivers of inflation in the CE-3. This will be visible particularly in Hungary where energy subsidies to households were reduced sharply since August and energy prices jumped significantly. This leads to expectations of further interest rate hikes in Hungary. Both Czechia and Poland reported only slow acceleration of annual inflation in July and their central banks are very likely at the peak of their hiking cycle (we see it at 7% in both cases). The Czech CNB remains present in the FX market where it intervenes in order to oppose the CZK weakening.

The Czech CNB left its key rate unchanged at 7% in August. This was the first on-hold decision since the start of the tightening cycle in June 2021. The August meeting was the first one after the personnel changes in the CNB Board that took place in July. The new Board prefers unchanged rates for the rest of 2022. Such scenario is supported by the forecast presented by the CNB, which projects that the key rate reached its peak at 7% and rate cuts should follow in 2023.

In Hungary, the MNB raised its base rate by 100 bps to 11.75% in late August and more rate hikes seem to be in the pipeline. Reduction in energy subsidies should result in a sharp acceleration of inflation from August onwards. The MNB will tighten its policy further in order to reduce inflation expectations. However, we think that the key rate may find its peak close to 13%, as high energy cost will have negative impact on real disposable income, household consumption and GDP performance in general.

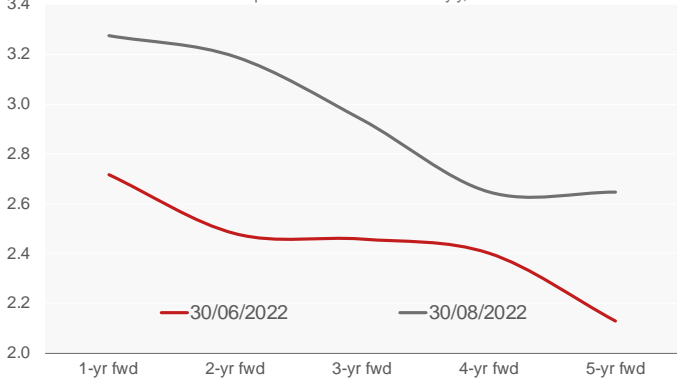
The Polish NBP raised its key rate by 50 bps to 6.50% in July. The next decision is due on September 7 when we expect a hike to 7.00%. This could be the peak for the key rate in a situation where Polish GDP fell sharply in Q2 (-2.3% qoq). Headline CPI (15.6% yoy in July) may be also close to its peak as the government is extending efforts to cap the growth in energy prices.

Government Bonds

Florian Späte

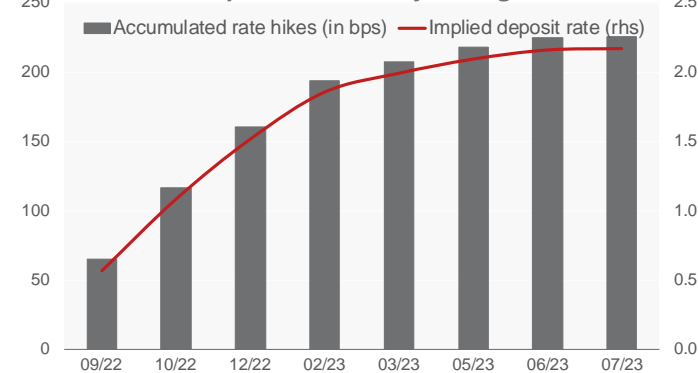
US: Much less benign inflation outlook

Market implied annual CPI inflation y/y, in %



Source: Bloomberg, GIAM calculations

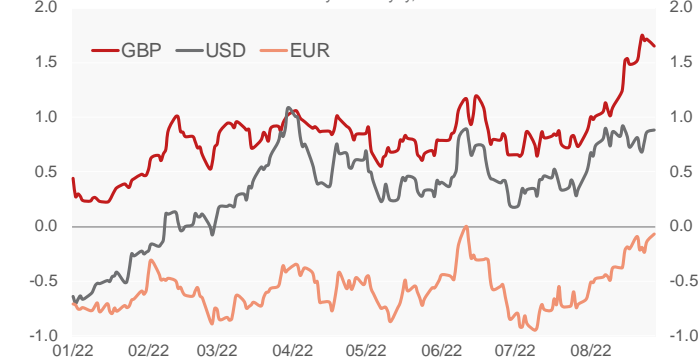
Implied ECB Policy Change



Source: Bloomberg, GIAM calculations

Central banks to become restrictive

OIS 1y3m / 5y5y, in %



Source: Bloomberg, GIAM

- Driven by new inflation concerns and another hawkish twist by central banks international government bond yields surged over summer again.
- In view of our adjusted key rate expectations, we also raise our yield forecasts. However, we continue to expect that the peak in the US is not far off. On the contrary, Bund yields still have further upside potential even in the medium term.
- The ECB's announcement of the TPI has had a dampening effect on intra-EMU government spreads so far. Going forward, political risks and weaker growth are likely to take their toll. We see some upside potential for EA non-core government bond spreads.

The inflation outlook has clouded noticeably over the course of the summer. Particularly, sky-rocketing gas prices pushed inflation expectations upwards across countries. It is noteworthy that the US could not escape this trend although it is less dependent on Russian gas than Europe. While at the end of June a return of US annual inflation rates in the vicinity of 2% was priced, financial markets now see inflation well above the target even in the middle of the decade (see top chart). In the EA short-term inflation expectations increased as well and the peak (to be reached in autumn) will be higher than forecast before, but the medium-term outlook is still solid with annual inflation to settle slightly above 2% from 2024 onwards. It is worth noting that EA inflation expectations are still rather well anchored considering the euro below parity contributes to higher inflation as well.

This may also be due to the fact that key rate expectations were once again corrected significantly upwards – particularly in the EA. While at the end of July a deposit rate of around 1% was priced for mid 2023 it is now markedly above 2% and financial markets expect the key rate to remain around that level in the years to come. The peak rate in the US moved upwards as well (to around 3.75%) but more crucially, unlike in spring, only a small key rate cut is priced until the end of 2023 (“higher for longer”).

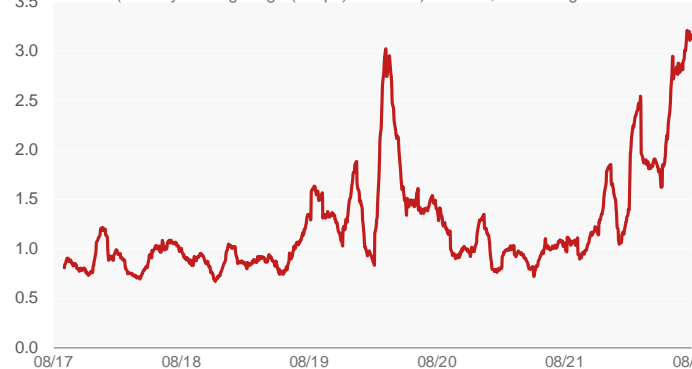
We consider the currently priced key rate expectations to be largely appropriate in view of the central banks' statements and adjust our yield forecast accordingly. Compared to the last issue of the Market Perspectives, we raise the 10-year Bund yield forecast in particular

Government Bonds

Florian Späte

Bund Future: Deteriorating Liquidity

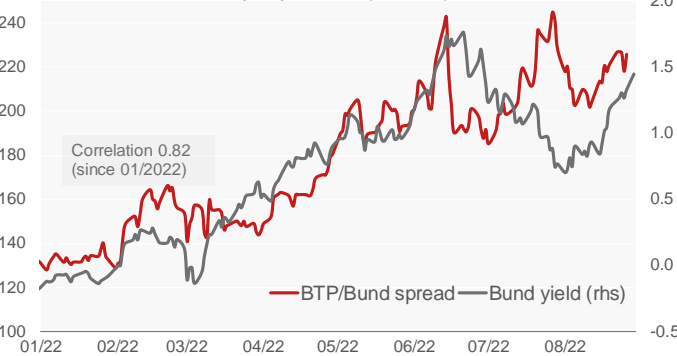
(Intraday trading range (in bps) / volume) x 10000, 1m average



Source: Bloomberg, GIAM

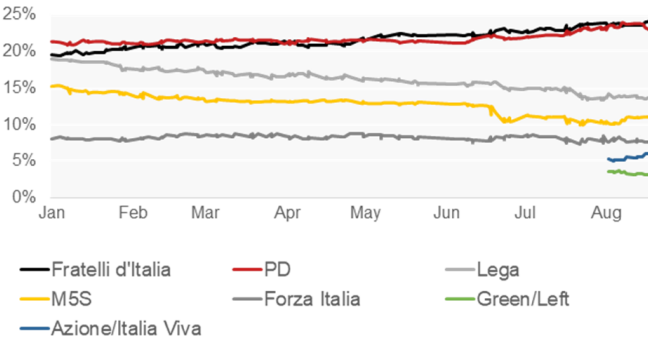
Bunds driving BTP spreads

10-year yield in %, spread in bps



Source: Datastream, GIAM calculations

Italy: Electoral Polls



Source: Europe Elects, GIAM

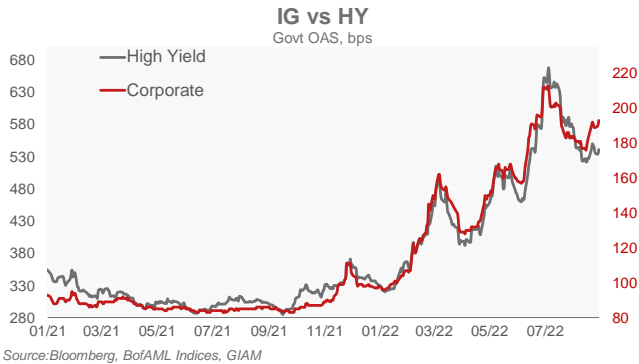
to 1.75% on a 12-month horizon.

One reason why we are not raising the forecast even more is that the low liquidity in summer has likely contributed to the recent increase. This should unwind again in the weeks to come. Our 12-month forecast is still below the 5y3M OIS rate of more than 2% which can usually be seen as a medium-term target for long-dated Bund yields. Moreover, 10-year real Bund yields are trading only around -0.90%. This is 55 bps below the level marked in June and leaves some upside potential. The US real yield level, which is noticeably below the peak as well (0.5% vs. 0.8%), also shows that the recent rise in nominal yields is not due to more positive growth expectations, but to a more pessimistic inflation outlook. Regarding US yields, we maintain our view that further upside potential is limited and the peak will likely be reached in Q1 2023.

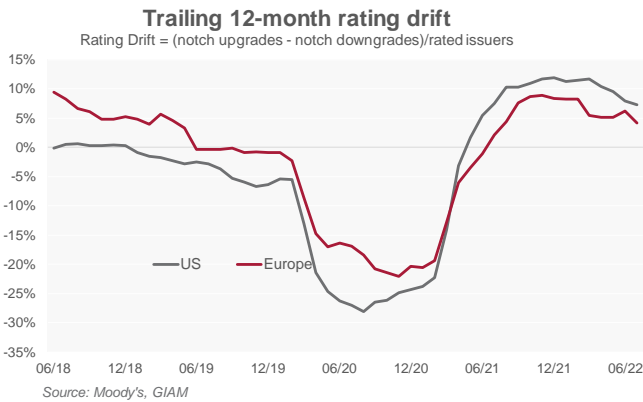
Long-term EA non-core bond spreads widened moderately in August. This development was broad-based and applied to all countries (hence, no idiosyncratic widening due to political instability in Italy). Overall, the announcement of TPI has served its purpose so far and short-dated spreads even tightened slightly. Moreover, the ECB has followed its words with action and supported non-core bonds by reinvesting redemptions particularly in non-core bonds in July. Nevertheless, we remain cautious as higher core yields in the wake of weaker growth in combination with the need to fund energy subsidies is an unfavourable mix for spreads. Redirecting redemptions in non-core bonds will not be sufficient in case of serious stress.

This applies even more as the forthcoming elections in Italy (September 25) will likely result in a right-wing government. Although the possible future Prime Minister Meloni argues that a new government would ensure stable public finances this is at least questionable in view of the plan for more fiscal spending. An activation of TPI because the government does not adhere to the EU Council' guidelines seems out of question. However, given the internal differences it is questionable whether a lasting government will be formed at all.

Finally, rating risk is back. Both, S&P and Moody's (rating already at Baa3) downgraded Italy's outlook to stable and negative, respectively. Although we see no immediate eligibility risk BTPs still appear dear relative to corporate bonds. This makes them vulnerable and we see leeway for a moderate spread widening.



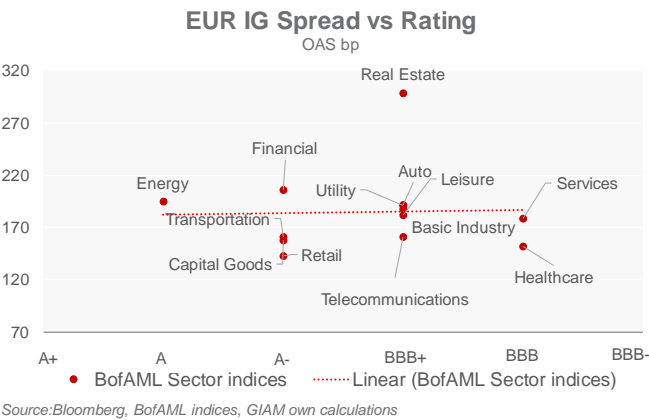
- In August, credit markets started to erase the strong tightening seen in July on the back of lower rates and of the inclusion of credit into the ECB anti-fragmentation tool. IG spreads will remain resilient, but HY appears vulnerable near term on the back of the rapid monetary policy normalisation.
- The reporting season confirmed our expectations of a modest deterioration of corporate fundamentals over the coming months.
- A key market driver this month will be the release of the details of the ECB climate policy that will apply to its still sizable corporate purchases.



After a strong tightening in July the hawkish message delivered by monetary policy makers since Jackson Hole has already started to cause some widening in August. We do expect risky assets in general to remain under pressure near term, and credit will make no exception to that in particular if talks about quantitative tightening intensify.

Decompression trade still on

Hence, we do prefer IG to semi-core and peripheral sovereigns. IG levels are currently incorporating a severe recession scenario. We expect spreads to tighten moderately from current extreme levels into year-end. For HY, we are more cautious as we think corporates will feel the pressure of the economic slowdown that has not yet been reflected in companies' earnings during the last reporting season. IG spreads are also wider versus their long-term average compared to HY. This is mostly because the HY primary market has been extremely quiet since the invasion of Ukraine.



A key idiosyncratic driver this month will likely be the release of the climate strategy from the ECB. They have announced that their credit purchases will be adjusted according to climate criteria. Even after the end of the QE in July, the reinvestments in private bonds are sizable and the antifragementation tool could also incorporate a climate twist. In Europe so far, it is mostly the Energy sector that was trading at a premium compared to its rating on the back of its poor ESG profile. We do expect this ESG premium to grow and become more broad-based over the coming months. This may further contribute to the reduction of the greenium, as the focus is gradually shifting from the instrument to the issuer.

EM sovereign bonds

Guillaume Tresca

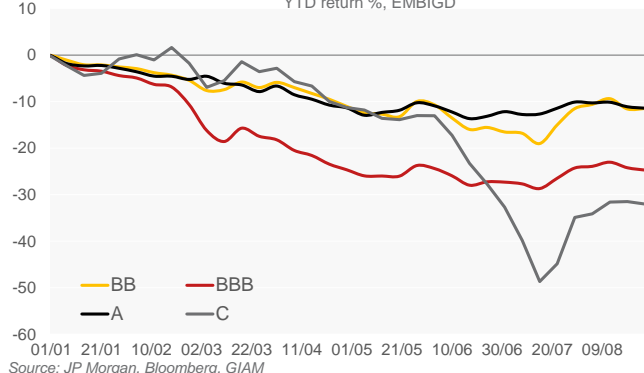
HY compression to end

EMBIGD spread, bp



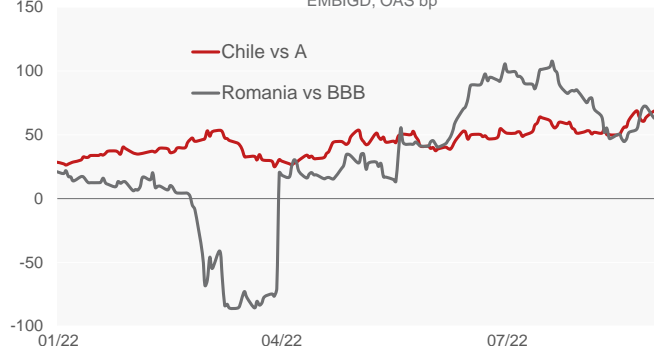
Strong BB performance to fade

YTD return %, EMBIGD



Romania and Chile performance

EMBIGD, OAS bp



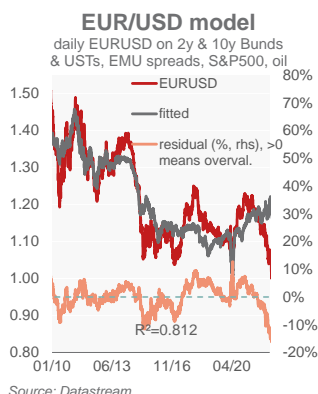
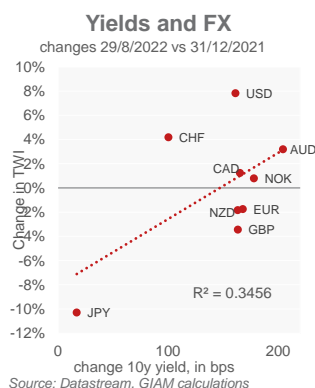
- The EM outlook remains challenging, still facing multiple headwinds. We expect spreads to widen by year-end in a very volatile environment.
- We maintain a defensive stance and still favour IG over HY. Issuance will negatively weigh on BBs.

Despite the summer spread compression, the EM outlook remains challenging, with multiple headwinds that have barely eased. The rally was driven by the false impression of a dovish Fed pivot, and the Jackson Hole symposium has reaffirmed the risk for higher and longer real rates and a strong USD. We note a disconnection between the EM fundamentals and the July/early August spread rally, so the post-Jackson Hole widening move should pursue in the month ahead. As long as a significant EM growth improvement does not occur, the case for spread tightening is low and volatility will be high. The only positive development has been the decline of the inflation dynamic across EMs, which would need to be confirmed. That being said, we maintain an OW for EM bonds in our global asset allocation, given the absolute high carry at its highest level since the GFC.

Stay defensive – mind the decompression

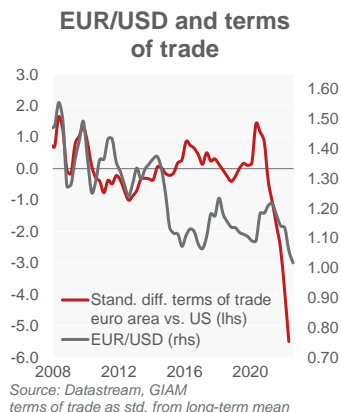
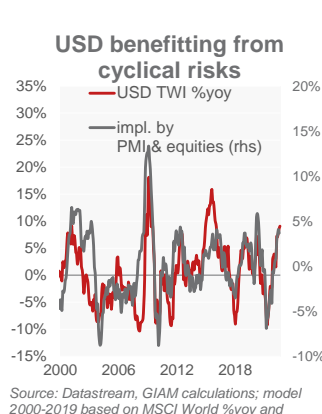
We maintain a defensive stance within an uncertain environment and still favour IG over HY. The recent rally of the HY segment is a good entry point to re-initiate defensive positions. More globally, the HY segment is optically cheap with a wide dispersion among names. EM HY has eventually not performed so strongly over the summer, more driven by global factors than pure idiosyncratic EM factors. Indeed, the recent EM HY performance aligns with the US HY sector. In addition, EM funds continue to maintain an OW HY stance, and a new bout of risk aversion will lead to underperformance. The technical backdrop should weigh on HY, too, as BB names will have to come to the primary market before year-end, especially in September. EM HY has only issued c. USD19bn so far vs. USD40bn expected. New issuance concession will be high.

In the IG space, we still like Romania, where fiscal numbers improved in Q2. EU fiscal transfers still provide a significant anchor. Despite tight fiscal fundamentals and less risk for a downgrade, Mexico keeps trading wide vs. its rating. Chile outperformed in Q2, but we will wait for the upcoming Constitutional referendum. In CEE, the energy problem will gain momentum, and it will penalise Hungary.



- Even after hitting fresh records, USD strength has scope to extend somewhat further, boosted by the global slowdown and the European energy crunch in particular.
- After breaking parity with the EUR, the CHF may look dear at face value – but much less so if inflation differentials are taken into account. The SNB embraces a stronger CHF in curbing price pressures, boding well for the Swiss currency.

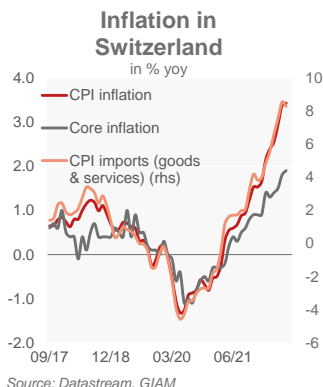
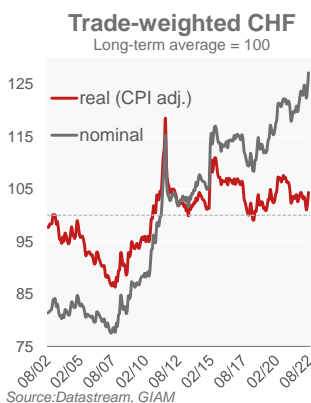
The USD keeps hitting fresh century records, (temporarily) breaking through EUR/USD parity and settling in the upper 130s on USD/JPY. The USD is unambiguously dear. Its real effective value is 20% above the longer-term average and it has significantly overshot levels implied by yield divergence. Against the EUR, it is exceeding values consistent with long-standing financial correlates by 16% (top charts).



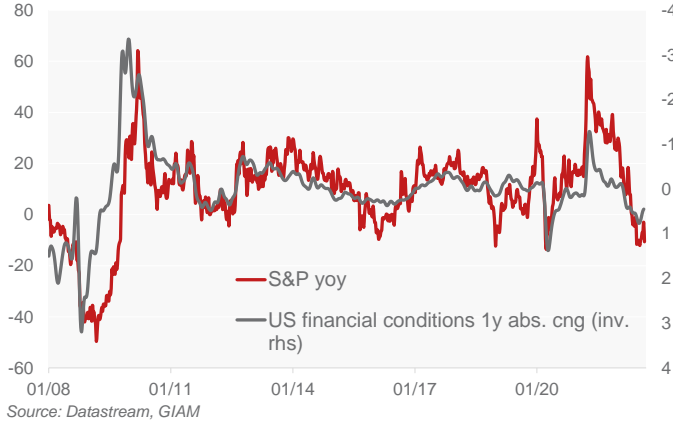
Yet persistent global cyclical and risk headwinds keep backing the anticyclical USD for now (mid-left chart). Admittedly, further gains may be more limited as other major central banks are playing catch up. The BoJ is the big exception, keeping the outlook for the JPY subdued near term until the case of a policy change may strengthen into 2023. We markedly upgraded our ECB rate forecasts though (see EA section), but as this hawkish tilt exacerbates the risk of a deeper EA recession, the benefits to the EUR will be small. Also, the euro is suffering from the sizeable term-of-trade shock on soaring energy import bills (mid-right chart). Political uncertainties in the run-up to Italian elections will neither help. We stick to our [bearish near-term view](#) for EUR/USD and now expect it to settle below parity for somewhat longer amid the looming recession and energy crunch in Europe.

CHF to benefit from euro area trouble

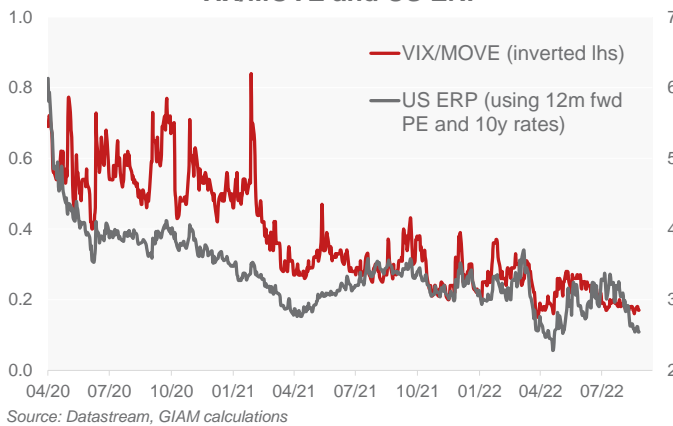
We maintain our constructive view on the CHF. A troubled euro area tends to underpin the Swiss currency. Admittedly, the CHF is dear, both vs. yield divergence (top-right chart) as well as in nominal trade-weighted terms (bottom-left). Yet the real effective (inflation adj.) CHF looks far less exuberant, as inflation in Switzerland (while rising) is by far better under control (core CPI still <2%) than in the euro area. At the same time, the SNB has turned more tolerant about a strong CHF as it helps to contain imported inflation as a main driver of overall price pressures. So even after EUR/CHF broke parity, we anticipate more CHF tailwinds over the coming weeks.



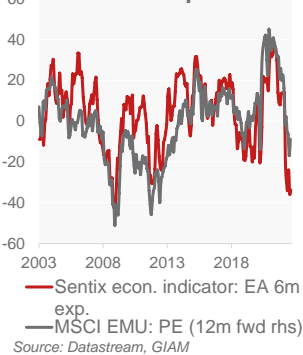
US financial conditions and S&P



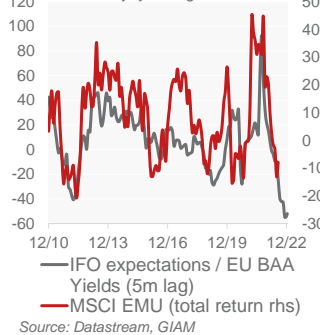
VIX/MOVE and US ERP



EMU: PE and Sentix 6m exp.



EMU valuation proxy: IFO exp. / BAA yields yoy changes



- The Fed signaled yields to stay higher for longer. In this situation, the market may be tempted to price in a more severe economic slowdown.
- Short-term, we see PEs to be pressured by low confidence and a resumed deterioration in financial conditions.
- We stay underweight on equities but still expect slightly positive total returns in 12 months.
- Within countries, we overweight UK versus EMU and are neutral on Japan, while adopting an UW on Switzerland. We remain neutral on EMs.
- Sector overweights: durables, div. financials, energy, food, healthcare equipment (new) and software. Underweights: capital goods, comm. services, insurance, media, pharma, RE, and transportation. Style bets are on Defensives and Growth/Value.

In the first half of August, stock markets rallied, being supported by improving financial conditions. This is not to continue as the Fed recently signalled to undertake everything in their power to combat high inflation, thus also indicating that yields are to remain high for longer. In this situation, the market may be tempted to price in a more severe economic slowdown, with equities suffering, especially over the next 3-6 months.

Furthermore, we see PEs to derate due to low confidence and a resumed deterioration in financial conditions. Earnings eps dispersion is trending down, just like the bond volatility (MOVE) and VIX/MOVE: all leading to downward pressure on the ERP. Global growth momentum will likely continue fading, which market has yet to discount. So far, Q2 earnings held well but macro surprises are falling and both real income and global activity deteriorate.

Decent Q2 season: seeds to future lower growth

The Q2 reporting season (almost over) in the US was a decent quarter with earnings surprise at 4%, which is close to the historical average (ca. 5%). With the surprise average over the last 9 quarters being at 13%, Q2 is trending to a more sustainable lower number. European companies have continued to deliver stronger earnings than expected by analysts (surprise of 10%). Overall, as Q2 GDP was very much subdued, so did eps growth of corporates ex-energy. Thus, weighted average of sectors ex energy was only slightly positive (+0.3%) in the US (+7.5% for Europe).

Analysis of the median stock: Q2 2022 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q1 2022	Q2 2022	Q1 2022	Q2 2022	Q1 2022	Q2 2022	
S&P	11.2 %	9.1 %	10.2 %	9.1 %	1.0 %	0.0 %	97.4%
Stoxx	16.0 %	9.6 %	15.2 %	16.1 %	0.7 %	(6.5)%	91.0%
Euro Stoxx	17.0 %	11.7 %	15.2 %	15.7 %	1.8 %	(4.0)%	92.7%
Topix	6.1 %	7.8 %	5.8 %	8.7 %	0.3 %	(0.9)%	95.6%

Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q1 2022	Q2 2022	Q1 2022	Q2 2022	Q1 2022	Q2 2022	
S&P	5.0 %	4.0 %	1.5 %	1.4 %	3.5 %	2.6 %	97.4%
Stoxx	7.6 %	3.3 %	2.4 %	2.8 %	5.2 %	0.5 %	91.0%
Euro Stoxx	7.6 %	4.9 %	2.6 %	3.7 %	4.9 %	1.3 %	92.7%
Topix	9.5 %	13.4 %	1.2 %	1.9 %	8.3 %	11.6 %	95.6%

Note: margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations

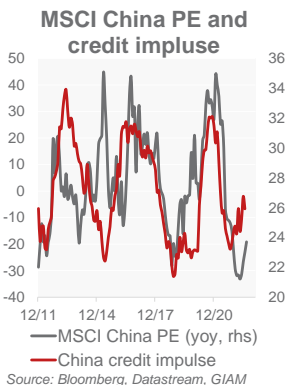
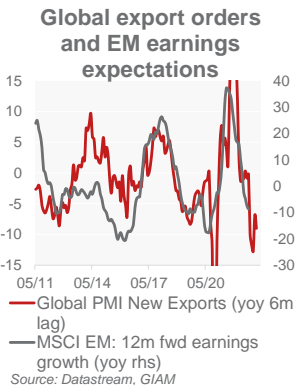
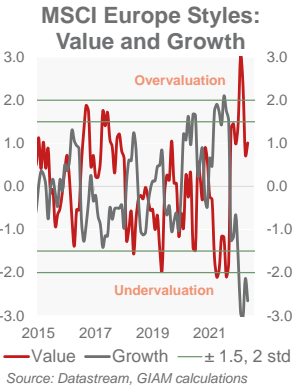
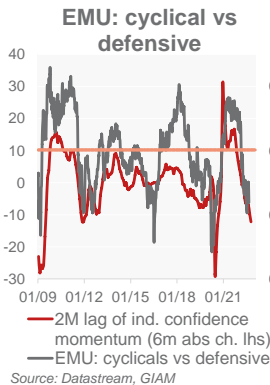
The margins trend is down but mostly due to high sales growth. Banks pushed up cost of risk in order to be more cautious (precautionary attitude). CPI/ULC 1-year change is going down and should lead NIPA margins downward by 1-2pp in 1 year. ISM new orders is signalling 12-month eps momentum (3m change) to break the zero line soon. Capacity utilization momentum is trending down, too, usually correlated to ROE and margins (to trend lower). Global revisions (MSCI World) are in negative territory for the first time since 2020 but yoy changes of revisions are already very low, near a cyclical through, so we could see some relief short term also because the market already discounted a big EPS slump in the months before. Overall, we see declining EPS momentum in progress. We expect margins to continue staying under pressure and see earnings deterioration ahead, thus maintaining our earnings forecast below analysts' expectation in 2022, 2023 and 2024.

Recommended allocation

Within countries we continue to set on UK vs. EMU, remaining neutral on Japan, and UW on SMI. EMU equities start to look attractive vs US ones: better internal country score, higher results from our short-term models as well as slightly better adjusted PEG ratio (1.7 vs 1.75). Given the still dormant gas supply related risks, we prefer to remain neutral on EMU vs US. As for sectors, we decrease an UW for RE, following the recent significant underperformance, and go OW on Healthcare Equipment. According to our machine-learning models, the sector looks significantly undervalued now (Z-score of 4.2), while earnings revisions are about to turnaround. Other OWs are durables (lower), div. financials, energy, food, and software. The sectors on UW are capital goods, comm. Services (higher), insurance, media, pharma and transportation. We continue to implement a small overlay to our sector allocation with style bets: OW Defensives and Growth/Value.

EM: neutral. Pressure from falling macro surprises

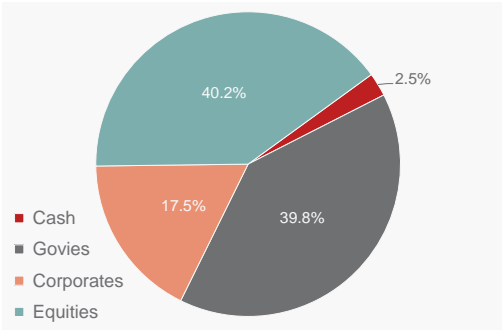
EMs are to be pressured by falling macro surprises and decreasing exports orders in the short-term. Beyond, valuation gap, higher long-term earnings growth (vs DMs) and increased yield gap vs US HY could trigger an extended EM outperformance. Last week, the State Council in China increased its policy easing measures. We continue to overweight Chinese equities, while recognizing the need to monitor risk related to China's property market.



Asset Allocation

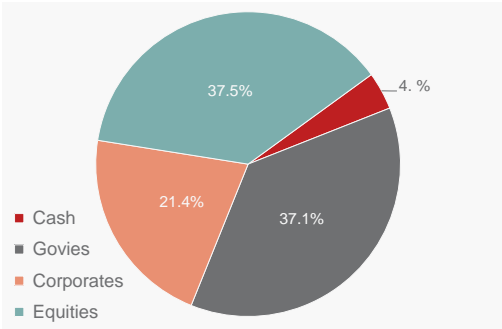
Thorsten Runde

Benchmark



Source: GIAM

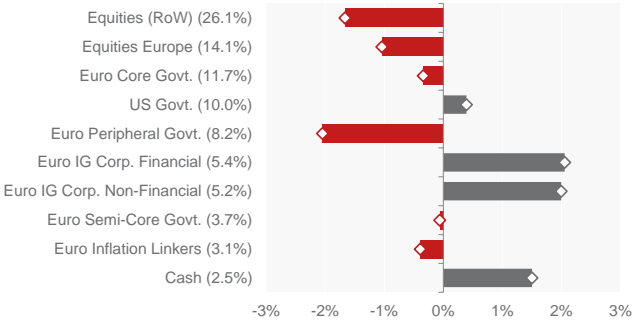
Modelportfolio



Source: GIAM

Active Positions

TOP 10 Benchmark Constituents



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

- Apart from the MSCI EM all other actively covered asset classes fell back into negative territory over the course of August (29.08.22).
- Of course, the MSCI EM also marks the top position in the performance ranking with +1%, followed by Cash (-0%) and the MSCI Pacific (-0.1%). The rear positions are occupied by long-dated govies, ranging from -5.1% for US Treasuries to -9.5% for Spanish Bonos.
- In the Credit segment EA IG non-fin and fin reveal similar performance figures with -3.8% and -3.3% respectively. HY clearly outperformed IG by roughly +320 bps.
- The most recent hawkish statements of senior central bank officials increased investor worries about significant rate hikes and a looming recession. Thus, the circumstances remain unfavourable for equities and long-dated bonds.
- We recommend maintaining the UWs in Equities and peripheral debt. We still avoid HY while keeping an OW in IG. We confirm our preference for Cash and shorter dated bonds.

In August (29.08.22), the relative performance of our model portfolio was +8.7 bps, thus at least partly compensating for the previous month's losses. This result is mainly achieved through the right positioning in government bonds and cash which together accounted for a good +15 bps. In particular, underweighting medium-to long-dated govies for the benefit of the short-dated ones paid off very well. Apart from the MSCI EMU all equity markets remained in the camp of the outperformers so that the overall underweight position continued to hurt (-1.6 bps). The significant correction in EA IG Credit while EA HY staying basically flat caught us on the wrong foot. Being optimally positioned for the oppo-site, we lost -4.2 bps here.

Maintain risk-off mode for the time being

Central bank officials and their recent hawkish statements are setting the mood in the financial markets. More significant interest rate hikes than have been priced in so far are in the cards dampening the risk-appetite. All-in, rising yields and a looming recession clearly weigh on risk-assets in general and on long-dated bonds. Thus, we confirm our tactical risk-off positioning. We maintain the UWs in Equities and peripheral debt. On the credit side we still avoid HY while keeping an OW in IG. We confirm our preference for Cash and short-dated bonds.

FORECAST TABLES

Forecast tables

Growth ¹⁾	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.7	1.7	0.0	0.7	- 0.0	1.5
Euro area	5.3	2.8	- 0.0	0.8	- 0.1	1.8
Germany	2.6	1.4	- 0.1	0.0	- 0.7	1.5
France	6.8	2.5	0.1	1.0	- 0.2	1.5
Italy	6.6	2.8	- 0.2	0.6	- 0.5	1.4
Non-EMU	6.4	3.2	0.1	0.3	- 0.2	1.6
UK	7.4	3.5	0.1	- 0.3	- 0.4	1.5
Switzerland	3.7	2.5	0.0	1.5	0.3	1.8
Japan	1.7	1.2	- 0.2	1.4	- 0.2	0.8
Asia ex Japan	7.8	3.9	- 0.7	4.9	- 0.2	5.1
China	8.1	2.7	- 1.0	5.2	- 0.2	4.8
CEE	6.7	0.8	2.5	1.4	0.8	3.5
Latin America	6.6	2.2	0.0	1.6	0.0	2.4
World	6.4	2.9	- 0.1	2.6	- 0.0	3.2

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

Inflation ¹⁾	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	4.7	7.5	- 0.6	3.6	- 0.2	2.3
Euro area	2.6	8.1	0.3	4.5	0.4	2.0
Germany	3.2	8.6	1.1	6.0	1.8	1.9
France	2.1	6.3	0.8	3.2	- 0.0	1.8
Italy	2.0	7.0	0.0	3.5	0.4	0.6
Non-EMU	2.3	8.1	0.6	6.9	2.2	1.8
UK	2.6	9.6	1.0	8.8	3.2	1.9
Switzerland	0.6	2.7	- 0.0	1.8	0.2	1.2
Japan	- 0.3	2.5	0.5	2.1	0.7	0.9
Asia ex Japan	2.0	3.8	0.1	3.2	0.0	2.6
China	0.9	2.4	0.0	2.2	- 0.3	2.0
CEE	9.3	29.7	- 0.3	16.8	3.3	7.9
Latin America ²⁾	6.6	8.0	1.1	4.5	0.6	3.3
World	3.5	7.8	0.1	4.8	0.5	2.9

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

Financial Markets

Key Rates	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
US	2.50	3.25	3.55	3.50	3.79	3.75	3.51
Euro area	0.00	1.00	1.11	1.50	1.67	2.00	2.02
Japan	-0.10	-0.10	-0.02	-0.10	0.01	0.00	0.08
UK	1.75	2.75	3.05	3.00	3.77	3.00	4.09
Switzerland	-0.25	0.75	0.44	1.00	0.88	1.25	1.29
10-Year Gvt Bonds							
US Treasuries	3.06	3.15	3.09	3.25	3.09	3.20	3.11
Germany (Bunds)	1.41	1.60	1.45	1.65	1.50	1.75	1.53
Italy	3.58	3.95	3.74	4.05	3.81	4.20	3.93
Spread vs Bunds	217	235	228	240	232	245	240
France	2.02	2.20	2.08	2.25	2.14	2.35	2.23
Spread vs Bunds	61	60	62	60	65	60	70
Japan	0.23	0.25	0.28	0.25	0.32	0.35	0.39
UK	2.61	2.80	2.68	2.80	2.70	2.75	2.76
Switzerland	0.83	0.95	0.83	1.00	0.84	1.10	0.87

*3-day avg. as of 29/08/22

**ICE BofA (OAS)

Credit Spreads**	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
EA IG Non-Financial	182	180		180		170	
EA IG Financial	202	200		200		190	
EA HY	538	560		575		550	
EM Sov. (in USD)	382	440		440		400	
Forex							
EUR/USD	1.00	0.99	1.01	1.03	1.01	1.10	1.02
USD/JPY	138	138	136	130	135	123	132
EUR/JPY	137	137	137	134	137	135	135
GBP/USD	1.18	1.15	1.18	1.18	1.18	1.25	1.18
EUR/GBP	0.85	0.86	0.85	0.87	0.86	0.88	0.87
EUR/CHF	0.96	0.95	0.96	0.97	0.96	1.03	0.96
Equities							
S&P500	4,096	3,925		3,980		4,090	
MSCI EMU	128.2	123.0		125.0		126.5	
TOPIX	1,967	1,875		1,915		1,965	
FTSE	7,445	7,160		7,255		7,380	
SMI	10,968	10,480		10,660		10,780	

3-Months Horizon*

10-Year Gvt Bonds	Germany (Bunds)	0.91	1.60	2.29
	US Treasuries	2.76	3.15	3.54
	Japan	0.19	0.25	0.31
	UK	2.26	2.80	3.34
	Switzerland	0.37	0.95	1.53
Equities	MSCI EMU	117	123	129
	S&P500	3,722	3,925	4,128
	TOPIX	1,785	1,875	1,965
	FTSE	6,866	7,160	7,454
	SMI	9,929	10,480	11,031
Forex	EUR/USD	0.97	0.99	1.01
	USD/JPY	135	138	141
	EUR/GBP	1.13	1.15	1.17
	EUR/CHF	0.93	0.95	0.97

12-Months Horizon*

10-Year Gvt Bonds	Germany (Bunds)	0.57	1.75	2.93
	US Treasuries	2.48	3.20	3.92
	Japan	0.22	0.35	0.48
	UK	1.83	2.75	3.67
	Switzerland	-0.03	1.10	2.23
Equities	MSCI EMU	115	127	138
	S&P500	3,700	4,090	4,480
	TOPIX	1,770	1,965	2,160
	FTSE	6,764	7,380	7,996
	SMI	9,787	10,780	11,773
Forex	EUR/USD	1.05	1.10	1.15
	USD/JPY	117	123	129
	EUR/GBP	1.20	1.25	1.30
	EUR/CHF	1.00	1.03	1.06

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

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