

Market Perspectives

Walking the talk, for now

GIAM Macro & Market Research

June 2022



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- Left far behind the curve by surging prices, major central banks are playing catch-up. This reins in inflation worries, but fuels growth concerns.
- A recession is not (yet) around the corner. But worries about weaker economic and earnings growth keep risky assets on the defensive.
- Central banks for now will walk their hawkish talk. But the upside for yields is limited from here, as self-correcting mechanisms (risks to growth and financial stability) are kicking in.
- The Fed should turn less hawkish by late summer, which may then revive the appetite for risk.

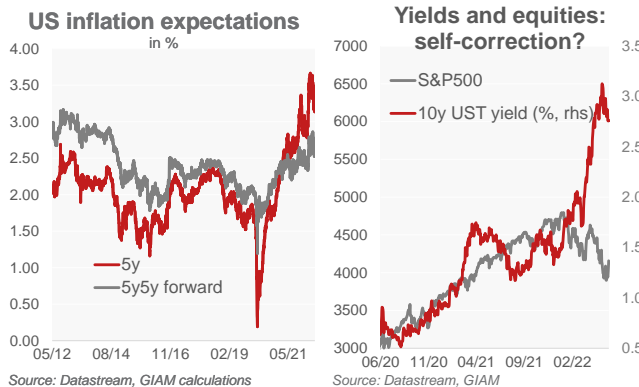
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- A recession is not (yet) around the corner. But worries about weaker economic and earnings growth keep risky assets on the defensive.
- Central banks for now will walk their hawkish talk. But the upside for yields is limited from here, as self-correcting mechanisms (risks to growth and financial stability) are kicking in.
- The Fed should turn less hawkish by late summer, which may then revive the appetite for risk.

Global risk assets are still fighting a triple blow from the Ukraine war, central banks' rushed tightening and Chinese lockdowns. US equities saw their longest series of weekly declines since 2001 through mid-May, before rebounding on Chinese stimulus hopes and robust US consumption data towards the end of the month.

Yet significant shifts in market themes are underway. For most of 2022, inflation worries – stoked by high commodity prices, supply bottlenecks and labour shortages – have pushed rates up and risk assets down, reversing market correlations dominating since the mid 1990s.



Yet, as we have [argued in the past](#), the upside for yields is now running into self-correcting mechanisms. Much of the global price increases are owing to supply side issues central banks cannot control. The Fed, ECB & Co still need to show their teeth to prevent rising inflation expectations from turning into a wage-price spiral and persistent price overshoots. Reassuringly for policy makers, inflation swaps have flattened out.

This comes at the costs of lower growth prospects. As the war in Ukraine rages, high energy and food prices curb real disposable income whilst China chokes off

growth amid a desperate zero-Covid crackdown, fears of a more severe slowdown have moved to the forefront.

A recession is not yet around the corner, as households in Europe and the US enjoy strong labour markets, consumers can draw on large excess savings while corporate balance sheets look far from stretched. Yet reeling US retailers (Walmart and Target suffering from piles of unsold stock) and sharply trimmed sales expectations of tech and media firms (incl. Snap and Netflix) show that the outlook for margins and profits has soured. The Bank of England was the first major central bank to show an outright 2023 contraction of activity in its May projections.

Bonds	27/05/22*	3M	6M	12M
10-Year Treasuries	2.75	2.85	2.90	2.95
10-Year Bunds	0.97	1.05	1.10	1.20
Corporate Bonds				
BofaML Non-Financial	163	140	140	130
BofaML Financial	171	145	145	135
Forex				
EUR/USD	1.07	1.06	1.09	1.12
USD/JPY	127	127	125	120
Equities				
S&P500	4065	4105	4285	4250
MSCI EMU	134	135	140	137

* avg. of last three trading days

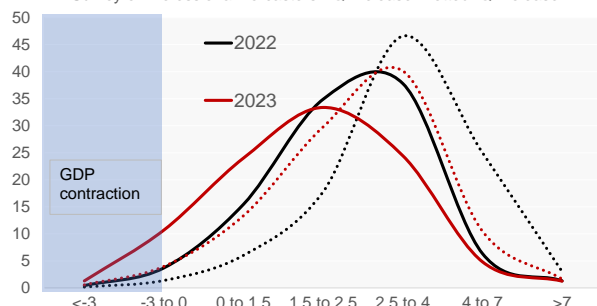
Prudent exposure to risk assets

Markets have already discounted a lot of bad news in its recent retreat – both in terms of global slowdown and CB hikes – while positioning seems overly bearish on some yardstick. Yet amid ongoing geopolitical risks (NATO/Russia, Taiwan), steep monetary tightening and slowing growth, we maintain a small underweight in equities and cut our HY exposure to neutral. We look forward to reload some more risk by late summer, if the Fed then starts turning less aggressive as we expect.

For now we keep our preference for high-rated Credit as the recent spread widening adds to the cushion from the high carry. A technical EA recession cannot be excluded, but it would take a severe one to justify significant IG widening from here. We favour only a marginal short duration stance in fixed income as the outlook for yields has become more balanced. The EUR has recovered some lost ground and may headed for a strong bounce later this year. Short term we caution against writing the USD off early as tensions around Ukraine and its fallout are yet to peak and markets' pricing of seven ECB rate hikes through mid 2023 looks overly aggressive.

Probability distribution of the growth forecast

Survey of Professional Forecasters - Q2 release. Dotted: Q1 release



Source: Philadelphia Fed,

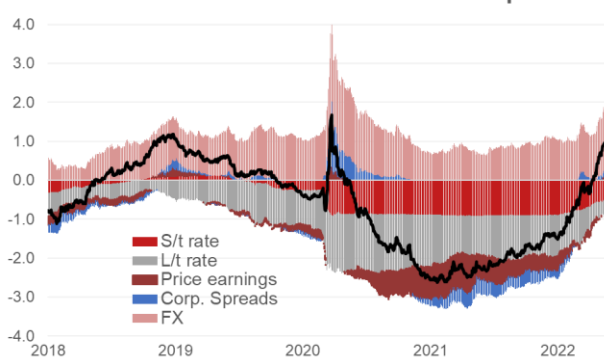
Inventories and Shipments

Shaded areas: recessions



Source: Census Bureau, Datastream, GIAM

Financial Condition Index and components



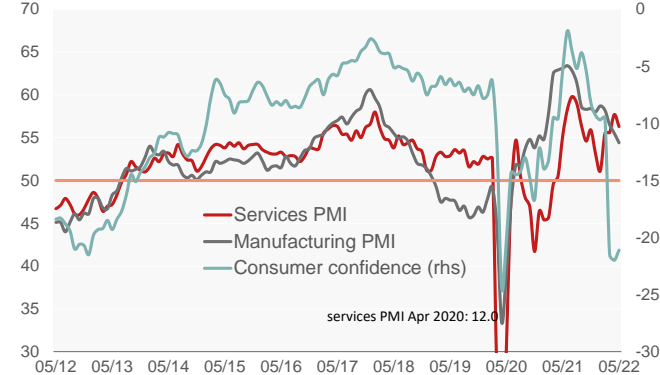
Source: Datastream, GIAM

- We revised down to 2.3% our growth forecast for 2022, on weaker global growth and a faster monetary tightening.
- Concerns on growth are partially replacing those on inflation, but we think that recession fears must be tempered by solid private sector balance sheets.
- With inflation sliding slowly from the peak, with large upside risks, the Fed's frontloaded action will bring the policy rate to 2.4% by year end.

With the strengthening of global (war in Ukraine, commodity price spike) and domestic (inflation, tighter financial conditions) headwinds to growth, the outlook has worsened. We revised our growth projection down to 2.3% for this year, and see a deceleration to below potential at 1.5% in 2023. The latest release of the Survey of Economic forecasters signals a 11% probability that GDP will contract next year. Fears of a recessions are widespread but, while our growth forecast is slightly below consensus, we think that a soft (or at worse "softish") landing remains very likely. Domestic demand proves resilient, with the April data showing that retail sales will grow at a 4%+ annualised pace in Q2 and both durable orders and shipment pointing to an encouraging momentum for capex, also due to low inventories. Longer term, limited private debt and record low borrowing costs provide an important cushion to the economy in case of a downturn. Of course, resilient demand amid an unprecedentedly tight labour market adds to upside risks for inflation and may force the Fed to tighten more. This is the biggest risk we see now. April CPI data had some tentative signs of a peak in inflation, but the climbdown from the current 6.1% core rate will be slow, and we do not expect it to end the year below 4%: the evolution of lockdowns in China and the wage dynamics remain key risks, especially given that sustained demand may allow firms to pass to a large extent cost rises onto consumers.

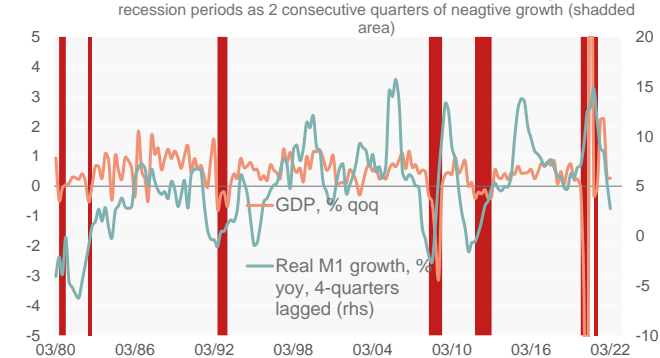
The Fed then needs and can raise rates faster over the coming months, with two 50 bps hikes in June and July, but will have to slow down its pace in the second half of the year as the sharp tightening in financial conditions will weigh on growth and inflation. The policy rate will then rise to 2.4% (the Fed estimate of the neutral level), by the year-end and then to peak below 3% by mid-2023.

Euro area key sentiment indicators



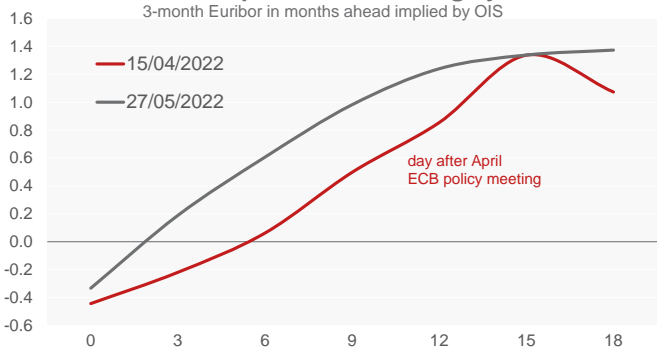
Source: Datastream

Euro area recession risks rising



Source: Datastream, GIAM calculations

Markets expect start of hiking cycle



Source: Datastream, GIAM calculations

- The news flow remained consistent with ongoing expansion in the second quarter.
- But forward-looking indicators, persistently high inflation and more and more dampening from China plus the war hint at pronounced slowing.
- The recession risk has increased but we expect the ECB to hint at higher policy rates at the June 9 meeting, mainly to tame inflation expectations.

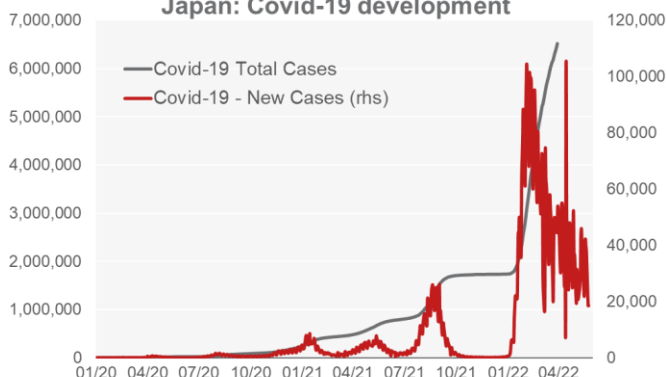
In May, key sentiment indicators stayed in line with ongoing expansion (the EC’s ESI) or even advanced further (composite PMI), leaning support to the view that the euro area kept on growing in the second quarter.

That said, beneath the surface there is clear evidence for slowing activity. Forward-looking indicators related to manufacturing receded, mirroring again stress from bottlenecks and weaker global demand. Amid high oil prices the trade balance which deteriorated already in March (to € -17.6 bin, from € -11.3) is set to weaken further. The almost full unwinding of stringency measures in Q2 supports activity. But with consumer confidence having come down sharply and inflation seen to stay elevated (May: 8.1 % yoy), we look for weaker activity close to stalling ahead.

How worse will it become? Indicators like real monetary growth (see mid-chart), the steepness of the yield curve and the oil price deteriorated, suggesting that inflation risks have increased. Whether or not they materialize will in the end strongly depend on the severeness of further lockdowns in China and whether Russian unilaterally stops gas supply. For the time being, we stick to our below consensus forecasts of 2.2%/1.6% for 2022/23 with risks on the downside.

The ECB (April accounts) as well as single Governing Council members communicated very clearly that QE is about to end in June and that a first rate hike in July is highly likely. Comments suggest that even a 50 bps hike is on the table. At the June 9 meeting, we expect a very clear message amid significantly higher inflation projections that policy normalization starts. Beyond July much will depend on the change in the growth and inflation mix. We think that the ECB will lift its policy rate to by cumulatively 75 bps to 0.25% this year. But we view current market expectations of cumulatively 100 bps hikes this year as overdone given that we look for a significant slowing of activity in the second half of the year.

Japan: Covid-19 development



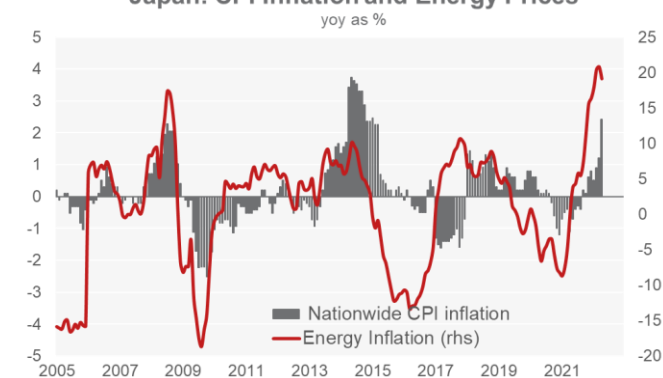
Source: Datastream, GIAM

Real Exports & Imports



Source: Datastream, GIAM calculations

Japan: CPI Inflation and Energy Prices



Source: Datastream, GIAM calculations

- Japan's GDP contracted in Q1 but less than expected, as private consumption held up. Q2 growth is expected to recover, although China's Covid lockdowns will leave their marks.
- Headline CPI rose to 2.5% yoy. However, this will not change the BoJ's monetary policy, given inflation increased for the "wrong" reasons. An early exit has become less likely.

According to the first print, Japan's GDP fell by 1.0% qoq annualised (ann) in Q1. However, this result was better than consensus had expected as private consumption almost held up (-0.1% qoq ann) despite the Covid lockdowns. Given receding Covid cases and the resultant lifting of "emergency" measures, private consumption is expected to contribute significantly to a rebound in Q2. Nevertheless, previous optimism for overall growth in Q2 has been dented by the impact of China's lockdowns on Japanese trade and thus industrial production. BoJ data show that exports and imports have fallen by 4.7% resp. 4.3% yoy in April, suggesting a substantial negative contribution of net exports to GDP growth in Q2. As exports and investment are positively correlated with a lag, investment growth could also be negatively affected. By contrast, on top of the existing emergency economic packages, the government seems to consider more stimulus after the July 2022 Upper House election. Overall, we expect Q2 GDP to still improve significantly from Q1 weakness. But we lower our 2022 growth forecast to 1.6%, down from 2.2% before.

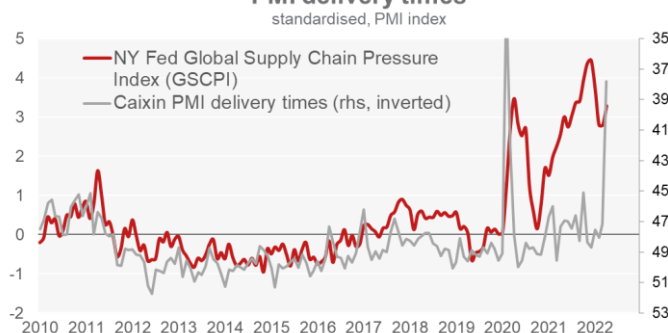
Japan's headline CPI inflation rose 2.5% yoy, core inflation to 2.1% yoy, slightly overshooting consensus expectations. The main driver – as described before – was the end of negative base effects from mobile phone charges but energy costs also rose by 19.1% yoy. By contrast, core-core inflation (ex fresh food and energy) remained low with 0.8% yoy. We expect headline inflation to remain close to 2.5% yoy for the remainder of the year. Accordingly, we revise our 2022 forecast slightly up by 0.2 pp to 2%. As these higher rates are driven by supply side factors as well as the depreciation of the yen, the BoJ will not respond. Governor Kuroda repeatedly excluded a revision of its ultra-easy monetary policy. As the yen recovered a bit from its lows and PM Kishida publicly supported Japan's easy monetary policy, an early exit before the end of Kuroda's term in April 2023 has become less likely.

China: Retail Sales



Source: Datastream, GIAM calculations

Global supply chain pressures and China PMI delivery times



Source: NY Fed, Datastream, GIAM

China: Investment in Real Estate and Property Sales



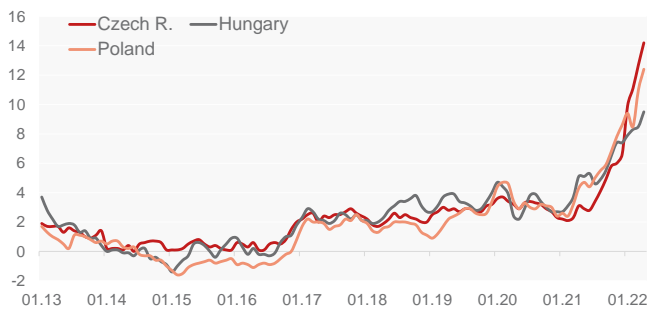
Source: Datastream, GIAM calculations

- China's April data deteriorated strongly on Covid lockdowns, with retail sales suffering the most.
- A range of (but not all) lockdowns are currently gradually lifted. Assuming new lockdowns can be largely prevented, production will likely recover much faster than consumption.
- We revised down our 2022 growth forecast to 3.5% and see risks more tilted to the downside.

China's April activity data deteriorated severely due to the Covid lockdowns. Industrial production receded by 2.9% yoy. Retail sales dropped by 11.1% yoy. Fixed asset investment slipped further with the property sector most severely affected, but also infrastructure declined. On the monetary side of the economy, total social financing growth eased while CPI inflation advanced to 2.1% yoy on rising food and energy prices. Core inflation diminished to 0.9% yoy.

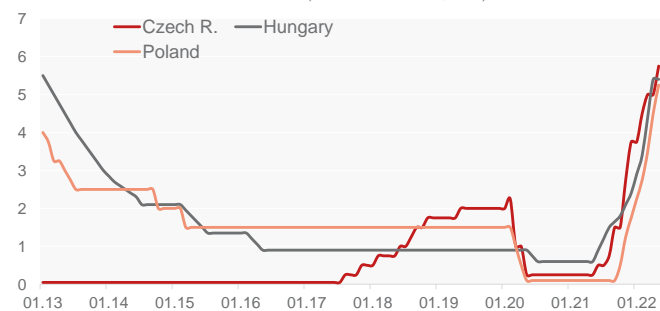
The outlook depends very much on the pandemic development. In Shanghai and elsewhere (but currently not yet in Beijing) lockdown measures are being more and more relaxed, suggesting that their worst impact could be over. China will maintain its zero Covid stance at least until Q4, but the implementation will rely more on regular (PCR-like) testing in order to prevent larger lockdowns. Access to public venues will depend on a fresh negative test result. "Bubble"-production will take on a larger role as well as a more unified approach to logistics. Assuming some success of this strategy (while fresh Covid outbreaks cannot be excluded), production could recover rather quickly but private consumption likely again be a laggard (like in early 2000). Opening up of services could be slow, with the testing needs an additional hurdle. Consumption vouchers could be an option (like in Hongkong), although there is no sign yet of policy providing such a boost. In any case, infrastructure will be a major tool, increasing local bond issuance. Property sales fell more than in 2020. Policy moved already to support this (system relevant) sector. The PBoC applied targeted measures, including a 20 bps cut to the mortgage rate floor and a 15 bps cut to the 5-year loan prime rate (LPR) which also lower mortgage rates. It avoided to cut the MLF rate or the 1-year LPR but we still see the need for a broader rate cut (MLF rate cut likely 10 bps). Given the recent macro data, we revise our growth forecast to 3.5%. We see efforts to increase in H2, but there are still large downside risks due to Covid amid a rather "bumpy" recovery.

Headline inflation
CE-3 countries (CPI yoy in %)



Source: www.czso.cz, www.ksh.hu, www.stat.gov.pl, GIAM

Monetary policy interest rates
CE-3 countries (end-of-month level, in %)



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

Main Forecasts

Czech Republic	2020	2021	2022f	2023f
GDP	-5.8	3.3	1.0	3.0
Consumer prices	3.2	3.8	12.4	3.9
Central bank's key rate	0.25	3.75	5.50	3.25
Hungary	2020	2021	2022f	2023f
GDP	-4.9	7.1	5.0	3.0
Consumer prices	3.3	5.1	8.8	4.7
Central bank's key rate	0.60	2.40	7.00	4.50
Poland	2020	2021	2022f	2023f
GDP	-2.5	5.7	5.7	3.3
Consumer prices	3.4	5.1	10.5	5.8
Central bank's key rate	0.10	1.75	6.50	5.25

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

- Inflation accelerated further in April and is expected to reach its peak only in late Q2 or early Q3. While commodity prices became the key driver of higher inflation in the past months, core CPI pressures also remain in place.
- Preliminary data for Q1 reported stronger than expected GDP performance across the region, which led us to increase our 2022 annual growth expectation for Hungary and Poland.
- The CE-3 central banks have been raising their interest rates, the peak could be reached by Q3. The central banks at the same time declared their support to stronger FX rates.

Inflation in the CE-3 has accelerated further in April, driven by commodity prices and by domestic factors (tight labour markets, expansionary fiscal stance). Inflation may culminate only in early Q3. GDP data for Q1 surprised on the positive side, and Poland as well as Hungary are likely to report a robust full-year growth even if GDP quarter-to-quarter dynamics start to fall since Q2 onwards. The CE-3 central banks keep a tightening stance. While the pace of interest rates hikes is likely to moderate in the months to come, the monetary authorities may focus on the FX rate and intervene in the market to oppose the weakening of the domestic currency, as the Czech CNB did in May.

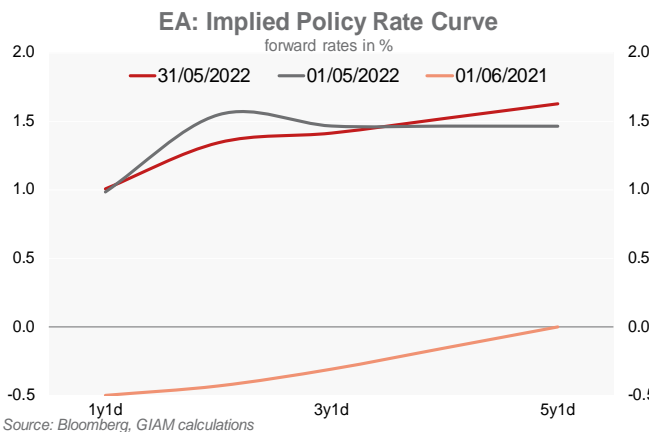
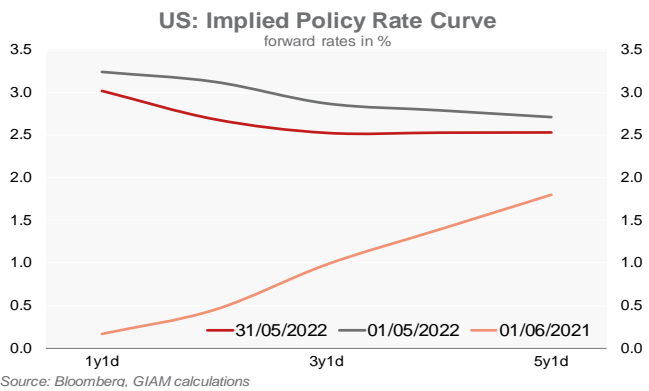
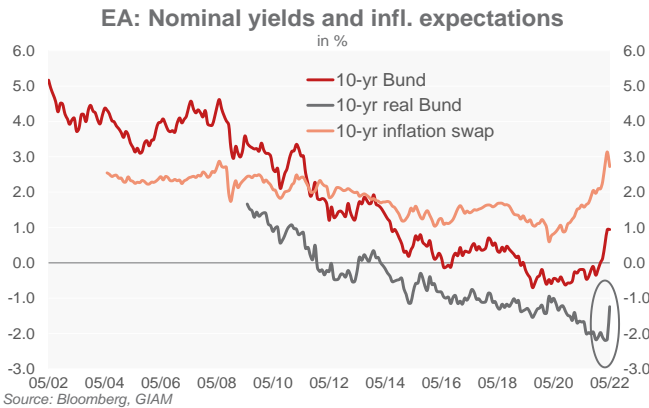
The Czech CNB raised its key rate by 75 bps to 5.75% in May. Its new forecast expected the key rate to exceed 8% in Q2 but an alternative scenario, which operates with a later reaching of the inflation target, saw the rate peaking below 6%. We expect a hike of 50 or 75 bps in June, stability in the key rate in Q3 and then rate cuts in Q4. Much will depend on the new composition of the CNB Board since early July.

In Hungary, the MNB raised its base rate by 100 bps in April to 5.40% but indicated slower hikes onwards. We expect the base rate to peak at 7.00% by July (the 1-week deposit rate, now at 6.45%, should reach the same level). The government announced a package of windfall tax for selected sectors and cuts in fiscal spending in late May in order to reduce budget deficit, which may have positive impact on the bond market.

The Polish NBP raised its key rate by 75 bps to 5.25% in May and said that rate hikes will continue until it is clear that inflation reached its peak. As this is likely to happen only in July, the key interest rate may easily climb to the area of 6.50% in Q3.

Government Bonds

Florian Späte



- Mounting growth concerns have stopped the sell-off of government bonds for the time being. However, we do not yet consider this to be a sustainable trend reversal.
- The forecast transatlantic yield spread tightening has already occurred to a large extent. Amid the aggressive pricing of ECB key rate hikes, we see only limited additional leeway near term, but there is further scope in the medium term.
- Euro area non-core government bond spreads have continued to widen – and there is further leeway. The technical situation is seen to worsen in the months to come.

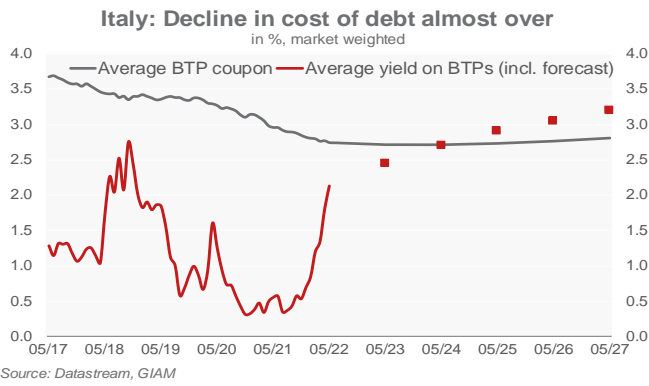
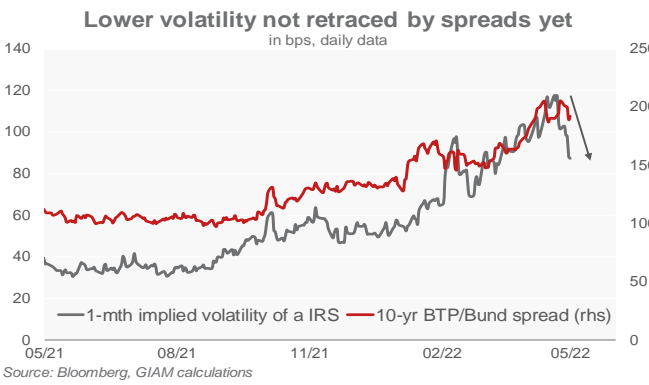
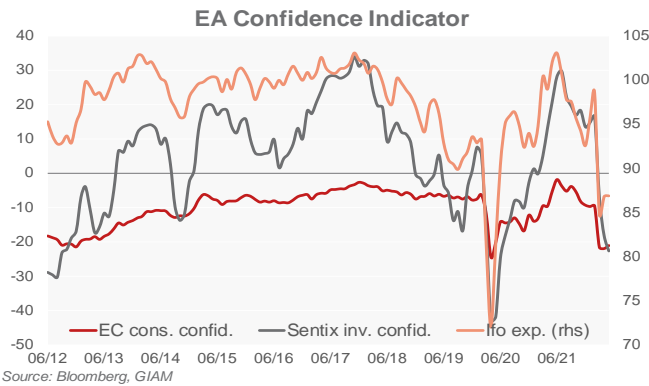
Something rather rare happened in May: US and Bund yields moved in different directions. While Bund yields kept on increasing moderately across the curve, US yields receded strongly as future key rate expectations were scaled back. As central banks remained hawkish market participants' concerns regarding the future inflation trend eased somewhat. Additionally, growth concerns have contributed to a sizeable drop in inflation expectations. Eventually, this triggered a strong increase in real 10-year Bund yields. At -1.2%, they have risen by almost 100 bps since the end of April and have reached the highest level since July 2020.

In addition to persistent inflation worries, we expect that growth concerns will increasingly affect international bond markets. Our growth forecasts for the US and the EA remain moderately below consensus. Additionally, financial markets are pricing a more realistic path for the Fed with the peak in the cycle unlikely to overshoot 3% significantly (at the time of writing the peak is even priced below 3%). By contrast, key rate expectations for the ECB have moved further up. While we share financial markets' expectations of a key rate around 1.5% in the medium term, we regard pricing for year-end 2022 as too ambitious. Currently more than 100 bps are discounted while we expect the ECB to follow a more cautious approach and to raise the key rate by "only" 75 bps to 0.25% until the end of 2022. It should be noted that our forecast does not include a 50 bps step, whereas financial markets are pricing this possibility.

Recent market developments have already largely reflected the transatlantic yield spread tightening that we had forecast ([see here](#)). Accordingly, amid the aggressive ECB pricing we see only limited leeway for

Government Bonds

Florian Späte



a transatlantic yield spread narrowing short term. This applies even more as the EA economy appears more vulnerable to an intensification of the war in Ukraine. Further down the road, however, the transatlantic yield spread can tighten more. With a key rate cut approaching in the US, we forecast the transatlantic yield spread to tighten across the curve in H2.

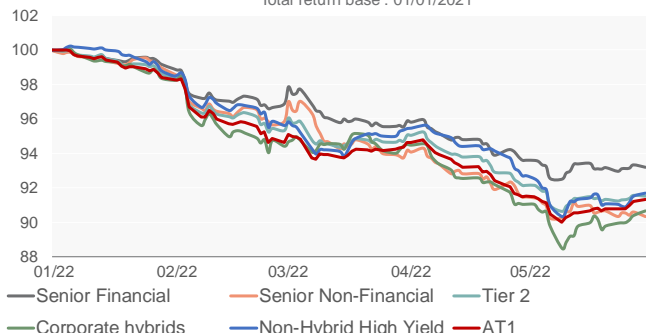
Overall, the general yield trend should point upwards in the near term, both in the US and in the EA. The inflation outlook remains bleak and uncertainty regarding the future development stays elevated with lockdowns in China (supply bottlenecks) and the ongoing war in Ukraine (incl. additional sanctions). Moreover, the peak in the inflation rate is still to come in the EA (peak is probably behind us in the US, but deceleration will be slow). This will support the term premium as well. Longer term, we see more leeway for Bund yields to rise as they are still low by historical standards, and (in contrast to the US) EA 5y3m OIS are well above the current 10-year yield and real yields have not yet reached sustainable levels.

EA non-core government bond spreads have widened further in May. However, the speed is still moderate and in line with other risky fixed income assets. What is more, the implied bond volatility has started to moderate over recent weeks. This is not yet mirrored by EA non-core bond spreads and offers some cushion going forward (see chart). Moreover, the ongoing disbursement of NextGeneration funds and speculations about an upcoming additional ECB instrument to prevent fragmentation are likely to cap any spread increase going forward.

Having said that, the environment will remain challenging, and we expect spreads to widen further in the months to come due to numerous factors. The higher core yield level reduces the search for yield and attractiveness of higher yielding government bonds. The ECB will stop QE in the short term, which will remove a very important support factor of the last years (reinvestments will continue but using capital keys for the time being). Debt sustainability concerns will come to the fore again (although in our base scenario we do not regard it as unacceptable yet). Finally, the technical situation will worsen as the EA government bond issuance activity is somewhat lagging compared to previous years. Hence, treasurers will have to pick up the pace to catch up (and redemptions will slow in June, implying the highest EA net issuance in 2022).

EUR Credit market performance by segment

Total return base : 01/01/2021



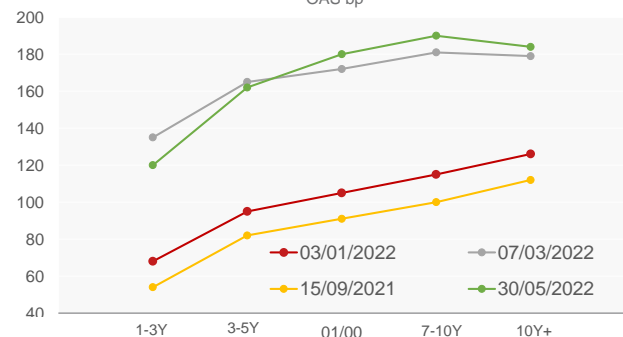
Moody's speculative-grade default rates

12 months trailing



EUR IG credit spreads by maturity

OAS bp



- We remain overweight Credit but mostly in IG, as valuations are consistent with a recession scenario which is not our central scenario.
- Corporate fundamentals will deteriorate on the sharp economic slowdown.
- The end of the ECB asset purchase program in early July, although priced in terms of levels, will likely trigger further spread volatility in the coming quarters.
- Technicals will remain fragile as the primary market will remain lively until the holiday season.
- Hence, we continue to recommend a defensive allocation, UW financial credit relative to non-financials. We also underweight the periphery versus the core, favour IG over HY, and subordinated versus pure HY.

Current credit spreads are consistent with a recession scenario in IG but not yet in HY. IG spreads are also much wider compared to historical standards than HY. We consider that current IG spread levels are consistent with our expectations of shallow growth but no upcoming recession.

Having said that, we expect corporate fundamentals to deteriorate, with defaults increasing further from 1.5% currently to 3% by year-end. Credit rating will also stop improving and marginally deteriorate at the lower end of the HY spectrum.

The ECB will stop purchasing bonds in a few weeks is largely reflected in credit spread levels. Nevertheless, the central bank will stop its buying flows on market weaknesses, and it should trigger greater volatility in the third quarter of this year.

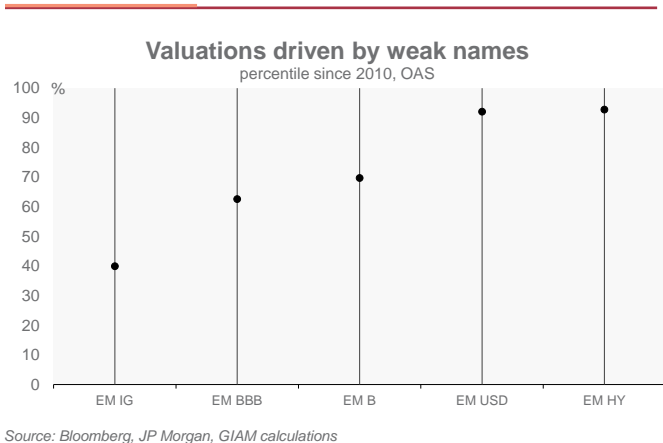
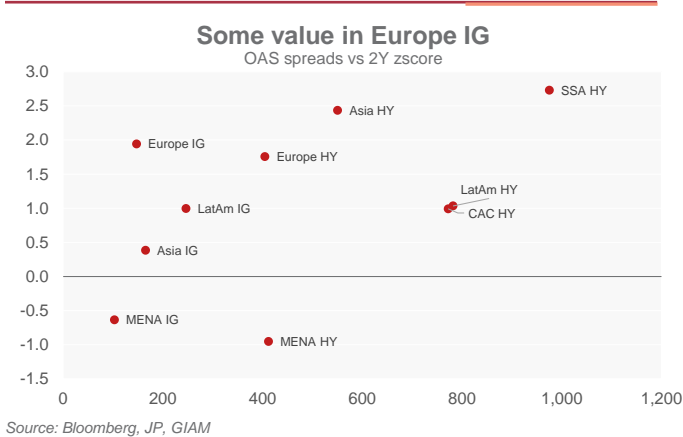
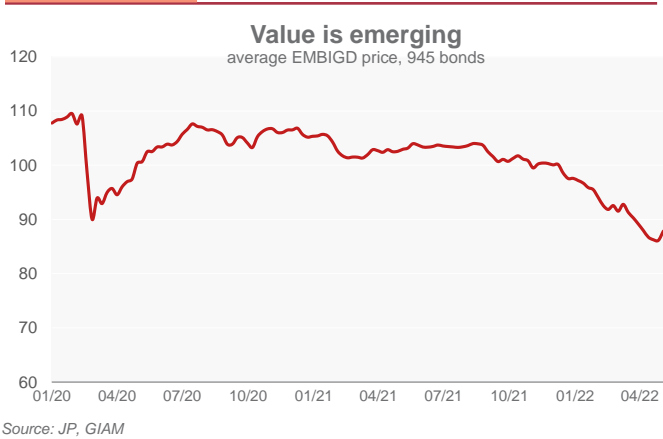
Technicals will remain fragile as the primary market will remain lively until the holiday season, pressuring the secondary market. On the flow front, the poor total returns year-to-date, although outperforming most other liquid asset classes, will likely continue to fuel outflows

IG credit spreads are attractive

We stay overweight Credit, as we continue to expect better total return prospects than the rest of the fixed-income space. Nonetheless, we remain very defensive, recommending to be OW IG vs. HY, underweighting the periphery vs. the core. Moreover, as we expect volatility to remain, we suggest reducing exposure to financial credit relative to non-financials. We also favour defensive sectors versus cyclical ones. Finally, we favour subordinated bonds to pure HY and corporate hybrids versus BBs.

EM sovereign bonds

Guillaume Tresca



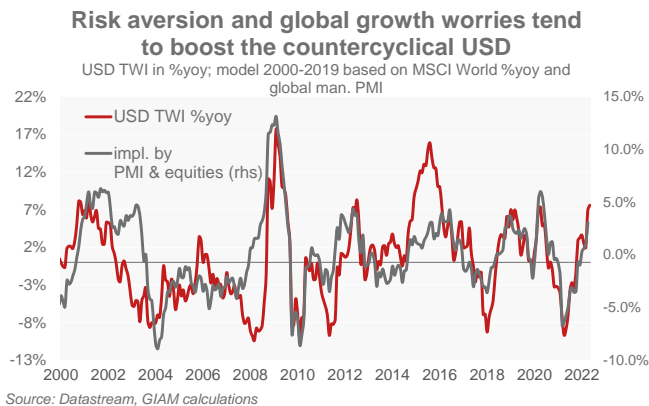
- We turn neutral from overweight for EM bonds vs. other FI assets given all the headwinds and uncertainty, especially in China.
- There are silver linings: valuations are cheap, yield is high and core rate should stabilise. But timing is uncertain.
- We favour EM IG over HY, see value in Europe and expect the commodity trade to fade.

We turn neutral from overweight for EM bonds vs. other FI assets. EM countries face too numerous headwinds, and the carry is not currently offering enough protection. The global uncertainty, the lack of Chinese economic policy support, and still severe lockdown measures lead us to have a more negative EM growth view. It will be on par with DM growth in Q2 with downside risks. EM spreads have widened meaningfully, and we remain of the view there is room for a compelling tightening in the second part of the year. However, the timing is too uncertain given the headwinds, and risks are still skewed to the downside. In addition, spreads will stabilise at higher pre-war levels to price in a larger geopolitical and fiscal premium. EMs have also exited the pandemic with weaker balance sheets, and fiscal adjustments in a period of high food inflation will be challenging.

Silver linings

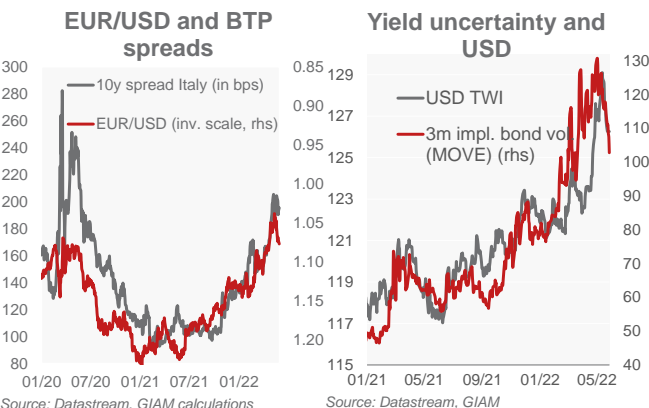
That said, there are several silver linings. Valuations are attractive by historical standards. Average EMBIG bond prices are lower than on March 20, the C bucket bond price is c. 36, at the lower end of recovery value. EMBIG yield is in line with distressed periods. Likewise, the negative duration impact will be less problematic. US core rates have already increased by c. 125bp YTD, and the fears of a recession will cap them. The IMF has recently adopted a more lenient stance towards debt sustainability for the weakest countries.

Within this environment, we continue to favour IG over HY despite its higher duration. EM HY is cheap, but only optically. Growth slowdown will affect the CCC and high funding rate countries. The positive commodity theme will ease, especially for HY names. The exception is MENA IG, benefiting from its safe-haven status. LatAm is the least vulnerable from a macroeconomics point of view, but it turns less appealing as the political risk gain momentum. CEE countries are offering value given their anchors to Europe and sound fiscal stances, except Kazakhstan.

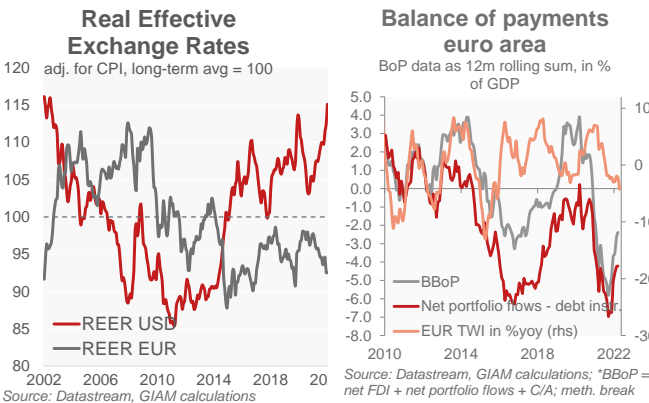


- The combination of geopolitical uncertainty and global growth worries is set to keep the anticyclical USD underpinned.
- Yet USD valuations are stretched,. We look for a more sustained EUR/USD rebound once escalation risks of the war in Ukraine have peaked.

The USD DXY has climbed fresh 20-year highs in May boosted by soaring US yields and mounting global risk aversion. More lately, though, rising worries about the robustness of demand in the US and trimmed expectations regarding the Fed's rate outlook have dashed expectations by some analysts already eying parity vs. the EUR, as the EUR/USD settled closer towards 1.08 towards the end of the month (after temporarily dropping below 1.04).

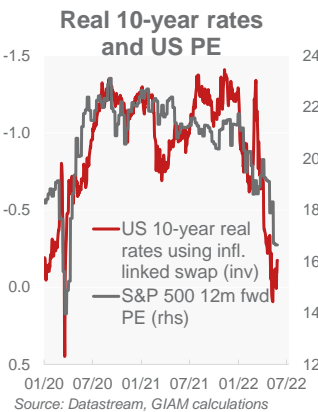
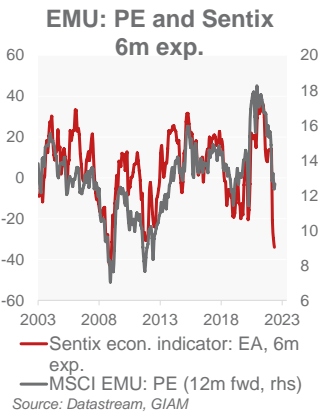
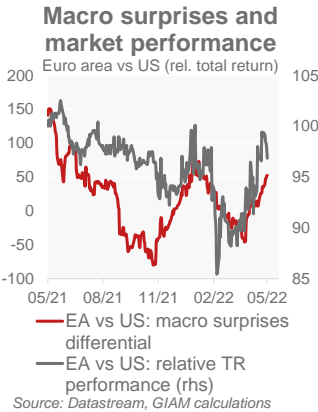
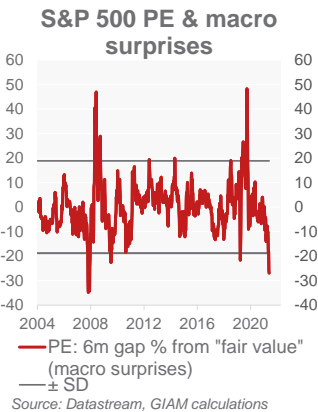


Short term, we caution against writing the USD off early. Geopolitics and inflation keep demand for the Greenback high (top chart). Rates uncertainty may have peaked (mid chart, right) but is unlikely to plummet amid persistent inflation risks, keeping the USD underpinned. Rate expectations have risen in the euro area, rendering a key support for the EUR recently. Yet worries about peripheral debt will remain elevated, burdening the EUR (mid left chart). While markets are rightly positioned for front-loaded ECB tightening from July onwards, the total of 175 bps hikes priced through mid-2023 appears too aggressive to us. And while 10y US yields have retraced by 40 bps from the highs reached earlier in May, we do not expect a protracted further fall over the coming weeks.



Yet against valuation yardsticks, the depressed EUR/USD does not look sustainable in the medium term. The real effective USD is dear (15% > long-term avg.) and the EUR/USD substantially undershooting purchasing power parity and fair value models. Reserve diversification and a widening US trade deficit add to the structural USD headwinds.

When will the EUR/USD bounce back? We carefully watch for signs that escalation risks around Ukraine are peaking. Relief around this war would rein in USD safe haven bids, tame economic risks to the euro area, allow the increasingly vocal hawks at the ECB to address inflation risks more decisively and portfolio inflows into EA to resume. So even if there is life in the USD short term, we still expect the EUR/USD to bounce back into the 1.10-.15 range later in the year.



- We see valuations at risk of further downgrades short-term due to expectations of slightly higher yields and declining confidence indicators.
- While central banks (CBs) remain very hawkish at this time, the Fed has recently not excluded a pause by year end, thus signaling a partial relief.
- We deem equities not to have reached a clear bottom yet and remain with a small UW position, waiting for the market to further discount the lower economic momentum.
- Within countries, we prefer to be relatively defensive with a tilt on Value: prefer (OW) US and UK versus EMU and Japan. Large underweight (UW) on Switzerland. We remain neutral on EMs.
- Sectors: keep a tilt on Value and lower valuations, exploiting a negative correlation with the USD. OW: Durables, DF, Energy, Materials, Telecoms and Utilities. UW: Cap. Goods, Food, Insurance, Media, Pharma, RE and IT Hardware.

The cycle clock is ticking, markets behave accordingly, showing relief. Still, we suspect a clear bottom is not formed yet. Maintain a small UW on equities. We see chances to increase exposure on further weakness.

CBs remain very hawkish in their experiment to control inflation, including a possible negative collateral effect on the economy, now officially considered. That said, this week the Fed did not exclude a pause by the end of the year to assess the conditions of the economy and inflation after the first rate hikes. That represented a partial relief for markets. Leading indicators are also pointing south more clearly, which, together with peaking US inflation, has put a cap on yields - another reason to party for risky assets. Furthermore, more recently the MOVE index (i.e. bond volatility) dropped significantly (from 128 to 99), contributing to the decline of equity volatility (VIX). The US dollar (USD) also lost some ground, giving relief to the EM index. The latter reacted also to declining Covid cases in China and to new measures to support the economy. Finally, the Q1 reporting season has come to an end, with nice surprises vs. analysts' expectations and investors' positioning reached a very low point.

A sign of a low positioning and relatively low market valuation is offered by our chart for the PE (price-earnings) level being explained by the "current" macro surprise index. Indeed, both in the US and EMU, PEs look quite depressed like only 5 times in the last 15 years, 2 of which occurred in 2009 and 2020.

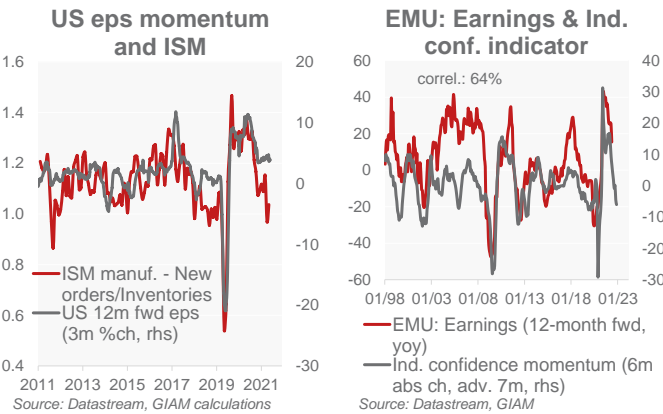
Analysis of the median stock: Q1 2022 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q4 2021	Q1 2022	Q4 2021	Q1 2022	Q4 2021	Q1 2022	
S&P	15.1 %	10.1 %	11.8 %	10.3 %	3.3 %	(0.1)%	95.8%
Stoxx	16.3 %	15.2 %	11.6 %	15.1 %	4.7 %	0.1 %	89.1%
Euro Stoxx	14.8 %	16.2 %	11.8 %	14.9 %	2.9 %	1.3 %	92.0%
Topix	11.6 %	6.0 %	6.0 %	6.1 %	5.7 %	(0.1)%	95.3%

Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q4 2021	Q1 2022	Q4 2021	Q1 2022	Q4 2021	Q1 2022	
S&P	4.1 %	5.4 %	1.8 %	1.6 %	2.3 %	3.9 %	95.8%
Stoxx	6.1 %	8.0 %	2.3 %	2.6 %	3.9 %	5.4 %	89.1%
Euro Stoxx	8.6 %	8.7 %	2.7 %	2.7 %	5.9 %	6.1 %	98.5%
Topix	10.9 %	9.5 %	1.2 %	1.2 %	9.7 %	8.3 %	95.3%

Note: margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations



Good news not enough, though

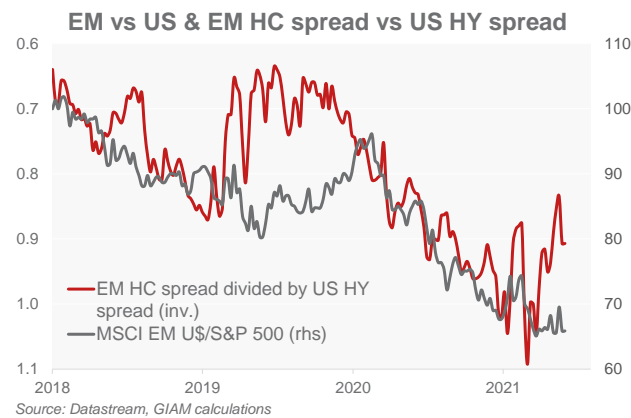
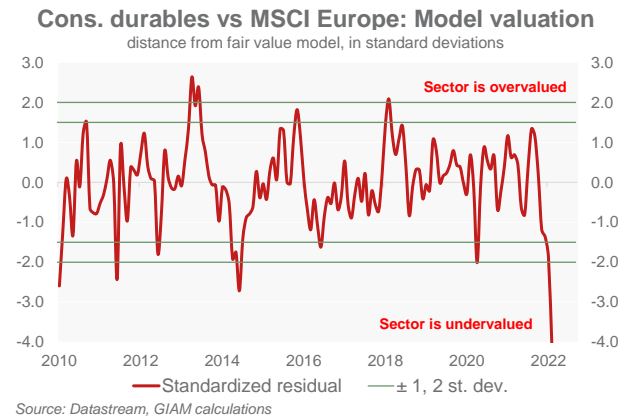
The market is trying to find a bottom, but short-term risks remain high. CBs will further reduce financial conditions appreciably in the next months. The macro surprises mentioned above are stalling and ready to come down. US ones are already in negative territory. Some confidence indicators are indeed very low, predicting slowdown ahead. This will trigger negative earnings revisions, too. Analysts have only increased their forecasts so far (not for the EM). To be clear, a recession, if any, will not occur this year but most probably in 2023. That said, we expect the market to discount more properly a lower momentum in the economy. Furthermore, current real rates command even slightly lower PEs than current ones and we expect rates to increase further, albeit limitedly so. The same seems true when looking to the PE and Sentix index: PE remains at risk of further downgrades.

Recommended allocation

Within countries, we want to be relatively defensive with a tilt on Value. The US Tech remains at risk to us: our fair value indicator (driven by 12m fwd earnings and 10-year rates) shows the Tech at premium of 13% vs the S&P500 index. That said, we think that peaking inflation, rates and USD should give some relief to the US, anyway. We OW US and UK (Value) versus EMU and Japan and we adopt a big UW on Switzerland (Growth and expensive index) and a neutral position in the EMs. Our machine-learning (ML) quant model support such view. After the rally vs. the US, the EMU index looks relatively at risk due to macro surprises which have so far overperformed US ones but could weaken in the next weeks: EMU economic momentum and earnings look relatively more at risk. Currently, UK market multiples look comparable to EMU but our Fair Value still shows a bigger upside. EU sectors: we favour Value, a negative correlation to the USD and low valuations, including ML models. Accordingly, we decreased Food, HealthCare and RE. We increased diversified financials (DF), Durables, Energy plus Utilities. OW: Durables, DF, Energy, Materials, Telecoms and Utilities. UW: Capital Goods, Food, Insurance, Media, Pharma, RE and IT Hardware.

EM: neutral. Pressure from falling macro surprises

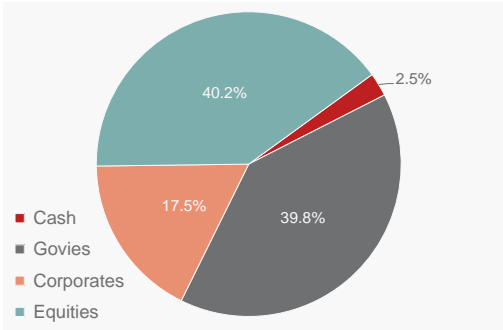
EMs remain vulnerable due to plunging global export orders and weaker earnings momentum. Peaking USD and high HC credit spread vs. HY gap are positives beyond the short term. China situation is also improving. We OW Korea and Chinese A-shares.



Asset Allocation

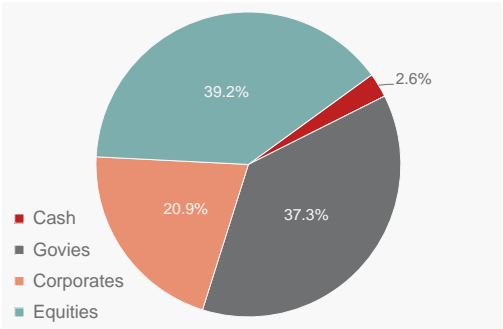
Thorsten Runde

Benchmark



Source: GIAM

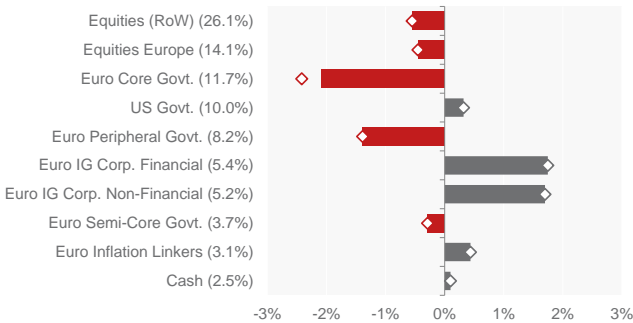
Modelportfolio



Source: GIAM

Active Positions

TOP 10 Benchmark Constituents



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

- After April, May was also negative for many of the actively covered asset classes (27.05.22).
- That said, there are five significant exceptions at the top of the performance ranking. On the equity side, the MSCI EMU gained +1.2% followed by the MSCI North America with +0.7%. On the fixed income side, short- to medium-dated US Treasuries made the race with +0.6% and +1.1% respectively followed by EM Govies (USD) with +0.4%.
- On average, equity markets suffered the most (-4.6%), followed by Government Bonds (-3.2%) and Corporates (-2.3%).
- Although less strong than in the previous month, long-dated govies further lost value relative to the short-dated ones. The average under-performance was -170 bps (Y10+ vs. 1-5Y).
- In the corporate section, EA IG once again outperformed EA HY by roughly +76 bps. Within IG, Financials were superior to Non-Financials (+59 bps).
- With a focus shift from inflation to cyclical risks, we deem the leeway for further yield increases limited. Monetary policy and geopolitical risks keep burdening risk assets. We recommend to set EA HY to neutral reducing the UW in EA Core Govies and leave the remainder unchanged.

In May (27.05.22), the relative performance of our model portfolio was more or less flat (-0.3 bps). The development on financial markets in the second half of the month was nearly a perfect mirror image of the first one. While on the fixed-income side there was initially a strongly positive development followed by a correction, the reverse was true for equities. On average, EA Core Govies (+1.6 bps) contributed the most to the overall result, whereas EA Corporates (-1.7 bps) brought up the rear.

Still too early to get back into the game

Despite the strong positive development of Equities in the second half of May, we deem it too early to rebuild exposure here, as monetary policy and geopolitical risks keep weighing on risk assets. With market concerns shifting from inflation to cyclical threats, a flight to quality might dampen any further rise in yields. Thus, we recommend to set EA HY to neutral shifting exposure to EA Core Govies. We leave all other positions unchanged for the time being.

FORECAST TABLES

Forecast tables

Growth ¹⁾	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.7	2.3	- 0.5	1.5	- 0.6	1.4
Euro area	5.4	2.2	- 0.5	1.6	- 0.6	1.8
Germany	2.9	1.2	- 0.8	1.7	- 0.7	1.5
France	7.0	2.7	- 0.2	1.3	- 0.4	1.5
Italy	6.6	2.2	- 0.3	1.5	- 0.3	1.8
Non-EMU	6.4	3.2	- 0.2	1.0	- 0.3	1.6
UK	7.4	3.5	- 0.3	0.6	- 0.4	1.5
Switzerland	3.7	2.5	- 0.1	1.5	- 0.3	1.8
Japan	1.7	1.6	- 0.4	1.9	0.0	0.8
Asia ex Japan	7.8	4.3	- 0.9	5.4	0.3	5.1
China	8.1	3.5	- 1.2	5.8	0.7	4.8
CEE	5.3	- 1.6	1.2	2.3	0.9	3.6
Latin America	6.6	1.8	0.0	1.9	0.0	2.4
World	6.3	2.8	- 0.4	3.2	- 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	7.3	0.1	3.3	- 0.0	2.3
Euro area	2.6	6.6	- 0.2	2.6	- 0.0	2.0
Germany	3.2	7.0	0.4	2.8	- 0.2	1.9
France	2.1	4.5	- 0.0	2.6	0.3	1.7
Italy	2.0	6.0	- 0.2	2.0	- 0.1	0.6
Non-EMU	2.3	6.9	0.4	4.2	0.7	1.6
UK	2.6	8.4	0.6	5.3	1.0	1.6
Switzerland	0.6	2.0	- 0.1	1.0	0.0	1.2
Japan	- 0.3	2.0	0.3	1.0	- 0.1	0.9
Asia ex Japan	2.0	3.5	0.2	2.9	- 0.0	2.6
China	0.9	2.5	0.3	2.1	- 0.2	2.0
CEE	9.3	29.5	1.1	16.0	4.4	7.6
Latin America ²	6.6	7.2	1.0	4.1	0.6	3.3
World	3.5	7.2	0.2	4.1	0.4	2.8

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

Financial Markets

Key Rates	27/05/22*	3M	6M	12M
US	1.00	2.00	2.38	3.00
Euro area	-0.50	-0.25	0.00	0.50
Japan	-0.10	-0.10	-0.10	0.00
UK	1.00	1.00	1.50	1.75
Switzerland	-0.75	-0.75	-0.50	-0.25
10-Year Bonds	27/05/22*	3M	6M	12M
Treasuries	2.75	2.85	2.90	2.95
Bunds	0.97	1.05	1.10	1.20
BTPs	2.91	3.05	3.15	3.35
OATs	1.50	1.55	1.60	1.75
JGBs	0.23	0.25	0.30	0.35
Gilts	1.93	1.95	2.00	2.00
SWI	0.73	0.80	0.85	0.95
Spreads	27/05/22*	3M	6M	12M
GIIPS	151	155	160	170
BofAML Covered Bonds	72	75	75	75
BofAML EM Gvt. Bonds (in USD)	388	350	345	350

Corporate Bond Spreads	27/05/22*	3M	6M	12M
BofAML Non-Financial	163	140	140	130
BofAML Financial	171	145	145	135
Forex	27/05/22*	3M	6M	12M
EUR/USD	1.07	1.06	1.09	1.12
USD/JPY	127	127	125	120
EUR/JPY	136	135	136	134
GBP/USD	1.26	1.23	1.27	1.29
EUR/GBP	0.85	0.86	0.86	0.87
EUR/CHF	1.03	1.02	1.04	1.06
Equities	27/05/22*	3M	6M	12M
S&P500	4,065	4,105	4,285	4,250
MSCI EMU	134.2	134.5	140.0	137.0
TOPIX	1,880	1,895	1,965	1,935
FTSE	7,558	7,595	7,920	7,755
SMI	11,544	11,520	12,095	11,780

*average of last three trading days

3-Months Horizon

Government Bonds	10-Year Bunds	0.58	1.05	1.52
	10-Year Treasuries	2.26	2.85	3.44
	10-Year JGBs	0.07	0.25	0.43
	10-Year Gilts	0.99	1.95	2.91
	10-Year Bonds CH	0.36	0.80	1.24
Equities	MSCI EMU	123.8	134.5	145.2
	S&P500	3,833	4,105	4,377
	TOPIX	1,764	1,895	2,026
	FTSE 100	7,071	7,595	8,119
	SMIC	10,833	11,520	12,207
Currencies	EUR/USD	1.03	1.06	1.09
	USD/JPY	124	127	130
	EUR/GBP	0.84	0.86	0.88
	EUR/CHF	1.00	1.02	1.04

12-Months Horizon

Government Bonds	10-Year Bunds	0.17	1.05	2.23
	10-Year Treasuries	1.91	2.95	3.99
	10-Year JGBs	0.00	0.35	0.70
	10-Year Gilts	0.40	2.00	3.60
	10-Year Bonds CH	-0.14	0.95	2.04
Equities	MSCI EMU	117.1	137.0	156.9
	S&P500	3,743	4,250	4,757
	TOPIX	1,682	1,935	2,188
	FTSE 100	6,774	7,755	8,736
	SMIC	10,493	11,780	13,067
Currencies	EUR/USD	1.07	1.12	1.17
	USD/JPY	113	120	127
	EUR/GBP	0.82	0.87	0.92
	EUR/CHF	1.03	1.06	1.09

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Società di gestione del risparmio, Research Department

Head of Research: Vincent Chaigneau

Head of Macro & Market Research: Dr. Thomas Hempell, CFA

Team:

- Elisabeth Assmuth | Research Operations
- Elisa Belgacem | Senior Credit Strategist
- Radomír Jáč | GI CEE Chief Economist
- Jakub Krátký | GI CEE Financial Analyst
- Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist
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