



GENERALI
INVESTMENTS

Market Perspectives

Covid paralysis recedes as political risk rises

September 2020



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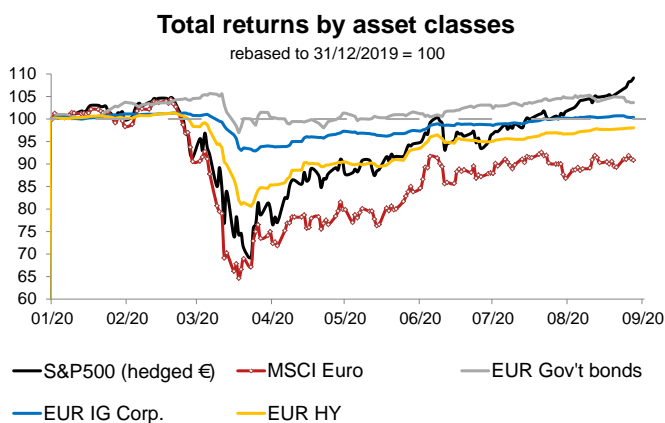
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Global View – Covid paralysis recedes as political risk rises

Thomas Hempell / Vincent Chaigneau

- After a buoyant August for risk assets, the rally is likely to flatten out. Rising new infections into the autumn, a levelling recovery pace and diverse political risks (US politics, Brexit, geopolitics) will keep a lid on risk sentiment.
- Yet recovering data, committed central banks, falling Covid-19 lethality and optimism about vaccines still support a slight pro-risk bias.
- We keep a prudent overexposure to risky assets, centred in high-quality buckets of Credit. Look to increase the pro-cyclical bias in portfolios as the Covid paralysis fades out.

Even after the large risk rally in summer and despite the persistent spreading of Covid-19, equities advanced fast in August (MSCI World up by another 6.6%), helped by recovering data, better-than-expected earnings and vaccine hopes. The S&P has reached new record highs, led by tech firms. Credit spreads compressed further, largely offsetting the modest increase in underlying core yields. These trends paid off nicely for our (cautious) pro-risk tilt expressed in July.



Rising new cases in Europe and renewed restrictions into the autumn remind us that the crisis is not over. The epidemics is still not fully understood, and seasonality could be a factor. Yet, if anything our concerns for the autumn have slightly diminished of late. Global infections seem to have peaked, with US cases now pulling back. Mortality has been declining, in part because hospitals have developed better protocols. Vaccines are expected on the market by 21H1 – another headwind for equity bears. Falling mortality rates and larger spare capacities in ICUs will allow governments to avoid blunt lockdowns.

Recovery facing intensifying political risks

The economic recovery has legs, even though after the Q3 rebound, its momentum will ease. Persistently high US unemployment claims (still >1m per week) and a surprise drop in European August PMIs are fresh reminders that

we are not amidst a V-shape recovery. After the strong initial rebound, economic scars will heal only gradually.

Political crosscurrents are mounting, unfortunately. While the US/China trade war has been put to the backburner, US president Trump has turned his ire on key Chinese tech firms (TikTok, WeChat, Huawei). Meanwhile China's geopolitical assertiveness in the South China Sea is rising. Brexit negotiations need to be concluded by October, and the lack of progress so far suggests that the deal, if any, will be minimalist (a lose-lose). Sabre-rattling between Turkey and Greece in the Mediterranean Sea looks increasingly dangerous.

US political risk is weighing too. Congress remains at loggerheads over a new fiscal package, including enhanced support to the unemployed that expired in July (Trump's executive orders only a partial fix). November elections may result in a 'blue sweep' (Democrats winning both presidency and Congress) that markets fear for tax hikes on corporates and wealthy individuals. In a worst case, Trump would dispute the results, leaving scope for weeks of constitutional uncertainties.

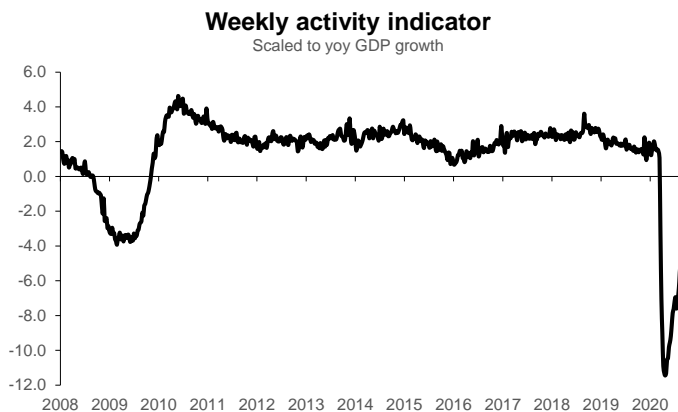
Bonds	27/08/20*	3M	6M	12M
10-Year Treasuries	0.71	0.75	0.80	0.90
10-Year Bunds	-0.41	-0.35	-0.30	-0.25
Corporate Bonds				
BofAML Non-Financial	115	110	105	100
BofAML Financial	113	110	105	100
Forex				
EUR/USD	1.18	1.19	1.20	1.22
USD/JPY	106	105	104	103
Equities				
S&P500	3469	3485	3500	3530
MSCI EMU	118.1	119.0	120.5	120.5

* avg. of last three trading days

In all, **the outlook for risky assets remains tilted to the upside, but now appears less sanguine**. With the economy still recovering and central banks reassuring on long-term policy support (as just implied by the Fed's revamp of its monetary policy strategy - see US section), markets may still benefit from mildly supportive risk sentiment amid a persistent search for yield. We maintain a prudent overweight in Credit, largely thanks to the carry, especially in safer buckets and longer maturities. Negative core yields are likely to keep trading range-bound and offer little value (mind 10-30y steepening potential). We keep a small overweight in equities, and will look to increase the pro-cyclical bias as the Covid paralysis recedes. The mid-term outlook remains bleak for the greenback, even though short term the EUR/USD rally is set to flatten out.

USA

Paolo Zanghieri



- The 31.7% qoq annualized GDP fall in Q2 was less catastrophic than expected. Sectors less affected by the lockdown are rebounding fast, but the resurgence in COVID cases may slow the rebound. We revised our growth forecast for 2020 up to -6.0%.
- Job creation remains subdued and the lack of an agreement on the extension of income support is a downside risk to consumption. This adds to uncertainty related to the November election.
- Under the new policy framework the Fed will be more tolerant of inflation and will increase its focus on unemployment.

Growth in Q2 was revised up to -9.1% qoq (-31.7% annualized), and during the summer the economy has shown signals of the anticipated rebound, especially in the sectors less affected by restrictions. Short term indicators point to GDP still some 6% below last year's levels. Taking stock of these developments we revised up our 2020 growth forecast to a still below consensus -6%.

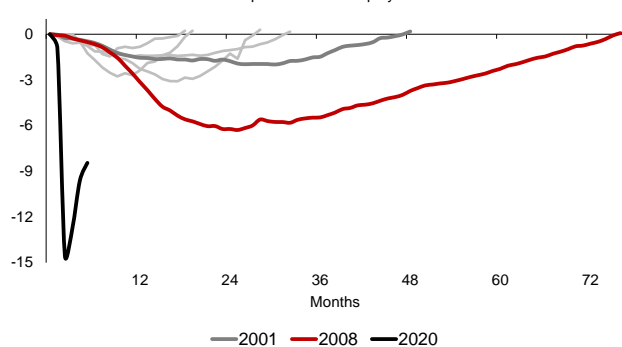
Multiple uncertainties loom over the H2 rebound

The unprecedentedly accommodative monetary policy is supporting the most interest sensitive parts of demand, especially where lockdown-related constraints are less binding. Construction is a case in point: in July, new single family home sales were up by 36% yoy. In normal circumstances a buoyant housing market would signal a fast recovery but caution is needed. In June, real consumption was still 5.5% lower yoy. Conflicting data is preventing uncertainty from going down from the extreme levels seen in spring, a potential drag on demand. The rebound in the job market seems to be losing steam, and employment remains much lower than in past recession episodes. The Congress failed to find an agreement to prolong the income support measures, which expired on July 31. Unless a deal is struck quickly, consumption growth may be severely curtailed. Politics will add to uncertainty in the two months before the presidential election: President Trump trails in the polls but concerns are emerging on the smooth running of the voting process, given the expected large share of voting by mail, which may slow down ballot counting.

The Fed: lower for (even) longer rates

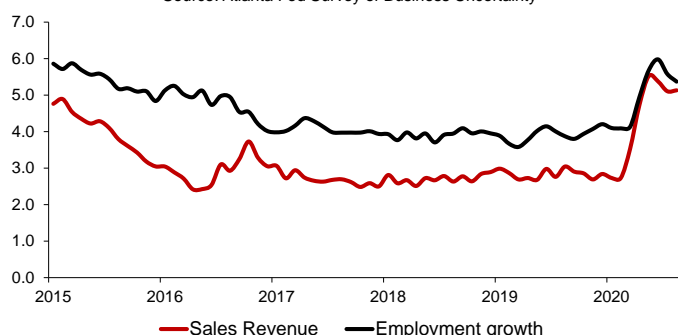
Speaking at the Jackson Hole virtual summit chair Powell announced a throughout revision of its monetary policy strategy, which went above expectations. The shift to an average inflation targeting over the business cycle, allowing for temporary overshooting from the 2% was expected. Apart from that, the Fed will grant itself some wiggle room as the time span used to average inflation will not be defined precisely. The surprise was the asymmetric treatment of labour market outcomes. The Fed will now target shortfalls from full employment rather than deviation from the equilibrium unemployment rate. This adds a further downward bias to expected rates.

US: Job losses in recessions
% of pre recession employment



Business uncertainty

Based on respondents' one year ahead expectations
Source: Atlanta Fed Survey of Business Uncertainty



Euro Area

Martin Wolburg

- Following a sharp increase in July, PMI sentiment deteriorated again in August. Still, indicators remain consistent with return to growth in Q3.
- The less bleak than expected Q2 GDP data caused us to revise our 2020 growth forecast up to -8.5% (from -10.0%) with risks staying on the downside.
- We expect no additional ECB policy measures to be announced at the September meeting.

Following the end of the full lockdown, the gradual easing of restrictions has been triggering a sharp rebound in economic activity. By June, industrial production (IP) has been rebounding by 22.5% and the return of the manufacturing PMI into expansionary territory in July/August suggests that this recovery continues. As of June IP was still 11% below the pre-Covid-19 level. In contrast, the recovery in the more domestically-oriented services sector took a hit as of late. The corresponding August PMI receded to just 50.1, from 54.7 before. It seems that tighter travel restrictions following the latest increase in Covid-19 infections left their mark. Not surprisingly, forward looking components also deteriorated.

Bumpy recovery ahead

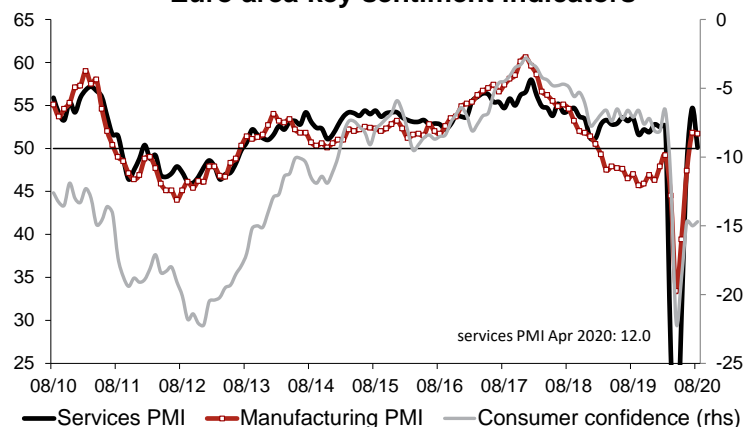
The August setback in the services and also composite PMI sentiment highlights that the recovery remains vulnerable. The key risk is a surge in new infections leading to a re-tightening of restrictions. This affects first of all the Southern European economies which exhibit the worst growth rate anyway (see mid chart) due to their strong reliance on tourism and hospitality. Moreover, the longer the unwinding of restrictions needs to be postponed the more negative the impact on employment. Fiscal support measures currently prevent layoffs and state guarantees help firms. But there is a risk of cliff edge effects from the unwinding of these measures although in Germany for instance the short-term working support has recently been extended until YE 2021. Likewise, a rise in insolvencies could trigger shockwaves via increased NPLs.

All in all, we raised our growth forecast not to the full extent implied by the better than expected Q2 GDP data as we became less optimistic on Q3. We now see 2020 growth at -8.5% (from -10.0% before).

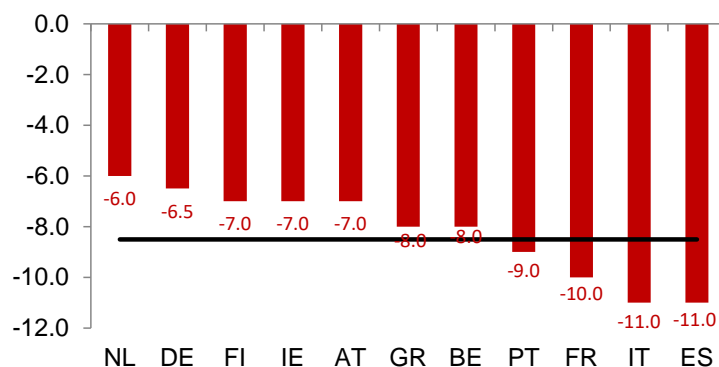
ECB's two-stage approach suggests more easing

ECB Chief Economist Lane presented at the Jackson Hole meeting the ECB's response to the pandemic more fundamentally. While the first stage was to counteract the negative effect on the inflation outlook (by PEPP etc) the second stage was to adjust policy ensuring a timely convergence to the inflation path. To us this implies that the ECB will increase degree of accommodation relative to the pre-pandemic stance medium term. However, at the forthcoming September 10 meeting we expect no action.

Euro area key sentiment indicators

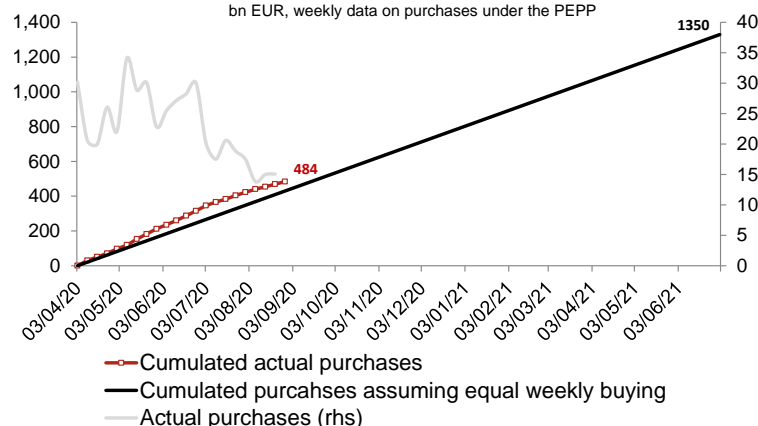


2020 exp. growth in the euro area



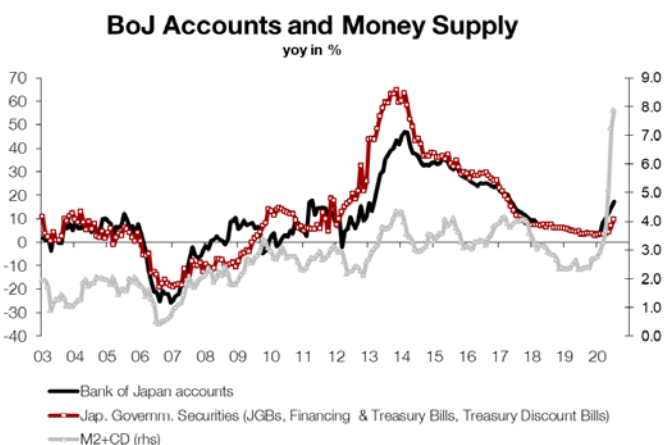
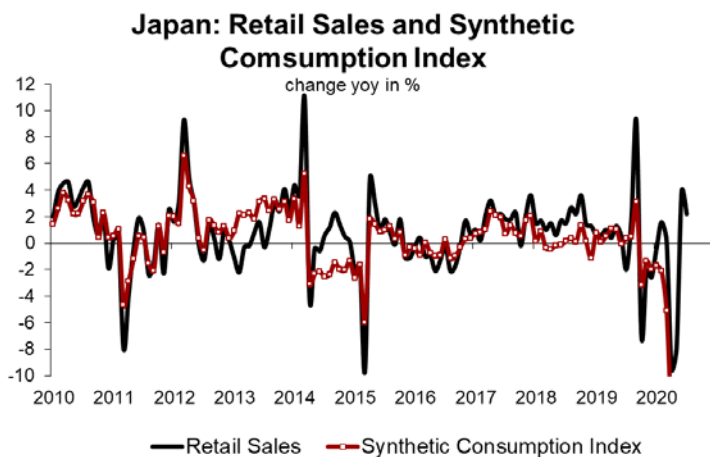
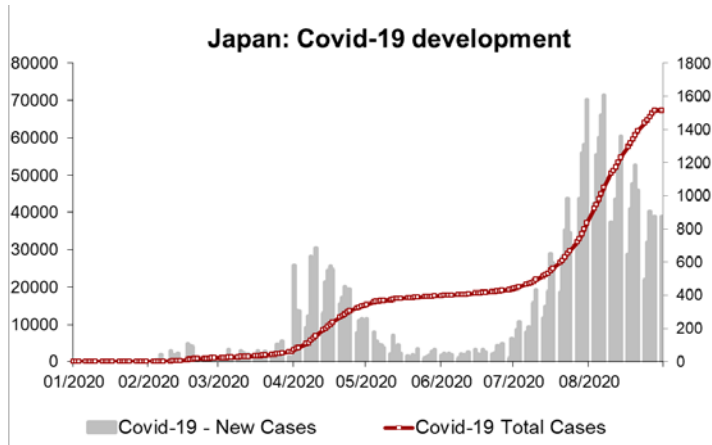
The ECB's PEPP

bn EUR, weekly data on purchases under the PEPP



Japan

Christoph Siepmann



- Japan's GDP plunged substantially in Q2. Looking into Q3, we expect the recovery to be somewhat lacklustre.
- PM Abe announced to step down. However, the government and the BoJ stand ready in case the situation deteriorates. Covid-19 facilities have started to show up strongly in money supply.

According to the first print, Japan's GDP dropped by 7.8% qoq resp 27.8% qoq ann. in Q2. Thus, Japan's economy remained in recession, which began with the sales tax hike on October 1, 2019, for the third quarter. The Q2 result is slightly less negative, but not materially different from the EU or the US. Exports plunged most dramatically amid international lockdowns. On the domestic side, private consumption was hit worst by the Covid-19 crisis, followed by business investment outlays. Government investment maintained positive growth, but was too small to exert a significant impact.

Looking ahead, Japan has seen a strong rise in fresh Covid-19 cases until early August, but they started to diminish again thereafter. Major lockdowns have been avoided. Nevertheless, the impact was felt in private consumption as people again stopped going out. Retail sales fell back again from their strong improvement in the month before, but will likely recover a bit amid lower Covid-19 cases, going forward. Private investment typically relies very much on the export outlook. While car sales have improved on better data in the US (which have been jeopardized again) and Europe, capital goods exports to China are likely to stay lacklustre amid its rebalancing from investment to consumption. However, help will probably come from electronics and G5 purchases. Taken together, investments are expected to need some time to bounce back. Regarding the supply side, manufacturing production surprised on the upside, but did not match the loss before. All in, the Q3 recovery is unlikely to make up for the slump in Q2.

PM Abe announced to step down

PM Abe announced to step down. He will be in office until a successor will have been found. Media report that there could be a simplified election method (only LDP Diet members to vote) on September 14. In any case, we do not expect big changes in fiscal policy in the short-term as the program is very much determined by the Covid-19 crisis. In case the situation would deteriorate, monetary and fiscal policy are likely to help again. Recently, data show a strong rise in money supply due to the BoJ program, in which it lends cash to banks against their lending to companies, incentivised with a sweetener of 10 bps. Banks rushed into this program. It de-facto neutralises the negative policy rates in this facility. In a wider context, this means that the BoJ now gives more attention to the stability of the banking sector.

China

Christoph Siepmann

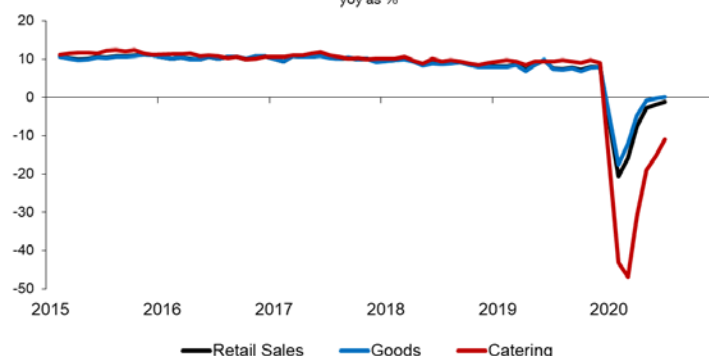
- China's economy kept on recovering but the bias between supply and demand continued.
- (Geo)political tensions have risen ahead of the US elections. We therefore expect China to concentrate on supporting domestic demand in H2.
- This includes targeted fiscal support for consumption and investment. Moreover, we stick to our view of more help from the PBoC.

As suggested by PMIs, China's macroeconomic dataset continued to improve in July. On the international trade side, export growth surprised strongly on the upside with a growth rate of 7.2% yoy, while imports slightly receded. Domestically, industrial production growth remained on the June level of 4.8% yoy. After four positive readings in a row, this might suggest that the bulk of China's V-shaped recovery on the supply side is over. The demand side is still lagging behind. Retail sales growth improved, but stayed in slightly negative territory (-1.2% yoy), with catering still the most subdued part. Domestic investment also further increased, but private investments remained the most lacklustre section. By contrast, infrastructure investment generally benefits from the implementation of fiscal stimulus measures while strong residential buildings sales supported real estate investment. On the monetary side, July data typically diminish for seasonal reasons. M2 growth dropped back from 11.1% yoy in June to 10.7% yoy in July, an identical drop in terms of percentage points as last year. New yuan loans also diminished somewhat but less than in the same period in 2019 while TSF remained comparably ample. CPI inflation rose by 0.2 pp to 2.7% yoy, entirely due to rising food prices.

China to concentrate on support for domestic forces

China's last Politburo suggested that the government is fully aware of the uneven domestic development. At the same time, international (geo)political conflicts are on the rise (TikTok, Huawei, Hong Kong "security" law, US listed Chinese companies, trade policy but conciliatory assessment of the phase I trade deal, South China Sea, etc), while large rainfalls had (again) stoked up speculations regarding the stability of the three gorges dam. The relationship to the US is likely to deteriorate further ahead of the US elections. And even a change in the US governing party is unlikely to be able to mend ties quickly. Accordingly, foreign demand will remain prone to setbacks and China's policy needs to concentrate on unleashing domestic forces in H2 to support growth. We do not expect a fresh policy package (the NPC meeting would have been the best opportunity) but targeted measures to stabilize income and employment. This also includes ongoing support for SMEs which provides the bulk of jobs. Consequently, despite the rise in yields (the reasons being controversially discussed ranging from geopolitics to prevent a rise in risky financing), we stick to our view of a 50 bps RRR cut in 2020 and a reduction of the Loan Prime Rate by 20 bps.

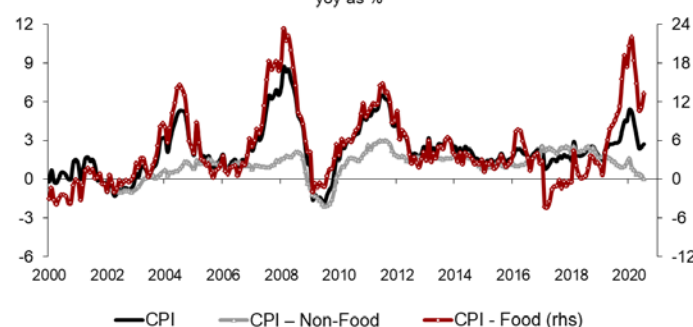
China: Retail Sales
yoy as %



China: Growth of Urban Fixed Asset Investment
yoy as %

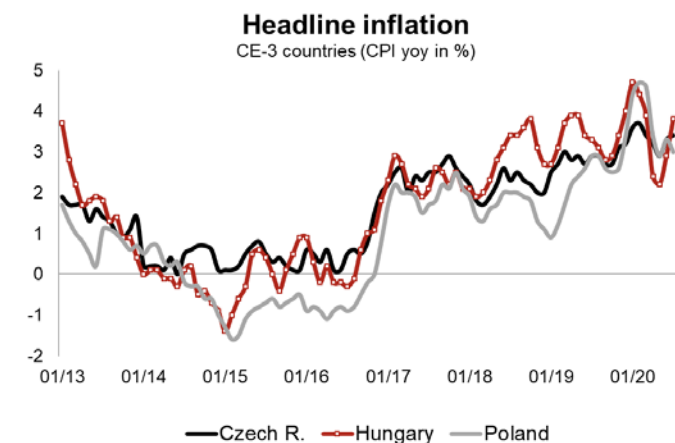
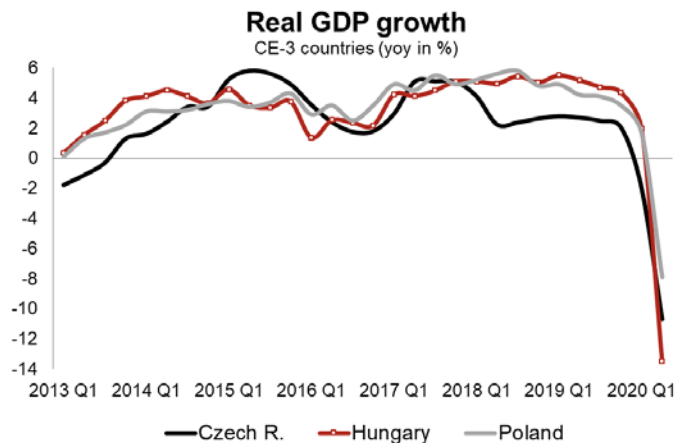


China: Consumer Price Inflation
yoy as %



Central and Eastern Europe

Radomír Jáč



- Preliminary data for Q2 report a sharp GDP decline with Hungary falling more than expected and the Czech GDP surprising positively.
- Inflation remains above targets set by regional central banks and core CPI increased further in July across CE-3 economies.
- High inflation limits room for additional monetary stimuli, as real interest rates are deeply negative. In Hungary, the MNB will increase QE purchases.

The CE-3 region reported a sharp decline in GDP for Q2. This was not a surprise, as activity was hit by Covid-19 related lockdowns. However, while data for the Czech Republic (-8.4% qoq, -10.7% yoy) and Poland (-8.9% qoq and -7.9% yoy) surprised positively, the fall in Hungary was sharper than expected (-14.5% qoq and -13.5% yoy). This led us to increase 2020 forecasts for the Czech GDP (from -7% to -5.8%) and to revise the outlook down for Hungary (from -6% to -7%).

Inflation has been surprising on the upside, particularly core CPI, which stands above 3.5% yoy in case of the Czech economy and above 4% yoy in Hungary and Poland. The projection is that inflation will moderate over the course of the monetary policy horizon but its current level reduces space for further monetary policy easing.

Central banks: High inflation limits space for stimulus

The Czech CNB kept its key rate unchanged at 0.25% at a monetary policy meeting in early August. Its new macro forecast expects interest rates to remain stable until mid-2021 with gradual increases afterwards. The Czech crown is expected to firm against the euro only gradually. We keep a more bullish view on the CZK and we think that the CNB will tolerate a stronger FX rate, as core CPI stands above its forecast. A stronger CZK may at the same time delay any future hike in interest rates.

In Hungary, the MNB's key interest rate found its floor at 0.60% after two cuts (by 15 bps each) delivered in June and July. However, at its meeting held in late August the MNB decided to increase the amount of government debt purchases under its QE programme. We understand it as a response to recent increase in local government bond yields and also to an upward revision of government budget deficit forecast for 2020. The Finance Ministry said that the budget gap is likely to reach a range of 7%-9% of GDP instead of 3.8%-4% expected previously for 2020. However, the related increase in HGB bond issuance should not be dramatic and we expect the market to absorb a larger bond supply without any tension.

The Polish NBP keeps its key rate on hold at 0.10% with the last MPC meeting taking place in mid-July. The next one is scheduled for early September. We expect the NBP to leave interest rates unchanged until the end of 2021 and to use QE for monetary policy fine-tuning.

Main Forecasts	2018	2019	2020f	2021f
Czech Republic				
GDP	3.2	2.3	-5.8	5.0
Consumer prices	2.1	2.8	3.2	2.1
Central bank's key rate	1.75	2.00	0.25	0.25
Hungary				
GDP	5.1	4.9	-7.0	4.9
Consumer prices	2.8	3.4	3.2	3.0
Central bank's key rate	0.90	0.90	0.60	0.60
Poland				
GDP	5.2	4.1	-4.2	4.6
Consumer prices	1.6	2.3	3.2	2.5
Central bank's key rate	1.50	1.50	0.10	0.10

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

Bonds/Fixed Income Strategy

Florian Späte

- After decreasing until the beginning of August core sovereign yields rose again. Particularly, positive macroeconomic surprises and hopes for a Covid-19 inflexion point triggered the moderate rebound.
- However, this is unlikely to be the start of a bear market as central banks continue to follow their accommodative monetary policy and exuberant macroeconomic expectations are likely to be dampened. Still, a further slight upward movement seems possible.
- Euro area non-core sovereign bonds performed well in August. Given the likely lack of market driving news we do not expect a further significant spread tightening. High yielding short-dated bonds are attractive for carry trades.

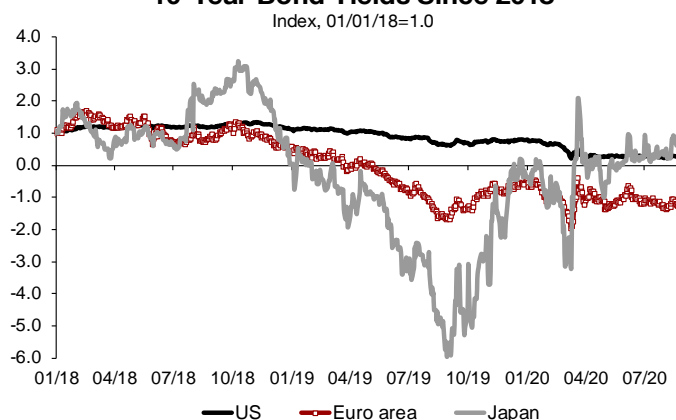
Expectations that core sovereign yields would fall further over summer so far proved unfounded. Ongoing positive macroeconomic surprises nurtured expectations of a rather swift economic recovery. The positive financial market sentiment was also supported by declining infection rates (in the developed world) and hopes for a development of a Covid-19 vaccine. Overall, 10-year Bund yields rose by 12 bps to -0.41% and their US counterparts by almost 20 bps to 0.71% in August. At the same time, the short end of the curve remained well anchored by the extremely dovish stance of central banks.

Although euro area and US yields remained in the trading range which has been in existence since April the noteworthy increase in inflation expectations continued. 10-year euro area inflation swaps increased by 10 bps and US ones by 20 bps. This shows that the nominal yield increase is not the result of higher real yields but it is the outcome of a further normalization of inflation expectations. Given the fact that inflation expectations are still below their long-term average and considering the expansionary fiscal and monetary policy stance the trend towards rising inflation expectations is likely to continue for a while. This applies even more as Fed Chair Powell indicated at the Jackson Hole symposium that the Fed will tolerate temporarily higher inflation and monetary policy will shift towards more discretion. Still, we consider the potential to catch up greater in the euro area than in the US.

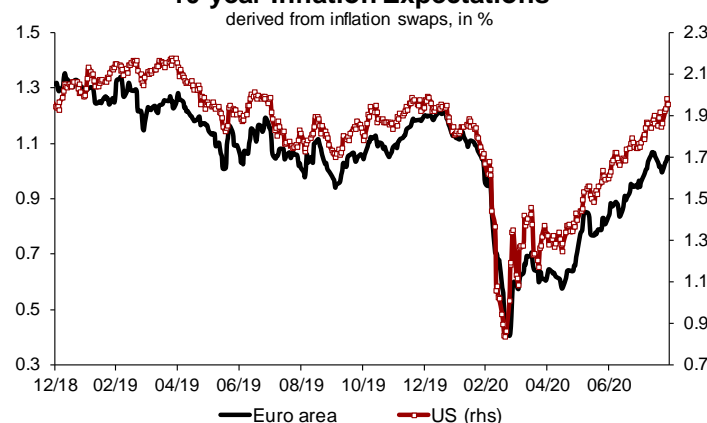
Trading range to remain unchanged

The ongoing normalization of inflation expectations, however, should not be confused with a bond bear market. Despite the repeated upwardly surprising macroeconomic indicators the economic rebound will lose steam in the months to come. The recovery will take a long time and pre-crisis levels will remain out of reach. Moreover, central banks continue to support sovereign bond markets. They will keep key rates on the current level for the foreseeable

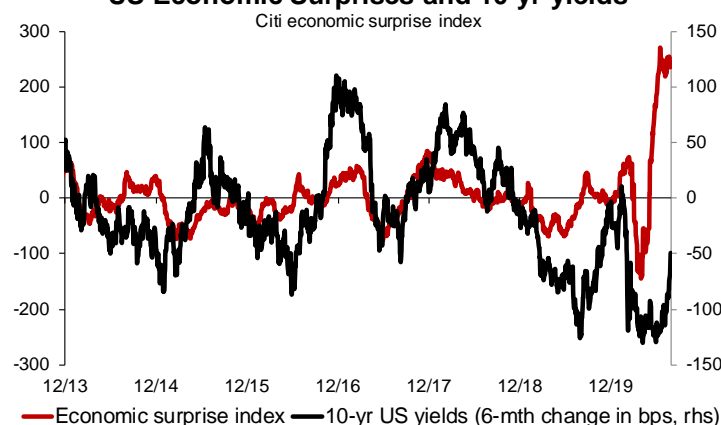
10-Year Bond Yields Since 2018



10-year Inflation Expectations



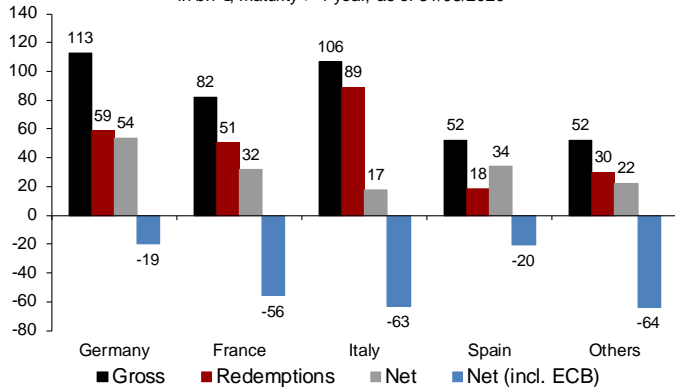
US Economic Surprises and 10-yr yields



Bonds/Fixed Income Strategy

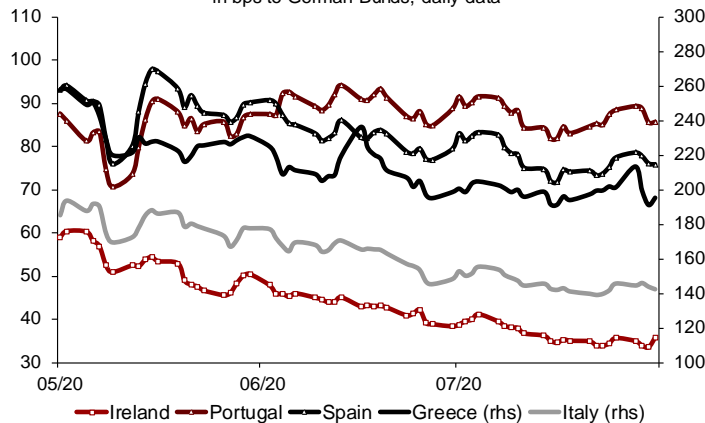
Remaining EA Sov. Debt Issuance in 2020

in bn €, maturity > 1 year, as of 31/08/2020



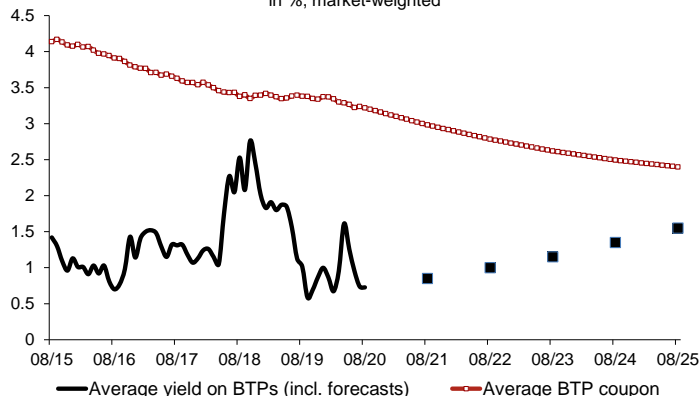
10-year Sov. Spread Euro Area Peripherals

in bps to German Bunds, daily data



Italy: Cost of Debt to decline going forward

in %, market-weighted



future and will provide ample liquidity to assist the economic recovery. Additionally, growing odds of a Democratic sweep can dampen sentiment for risky assets and, thereby, trigger downward pressure on yields. Finally, although the issuance activity will pick up again after summer the funding will remain below the spring levels. Year-to-date euro area treasurers have already completed around 70% of the annual target. Hence, the cash flow will be more market friendly as net issuance (including ECB purchases) will be negative until year-end.

Nevertheless, on balance yields are likely to inch up in the coming months. The economic releases indicate that an economic recovery is on the way supported by Covid-19 which fades slowly into the background. As stated above this trend will be driven by higher inflation expectations and not higher real yields. Moreover, it will remain confined to medium- and longer-dated yields as the short end will hardly move amid the expansionary monetary policies. We forecast 10-year euro area core yields to rise to -0.35% (3-mth) and -0.25% (12-mth). 10-year US yields are seen to climb to 0.75% (3-mth) and 0.90% (12-mth).

At the very long end of the euro area yield curve we see some more leeway. Not only that treasurers have started to issue especially very long-dated tenors (after focusing on medium-dated ones in early spring) but the appearance of the EU as a main market participant concentrating on very long-dated bonds is likely to leave its mark in the months to come.

Limited potential for euro area non-core bonds

Euro area non-core sovereign bond spreads tightened further in August. Italian and Greek papers outperformed Iberian ones. Meanwhile, spreads have almost entirely erased the widening in spring.

In the months to come, we see only limited leeway for a further widening as financial markets have got almost everything they hoped for and we do not expect significant market moving news flow. Not only the ECB stepped in and came up to expectations, but with the EU Recovery Fund agreement also a step towards risk sharing at a euro area level will be implemented. Then again, the de facto spread cap by the ECB will prevent any meaningful widening for the time being. This rather calm environment opens the opportunity to set up carry trades. We regard short-dated BTPs as most attractive.

The question remains what the situation will be in the longer term. Amid the expansionary monetary policy governments may have an incentive not to reduce fiscal deficits and to tackle structural problems. The interest burden would remain sustainable and the cost of debt would even fall further. However, negative real yields amid the money creation is likely to cause bubbles.

Corporate Bonds

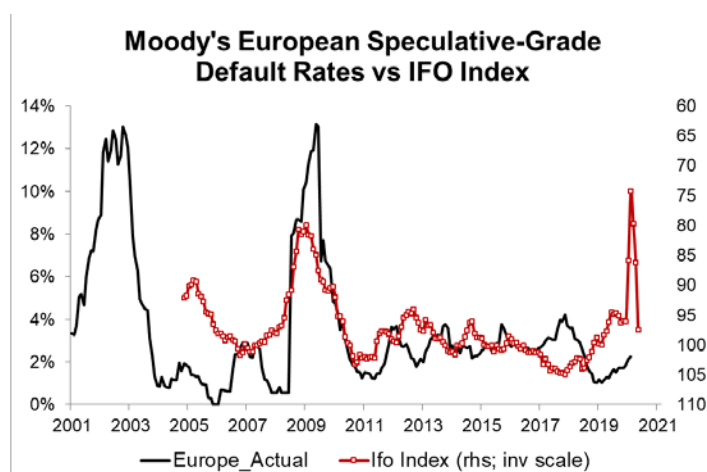
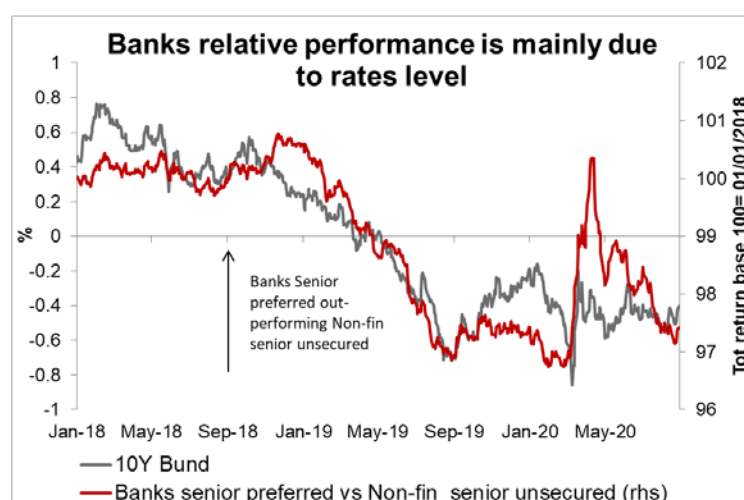
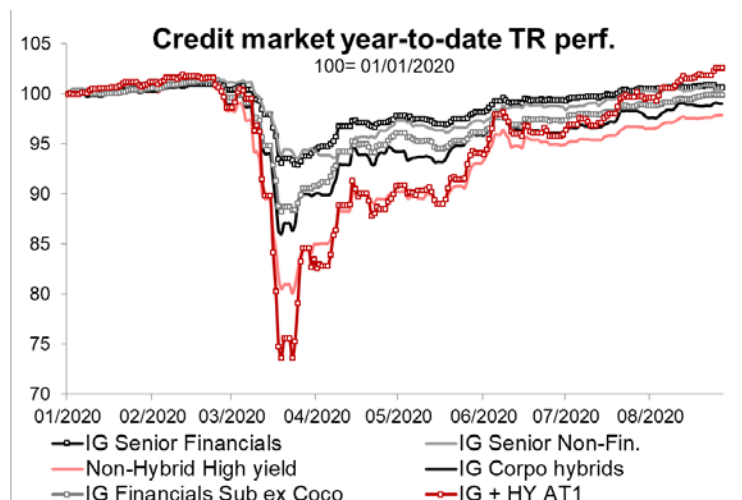
Elisa Belgacem

- Alongside other risky assets, credit spreads have continued their recovery throughout summer, getting gradually closer to pre-Covid levels.
- Riskiest credit assets are leading the move with subordinated debt posting impressive performances.
- S&P has revised its 12m trailing default forecast to 8.5%, but we expect index defaults to remain in the 5-6% region, which will weigh on HY.
- The reporting season will reopen soon slowing the spread tightening.
- As we expect the economic picture to start losing its lustre in autumn, we continue to recommend an OW in IG. We are neutral on HY as defaults will continue to rise, hence we prefer BBs.

After a reporting season that was on average slightly better than expected, credit spreads have enjoyed a quiet and rather liner tightening bias throughout summer. We have now senior bonds as well as AT1 posting positive YTD returns while high yield and corporate hybrids remain in negative territory. We also see a significant outperformance of financials vs non-financials thanks to an unprecedented regulatory support. Indeed the central bank purchases of corporate bonds will remain mechanically capping the downside. However several factor might limit the return to pre crisis levels, already in 2020. First, the reporting season was likely not good enough to prevent the rating agencies from initiating a second wave of downgrades in Autumn. Second the defaults will continue to increase, S&P expects now the European trailing-12-month speculative-grade corporate default rate to rise to 8.5% by June 2021 from 3.35% in June 2020, while we expect index default to remain rather in the 5-6% region. Third we expect the mechanical economic rebound to loose it lustre in Autumn providing less support for risky assets.

Subordinated bonds out-perform HY

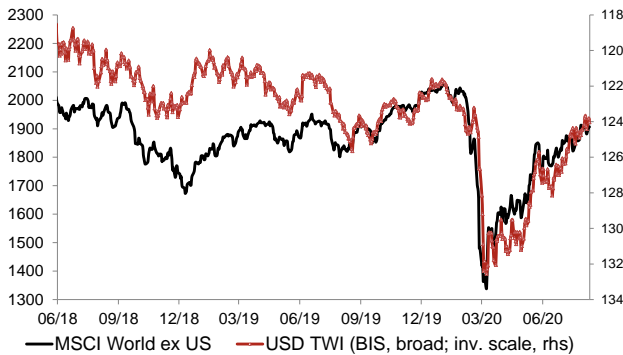
Hence going forward, we see IG grinding gradually tighter while there is still room for further valuation divergence between IG and HY. Indeed rising default rates will continue to weigh on HY into 2021 despite record public support. It will weigh more on the lower end of the rating spectrum, hence within HY, we retain a preference for BBs. On IG on the opposite, we expect near-zero default rates, while the pick-up versus govies is high. Yes, there will be migration risks, but we think it is well reflected in the price. Hence we recommend a neutral financials versus non-financials. We continue to prefer capital structure risk to credit risk, hence prefer corporate hybrids and AT1 to a lesser extent.



Currencies

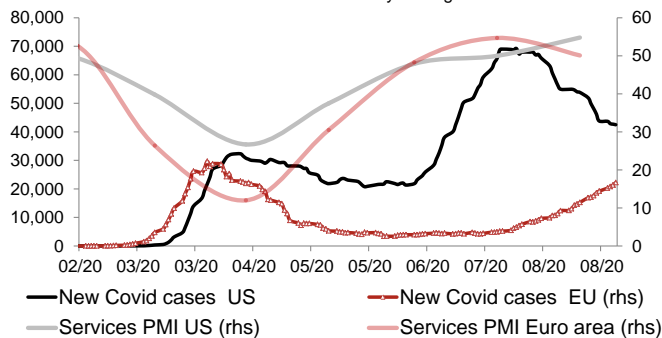
Thomas Hempell

USD still in tight grip of risk sentiment

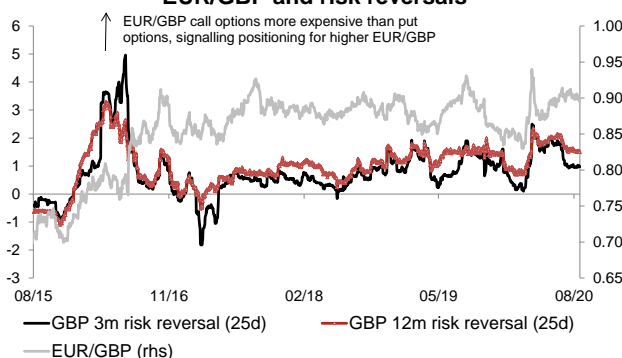


Covid-19 dynamics and PMIs: US vs Europe

Covid-19 cases as 5-day averages



EUR/GBP and risk reversals



- The EUR/USD is headed for moderate further gains over the medium term.
- Short term, however, the outlook is more balanced as the support from rebounding risk appetite gets lofty. Also, rising new Covid-19 cases in Europe and a slowing recovery may keep a lid on the euro.
- We see short-term downside to sterling amid brinkmanship in negotiations with the EU and deeper scars from Covid-19 in the UK.

The USD has stabilized in August, following a steep decline from mid-May through July. The medium term outlook is still for a structural decline not least due to a persistently eroded yield advantage which the Fed has just having cemented in its dovish review of its monetary policy strategy (see US section). Structural USD overvaluation, a sizeable twin deficit (fiscal and C/A) and a gradual diversification of global FX reserves out of the USD are further crosscurrents. We also see some further downside risks from the November elections. A Democrat victory (esp. a 'sweep' one incl. control of Congress) would undermine two pillars of USD support during the Trump presidency: corporate tax cuts and a reckless trade war with China.

USD consolidation in a structural downtrend

Yet, the short term EUR/USD outlook looks more balanced. Much of the USD weakness has been owing to rebounding risk sentiment (top chart), which will be hard to sustain. USD weakness has also become highly consensual and helped by a huge swing in speculative positions. Conversely, easing peripheral risk drove much of the euro rebound. With BTP/Bund spreads below 150 bps, we deem this risk compression largely exhausted.

Furthermore, Covid-19 infections are levelling off in the US but again rising in Europe. And the composite PMI readings saw relative recovery fortunes between the US and EA reversing in August (mid chart). Also, the looming end-game in (post-)Brexit negotiations could weigh on EUR/USD (see below). These factors are unlikely to reverse the structural path of the EUR/USD (we expect a more sustainable break above 1.20 for 2021). But setbacks over the next weeks may offer more appealing entry points for EUR/USD longs.

With a decline by more than 22% in H1, the UK was among the economies hardest hit by Covid-19. The looming expiration of furlough schemes in October may flatten the economic recovery. The BoE has declined negative rates for now, but kept this as an option in its toolbox. Most strikingly, resumed Brexit negotiations do not point to any progress. We still see chances of a bare-bone deal, but only after drama and brinkmanship over the coming weeks. Markets have been sanguine so far (bottom chart), but this makes GBP only more vulnerable to renewed weakness near term.

Equities

- Global equities performed well in August, with rotation towards Value and Cyclical (OW for us).
- Short term, we maintain a slight OW on equities due to lingering supportive policy action, better earnings and GDP momentum and neutral tactical indicators and positioning (not stretched yet).
- Our models see total returns of around +5% in 12 months. Risks: lower economic momentum, Covid 2nd wave and geopolitical risks.
- We are neutral EMU vs US and maintain a tilt towards EMs (OW), Value and Cyclical.

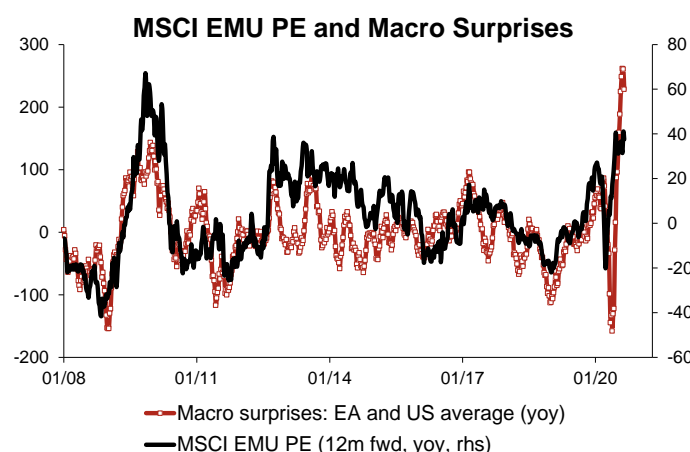
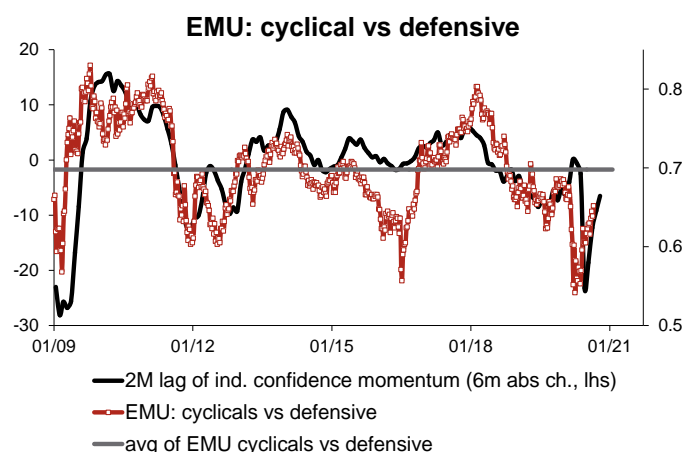
In August, the equity performance was again on the positive side, helped by steady positive macro surprises, good reporting season and earnings momentum in addition to continuing policy support. Corporate spreads declined, helping to contain the firms' cost of capital while higher 10-year rates induced the rotation towards the Value and the Cyclical sectors (OW). The S&P 500 overperformed the EMU and the Topix indices, while the Nasdaq index did even better. On the contrary, the MSCI EM index underperformed - notwithstanding good earnings momentum and lower EMBI spreads - together with the SMI and the FTSE 100.

New global Covid cases flattened out and mortality rates declined. In general, we reckon that while risks persist for the next Autumn, social and health systems are better equipped to manage new Covid cases.

Markets still attractive in absolute terms and vs. bonds

Notwithstanding the rally, markets remain attractive with our forecast for the next 12 months around 4% - 5% which implicitly maintain an attractive ex-ante risk premium vs bonds. Indeed, compared to our last assessment made in June, some factors have contributed to keep equity appealing. GDP in Q2 has come out better than feared with macro surprises also trending up. We revised our GDP forecast for 2020 to be less negative. This was coupled with a better reporting season for Q2. As for the latter, positive surprises were in the range of 23%-34% in the four relevant macro areas: US, Europe, euro area (EA) and Japan. The yearly earnings growth was bleak but overall less than feared: -7.3%, -19%, -30% and -21%, respectively. 12-month earnings forecasts improved globally by 4%, also due to a roll-forward effect (they refer to August 2021 and no more to July 2021 and the 2021 is a year of strong growth): +3.4% for the S&P 500, +1.8% for the MSCI EMU index and +2.6% for the MSCI EM index. Rolling effect excluded, a genuine upward revision was visible only in the US (+2%) across 2020-2022. As a last point, policy action will remain well supportive. Both the Fed and the ECB will maintain a strong dovish stance albeit their surprise effect can diminish from now on. The same is true for the fiscal manoeuvres.

Michele Morganti / Vladimir Oleinikov



Sector	S&P earnings growth, yoy: Q2 2020	Stoxx earnings growth, yoy: Q2 2020	Euro Stoxx earnings growth, yoy: Q2 2020	Topix earnings growth, yoy: Q2 2020	S&P sales growth, yoy: Q2 2020	Stoxx sales growth, yoy: Q2 2020	Euro Stoxx sales growth, yoy: Q2 2020	Topix sales growth, yoy: Q2 2020
Energy	-55.0%	-66.8%	-87.7%	-2.5%	-53.7%	-55.8%	-49.7%	-34.4%
Materials	-25.7%	-29.2%	-34.7%	-33.5%	-16.5%	-22.1%	-24.8%	-16.3%
Industrials	-29.6%	-19.9%	-24.2%	-35.4%	-24.7%	-25.8%	-28.3%	-19.3%
Cons. Discretionary	26.1%	-35.3%	-46.1%	-51.4%	-13.3%	-39.5%	-38.2%	-32.6%
Consumer Staples	-0.6%	-30.3%	-37.5%	-23.9%	-1.0%	-6.3%	-5.4%	-4.8%
Health Care	7.7%	-2.6%	-9.6%	-2.3%	3.3%	-3.4%	-3.3%	-3.5%
Financials	-30.4%	-16.3%	-35.6%	-25.5%	-2.2%	-1.7%	-6.2%	-0.5%
IT	3.1%	21.4%	19.9%	20.9%	5.3%	-2.9%	-4.3%	-12.2%
Comm. Services	-10.8%	-7.1%	-6.6%	9.8%	-3.7%	3.2%	4.8%	-10.1%
Utilities	6.7%	-22.8%	-22.8%	-55.6%	-6.2%	-5.4%	-4.9%	-7.8%
Real Estate	-3.4%	-18.2%	-	-16.2%	-6.1%	6.5%	3.9%	-11.6%
Market	-7.3%	-19.2%	-29.8%	-20.6%	-9.8%	-22.8%	-21.3%	-17.3%
Median (all sectors)	-3.4%	-19.9%	-29.4%	-23.9%	-6.1%	-5.4%	-5.4%	-11.6%

Sector	S&P earnings surprise: Q2 2020	Stoxx earnings surprise: Q2 2020	Euro Stoxx earnings surprise: Q2 2020	Topix earnings surprise: Q2 2020	S&P sales surprise: Q2 2020	Stoxx sales surprise: Q2 2020	Euro Stoxx sales surprise: Q2 2020	Topix sales surprise: Q2 2020
Energy	-14.0%	28.5%	24.9%	55.6%	-14.8%	-29.0%	-22.1%	-13.8%
Materials	17.1%	112.4%	391.7%	49.0%	0.4%	1.5%	2.4%	-0.3%
Industrials	66.7%	-7.6%	-45.2%	87.5%	4.7%	7.0%	11.0%	-13.3%
Cons. Discretionary	N.M.	0.1%	17.3%	-34.3%	7.2%	1.3%	1.7%	-0.9%
Consumer Staples	13.9%	34.8%	54.8%	-23.0%	1.3%	-1.0%	-2.2%	0.5%
Health Care	19.5%	2.4%	5.7%	30.7%	2.3%	-2.3%	-1.3%	-0.5%
Financials	16.4%	11.2%	19.4%	14.1%	1.2%	2.3%	1.3%	5.9%
IT	14.7%	13.1%	9.2%	39.1%	5.5%	1.4%	1.1%	-0.7%
Comm. Services	18.3%	-10.2%	-17.2%	30.9%	1.6%	1.5%	2.0%	1.3%
Utilities	6.6%	-1.9%	-1.9%	9.4%	-6.1%	-9.7%	-9.7%	5.5%
Real Estate	2.5%	91.3%	-	6.6%	2.6%	16.7%	23.0%	4.4%
Market	23.2%	31.4%	33.8%	25.3%	1.8%	-3.0%	-0.6%	-2.8%
Median (all sectors)	15.5%	11.2%	13.2%	30.7%	1.6%	1.4%	1.3%	-0.3%

Equities

Markets	Price / Earnings *		Price / Book *		Price / Cash Flow *		Dividend Yield *		Perf. -1M	PEG adj. *
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.		
WORLD	21.1	16.0	2.5	1.9	13.0	8.9	2.1	2.8	5.7	
USA	23.0	15.4	3.6	2.4	15.6	10.0	1.7	2.2	7.6	1.8
JAPAN	17.8	15.3	1.1	1.2	8.4	7.1	2.4	2.1	2.5	1.9
UK	15.3	13.8	1.4	1.7	8.5	7.8	4.0	4.1	-1.7	4.6
SWITZERLAND	18.0	15.5	2.7	2.3	12.1	11.2	3.1	3.5	-0.3	3.3
EMU	17.7	14.1	1.4	1.4	8.5	6.6	3.1	3.9	1.2	3.3
FRANCE	18.4	14.3	1.4	1.4	9.3	7.1	3.1	3.9	2.0	5.0
GERMANY	17.2	15.0	1.5	1.5	8.5	7.0	2.8	3.4	1.5	3.4
GREECE	12.9	12.8	2.3	1.5	6.0	5.8	6.1	4.2	1.1	2.5
ITALY	15.2	15.0	1.2	1.1	5.7	4.5	4.3	4.8	-0.9	3.2
PORTUGAL	19.1	12.9	1.9	1.7	6.6	5.9	4.6	4.6	-1.8	3.3
SPAIN	15.9	12.9	1.0	1.4	4.6	4.8	4.3	5.2	-1.1	2.8
EURO STOXX 50	17.0	13.3	1.5	1.4	8.6	6.3	3.3	4.3	0.9	3.4
STOXX SMALL	22.2	14.7	1.5	1.7	10.1	8.4	2.7	3.2	4.7	13.4
EM, \$	15.2	14.4	1.6	1.6	9.0	7.7	2.5	3.1	4.1	1.9
BRAZIL	15.8	9.3	1.9	1.7	7.7	13.8	3.3	4.0	-4.4	3.2
RUSSIA	8.2	6.9	0.7	0.9	5.1	4.3	7.4	4.5	2.5	4.3
INDIA	23.6	14.8	2.7	2.6	14.0	11.7	1.5	1.6	4.0	2.6
CHINA	15.4	12.9	1.9	1.7	10.5	7.8	1.7	2.9	8.3	1.6

Note: The first four markets are based on the main local indices, the rest on the corresponding MSCI indices.

Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003. PEG is PE divided by expected EPS long-term growth.

PEG adj. (higher = expensive): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it.

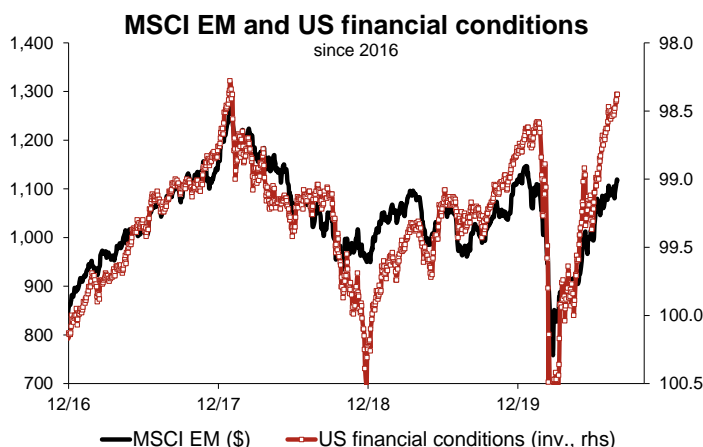
COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs).

Source: Thomson Reuters Datastream, IBES estimates.

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	0.70	1.24	-0.54	142.5	3.90
Scenario 2 (consensus 12m forward in 1 year)	1.14	1.25	-0.11	173.4	4.74
Scenario 3 (GI 12m fwd in 1 year)	0.95	1.90	-0.95	176.3	4.82
Scenario 4 (downside macro scenario)	0.50	1.00	-0.50	130.0	3.56
Scenario 5 (upside macro scenario)	1.50	1.50	0.00	190.3	5.21
Scenario 6 (lower recent ERP average)	3.25	2.30	0.95	166.3	4.49

	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	20.3	24.6	25.1	18.5	27.0
Avg S&P500 valuation	2,864	3,483	3,543	2,612	3,822
	-17.5%	0.4%	2.1%	-24.7%	10.1%

Note: Target ERP (4.7) is calculated assuming CPI in the range b/w 1.0% and 2.0%. We used 25% of risk premium's stand. deviation (SD). Possible range for scenario 3: 3,540 - 3,700.



Global earnings revisions are back in positive territory for the first time after 2018 and momentum in macro indicators should remain at least resilient.

Expensive market multiples don't tell all the truth

As said last month, spiking Fed's assets support higher US PEs (as was the case since 2005) and PEs tend to increase at the bottom of the cycle. Tactical indicators are not stretched yet but around neutral which could mean that volatility can be eventually higher in the next weeks. Positioning is also not yet strong on equities.

Our models still show a total return of 5% in one year (in part due to the cited roll effect), which remains attractive vs the fixed income. As for the US, a lower return (3-4%) is due, bringing the S&P 500 above 3,500. We maintain a slightly positive bias on equities (OW), with risks being represented by Covid, geopolitical risks (US-China, Brexit) and US elections (Democrat clean-sweep).

Country and sector allocation: tilt on Value/Cyclicals

We recommend a balanced portfolio (US aligned with EMU) with a marginal tilt to EMs. Mid-term, the cyclical recovery, marginal higher yields and steeper yield curves plus the improved sentiment due to the recovery fund could ignite an overperformance of EMU vs US that we estimate to be in the region of 5-7pp (via a reduced risk premium gap of 50 bps). Of course, a stronger EURUSD could at some point represent a headwind for the EA. For the time being, the EMU risk premium has already come down appreciably vs the US one. Less attractive are also the ECB assets momentum vs US (driving rel. PEs), the EMU PEG ratio and our internal EMU composite valuation score: we remain neutral EMU vs US. UK and Switzerland scores are similar to EMU ones (neutral). Japan scores very well but we want to see first the policy of the future prime minister (N).

On sectors, we maintain a tilt towards Value and Cyclicals. OW: Insurance, div. financials, capital goods and semiconductors (new). Media and telecoms are N from OW. UW: durables, transportation, and comm. & prof. services (RE is N from UW), and Momentum (slight OW).

EM: upside potential still present

Our constructive view on EMs remains intact. Positive for EMs is the ongoing growth improvement, which is seen in a relatively stronger rebound of EM manufacturing PMI (vs the EAs). In the short term, the EM equities are supported by increasing macro surprises and Fed's financial conditions. Beyond, they should benefit from a weakening US dollar, higher commodity prices, relatively low valuations and better earnings growth. Risks: intensifying US-China tensions closer to US elections. We favor Korea, Taiwan and Poland, having better Covid contagion trend, supporting M1 momentum, and high internal score ratings.

Asset Allocation

Thorsten Runde

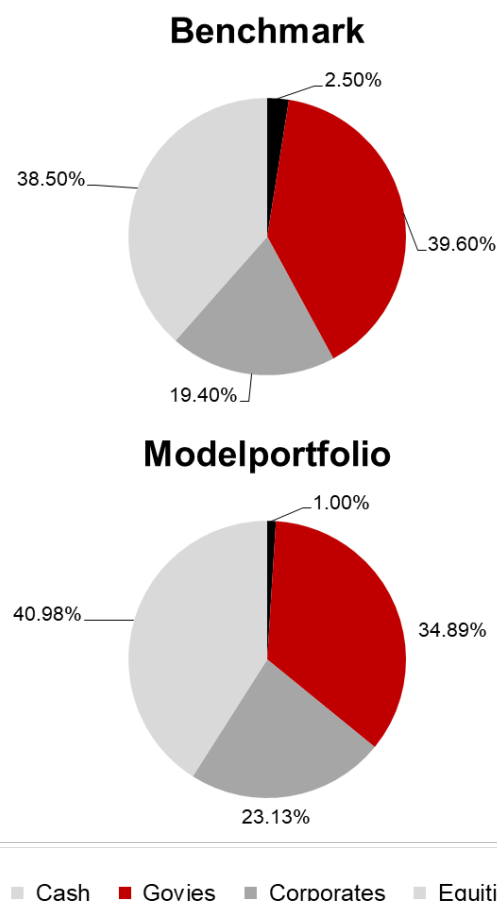
- The performance ranking of financial markets in the month of August was clearly lead by equities that made roughly +5.2% on average in the developed area. Emerging equity markets account for +3.9% so far (August 27).
- The government bond segments are more or less deeply stuck in the negative performance territory. Only EM government bonds surpassed the zero line so far.
- The worst performance across all asset classes is revealed by long-dated US Treasuries that roughly lost -5.0%.
- On the credit side, HY clearly outperformed the high-quality segments, in the EA (+120 bps) as well as in the US (+220 bps). Just EA IG credit managed to stay in positive territory (+0.2%) whereas the US counterpart performed distinctively worse (-1.5%).
- With the impacts resulting from the rising Covid-19 infection numbers being ambiguous and US figures surprising on the upside, we still deem ourselves quite well positioned with a portfolio structure moderately tilted towards risk assets.

In the course of August our model portfolio outperformed its benchmark by roughly +17.0 bps as most of the largest active positions paid off as expected. With their strong performance, not surprisingly, equities account for the biggest chunk with a performance contribution of +6.9 bps, followed by US Treasuries (+5.9 bps), EA core govies (+5.0 bps) and cash (2.8 bps). Just the active positioning in credits turned out to contribute negatively to the relative performance (-6.6 bps). That said, the reductions applied to the credit positioning last time also worked in the right direction.

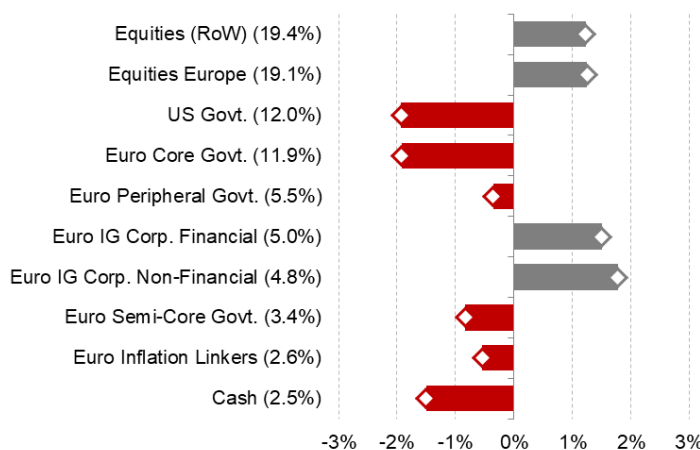
A general lockdown is not necessarily to be expected due to the re-increasing number of Covid-19 infections. Furthermore, the effects of the first lockdown on the US economy appeared less severe than expected. As we are acting on the assumption of a rather range-bound movement in yields, low-carry markets on the fixed income side do not look too appealing for the time being. All in this argues for the FOMO & TINA effects to be still working, keeping in mind that the recent rally on equity markets bears the risk of some short-term corrections.

FOMO & TINA still at work

Overall, we will stick to our moderately risk-taking positioning for the time being characterized by slight overweights in equity and credit and avoidance of low-carry markets like EA core govies and US treasuries.



Active Positions in TOP 10 Benchmark Constituents*



*Benchmark weights in parentheses, diamonds indicating previous recommendations

Forecast Tables

Growth

	2018	2019f	2020f	2021f
US	2.9	2.3	- 6.0	4.0
<i>Euro area</i>	1.9	1.2	- 8.5	6.0
Germany	1.3	0.6	- 6.5	5.5
France	1.8	1.3	-10.0	7.0
Italy	0.7	0.2	-11.0	6.0
<i>Non-EMU</i>	1.5	1.4	- 9.2	5.8
UK	1.3	1.4	-10.0	6.1
Switzerland	2.7	1.0	- 6.5	4.0
Japan	0.8	0.8	- 5.8	2.8
<i>Asia ex Japan</i>	6.2	5.2	- 1.0	6.9
China	6.6	6.1	1.8	7.5
Central/Eastern Europe	3.2	1.9	- 4.2	4.4
Latin America	0.1	- 1.1	- 7.1	3.2
World	3.5	2.7	- 4.5	5.3

Inflation

	2018	2019f	2020f	2021f
US	2.4	1.8	0.4	1.4
<i>Euro area</i>	1.8	1.2	0.3	1.2
Germany	1.9	1.4	0.6	1.5
France	2.1	1.3	0.5	1.2
Italy	1.1	0.8	- 0.1	0.9
<i>Non-EMU</i>	2.3	1.7	0.6	1.3
UK	2.5	1.8	0.6	1.3
Switzerland	0.9	0.4	- 0.5	0.2
Japan	1.0	0.5	0.0	0.1
<i>Asia ex Japan</i>	2.6	2.8	2.7	2.4
China	2.1	2.9	2.5	2.0
Central/Eastern Europe	6.0	6.7	5.2	5.0
Latin America	4.0	4.0	3.5	3.3
World	2.6	2.6	1.9	2.2

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

Financial Markets

3-month LIBOR	27/08/20*	3M	6M	12M
USD	0.25	0.20	0.20	0.20
EUR	-0.51	-0.45	-0.45	-0.45
JPY	-0.05	-0.10	-0.10	-0.10
GBP	0.07	0.15	0.15	0.15
CHF	-0.72	-0.70	-0.75	-0.75
10-Year Bonds	27/08/20*	3M	6M	12M
Treasuries	0.71	0.75	0.80	0.90
Bunds	-0.41	-0.35	-0.30	-0.25
BTPs	0.99	1.05	1.10	1.15
OATs	-0.12	-0.05	0.00	0.05
JGBs	0.04	0.05	0.05	0.10
Gilts	0.30	0.30	0.35	0.40
SWI	-0.42	-0.35	-0.30	-0.25
Spreads	27/08/20*	3M	6M	12M
GIIPS	107	105	105	105
BofAML Covered Bonds	37	35	35	35

Corporate Bond Spreads	27/08/20*	3M	6M	12M
BofAML Non-Financial	115	110	105	100
BofAML Financial	113	110	105	100
Forex	27/08/20*	3M	6M	12M
EUR/USD	1.18	1.19	1.20	1.22
USD/JPY	106	105	104	103
EUR/JPY	126	125	125	126
GBP/USD	1.32	1.29	1.36	1.40
EUR/GBP	0.90	0.92	0.88	0.87
EUR/CHF	1.07	1.08	1.10	1.12
Equities	27/08/20*	3M	6M	12M
S&P500	3469	3485	3500	3530
MSCI EMU	118.1	119.0	120.5	120.5
TOPIX	1622	1625	1640	1660
FTSE	6028	6035	6070	6090
SMI	10260	10360	10465	10465

*average of last three trading days

3-Months Horizon

Government Bonds	10-Year Bunds	-0.45	-0.35	-0.25
	10-Year Treasuries	0.67	0.75	0.83
	10-Year JGBs	-0.16	0.05	0.26
	10-Year Gilts	0.24	0.30	0.36
	10-Year Bonds CH	-0.46	-0.35	-0.24
Equities	MSCI EMU	112.7	119.0	125.3
	S&P500	3321	3485	3649
	TOPIX	1528	1625	1722
	FTSE 100	5744	6035	6326
	SMIC	9903	10360	10817
Currencies	EUR/USD	1.16	1.19	1.22
	USD/JPY	101.34	105	108.66
	EUR/GBP	0.89	0.92	0.95
	EUR/CHF	1.06	1.08	1.10

12-Months Horizon

Government Bonds	10-Year Bunds	-0.42	-0.25	-0.08
	10-Year Treasuries	0.73	0.90	1.07
	10-Year JGBs	0.47	0.10	-0.27
	10-Year Gilts	0.28	0.40	0.52
	10-Year Bonds CH	-0.45	-0.25	-0.05
Equities	MSCI EMU	106.9	120.5	134.1
	S&P500	3224	3530	3836
	TOPIX	1450	1660	1870
	FTSE 100	5516	6090	6664
	SMIC	9548	10465	11382
Currencies	EUR/USD	1.15	1.22	1.29
	USD/JPY	94.92	103	111.08
	EUR/GBP	0.81	0.87	0.93
	EUR/CHF	1.06	1.12	1.18

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

Imprint

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