

# Market Perspectives

## Chasing the bandwagon?

GIAM Macro & Market Research

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- Easing US inflation and receding energy prices have extended a synchronized rally of bonds and equities that investors may be tempted to chase.
- We see rising appeal in US bond markets as UST yields are likely past peak. Similarly, a decent carry renders high quality EA Credit attractive, with risks of stronger yield/spread increases muted.
- Yet we are prudent on riskier buckets, including Equities and HY Credit. They are not priced for a recession, the strong determination of central banks to rein inflation in, nor China's undecisive and Covid-frustrated effort to support growth.

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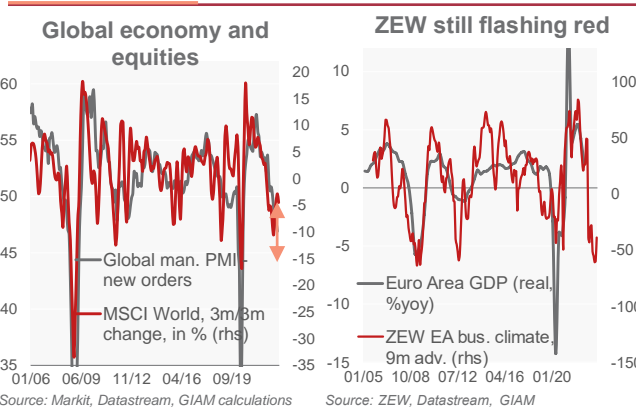
# Global View – Chasing the bandwagon?

Thomas Hempell

- Easing US inflation and receding energy prices have extended a synchronized rally of bonds and equities that investors may be tempted to chase.
- We see rising appeal in US bond markets as UST yields are likely past peak. Similarly, a decent carry renders high quality EA Credit attractive, with risks of stronger yield/spread increases muted.
- Yet we are prudent on riskier buckets, including Equities and HY Credit. They are not priced for a recession, the strong determination of central banks to rein inflation in, nor China's undecisive and Covid-frustrated effort to support growth.

Cautious investor will fear to miss out the synchronized bond and equity rally that has extended into November. A lower-than-expected Oct. US inflation print emboldened markets to price a sharper Fed pivot for late 2024, taking down US yields and providing risk assets with fresh oxygen alongside lower energy prices and ebbing UK/Gilts worries.

So even after the 13% bounce from Oct troughs (MSCI World), the temptation is high to join the bandwagon. Despite significant equity inflows, overall risk positioning remains defensive, leaving scope for a continued rally.



Also the headwinds from rising yields are set to ebb. UST yields are likely past peak. The decline in US core inflation to 0.27% mom in Oct. – only about half the average reading over previous months – was reassuring. Yet bond volatility will fade only gradually. Inflation blips in March and July proved futile. The Fed has flagged that it will require several encouraging inflation data points to reconsider the need for further tightening. Both the Fed and the ECB have emphasized that amid the persistent strong inflation overshoot, they still see the bigger risk in pivoting too early rather than too late. So it will be only

later in 2023 that UST yields look set to drop visibly as a moderate recession bites and inflation has more reliably embarked on a downward trend. In the euro area, we still see risks to yields moderately geared to the upside short term on a deteriorating supply/demand balance. Fiscal plans for 2023 point to significant bonds issuance just as the ECB is preparing quantitative tightening (QT). We also continue to favour an overweight in IG Credit as an attractive carry will help to cushion volatility and the risks of slightly higher spreads near term.

Yet for riskier assets incl. Equities and HY Credit, we are reluctant to chase this rally. Admittedly, many investors are still on the sidelines. Yet market pricing is much less prudent. Equity valuations look dear compared to real yields and recent price moves seem to anticipate prematurely some cyclical relief (left chart). Forward-looking indicators have surprised on the upside recently and may bottom out. Yet they still clearly point to an impending recession in the euro area, with downside risks prevailing as unusually cold winter weather may trigger gas shortages.

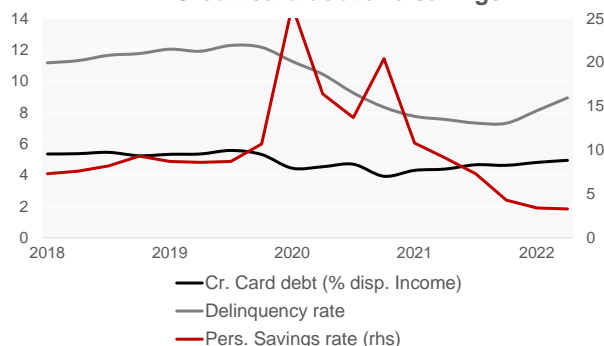
10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	3.72	3.60	3.50	3.25
Germany (Bunds)	1.96	2.05	2.05	2.00
Credit Spreads**				
EA IG Non-Financial	166	175	180	165
EA IG Financial	196	205	210	195
Forex				
EUR/USD	1.04	1.02	1.07	1.10
USD/JPY	139	137	133	130
Equities				
S&P500	3983	3960	3995	4060
MSCI EMU	136	136	135	139

\*3-day avg. as of 29/11/22 \*\*ICE BofA (OAS)

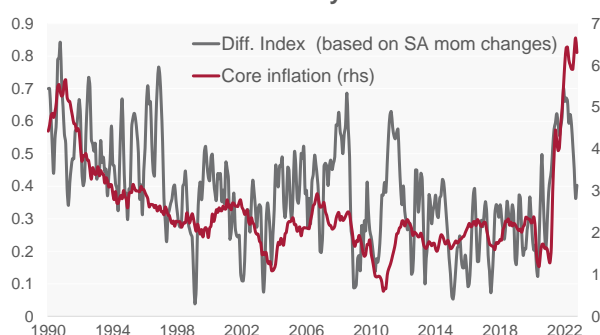
## China's uphill battle in exiting zero-Covid

Finally, China's handling of Covid bears its own risks to growth and supply chains. Markets cheered reports that China may rethink its zero-Covid strategy into 2023. Yet it will be a risky endeavour. Only two thirds of elderly above 80 are vaccinated. Effectiveness of China's vaccines is low. An exit from the zero-Covid approach needs to be preceded by a broad vaccine campaign, likely involving Western mRNA as rising transmission could easily overwhelm the health system, especially so over the winter season. None of this seems under preparation yet. Finally, recent public upheaval add to the risk that Covid controls turn into a matter of brute force and unrest that will barely prove a boon to risk appetite.

## Credit card debt and savings

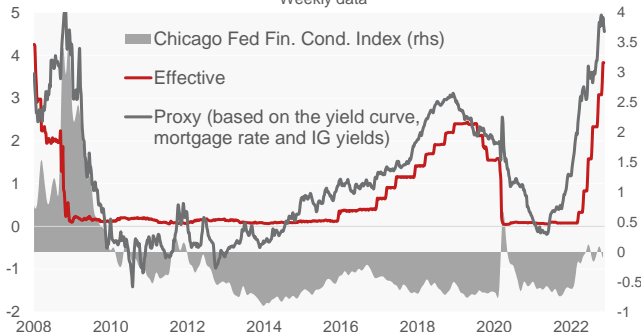


## Inflation dynamics



## Fed funds rate

Weekly data



- Activity in H2 thus far exceeded expectations, but surveys and leading indicators point to a slowdown. We expect GDP to rise by just 0.3% in 2023, with a mild contraction around mid-year.
- Core inflation has peaked and the goods component is sliding quickly. Rents CPI will cool only at the beginning of 2023.
- The Fed funds rate is set to peak at 5% in March, but the looming recession will likely force the Fed to cut at the end of the year.

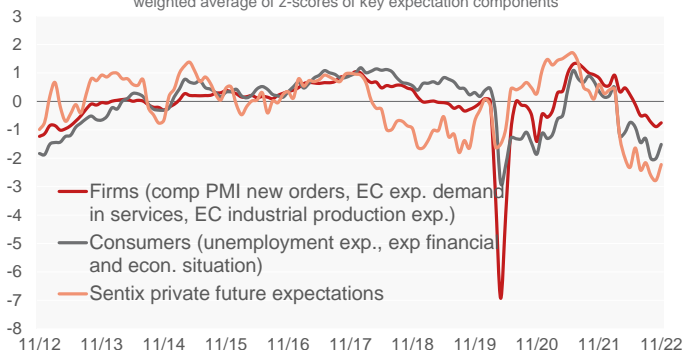
Q3 GDP surprised to the upside and Q4 activity still looks resilient. However, investment is clearly weakening and consumption is increasingly supported by dissaving and higher credit card debt, which makes households more vulnerable to interest rate rises. With business surveys remaining downbeat and leading indicators heading south, we project anaemic growth (0.3%) for 2022 with GDP likely to contract in the central quarters of the year. Tighter monetary conditions will lead to tepid growth (1.2%) in 2024.

Core inflation remains volatile due to the swings in a few components (used cars, healthcare), but should have peaked at 6.6% in October. The share of sectors with m/m increasing prices is declining fast. Goods prices are cooling due to easing gridlocks and new rents are slowing down but service price inflation is unlikely to abate before the first months of this year. We do not see core CPI inflation below 5% before the spring. The labour market is cooling slowly too. While jobs openings have fallen since the end of the summer, there remains nearly 1.9 unfilled job per unemployed. Wage growth has probably peaked but the 5% yoy increase in the employment cost index in Q3 is not compatible with a quick descent of inflation.

The minutes of the November meeting showed the FOMC's intention to slow the pace of monetary tightening, but also its willingness to push rates higher than the 4.75% signalled in September. We expect another 100 bps increase in the Fed fund rates, peaking at 5% in March. However, taking into account the broader impact on borrowing costs from forward guidance and QT, we estimate that the degree is tightening is consistent with that achieved if the funds rate had reached 5% by October 2022 (see chart on the left). Despite the FOMC's pledge to keep rates at a very restrictive level throughout 2023, our below consensus growth forecast implies that the Fed will cut rates by 50 bps in Q4.

## Stabilisation of expectations

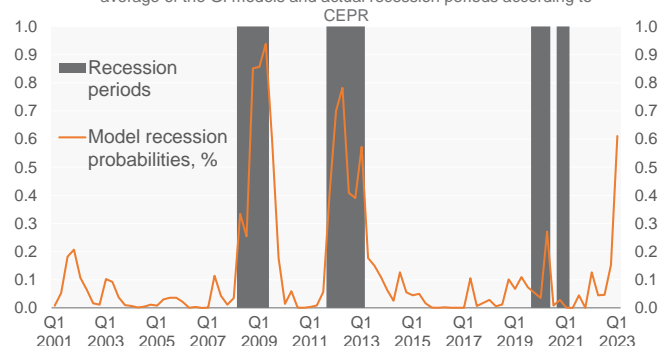
weighted average of z-scores of key expectation components



Source: Datastream, GIAM calculations

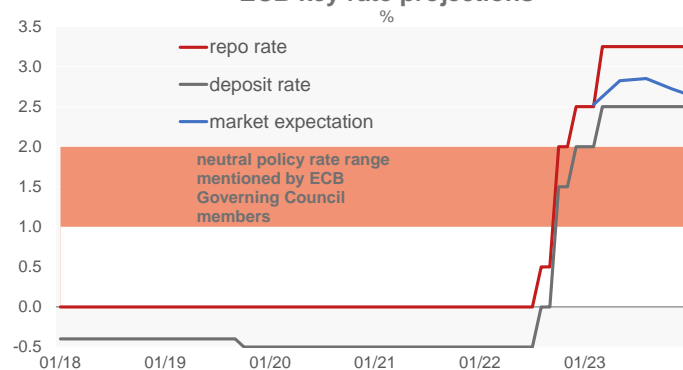
## EA recession ahead

average of the GI models and actual recession periods according to CEPR



Source: CEPR, Datastream, GIAM calculations

## ECB key rate projections



Source: Datastream, ECB, GIAM calculations

- Positive data surprises like Q3 growth and the Nov. PMIs sparked speculations that a euro area recession might be avoided.
- We disagree and still look for a winter recession but now expect it to be less severe.
- Nov. inflation was below the likely Oct. peak but it will stay stubbornly high for the time being.
- We expect a further 50 bps ECB hike in Dec. and now see a risk that it might hike by more than 50 bps in Q1/23 before remaining on hold.

Latest euro area data surprised on the upside. Contrary to expectations the economy continued to grow in Q3 and IP data (09/22: +0.9% mom) already suggest a positive overhang. Even more, November key sentiment indicators (e.g. PMIs, Ifo, consumer sentiment) advanced. The composite PMI for instance had been on a downtrend since May. This sparked speculations that a recession might be avoided.

We deem these hopes overly optimistic: Sentiment is still in a territory consistent with recessions. The improvement was widely driven by expectations and not by the a better actual situation. Inflation came slightly down from the Oct. peak of 10.6% yoy to 10.0% yoy in Nov. but is set to stay stubbornly high and to still average 9.0% yoy in the coming quarter. Recession-related indicators like real M1 growth (-6.3% yoy in Oct.) and the flattening of the yield curve amid tightening financing conditions still make a recession our base case. Our proprietary indicators sees a recession risk of about 60% for the winter half year. Due to an expected better final 2022 quarter we see GDP now expanding by 3.3% (up from 3.2%) and to shrink by only -0.1% in 2023 (up from -0.3%).

At the Dec. 15 meeting, the ECB will need to adjust its 2023 growth outlook of 0.9% to the downside and the inflation outlook of 5.5% to the upside. The monetary policy situation will get nastier. Governing Council (GC) members comments imply that in the challenging inflation environment hikes will continue even into restrictive territory. The GC seems to be split about the size of the Dec. hike but we still find a 50 bps hike most likely. As quantitative tightening measures will also be announced we stick to our view that it will largely substitute rate hikes in 2023 from Q2 onwards. However, high inflation and a less severe real activity outlook make a peak policy rate above 2.5% currently expected for Q1 the main risk in our view.

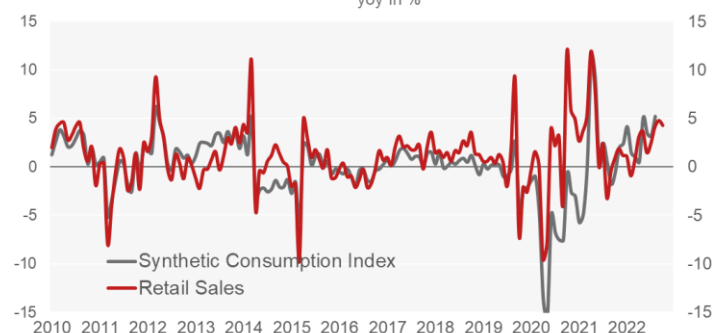
Japan: Real GDP and Private Consumption Growth

qoq, sa



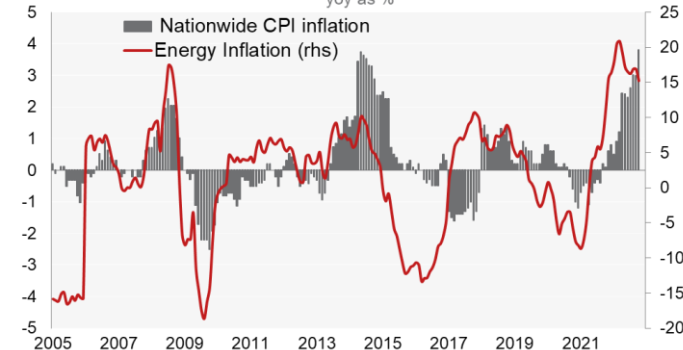
Japan: Retail Sales and Synthetic Consumption Index

yoy in %



Japan: CPI Inflation and Energy Prices

yoy as %



- Q3 GDP growth turned negative due to a special factor. This creates a base effect in Q4.
- Overall, we see Japan's growth to slow, but the weak yen, pent-up demand as well as supportive monetary and fiscal policies will help growth to stay around 1% in 2023. China's Covid outbreak is a downside risk.

According to the first print, Japan's Q3 real GDP growth surprised on the downside with -1.2% qoq annualised (ann.) compared with a consensus forecast of +1.2% qoq ann. The main factor behind the drop was a sharp import growth, caused by a one-off factor (according to the Cabinet Office a substantial advertising services payment). Meanwhile, private consumption and business investment kept expanding, albeit at a lower pace than in Q2. Looking ahead, the one-off imports create a positive base effect in Q4. More generally, the weak yen should help exports but the softening global business cycle and the risks from China's Covid situation will strongly limit the GDP support from net foreign demand. Notwithstanding fresh domestic Covid outbreaks, consumption could continue to benefit from post-Covid reopening, albeit at a reduced pace. We also see capex growth to stay slightly positive (while softening) due to pent-up demand and also to compensate for labour shortages. Monetary and fiscal policy will be of help too. All in, we see growth at 1.4% this year and at 1.1% in 2023.

Japan's CPI inflation jumped up to 3.7% yoy in October, marking the highest inflation since February 1982. Traditional core-core inflation (ex food and energy) rose to 1.5% yoy. Its main drivers continue to be energy (15.2% yoy) and food. Due to the past yen depreciation, imported inflation still jumped by more than 40%. However, what is holding inflation somewhat in check is services prices (0.8% yoy) compared to goods prices (6.5% yoy). Going forward, especially CPI energy inflation will be subject to diverging forces, but overall, government action is expected to suppress core CPI by 1.2 pp. We expect inflation to peak at around 4% yoy at the turn of the year. Meanwhile, BoJ Governor Kuroda did not signal any new thinking of the BoJ. Scheduled wages for regular workers rose by 2.0% yoy in September, unlikely to modify the BoJ's position. We expect headline inflation at 2.5% this year and at 2.8% in the next. Upside surprises can still result from delayed exchange rate effects.



## China: Retail Sales

yoy as %



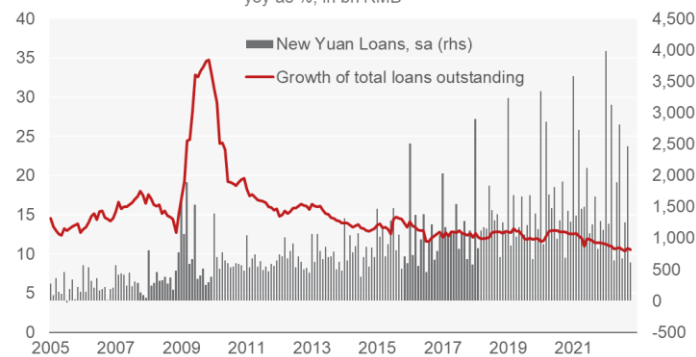
## China: Investment in Real Estate and Property Sales

yoy in %, 3mma



## China: Bank Loans

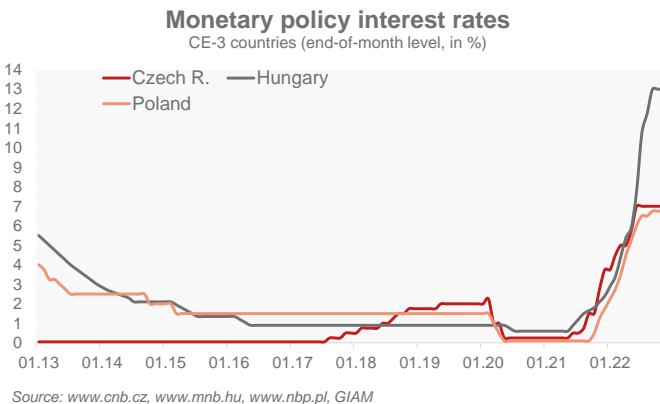
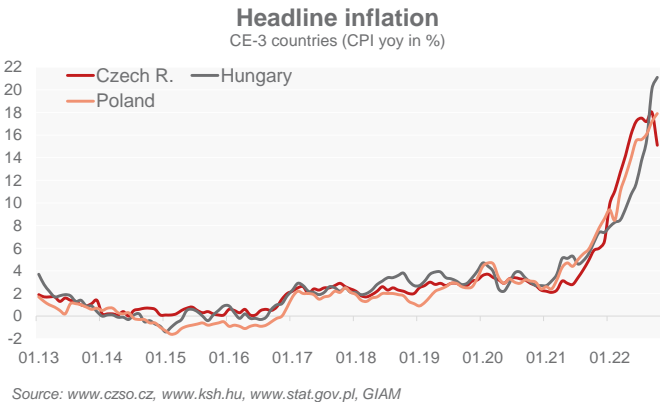
yoy as %, in bn RMB



- China currently sees record high fresh Covid-19 numbers. Risks for spreading are elevated.
- We expect China's Q4 (and less Q1) growth to suffer. Thus, we cut our 2022 forecast to 2.6%. Visibility is low with rising downside risks. The PBoC is likely to cut policy rates further (MLF by 10 bps) and the RRR by 25 bps early next year.

China has reported record numbers of fresh Covid cases. Unlike previous incidences (e.g. Shanghai in April) infections look much more spread across cities and regions. This makes the outbreaks more difficult to contain and elevates the risk of Covid slipping out of control (with possibly a high death toll among elderly people). Protests against Covid restrictions are on an unprecedented level. In mid-November the National Health Commission had announced a 20 items calibration of Covid restrictions, mainly reducing the quarantine period for close contacts and identification needs for secondary contacts. The move showed that the Covid strategy is under review. This could lead to a broader revision in spring. A new vaccination effort is widely regarded as a necessary prerequisite.

However, the latest macroeconomic dataset has been weak. PMIs receded markedly, exports (-0.3% yoy), imports (-0.7% yoy) and retail sales (-0.5% yoy) shrank, while industrial output growth fell back to 5% yoy. Investment eased to 5.8% yoy ytd, supported by infrastructure investment, but real estate still continued to contract rapidly. The PBoC and CBIRC issued a notice to financial institutions in mid-November, laying out a 16-point plan to greatly support the property sector's access to funding. This includes credit for project completion as well as housing loans. The measures should help the sector to improve (esp. project completion) but the fundamental demographic issues will remain. The PBoC also decided to generally ease liquidity via a cut in the reserve requirement ratio (RRR) by 25 bps (analogue to the Shanghai lockdown). Meanwhile, total social financing growth slowed in October, and the monetary impulse edged down. Given the headwinds to the economy, a slight reduction (10 bps) of key rates are plausible, followed by another RRR cut by 25 bps early next year. The real economy will stay bumpy into Q1. Given the prospect of widespread lockdowns, we cut our 2022 growth forecast from 3.2% to 2.6%, but kept 2023 forecast at 4.8% for the time being.



Main Forecasts				
Czech Republic	2021	2022f	2023f	2024f
GDP	3.5	2.5	0.5	3.0
Consumer prices	3.8	15.1	8.5	2.2
Central bank's key rate	3.75	7.00	5.00	3.00
Hungary	2021	2022f	2023f	2024f
GDP	7.1	4.8	0.1	3.5
Consumer prices	5.1	14.2	12.5	4.4
Central bank's key rate	2.40	13.00	8.50	4.00
Poland	2021	2022f	2023f	2024f
GDP	6.8	5.6	0.6	3.4
Consumer prices	5.1	14.4	12.5	4.8
Central bank's key rate	1.75	6.75	6.75	4.00

Source: [www.cnb.cz](http://www.cnb.cz), [www.mnb.hu](http://www.mnb.hu), [www.nbp.pl](http://www.nbp.pl), GIAM

- Inflation already reached its peak in Czechia, while Hungary and Poland may report further increase over the next few months. High inflation weighs on households' real incomes and consumption. GDP growth will slow in 2023 and even a full-year decline cannot be ruled-out.
- The CE-3 central banks do not intend to hike rates further: Czechia and Poland stood on-hold at the past few meetings. The Hungarian MNB has to design a cautious exit from its current restrictive monetary policy regime.

Economic activity declined in Czechia and Hungary in Q3 according to GDP flash estimates (-0.4% qoq in both cases). Poland reported GDP growth at 0.9% qoq but this came after a 2.3% qoq contraction in Q2. High inflation weighs on the real disposable income and on household consumption. Looking ahead, activity is likely to be weak in the CEE region and over the full-year 2023 GDP growth will be meagre, if any. It seems that annual inflation reached its peak in Q3 in Czechia but the peak is yet to be reached in case of Hungary and Poland. The inflation-target levels are likely to be met in H1 2024 at the earliest.

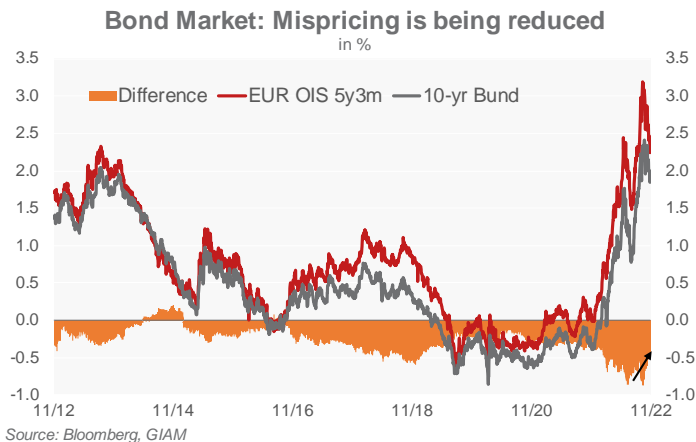
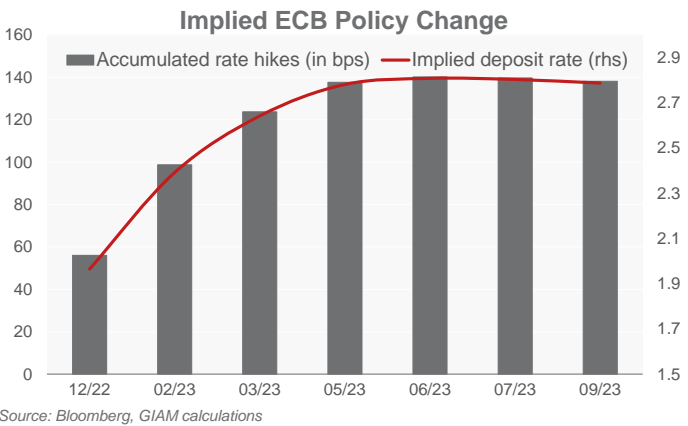
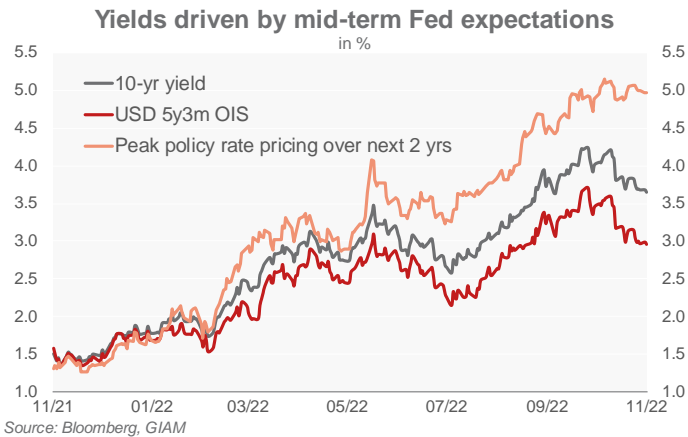
The Czech CNB left its key rate unchanged at 7% in November, as it did also at both policy meetings in Q3. Its new forecast suggests a sharp rate hike in Q4 with rate cuts to follow in early 2023 but a majority in the CNB prefers a longer stability of rates. We expect rates on hold until mid-2023 and envisage cuts in H2.

In Hungary, the MNB confirmed its policy regime introduced since mid-October, in which the base rate stands unchanged at 13% but the key policy tool is the O/N deposit with the rate at 18%. A debate on exit from the current policy regime may come in December but any exit will be cautious. We expect the re-introduction of longer-term operations (issuance of discount bills and longer-term deposits) as the first step and only later cuts in the rate for O/N deposits, followed by the abolition of the O/N deposit as the main policy tool. Markets will at the same time watch the situation regarding Hungary's access to EU funds.

The Polish NBP left its key interest rate in a second on-hold decision in a row unchanged at 6.75% in November. Although inflation is expected to remain above the target range until Q2 2025, the MPC focuses on the cooling economy. We now expect the key rate to stay at 6.75% until the end of 2023 and rate cuts in 2024.

# Government Bonds

Florian Späte



- A withdrawal of medium-term key rate expectations from excessive levels led long-term yields lower in November. This has supported risk sentiment and contributed to a further decrease in EA government non-core spreads.
- Going forward, we see leeway for US yields to fall further amid an ongoing decrease in inflation and mounting growth risks. On the contrary, Bund yields are likely to rise a bit given only sluggishly falling inflation rates and a swing in monetary policy which is still some way off.
- We reiterate our assessment that EA non-core bond spreads are at an unsustainable level and expect a noticeable widening in the months to come.

Although the expected peak for the key rate cycles in the EA and the US hardly changed in November, long-term yields fell significantly – particularly in the US. We consider the main reason to be lower medium-term key rate expectations. 5y3m OIS decreased by 55 bps (and by 50 bps in the EA) leading to a decline of 40 bps in 10-year US yields (25 bps in Bunds). Given the largely constant short-term key rate expectations, the development at the short end of the curve was much more muted triggering a further inversion of yield curves. Germany 2y/10y is at its most inverted since 1992, and US 2y/10y even since 1982.

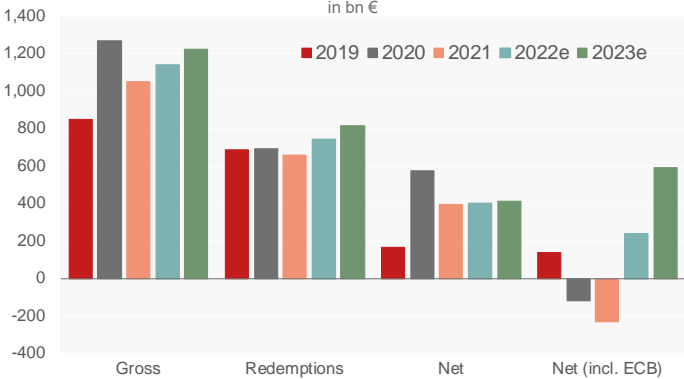
Going forward, we see further leeway for US yields to decrease. Sentiment indicators point to a significant growth slowdown in the current quarter and even negative quarterly growth rates in H1 2023. Moreover, US (core) inflation has peaked and will continue to decline in the months to come. This will be sufficient for the Fed to slow down key rate hikes with (the upper bound of the FFR) a peak of 5.0% in Q1 2023. However, a slowdown in the pace to rate hikes is likely to be visible as early as December, as only a 50 bps step is expected (compared to 75 bps in the previous four meetings). Finally, there are some downside risks to fiscal policy following the split Congress after the midterm elections. However, the extent of the decline is likely to be limited for the time being, as the Fed will continue tightening and appears to err on the side of overtightening. Moreover, inflation remains at a high level and, so far, there are no clear signs that the labour market is cooling down noticeably. We see 10-year US yields trickle down by 10 bps on a 3-month horizon and another 30 bps on a 1-year horizon.



# Government Bonds

Florian Späte

## Euro Area: Government Bond Issuances



Source: Bloomberg, Datastream, GIAM calculations

On the contrary, we see some leeway for Bund yields to rise. Although a recession can hardly be avoided core inflation has not yet sustainably peaked (and the decline will be very sluggish later on). What is more, given the weak growth environment and the energy crisis there is upside potential to fiscal policy. This applies even more in case the energy support measures would be maintained in 2023. This would trigger a further tightening of monetary policy (beyond what is currently priced). Even now at least 125 bps are still priced and as inflation is seen to remain well above the ECB target no key rate cut is expected anytime soon. Moreover, the ECB's Quantitative Tightening will be uncharted territory for EA government bond markets implying a higher term premium.

## Decoupling of EA non-core spreads

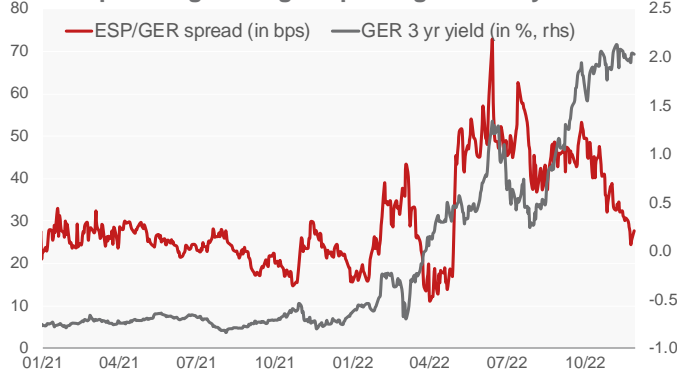


Source: Datastream, GIAM calculations

Accordingly, while the upward potential appears limited the unusual pattern will likely occur in which US yields fall while Bund yields rise. Given the decoupling from US yields, we regard it too early to go long Bunds and even a new peak in Bund yields cannot be excluded.

The overvaluation of EA non-core government bonds grew again in November. Amid a rebound in risk sentiment spreads are back to the levels of the end of April – a time when key rates were at zero, the growth outlook still healthy and the supply outlook moderate.

## Spread tightening despite higher core yields



Source: Datastream, GIAM calculations

Although a catalyst cannot be identified in the short term, we expect significantly higher EA non-core bond spreads in the coming months. To start with, the net supply situation is unlikely to ease substantially. As outlined above, we even see some upside risks for fiscal policy. But even if that does not happen, Quantitative Tightening will take net-net supply to a new record high in 2023 in any case (see top chart). The growth outlook is meagre and negative quarterly growth rates in the winter half-year appear to be a common thing. All this is happening in an environment of further rising key rates. Relative value considerations also urge caution. EA non-core bond spreads have decoupled from corporate spreads and appear dear from a valuation point of view.

EA non-core bond spreads also appear unattractive from a risk perspective as there is only limited room for a further spread tightening from current levels. On the contrary, in the case of deteriorating risk sentiment, they appear particularly vulnerable and the ECB's Transmission Protection Instrument will not be deployed at current levels.

## EUR Credit market performance by segment

Total return base : 01/01/2022

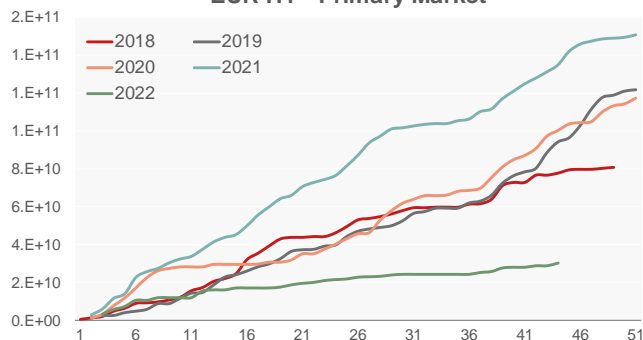


Source: Bloomberg, BofAML, GIAM own calculations

- Credit spreads have tightened alongside other risky assets
- IG spreads will remain resilient, but HY appears vulnerable near term as we are heading into recession.
- Worries regarding the liquidity of the HY segment are somewhat alleviated by the reopening of the primary market that saw several deals being printed.
- Concerns on callable instruments are mounting in the corporate hybrid space but we continue to expect calls to be the normality.

Credit has been lagging-recent rebound of equities. IG spreads will remain resilient, but HY appears vulnerable near term as we are heading into recession. Yet a key concern we had was the absence of primary market access for more than a semester in 2022

## EUR HY - Primary Market



Source: iBoxx, GIAM calculations

## Extension risk for corporate hybrids remains low

Over the course of 2022 spreads have more than doubled compared to end 2021, all callable instruments have rapidly repriced the extension risk to incorporate a much higher probability of non-calls. Yet not all instruments are equal with regards to redemption probability. In the AT1 space, there is absolutely no incentive to redeem bonds on call dates besides potential economic arguments or reputational risk. In the corporate hybrid space, it is different as for most of the market, S&P is removing the 50% equity treatment at first call date. This is making the redemption decision often in favour of calling the hybrid as, without equity treatment, the hybrid becomes an "expensive senior debt". There are a few exceptions and in that respect the announcement from Arrondtown that it will not call its hybrid due in January next year is casting some doubts. But overall, we do expect most hybrid issuers to try to find solution to call their bonds either replacing them with hard equity or refinancing them in the hybrid primary market hence.

## Decompression trade still on

We continue to prefer IG to semi-core and peripheral sovereigns. IG levels are currently incorporating a severe recession scenario.. For HY, we think that positioning is already very short, but risks remain elevated hence we think spreads should end the year 50 -60p wider. We continue to prefer subordination risk to credit risk.

## Corporate hybrids vs BBs

yield to worst, %



Source: Bloomberg, BofAML Indices, GIAM own calculations

# EM sovereign bonds

Guillaume Tresca

EM USD: carry provide a buffer  
3M TTR for different scenarios

OA \$ spread	US 7Y							
	3.5%	3.8%	3.7%	3.8%	3.9%	4.0%	4.1%	4.2%
426	6.1%	6.8%	6.2%	5.5%	4.8%	4.1%	3.4%	2.8%
438	6.8%	6.2%	5.5%	4.8%	4.1%	3.4%	2.8%	2.1%
448	6.2%	5.5%	4.8%	4.1%	3.4%	2.8%	2.1%	1.4%
456	5.5%	4.8%	4.1%	3.4%	2.8%	2.1%	1.4%	0.7%
466	4.8%	4.1%	3.4%	2.8%	2.1%	1.4%	0.7%	0.0%
476	4.1%	3.4%	2.8%	2.1%	1.4%	0.7%	0.0%	-0.6%
486	3.4%	2.8%	2.1%	1.4%	0.7%	0.0%	-0.6%	-1.3%
496	2.8%	2.1%	1.4%	0.7%	0.0%	-0.6%	-1.3%	-2.0%
508	2.1%	1.4%	0.7%	0.0%	-0.6%	-1.3%	-2.0%	-2.7%
518	1.4%	0.7%	0.0%	-0.6%	-1.3%	-2.0%	-2.7%	-3.4%
526	0.7%	0.0%	-0.6%	-1.3%	-2.0%	-2.7%	-3.4%	-4.0%

Source: Bloomberg, GIAM

- The EM outlook has improved, and we turn to neutral from underweight in our allocation.
- Tailwinds are numerous, and recession risk will weigh on spreads. A Fed pivot will offer a tactical rally, but we are not there yet
- Carry is providing a substantial buffer to spread widening. We favour IG and especially the BBBs.

The EM narrative has turned more constructive, even if all tailwinds have not been alleviated, and thus we turn market weight (MW) from under weight (UW). The negative duration effect is losing steam as long-term rates seem to have peaked and uncertainty on the Fed rate hike path declines. The carry provides a massive buffer to disruptive events or spread widening. A flat US rate scenario offers protection against a 30bp spread widening within three months.

The solid total return performance since October, c. +7%, has also been driven by a significant spread tightening that will be hard to replicate in our view. The hopes related to a Fed pivot have supported inflows into the asset class and have eased external refinancing concerns. However, EM spreads will hardly compress meaningfully as long as US real rates remain high and global financial conditions are tight. Moreover, the Chinese Covid situation has been fluid, and risks are skewed for the further deterioration that will unwind the positive spread momentum.

## From peak rate to recession concerns?

We maintain our OW on IG vs. HY, given the rising recession risk. A recession will likely follow the peak in US rates and the Fed pivot. In this environment, EM performs poorly according to the history of the previous Fed tightening cycles. Valuations are not cheap, both in IG and HY, if we exclude distressed names. The lowest-rated countries have recently outperformed, while refinancing risks are still acute in the medium term with deteriorating reserve adequacy ratio and higher interest-to-revenue ratio. In the IG space, valuations are also rich, but it is a safe haven given the pending uncertainties. BBB has most of the value given its high duration, benefiting from the US rate decline, and its high yield-to-worst at 5.7%. Given the prospect of a more significant USD decline, we favour USD debt over EUR debt. Moreover, EUR spreads will relatively underperform, given the higher recession risk in Europe.

## EM assets performance during past Fed hiking cycles

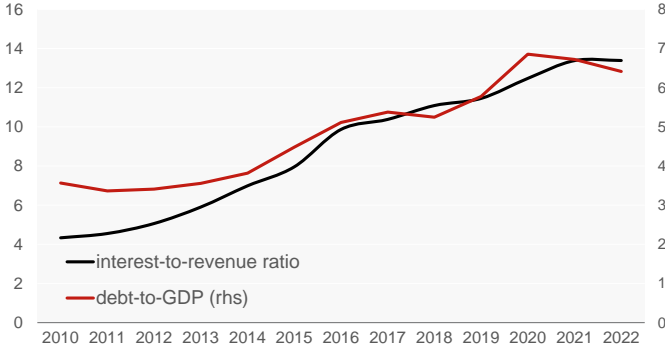
Months before/after last hike	1994					1997				
	-6	-3	3	6	12	-6	-3	3	6	12
GBI-EM hedged										
GBI-EM										
DXF	-4.2	-3.6	-3.9	-0.4	0.4	-7.2	-7.0	1.0	2.5	7.2
EMBIGD	-13.2	-12.9	17.2	23.1	41.9	8.2	0.3	9.1	16.3	16.5
CEMBI										

Months before/after last hike	2000					2006					2018				
	-6	-3	3	6	12	-6	-3	3	6	12	-6	-3	3	6	12
GBI-EM hedged						0.8	2.0	3.8	8.0	12.9	-3.1	-2.8	2.7	6.9	12.3
GBI-EM						4.9	7.6	4.6	15.6	25.7	-0.2	-2.1	2.9	8.7	13.5
DXF	-6.2	-2.6	4.1	0.8	9.9	4.5	1.1	1.0	-1.8	-3.8	-1.8	-1.1	1.2	0.0	0.2
EMBIGD	4.3	-2.2	9.7	11.7	20.5	-1.8	-2.2	6.4	10.4	11.4	1.0	-1.3	7.0	11.3	15.0
CEMBI						-1.1	-0.6	4.9	7.6	9.9	1.3	0.0	5.2	8.8	13.1

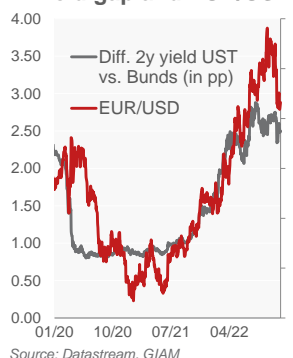
Source: Bloomberg, GIAM

## Frontier markets debt services doubled

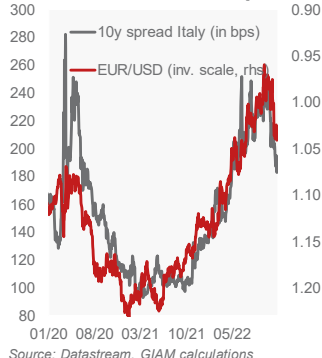


Source: IMF, GIAM

**Yield gap and EUR/USD**



**EUR/USD and BTP spread**



- The USD has passed its peak and a significant decline is looming for 2023.
- Yet short term, the greenback may still recover temporarily some lost ground.
- The looming winter recession burdens Europe and the EUR support from the sudden shift in speculative positions looks shaky.
- By contrast the oversold yen will benefit from lower US yields over both the short and medium term.

A broad risk rally and unwinding US rates expectations sent the USD DXY in Nov. on course for its worst month (-4.3% per 28/11) in almost eight years. The massive fundamental overvaluation leaves scope for a more significant drop over 2023.

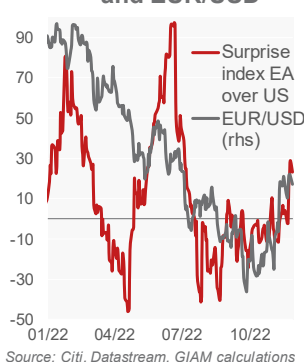
Short-term, the recent drop seems exaggerated on some dimensions. The EUR/USD bounce has clearly overshot the change in yield differentials (top left chart) even though it seems more aligned in terms of yield gap levels. Furthermore, a bigger shift into speculative long EUR positions and stronger European economic surprises (mid charts) have amplified the move. This looks shaky as Europe is heading into a winter recession and the mood on the EUR may sour. Reduced EMU risk premia (top right) also contributed but this support is unlikely to prove sustainable. And we are skeptical that the USD drag from the recent risk rally has legs near term. Short term, we thus anticipate EUR/USD closer to parity again. Yet as we will outline in our forthcoming 2023 outlook, we expect more protracted and broad-based USD weakness as a nearing Fed pivot drags on US yields and uncertainty.

## CNY burdened by sizeable yield gap

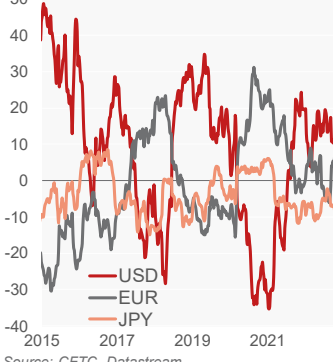
A sizeable yield gap (left bottom chart) amid opposed monetary policy paths in China and the US will continue to burden the CNY. Near term, the disruptions and potential unrest from China's zero-Covid restrictions amid rising winter infections will hurt too.

By contrast, the USD/JPY may be headed for a further decline. It remains closely tied to the US/Japan yield gap. The headwinds from lower US yields are likely to be complemented by mounting speculation about a relaxation of the BoJ's yield curve control into spring (chief Kuroda's term expires on April 8). Yet an only very gradual shift in yields and Japan's persistently high trade deficit are likely to cap the pace of JPY recovery over the coming months.

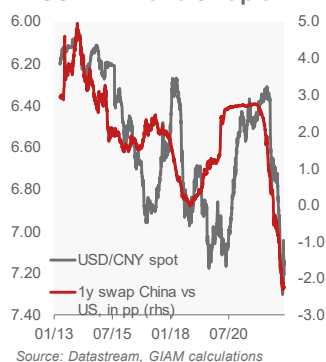
**Economic surprises and EUR/USD**



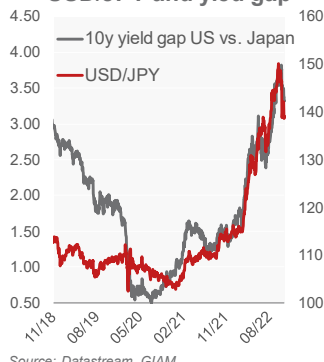
**Speculative positions**

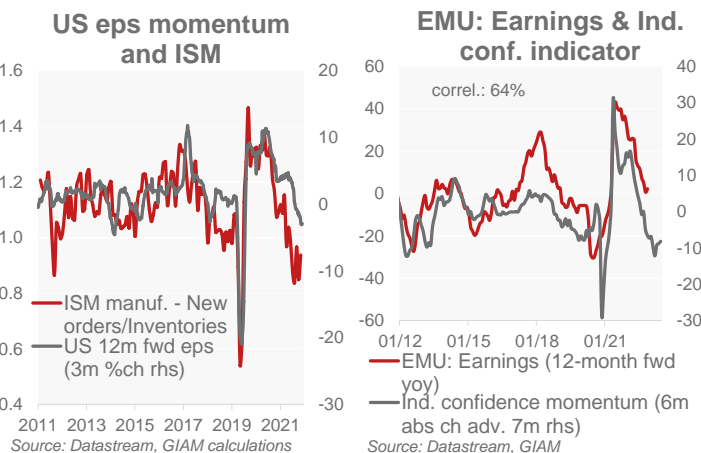
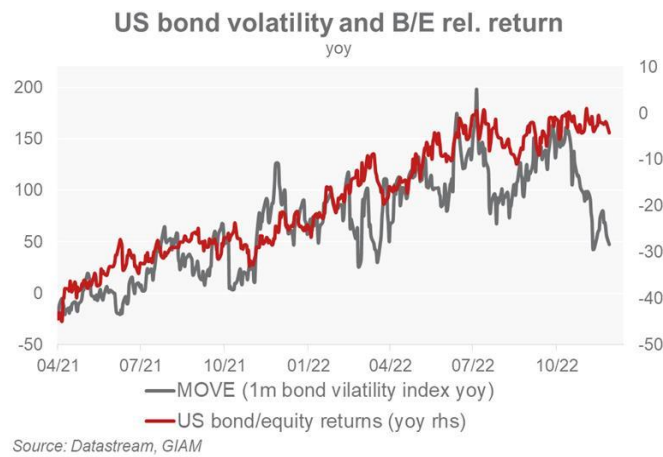
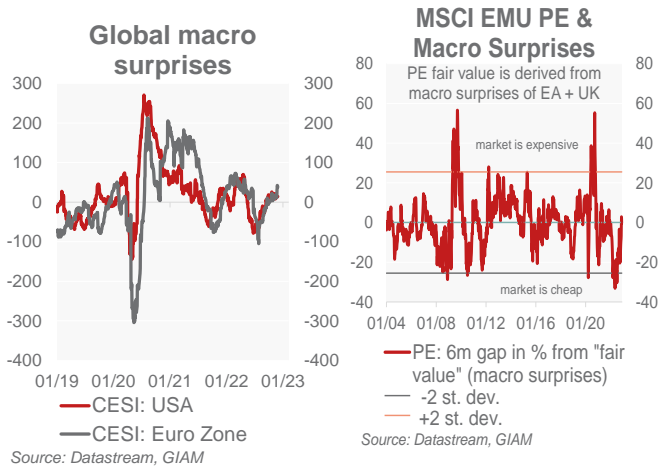


**USD/CNY and swap diff.**



**USD/JPY and yield gap**





- Depressed positioning, resilient macro momentum, peaking US inflation plus low relative equity volatility could prolong the rally.
- Valuations remain in an uncomfortable zone, though, and monetary tightening will continue to hurt over the next months. Lastly, earnings revisions should bottom only in mid-2023.
- We cut most of our UW position as US inflation and bond volatility are set to decline further. But we remain cautious on equities in the short term.
- For the next 12 months we expect positive total returns in the range between 3% and 6%. Slightly OW EMU vs US (new). Higher OW on UK and Japan. Neutral EM (new).
- Sector overweights: Banks, Div. Financials, Food, HC equip., Transportation, Capital Goods and Software. Underweights: Comm. Prof. Services, Telecoms, Media and Retailing.

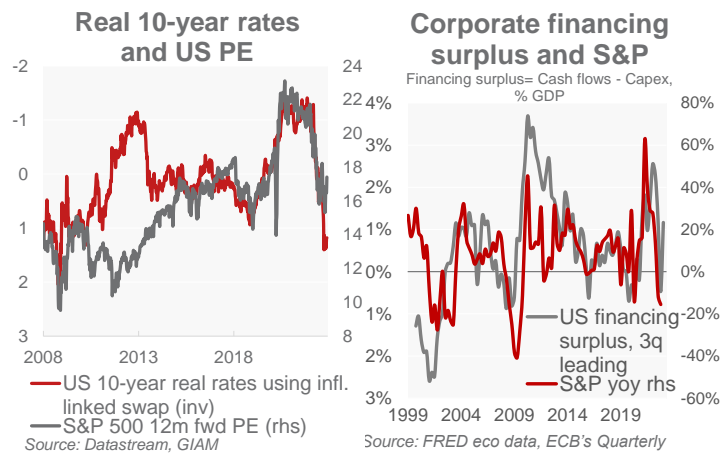
## Rally's triggers: Macro, Vola, positioning

November rally has many explanations and some of them are going to last for a while. Macro surprises are unexpectedly trending up in the euro area (EA), after having bottomed in July and being flat since mid-September. Accumulated savings, fiscal spending and strong labour market can be some of the reasons behind. From this point of view, PEs look fair when measured against the current macro surprises index level and could potentially continue to expand in the short term. US 10-year yields have probably reached the peak, as inflation trend looks less strong. They are lower by 40 bps in the month. This corresponds to nearly 5% in additional Fair Value momentum for the equity index.

While still hawkish, the lower uncertainty around CBs stance and the corresponding bond yield direction, has continued to push the MOVE index (US bonds' volatility) down from 148 to 132. The VIX declined, too, to reach the level of 22. The ratio VIX/MOVE remained mostly unchanged, thus confirming its downward trend year-to-date, which triggered also a lower US equity risk premium.

Finally, investors positioning remains low and can continue to encourage further short covering. Indeed, some brokers' desks state that, thanks to the rally started in October, only 40% of the shorts opened since January have been covered.





We highlight also more recent better news concerning the business cycle as some more forward-looking leading indicators look bottoming out. We refer to the ratio of ISM new orders/ISM inventories, IFO expectations, global Sentix index, EA Consumer Confidence indicator, US corporate financial surplus (cash flow minus capex) and the Senior Loan Officer Opinion Survey (Bank Lending Practices).

**Why we remain cautious: Neutral equities**

In early November we decided to cut our UW position to get almost neutral as we think the cited positive triggers could linger in the short term.

That said, the trend in earnings is declining and has further to go. We remain under consensus in terms of profit growth expectations, this year and mostly the next one. The growth bottom should happen only in Q2-Q3 2023. PEs are currently high when measured against the 10-year real rate. Our US fair value index shows the market being at the highest valuation premium since 2013. The extension of the rally is also getting mature by historical standards and equity-minus-bonds' flow have reached again a cyclical top notwithstanding the cited light positioning. Inflation will remain sticky and well above CBs target in all 2023, such that they will continue to tighten monetary conditions (rates + QT) till at least Q3 2023.

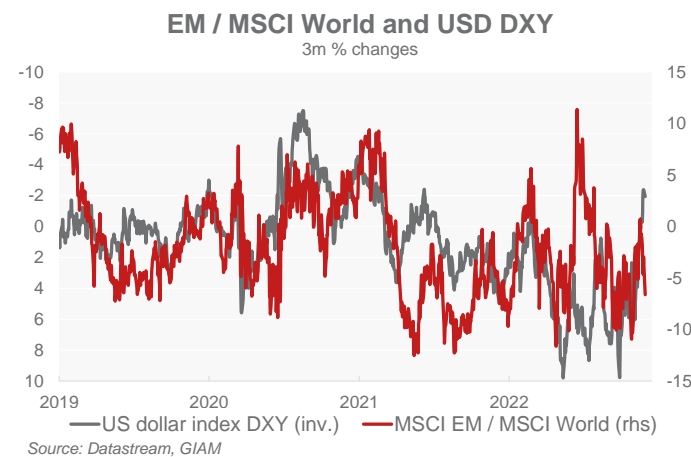
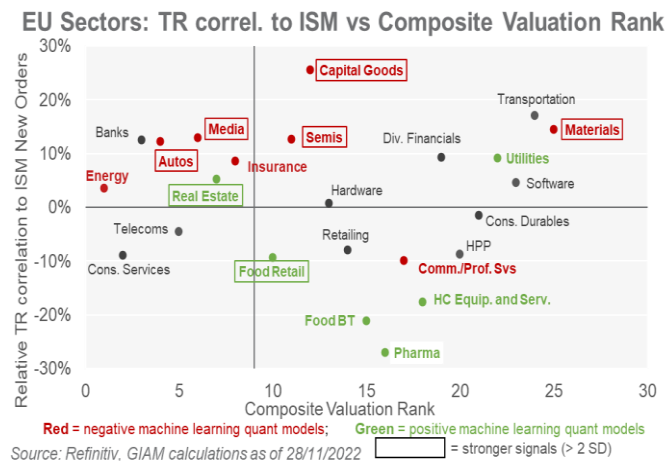
**Recommended allocation**

Within countries we go slightly OW EMU vs US. Higher OW is on UK and Japan. EU sectors: we go temporarily neutral on Energy (weaker Oil price, earnings and Value relative). OW: Banks, Cap. Goods, Div. Financials, Food, Healthcare equipment, Transportation and Software. UWs: Retail, Comm. Prof. Services, Telecoms and Media.

**EM equities: neutral in expectations for Fed pivot**

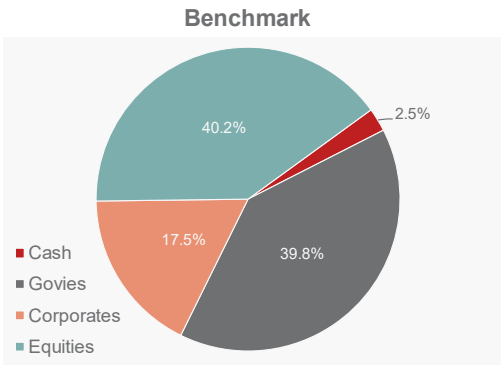
Headwinds over the last year have been represented by global economic weakening, a stronger USD dollar, higher inflation, and tighter financial conditions. Short term, such negative factors are expected to linger.

By the end of Q1, we see higher chances for a better EM relative earnings momentum and expect the dollar to start consolidating. Both would contribute to the next outperformance cycle of EM versus DM equities. Indeed, based on our historical analysis, EMs seem to be well positioned for the Fed pivot expected in March. Low valuations are an additional positive factor.

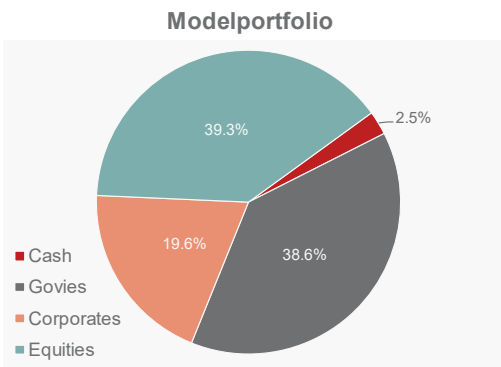


# Asset Allocation

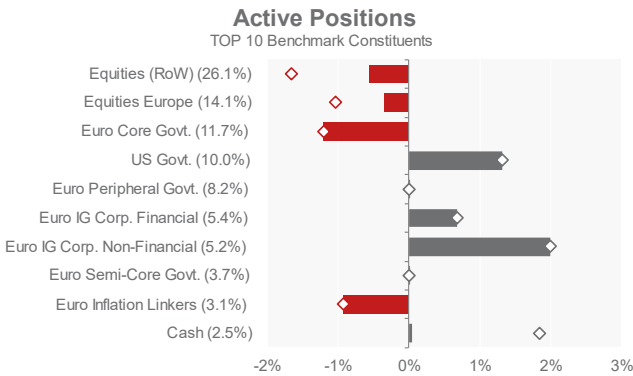
Thorsten Runde



Source: GIAM



Source: GIAM



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

- In November (28.11.22), all actively covered asset classes clearly remained in positive territory.
- Almost on a par, with about +7.7%, EM and EMU Equities are at the top of the performance ranking, followed by long-dated BTPs, US-Treasuries, and EM Govies (~+6.3%).
- The lower end of the performance spectrum is dominated by Cash and short-dated fixed income asset classes.
- With +1.9% IG Fin revealed the worst performance in the credit section, underperforming IG non-Fin by 100 bps and HY by even 190 bps.
- It is unlikely that the recent bounce in the Equity markets is already the turning point to a lasting upswing. That said, given the very bearish market positioning, there should be scope for bounces on positive news
- Thus, we recommend reducing the UW in Equities by taking exposure out of cash. Apart from that, we maintain our basic alignment in favour of IG Credit and US-Treasuries at the expense of risk-assets.

With around -15.7 bps the relative performance of our model portfolio was again negative in November (28.11.22). Like in the previous month, the only significant positive contribution resulted from the UW in EA Core Govies (+2.2 bps). Equities, US Treasuries, and Cash accounted for the largest losses, ranging around -5 bps. The strong performance of Equities that had proven to be particularly painful in the second half of October, continued to do so in the first half of November. As the dispersion within the return spectrum was getting distinctively smaller in the second half of November, the relative performance figures shrank and so did the performance contributions. Thus, the underperformance generated in the first weeks of the month was roughly ten times as large as in the last weeks.

## Carefully releasing the brakes

It is rather unlikely that the recent upswing in risk assets will (yet) lead to a long-lasting rally. However, investors' defensive positioning suggests that more bright spots could lead to further upswings. In that sense, we recommend to reducing the UW in Equities by taking exposure out of cash while leaving the basic alignment of the portfolio untouched.

# FORECAST TABLES

## Forecast tables

Growth <sup>1)</sup>	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	5.9	1.9	0.1	0.3	0.1	1.4
Euro area	5.3	3.3	0.1	- 0.1	0.0	1.2
Germany	2.6	1.7	0.2	- 1.0	- 0.1	0.8
France	6.8	2.5	0.0	0.0	- 0.2	1.0
Italy	6.7	3.4	- 0.1	- 0.4	- 0.2	1.3
Non-EMU	6.5	3.7	0.0	- 0.6	- 0.1	0.9
UK	7.5	4.2	- 0.0	- 1.2	- 0.3	0.3
Switzerland	4.2	2.5	0.4	1.5	1.0	1.8
Japan	1.7	1.4	- 0.1	1.1	- 0.3	1.3
Asia ex Japan	7.8	3.9	- 0.4	4.7	0.2	4.6
China	8.1	2.6	- 0.6	4.8	0.3	4.6
CEE	6.7	1.7	1.1	0.4	0.9	3.1
Latin America	6.4	3.1	0.0	1.0	0.0	2.0
World	6.4	3.2	- 0.0	2.1	0.2	2.8

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

Inflation <sup>1)</sup>	2021	2022		2023		2024
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	4.7	8.0	- 0.1	4.2	0.1	2.4
Euro area	2.6	8.5	0.0	6.0	- 0.0	2.5
Germany	3.2	8.6	0.4	7.3	0.4	2.7
France	2.1	5.6	0.1	4.5	0.0	2.4
Italy	2.0	8.2	0.2	5.2	- 0.4	0.6
Non-EMU	2.3	8.0	0.1	6.4	0.2	2.6
UK	2.6	9.1	0.2	7.5	0.4	2.6
Switzerland	0.6	2.9	0.0	2.2	0.0	1.5
Japan	- 0.3	2.5	0.2	2.8	1.1	1.3
Asia ex Japan	2.0	3.6	- 0.0	3.4	0.2	2.9
China	0.9	2.1	- 0.1	2.4	0.0	2.3
CEE	9.3	29.7	0.5	17.4	0.9	8.2
Latin America <sup>2)</sup>	6.6	7.8	1.1	4.9	0.7	4.0
World	3.5	7.9	0.1	5.4	0.3	3.2

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

## Financial Markets

Key Rates	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
US	4.00	5.00	4.81	5.00	4.99	4.75	4.40
Euro area	1.50	2.00	2.51	2.50	2.86	2.50	2.77
Japan	-0.10	-0.10	-0.02	-0.10	0.05	0.00	0.15
UK	3.00	3.50	4.06	4.00	4.56	4.00	4.43
Switzerland	0.50	1.00	0.95	1.50	1.17	1.50	1.37
10-Year Gvt Bonds							
US Treasuries	3.72	3.60	3.70	3.50	3.68	3.25	3.64
Germany (Bunds)	1.96	2.05	1.98	2.05	1.98	2.00	1.96
Italy	3.75	4.05	3.89	4.15	3.91	4.30	3.96
Spread vs Bunds	179	200	190	210	193	230	201
France	2.53	2.65	2.46	2.65	2.48	2.65	2.50
Spread vs Bunds	57	60	48	60	50	65	55
Japan	0.25	0.25	0.33	0.30	0.38	0.40	0.48
UK	3.11	3.10	3.17	3.05	3.15	3.00	3.22
Switzerland	1.06	1.15	1.04	1.15	1.03	1.10	1.04

\*3-day avg. as of 29/11/22

\*\*ICE BofA (OAS)

Credit Spreads**	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
EA IG Non-Financial	166	175		180		165	
EA IG Financial	196	205		210		195	
EA HY	496	600		630		600	
EM Sov. (in USD)	353	375		380		390	
Forex							
EUR/USD	1.04	1.02	1.05	1.07	1.05	1.10	1.06
USD/JPY	139	137	137	133	135	130	132
EUR/JPY	144	140	143	142	142	143	140
GBP/USD	1.20	1.17	1.21	1.22	1.21	1.24	1.21
EUR/GBP	0.86	0.87	0.87	0.88	0.87	0.89	0.88
EUR/CHF	0.98	0.97	0.98	0.99	0.98	1.01	0.97
Equities							
S&P500	3,983	3,960		3,995		4,060	
MSCI EMU	136.1	135.5		135.0		138.5	
TOPIX	2,005	2,005		2,015		2,075	
FTSE	7,491	7,395		7,430		7,565	
SMI	11,136	11,060		10,990		11,410	

### 3-Months Horizon\*

10-Year Gvt Bonds	Germany (Bunds)	1.18	2.05	2.92
	US Treasuries	3.09	3.60	4.11
	Japan	0.18	0.25	0.32
	UK	2.46	3.10	3.74
	Switzerland	0.48	1.15	1.82
Equities	MSCI EMU	128	136	143
	S&P500	3,725	3,960	4,195
	TOPIX	1,913	2,005	2,097
	FTSE	7,081	7,395	7,709
	SMI	10,483	11,060	11,637
Forex	EUR/USD	1.00	1.02	1.04
	USD/JPY	133	137	141
	EUR/GBP	1.15	1.17	1.20
	EUR/CHF	0.95	0.97	0.99

### 12-Months Horizon\*

10-Year Gvt Bonds	Germany (Bunds)	0.49	2.00	3.51
	US Treasuries	2.33	3.25	4.17
	Japan	0.27	0.40	0.53
	UK	1.91	3.00	4.09
	Switzerland	-0.19	1.10	2.39
Equities	MSCI EMU	125	139	152
	S&P500	3,630	4,060	4,490
	TOPIX	1,874	2,075	2,276
	FTSE	6,923	7,565	8,207
	SMI	10,367	11,410	12,453
Forex	EUR/USD	1.05	1.10	1.15
	USD/JPY	123	130	137
	EUR/GBP	1.19	1.24	1.28
	EUR/CHF	0.98	1.01	1.04

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

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