



A shot in the arm

December 2020



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This document was completed on November 30, 2020

Global View – A shot in the arm

Thomas Hempell / Vincent Chaigneau

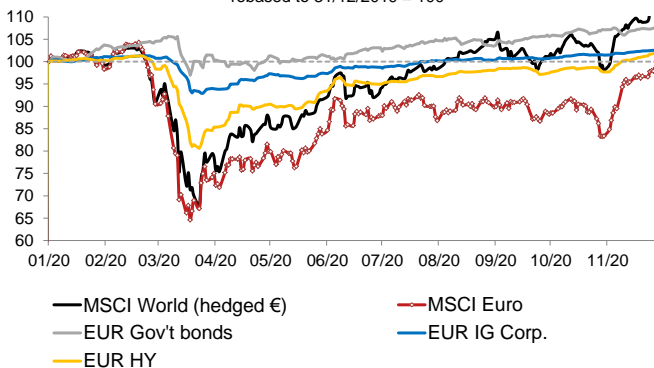
- The outstanding risk rally in November may appear reckless amid resurgent Covid cases, persistent risks of a hard Brexit and a (likely) split new US government taking office in January.
- Yet markets are right in pricing recent vaccine news as a game changer for the pandemic while central banks remain committed to extended stimulus.
- We thus slightly extend our pro-risk tilt, with a sizeable overweight in Credit and (more prudently) in Equities. A weakening US dollar favours exposure to EMs. Cash and Core Government Bonds remain unattractive.

We entered November with a prudent overexposure in risk assets despite concerns about renewed shutdowns and rising Covid infections in Europe and US elections uncertainties. In the end, the MSCI World gained a striking 13.6% (by Nov 27), staging its strongest month in 45 years!

The broad-based rally (comprising also Credit, EMs and Commodities) may seem reckless. Lockdowns in Europe may persist over the winter, while laissez-faire in the US warrants a sharply rising death toll. Daily Covid casualties exceeded 2,000 in the US even before Thanksgiving, a potential national superspreader event. US elections proved a tight race, and Trump's denial to acknowledge defeat does not bode well for bipartisanship in the upcoming (likely) split government, with Jan. 5 run-offs on two Senate seats in Georgia pivotal for majority in Senate. In Europe, the UK and EU remain at loggerheads over a Brexit deal, with severe trade and financial market disruptions looming for Jan 1 if no deal is struck soon.

Total returns by asset classes

rebased to 31/12/2019 = 100



Yet reassuring news on vaccines by Pfizer/BioNTech (Nov. 9, and a week later by Moderna) are dominating markets, accelerating the post-election boost to risky assets. In particular, vaccine efficiency rates of 95% from phase 3 trials will likely make broad-based vaccinations feasible soon. Admittedly, hopes on a third product by AstraZeneca seem more shaky. And broader inoculations efforts may still run into severe side effects, public resistance or

logistics issues. Yet there is also the possibility that other vaccines prove successful and speed up the rollout.

In a realistic scenario, vulnerable age groups and front-line health care workers may be vaccinated in Q1 2021 in the US and Europe, allowing for a meaningful relaxation of containment measures in spring. Herd immunity (requiring vaccination or antibodies by about 60% of the population) may even be reached by mid-year. The ensuing recovery of constrained businesses, pent-up demand and a stronger rise in confidence bode well for a marked economic rebound over spring and summer. A faster recovery will help the euro area recoup pre-crisis GDP levels already by late 2021 (and even in Q3 in the US).

Bonds	26/11/20*	3M	6M	12M
10-Year Treasuries	0.88	0.95	1.05	1.15
10-Year Bunds	-0.57	-0.55	-0.50	-0.40
Corporate Bonds				
BofaML Non-Financial	93	90	85	80
BofaML Financial	94	90	85	80
Forex				
EUR/USD	1.19	1.20	1.22	1.24
USD/JPY	104	103	102	100
Equities				
S&P500	3632	3675	3695	3740
MSCI EMU	126.2	127.5	127.0	129.0

* avg. of last three trading days

Recovering earnings and contained defaults

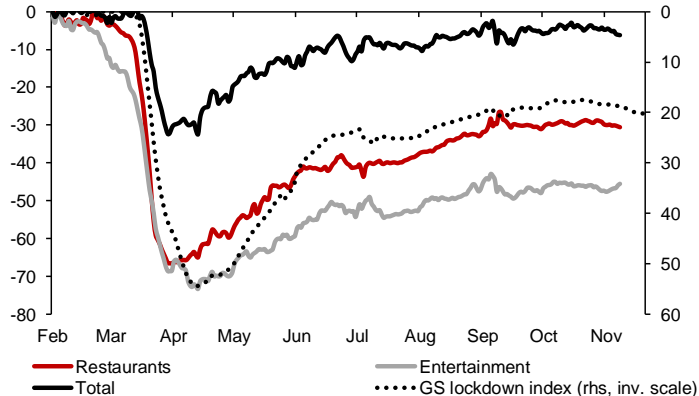
While short-term risk remain, we expect markets to increasingly look through near-term economic setbacks induced by the pandemic. Importantly, policy uncertainty is falling, and will continue to do so through the turn of the year. This tends to drive risk premia down, not least in equities that still offer a generous pick-up relative to bonds (particularly in Europe). We thus slightly increase our so far prudent pro-risk stance. The economic rebound will help to lift euro area earnings to recover by more than 40% next year (admittedly from depressed levels), while low yields and persistent monetary policy support can keep valuations elevated. The ECB is set to substantially extend its PEPP and TLTRO programs, while the Fed may lengthen the duration of its bond purchases. We thus see further moderate upside for equities, even though setbacks may be more frequent after the November rally. Any backup in yields will be limited, with inflation dormant and central banks ultra-accommodative. Yet very poor yields render Cash and Core Bonds unattractive, while Credit exposure remains appealing. We expect the hunt for yield, contained defaults and ongoing support from ECB purchases to allow for even somewhat tighter corporate spreads, despite the massive spread compression already seen. Further USD weakness bodes well for EMs bonds and equities.

USA

Paolo Zanghieri

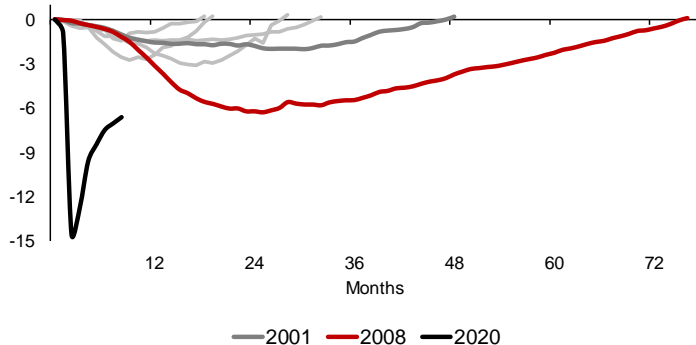
Consumer spending and restrictions

Based on credit card transactions. Source: <https://tracktherecovery.org/>



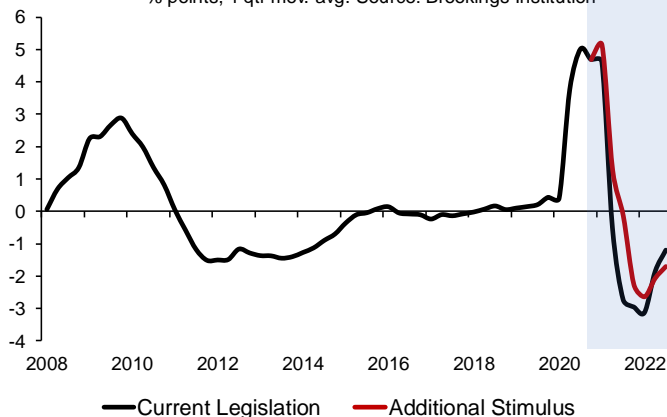
Job losses in recessions

% of pre-recession employment



Fiscal Impulse

% points, 4 qtr mov. avg. Source: Brookings Institution



- The short-term prospects are harmed by virus resurgence and the lack of any strong fiscal support, but news on vaccine reduced the risks for the second part of next year. We increase slightly our GDP forecast for 2021, to +3.9%.
- Activity in manufacturing and construction continues to progress at a healthy pace, but job creation slows down, especially in services.
- The Treasury's decision to limit the Fed's capability to buy credit and the short terms risks will likely force it to extend the duration of its bond portfolio.

The recent positive developments on vaccines strengthen the view that the US economy will reopen starting from the end of Q1. The new wave of infection points to a flat GDP in Q1; afterwards, however, consumption will lead to a strong pickup in H2. We raised our forecast for 2021 to 3.9%, after a 3.6% contraction in 2020.

Quick but limited boost from fiscal policy

Short term indicators show that purchases of services remains under strong pressure. At the same time job creation is losing steam: in October 638k new jobs were added, compared with over 1m per month recorded during the summer; yet disappointing data on jobless claims raise the risk of a stall in job creation. Manufacturing and construction continue to power ahead (the NAHB index for homebuilding reached in October its historical high), but it is not enough to offset the weaknesses in the rest of the economy

Our 2021 forecast is based on some fiscal stimulus enacted in Q1. We expect its size to reach at most US\$ 1tn, for several reasons: first, a likely Republican-controlled Senate is keen to limit the large increase in expenditures foreseen by the Democrats, and the perspective of vaccine availability has further reduced their appetite for fiscal expansion. Secondly, the Biden administration needs quick measures to bridge the gap between a weak start of the year and the acceleration expected from Q3 on. A less ambitious package is more likely to be agreed on quickly. The appointment of Janet Yellen at the Treasury should speed up compromise.

Fed: expanding QE remains the only option

All this leaves the Fed with a big responsibility to support the economy in the short term. However, the decision by the outgoing Treasury Secretary to terminate the support for credit and loans purchase reduced the tools available. Acting via purchases of Treasuries remains therefore the main instrument available. We expect a decision at the December meeting, entailing an increase of the duration of the bond portfolio. But the impact may be limited given the already very loose financial conditions.

Euro Area

Martin Wolburg

- While activity currently suffers from increased stringency measures to fight the 2nd Covid-19 wave, the prospects for 2021 improved.
- The key reason is the arrival of various effective vaccines that will likely lead to an abolishment of lockdown measures by mid-2021.
- That said, the ECB will very likely embark on bold additional support measures at its Dec. 10 meeting.

The second wave of the pandemic currently has a lock on euro area activity as it triggered a renewed tightening of stringency measures. Notwithstanding regional differences, the euro area as a whole is currently in a lockdown 'light' as the present degree of restrictions is well clearly below the peak experienced earlier this year. The composite PMI fell to 45.1 in November, in line with our expectation of shrinking activity in Q4/2020.

Vaccines to trigger turnaround

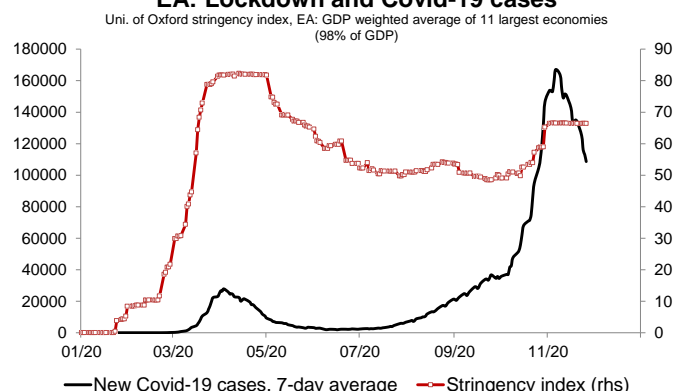
Looking ahead, a turnaround of activity to the better is in sight. A first set of effective vaccinations will very likely be followed by additional ones at the outset of next year. The positive impact on activity will depend on the one hand on the strength of the pandemic. On the other hand the ability to produce these vaccines in large quantities, successfully roll them out and the willingness of the population to become vaccinated is key. Depending on the interaction of these factors a wider range of activity paths – also on the upside - in the years ahead emerges (see mid-graph).

We deem it most likely that vaccination is starting already in December and is being completed by mid-2021. With the pandemic likely starting to abate after January already, economic activity will strongly be boosted by the unwinding of stringency measures and the boost in confidence supporting investment spending while reducing precautionary savings. All in all, following a drop of activity by -7.3% in 2020 we now see output expanding by 5.5% in 2021 and a return to pre-crisis activity by year-end 2021.

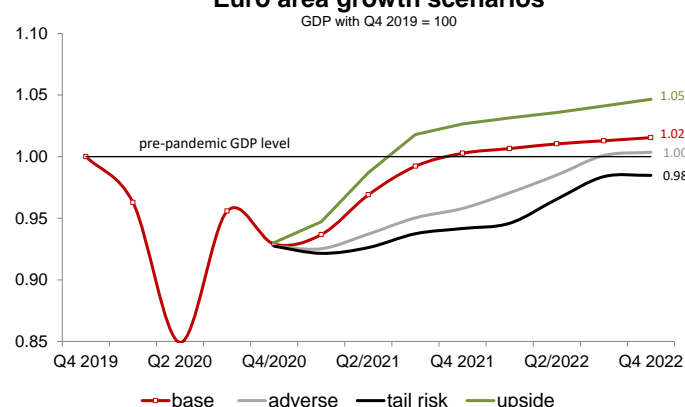
Bold ECB action in December expected

At the October policy meeting the ECB announced a reassessment of the outlook and a recalibration of instruments and the accounts from the meeting left no doubt that action will be taken at December 10. The Governing Council will not only err on the side of caution but also continue to try to push inflation up to its pre-pandemic path again. President Lagarde has frequently pointed at TLTROs and the PEPP as key tools to fight the pandemic. Therefore, we look for action on TLTROs (more, better conditions, longer maturity) as well as an extension of the PEPP towards year-end 2021 and an increase of its volume of currently € 1.35 tr by € 400 bn to € 500 bn accompanied by a still very dovish policy outlook.

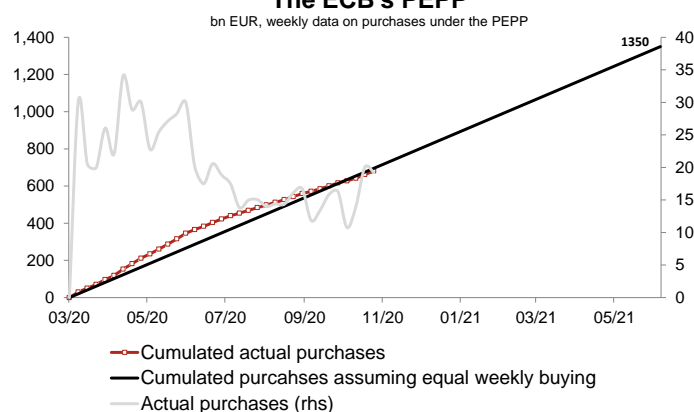
EA: Lockdown and Covid-19 cases



Euro area growth scenarios



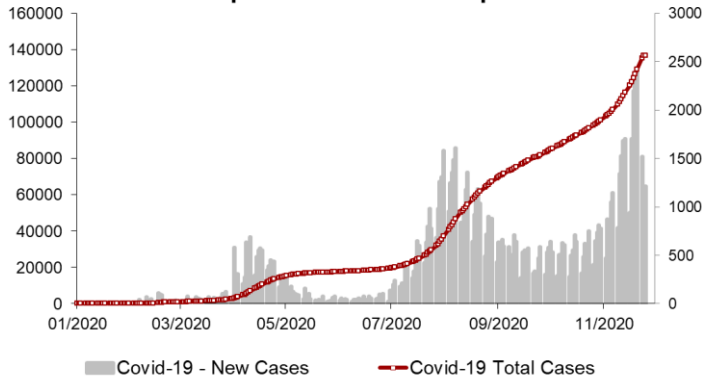
The ECB's PEPP



Japan

Christoph Siepmann

Japan: Covid-19 development



- **Japan's Q3 GDP surprised slightly on the upside due to strong government demand.**
- **Japan could not decouple from a second Covid-19 wave. We revised our GDP outlook down.**
- **The size of the third stimulus package could reach ¥20 tr, about 4% of GDP.**

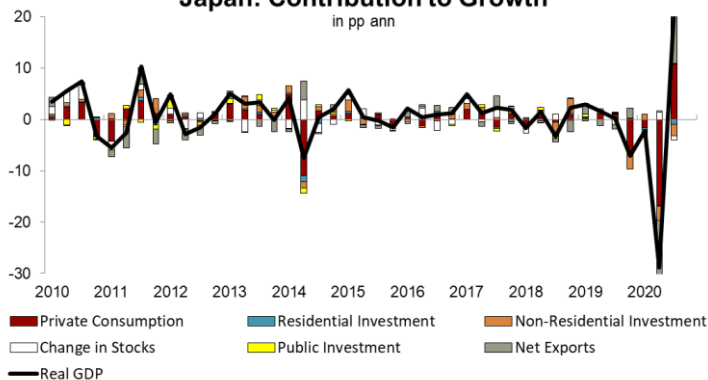
According to the first print, Japan's real GDP rebounded by 5.0% qoq or 21.4% qoq annualized (ann) in Q3, after a plunge by 28.8% qoq ann in Q2. The result was a bit higher than market expectations mainly due to a very strong increase in government consumption. Otherwise, private consumption and exports were the main drivers. Investment stayed poor, especially as real estate investment dropped significantly. Imports also receded, thereby boosting overall GDP with a strong net export demand. The latter will not be sustainable.

Japan could not decouple from 2nd Covid-19 wave

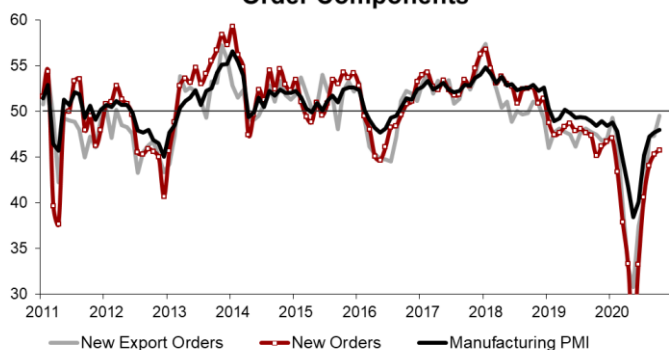
Unfortunately, Japan could not decouple from the second Covid-19 wave in November and fresh infections accelerated strongly. Data do not reflect this changed situation as they typically run only until October. October real exports and imports came in on the strong side, showing a continued recovery. This was also true for retail sales and industrial production. However, the fresh Covid-19 wave in Europe and the US will weigh on exports while China's demand will likely stay supportive. Domestically, the Go-to-Travel and Go-To-Eat campaigns have helped to stabilise the service sector. In the light of the fresh Covid-19 infection, the government has recently decided to impose certain restrictions. We expect retail and service demand to be hit from mid-November on. Given the buffers from the first half of the quarter, this leaves the chance for GDP to stay slightly positive in Q4, but we expect stagnation or even a slightly negative result for Q1. Regarding the Covid-19 vaccine, we expect the time to reach herd immunity to last until summer next year. As a consequence, we revised only slightly our GDP growth forecast to -5.4% in 2020 (previously -5.5%) but more strongly in 2021 to 2.1% (from 2.5% before).

Regarding the expected fiscal policy package, PM Suga instructed a draft by Nov. 10. An announcement is expected in early December. The size of the package is still very controversial with a headline figure of around ¥20 tr (about 4% of GDP) looks the most likely outcome. Meanwhile the BoJ announced a Special Deposit Facility geared towards the stability of the regions. We do not expect the BoJ to change its yield curve control approach but to strengthen some facilities which were set up to smooth Covid-19 financing needs. CPI inflation dropped to -0.4% yoy of late (core inflation -0.7% yoy) and we see inflation to turn slightly negative next year, averaging -0.3%.

Japan: Contribution to Growth
in pp ann



Purchasing Managers Index and Order Components



China

Christoph Siepmann

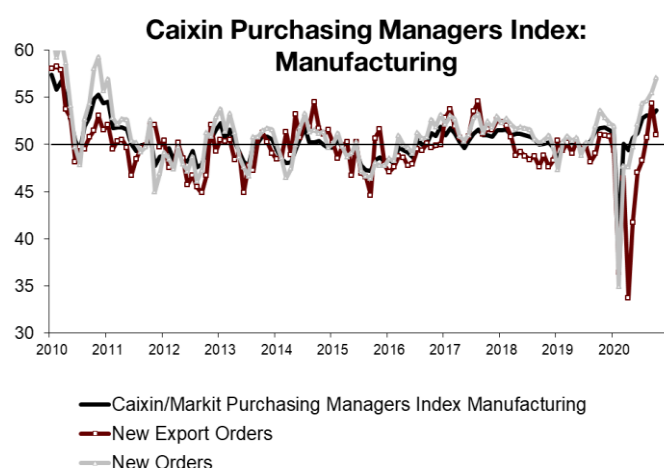
- **China's recovery continued to be on track. Despite some Covid-19 clusters, a major lockdown looks unlikely.**
- **Economic policy will likely become less ample.**
- **The government is reported to target a deleveraging of the real estate sector. This could elicit broader implications for growth and credit.**

Recently, China saw several bouts of locally transmitted fresh Covid-19 cases which triggered a strong response by authorities. Overall, the likelihood looks still small that China could run into a major second wave of infections.

The latest macro-economic data set reports the recovery to be well on track. The NBS manufacturing PMI surprised on the upside. Industrial production advanced by a strong 6.9% yoy, unchanged from the previous month. Support came from exports as well as from domestic demand. Exports increased by 11.4% yoy while the product mix shifted a bit to cyclical demand and away from health products. Given the hefty Covid19 outbreak in other parts of the world, this might change again. Domestically, investment quickened to 9.2% yoy which raised the official year-to-date reading to 1.8% yoy ytd, after 0.8% yoy ytd in the month before. Manufacturing and property investment rose further while infrastructure investment ticked up to 5% yoy. However, overall it remained still disappointing with regard to past local government bond issuance and the fiscal package decided upon at the last NPC meeting. Retail sales continued to improve, in October by a full percentage point to 4.3%, but did not meet market's even higher expectations. On the monetary side, headline CPI inflation dropped from 1.7% yoy in September to 0.5% yoy of late which was basically caused by negative base effects from last year's food price acceleration. Core CPI inflation is at 0.5% yoy for the second month in a row while non-food inflation hovers at around zero percent. Clearly, the Covid-19 effect on demand still needs to be fully overcome. The consumer goods section in the producer price index suggest that some downside pressures are still not over.

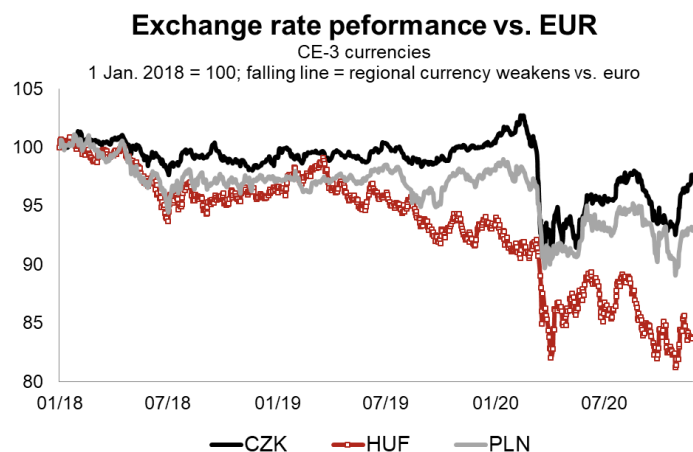
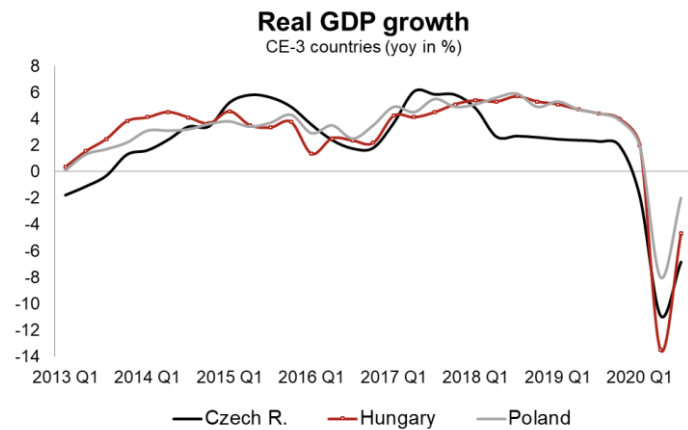
Real estate sector ahead of major deleveraging?

Given the recovery and also improvements in the labour market we expect the PBoC to scale back its policy easing but to likely keep a cautious stance. Of late, a string of state-owned-enterprises' (SoEs) bond defaults upset markets. Moreover, news are spreading that the government is mulling over a systematic deleveraging in the real estate sector. According to press reports it has developed a "three red lines" approach which classify enterprises of the sector into four categories. On this basis it will restrict future debt growth of respective companies between 0% and 15%. The approach could come as a headwind for the financial sector. However, real estate is a major growth driver in China which suggests that deleveraging will be handled with care.



Central and Eastern Europe

Radomír Jáč



- Regional GDP recovered nicely in qoq terms in Q3; a pandemic-related contraction in Q4 should be relatively moderate, as foreign trade will support the fully operational industrial sector.
- Improvement in global risk sentiment led the regional currencies to firm with the Czech crown and Polish zloty outperforming.
- The Czech CNB presented a hawkish view with a rate hike predicted for Q2 2021 while the Polish NBP raised its CPI outlook above the target.

Preliminary data for Q3 reported strong GDP recovery in quarter-to-quarter terms across the CEE. While measures related to the second wave of pandemic will lead to a renewed GDP contraction in Q4, the fall should be much softer than in Q2 when activity was hit by the first Covid-19 wave. Unlike in spring, industry and foreign trade are in full operation now, which is important for the regional economies with a large share of industry and exports in their GDP. Stronger than expected Q3 GDP data led us to improve the full-year outlook for Hungary and Poland.

The regional currencies firmed in past weeks, as some of the global risks moderated. In the CEE, the Czech crown outperformed, followed by the Polish zloty. We expect the CZK appreciation to exceed the central bank's forecast, which will help to keep interest rates stable at low levels.

Monetary policy messages impacted by high inflation

The Czech CNB left its key interest rate on hold at 0.25% in November. The central bank at the same time released a new quarterly forecast where the monetary policy outlook was surprisingly hawkish. The CNB's projection sees a first rate hike in Q2 2021 with the key rate at 1.00% at end-2021. However, the CNB at the same time predicts only a moderate CZK appreciation. The CZK outperforms the forecast already now and we expect monetary conditions to tighten via currency strengthening, enabling the CNB to keep interest rates on hold in 2021.

In Hungary, the MNB also stood on hold with the base rate at 0.60% and deposit rate at 0.75%. There are speculations that the deposit rate will be reduced by 15 bps to match the level of the base rate. Such call is driven by the recent decline in Hungarian inflation and by a recovery of the forint from its historical lows against the euro. However, the forint lagged its regional peers in the recent firming and the MNB is aware of FX rate's sensitivity to external factors. We therefore think that the central bank may not rush for a deposit rate cut too early.

The Polish NBP kept its key rate on hold at 0.10% and we expect stability until 2022. The NBP increased its inflation outlook for the next two years above the target set at 2.5%. While this does not mean that monetary policy will be tightened in a foreseeable future, we see this as a signal that there is no room for more interest rate cuts.

Main Forecasts	2019	2020f	2021f	2022f
Czech Republic				
GDP	2.3	-7.1	4.7	2.8
Consumer prices	2.8	3.2	2.1	2.1
Central bank's key rate	2.00	0.25	0.25	0.75
Hungary				
GDP	4.6	-6.5	4.6	3.0
Consumer prices	3.4	3.4	3.2	3.0
Central bank's key rate	0.90	0.60	0.60	0.90
Poland				
GDP	4.6	-3.2	4.5	3.6
Consumer prices	2.3	3.3	2.5	2.5
Central bank's key rate	1.50	0.10	0.10	0.75

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

Government Bonds

Florian Späte

- International sovereign bond yields moved on balance sideways in November. Neither the US elections nor the news concerning a vaccine impacted bond markets lastingly. Particularly long-dated euro area inflation expectations edged up.
- Going forward, we expect euro area core yields to remain around current levels as the ECB appears to be committed to keep core yields on a very low level. In contrast, there is some leeway for higher US yields amid an ongoing high supply of US Treasuries and a sustained economic recovery.
- Euro area non-core sovereign bonds continued their rally. Taking into consideration the ECB's determination to fight any fragmentation risks we expect the overperformance to continue for the time being.

Judged by net yield changes in November one might think that it was a rather calm and uneventful month. However, this hides some remarkable movements. To start with, the delay in the US election results triggered a sharp drop in long-dated US yields reflecting the decreased likelihood of a blue wave and the flight into the safe haven in light on an increased uncertainty. However, this proved short-lived as even a majority of Democrats in the Senate cannot yet be ruled out (two run-off elections in Georgia in January).

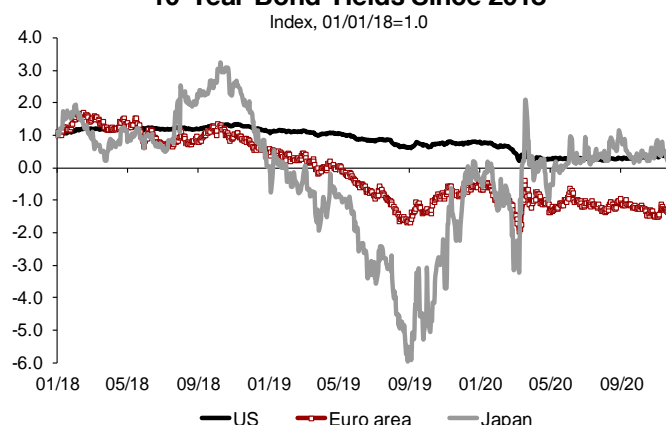
Moreover, news of a promising vaccine triggered hopes of a swift overcoming of the pandemic and, consequently, a sharp increase in international government yields. However, this turned out temporary and (particularly euro area) yields decreased again. We consider the ECB's reaction to be at least partly responsible for this development. On balance, sovereign yields on both sides of the Atlantic hardly changed in November.

Strong commitment by the ECB to keep yields low

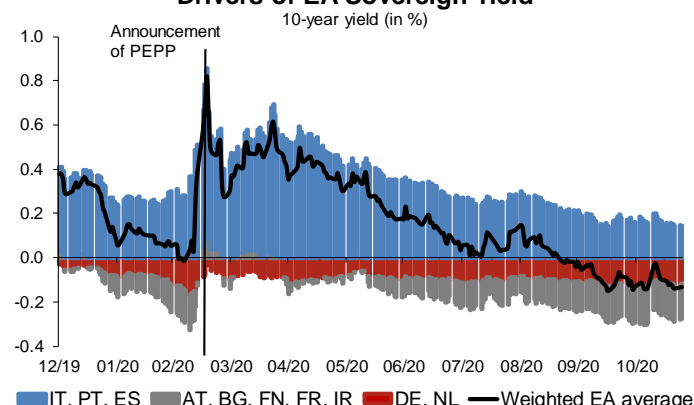
The ECB deployed the Pandemic Emergency Purchase Programme (PEPP) in March to reduce the fragmentation of euro area bond markets. As the chart shows this turned out very successful as the current weighted euro area yield average is well below the pre-crisis level. This downward trend has continued since summer although the ECB reduced its purchases. Remarkably, the ECB reacted to the good economic news regarding the vaccine with a strong increase in purchases although there were no increased fragmentation risks (if at all rather the opposite). This way the ECB was able to reverse the initial yield increase and despite the brightening economic outlook euro area yields remain close to the bottom.

We take this as a clear indication that the ECB is very committed not only to fight any fragmentation risks but to use all monetary policy tools to prevent any meaningful increase in core yields. The central bank aims to support the economic recovery with easy financial conditions.

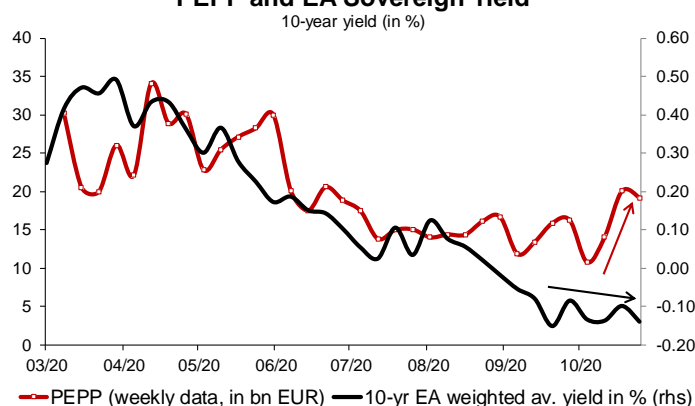
10-Year Bond Yields Since 2018



Drivers of EA Sovereign Yield

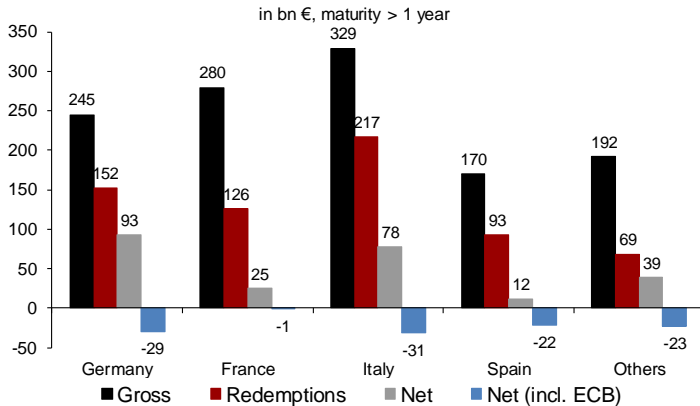


PEPP and EA Sovereign Yield

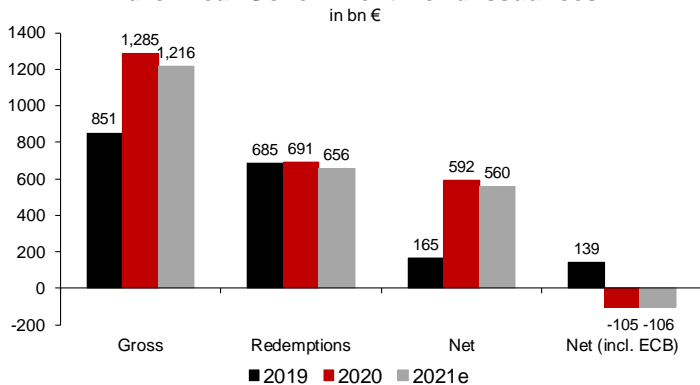


Government Bonds

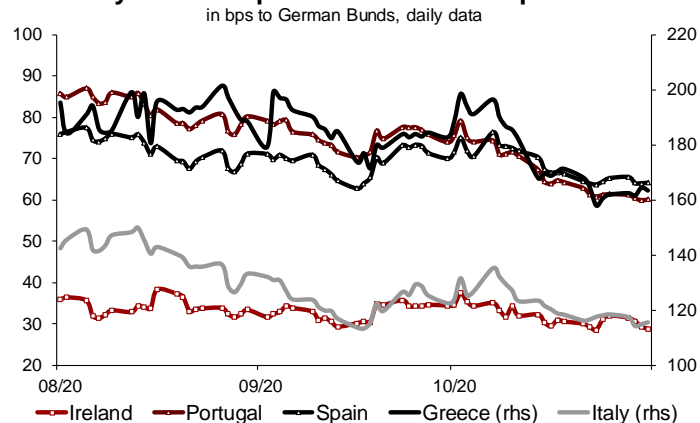
Euro Area Government Debt Issuance 2021



Euro Area: Government Bond Issuances



10-year Sov. Spread Euro Area Peripherals



Considering the ECB's reaction function we do not expect a significant increase in euro area core yields for the time being. It appears that financial markets have understood this message. The ECB's strong commitment has already led to a significant increase in inflation expectations (10-year euro area inflation swaps up by 20 bps in November) and 10-year real yields are almost back to the historical low. Accordingly, the forecast moderate increase in euro area core yields in 2021 is likely to be driven by higher inflation expectations while real yields will struggle to inch upwards.

The accommodative ECB policy stance will also help to take down the high supply of sovereign bonds in 2021. As fiscal deficits will come down only slightly funding needs remain elevated. Although at this stage projections are still fraught with a high degree of uncertainty, we expect gross and net supply to be almost as high as in 2020. Some assumptions are necessary to make this forecast. It is presumed that the increase in t-bills will continue albeit at a lower rate than in 2020. In addition to the uncertainty about the budget deficit, the extent to which national funding will be replaced by SURE and EU Recovery Fund funding is yet undetermined. Finally, the amount the ECB will use for purchases and to what degree the ECB will use agency and state bonds to replace sovereign bonds leaves room for speculation. Overall, we forecast the net supply (including ECB purchases) of sovereign bonds to remain in negative territory – roughly at the level of 2020.

While the weaker than expected fiscal stimulus and an forecast switch to longer-dated Treasury purchases by the Fed will limit the upward pressure on US yields, a slow rise in inflation amid an economic recovery is seen to gain the upper hand on US Treasuries. Hence, the US yield curve is expected to steepen moderately in the months to come. Accordingly, the transatlantic yield spread is forecast to widen again.

High-yielding non-core sovereigns remain attractive

Euro area non-core bonds continued their upward trend in November. 10-year sovereign bond spreads showed once again double-digit reductions.

Given the ECB's commitment to keep core yields on a very low level we regard non-core bonds as first choice. Particularly high-yielding peripheral bonds look appealing. In light of the achieved low spread levels we consider among others Greek bonds as attractive. In addition to recent positive rating news, Greece is one of the main beneficiaries of the forthcoming EU Recovery Fund (around 20% of GDP). At the short end of the curve Greek bonds offer the highest spread in the euro area. E.g., Greece 2.0% 04/2027 still offers a spread of more than 110 bps versus German Bunds. This will help to smooth out potential future fluctuations.

Credit

Elisa Belgacem

- Post US elections and vaccine news, credit spreads have accelerated their convergence towards pre-Covid levels.
- The second wave of stringency measures in Europe also means an extension of fiscal support into H121.
- We continue to expect defaults to rise to 5-6% in spring next year, but SMEs should suffer more with consequences on the banking sector.
- We think the compression trade currently in place will continue, supporting HY, while we still like IG for the carry versus sovereign.

IG is now only a few basis points away from pre-Covid levels while riskier parts of credit markets remain significantly wider than earlier this year.

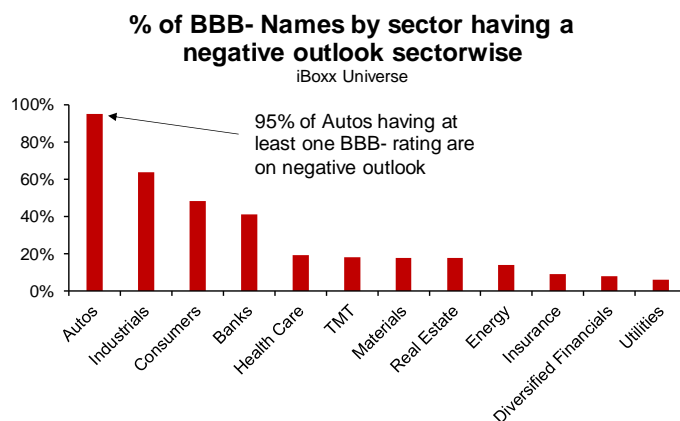
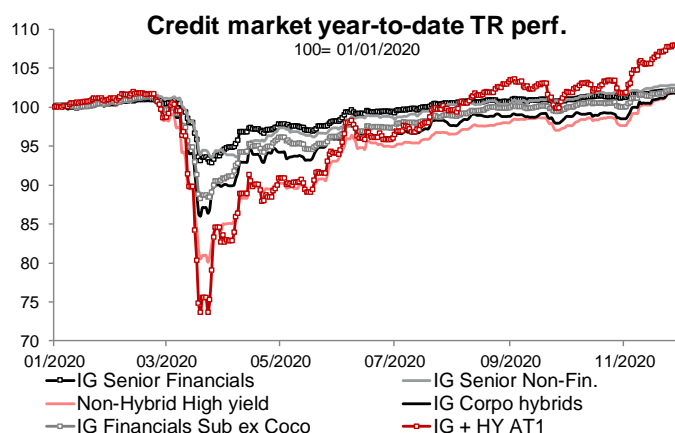
The second wave of stringency measures that have gradually been announced across Europe, appears to be significantly less damaging to the economy than the first wave. In parallel, the fiscal support to the corporate world is being extended into H121, protecting issuers liquidity and solvency. Hence, pressure on ratings, especially in IG, will continue but a 5-6% default rate remains our projections for Europe with a peak in spring 2021. However, we expect SMEs to suffer more than bond issuers with consequences on the banking sector.

As a consequence, the ECB has signalled that it will do more in December and could put more efforts on the TLTROs side than on purchases, with some risks of disappointing, since spreads are currently at very narrow levels, both on the govies and the credit side. At the same time, the banking sector will come under pressure when governments start gradually withdrawing their support to the private sector, with the expiry of guaranteed loans and moratoria. While direct purchases of bank bonds remain controversial as the ECB is also the banking regulator, TLTROs remains the easiest option to support the credit channel for the ECB.

Compression trade ongoing

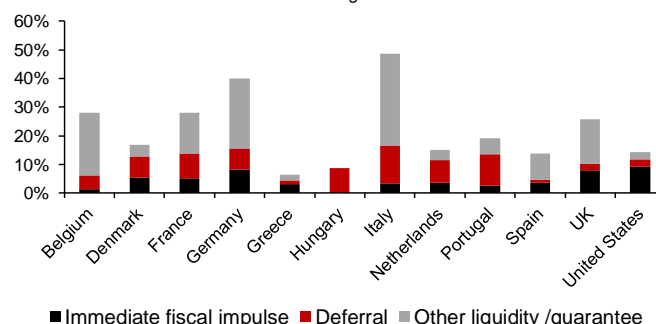
Hence going forward, we expect IG grinding gradually tighter while HY should outperform near term. Uncertainty surrounding rising default rates will continue to weigh on HY into 2021 despite record public support, while IG will be subject to rating downgrades.

If we think HY will continue to converge towards pre-Covid levels, we adopt a prudent bias across the board. It will weigh more on the lower end of the rating spectrum, hence within HY, we retain a preference for BBs. We continue to prefer capital structure risk to credit risk, and so we prefer corporate hybrids and AT1 to pure HY as we see them as a better risk-reward alternative.



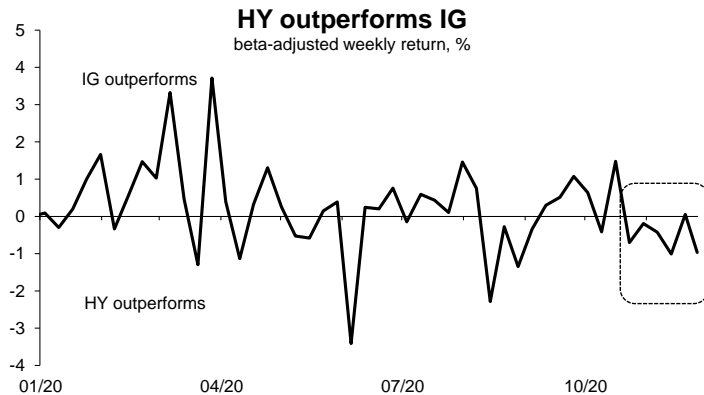
Discretionary 2020 fiscal measures adopted in response to coronavirus by 29 October 2020, % of 2019 GDP

Source: Bruegel Institute



EM sovereign bonds

Guillaume Tresca



- We turn more positive on EM and we now favour EM HY over EM IG. IG is still offering an attractive carry but it is more sensitive to a US rates rise.
- Rally has been rapid and a temporary consolidation could occur.
- Discrepancies remain with high idiosyncratic risks. We focus on the strongest BBs

We turn more positive on EM sovereign bond and now favour EM HY over IG. More precisely, we focus on solid BB while in the IG space we remain focussed on the BBB bucket. The double shots coming from a positive US elections outcome for EM and the hope for a Covid vaccine are providing a firm anchor and will support significantly cyclical assets and hence HY names. Moreover, the November spread compression has pushed the EM IG sector yield back to its historically low pre-Covid level. It offers a limited buffer to a long-term US rate rebound, leaving EM HY more attractive from a total return point of view. It remains that EM IG is still offering a better carry than DM.

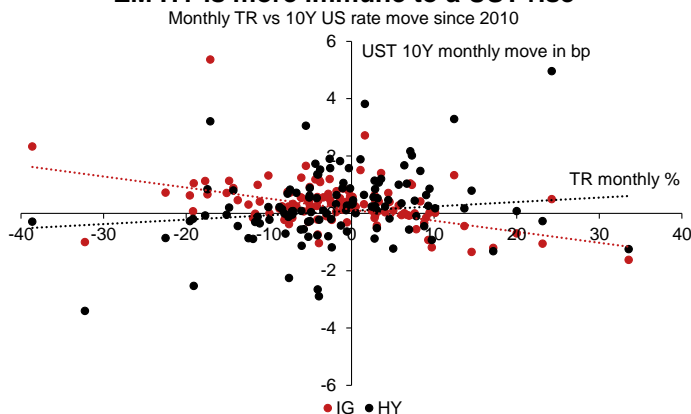
Even if two big hurdles have been cleared and EM medium-term pressure has clearly eased, the rally has been abrupt and one could see some temporary consolidation in December: EM HY outperformed on a beta-adjusted basis and EM issuance has broken the USD200bn year-to-date threshold with weak names coming to the market lately – e.g. Uzbekistan and Turkey – and a 100Y issuance by Peru.

Not all out of the woods

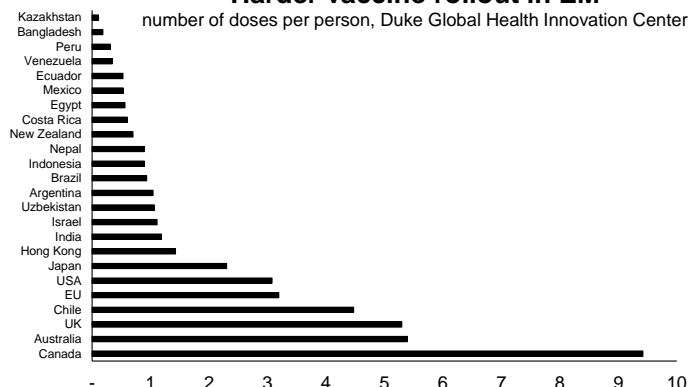
Not all EM countries are out of the woods and the vaccine rollout will be less smooth and rapid than in DM. Even if we currently see more value in HY than in IG, we focus only on strong BB names and avoid the B bucket where idiosyncratic risks are high: six countries defaulted or restructured in 2020, representing 9% of the BofA EM index face value. Rating agencies will continue to cut as more structural problems will emerge when dust settles. Since March, they have distinguished well the short and long-term effects and have highlighted the importance of governance.

More precisely, we will avoid South Africa where government must apply a challenging primary budget tightening, just to slow the debt deterioration, or Turkey where we need to see a confirmation in policy changes. LatAm can extensively benefit from a Biden victory and the vaccine: we see a risk for Mexico and Colombia to become *Fallen Angels* but we favour Peru and Chile. In the IG space, GCC could benefit from strong crossover demand, especially from Asia insurers. Russia is attractive with sound fundamentals but we see limited will from the government to stimulate and use fiscal space.

EM HY is more immune to a UST rise



Harder vaccine rollout in EM



Currencies

Thomas Hempell

- While resurgent Covid-19 cases in Europe and the US may still be USD supportive near term, the USD is prone for further weakness into 2021 on lower political uncertainties under a Biden presidency and more progress on vaccines.
- The EUR/USD will benefit, too, with new ECB's December measures unlikely to harm the EUR.
- The cheap JPY can defy the headwinds from improved risk appetite. Real yields are more favourable vs. US, while capital flows may turn more supportive.
- Sterling is likely to benefit mildly from a largely discounted last-minute deal, while a failure of talks would render a deeper GBP sell-off.

USD support from the tight US election outcome proved futile, with much-feared public unrest not materializing. Instead, the strong boost to the global outlook from vaccine news by Pfizer/BioNTech, Moderna and Astra-Zeneca may drive the USD even lower once short-term concerns on resurging Covid-19 infections in Europe and the US start to ease. Barring a surprise victory of two Democrat Senate candidate in Jan. 5 run-offs in Georgia, new US president Biden will be constrained by a split Congress. Nevertheless, a sizeable fiscal boost in Q2 is still feasible (see US section). Most importantly, though, markets will be reassured by a much more predictable and less confrontational foreign and trade policy, which will help to ease the sizeable premium still entailed in the US dollar.

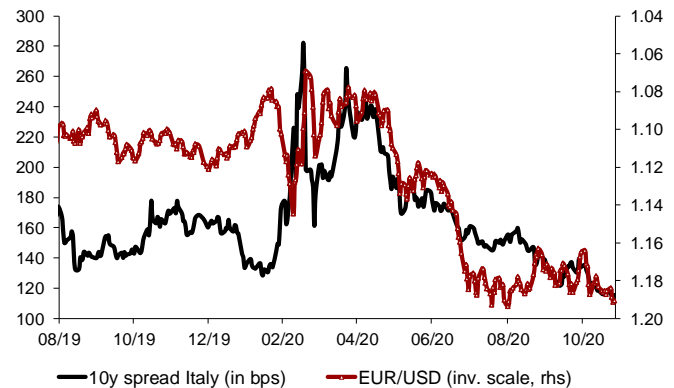
ECB December action unlikely to harm the euro

While EM and growth-sensitive currencies may strengthen most prominently (among G-10 we favour SEK and NOK), there is also scope for the EUR/USD to advance into the 1.20s. We are not particularly concerned about new ECB action undermining this move. A deposit rate cut (most impactful on FX) is unlikely. PEPP extension and improved TLTROs will ease monetary conditions. But this negative EUR impact will be offset by the implicit support to Southern European debt and European banks (even if we do not expect a repeat of the huge spread compression in the wake of the 2020 PEPP program, see top chart).

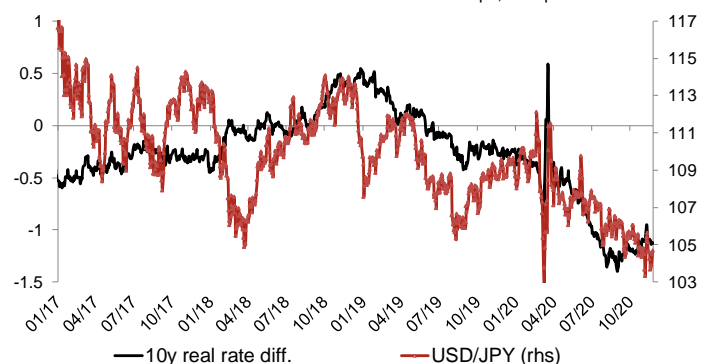
The risk-friendly outlook notwithstanding, we see more upside for the JPY. With the US having converged to the ultra-low yielders, Japan's 3% C/A surplus (vs. US deficit of similar size) and ebbing net-portfolio outflows underpin the yen, defying headwinds from recovering risk sentiment. The widening gap in real yields (mid chart) will also support the still undervalued Japanese currency.

A last-minute Brexit deal (somewhat more likely than not) will give only a moderate boost to GBP, with markets already largely discounting a compromise. That said, a chaotic no-deal departure would entail sizeably more sterling downside – ultimately also for EUR/USD on a larger economic fallout also in the euro area.

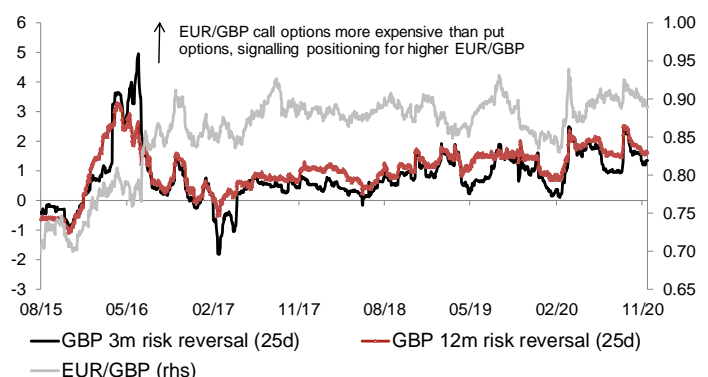
EUR/USD and EMU debt concerns



US/Japan real rate differential and USD/JPY
real rate based on UST/JGB and inflation swaps, in % p.a.

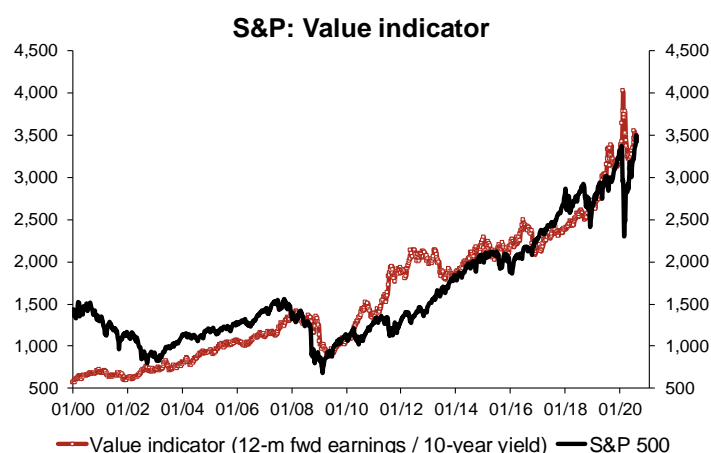
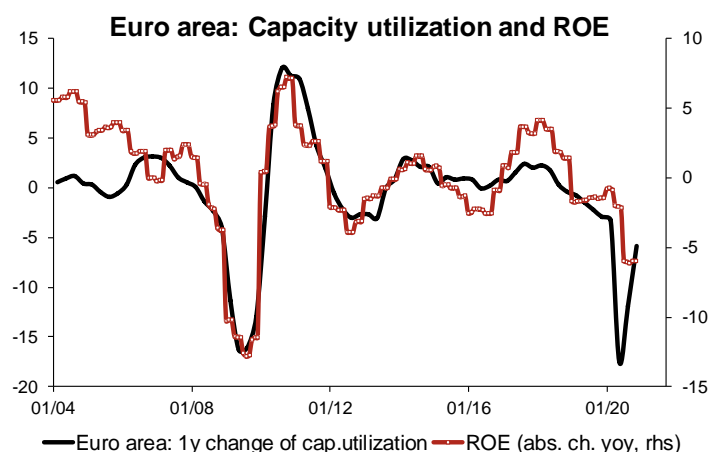
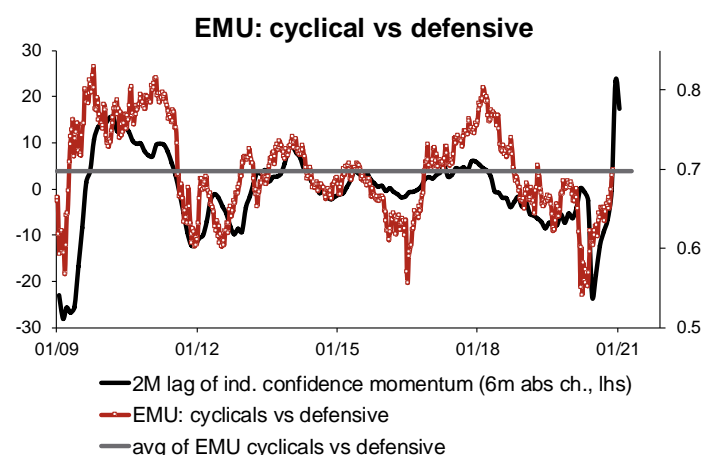


EUR/GBP and risk reversals



Equities

Michele Morganti / Vladimir Oleinikov



- Equity markets rallied after the US elections, enjoying a collapse in volatility, good news on the vaccine and continuing policy support.
- Earnings will flow abundantly in the next two years: for the euro area (EA) we forecast profits to grow above 40% in 2021 and +14% in 2022, with risks on the upside.
- A low yield environment and recovering inflation expectations should back the extension of the equity overperformance vs bonds. Value and Cyclical will continue to outperform, too. OW Japan, UK equities and EMs. Neutral EMU vs US.

In November markets rallied appreciably (MSCI World at +13%) with the EMU index (+17%) outperforming the US one (11%, while both Value and Cyclical did largely better than Growth and Defensive.

Equities are set to rise further in the next months

The VIX collapsed to 21 (from 40) right after US elections. This will cause investors to reinvest back part of their high cash positions in risky assets as political uncertainty diminishes along with the equity risk premium. Flows into equities increased noticeably recently but positioning is not extreme yet. Thanks to lingering huge policy support - fiscal and monetary - earnings will recover strongly over the next 24 months. Furthermore, the Biden policy - notwithstanding the lack of a unified government - will be more “reflationary” than Trump’s one, inducing slightly higher US rates and a steeper yield curve which will not represent a negative, as we forecast good earnings growth ahead, but will promote instead a style rotation into cyclical and value. In Europe positives are progress on the Recovery Fund, the vaccine development, the Brexit evolution after the Biden victory and the good Chinese macro momentum. The rotation into cyclical and value countries (EA, UK, Japan and EM) and sectors (industrials, financials, materials, energy) can continue mid term at the expense of growth ones.

Earnings expected to rebound strongly in 2021-2022

Firms’ confidence momentum remains strong. Markets can continue to rise, supported by a low yield environment but with increasing inflation expectations driven by the strong policy action. Like in 2009-2010, an increasing US inflation linked swap can back the continuation of the overperformance of equities vs. bonds (chart next page). Our models back a +42% earnings growth for EMU in 2021 and +17% for the US. EMU earnings should recover to 2019 levels in H2 2022, while those for the US at the end of 2021. Then, 2022 should see an earnings growth of around +10% for both. Such figures have upside risks: better-than-we-expect firms’ macro environment due to vaccine availability and more limited lockdowns in presence of a lower market volatility.

Equities

Such earnings development is able to generate above mid-single digit total returns in 12 months. At the moment markets are only slightly overvalued when we take into account current yields and current earnings estimates (see our Value indicator chart). But, as said, the latter are expected to rise significantly from here: the profit rebound has not started yet. US domestic NIPA earnings have already picked up and typically lead trailing earnings with a lag of 1 or 2 quarters. In the EA, the firms' capacity utilization is starting to bounce and the firms' ROE has chance to follow, increasing significantly from here.

After the rally, more Value, less Cyclical overweight

We maintain our preference for Value and Cyclical. Looking to the Value sectors, we see relatively strong earnings momentum vs the market. This is the case for financials, energy and materials, in particular; less so for industrials. Our quant models still see a huge undervaluation for Value but not so much for cyclicals, such as capital goods or commercial & professional services. For this reason we bring a small modification to our European portfolio, lowering capital goods (KG) from OW to N and putting only half of the money we get from KG into banks. The latter looks particularly vigorous in terms of relative earnings momentum, so we decided to go beyond the neutral position, trying not to raise further our risk exposure after the rally. OW: Financials, food retail, semis, materials and software. UW: media, TCM, transportation, and HPP.

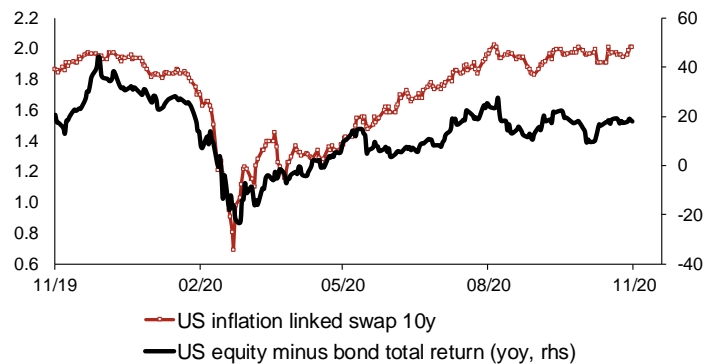
Country and sector allocation: tilt on Value/Cyclicals

Still neutral EMU vs US: short term, after the EMU's rally, relative earnings could see US favoured, notwithstanding the ongoing cyclical recovery. To our overweight positions in EMs and Japan, we now add UK equities, as we expect a Brexit deal coming soon: OW both the cheap FTSE100 and the dear, but more cyclical, FTSE 250 index, with Pound being unhedged.

EM: Indian stocks to benefit from recovery in 2021

The MSCI EM (+11.5%) has benefitted from a weaker dollar vs EM FX (-2.5%) and higher oil prices (+27%). In terms of multiples, EMs are trading at a discount of 28% vs historical average relative to the US. High macro surprises and a positive earnings momentum (3m % ch) are supportive. A sustained global recovery next year, more favourable global financial conditions, a weakening US dollar and higher commodity prices should benefit the EM market in the mid-term. India's earnings revisions have recently started to increase relative to EMs. The news on vaccine development should be particularly positive for this Covid plagued market. Our model (India rel. to EM) indicates an undervaluation by 1.2 stdev. We put Indian on only a slight OW as delivering vaccine to a 1.3 bn population could represent a logistical problem. We continue to favour Korea, Taiwan, and Poland.

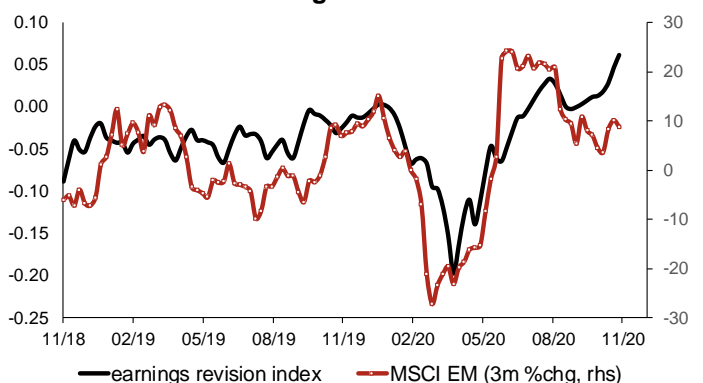
US inflation swap and Equity/Bond rel. return
corr=0.7



Markets	(1) Valuation score (80%) (lower=better)	(2) avg rel. performance (20%) (lower=better)	rel. perf. -6M (TR)	rel. perf. -12M (TR)	Beta 5 yr (USD based vs MSCI World)	Rank (1) + (2)
JAPAN	-0.7	-6.4	-5.4	-7.4	0.9	3
KOREA	-1.0	9.2	7.1	11.3	1.2	4
POLAND	-0.2	-23.1	-15.8	-30.3	1.4	7
EM	-0.6	6.6	8.9	4.4	1.1	10
SWITZERLAND	-0.2	-11.9	-13.5	-10.3	0.7	13
INDIA	-0.5	4.6	13.2	-3.9	1.0	14
TAIWAN	-0.6	11.4	10.4	12.4	1.0	16
CHINA	-0.6	13.5	8.7	18.3	1.0	17
RUSSIA	0.2	-18.7	-14.5	-22.9	1.3	23
US	0.0	0.5	-1.0	2.1	1.0	28
BRAZIL	0.1	-2.7	3.9	-9.3	1.4	30
UK	0.5	-18.4	-13.8	-23.0	1.1	32
EA	0.2	-2.0	3.5	-7.5	1.1	33
ITALY	0.5	-7.5	1.4	-16.4	1.3	39
SPAIN	0.9	-13.5	-4.8	-22.1	1.2	44

Note: Rank is derived from valuation (80%) and the avg relative performance (20%) (which considers 6m and 12m rel. perf. of each market vs the MSCI World). The valuation score is calculated as a sum of st. exp. total return (35%), avg PEG ratio adj. (for ROE and COE) (35%), Shiller PE discount (10%), mkt multiples discount taken from 2004 (10%), and PE vs. hist. avg. excl. bubble years (10%).
Most negative valuation score = cheapest = highest valuation rank (1); lowest perf. = highest perf. rank
Avg PEG is the average of fwd PEG and trailing PEG. fwd PEG is 12m fwd PE divided by exp. EPS long-term growth. EPS = 12m fwd earnings. Trailing PEG = trailing PE divided by earnings growth F0-F3.

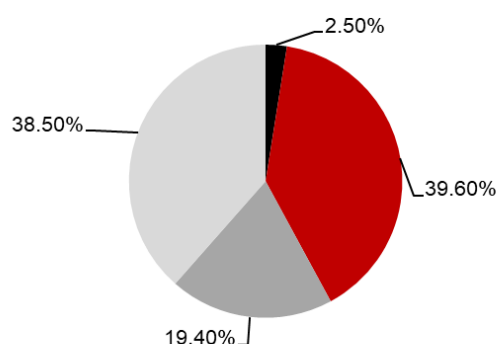
MSCI EM: price momentum (3m) vs earnings revisions



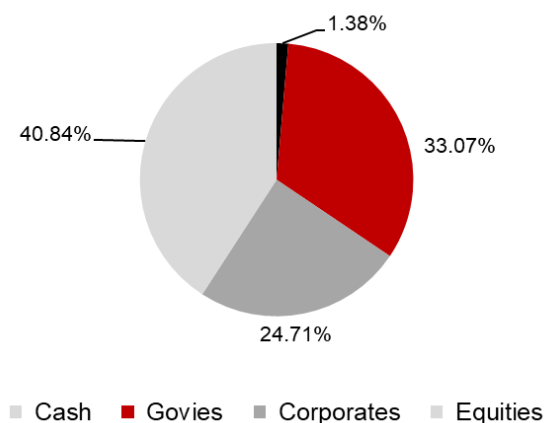
Asset Allocation

Thorsten Runde

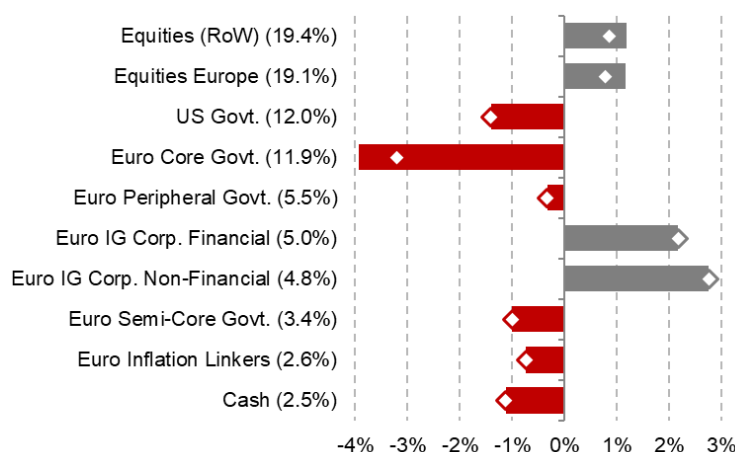
Benchmark



Modelportfolio



Active Positions in TOP 10 Benchmark Constituents*



*Benchmark weights in parentheses, diamonds indicating previous

- In the course of November equity markets rallied quite impressively, gaining more than +12.7% on average (November 27). The ranking is led by EMU (+17.4%) and even the worst performing equity market (EM) gained slightly below +10%.
- The fixed income side performed positively too, apart from Cash, EA Core Government bonds, Covered bonds, and short to medium-dated US Treasuries.
- With -0.2% short to medium-dated Core bonds were the worst performing asset classes over the past month. However, all losses (Core and US Treasuries) already materialized in the first half of November and were partly offset by gains in the second half.
- On the Credit side, EA IG Corporates roughly gained +1.0% since the end of October, Financials as well as Non-Financials. HY clearly outperformed IG by +315 bps.
- Reassuring Covid-19 vaccine news, less market uncertainties in the wake of the US elections and continued tailwinds for risky assets from central banks, let us moderately increase our stance in favour of equities at the expense of EA Core Govies.

Since the end of November the model portfolio has outperformed its benchmark by +34 bps so far. The majority of these (+31 bps) was already generated in the first half of November, where markets “celebrated” the outcome of the US elections and reassuring news on Covid-19 vaccines. The rally (+11.4% on average) in the first half of November made equities the only and strongly outperforming asset class. Thus, although just moderately over-weighted, equities contributed +13 bps to the overall result only topped by Core Govies (+19.5 bps) resulting from their distinct underweight. Just the performance contribution of corporates suffers from these technical circumstances due to their strong overweight (-25.4 bps).

Some relaxation at the Covid-19 front through encouraging vaccine news, less market uncertainties in the wake of the US elections and an ongoing constructive stance of central banks will keep yields low and support risk assets.

Brighter outlook to support risk assets

Basically we leave our moderate risk-taking stance unchanged. Beyond that, we unwind our last month's reduction in the equity positioning at the expense of Core Govies. We maintain the sizeable overweight in IG Credit. By enlarging the underweight in EA Core Govies we further reduce our exposure to low-carry markets.

Forecast Tables

Growth¹⁾

	2018	2019	2020		2021	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.9	2.3	- 3.6	0.1	3.9	0.1
Euro area	1.9	1.2	- 7.3	- 0.0	5.5	0.8
Germany	1.3	0.6	- 5.6	- 0.1	5.0	1.2
France	1.8	1.3	- 8.7	0.8	8.0	2.1
Italy	0.7	0.2	- 9.0	0.1	5.0	0.2
Non-EMU	1.6	1.5	- 9.2	- 0.4	4.7	0.5
UK	1.3	1.4	-11.0	0.0	5.0	0.3
Switzerland	3.0	1.1	- 4.3	0.0	3.4	0.0
Japan	0.8	0.8	- 5.4	0.1	2.2	- 0.3
Asia ex Japan	6.1	5.2	- 1.3	0.3	6.8	- 0.7
China	6.6	6.1	2.0	- 0.0	7.8	- 0.1
CEE	3.2	2.0	- 3.7	0.3	4.0	0.2
Latin America	- 0.0	- 1.2	- 9.1	- 0.2	3.2	- 0.2
World	3.5	2.7	- 4.2	0.1	5.1	- 0.1

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

Inflation¹⁾

	2018	2019	2020		2021	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.4	1.8	1.2	- 0.0	1.7	- 0.3
Euro area	1.8	1.2	0.3	0.0	1.0	0.1
Germany	1.9	1.4	0.5	0.0	1.5	0.0
France	2.1	1.3	0.5	0.0	0.8	0.0
Italy	1.1	0.8	- 0.2	- 0.1	0.6	0.2
Non-EMU	2.1	1.5	0.6	- 0.5	1.3	- 0.6
UK	2.5	1.8	0.8	- 0.8	1.5	- 0.9
Switzerland	0.9	0.4	- 0.5	0.2	0.2	0.0
Japan	1.0	0.5	0.0	0.0	- 0.3	- 0.3
Asia ex Japan	2.6	2.8	2.9	0.0	2.1	- 0.2
China	2.1	2.9	2.6	- 0.1	1.3	- 0.6
CEE	6.3	6.9	5.5	- 0.2	5.3	0.1
Latin America ²⁾	4.0	4.0	3.1	0.7	3.1	0.4
World	2.6	2.6	2.1	0.0	2.1	- 0.1

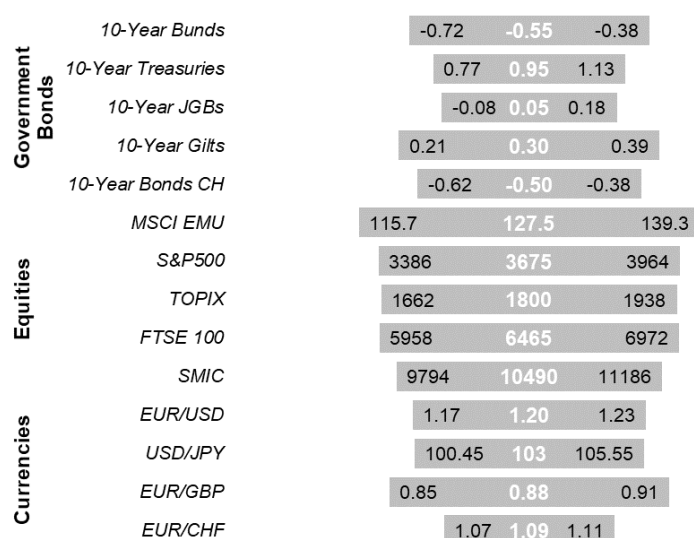
1) Regional and world aggregates revised to 2015 IMF PPP weights ; 2) Ex Argentina and Venezuela

Financial Markets

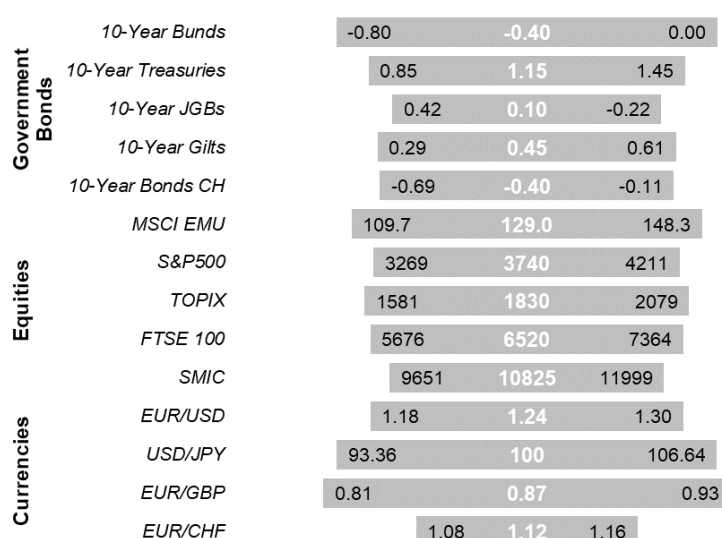
3-month LIBOR					Corporate Bond Spreads				
	26/11/20*	3M	6M	12M		26/11/20*	3M	6M	12M
USD	0.23	0.20	0.20	0.20	BofAML Non-Financial	93	90	85	80
EUR	-0.55	-0.50	-0.50	-0.50	BofAML Financial	94	90	85	80
JPY	-0.11	-0.10	-0.10	-0.10	Forex				
GBP	0.04	0.05	0.05	0.05		26/11/20*	3M	6M	12M
CHF	-0.78	-0.75	-0.75	-0.75	EUR/USD	1.19	1.20	1.22	1.24
10-Year Bonds					USD/JPY	104	103	102	100
	26/11/20*	3M	6M	12M	EUR/JPY	124	124	124	124
Treasuries	0.88	0.95	1.05	1.15	GBP/USD	1.34	1.36	1.40	1.43
Bunds	-0.57	-0.55	-0.50	-0.40	EUR/GBP	0.89	0.88	0.87	0.87
BTPs	0.57	0.65	0.70	0.75	EUR/CHF	1.08	1.09	1.10	1.12
OATs	-0.34	-0.30	-0.25	-0.15	Equities				
JGBs	0.02	0.05	0.05	0.10		26/11/20*	3M	6M	12M
Gilts	0.31	0.30	0.35	0.45	S&P500	3632	3675	3695	3740
SWI	-0.45	-0.50	-0.45	-0.40	MSCI EMU	126.2	127.5	127.0	129.0
Spreads					TOPIX	1769	1800	1800	1830
	26/11/20*	3M	6M	12M	FTSE	6395	6465	6460	6520
GIIPS	88	90	90	85	SMI	10493	10490	10520	10825
BofAML Covered Bonds	36	35	35	35					
BofAML EM Gvt. Bonds (in USD)	305	300	295	290					

*average of last three trading days

3-Months Horizon



12-Months Horizon



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

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