GENERALI ASSET MANAGEMENT

Market Perspectives

Bifurcation

March 2024

GIAM Macro & Market Research

'Market Perspectives' provide our monthly macro & market outlook and investment recommendations

- **Overly ambitious rate cuts expectations by the turn of the year have deflated to now far more reasonable levels. Notwithstanding concerns about the 'last mile' of the disinflation journey, we are starting to warm up to bonds; any further investor capitulation will be an opportunity to extend duration to beyond benchmark.**
- **Equity markets have proven remarkably resilient to the central bank repricing. This bifurcation owes much to the 'AI miracle' and rising optimism about the economy. Still, at this still fragile point of the cycle, and with (geo)political risk lurking, bullish investor sentiment and positioning, as well as depressed risk asset volatility, reflect a bit of complacency.**
- **Our underweights in Equities and High Yield credit are small, but we prefer safer (IG) buckets in Fixed Income and retain a tactical Cash overweight.**

Content

Global View – Bifurcation

Vincent Chaigneau

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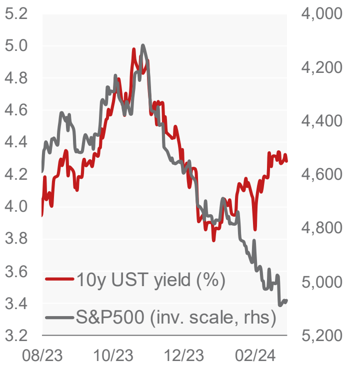
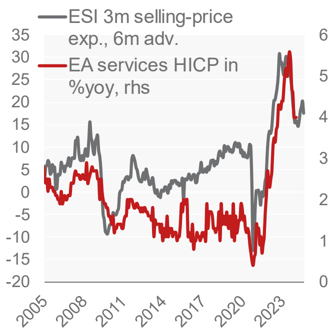
As we enter the final month of Q1, the dominant theme this year has been the bond-stock bifurcation: despite the hawkish repricing of rate cut expectations, equity markets have stayed on the steep positive slope of late 2023.

Stock-Bond bifurcation



Source: Datastream, GenAM

A challenging last mile for services prices



Source: Datasream, GenAM

Of course, the equity rally has remained concentrated, with Tech and Semi-conductors (and the poster child, Nvidia) stealing the show again. The equal-weight (EW) S&P is up just 2.5% YTD, vs 6+% for SPX; the EW MSCI Europe is below water (vs. index itself up 3.5%). But the equity resilience also reflects rising optimism about the economy, with the hard landing scenario now quickly evaporating. Look at the Stoxx600 index: Auto&Parts and Travel&Leisure, i.e. two cyclical sectors, are among the top-3 best performing sectors, along with Tech.

That optimism, along with bumps on the disinflation road, has contributed to the repricing of the central bank path. Disinflation has continued, but selected data supports the idea of a more difficult 'last mile'. For instance, the Price Paid components of the US ISM surveys, both Manufacturing and Services, have reversed to point North again. The Owner Equivalent Rent has proved stickier than expected. Wages also surprised to the upside in January. Even in Europe, selling price expectations have started to turn, questioning disinflation in Services (see chart).

The key question for investors, going forward, is whether risk assets can continue to shine, even without the support of quick and bold rate cuts, and with lurking risks in the background. Ukraine has struggled to defend its positions, Trump has talked NATO down and threatened massive tariffs hike on China. The European elections in June will confirm the rise of the populists. In this context, investor sentiment and positioning may reflect nascent complacency. Equity (up) and Cash (down) positions are not extreme at retail nor institutional level, but slightly stretched at this still fragile point of the cycle.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	4.27	4.15	3.90	3.80
Germany (Bunds)	2.42	2.30	2.10	2.20
Credit Spreads**				
EA IG Non-Financial	111	115	120	115
EA IG Financial	128	135	140	135
Forex				
EUR/USD	1.08	1.08	1.11	1.13
USD/JPY	151	149	146	142
Equities				
S&P500	5079	5060	5065	5130
MSCI EMU	161	158	158	163

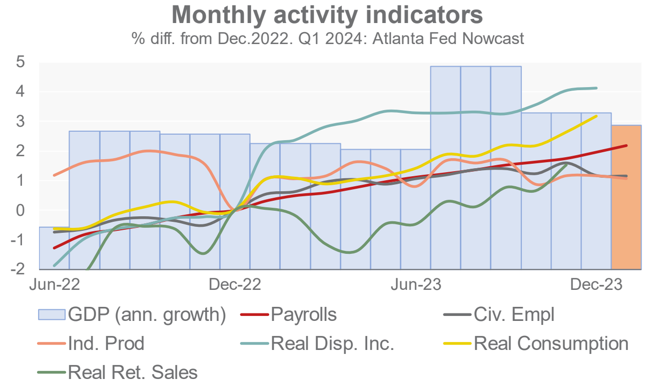
**3-day avg. as of 27/02/24* ***ICE BofA (OAS)*

Minimal short in risk assets, mulling duration extension

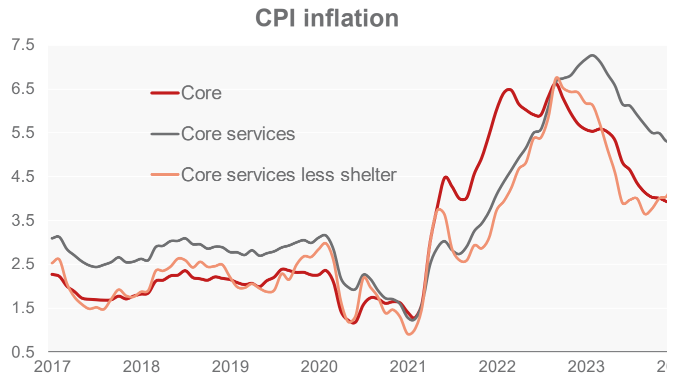
Luckily, the implied pricing of central bank rate paths now looks more reasonable. As we go to press the market is pricing some 82bp of cuts from the Fed this year, and 90bp from the ECB – coming from peak pricing of nearly 175bp for both at the turn of the year. We stick to our 100bp forecast for the ECB, but now only see 75bp cuts by the Fed. We slightly reduced our Treasury and EM HC bond over-weights last month, on fear of capitulation (too many investors positioned for lower yields early this year). But closer to the 4.40-4.50% area for 10-year Treasury yields we will be considering adding again and extending duration beyond benchmark. Over the past few months, we have significantly reduced our underweights in Equities and High Yields. Our key overweights currently stand in IG Credit (good risk-reward, spreads can go tighter still) and Cash – the latter a defensive twist to recognise the risk of unwinding following the strong joint stock-bond rally of late 2023.

United States

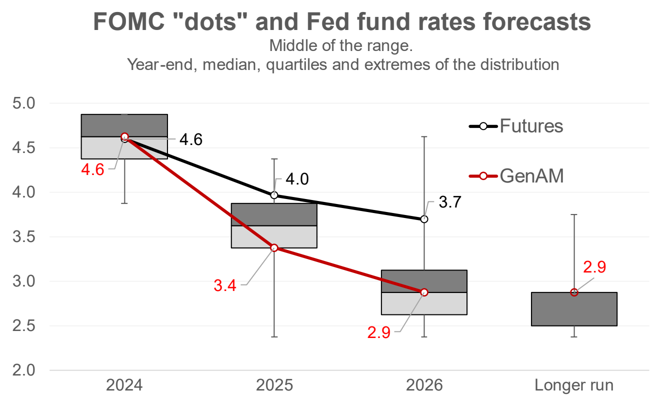
Paolo Zanghieri



Source:BLS, BEA, Fed, Refinitiv, GenAM



Source:Paweł Skrzypczyński, BLS, GenAM



Source:Federal Reserve Board, Datastream,GenAM estimates

- **Expectations of solid Q1 growth led us to upgrade our 2024 forecast to 2.4%. We expect a temporary and mild deceleration around the middle of the year and a bounce back in Q4.**
- **Inflation is proving very sticky: we still see it declining but core PCE will end 2024 still at 2.3% yoy. A strong labour market will keep wage growth elevated.**
- **The Fed is in no rush to cut rates. Our new baseline foresees 75bps of cuts this year, starting in June. The phasing out of QT is likely to start during the summer.**
- **Data released so far are consistent with Q1 GDP growing at above 2% annualised, based on that and given the strength of private sector balance sheet, we expect an even milder impact of tight money on demand. We therefore increase from 2.1% to 2.4% the growth forecast for this year.**

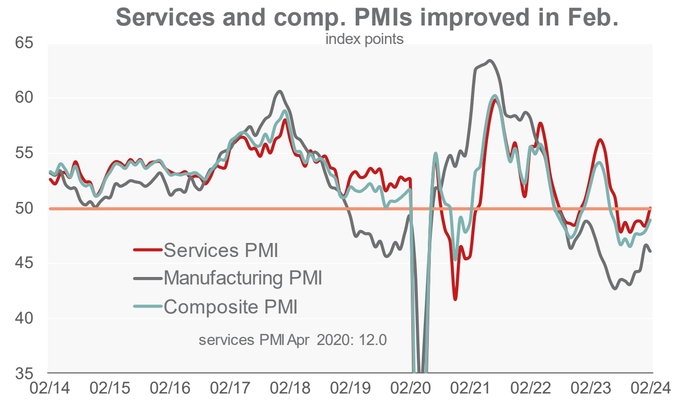
Positive surprises on growth were accompanied by less pleasant ones on inflation. January Cpi inflation were a nasty surprise, with services ex housing prices reaccelerating. This is in part due to yearly revision in regulated prices but shows that smooth disinflation cannot be taken for granted. We revised slightly up out projections for inflation, and we now see core PCE ending 2024 at 2.3%. Despite the strong showing of January payrolls (313k) the labour market is cooling, with the drop in job openings and quits. But this has not yet entailed any strong increase in unemployment (the rate still at a very low of 3.7%), this limits the downside for wage growth, but we expect annual growth in the employment cost index, currently at 4.2%, to end the year withing the 3-3.5% range consistent with 2%. The sustained pick up in productivity should help disinflation too.

Fed: late and cautious easing

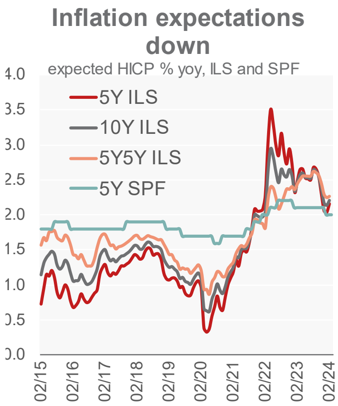
The FOMC has successfully steered market expectation toward it views of a very cautious approach to monetary easing, and now pricing is consistent with the 75bps cuts signalled by the December dots, which is also our updated forecasts. The Fed is very keen to move only when there is very solid evidence of disinflation. The surprise of the January CPI data has basically ruled out any move in May, even if higher inflation proves to be a blip. We expect the March meeting to provide a marked to market revision of the inflation outlook without big changes to the monetary stance. Then communication should steer expectations towards a cut in June. The March meeting should also see the beginning of the discussion on the evolution of QT. In our projection, the runoff in bond holdings should decelerate during the summer and end by the first months of 2025.

Euro Area

Martin Wolburg

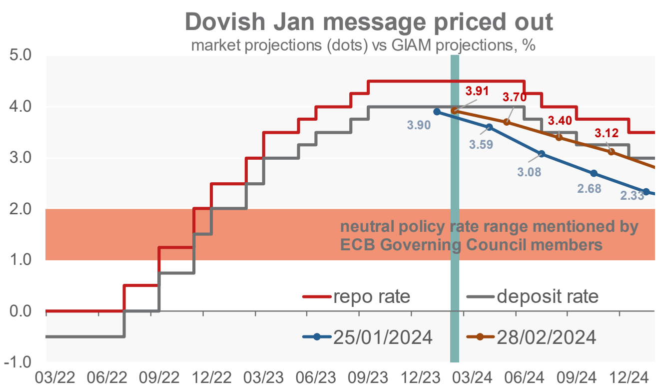


Source: Datastream, GenAM



Source: Datastream, ECB, GenAM

Source: Datastream, indeed, GenAM



Source: Datastream, ECB, GenAM calculations

- **Sentiment continued to improve in February backing our view that the economy will be back to expansion in Q1/2024.**
- **There are mounting signs for ongoing disinflation but persistently high wage growth sends a warning signal.**
- **We expect the ECB to further warm up to policy easing at the March 7 meeting with a first 25 bps rate cut likely by June and cumulatively 100 bps in 2024.**

The improvement of sentiment continued in February but there is no reason to become too excited about activity. On the positive side, the composite PMI advanced further (to 48.9, from 47.9) with the very much domestically-driven service sector sentiment (to 50.0, from 48.4) leaving contractionary territory. On the more sobering side, manufacturing sentiment took a hit again as weaker export orders suggest a still muted global environment. Also, the EC's Economic Sentiment Index surprisingly weakened. All in all – with hard data for Q1 still missing – we stick to our 2024 growth forecast of 0.6% yoy.

We stay confident about the euro area recovering not at least due to the ongoing signals for abating inflation which will translate into higher real income growth. Core PPI inflation (-0.5% yoy) has turned negative in October, future oil prices suggest that no further energy price driven inflation spike is ahead and also ECB measures of underlying inflation like supercore (at 1.9% yoy) have been coming down.

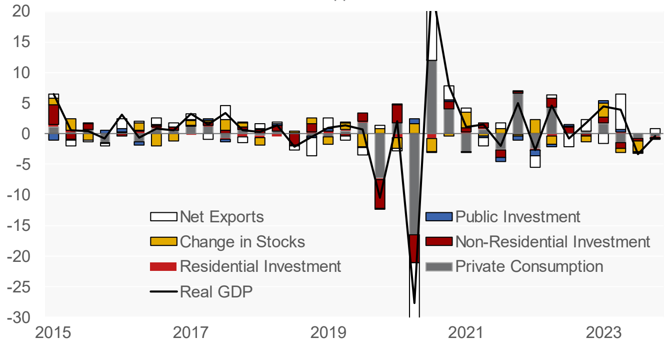
ECB likely to cut first in June

The Governing Council (GC) switched from the hiking mode to a dovish wait-and-see stance at its January meeting. We think that the update of the growth and inflation (to the downside) projections at the forthcoming March 7 meeting will increase the ECB's confidence in inflation converging to price stability towards the end of projection horizon in 2026. That said, there is one major risk on the GC's radar screen which keeps the ECB from taking outright action, namely wage growth. It soared significantly in response to the inflation spike and stays at elevated levels above 4% yoy (see middle chart, rhs). ECB officials continue to emphasize its importance for the underlying inflation trend and President Lagarde referred to important wage settlements taking place in the second quarter of the year. This confirms us in our view of a first (25 bps) rate cut only in June and 75 bps thereafter in 2024. Markets also got the message, postponed the first cut from April to June and adjusted their 2024 cumulative rate cut expectations from ~150 bps to a more realistic ~90 bps.

Japan

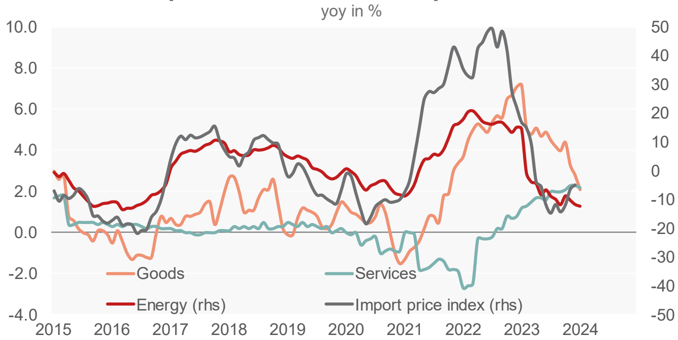
Christoph Siepmann

Japan: Contribution to Growth
in %, pp ann



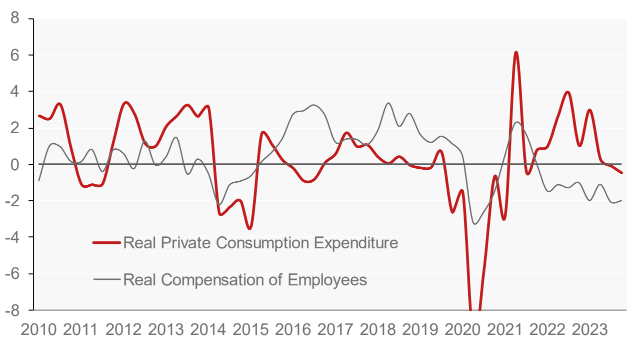
Source: Datastream, GenAM calculations

Japan: Consumer and Import Prices
yoy in %



Source: Datastream, GenAM calculations

Consumption and Compensation of Employees
real, sa, yoy in %



Source: Datastream, GenAM calculations

- **Japan's GDP unexpectedly receded in the Q4 2024, sending Japan into a technical recession. The main reason was private consumption. However, CPI inflation remained above the BoJ's inflation target.**
- **We expect inflation to become noisy over the next months but to overall remain on a downtrend. We see the BoJ to abolish YCC and NIRP in April as real disposable income returns to growth, driven by lower inflation, fiscal support and decent wage growth.**

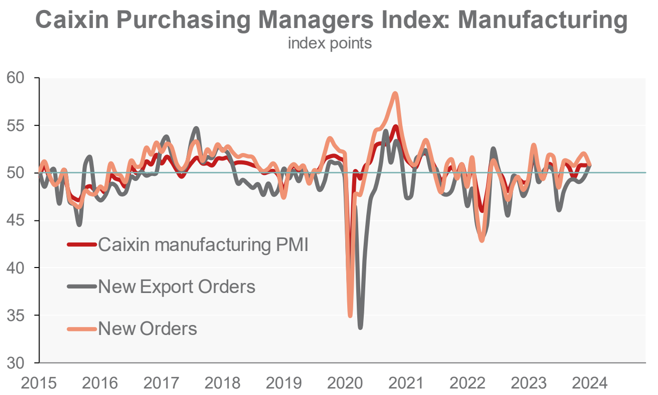
According to the first estimate, Japan's GDP dropped in Q4 by 0.4% qoq annualised (ann.), surprising on the downside (cons. exp.1.4% qoq ann). The main reason was private consumption, which diminished for the third quarter in a row, given the drop in real income following high inflation. While investment also receded, exports rose by 11% qoq ann., benefitting from the favourable yen and some "green shoots" in international trade. The technical recession prompted questions regarding the BoJ's exit scenario from the yield curve control policy (YCC) and the negative interest policy (NIRP). Doubts were even heightened by the consensus expectations of a drop in inflation below the BoJ's 2% target. However, the latter did not materialise. In fact, headline CPI inflation slowed from 2.6% yoy to 2.2% yoy in January. Looking ahead over the next months, inflation readings will remain noisy. Energy price subsidies caused in February last year mom inflation to decline by 0.6%. Thus, headline inflation will rise in February 2024 again, likely back to 2.8% yoy. Moreover, last October PM Kishida announced as part of the fiscal package the extension of subsidies until the end of April. Of late – given that Japan dropped into recession – the government has been reported to mull extending fuel subsidies until summer. Hence, at one point in time (in May or after summer) month-on-month inflation will jump up on the end of subsidies and keep yoy headline inflation higher. However, despite all noise, we see inflation to recede as a trend, declining from 3.3% in 2023 to 1.9% this year.

We see YCC and NIRP to be abolished in April

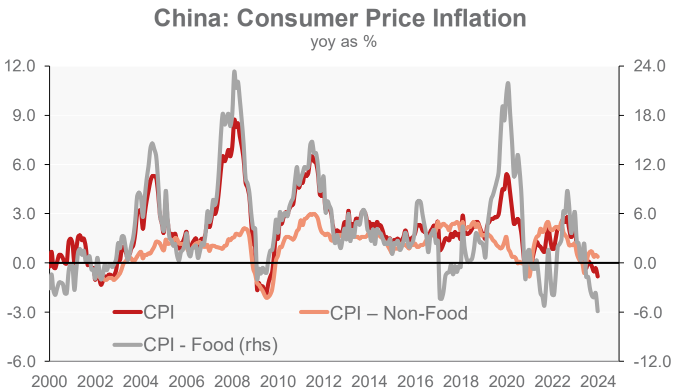
The higher inflation calmed market worries regarding the BoJ policy action. However, we see the BoJ not to act on higher inflation but on the expectation that real income growth will turn positive again. We indeed expect this shift to materialise on a combination of (trend) slowing inflation, fiscal support as well as decent wage growth. It is widely expected that wages could rise in the range of last year, i.e. above 3%. The spring wage negotiations are already underway. About half of the results will be available in mid-April, which is the reason, why we expect the BoJ to abolish YCC and NIRP by then. However, the decision is still surrounded by large uncertainties.

China

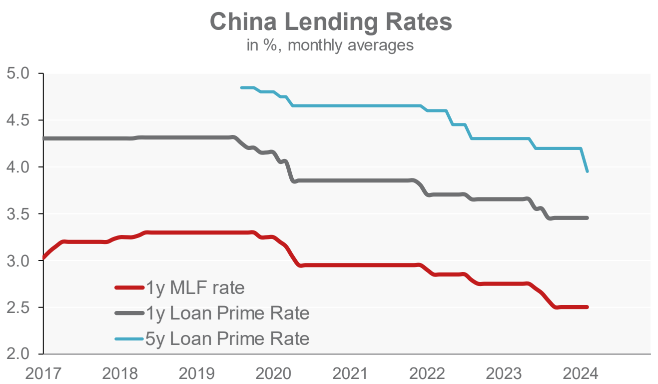
Christoph Siepmann



Source: Datastream, GenAM



Source: Datastream, GenAM calculations



Source: Datastream, GenAM

- **Due to the Chinese New Year holidays, there were only a few new macro data. Holiday travel shows private consumption to be the main supporter of China's growth. The PBoC eased monetary police to help the property sector.**
- **We expect more fiscal help to be announced at the National Peoples' Congress, but no "big bang. " We see another RRR cut by 25 bps around mid-year.**

Due to the Chinese New Year vacations, the statistical office published only a very limited data set. The two January PMI versions maintained their diverging messages. While we expect the difference to be kept in the short run, both versions agreed in some improvements in the export and production subcomponents. This looks to be in line with some "green shoots" in international trade, so that exports should turn more supportive again in 2024. Domestically, New Year holiday travel reached new highs after Covid, but per capita spending seems to have slowed. Services spending maintains its role as a primary mover of private consumption. Consumer confidence still needs to revive amid ongoing pressures from the labour market and property markets. However, after President Xi Jinping explicitly mentioned the possibility of a round of "replacement of old consumer goods with new ones", there is speculation that Beijing could eventually partly change its stance of prioritisation of production above consumption at China's National People's Congress (which begins its annual meeting on March 5). Generally, the official growth target is widely expected to be set "around 5%" which would formally warrant more fiscal support. However, we expect the official deficit rate at 3% of GDP plus another RMB 1 tr. of special CGB issuance. This is similar to last year and therefore entails no major positive fiscal impulse (although leftovers could be slightly expansionary).

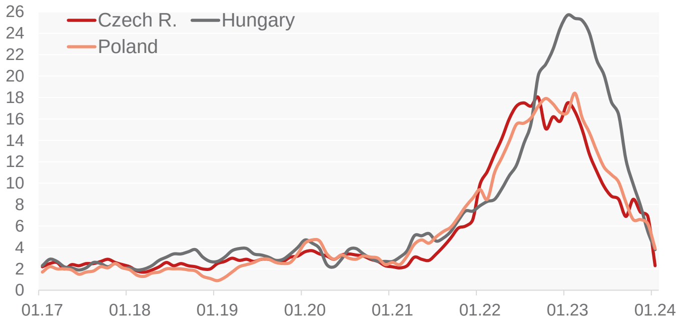
PBoC cut 5-year Loan Prime Rate

We expect the real estate sector to remain a drag on growth. However, the PBOC cut its 5-year Loan Prime Rate (LPR) by a record 25 bp to 3.95% in an effort to support the housing market. At the same time, it left the 1-year LPR unchanged at 3.45%, maintaining a targeted approach. The 5-year rate had already fallen close to 200 bps since late 2021, yet housing sales have stayed weak. Thus, the rate cut alone will not do the "trick" but in combination with efforts to strengthen developers financing (the long-awaited "whitelist") we expect the cut to help to mitigate downward pressures. The drag on growth will likely also keep CPI inflation muted, which we expect at 0.7% in 2024, after another deflationary print in January, due to food prices.

Central and Eastern Europe

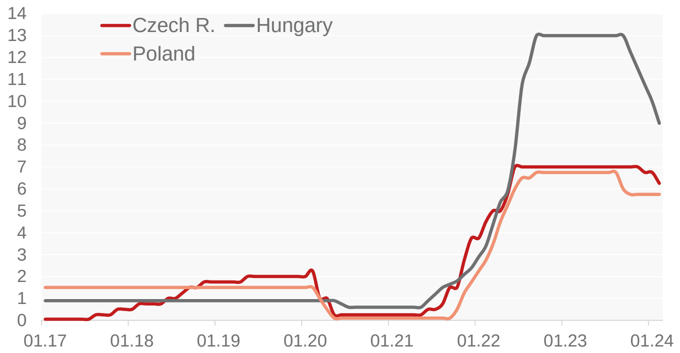
Radomír Jáč

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



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

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



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

Main Forecasts

Czech Republic	2022	2023e	2024f	2025f
GDP	2.4	-0.4	1.4	2.8
Consumer prices	15.1	10.7	2.1	2.0
Central bank's key rate	7.00	6.75	3.50	3.00
Hungary	**2022**	**2023e**	**2024f**	**2025f**
GDP	4.6	-0.8	2.9	3.4
Consumer prices	14.5	17.6	4.0	3.7
Central bank's key rate	13.00	10.75	5.00	4.50
Poland	**2022**	**2023e**	**2024f**	**2025f**
GDP	5.3	0.2	2.8	3.3
Consumer prices	14.3	11.6	4.3	3.7
Central bank's key rate	6.75	5.75	5.25	4.25

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

- **Inflation in the CE-3 countries declined substantially in January, reaching the inflation target area in the Czech Rep. and Hungary. Central banks in both countries are expected to cut interest rates further.**
- **The inflation target will be reached soon also in Poland but uncertainty over the outlook of regulated prices leads the NBP to keep its key rate on hold at 5.75%. We expect the on-hold approach to remain in place in H1, cautious rate cuts may follow in H2.**

Data for January confirmed the disinflation trend in the CE-3. The decline in the annual headline CPI seen at the start of 2024 was supported also by base effects in food and energy prices. Czech headline inflation fell from 6.9% to 2.3% yoy, i.e., to an area slightly above the inflation target set at 2% and below the CNB's forecast of CPI at 3% yoy. Similarly, headline CPI in Hungary fell from 5.5% to 3.8% yoy, to the range of the MNB's inflation target set at 3%. Polish headline CPI fell from 6.2% to 3.9% yoy and is expected to reach the 2.5% inflation target area in Q1. However, the inflation outlook for H2 remains uncertain, as the government is yet to decide to which extent it will keep the price cap for household energy and the 0% VAT rate on foods.

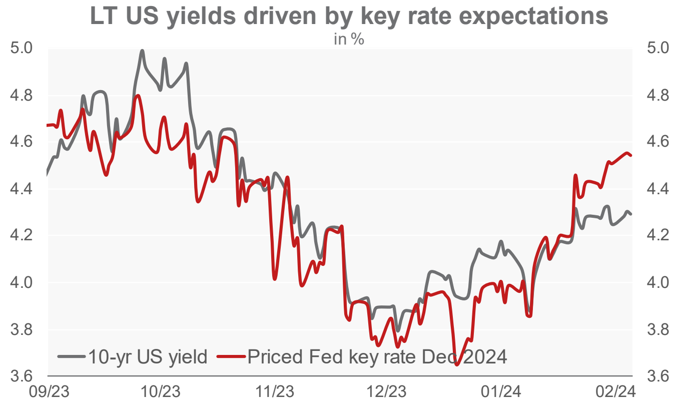
Preliminary data for Q4 revealed a slight GDP increase for Czechia and stagnation (0.0% qoq) for both Hungary and Poland. Czechia and Hungary reported a full-year GDP decline for 2023, while Polish GDP rose slightly. Recovery is expected for 2024 across the CE-3, household consumption should be the driver thanks to the increase in the real wage, and in Poland also thanks to a stronger fiscal support.

Monetary policy: Czech CNB's rate cuts accelerated

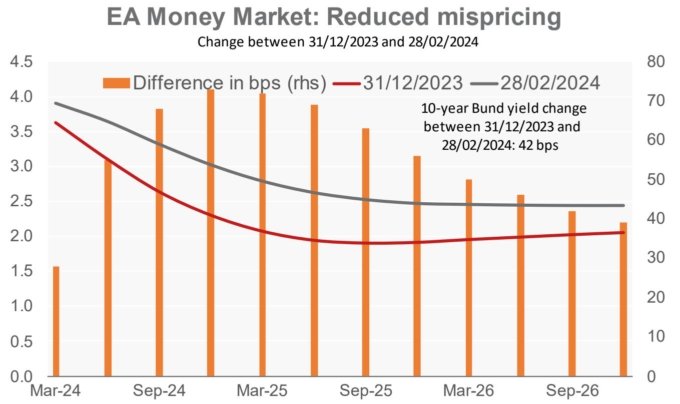
The Czech CNB cut its key interest rate by 50 bps to 6.25% in February. This came after a 25 bps cut in December. The CNB's forecast expects a significant policy easing with the key rate at 2.75 % at the end of 2024. The weaker crown FX rate is likely to lead to a slower monetary policy easing. However, a rate cut by at least 50 bps is expected in March. In Hungary, the MNB responded to a sharp fall in inflation and cut the key rate by 100 bps in February, to 9%. This was an acceleration from cuts by 75 bps seen at the previous four meetings. However, the forint weakened above 390 vs. euro and the FX rate volatility is likely to make the period of interest rate cuts by 100 bps rather short. The Polish NBP kept its key rate at 5.75% also in February. The NBP is likely to stay on hold in H1, waiting for more clarity regarding development on VAT rate for food and price caps on energy in H2. We expect gradual interest rate cuts in H2, assuming that the Polish government avoids any sharp increase in food and energy prices.

Government Bonds

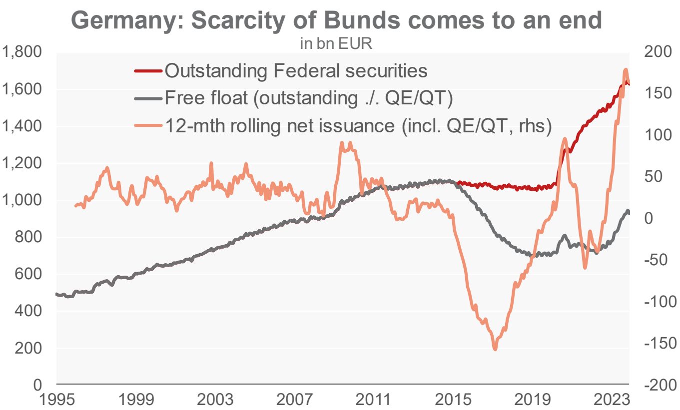
Florian Späte



Source: Bloomberg, GenAM



Source: Bloomberg, GenAM



Source: Bloomberg, German Datastream, Germany Finance Agency, GenAM calculations

- **The bear flattening of the government bond yield curves in February appears exaggerated and should at least partially correct itself in the coming weeks.**
- **Although the key rate cutting cycle will not begin before Q2, financial markets are likely already anticipating it amid falling inflation rates. Therefore, we expect that the trend will end and US and EA core yields will decrease slightly in the coming weeks.**
- **Additionally, EA non-core government bond spreads have continued to tighten. We have revised our forecast due to the favourable current market environment and no longer expect spreads to widen in the short term. In the medium term, we still see slightly higher spread levels.**

The bond market sell-off that started in January persisted into February. Due to positive economic data (e.g., EA economic surprise index on the highest level since Q2 2023 and US nonfarm payrolls) and higher-than-expected inflation rates (most notably in the US), financial markets have lowered their expectations of future key rate cuts. Currently, only 80 bps (end of January: 145 bps) are expected for the Fed and 95 bps (end of January: 160 bps) for the ECB until year-end 2024. As a result, the yield curve bear steepened in recent weeks with many tenors on both sides of the Atlantic reaching their highest levels since November.

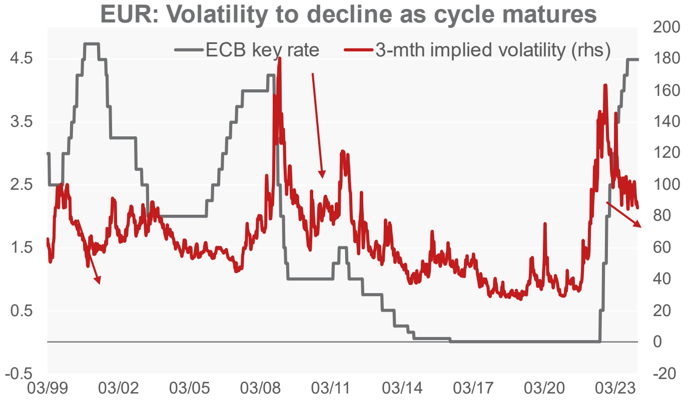
We assume that the mispricing regarding future monetary policy, which existed at the beginning of the year, has been largely eliminated. Our key rate forecasts until year-end for the Fed (-75 bps) and the ECB (-100 bps) are now almost in line with market expectations, removing the main driver for higher yields. Additionally, it has become apparent over the past few weeks that yields on long-term bonds are no longer perfectly tracking the rise in key rate expectations (see chart).

Accordingly, the macroeconomic environment is expected to once again play a crucial role in the bond markets in the upcoming weeks. Despite volatility, inflation rates are forecast to decrease, leading central banks to eventually lower key rates. Therefore, we consider the current annual yield highs as a chance to buy and recommend increasing duration. Although there is a possibility of a short-term increase in yields, the risk of a significant and lasting rise appears limited.

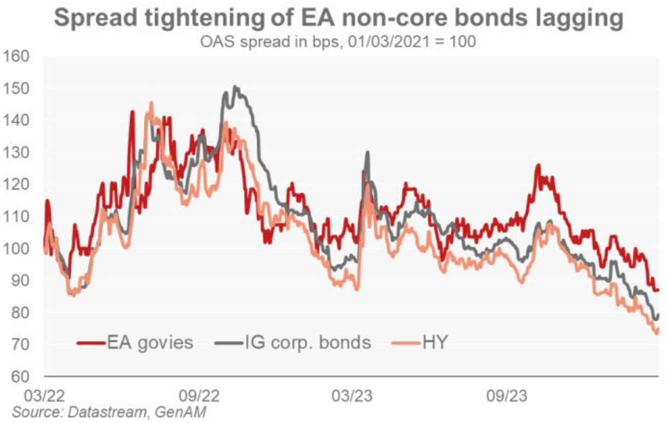
Over 3 months, we anticipate 4.15% for 10-year US yields and 2.30% for 10-year Bund yields. Looking one year ahead, yields are expected to decrease to 3.80% for Treasuries and 2.20% for Bunds.

Government Bonds

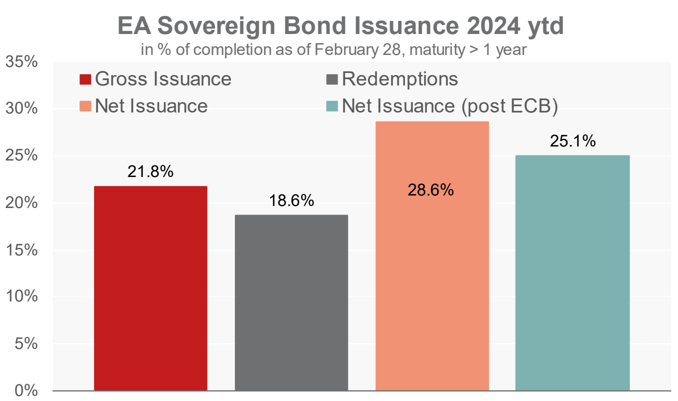
Florian Späte



Source: Bloomberg, GenAM



Source: Datastream, GenAM



Source: Datastream, Bloomberg, GenAM

The forecast drop in yields is likely due to real yields. We do not expect a sharp fall in inflation expectations due to uncertainty about future developments and the already reduced level, especially in the EA.

The sharp correction in ECB key rate expectations has contributed to a flattening of the 2-yr/10-yr Bund curve (from -25 bps to -45 bps). At this level, we now see potential for a 50 bps steepening of the curve on a 1-year horizon (to +5 bps).

Swap spreads have narrowed significantly. Nevertheless, we see further potential. The ECB's ongoing QT will further increase the volume of Bunds outstanding. In addition, the expected key rate cuts, falling bond market volatility, and the steepening of the curve described above will also lead to a narrowing of swap spreads. This will support, among others, supranationals. In a carry-friendly market environment, we still see catch-up potential, especially for long-dated EU bonds, and recommend an overweight position.

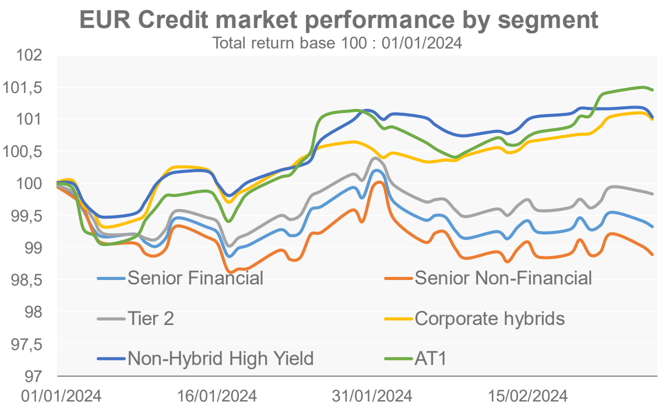
Ambitious valuation of EA non-core bonds

The risk-on mode in the financial markets has contributed to the good performance of EA non-core government bonds. The 10-year BTP/Bund spread has fallen to its lowest level in more than two years. In the short term, we see only a few triggers that could significantly increase risk aversion. Accordingly, we are upgrading our view on EA non-core bonds and expect spreads to move sideways in the coming months. This is all the more true as EA non-core bonds are somewhat lagging corporate bonds (see mid-chart). The expected decline in bond market volatility and the fact that more than a quarter of the new net issuance has already been placed on the market without any problems (and the third BTP-Valore issuance is currently looking very promising as well) also suggest that the market environment will remain stable.

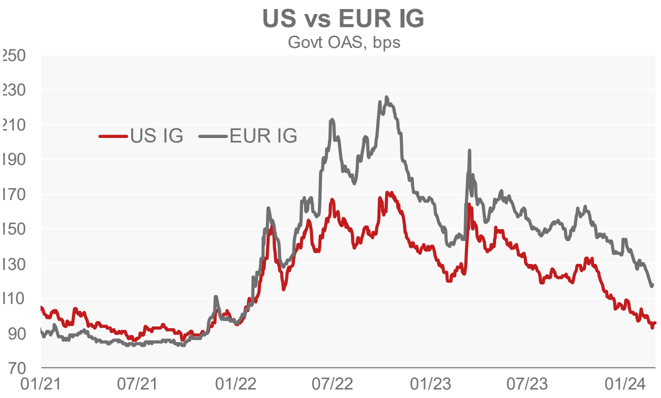
In the medium term, however, we see several challenges that are likely to weigh on the EA non-core government bond market. Growth will be slow to recover and will remain subdued over the medium term. As of H2, the ECB's QT will include the PEPP in addition to the APP and thus gain momentum. Accordingly, it may become more difficult to generate the necessary demand for new government bonds. The Recovery and Resilience Facility is a positive factor and funds are being disbursed. However, this effect will diminish in the coming years. Finally, the partially high debt-to-GDP ratios combined with the high debt-servicing expenditures will increasingly limit the fiscal room for manoeuvre. As a result, we expect spreads to widen somewhat in the second half of the year.

Credit

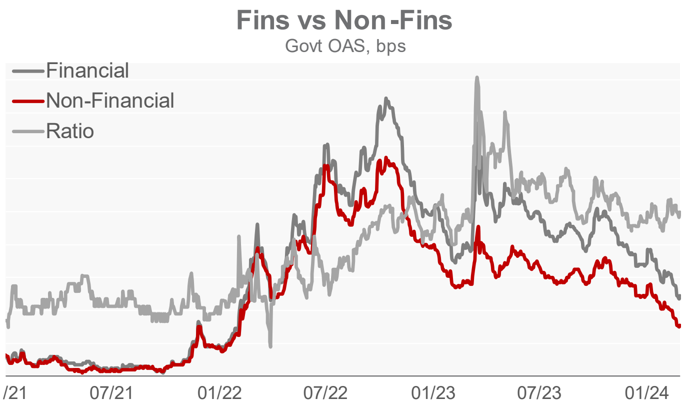
Elisa Belgacem



Source: Bloomberg, BofAML indices, GenAM own calculations



Source: Bloomberg, BofAML indices, GenAM



Source: Bloomberg, BofAML Indices, GenAM

- **Credit spreads start to look tight from many angles but carry remains attractive versus sovereign.**
- **As we upgrade our outlook for the US economy, we further reduce our mild underweight in high yield due to elevated carry and a stable default outlook.**
- **We remain long IG for the carry while we think fundamentals will prove resilient.**
- **Default rates are expected to reach 4.5% in Europe and 5-6% in the US in 2023.**
- **Even after the strong rally we see value in subordinated instruments versus pure HY.**

In January, the concerns about commercial real estate, especially in the US, resurfaced. Within European financials, a few players particularly exposed have been weaker, dragging with them the whole financial credit space for a week or two. But this didn't last. The subordinated bonds of Aareal and Deutsche Pfandbriefe bank are still pricing a very likely restructuring but this risk is now perceived as idiosyncratic by the market.

Financials feel immune to the CRE news flow for now

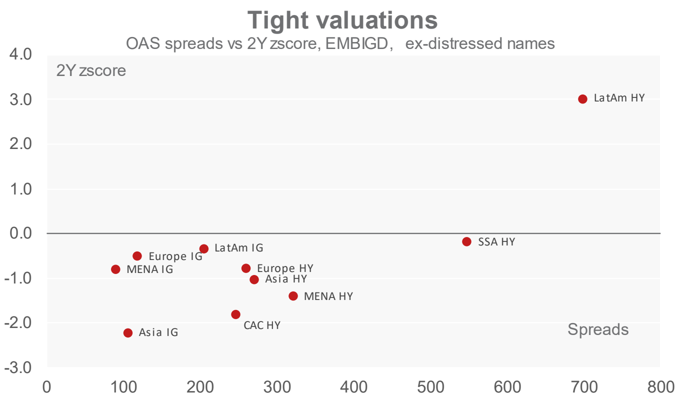
The rest of the financial space feel immune for now. Hence we don't change our neutral recommendation between financials and non-financials as we believe that on one side, financials fundamentals will face less tail risk in terms of asset quality deterioration because of lower interest rates, and financial spreads are still very generous compares to non-financials. But on the other hand financials issuances will be heavier to refinance the expiring TLTRO.

Enjoy the carry

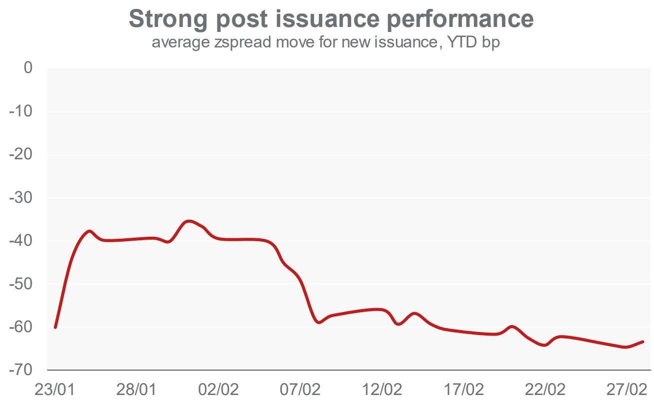
We believe IG spreads will oscillate around current levels for the months to come, ensuring elevated carry. Valuation considerations also lead to a preference for Europe over the United States. We do prefer long IG and subordination risk to pure HY. In the context of likely plateauing rates and uncertainty surrounding defaults in the HY space, a strategic move is proposed to play leveraged IG to enhance credit returns. While extending duration may not be favorable from a spread perspective, a positive rates view justifies a long position, particularly in the 5-7 year bucket.

EM sovereign bonds

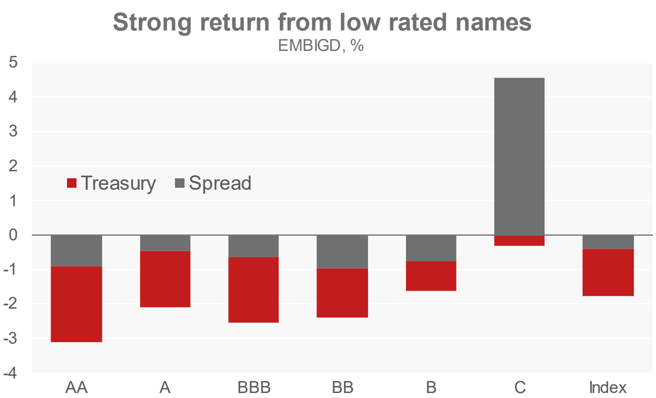
Guillaume Tresca



Source: Bloomberg, GenAM



Source: Bloomberg, GenAM



Source: JP, Bloomberg, GenAM

- **We reduce our overweight given the risk of higher US Treasury yields and the recent spread compression. The medium-term outlook remains supportive.**
- **We favour EM IG over HY, especially BBBs. In HY, we see value in single Bs. More globally, EM EURs should offer better return than EM USD bonds.**
- **Local debt has still better prospects. We favour FX hedged positions and the belly of the curve.**

We have tactically reduced our EM overweight as the risk of higher US rates has increased. As we have long argued, higher US rates are not necessarily a negative for the EM environment as they reflect strong macro data. EM fixed income is currently in a paradoxical environment where the stronger economic data and risk-on environment have led to a significant compression of EM spreads, but the rise in core rates has reduced expected returns. In the short term, the recent rebound in risk appetite (as evidenced by the strong HY supply), tight valuations and the risk of higher interest rates call for a more tactical approach with a focus on relative value trades and reduced beta exposure.

The medium-term outlook remains supportive as DM central banks are on track to ease and EM disinflation has been strong, providing room for further monetary easing.

Still favour EM IG

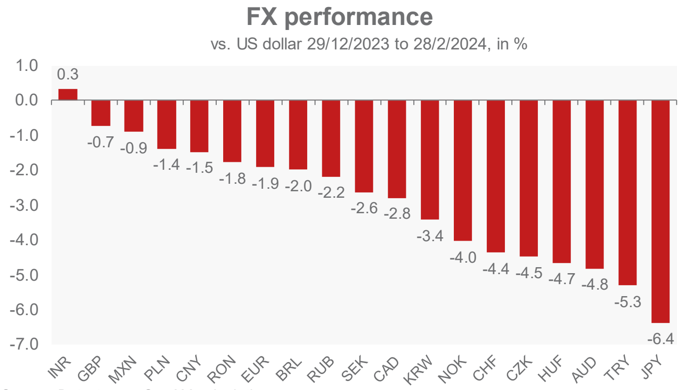
We continue to expect some widening in external debt spreads, especially after the strong spread rally ytd. This has essentially been driven by the EM HY part, where spreads are now stretched and close to three-year lows. It would take more idiosyncratic positives in distressed countries for further compression. We therefore maintain our preference for EM IG over HY, with a focus on BBBs. In IG, higher rated names do not offer enough spread buffer in case of widening. Romania remains our favourite. Qatar is now too tight and will rotate into Saudi Arabia. In HY, only the Bs still offer value and can benefit from the reopening of the primary market. Globally, we see better returns for EM EUR bonds versus EM USD bonds.

Resilience of EM local debt

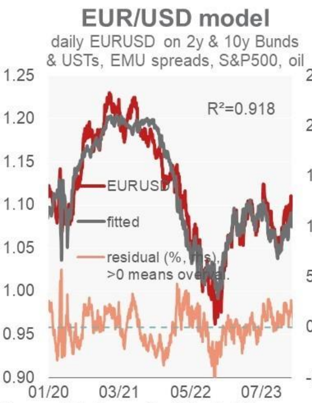
EM local debt still offers a better outlook. Despite the 40bp ytd rise in US Treasuries, the GBI EM index yield is only 3bp wider. Local return has been positive so far and it is the poor EM FX performance that has dragged on. We therefore recommend hedging the FX position, especially in low-yielding countries. EM central banks still have room to ease and can surprise (Hungary). However, the easing is well priced, and we prefer the belly of the curve in most countries, except Hungary and Mexico.

Currencies

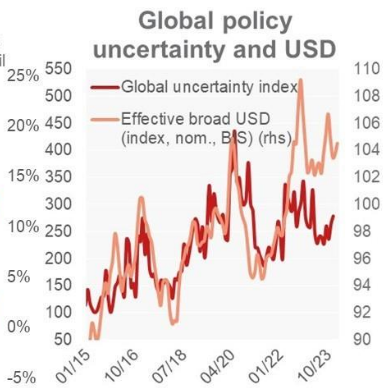
Thomas Hempell



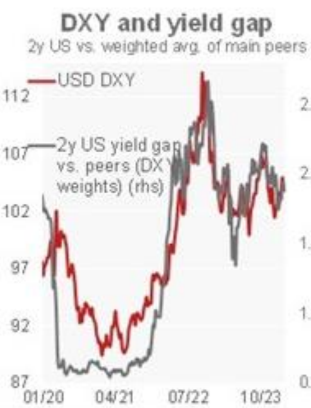
Source: Datastream, GenAM calculations



Source: Datastream, GenAM calculations



Source: www.policyuncertainty.com, Datastream, GenAM



Source: Datastream, GenAM

Source: Datastream, GenAM
terms of trade as std. from long-term mean

- **It is still premature to position for USD weakness near term. Solid US growth and slowing disinflation may delay rate cuts by the Fed while geopolitical uncertainties favour the greenback as a safe haven.**
- **Yet further into summer the USD's fortune may turn on the back of narrowing yield differentials and lower rates uncertainties. The euro area's gradual recovery will help to lift the EUR while the JPY benefits from the removal of policy accommodation by the BoJ.**

The sharp repricing of key rate expectations over February has extended this year's broad USD gains, mostly so against an ailing yen (top chart). The greenback (DXY) is now up by 2.6% against its main peers year-to-date, paying into our tactically bullish USD stance.

With our 2024 US growth forecast upgraded to 2.4% and the expected Fed pivot postponed into summer, we still deem it premature to position for short-term USD weakness. Markets have already come a long way in trimming their rate cut bets for 2024 (from >170bp to mere 80bp now), aligning them with our own base case. Yet any inflation disappointment (Jan PCE due March 1) may further spoil the goldilocks expectations and benefit the USD. Our proprietary short-term model also shows the EUR/USD somewhat on the dear side (mid-left chart). Geopolitical risks also warrant prudence as a further escalation of the conflict in the Middle East may still underpin the greenback (mid –right chart).

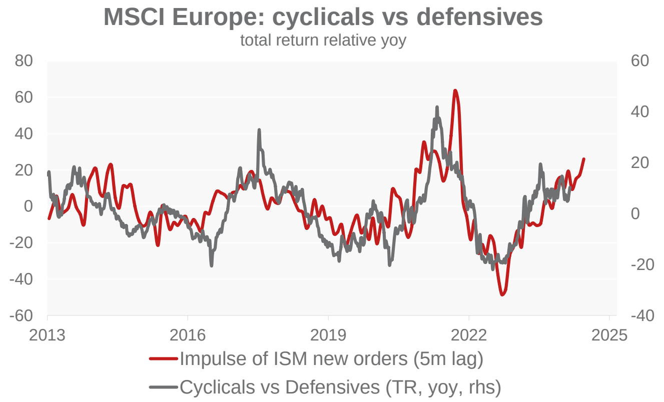
Still too early to position for USD weakness

Ultimately, we still expect central banks' inflation fight to succeed, allowing for sizeable rate cuts over H2 and 2025. With the Fed deeper in restrictive territory, the total amount of rate cuts (250bp over the next 2 years vs. 150bp for the ECB in our books) will compress the USD's yield advantage. This holds notably also for USD/JPY, as the BoJ looks set to not wait for much longer before removing its key rate from negative territory and terminate its yield curve control. That said, with the Fed now expected to move later and more gradually, we see a lesser degree of JPY strength over the next quarters than before. The EUR will also benefit from an (admittedly sluggish and stretched-out) recovery from stagnation. Fallen gas prices (now below 25€/MWh) have helped the euro area terms of trade to recover – partially reversing the big drag on the EUR in the wake of Russia's war of aggression against Ukraine.

The bottom-line is that renewed USD weakness is still on the cards – but only for later in the year as near-term geopolitical risks and inflation worries may keep the greenback bid for somewhat longer.

Equities

Michele Morganti and Vladimir Oleinikov



Source: Datastream, GenAM

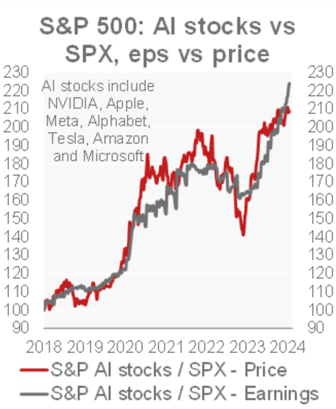
Analysis of the median stock: Q4 2023 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q4 2023
S&P	6.0 %	6.6 %	4.3 %	3.7 %	1.7 %	2.9 %	91.4%
Stoxx	6.0 %	3.9 %	3.4 %	2.0 %	2.6 %	1.9 %	49.9%
Euro Stoxx	0.4 %	3.5 %	0.9 %	0.2 %	(0.5)%	3.3 %	46.3%
Topix	7.8 %	11.9 %	4.8 %	4.2 %	3.0 %	7.6 %	95.3%

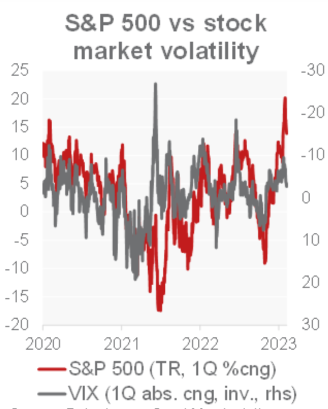
Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q4 2023
S&P	5.0 %	3.8 %	0.5 %	0.7 %	4.5 %	3.1 %	91.4%
Stoxx	2.6 %	1.0 %	(0.3)%	(0.1)%	2.8 %	1.1 %	49.9%
Euro Stoxx	3.1 %	4.2 %	(0.1)%	(0.2)%	3.2 %	4.3 %	46.3%
Topix	7.2 %	6.0 %	0.4 %	0.4 %	6.7 %	5.6 %	95.3%

Note: numbers for Q4 are calculated only for the companies which have so far reported in Q3
proxy for margin trend = earnings growth - sales growth

Source: Bloomberg, GenAM calculations



Source: Datastream, GenAM



Source: Datastream, GenAM calculations

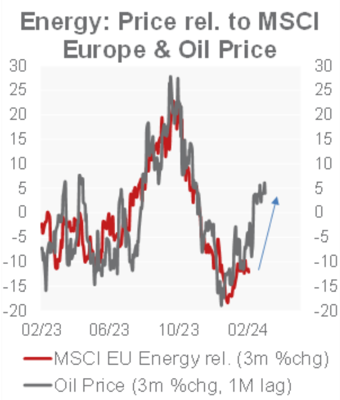
- **Markets are discounting better macro data while benefiting from good financial conditions and strong Tech earnings momentum. The reporting season shows nice surprises vs. analysts' expectations, too.**
- **In the short term, the positive trend may continue, but equities look increasingly risky. Positioning has visibly increased and a bottoming VIX is a short-term headwind for an overbought S&P500.**
- **After the recent rally, our 12-month TR targets are reduced, showing an average 5% in the EU vs 10-15% before. The US is approaching the upper band of our target range: 5,200 for the SPX. We stay slightly UW.**
- **OW: SMI, EMU vs. US, Japan, China (slight, slowly accumulating positions), Korea, and India.**
- **EU sectors: OW Banks, Durables, Energy, Food Bev. Tob., Health Care, Materials and Defense. UWs: Auto, Comm. Prof. Svs., Insurance, Media, RE, Software, Telecoms.**

The bull market is still driven by the roar of the IT sector, but it's not all about that. Outside of IT, the cyclical sectors are outperforming defensive ones due to the good momentum in leading indicators and real wages. Indeed, the uptrend in the ISM new orders suggests that cyclicals may still have some momentum left. In addition to this, financial conditions and Fed's liquidity (bank reserves) remain both supportive, with the macro surprise indices for the US, the euro area (EA) and China in positive territory. Finally, corporate balance sheets and cash flow momentum remain healthy. In this respect, future rate cuts and a more constructive macro environment in 2025 should continue to be supportive, helping to explain the increase in buyback announcements.

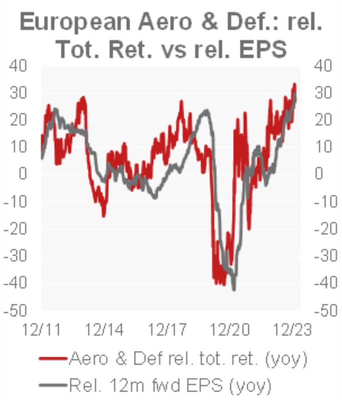
As for the US tech sector, it has attracted booming interest to such an extent that it now accounts for 36% of the S&P 500 index's total weight, a record high. This poses risks for the broader index, which remains hostage to the IT fortunes. Having said that, we must admit that earnings have been good so far, beating the market's ones: since 2018, AI earnings (7 stocks) have outperformed those of the SPX by almost 120%, a similar overperformance of the AI total return over the US market. Concerning valuation, the Tech sector has only recently become slightly more expensive than the SPX when looking at relative PE (using 12-month forward earnings) adjusted for the expected long-term earnings growth (PEG ratio = PE/growth). Volatility also remains very low and may have reached a cyclical low when one looks to the usual lagged effects of both higher Fed's rates and long-lasting inversion of the yield curve (10y-2y yield).

Equities

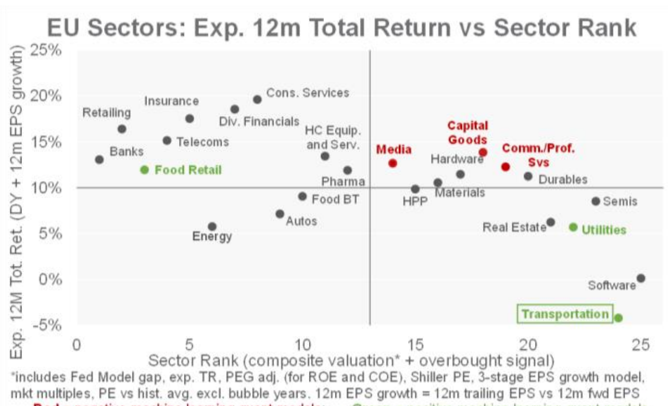
Source: Datastream, GenAM calculations



Source: Datastream, GenAM



Source: Datastream, GenAM



*includes Fed Model gap, exp. TR, PEG adj. (for ROE and COE), Shiller PE, 3-stage EPS growth model, mkt multiples, PE vs hist. avg. excl. bubble years. 12m EPS growth = 12m trailing EPS vs 12m fwd EPS
Red = negative machine learning quant models; Green = positive machine learning quant models
Source: Refinitiv, GenAM calculations as of 26/02/2024 ☐ = strong signal and better out-of-sample

That said, analysts are becoming more confident in their earnings estimates: the dispersion of their forecasts around the mean is declining fast, triggering also a lower risk premium. In this respect, the Q4 reporting season has helped to boost confidence. US EPS growth (yoy) is positive at 7.2% and the sales' one shows +4.1%. Both are better than in Q3. The earnings surprise remained unchanged (+7.5%), while the sales surprise increased (+1.3% vs +0.8% in Q3). The EA earnings have also beaten expectations (+9.1% vs +2.6% in Q3), showing flat growth (vs. -9.2% in Q3). This is confirmed also by the median stock analysis (s. table). Consensus sees US EPS growth recovering from Q4 '23 to 2025. EU one is expected to remain negative in Q1 '24 (-8.6% yoy) and then recover, too.

All good then? We think the market has already anticipated very good news and has become more vulnerable. In the very short term, the good momentum may continue, but we prefer to maintain a near-neutral stance. First, positioning (well above average now) and valuations (to be refined soon during our quarterly update) are now less attractive. After the rally of the last 3 months, the 12-month upside for the EMU index has been reduced. The one based on target PE has gone from almost +17% to 7%, but other valuation approaches show on average flat return from +7% before. For the US, we are also approaching the upper band of our target range: 5,200 for the SPX, based on the consensus earnings forecast rather than our more cautious one. The same goes for Japan. We see more upside for Switzerland. Second, the Fed's liquidity may start to decline in the coming months due to QT. We add the trend in the VIX (Q/Q no more falling), which is a headwind for an overbought SPX. Disruptive factors such as wars and political uncertainty (recently on the rise) are additional risk sources.

EM are neutral: OW China, India and Korea

EMs look cheap based on valuation. That said, we remain cautious due to both falling macro surprises and weaker EPS revisions. We OW Korea, China and India. China discounts a lot of negative news and M2 impulse is becoming more supportive thus offsetting some risks we see in the short term as economic policy has few changes to become too aggressive.

European sector allocation

We adjust our allocation to have more tilt on cyclical laggards and undervalued sectors (neutral cyclical/defensive). We bring utilities to neutral and software to a larger UW. We cut the UW in diversified financials (to N), bringing material and the defense sector to slight OW. OWs: Banks, Durables, Energy, Food Bev. Tob., HC, Defense and Materials. UWs: Auto, Comm. Prof. Svs., Insurance, Media, RE, Software , Telecom.

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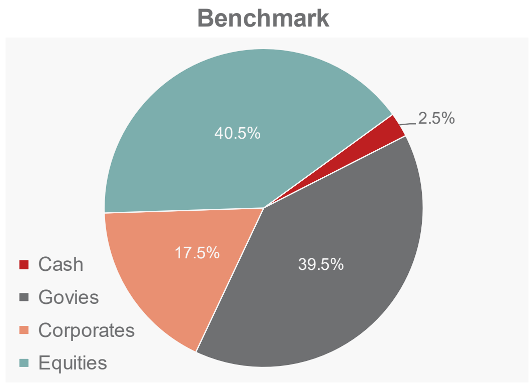
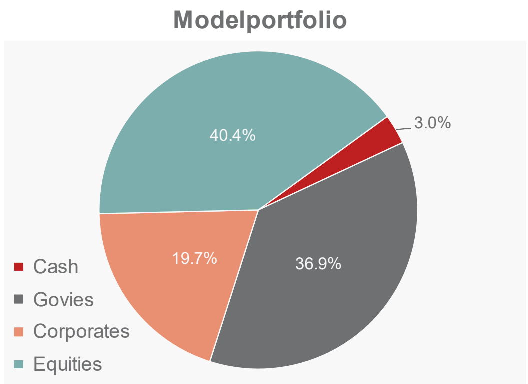
Asset Allocation

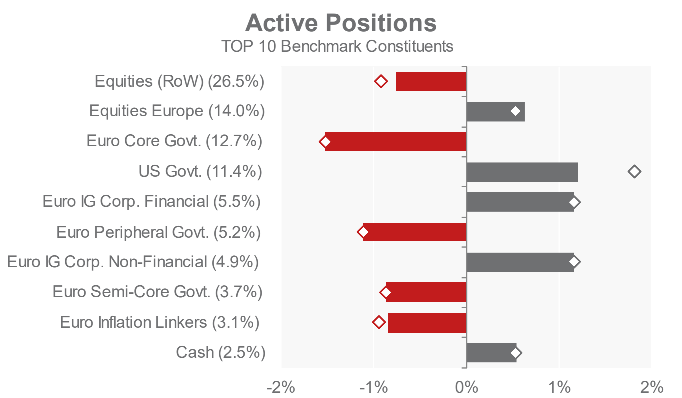
Thorsten Runde



Source: GenAM



Source: GenAM



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

- **February 2024 (28.02.24) was again a month in favour of risk assets. Equity markets represent the top five of the performance ranking, ranging from +5.6% for MSCI EMs to +1.7% for MSCI Europe ex EMU. EA HY is following on rank six with +0.5%.**
- **The bottom end of the ranking is held by medium- to long-dated Core Govies in the US and the EA with US Treasuries Y10+ being the worst performer (-3.5%) followed by Y10+ EA Core Govies (-2.7%).**
- **Overall, EA HY Credit again clearly outperformed EA IG (+137 bps). Within IG, Financials were again slightly superior to non-Financials (+22 bps).**
- **We still see downside potential for core yields on normalizing inflation and central banks starting to cut rates. Evidence of a soft landing in the US may render some support to equities. That said, a further repricing in rate expectations would harm risk assets as well as Bonds.**
- **Weighing up these offsetting trends we further cut our underweight positions in Equities and EA HY. Furthermore, we keep our tactical overweight in Cash and reduce the one in US Treasuries on repricing risks. We stick to our neutral duration stance.**

In February 2024 (28.02.24) our model portfolio just slightly underperformed its benchmark by -1.7 bps. All in, the UW positions in EA FI paid off the most throughout (+9.7 bps). By contrast, overweighting US Treasuries (-4.7 bps) and EA IG Credit (-4.4 bps) as well as underweighting US and EA Equities (-5.0 bps) proved particularly painful.

We see opposing risks for our tactical positioning. On the one hand, we still deem core yields geared to the downside on normalizing inflation as well as rate cuts by central banks. Furthermore, risk assets should be backed by a soft landing in the US which becomes increasingly evident. On the other hand, a repricing of the Fed rate expectations would hurt Bonds as well as Equities.

Still too early for a straight OW in risk assets

Weighing up these risks, we trim our small UW positions in Equities and EA HY towards neutrality by further reallocating from US Treasuries. We maintain the OW in Cash built up last month as a protection against the repricing risks. For the same reason we not yet extend our duration but stick to our fairly neutral stance here. With these recommendation being already effective since mid-February particularly the move from US Treasuries to risk assets worked in the right direction.

Forecasts

Macro Data

Growth 1)	2023	2024 forecast	2024 Δ vs. cons.	2025 forecast	2025 Δ vs. cons.	2026 forecast
US	2.5	2.4	1.0	1.7	0.0	1.9
Euro area	0.5	0.6	0.1	1.4	0.1	1.2
Germany	- 0.1	0.1	- 0.2	1.7	0.5	1.9
France	0.9	0.8	0.1	1.6	0.3	1.7
Italy	0.7	0.6	0.1	0.5	- 0.5	1.1
Non-EMU	0.2	0.5	0.1	1.5	0.2	2.0
UK	0.1	0.3	0.1	1.3	0.3	2.1
Switzerland	0.8	1.2	0.0	1.6	0.0	1.8
Japan	1.9	0.7	- 0.1	0.9	- 0.1	0.5
Asia ex Japan	5.0	4.6	- 0.2	4.8	0.2	4.5
China	5.2	4.5	- 0.1	4.5	0.2	4.1
CEE	2.5	2.2	0.1	2.8	0.5	2.8
Latin America	2.2	1.4	0.0	2.1	0.0	2.2
World	**2.9**	**2.7**	**0.1**	**3.0**	**0.2**	**2.9**

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

Inflation 1)	2023	2024 forecast	2024 Δ vs. cons.	2025 forecast	2025 Δ vs. cons.	2026 forecast
US	4.1	2.6	- 0.0	2.2	- 0.1	2.1
Euro area	5.5	2.4	0.2	2.2	0.2	2.0
Germany	6.0	2.5	- 0.0	2.3	0.2	2.0
France	5.7	2.5	0.0	2.2	0.3	2.0
Italy	5.2	2.1	0.1	2.1	0.3	2.0
Non-EMU	6.5	2.4	- 0.1	1.9	- 0.1	2.0
UK	7.4	2.4	- 0.2	2.1	- 0.1	2.0
Switzerland	2.2	1.6	0.0	1.2	0.0	1.5
Japan	3.3	1.9	- 0.3	1.6	0.1	1.4
Asia ex Japan	2.1	2.1	- 0.2	2.4	0.0	2.5
China	0.2	0.7	- 0.5	1.5	- 0.2	2.0
CEE	20.4	17.3	- 0.4	8.3	- 8.6	6.6
Latin America 2)	5.1	4.0	0.0	3.1	0.0	3.0
World	**5.3**	**3.8**	**- 0.1**	**2.9**	**- 0.7**	**2.7**

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

Financial Markets

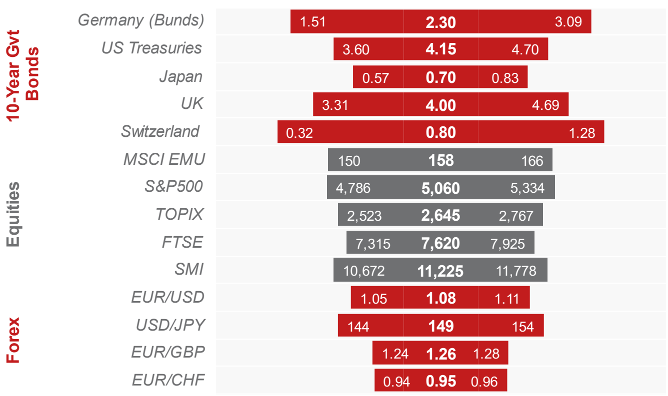
Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US (upper bound)	5.50	5.25	5.23	5.00	4.87	4.50	4.17
Euro area	4.00	3.75	3.74	3.25	3.43	2.75	2.60
Japan	-0.10	0.00	0.08	0.00	0.15	0.00	0.30
UK	5.25	5.25	5.14	5.00	4.91	4.50	4.21
Switzerland	1.75	1.50	1.50	1.25	1.29	1.00	0.98
10-Year Gvt Bonds							
US Treasuries	4.27	4.15	4.26	3.90	4.24	3.80	4.25
Germany (Bunds)	2.42	2.30	2.39	2.10	2.36	2.20	2.35
Italy	3.86	3.75	3.89	3.60	3.92	3.80	3.99
Spread vs Bunds	145	145	150	150	155	160	164
France	2.89	2.80	2.90	2.60	2.89	2.75	2.91
Spread vs Bunds	47	50	51	50	52	55	56
Japan	0.70	0.70	0.76	0.65	0.81	0.65	0.90
UK	4.13	4.00	4.13	3.75	4.11	3.65	4.14
Switzerland	0.85	0.80	0.80	0.75	0.79	0.80	0.77

*3-day avg. as of 27/02/24
**ICE BofA (OAS)

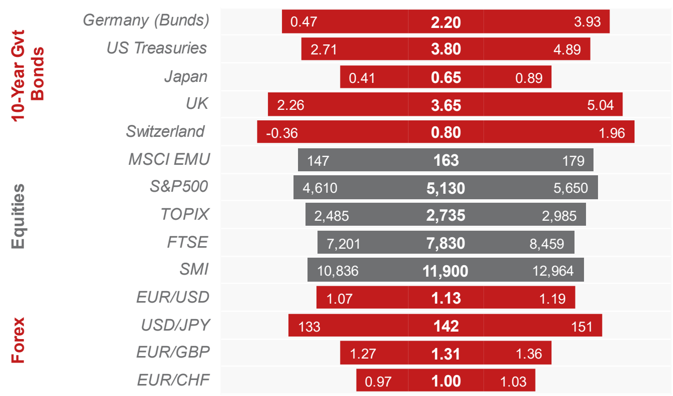
Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	111	115		120		115	
EA IG Financial	128	135		140		135	
EA HY	340	400		425		400	
EM Sov. (in USD)	277	300		310		290	
Forex							
EUR/USD	1.08	1.08	1.09	1.11	1.09	1.13	1.10
USD/JPY	151	149	148	146	146	142	143
EUR/JPY	163	161	162	162	160	160	157
GBP/USD	1.27	1.26	1.27	1.29	1.27	1.31	1.27
EUR/GBP	0.85	0.86	0.86	0.86	0.86	0.86	0.87
EUR/CHF	0.95	0.95	0.95	0.96	0.94	1.00	0.93
Equities							
S&P500	5,079	5,060		5,065		5,130	
MSCI EMU	161.1	158.0		157.5		163.0	
TOPIX	2,671	2,645		2,655		2,735	
FTSE	7,691	7,620		7,570		7,830	
SMI	11,463	11,225		11,265		11,900	

Forecast Intervals

3-Months Horizon*



12-Months Horizon*



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

Imprint

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