



GENERALI
INVESTMENTS

Market Perspectives

Enjoy summer while it lasts

August 2020



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This document was completed on July 31, 2020

Global View – Enjoy summer while it lasts

Thomas Hempell / Vincent Chaigneau

- **The policy-led rally has flattened out but we expect risk sentiment to be resilient over summer. Investor positioning, the economic bounce, dollar weakness and ongoing policy support still dominate for now.**
- **But clouds will be mounting this autumn. Already the US recovery is floundering, and hopes of a V-shape will die after summer. Covid will prove more threatening, and political risk will be rising.**
- **Our allocation recommendation retains a risk-on bias for now, but a cautious one, focused on IG Credit. The equity OW is minimal and defensive. We stay bearish USD and warn against duration shorts.**

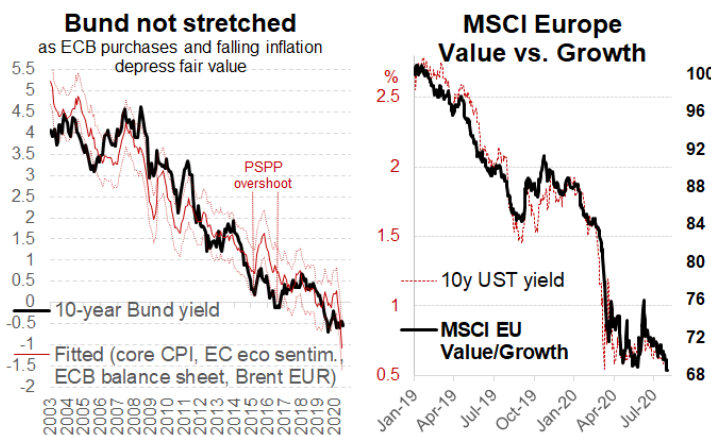
As lockdowns have been lifted and global activity rebounded from the Q2 nadir, hopes of a strong recovery have helped risk assets advance further over July, benefitting [our pro-risk tilt in the portfolios](#). With global equities (MSCI World) now almost flat on the year again despite the historically deep recession, there are mounting concerns that markets have become complacent.

open diplomatic conflict, with little signs of relief ahead of the US presidential elections in November.

Hiding in havens still premature

Yet despite the mounting concerns about the sustainability of risk sentiment, hiding in safe havens still looks premature. Local lockdowns may need to be reinstated, but not in the same scale as in spring, as more tools for containing the virus are at hand and medical capacities have been expanded. Support from both fiscal and monetary policy remains extremely strong. We assume US Congress will deliver a new bout of stimulus before the summer recess (8 August). The Fed may turn even more dovish if it opts to some form of average inflation targeting as it concludes the review of its monetary policy strategy (September?). In the meantime the Jackson Hole (virtual) gathering will lay down very dovish ideas about the future of monetary policy. The (hard fought) European compromise on € 750 bn Recovery Fund (incl. €390bn earmarked as grants) is a particularly welcome signal by EU leaders to mutual assistance. Also, the big retreat in the USD by almost 5% since mid May is reassuring especially for indebted firms and sovereigns in the emerging world. Valuations and investor positioning in most risky assets are now less compelling, but still not exuberant.

As we continue to surf the risk-on wave, we are preparing to scale back positions into what we think may be a difficult autumn. By then the virus might be more threatening. The idea of a V-shape recovery will die. Political risk will also be mounting (US election in November, conclusion of Brexit deal talks in October).



Indeed, the sharp rise of new infections in the US and Brazil underscores the sticky threat from Covid-19. Even in Europe and Asia, where public policies have been more effective, resurgent cases may give a flavour of the risk to the Northern hemisphere once people start to meet more frequently in closed rooms this autumn.

As we lay out in a recent [White Paper](#), the economic, behavioural and market impact of the Covid crisis will prove very protracted. A V-shaped recovery will remain a summer illusion. After an initial rebound, the recovery will lose momentum, with the persistent Covid uncertainties and elevated unemployment weighing on investment and consumption. Already in the US, the recovery in the labour market has stalled, with initial jobless claims rising for the first time again since March on Covid resurgence. US policy uncertainties are not helping either, with Congress still at loggerheads over extending or replacing a US\$ 600 boost to weekly unemployment benefits per person. Meanwhile, US/China trade frictions have morphed into an

Bonds	29/07/20*	3M	6M	12M
10-Year Treasuries	0.59	0.70	0.75	0.85
10-Year Bunds	-0.50	-0.40	-0.35	-0.30
Corporate Bonds				
BofaML Non-Financial	126	120	115	110
BofaML Financial	124	120	115	110
Forex				
EUR/USD	1.18	1.19	1.20	1.22
USD/JPY	105	105	104	103
Equities				
S&P500	3239	3255	3270	3310
MSCI EMU	116.4	117.5	118.5	119.0

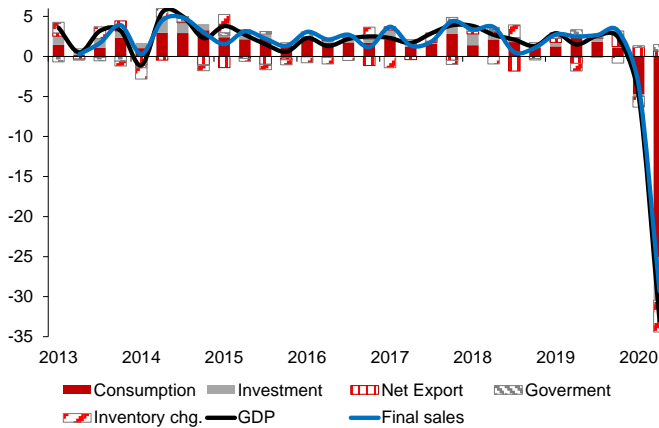
* avg. of last three trading days

Overall we stick to a prudent pro-risk tilt in the portfolios mostly via an overweight in EUR IG Credit with a tilt towards longer maturities while underweighting Cash and short-dated Govies. We keep the equity OW minimal. The USD is headed for further weakness, even though at a much more contained speed than seen over recent weeks.

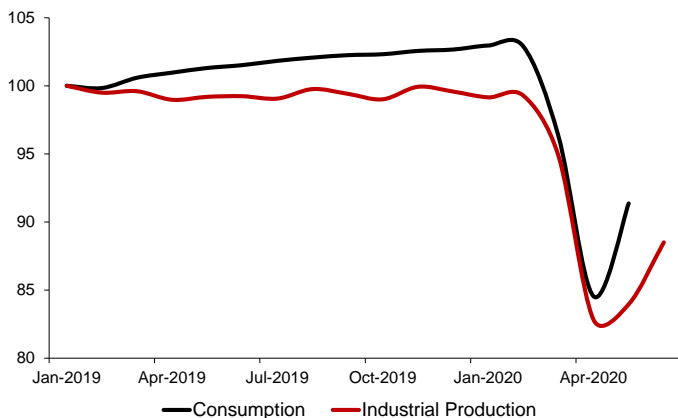
USA

Paolo Zanghieri

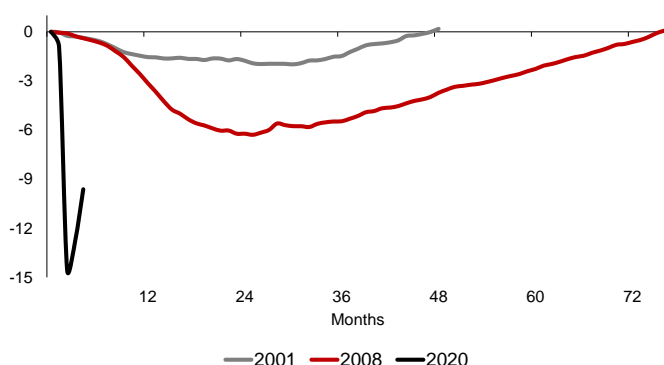
GDP and contributions
q-o-q annualized, seasonally adjusted



Consumption and Industrial activity
Jan. 2019 = 100



US: Job losses in recessions
% of pre recession employment



- In Q2, GDP fell by 32.9% qoq annualized. We expect the H2 recovery to be much slower, with the resurgence in COVID cases putting a strong downside risk to our -7.5% growth forecast for 2020.
- Activity was rebounding quite quickly, but high frequency indicators point to a weakening following the surge in contagion. The unemployment rate fell to 11.1% in June, but permanent layoffs are rising.
- The Fed strengthened its commitment to restore full employment. Yield curve control is actively discussed in order to strengthen QE.

The US economy is recovering. Activity should have bottomed at the beginning of May according to high frequency indicators on mobility and credit card activity. They show that consumption is levelling off already before the likely return to localized lockdowns. Key hard data indicators picked up in May and June, with industrial production and consumption back to around 90% of the pre-crisis level. The labour market reacted fast to the reopening in activity, after peaking at 14.7% in April, the unemployment rate declined to 11.1% in June, thanks to the strong recovery in the reopening sectors like travel and leisure.

Bounce-back in activity tested by virus resurgence

Going forward, the recovery looks increasingly at risk. Job market weaknesses may emerge as the bulk of layoffs are filed as temporary while the permanent ones are on the rise indicating the beginning of structural employment changes. The pandemic worsened again. The already high uncertainty on the speed of the recovery, has been compounded by the large surge in cases. In July on average 63.6k new daily cases were reported, after 28.6k in June. There are also risks related to the large measures the Congress put in place to protect workers' income and firms solvency. They are expiring at the end of July but at the time of writing, an agreement on an extension or new measures has not yet been reached.

Annualized GDP contracted by -32.9% in Q2, slightly less horrible than feared. Given the outlined risks, we stick to our 2020 growth forecast of -7.5% with downside risks prevailing.

The Fed takes stock of its measures

At its July meeting the Fed directly tied the economic recovery to the resolution of the health crisis whose direction remains much in doubt. At the same time Fed policymakers repeated a pledge to use their "full range of tools" to support the economy and keep interest rates near zero for as long as it takes to recover from the epidemic. Fed officials have already started discussing yield curve control as the next policy step as it would strengthen the effect of QE. Depending on the evolution of the pandemic in the US and on the further course of the fiscal policy measures we see the Fed standing ready to adjust its policy stance by September when also the final conclusions of its strategy review will be presented.

Euro Area

Martin Wolburg

- At the outset of Q3 key sentiment indicators rose back into expansionary territory.
- The EU Council agreement on the Recovery Fund amid a dovish ECB wait-and-see stance also supports our base case of a starting recovery.
- That said, rising Covid-19 infections increase the risk that renewed lockdown measures will choke-off the upswing.

The economic news flow on the euro area turned more and more positive over the last weeks. Following the gradual unwinding of lockdown measures in May, economic sentiment has started to improve. Most impressively, the composite PMI recovered from its April low of just 13.6 points to 54.8 points by July. Thereby it signals expansion for the first time since February. Hard data followed improved sentiment. In May, industrial production (+12.4% mom, from -18.2% mom), industry orders (+3.5% mom, from -23.5% mom) and real sales (+17.8% mom, from -12.1% mom) all started to recover.

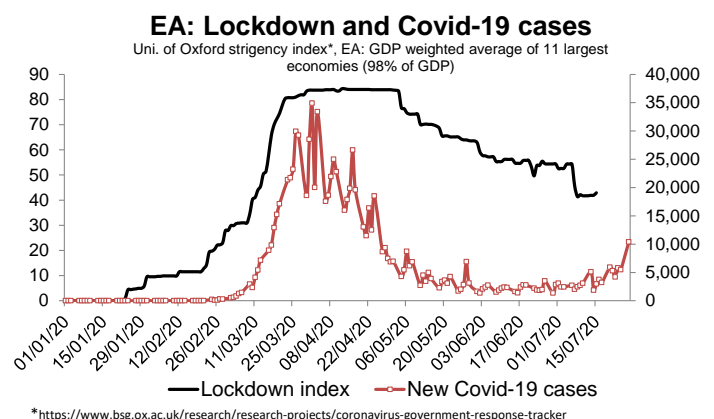
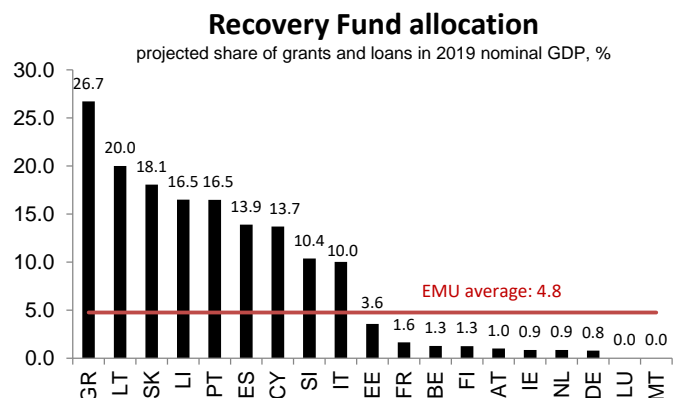
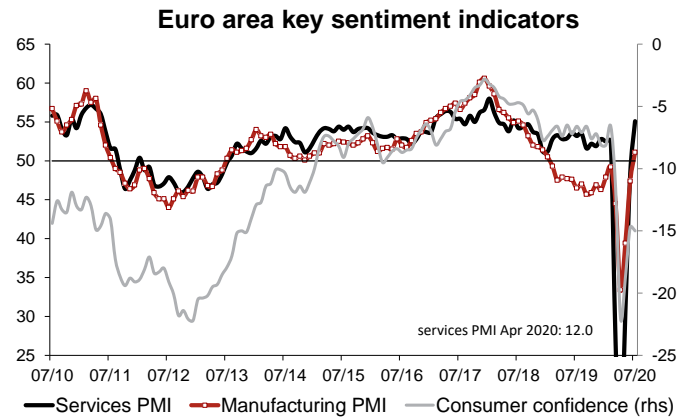
Tailwinds from the ECB and the Recovery Fund ...

Looking ahead, the post-lockdown recovery will get tailwinds from a supportive policy mix. The swift and bold ECB policy measures, e.g. the PEPP and LTROs, helped to loosen the monetary policy stance. At its July meeting the Governing Council confirmed its dovish wait-and-see stance. On top of that – and unlike to previous situations – a joint fiscal policy stimulus by means of the Recovery Fund will complement these efforts. The projected allocation of loans and grants is heavily tilted towards the especially pandemic hit and highly indebted Southern European economies. This will put the forthcoming recovery on a broader base.

... but risk of a second wave rose as of late

That said, we still see no reason to become overly optimistic on activity. The closing of the wide output gap (EC: -7.3% in 2020) is hampered by still needed restrictions until a vaccine can be rolled out while the pandemic is still strong in key exports markets, e.g. the US but also EMs. Increased uncertainty will dampen investment spending and support precautionary saving. Moreover, in most member states government support measures (e.g. on short-term working, insolvencies etc.) are temporary and will peter out if not extended, potentially triggering increasing NPLs and an additional push in unemployment. While all these factors hint towards a more cumbersome recovery the elephant in the room is the risk of a second Covid-19 wave which could choke-off the recovery given that new infections rose as of late.

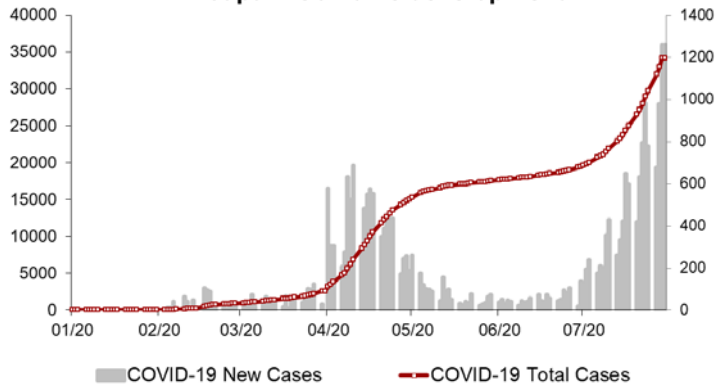
All in all, in spite of encouraging July data and a less than feared horrible Q2 (of “only”-12.1% qoq) we prefer to keep our 2020 growth forecast of -10.0% for the time being.



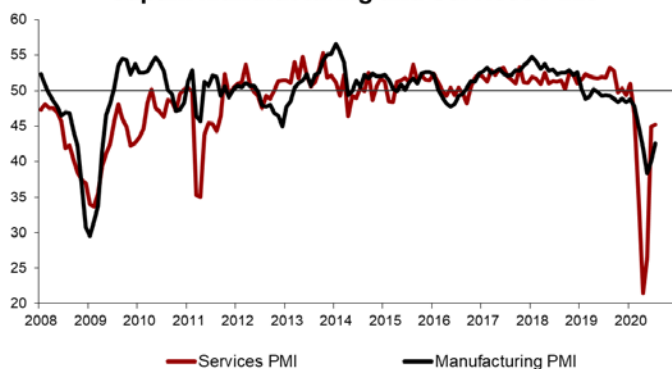
Japan

Christoph Siepmann

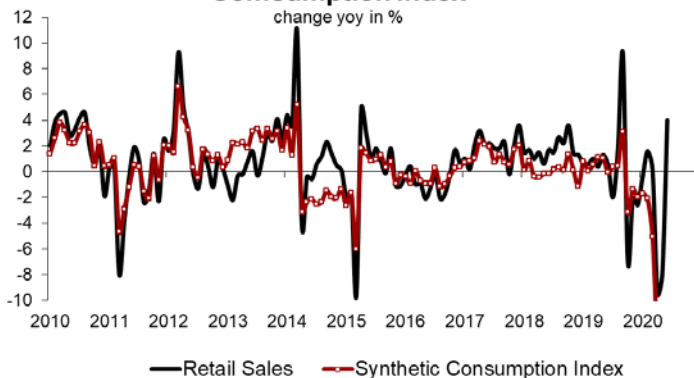
Japan: Covid-19 development



Japan: Manufacturing and Services PMIs



Japan: Retail Sales and Synthetic Consumption Index



- **Japan's GDP is set to plunge substantially in Q2. While June data in part rebounded, the acceleration of Covid-19 cases puts the view of a smooth recovery into question again.**
- **In case the situation deteriorates strongly, fiscal and monetary policy are ready to help. However, we do not see the BoJ to change its target rates.**

In the second half of July, Japan has seen (by its standards) a strong rise in fresh Covid-19 cases. Some regions have stepped up restrictions already, but overall they remained limited to reduce group contacts.

After lifting the lockdown end of May, June gave some insights on how the recovery might unfold. Industrial production (IP) started to rise by 2.7% mom. Nevertheless, Q2 IP diminished by 16.7% qoq. Bias-corrected outlook figures imply only a moderate improvement in IP. The July manufacturing PMI rose by only 2.5 points to 42.6, with order components staying deeply in contractionary territory. This suggests that any recovery still has to gain momentum on the supply side. On the demand side, retail sales decreased only by 1.2% yoy in June, improving sharply from a 12.5% yoy fall in May. This was much better than expected. However, with the fresh Covid-19 outbreak, there are hints that consumers are getting cautious again. Real exports increased by only 1.2% mom resulting in a 18.4% qoq drop in Q2. Overall, we expect Q2 GDP growth to have collapsed in the range of 25% - 30% qoq ann (due on Aug. 17).

Rather shallow recovery expected

Looking ahead, the fresh Covid-19 outbreak has added new uncertainties. Like elsewhere, there is a risk of a second wave in which the capacity of firms to buffer some impact of the corona crisis could be overstretched. Accordingly, the so far overall tight labour market would ease much more strongly and hit income of households much more severely. Under the assumption that the recent out-break can be limited and brought under control, we nevertheless see households to caution their behaviour again. The strong pent-up retail demand seen in June will likely become much flatter. Consumer confidence regarding income growth has fallen below the already softer level of the October 2019 sales tax hike. Capex is expected to stay subdued. Investments typically have a strong correlation to exports with a lag of two quarters. Given the globally accelerating spread of Covid-19, we expect international demand to remain volatile. On the positive side, the fiscal packages will play an increasingly important supportive role. We expect the BoJ to keep its yield curve rate targets unchanged. But both monetary and fiscal policy might roll out more emergency measures if the need arises. We expect Japan's Q3 recovery to remain somewhat shallow (not V-shaped) and GDP to drop by close to 6% this year.

China

Christoph Siepmann

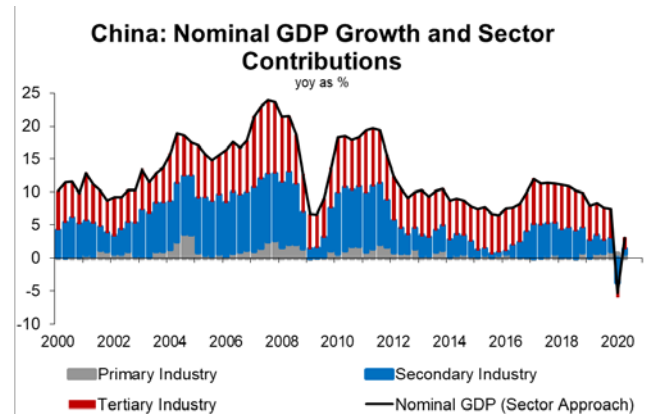
- China's Q2 GDP growth surprised on the upside. Nevertheless, the economy continues to be restrained from the demand side.
- In H2, the government will likely push investment demand via infrastructure outlays while consumption is expected to remain more subdued.
- The PBoC refrained from more easing so far. However, we consider it much too early for monetary policy to turn around already.

China's GDP rose by 3.2% yoy in Q2, after a Covid-19 related drop by 6.8% yoy in Q1. On a quarterly basis, official estimates show a Q2 GDP rise by 11.5% qoq following a 10% qoq contraction in Q1, a rather V-shaped recovery. However, year-to-date growth was still negative with -1.6%. Moreover, the upturn is still very uneven as June real activity data reveal. Industrial production (IP) advanced by 4.8%, the third positive reading in a row. Moreover, the latest reading is only about 1 pp below the 2019 IP growth average. Manufacturing PMIs suggest this strength to continue. Support for this upturn has been coming from the export side, which held up comparably well throughout the crisis (despite the strong drop in PMI new export orders), mainly due to heavy international demand for medical related goods. Moreover, imports turned positive for the first time this year, showing the recovery to have broadened. Looking ahead, PMI new export orders improved but stayed in slightly contractionary territory. Deliveries will remain sensitive to fresh Covid-19 outbreaks around the world (currently especially in the US). We expect some volatility to remain, going forward.

Fiscal support to prop up demand in H2

Domestically, investment demand improved to 5.4% yoy in June, but still receded by 3.1% yoy on a cumulative basis. Government infrastructure investment has been already supportive and we expect the (soft) NPC fiscal policy announcements to be increasingly felt in H2. The recent torrent flooding in parts of China may even lead to more projects. In any way, they add a new source of growth worries to markets. The housing sector is expected to also stay robust. However, private capex stayed subdued. Uncertainties in the domestic as well as global outlook, compounded by the US-China political tensions (in technology, finance, HK security law, US elections ahead) will keep firm's investments cautious. Industrial profits recovered in June, but year-to-date they are down by 12.8%. Finally, retail sales growth disappointed in June and we expect final consumption to be the laggard in the upturn.

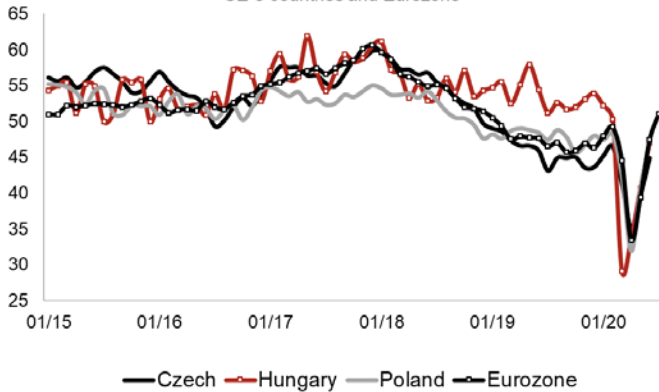
All in, we revise our 2020 growth outlook up to 1.8%, from 1.3% before. China's monetary policy easing has paused since May while money supply remained ample. Despite this reluctance, we see policy support still as needed and continue to expect a 50 bps RRR cut in 2020 and a reduction of the Loan Prime Rate by 20 bps via MLF cuts in H2 2020.



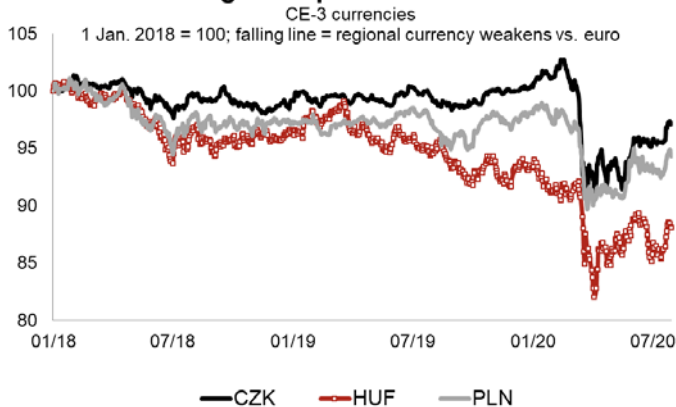
Central and Eastern Europe

Radomír Jáč

Manufacturing PMI
CE-3 countries and Eurozone



Exchange rate performance vs. EUR
CE-3 currencies



- Both surveys and official data support the view that the worst decline in economic activity is over and GDP will recover in Q3 on a quarterly basis.
- Regional central banks are expected to keep policy on hold after a series of easing measures delivered since March: monetary conditions are relaxed and deflation risks are not in a sight.
- Regional currencies benefit from external factors incl. approval of the European NGEU fund.

The newsflow from the CE-3 region provides a similar picture as in the rest of Europe. Economic activity recovers gradually from a collapse in early spring, caused by a Covid-related lockdown. However, Q2 is expected to report a sharp fall of GDP. An increase in quarter-to-quarter terms should follow in Q3 but economies will operate below their potential in the coming quarters and are expected to reach pre-Covid levels only in 2022.

We expect inflation to moderate in such a setting but CPI exceeded forecasts in Q2 and there does not seem to be a risk of deflation in the region. This means that the CE-3 central banks are not in a situation which would call for further bold measures in terms of monetary easing.

Improving news from the economy and the view that central banks will not rush to ease their policies further create a positive environment for the CE-3 currencies. Their recent firming against the euro was also related to the EU agreement on a EUR 750bn Covid recovery fund (the Next Generation EU fund). The CEE region will benefit from the fund significantly and, on top of that, the agreement on the NGEU fund is also seen as a key step in terms of further EU integration with positive impact on market sentiment including the CE-3 FX markets.

Central banks in a waiting mode after policy easing

The Czech CNB kept its key rate unchanged at 0.25% at a monetary policy meeting in late June and is likely to stay on hold also at the upcoming meeting on August 6. While the Czech crown is more than 3% stronger vs. euro so far in Q3 compared to the CNB forecast presented in May, inflation is visibly above expectation and market interest rates are a bit lower than anticipated by the central bank.

In Hungary, the MNB cut its key rate by 15 bps to 0.75% in late June and then again in July, to 0.60%. However, other interest rates were left unchanged and the central bank indicated that the level at 0.60% represents a floor, as it does not want to see market interest rates close to zero. The MNB restored its QE programme in late July, purchasing government bonds with maturity over 15 years with an apparent desire to flatten the yield curve a bit.

The Polish central bank kept its key rate on hold at 0.10% since the last cut delivered in May. Further interest rate reduction is unlikely and the NBP fine-tunes monetary conditions via bond purchases (QE programme).

Main Forecasts	2018	2019	2020f	2021f
Czech Republic				
GDP	2.8	2.4	-7.5	4.5
Consumer prices	2.1	2.8	3.2	2.1
Central bank's key rate	1.75	2.00	0.25	0.25
Hungary				
GDP	5.1	4.9	-6.0	4.5
Consumer prices	2.8	3.4	3.2	3.0
Central bank's key rate	0.90	0.90	0.60	0.60
Poland				
GDP	5.2	4.1	-4.2	4.6
Consumer prices	1.6	2.3	3.0	2.5
Central bank's key rate	1.50	1.50	0.10	0.10

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

Bonds/Fixed Income Strategy

Florian Späte / Vincent Chaigneau

- **Government bond yields trended sideways in July. But 10-year Treasury yields are now threatening to break through the March lows.**
- **Going forward, the economic rebound is likely to be lacklustre and inflation will remain low level in the foreseeable future. Financial repression will also contribute to keeping bond yields low, notwithstanding a further recovery in long-term inflation expectations.**
- **Euro area non-core spreads continued their downward trend amid the agreement on a EU Recovery Fund. While the search for yield is seen to keep non-core bonds well bid, the low spread level limits the potential for spread tightening.**

The low volatility environment continued in July. International core yields moved in a tight range. The short end of the curves is anchored by the very accommodative monetary policy stance. Although macroeconomic data surprised on balance on the upside and the compromise on a EU Recovery Fund could have triggered an upward trend on long-dated yields, concerns about rising Covid-19 infection rates, signs already of fatigue in the US recovery and dovish Fed signals all contributed to keeping yields low. 10-year Treasury yields are approaching 0.50%, back to the March low.

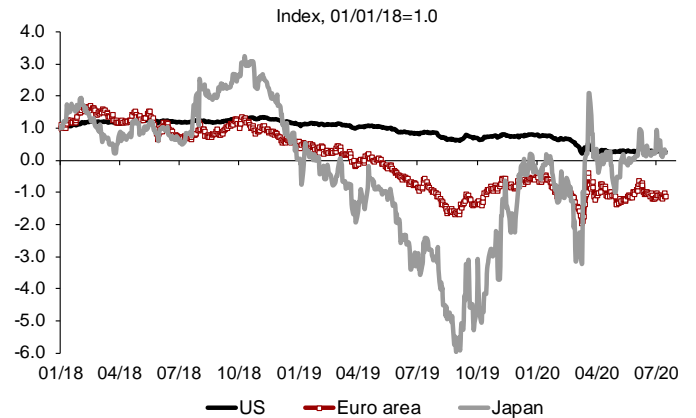
Overall, since the end of June 10-year euro area core yields fell by 10 bps to -0.55% and their US counterparts fell by 15 bps. It is noteworthy that these movements happened despite a further recovery in inflation expectations. Since the sharp drop in March 10-year inflation swaps have increased by more than 50 bps in the euro area and by nearly 100 bps in the US. This implies that 10-year real yields in the euro area have fallen by 70 bps and in the US by even 160 bps since the peak marked in March.

Further leeway for real yields to fall

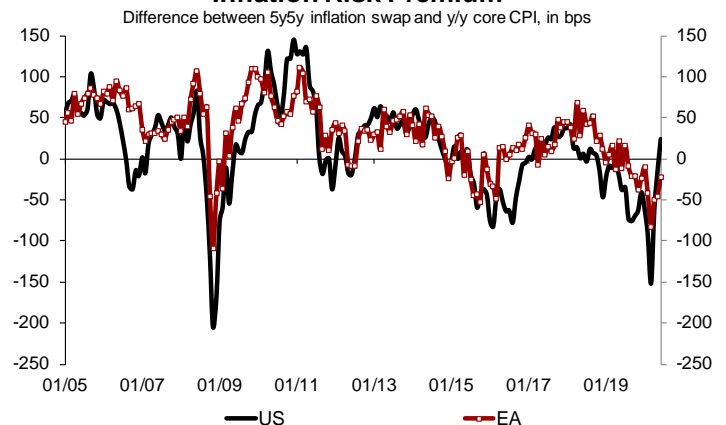
In the weeks to come, there is little scope for yields to move sustainably in either direction. The summer is beginning and liquidity is likely to be low. After being very active in spring there is little news to be expected from central banks (watch Jackson Hole though). The July meetings of the ECB and the Fed barely impacted financial markets. While they continue to emphasize their readiness to act and the state-dependency of the future policy path they are seen to remain on the side lines for the time being.

US yields are at the lower end of the trading range. With negative US key rates being priced for 2021, we see limited leeway for lower yields. Risky assets, underpinned by massive policy support, have already priced a quicker return to more normal circumstances in recent weeks. There is some (minor) catch-up potential if new Covid-19 cases in the US start to pullback.

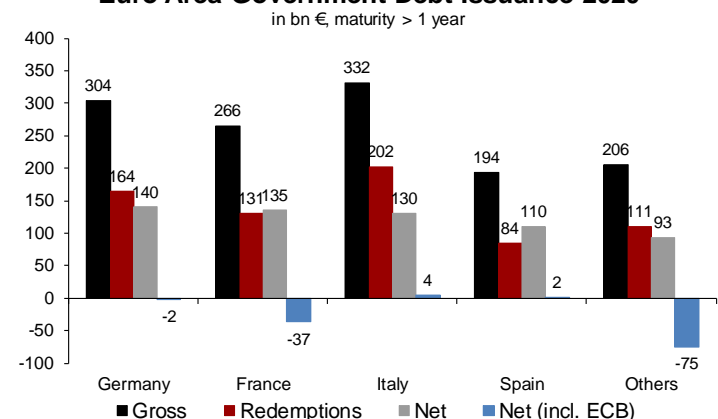
10-Year Bond Yields Since 2018



Inflation Risk Premium

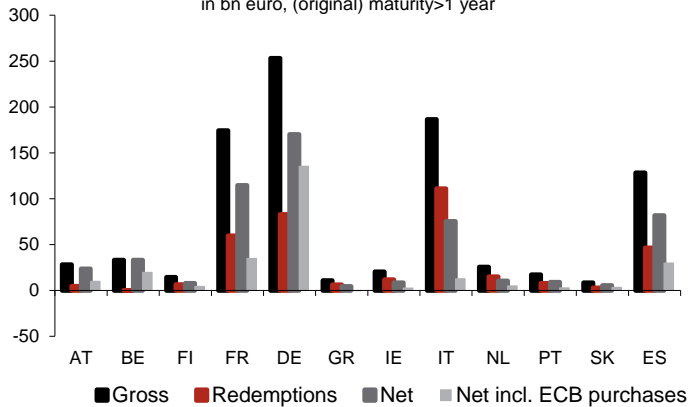


Euro Area Government Debt Issuance 2020

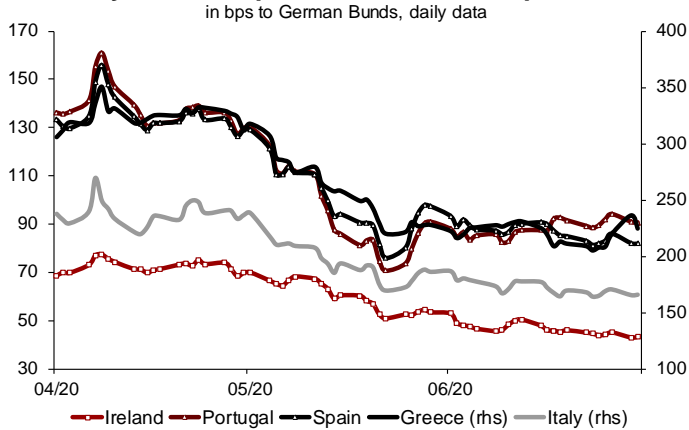


Bonds/Fixed Income Strategy

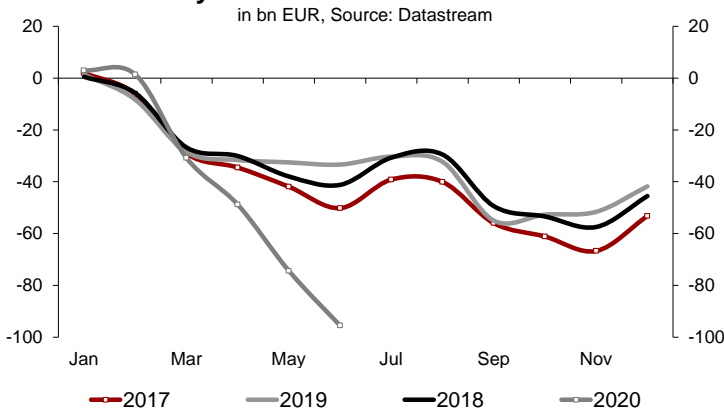
Sovereign Bond Issuance 2020 ytd
in bn euro, (original) maturity > 1 year



10-year Sov. Spread Euro Area Peripherals
in bps to German Bunds, daily data



Italy: Cash Balance State Sector
in bn EUR, Source: Datastream



A remarkable development in recent weeks has been the full decoupling between real yields (falling) and inflation breakevens (rising). The focus of central banks to prop up inflation expectations will ultimately trigger a further upside move – though potential over the coming year will be capped by subdued headline inflation. Long-dated inflation expectations are still low from a fundamental point of view (10-year euro area inflation swaps still below 1%).

Our forecasts show a modest pick-up 10-year euro area and US yields on a 3-month horizon. However, the risks are skewed to the downside; clouds will be mounting in the autumn, and any return of a risk-off environment may create downward pressure on yields again.

EU Recovery Fund to trigger even tighter spreads

Sentiment for euro area non-core bonds remained benign in July. Especially, Italian BTPs performed well. However, bond markets of less indebted countries yielded a positive return across all maturities, too. While the ECB did not decide on new policy measures, ECB President Lagarde stressed that the central bank would fully implement the Pandemic Emergency Purchase Program (PEPP). Although weekly purchases slowed the central bank appears to be committed to react to any market volatility. Deviations from ECB capital keys remain a key feature of the program. This flexibility is an important backstop for bond markets and depending on future developments a PEPP extension cannot be excluded.

The most noteworthy event in July was the compromise on the EU Recovery Fund. Although the initial proposal was watered down amid the strong resistance by the 'frugal four' (and other countries) it is a strong signal for risk sharing on an euro area level. The lower share of grants (relative to loans) and the applied conditionality is a concession to the less indebted countries. The political signal was decisive as it demonstrates the ability and the willingness of the EU to find solutions in a difficult environment. Although funds will be disbursed only from 2021 onwards, the compromise contributed to the friendly market environment and is expected to do so in the weeks to come.

Summing up, the de facto spread control policy by the ECB in combination with the compromise on the EU Recovery Fund will fight market fragmentation and keep spreads at bay. In addition, the ample liquidity provided by the ECB supports carry trades. Therefore, the tendency towards lower euro area government bond spreads is expected to continue. However, the achieved low spread levels limit the extent of the spread tightening. Finally, the uncertainty over the economic rebound (amid a potential second wave) and the low liquidity can trigger bouts of volatility in the weeks to come.

Corporate Bonds

Elisa Belgacem

- Credit spreads have continued their recovery in June, renewing with the lows established in May.
- The reporting season is forcing the primary market to take a break after a very intense H1. Better than expected results are helping.
- The volume of issuance is set for a record year.
- As we expect the economic picture to start losing its lustre in autumn, we continue to recommend an OW in IG. We are neutral on HY as defaults will continue to rise, hence we prefer BBs.

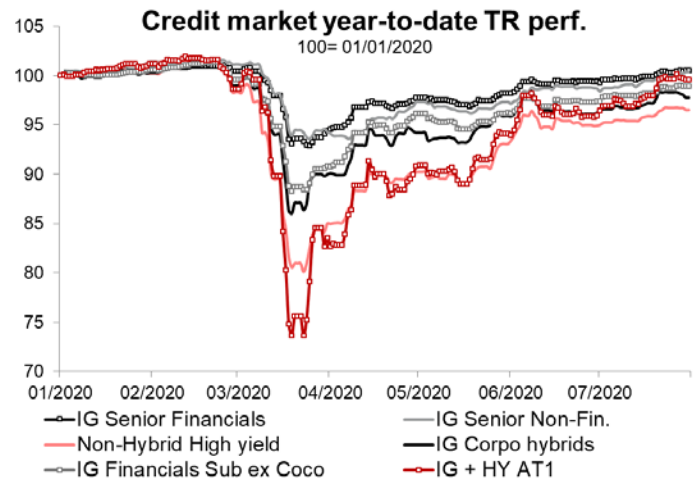
Credit markets are currently focused on the reporting season for two reasons. First, it forces the primary market to take a break, hence improving the market technicals. Second, because Q1 results did provide little visibility on the impact of the Covid-19 crisis on companies' earnings. So far the results are slightly better than expectations that were quite low, but companies are still giving little perspectives on their year-end guidance. Hence the rating agencies could initiate a second wave of downgrades after the reporting season will end, which will weigh negatively.

Nonetheless, the credit market technicals remain highly favourable and the ECB could easily increase the amount of corporate bond purchase up to EUR 20-30bn per month should volatility resurface. In such a case, it could also decide to include fallen angels to its program. Indeed, at its July meeting, the ECB indicated that the current good shape of credit markets didn't call for immediate further action. We think that, should the ECB purchase fallen angels, it would likely seek a fiscal guarantee coming from the recovery fund. This could potentially open the way for full HY market purchases like the FED is doing that could be warranted should Italy be downgraded to junk, implying mechanical corporate bonds downgrades.

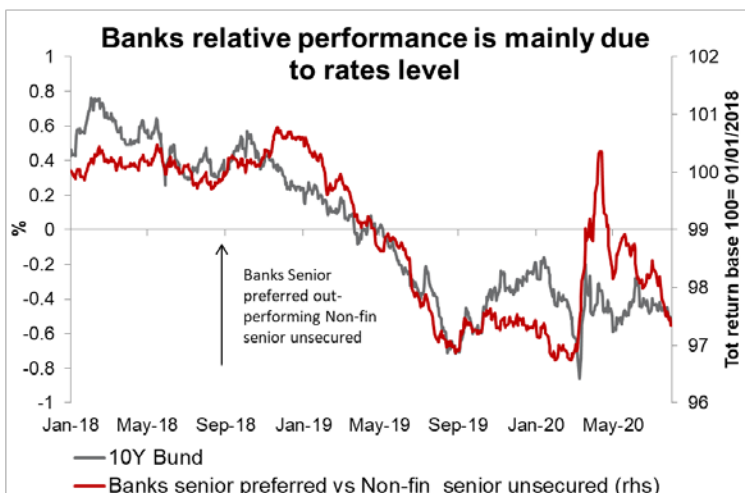
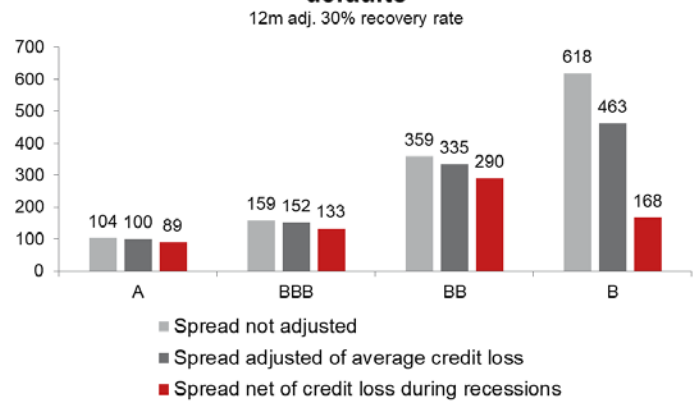
Seniors are back to positive YTD total returns

Going forward, we think that there is still room for further valuation divergence between IG and HY. Indeed, rising default rates will continue to weigh on HY into 2021 despite record public support. It will weigh more on the lower end of the rating spectrum, hence within HY, we retain a preference for BBs.

On IG on the opposite, we expect near-zero default rates, while the pick-up versus govies is high. Yes, there will be migration risks, but we think it is well reflected in the price. Hence we recommend an OW position neutral financials versus non-financials. We continue to prefer capital structure risk to credit risk, hence prefer corporate hybrids and AT1 to a lesser extent.

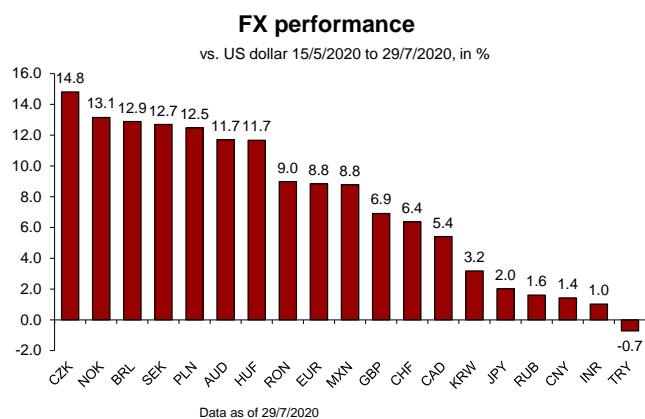


Default adjusted spreads for recession defaults



Currencies

Thomas Hempell



- USD weakness is likely to extend further, even after an almost 5% slide since mid May.
- The eroded US yield advantage, the US mishandling of the Corona crisis and a huge fiscal deficit will continue to weigh on the USD.
- The euro will be among the winners. The strong political signal from the EU Recovery fund and strong ECB action will help to contain doubts about EMU stability amid the crisis.

USD weakness has gained momentum. By July 29, the USD DXY has been down almost 7% vs. mid May and even 9% compared to the March 19 peak. European currencies have been benefitting particularly (top chart).

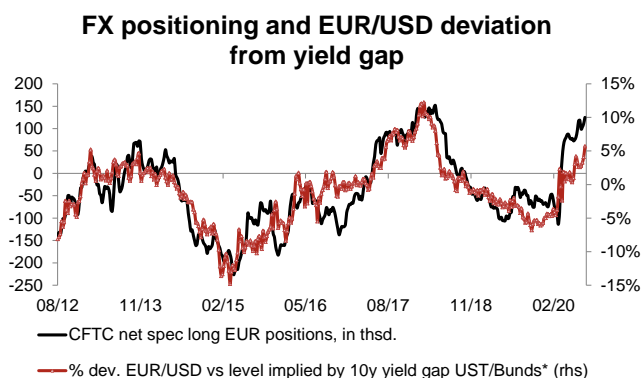
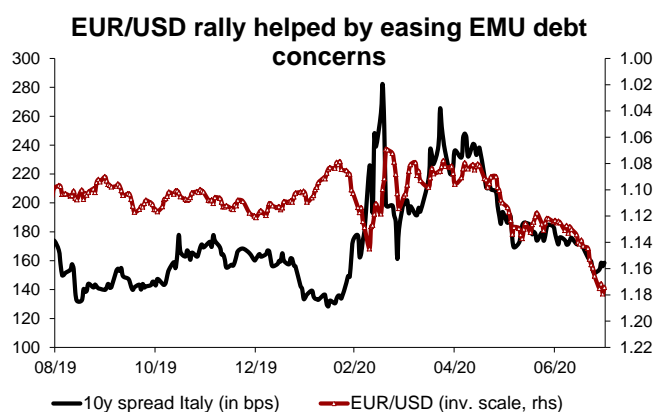
These losses notwithstanding, we anticipate further USD weakness over the next months. With the US turning into one epicentre of Covid-19, the USD is no longer benefitting from safe haven flows related to the pandemic. Furthermore, with the US yield advantage eroded by the Fed's 150 bps cuts this year, the USD is much more vulnerable to the sharp increase. We also expect international reserve managers to keep diversifying out of the USD, with the dollar's key currency status increasingly employed as a geopolitical tool by the US administration. Finally, concerns about a democratic sweep victory in the November elections will also continue to weigh on the greenback.

EUR/USD to benefit further

The euro is likely to benefit further. After already hitting our 12-month target in July, we revise our EUR/USD forecasts up (from 1.17 to 1.22 on a year's view). The tilt towards peripheral bonds in the ECB's asset purchases via the pandemic emergency program (PEPP) is now complemented by governments' commitment to the new € 750 bn Recovery Fund that foresees substantial fiscal transfers. This has helped to soothe concerns about EMU stability, adding to the support to the EUR (see mid chart). Admittedly, the EUR/USD bounce looks strong compared to still sticky transatlantic yield differentials. That said, it remains well within the scope of leading investors' positioning that still points to some further upside to the EUR/USD (bottom chart).

Key risks to the outlook arise mainly from the further evolution of the Covid crisis. The USD remains a highly anti-cyclical currency. In case a broad second wave of the pandemic requires renewed severe lockdowns globally, the USD could be sought in a risk-off episode.

We remain constructive on EUR/GBP amid a stronger Covid fallout in the UK and persistent concerns about a hard UK exit from the Single Market exit by year-end. That said, on the latter there is still leeway for compromise, which is why we look for a recovery of sterling going into 2021.



* based on 3y rolling regression coefficient EUR/USD vs. 10y yield

Equities

Michele Morganti

- Notwithstanding high market multiples, global equities performed well in July.
- Short term, we maintain a slight OW on equities as economic and earnings momentum add to still bold monetary and fiscal policy. Positions are also low and tactical indicators only in neutral territory.
- Starting from the autumn the risk profile could worsen again: lower economic momentum, possible Covid second waves and geopolitical risks.
- We are neutral EMU vs US and maintain a tilt towards EMs (OW). After the Recovery Fund approval, EMU could start outperforming the US on a mid-term horizon.

In July, equities continued to perform well as G10 and euro area (EA) macro surprises reached the US in the expansionary territory and the reporting season showed positive surprises. Previous bold policy action (monetary and fiscal one) and the agreement on the Recovery Fund played positively, too. Since July 20th markets retraced (but the MSCI World is still up 45% since the bottom in March). One negative catalyst was the increase in new Covid cases globally (albeit Europe looks less worrying and the US is recently stabilizing). Furthermore, US-China frictions escalated, hurting market sentiment.

Good reporting season limits negative revisions ahead

So far, almost 30% of companies have reported earnings. The median sector surprises have been positive (+10% in the US, Europe and Japan). Q2 numbers will be devastating (yoy growth) but should represent the bottom in this cycle crisis: -45% yoy for the US and -60% for EMU. Previous bottom for the MSCI EMU was at -40% yoy in the GFC. Annual earnings growth will likely turn positive again in Q1 2021. We cannot exclude further downside revisions to consensus but in our base scenario they should be limited: Q2 numbers are already gloomy while macro indicators have improved (see the chart in the middle).

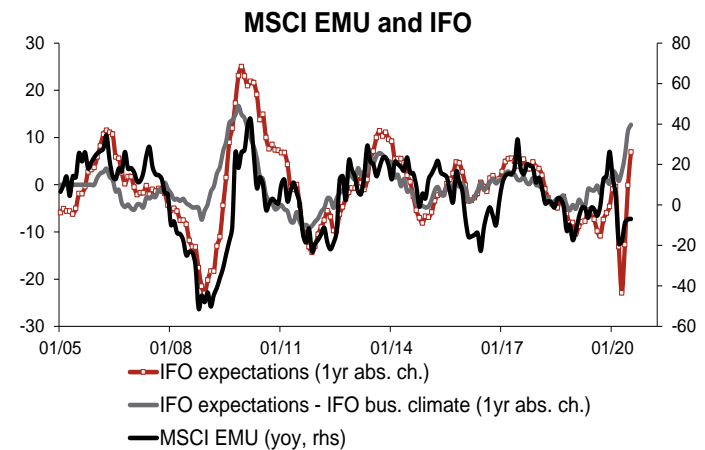
Resuming activity will trigger a rebound in Q3 macro data, sustaining earnings revisions. But sluggish demand, high unemployment, low capacity utilization, poor corporate investments and the risk of a second Covid-19 wave will keep the recovery subdued. Indeed, starting from the autumn the earnings momentum could lose some traction. The Google mobility indices have recovered but the acceleration is already losing speed. Having said this, fundamentally we can still afford a limited further negative revision from here (-3% to -4%) without having to reduce our 12-month total return targets (currently near 5%).

Valuation high but not a reason to worry, yet

The massive policy response, both fiscal and monetary, is supporting a rather spectacular expansion of equity multiples (+38% and 22% vs history for the US and the EA respectively; see table next page).

Total Return from 1/1/2020 to 27/7/2020 - in Local Currency

Equity Indices	Start	End	%TR
MSCI WORLD	9979	9913	-0,7
S&P 500	6554	6643	1,4
NASDAQ COMPOSITE	10539	12440	18,0
MSCI EMU	365	329	-10,0
MSCI EUROPE	9574	8510	-11,1
EUROSTOXX 50	1547	1396	-9,8
FTSE 100	6981	5754	-17,6
SMI	22448	22434	-0,1
TOPIX	2626	2439	-7,1
MSCI EM	2571	2518	-2,1
MSCI CHINA	163	182	11,5
MSCI INDIA	897	821	-8,5
MSCI KOREA	806	782	-2,9



Analysis of the median stock: Q2 2020 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q1 2020	Q2 2020	Q1 2020	Q2 2020	Q2 2020
S&P	0.00 %	(14.39)%	2.51 %	(5.13)%	27.2%
Stoxx	(1.24)%	(8.63)%	1.55 %	(4.55)%	32.4%
Euro Stoxx	0.17 %	(13.73)%	(1.52)%	(13.08)%	22.4%
Topix	(1.62)%	(2.63)%	0.32 %	(7.42)%	14.3%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q1 2020	Q2 2020	Q1 2020	Q2 2020	Q2 2020
S&P	3.37 %	11.33 %	0.93 %	2.24 %	27.2%
Stoxx	2.75 %	8.37 %	1.18 %	1.14 %	32.4%
Euro Stoxx	5.45 %	5.38 %	0.86 %	0.60 %	22.1%
Topix	4.04 %	4.11 %	(1.24)%	0.75 %	14.3%

Equities

Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg. Discount, %	PEG adj. *
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.		
WORLD	21.0	16.0	2.4	2.0	12.9	8.9	2.2	2.7	29.6	
USA	22.4	15.4	3.4	2.4	15.0	10.1	1.8	2.2	37.6	2.1
JAPAN	17.2	15.3	1.1	1.2	8.1	7.1	2.4	2.0	-1.7	1.9
UK	15.3	13.8	1.4	1.8	8.4	7.9	4.1	4.1	-0.6	4.4
SWITZERLAND	18.0	15.4	2.7	2.3	12.2	11.2	3.2	3.3	12.0	2.9
EMU	18.3	14.1	1.5	1.5	9.0	6.6	3.0	3.8	21.9	3.1
FRANCE	17.8	14.3	1.4	1.5	9.2	7.1	3.2	3.7	15.9	4.4
GERMANY	17.4	15.0	1.4	1.5	8.8	6.8	2.9	3.4	14.9	3.1
GREECE	12.7	12.8	2.3	1.6	6.1	6.1	6.2	4.1	-3.2	1.2
ITALY	16.1	15.0	1.2	1.2	5.9	4.7	4.4	4.7	9.8	2.8
PORTUGAL	19.9	12.9	2.1	1.8	5.9	5.9	4.7	4.5	17.3	3.4
SPAIN	14.7	12.9	1.0	1.5	4.8	5.1	4.2	5.1	-2.9	2.8
EURO STOXX 50	16.8	13.3	1.5	1.5	8.7	6.3	3.3	4.2	21.3	3.2
STOXX SMALL	21.8	14.7	1.4	1.7	9.9	8.4	2.8	3.2	15.9	7.0
EM, \$	15.0	14.4	1.6	1.6	8.8	7.5	2.5	3.1	10.0	1.9
BRAZIL	17.2	9.3	2.0	1.7	8.5	13.1	3.1	4.3	23.9	2.8
RUSSIA	8.2	6.9	0.7	0.9	5.2	4.4	7.3	4.2	-15.8	3.8
INDIA	23.3	14.7	2.7	2.6	13.5	11.5	1.6	1.6	20.0	2.2
CHINA	14.6	12.9	1.8	1.7	10.0	7.6	1.8	2.9	21.4	1.6

Note: The first four markets are based on the main local indices, the rest on the corresponding MSCI indices.
 *Multiples are based on 12m forward estimates; PEs are since 1987, the rest since 2003. PEG is PE divided by expected EPS long-term growth.
 PEG adj. (higher = expensive): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it.
 COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs).
 Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
 Source: Thomson Reuters Datastream, IBES estimates.

This momentum can continue for a while like H2 2009 experience shows. As said, macro surprises have increased (surged for the US), while major economies are turning around. Financial conditions are easing off quickly and, most importantly, spiking Fed's assets support higher US PEs as was the case since 2005 (see chart). Lastly, PEs tend to increase at the bottom of the cycle. Positioning remains contained and tactical indicators we follow are in neutral territory. That said, markets discount already – albeit not in full - a respectable earnings growth in 2021 (above +30%). Furthermore, as market multiples stay high, markets are more exposed to negative news flow and risks. That is why we hold a lower OW position in equity and we see mid-single digit total returns (TR) in 12 months.

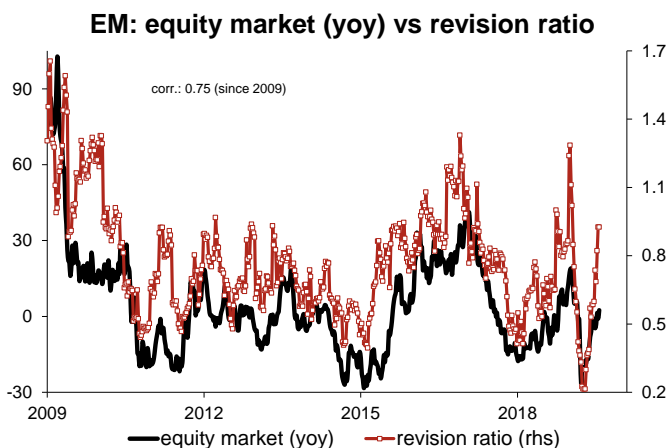
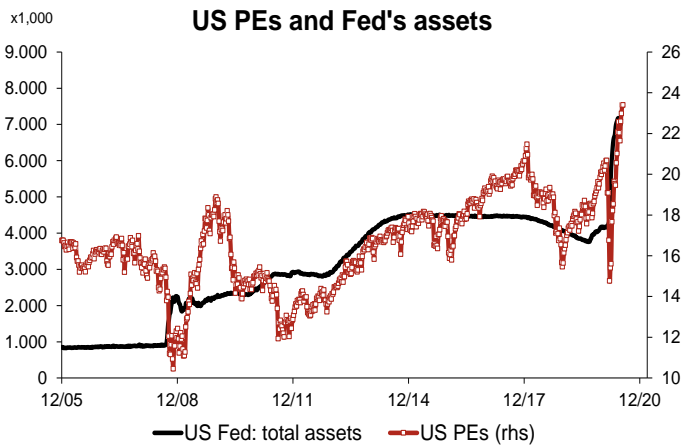
Starting from the next autumn we see a deterioration in the equity appeal: lower recovery speed, Covid second waves, geopolitical risks (US-China, Brexit) and US elections (fear of Democrats winning also the Senate).

Country and sector allocation

We recommend a balanced portfolio (US aligned with EMU) with a marginal tilt to EMs. Mid-term, the cyclical recovery, more stable yields and improved sentiment due to the recovery fund approval could ignite an overperformance of EMU vs US that we estimate to be in the region of 5-7pp (via a reduced risk premium gap of 50 bps). Of course, a stronger EURUSD could at some point represent a headwind for the EA. On sectors, we reshuffle our allocation as some of the previous safe bets became stretched but we are ready to jump in again as they still deserve superior growth ahead: pharma, utilities, and IT. Our analysis includes results from quant models, relative earnings revisions and relative valuations. OW: Insurance, div. financials, capital goods plus media, telecoms (with less conviction for the last two). UW: durables, transportation, real estate, and commercial & professional services, and Momentum (slightly). Other sectors not mentioned are neutral. Indirectly, we are slightly OW Value/Cyclical. In general, Value per se is not a clear buy to us as yields are going to stay low and our quant models do not offer a clear view at this time.

EM: deserve the OW

In July, the MSCI EM (+7.8%) benefitted from falling yields, tighter EMBI spreads and a weaker trade-weighted dollar, outperforming the MSCI World index by 2.8pp. In term of multiples, EMs are trading at discount to US while the EM spread gap remains attractive relative to US HY. Earnings revisions have improved supporting the market together with better macro surprises. Mid term, a weakening US dollar and relatively low valuations will provide tailwinds. We favor Korea, Taiwan and Poland, having better Covid contagion trend, supporting M1 momentum, and high internal score ratings.



Asset Allocation

Thorsten Runde

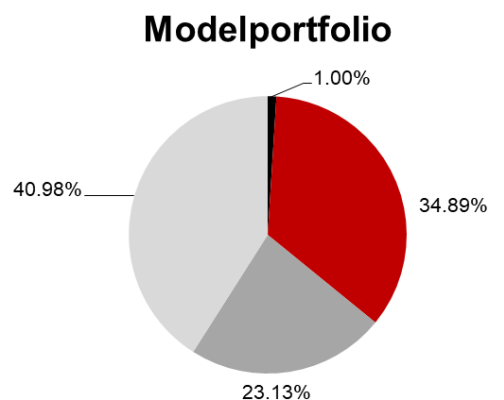
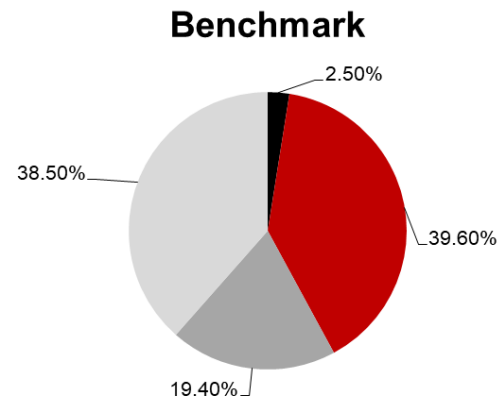
- In the first half of July equity markets of the developed economies roughly gained +3.6% on average whereas they have lost round about -1.2% in the second half so far (July 29). In both sub-periods they clearly underperformed the emerging markets that made +7% and +1.6% respectively.
- Core govies suffered in the first half of July, in particular the short- to medium-term buckets. All in, core govies roughly made +0.5% in July so far.
- Semi-core as well as peripheral govies clearly outperformed the core ones by +40 bps and +145 bps respectively. With roughly +3.8% 10Y+ BTPs turned out to be the most attractive segment in the govie arena, thereby also leaving behind most of the equity markets.
- On the credit side, the HY segments clearly outperformed, in the EA (+2.0%) as well as in the US (+4.0%). Both EA and US IG credit performance was distinctively lower (+1.4% EA; +2.4% US).
- A rebound in macro data and investors' FOMO & TINA may still keep risk assets underpinned over summer. Thus, we keep a prudent OW in equities while reducing the OW in HY Credit. We also keep a sizeable (but reduced) OW in high quality credit. We reduce UW in Cash and maintain a minimal long duration stance (mostly via IG Credit).

In the course of July our model portfolio outperformed its benchmark by +9.0 bps, almost exclusively achieved in the first half of the month. The weaker result in the second half of July was primarily driven by the poor equity performance together with the raised active equity positioning. The swing in equity markets also accounted for a distinctively lower benchmark return after July 15. Thus, with credit performance being fairly smooth over the month, they switched from the camp of underperformers in the first half to that of the outperformers in the second half.

A substantial degree of recovery hopes and central bank support already seems to be priced in by risk assets. As the materialization of a V-shaped recovery is very unlikely the prospects towards the end of the year appear much bleaker with the major threat of a second pandemic wave clearly highlighting that risks are remaining on the downside. Yet, the investors' overall positioning is still rather restrained. Together with a rebound in macro data this should continue to keep risk assets underpinned in the short term.

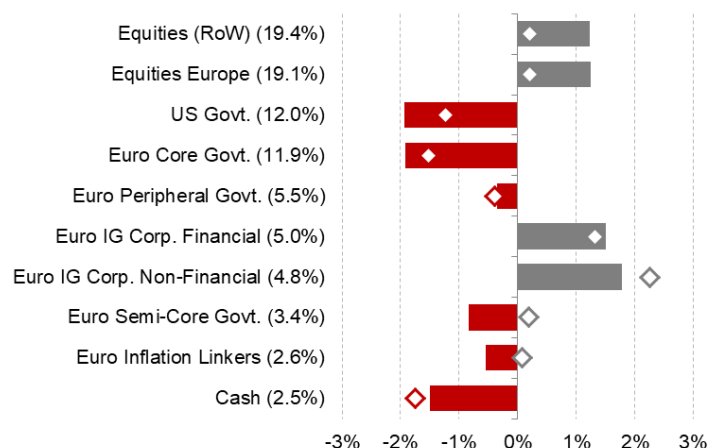
FOMO & TINA to underpin risk assets in the short-term

Thus, we keep a prudent OW in equities while reducing OW in HY Credit. We keep a sizeable (but reduced) OW in high quality credit. We reduce UW in Cash and maintain a minimal long duration stance (mostly via IG Credit)



■ Cash ■ Govies ■ Corporates ■ Equities

Active Positions in TOP 10 Benchmark Constituents*



*Benchmark weights in parentheses, diamonds indicating previous recommendations

Forecast Tables

	2018	2019f	2020f	2021f
US	2.9	2.3	- 7.5	5.0
<i>Euro area</i>	1.9	1.2	-10.0	5.5
Germany	1.3	0.6	- 8.0	5.5
France	1.8	1.3	-12.0	5.0
Italy	0.7	0.2	-13.0	6.5
<i>Non-EMU</i>	1.5	1.4	- 9.2	5.8
UK	1.3	1.4	-10.0	6.1
Switzerland	2.7	1.0	- 6.5	4.0
Japan	0.8	0.8	- 5.8	2.5
<i>Asia ex Japan</i>	6.2	5.2	- 1.0	7.2
China	6.6	6.1	1.8	8.0
CEE	3.1	1.3	- 5.7	4.4
Latin America	0.1	- 1.1	- 7.6	3.3
World	3.5	2.7	- 5.1	5.6

	2018	2019f	2020f	2021f
US	2.4	1.8	0.4	1.4
<i>Euro area</i>	1.8	1.2	0.3	1.2
Germany	1.9	1.4	0.3	1.4
France	2.1	1.3	0.3	1.2
Italy	1.1	0.8	- 0.1	0.9
<i>Non-EMU</i>	2.3	1.7	0.6	1.3
UK	2.5	1.8	0.6	1.3
Switzerland	0.9	0.4	- 0.5	0.3
Japan	1.0	0.5	0.0	0.1
<i>Asia ex Japan</i>	2.6	2.8	2.6	2.4
China	2.1	2.9	2.5	2.0
CEE	6.0	6.7	4.7	4.9
Latin America	4.0	4.0	3.5	3.3
World	2.6	2.6	1.9	2.2

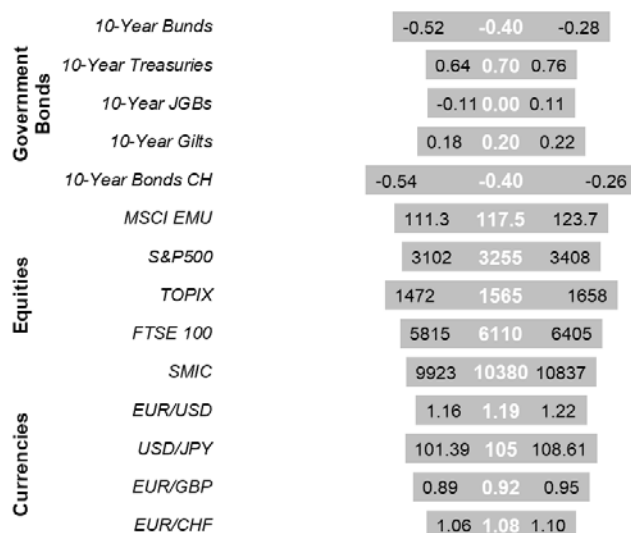
Financial Markets

3-month LIBOR	29/07/20*	3M	6M	12M
USD	0.27	0.30	0.30	0.30
EUR	-0.45	-0.45	-0.45	-0.45
JPY	-0.06	-0.10	-0.10	-0.10
GBP	0.09	0.15	0.15	0.15
CHF	-0.71	-0.70	-0.75	-0.75
10-Year Bonds	29/07/20*	3M	6M	12M
Treasuries	0.59	0.70	0.75	0.85
Bunds	-0.50	-0.40	-0.35	-0.30
BTPs	0.97	1.10	1.15	1.15
OATs	-0.19	-0.10	-0.05	0.00
JGBs	0.02	0.00	0.00	0.05
Gilts	0.11	0.20	0.25	0.35
SWI	-0.52	-0.40	-0.35	-0.30
Spreads	29/07/20*	3M	6M	12M
GIIPS	113	120	120	115
BofAML Covered Bonds	43	40	40	35

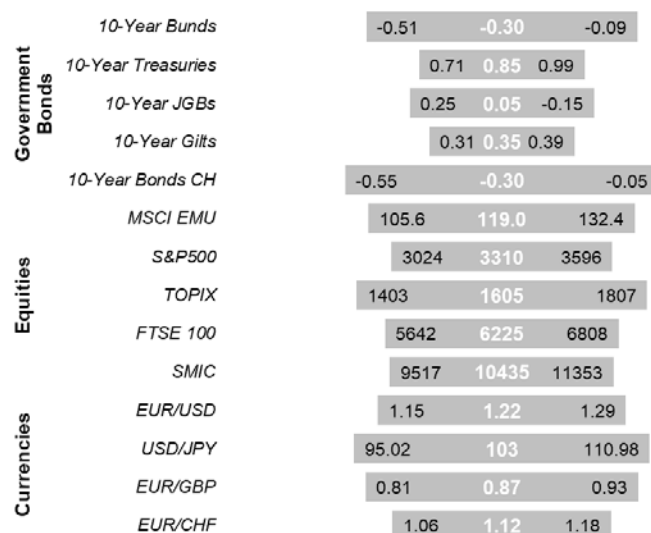
*average of last three trading days

Corporate Bond Spreads	29/07/20*	3M	6M	12M
BofAML Non-Financial	126	120	115	110
BofAML Financial	124	120	115	110
Forex	29/07/20*	3M	6M	12M
EUR/USD	1.18	1.19	1.20	1.22
USD/JPY	105	105	104	103
EUR/JPY	124	125	125	126
GBP/USD	1.29	1.29	1.36	1.40
EUR/GBP	0.91	0.92	0.88	0.87
EUR/CHF	1.08	1.08	1.10	1.12
Equities	29/07/20*	3M	6M	12M
S&P500	3239	3255	3270	3310
MSCI EMU	116.4	117.5	118.5	119.0
TOPIX	1565	1565	1585	1605
FTSE	6122	6110	6165	6225
SMI	10274	10380	10495	10435

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.

Imprint

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