



**GENERALI**  
INVESTMENTS

# Market Perspectives

## Grand Reopening

May 2021



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# Global View – Grand reopening

Thomas Hempell / Vincent Chaigneau

- Amid the global economic rebound from the pandemic and rising US inflation concerns, upside pressures on yields will persist. The PEPP acceleration has not stopped the yield ascent, and the ECB faces a difficult June meeting; so does the Bund.
- The Fed's patience may stoke inflation fears, but keep real yields in check - they matter most for risky assets. Vaccination progress, large excess savings/liquidity and surging earnings keep us long risk assets (Equities, Credit) for now, and underweight in longer-dated Government bonds.
- Discretionary positioning and equity fund inflows, however, have become stretched in parts. As the summer boom supports exuberance and vols recede, start thinking about cheap heading.

The global economy is enjoying a grand reopening. Rising infections still burden large parts of Europe and EMs (India, Brazil). Yet the vaccine champions are leading the way. The US is enjoying a strong rebound, with the boost from re-opening sectors seconded by strong fiscal packages and persistent Fed support. Evidence from the UK and Israel shows that effective vaccination campaigns allow for fast normalisation of significant parts of the economy. Risks from mutations persist, but much improved vaccine supply will help the EU to catch up over the spring and summer.

tapering asset purchases. In the US, the Fed's patience may keep real yields low for longer, but fan inflation concerns in the process. Meanwhile the ECB faces a tricky June meeting as the PEPP acceleration in Q2 has not stopped 10-year Bund yields from reaching new post-Covid highs. Assuming the hawks will stop an increase in the PEPP envelope, investors may well test the ECB's resolve.

A too rapid bounce in yields is still a threat for risky assets, alongside lofty valuations, surging equity inflows over the past six months and stretched positions in selected segments. Equities have already extended their 2021 rally into double-digit territory, benefitting [our pro-risk stance](#).

Yet there are good reasons to believe that the further rise in yields can be controlled and well digested. In the US, TIPS already discount a high degree of inflation worries with option markets pricing a [30% probability of a >3% inflation overshoot](#) over five years. Excessive inflation remains a remote threat in Europe where significant output gaps still keep reflation the major task for the ECB. Arguably the [Fed](#) and [ECB](#) will need to start considering the future of their asset purchase programs in summer. Nevertheless, they still have ammunition to counter a disorderly rise in *real* yields (which matter most for risky assets) via increased QE, strengthened forward guidance, duration extension or (unlikely) outright yield curve control.

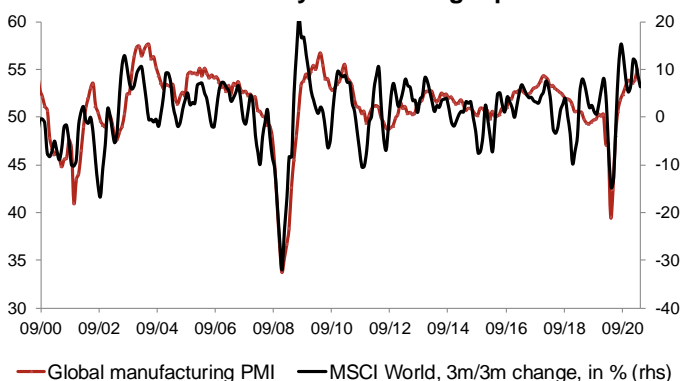
10-Year Bond Yields	Current*	3M	6M	12M
US	1.60	1.80	1.95	2.10
Germany	-0.25	-0.20	-0.15	-0.10
Italy	0.78	0.75	0.80	0.90
Japan	0.08	0.10	0.15	0.20
Forex	Current*	3M	6M	12M
EUR/USD	1.21	1.23	1.25	1.25
USD/JPY	108	109	107	106
EUR/GBP	0.87	0.87	0.87	0.88
Equities	Current*	3M	6M	12M
S&P500	4186	4225	4239	4265
MSCI EMU	143.1	143.5	144.6	146.0

\* 3-day avg. as of 28/4/2021

## Maintaining a pro-risk bias

We keep a pro-risk bias in our portfolios, with a moderate overweight in Equities and a more sizeable one in Credit. We continue to prefer Cyclical and Value stocks over Growth and Defensive ones. In Credit, we see particular value in financial papers and in HY, as the economic upswing will improve leverage metrics while default rates are already peaking. We keep an underweight in core European Govies on poor carry and rising yields (with the risks tilted towards an overshoot of our yield forecasts). We like European inflation linkers which still appear cheap into the recovery. The USD has already pared most of its initial Q2 bounce, and is headed for further headwinds amid a recovering global economy.

Global economy still backing equities



Fiscal policy in the euro area will by far fall short of the US stimulus. But various governments are expanding their fiscal plans for this year, adding to the Recovery and Resilience Facility, whose disbursement should start in H2 after it cleared a hurdle at the German Constitutional Court.

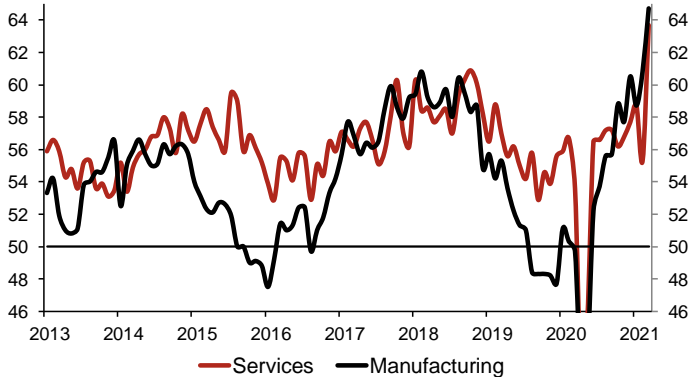
Upside pressures on yields are unlikely to abate in this setting. In the US, the fiscal impulse and temporarily high inflation prints (mostly on statistical base effects from last year's price slump) will keep inflation concerns high. In Europe, the pending grand reopening will encourage investors to diversify excess savings out of low-yielding safe government bonds into more juicy (and risky) alternatives. Central banks want to delay discussions about

# USA

Paolo Zanghieri

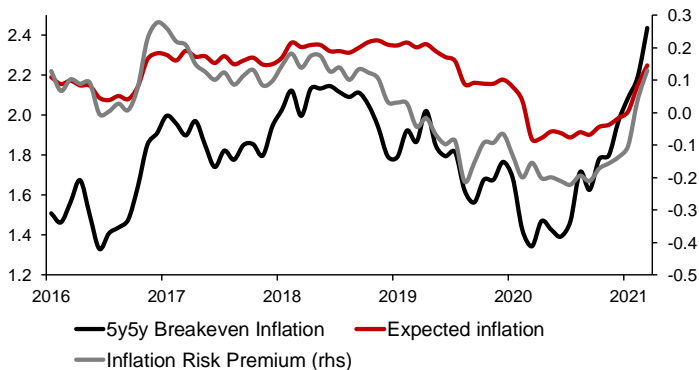
## ISM indexes

(values above 50 indicate expanding activity)

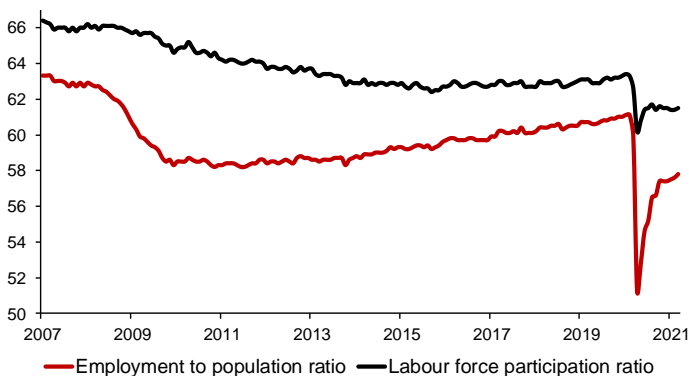


## Decomposition of the 5y5y breakeven

Source: DKW model, Federal Reserve Staff estimates



## Employment and Participation



- In Q1, GDP rose by a strong 6.4% ann., thanks to a surge in consumption. We expect GDP to rise by 7.5% this year, and growth to near 5% in 2022.
- Reopening is bolstering business confidence but worries about inflation remain. The temporary bounce back in inflation is materialising but should fade by summer.
- Despite the marked improvement in the labour market, any talk of tapering is premature. We expect it to be implemented in Q1 2022 only.

According to the advance release, in Q1 2021 GDP rose by a strong 6.4% annualised, driven by a surge in consumption (10.7% ann.) following the reopening and the extra income provided by the fiscal measures approved in March. Capex surprised to the upside increasing by 10.1% ann. Over the next quarter activity will accelerate as speedy vaccination will allow the full opening of the economy. We maintain our forecast of 7.5% growth in 2021. Very strong growth will spill over into 2022, and the newly announced infrastructure and welfare expenditure plan (worth US\$ 3.3 bn over ten years) tilts our 4.7% growth forecast risks to the upside. The proposed increases in taxes should have a negative but minor impact on demand: the increase in wealth and income tax target a limited share of population while and the negative impact on capex via reduced profits should be offset by that of stronger demand.

### Confidence rises but inflation fears too

The prospect of a quick reopening are fuelling business confidence, with the ISM for services up to 64.7, the highest level since record began. However, business sentiment indicators point also to increased worries about higher prices, adding to the risks flagged by consumer surveys and inflation breakevens. Base effects, the increase in the oil price and temporary supply bottlenecks have started to drive inflation up: headline CPI rose from 1.7% yoy in Feb to 2.6% yoy in March. It will peak at just above 3% yoy at the end of Q2 but in the second part of the year price increases will moderate. We see core PCE inflation (the Fed's preferred measure) ending the year at around 1.9%

### Fed: still early to discuss tapering

In the April meeting the Fed acknowledged the brightened outlook but underlined again that data are not showing yet the substantial improvement the Fed needs to start thinking about tapering. While March employment prints were very positive (with 916k new jobs), overall, the labour market is still far away from where it was pre-Covid-19. Participation to the labour market is still very low by historical standards. With the economy healing at a fast pace, we expect the discussion on tapering to become relevant around summer. The reduction in bond purchases should then be announced in autumn and start in Q1 2022. We expect the first rate rise for the beginning of 2024.



# Euro Area

Martin Wolburg

- With vaccination of almost 25% of the population the way is paved for herd immunity by summer and a lasting unwinding of lockdown measures.
- We look for a strong rebound in activity, stick to our 2021 growth forecast of 4.0% but see the risks now tilted to the upside.
- The ECB adopted a wait-and-see stance and started to discuss PEPP tapering.

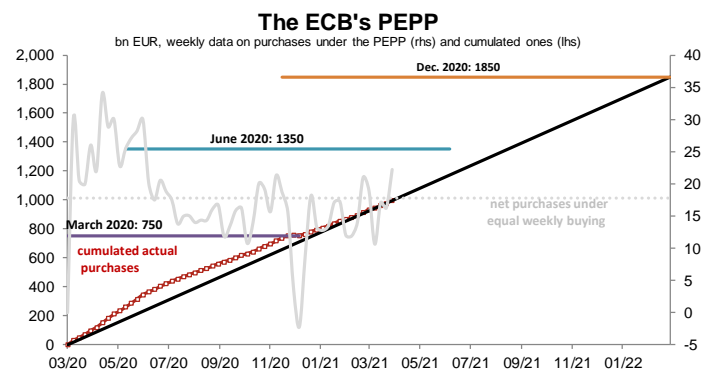
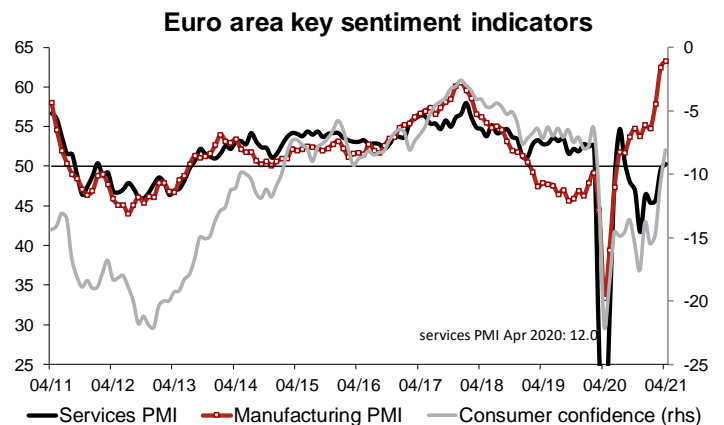
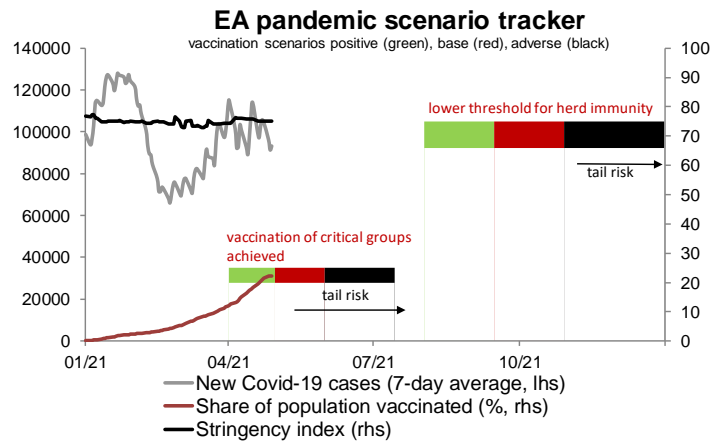
After a bumpy start of the European vaccination campaign amid surging infections, the situation improved significantly as of late: At the time of writing almost one quarter of the euro area population received at least one inoculation. With supply-shortages being overcome we look for herd immunity to be reached by summer. And with the most vulnerable part of the population having already received vaccination we look for the lasting unwinding of lockdown measures to start already in May and June.

The broad-based improvement of key sentiment indicators also hints in this direction. The April composite PMI of 53.7 is the highest since October 2018. Clearly, in terms of output growth these indicators exhibit an upward-bias as long as lockdown measures persist. But improvement of expectations and of new orders heralds the unleashing of activity once the lockdown is over. Accordingly, April consumer confidence rose back into pre-lockdown territory. Depending on the method used, excess liquidity to be deployed for consumption amounts between € 100 bn (3M deposits) and € 500 bn (savings rate). Moreover, a favourable global environment (with China and the US as key pillars) has already pushed capacity utilization in the manufacturing sector into upper regions.

All in all, with Q1/21 (preliminary flash) GDP growth of -0.6% qoq we see no reason to revise our growth forecasts of 4.0% for 2021 and 5.3% for 2022. But given the vaccination progress we now see the risks on the upside.

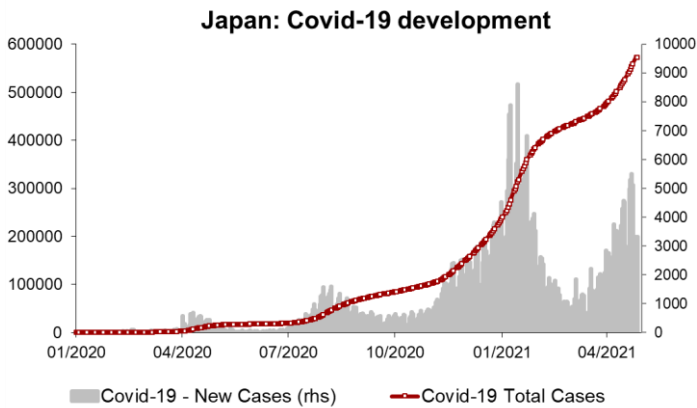
## ECB: PEPP tapering discussion started

At its April meeting, the Governing Council did not embark on any action. Already at the March meeting it had decided that PEPP purchases would be stepped up in Q2. The purchases since then suggest an average weekly buying of € 20 bn. This decision clearly implies reduced purchases thereafter. Within the ECB the discussion about the tapering of the PEPP has just begun. The June 10 meeting will be key as the macro outlook will then be updated. As it stands now, we do not expect a further increase of the PEPP volume but also look for the € 1.85 tr envelope to be fully exhausted. To smooth the tapering process we could also imagine a lengthening of the taper period beyond March 2022. In any case, the ECB left no doubt that it will continue to provide favourable financial conditions and will look-through the spring spike in headline inflation.



# Japan

**Christoph Siepmann**



- **Japan has been hit by another Covid-19 wave. The partial shutdown will hamper the recovery in Q2, after Q1 GDP already shrunk.**
- **The BoJ did not directly respond to the new shutdown after it had reviewed its policy in March.**
- **A rising oil prices impact will likely help to lift CPI inflation into positive territory by early Q2.**

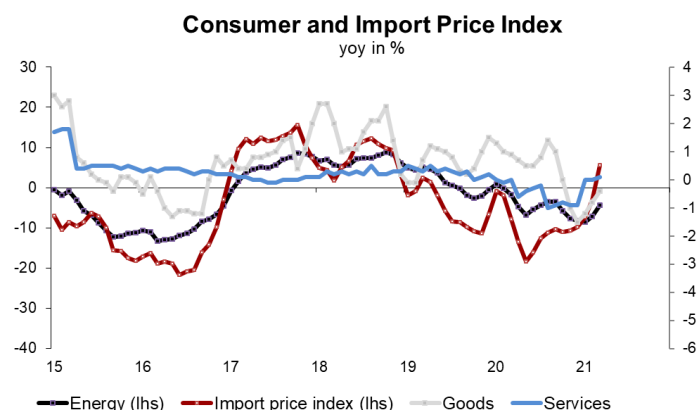
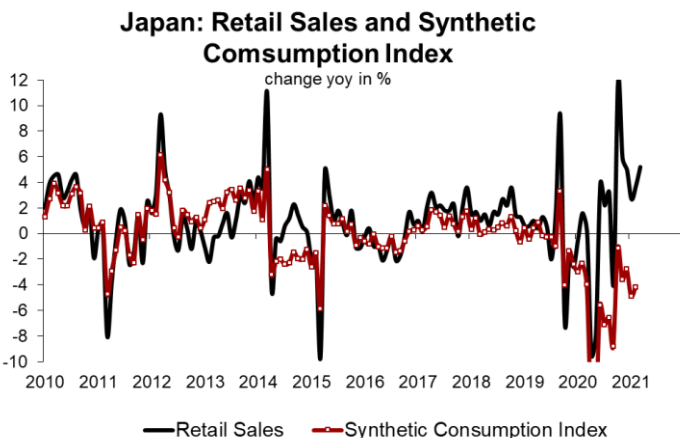
Japan has been hit by a fresh wave of Covid-19 infections. The government already announced the State of Emergency in Tokyo and three other major prefectures (Osaka, Hyogo, Kyoto). Currently the shut-down runs from April 25 to May 11 which includes the “Golden Week”, a major public holiday. Moreover, the government asked for a more complete closure than last time, not least to keep it short, given that the Tokyo Olympics are less than three month away (start on July 23). It remains unclear whether the State of Emergency needs to be extended regionally or later into May. Vaccination progress has been slow. The Olympics look again jeopardized.

### Recovery further postponed

Given the renewed partial lockdown, the expected recovery in Q2 from the negative growth in Q1 (data to be published on May 18) will soften. Private consumption will remain very volatile. Q1 growth is likely to recede by about 1.4% qoq, driven by weak domestic demand while the net export contribution will probably be rather neutral. Currently, we expect Q2 growth to stay slightly positive but the rebound of the Japanese economy to shift further into H2. We revised our growth forecast for 2021 down from 2.3% to 1.9%.

The BoJ did not respond directly to the new Covid-19 shutdown at its April 26/27 meeting. It had revised its tool box at its strategy review in mid-March. However, it said that the Covid-19 measures currently in place could be extended beyond September if necessary. The target rates under the yield-curve-control policy remained unchanged (-0.1% / 0.0%) while the JGB fluctuation band is now 5 bps wider (+/- 25bp). More importantly, the BoJ published revised inflation forecast. It now forecast FY 2021 inflation at 0.1% (0.5% before). Moreover, the bank does not see its inflation target of 2% reached even in FY 2023 but expects 1% only.

Japan's March CPI inflation improved to -0.2% yoy, after a fall by 0.4% yoy in the previous month. Core-core inflation edged up 0.3% yoy. A major factor in headline CPI are oil prices (in Yen) which turned positive in March in yoy-terms. This will increasingly influence headline CPI. On the other hand, mobile phone charges will drop from next month on. We revised our CPI inflation slightly up from 0.1% in 2021 to 0.3%. PPI is also on the rise, mainly due to raw materials prices.



# China

Christoph Siepmann

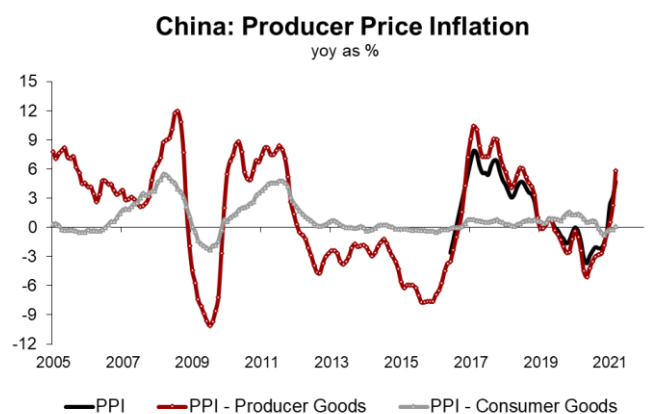
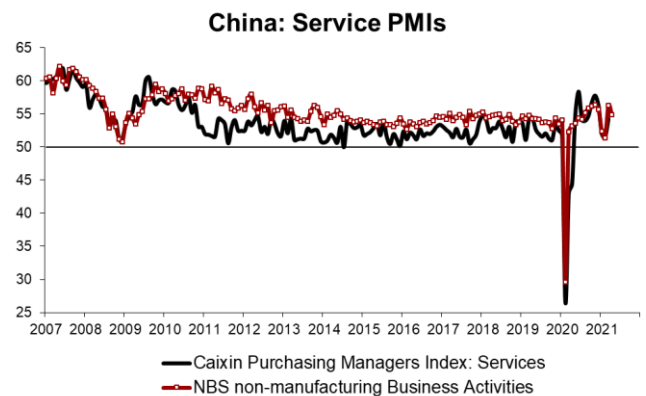
- **China's economy grew by 18.3% yoy in Q1 2021, but suffered from very weak dynamics. In Q2 we expect some normalization in sequential growth and yoy rates to drop to 7%-8% yoy.**
- **Given the continued recovery, Beijing will embark on more policy normalization. Less policy support will soften growth over the course of the year.**

China's economy grew by 18.3% yoy in Q1 2021, which was to an important part due to base effects (China's GDP had dropped by 6.4 % yoy in Q1 2020 given the Covid-19 outbreak). Moreover, the strong year-on-year number coincided with the lowest sequential expansion rate over the last decade (except for Q1 2020) with 0.6% qoq. This weakness had been visible mostly in PMIs which slowed markedly in January and February. The reasons were renewed Covid-19 (travel and quarantine) restrictions as well as an already advanced stage of the recovery. In March and April, manufacturing PMIs fluctuated a bit but overall – like the service PMIs – send a signal for a reacceleration. March monthly hard real activity data continued to suffer from strong base effects. However, their main message appears to be that the economy is still well supported from the export and the production side. Moreover, demand components looked to gather pace. In sum, we expect Q2 sequential growth to normalise while the yoy rates should drop to a range of 7%-8%.

### Growth dynamics to slow over the course of the year

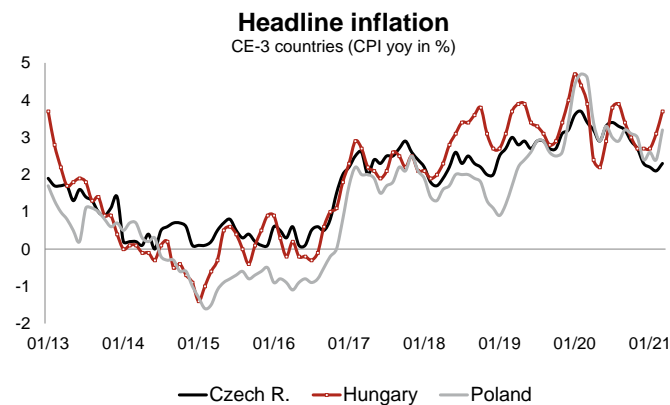
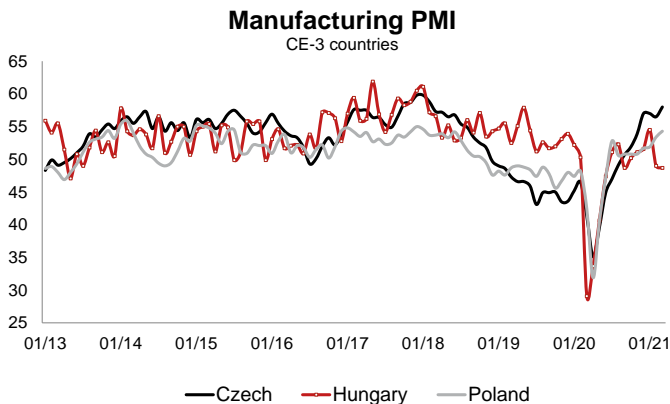
These fluctuations will be embedded in a general trend of less support from monetary and fiscal policy, i.e. some cooling of the economy over the course of the year. The PBoC is expected to stir money supply growth towards the nominal GDP growth rate. This is already underway. Latest new yuan loans expanded by a rate of 8.1% yoy in Q1, compared with bank credit growth of overall 16.8% in 2020. The monetary impulse is negative. We do not see the PBoC to respond meaningfully to rising PPI inflation which shot up to 4.7% yoy of late. Typically, the spill-over to CPI inflation is low. However, the latter will probably rise in line with the recovery, averaging 1.7% in 2021.

Fiscal policy will scale back its support by likely less than 2 pp of GDP. Especially the quota for local government bond issuance has remained rather comfortable. We expect the impact to be felt more in H2, i.e. only after the 100th anniversary of the founding of China's Communist Party (CCP) on July 1. However, China will embark again on its deleveraging agenda as the non-financial sector debt to GDP ratio increased by (IMF data) 24 pp to 277% last year. The focus for deleveraging will lie on the property sector (so-called three red lines approach), implicit local government debt and inefficient SOEs. Overall, we stick to our view of a growth rate of 8.4% in 2021. However, risks are now a bit tilted to the downside given the soft sequential growth in Q1 as well policy and PPI inflation risks.



# Central and Eastern Europe

Radomír Jáč



- The CE-3 region reports recovery of activity in industry and improving optimism in trade and services. The better mood is based on the view that pandemic restrictions will be eased soon.
- Stronger economic confidence is accompanied by growing price pressure but central banks keep relaxed policy stances as they want to avoid premature tightening of monetary conditions.
- The Czech CNB is likely to deliver a first rate hike in H2 while the Hungarian MNB may raise the deposit rate if global factors destabilize the forint.

The scenario of a solid GDP recovery remains in place for 2021, although activity in services and retail trade in Q1 and early Q2 was still hit by pandemic-related restrictions. Declining numbers of Covid-19 new cases will allow to ease restrictions across the region. While Q1 GDP will still report a quarter-to-quarter decline in some cases, the Q2 performance should be already clearly positive.

Inflation grew in all CE-3 economies in March and further increases should follow in Q2. Headline CPI will be pushed by fuel prices, base effects and also by supply shortages, caused by complications related to the pandemic. Inflation will exceed central banks' targets in all CE-3 countries in 2021. Moderation is expected in H2 or in early 2022 at the latest. Monetary policy response is likely to be cautious as economic recovery remains a priority.

## Poland: Supreme Court will rule on FX mortgages

The Czech CNB will debate monetary policy and its new macro forecast in early May but the key interest rate is expected to stay on hold at 0.25%. The forecast published in February expected three rate hikes for 2021, the first one in Q2 but the CNB Board stated that a debate on monetary policy tightening is likely to start only in Q3, as uncertainties related to the pandemic still remain significant. Two rate hikes in H2 are seen as a possible maximum for this year but further rate increases should follow in 2022.

In Hungary, the MNB kept its base rate stable at 0.60% at the MPC meeting held in late April and confirmed that it will focus on balance sheet operations incl. purchases of government bonds (QE). The MPC Statement indicated that the central bank remains ready to increase the depo rate from its current level of 0.75% if global factors were to push the forint toward an undesired weakening.

The Polish NBP says that the key rate will not be raised from its current level of 0.10% before 2022, although inflation is expected to exceed the 2.5% target in the next three years. Market wait for a decision of the Supreme Court (May 11) on conditions of conversion of mortgages denominated in foreign currency, which will be important for the local banks as well as sentiment on the zloty.

Main Forecasts	2019	2020	2021f	2022f
<b>Czech Republic</b>				
GDP	2.3	-5.6	3.0	4.5
Consumer prices	2.8	3.2	2.4	2.0
Central bank's key rate	2.00	0.25	0.50	1.25
<b>Hungary</b>				
GDP	4.6	-5.1	4.9	4.3
Consumer prices	3.4	3.3	3.6	3.3
Central bank's key rate	0.90	0.60	0.60	1.00
<b>Poland</b>				
GDP	4.6	-2.7	4.1	4.6
Consumer prices	2.3	3.4	3.0	2.7
Central bank's key rate	1.50	0.10	0.10	0.75

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



# Government Bonds

Florian Späte

- The recent transatlantic yield spread tightening is unlikely to last. A strong economic rebound and a further rise in inflation are expected to trigger a widening due to higher US yields.
- While the leeway for higher EA government yields appears rather limited in the short term, we forecast rising euro area yields in H2.
- The recent moderate widening of EA non-core spreads should not last. Progressing vaccination and an economic recovery are seen to support non-core bonds short term. Further down the road, however, ECB tapering concerns are expected to trigger somewhat wider spreads again.

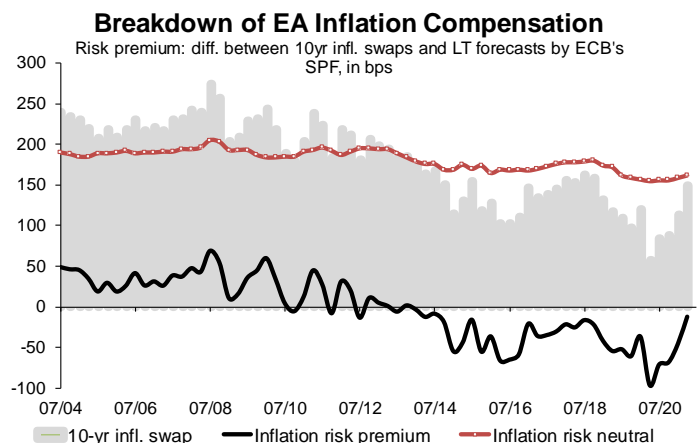
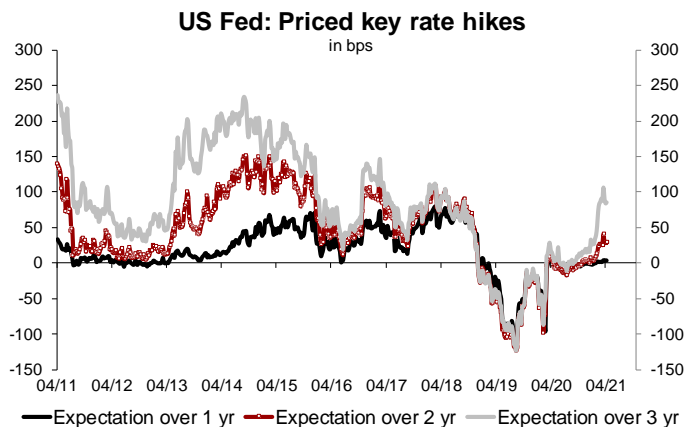
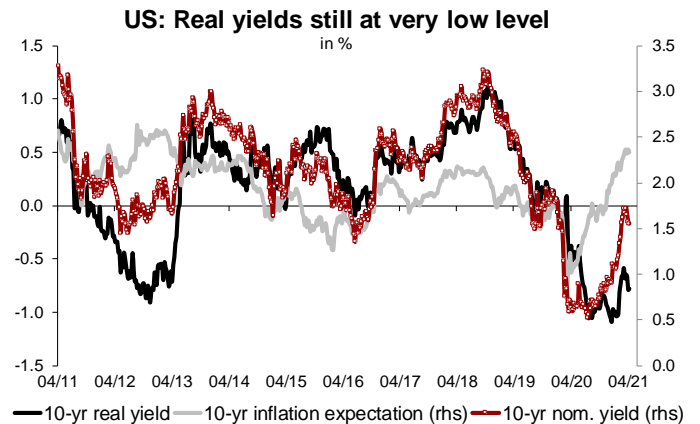
US Treasuries recovered from hefty losses in April. 10-year US yields fell by 20 bps before rebounding moderately again. We do not regard this as a change in trend but merely as a correction which is unlikely to last much longer. The rally in US Treasuries occurred despite a flow of strong macroeconomic data releases and an ongoing vaccination. It shows that financial markets have adjusted expectations and wait for a confirmation of the high-flying expectations.

## Upside for US yields despite excessive Fed pricing

On the back of our constructive view on the US economy we expect long-dated US yields to rise again in the weeks to come. The ISM is forecast to remain well above the long-term average and bond investors will not remain unimpressed by annual inflation rates surpassing the 3% threshold in the months to come. What is more, 10-year US yields are currently trading well below 5-year 5-year OIS swaps. This is rather unusual in times of rising yields and indicates some catch-up potential for 10-year yields. Moreover, the 5-year 5-year OIS swaps have fallen considerably in recent weeks and are now trading at around 2.15%. In times of an economic recovery they tend to rise to (or even above) the Fed's long-term dots. Despite the decrease in recent years long-term dots are still at 2.5%. Hence, there is scope for 5-year 5-year OIS swaps to rise in the weeks to come.

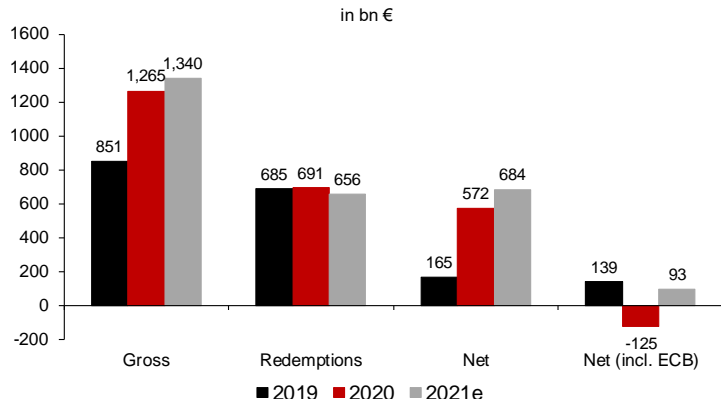
One caveat remains, however. Despite some moderation recently, we regard current Fed pricing as excessive (probably also driven by concerns about high inflation). Financial markets expect the US central bank to kick off a rating cycle in H1 2023. Until April 2024 almost four rate hikes (each 25 bps) are priced. This appears too optimistic as the Fed has no rate hike throughout 2023 in its own projections. Moreover, Fed officials stressed the dovish stance in recent weeks. Our own forecast is for a start of the rate cycle in Q1 2024. Accordingly, we see some room for disappointment and expect financial markets to scale back expectations in the months to come.

Hence, the leeway for short-dated yields to rise in the short term appears more limited than currently priced by financial

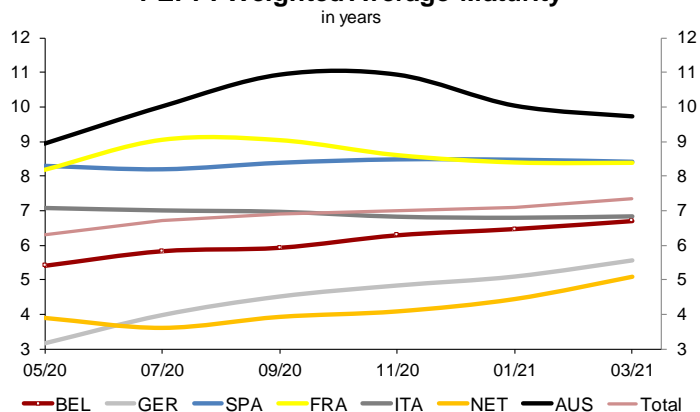


# Government Bonds

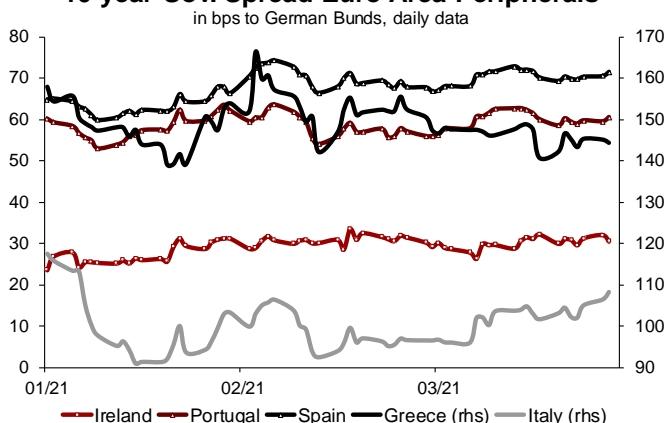
## Euro Area: Government Bond Issuances



## PEPP: Weighted Average Maturity



## 10-year Sov. Spread Euro Area Peripherals



markets. This will not leave the long end of the curve completely unscathed and will dampen the rise in long-dated yields as well. Still, we forecast 10-year US yields to rise to 1.80% on a 3-month and to 2.10% on a 12-month horizon.

The EA is lagging in many respects. Vaccination is slower (but strongly picking up recently) and the economic rebound will start at earnest only in Q2. Hence, 10-year yields have been risen by only 35 bps year-to-date (in contrast to 75 bps in the US). Still, the general trend for euro area government bond yields is upwards.

To start with, there has been upward revisions of budget deficits by EA governments. This implies higher issuance activity in the remainder of the year (not to mention around €150 bn of EU issuance under the EU Recovery Fund). After the already the positive net issuance in Q1 (including ECB purchases) it will remain in positive territory over the course of 2021. This is also due to the fact that ECB purchases are not overwhelming. According to recent data and to comments by ECB officials we expect the ECB to purchase under the PEPP a monthly volume of around €80 bn in Q2 (and to reduce purchases from Q3 onwards). Moreover, inflation expectations have moderated a bit recently. This is unlikely to persist and we expect them to rebound. Particularly the still negative inflation risk premium points to further upside potential.

Short term, one qualification is to be noted. In addition to the net purchases, the ECB also reinvests maturing T-bills. The evolution of the weighted average maturity of holdings suggests that they are reinvested into bonds. As in Q2 2020 a large amount of T-bills was issued (and partially absorbed by the ECB), this comes on top of the net purchases. Hence, the leeway for higher EA core yields in the short term appears more limited. Overall, we forecast 10-year Bund yields to rise to -0.20% on a 3-month horizon and to -0.10% on a 12-month horizon.

## Policy supports non-core bonds – for the time being

EA non-core sovereign bond spreads widened slightly in April to the upper end of the trading range. But, the near term outlook is constructive amid the accommodative fiscal and monetary policy mix. In addition, the German Constitutional Court cleared the way for the EU Recovery Fund. We expect most countries to submit their plans on time until the end of April.

Looking further down the road, we turn a bit more cautious. While high deficits imply a tailwind for growth, the long term effect depends on the way necessary reforms will be implemented. Although rating agencies back the fiscal expansion currently, financial markets will scrutinize the effectiveness of the spending and will focus on the higher debt burden again. In combination with the looming end of the PEPP we forecast non-core spreads to widen slightly over the course of H2 2021.

# Credit

Elisa Belgacem

- The compression trade is still on, with both IG and HY now way below pre-Covid levels.
- High carry products are the best performers in the context of fast rising rates.
- HY rated companies will benefit the most from rising inflation which supports the deleveraging.
- If some volatility cannot be excluded we expect the compression trade to go on throughout 2021.

Both IG and HY cash spreads moved tighter over the last month on the back of slowing supply due to the beginning of reporting season. Current expensive valuations will constrain the ability of spreads to materially tighten in this context of rate upward moves, but thanks to extraordinary technicals, we expect further 10bp tightening for the remainder of the year in IG, 20bp in HY.

We also received the confirmation that the ECB will act as a stabiliser of credit markets via the PEPP program. Indeed, as in the first weeks of January volatility increased and credit spreads approached 100bp versus Bund, the European central bank resumed small purchases of credit in its emergency program while it barely bought any corporate bonds in October and November last year.

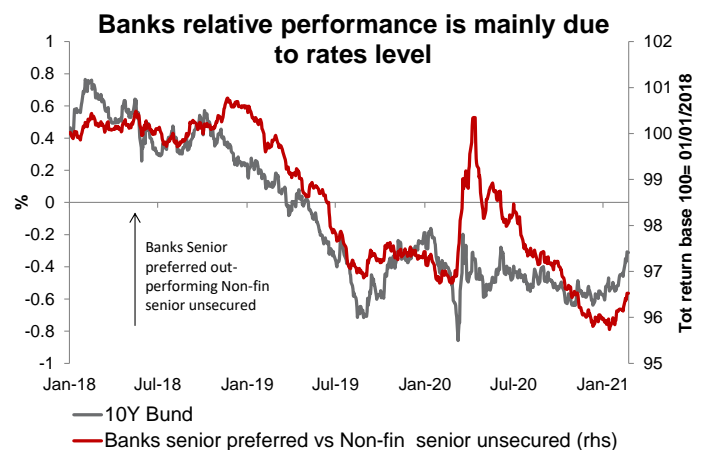
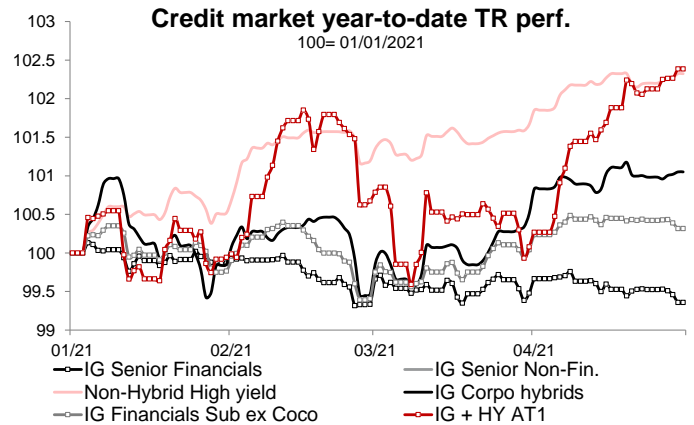
The default rates development continues to prove very benign. We expect the confirmation that European default rates have peaked already in November 2020 at 5% and are declining since then, which remains way below 2009 numbers. However, unlike Moody's, we expect those default rates to remain above LT average at around 4% by the end of 2021 when the fiscal support starts to be withdrawn.

But the outlook for SMEs will likely be less rosy than for bond issuers, and while bankruptcies have declined for technical reasons in 2020, the real test will be the beginning of the withdrawal of the fiscal support over the second half of this year. The consequences could be felt on the banking sector but we expect governments to take a safe stance while removing their support to the private sector.

## We remain overweight HY

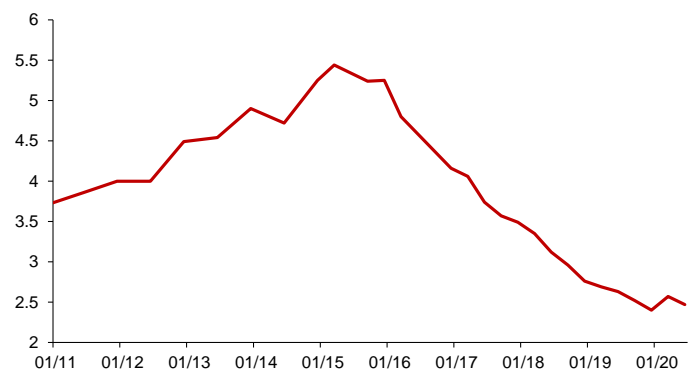
Hence going forward, we expect IG grinding gradually tighter while HY should outperform, providing better cushioning effect to higher rates. Furthermore, while higher inflation is benefiting credit in general it is a true tailwind to HY in supporting the deleveraging of companies.

Within IG we keep a pro-cyclical bias and favour BBB and subordinated bonds. Within HY, we retain a preference for BBs as they are lagging single-Bs while still displaying decent carry. We continue to prefer capital structure risk to credit risk, and so we prefer corporate hybrids and AT1 to pure HY as we see them as a better risk-reward alternative.



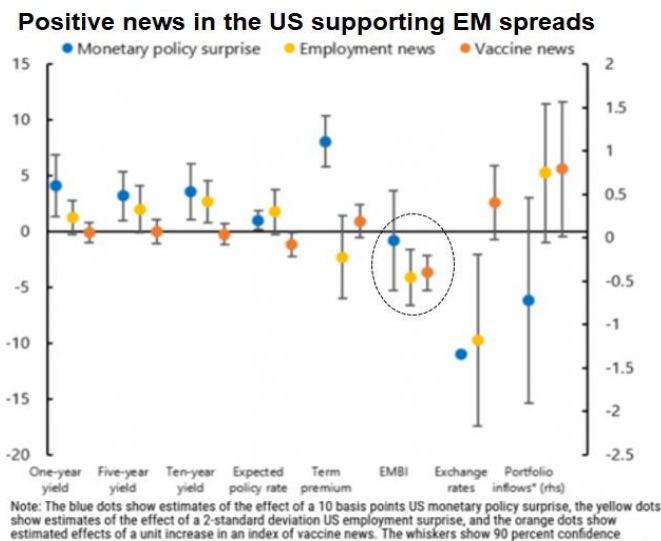
## Euro Area non-performing loans

source EBA



# EM sovereign bonds

Guillaume Tresca

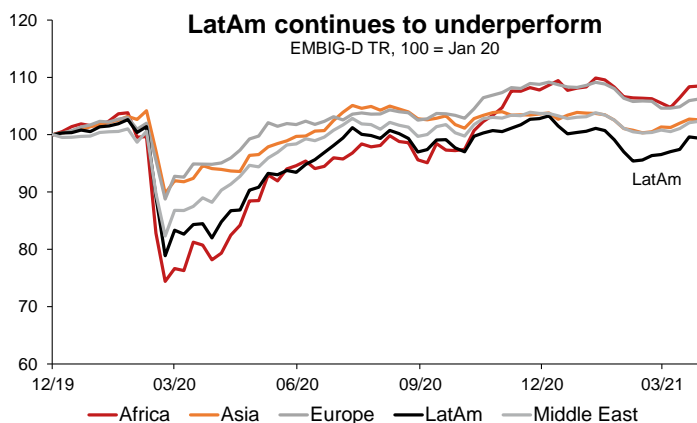


- We keep our neutral view but increase risk slightly, having a mild OW on EM HY
- EM external debt has proved more resilient, and a modest spread tightening is expected
- Uncertainties and local risks are running high. We avoid LatAm, favour Asia and like Romania

We maintain our neutral EM external debt view, but short-term risks have been receding and thus we increase risk slightly. It remains a tug-of-war between the rising US and EUR core rates and better global growth prospects. Expected return is low single digit and it remains a carry play, but EM external debt has proved more resilient of late with some spread tightening and IG/HY compression trade resuming.

**Some improvement...**

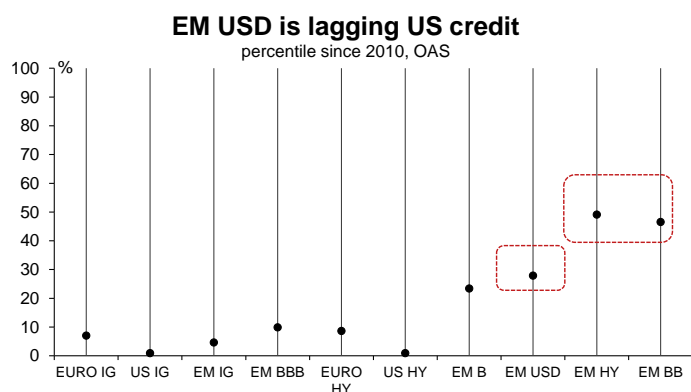
Indeed, the growth dichotomy between EM and DM has been now well priced in as the recent limited reaction of US rates to strong macro data have exhibited. UST rates will likely keep climbing but the velocity of the move should be less intense, having less an impact on EMs. A recent IMF study even shows that ultimately EM spreads are benefiting from positive US news.



Thus, we keep a mild OW on EM HY with a focus on BBs given lower duration, but we expect a modest global spread tightening. Indeed, idiosyncratic risks and uncertainties have been running high (Turkey, Covid, elections in LatAm) leading to a lack of conviction among investors despite a positive risk-on environment. More problematic is the deterioration of the EM sanitary situation in certain countries. EM vaccination ramp up will be slow, Q1 growth will likely disappoint, and it is difficult to look through short-term weaknesses given the already deteriorated fiscal metrics. On a positive note, all these risks have not triggered significant outflows and we have not seen a negative feedback loop between negative TR and outflows. Supply/demand balance has improved.

**...But remain selective**

We continue to prefer the North Asia complex over LatAm where the heavy political cycle coupled with the sanitary situation could jeopardize the recovery. Peru is at risk of further widening while Colombia can lose rapidly its IG status. That said, we like Chile and Mexico in the short-term. We still like MENA IG like Saudi Arabia. As exhibited by the latest IMF WEO, fiscal balance is improving in this region thanks to oil prices. In EMEA, our top choice is Romania where political risk is declining. In the B space, the DSSI extension without PSI participation and the SDR increase are providing a welcome support. Debt sustainability and G20 Common framework are still long-term risks, but it has not yet translated in debt operations.





# Currencies

Thomas Hempell

- The Q1 USD bounce has proven short-lived. We expect more headwinds to the Greenback into the global rebound over the spring and summer.
- As the Fed keeps pushing back against early rate hike expectations and the US twin deficit remains high, US economic outperformance will barely benefit the USD sustainably.
- We expect a significant leg higher in EUR/USD over the next 3-6 months until a mounting tapering debate in the Fed will keep a lid on the move.
- Easing safe haven flows amid a European economic rebound and higher Bund yields point to more upside in the EUR/CHF.

The USD bounce in Q1 from its 2020 weakness has proven short-lived, in line with [our expectations](#). The fast progress in US vaccination and bold fiscal packages triggered a shake-out in speculative short positions on the USD (top chart), while rising US yields kept underpinning the Greenback. But most of the resulting Q1 USD gains have been pared in April. With the grand reopening likely going global over the spring and summer, the USD will face more headwinds. As a countercyclical reserve currency it tends to suffer when global growth picks up.

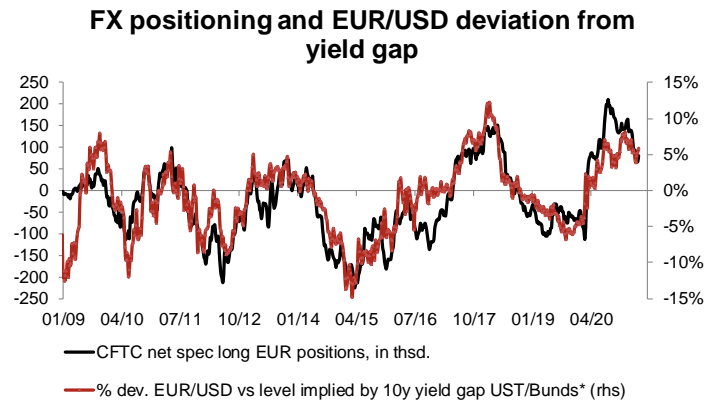
## USD support on Fed tapering talk only later in the year

The ongoing boost to growth from US fiscal action is unlikely to translate into sustained USD strength. [The Fed remains committed](#) to let the economy run hot, with its new policy framework foreseeing a period of inflation overshoot. The Fed will thus push back against premature rate hike speculation, vastly neutralizing the key channel from economic into currency strength. Furthermore, the yawning twin (fiscal and C/A) deficit does not bode well for the greenback (mid chart).

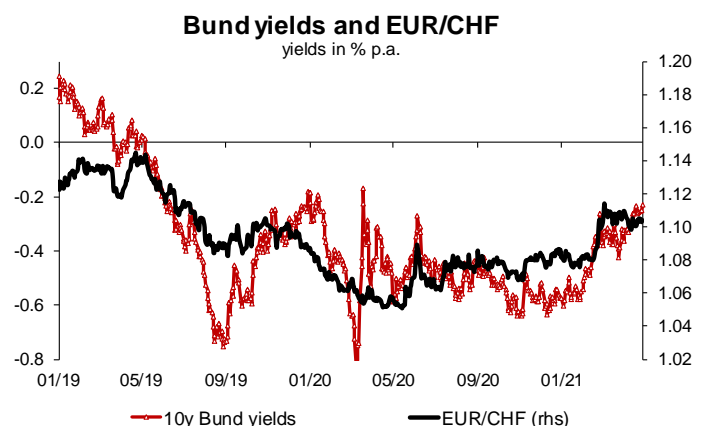
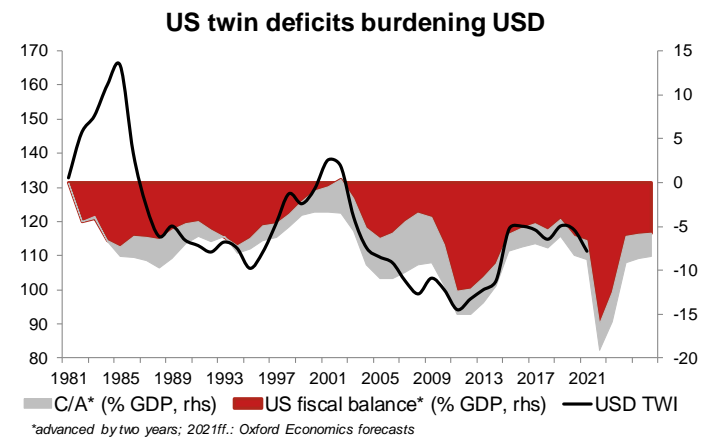
Longer-dated US yields may still rise, but a steeper US curve on inflation concerns has indeed proven a drag, not a boost to the Greenback in the past. With Europe catching up in the recovery amid stronger vaccination progress, we expect a visible leg higher in the EUR/USD over the next 3-6 months. We stick to our year-end forecasts of 1.25, however, as we expect a mounting tapering debate in the US to stabilize the USD later in the year.

## EUR/CHF to benefit from easing safe haven demand

The European economic rebound also bears more upside in EUR/CHF. We expect CHF safe haven flows to continue unwinding due to an improving economic outlook. Pay-outs from the European Recovery Fund may start only later in summer, but progress in the issuance of common debt and the substantial benefit geared towards Southern Europe will further help to soothe worries about EMU stability. Finally, the further gradual rise in Bund yields will make the Swiss franc less attractive (bottom chart).



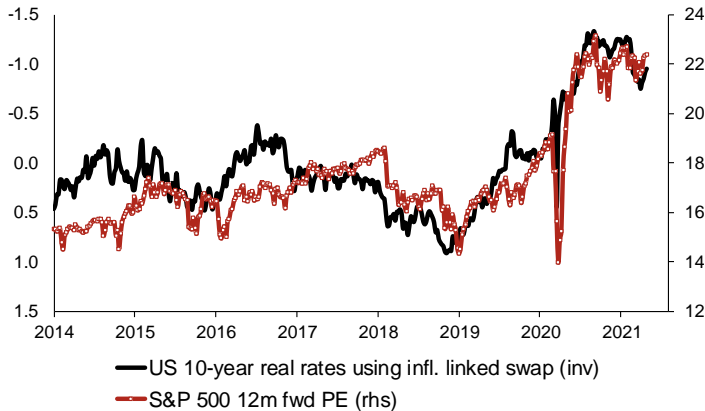
\* based on 3y rolling regression coefficient EUR/USD vs. 10y yield gap



# Equities

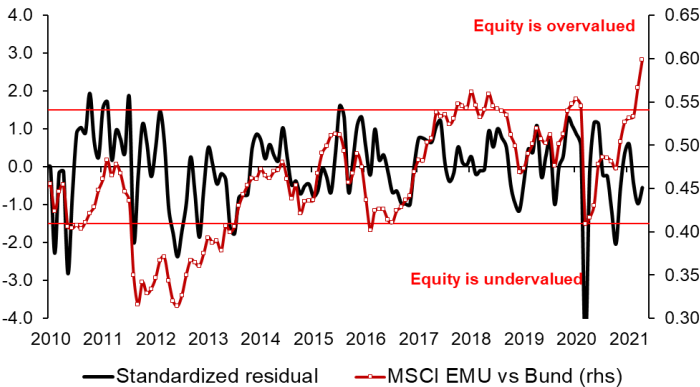
Michele Morganti / Vladimir Oleinikov

Real 10-year rates and US PE



Equity vs Bonds: EMU

distance from fair value model, in standard deviations



- Lower yields put the sector rotation on hold but the equity rally lingered also thanks to a surprising good earnings momentum.
- We see yields increasing, possibly putting moderate pressure on PEs, still not a threat to positive returns: earnings will do the job.
- While recent rally ate in our 12-month target, we remain positive as macro momentum and policy support are still strong positive factors.
- Crowded positioning (a negative) could linger further as lower volatility should push CTA flows to a cyclical high.
- Value (more) and cyclicals (less) are still OW, albeit the bulk of rotation is behind us. We favour EU and Japan vs US and EM. And add defensives names (staples) to financials and energy, lowering the OW on materials (declining M2 momentum in China).

Over the last month, markets rallied with the US and the Nasdaq outperforming EMU and Japan. The good economic momentum and higher confidence indicators were the main reasons behind. The cited US equity leadership is explained by softer 10-year rates, which reached a bottom at 1.55% in the month. After the previous sell-off - during which bond funds have reduced duration risk - pension funds seem to take the occasion to chase higher yields, buying long-dated Treasuries. Furthermore, the Fed has recently reassured investors about hike expectations, citing temporary inflation spikes and reaffirming its dovish stance.

## Lower yields put the sector rotation on pause

Lower yields have put the sector rotation on pause: from Growth - Defensive to Cyclicals - Value. Indeed, EU Growth outperformed Value by 3.5% while Cyclicals were able to beat Defensive by 1.7% but the Value-cyclicals (like financials and energy) were the laggards. That said, we deem US long-term real yields being too low judging by measures like R-star, productivity growth and real economic growth. Fiscal and monetary policy remain supportive, vaccination is progressing well and inflation expectations have scope to increase further. In sum, we see higher yields from here albeit in an orderly fashion, given the aim by central banks to maintain supportive financial conditions for longer. In such environment, the 2<sup>nd</sup> part of the sector rotation is only postponed. In the case of Value we can talk more about “rebalancing” rather than pure rotation given the huge underperformance accumulated in the last years.

## A good reporting season with huge positive revisions

After 50% of results are out we can say that the Q1 season is progressing surprisingly well (see table).

Analysis of the median stock: Q1 2021 reporting season

Median stock	Earnings Growth		Sales Growth		availability Q1 2021
	Q4 2020	Q1 2021	Q4 2020	Q1 2021	
	S&P	11 %	26 %	5 %	
Stoxx	2 %	34 %	(2)%	2 %	46%
Euro Stoxx	(5)%	40 %	(3)%	2 %	39%
Topix	19 %	15 %	(0)%	3 %	22%

Median stock	Earnings Surpr		Sales Surpr		availability Q1 2021
	Q4 2020	Q1 2021	Q4 2020	Q1 2021	
	S&P	8 %	11 %	2 %	
Stoxx	13 %	19 %	0 %	2 %	46%
Euro Stoxx	19 %	25 %	1 %	3 %	39%
Topix	25 %	12 %	3 %	1 %	22%

# Equities

Spiking yoy growth and good surprises are driving positive earnings revisions. The ISM is also adding to the positives. The new orders component reached a new high surpassing the cyclical peak in 2020. A weaker USD and higher oil prices triggered positive earnings revisions. Analysts now see a 25% yearly growth for earnings of the S&P 500 in Q1 versus 12% estimated in September 2020 or 20% in February. Similarly, for Q2 they see 55% yearly growth compared to 45% in September 2020 or 50% in early February. The leading sectors with positive revisions are financials and energy.

## Maintaining a positive stance on equity

In the month EMU posted another 3% return and the US 5%, eating in our 12-month targeted total return, which we now reduced to 5% for the former and 3.5% for the US. The S&P500 valuation range is seen at 3,900-4,300, negative Tax impact included. We stay positive as macro momentum and policy support remain strong positive factors in the short term. Risks mostly come from possible spikes in yields – reducing PEs – and crowded positioning. Here, the lower VIX (now 17) should cause further equity flows in CTA to reach a cyclical high.

We stay OW on Europe and Japan (value-cyclical). The rotation into value (higher OW) and cyclicals (lower OW) sectors is well advanced but not exhausted as GDP, yield and M1 momentum remain sanguine, together with policy support. Value stocks, in particular, are a hedge against a surprise spike in bond yields, and likely to benefit from the cyclical upswing and rising inflation expectations. That said, we aim to get some exposure to defensives (households) while still betting on energy and financials, lowering overbought cyclicals. OW: financials, energy, materials, and software. UW: cons. services (new), media, real estate (new), and telecoms. We bring household & personal products to neutral from UW.

## EM: maintaining a cautious view

In April, the MSCI EM (+3.7%) has been supported by a weaker dollar and higher oil prices but underperformed the MSCI World by 1.3pp. In terms of multiples, EMs are trading at a discount of 30% vs historical average relative to the US. While the Fed financial conditions are improving, the investor sentiment (Sentix) on EM equities remains low. Earnings have been recently revised down quite heavily. Furthermore, China may throttle back in the second half to avoid overheating, which is likewise not good news for emerging markets in the short run and would put, along with the sluggish vaccine rollout and the vulnerability of TMT stocks, EM stocks under additional pressure. Mid-term, the EMs should benefit from attractive relative valuations, ongoing rebound in growth, a weakening US dollar and higher commodity prices. For now, we are reassessing the prospects, waiting to re-enter the position. We favour India, Korea, and Poland.

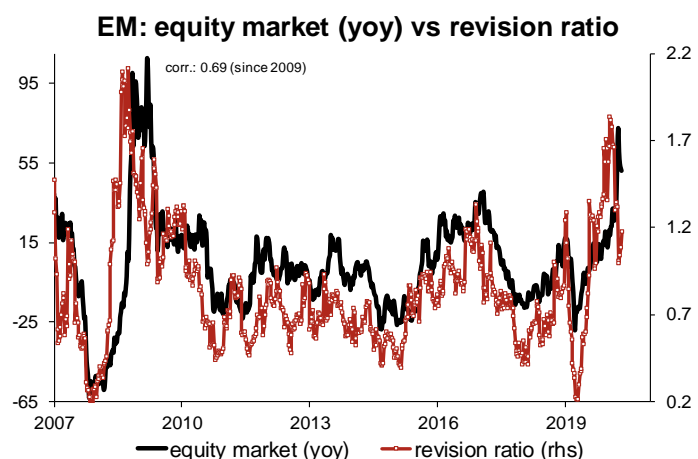
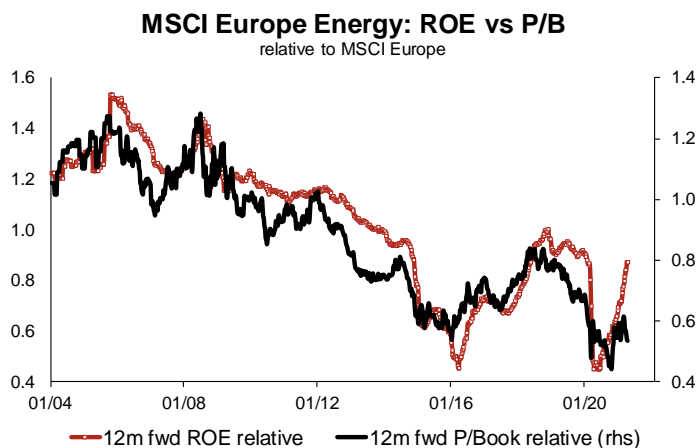
US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.47	1.37	0.10	176.5	4.29
Scenario 2 (consensus 12m forward in 1 year)	1.51	2.18	-0.67	202.6	5.03
Scenario 3 (GI 12m fwd in 1 year)	1.92	2.20	-0.28	208.6	5.18
Scenario 4 (downside macro scenario)	0.70	1.40	-0.70	115.0	2.86
Scenario 5 (upside macro scenario)	2.80	2.40	0.40	220.0	5.07

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Avg S&P500 valuation	3,643	4,274	4,402	2,428	4,258
	-4.6%	11.9%	15.3%	-36.4%	11.5%

Note: **Base risk scenario:** using 20% of risk premium's stand. deviation (SD=2.7) adds around 50 bps to the average risk premium calculated since 1872 (4.6% + 50 bps = 5.1%).

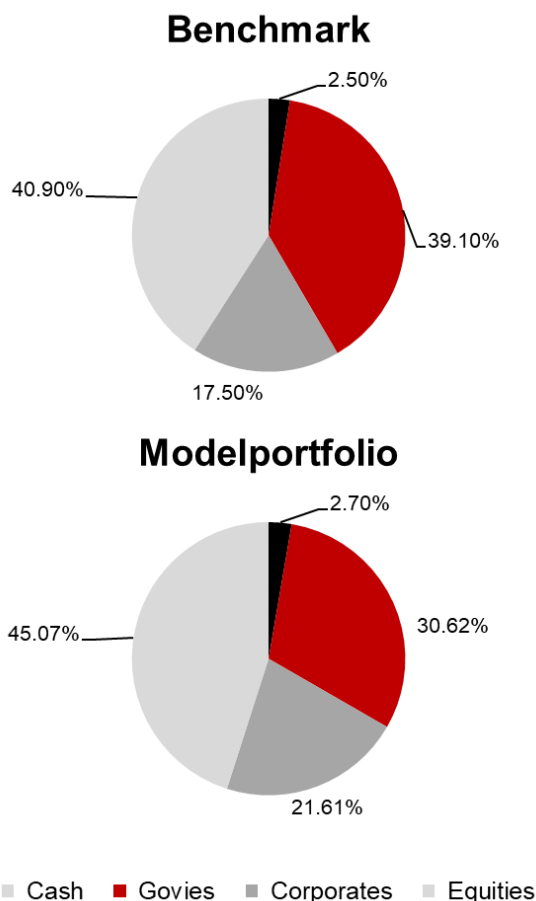
using 40% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Avg S&P500 valuation	3,258	3,812	3,926	2,165	3,833
	-14.7%	-0.2%	2.8%	-43.3%	0.4%

Note: **High risk scenario:** using 40% of risk premium's stand. deviation (SD=2.7) adds around 100 bps to the average risk premium (4.6% + 100 bps = 5.6%). Target ERP (4.6) is the average ERP during periods of low inflation (b/w 1.3% and 2.5%).

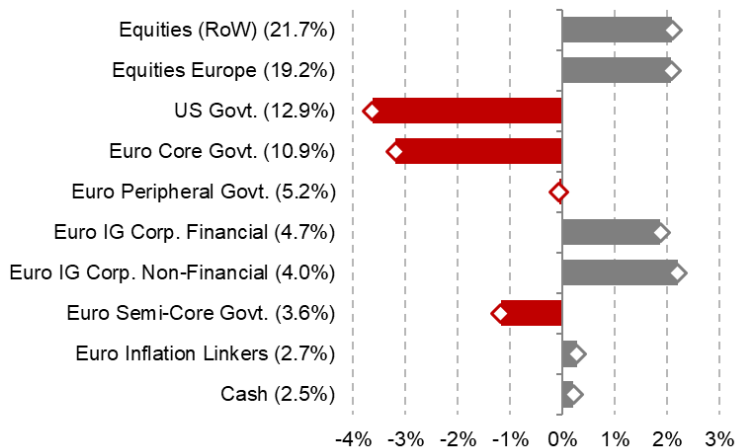


# Asset Allocation

**Thorsten Runde**



## Active Positions in TOP 10 Benchmark Constituents\*



\*Benchmark weights in parentheses, diamonds indicating previous

- In the course of April (until April 28<sup>th</sup>), the whole EA fixed income segment of our investment universe performed negatively, with HY being the only exception (+0.4%).
- On the positive side, Equities accounted for +2.0% on average followed US Treasuries which made +0.5% on average.
- The Equity performance ranges from -0.5% (MSCI PACIFIC) to +4.2% (MSCI NORTH AMERICA).
- Like in the previous months the long maturity buckets distinctively underperformed the shorter ones.
- On the EA Credit side, HY outperformed IG by round about +52 bps on average.
- With the global recovery gaining in breadth and policy makers committing themselves to continued strong support, risk assets should still benefit. Upward pressures on yields will weigh on Govie performance. Thus, we leave our recommended TAA stance in favour of Equities and EA Credit at the expense of Government Bonds unchanged.

In April, the model portfolio has outperformed its benchmark by +14 bps so far. The ranking of the most significant performance contributors to this overall result is led by Equities (+6.8 bps), followed by EA Core Government Bonds (+5.3 bps) and US Treasuries (+2.8 bps). The bottom end of the ranking is clearly dominated by Corporate Bonds (-5.6 bps). By and large, the focuses in the tactical positioning were again set correctly, revealing a performance contribution structure very similar to those in the previous months in 2021.

A strong economic upswing is gaining momentum. It is driven by the “grand reopening” made possible through an accelerating speed of vaccinations – a bit lagging in the euro area – as well as policy support, both fiscal and monetary. Global manufacturing is running hot, intensifying inflation concerns and weighing on the total return perspectives for fixed income securities (especially in the US, less in the EA). All in all, risk assets should be benefitting from these conditions.

### Pro-risk stance to be maintained

Against this backdrop, we leave our last month’s TAA recommendation unchanged. We keep a reasonable overweight in Equities and EA Credit. We stay underweight in US Treasuries and EA Govies as their prospects clearly suffer from rising inflation risks. Furthermore, we recommend to keep a small overweight in Cash and a moderately short stance on duration.



# Forecast Tables

## Growth<sup>1)</sup>

	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.2	- 3.5	7.5	1.8	4.7	0.7
<i>Euro area</i>	1.3	- 6.7	4.0	- 0.3	5.2	1.0
Germany	0.6	- 5.3	3.2	- 0.2	4.7	0.9
France	1.5	- 8.2	5.3	- 0.2	5.8	2.1
Italy	0.3	- 8.9	4.0	- 0.2	4.1	0.1
<i>Non-EMU</i>	1.5	- 7.6	5.1	1.0	4.7	- 0.2
UK	1.4	- 9.9	6.1	1.5	5.5	- 0.3
Switzerland	1.1	- 3.0	3.2	0.0	2.9	0.0
Japan	0.3	- 4.9	1.9	- 0.9	2.9	0.6
<i>Asia ex Japan</i>	5.3	- 0.8	7.4	- 0.7	5.5	0.1
China	6.4	2.3	8.4	- 0.0	5.4	- 0.0
CEE	2.2	- 1.8	4.4	0.6	3.7	0.1
Latin America	- 1.7	- 8.5	3.2	- 0.6	2.8	0.0
<b>World</b>	<b>2.6</b>	<b>- 3.5</b>	<b>5.8</b>	<b>0.1</b>	<b>4.6</b>	<b>0.3</b>

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

## Inflation<sup>1)</sup>

	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	1.8	1.2	2.4	- 0.0	2.3	0.1
<i>Euro area</i>	1.2	0.3	1.5	- 0.0	1.2	- 0.1
Germany	1.4	0.4	2.0	0.0	1.5	- 0.1
France	1.3	0.5	1.0	- 0.0	1.1	0.0
Italy	0.6	- 0.1	0.5	- 0.3	1.0	0.1
<i>Non-EMU</i>	1.5	0.6	1.3	- 0.1	1.6	- 0.1
UK	1.8	0.9	1.5	- 0.1	1.9	- 0.1
Switzerland	0.4	- 0.7	0.3	0.0	0.5	0.0
Japan	0.5	- 0.0	0.3	0.4	0.4	- 0.1
<i>Asia ex Japan</i>	2.7	2.8	2.4	0.2	2.7	- 0.0
China	2.9	2.5	1.7	0.2	2.3	0.2
CEE	6.6	5.5	7.4	1.0	5.8	0.7
Latin America <sup>2)</sup>	3.6	3.2	3.1	- 0.1	3.5	0.6
<b>World</b>	<b>2.5</b>	<b>2.1</b>	<b>2.6</b>	<b>0.1</b>	<b>2.6</b>	<b>0.1</b>

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

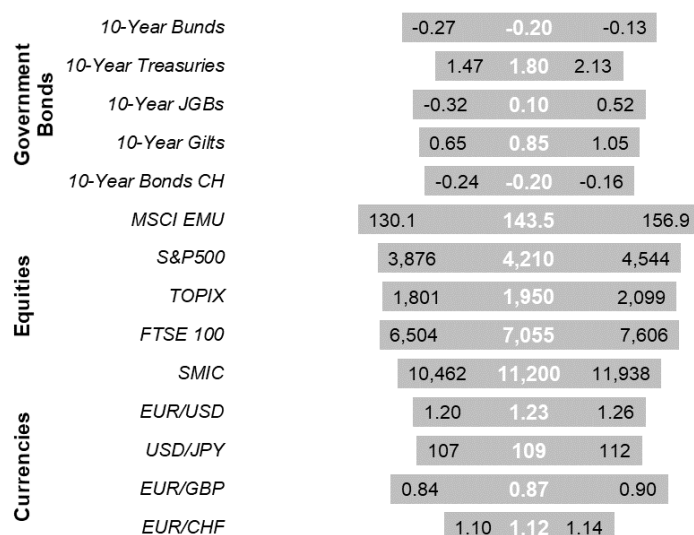
## Financial Markets

3-month LIBOR	28/04/21*	3M	6M	12M
USD	0.18	0.20	0.20	0.20
EUR	-0.54	-0.55	-0.55	-0.55
JPY	-0.07	-0.10	-0.10	-0.10
GBP	0.09	0.10	0.10	0.10
CHF	-0.75	-0.75	-0.75	-0.75
10-Year Bonds	28/04/21*	3M	6M	12M
Treasuries	1.60	1.80	1.95	2.10
Bunds	-0.25	-0.20	-0.15	-0.10
BTPs	0.78	0.75	0.80	0.90
OATs	0.01	0.05	0.10	0.15
JGBs	0.08	0.10	0.15	0.20
Gilts	0.78	0.85	0.95	1.05
SWI	-0.25	-0.20	-0.15	-0.10
Spreads	28/04/21*	3M	6M	12M
GIIPS	84	80	80	85
BofAML Covered Bonds	33	30	30	35
BofAML EM Gvt. Bonds (in USD)	279	275	270	275

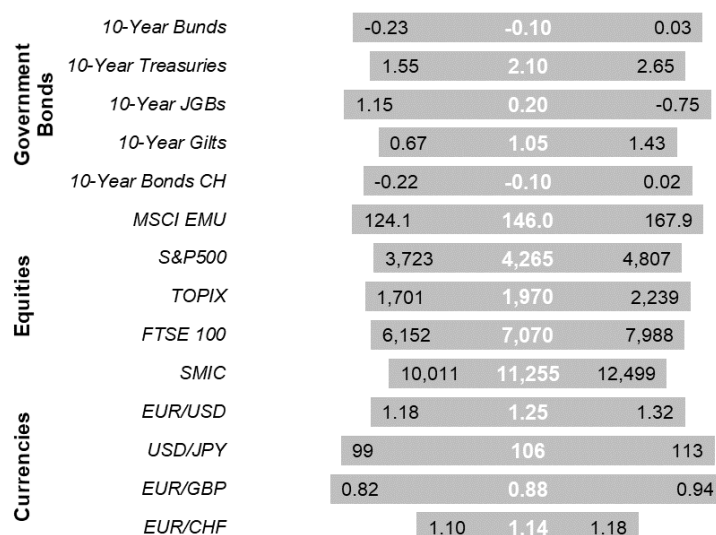
\*average of last three trading days

Corporate Bond Spreads	28/04/21*	3M	6M	12M
BofAML Non-Financial	84	80	75	75
BofAML Financial	88	80	75	75
Forex	28/04/21*	3M	6M	12M
EUR/USD	1.21	1.23	1.25	1.25
USD/JPY	108	109	107	106
EUR/JPY	131	135	134	133
GBP/USD	1.39	1.41	1.44	1.42
EUR/GBP	0.87	0.87	0.87	0.88
EUR/CHF	1.10	1.12	1.13	1.14
Equities	28/04/21*	3M	6M	12M
S&P500	4,186	4,225	4,239	4,265
MSCI EMU	143.1	143.5	144.6	146.0
TOPIX	1,910	1,950	1,955	1,970
FTSE	6,957	7,055	7,060	7,070
SMI	11,119	11,200	11,292	11,255

## 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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**Sources for charts and tables:** Refinitiv/Datastream, Bloomberg, own calculations

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