

Market Perspectives

Unfinished jobs

March 2023

GIAM Macro & Market Research

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

- Central banks' uphill battle against inflation overshoots is getting even harder.
- February has poured cold water on hopes that policy makers may quickly tame inflation towards target. We now have even higher peak rates in our books.
- The recent rebound in long-term real rates makes Equity valuations look even more stretched. Bottoming growth in European and China's reopening bounce are only a partial relief.
- We continue to favour a (trimmed) underweight in Equities and HY, while seeing value (mostly in the carry) in IG Credit.

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Global View – Unfinished jobs

Thomas Hempell

- **Central banks’ uphill battle against inflation overshoots is getting even harder.**
- **February has poured cold water on hopes that policy makers may quickly tame inflation towards target. We now have even higher peak rates in our books.**
- **The recent rebound in long-term real rates makes Equity valuations look even more stretched. Bottoming growth in European and China’s reopening bounce are only a partial relief.**
- **We continue to favour a (trimmed) underweight in Equities and HY, while seeing value (mostly in the carry) in IG Credit.**

As Ukraine mourns the numerous victims and damages suffered one year into Russia’s invasion, global equities have recovered from their initial sell-off, even if still down 4.3% since Feb 24, 2022. Bond markets, by contrast, have taken a more persistent hit. Even though prices for gas, oil and most commodity prices have fallen back to pre-war levels, inflation worries keep haunting policy makers and bonds, with European government bond markets down almost 25% and 10y Bund yields up by some 240bp.

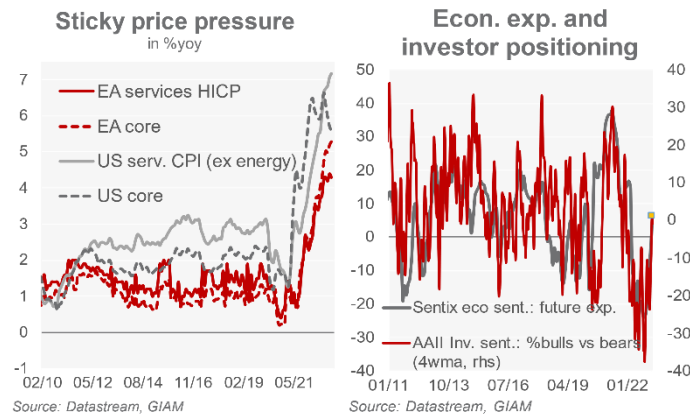
mentioned by Fed Chair Powell on the basis of initially more benign estimates.

An even tougher uphill battle

Thus central banks’ uphill inflation battle is getting even harder. As laid out in our US and Euro Area sections, we upgrade our forecasts for terminal rates for the Fed (+50bp to 5.75% by summer) and the ECB (3.75%, +25bp). And markets’ pricing of first rate cut in early 2024 is likely to prove optimistic in the case of the ECB.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	3.92	3.90	3.80	3.50
Germany (Bunds)	2.51	2.60	2.55	2.40
Credit Spreads**				
EA IG Non-Financial	137	145	150	145
EA IG Financial	159	165	175	165
Forex				
EUR/USD	1.06	1.07	1.10	1.15
USD/JPY	135	134	130	125
Equities				
S&P500	3991	3945	3960	3985
MSCI EMU	146	142	144	147

*3-day avg. as of 24/02/23 **ICE BofA (OAS)



Following market optimism on weaker inflation prints early in the year, February has poured cold water on hopes of a quick normalisation. Headline inflation is set to recede on lower energy prices and base effects, but sticky core inflation has laid bare the unfinished job of central banks (left chart). In the euro area, it extended its ascent to a record high of 5.3% in Jan. A tight labour market with continued job gains points to significant wage increases through 2023, supported by a better than expected resilience of the economy. In the US, strong US consumption, payrolls and core PCE inflation (incl. upward revisions of Dec. numbers) wiped out the first-glance disinflation progress

Market headwinds from monetary policy have been mitigated by the support from bottoming growth (PMIs, ifo, ZEW) in Europe and the reopening bounce in China. Resilience of recent activity numbers in the US, however, will still need to pass the test of fresh numbers for Feb. as mild weather at the outset of the year may have favourably distorted the picture. Leading indicators are still firmly point South.

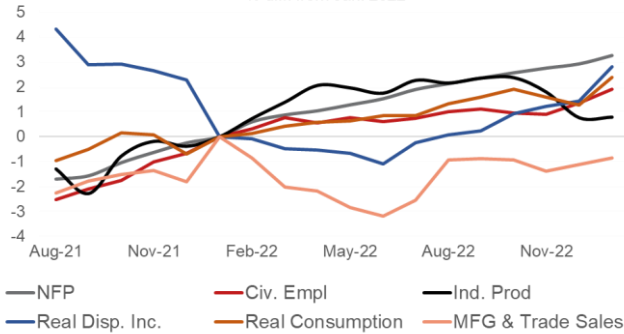
Short term, the need for extended rate hikes may leave moderate further upside to core yields. But the transmission of policy rate hikes to longer-dated yields will increasingly be curbed by market concerns that central banks may overtighten. Risky assets will feel the headwinds from the more hawkish monetary policy, rendering valuations even more stretched. Market positioning has recovered visibly from deeply bearish positioning (right-hand chart), unwinding the case for an extended contrarian rebound.

We stay cautious on Equities, HY and Southern European debt, even if with a slightly reduced tactical underweight. IG Credit still looks appealing on a relative basis, but the bullish case for EM bonds has become less compelling. Shaky risk sentiment and higher inflation uncertainty will provide a temporary reprieve for the USD - even though our mid-term view remains for renewed weakness.

US

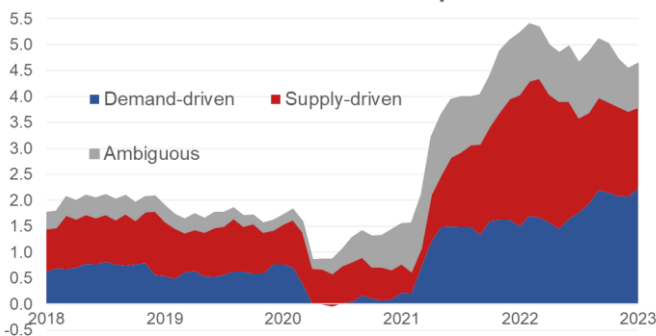
Paolo Zanghieri

Monthly activity indicators
% diff. from Jan. 2022



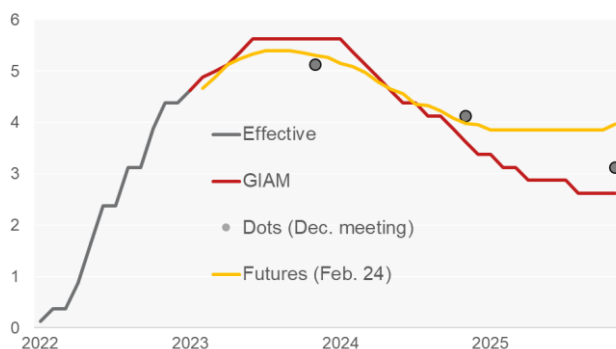
Source: BLS, BEA, Fed, Refinitiv, GIAM;

Core PCE inflation decomposition



Source: San Francisco Fed, GIAM

Fed fund rate expectations



Source: Federal Reserve Board, Refinitiv, GIAM

- **First hard data for 2023 showed consumption and underlying price pressure resilient, dashing hopes of a smooth and quick disinflation.**
- **We raise our estimates for Q1 and moved further into H2 the timing of the anticipated mild recession. As a consequence, we now expect 1% growth in 2023 followed by 0.4% in 2024 (from 0.6% and 1.2% before).**
- **The prospect of sticky inflation makes us upgrade the expected Fed peak rate by 50bp to above consensus 5.75%, with cuts unlikely before Q1 2024.**

January data on income and consumption showed that domestic demand (especially for services) is far from contracting. As a consequence, inflation remains stubbornly high, adding to the case for an even more forceful monetary policy tightening. The rise in disposable income (boosted by the inflation adjustment of social security payments) underpins consumption to a higher than expected extent. This adds to the positive surprises from January employment (non-farm +517k) and retail sales (+3.3% mom), even if warm weather may have distorted seasonal adjustment. The biggest surprise yet came from inflation: both the goods and services component rose beyond expectation raising the core rate by 0.6% mom (4.6% yoy). Moreover, Q4 inflation was revised up. Stronger demand is clearly behind inflation stickiness, but, despite evidence of reduced gridlock, supply constraints are still playing a big role. On the back of a stronger Q1 and anticipating a higher rates peak (see below) we have revised our growth forecast. We now expect activity contraction in Q3 and especially Q4 and a mild recovery thereafter. As a consequence, GDP should grow by 1% this year and just 0.4% next.

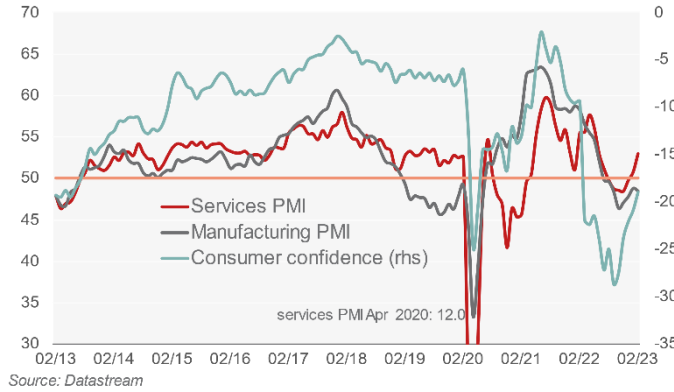
Higher rate peak, maintained until Q1 2024

January data show that the economy is too hot for a quick and smooth return of inflation. Before the data releases the Fed had already stepped up the hawkish rhetoric. For example, the minutes of the Jan FOMC meeting showed a few members in favour of a further 50 bps rise. Afterward, several board members warned that price stability remained a distant target. We raise our projected terminal rate into the 5.5%-5.75% interval, some 25 bps above than market prices. Some FOMC members expressed preference for a fast path to peak, implying a return to 50bps hikes: indeed futures for the March meeting give a 1/4 probability of such a move. We think this would be quite unsettling for markets and our baseline is a string of 25 bps hikes until July, accompanied by strong wording on the commitment to fight inflation. This will require a quite long period of tight rates and we pencil in the first cut only in March 2024.

Euro Area

Martin Wolburg

Euro area key sentiment indicators

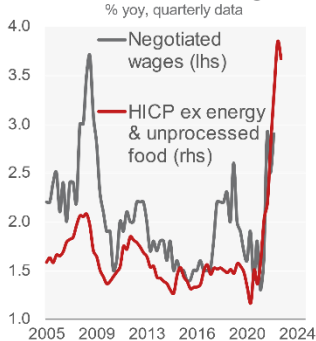


- Amid improving sentiment we revise our 2023 growth outlook up to 1.0% (from 0.7%, and above consensus of 0.0%).
- Energy price induced disinflation will gather momentum in the months to come. But underlying inflation is set to stay much stickier.
- Together with a series of hawkish Governing Council (GC) member comments we now see the peak rate at 3.75%, with a first cut unlikely before H2/2024.

In February, the economic outlook brightened further confirming our view that an euro area recession will be avoided and encouraging us to lift our 2023 growth outlook to 1.0% (from 0.7%), strongly above the consensus forecast of 0.0%.

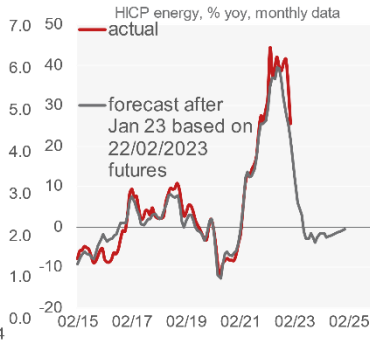
With the February composite flash PMI (of 52.3) having advanced further, our view of stalling activity in the first quarter of this year might even prove too shy. Also, forward-looking components in business surveys advanced further. We think it is well-founded. The labour markets remain in good shape, manufacturing firms seem to have largely solved the bottleneck issue (delivery times in PMI survey back to pre-pandemic levels) and Chinese reopening will start to support activity in spring. Moreover, with energy prices continuing to come down, consumers' purchasing power growth will improve in an environment of rising wages. That said, activity will not go through the roof. Global activity is still weak and quarterly growth rates are set not to exceed potential (of about 0.3% qoq) as monetary tightening will start taking its toll. Clearly, risks remain. But we think that downside risks mainly from again rising energy prices are broadly offset by upside risks from a wage-growth driven demand boost and accelerated depletion of excess savings.

Euro area: core inflation and wages



Source: Datastream, GIAM calculations

Ongoing energy disinflation

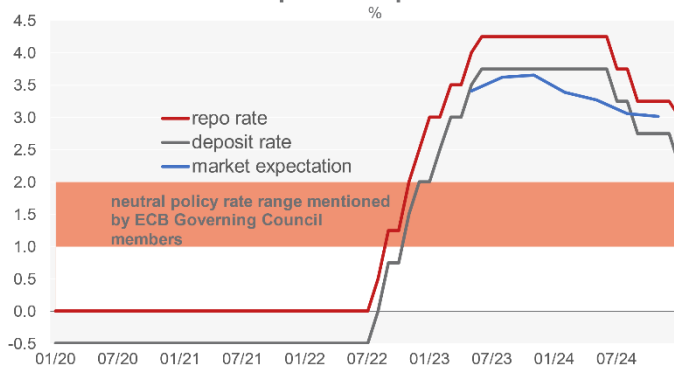


Source: Datastream, GIAM calculations

Hawkish ECB to lift the key rate to 3.75%

For the ECB the situation remains challenging. Core inflation is way too high and the inflation pressure is very broad-based. Latest comments from GC members were on balance hawkish suggesting that more tightening needs to be done. Especially strong wage growth is seen as a concern for the medium-term inflation outlook. While underlying inflation is set to come down, it will remain way above the ECB's comfort zone. Even when considering the risk of over-tightening, we think that the ECB will opt for 50 bps hikes in the next two meetings (March, and May) before ending its tightening cycle with a further 25 bps hike that lifts the depo rate to 3.75% by June. While this view is in line with current market expectations, we differ with markets by expecting that the peak rate will be maintained until mid-2024 at least. Only thereafter amid a more benign core inflation outlook, do we see leeway for a less restrictive policy stance.

ECB peak rate persistence



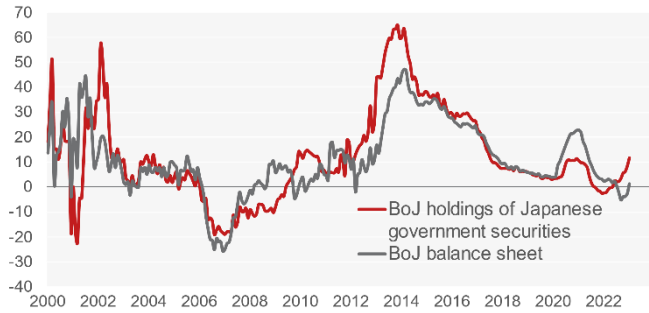
Source: Datastream, ECB, GIAM calculations

Japan

Christoph Siepmann

Growth of BoJ balance sheet and asset purchasing

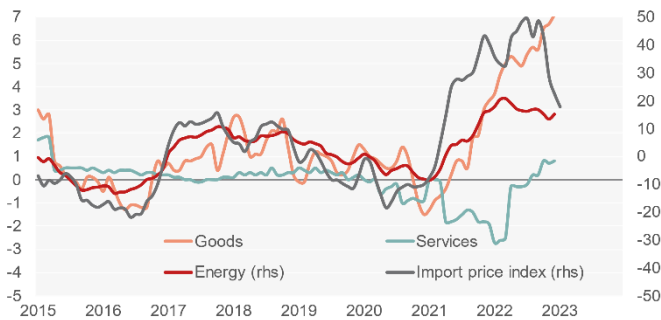
yoy, in %



Source: Datastream, GIAM calculations

Japan: Consumer and Import Prices

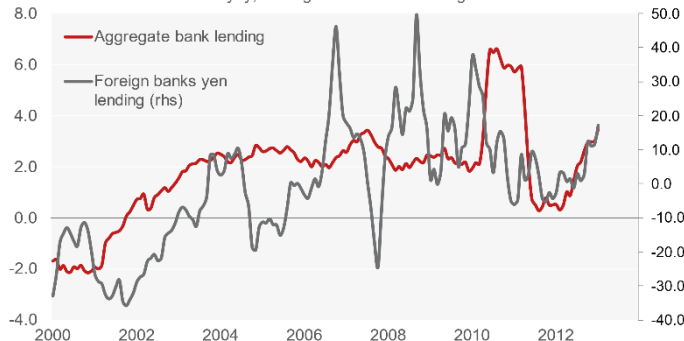
yoy in %



Source: Datastream, GIAM calculations

Aggregate Bank Lending

yoy, average amount outstanding



Source: Datastream, GIAM calculations

- **Incoming new BoJ Governor Ueda sees no need for a quick exit from the Yield Curve Control policy. We maintain our protracted exit view but risks are for an even slower process.**
- **Japan's economy seems to be slightly slowing while inflation should have passed its peak.**

In two Parliament hearings, Bank of Japan Governor nominee Kazuo Ueda positioned himself close to the views of the outgoing Governor Kuroda. His inflation diagnosis maintains the view of inflation being predominantly supply-side driven (energy, import prices) which central banks should not fight immediately. He also seems to be reluctant to tweak the BoJ's easy monetary policy to address side effects. Instead, signals of a higher trend inflation would prompt a modified policy. This puts wage developments again into the focus. All in, Ueda dampened market expectations of a quick exit to the current yield curve control (YCC) policy, while also conceding that any change would need to come as a surprise. He also suggested the BoJ could spend quite some time on a fundamental policy review, acknowledging that other factors than monetary policy also influence prices. That could be a hint that demographics could be given more weight in monetary policy concepts in the future.

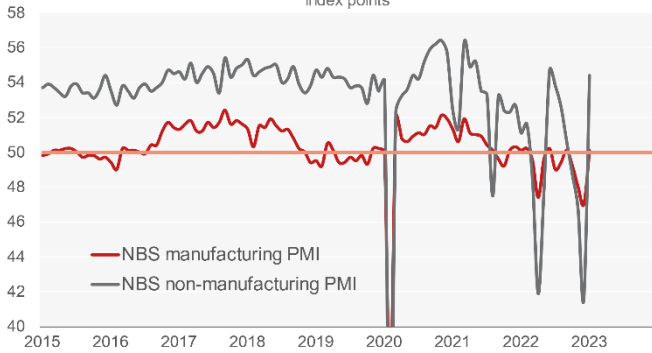
BoJ exit could even be delayed

For the time being, we maintain our view of a protracted BoJ's exit strategy. Nevertheless, risks are tilted towards an even slower process. We first see another widening of the 10y JGB yield band to 0.75% in Q2, before shortening the YCC to 5y maturities, before exiting YCC altogether. We see the negative interest rate (NIRP) policy to be maintained until 2024. Much depends on at least some wage increase to materialise. Some support is coming from recent news that wage agreements of two big car producers ended slightly above the 3% threshold. However, this cannot be extrapolated to the whole economy. Inflation rates should have peaked in January with headline inflation rising to 4.3% yoy, while core-core inflation rates increased to 3.2% yoy (ex fresh food and energy) or 1.9% yoy (ex food and energy). From January, electricity fares and gas prices will be subsidised which will start dampening headline inflation. GDP growth also seems to be softening. The flash manufacturing PMI remained in slightly contracting territory as well as the Reuters Tankan. Export growth eased further (but remained above consensus). However, retail sales could still benefit from post-Covid demand. The softening economy and receding inflation rates suggests, that the BoJ is unlikely to be in a hurry. We revised our GDP growth forecast for 2023 slightly down to 0.9%.

China

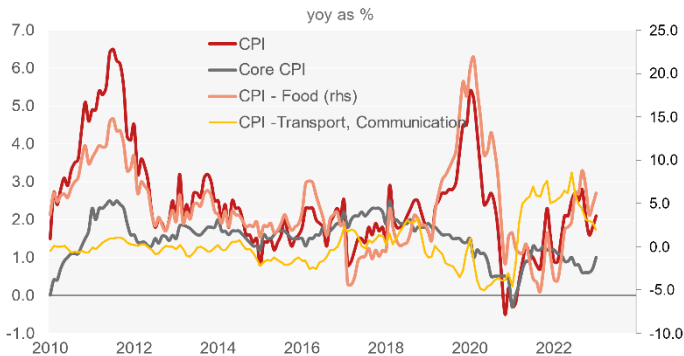
Christoph Siepmann

NBS Purchasing Managers Indices
index points



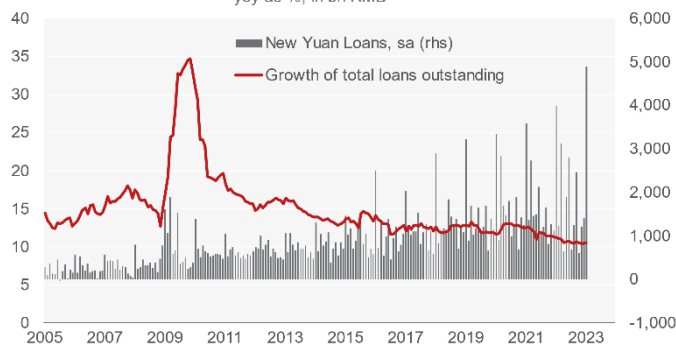
Source: Datastream, GIAM

China: Consumer Price Inflation
yoy as %



Source: Datastream, GIAM calculations

China: Bank Loans
yoy as %, in bn RMB



Source: Datastream, GIAM calculations

- **High-frequency indicators suggest that China's post-Covid recovery is underway.**
- **The National People's Congress will probably confirm supportive monetary and fiscal policies but not provide a "big-bang".**

China offers only limited information concerning the current Covid situation. The government rejected fears that the holiday season might have spread the virus to the countryside. Some news suggests that the city population has been already infected by 80%, thus approaching "herd immunity". However, China also declined to publish Covid death rates. Economic news is also limited in January due to the Chinese New Year holidays. Some high-frequency data like traffic congestion in the 100 biggest cities recovered to pre-Covid levels, suggesting an ongoing return to normal. Domestic travel is estimated to be slightly above 50% of 2019 readings, while Hong Kong visits seem to have soared. Travel abroad (e.g. Thailand) still looks underwhelming due to visa/passport issues. Overall, the data suggest that consumer demand is recovering, especially in the service sectors as they were disproportionately hit before. Going forward, the consumption recovery will be supported by pent-up demand. Excess deposits have risen significantly, estimated between 5% and 10% of GDP, although the rise is also the result of the drop in property purchases, the willingness to repay mortgages ahead of time, precautionary savings as well as a reduction in the use of wealth management products. However, we expect private consumption to be the main driver of the recovery although not as strong as in other countries as China did not support households by additional transfers. This also suggests that the rise in consumer price inflation will remain more limited. We expect an increase towards 3% yoy by the end of the year, from the latest readings of 2.1% yoy headline (1.0% yoy core) inflation rate.

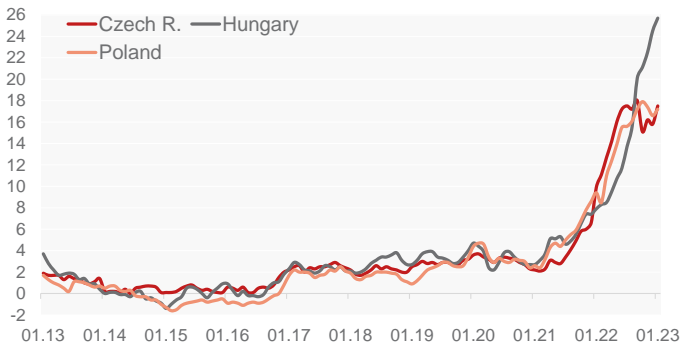
Real estate recovery is more protracted

By contrast, property sales look to have remained weak although some "green shoots" were reported in cities where downpayments and restrictions on second home purchases were loosened. Given the government support for developers and new initiatives for completing unfinished projects, trust in the sector should return over time. The PBoC already added more mortgage flexibility and may ease again the 5y MLF rate by 10 bps to foster the process. Fiscal policy will also remain supportive. We expect the National People's Congress (NPC), starting on March 5, to announce a slightly wider fiscal deficit and Local Government special bonds of RMB 4 tr, while setting a growth target between 5.0 to 5.5% for 2023. We forecast an overshoot to 5.7%.

Central and Eastern Europe

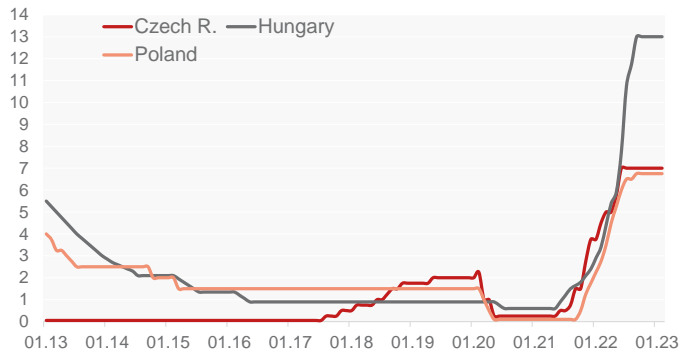
Radomír Jáč

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



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

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



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

Main Forecasts

Czech Republic	2021	2022f	2023f	2024f
GDP	3.5	2.5	0.5	3.0
Consumer prices	3.8	15.1	10.6	2.2
Central bank's key rate	3.75	7.00	5.00	3.00
Hungary	2021	2022f	2023f	2024f
GDP	7.1	4.6	0.3	3.5
Consumer prices	5.1	14.5	15.0	4.5
Central bank's key rate	2.40	13.00	9.00	4.50
Poland	2021	2022f	2023f	2024f
GDP	6.8	5.2	0.3	3.4
Consumer prices	5.1	14.3	13.7	4.8
Central bank's key rate	1.75	6.75	6.75	4.50

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

- **Headline inflation rose across the CE-3 in January but without any major surprise. Moderation in annual CPI is expected from February or March onwards but inflation targets will be reached only in 2024 or later.**
- **First data for Q4 reported that GDP declined across the CE-3. Detailed statistics are yet to be released, we expect them to reveal weak household consumption and in Poland also volatile inventories. We expect a weak full-year GDP growth across the region in 2023.**
- **The CE-3 central banks left their policy unchanged so far in 2023. While interest rates reached their peak, there is no hurry to shift the policy stance. We keep our view that the Hungarian MNB is likely to start in H1 a gradual exit from its current tight policy regime.**

Inflation increased in the CE-3 countries in January, often with important role of energy and auto fuel prices, which comes as no surprise. Czech headline CPI reached 17.5% yoy. It should start to moderate from February onwards, reaching single-digit numbers around mid-2023. Hungarian CPI (25.7% yoy in January) and Polish CPI (17.2% yoy) are expected to start to moderate from March at the latest. Weaker domestic demand, more favourable energy prices and statistical base effects should drive the disinflation.

CE-3 economies contracted in Q4: GDP fell by -0.3% qoq in Czechia, -0.4% qoq in Hungary and -2.4% qoq in Poland. Detailed data are yet to be released and we expect them to show a weaker household consumption, as real disposable income has been falling due to high inflation. Czechia and Hungary fell into recession in H2, and data from Poland indicate a weak start to 2023. While GDP growth over total 2022 was solid in the CE-3, the full-year growth in 2023 will be weak, even if GDP recovers nicely in qoq terms.

CE-3 central banks: a steady hand approach prevails

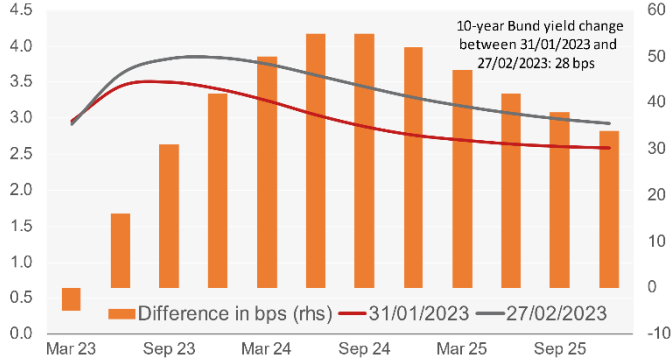
Monetary policy in the CE-3 was left unchanged so far in 2023. The Czech CNB kept its key rate at 7%. Stable rates are the most likely scenario for H1. We expect rate cuts in H2 (falling inflation, strong CZK). In Poland, the NBP is likely to keep its key rate on hold at 6.75% in 2023 (with a risk of a first rate cut already before the end of 2023). The Hungarian MNB is due to announce its monetary decision on February 28 afternoon and is widely expected to keep its tight policy stance with an O/N deposit rate at 18% as the key tool. We keep our view that the first step towards policy easing in Hungary (via a cut in O/N rate) can be announced in March when the MNB will have a fresh macro forecast.

Government Bonds

Florian Späte

EA Money Market: Increasing exp. 3m rates

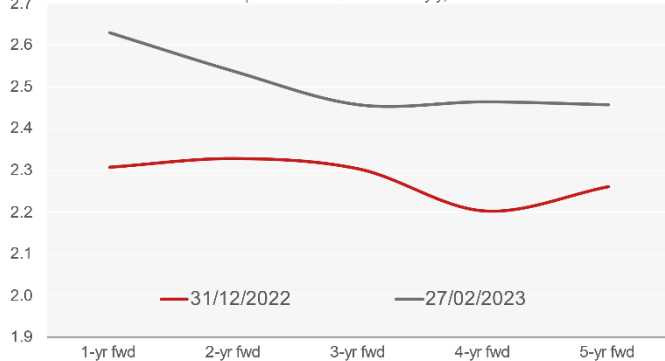
Change between 31/01/2023 and 27/02/2023



Source: Bloomberg, GIAM

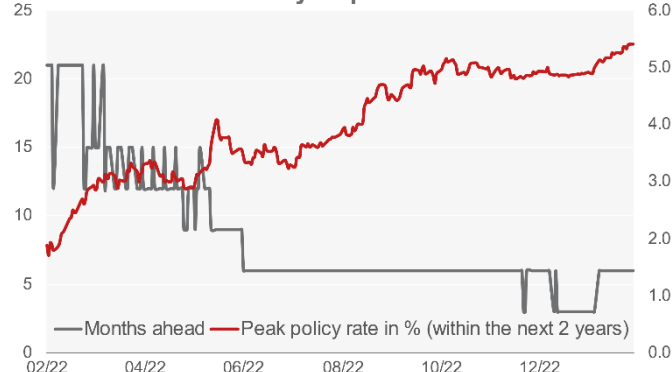
EA: Inflation to remain on an elevated level?

Market implied annual CPI inflation y/y, in %



Source: Bloomberg, GIAM calculations

US: Peak of rate cycle pushed further back



Source: Bloomberg, GIAM

- As highlighted last month the recovery of international government bond markets proved shaky. Driven by higher key rate expectations yield curves bear flattened across regions.
- However, given the yield levels reached, the air for a further increase is becoming significantly thinner. Since we do not see any catalyst for lower yields in the short term, we assume a sideways trend on elevated levels for the time being before particularly US yields are likely to fall again.
- EA non-core bond spreads have digested the sell-off well. Going forward, a less friendly market environment and the start of Quantitative Tightening (QT) is forecast to trigger a moderate spread widening.

After an unexpectedly good start into the new year, the correction of international bond markets was all the more severe in February. Driven by higher inflation expectations yields across all tenors and regions rose significantly in the past month. Particularly yields of shorter tenors marked new long-time highs at the end of February.

The sell-off was driven by good economic figures and inflation data that exceeded expectations. In combination with predominately hawkish central bank comments, key rate expectations have shifted upwards and further into the future. At the end of January, the ECB deposit rate was forecast to peak at 3.5% in July, and for the Fed a little above 5% was priced in June. Meanwhile, the corresponding peaks have risen to well above 3.75% in December (ECB) and over 5.5% in September (Fed).

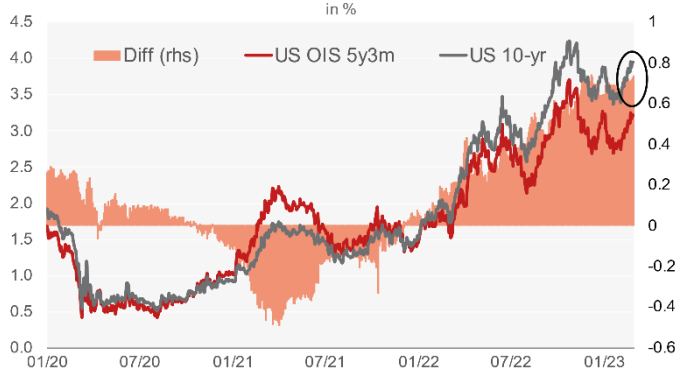
While in January we were still betting that yields would rise significantly, the forecast is becoming more difficult at the higher level. Although we do not consider current levels to be sustainable, we do not see any trigger for a sustained turnaround in bond markets in the short term. This is all the more true as we have raised our Fed peak rate expectation to 5.75%, which is still higher than expectations currently priced. Having said that, the risks appear increasingly skewed to the downside in the event of disappointing data or less hawkish statements from central bank officials. Accordingly, we anticipate a sideways movement in the months to come at the yield levels that have been reached. We forecast that US Treasuries will outperform Bunds.

Further down the road, we see leeway for lower yield levels. This applies in particular to US yields. Regardless of recent data, we forecast the US inflation rate to trend downward. This should be supported by our below consensus growth

Government Bonds

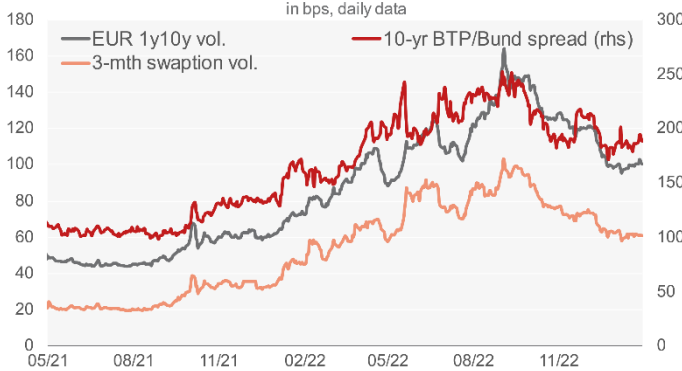
Florian Späte

US yields overshoot medium-term key rate



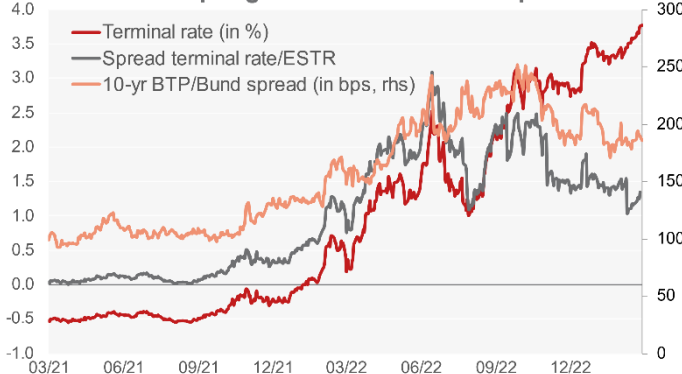
Source: Bloomberg, GIAM

Decreasing volatility supports - so far



Source: Bloomberg, GIAM calculations

Decoupling of terminal rate and spreads



Source: Datastream, GIAM calculations

forecast. Even if the US recession is not as severe as forecast a few months ago and will probably not start until Q4, it will still contribute to a normalization of the inflation environment. Additionally, the Fed will have reached the peak of the cycle and will initiate a trend reversal (at least verbally) on a twelve-month horizon. While financial markets still expect a key rate of 4% by the end of 2024, we assume more significant key rate cuts next year. Accordingly, we forecast 10-year US yields to fall to 3.5% on a one-year horizon (forwards: 3.85%).

On the contrary, we forecast growth above consensus in the EA in 2023. Nevertheless, long-term Bund yields are likely to trend downwards over the year as well, since inflation rates priced over the medium term appear to be quite high and have some downward potential (despite emerging upside risks to wages). However, the decline is seen to be more moderate than in the US (12-month 10-year Bund forecast: 2.40%). It appears less clear whether short-dated Bund yields are already in the overshoot phase. We do not even rule out that short-term 2-year Bund yields can rise slightly and remain around the elevated level on a 1-year horizon as well. Hence, we see further flattening potential for the Bund curve.

QT to start – one more burden for EA non-core bonds

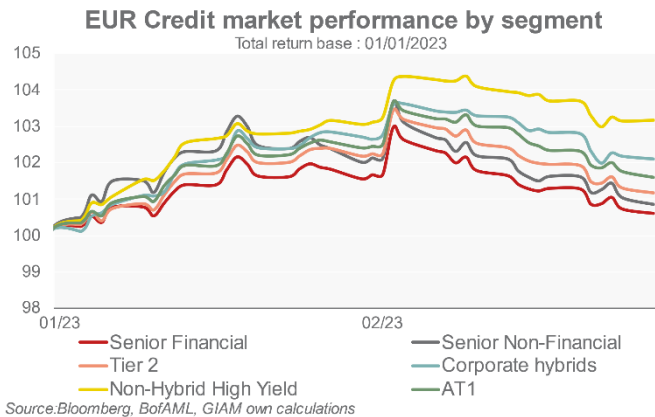
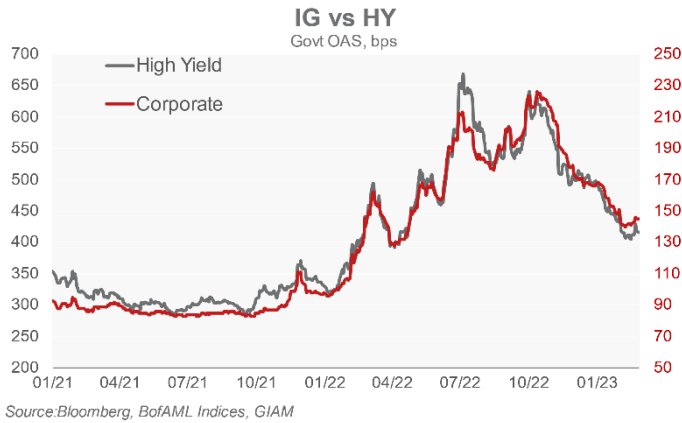
EA non-core bond spreads trended sideways in February. The brightening economic outlook and the friendly market environment supported government bonds perceived as riskier. Hence, they have coped well with the increase in yields.

Going forward, we advise exercising some caution. Since autumn spreads have shown a close correlation with bond market volatility. However, more recently the connection has become less tight and a further decrease in bond market volatility (which we deem likely in the medium term) is seen to be less of a support going forward. Additionally, APP QT will start in March with a monthly volume of € 15bn on average (PEPP redemptions will keep fully reinvested at least until 2024). This implies that around 40% of maturing sovereign bonds will not be reinvested until June. This share is forecast to double from July and it cannot be ruled out that the ECB will not reinvest maturing bonds in H2 at all. This is happening at a time when Japanese investors are already reducing their investments in foreign bonds. French bonds in particular were recently affected, but given the high volume, Spanish bonds appear vulnerable, too.

All in, we forecast EA non-core bond spreads to widen moderately going forward. However, this is partially offset by the carry, so that the underperformance is only moderate.

Credit

Elisa Belgacem



- After the tightening in credit spreads, especially in the CDS space, we expect IG spreads to trade in a range. We see some widening potential for HY (+100bp) over a 3-to-6-month horizon.
- We maintain our OW stance on IG. Current CDS levels are attractive to buying credit protection.
- We do like IG duration even though curves are already very flat. We maintain our neutral stance on financials versus non-financials and our preference for subordination risk versus credit risk.

Valuations metrics among the credit universe show that the European IG space is the cheapest compared to US IG and both EU and US HY. In 2022 Europe was considered the most impacted from the Ukrainian conflict and its consequences, and IG credit widened substantially compared to US credit. The picture looks different now with Europe likely avoiding recession and the US possibly entering one later this year. Technicals should be relatively neutral in EUR IG, with QT acting as a negative in the first half of 2023, but supply should also be limited, especially in non-financials. On the contrary US credit is starting to see outflows, as the yield of money markets is very close to IG.

US credit is more at risk than European one

On the fundamental side, default numbers have been higher in Europe in 2022 compared to the US which was uncommon over the past 15 years. Yet US defaults are likely to not only catch up but also surpass European default numbers by the end of the year. We do expect both regions to end 2023 with 4% default, almost doubling from current numbers. Hence, we do favour European credit to US.

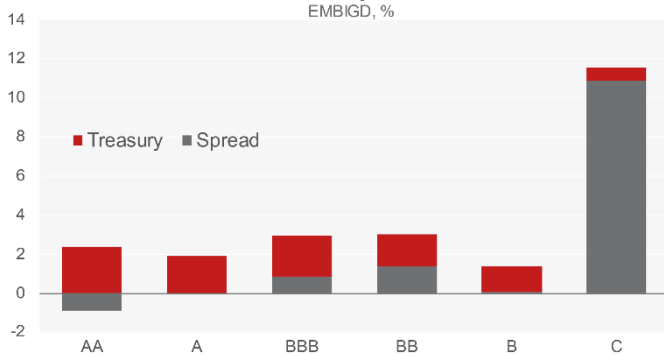
Prefer long IG and subordination risk to pure HY

Overall, we prefer IG to semi-core and peripheral sovereigns, on valuation grounds. In Europe, IG levels are still attractive after the rally versus historical standards. We expect spreads to trade around current levels over the course of next year. For HY, we think that current valuations do not reflect elevated risks. Consequently, we expect spreads should widen nearly 100bp in the first half of 2023 before ending the year 50 -60p wider compared to current levels. CDS have tightened much faster than cash, and we like to buy credit protection here. Also, we expect smaller companies to be the most at risk. Hence banks' asset quality should also deteriorate, which leads us to remain underweight financials versus non-financials in spread terms. However, as the carry is now higher in the financial space as spreads have substantially diverged over the course of 2022, we are neutral in total return terms.

EM sovereign bonds

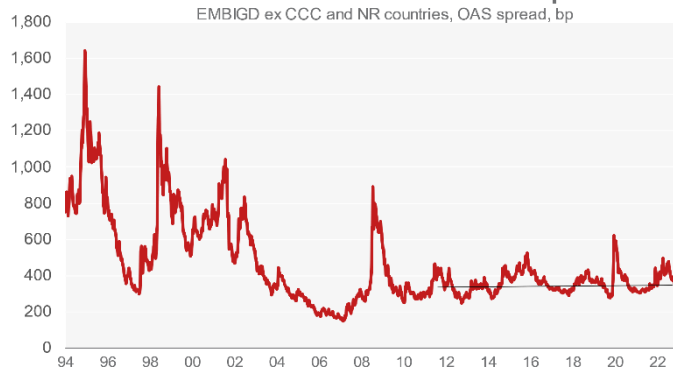
Guillaume Tresca

Return decomposition YTD



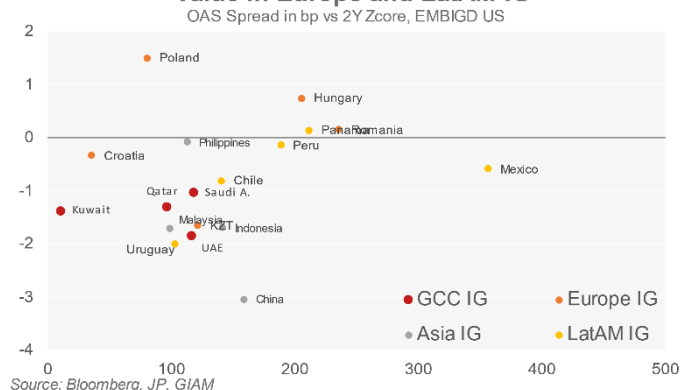
Source: JP, Bloomberg, GIAM

EM external debt is not cheap



Source: Bloomberg, JP, GIAM

Value in Europe and LatAM IG



Source: Bloomberg, JP, GIAM

- The EM environment has turned more uncertain and EM assets should trade sideways in the short term. We maintain a neutral stance on external debt.
- EM spreads will widen as valuations are expensive and technicals less supportive. However, the total return will be positive thanks to the strong carry.
- We maintain our IG preference, especially BBBs. Europe IG and to a lesser extent LatAm IG are attractive.

EM asset outlook has turned more uncertain, benefiting from the repricing of global growth but hurt by the risk of more rate hikes by DM central banks and a USD rebound. In EM, the disinflation process will also take longer than expected and more EM central banks are turning more hawkish. In the short term, we see a few compelling reasons for a bounce back. It will need the strength of the January data to be reversed and so far, it is quite the opposite with more indicators of sticky inflation and a resilient global economy. EM outlook is more supportive than in 2022 but it is better to maintain a neutral stance after a strong start to the year.

Wider external debt spreads but still a positive return

EM external spreads have been resilient, especially in the IG space, but the risk is for wider spreads and higher risk premia: valuations remain expensive both in IG and HY, especially with 1Y US standing at 4.8%. Moreover, financial conditions tighten, and EM external debt will adapt to the new terminal rate. EM spreads historically tend to move higher when US real yields go up. Finally, technicals are less supportive. EM did not reprice significantly the move seen since October and EM investors are less UW now. That said, short-term total return will remain positive, essentially driven by the carry. Carry can absorb a 3M spreads widening of 25bp.

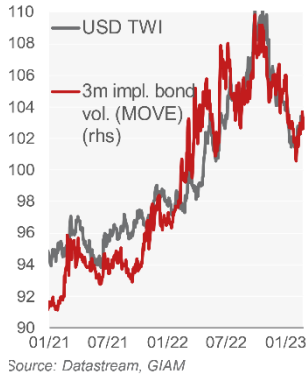
IG is still the name of the game

We maintain our preference for EM IG over HY. It has failed to perform but BBs are the best performers year-to-date and higher terminal rates/tighter financial conditions will weigh more on HY. It remains that value in the IG space is stretched and we focus on BBBs. Region-wise, Europe IG and to a lesser extent LatAm IG are attractive. In Europe, Hungary and Romania continue to trade cheap vs their ratings. Downgrade risk in Romania is low while in Hungary, there is enough room until HY. Mexico is tight by historical standards, but it still offers a high pickup vs. its rating peers. The tight fiscal stance, the proximity of the US and near-shoring prospects are positives.

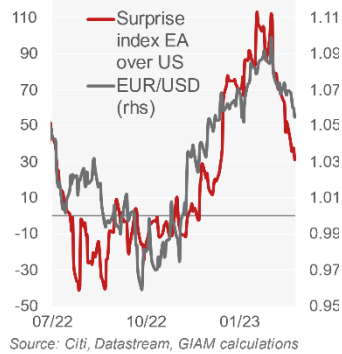
Currencies

Thomas Hempell

Yield uncertainty and USD



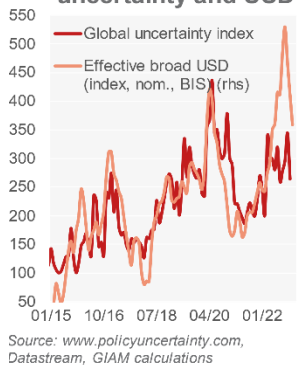
Economic surprises and EUR/USD



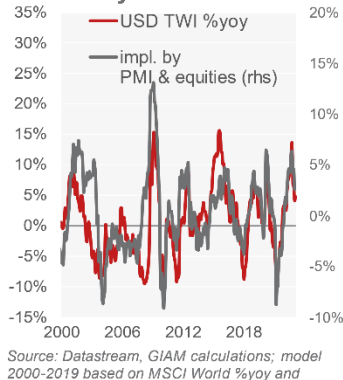
- After USD recouped all its year-to-date losses, the USD may hold its ground short term.
- Yet the recent USD bounce is unlikely to mark a trend reversal. With Fed rates reaching peak levels over the summer and disinflation sluggishly proceeding, easing rates uncertainty and more robust global growth data will erode demand for the safe-haven greenback.
- The EUR is set to find mounting support from capital inflows and a narrowing yield gap vs. the US.
- We also see JPY resuming its ascent. Yet a likely only cautious unwinding of YCC under the new BoJ governor and higher US rates will make the path more gradual and volatile than anticipated before.

Resurgent market worries about more protracted inflation and improving US data surprises have made the USD recoup all losses incurred earlier in the year (top left chart). Over the coming weeks, persistent uncertainties, US data resilience (top right), and shaky risk sentiment may help the USD to hold its ground.

Global policy uncertainty and USD



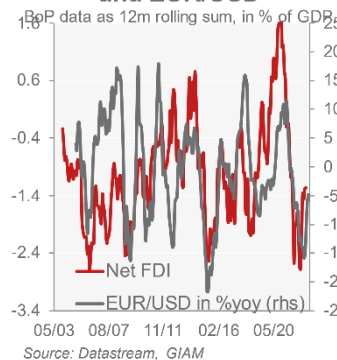
Anticyclical USD



Yet further out, we deem USD weakness unfinished. The USD is still dear on several metrics (fair value, PPP, real-effective exchange rate), but is also still in overshoot territory vs. policy uncertainty (mid-left chart). Recoveries in Europe and China will dent safe haven for the USD (mid-right).

But we also see more genuine strength for the EUR. We expect the transatlantic yield gap (mostly at shorter maturities) to narrow as the Fed will eye earlier and bigger rate cuts in 2024 than the ECB. With Europe having escaped a much-feared energy crunch more sustainably and energy prices having greatly receded, the terms-of-trade shock will partially reverse while capital inflows are likely to further gain momentum (bottom left).

Euro area: net FDI flows and EUR/USD



USD/JPY and yield gap

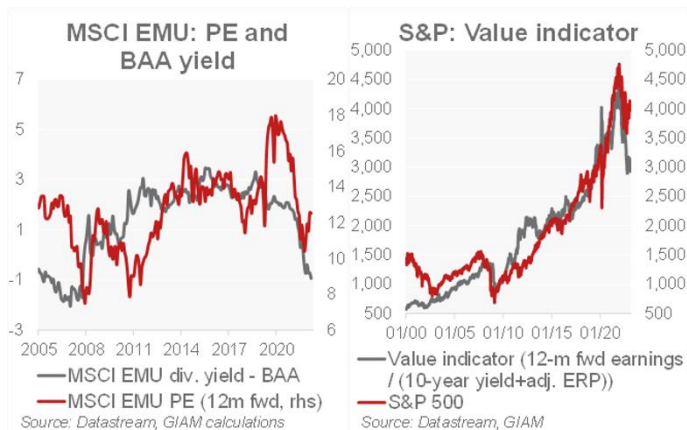
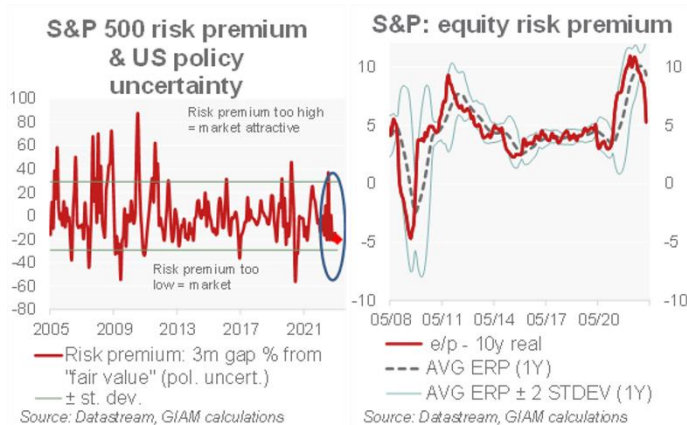
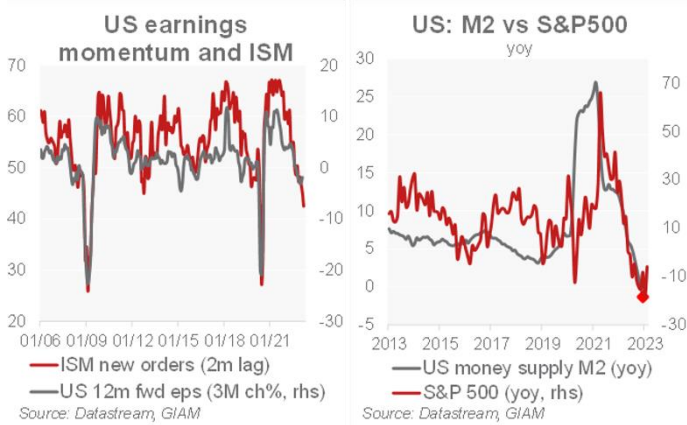


JPY ascent to prove more gradual and volatile

JPY has suffered a stronger setback as US yields have spiked and the designated new BoJ governor Ueda pushed back against a quick unwinding of yield curve control (YCC). Yet with wages likely to gain momentum in spring, we still expect the BoJ to pursue a gradual exit from its still very strong accommodation. An accelerated exit has become less likely after recent remarks by Ueda, but still bears the risks of a strong bounce in yields and the exchange rate. JPY may also benefit from a narrowing trade deficit by easing bills of oil and gas imports. Higher US rates and uncertainty regarding the BoJ policy transition, however, may make the JPY's ascent more gradual and volatile than expected before.

Equities

Michele Morganti, Vladimir Oleinikov



- **Mounting inflation worries at central banks are diminishing chances of a goldilocks scenario.**
- **Earnings and margins forecasts have still the potential to see downgrades. We do not expect a major profit downturn but analysts' consensus is likely to be downgraded by 3% to 10% for the years 2023-2025.**
- **US financial conditions look increasingly topish after having improved since the autumn. Negative signs also come from the M2 momentum, yield curve, housing confidence, and the risk premium (too low).**
- **Valuations remain in an uncomfortable zone, too, unless the cycle surprisingly accelerates from here at a robust pace, which is not our base scenario.**
- **We see equities generating limited positive returns over the next 12 months. That said, we will look for better entry levels once the slowdown and further policy tightening are fully priced in.**
- **Sector overweights: Banks, Durables, Div. Financials, Food Retail, Healthcare Equipment, Software and Utilities. Underweights: Comm. Prof. Services, Media, Materials (new), Insurance (new) and Pharma.**

The recent further escalation of the CBs' hawkish stance is contributing to mitigating the ongoing goldilocks scenario. 10-year rates have increased markedly together with both equity and bond volatility, not boding well for equity valuation in absolute terms as well as relative to bonds.

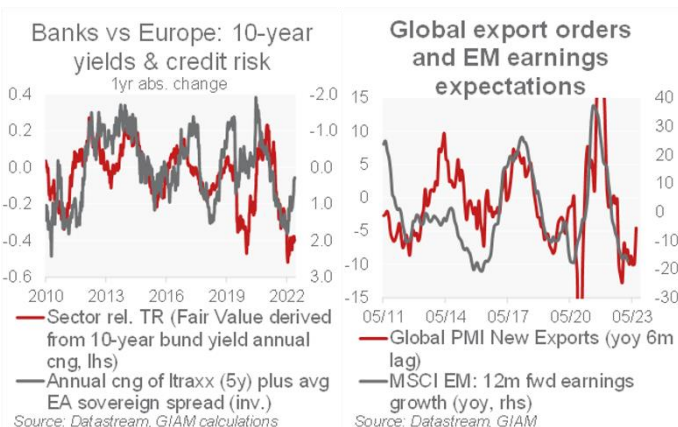
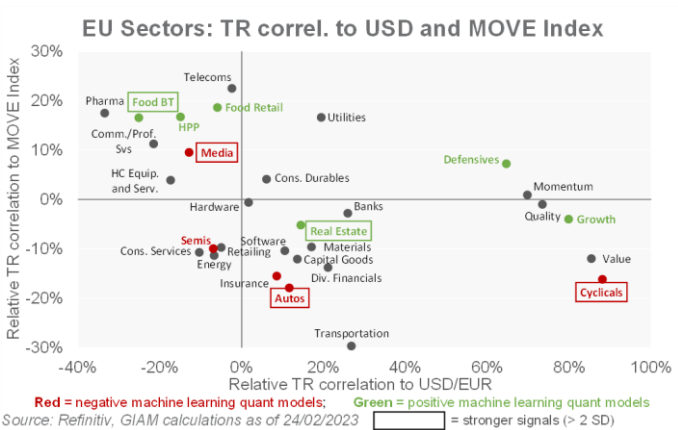
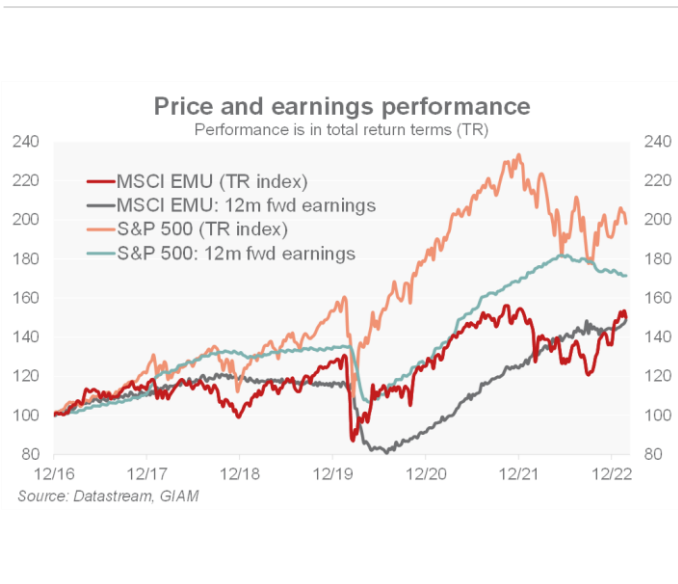
Earnings and margins are getting weaker

Earnings forecasts have downgrade potential. The ISM and the CB Leading indicator are pointing south. For the time being, the EA has seen net upgrades but macro surprises are rolling over after having reached a cyclical high and the stronger euro should start to represent a headwind. The Q4 reporting season has already shown a clear growth deceleration, esp. large caps. The median sector reported an earnings growth of -6% yoy, from flat in Q3. Margins are coming under pressure, too, and should remain so in the months ahead. Our models see the bottom of NIPA growth variations (yoy) by the end of this year and the first quarter 2024. Overall, they should come out flat in 2023 (-0.9% yoy) and up to 5% in 2024. This is not a major profit downturn but it should nonetheless cause the analysts' consensus to be downgraded by 3% to 10% for the years 2023-2025.

Furthermore, the US financial condition index is looking increasingly topish after having improved for almost a year. The M2 momentum (yoy) remains negative, too. Other negatives come from the yield curve and the risk premium.

Equities

Michele Morganti, Vladimir Oleinikov



As for the former, a pronounced and long lasting negative yield curve is not boding well for the future business cycle evolution. This could at some point scare investors. The same applies for the very low level of confidence in the real estate sector (NAHB index and existing home sales). The risk premium is quite low compared to the last 20-year historical average. It looks even too low relative to the current level of political uncertainty index, the relative momentum of VIX vs. bond volatility (MOVE index) and, finally, when compared to the confidence range in the last year (± 2 st.dev.). Finally, on valuation, markets remain at risk, mostly due to higher rates and credit spreads. Over one year, we see limited positive total return (TR), for the S&P 500 (+1.5%) and the EMU index (+4%). These are based on our earnings forecasts and PE target (16.5X USA and 12.5X EMU). But all other methodologies which compare market multiples to current yields and spreads would see downside unless the business cycle is expected to improve sensibly from here (which is not our base case). Finally, concerning risks, other than sticky core inflation, the Ukrainian conflict does not look to abate soon.

Slightly UW equities

We remain cautious short term while acknowledging that positioning is neutral at best. As said, we expect equities to generate a small positive return in 2023 and we will look for better entry levels once the slowdown and further policy tightening are fully priced in.

Recommended allocation

Within countries, we take a reduced OW EMU vs US. Higher OW is on UK, Japan and China. EU Sectors: UW Insurance vs Banks (relative earnings revisions, machine learning – ML). We lower Capital Goods to neutral (expensive in relative terms, negative Fed model's gap, neutral on ML) and Materials to underweight (high valuation). OW Banks, Durables, Div. Financials, Food Retail, Healthcare Equipment, Software and Utilities. UW Comm Pro Services, Media, Materials (new), Insurance (new) and Pharma.

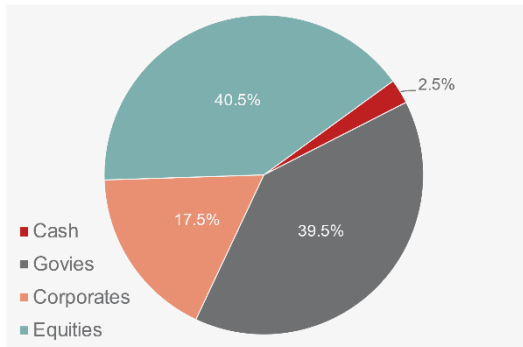
EM equities: to benefit from stimulative China's policy

EMs still lag in performance EM stocks (Z-score of -0.7). Increasing EM PMI levels and, in particular, global export orders point to possible bottoming-out of EM earnings. This is reinforced by China's reopening and the very positive momentum of money supply (M2). Additional positive factors are the weaker USD, low China's PE, and moderate inflation. We expect more boost to the economy following the political "two sessions" of NPC plenary meetings in March. We still overweight China while acknowledging geopolitical tensions among risks.

Asset Allocation

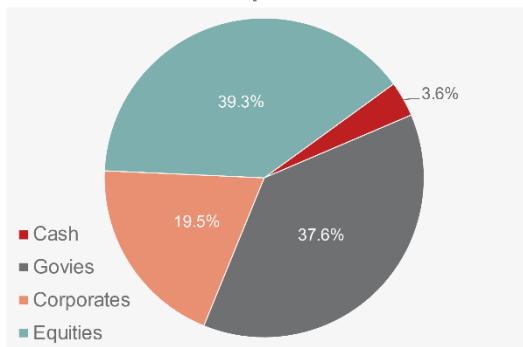
Thorsten Runde

Benchmark



Source: GIAM

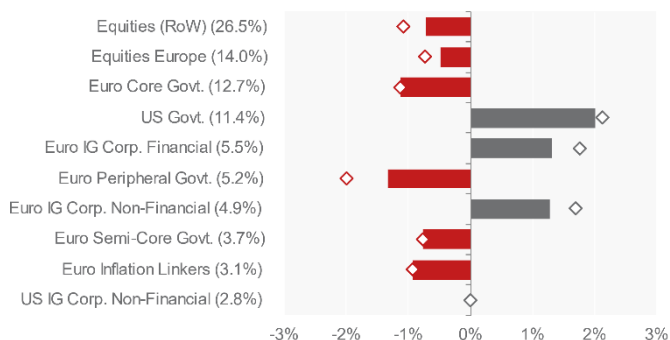
Modelportfolio



Source: GIAM

Active Positions

TOP 10 Benchmark Constituents



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

- The total return picture painted by market in February (24.02.23) is much more heterogeneous than one month before.
- With around +1.3% only European Equities ex EMU were able to stay safely in positive territory. Cash, Inflation Linkers, and EMU Equities just made it above the zero line.
- Long-dated Govies and EMs suffered particularly in a range from -2.6% for EM Govies to -5.7% for US Treasuries 10Y+.
- EA IG Fin and Non-Fin are on par with around -1.0%, thereby clearly underperforming HY by -100 bps.
- The most recent bounce in Equity and HY does not seem to fit the still subdued fundamental outlook. Corporate earnings should suffer amid stagnating (EA) or even mildly receding economic activity (US in H2). Near term however, receding yield worries and fading risks of a European energy crunch might still prove supportive.
- Thus, we basically stick to our defensive allocation stance. But we slightly trim our active positions. We reduce the UWs in Equities and BTPs by taking exposure from IG Credit, EM Govies, and US Treasuries.

With around -5 bps the relative performance of our model portfolio was again negative in February (24.02.23). The underweight positions in Cash proved most rewarding with slightly more the +1.8 bps, followed by around +1.1 bps generated by the overweight in IG Credit and +0.5 bps resulting from the underweight in North American Equities.

Most recently Equity markets surprised with bounce despite central banks continuing to hike rates, just on a more dovish interpretation of the wording. This overly optimistic reaction of course harmed the performance of any defensively aligned portfolio.

Two-sided risk setting

The recent rally in risk sentiment does not seem to fit the economic prospects that well. That said, receding yield worries, a less likely European energy crunch, and China gaining momentum might bring some relief in the near term. Thus, we basically confirm our defensive tactical alignment at the expense of Equities and BTPs but to a slightly trimmed extent. We cut the overweight in EM bonds by half given their outstanding increase in the past weeks. We avoid yield risk by keeping the duration exposure close to neutral.

Forecasts

Macro Data

Growth ¹⁾	2022	2023		2024		2025
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	2.0	0.6	0.3	1.2	0.1	1.5
Euro area	3.3	1.0	1.0	1.1	- 0.1	1.4
Germany	1.7	0.3	0.8	0.7	- 0.7	1.7
France	2.5	0.5	0.4	0.8	- 0.4	1.8
Italy	3.9	0.5	0.5	1.1	- 0.0	0.8
Non-EMU	3.6	- 0.3	0.4	1.0	0.1	1.6
UK	4.1	- 0.5	0.5	0.7	0.1	1.5
Switzerland	2.1	0.8	0.3	1.7	0.0	1.2
Japan	1.2	0.9	- 0.3	1.1	- 0.0	1.0
Asia ex Japan	4.1	5.1	0.6	4.9	- 0.4	4.9
China	3.0	5.7	1.1	5.0	- 0.3	4.7
CEE	1.6	0.2	0.4	3.2	1.1	2.9
Latin America	3.7	0.8	0.0	1.7	- 0.1	2.2
World	3.3	2.4	0.4	2.9	- 0.0	3.0

Inflation ¹⁾	2022	2023		2024		2025
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	8.0	4.5	0.7	2.6	0.1	2.0
Euro area	8.4	5.5	- 0.4	2.5	0.1	2.3
Germany	8.6	6.5	0.1	2.7	- 0.2	2.5
France	5.9	4.2	- 0.6	2.4	0.1	2.2
Italy	8.7	6.4	- 0.2	2.4	0.2	0.6
Non-EMU	8.0	5.8	- 0.4	2.0	- 0.7	1.8
UK	9.1	6.5	- 0.7	2.1	- 1.0	1.7
Switzerland	2.9	2.2	0.0	1.2	0.0	1.3
Japan	2.5	2.5	0.6	1.5	0.3	1.3
Asia ex Japan	3.5	3.4	0.3	3.0	1.1	2.9
China	1.9	2.6	0.3	2.4	0.1	2.4
CEE	29.6	17.7	0.3	8.2	- 2.4	6.2
Latin America ²⁾	7.8	5.2	0.7	3.9	0.5	3.1
World	7.8	5.4	0.3	3.3	0.3	2.8

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

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

Financial Markets

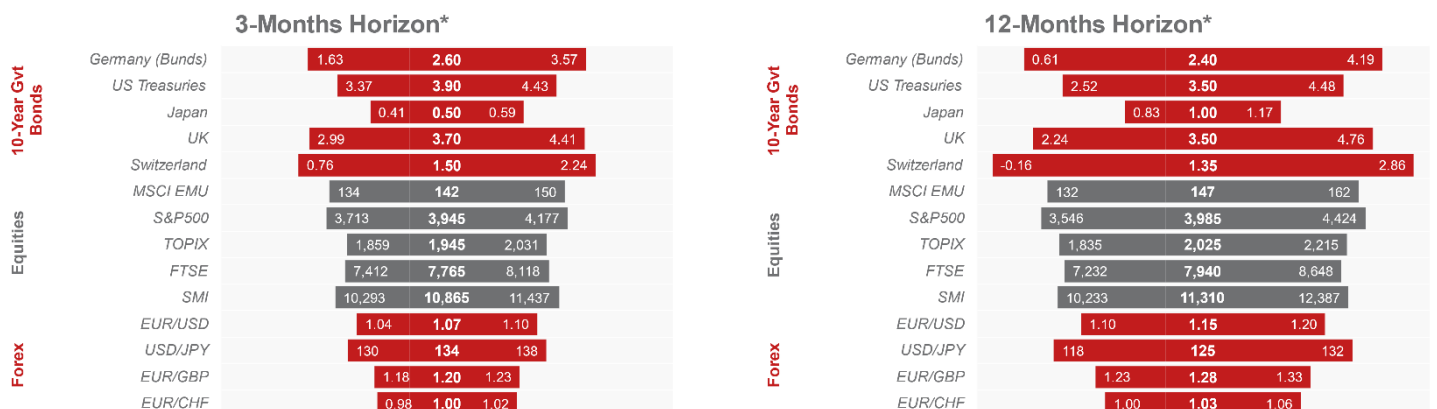
Key Rates	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
US	4.75	5.25	5.22	5.75	5.36	5.75	4.64
Euro area	2.50	3.50	3.31	3.75	3.63	3.75	3.45
Japan	-0.10	-0.10	0.03	-0.10	0.09	0.00	0.22
UK	4.00	4.25	4.39	4.25	4.64	4.25	4.28
Switzerland	1.00	1.50	1.45	2.00	1.71	2.00	1.80
10-Year Gvt Bonds							
US Treasuries	3.92	3.90	3.90	3.80	3.87	3.50	3.82
Germany (Bunds)	2.51	2.60	2.51	2.55	2.50	2.40	2.46
Italy	4.31	4.55	4.47	4.55	4.51	4.50	4.59
Spread vs Bunds	180	195	196	200	202	210	212
France	2.99	3.10	3.02	3.05	3.03	2.95	3.05
Spread vs Bunds	48	50	51	50	53	55	58
Japan	0.50	0.50	0.59	0.75	0.64	1.00	0.76
UK	3.62	3.70	3.69	3.65	3.68	3.50	3.72
Switzerland	1.41	1.50	1.43	1.45	1.43	1.35	1.43

Credit Spreads**	Current*	3M		6M		12M	
		Forecast	Fwd	Forecast	Fwd	Forecast	Fwd
EA IG Non-Financial	137	145		150		145	
EA IG Financial	159	165		175		165	
EA HY	424	500		525		500	
EM Sov. (in USD)	339	355		365		365	
Forex							
EUR/USD	1.06	1.07	1.06	1.10	1.07	1.15	1.08
USD/JPY	135	134	134	130	132	125	128
EUR/JPY	143	143	142	143	141	144	138
GBP/USD	1.20	1.20	1.20	1.24	1.21	1.28	1.21
EUR/GBP	0.88	0.89	0.88	0.89	0.89	0.90	0.89
EUR/CHF	0.99	1.00	0.99	1.01	0.98	1.03	0.97
Equities							
S&P500	3,991	3,945		3,960		3,985	
MSCI EMU	146.1	142.0		143.5		147.0	
TOPIX	1,980	1,945		1,975		2,025	
FTSE	7,906	7,765		7,805		7,940	
SMI	11,243	10,865		11,015		11,310	

*3-day avg. as of 24/02/23

**ICE BofA (OAS)

Forecast Intervals



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

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