



**GENERALI**  
INVESTMENTS

# Market Perspectives

## Choppy, not murky

February 2021



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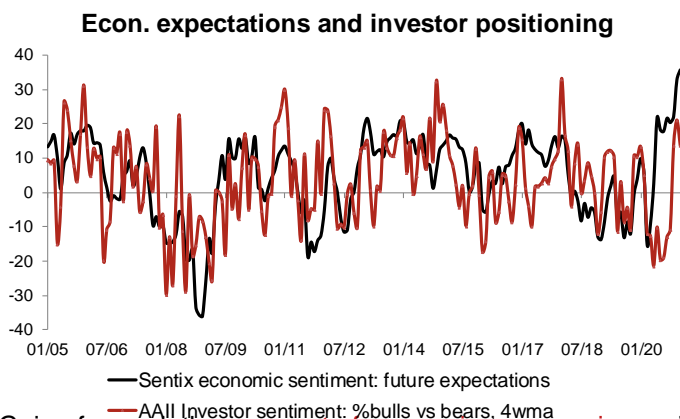
This document was completed on January 29, 2021

# Global View – Choppy, not murky

Thomas Hempell / Vincent Chaigneau

- A prospective economic boom into spring/summer, the clearing of tail risks and an impending US fiscal stimulus still bode well for risky assets.
- Yet with parts of the markets looking frothy, correction risks require more vigilance. Elevated Covid-19 cases in Europe and tighter lockdowns on new mutations may test investors' recovery hopes. A looming spike in US inflation may test central banks' yield curve control and valuations alike.
- We retain our pro-risk tilt, but slightly trim Credit and Equity overweights. Setbacks may offer buying opportunities into the spring economic acceleration.

Our increased preference for risk assets, even after the November rally, has paid out well, with the MSCI World up another almost 5%. Emboldened by the rollout of vaccines and a nearing economic rebound, investors have kept looking through rising Covid-19 numbers and bouncing US yields. The clearance of tail risks has played its part. The last-minute UK/EU trade deal has finally taken a hard Brexit nightmare off investors' minds and Poland and Hungary dropped opposition to the EU budget and Recovery Fund, avoiding a stalemate. The pre-Christmas US fiscal deal (\$900bn) and Georgia-induced "blue wave" (more fiscal support coming) also helped.



Going forward, the prospect of re-opening economies amid progressing vaccination still matters most for risk sentiment. US Congress will likely water down President Biden's push for an extra US\$ 1.9 tr stimulus, but this may still prove powerful enough for a >6% rebound of the US economy this year. A strong start into the reporting season and the reassurance by major central banks that they will stick to their highly accommodative policies for longer will continue to underpin risk appetite and the search for yield.

## Frothy markets requiring higher vigilance

Yet with selected market segments getting frothy and market positions very consensual, higher vigilance is required. First, the rally since November has been fuelled

by high recovery hopes (chart). Positions are generally not extreme, but more vulnerable to disappointment if new mutations and a sluggish vaccine rollout in Europe delay the onset of the recovery. Retail buying has contributed to the equity rally, but we find it reassuring that the bullish sentiment (e.g. AAII survey) has flattened out through January. Retail trading (r/WallStreetBets) has pushed selected stocks to crazy levels and caused a pick-up in volatility but we see limited implications for the broader markets insofar Hedge Funds losses and "de-grossing" do not lead to broad deleveraging and capitulation.

Second, while we expect yields to back up only mutedly amid central banks' de facto yields curve control, risks are tilted towards a stronger bounce. US inflation will rise temporarily into spring mostly on base effects, but also due to fiscal stimulus, pent-up demand and higher commodity prices. Inflation expectations and yields could temporarily overshoot, posing a threat to elevated valuations in many market segments, including Growth and Tech stocks.

Bonds	27/01/21*	3M	6M	12M
10-Year Treasuries	1.03	1.10	1.20	1.35
10-Year Bunds	-0.54	-0.50	-0.45	-0.40
<b>Corporate Bonds</b>				
BofaML Non-Financial	91	85	80	75
BofaML Financial	92	85	80	75
<b>Forex</b>				
EUR/USD	1.21	1.23	1.25	1.28
USD/JPY	104	103	102	100
<b>Equities</b>				
S&P500	3819	3845	3895	3990
MSCI EMU	128.8	130.0	130.5	134.5

\* avg. of last three trading days

## Setbacks as buying opportunities

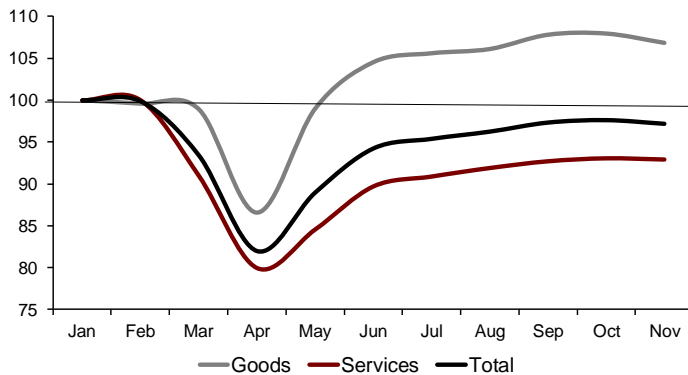
Ultimately, we deem such setbacks as buying opportunities. With vaccination capacities now building rapidly and economies learning to better cope with the virus, the 2021 recovery may be delayed but not derailed. While there are upside risks to US prices, low underlying inflation trends remain the much stronger challenge to central banks in the euro area and most other advanced economies amid wide output gaps and high unemployment.

In our tactical positioning, we trim our overweight in Credit and Equities (with a preference for Cyclical and Value), mirrored by milder underweights in Cash and Core Govies. We still like EM exposure in Equities and Fixed Income, with our focus in the latter on safer higher-yielding issuers that have lagged the recent rally.

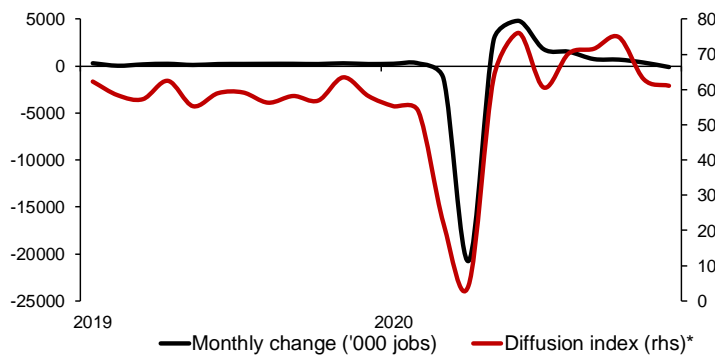
# USA

**Paolo Zanghieri**

**Real personal consumption expenditure**  
January 2020 = 100

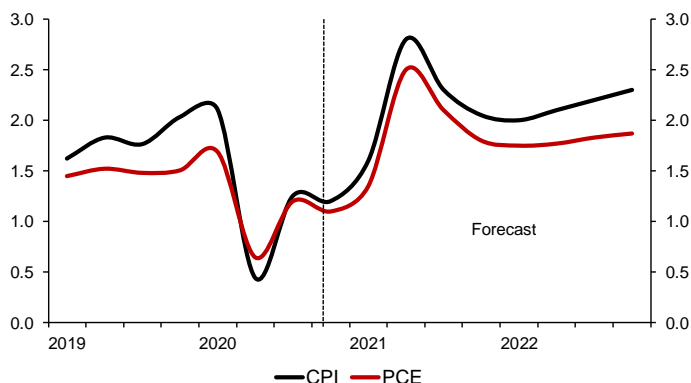


**Payroll growth**



\* net % of sectors with mom increased employment

**Inflation**



- The encouraging evolution of vaccination and the prospect of another round of fiscal stimulus led us to revise up our 2021 growth forecast to 6.1%.
- Short term risks related to the evolution of the pandemic remain elevated, but mainly for the sectors most exposed to the virus. Construction is booming and manufacturing is picking up.
- With limited inflation pressure and a labour market still in need of support, the Fed will remain accommodative. Talks of asset purchase tapering are postponed to at least the end of the year.

We expect the incoming administration to engineer a stimulus package worth around US\$1tn. The new resources could flow into the economy in Q2, adding to the boost to domestic demand provided by the easing of restrictions, allowed by large scale immunisation. As a result, we now expect the economy to grow by around 6% next year, after the 3.5% fall in 2020.

## Short-term risks related to the pandemic

However, the path to the growth rebound will not be smooth. In the short-term activity-related risks remain high, but mostly confined to the industries most affected by the health emergency. The data for the last part of the year continue to show a “K-shaped” profile for the recovery, with goods producing sectors rebounding much faster than services. Low rates and the changing patterns for housing created by the diffusion of working from home are leading the surge in construction activity: In December building permits increased by 17.3% yoy and in November house prices were up by 9.5% yoy (against a 2019 average of around 3.5%). Manufacturers’ orders for nondefense durables were up by 8.4% in December. On the contrary, personal consumption expenditure was in November still 2.4% lower than a year before, dragged down by services. Declining activity in leisure and hospitality explains most of the employment fall seen in December (-140k). The rest of the private sector continues to add jobs at a pace of around 400k per month.

## Inflation is not an issue and the Fed has a job to finish

Market worries about a spike in inflation are not warranted in [our view](#). Over the next few months base effects related to last spring’s price fall and strong demand may bring CPI inflation temporarily above 2.5% yoy. Yet the gradual reabsorption of labour market slack will ensure only a moderate increase afterwards. We do not expect core PCE inflation to reach the 2% target before the end of 2022. This leaves the Fed plenty of scope to maintain the current accommodative stance. The Fed funds rate should remain within the 0-0.25% range until mid-2024 at least and talks of tapering asset purchases may emerge only at the end of the year. At the FOMC January meeting, chair Powell recalled that returning to full employment still requires action by the Fed and did not flag any risks related to the upward pressure to equity valuation low rates are contributing to.



# Euro Area

Martin Wolburg

- The latest worsening of the pandemic induced tighter stringency measures. That said, we still think that the start of vaccination will give rise to a recovery.
- In sum we revised our 2021 growth forecast down to 4.0%.
- The ECB made clear that it will stay at the side-line for the time being.

Over the past weeks the pandemic situation worsened. The second wave of Covid-19 infections triggered tighter stringency measures across all economies. Even more, the arrival of more infectious virus mutations led to an extension of stringency measures well into the first quarter of the year. At the same time, the vaccination rollout has started. But production bottlenecks and logistical problems will likely delay the point at which the full vaccination of critical groups will allow a more substantial easing of stringency measures. In our base scenario we postponed this to May (from April) and see herd immunity that would allow almost fully dropping restrictions to be reached only by autumn (instead of summer).

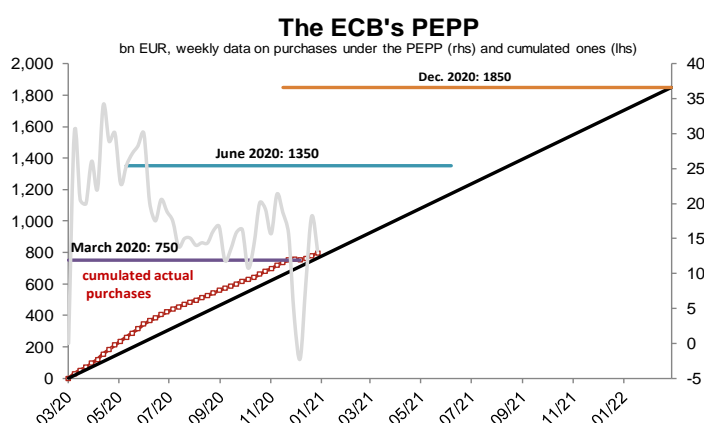
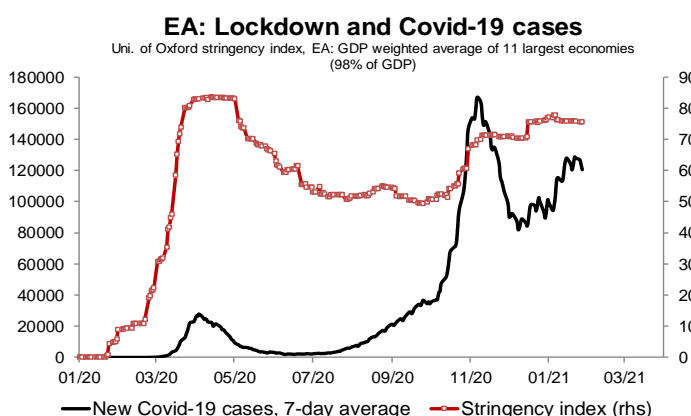
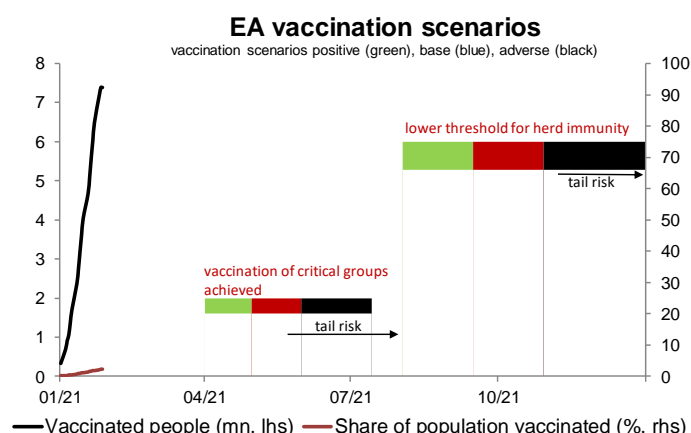
## Recovery postponed into summer

Activity is receding at the outset of the year. The January composite PMI fell to 47.5 (lowest since June) thereby remaining in clearly contractionary territory. We expect activity to shrink throughout Q1/21 so that with an also negative Q4/20 reading the euro area is currently in recession. We now expect activity to recover strongly only from Q3/21 onwards.

We have revised our 2021 growth outlook to 4.0% (from 5.3% before) but still expect a return to pre-crisis activity by year-end 2021. The risks are tilted to the downside and primarily related to lockdown measures but also to the fallout from rising NPLs which will increase with the length of the crisis.

## ECB only to act if risk scenarios materialize

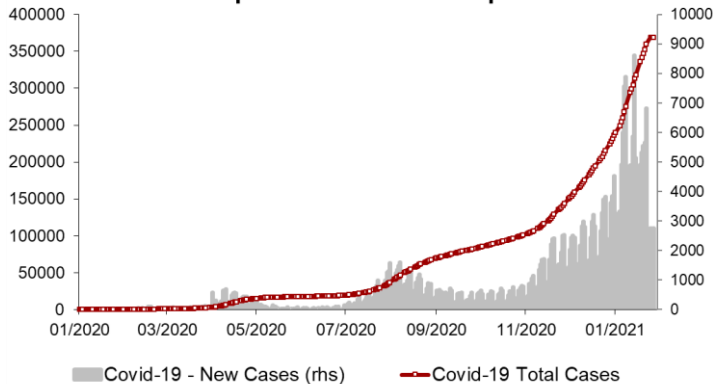
However, the ECB saw no need to act at its January meeting. Its macro assessment is still in line with the one in December when a bold package was launched. President Lagarde again praised the merits of the PEPP emphasizing its flexibility suggesting that purchases could be frontloaded and that financing conditions were still “*broadly favourable*”. She rather implied that the ball was now again in the field of the governments with a fast implementation of the Recovery Fund while keeping a generally supportive fiscal policy stance. In March the Governing Council will reassess the situation amid updated macro projections. In case of the current level of lockdown measures being maintained well into the second quarter we expect the discussion about additional support measures to start. In this case we deem another extension of the PEPP becoming highly likely.



# Japan

**Christoph Siepmann**

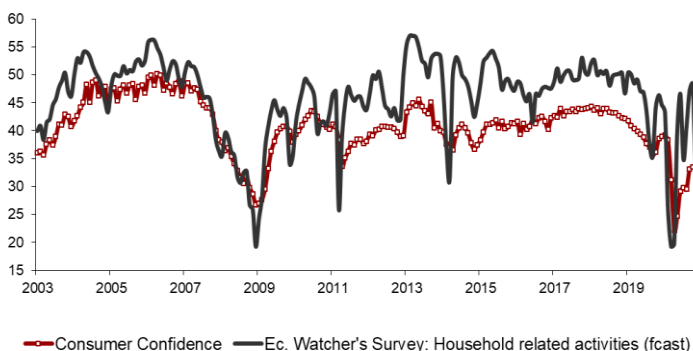
**Japan: Covid-19 development**



- A fresh Covid-19 wave will likely push Q1 2021 GDP growth again into negative territory.
- In December, headline CPI dropped to -1.2% yoy while core-core inflation receded by 0.4% yoy.
- The BoJ will review its policy in March. It is unlikely to touch its yield curve control but may tweak some special implementation measures.

Japan is in the midst of a third Covid-19 wave with fresh infections reaching new highs. In early January, PM Suga announced emergency measures for Tokyo and surrounding prefectures which were later extended to additional regions. They now cover about 60% of GDP. Measures were announced for roughly one month, but the risk is elevated that they need to be extended. However, the blow to the economy is likely more confined than in spring last year as they are more targeted towards the leisure and hospitality sector while encouraging work from home. January real activity readings will worsen. December industrial production as well as retail sales already slowed on a mom basis. Nevertheless, the strong rebound in October 2020 will guarantee another substantially positive GDP growth rate in Q4 (after 22.9% qoq ann in Q3 2020). By contrast, we now expect Q1 2021 growth to turn negative again. The further outlook clearly depends very much on the vaccination progress. Inoculation will likely start in February. PM Suga has pledged to vaccinate the whole population in H1 2021, a promise that looks tough to fulfil. However, we continue to expect a rebound to begin in Q2. Support will also come from the December fiscal package. Given the weak start in Q1, we revised our forecast for 2021 to 1.8%. This translates into a 3.2% GDP rate for the fiscal year 2021.

**Japan: Consumer Confidence and Economy Watcher's Survey**

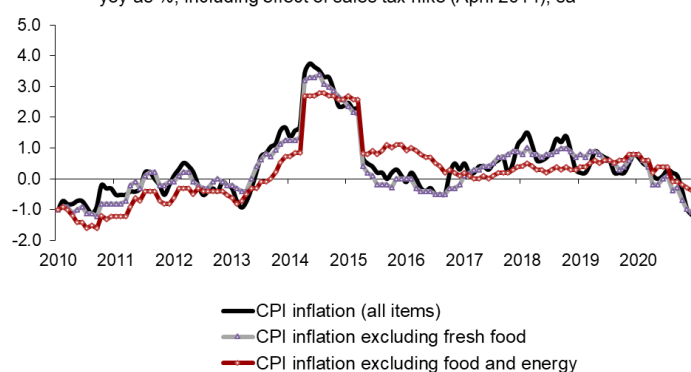


## BoJ to stand pat

Meanwhile Japan's headline CPI inflation dropped further to -1.2% yoy in December. The main negative drivers were "Fuel, light and water charges" as well as "Culture & recreation". In comparison, the core-core inflation (excl. fresh food and energy) receded only to -0.4% yoy. While energy prices are mainly responsible for the difference, other factors like reversed base effects (from the sales tax hike in Oct. 2019) as well as the "Go travel" subsidies also play a role. We expect the negative impact from the latter to vanish already in January as the program was suspended. While we expect the negative CPI rates to narrow over the next months, we forecast 2021 CPI inflation at -0.3%. Nevertheless, we expect the BoJ to stand pat regarding its yield curve control policy throughout 2021. Additional measures in terms of supporting funds cannot be excluded like the BoJ extended some deadlines in January. The focus regarding the BoJ now lies on its policy review in March. While no fundamental change is likely, the BoJ will probably tweak current policy to enhance sustainability and efficiency.

**Japan: CPI Inflation**

yoy as %, including effect of sales tax hike (April 2014), sa



# China

Christoph Siepmann

- China's Q4 GDP growth surprised on the upside, pushing 2020 growth up to 2.3%. December data came in a bit more mixed.
- China is witnessing a fresh Covid-19 outbreak, but absolute numbers are low.
- Given that the current Covid-19 outbreak can be contained, Beijing will embark on more policy normalization and revive its reform agenda.

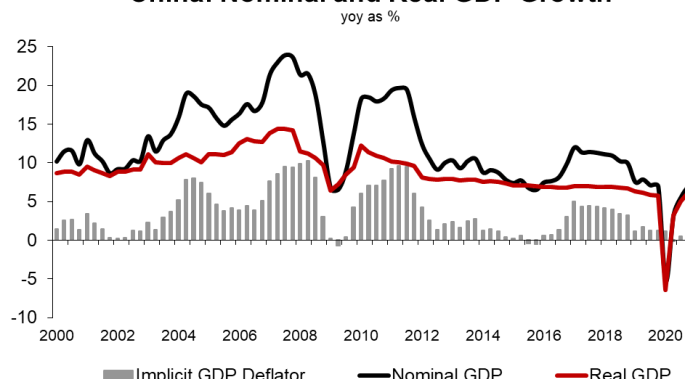
China is currently witnessing a rise in domestic transmitted Covid-19 infections. While the absolute level of fresh cases per day is low (about 100-150), Chinese authorities responded forcefully by quarantining at least 11 regions with about 29m people. China has still a good chance to contain the outbreak. However, consumer confidence will likely be negatively affected. Moreover, the Chinese New Year 2021 begins on February 12 (holidays extending from Feb. 11–17). Typically, this is a period of enormous travel which could also be hit by new restrictions. China aims at vaccinating 50m people before the holidays.

In terms of data, China's Q4 GDP growth surprised on the upside, climbing to 6.5% yoy, after 4.9% in Q3. This pushed total 2020 growth up to 2.3% which renders China one of a few countries around the globe with a positive GDP growth rate despite the Covid-19 pandemic. Meanwhile, December data were a bit more mixed. On the one hand, exports and IP remained strong. Exports came in again buoyant with a growth rate of 18.1% yoy (after 20.6% yoy in November) and IP even accelerated to 7.3% yoy. On the other hand, retail sales weakened to 4.6% yoy in December, from 5.0% in November. Urban fixed asset investment growth also softened slightly in yoy terms, but continued to rise on a cumulated basis (which are the official data). All in, while data were still strong, the pace of expansion could moderate a bit, going forward.

## Policy normalisation ahead

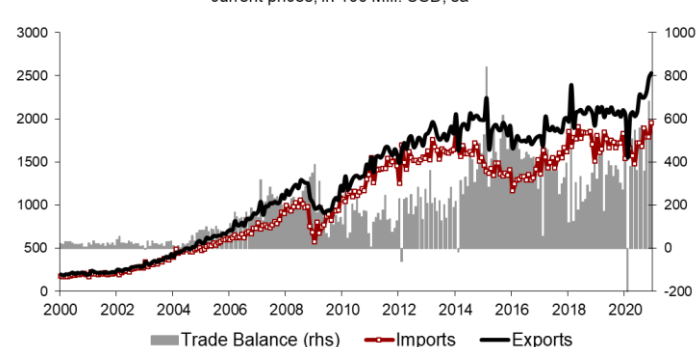
Assuming that the Covid-19 outbreak remains in check, the government will shift more and more to policy normalisation, and re-embark on de-risking as well as its reform agenda. Fiscal policy will turn less accommodative. We see the official deficit to return to 3% (from 3.6% in 2020) and no special CGB issuance any more. The PBoC will also reduce its support, mainly on the quantitative side while we do not expect any rate hike before very late this year. Accordingly, the credit impulse will turn negatively, suggesting that growth dynamics will recede over the course of 2021. In terms of de-risking, this will apply to the shadow banking sector and thereby also affect local government debt vehicles. In addition, the property sector will come under more scrutiny by the so-called "three red-lines" approach. The government will also pursue more its "dual circulation" strategy, which basically intends to render the Chinese economy less dependant on foreign demand and technologically more self-reliant.

China: Nominal and Real GDP Growth



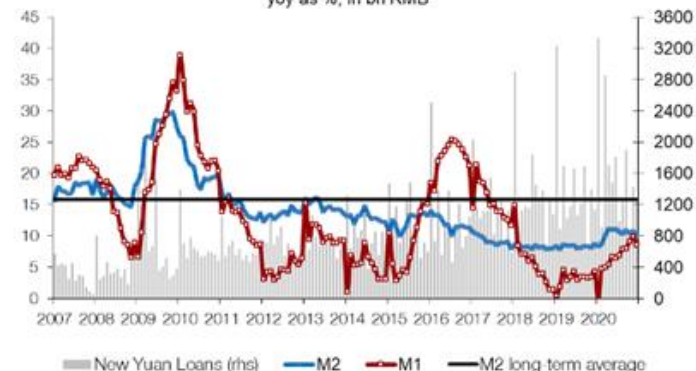
China: Foreign Trade

current prices, in 100 Mill. USD, sa



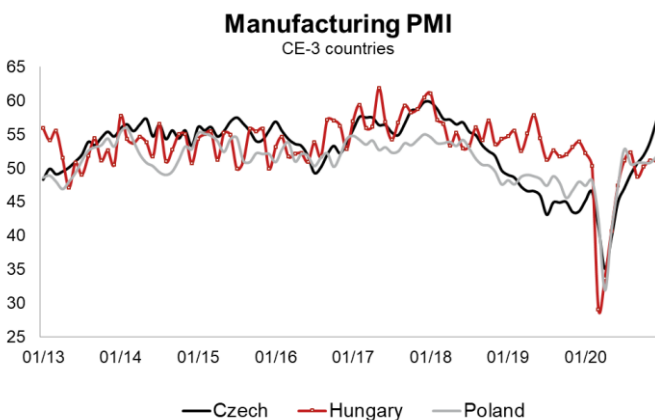
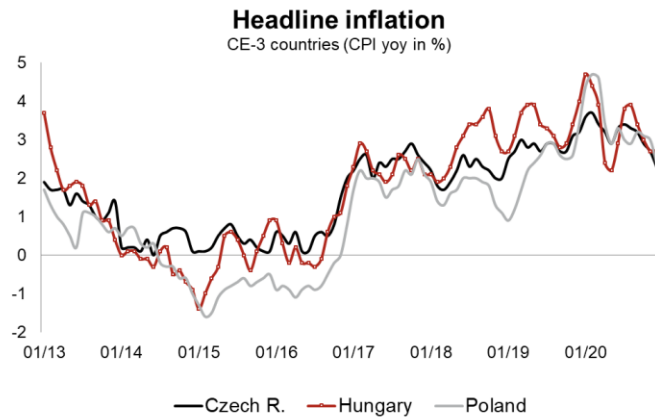
China: Money Supply

yoy as %, in bn RMB



# Central and Eastern Europe

Radomír Jáč



- The CE-3 economies are expected to report only a slight GDP contraction for Q4 2020 in qoq terms but lockdowns lead to a downward revision of growth forecast for 2021.
- Headline inflation moderated at year-end but core CPI remained high, which makes the CE-3 central banks reluctant to cut interest rates.
- The Czech CNB is likely to delay a rate hike while the Polish NBP intervened in the FX market in order to weaken the zloty at the year-end.

Surveys and monthly data indicate that the region will report a relatively modest GDP contraction in quarter-to-quarter terms in Q4 2020. While activity in services and retail trade was hit by pandemic restrictions, industry and foreign trade remained in full operation. This led us to raise forecasts for the full-year GDP outcome in 2020 for all CE-3 countries. However, at the same time we revised down growth outlook for 2021 as economic activity will be negatively affected by lockdowns at least in Q1.

Headline CPI fell below target in Hungary and Poland and just slightly above the target in the Czech Republic in December. However, core CPI stood well above 3% in all three economies, which led their central banks to stay cautious in their monetary policy considerations.

## Monetary policy interest rates to stay on hold

The Czech CNB left its key interest rate on hold at 0.25% in December. Its quarterly forecast released in November saw a first rate hike in Q2 with the key rate at 1.00% at end-2021. However, both headline inflation and core CPI came lower than expected in Q4 2020 while the CZK appreciation outperformed the CNB's forecast. We expect the CNB's new forecast, due in early February, to draw a later start of rate hikes and we keep our view that Czech monetary policy interest rates will stay on hold in 2021.

In Hungary, the MNB also stood on hold with the base rate at 0.60% and deposit rate at 0.75% at the MPC meeting held in late January. Although inflation declined to 2.7% yoy in the final months of 2020 (vs. target set at 3%), the MNB expects CPI to remain volatile in coming months and to exceed 3% on average in 2021. The central bank is thus likely to keep its deposit rate on hold at 0.75%, i.e. 15 bps above the base rate, at least until late March.

The Polish NBP kept its key rate on hold at 0.10% in January. Although several MPC members made dovish comments before the meeting, Governor Glapinski later said that stability in interest rates was a baseline scenario for 2021. The NBP intervened in the FX market in late December in order to weaken the zloty. While the central bank's P&L for 2020 was probably a factor behind the step, MPC said that intervention can be repeated if the zloty firms too quickly.

Main Forecasts	2019	2020e	2021f	2022f
<b>Czech Republic</b>				
GDP	2.3	-6.3	3.0	4.5
Consumer prices	2.8	3.2	1.8	2.2
Central bank's key rate	2.00	0.25	0.25	0.75
<b>Hungary</b>				
GDP	4.6	-6.3	3.4	4.3
Consumer prices	3.4	3.3	3.0	2.8
Central bank's key rate	0.90	0.60	0.60	0.90
<b>Poland</b>				
GDP	4.6	-3.0	4.0	4.6
Consumer prices	2.3	3.4	2.5	2.5
Central bank's key rate	1.50	0.10	0.10	0.75

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



# Government Bonds

Florian Späte

- Driven by fiscal stimulus hopes, US yields sold off at the start of the year. Euro area core yields did not follow amid extended lockdown measures. A common feature on both sides of the Atlantic was the further rise in inflation expectations.
- Looking further down the road the prerequisites for an increase in core yields are still given. However, we see higher US yields to be mainly driven by an increase in real yields while in the euro area inflation expectations have some leeway to catch up.
- After a strong start into the year euro area non-core markets entered choppy waters. The political crisis in Italy reminded market participants that the ECB will not react to idiosyncratic risks. Once a new government is formed, BTP spreads are likely to tighten again.

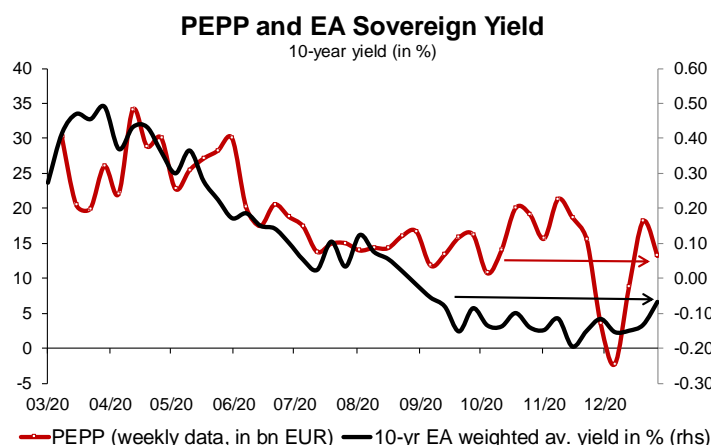
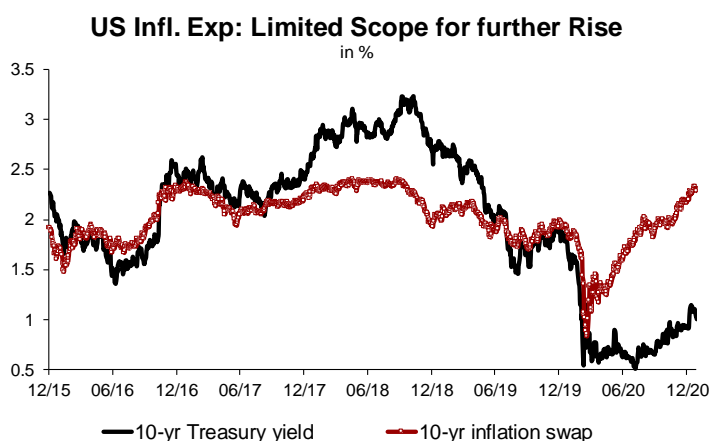
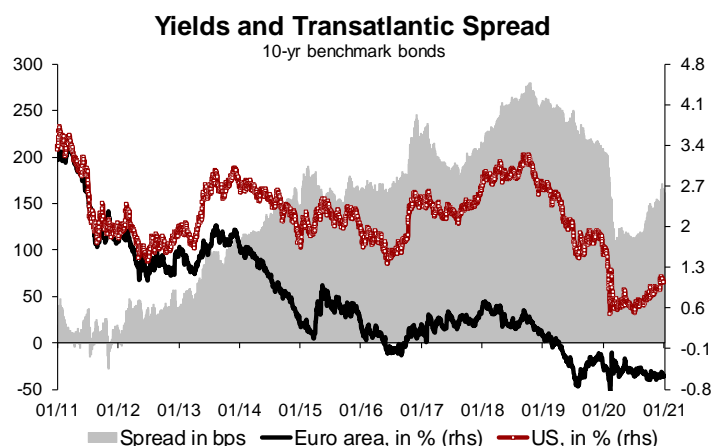
The victory of the US Democrats in the run-off elections in Georgia triggered a sell-off in US Treasuries at the beginning of January. Although the majority in the Senate is only razor-thin it will allow President Biden to implement a major part of his economic program. The resulting higher US fiscal deficit and increased Treasury supply are expected to pave the way to higher US yields. Still, 10-year US yields could not maintain the level of 1.15% and closed moderately above 1%. As short-term yields did not move on balance, the yield curve steepened further. Noteworthy, real yields hardly changed as the increase was almost exclusively driven by higher inflation expectations. At 2.30%, 10-year inflation swaps are close to a multi-year high.

Euro area core yields decoupled to a large extent. Long-dated yields inched up slightly and short-dated yields even fell in January. Strikingly, euro area inflation expectations rose as well. Eventually, real yields fell further in the euro area and are still trading close to historical lows.

## Rise in US yields not driven by inflation expectations

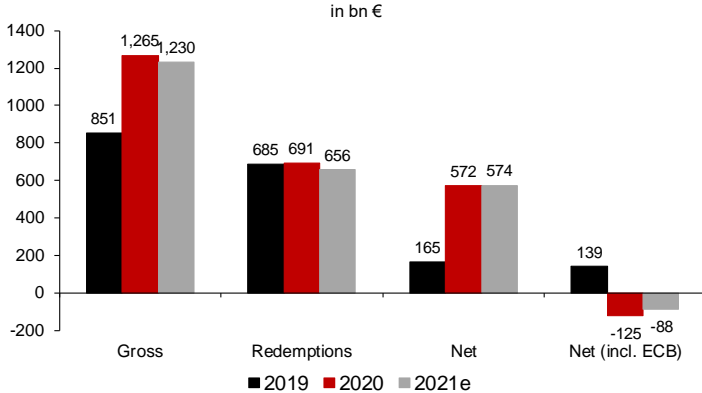
Although US inflation rates are seen to rise in the months to come this appears to be already priced by financial markets. Notwithstanding a high uncertainty about the future inflation path we do not expect significantly higher inflation rates in the medium term. Accordingly, a further lasting increase in long-dated inflation swaps is rather unlikely.

Hence, the bulk of the expected yield increase will be driven by real yields. The preconditions for this are given. US growth is set to rebound after a weaker start into the year. Moreover, supply remains a concern as the budget deficit is forecast to remain on a high level and the Fed will not absorb the complete net supply. However, the central bank remains flexible and will use forward guidance to prevent yields from going through the roof. On a 3-month

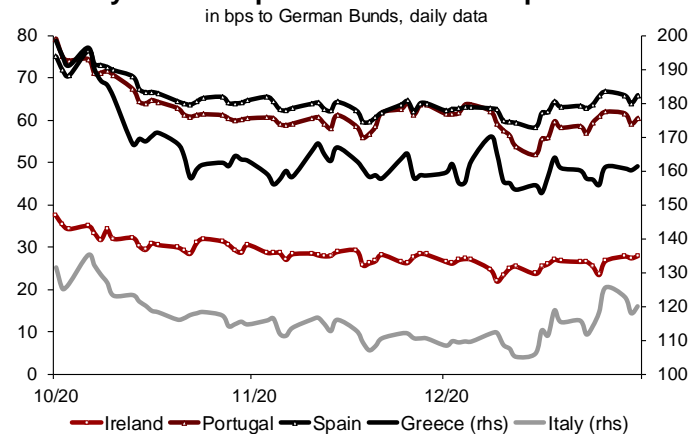


# Government Bonds

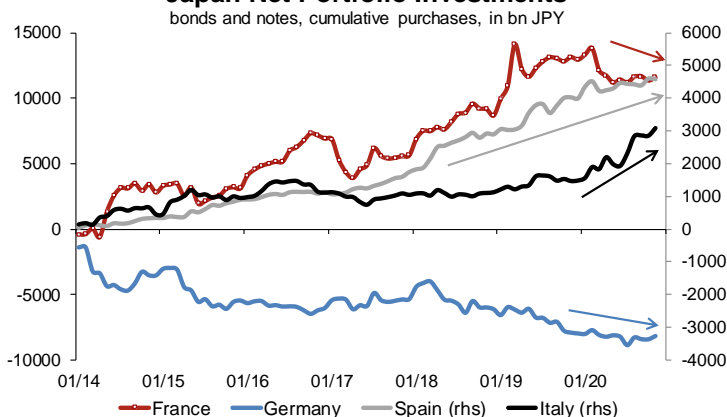
**Euro Area: Government Bond Issuances**



**10-year Sov. Spread Euro Area Peripherals**



**Japan Net Portfolio Investments**



horizon, we forecast 10-year US yield to rise to 1.10% and on a 12-month horizon to 1.35%.

The situation in the euro area differs a bit. Stronger mobility restrictions and problems with the roll-out of the vaccines have already triggered a reduction in growth forecasts. The extended lockdowns are expected to delay the economic rebound but they do not call it into question. Additionally, the ECB continues to intervene massively. In contrast to the Fed it will take down the complete net supply in 2021. This does not rule out that in Q1 net supply will be positive for seasonal reasons. Treasurers are particularly busy at the beginning of the year. However, the ECB increased its purchases only moderately after the holiday break. Accordingly, in the next weeks the central bank will not absorb the complete net supply. Moreover, treasurers are expected to term out debt to benefit from the very low yield environment. Still, in case core yields start to rise more meaningfully we expect the central bank to act quickly and to increase its purchases. Ultimately, the ECB has always emphasised the flexibility of its QE measures.

Nevertheless, euro area yields are forecast to rise moderately in the months to come. However, the composition is expected to differ from the US yield increase. Euro area inflation expectations are still rather low (10-year inflation swaps at 1.20%) and there is room for an increase. In contrast, real yields are likely to remain in deep negative territory. All in, we forecast 10-year yields to rise to -0.50% on a 3-month horizon and to -0.40% until the beginning of 2022.

## Political turmoil in Italy: not a game changer

After a good start into the year the political crisis in Italy spoiled the party. Although PM Conte survived a confidence vote he resigned afterwards amid shaky majorities. BTP spreads widened moderately but there was only limited contagion to other non-core countries (Portuguese spreads have even tightened slightly since the end of December).

The modest spread widening appears appropriate as snap elections remain a rather unlikely event. Even if euro-sceptical parties should prevail in snap elections, the consequences are forecast to be less severe as in spring 2018. The ECB is in a better position to calm financial markets and a possible confrontation with the EU is likely to be less severe.

The base scenario remains the successful formation of a new government. Once this is confirmed BTP spreads have scope to tighten again – but only when this is achieved. The search for yield in combination with the very low volatility ultimately leaves investors with no other choice.

# Credit

Elisa Belgacem

- In the first weeks of 2021, IG spreads have completed their convergence towards pre-Covid levels.
- The rally was not homogeneous, other market segments continue to remain much wider than a year ago.
- Expensive valuations continue to be counter balanced by extraordinary technicals.
- If some volatility can't be excluded we expect the compression trade to go on over the course of 2021.

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

Given some uncertainty remaining regarding the pace of the economic recovery in 2021 those levels could look expensive but we think they will remain well anchored.

Indeed, a main support for credit spreads will be the negative supply this year. Corporates issued massively in 2020 to constitute liquidity buffers but this trend is over. Thus, we think supply in European credit markets will be down 10 to 15%.

But the picture for net supply will be even more supportive for spreads as the ECB will likely continue to buy at least EUR5bn corporate bonds per month within the CSPP.

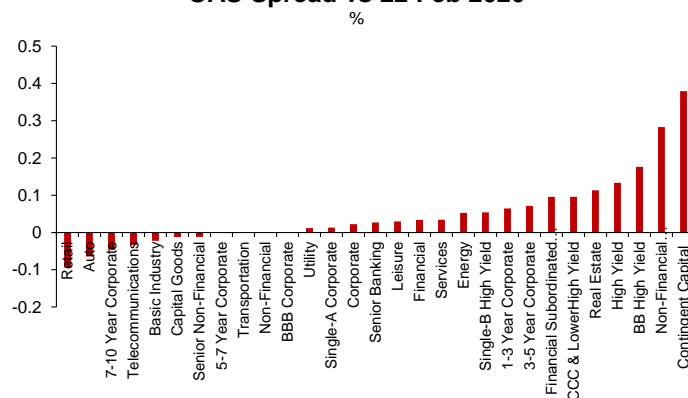
But the ECB will also help stabilise the credit market via the PEPP program although it is not yet purchasing credit via this program at this point. The ECB has stopped buying credit when the EUR IGH index fell below 100bp OAS, hence we suspect the central bank would resume its purchases should credit spreads cross that level again.

## Technicals will provide strong support

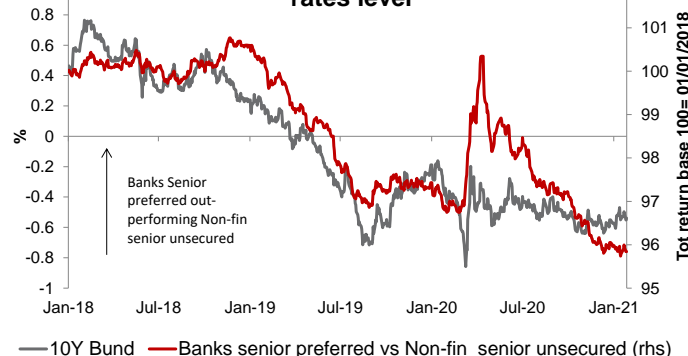
Going forward, we expect IG grinding gradually tighter while HY should outperform, although the coming weeks will prove challenging as the length of new lockdowns could be extended. It will also be the moment of truth for default rates that we expect peaking between 5% and 6% at the end of this quarter. Any disappointment there could be detrimental to HY.

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.

OAS Spread vs 22 Feb 2020

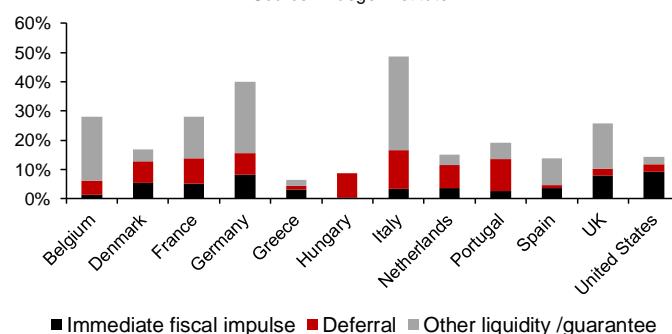


Banks relative performance is mainly due to rates level



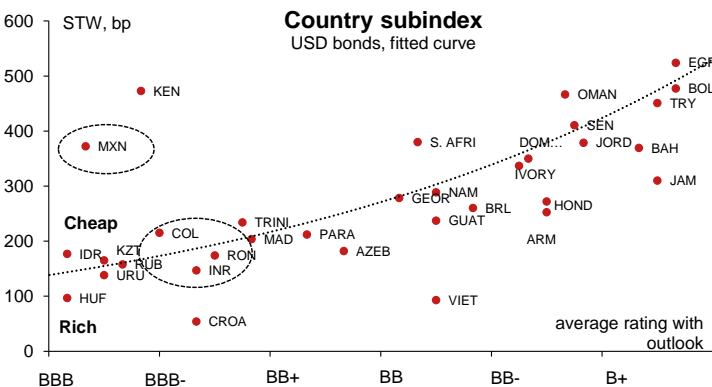
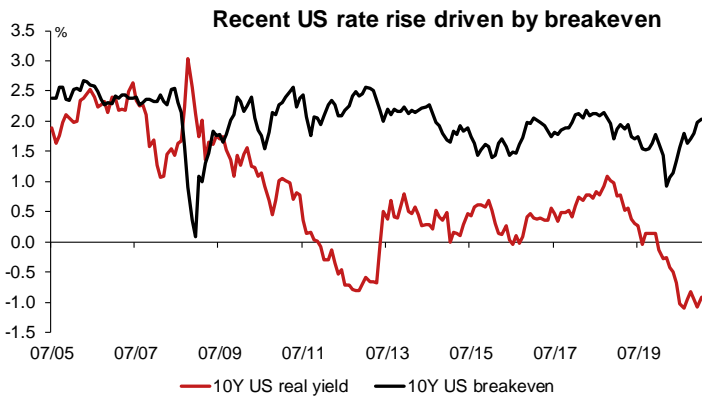
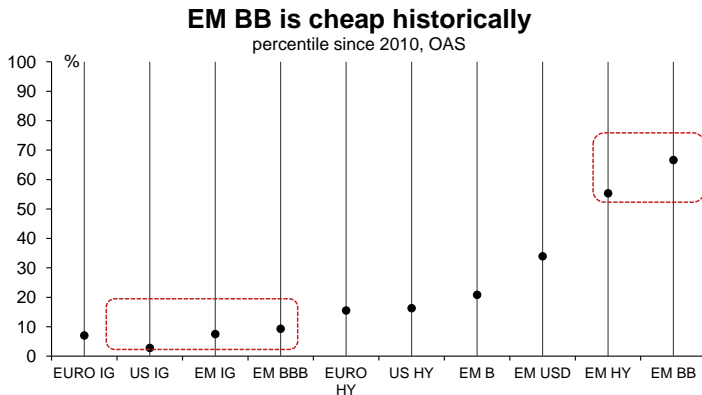
Discretionary 2020 fiscal measures adopted in response to coronavirus by 29 October 2020, % of 2019 GDP

Source: Bruegel Institute



# EM sovereign bonds

Guillaume Tresca



- After the euphoria, the outlook has deteriorated but it remains positive. We maintain our OW on EM HY vs IG but we reduce risk.
- US real yields are still in check but as the year progresses, relative-value trades and selection will gain more importance.
- Technicals are still supportive, albeit less than before. Heavy EM HY issuance could lead to some temporary indigestion.

After the December euphoria, the EM rally has lost steam with wider spreads for both IG and HY and the rise of US long-term rates has also hurt EM total return. The outlook has deteriorated and will be bumpier but it remains a supportive one. Our view for a front-loaded HY rally over IG is intact. Firstly, the EM macro outlook has kept improving with stronger EM PMIs and the larger US fiscal stimulus should lead to a stronger EM growth and thus to compress the EM risk premium. Secondly, it is the nature of the long-term US nominal rate rise that is important. It has been driven by breakevens rather than by real yields. Low real yields will keep the EM risk premium low and it will continue to attract cross-over demand. Thirdly, in terms of valuation, the BB bucket has tightened only modestly. EM IG is tight but with the recent rise of US rate, the BBB bucket has turned a bit more attractive, especially the low duration names. It is an opportunity to add more risk in the IG space, and to reduce slightly our OW in EM HY.

## Mixed technicals, albeit still positive

Technicals have been mixed: we notice some supply indigestion in the HY segment. January issuance has been running higher than last year which was already a record, with most of it skewed on EM HY. We sense that with the combination of still tight spreads and higher US yields we can see a rush of EM issuers, especially the weak names which need to secure funding. Fortunately, redemption is high, estimated at USD47bn until April and fund inflows have hardly slowed down.

## Focus on relative value afterward

Higher US rates will continue to dent return as the year progresses and with tight spreads, relative-value trades and selection will gain more importance. Looking at the spreads-to-rating curve, in the IG sector, we still like the GCC names. Abu Dhabi is too tight and heavy issuance is expected. We prefer Saudi Arabia which will benefit from higher oil prices. In the lower IG spectrum, Mexico is cheap and the risk of a downgrade is remote and well flagged. Romania is expensive but the political risk has been receding and relative to other CEE countries there is room for compression. In the BBs, we recommend Morocco which has a credible governance. Oman is attractive while we continue to dislike South Africa.



# Currencies

Thomas Hempell

- With global recovery hopes continuing to determine the USD, we still see more dollar weakness further into the year.
- The Fed's yield curve control will prevent the new fiscal stimulus from turning into USD strength.
- Yet short term, the EUR/USD may struggle to gain traction amid prolonged lockdown in Europe, a sluggish vaccine rollout and stretched speculative positions.
- Real yield differentials and capital flows point to gradual downside for the USD/JPY.

Following a decline into year-end in line with [our expectations](#), the USD's stabilization at the outset of the year could extend somewhat very near term. But we continue to see the USD heading south further into the year.

Indeed, the greenback remains inversely linked to global recovery expectations reflected in the MSCI World ex US (see top chart). With vaccine production ramped up and inoculations proceeding, rebounding global activity and risk sentiment will weaken the anticyclical dollar more visibly in spring/summer. The upcoming new US fiscal boost will not change that. The Fed has just [reinforced its commitment](#) to its implicit yield curve control for longer with the economy ["a long way from our employment and inflation goals"](#). US real yields may thus even fall somewhat further on reflation hopes, while a widening trade deficit weighs on the USD too.

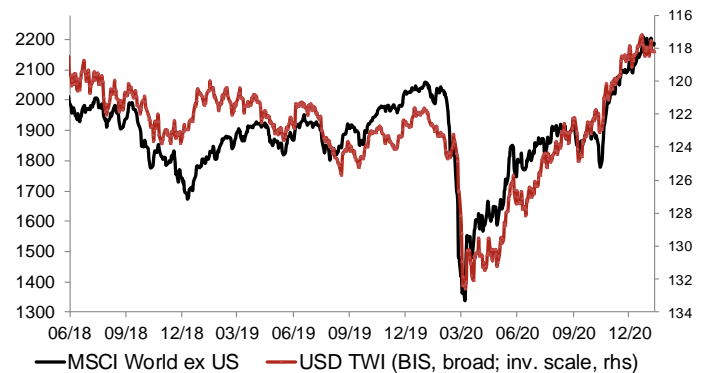
## Near-term headwinds to EUR/USD

With renewed and prolonged lockdowns triggering a technical recession in Europe, the EUR/USD may struggle to gain traction near term, however. Political uncertainties in Italy neither help, though we deem a deeper crisis with new elections unlikely. Also, speculative net USD shorts (CFTC, see lower chart) have reached the highest value in almost a decade, making also the EUR/USD more vulnerable to a temporary setback.

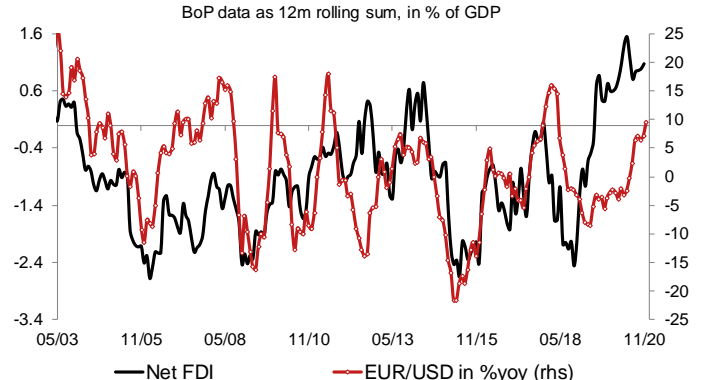
Once more imminent worries about the European health and economic outlook improve, the EUR/USD may head to the upper 1.20s during the year. The euro can still catch up with resurgent net FDI inflows (mid chart), while the C/A (~2% of GDP) remains strong, contrasting a deepening US deficit. And while the ECB will continue to [flag concerns about the exchange rate](#), the bar for cutting rates further (the only effective FX tool) is high.

We also see moderate downside for USD/JPY over the next months. The Fed's commitment to prolonged strong accommodation has added the USD to the ultra-low yielders, while Japan's sizable C/A surplus and ebbing net-portfolio outflows underpin the yen. At the same time, a wider gap in real yields works to the support of the yen, which on fundamental grounds is still undervalued.

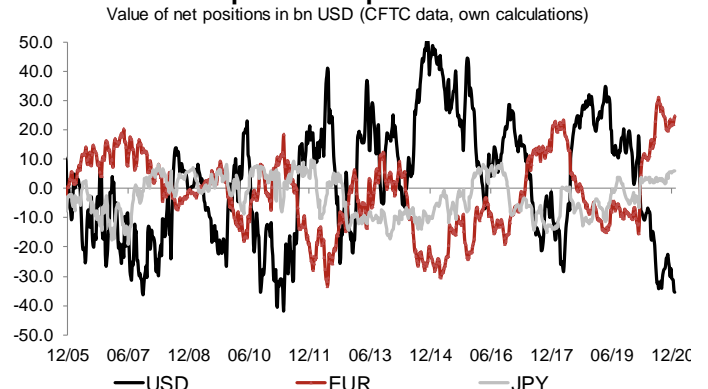
USD weakness amid risk rebound



Euro area: net FDI flows and EUR/USD

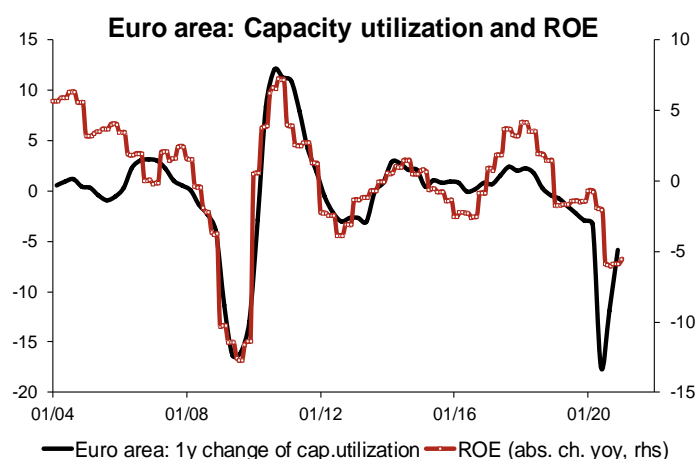
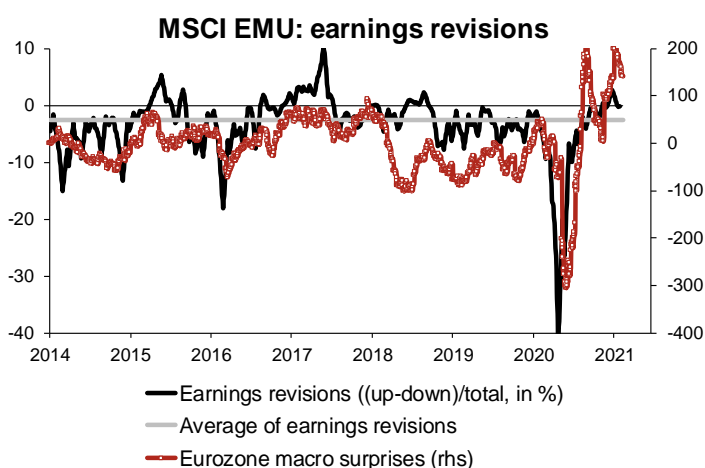
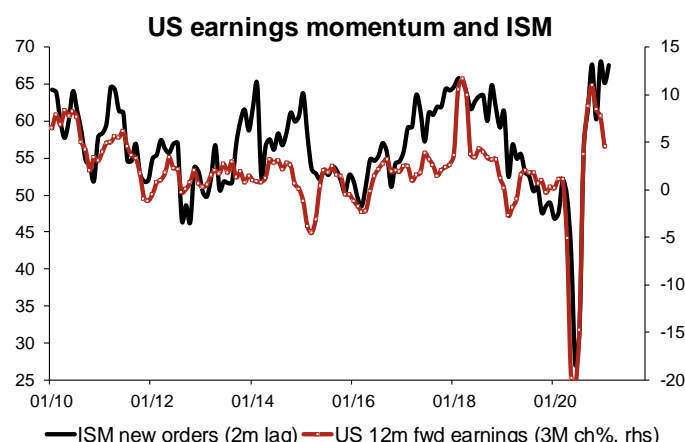


Speculative positions



# Equities

Michele Morganti / Vladimir Oleinikov



- Higher equity positioning, increasing Covid cases and vaccine-related risks induced us to decrease the equity OW last month. Still, equity investors can count on policy support, lingering GDP recovery and low real yields.
- Our positive 2021 equity view relies on earnings upturn and not on any equity multiple expansion. Q4 reporting season is doing well. Earnings should increase appreciably in the next two years: 40% for the euro area (EA) in 2021 and +14% in 2022.
- Investors should buy into additional market setbacks.
- Value and cyclicals should continue to overperform over the coming months. We favour Japan, UK and EMs and prefer EMU vs US over 12 months.

In January markets were flat as risks increased and volatility reached 37 (VIX, almost at the peak seen in early November – elections day in the US) from 27 of December. Covid cases and issues with vaccines roll-outs were the main issues. In particular, the euro area (EA) was the most affected with negative spillovers from lockdowns and economic revisions for 2021. On the contrary, US GDP revisions were positive. Such renewed Covid impasse is coming at the time when equity flows recoupled the cumulated outflow of the last 2.5 years. In particular, the last 3 months have seen the highest inflow for global equities since 2003.

While equities are stabilizing and the rotation into value and cyclicals has temporarily stopped, we think there is still potential for positive total returns through rotation into laggard sectors, namely value and cyclical. In particular, the macro momentum still holds well (with GDP and firms' margins increasing) and should remain underpinned thanks to the policy support and lingering low real rates.

Furthermore, equity flows have still scope to increase, especially in the EA, where they have remained muted. The optimism of retail US investors has also come down from recent peaks with cash positions still high in institutional investors' portfolios. Additionally, new Covid cases and hospitalizations in the US have finally receded and vaccine rollover is going quite well, just like in the UK.

## Robust earnings growth ahead

Finally our good earnings expectations are confirmed for this year and the next. In the US we also revised profits for 2021 up, together with the S&P 500 target (4000-4100 from 3820). The revision incorporates the net benefit of a Democrats' majority in the senate (second fiscal stimulus looming): additional 1.6% GDP growth and +6% earnings growth in 2021, even after taking into account the drawback from the +20 bps rise in the 10-year UST rate.

## Equities

The Q4 reporting season is also doing very well. For the US, expectations are for a yearly earnings growth of -7.8% after -6.5% in Q3: a positive yearly growth will start to be visible from Q1 2021 (+16.7%). After 160 firms reported, results look quite solid vs expectations, both for earnings and sales. Surprises are broadly positive especially for earnings (20%). They are better than Q3 ones (19%) and the last 9 quarters' average (10%). In particular, financials, industrials, discretionary and tech, did better than the sector average. Sales surprise is lower but still positive at 3.8% and better than in Q3 (2.8%) and the last 2 years (1.2%). This bodes well for our expectations of increasing earnings momentum. The latter is at the core of our total return targets given that market multiples (PE) have little scope to increase further from current already elevated levels - albeit justified by policy support, low yields, earnings trough and lower political uncertainty (see our equity [focal point](#)).

In sum, while risks are higher (we decreased our OW in equities last month), we think investors should profit from further set-backs. The macro momentum will remain upbeat and the rotation into laggard sectors has scope to restart (value and to a lesser extent cyclicals).

Country allocation: OW EMU vs US, due to ongoing cyclical recovery and higher US rates. We also overweight EMS, Japan and UK due to valuation and rotation vs ex-US cheaper indices.

### We maintain our preference for Value and Cyclical.

For Value sectors, we see relatively strong earnings momentum vs the market: financials, energy and materials. Our quant models still see a huge undervaluation for Value but not so much for cyclicals, such as capital goods. Banks looks particularly vigorous in terms of relative earnings momentum and deserve a slight OW, just like energy. OW: Financials, food retail, materials and software. UW: media, telecom, transportation and HPP. We bring semis to neutral due to stretched valuations and performance.

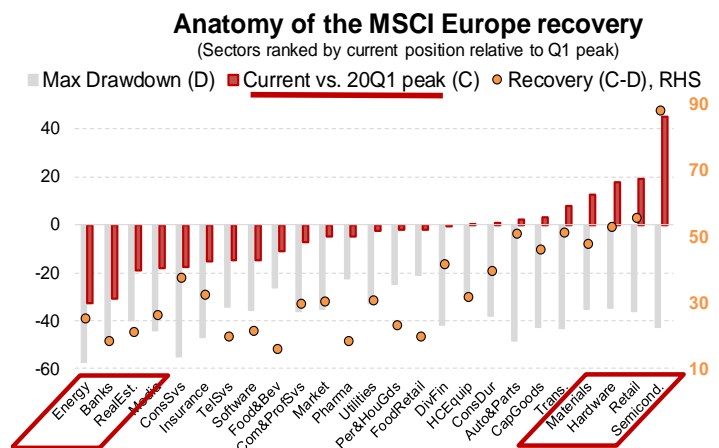
### EM: still OW although Sentix looks toppish

The high EM macro surprises plus increasing oil prices (+10%) and slightly weaker US dollar vs EM FX have been supportive for EM stocks (+6pp vs MSCI World). The market has somewhat overshoot its earnings momentum, closing the gape with Fed's financial conditions. EMs still looks attractive (20% discount to US), although the Sentix investor sentiment has become quite toppish, increasing the likelihood of short-term correction. We maintain our mid-term positive view. The new US administration will boost global growth, weighing on the US dollar, thus benefiting EMs. Additional positives are higher commodity prices and better earnings growth. We favour India, Korea, Taiwan, and Poland.

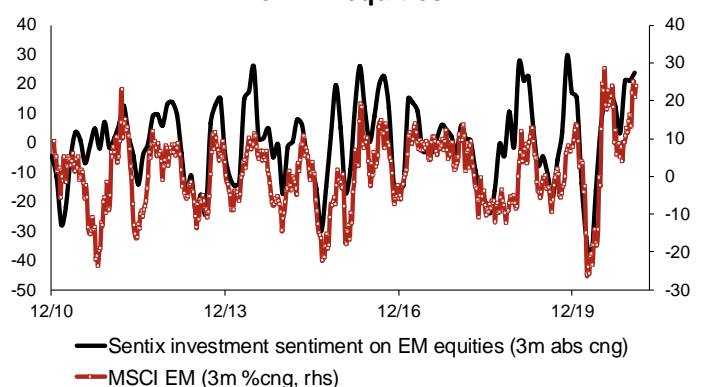
US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.13	1.16	-0.03	164.7	4.26
Scenario 2 (consensus 12m forward in 1 year)	1.21	2.00	-0.79	192.6	4.98
Scenario 3 (GI 12m fwd in 1 year)	1.35	2.20	-0.85	196.1	5.08
Scenario 4 (downside macro scenario)	0.70	1.00	-0.70	115.0	2.98
Scenario 5 (upside macro scenario)	1.95	1.50	-0.35	210.6	5.45

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	26.0	30.4	30.9	18.1	28.8
Avg S&P500 valuation	3,493	4,083	4,155	2,438	3,869
	-4.8%	11.3%	13.3%	-33.5%	5.5%

Note: **Base risk** scenario: using 20% of risk premium's stand. deviation (SD).  
Target ERP (4.6) is calculated assuming CPI in the range b/w 1.3% and 2.3%.



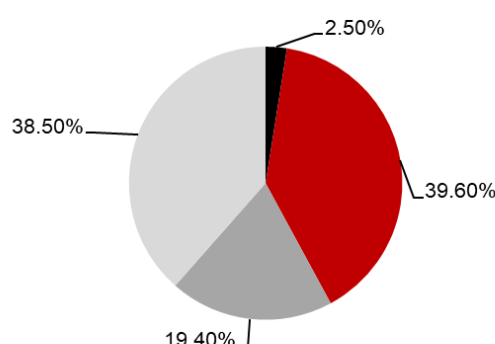
### MSCI EM vs Sentix investment sentiment on EM equities



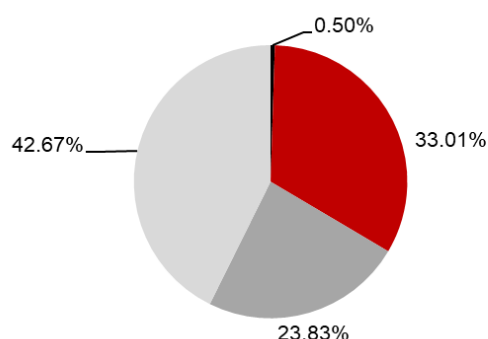
# Asset Allocation

Thorsten Runde

## Benchmark

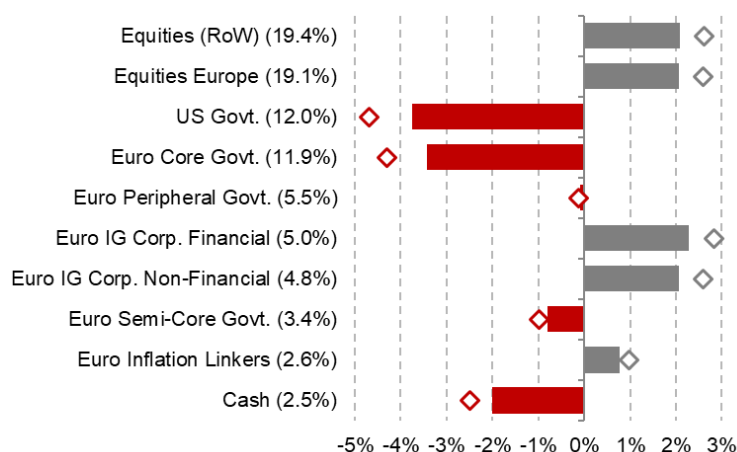


## Modelportfolio



■ Cash ■ Govies ■ Corporates ■ Equities

## Active Positions in TOP 10 Benchmark Constituents\*



\*Benchmark weights in parentheses, diamonds indicating previous

- Since the beginning of 2021 equity markets roughly gained +2.3% on average (*January 27*). The ranking is led by EMs (+6.8%). The worst performing equity markets (US and EMU) lost slightly below -0.2% and -0.1% respectively.
- Apart from EA HY (+0.4%), EA IG Non-Fin (+0.1%) and Inflation Linkers (+0.3%) the complete fixed income side performed negatively so far.
- With -2.4% long-dated US-Treasuries lost most in 2021 so far on a euro-hedged basis. However, this loss is composed of a sharp decline until Mid-January and a subsequent recovery.
- On the EA Credit side, HY clearly outperformed IG by round about +40 bps on average.
- There are still good arguments for an economic recovery and thus for risk assets. Yet, most of these arguments are already priced in, increasing the likelihood for potential setbacks in the short term. Thus, we stick to our tactical allocation stance in favour of equities and corporate bonds, but scale back the aggressiveness of the portfolio alignment.

Since the beginning of 2021 the model portfolio has outperformed its benchmark by +9 bps. However, the emergence over time is quite heterogeneous. While the portfolio was able to generate +14 bps until mid-January, it lost almost -6 bps afterwards. This result was clearly driven by equities which particularly benefitted from the 2020 year-end rally's run-off in the first two weeks of 2021. Together with US Treasuries they were the main contributors to the overall results in both subperiods, +6.7 bps each in the first one and -2.7 bps in the second one.

The prospects of a stronger economic rebound this year based on successful vaccination, a likely bold new US stimulus and persistently accommodative monetary policies still support risk assets. However, these factors seem to be already priced in to a large degree. Furthermore, vaccination issues in the euro area are raising the likelihood of temporary setbacks in the near term.

### Pro-risk stance to be kept, but less distinct

We confirm our tactical risk-taking stance by refraining from discretionary shifts between asset classes. Yet, we recommend to scale back the overall aggressiveness of the portfolio alignment to account for potential setbacks in the near term.

We maintain our most sizeable overweight positions in equities and in IG Credit. At the same time we confirm our recommendation to avoid low-income markets like EA Core Govies, US Treasuries and Cash.



# Forecast Tables

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

	2019		2020		2021		2022	
	forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.3	- 3.5	0.1	6.1	2.1	3.8		
Euro area	1.2	- 7.3	0.0	4.0	- 0.7	5.3		
Germany	0.6	- 5.0	0.4	3.3	- 0.6	4.7		
France	1.3	- 8.8	0.5	5.5	- 0.4	6.0		
Italy	0.2	- 9.0	- 0.0	3.5	- 1.4	2.5		
Non-EMU	1.5	- 8.7	0.1	4.2	- 0.4	4.2		
UK	1.4	-11.0	0.1	4.6	- 0.7	5.0		
Switzerland	1.1	- 3.7	0.0	3.6	0.3	2.1		
Japan	0.8	- 5.4	- 0.1	1.8	- 0.8	2.6		
Asia ex Japan	5.2	- 1.1	0.2	7.3	- 0.3	5.2		
China	6.1	2.3	0.2	7.8	- 0.2	5.5		
CEE	2.0	- 2.7	0.4	3.8	0.1	3.1		
Latin America	- 1.1	- 8.5	- 0.2	3.2	- 0.4	3.0		
<b>World</b>	<b>2.7</b>	<b>- 4.0</b>	<b>0.1</b>	<b>5.4</b>	<b>0.2</b>	<b>4.3</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.	forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	1.8	1.2	- 0.0	2.2	0.2	2.2		
Euro area	1.2	0.3	0.0	1.0	0.1	1.2		
Germany	1.4	0.4	- 0.1	1.4	0.0	1.3		
France	1.3	0.5	0.0	0.8	0.0	1.0		
Italy	0.8	- 0.2	- 0.0	0.6	0.2	0.6		
Non-EMU	1.5	0.6	- 0.5	1.4	- 0.6	1.6		
UK	1.8	0.8	- 0.8	1.7	- 0.8	1.9		
Switzerland	0.4	- 0.5	0.2	0.2	0.0	0.3		
Japan	0.5	0.0	- 0.0	- 0.3	- 0.3	0.3		
Asia ex Japan	2.8	2.9	- 0.0	2.2	- 0.1	2.5		
China	2.9	2.6	- 0.1	1.5	- 0.2	2.1		
CEE	6.9	5.6	- 0.4	6.2	0.6	5.3		
Latin America <sup>2)</sup>	3.6	3.1	0.2	3.1	0.2	3.0		
<b>World</b>	<b>2.5</b>	<b>2.2</b>	<b>- 0.1</b>	<b>2.3</b>	<b>0.0</b>	<b>2.4</b>		

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

## Financial Markets

<b>3-month LIBOR</b>	<b>27/01/21*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
USD	0.22	0.20	0.20	0.20
EUR	-0.55	-0.55	-0.55	-0.55
JPY	-0.08	-0.10	-0.10	-0.10
GBP	0.03	0.05	0.05	0.05
CHF	-0.76	-0.75	-0.75	-0.75
<b>10-Year Bonds</b>	<b>27/01/21*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
Treasuries	1.03	1.10	1.20	1.35
Bunds	-0.54	-0.50	-0.45	-0.40
BTPs	0.63	0.60	0.55	0.65
OATs	-0.31	-0.30	-0.25	-0.20
JGBs	0.03	0.05	0.05	0.10
Gilts	0.27	0.30	0.35	0.40
SWI	-0.47	-0.45	-0.45	-0.40
<b>Spreads</b>	<b>27/01/21*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
GIIPS	89	85	80	85
BofAML Covered Bonds	35	35	35	35
BofAML EM Gvt. Bonds (in USD)	288	270	260	255

\*average of last three trading days

<b>Corporate Bond Spreads</b>	<b>27/01/21*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
BofAML Non-Financial	91	85	80	75
BofAML Financial	92	85	80	75
<b>Forex</b>	<b>27/01/21*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
EUR/USD	1.21	1.23	1.25	1.28
USD/JPY	104	103	102	100
EUR/JPY	126	127	128	128
GBP/USD	1.37	1.38	1.42	1.45
EUR/GBP	0.89	0.89	0.88	0.88
EUR/CHF	1.08	1.09	1.10	1.11
<b>Equities</b>	<b>27/01/21*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
S&P500	3,819	3,845	3,895	3,990
MSCI EMU	128.8	130.0	130.5	134.5
TOPIX	1,857	1,865	1,895	1,945
FTSE	6,620	6,635	6,730	6,915
SMI	10,931	10,830	10,940	11,275

## 3-Months Horizon

Government Bonds	10-Year Bunds	-0.65	-0.50	-0.35
	10-Year Treasuries	0.89	1.10	1.31
	10-Year JGBs	-0.12	0.05	0.22
	10-Year Gilts	0.23	0.30	0.37
	10-Year Bonds CH	-0.53	-0.45	-0.37
Equities	MSCI EMU	117.9	130.0	142.1
	S&P500	3,541	3,845	4,149
	TOPIX	1,720	1,865	2,010
	FTSE 100	6,111	6,635	7,159
	SMIC	10,105	10,830	11,555
Currencies	EUR/USD	1.20	1.23	1.26
	USD/JPY	100	103	106
	EUR/GBP	0.86	0.89	0.92
	EUR/CHF	1.07	1.09	1.11

## 12-Months Horizon

Government Bonds	10-Year Bunds	-0.70	-0.40	-0.10
	10-Year Treasuries	1.00	1.35	1.70
	10-Year JGBs	0.49	0.10	-0.29
	10-Year Gilts	0.27	0.40	0.53
	10-Year Bonds CH	-0.64	-0.40	-0.16
Equities	MSCI EMU	114.8	134.5	154.2
	S&P500	3,495	3,990	4,485
	TOPIX	1,684	1,945	2,206
	FTSE 100	6,041	6,915	7,789
	SMIC	10,052	11,275	12,498
Currencies	EUR/USD	1.21	1.28	1.35
	USD/JPY	93	100	107
	EUR/GBP	0.82	0.88	0.94
	EUR/CHF	1.07	1.11	1.15

\*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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