Q2 2020

Investment View

Sudden stop, permanent scars

Content

Global View – Sudden stop, permanent scars 3
Macroeconomic Outlook 7
Fixed Income 11
Corporate Bonds 13
Currencies 15
Equities 17
Asset Allocation 19
Forecasts 20
Imprint 22

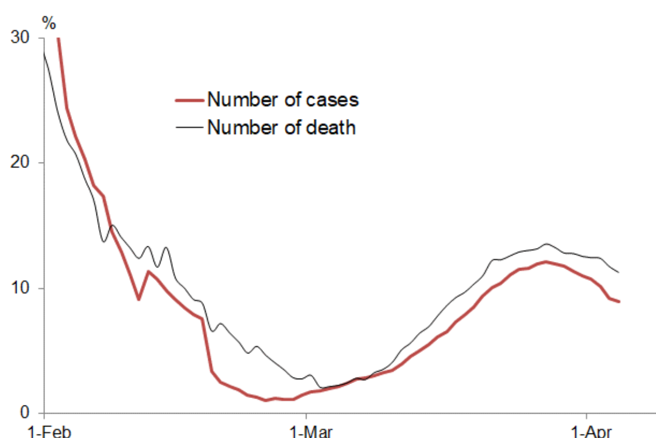
Global View – Sudden stop, permanent scars

- **The coronavirus has caused a sudden stop of the global economy. The recession will be deep; it will hopefully be short-lived, but a V-shape recovery is in doubt, as second-round effects will kick in (depressed capex, weaker consumer confidence etc.).**
- **Expect long-term scars: the social and economic fabric will change semi-permanently. The supply chains may become less global, more regional. The demand for health security and a tighter social net will rise. Interventionism is already growing, which in time may well hurt potential growth.**
- **Thankfully the policy response has been powerful. The soothing effect on global markets is already apparent. But solidarity is still missing in Europe. The risk for Euro Area (EA) stability is not so much for 2020, as large ECB buying will mostly cover the new funding needs. But if Europe wants to protect its long-term stability, it must act early.**
- **We recommend a cautious re-risking of portfolios. Equities offer value longer-term, but remain exposed to growth and earnings downgrades in the near term. Keep the overweight (OW) small for now, via defensive sectors and stocks.**
- **Our biggest OW is in IG Credit, on evidence that policy makers are showing a preference for creditors over shareholders.**

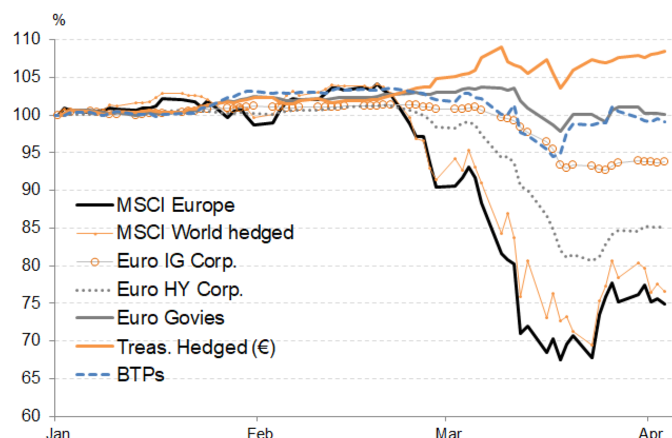
Lockdowns will continue until the number of new cases drop to a very low level. Even then, the return to 'normality' will be only progressive

Viral portfolio destruction. Six months ago our quarterly 'Investment Views' (Graph 1) lamented about the spread of the negative yield disease. In 2020 a far more dangerous and lethal epidemic has hit society, the economy and financial markets: the coronavirus. As we go to press, more than 1.2 million cases have been recorded globally (a number likely grossly under-estimated, given the under-testing), for a death toll of 65k. The damage to society is enormous, as half the planet has been put on lockdown, bringing large parts of the economy to a standstill. Social distancing is working: by early April the number of daily new cases in Italy had started to decline. Yet lockdowns need to continue until the number of new cases drop to a very low level. Even then, the return to 'normality' will be only progressive. A significant risk indeed is that the attempt to quickly set society on a normal footing again would be punished by a second wave of infections. There is hope that antibody testing could facilitate that return to normality, if those tests prove reliable enough and can be rolled out on sufficient quantities. As for the vaccines and drugs that would protect us from new episodes of coronavirus pandemic, they likely will not be fully ready before the turn of the year.

Graph 1: CORONAVIRUS 7-DAY AVERAGE % CHANGE IN NUMBER OF CASES & DEATHS



Graph 2: YEAR-TO-DATE TOTAL RETURNS



The damage to society, the economy and financial markets has been considerable. European equities are entering Q2 down 25-30% year-to-date, depend-

ing on the index we look at, and following a drawdown of ~35% in the month to 18 March. There hasn't been real saving grace to protect portfolios, except for US Treasuries; European government bonds mostly flat YTD (Chart 2).

Deep recession, despite massive policy response

Sudden stop of the economy implies a deep global recession in H1; second-round effects reduce the chance of a V-shape recovery

Abyssal. We struggle to quantify the economic shock, for China in Q1 and the western world over March-June. The OECD estimates that each month of severe lockdown costs two points of annual GDP to major economies. We see that as a low-ball estimate. In just two weeks, 10 million Americans asked for jobless claims; that represents a jump of about 6 points in the unemployment rate. This will strongly impact consumer spending and mortgage payments. Meanwhile corporations are facing a deterioration of their liquidity positions and taking more debt on, when they can, which will inevitably hurt capex for the rest of the year. We estimate a 1.1% drop in global GDP this year - worse than in 2009 - assuming a progressive easing of social-distancing measures through Q2. The risks remain heavily skewed to the downside, as the Q2 drop will be deep and the H2 recovery hampered by second-round effects. In any case, as we saw in previous crises, real GD will not fully catch up and return to its previous path.

Very strong policy response, but lack of solidarity in Europe a threat to longer-term stability

Massive policy response. Thankfully the policy response has been powerful. In the US, the $2trillion fiscal package represents about 10 point of GDP; look for the public deficit to be in the region of 15+%. This has been complemented by 'unlimited' QE from the Fed (Treasuries and MBS); in other words fiscal spending is financed by the central bank – effectively Helicopter Money. Also the US Treasuries will be issuing guarantees, for as much as $456bn, which the Fed can leverage up to ten times to lend to the private sector. The Fed used to be the lender of last resort of the financial sector, now it has that role for the non-financial sector too. The Fed has also reopened a myriad of facilities (commercial paper purchases, Money Market Fund liquidity etc.) to protect funding and address USD scarcity. It has created new tools, such as a Treasury repo facility for foreign central banks in need of US dollars. It has eased the bank's Supplementary Leverage Ratio (SLR). It is now buying corporate bonds and ABS. And so on. The ECB has launched a €750bn Pandemic Emergency Purchase Programme (PEPP), in the process relaxing the self-imposed issue and issuer limits; it has expanded CSPP to include commercial papers; it has eased conditions for targeted longer-term refinancing operations (TLTRO III). The fiscal response in Europe is also strong, in terms of the impulse and guarantees that intend to stop liquidity crises from morphing into defaults and bankruptcies. But the responses have been mostly national. As we go to press we see signs of progress, loans from the European Stability Mechanism (for up to 2% of GDP) and EIB guarantees are on the table; those are helpful but not quite as powerful as issuing bonds with the joint and several guarantee of EU member states. The devil will be in the details: will ESM loans be senior to national public debt? Can stigma be avoided? Will conditionality be minimal?

Inflation? Maybe, in the long run. What's more certain is disinflation over the coming year

Demand will recover more slowly than supply. While the long-term impact of this unprecedented policy response on inflation is unclear, the near-tem bias is for price pressures to diminish further. We expect demand to recover more slowly than supply. Capex will be durably depressed, and the rise in unemployment will hurt consumer spending globally. Longer term, we will probably not get the same fiscal austerity and bank regulation that proved disinflationary after the Great Financial Crisis. May the huge fiscal stimulus, record increase in the Fed's balance sheet and effort to protect low-income individuals and small businesses prove inflationary? Investors are unlikely to believe it until they see it; but at least this should justify higher inflation risk premia.

Interventionism. One side effect of the government support, guarantees and bailouts, will be a higher level of intervention in the economy. We already see bans

It will never be the same again. Rising interventionism reduces the chance to get through the debt overload via higher potential growth

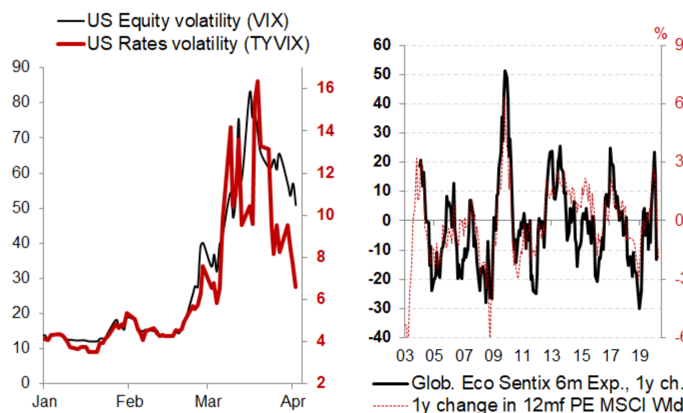
on bank dividends and on buybacks and dividends for companies getting government support, as well as pressure to cut dividends across all industries. Do not expect societies to go back to 'normal' after the virus contagion fades out. The calls for social safety nets, health security, climate change, increased government intervention etc. will not only require funding but may also prove to be a drag on productivity – reducing the chance to get through the debt overload via higher potential growth.

Portfolio re-risking – playing it safe

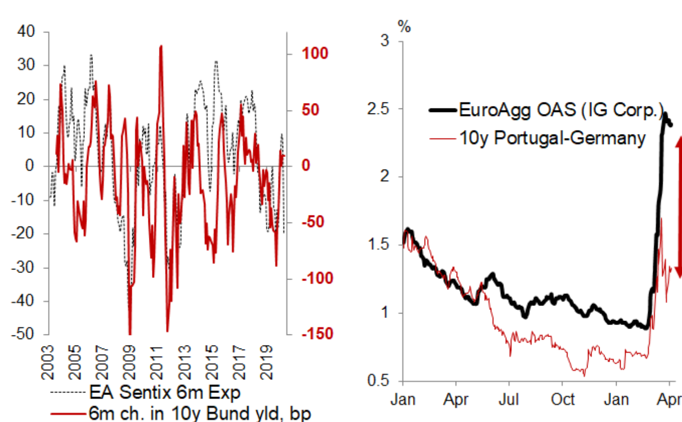
Panic receding. But global growth and earnings forecasts have not stabilized yet; near-term preference for defensive sector and stocks

Peak panic, then peak pessimism. The policy response has been particularly strong in the funding markets, and dollar scarcity has diminished already, though some stress points have not returned to pre-crisis levels (CP spreads, OIS-BOR). More generally, panic is subsiding, as the pullback in market volatility testifies. Implied volatility has retraced more quickly in the rates space than in equities (Graph 3), thanks to the Fed's threat to deliver unlimited QE. Bond yields are pulling back from the technically-driven surge in mid-march (foreign central banks and risk-party selling). Those signs are comforting, but we fear that peak pessimism will follow peak panic with some lag. During the GFC it took seventeen month for the S&P to go from peak to trough. We should not expect a repeat through this crisis, which will prove much deeper but hopefully shorter. Yet the global growth and earnings forecasts have not stabilized yet; there is also room for equity multiples to correct lower as economic sentiment deteriorates (Graph 3b). While sign that the virus contagion is slowing offers comfort, for now our near-term preference remains for defensive sector and stocks.

Graph 3: RATES VOLATILITY PULLS BACKFASTER THAN EQUITY VOL; PLUNGING ECO SENTIMENT MAY PUSH MULTIPLES LOWER



Graph 4: BUND YIELDS SEEMINGLY TOO HIGH; CORPORATE IG SPREADS LOOK LARGE RELATIVE TO SOVEREIGN



EUR long rates skewed to the downside

Long rates skewed to the downside. The 10-year Treasuries, which we had highlighted as a better safe-haven than Bunds, have almost returned to the lows of early March. But 10-year Bund hasn't (-0.43% vs -0.86%). Beyond the technical factors, there might be concerns that the quality of the debt will suffer from some Euroarea risk-sharing. We expect those to be too limited to stop Bund yields from trading at lower level, in the context of heavy ECB buying and depressed economic news (Graph 4a). We also see value in long-dated French or Spanish bonds, which have cheapened vs. swaps.

Investment Grade (IG) Credit the safer risky asset? Cash credit spreads have barely tightened from their local highs. Of course they got much wider in previous crises (Barclays EuroAgg IG Corporate Average OAS currently at 240bp, vs. peaks at respectively 380bp and 470bp in 2011 and 2009. But in the present case, the policy focus has been on loans and guarantees, to minimize defaults. The Fed has now

joined the ECB as a buyer of credit. Forced selling (fund withdrawal) has cash spreads large, and cheap relative to CDS. Normalising funding markets are helping too (including CP facilities). We are also seeing clear evidence that policy makers are showing a preference for creditors relative to shareholders; the freeze or cuts in share buyback and dividend will partially protect the cash flows. Finally, we find that corporate credit spreads are wide relative to sovereigns with equivalent ratings (e.g. Portugal, see Graph 4b).

Allocation recommendations

Back to a short cash position

Cut cash. In late February we switched our recommendation towards a temporarily long cash positions, in the light of the mounting risks. But balanced bond/equity portfolio have had a terrible performance since that, and we now reverse the cash position to underweight. We also recommend an underweight on short-dated Govies.

Cautious return to equities, despite good long-term value

Prudent return to equities. We recommend a very small overweight in equities, if only because they offer value on a 6- to 12-month basis. In the near-term, we will favour defensive sectors and markets. The terrible upcoming economic news should delay a sustained upturn from cyclical stocks.

Our biggest overweight is in IG Credit

Our biggest overweight is in IG Credit. This isn't without risk of course, given the rise in the number of fallen angels (IG indices are now heavy in BBB securities, some of which will be downgraded to High Yield). Hence the need to be very selective – our research effort is very substantial on bottom-up credit analysis and strategy. But, as discussed above, we find the return/risk combination attractive here, given the level of spreads, policy support and historically low level of defaults in the IG space. On a historical basis, we also find European IG and hard currency EM Sovereigns (EMBI) cheaper than other credit markets (both are close to the average level of spreads since 2000, which risker credits are still well below). We also find value in some USD IG credit, where the spread pick-up vs EU IG has increased (on a cross-currency hedged basis). With US policy flirting with debasement strategy (massive fiscal deficit funded by unlimited QE), and USD dollar funding stress being addressed aggressively by the large provision of USD liquidity abroad, we would certainly recommend to hedge the currency when buying USD assets. Finally, spreads in EUR High Yield credit are now generous, but we keep positions very limited there, given the cyclicality and risk of default.

EA stability may be questioned again, but probably not in 2020

We also like to overweight the long end of the semi-core European bond markets, which implies a slightly long duration position. The lack of solidarity may expose EA stability in the longer run: if Europe wants to avoid another sovereign crisis, it must act early. But the risk is not so much for 2020, as the ECB buying will mostly cover the new funding needs.

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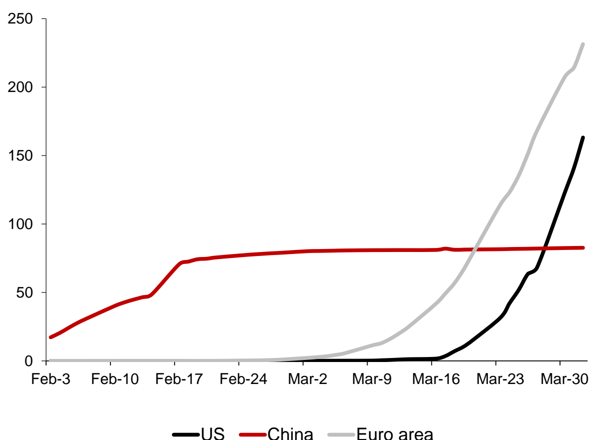
Macroeconomic Outlook

- **The Covid-19 pandemic has pushed the global economy into the worst post WW II recession as it is spreading across the globe. In 2020, we see Chinese growth to recede to 2.5% while output in the US and the euro area will undergo a severe recession. We forecast global activity to contract by at least 1%.**
- **Looking ahead, the evolution of the pandemic is key. In our baseline scenario we expect the shutdown to ease gradually starting from May, allowing the economy to restart. The rebound will then gather speed, helped by massive central bank and fiscal support.**
- **In this very fluid situation growth forecasts had been revised continuously to the downside. Uncertainty on the evolution of contagion and the possibility that weak sentiment puts a brake to the H2 rebound leaves risks strongly tilted to the downside. In a worst case scenario the global economy will even stay in recession next year.**

Covid-19 crisis worse than GFC. Length of shutdown period is key.

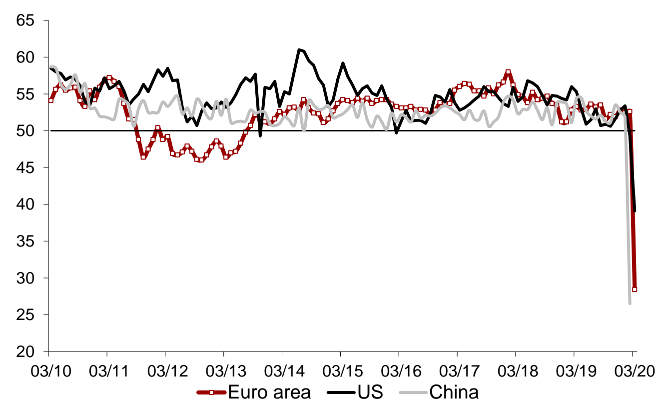
There is no time to take a breath for the global economy. Last year, trade war concerns contributed to a muted global environment. While there were signs of recovery, the Covid-19 epidemic entered the stage. It first hit the Chinese economy very hard but has in the meantime also moved to Europe and the US. At the time of writing more than 1.2 million people were infected globally. The fight against the pandemic is in full swing. The currently only effective mean is social distancing leading to shutdowns. The branches most affected are the ones where people usually stick together very closely or approach other people closely, e.g. travelling, restaurants, shopping and cultural activities. Governments have largely shut down public life; firms have scrapped travelling and ordered their employees into home office if possible. It is clear that such a shutdown is very costly. The OECD estimates that for each month of containment, there will be a loss of 2 percentage points (pp) in annual GDP growth. However, this is just an expected average. Some countries might be affected even more. For Germany the Ifo institute for instance sees these losses in the -2.8 to-6.4 pp range. In any case, it becomes evident that the length of the shutdown period is crucial for the activity outlook. In our projections we assume a shutdown period of about six weeks followed by strong rebound once the restrictions are abandoned. As some losses, e.g. tourism, cannot fully be recovered a net production loss will remain. Most economies will experience a contraction in activity in 2020 and so will global production. We look for a fall of global activity by about 1%, even worse than during the GFC when global production fell by 0.1%.

Graph 1: COVID-19 DEVELOPMENT ACROSS REGIONS



Number of Covid-19 cases, tsd. persons

Graph 2: SERVICES SENTIMENT IN KEY ECONOMIES



Services PMIs, index points

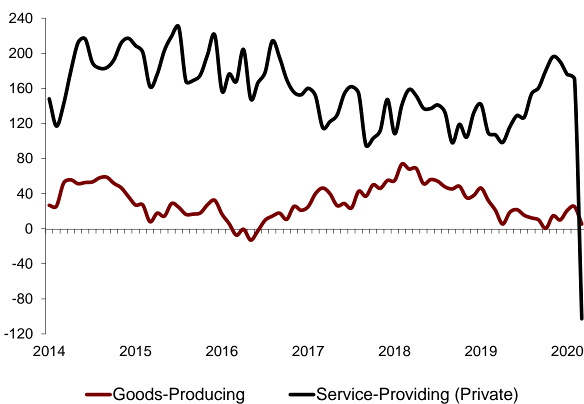
US

Employment collapses, fiscal stimulus ready to kick start the economy when health emergency is over

In the US the spreading of the virus is lagging Europe by a couple of weeks, but the number of cases is increasing fast. Decisions of lockdowns are taken at a state level, creating big uncertainty on how and to what extent the economy will be hit. The lack of a strong, centralized and public healthcare system is an additional worry. The first data covering the outbreak period are dire; in March alone employment shrank by more than 700k, with services badly hit by the lockdown on sectors like travel, tourism, restaurant and retail. The policy response has been rapid and on an unprecedented scale. The Fed slashed rates to zero, committed to buy unlimited amounts of Treasury Bonds and MBS. It set up several programs to flood the financial sector with liquidity and, unlike in the 2009 crisis, decided to buy corporate bonds and asset back security form the non-financial sector, also on the primary market. On the fiscal side, after the first emergency measures, the Congress rapidly agreed on a US$ 2 tn stimulus plan. It provides direct income support to households and extends unemployment benefits, provides credit guarantees and loans to firms and funds for healthcare.

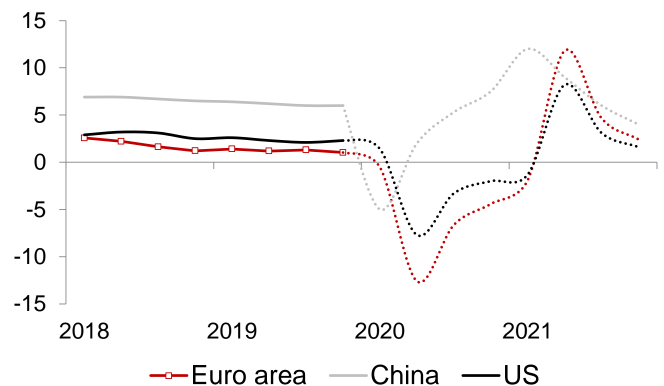
Faced with a sudden stop and a big fiscal boost, economic activity will experience a sharp contraction in Q2 (at least -8% qoq) followed by a rebound in the second half of the year, if contagion peaks by the summer. As a result we expect GDP to contract by at least 3% in 2020. Risks are clearly tilted to the downside; the fiscal stimulus may have its full impact only if the end of the health emergency allows activity to restart, and on this front the news are at best mixed. It may well be that contagion continues increasing in the second part of the year. In that case, the rebound will start no earlier than in autumn. Moreover, the impact of virus of confidence may last long, preventing a meaningful rebound in consumption

Graph 3: US LABOR MARKET SLUMP



Footnote 1 US: payroll growth by sector ('000 people, 3 mth mobbing average)

Graph 4: GROWTH PROJECTIONS FOR CHINA, US AND EURO AREA



Real GDP, % yoy

Euro area

The Covid-19 shock hit the euro area after a challenging year 2019 in which global headwinds dragged on domestic activity. At the outset of the year the situation had stabilized with January industrial production up by 2.3% mom, industry orders expanding by 2.5% mom and retail sales increasing by 0.6% mom, while the unemployment rate receded to 7.3% in February. Thereafter the headwinds from the pandemic became stronger and stronger. It first escalated in Italy (end of February) but has quickly spiraled also in other economies (in March). Due to contagion measures we expect that production halts in the affected sectors will be maintained through-

out April. Thereafter, we look for a gradual unwinding of the containment measures over the remaining second quarter.

Bold fiscal and monetary policy measures cannot prevent euro area from falling into deep recession

In order to cushion the economic fallout and to foster a swift rebound of activity after the pandemic a bold monetary and fiscal policy was passed. The ECB extended its asset purchases for 2020. An additional amount of € 120 bn will be devoted to purchases of corporate bonds. It also launched a new so called PEPP (Pandemic Emergency Purchase Program) with a volume of € 750 bn. Most noteworthy, it will not be subject to the issuer limit of 33% prevailing for the PSPP and there will also be more flexibility on the capital key buying than in previous programs. Credit creation will be supported by additional LTROs, improved conditions for TLTROs and some regulatory easing, for instance allowing banks to operate below the required capital level.

Unlike to previous crises there is also a bold fiscal response. It mainly relies on national support measures but there is also some direct support from the EU. They consist of direct measures like income subsidies for affected workers (likely € 350 bn or 3% of GDP) and state loans or guarantee schemes to prevent insolvencies (likely close to € 2 tr or 16% of GDP). The bold policy response is important to cushion the downturn and to enable a rebound in the second half of the year. All in all, we still expect 2020 euro area GDP to shrink by 6% at least and look for a rebound of 3.5% in 2021. A key uncertainty surrounding the post-Covid-19 development is the ability of countries to support the recovery by means of additional fiscal policy measures. While be urgently needed this will be hard to engineer for highly indebted countries like Italy. In this context a crucial question is whether some form of transfer towards weaker economies takes place. As it stands now, we deem facilitated access to ESM credit lines with only a light conditionality most likely.

China

China Covid-19 crisis: First in, first out?

China's manufacturing indices bounced back into expansionary territory in March. This was clearly a sign that the economy has passed its low point and production is on the mend. Judged by indices constructed from daily indicators, overall manufacturing capacity utilization improved to about 5-10 pp below normal (80%). Provided a second Covid outbreak can be prevented, the production side is expected to reach "2019 normal" around mid-April. By contrast, the service sector looks to lag behind with output still being about 30% below normal. Thus, there is indication that consumer confidence has not returned to previous levels amid the Covid-19 crisis and household demand could stay somewhat reluctant, going forward. On top, China's export demand will likely be strongly hit by a virus-induced global recession. China's export share in GDP is 17%. We expect the strongly negative export growth rated (-17.2% yoy in Jan/Feb) to even deteriorate. Given that the export manufacturing sector employs 25-30 mill. workers directly, the labor market will also come under pressure. This will also elicit negative second round effects on private consumption. The development could also threaten manufacturing capacity utilization again.

This all speaks in favor for a step up in government support. So far, China has been rather reluctant with extra crisis spending. We expect additional measures soon with a fiscal impulse between 3.5% and 4% of GDP. We forecast the PBoC to additionally cut the Loan Prime Rate by 30 bps via MLF cuts and additionally reduce the RRR by 100 bps in 2020. All in, we expect China's GDP to slow to about 2.5% in 2020, followed by close to 8% in 2021 due to strong base effects.

Regarding Japan, the virus hit at a time when the economy is still recovering from the sales tax hike in October 2019. The number of infections has been comparably low, but another spike could be forthcoming which would likely result in calling the state of emergency. The government is considering another large fiscal package (10% of GDP) while the BoJ is providing liquidity and credit measures. In stark con-

trast, the Indian central bank has room to cut key rates and did so by a 75 bps key interest rate cut (among other measures). We expect more cuts by another 100 bps.

Risk scenarios

Key risk factors are the pandemic, its effects on EMs and effectiveness of policy stimuli

The uncertainty surrounding our macro forecast rests on basically three elements. First, the ability to fight the pandemic: Containment measures could become necessary for much longer or the pandemic could resurge later or the fallout could be harder that thought. Second, the de-synchronized evolution of the pandemic across the globe could lead to stronger and longer lasting bottlenecks in trade and global value chains than thought. In most EMs, the healthcare systems cannot cope with mass epidemics and lockdowns may be harsher and longer lasting than in Europe. Third, the effectiveness of the policy stimulus is a global concern, especially for the euro area where a fiscal entity is missing and attempts towards it failed so far. As a result, euro area countries with a weaker fiscal position will face tighter constraints.

Risk is that global economy stays in recession in 2021 as recovery is only very shallow

In order to take on board all these uncertainties we devised two negative scenarios alongside our baseline, with a special focus on Europe. In the first, moderate risk one, we assume that a more persistent health crisis and deeper value chain disruption lead to a weaker recovery beginning in earnest only in Q4. Europe proves particularly weak and this raises additionally fears about debt sustainability, as the path

Graph 5: PMI NEW ORDERS AND EXPORT ORDERS

Index points

Table 1: CENTRAL AND RISK SCENARIOS FOR GROWTH

Scenario	Year	Region				
		US	Euro area	Italy	China	World
	2019	2.3	1.2	0.2	6.1	2.8
Central scenario	2020	-3.0	-6.0	-6.6	2.5	-1.0
	2021	2.8	3.5	2.0	7.7	4.5
Risk scenario	2020	-5.0	-8.0	-9.0	-0.5	-2.0
	2021	1.8	1.5	0.9	5.0	2.7
Extreme scenario	2020	-6.5	-10.0	-11.0	-3.0	-3.0
	2021	1.3	1.0	-1.3	3.0	2.1

Real GDP, % yoy

of fiscal retrenchment after the big 2020 stimulus does not appear fully credible. Global growth recovers only mildly. In the second, even more extreme scenario, eradicating the virus takes much longer (more than one year is needed to find a vaccine) and the global economic fallout is even more negative. Concerns on the European economic situation and the debt outlook are expressed louder by rating agencies while the political response is weak, delayed and uncoordinated. Euro breakup fears are back again. In terms of growth, a very sharp downturn gives way to a shallow global recovery. In Italy, a GDP contraction of more than 10% in 2020 is followed by another year of recession as fiscal measures and financial market dislocation depress domestic growth.

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Fixed Income

- **The spreading of Covid-19 had a strong grip on international bond markets in Q1 2020. In addition, strong fiscal and monetary responses resulted in a very volatile environment. Eventually, especially US yields decreased noticeably.**
- **Looking ahead, we see some further leeway for lower yields as the extent of the recession will become clearer only over time and amid the strong interventions by central banks. Once the news flow turns more positive, there is scope for a modest yield increase in the medium term.**
- **Despite bold ECB measures triggering a partial reversal of the bond spread widening, on balance risk premiums of euro area non-core countries rose strongly in the first quarter. Going forward, the ECB support will likely serve as a soft upper limit for spread levels. However, a significant tightening is unlikely without further steps towards risk sharing on the euro area level.**

International bond markets were rattled by the spreading of Covid-19 in Q1. At latest from end of February onwards, the efficient functioning of international bond markets was no longer ensured. Although global central banks reacted swiftly and provided ample liquidity and initiated several new Quantitative Easing (QE) programs, there are still severe dislocations. In addition, governments around the world resorted to expansionary fiscal policy. Overall, the policy response is likely to go well beyond the measures taken during the GFC in 2008/09.

Government bond yields on a roller coaster in Q1, but on balance strongly down

International government core bond yields were on a roller coaster in the first quarter. Despite the sell-off of risky assets, there were initially no lasting safe haven flows. Driven by technical factors (e.g. forced selling driven by outflows, realization of profits to balance losses) core yields even increased sharply (particularly in the euro area). Ultimately, core yields decreased again and finished the quarter significantly below the end-of-year levels. On balance, 10-year Bund yields fell by around 30 bps and 10-year Treasury yields by even 125 bps (leading to the lowest transatlantic yield spread for more than 6 years). Beside the higher initial US yield level this reflects the noticeable move to lower US key rates close to zero during an extraordinary Fed meeting in March. The different pattern is even more impressive at the short end of the curve. Due to a stable ECB key rate, 2-year Bund yields fell only slightly but their US counterparts collapsed by more than 130 bps to 0.25%.

Government bond yields administered by central banks

While central banks have influenced bond markets for several years, the new extraordinary measures will even increase the central banks' impact further. As the programs are massive and taking into account the central banks' commitment to do even more, it is apparent that the central banks will prevent any future development not in line with their targets. This implies that the QE programs will likely be used to avert any significant increase in yields. This way it will be ensured that governments can fund the strong increase in fiscal spending smoothly.

Future development very much determined by central banks – QE programs likely to prevent a lasting increase in yield level

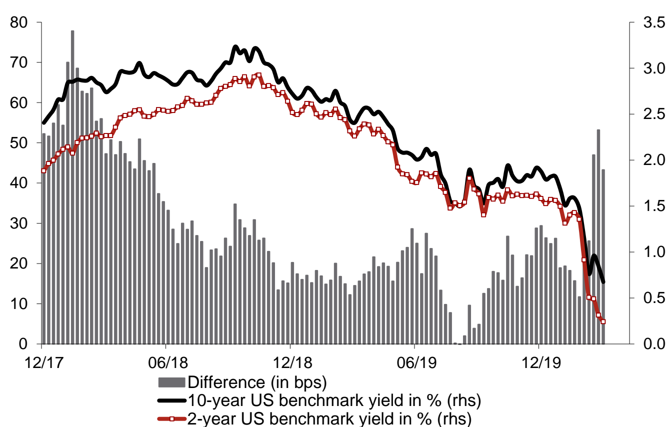
Central banks did not provide an explicit yield target. Hence, it is not obvious whether they intent to drive yields further down. However, given the deep recession and the bulk of disappointing economic hard data still to come, we see scope for even lower yield levels. This applies even more as long as the news flow regarding a containment of Covid-19 remains bleak. Therefore, on a short-term horizon 10-year US yields are seen to approach new lows and there is leeway for long-dated Bund yields to fall further, too (although we do not expect the lows marked in March to be reached again).

Moreover, the recent increase in real yields in an environment characterized by a sharp sell-off of risky assets and an imminent recession is stunning and hardly sustainable. E.g., real euro area long-dated yields increased sharply and are back to the level of spring 2019. Particularly long-dated inflation expectations have marked new

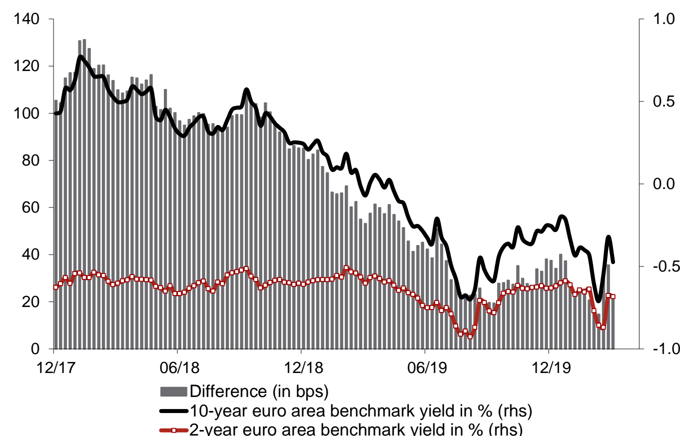
historical lows. Temporarily, 30-year inflation swaps even fell below 1%. Although they have recovered slightly since then, they are still way below the fair value region. To anchor inflation expectations again and to drive real yields lower, the ECB will include inflation-linked bonds in its QE programs. Hence, although a swift increase in inflation expectations is not on the cards amid the recession and the depressed oil price, there is scope for higher inflation expectations medium term. This applies even more as the massive policy response can create inflation potential. Even the attempt by the ECB to eventually inflate away the massive amount of debt cannot be precluded at present.

Looking into H2 2020 and beyond, we see some modest potential for higher yields again. Particularly in the US, there is some room for a bear steepening of the yield curve. Higher inflation expectations in combination with an economic rebound are likely to drive yields upwards again. However, even on a 12-month horizon 10-year US yields will struggle to exceed the 1% threshold significantly.

Graph 1: US – SHORT- AND LONG-DATED GOVERNMENT YIELDS



Graph 2: EA – SHORT- AND LONG-DATED GOVERNMENT YIELDS



Euro area non-core sovereign spreads to remain contained

ECB's new QE programs are expected to prevent a too strong divergence of euro area non-core spreads

While in the first two months of the year euro area non-core spreads initially tightened, the spreading of Covid-19 in Europe (originating from Italy) caught non-core bond markets on the wrong foot. Spreads spiked to long-term highs, but retreated once the ECB announced its bold policy measures. Still, on balance spreads of all non-core countries widened in Q1 reflecting the weakened fundamental position and investors' concern about the impact of Covid-19 on debt sustainability.

However, the strong ECB support will serve as a soft upper limit for spread levels. Not only will ECB purchases more than outweigh the increased issuance activity and net issuance of all euro area will be negative in 2020, but also the flexibility of the QE programs with respect to timing, asset classes and jurisdictions signals that the central bank is not willing to accept a malfunctioning of the transmission of monetary policy.

However, for a significant further tightening, EMU countries will have to agree on some kind of burden sharing via the ESM or even by taking steps towards the mutualization of debt. Although particularly the second alternative appears rather unlikely in the short term, we see some potential for slightly tighter non-core spreads.

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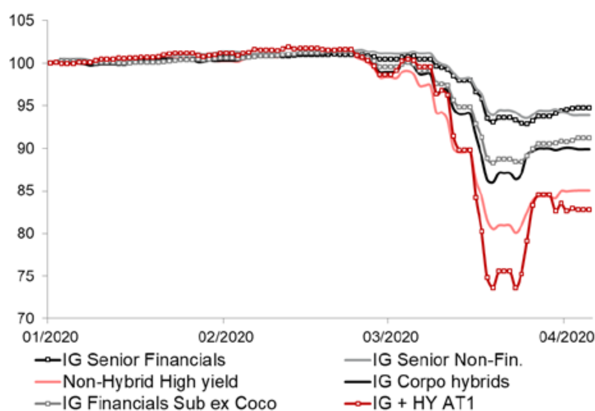
Corporate Bonds

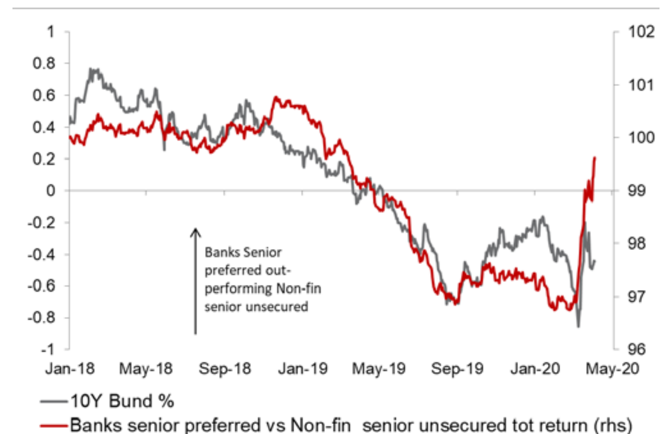
- **Credit market have been no exception in the recent phase of market volatility. After a smooth start into the year, the spreading of the Covid-19 outside of China has led to a significant widening of credit spreads, although still remaining below the 2008 and 2012 levels.**
- **Containment measures taken globally are threatening the liquidity and solvency profile of companies. The Fed and the ECB are now buying credit spreads at unprecedented levels. The system of government guarantees and bailout funds will also help.**
- **However higher rates, rating migration and outflow defaults will continue to weigh on spreads.**
- **Hence we recommend an overweight in Investment Grade (IG) Credit while staying cautious on High Yield.**

The non-economic nature of this crisis combined with the high uncertainty still prevailing regarding the magnitude of the economic shock the developed world will be facing makes the comparison with either 2008 or 2012 almost impossible from a credit market perspective. If overall the credit market is reflecting investors' anxiety regarding corporates' liquidity and solvency profile, both cash and synthetic indices remain below 2012 and, a fortiori, 2008 levels.

Graph 1: CREDIt MARKET YTD PERFORMANCE
BASE 100= 01/01/2020



Graph 2: EA – SHORT- AND LONG-DATED GOVERNMENT YIELDS



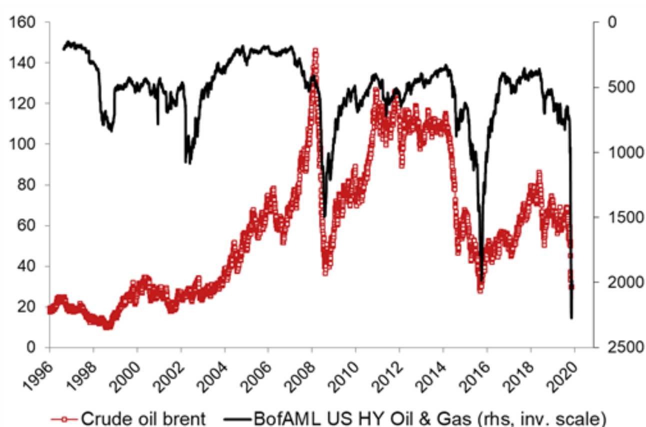
Corporate bonds the ultimate QE - supporting IG

Major central banks are buying investment-grade corporate bonds at a large scale. The ECB is now running its PEPP program on top of its CSPP II restarted last year. Assuming 25% of corporate bonds within the PEPP, we calculate that the ECB could fund more than a year of issuance need for eligible issuers (up to the 70% limit. The BoE has also restarted its corporate bonds purchase program while the Fed is buying credit for the first time directly as well as via ETFs. After a near freeze of the primary market, these interventions have allowed large and solid corporates to return to the market, hence alleviating the liquidity risk for investment grade. Other measures were taken to avoid a credit crunch by reducing the prudential pressure on the financial system, allowing banks to run lower capital ratios during the crisis. In Europe, regulators have asked in return both banks and insurance companies to suspend dividend payments. Indeed under the current scenario creditors are the main beneficiaries of this measure as no dividends being paid means better capitalization. The picture is less clear on subordinated financials as they would be the next in line after dividends, should the crisis deteriorate further. But we view the chances of an AT1 coupon ban as fairly low in a V or U-shaped activity scenario.

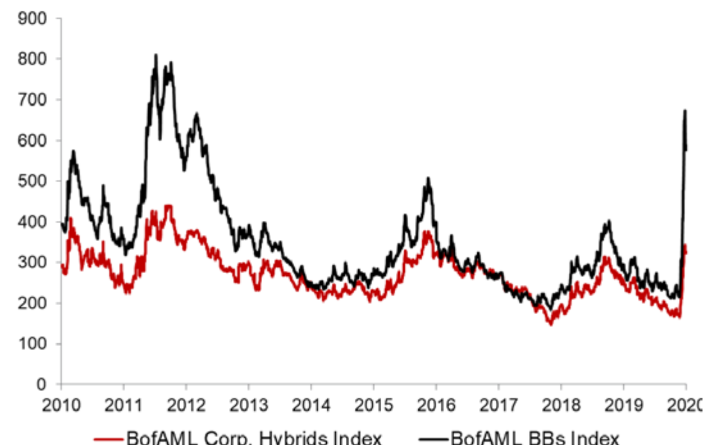
Defaults, rating migration, and flows to weigh on spreads

The policy response has been strong, but there is little doubt that default rates will rise. They could, however, remain below those of 2008 of nearly 10% globally for HY while for EUR IG the historical average is very close to zero on a five-year horizon. Recovery rates could be lower than the historical average of 40% because companies' leverage is currently at historical highs. The main question is now how flexible will rating agencies be. Back in 2008, nearly 15% of the BBB rated bonds were downgraded to HY. If we were to observe a similar move this time it would increase the size of high yield bonds by more than one third posing the problem of the absorbability of such amounts. The issue could be even more pressing in the loan market as CLOs are the main buyers and they will become forced sellers should B-rated rate bonds be massively downgraded to CCC. In that respect, the low oil price is adding further pressure in the US as the oil sector has been the main default provider since 2015 (see Graph 1). Finding buyers of low-quality credit will prove very challenging in a context of record outflows from credit funds in March contrasting with years of steady inflows into IG.

Graph 3: US – HY OIL & GAS VS. CRUDE OIL BRENT



Graph 4: CORPORATE HYBRIDS VS. BBs OAS VS. GOVERNMENT



Investment grade appears attractive

The elevated volatility has contributed to significant dislocation in credit markets. The iTraxx and CDX indices had been the first to react end of February but they are now trading significantly tighter than two weeks ago while cash remains at or near peak levels. Indeed supply has been an important factor in the relative performance of the different parts of the Credit market. The primary market remained frozen in the High Yield segment which allowed this asset class to perform as volatility decreased. On the opposite, in € IG Non-Financials, the supply was about twice a normal month of March with large premia paid. We recommend to take advantage of those dislocations and favour Non-financial IG at current levels; indeed spreads compensate already for a significant downgrade risk. Within high beta, our preference goes for corporate hybrids. As most issuers are eligible to the ECB at senior level, we see the extension risk as fairly low compared to AT1, we expect issuers to continue to pay coupons and the composition of the index is very defensive (Utilities Telcos.). We continue to expect decompression between investment grade and high yield in Europe and keep a cautious stance on HY looking for better visibility to re-enter the segment.

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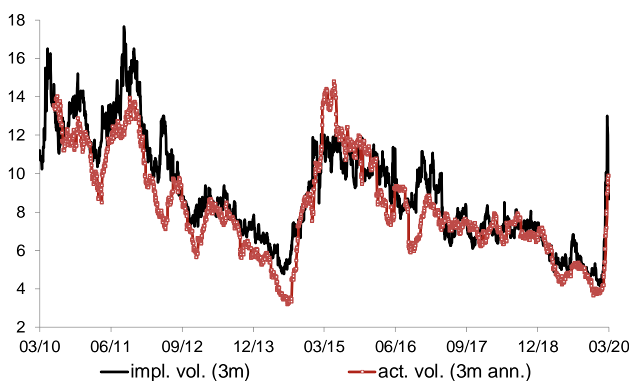
Currencies

- **A global funding squeeze has boosted the USD as the Covid-19 pandemic was triggering a global economic shut-off. Broad provision of USD liquidity by the Fed notwithstanding, we may witness further bouts of USD strength near term.**
- **Further out, however, we see the EUR/USD moderately higher. Deep Fed rate cuts and higher volatility have eroded the long-standing appeal of the USD. Furthermore, with more visibility on the fallout and the global shutdown to be gradually eased, safe haven demand for the Greenback is likely to recede.**
- **EM FX has been hit hard by the global risk-off mode and the USD funding squeeze. With visibility on the fallout in EMs outside China still low, we remain defensive for the time being.**
- **The SNB has strongly stepped up efforts to cap the CHF. We expect intervention to continue amid a rising deflationary threat, but see a EUR/CHF recovery only in H2 on a broader economic recovery.**
- **USD/JPY has defied the usual drawdown amid sharp rises in risk aversion and decoupled from US yields. With USD funding pressures to ease, we see moderate downside for USD/JPY.**

USD gains broadly amid a funding squeeze as Covid-19 goes global

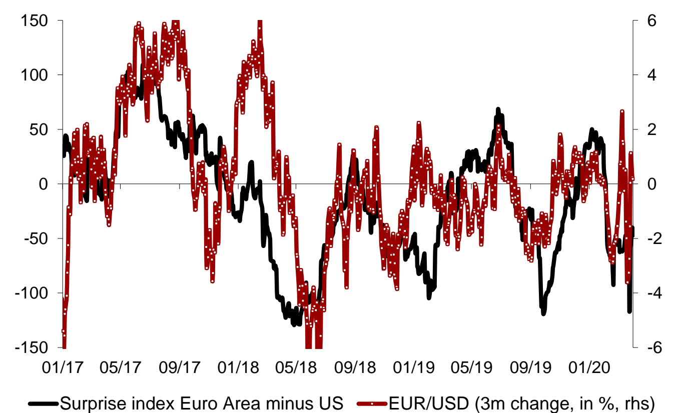
As the Covid-19 epidemic goes global, the USD has been boosted broadly. The rush for liquidity in the global financial market rout has pushed investors into the safety of the Greenback. Furthermore, the rush for USD credit lines by companies amid slumping revenues has triggered a global USD funding squeeze. The Fed reacted fast, both nationally via unlimited QE and internationally via generous swap lines and a new facility which allows foreign central banks temporarily to exchange USTs held with the Fed for USD liquidity. This will help to assuage the funding pressure especially in the G10 space with the spike in cross currency swaps reversing. Nevertheless, such that there may well be repeated bouts of USD scarcity underpinning the Greenback over the coming weeks, also as banks' tapping respective USD discount window is still hampered by the perceived stigma of needing help.

Graph 1: EUR/USD VOLATILITY



in % ann.

Graph 2: RELATIVE ECONOMIC SURPRISES AND EUR/USD



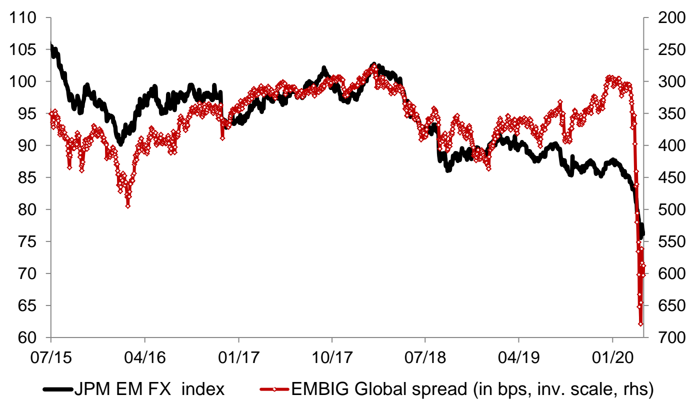
Eroded attractiveness of USD carry

The steep Fed rate cuts and higher volatility severely reduce the risk-adjusted carry provided by the USD

While further setbacks in the EUR/USD are feasible near term (acknowledged by our flattish 3-month forecast), we still see the mid-term trend geared to the upside. Importantly, attractiveness of the USD has been eroded severely by the Fed's drastic rate cuts and the spike in volatility (Graph 1), which also triggered a sharp reversal in speculator positioning towards USD net short. Europe is hit hard by the Covid lockdown, but the US is becoming the new epicentre, with economic surprises at

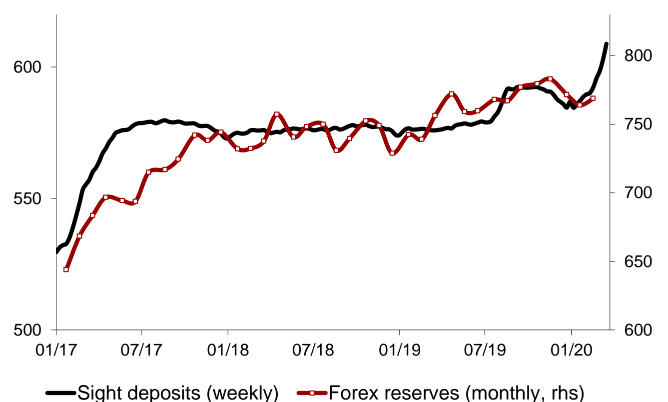
risk of disappointing, which would underpin the EUR/USD (Graph 2) – all the more if Europe agrees on some form of support (likely via ESM and the EU budget) alleviate debt concerns for Italy and Spain. Key downside risks to our 1.14 target on 12 months arise from a prolonged extension of the lockdown amid only muted help to Southern Europe. In this case, rising worries about debt sustainability and the fiscal capacity to support a recovery may weigh more severely on the EUR.

Graph 3: EM FX AND EM DEBT SPREADS



EM FX vs. USD; index: Jan 2, 2018 = 100

Graph 4: SWISS SIGHT DEPOSITS AND CENTRAL BANK RESERVES



in bn CHF

EM FX have suffered partially severe losses, but amid still limited visibility on the fallout of Covid especially in the EM world, we remain cautious

EM FX has been hit particularly hard by the global market rout since Feb 21, with the JPM EM FX down by more than 10% by April 1. The rout was led by commodity producers and high beta currencies, with BRL and ZAR depreciating by almost 25% vs. the USD. We remain cautious on EM FX in the near term, given the still limited extend of the fallout both in the EA and US, but also regarding the implications for the populations in EMs and their economies, which are much less equipped to master a sharp increase in infections and to weather the economic and financial stress from broad lock-downs. Oil producers may see some relief from a rebound in oil prices, in case Saudi Arabia and Russia can agree on a truce in their oil price war, with US President Trump ramping up efforts as a broker.

SNB intervention keeping CHF at bay

The Swiss franc will need to be capped by further SNB intervention before there will be upside for EUR/CHF in H2

After the breakdown of classical correlations earlier in the year, CHF and JPY have benefitted amid the recent market turmoil (up 1% and 4.1% vs. USD respectively since Feb. 21). We still see potential for the undervalued yen to catch up with much tighter US/Japanese yield differential and persistent global uncertainties as well as resuming repatriation flows. In Switzerland, only heavy intervention by the SNB (as signaled by a sharp increase sight deposits, Graph 4) could prevent the CHF from rising more sharply. While the bloated SNB's balance sheet (> CHF 800 bn of FX reserves) is a major concern, we still see the SNB strongly committed to keep the CHF at bay, also given the further drop of inflation in negative territory (-0.5%yoy in March). But it will likely take until Covid pressures ease and the global economy bottoms before we will see FX intervention easing and EUR/CHF recovering.

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Equities

- **In the quarter stock markets experienced monthly drawdowns which have surpassed those after Lehman crisis.**
- **To combat the fallout from the COVID-19 spreading, huge measures have been taken by policy-makers globally (both on the monetary and fiscal side) which triggered a visible rebound since March 23rd.**
- **Risk premia are near Lehman times but earnings dispersion is still worrying and both economic and earnings consensus forecasts have more room for further downside.**
- **We adopt a cautious short term with a tilt on defensives (SMI, UK and US) and selected EMs (Taiwan and Korea). Sectorwise we prefer pharma, software, utilities, telecom and staples.**
- **On a 12-month horizon, even using as input -38% and -30% earnings cut from peak (euro area and US resp.), we see the chance to realize double digit total returns, which encourage us to adopt a limited overweight on equities.**

Year-to date equities lost 26% (MSCI World) as Covid contagion spreaded in the west world and cities were locked down to contain the negative effects. It was a classical sell-off phase with EMU (-28%) underperforming the safer indices such as US (-23%), Switzerland (-12%) and UK (-27%). Growth, Quality, Momentum and Defensive styles largely outperformed Value and Cyclicals.

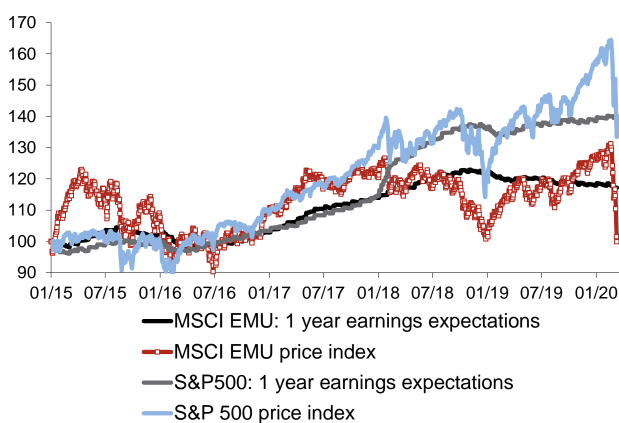
Developed markets have already started to respond to easing central banks but remain vulnerable in the short term

Huge measures taken (monetary and fiscal ones) triggered a visible rebound since March 23rd with a decreasing volatility. That said, defensives still retained their leadership - a sign that investors remain cautious and the market still vulnerable.

Limited OW, cautious short term and positive in 12 months

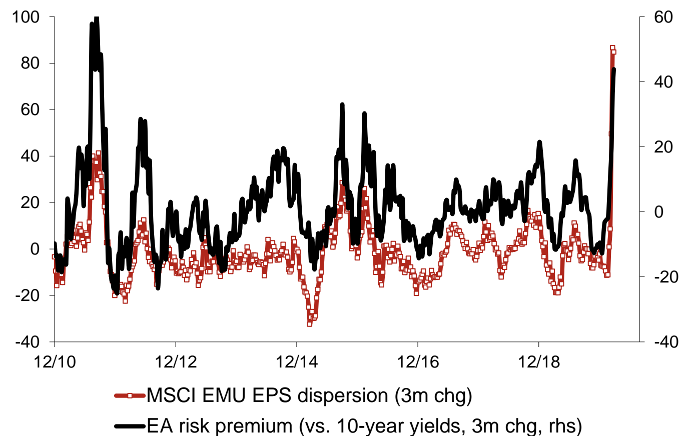
While the degree of global recession for Q2 and the entire 2020 is still under review and getting worse every week, we decided to be rather aggressive on earnings forecast, using -38% and -30% cut from peak for the euro area (EA) and the US, respectively. Nevertheless, factoring in appreciable monthly drawdowns, we can see

Graph 1: PRICE AND EARNINGS PERFORMANCE



(01/01/2015 = 100)

Graph 2: EA RISK PREMIUM VS EARINGS DISPERSION



3m changes

12-month return can be double digit

12-month returns in the region of at least 10%. Short term we are more cautious waiting for the US and Europe to reach the contagion peak while investors will have the time to digest horrible GDP figures for this year with eventual credit event plus further cuts in dividends and buy backs, which we estimate to be at least -30%. In the EA, a plan concerning coordinated help (while not debt mutualization) should help at the margin, too. The yield curve will also have the time to steepen as it did in previous slowdowns before the market reached the definitive trough. Hopefully, thanks to aggressive monetary policy, volatility will also decline below 50 in a stable

way. On the positive side, fiscal and monetary action are already quite strong coming much quicker than in 2008-9 crisis. Implied risk premium is already near 2008 excesses and 12-month returns could be double digit, even factoring in the highlighted downside in profits. We are more cautious short term, adopting only a limited OW on equities. Timing of contagion peak in the US and EU and duration of lockdown in relevant countries remains uncertain and so does the negative impact on the economy and earnings.

Maintain a defensive bias inside equities

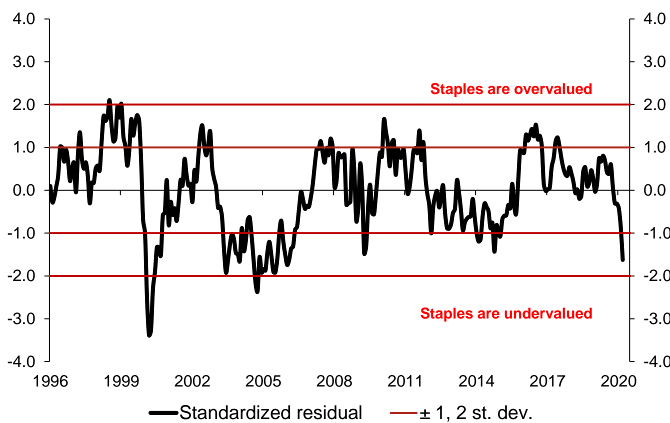
Maintain a defensive bias in countries, sectors and style. Relative valuations and past experience in drawdowns plus following recovery drive our stance

We maintain a preference of EU ex-EMU (still overweight) and the US (domestic, defensive, more aggressive response to crisis, financials enjoying higher yields). Still cautious on Japan and EMs (neutral). Healthcare, telecoms, utilities, staples and software are not yet expensive looking to both market multiples and our quant models. They behaved quite nicely during the recovery after the Lehman drawdown. Concerning styes, we are OW defensives vs. cyclicals, large cap, high dividend yield and momentum. Slight OW growth and Quality vs Value. Sector OW: pharma, software, utilities, telecom and staples. N financials and energy. UW: Real Estate, Materials, transportation and discretionary.

EM: resilient dollar to cap EM outperformance in the short term

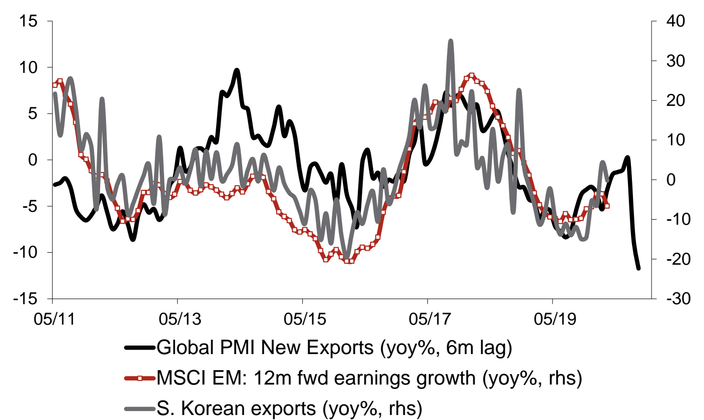
Pressured by the coronavirus spreading around the globe, the MSCI EM index has sunk by 21%, outperforming the MSCI World by 2.5 pp in only local terms. In dollar terms the EMs have underperformed by 1.3pp. However, it should be noted that the worst 30 day rate of change induced by the COVID-2019 was not as worse as for

Graph 3: STAPLES VS MSCI EUROPE: MODEL VALUATION



distance from fair value model, in standard deviations

Graph 4: GLOBAL EXPORT ORDERS, S. KOREAN EXPORT GROWTH AND EM EARNINGS EXPECTATIONS



EM outperformance is to be capped in the short term due to still high spreads and TW USD

developed markets (-27% vs. -34% for the US and 38% for the EA). The market multiples are now trading at a discount of 22% to history and EM PEs relative to US PEs have decreased in line with the corresponding HY spreads. While spreads and trade-weighted dollar have recently started to decrease, they remain very high representing a burden for EM companies (YTD +322 bps and 7.65% for spreads and TW USD, respectively). These factors along with lingering wild cuts in global GDP and export forecasts would cap EM outperformance in the short term, warranting a neutral stance. For the mid-term we are more poitive, favoring for the time being Korea and Taiwan, having better contagion momentum, M1 trends and valuations.

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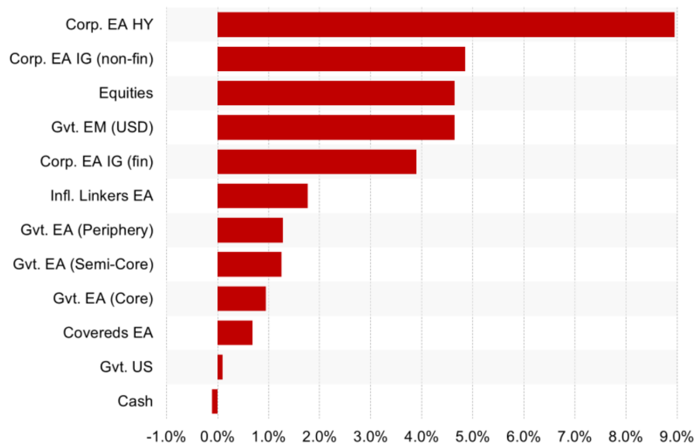
Asset Allocation

- **The economic fallout of the Covid-19 crisis seems to be taking on unprecedented dimensions. We are now acting on the assumption of a deep global recession in 2020.**
- **The massive fiscal and monetary policy measures resolved should lend support to the markets, particularly if accompanied by some less negative news on the virus front.**
- **No doubt, Covid-19 will continue to cast a shadow over everything for the time being. That said, given the massive policy support by central banks and the historical corrections on the equity markets, we deem a prudently more risk-prone allocation stance rewardable.**
- **In that sense we recommend to cautiously rebuild equity exposure with a focus towards defensives. The overweight in EUR IG credit should be expanded in particular for non-financials. Primarily this should be financed by an underweight in cash, quasi govies and covered bonds. We favour a moderately long duration in fixed income.**

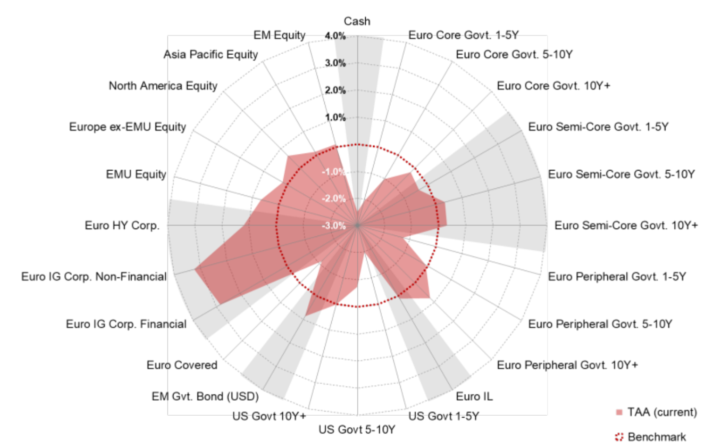
As signs grew that the impact of the Covid-19 crisis would be more severe than originally expected, we decided at the end of February to go for a neutral position in equities. In addition, the exposure to IG credit was neutrlalized in favour of cash in mid-March as a further measure of derisking the tactical allocation stance. Thus, in particular, the negative impact of the ~20% slump on equity markets experienced over that period could be mitgated significantly.

Graph 1: SELECTED AGGREGATED TOTAL RETURN FORECASTS



3-months horizon; Hedged into EUR; Semi-Core = Spain; Periphery = Italy

Graph 2: RECOMMENDED ACTIVE POSITIONS



In pp; Semi-Core = Spain; Periphery = Italy

There is no doubt that the Covid-19 crisis will have a firm grip on the global economy and thus also on financial markets. Yet, against the backdrop of the grave equity market corrections and first signs of a moderate recovery as well as the massive central bank support for credit, we consider the present situation favourable to cautiously rebuild some risk positions.

In that sense we recommend to moderately raise equity exposure with a focus on defensive sectors. The overweight in IG Credit should be expanded with a preference for non-financials. Primarily this should be financed by an underweight in cash, quasi govies and covered bonds. Furthermore, we have a general preference for longer-dated government bonds, in particular for semi-core and peripherals due to the higher carry. Overall, the duration should thus be moderately long.

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Forecasts

GROWTH

	2018	2019f	2020f	2021f
US	2.9	2.3	- 3.0	3.8
Euro area	1.9	1.2	- 6.0	3.5
Germany	1.5	0.6	- 6.0	4.0
France	1.7	1.3	- 5.5	3.5
Italy	0.7	0.2	- 6.6	2.0
Non-EMU	1.6	1.4	- 5.4	5.2
UK	1.4	1.4	- 6.5	6.0
Switzerland	2.8	0.8	- 2.0	1.3
Japan	0.8	0.8	- 1.9	2.2
Asia ex Japan	6.2	5.2	1.9	6.7
China	6.6	6.1	2.5	7.7
CEE	3.1	1.9	- 3.4	3.8
Latin America	0.1	- 0.6	- 0.7	2.3
World	**3.6**	**2.8**	**- 1.1**	**4.5**

INFLATION

	2018	2019f	2020f	2021f
US	2.4	1.8	2.1	2.2
Euro area	1.8	1.2	0.9	1.3
Germany	1.8	1.4	1.0	1.5
France	1.9	1.2	1.1	1.3
Italy	1.1	0.8	- 0.5	1.2
Non-EMU	2.3	1.7	1.2	1.4
UK	2.5	1.8	1.2	1.4
Switzerland	0.9	0.4	0.2	0.7
Japan	1.0	0.5	0.3	0.4
Asia ex Japan	2.6	2.8	3.3	2.5
China	2.1	2.9	2.9	1.8
CEE	6.0	6.7	4.7	4.5
Latin America	4.0	4.0	3.7	3.6
World	**2.8**	**2.6**	**2.6**	**2.4**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

FINANCIAL MARKETS

3-month LIBOR	**Current**	**3M**	**6M**	**12M**
USD	1.44	1.25	1.25	1.25
EUR	-0.25	-0.30	-0.45	-0.45
JPY	-0.04	-0.10	-0.10	-0.10
GBP	0.57	0.55	0.55	0.55
CHF	-0.62	-0.60	-0.75	-0.75
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	0.63	0.55	0.70	1.10
Euro-Area	-0.44	-0.55	-0.50	-0.30
France	0.05	-0.10	-0.10	0.05
Italy	1.48	1.30	1.25	1.30
Japan	-0.01	-0.10	-0.10	-0.05
UK	0.33	0.25	0.35	0.60
Switzerland	-0.34	-0.40	-0.35	-0.25
Spreads	**Current**	**3M**	**6M**	**12M**
GIIPS	155	150	145	130
BofAML Covered Bonds	63	60	55	50
BofAML EM Gvt. Bonds (in USD)	637	625	610	550

Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
BofAML Non-Financial	232	160	150	140
BofAML Financial	248	215	200	175
Forex	**Current**	**3M**	**6M**	**12M**
EUR/USD	1.09	1.09	1.11	1.14
USD/JPY	108	107	107	106
EUR/JPY	117	117	119	121
GBP/USD	1.24	1.24	1.28	1.34
EUR/GBP	0.88	0.88	0.87	0.85
EUR/CHF	1.06	1.06	1.07	1.09
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2527	2640	2670	2730
MSCI EMU	95.5	97.5	99.5	104.0
TOPIX	1330	1380	1400	1450
FTSE	5480	5705	5800	6000
SMI	9271	9575	9740	10000

As of 02.04.20

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Group	Asset	Low	Mean	High
Government Bonds (10Y)	US	0.48	0.55	0.62
	Germany	-0.65	-0.55	-0.45
	UK	0.19	0.25	0.31
	Switzerland	-0.49	-0.40	-0.31
Spreads	10Y-GIIPS Spread	118	150	182
	BofAML Covered Bonds	50	60	70
	BofAML IG Non Financial	130	160	190
	BofAML IG Financial	183	215	247
	BofAML EM (in USD)	561	625	689
Forex	EUR/USD	1.06	1.09	1.12
	USD/JPY	103	107	111
	EUR/GBP	0.85	0.88	0.91
	EUR/CHF	1.04	1.06	1.08
Equities	S&P500	2,520	2,640	2,760
	MSCI EMU	92.4	97.5	102.6
	TOPIX	1,301	1,380	1,459
	FTSE 100	5,440	5,705	5,970
	SMI	9,162	9,575	9,988

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Group	Asset	Low	Mean	High
Government Bonds (10Y)	US	0.95	1.10	1.25
	Germany	-0.48	-0.30	-0.12
	UK	0.47	0.60	0.73
	Switzerland	-0.41	-0.25	-0.09
Spreads	10Y-GIIPS Spread	72	130	188
	BofAML Covered Bonds	28	50	72
	BofAML IG Non Financial	85	140	195
	BofAML IG Financial	117	175	233
	BofAML EM (in USD)	422	550	678
Forex	EUR/USD	1.07	1.14	1.21
	USD/JPY	98	106	114
	EUR/GBP	0.79	0.85	0.91
	EUR/CHF	1.03	1.09	1.15
Equities	S&P500	2,507	2,730	2,953
	MSCI EMU	93.0	104.0	115.0
	TOPIX	1,278	1,450	1,622
	FTSE 100	5,478	6,000	6,522
	SMI	9,172	10,000	10,828

*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, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

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