GENERALI INSURANCE ASSET MANAGEMENT

Market Perspectives

A deepening poilicy dilemma

September 2023

GIAM Macro & Market Research

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

- **Markets' more cautious stance on risk assets is set to continue as the support from resilient US growth is increasingly offset by the need for high rates for longer.**
- **We still expect more economic pain to erode corporate margins, especially in the euro area, while elevated equity valuations look vulnerable to a correction.**
- **We keep a prudent underweight in Equity and HY while overweighting safer IG Credit and EM debt mainly due to an attractive carry.**
- **A continued growth slowdown and a higher probability that the Fed and ECB will skip rate hikes in September point to slightly lower yields. Yet a continued hawkish bias in central banks' forward communication will likely prevent a stronger bond rally.**

Content

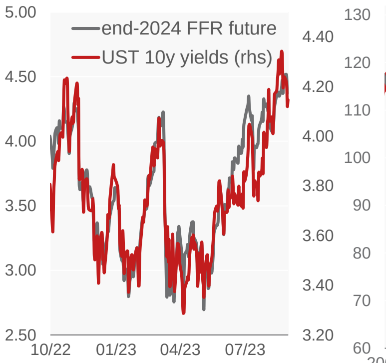
Global View – A deepening poilicy dilemma

Thomas Hempell

- **Markets' more cautious stance on risk assets is set to continue as the support from resilient US growth is offset by the need for high rates for longer.**
- **We still expect more economic pain to erode corporate margins, especially in the euro area, while elevated equity valuations look vulnerable to a correction.**
- **We keep a prudent underweight in Equity and HY while overweighting safer IG Credit and EM debt mainly due to an attractive carry.**
- **A continued growth slowdown and a higher probability that the Fed and ECB will skip rate hikes in September point to slightly lower yields. Yet a continued hawkish bias in central banks' forward communication will prevent a stronger bond rally.**

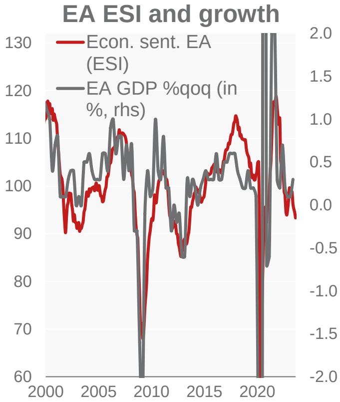
The summer has revealed an increasingly divergent and challenging global macro backdrop. Resilient US data is raising concerns about high US rates for longer. China is descending into deeper property and growth worries. And the euro area faces a deepening policy dilemma, as stubborn inflation contrasts with rising recession risks.

US rates exp. and yields



Source: Datastream, GIAM calculations

EA ESI and growth



Source: Datastream, GIAM

The ECB's policy dilemma is becoming particularly evident. High wage growth in the euro area points to persistent price pressures in services, where labour accounts for a high share of input costs. Having dismissed post-pandemic inflation overshoots for too long, the ECB will be keen to not blink prematurely on inflation. But activity indicators are slipping, with recent PMIs, Ifo and ESI all undershooting already subdued expectations and pointing to a contraction in Q3 (right chart), raising recession worries.

With the bulk of past rate hikes working through the economy and core goods inflation easing, the ECB doves will have a stronger case for skipping a September hike to digest more incoming data – a Sept. 14 pause in the ECB cycle now looks a little more likely to us (in an admittedly narrow call), as it does for the Fed on Sept 20.

This, alongside a further weakness in economic data, points to moderately lower yields. However, a continued hawkish bias in the Fed's and ECB's forward communication (not ruling out further hikes and dismissing hopes of an early pivot) is likely to prevent a stronger bond rally.

We continue to expect further headwinds for riskier assets, notably Equities and HY, while safer IG Credit may extend its resilience and benefit from the appealing carry. The odds of a euro area recession have increased. Recovering real incomes may help to stabilize activity later in the year. But a further deterioration in the global outlook and the pass-through of fast monetary tightening may keep the euro area in the stranglehold for even longer. In China, the rapid end to the reopening bounce and mounting problems in the property sector may undermine confidence and growth further, denting prospects also for European exporters.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	4.18	4.00	3.85	3.60
Germany (Bunds)	2.54	2.40	2.35	2.30
Credit Spreads**				
EA IG Non-Financial	143	150	155	150
EA IG Financial	171	185	190	185
Forex				
EUR/USD	1.08	1.08	1.10	1.11
USD/JPY	146	145	140	137
Equities				
S&P500	4446	4355	4330	4560
MSCI EMU	146	143	143	151

**3-day avg. as of 29/08/23* ***ICE BofA (OAS)*

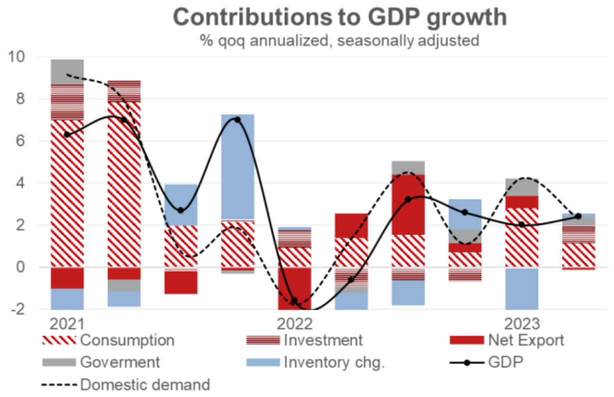
Margin pressures and high valuations a burden

This does not bode well for the earnings outlook, especially in the euro area, as margins will come under pressure from higher labour costs, depleting consumers' excess savings and slowing overall demand. Equity valuations remain stretched, too. The S&P500's P/E ratio is hovering around 19x, similar to where it was in April 2022. At that time, real 10-year US yields were close to zero while in late August they were close to 2%. Finally, investors' risk positioning also looks toppish. The rebound in sentiment from the depressed levels seen during the March banking woes underpinned much of the equity rally into early summer but has turned recently into a mild drag. Faltering growth in the euro area, a milder recession forecast for the US and a later expected pivot by the Fed will create further headwinds to the EUR/USD before it may resume its ascent later in the year.

United States

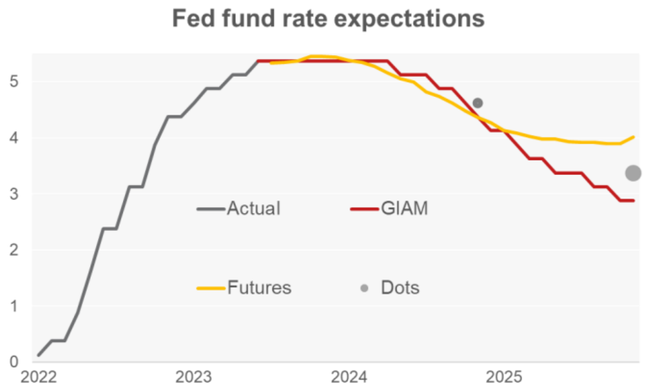
Paolo Zanghieri

- **After a strong Q2 and upbeat summer data, we raise our growth forecast to 2.1% this year and 0.6% next. We still see a winter recession, even though only a mild one.**
- **Job openings and quits are decreasing without triggering so far any increase in unemployment. Wage growth is moderating but remains high.**
- **Core inflation is on the way down but slowly; another Fed hike in September or November is possible but not our baseline. We do not expect the Fed to cut rates before Q2 2024.**



Source: BEA, GIAM

Source:Atlante Fed, BLS, Refinitiv, GIAM



Source: Federal Reserve Board, Refinitiv, GIAM

Domestic demand is proving more resilient than expected to tighter financial conditions. Q2 growth proved strikingly robust (2.1% annualised) and the first indications for Q3 point to a similar performance. Consumption remains very strong on the back of (quickly depleting) excess savings and accelerating real wages. Capex is suffering by less than feared from the spike in rates, and is helped at the margin by the fiscal incentives to energy and IT infrastructures legislated by the Inflation Reduction and CHIPs Acts. Still, the 500+ bps rate tightening has yet to be felt in full by the economy, and the expansionary fiscal stance is going into reverse. We then expect a GDP slowdown in the final part of the year, leading to a small (0.2% qoq) contraction in Q1 2024. While growth should reach 2% this year, we expect only 0.6% for 2024; high yields and weak credit growth will burden the recovery in H1.

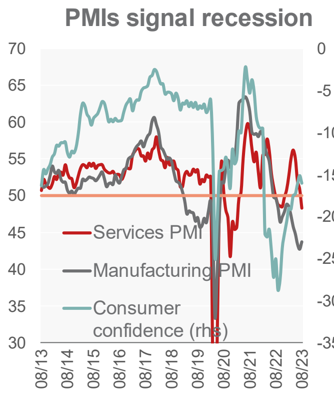
Job openings are declining fast and workers are more reluctant to quit their position. This is helping cool wages, which are still growing by some 1.5 pp higher than the rate consistent with 2% inflation. Inflation is heading down (in July the core rate was 4.6% yoy, from a 6.6% yoy peak in September 2022), yet the ex housing service component, closely monitored by the Fed, has moved sideways in the last three months around 4% yoy after falling from a peak of 6.7% yoy one year ago. We expect core CPI inflation to reach 4% yoy by year end. Upside risks remain given the strength of consumption and tentative signs of bottoming out of the housing market.

Rate cuts can wait until Q2 2024

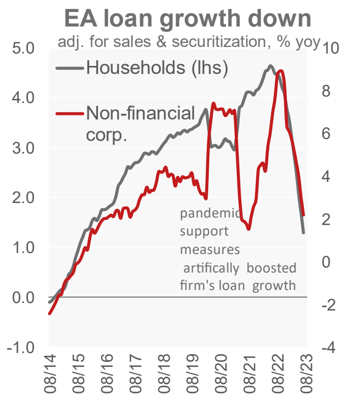
During the summer, FOMC members maintained a hawkish tone, as inflation risk remains high. Another rate increase in September or November, as priced by markets, is possible, but we think that the Fed is done with hikes. Hawkishness in communication is rather aimed at steering market expectations on the timing of the first cut. We expect it to happen at the end of Q2. We pencil in a total of 100 bps easing next year.

Euro Area

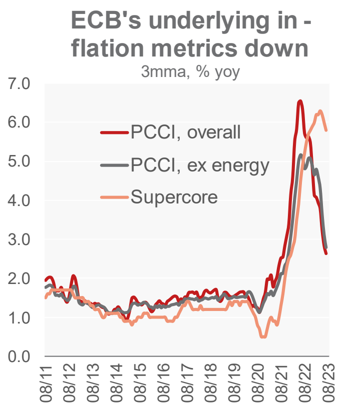
Martin Wolburg



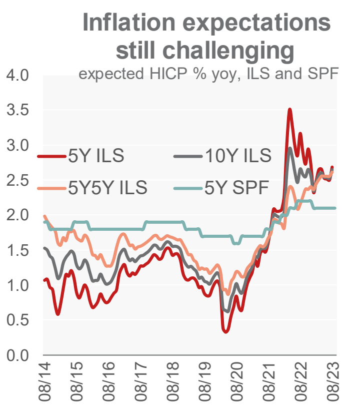
Source: Datastream



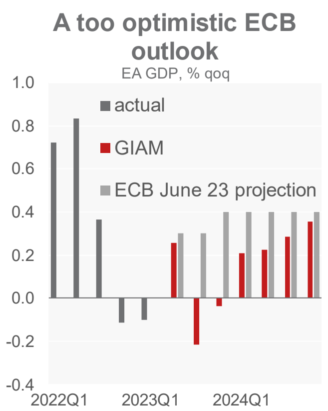
Source: Datastream, GIAM calculations



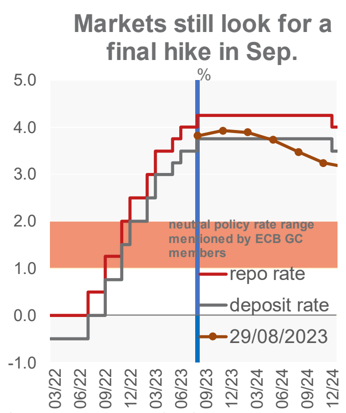
Source: Datastream, ECB



Source: Datastream, ECB, GIAM calculations



Source: Datastream, ECB, GIAM



Source: Datastream, ECB, GIAM calculations

- **The summer string of activity data shows protracted weakness but some support will come from receding inflation with measures of core inflation falling too.**
- **Activity in Q3 will recede and we reduced our 2023/24 growth outlook to 0.4% 0.5%. Risks of a H2 recession – while not our base case – are rising.**
- **We now deem it slightly more likely than not that the ECB's Governing Council (GC) will abstain from a final hike at the Sep. 14 meeting.**

Euro area activity resembles somewhat the weird summer: With Q2 GDP having expanded by 0.3% qoq the start was sunny but during Q3 the string of activity data clouded. Two observations are outstanding: First, services sector sentiment, which had proven resilient before, followed the the manufacturing sector and deteriorated to levels consistent with falling activity. The compositive PMI's Q3 average (of 47.8) so far implies shrinking output. Second, loan growth weakened further confirming a strong slowing of the economy. With 1.3% yoy loan growth to households even fell back to the weakest level since Nov. 2015. All in all, unlike to our previous expectations we now look for receding output over the third quarter of 2023.

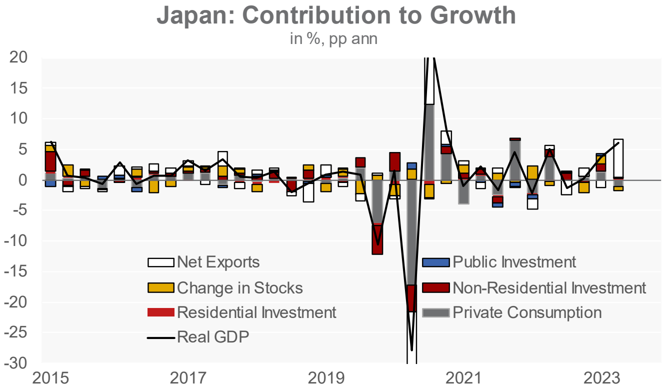
Will we enter into a recession? We still hesitate to make this our base case. The main reason is that disinflation has started and will continue. Measures of underlying inflation are now trending down. And special factors (like base effects from the 9 EUR ticket in Germany) will peter out giving leeway to a more meaningful fall in headline rates to around 3% yoy by year-end, from 5.3% yoy in August. Hence, real income growth will be supported. Moreover, we look for an improved international environment in Q4 again. That said, the risks remain tilted to the downside. A key signpost to watch is the labour market which has proven resilient so far. But with the PMI employment component at just 50.3 there clearly is a risk of a longer lasting and deeper slowdown.

ECB policy rate peak to be reached in September

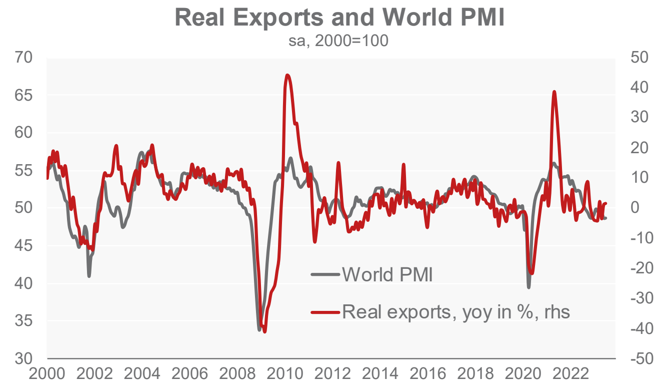
At the Sep. 14 meeting the GC will need to substantially revise its growth outlook down (see bottom lhs-chart). It will have confirmation that core inflation is coming down while the sharp fall in credit growth will hint at the unfolding dampening effect from policy tightening. But with strong wage growth (negotiated wages +4.3% yoy in Q2) and some market-based inflation expectation measures up there is still rationale for higher rates. It is a very tight call but we now deem it slightly more likely than not that the ECB will not lift rates again in September. However, we leave our 12-month expectation unchanged reflecting that the return to the 2% target will be a long distance run implying a hawkish policy tilt for the time being.

Japan

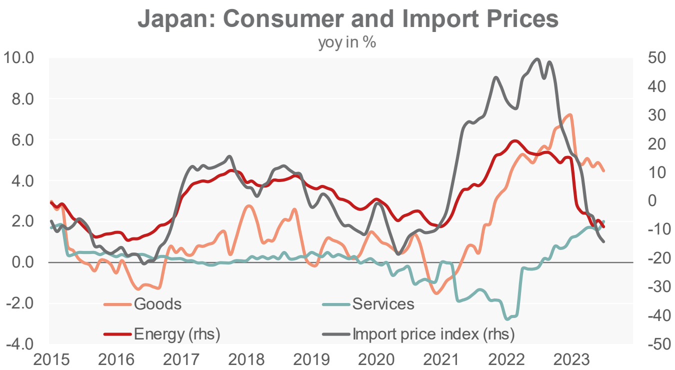
Christoph Siepmann



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

- **Japan's Q2 GDP growth surprised strongly on the upside with 6.0% qoq ann. due to strong net trade.**
- **Yet domestic demand disappointed. While we expect more data revisions, we revised our GDP growth forecast to 2% (up from 0.9%) resp. 1% for 2023/24.**
- **Headline inflation moved sideways although inflation dynamics accelerated again. We expect the BoJ to remain on hold for at least the rest of the year.**

Japan's economy grew much faster than expected in Q2 with real GDP advancing by 6.0% qoq annualized (ann), well above the market forecast of 2.9% qoq ann. The upside surprise was driven by net trade as exports rebounded (by 13.6%, after -14.4% qoq ann in Q1) while imports kept contracting. Exports benefitted especially from car sales and incoming tourism amid the ongoing weakness of the yen. Looking forward, the soft yen will likely continue to benefit exports, but the global manufacturing recession and especially the worries in China suggest export growth to weaken. This is also confirmed by the PMI sub-component "new export orders" which remained – albeit improving – in contractionary territory.

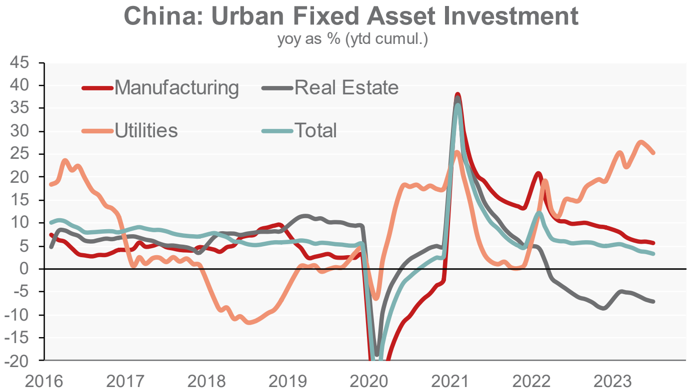
Q2 GDP figures also surprised on the domestic side. Private consumption unexpectedly dropped by 2.1% qoq ann while private capex was about flat. The private consumption results were at odds with rising consumer confidence as well as with the Economy Watchers Survey. In sum, the strong Q2 result should not be taken at face value. Basically, they imply more rebounds (revisions) for consumption, capex, and imports. Given this volatility, we see Q3 growth flat or slightly negative due to base effects. However, also Q1 growth had been revised upwards (from preliminary by 1.6 pps to 3.7% qoq ann) which let us revise our GDP growth forecast to 2% (up from 0.9%) resp. 1% in 2023/24.

BoJ expected to remain on hold

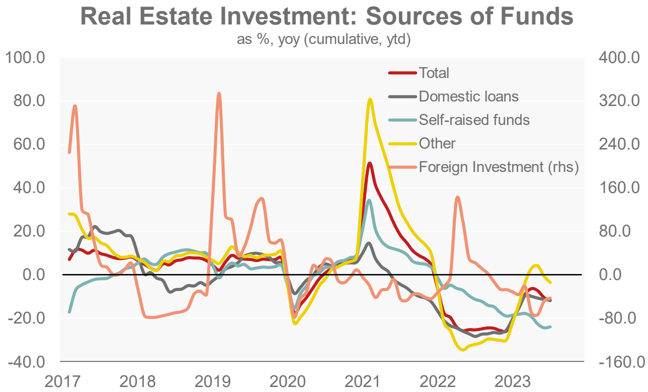
Japan's headline inflation remained unchanged in July at 3.3% yoy. However, inflation dynamics accelerated again from 0.1% mon to 0.5% mom. Main drivers were food prices but also services inflation related to communication, culture and recreation rose markedly. Core-core measures inched up to 4.3% yoy (ex fresh (!) food & energy) resp. 2.7% yoy (ex food & energy). Import prices (and thus energy prices) are on a strong downtrend (-14.1% yoy), despite the yen weakness. By contrast, service inflation now reached the 2% yoy threshold. However, after the BoJ already moved last month, we do not expect any additional action in the near term. Given its focus on the virtuous wage-price cycle, it will likely wait on more clarity on wage development in spring 2024. Given, the latest inflation numbers, we tweak up our forecast to 3.0% this year and 1.9% in 2024.

China

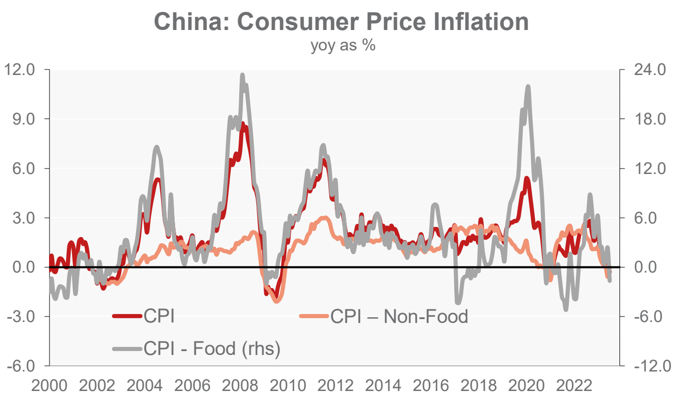
Christoph Siepmann



Source: Datastream. GIAM



Source: Datastream, GIAM



Source: Datastream, GIAM

- **China had a weak start into Q3 and fresh turmoil among property developers added to market worries.**
- **Monetary policy eased and we expect more cuts in the MLF rate by 20 bps and RRR ratio by 50 bps in H2. Fiscal policy has kept its piecemeal approach.**
- **We have become sceptical about a bolder fiscal policy package (which nevertheless remains a risk) and revise our GDP forecast down to 4.8% in 2023 and 3.8% in 2024.**

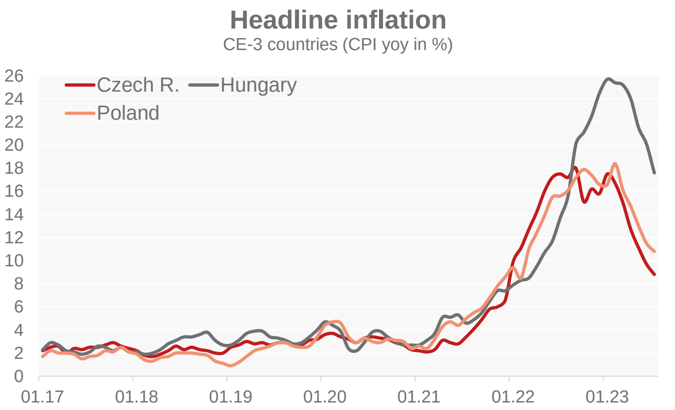
China's economy had a weak start into Q3. Almost all data came all in below consensus forecasts. On top, news about property developers (e.g., Country Garden) missing/ deferring payments added to market worries. July industrial production (IP) growth decelerated to 3.7% yoy, while IP monthly growth dynamics shrank to almost naught. This reflects soft foreign as well as domestic demand. Exports dropped by 14.5% yoy (imports by 12.4% yoy) in July. The international manufacturing recession suggests more weakness ahead. On top, some domestic components are amplifying the lack in demand. Year-to-date (ytd) fixed asset investments (FAI) softened to 3.4% yoy ytd with property investment being the major drag (-12.2% yoy ytd). While the government had successfully supported financing for finishing ongoing projects, new housing construction is ailing. The latter is the underlying reason for the diminishing self-financing of developers from incoming down-payments. Thus, more "bad news" from developers remain likely. We do not expect property demand to turn around over the short run. Negative feed-back loops cannot be excluded. However, we see an outright banking crisis as less likely. Finally, retail sales growth weakened further to a growth rate of 2.5% yoy, while the catering component (representing services) is still on a high level (15.8% yoy). We do not expect household demand to gather pace soon.

Piecemeal approach of fiscal policy

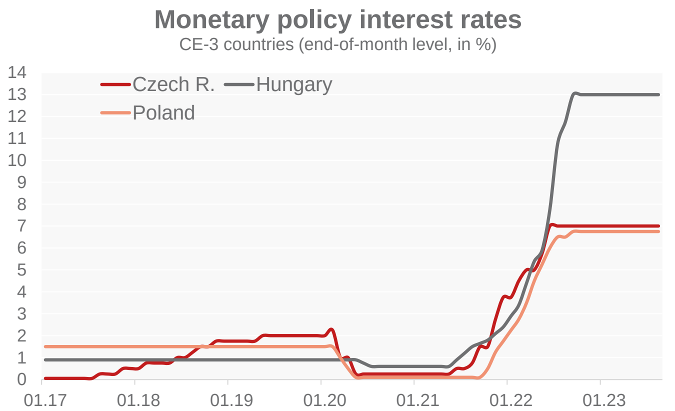
China also saw CPI inflation to drop into negative territory by -0.3% yoy. PPI deflation and a series of negative mom rates indeed reflect the weakness in overall demand. However, last month's drop was mainly due to food prices, while core inflation "doubled" to 0.8% yoy (a six month high). The PBoC cut the MLF rate by 15 bps and the 7-day reverse repo rate by 10 bps, but the Loan Prime Rate only partially followed. Looking ahead, while fiscal policy has introduced a range of incremental measures, it seems reluctant to set up an outright package (which nevertheless cannot be completely excluded). In this light, we revised down our growth forecast to 4.8% resp. 3.8% in this year and the next and see CPI inflation at 0.4% resp. 1.5% in 2023/24.

Central and Eastern Europe

Radomír Jáč



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



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

Main Forecasts

Czech Republic	2021	2022	2023f	2024f
GDP	3.5	2.4	0.0	2.5
Consumer prices	3.8	15.1	10.9	2.5
Central bank's key rate	3.75	7.00	6.50	3.50
Hungary	**2021**	**2022**	**2023f**	**2024f**
GDP	7.1	4.6	-0.6	3.5
Consumer prices	5.1	14.5	17.2	4.8
Central bank's key rate	2.40	13.00	11.50	5.00
Poland	**2021**	**2022**	**2023f**	**2024f**
GDP	6.9	5.1	0.0	2.7
Consumer prices	5.1	14.3	12.0	4.6
Central bank's key rate	1.75	6.75	6.00	4.75

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

- **A mix of declining inflation and a rather poor GDP performance is supportive to speculations on monetary policy easing in the CE-3 region.**
- **The Hungarian MNB kept a steady course with a cut in its O/N deposit rate by 100 bps in August and we expect a cut of the same size also in September.**
- **The Polish NBP is likely to deliver its first rate cut in September with more to come in Q4.**
- **The Czech CNB is in no to ease policy despite the recommendation from its own forecast. We expect rate cuts in Q4 but there is a risk that the CNB will stay on hold for longer.**

GDP data for Q2 reported a slight increase of 0.1% qoq (-0.4% yoy) for Czechia while Hungary recorded a fourth GDP quarter-to-quarter decline by -0.3% qoq (-2.3% yoy) in a row. Polish GDP fell by -3.7% qoq (-1.3% yoy) after a sharp increase of 3.8% qoq in Q1. Even if GDP performance improves in Q3 and Q4, the full-year result will be close to stagnation in Czechia and Poland, while Hungary may report a quite sharp GDP contraction in 2023. Stronger full-year performance is expected in 2024, as GDP will be supported by recovery in household consumption across the CE-3.

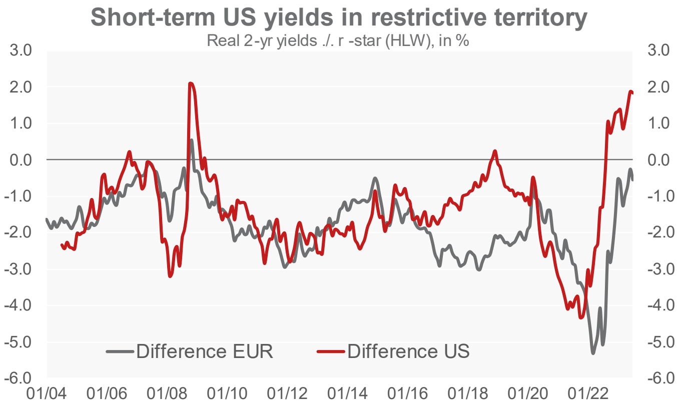
Inflation moderated further across the region in July. The moderation is widespread, driven by food and energy prices, and by core CPI items. The mix of disinflation and a rather poor GDP performance is supportive to speculations on rate cuts but Hungary is for now the only CE-3 country where the process of monetary policy easing has already started.

Monetary policy: Expect rate cut in Poland in September

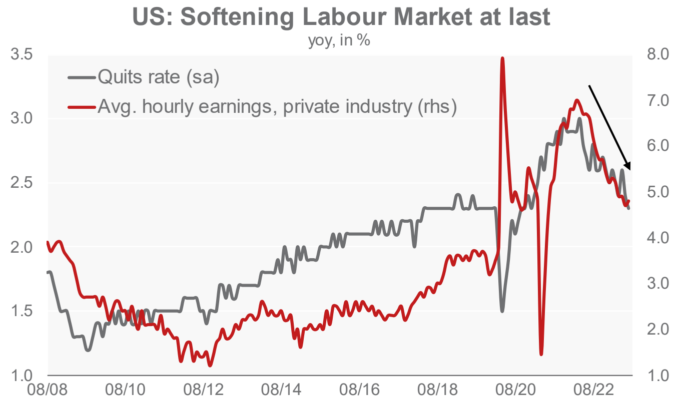
The Hungarian MNB cut its O/N deposit rate by 100 bps in August: to 14%. We expect the same step in September. This would mean that the O/N deposit rate would be aligned with the base rate at 13%. The MNB will then start cutting its base rate in Q4 and it notified that it will simplify its monetary policy toolkit after September. In Poland, the NBP did not hold monetary policy meeting in August. The next meeting is scheduled for September 6 and there are growing speculations that the NBP will start cutting its key rate from current 6.75%. We now think that a cut in September (by 25 bps) is more likely than not and that at least two more cuts of the same size may follow in Q4. The Czech CNB kept its key rate at 7% in August and said that rates will stay on hold also in September. While its own forecast shows rate cuts for Q3, the CNB keeps a cautious stance and stresses inflationary risks. The first rate cuts may come in Q4 but the possibility of a later move is non-negligible.

Government Bonds

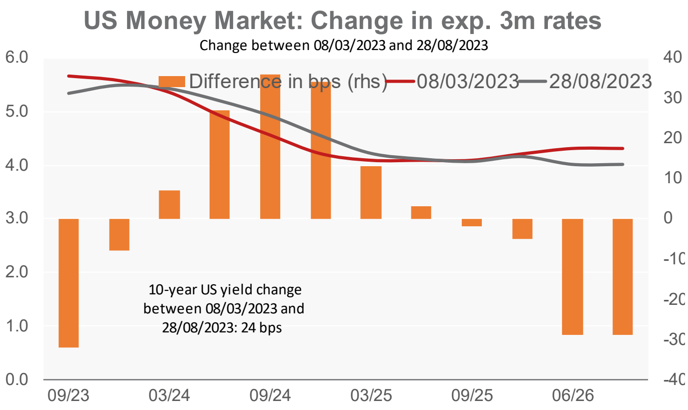
Florian Späte



Source: Bloomberg, NY Fed, GIAM



Source: Bloomberg, GIAM



ource: Bloomberg, GIAM

- **Government bond yields rose further in August, particularly in the US, on the back of robust US economic data and rising key rate expectations.**
- **However, given the expected economic slowdown, we stick to our view that yields will fall in the medium term. Central bank decisions in September may cause some short-term disruptions, but are unlikely to alter the trend of falling yields.**
- **Euro area (EA) non-core government bond spreads remained in a rather tight range. We expect the upcoming supply to contribute to a moderate spread widening going forward.**

Surprisingly resilient US economic data have not only resulted in a US key rate hike in autumn now being priced in with a probability of around 50% but also pushed back the timing of a first cut. Before the latest data came in somewhat weaker, various tenors marked new long-term highs. Despite significantly weaker EA data, this also pushed EA core yields up a little. Both in the US and in the EA, the rise is exclusively due to real yields (inflation expectations have hardly moved since the end of July in the EA and in the US they have even fallen a little).

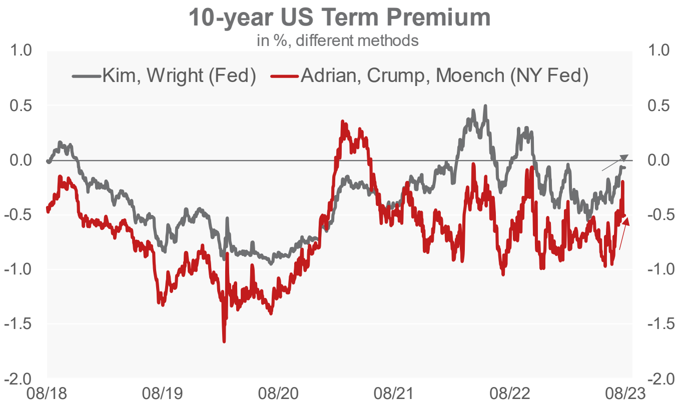
Despite the recent yield increase, we are sticking to our medium-term view of lower yields. While the Bloomberg Consensus no longer expects a quarter of negative growth in the US, we continue to forecast a slight recession around the turn of the year given the historically sharp key rate hikes. The US labour market in particular has weakened in recent months and the PMIs also point to a slowdown in momentum. The EA economy will likely shrink in Q3 with the risk of a recession having gained probability.

Accordingly, we assume in our base scenario that the Fed and the ECB have reached the peak rate in the current cycle. Since financial markets have priced in a further key rate hike of 25 bps (particularly for the ECB), there may be a noticeable yield decline following central bank meetings. Should the Fed and/or the ECB go for a final hike (which cannot be ruled out), the market reaction is seen to remain muted.

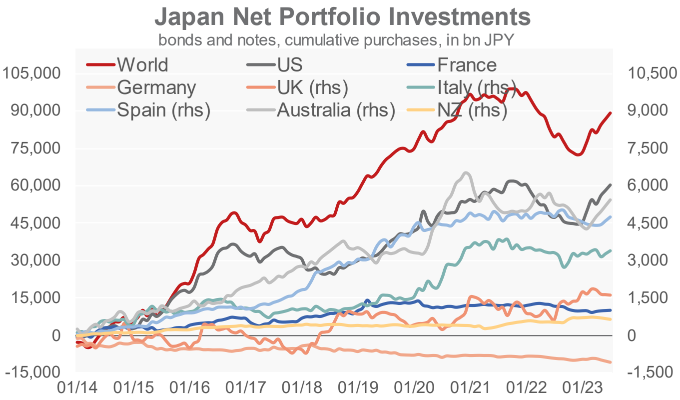
Overall, for several reasons, we see more leeway for lower yields in the US than in the EA. First, the US is already further advanced in its efforts to bring down inflation. Particularly, sticky wages will keep EA inflation on an elevated level for the time being. Given the high inflation, the focus of financial markets is currently more on inflation than on economic momentum. Second, monetary policy is much more restrictive in the US than in the EA (the difference

Government Bonds

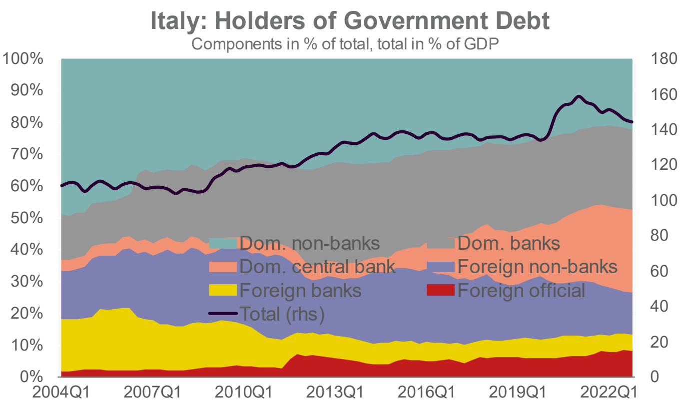
Florian Späte



Source: Bloomberg, GIAM



Source:Bloomberg, GIAM



Source: IMF, GIAM calculations

between 2-year real yields and r-star is almost 2% in the US and still slightly negative in the EA). Accordingly, there is more downward potential here, which should then also be reflected at the long end of the yield curve.

However, one caveat applies. The US term premium has increased by more than 30 bps since mid-July. We attribute its rise to the very high net-net government bond issuance in 2023 (although the expiring QT programme and an increasing share of funding via bills will give some relief from 2024 onwards). Moreover, the tweaking of the YCC by the BoJ dents the appeal of Treasuries (and other government bonds) for Japanese investors. As portfolio investments have risen in 2023 an important component of US Treasury demand has been called into question. Finally, there are some concerns about the level of the real long-term neutral rate (see also here). This uncertainty also contributes to a rising term premium. Accordingly, given the still low level of the term premium, we see some further upside.

However, the dominant yield drivers remain the economic and monetary policy. As explained above, we forecast a rather friendly bond market environment going forward. For 10-year US yields, we expect 4.0% on a 3-month view and 3.6% on a 12-month view (dissipating the current 2-year/10-year inversion). The corresponding forecasts for the EA are 2.4% and 2.3%, respectively.

Some further widening of EA non-core spreads

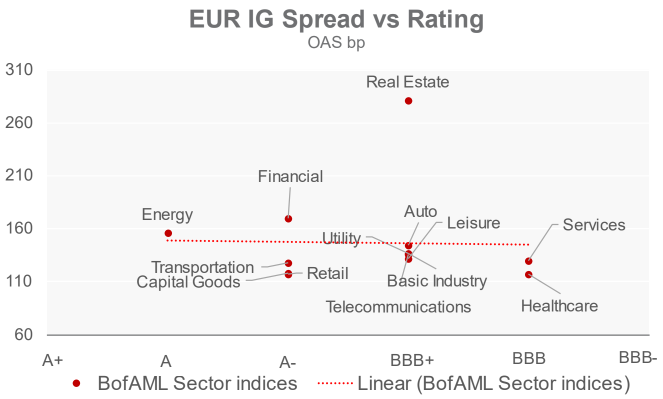
The performance of EA non-core government bond spreads did not follow a clear trend but could not benefit from the favourable seasonality. While Italian BTPs underperformed slightly, spreads of Spanish and Portuguese bonds tightened. Overall, the changes were quite small.

Going forward, there is leeway for somewhat wider spreads in September. It has always been a month with high issuance activity, but this time it is a bit out of line. Not only are redemptions lower compared to 2022, but above all the ECB's QT programme is gaining momentum. As a result, the net-net supply of EA non-core government bonds is significantly higher than last year. Moreover, the uncertainty about the future monetary policy in conjunction with the weak economic data has recently caused bond market volatility to rise again. In the short term, we do not expect any easing and therefore some further upside pressure on spreads. Overall, however, the movements are likely to continue to be limited and Italy in particular (well-advanced issuance activity, little dependence on foreign investors) is likely to perform relatively well after its recent somewhat poorer performance.

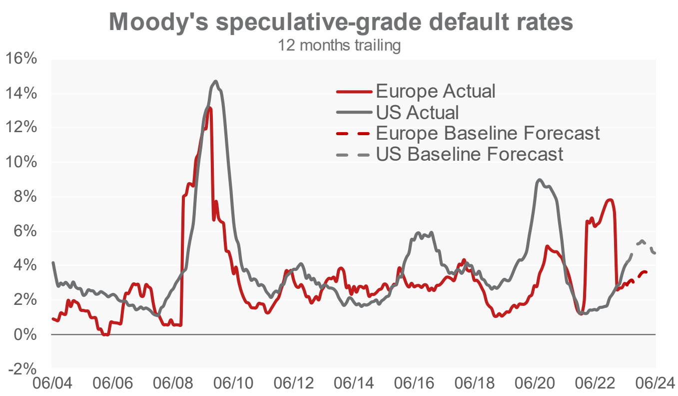
Credit

Elisa Belgacem

Source:Bloomberg, BofAML Indices, GIAM



Source:Bloomberg, BofAML indices, GIAM own calculations



Source: Moody's, GIAM

- **The usual September bond supply will put mild pressure on spreads, with HY the most affected in relative terms as corporates will start refinancing 2024 maturities.**
- **We maintain our OW stance on IG non-financials. Current CDS levels are attractive for buying credit protection.**
- **We remain under-weight financials versus financials as we expect bank asset quality to start deteriorating.**

Traditionally, September sees a lot of corporate issuances and credit markets have already started to position for it.

Supply risk will be relatively higher in financials and HY

However, any above-average level of supply could however put a widening pressure on spreads. The segment the most at risk of seeing its technicals deteriorating is the HY. Indeed, the year so far has been relatively light in terms of HY issuance, but 2024 is heavy on maturities and corporate treasurers will start refinancing. Also in the financial space, banks will continue to refinance the TLTRO, which is likely to maintain a relatively heavy supply compared to the non-financial space. Valuation metrics across the credit universe show that the European IG space is the cheapest compared to US IG and both EU and US HY. The fundamentals of IG non-financials should remain relatively solid.

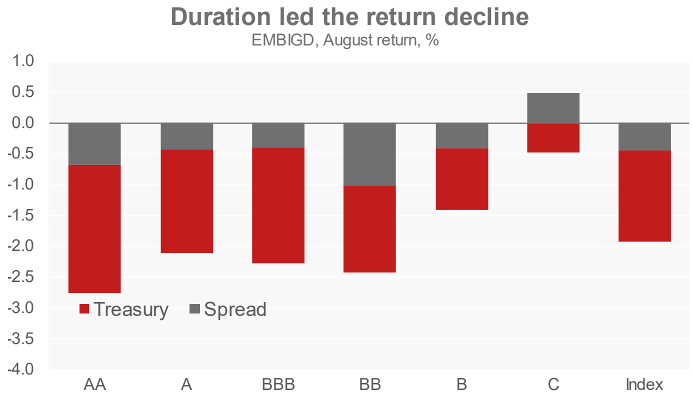
Defaults will continue to rise

As the global economic backdrop starts to show signs of weakening, while inflation remains above central banks' targets, corporate margins will start to decline due to lower demand and higher financing costs. This is particularly the case for smaller companies as they tend to have shorter debt maturities; EU HY maturities are currently around three years, meaning that the majority of HY debt will soon have been issued after monetary policy normalisation begins. Moreover, loans and private debt are floating rate instruments, which means that they feel the impact of higher interest rates on their entire debt stack, implying higher solvency risks. HY defaults are also accelerating in the US and Europe, and we expect them to end 2024 at 4.5% in Europe and 5.5% in the US.

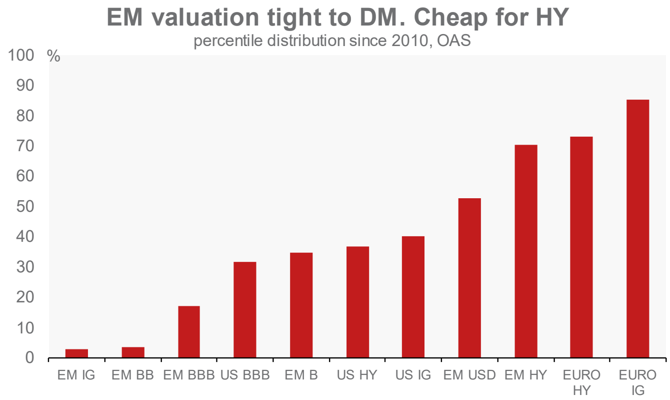
Overall, we prefer IG non-financials due to their defensive carry profile. For HY, we believe that current valuations do not reflect elevated risks. As a result, we expect spreads to widen by close to 75bp by the end of the year. CDS have tightened much faster than cash and we like to buy credit protection here. Bank asset quality is also likely to deteriorate, which leads us to remain underweight financials versus non-financials in terms of spreads.

EM sovereign bonds

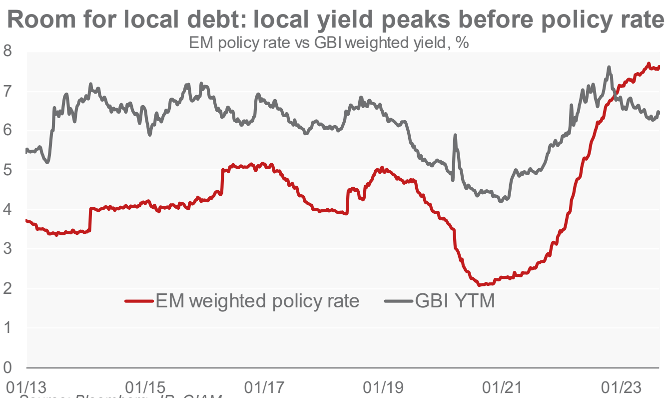
Guillaume Tresca



Source: JP, Bloomberg, GIAM



Source: Bloomberg, JP Morgan, GIAM calculations



Source: Bloomberg, JP, GIAM

- **EM prospects have marginally deteriorated after the repricing of DM rates and growing Chinese concerns. Better US prospects will mitigate their impacts.**
- **Outside China, EM growth is still resilient and firm disinflation opens space for monetary easing.**
- **We maintain an overweight stance in our allocation, favouring local over external debt. Valuations are tight and we avoid HY names.**

Summer has eventually not been calm and the EM fixed-income environment has slightly deteriorated. However, it remains a supportive one and so we maintain an overweight stance in our global allocation but the total return prospects have declined both in the local and external debt spaces. The main change is the rebound of global rates and the resilience of the US economy which are limiting the positive duration effect. We still expect lower UST rates in the medium term but less than before. The bright side is that the risk of a global economic slowdown and a US recession have been declining and so the risk of seeing wider EM spreads. We have therefore lowered our expectations for EM spreads: +15bp by year-end. In our view, the positive duration effect is still sufficient to offset the spread widening.

Economic resilience, limited contagion from China

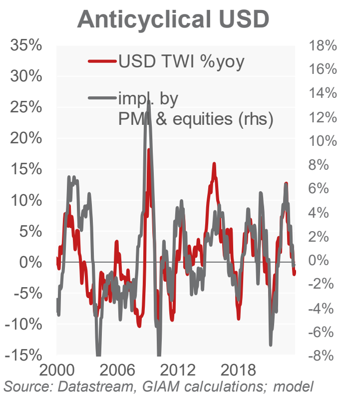
The Chinese backdrop has certainly deteriorated and the growth risks are skewed to the downside. Disappointing Euro area activity could also negatively weigh on CEE. However, we do not expect a Lehman moment in China that would spill over to other EMs and the surprising US economic resilience will help to offset these negative effects. EM ex-China PMIs have also been resilient. Mexico and manufacturing Asia exports can benefit from the US boost. More importantly, disinflation has been confirmed and large EM central banks surprised to the downside (Brazil, Chile). We expect more central banks to start cutting (LatAm).

Favour local debt and IG countries

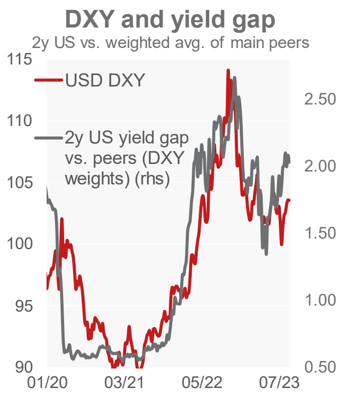
EM local debt continue to offer better prospects than external debt. Valuations are less tight and fast disinflation offers higher real rates than expected and provides some cushion to central banks. That said, the front end is already pricing in aggressive cuts and we favour the belly. The risk is for further steepening. For external debt, valuations are expensive, especially in IG but given the current position in the cycle, we avoid HY names. The HY segment is cheap but it is only due to distressed names, driven by idiosyncrasies. So we stick with our preference for BBBs like Romania. We still like Mexico EUR but valuations are increasingly less attractive after this year's rally.

Currencies

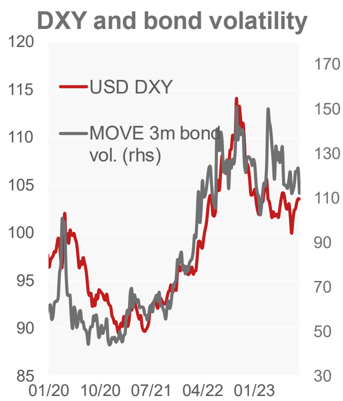
Thomas Hempell



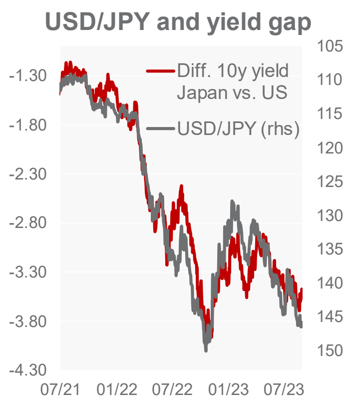
Source: Datastream, GIAM calculations; model 2000-2022 based on MSCI World %yoy and global man. PMI



Source: Datastream, GIAM

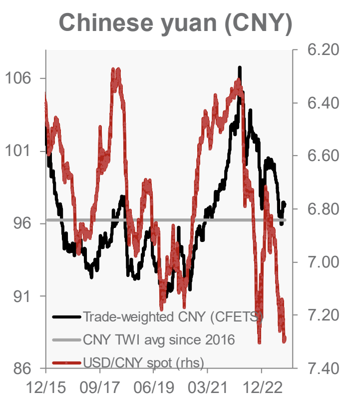


Source: Datastream, GIAM



Source: Datastream, GIAM calculations

Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

- **Faltering euro area growth, a milder US recession and a later prospective Fed pivot point to a further EUR/USD headwinds before it may resume its ascent later in the year.**
- **The ailing yen is approaching intervention levels. Reversing US yields are set to help JPY. But diminishing odds of an early BoJ policy twist keep a lid on the yen's near-term outlook.**
- **Chinese policymakers will cushion, but not prevent a further rise in the USD/CNY.**

Poor global data has helped to extend the USD recovery (top left chart). Indeed, we warned of looming EUR/USD setbacks. Poor data from the EA (sliding PMI and ifo) and China (weak exports, retail sales and property woes) contrasted the continued resilience in the US (GDP nowcasts point to a strong Q3), so regional divergence added to the USD tailwinds. The resulting widening of the yield gap points to even some further USD upside (top right chart). With the near-term outlook for the euro area and the ECB now more likely to remain on hold in September, the EUR/USD looks vulnerable to further setbacks near term.

USD weakness postponed

Ultimately, we still expect bottoming euro area growth, a mild US winter recession and easing rates uncertainty to then give way to more USD weakness. And the Fed will still lead the global easing cycle in 2024. But we acknowledge that the odds of a US soft landing have risen, while a Fed pivot will come later (now Q2/2024 in our books). This means that the triggers for renewed USD weakness are set to play out later and more sluggishly. We therefore lowered our EUR/USD forecasts to 1.08 and 1.11 on 3/12 months.

The beleaguered JPY remains largely tied to US yields, which – along with regional headwinds from China – have have taken USD/JPY above 145. This has raised the chances of Japanese FX intervention. Lower US yields should bring some JPY relief. But with further BoJ policy tweaks a longer way off, the domestic support to the yen is still weak. Indeed, given close Asian trade ties, the JPY is weighed down by the outlook of further CNY weakness (see below). Consequently, we look for a shallower decline in USD/JPY to 145 and 137 on 3/12 months (from 138/132).

We see some further weakness for the CNY, which is suffering from China's faltering growth momentum, its troubled property sector and monetary policy divergence vs. US (bottom-left chart). USD/CNY is headed for fresh multi-year highs, and policy makers will be keen to further slow the CNY's decline through indirect intervention and sluggish midpoint adjustment. The trade-weighted is by far less cheap than USD/CNY suggests (right chart), with a controlled depreciation a welcome boost to China's export prospects.

Equities

Michele Morganti, Vladimir Oleinikov

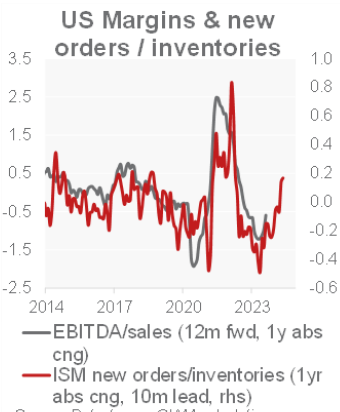
Analysis of the median stock: Q2 2023 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q2 2023
S&P	4.6 %	4.4 %	6.0 %	5.1 %	(1.4)%	(0.7)%	98.2%
Stoxx	11.1 %	10.2 %	10.3 %	5.8 %	0.8 %	4.4 %	89.2%
Euro Stoxx	11.1 %	8.3 %	8.8 %	4.6 %	2.3 %	3.7 %	90.8%
Topix	5.0 %	5.9 %	7.3 %	6.2 %	(2.3)%	(0.2)%	95.6%

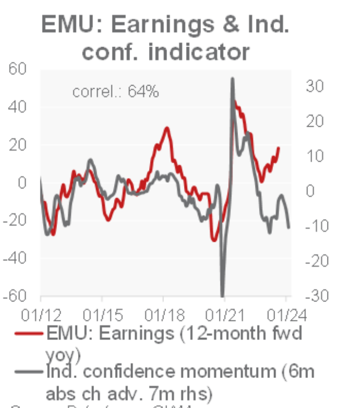
Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q1 2023	Q2 2023	Q2 2023
S&P	5.3 %	4.9 %	1.8 %	1.0 %	3.6 %	3.9 %	98.2%
Stoxx	7.7 %	3.2 %	1.8 %	0.4 %	5.9 %	2.8 %	89.2%
Euro Stoxx	7.8 %	2.7 %	1.6 %	0.2 %	6.2 %	2.5 %	90.8%
Topix	3.1 %	15.8 %	0.4 %	0.8 %	2.8 %	15.0 %	95.6%

Note: numbers for Q2 are calculated only for the companies which have so far reported in Q1
proxy for margin trend = earnings growth - sales growth

Source: Bloomberg, GIAM calculations

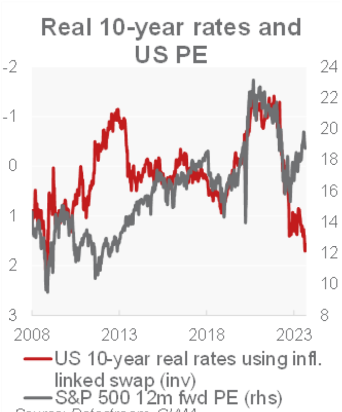


Source: Datastream, GIAM calculations



Source: Datastream, GIAM

Source: Datastream, GIAM



Source: Datastream, GIAM

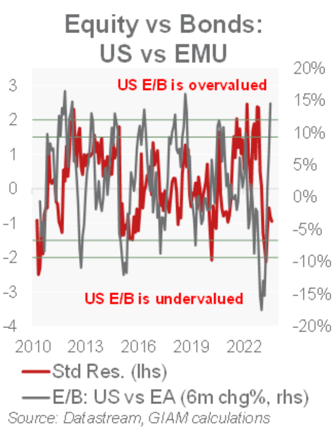
- **The resilience of the US economy is leading to higher yields and still hawkish central banks (CBs), which are weighing on markets. The strength of the US economy is reflected by corporate CEOs, who see the risk of recession diminishing and current conditions as satisfactory. But they remain quite cautious about the future.**
- **The Q2 EPS season is over, confirming positive surprises versus expectations, more for the US than the EMU. Margin proxies for the US are stabilising, while those for the EMU look fragile. However, some macro indicators (PMI) suggest that margins should not fall off the cliff too soon, either.**
- **We remain cautious in the short term: unattractive valuations also due to persistently high rates, very weak M2 momentum, equity-bond total return models (ML) heavily tilted in favour of bonds, plus China and euro area weakness.**
- **12-month view: total returns of +4% for the US and +7% for the EMU. Regional recommendation: OW Japan, SMI, China, India and slightly US vs EMU, notwithstanding a significant EMU undervaluation.**
- **EU sectors: OWs: Diversified Financials, Food Retail, Food Bev. Tob., HC Equip. & Svs., HPP, Pharma, Software, Utilities (new). UWs: Capital goods, Insurance, Media, Telecoms, Transportation.**

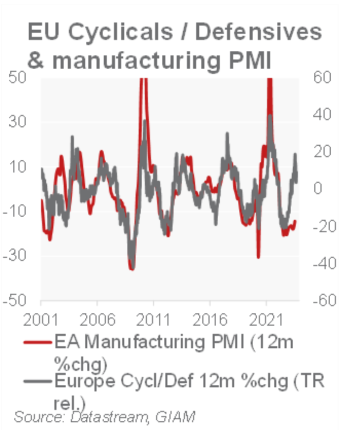
Higher yields and still hawkish central banks (CBs) weighed on market in August. This came mainly as a consequence of a resilient US economy as also testified by the NFIB and S&P500 CEOs' comments. They see diminishing risk of recession and satisfying current conditions (final demand and earnings), plus they cite AI capex needs in almost every sector and lingering hiring intentions.

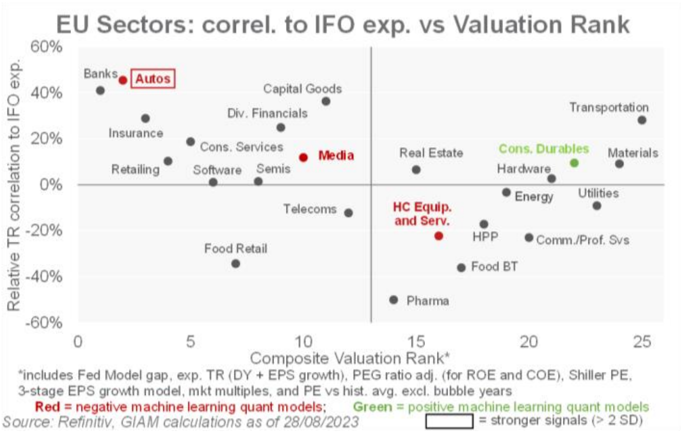
That said, firms remain very cautious for the future due to: EU and Chinese macro woes, tight labour market, higher cost of debt and a cautious consumer. BofA, in particular, reports that "clients seem to be waiting for some of the macro uncertainties to lift before starting to borrow further". Macro surprises in the US remain in positive territory, but declining from a cyclical peak, while, on the contrary, they are negative in the euro area (EA) albeit bottoming from a cyclical low. The Q2 reporting season is complete and, compared to results available one month ago, it shows lower growth but higher surprises vs. consensus. US surprises and guidance are stronger vs EA ones. US GDP growth should be solid also in Q3, which represents a positive for the next US reporting season. As for EMU, earnings and macro momentum looks more at risk. For both regions the economy is expected to slow down into 2024.

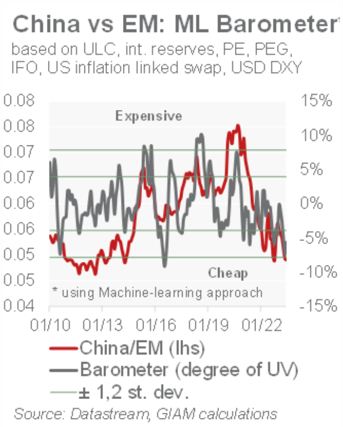
Equities

Michele Morganti, Vladimir Oleinikov









US margin proxies are stabilizing, while EMU ones looks vulnerable: weak Sentix, PMI and industrial confidence, and a stronger trade-weighted euro. That said, judging by the capacity utilization momentum or the standardized trend of PMI input/output price components, margins should not come off the cliff too soon, either.

Slightly UW equities. OW: JP, IN, SMI, US vs EMU (↓).

We remain cautious on equities in the short term. Our equity-bond total return (TR) models (ML) are strongly in favour of bonds. Second, the lagged effect of the monetary policy can still hurt (QT included). CBs remain relatively hawkish and yields could remain higher for longer. On average, in August, their increase was responsible for a loss in the theoretical equity valuation of about 2%. China and EA weakness, plus the Ukrainian war, add to the risks. Money aggregates (M2) and valuation are not helping, too: price earnings (PE) remain high, when considering the level of 10-year rates or BAA spreads. We are not sure they are justified because a recession is avoided. The risk is that such PEs would need an upsurging cycle to be sustained.

We are more positive over 12-months

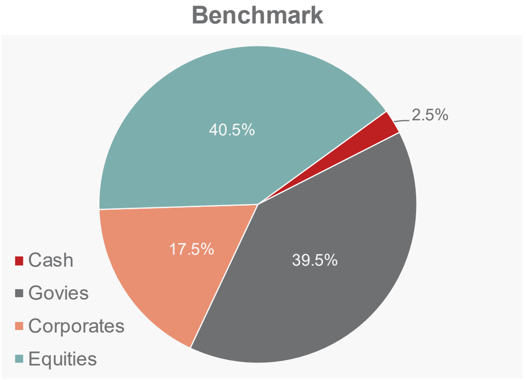
We expect returns in the range of 4%-7%. Regional allocation: OW Japan (valuation), SMI (earnings), China and India (eco), and US vs EMU (margins & macro momentum, ML equity-bond models, weak trade-weighted USD). That said, after having reached a peak in EMU undervaluation we decided to cut by half the US OW vs. EMU. **EU Sectors**: cyclicals gave up some of their performance, still they look stretched versus confidence surveys. We suggest some tweaks in our allocation: lower Food Retail (less OW, negative revisions) and Durables (to N, valuation, negative revisions, and possible China spill over), increase Utilities (to OW, neg. correlation with IFO, and good pricing power) and Telecoms (less UW, good valuation). OWs: Diversified Financials, Food Retail, Food Bev. Tob., HC Equip. & Svs., HPP, Pharma, Software, Utilities (new). UWs: Capital goods, Insurance, Media, Telecoms, Transportation.

EMs: challenging outlook due to weaker China's growth

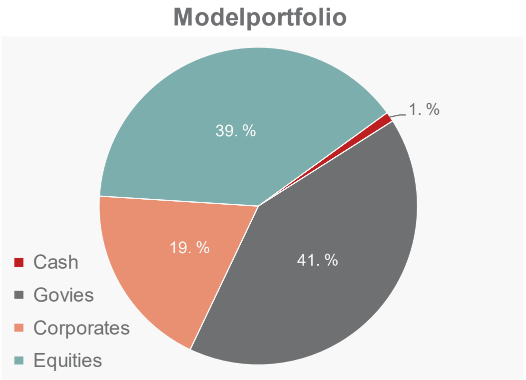
Weaker global trade is affecting the EM earnings momentum together with Chinese woes. We remain Neutral, mainly to our OW positions on China (reduced) and India. Chinese equities have already discounted a lot of negative news (significantly undervalued, UV). But money growth is weak and policy makers will rather stick to a piecemeal approach than a bold package (which can, however, not be completely dismissed). We are OW on India due to our good composite country score and UV indicated by ML model, improving economic growth and stronger earnings outlook.

Asset Allocation

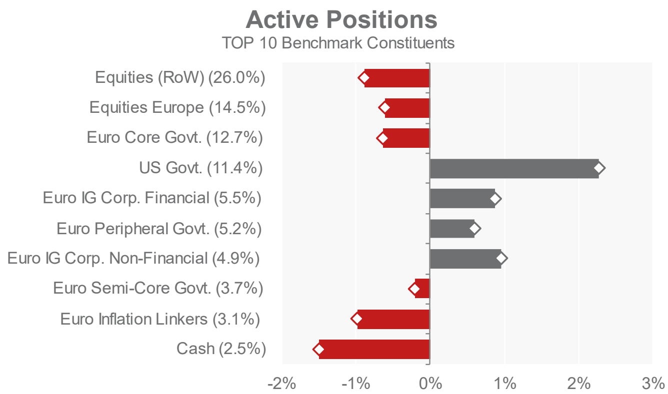
Thorsten Runde



Source: GIAM



Source: GIAM



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

- **In August (29.08.23), apart from Cash and short-dated European government bonds, the returns on all our covered asset classes were in the red.**
- **Equities, ranging from -4.1% (MSCI EM) to -1.0% (MSCI Europe ex EMU), are at the bottom of the performance ranking together with long-dated US Treasuries (-3.1%).**
- **The top of the ranking is clearly dominated by Cash (+0.3%) and short-dated European govies which are more or less at the zero line.**
- **Overall, EA HY Credit was outperforming EA IG (+31 bps). Within IG, Fin was just slightly superior to Non-Fin (+5 bps).**
- **Facing a challenging growth environment in the EA and a mild recession in the US towards the end of the year, we anticipate moderately lower yields. The unfavourable environment for risk assets should persist.**
- **We stay underweight in the most risky asset classes like Equities and EA HY Credit. We still favour low-risk credit, especially the carry from IG and short- to medium-dated peripheral bonds. We maintain the overweights in US Treasuries and USD-denominated EM govies on an FX hedged base.**

With +0.5 bps our model portfolio slightly beat its benchmark in August (29.08.23). All in, the overweight positions in EA IG Credit (+1.8 bps) and in short-dated Treasuries (+1.4 bps) proved most rewarding whereas the underweight in Cash (-2.1 bps) was the most painful active position.

Despite the recent surprisingly strong GDP data for the EA we stick to our view of a cooling economic activity while a recession is not our base case. The recent surge in US borrowing costs and a Fed not cutting rates before Q2 2024, as we assume, should provide some headwinds for the economy finally leading to a recession towards the yearend.

Unfavourable environment for risk assets to persist

All in, this argues for a continuation of our prudent tactical allocation stance. We stick to our UW positions in Equities. Given the credit cracks and recession risks, we confirm our UW in EA HY too. We still like the carry from lower-risk Credit like EA IG and short- to medium-dated BTPs. We prefer US Treasuries in general due to a decent carry and a higher downside tilt in yields feeding through EMs too. For the EA (Core, Bonos) we just favour the belly of the curves.

Forecasts

Macro Data

Growth[1]	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.
US	2.0	2.1	0.5	0.6	0.1
Euro area	3.3	0.4	- 0.1	0.5	- 0.4
Germany	1.8	- 0.5	- 0.2	0.5	- 0.6
France	2.6	0.3	- 0.3	0.8	- 0.1
Italy	3.9	0.8	- 0.3	0.6	- 0.2
Non-EMU	3.6	0.1	- 0.1	0.7	0.1
UK	4.1	0.0	- 0.1	0.5	0.1
Switzerland	2.1	0.8	0.0	1.4	0.0
Japan	1.2	2.0	0.8	1.0	0.0
Asia ex Japan	4.1	4.6	- 0.4	4.3	- 0.6
China	3.0	4.8	- 0.7	3.8	- 1.0
CEE	1.2	1.1	- 0.2	2.8	0.8
Latin America	3.7	1.3	0.0	1.5	- 0.0
World	**3.3**	**2.5**	**- 0.1**	**2.4**	**- 0.2**

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

Inflation[1]	2022	2023 forecast	2023 Δ vs. cons.	2024 forecast	2024 Δ vs. cons.
US	8.0	3.7	- 0.4	2.5	- 0.1
Euro area	8.4	5.5	0.1	2.5	0.1
Germany	8.6	6.1	0.2	2.7	0.1
France	5.9	5.3	0.2	2.6	0.1
Italy	8.2	5.2	- 0.9	2.4	- 0.1
Non-EMU	8.1	6.7	0.1	2.8	- 0.1
UK	9.1	7.5	0.1	3.0	- 0.2
Switzerland	2.8	2.5	0.2	1.5	- 0.0
Japan	2.5	3.0	0.1	1.9	0.2
Asia ex Japan	3.5	2.1	- 0.2	2.5	- 0.3
China	1.9	0.4	- 0.6	1.5	- 0.6
CEE	29.6	20.0	2.6	14.3	1.7
Latin America[2]	7.8	5.5	0.0	4.0	0.0
World	**7.8**	**5.2**	**0.1**	**3.7**	**0.0**

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

Financial Markets

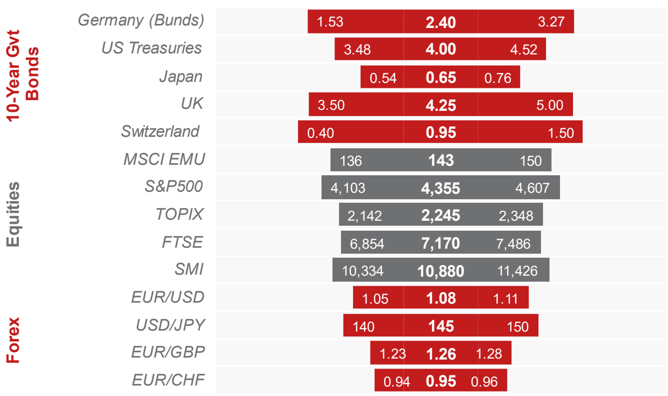
Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US (upper bound)	5.50	5.50	5.48	5.50	5.34	5.25	4.58
Euro area	3.75	3.75	3.83	3.75	3.81	3.75	3.26
Japan	-0.10	-0.10	-0.04	-0.10	0.00	0.00	0.14
UK	5.25	5.75	5.70	5.75	5.82	5.50	5.44
Switzerland	1.75	1.75	1.82	1.75	1.85	1.75	1.79
10-Year Gvt Bonds							
US Treasuries	4.18	4.00	4.16	3.85	4.13	3.60	4.10
Germany (Bunds)	2.54	2.40	2.52	2.35	2.50	2.30	2.46
Italy	4.21	4.10	4.22	4.10	4.24	4.10	4.31
Spread vs Bunds	166	170	170	175	175	180	185
France	3.07	2.95	3.08	2.90	3.08	2.90	3.09
Spread vs Bunds	53	55	56	55	58	60	63
Japan	0.66	0.65	0.72	0.70	0.76	0.75	0.86
UK	4.44	4.25	4.43	4.15	4.39	4.05	4.41
Switzerland	0.97	0.95	0.93	0.95	0.91	0.90	0.91

**3-day avg. as of 29/08/23*
***ICE BofA (OAS)*

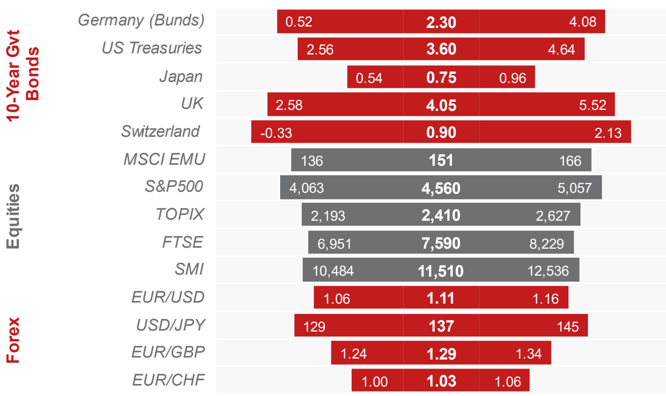
Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	143	150		155		150	
EA IG Financial	171	185		190		185	
EA HY	450	520		530		520	
EM Sov. (in USD)	319	335		350		330	
Forex							
EUR/USD	1.08	1.08	1.09	1.10	1.09	1.11	1.10
USD/JPY	146	145	144	140	142	137	138
EUR/JPY	158	157	157	154	155	152	152
GBP/USD	1.26	1.26	1.26	1.28	1.26	1.29	1.25
EUR/GBP	0.86	0.86	0.86	0.86	0.87	0.86	0.88
EUR/CHF	0.96	0.95	0.95	0.97	0.95	1.03	0.94
Equities							
S&P500	4,446	4,355		4,330		4,560	
MSCI EMU	146.1	143.0		142.5		151.0	
TOPIX	2,290	2,245		2,240		2,410	
FTSE	7,381	7,170		7,100		7,590	
SMI	11,032	10,880		10,830		11,510	

Forecast Intervals

3-Months Horizon*



12-Months Horizon*



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

Imprint

Issued by: **Generali Insurance Asset Management S.p.A. Società di gestione del risparmio | Research Department**

Head of Research: **Vincent Chaigneau**

Head of Macro & Market Research: **Dr. Thomas Hempell, CFA**

Team:

Elisabeth Assmuth | Research Operations

Elisa Belgacem | Head of Cross-Asset Quant & Dev, Senior Credit Strategist

Radomír Jáč | GI CEE Chief Economist

Jakub Krátký | GI CEE Financial Analyst

Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist

Vladimir Oleinikov, CFA | Senior Quantitative Analyst

Dr. Thorsten Runde | Senior Quantitative Analyst

Dr. Christoph Siepmann | Senior Economist

Dr. Florian Späte, CIIA | Senior Bond Strategist

Guillaume Tresca | Senior Emerging Market Strategist

Dr. Martin Wolburg, CIIA | Senior Economist

Paolo Zanghieri, PhD | Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."

This document was completed on 31. May 2023.