GENERALI INVESTMENTS

Market Compass

July 2021

MARKET OUTLOOK

- The policy unwind will be slow, while economic growth will stay above potential in 21H2.
- US inflation has surged. The shock is partly transitory, yet inflation may not return to the very muted pre-Covid trends. The Fed will navigate between the opposite risks of unplugging policy support too quickly and losing control of inflation expectations.
- The Fed's new strategy lacks clarity and occasional re-interpretation will cause volatility, calling for stronger use of hedges. We still expect the cautious approach to support a slow transition from early to mid financial cycle.
- The rising stock-bond correlation is bad news for diversification. We retain a positive risk stance but scale down our equity overweight, both in size and structure (long Value vs. Growth). Credit remains a good carry trade, even at that level of spreads. We recommend UW Govies and short duration.

Edited by

MACRO & MARKET RESEARCH TEAM

A team of 13 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.

US

- (+) Consumption and employment data point to a very strong growth over the summer…
- (!) ...But vaccination is plateauing, exposing a large part of population to the Delta variant
- (!) May CPI data continued to surprise to the upside
- (+) The Fed renewed commitment to fight inflation will keep expectations in check

UK

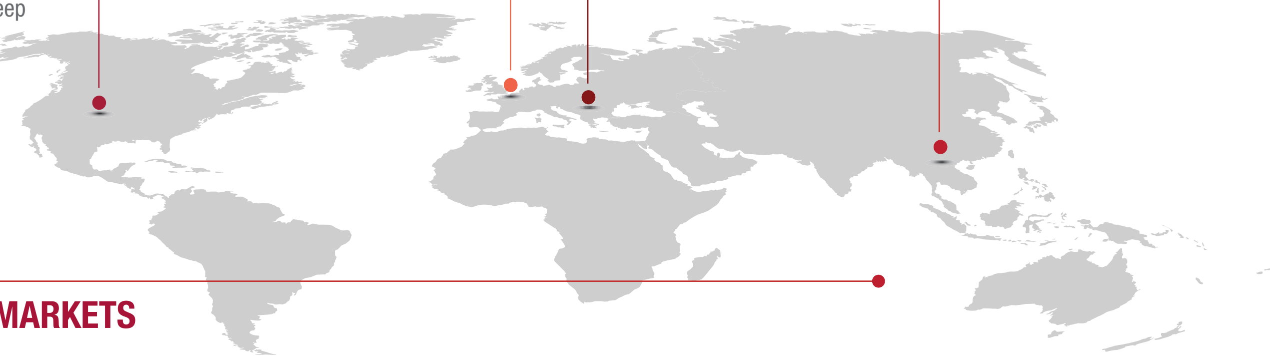
- (+) BoE maintained rates, QE and votes
- (−) Manufacturing PMI started to roll over
- (−) House prices on the rise, in part due to base effects
- (!) Strong diffusion of the Delta variant put full reopening of the economy at risk

EUROZONE

- (+) About 50% of population vaccinated, opening starts
- (+) ECB maintained a dovish stance
- (+) Business and consumer sentiment improved further
- (−) Some bottlenecks in manufacturing

CHINA

- (+) The global cycle supports external demand…
- (−) …But construction and infrastructures decelerate on fading policy stimulus
- (!) High commodity prices start affecting activity



EMERGING MARKETS

- (−) Emerging Markets growth recovery is stabilizing
- (−) Central banks have turned more hawkish with a surprising rate hike in Mexico and the beginning of a tightening cycle in Central Europe
- (!) Vaccination rollout remains slow while Covid cases resurgence is noticeable in Asia and Latin America

(+) Positive
(−) Nagative
(!) Topics to watch

DIRECTION OF TRAVEL

- Reduce overweight (OW) in Equities and High Yield (HY) Credit
- Maintain OW in Euro Investment Grade (IG) Credit
- Underweight (UW) in Core bonds due to inflation risk
- Emerging Markets: trim the OW in Equity and small UW Bonds
- Overweight in Cash to protect from inflation risk

Equities

- The ongoing earnings rebound to offset a modest pullback in PEs
- Both the policy support and economic confidence are close to the peak. Positioning remains high, along with investors' confidence in Value and Cyclical sectors
- Our equity allocation is getting more defensive. Prefer EA vs US, OW Japan, UK, and slightly EMs

Bonds

- Inflation expectations and real yields can increase given the economic recovery, particularly in the US
- Euro Area non-core sovereign bond spreads will remain supported by a benign cash flow and sustained ECB purchases. Longer-term, choppier environment once ECB purchases slow

Duration

- Short duration recommended

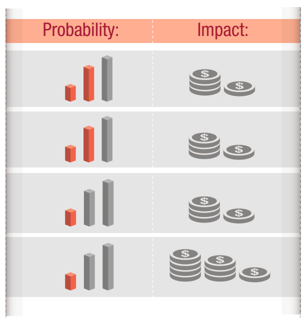
Currencies

- The Fed's hawkish twist in June has reanimated the USD
- Indeed, the new information about the Fed strategy no longer adds to our case for a weaker USD; we trim our EUR/USD targets
- Yet, the USD bounce is unlike to prove a trend reversal. The global recovery bears some more headwinds for the countercyclical USD

	--	–	0	+	++
Equities				Equities	
Credit				Credit	
Sovereign		Sovereign			
Cash					Cash
Euro Area					Euro Area
US				US	
UK					UK
Japan					Japan
China				China	
Emerging Markets					Emerging Markets
Gov. Euro Area (core)	Gov. Euro Area (core)				
Gov. Euro Area (peripheral)		Gov. Euro Area (peripheral)			
Gov. US	Gov. US				
Euro Investment Grade					Euro Investment Grade
Euro High Yield					Euro High Yield
Duration		Duration			
Euro vs. USD					Euro vs. USD
JPY vs. USD			JPY vs. USD		

TOPICS TO WATCH!

- Correction of crowded position in risk assets
- Spring inflation jump/vax advance trigger tapering concerns (especially in the euro area) and stronger yield rise
- Rough Tech regulatory tightening and US/International corporate tax increase
- Mutations challenging vaccine effectiveness, new shutdowns



Probability: High ⟷ Low
Impact: High ⟷ Low

SPECIAL FOCUS

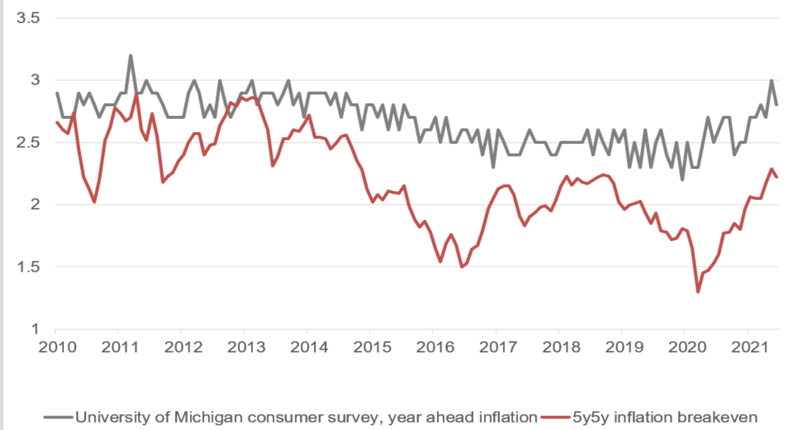
Peak in growth and monetary support calls for a more cautious approach

Growth in Western economies has likely peaked in 21Q2. The peak of monetary policy support is approaching too. Therefore, the performance of risk assets will not keep up with the strong pace recorded so far this year. Yet we argue against turning defensive too early. Global growth will continue to run above potential in H2 2021, while the policy exit is set to be very cautious and slow.

Central banks - especially the Fed - are facing a new dilemma: unplug policy support to prevent overheating or keep policy easy for longer and risk that inflation expectations start exceeding the 2% threshold. The lack of clarity of the Fed mandate may cause occasional re-interpretation - like the one seen after the June FOMC - and this will cause bouts of volatility.

The transition to a more advanced stage of the cycle usually sees equity multiples flatten out, while strong earnings growth keeps equities supported; the yield curve tends to flatten as investors start to price the policy rate "lift-off". We see long yields skewed to the upside, more so in USD than EUR, as inflation expectations still have upside room there.

US long-term inflation expectations



Source: Datastream as at July 2nd, 2021.

We position for a further curve steepening as there is still some upside for nominal bond yields, it appears more likely in the EA where the lift-off is still a very far distant threat. Given the improving economic outlook and the ongoing ECB support, we still like Credit.

Earnings, valuation and monetary policy still support an equity overweight, but we are scaling it down. Equities have become more sensitive to real yields and this correlation is bad news for portfolio diversification; this supports a more cautious approach. Hence we increase cash to OW and switch to less aggressive equity exposure.

GLOSSARY

HAWKISH and DOVISH

«Hawkish» describes a statement from the Central banks indicating that they may raise interest rates or reduce the support to the economy. The statement is called hawkish because it indicates the believes that the employment has recovered and inflation rate is high enough to warrant concern. A *«Dovish»* statement indicates the opposite.

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