# Market Perspectives

## Overfretting about the triple peak

August 2021

# Content

| | |
|---|---|
| **Global View** | **p. 3** |
| **USA** | **p. 4** |
| **Euro Area** | **p. 5** |
| **Japan** | **p. 6** |
| **China** | **p. 7** |
| **Central and Eastern Europe** | **p. 8** |
| **Government Bonds** | **p. 9** |
| **Credit** | **p. 11** |
| **EM Sovereign Bonds** | **p. 12** |
| **Currencies** | **p. 13** |
| **Equities** | **p. 14** |
| **Asset Allocation** | **p. 16** |
| **Covid-19: Facts & Figures** | **p. 17** |
| **Forecast Tables** | **p. 18** |
| **Imprint** | **p. 19** |

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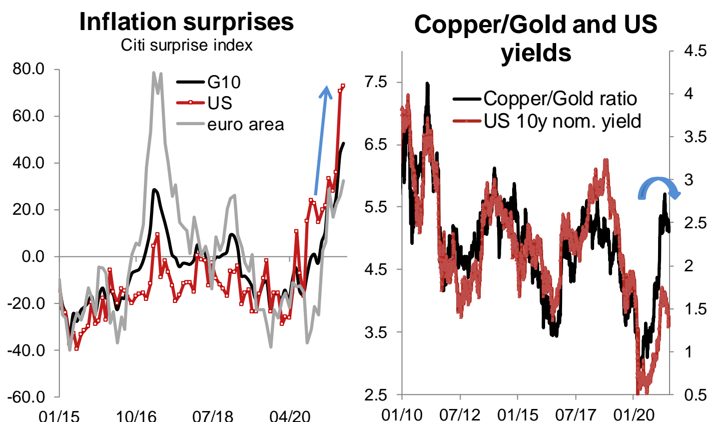
# Global View – Overfretting about the triple peak

**Thomas Hempell / Vincent Chaigneau**

- **The 'delta' variant and worries about the triple peak (growth, inflation, stimulus) have tamed the risk rally and sent bond yields lower.**
- **This is a consolidation, rather than a trend reversal. Global growth will stay above potential in H2. Policy removal will be far slower than it has been historically. US inflation will recede, but is unlikely to return to the pre-Covid subdued path.**
- **While staying prudent over less liquid summer, we maintain a pro-risk bias in our portfolio.**

The global reflation trade, in place since last year's vaccine release and US fiscal stimulus, has gone into reverse through spring and early summer. 10y UST yields temporarily fell below 1.20%, a >50 bps retreat from the March peak, defying a surge in US inflation to a 13-year high of 5.4%. Global equities have paused amid rising volatility, USD strength and a pullback in the cyclical copper/gold ratio (see charts).




In part, this correction reflects temporary technical forces. Vaccines and a tremendous US fiscal stimulus had led to consensual views and positions, e.g. record equity inflows in H1 and crowded US curve steepeners. The positioning clean-up has contributed to the recent flattening, while the unwinding of the Treasury cash position at the Fed squeezed bond issuance – a force that should soon vanish.

## Bond rally looks exaggerated, but sends a message

Arguably fundamental concerns are at play too. First, the fast spreading of the Covid-19 delta variant has raised worries about reopening strategies. Countries lagging in the vaccination race (mostly EMs ex China, but also Japan) may be forced into tougher restrictions. In Europe and the US, however, vaccinations have progressed fast, and hospitalizations and deaths have been far smaller than in the previous waves. While tourism and hospitality will be affected, governments will likely refrain from re-imposing broader restrictions. In all the variants have made tail economic risks a bit fatter, but we **still expect global growth to run above potential growth in H2**.

Second, the Fed's hawkish twist in June stoked worries about a policy mistake on premature policy tightening. Markets have brought forward the expected rate lift-off to end 2022. That has eased long-term inflation concerns, but also raised medium-term growth worries, bridging down long-term real yields. Fed Chair Powell, however, has since emphasized his **patience** and the long way to full recovery. The ECB has just cemented its dovish tilt in its strategy review and subsequent July meeting. Likewise, the fiscal policy support will be removed only slowly (US infrastructure, EU Recovery Fund).

Third, inflation fears have receded (5y5y US down 25bp from May peak). While the US inflation spike is largely transitory, we suspect that **structural shifts** will stop inflation from crashing back to pre-crisis levels.

In all, the 'triple peak' looks exaggerated, and so does the bond rally. The Fed will soon prepare the ground for tapering, which should contribute to a rise in long-term real yields (from record lows). Still, the recent market moves are a reminder that any upside in bond yields is limited, given the self-correcting mechanisms at play (asset valuation and debt sustainability depend on low real yields).

| **Bonds** | **21/07/21*** | **3M** | **6M** | **12M** |
|---|---|---|---|---|
| 10-Year Treasuries | 1.22 | 1.45 | 1.70 | 2.00 |
| 10-Year Bunds | -0.40 | -0.30 | -0.15 | 0.15 |
| **Corporate Bonds** | | | | |
| BofaML Non-Financial | 84 | 80 | 75 | 75 |
| BofaML Financial | 86 | 80 | 75 | 75 |
| **Forex** | | | | |
| EUR/USD | 1.18 | 1.19 | 1.20 | 1.21 |
| USD/JPY | 110 | 111 | 109 | 107 |
| **Equities** | | | | |
| S&P500 | 4313 | 4360 | 4375 | 4420 |
| MSCI EMU | 143.2 | 146.0 | 147.5 | 148.0 |

* avg. of last three trading days

Against this backdrop keep a reluctant stance on duration, with an underweight in long-dated core bonds. We remain constructive on Credit owing to easing default rates and persistent support from the ECB underpinning the asset's classes resilience. This holds also for Southern European sovereign bonds, which are main beneficiaries from the ECB's more dovish commitment in its new strategy.

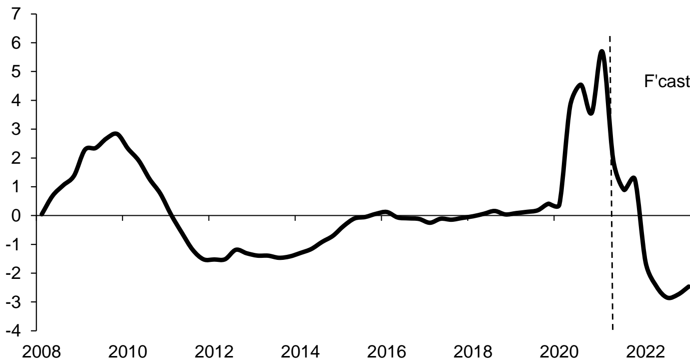
We keep a prudent overexposure to equities. We acknowledge higher risks over less liquid summer weeks. Solid earnings growth and ongoing fund inflows help. The USD may have overshot amid the recent unwinding of reflation trades. But given the ECB's more dovish commitment, we see less potential for the EUR to benefit from the economic rebound this summer.

# USA

Paolo Zanghieri

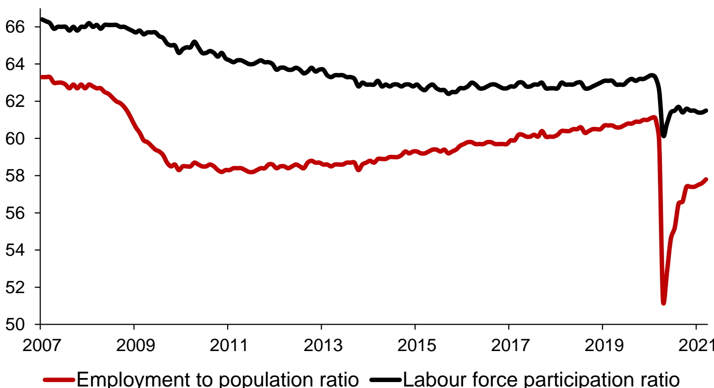
- **We trim our growth forecast for 2021 to 7.0%. The fading fiscal stimulus will be only in part be offset by consumption. Risks to the outlook are balanced.**
- **Constraints to labour supply will be gradually lifted allowing employment to rise fast. Inflation continued to soar, driven by the reopening, and will moderate only at the beginning of 2023.**
- **The Fed will continue to look through the inflation spike. By year end, the labour market recovery will allow the beginning of tapering.**

Growth is currently peaking amid the almost full reopening of the economy. Activity is set to decelerate in H2, and risks to the outlook are now roughly balanced. We trimmed down our 2021 growth forecast to a still above consensus 7.0% on a downward revised consumption bounce-back. Fiscal support to growth will weaken considerably, only partly offset by household consumption. However, the distributions of pent-up savings, heavily skewed towards wealthiest households, will limit the consumption surge. Moreover, temporary, but long lasting, higher inflation will dampen purchasing power. A tentative bipartisan agreement on infrastructure investment did not gather enough support in Congress. We expect a scaled down version of the infrastructure and welfare plan pushed by the president to be approved in Q4.

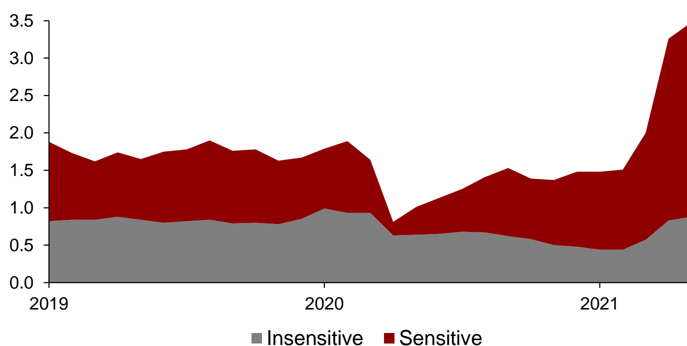



## Job growth to strengthen, inflation will normalise slowly

Despite strong job creation in May and June, employment still remains some 8m below the pre pandemic trend, compressed by low participation. Job openings data and business surveys flag bottlenecks leading to a labour market that appears to be very tight for an initial phase of the recovery. We expect the constraints to labour market participation (fears related to Covid-19, childcare, temporarily high unemployment benefits) to ease in Q3, allowing the unemployment rate to decline to around 4.5% by ear-end.




In June, CPI inflation continued to surprise to the upside, with a headline rate of 5.3% and core one of 3.4%. Research by the San Francisco Fed on the PCE index, show that more than 2/3 of the surge is related to sectors directly impacted by the Covid-19 crisis. However, the normalisation will take time, and we expect core CPI inflation to remain at around 3% by year-end. The surge in house prices, pushing up shelter inflation is a key upside risk to the outlook.




## Fed: outlook consistent with tapering from January

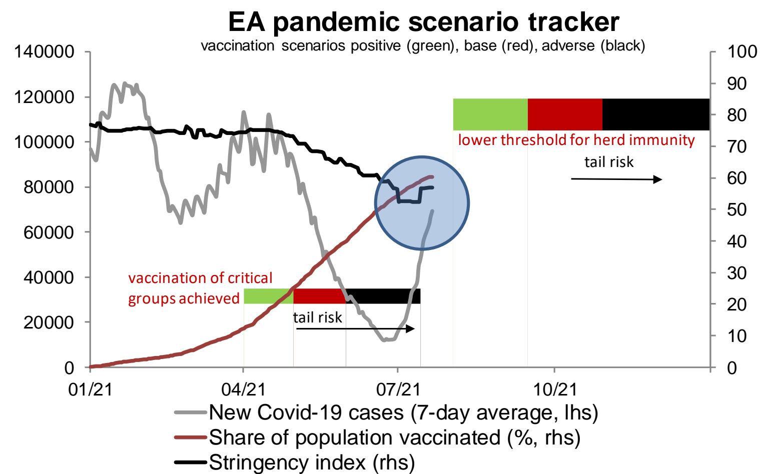
After the hawkish surprise of the June meeting, suggesting the lift-off is brought forward to 2023, tapering takes central stage. Chair Powel reiterated that the “substantial further progress” in the labour market needed to reduce bond purchases is still far off. However, these conditions should materialise by the end of the year. We therefore expect tapering to be announced in September and implemented in January 2021. Worries about the surge in house prices hint at a quicker tapering of MBS compared to Treasuries, but most FOMC members do not seem in favour of that.

# Euro Area

Martin Wolburg

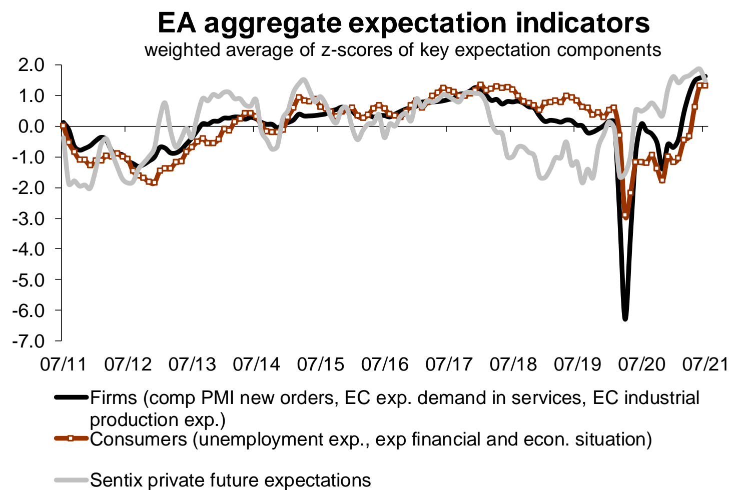
- **Sharply rising Covid-19 cases, possibly leading to new restrictions have increased the downside risk to euro area activity.**
- **Our 2021 GDP growth forecast of 4.6% critically hinges on fast vaccination progress allowing an acceleration in consumption activity.**
- **As part of its new strategy, the ECB's new forward guidance raised the bar for policy rate lifts further thereby cementing the dovish policy bias.**

The latest news flow about euro area activity was mixed. While key sentiment indicators for Q2 trended upwards, hard data paint a less rosy and partly disappointing picture. As of May, Q2 industrial production is merely unchanged from the quarter before. Bottlenecks (e.g. semiconductors) and weakening external demand stand behind this. Additionally, retail sales were up by 2.3% in Q2. This is in line with the economy expanding again but we see no need to revise upwards our below consensus forecast (1.1% vs 1.5% qoq) for the quarter.



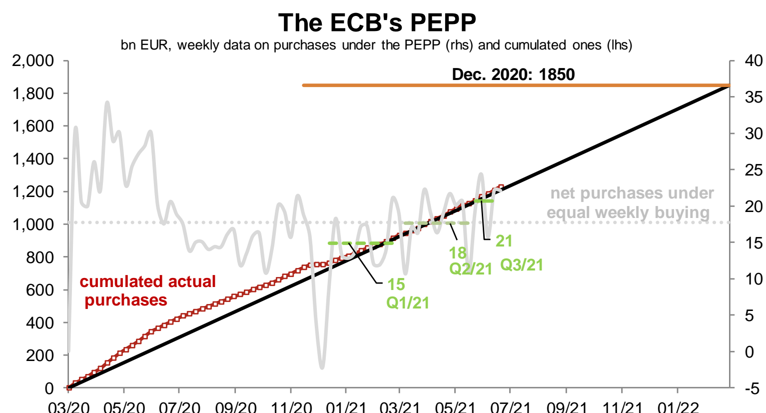

## Delta variant to drag on outlook

Looking ahead, the arrival of the much more infectious delta variant just when restrictions were lifted has led to a worsening of the pandemic situation. New cases are sharply up and stringency measures have already been tightened again in some countries (Italy, Spain). Vaccination is progressing but there is a clear risk that it will not be fast enough in order to avoid additional lockdown measures. Travel restrictions would hit tourism-dependent economies especially hard. Forward-looking components in key sentiment indicators look toppish and have already turned in some indicators, e.g. ZEW, Ifo and PMIs. While we were already expecting Q3 to mark the growth peak, there is clearly a risk that a combination of tightened stringency measures and ongoing bottlenecks in the manufacturing sector will keep Q3 growth below the 2.8% qoq underlying our 2021 growth forecast of 4.6%.



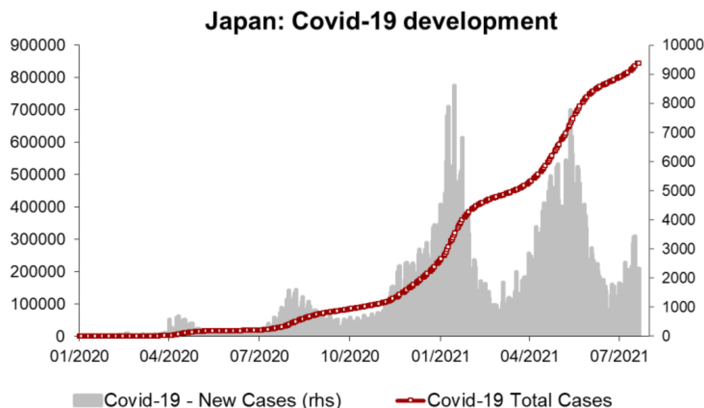

## ECB's new strategy cements dovish bias

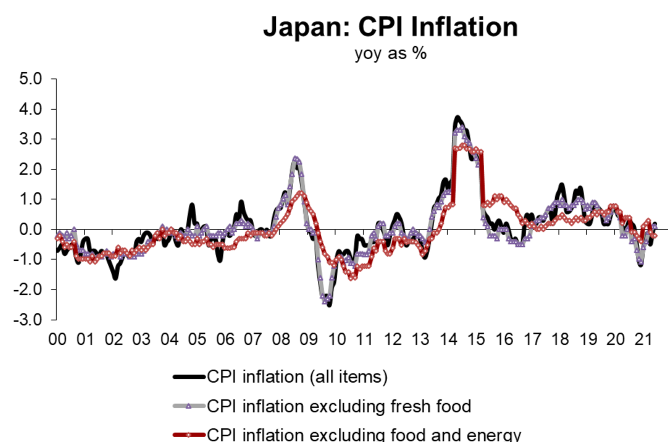
On July 8 the ECB surprisingly revealed its new strategy containing a symmetric inflation target, a greening of monetary policy, better communication and some potential for moderate inflation overshooting. At the July 22 meeting it has been put into practice for the first time. The forward guidance was strengthened. Raising rates now requires reaching the inflation target "*well ahead*" of the end of the forecast horizon and "*durably for the rest of the projection horizon*" while underlying inflation has to be consistent with medium term inflation at 2%. The transitory moderate overshooting is allowed. No change to the quarterly PEPP purchases nor any other instruments was announced. All in all, the ECB cements its dovish bias and given the increased hurdles to lift policy rates we see leeway for the first rate hike to be postponed into 2025.



# Japan

Christoph Siepmann






- **Olympics started in isolation amid the 4th Covid-19 state of emergency in Tokyo. We leave the growth forecast constant at 2.2 % in 2021.**
- **The BoJ introduced a first green funding for lending scheme but left its yield curve control policy unchanged.**

On July 12, the government decided to issue a 4th Covid-19 state of emergency in Tokyo, just three weeks after the previous one had been lifted. Special measures were also taken for the Okinawa prefecture and areas surrounding Tokyo. The restrictions are scheduled to run until August 22, unless the Covid-19 development allows for an earlier ending. Thus, Tokyo Olympics take place in isolation with no spectators allowed. Restrictions are mainly geared towards early closures of large commercial facilities, restaurants and the promotion of work at home. About 15% of the population are immediately affected.

This likely also implies that the expected stronger upturn in Q3 needs to be further postponed. However, we do not change our 2021 growth forecast of 2.2% as the following developments broadly compensate each other. First, Q2 growth is now expected to come in slightly on the positive side, mainly due to a more balanced net export performance. Second, given the weaker Covid-19 measures, Q3 private consumption should be less hit than before. Despite revising Q3 down, we still expect a moderately positive growth rate, given the low base of Q2. Third, there are growing signs for more economic stimuli and a supplementary budget around the next lower house election which needs to be held before October 22. While the overall size of the budget is likely to be limited (given substantial left-overs from the previous supplementary budget), it could well support the post-pandemic recovery, possibly address transfers to certain households and support digitalization and carbon-neutral measures. In sum, we shifted the bulk of the upturn into Q4.

## BoJ addresses climate change.

The BoJ announced a new funding for lending scheme, targeting climate change. It will provide funds at 0% to financial institutions that make investments or loans addressing the issues. The scheme will be launched during this year. Funds will be provided for one year in principle but can be rolled over. The scheme will run until the end of March 2031. The new measure fits into Category III of the BoJ's "Interest Scheme to Promote Lending", thus banks will not be paid a positive interest rate, but a bigger portion of their deposits parked at the BOJ will be exempt from negative interest rates. At the same time, the BoJ held its interest rates constant but revised the inflation outlook slightly up and growth down. Headline inflation increased to 0.2% yoy, but core-core inflation is sill at -0.2% yoy. We raised our inflation outlook also slightly up to 0.2% in 2021.

# China

Christoph Siepmann

- **China's economy grew by 7.9% yoy in Q2, after 18.3% in Q1. For H2, we continue to expect GDP growth to soften.**
- **The PBoC cut the RRR by 50 bps, signaling a more accommodative policy stance in H2.**

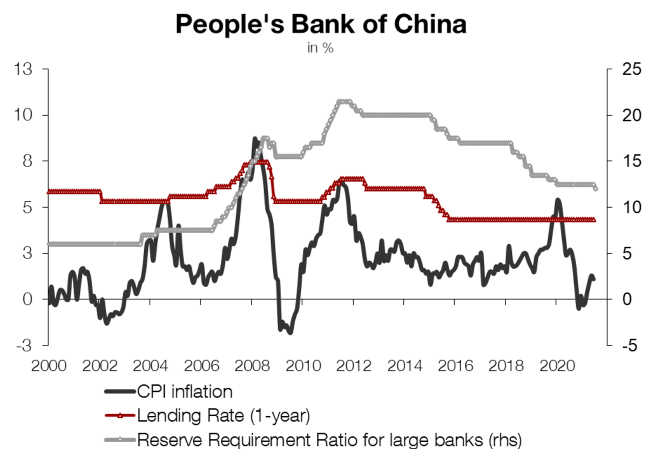
On July 9, the PBoC cut the RRR by 50 bps. The reduction came on the heels of a surprise demand by the Chinese State Council. The ultimate purpose of this cut is still not entirely clear. The previously strong slowing of the China's widest credit aggregate – Total Social Financing (TSF) – may have worried the government. This interpretation is consistent with the facts that the TSF growth stabilised in June, the absolute TSF amount was ample, and M2 growth even increased by 0.3 pp to 8.6% yoy. Moreover, the PBoC stated that it already achieved its "neutral" monetary policy stance. At the same time, parts of the liquidity released will be mopped up via the medium-term lending facility.

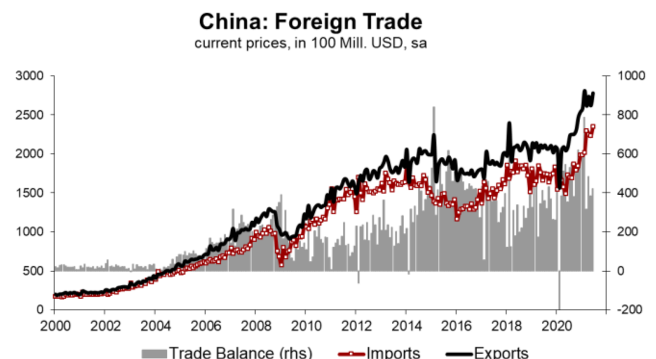
The move had also prompted speculation about some weakness of the real economy. This did not materialise. In Q2 2021, China's economy advanced by 7.9% yoy, only slightly below consensus expectations. Positive base effects still played a role, but much less than in Q1 2021 with its peak growth rate of 18.3% yoy. The main driver was the industry sector (14.8% yoy, followed by the service sector with 11.8% yoy) which also saw much higher inflation with 6.9% yoy. This reflects the rise in PPI inflation, which seems to have peaked of late. Sequential GDP growth accelerated to 1.3% qoq, in line with pre-pan-demic readings.

Monthly data (June) did not suggest softness in the real economy, either. Exports, which were feared to fluctuate due to a Covid-19 outbreak in a major container harbour, surprised on the upside. Industrial output grew by 8.3% yoy (7.8% yoy expected) and retail sales advanced by 12.1% yoy (compared to the consensus expectation of 11.0%). Base effects are still involved, but even the laggard of the recovery – private consumption – looks to improve.

## Government to prevent any stronger cooling

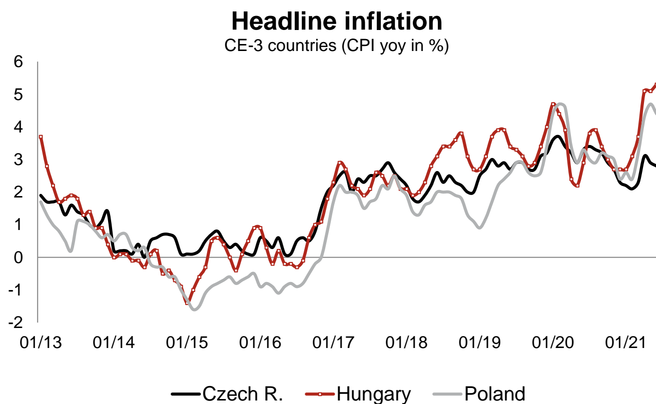
Accordingly, the RRR cut was as pre-emptive. We expect the PBoC to maintain this "freshly defined" neutral stance, i.e., we expect no further deceleration of the TSF growth rate. The negative monetary impulse will stay above previous troughs. Another RRR cut looks possible, but we do not see a rate cut. Meanwhile, CPI inflation surprised again on the downside with 1.1% yoy. This prompted us to revise our 2021 forecast down to 1.2% (from 1.6% before). We continue to expect export dynamics to slow in H2, due to the demand shift in AEs to services. Fiscal policy is likely to maintain its course, although infra-structure investment could accelerate (after weak results in H1) while the real estate sector could deleverage. All in, we see that the government is willing to prevent any stronger cooling and we maintain our GDP forecast of 8.4% in 2021.

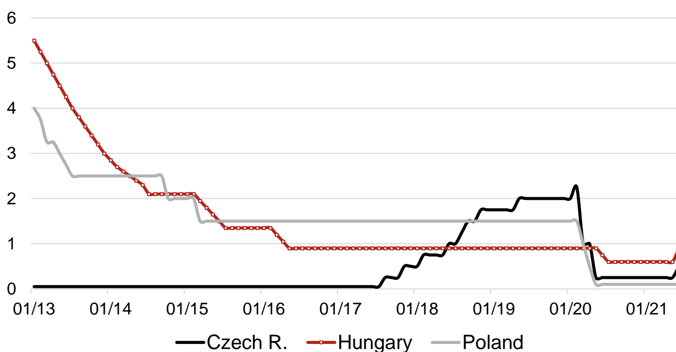


# Central and Eastern Europe

Radomír Jáč




| Main Forecasts | 2019 | 2020 | 2021f | 2022f |
|---|---|---|---|---|
| **Czech Republic** | | | | |
| GDP | 3.0 | -5.8 | 3.5 | 4.5 |
| Consumer prices | 2.8 | 3.2 | 2.8 | 2.3 |
| Central bank's key rate | 2.00 | 0.25 | 1.25 | 1.75 |
| **Hungary** | | | | |
| GDP | 4.6 | -5.1 | 7.0 | 4.1 |
| Consumer prices | 3.4 | 3.3 | 4.0 | 3.5 |
| Central bank's key rate | 0.90 | 0.60 | 1.50 | 1.75 |
| **Poland** | | | | |
| GDP | 4.8 | -2.6 | 4.7 | 4.6 |
| Consumer prices | 2.3 | 3.4 | 4.0 | 3.3 |
| Central bank's key rate | 1.50 | 0.10 | 0.25 | 1.00 |

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

- **Central banks in Hungary and the Czech Republic were the first in the EU to launch key interest rate hiking cycles. Monetary policy tightening is expected to continue in H2.**
- **Inflation data were mixed in June but headline and also core CPI stayed above target across the CE-3 and are likely to remain there in H2 due to growing demand and supply-side bottlenecks.**
- **The Polish central bank maintained a dovish policy stance with the key rate stable at 0.10%. We expect a first slight rate hike in Poland in Q4.**

Reopening of economies from lockdowns, realization of pent-up demand and supply-side constraints lead to growing price pressures across the region. Headline inflation increased in Hungary in June (to 5.3% yoy) and moderated in the Czech Rep. (to 2.8% yoy) and Poland (to 4.4% yoy). However, upside risks are present in all three economies: headline CPI is projected to stay above central banks‘ targets beyond 2021 and moderation to the area close to inflation target in 2022 is expected in the Czech economy and Hungary, as their central banks started to tighten monetary conditions in an effort to tame inflation. Poland with interest rates at a historical low and hesitance to react faces a risk of inflation remaining well above the target set at 2.5%.

## More rate hikes to follow in Czechia and Hungary

The Czech CNB raised its key rate by 25 bps to 0.50% in late June. The CNB quarterly forecast published in early May predicts three more rate hikes for H2. This would lift the key rate to 1.25% by year-end: a likely scenario, in our view. We expect the next rate increase at the upcoming monetary policy meeting on August 5 when the central bank will present a new quarterly forecast.

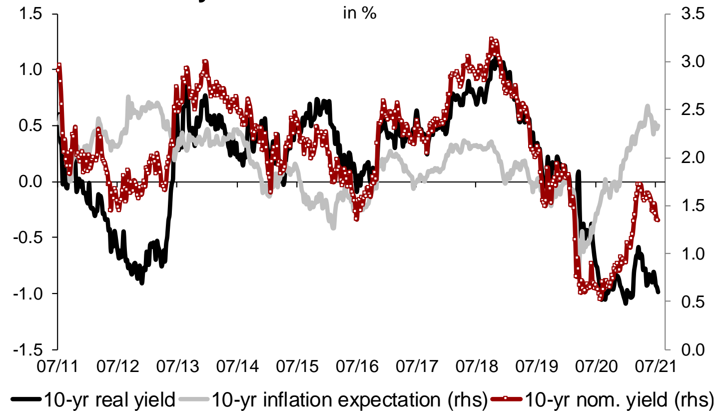
The Hungarian MNB was the first central bank in the EU that a launched monetary policy tightening cycle since the start of the pandemic. The MNB increased its base rate by 30 bps to 0.90% in June and said that further rate hikes may follow on a monthly basis. The next meeting takes place on July 27 and we expect a 20 bps hike of the base rate. We revised our call for a year-end level from 1.20% to 1.50% as inflation exceeded forecast in Q2 and the MNB comments have been quite hawkish.

In Poland, the key rate stands at 0.10% and a majority in the MPC warns against hasty tightening of monetary conditions despite the fact that both headline and core CPI are projected to stay above 3 % in 2021-2023 vs. the inflation target set at 2.5% +/-1pp. While a minority camp continues to call for a symbolic rate hike by ca. 15 bps, we think that such step is likely to come only in Q4 with the next macro forecast update due in November.

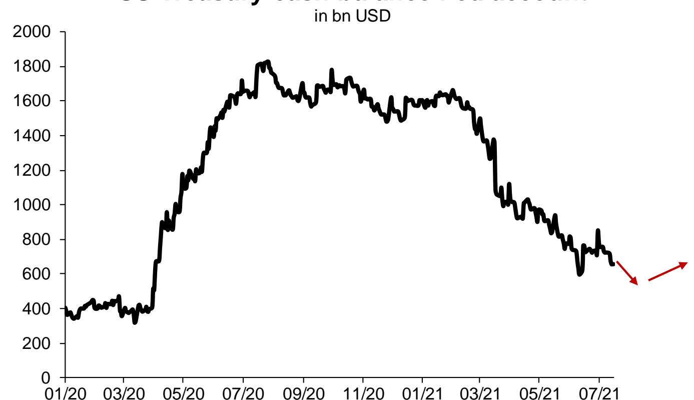
# Government Bonds

Florian Späte

- **Nominal yields decreased further in July, mainly driven by lower real yields while inflation expectations trended sideways.**
- **We think financial markets have got ahead of themselves and forecast yields to rise again. As technical factors reducing yields are likely to fade we see moderately higher yields going forward.**
- **Euro area non-core bonds will remain well supported by ECB purchases. The environment remains attractive for carry trades. Further down the road, the looming reduction in ECB purchases will cast its shadows ahead.**

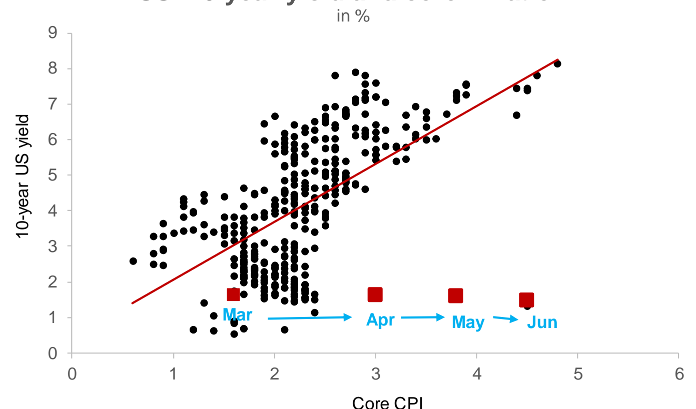



Several factors contributed to the ongoing decrease in government bond yields on both sides of the Atlantic. While some are likely to prevail limiting the leeway for higher yields others will disappear. To start with, the spreading of the delta variant raised concerns about the near-term economic outlook. However, higher new Covid-19 cases should not impact the general re-opening trend as the link of cases to deaths and hospitalization is much weaker. Additionally, the vaccination speed in the euro area holds up well (less in the US) and availability of vaccines is less of a concern than in spring. Hence, governments will find it difficult to justify ongoing restrictions.



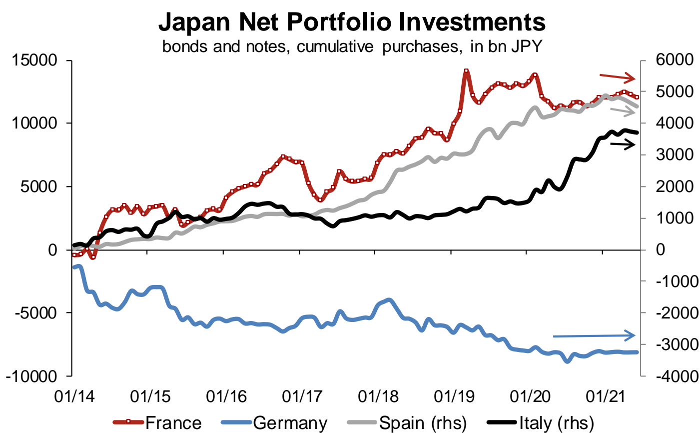

In the US, the reduction of the Treasury cash balance is forecast to come to an end short term (down from US-$ 1100bn in March to around US-$ 600bn currently). While a further decrease to US-$ 450bn until the end of July was signalled already by the Treasury, it is seen to rise thereafter again (assuming the US debt ceiling will be lifted on time). Accordingly, the 'stealth QE' will come to an end short term and the demand/supply ratio will shift again as supply will rise. Over the last 3 month the Fed absorbed the complete net supply. This unusual pattern is not sustainable and the rising supply is expected to give way to higher yields. This applies even more as the strong demand by foreigners and the banking sector is likely to soften going forward amid the reduced (=less attractive) yield level.

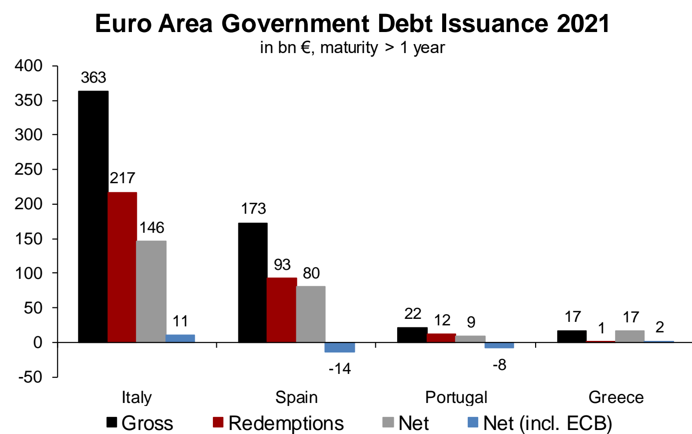
## International yields unlikely to rise strongly short term

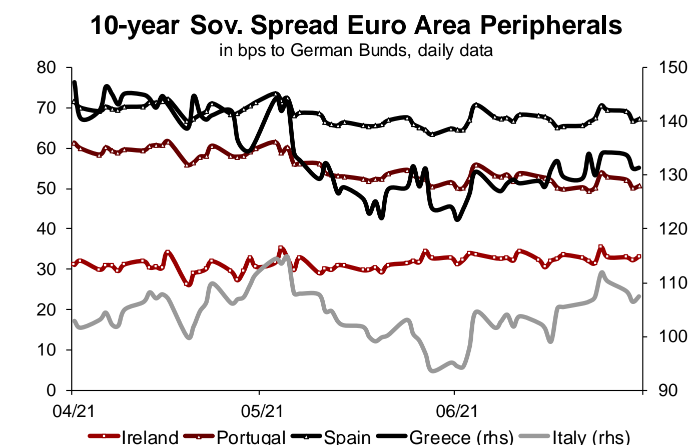



Other factors, however, will continue to impact international bond markets. Amid somewhat weaker macroeconomic data releases financial markets expect that the peak of economic momentum has been passed. This is particularly the case in the US. There is a concern that consumption will not hold up well and the resulting savings glut will cap a possible yield increase. We regard these concerns of a secular stagnation like situation as overdone because growth will remain above potential well into next year. Accordingly, the current pricing of the terminal key rate at around 1.5% appears too low. It is not only at odds with the Fed's dots at 2.5% but it is also not in line with an economy growing above potential for the time being.

# Government Bonds




Another factor to consider in the short term is the usual seasonality. If history is any guide, government yields tend to fall in July and August on average. Although the current market environment is special for many reasons, the cash flow friendly environment during the summer break is worth mentioning.

On balance, however, the strong growth environment in combination with an accelerating inflation rate is seen to gain the upper hand. Even though Fed officials never tire of emphasising that the inflation spike is transitory we expect some factors to last. Hence, the current level of inflation swaps appears not exaggerated. If anything, long-term inflation expectations have some leeway to rise as particularly the risk premium looks still moderate.

Even more, the real yield level appears unsustainable. Both, in the US and in the euro area long-dated real yields are close to the historical lows as the bulk of the decrease in nominal yields since spring is driven by lower real yields. The successful introduction of vaccines, an even more expansive fiscal policy globally and the stronger economic rebound has been priced completely out.

All in, we forecast 10-year US yields to rise to 1.50% on a 3-month view and to 2.00% on a 12-month horizon. Their euro area counterpart is seen to advance to -0.25% short term and to 0.15% on a 1-year horizon. The expectation of higher yields in the medium term is not least driven by the signals of central banks to only slowly withdraw from government bond markets in an environment of still high supply.

## Benign setting for carry trades – for the time being

The ECB is expected to remain the dominant factor for euro area non-core government bonds. We expect the ECB to not only keep purchases on an elevated level in Q3 but to maintain the volume of monthly purchases also in the months to come (excluding somewhat slower purchases in August and December for seasonal reasons). The issuance activity is well advanced as around two thirds of the annual volume is already placed. Some smaller countries have already issued more than 75%, most noteworthy Portugal. This implies a very positive cash flow in Q3 (negative net supply of € 85bn).

The low volatility is expected to continue. Hence, this environment paves the way for carry trades. This applies even more as the lower core yield level intensifies the search for yield again.

Looking into Q4 we see choppier waters. Although the ECB will likely reduce its monthly bond purchases only in 2022 markets are expected to price it earlier. This applies even more as the EU will issue at least € 150bn of new bonds next year. Moreover, not least due to high redemptions gross supply is expected to decrease only moderately in 2022. Hence, the technical situation will worsen next year. As a result, we see euro area non-core bond spreads to widen moderately from Q4 onwards.

# Credit

Elisa Belgacem

- **Credit markets should remain in a low-volatility regime at least until year-end.**
- **Less issuances and strong ECB buying over summer months let us to expect 10 bps tightening for IG into year-end and 25 bps for HY.**
- **The ECB has announced an ambitious climate strategy, but the lack of near-term action and little operational details is slightly disappointing.**
- **We continue to expect HY to outperform IG in total return terms over the coming months, backed by fast-improving default rate and fundamentals.**

The credit market has been so far extremely resilient to interest rate volatility. Indeed, the strong focus on financing conditions by the ECB associated with the flexibility of purchases under its PEPP and CSPP is helping to keep credit spreads' volatility low. The CSPP is expected to run at least until 2023 but probably even much longer post the strategic review, providing a long-term support to IG at least.

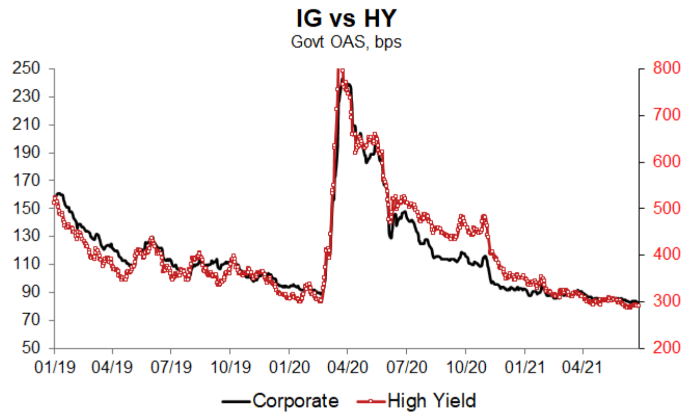
## New ECB climate policy will gradually impact credit

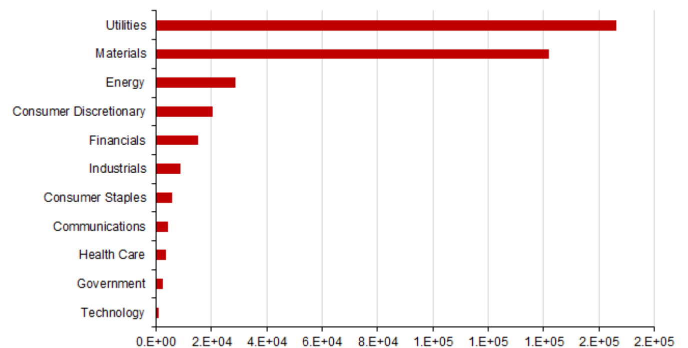
In July the ECB released its strategy review As expected it has decided to further incorporate climate change considerations into its monetary policy framework. First, through its analytical capacity in macroeconomic modelling, statistics and monetary policy about climate change. But more importantly by including climate change considerations in monetary policy operations in the areas of disclosure, risk assessment, collateral framework and corporate sector asset purchases. Vis a vis corporates the ECB has decided to take a two-stage approach, first asking for enhanced corporate disclosures, before linking gradually the climate profile of companies to both their eligibility to collateral and the purchase programs. Over the second half of 2022, the ECB will adapt the CSPP framework to possibly apply either haircuts or tilting the purchases with regards to the climate trajectory of each company

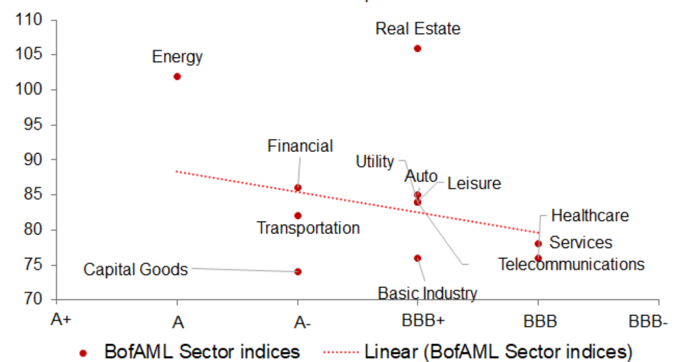
Although the timeline is slightly disappointing as it will take longer than a year for the ECB to start including climates considerations into its purchases, we believe that ESG will gradually become a larger factor in credit valuations.

## Technicals supportive into summer months

Near term, issuance will remain subdued over the summer months and the ECB will remain fairly active. Hence, we expect spreads to grind tighter. At the end of 2021 we see both IG and HY spreads nearly 10% tighter than their current levels. Within IG, we keep a pro-cyclical bias and favour BBB and subordinated bonds but within HY, we remain relatively cautious and continue to favour BBs, corporate hybrids and AT1. Also, given the near-term uncertainty on the rates outlook we keep a neutral duration positioning.



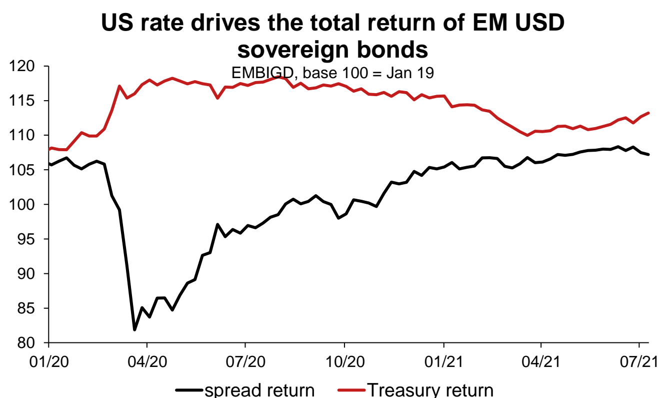



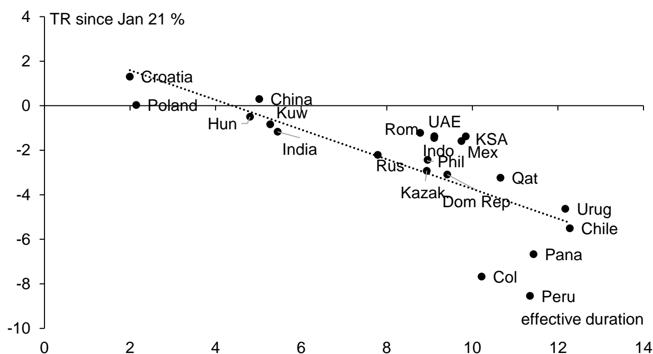
# EM sovereign bonds

**Guillaume Tresca**

- **We keep our market-weight in EM debt but we reduce risk. Higher US yields may weigh on total returns.**
- **Spreads will be more volatile amid growth concerns and a growing taper discussion. We expect a modest spread compression.**
- **We favour EM IG over EM HY with a focus on BBBs and BBs. We prefer EM EUR over EM USD**




Within a more challenging EM environment, we maintain our MW view on EM external debt, but we reduce risk. Indeed, it is the decline of US yiels that has led to positive performance of late. It will be difficult to achieve positive total return, as we envisage a mild recovery of US yields over the coming weeks. Spreads have been widening with growing EM growth concerns and a slow vaccine rollout.. Likewise, spread volatility will likely increase in mid-Q3 with the *Taper* discussion. Even if we expect some modest spread compression, it will not be enough to offset the negative duration effect in our view.

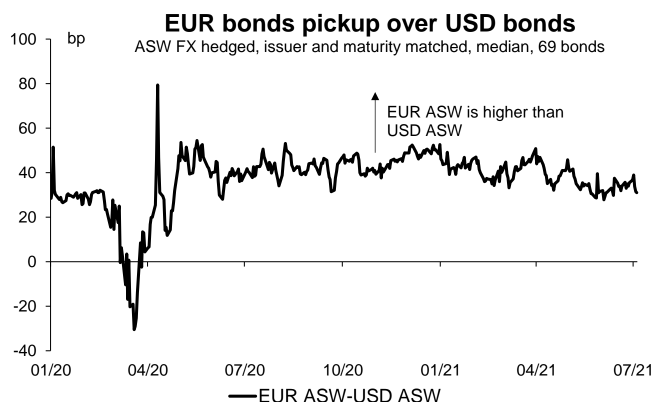



## End of the compression trade

We now prefer EM IG over EM HY with a focus on BBBs and BBs. The compression trade has been losing steam and with growing growth risks EM HY will keep underperforming. Moreover, EM HY tends to underperform in a rising rate environment driven by the real yield component.

Valuations remain tight in the EM IG space and so we focus on BBBs. Selection is key given the duration risk. Long-duration names have been underperforming YTD and so we continue to favour short duration names. We prefer low cash price bonds that exhibit higher convexity.

In the HY space, we continue to adopt a cautious stance with a focus on BBs. Almost half of EM countries will see wider fiscal deficits in 2021 and the debt profile keeps deteriorating. The weakest countries have been hit by the Covid resurgence and the COVAX program.  has not proved to be successful. Moreover, the G20 Common framework will continue to fuel anxiety in the low rated space. The process is still unclear and so we avoid CCC and below names.




## Favour relative value trades

Generally, we favour EM EUR bonds over EM USD bonds. Their duration is lower, and they continue to offer a better yield pickup. Region wise, EMEA is more resilient benefiting from higher oil prices and rapid vaccine rollout. We like Romania, Qatar and Saudi Arabia. North Asia is lagging with tight spreads and growth stalling. There is rating pressure on the Philippines. LatAm remains our least favourite. That said, Mexico is offering value and the situation is stabilising in Peru.

# Currencies

**Thomas Hempell**

- **Worries over the new 'delta' variant may keep demand for safe havens and the USD underpinned near term. Also, a dovish ECB guidance contrasts the Fed's hawkish June twist.**
- **A good chunk of the recent reversal in the reflation trade is likely to prove temporary, though, ultimately limiting further USD upside.**
- **We trim our EUR/USD forecasts, but still see some upside by year-end.**
- **JPY is cheap and favoured by real yields, yet lagging vaccinations in Japan will dent the yen's appeal in the near term.**

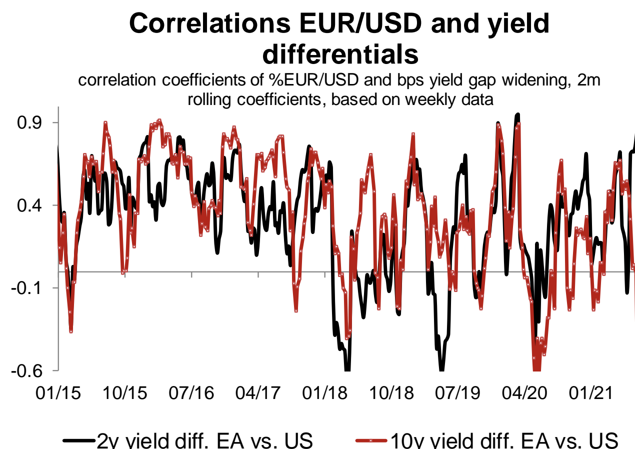
The unwinding global reflation trade amid the recent pick-up in new global Covid-19 cases has raised safe-haven demand for the USD, JPY and CHF alike. Yet while risks to the recovery have risen, vaccination success in many advanced economies should prevent new sharp lockdowns and a sudden end to the recovery.

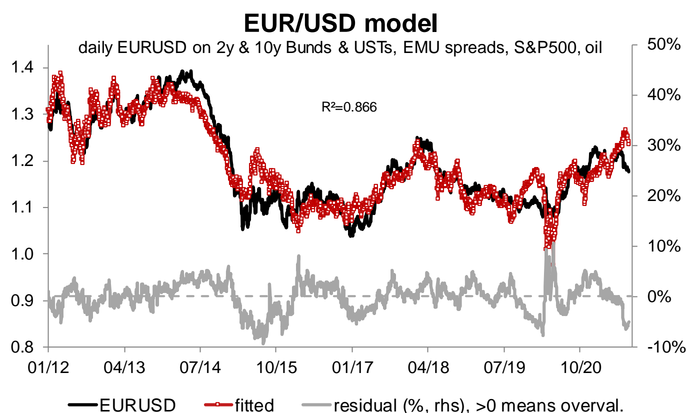
## Divergent policy twists to keep a lid on EUR/USD

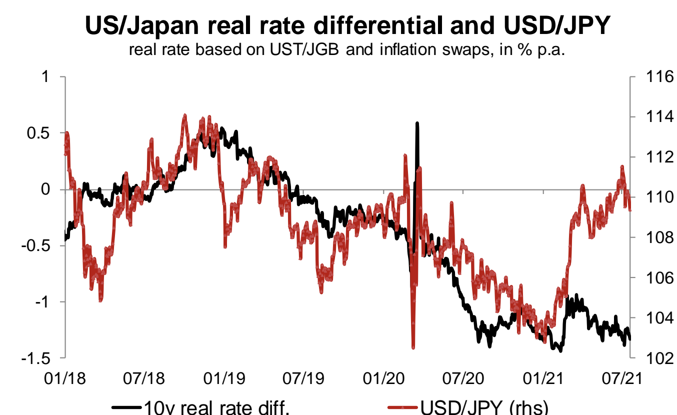
A modest revival of the reflation trade after the recent correction will also mean renewed headwinds to the countercyclical USD. Similarly, disrupted correlations point to some overshoot in the USD that coincided with plunging US longer-dated yields (top chart). Our EUR/USD model based on financial markets, which explains almost 90% of EUR/USD over the past 10 years (mid chart), points to a 5% undershoot in the EUR/USD. Still, the case for a higher EUR/USD has clearly weakened amid Covid-19 worries and divergent policy signals. The hawkish twist by Fed in June contrasts the dovish tilt by the ECB cemented in its strategy review and its July meeting. As a result, we cut our 3- and 12-month forecast to 1.19 and 1.21.

Renewed market scrutiny to Covid is also reflected in sterling's recent decline amid resurgent infections in the UK and PM Johnson's defiant lifting of virtually all pandemic restrictions on 'freedom day' (July 20). While we see moderate downside risks to sterling prevailing, we caution against overly strong shorts as the June inflation overshoot (2.5%yoy) has increased pressure on the BoE to reconsider the unwinding of its stimulus programme.

The JPY has benefited from the search for safe assets amid the recent unwinding of inflation trades. We still see US yields geared to the upside and a good chunk of the recent market correction as temporary, bearing downside risks to JPY prevail short term. Also, lagging vaccinations expose Japan to the 'delta' variant while the BoJ has cemented its highly accommodative stance with new green liquidity schemes at its July meeting. Further out, however, we expect a somewhat lower USD/JPY, owing to the yen's strong undervaluation and the drag from widened differentials in real yields.

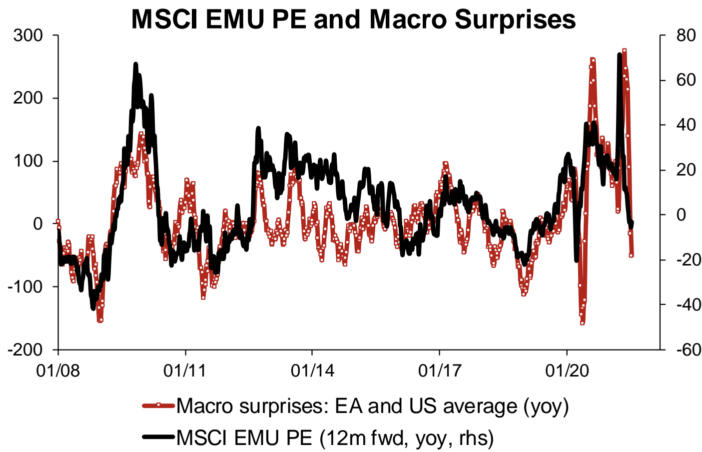


# Equities

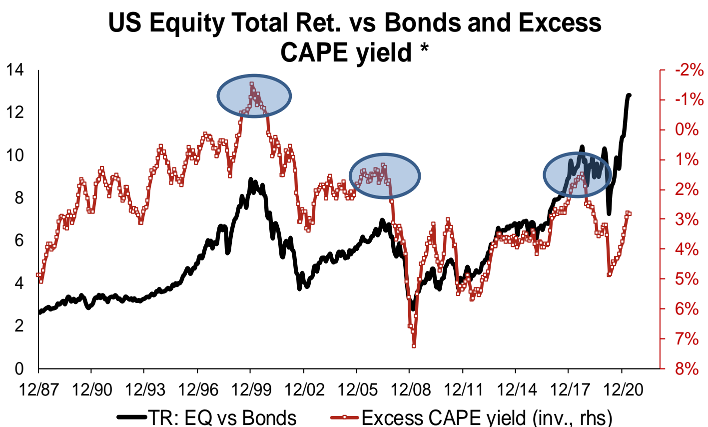
Michele Morganti / Vladimir Oleinikov




Analysis of the median stock: Q2 2021 reporting season

| Median stock | Earnings Growth | | Sales Growth | | availability |
|---|---|---|---|---|---|
| | Q1 2021 | Q2 2021 | Q1 2021 | Q2 2021 | Q2 2021 |
| S&P | 27.64 % | 64.37 % | 5.62 % | 19.56 % | 20.5% |
| Stoxx | 29.47 % | 39.45 % | 2.85 % | 11.64 % | 24.5% |
| Euro Stoxx | 58.90 % | 49.57 % | 3.13 % | 13.76 % | 11.2% |
| Topix | 8.05 % | 27.03 % | (0.11)% | 11.57 % | 11.3% |

| Median stock | Earnings Surpr | | Sales Surpr | | availability |
|---|---|---|---|---|---|
| | Q1 2021 | Q2 2021 | Q1 2021 | Q2 2021 | Q2 2021 |
| S&P | 12.22 % | 10.77 % | 2.11 % | 3.16 % | 20.5% |
| Stoxx | 9.89 % | 5.74 % | 1.54 % | 1.83 % | 24.7% |
| Euro Stoxx | 18.84 % | 9.05 % | 1.79 % | 3.05 % | 11.2% |
| Topix | (3.21)% | 9.49 % | (0.23)% | 0.95 % | 11.3% |




* real earnings yield minus real rate, using 10 yr avg for CPI and earnings

- **EMU and Value underperform in the low yield environment but overall, lower 10-year rates mean a higher equity fair value: +7% for every 50 bps decline in 10-year rates.**
- **While yields look close to a support, signs of a peaking cycle are increasing, and investors could be tempted to fully discount the end of the economy acceleration.**
- **For this reason, we maintain a prudent OW in equities, with only a slight OW of EMU vs US and a more defensive sector allocation within Europe.**
- **The US Q2 reporting season is doing well, showing an earnings surprise of 11%. That said, H2 is set for a deceleration in growth.**
- **As real rates remain low, the equity yield gap vs 10-year real rates stays attractive. Besides, higher US buybacks add 1.3% to the dividend yield of 1.4%, for a total cash yield of 2.7%.**
- **We see total returns of 6% in 12 months for EMU and 4% for the US.**

EMU equities and Value underperform in the lower yield environment. Much looks discounted at current rates but short-term current conditions remain uncertain, and we keep our more cautious sector allocation, with staples and software in OW and banks and energy only slightly so. Indeed, there are signs of peaking economic cycle. The latter are also reflected in some brokers' cycle indicators which turned south very recently, pointing to a slowdown phase. Delta mutation is adding to the negatives together with stalling leading indicators: the ISM, the IFO expectations, the yearly changes of the macro surprise index and Chinese M2. Finally, we are close to a peak in quarterly GDP growth and in the speed of policy support.

For these reasons, investors could be tempted in the next weeks to fully discount the end of the economy acceleration. Such phase could keep defensive and growth sectors in the spotlight. Indeed, since May our sector allocation has moved progressively into defensive names, lowering the overweight on Value.

## Q2 season is ok but yoy growth is set to decelerate

The Q2 reporting season is proceeding well and it is expected to show yoy earnings growth of 115% in Europe and 77% in the US. This is due to reopening, restocking, and strong pricing power which should offset weaker China and production bottlenecks. Furthermore, the quarter-on-quarter Q2 earnings growth is expected to be flat, probably providing good positive surprises, given the upgrade of the economy in the last three months. In Europe, good yearly earnings growth will be provided by energy, material, discretionary and industrials while Staples, Pharma, tech and utilities should underperform.

# Equities

After 102 results, median stock's earnings surprise in the US is 11% (18% for the market). In Europe, the median stock's surprise is at 6% (18% for the market).

## Positive stance with a prudent equity OW

As we turned more cautious, we maintain a prudent equity exposure, keeping a slight OW. Indeed, we think there are chances for equities to continue to beat bond returns. We slightly OW EMU vs the US.

To begin with, decent earnings growth can continue for a while, backing our total return forecasts of 4% in the US and 6% in Europe in 12 months. This is also due to the low yield environment which corresponds to a low cost of equity: 50 bps decline in long yield enhances the equity fair value by nearly 7%. In the last month, an earnings increase of 2% and a decline in 10-year yields of 20 bps have enhanced the fair value of the S&P 500 by 6%.

In China, the central bank has started to increase its support to SMEs and in H2 it could reinforce the accommodative stance, benefitting the global economic cycle. Lastly, bond yields could be not too far from a support, thus providing cushion to financials and energy sectors.

## Equity yield gap vs bond yield still quite attractive

Real rates remain rather from to previous critical levels experienced in 2018, 2008 and 2000. As a result, the equity yield gap vs 10-year real rates stays quite safe. In addition to this, US buybacks are increasing, adding 1.3% to the dividend yield of 1.4%, for a total cash yield to shareholders of 2.7%. This is also fully sustainable as cash to assets ratio for US firms is the highest since 1980. Our fair value of 4,400 for the S&P uses a 10-year yield target of 2% in 12 months. So, in the short term a higher fair value level could be justified albeit with increased volatility given the above-mentioned risks.

OW: banks, div. financials, energy, staples and software. UW: cons. services, media, real estate, telecoms und utilities. Our model shows Value to be very cheap albeit volatility can continue short term (low yield pressure).

## EM: taking tactically a neutral stance

A stronger dollar and wider EMBI spreads are weighing on EMs absolute (-4.5% in the month) and relative performance (-5% vs MSCI World). On the other side, financial conditions remain supportive and EMs are lagging their earnings revisions. That said, we currently see a neutral stance warranted due to China's economy losing steam, peaking global export momentum, rising USD, and fast spreading of delta variant in Southeast Asia. Mid-term, the EMs will be supported by the ongoing rebound in domestic growth, low relative valuations, a mildly weaker US dollar and higher commodity prices. We OW Korea, Poland and Taiwan and signal the big undervaluation of Chinese A-shares.

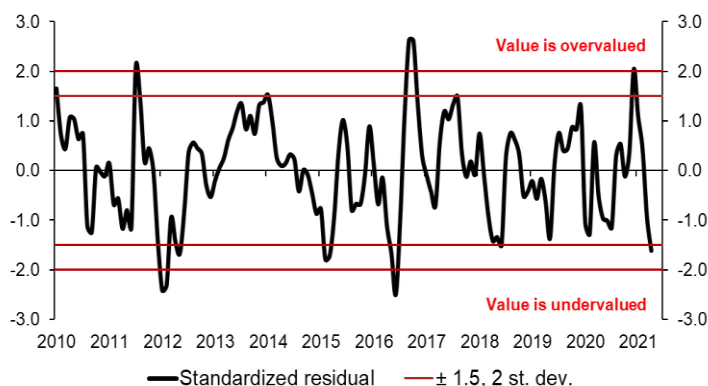
| US CAPE-based valuation (adj. for inflation) | 10Y | CPI | Real 10Y Rate | EPS | Current (e/p - 10y real) |
|---|---|---|---|---|---|
| Scenario 1 (current input with consensus CPI & 12m fwd earnings) | 1.56 | 2.64 | -1.08 | 196.5 | 4.43 |
| Scenario 2 (consensus 12m forward in 1 year) | 2.00 | 2.25 | -0.25 | 219.0 | 4.94 |
| Scenario 3 (GI 12m fwd in 1 year) | 2.15 | 2.30 | -0.15 | 213.0 | 2.89 |
| Scenario 4 (downside macro scenario) | 0.90 | 1.60 | -0.70 | 128.0 | 2.61 |
| Scenario 5 (upside macro scenario) | 2.80 | 2.50 | 0.30 | 228.8 | 4.86 |

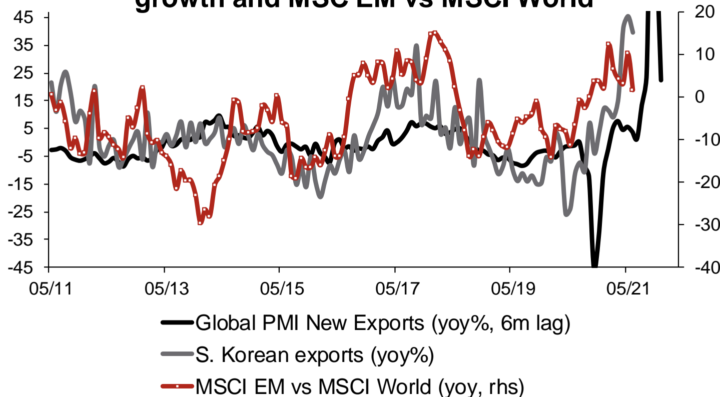
| using 20% of risk (SD) | Scen. 1 | Scen. 2 | Scen. 3 | Scen. 4 | Scen. 5 |
|---|---|---|---|---|---|
| Implied PE Trailing IBES | 25.3 | 28.1 | 27.4 | 16.5 | 27.6 |
| Avg S&P500 valuation | 4,035 | 4,489 | **4,371** | 2,628 | 4,408 |
| | -4.1% | 6.7% | 3.9% | -37.6% | 4.8% |

Note: **Base risk** scenario: using 20% of risk premium's stand. deviation (SD=2.7%) adds around 50 bps to the average risk premium calculated since 1872 (4.6% + 50 bps = 5.1%).

| using 40% of risk (SD) | Scen. 1 | Scen. 2 | Scen. 3 | Scen. 4 | Scen. 5 |
|---|---|---|---|---|---|
| Implied PE Trailing IBES | 22.5 | 25.1 | 24.4 | 14.7 | 24.8 |
| Avg S&P500 valuation | 3,597 | 4,003 | **3,897** | 2,342 | 3,956 |
| | -14.5% | -4.9% | -7.4% | -44.3% | -6.0% |

Note: **High risk** scenario: using 40% of risk premium's stand. deviation (SD=2.7%) adds around 100 bps to the average risk premium (4.6% + 100 bps = 5.6%).
Target ERP (4.6) is calculated assuming CPI in the range b/w 1.6% and 2.6%.

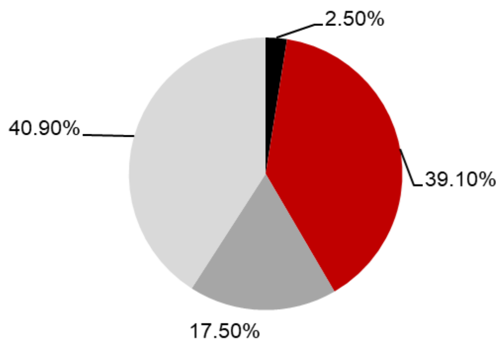


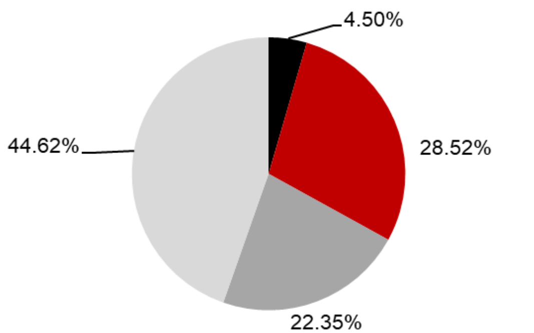
# Asset Allocation

**Thorsten Runde**

**Benchmark**

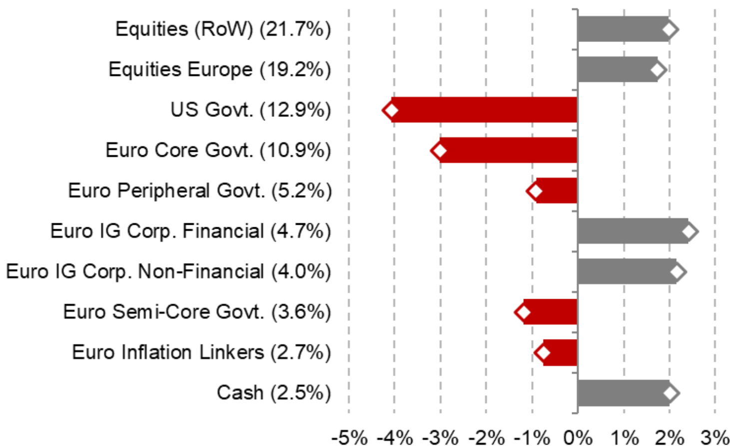



**Modelportfolio**




Cash ■ Govies ■ Corporates ■ Equities

**Active Positions in TOP 10 Benchmark Constituents***




**Benchmark weights in parentheses, diamonds indicating previous recommendations*

- **In July (*until July 21st*) the total return ranking was clearly led by long-dated Government Bonds. Returns so far range from +3.3% for EA Core Govies to +2.1% for Italian BTPs.**
- **Opposite to the previous months, Equities now predominantly bring up the rear with returns ranging from -3.3% for EMs to -0.4% EMU. Just North American Equities and Europe ex EMU managed to get over the zero-line.**
- **On the EA Credit side IG made +0.8% on average, thus outperforming HY by roughly +66 bps.**
- **Reduced pandemic precautions, backlog demand and ongoing policy support (monetary and fiscal) will sustain a solid global recovery over summer.**
- **Ascribing a substantial part of the recent drop in core yields to temporary factors, we maintain our TAA recommendation in favour of Equites and EA Credit at the expense of Government Bonds.**

In July, the model portfolio has underperformed its benchmark by -7 bps so far. With an basic alignment in favour of risk assets at the expense of Government Bonds, we were particularly caught on the wrong foot by the recent drop in core yields. Almost every asset class made a negative contribution to the overall result, first and foremost EA Core Govies (-1.9 bps), US Treasuries (-1.6 bps), and Equities (-1.5 bps). With +0.5 bps, only corporate bonds contributed positively to the result.

The unbroken advance of the highly contagious delta variant despite ongoing vaccination campaigns worldwide is probably one of the most important drivers behind the recent corrections on the bond and stock markets. Yet, considering this as temporary, we expect reduced pandemic precautions, backlog demand and ongoing policy support (monetary and fiscal) to still bode well for a solid global recovery over summer and thus for risk assets. On balance, we confirm our tactical positioning, but not without acknowledging the risks of an unwinding of crowded positions led by rising fears of an economic slowdown.

## Pro-risk stance confirmed with due caution

After weighing possible risks, we continue to recommend moderately overweighting equities and more distinctively EA Corporates. We stay underweight in US Treasuries and EA Govies, seeing some leeway for possible countervailing movements in yields, following the recent declines. Moreover, we recommend to keep an overweight in Cash and a short stance on duration.

# Covid-19: Facts & Figures

Mattia Mammarella / Sebastiano Alejandro Ruberti Torrado

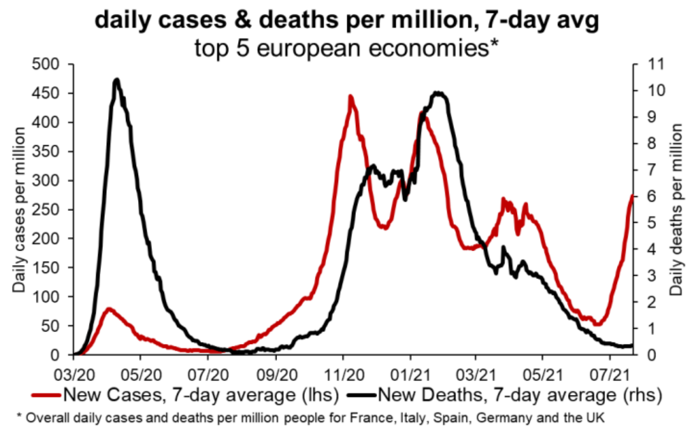
- **The diffusion of the Delta variant (40-60% more contagious) fuelled the recent increase of cases, posing uncertainties to the reopening plans.**
- **Countries are starting to require a new health pass to visit crowded places, in an attempt to limit the spread of the virus.**
- **Vaccines' rollout proceed fast in developed countries: more than 50% of the European population already received their first dose.**
- **Despite the recent increase in cases, vaccines appear to be effective in preventing hospitalization and death.**

## Delta variant pushes new cases up

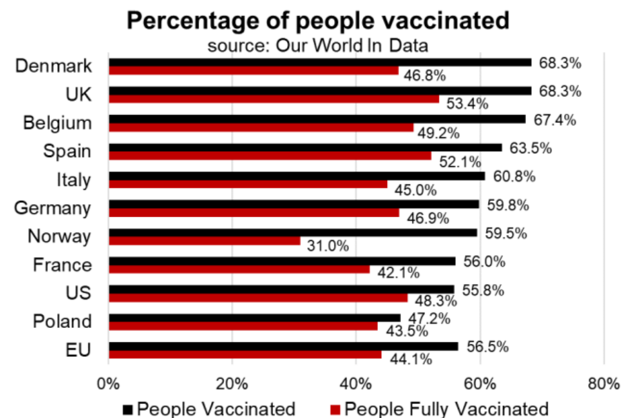
Covid-19 cases have been increasing in the last month amid the spread of the new, highly contagious Delta variant. This variant appears to be 40-60% more transmissible than the Alpha and is now dominant in most European countries. This surge in cases fuel uncertainties about the reopening timelines of many economies. For instance, France has rolled out a new Covid-19 health pass to enter the most crowded places, and Italy is moving in the same direction with the green pass. These certificates are obtained either completing the vaccination cycle, a negative Covid-19 test, or proof of recent recovery from the virus. Other European countries are planning to follow France and Italy, yet they worry about the social unrest it has caused. On a different note, the UK Government has now lifted all restrictions, despite scientists' warnings that this would accelerate the pace of infections.

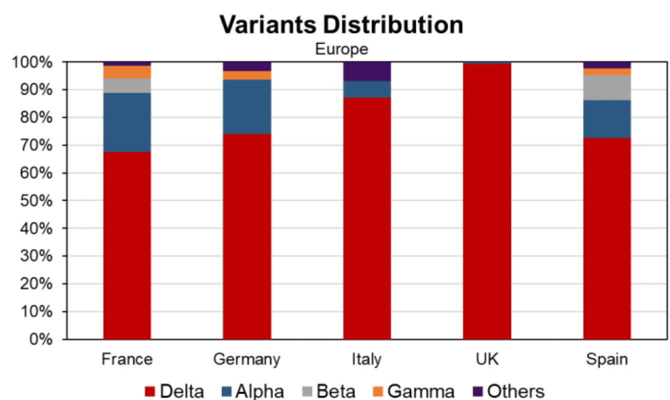
## Vaccines efficacy on test: deaths still low

Despite the spike in cases, daily deaths caused by Covid-19 appear to be stable or decreasing in countries with an advanced vaccination campaign. This is because, whilst the vaccines are not as effective in preventing infection, they appear to be effective in preventing hospitalization and thus, death. In a study by the New England Journal of Medicine, Pfizer appeared to be 88% effective at preventing symptomatic disease from the Delta variant with both doses, compared with 93.7% against the Alpha variant. However, on a negative note, the FDA added a warning to Johnson & Johnson's Covid-19 vaccine about links to a rare and potentially dangerous neurological reaction. A warning was also added by the FDA about the risk of heart inflammation to fact sheets for Pfizer-BioNTech and Moderna vaccines. These news could have an impact on the pace of the vaccination campaign both in the US and in Europe, where the slowing down of the campaign is not due to a lack of vaccine doses but to the reluctancy of the remaining people to get vaccinated.



* Overall daily cases and deaths per million people for France, Italy, Spain, Germany and the UK



# Forecast Tables

## Growth[1)]

| | 2019 | 2020 | 2021 | | 2022 | |
|---|---|---|---|---|---|---|
| | | | forecast | *Δ vs. cons.* | forecast | *Δ vs. cons.* |
| US | 2.2 | - 3.5 | 7.0 | *0.4* | 4.5 | *0.3* |
| *Euro area* | 1.3 | - 6.7 | 4.6 | *0.4* | 4.5 | *0.2* |
| Germany | 0.6 | - 5.1 | 3.6 | *0.3* | 4.4 | *0.3* |
| France | 1.8 | - 8.0 | 5.6 | *0.1* | 4.2 | *0.3* |
| Italy | 0.3 | - 8.9 | 4.8 | *0.6* | 4.2 | *0.0* |
| *Non-EMU* | 1.5 | - 7.5 | 5.5 | *0.3* | 4.4 | *- 0.3* |
| UK | 1.4 | - 9.9 | 6.5 | *0.5* | 5.0 | *- 0.4* |
| Switzerland | 1.1 | - 2.7 | 3.3 | *0.0* | 2.9 | *0.0* |
| Japan | 0.0 | - 4.7 | 2.2 | *- 0.6* | 3.3 | *0.7* |
| *Asia ex Japan* | 5.3 | - 0.8 | 7.4 | *- 0.6* | 5.3 | *- 0.3* |
| China | 6.4 | 2.3 | 8.4 | *- 0.3* | 5.4 | *- 0.2* |
| CEE | 2.3 | - 1.8 | 5.0 | *1.1* | 3.5 | *- 0.0* |
| Latin America | - 1.7 | - 8.6 | 3.3 | *- 0.8* | 2.8 | *0.0* |
| **World** | **2.6** | **- 3.5** | **5.8** | ***- 0.1*** | **4.4** | ***- 0.0*** |

1) Regional and world aggregates revised to 2015 IMF PPP weights

## Inflation[1)]

| | 2019 | 2020 | 2021 | | 2022 | |
|---|---|---|---|---|---|---|
| | | | forecast | *Δ vs. cons.* | forecast | *Δ vs. cons.* |
| US | 1.8 | 1.2 | 3.8 | *1.0* | 2.4 | *0.1* |
| *Euro area* | 1.2 | 0.3 | 1.9 | *0.2* | 1.4 | *0.1* |
| Germany | 1.4 | 0.4 | 2.5 | *0.3* | 1.6 | *- 0.0* |
| France | 1.3 | 0.5 | 1.5 | *0.2* | 1.1 | *0.0* |
| Italy | 0.6 | - 0.1 | 1.1 | *- 0.1* | 1.2 | *0.2* |
| *Non-EMU* | 1.5 | 0.6 | 1.8 | *0.4* | 1.9 | *0.1* |
| UK | 1.8 | 0.9 | 2.2 | *0.6* | 2.3 | *0.1* |
| Switzerland | 0.4 | - 0.7 | 0.3 | *0.0* | 0.5 | *0.0* |
| Japan | 0.5 | - 0.0 | 0.2 | *0.2* | 0.5 | *0.0* |
| *Asia ex Japan* | 2.7 | 2.8 | 2.3 | *- 0.0* | 2.6 | *- 0.1* |
| China | 2.9 | 2.5 | 1.2 | *- 0.3* | 2.1 | *- 0.1* |
| CEE | 6.6 | 5.5 | 8.1 | *1.1* | 6.7 | *1.1* |
| Latin America[2)] | 3.6 | 3.2 | 3.1 | *- 0.4* | 3.5 | *0.6* |
| **World** | **2.5** | **2.1** | **3.0** | ***0.3*** | **2.7** | ***0.1*** |

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

## Financial Markets

| **3-month LIBOR** | **21/07/21*** | **3M** | **6M** | **12M** |
|---|---|---|---|---|
| *USD* | 0.14 | 0.15 | 0.20 | 0.20 |
| *EUR* | -0.56 | -0.55 | -0.55 | -0.55 |
| *JPY* | -0.08 | -0.10 | -0.10 | -0.10 |
| *GBP* | 0.07 | 0.10 | 0.10 | 0.10 |
| *CHF* | -0.76 | -0.75 | -0.75 | -0.75 |
| **10-Year Bonds** | **21/07/21*** | **3M** | **6M** | **12M** |
| *Treasuries* | 1.22 | 1.45 | 1.70 | 2.00 |
| *Bunds* | -0.40 | -0.30 | -0.15 | 0.15 |
| *BTPs* | 0.70 | 0.70 | 0.90 | 1.25 |
| *OATs* | -0.05 | 0.00 | 0.25 | 0.50 |
| *JGBs* | 0.01 | 0.05 | 0.10 | 0.15 |
| *Gilts* | 0.58 | 0.70 | 0.90 | 1.15 |
| *SWI* | -0.36 | -0.25 | -0.10 | 0.15 |
| **Spreads** | **21/07/21*** | **3M** | **6M** | **12M** |
| *GIIPS* | 88 | 80 | 85 | 90 |
| *BofAML Covered Bonds* | 40 | 35 | 35 | 35 |
| *BofAML EM Gvt. Bonds (in USD* | 292 | 275 | 275 | 260 |

*average of last three trading days

| **Corporate Bond Spreads** | **21/07/21*** | **3M** | **6M** | **12M** |
|---|---|---|---|---|
| *BofAML Non-Financial* | 84 | 80 | 75 | 75 |
| *BofAML Financial* | 86 | 80 | 75 | 75 |
| **Forex** | **21/07/21*** | **3M** | **6M** | **12M** |
| *EUR/USD* | 1.18 | 1.19 | 1.20 | 1.21 |
| *USD/JPY* | 110 | 111 | 109 | 107 |
| *EUR/JPY* | 130 | 132 | 131 | 129 |
| *GBP/USD* | 1.37 | 1.38 | 1.38 | 1.39 |
| *EUR/GBP* | 0.86 | 0.86 | 0.87 | 0.87 |
| *EUR/CHF* | 1.08 | 1.09 | 1.10 | 1.11 |
| **Equities** | **21/07/21*** | **3M** | **6M** | **12M** |
| *S&P500* | 4,313 | 4,360 | 4,375 | 4,420 |
| *MSCI EMU* | 143.2 | 146.0 | 147.5 | 148.0 |
| *TOPIX* | 1,900 | 1,920 | 1,945 | 1,980 |
| *FTSE* | 6,908 | 7,000 | 7,040 | 7,080 |
| *SMI* | 11,943 | 12,110 | 12,260 | 12,260 |

## 3-Months Horizon

| | | | | |
|---|---|---|---|---|
| Government Bonds | *10-Year Bunds* | -0.41 | -0.30 | -0.19 |
| | *10-Year Treasuries* | 1.20 | 1.45 | 1.70 |
| | *10-Year JGBs* | -0.01 | 0.05 | 0.11 |
| | *10-Year Gilts* | 0.55 | 0.70 | 0.85 |
| | *10-Year Bonds CH* | -0.31 | -0.25 | -0.19 |
| Equities | *MSCI EMU* | 132.6 | 146.0 | 159.4 |
| | *S&P500* | 4,016 | 4,360 | 4,704 |
| | *TOPIX* | 1,772 | 1,920 | 2,068 |
| | *FTSE 100* | 6,453 | 7,000 | 7,547 |
| | *SMIC* | 11,318 | 12,110 | 12,902 |
| Currencies | *EUR/USD* | 1.16 | 1.19 | 1.22 |
| | *USD/JPY* | 108 | 111 | 114 |
| | *EUR/GBP* | 0.84 | 0.86 | 0.89 |
| | *EUR/CHF* | 1.07 | 1.09 | 1.11 |

## 12-Months Horizon

| | | | | |
|---|---|---|---|---|
| Government Bonds | *10-Year Bunds* | -0.07 | 0.15 | 0.37 |
| | *10-Year Treasuries* | 1.58 | 2.00 | 2.42 |
| | *10-Year JGBs* | 0.28 | 0.15 | 0.02 |
| | *10-Year Gilts* | 0.87 | 1.15 | 1.43 |
| | *10-Year Bonds CH* | -0.03 | 0.15 | 0.33 |
| Equities | *MSCI EMU* | 126.1 | 148.0 | 169.9 |
| | *S&P500* | 3,861 | 4,420 | 4,979 |
| | *TOPIX* | 1,713 | 1,980 | 2,247 |
| | *FTSE 100* | 6,168 | 7,080 | 7,992 |
| | *SMIC* | 10,923 | 12,260 | 13,597 |
| Currencies | *EUR/USD* | 1.15 | 1.21 | 1.27 |
| | *USD/JPY* | 100 | 107 | 114 |
| | *EUR/GBP* | 0.81 | 0.87 | 0.93 |
| | *EUR/CHF* | 1.07 | 1.11 | 1.15 |

*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, exponentially weighted. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

# Imprint

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