Spotlight on Fixed Income: Looking beyond the uncertainty

Views from around Generali Investments

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MARKETING COMMUNICATION FOR PROFESSIONAL INVESTORS
IN ITALY, FRANCE, GERMANY, AUSTRIA, SPAIN, PORTUGAL.

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Introduction

There is no doubt that investors today face an exceptionally tricky environment, with a host of issues clouding the outlook for global growth.

The Russia-Ukraine war has added yet more complexity to a macroeconomic backdrop that was already troubled by mounting inflation and soaring energy and commodity prices. Major central banks now face an unenviable task. For possibly the first time since the 1980s, they must tighten to push inflation firmly down, rather than merely keeping it under control. But how far can they tighten without threatening financial instability? Are we staring at stagflation? Will central banks make a policy error by tightening too much, too early?

These are crucial questions. However, for active fixed income managers, volatility also presents opportunities that others might miss. In this paper, we are pleased to present the views of fixed income managers from around the Generali Investments platform, as they share how they are balancing risk and reward amid the uncertainty.

Fixed Income Outlooks

Experts from across the Generali Investments ecosystem share their insights across LDI, responsible credit, government and corporate bonds, emerging market debt, long-short credit, and multi-strategy investing.

Each asset management firm's investment approach is fully autonomous, with their own distinct focus and investment philosophy. This plurality of thought is a key strength of our platform, aiming to help investors unlock new investment solutions and possibilities.

Please note Generali Investments is considered as a marketing communication and financial promotion related to the products and services of the following companies belonging to the Generali group: Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A. (hereinafter jointly, Generali Investments).

Forecasts

The forecasts from Generali Insurance Asset Management's ("GIAM") Macro Research Team are based on thorough macroeconomic analysis, their own fundamental models, and technical analysis. These forecasts feed into the research team's return expectations for various asset classes. These are then considered by the portfolio managers of GIAM's insurance and pension mandates, which GIAM manage for external clients as well as for Generali Group.

Financial Market Forecasts

Government Bonds	Current	3M	Cons. Q2 2022	6M	Cons. Q3 2022	12M	Cons. Q1 2023
10-Year Treasuries	2.66	2.75	2.03	2.80	2.12	2.90	2.28
10-Year Bunds	0.68	0.80	0.21	0.90	0.28	1.00	0.46
10-Year BTPs	2.27	2.45	–	2.60	–	2.75	–
10-Year OATs	1.22	1.25	–	1.35	–	1.45	–
Peripheral Spread							
GIIPS	127	130	–	135	–	140	–
Credit Spreads (IG Corp. / EM Gvt.)							
BofaML Non-Financial	128	140	–	140	–	130	–
BofaML Financial	134	145	–	145	–	135	–
BofaML EM (USD)	328	340	–	345	–	350	–
Forex							
EUR/USD	1.09	1.09	1.12	1.11	1.15	1.14	1.16
USD/JPY	124	124	116	122	116	118	117
EUR/GBP	0.84	0.84	0.83	0.84	0.84	0.85	0.86
EUR/CHF	1.02	1.02	1.05	1.04	1.07	1.06	1.08
Equities*							
S&P500	4,490	4,475 (0.0%)	-	4,560 (2.2%)	-	4,595 (3.8%)	-
MSCI EMU	137.3	134 (-0.4%)	-	138 (2.8%)	-	141 (5.8%)	-
FTSE	7,603	7,560 (0.3%)	-	7,715 (3.4%)	-	7,800 (6.5%)	-
SMI	12,400	12,250 (0.0%)	-	12,510 (2.2%)	-	12,520 (3.8%)	-
TOPIX	1,904	1,885 (-0.1%)	-	1,925 (2.8%)	-	1,975 (6.0%)	-

Source: Datastream, Bloomberg, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio ("Generali Insurance Asset Management") calculations. Prices as of 08 April 2022. *numbers in brackets denote total returns including expected dividend payouts.

Macro Forecasts

Growth	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	5.7	2.7	- 0.6	2.1	- 0.3	1.7
Euro area	5.3	2.2	- 1.0	1.6	- 0.7	1.6
Japan	1.7	2.5	0.2	1.8	- 0.0	0.8
China	8.1	3.7	- 1.3	6.3	1.1	5.2
World	**6.3**	**2.8**	**- 1.2**	**3.5**	**0.0**	**3.2**

Inflation	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	4.7	7.3	0.7	3.1	0.1	2.6
Euro area	2.6	6.6	0.9	2.6	0.5	2.0
Japan	- 0.3	1.8	0.4	1.1	0.2	0.8
China	0.9	2.5	0.3	2.1	- 0.2	2.0
World	**3.5**	**6.8**	**1.4**	**4.0**	**0.9**	**2.8**

Key Rates*	2020	2021	2022 forecast	2022 cons.**	2023 forecast	2023 cons.**
US	0.25	0.25	2.25	1.40	2.75	2.10
Euro area	- 0.50	- 0.50	0.00	- 0.33	0.50	0.05
Japan	- 0.10	- 0.10	- 0.10	- 0.10	0.00	- 0.08
China	3.85	3.80	3.40	n.a.	3.60	n.a.

Source: Datastream, Bloomberg, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio ("Generali Insurance Asset Management") calculations as of 08 April 2022. * year-end forecasts; FED: FFR upper bound, ECB: deposit rate, BoJ: Policy Rate Balance, China: Loan Prime Rate 1Y. ** means forecasts BBG.

A window of opportunity for liability-driven investors

Is it time for pure fixed-income pension funds to refine risk?

There is no doubt that investors of all stripes are facing an exceptional environment, with rising stagflation risk and lower support from central banks. However, the present volatility in fixed income markets presents a plethora of opportunities. Indeed, liability-driven investors now have a remarkable option to lock-in attractive investment yields while moving up in quality.

But, depending on the nature of their liability (pure insurance asset-liability matching products on one hand, pension funds on the other), tolerance for volatility and mark-to-market risk could differ substantially.

Let's take pension funds first, where we can see investors shift from allocating capital away from long-duration pure fixed income products to total return or more balanced allocations, even accepting a higher degree of credit and equity risk. Will this trend remain in a scenario of further escalation in the Russia-Ukraine crisis? Or will a flight to quality trend that pushes rates lower reverse it instead?

And what about alternative investments? In a low-interest rate environment, diversifying into alternatives has been an unstoppable trend, with significant yield enhancement and diversification benefit often at the cost of rising illiquidity risk.

In the current market environment, some liability-driven investors may have a competitive advantage: an often higher tolerance for volatility and a market dislocation that offers decent yields even in many low-risk market areas. On the other hand, fixed income-focused pension funds may need to re-define their risk appetite and be as forward-looking as possible, as setting a higher threshold for volatility limits may allow for higher long-term capital appreciation than before.

Bearish on government bonds

With real yields near their historical lows, the ability of government bonds to hedge a portfolio of riskier assets will continue to be very limited, at best. Given increasingly hawkish central bank policies driven by higher inflation, government bonds have underperformed in risk-off episodes so far this year.

Both US and European rates remain expensive in this higher inflation environment and the normalization of the belly of the curve should imply further bear flattening pressures. Inflation expectations were already on the rise before the Russia-Ukraine conflict. Geopolitical tensions, in conjunction with increasing real inflation data, will continue to support fears of persistent inflation among both consumers and investors.

Central banks are trying to decrease second round effects with more hawkish monetary policies, but real rates will remain depressed in a stagflation environment. However, inflation-linked bonds should continue to be supported by increasing inflation expectations. Current valuations are higher than few months ago but inflation break-evens have still room to perform in both US and European markets.

Corporate credit: Moving on up in quality

Credit spreads have widened aggressively across the board. We believe this is an opportunity for investors to move up in quality and accumulate previously expensive issues, such as green bonds.

Subordinated debt spreads have decompressed somewhat from senior debt; corporate hybrids and short-call Tier 1 are a clear target at the moment but we tend to favour issuers with the most solid fundamentals when looking for opportunities here.

In terms of sector allocation, current trends in commodities and inflation offer investors an opportunity to overweight energy and materials, while even gold-related issuers may be attractive from a fundamental perspective, as one of the key beneficiaries of the current environment.

Attention is probably deserved by the floating-rate notes market. In corporate credit, whenever rates are expected to increase and spreads sell-off aggressively, an opportunistic investor would be wise to look at this area, as rates duration is very low and bonds tend to trade purely on spreads.

Two additional areas of interest for us at the moment are single-A bonds in US dollar credit (which are very cheap vs BBB, historically), and BB-rated bonds in European high yield, that have not underperformed single-Bs despite their better fundamentals.

Staying nimble, active and cautious

While it's important to be nimble enough to pick opportunities when they arise, overall we still advocate a prudent stance in both government and corporate bonds.

Unlike 2021, where exposure to credit risk, and especially high yield, provided investors with protection in a rising interest rate environment, a top-down relative preference for credit over government bonds is not as clear-cut in 2022.

Even before the Russia-Ukraine war, we were neutral across government and corporate bonds, due to worsening valuations and deteriorating technicals, with a rising net supply of corporate issues and quantitative tapering ahead.

The geopolitical crisis has shown how exposure to spread products (not only credit, but also peripherals and emerging markets) can play against you, and absent any clear catalyst for a rebound, we do not see a case for a bullish outlook. It's worth noting that credit risk has widened in a very uneven manner, showing opportunities on one side but not much decompression across the ratings spectrum.

With relatively attractive valuations, we believe it is wise to move up in quality while progressively, and very selectively, adding risk. We maintain a defensive approach to duration that is below benchmark, and a positive stance on inflation-linked products and sectors (in both government and corporate bonds), and short-term peripheral bonds. Looking ahead, we are closely monitoring whether a new market equilibrium is found regarding inflationary pressures and wider valuations.

Enrico Scarin, *Head of Fixed Income Mark-to-Market Portfolios*

Gianluca Bergamaschi, *Portfolio Manager, Fixed Income*

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Plenisfer

Multi-strategy investing for a new era

‘The new active’ approach for optimising convexity

We believe that the environment facing investors over the next couple of decades will be profoundly different from that of the last 20 years, which benefited from deflation, an abundance of liquidity and accommodative monetary policies, as well as the availability of cheap labour, raw materials and energy. Now, investors face higher inflation, tightening liquidity, and a shortage of labour and materials.

In our view, this shift calls for an entirely new investment approach to deliver returns. That is why we do not allocate by asset class, but through five complementary strategies that are entirely unconstrained by benchmarks. These strategies are: income (bonds and dividends to achieve a stable cash flow), compounding (quality growth stocks for capital appreciation), macro (for total returns), uncorrelated alternative assets (mainly gold but also volatility and carbon certificates), and finally special situations (idiosyncratic opportunities across equities and fixed income). We also pay a lot of attention to tail risks and carefully hedge them accordingly.

We call our multi-strategy approach “the new active”. It aims to optimise the convexity of the portfolio, by finding opportunities that deliver specific performance outcomes while mitigating volatility.

Unlocking uncorrelated returns with special situations

We are pleased to say that this approach has benefited the performance of our strategy, withstanding high volatility to deliver positive returns. In unpredictable periods, special situations are key to generating uncorrelated performance in the portfolio. These are purely idiosyncratic opportunities that are less affected by the wider macro situation, and provide uncorrelated returns through M&A, deep value and turnaround equity positions, and stressed and distressed debt positions.

From a corporate bond perspective for instance, at the time of writing, our strategy has exposure to the Argentinian economy via critical sectors like telecoms and energy, through very short duration bonds that offer double digit yields.

China is another theme we are constructive on and we like overlooked opportunities within the troubled real estate sector. Following the slowdown that began in the last quarter of 2021, we expect China will pull out all the stops to return to decent growth this year. We expect that the second half of 2022 will see substantial progress in fiscal and monetary policy out of Beijing that will aim to bolster crisis areas and support wider growth. The restructuring process is therefore nearing a point that will provide more clarity on the medium-term viability of some stressed issuers.

Turning to our macro strategy, we entered 2022 with a non-consensus view on inflation, which we believe is going to be more persistent than the market thinks. This led us to be net negative duration in the portfolio, being short Bunds and US Treasuries, and we continue to believe this is a prudent approach for the year ahead.

In our view, despite nominal rate rises, real rates will continue to be negative in particular for the Eurozone – financial repression is still the name of the game, so we believe it's essential to focus on investments that generate positive, consistent real returns such as from energy, enablers of the energy transition, real estate, and contingent convertibles from European financials. In terms of currency exposure, we continue to prefer strong exposure to the dollar as a hedge against continued geopolitical and market uncertainty.

The good, the bad and the ugly

Looking to the rest of the year, our outlook is divided into "the Good, the Bad and the Ugly". The "Good" is represented by the positive outlook for economic growth, the "Bad" indicates the medium-term consequences of tapering and rising rates, and, finally, the "Ugly" is potential stagflation, driven by the spikes in energy prices exacerbated by the Russian invasion of Ukraine, and its impact on disposable income in Western countries, especially in Europe.

At the time of writing, markets have priced in the latter – stagflation or a potential recession, determined by the combination of rising inflation and more rate rises, alongside an economic slowdown. The coming months will be critical to understand if the Federal Reserve has taken the right path with its rate hike plans, or if, as the market fears, in the face of an economic slowdown, it will have to back down by adjusting rates downwards, as in 2019.

With this in mind, a credit strategy based on pure exposure to market risk could offer limited upside. In this highly fluid environment where sentiment can turn on a dime, we continue to favour idiosyncratic bond-picking choices and favour a highly flexible, active approach to defensive and cyclical themes such as telecoms, energy and industrials, and issuers capable of generating solid cash flows.

Mauro Ratto, *Co-Founder and Co-Chief Investment Officer*

Volatility presents opportunities

Don't underestimate quantitative tightening

Global interest rates will probably continue to face upward pressures in 2022 amid the persistency of inflation both in US and in Europe.

US inflation is clearly cyclical, fueled by a tight labour market that is generating wage pressures. Meanwhile, European inflation is more affected by the strong increase of energy-related prices and the financial effects of the Russia-Ukraine war, although there are signs of salary tensions in some European regions as well.

Against this backdrop, the major central banks have confirmed their commitment to normalising monetary policy faster than expected and markets are already pricing in several rate hikes in the US and some in Europe. However, markets do not yet seem to be considering the implementation of quantitative tightening, which would directly drain liquidity from financial markets, hitting riskier assets.

Fixed income markets are also pricing in the risk of a slowdown of the economic cycle, with some segments of the US yield curve having inverted or being very close to inversion. Indeed, the cyclical nature of US inflation requires a decrease of employment to return to the target of 2% inflation but the risk is clearly that a policy adjustment to hike rates "overshoots" and dampens growth more than necessary. As Europe is the epicenter of the Ukrainian crisis, it is the area most exposed to the financial effects.

Volatility should provide tactical opportunities

Given the persistency of inflation and the pressures on rates, we favour a very prudent government bond strategy. This is because while rate hikes are already priced in, the reduction of central banks' balance sheets is not. Volatility will probably persist for some time, which should provide active fixed income managers the opportunity for some tactical trades. However, we believe it is wise for portfolio duration to be maintained short or underweight compared to the benchmark.

Some cheap hedges against the risk of a marked slowdown or recession could be worth considering, in our opinion. In particular, in the US, the 5-10-year segment of the yield curve is already inverted but the 5-year could soon start pricing in the impacts of slowing growth, and in this case the curve would steepen again. The so called “transatlantic spread” could also offer opportunities: the spread between US Treasuries and German Bunds is now quite wide and typically flattens when moving closer to a slowdown or recession. These strategies also offer positive carry.

In our view, the risk-reward profile of investment grade credit is currently more favorable rather than in government bonds. In Europe, investment grade credit may offer value in relative terms versus both core and peripheral bonds, with the shortest part of the European curve more at risk.

High yield credit has performed quite well in relative terms. US high yield, for example, has been sustained by strong energy sector performance and the spread versus both European high yield and emerging market hard currency sovereign debt is extremely tight. A reversal of this may be an investment opportunity to monitor closely in coming months.

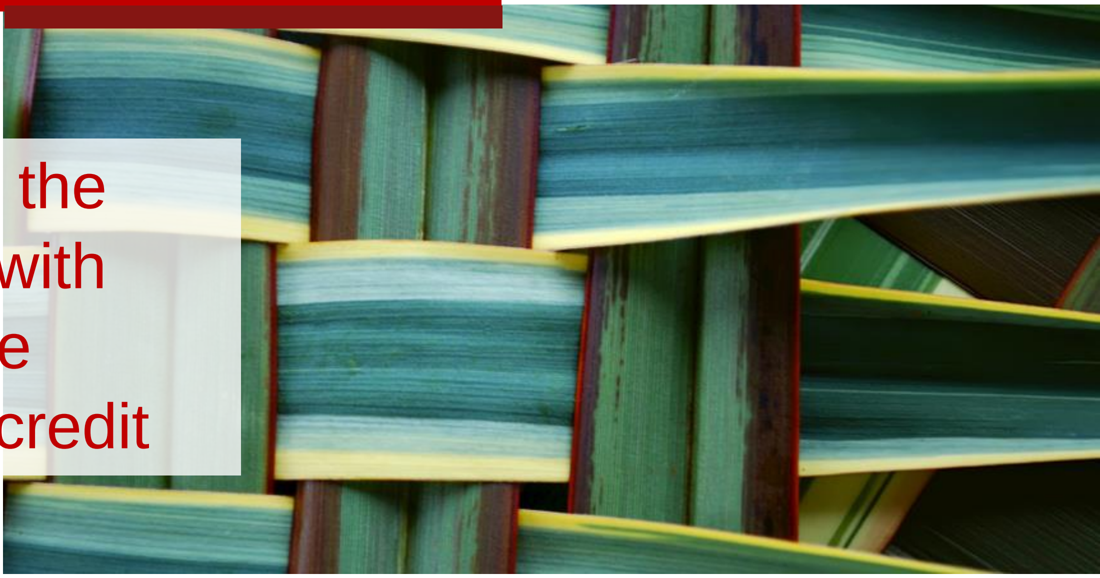
Generally, high yield now offers a decent yield, although it’s important to bear in mind that given volatility we prefer high-rated names and favour industrials and capital goods that have historically been pricing power “champions”. Conversely, we are underweight in sectors with the most variable profit margins over time such as retail and consumer goods. In the case of a recessionary environment, a relative long European high yield position versus US high yield should perform well.

Emerging market government bonds offer a higher carry compared to developed market bonds and therefore represent another opportunity. Many central banks in emerging markets already started the normalisation of their monetary policies in the last part of 2021, which represents a competitive advantage compared to most developed countries where adjustment has just begun. In addition, given the level of yields, it is generally expensive to maintain short positions in emerging markets, which further supports the asset class.

To summarise, we believe it is reasonable to expect more volatility in fixed income markets over the coming months. A prudent attitude on duration is therefore warranted, but for active managers, the credit and emerging markets spaces continue to offer opportunities in relative terms versus government bonds.

***Salvatore Bruno**, Head of Investments*

***Mauro Valle**, Head of Fixed Income*



Looking to the long-term with responsible corporate credit

At Sycomore Asset Management, we've been investing in responsible credit since 2012, back when the idea had yet to gain traction in fixed income markets. From those early years of the Eurozone sovereign debt crisis and the taper tantrum, to the geopolitical and economic uncertainties arising from the Russian invasion of Ukraine today, the world remains alive with risk.

As active, high conviction credit investors with a rigorous ESG focus, we aim to sort through short-term volatility to discover attractive opportunities issued by responsible companies. Through our proprietary investment framework, we identify companies that are genuinely transforming their business models to meet the challenges of a rapidly changing world, and that are making positive contributions to their all their stakeholders, from creditors and shareholders as well as to employees, wider society and the environment. We look for both companies and themes that are resilient enough to withstand volatility over the long term.

As credit investors with a focus on downside protection, we place particular attention to meticulously analysing the capital structures of companies, which are increasingly complex. We are high conviction bond-pickers, so we generally look for opportunities on a case-by-case using a bottom-approach rather than macro analysis.

We have long invested in credit issued by businesses to develop renewable energy, a theme which is gaining in urgency as the war in Ukraine continues to highlight the need for greater energy independence and less reliance on fossil fuels. We view the energy transition as a key, long-term investment theme, one that will remain relevant regardless of short-term volatility in fixed income markets. We favour utilities in Italy, for example, a country with a very ambitious renewables program, as well in France and Portugal.

Healthcare, telecoms, and online education are other key long-term, non-cyclical themes and sectors that we like and through which we apply a responsible investing lens. In addition, the auto market, which is transitioning to electrification, is a very long-term trend that poses many challenges, one of which is the huge amount of natural resources required. However, the electrification theme is also stimulating demand for specific components linked to batteries or connectivity, and to items that meet new standards, such as the weight distribution of the vehicle. We have been investing in auto part manufacturers that boast specific know-how in these features that we believe will benefit from future vehicle hybridation and electrification.

In today's environment, we prefer corporate bonds to government bonds, where we see limited upside given negative real rates, the deterioration of government credit fundamentals, quantitative tightening from central banks, and uncertainties in the interest rate trajectory. For seasoned investors with the ability to navigate through complex capital structures and using a method of analysis tested across different economic cycles, there remain plenty of corporate bond opportunities, in our view, that offer decent spreads. That is why, generally speaking, we prefer credit risk to interest rate risk. We favour high yield, particularly short-dated, over investment grade, given the higher risk premium and lower sensitivity to changes in interest rates and monetary policy.

Turning to inflation, it's worth highlighting that inflation is not entirely negative for indebted corporates. In fact, higher inflation improves the debt ratio of highly leveraged companies, by way of inflating their gross earnings. That is why we are currently looking for companies with strong pricing power and are avoiding those that are more sensitive to raw material inflation.

In terms of credit market liquidity, the default rate among corporates is low thanks to the support from governments during the heights of the Covid crisis. Many companies have raised money over the past two years and extended their debt maturities, which means there will not be a wall of maturities expiring anytime soon. So on a broad perspective, credit market liquidity is healthy and we do not expect a sizeable rise in defaults over the coming quarters. With all this in mind, we believe current credit market valuations provide a decent entry point for those investors with a medium-to-long-term view.

Emmanuel de Sinety, *Fund Manager, Sycomore Asset Management*

Corporate Credit | Simon Thorp, CIO Credit

The snow globe economy will settle, but not quite yet

Financial markets have been struggling to deal with two headwinds: inflation and the war in Ukraine. The Russia-Ukraine war has exacerbated the inflation outlook while also being perceived as worsening global supply chain disruptions. This has caught central banks off-guard as they now scramble to attempt to get "ahead of the curve". This means ending quantitative easing (and starting quantitative tightening in the case of the US) and ramping short-term interest rates as high and as fast as economies will allow.

Considering the scale and unexpected speed of these two headwinds it is somewhat surprising that risk markets fared as well as they did in in the first quarter. As the new quarter begins, we remain cautious. With central banks on a quest for higher rates and yields, fixed income will remain under pressure and it will continue to be a tough environment for investment grade.

Central banks are leading us to believe that rates can rise (and quite far) as economic growth will remain robust, but only a few months ago they were calling inflation "transitory". With credit spreads having recovered two-thirds of their widening since the lows of mid-March, we feel that markets are erring once again towards over-optimism.

On a positive note, credit market technicals have been quite strong. Investors appeared to be well-hedged at the start of the year with relatively high cash balances. Outflows have mainly affected investment grade, continuing a trend that we witnessed throughout H2 2021. As a result, there has been a noticeable compression in spreads as high yield outperformed investment grade. We expect this trend to continue as rates sell off and while confidence remains that economic growth will not be unduly hampered. Were this to change, we would expect markets to start pricing in greater forward default risk and as a consequence credit spreads would widen, with weaker high yield names leading the charge.

Overall, we stick by our view that 2022 will be characterised by increasing spread dispersion and rising volatility during the first half of the year, followed by a more benign environment in the second half as credit markets price in the bulk of the interest rate rises as well as any added risk premia to take into account rising default risk associated with slowing economic growth.

Emerging Markets | Peter Marber**,** CIO Emerging Markets

Emerging market default rates are likely to remain low

Looking ahead, there are two big issues that we're monitoring carefully. The first is the "Post-Covid Yield Curve." In 2020, the Fed cut rates to near zero to minimize Covid-19's impact and is now in catch-up mode to counter 40-year high inflation. The yield curve has inverted, which often but not always signals a recession, and perhaps not this time given the unique circumstances of the pandemic and the rate cuts. In any event, we are watching this unfold and carefully calibrating duration.

The second issue is a longer-term development: the "Post-Ukraine Global Economy." Many investors wonder if Russia's invasion marks a historic shift for the world economy and globalisation, similar to historic shifts such as after World War I. Conflict and nervousness could lead to a slow retreat from global financial and economic interdependence. It could also prompt more regional trading blocs. It is interesting to note that many emerging markets, including the two biggest – India and China – did not vote to condemn Russia in the recent United Nations vote. Many EMs still trade with Russia and they may not have wanted to be seen voting against a country which might hurt their economies further by cutting them off from oil and other Russian commodity exports.

While this big picture is important, in the short term it has led to inflation and higher interest rates in dozens of EM countries, which is creating both directional and relative value opportunities in local currency bonds. For example, many Latin American currencies linked to commodity prices have strengthened against the US dollar, while several in Central Europe that are closer to Ukraine, have fallen. There are also some distressed special situations in Lebanon and Sri Lanka that have brought the IMF in for assistance, which may create some interesting restructuring trades.

Finally, it is worth noting that while sovereign and corporate credit spreads in many EMs have widened, overall EM default rates have not jumped significantly, outside of China's property sectors and those hit by the Russia-Ukraine conflict. Apart from these stressed situations most EM issuers continue to exhibit strong overall fundamentals. Therefore we think default rates are likely to remain low, making it an attractive time to gain exposure to the carry offered by EM corporates. While financial markets are never easy, they have recalibrated and repriced quickly after recent events. As ever, we seek to take advantage of these opportunities while maintaining a focus on capital preservation.

Please note this is the opinion of Aperture Investors as at April 2022 and it may evolve over time, without prior notice.

Contact us

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info@generali-invest.com
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