GENERALI INVESTMENTS

Market Perspectives

A (temporary) Covid ‘leg down’

November 2020

Content

This document was completed on October 30, 2020

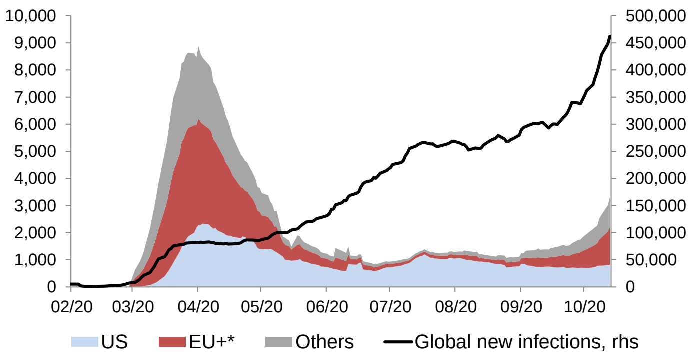
Global View – A (temporary) Covid 'leg down'

Thomas Hempell / Vincent Chaigneau

- **The rise in new Covid-19 cases and renewed lockdowns across Europe are casting long shadows over the economic recovery and markets.**
- **Yet much more targeted restrictions, a strong Chinese rebound and continued massive fiscal and monetary policy support will keep the second wave's impact far more muted than in spring.**
- **Amid higher risk, we trimmed our overexposure to equities further, while keeping a sizeable preference for high-grade Credit, which continues to benefit from ECB support and the hunt for yield.**

With the second Covid-19 wave gaining momentum in Europe, investor worries about the economic recovery are back with a vengeance. In October, our preference for highly rated Credit played out nicely, but was diluted by our (very prudent) overweight in equities, which suffered a marked correction in late October.

Covid-19 new daily deaths and infections
7-day averages



New lockdown measures across Europe are casting a shadow over the economic recovery prospects. The composite euro area PMI has already fallen back into contraction territory in October and activity data are set to worsen in November amid new lockdowns in France, Germany, Italy and other parts of Europe. While this will bring the recovery to a sudden halt (or even slight contraction) in the current quarter, a deep second dip may still be avoided. Restrictions will be much more targeted than in spring, indeed, with people and business better prepared, lethality lower and the virus generally better understood. And while face-to-face services may suffer another blow, manufacturing will hold up better, with China staging a V-shape recovery and international supply chains now less at risk than in spring. Meanwhile, unprecedented fiscal and monetary stimulus keep unfolding while global efforts to develop a vaccine are progressing.

Fiscal hopes to dominate in case of a 'blue sweep'

Apart from Covid-19 numbers, the Nov. 3 US elections will be in focus. A Democratic 'sweep' (Biden winning plus Democrats taking full control of Congress) may give way to tighter regulation and higher taxes in the longer run. But markets would likely take heart on the near-term scope for a big fiscal stimulus and much reduced domestic and international (trade) uncertainties. This should underpin risk assets, while US Treasuries and the USD would suffer (see US and strategy sections). A narrow, contested outcome or split government are still possibilities, though, leaving near-term uncertainties and the risk of a temporary spike in volatility high.

Bonds	**28/10/20***	**3M**	**6M**	**12M**
10-Year Treasuries	0.79	0.85	0.90	1.00
10-Year Bunds	-0.60	-0.60	-0.55	-0.45
Corporate Bonds				
BofaML Non-Financial	109	105	100	95
BofaML Financial	114	105	100	95
Forex				
EUR/USD	1.18	1.19	1.20	1.23
USD/JPY	105	105	104	103
Equities				
S&P500	3354	3370	3440	3580
MSCI EMU	110.4	111.0	113.0	116.5

* avg. of last three trading days

Similarly, brinkmanship persists in Brexit talk. Recent signals appear more compromising, though the risk of failure remains high. A Biden victory in the US may add to pressures on Johnson to accept a deal, as he may be much less inclined to strike a favourable trade deal with the UK on failed Brexit negotiations and risk of new conflicts in Northern Ireland.

Focus on high quality segments of risky assets

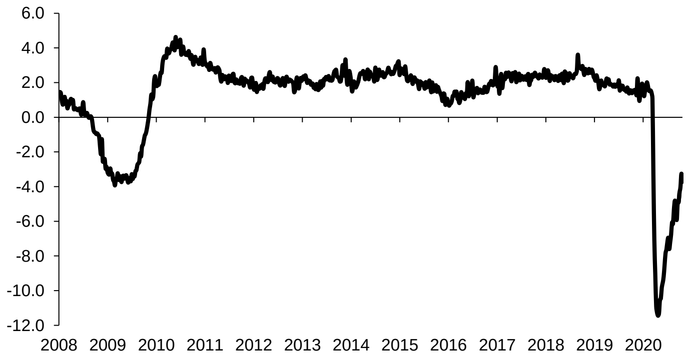
Amid the fast rise in Covid cases and unusually high near-term risks, we further trimmed our overexposure in equities to a very prudent amount, while reducing our moderate underweight in Southern European sovereign debt. The ECB will extend its asset purchase program in December, a support recently also acknowledged in S&P's outlook upgrade to neutral for Italy (BBB rating unchanged). US Treasury yields may rise on a Biden victory; but amid renewed European lockdowns and extended ECB support, Bund yields are unlikely to follow suit. Still, the deeply negative carry continues to render core bonds and cash unattractive.

By contrast, we keep a sizeable overweight in EUR IG Credit. Amid a persistent search for yield, the asset class has held up well over recent weeks while the ECB still has leeway to scale up its corporate bond purchases if needed. There is also scope for higher quality segments in High-Yield (BB) to catch up, even though we acknowledge the higher short-term risks on risk sentiment. The USD is supported by rising Covid uncertainties, but remains structurally bearish, more so in case of a 'blue sweep'.

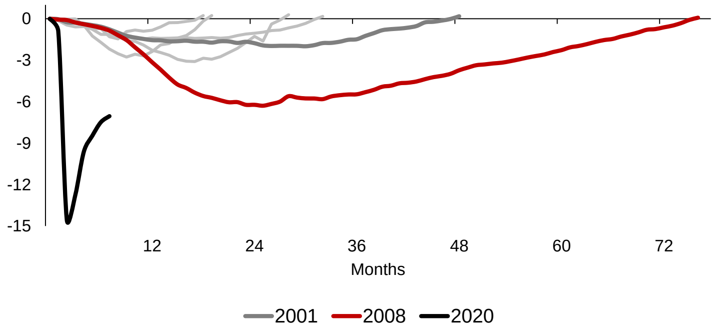
USA

Paolo Zanghieri

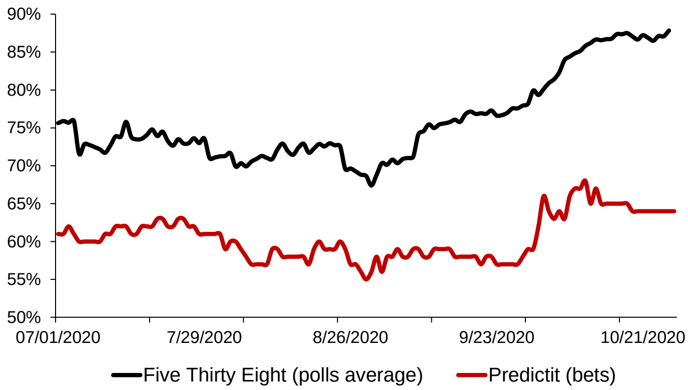
Weekly activity indicator
Scaled to yoy GDP growth



US: Job losses in recessions
% of pre recession employment



Biden: probability of being elected



- **In Q3 GDP rose 33.1% annualized, but growth will weaken in Q4 given the lack of fiscal support. GDP should shrink by 3.6% in 2020. Next year, growth will depend on post-election fiscal policy. Only a "blue wave", giving Democrats the Presidency and the Congress would lead to a strong fiscal boost.**
- **The sluggish recovery in services activity hampers job creation, despite the strong performance of construction and manufacturing.**
- **During the next meetings the Fed should give more details on how its QE program will evolve.**

In Q3, GDP snapped back by 33.1% qoq annualized as much of the economy reopened. Growth in Q4 will weaken markedly also due to a resurgence in Covid-19 cases, and the lack of additional fiscal stimulus. High frequency indicators show that in mid October GDP was around 4% lower than one year ago. Based on the strong Q3 showing, we revised our growth forecast for 2020 up to -3.6%. We pencil in a 3.7% rise for 2021; growth will depend on whether, the new Congress passes a large fiscal stimulus.

Employment recovery slowed down by services

The latest data releases add to evidence of a "K-shaped" recovery; interest rate sensitive sectors like housing are showing a very strong expansion, (permits grew 7.5% yoy in September), industries less affected by the lockdown like manufacturing are recovering, while services are still suffering. This affects employment numbers; in September, nonfarm-payrolls increased by 660k, a much slower speed than in the previous months. After having clarified how the new inflation strategy will work, the Fed is expected to provide more details on the evolution of QE.

How blue will the wave be?

Sen. Joe Biden's lead in nationwide polls is stable at around 8 pp, but his margin in key states is tighter. Surveys also point to a high likelihood of Democrats retaking control of the Senate. Given the exceptionally large turnout and the high share of postal voting, there are uncertainties on when the outcome of the election will be announced. Unless the Democrats win in a landslide, protracted legal challenges to the results are likely. In a "blue wave" scenario, Democrats take the Presidency and control the Senate. A full implementation of the fiscal package would require taking at least 60 out of 100 seats, but even with a slimmer majority a substantial part of the planned increase in expenditure could pass. The announced rise in corporate and wealth taxation would wait until the economy is stabilized. A Dem. majority would also tighten regulation on banks, energy and FAANGS. If the Republicans keep control of the Senate, it would be difficult for any President to change fiscal policy, with the possible exception of some extra expenditure on infrastructures, but action on regulation for nonfinancial firms would be still feasible.

Euro Area

Martin Wolburg

- **The second Covid-19 wave has started and is about to trigger further lockdown measures.**
- **We see the need to lower our 2021 growth outlook and now expect GDP to expand by 5.0%.**
- **At its October policy meeting the ECB signalled policy action in December.**

Following the end of the full lockdown, the gradual easing of restrictions had triggering a sharp rebound in economic activity. In the third quarter output grew by a whopping 12.7% qoq. That said, already in September new Covid-19 case have started to increase even passing the unprecedented threshold of 100k towards the end of October. As a result, euro area governments have started to intensify lockdown measures again and will continue to do so in the weeks to come.

Lockdown measures key activity driver again

Hence, economic activity has lost momentum. In October, the composite PMI's reading of 49.4 index point was below the critical threshold of 50 for the first time since June. The question is, how worse will it get? In Q2 activity shrank by -11.8% qoq but we think there are good reasons that it won't be that disastrous this time. The spring lockdown measures were extreme. The public discussion suggests that new measures will be more tailored, both with respect to sectors and regions. Moreover, in Q2 the very much export-dependent manufacturing PMI averaged 40.1 points, now its reading is 54.4 reflecting even improving export prospects.

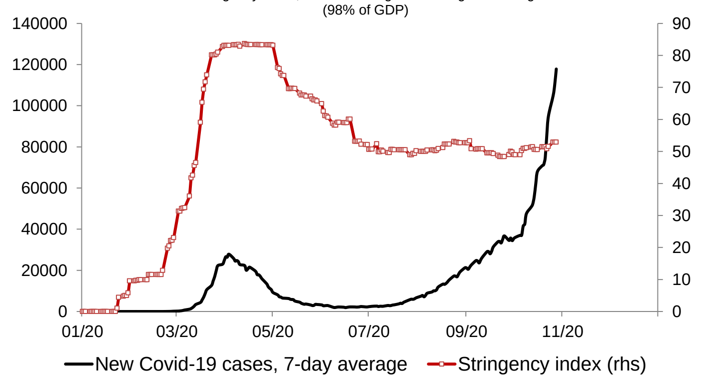
The key determinant for activity in this and next quarter is the degree of stringency measures. While we deem a return to the spring highs (of 80 points, see upper graph) unlikely, we view a tightening up towards 80% of the spring stringency as realistic. Given the short history of lockdown measures it is hard to assess their impact quantitatively but our models see significant negative effects. Accordingly, an increase of stringency by 1 point reduces quarterly growth between -0.13% and -0.27%. Therefore, we deem the implicit current Q4/2020 consensus growth estimate of 2.5% qoq far too optimistic and look for receding activity. While the Q3 data induced an upwards revision of 2020 growth to -7.0% (from -8.0%) we reduced our 2021 expectation to 5.0% (from 5.8%) with negative risks (also NPLs, Brexit) still dominating.

ECB about to act again in December

At the October policy meeting the ECB announced a reassessment of the outlook and a recalibration of instruments. In the press conference President Lagarde left no doubt that action will be taken in December. It also became clear that the ECB will adjust several instruments and that the boldness of action will largely depend on the evolution of the pandemic.

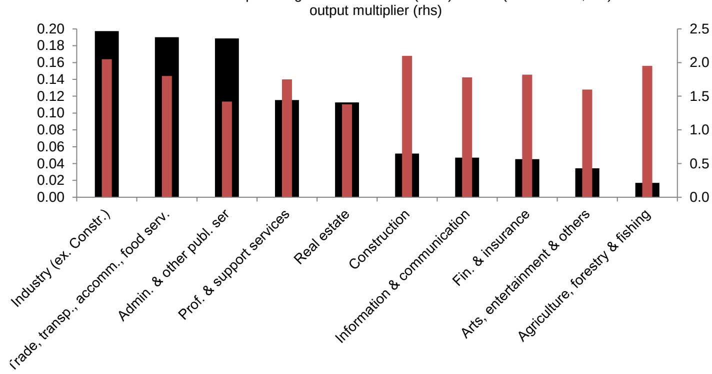
EA: Lockdown and Covid-19 cases

Uni. of Oxford stringency index, EA: GDP weighted average of 11 largest economies (98% of GDP)



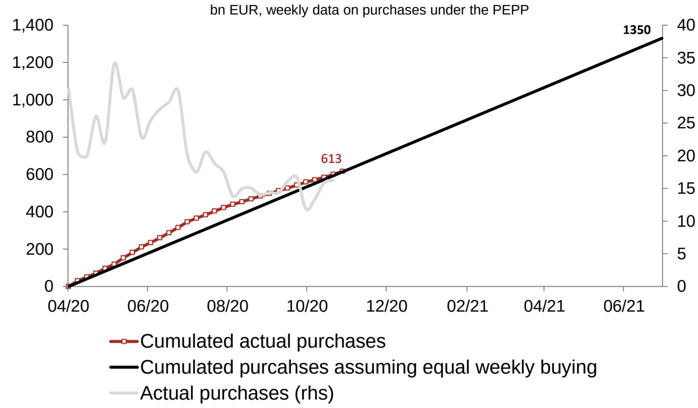
Euro area: Importance of sectors

for 2018: share of respective gross value added (GVA) in total (black boxes, lhs) and output multiplier (rhs)



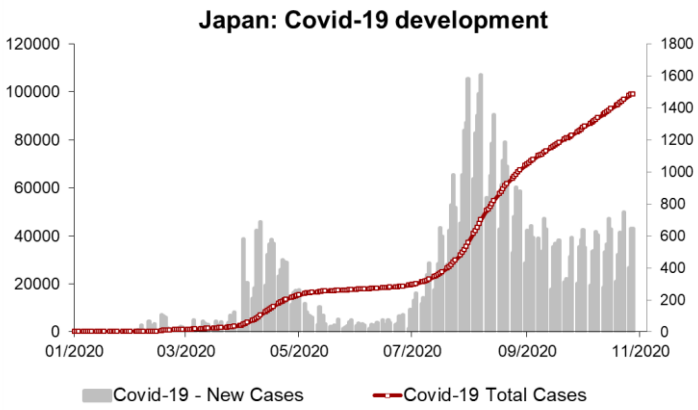
The ECB's PEPP

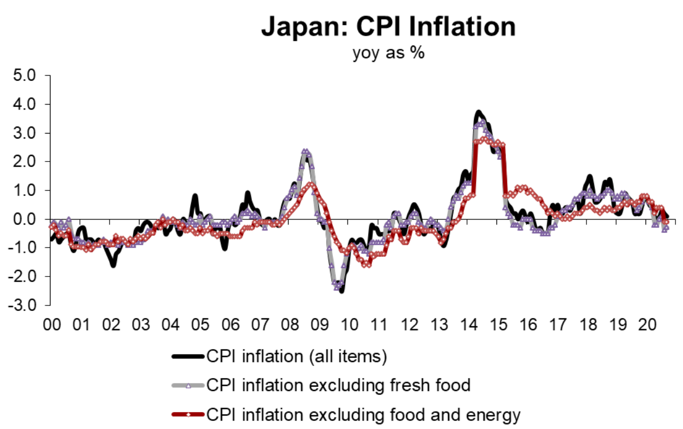
bn EUR, weekly data on purchases under the PEPP



Japan

Christoph Siepmann





- **Japan's Q3 GDP is likely to make up for about half of the Covid-19 induced slump in Q2. This leaves room for further improvement in Q4.**
- **The government likely submits a further stimulus package and prepares a 3rd extra budget in December. The BoJ is expected to reflect the move by extending its special operations.**

Japan's fresh Covid-19 cases have increased slightly over the last weeks but have not shown a major second wave. Against this background, Japan's economy has seen some recovery in Q3. Industrial production rose by 8.6% qoq in Q3, roughly about half of the fall in Q2 by 16.9% qoq. On the demand side, real private goods consumption likely improved by about 5.0% to 5.5% qoq, after a drop by 8.3% qoq in Q2. According to BoJ data, exports increased by 13.3% qoq (after -18.4% qoq in Q2) while imports dropped by 8.1% qoq (after a small rise in Q2). The latter will provide a strong boost from net exports to GDP. Only capex currently looks as to need more time for a meaningful upturn. All in all, we expect Q3 growth to come in around 4% qoq (around 16.5% qoq annualised), after a plunge by 7.9% qoq (-28.1% qoq ann) in Q2.

More fiscal support expected in December

The outlook will depend very much on whether Japan will be able to decouple from the current second Covid-19 wave in other parts of the globe and thus can avoid fresh lockdown measures. Given this scenario, the above data show that there is room for the recovery to continue. On the private consumption side this is especially true for services, while various good items – like passenger cars – already returned to almost pre-crisis levels. The government initiative „Go To Travel", which offers up to 50% discounts on domestic trips, should help to improve the situation in businesses like transport, hotels, restaurants, etc. Exports will likely be more affected by the second Covid-19 wave. International car sales might see some setback although China's demand has recently provided support. As Japan's capex outlays typically follow exports with a delay of two quarters, their outlook remains subdued. All in all, we trim our growth forecast to -5.5% in 2020 (up from -5.8%) and see 2.5% in 2021. The government is widely expected to announce a package in December and to also submit a third supple-mentary budget for FY20 in early January. The BoJ is likely to support the measures by extending its special operations or modify them slightly. We do not expect the BoJ to change its interest rates and the yield curve control policy. Economic policy has clearly shifted to the fiscal side. The BoJ recently estimated the underlying core inflation at about 0%. Next month the base effects from the past sales tax hike will additionally set in. We see core inflation to fall to -0.6% yoy by December.

China

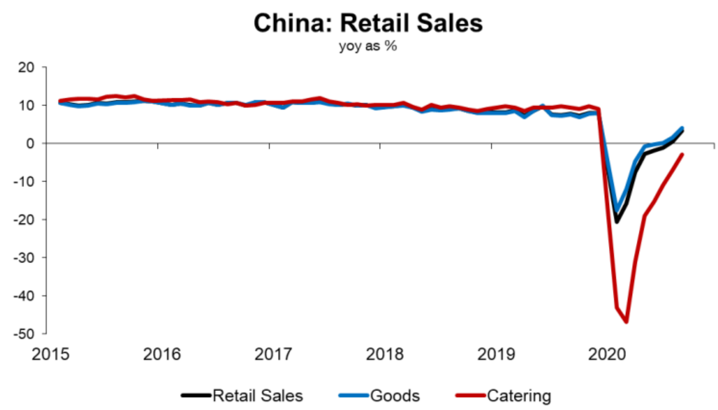
Christoph Siepmann

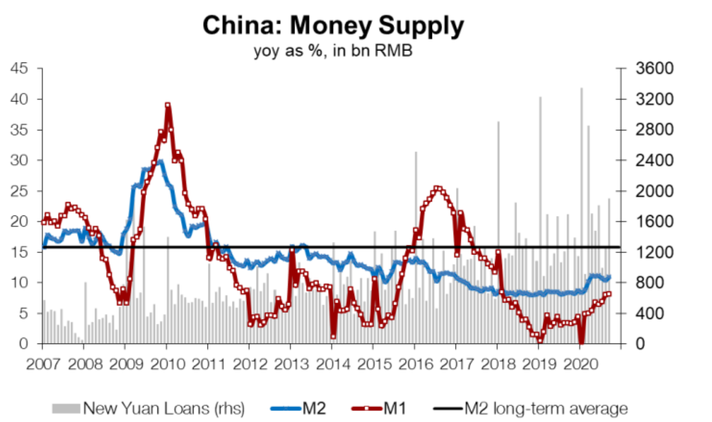
- **China's economy continued to recover and activity has broadened more to the demand side.**
- **This allows the PBoC to remain in a wait-and-see mode. Accordingly, we drop our previous expectation of more monetary easing.**
- **The new five year plan intends to reduce the reliance of China on international trade but instead to foster domestic consumption.**

China's latest economic data set shows that the recovery continued to strengthen and to broaden to the demand side. Q3 GDP growth improved to 4.9% yoy, which is a substantial upturn from the 3.2 % yoy in Q2. Still, it fell short of high consensus expectations of 5.2% yoy. On a year-to-date (ytd) basis output expanded by 0.7%, setting China on the path to be one of the few countries globally which will be able to post a positive growth number in 2020. September data confirmed the V-shaped recovery on the supply side. Industrial production (IP) accelerated from 5.6% yoy in August to 6.9% yoy, which is clearly above the average IP growth rate of 2019. On the demand side, retail sales accelerated from 0.5% yoy in August to 3.3% yoy in September. While goods sales improved to 4.1% yoy, the hard-hit catering sector could narrow its loss. Clearly, China's efforts in fighting the Covid-19 virus play a major role in improving confidence. Although China has seen a fresh local Covid-19 cluster early October in Qingdao, most cases are classified imported and thus quarantined on arrival. Regarding the second demand component, fixed-asset investment rose by 0.8% yoy ytd and increased by an estimated rate of 7.5% yoy in September. Among the major subcomponents, infrastructure investment still looks rather subdued given the expected stronger implementation of the fiscal package. Moreover, exports remained strong while imports shot up for the first time to 13.2% yoy,

PBoC in wait-and-see mode

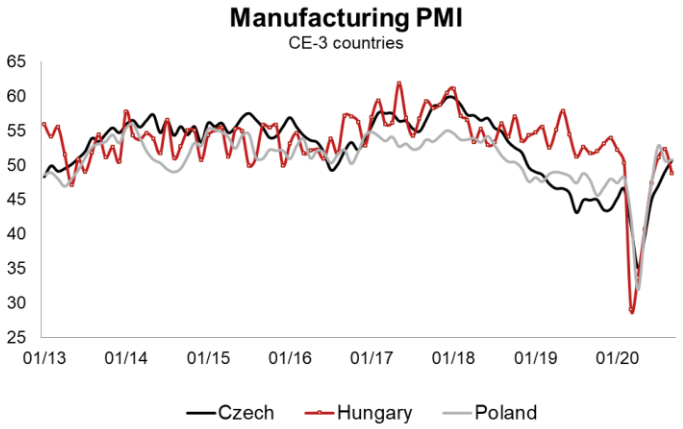
Looking ahead, PMIs suggest that the recovery will continue provided a major Covid-19 outbreak can be prevented. The demand side upturn allows the PBoC to remain in a wait-and-see mode. Accordingly, we drop our expectation that the PBoC will cut again the RRR and the LPR. However, money supply will likely remain ample (new yuan loans rose by 19.3% yoy ytd and TSF even more strongly by 43.7% yoy ytd). Inflation will continue to recede due to strong base effects from last year. Fiscal policy support should become more visible, but there are also hints that the package might not be fully implemented. The focus of policymakers is already shifting to long-term sustainability. At the end of October, the new five year plan was presented which intends to make China less dependent on international trade (given the rising strategic and technological conflict with the US) but to rely more on domestic consumption. We trim our 2020 GDP forecast to 2.0% (2.2% before), still close to the consensus of 2.1%.

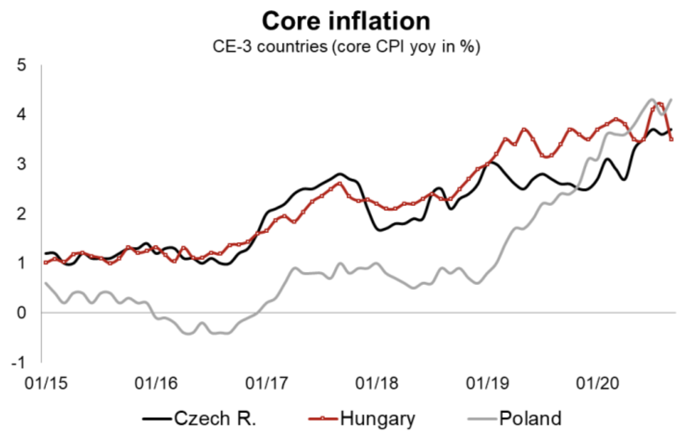




Central and Eastern Europe

Radomír Jáč





Main Forecasts	2019	2020f	2021f	2022f
Czech Republic				
GDP	2.3	-6.8	4.8	2.8
Consumer prices	2.8	3.2	2.1	2.1
Central bank's key rate	2.00	0.25	0.25	0.75
Hungary				
GDP	4.9	-7.0	4.9	3.0
Consumer prices	3.4	3.6	3.4	3.1
Central bank's key rate	0.90	0.60	0.60	0.90
Poland				
GDP	4.1	-4.2	4.6	3.5
Consumer prices	2.3	3.3	2.5	2.5
Central bank's key rate	1.50	0.10	0.10	0.75

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

- **Regional GDP data for Q3 are going to report quarter-to-quarter increases but the outlook for Q4 is clouded by the second wave of pandemic.**
- **Price pressures – particularly core CPI – at the same time remain elevated, which limits the room for further monetary policy easing.**
- **While the Czech and Polish central banks indicate no more rate cuts, Hungary hiked its deposit rate in response to the weaker forint.**

Both surveys and official monthly data indicate that GDP has recovered robustly in quarter-to-quarter terms in Q3 across the region. However, new restrictions that are being imposed in connection with the second wave of pandemic will have negative impact on economic activity in Q4. This may be visible particularly in case of the Czech economy but restrictions are coming also in other CEE countries. For now we revised 2020 forecast for Czech GDP (from -6% to -6.8%) but the risk is skewed to downside across the region.

Inflation, particularly core CPI, at the same time remains high, while interest rates are at their historical or multiyear low. This makes the CEE central banks hesitant to ease their policies further, especially in a situation where fiscal impulses are becoming stronger than anticipated.

Monetary policy: Cautious amid opposing factors

The Czech CNB has kept its key rate on hold at 0.25% since the last cut delivered in early May. The next monetary policy meeting is scheduled for November 5 and several members of the CNB board indicated that unchanged policy is the most likely outcome. While the second wave of pandemic creates downside risk to economic activity, inflation in the Czech economy remains well above the 2% target and the CZK FX rate is weaker than what the CNB expected, while the fiscal impulse is much stronger than anticipated by the central bank.

In Hungary, the MNB keeps its base rate at 0.60% since July. However, weakening of the HUF exchange rate led the central bank to increase interest rate used for deposit operations by 15 bps above the level of the base rate, i.e. to 0.75%. The MNB is ready to tighten conditions at the short end of the curve further, if needed, but recent moderation of inflation means that the central bank does not have to rush into more tightening in coming weeks. The MNB at the same time offers liquidity with long maturity and buys long-term debt via its QE programme with a quite explicit intension to flatten the yield curve.

The Polish NBP keeps its key rate on hold at 0.10% since May. The next MPC meeting takes place on November 4: the NBP will publish new macro forecast but interest rates are expected to stay on hold, most likely until 2022. The NBP may extend non-standard measures if needed but there is a clear reluctance to reduce interest rates further.

Government Bonds

Florian Späte

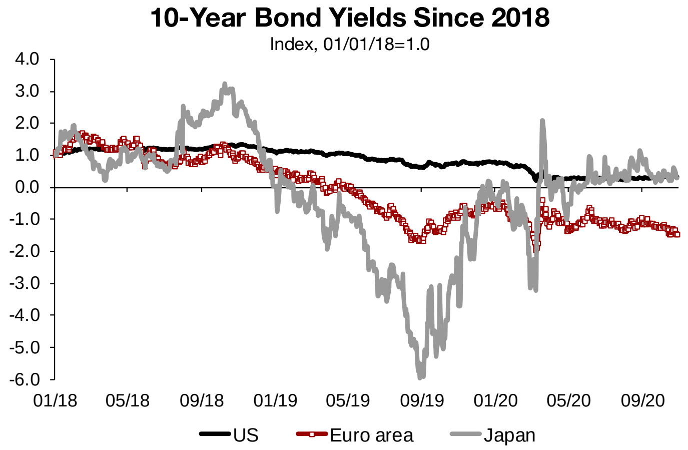
- **The transatlantic yield spread widened markedly in October. While concerns about the consequences of a second wave of Covid-19 infections triggered lower euro area core yields, expectations about an ongoing high supply of US Treasuries drove up US yields.**
- **This pattern is likely to continue in the weeks to come. A dovish ECB and a supportive technical situation will keep euro area yields around current levels for the time being. However, the receding uncertainty about the outcome of the US elections is seen to pave the way for higher US yields.**
- **Although volatility has increased somewhat, on balance euro area non-core bonds continued to perform well. At current spread levels, we do not anticipate a significant further spread tightening.**

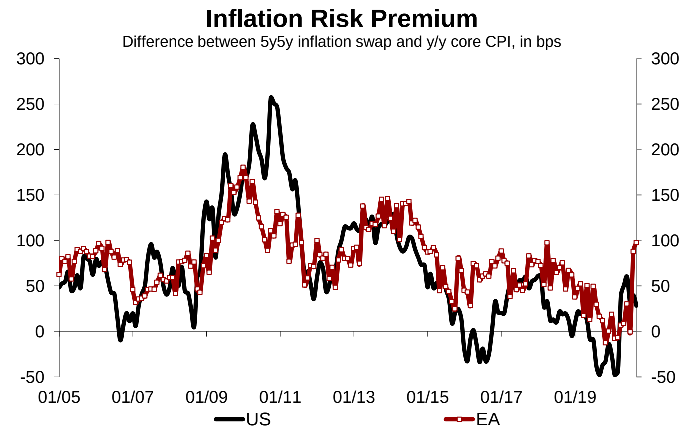
Overall, market developments were rather unusual in October. While euro area core yields fell across the curve by more than 10 bps, long-dated US yields continued to rise by almost 20 bps (short-dated US yields inched up only slightly). As a consequence, the transatlantic yield spread widened across the curve. While the 2-year US/euro area yield gap rose by 13 bps, the 10-year spread rose by 27 bps and the yield advantage for 30-year sovereign bonds even soared by 30 bps to the highest level since March. Noteworthy, inflation expectations did not change much – neither in the US nor in the euro area.

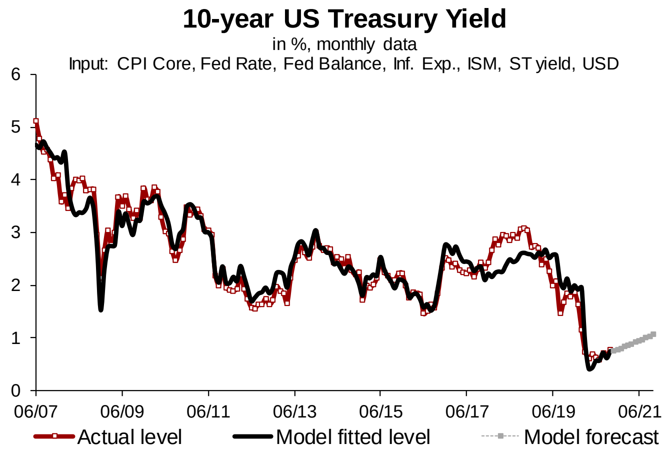
US yield trend points further upwards

The main driving factors for the yield development in October will remain in place going forward. To start with, euro area governments have responded with new restrictions to the second Covid-19 wave. Although the economic impact is hard to estimate as it will depend on the length and the extent of the restrictions, the economic rebound will lose momentum in the euro area. The ECB did not announce new policy actions at the end of October but the message was a dovish one. Moreover, the central bank clearly hinted at forthcoming measures in December. The Pandemic Emergency Purchase Program is almost certain to be augmented. Moreover, some action regarding target longer-term refinancing operations is likely and even another deposit rate cut cannot be excluded. Finally, the technical situation remains very supportive. Euro area governments have completed more than 90% of the annual issuance activity. Taking into account redemptions and ECB purchases net supply will be negative until year-end. Even looking into 2021 it is fair to say that net supply (considering ECB purchases) will remain in negative territory. Considering the expected slowing of the gross issuance, excess demand next year will be even higher than in 2020.

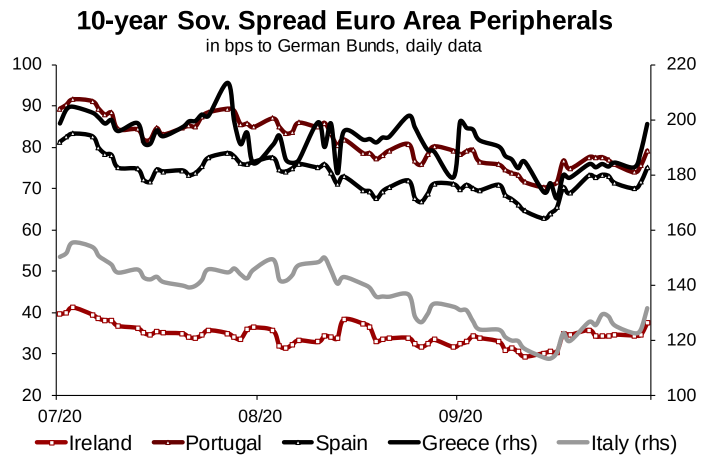
The situation in the US is noticeably different. Although

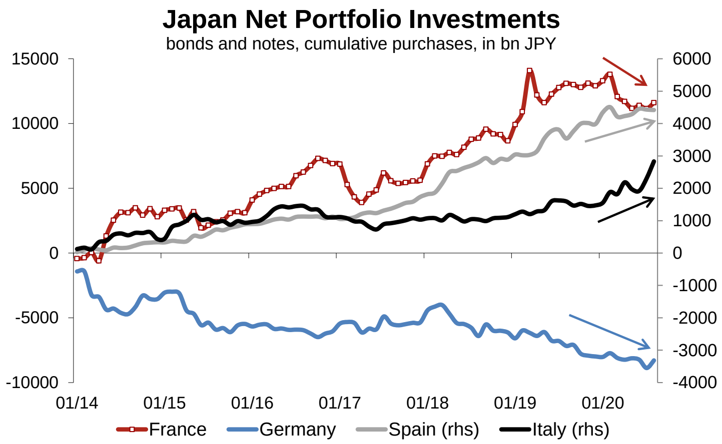


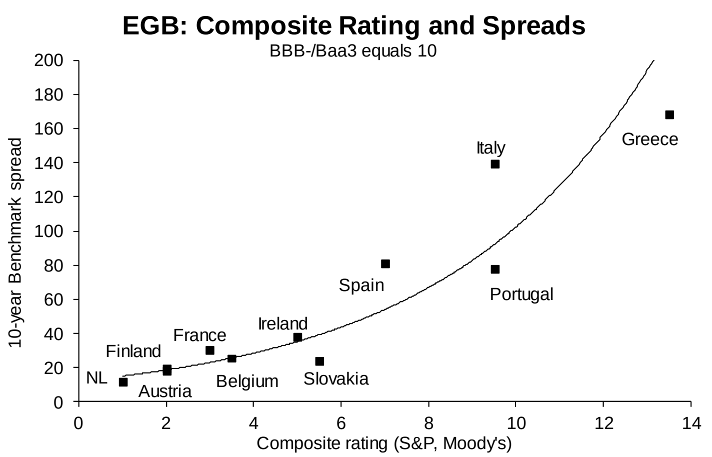




Government Bonds







Covid-19 infection rates are rising as well the political actions (and, hence, the economic impact) are much more muted. Furthermore, the US budget deficit will remain massive in 2021. Whatever the outcome of the US elections, it will be at least $1.8tn. Although the Fed will keep its accommodative policy stance and will continue to buy government bonds, net supply will be significantly in positive territory in 2021.

Eventually, the elections can speed up the upward trend in US yields. In case of a Democratic sweep uncertainty is removed fast. The budget deficit will be much higher (at least $2.5tr) and, hence, net supply will increase even faster. In this case inflation expectations are likely to rise contributing to higher nominal yields as well (in addition to higher real yields boosted by a rise in consumption and growth). As the Fed will anchor the short end of the curve in any case, the US curve is expected to bear steepen.

In the event of a contested election outcome there might be a temporary safe haven flight. However, we doubt that this will last. For one thing, at some point a result will be declared which will remove the political uncertainty. For another, the budget deficit will remain high in any case. In combination with the expectation that a vaccine will be found soon and a rather resilient US manufacturing sector the upward trend is likely to continue. The smallest rise in yields in the medium term is seen in the event of a split government as Congress and President would struggle to agree on major policy changes.

All in, we forecast euro area long-dated core yields to remain around current levels for the time being (10-year: -0.60%). Over the course of 2021 a slight upward trend is likely amid the fading impact of Covid-19 (12-month forecast: -0.45%). 10-year US yields are expected to continue the upward trend. While short-dated bonds are unlikely to move substantially, we forecast 10-year US yields to reach (if not exceed) 1.0% in 2021.

No end of non-core bonds' outperformance in sight

Against the background of good news euro area non-core bonds performed well in October. In addition to the benign outcome of regional elections in Italy in September, S&P removed the negative outlook (keeping the rating at BBB). Overall, particularly high-yielding non-core bonds continued to outperform core bonds.

Going forward, a further tightening is rather unlikely. Not only the worsened fundamental situation argues against it but also the fact that overweighting high-yielding euro area non-core bonds has become a consensus trade. At least demand from abroad has picked up since spring. While Japanese investors have sold French and German bonds they have increased the holding of Spanish and Italian bonds. Summarizing, the higher coupon of non-core bonds is expected to ensure an outperformance versus core bonds in the weeks to come.

Credit

Elisa Belgacem

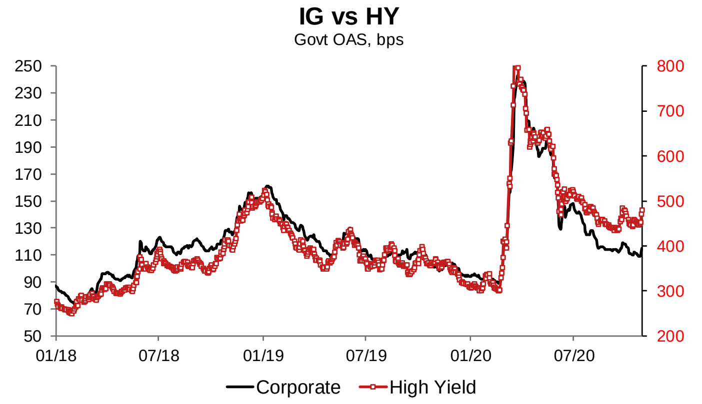
- **Alongside other risky assets, credit spreads have continued their recovery until a recent surge in Covid cases.**
- **Since the implementation of new stringency measures in Europe, HY has been logically reacting more than IG.**
- **S&P has revised its 12m trailing default forecast to 8.5%, while Moody's has downgraded its projection from 5.9% to 5.7%.**
- **Awaiting the US elections, Brexit negotiations and more clarity on the economic impact of "smart lockdowns", we continue to recommend an OW in IG compared to HY.**

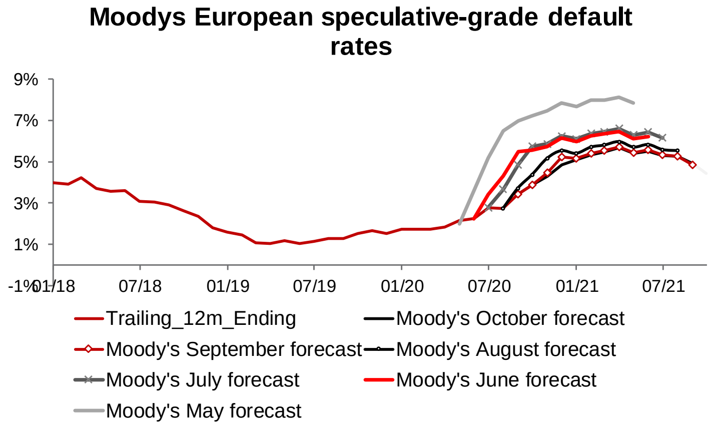
New stringency measures are gradually being announced across Europe, and the key question for credit markets will be whether this new type of lockdowns will be less damaging for the economic activity than in spring. In other words, shall we revise up our 5-6% default projections for Europe only marginally or significantly? If we assume that "smart lockdowns" will effectively be smart and that they will be accompanied by extensions of furlough schemes, guaranteed loans and moratoria into end 2021, defaults prospects should be only slightly higher than what we previously expected. Moreover, the ECB has signalled that it will do more in December and this is a clear life insurance policy for credit markets. Indeed, so far the ECB has only bought small amounts of corporate bonds within the PEPP (around EUR1.5bn each month) while it could easily multiply this amount by ten if financial conditions for European corporates were to tighten in the near term.

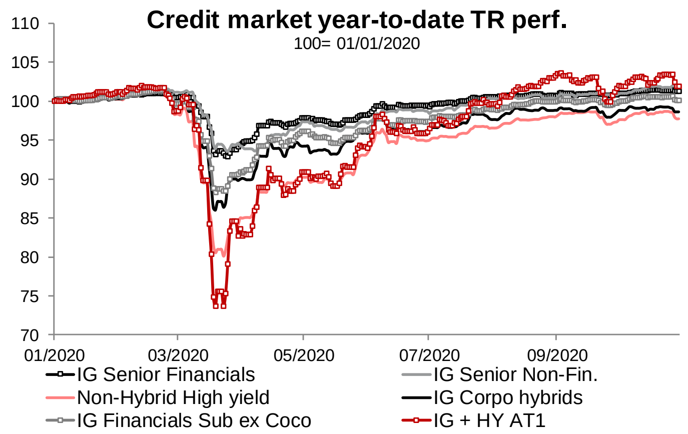
Financials have been suffering more recently vs non-financials, as they are more exposed to SMEs that will be more affected by the new Covid-related stringency measures. However, the regulatory support to the financial world will likely be raised once again to make sure that banks play their key role in lending to the economy.

IG will resist much better than in spring

Hence going forward, we expect some short-term volatility but after that we see IG grinding gradually tighter while near term there is still room for further valuation divergence between IG and HY. Uncertainty surrounding rising default rates will continue to weigh on HY into 2021 despite record public support. It will weigh more on the lower end of the rating spectrum, hence within HY, we retain a preference for BBs. We expect rating agencies to resume their downgrade moves, so we adopt a prudent bias across the board. We continue to prefer capital structure risk to credit risk and so we prefer corporate hybrids and AT1 to a lesser extent.

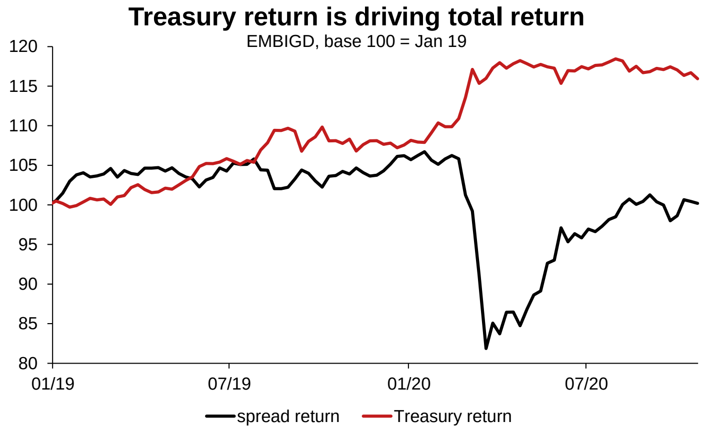






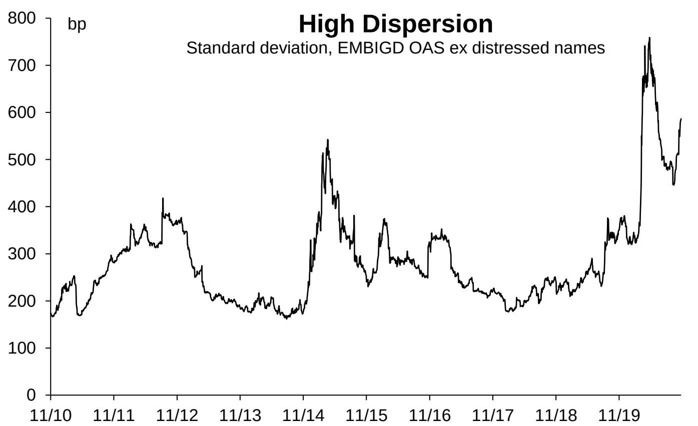
EM Sovereign Bonds

Guillaume Tresca



Elections Outcome scenario and impact

Outcome	EM spreads	Total return impact
Blue sweep Biden wins, Dem. Senate	**Tighter with positive growth scenario and less trade friction** LatAm and Central America to benefit Turkey, Russia to lose	Positive but UST rate rebound
Contested Biden Biden wins, Rep. Senate	**Tigher spreads** LatAm and Central America to benefit Turkey, Russia to lose	Positive but limited UST rate rebound
Status quo Trumps wins, Rep. Senate	**Wider spreads** GCC, Turkey, Russia, IG to benefit China, HY, cyclical to lose	Negative
Contested elections	**Wider spreads** IG to benefit HY to lose	Negative but transitory



- **We maintain an OW in EM sovereign credit that has proved to be resilient, but given high uncertainties we favour EM IG over HY.**
- **US elections are the elephant in the room but we expect a less abrupt impact than in 2016.**
- **Beyond the US elections, we maintain a positive EM view but differentiation will be paramount.**

Despite the rise of risk aversion and growing uncertainties, EM external debt has been resilient in October with positive returns. Outlook would remain uncertain and challenging with the US elections and the deterioration of the sanitary situations. We maintain an OW in EM sovereign credit but within the new environment we favour EM IG over EM HY.

Beyond the US elections, we maintain a positive view on EM spreads: US real yields have hardly rebounded and high carry has continued to attract significant inflows into EM external debt funds, even over the past two weeks. EM debt total return should essentially remain driven by the duration component and be positive as we only expect a modest rise of long-term US rates. Moreover, even if EM debt-to-GDP should climb to 62% from 50% today, the scars of the crisis will not be visible until 2022 and the IMF is for once asking for more fiscal support across EM in 2021

US elections: it is not 2016

We expect a less abrupt impact on EM sovereign debt of the US elections than in 2016. In our view, spreads widening post elections, if any, should be more contained: spreads appear to be cheaper and positioning has been lighter with the sanitary situation. That said, EM would benefit the most from a contested Biden victory but a Blue sweep outcome would be also positive as the subsequent US rate rebound should be contained.

On a country basis, dispersion has already been high and the elections outcome should accentuate it. Turkey and Russia, which has recently been on a back foot, could underperform under a Biden's victory while Mexico and Central America could benefit.

But sharpen your pencil anyway

Differentiation and idiosyncratic risks will gain more momentum. Fiscal space across EM is heterogeneous and we expect stress on weak names. Rating agencies have adopted a stringent view, especially Fitch, which downgraded further Morocco to non-IG. Risk of a downgrade in Romania in early 2021 exists. In Turkey, we see few reasons for an improvement. Countries with a rapid deterioration of debt like South Africa should suffer too. The GCC region will continue to benefit from cross-over demand. Outlook is less certain in Latin America: it has been hit but could benefit extensively from a vaccine.

Currencies

Thomas Hempell

- **Resurgent Covid-19 cases and the outlook of substantial further ECB accommodation in December will keep a lid on the euro near term.**
- **That said, a 'blue wave' in the US elections could trigger the USD's next leg lower. EM FX would benefit in particular from fiscal stimulus hopes and more predictable trade policies. But also the EUR/USD may inch upwards.**
- **A last minute Brexit deal still looks feasible and may lift GBP. By contrast, failing negotiations would result in a stronger slide of sterling.**

The USD took a further leg down in October, bucking the risk-off mode prevailing on global markets more lately. In part, this may reflect already some discounting of a Biden victory in the upcoming US elections. A 'blue wave' outcome would undermine the USD on concerns about tax hikes and tighter regulation. A soaring fiscal deficit amid yields capped by the Fed will also require a further discount on the dear USD to attract foreign capital inflows. EM FX may benefit in particular on hopes of more predictable trade policy. A split government under Trump may be mildly USD supportive (pro business regulation maintained) and broadly neutral under Biden (with more predictable trade policies reversing safe-haven flows into the USD, but a split Congress easing concerns about tax hikes and tighter regulation).

Contested election would boost USD

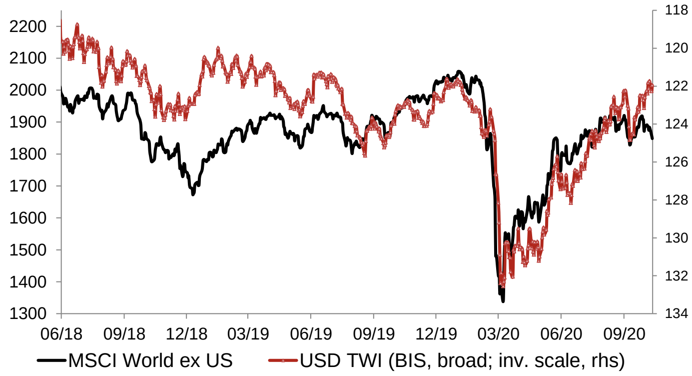
Strikingly, a contested US election outcome would underpin the USD in safe haven bids, notably vs. EMs (the USD was a prime beneficiary of US/China trade tensions). Concerns about the US impact, however, would limit the gains, keeping the EUR/USD reaction muted. The safe-haven JPY would benefit more clearly.

The strong surge of Covid-19 infections in Europe is keeping a lid on the EUR short term. The US may just be trailing the 2nd wave with a lag, but a deteriorating pandemic is still associated with safe haven demand for the USD. Easing Covid-19 worries on vaccine progress, however, are likely to help EUR/USD to pass the 1.20 threshold into next year.

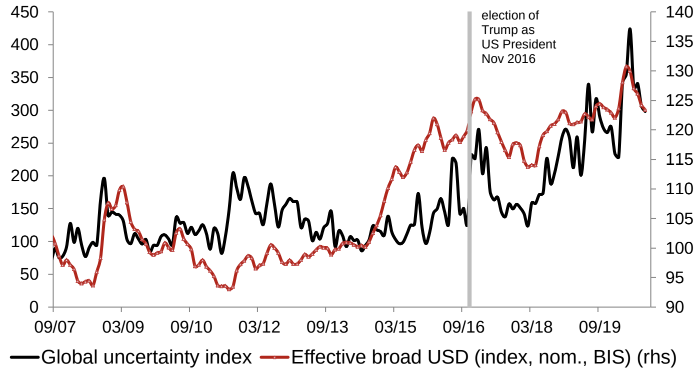
Brexit talks are entering their decisive phase in early November. A thin deal is still feasible and may help sterling gain some further ground. By contrast, failing talks still offer a more sizeable GBP downside on concerns over the detrimental impacts of a hard Brexit.

The sharp rise in CNY since summer may extend somewhat further on a Biden victory, China's V-shaped rebound and higher yield differential. Also, the trade-weighted yuan is only 1% above the average since 2016, not yet a strong concern for Chinese policy makers. Yet we expect the momentum to fade, with China already leaning against further CNY strength via tweaks to the calculated reference rate and .eased regulation on CNY short positions.

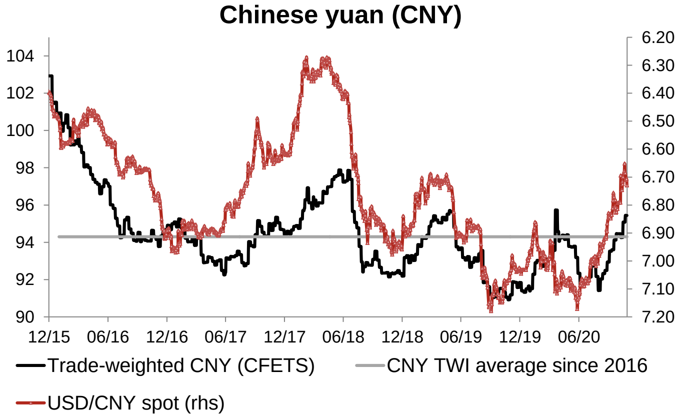
USD and risk sentiment



Global policy uncertainty and USD



Chinese yuan (CNY)

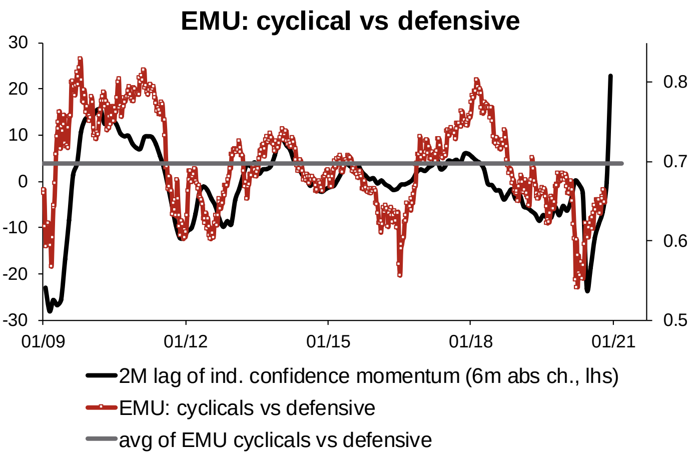


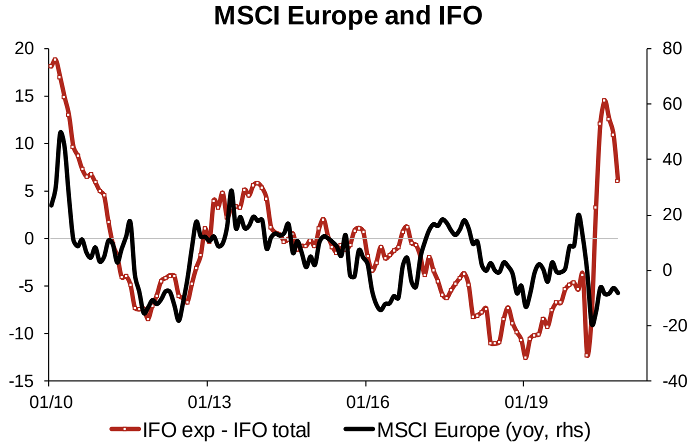
Equities

Michele Morganti / Vladimir Oleinikov

- **Equity markets suffered in October caused by the increase in Covid cases and in political risks.**
- **Due to semi-lockdown measures taken in Europe, the economic momentum is to suffer, thus putting EA equities under pressure in short term.**
- **However, further supportive fiscal and monetary measures should help to continuing recovery and we forecast 12-month total returns of around 8%.**
- **In the country and sector allocation, we recommend a tilt towards value and cyclicals, while having EMs and Japan in OW.**

October was a month of a sell-off, with VIX jumping from 26 to 40. This was mainly due to fast increase in Covid cases, Brexit related uncertainty plus the failure to approve the new US fiscal stimulus. The cross country/sector performance was the one which typically occurs during downturns, with defensive, growth and the US outperforming Value, cyclicals and Europe. In this market phase both the EM and Japan have outperformmed (our overweights). Indeed, both are managing Covid cases better than the (EA) and the US. Furthermore, they are relatively undervalued, score well in our country ranking (valuation, earnings growth and positioning) and their cyclical quality (and higher sensitivity to steeper US yield curve) has so far not been put into question because of the less disruptive Covid effects on the economy.





Q3 reporting season going well

With 40% of S&P 500 index results out the third quarter looks good for firms. US earnings and sales surprised by 12% and 2.5%. Yearly growth of the median stock is positive at 1.4% for earnings and 0.6% for sales. Staples, IT and Pharma showed highest and positive earnings and sales growth. For Europe and Japan, results are worse, while the EA shows positive earnings growth due to some outliers, with negative sales growth (-4%). That said, even in Europe earnings surprises are positive by 13% (for sales by 1%). For the EA, the lower GDP growth and the strong currency are limiting growth vs the US. The conclusion is that before the resurgence of new Covid cases, the cyclical upturn was still alive although expected to mitigate. Furthermore, as the two charts on the right show, markets, and cyclicals especially, had not fully exploited yet the undergoing cyclical recovery.

Analysis of the median stock: Q3 2020 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q2 2020	Q3 2020	Q2 2020	Q3 2020	Q3 2020
S&P	(13.42)%	1.44 %	(6.56)%	0.61 %	41.3%
Stoxx	(9.85)%	6.99 %	(7.28)%	(4.12)%	39.6%
Euro Stoxx	(10.41)%	10.32 %	(12.28)%	(5.09)%	34.4%
Topix	(1.40)%	(1.59)%	(7.64)%	(4.67)%	17.5%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q2 2020	Q3 2020	Q2 2020	Q3 2020	Q3 2020
S&P	12.91 %	11.88 %	2.26 %	2.51 %	41.3%
Stoxx	6.58 %	13.00 %	1.23 %	1.07 %	39.6%
Euro Stoxx	13.07 %	12.24 %	1.53 %	1.28 %	34.4%
Topix	7.98 %	10.51 %	0.59 %	(0.63)%	17.5%

Resurging Covid and political risks: what are limits?

As semi-lockdown measures are taking place in Europe, we cannot exclude to reach the peak of this second wave in some weeks. That said, the economic momentum will certainly suffer. For this reason, the EA is down by 9% since October's top. We think we could eventually see another -7% but no more. First, after such decline, the market would approach relevant technical supports (corresponding to bottoms experienced in April and May).

Equities

Second, we would exclude the market to fall beyond a 7%, reaching March bottoms as the latter correspond to a period when the strong policy support was not exploited yet. Furthermore, we expect both fiscal and monetary measures to increase further from here. Finally, when we look to the IFO index (expectations component, 3 month changes), we could expect it to reach previous cyclical bottoms, corresponding to an average market decline of around 7% from here, with the defensives-cyclicals gap reaching the April-May highs (high risk aversion).

Cautious but markets getting attractive again

Higher volatility will probably linger short term. US elections typically command increasing volatility till the election day, declining sharply thereafter. The uncertainty after the D-day is expected to last more this time due to the postal vote. A Democrat sweep should be positive, corresponding to a fiscal stimulus. US yields would probably rise a bit and the US yield curve remain steep, supporting cyclicals and Value. On the contrary, a Trump victory would favour growth style. That said, tactical indicators are still on the buy side and in our base scenario, while expected growth is reduced, we still expect recovery to hold and policy action to remain highly supportive. Under such conditions we expect to see a total return of around 8% in 12 months.

Country and sector allocation: tilt on Value/Cyclicals

In the last weeks, as Covid cases started mounting, we hedged our recommended portfolio by lowering the equity OW position, while putting in OW the EMs and Japan and not betting on EA vs US (defensive move). We maintain a tilt to Value/Cyclicals. We moved food and food retail in OW (revisions bottoming, neutral score, hedge to ptf) and let some cyclical growth in OW (tech hardware and semiconductors, good score, low PEG), having banks and energy neutral, the two most problematic Value representatives. Other OW: Insurance, div. financials and capital goods. UW: Telecoms, Media, and transportation.

EM: additional boost from a blue wave fiscal impulse

In October, the MSCI EM (+3.6%) has especially benefitted from a weaker dollar vs EM FX (-1.4%) and outperformed the MSCI World by 6.1pp. In terms of multiples, EMs are trading at a discount of 23% vs historical average relative to the US. The historically relatively high PE is supported both by lower yields and higher macro surprises. Positive for the EMs are also financial conditions and improving earnings growth, which results from the rebounded PMI global exports (in yoy terms they are now above the levels we had prior to the COVID outbreak). An eventual blue wave fiscal impulse would be negative for the US dollar and thus additionally positive for EMs. Within the EMs we favour Korea and Taiwan, having better Covid contagion trend, supporting M1 momentum, and high internal score ratings.

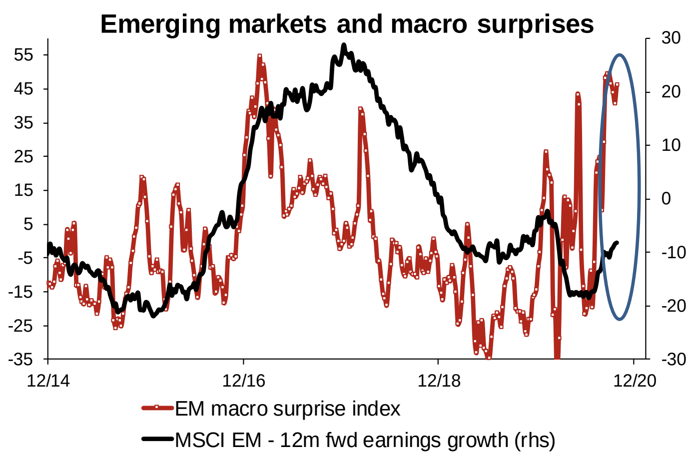
Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.	PEG adj.*
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %	
WORLD	19.2	16.0	2.3	2.0	12.0	9.0	2.3	2.7	22.1	
USA	20.7	15.5	3.3	2.4	14.2	10.2	1.8	2.2	31.6	1.7
JAPAN	17.1	15.3	1.1	1.2	8.6	7.1	2.4	2.0	1.1	1.9
UK	13.4	13.8	1.3	1.8	7.6	7.9	4.4	4.1	-10.0	3.9
SWITZERLAND	16.6	15.5	2.6	2.3	11.4	11.2	3.3	3.3	5.3	3.1
EMU	15.5	14.1	1.3	1.5	7.7	6.6	3.4	3.8	6.5	3.3
FRANCE	16.0	14.4	1.3	1.5	8.3	7.1	3.5	3.7	6.4	5.5
GERMANY	14.3	15.0	1.3	1.5	7.4	6.8	3.2	3.3	-1.3	3.1
GREECE	11.6	12.8	2.1	1.6	5.5	6.1	6.9	4.2	-14.9	2.3
ITALY	12.8	15.0	1.1	1.2	5.1	4.7	4.8	4.7	-5.5	3.0
PORTUGAL	17.1	13.0	1.8	1.8	6.0	5.9	5.0	4.5	6.5	3.3
SPAIN	14.0	12.9	0.9	1.5	4.2	5.0	4.8	5.0	-10.7	2.9
EURO STOXX 50	15.3	13.3	1.5	1.5	8.5	6.4	3.5	4.2	15.7	3.4
STOXX SMALL	19.6	14.8	1.4	1.7	9.4	8.5	2.9	3.2	8.7	6.8
EM, $	14.3	14.4	1.6	1.6	8.6	7.5	2.5	3.1	8.2	1.7
BRAZIL	12.4	9.3	1.8	1.7	7.2	13.0	3.8	4.3	0.1	2.8
RUSSIA	7.1	7.0	0.7	0.9	4.6	4.5	8.0	4.3	-26.8	2.5
INDIA	22.1	14.8	2.7	2.6	13.8	11.5	1.6	1.6	18.2	2.2
CHINA	15.2	12.9	1.8	1.7	10.3	7.6	1.7	2.9	25.4	1.5

Note: The first four markets are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003. PEG is PE divided by expected EPS long-term growth.
PEG adj. (higher = expensve): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it.
COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs).
Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
Source: Thomson Reuters Datastream, IBES estimates.

Total Return decomposition and PE expansion from 31/12/2019 to 28/10/2020

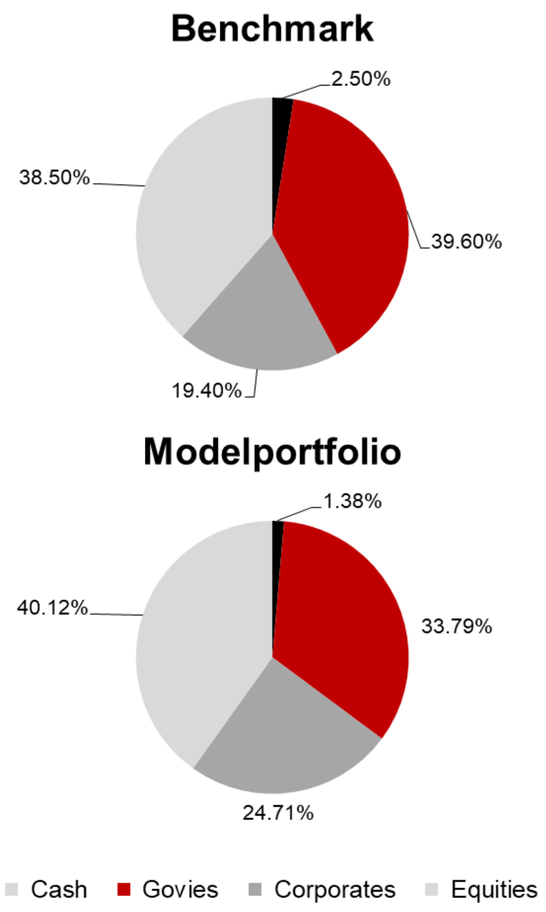
Index	%TR	%EPS	%PE	10-Year Rate Change (BPS)	Value Gap (Fair Value - Price) at 28/10/2020	Global rank based on valuation, earnings growth and positioning (lower = better)
MSCI World	-0.4	-12.5	11.8	-27	-3	
S&P 500	2.8	-9.7	12.1	-114	6	32
MSCI USA IT	24.8	4.9	17.9	-114	-16	
MSCI EMU	-16.6	-23.4	6.5	-48	2	34
TOPIX	-4.2	-21.8	19.8	3	-18	4
FTSE100	-23.9	-27.3	1.9	-57	19	23
SMI	-6.4	-7.0	-2.6	-3	6	18
MSCI ITALY	-24.9	-33.0	9.5	-63	17	19
MSCI EM ($)	2.7	-9.6	11.2	-83	-7	7
MSCI Brazil	-16.0	-12.6	-6.0	68	35	30
MSCI Russia ($)	-32.9	-43.0	10.9	-38	-16	5
MSCI India	0.9	-14.7	16.6	-70	4	11
MSCI China	23.0	-2.4	23.8	1	-28	12
MSCI EM Europe ($)	-34.0	-38.5	2.8	33	0	
MSCI EM Lat. Am. ($)	-35.5	-34.0	-4.5	15	17	
MSCI EM Asia ($)	13.6	-1.0	12.6	-57	-15	

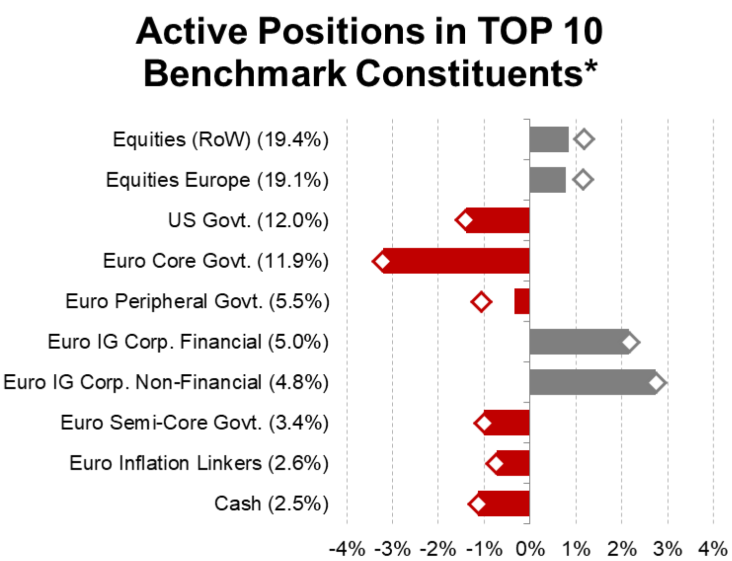
Earnings are 12-months forward; PE = Price/Earnings 12M forward; %DR is estimated as %TR - %PR;
Fair Value Indicator = 12M FW EPS / (10Y Rate + ERP - G); Value Gap = percentage diff. between Fair Value and Price
Fair Value Indicator Change = increase/decrease of theoretical fair value due to EPS or yields delta.
Average relative performance vs MSCI World over 6m and 12m is taken as a proxy for positioning.
Ranks are obtained across DMs & EMs, including 45 markets in total.
Source: Thomson Reuters, GIAM



Asset Allocation

Thorsten Runde





**Benchmark weights in parentheses, diamonds indicating previous*

- **Since the end of August equity markets lost -3.5% on average *(October 28)*, driven by the heavyweights in the model portfolio (EMU -7.3%, and US -6.0%). Only the EMs were able to show an increase in value (+1.3%).**
- **In contrast, on the fixed income side only Cash and USD denominated assets performed negatively with long-dated US Treasuries marking the tail-light by loosing -1.4%.**
- **EA Government bonds were the top performing asset class over the past two months with long-dated maturity buckets clearly beating the shorter-dated ones. The ranking is led by the Y10+ segment of Italian BTPs (+6.0%) followed by Core Govies (+4.5%) and Spanish Bonos (+4.0%).**
- **On the Credit side, EA Corporates roughly gained +0.7% since the end of August, with IG clearly outperforming HY by +160 bps in case of Non-Financials and +60 bps in case of Financials.**
- **The Covid-19 crisis, the US elections and Brexit negotiations basically argue for a less risky positioning. Yet, the search for yield seems unbroken. Thus, we just slightly decrease our equity exposure to reduce the UW in EA peripheral bonds.**

Since the end of August the model portfolio has lost so far -15bps compared to its benchmark. Over that period developed equity markets suffered particularly badly from the resurgence of the Covid-19 pandemic. On average, they lost -6.1%. On the contrary, EA Core Govies gained around +2%. Being overweighted in the former and distinctively underweighted in the latter accounts for the biggest chunk of the overall underperformance (-6.3 bps for Equities, -10.6 bps for Core Govies). Only corporate bonds are recorded on the positive side with a performance contribution of +15.6 bps.

Against the backdrop of the Covid-19 crisis, the US election and the Brexit negotiations there are quite some reservations about being too offensively invested. Yet, the ongoing recovery and the policy support should eventually back risk assets. Furthermore, with negative core yields staying range-bound we continue to see value in Credit and Peripherals due to higher carry.

Search for yield still unbroken

Overall, we will stick to our moderate risk-taking positioning for the time being. We recommend to reduce the overweight in equity a bit in favour of peripheral bonds *(this reallocation implemented in the last IC already generated +4 bps)*. We maintain a sizeable overweight in IG Credit avoiding low-carry markets like EA Core Govies, US Treasuries and Cash

Forecast Tables

Growth

	2018	2019	2020f	2021f
US	2.9	2.3	- 3.6	3.7
Euro area	1.9	1.2	- 7.0	5.0
Germany	1.3	0.6	- 5.6	4.0
France	1.8	1.3	- 8.7	6.0
Italy	0.7	0.2	- 8.5	6.0
Non-EMU	1.6	1.4	- 9.2	4.0
UK	1.3	1.4	-10.5	3.8
Switzerland	3.0	1.1	- 6.5	4.0
Japan	0.8	0.8	- 5.5	2.5
Asia ex Japan	6.1	5.2	- 1.6	6.7
China	6.6	6.1	2.0	7.5
Central/Eastern Europe	3.2	1.9	- 4.2	4.5
Latin America	- 0.0	- 1.2	- 7.0	3.2
World	**3.5**	**2.7**	**- 4.2**	**4.9**

Inflation

	2018	2019	2020f	2021f
US	2.4	1.8	0.4	1.4
Euro area	1.8	1.2	0.3	1.0
Germany	1.9	1.4	0.5	1.5
France	2.1	1.3	0.5	0.9
Italy	1.1	0.8	- 0.1	0.9
Non-EMU	2.1	1.5	0.4	1.1
UK	2.5	1.8	0.5	1.3
Switzerland	0.9	0.4	- 0.5	0.2
Japan	1.0	0.5	0.0	0.1
Asia ex Japan	2.6	2.8	2.8	2.4
China	2.1	2.9	2.5	2.0
Central/Eastern Europe	6.3	6.9	5.3	5.2
Latin America	4.0	4.0	3.5	3.3
World	**2.6**	**2.6**	**2.0**	**2.1**

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

Financial Markets

3-month LIBOR	**28/10/20***	**3M**	**6M**	**12M**
USD	0.22	0.20	0.20	0.20
EUR	-0.53	-0.50	-0.50	-0.50
JPY	-0.10	-0.10	-0.10	-0.10
GBP	0.05	0.05	0.00	0.00
CHF	-0.78	-0.75	-0.75	-0.75
10-Year Bonds	**28/10/20***	**3M**	**6M**	**12M**
Treasuries	0.79	0.85	0.90	1.00
Bunds	-0.60	-0.60	-0.55	-0.45
BTPs	0.65	0.70	0.75	0.80
OATs	-0.32	-0.30	-0.25	-0.15
JGBs	0.03	0.05	0.05	0.10
Gilts	0.24	0.25	0.30	0.40
SWI	-0.52	-0.55	-0.50	-0.45
Spreads	**28/10/20***	**3M**	**6M**	**12M**
GIIPS	98	100	100	95
BofAML Covered Bonds	38	40	40	35
BofAML EM Gvt. Bonds (in USD)	344	339	341	343

Corporate Bond Spreads	**28/10/20***	**3M**	**6M**	**12M**
BofAML Non-Financial	109	105	100	95
BofAML Financial	114	105	100	95
Forex	**28/10/20***	**3M**	**6M**	**12M**
EUR/USD	1.18	1.19	1.20	1.23
USD/JPY	105	105	104	103
EUR/JPY	123	125	125	127
GBP/USD	1.30	1.34	1.36	1.40
EUR/GBP	0.91	0.89	0.88	0.88
EUR/CHF	1.07	1.08	1.10	1.12
Equities	**28/10/20***	**3M**	**6M**	**12M**
S&P500	3354	3370	3440	3580
MSCI EMU	110.4	111.0	113.0	116.5
TOPIX	1616	1635	1660	1730
FTSE	5701	5720	5785	5970
SMI	9831	9950	9990	10445

*average of last three trading days

3-Months Horizon

Government Bonds	*10-Year Bunds*	-0.81	-0.60	-0.39
	10-Year Treasuries	0.69	0.85	1.01
	10-Year JGBs	-0.14	0.05	0.24
	10-Year Gilts	0.15	0.25	0.35
	10-Year Bonds CH	-0.73	-0.55	-0.37
Equities	*MSCI EMU*	100.2	111.0	121.8
	S&P500	3092	3370	3648
	TOPIX	1503	1635	1767
	FTSE 100	5251	5720	6189
	SMIC	9276	9950	10624
Currencies	*EUR/USD*	1.16	1.19	1.22
	USD/JPY	102.33	105	107.67
	EUR/GBP	0.86	0.89	0.92
	EUR/CHF	1.06	1.08	1.10

12-Months Horizon

Government Bonds	*10-Year Bunds*	-0.84	-0.45	-0.06
	10-Year Treasuries	0.74	1.00	1.26
	10-Year JGBs	0.52	0.10	-0.32
	10-Year Gilts	0.25	0.40	0.55
	10-Year Bonds CH	-0.80	-0.45	-0.10
Equities	*MSCI EMU*	99.1	116.5	133.9
	S&P500	3135	3580	4025
	TOPIX	1491	1730	1969
	FTSE 100	5201	5970	6739
	SMIC	9322	10445	11568
Currencies	*EUR/USD*	1.17	1.23	1.29
	USD/JPY	96.27	103	109.73
	EUR/GBP	0.82	0.88	0.94
	EUR/CHF	1.08	1.12	1.16

*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

Issued by: **Generali Insurance Asset Management S.p.A. SGR, Research Department**

Head of Research: Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

Head of Macro & Market Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team:
Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)
Elisa Belgacem (elisa.belgacem@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Guillaume Tresca (guillaume.tresca@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

Sources for charts and tables: Refinitiv/Datastream, Bloomberg, own calculations

Version completed on October 30, 2020

In Italy:
Generali Insurance Asset Management S.p.A. Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Piazza Duchi degli Abruzzi, 1
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management S.p.A Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com