GENERALI INVESTMENTS

Outlook 2021
Repair and Despair

Generali Insurance Asset Management Spa SGR

Content

Global View – Repair and Despair

- **2021 will see a 'repair' of the deep Covid-19 damages, with the economy set to rebound strongly as society normalises into summer.**
- **But there is much to despair about. Potential growth will be lower out of this crisis. Employment will recover more slowly and Covid has fanned inequalities. Investors can also lament about the fall of future investment returns.**
- **Falling policy uncertainty has compressed risk premia into the turn of the year. This process has legs, and more so as investors face a new certainty: going forward, fixed income returns will be mediocre. This will support risk taking.**
- **The revised central bank strategy creates a new investment paradigm: lower rates volatility, stretched cross-asset valuations, more frequent corrections and lower diversification benefits. More than ever, hedging strategies matter.**
- **We start the year with an overweight on equities, and a bias towards Cyclical and Value styles. The dollar will depreciate further, if less fast. EM currencies and equities offer good value. We stay long Credit, but less so. 2021 will not be a smooth ride; views are turning consensual, and extreme positioning may develop into spring. Use Q1 to build hedges.**

The year of black swans ends on a cheerful note for financial markets

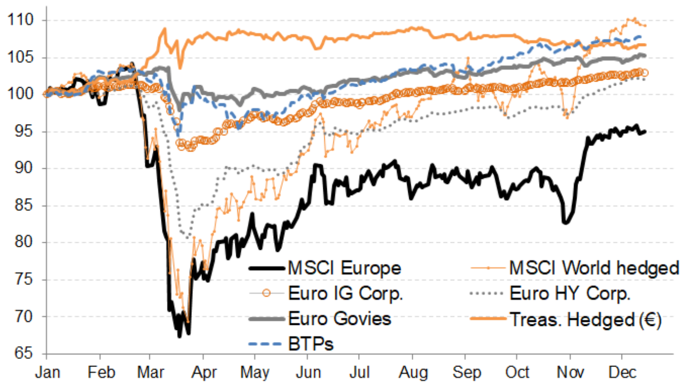
"Everyone has a plan: until they get punched in the face." Mike Tyson's warning surely applied to investment in 2020. Our 2020 Outlook 'The Beauty of Symmetry' of course did not predict the pandemic, but the title itself outlined the key role that central banks would play. Society was hit by an incredible exogeneous shock: the drawdown on developed market GDPs was between two and three times that of the Great Financial Crisis (GFC). In this context not many would have predicted in early spring that most risk assets would end the year very comfortably above water (S&P +14% as we go to press). Now is the time to repair the damage… and to despair.

A strong recovery, but permanent scars

Repair = strong recovery in 2021…

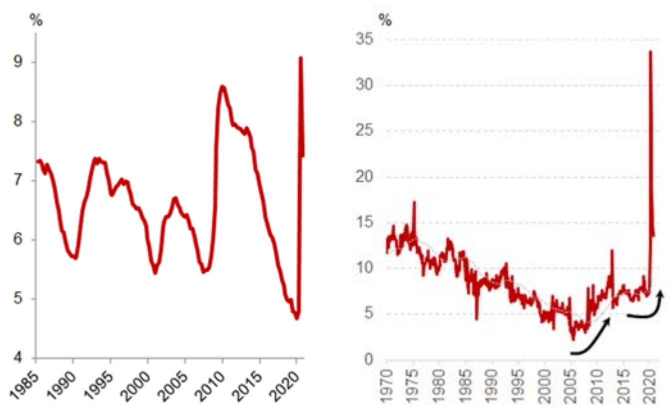
The powerful policy response, both fiscal and monetary, is clearly accelerating the recovery, notwithstanding the hiccups caused by renewed social restrictions on successive Covid-19 waves. With vaccines facilitating a normalisation of our social behaviours by spring and summer, we predict global growth at 5.2% in 2021. It is not

Graph 1: TOTAL RETURNS 2020



Up to 14 December 2020

Graph 2: REPAIR: OECD UNEMPLOYMENT RATE; US SAVING RATIO*



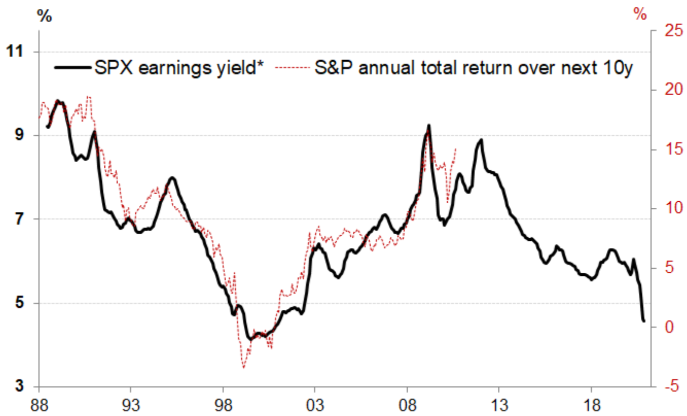
* As a % of disposable income

exactly a V-shape, as the latter would have implied that output and profits return to pre-crisis levels as early as end 2020. But we do expect that by end 2021, euro area (EA) GDP will already retrieve end-2019 levels. US GDP and corporate earnings will get there even quicker – a remarkable feast indeed. Yet there is much repair to be done. Employment of course will not recover as quickly (Graph 2a). Saving ratios have surged (1b) and are unlikely to return to pre-crisis levels as precautionary behaviours

… Despair = weaker potential growth, inequality, populism…

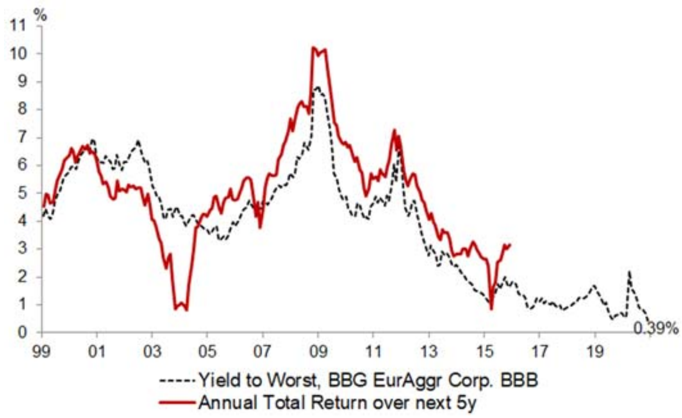
hamper consumer spending. Impaired corporate balance sheet will also be a drag on capital expenditures. There is much repair to be done on sovereign balance sheets too, though of course the post-GFC mistake of tightening fiscal policy too quickly will not be repeated. The IIF's Global Debt Monitor highlights a record build-up in gross debt, essentially on the corporate and sovereign side, in contrast to the pre-GFC (consumers and banks). The rescues were much necessary, to avoid an even harsher economic destruction, but have inevitably failed to discriminate between strong and weak companies, which risks a 'zombification' of the economy. All this will contribute to weaker potential growth going forward – which we see as low as 0.9% in the euro area, out of this crisis. Secular stagnation is a matter of despair indeed, and so is the rising income (and wealth) inequality and declining faith in democracy.

Graph 3: DESPAIR ASFUTURE EQUITY RETURNS ARE SET TO FALL…



* Based on 12m forward earnings, smoothed (6mth average)

Graph 4: … AND BBB CORP. WILL GENERATE MEAGRE FI RETURNS



… and lower financial returns

Investors too have much to despair about. The S&P has delivered an average annual total return of 15% over the past 10 years – amazing. Earnings yields are a good predictor of future returns (Graph 3) and tell us that equity returns will be much lower in the future (see "Life after Covid: 5-year total return forecasts"). Fixed Income returns will decline, too, as both carry and the potential for capital gains (falling yields) have melted like snow in the sun (Graph 4). In all, 2021 will be the year of repair but the long-term damages of the Covid-2019 crisis should not be underestimated.

The fall in uncertainty

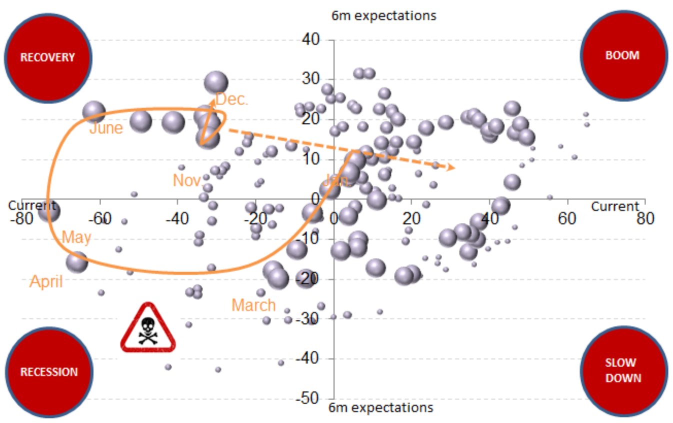
In the recovery fully priced in already? Graph 5 for instance shows investors' sentiment about the EA economy. '6-month Expectations' have improved sharply already, and may be peaking indeed. But the 'Current Situation' remains very poor, and has much room to improve. As the recovery proceeds in 2021, we expect equity returns to remain positive, but lower of course as 'Expectations' progressively flatten out (Graph 6).

A strong economic rebound, ongoing policy support and falling uncertainty support high valuations

Are risk asset valuations already pricing all the good news? We do not think so. There is no question that, with IG credit spreads back to pre-crisis levels and the 12-month forward price earnings ratio of the MSCI World close to 21, valuations are not cheap. But this must be seen in the context of 1/ a strong recovery in 2021, 2/ ongoing strong policy support and 3/ falling policy uncertainty. The latter is particularly critical as uncertainty is the main driver of risk premia.

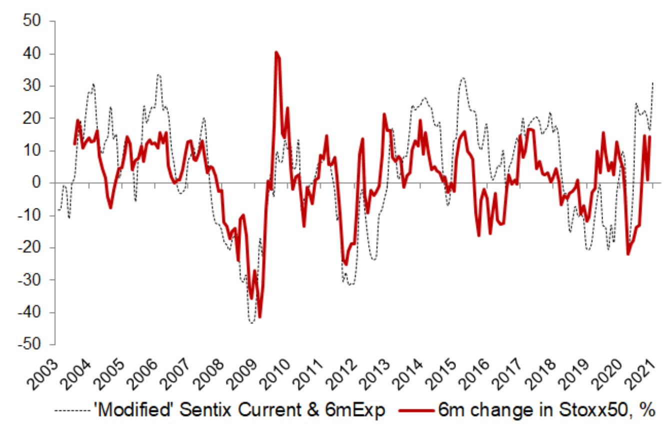
The US presidential elections reduced uncertainty as it improved the chances of smoother international relations and a return to multilateralism. Arguably the US-China cold war will continue, but the US will probably entertain more 'normal' relations with its traditional partners, including Europe. Brexit negotiations are ongoing as we go to press, but our central scenario is that the no-deal outcome will be avoided. The vaccines of course, barring any bad surprise on side effects for specific risk groups, make it far more likely that restrictions will be mostly lifted into summer 2021.

Graph 5: EUR SENTIX CURRENT SITUATION VS 6M EXPECTTIONS



Since 2007; the bigger the bubble, the more recent

Graph 6: SENTIX TO STAY HIGH AND SUPPORT POSITIVE EQUITY RETURNS

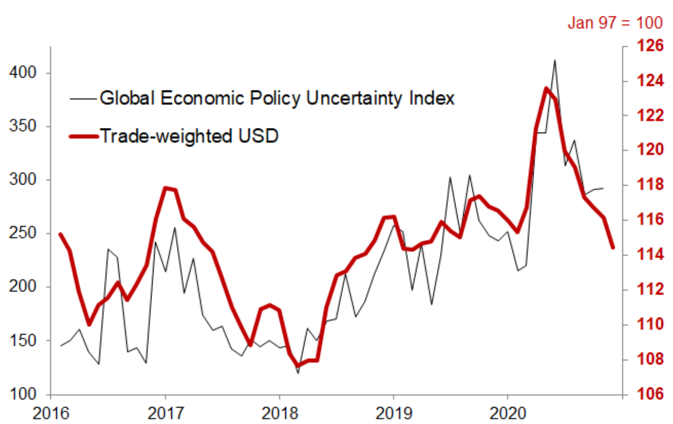


Modified (EU) Sentix = (Current + 6m Exp.) / 2 + 0.54 x (6m Exp. – Current)

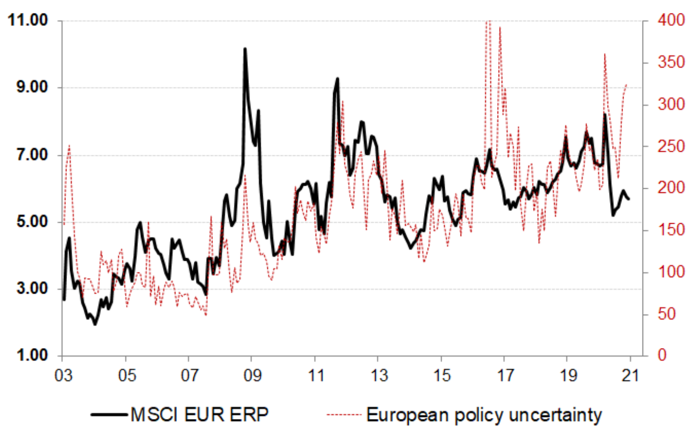
The certainty of poor Fixed Income returns is forcing investors to chase risk and liquidity premia

Graphs 7 and 8 show the link between policy uncertainty and financial variables. Policy uncertainty can be measured through news flows, and the work of Baker, Bloom and Davis in this field is useful. The US dollar typically tends to benefit from uncertainty and has been falling hard since end-April 2020 as the outlook became more predictable. The Equity Risk Premia (ERP) have also been falling as uncertainty declined. Mind that policy uncertainty still looks in Europe (Graph 8), as the renewed lockdowns, EU budget talks and Brexit tensions have clouded the outlook. We expect those uncertainties to lift into 2021, offering further support to risk sentiment at the start of the year. Not only policy uncertainty has declined, but a new certainty has developed, which we think profoundly alters the investment paradigm: **the *certainty* of poor Fixed Income returns is forcing investors to chase risk and liquidity premia.**

Graph 7: USD FALLS AS GLOBAL POLICY UNCERTAINTY* DROPS



Graph 8: EU POLICY UNCERTAINTY TO FALL, KEEPING ERP** LOW



* Baker, Bloom and Davis ** Equity Risk Premium, = 12mf Earnings yield - 10y EA av. sov. yield

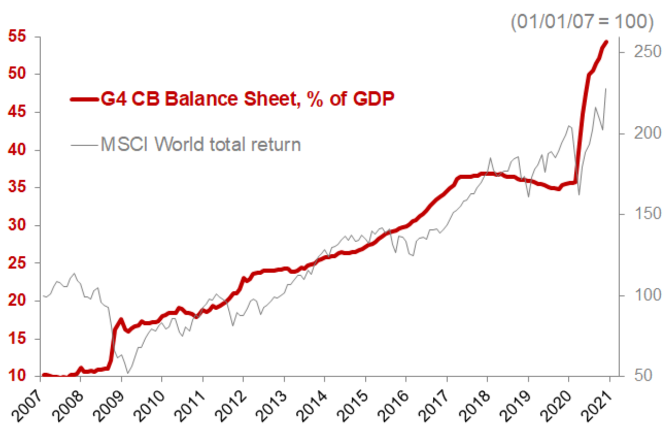
The new investment paradigm

Secular decline: 10-year real yields down from +4% to -1% over past 30 years

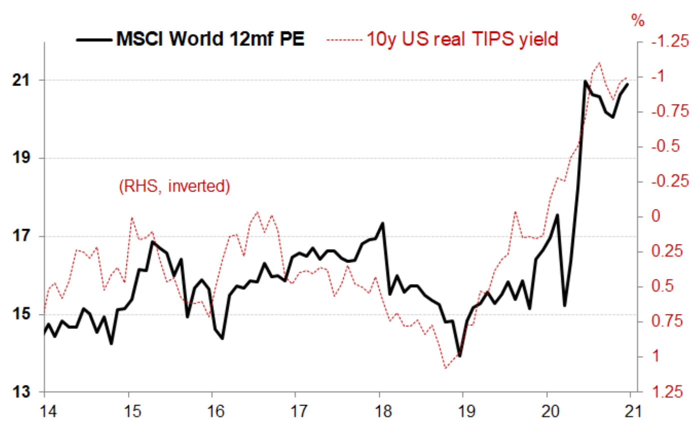
“This time is different” may be the most dangerous phrase for investors. What is different, however, is that real yields are trading deep into negative territory. US 10-year real yields are ranging around -1.0%, vs. near +4% when TIPS were created in the late nineties and around +1% in 2014-2018. The **secular decline of real yields** has been a feature of the past 30 years. It has been driven by secular stagnation, and the repeated efforts of central banks to rescue the economy following the internet bubble, the Great Financial Crisis, the euro area sovereign crisis and the Great Covid Crisis. They have not only cut rates, but injected massive amounts of liquidity in the marketplace, with 2020 dwarfing any previous experience (Graph 9). This liquidity needs to find a home; while the preference for liquidity and security tends to increase in the aftermath of a deep crisis, investors’ animal spirit quickly comes back and the hunt for juicy investments benefits riskier assets, particularly so when risk-free investments offer abject returns. Graph 10 shows that equity multiples have surged as real yields collapsed. Central banks very much intend to keep real yields depressed, as the secular stagnation theory precisely argues that savings and investments cannot balance at the full employment level without a depressed level of real rates. Of course, the high valuation metrics depress the medium-term performance outlook, yet mind that **for equities to enjoy single-digit returns in 2021, no further expansion of multiples is required**: the strong earnings recovery and ‘roll-up’ (forward earnings rise as the economy recovers) will do the job.

For equities to enjoy single digit returns in 2021, no further expansion of multiples is required

Graph 9: G4 CENTRAL BANKS BALANCE SHEET & MSCI WORLD



Graph 10: FALL IN US REAL YIELDS HAS SUPPORTED PRICE EARNING (PE) EXPANSION



New paradigm: lower rates volatility, stretched valuations, more frequent corrections and lower diversification benefit

Average Inflation Targeting (AIT) was already a feature in our 2020 outlook, where we stressed the fundamental implications of central banks making the inflation target more symmetric. Within this new framework, the last cycle would have never seen any rate hike. In the current cycle the Fed will keep rates near zero for years. We also expect the ECB to adopt a new inflation target as it concludes its strategic review this summer; already it has committed to pursuing its PEPP until at least March 2022. This new strategy from central banks creates a new investment paradigm whereby real rates are stuck at very low levels. We see four implications: 1/ Rates are low and **rates volatility is compressed**, which tends to support carry strategies. 2/ Low real rates trickle down to other asset classes, making **asset valuation generally stretched**. 3/ Stretched valuation and crowded positions, along with a more fragile market micro-structure (tiny trading books, passive investment, systematic portfolios etc.) will make **corrections more frequent**. 4/ **Portfolio diversification** is impaired, as there is little room for risk-free rates to decline and fixed income portfolio to rescue equity portfolios through recessions or risk-off events.

In this context, **the hedging strategy becomes ever more important** and needs to be placed at the core of the investment function.

It's all about bond yields… and investor positioning

Could bond yields rise and upset the whole investment paradigm? Graph 11 suggests that bonds yields have lagged other cyclical measures. They have done so for a good reason: the anchoring from central banks. We see room for a limited rise in yields next year, and more so in the US where inflation is substantially higher than in the euro area. But 10-year Treasury yields are still likely to close the year below 1.25%. Mind the upside risk in case of a blue sweep at the Georgia run-off elections, implying bolder fiscal expansion and, as a result, a less proactive Fed (duration extension less likely in that scenario). FI returns will be mediocre, and we retain an underweight (UW) in Govies; we see further steepening room, especially in 10-30y sectors. Mind that non-EUR sovereign markets offer yield pick-up, both in DM and EM, even on an FX-hedged basis; we see good diversification opportunities there, and more so for buy-and-hold insurance portfolios (US, Japan, Australia, selected EM).

Starting the year with an equity OW, smaller Credit OW, government bonds UW

We stick to our OW in Credit, but a smaller one given that there is much less juice left in this segment. IG spreads have returned to pre-crisis levels and are now likely to head towards the 2018 lows. We go down the rating scale, down to BBs, and still like Hybrids and AT1 for the carry and limited risks. High Yield defaults will rise but peak at a much lower level than post-GFC (5-6% in Europe vs. 8-9%).

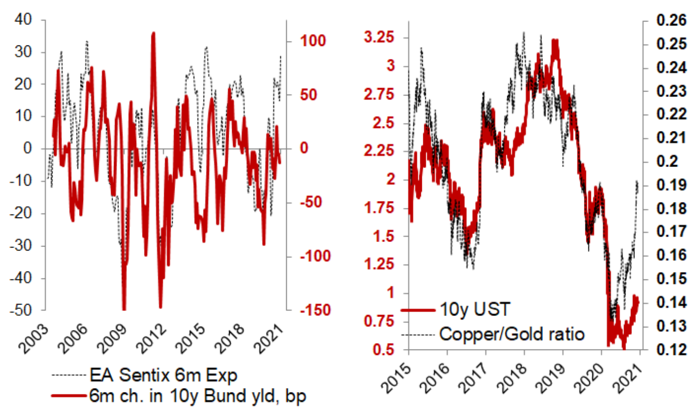
Value in EM currencies and equities

We will start the year with an OW in equities, with a bias towards cyclical and value stocks. We see much room for EM currencies and equities to catch up. The anti-cyclical USD remains bearish, but the fall will decelerate as the recovery becomes less China-centric.

Mind positioning, and scale up hedges as volatility pulls back further in Q1

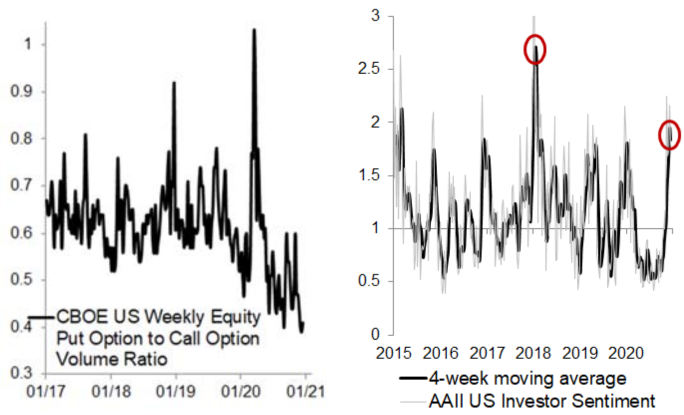
2021 will likely not be a smooth rise. The risks include disappointment on the vaccine (virus mutation, side effects), a severe Tech regulatory tightening, a hard Brexit or renewed US-China animosity. The biggest risk may be positioning. We see signs of exuberance, e.g. in the put/call ratio (12a) or record speculative positions on Copper. Yet positions are not as stretched as before the flash crash of 2018 (12b); the systematic community looks less leveraged and bullish. Still, we will keep a close eye on positioning and sentiment: tactical asset allocation matters.

Graph 11: BUND RESILIENT TO BULLISHECONOMIC SENTIMENT? UST RESILIENT TO BULLISH CYCLICAL FORCES?



Copper/Gold price ratio usually a solid cyclical indicator

Graph 12: US EQUITY CALLS FAR MORE POPULAR THAN PUTS, AAII* BULL/BEAR INDEX HIGH BUT NOT EXTREME



* AAII: American Association of Individual investors

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Macroeconomic Outlook

- **The Covid-19 pandemic is keeping a tight grip on the global economy near term. But the scene is set for a vigorous growth rebound over spring/summer 2021 thanks to strong progress on Covid-19 vaccines and amid persistent support from fiscal and monetary policy.**
- **Growth rates of 3.9% in the US and 5.5% in the euro area will help to recoup pre-crisis activity levels over H2 2021, but persistently wide output gaps will keep price pressures muted especially in the euro area.**
- **China's V-shaped recovery is set to remain on track despite reduced fiscal support. Helped also by a weaker US dollar and low real rates, most emerging markets will participate to the global rebound despite the dissemination of vaccine lagging the advanced economies.**

An *annus horribilis* for the global economy is drawing to a close with the deepest recession since WWII. Many economies remain battered and constrained by the winter resurgence of the Covid-19 pandemic. Fortunately, the prospects for 2021 are much brighter, with the scene set for a vigorous growth rebound.

The global rollout of Covid-19 vaccine is set to be a game changer, laying the ground for a strong global rebound

This is in the first place due to the fast progress on vaccine development. While this is usually a matter of years, the vaccine by BioNTech/Pfizer has received emergency approvals after less than twelve months in the UK and the US, with the euro area admision likey to follow soon. With most vulnerable people set to receive vaccinations in Q1, we expect restrictions to be lifted over spring and summer. The resulting economic rebound, in particular in countries and sectors most battered in 2020, will help the global economy to recoup pre-crisis levels of activities already this year. Existing fiscal support will be withdrawn only very gradually while some new US fiscal stimulus is still likely even under a split new administration. Key central banks will maintain their highly accommodative stances for longer as the persistently high output gap and unemployment will keep price pressures muted, in particular in the euro area.

Emerging Markets will lag in the rollout of vaccines, but will benefit from strong Chinese growth, a weak US dollar and low real rates

Emerging markets are likely to lag in the rollout of vaccines, even though some areas (notably China) have managed to keep the virus under control recently. We expect China's economy to grow by 7.8% in 2021, remaining a strong pillar of global economic growth. The PBoC will reduce monetary support only very prudently, focusing on quantitative tools, but not hiking rates before late 2021. The tailwinds from the V-shaped recovery in China, a weaker US dollar (a relieve to external debt service and to global trade) and low real rates will help EM economies to participate to the global rebound.

Apart from the virus and possible setbacks in vaccination efforts, the Brexit is a sizeable near-term risk for Europe. With an agreement hanging in the balance at the time of writing, our projections are based on the assumption of a last-minute deal. A hard end of the transition period out of the single market, by contrast, would imply a fallback to WTO rules, disrupting the close trade ties between the UK and Europe and shaving almost half a percentage point of 2021 GDP in the euro area (and even 1.5pp in the UK). This would dent, but not derail the 2021 recovery given the strong growth impulse from a vaccine-led recovery.

Vaccination to pave the way for recovery

Emerging Markets will lag in the rollout of vaccines, but will benefit from strong Chinese growth, a weak US dollar and low real rates

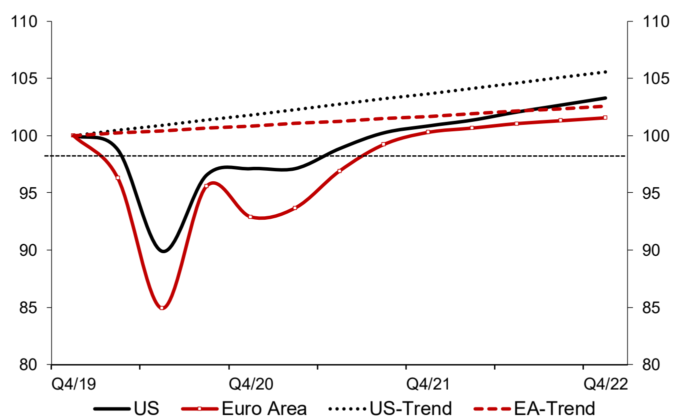
The speed of the recovery is still surrounded by high uncertainties as the the removal of lockdowns and restrictions hinges on when a critical share of populations becomes vaccinated. At the outset, production capabilities and logistical challenges will be the constraining factors. The approval of further vaccines (incl. e.g. Moderna and AstraZeneca) will be critical for lifting the speed of inoculations of most vulnerable groups. Later into the year, with more ample jabs available, the willingness of the population to become vaccinated will become binding for achieving herd immunity. Public scepticism is still worryingly high in some countries, incl. the US, France and parts of Eastern Europe, but resistance may ease if fears of severe side effects do not materialize.

Restrictions may prevail well into January, but vaccination progress will allow stringency measures to be lifted more meaningfully from spring onwards

We deem it likely that in the euro area the increased stringency measures that were adopted in response to the second Covid-19 wave will persist well into January 2021 but can gradually be eased thereafter as the pandemic situation improves and vulnerable groups and front-line health workers get vaccinated. This will allow restrictions to be significantly lifted in spring and to be fully abolished in the autumn, allowing not only for re-opening of intentionally closed sectors (e.g. travelling, accommodation, art and entertainment) but also triggering a sharp improvement in sentiment as the risk of renewed lockdowns will be largely off the table. This will boost consumption and investment activity additionally.

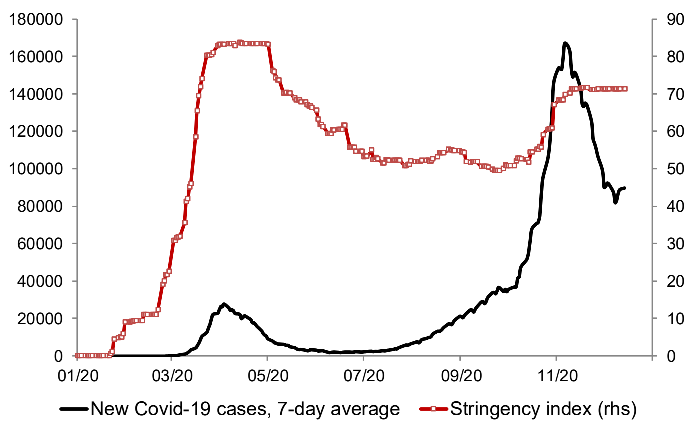
In the US, less stringent containment measures than in Europe are currently in place but vaccinations will have similarly positive effects on confidence. With the vaccination being rolled out gradually, the economy will have to endure the fallout from another wave of infections. Therefore, sluggish consumption growth will lead to stagnating output in Q1 while we expect only a limited cushion from a new fiscal package (see below). That said, we see herd immunity to be already reached by mid-year. This will allow pent-up demand to raise services consumption, with a sizeable upward impact on growth in the second half of the year. We expect GDP to rise by 3.9% in 2021.

Graph 1: A BENT 'SWOOSH' RECOVERY



real GDP, Q4 2019 = 100, GIAM Research forecasts

Graph 2: EURO AREA LOCKDOWN AND COVID-19 CASES



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

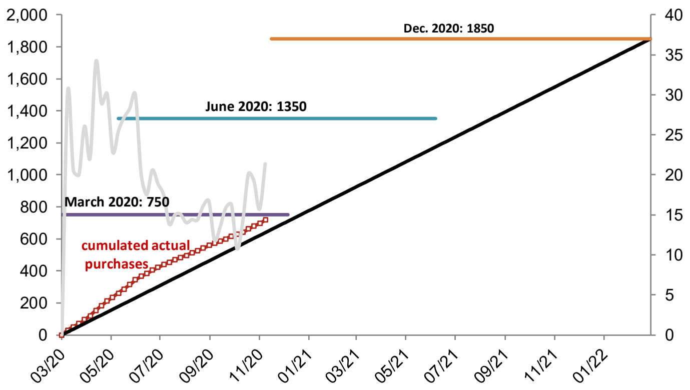
Ongoing support from fiscal and monetary policy

Euro area: Recovery Fund and ECB underpin a supportive environment

The 2021 upswing will also be supported by persisting policy support. In the euro area, the usual metrics show only a mildly reduced impulse from national fiscal measures in most countries in 2021. Crisis-fighting support measures can be scaled back without negative effects on activity as the pandemic eases. Thanks to the agreement on the next EU budget and the Recovery and Resilience Facility, the EU economies benefit from centrally provided funds for investment in growth-enhancing sectors already from next year onwards, while they need to be paid back only from 2028 onwards. This will benefit especially the Southern European economies that were hit particularly hard by the pandemic.

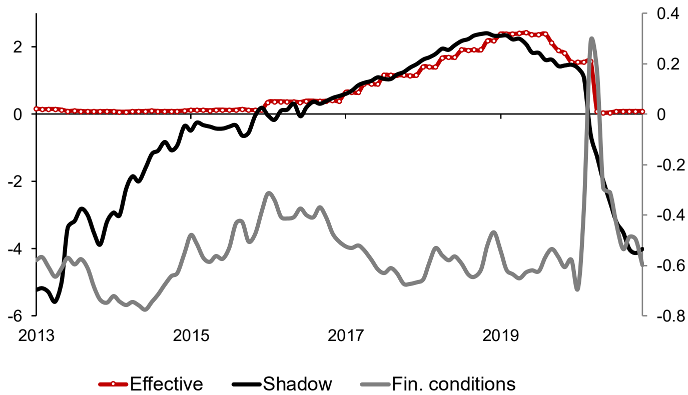
The euro area economic recovery will be accompanied by an ongoing highly supportive ECB policy stance. At its December 2020 policy meeting the Governing Council basically extended its current policy stance throughout 2021. Key measures adopted include the extension of the Pandemic Emergency Purchase Programme (PEPP) in terms of duration (to at least March 2022) and volume (by € 500 bn to € 1.85 tr), more TLTROs at better conditions and the extension of other tools (collateral rules, PELTROs) adopted in spring. Thereby, financing conditions will remain highly supportive. We expect activity to recovery strongly in the second quarter of 2021 and to remain well above normal thereafter lifting the annual growth rate to 5.5%, from -7.3% before. For 2022 we look for a continuation of the upswing, albeit at reduced momentum and see output expanding by 3.7%. That said, with the output gap remaining wide, price pressures will remain muted even amid the stronger economic rebound.

Graph 3: THE ECB'S PEPP



bn EUR, weekly data on purchases under the PEPP

Graph 4: US FEDERAL FUNDS RATE AND FINANCIAL CONDITIONS



The shadow rate includes the impact of QE, Financial conditions: Chicago Fed index

US: limited fiscal stimulus, the Fed has still scope to act on QE

In the US the likely lack of a Democratic majority in the Senate, and the preference of the new administration of speed over size will limit the scope of a new fiscal package and twist its composition away from direct transfers to household (the measure with the biggest short-term impact on growth). We expect measures worth no more than US$ 1tn to be passed into law before President elect Biden will be sworn in (Jan. 20). After that, political gridlock will likely prevent any substantial fiscal measures.

The outcome of the runoff election for two Senate seats in Georgia (Jan. 5) could change the situation, though. If the Democrats were to surprisingly win both, the 50-50 stalemate in the Senate would be resolved by a pivotal vote by vice-president Harris to the Democrat's favour, allowing them to enact strong fiscal measures. Concerning the Fed, under the newly presented average inflation targeting framework, rates will in our view not rise from the current almost zero levels before at least mid-2024. The Fed may still support growth via asset purchases. The recent decision by the Treasury to withdraw capital support to credit purchases narrows the set of tools the Fed can use. Yet it will still be able to act through Treasury and MBS purchases. Intervention can be direct, by lengthening the duration of the securities bought in order to flatten the yield curve, or indirectly, by steering market expectations through guidance on the future path of QE. But the support to growth may not be that large, as financial conditions are already favourable and the most interest rate sensitive sectors of the economy (first of all construction) are already growing at a strong pace.

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Government Bonds

- **International government bond markets were definitely under the sign of Covid-19 in 2020. Particularly an unprecedented monetary policy reaction kept financial markets afloat and will continue to impact government bond yields in 2021.**
- **Hopes for a vaccine-led growth rebound and slightly higher inflation rates are seen to trigger moderately higher yields over the course of 2021. Rising net supply amid a dovish Fed is seen to lead to a bear steepening of the US yield curve.**
- **Euro area government yields have less scope to rise as the ECB will keep sovereign bond net supply in negative territory. Still, slowly inching up inflation rates have the potential to lead euro area government yields slightly higher in 2021.**
- **Euro area non-core government bonds are expected to continue their outperformance. Above all spreads have more leeway to tighten in H1 2021 while higher-yielding non-core bonds are likely to again perform better than core bonds.**

Driven by the outbreak of Covid-19 government bond yields continued the downward trend from 2019 into 2020. Although they rebounded from the historical lows more than 40% of outstanding G10 sovereign debt is currently trading in negative territory (the respective share for the euro area is even close to 80%).

International government bond markets remain dominated by extraordinary political influence in 2021.

International government bond markets will remain strongly influenced by fiscal and monetary policies in 2021. Central banks will remain dovish and are likely to err on the side of caution in order not to derail the economic rebound (confirmed by the Fed's new framework 'Average Inflation Targeting'). As central banks will keep key rates on current low levels well beyond 2021 the short end of the curve will stay anchored for the time being. Nevertheless, fiscal policy will continue to be very expansionary in 2021 as above all in H1 2021 the Covid-19 pandemic will still leave its marks.

Once the vaccine-induced economic recovery takes hold from spring 2021 onwards it will be reflected in a rise in yields. Our base scenario assumes that there are no undesired side effects of the vaccine and that the virus does not mutate. If this is the case and the global economy does not recover higher yields are not on the cards. But, in case the recovery kicks in we expect 10-year US yields to rise to 1.20% by year-end. The increase could be much more pronounced if the Democrats win the two run-off elections in Georgia as this would imply a Democratic majority in the US Congress. This means US President Biden would be able to implement a major part of his economic policy programme and a much more expansionary fiscal policy. However, even with only a moderate fiscal package the way is paved for a bear steepening of the US curve.

Limited leeway for euro area yields to rise

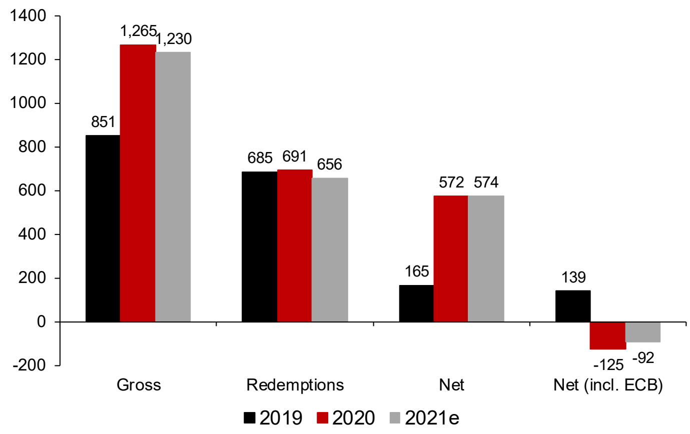
The upward movement in the euro area is likely to be more lacklustre than in the US for several reasons. The common currency area has been hit hard by the second wave and it will take longer until the pre-crisis GDP level is reached again. Particularly, inflation has fallen to an all-time low and will only inch upwards sluggishly.

Euro area real yields are forecast to remain on a very low level. Any increase in nominal yields is likely driven by higher inflation expectations.

The ECB appears to be committed to ensure ease financial conditions, support the economic rebound, and to lift inflation towards its medium-term target. It made clear that an increase in inflation is a prerequisite for a lasting change in its monetary policy. As this is still some way off, we do not see a significant yield increase over the course of 2021. For 10-year Bunds we forecast a yield level of -0.45% until the end of 2021. Hence, the transatlantic yield spread is expected to widen further at the long end of the curve (at the short end the widening is more muted as the accommodative policy of both central banks will to a large extent prevent any meaningful increase).

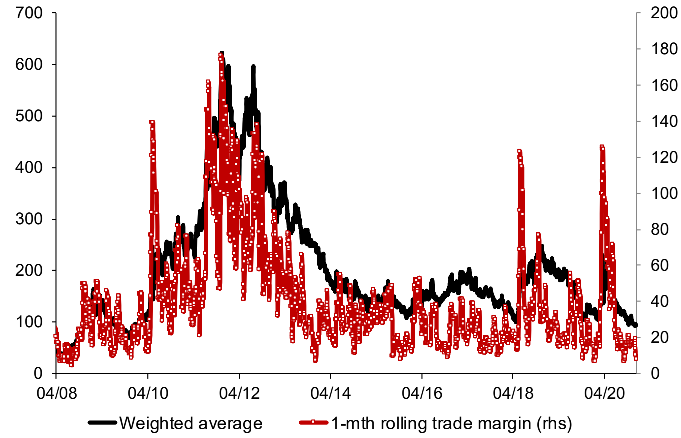
It is noteworthy that we forecast this meagre nominal yield increase to be most likely driven by higher inflation expectations. Hence, the pattern of falling/stable real yields and rising inflation expectations already visible since March is likely to continue.

Graph 1: EURO AREA SOVEREIGN BOND ISSUANCE



In bn €

Graph 2: SPREAD VOLATILITY CLOSE TO HISTORICAL BOTTOM



10-year sovereign bond spread of Italy, Spain, Portugal, Greece (in bps)

Unusual high uncertainty regarding the euro area bond issuance, but the ECB is expected to take down the bulk of new bonds.

The extremely accommodative ECB policy is reflected in the technical situation of euro area bond markets, too. As euro area budget deficits will shrink only modestly compared to 2020 funding needs will remain on a very high level in 2021. Although projections are still fraught with a high degree of uncertainty (e.g. level of funding needs, share of funding by T-bills, timing of disbursement of EU Recovery Funds), gross supply of sovereign bonds will likely shrink only marginally and net supply will remain at approximately the 2020 level also in 2021 (see graph 1). The ECB will act flexibly depending on the market environment. Effectively, the central bank will continue to control the yield level in the entire year 2021. Considering purchases of non-sovereign government bonds and taking into account T-bills we estimate that the ECB will buy around €665 bn of sovereign paper in 2021 (with a focus on Q1 amid the forecast frontloading by euro area treasurers). Hence, the ECB will absorb more than half of 2021 sovereign bond gross supply and, accordingly, net supply will remain in negative territory (in contrast to the US).

Higher yielding euro area non-core bonds remain first choice

Stable environment induces ongoing hunt for yield – Investors are recommended going for carry in euro area non-core bonds.

Supported by progress on fiscal integration the rally of euro area non-core sovereign bonds continued in 2020. Particularly, Greek and Italian bonds outperformed. As the environment remains benign this pattern is likely to continue in 2021. The implicit yield control by the ECB reduces fragmentation risks and has contributed to an extremely low volatility. Not only euro area core yields move in a tight range, but also the spread volatility of non-core bonds is close to a historical low (see graph 2). This encourages investors searching for a yield pick-up to go for carry and to invest in longer-dated bonds as well. This applies increasingly also to investors outside the euro area.

Accordingly, we see further leeway for non-core bond spreads to narrow. With speculations about a withdrawal of the ECB not on the radar screens yet non-core bonds are expected to perform particularly well in H1 2021. This is all the more true as higher debt ratios are to some extent balanced by lower funding costs, thereby pushing back debt sustainability concerns for the time being. Some (moderate) spread widening appears feasible in H2 as an improving economic environment is forecast to raise voices calling for a reduction of ECB support. However, this is not seen to reverse the outperformance of euro area non-core bonds in 2021.

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Corporate Bonds

- **The rally in corporate bonds has been impressive and IG indices are back to their pre-crisis levels, while HY spreads remain 15-20% wider. The compression has been the most pronounced in the long end of credit curves and cyclical sectors.**
- **Both IG and HY performances over 2020 in total return terms are very close, around 2.5%. We anticipate better prospects for TR performance in HY next year, but spreads will tighten in both universes.**
- **The support from the ECB will remain extremely strong both via the CSPP for EUR5bn per month and the PEPP if necessary. Christine Lagarde has made it very clear that the governing council will not tolerate any fragmentation of the credit market.**
- **In term of issuance, 2020 has been counterintuitively a record year but 2021 issuance will be down by 10 to 20%. Net issuance will be even lower taking into account the purchases by the ECB, representing a strong support for credit.**

The valuation of the credit market may look rich under many metrics, credit spreads are below long term averages. Yet wee keep a postive view on the asset class as upport from central banks, as well as the intesifying search for yield will likely contribute to further spread tightening. We exepct for end 2021 tighter spreads across the board from 10 to 15 bp in IG and 30-50bp in HY.

Indeed, credit spreads remain wider than similarl or less well rated sovereigns like Portugal and their slope is also offering more upside although credit curves have flattened very rapidely over the past two months. Moreover the postionning is not extreme in credit markets, IG funds are back to their January levels while high yields funds continue to manage less assets than pre-Covid, leaving room for further normalisation. Although if there is no exhuberance in terms of fund positionning, the postive view on credit is extremely consensual which is never a good sign.

The ECB is bigger than you

However, we do not want to fight the ECB. Its support will remain gigantic at least until March 2022. Not only the ECB will continue to buy EUR5bn corporate bonds via its CSPP program, but they will continue to fight any widening credit spreads or fragmentation across countries and sectors. With an estimated pace of EUR93bn purchases per month for the PEPP and flexibility around the monthly pace, the ECB has enough ammunition to reach this goal. When IG corporate spreads went below 100bp in OAS, the ECB interrupted the purchase of corporate bonds within its emergency program. Hence, we consider those 100bp as a threshold, and any widening above this 100bp threshold will lead the ECB to resume its purchases to prevent any further widening.

An only mild rise in European defaults expected… but for longer

The ECB has made clear it will not tolerate any rise in corporate spreads or fragmentation of the credit market

We also think the outlook for defaults will be less severe than expected at the peak of the crisis. Simple correlation with diffusion indices would suggest a peak in default around 10% in early 2021. Macroeconomic models including GDP forecasts, corporate leverage and ECB Bank Lending Survey point to defaults around 8% but the fiscal support granted to the private sector is very hard to factor into the equation. Hence, we think all the guaranteed loans, moratoria and furlough schemes will allow defaults to remain much below 2009 levels around 5-6% vs. 4% today. It is also related to the very defensive composition of HY benchmarks nowadays versus 2008, with BB representing now 70% of the BofAML index versus less than 50% in 2008, while BB defaults probability remain very low.

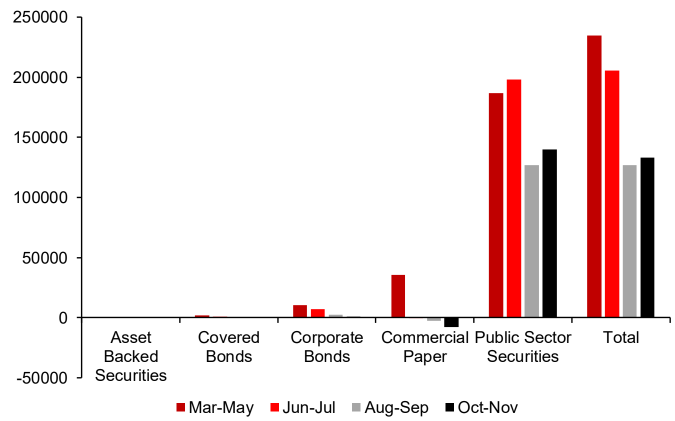
The zombification of the European economy is a possibility

However, the support to the corporate world is very expensive and can't last forever. We think that with the gradual removal of the stringency measures, governments will also start to reduce the fiscal support to corporates over the second half of 2021. Only then we will find out what share of the private sector was financed in vain and what share will return to normal profitability or even sub-normal. Likely, some defaults were only lagged by the fiscal support, resulting in a default rate likely to stay above the long-term average for longer. Recoveries may also fall below their long-term average of 40% as the leverage of the non-financial world was very high before the Covid, meaning that more debt will be repaid with the same assets. Moreover, while bond issuers may end-up well thanks to their large liquidity buffers, SMEs will be hit harder with some possible consequences on the banking sector.

The financial sector to resist deteriorating asset quality in 2021

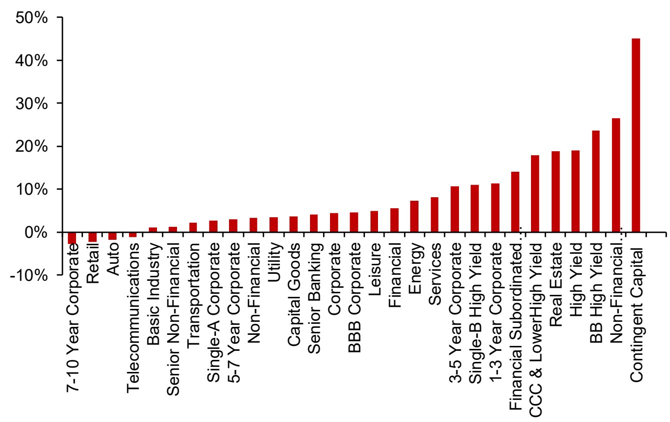
Financials entered this crisis much better capitalised than in 2008 but it did not prevent them from being very volatile in the first phase of the Covid-related sell-off. Nonetheless, the credit channel being key to the preservation of loose financial conditions, a very strong regulatory support has been offered to financials and banks throughout

Graph 1: BREAKDOWN OF CUM. NET PURCHASES UNDER THE PEPP



In € millions

Graph 2: CREDIT SPREADS VS. PRE-COVID LEVELS



OAS spread 22bd of February 2020 vs 14th of December 2020

2020. We had the revision of CRR, the postponement of the stress tests, the confirmation that the ECB would not block AT1 coupon payments. In a word, financial creditors have been cocooned while equity holders have been put to contribution. We think this trend will go-on in 2021 despite the deterioration in asset quality, hence we keep a neutral stance on financials versus non-financials.

We take moderate risk favouring AT1, hybrids and BBs.

In IG, the potential for tighter spreads remains but it will be challenged by rating migration. Almost 1/3 of BBB- rated names are on negative outlook, although the very rapid pace of the recovery should reassure rating agencies, hence we favour BBB over single As.

In HY, we think the market will outperform, led by the safest compartments namely the BBs and most solid single-Bs as the idiosyncratic risk will remain elevated until we have more certainties on the default outlook.

We continue to favour subordination risk to credit risk, across financials and non-financials

But our favourite risk enhancement alternative remains subordinated bonds, both AT1 and corporate hybrids as we think both extension and coupon risk will remain low in 2021, while they keep yielding more than similar rated senior instruments.

Within IG, we keep a cyclical bias and prefer to take risk in defensive sectors via the hybrids, while we remain more prudent in HY assessing each credit carefully.

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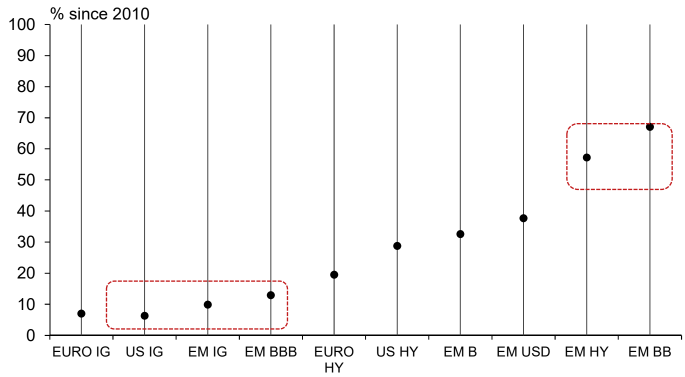
EM sovereign bonds

- **The 2021 outlook for EM sovereign bonds has turned more positive supported by a low real yield environment and better growth prospects. EMs are in a sweet spot and we expect spread to compress further to reach 285bp by year-end.**
- **The rise of long-term US rates is one of the main risks while EM IG valuations are stretched. We favour EM HY, more specifically the BB bucket.**
- **EMs are still in a default cycle and selection is of utmost importance. HY dispersion will remain high given the heterogenous fiscal risk and further downgrades. Likewise, Covid management and vaccine rollout will be differentiating factors.**

After a chaotic year, the EM environment has decisively improved over the past weeks and EM sovereign bond index will, fortunately, post positive return in 2020, with most of it coming again from the duration component. Our view for 2021 has turned more positive and given the risk related to a rise of long-term US rates, we expect the carry to provide most of the return in 2021. We will expect the EM US index to compress by 285 bps by year-end, leading to a c. 5.2% total return.

Graph 1: EM SOVEREIGN BONDS IN A SWEET SPOIT

Graph 2: EM BB IS CHEAP HISTORICALLY



Percentile, OAS

In a sweet spot!

The better environment will allow further spread compression. Spreads will not go back to their lows given the fundamental changes due to the Covid

EM sovereign bonds are currently in a sweet spot, supported by low US real yields and high PMIs like in 2013. Moreover, the double shots providing by the US elections and the vaccine are providing an anchor for EMs. Firstly, the Biden victory is the best outcome for EM as it will likely mean a less confrontational US geopolitics and a contained fiscal stimulus. For sure, a large US fiscal package would have meant a stronger global growth, but it would have been translated into much higher US rates that are detrimental for EM sovereign bonds. Secondly, the vaccine positive news flow has helped EM investors to look through the slowdown in the growth recovery and the EM debt overhang.

Within this supportive environment, growth normalisation and hunt for yields will allow further spread compression. Valuations are not stretched for EM sovereign bonds despite the rally of late. Arguably, the higher EM debt-to-GDP inherited from the Covid crisis is requiring a premium and so we do not expect EM spreads to revisit their decade lows. However, it remains that EM sovereign spreads have retraced significantly less than other credit indexes: EM USD index is now at its 38th percentile while EM HY index is even higher at its 57th percentile. Moreover, the BoFA EM USD index includes less distressed names and EM cheapness is even more striking when looking at the JP Morgan EMBIGD index.

Mind the US rate rise! EM HY in the best position

EM HY valuation is less stretched and offers more protection to a US rate rise

The expected rise of the US Treasury rate will cap the total return and will pressure duration, especially the low yielders. Thus, within the EM space, we will favour EM HY over EM IG in 2021. Even if on a global basis, EM sovereign index is not expensive, EM IG has already compressed, and it is close to its all-time lows and its duration is higher than the EM HY one. Thus, EM IG will offer a limited buffer to a rise of US rates.

If we assume a rise of the 10Y US rate to 1.20%, it will be difficult for EM IG to surpass a 3-4% return. For EM HY, we expect a 60bp spread compression which will lead the EM IG-HY spread in the middle of the cycle range. It will provide a total return close to 10%. A higher total return seems unlikely: EM HY spread will not go back to its lows in our view, given the fundamental changes which have taken place with the Covid and the risk of further rating downgrades.

The normalisation of EM HY issuance should have limited impact on spreads. We will expect EM HY issuance to gradually normalise in 2021 and it could reach 40% of total issuance, just below its post-GFC average. However, net issuance will decline substantially, and it will be at its lowest level since 2015.

Selection is the name of the game: focus on EM BB

Given the rising risk of short-term fiscal crisis for the weakest names, we focus on the BB bucket which has been lagging during the recovery rally, and we will be very selective. Dispersion at the index level could decline, essentially driven by IG names which will be uniformly impacted by the US rate rise. However, it should remain high across HY given the heterogeneous funding needs and fiscal spaces.

Dispersion to remain high given fiscal risks. EMs are still in a default cycle and so we favour EM BB

The Covid crisis has created scars across EM sovereigns with fiscal deficits expected to reach 10.7% of GDP in 2020 (+5.6pp) and debt to reach 72% in 2025. Long-term debt sustainability is not under threat globally but there is a large increase in the risk of fiscal crisis over the short and medium-term due to the large funding needs. Consequently, defaults/restructurations represented 9% of the assets in 2020 and even if it is expected to decline, it will likely remain above its long-term average. That said, the EM outlook is not so gloomy and homogenous. The IMF is not pushing for an austerian approach and is even calling for more fiscal support to ensure a resilient recovery. Moreover, EMs are in a better position to withstand the shock than in the past with better external balances.

At the BB level, we will avoid South Africa and Brazil which are facing challenging long-term debt sustainability. In the 10Y sector, Oman is relatively cheap. It suffers from a deteriorating debt profile but the required primary balance for debt sustainability is low. Paraguay and Romania remain attractive.

In the IG space, we like GCC names, especially in the 30Y sector, which could benefit from strong crossover and Asian insurer demand and higher oil prices. In the BBB sector, Peru, despite political jitters, offers strong macro fundamentals and rating is not at risk. Moreover, almost half of the index saw a rating downgrade in 2020 and it can continue as 60% of the index is under a negative outlook. In our view, Colombia is the most at risk of becoming a *fallen angel*, in a lesser extent Mexico while in Romania recent elections provided a relief.

Vaccine rollout will be a differentiating factor

Finally, Covid management will remain a differentiating factor. Vaccine rollout will be more difficult than in DM and should not happen before H2. Weakest countries with less efficient government/high level of corruption will likely underperform. Upper-income countries (Singapore, the UAE) or vaccine makers (China, Russia) will overperform. EM HY could also extensively benefit from the vaccine, especially commodity exporters thanks to the recovery.

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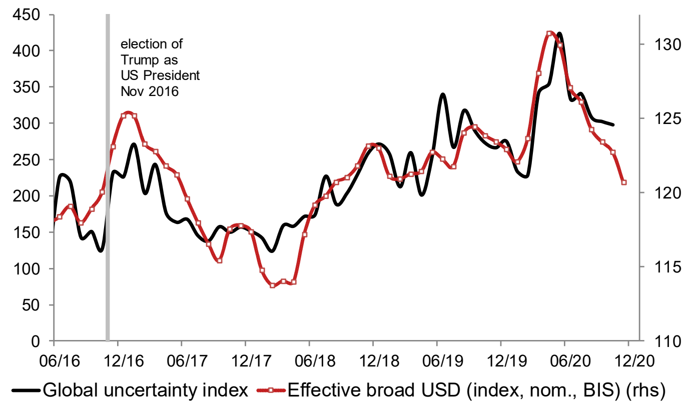
Currencies

- **Even after its recent leg lower, we expect more USD weakness amid a global reflationary rebound from the pandemic and less erratic US policies. A sizeable US twin deficit and an eroded yield advantage add to the headwinds.**
- **The EUR/USD is headed to advance further to 1.25 and beyond, helped by EMU progress and capital inflows (C/A surplus, recovering net FDI). With the ECB continuing to eschew further depo rate cuts, its tools to stop the euro's ascent seem blunt.**
- **With rates differentiation largely blurred by global monetary accommodation, balance of payment metrics will continue to play a bigger role, underpinning a rising JPY and keeping a lid on CHF weakness in the cyclical recovery.**
- **We see opportunities in cyclical currencies incl. Scandis (NOK, SEK) and EM FX (e.g. MXN).**

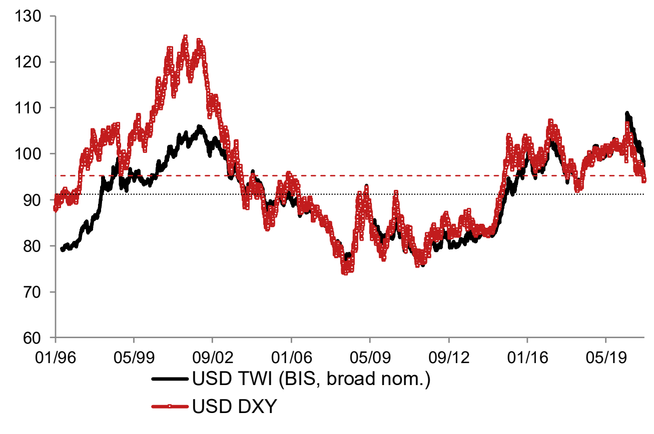
Global recovery and easing policy uncertainty to weigh on the anti-cyclical USD

The USD enjoyed strong demand amid the peak of the Covid-19 sell-off in March, but has since reversed sharply, with the trade-weighted USD down 3.2% year-to-date (Dec 13). Yet the USD still looks moderately dear and the underlying forces driving its reversal have not yet run their course. The USD is an anticyclical currency that tends to weaken amid global recoveries. The easing of global lockdowns on broader vaccination efforts will weigh further on the greenback amid the economic upswing. Similarly, Trump's trade war against China and allies alike was another USD support. While new President Biden will maintain a tough stance on China, his trade policies will be more predictable and less erosive to multinational institutions incl. the WTO. Easing policy uncertainties will thus drive the USD further down (Graph 1).

Graph 1: USD REVERSAL ON EASING POLICY UNCERTAINTY



Graph 2: USD - DOWN BUT NOT CHEAP



Eroded US yields weighing on USD

The USD needs to weaken to attract capital inflows amid an eroded yield advantage and continued reserves diversification

These forces are compounded by the US current account deficit of more than 3% of GDP and high fiscal borrowing needs. For many years, the US were able to attract capital inflows thanks to a solid yield advantage over other advanced economies. With this advantage eroded – likely for years – in particular at the short end of the curve and the USD still dear, investors will require a discount on the exchange rate – as visible more generally for the G10 space (Graph 4). Meanwhile, a less appealing yield and concerns about the weaponization of dollar dominance as a geopolitical tool will encourage global reserve managers to diversify their holdings further out of the USD.

Conversely, there is more upside to the still cheap EUR. Net foreign direct investments have turned positive, complementing capital inflows on the EMU's persistently high C/A surplus. Stubbornly low inflation will require strong policy accommodation by the ECB for years. While the monetary expansion tends to weigh on the exchange

Political progress in the euro area and continued capital inflows will underpin the euro

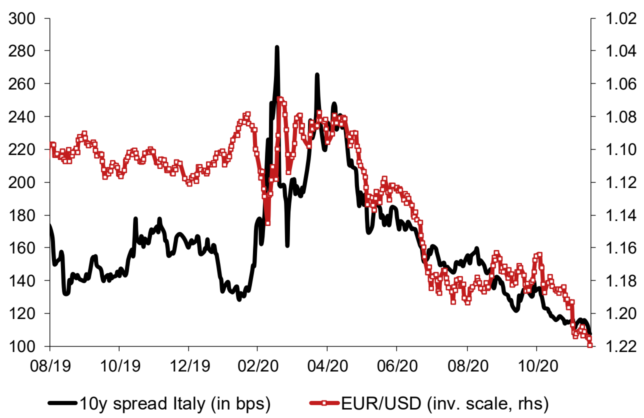
rate, the case is slightly different for the EUR. The ECB's APP and PEPP ensure the purchase of government bonds for years, while progress on fiscal risk sharing (incl. the Recovery Fund and progress towards a banking union) is helping to ease worries about Southern European debt. The ECB is keeping an eye on the stronger euro. But as long as it eschews a further deposit rate cut, its tools to lean against further euro strength are blunt. Indeed, the easing of EMU worries on the release of this year's PEPP program has supported tighter peripheral spreads and the euro's rise. Overall, we thus see further upside to the EUR/USD, which is likely to rise beyond 1.25 in 2021.

Opportunities in Scandis and EMs

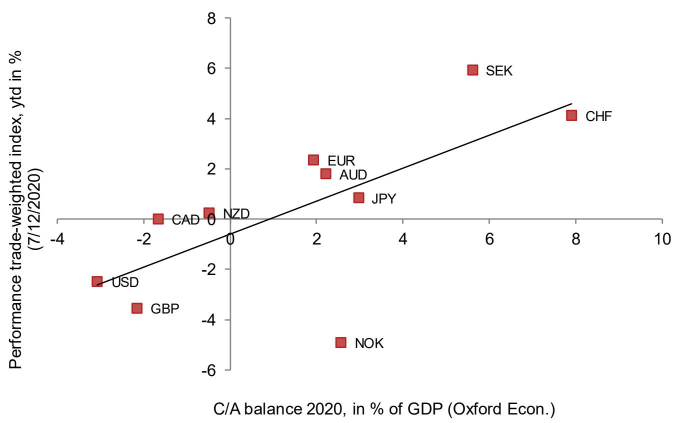
Outcome of Brexit talks pivotal for GBP, but fundamentals do not look very compelling

The fate of GBP remains closely tied to the outcome of Brexit negotiations, which hang in the balance at the time of writing after repeated deadline extensions. A thin last-minute deal would moderately boost GBP (with EUR/GBP moving towards 0.87), while an elevated C/A deficit and eroded yield advantage will keep a lid on sterling. By contrast, a chaotic no-deal departure would entail sizeable GBP downside, with EUR/GBP likely to pass 0.95. Gradually rising yields and the rollout of vaccines will dampen demand for the CHF, though the strong Swiss C/A surplus will keep CHF weakness very limited. Elsewhere in Europe, we see notable value in Scandis (SEK, NOK). Even after a rebound, they still look cheap, tend to outperform in cyclical recoveries and exhibit a high (inverse) beta to USD weakness.

Graph 3: EUR BENEFITTING FROM EASING EMU DEBT WORRIES



Graph 4: G10 EXCHANGE RATES AND CURRENT ACCOUNTS



Despite a risk-friendly outlook, we see more upside for JPY. With the US having turned into a low yielder, Japan's 3% C/A surplus and ebbing net-portfolio outflows underpin the yen. Amid low Japanese inflation, more favourable Japanese real yields will also support a lower USD/JPY, while the perspectives for EUR/JPY are flattish.

EM currencies have been lagging in this year's risk rally. In parts, this is attributable to significant rate cuts and even QE by EM central banks. Yet by historical standards, many EM FX look cheap, incl. several high-yielding currencies. Global recoveries tend to be supportive for EM FX. And the V-shape recovery of China and the likely moderate further extension of CNY strength lends additional support also to commodity exporting countries. We particularly like MXN, which is still relatively cheap, entails an attractive carry of about 5% and may benefit further from less erratic US trade policy under the new Biden administration.

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Equities

- **Equity markets extended their rally after the US elections, enjoying a collapse in volatility, good news on the vaccine and continuing policy support. The latter will stay unchanged at least in the next months.**
- **Low yields and recovering inflation expectations should back the extension of the equity overperformance vs bonds. Lower policy uncertainty and a further (though incomplete) pullback in volatility will help, too.**
- **Earnings will flow abundantly in the next two years: for the euro area (EA) we forecast profits to grow above 40% in 2021 and +14% in 2022, with risks on the upside.**
- **Our models see high multiples to linger, resulting in 5%-to-10% total returns in the next year.**
- **Under such conditions, Value and Cyclicals will continue to outperform. Overweight Japan, UK and EMs. Stay neutral on EMU vs US short term (more upside for EMU in 12 months).**

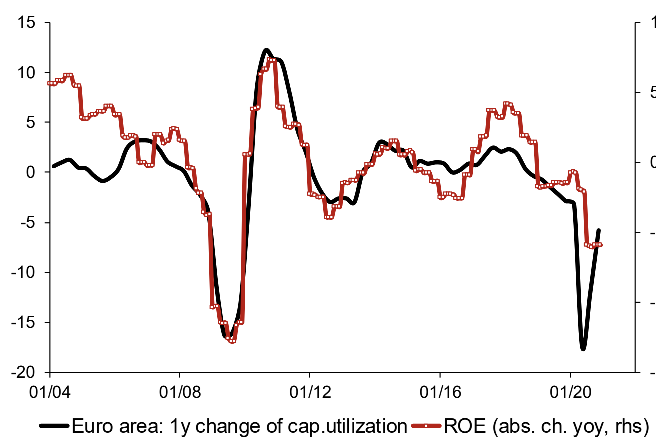
Equity overperformance vs bonds was supported by bold policy action, lower spreads and recovering inflation expectations

Equity markets rallied since March (+66% for MSCI World), benefitting from bold policy action (monetary and fiscal one) and peaking contagions. The fiscal stimulus achieved so far is in the range of 1.8 TN USD in Japan, 2.8 TN USD in the US, 2.1 TN USD in Europe and 0.9 TN USD in China (source: BoFA). Adding the monetary one we get a current total stimulus on GDP of 64% in Japan, 28% in the US, 21% in Europe and 8% in China. Overall, this is bolder and faster than what we have experienced during the GFC. The second wave Covid contagions in the summer introduced renewed volatility but after the US elections markets prolonged the rally. This was due to a collapse in volatility (VIX) from 40 to 22, good news on the vaccine and continuing policy support. EMs, cyclicals and Value started to outperform (still OW for us) and equity funds saw increasing inflows. We remain positive on equities for the next 12 months, forecasting total returns of 5-10%, much higher than for fixed income assets.

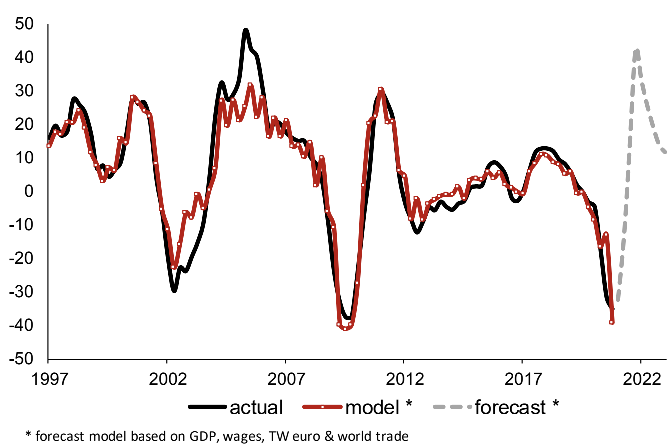
2021: lingering recovery triggers robust earnings growth

Looking ahead, earnings will flow abundantly in the next 2 years thanks to GDP growth, higher capacity utilization and ROE and policy support. Our models suggest

Graph 1: EURO AREA: CAPACITY UTILIZATION AND ROE



Graph 2: MSCI EMU EARNINGS



12-month trailing EPS, in %yoy

that for the euro area (EA) we can expect profits to grow above 40% and +14% in 2021 and 2022, respectively, with risks on the upside (US +17% and 16%). 2019 levels should be reached in mid-2022 for the EA and in 2021 for the US. EA earnings recovery will lag that of the US due to the lower Technology (12% vs 29%) and higher financials (14% vs 10%) and energy (4% vs 2%) weights. Market multiples should also remain high vs history. This is the natural consequence of lingering low real yields and credit spreads and the expectations that they will remain so. Policy uncertainty is also decreasing: US elections are behind us, EU progress towards economic support continues and a hard Brexit has lower chance to materialize. Furthermore, we expect the market volatility to continue to slightly drift lower as the economic situation slowly normalizes and financial conditions stay supportive.

Continuing low yields, policy support and strong earnings growth will back the extension of equity outperformance vs bonds

This in turn should keep at bay the equity risk premium or possibly decrease it from current levels. Under such conditions, our models (target PE, DDM, 3-stage eps growth model, Fed model) see high multiples (i.e. PE) to linger and indicate 5%-to-10% total returns in the next year. Reality check: using the very long Shiller series of risk premium for the US (in periods of low inflation) we get a better conclusion: a fair value for the S&P500 of around 3,800 for the next year (scenario 3, GI, table above). In sum, the low yield environment, recovering inflation expectations and the steepening of the US yield curve back the extension of the equity overperformance vs bonds. the Biden policy - notwithstanding the lack of a unified government - will be more “reflationary” than Trump’s one, inducing slightly higher US rates and a steeper yield curve which will not represent a negative, as we forecast good earnings growth ahead, but will promote instead a style rotation into cyclicals and value. The latter will continue outperforming Growth and defensives (shorter duration assets outperforming longer duration ones).

Table 1: S&P 500: SCENARIO ANALYSIS

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)	0.83	1.20	-0.37	163.5	4.27
Scenario 2 (consensus 12m fwd in 1 yr)	1.20	1.90	-0.70	192.6	5.03
Scenario 3 (GI 12m fwd in 1 year)	1.15	1.80	-0.65	185.0	4.83
Scenario 4 (downside macro scenario)	0.50	1.00	-0.50	115.0	3.00
Scenario 5 (upside macro scenario)	1.75	1.50	-0.15	211.8	5.53

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	24.5	28.8	27.7	17.2	31.7
Avg S&P500 valuation	3,381	3,981	3,825	2,379	4,379
	-7.1%	9.4%	5.1%	-34.6%	20.3%

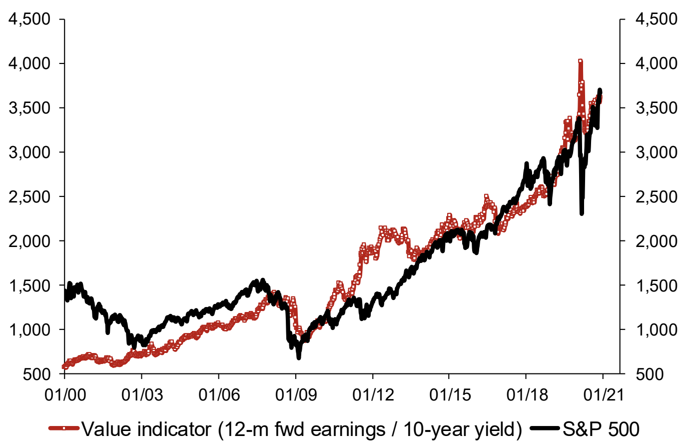
Note: **Base risk** scenario: using 20% of risk premium's stand. deviation (SD).

using 40% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	22.0	25.9	24.9	15.5	28.5
Avg S&P500 valuation	3,035	3,574	3,433	2,135	3,930
	-16.6%	-1.8%	-5.6%	-41.3%	8.0%

Note: **High risk** scenario: using 40% of risk premium's stand. deviation (SD).

Valuations are coherent to the risk over the last century

Graph 3: S&P: VALUE INDICATOR



Stay OW EMs, Japan, UK, Value and cyclicals. Aligned US vs EMU

We see TRs of 5%-10% in 12 months: keep cyclical and value bias

We maintain our preference for Value and Cyclicals sectors and countries. Looking to the Value sectors, we see relatively strong earnings momentum vs the market. This is the case for financials, energy and materials, in particular; less so for industrials. Our quant models still see a huge undervaluation for Value but not so much for cyclicals, such as capital goods or commercial & professional services. For this reason, we bring a small modification to our European portfolio, lowering capital goods (KG) from OW to N and putting only half of the money we get from KG into banks. The latter looks particularly vigorous in terms of relative earnings momentum, so we decided to go beyond the neutral position, trying not to raise further our risk exposure after the rally. OW: Financials, food retail, semis, materials and software. UW: media, TCM, transportation, and HPP.

As for countries, our OWs are UK (lower hard Brexit risks and deep relative undervaluation), Japan and EM. EMU could outperform the US in 12 months. But, for the

Relative earnings momentum for Value and cyclicals vs Market has recently been improving

shorter term, both our quant models and country score tool do not clearly favour EMU over the US. Among risks, we see the increasing pressure on US Tech (albeit their resilience due to superior earnings growth is still significant), US-China frictions and higher equity positioning to induce temporary setbacks. positioning as well tactical indicators we follow (BoFA and MS) signal market sentiment is getting more bullish even if not stretched yet. But equity demand should in-crease thanks to SWFs and Risk Parity Funds. A declining VIX (thanks to bold monetary policy) will help on this side. As buybacks and LBO normalize, the net equity supply should decline, adding to the positive market technicals. Such de-mand/supply improvement vs 2020 could reach nearly 1TN USD in 2021 (nearly the same as in 2019 vs 2018 which contributed to a big rally at that time).

EM equities to outperform their developed peers

YTD, MSCI EM index increased by 15.3%, benefitting particularly from lower yields (125 bps) and a weaker dollar (-3%). EM equities are showing a fast earnings recovery, supported by the ongoing rebound in growth following the global Covid outbreak. Despite this relative earnings strength, EM equities have only slightly outperformed

Graph: CYCLICAL VS DEFENSIVE

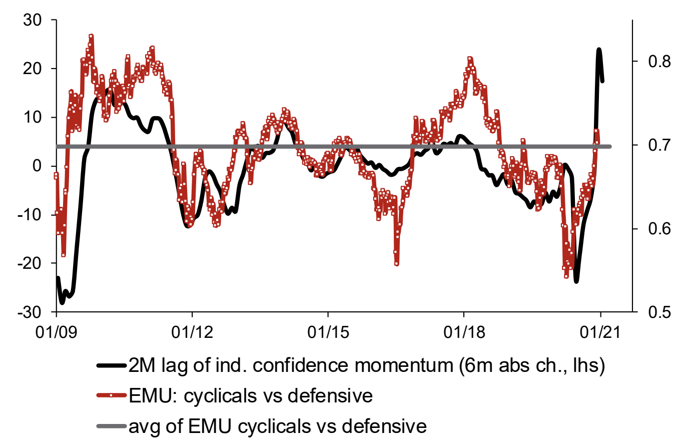
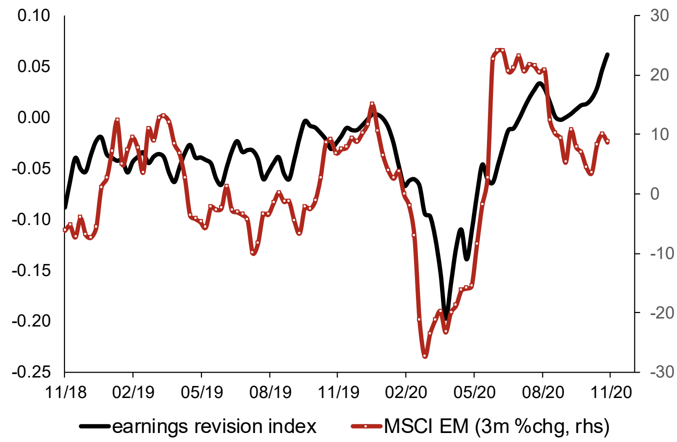


Table 2: MSCI EM: PRICE MOMENTUM (3M) VS EARNINGS REVISIONS



Global growth and more favourable global financial conditions are supportive for EMs

the MSCI World so far this year (by 1.9pp). In terms of multiples, EMs are trading at a discount of 26% vs historical average relative to the US and look also attractive using Shiller PE (almost one standard deviation below average) and our internal country scoring (based on different valuations metrics and future earnings growth). Improved macro surprises, the perspective of a sustained global recovery next year and more favourable global financial conditions are supportive, too. Midterm, we have a moderately bearish view on US dollar, which would be mildly additionally positive for EMs together with higher commodity prices. Furthermore, EMs tend to outperform while the US yield curve is steepening. That has already happened, but we think the curve will continue to steepen next year. Our expectation of a steepening US yield curve is based on the cited continuing recovery, slow increase in inflation rates, public spending and higher bond supply needs, which in the end should benefit the EM market in the mid-term. We forecast for EMs a 12-month total return of 10% (in euro terms). Within the EM universe we favour India, Korea, Thailand and Poland. While undervalued Indian stocks should benefit from recovery in 2021 (vaccine news), the other three countries have better Covid contagion trends, supporting M1 momentum, and high internal score ratings.

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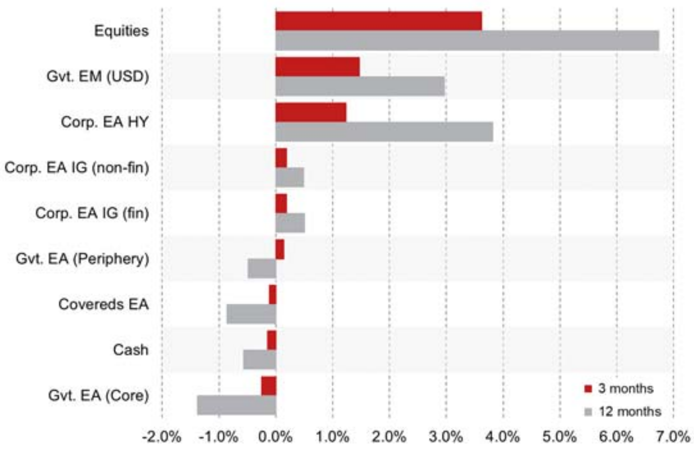
Asset Allocation

- **With the Covid-19 pandemic, an unforeseen factor has dominated (economic) life and thus also developments on the financial markets in 2020. Nevertheless, risky asset classes were the clear winners since the end of March, thus matching quite well our overall expectations.**
- **For 2021 a lot of the previous year's factors and conditions will remain in place. Covid-19 will keep us on our toes, but this time we look on balance for positive news on the back of vaccines. Monetary policy support will continue to keep yield developments rangebound and foster economic activity in combination with various fiscal packages.**
- **Despite some caveats around resurgent Covid-19 cases, a post-Brexit deal still hanging in the balance, and last question marks about the ultimate balance of power in the US, we deem the economic setting still favourable for risk assets.**
- **Given these conditions, equities and credit (particularly HY) are expected to remain the main providers of a positive return potential over the next three to twelve months. Furthermore, we see some value in EMs additionally supported by the expected USD weakness. Thus, we recommend starting into 2021 with a distinct overweight in equities, EMs, and corporate bonds avoiding low-carry markets as far as possible.**

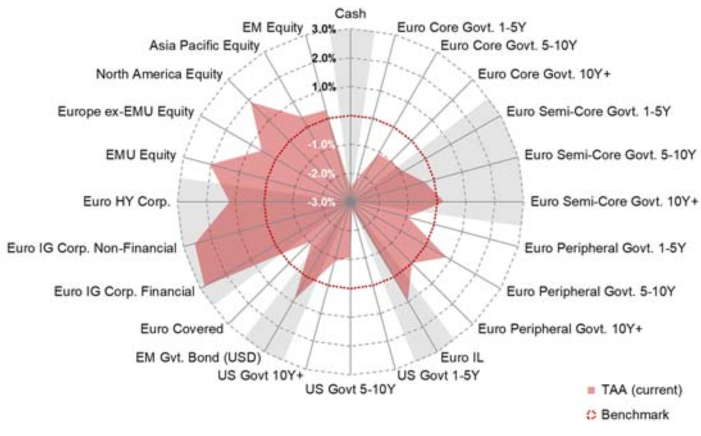
No doubt, the Covid-19 pandemic will continue to grip the markets tightly. That said, an effective distribution of vaccines will pave the way for a comprehensive revival of the global economy. Pre-crisis levels of activity are expected to be reached again by Q3 in the US and Q4 in the euro area. Furthermore, markets can rely on massive ongoing fiscal and monetary policy support. The latter will keep yield developments rangebound for the time being. EMs might be lagging the positive trends on the Covid-19 front, but they should particularly benefit from a weaker USD and low US rates through a big relief to their debt and exports alike.

Graph 1: AGGREGATED TOTAL RETURN FORECASTS



Hedged into EUR

Graph 2: BALANCED MtM MODEL PORTFOLIO (ACTIVE POSITIONS)



In pp; Semi-Core = Spain; Periphery = Italy

Prefer risk-assets to low-carry fixed income markets

All in, we see good arguments for a risk-asset-friendly environment to prevail in 2021. In fact, both on a three-months and a twelve-months view we only see distinct performance potential in equities (incl. EMs), USD-denominated EM govies, and in HY credit. All traditional liquid fixed income markets are expected to lose value throughout the year. Thus, they should be underweighted as far as possible, from a carry perspective as well as from a total return perspective. Against the backdrop of a further weakening USD we highly recommend investing on a hedged basis only.

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Forecasts

GROWTH

	2019	2020		2021		2022
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	2.3	- 3.6	*0.1*	3.9	*0.1*	3.1
Euro area	1.2	- 7.3	*- 0.0*	5.5	*0.8*	3.7
Germany	0.6	- 5.6	*- 0.1*	5.0	*1.2*	3.2
France	1.3	- 8.7	*0.8*	8.0	*2.1*	3.5
Italy	0.2	- 9.0	*0.1*	5.0	*0.2*	3.4
Non-EMU	1.5	- 8.8	*0.0*	4.5	*0.3*	2.8
UK	1.4	-11.0	*0.0*	5.0	*0.3*	3.0
Switzerland	1.1	- 4.3	*0.0*	3.6	*0.2*	2.1
Japan	0.8	- 5.4	*0.1*	2.2	*- 0.3*	1.4
Asia ex Japan	5.2	- 1.3	*0.3*	7.3	*- 0.2*	5.2
China	6.1	2.0	*- 0.0*	7.8	*- 0.1*	5.5
CEE	2.0	- 3.7	*0.1*	4.0	*0.3*	2.9
Latin America	- 1.1	- 8.7	*- 0.0*	3.2	*- 0.1*	3.0
World	**2.7**	**- 4.2**	***0.1***	**5.2**	***0.1***	**3.8**

INFLATION

	2019	2020		2021		2022
		forecast	Δ vs. cons.	forecast	Δ vs. cons.	forecast
US	1.8	1.2	*- 0.0*	1.7	*- 0.3*	1.9
Euro area	1.2	0.3	*0.0*	1.0	*0.1*	1.2
Germany	1.4	0.5	*0.0*	1.5	*0.0*	1.3
France	1.3	0.5	*0.0*	0.8	*0.0*	1.0
Italy	0.8	- 0.2	*- 0.1*	0.6	*0.2*	0.6
Non-EMU	1.5	0.6	*- 0.5*	1.4	*- 0.5*	1.6
UK	1.8	0.8	*- 0.8*	1.7	*- 0.7*	1.9
Switzerland	0.4	- 0.5	*0.2*	0.2	*0.0*	0.3
Japan	0.5	0.0	*0.0*	- 0.3	*- 0.3*	0.2
Asia ex Japan	2.8	2.9	*0.0*	2.2	*- 0.1*	2.5
China	2.9	2.6	*- 0.1*	1.5	*- 0.4*	2.1
CEE	6.9	5.5	*- 0.3*	5.3	*- 0.0*	5.0
Latin America	3.6	3.1	*0.4*	3.1	*0.3*	3.0
World	**2.5**	**2.1**	***- 0.0***	**2.1**	***- 0.1***	**2.3**

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

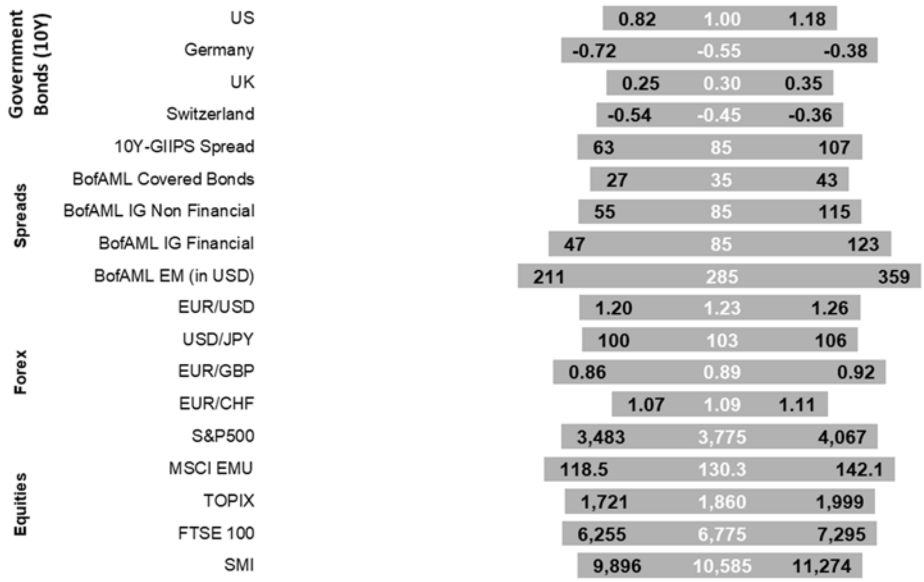
FINANCIAL MARKETS

3-month LIBOR	**Current**	**3M**	**6M**	**12M**
USD	0.22	0.20	0.20	0.20
EUR	-0.57	-0.60	-0.55	-0.55
JPY	-0.10	-0.10	-0.10	-0.10
GBP	0.04	0.05	0.05	0.05
CHF	-0.79	-0.80	-0.75	-0.75
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	0.90	1.00	1.05	1.20
Euro-Area	-0.62	-0.55	-0.50	-0.45
France	-0.37	-0.35	-0.30	-0.25
Italy	0.52	0.50	0.55	0.65
Japan	0.01	0.05	0.05	0.10
UK	0.20	0.30	0.30	0.40
Switzerland	-0.51	-0.45	-0.45	-0.40
Spreads	**Current**	**3M**	**6M**	**12M**
GIIPS	88	85	85	90
BofAML Covered Bonds	36	35	35	35
BofAML EM Gvt. Bonds (in USD)	297	285	280	275

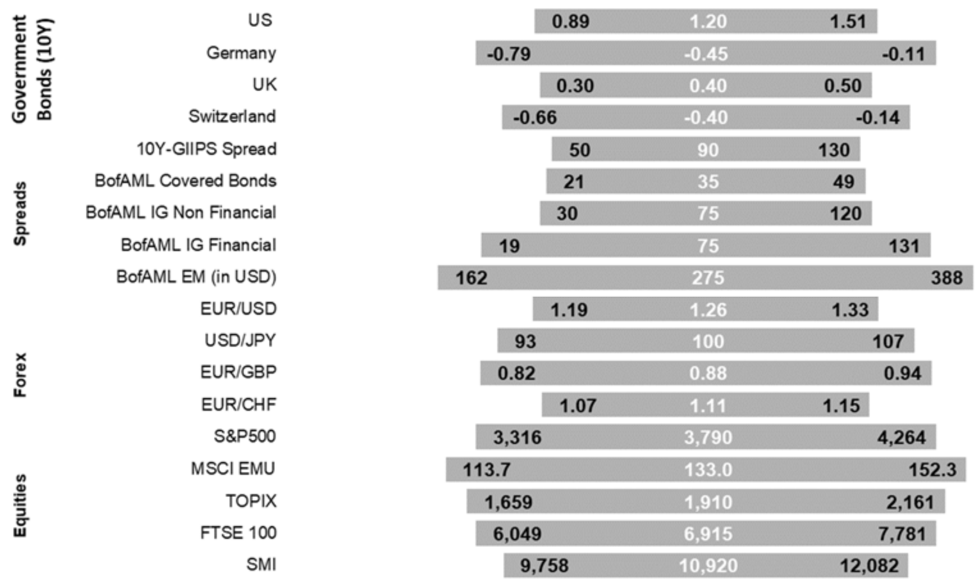
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
BofAML Non-Financial	93	85	80	75
BofAML Financial	94	85	80	75
Forex	**Current**	**3M**	**6M**	**12M**
EUR/USD	1.21	1.23	1.25	1.26
USD/JPY	104	103	102	100
EUR/JPY	126	127	128	126
GBP/USD	1.33	1.38	1.42	1.43
EUR/GBP	0.91	0.89	0.88	0.88
EUR/CHF	1.08	1.09	1.10	1.11
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	3,660	3,775	3,780	3,790
MSCI EMU	126.2	130.3	130.3	133.0
TOPIX	1,783	1,860	1,870	1,910
FTSE	6,559	6,775	6,795	6,915
SMI	10,387	10,585	10,620	10,920

As of 14.12.20 (3-day-average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

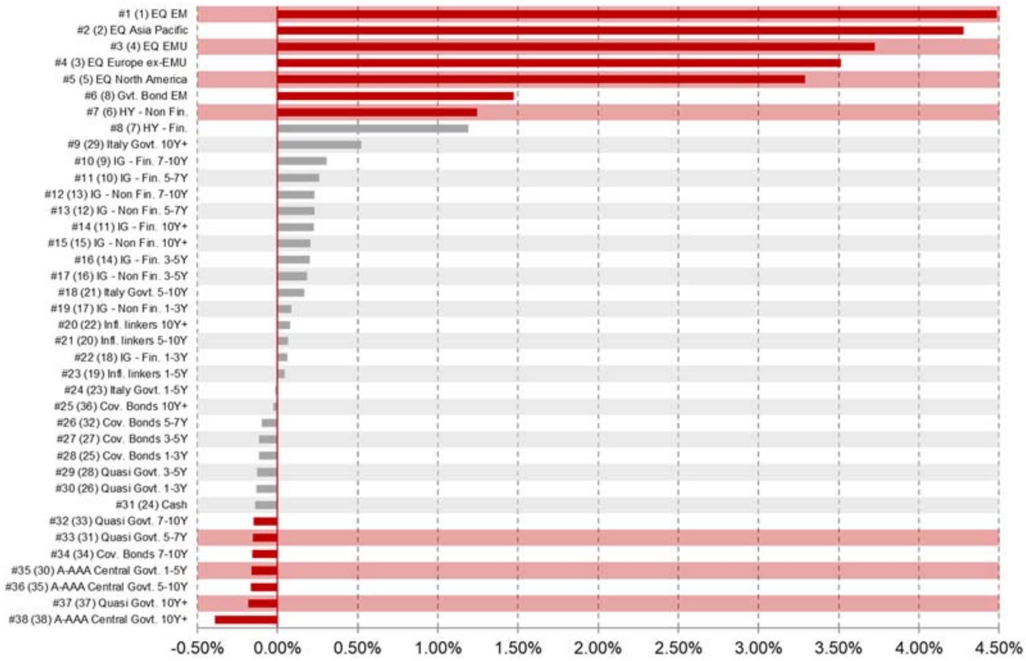


FORECAST-INTERVAL* – 12-MONTHS HORIZON



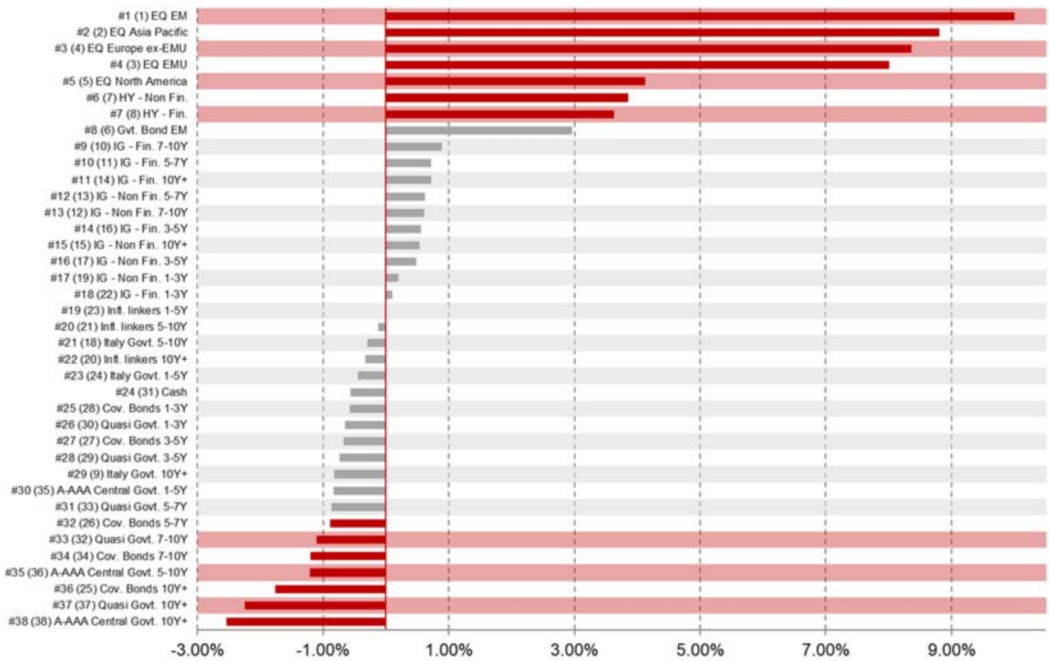
*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

TOTAL RETURN FORECASTS* – 3-MONTHS HORIZON



*hedged into EUR; 12-months rank in brackets; Cut-off: 04.12.2020

TOTAL RETURN FORECASTS* – 12-MONTHS HORIZON



*hedged into EUR; 3-months rank in brackets; Cut-off: 04.12.2020

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