GENERALI ASSET MANAGEMENT

Core Matters

Systematic Bond Investing with Term Premium

Florian Späte, Guillaume Tresca, Paolo Zanghieri

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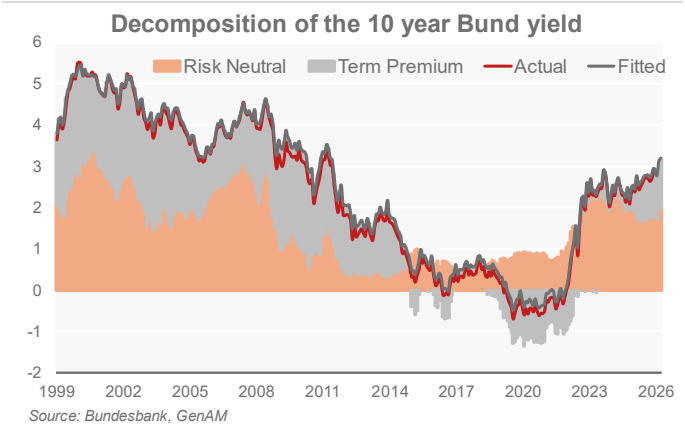
Our Core Matters series provides thematic research on macro, investment, and insurance topics

- We extended a popular methodology to compute the term premium to German Bunds, the main DM securities and the largest EMs. We also derive a proxy based on observable market rates.
- The estimates track well the evolution of the fiscal stance and the impact of central bank's balance sheet policies over the last 15 years. Their recent uniform increase is consistent with heightened concerns over public finances.
- Formally, we use the estimate to build a model linking the term premium to expected inflation and the net supply of safe assets. Our projections shows that the term premium of the 10yr Bund may rise from around 80 bps currently to just over 100 bps, back to the pre-debt crisis level.



Source: Bundesbank, GenAM

- Macro fundamentals continue to argue for rising term premium as persistent fiscal deficits and heavier issuance lift net bond supply, while QT and fading EM reserve accumulation reduce official, non-price-sensitive demand, increasing the free float and shifting more duration risk to private investors amid elevated volatility and inflation uncertainty.
- Subsequently, we outline various investment strategies. The framework derives monthly signals from term premium and yield curve steepness relative to 2-year averages. Deviations (±0.25σ) guide allocation between 10y bonds and money markets, shifting from neutral 50/50 to 80/20, with beta hedging to isolate curve dynamics and monthly rebalancing.
- Empirically, term premium signals show mixed and volatile performance, while the curve slope strategy proves more robust across markets. Both currently indicate an overweight in long-dated bonds, but given the uneven track record, signals should be used cautiously and as part of a broader allocation framework.
- In EMs, term premia did not undergo a long-term decline between 2010-2022 but were volatile across countries. Since then, premia have gradually increased. Strategies based on term premia provide excess return versus the benchmark, though this depends on the investment horizon. Excess returns increase with the investment horizon. The term premium in emerging markets is not a good short-term investment indicator, but rather a structural, long-term one.

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We build a model-based estimate for medium term projections, and a market proxy based on actual yields

Term premium as compensation for risk. The term premium is the compensation investors require for the uncertainty and risks of holding long-term bonds instead of rolling over short-term instruments. It varies with economic fundamentals, inflation expectations, monetary policy, technicals (bond supply and demand) and market sentiment. Risk aversion typically raises the term premium, while strong economic growth may lower it. Technicals include liquidity and institutional demand from central banks or other less price-sensitive investors like pension funds.

Term premia are not directly observable. The term premium is estimated using statistical models. We employ one of the most widely used techniques: the model developed at the NY Fed by Adrian, Crump, and Moench (ACM). The ACM model decomposes bond yields into two parts: expectations of future short-term interest rates and the term premium. It uses a no-arbitrage affine term structure framework, relying on principal component analysis to extract underlying yield curve factors. The model estimates risk-neutral yields – those prevailing if investors were indifferent to risk – and defines the term premium as the difference between actual and risk-neutral yields. The NY Fed provides estimates for US Treasuries since 1961: we extend the methodology to Bunds and other EGBs, UK Gilts, JGB and 13 emerging markets. We then use our estimates in two ways: first, we turn the model-based term premium estimate into a tradable proxy via a combination of the 2-10-year spread and the 2-year rate (we detail the methodology in Section 2) for relative value strategies. Second, we link term premium estimates to macroeconomic and financial variables, to build a model for medium-term projection and scenario analysis. Based on this, we then outline various investment strategies for DMs and EMs.

1. The Modelling approach

Creating a detailed yield curve. The first step is to create a detailed yield curve, from which the factors needed for the yield decomposition are extracted. The standard approach is the Nelson Siegel Svenson model, which expresses a zero-coupon yield at time t as a function of four factors and their maturity (m)

$$y_t^m = Level_t + Slope_t\left[\frac{1-e^{\frac{-m}{\tau_1}}}{\frac{m}{\tau_1}}\right] + Curvature_t\left[\frac{1-e^{\frac{-m}{\tau_1}}}{\frac{m}{\tau_1}} - e^{\frac{-m}{\tau_1}}\right] + AddCurv\left[\frac{1-e^{\frac{-m}{\tau_2}}}{\frac{m}{\tau_2}} - e^{\frac{-m}{\tau_2}}\right]$$

- The Level factor reflects the long-term yield component, setting the overall curve height and average expected interest rates.
- The slope factor measures short-term deviation, indicating curve steepness at short maturities; a higher slope often signals rising rates.
- The Curvature factor fits mid-term maturities, capturing the typical "hump-shaped" curve behaviour.
- Finally, the additional curvature factor adds flexibility for a second hump or dip, modelling complex shapes at longer maturities.

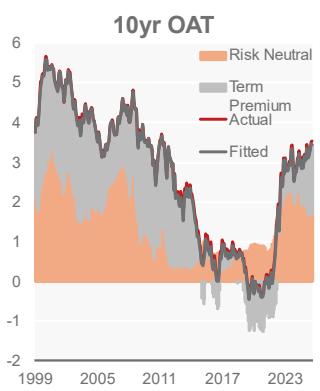
The Bund term premium collapsed with ECB QE, and is now increasing on fiscal concerns

Application to Bunds and other DM securities. The Federal Reserve and Bundesbank publish daily series level, slope and curvatures factors based on outstanding securities. For the other countries, we estimate them each period using a cross section of yields[1]. After constructing the full yield curve (3-month to 10-year), we apply the ACM procedure, which fits yields to observed market data, smoothing noise and irregularities for a consistent yield curve. From this, we extract the risk-neutral component – representing the average policy rate – and derive the term premium as the difference from the fitted yield. The chart on the front page shows the evolution of the 10-year Bund yield since 1999, alongside the fitted yield and its two components.

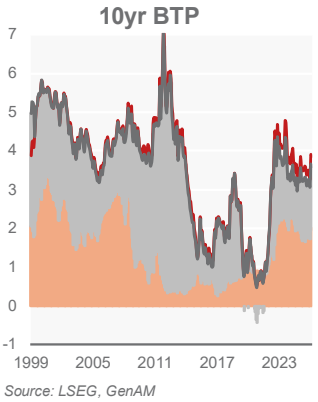
Euro. Before 2008, the term premium was generally positive, reflecting normal compensation, while the risk-neutral component tracked ECB policy expectations. It spiked during the global financial and euro area debt crisis amid uncertainty and risk aversion. Risk-neutral rates fell as the ECB cut policy rates and adopted dovish forward guidance. Afterwards, the term premium declined steadily, turning negative from 2018 to 2022 due to unconventional ECB policies and strong demand for safe assets. Risk-neutral rates stayed exceptionally low (0-50 bps from 2012-2021) as markets priced in "lower for longer". Both rebounded sharply in 2022 and again since March 2024, driven by inflation, supply shocks from the Ukraine war and ECB tightening. Risk-neutral rates rose as the ECB hiked, but the surge in the term premium became the main driver of long-term Bund yields, especially after Germany announced a large debt-financed spending plan in spring 2025.

The ACM method can be applied to the yield curves for the other euro area countries (France, Italy, Spain and Belgium). However, this would create country-specific ECB rate paths influenced by idiosyncratic factors like credit risk embedded in the principal components. For consistency, we compute the term premium for these countries as the difference between the fitted yield and the German risk-neutral component, assumed free of credit risk.

[1] To double check, we apply this methodology also to the US and German curve, finding very similar values.



Source: LSEG, GenAM



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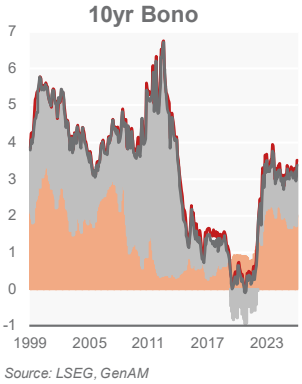

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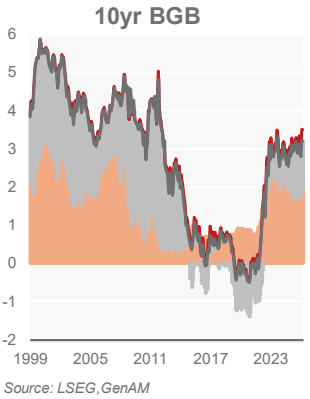
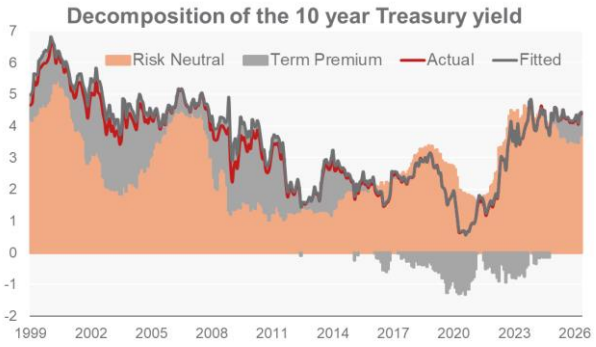


Source: LSEG,GenAM

US. Series on the term premium are published on a weekly basis by the NY Fed. After being compressed by QE, term premium has climbed again rapidly, also fuelled by the failure of the US government to rein in the post pandemic fiscal expansion. The term premium now sits at around 77bp, indicating that 10-year yields are mostly driven by the expectations of an historically tight monetary policy in the medium term.



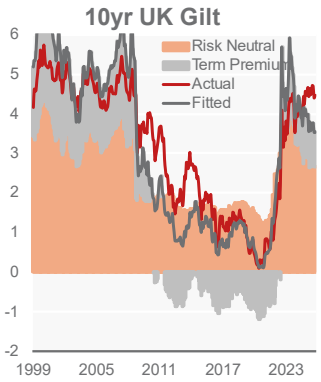
Source: NY Fed, GenAM

> The state of public finances is also a key driver of term premium rise in the US, Japan and UK

UK. Before 2009, the term premium on Gilts was stable, reflecting moderate risk compensation and steady conditions. It then fell sharply due to BoE Quantitative Easing. In 2022, the term premium surged, especially in September 2022, driven by fiscal policy concerns and turmoil following the UK 'mini-budget' of PM Liz Truss. This rise was amplified by worries over public finances, downgraded growth, and higher inflation expectations, offsetting the drop in the risk neutral component. Since August 2024, the premium has continued to climb, accelerating in October 2024. At around 100 bps, it is now back at the pre-Lehman (2008) levels.

Japan. Over the past 25 years the term premium has been the main driver of long-term JGB yields. The Bank of Japan's yield curve control and ultra-loose policy kept short-term rates near zero and capped long-term yields, anchoring expectations for future policy rates at 0%. With policy rates fixed, the term premium reflects all risk compensation and is responsible for all the recent increase in yields.

Currently, dispersion across term premia in developed economies is very low, reflecting concerns over public debt pushing up long-term yields.



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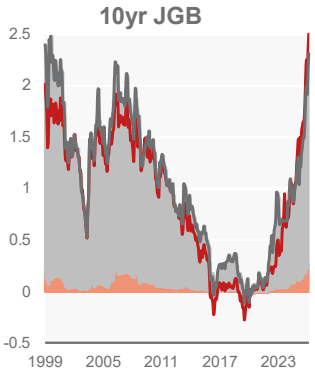

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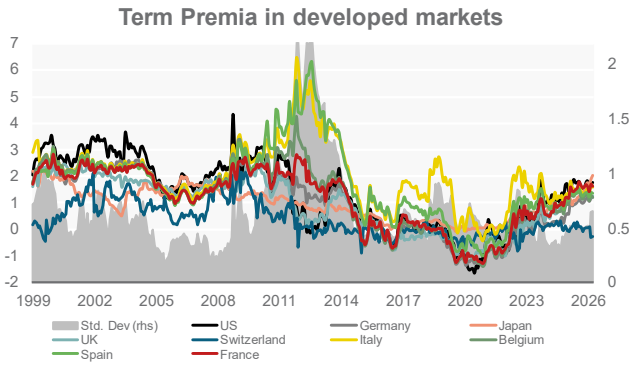
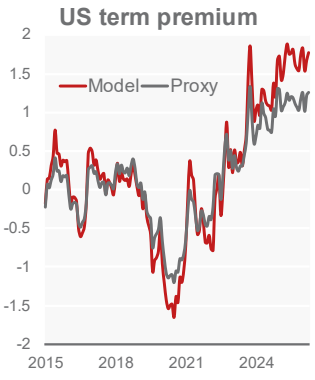


Source: FRB, BuBa, LSEG, GenAM

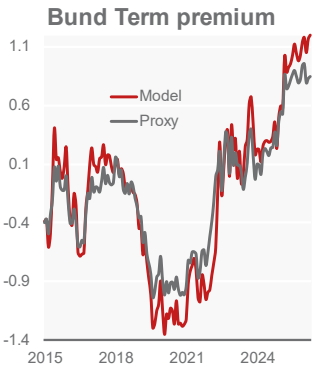
2. A Tradable Proxy

Combining yields to get a usable proxy. The model-based term premium is not directly investable, so we derive a proxy from market yields. Assuming the 2-year yield reflects medium-term policy expectations, we regress the 2/10-year spread on the 2-year yield. This removes the short-rate component, leaving a beta-weighted steepener

that captures yield curve steepness due to the term premium. The 'beta' ensures proportional adjustment. This approach tracks relative movements of the ACM term premium over time or across markets rather than absolute levels, as results depend on sample and structure. For trading, the proxy is most useful for spotting shifts in risk compensation – such as when the term premium rises relative to its historical average – rather than its exact value. A widening beta-weighted steepener can indicate greater long-term risk aversion or supply pressures, guiding relative value trades or duration positioning. These proxies show a strong correlation with the model output (96% to 99% in the DM sample).



Source: FRB, LSEG, GenAM



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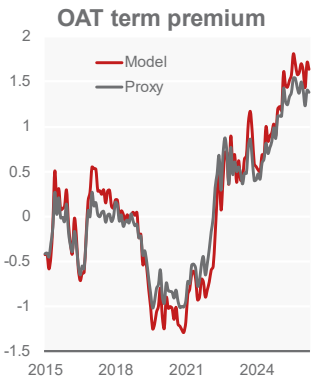
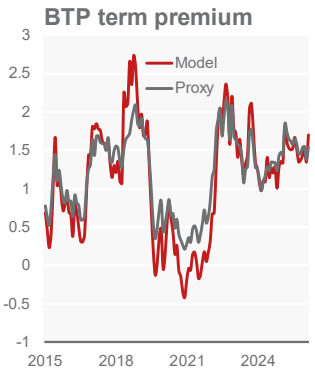


Source: LSEG, GenAM



Source: LSEG, GenAM

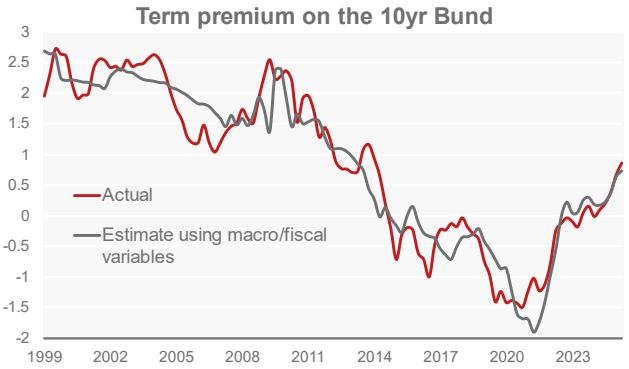
3. A model for medium-term projections

Term premia are macro-driven and likely to trend higher structurally. This chapter complements the statistical decomposition of the term premium discussed earlier by linking it directly to macroeconomic fundamentals. Two key messages emerge. First, medium-term fluctuations in the term premium can be meaningfully explained by macro variables – most notably **inflation expectations** and the **net supply-demand balance for safe assets**. Second, the post-pandemic shift towards persistent fiscal deficits and Quantitative Tightening (QT) suggests that the structural compression of the term premium seen in the 2010s is unlikely to persist, leaving further upside potential even if short-rate expectations stabilise.

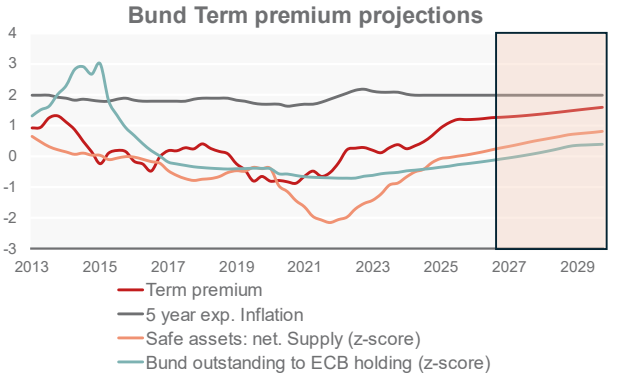
> Our model projects the 10-y Bund term premium to go back to around 100bps by 2030

Macro factors tightly explain the term premium. To formalise this link, we estimate a macro-based model for the 10-year Bund term premium, using an ACM-style decomposition as a starting point. The premium is then related to a parsimonious set of macro drivers and projected using long-term forecasts from the Oxford Economics Global Model, ensuring internal consistency across scenarios. The model is built around three key variables: (i) long-term euro area inflation expectations, proxied by the ECB's 5-year SPF forecasts; (ii) the global excess supply of safe assets – defined as high-rated debt net of central bank holdings and FX reserves; and (iii) the ratio of outstanding Bunds to ECB holdings, capturing the impact of unconventional monetary policy on effective duration supply. Together, these variables account for around 90% of the variation in the Bund term premium.

Term premia are set to rise, driven mainly by supply factors. Based on these relationships, and assuming inflation expectations stabilise around 2%, the projections



Source: Bundesbank, ECB, Eurostat, GenAM



Source: Oxford Economics, Bundesbank, GenAM

point to a gradual rise in the Bund term premium to slightly above 100 bps – close to pre-2015 levels. While inflation dynamics remain important, the supply channel plays a dominant role, as it determines how much duration risk must be absorbed by private investors.

Net bond supply is rising. Looking ahead, the underlying drivers are likely to remain supportive of higher term premia. Persistently large fiscal deficits and elevated issuance continue to increase net bond supply, while the retrenchment of central bank balance sheets under QT reduces non-price-sensitive demand. At the same time, EM reserve accumulation – another historically important source of demand – has lost

momentum. As a result, the effective free float of government bonds is rising, shifting more duration risk to private investors.

QT, macro uncertainty and weaker diversification lift term premia. Two additional mechanisms reinforce this trend. First, QT may reduce market liquidity and increase volatility, raising the compensation required for holding long-dated assets. Second, a more uncertain macro environment – characterised by repeated supply shocks and elevated inflation uncertainty – supports higher risk premium embedded in long-term yields. More broadly, the term premium remains sensitive to changes in inflation expectations, monetary policy, bond supply and demand, and market sentiment. In particular, the recent increase in supply-driven shocks – combining higher inflation with weaker growth – has weakened the diversification role of government bonds. As equity-bond correlations turn more positive, investors require additional compensation for holding duration, further lifting the term premium. This shift is also consistent with the broader "bond glut" narrative. As rising public debt and QT reduce the scarcity value of safe assets, the associated decline in convenience yield implies higher equilibrium term premium. In contrast to the pre-pandemic era, government bonds therefore offer fewer non-pecuniary benefits, reinforcing the need for higher risk compensation.

Higher supply, weaker demand and reduced diversification underpin structurally rising term premium

Medium-term drivers point to rising term premia. Taken together, both the model results and the broader macro backdrop point to further upside potential. Net bond supply is rising, official-sector demand is receding, inflation uncertainty remains elevated, and the hedging properties of duration have weakened. While short-term fluctuations – such as flight-to-quality episodes – can temporarily compress premia, the medium-term trajectory remains upward.

The era of structurally low term premia is ending. Potential countervailing forces, such as an AI-driven disinflation impulse, should not be ignored. However, current evidence suggests that these effects are either uncertain or offset by stronger investment demand and persistent fiscal expansion. Overall, the evidence indicates that the era of structurally compressed term premium is coming to an end. In a regime of higher bond supply, reduced policy support, and elevated macro uncertainty, further increases in global term premium appear both plausible and justified, even after the repricing already observed.

4. Application to investment strategies

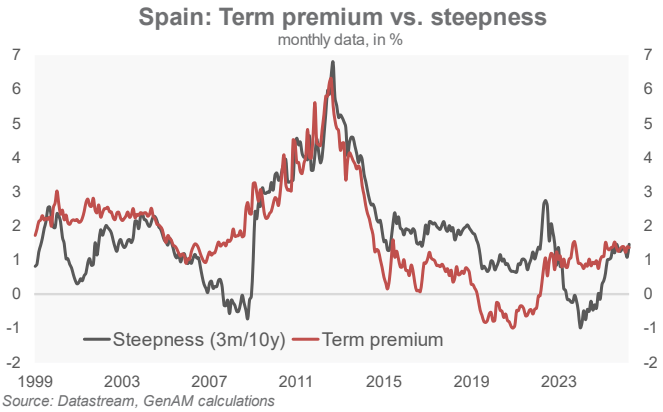
4.1 Strategy results for DMs

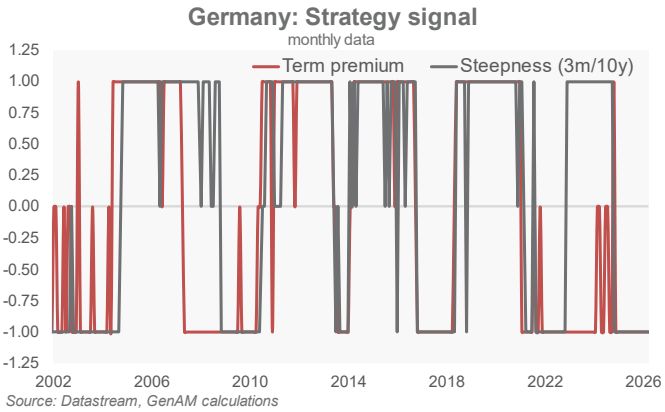
Yield curve steepness as an alternative measure of the term premium. This chapter develops investment strategies based on *term premium* and *yield curve steepness* across countries. A term premium represents the additional compensation for holding long-term bonds, while yield curve steepness serves as an observable proxy, especially when short-term rates are stable. High term premium and steep curves signal attractive long-term bonds, whereas low or inverted signals warrant caution.

High correlation between term premium and slope of the yield curve

Term premia exhibit persistent long-term trend. Both measures are strongly correlated across countries but differ in their dynamics. Yield curve steepness (here, the 3-month/10-year slope) is typically mean-reverting, while the term premium exhibits

more persistent long-term trends, declining almost continuously until 2022 before partially normalising.





4.1.1 Term premium and steepness as signals for investment strategies

Deviation from the 2-year average, adjusted for standard deviation, determines the investment strategy

Rule for generating the investment signal. We generate separate monthly signals from the ACM-based term premium and yield curve steepness for each country, comparing both to their respective 2-year moving averages to assess whether compensation is high.[2] Based on the deviation (±0.25 standard deviations), the strategy allocates between 10-year bonds and money market instruments: strong deviations lead to an 80/20 tilt, moderate values remain at a neutral 50/50 allocation. Thresholds limit turnover, and portfolios are rebalanced monthly (abstracting from transaction costs).[3]

Benchmark allocation constant over time. The benchmark remains fixed at a 50/50 allocation. When term premium or curve steepness are high (low), the strategies increase (reduce) duration relative to the benchmark. At month-end, a new signal is generated, and the portfolio is rebalanced (to proof the concept of the strategies trading costs are excluded). By taking offsetting positions in long-dated bonds and money markets and applying beta-hedging, the strategies aim to capture changes in yield curve slope while neutralising exposure to parallel shifts in the overall level.

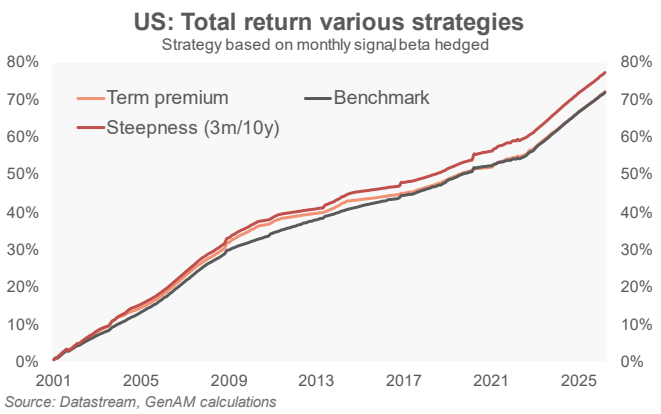
4.1.2 Steepness strategy superior to term spread strategy

Duration risk pays off and leads to outperformance compared to money market investments

Strategies outperform pure money market investments. We apply the strategies to eight DM bond markets. Under a *perfect-foresight* assumption (as a proof of concept), the ACM-based term premium strategy outperforms the benchmark in all countries, while the outperformance of the yield curve steepness strategy is mechanically ensured. This demonstrates that accurate knowledge of future term premium would

[2] This period was chosen to ensure sufficient data availability and test strategy performance, while avoiding excess volatility. Changing the period (e.g., 5 years) does not fundamentally change the results.
[3] Using a different threshold value or tilt does not significantly alter the results.

enable successful allocation, despite their indirect and time-varying relation to curve steepness. [4] Moreover, the expectations hypothesis is rejected in all cases, as money market returns remain consistently below those of the benchmark and both strategies outperform it even without perfect foresight, highlighting the benefit of combining bonds and money markets.



Source: Datastream, GenAM calculations

Source: Datastream, GenAM calculations

Rise in term premia is currently triggering increased bond allocations in the automatic term premium strategy

Mixed results for the term premium strategy. In practice, perfect foresight is not feasible, so we implement the strategies using moving averages. Signals from the term premium strategy show strong cross-country convergence, but overall performance is mixed, with outperformance in only five of eight markets and higher volatility than the benchmark.[5] Notably, between 2014 and 2019, the strategy signalled underweights in long-dated bonds despite continued curve flattening.

Risk and return statistics of various strategies, 2001-2026

	1-mth bond			Benchmark (50% 1-mth bond, 50% 10-yr bond)			MA term premium			MA yield curve steepness		
	Av. monthly return	Volatility	Return/risk	Av. monthly return	Volatility	Return/risk	Av. monthly return	Volatility	Return/risk	Av. monthly return	Volatility	Return/risk
US	0.19%	0.60%	0.32	0.24%	0.50%	0.48	0.24%	0.56%	0.42	0.25%	0.63%	0.40
Japan	0.01%	0.08%	0.16	0.08%	0.34%	0.24	0.08%	0.50%	0.16	0.08%	0.50%	0.16
UK	0.21%	0.64%	0.33	0.26%	0.69%	0.37	0.25%	0.78%	0.32	0.27%	0.80%	0.34
Germany	0.13%	0.50%	0.26	0.19%	0.51%	0.37	0.18%	0.58%	0.32	0.19%	0.57%	0.33
Italy	0.13%	0.51%	0.25	0.26%	0.68%	0.38	0.27%	0.96%	0.28	0.28%	0.97%	0.29
France	0.12%	0.50%	0.23	0.21%	0.68%	0.30	0.21%	0.86%	0.24	0.22%	0.88%	0.25
Spain	0.13%	0.51%	0.25	0.25%	0.65%	0.38	0.25%	0.90%	0.28	0.27%	0.92%	0.29
Belgium	0.13%	0.51%	0.26	0.22%	0.76%	0.30	0.23%	1.04%	0.23	0.24%	1.03%	0.23

Source: Datastream, GenAM calculations

Yield curve steepness strategy proves to be superior to both the benchmark and the term premium strategy

High synchronisation of yield curve steepness strategies across countries. By contrast, yield curve steepness is highly synchronised across countries and proves to be a more reliable and robust indicator, outperforming the benchmark in all markets. Its

[4] Unsurprisingly, a pure (long-only) bond market strategy outperforms both the benchmark and the analysed strategies in an environment of a generally upward sloping yield curve – albeit at the cost of significantly higher volatility.

[5] In addition to monthly signal generation, we have tested longer intervals as an alternative. The results remain structurally unchanged for quarterly and annual signal generation.

transparency and direct observability also avoid the model uncertainty inherent in term premium estimates.

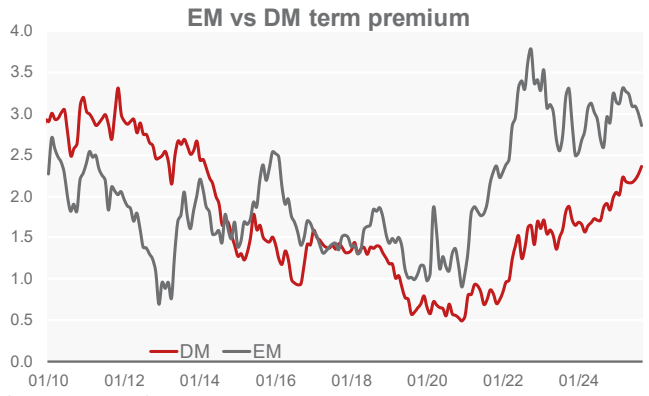
Supportive bond signals, but result warrant a cautious interpretation. Both strategies currently point to an overweight in long-dated bonds, reflecting higher term premium and steeper yield curves. However, given the mixed track record – particularly for the term premium approach – these signals should be interpreted with caution and seen as one input among many rather than a standalone allocation rule. This is especially relevant as our fundamental analysis (Chapter 3) suggests that term premium could rise further, potentially limiting the reliability of the current signals. [6]

4.2 Strategy results for EMs

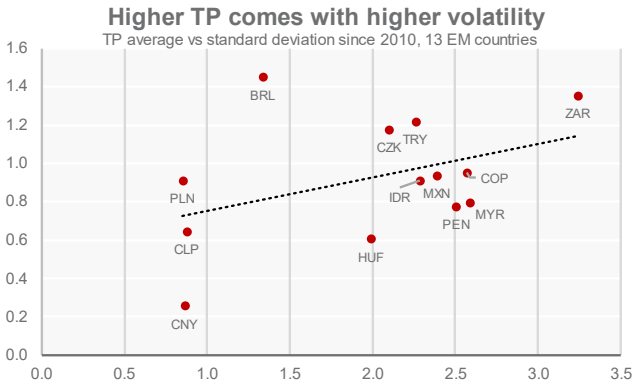
4.2.1 A volatile and idiosyncratic term premium

Less focus on the term premium. The debate on the term premium has been less prominent in EM local debt markets than in DMs. Likewise, it is used less often as a valuation metric in EM. Focus has rather been on the valuation of the front end of yield curves and yield drivers like FX and credit risk. Still, we estimate the term premium for 13 large EM countries in the JP Morgan GBI index since 2010 and find notable differences relative to DMs.

Firstly, the EM term premia show higher volatility, reflecting lower market liquid and strong idiosyncratic factors. Higher EM term premia are linked to higher volatility, relative to DM.



Source: Bloomberg, GenAM calculations



Source: Bloomberg, GenAM calculations

Secondly, the EM term premium did not decline meaningfully between 2010 and 2020, unlike in DM. The DM-EM correlation was low then, but both regions have seen a simultaneous rise in the term premium since 2020.

[6] A cross-country term premium strategy – overweighting markets with higher (z-score adjusted) term premia and underweighting those with lower ones – was tested against an equal-weight benchmark. However, as it persistently underperformed (by over 30% since 2010), it is not pursued further.

Thirdly, the correlation between the EM term premia and the local yield curve steepness is lower than in DM countries and even weak for certain countries. Since 2010, the correlation between the monthly change in term premium and curve steepness ranged from 0.11 (China) to 0.83 (South Africa), averaging 0.43.

4.2.2 A positive investment signal for EMs

More volatile markets require a different approach. We run a slightly different systematic term premium strategy for EM countries. We use the same benchmark and investment rules as for the DM countries, but we focus on the 5Y maturity and compute each country's bond total return performance with no beta hedging.

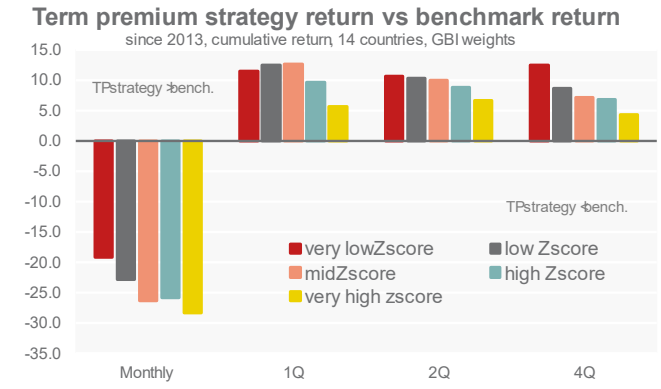
In addition, we lengthen the investment horizon and modify the standard deviation thresholds to reflect the different behaviour of EM sovereign bond markets, which are more volatile. Indeed, EM local curve dynamics differ during risk episodes: EM FX depreciates, the term premium rises, and EM central banks tend to hike policy rates aggressively, often causing a bear flattening. In such cases, staying at the very front end of the curve is preferable to extending duration. Examples include Turkey (2018 and 2021) and Brazil's recent tightening cycle, where the term premium remained high but front-end rates delivered even better returns. Therefore, if we maintain a short-term horizon of investment, the risk is to consistently underperform the money market rates and to fail to capture the structural change reflected by the term premium level.

For EM, the term premium is a useful indicator for long-term investment

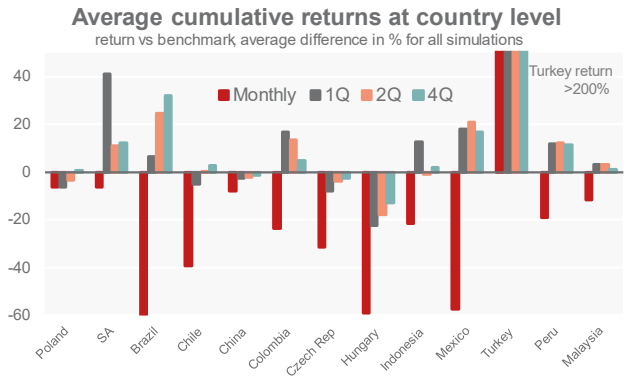
Outperformance over a longer-term investment horizon. We test the strategy over monthly, one-quarter, two-quarter, and four-quarter horizons. On the monthly horizon, unlike DM countries—the term premium is a weak investment signal. All countries except South Africa failed to outperform the benchmark. If we aggregate the country's performance using the GBI index weights, the underperformance vs the benchmark over the period is large. This underperformance is likely related to the bear flattening of local curves during stress periods.

When the horizon is extended, results turn significantly positive, and the term premium becomes a good investment signal. Outperformance versus the benchmark is the highest at the two-quarter horizon. The number of countries with positive returns also increases as the investment horizon lengthens. It confirms that the level of term premium is not a good short-term investment indicator, but rather a structural, long-term one.

We also run the strategies using different standard deviation threshold as an investment signal to reflect the higher EM volatility. Outperformance increases when the standard deviation is set higher. However, at some point, the excess return declines. Moreover, the outperformance remains negative at the monthly horizon regardless of the standard deviation used.

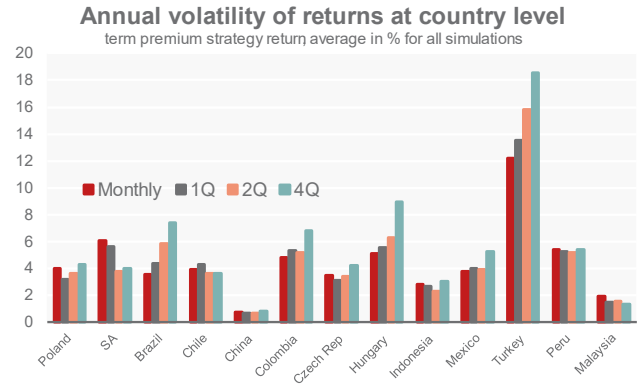


Source: Bloomberg, Datastream, JP Morgan, GenAM



Source: Bloomberg, DataStream, JP Morgan, GenAM

Volatile results. One of the limitations is the volatility of results, both across countries and across horizon of investment. Firstly, returns are volatile across countries, depending on the absolute yields level. Low yielders countries show lower return volatility while high yielders countries can exhibit high volatility (Brazil, Hungary, Turkey). That said, the high volatility comes with higher return. Secondly, annual volatility of return tends to increase with the investment horizon. For instance, the one-year horizon strategy will have a higher volatility than the strategy ran on a monthly horizon.



Source: Bloomberg, DataStream, JP Morgan, GenAM

5. Conclusion

Our estimates of the term premium help mease the impact of changes in the fiscal and monetary policy mix, and particularly the net supply of government bonds, on long-term rates. Our market proxy, based on observable rates, allows us to track it at higher frequency, to support sovereign bond allocations.

Yield curve steepness a more reliable input for DM investments. The duration strategy based on the steepness of the yield curve reliably outperforms the benchmark and the term premium strategy. While the term premium is complex and subject to long-term trends, the yield curve slope provides a simple, robust basis for systematic investment signals. In phases of high steepness and positive term premium, investors should generally increase duration and invest more heavily in long-term government bonds. However, we urge caution with structural breaks. Based on fundamental

considerations, we do not currently recommend overweighting long-term bonds, despite the mechanically derived signals from strategies. We see potential for further yield curve steepening and increasing term premium and therefore advise against aggressively long duration strategies at present.

Term premium is a useful indicator in EM local debt investing. Strategies based on term premium provide excess return versus the benchmark, though that depends on the horizon of investment. Excess return increases with the horizon of investment. It suggests that the term premium in EM countries is not a good short-term investment indicator, but rather a structural, long-term one.

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Head of Research	**Vincent Chaigneau**
Head of Macro & Market Research	**Dr. Thomas Hempell, CFA**
Team	**Elisabeth Assmuth** | Research Operations **Elisa Belgacem** | Head of Cross-Asset Quant & Dev, Senior Credit Strategist **Radomír Jáč** | GI CEE Chief Economist **Jakub Krátký** | GI CEE Financial Analyst **Michele Morganti** | Head of Insurance & AM Research, Senior Equity Strategist **Vladimir Oleinikov, CFA** | Senior Quantitative Analyst **Dr. Thorsten Runde** | Senior Quantitative Analyst **Dr. Christoph Siepmann** | Senior Economist **Dr. Florian Späte, CIIA** | Senior Bond Strategist **Guillaume Tresca** | Senior Emerging Market Strategist **Dr. Martin Wolburg, CIIA** | Senior Economist **Paolo Zanghieri, PhD** | Senior Economist
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