Market Perspectives

Divergent perspectives

February 2023

GIAM Macro & Market Research

'Market Perspectives' provide our monthly macro & market outlook and investment recommendations

- **With the energy crunch easing and China heading for a reopening bounce, the euro area will likely forego a widely anticipated winter recession. Yet the Fed's fast monetary tightening is still to take its toll of a shallow US mid-year recession.**
- **These divergent shifts in the outlook support a tighter transatlantic yield spread, a slight preference for EA vs. US stocks and more upside for the EUR/USD.**
- **Overall, however, elevated valuations and persistent headwinds to earnings keep us favouring a prudent stance on risk assets amid mounting sings of exuberance. Euro area IG Credit still looks attractive.**

Content

Your Partner for Progress.

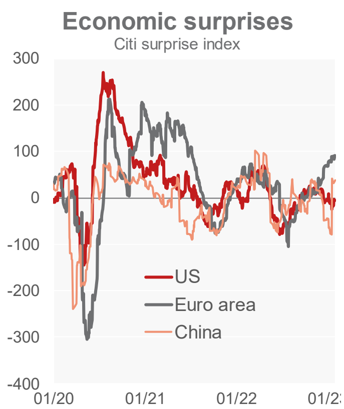
Global View – Divergent perspectives

Thomas Hempell

- **With the energy crunch easing and China heading for a reopening bounce, the euro area will likely forego a widely anticipated winter recession. Yet the Fed's fast monetary tightening is still to take its toll of a shallow US mid-year recession.**
- **These divergent shifts in the outlook support a tighter transatlantic yield spread, a slight preference for EA vs. US stocks and more upside for the EUR/USD.**
- **Overall, however, elevated valuations and persistent headwinds to earnings keep us favouring a prudent stance on risk assets amid mounting sings of exuberance. Euro area IG Credit still looks attractive.**

Amid a volatile winter, global markets staged a buoyant start into the new year. Just after the Fed and ECB had poured cold water on pivot hopes before Christmas, weaker inflation prints rekindled the bulls. Warm weather and energy savings have been dissolving fears of a European energy crunch, with hard year-end data proving surprisingly resilient and business expectations bouncing. China's surprise Covid U-turn and relaxed property regulation will make for a buoyant local spring recovery.

Thus we now see the euro area narrowly foregoing recession and make a meaningful upgrade to our EA growth forecasts for this year (see Euro Area section). A healthy chunk of the 2023 market rally (led by EA and EM stocks) can be justified by the improved EA and China outlook.



Source: Citi, Datastream, GIAM

Source:Conf. Board, BBG, GIAM

FOMO (fear of missing out) may still back the rally short term. But do not get carried away by the euphoria. Regional differentiation is becoming ever more apparent. The picture for continental Europe has brightened. Yet the sharp Fed tightening over the past year is starting to bite, with a (mild) mid-year US recession still more likely than not (chart).

The earnings consensus is not fully pricing the ensuing growth deceleration, as investors have been blinded by still solid lagging indicators including US Q4 GDP and a robust labour market. Valuations are slightly stretched vs. real rates. And premia on speculative Credit neither look appealing in historical terms nor against rising default rates. Meanwhile, very bearish positioning, which was a fertile ground for the recent bounce, has become more balanced.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	3.49	3.45	3.40	3.20
Germany (Bunds)	2.21	2.30	2.30	2.35
Credit Spreads**				
EA IG Non-Financial	142	155	160	145
EA IG Financial	163	175	190	170
Forex				
EUR/USD	1.09	1.10	1.13	1.15
USD/JPY	130	127	125	122
Equities				
S&P500	4049	3985	4025	4105
MSCI EMU	144	142	142	147

**3-day avg. as of 27/01/23 **ICE BofA (OAS)*

Pivot hopes look optimistic

Much of the market rally is owing to hopes that the Fed may pivot in summer. That looks optimistic. A further slowdown in the Fed's tightening pace to a 25bp hike in early Feb. is widely anticipated. But markets are under-pricing the Fed's determinedness to fight inflation both regarding the (too low) terminal rate and an anticipated pivot already in Q3. Similarly, eased headwinds to the euro area economy and the prospect of stronger wage increases will fuel rifts within the ECB – with the hawks likely to prevail for longer than markets currently assume. Markets also seem somewhat complacent about the headwinds to European sovereign debt arising from the ECB's looming quantitative tightening. The ECB will confine the run-off of bond holdings to €15bn/month from March to June, but seems prone to step up this pace from July onwards.

We thus keep our prudent stance on the riskier market segments, including Equities and HY. We avoid strong active duration positions overall, but continue to (now slightly) prefer US Treasuries over Bunds, even after the large narrowing of the past 3 months. Regionally, we keep a moderate preference of EA vs. US stocks. EUR/USD has more upside over 2023, even though short term, shaky risk sentiment keeps the outlook less clear-cut. We still like EUR IG thanks to a historically still decent risk premium.

United States

Paolo Zanghieri

- **A slower but better than expected Q4 lifted 2022 growth to 2.1%. For 2023 we foresee a contraction in the central quarters but 0.6% annual growth.**
- **Job offers and hiring intentions have weakened, but the unemployment rate remains near historical lows. This poses an upside risk to our 3.5% year-end core inflation forecast.**
- **With inflation declining and the growth outlook worsening, the Fed will ease the pace of tightening to 25 bps moves from the next meeting. We expect a peak rate of 5.25% followed by cuts only towards the end of the year.**

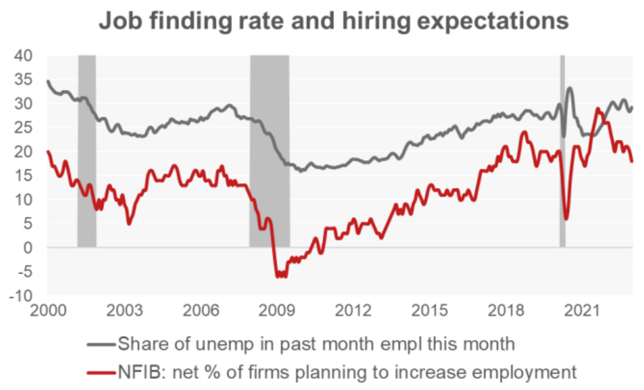
The better than expected Q4 GDP 2.9% annualised growth was mostly due to net trade and inventories, private domestic demand inched up by only a modest 0.2% as higher borrowing costs and inflation harm purchasing power. In line with the signals from most surveys we expect GDP to almost stagnate in Q1 and to contract mildly in the following two quarters, as the pressure for higher rates will peak. Therefore our upward revision of 2023 growth to 0.6% is almost solely due to base effect due to the relatively strong Q4 GDP showing.

The sombre picture shown by most business surveys is only in part reflected in the labour market. Firms are scaling back their hiring plans, but expectations remain relatively high. Hard data point to a still very tight labour market. The speed at which unemployed persons find a job remains extremely high and the quit rate is above the pre-pandemic peak.

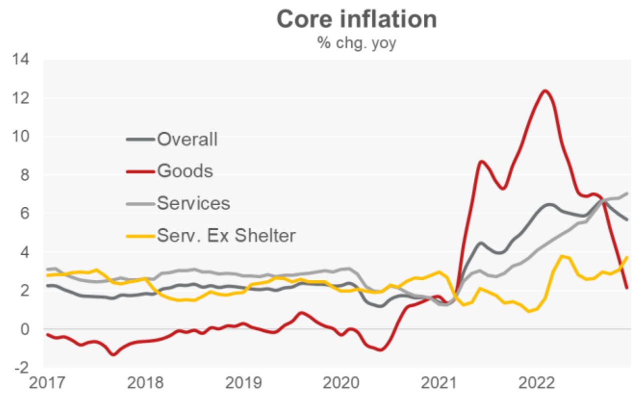
Fed slows tightening, but upside risks remain

A tight labour market will likely continue to bid up wages and this poses upside risk to the services component of core inflation, which is labour intensive and little exposed to the global disinflationary forces affecting goods. Shelter costs are nearing their peak and will gradually catch up with the sharp decline in house prices growth. We expect a material decline in core inflation, from the 5.7% of December to around 3.5% by year-end, with nonnegligible risks of a slower descent.

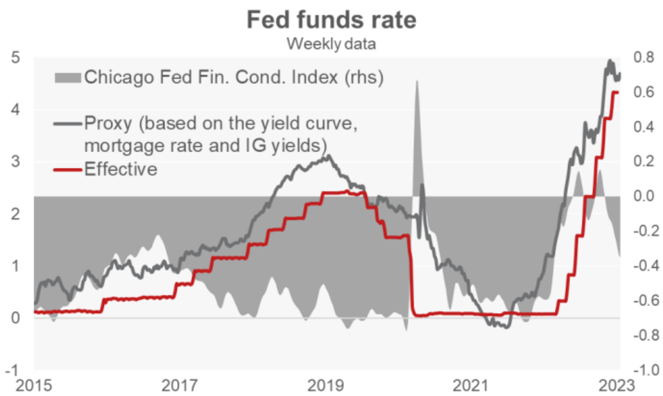
The peak in core inflation and the prosects of an economic slowdown have turned the Fed towards a slower pace of tightening. We expect three 25 bps rate rises, bringing the Fed funds rate to 5 to 5.25% by May. The mild recession we foresee for H2 will force a cut in Q4. However, risks are tilted to tighter policy. This could mean a higher peak to counteract the easing of financial conditions - resulting from expectations of a quick policy U-turn - , or a longer period of rates at the peak, should the economy prove more resilient and inflation stickier.



Source:BLS, NFIB, Refinitiv, GIAM



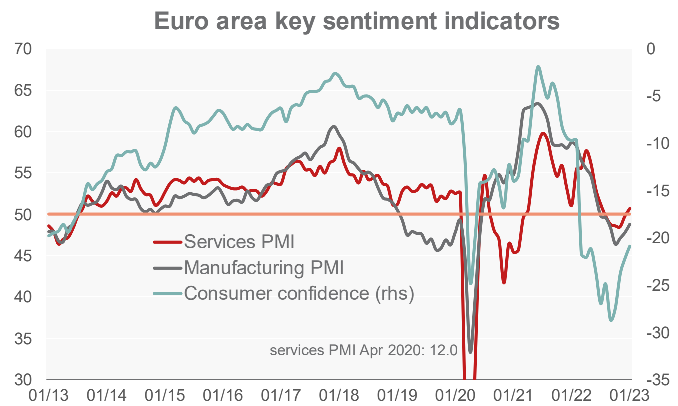
Source:BLS, Refinitiv, GIAM



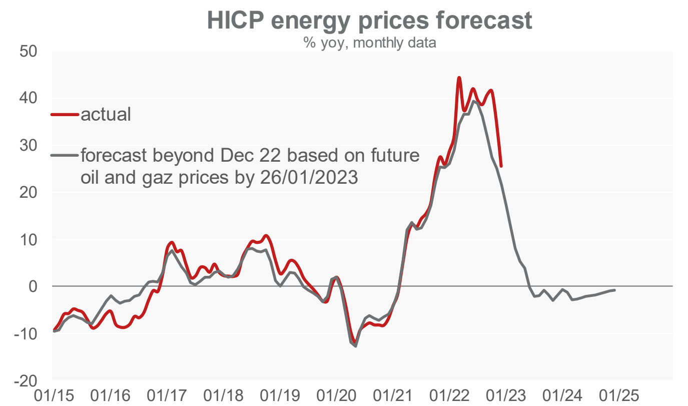
Source:Refinitiv, GIAM

Euro Area

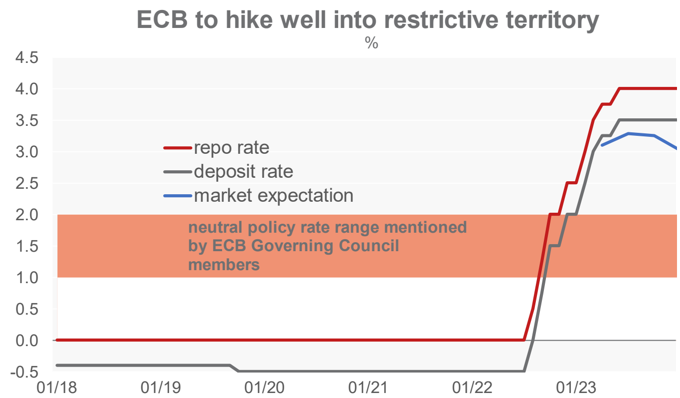
Martin Wolburg



Source: Datastream



Source: Datastream, GIAM calculations



Source: Datastream, ECB, GIAM calculations

- **The euro area economic outlook brightened. We no longer look for a winter recession and see growth at 0.7% in 2023, strongly above consensus of 0.0%.**
- **With the energy disruption risks off, lower energy prices, receding inflation and impulses from Chinese reopening ahead, we see a return to growth.**
- **Lower energy prices caused a reduction of the 2023 inflation forecast to 5.5%, below consensus of 6.3%.**
- **We expect the ECB to hike by 50 bps in Feb. and March and to end the hiking cycle at 3.5% in Q2.**

A smell of spring surrounds the euro area economic outlook and we revised our 2023 growth expectation sharply up to 0.7% (from 0.2%), strongly above the consensus forecast of 0.0%.

The January composite flash PMI (of 50.2) indicates non-negative growth for the first time since June 2022. Forward-looking components in the survey but also other indicators (Sentix, ZEW) improved significantly, suggesting that output will not recede in Q1.

We think that this rise in sentiment is well founded. Concerns about energy disruption almost became a tail risk as gasholders are well filled (to still about 80%). This contributed to a sharp decline in energy prices and led us to revise our 2023 inflation outlook to 5.5% (from 6.0%). In Q2 we expect inflation to recede more markedly, dragging less on real incomes. We then also look for a rebound of the Chinese economy (see part on China). Moreover, the bottleneck issue has already lost some of its sting and will ease further. E.g. delivery times in the man. PMI improved to a level only slightly below Jan 20, just before the pandemic. With the labour market strong (UR at a low of 6.5%), consumer confidence and real consumption activity are set to improve more strongly than currently envisaged.

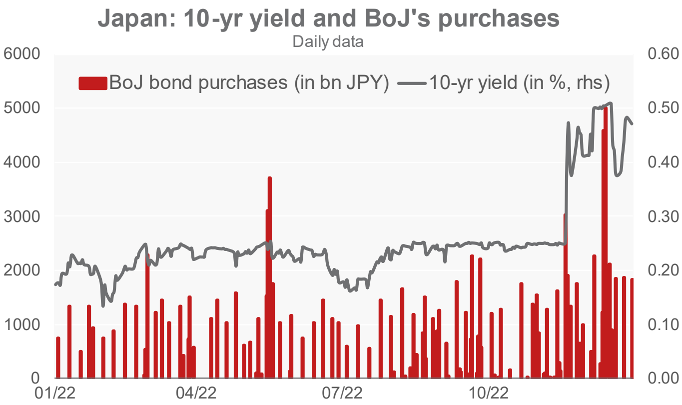
That said, activity will not go through the roof. Quarterly growth rates are set not to exceed potential (of about 0.3% qoq) as monetary tightening takes its toll (e.g. loans to households fell to 3.8% yoy in Dec., from 4.1% yoy). Yet we think it is time to switch from a recession and downside risk dominated scenario to a return of growth view.

ECB to remain hawkish to lift key rate to 3.5% by Q2

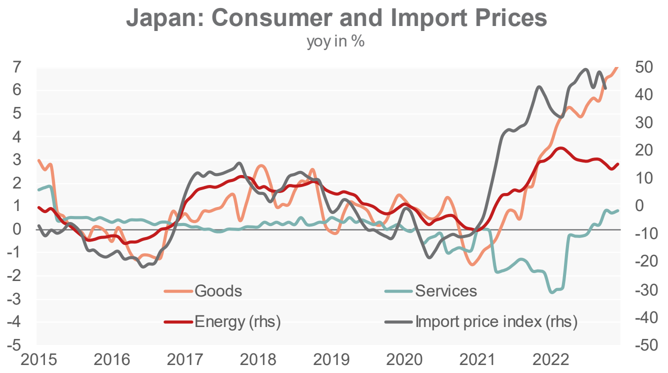
We think that the ECB will walk the hawkish talk from the Dec. meeting and lift the depo rate by 50 bps in Feb. and March, followed by further hikes to a peak rate of 3.5% in Q2. Inflation remains still far to high, core inflation is not set to recede lastingly in 2023, inflation expectations are still above target and the "doves" in the Governing Council will likely accept hikes into well restrictive territory in exchange for a more dovish approach to QT.

Japan

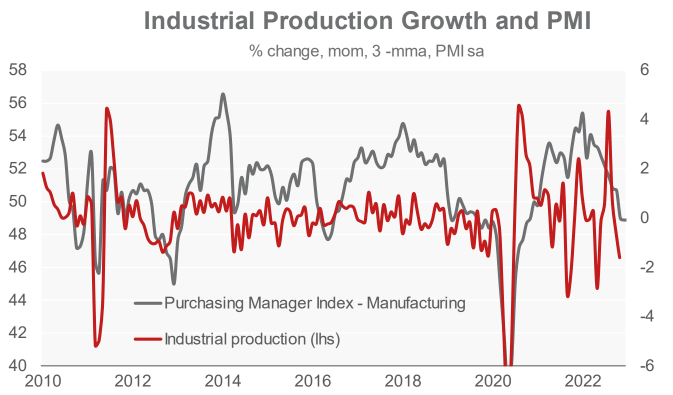
Christoph Siepmann



Source: Bloomberg, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

- **In mid-January, the BoJ rejected market pressures to modify its Yield Curve Control policy.**
- **However, we expect the BoJ to successively allow for more flexibility, given more momentum in wage growth. Inflation is likely to peak in January.**

In its latest meeting in mid-January, the Bank of Japan (BoJ) defied large speculative market pressure by keeping its Yield-Curve-Control (YCC) policy unchanged. The overnight rate stayed at -0.1% and the 10y Japan Government Bond (JGB) yield band was maintained at +/- 50 bps around 0%. On top, the BoJ enlarged its toolbox slightly by adding variable-rate loans to financial institutions of up to 10 years' duration to its options. Markets first responded with a strong drop of JGB yields, but they have moved up again towards the upper limit. We expect markets to focus now on Kuroda's successor as the next BoJ Governor, who will likely be announced on February 10. The first meeting under the new helm will take place on April 27/28 and could be preceded by a resurfacing of market turbulences.

Successive exit from YCC policy

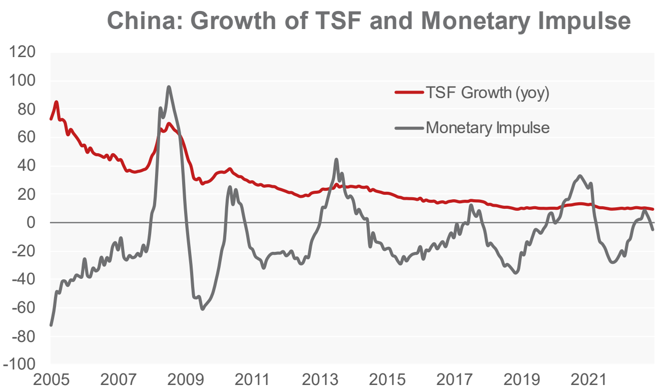
While we expect the BoJ to successively give up its YCC policy, the exact timing will well be influenced by important data releases. The top focus will lie on the spring (shunto) wage negotiations which have effectively begun. The momentum is higher than in recent years, reflecting the rise in inflation. We continue to expect a wage hike of around 3% (including seniority-driven pay), which – excluding the latter – would be broadly in line with productivity growth. Still, being the highest rate in years could justify tweaking YCC. Secondly, CPI inflation will be scrutinised. December headline CPI inflation rose to 4% yoy (Tokyo Jan. inflation to 4.3% yoy). Readings of core-core inflation measures came in at 3% yoy (ex fresh food and energy) or 1.6% yoy (ex food and energy). Provided no fresh shocks occur, inflation is expected to peak in January and then start receding, driven by government energy subsidies, softening mom rates, the recent appreciation of the yen, and increasingly important base effects. Nevertheless, we expect the headline CPI inflation to fall back below the BoJ 2% target only in late summer, so that the yearly average could remain at 2.5% in 2023.

With regard to real activity, industrial production has dropped in Q4 by 3.2% qoq, not least due to car production and the weakness in China. While global growth is expected to slow in H1 2023, the negative impact could increasingly be balanced by the upturn in China. Domestic demand should stay more robust, so that we see growth to remain broadly at the pace of last year with 1.1%.

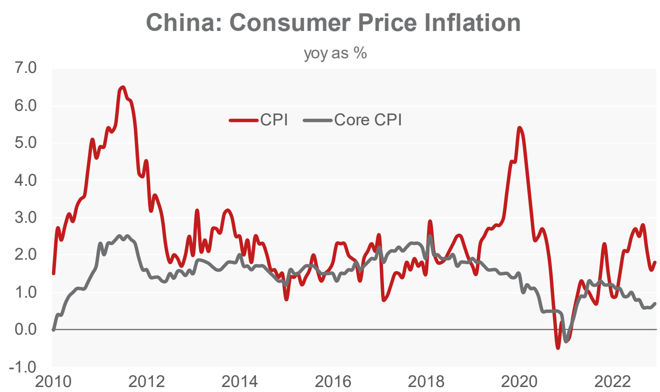
China

Christoph Siepmann

Source: Datastrem, GIAM calculations



Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

- **China's Q4 GDP figures surprised on the upside but were widely considered somewhat implausible.**
- **Post-Covid China is set to rebound strongly on pent-up demand and base effects. The real estate sector should also start improving on government support.**

After its ill-prepared U-turn on the zero Covid policy, Beijing's stopped publishing fresh infection numbers. Anecdotical evidence suggests a strong wave in November/ December in cities, which likely has already receded. However, China's New Year travel season (Jan. 22 – Feb. 7) may well spread the virus onto the country side, which could result in a second wave amid a rising death toll. Experience from other Asian countries suggests a Covid outbreak to typically last about three months, so that a rebound could follow from about mid-Q1 2023 on. The travel season will likely already have a positive impact on Q1 private outlays.

China's Q4 2022 GDP numbers surprised on the upside, but were widely commented as being at odds with PMIs and mobility data. Especially, qoq growth was reported at (surprisingly high) 0%, resulting in a growth rate of 2.9% yoy and the full 2022 year GDP growth of 3%. Alongside these GDP numbers, December data showed retail sales to further decrease, but less severe than before. Industrial production also came in softer, together with overall investments. The property sector continued to contract, while numbers were also less negative than before. Exports dropped by about 10% yoy, showing the cooling of the global economy. On the monetary side, CPI inflation increased slightly to 1.8% yoy while core inflation remained low at 0.7% yoy. The monetary impulse fell back into marginally contractionary territory.

Strong rebound expected

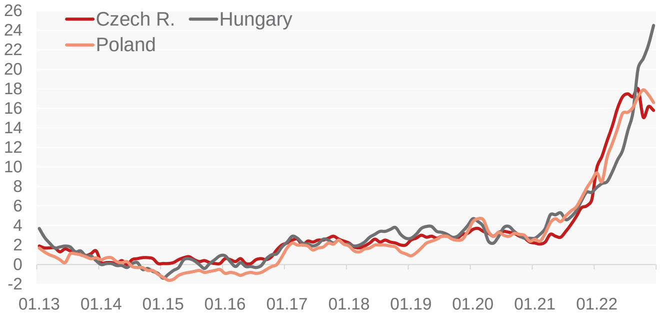
Looking ahead, the high Q4 base elicits numerical problems for the 2023 GDP estimate. Basically, we expect Q1 activity already to improve compared to Q4 2022, not only due to the travel outlays. In Q2, production and consumption will likely not only return to normal but "overshoot" as Covid savings suggest room for pent-up demand. However, that will not have the extend like in Western countries, as China refrained from larger fiscal transfers. Growth in Q2 will additionally benefit from the weak base (Shanghai lockdown in Q2 2022, GDP at 0.7% yoy) and thus is set to come in on the strong side. However, experience from other countries also suggests that the rebound will be accompanied by some acceleration of CPI inflation. We also see the property sector to successively recover over the next quarters amid government support and better access to funding . All in, we expect GDP growth at 5.7% (5.1% before) and CPI inflation at 2.5% in 2023.

Central and Eastern Europe

Radomír Jáč

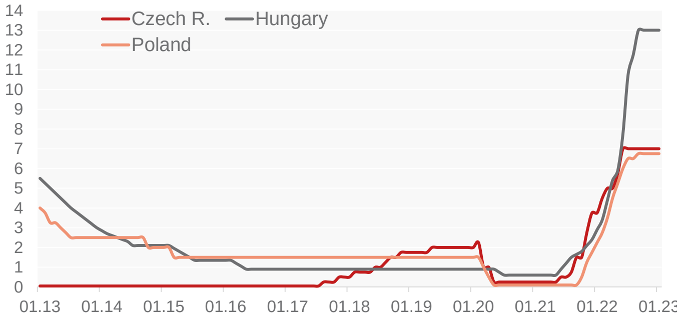
- **Inflation in the region showed a mixed picture in Q4, reflecting government measures but also specific in-built price pressures in the individual economies. Inflation moderated in Czechia and Poland, while Hungary reported a significant increase in CPI.**
- **Inflation most likely re-accelerated across the CE-3 in January, partially due to changes in regulated prices (energy for household) but a tendency towards a longer-lasting disinflation may start already in Q1.**
- **The CE-3 central banks left their policy unchanged in January. While inflation should decline during 2023, no hurry with rate cuts is expected. Only the Hungarian MNB is likely to start in H1 a gradual exit from its current very restrictive policy regime.**

Headline inflation
CE-3 countries (CPI yoy in %)



Source: www.czso.cz, www.ksh.hu, www.stat.gov.pl, GIAM

Monetary policy interest rates
CE-3 countries (end-of-month level, in %)



Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

Main Forecasts

Czech Republic	2021	2022f	2023f	2024f
GDP	3.5	2.5	0.5	3.0
Consumer prices	3.8	15.1	11.0	2.2
Central bank's key rate	3.75	7.00	5.00	3.00
Hungary	**2021**	**2022f**	**2023f**	**2024f**
GDP	7.1	4.8	0.1	3.5
Consumer prices	5.1	14.5	15.0	4.5
Central bank's key rate	2.40	13.00	9.00	4.50
Poland	**2021**	**2022f**	**2023f**	**2024f**
GDP	6.8	5.6	0.6	3.4
Consumer prices	5.1	14.3	13.7	4.8
Central bank's key rate	1.75	6.75	6.75	4.50

Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, GIAM

Inflation dynamics were mixed in the CE-3 region in Q4. While annual inflation in Czechia and Poland moderated, partially due to government measures aimed to shield households from the worst impact of growing energy prices, Hungary recorded a sharp acceleration of inflation before the year-end. Annual inflation is likely to have re-accelerated across the region in January but it is expected to move to a disinflationary path already during Q1 and disinflation should dominate in the rest of 2023 across the CE-3 economies.

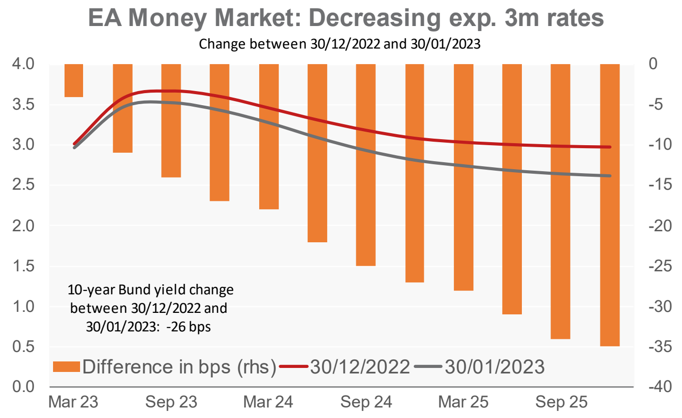
High inflation (annual headline CPI for December reached 15.8% in Czechia, 24.5% in Hungary and 16.6% in Poland) weighs on real wages and household consumption with a negative impact on the overall GDP. Czechia and Hungary very likely fell into recession in H2 2022 while Poland may face economic weakness in early 2023. However, the recent developments in global energy prices are supportive to our expectation that GDP in the CE-3 region will start to recover in quarter-to-quarter terms from Q2 on at the latest.

CE-3 central banks: no hurry to change policy stance

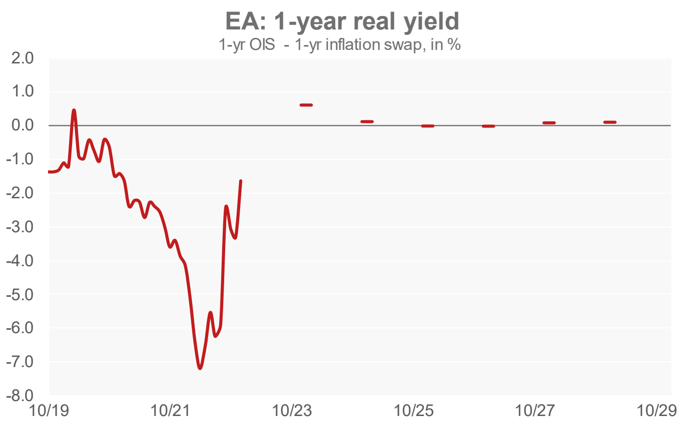
We share a view that monetary policy interest rates in the CE-3 already reached their peak but the central banks will not hurry to change their stance. They first want to see that inflation is moderating and that inflation expectations are still anchored at acceptable levels. The Czech CNB may start to cut its key rate from currently 7% in Q3 but in the meantime it will focus on reduction of inflation expectations via its public statements. In Poland we expect the key rate unchanged at current 6.75% in 2023 and the first cut to come only in early 2024. The Hungarian MNB keeps a tight policy with O/N deposit rate at 18% as the key tool. The MNB will monitor market sentiment before it decides for a gradual exit from its current policy regime. This may happen in March at earliest amid an updated macro forecast.

Government Bonds

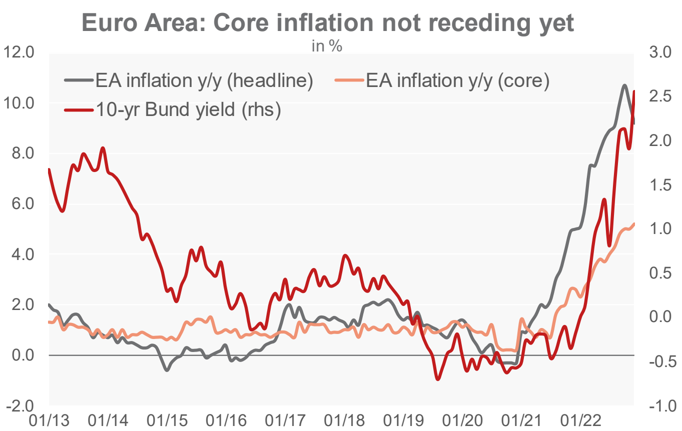
Florian Späte



Source: Bloomberg, GIAM



Source: Bloomberg, GIAM calculations



Source: Bloomberg, GIAM

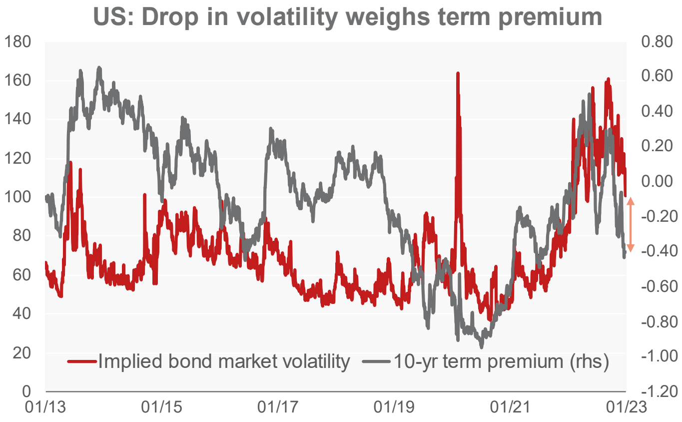
- **The government bond markets have made a very good start to the year. Driven by lower key rate expectations core government bond yield curves bull- flattened.**
- **We consider the recent yield movement to be exaggerated, especially for the euro area. Given further key rate hikes and a somewhat improved economic outlook, we see moderate upside potential for Bund yields.**
- **Euro area non-core government bond spreads have tightened to multi-months lows. Even if the issuance volume is moderately lower than currently expected given declining energy prices, the bond markets will be noticeably burdened given the forthcoming ECB's Quantitative Tightening (QT).**

After the disastrous year of 2022, government bond markets are off to a good start. Yields have fallen across the curve and the total return of government bonds is in the green and has made up a (small) part of the losses of the previous year. However, we do not expect this trend to continue and, at least on the European bond markets, yields are likely to rise again soon. For example, 10-year Bund yields have already picked up noticeably in the second half of January.

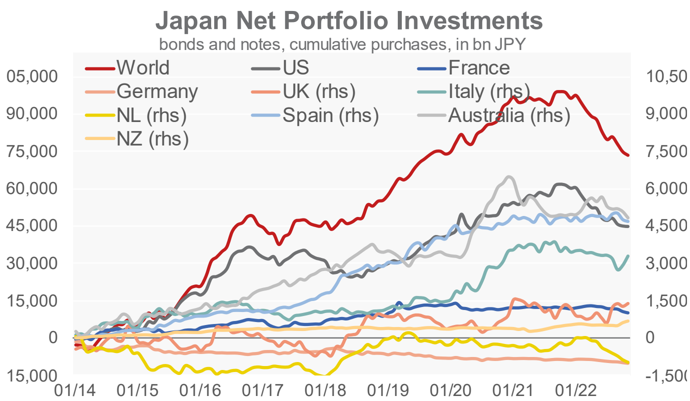
The main reason for the decrease in yields across the curve is the repricing of medium- and long-term key rate expectations. While the peak for the ECB is broadly unchanged between 3.25% and 3.5% (we tend to the upper end of the currently priced range) financial markets have adjusted the key rate path further down the road. A first cut is already (partially) priced for Q4 2023 and by year-end 2024 markets expect an ECB key rate of around 2.5%. This is also reflected in the expected 1-year real yield which is seen to be around 0% in the years to come (see chart). We regard this at odds with the hawkish ECB stance (expect not just another 50 bps step in February but also be prepared for a hawkish press conference), the sticky inflation rate in the euro area (core inflation is still not moving downwards and remains on a very high level, higher Spanish inflation dates for January may just be a wake-up call), and finally the improved euro area growth outlook. We no longer expect a winter recession and have increased our 2023 growth rate forecast to 0.7%.

Accordingly, we see upside potential for the priced ECB rate path. Usually, financial markets price a peak rate above the eventual outcome. As we look for a peak rate of 3.5% we see leeway for ECB peak pricing to rise to around 3.7% (from 3.4% currently). What is more, strong key rate cuts in 2024 are rather unlikely as according to our forecast inflation

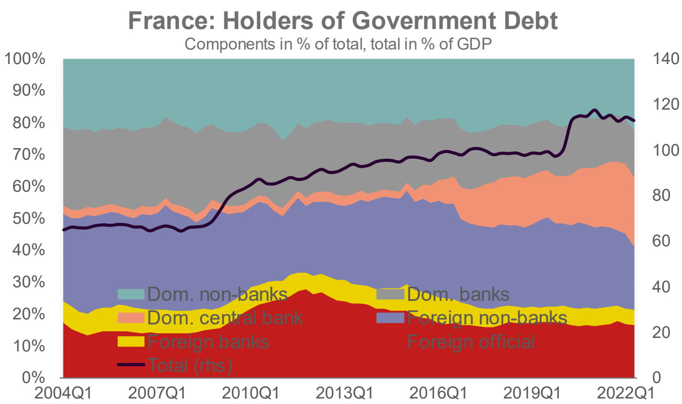
Government Bonds



Source: Bloomberg, GIAM



ource:Bloomberg, GIAM



Source: IMF, GIAM calculations

is seen to return to the ECB target only in 2026 amid sticky core inflation. Accordingly, we see some scope for Bund yields to rise and to remain on an elevated level also on a 1-year horizon.

The situation in the US is less straight. Although 10-year Treasury yields are meanwhile well below the peak of 4.25% and incoming data surprised on balance on the downside (e.g. the services PMI reached contractionary territory which usually triggers a strong decrease in yields), some factors are likely to weaken the downward trend.

Financial markets expect the Fed to stall the key rate cycle below 5% and forecast a key rate below 4.5% (upper bound) by the end of 2023. On the contrary, we forecast a peak of 5.25% and only 50 bps cut until the end of 2023. This is all the more true as financial conditions have eased since October, which is not conducive to an early end of the cycle. Moreover, the US term premium has come down significantly since November. While a decreasing lower volatility has contributed to the drop of the term premium the decline seems somewhat exaggerated and a normalisation would bring upward pressure on US yields. We forecast 10-year US yields to reach 3.20% on a 1-year horizon.

Good sentiment for non-core bonds appears deceptive

EA non-core government bond spreads have continued the downtrend and have now reached multi-month lows. However, we regard the current sentiment as fragile and expect spreads to widen going forward.

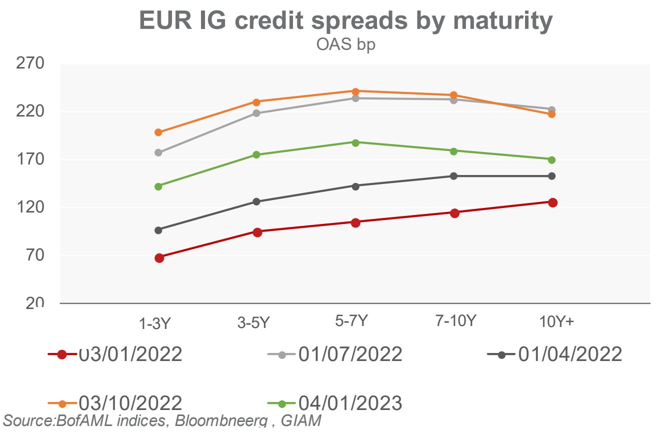
Even in case issuance will be lower than currently expected as lower energy prices and a more benign growth environment reduces the fiscal burden net-net government bond issuance will still rise to a record level in 2023. The ECB will provide more details concerning its QT at its February meeting. Will the ECB stick to the countries' capital keys? What will be the pace of QT? Will the central bank smooth QT? Will ECB President Lagarde give any hints regarding H2? However, regardless of the details issuance activity will have to accelerate soon after a calm start into 2023. We see particularly Italy, France, and Spain at risk given the demanding issuance programme.

Another factor will gain importance in 2023. Japanese investors were reliable buyers of EA non-core government bonds in the past. However, the turnaround in Japanese monetary policy is likely to continue and already in 2022 Japan has started to withdraw portfolio investments from abroad. With JGB yields rising, this trend is likely to continue and will burden EA non-core government bonds.

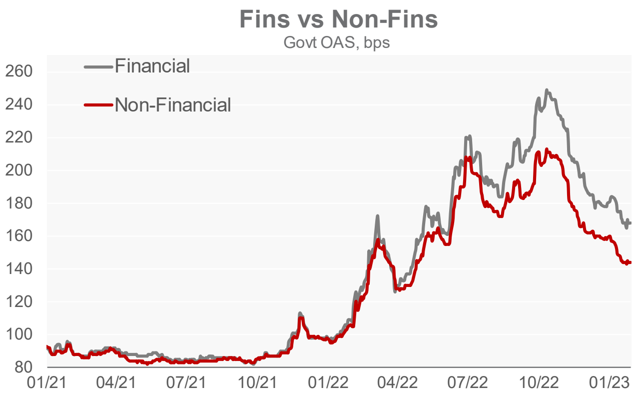
All in, we see non-core but also semi-core bond spreads to widen moderately over the course of 2023.

Credit

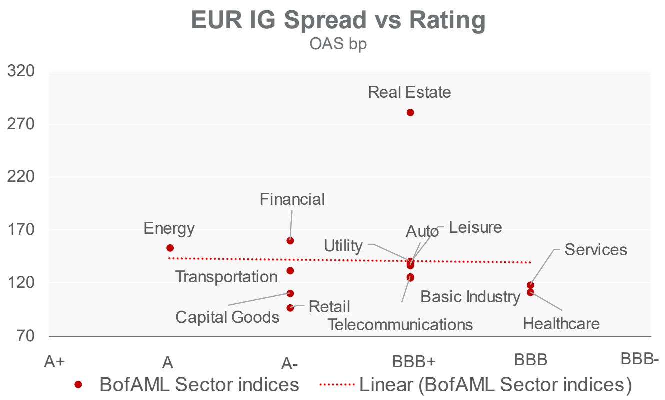
Elisa Belgacem



Source:BofAML indices, Bloombneerg , GIAM



Source:Bloomberg, BofAML Indices, GIAM



Source:Bloomberg, BofAML indices, GIAM own calculations

- **Diminishing tail risks have pushed credit spreads substantially tighter, especially in the CDS space, also leading to record-high primary issuances.**
- **We maintain our preference for high quality Credit, especially after the recent HY rally which looks prone for a reversal. Current CDS levels are attractive to buying credit protection.**
- **We like IG duration even though curves are already very flat. We maintain our preference for subordination versus pure credit risk and our neutral stance on financials versus non-financials.**

2022 was the worst year in history for EUR IG total return performance, allowing 2023 to start on more attractive levels. Consequently, flows are positive in January so far, supporting the rally. Valuations metrics among the credit universe show that the European IG space is the cheapest compared to US IG and both EU and US HY. Technicals should be relatively neutral in EUR IG, with QT acting as a negative in the first half of 2023, but supply should also be limited, especially in non-financials. Rates volatility will stabilise, which will support long IG as well as subordination risk embedding call optionality.

Climate premium to increase further in credit valuations

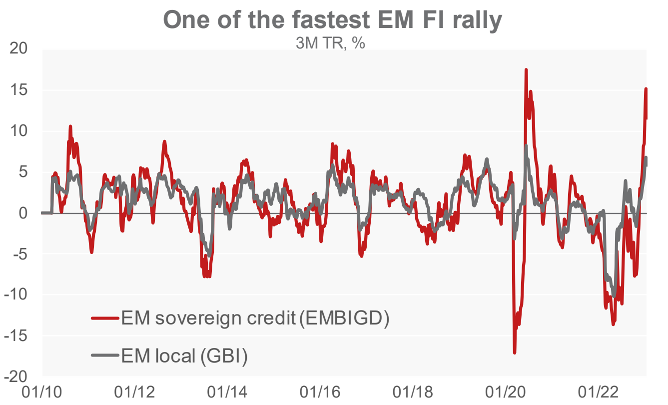
The ECB started in 2022 to tilt its corporate purchases according to climate criteria. With quantitative tightening fast approaching, the market impact initially envisaged was limited. Hence the ECB is now considering applying it also to its holdings. That means that the ECB could start selling some of their bonds holdings to improve the climate score of its portfolio. As most private investors are concomitantly attempting to enhance their portfolio's carbon footprint, we expect the "E" component of the ESG scores to further feed into credit market valuations, mainly in the most polluting sectors (Energy, Utilities).

Prefer long IG and subordination risk to pure HY

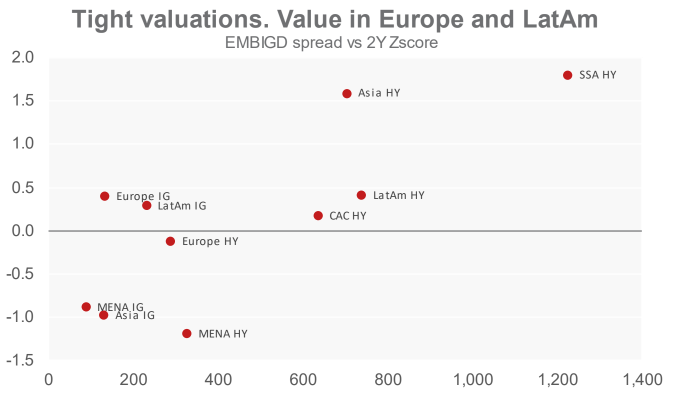
Overall, we prefer IG to semi-core and peripheral sovereigns, and Europe to the US on valuation grounds. In Europe, IG levels are still attractive after the rally versus historical standards. We expect spreads to trade around current levels over the course of next year. For HY, we think that current valuations do not reflect elevated risks. Consequently, we expect spreads should widen nearly 100bp in the first half of 2023 before ending the year 50 -60p wider compared to current levels. CDS have tightened much faster than cash, and we like to buy credit protection here.

EM sovereign bonds

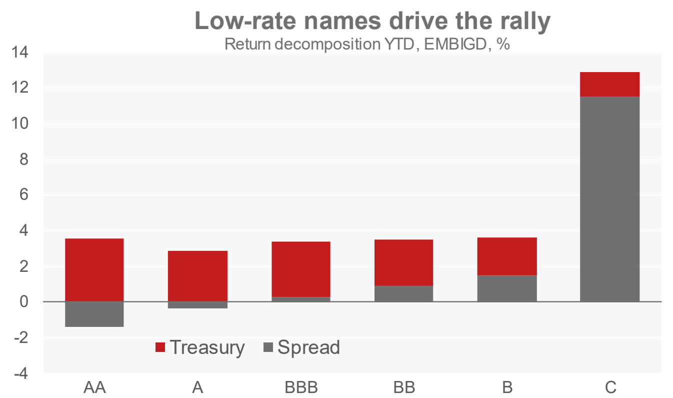
Guillaume Tresca



Source: Bloomberg, JP, GIAM



Source: Bloomberg, JP, GIAM



Source: JP, Bloomberg, GIAM

- **The surprising rapid Chinese reopening boosts the EM environment that faces a rare combo of positive factors.**
- **We maintain our positive stance on EM debt, even if the recent rally has been too rapid. A consolidation is likely, and we still expect EM spreads to widen by year-end on economic slowdown.**
- **Total return will remain positive. We maintain our preference for EM IG over HY. There is value in LatAm and Europe IG.**

The EM outlook has kept improving with the surprising rapid reopening of China, the peaking of the US dollar and the decline of recession risks in Europe and the US. Technicals have also been positive, with UW and long cash positions. The EM macro environment has also improved as EM inflation confirms its decline, especially in LatAm, while EM central banks are close to finishing their tightening cycle. It has been a while since the EM environment has not been supportive, and it has led us to maintain an OW stance in our global asset allocation. That said, everything is not rosy, and markets have likely gotten carried away. Indeed, the three-month EM rally across EM fixed-income is the fiercest for the past two decades, and a consolidation period is likely. We are still an environment where the Fed tightened by 425bp within a year, and EM balance sheets exited the pandemic in a weaker state. We remain of the view that large EMs exhibit sound macro and financial metrics. However, we should see more defaults across small and fragile EMs but without systemic contagion.

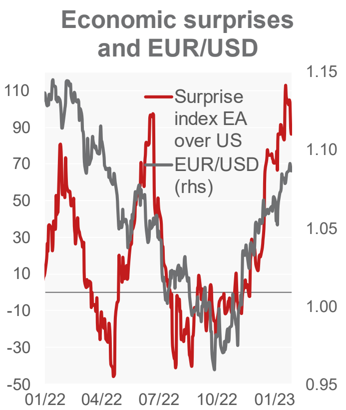
Tight valuation and focus on IG

There is more risk for wider EM spreads this year as activity will slow down and valuations are very rich. It is worth highlighting that EM spreads hardly tightened year-to-date and even underperformed US credit despite a supportive environment. It remains that absolute yields are very attractive, close to 2009 levels. Positive duration effect and carry will more than offset the negative spread effect in the medium term.

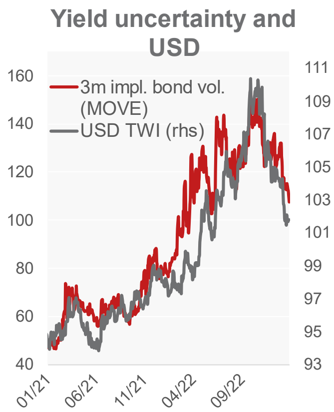
We continue to favour EM IG over HY. Within EM IG, we see most of the value in LatAm IG and Europe IG. Chile can benefit from the Chinese reopening, Mexico from the near-shoring. In Europe, Croatia has just joined the EUR and could attract new crossover funds 'flows. EM HY has been outperforming, with the weakest names driving the year-to-date rally. A lot of the recovery trade has been priced in, and we will only focus on quality BB names. Given cyclical risks, it is too risky to focus on lower-rated names.

Currencies

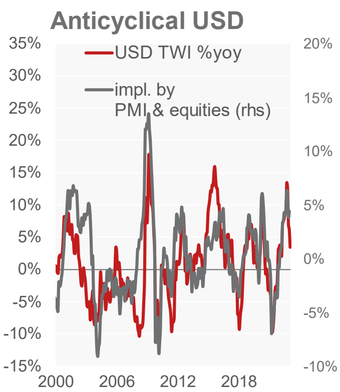
Thomas Hempell



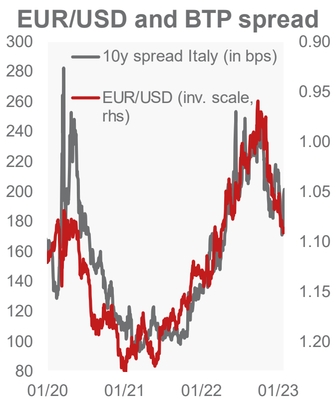
Source: Citi, Datastream, GIAM calculations



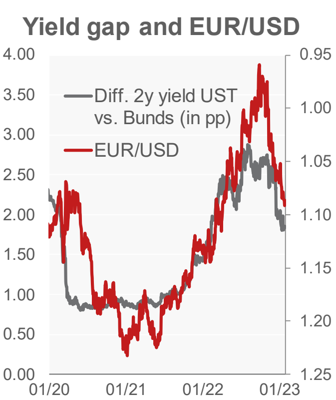
Source: Datastream, GIAM calculations



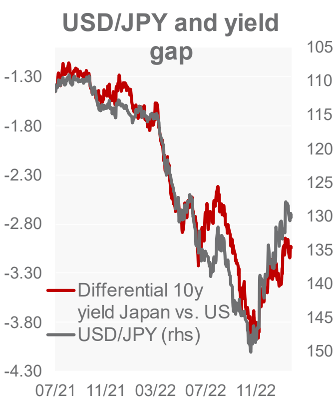
Source: Datastream, GIAM calculations;model 2000-19 based on MSCI World %yoy and global man. PMI



Source: Datastream, GIAM calculations



Source: Datastream,



Source: Datastream, GIAM calculations

- **There is more USD downside looming amid easing yield uncertainty and a less favourable US outlook.**
- **The EUR rebound will be supported by China's recovery boost and strengthened hawks at the ECB. The JPY will benefit from looming relaxation of yield curve control (YCC) by the BoJ.**
- **Short-term however, we see more two-sided risks as cracks in the risk rally may help the USD while EGB spreads are already (too) tight.**

The recent USD decline still has legs over the next quarters. Inflation has peaked and even as the path lower will be sluggish, falling rates uncertainty will further erode the dollar's safe haven appeal (top right chart). Last year's USD boost from the Fed's lead in the global tightening cycle will turn into a headwind as the economic damage to the US economy unfolds and later in the year the Fed is set to take the lead in cutting rates from high levels.

The dollar's decline will be matched by mounting FX support in Europe and Japan. Thanks to warm weather and an efficient policy response, Europe has foregone a much feared energy crunch and now seems set to avoid recession, while the US outlook is deteriorating (top left). The spring revival in reopening China will support European exports, while capital inflows into Europe will resume. This will spur the hawks at the ECB, where we see the risks tilted to stronger rate hikes than markets are pricing (see Euro Area section). Fundamentally, the USD is still dear and the EUR cheap, also vs. prevailing yield gaps (bottom left). We upgrade our year-end EUR/USD target from 1.10 to 1.15.

More USD downside – but mind short-term risks

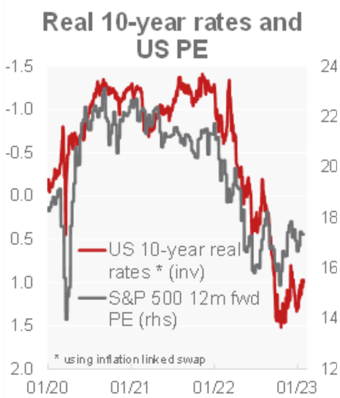
Short-term risks are more balanced, though. USD's losses have been boosted by rebounding global risk sentiment (mid left), which we deem shaky. Similarly, we are worried that markets have become complacent about EMU debt – a renewed rise in peripheral spreads would also weigh on the EUR (mid right). There may be more appealing entry points for benefitting from the structural EUR/USD rally.

The yen's rise is also unfinished. The JPY has posted significant gains since the BoJ widened its YCC corridor in December. While the Bank pushed back against market speculations about a relaxation or even scrappage of YCC, the genius is out of the bottle. We expect the new BoJ governor (who will take office in April) to prepare the ground for further policy normalisation. Admittedly, the yen's bounce is already anticipating some of this (bottom right). Yet the risks are tilted towards a more abrupt end to YCC as the Australian 2021 experience showed. An easing energy bill (curbing Japan's wide trade deficit) and lower US yields will complement tailwinds for the still deeply undervalued JPY.

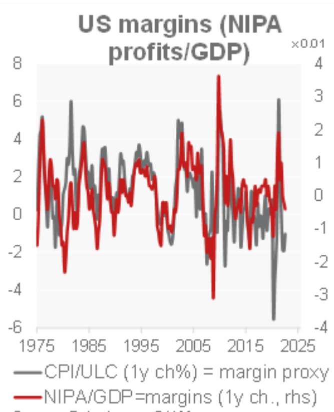
Equities

Michele Morganti, Vladimir Oleinikov

Source: Datastream, GIAM

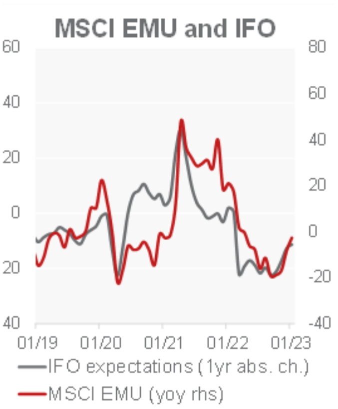


Source: Datastream, GIAM calculations

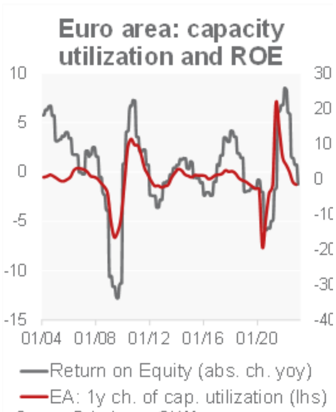


Source: Datastream, GIAM

Source: Datastream, GIAM



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

- **Markets are playing goldilocks as inflation is peaking and ex-US macro data improve. Low VIX, positioning plus China new policy add to the positives.**
- **Short term, though, earnings downgrade will linger, as testified by the Q4 reporting season. Bottoming macro indicators in the EU and weakening USD and US unit-labour costs will help, but not immediately.**
- **Valuations remain in an uncomfortable zone, too, and monetary tightening will continue to hurt. Earnings revisions should bottom only in mid-2023. The 3-month market performance is also at a cyclical high.**
- **We acknowledge the new supporting factors and expect equities to generate positive returns in 2023, with multiples likely to improve as we get closer to a Fed cut later this year. That said, we will look for better entry levels once the slowdown and further policy tightening are fully priced in.**
- **Sector overweights: Banks, Utilities, Div. Financials, Food, HC equip., Transportation, Capital Goods, durables and Software. Underweights: Comm. Prof. Services, Telecoms, Pharma, Media and Retailing.**

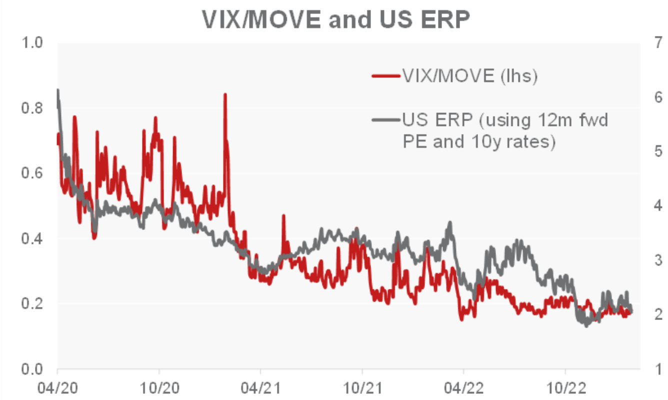
Markets are playing an inversion of stagflation mood, where inflation is peaking and the cycle in the euro area (EA) gives signs of bottoming. China reopenings, still low investors' positioning and subdued equity volatility (VIX) vs. bonds' one (MOVE index) are helping, too.

Still, we expect earnings to be downgraded in the short term. The US ISM and the leading index are pointing south, together with capacity utilization (and a still extremely inverted US yield curve). Weak world's GDP trend should also further limit sales growth in the next months.

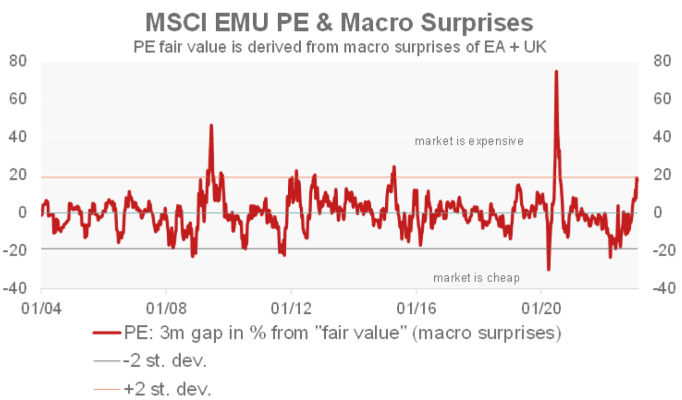
On this topic, the Q4 earnings season has started, and 145 US firms have reported so far (30% of S&P500), showing first signs of a recession pain. They show a negative annual earnings growth of -0.3% vs 0.1% in Q3 2022, when a similar number of companies published results. Likewise, sales have become weaker (+5.8% vs +9.9% in Q3) and margins overall have deteriorated, too. Expectations for both earnings and revenues in Q4 were beaten but less than in the previous quarter (2.1% vs 2.3% for earnings and 0.9% vs 1.3% for sales). Firms' preannouncements worsened as well, both vs Q3 and Q4 2021. Consensus earnings expectations for Q4 2022 fell and are currently at -3.0% yoy for the S&P500 as compared to +10.6% in July 2022.

A weaker USD and bottoming CPI/ULC (unit-labour costs, a proxy for margin momentum) are getting supportive for US firms' profitability but they are not likely to offset the effects

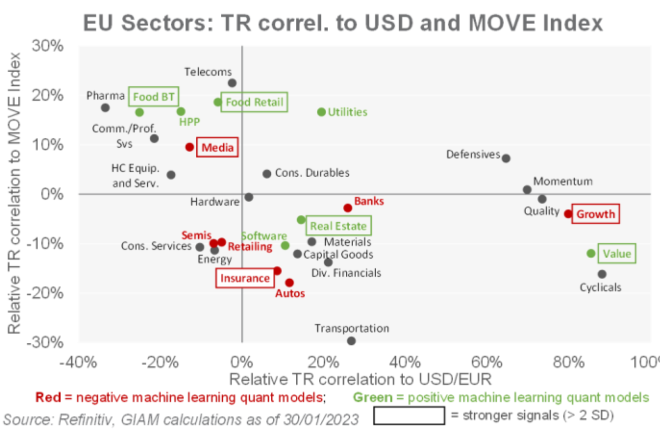
Equities



Source: Datastream, GIAM calculations



Source: Datastream, GIAM



Source: Refinitiv, GIAM calculations as of 30/01/2023

of the weakening economy, yet. Earnings downgrades and further monetary restrictions are to weigh on US stock market performance in the near term, net of the positive low positioning. The EA economy is currently more resilient, but an increasingly stronger euro should weaken its relative earnings' strength vs. the US one, soon. EA's capacity utilization momentum is also weakening, and the firms' ROE should stabilize but at a lower level than current one.

Why we remain cautious: Slightly UW equities

We see some risks ahead. Firstly, EMU's 3-month variations are at the top of the cycle, and on a short-term horizon, the 1-year forward PE is fully discounting (+2SD) the stellar EA macro surprise momentum. Furthermore, the Ukrainian war gives no signs of abating. Thirdly, while there are chances for the economic cycle to be bottoming in the ex-US world, valuations show signs of exuberance when one considers current price earnings versus the level of 10-year real rates or BAA credit spread. But most importantly, central banks remain hawkish overall, notwithstanding a peaking inflation (strong labour markets, resilient economies plus improved financial conditions). Further rate increases plus an ongoing QT could have negative consequences on credit conditions, the economic cycle and equity valuations.

In sum, we acknowledge the cited positives and expect equities to generate positive returns in 2023, with multiples likely to improve as we get closer to a Fed cut later this year. That said, we will look for better entry levels once the slowdown and further policy tightening are fully priced in.

Recommended allocation

Within countries we reduce the OW EMU vs US. Higher OW is on UK, Japan and China. EU Sectors: we play an underweight in Pharma vs. Utilities (new), based on relative earnings revisions, machine learning model's fair value momentum, correlation to USD and CPI surprise momentum. OW: Banks, Cap. Goods, Durables, Div. Financials, Food Retail, Healthcare Equipment, Software and Utilities. UW: Comm. Prof. Services, Media, Energy, Telecoms and Pharma.

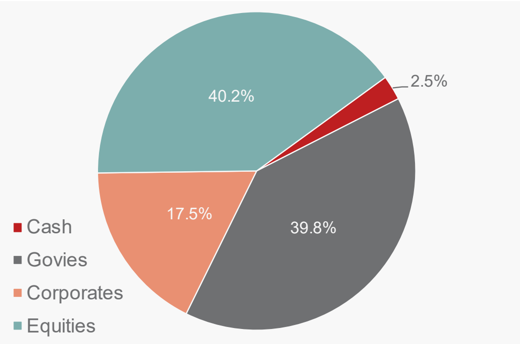
EM equities: to benefit from upturn in China's cycle

EM earnings have been decreasing due to weakening global economy. This is likely to change as China's economy is set to see growth recovery in 2023 due to post-covid reopenings and supportive policy (including the government one for the real estate). EM exports in volumes are slowly stabilizing and EM earnings revisions as well valuations relative to DMs have been steadily improving, finally getting positive. A weakening US dollar represents another positive factor.

Asset Allocation

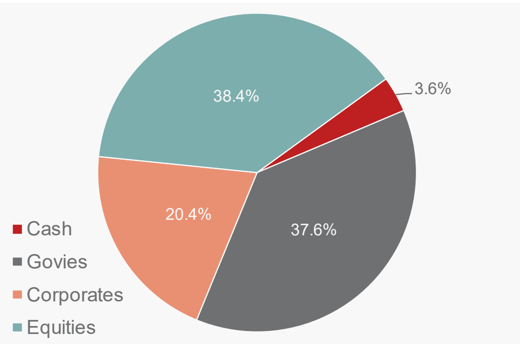
Thorsten Runde

Benchmark



Source: GIAM

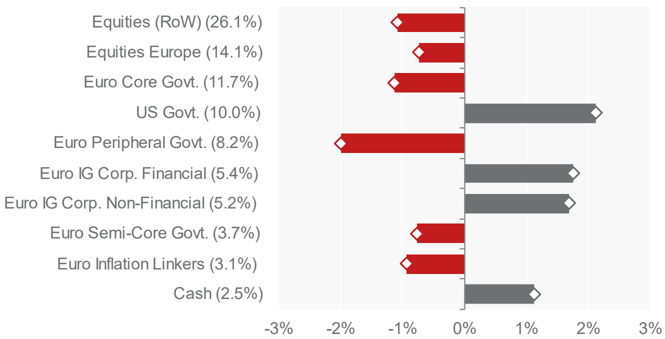
Modelportfolio



Source: GIAM

Active Positions

TOP 10 Benchmark Constituents



Source: GIAM; Benchmark weights in parentheses, diamonds indicating previousrecommendations

- **In January (27.01.23), the returns of all actively covered asset classes once more clearly remained in positive territory.**
- **With +9.9% and +8.4% respectively, EMU and EM Equities are at the top of the performance ranking, followed by North- American Equities (+6.3%), long-dated BTPs (+5.9%), and US-Treasuries (+5.7%).**
- **The lower end of the performance spectrum is dominated by Cash and short-dated fixed income asset classes.**
- **With +1.9% IG Fin revealed the worst performance in the credit section, underperforming IG non-Fin by 46 bps and HY by even 133 bps.**
- **We consider global growth headwinds still unfolding thus weighing on risk assets. US yields have passed their peak among a weakening economic momentum. In the euro area yields might rise a bit further, with peripheral debt most exposed. However, EA IG Credit still provides an attractive carry.**
- **We stick to our small underweight in Equities and EA HY. We overweight EA IG Credit and US Treasuries. Moreover, we underweight peripheral debt.**

With around -13 bps the relative performance of our model portfolio was again negative in January (27.01.23). The underweight positions in short- to medium-dated Italian BTPs and Spanish Bonos proved most rewarding with +3.7 bps and +1.9 bps respectively. With -7 bps the overweight in EA IG Credit has been most painful, followed by the overweights in Equities (-5.6 bps) and short- to medium-dated US-Treasuries as well as Cash (-4.6 bps each).

The Performance particularly suffered in the first half of the month where the strong performance of Equities and long-dated fixed income segments turned everything else into significant underperformers.

Stay on the side lines

Despite the recent benefitting factors (e.g. resilient data in Europe, China reopening) for risk sentiment, we consider global growth headwinds still unfolding and thus stick to our small UW in Equities and EA HY. The outlook for US yields is to the downside amid a Fed expected to start easing in Q4 and weak growth. Thus, we confirm our OW in US Treasuries. In the euro area signs point to further upside for Bunds. However, we stay OW in EA IG Credit due to its attractive carry. All in, we favour a rather neutral duration stance with a preference for medium maturities.

Forecasts

Macro Data

Growth[1]	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	5.9	2.0	0.1	0.6	0.3	1.2
Euro area	5.3	3.3	0.1	0.7	0.7	1.2
Germany	2.6	1.7	0.0	0.1	0.6	0.8
France	6.8	2.5	0.0	0.4	0.2	1.0
Italy	6.7	3.9	0.2	0.2	0.2	1.1
Non-EMU	6.6	3.7	- 0.1	- 0.4	0.2	0.8
UK	7.6	4.2	- 0.2	- 0.9	0.1	0.3
Switzerland	4.2	2.5	0.4	1.5	1.0	1.7
Japan	2.2	1.2	- 0.3	1.1	- 0.1	1.3
Asia ex Japan	7.8	4.1	- 0.1	5.2	0.7	4.8
China	8.1	3.0	- 0.1	5.7	1.1	5.0
CEE	6.6	1.7	0.5	0.4	0.8	3.1
Latin America	6.5	3.6	0.0	0.9	0.0	1.7
World	**6.5**	**3.3**	**0.0**	**2.4**	**0.5**	**2.8**

1) Regional and world aggregates revised to 2020 IMF PPP weights

Inflation[1]	2021	2022 forecast	2022 Δ vs. cons.	2023 forecast	2023 Δ vs. cons.	2024 forecast
US	4.7	8.0	- 0.1	4.5	0.7	2.6
Euro area	2.6	8.4	- 0.1	5.5	- 0.4	2.5
Germany	3.2	8.6	0.3	6.5	0.1	2.7
France	2.1	5.9	0.4	4.2	- 0.6	2.4
Italy	2.0	8.7	0.4	6.4	- 0.2	0.6
Non-EMU	2.3	8.0	0.0	6.1	- 0.1	2.3
UK	2.6	9.1	0.1	7.0	- 0.2	2.6
Switzerland	0.6	2.9	0.0	2.2	0.0	1.2
Japan	- 0.2	2.5	0.1	2.5	0.6	1.5
Asia ex Japan	2.0	3.5	- 0.1	3.6	0.5	2.9
China	0.9	1.9	- 0.2	2.6	0.3	2.4
CEE	9.3	29.6	0.3	17.8	- 0.2	8.2
Latin America[2]	6.6	7.8	1.1	5.0	0.7	4.0
World	**3.5**	**7.8**	**0.0**	**5.5**	**0.3**	**3.3**

1) Regional and world aggregates revised to 2020 IMF PPP weights ; 2) Ex Argentina and Venezuela

Financial Markets

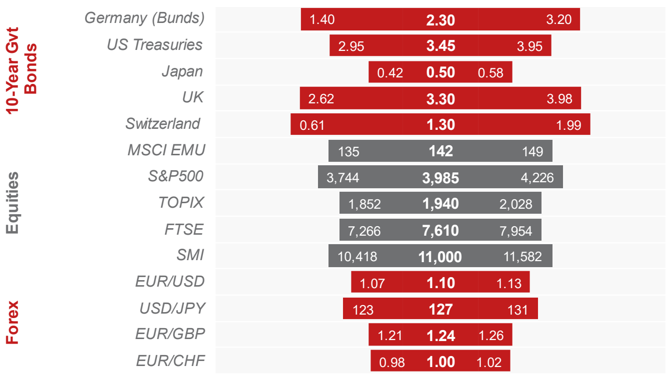
Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US	4.50	5.25	4.88	5.25	4.81	4.75	3.86
Euro area	2.00	3.00	3.01	3.50	3.31	3.50	3.00
Japan	-0.10	-0.10	0.03	-0.10	0.10	0.00	0.21
UK	3.50	4.00	4.26	4.00	4.39	4.00	3.85
Switzerland	1.00	1.50	1.32	1.50	1.49	1.50	1.37
10-Year Gvt Bonds							
US Treasuries	3.49	3.45	3.47	3.40	3.44	3.20	3.41
Germany (Bunds)	2.21	2.30	2.20	2.30	2.19	2.35	2.17
Italy	4.03	4.30	4.05	4.35	4.08	4.55	4.14
Spread vs Bunds	182	200	185	205	189	220	197
France	2.66	2.80	2.69	2.80	2.70	2.90	2.74
Spread vs Bunds	46	50	49	50	51	55	57
Japan	0.46	0.50	0.54	0.70	0.59	0.90	0.70
UK	3.30	3.30	3.35	3.25	3.37	3.20	3.41
Switzerland	1.21	1.30	1.21	1.30	1.22	1.35	1.23

**3-day avg. as of 27/01/23*
***ICE BofA (OAS)*

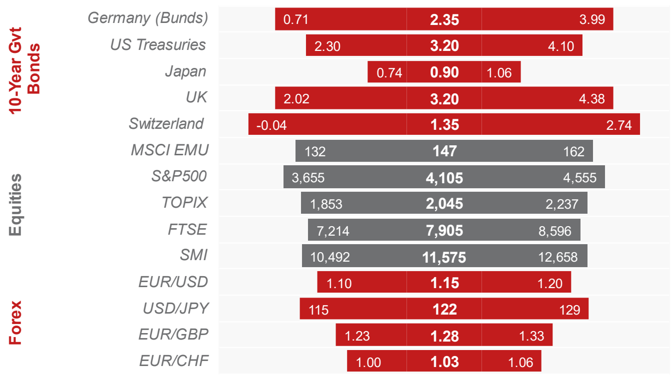
Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	142	155		160		145	
EA IG Financial	163	175		190		170	
EA HY	441	500		550		500	
EM Sov. (in USD)	337	355		365		370	
Forex							
EUR/USD	1.09	1.10	1.09	1.13	1.10	1.15	1.11
USD/JPY	130	127	128	125	127	122	123
EUR/JPY	141	140	140	141	139	140	137
GBP/USD	1.24	1.24	1.24	1.27	1.24	1.28	1.24
EUR/GBP	0.88	0.89	0.88	0.89	0.89	0.90	0.89
EUR/CHF	1.00	1.00	1.00	1.01	0.99	1.03	0.98
Equities							
S&P500	4,049	3,985		4,025		4,105	
MSCI EMU	144.2	142.0		142.0		147.0	
TOPIX	1,981	1,940		198		2,045	
FTSE	7,757	7,610		771		7,905	
SMI	11,352	11,000		11,155		11,575	

Forecast Intervals

3-Months Horizon*



12-Months Horizon*



**Forecast ranges of ±1 stdv. centred around point forecasts; based on historical volatilities; length of bars indicative only*

Imprint

Issued by: **Generali Insurance Asset Management S.p.A. Società di gestione del risparmio | Research Department**

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. Martin Pohl | GI CEE Economist
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

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."