GENERALI INVESTMENTS

Market Compass

May 2022

MARKET OUTLOOK

- Escalation risks of the Russian war in Ukraine, looming cuts in EU energy supply and the fallout of China's zero-Covid strategy are continued headwinds for the economy and risk assets.
- Complacent on inflation for too long, the Fed is rushing into sizeable rate hikes while ECB officials are considering a hasty lift-off as soon as July.
- Further upside for yields is more limited as global inflation is near peak and markets already discount a (too) long series of aggressive rate hikes.
- We keep a mild underweight on equities. Credit offers a juicy carry, but we prefer safer segments in Investment Grade (IG).

Edited by

MACRO & MARKET RESEARCH TEAM

A team of 13 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.

US

- (+) Net export dragged down Q1 GDP, but domestic demand remains healthy…
- (+) …as strong labour income offsets the hit of inflation on consumption
- (−) Inflation is probably peaking but will decrease very slowly
- (!) The Fed is set to raise rates fast over the next months, increasing the risks to growth in 2023

UK

- (−) BoE raised key rate to 1.0%
- (−) Consumption suffers from «cost of living» crisis
- (−) Inflation surged to 7% YoY

EUROZONE

- (−) War in Ukraine drags sentiment, expectations and boosts inflation
- (−) Risk that ECB is forced into earlier tightening rose
- (+) Composite PMI advanced in April
- (+) Mitigating policy measures against high energy prices

CHINA

- (−) China suffers from Covid lockdowns
- (−) PMIs fell deeper into contractionary territory
- (+) Monetary and fiscal will be stepped up

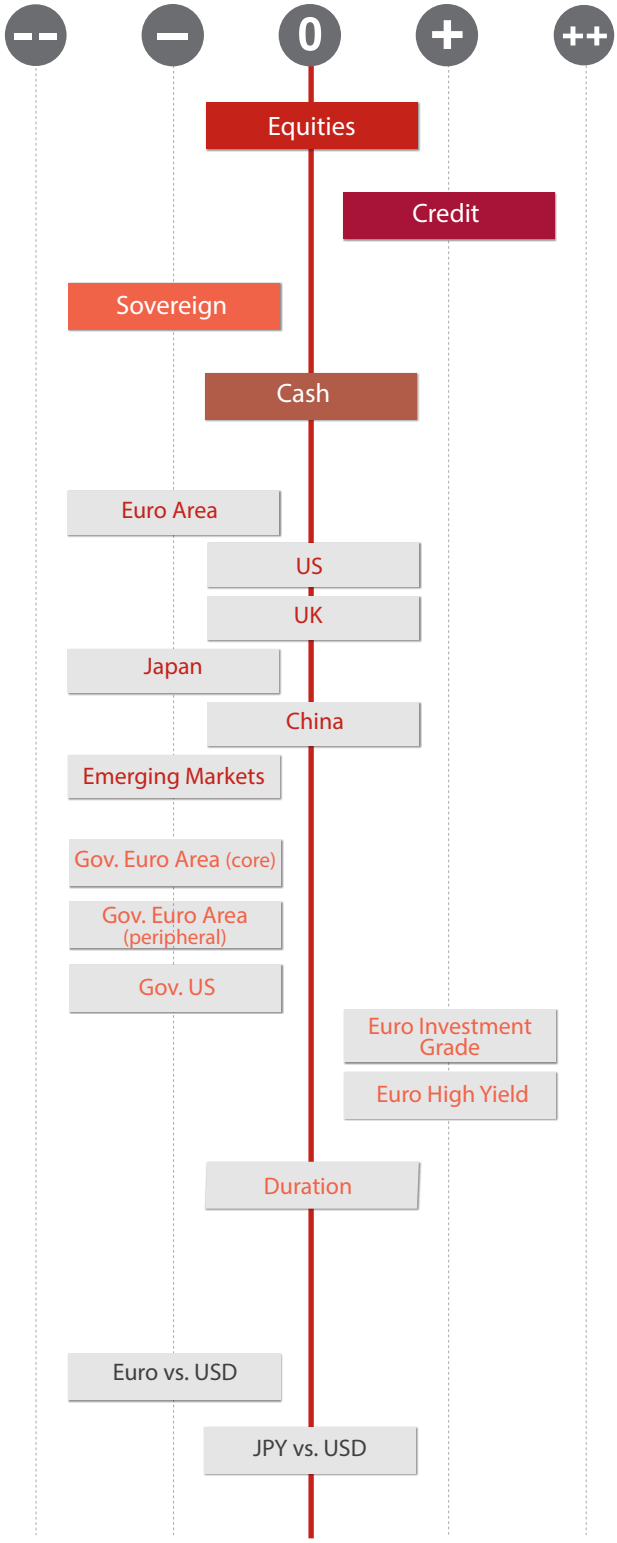
EMERGING MARKETS

- (−) EM assets underperformed in the wake of a more hawkish Fed and growth concerns
- (!) LatAm is so far the least vulnerable region but it faces a busy electoral cycle
- (−) EM growth will likely be on par with DM growth in Q2
- (+) Russia keeps paying its external debt but technical default is still looming

(+) Positive
(−) Negative
(!) Topics to watch

DIRECTION OF TRAVEL

- Moderate underweight (UW) in equity as buying the dip is too risky
- Sizeable overweight (OW) in credit, focus on IG and defensive sectors
- Within credit, prefer financials to non-financials and subordinated bonds to pure high yield (HY) and hybrids
- Keep UW in sovereign bonds, especially long-dated
- Small cash OW



Equities

- Pressure on PEs and negative earnings revisions due to fears of a GDP slowdown and hawkish central banks.
- Short term, we maintain a slight UW position in equities but see potential positive total returns in 6-12 months of ca. 6%.
- We favour US and UK vs EMU, to be more defensive and guarding against a slowdown.

Bonds

- Sell-off in government bond markets likely to lose momentum going forward.
- Transatlantic yield spread to tighten as markets got ahead of themselves regarding future Fed hikes.
- EA non-core bond spreads to remain under pressure amid less ECB support and a weakening growth outlook.
- We continue to prefer corporate IG, especially financials.

Duration

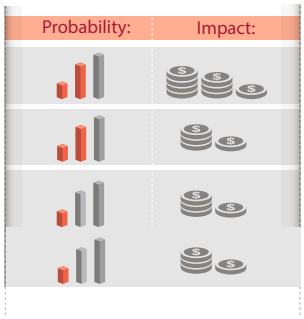
- Moderately short duration.

Currencies

- Geopolitical worries and rates uncertainty will continue to support the USD near term.
- EUR/USD is trading at a heavy discount, though, leaving scope for recovery once war tensions start to ease.
- The BoJ keeps refrains from tightening, leaving the fate of the yen at the mercy of US yields

TOPICS TO WATCH!

- Military escalation of Russian war and sanctions trigger gas supply disruptions in Europe
- Faster withdrawal of policy support hurts risk appetite and precipitates a slowdown
- Mutations challenging vaccine effectiveness and requiring new shutdowns
- Further sources of Geopolitical tensions (China/Taiwan, N. Korea)



Probability: High ⟷ Low

Impact: High ⟷ Low

SPECIAL FOCUS

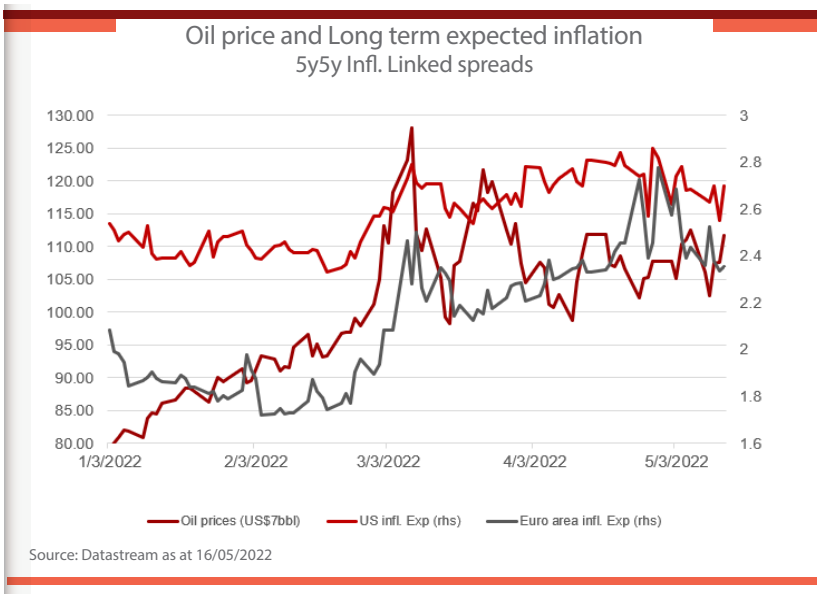
Central banks prioritise inflation fight to risks for growth- for now

In a painful month for bonds and equities alike, rising inflation and hawkish central banks sent yields soaring while geopolitical and growth worries drove risk premia up.

Global equities suffered their biggest monthly setback since the pandemic sell-off in March 2020. Caution is set to prevail among investors. The conflict is morphing into an attrition war, thrashing hopes of a quick negotiated solution. Sanctions on Russian energy exports are set to be extended to oil, while Russia may cut gas export to the EU; all this will keep tilting risks for energy prices up.

Lockdowns due to China's increasingly desperate zero-Covid strategy are weighing on global growth while risking renewed supply chain disruptions and price increases. Persistent inflation overshoots keep the hawks in the driving seat at central banks – at least for now as inflation credentials are prioritised over growth concerns.

The Fed is set to front-load its hiking cycle, with another 50 bps rate increase likely in June, after the one just implemented in May.



Source: Datastream as at 16/05/2022

We also see mounting risks that the ECB will bring its rates lift-off forward to as early as July. Further out, however, the fragility of the recovery and markets alike may ultimately make the Fed and the ECB tread more carefully.

Markets seem complacent on the growth risks: our forecasts are below consensus. With US rate hike expectations priced by summer 2023 looking excessive, we only see moderate further upside for yields from here.

Despite the gloomy sentiment, equities positioning is not aggressively defensive, as a shift into bonds is not appealing amid persistent inflation worries. This keeps us tactically underweight, most so in cyclicals and the Euro Area. We see residual value in Credit due to the attractive carry and spreads, but we favour defensive segments. USD strength is stretched but may extend short term amid persisting war concerns in Europe and a strikingly dovish BoJ eroding the yen.

GLOSSARY

INFLATION-LINKED BONDS

Inflation-linked bonds, or ILBs, are securities designed to help protect investors from inflation. Primarily issued by sovereign governments, such as the U.S. and the UK, ILBs are indexed to inflation so that the principal and interest payments rise and fall with the rate of inflation. Inflation can significantly erode investors' purchasing power, and ILBs can potentially provide protection from inflation's effects. Inflation-linked bonds are designed to help protect investors from the negative impact of inflation by contractually linking the bonds' principal and interest payments to a nationally recognized inflation measure such as the Retail Price Index (RPI) in the UK, the European Harmonised Index of Consumer Prices (HICP) ex-tobacco in Europe, and the Consumer Price Index (CPI) in the U.S.

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