GENERALI INVESTMENTS

Market Compass

February 2023

MARKET OUTLOOK

- With the energy crunch easing and China heading for a reopening bounce, the euro area will likely escape a widely anticipated winter recession.
- Yet the Fed's fast monetary tightening will take its toll on a shallow US mid-year recession.
- These divergent shifts in the macro outlook support a tighter transatlantic yield spread, a slight preference for Euro Area 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 signals of exuberance. Euro area IG Credit still looks attractive.

Edited by

MACRO & MARKET RESEARCH TEAM

A team of 13 analysts based in Paris, Cologne, 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

- (−) Domestic demand declined in Q4 (below 1% growth in 2023)...
- (+) …but confidence may have bottomed up
- (+) More signals of gradually cooling inflation
- (+) The Fed will likely end tightening by Q2

UK

- (−) CPI surprised on the upside with 11.1% yoy
- (−) PMIs in contractionary territory but slightly better than expected
- (−) GDP shrank by 0.2% qoq in the three months ending in November
- (!) Fiscal tightening to reach 2.3% of GDP, but mainly backloaded

EUROZONE

- (+) Data for Q4/22 surprised to the upside
- (+) Indicators suggest that a recession can be avoided
- (−) ECB raised rates by 50bps and will continue hiking rates and shrink the balance sheet
- (+) Labour market stays strong and inflation recedes markedly

CHINA

- (+) China reopening accelerates…
- (−) … but the economy to suffer from lockdowns and bad «mood»
- (+) PBoC cut reserve requirement ratio by 25 bps

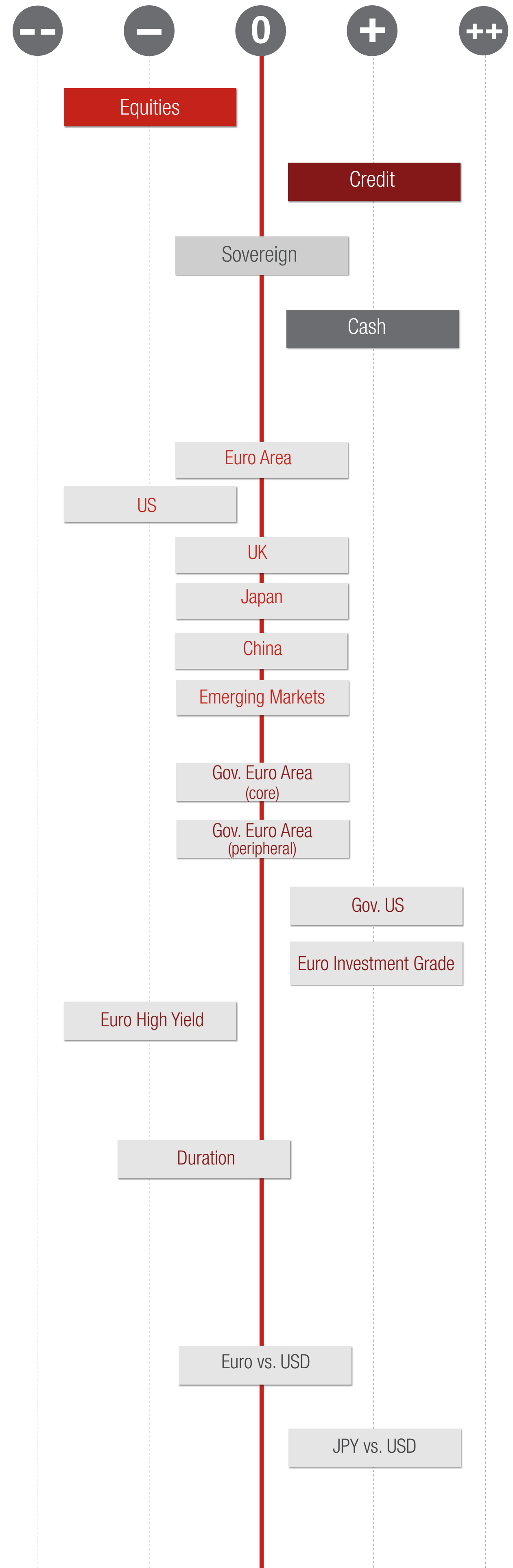
EMERGING MARKETS (EM)

- (+) EM narrative continues to improve
- (+) EM Inflation decelerates further, rate hikes to end

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

DIRECTION OF TRAVEL

- Small underweight (UW) in Equities
- Keep overweight (OW) in Investment Grade (IG) Credit and move EM bonds to OW
- High Yield (HY) remains unattractive
- Marginal UW on sovereign, continue to prefer US over Euro Area
- Reduce cash OW



Equities

- We acknowledge recent positives (peak inflation, better macro ex-US, low vol and positioning plus China reopenings) and see positive total return in 2023, with multiples improving as we get closer to a Fed cut in Q4.
- That said, we will look for better entry levels once the slowdown and further policy tightening are fully priced in.

Bonds

- A decrease in Euro Area (EA) core yields is unlikely to last amid a hawkish ECB and a better growth outlook. The decline in US yields is seen to lose momentum, but to continue.
- Sentiment for EA non-core bonds appears fragile as ECB's quantitative tightening will burden and support from Japanese investors will decline.

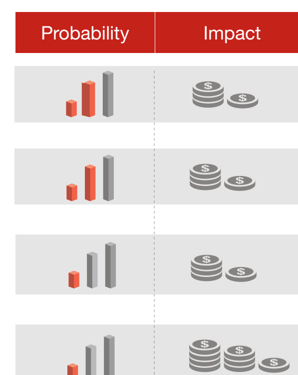
Duration

- Marginally short duration, preference for medium maturities.

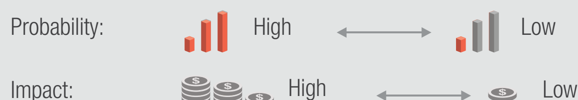
Currencies

- More USD downside is looming amid easing yield uncertainty and a weaker US outlook.
- A hawkish ECB and China's recovery support EUR. JPY will benefit from a likely relaxation of the BoJ's yield curve control.
- Short-term, however, we see more two-sided risks as cracks in the equity rally may help the USD.

TOPICS TO WATCH



- More sanctions, prospects of a long war → RISK-OFF
  Mild winter, partial resumption → RELIEF
- Two-sided inflation risks tilted towards the upside (even faster policy tightening).
- Disruptive end of BoJ's Yield Curve Control triggers sell-off in JGBs, with international spill-overs.
- Russia goes nuclear or new geopolitical tensions (China/Taiwan, N. Korea).



GLOSSARY

YIELD CURVE CONTROL

Yield curve control (YCC) involves targeting a longer-term interest rate by a central bank and then buying or selling as many bonds as necessary to hit that rate target. This approach, in use since late 2016 by the Bank of Japan, is dramatically different from the Federal Reserve's typical way of managing U.S. economic growth and inflation by setting a key short-term interest rate, the federal funds rate. As the Japanese government bond market is one of the largest in the world and Japanese investors have a significant weight in the market, it is relevant to know that changes in rates have potentially large global implications.

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