Market Perspectives

Risk premia erosion

February 2024

GIAM Macro & Market Research

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

- **"Immaculate disinflation" is getting increasingly consensual and brightening the 2024 market outlook, leading to a further erosion in risk premia.**
- **We expect a bumpier road near term. Rate cut expectations are flattening out. 2H23 US economic strength has likely caused complacency about actual risks, helping risk assets to perform positively again in January even as long-term yields backed up a bit.**
- **Stagflationary geopolitical risks in the Middle East may challenge then increasingly consensual Goldilocks (continued disinflation, resilient growth). Even with a soft landing more likely, we see limited value in extending risk taking right now – we prefer safer (IG) buckets in Fixed Income and tactically raise Cash exposure.**

Content

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Global View – Risk premia erosion

Thomas Hempell

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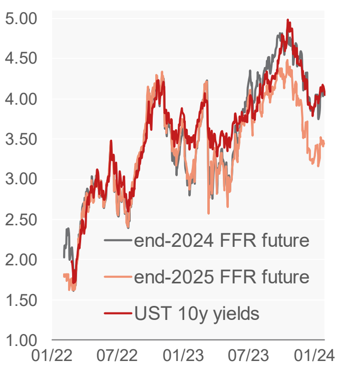
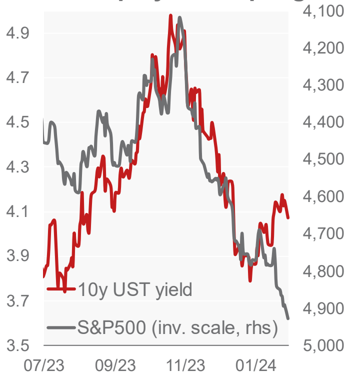
Confidence is growing that the Fed will manage a soft landing of the US economy. We now expect a shallower slowdown over mid-year and have raised our 2024 forecast to an above-consensus 2.1% as the boost from continued disinflation and solid wage growth will largely offset the drag on consumption from depleted excess savings (see US part). US economic resilience supports our conviction that markets' optimism about the timing and amount of Fed rate cuts is prone for disappointment. The market discounts 135bp of rate cuts by YE, with a March cut given a 50% probability. This is already 30bp less than in late December. But as we flagged in December, the steep easing of financial conditions associated with this pricing may turn self-defeating as central banks lean against these expectations amid continued inflation risks. (Fed Chair Powell will give more guidance in the FOMC press conference shortly after the release of this report.)

US rates exp. and yields



Source: Datastream, GenAM calculations

Bond/equity decoupling?



Source: Datastream, GenAM

Reassuringly, disinflation is proceeding in both the US (core PCE 2.9% yoy in Dec.) and the euro area (core CPI 3.4%). The momentum in the 3m/3m annualized readings seems even aligned with the central banks' 2% targets. Yet in parts this still reflects the likely exhausted effects from lower energy prices, eased supply bottlenecks and fading revenge spending in services. High wage growth remains a headache notably for the ECB. And the widening conflict in the Middle East bears risks of a fresh stagflationary shock. Houthi attacks in the Red Sea shipping are straining global supply chains, and an escalation of tensions may still send oil prices soaring steeply and reignite acute inflation worries.

10-Year Gvt Bonds	Current*	3M	6M	12M
US Treasuries	4.12	3.95	3.75	3.75
Germany (Bunds)	2.27	2.15	2.05	2.20
Credit Spreads**				
EA IG Non-Financial	122	130	130	125
EA IG Financial	138	150	150	145
Forex				
EUR/USD	1.08	1.08	1.11	1.13
USD/JPY	148	145	142	137
Equities				
S&P500	4904	4910	4950	5030
MSCI EMU	155	155	157	164

*3-day avg. as of 29/01/24 **ICE BofA (OAS)

Awaiting better entry points for equities and duration

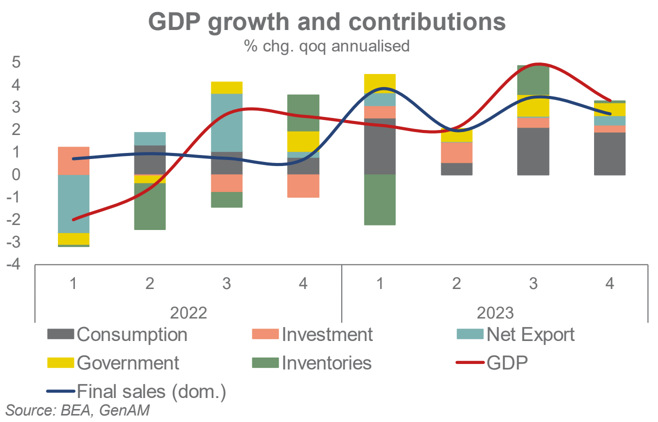
We still see core yields – notably in the US – geared to the downside over the course of the year as inflation fears recede and central banks will start cutting rates. Mind also that the 3.50% Fed Funds Rate priced by markets in 5 years looks about 65 bp too high on our accounts, leaving scope for a correction. Over the coming weeks, however, shorter dated rates expectations may remain in the driving seat even for longer-dated USTs (left chart) and may offer somewhat better yield entry points for lengthening duration.

Risk assets showed a negative correlation with yields for most of H2/2023 – but renewed economic and tech optimism into 2024 has helped stocks to defy the drag from correcting rate cut hopes (right chart). Stagflationary geopolitical risks may challenge this resilience as markets are already widely positioned for a perfect soft landing of the US economy – another warning against complacency.

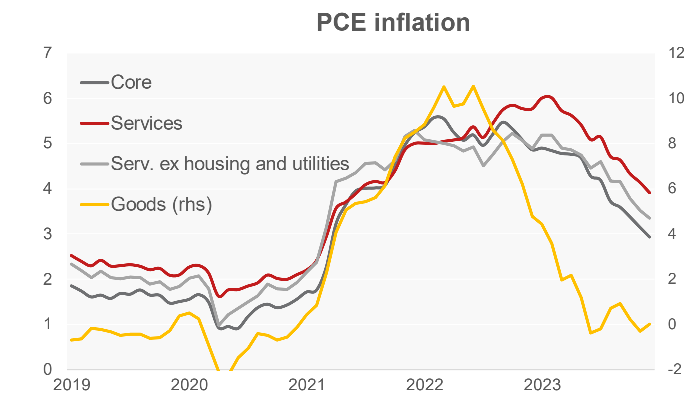
We thus keep a balanced and somewhat prudent approach to portfolio allocation even amid a soft landing for now. We maintain a very moderate underweight in the riskiest parts of our portfolio (Equities, HY), while favouring IG Credit and Quasi Sovereigns. We moderately raise our Cash position, however, trimming exposure in Fixed Income to hedge against the risk that a further repricing of rate expectations may weigh on both Bonds and Equities.

United States

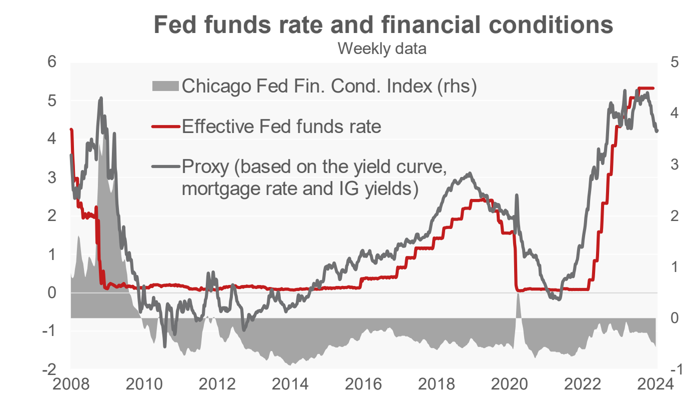
Paolo Zanghieri



Source: BEA, GenAM



Source:BEA, Refinitiv, GenAM



Source:Federal Reserve Board, Chicago Fed, Refinitiv, GenAM

- **The US economy enters 2024 on a sound footing as consumption remains very strong and capex withstands higher rates. We upgrade our 2024 growth to an above-consensus 2.1%**
- **Despite strong demand, inflation continues to cool down and we expect core PCE inflation to end 2024 at 2.2% yoy, close to the Fed target.**
- **With labour market smoothly rebalancing, the Fed can assess patiently the evolution of inflation. We see four 25bps rate cuts this year, starting from May.**

According to the first estimate, Q4 GDP rose by a much better than expected 3.3% ann. Consumption accounted for 2/3 of growth, as the boost from excess savings is gradually replaced by steady real income growth, while the fiscal boost is helping capex resilience. We expect growth to downshift to around 1% annualised in the middle of the year, reaccelerating in the final quarter. The carryover from Q4 2023 and a strong Q1 will lead to a full year growth of 2.1%. Meanwhile the labour market continues to rebalance in a gradual way, with minimal job destruction, the ratio between job openings to unemployed has dropped to 1.4 from 2 in spring 2022; it is not too far to the pre pandemic peak of 1.3. The quit rate is decreasing too, and all this is helping wage growth moderation, the employment cost index was up by 4.4% yoy in Q3, down from a peak of 5.1% yoy in Q2 2022, and only marginally above the 3.5%-4% range the Fed deems consistent with the 2% inflation target. This smooth process should continue. We see the unemployment rate rising from the current 3.7% to a peak of 4.2% in autumn.

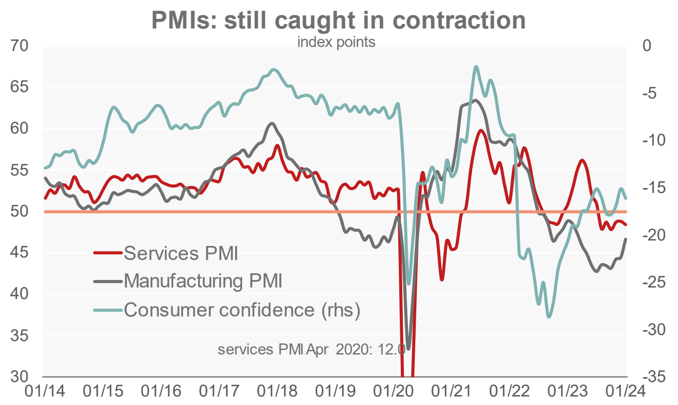
The persistent strength in demand is not hampering disinflation: price data for 2023 were revised downwards and in December core PCE inflation fell to 2.9% yoy. From now on we project a slower disinflation as the contribution of international trade in goods has finished. Still by the end of the year core inflation should have reached 2.2% yoy, comfortably close to target.

Fed in no rush to cut rates in Q1

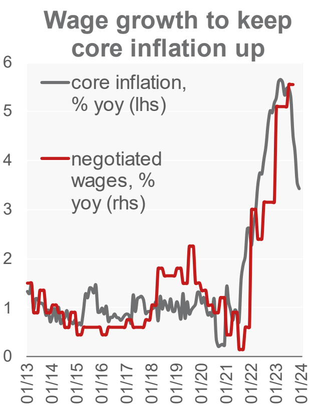
The development on both the growth and inflation fronts have vindicated the outlook the Fed has been advertising since the beginning of the year, i.e. a relatively soft landing of the economy. The absence of any significant recession risk allows the Fed to take a cautious approach to loosening, motivated first by the need to keep financial conditions relatively tight and by the possibility that disinflation may stall. Therefore, and unlike to what is expected by markets, the Fed will embark in a more cautious loosening cycle than in the past. We expect a first cut in May. This year should see a total of 100 bps of easing.

Euro Area

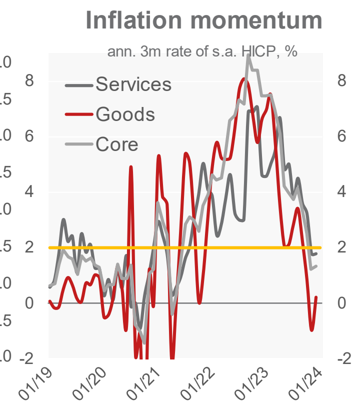
Martin Wolburg



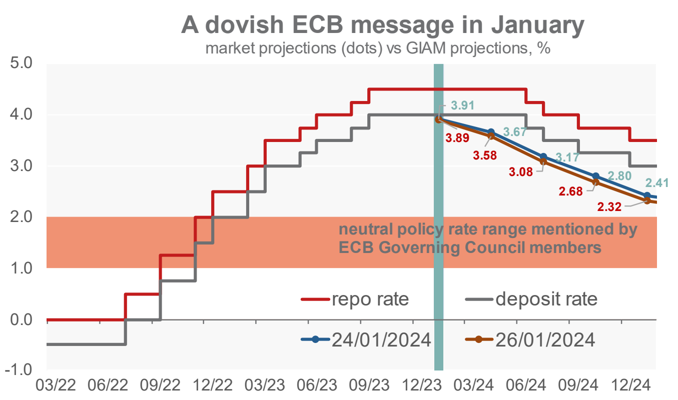
Source: GenAM, Datastream



Source: Datastream, GenAM calculations



Source:Datastream, ECB, GenAM



Source: Datastream, ECB, GenAM calculations

- **The first Q4/2023 GDP estimate showed stagnation so that the euro area narrowly avoided a technical recession. First sentiment indicators for 2024 support our view of a return to moderate expansion in 2024.**
- **Disinflation turned out to be more pronounced than expected with underlying inflation as well as oil futures pointing to more muted inflation. We reduced our 2024 inflation forecast to 2.4%, from 2.6%.**
- **The ECB adopted a more dovish tone at the January meeting. While we stick to our base case of a first cut by June, the risk of earlier action clearly increased.**

Euro area activity is likely to improve from low levels. According to the flash estimate output stagnated in Q4. Thereby the economy narrowly avoided a technical recession. Unexpectedly strong growth especially in Spain (+0.6% qoq) and Italy (+0.2% qoq) offset some of the drag from Germany (-0.3% qoq) and saved the euro area from a second quarter of contraction.

Looking ahead, there is reason to become more optimistic on activity. While still remaining at very muted levels sentiment indicators (see top graph) trended up and forward-looking components imply further improvement. With the inventory cycle turning, the labour market solid and inflation receding further activity is set to expand again. However, dampening effects from fiscal and monetary policy as well as weak US growth will make the recovery cumbersome, especially in the first half of the year. All in all, we see GDP expanding by 0.6% in 2024, slightly above consensus of 0.5%.

ECB torn between April and June rate cut

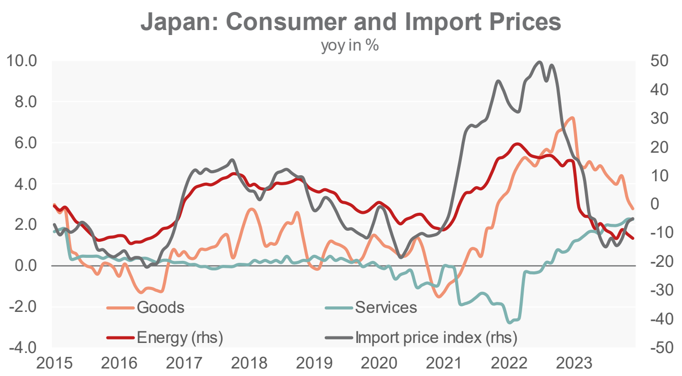
Inflation has constantly come down from its peak until November (to 2.4% yoy) but currently undergoes a temporary lifted by energy-related base effects. Looking though this volatility, underlying inflation has moderated surprisingly fast. Various indicators like core PPI (Nov -0.5% yoy) suggest that it will further recede from the Dec. reading of 3.4% yoy. While wage growth and geopolitically related oil price risks remain wild cards, we have adjusted our 2024 annual inflation expectation down to 2.4% (from 2.6%),.

The favourable inflation outlook caused the ECB to only think about the start of the cutting cycle now. The January meeting showed much less concern about inflation than before. Markets perceived the ECB as more dovish. Comments from Governing Council members suggest that the discussion centres around cutting in April or June. We maintain our view of a first cut by June but acknowledge that the risks of earlier action clearly increased. Moreover, in case of a benign inflation development there could be bolder than just 25 bps cuts.

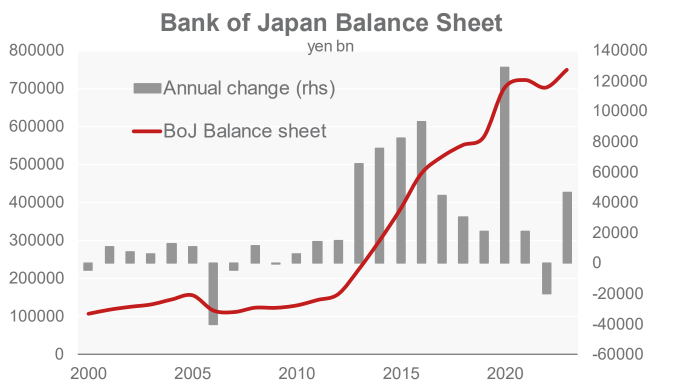
Japan

Christoph Siepmann

- **The BoJ maintained its monetary policy in January, giving little policy guidance. Market views are very diverse, but we keep our forecast that the BoJ will end NIRP and YCC in April.**
- **Risks to this forecast exist in both directions (recent hawkish comments vs. a possibly too optimistic BoJ inflation outlook). We see inflation at 1.9% in 2024 and 1.6% in 2025 while growth should come in close to 1%.**



Source: Datastream, GenAM calculations



Source: Bank of Japan , GenAM calculations

Source: Datastream, GenAM calculations

As widely expected, the BoJ decided in January to keep its monetary policy unchanged. However, market expectations regarding the further policy outlook remain very dispersed, and views are widely spread. We continue to see the BoJ exiting the yield-curve control (YCC) policy as well as the negative interest policy (NIRP) in a single move in April to but keep its qualitative and quantitative easing (QQE) intact. Currently, 10y JGB yields are significantly below the de-facto upper bound of 1% and the outlook for US Treasuries of the same tenor is to fall for the rest of the year. While markets could temporarily test the BoJ's resolution, we see no point in widening the tolerance band again while it looks attractive to abolish the ceiling when it likely stays unbinding for quite some time. Regarding the NIRP, we see the outlook more strongly attached to the hoped-for virtuous wage-price cycle. The BoJ expects core-core inflation (ex fresh food and energy) to come in at 1.9% in the fiscal years 2024/25, i.e., only slightly below the target of 2%. However, the BoJ would want to confirm its view with actual data from the spring wage negotiations, of which around 50% will be available by about mid-April. Some large enterprises showed willingness for another round of decent wage rises, but SMEs look much more reluctant. Overall, we expect the BoJ to see enough support for abolishing the NIRP. We do not anticipate another hike in the remainder of 2024. As the BoJ has so far acted very cautiously, risks that the BoJ delays or separates its moves remain elevated.

Disinflation could be faster than expected

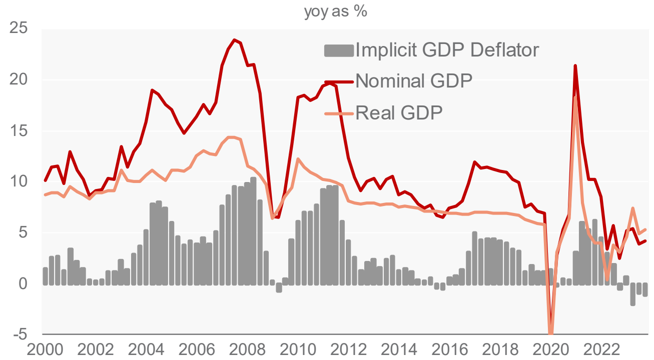
On the inflation side, Japan's headline inflation receded to 2.6% yoy, while the two core-core measures ex energy and fresh (!) food (3.7% yoy) and ex energy and food (2.8% yoy) continued to exceed the headline rate, given energy deflation. Moreover, the (January) bellwether inflation rate of the Tokyo area dropped markedly from 2.4% yoy in December to 1.6% yoy. One important driver was the service price component which was expected to carry the brunt of the wage increase but now could come down faster. This would entail another headache for the BoJ. We see inflation at 1.9% in 2024 and 1.6% in 2025 while growth should come in close to 1% in both years, which is around potential.

China

Christoph Siepmann

China: Nominal and Real GDP Growth

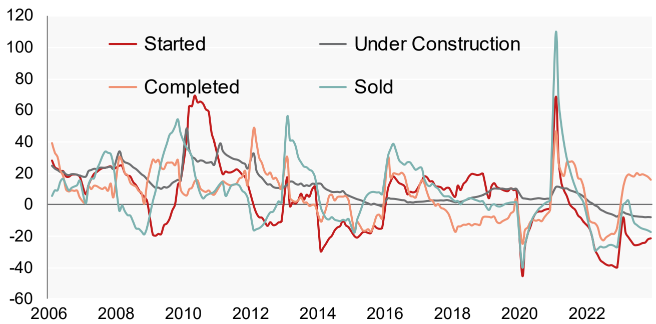
yoy as %



Source: Datastrem, GenAM calculations

China: Floor Space of Residential Buildings

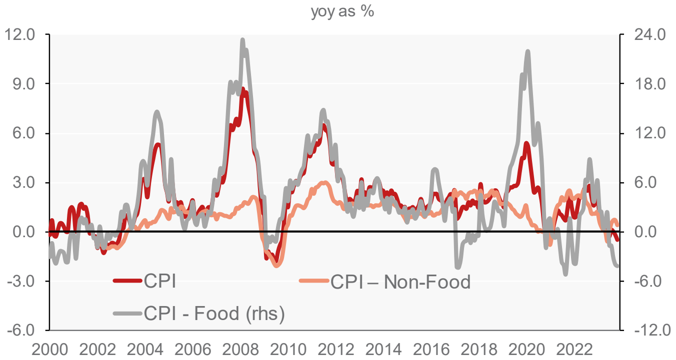
sq.m. yoy in %, cumulative



Source: Datastream, GenAm calculations

China: Consumer Price Inflation

yoy as %



Source: Datastream, GenAM

- **China's Q4 GDP growth as well as total 2023 growth came in at 5.2% yoy. The real estate sector remained the biggest drag which is unlikely to dissipate soon. We see 2024 growth at 4.5%. Fiscal policy is likely to stay supportive, but we still see no "big bang".**
- **The PBoC has cut the reserve requirement ratio (RRR) and we expect the medium-term lending facility (MLF) rate still to follow. More moves are likely in H2.**

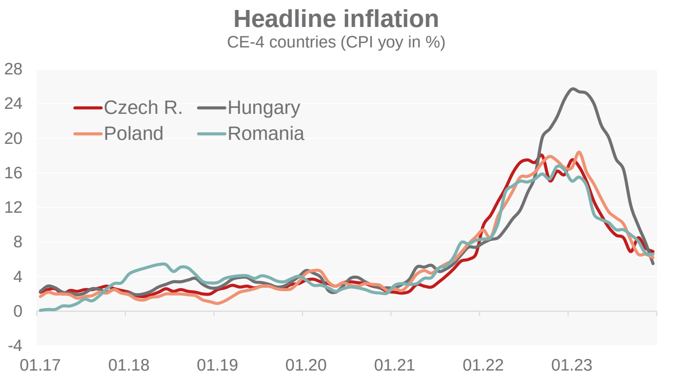
China's real GDP advanced by 5.2% yoy in Q4 2023 as well as in total 2023, in line with the official target of "around 5%". Real GDP was again pushed up by a negative deflator rate, which contracted similarly to Q3 by 1.1% yoy, predominantly due to the price decline in the manufacturing sector. Real estate continued to be the main drag on growth. Moreover, December data saw property investment drop to accelerate again to -12.4% yoy, while buildings "newly started" receded by -11.6% yoy. Both figures suggest that a quick fix is unlikely, and we expect the real estate sector troubles to mitigate only reluctantly over the year. Nevertheless, the (local) government seems willing to manage (but not prevent) the downturn by stepping up support in the forms of reducing necessary downpayments and purchase restrictions, improve funding for finishing projects, discuss (still unconfirmed) a white list for eligible developers and supply more social housing (funded by the PBoCs pledged supplementary lending so far RMB 350 bn, total possibly RMB 1 tr = 0.8% GDP). In October last year, the central government had also announced an additional deficit of 0.8 pp (to 3.8% of GDP) for infrastructure investment. We expect the 2024 deficit to remain at that level to avoid a fiscal drag. Including government managed funds the deficit will likely come in at 8.2% of GDP, also similarly to 2023. This implies the fiscal impulse to stay small. We see the high overall deficit as main obstacle to a "big bang" fiscal package and expect GDP growth at 4.5% in 2024.

PBoC cut RRR

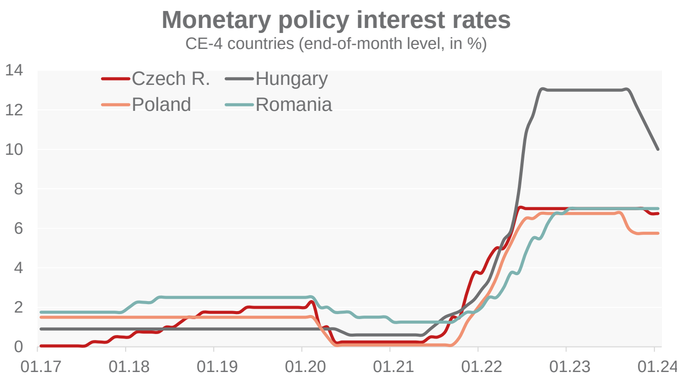
The BPoC announced to cut the RRR by 50 bps from Feb. 5 on. It also cut re-lending and re-discount interest rates by 25 bps for the rural sector and small firms. The move has been awaited for quite some time, suggesting that the PBoC might stick to only two RRR moves also in 2024 (second then in H2). We still see the BPoC MLF cut by 15 bps in Q1 and another cut in H2. December CPI inflation came in at -0.3% yoy and 0.1% mom. We see January CPI inflation to stay negative, but inflation typically increases ahead of the Chinese New Year (on February 10). From March/April on, base effects will dissipate so that CPI inflation is likely to remain in positive territory, thereafter, averaging 1% in 2024.

Central and Eastern Europe

Radomír Jáč



Source: www.czso.cz, www.ksh.hu, www.stat.gov.pl, www.insse.ro, GenAM



Source: www.cnb.cz, www.mnb.hu, www.nbp.pl, www.bnr.ro, GenAM

Main Forecasts

Czech Republic	2022	2023f	2024f	2025f
GDP	2.4	-0.4	1.5	2.8
Consumer prices	15.1	10.7	2.6	2.0
Central bank's key rate	7.00	6.75	3.50	3.00
Hungary	**2022**	**2023f**	**2024f**	**2025f**
GDP	4.6	-0.5	3.2	3.2
Consumer prices	14.5	17.6	4.8	3.2
Central bank's key rate	13.00	10.75	5.00	4.50
Poland	**2022**	**2023f**	**2024f**	**2025f**
GDP	5.3	0.6	3.0	3.4
Consumer prices	14.3	11.6	4.5	3.2
Central bank's key rate	6.75	5.75	4.75	4.00

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

- **Declining inflation opened room for further deep interest rate cuts in Hungary. The Czech CNB finally started cutting rates in December and indicated that further cuts are likely to follow.**
- **The Polish NBP kept its key rate on hold at 5.75% in January. Rate cuts can be back on the table in March at the earliest. While Polish inflation is expected to fall sharply in Q1, there is significant uncertainty over the food and energy price developments in H2.**

Data for December reported a nice decline of inflation across the CE-3 region and a further sharp fall in the annual CPI should follow in January. Surveys from the Czech economy indicate that there was no aggressive repricing of food at start of the new year. This supports the expectation that headline CPI fell from December's 6.9% to area of 3% yoy in January, which should encourage the Czech CNB to ease its policy. Headline inflation in Hungary fell from 7.9% to 5.5% yoy in December and the area of the 3% target may be reached by early spring. This opened room for more interest rate cuts.

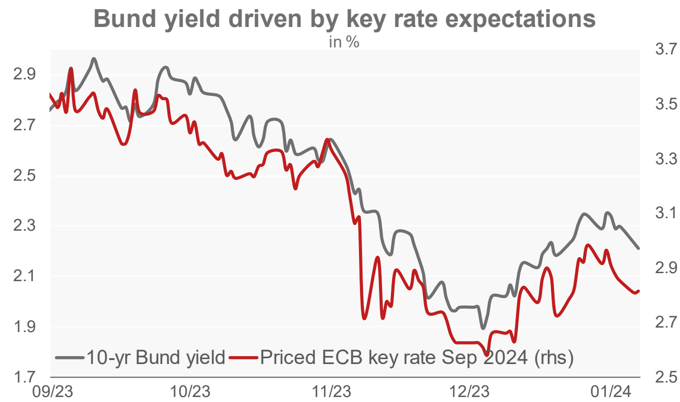
Polish headline CPI fell from 6.6% to 6.2% yoy in December and a sharp decline is expected in Q1, as the government extended the 0% VAT rate on foods and price cap for household energy. Inflation may reach the 2.5% inflation target area by March. However, outlook for H2 is marked by uncertainty: if the mentioned measures are not retained, headline CPI could increase quite sharply. This leads the NBP to wait for more clarity about the inflation outlook for H2 before it decides to restore interest rate cuts.

Monetary policy: Czech CNB also in rate-cutting cycle

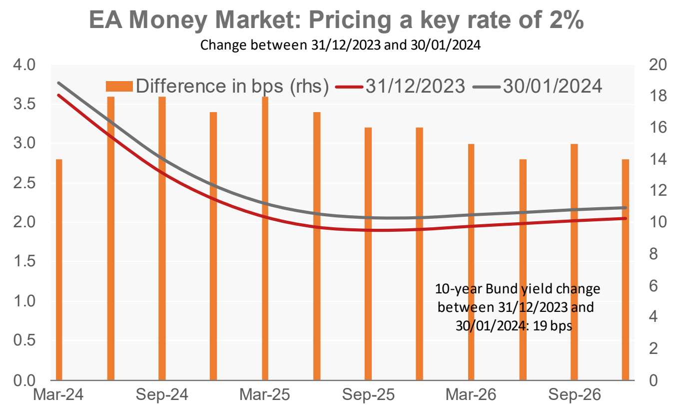
The Czech CNB cut its key interest rate by 25 bps to 6.75% in December. This was a first cut since the CNB ended its tightening cycle in June 2022. Comments that came from the CNB indicate that further rate cuts will come at the upcoming meetings. We expect cuts by 25 bps in February and March, and a switch to 50 bps in May. In Hungary, the MNB cut the key rate by 75 bps at all three meetings in Q4, to 10.75% in December. Before the January meeting the MNB indicated a possibility of a 100 bps rate cut, mainly due to the favourable development of inflation. However, volatility of the forint FX rate led the MNB to cut by 75 bps (to 10%) and we expect the same pace of rate cuts for the rest of Q1. The Polish NBP kept its key rate at 5.75% in December and also at the January meeting, after it delivered cumulative cuts of 100 bps in September and October. The NBP indicated that a rate cut may come in March when a new macro forecast will be available and when the central bank will hopefully have a more clarity about the inflation outlook for H2.

Government Bonds

Florian Späte



Source: Bloomberg, GenAM



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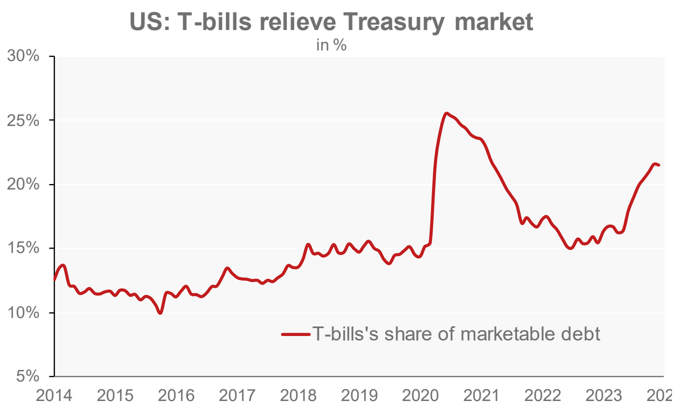


Source: Datastream, GenAM calculations

- **After the strong rally in Q4 2023 core government bond yields have backed up. Driven by less aggressive key rate expectations 10-year Bund and US yields have moved to the upper end of the trading range.**
- **Going forward, we see some leeway for lower core yield levels amid an ongoing decrease in inflation and looming key rate cuts.**
- **EA non-core government bond spreads have continued their rally and approached the level of early 2022. Given the high supply of new bonds and the increasing momentum of Quantitative Tightening (QT) over the course of the year, we consider the current levels to be too low and advise caution.**

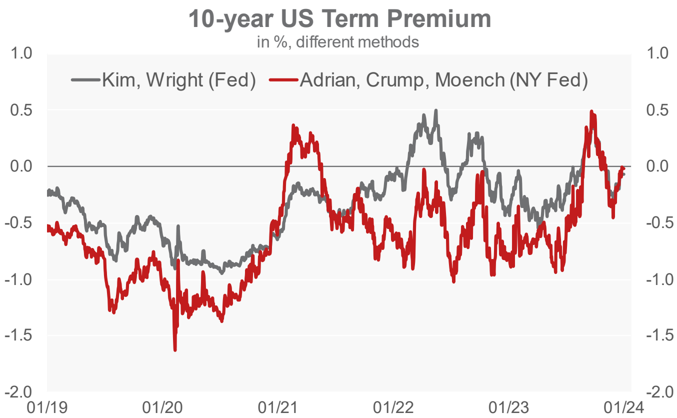
In the first few weeks of the year, some realism has returned to the international bond markets about the expected key rate cuts. While more than six key rate cuts by the ECB and the Fed for 2024 were still being priced at the end of 2023, the exaggerated expectations have been at least partially corrected. A bit more than five cuts are now expected by the end of the year and a start of the cycle in the current quarter is considered unlikely. Long-dated bonds have followed this movement almost completely and have risen again from the (too) low levels since the beginning of the year. We also expect the cycle of key rate cuts to begin in Q2, although (contrary to financial markets) we assume that the Fed will act before the ECB and that the central banks will adopt a somewhat more cautious approach and leave it at a total of four key rate cuts in 2024. This implies some upside potential for core yields, particularly for Bunds.

Accordingly, we are also somewhat more cautious about the expected normalisation of yield curves. While the financial markets see the 2y/10y Bund yield curve at 40 bps (from the current -25 bps) and the US Treasury curve at 30 bps (currently also -25 bps) for the year as a whole, we only expect the inversion to be eliminated in 12 months and the 2y/10y curve to be in the single-digit bps range.

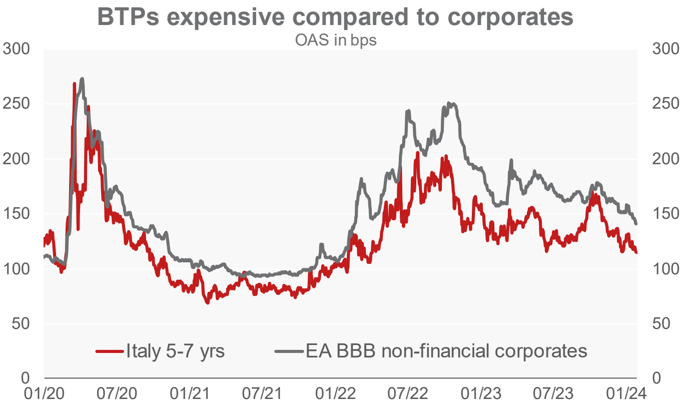
In addition to the (too low) key rate expectations, the term premium is also seen to put some upward pressure on core yields. After a decline in Q4, it recently rose again. The recovery in the free float and the ongoing pressure on public finances are likely to be reflected in a higher term premium in the medium term. The expected cycle of key rate cuts on both sides of the Atlantic also usually results in a higher term premium. However, the stronger reliance on T-bills (see chart) alleviates the upside pressure a bit. Moreover, the US Treasury recently announced lower-than-expected borrowing estimates for Q1 (from USD 816bn to USD 760bn)) and Q2

Government Bonds

Florian Späte



Source: Bloomberg, GenAM



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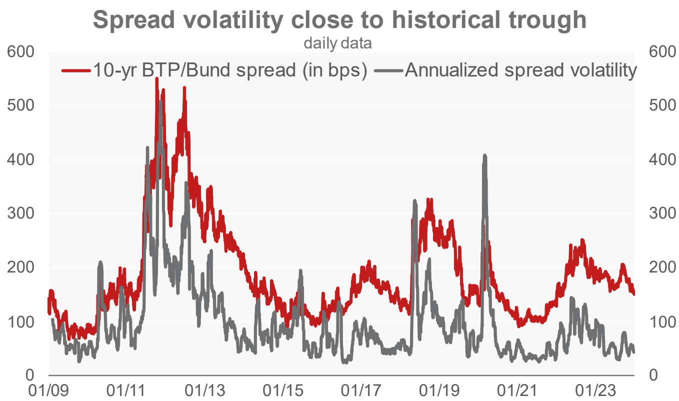


Source: Datastream, GenAM

(USD 202bn) signalling an improvement in the expected budget deficit path.

Nevertheless, we forecast that core yields will move slightly downwards in the weeks to come. In the US in particular, we expect weaker macro data. Inflation is likely to continue to decline over the course of the year (although financial markets have already priced a benign development). The approaching start of the cutting cycle (in combination with less hawkish central bank comments) is also likely to contribute to a moderate decline in yields. Finally, 10-year core yields tend to be at the upper end of the trading range, implying more downside than upside potential. In this environment, Treasuries are seen to perform better than Bunds given the forecast earlier start of the key rate cutting cycle, and the US real yield is still at a too high level. On a 3-month horizon, we forecast 10-year Bund yields at 2.15% and 10-year US Treasury yields at 3.95%.

Generally, we currently prefer inflation-linked bonds instead of nominal bonds because we believe the priced inflation picture is too optimistic. Geopolitical events also represent an upside risk for inflation.

Ambitious valuation of EA non-core bonds

EA non-core bond spreads have continued to tighten since the start of the year as dovish ECB comments and the strong performance of other risky assets supported them. Additionally, the wall of supply was well absorbed. Meanwhile, spreads are back to the level of the beginning of 2022 (before the war in Ukraine and the ECB key rate hikes).

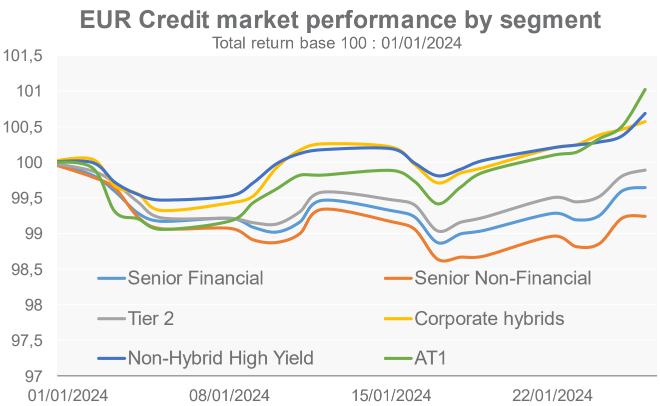
However, it is precisely because of this rally that we urge some caution and expect a less favourable development in the weeks to come. The risks appear to be no longer adequately priced at these spread levels. The current spread levels appear ambitious given the weak growth environment, the exaggerated expectations of key rate cuts, and the unfavourable technical situation (high supply especially in Q1). Moreover, while we still see downside potential in bond market volatility, the spread volatility is already close to long-term lows and offers little potential for additional support.

Although the market digested the high supply well in January, we believe supply fatigue is likely in the coming months. The PEPP QT that will begin in July will further aggravate the situation. Foreign investors in particular will be required to take down the material coming onto the market. However, the question arises as to whether they are willing to buy at current spread levels.

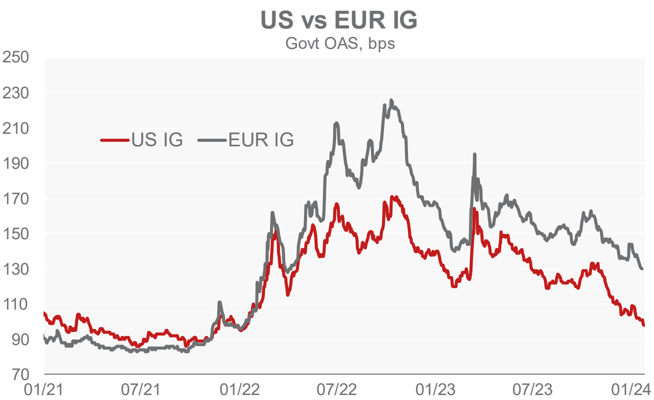
Overall, we see moderately wider EA non-core bond spreads going forward. 10-year BTP/Bund spread is seen to rise to 180 bps on a 12-month horizon.

Credit

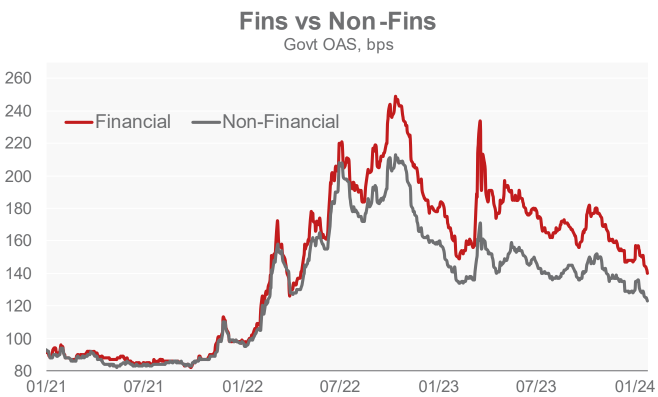
Elisa Belgacem



Source: Bloomberg, BofAML indices, GenAM own calculations



Source: Bloomberg, BofAML indices, GenAM



Source:Bloomberg, BofAML Indices, GenAM

- **After a quiet start to the year high yield (HY) issuances should pick up and pressure spreads, while IG should see relatively less issuances.**
- **We keep a mild underweight in HY due to elevated carry and a stable default outlook.**
- **We remain long IG for the carry while we think fundamentals will prove fairly resilient.**
- **Default rates are expected to reach 4.5% in Europe and 5-6% in the US in 2023.**
- **Even after the strong rally we see value in subordinated instruments versus pure HY.**

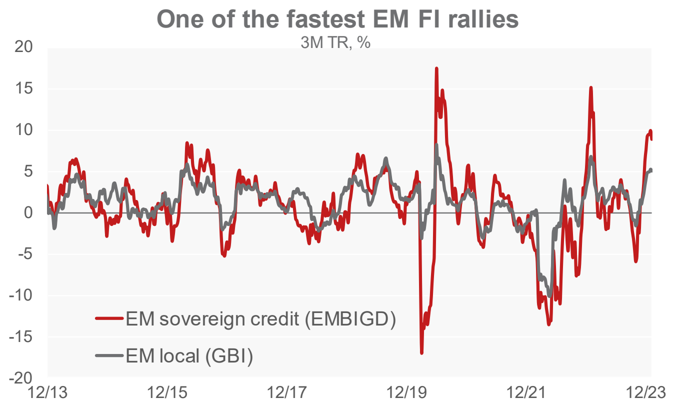
Looking ahead into 2024, high-yield issuances should surpass IG in relative terms, reflecting a higher share of bonds to be refinanced in the sub-investment grade. Indeed, IG corporates have issued more in 2023 and continue to display high cash levels on their balance sheets, that will gradually start be less remunerative with both the Fed and the ECB expected to cut rates significantly this year. For HY corporates, there was relatively little maturities to be refinanced in 2023, and Treasurers have been opportunistic waiting for lower rates in 2024 to come to the market. Over the last two years we have also seen private credit substituting the HY market for M&A or LBO refinancing. We think this trend should slowdown and issuers will look more at public market as it is currently attractive again to issue bonds. Also, loans and private markets are floating instruments versus HY being a fixed-rate product should be supportive in terms of flows as investors will be willing to secure higher fixed rates ahead of the expected rate cuts. We also expect that financials will issue more relative to corporates as they have less opportunities to chose their timing on top of the TLTRO that will have to be refinanced.

Prefer BBBs and subordinated bonds

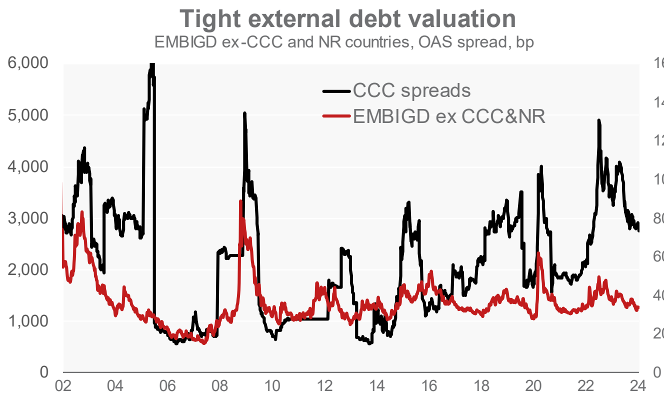
We believe IG spreads will oscillate around current levels for the months to come. Valuation considerations also lead to a preference for Europe over the United States. We do prefer long IG and subordination risk to pure HY. In the context of likely plateauing rates and uncertainty surrounding defaults in the HY space, a strategic move is proposed to play leveraged IG to enhance credit returns. While extending duration may not be favorable from a spread perspective, a positive rates view justifies a long position, particularly in the 5-7 year bucket. We have a neutral recommendation between financials and non-financials as we believe that on one side, financials fundamentals will face less tail risk in terms of asset quality deterioration because of lower interest rates, and financial spreads are still very generous compares to non-financials.

EM sovereign bonds

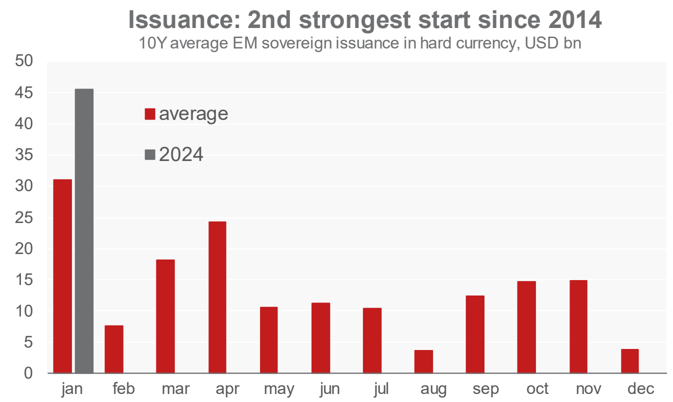
Guillaume Tresca



Source: Bloomberg, JP, GenAM



Source: Bloomberg, JP, GenAM



Source: Bloomberg, GenAM calculations

- **The EM fixed-income environment is still supportive with positive returns expected in 2024.**
- **EM external debt spreads may continue to widen in the short term, albeit modestly. We prefer EM IG, where valuations have turned more attractive.**
- **EM local debt will remain resilient, but it requires a tactical approach. We favour the belly of the curve.**

The EM global environment has hardly changed, still in a sweet spot benefiting from strong disinflation, relatively stable growth, the EM central bank rate cuts and the expected DM monetary easing. The yearly outlook is still positive, with positive expected returns. However, EM fixed income has been underperforming other credit assets YTD. We would expect it to remain on the back foot in the weeks to come, albeit the underperformance will be more muted.

Indeed, both EM external and local debt experienced one of the fastest rallies in late Q4. Spreads are tight, especially in the BB segment and further tactical spread correction will provide fresh air to valuations. In addition, January was historically one of the most active months in terms of issuance weighing on spreads. The primary market will remain dynamic as sovereign issuers will keep benefiting from good market conditions.

Reduce the beta exposure and favour EM BBB

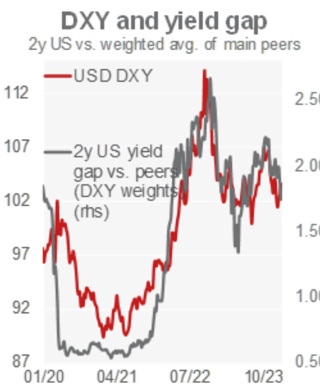
We maintain our preference for EM IG and especially the BBBs. EM IG has surprisingly underperformed vs US IG and it leaves EM IG relatively cheap to US IG. Moreover, our bullish US duration view will continue to benefit more to EM IG over HY. There is more value in the BBB segment where we like Romania currently benefiting from attractive valuations. We maintain a neutral view on Hungary but mounting tensions with the EU pose downside risks. In Panama, political noise ahead of the presidential elections leads us to maintain a negative view. Elsewhere in the EM IG space, we prefer Chile over Peru. Curve-wise, the steepening of the US curve has led to a flattening of EM IG curves, leaving the 10Y part more attractive.

EM local debt: more heterogeneity

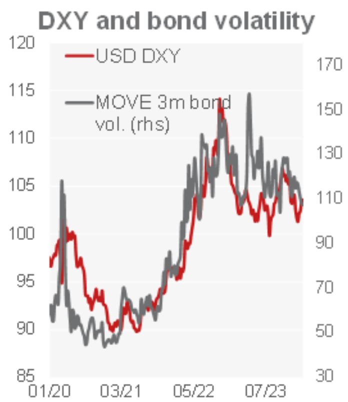
EM local debt has been more resilient, and we would expect to remain so. Valuations are more compelling. That said, EM rates are high beta to US rates and the soft-landing expectations will drive the performance in Q1 and would require a more tactical approach. The belly of the curve offers better valuation as the front end is pricing in significant rate cuts. There is still room for further front-end decline, but more locally in CEE and Mexico. EM Asia continues to look expensive, and we favour LatAm high yielders.

Currencies

Thomas Hempell



Source: Datastream, GenAM



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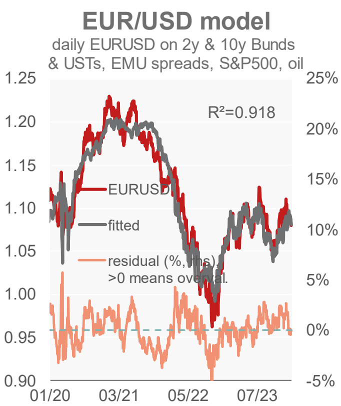
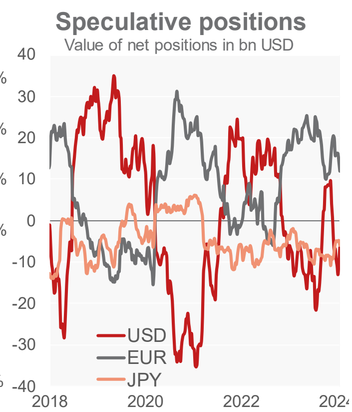
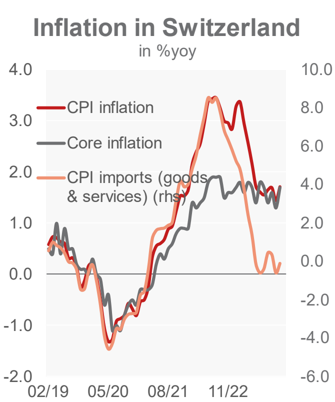


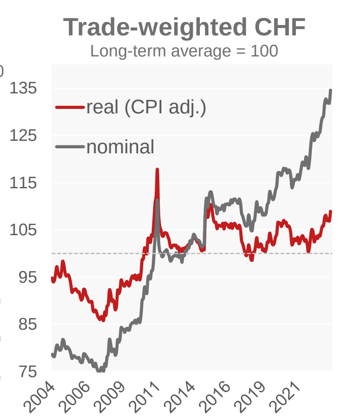
Source: Datastream, GenAM calculations



Source: CFTC, Datastream, GenAM



Source: Datastream, GenAM



Source:Datastream, GenAM

- **An improved US macro outlook still bolsters the USD short term. But continued disinflation, a receding US yield advantage and lower rates uncertainty point to a weaker greenback over the full year, which will show up in a higher EUR/USD and lower USD/JPY.**
- **We turn more constructive on the CHF as lower inflation increases the SNB's tolerance for a weaker franc as Swiss companies increasingly feel the competitive headwinds from a strong exchange rate.**

We cautioned into December that a USD bounce was on the cards near term before a bumpy descent over 2024. Indeed, even though the EUR/USD briefly spiked above 1.10 towards year-end 2023 the Greenback regained some ground as rate cut expectations were pared and US economic resilience persisted.

We have upgraded our US growth outlook from stagnation to a soft landing around mid year now expecting above-consensus 2.1% growth for 2024. This compares with a euro area that will recover only very sluggishly from stagnation over 2024. Near-term, this may still play in the cards of the USD, alongside risks of a setback in global risk sentiment. Otherwise, however, continued disinflation in both the US and the euro area will increasingly prepare the ground for first rate cuts later in spring. This will erode rates uncertainty and – given deeper US rate cuts in the offing – the USD's global yield advantage, both of which were major pillars of USD strength over the high-inflation episode (top charts).

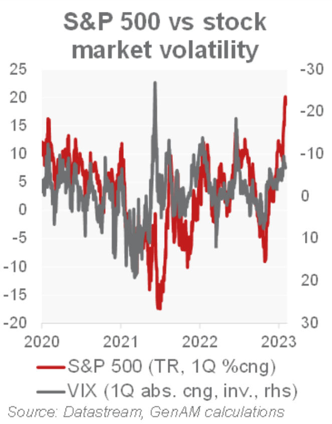
The EUR/USD neither looks dear vs. short-term fair value any longer (mid left chart) while speculative long EUR positions have softened (mid right). We anticipate a choppy sideways move in EUR/USD near term and a rise into the 1.10-.15 range over H2. We also anticipate a lower USD/JPY once US yields pull back more visibly.

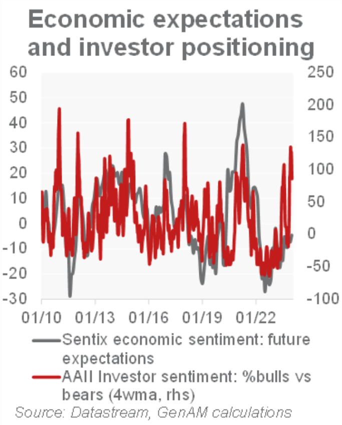
More constructive on EUR/CHF

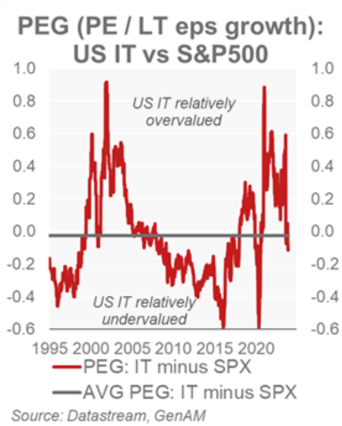
We turn more constructive on the EUR/CHF too. The ascent of the cross is still likely to be rather back-loaded amid near-term geopolitical risks and vulnerable risk sentiment. But the SNB is gradually giving up on its strong franc policy as inflation pressures are easing (left chart) and the dear CHF has become increasingly a competitive burden for the Swiss economy. The strong increase in the nominal CHF results mostly from the drastic inflation overshoot elsewhere – but also adjusted for inflation differentials, the real effective CHF is dear (bottom right). With the SNB more open to some CHF weakness and an end to FX selling, we see moderate upside for the EUR/CHF over the course of the year.

Equities

Michele Morganti and Vladimir Oleinikov







Markets	Fed model gap	Shiller PE (infl. adj.), discount (-)	avg LT models valuation (AVG - price, 1yr fwd)	Shiller risk premium for forecast inflation	PE target (1y fwd)	TR resulting from PE target, %	PE-driven TR decomposition (1) EPS 12m appraisal in 1y	(2) PE appraisal	(3) Cash yield
US	-34.9	26%	-13.0%	4,800 - 5,200	17.0X	-1.4	6.5	-10.1	2.6
JAPAN	-5.3	6%	7.9%		14.0X	9.9	6.9	-0.3	3.0
UK	-5.4	-16%	14.1%		11.0X	16.4	2.6	8.1	5.4
SW	-15.0	2%	9.4%		16.0X	15.6	7.5	3.2	4.4
EA	-7.6	3%	7.1%		12.8X	17.0	5.1	6.7	4.5
CHINA	37.8	-51%	-		11.1X	25.7	-	-	-

Note: Value gap is derived from 12m earnings devided by 10yr rates. Shiller PE: Price earnings ratio based on average inflation-adjusted earnings from the previous 10 years.
Source: Thomson Reuters Datastream, IBES estimates, GenAM.

- **Falling inflation and exaggerated expectations of rate cuts are now well discounted.**
- **Bullish positioning has visibly increased and the VIX trend represents a short-term headwind for an over-bought S&P500. Furthermore, we expect a softening in GDP growth in Q2-Q3. This makes us favour a cautious stance on equities in the short term.**
- **That said, historical evidence suggest that central banks' peak can prove supportive for equities. High AI prices are backed by solid earnings outlook and contained PEG ratio, and the EMU Sentix is stabilising, In the coming months, low EU PEs could expand.**
- **129 US firms reported. Surprise vs. expectations is positive by 6% and the median stock result is better vs. the SPX index. We remain below consensus in 2024 and 2025, but still expect decent growth ahead.**
- **We see a 12-month TR of around 9% for the ex-US indices, and a more limited 4% for the US. OW: EMU vs. US, Japan, SMI, China (slight, slowly accumulating positions), Korea, and India.**
- **EU sectors: OWs: Banks, Durables, Energy, Food Bev. Tob., HC Equip. & Svs., Pharma, Telecom. Svs., Utilities. UWs: Auto (new), Capital goods, Comm. Prof. Svs., Div. Fin., Insurance, Materials, Media, RE, Software (new).**

Falling inflation and expectations of rate cuts are well discounted in the short term. They still represent positive catalysts for equities in 2024. Positioning has increased visibly - BofA bull-bear index, AAII survey and equity fund flows vs. bonds – and last weeks' SPX performance is a 2SD move vs. history. Finally, the trend in VIX (Q/Q no more declining) represents a headwind for an overbought SPX. We also expect a softening in GDP growth in the next months albeit the US GDP looks very resilient and EMU momentum, weaker, should stabilize in the next quarter.

That said, previous cycles would suggest that CB's peak rate can maintain equity returns upbeat in the next months. Furthermore, corporate net cash flow is in good health (source for buybacks), AI stocks not overvalued and risks of financial stress look diminished. The EMU Sentix indicators are slowly stabilizing, overall suggesting that the low EU PEs may expand in the coming months. This in turn can produce around 10% TR in the ex-US world in 12 months. We see +4% TR in 12 months for the US, but should consensus be right on 10y rate and earnings (EPS) forecast, the S&P500

Equities

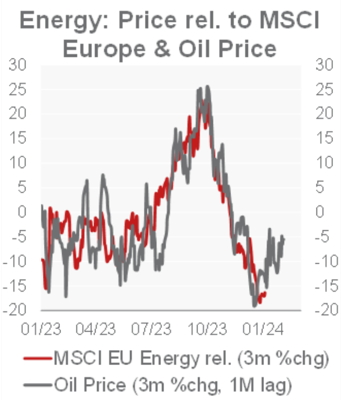
Analysis of the median stock: Q4 2023 reporting season

Median stock	Earnings Growth		Sales Growth		margin trend *		availability
	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q4 2023
S&P	4.8 %	2.7 %	3.9 %	3.4 %	0.9 %	(0.6)%	25.8%
Stoxx	5.5 %	5.2 %	5.2 %	2.8 %	0.4 %	2.4 %	8.3%
Euro Stoxx	4.1 %	3.1 %	2.1 %	0.0 %	2.1 %	3.1 %	6.0%
Topix	11.8 %	13.5 %	5.9 %	5.3 %	5.9 %	8.3 %	17.6%

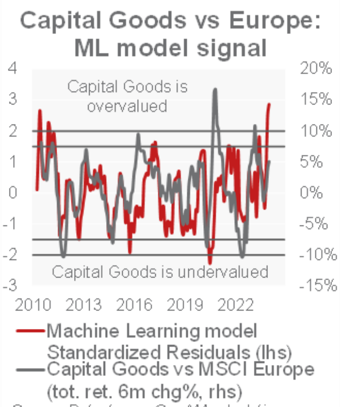
Median stock	Earnings Surpr		Sales Surpr		margin trend *		availability
	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q3 2023	Q4 2023	Q4 2023
S&P	4.9 %	5.4 %	0.6 %	0.6 %	4.3 %	4.7 %	25.8%
Stoxx	2.6 %	(3.0)%	(0.2)%	(0.4)%	2.8 %	(2.6)%	8.3%
Euro Stoxx	3.4 %	(4.2)%	(0.7)%	(1.0)%	4.1 %	(3.2)%	6.0%
Topix	7.3 %	4.3 %	0.7 %	0.3 %	6.6 %	4.0 %	17.6%

Note: numbers for Q4 are calculated only for the companies which have so far reported in Q3
proxy for margin trend = earnings growth - sales growth

Source: Bloomberg, GenAM calculations



Source: Datastream, GenAM calculations



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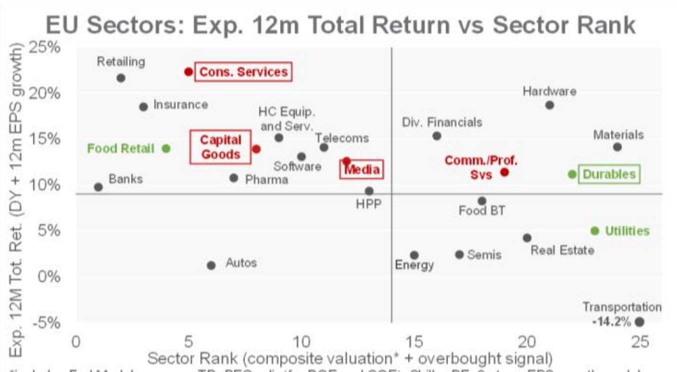


*includes Fed Model gap, exp. TR, PEG adj. (for ROE and COE), Shiller PE, 3-stage EPS growth model, mkt multiples, PE vs hist. avg. excl. bubble years. 12m EPS growth = 12m trailing EPS vs 12m fwd EPS
Red = negative machine learning quant models; Green = positive machine learning quant models
☐ = strong signal and better out-of-sample

Source: Refinitiv, GenAM calculations as of 26/01/2024

could be worth around 5,200. OW EMU vs. US via peak valuation discount and less diverging macro surprises. OW Japan (valuation, reforms), SMI (valuation), China (val., stimulus), India (val., eco), and Korea (val., eco).

Q4 reporting season

129 US firms reported and the EPS growth (yoy) for the S&P 500 is negative by 1.8%; the sales' one is positive by 3.6%. Both are below Q3, revealing some compression in margins and growth trend. The good news is that the surprise vs. expectations is positive by 6% and the median stock's result shows a higher growth of +2.7%. US consensus expects +4.9% EPS growth in Q4 (-8W.8% for EU), to which we add a possible mild positive surprise as, due to a negative firms' guidance and weak macro surprises, the Q4 growth forecast have been already reduced significantly from +11% yoy in September (EU: from -3% to -8.8%). Consensus sees US EPS growth to recover from Q4 '23 into 2025. EU one should remain negative in Q1 '24 (-9.9% yoy) and then recover, too. Overall, we agree on such momentum albeit we remain below consensus in 2024 and 2025 by 3% and 4.5%, respectively, in both countries. For the US, our models see 5.5% and 11% EPS growth, while for EMU 2% and 8%. For EMU, a resilient consumer confidence, low unemployment, high wages' growth and less negative financial conditions, should help.

EMs: neutral as macro surprises stay weak

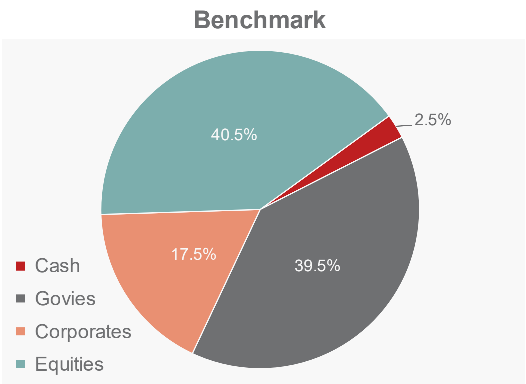
Mid-term, EMs should benefit from diminishing macro headwinds and policy reflation. However, macro surprises remain weak short term. Furthermore, while their PE vs. MSCI World PE is extremely low, expectations for the LT EPS growth remain subdued. As for China, we still see risks in the short term as economic policy has few chances to become too aggressive. But as valuations are significantly depressed from various angles, we stay on slight OW, preferring to accumulate slowly. Additionally, we are OW on India (eco) and Korea.

European sector allocation

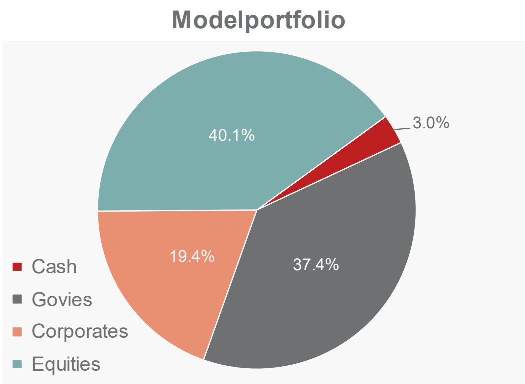
We slightly adjust our allocation to optimize risks-return expectations, maintaining the overall beta unchanged (slightly >1). We move to neutral Cons. Services (declining EPS revisions, ML models signalling overvaluation). We move to a slight UW Auto (EPS revisions, rel. fair value, correlation to a negative CPI) and Software (valuation, revisions, rel. fair value, rel. PBV vs ROE). We increase Materials (still UW, good earnings growth) and Energy (bottoming, supportive oil price). OWs: Banks, Durables, Energy, Food Bev. Tob., HC Equip. & Svs., Pharma, Telecom. Svs., Utilities. UWs: Auto (new), Capital goods, Comm. Prof. Svs., Div. Fin., Insurance, Materials, Media, RE, Software (new).

Asset Allocation

Thorsten Runde



Source: GenAM



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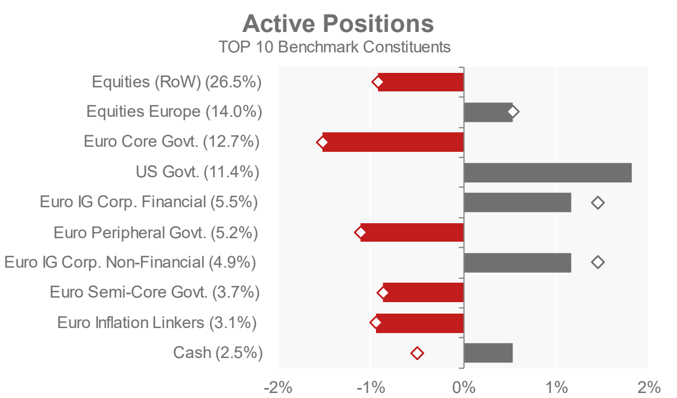


Source: GenAM; Benchmark weights in parentheses, diamonds indicating previous recommendations

- **In January 2024 (29.01.24) risk assets led the performance ranking. Apart from EM Equities (-2%) the performance is ranging from +0.4% for the MSCI Europe ex EMU to +4.5% for the MSCI Pacific. Also, EA HY made it under the top 5 with +0.9%.**
- **The bottom end of the ranking is held by long-dated Govies. Apart from 10Y+ Italian BTPs (-0.4%) this fixed income segment finds itself in deep negative territory (from -3.5% for US Treasuries to -2.7% for EA Core Govies). EM Govies delivered -2.1%.**
- **Overall, EA HY Credit clearly outperformed EA IG (+110 bps). Within IG, Financials were superior to non-Financials (+32 bps).**
- **Tight monetary policy and credit standards are keeping a lid on the global economy at the beginning of 2024. And although we have upgraded our forecasts for the resilient US economy, markets are already priced and positioned for a Goldilocks scenario, with too many rate cuts discounted.**
- **As this warrants near-term caution in Equities and HY we keep our UW positions here. We still prefer the carry from EA IG. But we slightly trim our OW here together with that in USTs to build up some OW in Cash. We keep a neutral duration stance.**

In January 2024 (29.01.24) our model portfolio underperformed its benchmark by 4.4 bps. The active positioning in the Govie segment contributed positively throughout to the result whereas the UW in the US Equities (-3.2 bps) as well as the OW in US Treasuries (-2.8 bps) proved particularly painful.

We deem market expectations too sanguine, pricing early and fast rate cuts and risk assets discounting the quite optimistic view of a soft landing. Against this backdrop current market developments seem overdone although we do see some relief towards mid-year. Thus, for the time being a cautious attitude towards risk-assets remains advisable.

Near-term caution in Equities & HY Credit warranted

Consequently, we leave our minor UW positions in Equities and EA HY unchanged. Though still favouring the carry from EA IG Credit we slightly trim our OW here and in US Treasuries to build up some Cash exposure acknowledging the risk of some repricing of key-rates. We see lower yields over 2024, but the near-term outlook is subject to two-sided risks. Thus, we keep a neutral duration stance.

Forecasts

Macro Data

Growth[1]	2023	2024 forecast	2024 Δ vs. cons.	2025 forecast	2025 Δ vs. cons.	2026 forecast
US	2.5	2.1	0.7	1.7	0.0	1.9
Euro area	0.5	0.6	0.1	1.4	0.1	1.2
Germany	- 0.1	0.1	- 0.2	1.7	0.5	1.9
France	0.9	0.8	0.1	1.6	0.3	1.7
Italy	0.7	0.6	0.1	0.5	- 0.5	1.1
Non-EMU	0.4	0.8	0.4	1.4	0.1	2.0
UK	0.4	0.5	0.3	1.3	0.3	2.1
Switzerland	0.9	1.8	0.6	1.2	- 0.4	1.8
Japan	1.7	1.0	0.2	0.9	- 0.1	0.5
Asia ex Japan	5.0	4.6	- 0.2	4.9	0.2	4.5
China	5.2	4.5	- 0.1	4.5	0.2	4.1
CEE	2.6	2.3	0.2	2.8	0.6	2.9
Latin America	2.1	1.9	0.5	2.1	- 0.0	2.2
World	**3.0**	**2.8**	**0.2**	**3.0**	**0.1**	**2.9**

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

Inflation[1]	2023	2024 forecast	2024 Δ vs. cons.	2025 forecast	2025 Δ vs. cons.	2026 forecast
US	4.2	2.5	- 0.1	2.2	- 0.1	2.1
Euro area	5.5	2.4	0.2	2.2	0.2	2.0
Germany	6.0	2.5	- 0.0	2.3	0.2	2.0
France	5.7	2.5	0.0	2.2	0.3	2.0
Italy	5.2	2.1	0.1	2.1	0.3	2.0
Non-EMU	6.2	2.5	0.0	2.1	0.0	2.0
UK	7.4	2.4	- 0.2	2.0	- 0.2	2.0
Switzerland	2.1	2.0	0.4	1.7	0.5	1.5
Japan	3.3	1.9	- 0.3	1.6	0.1	1.6
Asia ex Japan	2.1	2.2	- 0.0	2.4	- 0.0	2.6
China	0.2	1.0	- 0.2	1.5	- 0.2	2.2
CEE	20.4	17.4	- 0.3	8.3	- 8.7	6.6
Latin America[2]	5.9	4.2	0.3	3.1	0.0	3.0
World	**5.3**	**3.9**	**0.1**	**2.9**	**- 0.6**	**2.8**

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

Financial Markets

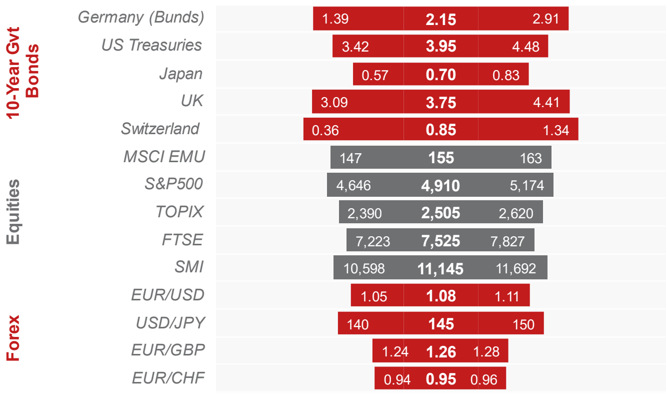
Key Rates	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
US (upper bound)	5.50	5.00	5.02	4.75	4.45	4.50	3.65
Euro area	4.00	4.00	3.67	3.50	3.11	3.00	2.17
Japan	-0.10	0.00	0.06	0.00	0.12	0.00	0.26
UK	5.25	5.25	5.11	5.00	4.73	4.25	3.83
Switzerland	1.75	1.75	1.55	1.50	1.30	1.00	0.92
10-Year Gvt Bonds							
US Treasuries	4.12	3.95	4.11	3.75	4.10	3.75	4.12
Germany (Bunds)	2.27	2.15	2.24	2.05	2.22	2.20	2.22
Italy	3.80	3.75	3.81	3.70	3.85	4.00	3.94
Spread vs Bunds	152	160	157	165	162	180	172
France	2.76	2.65	2.77	2.55	2.77	2.75	2.81
Spread vs Bunds	49	50	53	50	54	55	58
Japan	0.72	0.70	0.78	0.75	0.84	0.85	0.94
UK	3.94	3.75	3.98	3.65	3.96	3.65	4.00
Switzerland	0.89	0.85	0.85	0.80	0.84	0.85	0.84

*3-day avg. as of 29/01/24
**ICE BofA (OAS)

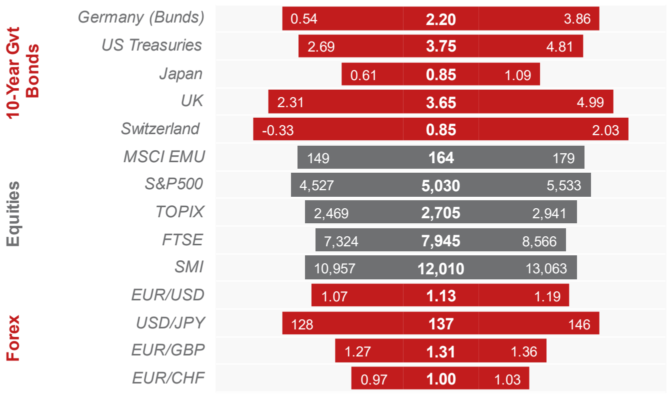
Credit Spreads**	Current*	3M Forecast	3M Fwd	6M Forecast	6M Fwd	12M Forecast	12M Fwd
EA IG Non-Financial	122	130		130		125	
EA IG Financial	138	150		150		145	
EA HY	373	425		450		425	
EM Sov. (in USD)	306	322		310		290	
Forex							
EUR/USD	1.08	1.08	1.09	1.11	1.09	1.13	1.10
USD/JPY	148	145	146	142	144	137	140
EUR/JPY	160	157	158	158	157	155	155
GBP/USD	1.27	1.26	1.27	1.29	1.27	1.31	1.27
EUR/GBP	0.85	0.86	0.86	0.86	0.86	0.86	0.87
EUR/CHF	0.94	0.95	0.93	0.96	0.93	1.00	0.92
Equities							
S&P500	4,904	4,910		4,950		5,030	
MSCI EMU	155.1	155.0		156.5		164.0	
TOPIX	2,520	2,505		2,580		2,705	
FTSE	7,599	7,525		7,670		7,945	
SMI	11,343	11,145		11,395		12,010	

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 Asset Management S.p.A. Società di gestione del risparmio | Research Department**

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