GENERALI INVESTMENTS

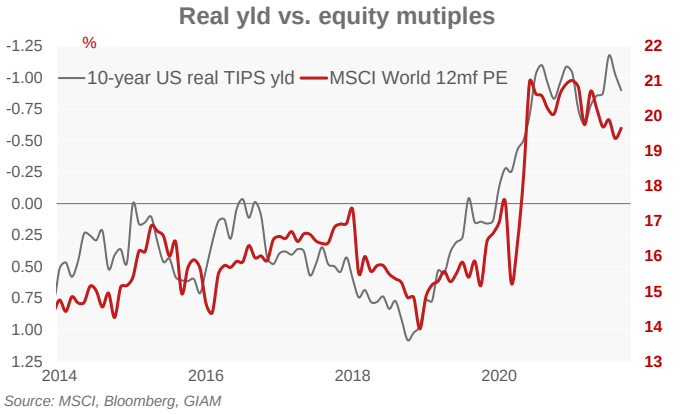
Investment View

Off Crutches

September 30, 2021

'Investment View' provides our quarterly macro & market outlook and investment recommendations

- The global economy has hit a speed bump, built on the Delta variant and supply chain issues; we expect growth to find a floor in H2, as the fourth Covid wave recedes, and China cautiously eases policy. But supply constraints are proving sticky, and surging commodity prices are a new threat to the consumer outlook. That risk deserves hedging.
- The global economy has enjoyed massive policy support over the past eighteen months. It is time to take the crutches off. The fiscal impulse is turning, not least in the US, and central banks are about to taper bond purchases. This has been well telegraphed, but sticky inflation creates new policy uncertainties, making the markets more volatile. As supply issues dominate both US employment and inflation, monetary policy efficacy is in doubt.
- Bond yields are recovering from the summer (reopening) slump. We see more upside but expect self-correcting mechanisms to contain the move. We hold an underweight in Govies, and a small duration short for now, but will not get too greedy with entry levels. We see Credit as offering a decent low-volatility carry still, but are now more selective.
- The three major tailwinds for equities (profit growth, money printing and fiscal impulse) are flattening out. So will the returns. But we still find equities cheap vs. bonds and go back to a stronger Value bias.



Source: MSCI, Bloomberg, GIAM

CONTENT

OFF CRUTCHES

Vincent Chaigneau

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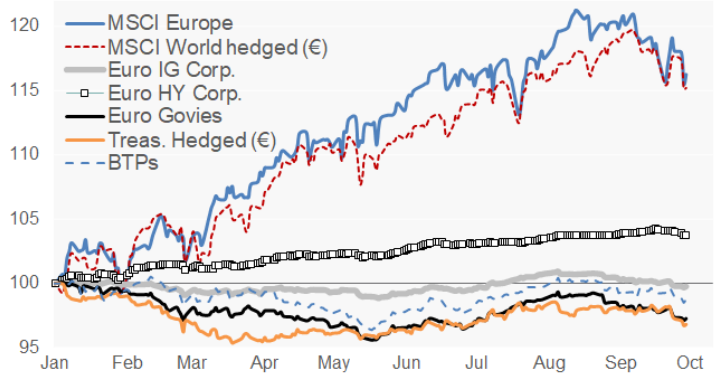
Now is time to take the crutches off, and markets are feeling a bit wobbly

This wobbly feeling. The global economy has walked (and even run) on crutches for the past eighteen months, with formidable monetary and fiscal policy support fostering the recovery and a luxuriant period for global markets. Goldilocks still ruled for most of summer, with bond yields pulling back as global growth hit a speed bump but equity investors raving about a stellar Q2 earnings season. Now is time to take the crutches off, and markets are feeling a bit wobbly. Even after the September correction, the MSCI world has still delivered some 14% year-to-date (dividends included, in USD). We see the recent move as a correction, rather than a new trend, but policy risk is rising, and the autumn promises to be more volatile.

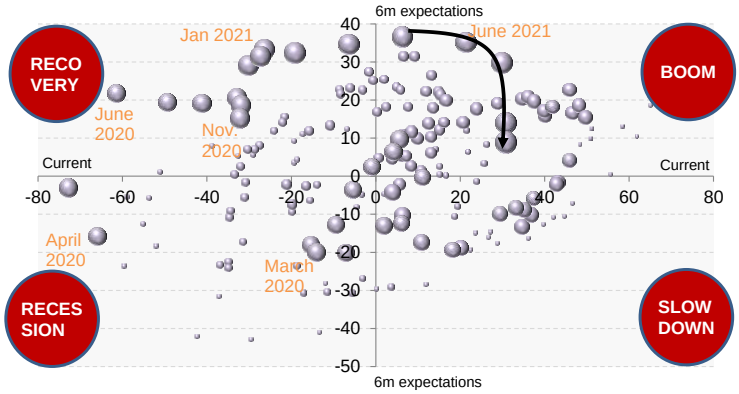
Year-to-date total return (€)



Source: Bloomberg, GIAM

EUR Sentix Current Situation vs 6m Exp.

Since 2007; the bigger the bubble, the more recent



Covid wave is receding, but supply constraints are not

Covid wave is now receding. Fifth wave this winter a risk, but social restrictions likely to be limited

Global growth to find a floor in H2... The global economy hit a speed bump over summer, on primarily two global forces: the delta variant and supply chain disruptions. China, where past policy tightening and regulatory interventions added to the local slowdown, and the US, where vaccination is lagging, have both suffered a significant slowdown. The Euro Area (EA) economy has shown good resilience but has still seen a sharp pullback in expectations (right chart above).

➢ Luckily, we see clear signs that the fourth global **Covid wave is now receding** and expect further social normalisation to support growth into year-end. Vaccine news has been sobering (lower efficacy versus Delta, time-sensitivity of mRNA, third shot, viral load of the vaccinated, Israel etc.) but the vaccines have still managed to

strongly decouple cases and hospitalisations (and deaths). As such, while a fifth wave may be coming this winter, we assume that related restrictions will be even lower.

Supply chain disruptions proving far more durable than policy makers were hoping for

- Unfortunately, **supply chain disruptions are proving far more durable** than policy makers were hoping for, and surging commodity prices are only adding insult to injury. The latter is a tangible threat to consumer demand, whose strength will be much needed as the western fiscal impulse recedes, particularly so in the US.

Global growth to find a floor in H2, but ongoing commodity price surge is a key risk to the consumer outlook

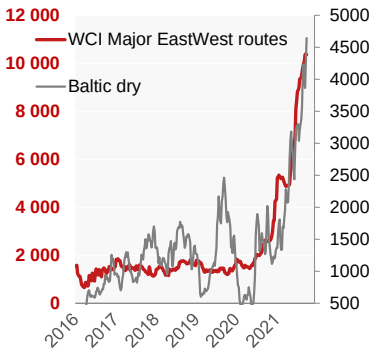
On a more positive note, we expect Chinese policy makers to cautiously relax the policy mix and prevent a hard landing of the economy (+8.0% this year, +5.2% next). The removal of the fiscal impulse will also be slow in the EA, with countries like France and Italy showing no hurry to bring deficits closer to the 3% mark, and the NGEU still playing out in 2022. In all, we assume an ongoing recovery, with EA GDP set to retrieve pre-Covid levels by Q4 2021 (+4.9% this year, +4.5% next). We see global growth at 5.7% this year, and 4.4% next year, with risks skewed to the downside as rising commodity prices and persistent inflation pressure threaten the consumer outlook.

We see both upside inflation risks and communication challenges in the context of the new mandate

... But policy risk is rising. Investors will need to navigate several icebergs this autumn. We do not see **Evergrande** – the poster child of excessive leverage and speculation in the Chinese property market – as the root of a systemic crisis. The Chinese government has embraced a multi-pronged strategy to cool the property market off, and this is working. However, they will be keen to avoid a crash, given the potentially large wealth effect and bank losses. The **debt ceiling** is another major risk, though eventually Democrats have the nuclear option of including the debt ceiling increase in the reconciliation bill. The fiscal and social package ($3.5tn intended) may be shaved off in the process, which will only emphasise the negative fiscal impulse. Finally, **Fed tapering**. This has been very well telegraphed, which should limit the market impact. However, we see both upside inflation risks and communication challenges in the context of the new mandate (Average Inflation targeting).

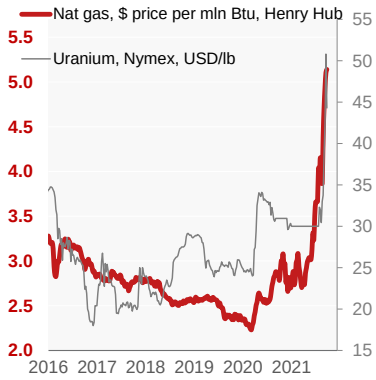
Fright Container prices

Hot-Rolled Coil Steel Index Futures



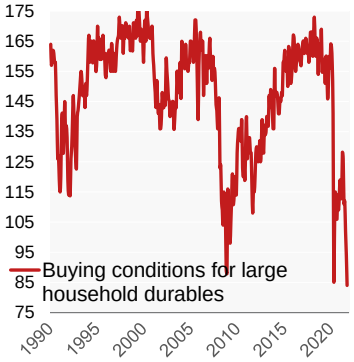
Source:Bloomberg,GIAM

Natural gas & Uranium



Source:Bloomberg,GIAM

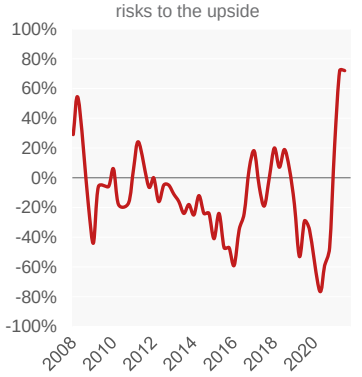
US consumer already fed up with high prices?



Source: UoM, Bloomberg,GIAM

FOMC sees inflation risk

Net % of FOMC members seeing core PCE risks to the upside



Source:Fed, Bloomberg, GIAM

Transitory inflation? Increasingly less so

Three months ago, already, we warned that "the shock is partly transitory, yet we have good reasons to believe that inflation will not return to the very muted pre-Covid trends". The size and speed of the policy mix support, a rising policy focus on inequality and the level-playing field, de-globalisation, ageing (lower global force), climate change are among the structural forces that may support inflation going forward. Of course, the 2021 inflation shock is partly transitory – a message that central banks have repeated ad-nauseum. However, risks of stickier inflation are rising:

➢ **Supply chain** issues are not being resolved as quick as expected. This shows up not just in producer prices but also in surveys about inventories, unfilled orders, backlogs etc.

Supply shock? Climate change and geopolitical forces also contributing to commodity price surge

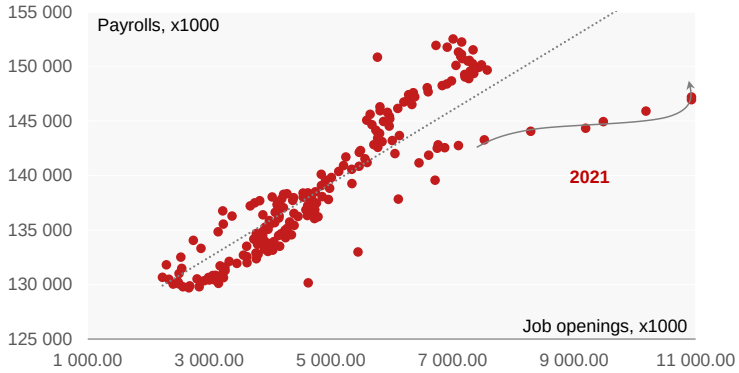
➢ **Commodity prices** are surging, threatening to impair the consumer's purchasing power and morale. Temporary factors are at play indeed: flooding in Germany and China, draught in Brazil, strong demand for good during the pandemic, soft wind in Europe etc. But more structural and geopolitical forces are also contributing, e.g. China's lower reliance on coal may imply a redistribution of the Russian natural gas. More generally, climate change implies an inextricable transition from old fossil energies to renewables energy. The old economy, typical fossil fuels, has been underinvested for years, and renewable energies require large investments for capacity constraints to diminish. This may create supply-demand imbalances that are unlikely to be resolved quickly. Hence the risk of ongoing price pressure; even after the recent rise, commodity price indices are very far from the 2008 peak.

➢ The **US labour market** has also suffered from restricted supply (left chart below), and rebalancing will require very strong job creation in the coming months and/or further wage gains.

➢ The **productivity** boom may be fading. Productivity surged through the pandemic, as corporations successively coped with labour shortages and booming demand. Strong productivity is good for margins, but also keeps unit labour costs muted. While the productivity boom may be partly structural (automation, digital transformation, work from home etc) it is likely to be largely cyclical. Any normalisation there, at a time of rising US wages, would add to inflation pressures.

US employment lagging job openings

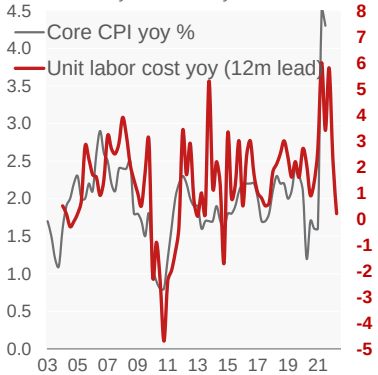
Since 2005, monthly



Source: BLS, Bloomberg, GIAM

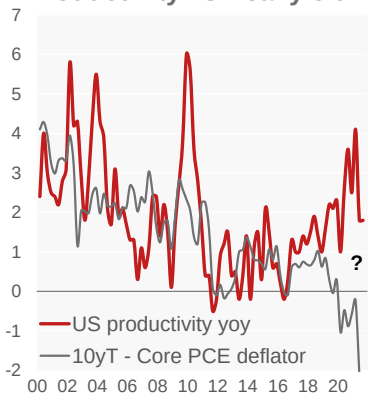
US ULC leads core inflation

Muted ULC key for transitory nature of inflation



Source: BLS, Bloomberg, GIAM

Productivity vs. real yield



Source: BLS, Bloomberg, GIAM

Central banks starting to show their teeth

Concerns about the efficacy of monetary policy, given that supply considerations are significantly impacting inflation and employment

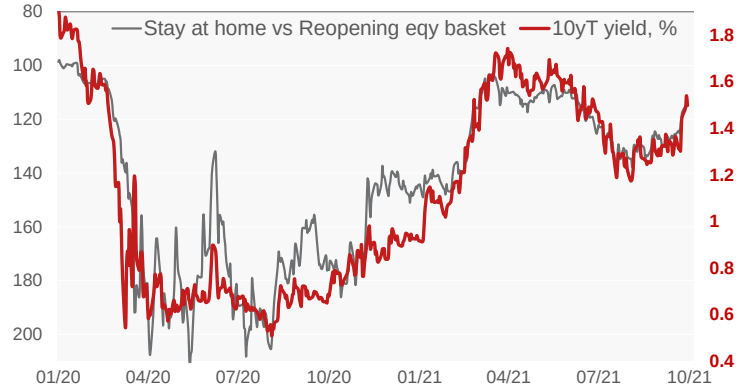
No tantrum, but headaches. Fed has so far skilfully navigated the journey to tapering, likely to be formally announced in November. By decoupling the rate lift-off from tapering, Powell has contributed to keeping market expectations about the rate path contained. But rising inflation risks are making the journey bumpier. The Fed has been clear that the inflation side of the mandate is now at a point where policy normalisation is warranted. Fed officials now very clearly see inflation risks skewed to the upside (chart). Employment is not there yet, but this is mostly because of restrained labour supply. So, we see a strong case for starting to taper bond purchases. Eventually, it is not entirely clear how the Fed would manage conflicting signals between inflation and employment. Worse still, concerns about the efficacy of monetary policy are rising, given that supply considerations are significantly impacting both inflation and employment; monetary policy does a better job stirring demand than supply. The ECB is in a slightly easier position, if only because the output gap is larger than in the US and wages appears far more muted. But the ECB hawks are also

showing their teeth, as angst about the management of the post-PEPP policy (from March 2022) will increase.

Reopening, sticky inflation (for now) and tapering all calling for (slightly) higher yields

Bond yields heading north. The pullback in bond yields in June and July was a surprise for us, notwithstanding the seasonal factors. We see the very dovish ECB sequence (new strategy and related communication adjustment) and the delta variant as key drivers of this correction. With the economy reopening more fully again, we expect bond yields to move North (left chart below). Sticky inflation will also make central banks less dovish, which will likely lead investors to revise the expected path for policy rates. USD OIS 5y3m is trading at 1.70%, which looks slightly low relative to the Fed's terminal rate at 2.5%. The 10-year Bund also looks stretched, relative to the sharp rise in inflation breakevens (right chart). Indeed 10-year real Bund yields are still extremely low, just above -2.0%, and are likely to adjust as we get closer to a more tangible ECB tapering in spring 2022 (like 10-year TIPS have started to adjust).

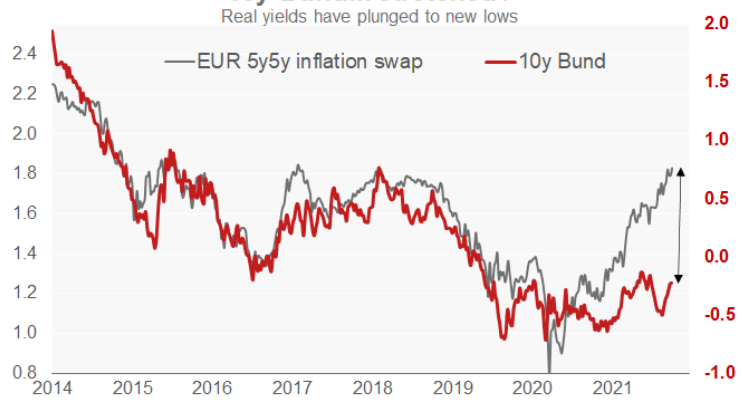
10yT driven by reopening sentiment



Source: GS, Bloomberg, GIAM

10y Bund... stretched?

Real yields have plunged to new lows

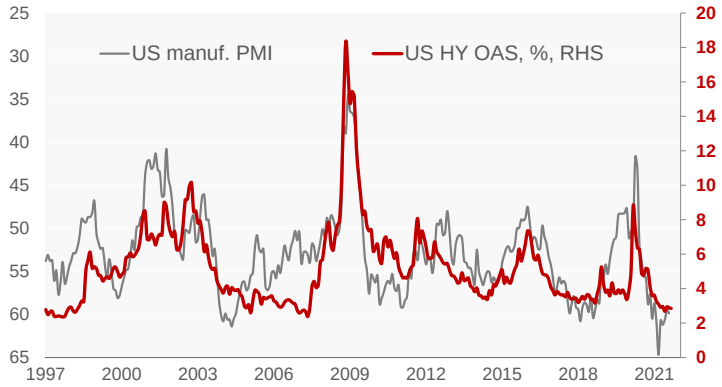


Source: Blmoomberg, GIAM

Credit still a decent low-volatility carry trade

Still a decent low-volatility carry proposition... Credit fundamentals have continued to improve, with trailing defaults falling and upward rating migrations accelerating. The asset class also looks well isolated from direct tapering impacts. Arguably a lot of good news is now in the price, and the potential for narrowing is small. But the asset class has been resilient to shocks, and spread volatility is near record low.

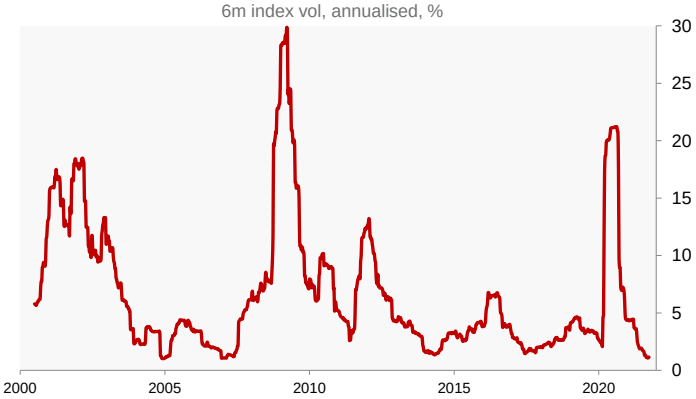
US High Yield vs. economic cycle



Source: ISM, Bloomberg, GIAM

EU HY near record low vol

6m index vol, annualised, %



Source: ISM, Bloomberg, GIAM

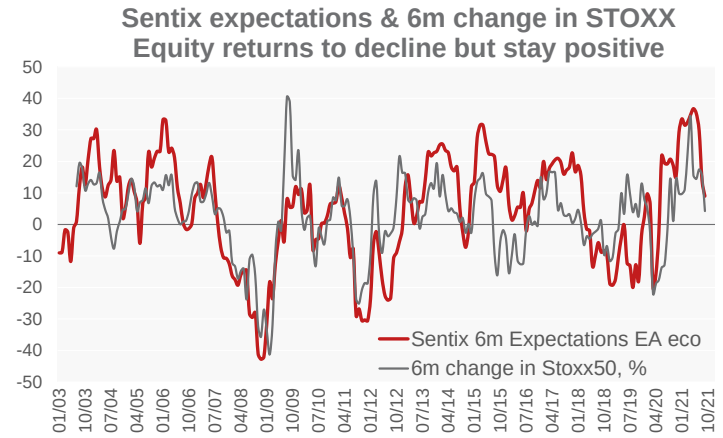
Credit unlikely to directly suffer from tapering; US High Yield looking richer than comparables

... with asymmetrical risks. The very tight spread environment has made risks very asymmetrical, hence we recommend a more cautious approach towards selected high-risk segments. US High Yield OAS spreads for instance are very close to their historical lows, more so than EUR High Yield. For choice we see more juice in EM Hard Currency debt still far from the bottom of the historical range. EM assets have

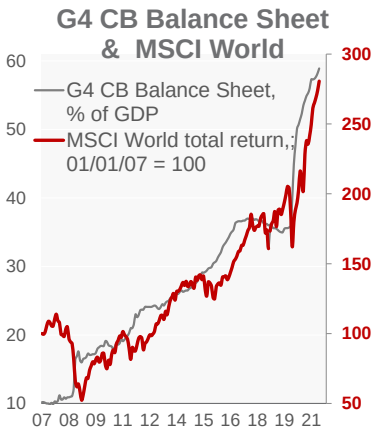
seen a lukewarm performance relative to DM (equities, FX, debt), but a less hawkish policy mix in China and a progressive vaccination catch-up should create a bottom.

Equities still up, but no longer running

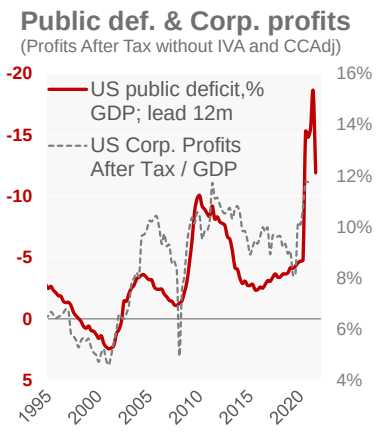
The tailwinds are diminishing. The three charts below make clear that peak economic (and profit) growth and peak policy are behind us. But investors surveys suggest that they have already well integrated the upcoming slowdown in profit growth.



Source: Sentix, Bloomberg, GIAM



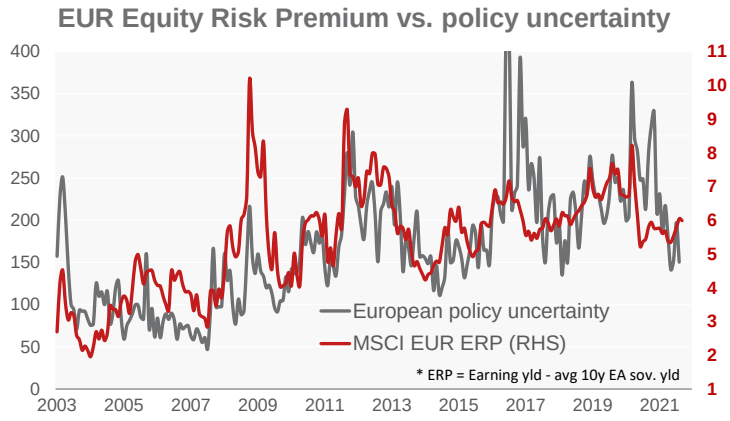
Source: MSCI, Bloomberg, GIAM



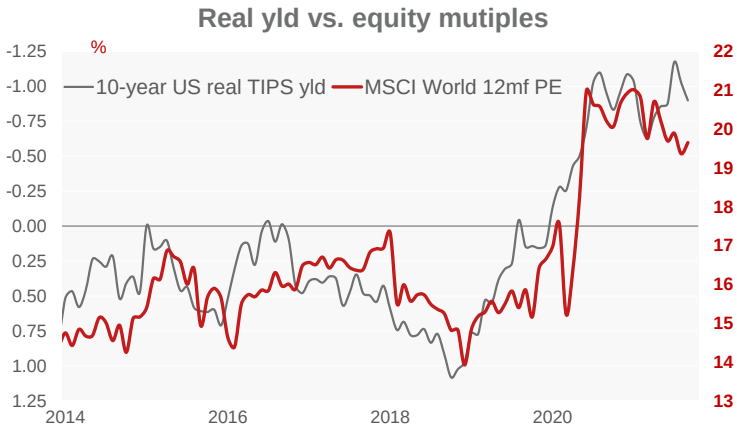
Source: Fed, US Treasury, GIAM

Equity returns set to slow sharply, but should still beat bonds

Equity Risk Premium (ERP) still hard to resist. Whilst we expect equity returns to slow sharply, they should still beat bonds. Equity multiples fell over summer, as prices seesawed while earnings surged. This leaves the ERPs at generous levels, particularly so in Europe (left chart below). Global equity valuations failed to track the fall in real yields in early summer; the latter are now recovering, which makes for a shakier financial environment. But as long as central banks manage to keep the move in long-term real yields contained, any correction in stocks should prove limited.



Source: Baker, Bloom & Davies, BBG, GIAM



Source: MSCI, Bloomberg, GIAM

Tactical asset allocation recommendations

We hold a positive risk bias but have significantly trimmed it. Our equity overweight (OW) is now smaller and focused on Europe and Japan (preferred to the US). We re-establish a larger Value bias, set to benefit from the rise in commodity prices and bond yields. We also trim our OW in Credit, particularly High Yield. We move into OW hard Currency EM debt. We continue to hold an UW in Core & Quasi Govies, and a small short in Duration. Beefing up cash makes sense through the autumn pitfalls. We will be buyers on dips in equities and expect self-correcting mechanisms (asset valuation depending on low yields, high leverage in the economy) to limit the rise in yields.

MACROECONOMIC OUTLOOK

Thomas Hempell, Christoph Siepmann, Martin Wolburg, Paolo Zanghieri

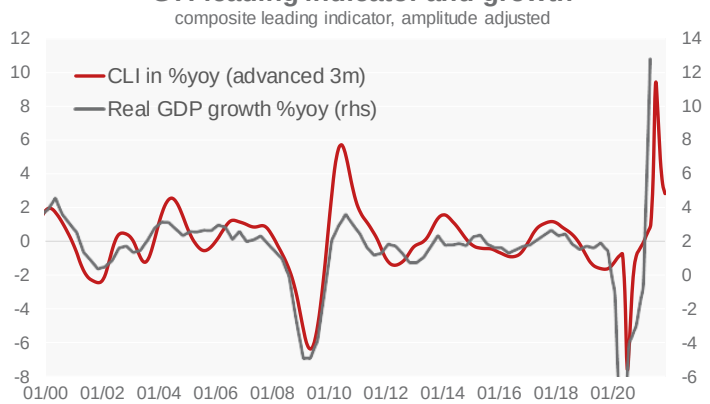
- **Global growth has peaked, with the post-pandemic rebound fading and Covid uncertainties lingering. The removal of policy support and a slowing expansion in China are also dragging on activity.**
- **Yet, the recovery is retarded, not derailed. Severe new lockdowns are unlikely, and large excess savings and recovering labour markets leave plenty of leeway for consumers to grow in private demand. Both in the US and the euro area, the rebound will grow above potential, but at a moderating speed.**
- **Bottlenecks in manufacturing, high commodity prices and persistent pandemic disruptions are posing upside risks to inflation that may get more entrenched especially in the US.**
- **The ECB's PEPP program will likely be unwound by March 2022 but be cushioned by increased regular APP purchases while a rate hike is still far off. In the US, the Fed is set to start tapering its asset purchases before year-end and may raise rates in late 2022.**
- **Tighter regulation, the Evergrande crisis and power shortages will continue to weigh on Chinese growth and will only be partially mitigated by targeted policy support.**

Global growth has peaked…

Global growth has peaked. Sentiment is burdened by resurgent Covid uncertainties into autumn, as protection from mRNA jabs is fading faster than thought. Supply bottlenecks will keep constraining manufacturing and global trade for longer, with shortages in microchips (car industry) a particular concern. Governments and central banks will need to gradually unwind their massive policy support measures aimed at mitigating the acute pandemic fallout. And the Chinese economy is slowing after its early rebound from the pandemic amid a regulatory clampdown and risks to the construction from recent trouble at Evergrande.

G7: leading indicator and growth

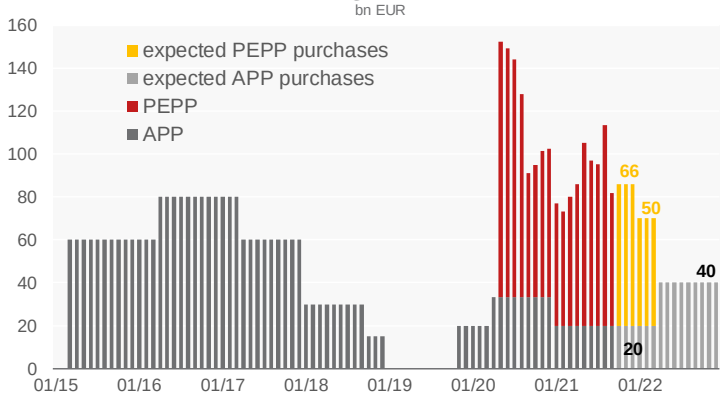
composite leading indicator, amplitude adjusted



Source: OECD, Datastream, GIAM calculations

ECB QE outlook

bn EUR



Source: Refinitiv, ECB, GIAM expectations

Recovery retarded, not derailed

…but the recovery still has legs well into 2022

Yet, all this will retard, but not derail the global recovery. Vaccinations do effectively contain severe Covid infections, keeping hospitalizations muted. With vaccination progressing, governments are unlikely to resort to any broad and severe restrictions. As a result, the re-opening rebound will be more stretched out, but not choked off.

While policy support is being removed, the adjustment will be calibrated much more carefully than after the Great Financial Crisis (in Europe also thanks to the roll-out of the NGEU funds). Most importantly, private demand has much more leeway to recover. Governments will pass the baton to consumers who are sitting on large excess savings while recovering labour markets will underpin consumer confidence. Meanwhile, companies have been stepping up investment not only in areas of acute

shortages (microchips), but also for enhancing IT infrastructure and organizational adjustments to the new post-pandemic normal.

Inflation risks have risen, with bottlenecks in manufacturing proving more sticky and commodity prices rising

On the less favourable side, price pressures are proving stickier than thought. Inflation has overshot strongly in various regions amid rising commodity prices, reopening disruptions, and bottlenecks in manufacturing. With inflation expectations on the rise, risks are growing that temporary pressures become entrenched via higher wage demands. Central banks around the globe are preparing the ground for less accommodation, especially via les asset purchases. Given persistent uncertainties from Covid and a fading fiscal impulse, monetary policy setters will need to act very carefully. While the Norwegian central bank was the first in the advanced world to deliver a rate hike in September, the BoE may follow in early 2022 and the Fed late that year. Yet hikes are still far off in the euro area and Japan.

ECB to cautiously withdraw policy support as the euro area recovery proceeds

Euro area growth is peaking bur recovery to stay intact

The unprecedented joint fiscal and monetary policy stimulus and significant progress on vaccination helped to the euro area to enjoy a strong summer bounce. The re-opening of the services sector was a driver for output expanding by 2.2% qoq in Q2, with this momentum likely maintained in Q3. Looking ahead, the recovery will proceed, but decelerate. The remaining stringency measures will be reduced only cautiously. Bottlenecks in intermediate inputs will continue to drag especially on the export-oriented manufacturing sector. The current inflation spike drags on real incomes. And with the pandemic pain easing, governments will withdraw their fiscal support. All in all, we see GDP growing by 4.9% in 2021 and 4.5% in 2022.

Amid the improved situation, the ECB announced to reduce its weekly PEPP purchases in Q4. We look for a further reduction next year and the scheduled termination of the programme by March. That said, the ECB will proceed very cautiously in withdrawing support, aiming to avoid a monetary policy cliff that could jeopardize financing conditions and the recovery. We expect the Governing Council (GC) to lift the volume of ordinary monthly asset purchases via the APP from € 20 bn to € 40 bn per month after March 2022.

Higher ECB ordinary QE purchases will avoid a policy cliff when ending the PEPP in March 2022

The hurdles for terminating QE and hiking rates are high. According to the new strategy the GC wants to see inflation reaching the 2% target well ahead of the end of its forecast horizon and beyond and also underlying inflation reflecting this. This point is still very distant, we deem 2025 most likely. The ECB will look through the current inflation spike that will abate in 2022 so that annual inflation falls back to 1.5% (even if commodity prices and bottlenecks leave upside risks). The ECB currently sees inflation merely at 1.6% yoy at year-end 2023. And as asset purchases are pledged to continue until shortly before the first rate increase, the market impact from expiring PEPP should be moderate. Only in case of a persistent inflation spike spilling over into core inflation would the ECB need to anticipate its first rate increase.

US: slower but solid growth. Upside inflation risks speed up Fed normalisation

US employment to continue to recover amid easing Covid fears, supporting consumption

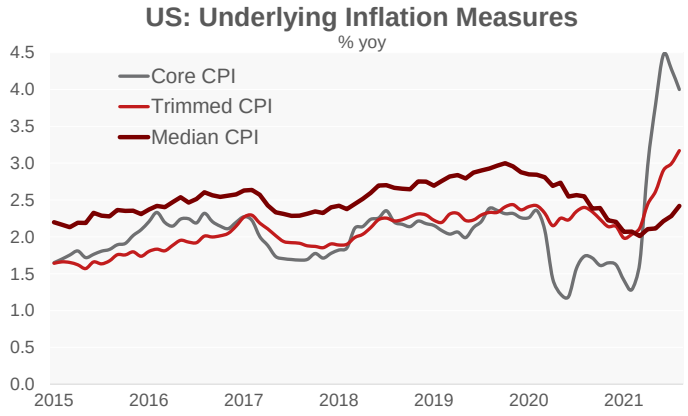
US growth has peaked in Q2 (6.6% qoq ann.) and will slow in line with the withdrawal of fiscal support. We see good chances, though, that labour income will be able to sustain consumption growth. Household income, net of government transfers, has increased at an average of 5% yoy in the three months to July, and the record level of excess savings provide a strong basis for consumption growth. Most will depend on the evolution of the pandemic, which is still preventing people from returning to the labour market (due to childcare and fears of contagion), capping the upside for employment growth despite record high job openings.

Hospitalisations and casualties are stabilising (with large differences across states), falling cases, which would benefit from a faster pace of vaccination, should weaken

the grip Covid is having on employment and services consumption. Easy financial conditions and strong domestic demand will keep supporting investment (10.2% annualised in Q2). Overall, we expect GDP growth at 6% in 2021 and more than 4% in 2022, still well above trend.

Tapering will begin by year-end. Sizeable upside risks to inflation may lead to 2022 rate lift-off.

Inflation remains a key risk to the outlook. CPI inflation moderated in August but remained well above the historical norm (headline at 5.2%yoy, core 4.0%). Yet the impact of bottlenecks is proving persistent, adding upside risks to our year-end 4.7% forecasts. The steady improvement in the labour market and inflation worries were key for the Fed's hints that QE tapering will begin before the end of the year. Moreover, half of the FOMC members now expect a rate lift-off by the end of 2022, and the median expectation for the fed fund rate is 1.75% by end-2014. Fiscal policy may be a source of market volatility until mid-October. The Biden administration is pushing an ambitious US$ 3.5tn fiscal package, geared on increasing welfare and "green" expenditures, but at the same time must find enough votes to approve the raise of the debt ceiling, which is instrumental to keep funding the government. Despite the tiny majority in the Congress, the Democrats have the means to force the approval of both measures, at the cost of a substantial reduction of the size of the fiscal package.



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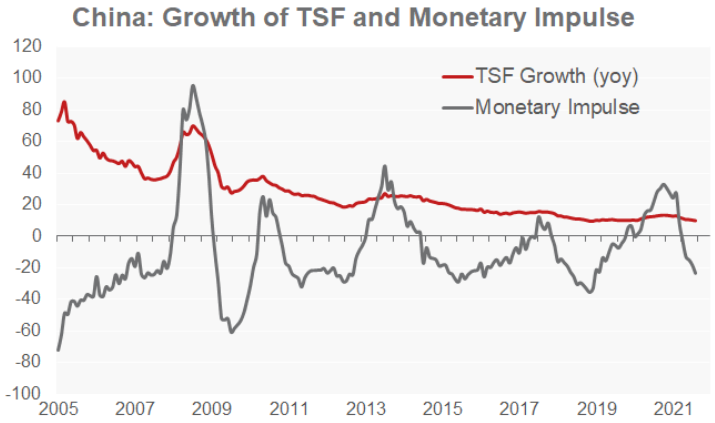


Source: datastream

Headwinds to China's economy to partially ease

China's monetary and fiscal policy likely to become less restrictive

China' growth has suffered in Q3 from multiple Covid lockdowns, regulatory tightening, less monetary and fiscal policy support as well as the Evergrande crisis. Most recently, power outages emerged as a fresh risk factor. Under China's zero tolerance policy, Covid outbreaks have hit retail sales and service production. Provided outbreaks can be brought under control, we expect these sectors to recover in Q4. Moreover, monetary and fiscal policy are likely to embark on a less strict course. Total social financing (TSF) growth, China's widest credit aggregate, receded by full 3 pp since last November. This drop outpaces previous consolidation phases. We expect the PBoC to cut the reserve requirement ratio (RRR) by 50 bps and to provide more liquidity. Fiscal policy has also been underwhelming while bond issuance reached only 44% of the quota granted. The Politburo already demanded an acceleration.

Nevertheless, there are hurdles for local governments to spend on infrastructure as the shadow debt of their financing vehicles is under Beijing's tight monitoring. The Evergrande crisis has increased the risk of cooling the economically very important real estate sector too much, but Beijing will work to prevent any larger spill-over effects. Beijing will also mitigate power outages by increased coal imports and price adjustments. All in all, we see Q4 growth dynamics to improve, but due to base effects the Q4 yoy rate is likely to weaken further. 2021 growth is expected at 8.0%, followed by 5.2% in 2022.

GOVERNMENT BONDS

Florian Späte

- **The recent upward trend in government bond yields is likely to continue in Q4. Less dovish central banks and growth above potential are forecast to pave the way to a moderate increase in yields.**
- **That said, the high level of debt worldwide and the vulnerability to a too strong and quick increase in yields will limit the upward movement. Moreover, lingering concerns about the US debt ceiling and a possible swelling of Covid infection rates in winter will also contain the expected rise in yields.**
- **Euro area non-core government bonds are still benefitting from the very accommodative ECB monetary policy stance. This will not change in the near term and will keep spreads at low levels in the months to come. Looking into next year, this support will weaken, and spreads are likely to widen.**

The overall almost unchanged international government bond yield levels in Q3 mask a rollercoaster ride. Since the beginning of August 10-year US and Bund yields have risen around 30 bps – and there is leeway for the increase to continue in the fourth quarter.

Global growth to find a floor in Q4

Firstly, the macroeconomic environment will support higher yields as the weakness of indicators appears to be discounted by financial markets. Going forward, growth in the US and in the euro area will remain above potential. What is more, China is seen to stabilize after a weaker Q3. Secondly, there is evidence that the spike in inflation turns out to be stickier than expected. The sharp rise in some commodity prices will feed through to higher consumer prices. The US labour market points to higher wage growth which implies ultimately higher consumer prices. This will underpin already heightened inflation expectations. Although financial markets have already adjusted expectations, the changing US inflation regime is only partially discounted for. In the euro area, the inflation risk premium is still negative which is at odds with the high uncertainty about the long-term outlook. Thirdly, the Covid wave has peaked. Considering the lower hospitalisation and mortality rates thanks to the slowly further advancing vaccination the reopening of economies is expected to continue.

Fifthly, various central banks have signalled that the very accommodative monetary policy stance will not last forever. The Fed has indicated a first key rate hike as early as 2022 and the BoE is even considering a first hike already in 2021. Thus, they have made clear that (despite modified monetary policy strategies) they do not want to remain inactive in the face of elevated inflation rates. Although financial markets have adjusted expectations there appears to be more room – particularly in the US. We agree with one hike in 2022 but forecast three more hikes in 2023 (in contrast to two hikes discounted by markets). Additionally, markets' pricing of the terminal US key rate is around 1.65%. While the Fed's own estimate of 2.5% appears unreachable there is room for a further adjustment which would also trigger higher long-dated US yields.

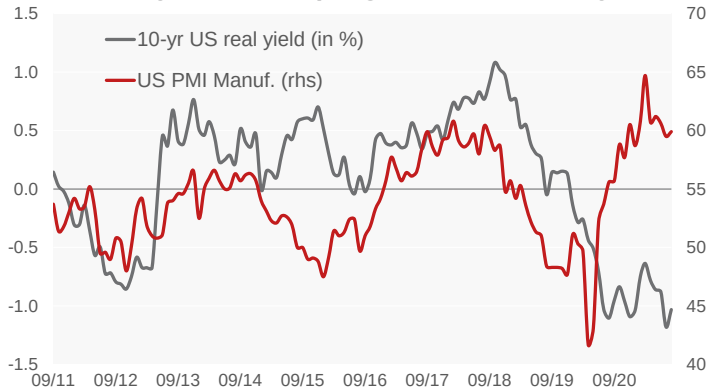
Central banks to reduce policy support going forward

While a first ECB key rate hike is not on the cards anytime soon it has started reducing the pace of QE purchases. We expect the central bank to buy € 60bn per month on average in the fourth quarter and € 50bn on average in Q1 2022. From Q2 2022 onwards the ECB is forecast to buy only € 40bn within the framework of the PSPP. The Fed is even seen to begin the reduction in Q4 and to finalise the (net) bond purchases by mid of 2022. Hence, a very strong pillar of international bond demand will become increasingly shaky (or even vanish altogether).

Sixthly, this also clouds the technical environment for government bonds as the decrease in supply will not make up for the drop in central bank purchases. Of course,

there is still a great deal of uncertainty about the issuance activity 2022 at this point in the year. But, based on current estimations, it appears that the US net supply will decrease to around US$ 1700bn. This is still the second highest in history and as the Fed is forecast to absorb only a little more than US$ 200bn (less than a quarter of 2021) the net-net supply (incl. the Fed) will come down only circa US$ 400 to US$ 1500bn. Net-net supply in the euro area will likely be positive again. It is even expected to rise to the highest level since 2014 as funding requirements are likely to remain on a rather high level and the ECB will spend less than 50% of the 2021 volume. If history is any guide the tapering will trigger higher real yields.

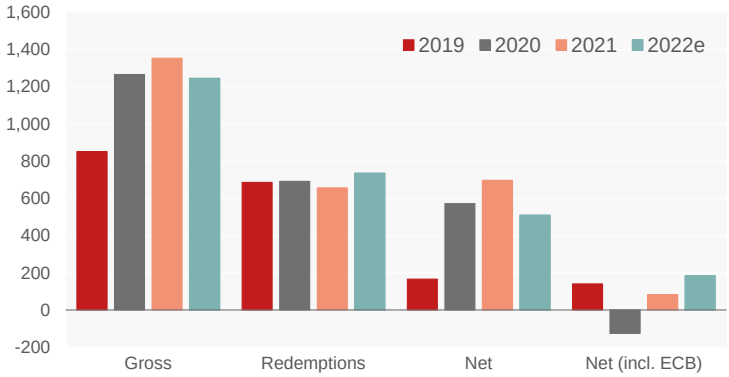
Real yields decoupling from the economy



Source: Bloomberg, Datastream

Euro Area: Government Bond Issuances

in bn €



Source: Bloomberg, Datastream, GIAM calculations

Seventhly, less dovish central banks will likely lift depressed term premiums into positive territory again. Given the still rather accommodative policy stance and the sustained low volatility, however, the extent will remain rather muted.

Some reservations remain, but will only slow (and not prevent) the forecast yield increase

Some caveats apply which will prevent too strong an increase in yields. Despite the path mapped out for policy normalisation central banks will reduce accommodation very cautiously. A too strong and quick increase in yields can overwhelm the global financial system amid the high level of debt. In the short term the US debt ceiling remains a concern and there is a risk of another Covid wave starting in winter. Moreover, at least in Q4 2021 the cash flow in the euro area will remain very supportive as treasurers' issuance activity is well advanced. Additionally, natural rates are seen to remain on a low level as a lasting rise in productivity growth is not on the cards. This will cap the yield increase even in the medium term.

Overall, we expect 10-year US and Bund yields to rise to 1.60% and -0.10%, respectively, on a 3-month horizon. Over the course of one year, we forecast another increase to 1.95% and 0.20%.

Euro area non-core bond spreads well supported – for now

ECB to keep euro area non-core bond spreads stable on a low level in Q4

The stable development of euro area non-core bond spreads is seen to continue in Q4. Although the ECB announced to reduce its purchases slightly the segment remains well supported for the time being amid the progressed issuance activity. Given the disbursement of the Recovery Funds' resources the foreign investors' confidence remains solid and bonds of non-core countries remain well bid. A special situation arises for French OATs. Amid the upcoming Presidential election campaign, we forecast OATs to underperform in the months to come.

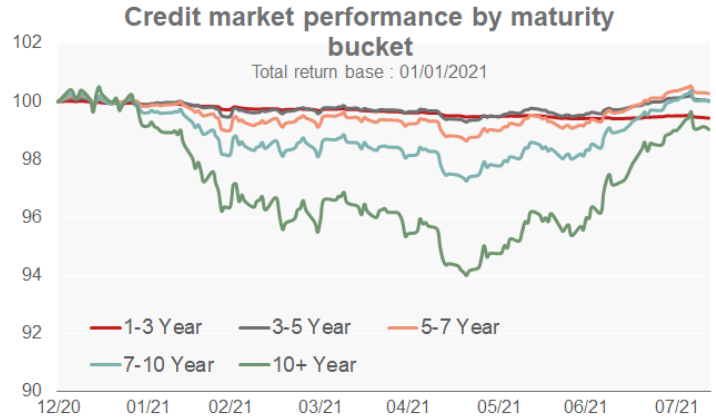
Looking further ahead, the situation will become more challenging. Support from the ECB will recede. What is more, the forecast increase in core yields reduces investors' search for yield to some extent. Hence, we forecast euro area non-core bond spreads to widen moderately from 2022 onwards. In the case of 10-year BTP/Bund spreads this implies a widening to 120 bps on a 1-year horizon.

CREDIT

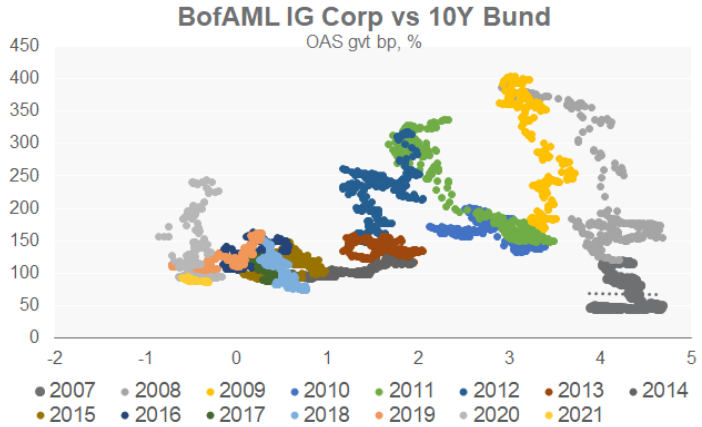
Elisa Belgacem

- **The growing pressure on central banks to normalise their policy sooner than expected could hurt credit, but our central case remains that the ECB will continue to purchase credit in the APP until at least end-2023.**
- **Hence volatility should remain low on IG, leading to slightly tighter spreads. But the upside/downside profile of HY is more balanced now on the back of a more fragile environment for risky assets near term.**
- **The second derivative of companies' fundamentals has likely turned negative, but we see fundamentals continuing to improve fast, implying less defaults and a still fast improving rating dynamic.**
- **The likely default of property developer Evergrande has not had any consequences on European credit markets, and we believe that it will remain an issue mostly contained in China.**

So far this year, carry has been king in credit markets, with high yield and AT1 out-performing the rest of the market. Volatility has remained extremely low. Even the very long end of credit curves has been resilient in spread terms despite the swings in underlying yields. We expect the end of 2021 to be less easy to navigate as policy risks are mounting, and valuations are increasingly expensive.



Source:Bloomberg, BofAML, GIAM



Source:Bloomberg, BofAML indices, GIAM

No tapering in sight for credit markets means strong technical to remain

Technicals will remain strong in credit beyond the tapering of the ECB PEPP…

Mounting inflation pressures are blurring markets perception by markets of the major central banks' reaction function. Nonetheless, for what regards the ECB, our central case remains continued support to the credit markets until end-2023 at the earliest. Up until now the credit purchases in the PEPP have remained limited, while the bulk of them is done in the APP. Consequently, the upcoming tapering of the PEPP should not be detrimental to corporate debt. In the case where the APP would be increased to avoid the cliff-effect in March 2022, this would even marginally be credit positive in signalling that the ECB will keep a significant soothing power for markets in general, and particularly for credit markets.

HY is more vulnerable to upsides in interest rates, especially real ones

…while higher real yields would be more detrimental to HY.

Hence this will keep volatility low in IG as the ECB has fought any widening pressure of spreads. But the uncertainty on the inflation outlook is starting to push yields higher, damaging credit total returns. In the second quarter of this year, credit had proved very resilient to higher nominal rates. This time real rates are also pushed slightly higher, HY returns have turned negative for the first time not triggering any selling pressure for now. Should real rates move higher faster than we currently expect, this would likely trigger outflows from the credit, being more detrimental for HY than for IG

as the sub-investment grade universe is more sensitive to flows than investment grade.

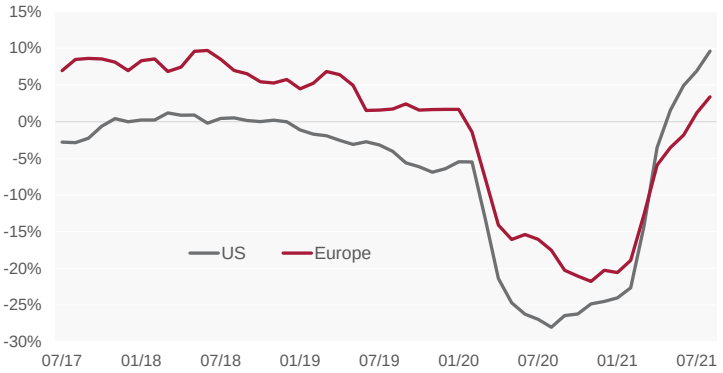
Fundamentals are extremely strong and continue to improve

Fundamentals will continue to improve although less rapidly

The last reporting season has been extremely strong, amplifying the trend in place of rapid company deleveraging supported by rapid earnings growth. This is translating both into ratings and default numbers. The rating trend is strong across both the US and Europe but also IG and HY. In Europe for instance, we have currently twice more upgrades than downgrades in the HY space. The number of companies defaulting is also normalising fast, coming close to 3% both in the US and in Europe, i.e. slightly above the long-term average, after a peak at 5% only in Europe and 9% in the US end 2020. Defaults should continue to decrease in the Western world despite the removal of the institutional support to corporates, which seems to proceed rather smoothly.

Trailing 12-month rating drift

Rating Drift = (notch upgrades - notch downgrades)/rated issuers



Source: Moody's, GIAM

European speculative-grade default rates

12 months trailing

Source: Moody's, GIAM

Evergrande spread contagion is limited to the Asian region

The Evergrande saga is a good reminder that excess leverage is not allowing corporate defaults to be decreasing everywhere. In China, the over-indebtedness of property developers are currently moth a micro and a macro problem, with Evergrande being the posterchild of the Chinese exuberant real estate market. Bondholders will likely be put to contribution, both on the offshore and onshore side, as currently reflected in Evergrande's bond prices trading around 25% of their notional value. The Chinese offshore bond market, as well as the Asian HY index, are trading wider on the news but we see no spillover effect in Europe, neither on the banking sector nor in the real estate one. This market behaviour is in line with our view that Evergrande is not a Lehman moment and will not spread globally.

Still OW credit but more defensive on HY

Favour BBBs, BBs, corporate hybrids and AT1s.

We continue to view the carry/volatility trade-off as attractive in credit, still justifying our OW position despite tight spreads. The strong technicals and fundamentals call for some modest tightening in IG, 5 to 10bp by year-end. In HY the upside/downside profile is more balanced as the asset class is not directly protected by the ECB. We have downgraded last month HY to neutral versus IG versus OW previously to reflect its higher vulnerability to the current environment.

Within IG we continue to like BBBs despite their richness as we believe it is the highest carry protected by the ECB. Within HY we like BBs as we want to position defensively. Both corporate hybrids and AT1s are our favourite yield-enhancement alternative as they trigger almost no yield give-ups versus their respective senior equivalent in BBs and single-Bs while they proved much less volatile during Covid. In terms of sector allocation, we continue to have a modest cyclical tilt.

EM SOVEREIGN CREDIT

Guillaume Tresca

- **The EM outlook remains challenging despite the decline of tail risks. Expected total return for EM external debt will be barely positive by year-end and volatility will grind higher in tandem with core rates.**
- **We maintain our MV view and now favour EM IG over HY. EM IG outperformance will be driven by its low beta status. We focus on BBB and low duration names. EM HY will be affected by growth concerns and higher real yields.**
- **Opportunities are emerging in LatAm where some disruptive risks have declined. We see value in Mexico EUR and Chile EUR. Colombia, after a significant widening, starts being attractive.**

Even if some tail risks have been abating, the EM outlook has remained challenging. It is too early to sound all clear on EM assets and volatility will grind higher with rising core yields. Indeed, the recent rapid surge of long-term UST rates and Chinese economic slowdown concerns have been a remainder that the expected total return for EM external debt by year-end will be barely positive in the best case.

We expect a modest spread compression and total return by year-end. Volatility will grind higher.

Thus, we maintain our MW view on EM EXD with a low risk profile as we expect a modest spread compression until year-end. EM external debt is still more a carry and relative play than a directional play. Dispersion among EMBIG names is high – fat tails – and it should help to focus on relative-value trades.

On the positive side, vaccine rollout has been improving and the largest EMs will likely reach herd immunity in mid-22. More problematic is the low-income countries as the COVAX program is lagging. However, the bright side is that the variant resurgence has had less impact on restrictions and mobility (especially in LatAm) and so on economic activity and fiscus eventually/

On the negative side, EM economic activity has been slowing throughout the summer. Even if the Evergrande related issue had limited impacts on the EM sovereign complex, China's growth outlook remains a dampening force and concerns on global growth will weigh on EM spreads.

Higher UST to lead to very modest TR by year-end

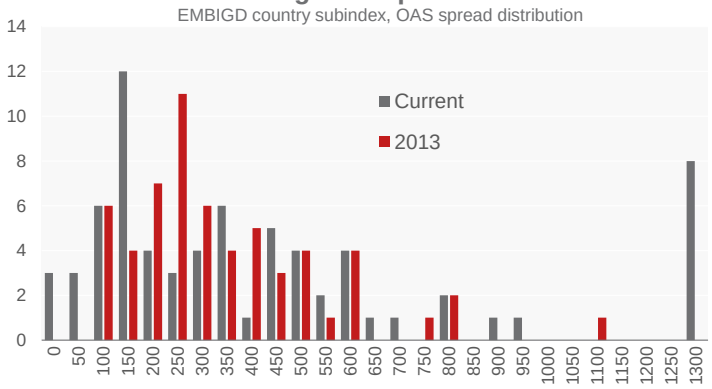
3M TR for different scenarios, BofA index

OAS spread	US 8Y 1.14%	1.24%	1.34%	current 1.44%	1.54%	1.64%	1.74%	1.84%
246	7.84%	6.99%	6.14%	5.30%	4.45%	3.60%	2.75%	1.90%
256	6.99%	6.14%	5.30%	4.45%	3.60%	2.75%	1.90%	1.05%
266	6.14%	5.30%	4.45%	3.60%	2.75%	1.90%	1.05%	0.20%
276	5.30%	4.45%	3.60%	2.75%	1.90%	1.05%	0.20%	-0.64%
286	4.45%	3.60%	2.75%	1.90%	1.05%	0.20%	-0.64%	-1.49%
296	3.60%	2.75%	1.90%	1.05%	0.20%	-0.64%	-1.49%	-2.34%
306	2.75%	1.90%	1.05%	0.20%	-0.64%	-1.49%	-2.34%	-3.19%
316	1.90%	1.05%	0.20%	-0.64%	-1.49%	-2.34%	-3.19%	-4.04%
326	1.05%	0.20%	-0.64%	-1.49%	-2.34%	-3.19%	-4.04%	-4.89%
336	0.20%	-0.64%	-1.49%	-2.34%	-3.19%	-4.04%	-4.89%	-5.74%
346	-0.64%	-1.49%	-2.34%	-3.19%	-4.04%	-4.89%	-5.74%	-6.58%

Source: Bloomberg, GIAM calculations

Higher dispersion

EMBIGD country subindex, OAS spread distribution



Source: Bloomberg, JP Morgan, GIAM calculations

Focus on IG over HY

IG/HY compression trade is losing steam

Within a more volatile environment, we turn OW EM IG over HY as we expect the IG/HY compression trade to lose steam. Indeed, EM IG outperformance will be driven by its low beta status while EM HY tends to underperform in a rising rate environment driven by higher real yields.

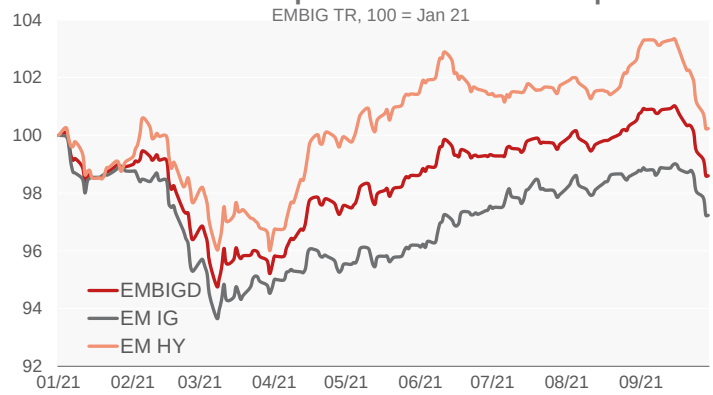
IG valuations are tight and so we focus on BBBs and low duration names. The recent sell-off provide opportunities in EM Europe that has been underperforming or in IG MENA where valuations have been cheap and could benefit from higher oil prices. We still avoid Asia IG where spreads and high duration do not offer a buffer against higher core rates.

HY to be affected by higher real yields and growth concerns

In the HY space, the strong performance through the summer will be hard to replicate. Question marks on the global growth and the Chinese slowdown should hurt temporarily high beta names. Moreover, EM HY issuance pipeline will turn heavy while market is OW. We note that the more-than-usual difficulty to absorb the latest Nigeria and Egypt primary issuances. In terms of valuation, EM HY looks globally cheap, but it is driven by distressed names. Several HY names, especially B and below, still exhibit poor fiscal metrics and so we focus on the quality BBs. That said, the new SDR allocation is providing some support to low-income countries, especially in LatAm.

EM HY summer performance: hard to repeat

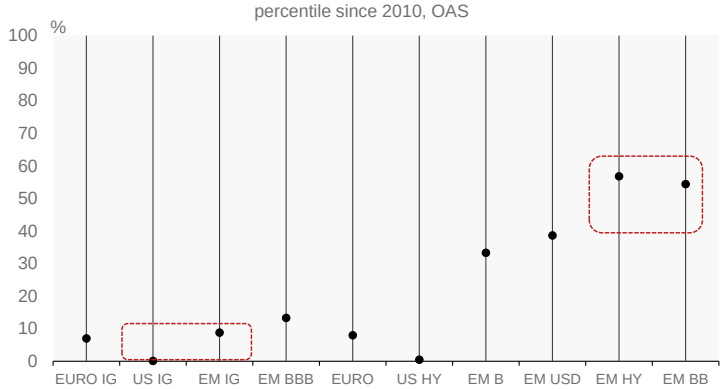
EMBIG TR, 100 = Jan 21



Source: Bloomberg, JP Morgan, GIAM calculations

Tight spread valuations

percentile since 2010, OAS



Source: Bloomberg, JP Morgan, GIAM calculations

LatAm: pockets of opportunities are emerging

LatAm has been underperforming YTD on the back of negative idiosyncratic factors (politics, Covid) and longer duration. Politics will continue to weigh in Q4, but the situation has improved with better vaccination rollout and economic recovery

Fiscal consolidation is the main source of concerns. Several countries will reduce their fiscal deficit in 2021 but it should not be enough to alleviate medium-term concerns. Upcoming elections could jeopardise the fiscal tightening.

That said, some countries offer value now. We recommend Mexico EUR and Chile EUR. Mexico is benefiting from a tight fiscal stance and the downgrade risk has been fading substantially. Populist risk has been diminishing. Chile spreads are attractive compared to rating peers. Political risk is remote, and fundamentals are still solid. Colombia, after a significant widening, is attractive. Expected fiscal improvement will provide support. On the other hand, it is too early to take risk in Peru. The risk of disruptive economic and fiscal policy is still too high.

A mild technical backdrop to weigh on spreads

EM sovereigns enter September with large financing needs yet to be completed. Recent deterioration of risk appetite has led to less-than-expected issuance and so we would expect issue to pick up significantly in Q4. With already tight spreads, absorption will lead to minor spread concession. Roughly USD60bn remains to be issued or c. USD25bn in net issuance. An acceleration in bonds inflows will be needed (USD1-2bn/week) as they have been quite low through summer with the Taper concerns.

CURRENCIES

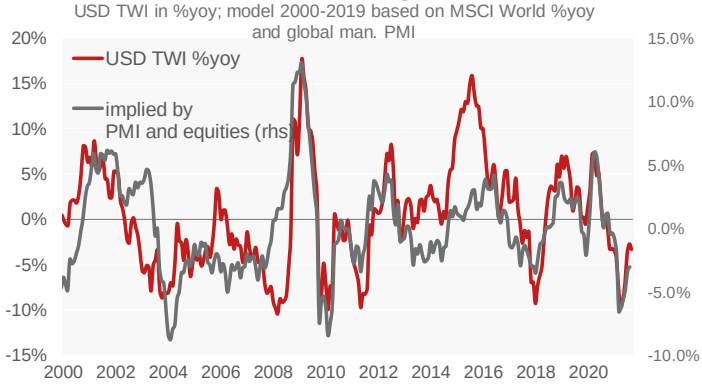
Thomas Hempell

- **The global recovery still has legs, bearing headwinds for the countercyclical USD. Yet tailwinds from the Fed are mounting. Support from the tapering QE may prove transitory, but an earlier rate lift-off (now in our books for end-2022) and faster rate hikes thereafter make us lower our mid-term EUR/USD forecast to below 1.15.**
- **We caution against writing off the EUR early, though. An ongoing recovery, the fading of the ECB's emergency support, the euro's new appeal for international bondholders by EU bonds and ongoing reserves diversification still support the single currency.**
- **The JPY is prone to suffer further short term from rising US yields, but more attractive real yields and capital inflows should bolster the cheap yen over the medium term.**
- **The SNB will be the laggard in the global monetary normalisation cycle, leaving downside for the overvalued CHF.**

While the summer Covid waves and bottlenecks in manufacturing have curbed the upswing, the global recovery still has legs. And we also see further (though moderating) upside for equities. This implies continued headwinds for the USD that is still lagging the global rebound (see left chart). The USD overshoot is also confirmed by our EUR/USD models based on yields, EMU risk, equities, and oil price, where the gap has widened to more than 7% (right chart).

USD crosscurrents amid global rebound

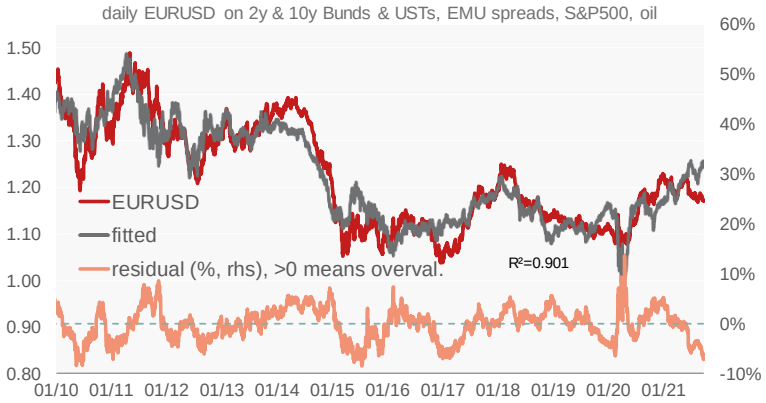
USD TWI in %yoy; model 2000-2019 based on MSCI World %yoy and global man. PMI



Source: Datastream, GIAM calculations

EUR/USD model

daily EURUSD on 2y & 10y Bunds & USTs, EMU spreads, S&P500, oil



Source: Datastream, GIAM calculations

Fed's lead in policy normalization supporting the USD

A more hawkish Fed outlook will imply more tailwinds to the USD…

Yet one of the reasons for USD strength is the recent more hawkish twist by the Fed amid persistent inflation overshoots. Not only have we moved closer to the tapering of QE (which may start as soon as November), but we now have a rates lift-off in our books already for late 2022 (from mid-2023 before) and steeper rate increases thereafter. USD sensitivity to short-term rates has been exceptionally high this year (left chart next page). Even accounting for risk sentiment, energy prices and long-term yields, a 10 bps widening in 2-year UST-Bunds yield differentials has been associated with a 2% lower EUR/USD. With the short-term yield gap to widen by >30bps, EUR/USD at 1.10 seems within scope over the next twelve months.

…even if we caution against writing off the EUR too easily

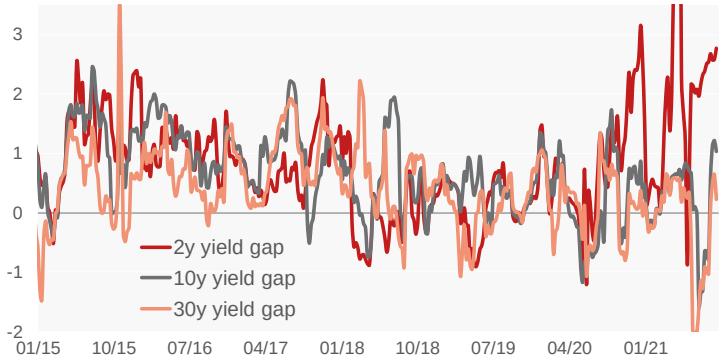
Yet, this is unlikely to materialize as yield sensitivity is likely to recede closer to much more muted historical levels. Also, amid the persistent euro area recovery, the ECB will itself start to taper its asset purchases in 2022. The C/A surplus ensures continued capital inflows while ongoing reserves diversification out of the USD benefits the EUR. The massive issuance of EU bonds will help to further reassure foreign investors on the long-term stability of the single currency. And following the massive USD support

We downgrade our twelve-month target for the EUR/USD to 1.15 on a more hawkish Fed outlook

from CFTC speculative positions from US$ 35.3 bn net short in January to US$ 13.4 bn net long in mid-September, this speculative push for the US dollar is set to fade. We thus see a stable EUR/USD near term, but downside to below 1.15 on a twelve-month view – a sizeable mark-down from the 1.20 mid-term target maintained in summer.

Betas EUR/USD and yield differentials

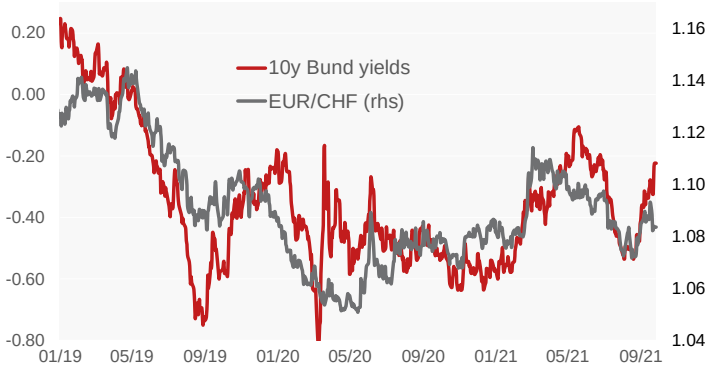
%EUR/USD associated with 10 bps in yield gap widening, 2m rolling estimates, based on weekly data



Source: Datastream, GIAM calculations

Bund yields and EUR/CHF

yields in % p.a.



Source: Datastream, GIAM

JPY burdened by rising US yields, but with recovery potential for 2022

Rising US yields imply yen weakness near-term. Medium term, cheap valuation and more attractive real yields in Japan may bolster the yen, though

With the BoJ keeping Japanese rates nailed close to zero, the yen remains tied to US yields. The recent bond sell-off has taken USD/JPY above 111 for the first time since the pandemic. And while we see a mild yen recovery into 2022 owing to favourable real yields in Japan, good chances of equity inflows and very cheap fundamental valuation, higher US yields and looming Fed rate hikes will keep the USD/JPY above 110 well into 2022.

The CHF has recently decoupled from Bund yields amid safe haven flows amid worries around Chinese developer Evergrande and deteriorating risk sentiment. Yet as we see more upside in equities and continued growth, the still overvalued Swiss franc has scope to catch up with the recent rise in Bund yields that points to EUR/CHF closer to 1.10 (right chart). And even if disinflation worries have abated in Switzerland, risks to the recovery will keep the SNB on the dovish sides and committed to continued FX intervention.

The British pound will remain supported by the more hawkish policy outlook provided by the BoE more recently. A first cut is in our books for early 2022, but an even earlier move as soon as November cannot be ruled out. That said, the expiration of furlough schemes and plans to raise taxes are weighing on the outlook. Mounting economic bottlenecks aggravated by the Brexit are not helping either, with the lack of lorry drivers adding to fuel and food shortages. Conversely, the EUR/GBP will find support in the continued continental recovery. Overall, these factors will balance largely near term, even though the more pronounced monetary policy outlook favours the GBP over the medium term, with the 12-month EUR/GBP outlook slightly lowered to 0.85.

Prudent stance on EM FX, even if CEE-3 offers opportunities

Amid a more challenging outlook for EM FX, we see opportunities in PLN, CZK and HUF

Emerging markets are much better positioned for the Fed tapering than in 2013, with external positions more balanced, exchange rates cheaper, reserves more plentiful and much less of hot money inflows having flown into EMs over the previous quarters. The slowdown in China is a headwind especially to Asian FX and commodity producers, although stronger supply shortages have commodity prices to somewhat decouple from lower Chinese demand. Overall, however, we remain prudent on EM FX. That said, we see opportunities in CEE-3 (PLN, HUF, CZK) thanks to the exposure to the European recovery and the scope for continued rate hikes.

EQUITIES

Michele Morganti and Vladimir Oleinikov

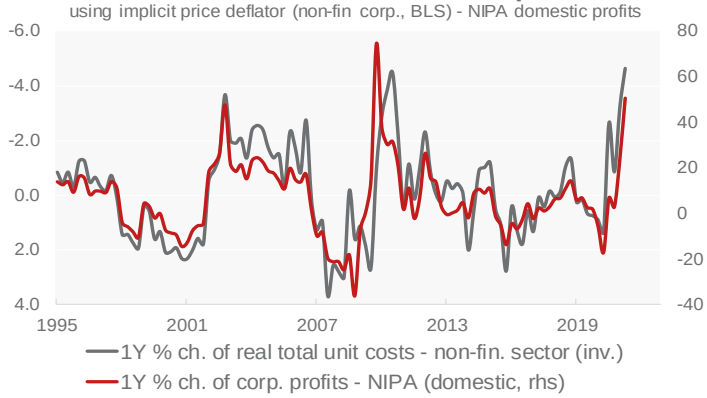
- **Equities are getting more volatile, but we think they still deserve an OW position, albeit lower than before the summer. Risks are indeed rising, consistently with a more mature phase cycle. China amplifies such concerns, as do policy normalisation, sticky inflation, surging input costs and higher yields.**
- **That said, even adopting a lower earnings growth estimate vs consensus for the next 3 years we still envisage a total return of at least 6% in 12 months for both the US and EMU. CAPE yield gap vs 10-year real yield is aligned to history and more attractive vs. past market peaks. Positioning and PEs have moved lower, with the EMU risk premium now at norm since 2008. Bond volatility and fast change in yields are a source of concern but unlikely to derail risky assets yet. Firms' margins are probably peaking, though remaining overall healthy in the next months.**
- **We slightly prefer EMU and Japan vs the US as both are more Value tilted and benefit from higher inflation and yields. Among European sectors, we OW Value (financials, energy) and to a lesser extent Cyclicals. The valuation of the latter is less appealing. Given higher risks, we OW also attractive secure sectors like software, food and pharma. We UW media, telecoms, utilities and real estate.**
- **MSCI China is still at risk as valuation is not cheap enough (neutral), given lingering regulatory uncertainty and weaker growth prospects. We are more positive on A shares and on Korea, Poland and Taiwan.**

Albeit lower than consensus, our yield and earnings expectations back positive total returns in 12 months

Higher risks do not mean the end of risky assets, yet. A mature economic cycle always brings some instability. Currently, we see falling global confidence indicators, inflation stickier than we thought, surging input costs and central banks turning more hawkish. Real long yields have risen, too. Furthermore, policy support is fading and China regulation crackdown, while self-induced, still has the power to trigger additional lower global growth, accelerating the end of positive profit revisions. Markets are currently digesting such negative news flow. That said, there are counter arguments for us to maintain an OW on equities, albeit to a lesser extent than before. In past recoveries net margins always in-creased for 1-3 years notwithstanding higher input costs (volume and operating leverage effect). Currently, unit labour costs are also low, and our margin proxy stays very high, though probably near a cyclical peak. Both the Fed and the ECB remain flexible and will smooth the transition process. Real rates stay low enough and supportive to valuations in the meantime. The fast increase in bonds volatility and rates represents risks, albeit currently still manageable. Lastly, the earnings yield (CAPE yield) spread versus 10-year real yield is aligned to norm, staying decidedly higher when compared to 2000, 2008 and 2018 market peaks.

US real total unit costs & NIPA profits

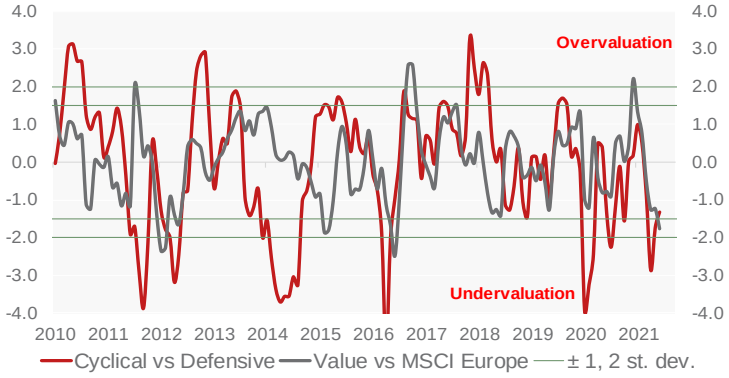
using implicit price deflator (non-fin corp., BLS) - NIPA domestic profits



Source: Datastream, GIAM

MSCI Europe Styles: Value and Cyclicals

distance from Machine Learning fair value model, in SD



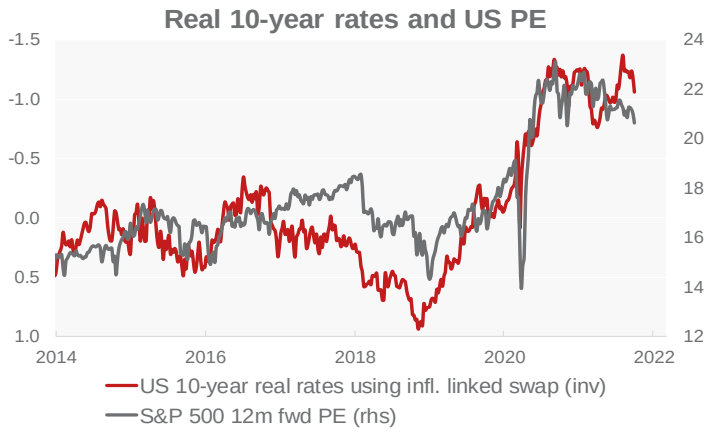
Source: Datastream, GIAM calculations

Still positive returns ahead, EMU and Value sectors are OW

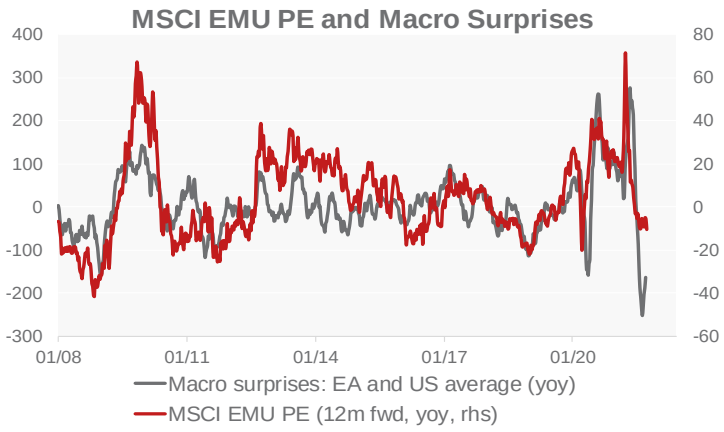
EMU risk premium is back to norm, making the index less vulnerable, given lingering supportive financial conditions

Toppish earnings revisions, but positive total returns in 12 months. As a result of weaker macro surprises and probable negative revisions ahead we adopt a cautious approach to earnings estimates for the next years. Indeed, our quant models and qualitative earnings assessment back an average earnings growth in 2021, 2022 and 2023 of nearly 50%, 7% and 7.5%, respectively, both in the US and the euro area (EA). We remain under consensus by 5% in 2022 and 7% in 2023.

Such estimates still provide a positive total return of at least 6.5% for the euro area and 5.5% for the S&P 500. Price/earnings estimates have already come down visibly and most of all, macro surprise momentum has reached a cyclical trough. Thus, the bulk of economic downgrades should be behind us. For the US valuation, we adopt an additional assessment based on long-term Shiller series for risk premium, using as inputs our earnings forecast and 10-year yield forecast (1.6% and 1.9%, in 6 and 9 months, respectively. The result is that we see the US index as fairly valued between 4,600 and 4,900 in 12 months. Given higher risks, we think that such fair value should become more volatile going forward that's why we lowered our OW position in equities. We have a slight preference for the EMU index and Japan vs US. Concerning sectors, we looked at our quant models, valuation, sensitivity to inflation and higher yields. They all suggest maintaining an OW on Value sectors (financial and energy) and less so on cyclical ones. The latter show in some cases not comfortable valuations (capital goods, comm/prof. services, tech. hardware and semis). Given the more mature phase of the cycle and cited risks, we adopt also an OW on more secure sectors like software, food and pharma. We UW media, RE, telecom and utilities.



Source: Datastream, GIAM



Source: Datastream, GIAM calculations

EM Equities: subject to higher volatility in the short term

EMs: We remain neutral short term as earnings are likely to lag global ones but valuations are getting attractive in the mid-term horizon

EM PEs have already normalized, reaching comfortable levels (12.7X) and getting attractive vs MSCI World. That said, EM earnings are lagging those of DMs, and likely to do so short term: temporarily slowdown of Chinese economy in Q3, lower vaccination rates, and falling export orders. In the mid-term, lower valuations should play out in favour of EMs as they would see the ongoing rebound in domestic growth and more supportive Chinese policy.

Chinese stocks (A-shares) are starting to look attractive within global equity universe. In mid-February, our fair value indicator (12-month forward earnings / 10-year yields) for the MSCI China showed an overvaluation of 35%, which has dropped to a current 3% after the recent market rout. MSCI China's pullback has not brought valuation to previous market trough (undervaluation of at least 20%). So, we remain UW short term amid unresolved regulatory uncertainty and weaker growth prospects. We favour A-shares (slight OW), due to more attractive valuations, lower regulatory pressure, and lower Tech weight. Within other EMs, we overweight OW Korea, Poland, and Taiwan.

ASSET ALLOCATION

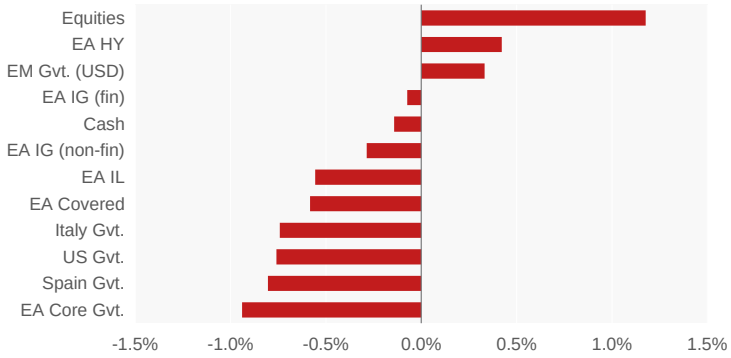
Thorsten Runde

- **Since the slump in the summer, yields have been on the rise again. We expect this trend to continue in a generally less supportive monetary policy environment, although with a limited potential.**
- **With growth to stay above potential in H2, we expect Credit to extend its resilience.**
- **Likewise, with real yields still close to historical lows and solid earnings perspectives there should at least be some further moderate upside potential for Equities.**
- **On balance, we continue to favour risk assets at the expense especially of longer dated government bonds. That said, owing to several risks ahead (e.g., debt ceiling dispute in the US, taper concerns) we trim our active tactical weights.**

After a successful second quarter, our model portfolio achieved just slightly positive active returns in Q3 2021 *(28.09.21).* The relative performance is generally back on track again since the beginning of August, after having significantly suffered from the corrections on the bond and stock markets in the first half of July.

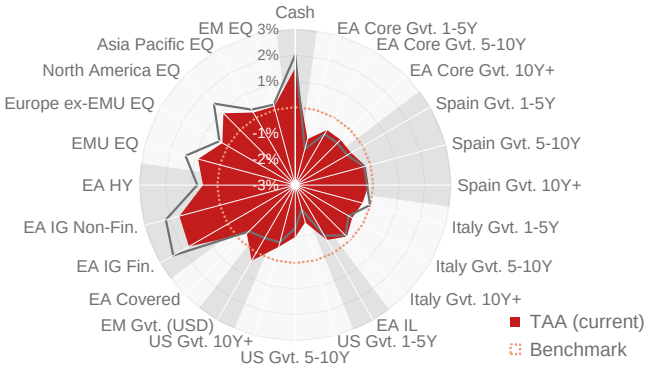
Global growth has entered a phase of consolidation driven by bad news about the duration of the protection offered by mRNA vaccines and persisting gaps in the supply chain. Yet, the recovery still has legs. Particularly, as vaccinations clearly mitigate the disease progression and thus the hospitalisation rate as well as the mortality, strict lockdown measures as applied during the third Covid-19 wave should be generally avoidable. With decoupling policy measures from the incidence value as the only relevant criterion, the way to more (economic) normality seems to be paved.

Aggregated Total Return Forecasts
(3m horizon, hedged into EUR)



Source: GIAM calculations

Balanced MtM Model Portfolio
(active positions in pp)



Source: GIAM calculations

Pro risk asset stance basically confirmed but to a slightly reduced degree

With real yields staying extremely low and growth remaining above potential in H2, we still see some further upside for risk assets. Yet, acknowledging for caveats like the debt ceiling dispute in the US, taper concerns, and inflation to prove less transitory than initially expected as well as the substantial gains already achieved, we recommend an even more cautious alignment than before.

We mildly reduce our prudent overweight positions in Equities and those in Credit. In turn we trim our underweights in the Government Bond section. We open a small overweight in EM Govies (USD) as the outlook has improved marginally on Covid concerns having receded somewhat with new cases flattening out and vaccination progressing. We carefully reduce the underweight in Cash and the short duration stance.

FORECASTS

Macro Data

Growth	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	2.3	- 3.4	6.3	0.1	4.5	0.1
Euro area	1.5	- 6.5	4.9	0.1	4.5	0.1
Germany	1.1	- 4.9	3.3	0.0	4.3	- 0.0
France	1.8	- 8.0	6.0	0.1	4.1	0.2
Italy	0.3	- 8.9	5.8	0.5	4.0	- 0.2
Non-EMU	1.5	- 7.5	5.8	- 0.0	4.4	- 0.3
UK	1.4	- 9.9	6.8	- 0.0	5.0	- 0.4
Switzerland	1.3	- 2.5	3.7	0.0	2.9	0.0
Japan	0.0	- 4.7	2.3	- 0.1	3.1	0.1
Asia ex Japan	5.3	- 0.8	7.1	- 0.4	5.2	- 0.5
China	6.4	2.3	8.0	- 0.6	5.2	- 0.4
CEE	2.3	- 1.7	5.1	0.4	3.5	0.0
Latin America	- 1.7	- 8.6	3.3	- 2.2	2.8	0.0
World	**2.7**	**- 3.4**	**5.7**	**- 0.3**	**4.4**	**- 0.1**

Inflation	2019	2020	2021		2022	
			forecast	Δ vs. cons.	forecast	Δ vs. cons.
US	1.8	1.2	4.2	0.1	3.0	0.1
Euro area	1.2	0.3	2.0	- 0.1	1.5	- 0.0
Germany	1.4	0.4	2.6	- 0.1	1.8	- 0.1
France	1.3	0.5	1.6	0.1	1.3	0.0
Italy	0.6	- 0.1	1.1	- 0.3	1.2	- 0.0
Non-EMU	1.5	0.6	1.9	0.0	2.1	- 0.1
UK	1.8	0.9	2.2	0.0	2.6	- 0.1
Switzerland	0.4	- 0.7	0.4	0.0	0.6	0.0
Japan	0.5	- 0.0	- 0.1	- 0.2	0.6	0.1
Asia ex Japan	2.7	2.8	2.3	- 0.1	2.5	- 0.2
China	2.9	2.5	1.1	- 0.3	1.9	- 0.4
CEE	6.6	5.5	8.2	0.3	6.8	0.8
Latin America	3.6	3.2	3.1	- 1.9	3.8	0.7
World	**2.5**	**2.1**	**3.1**	**- 0.2**	**2.8**	**0.0**

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

Financial Markets

3-month LIBOR	Current*	3M	6M	12M
USD	0.13	0.15	0.20	0.40
EUR	-0.56	-0.55	-0.55	-0.55
JPY	-0.07	-0.10	-0.10	-0.10
GBP	0.09	0.10	0.25	0.50
CHF	-0.75	-0.75	-0.75	-0.75
10Y Government Bonds	**Current***	**3M**	**6M**	**12M**
US	1.49	1.60	1.75	1.95
Euro-Area	-0.22	-0.10	0.00	0.20
France	0.13	0.30	0.45	0.55
Italy	0.81	0.95	1.10	1.40
Japan	0.06	0.05	0.10	0.15
UK	0.96	1.10	1.20	1.40
Switzerland	-0.15	-0.05	0.05	0.20
Spreads	**Current***	**3M**	**6M**	**12M**
GIIPS	83	85	95	100
BofAML Covered Bonds	38	40	40	45
BofAML EM Govies (in USD)	293	275	265	260

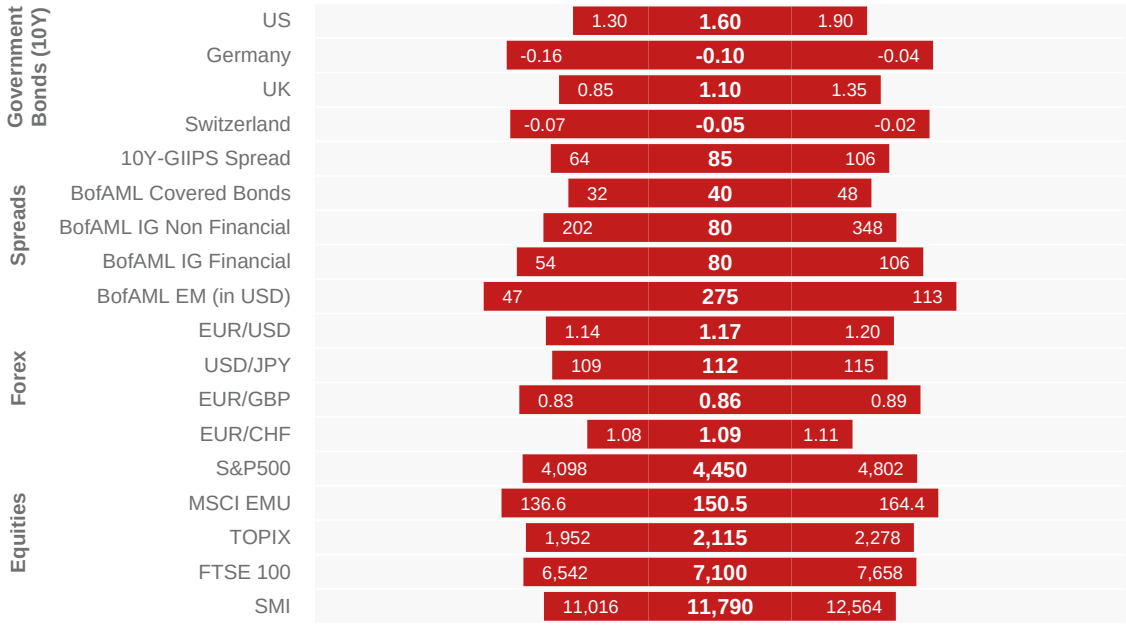
Corporate Bond Spreads	Current*	3M	6M	12M
BofAML Non-Financial	83	80	75	75
BofAML Financial	83	80	75	75
Forex	**Current***	**3M**	**6M**	**12M**
EUR/USD	1.17	1.17	1.16	1.14
USD/JPY	111	112	112	110
EUR/JPY	130	131	130	125
GBP/USD	1.36	1.36	1.36	1.34
EUR/GBP	0.86	0.86	0.85	0.85
EUR/CHF	1.08	1.09	1.10	1.12
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	4,417	4,450	4,500	4,600
MSCI EMU	148.5	150.5	152.5	154.0
TOPIX	2,087	2,115	2,115	2,135
FTSE	7,048	7,100	7,135	7,235
SMI	11,665	11,790	11,875	12,045

*as of 28.09.21 (3-day-average)

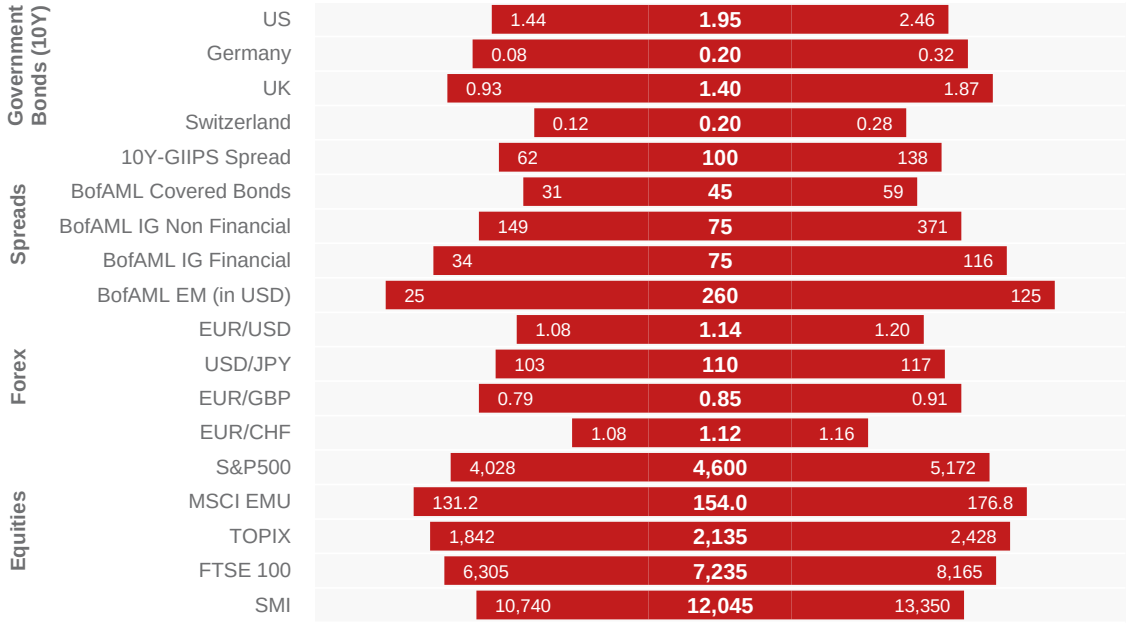
FORECASTS

Forecast Intervals*

3-Months Horizon



12-Months Horizon



*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5-year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the three-month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

IMPRINT

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