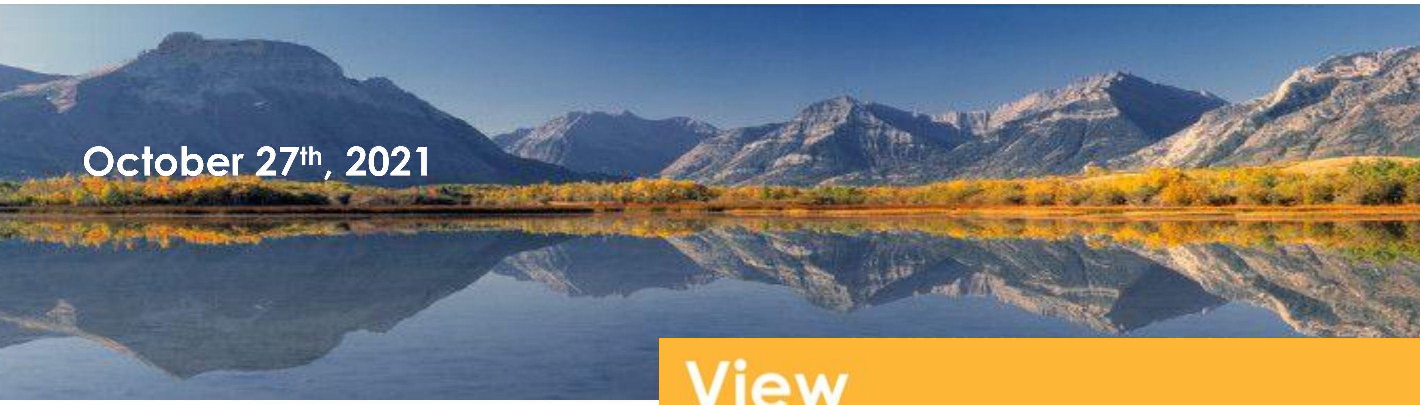

October 27th, 2021

View

Fideuram Asset Management

Macroeconomic Scenario

The growth of the global economy suffered a significant slowdown over the summer, after having been notably robust in the first half of the year. Our scenario envisages a recovery in growth rates in the current quarter, although global growth is being held back by clear supply-side constraints, which can be seen in the dislocation of global production and distribution chains, for example. And these problems are not likely to be resolved any time soon. This also means that upside risks on inflation in the medium term have increased and are likely to prompt central banks of the advanced economies to adopt a less accommodative stance.

Equity Markets

We continue to view the environment for risky assets as favourable, mainly due to the strength of listed companies in maintaining high levels of earnings growth coupled with expanding operating margins, as confirmed by the initial figures from the Q3 reporting season.

The macroeconomic mix of growth and economic policy is less favourable now because there are bottlenecks on the supply side (e.g., semiconductors, labour, and energy) and the Fed is preparing to initiate tapering and make monetary policy less accommodative.

On the technical side, we see two opposing forces: on the one hand, earnings growth that is working in favour and, on the other hand, weakening valuations due to rising interest rates and greater macroeconomic uncertainty. **We are therefore reducing the extent of our overweight**, maintaining a preference for value/cyclical segments over higher growth segments at least until interest rates stabilise at a higher level.

Geographically, we are therefore maintaining our positive view on Japan, Europe and the emerging markets and our neutral view on the US.

Bond Markets

The market continues to raise inflation expectations in the US and Europe, while the former president of the Fed, J. Yellen, anticipates high inflation throughout the first half of 2022 followed by a normalisation phase, adding "I don't think we are about to lose control of inflation".

Following the recent movements we are partially reducing our duration underweight in the US as we are approaching the valuation levels we consider sufficient. Instead of nominal bonds from core countries, we continue to prefer inflation-indexed bonds, as the risks of higher price dynamics have increased, as well as issues from peripheral European countries, in terms of carry.

We maintain a neutral view on corporate bonds, because we do not think that there is much room for a further narrowing of credit spreads, but we also do not think the conditions are there for a significant widening. In corporate credit, we continue to favour financial sector issues, in the more subordinated components, while maintaining our neutral rating for HY corporates, again in terms of carry. In emerging debt, we are maintaining our overweight but are adjusting our preference in favour of the hard currency segment over the local currency segment.

Within the latter, we are maintaining an overweight in Chinese local currency bonds.

Macroeconomic scenario

US: Clear supply-side constraints

The steep slowdown in GDP growth over the summer is expected to be followed by a **sharp recovery in the current quarter**, although in recent months the strength of demand has come up against **significant supply-side constraints, also reflected in labour market conditions**.

Despite the expiry of unemployment benefits, wage growth was very strong in September, while there was still no rebound in labour supply. It seems likely that supply-side constraints will not be resolved soon, increasing the risks to the medium-term outlook for inflation.

Against this backdrop, the Fed's formal announcement of tapering in early November appears to be a foregone conclusion, despite weak employment data in August and September.

Euro Area: Energy crisis

The price of natural gas in Europe has suffered an unprecedented shock in the last two months: at the end of October, the price of natural gas had risen by almost +500% since the beginning of the year.

There are numerous reasons for this, which cannot be resolved in the short term, in addition to the well-known problems of dislocation in the transport sector and in global production chains.

We have lowered our GDP growth forecast by around 1% annualised in the quarters between late 2021 and early 2022. **There will also be a significant impact on inflation**, which will rise from 3.4% in September to just below 4.5% in December, before remaining well above the ECB target (2%) throughout the first half of 2022.

We do not expect an inflationary spiral, or a de-anchoring of inflation expectations, **but the ECB's monetary policy will become more restrictive at the margin, with a more limited support programme,** once the PEPP comes to an end in March next year.

China: Slowdown in growth over the summer

GDP growth slowed sharply in the third quarter (to 0.8% annualised and 4.9% yoy) both due to restrictions to contain several Covid outbreaks and restrictive policies adopted by the government in the real estate and energy sectors.

The removal of anti-Covid measures at the end of August and the partial resolution of the energy problems should allow for a recovery in the current quarter, but the **outlook remains highly uncertain**, also due to the adoption of the "zero tolerance" strategy towards Covid-19.

We have further revised our growth forecast downwards (to 7.9% for 2021 and 5.1% for 2022)**.**

The likelihood of another cut in the reserve requirement ratio has also diminished: the PBoC appears to prefer to continue using open market operations to manage liquidity.

Equity Markets

Initial good news from the reporting season

The start of the reporting season in 3Q21 is offering reassuring numbers in terms of growth in both earnings and revenues. Although no more than half of the companies in the S&P500 have already published their figures, the fears of a possible slowdown in economic activity due to the resurgence of the pandemic through the Delta variant, have not yet materialised. The number of positive surprises so far has been partially aided by the level of the analyst expectations, which were revised downwards in previous months and are therefore easier to beat.

Good corporate numbers are helping to offset lingering fears of an economic slowdown accompanied by worrying and continually revised inflation figures, especially in the producer price components. The term “transitory” is increasingly being interpreted in the longer term, although concerns about a 1970s-style stagflation have so far not surfaced, with more talk of slowflation rather than stagflation.

This moderately cautious but still positive view has allowed the market to hit new highs, particularly in the US, and the appetite for buying on weakness has continued, especially among retail traders, as it has done throughout 2021.

We are therefore not changing our approach to the equity component of our portfolios, which are **moderately overweight and are gradually being reduced, with a preference for markets outside the US**..

Specifically:

- **in the US** the earnings season opened very well. According to the initial published figures, fundamentals are still solid, but the peak appears to have been passed and earnings are already above pre-Covid levels. Valuations appear challenging compared to other geographical areas, real rates are still showing room for adjustment, macroeconomic uncertainty has increased and the domestic political truce will only last until the end of the year. **We are therefore maintaining a neutral position, while awaiting an adjustment in valuations and a stabilisation of rates**;

- **we remain favourably positioned in Europe** in view of the valuation discount to the US and performance that does not reflect relative earnings trends. The greater weight of value/cyclical components makes the European market less sensitive to interest rate movements. In Europe too, earnings growth has probably peaked, but unlike estimates in the US, European earnings projections have not been restored to pre-pandemic levels;

- **we maintain a positive view on the Japanese market** due to lower valuations compared to other major geographical areas, the correlation with global cyclical improvement and support from the prospect of higher core rates. On the domestic policy front, the initial objectives declared by the new Prime Minister Kishida are to keep the internal circulation of Covid-19 under control and to boost the national economy with a substantial fiscal package;

- **we confirm our slight overweight in emerging markets** preferring to reduce risk in local currency bonds. Valuations have already incorporated a substantial risk premium for the tightening of regulations in China and our view is that profits may grow more (in the medium term, but not in 2022) than is indicated by the valuations. Until the point of maximum regulatory impact has been reached, the market may remain in an interim and volatile phase, but to maintain their goals of global leadership, the Chinese authorities may soften their tone, especially in some sectors.

Bond Markets

Temporary but more persistent inflation than initially estimated

Inflation data continues to surprise on the upside, making communication more complex for the major central banks. This is reflected in expected levels of inflation estimated in the market at period highs while real yields remain subdued and breakeven inflation curves continue to be inverted, confirming the perception of the temporary nature of this situation, although J. Powell and the former Governor J. Yellen admit that the timing of the recovery of prices will be longer than initially expected.

The Fed confirms the start of tapering before the end of the year while describing itself as "patient" regarding the start of the rate hike. The market is forecasting two full rises for 2022, putting it above the average projection for the Dots.

Government bonds

The recent sudden shift in the US interest rate curve mainly reflects risks on inflationary growth, which have again changed the scenarios on the likelihood of the transitory effect of recent price increases. We are partially reducing the duration underweight on the US curve: in valuation terms, the current 10-year US Treasury levels still appear to be below those consistent with the macroeconomic scenario and conventional and unconventional monetary policy action, which by our metrics are around 1.7%-1.8%.

We believe that more visible and significant upside surprises to growth or inflation are required for a hike above these levels, as the Fed's roughly one-quarter share of control over marketable debt and increased focus on financial conditions are placing a drag on real rates, which we still expect to rise gradually, compared to 2013.

In Europe, we are underweight in the core countries and short/medium-term maturities, but we have a more favourable view on exposure to peripheral government bonds in terms of carry. We also prefer inflation-indexed securities to the nominal component.

Spread products

Spreads in the corporate segment are still at compressed levels, but the combination of economic policy and the economic situation limits the space for expansion as it fosters an improvement in credit quality.

We confirm our preference for credit over the government component, but mainly with regard to exposures that are less vulnerable to underlying rates (such as financial bonds especially in the most subordinate classes).

We are maintaining our neutral view on the HY segment: at a time when the equity overweight is not excessive, despite historically compressed spread levels, taking a relatively low duration credit risk to improve the current profitability of the bond component of the portfolios appears to be a viable option.

We maintain our overweight in emerging debt but are shifting our relative preference in favour of hard currency bonds. US rates still have potential room to rise, but emerging dollar debt has a noticeable spread advantage over similarly rated corporate bonds. Within local currency debt, we remain overweight in the Chinese government component.

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