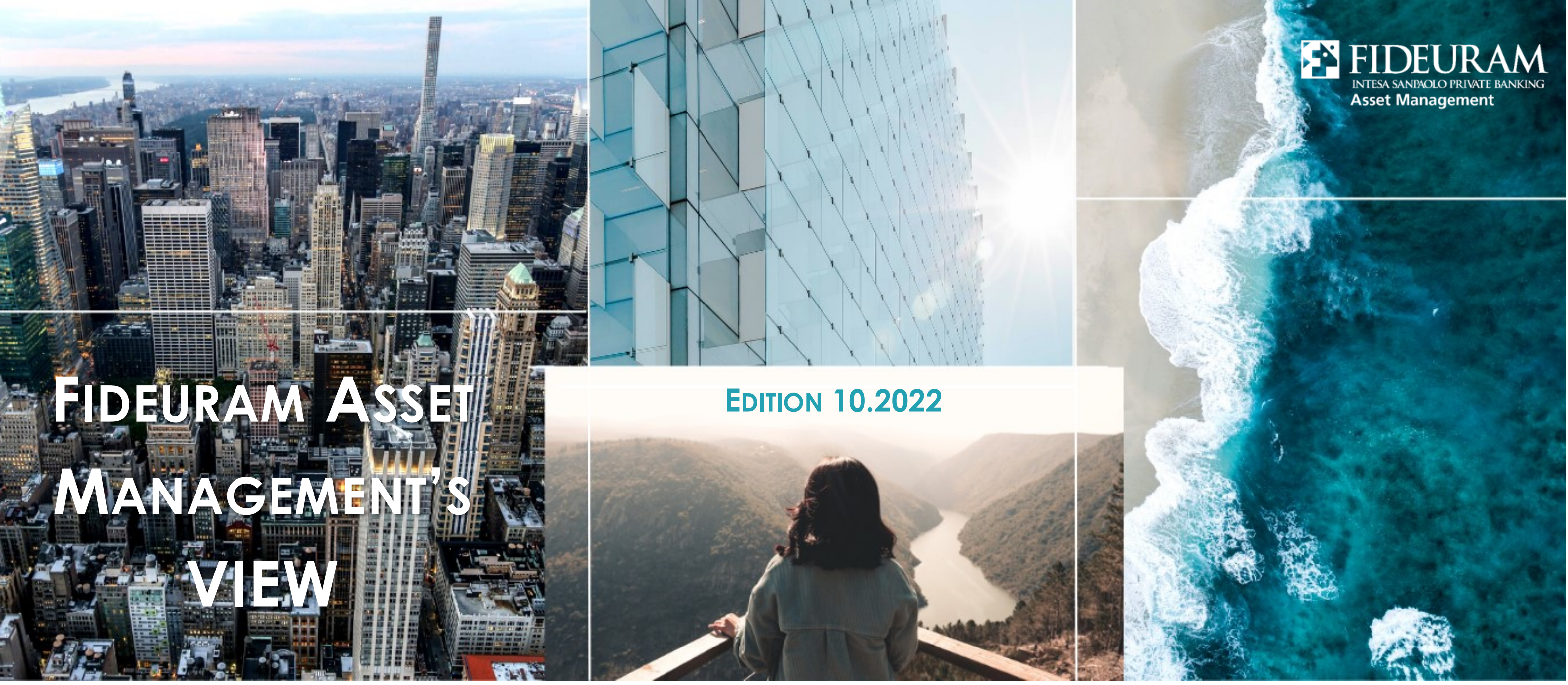


FIDEURAM
INTESA SANPAOLO PRIVATE BANKING
Asset Management

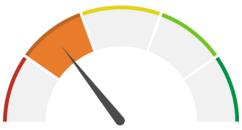
# Fideuram Asset Management's View

**Edition 10.2022**

## Macroeconomic Scenario

After accelerating in Q3, global growth is expected to slow down again towards the end of the year and we confirm our recession scenario in both the Euro Area (from the current quarter) and the US (from the beginning of 2023). However, the continued very robust labour market conditions in the US do not suggest that a recession is imminent, and therefore the likelihood has increased that the slowdown in economic activity will take place later next year. Despite the deterioration in the growth scenario, upward surprises in inflation continue to be reflected in an aggressive posture by central banks in the advanced economies (with the continued exception of the BoJ). Our baseline scenario, which continues to project that inflation will still be high on average in 2023 but will gradually decline over the course of the year, envisages that the Fed and ECB policy rates will peak in the first quarter of next year.

## Equity Markets



The mix of ongoing upward revisions of expectations of rising interest rates and the economic slowdown leads us to continue to approach portfolio management with caution in terms of overall risk -taking, specifically with a slight underweight in equities. An underweight, which we continue to concentrate in Europe where macro risks are higher, but which we are partially reducing with the aim of accompanying the market downturn by rebuilding the weight of equities. Tactically, because valuations are already pricing in much of the cyclical risks and investor positioning is low. And strategically, because as soon as the market has fully priced in the central banks, valuations will not be subject to the downward pressure of a rising discount factor. The US remains our market of preference. In terms of profits, we expect a slowdown but less severe than in previous recessions because revenue dynamics are expected to hold up better than in past contractions due to inflation and the effects of post-pandemic reopenings.

**Europe** – SLIGHTLY NEGATIVE

**United States** – NEUTRAL

**Japan** – NEUTRAL

**Emerging Markets** – NEUTRAL

## Bond Markets

Despite the attractiveness of expected yields, we are neutral on government bonds, duration and vis-à-vis credit risk. Volatility remains very high and we still consider the Fed pivot to be premature because US inflation has only recently and slowly started to decline. However, we think that the stabilisation of markets comes first from the stabilisation of interest rates, and while we cannot exclude overshooting movements in this very volatile phase that may take the US ten-year rate over 4%, looking forward we see an opportunity for an increase in the weight of bonds in our portfolios because we believe that we are nearing the upper limit of the upward trend of interest rate expectations. We foresee more uncertainty on European interest rates linked to the management of the energy crisis and the ECB's flexibility in managing its balance sheet. In corporate and emerging credit, we prefer the more defensive components, such as investment grade corporate bonds, financial sector issues and Chinese government bonds among the emerging markets.

**Government** – NEUTRAL

**Corporate** – NEUTRAL

**High Yield** – NEUTRAL

**Emerging Markets** – NEUTRAL



content updated as of October 26th, 2022

## USA: SHORT-TERM SCENARIO VERY UNCERTAIN

After a fall in the first half of the year, **GDP growth returned to positive territory in Q3**, mainly due to a strong contribution from net exports (primarily linked to weak imports). We continue to foresee a further slowdown in growth in the current quarter and entry into recession in early 2023, although currently the strength of the labour market does not appear to indicate that a recession is imminent. **The further upward inflation surprise in September** makes a new 75bp rate hike certain at the Fed meeting in early November. We also foresee another rate hike (in this case by 50 bps) in December, and our scenario now also includes a 25 bp hike at the February 2023 meeting, which should complete the tightening cycle.

## EURO AREA: A CAP FOR THE WINTER

European governments have taken important steps to tackle the energy crisis, with the introduction of a **"dynamic cap" on the price of gas**, to curb its volatility and **the establishment of a fund that will provide loans to countries** to support businesses and households. October's mild weather and record high stocks have sent the price of natural gas plummeting: the outlook for this winter has improved, but there is **still considerable concern about rebuilding stocks in 2023**, and support measures by individual governments must not undermine incentives for saving gas in the private sector. **The latest data confirm the recessionary scenario** we had foreseen in late 2022 and early 2023, but with inflation remaining very high until the first half of 2023. After the expected 75 basis point rise in October, the **ECB will raise rates by another 100 bps between December and February (or March)**.

## CHINA: THIRD TERM FOR XI JINPING

**GDP growth in Q3 (16.5% annualised) recovered much better than expected**, following the decline in the previous quarter (-10.4%). However, the September data confirmed the slow recovery of the real estate sector, while investment in infrastructure benefited from government support policies. Numerous risk factors, including the emergence of new infection outbreaks, slowing exports and the crisis in the real estate sector, continue to weigh on growth prospects. **For the current quarter, we expect growth of around 6.5% annualised, while the average growth estimate for 2023 has now been revised to above 3%.** The National Congress of the Communist Party concluded with a third term for President Xi, who significantly consolidated his control.

INVESTMENT VIEW

## Equity Markets

The European equity market is among the major markets that seems most vulnerable to both macroeconomic and geopolitical developments, with risks to growth being closely linked to the availability and cost of Russian gas, not to mention the monetary tightening under way. However, we have reduced the underweight position because valuations and investor positioning are low, particularly in certain sectors such as financials, which have instead benefited from greater earnings support due to interest rate performance.

Of the major geographic areas, the US is our preferred market. Profits are expected to fall, with a softer decline than in previous recessions. At current valuations, the market is already pricing in a recession that is brief and relatively shallow. In a future environment characterised by more stable interest rates, we foresee that the US market will be the first to see a return to purchases of equities. In the short term, macro and economic policy uncertainty may keep the market volatile.

The Japanese market trades at attractive prices which are lower than other geographical areas, but its macroeconomic profile, which is more linked to the performance of international trade and industrial dynamics, is more exposed and vulnerable to geopolitical developments and a weaker economic cycle. Profit growth is not particularly robust, but is benefiting from the weakness of the yen.

The macroeconomic backdrop has recently become more favourable for emerging markets as some central banks, including China's, have taken measures to support economic growth and earnings are improving. However, the current slowdown in the developed world and the persistent strength of the dollar continue to suggest a neutral stance.

**Europe**: SLIGHTLY NEGATIVE

**United States**: NEUTRAL

**Japan**: NEUTRAL

**Emerging Markets**: NEUTRAL

## Bond Markets

**Government**: NEUTRAL

The market expects the Fed to reach 4.75-5% in March 2023, and this expectation is compatible with a ten-year rate of around 4%. However, we consider a Fed pivot premature because inflation has only recently and slowly started to decline and we cannot rule out overshooting movements in excess of 4%. In Europe, the expectation of an increased dose of rate hikes by the ECB leaves rates relatively high if we consider the cyclical slowdown. However, the range of rates is very wide taking into account the impact of fiscal policy and central bank balance sheet management, with the latter favouring stable peripheral spreads at this stage.

**Corporate**: NEUTRAL

We foresee the situation evolving in a more favourable direction for the assumption of credit risk because expected yields are high and in the investment grade component spreads are further ahead in pricing in the less favourable cyclical developments. However, we are still in a position of substantial neutrality because the volatility of rates and spreads remains well above historical averages.

**High Yield**: NEUTRAL

As for the investment grade component, the high yield component also trades at attractive absolute yields. However, unlike the investment grade component, we did not increase exposure because spreads are pricing in less of the current macroeconomic downturn and uncertainty about changes in the default cycle.

**Emerging Markets**: NEUTRAL

The situation for the emerging component is also moving in a more favourable direction. Inflation has peaked in many countries and some central banks have taken steps supporting growth. However, the strength of the dollar means we are maintaining a cautious stance and a neutral positioning. We prefer the more defensive components, namely the hard currency segment and Chinese government bonds from among those in local currencies.



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EQUITY MARKETS

## Continued caution pending a stabilisation of the upward revision of interest rate hike expectations

Monetary policy was undoubtedly the main driver for the financial markets, which suffered the effects of a sudden removal of financial easing and a substantial rate hike in quick time. In particular, the continuing inflationary pressure prompted central banks to tighten monetary policy more than expected by the market, leading to a steady increase in expectations of higher official interest rates in recent months. **This structural increase in the discount factor** obviously **had a negative impact on all asset classes**, not only directly on the bond segment through the increase in the yield rate, but **also on the equity segment through the pressure on multiples**.

However, **we believe that we are nearing the end of the upward trajectory in interest rate expectations due to a number of factors**, chief among which is the fact that the actions taken by central banks have already led to a tightening of financial conditions. **A further rise is nevertheless still possible**, although there appears to be little room for this as it would impact on future growth expectations and would in any case stabilise the rate curve in the medium to long term. Secondly, **total inflation in the US appears to have started to move downwards**, albeit slowly. Finally, the first rate hike-induced disruptions are beginning to appear in some market segments, as was the case recently for the UK bond segment. The stabilisation of interest rates that would follow this final phase would be a necessary (but not sufficient) condition to enable stabilisation of equity markets through a decrease in pressure on multiples.

In terms of the economic cycle, our baseline scenario envisages a modest, short recession in both the US and Europe and a slowdown in corporate profits, although we think this may not be as steep as past contractions because revenues are expected to hold up better, due to inflation and the effects of the post-pandemic reopenings.

These considerations lead us to **remain cautious in our portfolio management in terms of overall assumption of risk through a slight underweight in equities**, which, however, has been reduced recently and concentrated in Europe where macro risks are higher. In view of the low investor positioning and valuations that are already pricing in much of the cyclical risks, **we have started an initial buying operation, albeit on an underweight basis, with the aim of accompanying the market downturn by rebuilding the weight of equities**.

BOND MARKETS

## Attractive yields, but volatility still high

In fixed income, volatility remains very high, which makes us still neutral despite the attractiveness of expected returns, even in the credit sector. In general, with regard to the analysis of European interest rates compared to US rates there is still greater uncertainty regarding the management of the energy crisis, **as well as the ECB's high flexibility in managing its balance sheet at this stage**.

### Government bonds

We think that **the stabilisation of markets comes first from the stabilisation of interest rates , and**, while we cannot rule out overshooting movements in this very volatile phase, **looking forward we see an opportunity for an increase in the weight of bonds in our portfolios.**

The US curve is reacting to labour market strength and inflation surprises that are pushing the market to project a more prolonged (more distant pivot) or more aggressive (higher peak) restrictive action. The Fed's focus is on the labour market and **core inflation**. In the short term, surprises in this regard may keep rate volatility high in both directions, which is prompting us to maintain a neutral approach, despite the attractive area that has been reached.

The correct interest rate levels in the Euro Area are more difficult to identify due to a number of factors related to the management of the energy crisis and the ECB's flexibility in managing its balance sheet.

### Spread products

The **investment grade component has reached the most attractive yield levels since the financial crisis.** The segment is gradually incorporating the negative factors represented by the tightening of financial conditions, and valuations appear consistent with a deterioration in the economy and earnings. There remains a certain vulnerability of spreads to rate volatility.

**Yields in the high-yield segment also look attractive in historical terms, but risks remain** related to deteriorating market liquidity, high volatility and the Fed's determination to fight inflation, which fuels uncertainty about the downgrade and default cycle (for now limited). At this stage the greater vulnerability of the more speculative components to these factors prompts us to position ourselves in more defensive, higher-quality components. Also for the emerging component, even though the environment is evolving in a more favourable direction at the margin, the strength of the dollar and the volatility of US interest rates are prompting us to maintain a neutral positioning.

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