Generali Investments Italy

Itinerari Previdenziali

Dove va l'economia?

Quali strategie adottare nel 2011 per difendere i partrimoni destinati a prestazioni previdenziali e sociali?

Luca Passoni
CEO Generali investments Italy

Rome, December 2010

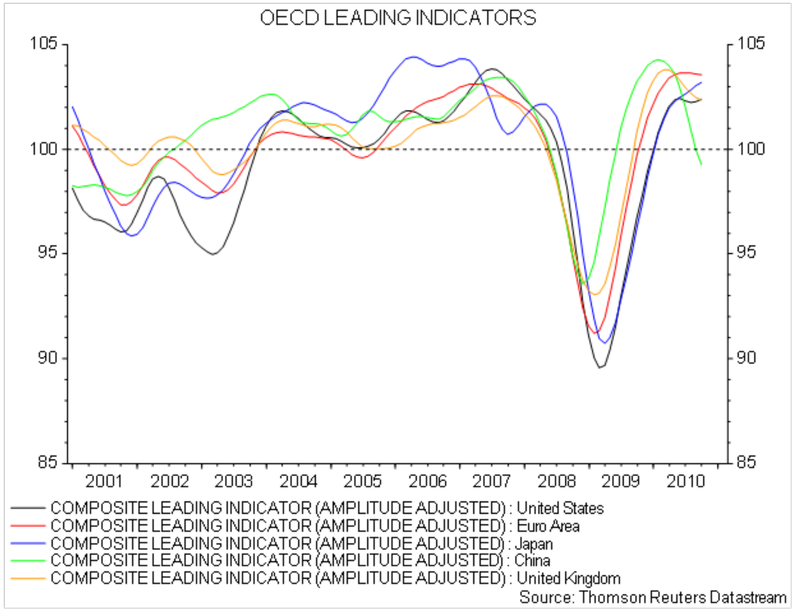
The macro picture

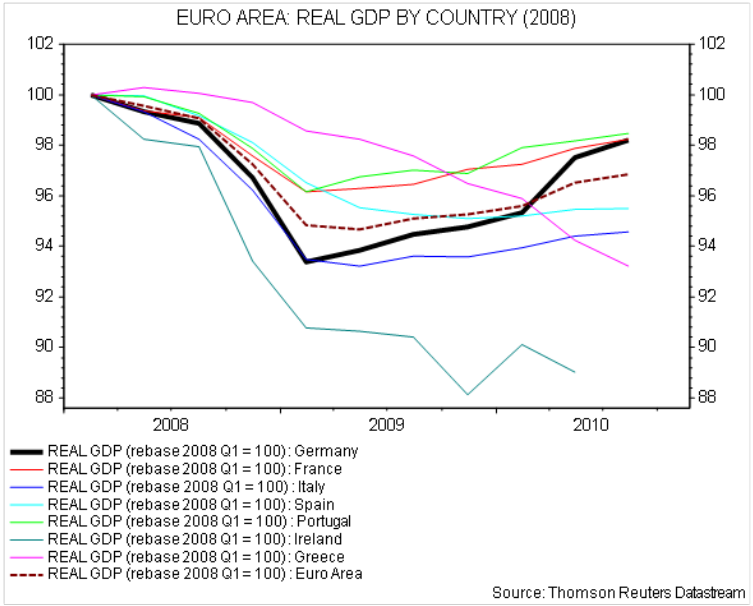
Current situation

•The global recovery phase is proceeding broadly but it also shows a multi-speed movement, with emerging economies (Asia and Latin America) that are seeing a strong growth while developed countries are still facing large adjustments. It is worth noting that even inside the Euro Area the growing momentum is led by Germany, by contrast peripherals' recovery is still slugghish (graph on the right).

•Global growth slowed down in the second part of 2010; China started tightening its monetary stance and the effects are showed by OECD leading indicator (graph on the left).

•Although still positive, the macro global picture presents some downside risks: labour market conditions, credit and house markets dynamics and fiscal consolidation in developed countries.

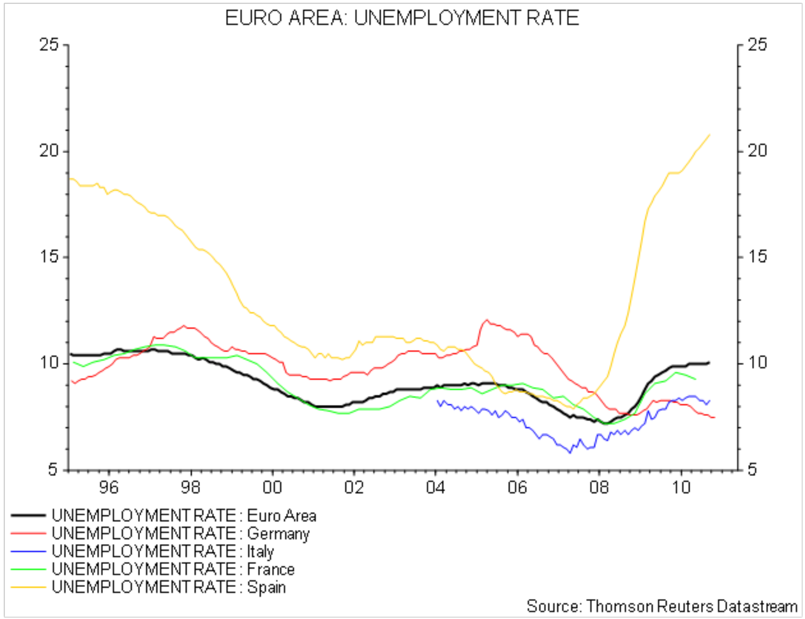


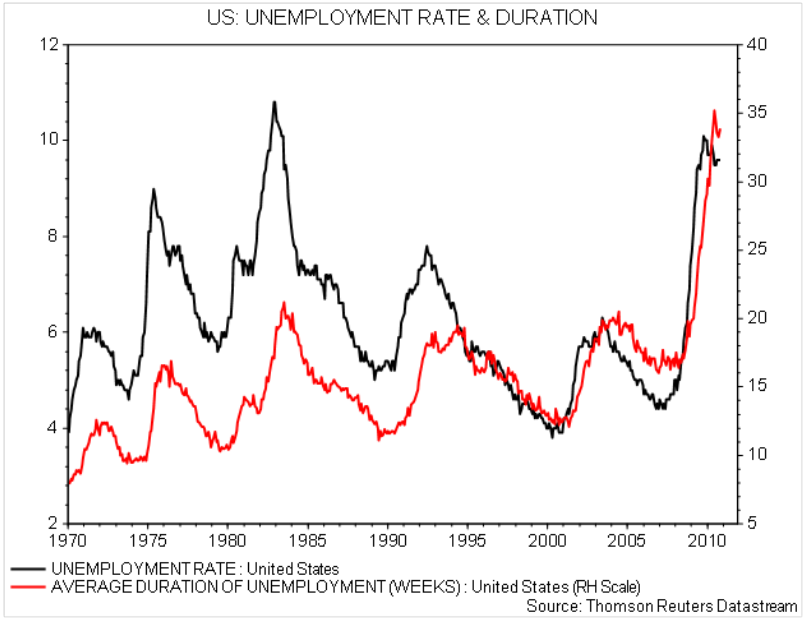


Labor market

•Recent US data showed an improvement in the labor market: nonfarm payrolls increased by 151k (by 262k including revisions), while initial jobless claims stabilized around 40k. Overall figures remain weak: the unemployment rate is unchanged at 9.6%, while average duration of unemployment is still near its historical highs (graph on the right). Moreover, the participation rate dropped further, hitting the lowest level since 1984. Extended unemployment benefits are going to expire starting by the end of November and they have to be renewed.

•Also European situation is still worrying: the unemployment rate is still high, despite the improvement in Germany. In Spain almost one fifth or labor force is unemployed (officially) and in the other countries pre-crisis levels are still far (graph on the left).





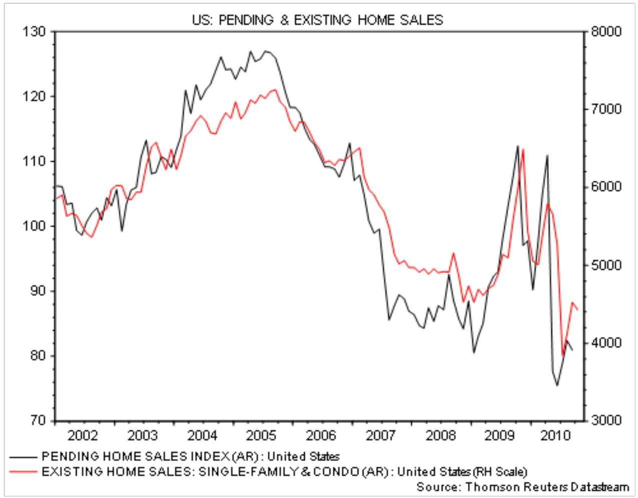
GENERALI GROUP

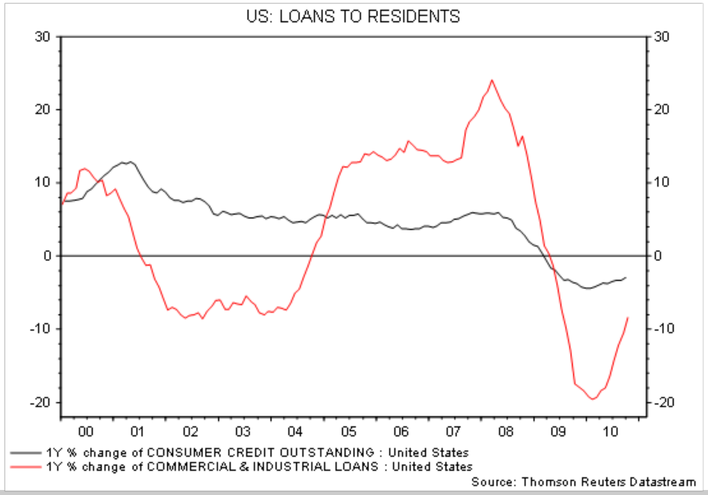
The macro picture

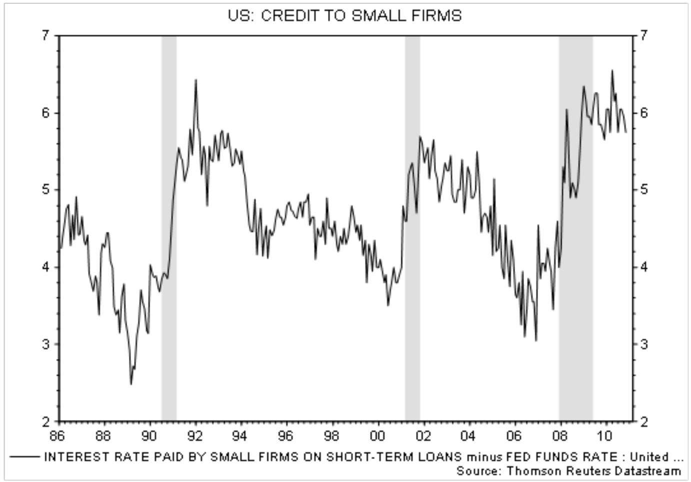
Credit and house markets

•US House stats worsened markedly after the expiration of “first buyers program”, similarly to what happenend at end of 2009 when the first program ended. Despite aggressive support of policy makers, with fiscal stimulus implemented twice, and a very low interest rate enviroment, US housing market conditions remain very weak (graph top right). Also in Spain, Ireland and UK house market is not improving.

•Credit is still at low level, both in the US and in Europe; US loans to residents, consumer and commercial, are still showing a negative yoy growth rate, although on monthly basis figures are marginally positive (graph on the left). Small firms conditions are still bad, compared with large caps (graph on the bottom right).







Euro Area fiscal situation

The table below summarizes the fiscal deficit at the end of the second quarter of 2010, as published by Eurostat. Greek data have been revised upward by the European statistical agency.

It is worth to note that Spain's fiscal balance is improving in accordance to its consolidation plan (2010 target at 9.3%), while Irish and Portuguese deficit widened further (to 21.0% and 9.5%) due to the cost of the rescue of the banking system in the case of Ireland and larger social security spending in Portugal.

Regarding Greece, Ministry of Finance's data show a balance improvement of nearly 3% in terms of GDP. The upward revision of data will require further efforts in terms of fiscal consolidation.

The impact of austerity measures on growth will be problematic for many countries, especially Ireland, whose spread against German bund hit new highs.

	Revenue	Expenditure	Balance	Fiscal balance		Fiscal balance	
	2010Q2 vs 2009Q2 change			2009Q4	2010Q2	2009Q4	2010Q2
Austria	1.0	0.4	0.6	-3.5	-3.2	67.5	69.9
Belgium	0.7	0.3	0.4	-6.1	-4.9	96.2	100.8
Bulgaria	0.1	-1.3	1.4	-4.7	-5.2	14.7	15.1
Cyprus	0.3	0.3	0.0	-6.0	-5.8	58.0	61.0
Czech Republic	0.3	0.2	0.1	-5.8	-5.7	35.3	36.7
Denmark	-0.4	0.8	-1.2	-2.8	-4.6	41.4	44.9
Estonia	0.0	-1.5	1.5	-1.8	0.6	7.2	6.9
Finland	0.4	0.4	0.1	-2.7	-3.2	44.0	47.5
France	n.a.	n.a.	n.a.	-7.6	n.a	78.1	82.8
Germany	n.a.	n.a.	n.a.	-3.0	-3.9	73.4	74.6
Greece	0.2	-3.4	3.6	-15.4	-11.7	126.8	132.9
Hungary	-0.5	0.2	-0.7	-4.4	-4.9	78.3	83.7
Ireland	0.2	-0.7	0.9	-14.4	-21.0	65.5	79.6
Italy	-0.2	-0.1	-0.1	-5.2	-5.2	116.0	119.1
Latvia	-0.4	-3.3	3.0	-10.2	-8.7	36.7	43.2
Lithuania	0.1	-0.7	0.8	-9.2	-8.2	29.5	35.0
Luxembourg	1.2	0.7	0.4	-0.7	-0.6	14.5	19.5
Malta	0.4	0.3	0.1	-3.8	-3.4	68.7	70.0
Netherlands	0.3	0.8	-0.5	-5.4	-6.0	60.8	63.3
Poland	0.7	0.5	0.2	-7.2	-6.9	50.9	54.3
Portugal	0.2	0.9	-0.7	-9.4	-9.5	76.3	80.9
Romania	0.2	0.6	-0.4	-8.6	-9.1	23.9	28.9
Slovakia	0.3	-0.1	0.4	-7.9	-7.7	35.3	38.7
Slovenia	0.2	0.4	-0.2	-5.8	-6.8	35.4	37.5
Spain	0.7	-0.1	0.8	-11.1	-10.8	53.2	56.7
Sweden	0.5	0.2	0.3	-1.2	-0.6	41.9	38.6
United Kingdom	0.7	0.3	0.4	-11.2	-10.7	68.2	73.2

Source: Eurostat, German Ministry of Finance and own calculations. All data as % of GDP.
n.a.: not available

Great Recession and asset management activity

In the aftermath of the so called Great Recession, the asset management activity will face several adjustments. This is particularly true for insurance companies, given also the regulatory constraints. Some points could be summarized as follows:

- **Reinvestment risk**: the risk/reward profile of asset classes is changed. The so called «Great Moderation» generated a low risk / high return environment, with the development and diffusion of structured products; in the aftermath of the financial crisis the market is now pricing risks in a more appropriate way. Risk analysis is now complementary to yield enhancing activity.

- **Diversification**: the risk repricing incresed the need of diversification in investment activity, given also the higher volatility that makets are facing. One example is the govenment bond market, where also inside the Euro Zone, the contry risk (see next slide on this) started to price strongly fiscal inbalances. This point is particurarly relevant fo insurance investment activity given its exposure to this asset class.

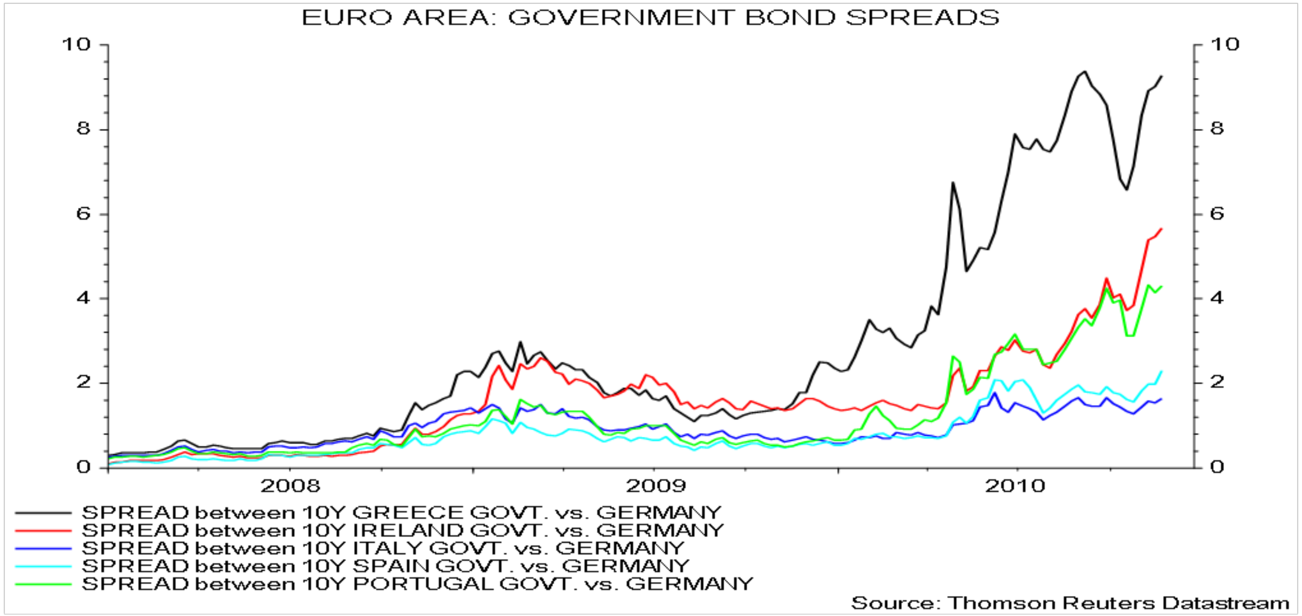
- **Solvency**: as widely known one of the main consequence of the crisis is the need to review the regulation of global financial system, in particular the solvency requirements for bank and insurance sectors. Capital requirements are calculated on a risk-adjusted basis, considering the different tipology of assets where the available capital is invested. The more risky the assets are, the higher the capital requirement that the company has to meet; following the financial crisis, authorities will introduce more stringent risk-based capital rules, which represents something new in the insurance sector. This change will become a furhter constrain for investment activity.

- The new financial environment will weight differently in life and non-life investment activity: for example non-life investment have generally a shorter term than life one and, consequently, are facing a higher reinvestment risk. Furthermore life portfolio can bear volatility markets better, given their longer term horizon.

The country risk

The graph below shows the 10y spread of European peripherals over German Bund: till 2008 the convergence of interest rate has been maintained, despite of different fundamentals of each of these countries. In the aftermath of the financial crisis the country-risk came out, given the differences in terms of policy maker response to recession, in terms of internal leverage and in terms of banking system solidity.

Fiscal imbalances that followed expansionary policies and the use of automatic stabilizers, brought to the widening of the risk-premium requested by the market to some countries. This affected strongly the investment activity of insurance companies, very exposed to government bond market, and therefore diversification become crucial to balance risk/reward ratio of investments. Given current regulations, the higher risk of downgrading represents a further constraint to investment activity in the insurance sector.



The investment activity during the crisis

In the first part of the crisis (2007-2008) all risky assets have been affected by high volatility and, consequently, a strong drop in terms of market valuation.

Therefore our asset allocation reduced risk exposure, increasing the weight of government bonds with high rating. Both corporate bond and equity have been reduced.

Starting from the first quarter of 2009 the macro picture stabilized a bit and we changed consequently our investment strategy:

- We increased the non-financial high rated corporate bond exposure, given the improvement of balance sheets of firms.
- Equity exposure has been gradually increased, using specific strategies based on internal valuation models.
- On the government bond side, the increase of country risk premium that followed the deterioration of fiscal imbalances, investment decision has been supported by specific top-down econometric models.

Conclusions

•In the US, the recovery is still dependent on government’s support: consumer spending has rebounded mainly thanks to net transfers. This is not sustainable, even if for the time being there is no upward pressure on government yield in the US (only 30Y minus 10Y spread is at record highs). Moreover, we expect the inventory cycle to come to an end.

•The second round of FED quantitative easing will have a modest impact on real activity and will not reduce unemployment nor eliminate the credit transmission problem. New measures should be investigated to address these issues. QE2 will benefit risky assets.

•In the Euro Area, recent macro data confirmed the decoupling: while the recovery in core countries is strengthening, peripherals countries face huge problems in terms of growth, public debt sustainability and banking system stability. We therefore remain negative on peripherals bond market, especially on Ireland.

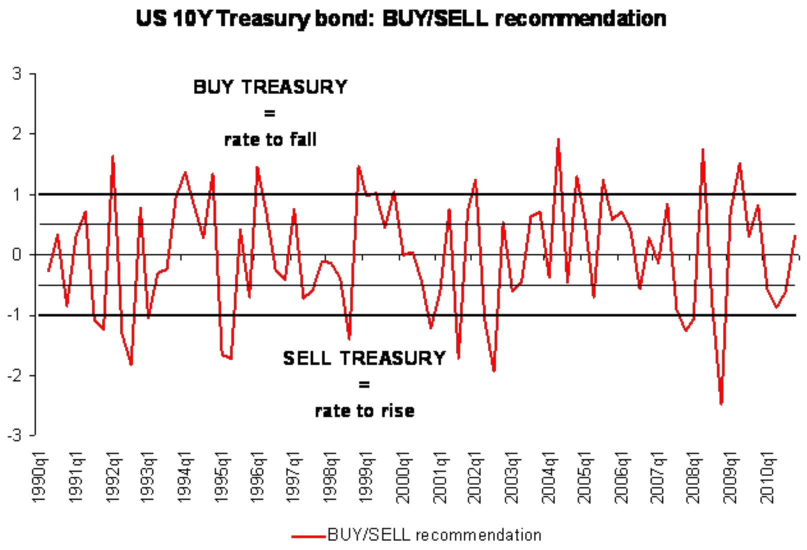
•We expect the recovery phase to continue at a sluggish pace during the next quarters, with monetary stance staying expansionary in order to offset the fiscal consolidation action.

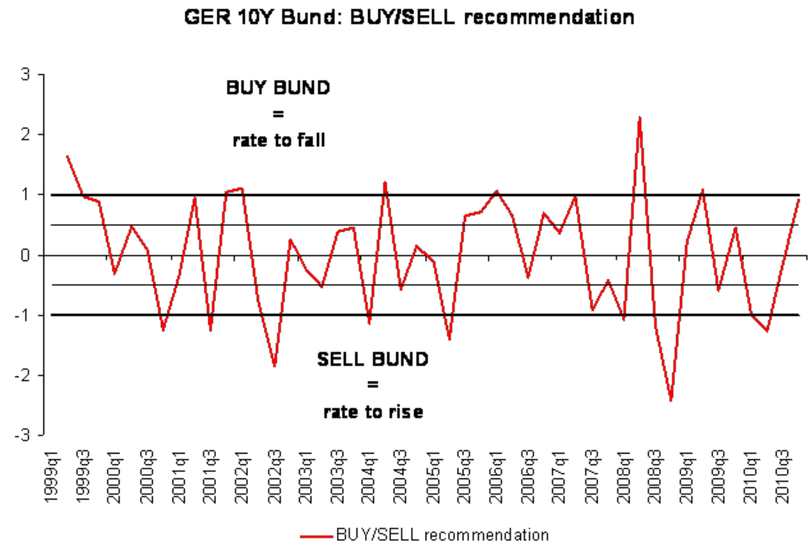
In this environment we estimated some internal models in order to consider investment opportunities given the level of valuation in each asset class.

Government bonds

In the long-term, government bond yields depend on growth and inflation prospects, current monetary policies and related market expectations, fiscal balance situation and agents' saving decisions. In the short run, the macroeconomic data flow and other market sentiments (i.e. fear of contagion from debt crisis) may lead to misalignments from the equilibrium.

At the time being, we think US and German government bonds to be fairly valued. Regarding peripheral countries, we believe delivering fiscal consolidation and debt sustainability to be the fundamental driver of long-run equilibrium spreads.



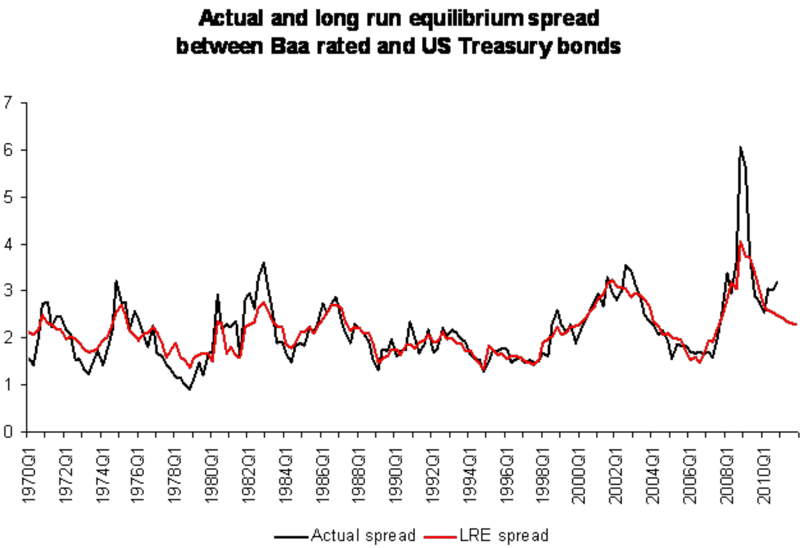


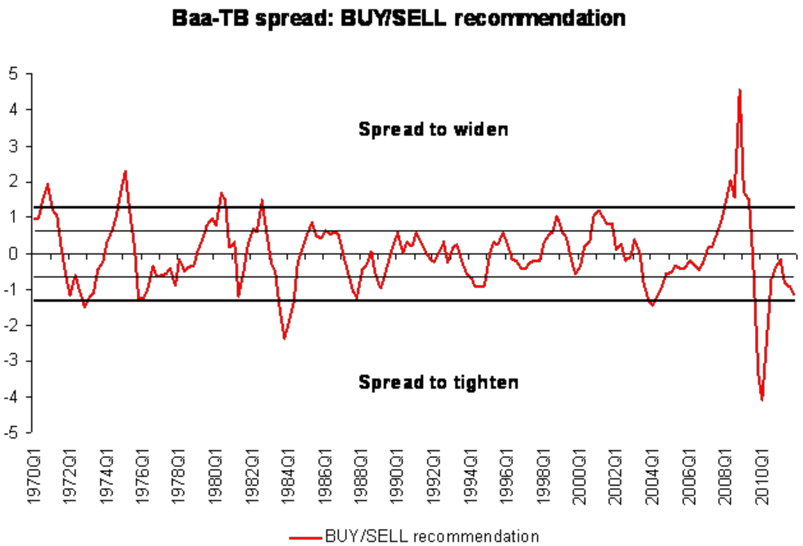
Conclusions

Corporate bonds

After the collapse of Lehman Brothers, corporate spreads surged to records highs, but returned to pre-crisis levels in the following quarters. Since April, as a consequence of Greek and Irish debt crisis, the spread between Moody's Baa rated bonds and US Treasury bonds has widened again.

In the long-term, we found out the spread to be driven by private and public debt ratios, firms' profitability and by policy interest rates. Given the deleveraging process in the private sector, the improved margins and the FED's loose monetary stance, we expect Baa minus Treasury bonds spread to tighten to the levels observed at the beginning of 2010.

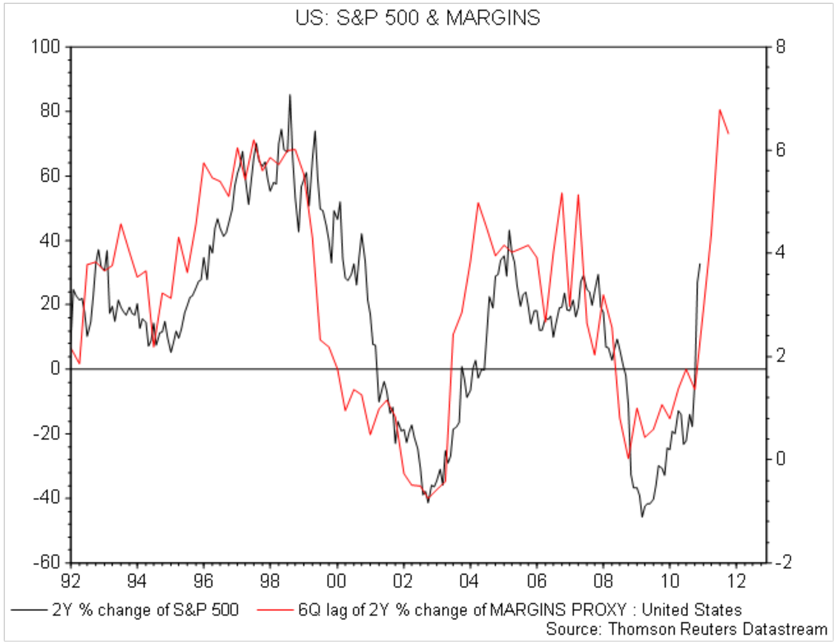


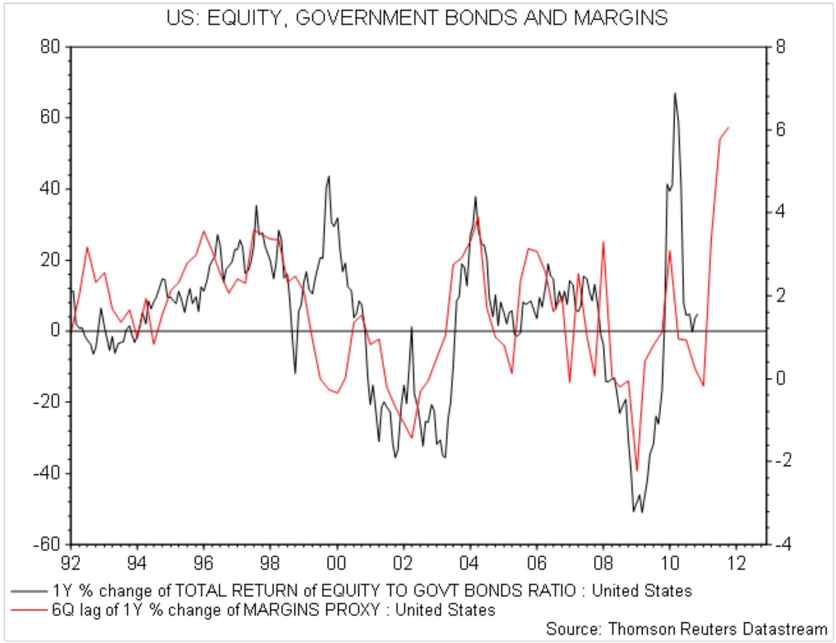


Equity

Equity depends strongly on firms' margins. The graph on the left shows the relationship between the two year change of S&P 500 versus the six-quarter-lagged value of a margins proxy based on macroeconomic data. It is worth to note that this proxy predicted the IT bubble two years in advance, and it also suggested a large slowdown in 2007.

The graph on the right shows the yearly change of the ratio between S&P 500 and US Treasury bond total returns, compared to the margins proxy. Based on this relationship, we expect equity to outperform Treasuries in the upcoming quarters.





Le informazioni fornite nel presente documento non costituiscono offerta o sollecitazione all’acquisto o vendita degli strumenti finanziari ivi descritti o a partecipare ad una strategia di trading.

Il documento è stato redatto esclusivamente a fine informativo, con l’obiettivo di fornire un concreto supporto tecnico, qualora foste interessati al tipo di investimento descritto. Le informazioni non hanno la presunzione di essere esaustive dell’argomento trattato. Resta fermo il dovere di leggere attentamente il prospetto informativo, prima di aderire all’investimento.

Nessuna assicurazione viene rilasciata in merito al fatto che i rendimenti sopra evidenziati siano indicativi di quelli ottenibili in futuro. Un eventuale cambiamento delle ipotesi di base, assunte per descrivere il rendimento sopra illustrato, comporta una modifica del risultato proposto.

Qualunque riproduzione di queste informazioni per intero o in parte è proibita.

GENERALI Investments è esonerata da ogni responsabilità relativa all’improprio utilizzo delle informazioni qui contenute.