

## Investment Outlook

# PATIENCE IS A VIRTUE

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## RATES

### USTs

**We remain LONG tactically**, for the following reasons:

- 1) **We continue to believe that the US economy is not overheating.** In our baseline scenario, we see the US economy continuing to grow at around potential with limited risks of overheating, while the latest core inflation dynamics remain consistent with an ongoing disinflation trend.
- 2) **We remain of the view that market Fed pricing is overly hawkish.** According to current money market curves, the Fed is expected to deliver around 40bp of rate hike by year-end. We believe this current pricing is too hawkish, our baseline is that the Fed will not deliver any hike this year.
- 3) **Carry- related considerations remain supportive.** USTs continue to trade close to post-Liberation Day levels, remaining near the Trump administration's pain threshold.

That said, **we maintain a cautious approach towards further accumulation of USTs, as upside risks to yields have increased over the past few weeks**, for the following reasons:

- 1) **Recent sell-offs appear to be macro-driven.** While last month's UST sell-off was largely driven by market frustration over the longer-than-expected duration of the Middle East conflict, the recent rise in Treasury yields appears to be supported by stronger-than-expected economic data and by the pricing of a higher probability of economic overheating.
- 2) **Markets may begin pricing in higher inflation expectations.** Since the beginning of May, real yields have moved steadily higher, while breakeven inflation rates have declined. Given the continued strength of the economy, we see a risk that markets will begin to reprice inflation expectations higher over the coming weeks.
- 3) **The term premium remains relatively low and below its pre-conflict average.** We believe the risks remain tilted towards a further increase in the term premium in the near term, especially taking into account the fact that under the new Chair, the Fed's reaction function has become increasingly difficult to read and in light of the extensive reform of the Fed that Chair Warsh is willing to bring to the monetary policy conduct.
- 4) **The balance of risks surrounding the fiscal deficit has shifted to the upside.** In May, the Trump administration paid more than USD 23bn in refunds, effectively offsetting tariff revenues and reducing net inflows to approximately zero. Press reports also indicate that over USD 60bn of additional refunds has already been approved. While uncertainty remains high regarding both the refund process and

the replacement of current tariffs after July, we believe fiscal risks have increased materially in recent weeks.

- 5) **Positioning has become more balanced.** Speculative investors have reduced their short positions at the front end of the curve, while asset managers have trimmed their long positions in the same segment. At the long-end of the curve, while asset managers remain long and have continued to add exposure over the last few weeks, leveraged funds have moderately trimmed their short positions.

Against this backdrop, **we are not increasing our exposure further at current levels, while maintaining our threshold for further accumulation at 4.80%.** Meanwhile, **we raise the threshold for turning NEUTRAL to 4.20% (from 3.95%).**

**Curve-wise, we continue to prefer the 2-5Y maturities compared to longer-ones and we would position for a steepening of the curve.**

**Strategically, we maintain our NEUTRAL stance.** Solid economic growth and a longer path for inflation to converge towards target point to yields remaining around current levels, or only slightly lower, in the medium-term.

**The main risk to both our tactical and strategic views remains that the US economy performs too well.** Given supply-driven tightness in the labour market, spending above potential could lead to an increase in labour demand and upward pressure on wages. Moreover, an overly resilient consumer sector, especially among lower-income cohorts, could give retailers confidence that households have sufficient capacity to absorb higher prices associated with rising gasoline costs. In both cases, the Fed would be forced to keep rates higher for longer and could potentially adopt an even more restrictive.

## Bund

**We remain LONG tactically and lower our accumulation threshold from 3.35% to 3.10%.**

After overshooting their recent "war range" in mid-May, Bund yields have corrected lower and are now trading at the low end of that range. At the same time, we see an inconsistency in current market pricing. While inflation breakevens have recently declined, real Bund yields have continued to drift moderately higher. We expect this divergence to correct over time through lower real yields. In our view, this adjustment could be triggered by one of two developments:

- 1) **A further deterioration in EA economic data.** A series of negative economic surprises could lead investors to price a higher probability of a technical recession and, in turn, to price a more accommodative monetary policy path from 2027 onwards.
- 2) **A persistently hawkish ECB stance.** Should the ECB maintain a hawkish tone in the coming weeks despite having already raised rates, markets may increasingly conclude that policy is exacerbating the growth slowdown, leading to a faster repricing of growth expectations and, consequently, lower real yields.

**Meanwhile, we leave our threshold for turning NEUTRAL at 2.60%.**

**Curve-wise, we continue to prefer the 2-5Y maturities compared to longer-ones and we would position for a steepening of the curve.**

**Strategically, we remain NEUTRAL and maintain our positive outlook.** Another potential rate hike by the ECB in Q3 could further weigh on economic momentum in

the EA, increasing the likelihood that the ECB may eventually need to reverse course and deliver at least one rate cut from Q4 2026 onwards.

## BTP

**We remain LONG tactically**, as we believe that constructive expectations regarding Italy's idiosyncratic factors – namely political stability and fiscal discipline – will continue to shield BTPs from excessive widening in risk-off environments.

**Consistent with our view on Bunds, we lower our threshold for further accumulation to 3.90% from 4.20%.**

Meanwhile, **we keep our threshold for turning NEUTRAL at 3.20%.**

**Strategically, we remain NEUTRAL and maintain our positive outlook.** Another potential rate hike by the ECB in Q3 could further weigh on economic momentum in the EA, increasing the likelihood that the ECB may need to reverse course over time and eventually deliver at least one rate cut from Q4 2026 onwards.

## EQUITY

**We move to a tactical NEUTRAL stance** (from LONG previously). The rally has been strong, and while macro conditions and fundamentals remain supportive, **we believe the near-term risk-reward has become less compelling.**

**We do not expect a meaningful FOMO-driven extension of the rally.** Part of the return profile has likely been pulled forward, raising the risk of earlier-than-usual profit taking in August and September, given that participation improved much earlier in the rebound. This makes the rally healthier overall but also implies less incremental support from late performance-chasing flows.

**The market will enter the reporting season with the bar set relatively high.** Analysts have continued to revise earnings estimates higher despite a Q2 heavily shaped by the war in Iran, which speaks to the resilience of the underlying backdrop. At the same time, this leaves the market facing a higher hurdle ahead of results, with less room for upside surprise.

**A separate risk is that any broadening in leadership could generate temporary weakness at the headline index level.** While ultimately constructive, such a rotation could trigger a short-lived increase in volatility and would likely resemble a repositioning phase rather than the start of a broader sell-off.

That said, **two supportive elements remain in place, discouraging a more conservative approach to the market.** Valuations, while elevated, do not appear overly stretched. Moreover, we continue to expect a further easing of geopolitical tensions, which should help preserve a constructive market backdrop.

**From a regional perspective, Europe is now our preferred market** (upgraded from NEUTRAL). We downgrade the US to NEUTRAL (from LONG). Although the US still appears fundamentally strongest, we do not believe this is the right point to express that preference aggressively at the index level following the recent rally. We remain NEUTRAL on EM and SHORT Japan.

**From a sector perspective, we are also moving to a more balanced stance, moderating our cyclical exposure and becoming more style-agnostic** (from a

previously strong pro-cyclical Growth bias). We are not turning outright defensive, but after the recent rally we believe the near-term risk-reward for Cyclical is less attractive, particularly with expectations already elevated.

**Strategically, we maintain our 12-month OVERWEIGHT stance on equities.** The recent de-escalation of tension in the Middle East reduces the risk of a more severe and prolonged macroeconomic shock, even if some uncertainty remains and the path ahead is unlikely to be linear. That said, **we continue to view any meaningful market weakness as a buying opportunity.**

## FX

**Tactically, we remain NEUTRAL on EUR/USD and DXY.**

Over the past few weeks, the dollar has continued to benefit from the persistence of the conflict in the Middle East and elevated energy prices, in line with the pattern observed since the start of the conflict. In addition, the dollar's sensitivity to positive US economic surprises has increased, further supporting the greenback and finally the hawkish market reading of the Fed provided additional tailwind.

While we expect solid economic data in the US to continue supporting the dollar in the near term, the fact that the dollar is currently trading at the upper end of its post-Liberation Day range limits its potential for further significant appreciation in the near-term, in our view. Moreover, with Iran and the US agreeing on a deal, the DXY might correct part of its recent gains.

**Strategically, we turn NEUTRAL on EUR/USD and DXY (from LONG and SHORT, respectively).** The rationale is twofold:

- 1) Traditional macro drivers are likely to regain prominence over the medium term. As the influence of Middle East-related developments gradually fades, we expect the US-EA yield differential and relative growth dynamics to re-emerge as the primary drivers of EUR/USD. In this context, we believe markets remain overly constructive on the EA growth outlook and continue to underestimate the probability of further ECB rate cuts in 2027. This should provide medium-term support to the U.S. dollar against the euro.
- 2) We continue to believe that a gradual normalization of the political risk premium, alongside the approaching midterm elections, could prompt a shift towards a more constructive strategic view on the greenback. This could ultimately allow the DXY to break above its post-Liberation Day trading range.

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