

Investment Outlook

WAIT AND FADE

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RATES

USTs

We remain LONG tactically, for the following reasons:

- 1) Neither signs of overheating nor evidence of indirect/second-round effects have emerged at this stage. Growth momentum remains at potential while the energy shock stemming from the Middle East is not breaking through to Main Street. Wage growth continues to ease while both core consumer and producer prices remain consistent with a disinflationary trend, once the technical/temporary factors that biased the April prints to the upside are properly considered.
- 2) We remain of the view that market Fed pricing is overly hawkish. The Warsh era is about to start. While our baseline (2-3 cuts by year end) is under review as we wait for more clarity regarding Warsh's stance, we believe, at this stage, that his bias remains towards lower rates; hence, the bar for higher rates (currently priced by the market) is very high. Therefore, the risk-balance is skewed towards lower rates than those currently priced in.
- 3) Carry- and policy-related considerations. The level of UST rates, in some areas even above those reached in the aftermath of last year's liberation day (e.g the 5Y tenor), remains interesting in absolute terms. Tailor-made verbal intervention, either from the Fed or from the Treasury, similar to the comments delivered in April last year when the 10Y UST reached 4.50% can't be ruled out.
- 4) Limited fiscal slippage risks compared to the pre-Supreme Court ruling baseline on IEEPA tariffs. We still think that the 2026 deficit will land in the 6% area and that upside risks are relatively contained despite the legal challenges to tariffs collected under Authority 122 and possible refunds of tariffs collected under IEEPA.
- 5) Smart funding. While funding needs in Q2 will be higher than expected (USD 189bn vs. USD 110bn announced in February), the Treasury will fund the increase via T-bills and has communicated that it anticipates no change in bond issuance for the next several quarters, in line with the guidance provided in recent quarters.
- 6) Technical considerations. Our model indicates that 10Y UST yields are 40bp above their fair value.

Over the month, 10Y rates reached the accumulation threshold (4.40-4.50%) we had indicated. For the reasons discussed below, however, we **are not increasing our exposure further and have raised the bar for further accumulation to 4.80%**, for the following reasons:

- 1) Price action post the US-China meeting suggests that markets are increasingly worried that reopening the Hormuz Strait might take longer than previously expected. The news that China will buy oil from the US suggests that China's own incentive to resume the normal oil flow may have weakened somewhat in the near

term. Although we do not expect the reported US-China deal on oil supply to be a self-sustainable equilibrium over the medium term (more on this below), we believe it might be enough to keep UST rates under pressure until China's efforts to seal a deal between the US and Iran clearly resurface.

- 2) Compared to other systemic regions, notably the EA, the US economy is on solid footing. While we have been downgrading our above-consensus growth forecast lately, as rising gasoline prices weigh on consumer spending prospects, the consensus has been upgrading its view. Against this backdrop, solid incoming data, including cosmetically strong CPI and PPI prints, led the market to begin pricing in procyclical overheating risks.

Meanwhile, we leave the bar to turn NEUTRAL at 3.95%:

Strategically, we stick to our NEUTRAL stance. From a medium-term perspective, factors pushing yields downward and upward counterbalance each other:

- 1) Still solid economic growth but overheating risks under control. We forecast growth to average 2.2% in 2026, similar to 2025 and close to potential. Fiscal support from the OBBA via tax refunds has been used to smooth the increase in gasoline prices, repay debt and/or increase savings. Moreover, while the costs of the Middle East war and Trump's declining popularity among MAGA Republicans reduce the odds of electoral fiscal easing ahead of the midterm elections, we see the risk of a higher deficit in 2027 due to rising defence expenditure. In a nutshell, the fiscal lever - potentially the most overheating force among those we identified at the beginning of the year - has been diverted towards unproductive spending.

- 2) We are of the view that China buying US oil can be, at best, a temporary compromise aimed at providing the US with more time to negotiate with Iran over Hormuz from a position of strength. It does not represent, in our view, the beginning of a new, long-term cooperative equilibrium between the US and China over oil. Firstly, by *Pontius Pilating* - i.e. not standing by Iran once the oil supplies needed for its economy are guaranteed - China would lose credibility vis-à-vis its international allies, including Russia and India. Secondly, China must remain oil-independent from the US if it wants to remain a credible alternative global superpower to the US. For this reason, we believe that China will continue to work with both Iran and the US to re-open the Hormuz Strait.

- 3) Uncharted monetary policy stance. The Warsh era will begin in June. We remain of the view that Warsh's bias continues to be towards lower rates. While strong incoming data and divided views within the FOMC challenge his likely preference for lower policy rates, we believe that he has enough arguments to downplay overheating risks (wage/growth is stable) and/or second-round/indirect risks (tariff pass-through is largely over, while the recent strong CPI/PPI prints are largely mechanical and driven by one off factors).

The main risk to both our tactical and strategic views is that the US economy fares too well. Given supply-driven tightness in the labour market, spending above potential could lead to an increase in labour demand and higher wages. Moreover, an overly resilient consumer sector, especially among low-income cohorts, could give retailers confidence that households have sufficient leeway to absorb higher prices justified by rising gasoline prices. In both cases, the Fed would have to keep rates higher for longer and possibly even adopt a tighter monetary policy stance.

Bund

We remain LONG tactically.

We continue to believe that Bund yields have little room to increase from current levels, for the following reasons:

- 1) Unless the conflict continues over the medium term (which is not our base case), we do not expect the energy shock to feed through into higher core inflation.
- 2) EA growth forecasts have already been revised to the downside due to the Middle East conflict, but risks remain skewed further to the downside.
- 3) The ECB's likely delivery of one/two hikes in a context of weakening economic momentum and further progress in disinflation will likely lead to a deterioration in medium-term growth and inflation expectations.

Over the month, 10Y rates reached the accumulation threshold (3.10-3.20%) we had indicated. For the reasons discussed below, however, we **are not increasing our exposure further and have raised the bar for further accumulation to 3.35%**.

While the EA economy is in a much weaker place compared to the US economy, we expect volatility in Bunds to remain elevated in the near term due to:

- 1) Spillovers from USTs.
- 2) A more hawkish central bank compared to the Fed.
- 3) Higher sensitivity to energy prices compared to USTs.

Meanwhile, we leave the bar to turn NEUTRAL at 2.60%.

Strategically, we remain NEUTRAL. In our baseline scenario, any inflation and growth impact stemming from the Middle East conflict should remain manageable, while the fiscal package in Germany is likely to keep yields broadly anchored around current levels.

That said, **we are introducing a more constructive tilt to our strategic positioning.** One/two potential rate hikes by the ECB in Q2 and 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).

BTP

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

That said, as was the case with Bunds, over the month, 10Y rates reached the accumulation threshold (3.95-4%) we had indicated. For the reasons discussed below, however, **we are not increasing our exposure further and have raised the bar for further accumulation to 4.20%:**

- 1) Rates volatility triggered by news flow related to the Middle East conflict.
- 2) One/two possible rate hikes by the ECB. While the sensitivity of BTPs to tighter financing conditions has declined compared to the past, rate hikes could still lead to a moderate widening in the BTP-Bund spread.

Meanwhile, **we keep our bar to turn NEUTRAL at 3.20%.**

Strategically, we remain NEUTRAL. However, in line with Bunds, **we are introducing a more constructive tilt to our strategic positioning,** as one/two possible rate hikes by the ECB in Q2 and Q3 could deepen the loss of economic momentum in the EA, potentially forcing the ECB to reverse course further down the road and deliver at least one rate cut (from Q4 onwards).

EQUITY

We remain tactically LONG. While the rally has already been meaningful, we do not think the move is over. Our constructive stance rests on four pillars: improving geopolitical news flow, supportive company fundamentals, still-light positioning, and a dovish Fed funds repricing.

Our base case is still one of stabilisation rather than renewed escalation in the Middle East, which should allow the geopolitical risk premium embedded earlier in the year to fade further. At the same time, **company fundamentals remain supportive.** Earnings revisions have already improved, but we do not think the market has fully exhausted the benefit from resilient corporate delivery.

Positioning also remains relatively light despite the rebound, leaving room for further re-engagement if the backdrop stays constructive.

Valuations are not a constraint at this stage. The market remains materially less stretched than it was at the October peak, which limits the case for turning tactically cautious too early. From here, **the clearest additional upside catalyst would be a more supportive shift in policy expectations.** In other words, geopolitics, fundamentals and positioning should continue to underpin equities, while a favourable Fed repricing would drive the next leg higher.

That said, **one tactical risk to watch is that any broadening of the rally after the current period of strong market narrowing could bring a temporary rise in volatility.** We would view this less as the start of a sell-off and more as a repositioning phase within the market.

From a regional perspective, we continue to prefer the US over the rest of the world, supported by relative energy independence, a firmer domestic backdrop and stronger earnings visibility. Europe remains more exposed to the lingering effects of the energy shock, while EM may benefit at the margin from lower oil prices and a softer USD, though not enough to displace our preference for the US.

From a sector perspective, we continue to favour Cyclical over Defensive, while maintaining a Growth tilt. Materials and Semiconductors remain our preferred exposures, while Energy continues to provide a useful hedge within portfolios.

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

FX

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

On the one hand, there are factors in favour of a stronger DXY and a weaker EUR/USD in the near term:

- 1) The continuation of the conflict in the Middle East is keeping volatility and energy prices elevated.
- 2) The US economy remains solid, while the EA economy is weakening and risks are skewed to the downside.

On the other hand, uncertainty around central bank actions and positioning are factors favouring the EUR vs. the dollar in the near-term. In particular:

- 1) The ECB is expected to hike rates in June and could still retain a hawkish bias.
- 2) While the FOMC rhetoric has progressively shifted from dovish towards neutral, Kevin Warsh's debut as Chair at the June meeting could tilt the balance slightly back towards a more dovish stance.
- 3) Speculative positioning on the EUR remains historically short.

Strategically, we remain LONG on EUR/USD and SHORT on DXY, reflecting increased hedging of USD assets and a continued trend of foreign outflows from USD assets. That said, **we continue to signal that a likely peak in the political risk premium, alongside the approaching midterm elections, could prompt a shift to a more constructive strategic view on the greenback. Moreover, potential rate cuts by the ECB from Q4 onwards could further weigh on the common currency in the next 6-12 months.**

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