



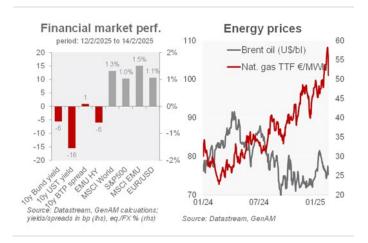
- The start of bilateral US/Russia negotiations over Ukraine has unnerved the heads of governments in Ukraine and Europe. Yet markets are already eyeing the prospects that sanctions against Russia may soon be lifted, with gas flows to Europe potentially resuming, underpinning risk sentiment.
- Falling energy prices would tame a key headwind for the European economy, even though idle
 pipelines and aversion against falling into old energy dependency will limit the relief. The European
 economy may also benefit from a moderate bounce in consumer and business sentiment.
- Tectonic shifts in the geopolitical order, including strains in the transatlantic alliance, are making it
 more urgent for Europe to address its weak strategic positioning. Reconstruction and military efforts
 will require fiscal room, and possibly some joint issuance, e.g. via the ESM.
- This has significant implications for bonds, limiting the downside in EUR bond yields, as well as the chance of a reversal in swap spreads and credit spreads. "Tighter for longer" is in the order.
- The outlook of a sustainable peace deal may support EUR/USD but is unlikely to prove a game-changer amid continued US exceptionalism, trade uncertainties and a wide US yield advantage.
- Across EMs, CEE countries will most benefit from a decline of risk premium and a better growth/inflation mix.
- Peace talk is positive for Equities ex-US, helping the EMU market to reach its full valuation potential (+7% over 12 months, including dividends) even though a smaller downside in long-term rates will partly offset the upside growth and earnings effect. Financials, capital goods, defence (still some upside), construction materials, metals & mining and Chemicals may benefit.
- A ceasefire, or even better a durable peace deal, would feed credit spreads tightening, even at these stretched levels. European autos and consumer retail may get some relief.

Recent developments mark a tectonic shift in US foreign policy, geopolitics and more specifically European security. First, President Trump announced the "immediate" start of

negotiations with Russia over Ukraine, boosting hopes of a ceasefire and – ultimately – even a peace agreement three years after Russia's invasion. Subsequent details from the US

administration have made clear that, while Ukraine may have a seat at the negotiation table, Europe is too weak and does not deserve one. The transatlantic rift deepened on 14 February at the Munich Security Conference, when VP JD Vance exposed fundamental differences about societal views and values, arguing that the key threat for Europe was coming "from within", rather than the outside.

The situation is fluid yet, in this report, we try to draw key implications for the economy and financial markets. On the political side, envisaged direct talks between Trump and Putin in Saudi Arabia this week have quickened fears in European capitals that a peace deal may be brokered between the US and Russia over their heads. Worse, before negotiations have started, the US seem to have budged to key demands from Russia, basically dismissing Ukraine's prospects of future NATO membership and arguing that Ukraine would have to concede parts of occupied territory to Putin. The US also made clear they would not be sending their own troops to back security guarantees for Ukraine, which would leave the burden fully onto European shoulders. That point however seems opened to negotiation, as the US also proposed a deal to Ukraine, whereby they would contribute to security if Ukraine ceded ownership of around 50% of the rights to the country's rare earth minerals. EU High Representative for Foreign Affairs Kaja Kallas warned of a "dirty deal" with adverse long-term consequences if Russian risk of aggression keeps looming over Eastern Europe.



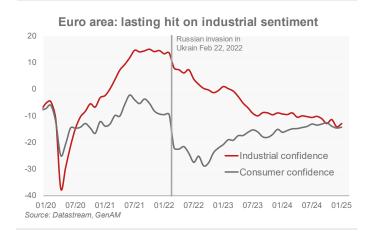
In any case, this is just the beginning of a potentially protracted negotiation period and success is far from guaranteed. Yet even before the US election Trump said he was striving for a swift solution. Even under barely acceptable terms, Ukraine and Europe would struggle to reject a US/Russia deal. Trump may simply threaten to put its key military support to Ukraine on hold, which would in turn quickly undermine Ukraine's defence capabilities.

European headaches notwithstanding, markets have responded with a risk-on mood, including a stronger EUR, to

first news about direct Trump/Putin negotiations on Feb 12 (left chart above) – though the equity relief effect also came from separate US trade communication on reciprocal tariffs by the US administration being delayed to April. Gas prices came off their recent peak (right chart above), also helped by EU efforts to allow for more flexibility in refilling run-down gas storage levels.

We see **three main channels** in how a ceasefire (modest impact) or a lasting peace deal (high) could affect the European markets:

Firstly, and most importantly, gas prices would fall if sanctions against Russia were to be (partially) lifted. It is unclear to what extent European governments would be willing to increase gas flows from Russia, which would not only provide Putin with fresh funds to further build its military power but also reignite former energy dependencies. It would also run counter the efforts to further extend LNG imports from the US as a leverage to appease Trump's demands for Europe to reduce its trade surplus with the US. Yet some EU countries (Hungary, Slovakia, potentially even Austria) may still break ranks with peers by raising imports from Russia. A receding risk premium would help too. Energy prices, and gas in particular, are likely to recede, even if not drastically so.



Second, business and consumer confidence may gain, even though this channel may provide only moderate upside. The deep initial adverse shock to consumer confidence in the aftermath of the Russian invasion has already recovered over the past two years (chart above). Industrial confidence has been hammered more persistently, not least in high-energy intensity sectors. That said, trade worries and stronger competition from China also have also been and will remain at work. So will deeper-running worries about Russia's threat on Europe. Still, the hope of fewer supply chain disruptions and safer and cheaper energy supply over the coming years may prove some tailwind.

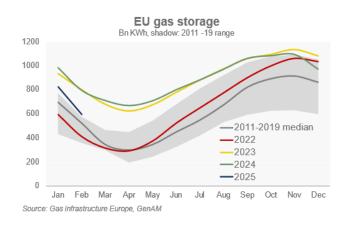
Third, a sustainable peace deal would mark the start of a large-scale **reconstruction program and military guarantees**, in the form of troops and equipment for Ukraine.

Part of the financing will come from new fiscal funds by the EU or members, relaxing the regional fiscal stance. This may help to further raise demand and modestly add to growth, although the multiplier of military spending tends to be small, as the import component (from the US) is high. Rising public deficits and debt levels may also bring fiscal sustainability questions to the fore again. This has significant implications for bonds, limiting the downside in EUR bond yields, as well as the chance of a reversal in swap spreads and credit spreads. "Tighter for longer" is in the order.

In the following, we discuss the impact on energy supply and European growth in more detail. We have a closer look at the CEE region, which due to geographical and economic ties is particularly exposed to further developments in Ukraine. We then have a closer look at implications for financial markets.

Modest short-term relief from increased Russian gas supply

Cold weather has increased demand for natural gas, pushing prices up and storage levels down to low levels relative to the post-Covid period. Demand from the EU will increase sharply in the next few weeks (+45% y/y) if storage is to reach reasonable levels by summer. Most of the EU's demand is now met by LNG, where competition from Asia is strong, and Asian countries may increase their bid for US LNG to avoid tariffs. This tilts the price risk to the upside.

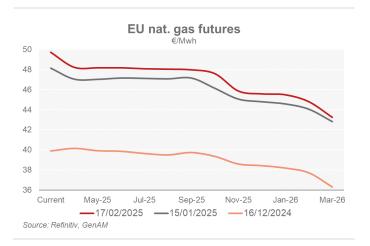


We expect a potential ceasefire to offer limited relief to EU gas prices, as political, technical and commercial constraints may prevent a rapid increase in Russian gas flows to the EU.

Political considerations: Early discussion between the US and Russia have included the potential lifting of sanctions. Europe, however, will have a say on this. Returning to Russian gas would be a major U-turn in EU policy, as it would mean abandoning the commitment to phase out Russian gas by 2027, a stated goal of the Repower EU project. Diverging national interests will (yet again) imply lengthy discussions. It would also partially undo the work done to diversify energy sources and pose a potential threat

to future energy security. In addition, Russian gas would crowd out EU imports of US LNG. Increasing purchases of US gas is one of the main proposals the Commission is likely to make in its dealings with the Trump administration on tariffs. Longer term, the sharp reduction in gas prices in Europe would reduce the viability of several LNG export facilities currently under construction in the US. However, continued high prices would increase the incentive to strike a deal with Russia.

Technical consideration: Turkstream is the only active route, but it is already operating at full capacity. All other pipelines are either damaged (Nordstream 1), not approved (Nordstream 2) or shut down (Yamal in Poland and the Ukrainian network). Restoring NS1 would take months, while getting NS2 approved would require a major discussion between Germany and the rest of the EU. The reopening of the Ukrainian network (which accounted for around 1/3 of the gas piped into Europe in 2019) could be the result of the deal, but the Kyiv government has a big say on that.



Business considerations: EU countries may be reluctant to sign long-term contracts with Russia, which proved unreliable even before the invasion of Ukraine. It would also run counter to the EU's goals of weaning itself off gas (especially Russian gas). In addition, countries have invested heavily in regasification facilities and may not like the idea of turning them into semi-retired assets. All of this may prevent Russian gas from flowing in the volumes needed to bring prices down significantly.

We think that increasing Russian gas flows via Ukraine and LNG is the best the EU can do in the short term. This could lower prices by around 20-25% by mid-2026, a steeper fall than what is currently priced in futures. On top of the increased supply, an additional, but hard to quantify push could come from the reduction in the risk premia, if the ceasefire proves durable. The ECB estimated that 10% increase in gas prices increases very gradually headline inflation, with the impact peaking at 0.1pp after two years. The Bank of Spain finds a slightly larger effect (0.19pp after one year and a half, 0.16pp after two years). This means that a

25% reduction in gas prices could lower headline inflation by 0.25 and 0.4pp in the medium term.

Oil prices less affected as Russian exports re-routed

Russia successfully managed to re-route oil and refined products exports to Asia following Western sanctions. The current low production seems to be motivated mainly by compliance to OPEC+ quotas. Therefore, a ceasefire in Ukraine would have little effect on supply. Some trade routes may reopen, as sanctions on tankers may be loosened, but the impact of global oil prices is likely to be lower than 5 US\$/bbl.

Euro area: benefits from lower gas prices

The Russian invasion of Ukraine and disruptions of energy supply heavily weighed on industrial production, with energy-intensive industries heavily affected. Economic uncertainty also dealt a heavy blow to business and consumer confidence. A ceasefire and prospects of a lasting peace-deal would ease these headwinds. Meanwhile, the need for quickly raising defence expenditures will trigger some fiscal easing – which is mildly supportive to growth but will also raise sustainability concerns for highly indebted EMU members.

Immediate support from higher confidence on activity. A lasting ceasefire agreement would improve the economic outlook. Yet sanctions against Russia may be lifted only gradually and a resumption of large-scale energy imports from Russia is unlikely. The decline in energy prices is likely to be moderate short term but easing uncertainties about energy prices could still lift consumers and firms' sentiment.

More positive effects in H2 ahead. With energy prices coming down more lastingly in the second half of the year and the confidence in a lasting peace deal rising, there should be an additional push to confidence amid higher real incomes. A small revival of the animal spirits would improve financing conditions and investment. That said, labour scarcity could intensify as Ukrainian refugees return home, offsetting some of the positive growth effect.

Increased fiscal needs. Financial support for Ukraine has been significant. Aid for the Ukraine consists of financial, humanitarian and military support. We doubt that this support to Ukraine will be scaled back immediately. According to the IfW Ukraine Support Tracker, Europe has allocated €132bn in aid to Ukraine over 2022-2024 (thereof €70bn in financial & humanitarian and €60bn in military aid), thereby overtaking the US as the main donor (total of 114bn) and implying a burden of on average about 0.2% of nominal euro area GDP. But pressures for a much more significant role in securing peace in Ukraine will rise. At the same time, growing neglect by the new US Administration as a key military backstop for Europe strengthens the case for a fast revamping of military

expenditure and much closer European military coordination. Trump's request to lift defence expenditures to 5% of GDP seems a maximalist demand. Even an increase to 3% over the coming years would imply an increase in defence spending of 1% of GDP. The European Commission has already suggested to activate the "escape clause" of its fiscal rules and discussions about joint EU funding for defence as a "public good" is likely to gather momentum. The growth impact from higher defence spending, however, will prove moderate as the import share of military investment goods is high.

Somewhat higher growth and lower inflation: All in all, the ceasefire agreement would be positive. A ceasefire agreement may lift euro area 2025 growth by 0.1 to 0.2 pp to 0.9-1.0% from our current 0.8% base forecast. Just before the ceasefire rumours oil and gas futures implied a 0.2 pp contribution of energy prices to 2025 annual inflation. We conjecture that with lower gas prices ahead this contribution could roughly be halved so that annual inflation would be at 2.0%, down from the 2.1% currently in our books.

ECB outlook little affected. Stronger growth per se would imply the need for less policy support. However, even with 1.0%, growth will remain subpar in 2025 and still fall slightly below the ECB's latest projection of 1.1%. In contrast, lower headline inflation per se could in principle give more leeway for policy easing. But we think that the ECB will look through energy price effects and focus on underlying inflation. We do not expect it to be significantly impacted here and the possible return of Ukrainian employees might even exert some upside effects. Key remains the evolution of wages and the thereby strongly influenced services inflation. Bottom line, we currently see little reason that a ceasefire deal would materially change our central forecasts of 100bp of further ECB cuts to 1.75% by July.

Peace agreement would make a huge difference: In the less likely case of a sustainable peace agreement, the above-described effects would be more pronounced. Back-of-the-envelope calculations point to a boost of GDP growth by 0.2-0.4pp to a 1.0-1.2% range for 2025. As stronger activity offsets the negative price effect from lower energy prices, headline inflation would be little changed or could even be somewhat above current baseline. In this case the ECB may become more cautious in cutting rates and might already stop its cutting cycle at 2-2.25%, the upper bound of the neutral policy range recently identified by ECB research.

EMs: CEE the largest beneficiaries

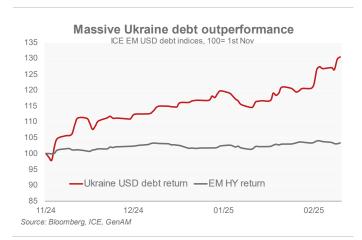
Several emerging market countries would benefit directly from a peace deal. Even if the outlook remains unclear and long-term viability is not guaranteed, the sentiment boost would suffice to support EM risk assets, at least in the short term

CEE countries are the EM countries most exposed to developments in Ukraine. Local debt and FX would benefit the most. Indeed, in 2022, CE4 FX lost between 7% and 12% against the dollar within a month of the invasion of Ukraine, with Hungary and Poland suffering most. Local debt was also hit, as well as CEE external debt, to a lesser extent. So far, only Ukrainian external debt has rallied, with a 27% excess return over EM HY US debt. However, outperformance has been muted for other CEE assets.



We see five key transmission channels for CEE:

- Business sentiment: the most straightforward channel in the short term. The CEE region may become more attractive for FDI as uncertainty declines.
- Energy: The likelihood of cheaper energy in the future would most benefit Hungary and Slovakia, given their heavy reliance on Russian gas. The Hungarian government has been vocal for years, and the country's bond market has recently underperformed on fiscal and EU concerns. Romania is less dependent on gas, given its domestic production.
- More dovish policy: The mix of stronger currencies and cheaper energy could lead to lower inflation in CEE, providing room for monetary easing, supporting household consumption and broader domestic spending.
- Germany effect: Similarly, cheaper energy and "peace in the East" would be positive for the German industry and, by extension, CEE exporters. Open economies such as Hungary and the Czech Republic would gain.
- Labour supply: A sense of stability would lead to an outflow of refugees, tightening the labour supply. The needed confidence for a return, however, will depend on the details and security guarantees by NATO allies. According to the UN, Germany (1.25million) and Poland (1m) have received the largest number the 6.3 million Ukrainian refugees registered in Europe, followed by the Czech Republic with c. 400,000 and Romania c. 180,000.

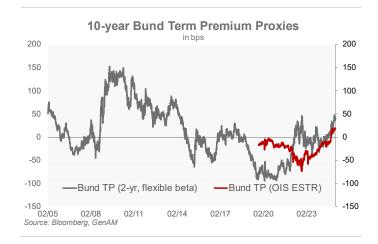


Beyond CEE countries, peace talks are bullish for global EMs. A somewhat weaker USD would support EM local debt, even more since investor positioning is light. Lower energy prices would leave scope for more monetary easing or a less hawkish stance, favouring carry trades in TRY, EGP and INR.

Bonds: Defence spending needs may raise term premium

It is hard to draw conclusions about euro area government bond markets at this early stage. In the case of a ceasefire, the impact on euro area growth, inflation and the ECB's monetary policy will be limited. The direct impact on euro area yields is likely to be limited and may have been largely priced already (the 10-year transatlantic yield spread has narrowed by 10-15 bp to around 200 bp since 12 February). This applies even more as partially offsetting effects are at work (higher growth & deficits vs. lower headline inflation).

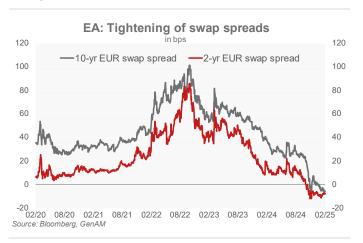
If a lasting peace agreement is reached, the positivegrowth effects and an early end to the ECB's rate-cutting cycle could lead to a more noticeable rise in yields compared with our current baseline (10-year Bund yields on a 12-month horizon: 2.10%). However, yields could still fall.



No matter what happens in Ukraine, countries in the euro area will be **spending much more on defence**. Recent events

also suggest that Germany may reform its debt brake policy, which could lead to more government spending. And reports suggest that, besides national borrowing, Europe's institutions (e.g. EU, ESM) might also provide joint financing. This will be **reflected in a higher-term premium**, if less so in the 2-10-year segment (amid the low yield level at the short end of the curve) than at the very long end.

The magnitude is significant. We estimate that an extra 1% of increased defence spending implies at least €150 billion of additional government bond supply (assuming a small multiplier). Given our current estimate of around €850 billion of net government bond issuance (including the ECB's QT) in 2025, this would be a significant additional burden on the euro area government bond markets.



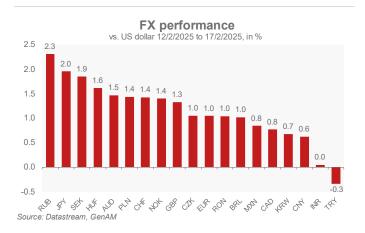
A lasting peace agreement would support risk sentiment and risky assets, so euro area non-core government bond may prove resilient to higher supply and spreads may even tighten, especially if funding at the European level is agreed. Higher budget deficits will reinforce the trend towards tighter swap spreads.

Given the fiscal challenges ahead, a slightly reduced long duration may be warranted. In any case, **bonds are also likely to become cheaper relative to swaps**.

FX: only modest EUR support from peace deal

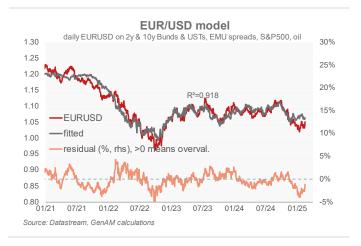
The RUB, EUR and CEE peers have been among the main beneficiaries of impending Russian peace talks (chart top right), though some relief in volatile tariff news and decent US PPI details also weighed on the USD in mid-February (lower US yields also benefitting the JPY). In part, the USD currently looks vulnerable to setbacks amid high valuations and crowded speculative long positions (chart next page).

The EUR may benefit somewhat from a reversing risk premium if the war in Ukraine is headed for a sustainable peace agreement. Over the six months following Russia's invasion of Ukraine in Feb. 2022, EUR/USD fell by almost 14%, breaking through parity. A large chunk of the move can be attributed to rates moves, risk sentiment etc. But even after

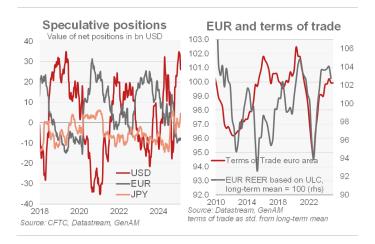


controlling for these FX drivers, the residual obtained from our fair value model (chart below) shows a repricing in the EUR risk premium (decline in EUR/USD unexplained by financial market drivers) by 6% over that period. Some modest easing in the risk premium may still be on the cards.

A "dirty peace" imposed by Trump and Putin on Ukraine and Europe may trigger only a short-lived bounce as strategic geopolitical uncertainties from Trump's questioning of military commitment to Europe may offset the relief. That said, a big chunk of the 2022 EUR risk premium seems to have evaporated over the past two years as the frontlines in Ukraine turned into attrition war. And the renewed increase in the risk premium since last autumn seems related to Trump's tariff uncertainties rather than Ukraine. So it seems more likely that whipsawing trade war fears may continue to dominate the premium over the coming months.



Yet some further aspects point to some modest EUR support from a peace deal. Falling energy prices would support the euro area's terms of trade and thereby the EUR (right chart below). And the slight support to GDP from confidence may also boost the single currency. Yet this may be largely offset by strained public finances of euro area members on increased fiscal deficits. And with the outlook for the ECB little affected by a peace deal, the US yield advantage as a key driver for USD strength will be barely affected. Overall, peace talks over Ukraine may thus provide some further moderate

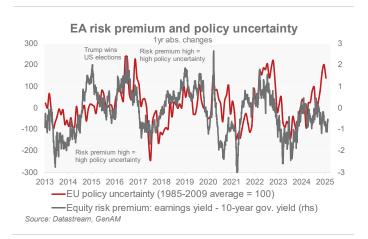


upside for the EUR, but given persistent fundamental support to the USD (US exceptionalism, yield advantage, trade uncertainty and tariffs) it is unlikely to prove a major game changer for EUR/USD.

Equities: scope for some further relief

Emerging news of impending peace talks have contributed to the YTD strong (out)performance of European stocks, confirming our generally positive stance on equity markets amid support from resilient global growth, monetary easing, and rotation out of the US tech sector.

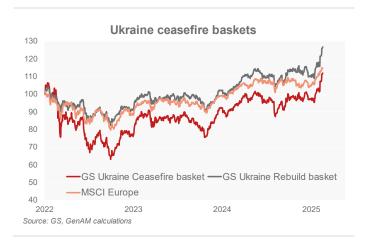
A potential ceasefire could provide an additional tailwind



to sentiment, backing a further decrease in the already peaking policy uncertainty index. The assumed 0.1- 0.2 pp boost to EMU GDP could increase 12-month earnings by 0.8-1.0%. Arguably, this may be partly offset by a smaller downside in EMU long yields.

That said, the EMU index has already reached the lower end of the valuation range we established in early December 2024 (+11% TR). We expect a further 7% over the next 12 months, of which 4.5% are dividends and buy-backs. As a result, in our base scenario, the price appreciation looks now overall limited, with much uncertainty about the process. The latter would continue to justify an OW position in the *EU made in*

the USA basket (EU firms having much production capacity in the US).



Regarding sectors, Goldman Sachs' baskets of EU firms with exposure to Ukraine's reconstruction (Rebuild basket, Bloomberg ticker GSXEUKRA) and beneficiaries of a deal (Ceasefire basket, GSXECEAS) are already up 15% year-to-date (YTD) vs. 9% of the MSCI EU. Since 2022, the Rebuild basket has gained 27%, while the Ceasefire basket has increased by 12%, compared to the market's 15% rise.

A possible Ukraine ceasefire also reaffirms us in our overweight small cap, basket of M&A candidates, and cyclicals vs. defensives. In particular, financials, capital goods — defence (still upside on a mid-term view), construction materials, metals & mining. Tactically, we also suggest a slight OW on Chemicals, positively exposed to a pullback in energy prices. Underweights: professional services, consumer goods, media and utilities. Our bets are also positively correlated with further tightening trend in CEE bond CDS and Ural-Brent oil price spreads.

Credit: Laggards may benefit

The potential ceasefire in Ukraine could have several impacts on credit markets. Improved overall market sentiment may trigger inflows into euro-denominated assets. This positive sentiment might particularly benefit sectors that are currently trading at a significant discount, such as **European autos**.



European Credit has already outperformed against US peers, with EUR IG tightening by 15 bp since the start of the year compared to 2 bp of tightening for USD IG. If a ceasefire is confirmed, this trend could continue, with euros potentially trading inside of dollars for much of the previous cycle.

The impact on business and consumer sentiment could be significant. European consumer spending has been soft despite solid real wage growth, primarily due to a rise in the savings rate. A ceasefire could ignite consumer 'animal spirits', boosting consumer and retail names with significant domestic revenue exposure.

A fall in oil prices (arguably limited) would be directly positive for **airlines** and generally beneficial through stronger global growth and lower inflation. This could further support credit markets by reducing costs for businesses and improving profitability.

The **European manufacturing sector** could see some marginal benefit from lower costs amid lower energy prices. However, it is unlikely to immediately become competitive again on the global stage.



In conclusion, a ceasefire in Ukraine could lead to **tighter credit spreads** and improved sentiment in euro-denominated assets, particularly benefiting sectors like European autos and consumer retail. However, the full impact on credit markets will depend on the extent and permanence of the ceasefire, as well as the resumption of gas flows and other geopolitical factors.





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Società di gestione del risparmio, Research Department

Head of Research: Vincent Chaigneau

Head of Macro & Market

Research:

Dr. Thomas Hempell, CFA

Team: Elisabeth Assmuth | Research Operations

Elisa Belgacem | Senior Credit Strategist Radomír Jáč | GI CEE Chief Economist Jakub Krátký | GI CEE Financial Analyst

Michele Morganti | Head of Insurance & AM Research, Senior Equity Strategist

Vladimir Oleinikov, CFA | Senior Quantitative Analyst Dr. Thorsten Runde | Senior Quantitative Analyst Dr. Christoph Siepmann | Senior Economist Dr. Florian Späte, CIIA | Senior Bond Strategist

Guillaume Tresca | Senior Emerging Market Strategist

Dr. Martin Wolburg, CIIA | Senior Economist **Paolo Zanghieri, PhD |** Senior Economist

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