

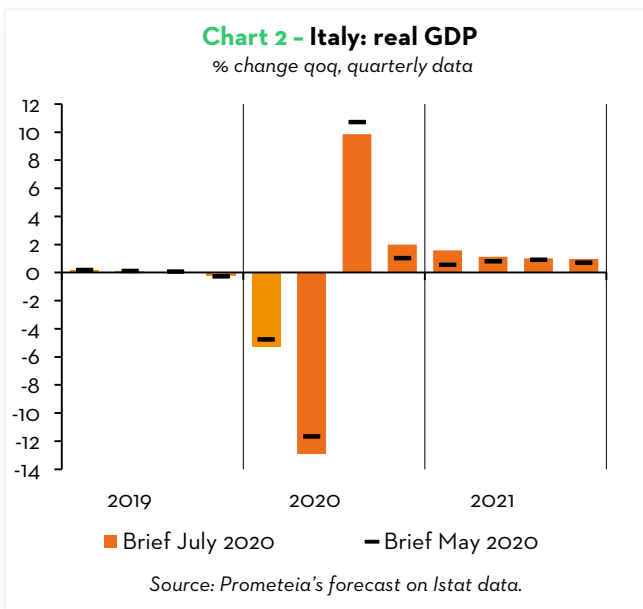
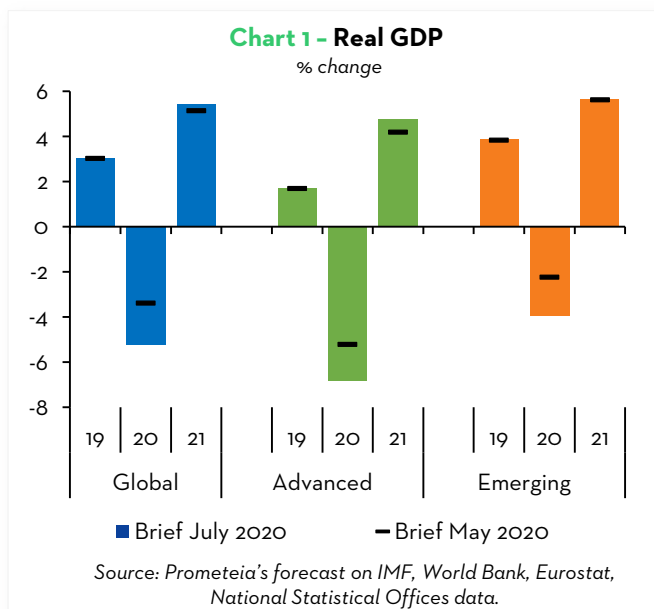
### Executive summary

#### The recession spares no one

- The coronavirus pandemic continues to grow: while in Europe and China new cases seem to be confined to clusters, in the US, South America and India the situation is worsening, casting doubt on the timing and speed of the global recovery.
- We have revised our GDP forecasts downward both because of longer lockdowns and their larger than expected effects, and because even in those countries that have removed lockdown, recovery is proceeding at a slow pace. Rules and recommendations about individual physical distancing and general caution continue to affect consumer habits.
- The desynchronization among economies is causing problems for trade channels and global value chains. Overall, in 2020, we expect decreases of 5.2% in global GDP (Chart 1) and 14.4% in global trade.
- The impressive amounts of resources being injected into the economy by governments and central banks worldwide are only partly offsetting the fall in household incomes. We expect the Recovery Package under discussion in Europe will increase euro area GDP by 0.4pp a year in 2021-2024 (InFocus 1).

#### Is the worst over in Italy?

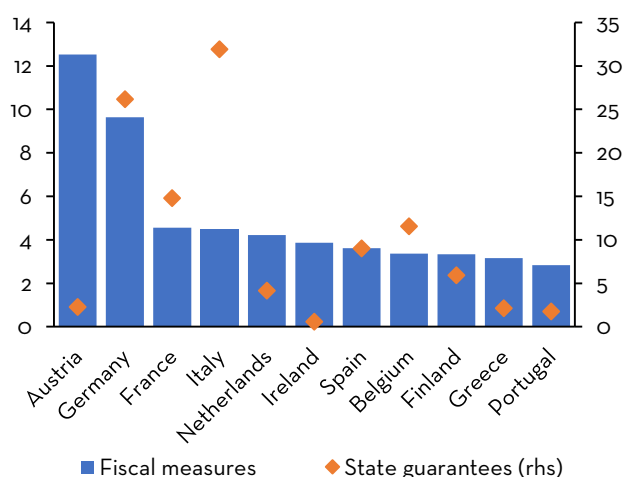
- Italy's Q2-2020 fall is estimated to be much higher than in Q1 (-12.9% vs -5.3% qoq) due to the lockdown measures and the drop in demand (Chart 2). The end of the lockdown and the fiscal package will support the recovery in the second half of the year.
- We expect GDP to fall by 10.1% on average in 2020 and to rebound by 5.9% in 2021. However, despite this recovery, GDP will be 3% below pre-COVID levels at the end of 2021.
- At the end of 2020, employment will be more than 2 million full-time equivalent units below pre-crisis levels (InFocus 2) - a result that combines asymmetric effects among sectors and among types of employment contracts.
- In order to contain the recessionary phase and allow a more rapid recovery, the Italian government, through the 'Cura Italia' decree approved at the end of March and the subsequent 'Rilancio' decree, has allocated €75 billion, 4.5% of GDP. This is an unprecedented financial commitment, although slightly below the euro area average.



## Global scenario

**Chart 3 - Government interventions in 2020**

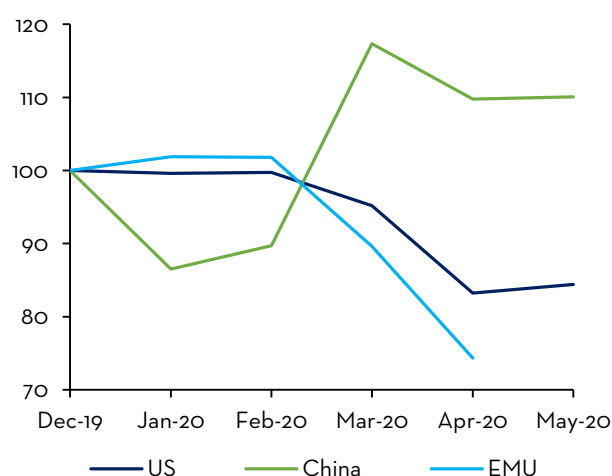
% of national 2019 GDP



Source: Prometeia's calculations on IMF and national governments data.

**Chart 4 - Industrial production index**

december 2019 = 100



Source: Prometeia's calculations on National Statistical Offices data.

**The COVID-19 outbreak is hitting many emerging countries very hard.** Brazil and the rest of South America, India, Russia and South Africa are all experiencing similar situations to those experienced in Europe a couple of months ago. A record contraction of the economy is expected in the 2<sup>nd</sup> and, possibly, 3<sup>rd</sup> quarters in a context of less developed sanitary systems and fewer resources to deploy for the recovery. Lower external demand, in particular, for raw materials, is adding to this gloomy outlook.

**Commodity prices are increasing**, after reaching a minimum in April, but this rise is driven, mostly, by concern over supply (US shale oil, South American metals) rather than a clear surge in demand.

**Euro area's slow and uncertain recovery.** April marked the crisis low in Europe. Since May, confidence among households and firms has been increasing moderately, suggesting some future improvements amid supply-side constraints and persisting uncertainty. In our scenario, euro area GDP is expected to fall by 8.1% in 2020, with a historic downturn in Q2 (-12% qoq), followed by a moderate recovery. In 2021, we expect only a partial recovery of the loss (5%): we do not expect 2019 levels to be regained until 2023. Both lockdown costs and speed of recovery are uneven among countries.

**Economic policies are playing a crucial role at both national and EU levels.** In 2020, Member States adopted fiscal measures amounting to 6% of euro area GDP and some have provided huge levels of loan guarantees to ensure liquidity for firms (Chart 3). In addition, the EU institutions have already agreed an emergency package and are now discussing a recovery instrument (InFocus 1). Finally, the ECB is providing additional liquidity to banks

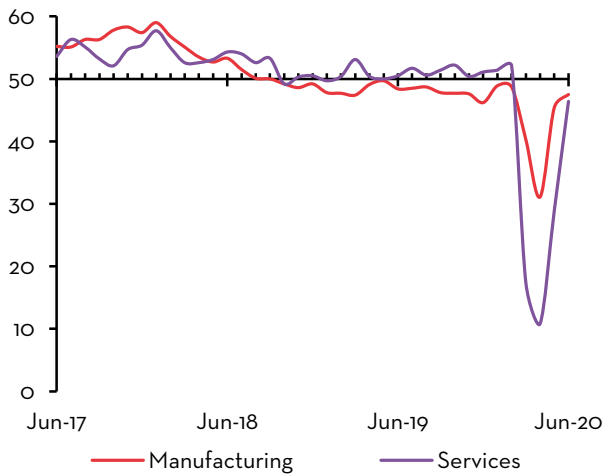
(PELTROs) and substantially increasing bond purchases (PEPP and extension of APP). The ECB's decisions and the announcement of the Next Generation EU proposal have contributed to reducing EMU spreads.

**In the US, the COVID-19 outbreak is currently worsening, casting some doubt on the possibility of a fast recovery** suggested by the labour market improvements that emerged in May and June. Government measures have reached \$3,000 billion (including \$600 bn in grants), almost \$1,200 billion of which has been disbursed to support households and unemployed people; however, precautionary saving and high uncertainty are constraining consumption. The FED announced that the current ultra-accommodative policy would be maintained, without specifying an end date.

**In our scenario, we expect both the Fed and the ECB to maintain the policy rates unchanged** at least until 2023.

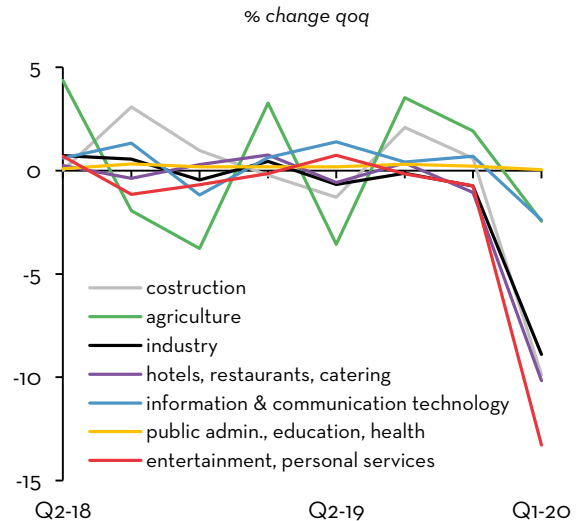
**Economic recovery in China seems slower than was expected. While the manufacturing sector appears fairly solid**, new clusters of COVID-19 are increasing uncertainty - mainly in the service sectors. Industrial production grew yoy in April and May (Chart 4), services only in May, while retail sales continued to lag. Public investments served to soften the yoy reduced growth in overall investment as private investment remains weak. In May, China's government approved a package of measures to support growth that could amount to 6% of GDP, which is less than in 2008-9 and includes few direct stimuli. External demand is not expected to help since many trade partner countries are still suffering the effects of the COVID-19 epidemic.

**Chart 5 - Purchasing Manager Index**



Source: Refinitiv.

**Chart 6 - Employment: sectoral effects**



Source: Prometeia's calculations on Istat data.

**All demand components, with the exception of inventories, contributed to the drop in GDP in Q1-2020.** Exports of goods and services were severely affected by the collapse of tourism flows, which fell by 38.8% qoq. Government consumption stagnated, since it had yet to incorporate increased expenditure on healthcare to survive the pandemic.

**Not all sectors have been hit in the same way.** On the supply side, there is high heterogeneity, testifying to the asymmetries related to this crisis: manufacturing, retail trade, accommodation and food service activities have been the hardest hit sectors, falling by about 9% qoq in Q1, whereas financial services recorded a reduction of only 1%. Data on industrial production show that production of transport means and textile products halved in March compared to February whereas pharmaceuticals and food products fell much less, 8.7% and 4% respectively. This gap widened in April with the suspension of all non-essential economic activities.

**Economic indicators recovered in May and June.**

Industrial production (excluding construction) grew significantly (41.2%) in May compared to April (-20.3% yoy) mainly due to the easing of lockdown measures. June saw some positive signals in households' and firms' confidence. After the recovery in May, the PMI improvement continued in June, especially in the services sector (Chart 5). According to this index, we would expect activity to have reached its lowest level in Q2 and recovery to begin in the second half of the year, sustained by massive public sector support. Overall, GDP is expected to decrease by 10.1% in 2020 and to rebound by 5.9% in 2021.

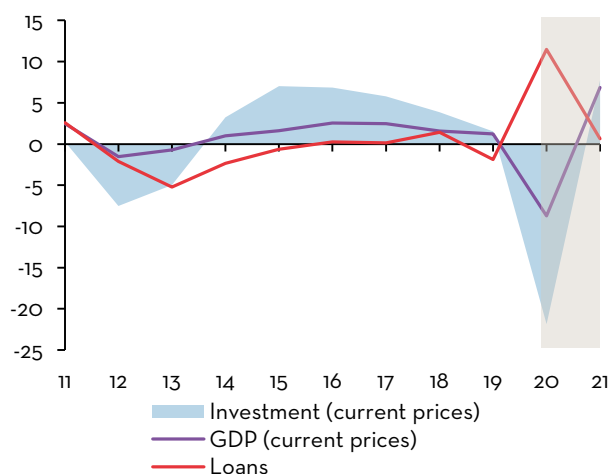
**The pandemic has crushed the labour market.** The asymmetric nature of the crisis is evident, also, in the

employment trends, which show a huge drop in the tourism and leisure/entertainment sectors in Q1-2020, which then extended to other services, manufacturing and construction (Chart 6). Overall, we forecast a fall in employment of 2.4% in 2020 and 1.1% in 2021. In 2020, the losses in full-time equivalent units - a measure of actual labour input - will be very severe at -8.3% and -14.5% for employees and self-employed, respectively. In 2021, we expect full-time equivalents to rise by 5.5% and 1.8% for employees and self-employed, respectively. The unemployment rate is expected to be 9.7% in 2020 and 12.1% by end 2021.

**In 2020, average inflation will be null,** pushed down by falling oil prices and the effects of the COVID-19 shock on demand for consumption goods and services, but sustained by food prices. However, throughout the year, we expect huge fluctuations and asymmetries among types of goods - food, energy, manufactured goods and services. Increasing food and energy prices will drive a slow recovery of inflation in 2021 (0.7%).

**Unprecedented fiscal measures.** The recent 'Cura Italia' and 'Rilancio' decrees involved the allocation of €75 billion in 2020 (4.5% of GDP) to strengthen the national health system and support families and businesses. Of these, €30 billion were earmarked as support for workers' and households' incomes and most of this amount has been allocated to short-time employment schemes, which is increasing expenditure for already insured workers and is broadening the beneficiary group. Also significant is the expenditure allocated to one-off payments to 5.2 million workers, mainly self-employed. Measures to support the economy and businesses, combined with

**Chart 7 - Economic activity and loans to non-financial corporations - % change yoy**



Source: Prometeia's forecasts on Bank of Italy and Istat data.

bank loan guarantees, amount to almost €25 billion. Around €7 billion has been earmarked for sectoral interventions. In our scenario, we assume that the depth of the recession will warrant further fiscal stimuli in 2020 – for social benefits in particular, and in 2021, corresponding to 2pp of GDP. Overall, we estimate that the fiscal stimulus will have an impact on GDP growth of 3.5pp in 2020 and 0.5pp in 2021.

**In our scenario, Italy will make use of European funds** to finance part of its fiscal measures, as detailed in the first InFocus of this Brief.

**The worsening of public finances.** The combined effects of the sharp contraction in GDP and

measures to support the economy, will result in an increase in the deficit to GDP ratio from 1.6% in 2019 to 11% in 2020, and in the public debt to GDP to the historic peak of 159.4%.

**A number of extraordinary measures have been put in place to support private sector liquidity needs.**

On the one hand, in 2020, businesses will benefit from exceptionally large flows of bank loans worth €92 billion (€30 bn in the first 5 months of 2020), for a yearly growth rate of 11.5% (Chart 7). These flows – stimulated by state guarantees and low interest rates – are intended to compensate revenue losses rather than to fuel new investments. They will prevent many companies from passing from a liquidity crisis to insolvency and will allow others to build a liquidity buffer to cope with the uncertain prospects. On the other hand, in 2020, loans to households will be limited €2.3 billion, corresponding to a yearly growth of 0.3%, following the contraction in consumption.

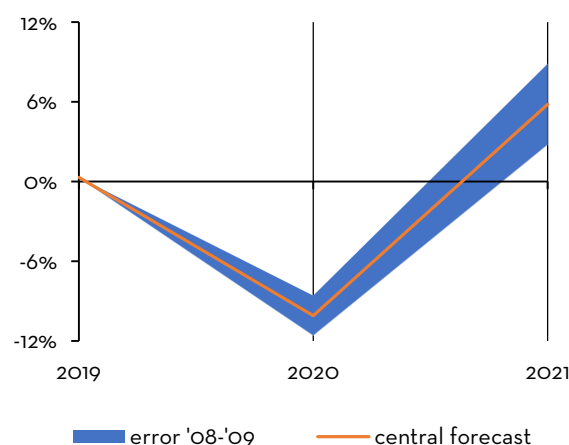
**The reduction in non-performing loans (NPL) will continue this year and will be stronger in 2021.**

The de-risking process will resume in the second half of 2020, with estimated sales transactions of NPLs around €25 billion. The severity of the economic slowdown in the current year will lead to an increase in impaired loans, which will be mitigated by the effects of the debt moratorium and the low level of interest rates. However, these effects will not be sufficient to bring the stock of non-performing loans in total loans back to the values forecast before the COVID-19 crisis.

## Risks to the projection

- In the medium term, rising global public and private debts may hold back average growth.
- In the EU, the Next Generation EU proposal may fall short of the European Commission's objectives and deprive hard-hit countries of important support.
- In the US, labour market recovery may prove more difficult than expected. In Europe, the risk is that the temporary measures are only deferring the moment when unemployment will hike.
- Political and trade conflicts between the US and China and a disorderly Brexit (without trade agreements with the EU) could further limit and fragment global trade.
- The sharp increase in Italy's public debt could generate tensions in financial markets and further complicate the recovery.

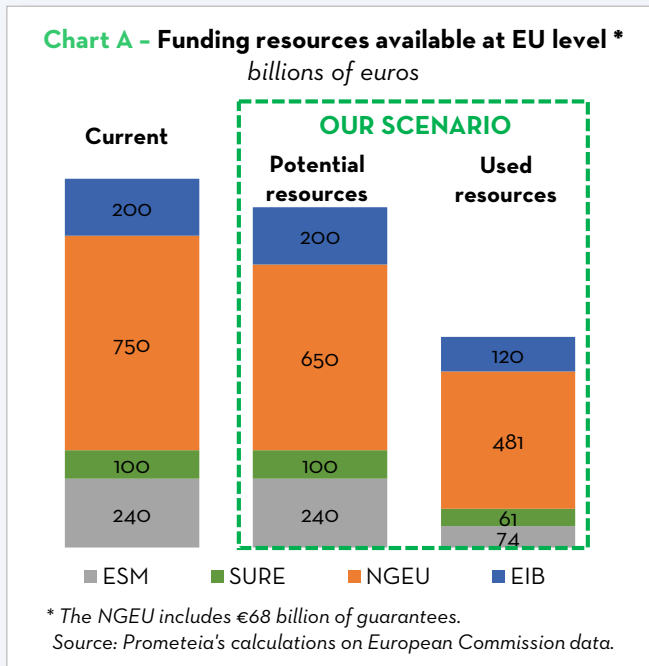
**Chart 8 - Italy: Prometeia's forecast of annual GDP growth - central value and uncertainty based on past forecasting errors**



Source: Prometeia's calculations.

## The EU response to the emergency: The types of resources and how they will be used

The EU institutions have reacted to the pandemic shock in a timely and vigorous way. In March, more flexibility of European rules was allowed by activation of the general escape clause (which temporarily suspends the Stability Growth Pact), approval of a State Aid Temporary Framework, and the decision to make non-utilized EU funds available to Member States. In April, the European Commission (EC) proposed an **emergency package**, approved by the European Council, which mobilizes up to €540 billion for exceptional and immediate expenditures borne by Member States. In May, the EC proposed a new recovery instrument of €750 billion (Chart A).



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**This InFocus illustrates the measures already approved and those under discussion, and our assumptions about their use.**

### The Emergency Support Package: ESM, SURE and EIB

The first support package aims to make €540 billion available to States and businesses as early as the second half of 2020. The package consists of three measures:

- **The new ESM credit line (€240 bn at EU level), known as Pandemic Crisis Support.** It can be used to finance direct and indirect health care expenditure related to COVID-19. It is already operational and support will be available to all member countries up to a limit of 2% of Gross National Income, until December 2022. Countries may withdraw a maximum of 15% of the credit line each month, a share in line with the timeframe needed the ESM to collect resources.

- **SURE (Support to mitigate Unemployment Risks in an Emergency) consists of a total of €100 billion in loans**, with favourable (but yet unspecified) conditions, which Member States may request to finance short-time work schemes, protect self-employed individuals and finance health measures (particularly in the workplace). These loans will be financed on the international capital markets and guaranteed by the contributions - representing at least 25% of the total loans - to the EU budget made by Member States. The guarantee payments will be based on countries' relative shares in EU total Gross National Income. No allocation threshold has been defined, though a prudential rule states that the three largest beneficiaries should not receive more than 60% of the total. SURE will become available once all Member States have provided their guarantees and will continue until December 2022.

- **The European Investment Bank will provide up to €200 billion, mainly for small and medium-sized enterprises** (65% of total loans) up to (so far) the end of 2021. This will require Member States to contribute pro-rata to the establishment at the EIB of €25 billion Pan-European Guarantee Fund.

### The recovery instrument: Next Generation EU

In May, alongside the Multiannual Financial Framework 2021-2027 proposal, the EC proposed Next Generation EU, a new temporary instrument worth €750 billion, to be split between grants (€500 bn, including €68 bn of guarantees) and loans (€250 bn). The European Council will discuss this proposal on 17 July, but there are no expectations of a rapid agreement. **The proposed instrument includes 12 programmes, with three main stated objectives: to support the recovery of Member States; to boost private investment; and to learn from the crisis.** Countries should receive funds between 2021 and 2024 to be used for investment or reforms related to national priorities, as indicated by the EU country-specific Recommendations, and/or for EU priorities such as the green and digital transitions.

Next Generation EU is a completely novel EU instrument. The (temporary) increase in EU resources will be

financed by the issue of European bonds. Repayments will be scheduled between 2027 and 2058 and, according to the EC's proposal, could be financed by the introduction of new EU resources (web tax, carbon taxes, plastics taxes). These new EU resources could be a step to guarantee fiscal independence of the EU making it less reliant on Member States' contributions.

## Our assumptions

**We assume that the ESM-SURE-EIB aid package will be operational from this autumn and high-debt countries, which face higher financing costs, might find it convenient, especially if they have been hit hard by the crisis.**

**In our scenario, Italy, Spain and Portugal will use the ESM credit line.** Italy is likely to benefit the most (Greek debt is already held largely by supranational institutions) from the lower cost of debt, followed by Spain and Portugal, which will value the savings enabled by lower interest rates.

**Loans under SURE have received wide approval from Member States, suggesting that many countries will access them.** In the coming months, many sectors will continue to operate below potential, and many short-time work schemes could remain in place, requiring countries to commit significant resources.

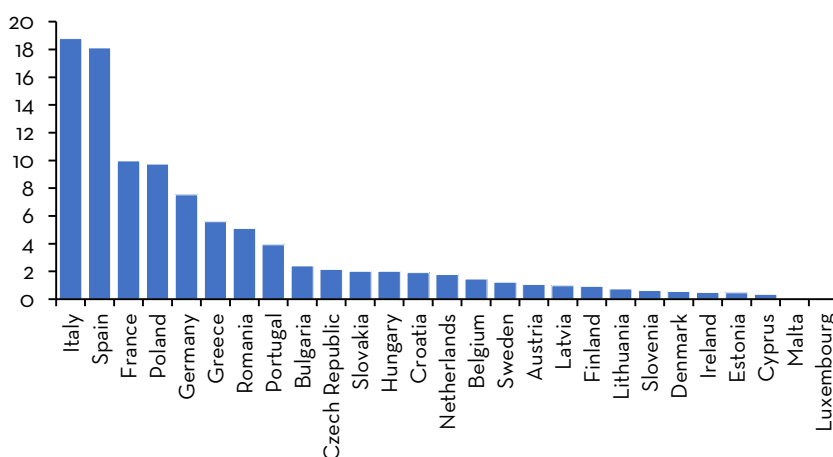
Finally, **the EIB loans to businesses through national promotional institutions** (Cassa Depositi e Prestiti for Italy) and local financial intermediaries are linked to the number and economic size of the projects submitted and approved. While the time frame is tight, we expect **the EIB to be able to mobilize a relevant proportion of the planned loans.**

Over the **Next Generation EU**, there is a consensus among countries about the need for a recovery support instrument, but **some elements of the proposal remain controversial such as the total amount of funds, their distribution between grants and loans, and the allocation criteria.** Our assumption is that **Member States will reach agreement on a lower amount (€650 bn) than originally proposed by the EC, with fewer grants (€350 bn instead of €500) and more loans (€300 bn instead of €250).** In our scenario, the allocation key is expected to be the weighted average of the national shares in the three Next Generation EU programmes, which allocation is already available. The three programmes are: i) the Recovery and Resilience Facility (€310 bn of grants, although the allocation rule for the €250 bn of loans included in the instrument is unknown); ii) the Just Transition Fund (€30 bn of additional grants); iii) the European Agricultural Fund for Rural Development (€15 bn of additional grants). According to our calculations (Chart B), Italy would receive the largest share of the grants (18.8%), followed by Spain (18.1%), France (10%), Poland (9.7%) and Germany (7.5%).

**However, since some countries may not find the loans convenient, and since there may be some delays in implementing the projects, we expect the effective amount exploited between 2021 and 2024 to be around €400 billion.** As indicated by the European Commissioner for Economy, Paolo Gentiloni, and the Commission's EU annual budget proposal for 2021, we expect the funding package to be concentrated on the first two years and that the hardest hit countries will receive the highest support relative to GDP.

**Chart B - Cross-country allocation key proposal**

% of total



Source: Prometeia's calculations on European Commission data.

**We estimate that this instrument will increase GDP by around 0.5% in Italy and 0.4% on average yearly in the euro area, during the period 2021-2024.** Countries will benefit from the direct effect, linked to the increased public spending, on domestic demand, initiation of significant trade flows among the countries in the area, and a 'confidence' effect. In addition, the launch of EU programmes to support the economies most affected by the pandemic should have positive effects on their financial flows and credit conditions.

## Labour markets: How to mitigate the tide of the pandemic?

**The pandemic is imposing a very high price on labour markets worldwide.** All countries have taken actions to deal with the impact of the containment measures on labour markets and the disruption to non-essential economic activities. These actions vary across countries and reflect national labour market specificities. However, two general economic policy responses have been observed.

**The first, the approach adopted by the US, consists of allowing layoffs - and, therefore, increased unemployment - and providing income support to workers.** This approach is consistent with the high turnover and low rigidity characterizing the American labour market.

**The second response tends to apply more to Europe, where, despite national differences, efforts are focusing on preventing an excessive rise in unemployment and maintenance of jobs.** Again, this approach is coherent with the greater rigidity and the stronger unemployment persistence characterizing European labour markets. We focus in particular on France, Germany, Spain and Italy.

**In the US,** under the four economic support plans approved in March and April (\$2,400 bn net of guarantees for businesses), **23% of the funding was to support households' and workers' incomes.** Companies with up to 500 employees were allocated funds to allow their workers up to 2 weeks of paid leave to cover quarantine or to assist family members affected by the virus. \$260 billion was earmarked to extend the benefits available to workers who lost their jobs. Unemployment benefits increased to \$600 a week, with the period of assistance extended by an additional 13 weeks. Coverage was increased to include those who were unemployed before the outbreak of the pandemic - at the latest from March 2019 - and who had reached the 26-week threshold for unemployment benefit.

**The flexibility in the US labour market was mirrored by the sudden and strong impact of the pandemic.** In April, employment dropped by 23 million units compared to February. Following the first reopening in May and June, 7.5 million jobs were recovered. In June, 9 million workers declared themselves as working according to involuntary part-time contracts (compared to 4 million at the beginning of 2020) and more than 4.5 million people left the labour market compared to end 2019.

**In Europe, the timely activation of state programmes to allow reduced working times, prevented sudden and significant increases in the number of unemployed people.** However, many countries - and in some this is also the reason why the unemployment rate has fallen - experienced a sharp increase in the number of inactive people during the lockdowns. Although, perhaps, temporary, this poses the risk of a persistent decline in the labour market participation rate in the coming months.

**France** has the highest number of workers involved in a partial unemployment scheme ('Activité partielle'), that is, 13.6 million workers (almost 50% of total workers) on 22 June. The majority of this scheme's beneficiaries are in the categories of accountants, architects and travel agents (20% of the total), followed by trade and construction workers (respectively 15.8% and 10.9%). The French government has allocated €31 billion for this scheme, almost 30% of the total discretionary fiscal measures put in place to tackle the pandemic.

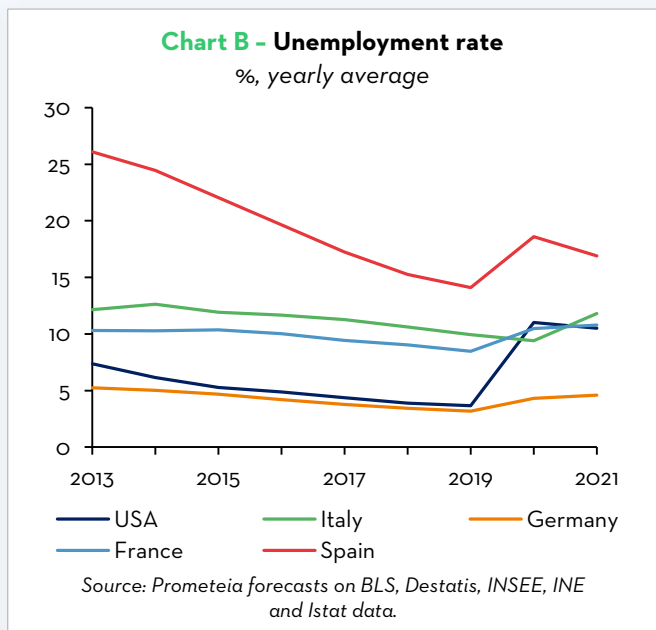
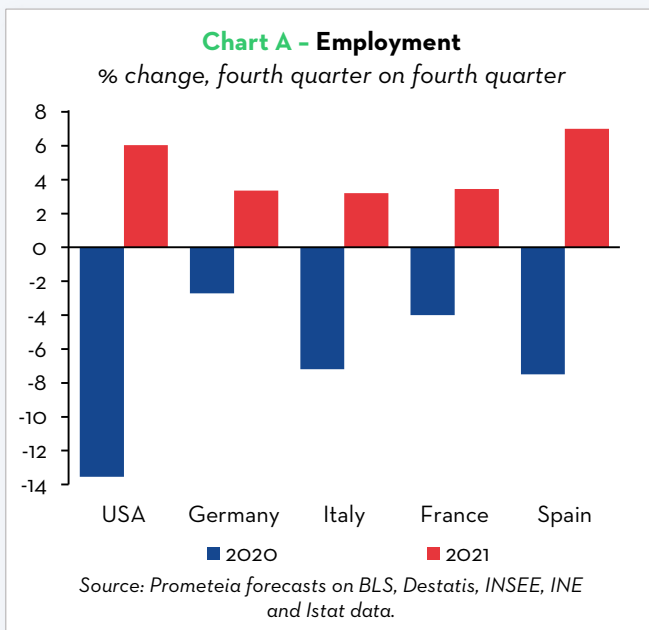
**In Germany,** where the effectiveness of social shock absorbers was proven during the global financial crisis, the number of workers affected by the reductions in working times ('Kurzarbeit') is 11 million, 26% of those employed. According to the IFO, in May 2020, the number of workers on short-time work schemes was 7.3 million, well above the May 2009 peak of 1.5 million. In contrast to the French case, in Germany only 1.6% of those suffering reduced working hours are employed in the construction sector; over 35% work in the business services sector and almost 28% in manufacturing. In April, the federal government allocated €10 billion to extend the duration and amount of the scheme and recent estimates suggest that the overall yearly outlay is around €40 billion.

**In Spain**, the ERTE ('Expediente de Regulación Temporal de Empleo') involves 4 million workers, more than 20% of those employed. The majority were furloughed, with only a minority working shorter hours. The fact that most of the beneficiaries of the scheme are located in regions that depend heavily on tourism, such as Andalucía, the Canary Islands and Catalonia, highlights the importance of the income support provided by the scheme. The resources earmarked for the ERTE amount to €18 billion.

**In Italy**, the extraordinary short-time work scheme CIgD ('Cassa Integrazione Guadagni in deroga') was extended to all categories of employment, regardless of firm size or sector of activity, at an overall cost of €20 billion. Many firms have taken advantage of the scheme, which involved around 3.5 million full time equivalent workers during the second quarter of 2020 and over 6 million monthly payments.

**In addition to the measures implemented by each European country**, the European Commission has proposed a new instrument, **SURE**, which is described in InFocus 1.

**To sum up, employment will fall sharply in 2020, despite the recovery expected from this summer, and will not return to pre-COVID levels in 2021 (Chart A).** In terms of unemployment, in many countries, rates will peak in 2021 when some previously inactive working-age people may re-enter the labour market and some workers will be laid off having been employed under the extraordinary short-time work scheme (Chart B).





**Table 1 - The world economy main indicators (% change)**

	2019	2020	2021
World real GDP	3.0	-5.2	5.4
World Trade	-0.5	-14.4	11.2
Manufacturing prices \$	-2.6	-1.8	1.9
Brent oil price (\$/bbl, level)	64.2	42.2	43.3
GDP			
- United States	2.3	-5.7	4.4
- Japan	0.7	-5.7	4.2
- EMU	1.2	-8.1	5.0
- China	6.1	0.6	8.9
Consumer prices			
- United States	1.8	0.9	1.2
- Japan	0.5	1.3	0.2
- EMU	1.2	0.2	1.0
- China	4.0	3.4	2.1
\$/€ exchange rate (level)	1.12	1.12	1.13
£/€ exchange rate (level)	0.877	0.885	0.904

**Table 2 - Italy: main indicators (% change)**

	2019	2020	2021
GDP*	0.3	-10.1	5.9
Imports of goods fob and services	-0.2	-13.8	10.9
Private consumption	0.4	-9.0	5.2
Government consumption	-0.4	2.0	0.1
Gross fixed investment:	1.4	-19.5	8.3
- machinery, equipment, other products	0.4	-21.7	8.3
- constructions	2.6	-16.7	8.3
Exports of goods fob and services	1.4	-18.9	14.1
Domestic demand	-0.2	-8.3	5.0
Industrial production	-1.1	-18.7	11.2
Trade balance (% of GDP)	3.2	3.1	3.5
Terms of trade	1.5	3.7	-0.7
Consumer prices	0.6	-0.1	0.7
Per capita wages - manufacturing	1.9	-0.1	0.8
Total employment	0.3	-10.1	4.5
General government balance (% of GDP)	-1.6	-11.0	-6.1

\* Chain-linked values; data adjusted for seasonal and calendar effects.

**Table 3 - Exchange Rates and Interest Rates**

		20 Q1	20 Q2	20 Q3	20 Q4	21 Q1	21 Q2	21 Q3	21 Q4
Exchange rates vs euro	US dollar	1.10	1.10	1.13	1.13	1.13	1.13	1.13	1.13
	Yen	120.1	118.3	120.2	120.1	120.1	120.5	121.3	121.8
3 month interest rates %	US libor	1.51	0.58	0.29	0.29	0.29	0.29	0.29	0.29
	Euribor	-0.37	-0.30	-0.40	-0.41	-0.41	-0.41	-0.40	-0.39
10 year government bond yields %	US	1.39	0.69	0.65	0.65	0.70	0.75	0.81	0.85
	Germany	-0.44	-0.47	-0.45	-0.45	-0.46	-0.43	-0.32	-0.24
	Italy	1.25	1.64	1.54	1.66	1.58	1.53	1.62	1.69

**Table 4 - Real GDP: comparison of the forecast - % qoq and annual % change**

		20 Q1	20 Q2	20 Q3	20 Q4	2020	21 Q1	21 Q2	21 Q3	21 Q4	2021
United States	Brief May 2020	-1.2	-10.0	9.6	0.4	-3.5	0.4	0.4	0.5	0.6	3.4
	Brief July 2020	<b>-1.3</b>	-13.1	8.1	4.7	-5.7	0.2	0.4	0.3	0.3	4.4
EMU	Brief May 2020	-3.8	-10.7	8.4	1.7	-7.3	0.7	0.9	1.1	1.8	4.9
	Brief July 2020	<b>-3.6</b>	-12.0	7.6	3.1	-8.1	0.5	1.1	1.3	1.1	5.0
Italy	Brief May 2020	<b>-4.7</b>	-11.7	10.7	1.0	-8.5	0.6	0.8	0.9	0.7	4.5
	Brief July 2020	<b>-5.3</b>	-12.9	9.8	2.0	-10.1	1.6	1.1	1.0	1.0	5.9

## Prometeia

Piazza Trento e Trieste 3, 40137 Bologna, Italia – tel. +39 051 648 0911 – fax +39 051 220 753

www.prometeia.com

based on data available up to 13<sup>th</sup> July 2020

contributors: Michele Burattoni, Monica Ferrari, Elena Giarda, Simone Passeri

contact persons: [Lorenzo.Forni@prometeia.com](mailto:Lorenzo.Forni@prometeia.com), [Stefania.Tomasini@prometeia.com](mailto:Stefania.Tomasini@prometeia.com), [Lorena.Vincenzi@prometeia.com](mailto:Lorena.Vincenzi@prometeia.com)

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