



GENERALI
INVESTMENTS

Outlook 2018

Out of Rehab



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Global View – Out of Rehab

- Following the Great Financial Crisis, central banks have put the global economy and markets on rehab for most of the past ten years. With the global economy now looking stronger and more stable – it is time to get out. How global markets adjust to central banks withdrawing support more forcefully will define the coming financial year.
- For now investors are taking the super-slow policy exit for granted; we do not. Inflation is likely to pick up in 2018. The rise will be moderate, but significant enough for central banks to show their teeth. This will create mild pressure on shockingly low long-term real rates. This should matter to everyone, as low real rates are at the core of stretched valuation across most asset classes.
- While we retain our positive risk bias, at least in the first quarter of 2018, we turn more cautious on assets that are most exposed to four risks: extreme valuation, the repricing of monetary policy (and long-term real rates), a slowdown in China and idiosyncratic credit events.
- Our selective approach to risk favours real assets, European and Japanese equities. In our core scenario, mild spread widening still sees EUR Credit beat EUR Govies in 2018 (though both deliver negative returns). Such analysis however fails to reflect that risks for HY spreads are skewed to the widening side. Therefore, we see value in shortening the credit exposure, but positioning for flatter EUR swap and Government curves at the very long end.
- We conclude on spectacular evidence that financial assets have enjoyed the best of all worlds. It is wise to not only start positioning more cautiously but also spend more time – and cheap option premium – on hedges.

Goldilocks in 2017 as global growth picked up and inflation stayed muted

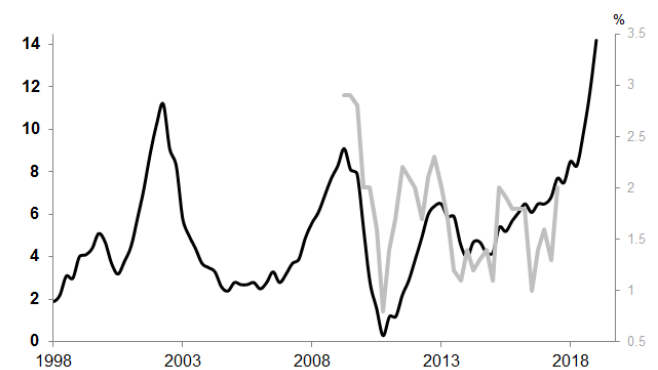
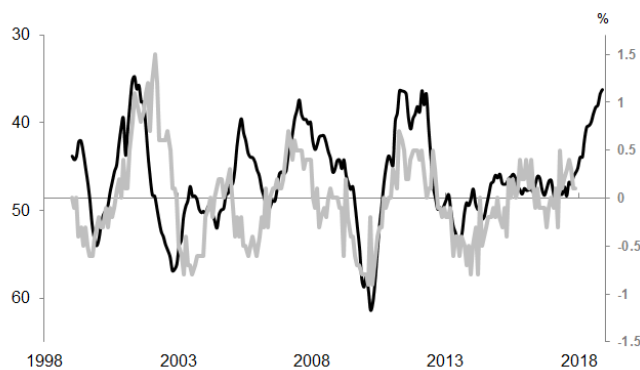
Not too cold, not too hot: “Goldilocks” indeed has characterised the global economy for the past year, much to the benefit of global asset prices. For the first time since the Great Financial Crisis (GFC) of 2007-2008, the consensus for world GDP forecasts has moved up consistently throughout the year. The strong cyclical upswing has been synchronised, with China and to an even greater extent the euro area surprising most positively. In the meantime inflation has remained muted; for that matter US inflation has surprised to the downside: core PCE inflation cooled off from 1.9% yoy in early 2017 to a low of 1.3% by late summer. This combination of solid world growth and low inflation has been a blessing for global markets, not least for EM equities which have delivered a total return of some 32% in USD.

Stretched valuations imply a more challenging environment in 2018; key to identify potential triggers for a turn in risk sentiment

Cherry picking in 2018: We expect ongoing solid global growth to offer further support to risky assets over the coming year, but stretched valuations suggest a more selective approach to risk taking. Arguably turns in risk sentiment never happen on their own. So it is important to identify potential triggers, their timing and the assets most exposed to them. Our most prominent concern lies in the “normalisation” of long-term real rates.

Graph 1: INFLATION MAY START TO SURPRISE TO THE UPSIDE

Graph 2: LABOUR SHORTAGE, EVEN IN EUROPE



— EUR PMI Supplier's delivery time (12m lead) — EUR Core CPI, 12m change

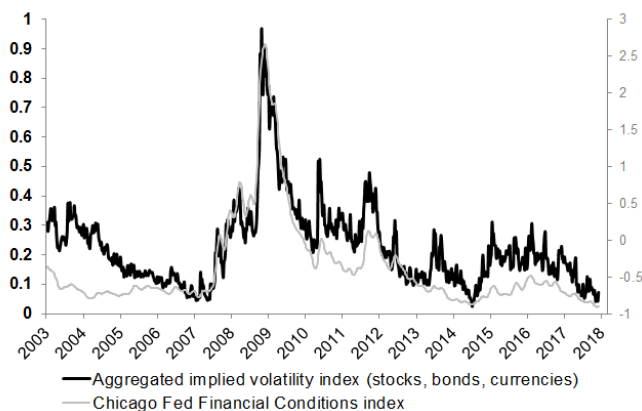
— Factors limiting production - Labour (12m lead) — EA nominal wages, yoy

Low inflation: structural or cyclical? Probably both

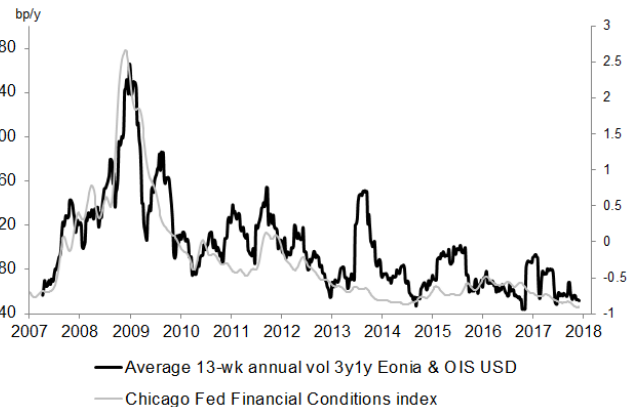
Leading inflation indicators suggest that inflation may well surprise to the upside in 2018

Possibly the most important question for investors in 2018 is whether low inflation trends are a function of cyclical or structural dynamics. Nobody is exactly sure: even central bankers are currently very humble on that matter. Structural factors include demographics (rise of the 25-65y age group which tends to save more, particularly so as life expectancy rises), the global pool of labor, the poor quality of newly created jobs, intense competition (internet) etc. The cyclical thesis relies on inflation lagging the growth cycle, in which case the 2017 economic upswing may be followed by a pickup in inflation. The tenant of the 'structural' thesis point in particular to the flat US Phillips curve in this cycle: the unemployment rate has plunged but wage growth has barely budged. We argue in this report that US employment costs have actually started to pick up. Even in the euro area, leading inflation indicators suggest that core inflation may well surprise to the upside in 2018 (see Graphs 1 and 2).

Graph 3: IMPLIED VOLATILITY HAS COLLAPSED...



Graph 4: ... AS MARKETS TAKE CAUTIOUS CB STANCE FOR GRANTED



Investors are taking the super-slow policy exit for granted; we don't.

→ Financial markets have embraced the idea that low inflation trends will persist, and that central banks will continue to proceed very cautiously. Even as the cycle matures and the chances of more forceful monetary policy action rise, the realised volatility of forward short-term rates is standing near record low levels (Graph 4); this confidence in extremely smooth policy normalisation lies at the root of the low volatility across asset classes and exceptionally sanguine financial conditions (Graph 3). In short investors are taking the super-slow policy exit for granted; we do not. Central banks do not want to 'rock the boat' but, as inflation picks up, it will become harder to use forward guidance as an anchor of stability and low volatility.

Stretched asset price valuations are sourced in shockingly low long-term real rates.

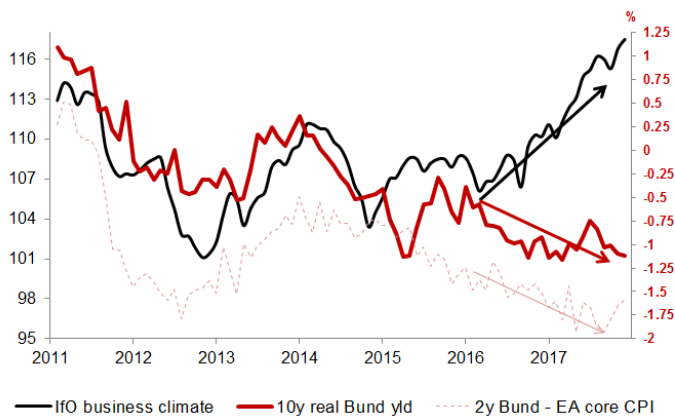
Central banks starting to move more forcefully: mind REAL rates

Because structural forces will contain the pickup in inflation, the latter per se should not necessarily be a central driver to portfolio allocation. **Real rates**, in our opinion, are currently a far more important input to asset valuation. Consider Europe for instance, where 2y2y inflation (swap) is trading around 1.35%. This is a bit low, but not 'stupid'. EUR 5y5y inflation at 1.70% (up more than 20 bps from the trough of June 2017) is also weak vs 10-year average (2.11%) but reasonable. Far more surprisingly, the yield-to-maturity of a 10-year inflation-protected Bund (DBRI) is trading at -1.20%, only some 20 bps above the record low of 2015 (-1.40%)! Why buying an asset, which if held to maturity will deliver a real return of -1.20%?

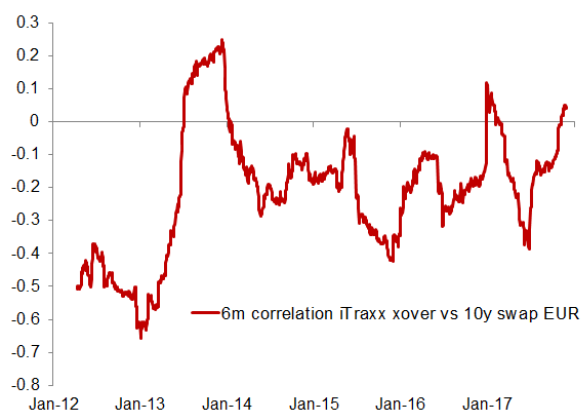
In fact long-term real rates are entirely **disconnected** from the growth cycle (Graph 5). The acceleration in growth has so far failed to shake investors' unwavering belief in the 'new normal', characterised by the persistence of low interest rates. In other

words, investors believe that the so-called “natural rate of interest” (r-star, or the inflation-adjusted equilibrium policy rate) is permanently depressed, be it because of a decline in potential growth, a chronic excess of savings or lack of demand, post-GFC hysteresis, elevated global leverage etc. That belief irradiates throughout the yield curves, across different regions and maturities.

Graph 5: LONG-TERM REAL RATES EXPOSED TO CORRECTION



Graph 6: CORRELATION RATES VS CREDIT TURNING POSITIVE



Yet the jury is still out on whether long-term real rates are durably impaired by the aforementioned structural factors (some of which, like demographics and regulation, may have peaked by now) or they have been held off by temporary forces. The supply and demand for bonds may be one of them, and we dedicate a full section to the topic in this report. Central bank buying has peaked, as the ECB is now tapering and the Fed slowly cutting its balance sheet. Most importantly, long-term real rates are also influenced (carry considerations) by short-term real rates (Graph 5). Though central banks (and investors even more so) now consider that r-star is low, not everyone agrees. The BIS for instance sees the analysis as misguided and worries that outrageously easy monetary policy will create new financial stability risks. Indeed central banks and investors altogether may simply be blinded by the low inflation trends, which have reinforced their belief that monetary policy is correctly tuned (if policy was too easy, presumably inflation would rise).

The largest impact from a pick-up in inflation may actually lie in the real rate space.

Stretched asset price valuations are sourced in shockingly low long-term real rates.

➔ A pickup in inflation trends in 2018 may well shake both the strong belief about depressed neutral rates and the confidence that central banks will move at a snail’s pace. Even the laggards, such as the BoJ, may have to move in 2018: the peg of 10-year JGB yields to 0% will become untenable if global yields move north. Somewhat contra-intuitively, the largest impact from a pickup in inflation may actually lie in the real rate space, where valuation is most stretched. This would have an outsized impact on global financial markets, because the low level of bonds yields is at the heart of stretched valuation across a large range of assets. Take equities for instance: on all centric valuation measures, such as simple or cyclically-adjusted Price Earnings Ratios, they look expensive, particularly so in the US. But when compared to government bonds (Equity Risk Premium), they do not. The risk of real rates repricing higher supports a more selective approach to risk taking.

Cherry picking among risk assets

Portfolio allocation in 2018 consists in a balancing act: investors are wary of jumping out of the risk bandwagon too early but need to prepare for a less friendly risk environment. While we retain our positive risk bias, at least in the first quarter, we turn more cautious on assets that are most exposed to the four following risks:

- A correction from stretched **valuation**, e.g. in the equity space we prefer EUR, UK and Japanese equities to US.

- **A repricing of monetary policy around the world, not least in the US** (Fed hikes underpriced), and a coincidental rise in long-term real yields. Graph 6 highlights for instance that the correlation between rates and High Yield spreads seems to be turning, i.e. the rise in yields may exert widening pressures. Though the upside potential of the US dollar looks limited given the relatively old age of the US economic cycle, a repricing of the Fed (and other G10 central banks) may support near-term USD strength vs EM currencies generally.

Four key risks:

- correction from stretched valuation
- repricing of monetary policy
- slowdown in China
- idiosyncratic credit events

- **A slowdown in China**, following positive surprises in 2017. Containing leverage in the asset and wealth management industry is a clear policy target. Tightening there has contributed to the rise in 10-year Chinese bond yields by nearly 100 bps over the past year (to near 4.0%). This exposes Chinese assets that have most benefited from leverage, e.g. the property sector, which has already started to cool off.

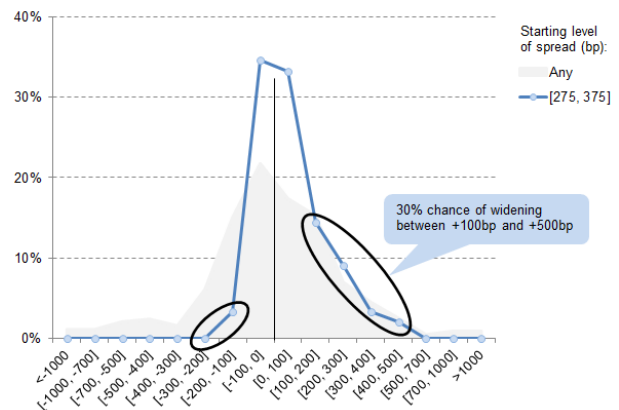
- **Idiosyncratic credit events**, which tend to be the mother of all credit market corrections. Selected sectors such as US tech where leverage has surged will be particularly exposed to any substantial rise in real yields.

Graph 7: BARCAP US CORP HY YTW, 10Y SPREAD



Grey band highlights 2017 range, roughly [2.75%-3.75%]

Graph 8: FROM CURRENT TIGHT LEVEL, 30% CHANCE* OF >100 BPS WIDENING IN US HY OVER COMING YEAR



*based on historical occurrence since 1987

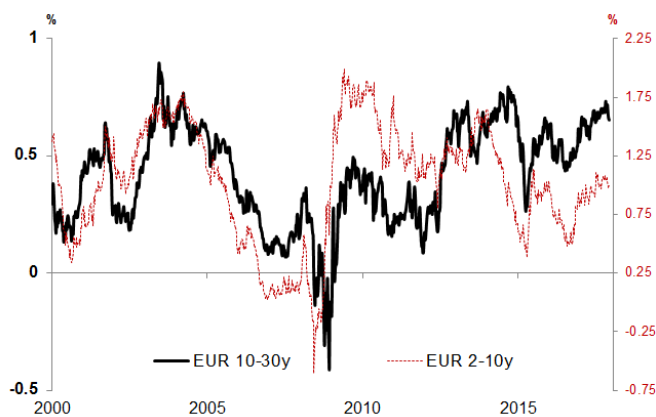
High Yield credit most exposed to a rise in real yields. Central scenario is not too harsh on the asset class but risks are very much skewed to the downside (widening).

The riskier part of the credit market is most exposed to those four threats. In particular corporations that are highly leveraged (High Yield sector) are, by definition, exposed to a rise in real yields. With default rates so low and carry still not negligible there is no need to rush out just yet, at least as long as global growth flourishes and real yields stay low. In fact the widening in HY spreads that we foresee over the coming year (both in USD and to a lesser extent EUR) is relatively mild, hence total returns in that asset class may still outperform that of Investment Grade credit and government bonds. But the risks attached to this central scenario are very much skewed to the downside (i.e. widening side for HY spreads). Indeed, if and when the tide turns, the exit door will be too small: we are concerned by the microstructure of this market, traditionally less liquid, following the sharp reduction in trading books and the proliferation of passive funds (ETFs). Starting from the current tight level of spreads, historical analysis suggests there is a 30% chance of a widening by more than 100 bps over the coming year in US HY spreads. As Graph 8 shows, at the current level the distribution of spread changes over 12 months has a strong skew to the right side (widening). Thereby lies the risk of traditional asset allocation based on central total return forecasts: it ignores skews in the distribution of returns.

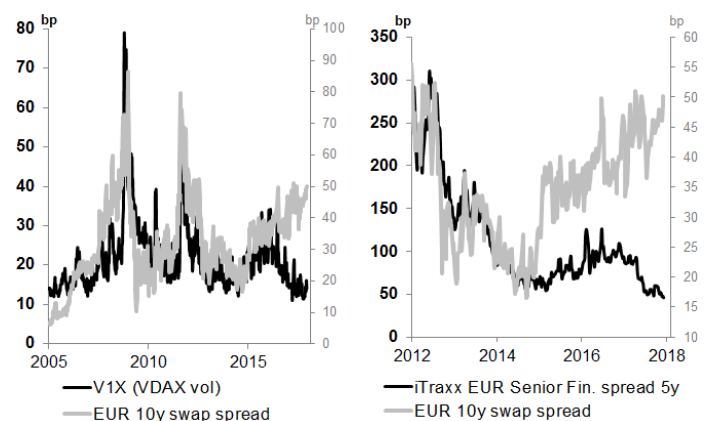
Shorten credit exposure. Long EUR STOXX, NKY and real assets.

To surf the HY wave and enjoy the residual carry, keep exposure in short sectors of the curve, less exposed to fears of a future pickup in defaults. Selective short-dated USD-denominated EM debt also offers value. Within the risk spectrum, we continue to prefer European and Japanese equities, where valuation is less stretched. We also like assets and strategies that would benefit, or at least prove defensive, should global inflation surprise to the upside in 2018, such as EUR yield 2-10y curve steepeners and real assets (e.g. Real Estate, where not stretched). Inflation-linked bonds should outperform nominal bonds, if not by a large margin (linkers prove less defensive when the rise in nominal yields is driven by the real component).

Graph 9: EUR 10-30Y IS TOPPISH, 2-10Y ISN'T



Graph 10: THE BEST OF ALL WORLDS... LOW VOLS, TIGHT CREDIT SPREADS BUT LARGE SWAP SPREADS



Consider combination of short-dated credit exposure and long-dated Govies as EUR 10-30y slope has most likely peaked.

To compensate for the shortening of the credit exposure, consider extending from the belly of the government curves towards the long end. We see 2-10y EUR skewed towards further bearish steepening, while 10-30y now looks toppish (Graph 9). Both the end of the ESM paying flows on long-term fixed rates for Greece (officially over) and potential changes in the interest rate modules of Solvency Capital Requirement (in a way that would increase the pressure on insurers to hedge the risk of falling yields) may support a downside reversal of EUR 10-30y. Accordingly, we recommend reducing the exposure to the belly of the EUR curve (5- to 10-year sector).

Fund cheap credit hedges by selling extreme upward rates scenarios.

Other ways to mitigate the risk of a turn in sentiment towards the credit asset class is through derivatives, e.g. buy cheap optional credit protection such as iTraxx payer spreads. Such strategies can be cheapened further by selling extreme upward rates scenarios. Indeed in our opinion any rates sell-off will be limited by the feedback loop effect: there is so much leverage globally that a large sell-off would cause a downturn and a dovish central bank reaction.

Financial assets have truly enjoyed the best of all worlds, but the party looks tired.

To conclude let us reflect on Graph 10, which does a good job highlighting that financial assets have truly enjoyed the best of all worlds. Even as equity volatility and credit spreads collapsed, government bonds richened (including on an asset swap basis). Such unusual financial 'party' reflects stronger growth, low inflation and extraordinary monetary policy accommodation (incl. central bank purchases). If the stock effect dominates the flow effect, as the ECB believes, mean reversion will be slow. However no one is exactly sure where the threshold is and when policy normalisation finally starts to impact risk appetite. It is wise to start positioning more cautiously and spend more time – and cheap option premium – on hedges.

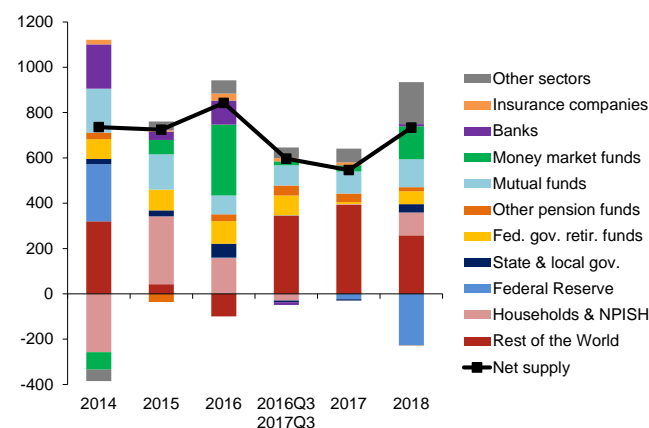
Bond demand/supply

- Central banks' support to government bond markets is set to decline meaningfully in 2018. The Fed has recently started its balance sheet reduction program, while the ECB should end its bond purchases by fall 2018.
- The net supply of US Treasuries is expected to rise markedly while the Fed will reduce its holdings by around US\$ 230 bn. The upward pressure on yields may be limited should the extension of the average debt maturity come to an end.
- The net issuance of government bonds will decrease in most euro area countries in 2018. While reduced ECB purchases imply a stronger reliance on other investors, the overall upward pressure on yields is likely to remain contained.

Global central banks will reduce their net asset purchases from around US\$ 1.5 trillion in 2017 to zero by end-2018

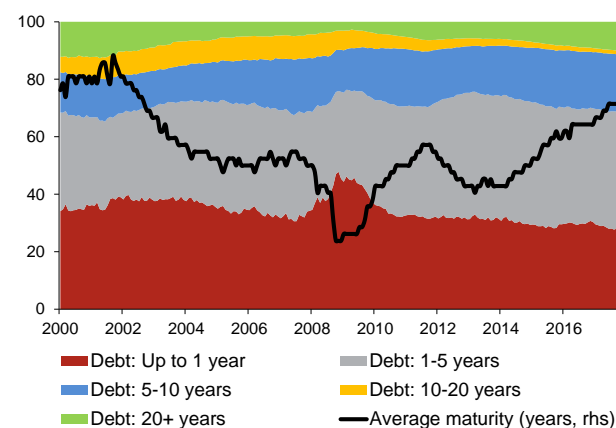
After relentless purchases amounting to almost US\$ 10 trillion since 2009, the major global central banks will markedly reduce their support to government bond markets in 2018. The Federal Reserve has already started its balance sheet reduction program in October, while the ECB will likely more than halve the monthly purchases under its Public Sector Purchase Programme (PSPP) starting from January 2018 and will probably stop them by fall 2018. New net buyers of government securities will have to emerge, but they will likely require higher yields to absorb net supply.

Graph 1: US TREASURIES NET SUPPLY AND DEMAND



1-year rolling data in US\$ bn. Projections by GI Research

Graph 2: MATURITY BREAKDOWN OF US GOVERNMENT DEBT



Public debt held by private investors, % of total

Increased demand for US Treasuries by households, money market and mutual funds, while foreign buyers should remain below average

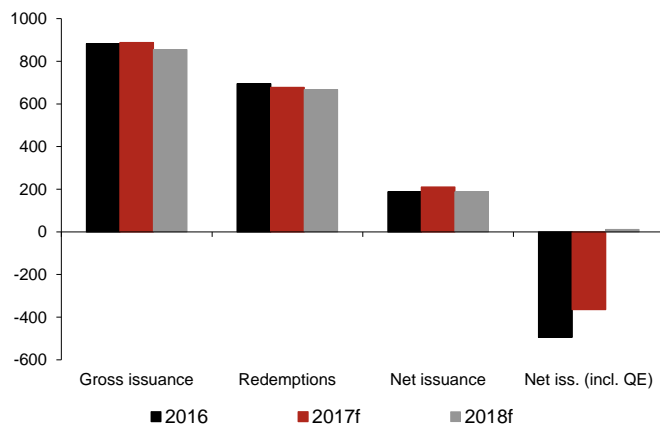
Renewed focus on T-bill issuance to ease supply/demand gap

The US tax reform is in the final stage of the approval process and there are high chances for it to be effective from the very beginning of 2018. The reform is expected to increase the federal government deficit by US\$ 120 bn per year over the next decade and this will bring the total borrowing needs to almost US\$ 1 trillion in 2018. We estimated that this should translate in a net supply of Treasury securities of around US\$ 730 bn (with the remainder being raised via other funding means), an increase of 34% compared to 2017.

The projected increase in net supply comes at a bad time as the Fed will speed up the reduction of its balance sheet. Indeed, we expect the Fed not to reinvest around US\$ 230 bn in maturing Treasury securities in 2018. This means that other sectors will have to contribute more decisively to balance demand and supply. Foreign buyers – the largest holder of US government bonds, 39% of total – will only cover one-third of net supply, well below the 50% share seen between 2000 and 2014. Also banks are unlikely to contribute as much as in the recent past as they have already reached their augmented regulatory requirements after boosting their holdings from US\$ 100 bn in

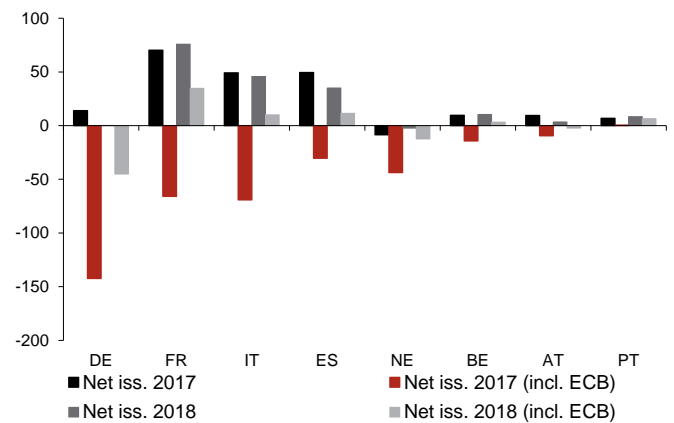
2008 to 600 bn. On the contrary, we expect households, money market and mutual funds to contribute more decisively after very timid purchases in 2017. In order to deal with the increase in supply, the Treasury Borrowing Advisory Committee recommended increasing the issuance of T-bills. This seems reasonable as the outstanding share of T-bills over total debt is at historical lows, while the weighted average debt maturity is at 15-year highs. This should help reducing the impact over longer-dated US Treasury yields.

Graph 3: EURO AREA: GOVERNMENT BOND ISSUANCE



In bn €

Graph 4: MAIN EA COUNTRIES: GOVERNMENT BOND ISSUANCE



In bn €

Reduced ECB purchases to trigger higher euro area net issuance

Mainly due to the strong growth the net issuance of euro area government bond supply is forecast to fall from around €210 bn to less than €190 bn in 2018. Nevertheless, the reduction of ECB purchases (and the forecast termination of net purchases by the end of Q3) means a strong increase of supply available for other investors (and we expect this flow to be more relevant for bond markets than the still high stock of ECB bond holdings). While the net issuance including ECB purchases has been in negative territory since 2015 (2017e: -€365 bn), it is expected to be marginally positive next year (€11 bn) – assuming ECB net purchases stop at the end of Q3. In case, the PSPP will be phased out softly, the net issuance will remain in negative territory.

However, the broad picture conceals differing developments in single countries. While the net issuance of Germany (and other fiscally sound countries) will remain negative, the net issuance of France, Italy and Spain will be positive for the first time since 2014. But, as the ECB will still absorb almost €180 bn of bonds in 2018, the net supply will remain well below the crisis levels (and below the pre-crisis years). In combination with the low yield level, this is expected to encourage treasurers to keep the maturity of new issuances on a high level (and frontload the supply).

The reduction of the PSPP implies that other market participants will have to step up their purchases. While they have reduced their government bond holdings since the start of 2015, this trend will reverse in 2018. However, the euro area banking sector is unlikely to replace the ECB as the general deleveraging trend has not run its course yet. Against it, particularly insurances, pension funds and other funds are likely to partly fill the gap. Nevertheless, ex ante net supply will be slightly higher than demand next year which implies a moderate upward pressure on government bond yields.

Government bond net issuance of some countries to become positive in 2018 for the first time since 2014

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Macroeconomic Outlook

- **The foregone year was the first to exceed initial growth expectations since 2010. Helped by unabated strong domestic demand in the advanced economies, 2018 is set to prove another year of reassuring economic expansion.**
- **After the temporary headwinds faced in 2017, US inflation is poised to go back to above 2% amid a tightening labor market. Inflation is edging up in the euro area, too, thanks to reduced slack and bigger scope for margin improvement.**
- **Central banks will withdraw monetary policy support in 2018. First of all the Fed will continue to hike rates and gradually unwind its balance sheet. The ECB will end QE and prepare for the start of the rate hiking cycle in 2019.**
- **The political uncertainty associated with the Brexit negotiations will negatively impact predominantly the UK, while Italian election and the slow EU integration process are unlikely to alter the solid growth outlook for the euro area.**

The foregone year ended a long strike of growth disappointments.

The global economy is entering the new year on a strong footing. During 2017, global economic growth has surprised markedly on the upside after consistently falling short of expectations over the previous six (!) years. In our view, the strong global growth momentum will also be maintained next year.

Global expansion will remain underpinned by strong demand in the advanced economies.

This is in particular due to the favorable outlook for domestic demand in the advanced economies. Private consumption will remain a solid pillar for growth, underpinned by employment gains, increasing wage growth and buoyant consumer sentiment. In the US, euro area and Japan combined, consumer confidence is 1.3 sigma above historical average and rising. In the US, the mood has even hit a 17-year high. What is more, business investment has more leeway to strengthen, thanks to very low interest rates (in Japan and the euro area in particular), strong consumer demand, solid exports prospects and likely tax reductions in the US. New orders as reported by purchasing managers are soaring in the euro area. But also in the US, rising durable goods orders point to upbeat capex plans. This will not only add to demand but also lift productivity and thus future potential growth. Finally, with the odds of a tax reform now more favorable, we anticipate some moderate support to the US economy also from the fiscal side.

A moderate slowing of the Chinese economy will be more than compensated by growth acceleration in other major EMs.

The Chinese economy is likely to slow somewhat, due to a cooling property market, less fiscal support and tighter financial regulation to rein in leverage and excessive risk taking. This is good news since this will help to contain the risk of a sharp slowdown at a later stage. That said, we anticipate Beijing to proceed very cautiously, triggering only a mild growth slowdown. On a global scale, this drag will be more than compensated by a growth acceleration in the other three major emerging markets Brazil, India and Russia. In the CEE region, growth will remain strong but cool down somewhat from the elevated rates seen in 2017.

Inflation springs back to life

US inflation will inch up from Q2 2018 onwards

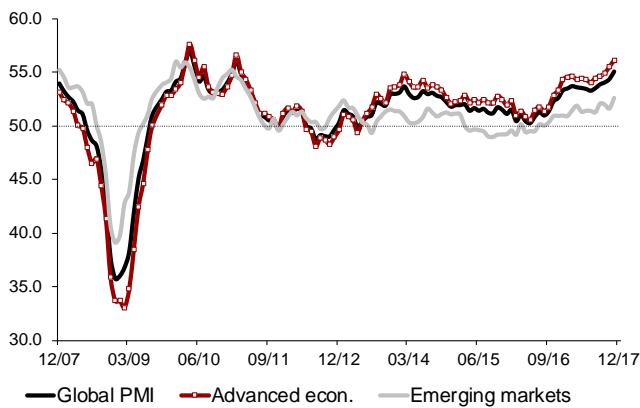
Continued weakness in inflation in advanced economies characterized most of 2017, casting doubts on the gradual normalization in monetary conditions announced by the ECB and, above all, by the Fed. In the US, the marked drop in core inflation from 2.2% in Q1 to 1.7% in Q3 was largely due to falling prices in specific categories, due either to competition (like in mobile phone services) or the effect of healthcare regulation (physicians' fees and drugs). Labor costs continued to edge up in line with a tighter labor market, even though wage increases were capped by subdued inflation expectations and feeble productivity growth. The rise in producer price and housing costs gathered speed. All this calls for the underlying inflation to recover next year, especially after Q2, when most of the adverse base effects will fade away. We expect the US core CPI rate to end the year at around 2.2%, with some upside risk from positive effects of the tax reform. On top of that, OPEC and Russia seem to have

found an agreement on production caps, which should allow the Brent price to stabilize within a 58-60 US\$/bbl band next year, strengthening headline inflation.

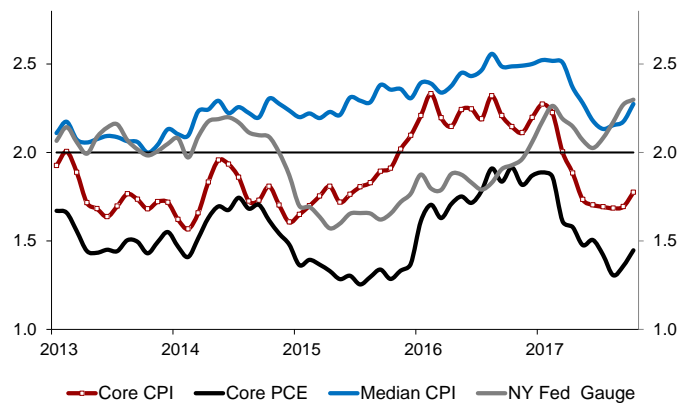
Tighter labor market to uplift euro area inflation

In the euro area, the evolution of inflation will follow a more standard script. Another year of above-potential growth will close the output gap and bring down the unemployment rate further. This will eventually lift labor costs from the current very low levels. Moreover, import and producer prices are firming, pointing to a compression of margins. The healthy condition of domestic demand will allow firms pass through input price increases. This will help core inflation to end the year at 1½% from the current values of around 1%. While a stronger euro will be a drag on import prices (incl. for oil), thereby subtracting from headline inflation, we see the overall risks to the inflation outlook now tilted towards the upside for next year, given the solid momentum of job creation and demand.

Graph 1: GLOBAL MANUFACTURING PURCHASING MANAGER INDICES Graph 2: US UNDERLYING INFLATION



Index points; values >50 signalling expansion



% chg. yoy

Expected Fed rate hikes underestimated by markets

Central banks withdrawing support at different paces

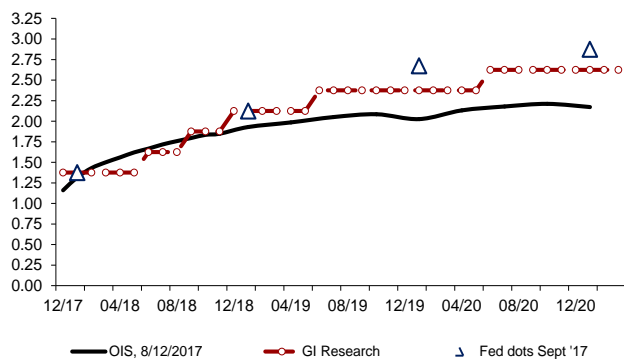
The still very accommodative monetary policy stance of major central banks stands in stark contrast to the macro outlook. To avoid falling further behind the curve and risk an overheating, they will have to withdraw monetary policy support. This concerns first of all the Fed which has started to reduce its balance sheet in 2017 and lifted the Fed Funds Rate to above 1.0%. The nominated new chairman Jerome Powell has pledged to continue the Fed’s current monetary policy approach, by gradually raising interest rates so long as economic growth remains healthy. We deem this credible and anticipate rate hikes by cumulated 75 bps in 2018 to above 2.0%, all the more as we look for a visible increase of core inflation. Our view stands in contrast to markets which have currently priced a rate of 1.8% by then.

ECB to stop QE and to prepare markets for key rate hikes in 2019

In the euro area, monetary policy normalization is still in its infant stage. The ECB is set to half its monthly QE purchases to € 30 bn from January onwards and to continue buying assets until September 2018 (but will reinvest maturing bonds well beyond that date). With the output gap closing and inflation recovering, we see the ECB shifting from strong accommodation to a more hawkish tone next year. In this setting, markets will increasingly focus on the timing of the ECB’s first rate hike. We deem it most likely that there will be a 15 bps deposit rate hike in H1/2019 (also priced by markets) followed by a 25 bps increase of the repo and the deposit rate not before the second half of 2019 (not yet discounted).

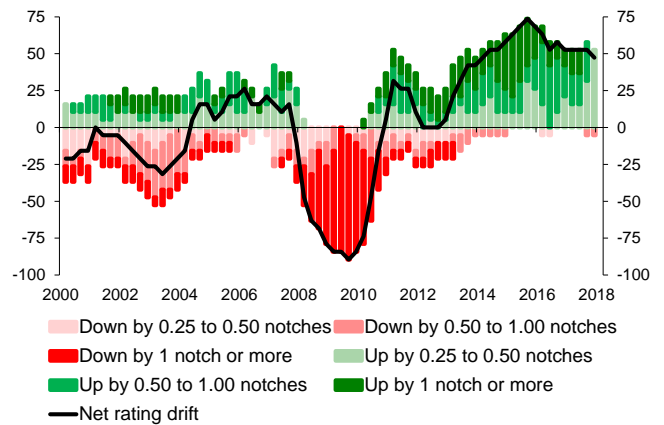
Elsewhere in the advanced economies, policy normalization will similarly be the topic for 2018. The BoE has started to raise its key rate in 2017 and we look for another 25 bps hike in 2018 to fight imported inflation. We also expect rate increases in Central and Eastern Europe, notably the Czech Republic and Romania, where the economies are already running at full capacity. Also Poland may launch tightening in late 2018. In contrast, Japan still suffers from persistently low inflation. While the BoJ will continue to conduct QE, we expect it to lift its 10-year yield target to 0.25% in late 2018 in order to account for the international environment or rising yields.

Graph 3: EXPECTED PATH OF FED FUNDS RATES



in % p.a.

Graph 4: EURO AREA NET RATING DRIFT



% of countries with an improving vs worsening internal rating

Growth to trump slow EU integration progress

Brexit negotiations about trade to prove difficult, with uncertainties holding back growth in the UK

Limited progress on deeper EU integration to be offset by solid growth outlook and reduced imbalances

The coming year will also be a year of political particular challenges and opportunities for the EU integration process. Following the UK's Brexit decision in June 2015, the first stage of Brexit negotiations between Britain and the EU has recently been concluded, with a broad compromise on the Brexit bill, citizens' rights and the Irish border issue. However, we expect the upcoming trade negotiations to prove even more difficult. Consequently, any bespoke deal will face significant hurdles which will hold uncertainty high, implying a relative underperformance of UK growth.

Regarding the opportunities of an EU reform, President Macron's push for deeper fiscal integration is still struggling to gain momentum. Also, several member states seem unimpressed by the EU Commission's proposals (ESM to be advanced to a European Monetary Fund; new budget instruments for the EU budget; introduction of a European Finance Minister). Country-specific political events could further delay the process. In Germany, the negotiations over the new government formation are proving more difficult than expected, while general election in Italy (most likely in March) is a key source of uncertainty. Opinion polls point to a hung parliament as the base case, while a Eurosceptic majority cannot be ruled out. Italy's fiscal and structural reform fatigue would further hamper EU integration talks. That said, the lack of significant progress on EU reforms is likely to have only a limited negative impact on financial markets for the time being. Indeed, the solid growth outlook and the improved fundamentals (as shown by the positive drift in our internal sovereign rating, Graph 4) provide a better cushion versus external shocks than in the past.

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Fixed Income

- After moving on balance broadly sideways in 2017, increasing inflationary pressure and a robust economic backdrop will pave the way to higher long-dated government bond yields on both sides of the Atlantic in 2018.
- Whereas key rate hikes by the Fed are expected to trigger a further flattening of the US curve, the ongoing ECB QE bond purchases at least until September 2018 are likely to contribute to a widening 2-year/10-year gap in the euro area.
- Southern European government bonds are forecast to run into rougher waters, particularly during the first quarter in the run-up to the Italian general election. Over the course of the year the higher carry will shield them somewhat, but this will most likely not be sufficient to secure a positive total return.

At the end of 2016, there was a broad consensus that government bond yields would rise in the course of 2017. However, supported by stubbornly low inflation rates, bond markets defied expectations and long-dated government bond yields on balance hardly moved in 2017.

Central banks to trigger higher sovereign yields in 2018

The macroeconomic preconditions for higher yields are increasingly met over 2018. The global economy enters the next year with strong momentum and growth is seen to remain above potential in 2018. Ultimately, this will impact core inflation rates. Although the inflationary pressure is expected to remain contained for the time being, an increase of extremely low inflation rates towards a more normal environment should impact international bond markets.

Another factor which is seen to drive bond yields up in the course of 2018 is the move towards further monetary policy normalization. Central banks around the world have already started reducing the monetary accommodation and this trend is likely to accelerate over the course of 2018. Although this has been well flagged by central banks, financial markets still underprice the future monetary tightening. To start with, the market hardly prices two hikes by the Fed (each 25 bps) in 2018. Rising inflationary pressure (not least due to a tight labor market) and the passing of the US tax reform will give the US central bank the opportunity to tighten more. We expect the Fed to hike three times in 2018 (which is also in line with the Fed's dots). This is seen to trigger higher yields at the short end of the curve. 2-year Treasury yields are forecast to reach 2.40% by the end of 2018.

If history is any guide, this will drive up long-term US yields as well. There have been three rate cycles since the mid-90s. Each time long-dated yields increased during the cycle and reached a significantly higher level at the end of the cycle. As the curve generally does not invert during the hiking cycle, 10-year yields will rise at least to the peak of the key rate cycle. The current cycle is special in the sense that the first key rate hikes have not impacted long-dated US yields noticeably yet. This appears unsustainable and 10-year US yields have leeway to rise to 2.80% by the end of 2018. Further down the road, not least due to an expected increase in the currently very low term premium, long-dated Treasury yields have scope to increase even more. However, given the structural changes and speculations about an end of the economic upswing 10-year US yields are unlikely to increase significantly above the 3% threshold.

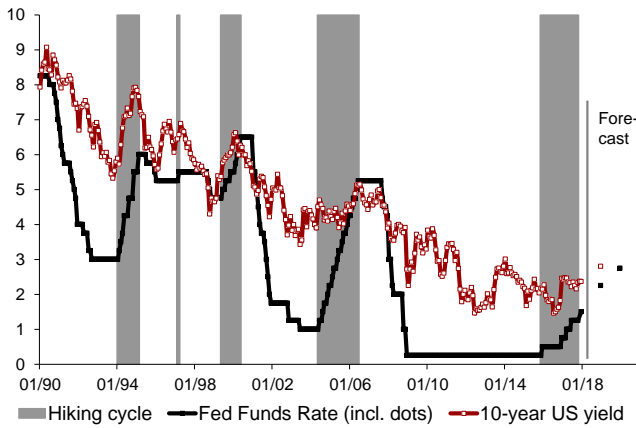
The scope for euro area core yields to climb appears even greater as the current yield level is still much more depressed. Not only nominal 10-year Bund yields have hardly backed up over the course of 2017, but real 10-year Bund yields remain at -1.20% – close to a historical trough. Easy financial conditions, a growth rate well above potential and signs of inflation normalization will give the ECB leeway to terminate its QE programme and signal a first key rate hike for 2019 subsequently. This is not priced by financial markets as a first ECB repo rate hike is only anticipated by mid

Well synchronized global expansion to pave the way to higher sovereign bond yields in 2018

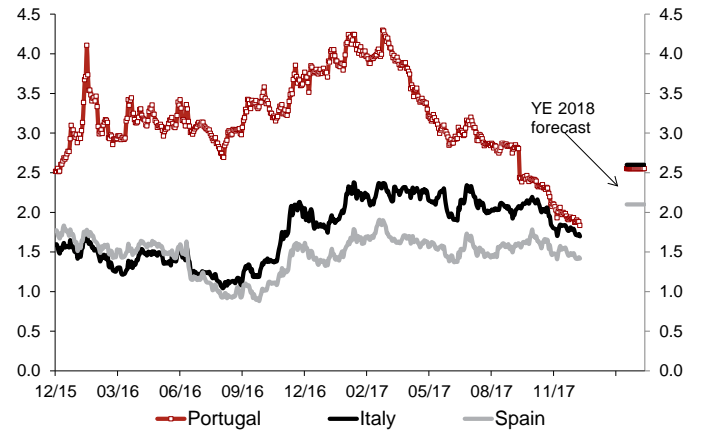
Real 10-year Bund yields not significantly above the historical trough at odds with sound macroeconomic momentum

of 2020. Hence, market participants are likely to be caught on the wrong foot and will have to adjust the expectations upwards in the course of 2018.

Graph 1: US: LONG-TERM YIELDS DRIVEN BY THE FED



Graph 2: 10-YR SOUTHERN EUROPEAN SOVEREIGN BOND YIELDS (IN %)



Withdrawal of ECB support to trigger higher euro area core yields in the course of 2018

In addition, the ECB will scale down its QE programme from January onwards. The central bank signaled that particularly the Public Sector Purchase Programme will be reduced. This implies that the monthly amount spent on government bonds will fall from around €45 bn to less than €20 bn. As the scarcity of German Bunds will become pressing over the course of 2018, the ECB will buy less German bonds than implied by the capital key. Hence, from January onwards monthly net purchases of German paper will decrease to around €5 bn (from around €12 bn) and will likely cease completely in Q4 (except reinvestment flows). Accordingly, 10-year Bund yields are forecast to reach 0.90% at the end of 2018, whereas 2-year Bund yields are seen to remain in negative territory throughout 2018.

Rally in Southern European sovereign bonds unlikely to continue

Non-core euro area government bonds have performed very well in 2017 and sovereign spreads tightened across the board. While in the case of Portugal the idiosyncratic component was the main driver given the strong macroeconomic development and the upgrade to Investment Grade by S&P, the systematic component was the main driver for the strong performance of the other countries. The above-trend economic growth in the euro area, receding political risks and the low risk aversion helped to drive the systematic component to long-term lows.

In the short term, the general election in Italy (most likely to take place in March 2018) will keep markets on their toes. If history is any guide, the election campaign and a possible eurosceptical election outcome (a hung parliament remains our base scenario) is expected to trigger a widening of BTP/Bund spreads.

Political events, higher Bund yields and termination of the ECB QE programme to trigger a moderate spread widening of Southern European bonds

Although the solid macroeconomic situation will likely contain spillovers to other markets, the general environment for non-core euro area sovereign bond markets is expected to become bumpier over the course of 2018. The forecast increase in Bund yields reduces the search for yield and limits investors' need for a yield pick-up. What is more, the reduction and ultimately the termination of (net) ECB purchases will burden non-core bonds as well. Hence, in all peripheral spreads are forecast to widen moderately in 2018. The carry will most likely not be sufficient to prevent the first negative total return of Southern European government bonds since 2011.

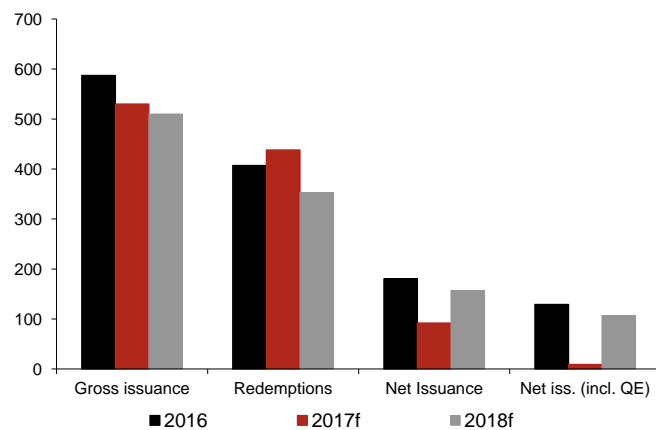
Corporate Bonds

- Although the fundamental situation of euro area corporate bonds remains healthy in 2018, increasing net supply and higher underlying yields are expected to dampen the outlook for corporates.
- The phasing out of the ECB's QE programme over the course of 2018 in combination with ambitious valuations will trigger a spread widening of non-financials. The annual total return is expected to be in negative territory.
- Senior Financial bonds will likely underperform Non-Financials in the run-up to the Italian general election. Later on, however, we expect them to recover in relative terms due to their lower sensitivity to fading CSPP purchases.

Sound fundamental situation of euro area IG corporates to prevail in 2018

To begin with, the fundamental situation of euro area IG corporate bonds will remain sound in 2018. The leverage decreased even slightly in the course of 2017 and the robust macroeconomic environment will contribute to healthy balance sheets. What is more, default rates are on a low level and will likely fall even further next year.

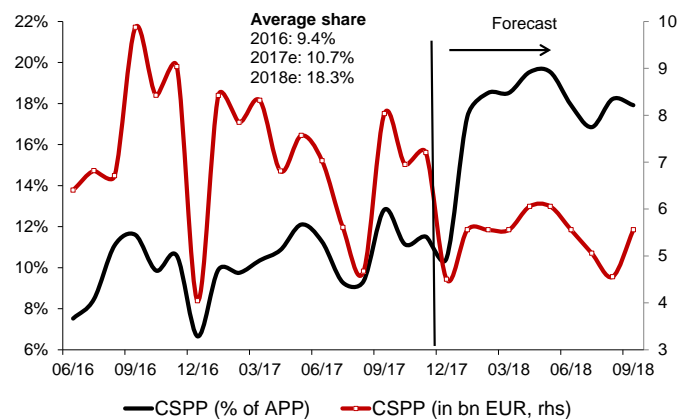
Graph 1: EURO AREA – IG CORPORATE BOND ISSUANCE



in bn €; 500m € and up

Net supply to increase, but not to worrisome levels yet

Graph 2: INCREASING WEIGHT OF CSPP



However, some supporting factors are likely to vanish. While the gross issuance will decrease slightly in 2018, the net issuance is forecast to rise due to an increased leverage. Although net supply will not reach the levels as of 2016, active primary markets will become a burden for IG corporate bonds. This applies all the more as the ECB will buy only around €50 bn of corporate bonds in 2018 (2017e: €82 bn). What is more, the forecast increase in underlying government yields will make corporates somewhat less appealing. Although government yields will remain low by historical standards, the higher yield level will reduce investors' pressure to search for a pick-up. The inflow of funds tends to follow the absolute performance with a time lag. This calls into question the sustainability of recent (positive) inflows and constitutes another uncertainty for corporate bond markets in 2018.

Phasing out of ECB purchases to burden non-financials in 2018

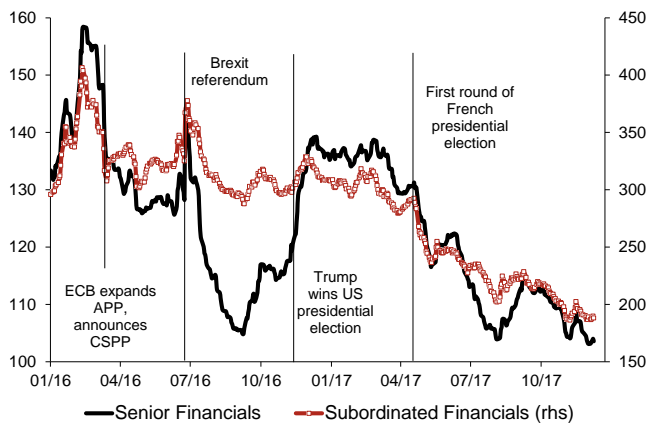
The reduction (and ultimately the termination) of the Corporate Sector Purchase Programme (CSPP) will be a drag, particularly for non-financial corporate bonds. Although the central bank signaled its willingness to increase the CSPP's share in the overall programme (we assume an increase from less than 11% to more than 18% in 2018), the absolute monthly amount will drop to around €5.5 bn (from €7 bn currently). Taking into account the higher net issuance, it implies that the market will have to absorb next year around €50 bn of non-financial corporates more than in 2017.

Ongoing ECB purchases might contain the spread widening in H1, but environment to worsen in H2

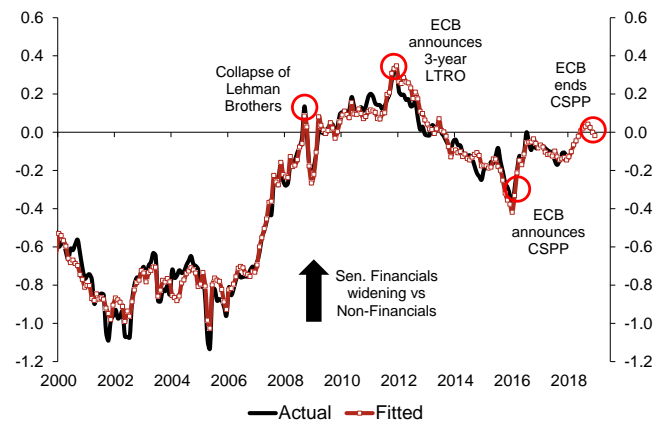
Given the supportive environment, this is unlikely to trigger a lasting sell-off. However, it is expected to trigger a moderate spread widening of non-financials – particularly in H2 with the vanishing support by the ECB. All the more as current non-financial spreads are very low. Taking into account the lower average ratings, the current spread is almost back to the pre-crisis lows. Considering the forecast increase in underlying yields, investors should prepare for a negative total return in 2018.

The question rises how to position in a bumpier environment. Generally, high-rated non-financials are less vulnerable and tend to outperform in periods of spread widening. However, non-financials with a higher duration should be avoided as the forecast increase in underlying yields will hit long-dated bonds in particular.

Graph 3: IBOXX EUR INV. GRADE FINANCIAL BOND SPREADS



Graph 4: EUR INV. GRADE SENIOR FINANCIALS VS NON-FINANCIALS



Duration-adjusted spread vs German Bunds, in bps

ICE BofA indices. Difference in logs of Option-Adjusted Spreads

Prefer Senior over Subordinated Financials after big rally in 2017

EUR IG Financial corporate bonds outperformed Non-Financials in 2017 ytd (total return of iBoxx indices: +3.77% vs +2.54%). This reflects the very strong performance of Subordinated bonds (+8.38%), whose duration-adjusted spread over Bunds fell by 120 bps to 188 bps, the lowest level since November 2007. Also Senior Financials posted decent returns (+2.38%) thanks to the 31 bps decline in the duration-adjusted spread (down to 104 bps, the lowest level since May 2015). The removal of the ‘Frexit risk’ following Mr. Macron’s victory in French presidential election, falling sovereign spreads, the strong macro momentum and the ongoing recovery in banks’ profitability were the main drivers of the positive performance during 2017.

Political uncertainty and fading CSPP purchases to offset each other, favoring a broadly stable spread differential between Senior Fins and Non-Financials

Looking ahead, Senior Financials are likely to trail Non-Financials in the first part of 2018. The rise in political uncertainty in the run-up to the Italian general election (most likely in March) and the corresponding projected widening in sovereign spreads will weigh more on financials. Later on, however, we expect Senior Financials to recover in relative terms (12-month spread target: 125 bps vs 140 bps for Non-Financials) mostly due to their lower sensitivity to fading CSPP purchases. Within financials, we recommend a more cautious allocation, favoring a mild overweight on Senior bonds vs Subordinated ones. Indeed, Subordinated bonds’ valuation looks stretched and some softening in euro area growth (from the currently toppish levels) is consistent with an outperformance of Senior Financials.

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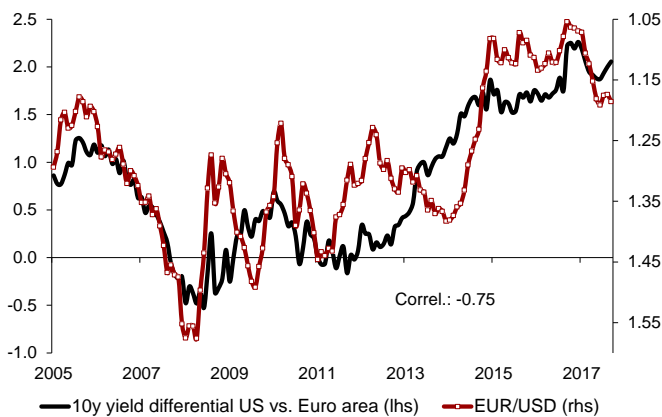
Currencies

- After rallying by roughly 10% this year, the EUR/USD has scope to rise even further in 2018. Long-term fair value considerations, improved credentials as a reserve currency and speculation about higher ECB rates will support the euro.
- Short-term, however, we anticipate a temporary USD recovery on less support from topish euro area data surprises, political uncertainties ahead of Italian elections and further Fed rate hikes.
- The Japanese yen remains inversely tied to US yields and is set to weaken visibly over the coming quarters.
- Recoveries of sterling will likely prove short lived, amid ongoing Brexit uncertainties and the UK's large C/A deficit.
- EM currencies benefit from stronger global growth, but appear vulnerable to an expected increase in US yields.

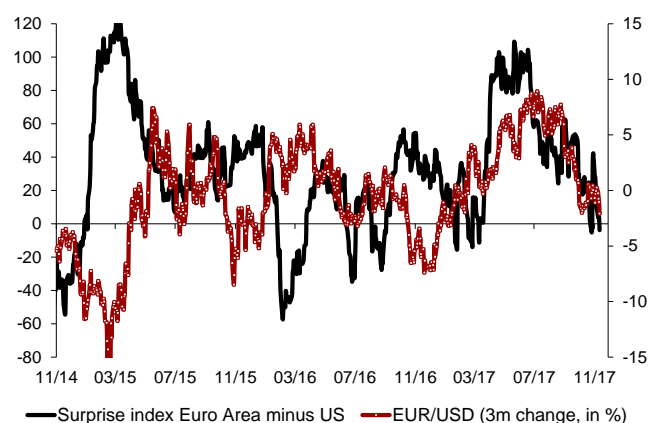
Striking EUR/USD strength in 2017 on strong euro area data surprises and a more hawkish ECB shift

The strength of the EUR/USD was the major 2017 surprise on FX markets. Despite three further rate hikes by the Fed and widening short-term yield differentials, the EUR/USD gained 10% by early December. To a large extent this was due to doubts about US politics, strong data surprises in the euro area and the ECB's move towards an unwinding of its asset purchase, with ECB president Draghi's upbeat speech on the economic outlook in Sintra in late June a key catalyst.

Graph 1: EUR/USD AND LONG-TERM YIELD GAP



Graph 2: CITI ECONOMIC DATA SURPRISES AND EUR/USD



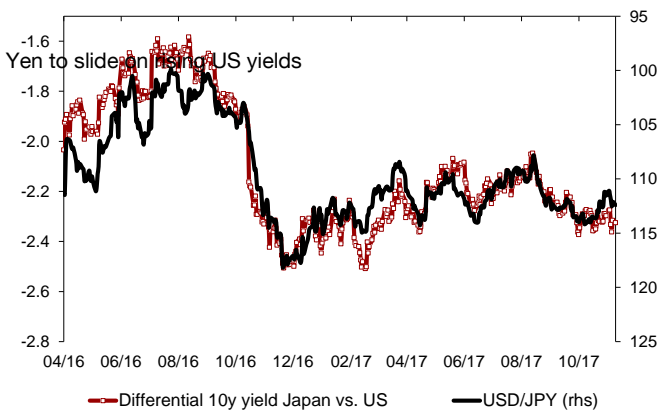
Fundamentally, the EUR/USD has more leeway to move higher...

Based on long-term fundamental gauges, the euro still looks cheap against the US dollar. Purchasing power parities, for example, suggest that EUR/USD around 1.30 would look fair. Also based on deviations of the trade-weighted EUR and USD from their long-term averages, the EUR/USD has potential to rise further. Moreover, structural forces are likely to support the EUR. The euro's share in international FX reserves had fallen from 28% in 2009 to around 20% in 2015 (roughly stable since then). With the euro area on a clearer recovery path now, we anticipate also reserve managers' appetite for the single currency to unfold again. The euro area is also receiving continuous capital inflows via its almost € 350 bn annual C/A surplus (contrasting a \$ 461 deficit in the US). Most meaningfully, strong support is likely to arise from the ECB later next year. With the QE program likely to end in September, the ECB will start to prepare markets for a first deposit rate hike in H1 2019. Rate hikes will be very gradual, but the overall signal of an exit from its ultra-low rate policy may well have a very strong impact on the FX markets.

... but short term, USD strength is likely to prevail on further Fed rate hikes.

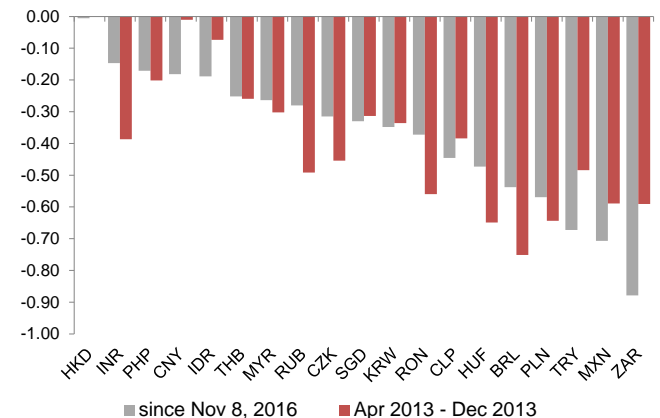
Short term, however, we anticipate dollar strength to prevail. While the economy will remain strong, the temporarily very high momentum of economic surprises in the euro area has already started to ease. Similarly, further rates hikes by the Fed and political uncertainties in Europe ahead of Italian elections will also help the US dollar, as will the likely approval of a US tax reform. We thus see the EUR/USD falling to levels closer to 1.15 in H1, before seeing a stronger rebound to levels in the 1.20-.25 range in H2. The costs of hedging USD exposure are set to increase further from roughly 250 bps currently to almost 300 bps for 1-year contracts.

Graph 3: JPY/USD AND 10-YEAR YIELDS



yield differential in percentage points

Graph 4: BETAS OF EM CURRENCIES VS. 10Y TREASURY YIELDS



weekly % changes vs USD assoc. with a 10 bps increase in 10y US yields

The Japanese yen is about to weaken against the USD, but even more so vs. the euro, amid the anticipated increase in yields in the US and the euro area. With the Bank of Japan set to maintain and only moderately adjust its yield curve control, the yield gap between the US and Japan will widen and lead the USD/JPY higher (see Graph 3). But higher US yields will also weigh on EM currencies. In fact, we find that sensitivities with respect to US yields are about as high as back in 2013, when the so-called ‘taper tantrum’ triggered a simultaneous sell-off in both bond markets and EM currencies alike. We also anticipate some moderate depreciation of the CNY/USD, mainly on the ground of easing growth in China, which is neither favorable for a strong exposure to EM currencies in general.

Sterling not out of the woods yet, Swiss franc to weaken further

Recoveries in sterling are likely to prove short-lived amid continued strong Brexit uncertainties

The recent relief to the British pound is unlikely to prove the start of a protracted recovery. Deep political uncertainties around the Brexit will persist, weigh on the UK economy and keep the risk premium on sterling elevated. This will help a generally stronger euro to surpass the 0.90 EUR/GBP threshold again over the coming months.

The Swiss franc remains fundamentally overvalued, despite its decline by 8% against the euro this year. Easing fears of political disruptions in the euro area and improving economic stability will lead various investors to further unwind safe have deposits parked in Swiss franc. The monetary policy by the SNB will remain closely tied to the ECB, even though it may lag the euro area by one or two quarters. We anticipate the CHF/EUR to weaken further towards 1.20 over the course of 2018, accompanied by continued FX intervention by the SNB.

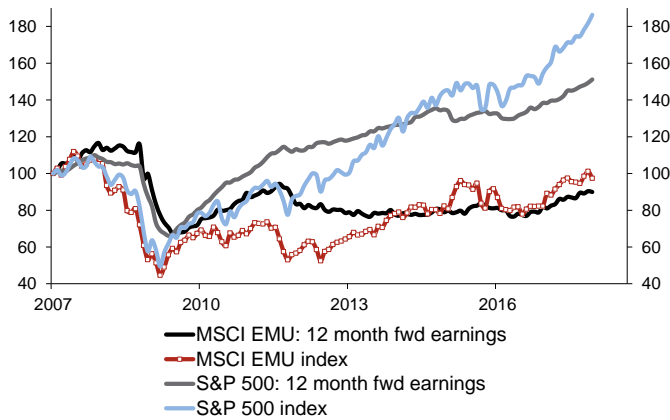
Equities

- In 2017 global equities did well due to lower systemic risks, higher global growth, and supportive central banks.
- Short-term we are less bullish due to higher valuations and high investor complacency, which are to be challenged by less dovish central banks.
- That said, we expect decent 12-month total returns in the EA and Japan (+6%) due to continuing earnings growth.
- We are constructive mid-term on EMs, once Fed and USD expectations are repriced.

Currently, we favor a more balanced allocation between euro area (EA) and US equities and a tilt towards more defensive sectors

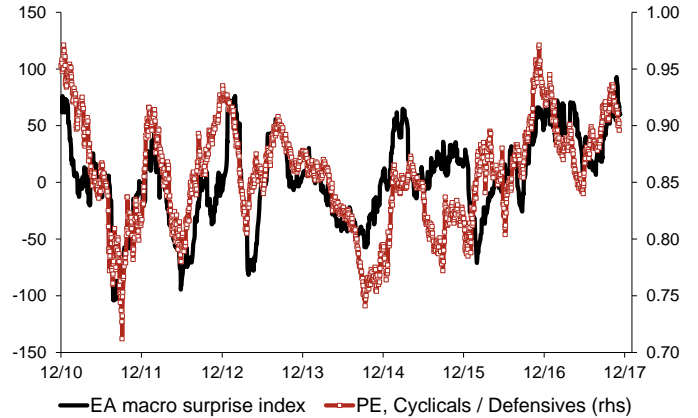
Given our solid global macro scenario, we forecast mid-single digit positive total return for equities over next year, a weaker performance than in 2017 due to higher valuations and decreasing global monetary stimulus. While riskier, the most cyclical and cheaper equity markets (euro area and Japan) should perform better than the defensive ones (S&P 500). In the US, valuations are above average and less attractive, but the downside risk is limited as we forecast an only moderate rise in real yields. Furthermore, the almost certain implementation of Mr. Trump’s fiscal policy should lift US consensus earnings forecasts by nearly 5%. However, in the short term, higher valuations and investors’ exuberant sentiment could be challenged by less dovish central banks, possibly higher geopolitical risks, toppish macro surprises and stronger focus on credit and Chinese risks. Political uncertainty will continue to weigh on invest-

Graph 1: PRICE AND EARNINGS PERFORMANCE



(01/01/2007 = 100)

Graph 2: P/E CYCLICALS/DEFENSIVES & MACRO SURPRISES



tors’ confidence, especially in Europe. A pronounced Chinese slowdown and a spike in 10-year yields are among the key risks. A continuing surprise on earnings growth and positive macro flows are positives.

Cautious in the short term (valuations and investor complacency)

Year-to date (YTD), global equities have posted a total return (TR) of 22%, while the EA (+15.0%) underperformed the US (but outperformed in euro terms by 7pp). Positive triggers were increasing global GDP growth estimates, recovering business confidence, declining global political uncertainty and dovish central banks. Firms’ confidence surged towards cyclical highs while, at the same time, unit labor costs came out stable or even declined slightly. This created conditions for a “goldilocks” scenario, via increasing margins and continuing low cost of debt. Despite comparable earnings growth, the EA performance has lagged the US one.- A stronger trade-weighted (TW) euro (+5%), the expectation of the US tax reform, muted global inflation and stable global 10-year yields (affecting EA financials) all contributed to this relative under-

performance. Should current levels last, the exchange rate could have a negative impact on EA profits of around 4% by mid-2018. Furthermore, stable global yields caused the “secure growth” sectors, such as IT, biotech and health care services to outperform. These three sectors have a higher weight in the US index (30% in total) than in the EA one (10.7%).

Valuation. As a result of the good performance YTD, being supported by a decent earnings growth (+13%), current global market multiples are higher than historical average by 15.3%, but the S&P 500 stands out with a premium of 22.6%. The multiples for the EA and Japan are higher by respectively 13.3% and 4.6% but lower for EMs by 2.7%. Our valuation models show that most markets are fairly valued in the short term but the US is very expensive. In our view, investors have so far ignored risks related to US valuations mainly due to low real rates and bullish expectations on US tax reform. In Europe, EA confidence indicators look toppish, too. Furthermore, market implied volatility has reached new historical lows. Investors show a strong confidence that central banks will remain slow and cautious for longer in reducing the monetary stimulus. As a consequence, financial conditions stay particularly supportive, favoring business sentiment and risk taking. Yet, we forecast inflation to slowly increase as output gaps have been reduced and labor markets continue to improve. Hence, central

The global earnings growth of 13% has backed up a solid total return performance of the MSCI World index (+21.7%)

Table 1: US CAPE-BASED VALUATION (ADJ. FOR INFLATION)

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with our 2017 eps estimate)	2.45	2.00	0.45	128.7	4.18
Scenario 2 (base 2018)	2.80	2.20	0.60	152.6	4.89
Scenario 3 (downside 2018)	1.90	1.70	0.20	114.0	3.90
Scenario 4 (upside 2018)	3.20	2.50	0.70	160.0	5.06
Scenario 5 (goldilocks)	2.45	2.20	0.25	152.6	5.24

	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	18.3	21.1	17.0	21.7	22.6
Avg S&P500 valuation	2,356	2,714	2,192	2,794	2,905
	-10.7%	2.9%	-16.9%	5.9%	10.1%

Note: Target ERP (4.7) is calculated assuming CPI in the range b/w 1% and 4%.

Table 2: EQUITY MARKETS VALUATION DASHBOARD

Markets	PE		PB		PCF		DY		Avg. Discount
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	
WORLD	17.0	16.0	2.3	1.9	11.0	8.6	2.5	2.7	15.3
USA	18.5	15.3	3.0	2.3	12.6	9.8	2.0	2.2	22.6
JAPAN	14.8	15.7	1.3	1.3	8.6	7.0	2.0	1.9	4.6
UK	14.2	13.8	1.8	1.8	9.1	7.9	4.2	4.0	2.9
SWITZERLAND	16.8	15.4	2.4	2.2	12.4	11.2	3.5	3.3	5.7
EMU	14.5	14.2	1.6	1.5	8.3	6.4	3.3	3.9	13.3
FRANCE	15.2	14.3	1.6	1.5	9.1	6.8	3.3	3.8	14.6
GERMANY	13.8	15.1	1.7	1.5	9.0	6.6	3.0	3.4	13.3
GREECE	14.2	12.8	1.7	1.6	7.5	6.0	3.6	3.9	12.2
ITALY	13.3	15.3	1.2	1.2	5.9	4.6	4.2	4.7	6.7
PORTUGAL	17.1	12.6	1.8	1.7	6.7	5.9	4.4	4.5	14.4
SPAIN	13.1	13.0	1.3	1.6	5.3	5.1	4.0	5.1	2.1
EURO STOXX 50	14.3	13.3	1.6	1.5	8.2	6.1	3.6	4.3	16.2
STOXX SMALL	16.5	14.3	1.9	1.7	10.4	8.2	2.9	3.2	17.1
EM, \$	12.2	14.6	1.5	1.6	7.5	7.7	2.8	3.1	-2.7
BRAZIL	12.4	8.9	1.6	1.7	7.4	14.2	3.8	4.3	0.3
RUSSIA	6.1	7.1	0.6	0.9	3.5	4.6	6.1	3.5	-35.1
INDIA	18.4	14.4	2.8	2.7	12.5	11.5	1.6	1.6	11.2
CHINA	13.2	13.0	1.7	1.7	8.3	7.5	2.1	3.0	10.7

Note: Discount in % to long-run norm; blue (neg.) numbers = undervaluation. Red (pos.) numbers = overvaluation. PEs are since 1987, the rest is since 2003. In case of DY, a discount means the market had a higher DY, meaning the market is at premium for this multiple. 12m f = expected in 12 months
Source: Thomson Reuters Datastream, IBES estimates.

banks can surprise investors with a more hawkish communication stance in the next few months.

Sentiment and positioning. In recent surveys, global fund managers declared a higher appetite for risk, lowering their cash positions. Lastly, the risks emanating from the next Italian elections and the political impasse in Germany could delay the EU integration talks, further limiting the equity upside. We add to this the recent pressure on high yield bonds and the upward move in Chinese 10-year rates, both signaling some initial pressure on the riskier credit spectrum.

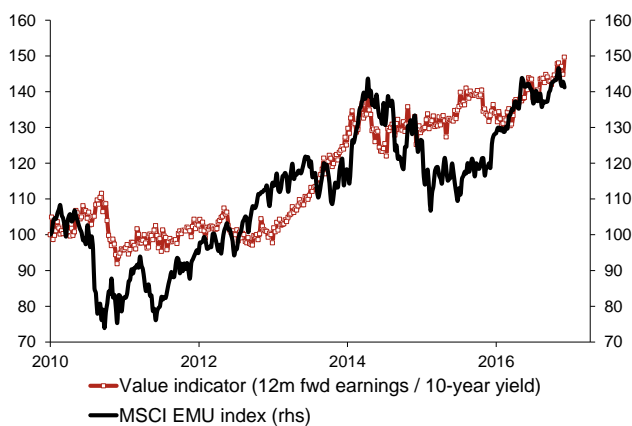
➔ For these reasons we approach the first months of the next year with a more cautious approach to equities, favoring a balanced portfolio. On European sectors, we would adopt a more balanced and a slightly less cyclical sector allocation. Thus, overweights are the more undervalued sectors with safer relative earnings revisions: in particular oils, retailers and, less, telecoms. We cut Banks to neutral, but stand ready to increase exposure on further weakness. Financials are still slightly overweight through insurance (lower beta). Also materials, commercial and professional services, healthcare equipment and IT hardware are put on underweight temporarily, with capital goods at neutral.

Over the next year we expect a total return of 5-6% in both the EA and Japan

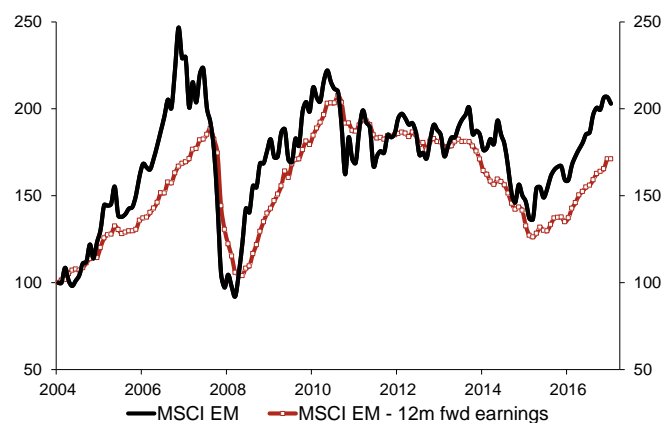
Still positive on 12-month horizon: overweight Japan and the EA

We remain constructive on equities in 2018. Using a long-term approach to valuations (discount models, risk premium assessment, market multiples etc.) and comparing equity yields to our expectations for bond yields (both government and corporate), we can expect total returns of 5-6% from both the EA and the Japanese markets, and a subdued one (3%) for the US. Such returns are definitely appealing if compared with fixed income's ones and are consistent with a decline of trailing PEs in the next years: for the EA from 16X in 2017 to 15X in 2018 (with expected earnings growth in 2018 at 8%). Higher core yields in 12 months (+50 bps) should contribute to an outperformance of EA equities, unless the EU political risk escalates. On sectors, we see the following drivers for 2018: lingering good earnings growth, higher real yields, steeper curve in the euro area (EA) and valuations. A steeper yield curve, being supportive for European equities per se, should be more so for cyclicals, financials, software and transportation. In particular financials are cyclical, cheap, with less tail risks than before, stronger capital buffers and good dividend yield. On the contrary, a steeper curve should hurt staples, pharma, real estate (RE), telecoms and utilities.

Graph 3: MSCI EMU INDEX: VALUE INDICATOR



Graph 4: EMERGING MARKETS: EARNINGS VS PRICE



EM: cautious short term. Constructive beyond

In 2017 EM equities have outperformed developed markets by 11 pp in US dollar terms. This was caused by the recovery in global trade, a weaker US dollar and low financing costs. Based on multiples, the EM stocks have become more expensive, their multiples' discount vs the history decreasing from 9.4% at the start of the year to the current 2.7%. In the short term, the EMs are exposed to a Fed repricing and USD bounce, along with lower macro surprises and a stronger focus on credit and Chinese risks. Once Fed and USD expectations are repriced, though, the EMs should benefit from higher earnings growth and still relatively lower valuations. Furthermore, healthy demand expansion in the advanced economies are gradually spilling over into EMs, underpinning growth outlook via better exports. External fragilities have diminished over the past years, e.g. C/A deficits in vulnerable countries have generally been reduced. Overall, EMs should experience a slightly higher total return in local currency than the EA in 2018, but this will be offset by high hedging costs of around 4%. We favor India, Korea and CEE countries, while maintaining a prudent stance on China.

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Forecasts

GROWTH

	2015	2016	2017f	2018f
US	2.9	1.5	2.2	2.4
<i>Euro area</i>	2.0	1.8	2.3	2.1
Germany	1.5	1.9	2.5	2.0
France	1.0	1.1	1.7	1.8
Italy	0.9	1.1	1.5	1.3
<i>Non-EMU</i>	2.6	2.0	1.8	1.6
UK	2.4	1.8	1.6	1.4
Switzerland	1.2	1.4	0.8	1.8
Japan	1.2	1.0	1.5	1.3
<i>Asia ex Japan</i>	6.2	6.4	6.0	6.0
China	6.9	7.1	6.8	6.4
CEE	1.3	1.5	3.6	3.1
Latin America	- 0.5	- 1.5	1.0	1.9
World	3.5	3.1	3.6	3.6

INFLATION

	2015	2016	2017f	2018f
US	0.1	1.3	2.1	2.2
<i>Euro area</i>	0.0	0.2	1.5	1.3
Germany	0.1	0.4	1.7	1.6
France	0.1	0.3	1.1	1.2
Italy	0.1	- 0.1	1.3	1.0
<i>Non-EMU</i>	0.1	0.7	2.5	2.5
UK	0.0	0.7	2.7	2.7
Switzerland	- 1.1	- 0.4	0.5	0.7
Japan	0.8	- 0.1	0.4	0.7
<i>Asia ex Japan</i>	2.4	2.6	2.2	3.0
China	1.4	2.0	1.6	2.3
CEE	9.2	5.2	5.0	4.8
Latin America	6.2	6.3	4.3	3.9
World	2.3	2.3	2.4	2.7

Regional and world aggregates revised to 2015 IMF PPP weights; Latin America Inflation excluding Argentina and Venezuela

FINANCIAL MARKETS

3-month LIBOR	Current	3M	6M	12M	EM Gvt. Bonds Spreads	Current	3M	6M	12M
USD	1.51	1.60	1.70	2.20	Latin America	420	417	420	425
EUR	-0.38	-0.38	-0.38	-0.35	Asia ex Japan	154	159	165	172
JPY	-0.02	0.00	0.00	0.05	CEE	111	111	112	113
GBP	0.52	0.55	0.60	0.80	Forex	Current	3M	6M	12M
CHF	-0.75	-0.75	-0.75	-0.75	EUR/USD	1.18	1.17	1.17	1.23
10Y Government Bonds	Current	3M	6M	12M	USD/JPY	113	114	116	118
US	2.37	2.50	2.60	2.80	EUR/JPY	134	133	136	145
Euro-Area	0.34	0.50	0.70	0.90	GBP/USD	1.35	1.29	1.27	1.34
France	0.63	0.80	1.00	1.20	EUR/GBP	0.88	0.91	0.92	0.92
Italy	1.71	2.30	2.40	2.60	EUR/CHF	1.17	1.18	1.19	1.20
Japan	0.04	0.05	0.10	0.25	Equities	Current	3M	6M	12M
UK	1.26	1.40	1.50	1.60	S&P500	2637	2630	2640	2565
Switzerland	-0.15	-0.10	0.00	0.10	MSCI EMU	127.1	127.0	128.0	130.5
10Y Spreads	Current	3M	6M	12M	TOPIX	1791	1790	1805	1840
Covered Bonds	70	70	70	75	FTSE	7322	7335	7410	7550
GIIPS	120	145	140	140	SMI	9297	9300	9370	9520
Corporate Bond Spreads	Current	3M	6M	12M					
IBOXX Non-Financial	116	120	125	140					
IBOXX Sen-Financial	103	109	120	125					

As of 05.12.17 (3-day-average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

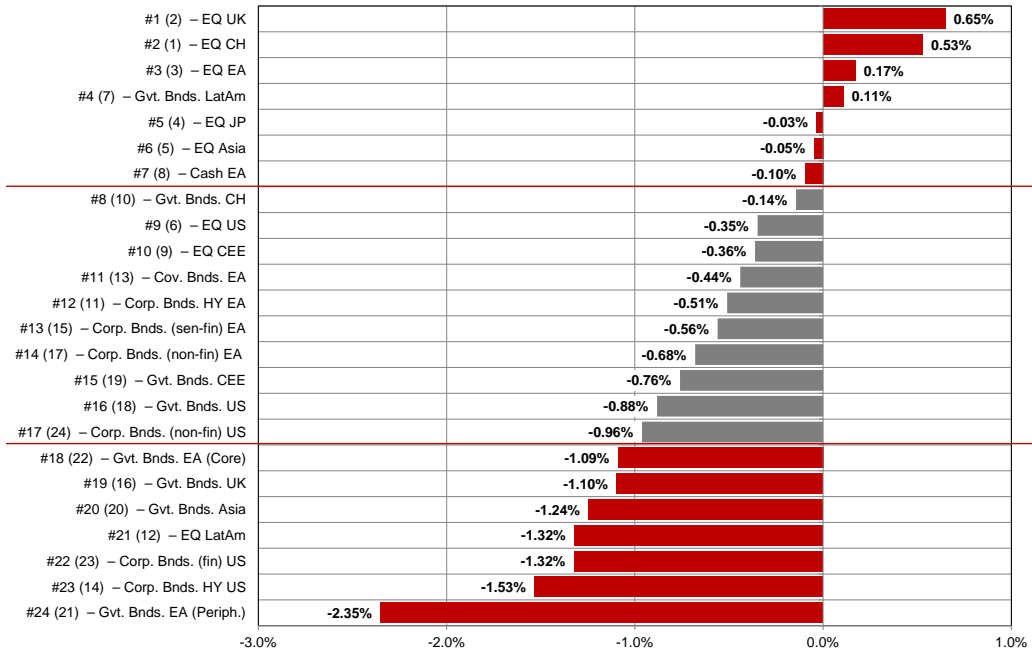
Government Bonds (10Y)	US	2.16	2.50	2.84
	Germany	0.45	0.50	0.55
	UK	1.22	1.40	1.58
	Switzerland	-0.07	-0.10	-0.12
	10Y-GIIPS Spread	126	145	164
	EUR Covered Bond Spread	59	70	81
Spreads	Euro Corporate Spread (Non-Fin)	107	120	133
	Euro Corporate Spread (Sen-Fin)	98	109	120
	EM Latin America Spread	372	417	462
	EM Asia Spread	140	159	178
	EM Europe Spread	99	111	123
	Forex	EUR/USD	1.13	1.17
USD/JPY		109	114	119
EUR/GBP		0.88	0.91	0.94
EUR/CHF		1.15	1.18	1.21
S&P500		2,520	2,630	2,740
Equities	MSCI EMU	119.5	127.0	134.5
	TOPIX	1,659	1,790	1,921
	FTSE 100	6,985	7,335	7,685
	SMI	8,879	9,300	9,721

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Government Bonds (10Y)	US	2.14	2.80	3.46
	Germany	0.79	0.90	1.01
	UK	1.23	1.60	1.97
	Switzerland	0.04	0.10	0.16
	10Y-GIIPS Spread	103	140	177
	EUR Covered Bond Spread	55	75	95
Spreads	Euro Corporate Spread (Non-Fin)	116	140	164
	Euro Corporate Spread (Sen-Fin)	103	125	147
	EM Latin America Spread	329	425	521
	EM Asia Spread	128	172	216
	EM Europe Spread	89	113	137
	Forex	EUR/USD	1.15	1.23
USD/JPY		108	118	128
EUR/GBP		0.86	0.92	0.98
EUR/CHF		1.14	1.20	1.26
S&P500		2,348	2,565	2,782
Equities	MSCI EMU	115.3	130.5	145.7
	TOPIX	1,552	1,840	2,128
	FTSE 100	6,874	7,550	8,226
	SMI	8,633	9,520	10,407

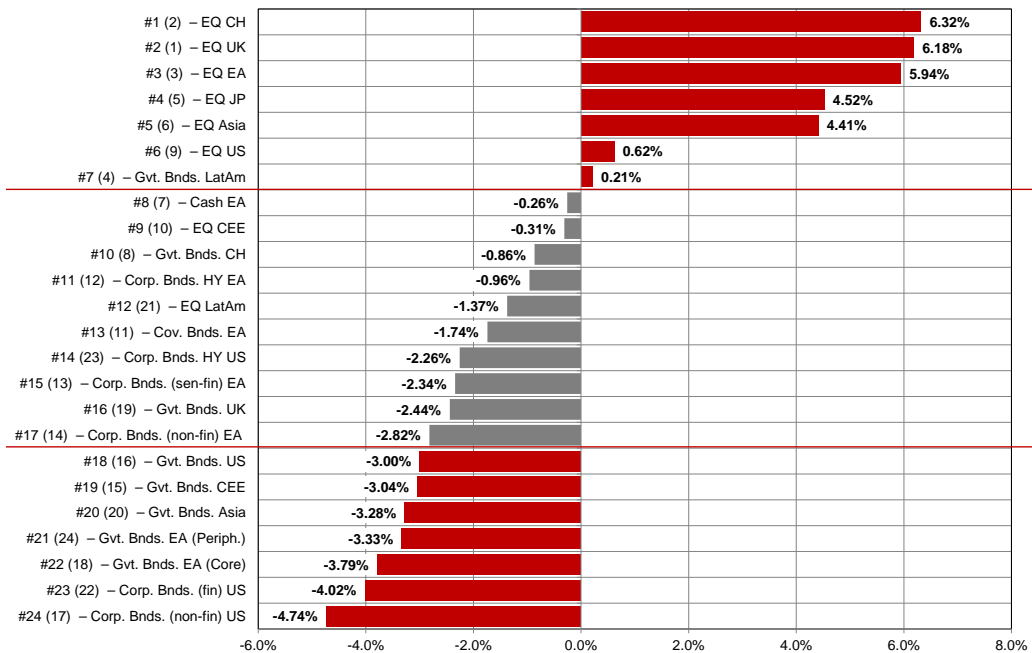
* The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, equally weighted in the case of the 12-month forecast and exponentially weighted in the case of the 1 month forecast. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

TOTAL RETURN FORECASTS* – 3-MONTHS HORIZON



*hedged into EUR; 12-months rank in brackets

TOTAL RETURN FORECASTS – 12-MONTHS HORIZON



*hedged into EUR; 3-months rank in brackets

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