GENERALI INVESTMENTS

Market Perspectives

March 2017

Content

Global View

Thomas Hempell

- **Global financial markets remain caught between continued strong economic data and rising political uncertainties in Europe and in the US.**
- **The outlook of accelerated Fed rate hikes and rising inflation will likely lift US yields further.**
- **By contrast, safe haven bids in Europe and asset purchases by the ECB will keep increases in Bund yields limited. Risk premia on French and Italian debt will remain elevated.**
- **In this setting, high quality euro area corporate bonds and to a lesser extent European equities remain among the most favorable asset classes.**

A continued flow of strong economic data and a decent earnings season in the US and Europe continued to underpin global equity markets in February, with the MSCI World up 2.7% by the time of writing. Political worries about the upcoming presidential elections in France sent the yield on 10-year Bunds almost more than 20 bps lower. Meanwhile, the spread of similarly dated French OATs temporarily rose to levels above 80 bps, the highest levels since 2012. Following a retreat in January, the US dollar strengthened by 2% against the euro.

	Growth			Inflation		
	2016e	**2017f**	**2018f**	**2016f**	**2017f**	**2018f**
US	1.6	2.4	2.5	1.3	2.3	2.5
Euro area	1.7	1.5	1.3	0.2	1.6	1.5
China	6.7	6.4	6.1	2.1	2.5	2.3
World	3.1	3.4	3.5	2.4	2.7	2.8

f= forecast

Looking ahead, we expect two opposed forces to continue to set the tone on financial markets: solid economic data on the one hand and political uncertainties both in the US and in Europe on the other. The world economy has gained in momentum over recent weeks, in particular in the advanced economies. In the euro area, the flash composite PMI for February rose to its highest value in almost six years. With the momentum in services gaining particularly strongly, the acceleration in activity is broadening and increasingly supported by domestic demand. In the US, rising investment spending complements upbeat consumer sentiment and a strong labor market. At the same time, inflation rates have started to increase sharply. But this is mostly due to base effects from the sharp fall in the oil price early last year. Among the major advanced economies, underlying price pressures will creep up more visibly only in the US (and in the UK due to the weaker pound).

As a result, monetary policy divergence will persist. In the US, even a March rate hike cannot be fully ruled out. But more likely, we see the Fed waiting until June with its next move, once there is more clarity on the fiscal and regulatory policies by the Trump administration. We anticipate this step to be followed by two further hikes in the second half of the year. In the euro area, by contrast, the ECB will maintain its accommodative policy stance for longer.

While the economic backdrop is likely to remain favorable, political risks are on the rise again. A lot of questions remain unanswered on US tax and regulation policies, but financial markets will be focused on European politics, and France in particular. While the right-wing and euro-skeptical candidate Ms. Le Pen is leading the polls, her victory against a more mainstream candidate (Mr. Fillon or Macron) still seems rather unlikely. That said, with the consequences of a Le Pen victory potentially severe (a ‘Frexit' at the extreme), electoral polls may trigger even stronger swings in the spreads of French OATs over Bunds in the weeks to come. In Italy, the return of political uncertainties, meagre growth and lack of reform momentum is likely to keep risk premia elevated.

Bonds	**Current**	**3M**	**6M**	**12M**
10-Year Treasuries	2.36	2.50	2.65	2.90
10-Year Bunds	0.21	0.30	0.45	0.60
Corporate Bonds	**Current**	**3M**	**6M**	**12M**
IBOXX Corp. Non Fin	148	145	140	145
IBOXX Corp. Sen. Fin	138	135	135	140
Forex	**Current**	**3M**	**6M**	**12M**
USD/EUR	1.06	1.04	1.02	1.05
JPY/USD	112	115	119	125
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2367	2355	2350	2320
MSCI EMU	116.3	117.0	117.5	117.5

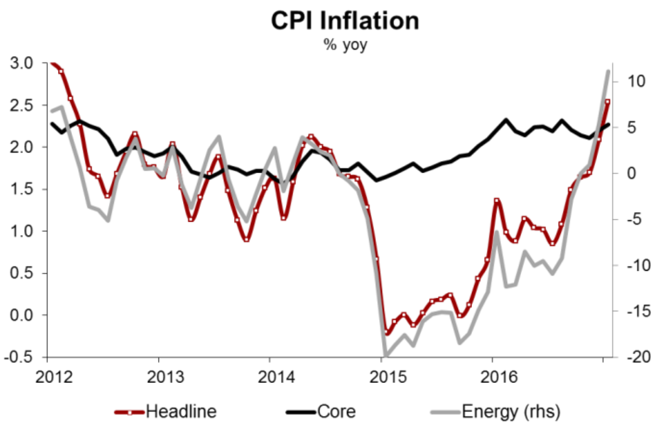
Current Values = average of closings Feb 23-27

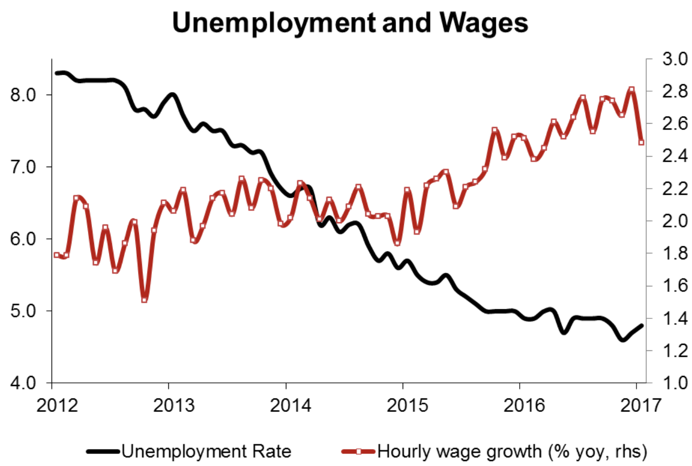
In this setting, US yields are likely to resume their upward trend, whereas Bund yields will be held back by the ECB's asset purchases and European safe haven bids. The latter will continue to burden Southern European debt, but also French sovereign debt may remain under pressure short term.

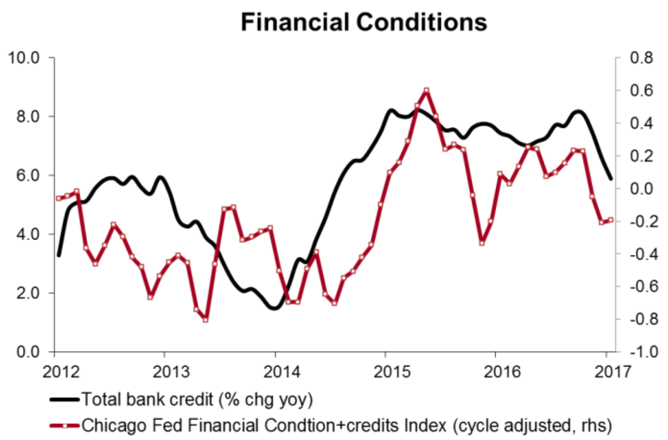
By contrast, we anticipate euro area corporate bonds to remain better shielded against these uncertainties, thanks to the decent economic momentum and the ongoing purchases by the ECB. European equities may still render slightly positive returns, while the EUR/USD is likely to weaken somewhat further over the coming weeks.

USA

Thomas Hempell / Paolo Zanghieri







- **In January, headline inflation rose to 2.5% yoy, due to energy. Core inflation edged up only marginally to 2.3%**
- **Later this month, the administration will present its proposed tax reform, which will include rate cuts. Border adjustment is facing strong criticism.**
- **The minutes of the January FOMC meeting showed a more hawkish tone. A rate hike in March is feasible, but not very likely given the uncertainty on fiscal policy.**

The first information on Q1 points at the continuation of solid, domestic demand growth in the first part of the year. In particular, January labor market data showed large (227K) employment gains without any acceleration in wages, as hourly compensation slowed down to 2.5% yoy. The unemployment rate remained stable at 4.8%. We confirm our view of a solid growth momentum in the first half of the year, with some further support from tax cuts in Q4, leading to 2.4% GDP growth in total 2017.

The increase from 2.1% yoy to 2.5% yoy posted by inflation in January was due to the base effect from energy prices (up by 11% yoy). Core inflation was up by 2.3% yoy, broadly in line with the previous months' readings. This was the result of a mild deceleration in rents, more than offset by stronger goods inflation. Going forward we expect the volatility from energy prices to peter out and a moderate increase in the core rate, on the back of stronger import prices, leading headline inflation towards the end of 2017 at 2.4%.

Credit growth cools

In January, commercial credit was down 0.9% mom, following a 0.7% fall in December. In year on year terms, growth slowed to 5.9%, down from the peak of 8.2% posted in February 2015. The Fed surveys on lending practices showed that in the final quarter of 2016 standards on commercial and consumer loans were unchanged from the third quarter, while those on real estate credit tightened. Slower credit growth is a natural response of trending-up interest rates and a reaction of the sharp increase in delinquencies following a prolonged period of easy credit. Overall, taking into account all sources of external funding, financial conditions appear in line with this phase of the business cycle, and will become a drag on growth only in case of a stronger reaction of credit growth and corporate bond yields to higher rates, which is not our baseline.

Tax reform to be announced in March

Later this month, the Administration is expected to present the fiscal reform plan The key issue is how to make up for the reduction in revenues the promised lower rates would bring about.

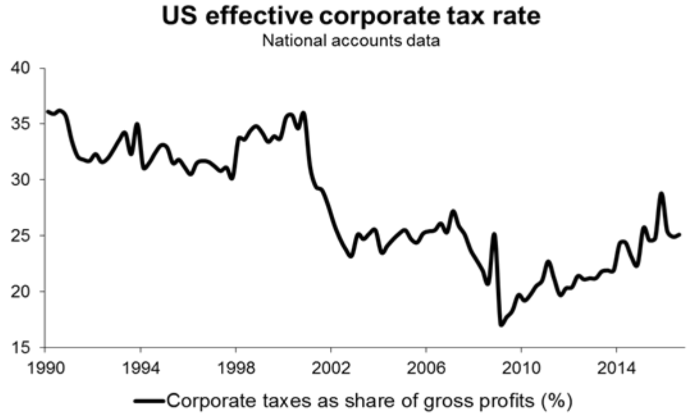
USA

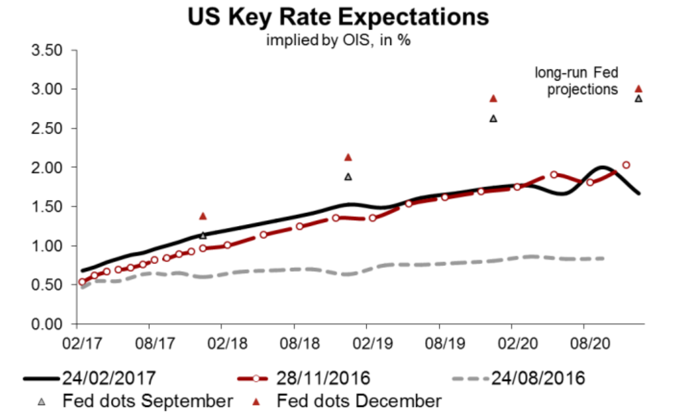
The border adjusted tax proposed by the Republican Party, by which expenditures on imported goods would be no longer deductible (which would increase substantially revenues) appears less likely to be implemented in full. It has attracted a fierce opposition from industries, like retailers, heavily relying on imports. Moreover, there are widespread concerns over its impact on consumer price inflation and international trade, as border adjustment tax may not be compliant with WTO rules. We expect a compromise to take the form of a reduction in tax rates but to a lesser extent than what announced in the electoral campaign: we expect the statutory rate for corporation to fall from the current 35% to around 25%. Some trimming in tax exemptions, in order to broaden the tax base, will lead to a smaller reduction in the effective rate. We think that the probability of a full implementation of the border adjustment is below 30% Lower taxes will improve domestic demand starting from the end of this year, with the full impact expected in the first half of 2018. This underpins our forecast of a mild acceleration (to 2.5%) of growth next year, with federal deficit increasing by around 1 percentage point.

The Fed turns more hawkish

The FOMC meeting in early February ended – as had been widely expected – with no change in the interest rates nor a major amendment in the statement compared to December. However, the minutes to the meeting revealed some somewhat more hawkish details in the FMOC discussion. Many participants to the meeting were of the view that another increase in rates may be appropriate "fairly soon" as further data on inflation and employment were in line or above their expectations. Following the fairly strong January labor market report and other upbeat data released over the past weeks, these conditions can so far be taken as given. In her testimony before Senate, Janet Yellen consequently stated that the March meeting was "live". But in line with the FOMC discussion, Yellen also stressed the high uncertainties regarding fiscal and other policies which complicated the projections for the economic and inflation outlook. Finally, the minutes also revealed that the FOMC members agreed to start discussing the reinvestment policy for maturing Treasuries and MBS held on the Fed's balance sheet.

Given the strong US data, a next rate hike as soon as in March is feasible, but we still do not deem it very likely. Markets have been so far only very little prepared for such a step, discounting only a one in three probability. Furthermore, the Fed may seek to have some more clarity on prospective fiscal and regulatory policy changes. We therefore deem it more likely that the Fed remains on hold in March, but that it will prepare markets more decisively for a near-term rate hike in June and even two more during the second half of the year.



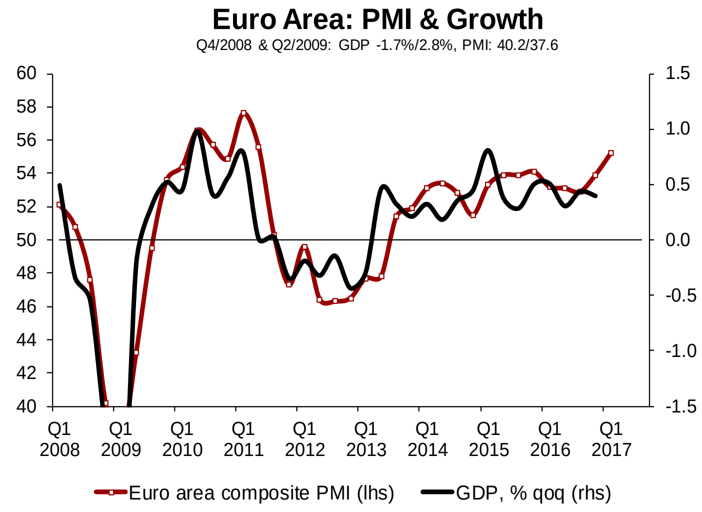


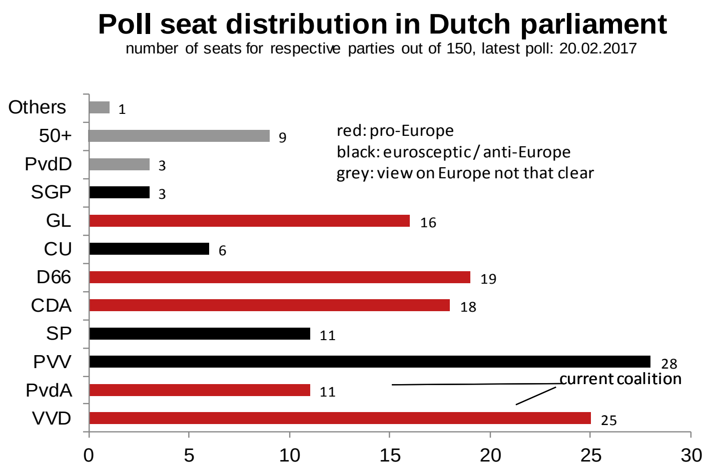
Main Forecasts[1)]	2015	2016f	2017f	2018f
GDP	2.6	1.6	2.4	2.5
Consumer spending	3.1	2.8	2.5	2.7
Gov. consumption	0.7	0.9	0.9	0.5
Investment	5.4	1.8	5.0	5.8
- residential inv.	8.9	7.8	5.1	4.5
- structures	-1.5	-2.3	5.1	4.2
- intell. property production	5.7	1.9	4.2	6.2
- equipment/software	3.1	0.4	5.5	6.9
Inventories	0.4	-0.3	-0.1	-0.2
Exports	1.1	2.7	3.9	3.6
Imports	4.9	4.2	4.9	5.4
Net trade	-0.6	-0.3	-0.3	-0.3
Domestic demand	3.2	2.3	2.6	2.8
Consumer prices	0.1	1.3	2.3	2.5
Unemployment rate[2)]	5.3	4.8	4.5	4.5
Budget balance[3)]	-2.5	-2.9	-3.4	-4.5
Fed Funds Rate[4)]	0.38	0.63	1.38	2.13

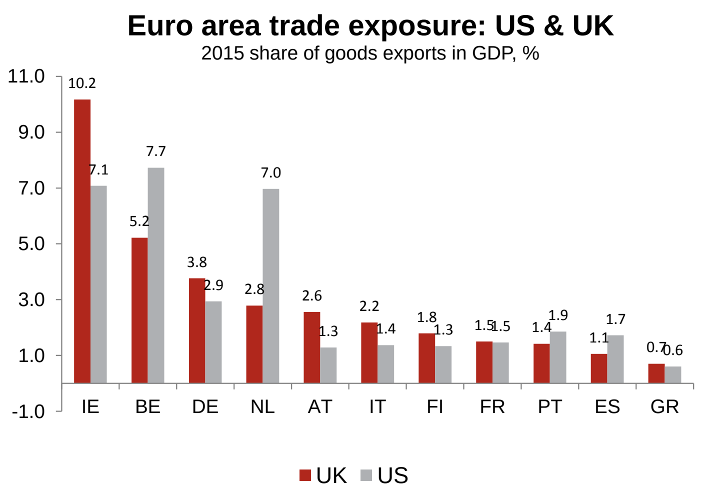
1) Unless noted otherwise, annual % changes, net trade and inventories: growth contribution to GDP 2) yearly average as %, 3) in terms of GDP, federal deficit 4) as %; year-end

Euro Area

Martin Wolburg







- **The February composite PMI reached the highest level since April 2011, thereby hinting at an excellent start into the year.**
- **Looking ahead, numerous risks from US protectionism, the Brexit and elections within EMU together with higher inflation likely dampen activity.**
- **While the upside risks to growth have risen we expect the ECB to maintain a steady course given high risks and still low underlying inflation.**

In February, key euro area sentiment indicators defied expectations of a plateauing or slight fall and once again surprised on the positive side. Most importantly, the composite flash PMI advanced to 56.0, the highest level since April 2011 and one standard deviation above average. Sentiment improved in the more domestically oriented service sector (to 55.6, from 53.7) as well as in the export oriented manufacturing sector (to 55.5, from 55.2). The mood rose in Germany, France and – as the headline number suggests – on average also in Italy and Spain. The German Ifo index backed the message provided by the PMIs and rebounded to the December level. With business expectations as well as employment indicators also trending up, the way is paved for a continuation of the recovery with consumption activity being increasingly complemented by equipment investment spending. Moreover, the PMIs released for Q1/2017 so far imply a quarterly growth rate of 0.6% qoq, clearly above our assumption of 0.4% qoq. While we would normally not hesitate to revise our growth outlook to the upside, we do so this time. The key reason is that the risks at the horizon have increased.

US border tax, Brexit fallout and elections in France

Looking ahead, the US government has started to discuss plans to reform its tax system and to move towards a border tax of 20% which would penalize imports and subsidize exports. The US is the euro area's major export destination (2015: 13.9% of all extra-EMU exports) and in 2016 the goods trade surplus was € 100 bn (with exports of € 280 bn), roughly 1% of euro area GDP. The effect of such a tax would be significant and might have the potential to erase the trade surplus against the US. If this were the case, euro area activity would be significantly harmed.

Moreover, at the end of March the UK will most likely trigger Art. 50 of the EU Treaty. While the institutional setting between the UK and the EU will not change for the time being, the effects of a weaker sterling and slowing growth in the UK will contribute to weakening demand from the second-largest export market (2015: 13.5% of all extra-EMU exports). In 2016, the goods trade surplus likely was € 118 bn (with exports of about € 270 bn).

Euro Area

According to some rough calculations the surplus will be reduced by about € 20 bn (or 0.2% of euro area GDP) in 2017, without considering possible shifts of investment away from the UK into the euro area.

Third, over the last weeks the risk emanating from the presidential election in France has increased. The big concern is that with a victory of an extremist candidate France could ultimately leave the euro. As of late, the rising support for the extreme left candidates caused financial market concerns to increase. However, polls still hint at an ultimate victory of a center candidate. We also expect this to happen and hence see leeway for a positive impact not only on financial markets but also on economic confidence. Moreover, there are general elections in the Netherlands on March 15 but here polls do not suggest any chance for a Eurosceptic government to be finally formed (see mid graph, previous page).

Growth to still moderate over the course of the year

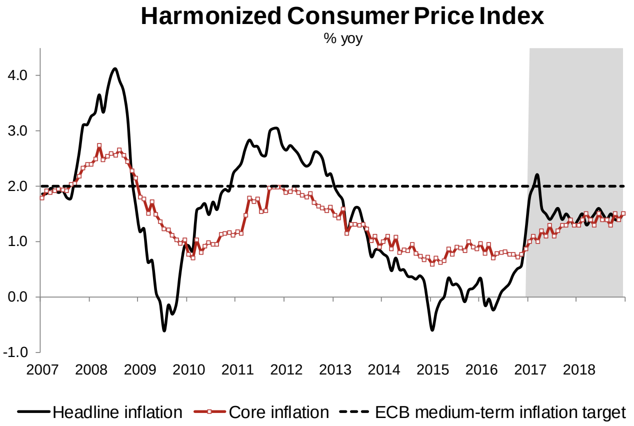
Apart from the just discussed risks, the increase in headline inflation will continue. Following a reading of 1.8% yoy in January, we expect headline inflation to reach the 2% threshold in February. Moreover, in December PPI inflation soared to 1.6% yoy, the highest since January 2013, and import prices turned positive again (+0.7% yoy). This suggests that core inflation is also trending up. Higher inflation will dent purchasing power and hence activity. Against this backdrop and the political risks, the drop of the February consumer confidence sends a note of caution.

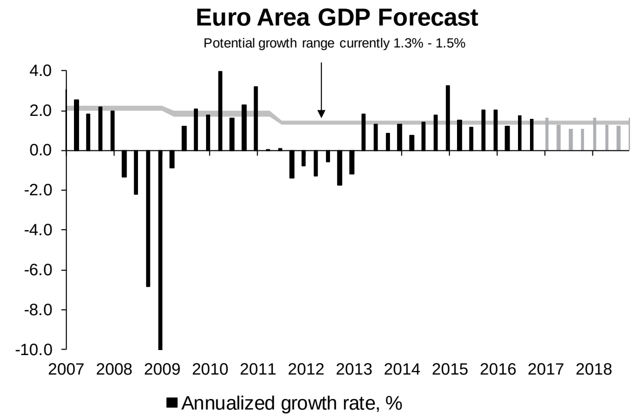
Therefore, we refrain from revising our 2017 growth forecast of 1.5% to the upside but emphasize that the risks have shifted more towards the upside.

ECB to hold a steady course

With the composite PMI having passed the threshold of 55, sentiment has reached a territory historically consistent with key rate hikes. However, what really counts for the ECB is core inflation which exhibits a high correlation with the monetary policy rate (of 0.66 from 2000 to now). Here, the January reading of 0.9% yoy is still way below the ECB's norm of price stability. Moreover, the ECB will also be aware of the downside risks to activity, especially the big one related to the US. Also, the ECB's Chief Economist recently reiterated that the recovery was still dependent on substantial support from the ECB. Therefore, we expect the ECB to hold a steady course and to communicate this also at the next meeting on March 9.

That said, the ECB will most likely need to revise its inflation outlook (2017: headline 1.3%, core: 1.1% at present) to the upside when releasing its new macro projections. Therefore, we continue to look for the start of the tapering discussion in the second half of the year, if none of the macro risks discussed before materializes.



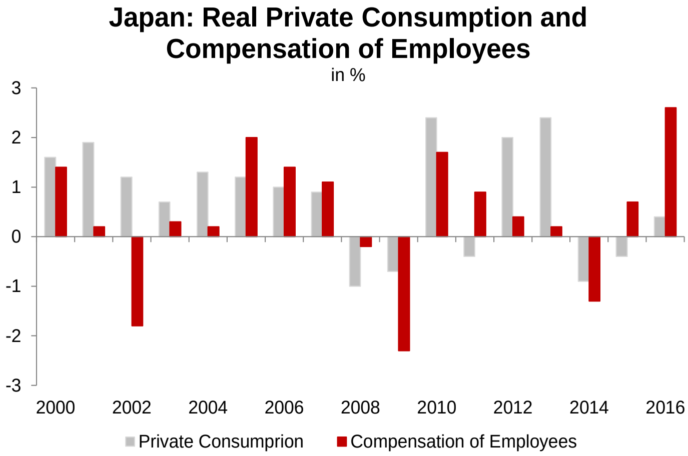


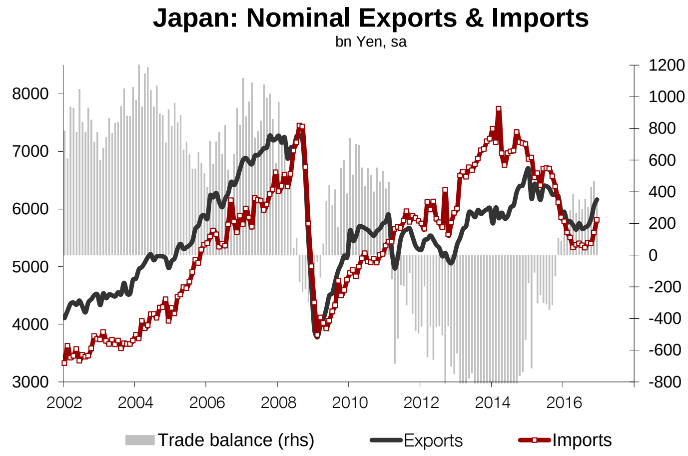
Main Forecasts[1)]	2015	2016	2017f	2018f
GDP	1.9	1.7	1.5	1.3
Consumer spending	1.8	1.8	1.2	1.1
Gov. consumption	1.4	1.9	0.9	0.8
Total fixed investment	3.0	2.4	1.1	1.4
Inventories	-0.2	-0.1	0.1	0.2
Net trade	0.2	-0.1	0.3	0.1
Domestic demand	1.9	1.8	1.1	1.0
Consumer prices	0.0	0.2	1.6	1.5
Unemployment rate[2)]	10.9	10.0	9.7	9.3
Budget balance[3)]	-2.1	-1.9	-1.6	-1.6
ECB refi rate[4)]	0.25	0.00	0.00	0.00

1) unless noted otherwise, annual % change, net trade and inventories: growth contribution to GDP, 2) yearly average as %, 3) ratio of budget balance to nominal gdp, 4) as %; year-end

Japan

Christoph Siepmann





Main Forecasts[1]	2015	2016e	2017f	2018f
GDP	1.2	1.0	1.1	0.8
Consumer spending	-0.4	0.4	0.9	0.8
Government consumption	1.6	1.5	0.6	0.8
Investment	0.1	1.0	1.7	2.0
Inventories	0.4	-0.1	-0.1	-0.2
Net trade	0.4	0.1	0.2	0.1
Domestic demand	0.7	1.0	0.9	0.8
Consumer prices	0.8	-0.1	0.7	0.8
Unemployment rate[2]	3.4	3.1	3.0	2.9
Budget balance[3]	-5.2	-5.2	-5.1	-4.1

1) unless noted otherwise, annual % changes, net trade and inventories: growth contribution to GDP 2) yearly average as %, 3) in terms of GDP, general government 4) as %; year-end

- **Japan's Q4 GDP growth came in at 1.0% qoq annualized, mainly driven by net exports while private consumption remained flat.**
- **The recent meeting of President Trump and PM Abe has calmed fears of an imminent economic policy clash. However, trade frictions are not off the table.**

According to preliminary data, Japan's real GDP improved by 1.0% qoq annualized (ann) in Q4 2016. Growth was predominantly driven by exports of goods and services which increased by 11.0% qoq ann. As imports grew only by 5.4% qoq ann, net exports were the main positive contributor of the GDP expansion. Japan clearly benefitted from the upturn in the global manufacturing cycle and the relatively soft yen. By contrast, private consumption was flat, continuing the overall weakness in household demand. In total 2016, private consumption increased only by 0.4%, just compensating the loss of 2015, but still not yet for the decrease by 0.9% in 2014 when the sales tax hike had been hiked. The real compensation of employees, however, improved since then by about 2% on net, so that income and consumption have somewhat decoupled. It is increasingly put forward, that the rising share in pensioner households – which do not benefit from rising employees' incomes – are behind this general weakness. With regard to employees, base payment hikes in this year's spring negotiation are expected to come in at 0.3-0.4%, slightly below last year's results. While this will likely be unable to generate a decisive turn to more consumption strength ahead, it remains an important element in Abenomics to shift expectation towards a more inflationary macroeconomic environment.

Trade dispute with US still possible

Although Japan's January real exports had a weak start into 2017, they should generally manage to participate in the current global manufacturing upturn. Given positive net exports together with some short-term pent-up consumption demand as well as expenditures from the last fiscal package, this combination of factors should be sufficient to hold Japan's GDP growth around 1% qoq annualized in Q1 and beyond. However, US trade policy remains an important risk factor, despite some observable coherence in the first formal meeting between US President Trump and PM Abe. Trump seems to have endorsed Japan's monetary policy approach, independent of its yen implications. An economic dialogue will be installed on a bilateral trade framework, fiscal and monetary policy as well as on infrastructure and energy. However, it remains doubtful if this dialogue can meaningfully channel possible US trade sanctions, as Japan causes the second largest deficit in the US trade balance.

China

Christoph Siepmann

- **Manufacturing PMIs in China have softened but continue to signal stable growth near-term.**
- **CPI inflation trended up again but we expect spill-over effects from PPI to stay manageable.**
- **We consider the latest PBoC short-term interest rate hikes as directed against excessive risk taking and not as the start of an hiking cycle.**

As usual in February, China published only a limited data set in order to avoid statistical distortions from the shifting Chinese new year. Data comprise PMIs, foreign trade, inflation and money supply, but not IP and investment.

Readings of January PMIs were a bit mixed. While the Caixin manufacturing PMIs dropped markedly by 0.9 index points to 51.0, the NBS version receded only very slightly. However, both indices stayed well within expansionary territory, pointing at ongoing stable growth. In the Caixin version, a major drag stemmed from the output and new orders subcomponents, while new export orders gained some pace. The latter is coherent with some recent export stabilization on a seasonally adjusted basis. Export growth reached 7.9% yoy in January. However, this high reading is largely due to a strongly positive base effect (which will repeat again in February). PMI new export orders around Asia mostly showed some improvement, so that the uptrend in the production cycle in advanced economies likely has elicited some positive spill-over effects which should continue over the upcoming months. However, a trade conflict with the US remains a high risk factor.

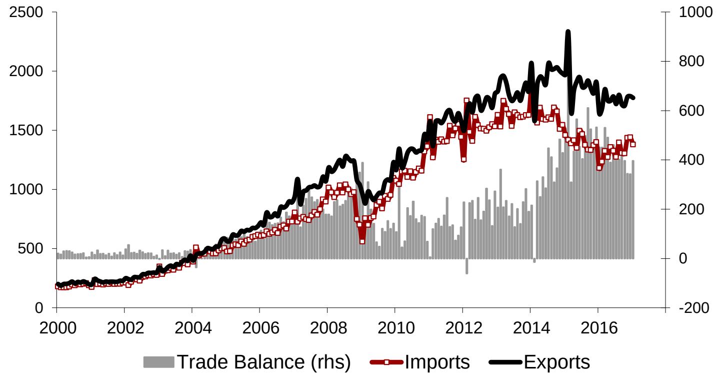
Meanwhile, CPI inflation moved up to 2.5% yoy mainly due to rising food and transport prices. Food prices typically rise ahead of the Chinese new year, whereas traffic prices likely also reflect negative base effects from the oil price development. Moreover, PPI inflation continued accelerating strongly to 6.9% yoy, against the backdrop of stable growth, an upturn in the real estate sector, government infrastructure projects as well as capacity cuts in the coal and steel sectors. Spill-over effects to CPI have become increasingly possible. However, so far the consumer goods component in the PPI remained subdued. Overall, we expect the effect to stay manageable as latest PMI input and output price subcomponents have started to recede.

PBoC unlikely to embark already on a tightening cycle

Rising inflation stoked market fears, that the PBoC could embark on a tightening cycle. These fears were compounded as the PBoC hiked a broad range of its short-term interest rates in early February. We interpret the move as motivated by liquidity management and for macro-prudential reasons. Although China's growth has stabilized, we would consider it premature to already tighten the monetary reigns. However, the PBoC wishes to end excessive risk taking in the banking sector, therefore further smaller hikes on the liquidity side are possible. The upcoming National People's Congress could bring morel hints.

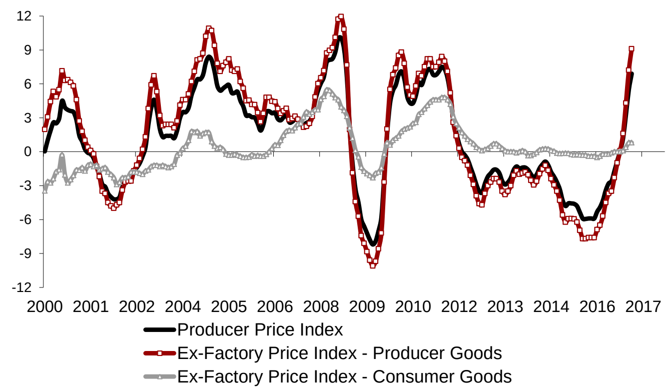
China: Foreign Trade

current prices, in 100 Mill. USD, sa

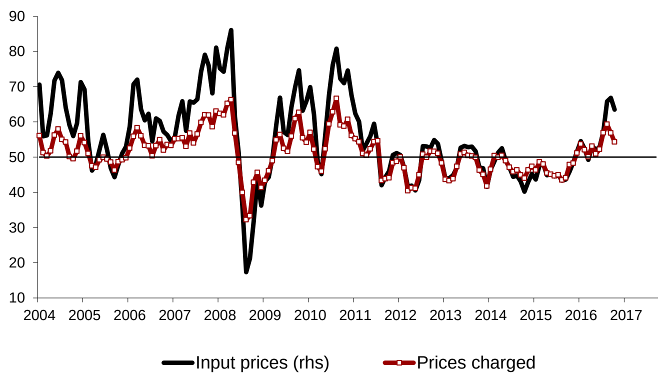


China: Producer Price Inflation

yoy as %

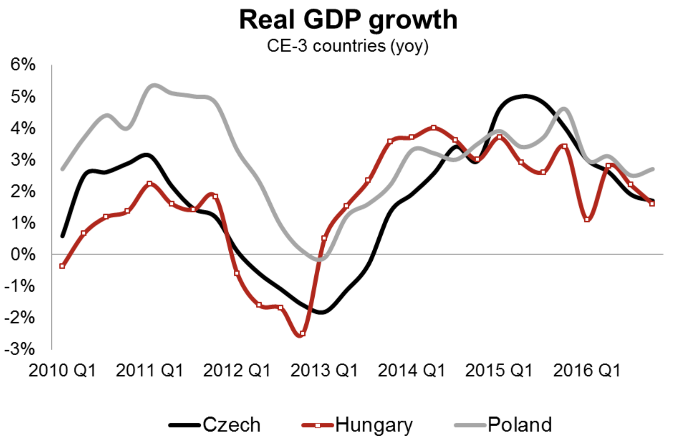


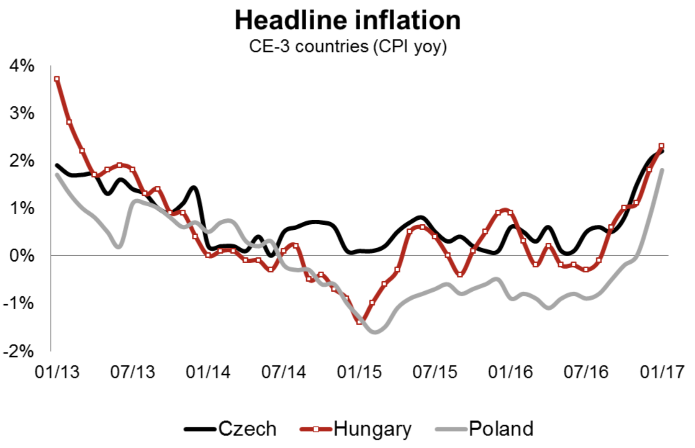
PMI Manufacturing: Price Development



Central and Eastern Europe

Radomír Jáč





Main Forecasts	2015	2016e	2017f	2018f
Czech Republic				
GDP	4.6	2.3	2.0	2.6
Consumer prices	0.3	0.7	2.2	2.0
Central bank's key rate	0.05	0.05	0.05	0.05
Hungary				
GDP	3.1	1.8	4.0	3.2
Consumer prices	-0.1	0.5	2.7	3.0
Central bank's key rate	1.35	0.90	0.90	1.50
Poland				
GDP	3.9	2.8	3.0	3.0
Consumer prices	-0.9	-0.6	2.0	2.0
Central bank's key rate	1.50	1.50	1.50	2.00

GDP and consumer prices: annual % change; CB interest rate: in %, year-end

- **Flash estimates of Q4 GDP confirm that growth picture in the region was mixed at year-end but outlook into 2017 remains positive.**
- **Inflation continues to grow, also at start of 2017 due to commodity prices but also due to recovery in the core CPI.**
- **Imminent impact on monetary policy is supposed only in the Czech case, while Hungary and Poland should keep monetary conditions relaxed.**

Flash estimates of the GDP performance in Q4 revealed a weaker than expected growth in the Czech Republic and Hungary, while Poland surprised on the positive side. The full-2016 growth surprised only in case of Poland, which was caused not only by the better than expected Q4 data, but also by positive revisions of the previous quarters. Worth noting is that the slowdown in GDP growth, seen in all three countries in 2016, was caused by the weaker usage of funds from the EU budget, which had a negative impact on investment expenditure. This situation should improve in 2017, i.e. investment expenditure should recover. Household consumption should remain the key driver of growth, being supported by the situation in the labor market and also by fiscal/social programs conducted by the national governments.

Worth mentioning is Hungary, where the planned usage of the EU funds, accompanied with the fiscal impulse and wage increases, may push GDP growth to area of 4% this year. The output gap is closing or became even positive in all three countries, and the labor force shortage starts to impact the wage growth. This, together with the current pressure created by commodity prices, is pushing inflation higher. Czech inflation (2.2% yoy in January) already crossed the 2% target set by the central bank and may accelerate further. Headline CPI is heading in the same direction also in Hungary and Poland but central banks in both countries still interpret the increase as being driven mainly by commodity prices and they do not intend to tighten monetary conditions in their economies.

Czech CNB expected to end FX commitment in Q2

The CNB confirmed its pledge not to remove the FX commitment (to keep EUR/CZK > 27) before Q2 and also repeated its view that the exit from the commitment is likely in mid-2017. However, the higher than expected CPI data lead the market to speculate on the earliest possible exit from the FX commitment, i.e. in early Q2. At the same time the market expects volatility for the Czech crown after the exit due to the large volume of speculative positions that are betting on the CZK appreciation.

The polish central bank maintains a firm wait-and-see attitude and intends to keep its key policy rate on hold at 1.50% this year and expects rate hikes only in 2018. In Hungary, the MNB keeps money market conditions relaxed via liquidity operations with the base rate stable at 0.90%.

Bonds/Fixed Income Strategy

Florian Späte

- **International bond markets performed well despite strong economic data in February. Particularly German Bunds benefitted from political concerns and recovered the January losses completely.**
- **While peripheral bonds remained under pressure, mainly French OATs were in the focus of market participants. The looming elections in conjunction with polls showing centrist candidates losing support, triggered a further OAT/Bund spread widening.**
- **In light of the solid economic recovery, the current euro area core yield level appears too low. Thus, we recommend a moderate short duration. Regarding peripheral bonds, we switch to a neutral duration as the scope for a further significant and lasting spread widening is limited.**

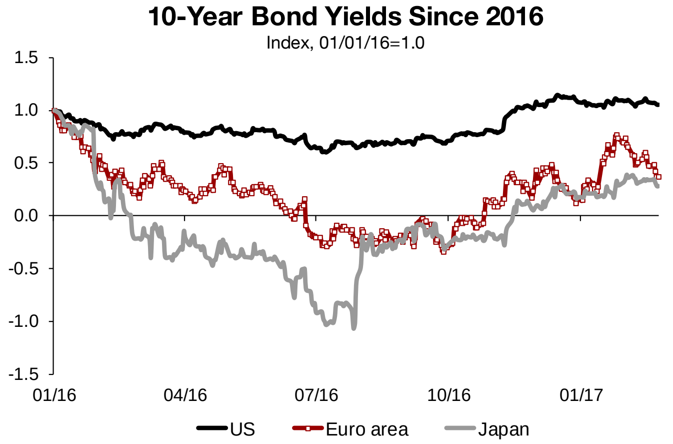
The sentiment on international core bond markets was good in February. Particularly long-dated German Bund yields fell strongly and are almost back to the levels of the end of December. Short-dated German Bunds even marked new historical lows in the second half of February. We regard the ongoing political concerns about the future of the EMU as the main reason for the safe haven flows. These worries outweighed on balance surprisingly strong economic data. As inflation expectations trended only slightly downwards – supported by higher headline inflation rates and higher oil prices – euro area real yields fell strongly. Meanwhile, the real 10-year Bund yield is around -1.25%. A real yield close to the historical low of -1.40% is clearly at odds with the solid economic recovery and points to a considerable overvaluation of German Bunds.

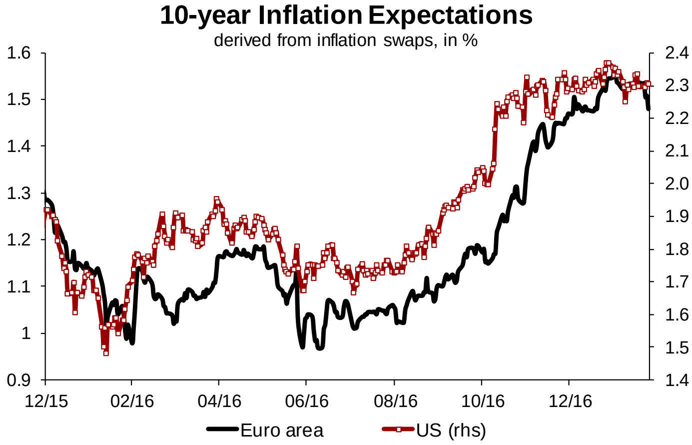
US yields fell as well in February, but to a lesser extent. As a result, the transatlantic yield spread widened in the course of the month again. Particularly at the short end of the curve, the diverging monetary policies left their mark. The 2-year yield gap has risen well above 200 bps to the highest level for 17 years in February.

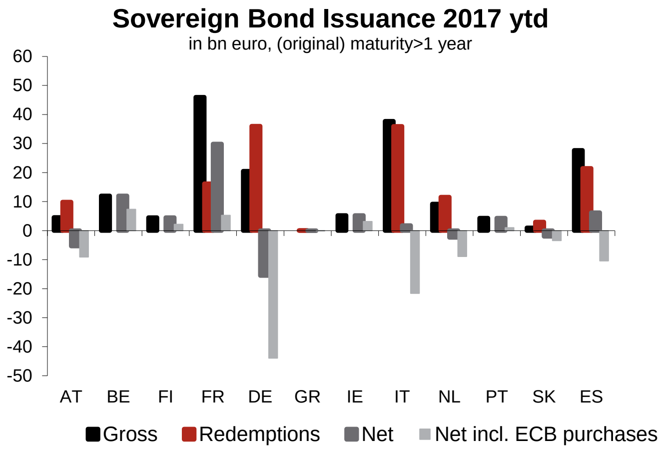
Core yields to rise despite political uncertainties

An agenda full of political events in the euro area (elections in the Netherlands and in France) and in the US (fiscal and regulatory policies by the Trump administration) will keep international government bond markets on their toes for the time being. This implies that the election risk premium will remain high, volatility will not fall lastingly and temporarily even higher spreads cannot be ruled out.

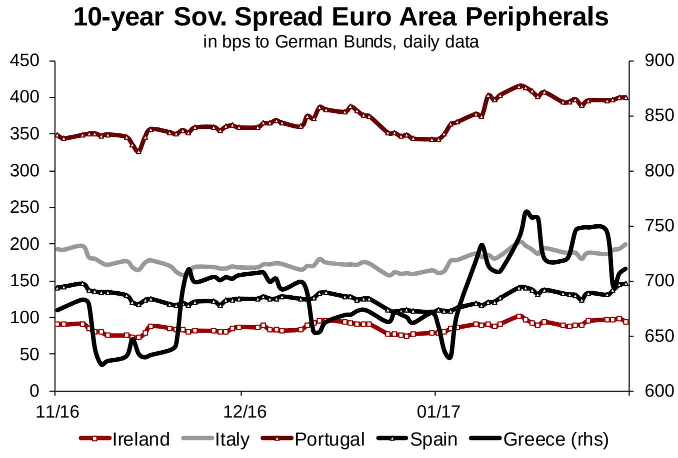
Ultimately, however, the fundamentals are seen to gain the upper hand. What is more, we expect the moderate parties will prevail and that a political crisis in the euro area will be avoided. Moreover, the fund flows will be more positive. Year-to-date, the euro area net issuance in 2017 is already more than € 80bn. Taking into account that the estimated full-year net issuance will be around € 180bn,

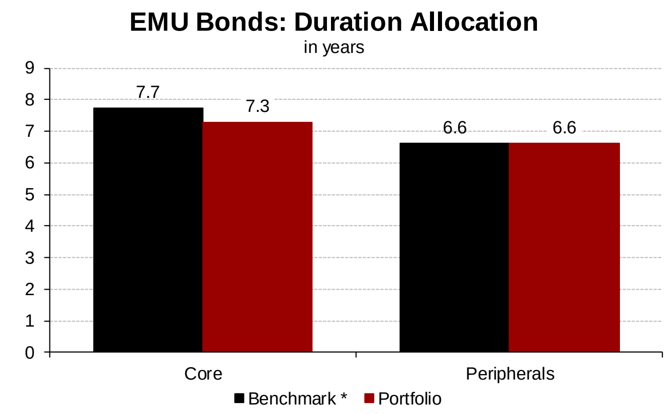


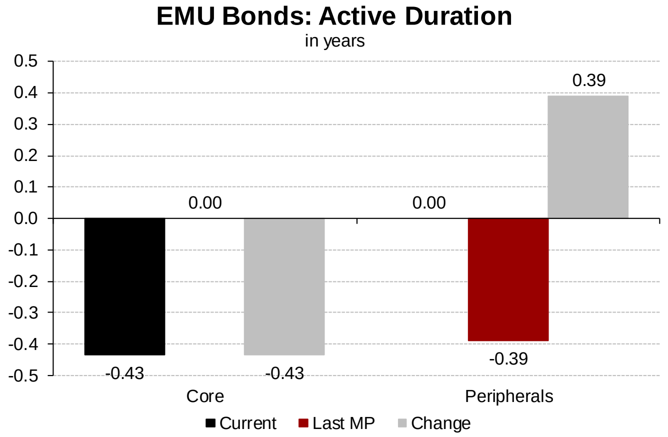




Bonds/Fixed Income Strategy







almost 50 % of the 2017 net issuance was already absorbed by bond markets. In the case of France, the net issuance is positive even after considering ECB purchases.

The remaining net issuance of less than € 100bn is more than compensated by the ECB purchases. The respective displacement effect in the remainder of the year will be close to € 400bn and the net issuance of all countries (including ECB purchases) will be in negative territory. Hence, assuming our base scenario of a benign election outcome in the Netherlands and in France, there is scope for tighter core spreads. This easing of concerns will drive up Bund yields as well. On balance, we forecast 10-year Bund yields to rise to 0.30% on a 3-month horizon and to 0.60% on a 1-year horizon. As the euro area yield curve will remain directional, this upward tendency will be accompanied by a moderate yield curve steepening.

The leeway for US yields to rise is even higher. As only slightly more than two Fed rate hikes are priced currently (we forecast three hikes in 2017) and the way is paved to a higher nominal growth rate, the US yield curve is seen to shift upwards in the months to come. Consequently, the transatlantic yield spread will widen more.

No further marked peripheral bond spread widening

Peripheral bonds have once again underperformed in February, but we doubt that it will last much longer. While we do not rule out early elections in Italy, the political fragmentation is expected to prevail and support for euro sceptical parties will remain high, a further lasting BTP spread widening is unlikely to take place.

More generally, the risk of an imminent ECB tapering is low. The central bank is seen to execute its program until the end of 2017 and to phase it out in the course of 2018. In addition, the ECB acknowledged recently some flexibility with respect to a deviation from capital keys. Hence, in light of the elevated spread levels reached in February, a further considerable spread widening is unlikely. Although volatility will remain high, we do not forecast a continuation of the recent underperformance of euro area peripheral bonds.

Our portfolios

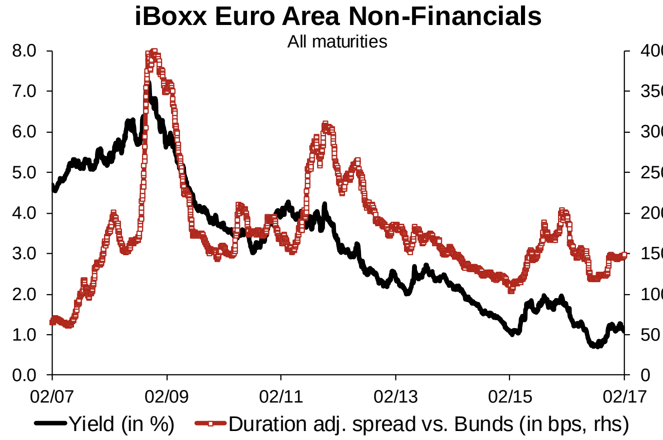
Given our cautious view on core euro area bonds, we reduce the recommended duration and prefer a moderate short duration for the months to come (-0.43 years versus 0.00 years in January). Despite the short duration, the total return of core government bonds will still be negative going forward. As outlined above, we are more confident with respect to peripheral bonds. In light of the attractive carry of 0.35% on a 3-month horizon and assuming benign election outcomes, we lengthen the suggested duration and recommend a neutral duration going forward.

Corporate Bonds (Non-Financials)

Florian Späte

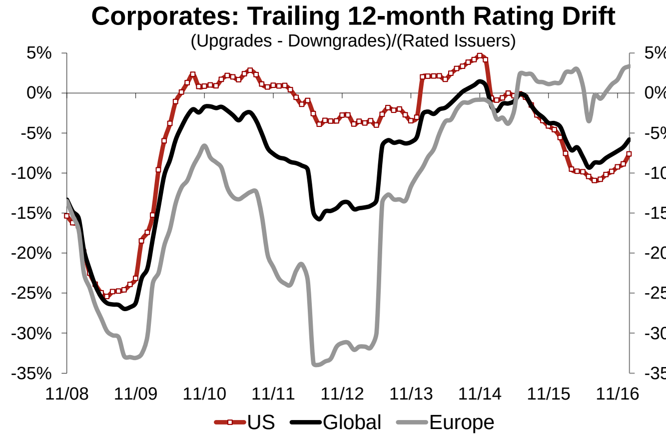
- **Non-financial corporate bond spreads continued to trade in a very tight range in February. Still, falling underlying yields triggered a positive monthly performance.**
- **While the fundamental situation of euro area IG non-financials will remain healthy, political concerns have so far stood in the way of a resumption of the rally.**
- **On balance, there is scope for a moderate spread tightening in the months to come. Further down the road, however, this favorable trend is expected to stall.**

Euro area non-financial Investment Grade corporate bonds continued to trade in a tight range in February. Although there was a slight upward drift over the course of the month, the (duration-adjusted) spread rose by only 3 bps to 148 bps. Given the more distinct decrease in underlying yields, the non-financial yield fell from 1.25% to 1.05%. This helped non-financials to achieve a positive total monthly return. Year-to-date, they have yielded a total return of 0.6% so far.

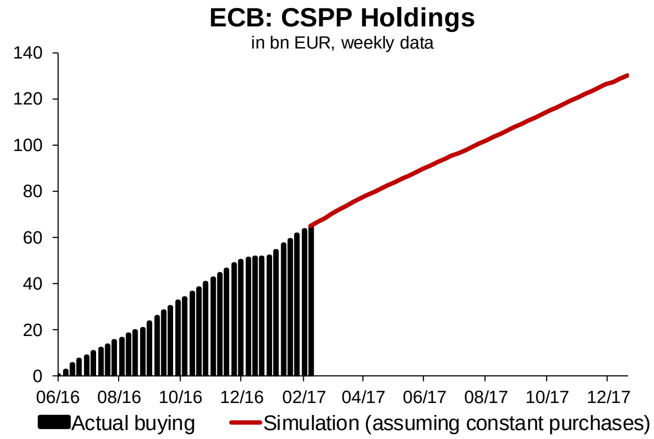


Sound fundamentals to support non-financials

Thus, non-financials have on the one hand brushed off political hurdles. On the other hand, they were not able to participate in the rally of High Yield corporates or equities. While the near-term outlook for non-financial spreads is a bit bumpier given the upcoming elections in the Netherlands and in France, we expect non-financials to perform reasonably well.



As we do not expect an extremist party to gain power in the euro area this year, current political concerns are forecast to phase out in the months to come. What is more, the 12-month trailing rating drift reached a multi-year high in January (3.3%). In addition, although the default rate inched up in January to 2.3%, it is still well below the long-term average of 3.8%. Going forward, in light of the benign funding situation and the moderate leverage, the default rate is seen to slide and to hover around 2% over the course of the year.

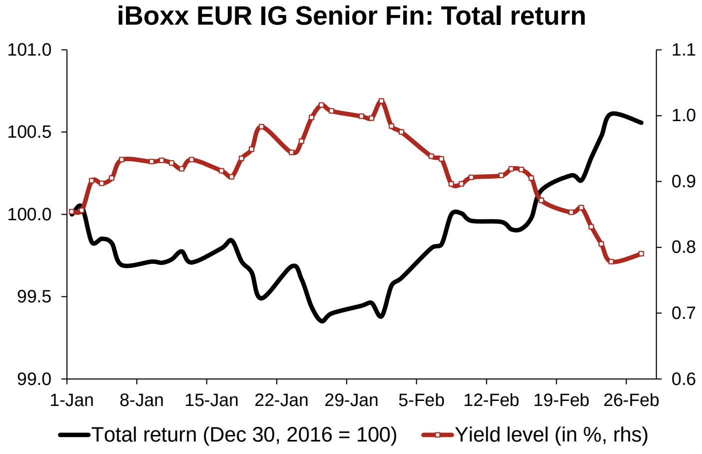


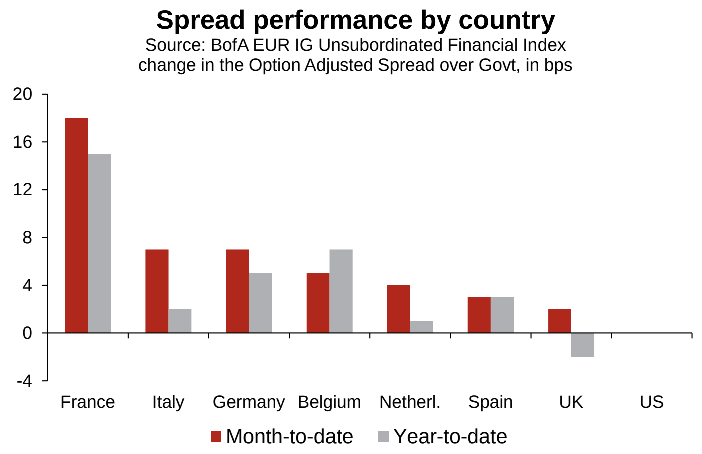
Finally, the ECB will continue to support euro area IG corporate bonds for the time being. In Q1, the central bank will purchase around € 8bn/month and reduce it to around € 6bn/month from April onwards. This will help to absorb the healthy issuance and will stand in the way of a lasting spread widening. A tapering of purchases is still some way off and current concerns about an early termination of the QE program appear overdone.

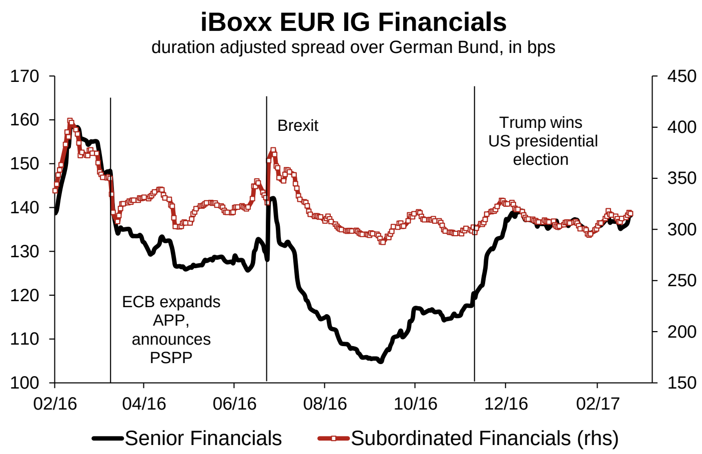
Consequently, we see scope for somewhat tighter non-financial spreads in the months to come (3-month target: 145 bps). Only in H2 2017 a tapering discussion is forecast to gain momentum and to trigger slightly higher spreads.

Corporate Bonds (Financials)

Luca Colussa







- **EUR IG Senior Financial bond spreads widened marginally in February due to the negative spillovers from higher sovereign risk premia and heightened political uncertainty.**
- **That said, the sharp decline in Bund yields helped Senior Financial bonds to post a monthly total return in excess of 1%, the highest since July 2016.**
- **While Bund yields could stay low for a while, a correction to higher levels will fully erode the carry, resulting in a slightly negative total return for Senior Financials over the next quarter.**

EUR-denominated Investment Grade (IG) Senior Financial bond spreads widened marginally in February. The duration-adjusted spread over Bunds rose by 4 bps to 139 bps, thus reaching the upper band of the very narrow trading range being in place since early December 2016. The sharp decline in the underlying Bund yields (-24 bps), however, resulted in a total return of 1.10%, the largest monthly gain since July 2016. The yield to maturity of the iBoxx IG Senior Financial index fell to 0.79%, the lowest level since Mr. Trump's victory on November 8. Also Subordinated Financial bonds delivered a positive total return (+1.05%), though the widening in the spread was somewhat more pronounced (up 12 bps to 312 bps).

French banks underperformed amid political risks

French financial bonds markedly underperformed their peers in February. According to Bank of America data, the average Option Adjusted Spread (OAS) of French names widened 18 bps in February, almost three times the change seen on German and Italian names (+7 bps). The comparison with US (unchanged OAS) and UK (+2 bps) financials – which represent 27.6% of the BofA index – was even more striking. Obviously, the main driver for the underperformance was the tension on the French sovereign bonds, with the 10-year OAT-Bund spread hitting the highest level since November 2012.

Slightly negative total return expected over 3 months

The uncertainty over the outcome of the French presidential elections (April 23 / May 7) could continue to fuel the flight-to-quality mode and further depress Bund yields in the near-term. This would offset a possible widening in Senior Financials spread in the meanwhile.

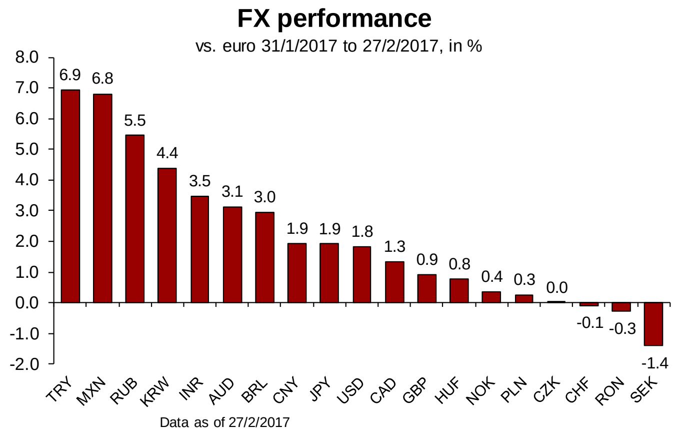
That said, we do not anticipate Ms. Le Pen to prevail in the second round and this would provide relief for markets. This should lead to higher Bund yields and to a marginal retightening in Senior Financial spreads (3M target: 135 bps). The former effect, however, should prevail, thus depressing the total return potential. We expect EUR IG Senior Financial bonds to post a slightly negative total return (-0.20%) over the next three months.

Currencies

Thomas Hempell

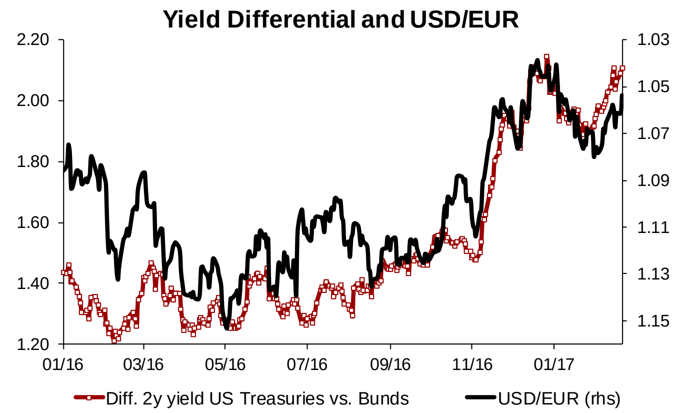
- **The euro weakened broadly in February, burdened by political worries over France.**
- **Near term, we anticipate some further weakness in the EUR/USD on monetary policy divergence and political risks in Europe.**
- **Later during the year, however, mounting speculation about tapering by the ECB should lead the EUR/USD to bottom.**
- **Stronger economic data helped EM FX to recover somewhat from the losses after the US elections.**
- **However, the risk of protectionist policies, higher US rates and a weaker Chinese yuan are likely to burden most EM currencies going forward.**

The euro weakened visibly over the course of February. Against a broadly stronger US dollar, the single currency depreciated by 2% (1.3% in trade-weighted terms). At the same time, several EM currencies, notably the Russian ruble, Mexican peso and Turkish lira, pared parts of earlier losses amid globally upbeat economic data.



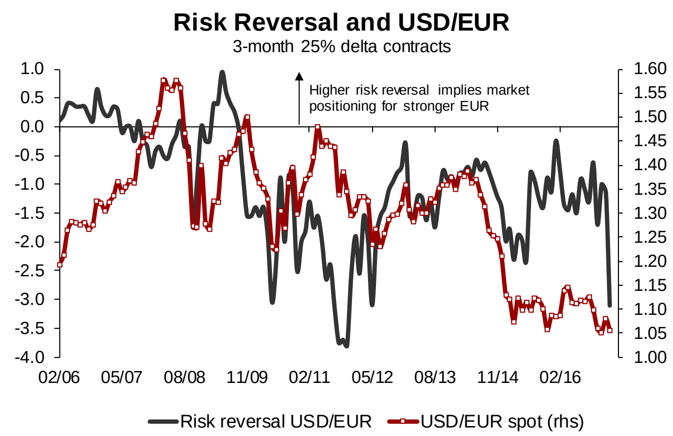
Yield gap to underpin USD vs. EUR near term

The US dollar resumed its strengthening trend, after the sharp post-election rally had gone partially into reverse in January. One key reason was a repricing of future US monetary policy. Fed Chair Janet Yellen sent a moderately hawkish message in her testimony before Congress, stating that a hike at an upcoming meeting will “likely be appropriate”. But the dollar also benefitted from a more general mood by financial markets to again embrace the “Trump trade”, characterized by rising equities and a stronger US dollar.



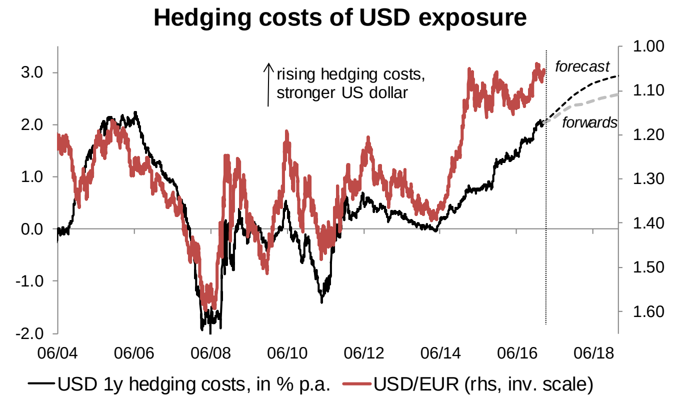
While the Fed may still wait with its next rate hike until June, we anticipate that rising price pressures and bolder fiscal plans to be revealed by the Trump administration will trigger the Fed to deliver two further rate hikes over the second half of this year. This will support the US dollar, given its close correlation with short-term yield differentials.

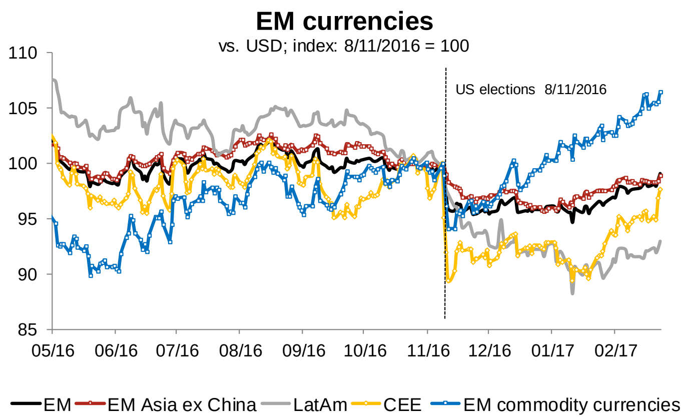
Conversely, the euro will likely remain burdened by persistent political worries. In particular, markets are worried about perceived conversion risk: In case the populist and anti-euro candidate Ms. Le Pen prevails in the French presidential elections, euro-denominated French debt might be redenominated into franc. While this result from a potential ‘Frexit’ referendum does still not appear very likely, concerns about this high-impact tail risk have sufficed to trigger safe haven flows in Europe that have depressed 2-year Bund yields to record lows below -90 bps, widening the transatlantic yield gap even further.

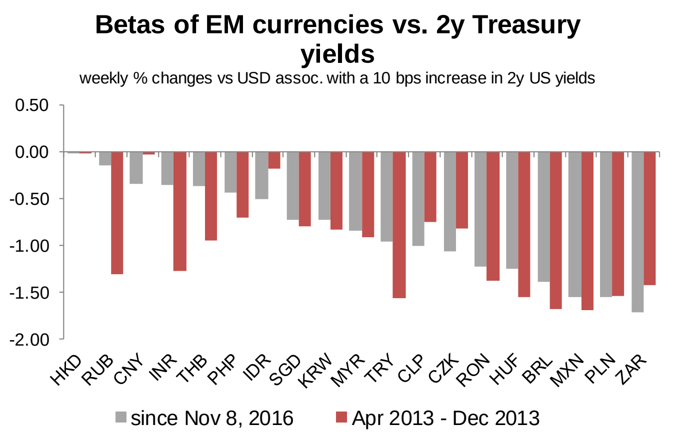


What is more, demand for protection against a sudden euro depreciation has increased sharply, with risk reversals (reflecting the relative costs of insuring against a depreciation vs. appreciation of the EUR/USD by a similar amount) hitting levels last seen in 2012.

Currencies







Near term, these downside pressures from a widening yield gap and political risks ahead of the French presidential elections in April will continue to burden the EUR/USD. That said, further out, the euro seems more likely to bottom. With the victory of a moderate and reform-oriented candidate in the French elections still the more likely scenario, political worries are more likely to abate in H2. What is more, continued solid economic data make it likely that the debate about the ECB's tapering its QE program will gain in traction in the second half of the year. This implies that further gains in the US dollar in the near term may be an opportunity to unwind existing USD exposure, also given that hedging costs are about to rise even further beyond the 2% p.a. already reached.

Upside to EM currencies is limited

Emerging markets currencies had suffered strongly in the wake of the US elections, with the Mexican peso and the Turkish lira hit particularly strongly. Thanks to the solid oil prices, rising commodity prices and hopes of eased sanctions on Russia, commodity currencies recovered quickly well above the pre-election levels (see chart). Most other EM currencies are still trading weaker against the US dollar than in November but have pared part of their losses over recent weeks. In the first place, this was due to a technical relief for the most strongly hit currencies (MXN, TRY), with the MXN also benefiting from the central bank's announcement to offer up to US$ 20 bn in currency hedges to stabilize the Mexican currency. But the broader EM relief also reflected some optimism amid surprisingly strong global data.

Looking ahead, EM currencies may still benefit from the improved global growth outlook. That said, in the medium term we see overall downside risks for EM currencies to prevail for three key reasons. First, the risk of stronger protectionist measures is (with the exception of the Mexican peso) so far not very much discounted. While the specific policy actions may not trigger a broader trade war, even US sanctions on only specific countries could still create sufficient trade uncertainties that will weigh on EM currencies. Second, as discussed above, the normalization of US monetary policy will proceed at an accelerated path. As shown in the lower chart, the sensitivity of EM currencies to short term rates in the US remain generally similar to the 2013 taper tantrum, even though some countries (mainly in Asia, but also Turkey) have achieved to reduce their vulnerabilities here.

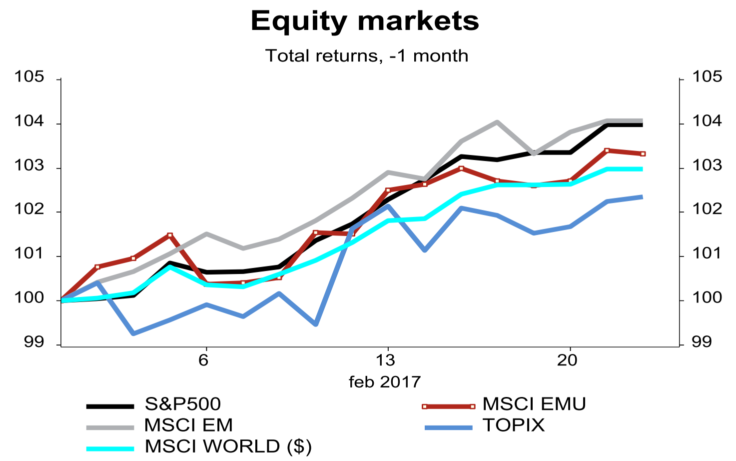
Finally, we expect an about 5% depreciation over the year for the Chinese yuan amid continued capital outflows and slowing growth dynamics. With the yuan an important reference currency, this will also add to depreciation pressures especially for currencies in emerging Asia.

Equities

Michele Morganti

- **Global equities prolonged their positive tone in the month. Support came from economic indicators accompanied by the increasing sales growth in the euro area in Q4.**
- **The earnings outlook is encouraging but limited by structural low growth and high political risk. Possible spikes in 10-year yields in H2 could eventually put pressure on market multiples.**
- **Shorter term we remain constructive on cheaper euro area equities, Japan, and selected EMs. Inside Europe, we favor value-cyclical sectors, including financials, while staying short staples.**

Equities protracted their positive trend in the month. The MSCI World index is up by +3% with emerging markets (EM) and the S&P 500 outperforming (+4%). The MSCI EMU index increased by 3.5% and the Topix by 2.5%.



The earnings' upward cycle remains intact

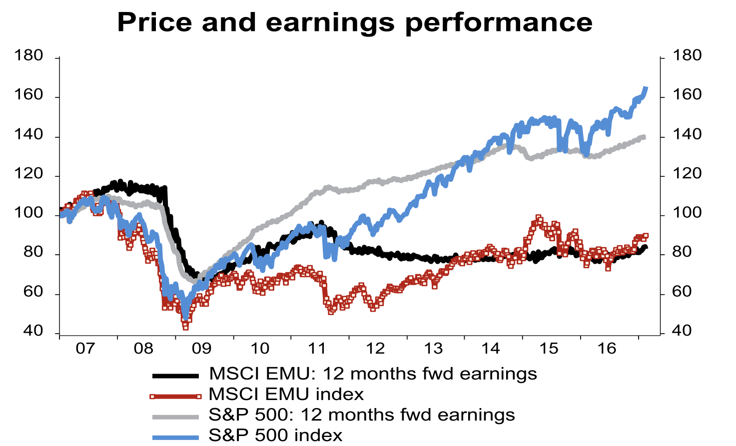
Due to supportive confidence indicators and stabilizing nominal sales growth, the global earnings estimates for 2017 have increased by 0.5% year-to-date. US estimates decreased by 1%. Such a decline could have originated from the negative analysts' revisions which are common at the beginning of the year in an environment of persisting structural low growth (pressures were mentioned by several US firms in Q4). Another explanation could be the uncertainty around Trump's policy agenda and the negative effects originating from a stronger USD. The euro area (EA) and Japanese earnings cycles are relatively younger, suffering at this stage less from seasonality also thanks to supportive monetary policies and weaker currencies. Due to the usual rolling effect, the 12-month forward estimates (frequently used as input for PEs) are up year-to-date by 2.3% for the EA, +1% for the US and +3.4% for Japan.

Analysis of the median stock

Median stock	Earnings Growth		Sales Growth		availability
	Q3 2016	Q4 2016	Q3 2016	Q4 2016	Q4 2016
S&P	8.79 %	8.57 %	2.94 %	3.82 %	87.8%
Stoxx	9.79 %	7.24 %	2.06 %	4.23 %	61.0%
Euro Stoxx	5.75 %	4.48 %	0.64 %	3.85 %	51.0%

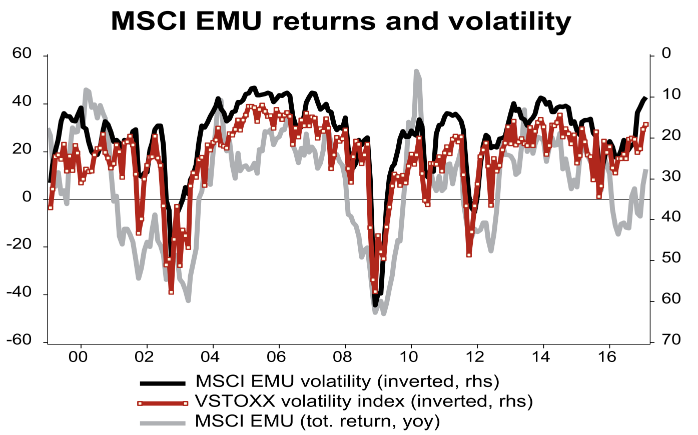
Median stock	Earnings Surpr		Sales Surpr		availability
	Q3 2016	Q4 2016	Q3 2016	Q4 2016	Q4 2016
S&P	3.36 %	2.25 %	0.19 %	0.18 %	87.8%
Stoxx	2.69 %	1.49 %	(0.22)%	0.84 %	61.0%
Euro Stoxx	3.44 %	0.50 %	(0.14)%	1.06 %	51.0%

As expected, the US Q4 2016 reporting season progresses well. The yearly growth is 5% vs 3% in Q3. Energy and material sectors did particularly well. The sales growth accelerated from 2.4% to 4.6% in Q4. As in Q3, the positive surprises are near to 75% of total but as less negative preannouncements before the season started were declared, beating estimates was relatively more difficult in Q4. As for the EA, we highlight the increasing median sector sales growth (+2.7% yoy vs. 0.6% in Q3). For the median stock, results are even more encouraging.



In sum, the reporting season confirms the lingering cyclical rebound of corporate earnings which started 2016. Given supportive macro data, we expect this trend to continue for the reminder of the year. Due to the stabilization of inflation data, oil prices and higher yields, we expect financial and energy sectors to contribute positively to the global earnings growth in the next months. That said, the world economy is currently backed by still manageable inflation costs and supporting monetary policies.

Equities



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Markets	PE		PB		PCF		DY		Avg.	Avg.
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	Discount	Disc. (-1M)
USA	17.9	17.5	2.8	23.4	11.8	22.4	2.1	-4.0	16.8	13.1
JAPAN	14.5	-7.6	1.2	-1.9	7.9	12.4	2.1	11.2	-2.1	-14.7
UK	14.6	5.9	1.8	-1.4	9.1	16.8	4.1	4.2	4.3	1.2
SWITZERLAND	16.8	9.7	2.3	4.6	13.6	21.8	3.6	9.9	6.6	1.4
EMU	14.3	0.9	1.5	-0.3	7.8	24.8	3.4	-13.3	9.7	9.4
FRANCE	14.4	0.4	1.5	-1.5	8.4	25.5	3.5	-8.2	8.2	8.1
GERMANY	13.9	-7.8	1.7	13.6	8.5	31.8	2.9	-13.6	12.8	-12.3
GREECE	13.4	4.9	1.5	-6.9	7.0	19.5	3.3	-15.5	8.3	10.5
ITALY	12.4	-19.5	1.0	-21.4	4.5	-0.4	4.6	-1.9	-9.8	-3.9
PORTUGAL	15.6	25.0	1.8	2.8	6.4	10.5	4.5	0.6	9.4	7.8
SPAIN	13.0	0.5	1.2	-28.3	5.5	8.4	4.2	-18.8	-0.2	-2.4
EURO STOXX 50	14.0	5.9	1.5	1.6	7.7	28.8	3.7	-14.6	12.7	11.8
STOXX SMALL	16.3	15.7	1.8	7.4	8.4	5.6	2.9	-10.9	9.9	6.9
EM, $	12.3	-16.1	1.5	-9.2	7.5	-1.7	2.8	-21.5	-1.4	-2.8
BRAZIL	12.5	42.4	1.5	-9.3	7.3	-49.8	3.5	-19.8	0.8	0.4
RUSSIA	5.8	-18.6	0.7	-29.2	3.5	-23.6	5.2	51.6	-30.8	-27.3
INDIA	17.4	22.4	2.7	1.7	11.9	4.2	1.6	-0.3	7.2	2.6
CHINA	12.5	-4.2	1.5	-13.8	8.0	6.8	2.2	-27.9	4.2	-1.1

Note: Discount in % to long-run norm; blue and negative numbers = undervaluation. Red and 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

Both should decrease their support in the next quarters. Furthermore, we remain in an environment of structural low sales growth (see chart). The latter is coupled with high political uncertainty, in particular, in Europe and increasing competition coming from firms in the emerging world. For the time being, our earnings forecasts remain below consensus but with risks on the upside. Having decent earnings growth this year will represent a higher chance to gain the forecasted dividends which amounts to 3.3% for the EA in 2017.

The debate around low volatility and US valuations

Concerning the troughs reached by the equity volatility, a debate is occurring around the possible negative signal for future performance which can derive from it. While a possible bounce in volatility could weigh on equity short-term performance, we consider that current low volatility (also due to very low real rates and only slowly increasing central bank rates) usually favors risky assets. Furthermore, in the past there were examples of periods in which the volatility stayed low for quite some time and equities enjoyed good returns in the meanwhile (2003-2007 and 2012-2015, see chart).

As for valuations, current EA multiples are at top of the range since 2007 but still on average over a longer term horizon. The financial crisis and the deflationary spirals are calming down due to what seems a partial success by the aggressive monetary policies. So, it looks understandable that market multiples are running higher. In the US, the noticeable earnings rebound caused by a stronger economic cycle and cost-cutting initiatives (reinforced during the crisis in early 2016) have also produced a significant index price rebound. The latter was possible also thanks to low real rates. But the price trend has come ahead of the earnings cycle (see chart previous page) and corresponds to a 17X PE (12-month forward) as well as to toppish cyclically adjusted PE (CAPE). While short term risks look contained, such high valuations will be at risk starting from H2 this year given the tight labor market (producing higher wage costs) and potentially higher yields. EA equities deserve a higher potential due to their higher sensitivity to the cycle, the bigger support from the monetary policy and lower valuations. On the contrary, the political risk is a negative and produces a relatively higher volatility vs. the US.

In sum, while acknowledging the risk coming from politics we confirm our constructive stance on equities, especially on the cheaper EA and Japanese ones and recommend to use set-back to increase positions. Japan is characterized by lower valuation, political risk, higher cyclicality and in perspective weaker currency. Concerning possible risks, we cite in particular higher long-term yields and less dovish monetary policies in H2 at a time when indices could be higher than current levels and so more vulnerable. We like cyclicals, financials, telecoms and recommend not to stay underexposed on energy and materials. We are negative on staples.

Emerging Markets Equities

Vladimir Oleinikov

- **The current earnings momentum in local currency continues to be supported by better macro surprises, higher commodity prices and tighter spreads. Risks come from possible US trade protectionism, a strong USD and higher US yields.**
- **We continue to be constructive mid-term on EMs, while remaining tactically neutral for the moment.**
- **We still favor India along with Korea and CEE countries.**

Over the last month, EM equities have continued their upward movement (+4.15% in US dollar terms). The top performer was Poland (+10.0%), followed by Brazil, China, and Hungary (around +6.0%). The Russian market has shown the worst performance (-5.6%). The Polish market is still influenced by the run-up of financials and materials. In case of the Chinese market, it is materials as well (+16%), which benefitted from an appreciable increase in production prices.

Overall, EM 2017 earnings have been revised slightly up by 0.4% over the last month. The markets for which they have been upgraded significantly are: Korea (+2.6%), Mexico (+1.7%), and Hungary (+1.3%). The MSCI China's earnings have been hardly revised up (+0.3%), with A-share earnings (Shanghai index) experiencing an increase by 0.8%. The earnings of the Russian companies have, on the other hand, been downgraded by 3.8% (materials and oil by 5.0%).

Based on multiples, the EM stocks are essentially fairly valued (discount of 1.4% to history). Higher oil and commodity prices have improved the external and fiscal balances of most EM economies. This in turn seems to get EM investors to focus more on the idea that a stronger US economy will fuel growth in developing nations, bolster even further corporate profits and support prices for the commodity exports that many of the countries rely on. Nonetheless, as higher yields usually pull investors away from riskier assets, a tighter US monetary policy should put pressure on EM stocks later in H2 2017.

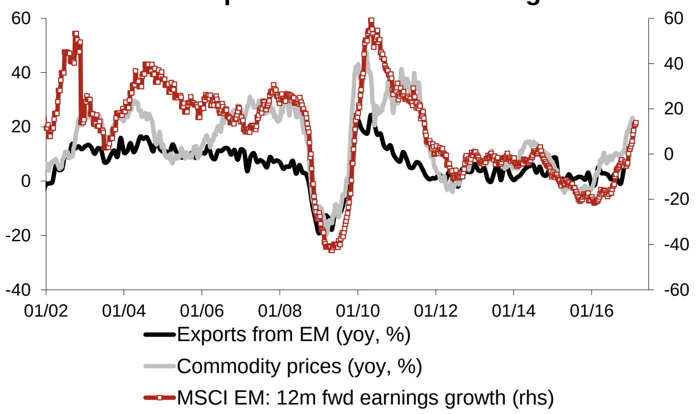
China: controlled slowdown, global trade concerns

Judging by the multiples vs their history, the MSCI China index is slightly overvalued (premium of 4%). Our model based on macro variables indicates a negative potential of almost 10%. The scope for earnings upgrades seems to be limited, too, on account of falling industrial earnings (their growth has decreased over the last two months from 14% to merely 2.3%). Irrespective, the price development of Chinese equities does not fair well when compared to its earnings dynamics relative to the EM markets and the market's PE suffers potentially from a weaker expected earnings growth. Furthermore, with Chinese economy representing 50% of the US trade deficit, it is subject to a considerable risk of introducing a border tax by the Trump administration.

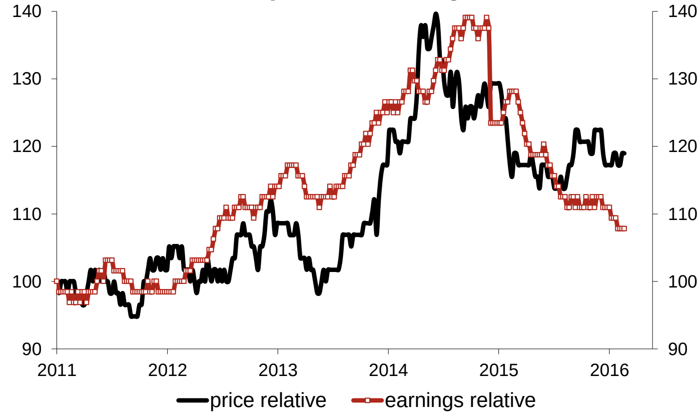
Markets	price, %-chg -1M	price, %-chg YTD	earnings, %-chg -1M	earnings, %-chg YTD	10y yld chg, YTD	FX (TW), %-chg MTD	FX (TW), %-chg YTD
WORLD ($)	3.3	5.2	0.1	1.7			
US	4.0	5.5	-0.1	1.0	-3	-0.1	-1.8
EMU	1.6	2.2	1.4	2.4	26	-1.6	-1.4
GREECE	-1.8	-5.0	-1.4	-0.7	30	-1.6	-1.4
CZECH REP.	4.8	5.5	-0.6	-1.1	35	-1.0	-0.7
HUNGARY	4.7	8.1	2.5	4.8	62	-0.2	-0.3
POLAND	12.6	16.2	0.3	3.4	17	-0.5	1.8
EM ($)	6.5	10.3	3.1	6.4	-33		
BRAZIL	5.9	13.1	3.8	2.1	-113	2.3	4.4
CHINA	8.4	13.4	0.9	3.5	31	0.2	-1.0
INDIA	6.7	8.8	-0.4	0.6	43	1.1	0.1
INDONESIA	2.6	1.4	1.0	1.9	-35	0.1	-1.0
KOREA	2.5	5.2	5.0	8.5	15	1.0	4.0
MALAYSIA	2.8	4.2	0.7	1.0	-18	-0.3	-0.9
MEXICO	1.5	3.3	0.3	4.1	-16	4.8	2.6
RUSSIA	-2.7	-6.1	-0.1	6.3	-17	5.0	4.9
TAIWAN	4.2	5.0	1.4	2.3	-10	1.6	3.7
THAILAND	1.9	2.4	1.3	2.9	2	0.5	0.7
TURKEY	7.3	14.1	3.5	4.6	-62	6.2	-3.0
VIETNAM	4.1	4.5	1.0	18.9	-19	-0.9	-1.9
SHANGHAI	4.4	5.1	1.4	3.0	31	0.2	-1.0

All the markets are represented by MSCI indices, except for US (S&P500) and Shanghai.

EM: exports vs. forward earnings



MSCI China: price & earnings rel. to EM

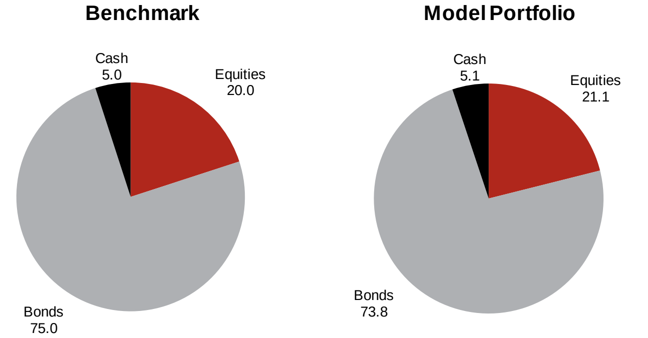


Mark to Market Allocation

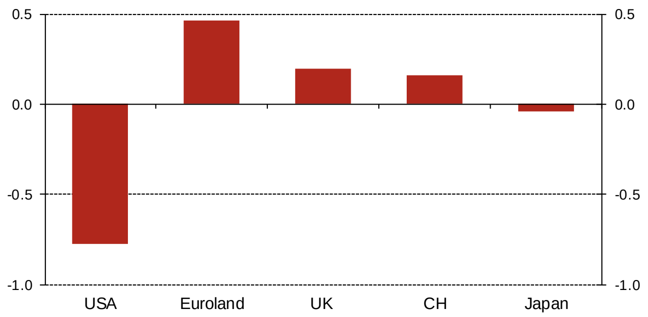
Thorsten Runde

Asset Class	Benchmark	Model Portfolio	Previous Allocation
Equities	***20.0***	***21.1***	***20.7***
Bonds	***75.0***	***73.8***	***74.2***
Cash	***5.0***	***5.1***	***5.1***
Equities, US	3.0	**3.0**	2.9
Equities, EMU	12.0	**12.8**	12.6
Equities, UK	2.0	**2.2**	2.1
Equities, Switzerland	1.0	**1.1**	1.0
Equities, Japan	2.0	**2.1**	2.1
Bonds, Gvt. US	11.3	**10.5**	11.4
Bonds, Gvt. EMU Core	27.0	**26.2**	26.0
Bonds, Gvt. EMU GIIPS	18.0	**18.2**	18.0
Bonds, Gvt. UK	7.5	**7.6**	7.6
Bonds, Gvt. Switzerland	3.8	**3.6**	3.6
Bonds, Gvt. Japan	7.5	**7.6**	7.6
Cash, Euro 3-Mth.	5.0	**5.1**	5.1

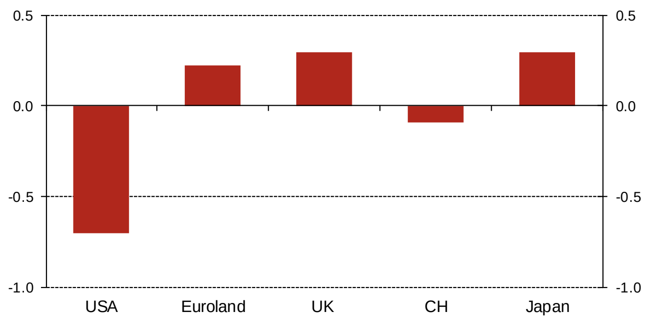
Asset Classes



Equities - Regional Structure



Bonds - Regional Structure



- **In the course of February, all equity markets have shown positive developments, with the US being the most attractive one so far.**
- **Long-dated government bond yields have fallen on the main markets, thus lifting all performance figures into positive territory.**
- **The risk premia on Southern European sovereign debt widened.**
- **Looking forward, we expect financial markets to remain trapped within solid economic data on the one hand and growing political imponderables in the US and across Europe on the other hand.**
- **The divergence in monetary policy is expected to persist, putting upward pressure to US yields while keeping the interest environment across the euro area at low levels.**
- **Thus, we once again recommend to moderately overweight equities at the expense of core government bonds, thereby preferring European markets to the US.**

In the course of February 2017, all equity markets of our investment universe have once again performed quite strongly, revealing return figures ranging from slightly below 0.9% for Japan to a good 4.2% in the US. The yields of long-dated government bonds have fallen on the main markets, whereas the risk premia on Southern European sovereign debt widened. Overall, all government bond markets under consideration also performed positively, led by the UK with roughly 2.9%. All in, the recommended allocation stance in favor of equities basically paid off for February.

Between a solid data flow and political uncertainties

The recent data flow continued to underpin the strong constitution of the global economy. Furthermore, the earnings seasons in the US and Europe have been quite decent so far. Both facts are expected to be supportive for equity markets. That said, in the political arena there are still lots of question marks with respect to tax and regulation policies in the US and, even more important, with respect to the French presidential elections, bearing the potential to destabilize the whole euro area.

Cautious overweight in European equities

Like in the last month, equity volatility is likely to remain elevated, with euro area stocks still better positioned for slight gains than already expensive US ones. Diverging monetary policies will lead to rising US yields and keep the euro area core ones at low levels. Thus, we again recommend to stick to the moderate overweight in equities at the expense of core government bonds, thereby preferring Europe to the US.

Forecast Tables

Growth

	2015	2016e	2017f	2018f
US	2.6	1.6	2.4	2.5
Euro area	1.9	1.7	1.5	1.3
Germany	1.5	1.7	1.3	1.3
France	1.2	1.1	1.2	1.2
Italy	0.6	0.9	0.5	0.6
Non-EMU	2.4	2.1	1.7	1.5
UK	2.2	2.0	1.5	1.3
Switzerland	0.8	1.4	1.6	1.4
Japan	1.2	1.0	1.1	0.8
Asia ex Japan	6.2	6.0	5.9	5.8
China	6.9	6.7	6.4	6.1
Central/Eastern Europe	0.2	1.0	2.3	2.9
Latin America	- 0.4	- 1.3	0.9	1.7
World	**3.4**	**3.1**	**3.4**	**3.5**

Inflation

	2015	2016f	2017f	2018f
US	0.1	1.3	2.3	2.5
Euro area	0.0	0.2	1.6	1.5
Germany	0.1	0.4	1.8	1.7
France	0.1	0.3	1.5	1.3
Italy	0.1	- 0.1	1.2	1.0
Non-EMU	0.1	0.7	2.6	2.7
UK	0.0	0.7	3.0	2.9
Switzerland	- 1.1	- 0.4	0.4	0.8
Japan	0.8	- 0.1	0.7	0.8
Asia ex Japan	2.4	2.7	2.8	3.1
China	1.4	2.1	2.5	2.3
Central/Eastern Europe	9.3	5.2	4.9	4.5
Latin America	6.2	6.2	4.4	3.9
World	**2.3**	**2.4**	**2.7**	**2.8**

Regional and w orld aggregates revised to 2015 IMF PPP w eights; Latin America Inflation excluding Agentina and Venezuela

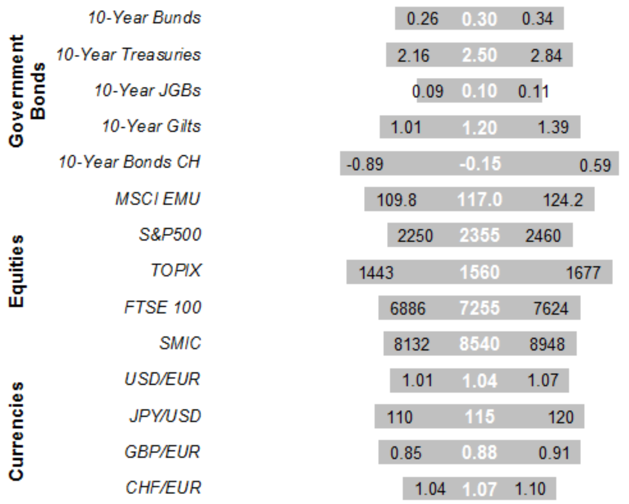
Financial Markets

3-M Money Market Rates	**27.02.17***	**3M**	**6M**	**12M**
USA	1.05	1.15	1.40	1.80
EUR	-0.35	-0.35	-0.35	-0.35
JPN	-0.03	0.00	0.00	0.00
UK	0.35	0.40	0.40	0.40
SWI	-0.73	-0.75	-0.75	-0.75
10-Year Bonds	**27.02.17***	**3M**	**6M**	**12M**
Treasuries	2.36	2.50	2.65	2.90
Bunds	0.21	0.30	0.45	0.60
BTPs	2.18	2.25	2.40	2.50
OATs	0.93	0.95	1.05	1.10
JGBs	0.06	0.10	0.10	0.15
Gilts	1.13	1.20	1.30	1.50
SWI	-0.21	-0.15	0.00	0.10
Spreads	**27.02.17***	**3M**	**6M**	**12M**
GIIPS	183	180	175	170
Covered Bonds	97	90	85	80

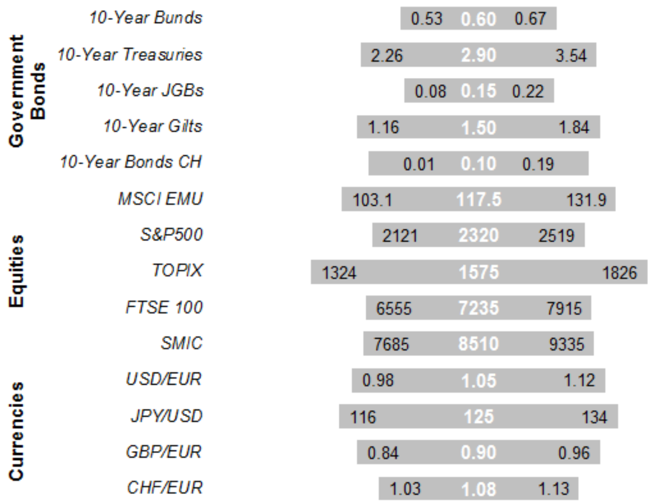
Corporate Bond Spreads	**27.02.17***	**3M**	**6M**	**12M**
IBOXX Non-Financial	148	145	140	145
IBOXX Sen-Financial	138	135	135	140
Forex	**27.02.17***	**3M**	**6M**	**12M**
USD/EUR	1.06	1.04	1.02	1.05
JPY/USD	112	115	119	125
JPY/EUR	119	120	121	131
USD/GBP	1.25	1.18	1.15	1.17
GBP/EUR	0.85	0.88	0.89	0.90
CHF/EUR	1.07	1.07	1.08	1.08
Equities	**27.02.17***	**3M**	**6M**	**12M**
S&P500	2367	2355	2350	2320
MSCI EMU	116.3	117.0	117.5	117.5
TOPIX	1547	1560	1570	1575
FTSE	7256	7255	7290	7235
SMI	8539	8540	8580	8510

*average of last three trading days

3-Months Horizon



12-Months Horizon



*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, exponentially weighted. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

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