GENERALI INVESTMENTS

# Market Perspectives

June 2017

# Content

# Global View

**Thomas Hempell**

- **European risky assets benefitted in May from the victory of Emmanuel Macron in the French presidential elections, even though uncertainties about US politics kept a lid on equities and yields.**
- **We anticipate the solid macroeconomic momentum to keep the Fed on its course of normalizing monetary policy, rendering moderate pressures on global yields.**
- **Stretched valuations, especially on US stock markets, and political events have increased the risk of temporary setbacks on financial markets.**
- **While still preferring European risky over so-called safe haven assets, we thus favor a somewhat more prudent allocation stance than last month.**

Global financial markets took some further relief after the pro-European and reform-minded Emmanuel Macron prevailed in the French presidential elections on May 7. At the same time, however, uncertainties about the reform agenda in the US have triggered a further reversion of the so-called 'Trump trade'. Yields on US Treasuries and Bunds decreased marginally on balance over the course of May. Spreads on Italian sovereign debt declined, while global equities advanced somewhat further, with the MSCI EMU up by 1% at the time of writing. The euro continued to strengthen markedly against the US dollar to levels above 1.10 USD/EUR.

| | Growth | | | Inflation | | |
|---|---|---|---|---|---|---|
| | **2016e** | **2017f** | **2018f** | **2016f** | **2017f** | **2018f** |
| **US** | 1.6 | 2.2 | 2.3 | 1.3 | 2.3 | 2.4 |
| **Euro area** | 1.7 | 1.7 | 1.4 | 0.2 | 1.6 | 1.5 |
| **China** | 6.7 | 6.6 | 6.3 | 2.0 | 2.1 | 2.3 |
| **World** | 3.0 | 3.3 | 3.4 | 2.3 | 2.7 | 2.8 |
| f= forecast | | | | | | |

While the victory of Macron in the second round of the elections did not come as a major surprise, it still helped to further soothe market concerns about the stability of the euro area. Depending on the outcome of the French parliamentary elections on June 11/18, it may even spark optimism about economic reforms in France and new Franco/German initiatives at the EU level. At the same time, however, early elections in Italy this year still remain a possibility. If political parties achieve to agree on a new electoral law, elections in autumn may end in a neck-and-neck race between Eurosceptic and pro-European forces, heralding a period of political uncertainties in the euro area's third largest economy.

Deeper political uncertainties currently emanate from the US. With members of Mr. Trump's team under investigation on undisclosed links to the Russian government, the US president may struggle even harder to deliver on his economic reform proposals, which include tax cuts and infrastructure spending to boost growth.

On the positive side, however, the global macroeconomic momentum is likely to remain solid. In the euro area, there is mounting evidence that a recovering labor market and a pick-up in investment spending will help to sustain the current decent economic expansion. And in the US, where economic data recently disappointed, we expect growth rates to recover over the coming months, underpinned by solid consumption and firming investment intentions by firms. There is also evidence that – despite the fears about rising protectionist measures – global trade is providing tailwinds to the global macro backdrop.

| **Bonds** | **29.05.17*** | **3M** | **6M** | **12M** |
|---|---|---|---|---|
| 10-Year Treasuries | 2.25 | 2.40 | 2.55 | 2.75 |
| 10-Year Bunds | 0.33 | 0.45 | 0.60 | 0.70 |
| **Corporate Bonds** | | | | |
| IBOXX Corp. Non Fin | 134 | 130 | 130 | 140 |
| IBOXX Corp. Sen. Fin | 120 | 120 | 125 | 130 |
| **Forex** | | | | |
| USD/EUR | 1.12 | 1.10 | 1.11 | 1.12 |
| JPY/USD | 111 | 114 | 117 | 120 |
| **Equities** | | | | |
| S&P500 | 2416 | 2405 | 2415 | 2405 |
| MSCI EMU | 126.4 | 127.5 | 128.0 | 129.0 |
| * avg. of last three trading days | | | | |

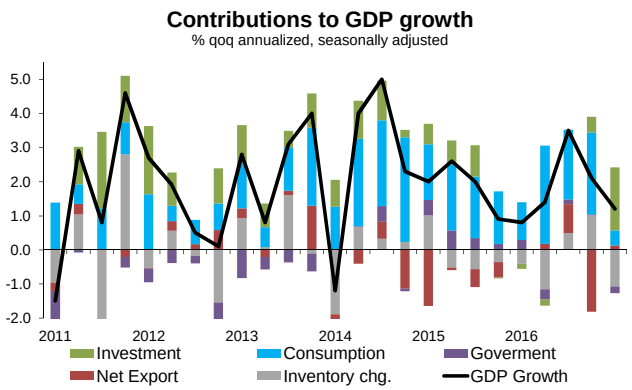
In this environment, we continue to expect the Federal Reserve to pursue its goal of a very gradual policy normalization over the course of the next months, with a next rate hike likely in June. The ECB may also convey a slightly more hawkish message with the due update of its macroeconomic projections in June.

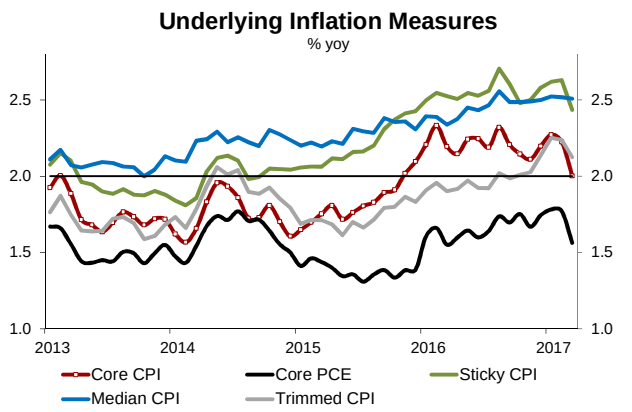
This means that two key sources of upside pressures on yields (solid macroeconomic momentum and the outlook of less accommodative monetary policies, especially by the Fed) will continue to set the tone on financial markets. This is why we still favor a below-benchmark exposure to low-yielding core government bonds like Bunds and Treasuries. That said, following the rally in equities by 9% (MSCI World) year-to-date, valuations look stretched in parts of the market, especially in the US. And, given the persistent disturbances from the political side, the risk of temporary setbacks on financial markets has increased.

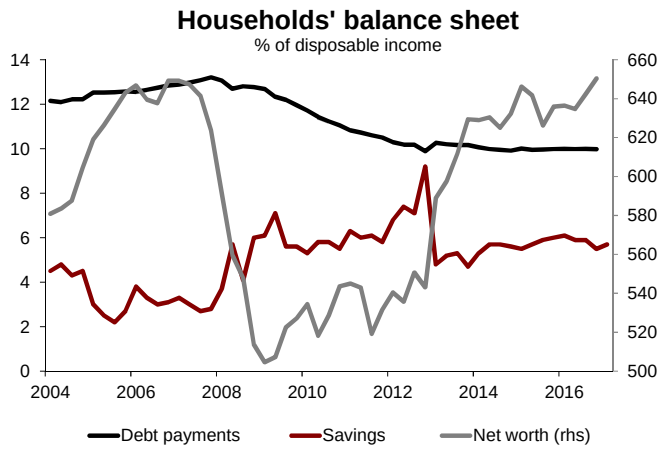
We still expect risky assets – especially in Europe – to continue to outperform so-called safe haven assets. However, given the mentioned risks, we favor a somewhat more prudent exposure than over the past four weeks.

# USA

**Paolo Zanghieri**




- **Steady consumption and a pick up in investment will lead GDP to increase by 2.2% this year. A smaller than expected fiscal boost will underpin slightly stronger growth next year.**
- **Job creation and wage growth continue. Despite some volatility, underlying inflation is set to remain above 2%.**
- **The minutes of the May FOMC meeting provided first details on the balance sheet reduction. We continue to expect two 25 bps rate hikes in June and December.**

GDP growth in Q1 slowed to 1.2% qoq annualized. This was mostly due to one-off factors, especially warm weather cutting utilities consumption and an overdue correction in auto sales after several quarters of strong growth, amid rapidly falling credit quality. Economic fundamentals, first of all those of the labor market, remain consistent with rather strong growth, given the late stage of the business cycle: we expect GDP to increase by 2.2% for the year as a whole. The increasingly confused domestic political outlook has drastically reduced the possibility of far-reaching tax reforms. We expect some cuts in personal and corporate tax to provide support in 2018, but political uncertainty has tilted the growth risk balance to the downside.

Temporary factors (most importantly a very large drop in the price of wireless communication) were responsible for the weakening in core inflation seen in March and April. However, given the ongoing tightening of the labor market, we stick to our outlook of gradually strengthening inflationary pressures. Headline inflation will average 2.3% this year and 2.4% in 2018.

## Labor market to drive growth and inflation

After the weather-related lull in March, job growth recovered in April, with 211k jobs being added to the economy. Solid employment growth sustains consumer confidence, with the University of Michigan index remaining near the 10 year high. Sentiment will help labor income in sustaining consumption, expected to rebound from the temporary Q1 setback. In April hourly earnings went up by just 2.5% yoy, but median wages, which better account for employees' purchasing power were up 3.5% yoy, in line with the performance observed since the beginning of last year. The steady increase in house prices and, despite some recent volatility, equities have pushed net worth as share of income to pre crisis high, allowing for a positive wealth effect on consumption. On the contrary we do not expect the savings rate to slide back to the low pre crisis level as precautionary savings seems to have structurally increased. Household finances should be resilient to the expected smooth increase in interest rates, as deleveraging has markedly reduced the share of income devoted to debt servicing.

# USA

## Expectations on fiscal boost cool

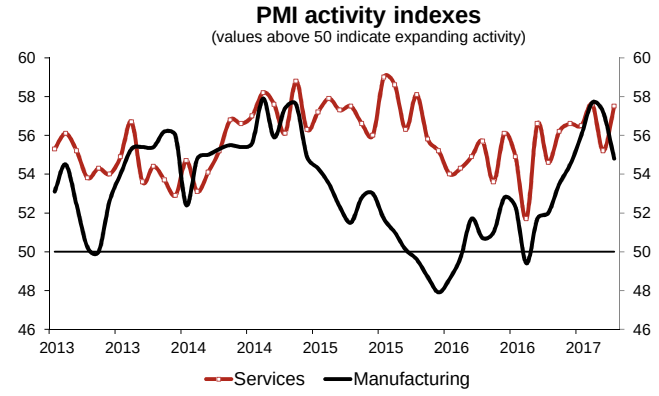
Q1 data showed the much awaited turnaround in non-residential investment (with private fixed investment up by 11.3%, after 0.9% in Q4 2016) and we project capex to continue to strengthen. Despite mildly disappointing Q1 data, profits continue to grow in annual terms, even though the ongoing surge in unit labor costs (+2.8% yoy in Q1) may moderate profit growth going forward. Moreover, Q1 data on lending standards and financial conditions signal an overall good outlook for external financing. The recent weakening in the manufacturing PMI and other sentiment indexes constitute a downside risk to the outlook for investment. However, we tend to consider it to a large extent a revision of the very upbeat expectations on the fiscal and regulatory policies which drove the surge in sentiment after the election.

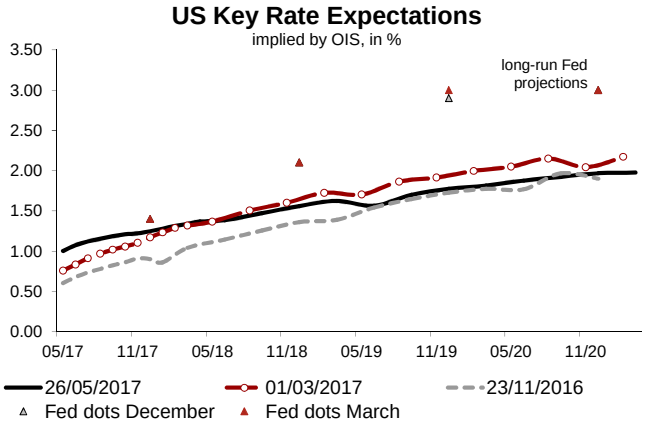
Politics constitutes the biggest downside risk to our growth outlook. The mounting difficulties the Trump administration is facing (from the alleged links with the Russian government to the problems in filling top positions, also in the Treasury), and the apparent lack of a clear economic policy agenda weigh on the likelihood of implementation of the fiscal plan outlined in the campaign. Yet, given the risk that the fall in Trump's popularity may harm the Republican party in next year election, lawmakers are compelled to deliver some stimulus. For this reason we still expect a small (no more than 0.5% of GDP) boost from lower income tax, to become effective no earlier than at the beginning of 2018.

## The Fed sketches balance sheet reduction

The minutes of the May FOMC meeting acknowledged the temporary nature of the soft Q1 data. This led to basically no change in the outlook for employment, growth and inflation, and therefore the path of monetary policy normalization, entailing two more hikes this year, was confirmed. We expect interest rates to be raised during the June and December meetings.

The most important information contained in the minutes were the first details of the plan to start reducing the Fed's balance sheet. Starting from the last months of this year, the FOMC would announce a series of gradually increasing limits to the amount of Treasuries and MBS that would be run off each month. Only the amounts exceeding this cap would be reinvested. As a consequence, the increase of the caps would lead to a gradually larger reduction in the Fed's securities holding. The initial level of the cap would be set at "low levels" and increased every three month. Once the desired level is reached, it will be kept until the full normalization of the balance sheet. No quantitative estimates of the size and speed of the reduction have been provided. The details of the plan will be discussed in the June meeting and a formal announcement may be provided at the September meeting in our view.



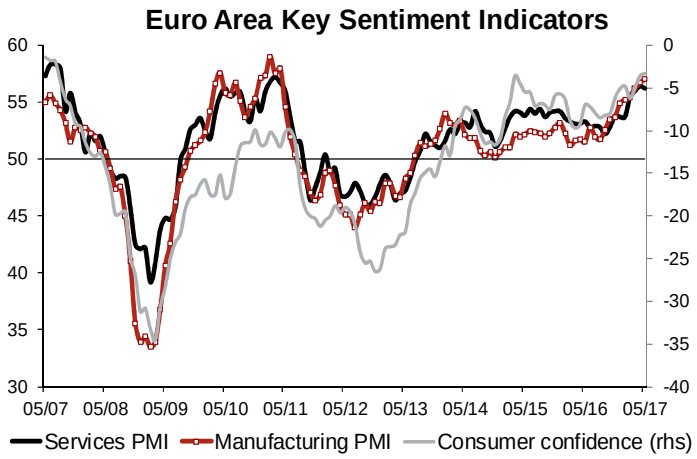



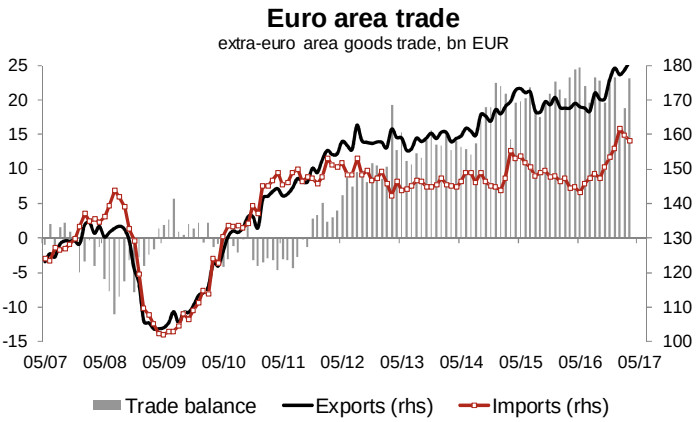

| Main Forecasts[1)] | 2015 | 2016 | 2017f | 2018f |
|---|---|---|---|---|
| **GDP** | 2.6 | 1.6 | 2.2 | 2.3 |
| Consumer spending | 3.1 | 2.8 | 2.3 | 2.4 |
| Gov. consumption | 0.7 | 0.9 | 0.8 | 0.5 |
| Investment | 5.4 | 1.8 | 4.9 | 4.6 |
| - residential inv. | 8.9 | 7.8 | 5.1 | 4.2 |
| - structures | -1.5 | -2.3 | 4.2 | 3.8 |
| - intell. property production | 5.7 | 1.9 | 4.2 | 5.4 |
| - equipment/software | 3.1 | 0.4 | 5.5 | 4.6 |
| Inventories | 0.4 | -0.3 | -0.2 | -0.2 |
| **Exports** | 1.1 | 2.7 | 4.1 | 3.6 |
| **Imports** | 4.9 | 4.2 | 5.2 | 5.4 |
| Net trade | -0.6 | -0.3 | -0.3 | -0.3 |
| Domestic demand | 3.2 | 2.3 | 2.5 | 2.4 |
| **Consumer prices** | 0.1 | 1.3 | 2.3 | 2.4 |
| **Unemployment rate[2)]** | 5.3 | 4.8 | 4.5 | 4.4 |
| **Budget balance[3)]** | -2.5 | -2.9 | -3.3 | -4.4 |
| **Fed Funds Rate[4)]** | 0.38 | 0.63 | 1.38 | 2.13 |

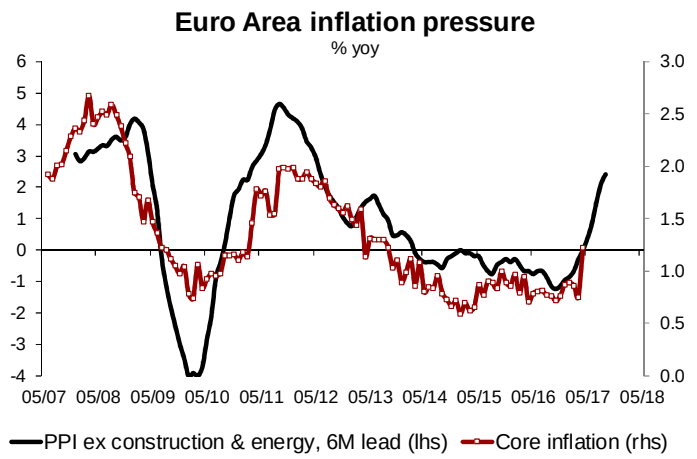
1) Unless noted otherwise, annual % changes, net trade and inventories: growth contribution to GDP 2) yearly average as %, 3) in terms of GDP, federal deficit 4) as %; year-end

# Euro Area

**Martin Wolburg**




- **The May flash composite PMI stayed at the 6-year high marked in April, suggesting unabated growth in Q2.**
- **With Macron having become France's new President, the Frexit risk is off the table. Polls suggest that his reformist party could get an absolute majority in the June legislative election.**
- **We expect the ECB to become less dovish and to start shifting its focus on tapering at the meeting on June 8.**

In May, sentiment remained at the six-year high marked the months before as the composite flash PMI rested at 56.8. It was the improvement of the external environment that kept sentiment at record-high levels. The PMI of the more export oriented manufacturing sector advanced further (to 57.0 from 56.7) whereas sentiment in the more domestically oriented service sector receded slightly (to 56.2, from 56.4). Also, forward-looking components like business expectations and new export orders improved and employment creations strengthened further according to the survey. Moreover, flash consumer confidence further improved in May.

All this bodes well for the euro area outlook. The release of the euro area flash GDP for Q1/2017 showed a growth rate of 0.5% qoq. Taking into account that sentiment indicators as of late overestimated actual growth they hint at unabated activity in Q2.

## France: From Frexit concerns to higher growth?

With Emmanuel Macron having become France's President, the risk of a Frexit is now off the table. This reduces uncertainty concerning EMU and hence impacts positively on sentiment. However, regarding France the focus has now shifted to the parliamentary election to be held in June (June 11 and June 18) and the question whether the new president will be able to form a reformist government. A new government has already been formed, encompassing also members from other parties. That said, according to latest polls Macron's party (named La République en Marche) will even be able to secure between 310 and 330 out of 577 seats in the national assembly, an absolute majority. If this becomes true, he will have the power to go ahead with reforms.

Looking ahead, Macron announced to start with a labor market reform. Key aims are to bring the decision making to the firm level, to introduce upper limits for severance payments and to simplify procedures. As resistance is likely to be strong, the ability to push through a labor market reform will be viewed as a litmus test for the government to engineer change. In case of a positive outcome the potential growth rate (of currently 1.2%) for France, and hence also for the euro area as a whole, will be raised.

# Euro Area

## Euro area growth momentum will be hard to maintain

While we continue to expect strong activity in the further course of the year, we deem it unlikely that the current growth momentum can be maintained. A key factor is the dampening effect of inflation on consumption activity. With inflation likely hovering around 1.5% in H2, real wages in the euro area will broadly stagnate (compensation per employee at 1.6% yoy in Q4/2016) as there are no signs of an acceleration in wage increases on the euro area level yet. Moreover, the savings rate has already come down to the all time low of 11.9% in Q4/2016, limiting the leeway for a further reduction. Therefore, inflation will increasingly start to bite and will leave employment expansion the only support for consumption activity. Moreover, with the start of the Brexit negotiations and weaker growth in the UK, activity will also be dampened.

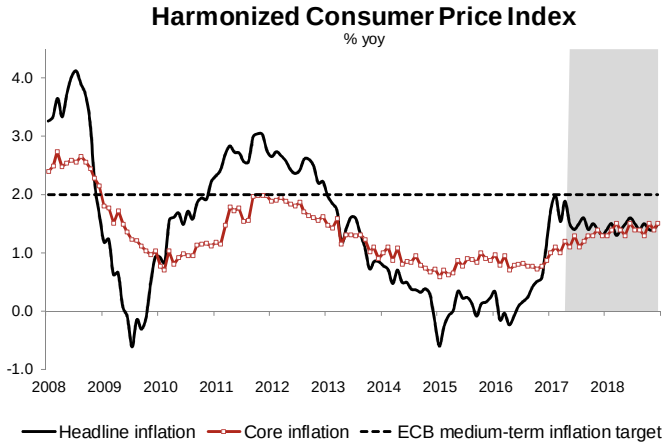
That said, due to the strong Q1 growth and the likely equally strong Q2, we have raised our 2017 growth outlook to 1.7% (from 1.6%) while we left our 2018 growth expectation unchanged at 1.4%.

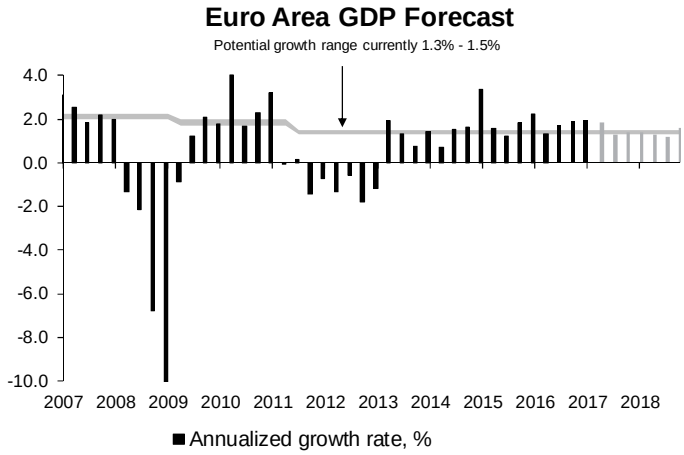
## ECB likely to adopt a less dovish tone at June meeting

Last month's dataflow stimulated the discussion about the ECB policy outlook. While business sentiment stayed at a multi-year high, there is indication for underlying inflation to also mount. In May, the flash core inflation reading was at 1.0% yoy, in line with the average of the first five months of the year. Looking ahead, with March core producer price (+2.4% yoy) and import price (+2.9% yoy) inflation having gained momentum, an increase in underlying inflation is in the cards. This is also in line with the message of higher output prices provided by the latest PMI survey. Also, monetary indicators like private loans (+2.4% yoy in April) send the same message. That said, the output gap is still negative (at -0.7% according to the European Commission) and the unemployment rate of currently 9.3% is still above the calculated equilibrium (NAIRU) level of presently 8.9% suggesting ongoing slack in the economy and arguing for a more gradual rise in underlying inflation.

While the latest macro data are broadly consistent with the ECB's macro scenario, we deem an upward revision of the 2017 core inflation outlook of currently 1.1% at the June meeting likely. We also expect a less dovish message from the next meeting on June 8. The downward tilt in the assessment of economic risks could be removed and the easing bias be dropped. That said, we continue to expect the ECB to fully implement its QE program and keep on expecting a repo rate hike not before the end of QE which we currently foresee not before 2019.

In our view, the June meeting will mark the starting point for the exit from the exceptional monetary policy stance. The expected tapering path will increasingly come into the focus and impact financial markets more meaningfully.



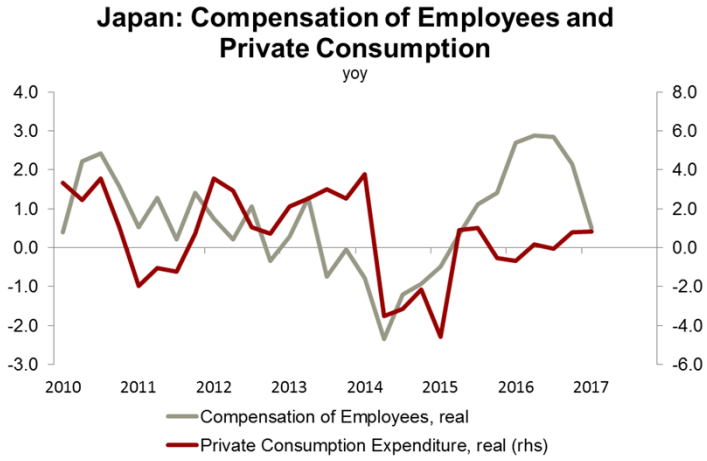



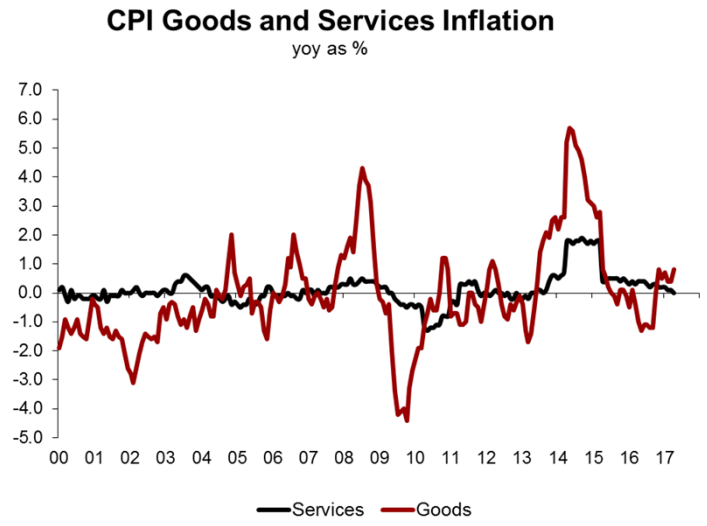

| Main Forecasts[1)] | 2015 | 2016 | 2017f | 2018f |
|---|---|---|---|---|
| **GDP** | 1.9 | 1.7 | 1.7 | 1.4 |
| Consumer spending | 1.8 | 1.9 | 1.4 | 1.1 |
| Gov. consumption | 1.3 | 1.8 | 1.2 | 1.0 |
| Total fixed investment | 3.0 | 3.5 | 4.6 | 1.8 |
| Inventories | -0.1 | 0.0 | 0.3 | 0.1 |
| Net trade | 0.2 | -0.3 | -0.5 | 0.1 |
| Domestic demand | 1.9 | 2.1 | 2.0 | 1.2 |
| **Consumer prices** | 0.0 | 0.2 | 1.6 | 1.5 |
| **Unemployment rate[2)]** | 10.9 | 10.0 | 9.5 | 9.3 |
| **Budget balance[3)]** | -2.1 | -1.7 | -1.5 | -1.5 |
| **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 | 2016 | 2017f | 2018f |
|---|---|---|---|---|
| GDP | 1.2 | 1.0 | 1.4 | 1.0 |
| Consumer spending | -0.4 | 0.4 | 0.9 | 0.8 |
| Government consumption | 1.6 | 1.5 | 0.4 | 0.8 |
| Investment | 0.1 | 1.0 | 2.0 | 2.0 |
| Inventories | 0.4 | -0.1 | 0.1 | 0.0 |
| Net trade | 0.4 | 0.1 | 0.3 | 0.1 |
| Domestic demand | 0.7 | 1.0 | 0.9 | 0.8 |
| Consumer prices | 0.8 | -0.1 | 0.5 | 0.8 |
| Unemployment rate[2)] | 3.4 | 3.1 | 2.8 | 2.7 |
| Budget balance[3)] | -3.5 | -4.3 | -3.9 | -3.3 |

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 GDP growth accelerated in Q1 to 2.2% qoq annualized, benefitting from global growth and less suppressed consumer demand.**
- **Currently, headline inflation has risen due to the energy component while underlying inflation remained negative. This suggests the BoJ to stick to its current policy.**

According to the first estimate, Japan's GDP advanced by 2.2% qoq annualized in Q1, accelerating markedly from the 1.4% qoq ann in the quarter before. The most important driver was exports while private consumption ceased to be an outright drag. Exports rose by 8.9% qoq ann, already decelerating from the quarter before, whereas import growth was broadly unchanged. Accordingly, net exports contributed by about 0.5 pp to growth, lower than in the previous two quarters, but still signaling that Japan managed to participate strongly in the upturn of the global production cycle. However, in March and April, exports fell in month-on-month terms while imports continued to rise. Thus, we expect Japan's export momentum and consequently the contribution to growth to continue to soften further in Q2. Moreover, the export upturn failed so far to induce a meaningful recovery in capex as business investment growth fell back to 0.9% qoq ann in Q1. Nevertheless, the last BoJ Tankan survey and also latest data from the monthly Reuters Tankan show a relatively high level of business confidence, so that we still expect investments to slightly improve. Finally, private consumption recovered to 1.4% qoq ann, after an especially weak result of 0.2% qoq ann in Q4. Apart from the seniority pay increase, the basic wage hike in Japan eased compared to last year. Major firms offered only 0.3%. Thus, from the wage side, an acceleration of private consumption seems unlikely as the recent gap between real compensation and consumption unfortunately closed from the income side. This all suggests that Japan's growth rate in Q2 is likely to soften again compared to the strong result in Q1.

### Underlying inflation to stay low

Soft private consumption and low wage increases also render the BoJ's inflation target hard to achieve. In April, headline inflation increased to 0.4% yoy, after 0.2% yoy in the month before. However, the upturn was mainly driven by energy prices which advanced by 4.5% yoy. This was also visible in goods price inflation, rising to 0.8% yoy amid a spike in petroleum products of 12.8% yoy. By contrast, service prices – indicating domestic demand largely independent from energy and exchange rate developments – were flat over the year. Moreover, inflation excluding food and energy continued to decrease by 0.3% yoy. In any case, the BoJ is still far away from its inflation target. Accordingly, we do not expect any change in its yield targets for the time being, except in case of strongly rising international yields.

# China

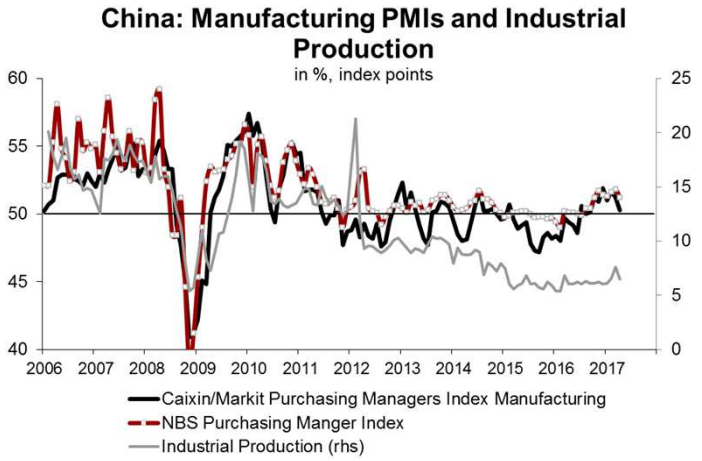
**Christoph Siepmann**

- **After a strong Q1, China's growth softened at the start of Q2.**
- **The government reduced its fiscal policy support and the banking regulator tried to cut into risky financial leverage.**
- **However, in a year of leadership reshuffle we do not expect Beijing to risk a stronger cooling.**

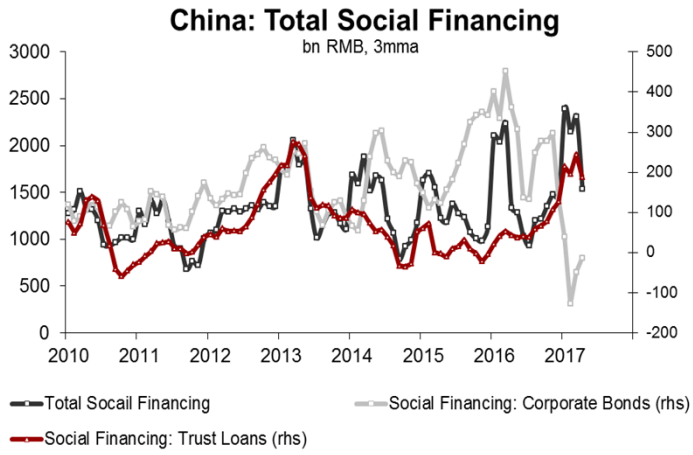
After China's economy had a good start into the year with a growth rate of 6.9% yoy in Q1 (but an already weaker qoq rate), data from the first month of Q2 showed some softening. Both manufacturing PMIs receded in April, with the Caixin version dropping back into only slightly expansionary territory with a level of 50.3. Accordingly, industrial production growth returned to 6.5% yoy, after 7.6% yoy in March. However, this level was much more in line with readings since the beginning of the year and does not by itself suggest any major cooling. Similarly, urban fixed investment weakened by 0.3 pp to 8.9% yoy ytd, the same level as of February. Investment growth in mining remained strongly negative in accordance with the overcapacities in the sector. However, PPI inflation, which brought about some relief to coal and steel producers, continued to recede to 6.4% yoy, signaling that it definitely peaked two months ago. Government support to investments showed a mixed approach. While infrastructure outlays even increased, regular central government projects saw a further decline and local projects moved sideways. By contrast, investment in the real estate sector continued to move up. However, property sales especially of residential buildings cooled more strongly in April, showing that tightening measures at local levels are starting to bite. Therefore, we expect real estate investment growth also to weaken over summer. Finally, export growth also dropped back from the very strong levels seen in March.

**Government likely to stick to its 6.5% growth pledge**

All in, April data suggest that growth in China will "normalize" in Q2, back from the very strong readings in Q1. Apart from infrastructure, this is due to the government which has scaled back its support and less leeway from exports. However, given that China faces a large leadership reshuffle in autumn and communicated at least 6.5% growth at the NPC meeting, we expect the government to continue to manage its support according to the cyclical needs. This is most likely also true for monetary policy. However, against the background of the high credit-to-GDP ratio of about 230%, the high debt of SOEs and the strong rise in more risky components of Total Social Financing, the BPoC seized the opportunity of high growth in Q1 by already tightening its liquidity and marginally raising short-term interest rates. In addition, China's banking regulator issued no less than seven policy directives since end-March to cut into financial leverage, which seems starting to have an effect. Nevertheless, we do not expect Chinese authorities to really risk a downturn of the economy.

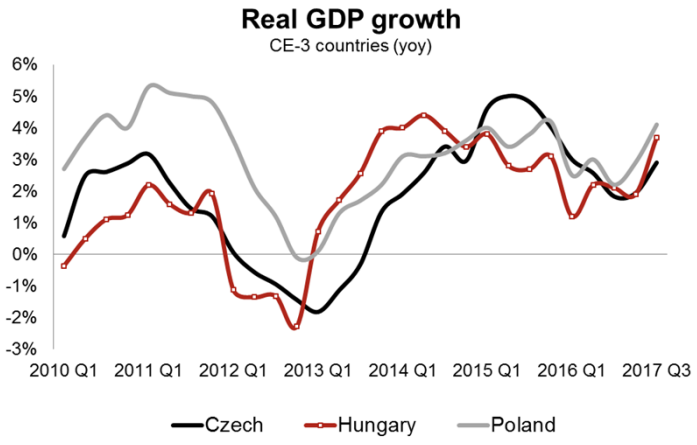






# Central and Eastern Europe

**Radomír Jáč**





| Main Forecasts | 2015 | 2016 | 2017f | 2018f |
|---|---|---|---|---|
| **Czech Republic** | | | | |
| GDP | 4.6 | 2.3 | 2.5 | 2.7 |
| Consumer prices | 0.3 | 0.7 | 2.2 | 2.0 |
| Central bank's key rate | 0.05 | 0.05 | 0.05 | 0.50 |
| **Hungary** | | | | |
| GDP | 3.1 | 1.8 | 3.6 | 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 | 3.3 | 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

- **Strong Q1 GDP growth may have overstated the actual momentum, but the outlook is positive.**
- **Headline inflation moderated at start of Q2 thanks to commodity prices, while core inflation mostly increased as a response to growing demand.**
- **Hungary and Poland aim to keep stable monetary conditions. Czech CNB's forecast points at a Q3 rate hike but the its board indicates a later action.**

Regional economies had strong start into 2017, with GDP growth of 1% qoq or even more in Q1. Besides more durable factors (household consumption supported by positive developments in the labor markets, exports benefiting from the good economic situation of major trade partners), the Q1 GDP performance was very likely also supported by an irregular seasonality (timing of Easter). The irregularities led to a significantly higher number of working days in 1Q. These factors will act in an opposite (i.e., negative) direction in 2Q and GDP growth may thus moderate in the current quarter. That said, the outlook for the whole 2017 is positive, as the aforementioned factors should be accompanied also by a fiscal impulse, including the recovery in public investment, co-funded by the EU.

Following the increase seen in the first months of 2017, headline inflation started to moderate in spring, as the pro-inflationary base effect of food and oil prices is fading out. Such a development was expected and commodity prices may act against an increase in inflation also in the coming months. Core inflation at the same time maintains the trend towards a gradual increase, which is a reflection of the growing demand in the respective economies, of the growing capacity utilization and also of specific factors in some cases (tax-related measures in the Czech Republic with a temporary impact on core CPI).

## Czech monetary policy remains in the spotlight

While Czech headline CPI is likely to return above the 2% inflation target in the coming months (it stood exactly at 2.0% yoy in April), inflation is likely to remain below the target set at 3% in Hungary and 2.5% in Poland. Both, the Hungarian and Polish central banks therefore do not see a need to tighten their monetary policy (Hungarian MNB is actually ready to further adjust its liquidity management tools in order to maintain monetary conditions at their current loosened level).

The Czech central bank published fresh quarterly forecast in early May. The forecast assumes a monetary tightening via an interest rate hike in Q3. However, CNB officials indicate that tightening may start later in order to avoid the risk of acting prematurely. It seems the CNB board wants to see Q3 data before any move towards tightening. We think that CPI may come slightly below the CNB forecast in H2, as was the case already in April, and that it may test the sub-2% area in late 2017. We thus expect the CNB rate hikes only in 2018.

# Bonds/Fixed Income Strategy

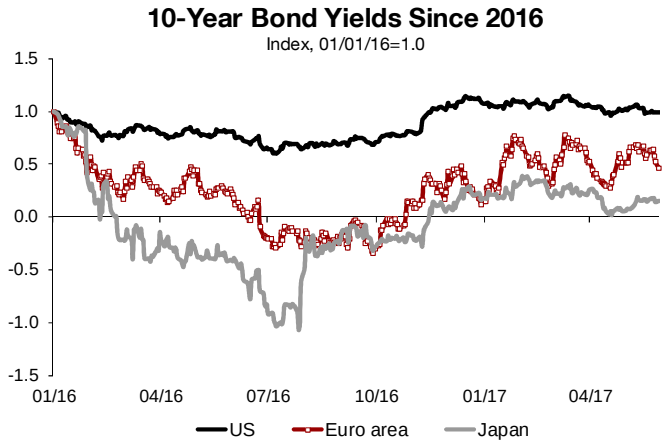
**Florian Späte**

- **International bond markets kept on looking for a direction in May. Initially, the French election triggered somewhat higher yields, but concerns about the US outlook pressed core yields lower again.**
- **While Southern European bond spreads performed well most of the month, speculations about snap elections in Italy already in 2017 led spreads wider again.**
- **Going forward, the way is paved for higher bond yields. The weakness of the US economy is expected to be temporary and central banks are expected to stay on course for a gradual withdrawal of policy accommodation. Accordingly, we recommend a short duration for euro area core and peripheral government bonds.**

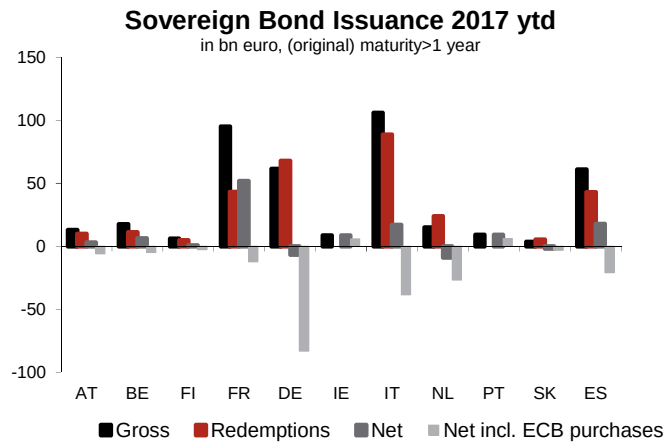
The trading ranges remained in place in May. Although the eventual election of Macron as new French president induced somewhat higher core bond yields in the first half of the month, the upward trend did not prevail. Concerns about the ability of the new US administration to deliver on the announced policy initiatives in combination with some disappointing US macroeconomic data, brought about a turn. Sovereign core yields on both sides of the Atlantic fell again. On balance, 10-year US Treasury yields fell by 3 bps to 2.25% and 10-year Bund yields moved largely sideways and finished the month at 0.33%. The difference is exclusively due to a stronger retreat of US inflation expectations. As 10-year euro area expectations fell marginally by 3 bps to 1.37%, the 10-year US inflation swap decreased another 12 bps to 2.11%. It is noteworthy that meanwhile long-dated US inflation expectations are back to the level of November 2016 (before the US election) and short-dated ones are even below the initial level. Overall, yield curves flattened moderately in May. 2-year US yields increased by 3 bps to 1.29% and the euro area counterparts rose from -0.73% to -0.71%.

## Central banks to pave the way to higher core yields

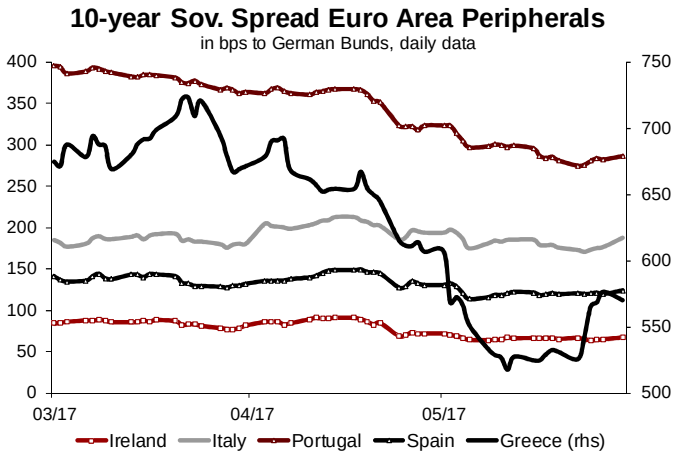
In the weeks to come, the news flow from the central banks is likely to have a significant impact on bond markets. Although the ECB is not expected to announce at this point in time already concrete measures, the central bank is forecast to shift to a less dovish statement (see for details in the euro area section). Therewith, expectations that the accommodative monetary policy will slowly be withdrawn in the course of 2018 will likely be confirmed. Moreover, the Fed will hike by another 25 bps on June 14. Given that financial markets price this step with a probability of 100%, it will not surprise market participants. However, we think that financial markets are too complacent regarding the future course of the US central bank. Until the end of 2017 no further hike is completely priced. This conflicts with the

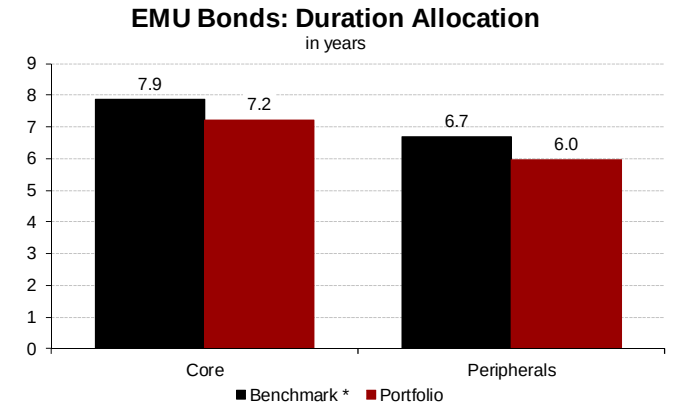




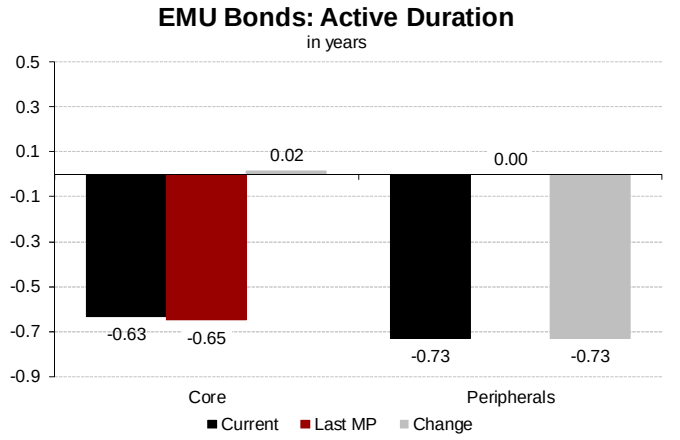


# Bonds/Fixed Income Strategy




* JPMorgan EMU Government Bond Index




Fed Dots and the GI forecast of one additional hike until the end of the year. Moreover, financial markets discount only three rate hikes until the end of 2018 (in contrast to five hikes according to the Fed Dots). Given that we regard the weak US growth in Q1 (1.2% qoq annual.) as a temporary blip, market participants are likely to be caught on the wrong foot. Hence, there is scope for core government bond yields to rise going forward. This applies above all to US yields as the ECB will confine to wording for the time being. In addition, the technical situation stands in the way of a strong increase in euro area core yields in the short term. European treasurers have placed already around 50% of the annual issuance volume and the redemption profile in the months to come supports euro area government bonds – particularly including the ongoing ECB purchases.

All in, government bond yields are seen to rise in the weeks to come – in the US somewhat more than in the euro area. The increase is expected to be more pronounced at the long end of the curve triggering a moderate re-steepening of international yield curves.

## Speculation about snap elections in Italy a burden

As expected, the election of Macron triggered a peripheral spread tightening initially. Moreover, Greece's preliminary agreement with the Institutions supported the positive market sentiment. Although the environment got a hit over the last days, on balance spreads tightened in May between 5 bps (Ireland) and 37 bps (Portugal).

The main reason for the dip over the last days is a possible snap election in Italy. While so far the market consensus was elections in 2018 (end of the legislative term), news regarding a reform of the voting system already before summer could trigger snap elections in autumn 2017. Although early elections are far from certain, press reports that the main parties agreed on the introduction of a proportional voting system with an entry voting threshold of 5% could pave the way to elections in September or October. According to current polls there is a non-negligible risk that anti-establishment parties could win the government. This is expected to keep markets on their toes for the time being and stands in the way of a spread re-tightening (despite the ECB's QE).

## Our portfolios

Given the expected environment, a short duration is recommended for both euro area core (-0.63 years) and peripheral (-0.73 years) bonds on a three month horizon. While this is basically a confirmation of our cautious stance for core bonds, we turn more pessimistic in the short run for Southern European bonds taking into account the good performance since mid of April and the risk of early elections ins Italy. The spread widening is unlikely to be balanced by the higher carry.

# Corporate Bonds (Non-Financials)

**Florian Späte**

- **Non-financial corporate bonds consolidated in May. Spreads moved basically sideways, but non-financials benefitted from the decreasing underlying yield.**
- **May was a month of two halves. Supported by the election of Macron and a positive rating trend non-financial spreads reached the lowest level since November 2016, only to widen again on the back of a strongly increased net issuance.**
- **Going forward, non-financial corporates have scope to perform decently. Further down the road, the likely tapering of ECB bond purchases is likely to trigger some spread widening.**

Non-financial Investment Grade corporate bonds had a good start into May. Supported by the election of Macron and a positive rating drift, non-financial spreads continued the tightening trend until the mid of May. At 129 bps spreads marked the lowest level since November 2016.

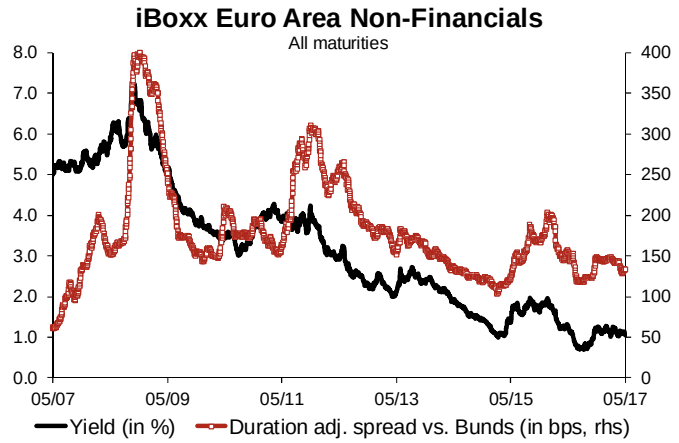
However, after being negative for four months in a row, the net issuance soared to almost €30 bn in May. Markets were not able to take this down without concessions. Consequently, spreads widened again and finished the month under review almost unchanged at 134 bps. Taking into account the drop in underlying yields, non-financials still achieved a decent total return in May.

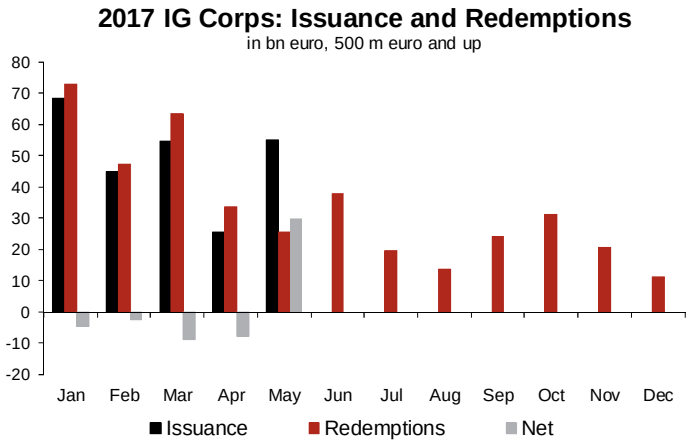
## Positive net issuance to remain a burden

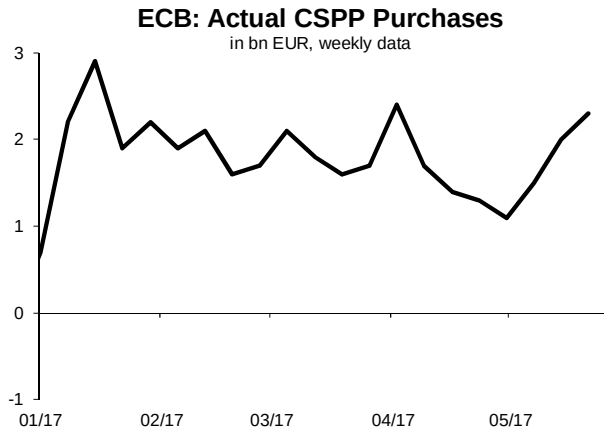
In the months to come, we expect net issuance to remain positive. Although the level is expected to come down, this will be a burden going forward. The positive net issuance hits a market which has to cope with reduced ECB purchases anyway. The decrease in ECB's QE volume from €80 bn to €60 bn in April was also noticeable on corporate bond markets. The average weekly purchases dropped to €1.7 bn – and the increase in the second half of May is probably the consequence of strong primary market activity and unlikely to be sustained.

Despite this burdening factors the overall picture is not gloomy. The macroeconomic background in the euro area is solid and is expected to remain firm. This helps the companies to preserve their balance sheets and to maintain their good fundamental situation. What is more, although ECB purchases will be lower than at the start of the year, the central bank remains an important demander and this will help to absorb the positive net issuance in the months to come. Finally, non-financials offer a higher carry than euro area sovereign bonds which is an important factor in a low yield environment.

Consequently, non-financial corporate spreads have some scope to tighten in the near term. With the tapering discussion to come to the fore again, however, spreads are forecast to widen, but most likely in an orderly way.

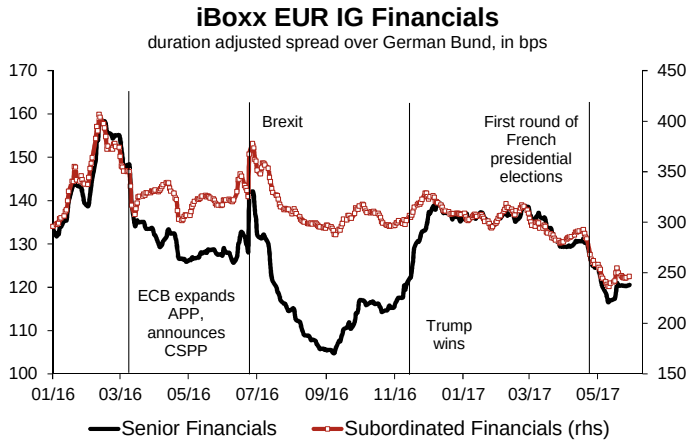


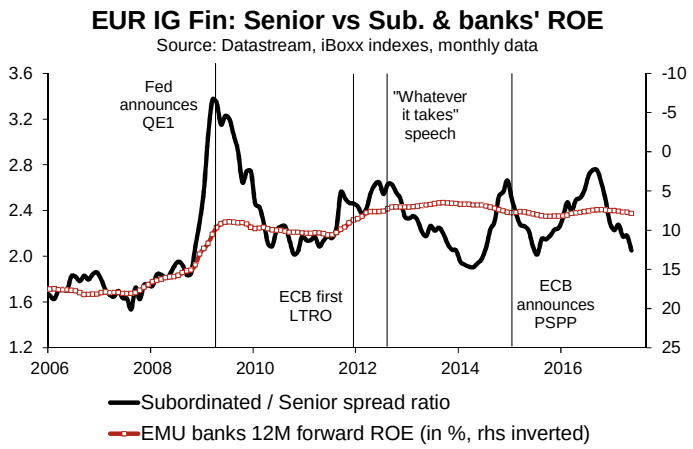



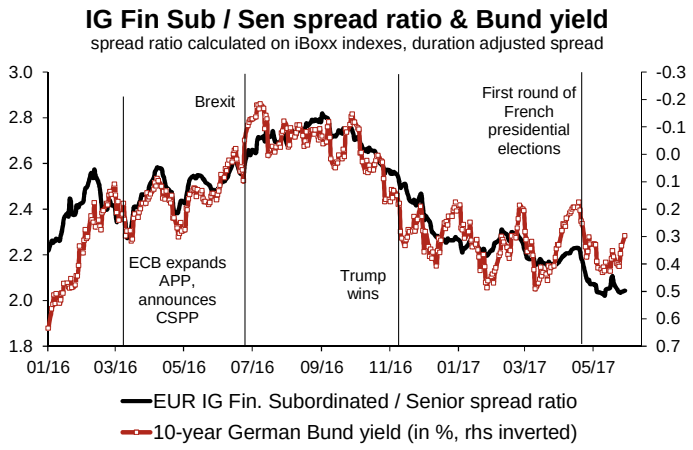



# Corporate Bonds (Financials)

**Luca Colussa**




- **EUR IG Senior financial bonds performed well in May on the back of lower core yields and a further moderate tightening in spreads. Subordinated bonds outperformed Senior ones.**
- **Senior financial bond spreads hit the lowest level since Nov 2016 after Macron's victory in the presidential run-off. They then widened slightly along with the increase in sovereign spreads.**
- **Going forward, we see limited scope for further spread tightening also due to the rising risk of snap elections in Italy. After the strong rally, we reduce the overweight on Subordinated bonds.**

EUR Investment Grade (IG) Senior Financial bonds marked the second monthly gain in a row thanks to the slight decline in the underlying Bund yields and the further tightening in spreads. The total return of the iBoxx index in May was +0.43%, which brings the year-to-date performance to +0.92%, marginally better compared to non-financial bonds (+0.84%).

Macron's victory in the French presidential run-off contributed to the reduction in risk premiums in the first part of May. The duration-adjusted spread over Bund fell 7 bps to 117 bps, the lowest level since November 2016. Later on, Senior Financial spreads reversed part of the tightening (up to 120 bps) along with the mild increase in sovereign risk premiums. French banks' bonds outperformed marginally in terms of spread tightening.

## Relative valuation of Sub. vs. Senior is less attractive

Subordinated financial bonds kept outperforming Senior notes in line with our expectations. The monthly total return was just shy of 1% also thanks to the 12 bps tightening in the duration-adjusted spread. The latter fell as low as 236 bps, the lowest level since early June 2015, before rising back to 246 bps.

After the strong year-to-date performance (+4.19%), we see the relative valuation of Subordinated vs Senior bonds as somewhat stretched. Firstly, the ratio between the two spreads is 0.7 standard deviations below the 10-year average, a discount not seen since July 2015. Secondly, the spread ratio stands below the long-run fair value implied by the banks' forward return on equity (ROE, see chart in the middle of the page). Thirdly, Subordinated bonds seem to be already discounting higher Bund yields (see bottom chart). We consequently recommend to reduce the overweight of Subordinated vs Senior Financial bonds and to adopt a neutral stance.

Looking to the asset class as a whole, the projected increase in core yields and the limited scope for further spread tightening – also due to the increased risk of early elections in Italy – will likely put a lid on the future total return performance.

# Currencies

**Thomas Hempell**

- **Relief about the French election outcome, solid economic data in the euro area and political trouble in the US have send the euro stronger over the past months.**
- **While the medium term outlook for the euro is solid, we would not be surprised to see the US dollar recovering some ground again temporarily given the gap with respect to yield differentials.**
- **Rising US yields are likely to keep the Japanese on a weakening trend.**

Over the course of the past month, the euro strengthened broadly, gaining 2.6% against the US dollar and 1.4% in trade-weighted terms, supported by the victory of Emmanuel Macron in the French presidential elections, strong economic data and a US dollar that was burdened by growing doubts about US President Trump's ability to deliver on his ambitious tax reform agenda. The Brazilian real stood out as a prime loser of the political scandal around President Temer that may jeopardize further progress on economic and fiscal reforms.

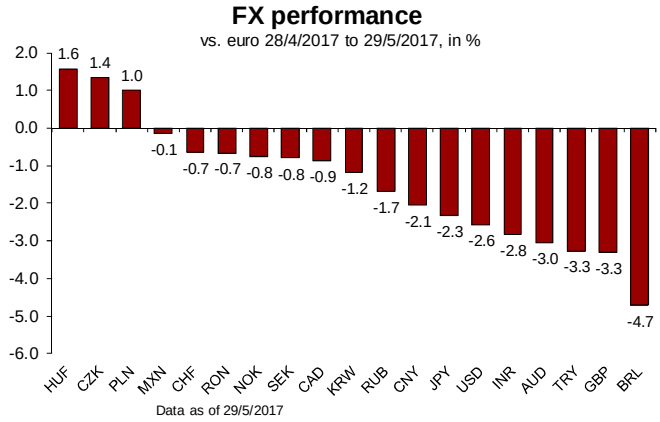
## Medium term outlook for euro remains solid

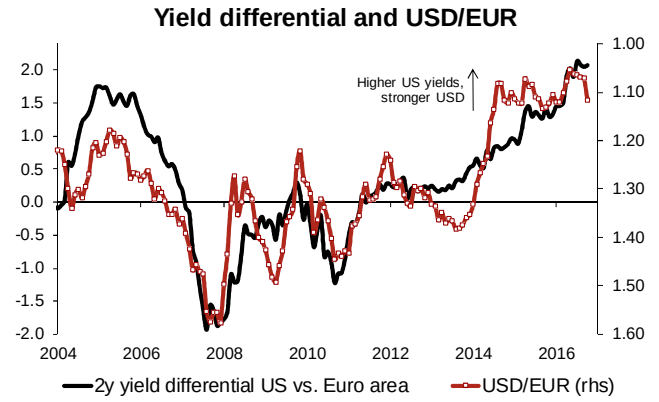
Looking ahead, we expect the euro to hold up well against the US dollar. Most importantly, the French elections have removed a key source of doubts about EMU stability, while giving way to some reform hopes in France and for the EU as a whole. Second, the economic momentum in the euro area remains very robust and will keep markets focused on the questions of when the ECB will acknowledge for this strength and hint at the tapering of its asset purchase program. Finally, on the US side, the recent revelations about Russian ties of the Trump team have created not only substantial political uncertainties, but have also increased the risks around a significant tax reform.

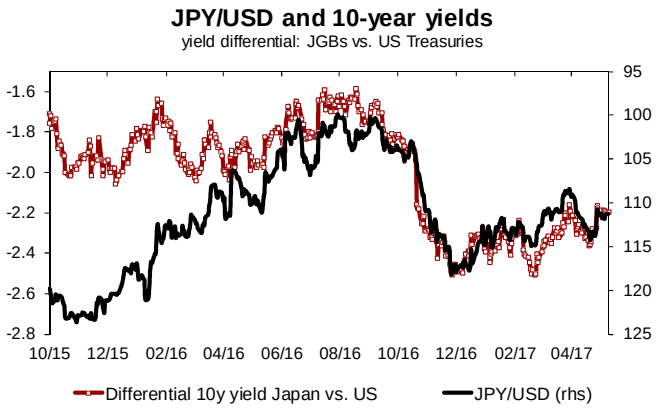
Near term, however, we caution against writing off the US dollar too soon. Compared to yields differentials, the US dollar looks cheap, and it is noteworthy that the dollar has pared all its gains of the so-called "Trump trade" since Nov. 8. Furthermore, markets continue to underestimate the Fed's willingness to proceed with its rate normalization. As a result, barring an outright escalation of political events in the US, we would not be surprised to see the US dollar paring some of its recent losses near term. Further out, however, the EUR/USD is likely to hold ground at levels above 1.10 USD/EUR on looming QE tapering in 2018.

## Yen remains tied to US yield outlook

The yen, meanwhile, continues to track the roller-coaster ride of yields in the US. Key reason is that, amid the continued yield curve control by the BoJ, any move in US Treasury yields translates into a respective change in the yield gap between the US and Japan. With the BoJ sticking to its policy for longer, this is unlikely to change. We anticipate US yields to ultimately rise again, which should also translate into a weaker JPY/USD exchange rate.

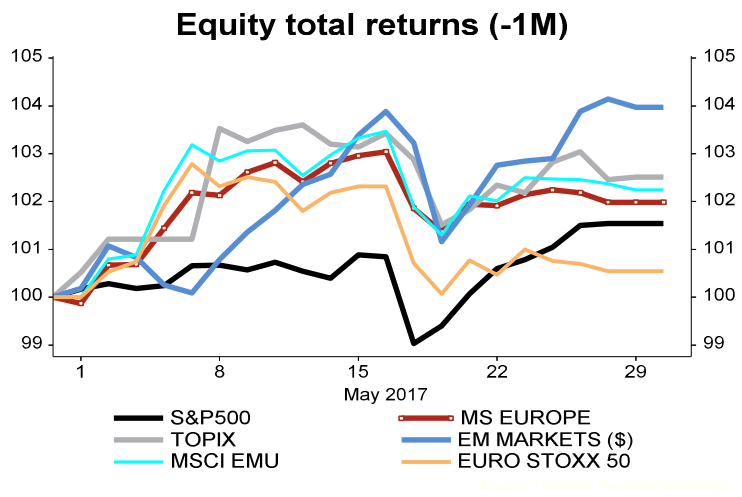


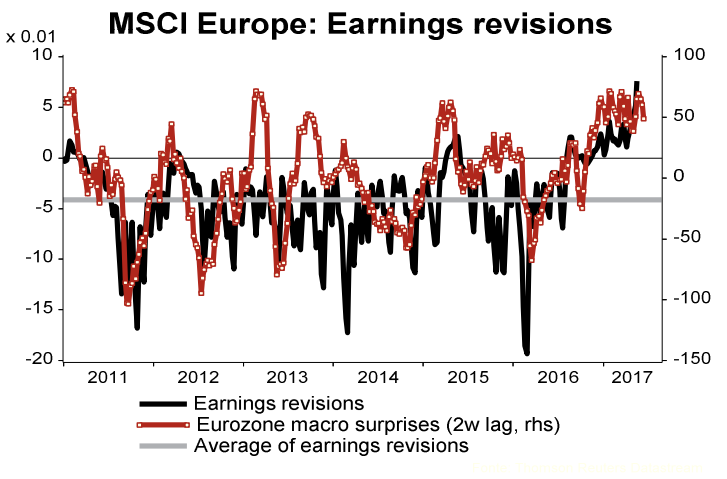



# Equities

Michele Morganti




**Analysis of the median stock: Q1 2017 reporting season**

| Median stock | Earnings Growth | | Sales Growth | | availability |
|---|---|---|---|---|---|
| | Q4 2016 | Q1 2017 | Q4 2016 | Q1 2017 | Q1 2017 |
| S&P | 8.53 % | 9.09 % | 4.47 % | 5.37 % | 91.4% |
| Stoxx | 6.84 % | 12.96 % | 4.78 % | 7.54 % | 94.1% |
| Euro Stoxx | 5.26 % | 12.50 % | 5.02 % | 7.67 % | 94.5% |
| Topix | 12.49 % | 20.08 % | 0.05 % | 3.06 % | 95.5% |

| Median stock | Earnings Surpr | | Sales Surpr | | availability |
|---|---|---|---|---|---|
| | Q4 2016 | Q1 2017 | Q4 2016 | Q1 2017 | Q1 2017 |
| S&P | 2.23 % | 4.40 % | 0.12 % | 0.94 % | 91.4% |
| Stoxx | 1.49 % | 5.51 % | 0.91 % | 1.73 % | 94.1% |
| Euro Stoxx | 1.42 % | 3.93 % | 0.82 % | 1.78 % | 94.5% |
| Topix | 13.86 % | 7.07 % | (0.69)% | 0.55 % | 95.5% |

- **Equities stayed upbeat due to benign macro data and the outstanding Q1 reporting season.**
- **Monetary policies are supportive in the euro area (EA) and in Japan. The second leg of the recovery should finally occur and yields should move up accordingly, favoring value and cyclical markets.**
- **That said, we are more cautious on equities, remaining constructive mid-term. PEs are not so far from cyclical highs and expensive in the US.**
- **We favor the EA and Japan over Switzerland and the US and are neutral on the UK and EMs. Inside Europe, we overweight discretionary, financials, TLC and media, while staying short staples.**

Equities have continued further their positive trend in May. The MSCI World index returned +1.5%, almost aligned to the S&P 500. The MSCI EMU and the Topix gained more (+2%) while EMs outperformed (+3.7%).

## Waiting for the second leg of the recovery

Last month we described the second leg of the current recovery. In particular, we see more chances for the corporate capex to increase in the next months. This in turn should lead to a continuing strengthening of the labor market and finally to higher wages and core inflation. The latter represents the ultimate target of the ECB and the BoJ. While it will take some time for inflation goals to be fully reached, in H2 we could already receive details concerning the timing and modalities to reduce the monetary stimulus. In the US, the cycle is more advanced, so that we will see further rate hikes and, possibly, an anticipated guidance over the reduction of the Fed's balance sheet. As for the EA, we can assume that the second leg of the recovery is finally plausible and reachable. Leading indicators linger at high levels, backed by supportive financial conditions and business confidence. Our EA economist sees macro surprises to stay tilted on the upside in the short term.

As said, increased earnings allow firms to expand investments and hiring. Indeed, the earnings growth for US companies in Q1 showed a meaningful +15.4% yoy vs. the 4.8% in Q4 2016. The sales growth was +8.6% vs. 4.5%. The ratio of positive-to-total surprises improved towards 79% for earnings (from 74.2% in Q4) and 64% for sales (from 52%). The European results showed very positive outcomes, too, and more importantly on the sales front. The breadth of beats across sectors was significant. We expect Q2 to show decent results, too, due to the good economic momentum, still manageable unit labor costs, increasing margins, and positive US NIPA profits. That said, we expect Q2 profits in year-on-year terms to be not as vigorous as in Q1 due to the less easy comparisons (Q1 2016 being a cyclical bottom).

# Equities

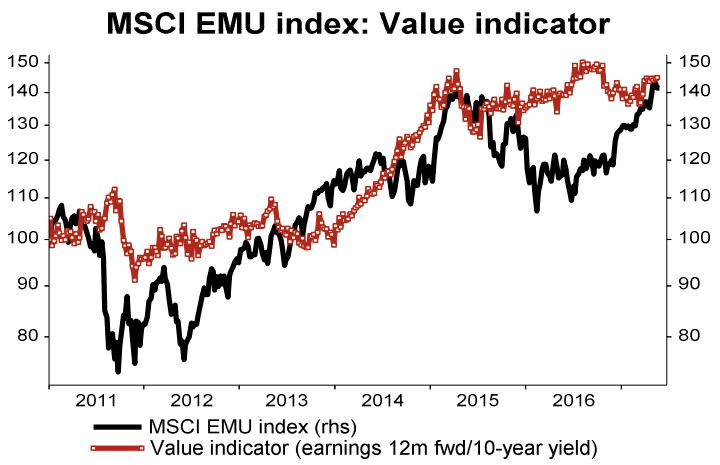
Concerning bond yields, we expect 10-year rates to move higher both in the EA and the US, consistently with the macro picture described above. Such a trend should cause value, domestic and cyclical sectors to continue to outperform. For the time being, investors remain skeptical about the second leg of the recovery to materialize and consequently about yields creeping higher.

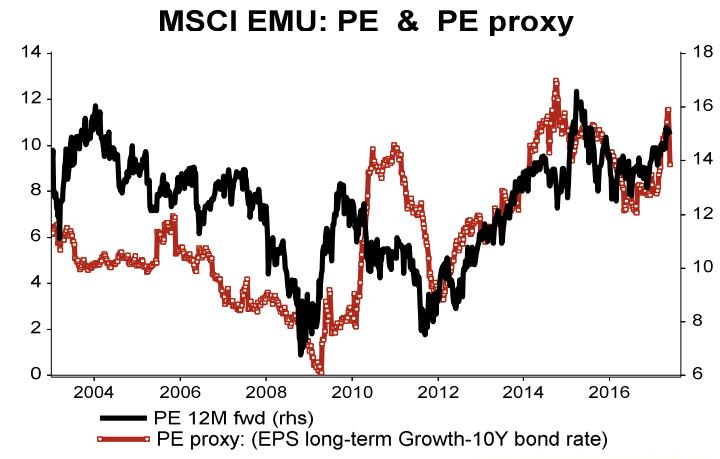
## Why we turned more cautious in the short term

Recently, we turned more cautious on equities, reducing the overweight, notwithstanding improving fundamentals. The EA PE (12-month forward) is near the 15X level and it reached the 16X level only twice in the last 15 years (2004 and 2015). Other market multiples are 15% above historical average and our "value" indicator shows the EA market to be fairly valued on a short-term view (the US is expensive and the Topix still cheap). Furthermore, the equity volatility has started to increase vs. the bond's one. This could eventually trigger a higher risk premium in the next future. Finally, when surveyed, investors declare a short-term positioning on financials and the EA equities which is above historical average.

## Still constructive on the mid-term

The bull market is mature but not exhausted yet. Valuations outside the US are not showing bubbles and earnings should continue to increase. 10-year rates should increase, too, but not dramatically so. They will confirm the second leg of the recovery and back a positive performance of value and cyclical sectors. Later on, should the US yields increase above the 3% threshold, equities would be subject to derating. We expect the market to be more volatile but able to prolong its positive trend also in 2018, mainly due to rising earnings. It will be more difficult for investors to buy an increasing and more expensive market but this is what happened already in 1998, 2003-2007 and in 2014-2015. We overweight the EA and Japan due to cheaper valuations, higher weight of cyclical sectors and supportive monetary policies. Japan is the attractive "laggard" as it remains one of the cheapest market. We still see the yen to weaken till 120 against the US dollar, thus supporting earnings growth. In Europe we would move partially out of Italy into Spain. Italy is cheaper but its political risk has increased (elections). Spain is relatively more expensive but the political risk more contained. We remain neutral on the UK and EM, and underweight the defensive Switzerland. Among European sectors we continue to favor the financials, discretionary and telecoms. Food and utilities are the least favored. Commodity sectors are a neutral. For the EA we envisage a prudent 12-month return in the range of +4-5%, of which 3.2% is the dividend yield and the rest is the earnings growth (+5%) which can absorb in part a PE compression (from the current 15X to slightly above the historical average, at nearly 14.5X).




last available date: 29/05/17

| Markets | PE | | PB | | PCF | | DY | | Avg. | Avg. |
|---|---|---|---|---|---|---|---|---|---|---|
| | 12m f | Discount | 12m f | Discount | 12m f | Discount | 12m f | Discount | Discount | Disc. (-1M) |
| USA | 17.8 | 16.8 | 2.8 | 23.8 | 11.9 | 22.8 | 2.1 | -4.5 | 16.9 | 16.8 |
| JAPAN | 14.1 | -10.2 | 1.2 | -3.1 | 7.7 | 10.2 | 2.1 | 13.9 | -4.2 | -16.7 |
| UK | 14.9 | 7.4 | 1.9 | 3.5 | 9.3 | 19.5 | 4.1 | 2.9 | 6.9 | 3.4 |
| SWITZERLAND | 17.4 | 13.5 | 2.5 | 10.5 | 13.1 | 17.1 | 3.4 | 5.2 | 9.0 | 6.0 |
| EMU | 14.9 | 5.6 | 1.6 | 7.3 | 8.3 | 31.6 | 3.2 | -18.6 | 15.8 | 17.4 |
| FRANCE | 15.2 | 6.2 | 1.6 | 6.6 | 9.1 | 34.6 | 3.2 | -15.4 | 15.7 | 15.2 |
| GERMANY | 13.8 | -8.9 | 1.7 | 14.2 | 8.7 | 33.5 | 2.9 | -13.0 | 12.9 | 14.6 |
| GREECE | 14.7 | 14.8 | 1.7 | 6.3 | 7.8 | 32.3 | 3.3 | -15.1 | 17.1 | 14.5 |
| ITALY | 12.9 | -15.8 | 1.1 | -11.8 | 4.9 | 8.5 | 4.1 | -11.7 | -1.8 | -1.4 |
| PORTUGAL | 16.6 | 33.2 | 1.8 | 4.4 | 6.5 | 11.5 | 4.3 | -4.1 | 13.3 | 13.2 |
| SPAIN | 14.2 | 9.7 | 1.3 | -18.0 | 5.5 | 9.5 | 3.7 | -27.7 | 7.2 | 8.3 |
| EURO STOXX 50 | 14.5 | 9.7 | 1.6 | 7.7 | 8.2 | 36.1 | 3.5 | -19.1 | 18.2 | 19.2 |
| STOXX SMALL | 17.0 | 19.8 | 1.9 | 13.4 | 11.0 | 36.4 | 2.8 | -13.3 | 20.7 | 20.6 |
| EM, $ | 12.3 | -16.0 | 1.5 | -6.9 | 7.6 | -1.0 | 2.7 | -12.4 | -2.9 | -3.7 |
| BRAZIL | 11.2 | 27.3 | 1.4 | -15.2 | 6.8 | -53.3 | 3.8 | -12.5 | -7.2 | -6.3 |
| RUSSIA | 5.4 | -24.6 | 0.6 | -35.0 | 3.3 | -28.9 | 6.0 | 74.2 | -40.7 | -35.8 |
| INDIA | 18.1 | 26.7 | 2.8 | 3.7 | 12.3 | 7.6 | 1.6 | -1.3 | 9.8 | 9.0 |
| CHINA | 12.9 | -0.8 | 1.6 | -8.9 | 8.0 | 6.9 | 2.2 | -28.4 | 6.4 | 3.4 |

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

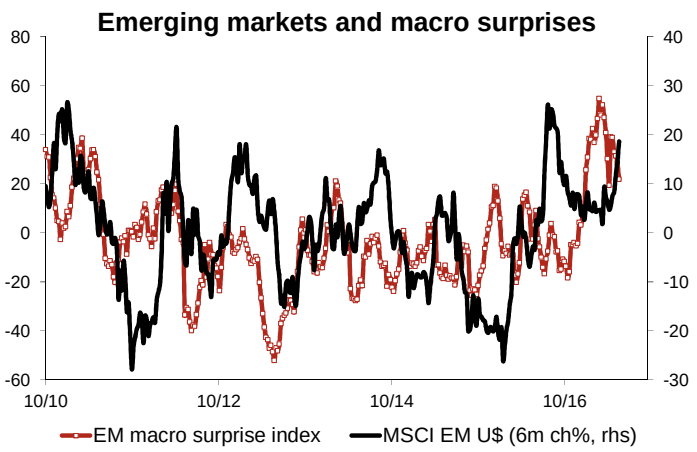
Source: Thomson Reuters Datastream, IBES estimates.

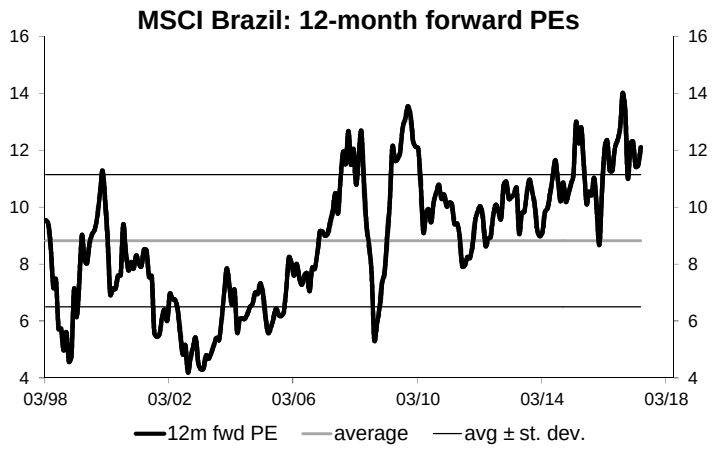
# Emerging Markets Equities

**Vladimir Oleinikov**

| 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 ($) | 1.8 | 9.2 | 2.1 | 7.4 | | | |
| US | 1.3 | 7.9 | 1.0 | 3.8 | -20 | -1.3 | -4.2 |
| EMU | 1.0 | 10.0 | 1.4 | 6.6 | 16 | 1.5 | 2.4 |
| GREECE | 10.2 | 14.6 | 7.4 | 9.3 | -103 | 1.5 | 2.4 |
| CZECH REP. | 0.5 | 9.9 | 1.4 | -0.9 | 30 | 2.4 | 3.1 |
| HUNGARY | 2.4 | 4.6 | 2.3 | 12.6 | 15 | 2.6 | 1.4 |
| POLAND | -2.3 | 19.2 | 1.5 | 16.8 | -45 | 2.2 | 6.9 |
| EM ($) | 3.8 | 17.7 | 2.1 | 13.4 | -48 | | |
| BRAZIL | -2.3 | 4.9 | 0.0 | 5.5 | -62 | -3.6 | -4.0 |
| CHINA | 6.2 | 23.4 | 1.9 | 8.8 | 62 | -0.7 | -3.2 |
| INDIA | 1.6 | 14.5 | 1.0 | 2.1 | 15 | -1.5 | 1.7 |
| INDONESIA | 1.5 | 10.2 | 0.8 | 5.9 | -100 | -0.6 | -2.3 |
| KOREA | 7.2 | 19.0 | 3.6 | 23.5 | 15 | 0.9 | 4.3 |
| MALAYSIA | -0.5 | 7.4 | 0.6 | 2.2 | -36 | 0.7 | 1.3 |
| MEXICO | 0.1 | 7.3 | 0.8 | 3.8 | -16 | 1.9 | 9.7 |
| RUSSIA | -4.0 | -13.7 | 0.6 | 8.0 | -79 | -1.3 | 3.0 |
| TAIWAN | 3.1 | 10.1 | 0.7 | 4.8 | -17 | -0.4 | 4.5 |
| THAILAND | 0.1 | 3.4 | 0.6 | 6.0 | -3 | 0.8 | 1.6 |
| TURKEY | 2.8 | 25.6 | 2.4 | 14.5 | -73 | -2.2 | -5.8 |
| VIETNAM | -0.3 | 9.1 | -2.4 | 23.2 | -41 | -0.5 | -2.8 |
| SHANGHAI | -1.4 | 0.2 | -0.7 | 3.5 | 62 | -0.7 | -3.2 |

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




- **While there is still room for EM stocks to go up, the rally is losing steam. The macro surprises are less supportive and the performance gap vs. oil has turned rather unfavorable.**
- **We see EMs to be subject to risks: 1) higher yields in the US, 2) a capped performance of oil prices, 3) over-tightening in China shadow banking, 4) global geopolitical risks, 5) local political risks in Brazil.**
- **We continue to be constructive mid-term on EMs and still favor India along with Korea and CEE countries.**

Over the last month, EM equities have increased by 3.5% in US dollar terms. The top performer was Greece (+10.2%), followed by Korea and MSCI China (7.2% and 6.2%, respectively). The worst performing ones were Russia (-4%), Poland, and Brazil (both -2.3%). The Greek market rallied prior to the Eurogroup meeting on May 22 on expectations for the funds to be unblocked. This did not happen but the debt relief program is expected to be implemented nevertheless. Both the Russian and Polish markets have been affected by the negative performance of the energy and material sectors (resulting from lower commodity prices). Brazilian stocks suffered from the recent developments of the corruption scandal involving President Temer.

Overall, EM 2017 earnings have been revised up by 0.6% during the last month. The markets for which they have been upgraded significantly are: Greece (+5.4%), Korea (+3.0%), Czech Republic (+2.6%), and Hungary (+2.1%). The earnings of the Russian companies have, been downgraded by 1.4% (energy -2.5%, telecoms -9%).

Over the month, the EMs have gotten a bit more expensive, still remaining slightly undervalued based on their multiples (discount of 2.9% to history). While there is still room for EM stocks to go up, the rally is losing steam. Tumbling commodity prices are hurting and the gap in performance vs oil is rather unfavorable. Furthermore, tighter US monetary policy and higher long-term rates should put pressure on EM stocks in the short term.

## Brazil: dear, not supported by fundamentals

After the strong bull market in 2016, the market looks overvalued compared to its fundamentals. The market's price trend has outrun its expected earnings trend. Furthermore, the index appears quite expensive by the conventional 12-month forward PE, which is currently at 12.1 and is more than one standard deviation above the historical average of 8.8. Under the current market conditions (Brazil's vulnerable economy, political uncertainty, and comparatively lower profitability), the market should be priced with a discount, not a premium.

# Mark to Market Allocation

**Thorsten Runde**

- **Over the past month all equity markets have again shown positive developments, with the UK clearly being the most attractive one so far.**
- **Long-dated government bond yields remained nearly unchanged on the main markets, thus lifting nearly all performance figures into positive territory.**
- **Spreads on Southern European sovereign bonds tightened further.**
- **Looking forward, with reduced risks from the French presidential election outcome, global financial markets will focus on the US and speculations about future Fed policy action.**
- **Yields have further leeway to inch up. Risk premiums on Southern European debt are likely to rise moderately.**
- **All in, risky assets appear more vulnerable to temporary setbacks, favoring a somewhat more prudent stance on equities than over the previous weeks.**

Since our last recommendation, the equity markets of our investment universe have once again performed positively, revealing return figures ranging from around 2% for the euro area and Japan to 4% in the UK. Apart from euro area core government bonds, the main fixed income markets performed positively, too. With roughly 1.5% peripheral bonds are leading the performance ranking. In general the recommended allocation stance in favor of equities paid off well again in the course of May. In particular, correctly overweighting peripherals at the expense of euro area core government bonds contributed positively to the TAA result

## More cautious allocation stance advisable

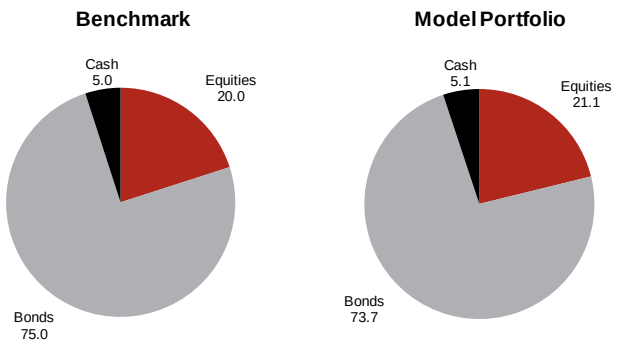
Amongst the solid global macro setting, the decrease of euro area political risks, core yields in Europe have further leeway to inch up, while risk premiums on Southern European debt are likely to rise moderately. That said, following the recent strong performance of risky assets, very low volatility, signs of markets' complacency and heightened geopolitical uncertainties, risky assets appear more vulnerable to temporary setbacks compared to the beginning of the quarter. Thus, we basically stick to our TAA recommendations made last month. However, a somewhat more cautious allocation stance on equities appears advisable.

## European equities still to be preferred

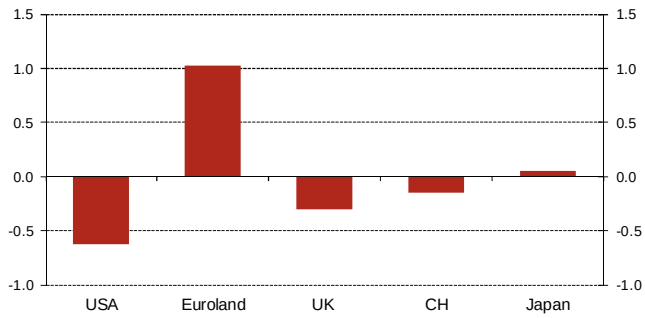
Against the backdrop of a solid economic momentum in the euro area, this still argues in favor of a moderate overweight in European equities, in particular the euro area ones.

| Asset Class | Benchmark | Model Portfolio | Previous Allocation |
|---|---|---|---|
| ***Equities*** | ***20.0*** | ***21.1*** | ***21.4*** |
| ***Bonds*** | ***75.0*** | ***73.7*** | ***73.5*** |
| ***Cash*** | ***5.0*** | ***5.1*** | ***5.1*** |
| *Equities, US* | 3.0 | **3.0** | 3.0 |
| *Equities, EMU* | 12.0 | **12.9** | 13.1 |
| *Equities, UK* | 2.0 | **2.1** | 2.1 |
| *Equities, Switzerland* | 1.0 | **1.0** | 1.1 |
| *Equities, Japan* | 2.0 | **2.1** | 2.1 |
| *Bonds, Gvt. US* | 11.3 | **11.4** | 11.3 |
| *Bonds, Gvt. EMU Core* | 27.0 | **26.3** | 25.7 |
| *Bonds, Gvt. EMU GIIPS* | 18.0 | **17.1** | 18.4 |
| *Bonds, Gvt. UK* | 7.5 | **7.6** | 7.3 |
| *Bonds, Gvt. Switzerland* | 3.8 | **3.8** | 3.6 |
| *Bonds, Gvt. Japan* | 7.5 | **7.6** | 7.2 |
| *Cash* | 5.0 | **5.1** | 5.1 |

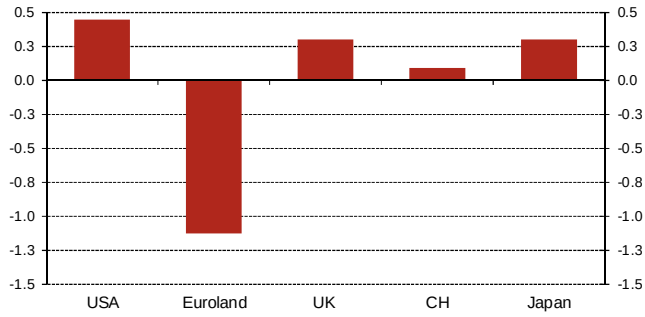
## *Asset Classes*




## *Equities - Regional Structure*




## *Bonds - Regional Structure*



# Forecast Tables

## Growth

| | 2015 | 2016e | 2017f | 2018f |
|---|---|---|---|---|
| US | 2.6 | 1.6 | 2.2 | 2.3 |
| *Euro area* | 1.9 | 1.7 | 1.7 | 1.4 |
| Germany | 1.5 | 1.8 | 1.7 | 1.5 |
| France | 1.2 | 1.1 | 1.2 | 1.3 |
| Italy | 0.7 | 1.0 | 0.7 | 0.6 |
| *Non-EMU* | 2.4 | 1.9 | 1.7 | 1.5 |
| UK | 2.2 | 1.8 | 1.5 | 1.3 |
| Switzerland | 0.8 | 1.3 | 1.5 | 1.6 |
| Japan | 1.2 | 1.0 | 1.4 | 1.0 |
| *Asia ex Japan* | 6.2 | 6.1 | 6.0 | 5.9 |
| China | 6.9 | 6.7 | 6.6 | 6.3 |
| Central/Eastern Europe | 1.2 | 1.4 | 1.4 | 2.6 |
| Latin America | - 0.5 | - 1.5 | 0.7 | 1.8 |
| **World** | **3.4** | **3.0** | **3.3** | **3.4** |

## Inflation

| | 2015 | 2016f | 2017f | 2018f |
|---|---|---|---|---|
| US | 0.1 | 1.3 | 2.3 | 2.4 |
| *Euro area* | 0.0 | 0.2 | 1.6 | 1.5 |
| Germany | 0.1 | 0.4 | 1.8 | 1.7 |
| France | 0.1 | 0.3 | 1.4 | 1.4 |
| Italy | 0.1 | - 0.1 | 1.3 | 1.0 |
| *Non-EMU* | 0.1 | 0.7 | 2.7 | 2.7 |
| UK | 0.0 | 0.7 | 3.0 | 2.9 |
| Switzerland | - 1.1 | - 0.4 | 0.5 | 0.7 |
| Japan | 0.8 | - 0.1 | 0.5 | 0.8 |
| *Asia ex Japan* | 2.4 | 2.6 | 2.7 | 3.1 |
| China | 1.4 | 2.0 | 2.1 | 2.3 |
| Central/Eastern Europe | 9.2 | 5.2 | 5.2 | 5.2 |
| Latin America | 6.2 | 6.3 | 4.3 | 3.8 |
| **World** | **2.3** | **2.3** | **2.7** | **2.8** |

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

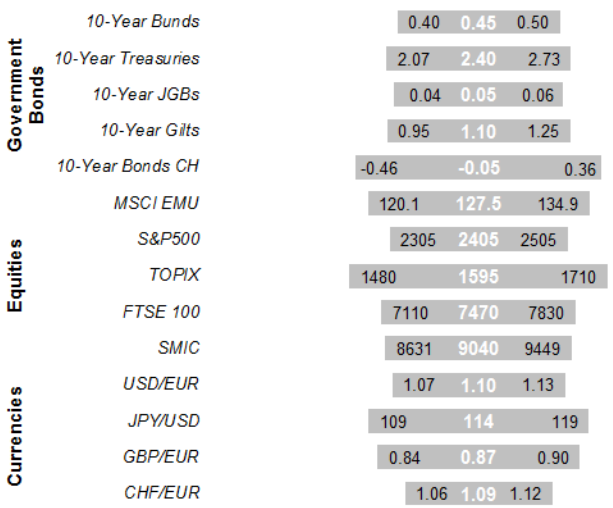
## Financial Markets

| **3-month LIBOR** | **29.05.17*** | **3M** | **6M** | **12M** |
|---|---|---|---|---|
| *USD* | 1.20 | 1.50 | 1.65 | 2.00 |
| *EUR* | -0.37 | -0.35 | -0.35 | -0.30 |
| *JPY* | -0.01 | 0.00 | 0.00 | 0.05 |
| *GBP* | 0.30 | 0.40 | 0.40 | 0.40 |
| *CHF* | -0.73 | -0.75 | -0.75 | -0.75 |
| **10-Year Bonds** | **29.05.17*** | **3M** | **6M** | **12M** |
| *Treasuries* | 2.25 | 2.40 | 2.55 | 2.75 |
| *Bunds* | 0.33 | 0.45 | 0.60 | 0.70 |
| *BTPs* | 2.13 | 2.35 | 2.55 | 2.75 |
| *OATs* | 0.76 | 0.90 | 1.05 | 1.15 |
| *JGBs* | 0.04 | 0.05 | 0.10 | 0.15 |
| *Gilts* | 1.02 | 1.10 | 1.20 | 1.30 |
| *SWI* | -0.13 | -0.05 | 0.05 | 0.20 |
| **Spreads** | **29.05.17*** | **3M** | **6M** | **12M** |
| *GIIPS* | 159 | 165 | 170 | 175 |
| *Covered Bonds* | 80 | 75 | 80 | 85 |

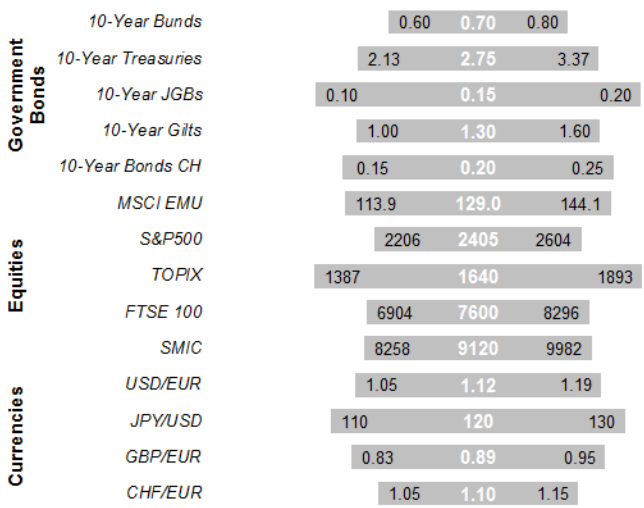
*average of last three trading days

| **Corporate Bond Spreads** | **29.05.17*** | **3M** | **6M** | **12M** |
|---|---|---|---|---|
| *IBOXX Non-Financial* | 134 | 130 | 130 | 140 |
| *IBOXX Sen-Financial* | 120 | 120 | 125 | 130 |
| **Forex** | **29.05.17*** | **3M** | **6M** | **12M** |
| *USD/EUR* | 1.12 | 1.10 | 1.11 | 1.12 |
| *JPY/USD* | 111 | 114 | 117 | 120 |
| *JPY/EUR* | 125 | 125 | 130 | 134 |
| *USD/GBP* | 1.29 | 1.26 | 1.26 | 1.26 |
| *GBP/EUR* | 0.87 | 0.87 | 0.88 | 0.89 |
| *CHF/EUR* | 1.09 | 1.09 | 1.10 | 1.10 |
| **Equities** | **29.05.17*** | **3M** | **6M** | **12M** |
| *S&P500* | 2416 | 2405 | 2415 | 2405 |
| *MSCI EMU* | 126.4 | 127.5 | 128.0 | 129.0 |
| *TOPIX* | 1573 | 1595 | 1595 | 1640 |
| *FTSE* | 7538 | 7470 | 7480 | 7600 |
| *SMI* | 9036 | 9040 | 9110 | 9120 |

### 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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