GENERALI INVESTMENTS

Outlook 2016

Coping with monetary policy divergence

Content

Global View

- **The foregone year was marked by sluggish global growth, investors' doubts about China and emerging markets more generally and dovish monetary policy surprises from major central banks. Utimately, though, the Fed delivered a well communicated liftoff in December. Yields in advanced economies remained very low, while equities benefitted.**
- **Looking ahead, we anticipate 2016 to be characterized by a mediocre, albeit resilient economic recovery of advanced economies. A very gradual normalization of monetary policy in the US will contrast the ongoing strong support from other major central banks, including the ECB, the Bank of Japan and the People's Bank of China.**
- **Challenges for investors will remain high amid the depressed yield levels on safer assets. For European risky assets, however, the combination of a gradual economic recovery and the commitment by the ECB to a very supportive stance for longer should still render decent returns on investments in equities and credit.**

Downgrade of global growth expectations

Advanced economies continued to recover gradually over the past year. That said, global growth figures fell far short of expectations even in the eighth year after the outbreak of the Global Financial Crisis (GFC). While consensus expectations were aiming at 3% annual GDP growth for both the US and the world economy at the outset of 2015, these expectations were lowered by 0.5 pp over the course of the year. Also global growth forecasts for 2016 have been lowered. Apart from adverse winter conditions in the US, mounting doubts about the growth outlook for emerging markets – and China in particular – were a key reason for the rerating. At the same time, inflation in the advanced world continued to undershoot targets. Meanwhile, major central banks maintained their strongly supportive monetary policies. The Fed delayed its liftoff from seven years of almost zero interest rates until year-end. The ECB embarked on outright QE at the start of the year and concluded ithe year with the decision to extend the duration of its QE program and to cut the deposit rate even deeper into negative territory.

After touching new historical lows, yields on European core bonds entered December at levels close to those prevailing at the start of the year

In this environment, the global low-yield environment persisted. In mid December, yields on German and US government bonds were around the same levels as at the start of the year. The yield on German 10-year Bunds, which had touched a new historical low at 0.05% in spring, traded between 0.5 and 0.6%. Spreads on Southern European government bonds narrowed moderately over the year thanks to the strong support from the ECB's QE program and despite the spike in uncertainties about a 'Grexit' over summer. By contrast, the risk premia on euro area corporate bonds widened noticeably, driven by heavy supply and a more muted global growth outlook. The US dollar was the winner from monetary policy divergence, gaining roughly 10% both in trade-weighted terms and against the euro. Equities were up 8% in the euro area, but these gains were still short of the 23% peak temporarily reached foru euro area equities amid the tailwinds of the ECB's QE program started in March. By contrast, US equities were barely changed compared to the start of the year.

Mediocre but resilient growth with divergent monetary policies

Looking into 2016, the challenges to investors remain substantial. With yields on government bonds and credit already so depressed, the current income provides only a tiny buffer against price losses resulting from even moderate yield increases. And after a potentially fourth straight year of gains on European stock markets, a key question is whether risky assets can stage another year of positive returns.

The recovery of advanced economies is likely to proceed in an unspectacular, yet resilient fashion

Regarding the macroeconomic picture, we anticipate a slight acceleration of global economic activity which will still leave the world with only mediocre growth rates compared to the pre-crisis norm. The US economy looks most robust, but its forecasted expansion by 2.6% is still short of the average of 3.0% prevailing over the ten years before the GFC. And even though its real GDP is still 2% below the pre-crisis peak, the euro area economy will grow only slightly above its potential growth rate at 1.6%. While the growth prospects for advanced economies are far from overwhelming, they should still provide a decent backdrop for risky assets. Helped by the low oil price and depressed interest rates, domestic demand will consolidate in the advanced economies, defying the structural headwinds from the emerging economies.

Monetary policy will diverge sharply in this setting. On the one hand, the Federal

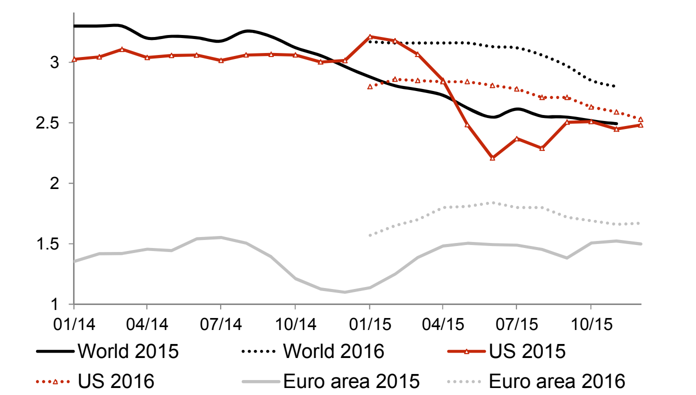
The Fed will proceed very gradually in tightening monetary policy...

Reserve in the US will proceed very gradually in normalizing its policy stance. Following a widely anticipated first rate hike in December, we expect the Fed to raise its key rate only very cautiously. This hiking cycle may yet prove a bit more challenging for global risk sentiment and emerging markets alike, but ultimately the US central bank seems set to proceed gradually enough to prevent a repeat of the 2013 'taper tantrum' which trigged a sharp sell-off in US bonds.

... while the ECB stays committed to QE for much longer

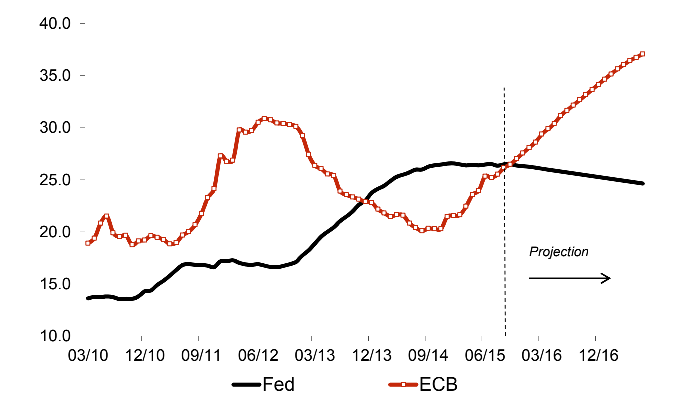
On the other hand, the ECB will stay committed to its QE program and negative deposit rates for long. We even see the chance of another extension of the asset purchases in case the inflation outlook in the euro area worsens over the coming months. Also the Bank of Japan may opt for another increase in its asset purchase program if price pressures in Japan do not accelerate further.

REVISIONS OF GROWTH EXPECTATIONS



Graph 1; consensus estimates for real GDP growth, in % yoy

CENTRAL BANK BALANCE SHEETS



Graph 2; in % of GDP

Chronic strains but no meltdown of emerging markets

Headwinds to emerging markets are likely to prove chronic, but a broad-based EM crisis is not on the cards

For emerging economies (EMs), the headwinds seen over the past quarters will likely prove chronic in 2016. Most importantly, economic growth in China will slow down further, moving further away from the 7% target prevailing a year ago. Commodity exporters, including large countries like Russia, Brazil and South Africa, will continue to feel the immense pressure of lower demand for raw materials while high inflation, depreciating currencies and less abundant capital inflows will prevent their central banks from accommodating for these headwinds. Moreover, a gradually tighter US monetary policy will add to pressures on economies which have releveraged strongly over the past years (e.g. Turkey and Brazil) or which have already accumulated a very high level of debt, in particular in Asia (Malaysia, South Korea, Thailand). These headwinds will prevent the emerging world from recovering to old rates of expansion any time soon.

On the positive side, however, we deem fears of an acute EM crisis as overdone. For one, we expect policy makers in China to succeed in engineering a soft landing of the economy, helped by continued fiscal support and the more abundant bank liquidity from lower reserve requirements. Moreover, the important real estate sector is likely to find a bottom. Regarding other EMs, fundamentals appear much more resilient today than in earlier crises (in particular the Asian crisis in 1997). EMs have widely embraced flexible exchange rates, which have undergone a huge adjustment already. Moreover, on aggregate they are running a current account surplus, i.e. they are net exporters of capital. Finally, most EMs have accumulated large piles of FX reserves, which provide a credible backstop against sudden currency sell-offs.

Low yield environment to prevail for longer

In this mediocre, yet resilient macroeconomic setting, we expect the yield environment in the euro area to remain depressed for longer. Owing to the strong support from the ECB asset purchases and the ongoing search for yield by European investors amid the

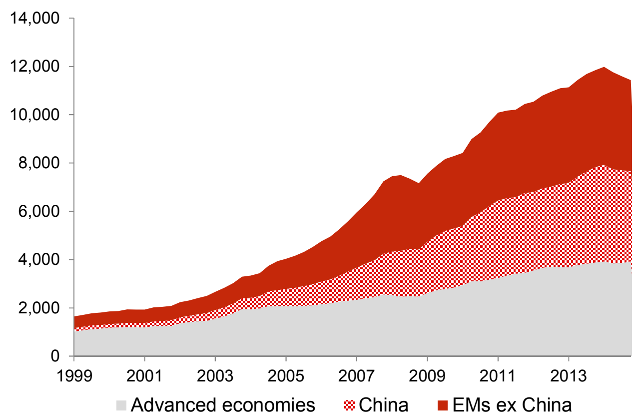
European yields will remain depressed for longer, with the spreads on Southern European bonds likely to narrow further

low-yield environment, yields on credit products can decline somewhat further from the low levels already reached, providing moderately positive total returns. We also see some upside potential for equities in the euro area, underpinned by higher earnings, a weaker euro, decent valuations and investors' search for yield. For the US, however, the equity cycle appears more mature, with earnings already at high levels and the normalisation of monetary policy creating some headwinds to valuations.

The costs of hedging US dollar exposure will rise

Investments in US dollar assets should benefit from another leg higher in the Greenback. We anticipate the EUR/USD to come much closer to parity again over 2016, primarily driven by the ever more visible monetary policy divergence. For those investors, however, who hedge their US dollar exposure, returns on their portfolio will be dented by rising hedging costs. These costs for 1-year hedges have risen from 0.5% p.a. a year ago to 1.2% currently. By early 2017, the costs are likely to come close to the current yield of 10-year US Treasuries at 2.3%.

GLOBAL CENTRAL BANK RESERVES



Graph 3; in bn US$

FINANCIAL MARKETS

10-Year Bonds	Current*	3M	6M	12M
US	2.20	2.35	2.45	2.60
Euro area	0.57	0.65	0.70	0.80
Japan	0.31	0.35	0.40	0.45
Forex	**Current***	**3M**	**6M**	**12M**
USD/EUR	1.10	1.06	1.03	1.02
JPY/USD	121	124	125	128
GPB/EUR	0.72	0.70	0.73	0.75
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2037	2075	2085	2100
MSCI EMU	111.6	115.5	119.5	122.5

*** as of Dec 14, 3-day average**

Table 1

Key risks arise from a hard landing in China, market overreaction to the Fed and setbacks regarding the process of European integration

This challenging outlook with some opportunities for enhancing returns is surrounded by risks primarily on three dimensions. First, the economic and political dynamics in China require a skillful handling by its leadership. Even though we believe in our base scenario that policy makers will manage the balancing act between ongoing reform efforts and further monetary and fiscal stimulus, the risk of a failure is non-negligible. In this risk scenario of a hard landing, commodity prices would face even more downward pressures, while commodity exporting EMs may face more severe strains.

A second major riks relates to the Fed. While it will likely proceed extremely carefully in normalizing its key rate, there remains a clear risk that markets overreact, as was illustrated by the 2013 tantrum. In this case, US bonds and EM assets seem prone to suffer most.

Finally, there is a risen risk that the European integration faces more severe setbacks. The current refugee crisis is already threatening border-free travel in the Schengen area. This could turn into economic harm for the euro area once mobility of workers and the free exchange of goods and services are hampered. At the same time, the ascent of nationalist and euro-sceptic parties may harm the ability to find compromises, raising doubts about the EU's ability to tackle important economic and political problems in a timely fashion. Meanwhile, Britain is likely to hold a referendum on EU membership (even though it may still be scheduled for 2017). A 'Brexit' vote would not only be a harsh setback for the British economy, but also for the rest of the EU. It would not only question the irreversability of the EU in its current form, but would also remove an important market-liberal voice in the political interplay at the EU level.

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Macroeconomic Outlook

- **With the euro area recovery having broadened we deem domestic activity strong enough to offset dampening effects from weak EM growth. While we consider further ECB action not to be imminent, we look for additional measures if downward risks to inflation materialize.**
- **The US economy is expected to grow at 2.6% in 2016, driven mostly by household consumption. Inflation will reach 2% by the end of the year. The mild inflationary outlook and the risk of a further appreciation of the dollar will lead the Fed to approach tightening with extreme caution.**
- **China is expected to continue to slow in 2016 in a controlled fashion while near-term the ongoing help from monetary and fiscal policy should have some stabilizing effects.**

Domestic demand main driver of euro area recovery

In 2015, economic activity continued to diverge among important regions in the world. While it kept on weakening in China, growth was solid in the US and strengthened in the euro area. Looking ahead, activity in EMU will in our view prove resilient in the year to come. Euro area growth has strongly been boosted by the real income enhancing effect from low oil prices and support from a weak euro against the currencies of the main trading partners. While these factors will likely remain in place also next year, they will be much less supportive in our scenario. That said, seven years after the Great Financial Crisis and five years since the beginning of the euro crisis activity stands on a sounder footing. First, the post-crisis recession in the peripheral economies (with Greece as a notable exception) has come to an end and the labor markets in these countries have started to improve. Most notably, Italy returned on a growth trajectory. Second, the recovery is no longer creditless. Since March private loans no longer contract and since July loan growth to non-financial corporations turned positive. This reflects a combination of factors ranging from less corporate deleveraging needs, highly favorable financing conditions and successfull restructuring in the banking sector to a more favorable outlook and is likely to continue. Third, the period of tough fiscal consolidation is over. Fiscal policy will broadly remain neutral next year on the euro area level. Given refugee-related costs as well as the announcement of increased security spending in response to the Paris terror attacks even a small fiscal stimulus might result.

Upswing to continue at solid pace

Against this sound fundamental background, the stage for a continuation of the recovery is set. However, global activity has shown signs of weakening in 2015 and will suffer from weaker Chinese and emerging market growth also next year. While there will be some cushion from the weaker euro, activity will largely rely on domestic demand. A sustained take-off in investment activity that disappointed so far is still the missing link in order to make the recovery fully self-sustaining. In 2016, we see leeway for stronger investment spending due to capacity utilization going back to normal, favorable financing conditions, further receding financial fragmentation, improved profit margins and less adjustment needs in the construction sector of some economies. All in all, we look for another year of solid economic activity, mainly driven by domestic demand. We forecast gross domestic product to expand by 1.6% in 2016, after 1.5% in 2015. We see the risks on the downside and mainly related to weak external growth as well as idiosyncratic risks (e.g. Spanish election outcome, refugee crisis response, VW scandal).

ECB stands ready for further action, if needed

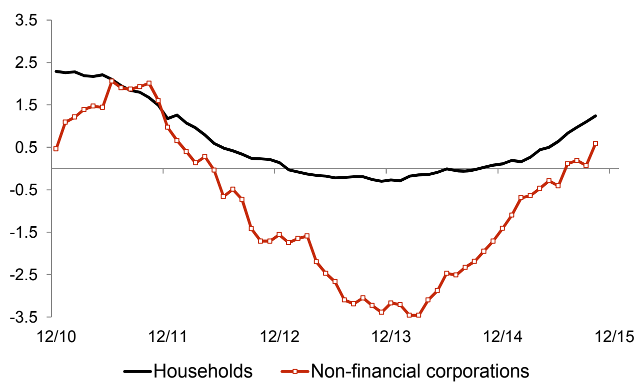
In spite of the ongoing recovery, low energy prices and a still negative output gap will continue to keep underlying inflation low. We expect it to average 1.0% next year and see headline inflation converging to this reading due to the petering out of energy-price induced disinflation. The ECB decided in December to extent QE by six months to March 2017, to reinvest principal payments, to increase the universe of eligible assets, to reduce the deposit rate by another 10 bps to -0.3% and to extend the full allotment in fixed tender procedure to at least the end of 2017. As a result, the ECB‘s balance sheet will touch the € 4000 bn threshold and help to maintain favorable financing conditions. In our scenario further ECB action is not imminent for the time being. That said, the ECB clearly has an easing bias. In our view, a stark weakening of global activity, disappointing price data that put the ECB‘s inflation forecast of 1.6% for 2017 into question, the resurgence of a positive correlation of inflation expectations and the oil price or an appreciation of the euro, all have the potential to trigger additional ECB monetary policy action in 2016.

Solid US growth accompanied by cautious Fed tightening cycle

In terms of size and key growth drivers, the outlook for the US economy in 2016 is expected to look broadly similar to that in 2015, with GDP up by 2.6%. Household consumption will remain the key driver: The boost to real disposable income provided in 2015 by plunging oil prices will be complemented by an ongoing, steady increase in labor income. Moreover households balance sheets are in an overall good shape: the deleveraging undertaken during the last years and the extremely low interest rates on loans have curbed interest expenditure, and net worth as percentage of income is back to the pre-crisis peak. This also helps the construction markets, with prices and activity increasing at a sustainable pace. On the corporate side, the subdued growth in capital expenditure seen in 2015 is almost totally due to the oil sector, and the plunge in investment activity is expected to bottom out in 2016 H1, as oil production has been scaled down. In other industries investment is expected to continue to grow, thanks to strong domestic demand and favorable credit conditions, as the very flat path of monetary tightening will not harm bank credit flows. Some concerns arise from the tensions in the high yield corporate bonds arena, to the extent that troubles in the energy sectors are transmitted to issuers from other industries. Another source of risk is related to the outcome of the Presidential Election in November; many firms may prefer to postpone capital increases waiting for possible changes in taxation or regulation. Overall, on the fiscal side, government expenditures should provide a mild (around 0.2%) support to growth. The strong appreciation of the dollar and weak demand from several trading partners will result in net exports continuing to weigh on growth, but to a lesser extent than in 2015 as we do not foresee any further strong strengthening of the USD. Yet, the impact of a further appreciation constitutes by far the most important risks to growth in 2016.

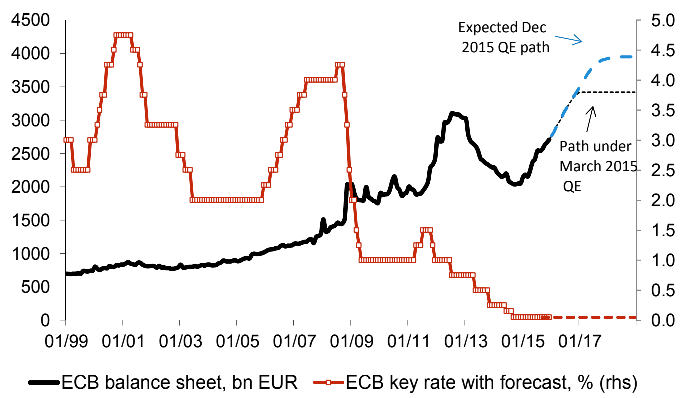
The solid employment gains seen in 2015 Q4 are likely to extend into 2016. We expect the unemployment rate to fall below normal already in 2016 H1. This will lead to an acceleration in wage growth; real wages are already growing at over 2% yoy. A strong increase may eventually feed into core inflation and dent corporate profitability, with negative repercussions on capex. With oil prices slowly rising from the current record low levels, core and headline inflation will likely converge to around 2% by the end of the year. Headline inflation will average 1.7% in 2016. The evolution of the core rate will be driven by the expected smooth increase in unit labor costs. As inflation pressures will remain moderate and as there are risks to growth stemming from too strong a dollar, the Fed will take a very smooth and cautious stance in normalizing monetary policy.

EURO AREA: LOAN GROWTH



Graph 1; adjusted for sales & securitization, % yoy

ECB POLICY SCENARIO



Graph 2

China slowing to continue but no hard landing

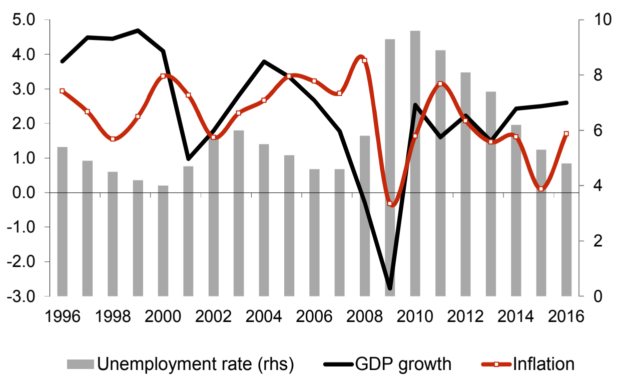
China „stop and go“ policy to continue

China’s economic policy continues to face the ongoing dilemma to work through past excesses – in part induced to counter the effects of the Great Financial Crisis – while at the same time to keep GDP growth at a “comfort” level. This challenge is not new and economic policy has over the past years resorted to a “stop and go” policy to prevent too strong a cooling. The problems are mainly concentrated in heavy industries (esp. mining, steel, cement) amid strong investment over the past years. These overcapacities are now subject to substantial lower demand caused not least by the downturn in the real estate sector, and in part exacerbated by weakness in exports. In fact – while the real growth rate is heavily disputed – nominal growth figures show that the industry sector already slowed to 0.2% yoy in Q3, leaving almost all expansion to the service sector with a rate of 11.9% yoy. Accordingly, monetary and fiscal policy have already stepped up their support significantly over the course of the year. Government expenditures expanded of late by a rate close to 30% yoy. Monetary policy cut the one-year benchmark lending rate in total by 165 bps to 4.35% and the RRR by 250 bps to 17.5% (for big banks).

China likely to aim at growth around 6.5% in 2016

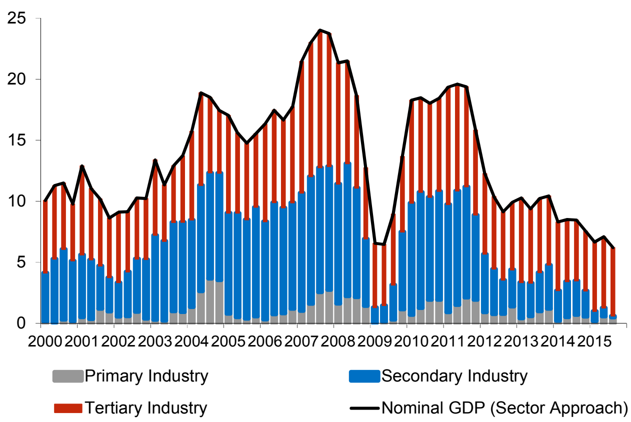
However, retail sales continued to edge up, giving no sign of a negative wealth effect after the stock market slump in summer. Moreover, property sales, a leading indicator of real estate investment, rose significantly, although it lost some vigor of late. As a consequence, we see a good chance of some near-term stabilization in major real activity indicators. Incipient signs could already be seen in the Caixin manufacturing PMI as well as in an easing inventory correction. However, if successful, economic policy will then likely withdraw some of its support, leaving the stage to a further controlled slowing. We expect China to aim at a growth rate of about 6.5% in 2016 and forecast a rate of 6.4%. We deem monetary policy to mainly resort to RRR reductions. This tool was previously intended to absorb capital inflows the effect of which is no longer needed. Benchmark interest rates are already on historically low levels. In any case, growth in China will predominantly rest on services. Government support in the form of infrastructure investment will also contribute. Against this background of weakening growth, core inflation will remain subdued. The deflation in producer prices will continue, but – as over the last years – a significant spill-over into consumer inflation remains unlikely. In sum, we see as general tendency in 2016 a continued slowing of the Chinese economy with some temporary stabilization near-term. We keep our base case that this will be a controlled process, as the government has still enough ammunition to support the economy.

US: GROWTH, INFLATION AND UNEMPLOYMENT



Graph 3; in %

CHINA: NOMINAL GDP GROWTH AND SECTOR CONTRIBUTIONS



Graph 4; yoy as % or pp

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Fixed Income

- **Core yields on both sides of the Atlantic are likely to remain in a narrow trading range in 2016. Concerns about global growth and a still accommodative monetary policy stance stand in the way of a significant increase in core yields.**
- **In this environment investors will continue to search for a yield pick-up. Although the air is getting thinner peripheral bond spreads have some leeway to tighten in the course of next year – mainly due to the ongoing support from the ECB.**
- **Accordingly, core government bonds in the US and in the euro area are expected to yield a negative total return in 2016 with euro area core bonds doing slightly better than US ones. The carry and some moderate spread tightening is forecast to lift the total return of peripheral bonds into positive territory next year.**

Long-dated euro area core yields were very volatile in 2015. After the QE induced duration shock triggered a fall to 0.05% in 10-year Bund yields in April, the strongest sell-off for years drove 10-year Bund yields close to 1% in June. Since then, core yields have drifted and will on balance likely finish the year nearly unchanged. In contrast, yields at the short end of the curve have moved further into negative territory mainly driven by the purchases of the ECB and the decision to lower the deposit rate to -0.3% in December. Peripheral bonds showed a similar development. Although concerns about Greece caused temporary turmoil in summer, peripheral government bond spreads tightened on balance in the course of 2015. It has to be noted that peripheral bonds were more and more traded like duration products and less as spread products.

Significantly lower total government bond returns in 2016 – Peripheral bonds still performing better than core bonds

As a result, peripheral bonds once again outperformed core bonds. Due to the carry and the spread tightening they yielded around 3 pp more than core bonds. However, with around 3.5% the return of peripheral bonds was much lower than 2014 when double-digit returns were achieved. Core bonds approximately earned the carry in 2015. Generally, the longer the duration the higher was the return investors were able to earn. However, even at the short end bonds from all euro area countries got a positive return. From a regional point of view, Italian bonds benefited from the reform progress and performed best. Year-to-date investors in Italian bonds obtained a total return of close to 5%.

US Treasury yields moved slightly up in 2015. However, as the Fed hesitated to start its key rate cycle, the extent was less than expected at the start of the year. Only the short end of the curve shifted upwards in light of the approaching first key rate hike since 2006. Accordingly, the annual return of US Treasuries (in local currency) was a bit above 1% in 2015. The transatlantic yield spread remained roughly unchanged at the long end of the curve but increased considerably to almost 130 bps at the short end.

Only modest increase in core yields until the end of the year

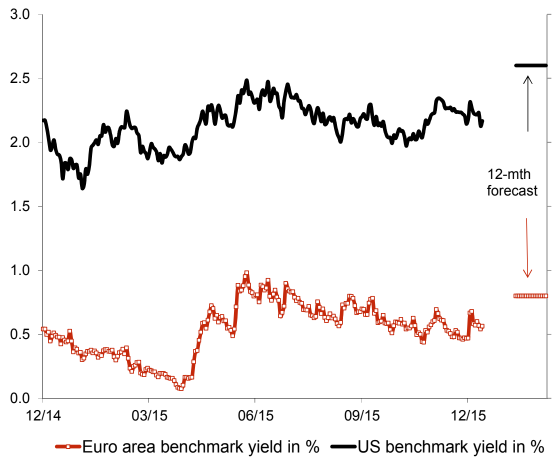
Going forward, the leeway to significantly higher yields appears limited. Global activity is expected to remain subdued and periods of growth concerns are likely now and then. Particularly several countries in the developing world will struggle to overcome the structural deficits. What is more, although inflation rates are expected to rise in the course of 2016 a broad-based inflation pressure is not in sight (assuming our forecast of an ongoing oversupply in commodity markets proves correct). In addition, the monetary stance of many central banks around the world is forecast to remain accommodative.

Despite disappointment about QE modifications ECB stands in the way of a significant increase in euro area core yields

Therefore, long-dated euro area core yields will creep upwards only sluggishly. Although the ECB actions announced in December fell short of market expectations, the extension of the program until March 2017 signals a stronger low-for-long commitment. It is important to stress that the central bank – even if the QE program is not modified – will absorb EUR 720 bn of fixed income paper (thereof, nearly EUR 500 bn of government bonds). In this environment the short end is forecast to remain anchored and is unlikely to shift upwards meaningfully. The higher opportunity costs of holding cash will support bond markets as investors have an incentive to put money to work. The inclusion of regional debt on the ECB's purchase list is unlikely to relax the scarcity of German paper lastingly as it is only sufficient to enable the extension of the program. In addition, the ongoing economic recovery will trigger a reduced issuance activity. Borrowing is forecast to be EUR 30 bn below 2015 levels and a benign redemption profile reduces gross issuance by another EUR 30 bn. All in, the ECB will take down more than half of the gross supply and more than two-and-a-half times the net supply of euro area countries.

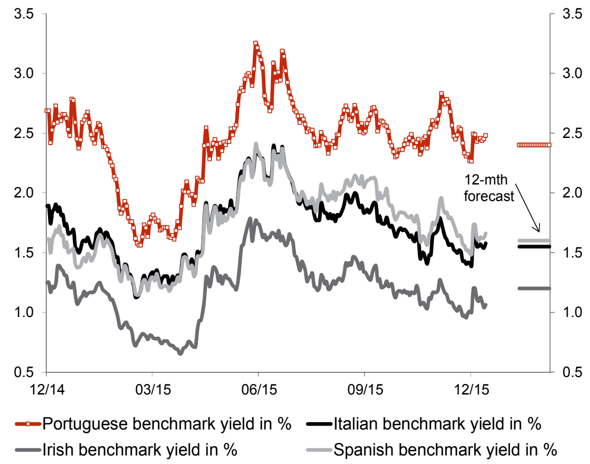
Accordingly, long-dated euro area core yields are expected to trade in a range between 0.5% and 1.0% in the course of 2016. We expect 10-year Bund yields to finish the year at a level of 0.8%. Consequently, the euro area curve – measured as the spread between 2-year and 10-year Bund yields – is seen to steepen moderately to 110 bps (from around 90 bps currently). As a result, the total return of euro area core bonds will likely be even lower than in 2015 and is expected to turn in slightly negative territory.

EURO AREA, US



Graph 1

PERIPHERALS



Graph 2

Lift-off by the Fed to pave the way to moderately higher US yields in 2016

The main difference to the situation in the US is the different monetary policy stance. The Fed will continue to hike its key rate in the course of 2016. At the end of 2016, we forecast a key rate level of 1.0%. This is comparable to current market expectations and, hence, a cycle along these lines is unlikely to exert much upward pressure on long-dated US yields. Moreover, the current term premium – measured as the difference between 10-year overnight index swaps and 10-year Treasury yields – is roughly 40 bps, the highest level for years. Nevertheless, the start of the key rate cycle in combination with some wage pressure in the US is seen to lift long-dated US yields a bit more than in the euro area. All in, 10-year US Treasury yields are expected to rise by 40 bps to 2.6% until the end of 2016. This means that the transatlantic yield spread will rise to 180 bps. In line with the rising key rate, the short-end of the curve will move upwards a bit more. On a 12-month horizon, the 2-year Treasury yield is forecast to be around 1.6%. This bear flattening of the US curve will contribute to a meager total return of US Treasuries in 2016. Despite the higher carry compared to euro area bonds, they are expected to perform worse. The total return (in local currency) is seen to be between -1% and -2%.

ECB to be the main driver for peripheral bonds

In this environment of low returns peripheral bonds are assets which can be a kind of investment of last resort. Although the carry has come down considerably, the current income is still more than twice the one of core bonds. In addition, displaced core bond investors by the ECB QE program will look for alternatives and peripheral bonds are first choice in this respect. While periods of volatility are likely to occur, investors should see this as buying opportunities. All in, the envisaged moderate increase in underlying yields is forecast to be balanced by a spread tightening. Hence, on balance the peripheral yield level is expected to move sideways and investors should earn the carry in 2016.

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Corporate Bonds

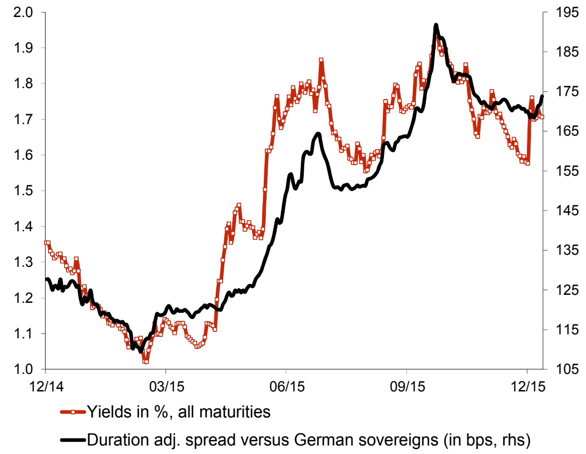
- **While a strong issuance activity and concerns about the state of the global economy will burden euro area investment grade (IG) corporate bonds in 2016, a more attractive spread level and a reversing trend in flows are positive factors.**
- **Although the fundamental situation of non-financials have taken a turn for the worse, the key figures are not worrisome yet. The low yield environment is forecast to trigger a spread tightening by around 35 bps until the end of 2016.**
- **Higher capital ratios and recovering – albeit still low – profitability support a spread tightening for senior financials. However, the less favorable bail-in framework (BRRD/TLAC) and the low carry will limit the total return potential.**

The performance of euro area IG corporate bonds fell short of expectations in 2015. Although we were prepared for a lower return, the first negative annual return since 2008 was a disappointment. It is easy to list a number of reasons for this development and to remain bearish for 2016. Concerns about the global economy are unlikely to vanish. Liquidity will remain low and can trigger periods of high volatility in future. Moreover, the ECB has not yet included corporates in its purchase list and it is unlikely that the central bank will do so next year. However, the most important stress factor in 2015 was the high issuance volume. Restricting the analysis to bonds with a volume of more than EUR 500m, the net issuance was close to EUR 100bn – the highest level since 2010. This is unlikely to change as non-domestic issuers will continue to benefit from the low yield environment and domestic issuers have started a cautious releveraging process. A clear indication for this is the increase in M&A activity which has started in fall 2014.

Strong issuance to continue in 2016 – Reversing flow of funds is key for absorbing net issuance

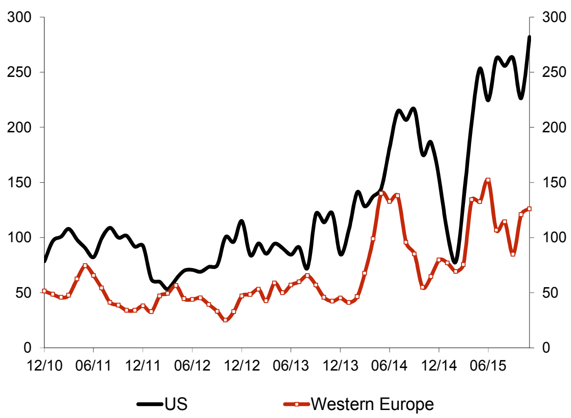
However, there are reasons not to become too pessimistic. The ECB purchases will continue to squeeze markets. So far, investors have put their money aside and have to a large extent not re-invested it. For example, since the start of the QE program deposits of euro area residents have risen by nearly EUR 700bn. However, the negative deposit rate has increased the opportunity costs of not being invested. The difference of the corporate yield level and the euro overnight rate has risen by nearly 100 bps since March 2015. Moreover, although the yield level of around 1.7% is not attractive from an absolute point of view, the yield differential to sovereigns has increased sharply since the start of 2014. This is likely to trigger inflows which will help to meet the issuance activity.

IBOXX EURO AREA CORPORATES



Graph 1

MERGERS AND ACQUISITIONS: VOLUME



Graph 2; all industries, in bn USD, 3-mth mov. average

Euro area non-financials to withstand troubled global waters

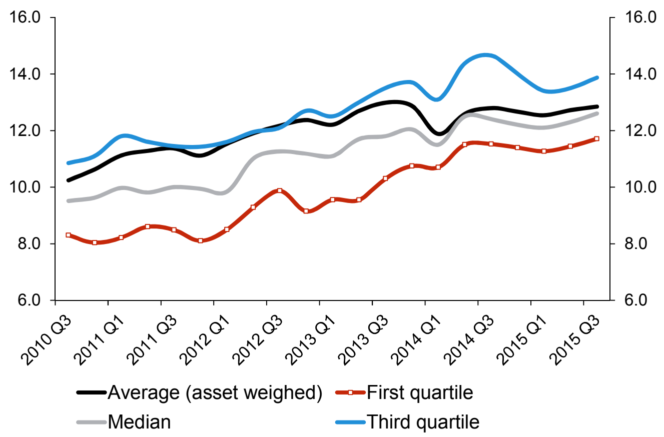
Hit by idiosyncratic shocks, global growth concerns and a general weakness in the manufacturing sector non-financials underperformed in 2015. In fact, some fundamental figures have deteriorated in recent months. The leverage of non-financials has increased and the interest charge coverage has come down. However, current levels are not

Euro area non-financials to decouple partially from a weaker global trend next year

worrisome and still in line with the historical average. Moreover, earnings are expected to rise going forward and this is seen to keep the key figures at a sustainable level.

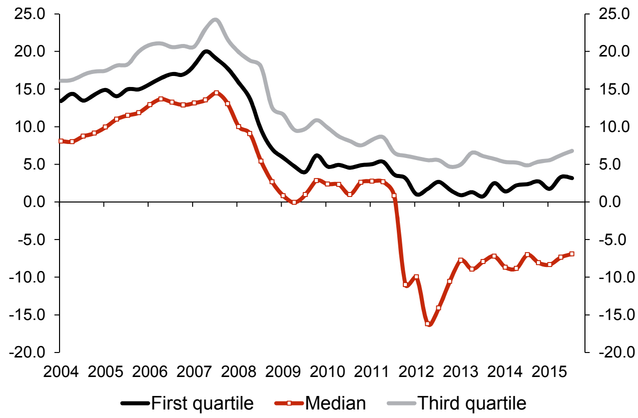
While defaults are expected to rise globally, euro area non-financials are likely to escape to a large extent. As the euro area is less exposed to the commodity sector, defaults will rise only moderately. From a current level of 2.4%, defaults are expected to drift upwards but to remain below 3% in 2016 (long-term average: 4%). All in, there is scope for non-financials to perform well next year. We forecast a spread tightening of around 35 bps to 135 bps until the end of 2016. Particularly, domestic non-financials which are less exposed to the world economy are expected to perform well next year.

EUROPEAN BANKS CET1 RATIO



Graph 3; fully-loaded ratio, major public listed banks, in %

EUROPEAN BANKS PROFITABILITY (ROE)



Graph 4; major public listed banks, in %

Banking regulation a key driver for senior financials

Senior financials outperformed non-financials during the two main volatility episodes in 2015, the sharp rebound in core yields in Q2 and the market correction amid global growth fears since August. The total return of senior financials has been barely positive YTD despite some spread widening (+35 bps) compared to end of 2014 levels.

Solid fundamentals a clear positive for senior financials, but impact of regulation to be monitored

Many of the positive factors supporting this asset class will remain in place also during 2016. First, ECB's ongoing monetary stimulus will perpetuate the hunt for yield. The carry of senior financials (now at 130 bps) remains attractive when compared to peripheral government bond spreads (at 5-year lows) and negative Bund yields on a duration-equivalent basis. Second, the implementation of the Combined Buffer Requirements (CBR) – 4-year phase-in period starting from 2016 – will lead to a further increase in capital ratios, thus structurally lowering the probability of default. Third, the continuation of the recovery in the EA will benefit credit quality and banks' profitability. On the other hand, another piece of banking regulation will likely weigh on senior financials. The Bank Recovery and Resolution Directive (BRRD) and the recently published Total Loss-Absorbing Capacity (TLAC) framework for systemic banks will likely affect the bail-in status of senior financials bonds. While a pan-European framework is yet undefined, Italy and Germany have already opted for the statutory subordination of senior unsecured bonds, thus increasing the chances for losses on these instruments in case of resolution. The possibility of bail-in makes senior financial debt more similar to other subordinated instruments like Tier 2 and AT1. A re-pricing of risk could consequently favor the latter, limiting the scope for the expected spread compression for senior financials to a mere 30 bps by the end of 2016.

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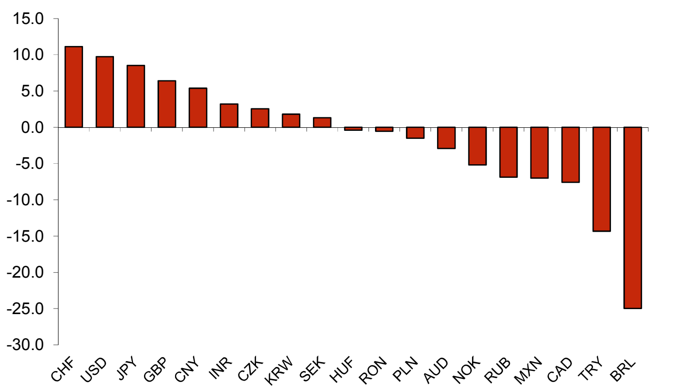
Currencies

- **The past year turned out to be another year of the US dollar, which soared against a broad set of currencies.**
- **Looking ahead, the dollar's rise seems not yet over, remaining backed by monetary policy divergence between the Fed and most other major central bank. The resulting weakness in EUR/USD is additionally supported by strong portfolio flows out of the euro area amid the depressed yield environment.**
- **The British pound is facing more meaningful depreciation risks in the run-up to the EU referendum which may well take place this year. A high current account deficit makes it vulnerable to a decrease in portfolio inflows.**
- **Chinese authorities are likely to allow the yuan (CNY) to weaken against the US dollar. However, this weakness will be moderate and gradual and is still consistent with some moderate appreciation against the euro.**

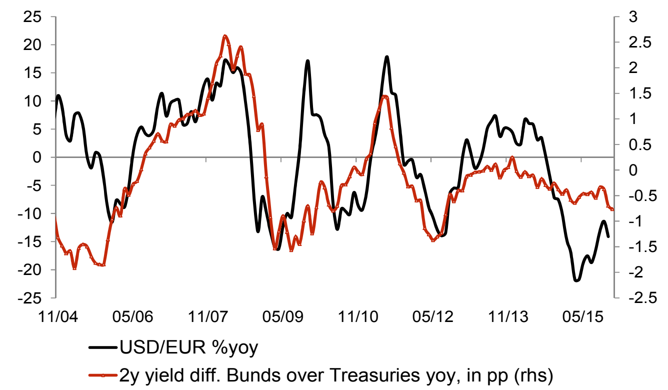
The year 2015 was another year of the US dollar. By early December, the greenback soared roughly 10% against the euro and against a trade-weighted basket of currencies, similar to the strong performance already in 2014. The dollar strength was particularly pronounced vs. emerging market (EM) currencies. Our EM currency index (ex China) fell by 12%, with commodity-linked currencies like the Brazilian real (-31%) and the South African rand (-23%) posting the strongest slumps. In Europe, the outstanding FX event this year was the surprise decision by the Swiss National Bank (SNB) to scrap the floor to the CHF/EUR, which led to a temporay 30% rise in the Swiss currency vs. the euro.

FX PERFORMANCE OVER 2015



Graph 1; year-to-date vs. euro, in % (as of Dec. 14)

USD/EUR AND YIELDS



Graph 2

EUR/USD to move closer to parity

Looking ahead, 2016 will turn out the third year in a row of US dollar strength in our view, with monetary policy divergence still the main driver. The gap between 2-year yields of US Treasuries and Bunds, which reflect the anticipated divergence, has risen by almost 50 bps over the course of 2015. For the coming year, we anticipate even an increase by 70-80 bps, which historically is consistent with at least an 8% lower EUR/USD.

Portfolio outflows underpin the case of a weaker euro

Reversely, the case for a weaker euro remains strong. In fact, the ECB cannot afford to tolerate a stronger euro amid the persistent undershoot of its inflation target. What is more, despite a high current account surplus of 3% of GDP, the broad balance of payments (C/A, net FDI and portfolio flows combined) for the euro area is roughly balanced owing to huge portfolio outflows, which is historically consistent with ongoing weakness in the trade-weighted euro. And fundamentally, the real effective value of the euro is only moderately below its long-term average, despite the massive monetary policy support pledged by the ECB well into 2017. We thus anticipate another significant leg lower in the EUR/USD over the course of next year.

The costs of hedging US dollar exposure will continue to rise materially

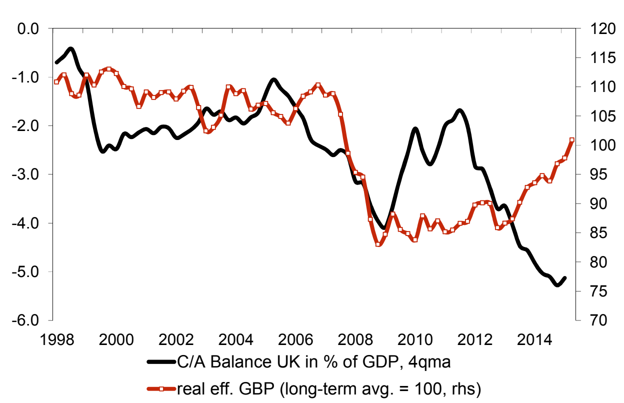
At the same time, heged exposure to US dollar assets will become less attractive. The effective costs of a hedge for the full year 2016 amount to roughly 1.3% and are likely to rise to even 2-2.5% in 2017. Against this background, leaving at least a part of USD exposure open may help to compensate for this effect.

Mounting risks to the British pound in the run-up to a EU referendum

The combination of a large current account deficit and the looming ‚Brexit' referendum leaves the British pound vulnerable in 2016

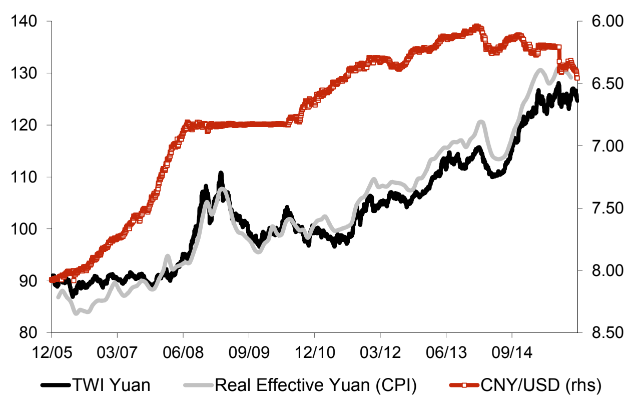
By contrast, we see substantial risks for the British pound (GBP). At first glance, the British currency faces support from the monetary policy, with the Bank of England likely to follow the Fed with a lag by hiking its key rate in H2 2016. However, a key risk is the combination of a large current account deficit (above 5% of GDP) and the looming risk of a 'Yes' vote in the Brexit referendum, which is likely to take place next year (but in any case no later than 2017). The embedded uncertainties may undermine investor confidence abroad in the run-up to the event, while the C/A deficit makes the pound vulnerable to a decrease in portfolio inflows. Moreover, the GBP/EUR already looks quite dear even when accounting for the higher yields prevailing in the UK. This limits the appreciation potential even after a benign referendum outcome. The distribution of risks thus clearly favors to hedge GBP exposure in our view, despite the costs of slightly more than 1% p.a. for a one-year coverage.

UK CURRENT ACCOUNT AND REAL EFFECTIVE POUND



Graph 3

CHINESE YUAN



Graph 4

Currencies of vulnerable emerging markets will remain under pressure

Most EM currencies will remain under pressure against the US dollar in the coming year. This holds in particular for more vulnerable countries like Turkey, Brazil and South Africa. Against the euro, however, these losses should be more contained and in some cases, like for the Indian rupee, outright FX exposure could prove profitable thanks to the high carry of more than 7% p.a.

Meanwhile, the fate of the Chinese yuan (CNY) seems closely linked to the US dollar. If our assumption on US dollar strength is right, Chinese authorities will likey aim to ease the ties of the yuan to the Greenback by allowing for a depreciation of the CNY/USD to levels around 6.70 CNY/USD. Such a move would still leave the yuan strengthening slightly against the euro. In any case, we do not share some analysts' view that Chinese authorities were aiming at a sharp devaluation of its currency. On the contrary, the heavy intervention in favor of the yuan during the second half of 2015 shows that, on the contrary, China is eager to prevent any sharper weakness of its currency. Also after he CNY inclusion into the basket of special drawing rights (SDR) at the IMF, China will be eager to maintain the attractiveness of the yuan to favor its internationalization.

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Equities

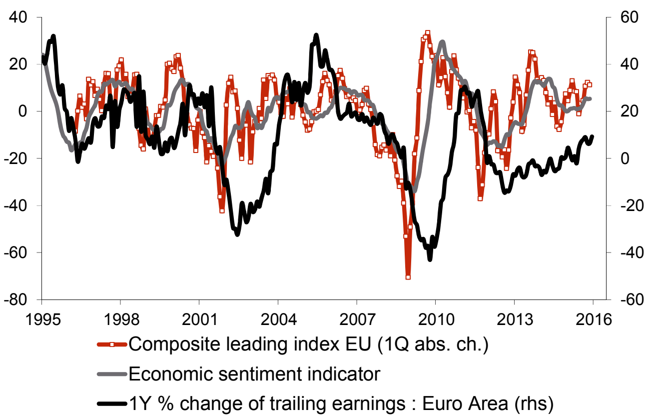
- **Euro area (EA) equities offer an attractive dividend yield of around 3% and an expected total return (TR) of nearly 13%.**
- **We remain less positive on the US with a TR of +5%, pointing out at a high risk of decreasing earnings estimates. We are still positive on Japan but with a lower expected TR (10%) compared to the EA after the rally occurred so far.**
- **We are cautious on the EM (expect 7% in local currency) but at some time in 2016 there could be opportunities to buy as we think they are experiencing their hardest capitulation phase.**
- **Risks: excessive acceleration in US unit labor costs, geopolitical tensions and strong Chinese slowdown.**

Twelve months ago we envisaged another good year for equities, in particular for the euro area (EA, the YTD total return of +6.5% for the MSCI EMU), but with the exclusion of EMs (the total return of -17% in USD), which were expected to eventually capitulate to offer a possible attractive entry point. Spain (-3%), Switzerland (-2.5%) and the UK (-5%) have shown negative performance YTD. The US was forecasted to underperform in local currency but having a positive return (YTD total return of -0.8%) while we remained positive on the Topix (+10.5% YTD). Other than that, we expected higher volatility and geopolitical risks to linger. Looking into 2016 we see, first of all, a continuation of the latter two trends. With regard to the former, there is an increasing evidence of the negative effects coming from lower capital market depth (also due to stricter capital regulation) which adds to the ones originating from the shift in monetary policy in the US. While slightly increasing from current levels, the risk-free rates should remain contained, so overall supportive for equity valuations. Higher volatility, enduring geopolitical risk factors and the possible negative effects spreading from weak US earnings suggest maintaining a more cautious approach in 2016. In this respect, deeper diversifications of the equity portfolio into different regions and sectors should help.

Upside potential in the EA for 2016, more cautious in the short term

Low yields and decent earnings growth (8%) should provide attractive returns in the EA both in absolute terms and relative to bonds, notwithstanding fair market multiples versus history. Our quantitative models along with earnings-based valuations (see table with long-term models) are supportive. On the US, we have a neutral/negative view mid-term as margins are under pressure. The Japanese market is only slightly overweight short term but we are still positive on a 12-month view. Overall, we are relatively cautious in the shorter term. The last ECB action turned out to be less dovish than expected and the Fed hike will keep volatility high. A strong dollar coupled with continuing weak

EURO AREA EARNINGS AND LEADING INDICATOR



Graph 1

LONG-TERM MODELS

Long-term models	Current Index	Pe's 12m: 15.5X for US/SMI and 14.5X for Europe and Japan	fair value (12-m EPS/10-year yield)	eq./bond yield gap	DDM	Gordon 3 stage DEV	Current average valuation	Current average price up/downside
Weights		20.0%	15.0%	15.0%	25.0%	25.0%	100.0%	LT Models
S&P 500	2,052	1,919	2,211	2,428	2,210	1,851	2,095	2.1%
Weights		20.0%	15.0%	15.0%	25.0%	25.0%		
MSCI EMU	157	162	180	180	190	167	176	11.7%
Weights		20.0%	15.0%	15.0%	25.0%	25.0%		
MSCI EUROPE	1,393	1,419	1,552	1,563	1,656	1,493	1,538	10.5%
Weights		20.0%	15.0%	15.0%	25.0%	25.0%		
FTSE 100	6,088	6,199	6,477	6,477	7,133	6,546	6,603	8.5%
Weights		20.0%	15.0%	15.0%	25.0%	25.0%		
SMI	8,633	8,409	9,518	10,046	9,954	9,536	9,489	9.9%
Weights		20.0%	15.0%	15.0%	25.0%	25.0%		
TOPIX	1,540	1,581	1,677	1,817	1,842	1,594	1,699	10.3%

Table 1

commodity prices keep pressure on EMs and commodity-driven sectors. And while global macro surprises have stabilized, profit estimates remain weak, so that the current forecasted growth for 2016 is one of the lowest on record since 1995 (every December), both in the US and the EA (nearly 7.5%). Furthermore, the EA relative earnings strength has weakened recently and the earnings dispersion increased (analysts' uncertainty).

The MSCI EMU should experience decent profit growth and maintain an attractive dividend yield (3%)

Euro area: economic expansion should drive earnings up in 2016

We expect an expanding domestic economy: Unemployment is declining, business and consumer confidence is high, wages are growing at a subdued pace (not a threat to profits), the fiscal drag is declining together with the cost of debt and com-modity prices. What's more, the monetary policy remains supportive for the foreseeable future. As a result, earnings growth in EA is performing well once materials and oils are excluded (7% in Q3) and the dividend yield remains highly attractive (above 3%). A weak TW euro and increasing inflation will also continue to provide support to profits (we see +8% in 2016). EA earnings are currently around 20% below trend and the cyclically adjusted PE is 12.8X (vs. historical average of 17.6X). The higher spread between GDP growth and bond yield should also back higher PE multiples vs. historical average.

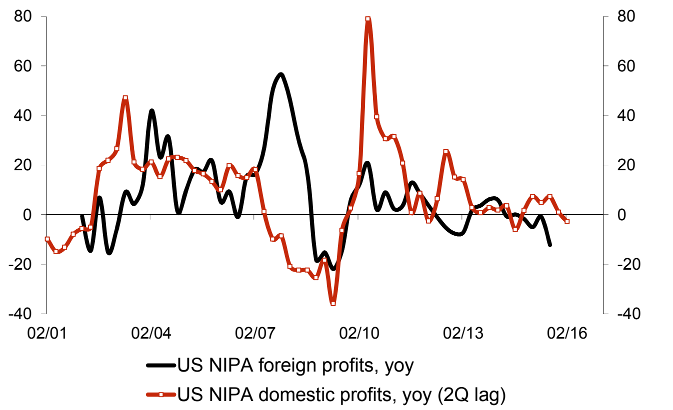
US equities: a structurally expensive market with pressure on profits

We are positive on the US economic development in 2016. The low 10-year rate (2.6% by the end of 2016, real rate below 1%) supports equity valuations in the short term: fair value is at 2,095 using 122$ p.s. in 2016. That said, external and internal pressures on sales and corporate profits are rising and we remain relatively underweight on US equities. The cyclically adjusted PE is expensive (above 26X) and needs stable-to-increasing margins to be sustained. But foreign profits have declined appreciably together with manufacturing sales and the ISM. The dollar and the pressure from a weak oil price should continue to hurt short term. That said, during 2016 the pressure should alleviate as the oil price stabilizes together with the USD in yoy terms. Increasing wages and low productivity are pushing up unit labor costs (3% yoy) and putting pressure on margins. In sum, earnings are toppish and valuations affordable only due to low yields. Increasing credit spreads (HY especially) are not helping, too. The defensive nature of this index provides some cushion together with a high free ash flow yield (5%) and a contained leverage for the larger firms and the consumer.

EA to outperform US midterm. More cautious in the short term

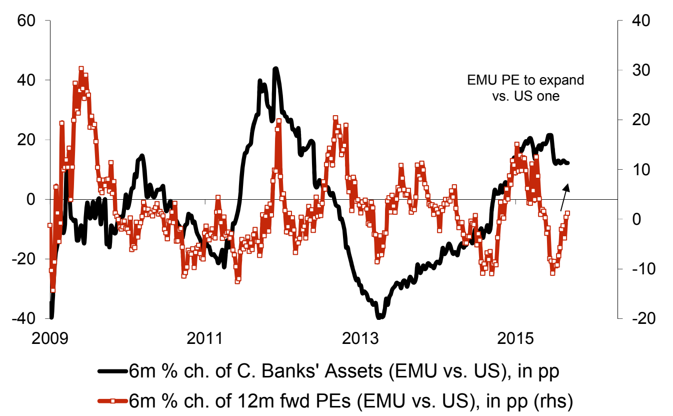
We expect the EA to outperform the US due to lower valuation, better earnings growth

US NIPA PROFITS: DOMESTIC AND FOREIGN



Graph 2

EQUITY VALUATION AND CENTRAL BANKS: EMU VS. US

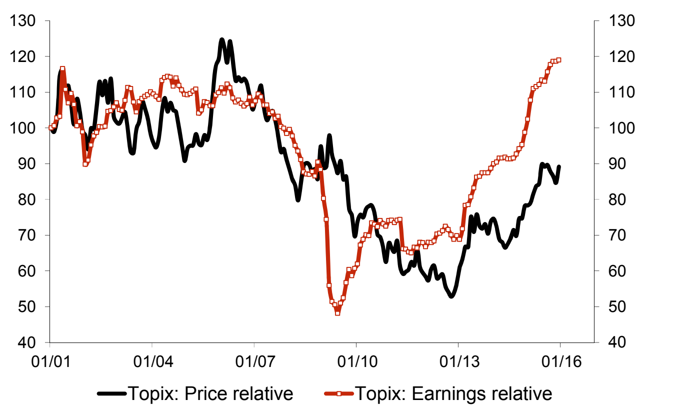


Graph 3

and the dovish central bank. Japan is fairly valued on a short tem view. We prefer EA equities. Diverging monetary policies should trigger a higher transatlantic yield spread and EA PEs. Small caps in the EA should perform well due to a higher sensitivity to growth, better financial conditions and higher exposure to domestic/cyclical themes. Italy is a strong beneficiary of QE (lower spread) and the relative valuation still looks favorable. Reforms and high confidence indicators are additional positives.

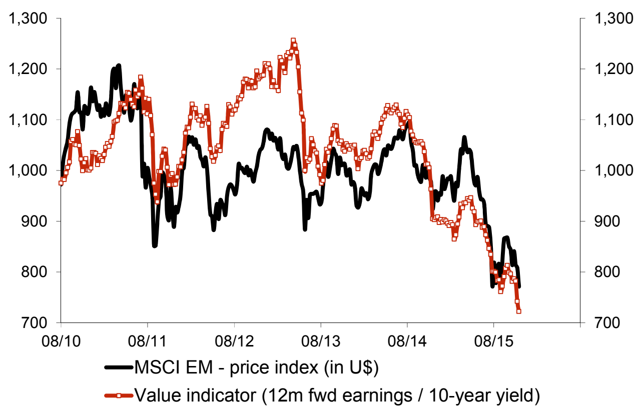
We are positive on Japan on a 12-month view due to corporate restructuring (ROE uphill), weak yen and dovish monetary policy. Valuation is appealing on a 6-12 month view: Earnings should grow at around 8% in 2016. Even maintaining a prudent profit growth in 2017 (near 2%), we see the chance to obtain a total return of 10% in 12 months. We have a less bullish view in the short term as our quantitative models are in negative territory and our earnings estimates below consensus. We expect the BoJ to remain on the dovish side and eventually to act before the next round of wage increases. The yen should remain downbeat, thus supporting corporate sales. Finally, higher wages bode well for the prospects of the domestic economy and inflation.

TOPIX: RELATIVE TO MSCI WORLD



Graph 4

MSCI EM INDEX: VALUE INDICATOR



Graph 5; using hard currency yield for bonds

The US is fairly valued but becomes expensive when earnings are adjusted by the cycle. Japan remains attractive on a 12-month view

EMs still capitulating, structural reforms are key

Since August, when worries of a deepening China economic slowdown intensified, emerging market (EM) earnings have been significantly downgraded (-13% in 2015-2017). CEE countries have been less affected than countries from Asia or Latin America. Economic and profit trends weakened due to lower margins, a stronger dollar, lower commodity prices and politics. Whereas the current accounts for many EM countries have improved, it cannot be taken as a sign of a stabilization of global trade as exports remain weak. EM equities look undervalued by -16%. That said, investors are waiting for commodity price stabilization and a positive response from politics in terms of structural reforms. We look for the development of these two triggers before calling the bottom of the EM equities. MSCI China is to benefit from contained valuations and the recent monetary and targeted fiscal interventions (expected earnings growth has risen over the last 3 months by 3.7 pp). As India is a net oil importer, the market should benefit from a lower oil price. The relatively expensive valuation is compensated by both the higher ROE and the pronounced earnings long-term growth. Hungary is a fair valued market, which is to benefit further from solid economic growth. Overall, we do not see positive signals coming from EM yet. Within the EM space we favor MSCI China, India and the smaller CEE countries.

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Asset Allocation

- **We consider the year 2016 to be characterized by a dichotomy in central bank behaviour, which should favor euro area assets over US assets in general.**
- **Furthermore, we are expecting diverging economic developments between emerging and developed markets, basically arguing for having an investment focus in the latter.**
- **Last but not least, the prevailing low interest environment still favors investments that are able to offer some kind of yield-pickup compared to core government bonds.**

Euro Area to be preferred to the US

We consider the year 2016 to be characterized by a dichotomy in central bank behavior. On the one hand, there is the Fed starting the first tightening cycle following a seven-year period of Fed Fund Rates being close to zero. On the other hand, central banks like first and foremost the ECB will continue to provide support to financial markets by pursuing their expansionary monetary policy. From that perspective, an investor should generally prefer euro area assets to US ones.

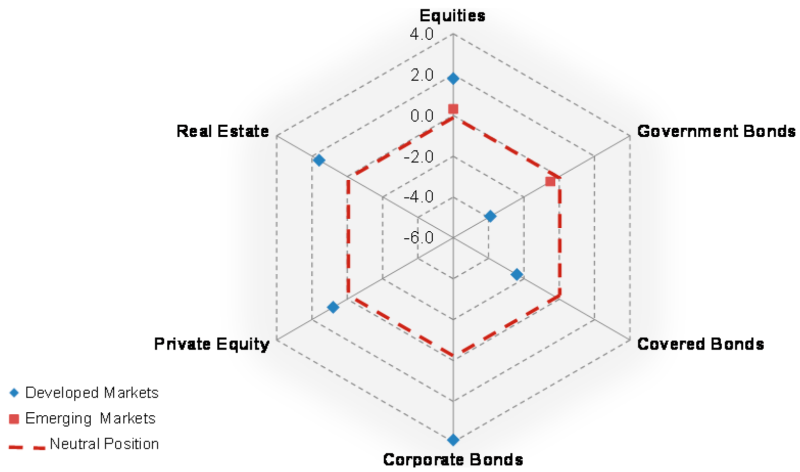
Developed markets to be favored over emerging markets

Furthermore, we are expecting diverging economic developments between the emerging and the developed world. Although we do not act on the assumption of a straight forward emerging market crisis, growths prospects should be humble for the time being. That said, growth in the developed markets – although only moderate too – should be resilient to these headwinds arising from the EMs. In that sense, having an investment focus in the developed world appears recommendable.

Still favorable environment for risky assets

Last but not least, the prevailing low interest environment still favors investments that are able to offer some kind of yield-pickup compared to core government bonds. In that sense, the exposure to the latter should primarily be underweighted in favor of risky assets, i.e. equities and corporate bonds.

MODEL PORTFOLIO: TAA - RADAR SCREEN



Graph 1; active positions in percentage points

The critical economic and political situation in China, the start of the tightening cycle by the Fed, and further potential setbacks for the European integration should contribute to market volatility. Against this backdrop, we recommend to implement only moderate active positions.

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Forecasts

GROWTH

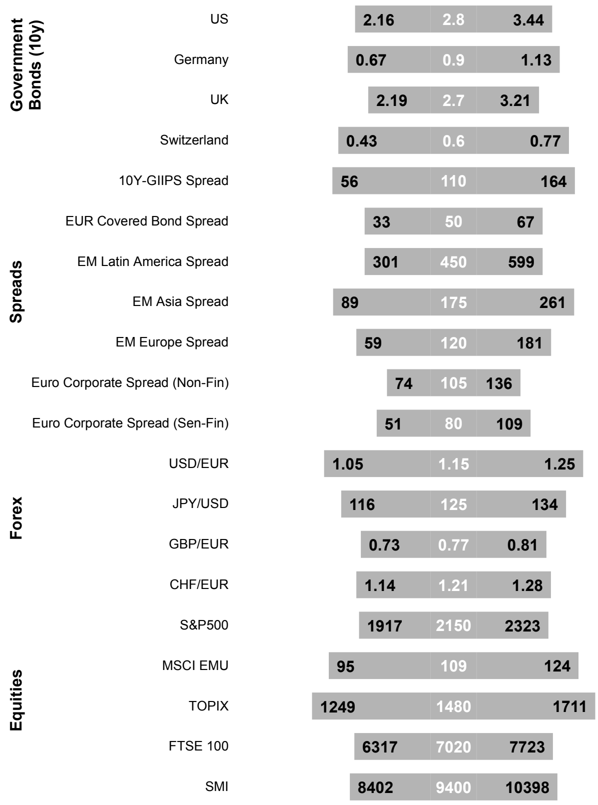
	2013	2014	2015f	2016f
US	1.5	2.4	2.5	2.6
Euro Area	- 0.3	0.9	1.5	1.6
- Germany	0.4	1.6	1.5	1.7
- France	0.7	0.2	1.1	1.2
- Italy	- 1.8	- 0.4	0.7	1.1
Non-EMU	1.5	2.6	2.4	2.3
- UK	1.7	2.8	2.4	2.3
- Switzerland	1.8	1.9	0.8	1.2
Japan	1.5	- 0.1	0.7	0.9
Asia ex Japan	5.9	6.2	5.8	5.8
- China	7.7	7.4	6.9	6.4
Central/Eastern Europe	1.9	1.8	- 0.0	1.6
Latin America	2.7	1.0	- 0.3	0.5
World	**2.5**	**2.8**	**2.6**	**2.9**

INFLATION

	2013	2014	2015f	2016f
US	1.5	1.6	0.1	1.7
Euro Area	1.4	0.4	0.0	1.0
- Germany	1.6	0.8	0.2	1.3
- France	1.0	0.6	0.1	1.0
- Italy	1.3	0.2	0.1	1.0
Non-EMU	1.8	1.0	0.1	0.8
- UK	2.6	1.5	0.1	1.2
- Switzerland	- 0.2	0.0	- 1.1	- 0.2
Japan	0.4	2.7	0.8	0.7
Asia ex Japan	3.5	3.3	2.2	2.7
- China	2.7	2.0	1.4	1.6
Central/Eastern Europe	5.3	5.6	8.9	5.9
Latin America	7.5	10.4	14.1	15.3
World	**2.0**	**2.3**	**1.6**	**2.4**

FINANCIAL MARKETS*

3-month Money Market	**Current**	**YE 2016**
US	0.49	1.20
Euro-Area	- 0.12	- 0.15
Japan	0.08	0.10
UK	0.58	0.90
Switzerland	- 0.81	- 0.85
10Y Government Bonds	**Current**	**YE 2016**
US	2.20	2.60
Euro-Area	0.57	0.80
Japan	0.31	0.45
UK	1.85	2.20
Switzerland	- 0.21	- 0.05
10Y Spreads	**Current**	**YE 2016**
Covered Bonds	70	55
GIIPS	102	80
EM Gvt. Bonds Spreads	**Current**	**YE 2016**
Latin America	584	630
Asia ex Japan	256	250
CEE	152	159
Corporate Bond Spreads	**Current**	**YE 2016**
IBOXX Non-Financial	171	135
IBOXX Sen-Financial	129	95
Forex	**Current**	**YE 2016**
USD/EUR	1.10	1.02
JPY/USD	121	128
JPY/EUR	133	131
USD/GBP	1.52	1.36
GBP/EUR	0.72	0.75
CHF/EUR	1.08	1.11
Equities	**Current**	**YE 2016**
S&P500	2037	2100
MSCI EMU	112	123
TOPIX	1548	1675
FTSE	6056	6480
SMI	8587	9240



***As of 12/15/2015**

Imprint

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