GENERALI INVESTMENTS

Outlook 2017

Growth resilience and receding central bank support

Content

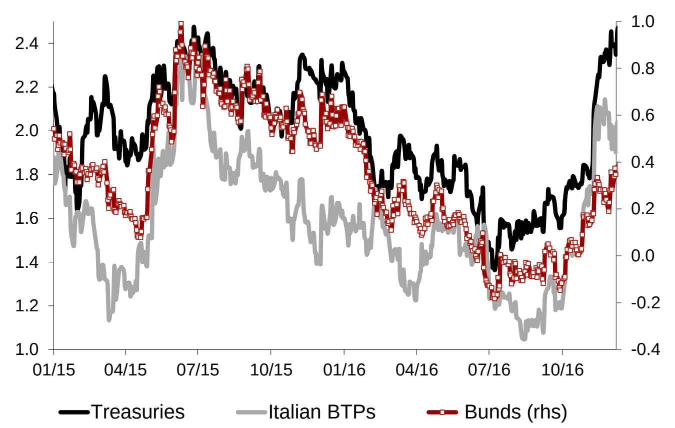
Global View

- **Political shock events and repeated growth fears have kept volatility on global financial markets high over the past year, culminating in the British decision to leave the EU.**
- **Notwithstanding, resilience on financial markets prevailed. This was also the result of an even more accommodative twist by major central banks.**
- **Going into 2017, global growth has gained in resilience recently. It will remain muted, though, with ending recessions in Russia and Brazil alongside improved dynamics in the US accounting for the bulk of a mild pickup in global growth.**
- **Investors will still face a challenging environment, with political risks and easing tailwinds from central banks weighing on asset returns.**
- **Amid an environment of gradually recovering global yields, a stronger focus on European real assets and higher yielding corporate bonds in the euro area should help to protect investment returns.**

2016 was a year of unusually risky political events: Brexit, US elections, the Italian constitutional referendum

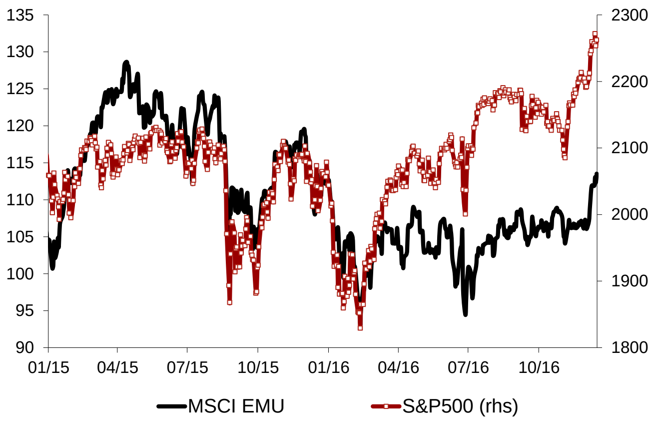
Elevated political risks and repeated growth fears have kept volatility on global financial markets high in 2016. Concerns about the fallout of the first key rate hike by the Fed at the end of 2015 and fears of a sharper growth deceleration in China weighed on emerging markets initially. The oil price plummeted to a 12-year low in February and core bond yields fell to record lows toward the mid of the year. Political uncertainties culminated in a surprising decision by British voters to leave the EU on June 23. That said European economies proved strikingly resilient to this political event. Later in November, the victory of Donald Trump in the US presidential elections, largely anticipated as an uncertainty shock, was swiftly cheered by global financial markets which focused on the reflationary promises of a fiscal stimulus and eased regulation. In a third political key event of the year, the clear ‘No’ by Italian voters in a constitutional referendum in Italy in December was quickly followed by a rebound in risk sentiment. Going through a sequence of tail risk events, resilience of the global economy and financial markets prevailed.

GOVERNMENT BOND YIELDS



Graph 1; 10-year maturities, in % p.a.

EQUITY INDICES



Graph 2

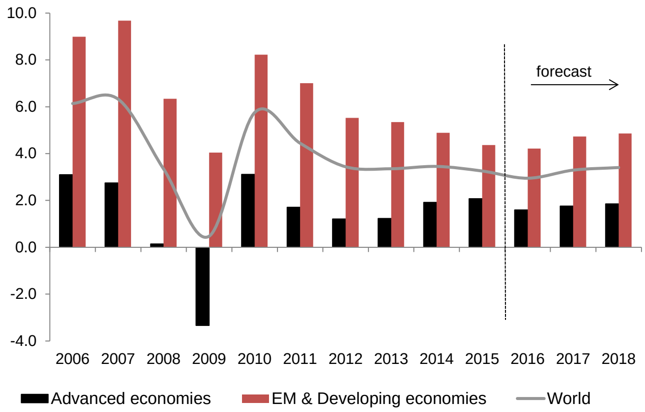
This was also the result of a more accommodative shift by major central banks. The Fed delayed its second rate hike until December, while the ECB stepped up its quantitative easing by € 20 bn to a pace of € 80 bn per month, including corporate bonds in its asset purchase program. By mid-December, equity markets rallied by more than 10%, outperforming the virtually flat European stocks (MSCI EMU: +0.8%). US Treasury yields rose on balance, while euro area non-financial corporate bonds rallied.

Recovering, but still sluggish global growth

Easing recessions in Russia and Brazil will acount for the bulk of the pick up in global growth 2017

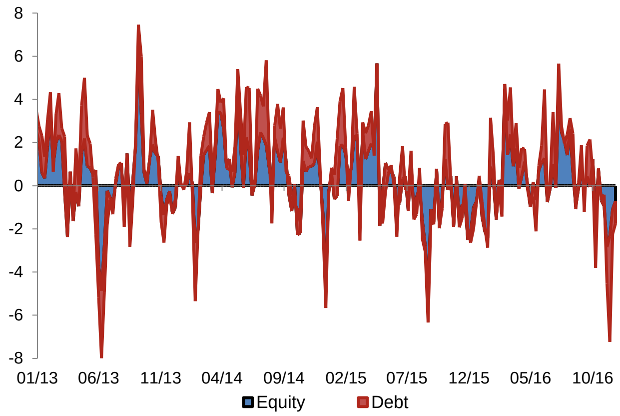
The global economy is entering 2017 on a resilient footing, but global growth will remain well below the historic norm, picking up from 3.0% this year to 3.3% next. Two thirds of this acceleration will be due to ending recessions in Russia and Brazil, with the US accounting for the remainder of the improvement. Easing tailwinds from the low oil prices will keep expansion in the euro area slightly below the 2016 average, while the Chinese economy will continue to slow gradually.

GLOBAL ECONOMIC GROWTH



Graph 3; in %yoy

NET PORTFOLIO FLOWS TO EMERGING MARKETS



Graph 4; weekly in US$ bn, source: IIF

An overall decent growth outlook remains challenged by political and financial market risks

That said the outlook remains subject to substantial uncertainties. We anticipate that tax cuts and new infrastructure investment will lift the expansion of the US economy to slightly above potential, while effective protectionist measures will turn out less punitive than proclaimed in the election campaign. However, so far Trump's fiscal plans lack details and may be watered down by Congress. Higher US yields and a stronger dollar may accelerate capital outflows from emerging markets (and China in particular) more strongly, thus proving a larger burden than envisaged in our base line.

Disinflation fears in the advanced economies will continue to ease. That said hopes of a period of swift global reflation appear prone to disappointment. Growth acceleration and a faster normalization of inflation will be a theme for the US. But in other parts of the advanced economies, most notably Japan and the euro area, the path towards higher underlying inflation rates (once volatile effects from energy and food are stripped out) will still prove a very sluggish one.

Political risks will continue to rank high in Europe, but the hurdles for yet another EU exit referendum are high

In the euro area, political uncertainties will persist. After the resignation of the reform-minded PM Renzi, early elections in Italy cannot be ruled out. A prolonged political stalemate is a risk to anyway only meagre growth and may take sustainability concerns regarding Italy's public debt (at 133% of GDP) to the fore again. General elections in France, the Netherlands and Germany will reveal the further rise of extremist and eurosceptical forces in Europe. That said fears of another EU referendum in one of these countries appear overdone, given high legislative hurdles. But a surprise victory of the far right in France's presidential elections would still severely challenge European unity, adding to the political tensions that will be associated with the start of negotiations about the terms of the UK's exit from the EU.

Tailwinds from monetary policy will ease

The tailwinds from monetary policy will ease next year, even though unevenly. The Fed is likely to raise rates by another 75 bps while the ECB will remain highly ac-

Fed may hike rates by another 50 bps points in 2017, while the ECB will curtail its asset purchases only very cautiously

commodative, but still lower its asset purchases to € 60 bn per month from April onwards. The US seems set to weather higher rates well. But the resulting upward pressures in global yields and a stronger US dollar will burden countries and companies that have incurred large US$ debt over the past years. The ongoing quantitative easing by the ECB will continue to prove an important backstop for pressured countries in Southern Europe. Towards autumn, however, continued solid growth and mildly recovering inflation are likely to start the public debate of tapering the ECB's asset purchases, adding to the moderate headwinds from tighter US monetary policy.

MACRO OUTLOOK

	Growth			Inflation		
	2016f	2017f	2018f	2016f	2017f	2018f
US	1.6	2.2	2.4	1.2	2.2	2.4
Euro area	1.6	1.3	1.3	0.2	1.3	1.5
Germany	1.7	1.3	1.3	0.4	1.5	1.7
France	1.2	1.0	1.1	0.2	1.2	1.1
Italy	0.8	0.5	0.7	0.0	1.0	1.1
Non-EMU	2.1	1.6	1.4	0.6	2.4	2.6
UK	2.0	1.4	1.2	0.6	2.7	2.9
Japan	0.7	1.0	0.9	- 0.1	0.6	0.7
Asia ex Japan	6.0	5.9	5.9	2.7	3.0	3.0
China	6.7	6.4	6.0	2.1	2.4	2.2
CEE	1.1	2.4	2.7	5.2	4.4	4.2
Latin America	- 1.4	0.9	1.7	6.3	4.8	4.1
World	3.0	3.3	3.4	2.4	2.7	2.8

Table 1; annual changes, in %

FINANCIAL MARKETS FORECASTS

10-Year Bond Yields	**Current***	**3M**	**6M**	**12M**
US	2.53	2.60	2.70	2.85
Germany	0.34	0.30	0.35	0.50
Italy	1.84	1.90	2.05	2.40
Japan	0.08	0.05	0.05	0.10
Forex	**Current***	**3M**	**6M**	**12M**
USD/EUR	1.06	1.02	1.00	1.05
JPY/USD	116	120	122	125
GBP/EUR	0.84	0.87	0.88	0.90
Equities	**Current***	**3M**	**6M**	**12M**
S&P500	2262	2230	2250	2240
MSCI EMU	113.0	112.5	113.0	114.0

Table 2; *current as of Dec. 15, 3-day average

This setting of resilient growth, political uncertainties and easing monetary support will remain challenging for investors. The current income on safe but very low (or negatively) yielding high-quality bonds will likely be depressed to negative total returns even by just a very moderate increase in yields, with longer dated titles suffering particularly strongly. The yields increase will likely be more pronounced for US bonds, cancelling the apparent advantage of higher current yields.

Focus on real assets and higher yielding corporate bonds in Europe amid gradually rising global yield levels

In this environment, a stronger focus on real assets may well provide some advantages thanks to a more resilient growth outlook. We are less convinced of US equities, given the elevated valuations, the margin squeeze from rising wage costs, tighter Fed policy and a stronger US dollar. Euro area stocks, which have been lagging this year, however, may well provide positive albeit low returns in 2017. Similarly, higher yielding European corporate bonds should remain underpinned by the ECB, still decent valuations and a favorable macroeconomic environment. Southern European debt, by contrast, seems more vulnerable to political uncertainties amid gradually rising global yields and less accommodative central banks. The US dollar is likely to strengthen further against a broad set of peers. Later in the year, however, the EUR/USD may bottom once reassurance about resilient euro area growth triggers a 'tapering' debate at the ECB and political risks in Europe fade following the particularly sensitive elections in France.

Thomas Hempell
+49 (0)221 / 4203-5023

Macroeconomic Outlook

- **In the US, the new administration's tax cuts will deliver stronger growth and inflation, with the effect on growth to be seen in the final months of next year. We anticipate three rate hikes by the Fed in 2017.**
- **We expect the euro area to grow solidly in 2017, weathering headwinds from elections in a number of countries and the Brexit fallout. After having committed to QE throughout next year, we expect the ECB to start tapering in 2018 and to enter into the discussion in autumn.**
- **Regarding China, we expect Beijing to cautiously reduce its fiscal support again.**

Following the Brexit-vote earlier this year, the Trump-victory in the US and the "No" vote in the Italian constitutional referendum joined the list of potential political woes. Looking ahead, while the uncertainty has clearly risen, the projected ending of the recession in Russian and Brazil as well as positive impulses from US fiscal policy contribute to slightly better global growth.

US: "Trumponomics" to start lifting growth in Q3 2017

Trump's fiscal stance to deliver higher growth and inflation in the US

Mr. Trump's victory in the presidential election and the fact that he will enjoy a Republican mayority in the Congress significantly altered the outlook for the US economy. His economic manifesto forsees large cuts (estimated at over 2% of GDP per year) in personal and corporate income tax, in addition to far-reaching deregulations and plans to incentivize private expenditures in infrastructure. Moreover, and more controversially, there is the intention to restrict foreign trade. Crucial details on the implementation of the fiscal measures are still missing, and concerns over the federal debt will likely prevent a full implementation of the plan; however, there is agreement on the fact that GDP growth will be positively affected from the second half of 2017, with the peak of the boost expected by mid-2018, when the extra spending in infrastructure will kick in. The new policies will impact an economy growing at a steady speed, with the labor market startingto show some signs of overheating. In Q3, US GDP was up by 3.2% qoq annualized, driven by private consumption and net trade, while investment continued to lag behind. In November, the unemployment rate was with 4.6%below the 4.8% equilibrium rate. Labor market tightening is eventually feeding through wages, which were up by 2.8% yoy, the fastest increase in more than five years. The stabilization in oil prices drove headline inflation to 1.6% in October, with increasing evidence of upward pressures on underlying inflation.

Going forward, we expect consumption to moderate its growth on the back of higher inflation, but will benefit from support from tax cuts in the final months of the year. Capex will likely stage only moderate growth in the first half of the year, as firms will wait for the details of the fiscal plan, before accelerating from Q4 on. This would translate into accelerating domestic demand, which – coupled with a mild rebound in net exports – will raise GDP growth from the 1.6% expected for 2016 to 2.2% in 2017. At the same time, inflation is expected to advance to above 2% by the first quarter of this year and continue to trend up until 2018. Higher tariffs on imports, if implemented, could translate rapidly into higher inflation, while providing only a small contribution to growth.

The prospects of stronger growth, higher inflation and a larger federal deficit have led to a strong repricing in bond markets, with the yield on the 10-year Treasuries accelerating its upward trend and reaching 2.5% by mid-December. In its December meeting, the Federal Reserve raised the Fed Fund target range by 25bps, as widely expected. The FOMC also marginally revised up the forecast for growth as well as inflation and, more importantly, raised the expectation for the future path of interest rates, which are now consistent with three hikes in 2017 (from two foreseen in September). The new projections, however, do not yet factor in the new fiscal stance. This implies that the Fed's rate projections may be upgraded further over the coming quarters in case a substantial fiscal package will be supported by Congress next year.

Euro area to grow solidly

The euro area economy digested the Brexit shock very well so far. Key sentiment indicators continued to advance and some even climbed to the highest level within this year. GDP continued to expand at an unabated rate of 0.3% qoq in the third quarter and is likely to have maintained this rate also at the end of the year. Employment growth has stabilized and likely averaged 1.4% over the year. Moreover, low inflation, the highly accommodative ECB monetary policy stance and some support from fiscal policy helped.

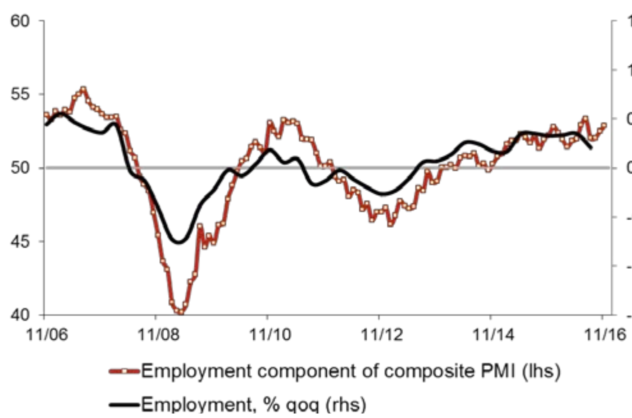
Domestic demand the backbone of the recovery

Looking ahead, we expect the domestically driven economic momentum to remain intact but supporting factors will weaken. As oil prices turned higher over the course of the year and are expected to increase further, its effect on inflation will switch from disinflationary to inflationary, thereby denting some purchasing power. Furthermore, the fiscal stance will be less supportive. The depreciation of the British pound and weaker growth in the UK will also leave their mark. Activity in the euro area will also continue to be burdened by uncertainty and political risks. We see political risks primarily related to the post-referendum situation in Italy, the rise of populist and Eurosceptic parties in forthcoming elections in the Netherlands and France amid the banking sector trouble intensifying. Even if these risks do not materialize they will induce a more cautious view towards investment spending. The situation may be further aggravated by the risk of a hard Brexit, which might increasingly take shape once the exit negotiations start (likely in March). The Trump victory is a two-sided sword for the euro area: On the one hand, it might benefit from higher US growth but on the one other hand, a more protectionist stance and tighter monetary conditions as a result of higher US yields might work in the opposite direction. All in all, we expect overall output to expand by 1.3% in 2017, slightly less compared to 1.6% in 2016.

US: UNEMPLOYMENT AND WAGES

Graph1

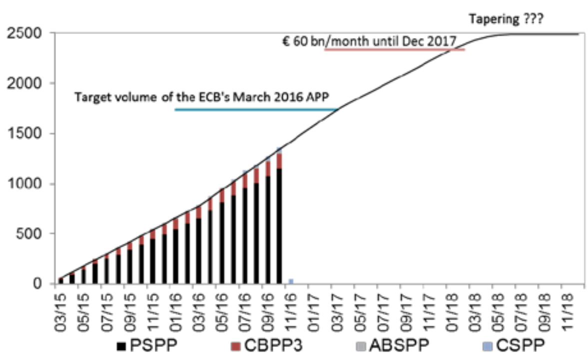
EURO AREA: EMPLOYMENT PROSPECTS



Graph 2

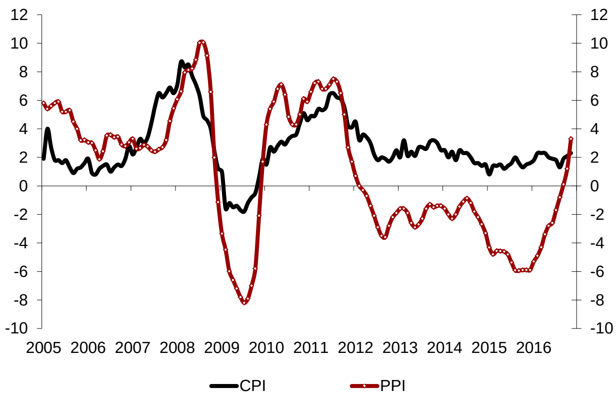
Mainly due to higher energy prices we see inflation picking up to 1.3% in 2017. However, underlying inflation will only sluggishly recover from the current reading of 0.8% yoy as the effects from the past oil price decline are still feeding through and the output gap is still negative. Against the backdrop of a still muted inflation outlook, the ECB extended its quantitative easing by nine months to December 2017 but reduced the volume of monthly purchases to € 60 bn (from € 80 bn) as the risk of deflation receded significantly. Whether the next step will be tapering (as we expect) or another extension of QE largely depends on the situation in autumn 2017 when the ECB will have to think about the further course of its policy.

ECB'S QE PROGRAM



Graph 3; bn EUR

CHINA: CONSUMER AND PRODUCER PRICE INFLATION



Graph 4; in %

China's growth to soften again after spring

Rising PPI inflation reduces SoEs margin pressures and renders debt more manageable

Over the course of 2016, China's economic growth held up better than expected. GDP expanded by 6.7% yoy in Q3 for the third (identical) quarter in a row. The stabilization was the result of expansionary fiscal policies mainly in the forms of infrastructure investments, stimulating measures for the real estate sector as well as using the government influence to push up investment of State-owned enterprises. The second most important development was the end of the strong PPI deflation, which narrowed from about -6% yoy at the beginning of 2016 to 3.3% yoy of late. Against the backdrop of capacity cuts in the coal and steel sectors and helpful international commodity price developments, the turn-around has two major implications. First, it helps to support the recovery of profit margins in the industry sector, and secondly it reduces the real value of debt. Both is especially beneficial to the heavily indebted SoEs (State owned Enterprises), reducing fears of possible medium term financial instabilities. Overall, this also implies less need for state support. While PPI and CPI inflation decoupled over the last years, we expect the recent rise to entail some upward pressure on CPI inflation, which we expect at 2.4% in 2017. The reflation will also lift nominal GDP, while we expect real GDP to start softening again after spring. The government is likely to moderate its stimuli in order to not deteriorate China's already very high credit to GDP ratio further. However, Beijing will probably act rather cautiously against the background of possibly looming trade disputes with the US, given US President-elect Trump campaign threats to impose punitive tariffs. All in, we expect GDP at 6.4% in 2017. We see China's monetary policy on hold, but the rising divergence to the Fed stance charges the PBoC with managing capital outflows without risking financial market stability.

Christoph Siepmann
+49 (0)221 / 4203-5050

Martin Wolburg
+49 (0)221 / 4203-5061

Paolo Zanghieri
+39 0260 -765748

Fixed Income

- **Core government bond yields on both sides of the Atlantic are likely to continue their recent trend in 2017. Higher nominal growth and an increasing term premium are expected to trigger a moderate upward movement of long-dated yields.**
- **In light of the recently eased criteria for the QE programme, the euro area yield curve is forecast to steepen. In contrast, the US curve has scope to flatten as the Fed is expected to continue its hiking cycle.**
- **Given the looming political risks in the euro area, Southern European bonds are likely to remain under pressure. Particularly, Italian BTP spreads have leeway to widen further.**
- **As the general trend for international government yields is seen to point upwards, total returns are likely to remain very low and in many cases can turn out to be negative.**

Regime shift on US bond markets to last in 2017 and to spill over to other bond markets

The trend towards higher government yields established in Q4 2016 is expected to prevail in the course of 2017. Triggered by Donald Trump's surprise victory and the expected corresponding shift in the future US economic policy, the historical low yield levels are unlikely to be tested again next year. While the exact design of the new economic policy is still not completely clear, the mix of a more expansionary fiscal policy, a restrictive stance on migration and a shift towards protectionism is forecast to trigger higher inflation rates going forward. In combination with a moderately accelerating real growth this is seen to lift US yields further. What is more, the high degree of uncertainty will result in a higher compensation for investors. Although the term premium has increased in recent weeks already, there is some scope for the trend to continue. Furthermore, the Fed will speed up its hiking cycle. We expect three more rate hikes in 2017 which should leave their marks on US yields.

While a higher term premium and higher nominal growth should lift euro area core yields as well, the monetary policy stance will continue to diverge. The ECB announced at the beginning of December that the current QE programme will be extended at least until the end of 2017 (although at a reduced amount). This implies that the ECB will hold almost € 450bn of German Bunds by the end of 2017. This is more than 30% of all QE eligible German Bunds and indicates that the ECB will remain an important player in the market. In addition, the political uncertainty in the euro area is currently on a high level. Given the looming elections in 2017 and the unresolved problems in Italy the corresponding index has leeway to rise further. This should in combination with the ongoing QE purchases keep a lid on euro area core government bond yields and limit any spillover from the US.

The diverging monetary policy stance is the likely cause for a different development of yield curves. As the Fed will shift to a more aggressive policy stance next year and the hiking cycle is forecast to continue in 2018, the short end of the US curve has more scope to rise than the long end of the curve – hence, the US curve is forecast to flatten. In contrast, the removal of the deposit rate floor and the inclusion of very short-dated bonds in the QE programme point to a steepening of the euro area curve.

Italian BTPs to remain burdened by political uncertainty

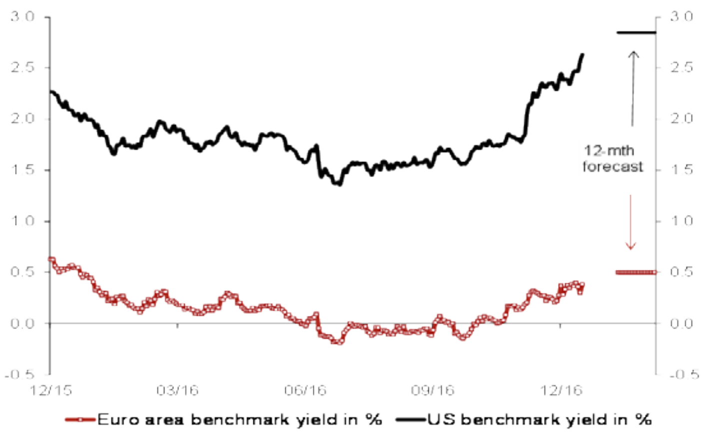
Environment for Southern European bonds to become more challenging in 2017

While Spanish government bonds performed reasonably well in 2016, Italian (and Portuguese) ones came under pressure. The environment for Southern European bonds is unlikely to improve lastingly next year. Although the formation of an euro-sceptic government in France, the Netherlands or Germany in 2017 is not on the cards, euro-sceptic parties are seen to gain support, and negotiations and agreements on a European level will become more difficult. Given the looming political risks, financial markets' current complacency is striking. However, this is unlikely to prevail. Given that peripheral bonds have become less attractive from a relative point of view (due to higher core yields) and the expectation that in the course of H2 2017 speculations about a tapering of the QE programme will start, a moderate spread widening is to be expected.

Despite attractive carry the uncertain political situation and the troubled banking sector will likely burden Italian BTPs

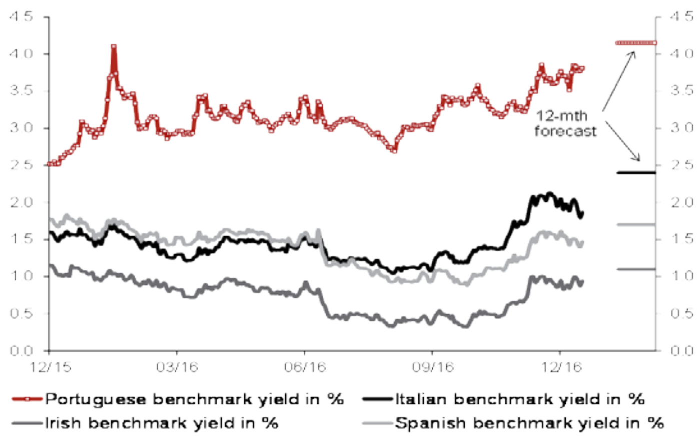
This applies all the more to Italian BTPs. Although they have underperformed in recent months both German Bunds and Spanish Bonos, the spread widening has some scope to continue. The political situation is unstable and early elections cannot be ruled out. Depending on the electoral law, even a 5StarMovement ruled government is possible. What is more, the Italian banking sector is undercapitalized and burdened by a high share of non-performing loans. In case an adverse solution for the banking sector will be agreed on, this can impact the Italian sovereign spread as well. Finally, a downgrade by at least one more rating agency in the course of 2017 is highly probable. Apart from these political considerations, the current spread level of Italian BTPs is attractive and our models indicate an undervaluation of Italian BTPs. However, the current uncertain situation is not covered completely by our models, hence; we send a note of caution and expect that the higher carry will be more than offset by the spread widening. Only in the unexpected case of a broad-based risk-on mode with a shrinking probability that a 5StarMovement government will be established in the course of 2017, Italian BTP spreads have some leeway to tighten.

LONG-DATED GOVERNMENT BOND YIELDS: EURO AREA, US



Graph1

LONG-DATED GOVERNMENT BOND YIELDS: PERIPHERALS



Graph 2

Meagre total returns for government bond investors in 2017

Government bonds to yield very low total returns in 2017 – BTPs to continue to underperform

While the total return of government bonds was still decent in 2016, the next year is likely to become a more challenging one for government bond investors. As described, the general trend for international bond markets in 2017 is set by the US market and the forecast moderate upward shift of the US yield curve is seen to spill at least partially over to other bond markets.

Hence, market participants should adapt to increasing yields and lower bond prices. As the carry is low, the buffer to balance losses is limited. Therefore, the total return will be meagre and in some cases it can even be negative. To start with, US Treasuries will likely yield a low, but positive return across the curve (in local currency) as the carry will offset moderate price losses. In contrast, euro area government bonds across all maturities are expected to suffer losses next year. While the higher carry will shield Southern European bonds somewhat in 2017, it will not make up for the expected spread widening. Italian BTPs will most likely remain particularly weak next year.

Florian Späte
+49 (0)221 / 4203-5052

Corporate Bonds

- After a strong return in 2016, the next year is likely to be more challenging for euro area corporate bonds. As the scope for tighter spreads appears limited, the expected increase in underlying yields will exhaust the carry at least partially.
- On the back of ongoing ECB purchases and low default rates, non-financial corporates are expected to perform reasonably well in H1 2017, but to come under some pressure in the second half of next year.
- Recovering banks' profitability amid mildly higher yields should benefit financial bonds. However, we expect increased political risk to play as an offsetting factor, reducing the scope for spread tightening and feeding market volatility.

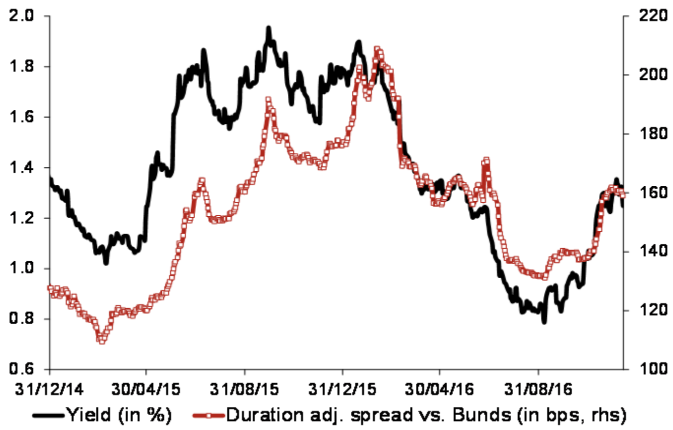
Very solid performance of euro area IG corporate bonds in 2016 – more challanging environment in 2017

Euro area corporate bonds were on a roller coaster in 2016, but overall achieved a decent total return with non-financials outperforming financials. Generally, the decrease in underlying yields was accompanied by tighter corporate bond spreads. The total return of US corporates was even higher as spreads narrowed significantly in the course of the year, thereby even compensating the increase in US Treasury yields.

Several opposing factors will impact euro area corporates in 2017. On the one hand, the economic rebound is expected to remain solid, hence, strengthening the fundamental situation of corporates. What is more, as flows tend to follow the return, the decent performance in 2016 will trigger further inflows. In addition, the record high issuance activity in 2016 is forecast to slow a bit. On the other hand, the relative yield advantage of corporates (particularly versus peripheral government bonds) has come down and the trend towards higher yields will burden products with a pick up.

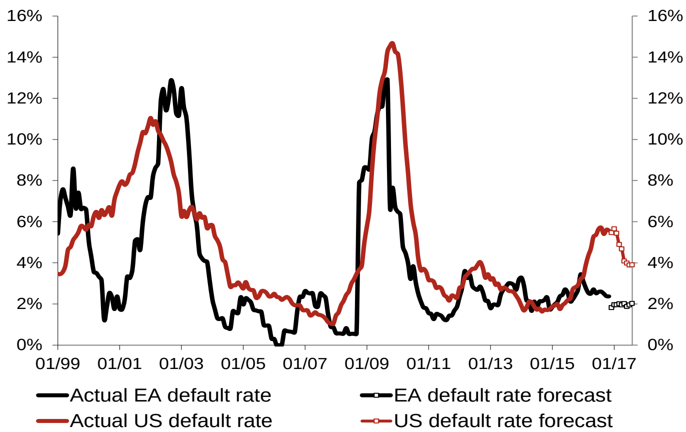
Generally, the total return is expected to be very low, but still in positive territory. Given the forecast increase in underlying yields, investors should avoid long-dated corporates. Moreover, due to our cautious view on peripheral government bonds, corporates domiciled in core euro area countries are seen to perform better. US corporates are likely to come under pressure from two sides: higher US Treasury yields and a moderate spread widening. Hence, despite the higher carry, the total return (in local currency) is forecast to be lower than their European counterparts.

IBOXX EURO AREA CORPORATES



Graph1

US AND EURO AREA DEFAULT RATES



Graph 2; trailing 12-month speculative grade default rates

Low defaults and the ECB to shield non-financials – at least in H1

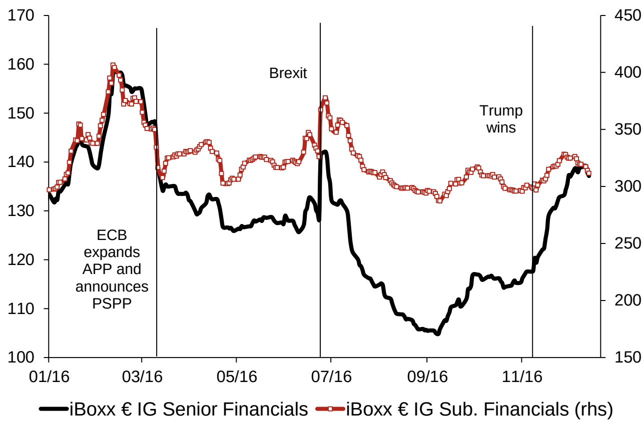
Euro area non-financial corporates will remain supported throughout the next year by sound fundamentals and ongoing ECB purchases. The trailing 12-month default

Moderate spread tightening potential for non-financial corporate bonds in H1, but mounting headwinds in H2 stand in the way of a continuation of the rally

rate will remain on depressed levels, well below the long-term average of 3.8%. From a current level of 2.4%, it is forecast to fall towards 2.0% and to stay around this level over the course of 2017. What is more, the ECB will purchase around € 9 bn of non-bank corporates each month until March 2017 and then (probably) reduce it slightly.

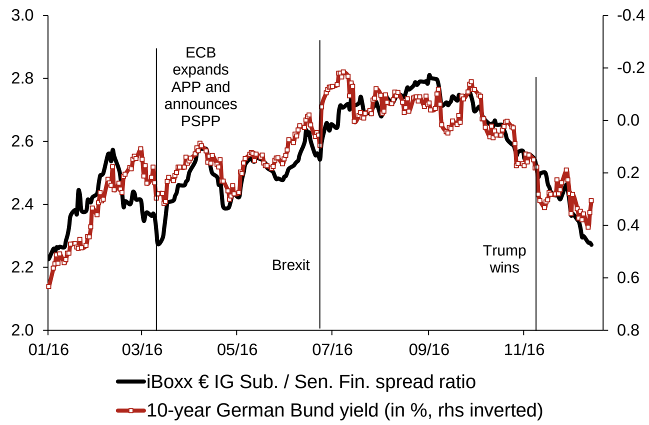
In this environment there is some scope for non-financial spreads to tighten. But, going into H2 headwinds will mount as underlying yields are seen to rise moderately and a debate about a potential QE tapering is likely. Given that the QE programme is a strong supporting factor, the scope for a continued tightening appears limited. On balance, non-financials should still do reasonably well in 2017 (total return: +0.8%).

IBOXX EURO AREA FINANCIAL CORPORATES



Graph3; Spread vs German Bund (duration adj), in bps

SENIOR-SUBORDINATED SPREAD RATIO AND BUND YIELDS



Graph 4

Renewed sovereign risk pressure to feed volatility on Financials

Financial bonds underperformed non-financial ones in the first half of 2016 due to the inclusion of the latter in the ECB's QE program, the Brexit shock and record-low yields harming banks' profitability. The rebound in core yields in the fourth quarter helped to reduce the underperformance but it also trimmed the positive year-to-date total return to around 0.70% for both Senior and Subordinated Financials.

Market timing around the key political events in the euro area will be crucial to beat the extremely low total return expectations for Senior Financials

Both EUR IG Senior (+4 bps to 137 bps) and Subordinated (+14 bps to 311 bps) spreads are little changed compared to end-2015 levels. We expect this sideways movement to continue (Senior Financials spread at 140 bps at end-2017). On the positive side, European banks can benefit from the expected gradual recovery in profitability, which will be driven by the ongoing restructuring process (lower cost base), the mild increase in core rates and steeper yield curves. Moreover, the results of the EBA stress test confirmed the increased capital resilience of European banks and plentiful liquidity in the system provides time to further increase capital buffers. On the other hand, heightened political tensions in the euro area are likely to feed volatility in sovereign risk premia. Given the still strong sovereign-bank link, we expect the latter to play as an offsetting factor. The possible spikes in sovereign spreads ahead of key political events (e.g. French presidential elections) could offer interesting entry points, helping to beat the very low expected total return performance (+0.4% for Senior Financials) implied by a pure buy-and-hold strategy.

Luca Colussa
+39 040 / 671-250

Florian Späte
+49 (0)221 / 420-5052

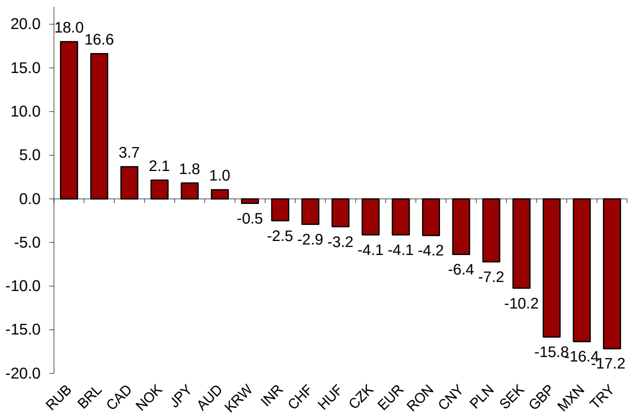
Currencies

- **A sell-off in the British pound in the wake of the Brexit vote, a protracted yuan depreciation and sharply divergent paths of other EM currencies characterized global FX markets in 2016.**
- **Going into 2017, the US dollar is set to extend its momentum of strength on the outlook of a more visible normalization of US rates, approaching parity with the euro.**
- **Later in 2017, however, the euro may regain some ground once resilient growth will bring prospective QE tapering by the ECB in 2018 to the fore.**
- **Other currencies, including the Japanese yen, the British pound and the Chinese yuan, however, are likely to remain subject to ongoing depreciation pressures over the course of next year.**

The US dollar strengthened further in 2016, while the British pound was hammered by the Brexit vote in June

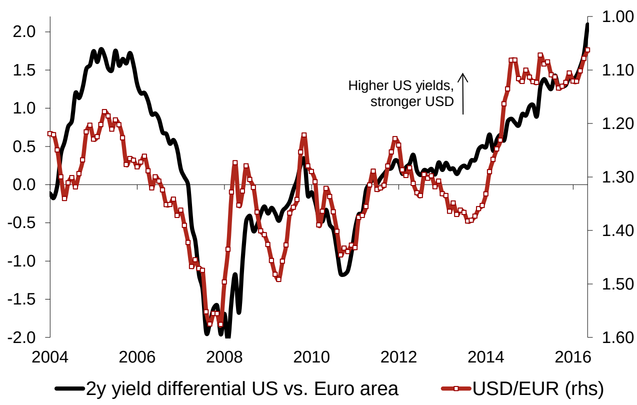
Political events, swings in monetary policy expectations and the recovery of the oil price dominated the global foreign exchange markets in 2016. Unwinding expectations of US rate hikes amid mounting global growth jitters at the start of the year weighed on the US dollar in H1. With US growth picking up and reflation hopes spiking after the victory of Donald Trump in the US presidential elections, however, the Greenback surged again on a broad basis. The British pound suffered severely in the wake of the 'Leave' vote in the British EU referendum in June. Regarding emerging markets, the Mexican peso (on fears of trade sanctions by Trump) and Turkey (on political stress and external vulnerabilities) weakened sharply, whereas bottoming recessions and an improved commodity outlook helped the Russian ruble and the Brazilian real to rebound sharply from an earlier sell-off.

FX PERFORMANCE 2016



Graph 1; vs. euro, in % (year-to-date as of Dec 15)

YIELD DIFFERENTIAL AND USD/EUR



Graph 2; yield differential in percentage points

US dollar to enter 2017 on a strong footing

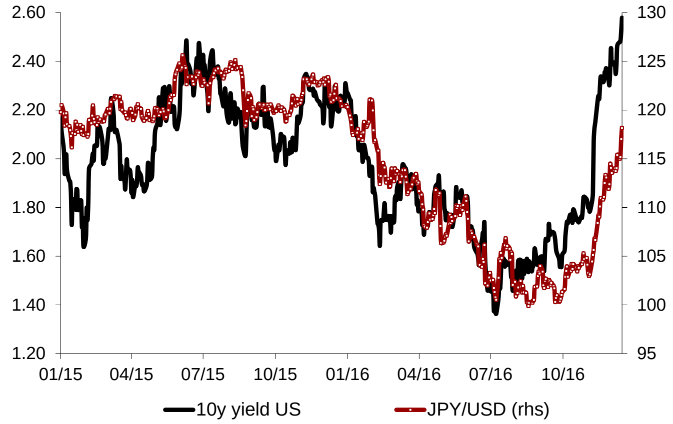
Going into 2017, the US dollar will continue to be backed by rising US rates. With the Fed likely to deliver three rate hikes next year, yield differentials will widen further, weighing on the EUR/USD. The ECB committed in December to prolong its asset purchases – albeit at a reduced pace of € 60 bn from April onwards –, giving leeway for the euro to ease further towards parity with the US dollar. Political risks emanating from Italian politics and banks will also weigh, as will worries about a populist rise in key elections in the Netherlands (March) and France in spring.

Later in 2017, however, we see several forces that will help the single currency to bottom. Most prominently, with euro area growth likely to prove resilient and inflation

The yield control by the BoJ and rising US yields will continue to weigh on the JPY, while the start of Brexit negotiations will lay bare the GBP vulnerabilities amid a still large current account deficit of the UK

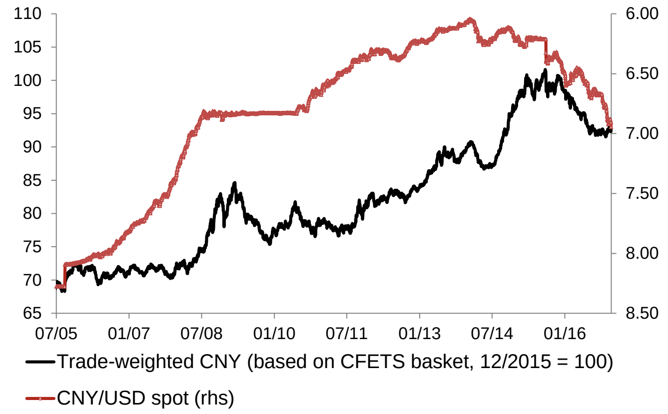
recovering very gradually, the debate about tapering of the ECB's QE will likely start more prominently in autumn 2017. The likely prevention of a victory of Marie Le Pen in the French presidential election will reduce risks to euro area stability. Regarding the external balances, the current account surplus in the euro area of above 3% of GDP will persist, while the US deficit seems likely to widen from currently 2.6% of GDP. This may at some point also lead to a rebalancing of speculative positions which remain strongly tilted towards EUR/USD weakness. As a result, we anticipate another leg lower in the EUR/USD until autumn, to be followed by some recovery of the single currency later in the year.

JPY/USD AND 10-YEAR US TREASURY YIELD



Graph 3

CHINESE YUAN VS USD AND TRADE-WEIGTHTED VALUE



Graph 4

The yen, by contrast, is prone for further weakness over the next whole year. Japanese yields remain anchored by the new BoJ policy framework. Rising US yields will thus widen the yield gap, taking the yen back towards levels visibly around 125 JPY/USD. We also anticipate renewed downward pressures of the British pound, which has recovered partially lately from the sharp post-Brexit slump. Official Brexit negotiations are set to be triggered by spring, and they will create stronger uncertainties over a 'hard' Brexit, given the strong British stance on immigration and the insistence on free movement of labor as integral part of full market access by the remaining EU members. With the UK heavily reliant on continued strong capital inflows due to its ongoing large current account deficit of almost 6% of GDP, we anticipate renewed weakness to levels around 0.90 GBP/EUR by end-2017.

US dollar strength against EM currencies

EM currencies to weaken on rising US rates and risks to global trade. Also, the tightly regulated CNY/USD is likely to trade 5% weaker by end-2017

Emerging market (EM) currencies will remain under pressure amid tighter US monetary policy and global trade risk from the protectionist bias by the Trump administration. But generally EM central bank reserves are high. And in contrast to the 2013 taper tantrum, EM current account balances are now in surplus, reducing the risk of a strong and broad-based EM sell-off.

Depreciation pressures are also likely to prevail on the Chinese yuan. Only massive reserve depletion has contained the fall in the CNY/USD by more than 6% this year. Capital outflows will prevail amid slowing growth in China and rising US rates, with tighter capital controls cushioning the outbound move. The Chinese central bank will likely continue to achieve to keep the trade-weighted yuan quite stable. But against the US dollar, we expect 5% weakness to levels around 7.30 CNY/USD.

Thomas Hempell
+49 (0)221 / 4203-5023

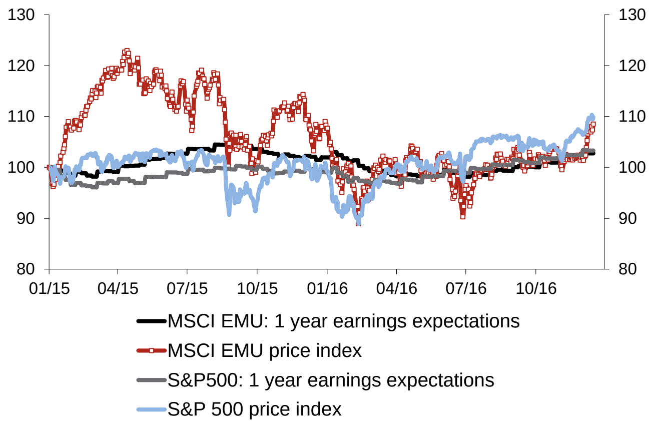
Equities

- Given the moderate recovering macro scenario, we forecast a flat-to-slightly positive total return on a 1-year horizon.
- Riskier and cyclical equity markets (euro area and Japan) have the chance to perform better than the defensive ones.
- Global earnings growth should continue to improve, keeping the dividend yields sustainable (3.5% in the euro area).
- We remain constructive on Emerging Markets (EM) on a medium-term view. We favor India, CEE and Korea.
- Risks: higher than expected yields, Chinese outflows and European political risk to weigh on market multiples.

Given our moderate recovering global macro scenario, we forecast a flat-to-slightly positive total return for equities on a 12-month horizon. While riskier, the most cyclical equity markets (euro area and Japan) have the chance to perform better than the defensive ones (the S&P 500). In the US, valuations are higher than average and less attractive, but the downside risk is limited given our forecast of low real yields for the next 12 months. Furthermore, even a partial implementation of Mr. Trump's fiscal policy could be able to lift US earnings forecasts from current expectations. Concerning risks, political uncertainty will continue to represent one of the most relevant threats to investors' confidence, in particular for Europe. A stronger dollar, increasing protectionism, an acceleration of Chinese capital outflows and, most of all, higher than expected US yields could also limit the equity upside and cause temporary set-backs (for EMs, in particular). Finally, temporary market woes originating from banks' non-performing-loans or higher Italian yields are also possible. On the positive side, we cite the global earnings growth (yoy) which should continue to improve after the bottom experienced in the last summer. In the euro area, this should represent a shield for attractive dividend yields (3.5%). For Japan, a weaker yen and supportive BoJ represent additional positives.

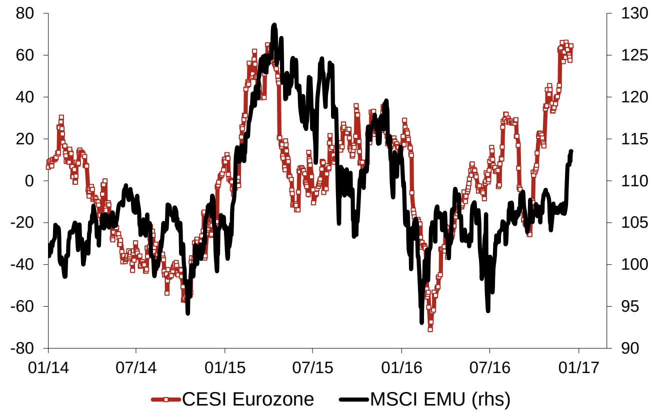
The political uncertainty will remain a constant. Nevertheless, we expect mid-single digit total returns for the next year

PRICE AND EARNINGS PERFORMANCE



Graph 1; (01/01/2015 = 100)

EURO AREA CITI MACRO SURPRISE INDEX VS MSCI EMU



Graph 2

Subdued but positive total returns on a 12-month horizon

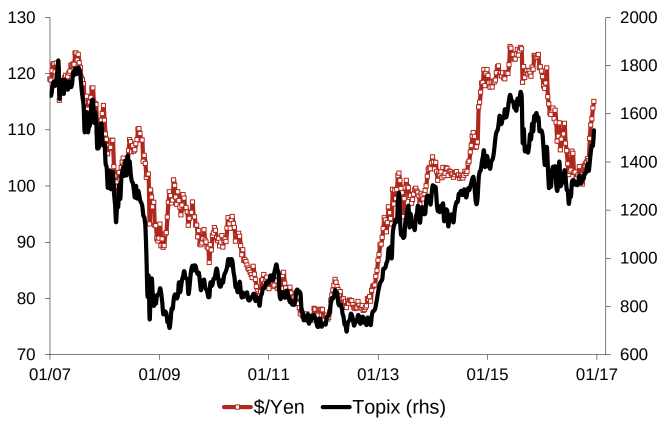
Year–to-date, the MSCI World index delivered a total return of +8%. The US outperformed with a +13%, while the MSCI EMU underperformed at +4%. In Europe, the FTSE 100 gained nearly 17% in local currency (thanks to a depreciating pound), while Switzerland lost 3.4% and Italy 7.7%. After the global deflation fears and the bottoming out of commodity prices in the first quarter of 2016, a more stable evolution of economic activity and inflation followed. The latter led to a rebound of the earnings momentum, starting from energy and material sectors. As yields increased and yield curves steepened, financials started to outperform as well. Then, Mr. Trump's victory and the OPEC agreement added to the reflationary mood. In both cases, uncertainty on the actual implementation of the proposed measures remains high.

Earnings should gradually recover over the coming quarters, with profits growing at least 5% in the EA and 3% in the US (ex-Trump's program)

Corporate earnings were hit strongly in H1 2016: In particular in the EA, due to the high weight of financials (17%), a stronger trade-weighted euro and in part lower nominal GDP growth. Since July, global earnings estimates for the current year have stabilized and for the next 12 months we expect earnings to gradually recover, with profits growing in the EA by at least 5% and by 3% in the US (without including the possible boost from Trump's plans). The outlook for EMs is more encouraging (ca. 7%). That said the expected earnings growth should be enough for investors to enjoy at least a 3-4% total return in a 12-month horizon, i.e. the dividend yield, plus the buy back.

Increasing real yields do not represent a threat for equities, yet. While their recent upward move has indeed started to reduce the positive valuation cushion of the European and Japanese equities, their level remains too low to materially affect price/earnings (especially in Europe and Japan). On the contrary, US equities can be affected more strongly towards the end of 2017 due to higher valuations. Fiscal expansion and deregulation in the US may induce some positive earnings revisions but then, the negative impact of the stronger dollar and the higher yields which could be triggered by the fiscal stimulus itself has to be taken into account. Furthermore, higher unit labor costs should continue to cap corporate margins. In the EA, while political uncertainty represents a risk, EA valuations are cheaper, the euro is weakening and the ECB policy is more dovish.

$/YEN & TOPIX



Graph 3

MSCI EMU: PROFITS AND PRICE EARNINGS RATIO

Markets	PE		PB		PCF		DY		Avg.
	12m f	Discount	12m f	Discount	12m f	Discount	12m f	Discount	Discount
USA	17.3	13.8	2.7	17.4	11.4	18.6	2.2	-1.6	12.9
JAPAN	15.1	-47.3	1.2	-1.5	7.9	13.0	2.1	9.9	-11.4
UK	14.5	5.0	1.7	-4.0	8.7	12.3	4.2	5.3	2.0
SWITZERLAND	16.1	5.0	2.2	-1.7	12.9	15.9	3.8	16.8	0.6
EMU	13.8	-2.5	1.4	-4.9	7.4	18.9	3.6	-8.8	5.1
FRANCE	14.6	1.8	1.4	-2.5	8.4	25.6	3.5	-7.7	8.1
GERMANY	13.6	-10.6	1.6	10.1	8.2	27.9	3.1	-9.7	9.3
GREECE	13.2	3.7	1.4	-8.7	6.9	17.6	3.2	-18.9	7.9
ITALY	12.8	-16.8	1.0	-18.7	4.9	6.8	4.6	-2.4	-6.6
PORTUGAL	15.8	27.3	1.8	2.4	6.4	10.5	4.5	0.6	9.9
SPAIN	13.3	2.4	1.2	-29.2	5.0	-1.4	4.3	-17.9	-2.5
EURO STOXX 50	14.0	5.9	1.5	0.3	7.6	28.2	3.7	-12.9	11.8
STOXX SMALL	15.6	11.2	1.8	6.6	6.6	-17.4	3.1	-5.0	1.4
EM, $	11.9	-19.0	1.4	-15.1	7.1	-6.9	2.9	-18.7	-5.6
BRAZIL	12.3	40.8	1.3	-21.9	6.7	-54.2	3.7	-15.5	-4.9
RUSSIA	6.3	-11.8	0.7	-26.2	3.8	-17.7	4.8	40.7	-24.1
INDIA	16.0	12.7	2.5	-5.3	11.0	-3.7	1.7	6.9	-0.8
CHINA	11.3	-13.1	1.3	-23.0	7.2	-3.4	2.4	-22.2	-4.3

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

Table 1

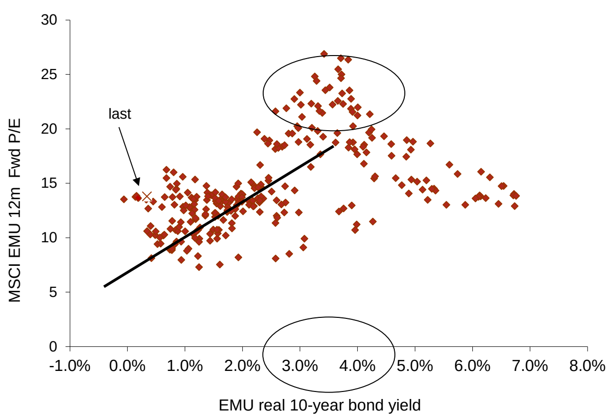
Regional markets and sectors: overweight Japan and the EA

Increasing real yields do not represent a threat for equities, yet. The US is more at risk

Given higher US yields and stronger expected growth and inflation, the rotation inside the equity space has scope to continue: from expensive and defensive sectors and markets towards more value, cyclicals and financial ones. Therefore, we overweight the euro area, Japan and slightly the UK FTSE 100 (both in local currency). We remain relatively underweight on the US and Switzerland. Earnings are improving and valuations - with the exception of the US - look rather affordable. In the US, high multiples (see table) are sustainable under two conditions. First, earnings need to grow by at least 3-5% in 2017 and, secondly, the real 10-year rate should remain contained at 50-100 bps.

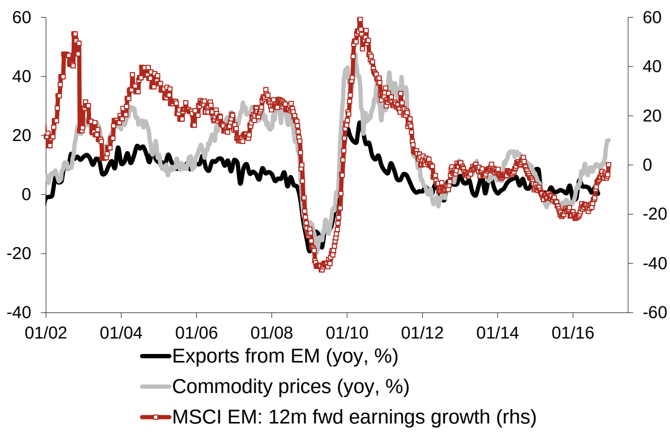
As for sectors, given the improvement in the economic outlook, investors are encouraged to sell the expensive and secure growth sectors (such as staples) to buy cheaper and more cyclical ones. In Europe, we overweigh financials, pharma, materials, transportation and capital goods. We keep an underweight on staples and remain neutral on energy. Banks remain structurally impaired due to low growth, low interest rates, regulation, and high NPLs. That said, more recently there were also some positives: a lower risk of negative policy rates and steepening yield curves (helping the net interest income), a continuing NPL's restructuring activity (albeit volatile and slow), lower pressure on capital requirements and increasing speculations on M&As. Finally, valuations remain appealing in relative terms and earnings revisions should continue to improve.

EMU PE AND REAL LONG YIELDS SINCE 1993 (TMT BUBBLE)



Graph 4

EM: EXPORTS VS. FORWARD EARNINGS



Graph 5

EM: Currently neutral. Constructive on a mid-term view

The recent pressure on yields and EMBI spreads is to linger in the short term. But we remain constructive over a mid-term

EM equities have outperformed the developed markets (DM) by 2.5 pp in US dollar terms YTD, but underperformed them significantly (by 8.5 pp) since the US elections due to the previous EMs' exuberance and the recent pressure on yields and EMBI spreads. The latter could in our view be protracted in the short term. On the negative side, the new US Administration increases the chances of a more hawkish Fed's stance. However, we reckon that the effect of the Fed hikes will be less strong than in the 2013 "taper tantrum" as the EMs now are characterized by better current accounts and stronger FX reserves. Furthermore, equities are to be supported by stable commodity prices. The risks come from a still unclear part of Trump's program on trade restrictions, which should trigger negative revisions to selected EMs, should the initiatives on trade turn out to be aggressive.

Judging by the multiples, EM stocks are still cheaper than DMs (see table) and macro fundamentals are improving. The smaller CEE countries are to benefit from solid GDP growth, low inflation, and positive earnings revisions. While political uncertainty in India should stay high in the short term, both fundamentals and monetary policy remain supportive, along with higher corporate margins. We also favor Korea and the riskier Russia, due to low valuations.

Michele Morganti
+39 040 / 671-599

Vladimir Oleinikov
+49 (0)221 / 4203-5036

Asset Allocation

- **For 2017 we are acting on the assumption of a still muted but slightly picking up global growth.**
- **Political imponderables as well as easing support from central banks will be a burden on financial market returns.**
- **Given the very low current yield levels together with the expectation of yields rising, total returns of high-quality bonds will likely be forced down into negative territory.**
- **For the time being, these circumstances favor investments in real assets and higher yielding bonds in Europe.**

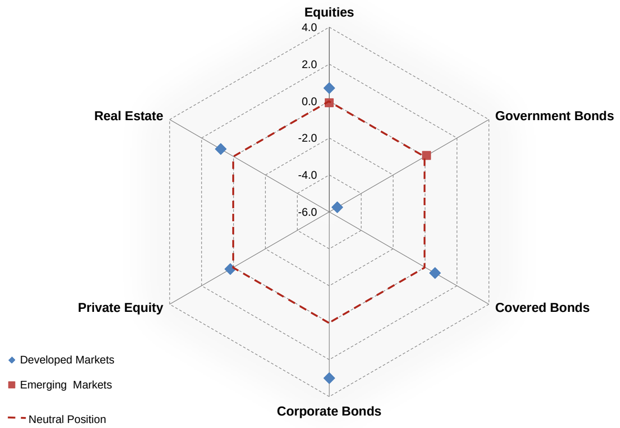
The dichotomy in central bank behavior is anticipated to persist well into 2017. The Fed is expected to continue its hiking cycle, whereas the ECB will extend its quantitative easing. Towards the end of the year, though, the further picking up growth will probably fuel discussions on the ECB starting to gradually decrease its asset purchases.

Dichotomy in central bank behavior and political risks to persist for the time being

The very low yield levels on high-quality bonds will keep the current income of this asset class unattractive. Together with the assumption of rising yields, the corresponding total return levels are expected to fall back into negative territory. The yields increase will likely be more pronounced for US bonds than for European ones, thereby undoing the apparent advantage of higher current levels.

For the time being, resilient growth and easing tailwinds from central banks favor investments in real assets and higher yielding corporate bonds in Europe. Having said that, southern European debt appear particularly endangered to political uncertainties.

MODELPORTFOLIO: TAA – RADAR SCREEN



Graph1; active positions in percentage points

Real assets and higher yielding European corporate bonds to reveal the most attractive returns

Also on the equity side, there is a clear preference for Europe compared to the US. Valuations of US equities are already stretched. Additionally, wage pressure, a tighter Fed policy, and a stronger US dollar should work negatively. Contrawise, euro area equities which have been performing below average in 2016 should be able to provide at least small positive returns.

Thorsten Runde
+49 (0)221 / 4203-5044

Forecasts

GROWTH

	2015	2016f	2017f	2018f
US	2.6	1.6	2.2	2.4
Euro area	1.9	1.6	1.3	1.3
Germany	1.5	1.7	1.3	1.3
France	1.2	1.2	1.0	1.1
Italy	0.6	0.8	0.5	0.7
Non-EMU	2.4	2.1	1.6	1.4
UK	2.2	2.0	1.4	1.2
Switzerland	0.8	1.0	1.3	1.4
Japan	1.3	0.7	1.0	0.9
Asia ex Japan	6.1	6.0	5.9	5.9
China	6.9	6.7	6.4	6.0
CEE	0.1	1.1	2.4	2.7
Latin America	- 0.5	- 1.4	0.9	1.7
World	**3.3**	**3.0**	**3.3**	**3.4**

INFLATION

	2015	2016f	2017f	2018f
US	0.1	1.2	2.2	2.4
Euro area	0.0	0.2	1.3	1.5
Germany	0.1	0.4	1.5	1.7
France	0.1	0.2	1.2	1.1
Italy	0.1	0.0	1.0	1.1
Non-EMU	0.1	0.6	2.4	2.6
UK	0.0	0.6	2.7	2.9
Switzerland	- 1.1	- 0.4	0.2	0.6
Japan	0.8	- 0.1	0.6	0.7
Asia ex Japan	2.4	2.7	3.0	3.0
China	1.4	2.1	2.4	2.2
CEE	9.3	5.2	4.4	4.2
Latin America	6.2	6.3	4.8	4.1
World	**2.3**	**2.4**	**2.7**	**2.8**

FINANCIAL MARKETS

3-month Money Market	**Current**	**3M**	**6M**	**12M**
US	0.96	1.10	1.25	1.60
Euro-Area	-0.33	-0.35	-0.35	-0.35
Japan	-0.06	-0.05	-0.05	-0.05
UK	0.38	0.40	0.40	0.40
Switzerland	-0.74	-0.75	-0.75	-0.75
10Y Government Bonds	**Current**	**3M**	**6M**	**12M**
US	2.53	2.60	2.70	2.85
Euro-Area	0.34	0.30	0.35	0.50
France	0.77	0.75	0.80	0.90
Italy	1.84	1.90	2.05	2.40
Japan	0.08	0.05	0.05	0.10
UK	1.44	1.45	1.55	1.65
Switzerland	-0.08	-0.10	-0.05	0.00
10Y Spreads	**Current**	**3M**	**6M**	**12M**
Covered Bonds	89	85	80	80
GIIPS	141	150	160	170
Corporate Bond Spreads	**Current**	**3M**	**6M**	**12M**
IBOXX Non-Financial	145	140	140	145
IBOXX Sen-Financial	137	135	135	140

EM Gvt. Bonds Spreads	**Current**	**3M**	**6M**	**12M**
Latin America	480	500	510	515
Asia ex Japan	194	210	212	215
CEE	157	150	145	140
Forex	**Current**	**3M**	**6M**	**12M**
USD/EUR	1.06	1.02	1.00	1.05
JPY/USD	116	120	122	125
JPY/EUR	123	122	122	131
USD/GBP	1.26	1.17	1.14	1.17
GBP/EUR	0.84	0.87	0.88	0.90
CHF/EUR	1.08	1.08	1.09	1.10
Equities	**Current**	**3M**	**6M**	**12M**
S&P500	2262	2230	2250	2240
MSCI EMU	113.0	112.5	113.0	114.0
TOPIX	1541	1530	1545	1565
FTSE	6972	6915	6985	6930
SMI	8172	8090	8130	8090

As of 15.12.16 (3-Day-Average)

FORECAST-INTERVAL* – 3-MONTHS HORIZON

Government Bonds (10Y)	US	2.23	2.60	2.97
	Germany	0.24	0.30	0.36
	UK	1.21	1.45	1.69
	Switzerland	-0.09	-0.10	-0.11
Spreads	10Y-GIIPS Spread	127	150	173
	EUR Covered Bond Spread	72	85	98
	EM Latin America Spread	435	500	565
	EM Asia Spread	182	210	238
	EM Europe Spread	122	150	178
	Euro Corporate Spread (Non-Fin)	122	140	158
	Euro Corporate Spread (Sen-Fin)	119	135	151
Forex	USD/EUR	0.99	1.02	1.05
	JPY/USD	115	120	125
	GBP/EUR	0.84	0.87	0.90
	CHF/EUR	1.05	1.08	1.11
Equities	S&P500	2,130	2,230	2,330
	MSCI EMU	105.5	112.5	119.5
	TOPIX	1,413	1,530	1,647
	FTSE 100	6,560	6,915	7,270
	SMI	7,700	8,090	8,480

FORECAST-INTERVAL* – 12-MONTHS HORIZON

Government Bonds (10Y)	US	2.16	2.85	3.54
	Germany	0.39	0.50	0.61
	UK	1.21	1.65	2.09
	Switzerland	-0.04	0.00	0.04
Spreads	10Y-GIIPS Spread	126	170	214
	EUR Covered Bond Spread	57	80	103
	EM Latin America Spread	377	515	653
	EM Asia Spread	150	215	280
	EM Europe Spread	86	140	194
	Euro Corporate Spread (Non-Fin)	113	145	177
	Euro Corporate Spread (Sen-Fin)	108	140	172
Forex	USD/EUR	0.98	1.05	1.12
	JPY/USD	115	125	135
	GBP/EUR	0.84	0.90	0.96
	CHF/EUR	1.05	1.10	1.15
Equities	S&P500	2,050	2,240	2,430
	MSCI EMU	100.0	114.0	128.0
	TOPIX	1,315	1,565	1,815
	FTSE 100	6,276	6,930	7,584
	SMI	7,300	8,090	8,880

Imprint

Head of Research (*ad interim*):	Santo Borsellino (santo.borsellino@generali-invest.com)
Deputy Head of Research:	Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)
Team:	Luca Colussa, CFA (luca.colussa@generali-invest.com) Radomír Jáč (radomir.jac@generali.com) Jakub Krátký (jakub.kratky@generali.com) Michele Morganti (michele.morganti@generali-invest.com) Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com) Dr. Martin Pohl (martin.pohl@generali.com) Dr. Thorsten Runde (thorsten.runde@generali-invest.com) Frank Ruppel (frank.ruppel@generali-invest.com) Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com) Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com) Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com) Paolo Zanghieri (paolo.zanghieri@generali.com)
Edited by:	Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com) Tamara Hardt (tamara.hardt@generali-invest.com)

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In Italy:
Generali Investments Europe
S.p.A Società di gestione del risparmio

Corso Italia, 6
20122 Milano MI, Italy

In France:
Generali Investments Europe
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Investments Europe
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-invest.com