GENERALI INVESTMENTS

Market Perspectives

Blowing hot and cold

August 2018

Content

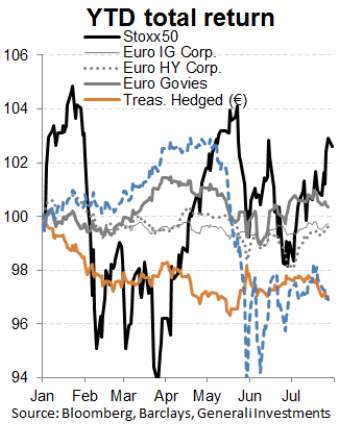
This document was completed on July 31, 2018

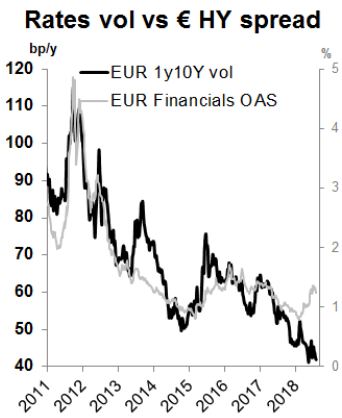
Global View

Vincent Chaigneau

- **Trump is blowing hot and cold on trade. China is slowing but policy makers are now easing off the policy brake. The EA economy has failed to re-accelerate but the ECB is cuddling investors. Italy's Salvini is sounding disruptive but Tria reassuring.**
- **Those offsetting forces are keeping markets relatively quiet. The underlying economic and policy trends leave us defensive on bonds. 10yT is testing 3.0% again and the Bund is too far behind. We still prefer equities but take advantage of recent gains to reduce exposure vs mid-year allocation.**
- **We tactically rebalance towards assets that have lagged and where we have had an underweight, e.g. EUR Financials and non-core (ex-Italy) bonds. EM hard currency debt is also finding a base.**
- **Volatility will rise as the Fed keeps hiking.**

Our quarterly Investment View's message remains mostly valid. That said equity markets have bounced back (see total return chart), leading us to take some chips off the table recently (see below and 'Asset Allocation' section).





US keeps global economy afloat

Following a disappointing Q1 (GDP up by 0.4% qoq) the eurozone economy failed to accelerate in Q2. But economic surprise indices have rebounded (from low levels) and growth has stabilized slightly above potential. Concerns about Chinese growth flourished in spring – infrastructure investment slowed sharply as the deleveraging policy started to bite – and the growing trade tensions haven't helped. But policy makers are now trying to mitigate the regulatory tightening, by accepting the weakening of the currency, cutting reserve requirement ratios, injecting liquidity, announcing local government bond issuance to fund infrastructure and incentivizing banks to buy low-rated bonds. The effort does not match previous stimulus plans but should be enough to keep the local economy afloat. Thankfully, the US is firing on all cylinders (Q2 GDP up by 4.1% saar) as the effect of the fiscal stimulus approaches peak point.

In all, the global economy remains alive and well, though risks have increased along with trade tensions. The Trump-Juncker meeting led to a welcome ceasefire which, along with Chinese policy action, has provided a boost to global stock markets. Isn't it time to embrace risk more forcefully again? We note that the 'deal' included increased EU imports of US soybeans and liquefied natural gas, which may be hard to deliver. Also the 'truce' with China proved very short lived. And buy signals are not conclusive just yet, as risks are priced only selectively.

Risks are only selectively priced

The trade tensions have already left their marks on Chinese equities (now seemingly finding a floor), auto stocks or the Bund yield (still low). But MSCI World is within 5% of its record high. Other measures such as financial volatilities, remain sanguine. This is despite signs that the Fed is proceeding more forcefully with policy normalization; as the Fed gets restrictive vols should increase. So following the recent equity gains we reduce our overweight (OW) to a minimum, though we continue to prefer equities to Fixed Income over 6-12 months.

Bonds	**27/07/18***	**3M**	**6M**	**12M**
10-Year Treasuries	2.96	3.05	3.15	3.25
10-Year Bunds	0.40	0.50	0.60	0.90
Corporate Bonds				
BofaML Non-Financial	107	110	115	125
BofaML Financial	124	130	130	135
Forex				
EUR/USD	1.17	1.17	1.20	1.23
USD/JPY	111	112	113	114
Equities				
S&P500	2834	2810	2815	2855
MSCI EMU	127.0	125.5	128.5	129.0

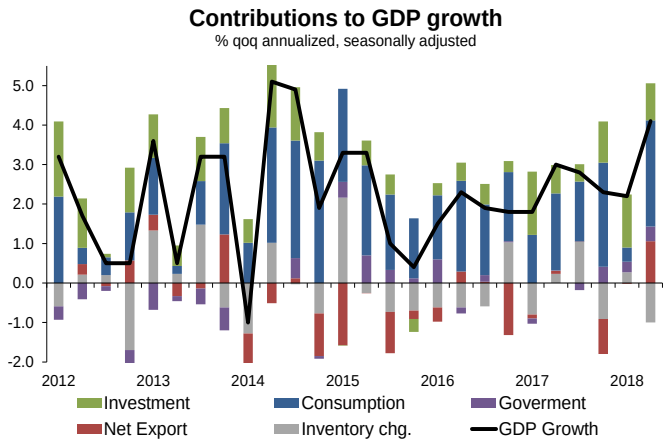
* avg. of last three trading days

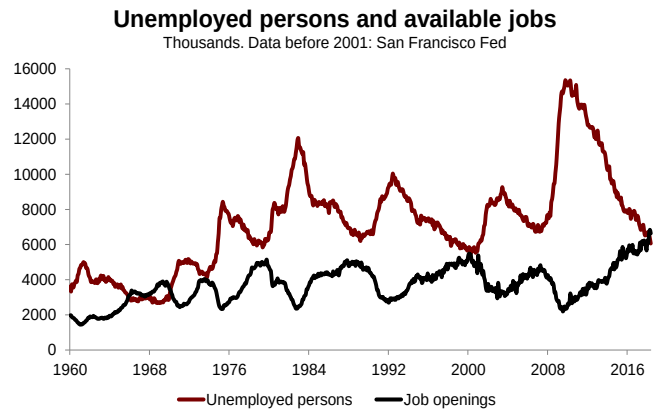
Tweaking the asset allocation

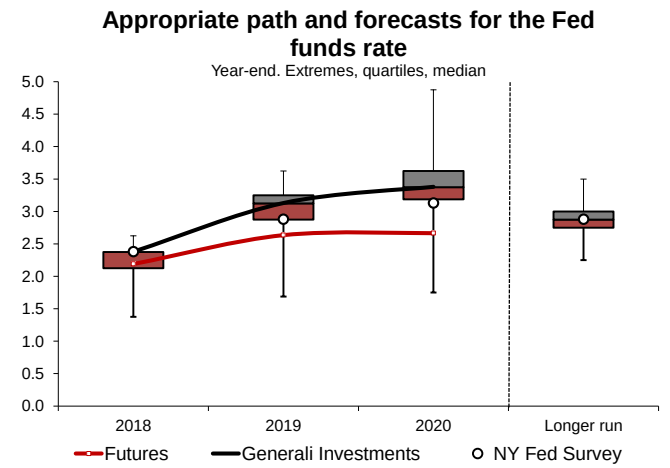
As we reduce equity allocations we reallocate towards assets that have lagged and offer decent carry but limited risk over summer, namely EUR Financials and non-core sovereigns (ex-Italy). We reduce our underweight in both. Arguably those two asset classes are exposed to renewed sovereign stress. We remain concerned about the stance of the new Italian government, and expect the budget discussions to cause stress within the coalition as well as with EU partners and institutions this autumn. That said the news flow should be limited over the coming weeks and those assets have already suffered on a relative basis (chart). Our allocation remains dominated by a long position in cash – highlighting our poor total return expectations across the investment universe – and a short position in Govies, where the ECB's dovish forward guidance has created a false sense of security.

USA

Paolo Zanghieri







- **Temporarily strong net export and a pick up in consumption were behind the 4.1% annualized GDP growth in Q2. GDP is expected to increase by 2.8% in 2018. Sentiment indicators are not yet signaling any strong concern about trade frictions.**
- **Core inflation rose to 2.3% in June, and we expect it to end the year at 2.4%. Oil prices lifted headline inflation to 2.9%. It should ease slightly in the second part of the year.**
- **The June Fed meeting confirmed the positive outlook for the economy. The Fed will hike rates four times this year.**

In Q2 GDP was up by a better than expected 4.1% annualized. Much of this increase was due to higher net exports, as trade partners frontloaded purchases in expectation of the coming into force of the sanctions on US agricultural goods. Growth will peak at 2.8% this year, before reverting to the 1.7% trend growth rate.

The recent coming into force of the tariffs against Chinese import and the announcement of other and more encompassing trade restrictions clearly constitutes the main downside risk to growth. Prices of some inputs, such as steel have already increased sharply along with those of the few consumer goods targeted so far by tariffs (such as washing machines) and an escalation into a full trade war would likely disrupt global value chains. While there is ample anecdotal evidence of concern, business climate indicators are not yet showing any particular uneasiness.

Labor market tightens but inflation picks up mildly

The recent data are consistent with the view of a strong increase in employment amid relatively mild inflationary pressures. In June the unemployment rate went back to 4% as more people re-entered the labor force. A very tight labor market (there are now more jobs available than unemployed persons) has not led to an acceleration in wage growth and core CPI inflation in June ticked up to 2.3%. This should translate into a June reading for the core PCE inflation (the Fed's preferred gauge) of 1.9% only 0.1 pp below the level expected to be reached in December, one of the many indications that risks to inflation are tilted to the upside.

The Fed will hike rates four times this year

In the June meeting the Fed raised the target band for the Fed funds rate to 1.75%-2%, as expected. It also revised up to four hikes the optimal path for interest rates increases this year. The cyclical peak for the Fed fund rates has remained unchanged at 3.4% and will be reached by mid 2020. The tone of the press conference and the minutes showed an upbeat assessment of the state of the economy but also concerns on the impact of trade frictions on firms investment plans and growth.

Euro Area

Martin Wolburg

- **Q2 GDP was reported at 0.3% qoq. We expect growth to not fall below potential also in Q3 and stick to our 2018 growth forecast of 2.0%.**
- **The easing of the transatlantic trade tensions is a positive, confirming us in our view that quarterly growth will stay above potential.**
- **The ECB stuck to its policy stance at the July meeting and did not outline details of the post QE reinvestment policy yet.**

Euro area Q2 flash GDP growth was reported at 0.3% qoq, slightly below our expectation and down compared to the previous quarter. Thereby, the economy maintained a pace in line with potential but the July composite PMI weakened (to 54.3) below the Q2 average (of 54.7).

US-EU ceasefire on tariffs to stabilize sentiment

The tentative agreement between the US and the EU to resolve the steel and aluminum tariff issues, to launch negotiations towards zero tariffs on industrial goods and to not impose further tariffs during the negotiation talks is good news. However, we do not expect a strong rebound as we view the agreement as fragile and it has to be kept in mind that the US-Chinese trade conflict - with negative repercussions on Asia as whole - does not show signs of easing. In July, PMI new export orders weakened further, so that they were only slightly above normal but easing trade tensions will clearly help to sustain exports.

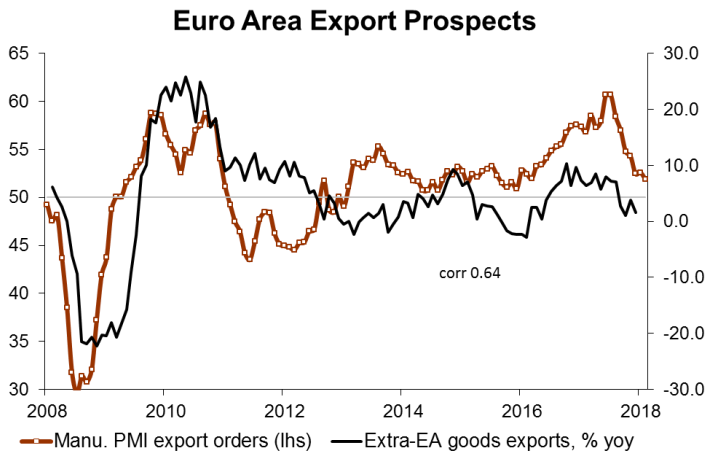
Also, the labor market improvement as the backbone of the domestically driven recovery remains intact (employment +0.4% qoq in Q1, wage growth strengthening) and consumer confidence stays firm at elevated levels. All in all, we stick to our (below consensus) growth forecast of 2.0% for 2018 and 1.7% for 2019.

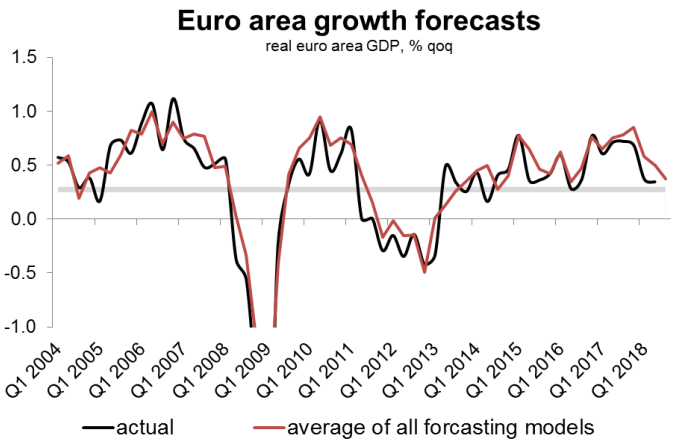
ECB: no clues on reinvestment policy yet

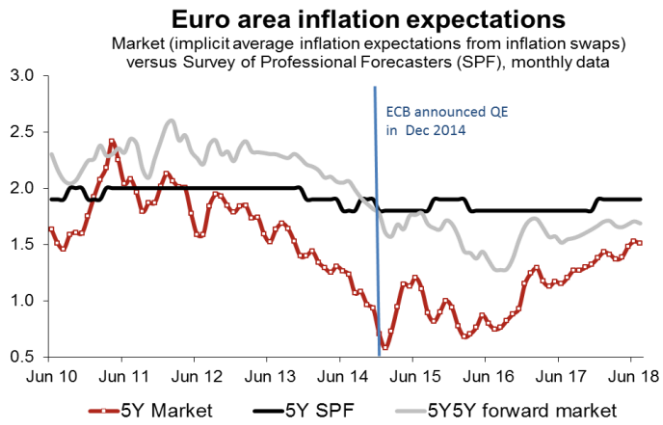
At its July meeting, the ECB left its key rates as well the forward guidance unchanged while confirming that QE will end in December 2018. Overall, the ECB maintained its dovish wording from the last meeting.

The macro outlook remained unchanged but the Governing Council acknowledged that the still looming risk of escalating trade tensions shifted the growth risks from broadly balanced to "*still be assessed as broadly balanced*". However, given the improvement in inflation and inflation expectations we view the hurdles for postponing the end of QE in any case as extremely high.

The post-QE reinvestment policy was not discussed but President Draghi stated that capital key buying remains the ECB's anchor. We think that this discussion will have to start at the September meeting, about three months before the end of QE. Looking further ahead, we continue to expect a first (depo) rate hike in September 2019, nine months after the end of QE.







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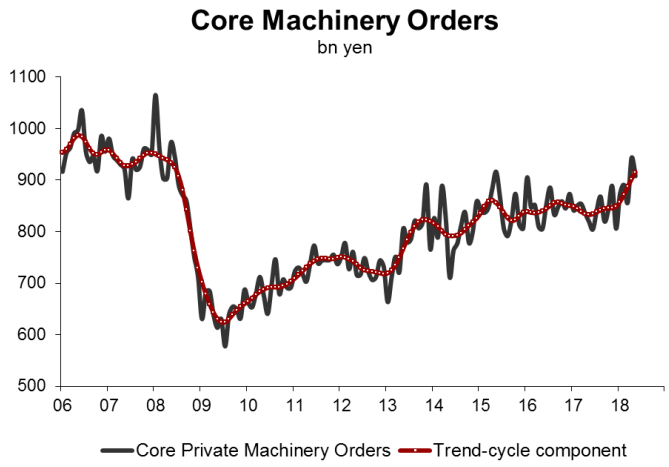
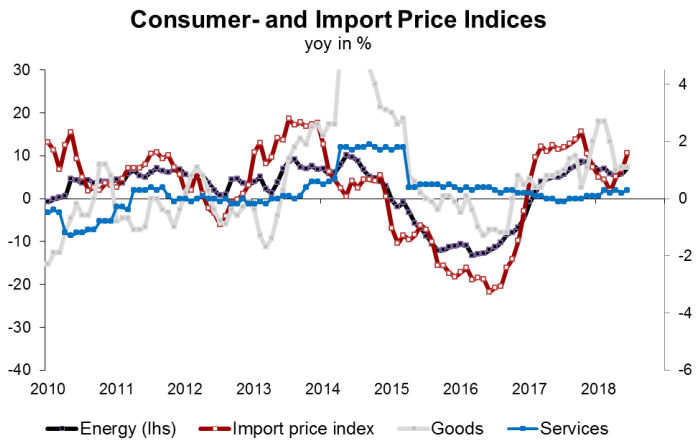
Japan

Christoph Siepmann





Main Forecasts[1)]	2016	2017e	2018f	2019f
GDP	1.0	1.7	1.0	1.1
Consumer spending	0.1	1.0	0.6	1.0
Government consumption	1.3	0.1	0.5	1.1
Investment	1.1	2.6	2.0	1.9
Inventories	-0.2	-0.1	0.2	0.0
Net trade	0.5	0.5	0.2	0.0
Domestic demand	0.6	1.2	0.6	1.1
Consumer prices	-0.1	0.5	1.0	1.0
Unemployment rate[2)]	3.1	2.8	2.4	2.3
Budget balance[3)]	-4.2	-4.1	-3.3	-2.9

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

- **Japan's GDP growth has likely recovered in Q2 to around 1.5% qoq ann, after -0.6% in Q1.**
- **CPI inflation still shows no meaningful signs of acceleration. The BoJ revised down its forecast.**
- **The BoJ's monetary policy will remain extremely lose, but it added some flexibility.**

Japan has recently been hit by several natural disasters (earthquake, flooding, heatwave) which point to a troubled start into Q3. However, except for the manufacturing PMI – which fell to 51.6 points, the lowest level since November 2016 – data so far cover only Q2. Industrial production (IP) surprisingly fell by 2.1% mom in June, perhaps reflecting in part the earthquake. Nevertheless, overall IP recovered in Q2 by 1.2% qoq, thereby markedly re-accelerating from the Q1 drop by 1.4% qoq. Looking into the demand side, retail sales rebounded in June by 1.8% yoy. Thus, Q2 private consumption could gain about 0.3% qoq, after the slight drop in Q1. Core private machinery orders improved markedly of late, which is in line with the last BoJ Tankan report. While large manufacturers saw their business confidence soften, investment plans for the FY2018 came in more positively than one year ago. Therefore, we expect business investment to continue to improve in Q2, a stance which should be maintained throughout the year (provided US tariffs threats on cars will not resurface soon). Finally, according to BoJ data, real exports rose by about 0.5% qoq in Q2, while imports receded by 1.5% qoq. Therefore, a positive impact from net exports on GDP growth has to be expected. In sum, activity is likely to have rebounded to around 1.5% qoq ann in Q2. Further out, as the base effect will diminish, we see growth to fall back to slightly above 1% qoq ann again.

BoJ avoided signaling any policy tightening

Meanwhile, June CPI inflation displayed no sign of a meaningful change. Nationwide headline inflation stayed constant at 0.7% yoy, while the BoJ's preferred core-core inflation measure (ex fresh food and energy) even receded to 0.2% yoy, after 0.3% before. Service inflation remained very low but goods prices saw a small positive impact from rising energy and import prices. Against this background, the BoJ revised its CPI inflation forecast (ex fresh food) further down to 1.1% in FY 2018. Ahead of the BoJ meeting on July 30/31, markets had speculated that the BoJ might raise the prospect of a target rate hike for 10-year JGBs, at least to help bank's profitability with a slightly steeper yield curve. However, the bank maintained its policy rate at -0.1% and the 10-year rate at 0%, but conceded that "yields may move upward and downward to some extent mainly depending on developments in economic activity and prices". It also added some flexibility to the size of the policy balance will rely more on forward guidance. It will also shift ETF buying to track the TOPIX. Overall, monetary policy will stay extremely lose.

China

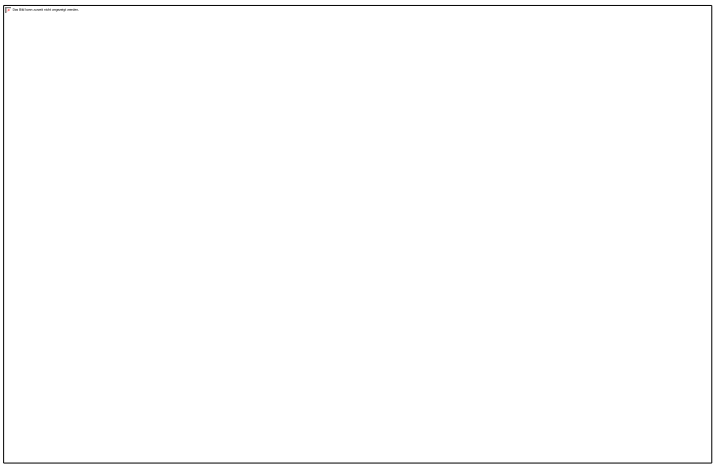
Christoph Siepmann

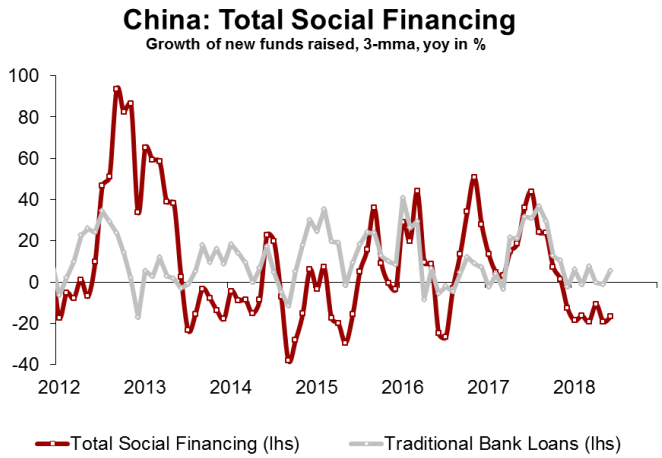
- **In Q2 2018, China's growth softened only marginally to 6.7% yoy.**
- **Fresh US tariff threats could prove much more disruptive than the sanctions already in place.**
- **The PBoC is likely to focus more strongly on neutralizing the credit impact of the ongoing regulatory tightening, while outright expansionary monetary policy looks still somewhat off.**

According to official data, China's real GDP expanded by 6.7% yoy in Q2, only marginally lower than the Q1 growth rate of 6.8% yoy. Nominal GDP growth lost slightly more pace, receding from 10.2% yoy in Q1 to 9.8% yoy ytd in Q2. June real activity data confirmed the mild slowing with investment growth edging down to 6.0% yoy ytd (after 6.1% yoy ytd in May, but from close to 8% at the beginning of 2018) and industrial production cooling to 6% yoy, after 6.8% in May. However, exports remained surprisingly strong while imports diminished markedly. While these readings were much in line with market expectations, China's resilience has nevertheless been astonishing so far. July will mark the first month with 25% US tariffs actually in place on US$ 34 bn of Chines exports, but mid-July saw also the publication of a list for possibly additional 10% tariffs on US$ 200 bn. US President Trump also announced to be "ready" to impose tariffs on all of China's import goods. While the first round of tariffs will impact China's growth only very slightly, the additional threats would make it necessary to revise expected 2018 growth down. A major trade conflict would also hurt Asia due to the highly integrated supply chains, especially for electronics.

BPoC to mitigate effects from regualtory tightening

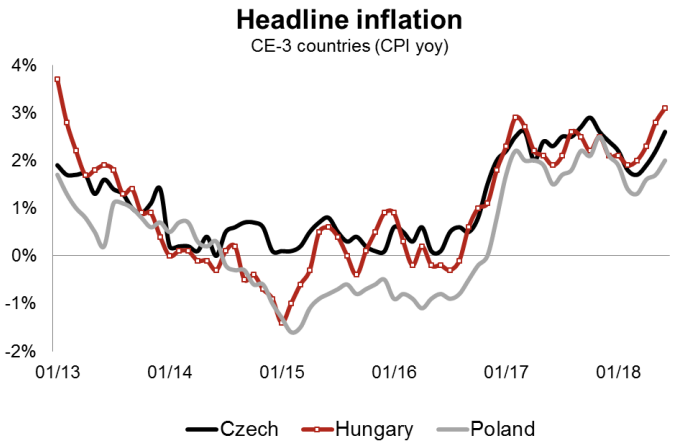
The trade conflict with the US hits China at a time, when it already pursues a policy of deleveraging (and de-risking) the economy from its very high credit-to-GDP ratio of 253% (2017 IMF data). Thus, the country is exposed to two important risks at the same time. Accordingly, markets have speculated of late that China will return to a monetary easing policy soon. We are more reluctant, in the sense that we would not expect China to give up its deleveraging policy unless growth was threatened markedly. However, according to recent reports, regulatory tightening has proven a real challenge to the asset management industry. Total social financing still recedes at a rate of 16.7% (3mma yoy), while new yuan loans from banks expanded by 13.3% yoy ytd in June. The shift from shadow banking back into the official banking sector makes it necessary for the PBoC to provide the banking sector with ample cash and to protect especially SME from being cut off from credit supply. The PBoC has already cut the RRR twice and we expect another 100 bps to come, combined with more long-term liquidity. Moreover, as expected the State Council has recently announced a more pro-active fiscal policy with tax cuts of RMB 1.1. tr and local government bond issuance by RMB 1.35 tr, which will support infrastructure investments.

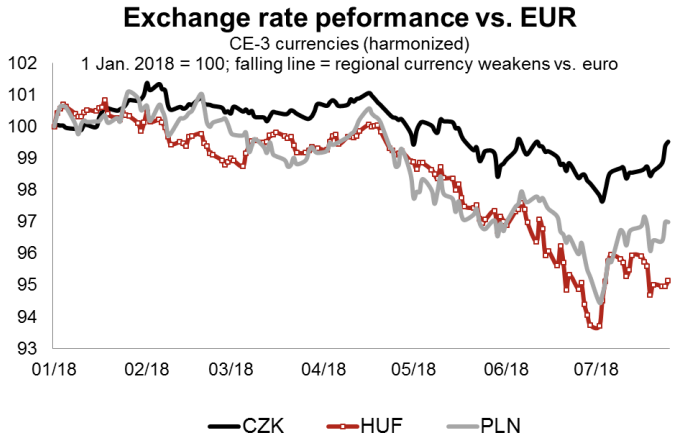




Central and Eastern Europe

Radomír Jáč





Main Forecasts	2016	2017	2018f	2019f
Czech Republic				
GDP	2.4	4.5	3.2	2.9
Consumer prices	0.7	2.5	2.2	2.1
Central bank's key rate	0.05	0.50	1.25	1.75
Hungary				
GDP	2.1	4.2	4.3	3.1
Consumer prices	0.4	2.4	2.6	3.0
Central bank's key rate	0.90	0.90	0.90	1.25
Poland				
GDP	3.0	4.7	4.6	3.6
Consumer prices	-0.6	2.0	1.9	2.5
Central bank's key rate	1.50	1.50	1.50	2.00

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

- **Inflation accelerated in all CE-3 countries in Q2, mainly due to commodity prices but also due to weakening of the regional currencies.**
- **These currencies were hit by global factors and the negative sentiment culminated in early July. The CE-3 currencies recovered partly since then but they still create a pro-inflationary risk, particularly in the Czech Republic and Hungary.**
- **The Czech CNB increased interest rates in June and a further rate hike is likely in Q3. In Hungary, the MNB became less dovish in its comments.**

Inflation increased in all three CE-3 countries in Q2. While the direction was not a surprise, the increase in the headline inflation rate was higher than expected. Commodity prices (fuel, food) but also depreciation of the CE-3 currencies were the key drivers of the higher CPIs.

The CE-3 currencies were hit by global factors in Q2 and although they managed to recover partially in July, they still remain well below the levels seen at start of 2018 (HUF, PLN) or much weaker than expected by the central bank (CZK). The exchange rate development may have significant impact on inflation especially in small open economies, such as the Czech Republic and Hungary.

Czech headline inflation reached 2.6% yoy in June vs. the target set at 2%. Inflation exceeded the target also in Hungary (3.1% yoy vs. at 3%). Poland still has inflation below the target (2.0% yoy in June vs. the target set at 2.5%) but the increase in the headline CPI was visible also in its case. While the base effects on commodity prices are likely to lead to a moderation in the headline inflation across the region in H2, the recent developments are showing their impact on the monetary policy stance in the CE-3 countries. This is the case mainly in the Czech Republic but an impact is seen also in Hungary.

Monetary policy: Czech CNB in tightening mode

The Czech CNB raised its key interest rate by 25 bps to 1.00% in June, stating that the decision was a clear case, as developments of both inflation and the CZK exchange rate create pro-inflationary risks. The CNB will publish a new macro forecast in early August and indicated that the projected interest rate trajectory will be shifted higher. This means that the CNB will very likely increase its rates again in Q3, possibly already in August.

The Hungarian MNB kept its policy stance unchanged but explicitly said that the current loose monetary conditions can no longer prevail until the end of the 5-to-8-quarter horizon of monetary policy, as the external environment is changing. However, we do not expect a hike in the MNB base rate (currently at 0.90%) before 2019.

The Polish NBP keeps a wait-and-see mode, as inflation remains below the target and is less sensitive to the exchange rate fluctuations. The first interest rate hike in Poland looks likely in mid-2019 at the earliest.

Bonds/Fixed Income Strategy

Florian Späte

- **The widespread absence of negative news triggered a modest rise in international bond yields across the curve in July. As inflation expectations trended sideways, real yields rose.**
- **In this environment, Southern European government spreads tightened slightly. Although Italian politicians reassured markets, the acid test is still to come. In autumn, the new government will present its new budget plan for 2019.**
- **While the summer months are generally characterized by lower liquidity, the way is paved for an increase in yields on both sides of the Atlantic. Hence, we do not change our cautious duration stance for euro area government bonds.**

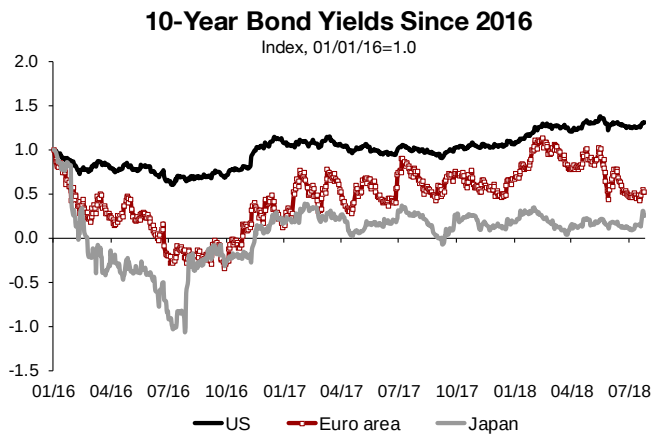
After busy weeks at the end of Q2 with market turmoil in Italy and concerns about an escalation of trade tensions, the start into this quarter was much smoother. While the new Italian government assured financial markets that an Italexit was not on the cards, a new escalation of trade tensions did not occur. In fact, EU Commission President Juncker even reached an agreement with US President Trump to start talks on trade focusing on eliminating tariffs. Thereby, levying tariffs on cars appears rather unlikely – at least while negotiations persist.

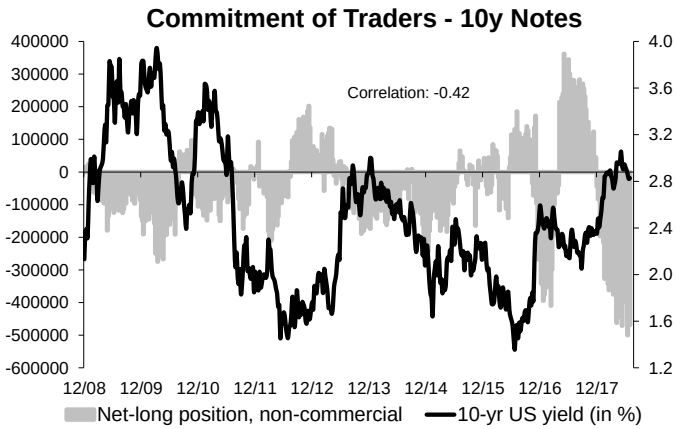
This was sufficient to trigger a moderate increase in government bond yields across the curve. While the US yield curve bear flattened further (2-yr/10-yr yield difference down to around 30 bps), in the euro area particularly medium-dated bond yields increased. Although commodity prices receded particularly until the mid of July, inflation expectations held up and did not change substantially compared to the end of June. Hence, the rise in nominal yields also means higher real yields. Accordingly, German real yields backed up from their trough marked in June. At -1.20%, however, 10-year real yields are still at fundamentally not justifiable levels.

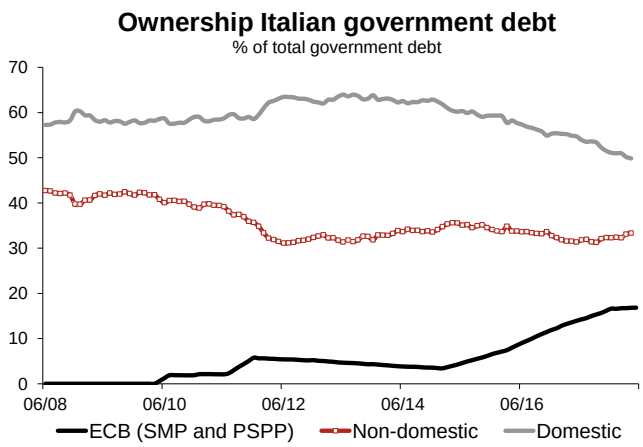
Tug of war to continue

As usual, the coming weeks will be characterized by a reduced trading volume and lower liquidity. But, there is a seasonal pattern to be considered which is at least partly explainable by the low issuance activity in summer. Based on data over the last 20 years, US yields tend to fall by 10 bps and Bund yields by around 7 bps in August. What is more, at least in the US, the positioning is rather extreme. The net-long position of non-commercial traders is close to a historical low. Considering the negative correlation with yields, the current short positioning appears to be a severe obstacle for higher US yields – at least in the short term.

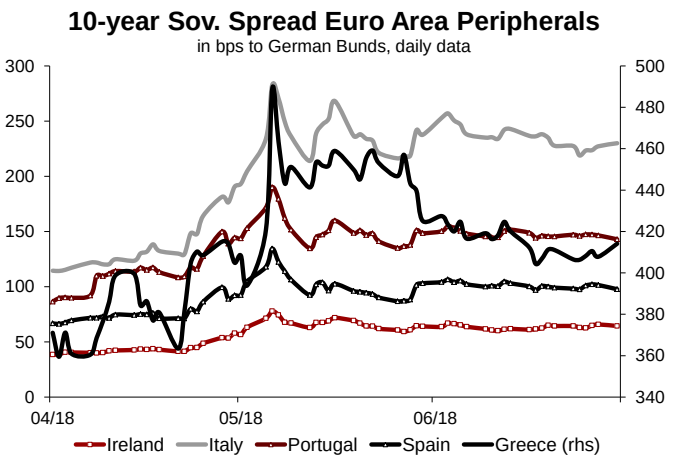
In contrast to these technical issues which tend to impede higher government yields, the fundamental case for higher yields is still valid. Real yields on both sides of the Atlantic are still too low with respect to the economic fundamentals.

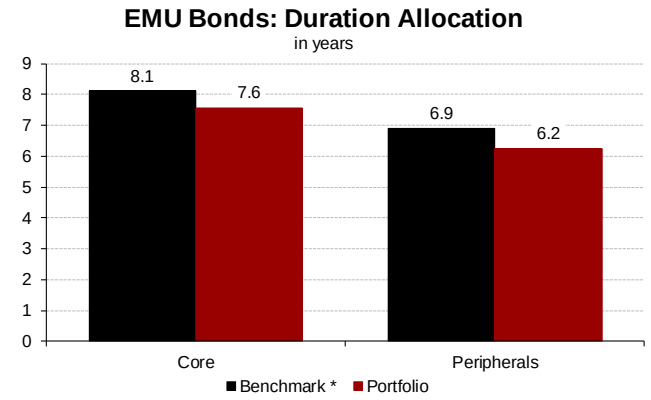




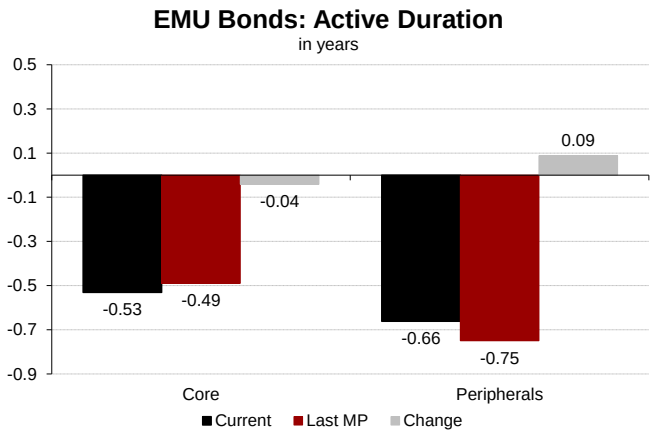


Bonds/Fixed Income Strategy





* JPMorgan EMU Government Bond Index



Above all, real yields in the euro area are on an unsustainable level. They are not far above the lows marked in early 2015. At that time, however, the euro area was still emerging from a recession and the ECB had just started the QE programme. Currently, the euro area is running on all cylinders and the central bank is about to end its QE programme. Moreover, the euro area economic releases have backed up in recent weeks. Although the economic momentum has slowed since the start of the year, economic surprises have recovered. Going forward, the euro area is likely to achieve a growth rate above potential. In addition, although many questions remain, harassing fire from concerns about a looming trade war is likely to recede (at least for the time being) after the provisional agreement between the EU and the US.

Finally, financial markets are still too complacent about the future course of central banks. Until the end of 2019 less than four Fed hikes are priced although the Fed stressed several times that it intends to continue to hike on a quarterly basis for the time being (GI Research: five hikes until Dec 2019). The ECB signaled its willingness to keep monetary key rates unchanged until summer 2019. However, 4y1y Bund forwards (as a proxy for the terminal key rate) below 0.70% are too low and look unsustainable. All in, we forecast government bonds yields to remain volatile for the time being, but the medium-term trend is upwards.

Acid test for Italian BTPs has still to come

Supported by reassuring comments from Italian politicians, the BTP spread tightened slightly compared to the end of June. But, overall, movements remained contained and range-bound. This is unlikely to change in the weeks to come. All eyes are already turning to the draft budget for 2019 to be presented at the end of September. This is likely to provide more insight into the fiscal posture of the populist coalition and could potentially trigger a serious conflict with the EU Commission.

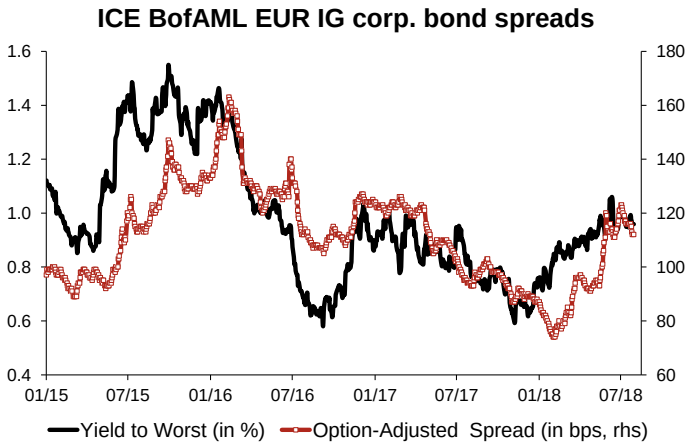
Although the share of non-domestic BTP holders is on a comparatively low level, the withdrawal by the ECB from government bond markets to a large extent by the end of the year has the potential to trigger higher volatility again. Hence, we continue to advise some caution.

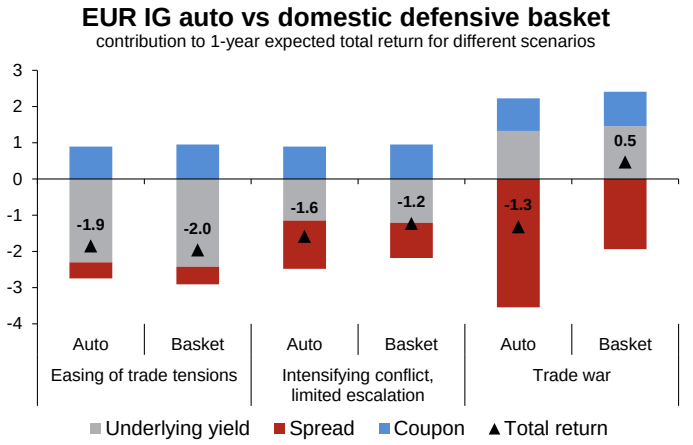
Our portfolios

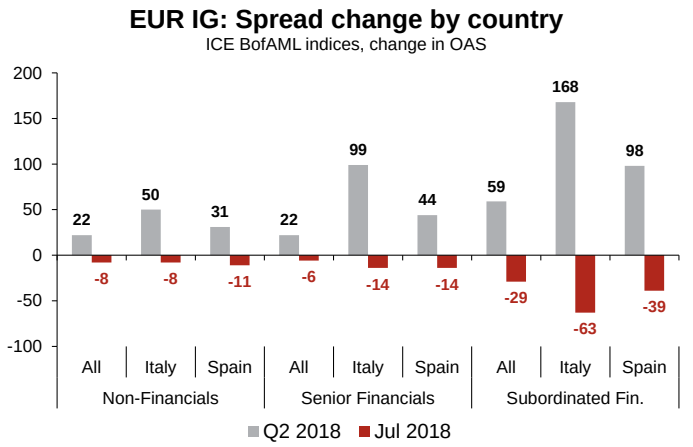
As outlined above, the way is paved for higher euro area government yields. Hence, we do not adjust our duration stance noticeably compared to the last issue of the MP. We prefer a short duration stance for both core and peripheral bond markets and adjust only slightly (core: from -0.49 years to -0.53 years, peripheral: from -0.75 years to -0.66 years).

Corporate Bonds

Luca Colussa







- **EUR IG corporate bond spreads fell noticeably in July thanks to the a recovery in macro surprises in the euro area and easing concerns about a trade war between the EU and the US.**
- **Subordinated financials, and Italian issuers in particular, outperformed thanks to higher Bund yields (positive for banks profitability).**
- **Looking ahead, given the downside risks from Italian politics and a still looming trade war, we recommend underweighting export-oriented sectors vs domestic, defensive ones. We retain but reduce our underweight on financials.**

EUR Investment Grade (IG) corporate bonds had a good start into the new quarter. Following a total return loss of around 60 bps and a widening of the Option-Adjusted Spread (OAS, ICE BofAML indices) of 34 bps in H1, EUR IG corporate bonds posted positive total returns in July (+0.38%), while the OAS fell by 9 bps to 121 bps. The positive performance was driven by the improvement in macro surprises in the euro area (EA) and easing tensions between the US and the EA over a possible escalation in the trade war. Indeed, US President Trump and the President of the European Commission Juncker announced a "ceasefire" on trade, reducing the threat of a 25% tariff on imported cars by the US.

Stay defensive Autos as trade war risk may linger

Despite the recent positive news flow, we do not deem the Trump-Juncker agreement to be a lasting solution to trade tensions. In addition, even if the US-EU relationship normalizes, global trade and economic activity can still suffer in case of a stiffer US stance towards China. Hence, we recommend underweighting export-oriented sectors versus domestic, defensive ones. Within the EA IG space, we like a basket of Real Estate, Retail, Leisure and Non-cyclical Services against Auto, as it offers a cheap insurance versus downside risks from trade frictions.

Italian financials to be tested again in September

The decent macro news flow and the mild increase in core yields (5-year Bund yield up by 8 bps, although still more than 30 bps below year-to-date highs) favored an outperformance of financial bonds over non-financial ones. Subordinated financials posted a positive total return of 1.68%, thus more than halving the year-to-date losses. The OAS fell by 29 bps to 197 bps. Within Subordinated financials, Italian issuers were the most brilliant. Despite an overall sideways movement in the BTP-Bund spread, the average OAS of Italian subordinated financial bonds fell by 63 bps to 341 bps. Looking ahead, however, we stay prudent on Financials in the near term. Italian political will woes likely intensify again in September and this can have renewed negative spillovers on the sector.

Currencies

Thomas Hempell

- **Contrary to textbook models, the USD has not benefitted from trade war concerns. This matches historical episodes of US tariffs, when the political aim to see a weaker USD prevailed.**
- **While USD strength may have legs short-term, we do not anticipate a protracted rally in the Greenback.**
- **The Chinese yuan may weaken somewhat further. But this is not a precursor of a larger deliberate devaluation by Chinese authorities.**

After striking USD strength in Q2 (the trade-weighted dollar gained more than 5%), the momentum has faded in July. The US dollar still fails to benefit from trade war fears (as textbook models would suggest). This may be due to the fact that the tariffs imposed by the US Administration are primarily perceived as a protectionist tool which ultimately also envisages a weaker rather than a stronger exchange rate.

In fact, this pattern is not unprecedented. As shown in the mid chart, historical periods of US protectionism were in fact associated with a weaker US dollar. Given the yawning trade deficit President Trump is repeatedly flagging, the case may be even stronger in the current episode.

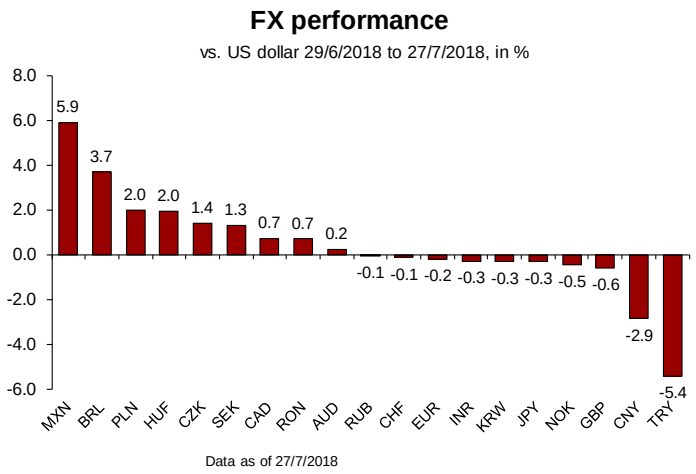
That said, the USD may still have some legs short term, thanks to US economic outperformance due to the fiscal stimulus and headwinds to EUR/USD from EMU political uncertainties. Further out, however, with US late cycle concerns coming to the fore and the US twin deficit (C/A and fiscal) rising, we do not anticipate a protracted USD rally. On the contrary, we ultimately anticipate EUR/USD to move North of 1.20 again going into next year.

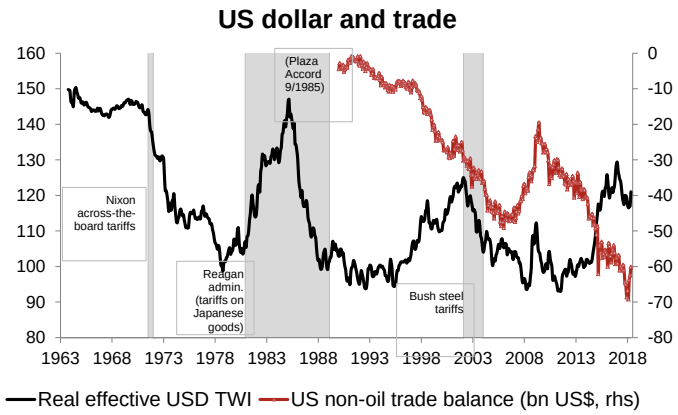
CNY weakness not the start of a currency war

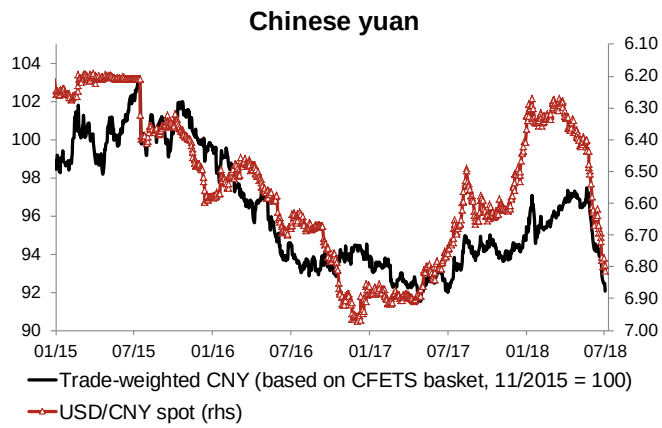
With trade tensions between the US and China intensifying further, the Chinese yuan has come under significant pressure over the past weeks. Since mid June, the USD/CNY has risen by about 6%, an unusually strong move for the tightly regulated exchange rate.

We do not deem this move to be the first leg in a deliberate devaluation in a looming currency war between the US and China, though. Instead, the recent fall in the CNY vs. the USD seems to a large extent the delayed response to dollar strength. The recent correction is following striking CNY strength in trade-weighted terms over the first half of this year. So the CNY has rather caught up with other major and EM currencies and the recent correction on Chinese stocks.

Looking ahead, we anticipate the USD/CNY to rise somewhat further to levels close to 6.90 due to rising economic headwinds to China from US trade sanctions, monetary policy accommodation and a general inclination by Chinese policy makers to leave the exchange rate more strongly determined by market forces.







Equities

Michele Morganti / Vladimir Oleinikov

- **Markets rebounded in July as trade risks temporarily abated and VIX declined. EMs, auto and the banking sectors were ready for a rebound, after having experienced huge set-backs.**
- **The good reporting season helped, too, but in the short term growth momentum looks capped.**
- **Peaking macro momentum, decreasing monetary stimulus and higher credit tensions reduce the appeal on equities short term, together with political and trade risks. We stay cautious, with a defensive sector tilt and balanced EMU-US. We favor UK, Japan, Switzerland and, tactically, EMs.**
- **On a 12-month horizon we see an upside potential for the EA and Japan of nearly 6% in total return terms. For this reason we look for future dips to increase equity positions.**

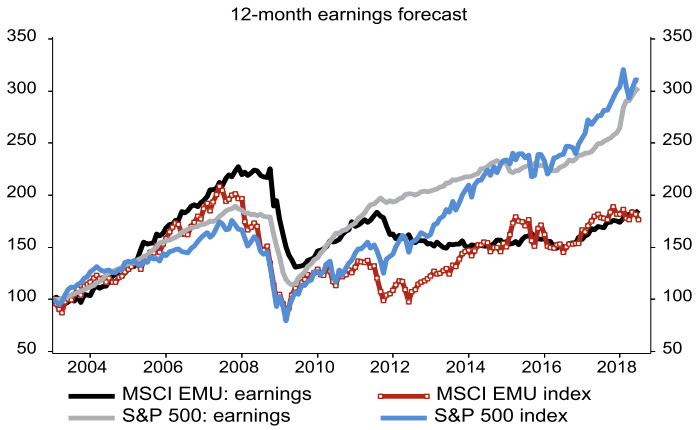
Markets rebounded in July for several reasons. Macro conditions remain overall upbeat in the US and are only softly deteriorating in the euro area (EA) as well as in China. Volatility decreased (VIX) from 16 to 13, helping, too. The reporting season was relatively strong, supporting the equity rebound and both the BoJ and the PBoC were rumored to maintain their monetary policies on the dovish side. Furthermore, and more importantly, trade frictions temporarily abated. Finally, the MSCI EM index, the auto sector and the banking one (hostages of a strong USD, trade frictions and higher risk aversion) had already severely underperformed the market in the last weeks.

Such triggers induced positive market returns (price + dividends): 4% on average, with Switzerland outperforming (+8%). The MSCI EMU (3.5%) underperformed the US as well as the EM index (both 4.5%). As 10-year yields increased (+10 bps for Bund and Treasuries), banks (+3.5%) and the EMU Value index (3.9%) were able to outperform the EMU and the EU Growth index (3.1%).

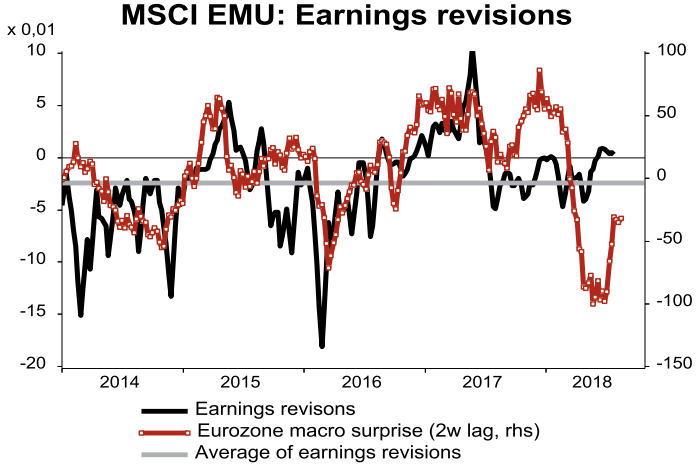
Peaking EU macro momentum and credit tensions hurt

As said, the EA macro momentum is getting softer but remain decent overall with macro surprises stabilizing. Having said this, the defensive sectors are, for the time being, outperforming cyclicals as the latter were quite overvalued at this point of the cycle. This trend could continue for a while until markets fully discount the ongoing reduction in monetary stimulus in the US and the EA. The latter is putting pressure on credit and on equity market multiples (see chart). Trade as well as political risks (Italy, immigration, progress towards the EU union and Brexit) remain also high and volatile. Finally, the investors' positioning on risky assets is low but not yet in positive territory. For this reason we remain cautious short term, and prefer balanced allocation between EMU and the US, but stress EMU's increasing relative appeal. We stay overweight UK, Japan and Switzerland.

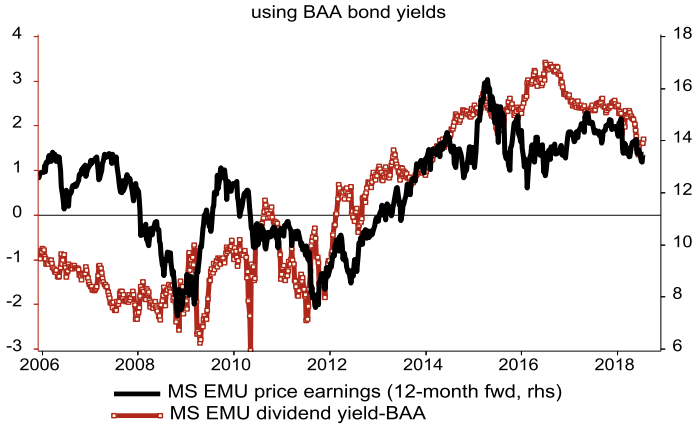
Price and earnings performance



MSCI EMU: Earnings revisions



MSCI EMU: risk premium



Equities

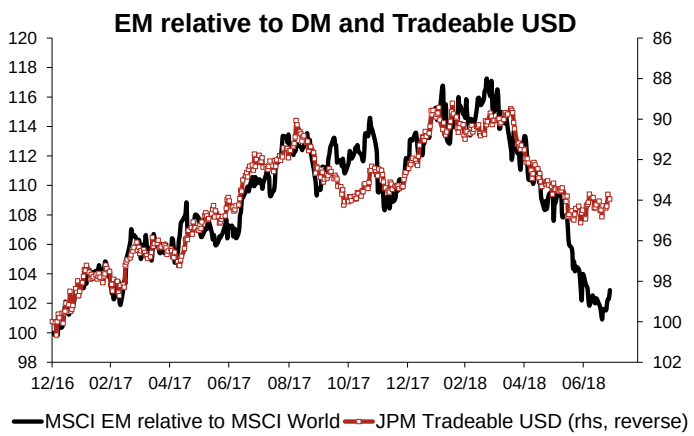
Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %
WORLD	15.7	16.0	2.3	1.9	10.6	8.7	2.5	2.7	11.4
USA	16.8	15.3	3.1	2.3	12.0	9.9	2.0	2.2	17.5
JAPAN	13.5	15.6	1.3	1.3	8.0	7.1	2.2	1.9	-4.2
UK	13.2	13.8	1.7	1.8	8.6	7.9	4.3	4.0	-1.9
SWITZERLAND	15.5	15.4	2.4	2.2	10.6	11.2	3.6	3.3	-1.8
EMU	13.6	14.2	1.6	1.5	8.1	6.5	3.5	3.9	9.3
FRANCE	14.2	14.4	1.6	1.5	8.9	6.9	3.4	3.7	11.1
GERMANY	12.9	15.1	1.6	1.5	8.0	6.7	3.2	3.3	4.3
GREECE	11.8	12.8	1.5	1.6	6.7	6.0	5.3	3.9	-8.9
ITALY	11.2	15.3	1.2	1.2	5.5	4.7	4.6	4.6	-1.7
PORTUGAL	17.1	12.7	1.9	1.7	6.6	5.9	4.3	4.5	15.8
SPAIN	11.9	12.9	1.2	1.6	5.5	5.1	4.5	5.1	-2.5
EURO STOXX 50	13.2	13.3	1.5	1.5	7.8	6.2	3.8	4.2	9.8
STOXX SMALL	17.2	14.4	2.0	1.7	10.2	8.3	3.0	3.2	16.9
EM, $	11.5	14.5	1.5	1.6	7.4	7.7	3.0	3.1	-7.0
BRAZIL	10.7	9.0	1.7	1.7	6.8	13.9	4.2	4.3	-7.0
RUSSIA	5.4	7.1	0.7	0.9	3.3	4.5	7.3	3.7	-44.5
INDIA	18.6	14.5	2.8	2.7	12.5	11.5	1.6	1.6	10.6
CHINA	11.7	13.0	1.6	1.7	7.6	7.6	2.5	3.0	0.0

Note: The first four markets (ex. World) are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003.
Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
Source: Thomson Reuters Datastream, IBES estimates.

Analysis of the median stock: Q2 2018 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q1 2018	Q2 2018	Q1 2018	Q2 2018	Q2 2018
S&P	23.16 %	22.88 %	8.28 %	8.03 %	53.9%
Stoxx	3.66 %	6.82 %	2.18 %	3.48 %	50.9%
Euro Stoxx	3.60 %	3.85 %	0.14 %	1.23 %	48.9%
Topix	4.33 %	3.60 %	5.25 %	4.16 %	26.7%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q1 2018	Q2 2018	Q1 2018	Q2 2018	Q2 2018
S&P	5.02 %	4.20 %	1.48 %	0.84 %	53.9%
Stoxx	0.86 %	(1.48)%	(0.21)%	0.65 %	50.9%
Euro Stoxx	0.39 %	(1.89)%	(0.38)%	0.15 %	48.9%
Topix	(6.28)%	2.37 %	0.00 %	0.00 %	26.7%



We take advantage of the recent rebound to lower the weight of cyclicals in favor of more defensive sectors like pharma, less risky discretionary (no auto), still oils and households. We remain slightly OW in telecoms, insurances and neutral on banks. Materials, industrials, diversified financials and IT are underweight. On a mid-term view, we use weak market phases to re-increase exposure to cyclicals and financials. *Value* is a wild card, pressured by yields moving up only slowly and by softer macro momentum. So, we recommend only a limited OW on *Value* compensated by an OW on *Quality* and neutral on *Growth*.

On a 12-month horizon, even our lower expected earnings growth vs. consensus signals an upside potential for the EA and Japan of nearly 6% in total return terms. For this reason we look for future dips to increase equity positions.

A good reporting season is not enough

While US profit growth remains strong in absolute terms, macro surprises and earnings revisions are weak, after the big increase due to US tax reform. A stronger trade-weighted US dollar is not helping, too. We expect a decent earnings development to linger till the end of the year when the US momentum should peak. Trade frictions should also not help in this respect. In the EA, confidence indicators are weaker, capping earnings growth, at least in the short term. EA capacity utilization has stopped increasing and coherently, the corporate ROE is declining, even if from high levels. This in turn makes the equity case for us to be less appealing short term.

EM: short term, US tightening looks priced in

Based on multiples, the EM stocks have become a bit more expensive but still selling at a discount of 7% versus their history. Earnings estimates have already declined both for 2018 and 2019, losing about 6.5% from the recent peak in April.

Over the month, EM stocks have benefitted from decreasing yields (-13 bps), EMBI spreads (-41 bps), and a weaker US dollar (-0.5%). Higher macro surprises should support markets and Fed tightening seems, for the time being, to be priced in. With EM equities having a very strong inverse correlation to USD, the gap attained (see chart) should contribute to higher EM performance as well. The August month is, however, usually characterized by tighter liquidity causing minimal trading during summer months. With trade uncertainty continuing, the most export-oriented countries are certainly more at risk. India representing more a domestic story should be preferred. The Korean market has suffered quite a bit from soaring economic policy uncertainty but the fundamentals have remained essentially intact. We are equally favoring CEE countries.

Asset Allocation

Thorsten Runde

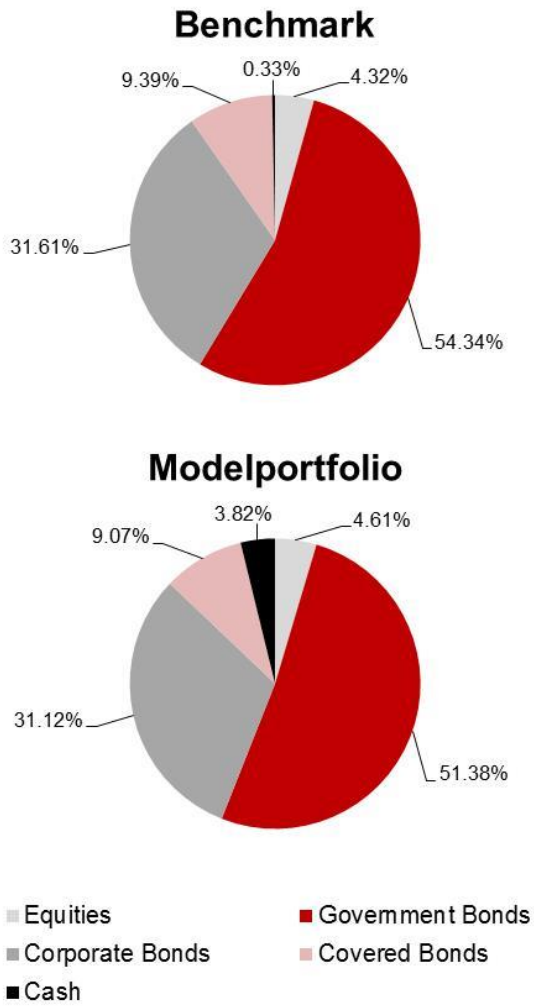
- **In the course of July the developed equity markets of our investment universe roughly gained 3.1% on average after a sharp correction in the second half of June.**
- **The mirror-image observation applies to core government bonds, whose performance over the past four weeks has been slightly negative across all maturity buckets.**
- **The performance of Italian government bonds has been negative whereas the figures for the Spanish ones have been consistently in positive territory since the beginning of July.**
- **Over the same period, both financial and non-financial corporate bonds performed positively across all maturities and credit segments. In particular the HY segment did extremely well.**
- **We still expect equities to beat bonds over 6-12 months, but are reducing exposure in the near term to reduce the overall risk of the portfolio.**
- **To preserve carry, the funds thus released should be invested in euro area peripheral sovereigns (ex Italy) and euro area IG financials, which have lagged.**

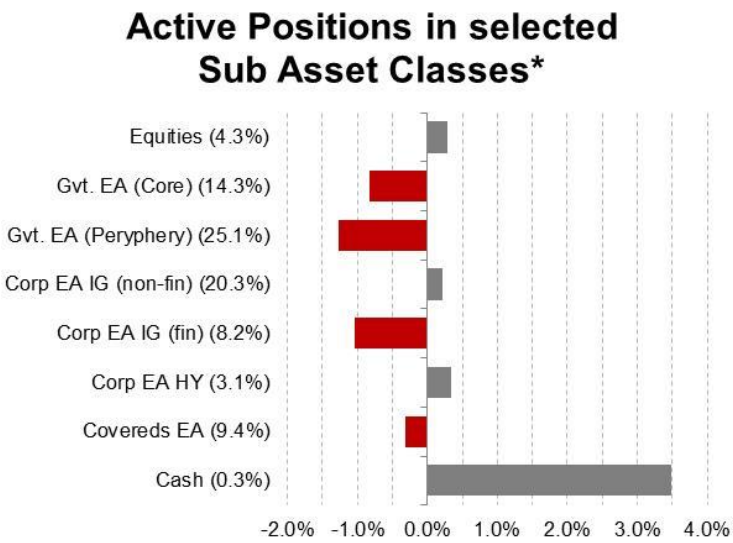
While the macroeconomic data flow in the euro area stabilized, concerns about a further escalation of the trade conflict between the US and its trading partners triggered falling core government bond yields. Until mid July, international equity markets moved in a rather tight trading range and did not show a clear direction. On balance, US equities increased moderately and euro area stocks fell slightly. Last week, with EC President Juncker and US President Trump agreeing to resolve the steel and aluminum tariff issues and to launch further negotiations equity markets started a relief rally pushing the added value of our tactical portfolio alignment into positive territory.

Pro-risk stance to be slightly reduced

Generally, the protectionist threat from US tariffs and retaliation measures cast a shadow on risky assets. Although the most recent developments appear quite promising, we are not too optimistic about this, as Trump has proven its unpredictability many times in the past.

Thus, though still constructive on 6 - 12 months, we turn almost neutral on equities tactically for the time being. As there is currently little value in flying to quality, we still avoid core euro area sovereign bonds. Instead, we prefer euro area peripheral sovereigns (ex Italy) and euro area IG financials. Finally, we maintain the overweight in cash and continue to prefer a short duration.





Benchmark weights in parentheses

Forecast Tables

Growth

	2016	2017	2018f	2019f
US	1.5	2.3	2.8	2.4
Euro area	1.8	2.5	2.0	1.7
Germany	1.9	2.2	1.9	1.7
France	1.1	2.0	1.7	1.6
Italy	1.0	1.5	1.1	0.9
Non-EMU	2.0	1.8	1.6	1.6
UK	1.8	1.7	1.4	1.5
Switzerland	1.4	1.1	2.2	1.8
Japan	1.0	1.7	1.0	1.1
Asia ex Japan	6.4	6.1	6.0	5.9
China	7.1	6.9	6.5	6.2
Central/Eastern Europe	1.5	3.9	3.2	2.6
Latin America	- 1.3	0.8	1.0	2.0
World	**3.2**	**3.7**	**3.6**	**3.5**

Inflation

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.2
Euro area	0.2	1.5	1.6	1.6
Germany	0.4	1.8	1.7	1.7
France	0.3	1.0	1.6	1.5
Italy	- 0.1	1.2	1.2	1.2
Non-EMU	0.7	2.5	2.4	2.2
UK	0.7	2.7	2.6	2.3
Switzerland	- 0.4	0.5	0.9	1.0
Japan	- 0.1	0.5	1.0	1.0
Asia ex Japan	2.6	2.2	2.9	2.9
China	2.0	1.6	2.1	2.1
Central/Eastern Europe	5.2	5.0	5.2	5.7
Latin America	6.3	4.3	3.8	4.2
World	**2.3**	**2.3**	**2.8**	**2.8**

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

Financial Markets

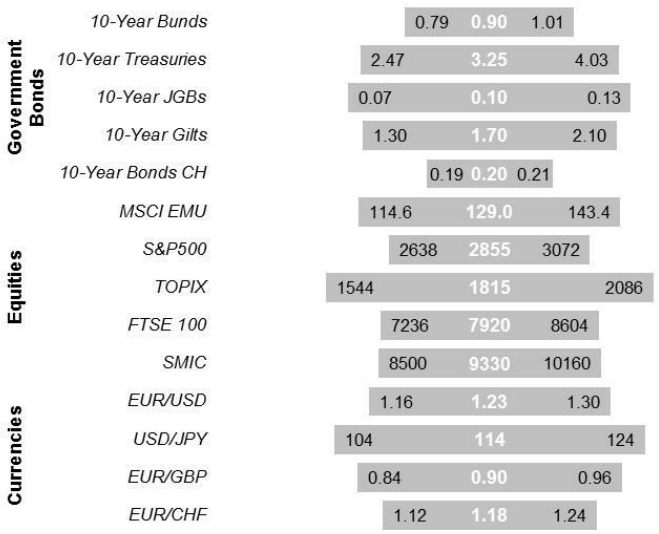
3-month LIBOR	**27/07/18***	**3M**	**6M**	**12M**
USD	2.34	2.45	2.70	3.15
EUR	-0.36	-0.35	-0.35	-0.35
JPY	-0.03	-0.05	0.00	0.05
GBP	0.79	0.80	0.90	1.05
CHF	-0.72	-0.75	-0.75	-0.75
10-Year Bonds	**27/07/18***	**3M**	**6M**	**12M**
Treasuries	2.96	3.05	3.15	3.25
Bunds	0.40	0.50	0.60	0.90
BTPs	2.71	3.00	3.15	3.10
OATs	0.70	0.85	0.95	1.20
JGBs	0.09	0.10	0.10	0.10
Gilts	1.28	1.35	1.50	1.70
SWI	-0.04	0.00	0.10	0.20
Spreads	**27/07/18***	**3M**	**6M**	**12M**
GIIPS	166	180	185	160
Covered Bonds	79	85	85	85

*average of last three trading days

Corporate Bond Spreads	**27/07/18***	**3M**	**6M**	**12M**
BofaML Non-Financial	107	110	115	125
BofaML Financial	124	130	130	135
Forex	**27/07/18***	**3M**	**6M**	**12M**
EUR/USD	1.17	1.17	1.20	1.23
USD/JPY	111	112	113	114
EUR/JPY	129	131	136	140
GBP/USD	1.31	1.31	1.33	1.37
EUR/GBP	0.89	0.89	0.90	0.90
EUR/CHF	1.16	1.16	1.17	1.18
Equities	**27/07/18***	**3M**	**6M**	**12M**
S&P500	2834	2810	2815	2855
MSCI EMU	127.0	125.5	128.5	129.0
TOPIX	1765	1735	1785	1815
FTSE	7674	7600	7745	7920
SMI	9111	9010	9270	9330

3-Months Horizon

12-Months Horizon



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

Imprint

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Version completed on July 31, 2018

Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

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