



**GENERALI**  
INVESTMENTS

# Market Perspectives

*A correction, not a bear market (yet)*

November 2018



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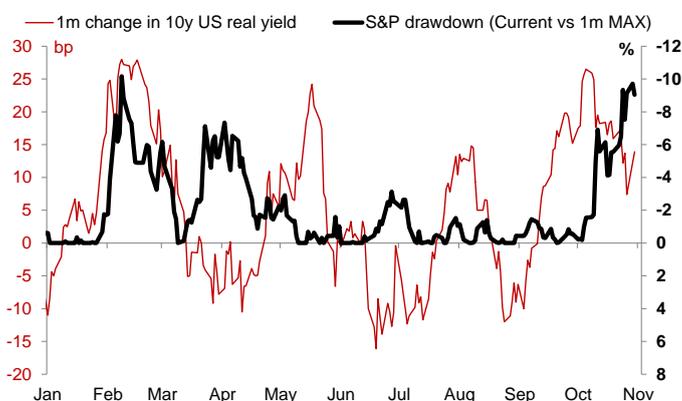
# Global View

Vincent Chaigneau / Thomas Hempell

- It is easy to get pessimistic considering the political and policy headwinds behind the nasty market correction in October. The Fed, trade war and Italy/EU standoff will keep volatility high.
- Fed normalization was always going to shock both volatility and the bond-stock correlation. We see the recent sell-off as yet another, if more severe, warning that there aren't many places to hide at this stage of the cycle. But it is a correction, not the start of a bear market. Global growth isn't crashing.
- We remain positioned for a further rise in yields (more so in South Europe), still prefer cash and favor a moderate overexposure in 'value' equities.

Volatility is back with a vengeance: as we go to press equity markets are heading to the sharpest monthly setback since May 2010, when the MSCI World lost 9.9% (-9.5% month-to-date on Oct. 30). The VIX has doubled to 25%. Ironically, the rout was initiated by a self-defeating spike in US yields. Following an exceptionally strong ISM on Oct. 3, 10y UST yields jumped by almost 20 bps. The Italy/EU stand-off and trade tensions (China information technology) added to risk aversion. Approaching end-October, 10y UST yields are little changed, Bund yields 10 bps lower and Italian spreads some 20 bps higher than in September. The market rout has shaved equity values globally and sent HY yields soaring by more than 60 bps.

## US equities dreading sharp rise in real rates



We had [argued in September](#) that a poorer growth/inflation mix and Fed tightening would make the financial market environment more fragile. Risks have unfolded in a fairly dramatic fashion indeed. Our cautious stance on Italian debt and preference for cash helped to largely offset the headwinds from a moderate overexposure in equities.

### Plenty of risks abound

Looking ahead, it is easy to get carried away by a pessimistic view on global market conditions. Above all, don't expect the Fed to give in on its way to the exit. Amid strong US data and mounting price pressures, hurdles are

much higher for the Fed to pause.

US–China trade tensions keep lingering. Vice President Pence made clear ([Oct. 4](#)) that the conflict is a strategic one about economic, technological and military supremacy. Hopes for a quick settlement after the US mid-terms look premature, with US tariffs on China set to rise to 25% if no deal is struck by year-end. Risks of tariffs on European cars are rising too, with US commerce secretary Ross warning that Trump's "patience was not unlimited".

The European Commission rejected Italy's 2019 budget plans; the populist government is not in the mood to give in just yet, despite the market pressure and deteriorating business sentiment. We fear confrontation will continue until the European election in May. Entrenched trouble to find a Brexit deal that has a chance of finding UK parliament approval are adding to the uncertainties.

Bonds	29/10/18*	3M	6M	12M
10-Year Treasuries	3.10	3.20	3.30	3.40
10-Year Bunds	0.38	0.45	0.70	1.00
<b>Corporate Bonds</b>				
BofaML Non-Financial	122	120	120	125
BofaML Financial	137	135	135	140
<b>Forex</b>				
EUR/USD	1.14	1.13	1.17	1.23
USD/JPY	112	114	115	115
<b>Equities</b>				
S&P500	2669	2735	2700	2695
MSCI EMU	113.8	118.0	116.0	116.5

\* avg. of last three trading days

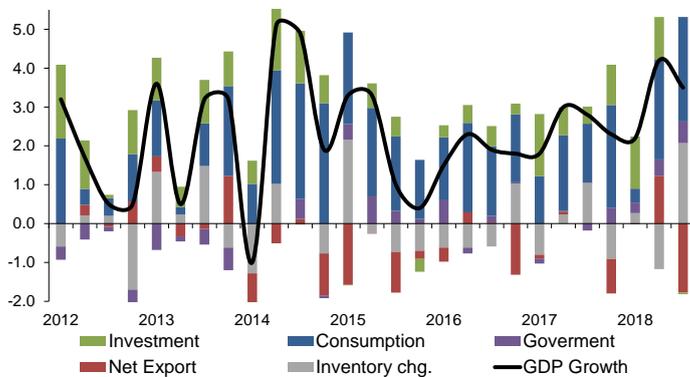
### Selective opportunities after market correction

While the financial world has become a more dangerous place, the newsflow and positioning adjustment may have reached a nadir for now. Soft economic news – sanctioned by disappointing Q3 GDP in China and the euro area – has been the mother of this correction. But we expect a rebound in Q4 EA growth, while Chinese monetary (and soon fiscal) stimulus should slowly filter in. A key risk is that US growth slows down – soft capex in Q3 and capital good orders deserve watching – but positioning for this looks premature. The sheer size of the risk drawdown and decent valuations offer selective entry points. In equities, a higher exposure to "value" stocks looks attractive. Short-dated, low-rated corporate bonds look appealing, too, after the recent widening (EUR credit curve quite flat). We remain cautious on duration and favor cash over bonds. Inflation expectations still have room to rise, especially in the US, keeping upside pressures on global yields intact (with lower risk appetite a mitigating factor). We maintain a cautious stance on Italian debt given the local economic slowdown, the high bar for a change of political stance and the lack of ECB tools and reason for intervention.

# USA

**Paolo Zanghieri**

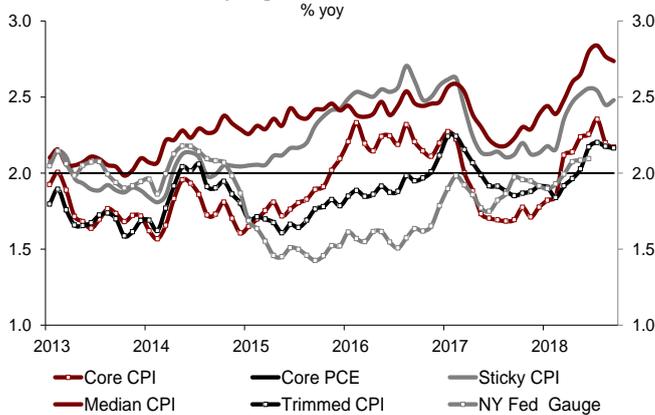
**Contributions to GDP growth**  
% qoq annualized, seasonally adjusted



- Q3 GDP growth beat expectations at 3.5% annualized. Steady consumption was offset by subdued capex and export. Growth will likely average 2.9% in 2018.
- Despite some volatility in the summer, inflation is gathering speed, as firms start passing higher costs onto retail prices. We expect core inflation to end the year at 2.4%.
- Positive data on activity and inflation add to the case for a gradual withdraw of monetary stimulus, despite some tightening in financial conditions. We still expect four rate hikes by the end of 2019.

According to the first estimate, in Q3 GDP increased by 3.5%(yoy ann.), higher than expected. Consumption was again the leading driver, offsetting the expected setback in net export. The weakness of investment seems at odds with still upbeat business surveys; the behavior of capex will be crucial to assess the strength of the cycle, especially as the impact of the fiscal stimulus will peak in Q4. Restocking ahead of the coming into force of sanction may explain the large contribution of inventories. The impact of sanctions on activity has yet to show up. Some signs are appearing in input costs, but the overall contribution to inflation is still limited.

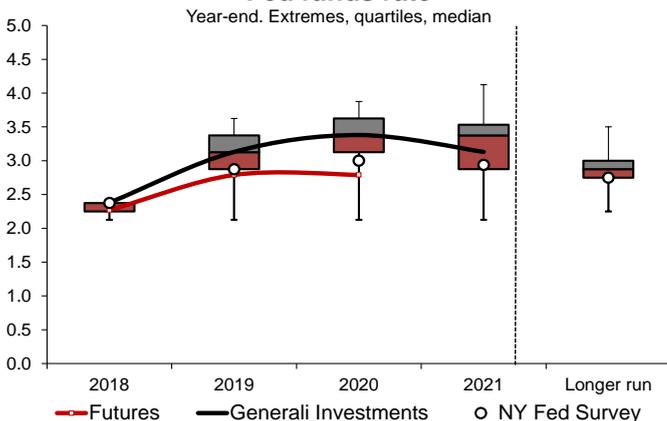
**Underlying Inflation Measures**  
% yoy



**Core inflation to edge up**

The unemployment rate, at 3.7%, reached in September the lowest level in almost 50 years, with wages up by 2.9% yoy. A tighter market for labor and intermediate goods is raising costs, and this will translate to an increasing extent into higher retail prices. The increase in core inflation paused in September due to idiosyncratic factors, but the underlying trend is clearly on the rise. We expect it to inch up to 2.4% yoy by year-end. This should translate into core PCE inflation of just above the 2.0 % expected by the Fed.

**Appropriate path and forecasts for the Fed funds rate**  
Year-end. Extremes, quartiles, median



**The Fed to hike rates four times by end 2019**

In such an environment, the Fed is stressing more forcefully that the risks to growth are more symmetric and less skewed to the downside. At the same time the Fed communication continues to stress that monetary conditions remain accommodative. The guiding role of the neutral rate has been downplayed, and more importance is now given to expected inflation and to the extent to which it remains anchored to the 2% target. At the same time, despite the sharp correction in stock prices, higher long term rates and a stronger dollar, financial conditions remain overall loose, adding to the case for higher policy rates, especially as the risks to inflation remain tilted to the upside. We maintain our call of a rate hike in December, and three more in 2019.

# Euro Area

**Martin Wolburg**

- **Q3 GDP disappointed and sentiment weakened further in October causing us to revise our growth outlook down.**
- **Pending trade war concerns, the risk of a hard Brexit and woes emanating from the Italian 2019 budget proposal are dampening the mood.**
- **That said, the ECB remains on its policy normalization track and will end QE in December .**

According to the preliminary GDP estimate, the euro area grew by 0.2% qoq in Q3, down from 0.4% qoq. Over the past months the euro area economic outlook became more uncertain. On the positive side, employment growth is set to continue, negotiated wages trend up and capacity utilization is clearly above normal.

On the negative side, confidence took a hit over the past months. In October, the flash composite PMI dropped to 52.7, the lowest reading since September 2016 and only 0.2 standard deviations above normal. Since June, consumer confidence has been back in negative territory. Generally, the euro area economic dataflow has been surprising on the downside since mid-September.

The key external factors standing behind this drop in confidence which is at odds with the sound domestic economic situation are in our view the risk emanating from a potential trade war, a slowdown in China and a hard Brexit. In October, export orders fell into contractionary territory (48.9), the lowest level since April 2013. A hard Brexit would additionally affect trade in services negatively so that the latest drop in services business expectations (by 2.4 points) does not come as a surprise. Moreover, the escalation of the Italian budget issue adds to uncertainty and dampens confidence not only in Italy.

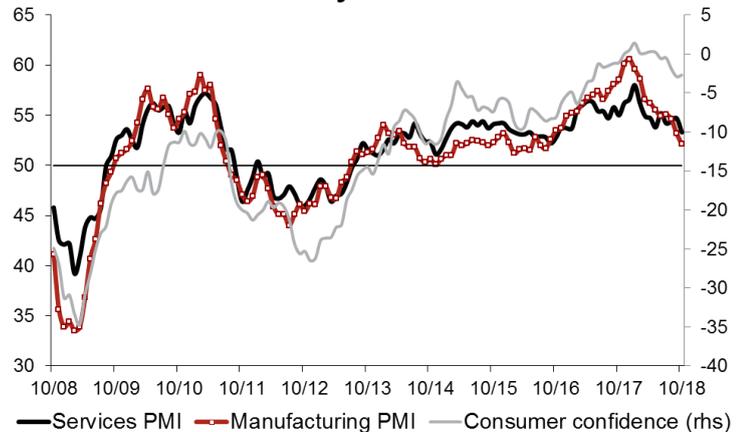
All in all, we revised our growth forecasts for 2018 down to 1.9% (from 2.0%) and for 2019 down to 1.6% (from 1.7%) and still see risks on the downside. In case of a hard Brexit, we would reduce our 2019 growth outlook further to 1.2%.

### ECB stays on normalization track

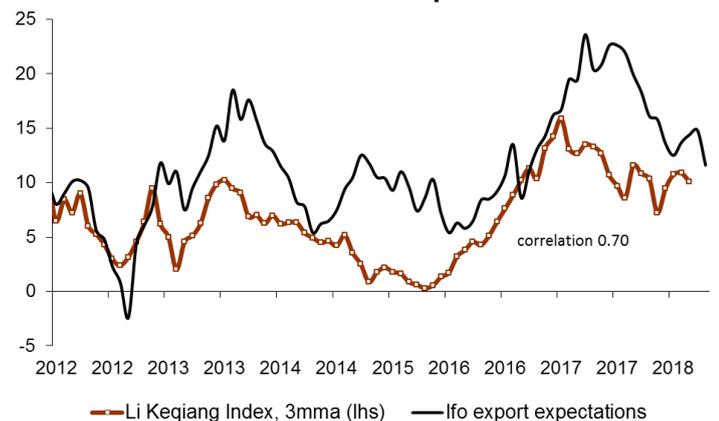
At its October 25 meeting, the ECB confirmed the end of QE in December while sticking to its constructive macroeconomic base case which does not include the materialization of the above mentioned risks. The ECB will review its outlook in December and for the time being, we continue to expect a first (depo) rate hike in September 2019.

Regarding the financial market woes triggered by the 2019 Italian budget proposal, Draghi was quite clear in rejecting demands for help from the ECB. He stated that the Italian government should reduce the tone, not question the institutional framework of the EMU and do policies that lead to a reduction in the spread.

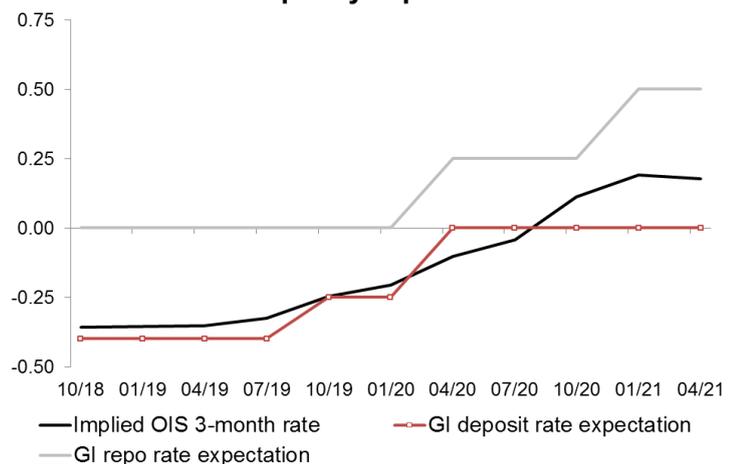
**Euro Area Key Sentiment Indicators**



**China & German export orders**



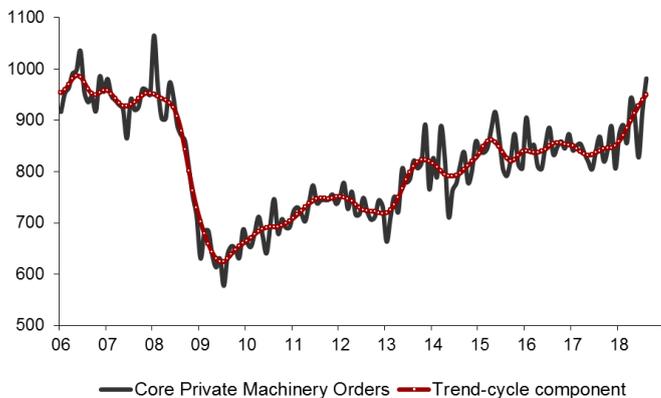
**ECB policy expectations**



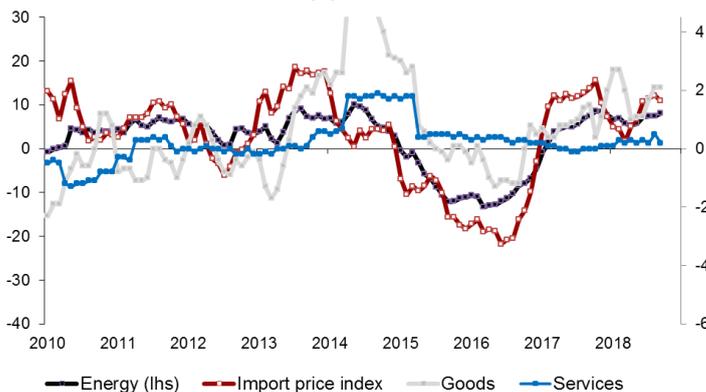
# Japan

**Christoph Siepmann**

**Core Machinery Orders**  
bn yen



**Consumer- and Import Price Indices**  
yoy in %



- Japan's Q3 GDP growth has likely returned into negative territory, due to natural disasters. We expect growth to recover in Q4.
- Given low core-core inflation, the BoJ will likely maintain its current monetary framework.
- Against the backdrop of recent natural disasters, two supplementary budgets are in the pipeline. The sales tax hike in October 2019 will also be buffered strongly.

Japan has been repeatedly hit by natural disasters this year. In September, the Typhoon Jebi was recorded the strongest within last 25 years. Moreover, a magnitude 6.7 earthquake hit especially Hokkaido. Reports suggest that supply chains have in part been dented, with negative repercussions on industrial production, which receded by 1.1% mom in September, adding up to a drop of 1.7% qoq in Q3. Retail sales also suffered, but were supported by the rush demand for cigarettes ahead of the tax hike in October. Thirdly, also exports suffered in September with real seasonal adjusted results in Q3 summing up to an estimated decrease of 2.7% qoq, the first negative growth rate since Q1 2016. Imports, overall, recovered from their weak reading in Q2 to about 1% qoq. As a result, net exports will act as a drag on Q3 GDP growth. Finally, machinery orders remained strong, suggesting that business investment will keep a lively pace, after in Q2 they had advanced already by a revised 3.1% qoq. The latter was the major reason for the upward correction of Q2 GDP growth to 3% qoq annualized. By contrast, for Q3, we expect GDP growth to come in negatively in the range between -0.5% to -1% qoq annualized. However, as these fluctuations are due to one-off factors, we expect growth to recover in Q4.

### More support from fiscal policy

Japan's headline inflation receded slightly by 0.1 pp to 1.2% yoy in September, while core-core inflation (less food and energy) slowed back to 0.1% yoy. The BoJ version of core-core inflation, i.e. CPI excluding fresh food and energy remained unchanged at 0.4% yoy. The rise in food and energy prices were mostly visible in goods prices, whereas overall service prices only increased by 0.2% yoy. We expect headline inflation to slow again next year, given that oil prices have come off from their recent highs. Against this background, the BoJ did not change its monetary policy framework today, and we do not expect any change ahead of the sales tax hike in October 2019. However, fiscal policy is likely to get more expansionary. A first supplementary budget of ¥ 935.6 bn is earmarked for disaster relief. It will likely be followed by a second. Together, they could reach about 0.5% of GDP. The sales tax hike in October 2019 will also be temporarily strongly buffered to avoid a negative impact like in 2014. This prompted us to revise our GDP forecast up to 1.3% in 2019, from 1.0% before.

Main Forecasts <sup>1)</sup>	2016	2017	2018f	2019f
<b>GDP</b>	1.0	1.7	0.9	1.3
<b>Consumer spending</b>	0.1	1.0	0.6	1.1
<b>Government consumption</b>	1.3	0.1	0.5	1.1
<b>Investment</b>	1.1	2.6	1.9	3.6
<b>Inventories</b>	-0.2	-0.1	0.2	0.0
<b>Net trade</b>	0.5	0.5	0.2	-0.2
<b>Domestic demand</b>	0.6	1.2	0.6	1.6
<b>Consumer prices</b>	-0.1	0.5	1.0	1.0
<b>Unemployment rate<sup>2)</sup></b>	3.1	2.8	2.4	2.2
<b>Budget balance<sup>3)</sup></b>	-3.6	-4.3	-3.7	-2.8

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

# China

Christoph Siepmann

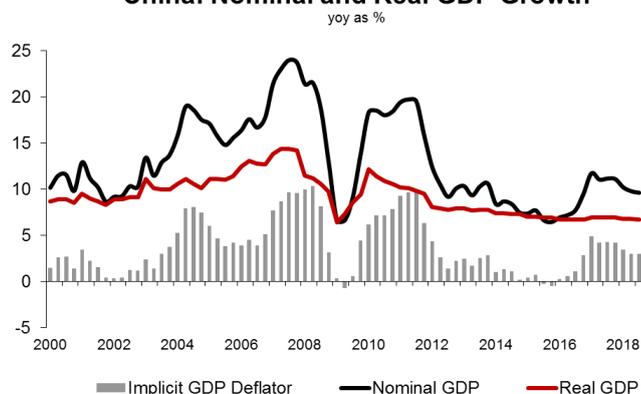
- In Q3 2018, China's GDP growth eased by 0.2 pp to 6.5% yoy, driven by the industry sector.
- The PBoC cut its RRR by 100 bps but its liquidity effect will likely remain limited.
- We expect China's growth softening to continue, prompting more RRR cuts and expansionary fiscal policy measures.

China's Q3 GDP growth softened to 6.5% yoy, after 6.7% yoy in the previous period. The slowing was exclusively driven by the industry (incl. construction) sector, while growth of the service sector continued to edge up. On a nominal basis, GDP expansion eased from 10% yoy in Q2 to 9.8% yoy. The weakening had been signaled by the development of monthly indicators over the past quarter, thus it did not come as a surprise. Both manufacturing PMIs had receded on average, the Caixin version from 51.1 in Q2 to 50.5 index points in Q3. Urban investment growth averaged 5.4% yoy in Q3, after a Q2 reading of 6.4% yoy. Industrial production dropped by 0.6 pp to about 6% yoy in Q3. More surprisingly, however, export growth has remained broadly unchanged so far, not only over Q3 as a whole but also in September, despite the escalating trade war between China and the US. This was likely due to the general US import pull (driven by fiscal policy induced healthy US growth), some front-loading of US imports ahead of likely rising tariffs next year (while the 10% tariffs on US\$ 200 bn came only into effect on Sept. 24) and the depreciation of the yuan. However, the drop of the PMI new export orders suggests a change, going forward, raising the drag from net exports on GDP growth from the already negative reading of -0.66 pp yoy ytd in Q3. Looking ahead, we expect China's gradual softening to continue. The trade conflict is unlikely to be easily solvable.

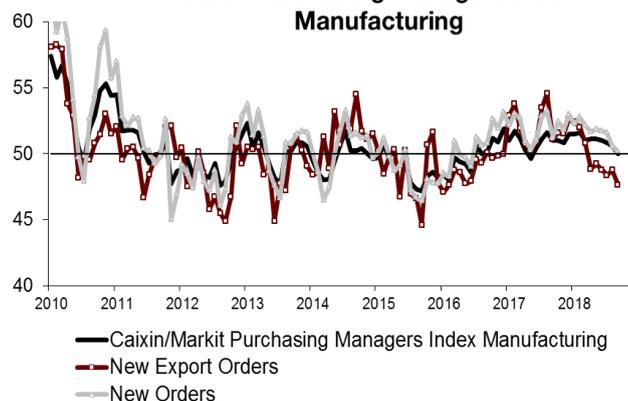
## More easing measures ahead

We also maintain our view that Beijing is likely to protect its 6.5% growth target this year (and expect 6.3% in 2019) by deploying monetary and fiscal policy measures in a gradual fashion. While local governments have been reported to issue infrastructure bonds up to their quota, infrastructure investment growth so far has continued to recede, although at a softer pace. We expect more support from this side, going forward. Beijing also announced new personal tax deductions, effective at the start of next year. The amount of the deductions is estimated to only 0.08% of GDP. However, additional tax cuts next year might exceed 1% of GDP. We also expect some easing in the real estate sector, given the continued drop in property sales. The PBoC cut its RRR by 100 bps. But at the same time it will not roll over RMB 450 bn MLF lending and expects liquidity demands for tax payments to eat up another large part. We nevertheless see a small positive impact. TSF figures have been revised by adding local government special bonds and other items. But ongoing regulatory tightening led to a further drop in typical shadow banking sub-components.

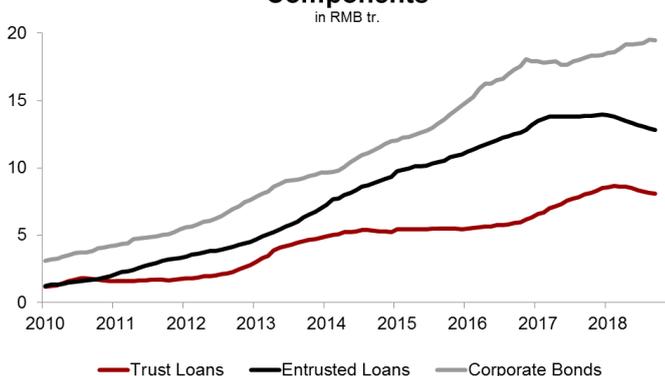
China: Nominal and Real GDP Growth



Caixin Purchasing Managers Index: Manufacturing



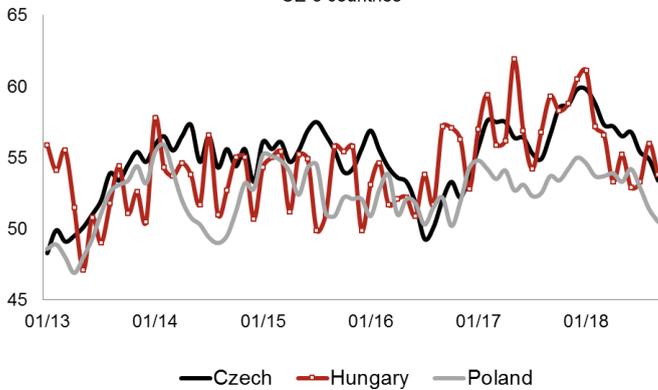
China: Development of Shadow Banking Components



# Central and Eastern Europe

Radomír Jáč

**Manufacturing PMI**  
CE-3 countries



**Headline inflation**  
CE-3 countries (CPI yoy)



- Available data and surveys indicate a slowdown in growth in CE-3 countries in Q3. Nevertheless, the growth dynamics still remain solid.
- Inflation picture is mixed with a lack of price pressures in Poland and an above-target headline CPI in the Czech economy and Hungary.
- While the Hungarian central bank looks through higher inflation, as non-core CPI items are the key drivers of the price growth, the Czech CNB remains in tightening mode and is expected to increase interest rates again in November.

Manufacturing PMI surveys point to a slower pace of expansion in the respective sector in the CE-3 countries, as growth of new orders, including exports, moderates. Hard data from the region remain solid but would be also compatible with some slowdown in annual GDP growth in H2. Still, the dynamics should remain robust, particularly in Poland and Hungary, and all three CE-3 economies continue to operate above their potential.

However, the overall picture is mixed with the overheating of the economy being most visible in the Czech case, followed by Hungary, while data from Poland continue to report a lack of visible upward price pressures. The Q3 data at the same time show that inflation faced upside pressure not only from commodities but in some cases also from volatility in core CPI items. The Hungarian MNB may look through the recent increase in inflation, although headline CPI reached 3.6% yoy in September vs. the target set at 3%. On the other hand, Czech headline CPI moderated from 2.5% to 2.3% yoy, mainly thanks to lower core inflation (down from 2.5% to 2.1% yoy) but the CNB is likely to tighten its policy further, as inflation is expected to stay above the target set at 2%. Polish CPI remains well below the target set at 2.5% (it reached 1.9% yoy in September).

## Czech CNB still remains in tightening mode

The CNB increased its key interest rate (by 25 bps to 1.50%) again in late September, mainly reflecting the higher than expected core inflation, recorded in summer. A further rate hike (by 25 bps to 1.75%) is expected in early November. The CNB will also publish a fresh forecast, which is likely to point to some further policy tightening in 2019 but at much slower pace than in 2018.

The Hungarian MNB announced a set of changes in its unconventional tools in September but interest rates stayed on hold and the overall financial conditions remain loose. Further shifts in non-standard tools are likely in H1 2019 and may include an increase in O/N deposit rate (currently at -0.15%). The key base rate is unlikely to be increased from its current level of -0.90% before H2 2019.

The Polish NBP is unlikely to end its wait-and-see policy stance anytime soon. We continue to expect the first interest rate hike no earlier than in mid-2019.

Main Forecasts	2016	2017	2018f	2019f
<b>Czech Republic</b>				
GDP	2.4	4.5	2.9	2.7
Consumer prices	0.7	2.5	2.2	2.1
Central bank's key rate	0.05	0.50	1.75	2.00
<b>Hungary</b>				
GDP	2.1	4.2	4.4	3.5
Consumer prices	0.4	2.4	2.9	3.2
Central bank's key rate	0.90	0.90	0.90	1.25
<b>Poland</b>				
GDP	3.1	4.8	4.7	3.6
Consumer prices	-0.6	2.0	1.8	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

# Bonds/Fixed Income Strategy

Florian Späte

- On balance, core government bond yields did not move much in October. The increase at the start of the month turned out to be temporary. Given the challenging environment, the scope for a strong upward movement near term appears limited.
- The intensifying conflict between Italy and the EU Commission kept BTPs under pressure. With little willingness to make any concessions, the outlook for Italian government bonds remains rather bleak in the short term.
- Although other Southern European government bond markets did not escape unscathed, contagion was limited. Given the nature of the conflict, spillovers are likely to be contained going forward as well.

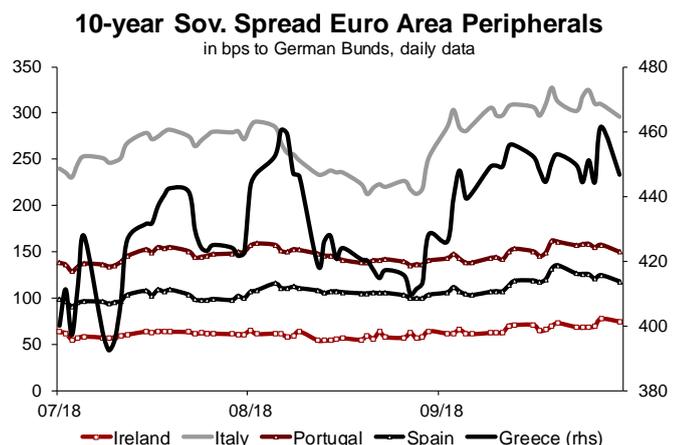
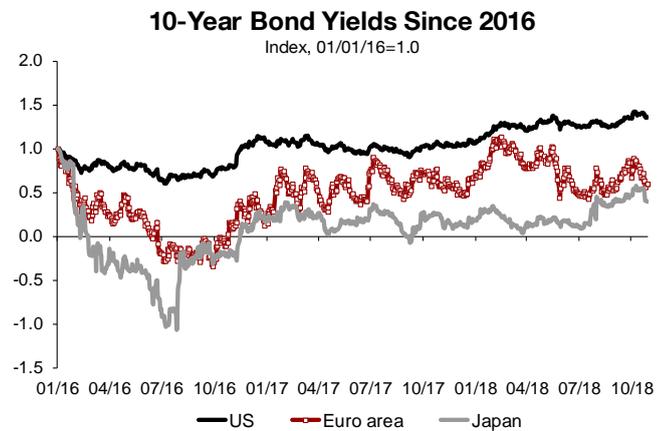
At the beginning of October, international government bond yields initially continued their upward trend. While 10-year Bund yields rose to 0.57%, 10-year Treasury yields left the 3% threshold far behind. Eventually, the broad-based increase triggered concerns about the consequences of a higher yield level. As a result, a risk-off mode on financial markets gained the upper hand and risky assets corrected. This sell-off was reinforced by concerns about a more significant economic slowdown and several looming political issues (e.g. conflict Italy/EU Commission). Ultimately, safe haven flows resulted in a reversal of the initial movement.

On balance, 10-year Bund yields declined by 9 bps to 0.38%. As financial markets also scaled back future ECB key rate hikes expectations, the euro area yield curve shifted almost parallel downwards. While euro area inflation expectations receded only slightly, real yields moved down as well. In contrast, US yields rose slightly. Particularly, short- and very long-dated US yields maintained a somewhat higher level compared to September. Due to lower US inflation expectations, real US yields rose noticeably. 10-year real US yields climbed to 0.90% -- the highest level since Q1 2011.

## Conflict between Italy and EU to remain in the focus

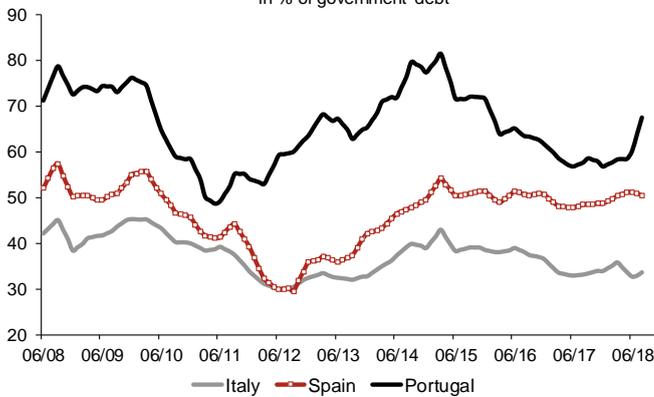
The conflict between the Italian coalition government and the EU Commission about the appropriate fiscal stance is expected to set the agenda for European government bond markets going forward. After the EU Commission rejected Italy's budget plans, the Italian government has time until mid of November to submit an adjusted version. However, the willingness to make any revisions looks low for the time being. This can ultimately lead to an official rejection of the budget and the launching of an excessive deficit procedure as soon as mid of December. However, potential sanctions would only be imposed after several months.

Italian government bonds remained under pressure in October although the recent rating actions were more



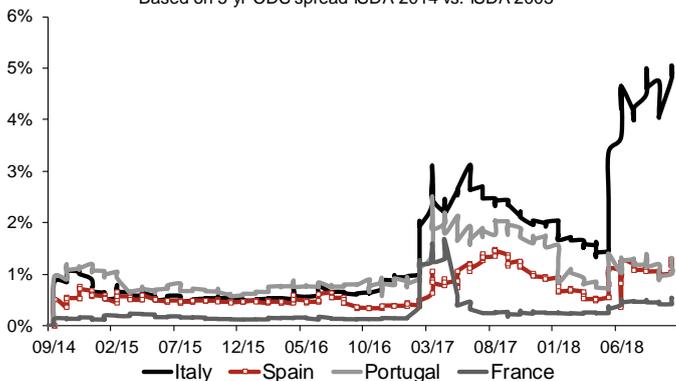
# Bonds/Fixed Income Strategy

**Euro area: Foreign Govt Bond Holdings**  
in % of government debt

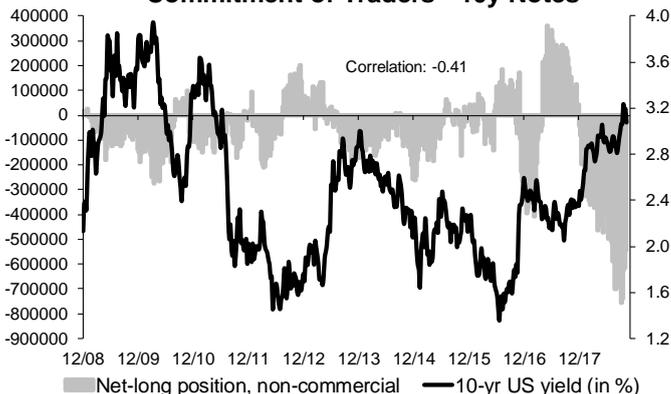


**Probability of euro exit**

Based on 5-yr CDS spread ISDA 2014 vs. ISDA 2003



**Commitment of Traders - 10y Notes**



benign than feared. Moody's lower the rating by one notch to Baa3, but it assigned a stable outlook. S&P kept the rating unchanged at BBB and only lowered the outlook to negative. The 10-year BTP/Bund spread rose above 300 bps over the course of October.

Going forward, there is no lasting stabilization in sight. For the time being, the tug-of-war between Italy and the EU Commission will continue. On the one hand, it is difficult for the Italian government to give up on its election promises and it might even be in the interest of the government to keep the conflict simmering. On the other hand, the EU Commission can hardly tolerate the rule violation and it will likely follow a tough line. In this environment, the Italian risk premium is expected to remain volatile and given market concerns about debt sustainability and the meagre growth outlook for Italy, there is scope for a further widening of the BTP/Bund spread in the weeks to come.

### Signs of contagion to other European bond markets

While other European bond markets were little affected until the beginning of October, EMU sovereign spreads in general have increased since then. However, they have not reached worrisome levels and they remain well below the ones marked in May. Hence, financial markets continue to differentiate between Italy and other markets. This can also be seen by the different development of foreign bond holdings. While foreign ownership of Italian bonds has not recovered from the lows marked in 2011/2012, trust in Portuguese and Spanish bonds has been restored. What is more, the priced probability of a euro exit is close to zero for these countries. Against it, although the probability of an Italexit is still remote and priced as a tail risk, financial markets attributes a non-negligible probability to such a scenario.

### Challenging environment to limit rise in core yields

In this environment, core yields will struggle to increase substantially near term. On top of the persisting intra-European conflict, other concerns are unlikely to vanish in the near term. The possibility of a hard Brexit remains a real threat and recent signals do not point in the direction of an easing of the global trade conflict, but towards an intensification. Moreover, the US fiscal stimulus has reached its peak and it will soften in the quarters to come. Finally, the recent data flow in the euro area signals a slowing of the economy towards potential growth.

Then again, the US central bank does not show any signs of slowing the rate cycle and the euro area monetary policy way forward is marked out toward a less accommodative stance. Accordingly, we expect euro area and US yields to creep upwards in the months to come. Particularly, euro area yields have more scope to rise from current levels in 2019.

# Corporate Bonds

Luca Colussa

- EUR IG corporate bond spreads moved markedly up in October. The spread on Financials hit the highest level since February 2017, while the one on Non-Financials tested the highs seen after the Brexit referendum in June 2016.
- Several of the negative drivers – political woes in Italy, trade frictions and cooling demand in China, weighing especially on autos, fading net purchases by the ECB – are likely to persist in the near term.
- That said, given the large repricing suffered over the past month, we expect a slight spread tightening until year-end, followed by a further moderate widening later in 2019.

Euro area IG corporate bond spreads widened markedly in October as the risk-off mood prevailed on markets. The Option-Adjusted Spread (OAS) on Financials increased by 15 bps to 138 bps, the highest level since February 2017, while the one on Non-Financials rose by 14 bps to 123 bps, thus testing the highs seen after the Brexit referendum in June 2016. The total return performance was only slightly negative (-0.12% for both Financials and Non-Financials, in line with our expectations of broadly similar performances) thanks to the decline in the underlying Bund yields.

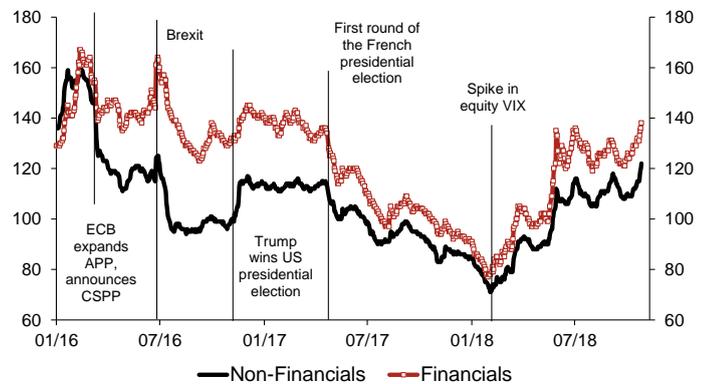
### Even more pressure on auto sector and Italian names

Within Non-Financial bonds, the auto sector extended the year-to-date underperformance. The OAS on the sector widened by 29 bps to 148 bps in October, leading to a total return loss of 0.86%, thus almost doubling the year-to-date losses (down by 1.73% vs -0.56% for Non-Financials). The auto sector continues to be hit by growing trade frictions and cooling demand in China (3MMA sales of automobiles down by 7.0% yoy in September, the worst decline since January 2012).

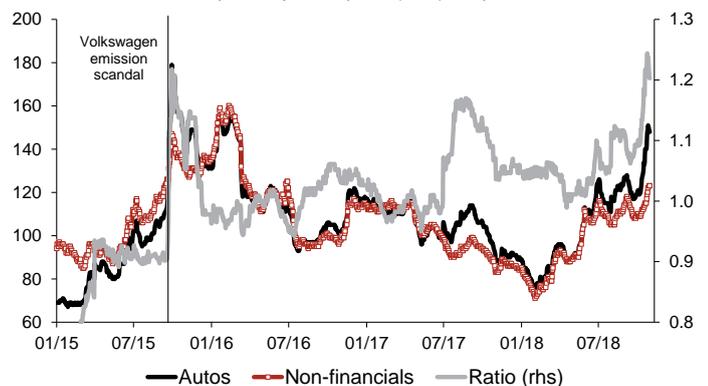
Italian names were the other main underperformer. In particular, the pressure on Italian Senior Financials intensified further amid rising speculations over the impact of rising BTP-Bund spreads over banks' capital ratios. The OAS on Italian Senior Financials rose by 45 bps to 235 bps, more than three times the lows seen in January.

In the near term, we see most of these negative drivers to persist. In addition, the ECB has already reduced the monthly pace of net purchases of corporate bonds from around €5 bn to €2-3 bn and will end them by year-end. That said, given the sharp widening seen in October and the more attractive valuation, we see scope for a mild re-tightening until year-end. We expect the OAS on Financials and Non-Financials to decline to 135 and 120 bps respectively over 3M, also as a result of some renewed upward pressure on Bund yields. In 2019, we then see some additional moderate widening of around 5-10 bps.

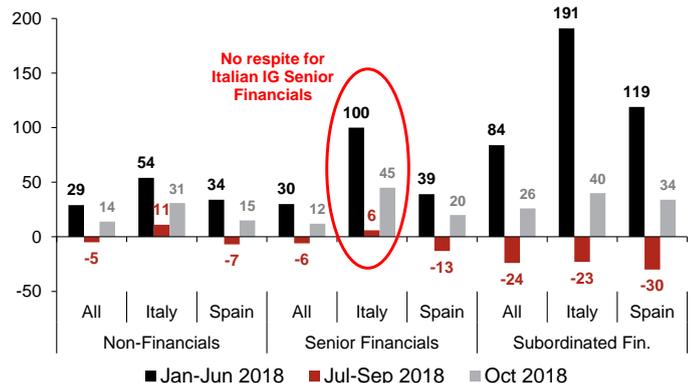
**EUR IG Corp: Financials vs Non-financials**  
Option-Adjusted Spreads over German Bunds, in bps



**EUR IG Auto vs Non-Financials**  
Option-Adjusted Spread (OAS), in bps



**EUR IG: Spread change by country**  
ICE BofAML indices, change in Option-Adjusted Spread

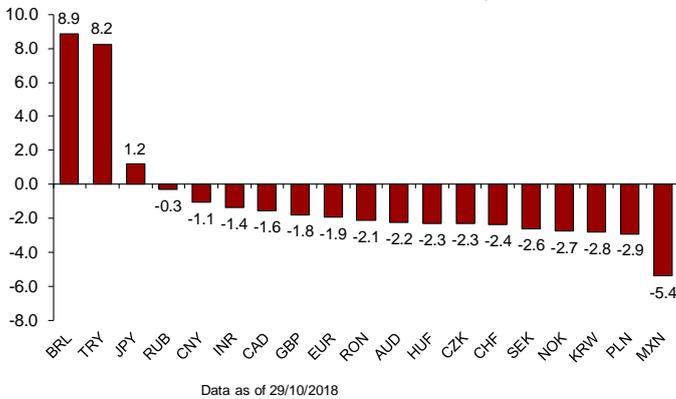


# Currencies

**Thomas Hempell**

## FX performance

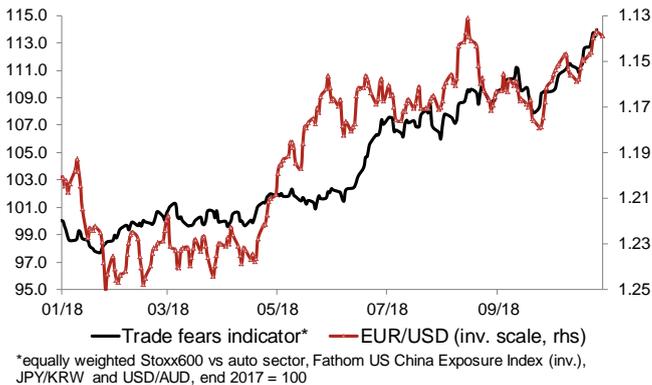
vs. US dollar 28/9/2018 to 29/10/2018, in %



- Political woes in Europe and the escalating trade US/China trade conflict will keep a lid on the EUR/USD over the coming weeks.
- China will stem against sharper CNY weakness, but trade tensions and rising rate differentials make it increasingly likely that USD/CNY breaks through the 7.0 threshold this year.
- EM currencies have stabilized, but moderate downside risks prevail from trade tensions, a tighter Fed policy and a slowing EM growth momentum.

As all other G10 currencies except for the JPY, the euro has retreated further against the USD over October. And despite our still constructive medium term outlook on the single currency, the near-term risks are geared towards the downside. Uncertainties around the Italian 2019 fiscal budget remain high and a prolonged clash between Italy and the European Commission would continue to weigh on the euro.

## Trade war concerns and EUR/USD

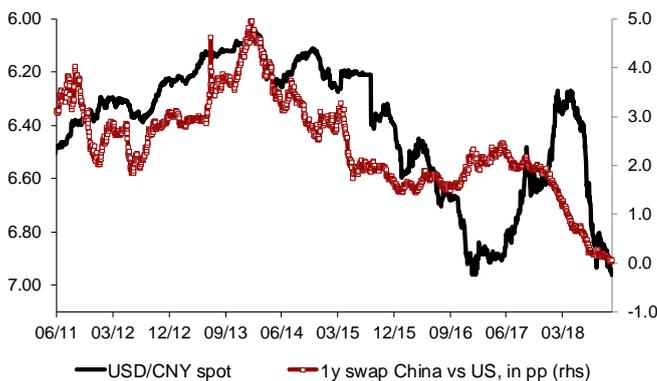


Similarly, the US/China trade conflict seems headed for a further escalation. As illustrated in the mid chart, trade war concerns have turned into a strong support for the US dollar. Brinkmanship on Brexit negotiations will mostly weigh on sterling, but also EUR/USD will remain affected. Finally, recent euro area data have disappointed. It will require a more reassuring string of macro news to strengthen a key source of euro support for next year, which will be the first ECB rate hike in more than 7 years, envisaged for Sept. 2019.

## USD/CNY at the verge of crossing 7.00

Since early February, the tightly managed Chinese yuan has lost 10% against the Greenback. This sell-off, though, has not been engineered by the PBoC. We neither share the popular view that China is about to use the exchange rate as a tool in the trade war with the US. On the contrary: We expect China to step up efforts to rein in CNY weakness via FX intervention. Uncontrolled CNY weakness bears the risk of triggering further capital outflows and sell-offs of Chinese stocks. That said, this may still not prevent the USD/CNY from ultimately breaking the 7.0 threshold for the first time in a decade before year-end. Yield differentials continue to widen, while the intensifying US/China conflict is clearly favoring the Greenback.

## USD/CNY and swap differential



EM currencies in general have stabilized despite spiking global risk aversion, with battered TRY and BRL rebounding sharply on political grounds. This corroborates our view that the EM FX sell-off is already very advanced amid overall decent fundamentals. Short-term, however, moderate downside risks still prevail on EM FX from trade tensions, a tighter Fed policy and a slowing EM growth momentum.

# Equities

Michele Morganti / Vladimir Oleinikov

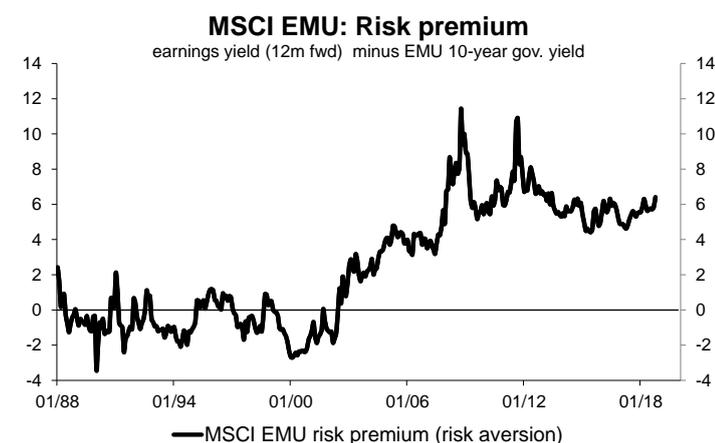
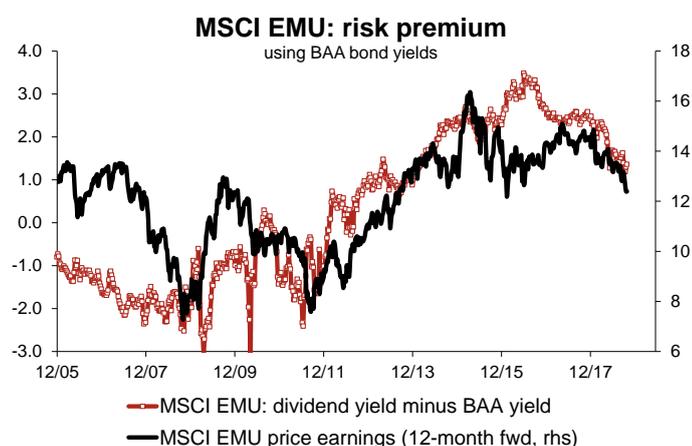
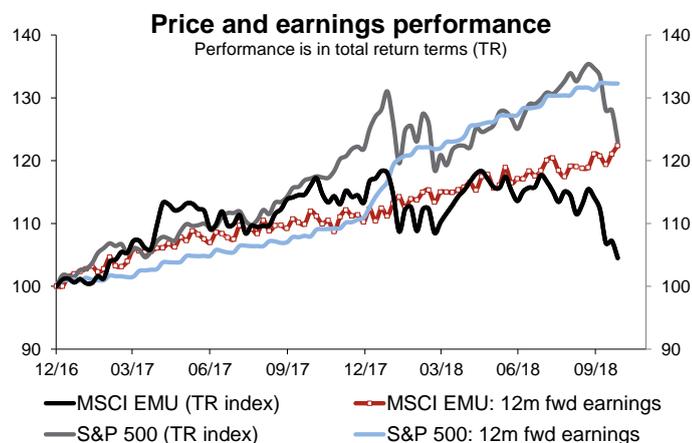
- Markets pressured by higher rates, trade and Italian risk. VIX rebounded strongly together with higher dispersion of analysts' estimates and equity risk premium. Risks in the EA growth projections are tilted on the downside.
- Helped by higher yields, Value (OW) outperformed Growth and the EA both the S&P and the Nasdaq.
- Short term, high market stress should induce a rebound. We are ready to play banks vs pharma. That said, we stay cautious, with a balanced EMU-US and favoring UK, Japan and the SMI.
- The 2019 should be tough due to monetary stimulus reduction, higher US yields, lingering exogenous risks and peaking growth. Over 12-months, we forecast returns of 6% for the EU (3% the US) but the bulk of it should occur in the next few months while the 2019 could be very volatile.

## Growth fears and credit risk acting at the same time

Markets continued to suffer heavily as different sources of risk acted together: higher rates, trade frictions, Italy and growth concerns. First, since few weeks, Fed's stance is taken even more seriously by investors who are expecting continuing hikes next year. Sudden spike in the US 10-year rates since early September (+40 bps to 3.23%) rang an alarming bell to risky assets, pushing higher their cost of capital and reducing the theoretical current asset value. Credit risk remained under stress, too, affecting equities negatively, especially banks. Second, continuing trade frictions are putting doubts on growth perspectives in the Chinese economy and the auto sector. Some car producers began to show poor guidance in the reporting season, together with other EU companies (more cyclical and export-oriented). Lastly, the Italian risk increased further (+30bps for the BTP spread). Investors also fear a banking doom loop (lower growth and NPL's prices and lower asset value, etc.). As a result, Italian financials lost 11% in the month, reaching a -30% since the end of April.

## Higher VIX, earnings dispersion and risk premium

As BAA spread remained under pressure, so did market multiples. Additionally, growth projections in the EA continued to deteriorate. In this respect, higher BAA spreads together with a declining IFO index (in particular, its expectations component) explain market weakness well. Sentiment deterioration is fully reflected in the VIX trend which reached the level of 24.6 from 12.5 at the end of September. Of course, as a result, the risk aversion and the equity risk premium are pushed higher. The latter is currently at 6.3% for the EA, scoring second only when compared to 2016 levels (6.6%) or 2008/2011 levels (around 10-11%). The reporting season contributed to the concerns for Europe, showing signs of increasing input costs and pressures on margins.



# Equities

Analysis of the median stock: Q3 2018 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q2 2018	Q3 2018	Q2 2018	Q3 2018	
S&P	22.36 %	19.95 %	7.96 %	6.17 %	55.8%
Stoxx	13.61 %	5.14 %	5.33 %	5.53 %	46.2%
Euro Stoxx	13.09 %	3.45 %	3.18 %	4.81 %	42.7%
Topix	4.65 %	4.79 %	3.73 %	3.45 %	25.6%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q2 2018	Q3 2018	Q2 2018	Q3 2018	
S&P	3.96 %	3.09 %	0.84 %	0.25 %	55.8%
Stoxx	0.83 %	0.22 %	0.87 %	0.02 %	46.2%
Euro Stoxx	0.09 %	0.00 %	0.58 %	0.02 %	42.7%
Topix	2.74 %	(3.26)%	0.12 %	(0.89)%	25.6%

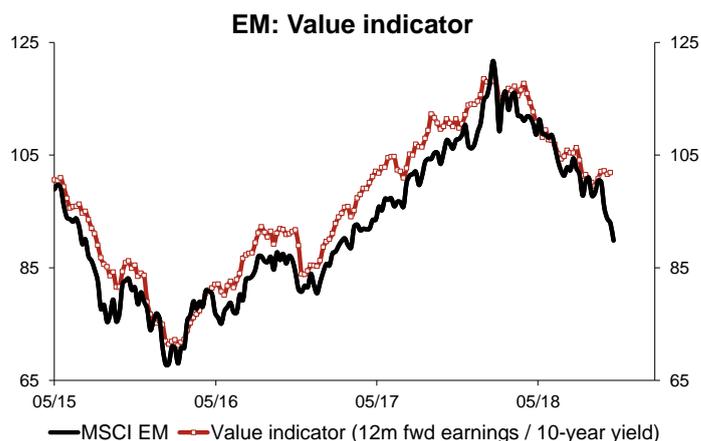
Markets	PE		PB		PCF		DY		Avg.	
	12m f	Discount	Discount	Disc. (-1M)						
WORLD	14.0	-12.7	2.1	6.6	9.5	8.4	2.8	2.5	0.0	11.3
USA	15.3	-0.4	2.9	21.8	10.9	9.5	2.2	0.1	7.7	19.4
JAPAN	11.8	-24.0	1.1	-12.4	7.0	-1.2	2.5	31.0	-17.2	-2.8
UK	11.9	-14.2	1.6	-12.9	7.7	-2.1	4.7	18.4	-11.9	-4.5
SWITZERLAND	14.6	-5.1	2.2	0.4	10.1	-10.4	3.8	15.5	-7.6	-4.0
EMU	11.8	-16.8	1.4	-8.9	7.2	10.4	4.0	4.1	-4.8	6.6
FRANCE	12.5	-12.9	1.4	-4.4	7.9	13.4	3.8	1.0	-1.2	8.7
GERMANY	11.5	-23.8	1.4	-6.0	7.5	11.7	3.7	9.8	-7.0	0.9
GREECE	12.6	-1.4	1.9	22.0	6.6	8.6	5.7	44.7	-3.9	-2.6
ITALY	9.7	-36.5	1.1	-12.2	4.8	2.4	5.2	11.9	-14.5	-3.3
PORTUGAL	14.4	13.4	1.7	-2.5	5.7	-4.0	4.9	9.7	-0.7	9.5
SPAIN	10.6	-18.2	1.1	-30.6	4.9	-3.1	5.1	0.2	-13.0	-6.5
EURO STOXX 50	11.8	-11.0	1.4	-3.8	7.2	17.1	4.2	0.4	0.5	5.9
STOXX SMALL	14.9	3.1	1.7	2.8	9.4	13.4	3.3	4.3	3.7	12.8
EM, \$	9.9	-31.9	1.3	-19.6	6.2	-19.6	3.5	14.9	-21.5	-10.5
BRAZIL	10.6	16.9	1.7	2.8	6.8	-50.8	4.3	-0.5	-7.7	-12.9
RUSSIA	4.9	-31.1	0.6	-34.2	3.1	-31.8	8.0	114.1	-52.8	-43.7
INDIA	16.6	14.8	2.4	-8.0	11.2	-3.1	1.8	10.0	-1.6	7.8
CHINA	9.5	-26.9	1.3	-26.5	6.1	-19.4	3.1	1.7	-18.6	-5.6

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

PEs are since 1987, the rest is since 2003. In case of DY, a discount means the market had a higher DY,

meaning the market is at premium for this multiple. 12m f = expected in 12 months

Source: Thomson Reuters Datastream, IBES estimates.



As a consequence, the dispersion of analysts' estimates increased abruptly, reaching levels not far from 2016 peaks, when a similar analysts' uncertainty materialized.

### Pricing in a lot short term but 2019 will be tough

More recently, valuations in some risky areas went near extreme low levels: Italy, Auto, EM, financials and the S&P 500 at 2650. Furthermore, the Value started over performing Growth, which was good for the EA relative to the S&P and the Nasdaq. We cannot exclude further downside but October could represent a good entry point for the next 2-3 months. That said, decreasing monetary stimulus, credit tensions and other risks keep us not exploiting full OW.

2019 will be a very difficult year due to higher US yields, credit spreads and inflation, with peaking US GDP and NIPA profits' momentum. The ongoing monetary stimulus reduction will add to the uncertainties triggered by EU elections and trade frictions. A stronger TW euro should also put additional pressure on EU equities. Thus, we keep a cautious view at the beginning of the year, waiting for markets to fully digest changing monetary and credit environment. We remain neutral cyclicals versus defensive sectors. We overweight discretionary (slightly so the autos) and insurances. Small UW on Oils, ready to go further underweight as performance is stretched versus fundamentals. Materials and IT are kept as UW. OW on Value vs. Growth. We are ready to play long banks vs. pharma: relative TR trend is stressed versus macro fundamentals (validating the Value vs Growth trade). On a 12-month horizon, we forecast positive returns (6% for the EU and 3% in the US) but the bulk of it should materialize in the next few months while the 2019 could be very volatile.

### EM: to suffer from tightening conditions

Over the last month, EM equities dropped further (-11%) and current valuation trade at a discount of 21.5% vs history. Shiller PE shows a depressed market, being one standard deviation below historical average. Earnings estimates for both 2018 and 2019 have been lowered across the board, except for Russia (high oil prices), the Czech Republic, Hungary and Brazil. Analysts' expectations on long-term earnings growth are a cyclical trough vs the US since 2006. Thus, EM PEs relative to US ones are at the lowest point since 2016 (once 2009 is excluded). The sentiment over China prospects remains poor thanks to trade frictions. Thus, we remain cautious in the short-term on EMs. Within the EM universe, we keep favoring Korea, India, along with the CEE markets. Additionally, we recommend to overweigh Brazil in the EM portfolio as Brazilian stocks should benefit from fewer barriers on the way to expected reforms, a recovering economy, increasing margins and payouts.

# Asset Allocation

Thorsten Runde

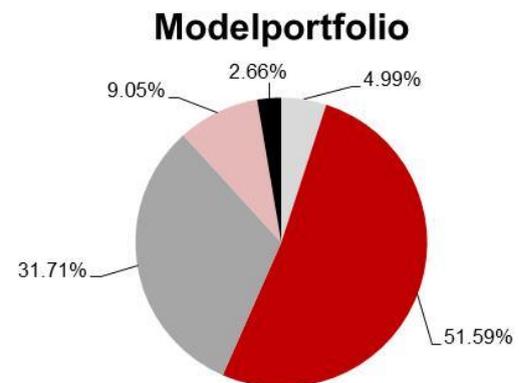
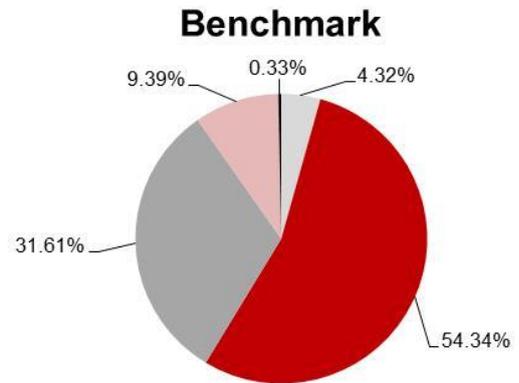
- In October (until October 29<sup>th</sup>), the performance of all equity markets in our investment universe was strongly negative, in a range from roughly -9% to -7.8%.
- Peripheral government bonds lost value, in particular in the long maturity buckets (e.g. -2.2% for BTPs 10Y+), whereas in the core area the performance was positive throughout.
- Over the same period, non-financial investment grade corporate bonds as well as financial ones revealed negative performance figures across all maturity buckets. High yield corporates lost the most in value (-1.1% for non-financials and -2.6% for financials).
- We maintain a small overweight in equities reflecting our positive view on 6m.
- We keep the overweight in cash and non-financials and continue to prefer a short duration.
- Furthermore, we still avoid euro area government bonds, core to a distinctively lesser extent than the periphery, and financial corporates.

Market participants' propensity to take risk has shrunk distinctively against the backdrop of global trade tension, rising US yields, and in particular the budget uncertainties in Italy, putting in particular BTPs and equities under pressure. Within our investment universe, only core government bonds, quasi government bonds, and covered bonds have recorded an increase in value in the course of October, reflecting the flight to quality. Most notably, our largest active positions (UW in peripherals, OW cash) generated some added value. On the other hand, the overweight in equities, although much smaller, more than thwarted the aforementioned positive effects due to the extremely negative performance of that asset class.

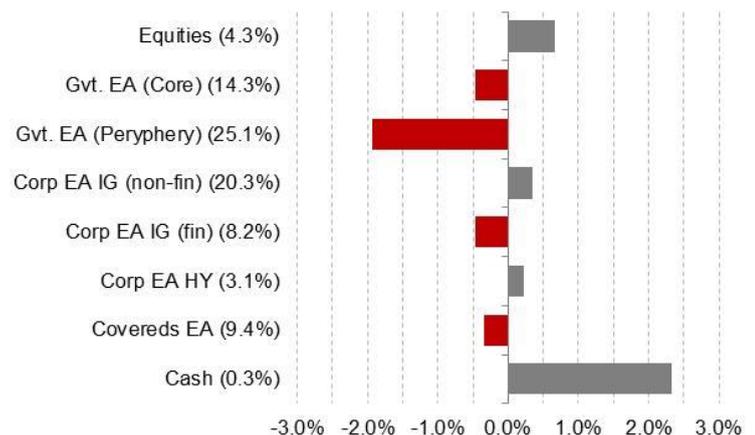
### Maintain cautious pro-risk stance

The current framework of political risks (trade war, Italian Budget/Italexit) and monetary policy normalization is expected to prevail in the mid-term. In that sense, the pressure on risky assets in general and on BTPs as well as equities will also stay with us for the time being. That said, we deem these risks priced in for the most part. Particularly, equity markets seem to have overshot, increasing the likelihood for countermovements.

Against this backdrop, we recommend to tactically stick to a cautious pro-risk stance. We maintain a small overweight in equities reflecting our positive view on 6m. We keep the overweight in cash and non-financials and continue to prefer a short duration. Furthermore, we still avoid euro area government bonds, core to a distinctively lesser extent than the periphery, and financial corporates.



### Active Positions in selected Sub Asset Classes\*



\*Benchmark weights in parentheses

# Forecast Tables

## Growth

	2016	2017	2018f	2019f
US	1.6	2.3	2.8	2.5
<i>Euro area</i>	1.8	2.5	1.9	1.6
Germany	2.2	2.2	1.7	1.5
France	1.1	2.3	1.7	1.6
Italy	1.0	1.5	1.0	0.8
<i>Non-EMU</i>	2.0	1.8	1.5	1.6
UK	1.8	1.7	1.3	1.5
Switzerland	1.4	1.1	2.2	1.7
Japan	1.0	1.7	0.9	1.3
<i>Asia ex Japan</i>	6.4	6.1	6.1	6.0
China	7.1	6.9	6.5	6.3
Central/Eastern Europe	1.4	3.9	2.9	1.8
Latin America	- 1.3	0.8	0.5	1.5
<b>World</b>	<b>3.2</b>	<b>3.7</b>	<b>3.6</b>	<b>3.4</b>

## Inflation

	2016	2017	2018f	2019f
US	1.3	2.1	2.5	2.4
<i>Euro area</i>	0.2	1.5	1.7	1.6
Germany	0.4	1.8	1.8	1.8
France	0.3	1.0	1.8	1.6
Italy	- 0.1	1.2	1.4	1.4
<i>Non-EMU</i>	0.7	2.5	2.3	2.1
UK	0.7	2.7	2.5	2.2
Switzerland	- 0.4	0.5	1.0	1.0
Japan	- 0.1	0.5	1.0	1.0
<i>Asia ex Japan</i>	2.6	2.2	2.8	2.9
China	2.0	1.6	2.1	2.3
Central/Eastern Europe	5.2	5.0	6.3	7.9
Latin America	6.3	4.3	4.0	4.3
<b>World</b>	<b>2.3</b>	<b>2.3</b>	<b>2.8</b>	<b>3.0</b>

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

## Financial Markets

3-month LIBOR	29/10/18*	3M	6M	12M	Corporate Bond Spreads	29/10/18*	3M	6M	12M
USD	2.52	2.55	2.70	3.10	<i>BofAML Non-Financial</i>	122	120	120	125
EUR	-0.35	-0.35	-0.35	-0.25	<i>BofAML Financial</i>	137	135	135	140
JPY	-0.10	-0.05	0.00	0.05	<b>Forex</b>	<b>29/10/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
GBP	0.81	0.80	0.90	1.05	EUR/USD	1.14	1.13	1.17	1.23
CHF	-0.74	-0.75	-0.75	-0.75	USD/JPY	112	114	115	115
<b>10-Year Bonds</b>	<b>29/10/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>	EUR/JPY	128	129	135	141
Treasuries	3.10	3.20	3.30	3.40	GBP/USD	1.28	1.23	1.27	1.37
Bunds	0.38	0.45	0.70	1.00	EUR/GBP	0.89	0.92	0.92	0.90
BTPs	3.43	3.55	3.70	3.80	EUR/CHF	1.14	1.13	1.15	1.17
OATs	0.75	0.85	1.05	1.30	<b>Equities</b>	<b>29/10/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>
JGBs	0.11	0.10	0.10	0.15	S&P500	2669	2735	2700	2695
Gilts	1.41	1.45	1.55	1.70	MSCI EMU	113.8	118.0	116.0	116.5
SWI	-0.02	0.00	0.05	0.20	TOPIX	1596	1665	1630	1670
<b>Spreads</b>	<b>29/10/18*</b>	<b>3M</b>	<b>6M</b>	<b>12M</b>	FTSE	6990	7250	7065	7120
GIIPS	218	225	215	200	SMI	8711	9065	8725	8910
<i>BofAML Covered Bonds</i>	60	55	55	60					

\*average of last three trading days

### 3-Months Horizon

Government Bonds	10-Year Bunds	0.40	0.45	0.50
	10-Year Treasuries	2.80	3.20	3.60
	10-Year JGBs	0.09	0.10	0.11
	10-Year Gilts	1.20	1.45	1.70
	10-Year Bonds CH	-0.01	0.00	0.00
Equities	MSCI EMU	112.0	118.0	124.0
	S&P500	2639	2735	2831
	TOPIX	1561	1665	1769
	FTSE 100	6956	7250	7544
	SMIC	8713	9065	9417
Currencies	EUR/USD	1.09	1.13	1.17
	USD/JPY	109	114	119
	EUR/GBP	0.89	0.92	0.95
	EUR/CHF	1.10	1.13	1.16

### 12-Months Horizon

Government Bonds	10-Year Bunds	0.89	1.00	1.11
	10-Year Treasuries	2.58	3.40	4.22
	10-Year JGBs	0.11	0.15	0.19
	10-Year Gilts	1.26	1.70	2.14
	10-Year Bonds CH	0.20	0.20	0.21
Equities	MSCI EMU	103.6	116.5	129.4
	S&P500	2491	2695	2899
	TOPIX	1425	1670	1915
	FTSE 100	6497	7120	7743
	SMIC	8117	8910	9703
Currencies	EUR/USD	1.16	1.23	1.30
	USD/JPY	105	115	125
	EUR/GBP	0.84	0.90	0.96
	EUR/CHF	1.11	1.17	1.23

\*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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